Norwegian monetary policy in the age of the euro

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Introduction

Welfare and prosperity in Norway rely on the free movement of goods, services, capital and knowledge. The EU accounts for about 80 per cent of Norway's foreign trade. By virtue of the EEA Agreement, Norway is part of the internal market. The Norwegian economy is interwoven with European economies. This has also been reflected in Norway's monetary policy throughout much of the post-war era.

Monetary policy's most important task is to provide a nominal anchor for the economy. Since the Second World War, there have been several monetary policy reforms in Norway. In the period between 1972 and 1986, monetary policy was to a limited extent focused on curbing the effects of cost shocks on prices.

During this period, inflation was high and variable. Consumer prices rose almost twice as much as in Germany. At the same time, the krone's value against the German mark was almost halved.

From 1986 to 1992, Norway operated a fixed exchange rate regime. The fixed exchange rate was the anchor for inflation in Norway. The difference between inflation in Norway and Germany narrowed substantially.

From 1986 to 1990, monetary policy was oriented towards maintaining a fixed exchange rate against a trade-weighted basket of currencies. In 1990, the krone was pegged to the European currency unit, the ECU. The peg was abandoned in December 1992 when international currency turbulence compelled Norway and several other countries to discontinue the fixed exchange rate system against the ECU. However, monetary policy was still geared towards maintaining a stable krone exchange rate against European currencies. The ECU was used as the main reference for European currencies. The euro took over this role when it was introduced on 1 January 1999.

Developments since the beginning of 1997 indicated that the exchange rate was no longer an appropriate operational target of monetary policy. Norges Bank therefore placed increasing emphasis on low and stable inflation as a precondition for exchange rate stability. In our opinion, the best contribution monetary policy could make to a stable krone exchange rate against the euro was low and stable inflation in line with inflation in the euro area. Monetary policy was therefore oriented towards bringing inflation over time into line with that aimed at by the European Central Bank.

Guidelines for economic policy in Norway

On 29 March, the Government issued new guidelines for monetary policy. Monetary policy shall now be oriented towards low and stable inflation. The operational target of monetary policy is consumer price inflation of 2½ per cent. At the same time, new guidelines for fiscal policy were drawn up, providing for the use of petroleum revenues over the central government budget equivalent to the expected real return on the Government Petroleum Fund.

The new guidelines for monetary policy did not entail any significant change in the conduct of monetary policy. Quantifying an inflation target, in line with international practice, has made it easier to explain and understand Norwegian monetary policy.

The implementation of monetary policy

Monetary policy influences the economy with considerable and variable lags. 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.

The effects of interest rate changes are uncertain. In addition, it may be difficult to assess the current situation. Different indicators may point in various directions and economic statistics are normally published with a lag. This suggests that a gradualist approach to setting interest rates is appropriate. We will then acquire new knowledge and can adjust interest rates underway.

If evidence suggests 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. There is symmetry here. It is just as important to avoid an inflation rate that is too low, as it is to avoid an inflation rate that is too high.

Economic policy in the euro area

The introduction of the euro on 1 January 1999 also meant the introduction of a single monetary policy in the eleven member countries. Greece joined as the twelfth country on 1 January 2001. The population of the euro area is a little more than 300 million and the euro area economy accounted for about 16 per cent of world GDP last year.[1] Price stability is the primary objective of the single monetary policy in the euro area. The Governing Council of the European Central Bank has defined price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 per cent. The project will be completed in January and February 2002. On 1 January, euro banknotes and coins will be put into circulation. During a changeover period, national currencies can be used as a means of payment alongside the euro. This period is no longer than two months in any of the member countries. As from the beginning of March, the euro will be the only legal tender in all euro area countries, and all prices will be in euros.

The objective of monetary policy in the euro area is price stability in the euro area as a whole. If asymmetric shocks across euro area countries occur, the national authorities can use fiscal policy to stabilise economic developments. While adhering to the Stability and Growth Pact, fiscal policy could become more effective in the small and medium-sized economies since the exchange rate and interest rates will not in principle be affected. In addition, local wage determination and investment flows will over time contribute to reducing differences in profitability and production costs.

The responsibility for fiscal policy rests with the national government of each euro area country. Fiscal policy can be adapted to the economic situation, provided the provisions of the Stability and Growth Pact are adhered to. Under the Pact, Member States are committed to pursuing the medium-term objective of budgetary positions close to balance or in surplus. Fiscal policy can be used to deal with cyclical fluctuations, but the budget deficit must not exceed 3 per cent of GDP unless it is deemed to result from an unusual event or severe economic downturn.

In Norway, fiscal policy also has a long-term anchor, and monetary policy is oriented towards low and stable inflation. The guidelines for the use of petroleum revenues set limits on the structural budget deficit. Like the Stability and Growth Pact in the EU, these guidelines will contribute to economic stability.

The economic situation and the monetary policy stance

Growth forecasts for the global economy have been revised downwards markedly in recent months. Since December 2000, growth forecasts for our trading partners have been halved for 2001. The tragic events of 11 September will have a further dampening effect on activity in the US, Asia and European economies.

In the euro area, high oil prices, livestock diseases, the decline in the ICT sector and reduced demand in the US have had a negative impact on economic developments. GDP growth has also slowed considerably over the last year. Unemployment has shown a substantial decline in recent years and is low in many of the smaller countries. Unemployment is high in the large countries. Particular structural features, such as wide regional disparities, are contributing to the high level of overall unemployment. The terrorist attacks of 11 September have reduced demand in the aviation and travel industries. The European Central Bank has cut its key rates by 1 percentage point so far this year.

Until the autumn, the Norwegian economy had remained relatively insulated from the world economic slowdown. It now appears clear that Norway will also be affected by the slowdown. A number of Norwegian enterprises in export industries and the travel industry have felt the effects of growing caution among households and businesses worldwide. Investment in mainland enterprises will probably also decline.

However, the economic situation in Norway is different from that of the euro area. The Norwegian economy is still characterised by high capacity utilisation with a limited supply of labour. Registered unemployment has been low and stable since the autumn of 1998. Employment is growing sharply in the public sector and the construction industry.

In recent years, consumer price inflation has been higher in Norway than among our trading partners. The year-on-year rise in prices was 2.4 per cent in September. Stable prices for imported consumer goods is contributing to containing inflation in Norway. The rate of increase in prices that is primarily influenced by domestic costs is high.

It is not a new phenomenon that Norway is at a different stage of the business cycle than the euro area countries. One reason for this is that changes in the external environment often have a different impact on the Norwegian economy than other European economies. For example, a sharp rise in oil prices has a dampening impact on purchasing power and the activity level in the euro area. In contrast, this tends to boost petroleum investment and household confidence in Norway. The development of a national oil industry and restructuring in the 1980s and 1990s have also contributed to a cyclical path that is specific to Norway. For example, petroleum investment was probably one of the main driving forces behind the booms in the mid-1980s and in 1997-1998.

Norwegian labour costs have risen by 5-6 per cent annually in recent years, while labour costs in the euro area countries have increased by less than 3 per cent annually. When cyclical developments are not synchronised and labour costs are at different levels, interest rates will also vary.

In the current situation, Norwegian interest rates on a par with interest rates in the euro area would lead to instability. If monetary policy had not contributed to curbing demand, the pressure on economic resources would have led to accelerating inflation.

Countries participating in EMU have gained access to a large, liquid financial market in their own currency, with low transaction costs. The risk of exchange rate losses associated with cross-border investment and borrowing in the euro area has been eliminated. This can result in substantial gains, not least for some of the smaller countries. The business sector in the euro area is taking advantage of this. The volume of bonds issued by non-financial corporations has increased substantially each year since the introduction of the common currency in January 1999.

Financial markets are small and fairly illiquid in Norway compared with the euro area. Combined with the uncertainty associated with exchange rate developments, this can add a premium on the required rate of return on investments in NOK. This can in turn contribute to a higher long-term interest rate in Norway than in the euro area countries over time. In the long term, financial market participants expect Norwegian interest rates to be close to 1 percentage point higher than in the euro area.

Exchange rate developments after the introduction of the euro

Before the introduction of the euro on 1 January 1999, it was assumed that the establishment of a large currency area in Europe could result in more substantial exchange rate fluctuations than earlier. Foreign trade for EMU as a whole accounts for a smaller portion of the economy than for Germany, for example. The focus on exchange rate changes could thus be expected to fade. The Norwegian krone would also be affected by such increased fluctuations.

For Norway and other countries on the rim of the euro area, exchange rate fluctuations have not increased since the introduction of the euro. To the contrary, the effective exchange rates for pound sterling, the Swiss franc, the Swedish krona and the Norwegian krone have varied somewhat less than in the period 1996-1999. These currencies have also fluctuated somewhat less against the euro than they did against the German mark the last few years before 1999.

Market participants also seem to assess the risk of future short-term fluctuations in the krone exchange rate against the euro as fairly moderate. This uncertainty, which is indicated by the costs of hedging against future exchange rate fluctuations in the short term, is now relatively limited for the Norwegian krone compared with other currencies on the rim of the euro area.

Changes in the terms of trade are an important source of exchange rate fluctuations. The terms of trade measure the prices for goods and services that we export in relation to the prices for those we import. Commodities account for a substantial share of Norwegian exports. Commodity prices are subject to wide variations. Experience shows that a deterioration in the terms of trade results in a depreciation, whereas an improvement leads to an appreciation. The exchange rate thus acts as a stabiliser, a buffer that partly curbs the effects of changes in the terms of trade on economic activity. Developments in the krone exchange rate can also contribute to restraining the effects on prices of higher wage growth and other domestic cost disturbances when there is confidence that inflation will be stable over time.

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. The Fund has thus diminished the impact of short-term fluctuations in oil prices 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. The relatively low level of uncertainty that market participants seem to attach to krone exchange rate developments may be a reflection of this.

Introduction of euro banknotes and coins

The introduction of euro banknotes and coins from 1 January 2002 has no direct consequence for Norwegian monetary policy. For households and businesses in the euro area, the new currency will become a physical reality, not just an accounting currency. The practical advantages of the common currency will become more apparent. The euro may be used in twelve countries. The costs connected with currency exchange between the twelve countries disappear. When the national currencies are withdrawn, price differences between the euro area countries will become more apparent. The result may be increased competition and lower interest rates over time. Euro area citizens will develop a more positive attitude to the euro as their money. They will experience that the euro is stable, as it will be reflected in a stable level of retail prices.

The changeover period, from the introduction of euro banknotes and coins until the national currencies cease to have legal tender status, is short. Norwegian enterprises and households will also have to exchange their cash in euro area countries' national currencies. There seems to be a perception that exchange between two foreign currencies in Norwegian banks must be made via Norwegian krone, so that two exchange transactions are actually made, with fees being charged twice. I would like to use this opportunity to point out that there is no rule that stipulates that, for example, German banknotes are to be exchanged into Norwegian banknotes before being exchanged into euro banknotes.

The UK, Sweden and Denmark have so far chosen to remain outside EMU. Sweden and the UK have inflation targets and floating exchange rates, while Denmark's monetary policy is oriented towards a fixed exchange rate against the euro. These three countries are important to Norway, both because of their geographical proximity and because they account for close to 40 per cent of Norway's foreign trade. If these countries join EMU some time in the future, it is possible that the use of the euro by Norwegian households and businesses will increase somewhat. However, extensive use of the euro as a means of settling domestic payment transactions is unlikely. In those cases where we have seen partial or total currency substitution, such as in some countries in Eastern Europe and Latin America, it has usually been a result of strongly deteriorating confidence in the local currency. Confidence can deteriorate when inflation is high and variable or when government finances are on the verge of collapse.

By influencing the volume of NOK in circulation, Norges Bank will always be able to ensure that the internal value of the Norwegian krone is maintained in line with the guidelines for monetary policy.

If the introduction of the euro increases efficiency and economic growth in the participating countries, this will have positive spillover effects on the Norwegian economy. Stable economic developments in the euro area are also very important for the Norwegian economy.

Thank you for your attention.

GDP calculated in a common currency based on purchasing power parity.