The conduct of monetary policy

Introductory statement by Governor Øystein Olsen at the hearing before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament).

- Webcast (Stortinget, høringssal 1) In Norwegian

Please note that the text below may differ from the actual presentation.

I would like to thank the Chairman of the Committee and thank you for this opportunity to report on the conduct of monetary policy in connection with the Storting's deliberations on the Government's Financial Markets Report. My statement here today is based on the Bank's Annual Report, but also on the Executive Board's assessments for the period to the most recent monetary policy meeting and new information.

When I was here last year, the key policy rate had been reduced by 0.25 percentage point to 1.5 percent in March. The key policy rate has since been kept unchanged. The key policy rate is low because inflation is low and because external interest rates are at very low levels.

The year 2012 was characterised by weak growth among Norway's trading partners and turbulence in financial markets. Uncertainty about global economic developments, particularly in Europe, was high. Key rates in many countries were close to zero, and both the European Central Bank (ECB) and the Federal Reserve announced that key rates would be kept low for a long period.

Economic developments in many advanced economies remained weak into 2013. Global growth is being driven by rapidly growing emerging economies. In the euro area, activity has slowed in several of the largest economies, and there are prospects that the downturn may persist for somewhat longer than previously envisaged. Unemployment is high and rising in a number of countries. In Spain and Greece, unemployment now exceeds 25 percent, and among young people, more than half are jobless. The economic situation is better in the US, but growth is moderate. Oil prices have fallen somewhat in the course of spring, but are still at a high level.

With key rates close to zero, several central banks have adopted unconventional measures to stimulate growth and support inflation. Measures that change the composition and size of a central bank's balance sheet differ from the usual monetary policy operations in that instruments other than the key rate are deployed to influence market rates and economic activity. The ECB and the central banks in the US, the UK and Japan have implemented such balance sheet policies to directly influence long-term interest rates and thus funding costs for enterprises and households. The Japanese central bank also introduced new measures this spring. The central bank will double the monetary base by the end of 2014, mainly by buying more Japanese government bonds, in order to boost inflation, reduce real interest rates and promote economic growth.

The improvement in global financial markets reflected the measures implemented by the ECB through 2012. Risk premiums in money and bond markets fell in autumn 2012, easing access to funding for debt-laden European countries. The effect of the improvement in financial markets has not so far fully fed through to credit conditions for the household and business sector. In several southern European countries, banks are still facing difficult funding conditions, keeping bank lending rates high and dampening growth in consumption and investment. This is affecting small and medium-sized businesses in particular.

Although the improvement in money and bond markets also resulted in an improvement in funding conditions for Norwegian banks, it had little effect on bank lending rates for households and enterprises. In the course of spring, banks have raised lending rates for households and enterprises as a result of expectations of higher capital requirements.

Growth in the Norwegian economy has remained solid for the past 18 months, supported by higher activity in the petroleum sector and construction industry, favourable terms of trade and high population growth. At the same time, some segments of the export industry are feeling the impact of lower demand from Europe and a high domestic cost level. Unemployment has remained low and there has been a moderate rise in household consumption.

Household debt is high and is rising faster than incomes. At the same time, households are saving more. Debt growth is being driven by a sustained rise in house prices. However, debt and assets are unevenly distributed. This increases household vulnerability.

Inflation is low in Norway and has recently edged downed further. Underlying inflation is estimated to be in the interval 1-1½ percent. Low external price impulses and an appreciation of the krone in recent years have held the rise in prices for imported goods at a low level.

The analyses in the March 2013 *Monetary Policy Report* indicate that costs in household-oriented industries have risen at slower pace than in the mainland economy as a whole in recent years. This is partly due to relatively high productivity growth. At the same time, high inward labour migration is providing a flexible supply of labour, which is curbing wage growth. Wage growth in Norway is also being influenced by low wage growth in neighbouring countries.

Trade-offs in monetary policy

Norges Bank's conduct of monetary policy is oriented towards low and stable inflation. The operational target of monetary policy is annual consumer price inflation of close to 2.5 percent over time. At the same time, monetary policy shall contribute to stabilising developments in output and employment.

Since the introduction of the inflation target in 2001, annual consumer price inflation has averaged 1.8 percent, which is somewhat below, but close to, 2.5 percent. In Norges Bank's assessment, consumer price developments since 2001 have been well within the flexibility provided for under the monetary policy mandate.

The monetary policy response pattern can be summarised in three criteria for an appropriate interest rate path. The first criterion states that the interest rate should be set with a view to stabilising inflation at target or bringing it back to target after a deviation has occurred. The specific time horizon for stabilising inflation at target will depend on the disturbances to which the economy is exposed and their duration.

The second criterion states that the interest rate path should provide a reasonable

balance between the path for inflation and the path for overall capacity utilisation in the economy, i.e. that the inflation targeting regime is flexible. Flexible inflation targeting builds a bridge between the long-term objective of monetary policy, which is to provide an anchor for expectations of low and stable inflation, and the objective of stability in the economy.

The third criterion states that monetary policy should be robust and should seek to mitigate the risk of a build-up of financial imbalances. The criterion is an expression of the lack of a complete understanding of how the economy functions or the shocks to which the economy may be exposed. The consideration of robustness can therefore be interpreted as a form of insurance against adverse outcomes. Norges Bank does not have independent objectives for asset price inflation or debt growth. However, by mitigating the risk of financial imbalances, we may also achieve more stable developments in inflation, output and employment over time.

In the case of conflicting objectives, the choice of interest rate path will involve a trade-off between different considerations.

If monetary policy only took into account the low level of inflation, the key policy rate would be rapidly reduced and kept close to zero for a good while. Inflation might then pick up faster, partly as a result of a weaker krone. In the light of the trade-off against other considerations, however, the Bank does not want to accelerate the pace of inflation. The result would be a pronounced impact on output and employment and increase the risk of a build-up of financial imbalances. When weight is also given to robustness and to stabilising developments in the real economy, the interest rate path will be higher.

As a result of ample cross-border labour flows, changes in competitive conditions and new trade patterns, consumer price inflation has now been below 2.5 percent for a period. Prices for domestically produced goods have risen considerably more than consumer prices, reflecting the improvement in Norway's terms of trade. Incomes, output and employment are growing at a solid pace and capacity utilisation is estimated to be above a normal level. Household debt and house prices have increased more than incomes. In today's situation, it is appropriate to use a few years to bring up inflation. The interest rate has therefore not been reduced further.

A higher key policy rate could have curbed debt growth and demand pressures in the Norwegian economy. But in view of persistently low external interest rates, such a policy would likely have resulted in a sharp appreciation of the Norwegian krone, and inflation and activity in the Norwegian economy would have fallen to too low a level. The weak external environment is thereby also contributing to keeping Norwegian interest rates low.

With firmly anchored inflation expectations, Norges Bank can today give weight to stabilising economic developments when setting the interest rate. Inflation targeting has become more flexible. We have chosen to take a long-term approach to bringing inflation back up. But we will not lose sight of the inflation target. Should the outlook for inflation or growth weaken considerably, there will still be room for manoeuvre to counteract such developments through monetary policy.

Monetary policy in the light of new banking sector regulation

The financial crisis taught us some important lessons. First, the crisis illustrated that low and stable inflation is not sufficient to ensure financial stability. Second, the crisis clearly revealed shortcomings in the regulatory framework for banks. As a result, banking and financial regulation is now undergoing change worldwide. Regulation and supervision are the authorities' most important instruments to prevent financial instability.

In March, the Government presented a legislative proposal on new capital adequacy requirements for banks. The proposal is in line with the EU's new regulatory framework. A key element in the new framework is capital buffers that banks will be required to hold in addition to the minimum requirement. This will increase banks' loss-absorbing capacity. A countercyclical capital buffer will come on top as a capital requirement that can be increased in good times and removed in bad times. The countercyclical buffer is to consist of Common Equity Tier 1 capital and will normally be set between 0 and 2.5 percent of a bank's risk-weighted assets.

The countercyclical buffer is intended to counteract the procyclical effects of substantial changes in credit and asset prices. The buffer will help contain the risk of deleveraging in bad times. But an increase in the buffer can also dampen rapid credit growth in good times. The effect will depend on banks' reaction when the buffer is increased.

Norges Bank will have primary responsibility for elaborating the basis for decisions on the countercyclical capital buffer. In drawing up the basis, the Bank will collaborate and exchange relevant information with Finanstilsynet (Financial Supervisory Authority of Norway). The buffer will be set by the Ministry of Finance.

Once the regulation is in place, most likely in late summer, Norges Bank will issue concrete advice to the Ministry of Finance on the level of the buffer. Thereafter, the Bank will issue advice on the buffer four times a year. The criteria on which the Bank's advice is based were presented in the March *Monetary Policy Report.*

Norges Bank will present analyses and issue advice on the size of the countercyclical capital buffer in conjunction with the decision basis for monetary policy. The aim is to ensure that the analytical basis is consistent with the formulation of monetary policy.

The objectives of the countercyclical capital buffer and the key policy rate are different. The objective of the buffer is to strengthen banks' resilience to losses in an economic downturn, while the objective of monetary policy is low and stable inflation over time. The inflation target is weighed against the aim of smoothing fluctuations in output and employment.

The new instrument will be taken into account in monetary policy. Both the key policy rate and the buffer work through banks' responses. The buffer will be set on the basis of an assessment of the risk that financial imbalances may trigger or amplify an economic downturn. Capital adequacy requirements, and their effect on bank lending rates, will be one of many factors underlying the monetary policy analysis and interest rate setting.

The countercyclical capital buffer will strengthen the resilience of the banking sector during an upturn. It may also, to some extent, counteract the build-up of financial imbalances. But the effect on bank behaviour is uncertain. Thus, Norges Bank cannot disregard financial imbalances when setting the key policy rate. The criteria for the conduct of monetary policy remain firm also after the introduction of a countercyclical capital buffer.

When assessing the various considerations, monetary policy must pursue its primary objective – low and stable inflation. We cannot overburden monetary policy. Other economic objectives must be pursued using policy tools such as financial regulation, the tax system and fiscal policy.

Thank you for your attention.