

Norges Bank's monetary policy strategy statement

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Norges Bank's Monetary Policy and Financial Stability Committee has adopted a monetary policy strategy. The strategy describes the Committee's interpretation of the monetary policy mandate and provides a framework for the Committee's assessment of how monetary policy will respond to different shocks. The strategy will be developed over time based on knowledge about the functioning of the economy and the monetary policy experience of Norway and other countries.

Monetary policy tasks

Norges Bank's monetary policy mandate is laid down in the Central Bank Act and the Regulation on Monetary Policy. The primary objective of monetary policy is to maintain monetary stability by keeping inflation low and stable. This is articulated in the Regulation on Monetary Policy by specifying that the operational target is annual consumer price inflation of close to 2 percent over time. The Regulation also states that inflation targeting shall be forward-looking and flexible so that it can contribute to high and stable output and employment and to counteracting the build-up of financial imbalances.

Economic developments can have a bearing on the degree to which monetary policy can fulfil the different objectives in the mandate. Over the past 20 years, global interest rates have gradually declined, largely owing to the fall in the equilibrium real rate of interest, which is the rate that creates balance between aggregate demand and production capacity. The fall in the equilibrium real interest rate is a global trend, which is likely due to various factors such as falling productivity growth, population ageing, rising demand for safe fixed-income products and the legacy of the financial crisis. Whether a persistently expansionary monetary policy in major economies has also played a role is a matter of discussion among economists. As a small open economy with free capital movements, the interest rate level in Norway cannot over time be substantially higher than the interest rate level among its trading partners. This global trend has therefore had implications for the interest rate level in Norway and poses challenges to achieving the monetary policy objectives.

One of the challenges posed by the fall in the equilibrium real interest rate is that it has reduced monetary policy space. There is a limit to how low central bank policy rates can be set without losing monetary policy transmission to bank lending rates. A lower equilibrium real interest rate will in isolation reduce the distance down to the policy rate's lower bound, which may impair central banks' ability to mitigate strong negative shocks by means of expansionary monetary policy.

Another challenge posed by the fall in the equilibrium real interest rate, particularly in combination with an expansionary monetary policy, is that financial imbalances may build up. This increases the risk of severe economic downturns in the future. In its conduct of

monetary policy, the Bank also seeks to promote economic stability in the longer term by taking into account the risk of financial imbalances accumulating.

Both the fall in the equilibrium real interest rate and the day-to-day implementation of monetary policy have implications for wealth and income distribution. Lower interest rates push up asset prices, which benefits homeowners and owners of other assets, while reducing interest expenses and increasing disposable income for households with residential mortgages. A more indirect distributional effect is that fewer people will lose their jobs and wage income when the policy rate is lowered to curb an economic downturn. Even though monetary policy affects income and wealth distribution, the policy rate is not a well-suited distributional policy instrument. First, the policy rate is a blunt instrument for achieving distributional objectives. Second, there is a limit to how many objectives one instrument can seek to fulfil without prejudice to the main tasks of monetary policy, ie to maintain price stability and contribute to high and stable output and employment in the short and long term. Nevertheless, the central bank must take into account income and wealth distribution in interest rate setting, among other reasons because it affects monetary policy transmission to aggregate demand.

Structural trends over which interest rate setting has little or no influence may also have implications for monetary policy. Climate change is one example. The policy rate is not a suitable instrument for influencing climate change, but measures to reduce greenhouse gas emissions will affect the structure of the economy and hence the conduct of monetary policy. In addition, the increased frequency of climate-related natural disasters and extreme weather events worldwide may affect the Norwegian economy and make monetary policy trade-offs more demanding. In periods of structural changes and considerable uncertainty, for instance caused by climate-related changes, it is even more important than otherwise for monetary policy to contribute to price stability and stability in the real economy.

The following provides a further account of how Norges Bank will deliver low and stable inflation, promote high and stable output and employment and seek to mitigate a build-up of financial imbalances. A description of the general features of the monetary policy response pattern and relevant instruments is also presented.

Low and stable inflation

When setting the policy rate, Norges Bank aims to stabilise inflation around 2 percent. 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.

Persistently high inflation is costly to society, among other reasons because it leads to uncertainty about the value of money and makes economic planning difficult. Some inflation provides flexibility in the economy in that changes in relative real wages across different sectors and occupational groups do not necessarily entail nominal wage cuts. In addition, some inflation increases monetary policy space because there is a limit to how low policy rates can be set before there is a loss of transmission to banks' lending rates. With some

inflation, the average level of the nominal interest rate for a given level of the equilibrium real interest rate will be higher and hence the distance to the lower bound greater.

It is not possible to fine-tune inflation, but in interest rate setting the Bank gives weight to avoiding large and persistent deviations from the inflation target, whether above or below the target. How quickly the Bank seeks to return inflation to target will depend on the shocks that have occurred and whether there are conflicts between the policy stance needed to reach the target and other monetary policy considerations. When inflation is below target, activity in the real economy will influence how fast it is appropriate to bring inflation back up again. The Bank will normally set the policy rate to bring up inflation faster if economic activity is low than if activity is high. Correspondingly, in a context of above-target inflation, the Bank will aim to bring down inflation faster when activity in the real economy is high than when activity is low.

The annual rise in the consumer price index (CPI) is used by the Bank as a target variable, which the Bank's monetary policy seeks to stabilise around the inflation target. However, because CPI inflation fluctuates considerably in the short term and because the Bank's monetary policy largely chooses to see through short-term fluctuations, the Bank uses several indicators of underlying inflation. In Norway, short-term fluctuations in CPI inflation are most often caused by large short-term changes in energy prices. The CPI adjusted for tax changes and excluding energy products (CPI-ATE) is therefore an important indicator used in the Bank's inflation assessments.

High and stable output and employment

In its conduct of monetary policy, Norges Bank seeks to stabilise employment around the highest level that is consistent with price stability over time. Normally, the aim is to maintain employment close to a level representing full employment, where those willing to work have a job to go to. However, in practice, wage and price inflation will tend to accelerate before this level is reached. The relationship between the level of economic activity and wage and price inflation is uncertain and will likely vary over time. When setting monetary policy, the estimated rate of employment that can be reached before prices and wages accelerate is an important part of the Bank's monetary policy assessments.

The highest level of employment that is consistent with price stability over time is primarily determined by structural conditions such as the tax and benefit system, wage formation and labour force composition. If Norges Bank systematically seeks to bring employment above this level by means of an expansionary monetary policy, a period of tighter monetary policy and higher unemployment may be necessary at a later stage in order to restore price stability.

Norges Bank estimates an output gap, which is used as an indicator in assessing output and employment relative to the highest level that is consistent with price stability over time. When estimating the output gap, particular weight is given to labour market developments, while short-term fluctuations in labour productivity are normally disregarded. There is therefore no conflict between high and stable output and high and stable employment in the Bank's operational interpretation of the mandate.

The economic costs of cyclical fluctuations are asymmetrical, which the Bank's monetary policy response pattern seeks to take into account. Normally, an increase in employment beyond what the Bank estimates to be the highest level consistent with price stability involves no direct costs. Only the indirect costs – wage and price inflation becoming too high – will normally prompt the Bank to seek to counteract such an increase. As long as inflation is expected to remain within a range close to 2%, the Bank will not normally aim to quickly close a positive output gap by tightening monetary policy unless there are signs that financial imbalances are building up. Lower employment, on the other hand, involves direct costs both in the form of losses in aggregate income and output and in the form of economic and health consequences for those unable to find employment. When the Bank estimates a negative output gap, this implies in isolation that the Bank will pursue an expansionary monetary policy to stimulate employment.

Possible 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. To avoid a sharp downturn from resulting in long-term or permanent falls in employment, it may be appropriate to accept that inflation will temporarily overshoot the target while labour market conditions normalise. By preventing downturns from becoming deep and protracted, monetary policy can contribute to keeping the average level of employment over time as high as possible.

Mitigating the build-up of financial imbalances

The build-up of financial imbalances increases the risk of a severe downturn further out. The consideration of mitigating financial imbalances therefore derives from the consideration of high and stable output and employment over time.

Monetary policy cannot take primary responsibility for mitigating the build-up of financial imbalances. The regulation and supervision of financial institutions are the most important tools for cushioning shocks to the financial system.

A persistently low interest rate level can sow the seeds of increased risk-taking, soaring property prices and rapid debt accumulation. High debt makes households and firms more vulnerable to income shortfalls, augmenting the risk of a severe downturn in the future. If there are signs that financial imbalances are building up, the consideration of longer-term stability may warrant maintaining a somewhat higher policy rate than the consideration of maintaining high and stable output and employment in the short term may suggest. How much higher the interest rate is set depends in part on other regulations and their effect.

Setting a higher policy rate to mitigate the build-up of financial imbalances may involve costs in the form of lower demand in the near term. In the Bank's monetary policy assessments, reducing the risk of a severe downturn in the long term is weighed against maintaining high and stable output and employment in the near term. In many situations, the degree of conflict between the two considerations will be minimal. In an upturn, for example, house prices and

credit will tend to rise sharply. A tighter monetary policy stance will then contribute to both greater stability in the short term and a lower risk of a severe downturn further out. In a situation where the risk of a severe downturn is acute, both the need to stabilise the real economy and maintain financial stability could suggest a rapid reduction of the policy rate as this could counteract a sharp decline in asset prices, which could have triggered or amplified a downturn.

In some situations, there may be a greater conflict between short-term and long-term stability. In a downturn, the policy rate will normally be lowered to cushion the contraction. Even though a lower level of economic activity also dampens house price inflation and debt growth, a lower policy rate will in isolation stimulate the housing market. Such stimulus will often be desirable and contribute to dampening the decline in economic activity, but in some cases house prices and debt can rise to such a high level that it conflicts with the aim of long-term stability. This would then provide grounds for lowering the policy rate somewhat less or starting to normalise the policy rate slightly earlier than suggested by the need to support activity in the short term.

Instruments and response pattern

Norges Bank's main monetary policy instruments are the policy rate, which is the interest rate on banks' deposits in Norges Bank up to a specified quota, and forward guidance, including the policy rate forecast. To ensure that the policy rate passes through to other market rates, Norges Bank sets the terms and conditions for banks' loans and deposits in Norges Bank so that banks benefit from lending to one another at a rate close to the policy rate.[1]

The policy rate influences inflation and the real economy with a lag, and the effects are uncertain. To reduce the risk of monetary policy contributing to economic instability, Norges Bank will normally respond less forcefully to shocks than if there had not been uncertainty about the transmission of monetary policy. Furthermore, the policy rate is normally changed gradually to make monetary policy more predictable and to reduce the risk of undesirable financial market volatility and unexpected reactions of households and firms. In situations where the risk of particularly adverse outcomes is pronounced, or if there is no longer confidence that inflation will remain low and stable, it may be appropriate to react more forcefully than normal in interest rate setting.

The economy may at times be exposed to such large negative shocks that the policy rate cannot be set as low as the shock might suggest because there is a limit to how low the policy rate can be set and still pass through to banks' lending rates. It is uncertain where this level lies for Norges Bank's policy rate, but based on the experience of other central banks, it is likely somewhat below zero. The Bank does not rule out that a negative policy rate may also become relevant for Norway, for example, if there is a need for a very expansionary monetary policy stance in a situation where financial market stress results in tight financial conditions despite other measures such as extraordinary loans to banks. However, Norges Bank will

normally be very reluctant to set a negative policy rate, partly because it may have an undesirable and unintended impact on financial markets.

Other central banks use instruments such as government bond purchases to influence long-term rates. This is less relevant for Norges Bank because the share of fixed-rate loans is relatively low and Norway's government bond market is much smaller than in many other countries. The Bank's assessment is that the costs of using such instruments may outweigh the benefits. Norges Bank would have to be faced with highly exceptional circumstances to use foreign exchange market interventions to increase the degree of monetary accommodation in situations where the room for further policy rate reductions has been exhausted. However, in response to extraordinary conditions in the NOK market, intervention could be warranted to help stabilise the market, which the Bank did in March 2020.

In normal business cycles, monetary policy serves as the first line of defence in stabilisation policy. However, there is substantial fiscal space in Norway, and the experience of using both monetary and fiscal policy measures in addressing severe economic downturns has been positive. Monetary policy and fiscal policy have different characteristics and can be complementary in many situations. Policy rate decisions can be implemented quickly, and the policy rate has a broad effect on the economy. Deciding on and implementing fiscal policy measures often take longer but can on the other hand be more targeted. The latter is particularly important when shocks affect different population groups very unevenly, as exemplified by the Covid-related containment measures. Fiscal policy will also be important in situations where the economy is broadly affected by a downturn, but the room for further rate cuts has been exhausted.

Footnote

[1] For a further description of liquidity management, see Norges Bank Papers 3/2021.