Mr Gjedrem focuses on monetary policy challenges in Norway

Article by Mr. Gjedrem, Governor of Norges Bank, the Norwegian central bank, published in the Norwegian daily *Aftenposten* on 3 May 1999.

In Norway, fiscal policy has a prominent role in stabilising growth in production and employment. The Government Petroleum Fund shall serve as a buffer so that fluctuations in the government's oil revenues do not influence the mainland economy, but only have an effect on capital exports. The local and centralised income settlements determine wage growth. Monetary policy instruments are oriented with a view to maintaining a stable krone exchange rate against European currencies.

If the government budget stabilises the domestic economy, wage growth is kept on a par with the level in Europe, and fluctuations in oil revenues are absorbed by the Petroleum Fund, Norges Bank stands a good chance of ensuring exchange rate stability through monetary policy.

However, this has not been the case since 1996. The government budget has not made a sufficient contribution to smoothing growth in domestic demand and production, wage growth has been substantially higher than in other countries, and oil revenues have fluctuated widely. Furthermore, it seems that the krone is easily exposed to the contagion effects of turbulence in international markets. The krone exchange rate has fluctuated in spite of Norges Bank's active use of instruments. Developments in recent years indicate that Norges Bank cannot fine-tune movements in the krone exchange rate.

Instruments

Extensive and persistent exchange-market interventions to influence the krone exchange rate have, in Norges Bank's experience, yielded poor results. Market participants may perceive such transactions as an interesting opportunity to make a profit, which may trigger enormous capital movements.

The interest rate is therefore Norges Bank's most important instrument. Higher interest rates normally lead to a strengthening of the krone exchange rate. However, interest rates may reach such a high level that this contributes to a cyclical downturn. This would undermine the credibility of monetary policy and result in downward pressures on the krone. In this situation, lower interest rates may contribute to stability and strengthen the krone.

Along the same lines, lower interest rates will normally lead to a weakening of the krone. But if interest rates are so low that this contributes to inflation, this will also undermine monetary policy credibility, and the krone will be unstable.

The objective and the mandate

Monetary policy can provide a nominal anchor for the economy. Since 1986 the authorities have focused on exchange rate stability. Price inflation has been low. Yields on long-term securities indicate no expectations of rising inflation. The perception of market participants seems to be that Norway will not resume a policy resulting in high inflation.

The political authorities formulate Norges Bank's mandate for the conduct of monetary policy. The mandate, formulated in the regulation issued in the spring of 1994, states: "The monetary policy to be conducted by Norges Bank shall be *aimed at* maintaining a stable exchange rate against European currencies, *based on* the range of the exchange rate maintained since the krone was floated on 10 December 1992. In the event of *significant changes* in the exchange rate, policy instruments will be oriented *with a view to* returning the exchange rate *over time* to its initial range. No fluctuation margins are established, nor is there an appurtenant obligation on Norges Bank to intervene in the foreign exchange market" (my italics).

The regulation is based on the fact that we have a floating exchange rate. The first sentence means that this is a managed float. Instruments are to be oriented towards maintaining a stable krone exchange rate against European currencies. Norges Bank chose to define the reference *European currencies* as the euro from 1 January 1999.

The last sentence in the regulation distinguishes our system from a fixed exchange rate regime in that no fluctuation margins have been established around a central rate. To the extent this system calls forth associations with a fixed exchange rate regime, the concept *initial range* should be interpreted as a broad indication of a central rate around which the krone can fluctuate.

The second sentence refers to *significant changes* in the exchange rate in relation to the initial range. It is important to note that no specific values have been defined for *significant changes*, such as the fluctuation margins of 2¼ per cent, 6 per cent and 15 per cent used by the EU countries in their exchange rate regime. *Significant* must be given an economic content. A reasonable interpretation is that exchange rate movements must not influence expectations concerning price and cost inflation to the extent that changes in the exchange rate become self-reinforcing.

The expressions *with a view to, over time, aimed at* and *based on* also show that Norges Bank has considerable scope for exercising discretion.

Exercising discretion

In exercising this discretion, Norges Bank places emphasis on the fundamental conditions for achieving exchange rate stability over time. Price and cost inflation must be brought down to the level aimed at by the euro countries. At the same time, monetary policy must not in itself contribute to a deflationary recession.

The regulation's requirement with regard to returning the exchange rate to its initial range may – if stretched – imply an element of "parity policy"[*]. For example, in a scenario with a sharp and prolonged fall in oil prices, the krone exchange rate may remain outside the initial range for a longer period. If Norges Bank responds by raising interest rates in order to force the krone back to its initial range, monetary policy could lead to a recession that will undermine confidence in the krone. Similarly, after an appreciation a situation may arise whereby a movement of the exchange rate back to the initial range may require that interest rates be reduced to such a low level that this results in higher inflation. However, this would weaken the basis for exchange rate stability over time. Hence, Norges Bank cannot with open eyes orient its policy instruments towards triggering higher inflation or a deflationary recession. If a situation arises whereby Norges Bank is not able to return the exchange rate to its initial range without such consequences, the Bank will inform the government authorities that measures other than those available to the central bank are required.

The present exchange rate range has more or less prevailed for more than ten years. On the basis of its analyses, Norges Bank does not find grounds to maintain that this range is not the appropriate one.

Interplay between policy areas

There are considerable differences between Norway and other industrial countries in the structure of the economy, the organisation of decision-making processes and the formulation of economic policy. In Norway, income and wage determination is fairly centralised; a number of fora to foster cooperation between the social partners have been established, as has special legislation which makes it easier to resolve labour conflicts than in many other countries. The central government budget is used more actively to stabilise economic developments, partly because the Norwegian state has substantially greater economic leeway than other countries.

A salient feature of the Norwegian economy is the importance of oil revenues, which may fluctuate considerably from year to year. The Government Petroleum Fund was established to serve as a buffer against fluctuations in oil revenues. It dampens the impact of changes in oil prices on the Norwegian krone.

In recent years, a number of countries have switched to a monetary policy regime based on a target of low inflation. With a passive fiscal policy, monetary policy then in practice assumes a greater role in the stabilisation of economic developments.

In Norway, we have a different institutional structure and monetary policy objective. When the krone has been stable and inflation shows signs of rising, Norges Bank's first reaction is to inform the political authorities that measures other than those available to the central bank are required. Norges Bank would do the same if the requirement of returning the krone to its initial range could no longer apply. In a country with an inflation target, the central bank would deal with this itself, without first consulting with the government authorities. However, as mentioned, Norges Bank cannot with open eyes inflate or deflate the economy.

Norges Bank's mandate must be viewed in the light of the emphasis placed by the government authorities on conducting a disciplined, but active fiscal policy. The mandate gives Norges Bank a basis for conducting a monetary policy that provides a nominal anchor for the Norwegian economy.

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* As used in the Norwegian debate, "parity policy" refers to the monetary policy of the 1920s, when the Norwegian krone was forced back to its former gold parity by means of highly deflationary policies. (Footnote not included in Norwegian text).