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Modernisation of the Regulation on Monetary Policy

Norges Bank refers to the letter from the Ministry of Finance of 21 February 2018 on the guidelines for monetary policy, enclosing a draft regulation submitted to Norges Bank for comment pursuant to Section 2, third paragraph, of the Norges Bank Act.

In Norges Bank's assessment, the monetary policy framework has worked well.[1] Inflation has been low and stable, and the inflation target has anchored inflation expectations. During the period of inflation targeting, the Norwegian economy has been exposed to major shocks. A flexible inflation targeting regime has helped to dampen the impact on output and employment.

In the opinion of Norges Bank, the new regulation clarifies the monetary policy mandate and underpins the Bank's flexible approach to inflation targeting. In Norges Bank's assessment, the new regulation will not result in significant changes in the conduct of monetary policy.

In the following, the Bank provides a further account of its understanding of the formulation of the regulation.

Section 1 of the regulation reads as follows:

"Monetary policy shall maintain monetary stability by keeping inflation low and stable."

The regulation thus clarifies the primary task of monetary policy. Price stability is the best contribution that monetary policy can make towards sound and stable economic developments over time.

Section 3 of the regulation reads as follows:

"The operational target of monetary policy shall be annual consumer price inflation of close to 2 percent over time."

[1] In connection with the work to modernise the Regulation on Monetary Policy, the Ministry of Finance asked Norges Bank to assess its experience with the monetary policy framework in Norway since 2001. The memo containing the Bank's assessments was submitted to the Ministry of Finance on 31 January 2017 and is published on Norges Bank's website.

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It is not possible to quantify precisely an optimal inflation target for the Norwegian economy. A numerical target of 2 percent is consistent with the inflation target of most of Norway's trading partners.

It is difficult to find compelling arguments for setting an inflation target in Norway today that differs from that of surrounding countries. In 2001, when inflation targeting was introduced, the Norwegian economy was in a situation where increasing oil revenues would gradually be phased into the economy. It was widely expected that the phasing-in of revenues would entail an appreciation of the real exchange rate. At the time, the numerical target was set at 2.5 percent. The reasoning was that an expected real appreciation could then occur partly in the form of wider price and cost differentials between Norway and its trading partners. The period of rising oil revenue spending now appears largely to be over.

Over time, lower average inflation owing to a lower inflation target will result in a correspondingly lower nominal interest rate. International experience has shown that the room for manoeuvre in monetary policy is not exhausted when the policy rate is close to zero. In Norges Bank's assessment, the room for manoeuvre in monetary policy will be sufficient with a 2 percent inflation target.

Section 3 of the regulation continues:

"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."

This formulation is consistent with how monetary policy has been conducted in practice. Over time, the horizon for achieving the inflation target has been extended. Monetary policy has become more flexible.

Norges Bank will set the interest rate with the aim of stabilising inflation around the target in the medium term. The horizon will depend on the disturbances to which the economy is exposed and the effects on the outlook for inflation and the real economy. In its conduct of monetary policy, Norges Bank will take into account indicators of underlying consumer price inflation.

As long as there is confidence that inflation will remain low and stable, monetary policy can contribute to smoothing fluctuations in output and employment. A flexible inflation targeting regime can prevent downturns from becoming deep and protracted. This can reduce the risk of unemployment becoming entrenched at a high level following economic contractions. Nevertheless, monetary policy cannot assume primary responsibility for high output and employment. The level of output and employment over time depends on overall economic policy, including the tax and social security system, the wage formation process and the functioning of the labour market.

The regulation and supervision of financial institutions are the primary means of addressing shocks to the financial system. To some extent, monetary policy can contribute to counteracting the build-up of financial imbalances and thereby reduce the risk of sharp economic downturns further ahead. How much weight this consideration will be given in the

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conduct of monetary policy will be situation-dependent and must be based on an overall assessment of the outlook for inflation, output and employment.

The krone exchange rate is important for developments in inflation, output and employment. How Norges Bank will react to movements in the exchange rate will depend on how these movements affect the economic outlook.

Section 4 of the regulation reads as follows:

“Norges Bank shall regularly publish the assessments that form the basis of the implementation of monetary policy.”

Norges Bank places emphasis on transparency in its monetary policy communication. The Bank reports on the conduct of monetary policy in its Annual Report. The assessments on which interest rate setting is based will be published regularly in the Monetary Policy Report and elsewhere.

Sincerely,

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