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, 15 May 2014.

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Accompanying charts can be found on the Central Bank of Norway's website: Charts (PDF).

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

I would like to thank the Chairman of the Committee for this opportunity to report on the conduct of monetary policy. My statement here today is based on Norges Bank's Annual Report for 2013 and has been updated based on new information and assessments up to the monetary policy meeting last week.

Norges Bank's operational conduct of monetary policy is oriented towards low and stable inflation. The operational target is annual consumer price inflation of close to 2.5 percent over time. Monetary policy shall also contribute to smoothing fluctuations in output and employment. The key policy rate is the main instrument of monetary policy.

Chart: Inflation and capacity utilisation

In 2001, an inflation target was assigned to Norges Bank. The experience has been positive. Over the past ten years, consumer price inflation has on average been somewhat below, but close to 2.5 percent. The world economy has to a large extent been marked by imbalances through this period. Growth in the Norwegian economy slowed in the wake of the financial crisis, but has since been close to a normal level. Unemployment has remained low.

Chart2: Norges Bank's key policy rate

The key policy rate is lower than what can be considered to be a normal level. Norway is a small, open economy. Exceptionally low interest rates abroad influence the key policy rate in Norway. At the same time, there is still a considerable difference between the key policy rate and the interest rates facing households and enterprises. Banks' lending margins are not particularly low as their lending margins are high.

Chart3: Key rates abroad

Low interest rates and unconventional monetary policy internationally reflect a continued low activity levels and high unemployment. In some countries, particularly in Europe, inflation has also shown a considerably decline. Policy rates are still close to zero in many countries and both the European Central Bank (ECB) and Sveriges Riksbank cut rates last year.

Leading central banks have taken new steps to provide markets with forward guidance, with the aim of signalling low interest rates for a long period ahead. In today's situation, the forward guidance is intended to signal low interest rates for an extended period of time in order to sustain inflation and boost growth.

Other unconventional monetary policy actions are also in use. With large-scale securities purchases, the central banks in the US, the UK and Japan have sought to reduce long-term interest rates and thereby funding costs for firms and households. The provision of liquidity has also led to higher equity and securities prices. The US Federal Reserve started tapering asset purchases last year, resulting in a slight, renewed increase in long-term interest rates.

Chart 4: GDP for trading partners

Growth among our trading partners picked up in the latter half of 2013, particularly in the US. Although euro-area growth has also improved, unemployment and debt levels remain elevated. Emerging economies are growing at a clearly faster pace than advanced economies, but the pace has slackened somewhat. A number of emerging economies have been affected by capital outflows and currency depreciation. The tapering of asset purchases by the US Federal Reserve has likely also contributed to these developments. Countries with large current account deficits are particularly hard hit.

Chart 5: Consumer prices abroad

Inflation has fallen in many countries over that past few years. Euro area inflation fell to a very low level in 2013, fuelling fears of deflation. However, a portion of the decline in inflation is related to developments in food and energy prices. Furthermore, the decline has been most pronounced in periphery countries. In those countries, negative or very low price growth reflects a need for improving competitiveness. In the core countries, such as Germany and France, inflation has remained on a steadier course. Long-term inflation expectations seem to be firmly anchored in most advanced economies.

Chart 6: GDP for Mainland Norway

Growth in the Norwegian economy slowed through 2013. The slowdown was most pronounced in the construction and oil supplier industries. Some export industries were also affected by weak demand in Europe and high cost levels. Growth in household demand was moderate in 2013. Household saving increased further and is now at a historically high level. Unemployment edged up through 2013. Capacity utilisation in the economy is still assessed to be close to a normal a level.

Chart7: The krone exchange rate

After appreciating over a longer period, the krone showed a pronounced weakening in 2013. Both domestic and international conditions contributed to the depreciation. Signs of weaker growth in the Norwegian economy probably had an impact. An improvement in the economic situation in the euro area may also have contributed. Although the krone has appreciated somewhat thus far in 2014, it is still clearly weaker than at the beginning of 2013.

Chart 8: Consumer prices in Norway

Inflation has increased. As measured by the CPI-ATE, inflation averaged 2.5 percent in the first quarter of 2014. The krone depreciation has contributed to a faster rise in prices for imported consumer goods. Prices for domestically produced goods and services also rose at a faster pace in 2013, at just below 3 percent in the latter half of the year. The rise in house rents and food prices through 2013 partly reflects a revision of the calculation method for these goods items in the CPI.

In the coming months, inflation is projected to edge down, partly reflecting the unwinding of temporary effects. Underlying inflation is now estimated to be between 2 percent and 2½ percent, which is one percentage point higher than one year earlier.

Chart 9: Norges Bank's key policy rate projections

Saving, investment and spending decisions are influenced by expectations concerning future interest rates. Communication on the future course of monetary policy, including the publication of key policy forecasts, therefore plays an important role. Even though the key policy rate has been kept unchanged, Norges Bank's forecasts for the key policy rate ahead were revised down through 2013.

The downward revision of the key policy rate forecasts primarily reflects lower growth forecasts for the Norwegian economy. There are also prospects that wage growth will be somewhat lower than envisaged earlier. Growth among our trading partners and interest rates abroad have been somewhat lower than projected one year earlier. At the same time, banks' lending margins are somewhat higher than expected.

Chart 10: Inflation and capacity utilisation

The analyses in the latest Monetary Policy Report published in March suggested that the key policy rate should be held at today's level in the period to summer 2015, followed by a gradual increase. With such a path for the key policy rate, there are prospects that inflation will be slightly below, but close to 2.5 percent throughout the projection period. Capacity utilisation may edge down over the next year and thereafter move up to close to a normal level.

Chart 11: Household debt and house prices

Monetary policy aims to be robust by, among other things, taking into account the uncertainty associated with economic driving forces and the functioning of the economy. In addition, in the conduct of monetary policy we seek to take into account the risk of a build-up of financial imbalances. After rising sharply over many years, house prices flattened through 2013. In recent months, house prices have shown a renewed rise. Household debt has increased at a faster pace than household income over several years.

A robust monetary policy aims to provide an improved path for inflation, output and employment over time. A lower key policy rate can push up both inflation and demand for goods, services and labour in the short run. On the other hand, a lower key policy rate would have augmented the risk of a further build-up of financial imbalances. A persistently pronounced increase in house prices and debt may lead to a build-up of financial imbalances that may trigger or amplify an economic downturn – with high unemployment as a result. This suggests a gradual approach in interest-rate setting.

Robust banks and financial sector regulation are crucial for financial stability. Increased capital requirements for banks are now being phased in. In 2013, the Ministry of Finance assigned Norges Bank the task of providing advice on a countercyclical capital buffer for banks. In December, the Ministry set the buffer rate at 1 percent, in line with the advice issued by Norges Bank. The requirement will apply from 30 June 2015.

The purpose of the countercyclical capital buffer is to enhance banks' resilience to periods of large losses. The buffer rate will be increased when financial balances are building up or have built up over a period. In the event of an economic downturn and large bank losses, the buffer rate can be reduced, with a view to mitigating the procyclical effects of an undesired tightening of bank lending.

The buffer is not an instrument in the ordinary management of business cycles. Changes in capital requirements may nonetheless influence banking behaviour and hence economic developments. Banks can satisfy increased capital requirements in several ways. They can raise equity from their owners and some banks have already done so. Should banks choose to increase their lending margins or restrict lending by other means, this will have an impact on economic activity and inflation. New capital requirements may therefore influence the conduct of monetary policy.

While increased capital requirements will strengthen banks' solidity and may mitigate the build-up of imbalances, we cannot proceed under the assumption that new regulations will eliminate the risk of financial instability. A robust monetary policy will therefore continue to take into account the risk of a build-up of financial imbalances. At the same time, monetary policy must not be overburdened. When assessing the monetary policy trade-offs, the primary objective of monetary policy must remain low and stable inflation. We will not lose sight of the inflation target. Should the outlook for inflation or economic activity show a pronounced change, we still have monetary policy leeway – in both directions.