Svein Gjedrem: Monetary policy in Norway

Opening remarks by Mr Svein Gjedrem, Governor of the Norges Bank, to Norges Bank workshop on "The Conduct of Monetary Policy in Open Economies", held in Oslo, on 26-27 October 2000.

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Introduction

I am happy to welcome you to this workshop on "The conduct of monetary policy in open economies". The workshop brings together researchers and practitioners of monetary policy from a wide variety of countries. The aim is to stimulate exchanges both across countries and between researchers and monetary policymakers on a topic of common interest.

Research on monetary policy is an international field. We thus find it tremendously useful to be a part of an international network of researchers and practitioners concerned with monetary policymaking. Contact across central banks does represent an important source of inspiration to the policy discussions in Norges Bank.

Norwegian monetary policy

The papers presented at this workshop address topics that are highly relevant to monetary policy in general and Norwegian monetary policy in particular. Some of you may be familiar with the Norwegian system. For others it may be unknown that Norway has a monetary policy regime that is unique in an international context: it is a system of neither a fixed exchange rate nor an inflation target. Let me explain in more detail:

The political authorities formulate Norges Bank's mandate for the conduct of monetary policy. The Exchange Rate Regulation of 6 May 1994 states that monetary policy in Norway should be aimed at maintaining a stable exchange rate in relation to European currencies over time.

Norges Bank has defined "European currencies" as the euro. What we mean by a "stable exchange rate…. over time" needs to be made more precise. The krone exchange rate has fluctuated in recent years, in spite of Norges Bank's active use of instruments, indicating that Norges Bank cannot fine-tune movements in the krone exchange rate. Thus, in its use of the interest rate Norges Bank focuses on the fundamental preconditions for stability of the krone exchange rate over time.

Empirical work on the Norwegian economy suggests that there is mean reversion in the real exchange rate. This implies that higher inflation in Norway than among its trading partners tends to be followed by a nominal exchange rate depreciation. Thus, in order to stabilise the nominal exchange rate against the euro, monetary policy instruments must be oriented towards bringing inflation down to the level aimed at by the Eurosystem.

However, we cannot exclude the possibility that a shock that leads to a change in the equilibrium real exchange rate occurs. Examples of such shocks are a large permanent shock to the oil price or a permanent increase in the government expenditure. If such shocks occur, Norges Bank must prevent monetary policy from contributing to higher inflation or a deflationary recession, since that would undermine the confidence in the krone. There are, however, some institutional responses that will take place if the Bank is not able to return the exchange rate back to its initial range, as defined by the mandate, without contributing to inflation or a deflationary recession. I will come back to this issue later in my speech.

The base drift problem

If the inflation rate in Norway deviates from the inflation rate in the euro countries, the nominal exchange rate will need to adjust over time. However, some of you may object that stabilising the Norwegian inflation rate at the level aimed at by the euro countries may not be sufficient to stabilise the nominal exchange rate. The reason is that inflation in both Norway and the euro countries will be subject to stochastic shocks. This means that even if the expected inflation rates in Norway and the euro countries were the same, the actual inflation rates would deviate. Technically speaking, the relative price levels will be subject to base drift, and so will the nominal exchange rate. Professor Larry Ball has discussed this in a paper on Norwegian monetary policy.

Keeping the relative price level constant would require that we target the price level and not the inflation rate. However, in the 1920s Norway experienced that a policy aimed at achieving a specific level for the purchasing power of money led to substantial macroeconomic instability. Aiming at a price level target may in some situations require a monetary policy that leads to a deflationary recession, which may be hard to turn due to the zero limit on nominal interest rates. In other situations it may require inflating the economy. A monetary policy leading to inflation or a deflationary recession will undermine confidence in the krone, thereby generating exchange rate instability.

We also note that the present exchange rate range has more or less prevailed for more than 10 years, indicating that base drift may not represent a substantial problem in practical policymaking.

How does Norges Bank operate?

Forecasts of inflation and general macroeconomic development play a large role in the conduct of Norwegian monetary policy. Projections are presented in the Bank’s quarterly Inflation Reports. If the inflation forecast does not approach the level aimed at by the euro countries in 2 to 3 years for a given interest rate path, Norges Bank will consider adjusting the interest rate. In this narrow sense, one could say that the conduct of monetary policy in Norway has some similarities with “inflation forecast targeting”, in Lars Svensson’s terminology.

In addition to economic forecasts, we aim to develop tools that can supplement the use of our large macroeconometric model. At the moment we are working on the construction of simple calibrated models that will be presented at this workshop. The calibrated models can be employed, for instance, to test the performance of simple indicator rules.

How does the Norwegian system differ from inflation targeting?

The institutional arrangement for monetary policy in Norway does differ in some respects from that in countries with an inflation target. Some central banks with explicit inflation targets have to give an explanation to the Government or other authorities if the inflation target is not being met. Our mandate, however, refers to an exchange rate target as opposed to an inflation target. If a situation arises in which Norges Bank is not able to return the krone to its initial range, as defined in the mandate, without triggering inflation or a deflationary recession, the Bank will inform the authorities that measures other than those available to the central bank are required. One possibility could then be to recommend fiscal measures that make it possible to bring the krone exchange rate back to its initial range and stabilise it.

Some observers have argued that the possibility that such situations can arise creates an uncertainty that may weaken the credibility of Norwegian monetary policy. However, Norges Bank has declared that it cannot with open eyes contribute to higher inflation or a deflationary recession. Financial market indicators show no evidence of monetary policy lacking credibility.

Although the actual conduct of monetary policy is similar to inflation targeting, there are a number of institutional differences between the Norwegian system and inflation targeting regimes.

1. Norway has a long tradition of cooperation between the political authorities and the social partners. Income and wage determination is fairly centralised, and the social partners evaluate the effects of wage outcomes on employment.

2. In a number of countries that have switched to a monetary policy regime based on inflation targeting, fiscal policy is oriented towards reducing government debt and deficits. In Norway, fiscal policy has traditionally played an important role in demand management.

This task is facilitated by the fact that the Norwegian government has greater financial leeway than most other countries, due to its oil revenues.

Norwegian government authorities receive substantial revenues from the extraction of oil in the North Sea. Norway is the world's second largest exporter of oil, and the budget surplus is currently approximately 11% of GDP.

Oil revenues increase consumption possibilities. However, it is a challenge to manage these resources in a way that increases welfare for both current and future generations. A rapid expansion of the sheltered sector based on uncertain and perhaps temporary increases in petroleum revenues may lead to the situation called Dutch disease.

To manage its resources, Norway has created the Government Petroleum Fund, which receives revenues from the petroleum sector, transfers the amount necessary to produce a balanced government budget and invests the surplus abroad. As long as the increase in petroleum income is kept outside the domestic economy, there will be less need for structural change and thus less need for exchange rates to change.

A one dollar increase in the oil price gives an increase in GDP of almost 1% and most of it arrives as increased budget revenues. With large and varying budget revenues, the basis for determining central government expenditure and taxes from one year to the next may easily be impaired. If budget expenditure is allowed to fluctuate in step with oil prices, the result may be abrupt shifts and instability in the Norwegian economy. Changes in oil prices may then quickly influence wage and price expectations, the exchange rate and long-term rates. In that case it will be very demanding to achieve nominal stability. Short-term interest rates would have to be changed frequently and sharply and would generally reflect a high risk premium for the Norwegian krone. It is therefore important that the annual budgets are anchored in a long-term strategy that takes into account that oil revenues may fluctuate from one year to the next. In addition, it is advantageous if fiscal policy can be used to counter fluctuations in demand and production.

Final words

By hosting this workshop, we hope to take part in an exchange of new knowledge about the conduct of monetary policy. We hope that the workshop will be a fruitful experience for both researchers and monetary policymakers.