Room for manoeuvre or predictability in monetary policy

By Svein Gjedrem, Governor of Norges Bank, Aftenposten 08 Jun 2000.

Norges Bank reduced key rates in the spring of 1999. This spring we have increased them. The timing of these interest rate changes has been the subject of debate. Norges Bank has been accused of taking sides in the annual wage negotiations.

There have been a number of shifts in monetary policy since the mid-1980s when the system of direct credit regulation and politically administered interest rates was dismantled. There have been three important turning points:

- After several rounds of devaluation in the 1970s and 1980s and a final devaluation in May 1986, the Norwegian authorities decided to shift to a fixed exchange rate regime. The monetary authorities tied themselves to the mast to resist short-term temptations. Interest rates were set unilaterally with a view to maintaining the exchange rate within a narrow band. At the same time, the value of the krone was defended by means of extensive krone purchases in the foreign exchange market. The fixed exchange rate regime brought a gradual reduction in inflation. At the same time, an active fiscal policy contributed to making monetary policy more credible, because unemployment was lower than it would otherwise have been.
- In December 1992, the fixed exchange rate regime had to be abandoned in the face of persistent unrest and widespread speculation in European currency markets. The Norwegian krone remained stable, nonetheless, and Norges Bank's policy response pattern did not change to any significant extent. The stability of the krone, however, was primarily due to an appropriate fiscal response to economic developments, low wage inflation and relatively stable oil prices.
- Around the turn of the year 1996/1997, the krone showed greater instability, which is reflected in the exchange rate movements in the course of a day, from one day to another and from one quarter to the next. The level of economic activity was high during this period and cost increases were substantial. There were also major fluctuations in oil revenues, and unrest in international financial markets spread to our currency.

Since then, the foreign exchange rate has no longer been a suitable operational objective of monetary policy. Experience shows that Norges Bank can no longer fine-tune developments in the krone. One important reason for this is that the free flow of capital has limited the central bank's scope for influencing the krone exchange rate through the purchase and sale of kroner in the foreign exchange market. When a central bank trades in its own currency, market participants can play on the fact that the exchange rate does not reflect underlying market conditions. With the free flow of capital, this may trigger major capital movements over a short period.

The key rates, which are Norges Bank's most important monetary policy instrument, have a more indirect and less predictable effect on the exchange rate, at the same time that the exchange rate may be influenced by a number of conditions that are beyond the Norwegian authorities' reach and control.

The government authorities have laid down a mandate for monetary policy, which reads as follows:

"The monetary policy to be conducted by Norges Bank shall be aimed at maintaining a stable krone exchange rate against European currencies, based on the range of the exchange rate maintained since the krone was floated on 10 December 1992. In the event of substantial changes in the exchange rate, monetary policy instruments will be oriented with a view to returning the exchange rate over time to its initial range. No fluctuation margins are established, nor is there an appurtenant obligation on Norges Bank to intervene in the foreign exchange market."

The mandate provides room for interpretation and discretion in the exercise of its authority. In a letter of 21 October 1999 to the Ministry of Finance, Norges Bank explained its interpretation of the mandate. When setting interest rates, Norges Bank places emphasis on the fundamental preconditions for exchange rate stability. Price and cost inflation must over time be reduced to the level aimed at by the euro area. At the same time, monetary policy must not in itself contribute to deflationary recessions. In addition, Norges Bank has explained in fairly great detail how the Bank will respond when price and cost trends and the basis for exchange rate stability are affected by external conditions.

Norges Bank's quarterly Inflation Report provides an overview of price and cost developments and the Bank's best judgement concerning developments in inflation and the basis for exchange rate stability. Therefore, the Inflation Report constitutes an important component of the basis for interest rate decisions.

Norges Bank's Executive Board evaluates interest rates eight times a year on pre-established dates. After these meetings, the Bank provides information about its interest rate decisions and assessment of future interest rate setting. After the most recent monetary policy meeting, the Bank stated that "In light of recent trends in the economy and the balance of risks, the probability that the next change in interest rates will be an increase is greater than the probability of a reduction".

The mandate for monetary policy, the Bank's interpretation of the mandate and the policy response pattern as it is publicly known, the Inflation Report and the assessment of future interest rate setting are crucially important to the decisions of the Bank's governing bodies. All of these elements bind the Bank's governing bodies in almost the same way that exchange rate developments did under the fixed exchange rate system. A well-established pattern of action may nevertheless be broken, but only in extraordinary situations, for example, when financial stability is seriously threatened.

Predictability in the central bank's behaviour reduces uncertainty for all economic agents. It makes the Norwegian economy less vulnerable to doubt and interest rate speculation and it contributes to smoother developments in long-term interest rates. Continuity and consistency are therefore the best contribution Norges Bank can make to economic stability and exchange rate stability over time when there is free movement of capital and the krone is floating.

However, at the same time, this limits the room for manoeuvre in interest rate policy. Norges Bank would have had greater leeway if we had been less open about our response pattern - if we played our cards closer to the chest. We could have tried to surprise the players in the economic arena and then perhaps in the short term achieved a greater impact from the interest rate changes. However, companies and financial institutions would gradually learn and try to protect themselves. The result in the long term would be less confidence in monetary policy, higher interest rates and lower investment and employment levels.

When the Bank commits itself to a specific policy response pattern, there is no room for tactical interest rate setting in relation to other important decision-making processes, such as the wage settlements each spring or the central government budget debate each autumn. In other words, there is no room for using interest rates to directly influence these decision-making processes. Setting interest rates in this manner could systematically result in higher interest rates because Norges Bank would always have to have something to give. This could also involve explicit or implicit promises that the Bank would have difficulty honouring over time. In practice, the wage negotiations last from February to June, whereas the Government and the Storting deliberate the central government budget and make the most important decisions between July and December. The central bank cannot be passive in relation to interest rate policy for such a long period of time. This would substantially increase the response time in monetary policy and weaken the basis for exchange rate stability.

Monetary policy, fiscal policy and the wage settlements must be coordinated at a higher level, just as different areas of economic policy are coordinated by means of the Government's guidelines in the National Budget.