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, 4 May 2015.

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

Accompanying charts can be found at the end of the speech or on the Norges Bank's website.

I would like to thank the Chair of the Committee for this opportunity to report on the conduct of monetary policy. My introduction here today is based on Norges Bank's Annual Report for 2014 and our monetary policy assessments up to the monetary policy meeting in March.

Chart: Inflation and projected capacity utilisation

Monetary policy in Norway is oriented towards keeping inflation low and stable. The operational target is consumer price inflation of close to 2.5 percent over time. The inflation target provides the economy with a nominal anchor. Inflation has edged up in recent years and hovered around 2.5 percent through 2014. When inflation expectations are firmly anchored, monetary policy can serve as the first line of defence when the economy turns down.

Monetary policy seeks to be robust and takes into account the risk of particularly adverse economic outcomes. The goal is to avoid an abrupt economic downturn and higher unemployment. In the event of major shocks, for instance a sharp drop in oil prices, this may imply a more active monetary policy than normal. The consideration of robustness also implies that monetary policy seeks to mitigate the risk of a build-up of financial imbalances. Hence, house price inflation and debt growth are also important for monetary policy. Norges Bank weighs the different types of risk against each other.

Six years have now passed since the global economy was hard hit by the financial crisis. The Norwegian economy has fared well in the years following the financial crisis, stimulated by vigorous activity in the petroleum industry. Growth has slowed in recent years and a decline in oil investment will result in low growth for a period. Against the background of weaker growth prospects for the Norwegian economy and reduced foreign interest rates, Norges Bank lowered its forecast for the key policy rate through 2014 and reduced its key policy rate in December 2014.

Chart: Money market rates for trading partners

Global economic growth remains moderate, but there are wide differences across countries. The sharp fall in oil prices is positive for most of our trading partners, but is dampening activity in oil-producing countries at the same time. Growth in the US is now on a firm footing, even though developments have been slightly weaker recently. An expansionary monetary policy appears to be working and both consumption and investment have picked up. Unemployment has declined.

Euro area activity is picking up, but growth remains low. Household consumption is on the rise, while business investment remains at a low level. High unemployment and continued deleveraging in the private and public sector will likely weigh down on the euro area economy for a long period ahead.

Growth is slowing in China, partly reflecting weaker investment in the real estate sector.

In April, the IMF published a new assessment of the world economic outlook. The IMF forecast for global growth was revised down by ¼ percentage point, owing to weaker growth prospects for emerging economies. The IMF projects global GDP growth at 3.5 percent in 2015, rising to 3.8 percent in 2016 and judges that financial stability risks have increased, with greater volatility in both financial markets and foreign exchange markets.

Consumer price inflation is low among most of our trading partners and close to zero in many countries. The oil price decline is contributing to holding down inflation. Many central banks have responded to the low level of inflation by further monetary policy easing. Policy rates are negative in some countries. The European Central Bank (ECB) and Sveriges Riksbank have, in addition, taken unconventional measures to counter the risk of deflation and stimulate activity, with large-scale purchases of securities, including government bonds.

Long-term government bond yields have continued to fall in many countries. Expansionary monetary policies, including that of the ECB, have likely contributed to the fall in long-term interest rates. The rise in international interest rates has been pushed further out in time. Low foreign interest rates influence developments in the krone and hence the inflation outlook in Norway. This is contributing to keeping interest rates low in Norway too.

Chart: Oil price and import-weighted exchange rate index (I-44)

The sharp fall in oil prices since summer 2014 has affected the outlook for the Norwegian economy. The fall in oil prices came on top of a planned downscaling of activity in the Norwegian oil sector. After expanding rapidly over several years, oil investment and activity in the sector are now set to be at a considerably lower level over the next few years. This will have negative spillover effects on the mainland economy.

Monetary policy cannot assume a primary responsibility for delivering necessary structural changes in the economy. But through the effects on the exchange rate, monetary policy can provide a push to restructuring in the business sector. The prerequisite for a pronounced weakening of the krone concurrent with low interest rates is continued confidence that inflation will remain low and stable over time.

Let me now turn to a more detailed account of the monetary policy pursued over the past year.

Monetary policy in 2014 was marked by steadily lower foreign interest rates and weaker domestic growth prospects.

Chart: Petroleum investment

The Norwegian economy broadly followed the path projected at the start of 2014. But the picture changed just before summer. Ahead of Norges Bank's monetary policy meeting in June, information indicated that oil investment would fall markedly in 2015. High cost growth and focus on improving profitability prompted oil companies to scale back their investment plans. Against this background, there were prospects that the Norwegian economy would grow at a slower pace than expected earlier. At the June monetary policy meeting, Norges Bank kept the key policy rate unchanged, but lowered the projected path for the key policy rate. We gave weight to the possibility of a further weakening of the growth outlook for the Norwegian economy, which might warrant a reduction in the key policy rate.

Through autumn oil prices declined markedly to around USD 70 per barrel at the beginning of December, or to a level at about 35 percent below the average for the first six months of 2014. At the same time, the krone depreciated considerably. A weaker krone leads to higher import prices. At the same time, the competitiveness of Norwegian trade-exposed industries improves. The depreciation of the krone thereby dampens the effects of a lower oil price on the Norwegian economy. The outlook for the Norwegian economy had nevertheless clearly weakened. At the monetary policy meeting on 10 December 2014, Norges Bank gave particular weight to reducing the risk of a pronounced downturn in the Norwegian economy as a result of the sharp fall in oil prices. The key policy rate was thus reduced by 0.25 percentage point to 1.25 percent. The analysis in the December 2014 Monetary Policy Report implied a key policy rate at that level or somewhat lower in the coming years.

Chart: Projections for the key policy rate in various Monetary Policy Reports

In the period to the monetary policy meeting in March 2015, the Norwegian economy had moved broadly in line with the path projected in December 2014. Inflation remained close to 2.5 percent. Unemployment had remained stable and was slightly lower than expected. At the same time, the outlook ahead was weaker than envisaged in December. Oil prices had continued to slide and activity in the petroleum industry appeared to be falling more than previously anticipated both this year and next. Wage growth in 2014 turned out to be lower than assumed and there were prospects of somewhat lower wage growth ahead than projected earlier.

At the monetary policy meeting in March, Norges Bank gave weight to that fact that the key policy rate had been reduced in December to counter the risk of a pronounced downturn in the Norwegian economy as a result of lower oil prices. So far, the effects on the real economy had been relatively small. At the same time, house prices had continued to rise at a rapid pace. The rapid rise in property prices may lead to higher debt growth. That may increase household vulnerability and trigger or amplify a downturn in the economy further ahead. Based on an overall assessment, Norges Bank chose to leave the key policy rate unchanged. If developments in the Norwegian economy are broadly in line with that projected in the period ahead, there are nevertheless prospects that the key policy rate will be reduced further in the course of the first half of this year.

The analysis in the latest *Monetary Policy Report* suggests that capacity utilisation in the Norwegian economy will decline ahead. Moreover, there are prospects that unemployment may increase somewhat, but reduced labour immigration will likely limit the increase. The krone deprecation since autumn 2014 will contribute to underpinning inflation in the coming period, but inflation is projected to move down further ahead.

In the conduct of monetary policy, we seek to mitigate the risk of a build-up of financial balances, but monetary policy cannot assume a primarily responsibility for financial stability. Should financial imbalances build up further, the required countercyclical capital buffer for banks may be increased. Rapid rises in house prices and debt may also require the implementation of other, more targeted measures in order to mitigate the risk associated with the high level of household debt.

In March this year, the Ministry of Finance requested Finanstilsynet (Financial Supervisory Authority of Norway) to consider whether it would be appropriate to implement measures aimed at limiting growth in credit and house prices. Norges Bank submitted its comments today where we endorse Finanstilsynet's proposal while underlining the importance that regulation should give the banks flexibility – and responsibility for conducting sound credit assessments. Norges Bank recommends that the maximum limit for the loan-to-value ratio be set at 85 percent as a regulatory requirement, but that banks are also permitted to extend a certain proportion of loans with a loan-to-value ratio higher than 85 percent. Such quotas for new loans that exceed the regulatory limit are commonly referred to as speed limits. Norges Bank recommends that the tightened requirements for principal repayments for loans with high loan-to-value ratios and for debt servicing be set out in the form of guidelines rather than in the form regulations. The prudent lending requirements strengthen the robustness of banks and households and should be regarded as a permanent structural measure.

Let me conclude by turning back to the present situation and challenges for the Norwegian economy. Oil prices have nearly halved since last summer. So far, the effects on the mainland economy have been relatively small. Nevertheless, the Norwegian economy must now adapt to lower demand from the oil sector and lower oil revenues.

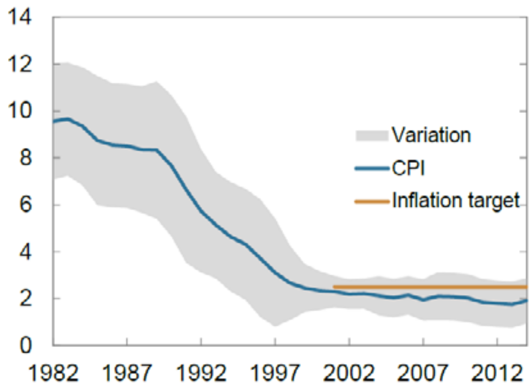
The shift to an oil-driven economy with a high wage capacity was a comfortable journey. The journey forward, where the oil service industry must downscale and other trade-exposed industries must grow, will be more challenging.

The point of departure for coping with the period of restructuring we are now facing is favourable. We have economic policy leeway. Inflation expectations are firmly anchored and the krone exchange rate is functioning as a stabiliser. And perhaps most important of all: Norwegian businesses and the social partners have previously shown an ability to restructure. That ability will also be decisive this time.

Thank you for your attention.

Inflation

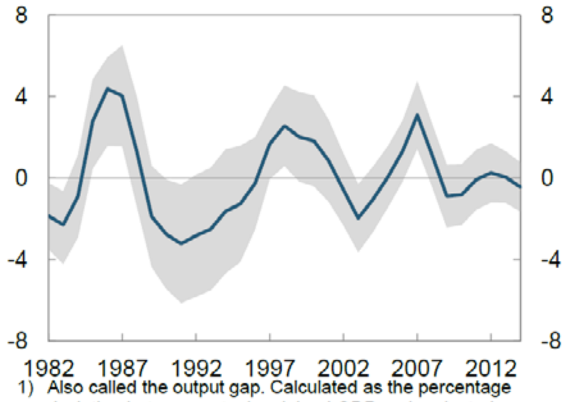
10-year moving average and variation[2] in CPI. Percent. 1982 – 2014



1) Moving average is calculated 10 years back.
2) The band around the CPI is the variation in the CPI in the average period, measured by +/− one standard deviation.
Sources: Statistics Norway and Norges Bank

Projected capacity utilisation[1]

Level and variation[2]. Percent. 1982 – 2014



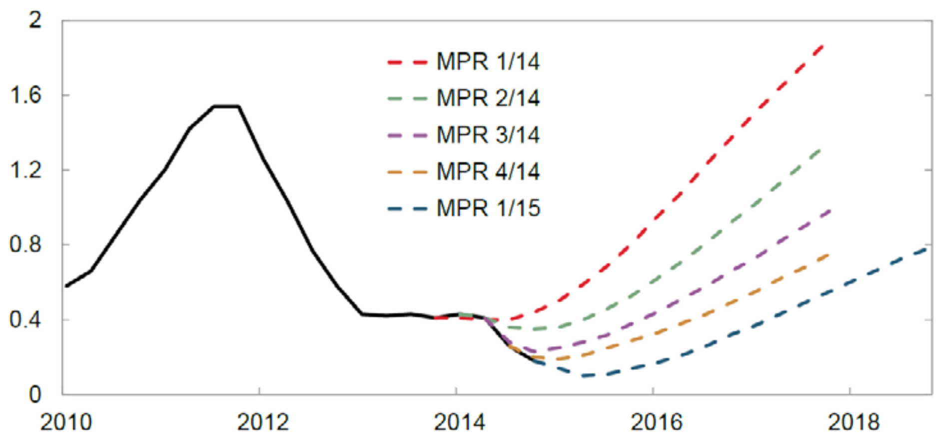
1) Also called the output gap. Calculated as the percentage deviation between actual mainland GDP and projected potential mainland GDP.
2) The band shows the variation in the output gap measured by +/- one standard deviation. The standard deviation is calculated over a 10-year period

2

Source: Norges Bank

Money market rates for trading partners

Percent. 2010 Q1 – 2018 Q4



1) Estimated forward rates at different points in time (broken lines).
Sources: Thomson Reuters and Norges Bank

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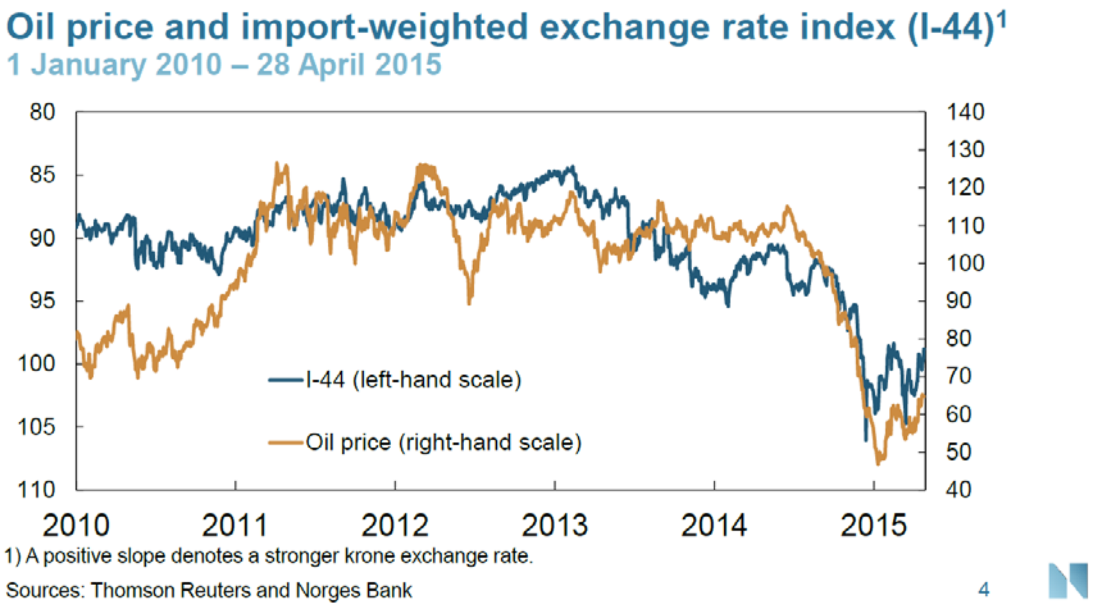

Oil price and import-weighted exchange rate index (I-44)1
1 January 2010 – 28 April 2015
80
85
90
95
100
105
110
140
130
120
110
100
90
80
70
60
50
40
I-44 (left-hand scale)
Oil price (right-hand scale)
2010
2011
2012
2013
2014
2015
1) A positive slope denotes a stronger krone exchange rate.
Sources: Thomson Reuters and Norges Bank
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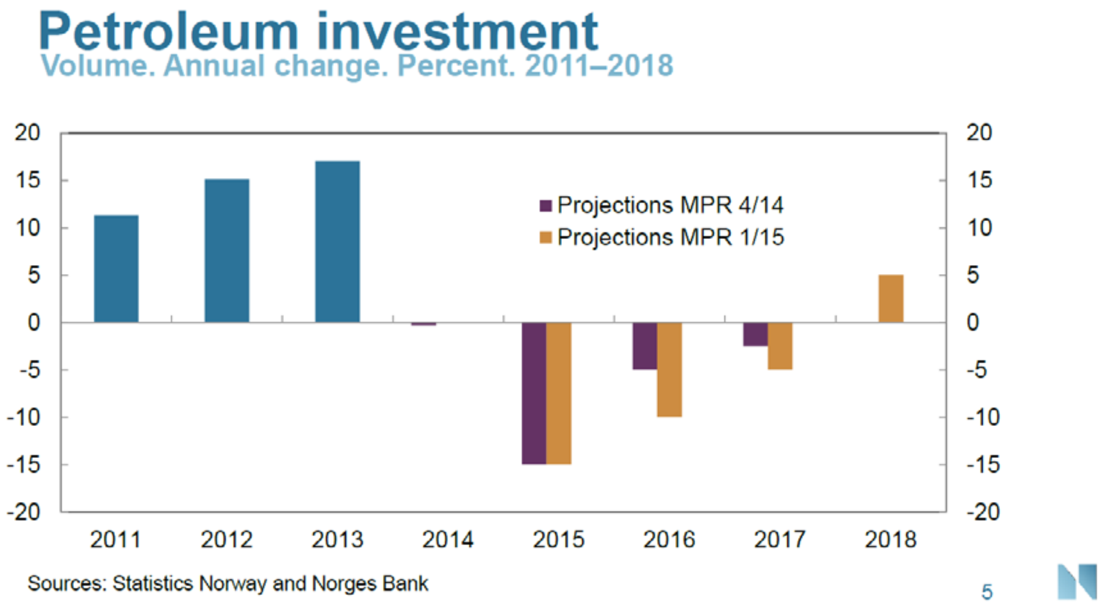
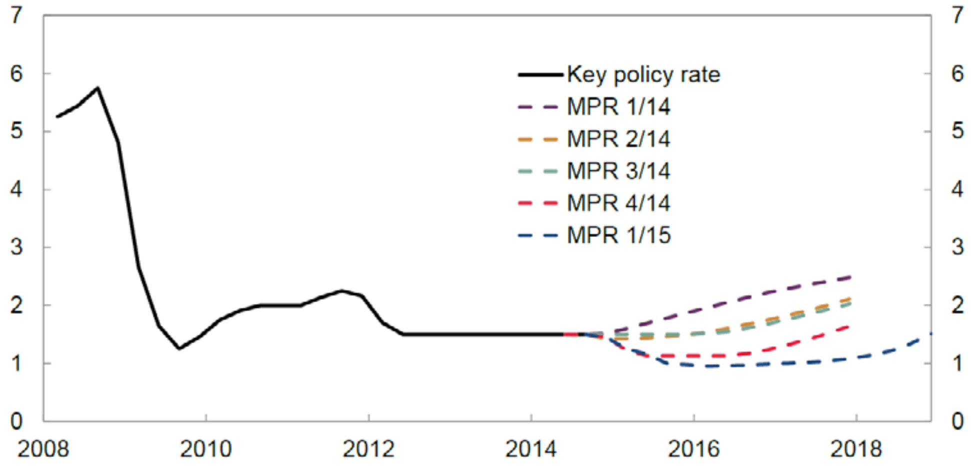


Petroleum investment
Volume. Annual change. Percent. 2011–2018
20
15
10
5
0
-5
-10
-15
-20
Projections MPR 4/14
Projections MPR 1/15
2011
2012
2013
2014
2015
2016
2017
2018
Sources: Statistics Norway and Norges Bank
5

Projections for the key policy rate in various Monetary Policy Reports

Percent. 2008 Q1 – 2018 Q4



Source: Norges Bank

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