Monetary policy is functioning

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The Norwegian economy is growing at a solid pace, and there are prospects that growth will remain high in the year ahead. The recession was mild after the preceding expansion culminated two and a half years ago. The higher rate of cost inflation in Norway relative to other countries was broken without production being impacted to the same extent as during the recessions in the early 1980s and around 1990. One of the main reasons for this is probably that low inflation in the 1990s and the current monetary policy have anchored expectations of low and stable inflation among economic agents.

The need to bring down inflation was the main reason why New Zealand, the first country to do so, introduced an inflation target for monetary policy at the end of the 1980s. Canada, the UK, Sweden and Australia followed suit later in the 1990s. Inflation targeting has gradually become the normal monetary policy system in developed economies. In Norway, the Government introduced an inflation target in 2001. The target is set at 2.5 per cent. In the euro area, monetary policy is oriented towards price stability, defined as inflation below, but close to 2 per cent.

Inflation targeting has proved to be a sound system and particularly well suited for small, open economies. Normally, interest rate setting under an inflation targeting regime will also contribute to stabilising output and employment. In periods of recession, with prospects of low and falling inflation, the interest rate will be reduced to boost demand and prevent an inflation level that is too low. During an upturn when there are prospects of high inflation, the interest rate will be increased. Inflation targeting is softer around the edges than the exchange rate regimes Norway and many other countries operated earlier. The system has proved fairly robust to disturbances.

Nevertheless, the soft landing of the Norwegian economy after several years of high domestic cost inflation and a low level of activity abroad must not lead us to believe that output and employment cannot show pronounced fluctuations in the future. Monetary policy can have a stabilising effect, but it cannot eliminate cyclical fluctuations. Monetary policy's most important contribution is to anchor inflation expectations.

Compared with the previous fixed exchange rate regime, where the interest rate level abroad normally established a floor for the interest rate in Norway, today's regime provides greater leeway in interest rate setting. Domestic interest rates will nevertheless follow interest rates in other countries in periods because the Norwegian economy is very open, with free cross-border capital flows. If there are prospects of weak global growth and low inflation, international interest rates will be low. Low external inflation influences the Norwegian economy through low price inflation for imported consumer goods and intermediate goods. In addition, Norwegian exporters will be faced with lower prices in their markets. In such situations, there will often be prospects of low inflation in Norway, and interest rates will be low in Norway.

An important channel for monetary policy is the foreign exchange market and the krone exchange rate. Norges Bank has not defined a target for the exchange rate. Movements in the krone are nonetheless of considerable importance in interest rate setting because the exchange rate influences inflation and output. In open economies with free capital movements, the exchange rate is influenced by economic developments. The krone fluctuates. If growth in the Norwegian economy is higher than external growth and there are prospects of high domestic inflation, the interest rate will be increased, and the value of the krone will normally rise. If there are prospects of low domestic inflation and falling production even if other countries are faring well, the monetary policy response will normally lead to a fall in the value of our currency. Such fluctuations in the exchange rate are desirable and contribute to stabilising both inflation and output. A krone that is stable - but too strong - engenders economic costs in the form of lower activity. Likewise, a krone that is stable - but too weak - is a source of high inflation.

Nor is it surprising that the krone fluctuates as other countries' currencies also fluctuate. The krone exchange rate does not stand out as particularly unstable compared with other currencies. On occasion, however, adverse or excessive movements in the foreign exchange market can be observed. This is not a result of inflation targeting, but must be seen in connection with open trade and free capital flows.

Norwegian enterprises have the possibility of hedging against exchange rate fluctuations. A survey of 128 Norwegian enterprises shows that a majority of enterprises that are exposed to currency risk have a hedging strategy. One form of natural hedging is to buy intermediate goods in the same currency in which the goods are invoiced. Another form is to take up a loan in the same currency as that of the enterprise's assets. In addition, enterprises can also use the forward exchange market and options market to hedge against temporary currency fluctuations.

In an economy such as Norway's with large oil revenues, the margin of manoeuvre in economic policy may appear to be considerable. But this margin of manoeuvre can be a source of instability. The need for credible policy rules and a clear division of responsibility in economic policy can be traced back to last year's winners of the Nobel Prize in economic sciences, Finn Kydland from Norway and Edward Prescott from the US. During the 1970s, they observed that business cycle fluctuations did not diminish even if the authorities in many countries increasingly used both fiscal and monetary policy to reduce them. At the same time, inflation accelerated and became an independent problem in many countries. According to Kydland and Prescott, the outcome was not surprising. They showed that the margin of manoeuvre in economic policy may have a price. Even if the authorities have a long-term objective of stability and high economic growth, it may be tempting to surprise economic agents with an expansionary policy to increase activity in the short term, for example through currency devaluation. Knowing that the authorities have this possibility and that they have incentives to use it induce households and businesses to adapt in advance. As a result, inflation can accelerate without an increase in the activity level in the economy. The lesson was that economic policy can achieve better results if the authorities can commit themselves to a pre-established set of credible policy rules.

The conduct of monetary policy in Norway, as in many other countries, is delegated to the central bank with an objective of low and stable inflation. The inflation target can be seen as an answer to the problems raised by Kydland and Prescott.