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Modernisation of the Monetary Policy Regulation

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Recipient: Norges Bank (Central Bank)

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In the Financial Markets Report for 2016, the Ministry of Finance announced that work had begun to modernise the Monetary Policy Regulation. The current regulation was laid down in 2001. The wording of the current regulation reflected the challenges that were of relevance at the time, and there is a need to bring it up to date.

The experience with an inflation target as part of the monetary policy framework has been positive. The economy has at times been exposed to major shocks since the inflation target was introduced. Monetary policy has contributed to firmly anchoring inflation expectations and stabilising developments in output and employment.

Since 2001, monetary policy thinking and practice have evolved. Growing confidence in the inflation target and the inflation targeting regime has provided increased scope for giving gradually more weight to real economic stability when setting the interest rate. In recent years, Norges Bank has also given some weight in its interest rate setting to counteracting the build-up of financial imbalances.

In the view of the Ministry of Finance, the evolution of monetary policy practice has been positive. Economists and the social partners appear to share this assessment. A modernised regulation should reflect the lessons learned since 2001, as well as the current perception of the role and implementation of monetary policy.

The Minister of Finance will recommend that the guidelines for monetary policy be modernised by laying down a new regulation pursuant to Section 2, third paragraph, of the Act on Norges Bank and the Monetary System etc. (Norges Bank Act).

Section 1 Monetary policy shall maintain monetary stability by keeping inflation low and stable.

Section 2 Norges Bank is responsible for the implementation of monetary policy.

Section 3 The operational target of monetary policy shall be annual consumer price inflation of close to 2 percent over time. 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.

Section 4 Norges Bank shall regularly publish the assessments that form the basis of the implementation of monetary policy.

Section 5 This regulation enters into force immediately. Regulation No 278 of 29 March 2001 on Monetary Policy is repealed from the same date.

The most important changes are:

1. *The reference to real economic stability is changed*

The proposed new regulation specifies that inflation targeting shall be forward-looking and flexible. This ensures that monetary policy can contribute to high and stable output and employment and to counteracting the build-up of financial imbalances (point 2). This replaces the current objective of "contributing to stable developments in output and employment". Monetary policy cannot assume primary responsibility for high employment, but it can make a contribution in conjunction with a well-functioning wage formation process, appropriate framework conditions for the labour market and a fiscal policy that promotes growth and stability.

2. *The aim of counteracting the build-up of financial imbalances is included in the regulation*

Internationally, there is broad agreement that financial imbalances are an important consideration, but there is a debate on whether this consideration should be a separate monetary policy objective or whether it is covered by more general aims regarding real economic stability over time. The Ministry has included such a formulation in the regulation because Norges Bank, in its conduct of monetary policy over several years, has given weight to counteracting the build-up of financial imbalances. There appears to be broad support for this practice among Norwegian economists. Monetary policy cannot take primary responsibility for financial stability, but it can make a contribution.

3. *The inflation target is changed to 2 percent*

When the inflation target was set at 2.5 percent in 2001, it was emphasised that the Norwegian economy was facing a period marked by the phasing-in of oil revenues and an expansion in the public sector and non-tradable sectors. This would necessarily entail weaker competitiveness, which could occur in the form of somewhat higher inflation than among trading partners. The period of phasing in oil revenues is now largely behind us. A key argument for maintaining a higher inflation target than other countries is therefore no longer relevant. In practice, all comparable countries currently operate an inflation target of 2 percent. Average inflation in Norway has been at 2 percent during the period of inflation targeting, while resource utilisation has been high and unemployment low, about which there was some uncertainty when the target was set.