

The krone and the interest rate

By Central Bank Governor Svein Gjedrem, Norges Bank, Dagens Næringsliv, 6 July 2001.

On March 29, the Government approved a new operational target for monetary policy. Norges Bank shall set the key rate with a view to maintaining low and stable inflation. The inflation target is set at 2 1/2 per cent.

We no longer have a specific exchange rate target for the Norwegian krone. The krone is floating. Nevertheless, developments in the krone exchange rate are still very important when Norges Bank sets the interest rate. This is due to a number of factors:

- Changes in the krone exchange rate affect prices measured in NOK for imported consumer goods and services. Bearing in mind that imported goods are used in Norwegian production, the rise in prices for imported goods and services combined determine nearly 40 per cent of consumer price inflation.
- Developments in the krone have an impact on earnings in companies in the internationally exposed sector, which have also traditionally been wage leaders.
- Changes in the exchange rate affect the competitiveness of Norwegian business and industry as well as demand at home and abroad. Thus, the activity level in the economy is affected.
- As the Norwegian and international money and capital markets become more integrated, changes in the exchange rate will be increasingly important. Changes in the exchange rate generate wealth gains and losses for Norwegian households and enterprises.

The value of the Norwegian krone will vary, as exchange rates do in most countries. There are many reasons for fluctuations in the exchange rate.

Changes in the exchange rate are often due to disturbances to the economy. One example is a change in the terms of trade, which measure prices for exported goods and services in relation to prices for imported goods and services. Commodities account for a substantial share of Norwegian exports. Prices fluctuate widely. As a result, Norway is exposed to fairly large variations in its terms of trade. A decline in commodity prices results in less favourable terms of trade. This reduces our source of revenues and experience shows that the exchange rate will weaken. On the other hand, an increase in commodity prices improves terms of trade and often results in a strengthening of the exchange rate.

It is desirable for the krone exchange rate to fluctuate in pace with developments in the terms of trade or demand for Norwegian products. If prices for our export products decline, a weakening of the exchange rate will dampen the income loss for internationally exposed industries. Therefore, the exchange rate may be viewed as an automatic stabiliser, or buffer, which protects the economy to some degree against changes in the terms of trade. Oil and gas are the commodities that account for the largest share of Norwegian exports. A substantial portion of the revenues from the sale of oil and gas is invested in foreign equities and bonds through the Government Petroleum Fund. As a result, short-term fluctuations in the oil price have less impact on the domestic use of petroleum revenues. In the last 20 years, fluctuations in the terms of trade have been three to four times greater for the Norwegian economy including the petroleum sector than for the mainland economy. The Petroleum Fund thus relieves pressure on the krone exchange rate.

Changes in the krone exchange rate may also be due to changes in the interest rate. Higher interest rates normally make it more attractive to buy NOK-denominated assets and reduce NOK-denominated debt, leading to an appreciation of the krone. In contrast, a decrease in interest rates will normally result in lower demand for the krone and a weaker exchange rate. Experience shows that the interest rate only has this predictable effect on the krone exchange rate when it contributes to stabilising inflation.

The exchange rate constitutes an important channel through which monetary policy operates. Changes in the exchange rate are both desirable and intended when they contribute to stabilising inflation.

However, fluctuations in the exchange rate can also be a source of economic disturbances. Sentiments in the foreign exchange market may induce market participants to be excessively positive to a currency for a time while at other times they are overly negative. This can trigger unnecessary and extensive fluctuations in the exchange rate, which can spill over to other parts of the economy.

Norges Bank's reaction to a change in the exchange rate will depend on an assessment of the effect on inflation. This requires an evaluation of the reasons for and the permanence of the change. There is reason to believe that short-term fluctuations in the krone exchange rate have little impact on inflation. When the changes are potentially more permanent and thus may be assumed to have a greater impact on inflation, the Bank will set the interest rate with a view to stabilising inflation. However, it is difficult to establish whether exchange rate fluctuations are permanent or temporary. Therefore, Norges Bank will normally proceed with caution in connection with any interest rate changes in response to fluctuations in the exchange rate. A special situation arises if strong turbulence in the foreign exchange market indicates that confidence in monetary policy is in jeopardy. A rapid and pronounced change in the interest rate may then be appropriate.

In addition to the interest rate, foreign exchange market intervention is a monetary policy instrument. However, in Norges Bank's experience, extensive and sustained interventions to influence exchange rates have yielded poor results. Interventions can often lead to game situations where market operators regard the central bank's attempts to influence the exchange rate as an interesting opportunity to make a profit, thus amplifying the fluctuations in the exchange rate. However, it may be appropriate in special situations to intervene to a limited extent to stabilise inflation, should the krone move to a level that we do not consider reasonable on the basis of fundamentals. This may also be appropriate in the event of extensive short-term fluctuations in thin markets.

We must expect fluctuations in the krone. However, low and stable inflation will lead to expectations of stable developments in the krone exchange rate over time.