# The Executive Board's assessment

## Monetary policy

At its meeting on 13 March 2013, the Executive Board decided that the key policy rate should be in the interval 1%–2% in the period to 20 June 2013, unless the Norwegian economy was exposed to new major shocks. In the March 2013 *Monetary Policy Report*, capacity utilisation was estimated to be somewhat above a normal level. 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 March *Report* implied a key policy rate of around 1.5% in the period to spring 2014, followed by a gradual increase towards a more normal level.

At its meeting on 24 April 2013, the Executive Board discussed themes of relevance for the June 2013 *Monetary Policy Report*, including analyses of banks' response to new capital requirements.

In its discussion at the meeting on 8 May 2013, the Executive Board pointed out that the growth outlook for Europe appeared to have weakened somewhat, while global growth remained firm. The expected upward shift in key rates abroad had again been moved further out in time. Inflation in Norway had been a little lower than projected. Wage growth appeared to be lower than projected this year. On the other hand, the krone had depreciated. The Norwegian economy appeared to be moving broadly in line with that projected. The Executive Board decided to keep the key policy rate unchanged at 1.5%.

In its discussion on 5 June and 19 June, the Executive Board placed emphasis on the following developments:

- Growth among trading partners is somewhat lower than expected. In Europe, the downturn is likely to persist longer than previously projected. In the US, growth is temporarily being dampened by tax increases and expenditure cuts, but growth prospects for the coming years are positive. Growth remains robust in emerging economies, but has been somewhat weaker than envisaged earlier. Oil prices have edged down.

- Key interest rates are close to zero in many countries. Market key rate expectations have shown little change since the March *Report*.

- The krone, as measured by the import-weighted krone exchange rate index (I-44), has been 1.3% weaker so far in Q2 than projected in the March *Report*.

- Banks have increased interest rates on loans to households and enterprises. At the same time, premiums in money and bond markets have edged down.

- Growth in the Norwegian economy has been lower than projected earlier. According to the enterprises in Norges Bank's regional network, output prospects have weakened somewhat. Unemployment has been slightly higher than expected.

- House prices have remained broadly unchanged in recent months, but household debt is still rising at a faster pace than income.

- Consumer price inflation has been slightly higher than projected in the March *Report*. Underlying inflation is now estimated to range between 1¼% and 1¾%. Wage growth is projected at around 3½% in 2013, which is slightly lower than projected earlier.

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 low because inflation is low and because interest rates abroad are very low. 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 now suggest that the key policy rate will be lower than the forecast in the March *Report* throughout the entire projection period and that it will take longer for inflation to move up towards the inflation target.

In its discussion, the Executive Board noted that the outlook for the euro area remains highly uncertain. Activity is falling at a slower pace and fiscal tightening appears to be on a smaller scale this year than in 2012. The situation is nevertheless associated with considerable challenges. Unemployment is record high and is particularly high among youth. There is still a need for deleveraging in the private and public sector. An extensive restructuring must be carried out in euro area countries in order to boost their long-term growth potential. It will most likely take several years for production to return to the levels prevailing prior to the financial crisis.

Activity among many Norwegian export companies is being dampened by a high cost level and low external demand, particularly in European markets. Sluggish economic developments and low cost growth among trading partners may have contributed to slower wage growth in Norway, in addition to the high level of labour immigration over many years. These conditions may also have an impact on future wage settlements.

Growth appears to have slackened in several industries. Employment has increased less than projected and unemployment has risen. Capacity utilisation is now assessed to be close to a normal level.

Norwegian banks are adapting to higher capital requirements, including the impending introduction of a countercyclical capital buffer. Banks have increased their lending margins and are improving their capital adequacy already ahead of the introduction of the new regulations. Higher capital-to-loan ratios increase the robustness of banks, and may in addition contribute to restraining the rise in house prices and debt growth. The Executive Board noted that house prices are rising at a somewhat slower pace, but that growth in household debt remains higher than income growth.

In its discussion of the monetary policy situation, weight was given to the fact that inflation is low and that inflation further out is lower than projected in the March *Report.* Capacity utilisation is assessed to be slightly lower than projected earlier. The Executive Board was of the view that these conditions imply a lower key policy rate ahead than projected in the March *Report*. At the same time, weight was given to the dampening impact of external forces on wage and price inflation. As long as the crisis in Europe persists and labour immigration remains high, a pronounced decrease in the key policy rate is likely necessary in order to bring up inflation more rapidly. Such an interest rate response may lead to a further acceleration in house prices and debt, augmenting the risk that financial imbalances trigger or amplify an economic downturn. This suggests a less pronounced response in interest rate setting. Against this background, the Executive Board was of the view that it is appropriate to allow more time to bring inflation up to target. At the same time, weight was given to setting the key policy rate so that there are prospects of rising inflation with a view to preventing inflation expectations from becoming entrenched at too low a level. If the Norwegian economy moves broadly in line with the projections in this *Report*, the Executive Board's assessment is that the key policy rate should remain at today's level or at a somewhat lower level in the period ahead.

At its meeting on 19 June, 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 19 September 2013, unless the Norwegian economy is exposed to new major shocks.

## Financial stability – countercyclical capital buffer

At its meeting on 13 March, the Executive Board concluded that banks should build an extra capital buffer in the period ahead that they can draw on to absorb higher losses in bad times. The Executive Board also emphasised that the introduction of a countercyclical capital buffer must be viewed in the light of other requirements applying to banks.

Since the March *Report*, the Storting (Norwegian parliament) has adopted new legislation on capital requirements for banks. As from summer 2014, all banks will be subject to a minimum capital adequacy requirement of 13.5%, at least 10 percentage points of which must consist of Common Equity Tier 1 capital. An extra requirement of up to 1% in 2015 and up to 2% in 2016 will be imposed on banks classified as systemically important. The countercyclical capital buffer will come on top of these requirements.

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 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 the view of the Executive Board, several years of rising house prices and lending to households have increased the risk that financial imbalances may trigger or amplify an economic downturn. Household debt is still rising faster than income and many households may find it challenging to service their debt in the event of a loss of income or higher borrowing rates. Corporate debt growth has been moderate in recent years, and total credit growth has been lower than the estimated historical trend. House price inflation has also slowed somewhat recently.

Over the coming months, the Ministry of Finance will draw up a regulation concerning the countercyclical capital buffer. When the regulation has been finalised, Norges Bank aims to issue concrete advice, on the level of the buffer and the timing of its introduction, probably in the next *Report,* to be published on 19 September. In the view of the Executive Board, banks in Norway are now well positioned to increase their capital ratios. Earnings are solid and losses are currently low. In the opinion of the Executive Board, Norwegian banks should hold a countercyclical capital buffer. The level of the buffer must be considered in the light of other capital requirements that will be gradually increased over the coming years.

Øystein Olsen
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