Reception of the report from Norges Bank Watch (NBW)

Remarks by Ida Wolden Bache, Deputy Governor of Norges Bank, 5 March 2021.

In February/March each year, the Centre for Monetary Economics (CME) presents a report commissioned by the Ministry of Finance on Norges Bank's activities. A committee of independent economists assesses Norges Bank's conduct of monetary policy. The reports are published by the CME in its Norges Bank Watch Report Series.

First, I would like to thank this year's Norges Bank Watch committee for a thorough and good report. I also thank you for the opportunity to comment on the report. An independent assessment of Norges Bank's work and policy performance is of value to us.

The year 2020 was a peculiar and dramatic one for the world, for Norway and for Norges Bank. It was also the first year the Bank operated with its newly created Monetary Policy and Financial Stability Committee. The NBW review is therefore especially interesting this year.

While NBW concurs with Norges Bank's overall assessment of economic developments and its conduct of monetary policy through 2020, they point out that we could have acted faster in March. Some central banks did indeed loosen monetary policy in the weeks before we did, but Norges Bank also responded swiftly and took substantial action. We decided to cut the policy rate by a half of a percentage point before the Government announced a national lockdown on 12 March. The following week, when the scope of the Government's measures had become clearer, we reduced the rate to 0.25 percent. In the course of those hectic weeks in March, we also took measures to improve liquidity in the money and foreign exchange market. We offered banks extraordinary fixed-rate loans, and took the unusual step of intervening in the foreign exchange market. On the advice of Norges Bank, the Ministry of Finance reduced the countercyclical capital buffer requirement.

In other words, we took the strongest and most important measures already in March. But why was the policy rate not reduced to zero in one go? The situation in March was unclear and highly uncertain. Also, it is not the case that the lower bound for the policy rate is an absolute bound independent of the economic shock to which the economy is exposed. In March, we stated that we did not rule out further rate cuts. Up to the rate-setting meeting in May, the Committee sought to establish a clearer picture of the outlook and discussed how far it would be appropriate to reduce the policy rate. We concluded that it was appropriate to reduce the rate to zero, and stated at the same time that we did not envisage further rate cuts.

Nowcasting and forecasting have been challenging over the past year. The pandemic and the measures to contain it have placed constraints on both supply and demand, compounding the challenges involved in estimating the output gap. NBW is of the view that we should have given more weight to supply-side constraints, and that our output gap estimate should have been less negative. In our assessment of the output gap, we have given particular weight to the historically sharp rise in unemployment. But, we have differentiated between the ordinary unemployed and furloughed workers, by applying the assumption that furloughed workers only represent available resources to a limited extent. We have assumed that potential output has declined, mainly in the near term, but also to some degree further ahead. But the overall assessment has still been that there has been substantial spare capacity in the economy.

NBW would like to see a more ambitious communication framework for monetary policy, not least now that we have the Monetary Policy and Financial Stability Committee. NBW would like, for example, detailed Committee minutes.

Norges Bank attaches importance to predictability and clear communication, but we tend to place greater emphasis on being open about the Committee's trade-offs and assessments, and the underlying analyses, rather than communicating who said what at which meeting. Examples illustrating that from last year are the extraordinary *Monetary Policy Report* we published in May when uncertainty was especially high, the inclusion of different economic scenarios in two of the *Reports* and our presentation of technical model-based analyses of the policy rate forecast. In addition, as NBW also notes, we expanded the section of the *Report* that presents the Committee's monetary policy assessment. But we are not there yet. Central bank communication is work in progress, which we will continue to pursue.

NBW takes a positive view of Norges Bank's response to the market stress in March last year. At the same time, NBW is of the view that the increase in money market risk premiums in autumn weakened the impact of monetary policy and that we should have counteracted that.

The primary objective of liquidity policy is to keep the very short-term money market rates close to the policy rate. To achieve that objective, we ensure that there is sufficient liquidity in the banking system every day. The price banks have to pay for liquidity at longer maturities may vary. As long as the short-term money market functions, Norges Bank does not aim to influence such risk premiums. The risk premiums in the money and credit market are taken into account in the monetary policy analysis. In autumn, as the rise in the money market premium was judged as temporary, it did not affect the monetary stance.

In March, extraordinary conditions prevailed. There was a very high degree of uncertainty, and money markets functioned poorly. It was important to ensure that banks had a predictable supply of liquidity at a longer horizon. The acute stress in the money market subsided through summer and autumn. Risk premiums were volatile, but the markets functioned. As an assurance, we still offered extraordinary loans to the end of the year, albeit at a somewhat higher price. We also took other measures in response to the challenges in the overnight market in September.

NBW points out that we could have adjusted our foreign exchange transactions on behalf of the government in order to influence liquidity in the banking system. Norges Bank converts foreign exchange from the Government Pension Fund Global and foreign exchange income from the petroleum sector into Norwegian kroner to cover the non-oil budget deficit. This task is kept separate from Norges Bank's other tasks and responsibilities. We do not want there to be any doubt as to the purpose of our krone purchases. If we adjust the foreign exchange transactions to influence liquidity in the banking system, we would be increasing the element of judgment in our estimations, which would entail less transparency. When we plan and carry out krone purchases, we therefore apply the Ministry of Finance's projections for the government's krone needs, which we will continue to do.

NBW has also performed a thorough review of Norges Bank's advice on the countercyclical capital buffer and the framework for it.

NBW asks why the countercyclical capital buffer was not reduced to zero percent in March. We believe that stopping at 1 percent has proved to be appropriate in retrospect, but also in real time. A 1.5 percentage point reduction in the buffer freed up substantial bank lending capacity. At the time of the reduction, the banks had not sustained any loan losses. If loan losses had increased markedly or if banks had tightened credit, the buffer could have been reduced further with immediate effect.

NBW takes a positive view of the clarifications in the new framework for the countercyclical capital buffer, which was published in December 2019, but has made some suggestions for improvement. Before the reduction in March the countercyclical capital buffer was 2.5 percent on the back of financial imbalances that had built up over a longer period. The assessment of financial imbalances is based on a broad set of indicators and analyses, including stress tests of banks' loss absorbing capacity and credit supply. The framework is designed so that the buffer should be reduced in response to a sharp downturn in order to boost banks' lending capacity, but not necessarily in response to signs of receding financial imbalances. If we see a persistent easing of financial imbalances and a positive outlook for financial stability, the buffer requirement can be reduced. This situation has not occurred in the Norwegian economy since the introduction of the countercyclical capital buffer requirement. Indicators of financial imbalances and the buffer framework have evolved over time in line with new insights, and will continue to do so. We will bear in mind the feedback from NBW in the work ahead.

Let me conclude. After a peculiar and dramatic year, our country and economy are still facing a demanding situation. While the degree of uncertainty has fortunately diminished since the end of March last year, there are still many questions outstanding, among them the way back to a normal economy and the longer-term consequences of the pandemic.

It is now twenty years ago that Norway commenced inflation targeting. The NBW report devotes a separate chapter to the experiences with inflation targeting, and we share their view that the framework has functioned well.

The past year has shown that the new Monetary Policy and Financial Stability Committee has also functioned well. The Committee has met, indeed often virtually, at short notice and we have had good discussions. With a solid framework, a well-functioning Committee and valuable input from Norges Bank Watch we are well positioned to continue our work.

Thank you for a good report, and thank you for your attention.