

Monetary policy strategy - from mandate to decisions

Speech by Governor Øystein Olsen at the Centre for Monetary Economics (CME) / BI Norwegian Business School on 20 October 2021.

Introduction

The main task of monetary policy is to maintain monetary stability. How that task is carried out has varied over the years. Today's monetary policy regime in Norway – inflation targeting – will this year have been in operation for 20 years. The regime has long since overcome its teething problems and is now beyond its adolescence. But that does not mean it has found its final form. From time to time, we must pause and reflect, as was the case when a new central bank act and a new monetary policy regulation were drawn up. The new mandate has been in effect since March 2018 and reflects among other things our experience with inflation targeting so far.

Chart: From mandate to decision

Norges Bank's monetary policy mandate is to ensure low and stable inflation, contribute to high and stable output and employment while seeking to mitigate a build-up of financial imbalances. But what does the formulation of the objectives entail, and how can we strike the right balance between these potentially conflicting objectives? There are no unequivocal answers to these questions.

The transition from mandate to concrete decisions requires a framework for monetary policy discussions and assessments, that is to say a strategy that can guide us in how we should react to different challenges and shocks.

The monetary policy strategy provides a good starting point when demanding trade-offs have to be made. By being open about our thinking about the mandate and the choices we must make, we are seeking to promote understanding about the policy pursued and anchor inflation expectations to the target. Further developing and articulating the strategy is a continuous process and an important part of the work undertaken by Norges Bank's Monetary Policy and Financial Stability Committee.

Over the past year and a half, the economic consequences of the pandemic have been at the centre of monetary policy discussions, not only at Norges Bank but at all central banks. The challenges have revolved around issues that are at the core of the monetary policy strategy. One challenge has been that low interest rates over time limit the space for pursuing an accommodative monetary policy when severe shocks hit the economy. Another is the risk that the historically deep pandemic-induced downturn will leave lasting scars in the

form of lower employment. A third challenge relates to the rapid rise in house prices, which could increase the risk of financial imbalances building up.

These are the issues forming the backdrop for today's speech.

Different shocks affect the economy

The economy is recurrently exposed to both small and large shocks and disturbances that push inflation away from the target. Some of them we disregard, especially when we believe that the effects will be both small and transitory. However, should the economy be hit by a shock that is expected to entail large and long-lasting changes in inflation and employment, we will react. Our reaction depends on the resulting effects on the economy.

In textbooks on economic theory, shocks are classified as either supply shocks or demand shocks. The shocks have different implications for monetary policy. A negative demand shock results in lower output and lower inflation, warranting an expansionary monetary policy response. A negative supply shock also results in lower output, but leads to higher inflation. The monetary policy response depends on how much weight is given to supporting output and employment compared with the need to curb inflation. Flexible inflation targeting allows us to adapt monetary policy to the shocks affecting the economy and the prevailing situation.

The pandemic resulted in a sharp contraction in demand on the one hand and supply constraints on the other. Workers fell ill or were in quarantine, and businesses were ordered to close and global supply chains were disrupted. This would normally have fuelled price and wage pressures, but the rise in prices for domestically produced goods and services slowed. This was mainly because consumers reduced spending on goods and services involving Covid transmission risks, either of their own will or because of pandemic-related restrictions.¹⁴ Wage growth has also been low.

The effects were broadly similar to those caused by a large negative demand shock. A more expansionary monetary policy was therefore needed to support demand and employment in unaffected sectors. Low interest rates also helped firms and households facing income shortfalls to continue servicing their debt.

Monetary policy is a first line of defence in stabilising the economy. Policy rate decisions can be implemented rapidly, and the policy rate affects broad sections of the economy. But both the pandemic, and before that the Great Financial Crisis, have illustrated that fiscal policy must play a key role in limiting a fall in income and demand when the economy is hit by large shocks. Fiscal policy was able to target measures to support the hardest-hit sectors and groups. Unemployment benefits and furlough schemes were expanded to offset some of the income shortfalls for the most vulnerable households. Guarantees and loans to support firms have helped keep bankruptcy rates at a low level and made it easier for businesses to resume activities when the pandemic-related restrictions were removed. Such targeted measures have dampened the contraction of the real economy (Bjertnæs et al, 2021).

Low neutral real interest rate constrains policy space

At the beginning of the pandemic, monetary policy was already stretched close to the limit in many countries. Following the Great Financial Crisis and the euro crisis, central banks lowered their policy rates to historically low levels and some responded with unconventional monetary policy tools. Expansionary monetary policies were not the only reason behind low interest rates. Structural changes are also part of the explanation. Population ageing, falling productivity growth and rising demand for safe fixed-income products have driven down the real equilibrium interest rate – also called the neutral real interest rate. This is the interest rate level that provides balance between aggregate demand in an economy and its potential output.

Chart: The neutral real interest rate has fallen

The neutral interest rate is unobservable and must therefore be estimated. The chart shows the estimates of the neutral real money market rate using two different methods. Both methods show a decline over time. Other studies find similar results.

These analyses indicate that the neutral real interest rate is now around zero, which has implications for monetary policy. A lower real equilibrium interest rate has reduced the leeway in setting interest rates in that central bank policy rates cannot be set substantially below zero before there is a loss of monetary policy transmission to banks' deposit and lending rates. This means that more frequently than in the past situations can arise where monetary policy may not be as accommodative as warranted by cyclical conditions. Less monetary policy muscle will be available in downturns than in upturns. The risk is then an activity level and inflation rate that on average are lower than desired.

The fall in the neutral real interest rate and the risk of longer periods of persistently low inflation have been prominent concerns in the conduct of monetary policy internationally in recent years and have been important elements of the strategy discussions at many central banks.

In the US, the Federal Reserve has affirmed that it may be necessary to target inflation of somewhat above 2 percent after a period of inflation below target (Federal Reserve, 2020). The European Central Bank has recently introduced a symmetric inflation target of around 2 percent over the medium term, and has also signalled that if necessary inflation may lie somewhat above target for some time (ECB, 2021). For both central banks, the importance of anchoring inflation expectations to the inflation target has been key in drawing up the new strategy. By communicating that they accept, or even desire, inflation above target, they are also signalling that interest rates could remain low for a long time. This alone could make monetary policy more accommodative.

For Norway, a low neutral real interest rate also means that we might more frequently face a situation where the effective lower bound on the policy rate limits the scope for monetary accommodation. But experience suggests that this is less of a challenge for Norway than many other countries. The

Norwegian krone has a tendency to depreciate and drive up inflation in a context of a global downturn and heightened uncertainty. This can contribute to holding up inflation, thereby counteracting the actual real interest rate increase for a given nominal rate.

Low and stable inflation is the primary objective

Chart: Inflation fluctuates around the target

Low and stable inflation is the primary objective of monetary policy. Price stability is the best contribution monetary policy can make to promoting welfare, high employment and economic growth over time. An explicit inflation target provides economic agents with an anchor for inflation expectations. Provided there is confidence in low and stable inflation, variations in inflation around the target are not likely to engender any significant economic costs. We can then also take into account considerations other than inflation when assessing the monetary policy trade-offs. But if inflation persistently runs substantially above or below target, confidence in the nominal anchor may be shattered.

Monetary policy aims at stabilising inflation around the target of 2 percent. Our ambition is to avoid large and persistent deviations from the inflation target, whether above or below the target, but not to fine-tune inflation. Nor is the latter possible. Monetary policy operates with a lag, and there is uncertainty as to how the policy rate affects different parts of the economy.

In assessing the appropriate response to deviations from the inflation target, we will give weight to the causal factors and the risk of widening deviations. We will often choose to look through short-term variations in inflation. This autumn's price movements are a good example. In September, annual CPI inflation was just over 4 percent, while indicators of underlying inflation were substantially lower. The difference mainly reflects the sharp rise in energy prices in recent months, prices that have shown wide variations previously.

How quickly we seek to return inflation to target will depend on whether there are conflicts between the policy stance required to reach the inflation target and the other monetary policy considerations. When inflation is below the target, activity in the real economy may influence how fast it is appropriate to bring inflation up to the target again. When we set the policy rate, we will normally seek to bring inflation up faster if economic activity is low than if activity is high. In a context of above-target inflation, we will aim to bring inflation down faster when activity in the real economy is high than when activity is low.

Since inflation targeting was introduced two decades ago, it has gradually become more flexible. At the start, the aim was to stabilise inflation around the target within two years. The horizon was later extended to "one to three years" and then to the "medium term". We were able to make these changes because inflation expectations have been firmly anchored around the target (Meld. St. 8 (2017-2018)). How quickly we seek to return inflation to target can then be

balanced against the other monetary policy considerations. This provides scope for giving more weight to output and employment when the economy is exposed to large and persistent shocks.

Monetary policy can contribute to high employment

Monetary policy cannot take primary responsibility for the level of output and employment but will in normal times be a first line of defence in stabilising the economy.

As I touched upon earlier, there were good reasons to lower the policy rate to a historically low level in March last year. We are emerging from a downturn that has been historically deep. When the pandemic hit Norway and the economy was shut down in the first half of 2020, almost 10 percent of the labour force was registered as fully unemployed. Conditions have improved since then, and unemployment has fallen back close to pre-crisis levels.

Chart: The number of long-term unemployed is still high

But the number of long-term unemployed is still high, while labour demand has increased sharply in recent months. According to our estimates, the number of job vacancies as a share of the labour force is now at the highest level recorded since before the Great Financial Crisis (Norges Bank, 2021). This probably reflects temporary adjustment problems in the wake of the pandemic, but may also be a sign of mismatch between the skills of the unemployed and those required by employers. If that is the case, unemployment may become entrenched at a higher level than before the pandemic.

In our operational interpretation of the mandate, high and stable output in practice goes hand in hand with high and stable employment.²¹ In principle, employment close to a level representing full employment, where anyone who is willing to work has a job to go to, is a positive thing. Where that level lies, however, is uncertain and will vary over time, depending on how many of the unemployed or those outside the labour force are willing or able to get a job.

Chart: What is full employment?

The dark blue line in the chart shows developments in the labour force, which comprises the employed and active job seekers. The figures are based on Statistics Norway's Labour Force Survey. If we include persons reporting that they want to find a job, even if they are not actively seeking work, the level is even higher, as shown by the yellow line. The light blue line denotes the population divided into a number of groups based on age and sex and shows the level of total employment if each of these groups reaches their highest historical level. The level has changed in pace with changes in demographics and employment rates within the groups.

It is unrealistic for actual employment to reach a level that could represent full employment. Even in a well-functioning labour market with low unemployment, there will always be people looking for new jobs and employers looking for new

workers. In practice, wage and price inflation will also tend to accelerate before the level representing full employment is reached.

Chart: Employment consistent with price stability? (I)

In the conduct of monetary policy, we aim to achieve the highest level of employment that is consistent with price stability over time. The level is primarily determined by structural conditions such as the tax and benefit system, wage formation and labour force composition. Monetary policy's task is to *contribute* to stabilising employment around this level.^[3]

The economic costs of cyclical fluctuations are asymmetric. In the conduct of monetary policy, high employment is only undesirable to the extent it leads to wage and price inflation that is too high. Low employment, on the other hand, can result in inflation that is too low, but also involves direct costs in the form of lost wealth creation and financial and health consequences for those who do not find a job.

Our monetary policy response pattern seeks to take account of asymmetric costs. In a situation where unemployment is lower than normal, we will not necessarily tighten monetary policy, as long as inflation is expected to remain in a range close to 2 percent and there are no signs that financial imbalances are building up. However, we will be more inclined to conduct an expansionary monetary policy when unemployment is higher than normal.

Chart: Employment consistent with price stability? (II).

So-called hysteresis effects can also contribute to asymmetry in the costs of cyclical fluctuations. When downturns are deep and protracted, unemployment can become entrenched at a high level, with many job seekers eventually withdrawing from the labour market. Wage and price inflation can then accelerate at a lower level of employment than before the downturn. The level of employment that is consistent with stable inflation will fall.

The long-term unemployed find it more difficult than the short-term unemployed to find a job when labour demand increases (Fevang, Markussen and Røed, 2020). There are a number of reasons for this. People who are out of work for a long period can lose the necessary skills or motivation to apply for a new job, and their skills may not match those required by potential employers. A study on the 2014 oil crisis showed that the chances of being employed were lower for those in particularly vulnerable areas, even five years after the crisis (Ellingsen and Galaasen, 2021). Many dropped out of the labour force after a long period of unemployment.

Price and wage pressures in the economy will normally be lower when unemployment is high, making it easier for the unemployed to find new jobs. A number of empirical and theoretical research studies have, however, highlighted that the long-term unemployed and persons with weak attachment to the labour market have limited influence on wage formation. Our own analyses show that downward pressure on prices primarily comes from

the *short-term* unemployed. Thus, for a given level of total unemployment, a larger share of long-term unemployed will result in *higher* wage and price inflation than if the unemployed are largely short-term. Prices and wages will be pushed up as short-term unemployment returns to a low level.

To avoid long-term or permanent falls in employment, it may be necessary to take early and forceful action at the beginning of a downturn. In such situations, it may also be appropriate to accept that inflation will temporarily overshoot the target while labour market conditions normalise. By preventing downturns from becoming deep and protracted and short-term unemployment from turning into long-term unemployment and exclusion, monetary policy can contribute to keeping the average level of employment over time as high as possible.

Low interest rates increase the risk of financial imbalances

Low interest rates over the long run increase the risk of a build-up of financial imbalances. The highly accommodative monetary policy stance through the pandemic has contributed to rapid house price inflation in Norway as in many other countries. These developments reflect the specific nature of the downturn, which has had an uneven impact. Even though many people have lost their job or been furloughed, household incomes have largely held up. At the same time, consumption opportunities have been limited, with many people spending much of their leisure time as well as their working hours at home. A historically low interest rate level has made it easier for households to service their mortgages.

Chart: House prices and debt have been rising for a long time

The rise in house prices in Norway during the pandemic comes on top of a long period of rapid house price inflation. Household debt ratios have risen considerably in pace with the rise in house prices. While existing homeowners have benefited from higher prices in terms of home equity gains, many households have taken up loans to enter the housing market.

A sharp rise in house prices and rapid debt accumulation may make households more vulnerable to income shortfalls, augmenting the risk of future severe downturns. Large and abrupt falls in house prices or income during an economic downturn may cause heavily indebted households to tighten consumption, further amplifying the downturn.

The monetary policy consideration of mitigating financial imbalances derives from the consideration of high and stable output and employment. A persistently low interest rate level can sow the seeds of increased risk-taking, soaring property prices and rapid debt accumulation. If there are signs that financial imbalances are building up, the need to maintain high and stable output and employment may warrant a slightly higher policy rate than otherwise. This can help reduce the risk of severe downturns.

On the other hand, a higher policy rate can involve costs in the form of lower demand and inflation in the near term (Gourio, Kashyap and Sim, 2017). In the practical conduct of monetary policy, we seek to weigh these costs against the benefits.

Short-term stability does not necessarily conflict with longer-term stability. House prices and credit often rise sharply typically in periods when the level of economic activity is high and inflation is accelerating. A tighter monetary policy will then contribute to both greater stability in the short term and a lower risk of a severe downturn further out.

Monetary policy cannot take primary responsibility for mitigating the build-up of financial imbalances. In the long run, house price inflation and debt growth are largely determined by income growth, the tax system, the neutral real interest rate and housing and credit market regulation. These are conditions over which monetary policy has little sway. The regulation and supervision of financial institutions are the most effective means to counter shocks to the financial system.

Monetary policy cannot influence long-term trends

If interest rate setting is to work as an effective economic policy instrument, it must not be overburdened. Monetary policy cannot influence or take responsibility for structural trends, such as changes driven by technology, demographics, globalisation or changes in the way we organise our welfare system.

Let me give you a concrete example. Changes in economic inequality over time are largely the result of factors outside the reach of monetary policy. Globally, greater trade with low-cost countries, new technology and changes in tax and benefit systems are among the factors cited to explain the increase in inequality in many countries in recent decades.

But persistently low interest rates affect income and wealth inequality. Property and other asset prices rise while debt-servicing costs fall. Nevertheless, monetary policy is not a well-suited distributional policy instrument. This is partly because the policy rate is a blunt instrument for addressing inequality. In addition, there is a limit to how many objectives monetary policy can seek to attain without prejudice to its main tasks, which are to maintain price stability and contribute to high and stable output and employment.

Another factor that could potentially have far-reaching consequences for economic developments is related to climate change. Measures to reduce greenhouse gas emissions will affect the structure of the economy in general and industries linked to oil and gas production in particular. This could change how shocks affect the economy and the way interest rates operate (NGFS, 2020).

The policy rate is not a well-suited instrument for influencing climate change, but in its work on monetary policy Norges Bank strives to expand its knowledge

of how climate-related measures and climate change affect economic developments.

Conclusion

Allow me to conclude.

After two decades of inflation targeting, the regime has proved to be robust. It has passed the test of several major shocks, most recently during the pandemic. An important reason is the evolution towards a more flexible approach to targeting inflation. This provides a good platform on which we can continue to build. We have also learned a number of lessons, which I will summarise in three points:

First: As long as inflation expectations are firmly anchored, moderate deviations from the inflation target do not entail substantial economic costs.

Second: The conduct of monetary policy involves trade-offs between different considerations. When inflation targeting is forward-looking and flexible, it can also contribute to high and stable output and employment and to mitigating the build-up of financial imbalances.

Third: Monetary policy can function as a first line of defence in stabilising the economy, but it cannot stand alone when the economy is hit by large shocks. Fiscal policy must then play a key role, as it did during the pandemic.

And finally, as I mentioned by way of introduction, Norges Bank's monetary policy strategy must continuously be developed in the light of the experience gained. *That* is an important part of the mission assigned to the Bank's Monetary Policy and Financial Stability Committee.

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Footnotes

[1] Guerrieri et al (2020) have presented the situation as a “Keynesian supply shock”, where a negative supply shocks causes demand shortages that lead to a contraction in output larger than the supply shock itself. The lockdown also caused demand to fall in sectors that were not directly affected.

[2] We use the output gap as the starting point for our assessment of developments in the real economy. Even though the output gap is defined relative to mainland GDP, our calculation of the size of the gap is particularly based on labour market developments. This means that we normally look through short-term fluctuations in labour productivity.

[3] In our monetary policy assessments, we will regularly update our estimates of how high employment can rise before it conflicts with the overall objective of price stability.