Svein Gjedrem: The conduct of monetary policy

Introductory statement by Mr Svein Gjedrem, 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, 18 May 2010.

Please note that the text below may differ from the actual presentation. The statement is based on Norges Bank's Annual Report for 2009, Monetary Policy Report 1/10 and the Executive Board's assessments in the period to the monetary policy meeting on 5 May.

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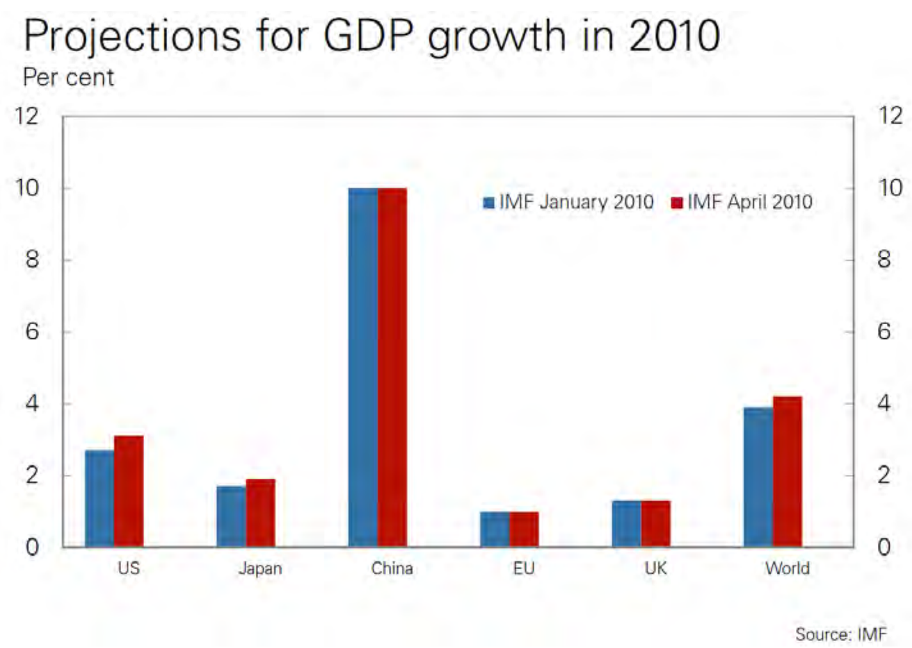
I would like to thank the Chairman of the Committee and also thank the Committee for this opportunity to report on the conduct of monetary policy in connection with the Storting's deliberations on the Government's Financial Market Report (previously the Credit Report). My statement is based on the Bank's Annual Report, but is also updated based on the Executive Board's assessments for the period to the previous monetary policy meeting and new information received to date. I also refer to this year's report from Norges Bank Watch, a group of experts that evaluates Norges Bank's conduct of monetary policy.

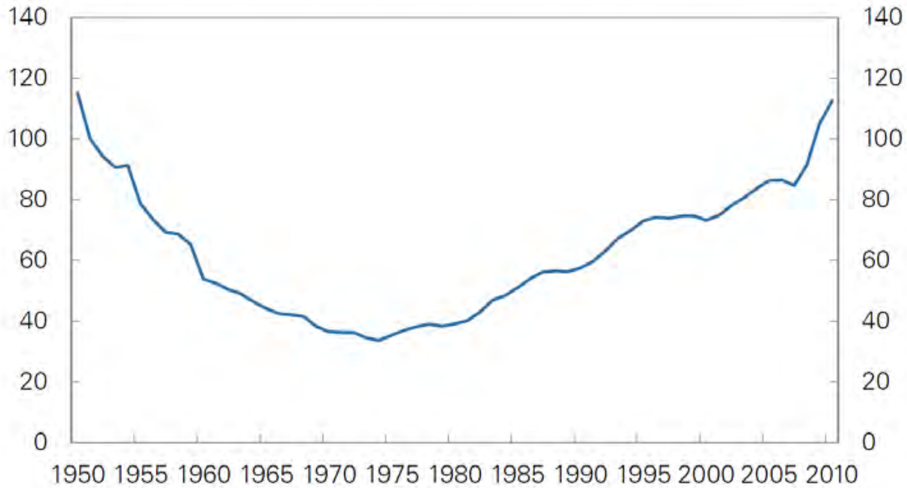
1. New imbalances



The most acute phase of the financial market crisis has for a period appeared to be over. In most parts of the world, output growth has resumed. The recovery has been strongest in emerging Asia. The upturn in OECD countries has been more moderate. The economies of many countries will continue to be marked by high levels of spare production capacity.

New imbalances – sovereign debt to GDP in the G-7

In per cent



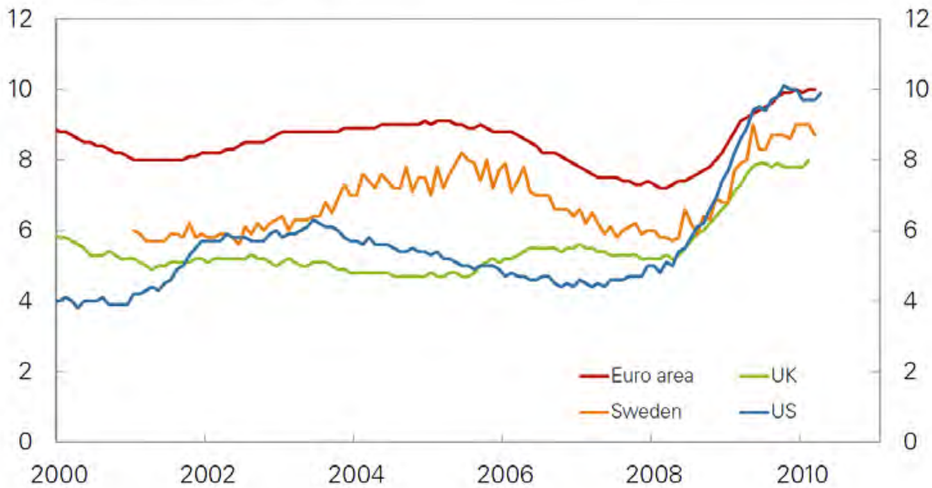
Source: IMF Global Financial Stability Report

But the situation is fragile. The crisis has given rise to new imbalances. Fiscal deficits have risen substantially in many countries and a number of countries are in the midst of a fiscal crisis. Government debt in the major advanced economies is as high measured as a share of GDP as it was immediately after the Second World War when the surge in military spending had been financed by borrowing.

New imbalances – increased unemployment

Share of labour force. Per cent. Seasonally adjusted

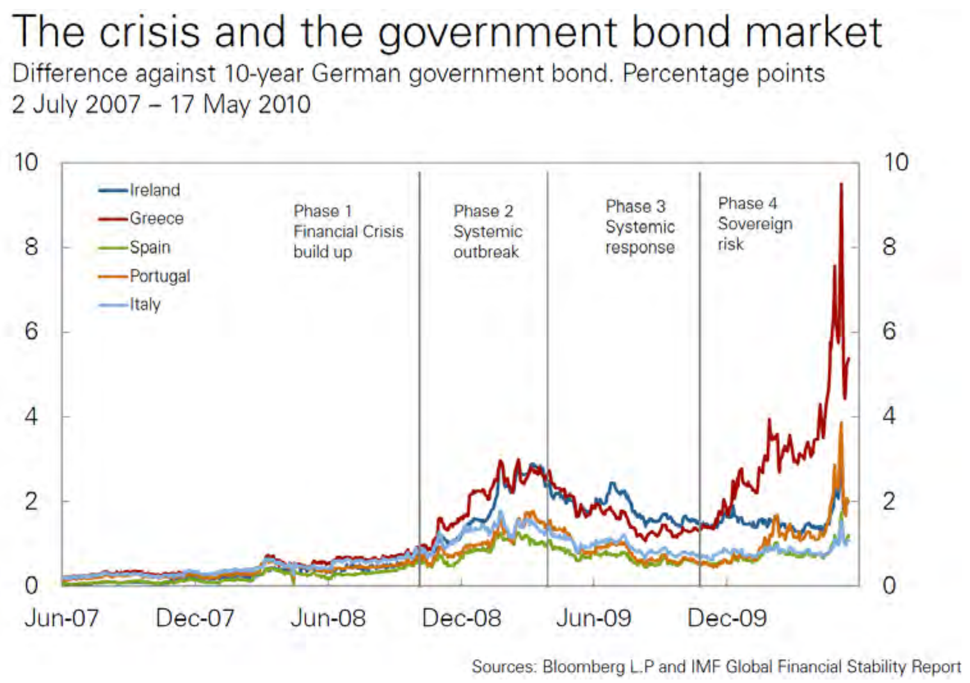
January 2000 – April 2010



Source: Thomson Reuters

Even with substantial tax cuts, strong growth in public spending and very low interest rates, unemployment has risen considerably in both the US and Europe. In many countries, unemployment has reached double digits. There is a risk that unemployment will become entrenched, particularly perhaps in Europe.

2. Financial crisis



After a long upturn, the financial crisis started to unfold in summer 2007.

In autumn 2008, a full-blown systemic crisis erupted in the financial system. After the collapse of the investment bank Lehman Brothers, activity in money and credit markets almost came to a halt. Risk premiums in money markets and in corporate bond markets rose to a very high level. Governments took action to stabilise economic developments by supporting banks, cutting taxes and increasing spending. During this phase, the effects on government borrowing rates were limited. Interest rates in Greece and Ireland rose markedly.

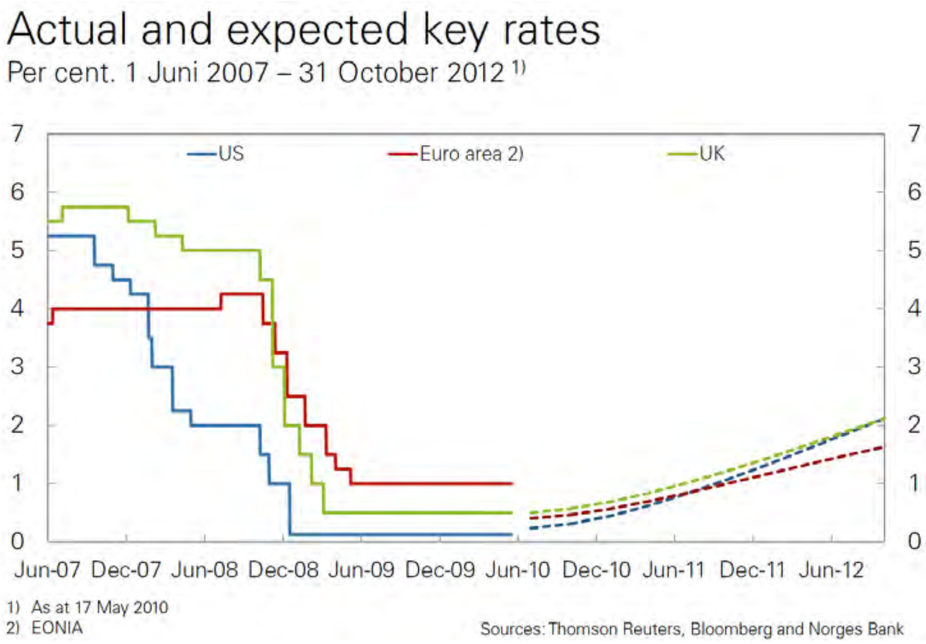
The fall in financial markets came to a halt at the beginning of March 2009. On 9 March 2009 the Federal Reserve published the results of a comprehensive stress testing of US banks. In retrospect, it appears that a better overview reduced uncertainty in financial markets. International equity markets then rebounded for a period and premiums were reduced.

Up to last autumn, there was little concern in the markets as to governments' ability to finance fiscal deficits and service debt.

In late autumn last year, the crisis entered its latest phase so far, and the situation in Greece was a subject of growing concern. The fiscal deficit was considerably larger than previously reported and announced. Reports also indicated errors in government debt figures. Ireland had already implemented tightening measures and was therefore in a better position.

Recently, uncertainty concerning the economic situation in Greece has spread to other southern European countries. European money, bond and foreign exchange markets have also been affected. Equity markets have fallen sharply. On 2 May, Greece, the IMF and the euro area countries reached an agreement to provide a total of EUR 110 billion in loans to Greece. Greece has presented an economic programme to stabilise and then reduce government debt and to boost growth potential. However, the loan was not sufficient to quell market unrest. On the contrary, premiums rose. The governments of several other countries were in danger of not being able to pay their bills.

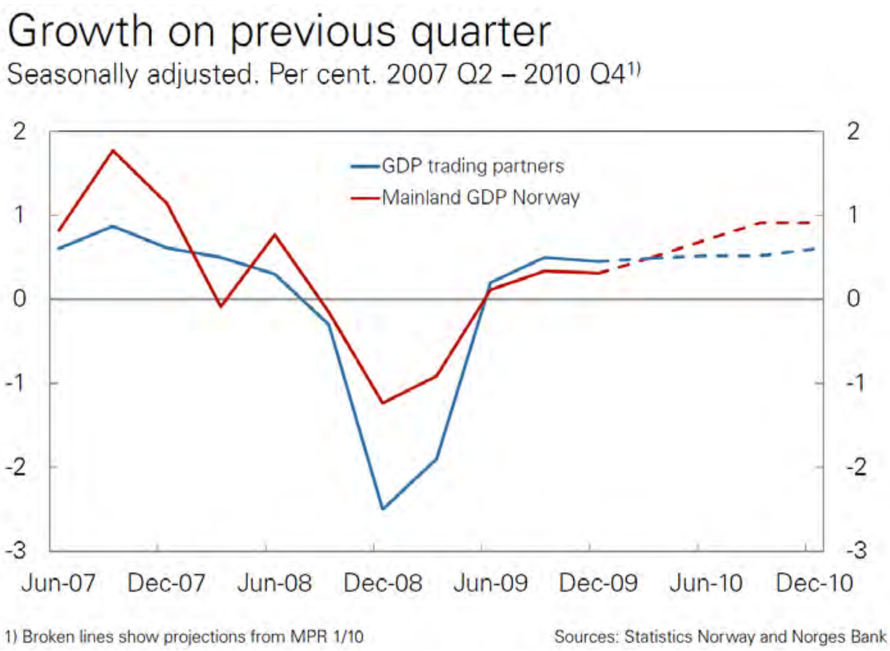
At a crisis meeting on 8–9 May, EU finance ministers therefore agreed on a EUR 500 billion European Financial Stabilisation mechanism to support countries unable to borrow in the market. The largest portion will be provided through loans guaranteed by individual euro area countries. The IMF will provide support in the form of loans upon application from an individual country, perhaps up to a total of EUR 250 billion. Several countries announced sharper spending cuts. The ECB will buy government and other bonds and offer extra loans to banks to promote the smooth functioning of markets. Moreover, the Federal Reserve has entered into agreements with other central banks to re-establish temporary dollar swap facilities to avoid failure in dollar funding markets.



3. Norwegian economy

To mitigate the effects of the financial crisis, central bank key rates were cut sharply in 2008 and are still close to zero in a number of countries.

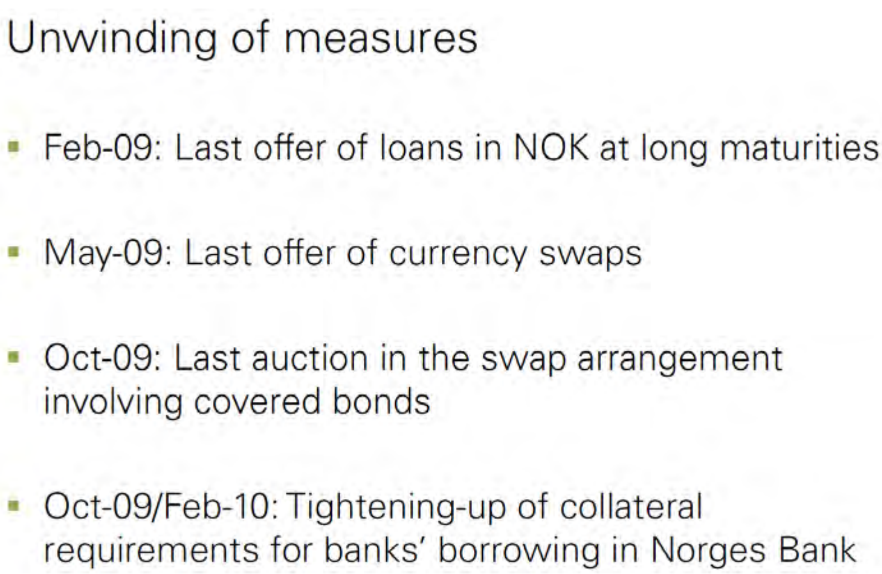
The key policy rate in Norway was also reduced from autumn 2008. Norges Bank also implemented a number of extraordinary measures to improve credit flows. Banks were provided with longer-term liquidity and direct access to US dollar liquidity, and collateral requirements for loans from Norges Bank were relaxed. On the advice of Norges Bank and a proposal from the Ministry of Finance, the Storting decided that banks would be entitled to exchange covered bonds for government securities. The Norwegian State Finance Fund and the Norwegian State Bond Fund were established to bolster the supply of bank equity capital and loans to enterprises. In addition, the Storting allocated funds to central and local government authorities for maintenance and investment in order to support activity.



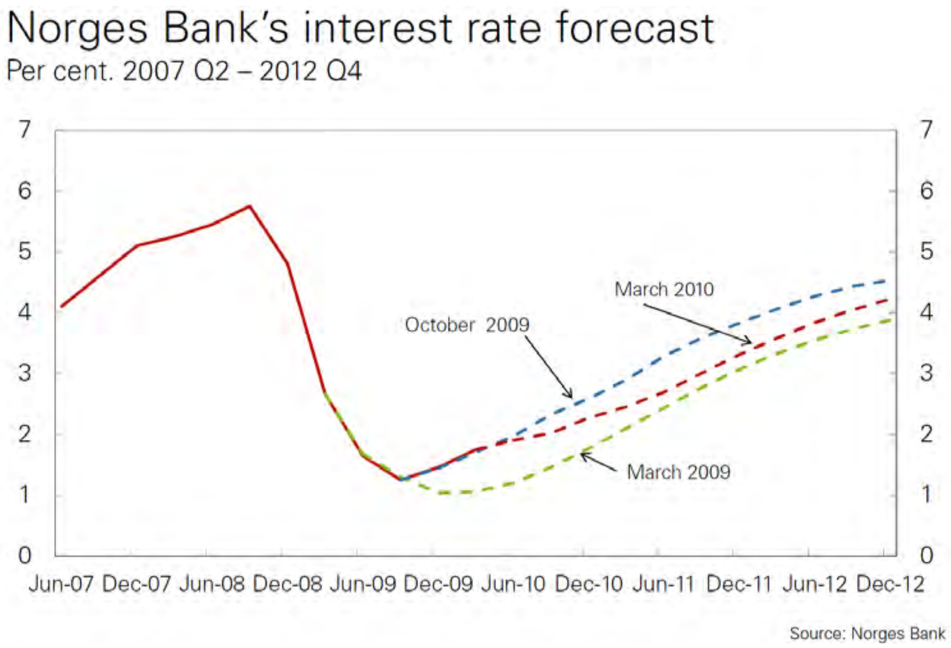
Economic growth in Norway came to a halt in autumn 2008, and output fell in both the fourth quarter and the first quarter of 2009. Growth resumed from the second quarter. The substantial decrease in the key policy rate, combined with increased public spending and high oil investment has contributed to supporting activity. Capacity utilisation is nonetheless still lower than normal, although the downturn appears to have been mild so far.

Without low key rates, inflation would have fallen too far.

Unemployment rose less than we projected last year. Firms retained employees despite the fall in activity and many young people exited the labour force in favour of education. The mild downturn in Norway is also reflected in the wage settlements, which have provided for appreciably higher pay increases than among our trading partners.



In late spring last year, liquidity premiums in money and bond markets started to fall in Norway. As these markets began to normalise, the extraordinary measures could be phased out. Long-term loans were no longer provided after February 2009. After May, foreign exchange swap agreements were no longer provided. Spring 2009 saw the first signs that the covered bond market was beginning to function. In June, it was announced that the swap arrangement would be phased out by gradually adjusting the minimum price to the bond rates prevailing in this market at that time. And finally, in October, Norges Bank tightened the collateral requirements for loans.



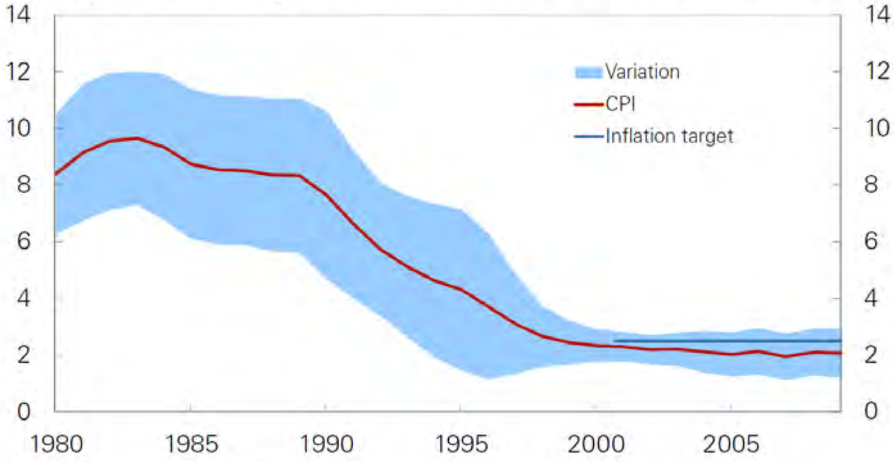
Our interest rate forecasts were revised up and indicated that the key policy rate would be raised when the impact of the financial crisis began to wane. Since October 2009, the key policy rate has been increased by a total of 0.75 percentage point to 2 per cent. Our March forecast indicates that the key policy rate should be increased gradually towards a more normal level, but at a slower pace than expected last autumn. The events in Europe and in financial markets in recent weeks have increased the uncertainty surrounding the outlook for the European and the Norwegian economy and for the interest rate.

4. Some lessons from the financial crisis

Norges Bank's implementation of monetary policy shall be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time. In addition, interest rate changes can contribute to smoothing swings in output and employment. In assessing the outlook for prices and output, we also take account of house prices, overall credit and the krone exchange rate. These variables are thereby also given weight in interest rate setting.

Inflation

Moving 10-year average[1] and variation[2] in CPI[3]. Per cent. 1980 – 2010



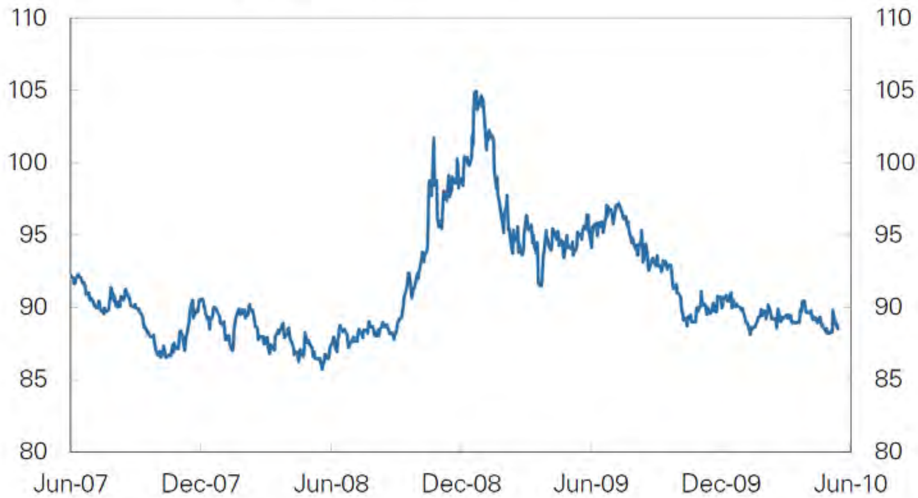
1) The moving average is calculated 10 years back
2) The band around the CPI is the variation in the CPI adjusted for tax changes and excluding energy products in the average period, measured by +/- one standard deviation
3) Projections for CPI from MPR 1/10 form the basis for this estimate

Sources: Statistics Norway and Norges Bank

Inflation targeting has served the Norwegian economy well in the run-up to the crisis and later. Inflation expectations are firmly anchored. This is partly because inflation has on average over time been close to, but somewhat lower than, the target of 2.5 per cent, and because annual variations have not been pronounced. Inflation measured by the CPI is now 3.3 per cent, but 2 per cent if the temporary increase in electricity prices is excluded. Inflation will fall later in the year. In the period of expansion in the Norwegian economy up to summer 2008, the increase in the interest rate contributed to keeping inflation low. During the crisis, we were able to reduce the interest rate markedly without an upward shift in inflation expectations. The real interest rate turned negative. The interest rate reduction rapidly stopped the fall in consumption and property prices.

The krone exchange rate

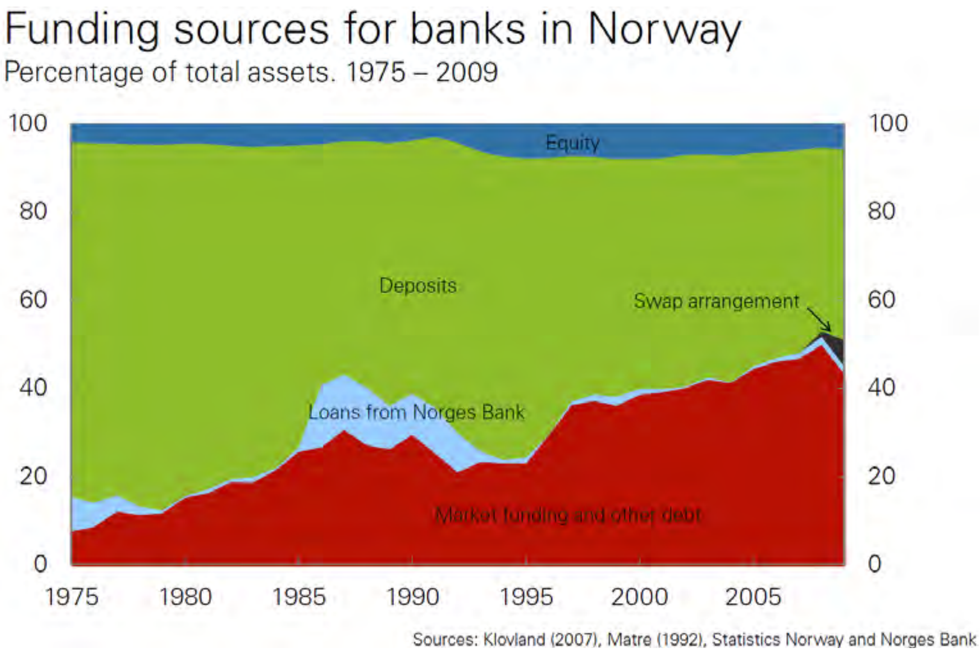
The import-weighted exchange rate index (I-44).
1 June 2007 – 14 May 2010



Source: Norges Bank

The krone exchange rate has also by and large contributed to stabilising inflation and employment. In the short term, the krone exchange rate can fluctuate widely, and it depreciated in autumn 2008 because capital sought safe havens. This helped Norwegian manufacturing in the first phase of the downturn. Since then, the krone has appreciated considerably. This has dampened inflation prospects.

Experience from the crisis in other countries indicates that monetary policy alone cannot ensure stable economic developments. Monetary policy has only one instrument by which to achieve the objective of low and stable inflation, and the interest rate is a crude instrument. Hence, other objectives must be achieved by means of, for example, financial regulation and the tax system.



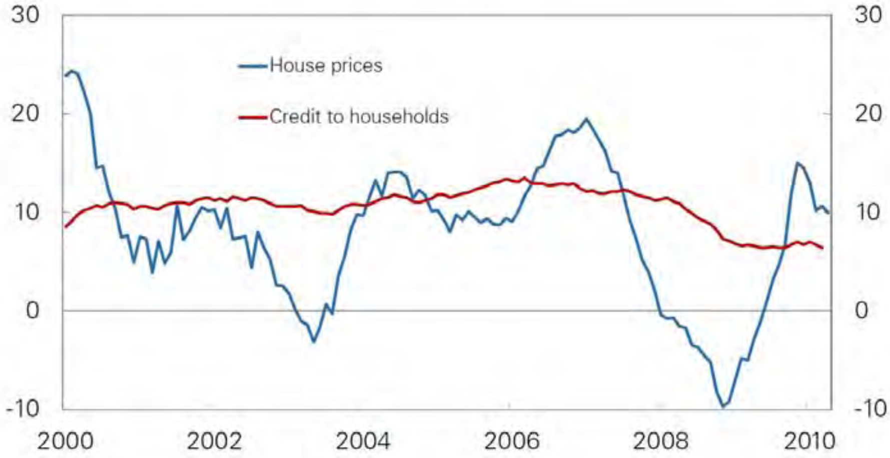
In Norway, a number of arrangements functioned during the financial crisis. Banks' capital adequacy ratios were at the outset fairly high, with high quality Tier 1 capital, and Norway had a bank guarantee fund financed, albeit only just, by capital paid in by banks. Norges Bank also holds ample foreign exchange reserves and was able to supply foreign exchange to banks.

Norwegian banks felt the impact of the global financial crisis primarily as a result of reduced access to funding. Over time, banks have increasingly relied on fairly short-term funding in global markets to finance their lending. This is the main reason why Norwegian banks encountered problems when funding from foreign sources dried up in 2008. For Norwegian banks, the financial crisis essentially proved to be a funding and liquidity crisis.

New and increased equity capital and liquidity requirements for banks can promote stability in the financial system. The requirements should probably be more stringent in Norway than the minimum requirement that is likely to be agreed internationally. It is also important to cooperate with the other Nordic countries to avoid a situation where more lightly regulated banks aggressively market loans in Norway.

Growth in credit to households[1)] and change in house prices

12-month change. Per cent. January 2000 – April 2010[2)]



1) Credit from domestic sources, C2

2) House prices for April. Credit growth to end-March

Sources: Statistics Norway, OPAK, the real estate sector (NEF, EFF, FINN.no og ECON Pöyry), OBOS and Norges Bank

The global financial crisis has shown that credit cycles and property market bubbles that burst represent one of the greatest challenges to economic policy. The experience of many countries over several decades has shown that house prices and residential mortgage lending usually rise prior to the outbreak of a banking crisis.[1]

In Norway, interest rate expenses can be deducted from taxable income, while capital gains on dwellings and the benefit of home ownership are not taxed. Housing is taxed as an asset, but not at its market value. High tax subsidisation of home ownership and a large proportion of floating-rate loans contribute to considerable fluctuations in house prices in Norway. Furthermore, the rise in house prices over the past two decades has been high compared with countries where house price bubbles have now burst. High house prices and substantial household debt add to the economy's vulnerability.

In March, Finanstilsynet (Financial Supervisory Authority of Norway) issued new guidelines for prudent residential mortgage lending. The guidelines may have a somewhat dampening impact on the rise in debt and house prices.

The global financial crisis has revealed weaknesses in the financial system.

Regulation of financial institutions should seek to limit risk not only in individual banks, but also in the financial system as a whole. Risk is amplified by the interaction between financial institutions.

Today, we can see that the crisis was amplified by the very surprise over the extent to which financial markets are interwoven. Losses on subprime mortgages in the US shattered confidence in the entire financial system. Financial institutions started to doubt their counterparties and interbank lending came to a halt.

Experience shows the need for tighter regulation of systemically important banks. This can for example be achieved by introducing higher bank capital and liquidity requirements for such banks. The capital requirement for mortgage lending should to a larger extent reflect the overall risk of such loans.

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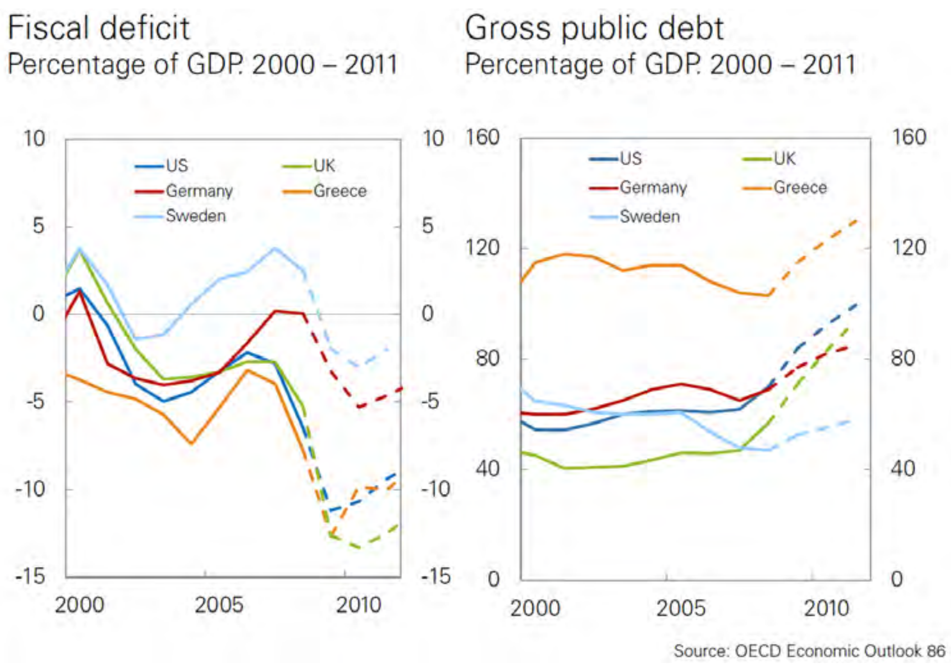
1 See Carmen M. Reinhart and Kenneth S. Rogoff (2009): "This Time Is Different. Eight Centuries of Financial Folly", Princeton University Press.



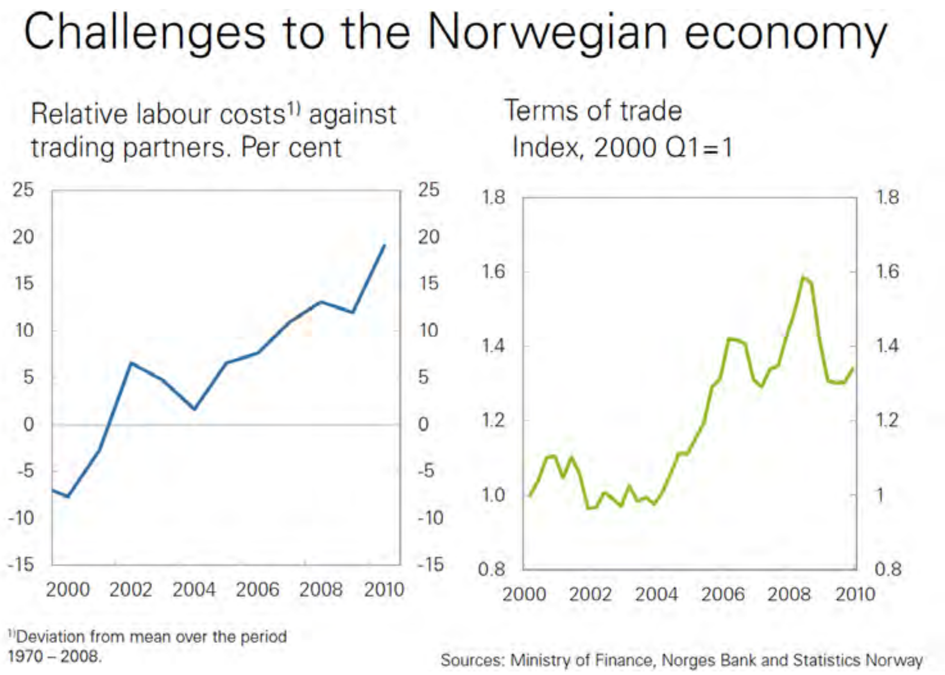
Justified criticism has been levelled at international banks. The focus is now shifting to government fiscal management in many countries. Fiscal slippage seems to have been considerable in some European countries in particular. EU budget policy guidelines have been diluted and have not been adhered to. Countries have experimented with budget frameworks and have debt-financed public investments, which require operating and maintenance costs but yield little income. With already large deficits, the crisis has destroyed state finances in many countries. Economic developments over the next 5–10 years will be marked by the tightening measures that will now have to be implemented in these countries.

However, there are exceptions. State finances in Nordic countries are in order, which provides a better starting point.

With ample state coffers, the Norwegian economy was to a considerable extent insulated from the effects of the financial crisis in 2008 and 2009. Norway has had room for manoeuvre because solid state finances secure credibility and because inflation expectations are firmly anchored. Even though oil prices fell from close to USD 150 per barrel in summer 2008 to almost USD 30 at the end of the year, Norway's state finances were not called into question. In addition, oil prices increased markedly as early as spring last year. The oil fund mechanism curbs the effects of oil price fluctuations on demand and output – as well as on inflation and the krone exchange rate.

The Government Pension Fund Global is also an important source of funding for public spending in the next decades. Reductions in government welfare spending, which will probably be a matter of necessity with an increasingly ageing population, will be smaller than would have been the case without the fund.

5. Challenges to the Norwegian economy



In the period 1992–2008 the Norwegian economy experienced a long upturn. In the 2000s, the cost level started to rise, partly reflecting a sharp improvement in our terms of trade. Prices for Norwegian goods, such as oil, gas, metals, minerals and fish increased sharply while import prices fell.

Looking ahead, the impact of these driving forces cannot be expected to be as favourable. It is hardly likely that export prices will show a renewed surge. Moreover, our economy has become vulnerable. Norwegian labour has never been as costly as today. Measured against Norway's trading partners, the cost level is almost 20 per cent higher than the average for Norway's oil age. Norwegian enterprises will often lose contracts abroad with the current high level of spare capacity in other countries.

During the upturn, Norwegian enterprises fared well in spite of high costs because they increased efficiency and because sales were strong and prices high. Norwegian labour has been very costly, but nevertheless fully employed. Market conditions will become more demanding ahead. Even with a floating exchange rate, we cannot expect any substantial decline in Norway's relatively high cost level as economic conditions are even weaker in other countries in our region.

The industry structure in Norway is different from that of other advanced economies. We benefit from growth in Asian countries because of our sizeable commodity exports and freight industry. We are vulnerable to a slowdown in growth in Asia, which could lead to a fall in commodity prices and deterioration in our terms of trade. Norway's high cost level may at the same time make it difficult for the business sector to shift to new markets.

The economic geography of Norway will change over the next 10–15 years. The domestic cost level and low growth in Europe will bring pressure to bear on jobs and businesses in manufacturing communities. Job losses will have the most pronounced effects in areas where manufacturing has the highest concentration. Entire manufacturing sectors may be lost.

6. Conclusion

Let me conclude.

The key policy rate was reduced substantially in order to mitigate the effects of the financial crisis on the Norwegian economy. This contributed to a pickup in economic growth. There are prospects that inflation over some time will remain fairly close to the inflation target. The downturn in Norway proved to be mild and unemployment has not moved up to a high level. Developments in Europe are also amplifying the uncertainty concerning the outlook for the Norwegian economy.

Thank you for your attention.