The work of setting interest rates

By Svein Gjedrem, Central Bank Governor, Finansavisen, 9 November 2001.

Norges Bank analyses the inflation outlook in its *Inflation Reports*. These reports are presented at press conferences following the Executive Board's monetary policy meetings, which take place three times a year, most recently on 31 October. Work on the inflation reports extends over a period of several weeks. The purpose of this article is to provide an account of the main features of this process, and the basis upon which Norges Bank's Executive Board sets the interest rate.

On 29 March this year, the Government assigned a new operational mandate for monetary policy to Norges Bank. According to the new guidelines, Norges Bank's implementation of monetary policy shall be oriented towards maintaining low and stable inflation. The operational target is annual consumer price inflation of approximately 2.5 per cent over time.

The interest rate influences inflation through a number of channels. A higher interest rate will normally contribute to reducing inflation by curbing demand for goods and services and strengthening the krone in relation to other currencies. A lower interest rate will have the opposite effect. If it appears that inflation will be higher than 2½ per cent with unchanged interest rates, the interest rate will be increased. If it appears that inflation will be lower than 2½ per cent with unchanged interest rates, the interest rate will be reduced.

It takes time before changes in the interest rate have an effect on inflation. Analyses performed by Norges Bank indicate that a substantial share of the effects on inflation occur within two years. Two years is therefore a reasonable time horizon for achieving the inflation target of 2½ per cent. Therefore, the inflation outlook in two years may be viewed as a derived objective of monetary policy.

The inflation target provides the framework for monetary policy. Norges Bank's Executive Board makes decisions regarding changes in the interest rate. The economic outlook will always be uncertain. We must therefore exercise professional judgement in setting interest rates.

The Executive Board is appointed by the King in Council, and consists of five members who are employed outside the Bank, as well as the Central Bank Governor and Deputy Central Bank Governor. The Executive Board functions as a unified group, and the members are collectively responsible for the Bank's decisions:

- The Executive Board discusses the economic outlook at a separate evening meeting three weeks before the *Inflation Report* is presented. On the basis of preliminary projections for the report, the Executive Board assesses the outlook for inflation two years ahead, and the uncertainty surrounding the projections. The following day, the Executive Board summarises its discussions and assesses the consequences for monetary policy for the next four months. This assessment constitutes an important internal reference point when the Executive Board later makes a decision regarding the interest rate. It will also provide a basis for our externally oriented communication through speeches and the media.
- The Executive Board meets every three weeks. A brief update of economic developments is provided at ordinary meetings. At every second meeting - every six weeks - the Executive Board discusses monetary policy in depth. The Executive Board assesses developments in a number of different economic indicators, with special emphasis on substantial deviations from the assessments in the last *Inflation Report*. Decisions regarding changes in interest rates are normally taken at these meetings. At a separate meeting, the Minister of Finance is

informed of the proposed decision which is presented to the Executive Board. The dates of monetary policy meetings are published.
- The Executive Board's decision is published in a press release immediately after monetary policy meetings. After each monetary policy meeting, a press conference is held at which the Bank's assessments are summarised and the Executive Board's decision is presented.

We place emphasis on transparency with regard to Norges Bank's conduct of monetary policy. By publishing the Bank's assessments, we seek to reduce uncertainty regarding the Bank's response pattern. If our monetary policy is reasonably predictable, we can avoid an important source of risk and instability. This does not imply that expectations in financial markets influence the interest rate. Norges Bank will always set the interest rate it deems to be appropriate.