Monetary policy in 2002

by Svein Gjedrem, Governor of Norges Bank, article in Finansavisen 2 April 2003.

The implementation of monetary policy is delegated to Norges Bank by law. Norges Bank's operational objective has been laid down by the Government in the Regulation on Monetary Policy. Since the objective has been clearly defined, the conduct of monetary policy can be evaluated. The Bank reports on the implementation of monetary policy in its Annual Report, which will be available soon for 2002.

The operational objective of monetary policy is low and stable inflation. The inflation target is set at 2½ per cent. The sight deposit rate is set on the basis of the inflation outlook, normally two years ahead. If there are significant deviations between actual price inflation and the target, the Bank will provide a thorough assessment in its AnnualReport. Particular emphasis will be placed on any deviations outside an interval of +/- 1 percentage point.

According to Norges Bank's mandate, monetary policy has been assigned a clear responsibility for stabilising the economy. High demand for goods and services and labour shortages normally point to higher inflation in the future. When interest rates are increased, demand falls and inflation is kept at bay. When demand is low and unemployment rises, inflation will tend to slow. Interest rates will then be reduced.

The implementation of monetary policy can be evaluated against a number of criteria:

- Was the underlying rise in consumer prices in 2002 close to the target of 2½ per cent?
- Was monetary policy in 2002 adapted to the inflation target?
- Has the conduct of monetary policy contributed to output and employment stability?
- Has monetary policy underpinned confidence that inflation will be 2½ per cent?

Consumer price inflation in 2002

Substantial changes in the inflation rate may at times occur as a result of extraordinary fluctuations in prices for some products or changes in direct and indirect taxes. Norges Bank shall disregard such extraordinary and temporary disturbances when setting interest rates. Statistics Norway has published figures for consumer price inflation adjusted for tax changes and excluding energy products (CPI-ATE) since October 2001. This index of underlying inflation is a basis for the retrospective evaluation of monetary policy.

The underlying rise in consumer prices averaged 2.3 per cent from 2001 to 2002. As the year progressed, inflation was increasingly influenced by the strong krone. Prices for imported consumer goods, particularly clothing and footwear, fell markedly towards the end of the year. At the same time, the rise in prices for domestically produced goods and services remained at a high level as a result of strong growth in labour costs. The year-on-year rise in the CPI-ATE slowed from a 2.7 per cent peak in June and July to 1.8 per cent in December. The underlying rise in consumer prices remained well within an interval of +/- 1 percentage point around the inflation target throughout the year.

Was monetary policy in 2002 adapted to the inflation target?

At the beginning of 2002, the interest rate was adjusted to the outlook for inflation at the beginning of 2004. The Norwegian economy was characterised by low unemployment, labour shortages in many sectors and high growth in labour costs. The interest rate in Norway therefore remained above the international level. A wide interest rate differential has probably contributed to the appreciation of the krone.

The outcome of the wage settlement in spring 2002 pointed to even stronger growth in labour costs in Norway and, as a result, accelerating inflation. Strong growth in private disposable income, solid growth in credit to the household sector and a continued sharp increase in house prices had the same effect. The appreciation of the krone until this time could not fully counteract stronger wage growth and higher growth in domestic demand. All in all, this induced an increase in the sight deposit rate in July.

In late autumn, new information substantially changed the outlook for economic developments. Growth forecasts for the world economy had deteriorated further. The krone had continued to appreciate. Interest rates were reduced in other countries and expectations concerning future interest rates fell appreciably. At the same time, the outlook for the Norwegian economy had weakened. Electricity prices rose sharply and households and enterprises became less optimistic. House prices levelled off. Many enterprises in the public and private sector focused on reducing labour costs following the costly wage settlement, and unemployment rose more than expected. Our analyses indicated that a continued strong krone would bring inflation under the target of 2½ per cent at the end of 2004. This was the background for the decision to reduce the sight deposit rate to 6.5 per cent on 11 December.

Has the conduct of monetary policy contributed to output and employment stability?

Through 2002, the interest rate remained high as long as demand for goods and services was high and the labour market was tight. Towards year-end, when the outlook shifted towards weaker demand, rising unemployment and falling inflation, the interest rate was reduced. This illustrates that monetary policy can contribute to stabilising developments in output and employment.

The strong krone led to lower prices for imported goods. This resulted in low price inflation, in spite of the strong growth in labour costs. If monetary policy had attempted to achieve the inflation target in the very short term, the interest rate could have been held constant or reduced in the summer of 2002. Household and enterprises could then have continued to increase their borrowing. The strong wage growth could have gradually fed through to higher inflation. It would then have been necessary to raise the interest rate - perhaps to a higher level than would otherwise have been the case. Higher inflation and sharper lending growth would have weakened the possibilities of counteracting a downturn by relaxing monetary policy. The end result would have been wider fluctuations in aggregate demand, output and employment than is currently the case.

When real wages increased far more than underlying productivity, enterprises and public entities were unable to sustain the increase in labour costs. This leads to downscaling and a fall in employment. In such a situation, an easing of monetary policy may lead to even higher price and cost inflation and unstable developments in the economy.

Monetary policy cannot mitigate an increase in unemployment that is caused by a cost-push shock resulting from wage negotiations.

Has monetary policy underpinned confidence that inflation will be 2½ per cent?

If monetary policy is to function as intended, confidence that inflation will be approximately 2½ per cent over time is a precondition. It is important that households, employees, companies and the public authorities can use the inflation target as a basis for their planning. The experience of the

1970s and 1980s showed that it can take time and be costly if confidence in monetary policy is undermined.

It is possible to measure expectations of inflation ahead, both directly and through various measures of implied forward rates. Forecasts for inflation in Norway two years ahead based on independent surveys of market participants are published internationally. The projections published in October 2002 showed that price inflation in the long term is expected to be equal to the inflation target of 2½ per cent.

Another indicator is the differential between implied forward rates in Norway and other countries. Through 2002, the differential between long-term forward rates in Norway and Germany fell from approximately 1 to a little more than ½ percentage point. This differential can largely be explained by a somewhat higher inflation target in Norway than in the euro area. This suggests that there is confidence that inflation in Norway over time will remain close to the target.