Steady course for monetary policy

Governor Øystein Olsen. Dagens Næringsliv 14 May 2018.

Norges Bank aims to maintain low and stable inflation. In the conduct of monetary policy, substantial weight is also given to output and employment.

Since 2001, the operational target of monetary policy has been low and stable inflation. This has been retained in the new regulation on monetary policy issued by the Government on 2 March this year. The new regulation specifies that "inflation targeting shall be forward-looking and flexible, so that it can contribute to high and stable output and employment and to counteracting the build-up of financial imbalances."

This formulation is consistent with how monetary policy is conducted in practice. Over time, monetary policy has become more flexible. Norges Bank has gradually been giving greater weight to output and employment.

The various components of economic policy must interact to achieve sound and stable economic developments over time – with high employment and low unemployment. A clear division of responsibility between fiscal policy, monetary policy and the wage formation process is the basis of effective interaction. Norges Bank is responsible for the conduct of monetary policy.

Monetary policy's most important contribution is to maintain monetary value through low and stable inflation. Both too high and too low inflation can involve costs to society, with arbitrary wealth redistribution, underinvestment and scarce resources that may be misallocated or left idle. This is usually referred to as providing the economy with a nominal anchor. When households and enterprises can base their economic decisions on low and stable inflation, this provides an important foundation for higher activity and welfare over time.

As long as there is confidence that inflation will remain low and stable, monetary policy can contribute to smoothing fluctuations in output and employment. When the economy is exposed to shocks, such as a financial crisis or a fall in oil prices, monetary policy can respond rapidly. Sufficiently flexible inflation targeting could help ensure that lower employment levels do not persist over the long term following a downturn. This can reduce the risk of unemployment becoming entrenched at a high level.

The probability of a pronounced downturn in the economy has been shown to increase after periods of rapid asset price inflation and debt growth. Monetary policy can also to some extent contribute to high and stable output and employment by giving weight to counteracting the build-up of financial imbalances.

However, monetary policy must not be overburdened. If Norges Bank pursues objectives it does not have the instruments to fulfil, confidence in monetary policy may be eroded. The regulation and supervision of financial institutions must be the primary means of addressing shocks to the financial system. Employment levels over time are determined by structural conditions, such as the functioning of the labour market, the tax and social security system and the wage formation process. In Norway, a well-functioning wage formation process has enabled unemployment to remain low while wage growth has remained moderate.

The new regulation underpins Norges Bank's flexible approach to inflation targeting. In the conduct of monetary policy, substantial weight will continue to be given to the real economy. In this context, whether the inflation target is 2.5 percent or 2 percent is less important. At 2 percent, the inflation target is now at the same level as that of most of Norway's trading partners. The reduction of the target will not in itself significantly affect the short-term interest rate outlook.

Never before have global interest rates been as low for such a long period. Growth abroad has now picked up, and there are prospects of a gradual interest rate increase among Norway's trading partners. The outlook is also brighter in Norway. In the two years since the cyclical trough was reached, growth has gained a firm footing and the unemployment rate has declined across the country. The outlook suggests that it will soon be appropriate to raise the key policy rate – and this is a good sign.