# Inflation target - how interest rates are set

**By Central Bank Governor Svein Gjedrem, Aftenposten, 29 May 2001.**

On 29 March, the Government assigned a new operational mandate for the implementation of monetary policy to Norges Bank. Norges Bank shall set the interest rate with a view to maintaining low and stable inflation. The inflation target is set at 2½ per cent.

The best contribution monetary policy can make to growth and employment is low and stable inflation. We cannot achieve higher employment in the long run by accepting higher inflation. On the contrary, the experience of our country and that of others in the 1970s, 1980s and 1990s is that periods of high inflation are followed by downturns with high unemployment. High and variable inflation also leads to an arbitrary redistribution of wealth and income.

Higher interest rates curb demand for goods and services and reduce inflation. Lower interest rates have the opposite effects. If evidence suggests that inflation with unchanged interest rates will be higher than 2½ per cent, the interest rate will be increased. If it appears that inflation with unchanged interest rates will be lower than 2½ per cent, the interest rate will be reduced. There is symmetry here. It is equally important to avoid an inflation rate that is too low as it is to avoid an inflation rate that is too high.

We do not expect a change in the interest rate to have an immediate impact on inflation. Our analyses indicate that a substantial share of the effects of an interest rate change occurs within two years. Two years is thus a reasonable time horizon for achieving the inflation target of 2½ per cent. This means that interest rates are set with a view to achieving an inflation rate of 2½ per cent two years ahead.

In some situations where unexpected events lead to an inflation rate that is too high, it may be appropriate to apply a longer time horizon than two years. For example, reducing inflation to 2½ per cent within this time horizon may be associated with unnecessary real economic costs. A precondition for applying a longer time horizon is that there is clear evidence of strong confidence in low and stable inflation over time on the part of economic agents. As experience with setting interest rates using an inflation target is gained, the scope for placing emphasis on stability in the real economy will probably increase.

Low and stable inflation is a necessary precondition for stability in the foreign exchange and financial market and the property market. However, there have been episodes where bubbles have accumulated in these markets, in the form of sharp increases in assets prices in an environment of low inflation. Price increases in property and financial markets can have a considerable impact on wage growth and consumer price inflation after a period. When the bubbles burst, the result may be an economic downturn. Developments in financial markets and property markets can be a source of a more unstable inflation environment. In principle, it would be appropriate to use the interest rate to counter this. In practice, however, it is difficult to assess whether property and financial asset prices are sustainable.

When Norges Bank concludes that a change in the key rate is appropriate, the change will in most cases be made gradually. This is because there is normally uncertainty attached to the situation in the economy, disturbances to which the economy may be exposed and how fast an interest rate change influences price inflation. But we will not always take a gradualist approach. A rapid and pronounced change in the interest rate is appropriate if, for example, heightening turbulence in financial markets or a cost-push shock resulting from negotiations indicates that confidence in monetary policy is in jeopardy.

Norges Bank analyses the inflation outlook in its *Inflation Report,* which is published three times a year. Further assessments are presented every sixth week in connection with the Executive Board's monetary policy meetings. It is, as mentioned, the inflation outlook two years ahead that determines the interest rate set by Norges Bank. If special circumstances prompt Norges Bank to apply a different time horizon, the Bank will provide an assessment of this. The same applies should special emphasis be placed on developments in the financial market and property markets.

Today's inflation rate is partly the result of the interest rate that was set one to two years ago. Current inflation figures do not provide an adequate basis for determining the level at which interest rates should be set today. Monthly figures for the consumer price index are also influenced by random and temporary factors that have little impact on developments in inflation over time. Precipitation levels have an effect on electricity prices. Changes in indirect taxes have an immediate impact on the consumer price index. The direct effects of these factors on inflation are exhausted after a year. Hence these factors do not have any implications for the interest rate, which is normally set with a view to maintaining inflation at 2½ per cent two years ahead.

However, it is still interesting to adjust monthly inflation figures for temporary effects to determine whether developments are broadly in line with our projections. This is why Norges Bank presents figures for consumer price inflation where the effects of some temporary factors are excluded. However, the automatic adjustment of inflation figures for the direct effects of one-off factors can also be associated with pitfalls. Higher indirect taxes and electricity prices can be a source of accelerating inflation via spillover effects on other prices and wages.

The mandate for monetary policy with an inflation target provides a sound basis for assessing Norges Bank's interest rate setting. Inflation at one point in time, adjusted for certain temporary effects, provides a measure of whether interest rate setting was appropriate. Market participants and others can assess the quality in the inflation reports and analyses published by the Bank, and whether our analyses are consistent with our interest rate setting. The uncertainty associated with economic developments and inflation, as observed since the mid-1990s, may indicate that we normally reach the inflation target within an interval of +/- 1 percentage point.

The Government has assigned a task to Norges Bank. Norges Bank uses its professional judgement in a delimited area. The results of our decisions can be measured. Hence the government authorities can evaluate our performance.