

Øystein Olsen: The Norwegian economy – macroeconomic developments and monetary policy

Speech by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at the Finance Norway's Capital Markets Day 2018, Oslo, 6 April 2018.

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Accompanying [slides](#)

First of all, I would like to thank Finance Norway for the opportunity to speak to you today about macroeconomic developments and monetary policy in Norway. As you may be aware, a new regulation on monetary policy came into force earlier this spring. I will return to the regulation and its implications for the conduct of monetary policy and the interest rate outlook. But first, let me start abroad.

Chart: Economic growth following the financial crisis

The advanced economies have emerged from a challenging period. Ten years ago the world economy was hit by a shock and thrown into the deepest recession since the 1930s.

The economic downturn that followed the financial crisis stands apart from earlier recessions. It was both deeper and longer. Potent measures were deployed to address the crisis, but it has still taken time to get the world economy back on its feet.

Monetary policy had to play a substantial role in the wake of the crisis. Without powerful economic policy measures, there was a risk of a self-reinforcing recession.

Chart: Global real interest rates

Central banks were led into unknown territory and implemented unconventional measures. Already low long-term real interest rates were brought down even further.

Ten years of historically low interest rates and large-scale asset purchases give cause for reflection. An important question is what responsibilities should rest with a central bank. A related theme is what is meant by the objective of low and stable inflation.

Chart: Inflation in Norway

The primary objective of monetary policy is to maintain monetary stability, as part of the central bank's responsibility for the monetary system.

Inflation that is either too high or too low has undesired consequences, such as arbitrary wealth redistribution, underinvestment and resource misallocations. The result is lower activity and lower welfare.

Since 1990, an increasing number of countries have chosen to link monetary stability to a numerical inflation target. Since the financial crisis, all of these countries have maintained their inflation targeting regimes. This reflects the overall positive experience with this framework. It did not get in the way of a powerful response to the financial crisis.

In Norway too, inflation targeting has functioned well. Inflation has remained low and stable since it came down in the early 1990s, and the inflation target has anchored inflation expectations. During the period of inflation targeting, the Norwegian economy has been exposed to major shocks. A flexible inflation targeting regime has helped dampen their impact on output and employment. Employment variability has been lower since 2001 than in previous periods.

Lessons have been learned along the way. Initially, central banks had high ambitions to steer inflation to target within a clearly defined time horizon. But experiences with the regime provided useful insight, and the ambitions were later adjusted. When confronted with shocks, small open economies in particular experienced that a rapid return to the inflation target could have undesired consequences for the real economy.¹ Norges Bank has addressed this concern by giving greater weight to output and employment. The inflation target horizon has been extended and monetary policy has gradually become more flexible.

A few weeks ago, on 2 March, the Government adopted a new, modernised regulation on monetary policy.² The new regulation clarifies the monetary policy mandate and underpins the Bank's flexible approach to inflation targeting. In Norges Bank's assessment, the new regulation will not result in significant changes in the conduct of monetary policy.³ Let me elaborate somewhat on the implications of the new regulation.

"Monetary policy", according to the new regulation, "shall maintain monetary stability by keeping inflation low and stable."

The regulation thus clarifies the primary task of monetary policy. Price stability is the best contribution that monetary policy can make towards sound and stable economic developments over time.

It does so by ensuring that inflation stays within a range somewhat above zero, while being kept under control. Since inflation targeting was introduced in Norway, inflation has been close to, but on average somewhat below, the previous target of 2.5 percent. Inflation has consistently remained within a band where the deviations from the target cannot be said to have entailed significant economic costs.

According to the new regulation, "the operational target of monetary policy shall be annual consumer price inflation of close to 2 percent over time."

It is not possible to quantify precisely an optimal inflation target for the Norwegian economy. A numerical target of 2 percent is, however, consistent with the inflation target of most of Norway's trading partners.

In 2001, when inflation targeting was introduced, the Norwegian economy faced the prospect of gradually increasing oil revenue spending. It was widely expected that the phasing-in of revenues would entail an appreciation of the real exchange rate. At the time, the nominal target was set at 2.5 percent. An expected real appreciation could then occur partly in the form of wider price and cost differentials between Norway and its trading partners. The period of rising oil revenue spending now appears largely to be over. Thus, it is difficult to find compelling arguments for setting an inflation target in Norway today that differs from that of our trading partners.

The new regulation is consistent with how monetary policy has been conducted in practice in recent years. The regulation states that: "Inflation targeting shall be forward-looking and flexible so that it can contribute to high and stable output and employment and to counteract the build-up of financial imbalances."

As long as there is confidence that inflation will remain low and stable, monetary policy can contribute to stabilising the economy. When the economy is exposed to shocks, the central bank can respond rapidly by adjusting the key policy rate, as we did in 2008 and when oil prices fell in 2014. A flexible inflation targeting regime can reduce the risk of unemployment becoming entrenched at a high level following economic contractions. Nevertheless, monetary policy cannot assume primary responsibility for high output and employment. The level of output and employment over time depends on overall economic policy, including the tax and social security system, the wage formation process and the functioning of the labour market. Monetary policy is only one component of such an overall framework.

The importance of financial markets and financial stability was underestimated before the crisis – also by central banks. The financial crisis revealed how harmful financial imbalances can be. Monetary policy can in given situations take account of the risk of a build-up of financial imbalances. But monetary policy cannot take primary responsibility for heading off a gathering storm. Regulation and supervision of financial institutions are the primary means of addressing shocks to the financial system.

The build-up of financial imbalances has in recent years been given little weight in monetary policy among the major central banks. Their focus has been on counteracting a deeper and more prolonged downturn and on preventing deflation.

In countries that were less affected by the financial crisis, more attention has been devoted to financial stability considerations. In high-tech, global financial markets, capital moves rapidly between different currencies. A wide interest rate differential could have a substantial impact on the exchange rate, with repercussions on inflation, output and employment. This is why low interest rates in large economies that were severely hit by the financial crisis quickly led to lower rates in countries where the cyclical situation, in isolation, would have implied higher rates. This was the case in Norway until oil prices fell. Other small open economies have been in the same situation.

Chart: House prices

These countries have imported low interest rates and experienced rapidly rising house prices and debt. They have introduced measures to limit elevated debt in order to prevent imbalances from building up further. In Norway, stricter mortgage lending requirements have been imposed on banks. These measures have probably contributed to the recent correction in Norwegian house prices. Over the past year, house prices have fallen. The shift in the housing market has reduced the risk of an abrupt and more pronounced decline further out. Household credit growth remains high, but over time lower house price inflation will dampen credit growth.

The exchange rate places a limit on how far Norwegian interest rates can deviate from foreign rates. But with a floating exchange rate, monetary policy can help to stabilise the economy when it is exposed to shocks. In the previous monetary policy regulation, there was a reference to the stability of the krone exchange rate. This has been omitted from the new regulation, but will not lead to material changes in the conduct of monetary policy. How Norges Bank will react to movements in the exchange rate will depend on how these fluctuations affect the outlook for inflation, output and employment.

Chart: Exchange rate and oil prices

A recent example is the monetary policy response to the negative oil price shock in 2014. The exchange rate served as a shock absorber. With confidence in the inflation target, monetary policy was able to underpin a weaker krone. The krone depreciation, combined with moderate wage settlements, contributed to a marked improvement in business profitability and competitiveness.

Chart: GDP for mainland Norway

Let me now turn to the outlook for the Norwegian economy. Two years after the cyclical trough was reached in Norway, growth has gained a firm footing. In our latest Monetary Policy Report, the negative output gap is projected to narrow and close early next year.

There are prospects for solid growth in business investment and renewed optimism in the petroleum industry. A number of large development projects will contribute to a rebound in oil investment in the coming years. The impetus from abroad has strengthened and exports are picking up. On the other hand, housing investment has fallen, and is likely to decline further.

Growth in household consumption picked up markedly last year. Higher real wage growth and continued employment growth should support consumption growth ahead, while higher interest rates will likely have a dampening effect.

Chart: Inflation

After falling markedly in the period to autumn 2017, inflation has edged higher. While underlying inflation is still low, rising capacity utilisation will probably push up price and wage inflation further out. Core inflation is now projected to rise to a little above 2 percent in 2021.

Chart: The Executive Board's assessment and interest rate forecast

At its monetary policy meeting in March, the Executive Board gave weight to the sustained upturn in both the global and the Norwegian economy. The Executive Board decided to keep the key policy rate unchanged at 0.5 percent. The Board's current assessment is that the key policy rate will most likely be raised after summer this year.

The March Monetary Policy Report is the first report since the new regulation on monetary policy came into force. Although the new regulation will not result in significant changes in the conduct of monetary policy, the interest rate outlook is to some extent affected by the lowering of the numerical inflation target.

Chart: Factors behind changes in key policy rate since MPR 4/17

The effect on the key policy rate from the new inflation target is summarised in this chart. The black line shows the change in the key policy rate forecast since the previous meeting in December. The contribution from the new inflation target is shown by the red bars, while the other bars show the effect from other factors.

Over time, lower inflation owing to a lower inflation target will result in a correspondingly lower nominal interest rate, so that the long-term real interest rate is unchanged.

In the near term, however, a lower numerical target implies a slightly less expansionary monetary policy as actual inflation is somewhat closer to target. But because the inflation targeting regime is flexible, with weight given to developments in output and employment, the effect on the key policy rate in the short to medium term will be marginal.

Let me conclude. The global economy finally appears to have recovered from the prolonged weakness that followed the financial crisis. Growth has also strengthened in Norway after the decline following the oil price collapse. The outlook for the Norwegian economy suggests that the key policy rate may be increased this year for the first time in seven years – this is a good sign.

¹ See for example Wheeler G. (2014): "Reflections on 25 years of Inflation Targeting", Reserve Bank of New Zealand, speech delivered on 28 November 2014 and Norges Bank (2017): "Experience with the monetary policy framework in Norway since 2001", *Norges Bank Papers* 1/2017.

² See Ministry of Finance (2018): "New regulation on monetary policy," Press release of 2 March 2018, or Meld. St. 8 (2017–2018). *Ny forskrift for pengepolitikken*. (White Paper from the Ministry of Finance. In Norwegian only.)

³ See Norges Bank (2018): "Modernisation of the Regulation on Monetary Policy", Norges Bank's letter of 28 February 2018 to the Ministry of Finance.