

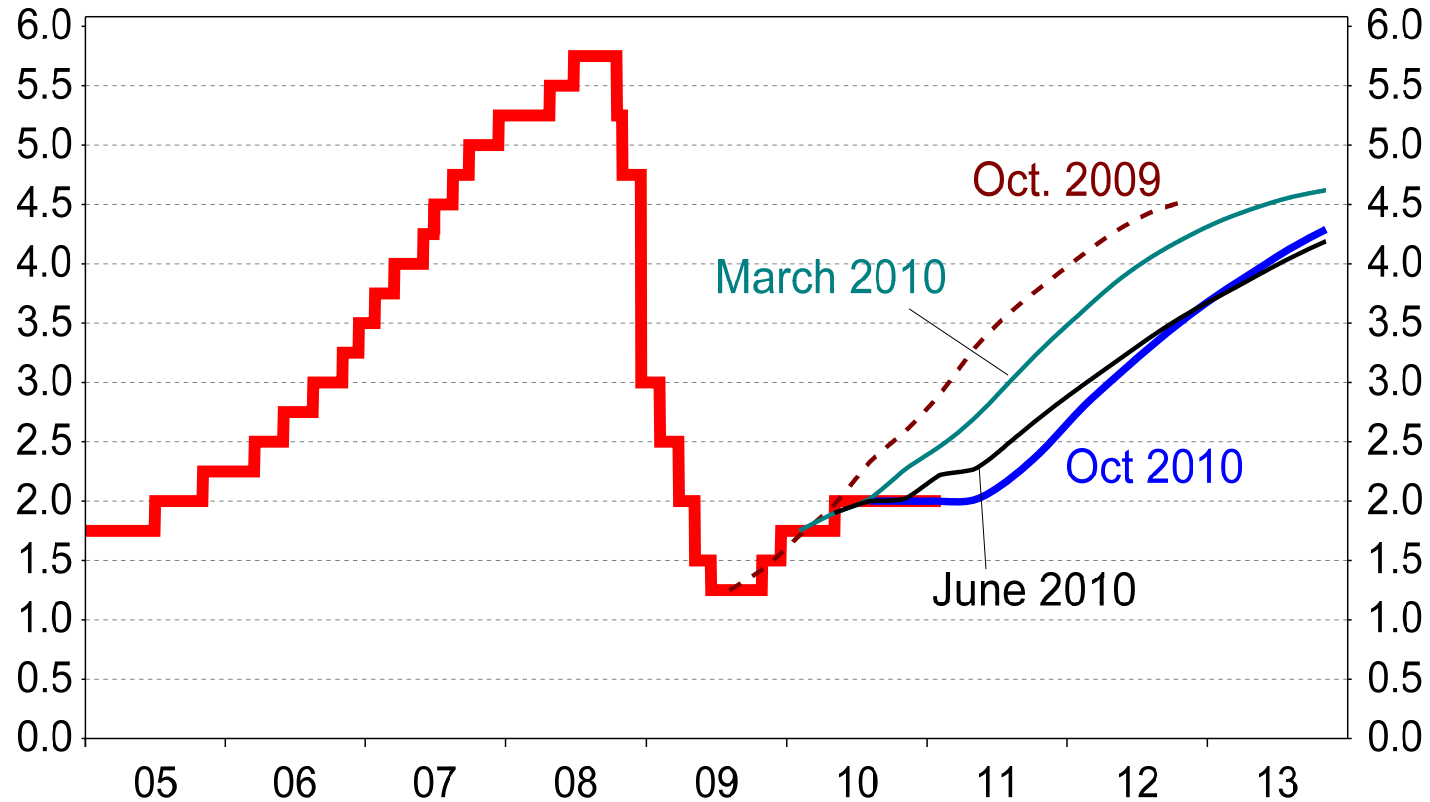
NBW 2011 - An independent Evaluation of Monetary Policy in Norway

*Hilde C. Bjørnland
BI Norwegian School of Management
hilde.c.bjornland@bi.no*

*Bjørn Roger Wilhelmsen
First Securities
bjorn-roger.wilhelmsen@first.no*

Monetary policy in 2010: Interest rate normalisation delayed

Figure 2.1: Sight deposit rate projections



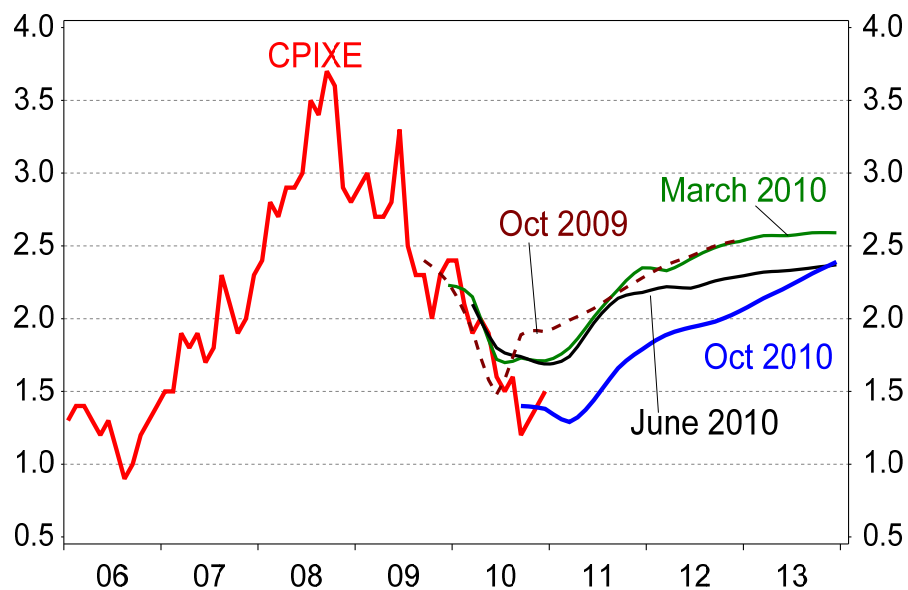
Source: EcoWin, First Securities

- The key policy rate was hiked only once, in May 2010

Outlook for inflation and GDP growth revised down

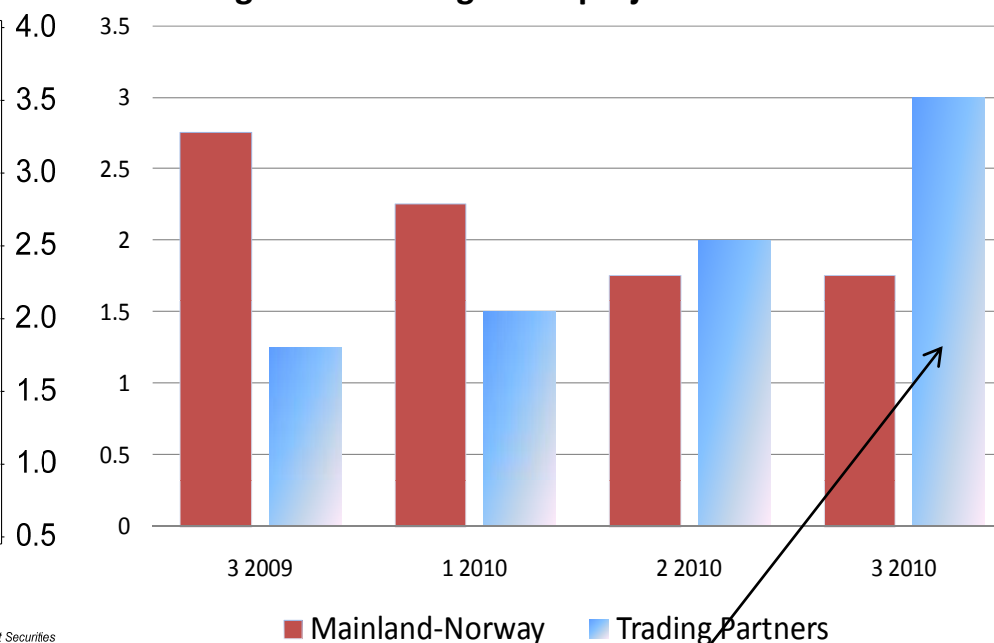
This was related to domestic factors, not global growth

Figure 2.2: CPIXE and projections



Source: EcoWin, First Securities

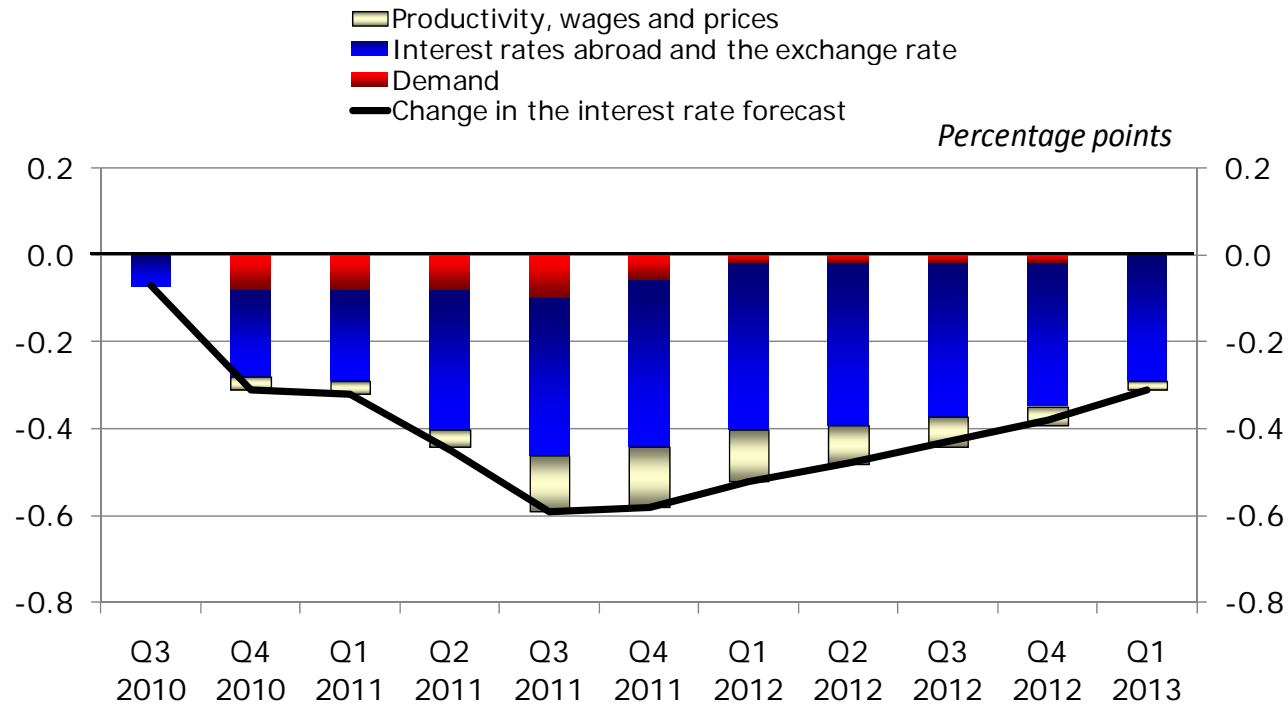
Figure 2.3: GDP growth projections for 2010



- The Bank underestimated the pace of global growth

MPR 1/2010: NOK and rates abroad contributed to lower rate path

Figure 2.4 Contribution to changes in rate path since MPR 3/09

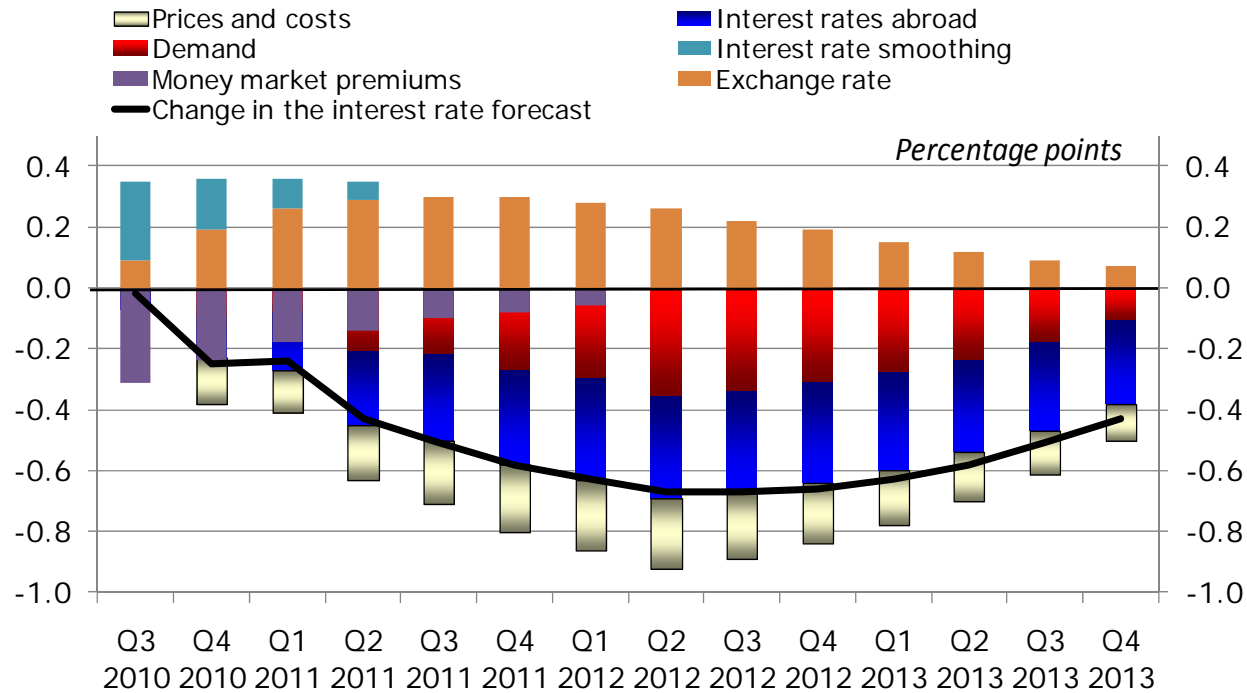


Source: Norges Bank's Monetary Policy Report 1/2010

- Sovereign debt concerns
- Unconventional monetary policy measures

MPR 2/2010: A mixed picture, but lower interest rate path yet again

Figure 2.5 Contribution to changes in rate path since MPR 1/10

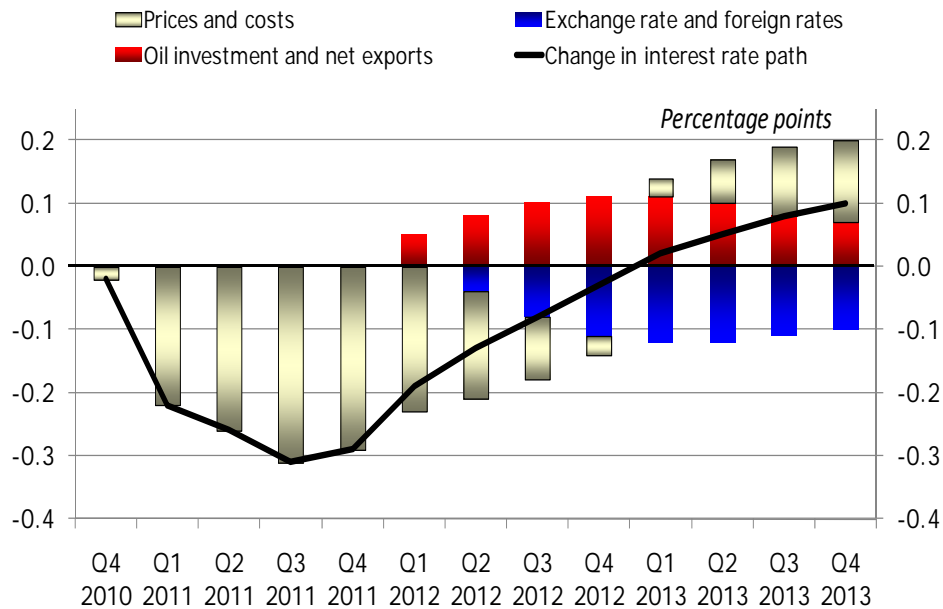


Source: Norges Bank's Monetary Policy Report 2/2010

- “Interest rate smoothing” bar was introduced
- This new bar was necessary to avoid a transitory interest rate cut

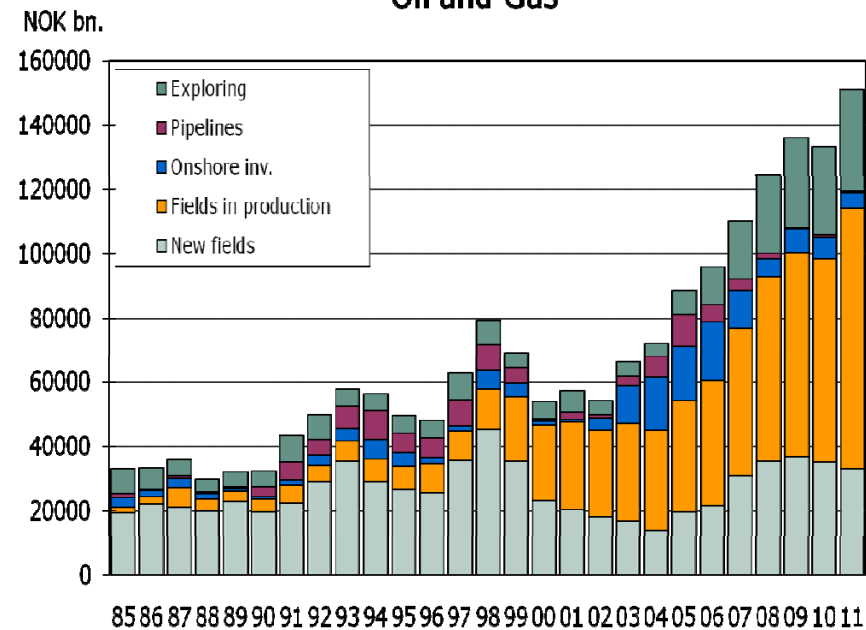
MPR 3/2010: Lower rate profile in 2011, higher in 2013

Figure 2.6 Contribution to changes in rate path since MPR 2/10



Source: Norges Bank's Monetary Policy Report 3/2010

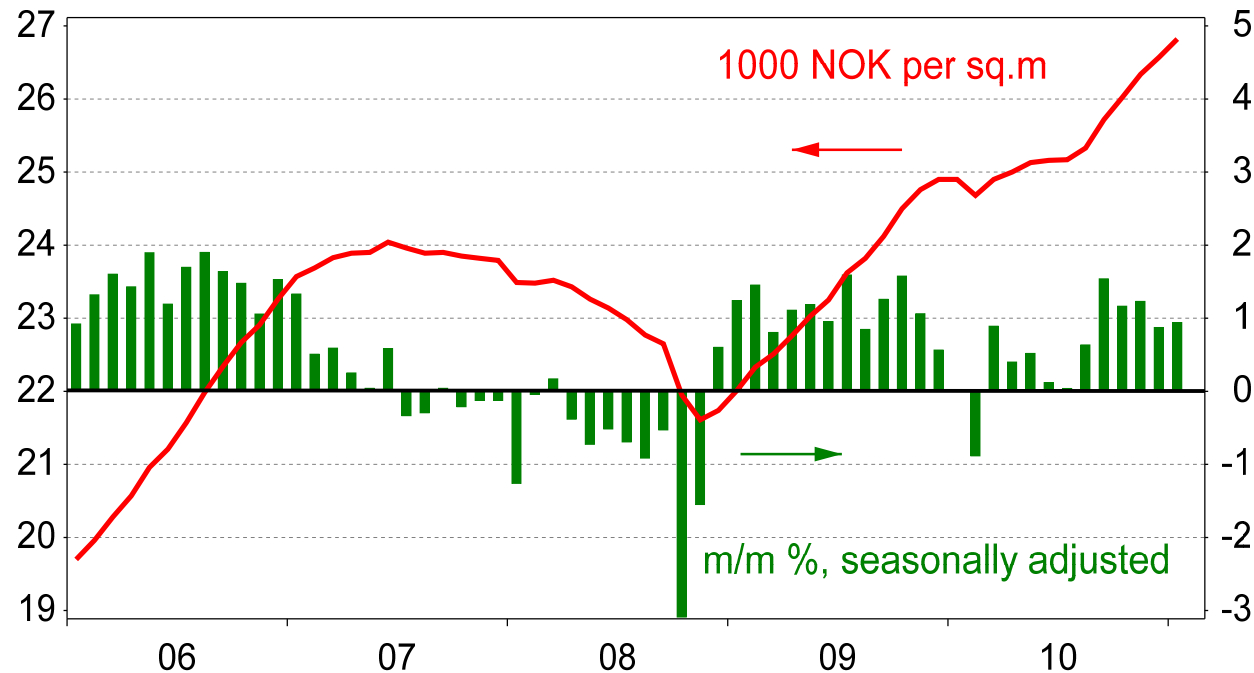
Investments on Norwegian Continental Shelf Oil and Gas



- Forecasts for Mainland-Norway GDP growth in 2011 and 2012 revised up
- However, this upward revision had no effect on the rate profile in 2011

December: Rise in house prices stronger than expected or not?

Figure 2.8: Existing home prices



Source: NEF

- FS report No. 2/2010: “The [house] price increase in October was higher than assumed in Monetary Policy Report 3/10”
- December press conference: “Rise in home prices in line with expectations”

Monetary policy in 2010: **NBW view**

- The committee questions if the outlook for stronger growth in oil investments and exports should have affected the interest rate forecast for 2011
- Communication on house prices after the Board meeting in December should have been clearer:
 - Higher than expected or not?
 - Implications for monetary policy if the trend in house prices were to continue?
 - Minutes would certainly have been helpful
 - Illustrates room for improvement when it comes to integrating financial stability considerations in the discussions of monetary policy

Four forecasts every year?

- NBW view: Norges Bank should consider publishing a press release and a monetary policy update in conjunction with at least one of the other meetings of the Executive Board (preferably in December)
 - Forecasts at the end of every quarter (Mar, Jun, Sep, Dec)
- The monetary policy update should contain a limited number of forecasts for central macroeconomic variables
- Updated short-term forecasts for growth and inflation (SAM): What are the monetary policy implications?

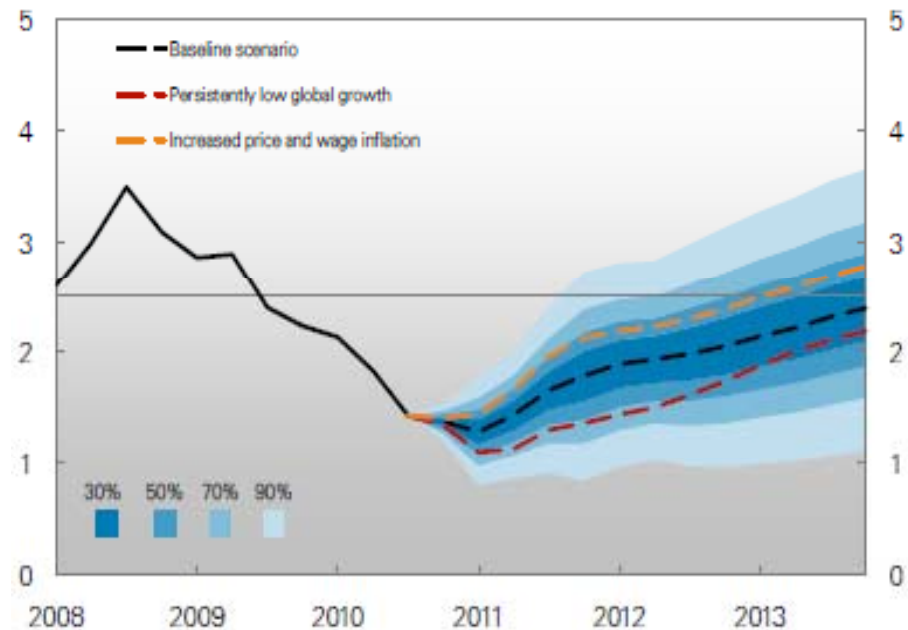
CPIXE should not be used as the main indicator of inflation

- We encourage the use of various measures of underlying inflation, because headline CPI can be volatile
- But CPIXE is not an optimal indicator of inflation to be used in the forecasting process:
 - It's constructed by Norges Bank, not Statistics Norway
 - Not transparent: Real-time values for CPIXE deviates from final data in periods with rapid changes in forward prices on energy
 - Fan charts backwards?
 - Difficult for market participants to produce forecasts for the energy trend included in the CPIXE

NBW view on underlying inflation in the forecasting process

- Headline CPI could take a more prominent role in the forecasting process
 - Explain why measures of underlying inflation and headline CPI deviates
 - Always transitory disturbances behind differences in core and headline CPI?
 - What about second rounds effects?

Chart 1.23c CPIXE⁽¹⁾ in the baseline scenario and in the alternative scenarios. 4-quarter change. Per cent. 2008 Q1 – 2013 Q4



- A combination of CPI-ATE and CPI will take into account trends in energy prices, taxes and possible second round effects of these trends

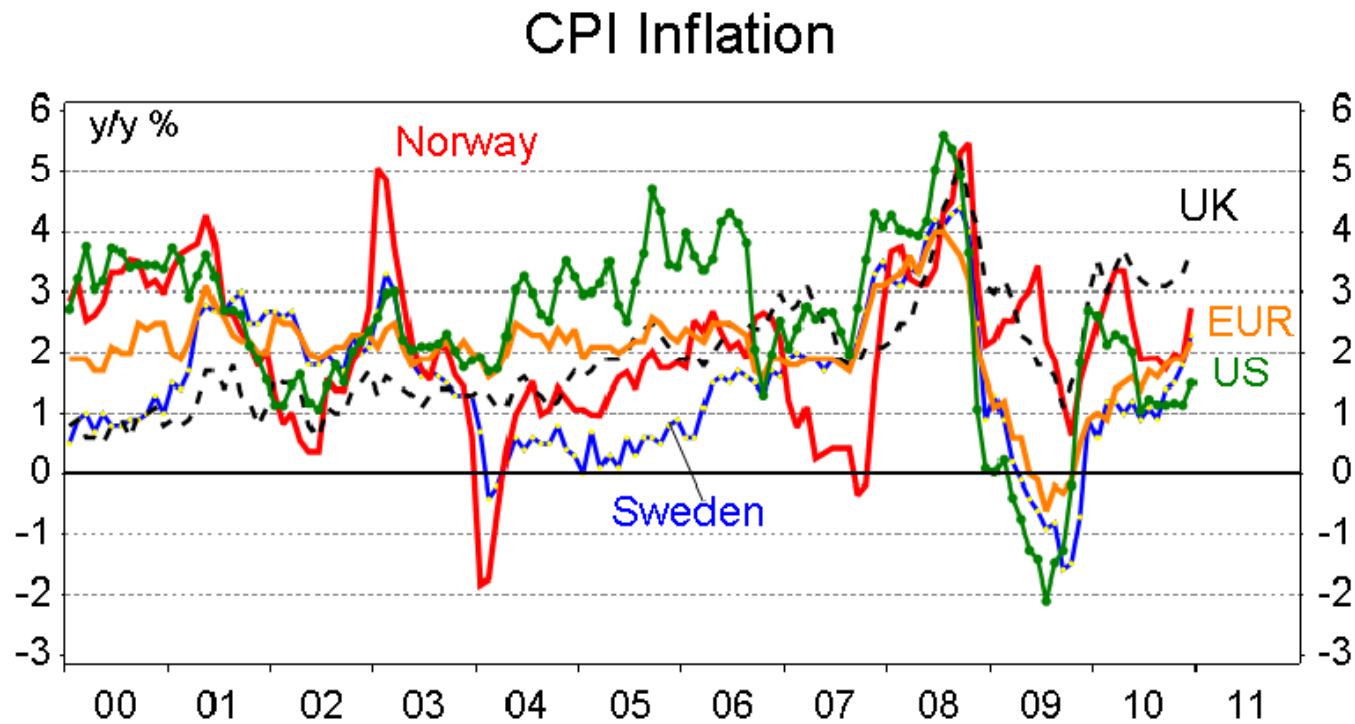
A decade (or so) of inflation targeting

Economic performance – Stylized facts

10 (-12) years of Inflation targeting in Norway

- March 1999; Norges Bank and its new Governor Svein Gjedrem would place emphasis on the fundamental conditions for achieving exchange rate stability over time, such as stabilizing price and cost inflation:
 - *“In order to achieve exchange rate stability against the euro, monetary policy instruments must be oriented in such a way that price and cost inflation is brought down towards the corresponding aim for inflation for the European Central Bank (ECB).”*
- March 2001, formal inflation targeting framework adopted for monetary policy. The operational target of monetary policy specified to be annual consumer price inflation of close to 2.5% over time. In addition:
 - *“Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.”*

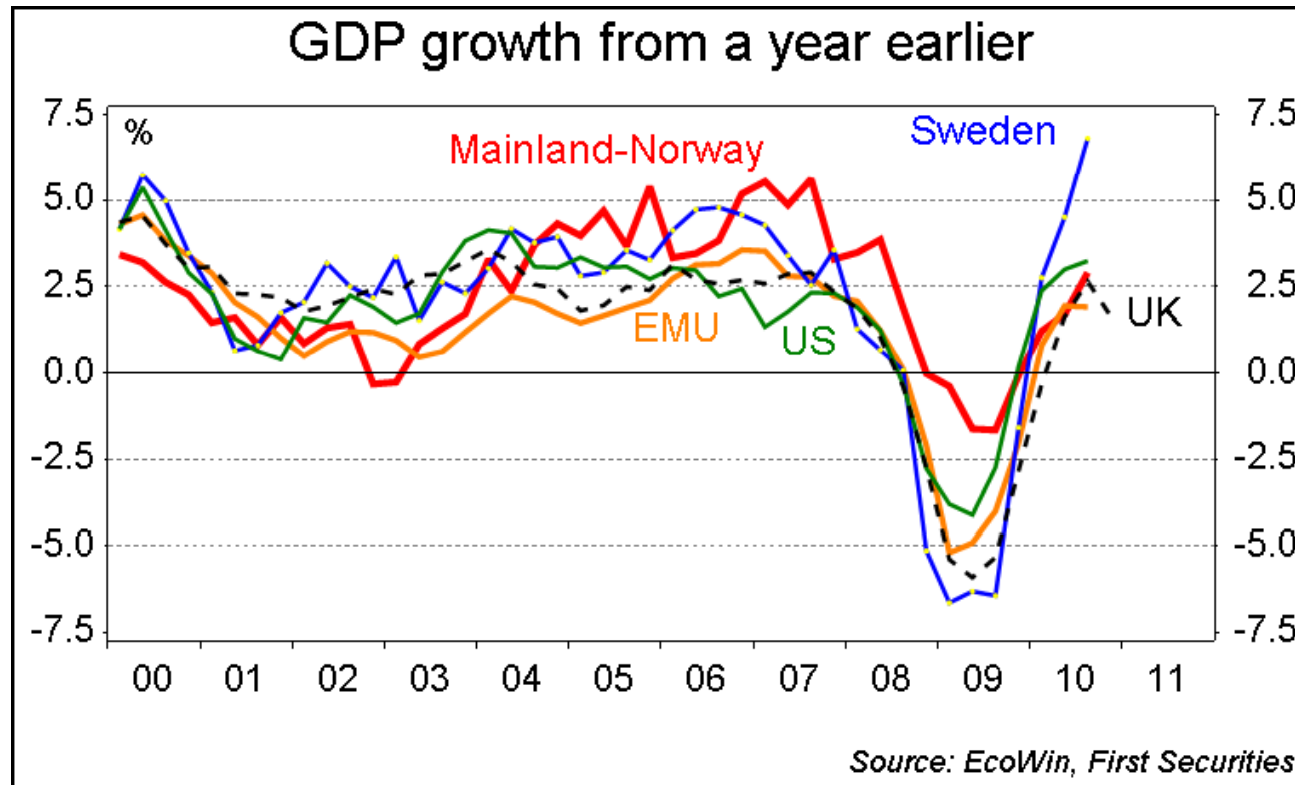
Inflation rates fluctuates around the target, on average below



Source: EcoWin, First Securities

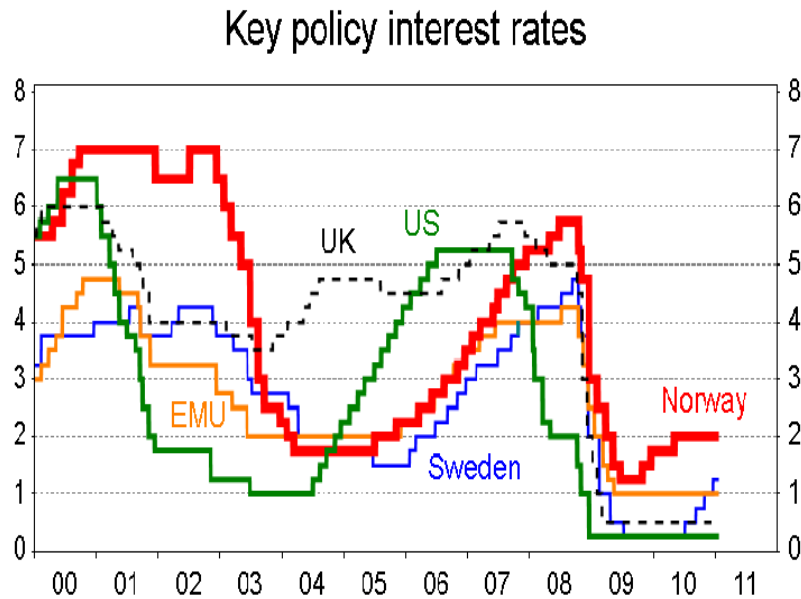
- Norway ranks after US in terms of volatility

Sustainable growth rates



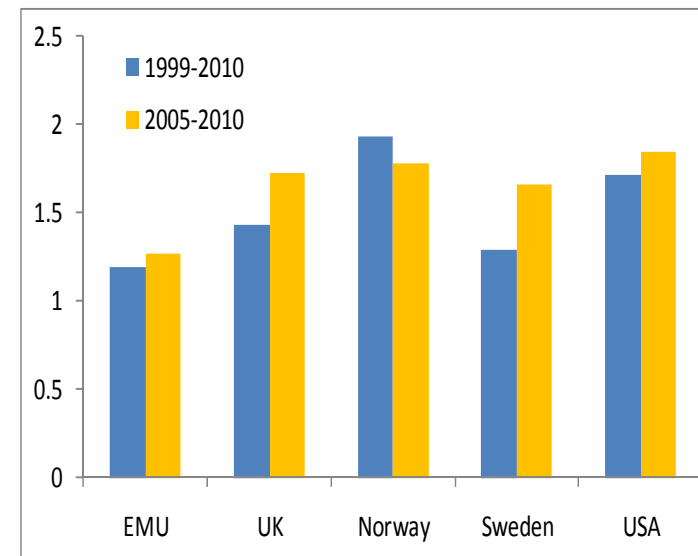
- Average annual growth rates for GDP mainland Norway has been 2.3 percent, only surpassed (marginally) by Sweden

Large and frequent (aggressive) interest rate changes



Source: EcoWin, First Securities

Standard deviation of the annual change in key policy rates

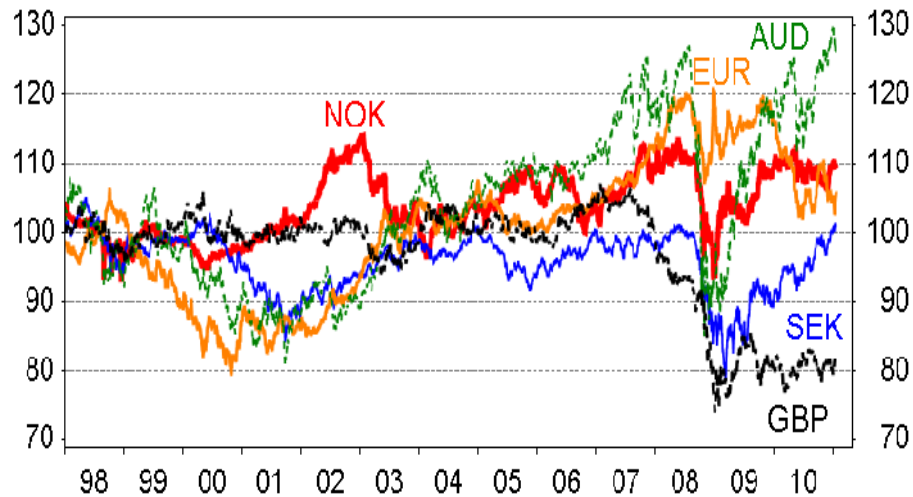


➤ Norges Bank ranks as one of the most aggressive central banks with regard to interest rate volatility. After 2005, more in line with the other countries

Norway - Most stable nominal exchange rate, although appreciated slightly

Nominal effective exchange rates

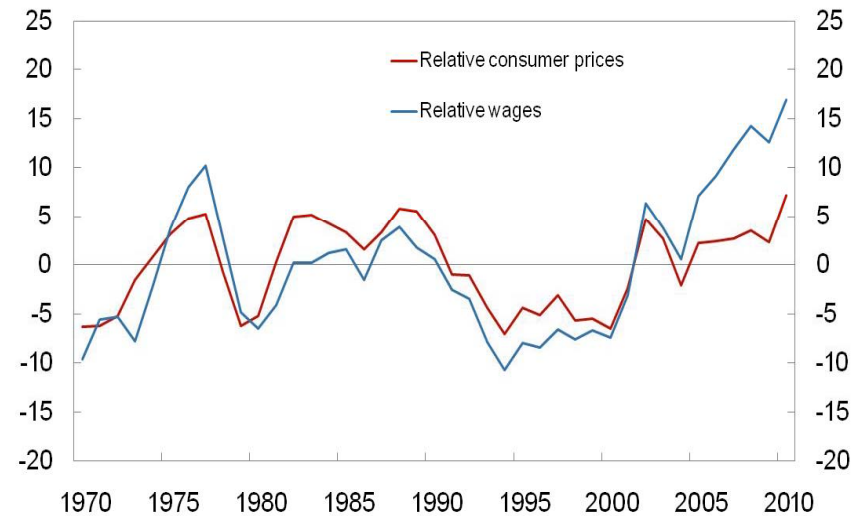
Indices, 1998=100



Source: EcoWin, Bank of England, First Securities

Real exchange rate

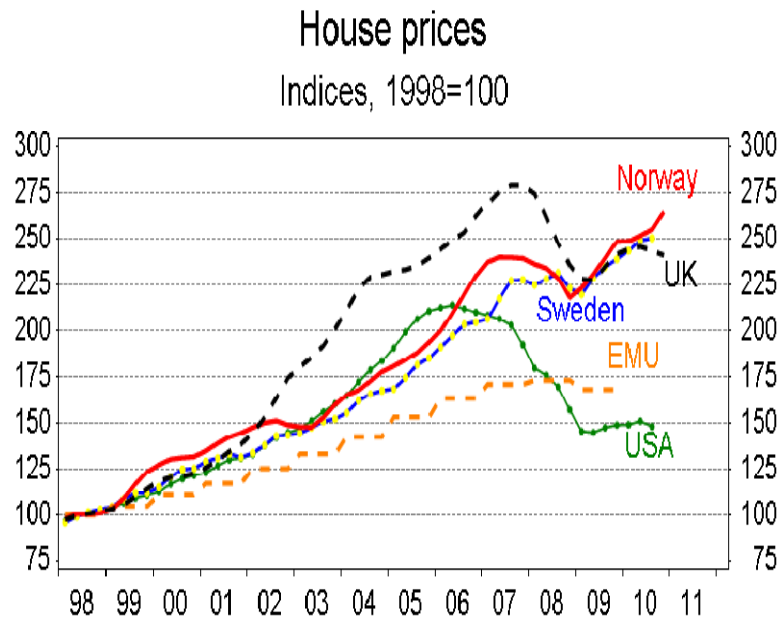
Deviation from mean, 1970 – 2010.



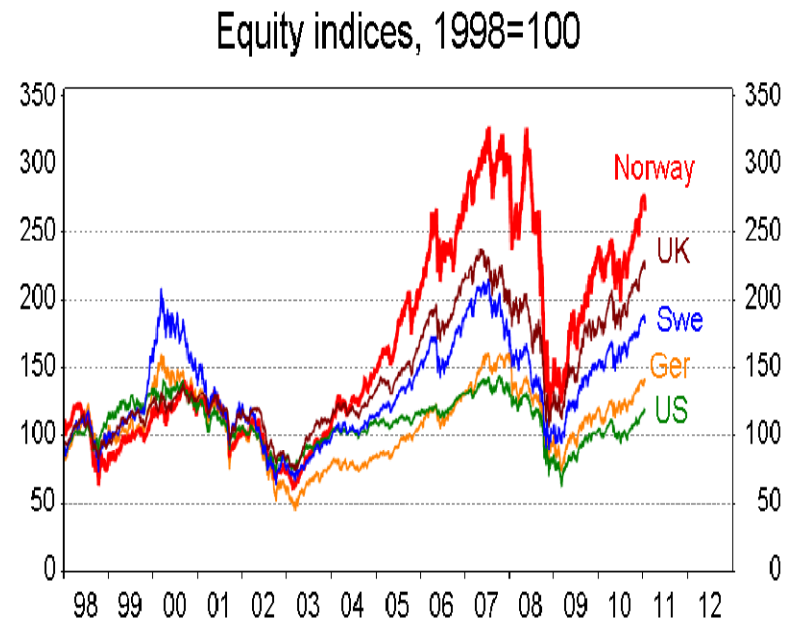
- The real exchange rate (relative wages) show evidence of declining competitiveness.

House price growth – Norway in the lead

Equity prices – Norway the most volatile



Source: EcoWin, First Securities

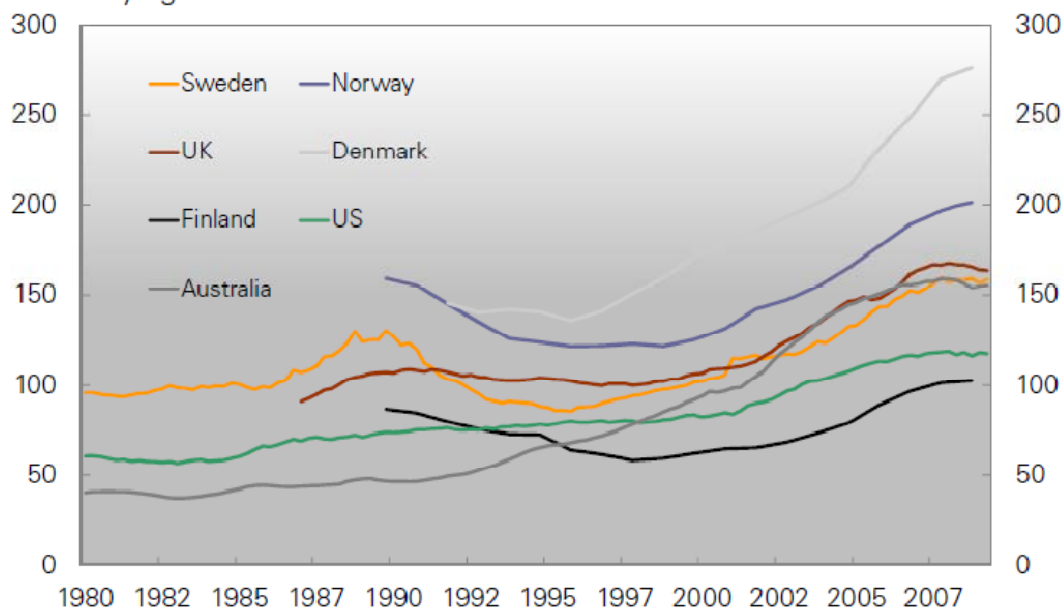


Source: EcoWin, First Securities

- Although many other factors contribute, monetary policy has clearly played a role

Fast growth in various asset prices has increased the household debt burden so that it is now very high, both historically and in comparison with other countries

Chart 19 Household debt as a percentage of disposable income¹⁾. Per cent. Quarterly figures. 1980 Q1–2009 Q2



1) Figures are not necessarily comparable due to differences in definitions and institutional arrangements.

Sources: BIS, central banks, Thomson Reuters and Sveriges Riksbank

NBW view on the stability in the inflation targeting area

- Monetary policy in Norway has been a success in terms achieving inflation rates close to the target and contributing to sustainable growth rates.
- Contrary to much concern when inflation targeting was introduced, the nominal exchange rate has also remained fairly stable over this period, although on average, appreciated slightly.
- Norges Bank still ranks as one of the most aggressive central banks with regard to interest rate volatility.
- High variation in equity prices and unprecedented high growth rates in house prices. Monetary policy has clearly played a role.
- High pass through from interest rates to asset prices and high debt ratios makes the Norwegian economy more vulnerable to shocks in the future.

Financial stability and monetary policy in practice

Financial Stability report 2/2010 (December)

- *“Low interest rates are favouring current consumption, including housing consumption. Expectations of low interest rates ahead may contribute to higher debt growth ...High debt burdens may increase households’ vulnerability to unexpected interest rate hikes, pronounced income shortfalls or an abrupt turnaround in the housing market.”*

Monetary policy press conference December:

- *“The rise in house prices and consumer spending has picked up recently. The consideration of guarding against the risk of future financial imbalances that may disturb activity and inflation somewhat further ahead suggests that the key policy rate should not be kept low for too long.”*

✓ ***What is too long?***

NBW view: Implications for monetary policy

- Norges Bank should make it clearer as to how the issues of major concern in financial stability influence monetary policy decisions in practice.
- How are specific analysis and recommendations from financial stability integrated into the actual monetary policy framework?
- Disclosure of judgment as to how the risk of future financial imbalances may (or may not) disturb activity and inflation somewhat further ahead becomes extremely important.

NBW- view: Communication and the role of the executive board

- A record of the discussion that has preceded the decisions at the Executive Boards meetings would be useful and make monetary policy more transparent and credible.
- Requires minutes to be released from the policy meetings. Would strengthen accountability and further improve transparency.
- These minutes could note, without attribution to individual members, which issues were discussed and what arguments were presented.
- Provide an indication of the degree of disagreement and/or uncertainty among the members.

□ *“The moral of the story is that monetary policy cannot be reduced to a mechanical reading exercise. However well-prepared the material on which monetary policy decisions are based, there will always be complex and important aspects that policymakers must take a stance on. It is important that these aspects are discussed from several different perspectives. This is one reason why we have an Executive Board made up of economists with different backgrounds and expertise.”*

Ms Barbro Wickman-Parak, Deputy Governor of the Sveriges Riksbank,
26 January 2011