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, 14 May 2018.

* * *

Accompanying slides

Thank you for this opportunity to report on the conduct of monetary policy. My introduction here today is based on Norges Bank's *Annual Report* for 2017 and our monetary policy assessments up to the monetary policy meeting at the beginning of May.

The various components of economic policy must interact to achieve sound and stable economic developments over time – with high employment and low unemployment. The primary objective of monetary policy is to maintain monetary stability.

Since 2001, the operational target of monetary policy has been low and stable inflation. This has been retained in the new regulation on monetary policy issued by the Government on 2 March this year. The regulation clarifies the monetary policy mandate and will not result in significant changes in the conduct of monetary policy.

I will return to this topic later, but first of all I would like to go back to just over a year ago.

At the beginning of 2017, the level of spare capacity in the Norwegian economy was still fairly high and there were prospects that inflation could remain below the inflation target in the coming years. International interest rates were very low. Norges Bank had kept the key policy rate at 0.5 percent for a year, and there was a slightly higher probability that the key policy rate would be reduced further than that it would be increased in the near term. There were signs of some brightening, both internationally and in Norway, but considerable uncertainty prevailed.

Chart: Global GDP growth

The economic outlook changed through 2017. Global growth gradually gained a firm footing, and global growth projections were revised up. For several of Norway's main trading partners, unemployment was lower towards the end of 2017 than before the financial crisis.

Despite rising growth abroad and falling unemployment, wage growth remained moderate. In 2017, most of Norway's trading partners were still experiencing below-target core inflation.

Chart: International interest rates

Policy rates in the US, UK and Canada were raised in 2017. In addition, the Federal Reserve started to cautiously reduce its balance sheet, while the European Central Bank (ECB) announced that it would reduce its asset purchases from 2018. Nevertheless, international interest rates remain low, and signals from central banks as well as market expectations indicate a very gradual rise in interest rates.

Chart: Oil prices and the krone exchange rate

Oil prices have risen over the past two years, which may reflect steady growth in global oil consumption. Oil prices have recently increased further owing to geopolitical tensions. The krone has appreciated somewhat in this period.

Chart: Mainland GDP

In Norway, growth in the mainland economy picked up through 2017 and the economic outlook improved. Low interest rates, improved competitiveness and an expansionary fiscal stance contributed to the upturn, while oil investment declined at a slower pace after falling sharply for several years. Although the activity level in the Norwegian economy was still somewhat below a normal level, the economy was emerging from the downturn that followed in the wake of the fall in oil prices in 2014. Employment was rising and unemployment was falling.

The improvement in the labour market was reflected in a moderate increase in wage growth, which in the preceding years had been restrained by the decline in oil prices, lower capacity utilisation and lower underlying productivity growth.

Chart: Consumer prices

The depreciation of the krone following the sharp fall in oil prices in 2014 and 2015 gradually fed through to prices and resulted in higher inflation. As this effect faded and the krone appreciated, inflation fell back. Both low imported inflation and weak cost growth in the Norwegian economy contributed to low inflation in 2017. Underlying inflation remains below target, but prospects for higher levels of activity and slightly higher wage growth indicate that inflation will rise in the period ahead.

Chart: Debt ratio and interest burden

Elevated house price inflation and high debt growth have increased household sector vulnerabilities. After rising faster than household income for several years, house prices began to fall in April 2017. The correction reflects the pace of housing construction, which has risen to a high level, at the same time as population growth has shown a marked fall. In addition, the requirements in the residential mortgage regulation were tightened on 1 January 2017. Nevertheless, so far the correction seems to be limited, and house prices have edged back up in recent months.

Chart: Key policy rate

The key policy rate has now been 0.5 percent for a good two years. The very low level of global interest rates has contributed to the low interest rate level in Norway. At the same time, the Executive Board’s assessment through 2017 and into 2018 has been that there is a continued need for an expansionary monetary policy.

The projections for the key policy rate have gradually been revised up as the outlook for the Norwegian economy has improved. Economic activity is now approaching a normal level, and inflation is projected to move up in the period ahead. Our latest analyses, presented in March 2018, suggest that the key policy rate will most likely be raised after summer 2018. At the same time, the Executive Board has given weight to the consideration that uncertainty as to the effects of a higher interest rate suggests a cautious approach to interest rate setting.

Chart: Consumer prices

Looking at the wider picture, we can, 17 years after inflation targeting was formally introduced in Norway, draw the conclusion that the system has functioned well. We can now look back on a quarter of a century of low and stable inflation.

Chart: Fluctuations in output and employment

A monetary policy oriented towards low and stable inflation has not compromised stability in the real economy – in fact, the opposite is true. Employment variability has been lower since 2001 than in previous periods, despite the substantial shocks that have impacted the Norwegian economy.

However, lessons have been learned along the way. Initially, most inflation-targeting central banks emphasised the importance of steering inflation towards the target within a clearly defined time horizon. Experience of this regime provided useful insight, and ambitions were later adjusted. International events, such as falls in global commodity prices and other major changes in export and import prices, can have a considerable impact on small open economies. This can result in wide fluctuations in inflation that cannot be counteracted without having a substantial impact on the real economy. 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.

Chart: Monetary policy mandate

The benefits of flexible inflation targeting were emphasised when the Government in March 2018 presented a new regulation on monetary policy. The new regulation specifies that inflation targeting shall be forward-looking and flexible, so that it can contribute to high and stable output and employment and to counteracting the build-up of financial imbalances.

In the interest of long-term economic stability, fiscal policy, monetary policy and the wage formation process must complement each other. A shared understanding of how these components interact is very important.

Monetary policy's most important contribution to economic stability is to maintain monetary value through low and stable inflation. Both too high and too low inflation can involve costs to society, with arbitrary wealth redistribution, underinvestment and scarce resources that may be misallocated or left idle. This is usually referred to as providing the economy with a nominal anchor. When households and enterprises can base their economic decisions on low and stable inflation, this provides an important foundation for higher activity and welfare over time.

As long as there is confidence that inflation will remain low and stable, monetary policy can contribute to smoothing fluctuations in output and employment. When the economy is exposed to shocks, such as a financial crisis or a fall in oil prices, monetary policy can respond rapidly. Sufficiently flexible inflation targeting could help ensure that lower employment levels do not persist over the long term following a downturn. This can reduce the risk of unemployment becoming entrenched at a high level.

The probability of a pronounced downturn in the economy has been shown to increase after periods of rapid asset price inflation and debt growth. Monetary policy can also to some extent contribute to high and stable output and employment by giving weight to counteracting the build-up of financial imbalances.

However, monetary policy must not be overburdened. If Norges Bank pursues objectives it does not have the instruments to fulfil, confidence in monetary policy may be eroded. The regulation and supervision of financial institutions must be the primary means of addressing shocks to the financial system. Employment levels over time are determined by structural conditions, such as the functioning of the labour market, the tax and social security system and the wage formation process. In Norway, a well-functioning wage formation process has enabled unemployment to remain low while wage growth has remained moderate.

The new regulation underpins Norges Bank's flexible approach to inflation targeting. In the conduct of monetary policy, substantial weight will continue to be given to the real economy. In this context, whether the inflation target is 2.5 percent or 2 percent is less important. At 2 percent, the inflation target is now at the same level as that of most of Norway's trading partners. The reduction of the target will not in itself significantly affect the short-term interest rate outlook.

Never before have global interest rates been as low for such a long period. Growth abroad has now picked up, and there are prospects of a gradual interest rate increase among Norway's trading partners. The outlook is also brighter in Norway. In the two years since the cyclical trough was reached, growth has gained a firm footing and the unemployment rate has declined. The outlook suggests that it will soon be appropriate to raise the key policy rate – and this is a good sign.

Thank you for your attention.