

Central bank priorities as the ECB moves towards normalisation

Remarks by Governor Øystein Olsen at the J. P. Morgan Investor Seminar on October 13, 2017.

Thank you for the invitation to this seminar and the opportunity to share the floor with my Danish and Swedish colleagues. We represent three small economies with many common features, most notably in today's context our openness to trade and dependence on international developments.

However, there are also important differences. As you probably all know – Norway extracts and exports large amounts of oil and gas. As a consequence, Norway experiences considerable terms of trade volatility owing to commodity price fluctuations. This aspect of our economy is vital in understanding recent developments and when discussing the future.

A small, open, commodity-producing economy is easily hit by shocks originating in international markets. This was clearly illustrated during the financial crisis and after the fall in the oil price in 2014. The oil price collapse triggered a strong decline in investment activity in the petroleum sector, which in turn affected the wider economy. Last year, growth in mainland GDP was at its lowest since the financial crisis. Unemployment increased through 2015 and to some extent in 2016, particularly in Norway's oil-dependent regions.

We cannot avoid being affected by abrupt changes in terms of trade and other international shocks. But we seem to have learned from previous experiences. Since the mid-1990s, a main purpose of the economic policy framework has been to shelter the economy from fluctuations in oil prices.

The set-up of the Government Pension Fund Global and the fiscal rule for petroleum revenue spending is one important defence mechanism in this context. The government's net cash flow from the petroleum industry is transferred in its entirety to the Government Pension Fund Global. A transfer from the Fund to cover a non-oil budget deficit requires a decision by the Norwegian parliament. In addition to preserving the real value of the Fund for the benefit of future generations, this set-up insulates the budget from short-term fluctuations in petroleum revenues. It also leaves space for fiscal policy to counteract economic downturns. In effect, since 2013, the increase in oil revenue spending has roughly matched the fall in oil investment.

Monetary policy has also played a role. Our monetary policy is oriented towards low and stable inflation. The operational target of monetary policy is annual consumer price inflation of close to 2.5% over time. Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment. With confidence in the inflation target among economic agents, monetary policy in Norway has been able to contribute to stabilising the business cycle.

Lower income from oil exports following the fall in the oil price meant cost-competitiveness needed to improve. A floating exchange rate greatly facilitated this process. In the aftermath of the oil price fall, the krone exchange rate tracked the oil price and wage settlements remained moderate. With inflation expectations well anchored, the Bank's target rate could be reduced, thus underpinning a weaker krone. As a result, relative labour costs declined markedly, strengthening the position of Norwegian firms exposed to international competition. Over time this could enable new exports to emerge as the production of oil and gas dwindles.

Over the past few quarters, growth has picked up, the labour market has improved and unemployment has fallen. The policy mix has played an important role, helped by a recovery of the oil price. Competitiveness in the oil service industry has also improved considerably, particularly after the substantial cost-cutting measures introduced by companies in this industry in recent years.

With a floating exchange rate, domestic interest rates can differ from external interest rates, but an interest rate differential that becomes too wide can have a substantial effect on the exchange rate, generating instability in inflation, output and employment. Thus, the domestic interest rate will also be influenced by external rates to a large extent under an inflation-targeting regime.

This was illustrated by a positive, but limited, interest rate differential in the first years following the global financial crisis, when the effect on Norway's economy was less severe than for most other European economies. This allowed monetary policy to respond to the economic downturn that followed in the aftermath of the fall in oil prices. The key policy rate was lowered and has been kept at 0.5 percent since March 2016.

Our experience has shown us the crucial importance of flexibility in inflation targeting in enabling us to make the appropriate trade-offs in response to shocks to the economy. 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.

The past couple of years have been demanding for the Norwegian economy, and the transition towards being less oil-dependent is ongoing. New sectors must grow to offset the downturn in petroleum-related industries. Monetary policy can facilitate this process, but the necessary adjustments must take place in the business sector.

At its September meeting, Norges Bank's Executive Board decided to keep the key policy rate unchanged at 0.5 percent. The Executive Board's current assessment of the outlook and balance of risks suggests that the key policy rate will remain at today's level in the period ahead, followed by a gradual increase to close to 1.5 percent towards the end of 2020. Inflation is expected to remain low in the years ahead. At the end of 2020, inflation is projected to be just below 2 percent. Capacity utilisation for the economy as a whole is projected to rise gradually and to be somewhat above a normal level in 2020.

This assessment is based on the outlook for economic developments abroad. While inflation is rising and growth prospects are improving internationally, global interest rates may have passed their lowest point. Expected money market rates indicate that short-term interest

rates among our 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.

If developments abroad take an unexpected turn, the Norwegian economy will be affected. The challenges may become more severe than they seem at present. However, we believe the economic policy setup, with substantial fiscal policy leeway, a flexible labour market and our monetary policy framework, will enable us to face these challenges.

And not to forget - a normalisation of monetary policy is most notably an indication of a normalisation of economic developments in the countries surrounding us. This is most welcome.

Thank you for your attention.