Øystein Olsen: The conduct of monetary policy

Introductory statement by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at the hearing before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament), Oslo, 29 May 2012.

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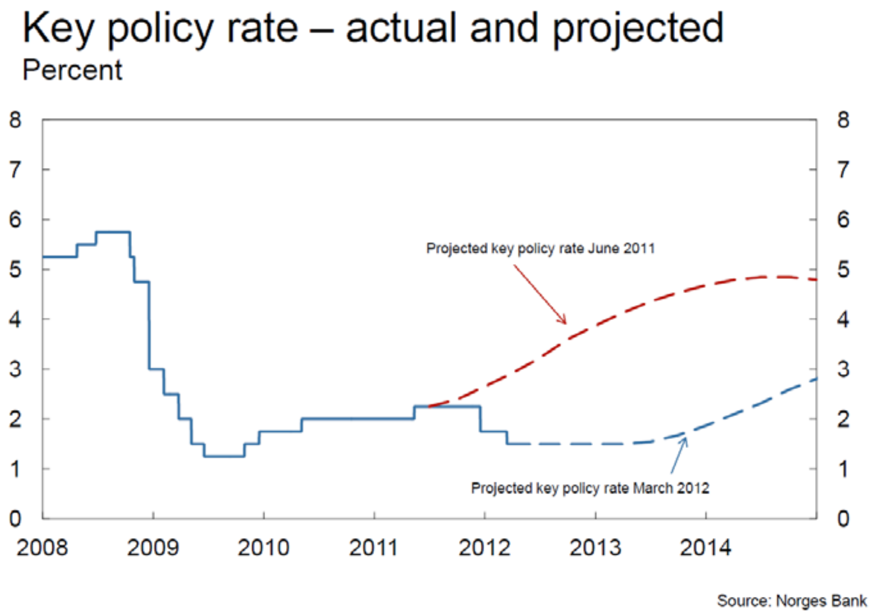
Please note that the text below may differ from the actual presentation. The statement is based on Norges Bank's Annual Report for 2011, Monetary Policy Report 1/12 and the Executive Board's assessments in the period to the monetary policy meeting on 10 May.

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 Market 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.

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



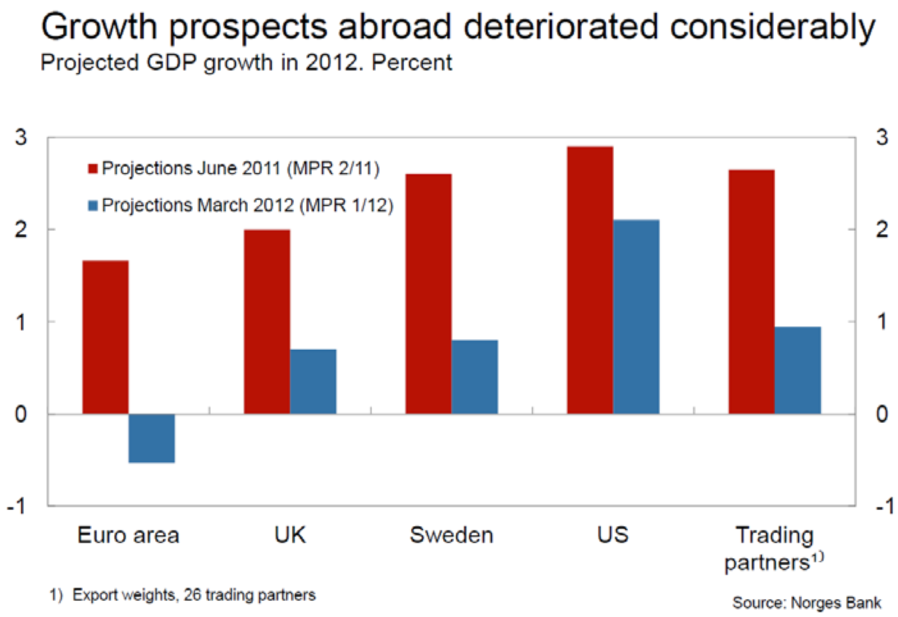
When I was here last year, the key policy rate had just been raised to 2.25 per cent. Inflation was low at around 1¼ per cent, but there were prospects that growth in advanced economies was recovering and that both capacity utilisation and inflation in Norway would pick up. The key policy rate was kept unchanged at the June meeting, but the interest rate forecast implied a likely interest rate increase after summer. Norges Bank did, however, underline the risk of a possible appreciation of the krone and inflation that might become too low as a result of economic divergences between Norway and other countries.

In the course of summer and autumn, international growth prospects worsened considerably. Financial market tensions heightened, and market participants' key rate expectations were lowered appreciably. Yields on government bonds in countries with weak public finances jumped, while equity prices declined. Money market premiums moved up and banks' funding costs rose.

The turbulence and weaker growth prospects abroad fed through to the Norwegian economy. At the monetary policy meetings in August, September and October, the Executive Board decided to leave the key policy rate unchanged at 2.25 percent.

Around the turn of the year, financial turbulence intensified and the risk of a downturn increased, particularly in Europe. The debt crisis in the euro area made it more difficult and expensive for European banks to procure market funding. Norwegian banks were also affected. With a view to countering the higher premiums in the money market and curbing the effects of weaker developments abroad on the Norwegian economy, the key policy rate was reduced to1.75 percent in December.

The situation in international financial markets improved in the course of winter. The krone appreciated. On the other hand, growth in advanced economies was weak and euro area GDP fell towards the end of the year. Central banks abroad announced that the key rates would be kept at a low level for a prolonged period. At the monetary policy meeting in March, Norges Bank underlined that weak growth prospects abroad and the strong krone were keeping inflation at a low level and curbing activity in some sectors. The key rate was reduced to 1.5 percent at that meeting.

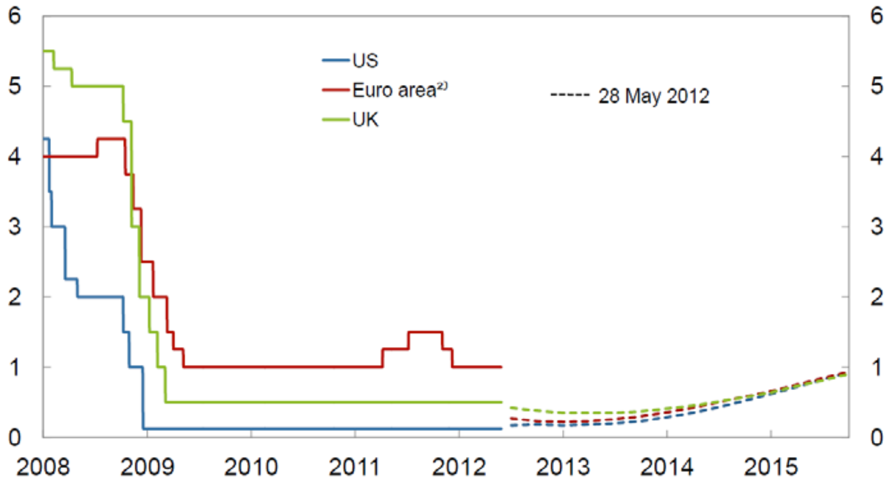


Europe is now in a downturn. Many countries are struggling with large deficits and mounting government debt. Structural reforms are being implemented, pension schemes are being tightened and tax systems are under review. At the same time, tighter credit standards and increased capital requirements will limit the supply of bank credit. In addition, a number of countries must restore competitiveness after a period of high cost growth prior to the financial crisis. In the short run, the tightening measures pull down activity and push up unemployment.

Central banks in other countries are using strong measures to prop up activity and inflation. As shown in the chart, key rates among many of our trading partners are close to zero and are expected to remain low for a long period. In the US, UK and Japan the central banks have made large-scale government bond purchases in order to push down long-term interest rates. The European Central Bank (ECB) has also stretched itself, for example by providing long-term loans to banks. The ECB operations during winter contributed to boosting liquidity and reducing risk premiums in the European banking system and in the sovereign debt market.

Very low key rates abroad

Actual and expected key rates[1)]. Percent

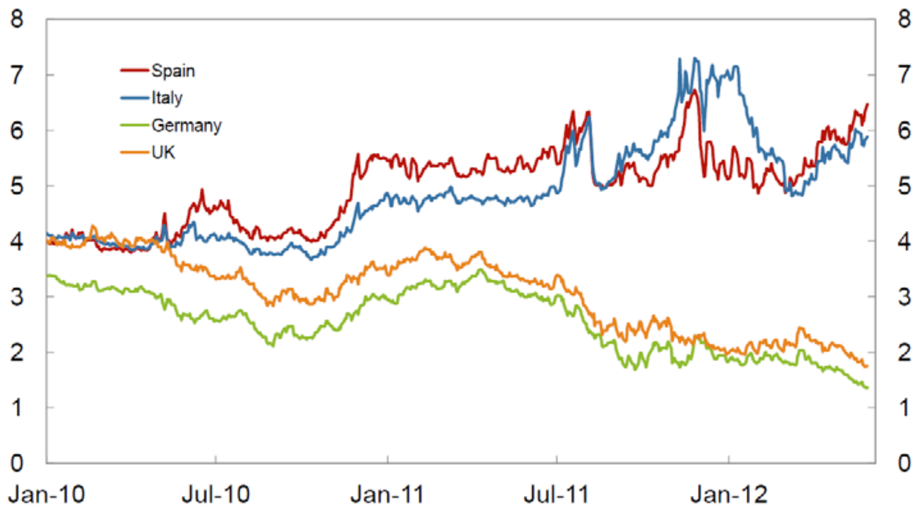


1) Based on Overnight Index Swap (OIS) rates
2) Actual rates: Main refinancing operations rate. Expected: EONIA rate

Sources: Bloomberg and Norges Bank

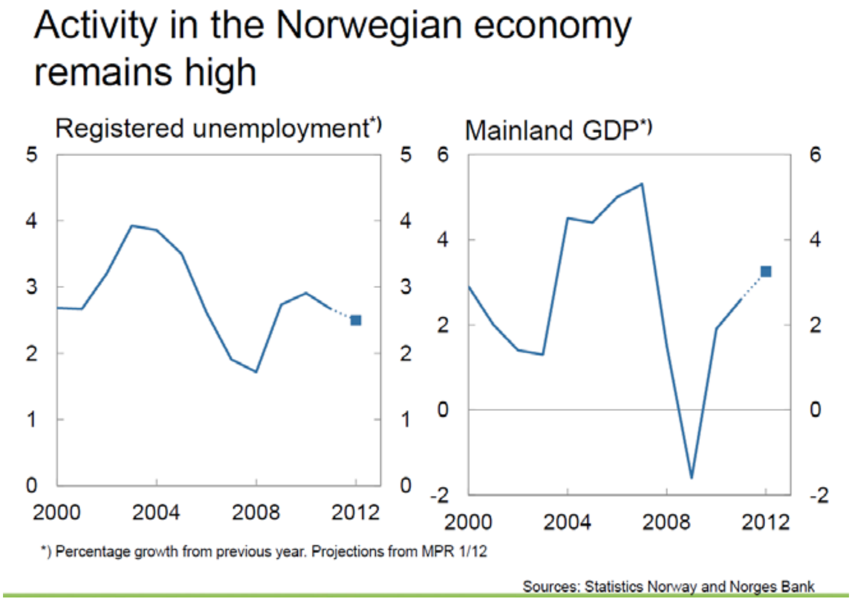
Renewed uncertainty in financial markets

Yields on 10-year government bonds. Percent

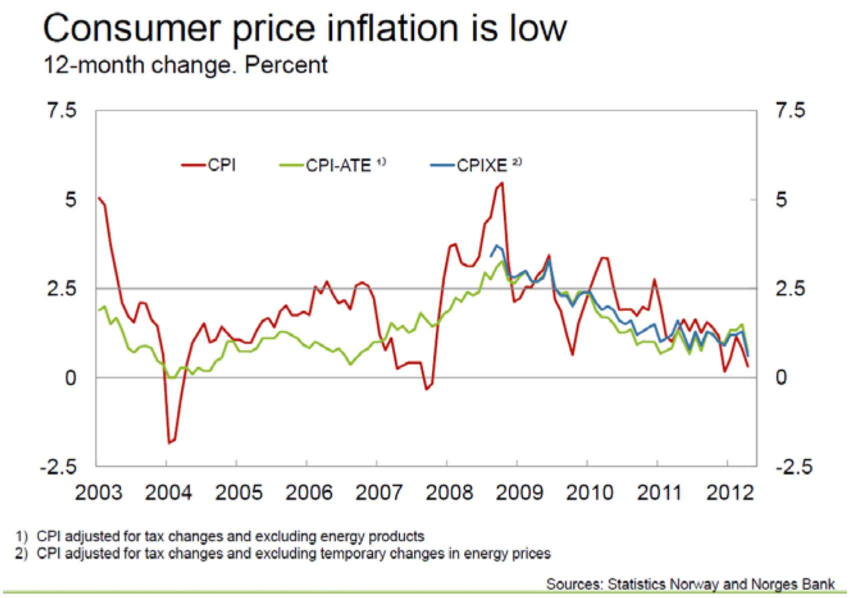


Source: Thomson Reuters

Financial market turbulence has flared up again recently, with particular focus on the macroeconomic situation and budget developments in Spain and other countries in southern Europe. The political unrest in Greece and growing fears of a Greek government debt default have curbed risk appetite in the markets. Yields on Italian and Spanish government bond have increased, while US, UK and German government bond yields have fallen to historically low levels. International equity indices have declined, particularly in Europe.



Despite a prolonged downturn abroad and financial market turbulence, activity in the Norwegian economy is remains robust. Capacity utilisation has been close to normal over the past year. GDP for mainland Norway expanded by 2.4 per cent in 2011 according to preliminary figures. Prices for Norwegian export goods are favourable relative to import prices. The oil and construction industries are booming and both employment and the supply of labour are on the rise. Unemployment is low and fairly stable. At the same time, house prices are moving up and household debt is still rising faster than household income. On the other hand, some segments of the export industry are feeling the adverse effects of developments in Europe and a strong krone.



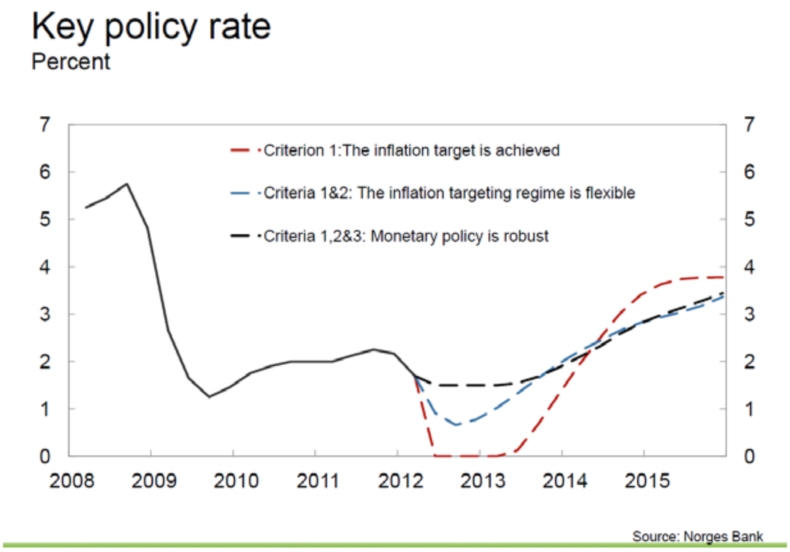
Key policy rate is low because inflation is low and because the downturn abroad and a strong krone are dragging down on growth in some sectors in Norway. Very low interest rates abroad and high premiums in money and credit markets reinforce this picture. There are unusually wide differences between various interest rates, reflecting the high level of money market and credit premiums. Many households are paying up to 4 percent on housing loans and interest rates on corporate loans range between 5 and 6 percent.

When setting interest rates, the Bank does not give weight exclusively to bringing inflation back to target. Weight is also given to the effects of the interest rate on output and employment. At the same time, weight is given to the risk that a prolonged period of low interest rates can lead to elevated risk-taking and excessive debt accumulation in the household and business sector. Such imbalances may have spillover effects further ahead, with substantial effects on output and employment.

Criteria for an appropriate interest rate path

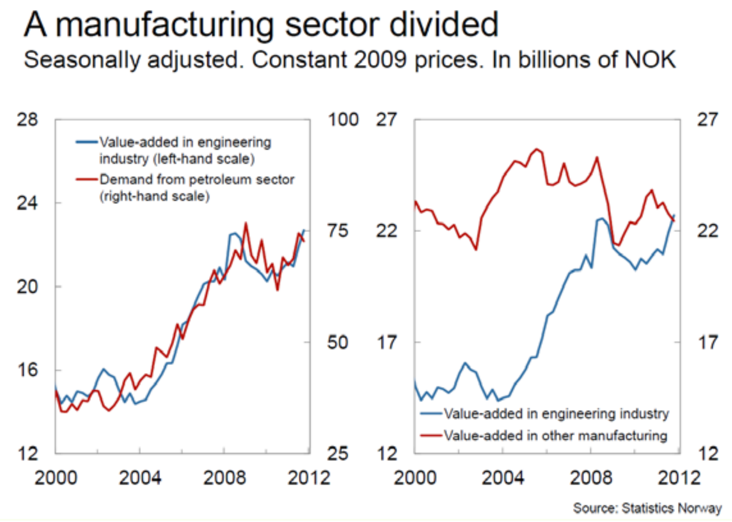
1. The inflation target is achieved
2. The inflation targeting regime is flexible
3. Monetary policy is robust

In the March 2012 *Monetary Policy Report*, Norges Bank clarified how these considerations are expressed in the Bank's response pattern. In that connection, the Bank adjusted the criteria to which it gives weight in interest rate forecasting. The key policy rate is set so that inflation is brought back to target. At the same time, inflation targeting is flexible, which means that the path for inflation should be weighed against developments in output and employments. Interest rate setting should also be robust. This means that the interest rate should be set so that monetary policy mitigates the risk of a buildup of financial imbalances.



Normally, the key policy rate cannot achieve several objectives simultaneously. In the case of conflicting objectives, the choice of interest rate path will involve a trade-off between different considerations.

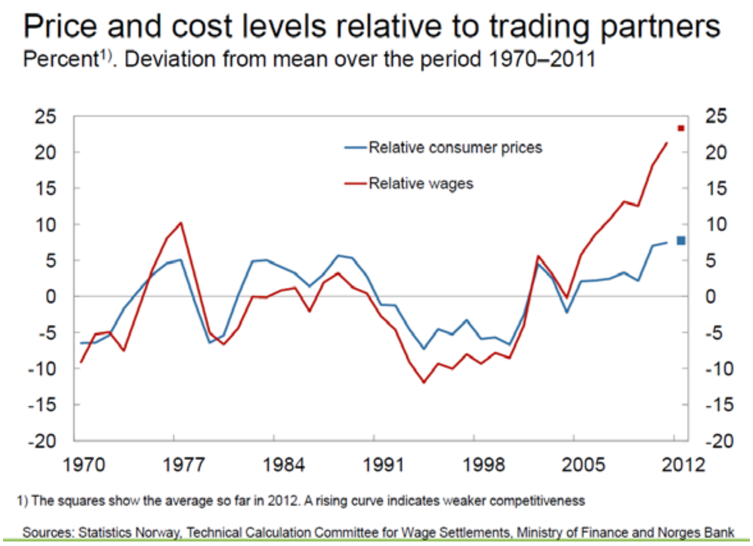
If monetary policy only took into account the low level of inflation, the key policy rate would be rapidly reduced and kept close to zero for a good while. Inflation might then pick up faster, partly as a result of a weaker krone. In the light of the trade-off against other considerations, however, the Bank does not want to accelerate the pace of inflation. The result would be a pronounced impact on output and employment and increased risk of a buildup of financial imbalances. A prolonged period of low interest rates may increase the risk that debt and asset prices will be driven up to levels that are unsustainable over time. When weight is also given to the two other criteria, the interest rate path therefore becomes higher even though the level of the key policy rate is low from a historical perspective.



The Norwegian economy is well poised to face new shocks and challenges. While many of our trading partners are struggling with low growth, high unemployment and mounting government debt, the Norwegian economy still features buoyant activity, low unemployment and government budget surpluses.

The petroleum industry and oil revenues have given us a solid economic foundation compared with other countries. At the same time, the oil revenues and the high cost level pose certain challenges to the Norwegian economy. With today's high oil prices, petroleum investment is likely to expand sharply in the years ahead. Petroleum-related industries are faring well. Public sector enterprises are also enjoying a favourable and stable environment. Internationally exposed industries are facing sluggish markets and high costs. Norway's dual economy is coming into clearer evidence.

Petroleum activity influences the Norwegian economy partly through actual production activity and partly through government spending of petroleum revenues. In 2011, petroleum revenue spending over the central government budget was below 5 percent of mainland GDP, while demand from the petroleum sector was about 17 percent.



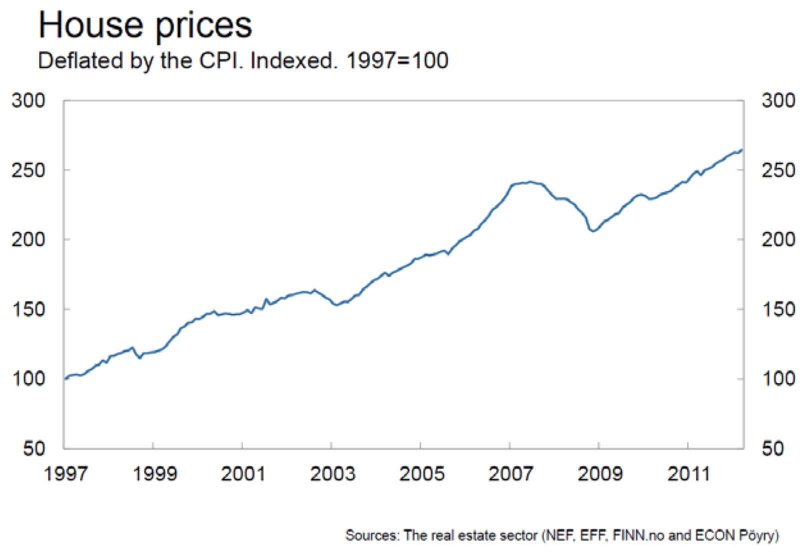
High oil prices and investment growth are fuelling demand for labour in the oil sector and the supplier industry. In an economy with close to full employment, this leads to intensified competition for skilled labour. The result is reduced profitability in other internationally exposed industries.

The phasing in of a new, profitable industry and increased spending over public budgets have the effect of crowding out other activity. Some decline in other industries is an inevitable consequence of domestic spending of oil revenues. For the economy to be sustainable over a longer horizon, it is important to find an appropriate balance and prevent excessive crowding out of exposed sectors. Monetary policy has little to contribute in this regard, whereas fiscal policy and other economic policy instruments are decisive.

Rapid wage growth over many years has led to a high domestic cost level. Measured in a common currency, the cost level in Norway relative to our trading partners is 20 percent higher than the historic average for Norway's oil age. As a result of the high cost level, internationally exposed industries are vulnerable to weaker international growth, a fall in export prices and a stronger krone.

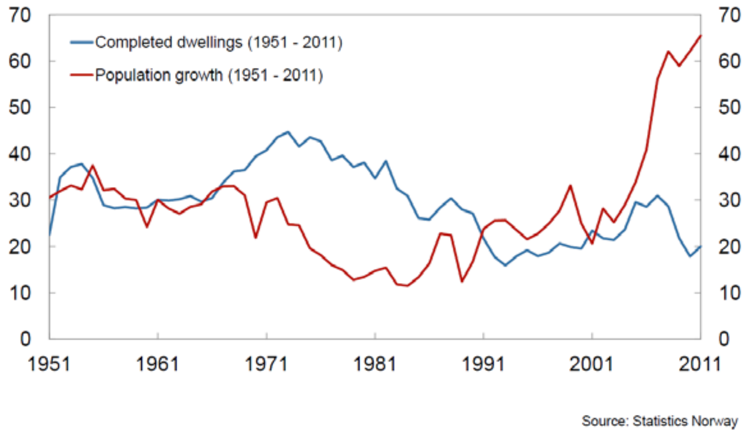
The real value of the krone has increased in recent years, reflecting solid domestic economic growth, high oil prices and relatively weak growth among our trading partners. As long as there are no available resources in the Norwegian economy, increased petroleum revenue spending over the central government budget will push up the real value of the krone or undermine competitiveness.

This is likely to continue as long as we plough more oil money into the economy. The petroleum fund mechanism and moderate and predictable petroleum revenue spending over the central government budget will nevertheless make a considerable contribution to stabilising economic developments ahead. By limiting petroleum revenue spending to the real return on the Fund, we can also ensure that future generations share the benefits provided by our petroleum wealth.



House prices are at a historically high level. The rapid growth in household income has been a key factor behind the rise in house prices for some time. In recent years, this tendency has been amplified by high immigration and hence strong population growth.

Population growth and completed dwellings
In thousands. Annual figures



In spite of vigorous building activity, the number of completed dwellings is still low in relation to population growth. This housing gap has developed over several years and is pushing up house prices. A tight labour market and low interest rates are pushing in the same direction.

The rise in house prices and the rate of debt accumulation are closely linked. Since the mid-1990s household debt in Norway has risen appreciably faster than income. On average, household debt is now twice as high as disposable income.

A rising share of households are facing a debt burden that makes them vulnerable when the interest rate again moves up to a normal level or if economic developments in Norway should take a turn for the worse. In such a situation, many households might find it challenging to service their debt and may reduce household spending. A pronounced fall in household demand will have a negative impact on corporate earnings and enterprises' capacity to service loans from Norwegian banks.

The key policy rate influences a number of variables, including the krone exchange rate, debt and house prices. In its interest rate setting, the Bank seeks to take into account all the key relationships in the economy, those that influence the real economy and inflation. But there is a limit to the tasks that can be given to monetary policy. Monetary policy cannot alone prevent financial imbalances or secure the competitiveness of the Norwegian business sector.

The objective of monetary policy is low and stable inflation and the Bank only has one instrument – the interest rate. Inflation expectations are now firmly anchored, which means that Norges Bank can give weight to stabilising economic developments in interest rate setting. But monetary policy cannot be overburdened. When assessing the various considerations, monetary policy must pursue its primary objective – low and stable inflation. Other economic objectives must be pursued using policy tools such as financial regulation, the tax system and fiscal policy.

Thank you for your attention.