Foreword

The operational target set by the Government for monetary policy is an inflation rate of close to 2.5 per cent over time. In an open economy, the exchange rate channel is one of several channels through which monetary policy affects the economy. The extent to which the exchange rate appreciates as a result of an increase in key interest rates depends on several factors outside the control of the central bank. The potency of the exchange rate channel will therefore vary over time. The exchange rate will often function as an automatic stabiliser. In periods with high activity in the economy – or when there are expectations of high activity – the exchange rate may appreciate, even if the key interest rates remain unchanged. Similarly, the exchange rate may depreciate when activity is too low.

Competitiveness is important to activity in business and industry. When Norges Bank prepares the inflation outlook, it takes into account the exchange rate channel and the effects of the exchange rate on domestic activity and inflation. Thus the exchange rate is of significance to the setting of interest rates. Monetary policy is, however, not based on a fixed view of what constitutes the correct level for the exchange rate over time and there is of course no accepted view of what is the correct business structure in the long term. This is in accordance with the operational target of low and stable inflation and in line with inflation targeting practice in other countries.

The Norwegian krone strengthened considerably through 2001 and 2002. The movements in the exchange rate were analysed carefully by Norges Bank with the aim of shedding light on which factors could explain this development. In autumn 2002, Jan F. Qvigstad, Chief Economist and Director of Norges Bank Monetary Policy, took the initiative to collect this work for publication. This issue of Norges Bank's Occasional Papers contains a number of signed articles written by employees of Norges Bank, which use different approaches and methods to look at factors that may help us to *understand movements in the exchange rate. The analyses were carried out in Norges Bank in 2002 and preliminary results were presented at a seminar for the Ministry of Finance and Statistics Norway on 7 February 2003. The views and conclusions expressed are those of the authors alone and are not necessarily shared by Norges Bank or colleagues in the Bank. We would like to emphasize that this publication is not seen as a final presentation of the work; we intend to continue working with many of the problems and issues raised in these articles. We do hope, however, that this presentation of expert analyses of exchange rate movements will provide a good illustration of the scope and complexity of the literature in this area.*

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