EBD/01/35

March 30, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Norway—New Regulation on Monetary Policy**

The Secretary has received the following memorandum dated March 29, 2001 from Mr. Lehmussaari:

> Please find attached a copy of a letter from the Central Bank of Norway which was sent to the Managing Director today.

Att: (1)

Other Distribution:
Department Heads

NB

Central Bank of Norway

The Governor

Mr Horst Köhler, Managing Director
International Monetary Fund

Your ref. | Our ref. 980/SG/ASV/ELO | Oslo, 29 March 2001

Dear Mr Köhler,

Pursuant to Article IV, Section 2(a) of the IMF's Articles of Agreement, Norway hereby notifies the Fund that a new regulation on monetary policy has been established by Royal Decree of 29 March 2001 pursuant to Section 2, third paragraph, and Section 4, second paragraph, of the Act of 24 May 1985 no. 28 on Norges Bank and the Monetary System.

Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank's implementation shall be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time.

The regulation comes into force immediately. The regulation of 6 May 1994 on the exchange rate system for the Norwegian krone is repealed from the same date.

Please find enclosed the press release of 29 March 2001 from Norges Bank, Norges Bank's letter of 27 March 2001 to the Ministry of Finance and the new regulation on monetary policy.

Yours sincerely,

Svein Gjedrem

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NORGES BANK
Central Bank of Norway

Press release 29 March 2001

The implications of the new mandate for monetary policy

The Government has today issued a new regulation on monetary policy, with the introduction of an inflation target of 2.5 per cent. Norges Bank issued its opinion on the new mandate and the consequences for the conduct of monetary policy in a submission of 27 March 2001 to the Ministry of Finance. In the submission, Norges Bank states that the communication of Norwegian monetary policy may be facilitated with the Government now quantifying an inflation target, in line with international practice. The submission is published on Norges Bank's website.

Central Bank Governor Svein Gjedrem affirms that the application of the new guidelines will not result in significant changes in the conduct of monetary policy. This applies both to the basis for the Executive Board's monetary policy decisions and day-to-day liquidity management.

Unchanged monetary policy stance

In the light of recent trends in the economy and the balance of risks, the probability that the next change in interest rates will be a reduction is still the same as the probability of an increase, says the Governor.

In the March *Inflation Report*, price inflation was projected to fall below 2½ per cent towards the end of next year and into 2003. However, we must assess the effects of the inflation target on inflation expectations. Changes in inflation expectations may influence our wage and price inflation projections. The moderate phasing in of petroleum revenues as described in the Government's Long-Term Programme may also have an impact. Our projections are based on a technical assumption of a neutral fiscal stance. On balance, the evidence at hand does not support a change in Norges Bank's monetary policy stance, says Governor Gjedrem.

NORGES BANK
Central Bank of Norway

The following letter was submitted to the Ministry of Finance on 27 March 2001

Guidelines for monetary policy

Norges Bank refers to the Ministry of Finance's letter of 26 March 2001 concerning the guidelines for monetary policy, enclosing a draft for a new regulation submitted to Norges Bank for comment.

The Bank does not object to the formal procedure, with the adoption of a joint regulation pursuant to Section 2, third paragraph, and Section 4, second paragraph, of the Act on Norges Bank and the Monetary System.

The draft regulation states:
"...Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time."

The fundamental task of monetary policy is to provide the economy with a nominal anchor. Nominal stability is the best contribution monetary policy can make to economic growth and prosperity. A nominal anchor is also a necessary precondition for stability in financial markets and property markets.

Pursuant to its existing mandate, Norges Bank has oriented monetary policy instruments with a view to bringing price and cost inflation down towards the corresponding aim for inflation of the European Central Bank. There has been confidence in the conduct of monetary policy. The communication of Norwegian monetary policy may nevertheless be facilitated with the Government now quantifying an inflation target, in line with international practice.

The inflation target of 2.5 per cent is slightly higher than similar objectives for Sweden, Canada and the euro area, but corresponds roughly to targets in the United Kingdom and Australia. The target is also approximately in line with the average inflation rate in Norway in the 1990s.

Norges Bank is responsible for the implementation of monetary policy. In the light of developments in recent years, the application of the new guidelines will not result in significant changes in the conduct of monetary policy. Norges Bank's key rates will be set on the basis of an overall assessment of the inflation outlook. In the following, Norges Bank presents its understanding of the regulation and the consequences for its implementation of monetary policy.

Monetary policy affects the economy with considerable and variable lags. Consequently, the Bank must be forward-looking in its interest-rate setting. The effects of interest rate changes are uncertain and vary over time. Changes in the interest rate will be made gradually so that the Bank may assess the effects of interest rate changes and other new information on economic developments. If price inflation deviates substantially from the target for a period, Norges Bank will set the interest rate with a view to gradually returning consumer price inflation to the target. Norges Bank will seek to avoid unnecessary fluctuations in output and demand.

Consumer price inflation normally varies from month to month. Substantial changes in the inflation rate may at times occur as a result of extraordinary fluctuations in certain product markets or changes in direct and indirect taxes. In its analyses of different measures of underlying inflation, Norges Bank will assess the effects of changes in the interest rate level, taxes, excise duties and extraordinary temporary disturbances. Deviations between actual and projected underlying inflation will normally be in the interval +/- 1 percentage point.

Norges Bank places considerable emphasis on the transparency and communication of monetary policy. Analyses carried out by the Bank and the background for the Bank's decisions are published regularly. The Bank reports on the implementation of monetary policy in its annual report. If there are significant deviations between actual price inflation and the target, the Bank will provide a thorough assessment in its annual report. Particular emphasis will be placed on any deviations outside the interval +/- 1 percentage point.

The krone is floating, and the value of the krone fluctuates periodically, as do the exchange rates of other small and open economies. The best contribution monetary policy can make to stabilising exchange rate expectations is to aim at the objective of low and stable inflation. Changes in the Norwegian interest rate level have a predictable effect on the krone exchange rate only when they also contribute to low and stable inflation.

In its letter to Norges Bank, the Ministry of Finance states:
"In the Government's Long-Term Programme for 2002-2005, fiscal policy will be subject to the following guidelines:

- Considerable emphasis must continue to be placed on stabilising fluctuations in the economy in order to ensure appropriate capacity utilisation and low unemployment.
- Petroleum revenues will gradually be phased into the economy, approximately in step with the expected real return of the Petroleum Fund.

This implies a moderate increase in the phasing in of petroleum revenues in the years ahead.
Fiscal policy shall continue to have a main responsibility for stabilising developments in the Norwegian economy. At the same time, petroleum revenues shall be phased in gradually and in a sustainable manner in the Norwegian economy, with considerable emphasis on ensuring a continued strong internationally exposed sector, contributing to long-term balance in the economy.

In this situation, a clear, formal anchor is required to reinforce monetary policy's role in underpinning stable economic developments. ..."

Norges Bank concurs that there must be a sound interplay between fiscal policy and monetary policy to ensure stable economic developments. It would be advantageous if fiscal policy could be used to counter fluctuations in demand and production.

Norges Bank would assert that a gradual phasing in of petroleum revenues approximately in step with the expected real return of the Petroleum Fund will, *ceteris paribus*, contribute to deteriorating conditions for businesses exposed to international competition.

The Norwegian economy and government finances are influenced by large and varying revenues from petroleum activities. The basis for determining central government expenditure and taxes from one year to the next may then easily be impaired. If budget spending is allowed to vary in step with oil prices, the Norwegian economy may experience abrupt shifts and instability. Changes in oil prices could then quickly influence wage and price expectations, the exchange rate and long-term interest rates. In that case it would be very demanding to achieve nominal stability. Short-term interest rates would then have to be changed frequently and sharply and will generally reflect an increased risk premium on the Norwegian krone, which over time would result in a generally higher interest rate level. Norges Bank would therefore emphasise the importance of establishing broad consensus concerning a credible long-term anchor for fiscal policy which takes into account that oil prices may fluctuate from one year to the next.

Yours sincerely

Svein Gjedrem

Jan F. Qvigstad

Regulation on Monetary Policy

Established by Royal Decree of 29 March 2001 pursuant to Section 2, third paragraph, and Section 4, second paragraph, of the Act of 24 May 1985 no. 28 on Norges Bank and the Monetary System

I

§ 1.
Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank is responsible for the implementation of monetary policy.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time.

In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

§ 2.
Norges Bank shall regularly publish the assessments that form the basis for the implementation of monetary policy.

§ 3.
The international value of the Norwegian krone is determined by the exchange rates in the foreign exchange market.

§ 4.
On behalf of the State, Norges Bank communicates the information concerning the exchange rate system ensuing from its participation in the International Monetary Fund, cf. Section 25, first paragraph, of the Act on Norges Bank and the Monetary System.

II

This regulation comes into force immediately. Regulation no. 0331 of 6 May 1994 on the exchange rate system for the Norwegian krone is repealed from the same date.