The Executive Board's assessment

From 2013, the Monetary Policy Report will be published four times a year and will also include an assessment of financial stability. The Executive Board's assessment is a summary of the Executive Board's discussion of monetary policy strategy and countercyclical capital buffer requirement for banks.

Monetary policy

At its meeting on 31 October 2012, the Executive Board decided that the key policy rate should be in the interval 1%–2% in the period to 14 March 2013, unless the Norwegian economy was exposed to new major shocks. In the October 2012 *Monetary Policy Report*, capacity utilisation was assessed to be above a normal level. Inflation remained low, but developments in the Norwegian economy suggested an upward drift in inflation further ahead. There was still considerable uncertainty surrounding international economic developments. The analysis in the October *Report* implied a key policy rate of 1.5% in the period to the turn of the year, followed by a gradual increase towards a more normal level.

In its discussion at the meeting on 19 December 2012, the Executive Board pointed out that the growth outlook for Europe appeared to have weakened somewhat since the October *Report*. The expected upward shift in key rates abroad had been moved further out in time. At the same time, risk premiums in bond markets had moved down. Developments in the Norwegian economy appeared to be broadly in line with the projections in the October *Report*. The Executive Board decided to keep the key policy rate unchanged at 1.5%.

At its meeting on 19 December, the Executive Board also discussed themes of relevance for the March 2013 *Monetary Policy Report*, including the analytical framework for the countercyclical capital buffer and the relationship between cost developments and price inflation in various sectors.

In its discussions on 27 February and 13 March, the Executive Board placed emphasis on the following developments:

- Conditions in international financial markets have continued to improve. Growth in emerging economies is also expected to hold up global growth in the period ahead. At the same time, there are prospects that growth in 2012 and 2013 among trading partners, especially in Europe, may be lower than projected in the October *Report*.

- Market expectations concerning key interest rates abroad have shown little change since the October *Report*. Equity prices have increased.

- The krone appreciated somewhat in the period to mid-February, but has since weakened. The import-weighted exchange rate (I-44) is now in line with the projections in the October *Report*.

- Premiums in money and bond markets are broadly in line with the projections in the October *Report*. Bank lending margins remain high. A number of banks have announced an increase in their lending rates in response to expectations of stronger capital requirements.

- Growth in the Norwegian economy is solid, but was somewhat lower than expected throughout 2012. Employment growth has tapered off, but unemployment remains low. Capacity utilisation is assessed to be above a normal level, but has been revised down slightly compared with the October *Report*. Activity remains high in the construction industry and industries supplying goods and services to the petroleum sector. At the same time, many Norwegian enterprises are feeling the impact of weak demand among trading partners and high costs. Household consumption is growing somewhat more slowly than projected in the October *Report*. House prices have risen at a slightly faster pace than anticipated.

- Inflation in Norway remains low and has been slightly lower than projected in the October *Report*. The underlying rise in prices has ranged between 1% and 1½% over the past year.

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. In order to attain this objective, stabilising inflation is balanced against stabilising output and unemployment. Monetary policy also seeks to be robust and to take into account the risk that financial imbalances build up and trigger or amplify an economic downturn.

The Executive Board noted that the analyses now imply a key policy rate at today's level in the period to spring 2014, followed by a gradual increase towards a more normal level. The interest rate forecast is below the October forecast throughout the projection period.

In its deliberations, the Executive Board pointed out that interest rates abroad are very low and there is still considerable uncertainty linked to developments in Europe. At the same time, robust growth among emerging economies is keeping prices for many commodities high. This will sustain growth in the Norwegian economy in the period ahead.

The krone is strong. High oil prices and a positive interest rate differential may indicate that the krone will remain strong, while improvements in financial markets and increased risk appetite may make other currencies more attractive among investors.

Inflation is low. The weak impetus from external prices and the appreciation of the krone are keeping imported inflation low. The Executive Board noted that the analyses in this *Report* indicate that cost growth in the household services sector has over a longer period been lower than previously assumed. It was also pointed out that high labour immigration has led to a more flexible labour supply, which may dampen wage growth. Low wage growth in neighbouring countries may also restrain wage growth in Norway. These factors imply that there are prospects that it may take longer than previously assumed for inflation to pick up.

The Executive Board was concerned that the risk of a build-up of financial imbalances is rising as household debt and house prices are rising faster than income.

The aim of bringing inflation back to target suggests in isolation a lower key policy rate. At the same time, capacity utilisation is above a normal level. The aim of stabilising output and employment suggests in isolation a somewhat higher key policy rate, as does the aim of maintaining a robust monetary policy and mitigating the risk of a build-up of financial imbalances. On the basis of an overall assessment, the Executive Board was of the view that it would now be appropriate to set the key policy rate so that it takes somewhat longer than earlier for inflation to move back to the target of 2.5%.

At its meeting on 13 March, 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 20 June 2013, unless the Norwegian economy is exposed to new major shocks.

Financial stability – countercyclical capital buffer

The basis for the Executive Board's assessment of the countercyclical buffer requirement is that the buffer should be increased when financial imbalances build up. This will bolster banks' resilience to an impending downturn and may dampen high credit growth. Banks would be allowed to draw on the buffer in the event of an economic downturn and large bank losses, with a view to mitigating the procyclical effects of tighter bank lending.

The Executive Board notes that total debt is high in relation to GDP. Household debt is high in particular and is growing faster than income. At the same time, households are saving more, including in the form of increased bank deposits. However, liabilities and assets are unevenly distributed, which increases vulnerability. House prices are also rising faster than household income. There are prospects that house prices and household debt will continue to increase faster than income ahead.

In the commercial property market, the industry to which banks have the highest loan exposure, selling and rental prices in some segments have risen in recent years. In the event of a downturn in the Norwegian economy, the potential fall may be considerable.

In the run-up to the financial crisis in 2008, Norwegian credit institutions' wholesale funding ratios rose, and financial market failure was one of the primary reasons that banks experienced funding problems. Wholesale funding ratios have remained approximately unchanged in the years following the crisis, but overall, funding structures have become more resilient.

In the view of the Executive Board, several years of rising credit and asset prices have increased the risk that financial imbalances may trigger or amplify an economic downturn. Banks should now build an additional capital buffer that they can draw on in the event of rising losses in an economic downturn. The introduction of a countercyclical capital buffer must be viewed in the light of other requirements applying to banks. Norges Bank assumes that the countercyclical buffer will apply in addition to other requirements for Common Equity Tier 1 capital, currently set at 9%. The Government has announced that statutory provisions for new capital requirements for banks will be introduced in the course of spring. Norges Bank will issue concrete advice on the level and timing for introducing the countercyclical buffer when the regulatory framework has been established.

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