The conduct of monetary policy

Introductory statement by Governor Ida Wolden Bache at the hearing of the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament) in connection with the Storting’s deliberations on the Financial Market Report, 28 April 2022.

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

Introduction

Thank you for this opportunity to report on the conduct of monetary policy. My statement is based on Norges Bank’s *Annual Report* for 2021 and the Monetary Policy and Financial Stability Committee’s assessment published in March.

More than two years have now passed since the coronavirus pandemic led to a sharp contraction in the Norwegian economy. In response to the pandemic, Norges Bank reduced the policy rate to zero percent over the course of spring 2020. The countercyclical capital buffer was reduced from 2.5 to 1 percent. In addition, the government provided extensive fiscal support to mitigate the adverse effects of the pandemic on businesses and households.

We can now see that activity rebounded faster than expected. Economic conditions became more normal again last year, and there was no longer a need for the same degree of monetary accommodation. Later in autumn, it became increasingly clear that the policy rate should be raised towards a more normal level to stabilise inflation around the target somewhat further out. Since summer last year, the policy rate has been raised from zero to 0.75 percent, and we project a further rise in the policy rate. As the economy was returning to normal, the countercyclical capital buffer was also increased again.

Russia’s invasion of Ukraine has deeply affected us all in recent months. The war is causing massive damage and human suffering and has introduced a new source of uncertainty regarding the domestic and global economic outlook.

Normalisation of the Norwegian economy through 2021

Let’s first take a look at domestic developments.

[*Chart: Activity is higher than its pre-pandemic level]*

The pandemic and the associated containment measures have caused large fluctuations in activity over the past two years. We saw a strong rebound in the Norwegian economy after the reopening of society in spring 2021. Over summer, activity exceeded its pre-pandemic level.

Around the turn of the year, we saw a temporary fall in activity due to a rise in caseloads and new containment measures, but the impact of the Omicron variant was milder than the assumption underlying our December projections last year. After the containment measures were lifted in February, activity in the hardest hit sectors quickly recovered.

[Chart: High employment and low unemployment]

The labour market has improved in step with the rise in activity. After a sharp increase in spring 2020, unemployment has declined to a low level. In March, registered unemployment was 1.9 percent, which is the lowest rate recorded since before the financial crisis in 2008. Employment has risen sharply at the same time. The employment rate is now at its highest level in over ten years.

[Chart: High capacity utilisation in the Norwegian economy]

Labour market conditions have clearly tightened, with reports of capacity constraints and labour shortages from Norges Bank's Regional Network this past winter. The share of enterprises reporting full capacity utilisation is at its highest since 2007. A shortage of labour is a growing problem in most regions. The high number of vacancies suggests strong demand for labour. It is our assessment that capacity utilisation is above a normal level and that the Norwegian economy is now running above potential.

A tight labour market tends to bring up wage growth. Last year, wage growth was higher than we had expected, and survey-based information shows that the social partners have higher wage expectations this year. One reason is that consumer price inflation is expected to be fairly elevated this year. This year's spring wage negotiations are underway, and a wage norm of 3.7 percent has been agreed with manufacturing sector trade unions. We expect wage growth to pick up somewhat in the coming years.

High global inflation

Global growth has also rebounded strongly as most countries unwound pandemic-related containment measures. Activity among our trading partners is now higher than its pre-pandemic level. Labour markets have improved, and wage growth is on the rise.

[Chart: High global consumer price inflation and elevated commodity prices]

After a period of very low inflation and concerns that inflation would become *too* low, inflation has now surged in many countries. In the US and the UK, inflation has reached a level not seen for several decades, partly driven by pandemic-induced conditions. The pandemic has constrained consumption opportunities, and as in Norway, household spending shifted from services to goods. At the same time as demand has increased, lockdowns and other containment measures have led to supply chain disruptions and a steep rise in global freight rates.

There has also been a steep rise in global prices for energy, metals and agricultural products. Demand for commodities picked up as the global economy recovered, but supply-side constraints have also emerged, partly owing to the pandemic and extreme weather events. Russia’s invasion of Ukraine led to a further increase in prices for energy and other commodities. Futures prices indicate that energy and other commodity prices will fall, but that they may remain at a higher level than in pre-pandemic years for some time ahead.

Higher inflation and increased inflation expectations have led to a pronounced rise in global policy rate expectations over the past year. A number of central banks have started the tightening cycle, with further rate hikes expected ahead.

We expect the economic upswing among trading partners to continue, but the war in Ukraine will weigh on growth. Business and living costs have risen as a result of the surge in commodity prices and a broadening rise in inflation. The loss of export markets and heightened uncertainty among households and firms may also set back growth, particularly in Europe. At the same time, the pandemic remains a source of uncertainty. Stringent containment measures have been introduced in several large Chinese cities.

Inflation has also risen in Norway

[Chart: Inflation has also risen in Norway]

Inflation has also risen in Norway. Over the past year, high electricity prices have driven up inflation, and the 12-month rise in consumer prices is now clearly above the 2 percent inflation target.

When setting the policy rate, we usually look through temporary fluctuations in inflation and are more concerned with what we refer to as underlying inflation. Underlying inflation can be measured in various ways, but here it is illustrated by the CPI-ATE, which is the consumer price index adjusted for tax changes and excluding energy products. Underlying inflation has risen from low levels in autumn. Both imported goods inflation and domestic goods and services inflation have moved higher.

We expect underlying inflation to continue to rise, driven by high imported goods inflation, limited spare capacity in the Norwegian economy and prospects for rising wage growth.

The objective of monetary policy

[Chart: The objective of low and stable inflation]

In 2021, the Monetary Policy and Financial Stability Committee conducted a review of the *monetary policy strategy*. The strategy, which was published in December, describes the Committee’s interpretation of the monetary policy mandate and how the Committee manages the trade-offs between the different policy considerations.

The primary objective of monetary policy is low and stable inflation, defined as an annual rise in consumer prices of close to 2 percent over time. An explicit inflation target provides economic agents with an anchor for inflation expectations. Persistently high inflation is costly for society in that it creates uncertainty about the value of money and hampers financial planning. As long as there is confidence that inflation will remain low and stable, variations in inflation around target are not likely to generate any significant socio-economic costs. In interest rate setting, we give weight to avoiding large and persistent deviations from the inflation target, whether above or below target.

Our mandate states that inflation targeting shall be flexible. This means that monetary policy also seeks to promote high and stable output and employment. While high unemployment entails direct costs both for society and those who do not find work, high employment, or very low unemployment, entails only indirect costs in the form of potentially excessive price and wage inflation. The aim of maximum employment must therefore be weighed against the risk of inflation becoming too high. If the policy rate is kept low to stimulate economic activity over a long period, economic pressures will eventually reach a level where prices and wages start accelerating.

Under the mandate, we are also responsible for helping to mitigate the buildup of financial imbalances. Typical signs indicating an increase in financial imbalances are high house price inflation and a rapid rise in household debt, which could in turn amplify a future economic downturn. We must therefore not be too short-term oriented in interest rate setting but must closely consider how our current policy could potentially affect economic stability in the longer run. This means, for example, that we are aware that a period of very low interest rates can lead to an increase in financial imbalances.

However, monetary policy cannot take primary responsibility for mitigating the buildup of financial imbalances. The first line of defence against shocks to the financial system must be regulation and supervision of financial institutions. The countercyclical capital buffer and systemic risk buffer for banks are part of macro- regulation of the financial system. In September of last year, Norges Bank was given the decision-making responsibility for the countercyclical capital buffer and formal advisory responsibility for the systemic risk buffer. Since then, the countercyclical capital buffer has been raised on two occasions.

The monetary policy trade-offs in March

[Chart: Higher interest rates ahead]

At the latest monetary policy meeting in March, we raised the policy rate to 0.75 percent and presented a policy rate forecast indicating that the policy rate will be raised gradually to around 2.5 percent at the end of 2023. The average interest rate on residential mortgage loans, which is now a little above 2 percent, could therefore eventually increase to around 4 percent. In March, we also raised the buffer to 2.5 percent, effective from 31 March 2023.

The rise in the policy rate reflects the high level of activity in the Norwegian economy and strong demand for labour. Inflation has increased, and rising wage growth and higher imported goods inflation will likely drive up underlying inflation ahead.

We believe the upswing in the Norwegian economy will continue, but the war in Ukraine has added to the uncertainty regarding growth prospects. High energy prices are generating substantial government revenues and could boost investment and energy exports, but also entail higher business and living costs. At the same time, the war appears to be exacerbating disruptions to global value chains.

[Chart: Continued upswing and inflation close to target somewhat further out]

Our primary mandate is to keep inflation low and stable. At the monetary policy meeting in March, the Committee's assessment was that the objective of stabilising inflation around the target somewhat further out implied a higher policy rate. If we had not raised the policy rate, we would have seen a growing risk of excessive inflation further out. That could have led to a need for larger rate hikes at a later stage, which could in turn have increased the risk of an economic setback. At the same time, the economic outlook is uncertain, as is households' response to higher interest rates. This warrants a gradual increase in the policy rate.

A gradual rate increase will help bring inflation close to target somewhat further out. Higher interest rates will slow down the economy, but we expect unemployment to remain low. Higher interest rates will lead to higher costs for borrowers and curb consumer spending. At the same time, household saving was higher than normal during the pandemic. Given the high level of savings, combined with faster wage growth and high employment, we expect a continued increase in consumption. Strong growth in mainland business investment is also expected to lift activity ahead. Manufacturing investment, partly driven by the climate and energy transition at home and abroad, will likely account for a large share of investment growth.

Conclusion

Let me conclude.

Two years after the onset of the pandemic we can safely say that the Norwegian economy has weathered the crisis well so far. Economic activity is strong in Norway, and the buildup of pressures in the economy are likely to drive up inflation ahead. The policy rate is therefore on the rise.

But the forecasts are subject to uncertainty. If the economy evolves differently than projected, the policy rate path may also change. The war in Ukraine is weighing on the global economic outlook. There is substantial uncertainty as to the magnitude and duration of the war-induced impacts on trading partner economies and the Norwegian economy. Global growth may slow more than projected amid rising inflation. Domestic capacity constraints and persistent international price pressures may also lead to higher wage and price inflation than we now foresee.

While greater global trade and competition have contributed to keeping price inflation low for a long period, globalisation has slowed in recent years. The pandemic appears to have amplified a trend where a growing number of businesses prefer to secure their own supply lines and move a larger share of production closer to customers. The war in Ukraine has driven up commodity prices and prompted many countries to find ways of reducing import dependence on Russian energy and raw materials. This could hasten the transition from fossil fuels to renewables. During the transition phase, we might face higher energy and commodity prices than we have been accustomed to in recent years.

We may face more challenging monetary policy trade-offs ahead. But we have a clear mission and we will continue our efforts to fulfil the mandate of keeping inflation low and stable and contribute to economic stability in the years to come.

Thank you for your attention.