Øystein Olsen: Monetary policy and financial stability considerations

Speech by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at the European Banking & Financial Forum, Prague, 27 March 2012.

*   *   *

The text below may differ from the actual presentation. This speech does not contain assessments of the current economic situation or interest rate setting.

Introduction

The past few years have clearly shown the costs of financial instability. The near collapse of the financial system in autumn 2008 led to the most severe economic downturn of our time. There was a dramatic decline in international trade, and total world output fell from one year to the next for the first time in generations.

When financial markets failed, the authorities had to intervene. Bailout packages for banks shifted debt from private to public hands. Governments increased spending in order to curb the fall in activity. Many countries are now trying to rein in large deficits and rising government debt under difficult conditions. Pension rules and tax systems are under review. The costs of such structural reforms would have been lower in good times.

A financial crisis has to be met with appropriate measures, but the main objective in our work on financial stability must be to reduce the risk of crises emerging. History tells us that a financial crisis typically arises when debt has accumulated over a long period. An important task is therefore to contain the buildup of imbalances and secure a robust financial system.

A decade of inflation targeting

The Norwegian economy emerged quickly and fairly painlessly from the recent global economic downturn. Since 2001, economic policy in Norway has been guided by a fiscal rule and a flexible inflation target. With solid government finances based partly on petroleum revenues and firmly anchored inflation expectations, there was room for manoeuvre both in monetary and fiscal policy when the financial crises hit.

Inflation in Norway is currently low, but it has been close to target over the past decade. During this period, monetary policy has faced demanding trade-offs, and the application of judgment has been put to a test. We have gradually learned more about the functioning of our economy under an inflation targeting regime. Let me touch upon some of these insights.

Fairly soon after we had adopted inflation targeting, we learned how demanding it may be to strike a balance between different monetary policy considerations in a small open economy. When the key policy rate is raised to restrain a pronounced rise in domestic inflation, it may strongly impact the exchange rate, as we experienced in the period 2002–2003. Both the real economy and inflation were affected.

Midway through the decade, global inflation rapidly declined. China's entry into the WTO, and increased imports from Asia to the west led to a persistent fall in import prices. The combination of very low inflation and strong economic growth posed new challenges for monetary policy. Interest rates – both in Norway and abroad – were set at low levels. This amplified the cyclical upturn in our part of the world.

Towards the end of the decade, during the financial crisis, policy interest rates were reduced sharply and to record-low levels. That was a natural and necessary response. But a persistently low interest rate poses challenges in an economy where there is a strong appetite for borrowing and property prices are rising, as this may increase the risk of imbalances further ahead.

These experiences have provided new insights into how the interest rate functions under an inflation targeting regime. Norges Bank's analyses and communication have evolved. Economic agents have become familiar with our response pattern. When setting the key policy rate, we do not exclusively assign weight to bringing inflation back to target, but we also take into account the impact of the interest rate on output and employment. Inflation targeting has become more flexible.

In our most recent *Monetary Policy Report*, published in March 2012, we further clarified the Banks's response pattern. By way of three criteria, we highlight what we take into account when we set interest rates. The first criterion states that the interest rate should be set with a view to stabilising inflation at target or to bring it back to target if a deviation has occurred. The second criterion states that the interest rate path set by the Bank for the period ahead should provide a reasonable balance between the path for inflation and the path for overall capacity utilisation in the economy, i.e. the inflation targeting regime is flexible. The third and final, criterion states that monetary policy should be robust. The interest rate should be set in order to mitigate the risk of a buildup of financial imbalances, and so that acceptable developments in inflation and output are likely also under alternative assumptions about the functioning of the economy.

The various considerations taken into account in the criteria must be weighed against each other.

At our most recent interest rate meeting the key policy rate was reduced by 0.25 percentage point to 1.50 percent. In its assessment, the Executive Board stated that *"...weak growth prospects abroad and the strong krone are contributing to keeping inflation low and dampening economic growth in Norway (...). If the interest rate is set too high, the krone may appreciate further, inflation may continue to fall and growth in output and employment may become too low. This suggests that the key policy rate should be reduced further. On the other hand, there is virtually normal capacity utilisation in the Norwegian economy. Moreover, low interest rates over time may induce households and enterprises to take excessive risks and accumulate excessive debt."*

By taking account of the deviation in the nominal interest rate from a normal level when setting the key policy rate, Norges Bank seeks to counter the buildup of financial imbalances that may disturb activity and inflation further ahead. This does not mean that the level of the key policy rate is an independent objective in its own right. Rather, the purpose is to overcome weaknesses in our analytical tools related to the possible buildup of financial imbalances resulting from keeping interest rates low over time. Monetary policy will continue to react to shocks that affect the medium term path for inflation, output and employment.

After a decade of learning, inflation targeting has become more flexible. Flexibility is good to have, and easy to lose. The inflation target has to be reached over time, otherwise our credibility is put at risk. In assessing various considerations, monetary policy must be geared to meeting its primary objective of low and stable inflation. There are limits as to how many goals monetary policy can meet. Other instruments must be used to attain other objectives. To ensure that new or further financial imbalances do not build up we also need a tighter international overarching policy framework to address the stability of the financial system as a whole. A macroprudential policy framework should be part of this new framework.

Macroprudential policy framework

Financial market participants can trigger self-reinforcing economic fluctuations. Individual banks and investors do not necessarily take into account the overall risk in the financial system. The consequences became clear during the financial crisis: banks had inadequate equity capital, relied excessively on short-term wholesale funding and had insufficient buffers of liquid assets.

The new international regulatory framework is intended to remedy this situation. I would like to draw attention to three main aspects of ongoing work in this area:

First, stricter capital adequacy and liquidity coverage standards are in the offing. Higher and better-quality capital will increase banks' resilience to pronounced fluctuations in the economy without their having to tighten lending abruptly.

Second, the new framework includes macroprudential tools. One such measure is the countercyclical capital buffer. Banks may be subject to additional capital requirements if credit growth in the wider economy is excessive. This will smooth out lending growth and better equip banks to bear potential losses during downturns.

Third, the authorities must acquire tools that allow banks to be wound up in an orderly manner. The structure of banking groups should be transparent, and thus enable differentiated government interventions in case of a crisis. Plans must be drawn up for the recovery or resolution of banks in the event of difficulties. Owners and creditors – not taxpayers – must bear the losses. The interest rate on banks' funding will then reflect the risk they take rather than an implicit government guarantee. This will in itself have a preventive effect.

Politicians have the overriding responsibility for financial stability. It can be demanding to restrain credit growth in times of strong optimism and confidence in the future. Well defined mandates and a clear delegation of responsibility in the field of monetary policy has worked well. Similarly, the legal authority to implement macroprudential measures to safeguard financial stability should be delegated.

It must be acknowledged that no regulation can prevent financial institutions from encountering difficulties. A new regulatory framework must therefore ensure that banks bear the ultimate responsibility for risk undertaken by them. Regulatory compliance will then be in their own interest.

We can never fully insulate the financial system from shocks. But we can increase our resilience. One of the most important things we can do is to keep our own house in order – by preventing major imbalances from building up in the economy or in the financial system, and by ensuring that the financial system in general is robust.

Thank you for your attention.