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, 19 May 2016.

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

Thank you for the opportunity to report on the conduct of monetary policy. My introduction here today is based on Norges Bank's Annual Report for 2015 and our monetary policy assessments up to the monetary policy meeting last week.

Chart: Inflation

Monetary policy in Norway has since 2001 been oriented towards keeping inflation low and stable. The operational target is consumer price inflation of close to 2.5 percent over time. Over the past 15 years, inflation has averaged around 2 percent. This is close to the target.

Norges Bank operates a flexible inflation targeting regime, giving weight in our interest rate setting to developments in output and employment as well as inflation. The effects of monetary policy are uncertain. This normally suggests proceeding with caution. As monetary policy also seeks to be robust and take account of the risk of particularly adverse outcomes for the economy, the tasks of monetary policy should include contributing towards mitigating the risk of a build-up of financial imbalances.

Over the past year, monetary policy in Norway has to a great extent been influenced by weaker economic growth, resulting from the fall in oil prices and lower activity in the petroleum industry. To counteract the decline, the key policy rate has been reduced by a total of 1 percentage point since December 2014. The key policy rate is now 0.5 percent.

A small open economy such as Norway is also influenced by the world around us. Norway's low interest rate level is largely a consequence of low interest rates abroad.

Chart: Global growth projections

Growth in the global economy has been low in recent years, partly reflecting long-term trends such as lower productivity growth and demographic changes. Long-term interest rates abroad have shown a falling trend since the 1980s. Over the past few years, the repercussions of the financial crisis and the need for deleveraging in many countries have weighed on growth. While the moderate recovery in advanced economies continued last year, growth in China and other emerging economies slowed. In its April World Economic Outlook report, the International Monetary Fund (IMF) revised down its global growth forecasts yet again. At the same time, the IMF stressed the risk that growth may again prove to be weaker than projected.

For several of Norway's main trading partners, inflation is close to zero. The low level of inflation is partly the result of the fall in many manufacturing and commodity prices, including oil prices. In addition, cost pressures in many countries are moderate after several years of high unemployment and low wage growth.

Chart: Money market rates for trading partners

The low level of inflation has led central banks to implement further monetary policy easing over the past year. Policy rates are now negative in a number of countries. In addition, several central banks have introduced other instruments to stimulate economic activity and mitigate the risk of deflation. The European Central Bank (ECB) has expanded its asset purchase programme to include government bonds. The Riksbank, the central bank of Sweden, introduced a government bond purchase programme at the beginning of last year. On the other hand, the Federal Reserve raised its policy rate for the first time in nine years in

December 2015. Trading partners' policy rates can be expected to remain low for a long period ahead.

External developments influence the Norwegian economy through several channels: through demand for Norwegian goods and services, through financial markets and the exchange rate and, not least, through commodity prices.

Chart: Oil prices

The fall in oil prices began in summer 2014 and continued through 2015. Oil prices have picked up again somewhat in recent months to just over USD 45 per barrel, but are still at less than half of their pre-fall level. Futures prices have also decreased in the past year. These prices now indicate only a moderate rise in oil prices ahead. The decline in oil prices partly reflects large oil supply surpluses and lower demand for oil in China and other emerging economies experiencing weaker growth.

The effects of the fall in oil prices on the Norwegian economy gradually became evident through 2015 and were particularly pronounced in regions and sectors closely linked to the oil industry.

Chart: Petroleum investment

The most direct channel through which the fall in oil prices is transmitted to the economy is via the supply of intermediate goods and services to the petroleum industry. Oil companies have postponed or cancelled a number of development projects on the Norwegian continental shelf as a result of the decline in oil prices and have implemented a range of measures to reduce operating and maintenance costs. Total petroleum investment fell by 15 percent between 2014 and 2015. At the same time, lower demand from the global petroleum industry has led to a decline in Norwegian oil service exports.

The decrease in activity in the oil industry is having spillover effects on the wider mainland economy. The effects are most pronounced in industries providing goods and services directly to oil companies, but are also clearly evident in a number of other industries. Mainland business investment also showed a fall in 2015, driven by a weaker growth outlook and uncertainty surrounding economic developments. Growth in household consumption has nonetheless remained fairly firm. House prices and housing investment have continued to rise, although the fall in oil prices has had a dampening effect in some areas of the country. Public demand has also stimulated the economy.

Chart: Relative labour costs

The Norwegian krone has depreciated markedly in the wake of the fall in oil prices and is now approximately 15 percent weaker than two years ago. The depreciation has led to a marked improvement in Norwegian firms' cost competitiveness.

The main responsibility for developments in relative wages lies with the social partners. If the improvement in competitiveness is to be sustained, Norwegian labour costs must develop more in line with the labour costs of our trading partners. This will make it easier to build up a larger non-oil tradable sector.

The krone depreciation has helped start the restructuring process in the Norwegian economy. After a decade of higher growth in imports than mainland exports, export growth has recently outpaced import growth. The tourism industry is one of a number of industries experiencing an upswing. Many export firms have announced plans to increase investments in 2016, which will provide opportunities for an increase in production and market shares.

Chart: Unemployment

Employment in Norway has been high for many years. Compared with other countries, unemployment has been low. In the competition for labour resources, oil production and oil service companies have drawn the longest straw. The situation has now changed. Unemployment has increased over the past year. Regions with close links to the oil industry, which have benefitted from the oil boom for many years, are being hit hard. Although employment continued to rise last year, employment growth has slowed.

Total mainland activity increased by 1 percent between 2014 and 2015. This is the lowest pace of economic growth since 2009. Growth may edge down even further this year before gradually picking up again. Growth is being restrained by the marked fall in petroleum investment and weak growth in other business investment, while it is being supported by household consumption, exports of traditional goods and public demand.

The depreciation of the krone is also supporting inflation. The rise in prices for imported goods has increased over the past year, and the year-on-year rise in the consumer price index has been just over 3 percent in recent months. Inflation may be dampened ahead by the decline in wage growth and as the effects of the krone depreciation unwind.

Chart: Key policy rate

The key policy rate was lowered to 0.5 percent at the March monetary policy meeting. According to the Executive Board's assessment of the outlook in March, the key policy rate may be reduced further in the course of the year. The key policy rate was kept unchanged at the monetary policy meeting in May.

There is no crisis in the Norwegian economy, but we are facing restructuring. Restructuring must start in the business sector. Activity in the oil sector will be reduced to a considerably lower level. Other industries must emerge and provide the basis for new jobs. Economic policy can only facilitate this process. Restructuring takes time.

Monetary policy is the first line of defence in managing the economy. In the wake of the sharp fall in oil prices since summer 2014, the key policy rate has been lowered several times. Monetary policy is facilitating restructuring by supporting a weaker krone and thereby speeding up the adjustment to a lower cost level. In addition, lower interest expenses are easing the burden for many households and enterprises. There is still room for manoeuvre in monetary policy. However, in an economy undergoing restructuring, monetary policy cannot fully counteract the effects on output and employment.

Internationally, monetary policy has faced substantial challenges in recent years. Inflation and interest rates are both close to zero in many countries. The instruments used have rarely been used before. The effect of this policy is uncertain and the expected increase in policy rates has been repeatedly pushed further into the future. Central banks are in uncharted territory.

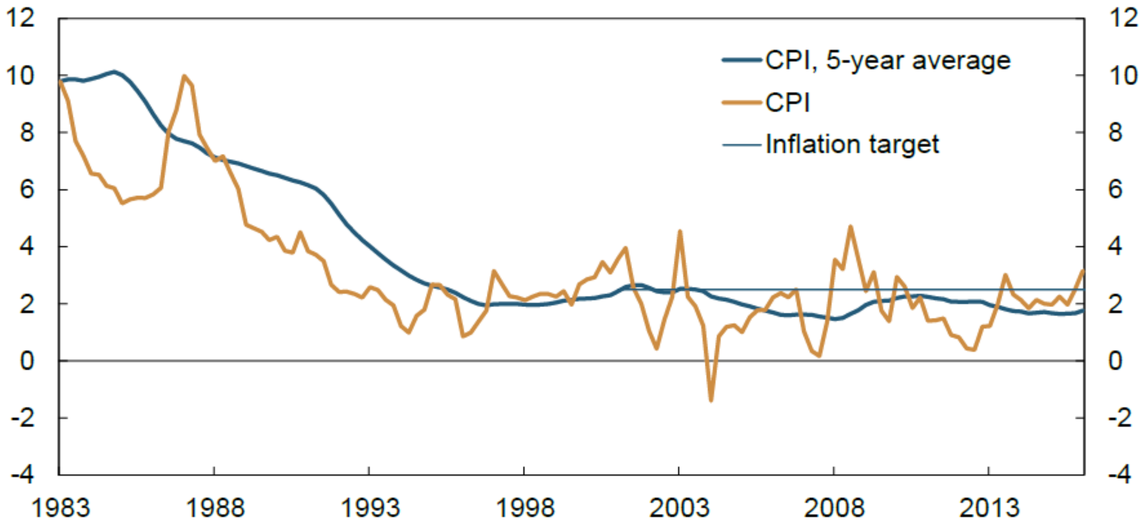
The experiences of other countries indicate that the lower bound for policy rates is below zero, although precisely how far below is difficult to estimate. Lower interest rates may increase financial system vulnerabilities. Low interest rates also increase the risk of a surge in credit growth and property prices. When the key policy rate approaches a lower bound, the uncertainty surrounding the effects of monetary policy increases. This suggests proceeding with greater caution in interest rate setting. However, should the Norwegian economy be exposed to new major shocks, the possibility cannot be excluded that the key policy rate in Norway may also turn negative.

The Ministry of Finance will assess the need to modernise the regulation on monetary policy. After 15 years of the current regulation, a review may be in order. I would, however, emphasise that our experience of the current monetary framework is positive. Confidence in low and stable inflation is firmly anchored. The primary task of monetary policy must always be price stability. When inflation is firmly anchored, monetary policy can also contribute to stable developments in the real economy. Monetary policy can react quickly to cyclical changes, as was the case during the financial crisis when the key policy rate was markedly reduced in order to limit the downturn. The framework has also functioned well in face of the substantial decline in oil prices. The flexibility and room for the exercise of judgement provided by the mandate has strengthened monetary policy and the Norwegian economy.

Thank you for your attention.

Inflation

Four-quarter change. Percent



Sources: Statistics Norway and Norges Bank

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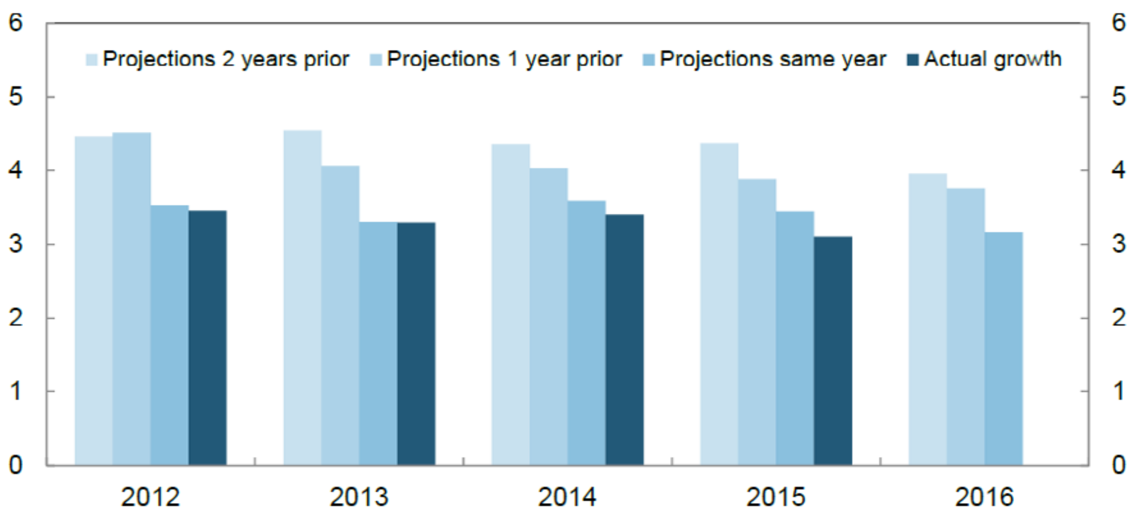
Global growth projections

Growth from previous year. Percent. Actual and projections[1)]



1) Projections from April every year.
Source: IMF

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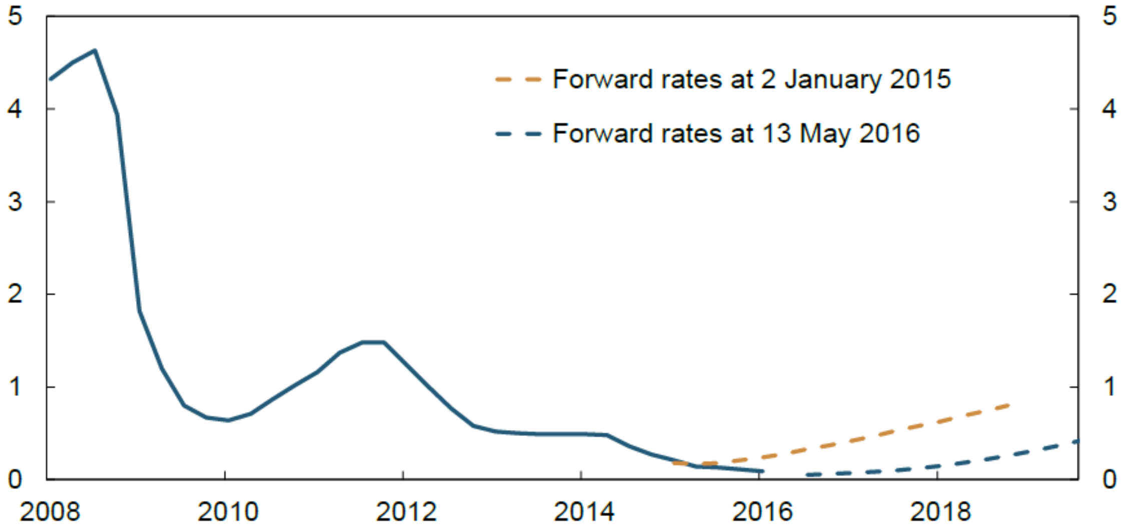
Money market rates for trading partners

Percent



Sources: Bloomberg, Thomson Reuters and Norges Bank

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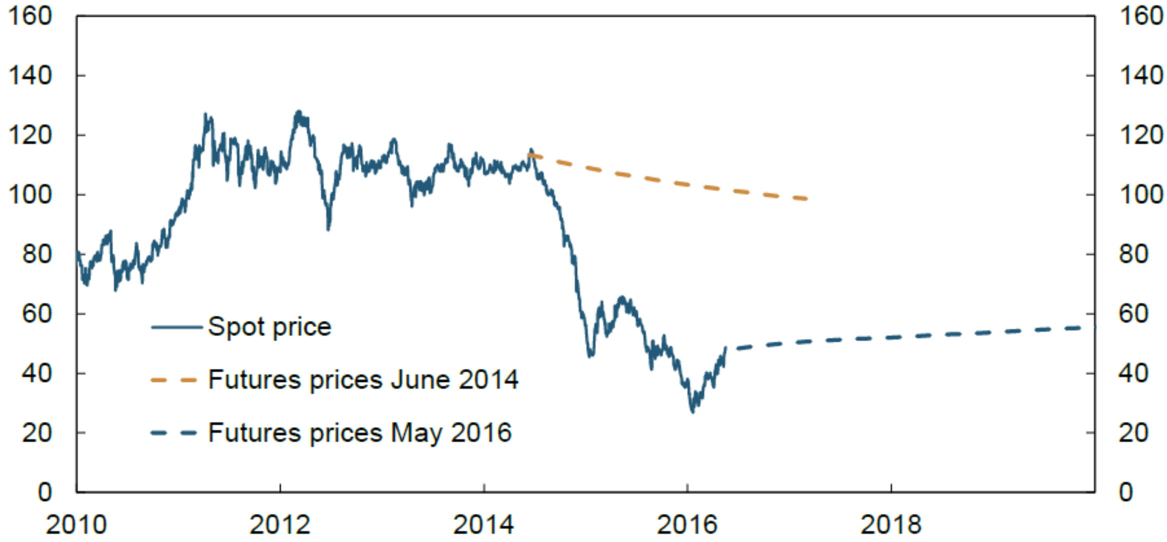
Oil prices

USD per barrel



Sources: Thomson Reuters and Norges Bank

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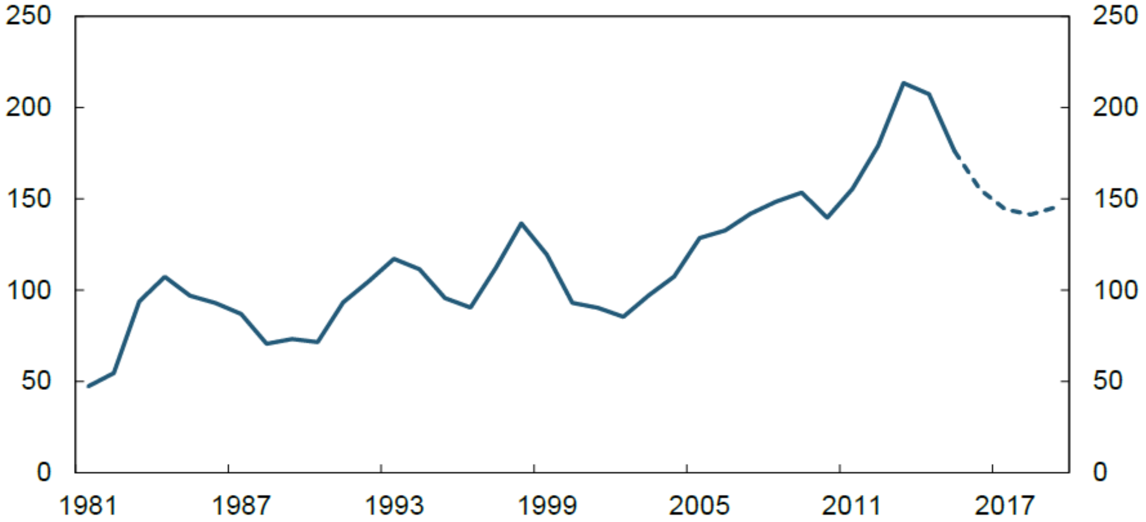
Petroleum investment

Constant 2013 prices. In billions of NOK[1)]



1) Projections for 2016 – 2019 in Monetary Policy Report 1/16.
Sources: Statistics Norway and Norges Bank

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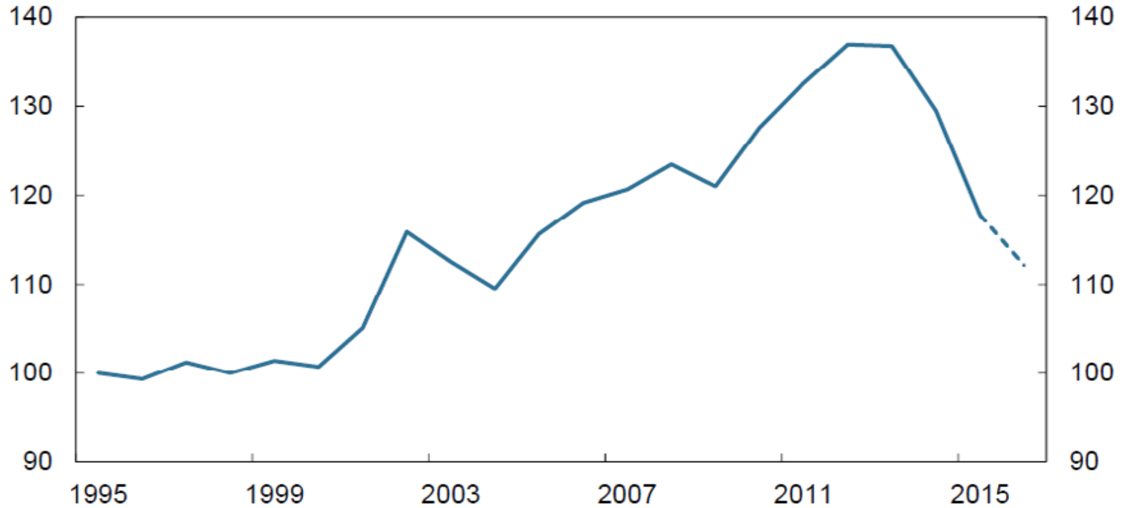
Relative labour costs[1)]

Index. 1995 = 100[2)]



1) Hourly labour costs in manufacturing. Measured in a common currency.
2) Projections for 2016 in Monetary Policy Report 1/16.
Sources: The Norwegian Technical Committee for Wage Settlements (TBU) and Norges Bank

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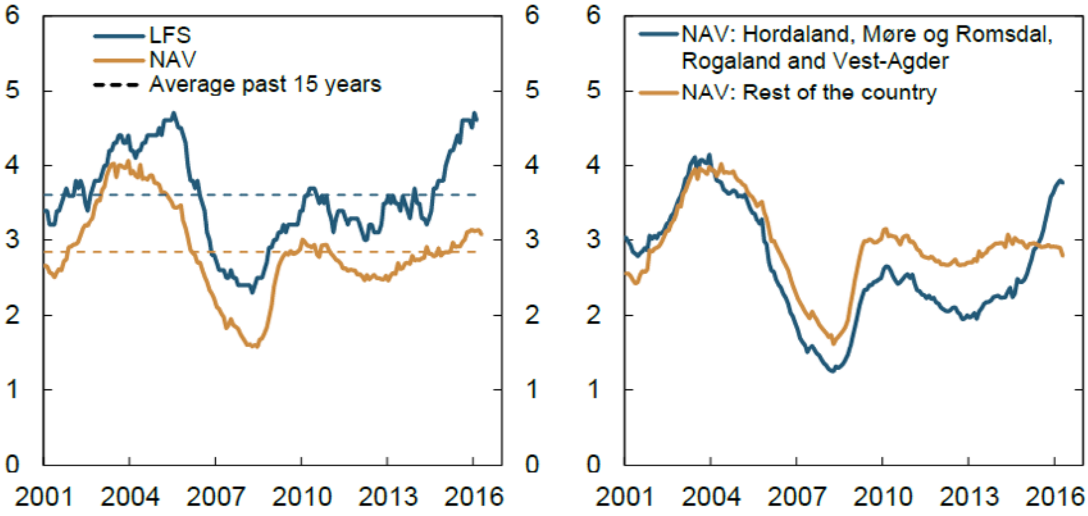
Unemployment

LFS[1)] and NAV[2)]. Percent



1) Labour Force Survey.
2) Norwegian Labour and Welfare Administration.
Sources: NAV, Statistics Norway and Norges Bank

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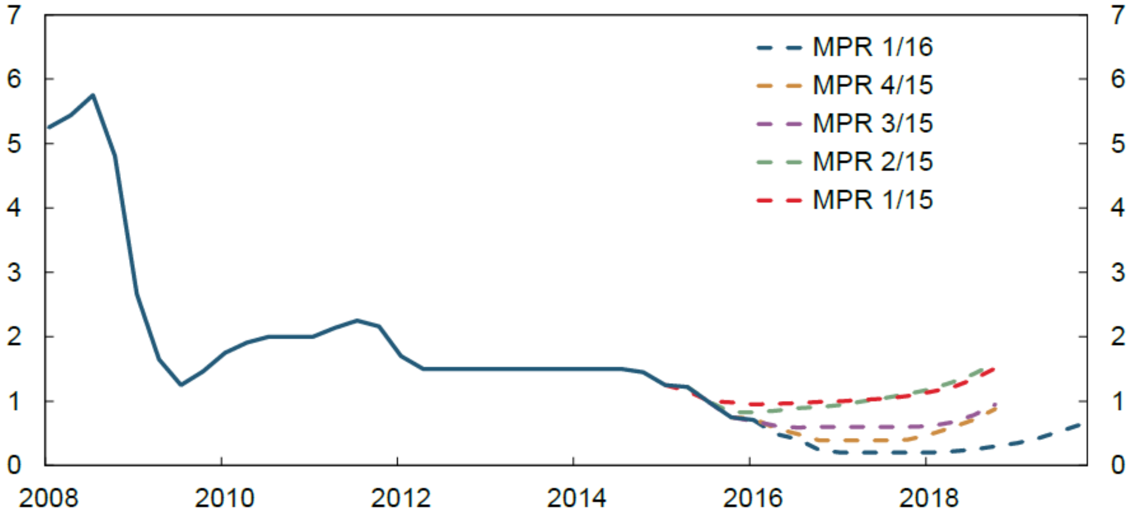
Key policy rate

Actual and as projected in recent monetary policy reports. Percent



Source: Norges Bank

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