Øystein Olsen: The conduct of monetary policy

Introductory statement by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament), Oslo, 15 May 2017.

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Accompanying slides

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 2016 and our monetary policy assessments up to the monetary policy meeting earlier this month.

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. Monetary policy is at the same time flexible in that our interest rate setting also takes developments in output and employment into consideration.

The key policy rate was lowered to 0.5 percent in March 2016 and has since been kept unchanged. The key policy rate is low because interest rates abroad are low, while capacity utilisation in the Norwegian economy is below a normal level and the forces driving inflation are moderate. Low growth and the risk of deflation in the global economy have brought down interest rates among Norway's trading partners to a very low level.

Chart: Global and trading partner GDP

Growth in the global economy has gradually slowed in recent years and was in 2016 at its lowest since the financial crisis. The slowdown reflects more moderate growth in China and stagnation in some other important emerging economies. Among Norway's trading partners, which are dominated by advanced European economies and the US, growth has picked up from the very low post-crisis levels. Unemployment has decreased considerably in a number of countries. In the April issue of the International Monetary Fund's (IMF) semi-annual report, a moderate pickup in global growth is projected for the years ahead.

At the same time, there is considerable uncertainty about international developments. Signals of rising protectionism and global political unrest may reduce economic growth.

Inflation among Norway's trading partners is still low, but has recently edged up, partly as a result of higher energy prices. Inflation can be expected to gain further momentum ahead as activity in trading partner economies picks up.

While inflation is rising and growth prospects are improving, global interest rates may have passed their lowest point. Expected money market rates indicate that short-term interest rates among trading partners will rise in the years ahead. However, interest rates will probably remain low, compared with pre-crisis levels, for an extended period of time.

Chart: US, euro area and Swedish interest rates

Short-term interest rates have been on the rise in the US for some time, after the Federal Reserve began to raise the policy rate towards the end of 2015. In the euro area, the policy rate has been negative since 2014, with the latest reduction made by the European Central Bank (ECB) in March 2016. Market participants expect the first policy rate rise in the euro area to occur in the course of next year. The ECB is purchasing bonds in the market to stimulate activity and boost inflation, but has now begun to reduce the pace of its purchases. The policy rate in Sweden is also negative, with the latest reduction made in February 2016. The Swedish

Riksbank’s forecast indicates that the first policy rate increase will occur next year.

Chart: Oil prices

Oil prices gradually rose through 2016 and have in recent months hovered around USD 50 per barrel. Futures prices indicate that oil prices will remain close to today’s level in the years ahead. Oil prices have almost doubled since reaching their lowest level in early 2016, but are nonetheless less than half the level recorded before the steep fall in oil prices in summer 2014.

Petroleum investment has declined markedly compared with the 2013 level. Lower oil industry demand has affected the wider economy. Last year, growth in mainland GDP was at its lowest since the financial crisis.

Chart: Unemployment

Unemployment increased through 2015 and to some extent in 2016, particularly in southern and western Norway. So far this year, the labour market has improved and unemployment has fallen.

Monetary policy supports the necessary restructuring of the Norwegian economy. The key policy rate is low and the krone depreciated in pace with the fall in oil prices. Combined with moderate wage settlements, the krone depreciation has contributed to a marked decline in relative labour costs, strengthening the position of Norwegian firms exposed to international competition.

Chart: Relative labour costs

Improved cost-competitiveness is an important factor in enabling new exports to emerge as the production of oil and gas dwindles. Tourism in Norway has risen markedly in recent years, and exports of traditional manufactured finished products have shown an appreciable increase. However, the increase is not sufficient to compensate for a decrease in exports from other sectors of the mainland economy. Total mainland exports were lower last year than in 2014. The most important reason for this is the marked decrease in oil service industry exports in the wake of the fall in oil prices. But even excluding this part of the export industry, growth in mainland exports since 2014 has been lower than growth in trading partner imports.

Chart: Mainland exports

Weak export growth partly reflects supply-side constraints in some sectors. Production stoppages at several large companies led to a decrease in industrial commodity exports last year, while salmon lice infestations contributed to a decline in seafood exports. Other service sector segments in addition to the oil service industry also appear to have been adversely affected by the downturn in the global petroleum industry.

A weaker krone is also an advantage for Norwegian firms competing in the domestic market. Competitiveness in the oil service industry has improved considerably, particularly after the substantial cost-cutting measures introduced by companies in this industry in recent years. We have recently seen that a larger share of contracts on the Norwegian continental shelf is being awarded to Norwegian companies.

Fiscal policy has had a significant impact as a countercyclical tool. Since 2013, the increase in oil revenue spending has roughly matched the fall in oil investment.

Chart: Investment

Low interest rates and high public demand have resulted in robust growth in the public sector and the construction industry.

With high house price inflation, housing investment has increased substantially. Investment in housing is now higher than investment in oil activity.

Chart: Growth in mainland GDP

The economy is now turning the corner. Contacts in Norges Bank's regional network have reported gradually rising growth. The upturn seems to be broadly based across industries and regions.

There are clear signs that unemployment is falling both in oil-dependent regions and in the rest of the country. At the same time, employment growth has been modest, and some of the decline in unemployment is the result of labour market withdrawal. Looking ahead, there are prospects that employment will increase as growth in the mainland economy picks up, partly driven by mainland corporate investment, which seems to be picking up. Oil investment is also expected to show a moderate upswing as from next year. Export growth is also likely to pick up, supported by growth among Norway's trading partners.

At the same time, there is reason to expect less fiscal stimulus ahead. The Government has adjusted the fiscal rule for oil revenue spending. Oil revenue spending over time is required to correspond to the expected real return on the Government Pension Fund Global, which has been revised down from four to three percent. In our analyses published in March this year, we have assumed that oil revenue spending as a share of the economy will remain approximately unchanged in the years ahead. This will entail lower growth in public demand than in recent years.

At the same time, monetary policy continues to be expansionary. According to Norges Bank's March 2017 forecast, the key policy rate will remain close to today's level in the years ahead, followed by a gradual rise from 2019.

Chart: Key policy rate and inflation ahead

In 2016, the pace of consumer price inflation was at its highest for many years, driven to a great extent by the considerable depreciation of the krone up to the beginning of last year. Inflation has slowed since last summer and our projections in the March *Monetary Policy Report* indicate that inflation will slow further in the years ahead. At the same time, inflation expectations seem to be firmly anchored. The upturn in the real economy appears to have taken hold and unemployment has declined. With a key policy rate close to today's level, there are prospects that inflation will pick up again further ahead.

The Ministry of Finance is currently assessing the need to modernise the regulation on monetary policy. After more than fifteen years, this is a natural step. Based on our experience over this period, it is Norges Bank's assessment that the monetary policy framework has worked well.

Inflation has been predominantly low and stable since inflation targeting was introduced in 2001. Average annual consumer price inflation has been close to, albeit somewhat below, 2.5 percent. At the same time, employment has consistently been more stable since 2001 than in previous periods, in spite of the fact that the Norwegian economy has been exposed to substantial shocks.

Chart: Inflation

The inflation target has anchored inflation expectations. At the same time, there has been sufficient room for flexibility and the exercise of judgement to enable monetary policy to dampen the impact on output and employment when the economy has been exposed to shocks.

Our experience has shown us the crucial importance of flexibility in inflation targeting to enable us to make the appropriate trade-offs in response to these shocks. The time horizon for achieving the target must be sufficiently long, and the balance of risks, including risks related to financial stability, must be taken into account. We have also experienced the important role the exchange rate has played as shock absorber, particularly during the financial crisis and in periods of falling oil prices. At the same time, the interest rate level abroad places limitations on the room for manoeuvre in monetary policy in a small open economy such as Norway.

Monetary policy's main task is to provide the economy with a nominal anchor. As long as inflation is firmly anchored, monetary policy can also address other concerns. We can seek to counteract the build-up of financial imbalances by keeping the interest rate a little higher than would otherwise be the case. But Norges Bank cannot take the main responsibility for developments in house prices and debt. Nor can monetary policy influence the economy's long-term growth capacity.

The past couple of years have been demanding for the Norwegian economy. Growth is now picking up, but the pace of growth is not expected to rise to the levels prevailing before the fall in oil prices. The Norwegian economy is undergoing restructuring. Monetary policy can facilitate this process, but the necessary adjustments must come from the business sector.

Thank you for your attention.