Svein Gjedrem: Monetary policy in Norway

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), given at Norges Bank's Conference on Monetary Policy 2006: Evaluating Monetary Policy, Oslo, 30 March 2006.

The speech is based on Inflation Report 1/06 and previous speeches.

The Charts in pdf-format can be found on the Norges Bank's website.

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1. Introduction

The title of this conference is "Evaluating Monetary Policy". The conference therefore gives me an opportunity to provide a background for the assessment of monetary policy in Norway.

2. Transparency and communication of monetary policy strategy

In most industrial countries, monetary policy is oriented towards low and stable inflation. Low and stable inflation is the most important contribution monetary policy can make to sound economic developments. As a framework for organising and explaining monetary policy, inflation targeting is now common. In our country, inflation targeting was introduced in March 2001.

As non-elected bodies, central banks are granted substantial autonomy in the execution of monetary policy. Here, as in many other countries, the political authorities have delegated monetary policy decision-making to the central bank. This means that it has instrument independence, that is, the Bank's Executive Board sets the short-term interest rate. The Bank is also accountable to the political authorities.

To be able to evaluate our policy – not only the political authorities – but also financial markets and the general public need to know how we interpret our mandate, our view on how the economy works and trade-offs. Therefore, monetary policy must be transparent.

Transparency and communication are also important for monetary policy effectiveness.

Monetary policy works mainly through expectations and is only effective if the central bank is able to influence interest rate expectations.

Professor Michael Woodford has expressed this very clearly in stating that monetary policy is "management of expectations". *"For not only do expectations about policy matter, but (…) very little else matters"*.

The central bank determines the shortest money market rates through the key rate. The shortest rates, however, are of limited importance. Economic agents' spending depends more on their interest rate expectations.

In recent years, Norges Bank has strived to achieve greater transparency with regard to its monetary policy strategy. As from the beginning of 2003, the Board has published its monetary policy strategy document for the next four months. The strategy was initially published at the end of the period to which it applied. Since June 2004 it has been published ahead of the period. While the document was initially an appendix to our *Inflation Report*, it is now the first section of the *Inflation Report* with monetary policy assessments.

The strategy includes a recommended interval (red bars) for the policy rate over the following four months, conditional on economic developments that are broadly in line with our projections. The Board assesses the key rate at monetary policy meetings within these four months on the basis of the approved strategy. The Bank thus gives the market some indication of the upcoming monetary policy decisions.

As from last November, we took this process one step further and published our own forecast for the interest rate three years ahead. This means that we have now in a sense "assumed ownership" of the interest rate in our projections. Chart 3 shows the interest rate forecasts in the previous *Report*, published a few weeks ago.

Forecasts for inflation, output, the interest rate and other variables are based on an assessment of the current situation and a perception of how the economy works. There is substantial uncertainty associated with future interest rates, as illustrated in the fan charts.[1]

While we assumed the interest rate to be constant through the forecasting period in 2001 and 2002, our projections were based on market expectations in 2003 and up to November last year. On some occasions we stated that it was our view that the interest rate would move on a different path than that indicated by market expectations. For example, in June 2004 we stated that "the most appropriate alternative now seems to be that the interest rate should be kept unchanged for a longer period than indicated by market expectations".

However, monetary policy is probably most effective when the central bank communicates its monetary policy intentions directly rather than commenting on others' interest rate expectations. By publishing the strategy interval and our own interest rate forecast, we give the public more information about our intentions. This should – we hope - make future interest rates more predictable and monetary policy more effective. Therefore, the strategy interval and the interest rate forecasts are important elements of our communication strategy.

In addition, it is easier to interpret and evaluate our forecasts based on an interest rate assumption that we consider to be realistic.

3. The balance between the objectives: criteria for a good interest rate path

Important components in the assessment of what constitutes a good interest rate path are expressed in a set of criteria:

If monetary policy is to anchor inflation expectations near the target, interest rate policy must be geared to moving inflation towards the target. Inflation should be stabilised close to the target within a reasonable time horizon, which in our view is normally 1-3 years.

Provided inflation expectations are on target, the inflation gap and the output gap should be in reasonable proportion to each other until they close. Looking ahead, the inflation gap and the output gap should normally not be positive or negative at the same time.[2]

Given the low inflation rate, we have decided to keep interest rates at a low level and have at times considered an even lower interest rate. However, as the Norwegian economy has shown solid growth since summer 2003, we decided instead to allow a somewhat longer period for bringing inflation back to target.

Chart 6 shows our projections of inflation and the output gap from the previous *Inflation Report*. The paths reflect our aim of striking a balance between inflation and output stabilisation. The paths also reflect the fact that monetary policy works through the demand side and the capacity utilisation of the economy. Therefore, we have to accept a positive output gap in the years ahead as a means of bringing inflation up to target.

Interest rate developments should result in acceptable developments in inflation and output also under alternative, albeit not unrealistic, assumptions concerning the economic situation and the functioning of the economy.

In the *Inflation Reports* we analyse developments in inflation, output and the interest rate under alternative scenarios.

Chart 8 is from the latest *Inflation Report*. It shows on the left hand developments in inflation and output under two alternative scenarios, one with lower inflation and one with a wider output gap. Consequences for the interest rate are shown on the right hand. In the case of lower inflation, the interest rate path falls below the baseline scenario. In contrast, a wider output gap results in a higher

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[1] The uncertainty surrounding the forecasts and how we calculate the fan charts are discussed in a box in *Inflation Report* 3/05: "Uncertainty surrounding future interest rate developments".

[2] However, economic theory indicates that under an optimal precommitment policy, it will under some circumstances (e.g. after a cost push shock) be optimal to keep both the inflation gap and the output gap negative or positive for some time ahead, see for example Walsh, Carl (2003): Monetary Theory and Policy, Second Edition, MIT Press, Cambridge, MA.

interest rate path. In both scenarios it is assumed that it takes time to identify the causes of developments and to adjust policy.

Beyond such specific scenario analyses, in the *Inflation Report* we also discuss more generally possible consequences of more severe disturbances to the economy.

The interest rate should normally be changed gradually so that we can assess the effects of interest rate changes and other new information. Thus, we started increasing the key rate from a low level of 1.75 per cent last summer. Thereafter, the interest rate has been increased in small increments of 25 basis points to 2.5 per cent.

Interest rate policy must also be assessed in the light of developments in property prices and credit.

A build-up of financial imbalances may influence future inflation and output. In recent years, house prices and household debt have increased sharply in several countries and in our country as well.

Growth in housing investment moved up further in 2005 from the record-high level in 2004. A gradual normalisation of the interest rate level and a larger supply of new dwellings are expected to curb the rise in resale home prices in the years ahead.

The question of whether financial stability considerations should be explicitly included in monetary policy is a subject of widespread debate, both in academia and within central banks. The answers diverge and international consensus has not yet been reached.

A flexible inflation targeting regime provides scope for taking into account the impact of potential financial imbalances on future inflation and output. Asset prices and household credit and debt are inputs for the analysis of future developments in inflation and the output gap. In this way, the assessment of asset prices and debt levels may influence interest rate policy.

Furthermore, it is important to keep in mind that the unwinding of financial imbalances may lie many years ahead, well beyond the horizon for the inflation target. It is questionable whether monetary policy today should respond to potential repercussions of possible financial imbalances well beyond the monetary policy horizon.

First, it is well documented that asset price bubbles and financial imbalances are very difficult to identify ex ante. Second, the appropriate timing of a proactive monetary response is likely to be difficult to determine, given the lags in the impact of monetary policy. Third, even in the case where the central bank knew that financial imbalances were building up, the size of the interest rate rise needed to reduce the imbalances might be so large that it could lead to a severe economic downturn.

In Norway, the central bank is one of the institutions with responsibility for analysing and monitoring the financial system. As a flexible inflation-targeting country, we have chosen to incorporate financial stability considerations into the monetary policy decision-making process, partly because asset prices and debt are important for inflation and output, and partly because it provides focus on potential risks to financial stability.

It may also be useful to cross-check by assessing our interest rate policy in the light of simple rules like the Taylor rule, which are less dependent on a specific analytical framework for the Norwegian economy. On the other hand, the rules will not capture all details in the projections, but can provide an indication of whether the current interest rate level is reasonably adapted to the economic situation. As we now publish our own interest rate forecast, market interest rate expectations are one cross check of particular interest. If expectations deviate from our projection, it may indicate that the market has a different view of future economic developments. If we are to influence interest rates in the money market, we must be able to explain such deviations. Of course, it might also be the case that the market's view is the most accurate.

We must always bear in mind that monetary policy is not an "exact science" based on well-defined natural laws. It is not possible to fine-tune the interest rate to attain the objectives with high degree of precision. Irrespective, the criteria for a good interest rate path provide a guide for our interest rate policy.

4. Inflation volatility, deviations from the inflation target and external shocks

Inflation adjusted for energy prices and taxes has been low in Norway in recent years. It has risen somewhat, but it is still considerably lower than the target of 2.5 per cent.

Inflation has been and is still being restrained by the fall in prices for imported consumer goods, an unexpected high level of competition in domestic markets and increased cross-border labour flows. The trend in prices for consumer goods and services over the past two or three years is a result of favourable developments in the Norwegian economy. Low inflation is being accompanied by real income growth and a rise in production and is not the result of declining demand, activity or employment.

Deviations from the inflation target in Norway have been somewhat higher than in other countries, which may partly reflect the degree of openness of our economy. Chart 12 shows deviations from target and the degree of openness. The higher the columns, the larger the deviations are from target. The lines indicate the degree of openness. This may indicate that there is a relationship between the degree of openness and deviations from target, although Canada is an exception.

It should also be noted that the figures for the twelve-month rise in consumer prices are considerably more volatile here than in other countries. We see from the figures that consumer prices in Norway, even when tax changes and energy products are excluded, are more volatile than indices in other countries where these products are included.

Developments in recent years have also been influenced by the pronounced favourable disturbances to which the Norwegian economy has been exposed. Developments in Norway's terms of trade provide an illustration.

As consumers, we enjoy the benefits of falling prices for many imported goods. As a nation, we benefit from a fall in prices for the goods we import relative to prices for the goods we export. Norway's terms of trade have improved. The impact of the rise in oil and gas prices is particularly strong. However, there have also been terms-of-trade gains in the mainland economy. The situation in Norway differs from that of our Nordic neighbours.

Although the domestic economy is partly insulated from oil price fluctuations through the oil fund mechanism, terms-of-trade gains have been a challenge to monetary policy in Norway. Low imported inflation has put downward pressure on our rate of inflation. At the same time, our currency has remained strong, partly reflecting an improvement in Norway's terms of trade.

In a period of increasing cross-border labour flows, substantial technological advances, changes in competitive conditions and new trade patterns, we may, with our very open economy, have to accept a somewhat greater variability in inflation and deviations from the target, as we have witnessed over the past two to three years.

Thank you for your attention!