The Executive Board's assessment

Monetary policy

At its meeting on 19 June 2013, the Executive Board decided that the key policy rate should be in the interval 1%–2% in the period to 19 September 2013, unless the Norwegian economy was exposed to new major shocks. In the previous *Monetary Policy Report* published on 20 June, it was pointed out that growth prospects both at home and abroad had weakened slightly. Capacity utilisation was estimated to be close to a normal level. Wage growth was lower than expected. Inflation remained low and there were prospects that it would take longer for inflation to pick up than projected earlier. Considerable uncertainty remained concerning developments in the international economy. The analysis in the June *Report* implied a key policy rate of around 1.5% or somewhat lower in the period to autumn 2014, followed by a gradual increase towards a more normal level.

In its discussion on 4 September and 18 September, the Executive Board placed emphasis on the following developments:

- Growth among trading partners as a whole is broadly in line with that projected. There are signs of rising growth in many advanced economies, while growth has slackened in several emerging economies. The price of crude oil has increased somewhat since the June 2013 *Report.*

- Key interest rates are close to zero in many countries, but market expectations concerning policy rates abroad have increased somewhat since the June *Report.* The first interest rate increases in major advanced economies are expected towards the end of 2014 and in the course of 2015.

- The krone depreciated markedly during the last weeks of June, but has appreciated recently. The krone, as measured by the import-weighted krone exchange rate index (I-44), has been about 2% weaker so far in the third quarter than projected in the June *Report.*

- Banks increased interest rates on housing loans by 0.3 percentage point between Q1 and Q2, approximately as projected in the June *Report*. Premiums in the money market have decreased slightly.

- Growth in the Norwegian economy has been somewhat lower than projected in the June *Report*. In August, the enterprises in Norges Bank's regional network reported that growth had been moderate through summer, and growth is expected to remain unchanged ahead. Unemployment remains stable.

- House price inflation has abated and been lower than expected, while household debt growth remains high.

- Consumer price inflation has been clearly higher than projected. Consumer price inflation adjusted for tax changes and excluding energy products (CPI-ATE) was 2.5% in August.

The point of departure for the Executive Board's assessment of monetary policy is that the key policy rate is set with a view to keeping inflation close to 2.5% over time. The objective of low and stable inflation is weighed against the objective of stable developments in output and employment. Monetary policy also seeks to be robust and take into account the risk that financial imbalances build up and trigger or amplify an economic downturn.

The key policy rate is 1.5%. The key policy rate is low because interest rates abroad are very low and because the prospects for inflation have been low for a long time. At the same time, there is a substantial spread between the key policy rate and the interest rates facing households and enterprises.

The Executive Board noted that the analyses in this *Report* imply a key policy rate at today's level in the period to summer 2014, followed by a gradual increase to a more normal level. Underlying inflation is now estimated at between 2% and 2½%. Inflation is projected to run at around 2¼% towards the end of the projection period and capacity utilisation is expected to be close to a normal level in the coming years.

In its discussion, the Executive Board pointed out that there are signs of rising growth in many advanced economies. Activity has stopped declining in the euro area, but considerable challenges remain. At the same time, growth prospects for many emerging economies have weakened. Capital outflows from emerging economies have triggered a depreciation of their currencies, increasing the vulnerability of emerging countries with large current account deficits and high debt in foreign currency. There is considerable uncertainty surrounding future developments in these countries. If growth rates show a further decline, oil and non-oil commodity prices may fall.

There have been wide fluctuations in the krone since the end of June. Through summer, foreign exchange markets have been marked by expectations concerning the future stance of monetary policy among major advanced economies. Moreover, the krone has reacted more than usual to new information on economic developments in Norway. Limited liquidity in the krone market may have contributed to amplifying the movements in the krone exchange rate. It was recognised that the movements of the krone ahead are uncertain and that foreign-exchange market themes shift rapidly.

The Executive Board noted that the economic situation in Norway remains solid although they also noted that growth has slowed and been lower than expected earlier. The share of enterprises in Norges Bank's regional network that report capacity constrains has decreased. This may indicate that capacity utilisation in the Norwegian economy has declined. It was also pointed out that labour immigration entails a flexible labour supply in many industries, which may make it difficult to gauge the level of capacity utilisation.

National accounts figures indicate that productivity growth is still low. Weak productivity growth has been a feature of both the Norwegian economy and many of our trading partners in the period following the financial crisis. One reason cited was the combination of moderate business investment activity and an ample supply of labour. The Executive Board further considered whether the recent low growth in productivity may be of a more temporary character. Companies may have chosen to retain their workforces despite weaker output growth because they are uncertain as to future developments in the Norwegian economy.

The Executive Board also discussed the moderate growth in private consumption, pointing to many years of strong credit growth which has resulted in a very high level of household indebtedness. The high debt level is likely to continue to have a dampening impact on growth in consumer spending ahead. It was further noted that the uncertainty surrounding economic developments, tighter bank lending standards, demographic changes and the pension reform may have induced households to increase savings.

The rise in consumer price inflation in recent months may reflect higher purchase prices for imported goods, but may also be ascribable to rising business costs and higher operating margins. It was pointed out that given the particularly large changes in inflation in recent months, the uncertainty surrounding developments in the coming months is higher than normal. The Executive Board also discussed the driving forces of inflation ahead and noted that developments in wage growth will be important. Sluggish economic developments and low cost growth among our trading partners may influence wage settlements in Norway in the coming years. Moreover, the high level of labour immigration may continue to restrain wage growth.

In its discussion of monetary policy, the Executive Board gave weight to the fact that inflation has been higher than expected and that the krone exchange rate has weakened, but that the driving forces of inflation remain moderate. Weight was also given to somewhat slower growth in the Norwegian economy and slightly lower-than-projected capacity utilisation. A rapid rise in the key policy rate may increase the risk of a more pronounced dampening of activity growth, an appreciation of the krone and too low inflation. Weight was also given to the fact that house prices and debt have risen faster than income for a long period. A lower key policy rate may increase the risk of a renewed acceleration in house prices and debt accumulation and of a build-up of financial imbalances. The Executive Board's overall assessment is that the key policy rate should remain at today's level in the period ahead.

At its meeting on 18 September, the Executive Board decided to keep the key policy rate unchanged at 1.5%.

At the same meeting, the Executive Board decided that the key policy rate should be in the interval 1%–2% until the publication of the next *Report* on 5 December 2013, unless the Norwegian economy is exposed to new major shocks.

Financial stability – countercyclical capital buffer

At its meeting on 19 June, the Executive Board concluded that banks in Norway are well positioned to increase their capital ratios and that they should hold a countercyclical capital buffer. The Executive Board also emphasised that the level of the buffer must be considered in the light of other capital requirements that will be gradually increased over the coming years.

In its discussion on 4 and 18 September, the Executive Board placed emphasis on the following developments:

- After several years of rapidly rising house prices, house price inflation has slowed and has been lower than expected.
- Household debt ratios are high and debt is still rising faster than income.
- Banks have tightened lending somewhat. At the same time, enterprises have increased their borrowing abroad and in the bond market.
- Banks' wholesale funding ratios have recently edged down.
- Commercial property prices have fallen somewhat.
- Banks' earnings so far this year are solid and losses are low.

The basis for the Executive Board's assessment is that banks should build a countercyclical capital buffer when financial imbalances are building up or have built up over a period. This will strengthen the resilience of the banking sector to an impending downturn and strengthen the financial system. A countercyclical capital buffer may also curb credit growth. Banks will be allowed to draw on the buffer in the event of an economic downturn and large bank losses. This may mitigate the procyclical effects of tighter bank lending.

The Executive Board emphasises the fact that the countercyclical capital buffer is not an instrument for fine-tuning the economy. Should economic developments continue to be characterised by relatively long periods of lending growth and low losses, banks should normally hold a countercyclical capital buffer.

In its discussion, the Executive Board noted that the risk remains that financial imbalances will trigger or amplify an economic downturn. House prices have reached high levels and household debt ratios continue to rise. Recently, house price inflation has slowed and some of the indicators of financial imbalances have declined slightly. However, the Executive Board concluded that the amplitude of a potential economic downturn, and thereby banks' vulnerability, remains considerable in the event of an economic setback.

The Executive Board pointed out that there may also be costs associated with raising banks' capital ratios. A large number of regulatory changes are now being implemented simultaneously and the level of the buffer must be considered in the light of other capital requirements. Banks are well positioned to build up capital.

The Executive Board is of the view that banks should build a countercyclical capital buffer. The aim of avoiding excessive credit tightening suggests that capital requirements should not be raised quickly. When the regulation has been finalised, Norges Bank will give concrete advice on the level of the buffer and the timing of its introduction, probably in connection with the next *Report*, to be published on 5 December.

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