Øystein Olsen: Navigating normalisation

Speech by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at the Bank of Thailand – OMFIF High-level Seminar, Bangkok, 9 October 2018.

* * *

First, let me thank you for the opportunity to speak to you today. I am very happy to visit the Bank of Thailand and to participate on this panel.

The financial crisis demanded powerful economic policy measures. Monetary policy had to take on substantial responsibility, in Norway as in many other countries. As we are hopefully heading for more normal times, it is important to evaluate our policy framework. Our experience is that a flexible inflation targeting regime has helped dampen the impact on the real economy. In recent years, output and employment volatility has been relatively limited despite large shocks to the Norwegian economy.

The exchange rate has played an important role as a shock absorber, especially during the financial crisis and in periods when oil prices have fallen. At the same time, the interest rate level abroad places limitations on the room for manoeuvre in monetary policy in a small open economy like Norway.

Our economy and economic policy

Before I elaborate on this, I would like to give you some background on my country. Norway is a small country with a little more than five million inhabitants. The economy is open; total imports and exports make up about 2/3 of GDP. The public sector benefits from the government's large revenues from petroleum extraction, and although the direct employment effect is small, the impact on the overall economy is significant.

These specific features of the Norwegian economy are important concerns behind the framework for economic policy. *Fiscal policy* is governed by a fiscal rule, designed to insulate public finances from oil price volatility. The government's large petroleum revenues are channelled into the Government Pension Fund Global and the fund's capital is invested abroad. The fiscal rule specifies that only the expected real return of the fund, on average over the cycle, is to be spent over public budgets every year. With this set-up, the fund also provides leeway for discretionary fiscal expansion when needed and enables future generations to benefit from Norway's petroleum revenues.

Monetary policy has targeted low and stable inflation since 2001. After an adjustment earlier this year, the operational target of monetary policy is now annual consumer price inflation of close to 2 percent over time. 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.

Norges Bank sets the key policy rate with a view to stabilising inflation at the target in the medium term. The horizon will depend on the disturbances to which the economy is exposed and the effects on the outlook for inflation and for output and employment.

Large and sudden outflows of capital are a potential source of instability for small, open economies. Large exchange rate movements have at times been a source of instability. In Norway, the household, banking and corporate sectors as a whole take on currency risk to a limited extent. Furthermore, government finances are solid, and fiscal policy is not affected to any great extent by short-term exchange rate movements. This allows the exchange rate to play an important role in absorbing shocks to the economy. We have thus been able to reap the benefits of an efficient international capital market without having to deal with its challenges.

At the same time, in a world of high capital mobility and extensive trade, monetary policy's room for manoeuvre is constrained by the exchange rate channel. In a small open economy with a floating exchange rate, the domestic interest rate can differ from interest rates abroad. However, an interest rate differential that becomes too wide can lead to considerable exchange rate volatility, which will in turn feed through to inflation, output and employment. Thus, the domestic interest rate cannot be set without regard to the level of external interest rates. The room for manoeuvre in monetary policy is further constrained in periods when external interest rates are close to or below zero.

Although the financial crisis in 2008 had a marked impact on Norway, our economy was affected to a lesser extent than most other advanced economies. There are a number of reasons for this. The Norwegian economy was in an upturn when the crisis hit. Commodity prices fell, but soon rebounded. Norwegian banks were not directly exposed to loss-making financial instruments backed by subprime US housing mortgages. The banks suffered for a short period when international liquidity dried up, but these problems were resolved. In addition, substantial fiscal leeway enabled policy to respond forcefully, allied with a slashing of interest rates, from 5.75 percent in September 2008 to 1.25 percent in June 2009. The economy recovered rather quickly, and we did not need to resort to quantitative easing or interventions in the foreign exchange market.

When the oil price plummeted in 2014 and 2015, the value of our currency fell sharply, reflecting weaker terms of trade. Norges Bank reduced the key policy rate. This dampened the decline and facilitated structural adjustments in the Norwegian economy. As the krone depreciation did not result in demands for wage compensation, competitiveness improved. Fiscal policy also responded forcefully. Together, this enabled a reasonably swift return to more normal economic conditions. At the same time, low interest rates contributed to increasing housing prices and debt levels in Norway, as in some other countries.

We are ready to normalise monetary policy

Over the past couple of years, growth in the Norwegian economy has been solid, underpinned by an economic upturn among our trading partners, increasing oil prices and low interest rates. The labour market has improved. Spare capacity is gradually diminishing, and capacity utilisation now appears to be close to a normal level. Underlying inflation is close to the 2 percent inflation target.

Against this background, Norges Bank increased the key policy rate in September –for the first time in seven years. If the economy evolves as we now expect, this is the beginning of a gradual normalisation of the interest rate level. A long period of low interest rates and mounting household debt burdens has led to greater uncertainty surrounding the effects of higher interest rates. This suggests a cautious approach to interest rate setting. Rising protectionism internationally and turbulence in some emerging economies adds to the risk picture, with potentially strong negative effects for Norway.

Communication is an important part of our monetary policy. We aim to be transparent and to communicate frequently, simply and clearly. We have published our own interest rate projections since 2005. All through this year we have repeatedly indicated that the key policy rate most likely would be raised after summer.

Financial stability

The financial crisis was a reminder that price stability is not sufficient to guarantee financial stability. In an environment of low global interest rates, there is a clear risk of a build-up of financial imbalances, which increases the risk of new economic downturns further out. Norges Bank has thus in periods kept its key policy rate somewhat higher than implied by a short-term goal of inflation and output stability. This does not mean that asset prices or debt have been given independent roles as target variables of monetary policy. The decisive factor has been the consideration of economic stability over time.

The main responsibility for counteracting financial imbalances cannot lie with monetary policy. If monetary policy seeks to pursue goals beyond its reach, the credibility of monetary policy will gradually weaken. Regulation and oversight of financial institutions must therefore continue to be the first line of defence against shocks to the financial system.

The regulation of Norwegian banks largely follows EU rules, which in turn are governed by guidelines decided by the Basel Committee. Generally, we have been able to implement stricter regulation more rapidly than most other countries, partly because the economic downturn in Norway has been relatively mild. The Ministry of Finance has also introduced residential mortgage lending regulations to slow down the increase in house prices.

Conclusion

I believe both international and our own experiences with inflation targeting have been predominantly positive. While the exchange rate targeting regime that prevailed until the late 1990s tended to function procyclically, flexible inflation targeting has contributed to stabilising the economy when it has been exposed to shocks. In Norway, we can now look back on a quarter of a century of price stability. At the same time, employment has shown less variation since 2001 than in previous periods, in spite of the substantial disturbances that have hit the Norwegian economy.

In the early years of inflation targeting, policymakers had high ambitions of fine-tuning inflation to meet the target and of achieving this goal within a clearly defined time horizon. But useful lessons have been learned. In the face of various kinds of shocks, small open economies in particular found that bringing inflation rapidly back to target can have undesirable consequences for the real economy. It has been essential to practise flexibility in inflation targeting to address shocks. The horizon for achieving the target has been lengthened. The latest adjustment of the mandate for monetary policy in Norway clarifies this flexible interpretation of the inflation target. We believe the framework is well suited to guiding monetary policy through the years ahead.