Øystein Olsen: The purpose and scope of monetary policy

Speech by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at the Centre for Monetary Economics (CME) / BI Norwegian Business School, Oslo, 26 October 2017.

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Accompanying slides

On 23 June this year, the Central Bank Law Commission submitted its proposal for a new central bank act and for the future organisation of Norges Bank and the Government Pension Fund Global.[1] I want to commend the Commission, headed by my predecessor Svein Gjedrem, on its thorough work. Important issues have been thoroughly examined and deliberated. Norges Bank has carefully scrutinised the Commission's proposals before submitting its response to the consultation document. As our response was published today, this speech provides a good opportunity to elaborate on Norges Bank's views on some of the key aspects of the Commission's recommendation.

I will primarily focus on the Commission's proposal for an objects clause in the new central bank act and in particular on one of the core functions of the central bank – monetary policy. What is the main objective of monetary policy, and what scope is available to monetary policy for pursuing other goals? Towards the end of my speech, I will also discuss the future organisation of the central bank and the Government Pension Fund Global (GPFG).

Norges Bank's main functions

The current Norges Bank Act establishes that Norges Bank is Norway's central bank and describes the Bank's functions and its role as executive and advisory body for monetary, credit and foreign exchange policy. The functions described are in line with the customary functions of a central bank and follow from the Bank's key role in financial markets. But there is little in the current Act to indicate which long-term objectives the Bank should pursue. The Commission wants to change this. The Commission proposes the introduction of an objects clause that clearly defines the Bank's purpose.

Norges Bank supports this proposal. At the same time, the Bank would emphasise that the interpretation of the objects clause must reflect the central bank's different degree of influence over the various objectives. The central bank's toolbox is limited, and for some objectives, the instruments available to other institutions may be more important for the result.

Chart: Section 1-2 Norges Bank's purpose – the Commission's proposal

The proposed objects clause contains two paragraphs. The first paragraph reads: "the purpose of Norges Bank is to maintain monetary stability and promote the stability of the financial system and an efficient and secure payment system", while the second paragraph reads: "the Bank shall otherwise contribute to high and stable output and employment".

A well-functioning monetary system is a fundamental prerequisite for the efficient functioning of an economy. Norges Bank plays a key role in this context. It naturally follows that the objectives set out in the first paragraph of the objects clause are primary objectives for the Bank and fully in line with the principles on which the Bank already bases its activities.

Trust in the stability of the value of money is the very foundation of the monetary system. In addition, households and businesses must be confident that the payment system will allow them to conduct transactions securely at all times. An efficient and stable interbank payment and settlement system also provides a necessary basis for the stability of the financial system. With financial system stability, investors can channel available capital to investments offering the highest return.

Norges Bank also has a key role in the management of crises in the financial system. In a crisis, the Bank can supply liquidity both to influence market interest rates and to stabilise the financial system.

Flexible inflation targeting

The purpose of "maintaining monetary stability" sets a long-term objective for monetary policy. The day-to-day conduct of monetary policy requires a more operational target. Most countries set this target in the form of a regulation or a more time-limited mandate issued by the government. The operational target is set to meet the primary objective, but is also a means of holding the central bank accountable.

Chart: Emergence of inflation targeting

The objective of monetary stability is compatible with a range of operational targets. In the past, central banks were expected to ensure that money would keep its value in precious metal. Later, this was replaced by a fixed exchange rate regime whereby the currency was pegged to other currencies. Various forms of fixed exchange rate regimes are still in use in many countries, but since New Zealand introduced inflation targeting as a framework for monetary policy in 1990, an increasing number of countries have chosen to link monetary stability to a numerical inflation target. Today, more than 30 countries have adopted some form of inflation targeting.

International experience with inflation targeting has been predominantly positive. Both during and after the global financial crisis, economic growth performance has been better in inflation-targeting countries. One important reason may be that a floating exchange rate with a credible anchor for inflation has had a stabilising effect on the economy.

Chart: Low and stable inflation

Inflation targeting has also worked well for Norway. After decreasing in the early 1990s, inflation has since been low and stable. We can now look back on a quarter of a century of price stability. At the same time, employment has shown less variation since 2001 than in previous periods, in spite of the substantial shocks that have hit the Norwegian economy.

In some countries, particularly in emerging economies, exchange rate movements have at times been a source of instability. This is less of a challenge in Norway. The Norwegian household, banking and corporate sectors as a whole take on exchange rate risk to a limited extent. Furthermore, government finances are solid and are not affected to any great extent by short-term exchange rate movements, allowing the exchange rate to play an important role in absorbing shocks to the economy. Particularly in periods of falling oil prices, a weaker krone has had a stabilising effect on the business cycle. With confidence in the inflation target, monetary policy has been able to underpin such movements.

At the same time, in a world of high capital mobility and extensive trade, monetary policy's room for manoeuvre is constrained by the exchange rate channel. In a small open economy with a floating exchange rate, the domestic interest rate can differ from interest rates abroad. However, an interest rate differential that becomes too wide can lead to considerable exchange rate volatility, which will in turn feed through to inflation, output and employment. Thus, the domestic interest rate cannot be set without regard to the level of external interest rates. The room for manoeuvre in monetary policy is further constrained in periods when external interest rates are close to or below zero.

Under an inflation-targeting regime, a numerical target is set for the inflation rate, either in the form of a point target or a target range. In its conduct of monetary policy, the central bank aims to keep inflation close to the point target or the midpoint of the target range over time.

Inflation can impose costs on society if it is too high and if it is too low. High inflation is often variable, making economic planning difficult. The real economic costs of bringing high and rising inflation under control have also proved to be substantial. But inflation should not be too low either. Some degree of inflation can oil the wheels of the economy and at the same time increase the monetary policy room for manoeuvre. The lower inflation is, the shorter the distance is between the nominal interest rate and its effective lower bound in a normal situation. If inflation moves into negative territory, the costs can be considerable. Deflation – a persistent fall in prices – can amplify a downturn.

In the early years of inflation targeting, policymakers had high ambitions of micromanaging inflation to meet the target and of achieving this goal within a clearly defined time horizon. But with experience, useful lessons were learned and these ambitions were gradually toned down. In the face of various kinds of shocks, small open economies in particular found that bringing inflation rapidly back to target could have undesirable consequences for the real economy. It was essential to practise flexibility in inflation targeting to address these shocks. The horizon for achieving the target was lengthened. This has also been the case in Norway.

In Norway, inflation has over time been close to, albeit somewhat below, the target. Inflation has at times deviated from 2.5 percent, undershooting or overshooting the target. However, inflation has remained within a range where there is little evidence to suggest that deviations from the target have involved appreciable costs to society. This is reflected in the Bank's conduct of monetary policy. We have been able to take time to bring inflation back to target, which has provided more leeway for giving weight to developments in output and employment in the monetary policy trade-offs.

Even though there may be a range of "optimal" inflation rates, there may nonetheless be good reasons to aim for a specific target rate, whether the inflation target is formulated as a point target or as a target range. A clear target for inflation can contribute to anchoring inflation expectations more firmly.

The Bank's response pattern with regard to deviations from the inflation target is state-dependent. First, the Bank's response will be based on a trade-off between the consideration of low and stable inflation and the consideration of stable developments in output and employment. If inflation is somewhat below target while the outlook for output and employment is favourable, the Bank will be less concerned about inflation than if output and employment prospects are weak. Second, the Bank's response will be affected by the size of the inflationary gap. If inflation deviates considerably from the target, the costs over time can be substantial. There is also a risk that the anchor for inflation expectations will then slip. In such situations, the Bank will therefore give considerable weight in its conduct of monetary policy to bringing inflation back to target.

In the Bank's latest monetary policy report, inflation was projected to remain somewhat below target in the years ahead, against the background of prospects for moderate wage growth in the wake of the fall in oil prices and the need for economic restructuring, among other things. Rather than operating a strict inflation targeting regime and lowering the key policy rate, Norges Bank has chosen to bring inflation back to target more slowly, in the light of firming growth in the Norwegian economy and decreasing unemployment. Higher capacity utilisation and prospects for increased inflation abroad imply that the risk of too-low inflation is small. The Bank gives weight to the expectation that inflation will pick up gradually from today's level.

Real economic considerations in the conduct of monetary policy

Since 2001, Norges Bank has gradually given more weight in its conduct of monetary policy to a reasonable trade-off between the path for inflation and the path for output and employment. Over this period, monetary policy has gone from “underpinning fiscal policy” to being the first line of defence in stabilising the economy.

Norges Bank’s role in stabilising the economy is clearly defined in the draft objects clause, which reads “the Bank shall otherwise contribute to high and stable output and employment”.

This formulation differs somewhat from the usual wording in other central bank acts. In most central bank legislation, the central bank’s primary purpose is limited to the responsibility for maintaining price stability and for performing tasks relating to financial stability, in some cases supplemented by a more general objective, such as underpinning the government’s economic policy.

In some central bank acts, however, high employment is included as one of the central bank’s primary objectives, as is the case in the US. A so-called dual mandate was established for the Federal Reserve, where the objectives of full employment and price stability are put on an equal footing.

In practice, monetary policy conducted by a central bank with a dual mandate will not necessarily differ from that of a central bank operating a flexible inflation-targeting regime. A central bank with a flexible inflation-targeting regime will also be concerned with the level of employment.

In the draft of the new central bank act, maintaining monetary stability is the primary objective. The proposal does not provide for a dual mandate for monetary policy. This is a wise choice. Even though the difference between inflation targeting and a dual mandate is probably small in practice, there are good arguments for keeping price stability as the primary objective of monetary policy. This will clearly define the main role of monetary policy. In the practical conduct of monetary policy, the central bank will always be faced with a trade-off between different considerations. The order of priority for these considerations does not dictate the weight the central bank can give to stable output and employment in the short term.

Norges Bank does not interpret “high and stable output and employment” to mean that the Commission is advocating that monetary policy should have greater responsibility for stabilising the economy than it does today. Monetary policy cannot have primary responsibility for the level of output and employment. There is broad consensus among economists that monetary policy cannot influence the long-term growth potential of the economy.

The level of economic activity, and thereby employment, is a result of overall economic policy, particularly with regard to more structural factors such as wage and income formation, the tax and social security system and the functioning of the labour market. Monetary policy is only one piece of this picture.

But monetary policy can make important contributions to stabilising the economy. First, the policy rate can be rapidly adjusted in response to shocks to the economy, as for example in 2008 and 2014. Second, the policy rate has a direct and pronounced impact on many segments of the real economy. This means that as long as there is no conflict with the inflation outlook, monetary policy can be oriented to influence average output and employment over time.

Many countries, including Norway, have experienced that employment losses in connection with an economic downturn are not fully reversed following a turnaround; for example, unemployment may become entrenched at a high level or the labour force may be reduced. In the literature, this is referred to as hysteresis. Research indicates that the costs of a downturn may be far higher than the immediate output loss.

With a sufficiently flexible inflation targeting regime, it is possible to prevent a long-term reduction in employment following a sharp fall in the level of activity. At the same time, this means accepting that inflation will temporarily overshoot the target while labour market conditions normalise. The benefit is somewhat higher average employment than under less flexible inflation targeting.

But if the policy rate is kept lower than the level necessary to stabilise inflation for a considerable period of time, there is a risk that inflation will accelerate. A monetary policy objective of achieving the highest possible level of employment can therefore come into conflict with the primary objective of "monetary stability". If that were to happen, the Bank will give precedence to its primary objective – low and stable inflation. Delivering low and stable inflation is the best contribution monetary policy can make to favourable and stable developments in the economy over time.

Financial stability considerations

Monetary policy can also contribute to high and stable output and employment by giving weight to preventing a build-up of financial imbalances. Experience shows that the likelihood of a severe economic downturn increases when financial imbalances have built up. Economic downturns caused by financial crises tend to be both deeper and longer than other downturns. If monetary policy helps to restrain the build-up of financial imbalances, this may also mitigate the risk of severe economic downturns further ahead.

The extent to which explicit weight should be placed on financial stability in interest rate setting is state-dependent and must be based on an overall assessment of the outlook for inflation, output and employment. In many situations, financial stability considerations will pull in the same direction as the objectives of price stability and real economic stability. If the economy is booming, with prospects for high inflation and a risk of a build-up of financial imbalances, monetary policy tightening will accommodate all the considerations above. Likewise, lowering the key policy rate in response to a severe downturn with increased bank losses will contribute to sustaining activity and limiting bank losses.

In other situations, the different considerations will pull in opposite directions. If there are prospects that inflation will be too low amid rising debt and house prices, it may be appropriate to give weight to real economic stability considerations and bring inflation back to the target somewhat more slowly.

In recent years, Norges Bank has kept its key policy rate somewhat higher than implied by a short-term goal of inflation and output stability would in isolation suggest. This has occurred in an environment of low global interest rates and where a build-up of financial imbalances has increased the likelihood of inflation, output and employment volatility further out. This does not mean that asset prices or debt have been given independent roles as target variables of monetary policy. The decisive factor has been the consideration of economic stability over time.

A monetary policy that "leans against the wind" can entail costs in the form of lower demand and inflation in the short run. In the practical conduct of monetary policy, these costs must be weighed against the benefits. The main responsibility for counteracting financial imbalances cannot lie with monetary policy. If monetary policy seeks to pursue goals beyond its reach, the credibility of monetary policy will gradually weaken. Regulation and oversight of financial institutions must therefore continue to be the first line of defence against shocks to the financial system.

In the proposal on a new central bank act, Norges Bank is given a clear responsibility for promoting financial stability. Norges Bank interprets the proposal to mean that the responsibility the Bank already has for promoting financial stability in a broad sense will be formalised. The Bank's responsibility and work in this field have evolved over time, but the work on financial stability has gained importance particularly after the financial crisis, as it has for other central banks.

As noted in the Commission's report, Norges Bank cannot alone ensure the "stability of the financial system". The main responsibility for financial stability rests with the Government, while the Ministry of Finance, the Financial Supervisory Authority of Norway and Norges Bank are responsible for the use of the various instruments delegated to them. Norges Bank is among other things lender of last resort and operates the interbank settlement system.

The overriding responsibility for macroprudential policy rests with the Ministry of Finance. Norges Bank holds the view that a clearer framework for setting and using macroprudential instruments is needed in Norway. Time-varying macroprudential instruments could to advantage be delegated to an independent authority. Delegating instruments to an independent authority could facilitate implementation and enhance predictability over time. It could also ensure that the decision is taken in the interests of financial stability.

Today Norges Bank draws up the decision basis for the countercyclical capital buffer and advises the Ministry of Finance on the level of the buffer. The Commission proposes that decision-making responsibility for the level of the countercyclical capital buffer be delegated to Norges Bank. Norges Bank supports this proposal.

The Commission also suggests that it may be appropriate for Norges Bank to assume responsibility for other instruments to mitigate systemic risk in the financial sector. The Commission refers in particular to the residential mortgage lending regulation. This regulation also serves other purposes in addition to the mitigation of systemic risk. Norges Bank will contribute with advice on the design of regulations in this area, but the Bank should not be formally responsible for regulations that include provisions on banks' business practices and consumer protection. This should be the responsibility of the Ministry of Finance.

Organisation of the GPFG and central banking functions

Chart: Number of employees in Norges Bank

The organisation of Norges Bank has changed considerably over time, particularly over the past 20 years. While central banking activities have been concentrated on core functions, Norges Bank has built up an investment management organisation that is responsible for managing the equity, bond and real estate portfolios of the GPFG.

The Central Bank Law Commission proposes to remove the GPFG from the aegis of Norges Bank. The Commission recognises that the Bank has managed the GPFG and performed its central banking functions in a satisfactory manner. At the same time, the Commission points out that the GPFG would stand to gain from being placed under the management of a separate organisation with a board whose sole area of responsibility is investment management.

In recent years, the investment mandate has been changed to give the Bank greater responsibility for determining the GPFG's investment strategy. Investment management has also become more demanding in terms of resources for both the Executive Board and the organisation. In addition, the Bank has been given responsibility for decisions to exclude companies or place them under observation for ethical reasons. The Bank has been able to take on these tasks by further developing the governance structure and the organisation. If responsibility for the management of the GPFG remains with the Bank, the existing investment mandate could serve as a basis for the future development of the GPFG. Norges Bank is well equipped to continue to carry out this task.

The future organisation of the GPFG should be assessed in conjunction with the future development of the investment strategy. As noted by the Commission, a number of strategic decisions can be left to the manager while at the same time expanding the investment strategy to include new unlisted asset classes. Prospective developments along these lines could suggest that the management of the GPFG should not be organised within the central bank.

In addition to proposing that the management of the GPFG should be placed in a statutory entity separate from the Bank, the Commission also proposes substantial changes to the Bank's governance structure. These changes include the establishment of a committee for monetary policy and financial stability that would be responsible for the use of instruments in these areas and would be chaired by the Governor of Norges Bank. Moreover, the Commission proposes the establishment of a board of Norges Bank solely comprising external members. The Commission proposes that this board should be responsible for central banking matters that do not fall within the remit of the committee and for operational, budgetary and administrative matters.

The arguments for establishing a committee for monetary policy and financial stability are weaker, in Norges Bank's view, if the GPFG is separated from Norges Bank. Without responsibility for the GPFG, the Board's range of responsibilities will be substantially reduced.

In addition, dividing responsibility for central banking matters between the two bodies will pose challenges, particularly with regard to the division of work and reporting. The central bank's core functions are closely intertwined and must be viewed as a whole, as experienced during the financial crisis. A solution where responsibility must be transferred from the board to the committee in critical situations, as proposed by the Commission, could give rise to a lack of clarity and conflicts of competence. An important point in this context is that in the implementation of the committee's tasks, the Governor will not be responsible to the board, but will report directly to the Ministry of Finance on central banking matters.

If the management of the GPFG is removed from the aegis of Norges Bank, the Bank's function will be to exercise authority with regard to monetary policy, financial stability and the payment system. A board with broadly the same composition as at present would then function well. Combining responsibility for central banking matters and administrative matters in this board will place responsibility with the same body in both normal and crisis times. The consideration of central bank independence also points towards this solution.

If the GPFG remains under the aegis of the Bank, Norges Bank acknowledges that there are arguments in favour of establishing a committee for monetary policy and financial stability. Such a committee would take over the board's central banking matters, allowing the composition of the board to be more closely tailored to tasks specifically related to investment management. If this solution is chosen, the Executive Board is in favour of a model based on today's governance structure for Norges Bank.

Conclusion

Norges Bank has been an important public institution, acting in the national interest, for over 200 years. Important core functions have been performed by the Bank from the very beginning. Norges Bank is responsible for safeguarding the value of money and promoting economic stability. At the same time, the Bank's mandate and the society in which the Bank operates have changed over time. Some functions have been eliminated altogether over the years: there is no longer any need for the Bank to follow up the strict credit and exchange rate regulation of the past, and the manufacture of banknotes and coins has been outsourced. Other functions have been added, one of which is the management of the GPFG.

Norges Bank is used to change. With 200 years of history behind us, the Bank has the professional capacity and experience to perform its tasks efficiently, even when the Bank's functions and the external environment change. No matter how the Commission's concrete proposals are followed up, I am confident that Norges Bank will continue to be a useful public institution.

[1] Official Norwegian Reports 2017:13. *New central bank act. Organisation of Norges Bank and the Government Pension Fund Global*.