Norges Bank Watch 2020

An independent Evaluation of Monetary Policy in Norway

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FOREWORD

Each year the Centre for Monetary Economics (CME) at the Department of Economics, BI Norwegian Business School, appoints an independent group of experts to evaluate monetary policy in Norway.

This year the NBW committee consists of Kyrre Martinius Knudsen, Chief Economist at SpareBank 1 SR-Bank, and Professor Gernot Doppelhofer, Norwegian School of Economics (NHH).

The NBW committee is solely responsible for the report and the views therein. The report does not necessarily represent the views of the CME or of its members.

The Ministry of Finance uses the Norges Bank Watch reports as input to their annual Financial Markets Report to the Parliament, when assessing the conduct of monetary policy. The Ministry of Finance partly funds the Norges Bank Watch reports.

Oslo, March 3, 2020

Centre for Monetary Economics

Tommy Sveen

Executive summary

Following important monetary policy events in 2018 (lowering inflation target, first hike in many years and new regulation), 2019 also became eventful. The key policy rate was gradually increased from 0.75 to 1.5%, in March, June and September, and a new monetary policy and financial stability committee (henceforth called "committee") was appointed.

Overall, the increases in the key policy rate at the meetings in March and June were well prepared and thus successful from a communicational point of view.

The guidance before the meeting in September was, however, ambiguous. The signal in June was of an upcoming hike the next half year, but the communication in the meeting in August could be interpreted in different ways: either as a signal of an upcoming hike and after that stable due to increased uncertainty, or as increased uncertainty, implying no upcoming hike.

Analysts in the Reuters poll were divided roughly in half between an upcoming hike or an unchanged policy rate. The decision therefore impacted key markets. NBW stresses that Norges Bank should be precise in its communication.

This also highlighted the disadvantage with no press-conference at half of the policy rate meetings, like in August. Norges Bank didn't have the possibility to clarify its statements. NBW reiterates previous advice to Norges Bank of having press conference at all policy rate meetings and add more analysis at the in-between meetings. The same goes for more nuances in the minutes from policy rate meetings, which may be relevant to incorporate with the new committee, as well as a regular self-assessment of whether the policy rate decisions have market impact. Apart from that, the overall structure with eight policy meetings a year works well and Norges Bank has made key messages more easily accessible with the format of "short-statements".

In some speeches, Norges Bank provides nuances about monetary policy. NBW highlights three important speeches in 2019. The 2019 annual address touched upon a broad range of topics. The CME-speech October 2019 was titled "The monetary policy toolkit" and highlighted some (but limited) monetary policy space. NBW's overall interpretation of the speech is that fiscal policy will be increasingly important in more severe downturns. We encourage Norges Bank to look at scenarios where monetary policy has to play a more prominent role.

Issues related to sustainability and climate change are rising in the agenda. The deputy governor's speech "Climate change, climate risks and Norges Bank" in November 2019 therefore gained attention. Norges Bank plays a role as asset manager, regulator of the financial sector, and in conducting monetary policy. Climate change may impact the Norwegian economy in various ways, and NBW encourages Norges Bank to have a broad view when it comes to climate risk and sustainability. The speech highlighted nuances in how climate change may affect monetary policy, such as how to react to negative supply shocks or increased uncertainty. Norges Bank could support market participants by providing information on the assessments of the potential for persistence in such shocks.

In Monetary Policy Reports, Norges Bank provides insight in factors behind changes in the policy rate forecast. Overall NBW applauds this, including the separate information box in the

Monetary Policy Report, but still asks for more insight in the judgment element for policy rate forecast changes.

The output gap is a key monetary policy variable, but cannot be observed and must be estimated. NBW encourages Norges Bank to explore improvements of the output gap indicator, as well as elaborating on the uncertainty of the indicator due to different approaches. Using several indicators of the output gap might lead to confusion, but it is important to communicate the uncertainty policymakers are facing regarding the state of the economy, as measured by the output gap.

The depreciation of the foreign exchange rate in recent years provides a tailwind for the Norwegian economy, abstracting from other factors. Still, it may also have negative effects for specific sectors, as well as increasing general uncertainty for Norway. NBW encourages Norges Bank to explore effects of depreciation and volatility further, and communicate how they affect monetary policy.

Key central banks such as the ECB and the Fed are currently reviewing their monetary policy. Although the framework in Norway has been changed over the last years, the reviews can impact how monetary policy in Norway should be designed and operated. Norges Bank should therefore follow these processes closely. The assessments from NBW 2019 regarding new regulation on monetary policy in 2019 may be relevant in this regard. NBW 2019 argued that the lower inflation target reduced the scope for monetary policy, and that Norges Bank should report the estimate of the maximum level of employment, which is consistent with price stability.

The practice of flexible inflation targeting appears to work well for monetary policy in Norway. A careful updating of information about the state of the economy (including the output gap), as well as expected developments of inflation and interest rates, is important in order to anchor inflationary expectations and achieve credibility of monetary policy.

NBW encourages Norges Bank to develop a framework for setting the current and future policy rate, which is consistently reflecting possible nonlinearities and asymmetric risks in the economy. The fan charts illustrating uncertainty around the expected path for future policy rates and key economic variables are not reflecting these potential nonlinearities and asymmetries. A sizeable part of the judgement element for setting the current and future policy rates could be incorporated in a more complete framework for optimal policy.

NBW also suggests simplifying the process for macro-prudential policy, by making Norges Bank operationally independent and responsible for setting the level of the countercyclical capital buffers, while being given an explicit mandate by the government. NBW notes the coordination of macro-prudential policies between the Ministry of Finance, Norges Bank and Finanstilsynet, but encourages further discussion about the division of responsibilities, for example the determination of all capital buffers. More generally, NBW encourages a debate of whether Norges Bank should be responsible for all aspects of financial stability, including lending practices and lender of last resort.

From 1 January 2020, the new monetary policy and financial stability committee has become responsible for determining monetary policy in Norway according to the new central bank law. NBW notes that the three internal members are the majority compared to the two external members. NBW encourages the possibility to extend the committee by an additional member, while giving the Governor a double-vote in case of a split decision. The position of the external members could be strengthened by increasing the employment from the current 20% position to a higher employment share.

In line with previous NBW reports, we also encourage Norges Bank to release detailed minutes from committee meetings, or at least provide more nuances about the discussions within the committee.

1. Introduction

This report, Norges Bank Watch 2020, is an evaluation of the conduct of monetary policy in Norway in 2019. In addition, the report discusses policy issues for Norges Bank

The report is organised as follows:

Section 2 discusses monetary policy and communication of decisions in 2019. This includes the overall macro development in Norway and monetary policy, the structure of policy and communication, a summary of the eight policy rate meetings and three important speeches in 2019. We also discuss factors behind the path of future policy rates, output gaps and other measures of capacity utilization, foreign exchange rate, inflation and uncertainty, and ongoing monetary policy review in ECB and Fed.

Section 3 discusses issues related to regulation of monetary policy objectives, including the inflation target, high and stable employment, and financial stability considerations. We conclude by discussing the newly appointed monetary policy and financial stability committee and communication of policy decisions.

The NBW committee met with the Ministry of Finance on 9 December 2019, and with Norges Bank on 16 January 2020. We wish to thank Norges Bank, the Ministry of Finance, Erika Christie Berle, Svein Gjedrem, Max-Emil M. King, Jan Tore Klovland, Per Espen Lilleås, Bjørn Sivertsen, Kjetil Storesletten, Marianne Sturød, Tommy Sveen and Nathalie Berner Sørhaug and Øystein Thøgersen for constructive comments.

The views expressed here are solely the ones by the NBW committee.

2. Monetary Policy and Communication in 2019

2.1 Introduction and overall macro and monetary policy in 2019

The Storting and Government define the objectives of monetary policy by law and regulation and Norges Bank's role is to contribute to achieving the objectives (Norges Bank legislation).

The primary objective of monetary policy is low and stable inflation, and Norway has an inflation-targeting monetary policy regime. The operational target of monetary policy shall be annual consumer price inflation of close to 2 percent over time. Inflation targeting shall be forward-looking and flexible so that it can contribute to high and stable output and employment and to counteracting the build-up of financial imbalances.

The monetary policy framework was changed in March 2018. According to the related letter from Norges Bank to the Ministry of Finance (Norges Bank 2018a): “In the opinion of Norges Bank, the new regulation clarifies the monetary policy mandate and underpins the flexible approach to inflation targeting. In Norges Bank's assessment, the new regulation will not result in significant changes in the conduct of monetary policy.”

Although Norges Bank concluded that the new legislation didn’t imply in significant changes, NBW 2019 commented that there could be broader implications of the changes. More on this in section 2.8 and 3.1.

Inflation targeting as a monetary policy objective internationally was introduced internationally in the early 1990s. In Norway the legislation was introduced in March 2001. In general, the international and Norwegian experiences with inflation targeting have been positive (Norges Bank 2017a), although significant shocks such as the 2008 financial crisis also illustrates that inflation-targeting is not a guarantee for overall macroeconomic stability.

Since the introduction of the inflation target in Norway, first 2.5 percent from 2001 to 2018 and thereafter 2.0 percent, inflation has been fairly close to the target. Inflation expectations also seem to be anchored close to the target. Norges Bank (2019d) states that expectations remained somewhat higher than the new target, but also that is has been assumed that it will take some time for inflation expectations to adjust to the new target.

A general comment from NBW is that the overall framework seems sound and reasonable for a small, open economy like Norway. One challenge however is that there is more than one objective for monetary policy, and the weighting of objectives may change over time. Assessing monetary policy in Norway is therefore not straight-forward. Nevertheless, inflation has over time has been close to the target and the economy absorbed both the financial crisis and the oil downturn. By year end 2019 employment was high and the registered unemployment rate was low at 2.3 percent.

Following important monetary policy events in 2018 (lowering inflation target, first hike in many years and new regulation), 2019 also became eventful. The key policy was gradually increased from 0.75 to 1.5%. A new monetary policy and financial stability committee was established.

After the downturn in 2015 and 2016 due to a decline in the oil price, growth in the Norwegian economy picked up in 2017 and 2018. Growth was solid also in 2019, at 2.5 percent for GDP-mainland according to Norges Bank estimate (2019d). Inflation was close to, but still somewhat higher than, the goal of 2 percent for most of 2019. Growth has been higher than potential growth and the output gap became positive in 2019 for the first time since 2013. Employment grew by more than 1.5 percent for the second year in a row. The registered unemployment rate fell somewhat and was close to the lowest level in more than 10 years, according to the Norwegian Labor and Welfare Administration (NAV). The broader unemployment measure, Statistics Norway's labor force survey (SSB LFS), rose slightly during 2019, implying a somewhat less tight labour market than registered unemployment.

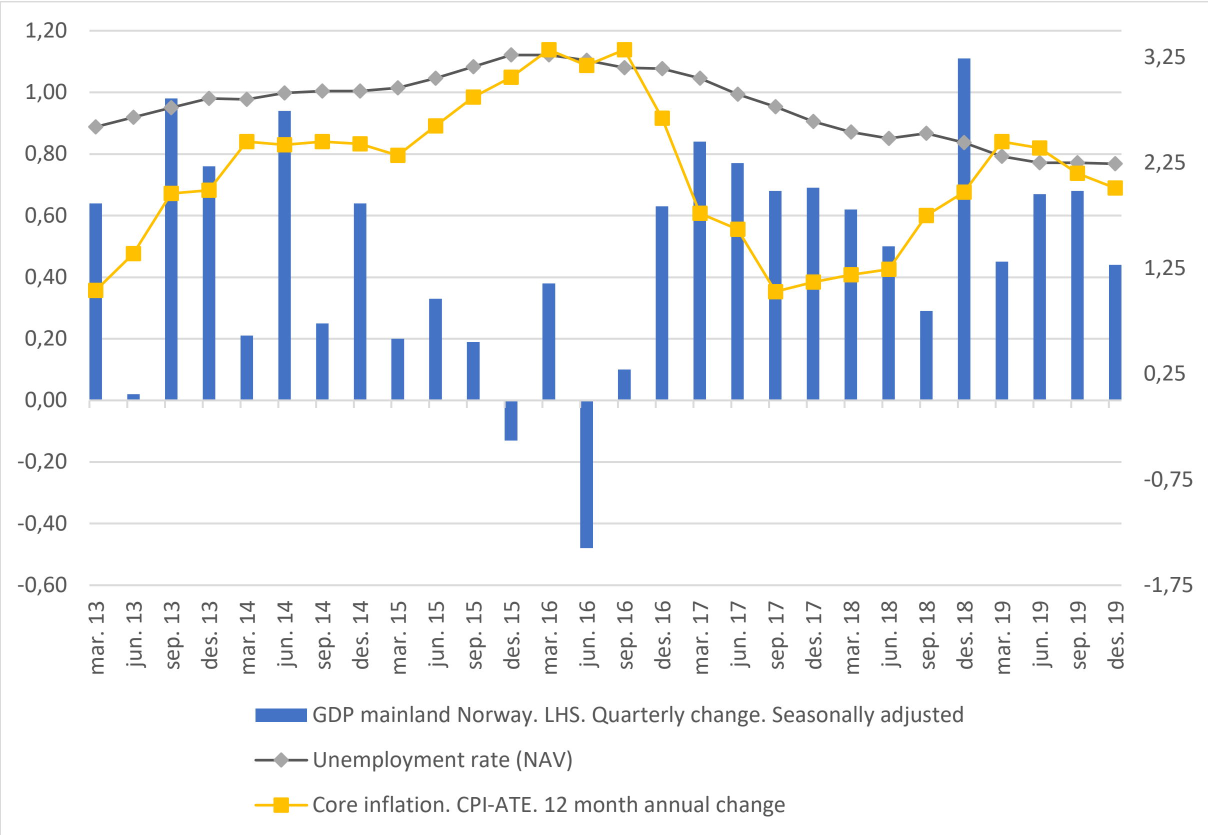

Figure 2.1: Norwegian GDP, quarterly change (left axis), unemployment and core inflation (right axis). Percent. Source: Norges Bank MPR 4/2019.

Against this macroeconomic backdrop, Norges Bank increased the policy rate three times in 2019, from 0.75 to 1.5 percent. The first hike was in March, then in June and the third in September. There were limited changes in the policy rate forecast during 2019 (from MPR 4/18 to MPR 4/19). The forecast was raised in the short-term and slightly lowered from 2021.

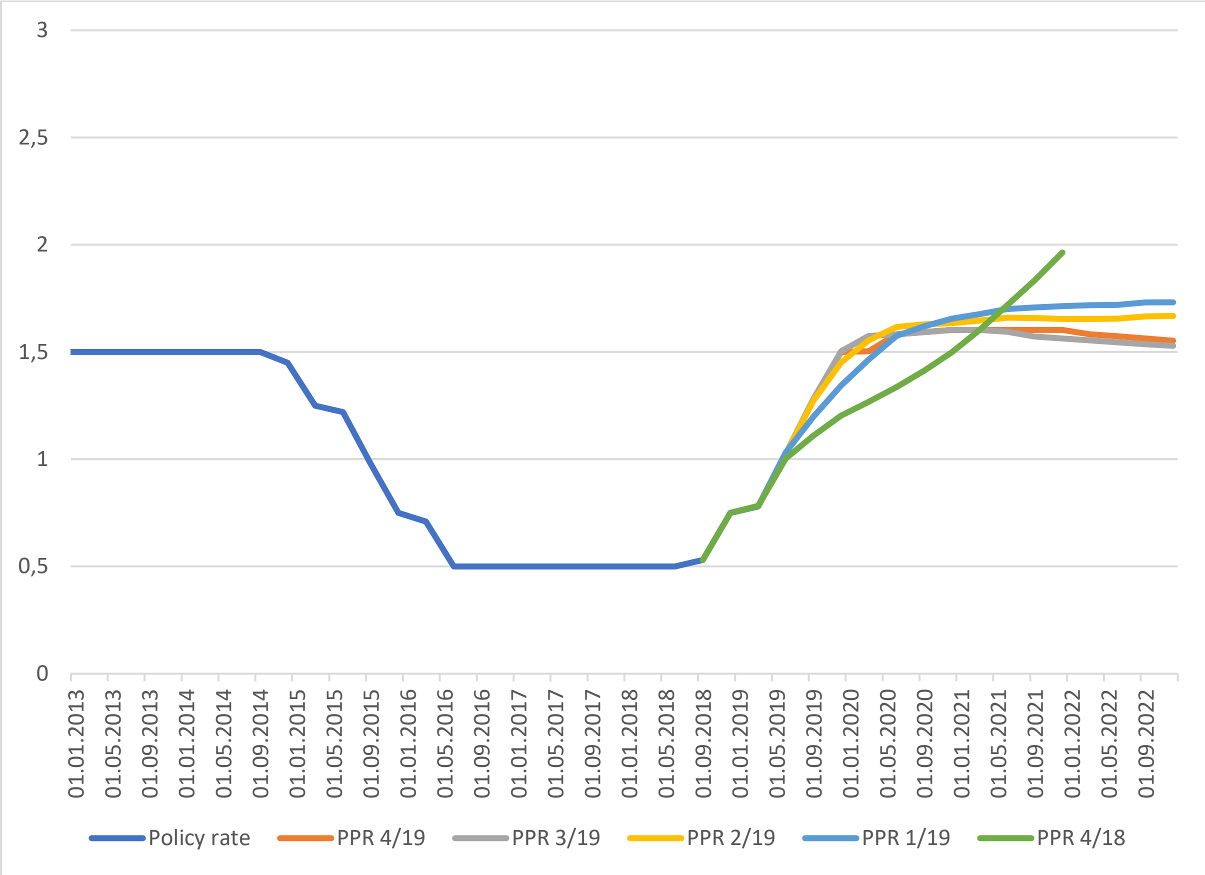

Figure 2.2: Forecasts of the policy rate. Percent. Source: Norges Bank.

Inflation in Norway is volatile, particularly due to Norway being a small, open economy. From 2016 to 2019 core inflation spanned from 1% to 3.3%.

Inflation and outlook for inflation increased somewhat during 2019 (from MPR 4/18 to MPR 4/19), but in general remained fairly close to the inflation target of 2%.

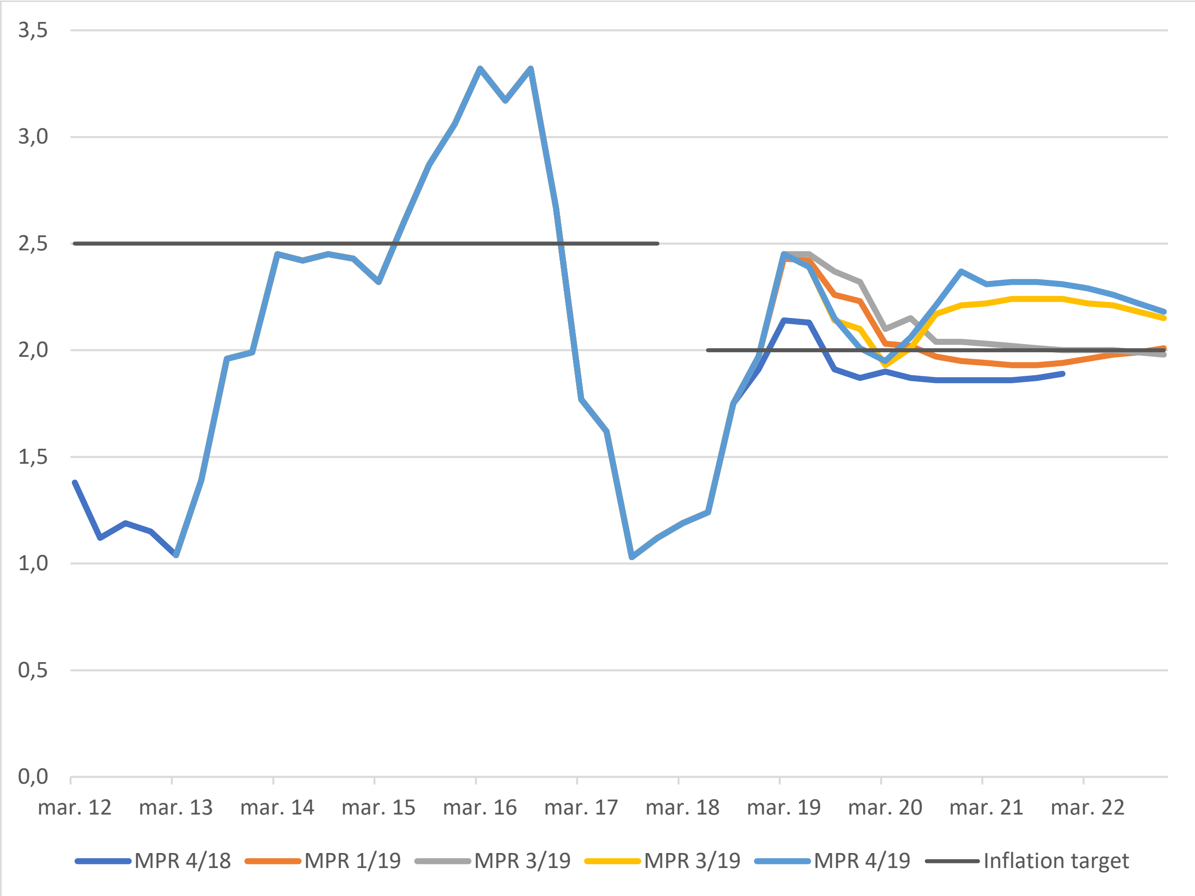

Figure 2.3: Forecasts of inflation CPI-ATE. Percent. Source: Norges Bank.

2.2 Structure of monetary policy and communication in 2019

In 2019 Norges Bank conducted eight monetary policy meetings evenly spread out over the year. Four of these eight meetings included broad assessments and outlook regarding macroeconomics and monetary policy in the Monetary Policy Report with financial stability assessment (MPR), and key findings presented at the press conference. At the remaining four meetings, there was only a brief statement, and limited new information, and no press conference. Generally, the interest rate is not changed at these "in-between" meetings. This structure was the same in 2017 and 2018.

Regarding Norges Bank's press conferences, there is no transcript of the Q&A part. Central banks like ECB and Federal Reserve publish a transcript, whereas Riksbanken and Bank of Canada do not.

Furthermore, from 27 June 2017, Norges Bank releases minutes related to monetary policy in the Executive Board's meeting with the announcement of the interest decision. The minutes sum up key takeaways, but are based upon the MPR, and as such do not add more information or nuances in their current form.

Previous NBW has highlighted favorable changes in the structure of the last years, but also asked for more complete minutes that shed light on the differences of opinions within the committee and the trade-offs being discussed. NBW 2020 reiterates this view. Also, we argue that the information from in-between meetings should provide more analysis. As highlighted in section 2.2 below, the 2019 august meeting is one example where mixed signals confused the market. The August meeting also illustrated challenges for policy meetings without a press conference. NBW encourages Norges Bank to have press conference at all eight policy rate meetings, as well as to release transcripts for the press conference (also in English to have a broad outreach). The new setup from 2020 with a separate committee responsible for monetary policy and financial stability may open for a renewed setup.

NBW reiterates the advice from NBW 2019 that Norges Bank should regularly measure to what extent monetary policy communication impacts key markets.

Speeches by Norges Bank representatives are mainly grounded on material from previous MPR and meetings. Still, some key speeches may add new information. These include the Governor's Annual address and the speech at the Centre for Monetary Economics (CME). Topics related to sustainability and climate risk are rising on the agenda, and Deputy Governor Egil Matsen's speech 8 November 2019 on climate risk gained attention. The speech included perspectives on the monetary policy response to climate risk.

Moreover, the Bankplassen blog was initiated in 2018 to promote analysis on relevant topics, which is a welcome addition. However, the views are solely those of the authors and not necessarily those of Norges Bank. As such, it is not assessed as a platform to communicate monetary policy. The same goes for Norges Bank Staff Memos.

2.3 Monetary policy meetings in 2019

Key takeaways from the eight policy rate meetings and NBWs comments are presented below.

24 January 2019 (no MPR or press conference)

Press release from Norges Bank:

> "Policy rate unchanged at 0.75 percent
>
> Norges Bank's Executive Board has decided to keep the policy rate unchanged at 0.75 percent.
>
> In Monetary Policy Report 4/18, which was published on 13 December 2018, the Executive Board's assessment was that capacity utilisation in the Norwegian economy was close to a normal level. Underlying inflation was close to the 2 percent target. The Executive Board's assessment of the outlook and balance of risks suggested that the policy rate would most likely be raised in March 2019.
>
> The outlook and the balance of risks imply a gradual increase in the policy rate. Global growth is a little weaker than projected, and there continues to be considerable uncertainty surrounding developments ahead. In Norway, economic growth and

labour market developments appear to be broadly as projected, while inflation has been slightly higher than expected.

`Overall, new information indicates that the outlook for the policy rate for the period ahead is little changed since the December Report’, says Governor Øystein Olsen.”

NBW remarks that the decision to keep the policy rate unchanged at 0.75 percent was in line with previous signals, including the established routine of not changing the policy rate in these in-between meetings. Previous guidance of an upcoming increase in March 2019 was reiterated.

21 March 2019 (MPR and press conference)

Press release from Norges Bank:

“Policy rate raised to 1.0 percent

Norges Bank's Executive Board has decided to raise the policy rate by 0.25 percentage point to 1.0 percent.

The Norwegian economy is expanding at a solid pace, and capacity utilisation now appears to be slightly above a normal level. Underlying inflation is a little higher than the inflation target. The uncertainty surrounding global developments and the effects of monetary policy suggests a cautious approach to interest rate setting. Overall, the outlook and the balance of risks imply a gradual interest rate increase ahead.

The upturn in the Norwegian economy appears to be stronger than anticipated earlier. On the other hand, there are prospects for weaker growth and lower interest rates abroad. The policy rate forecast indicates a slightly faster rate rise in 2019 and a somewhat lower policy rate further out than projected in the previous Report. With this path for the policy rate, inflation is projected to be close to target in the years ahead, at the same time as unemployment remains low. The policy rate path will be adjusted in response to changes in economic prospects.

"Our current assessment of the outlook and balance of risks suggests that the policy rate will most likely be increased further in the course of the next half-year", says Governor Øystein Olsen.”

NBW remarks that the hike in the policy rate from 0.75 to 1.0 percent was in line with previous guidance and thus as expected by market participants. Moreover, it was guided an upcoming hike in the policy rate the next half-year.

9 May 2019 (no MPR or press conference)

Press release from Norges Bank:

> “Policy rate unchanged at 1.0 percent
>
> Norges Bank's Executive Board has decided to keep the policy rate unchanged at 1.0 percent.
>
> In Monetary Policy Report 1/19, which was published on 21 March 2019, the Executive Board's assessment was that capacity utilisation in the Norwegian economy was slightly above a normal level. Underlying inflation was a little higher than the 2 percent inflation target. The policy rate was raised by 0.25 percentage point to 1.0 percent in March. The Executive Board's assessment of the outlook and balance of risks suggested that the policy rate would most likely be raised in the course of the next half-year.
>
> The outlook and balance of risks continues to imply a gradual increase in the policy rate. The uncertainty surrounding global developments persists. In Norway, capacity utilisation appears to be rising broadly as expected, while inflation has been slightly higher than projected. Overall, new information indicates that the outlook for the policy rate for the period ahead is little changed since the March Report.
>
> The Executive Board decided to keep the policy rate unchanged at 1.0 percent.
>
> "The Executive Board's current assessment of the outlook and balance of risks suggests that the policy rate will most likely be raised in June", says Governor Øystein Olsen.”

NBW remarks that the decision to keep the policy rate unchanged at 1.0 percent was in line with previous signals, including the established routine of not changing the policy rate in these in-between meetings. Thus, it was in line with market expectations. Also, more precise signals of the upcoming hike were provided through the statement “(…) the policy rate will most likely be raised in June”. Market’s expectations were formed accordingly.

20 June 2019 (MPR and press conference)

Press release from Norges Bank:

> “Policy rate raised to 1.25 percent
>
> Norges Bank's Executive Board has decided to raise the policy rate by 0.25 percentage point to 1.25 percent.
>
> Growth in the Norwegian economy is solid, and capacity utilisation is estimated to be somewhat above a normal level. Underlying inflation is a little higher than the inflation target. At the same time, trade tensions are a source of substantial global uncertainty. Uncertainty surrounding the effects of monetary policy suggests a cautious approach to interest rate setting. The overall outlook and balance of risk suggest that the policy rate be increased somewhat further.

The upturn in the Norwegian economy appears to be a little stronger the coming year than projected earlier. On the other hand, there are prospects for weaker external growth and lower foreign interest rates. The policy rate forecast indicates a slightly faster rate rise in the coming year than projected in the March Report, but the policy rate path is little changed further out. With a policy rate in line with the forecast, inflation is projected to remain close to the inflation target in the years ahead, at the same time as unemployment remains low. The policy rate path will be adjusted in response to a change in economic prospects.

"Our current assessment of the outlook and balance of risks suggests that the policy rate will most likely be increased further in the course of 2019", says Governor Øystein Olsen."

NBW remarks that the decision to increase the policy rate from 1.0 to 1.25 percent was in line with previous signals and thus as expected. The meeting highlighted the uncertainty related to trade tensions, as well as uncertainty surrounding the effects of monetary policy that suggested a cautious approach to interest rate setting. Somewhat stronger development in the Norwegian economy than previously expected suggested a slightly faster rise in the policy rate. The guidance was that the policy rate would probably be raised further in 2019. The policy rate forecast for 4th quarter 2019 was 1.45 percent. NBW remarks that this implied a relatively high probability for a hike at the meeting in September, given the routine of not changing the rate at the in-between meetings.

15 August 2019 (no MPR and press conference)

Press release from Norges Bank:

Policy rate unchanged at 1.25 percent

Norges Bank's Executive Board has decided to keep the policy rate unchanged at 1.25 percent.

In Monetary Policy Report 2/19, which was published on 20 June 2019, the Executive Board's assessment was that capacity utilisation in the Norwegian economy was somewhat above a normal level. Underlying inflation was a little higher than the 2 percent inflation target. The policy rate was raised by 0.25 percentage point to 1.25 percent. The Executive Board's assessment of the outlook and balance of risks suggested that the policy rate would most likely be increased further in the course of 2019.

The upturn in the Norwegian economy is continuing broadly as expected in June. Underlying inflation has been a little lower than projected. Deepening trade tensions and heightened uncertainty surrounding the UK's relationship with the EU may weigh on growth abroad and in Norway. On the other hand, a weaker krone may contribute to higher inflation ahead.

> “Overall, new information indicates that the outlook for the policy rate for the period ahead is little changed since the June Report. The global risk outlook entails greater uncertainty about policy rates going forward”, says Governor Øystein Olsen.

NBW remarks that the decision to keep the policy rate unchanged at 1.25 percent was in line with previous signals, including the established routine of not changing the policy rate in the in-between meetings. The decision was in line with market expectations.

However, there was some uncertainty about the interpretation of the signals for the upcoming meeting. On one hand, the following sentence could be interpreted as a reiteration of an upcoming hike: “Overall, new information indicates that the outlook for the policy rate for the period ahead is little changed since the June Report.” On the other, the following sentence could be interpreted that there was increased uncertainty, and that there wouldn’t be more increases in the policy rate: “The global risk outlook entails greater uncertainty about policy rates going forward”.

The guidance from Norges Bank was ambiguous. It could be interpreted in different ways: either a signal of an upcoming hike and after that stable due to increased uncertainty, or increased uncertainty implying no upcoming hike.

This impacted the formation of market expectations.

As there was no press conference, Norges Bank didn’t have a possibility of clarifying the statements.

19 September 2019 (MPR and press conference)

Press release from Norges Bank:

> Policy rate raised to 1.50 percent
>
> Norges Bank's Executive Board has decided to raise the policy rate by 0.25 percentage point to 1.50 percent.
>
> Over the past year, the policy rate has been raised, and the monetary stance has become gradually less expansionary. In the Executive Board’s assessment, the overall outlook and balance of risks suggest a slightly higher policy rate. Underlying inflation is close to the inflation target. Growth in the Norwegian economy remains solid, and capacity utilisation is somewhat above a normal level. This suggests in isolation a higher policy rate. A higher policy rate may also mitigate the risk of a renewed acceleration in debt growth and house price inflation. At the same time, foreign interest rates are very low, and there is considerable uncertainty surrounding global growth prospects. This suggests a cautious approach to interest rate setting.
>
> The policy rate forecast indicates a slightly smaller rate rise than in the June Report. Weaker growth prospects and lower interest rates abroad have contributed to the downward revision. Slightly lower inflation and a somewhat less tight domestic labour market compared with the June projections have also pulled down the rate path. A

weaker-than-projected krone has in isolation pulled up the policy rate path. With a policy rate in line with the forecast, inflation is projected to remain close to the inflation target in the years ahead, at the same time as unemployment remains low. The policy rate path will be adjusted in response to a change in economic prospects or the balance of risks.

> The Executive Board's current assessment of the outlook and balance of risks suggests that the policy rate will most likely remain at this level in the coming period," says Governor Øystein Olsen.

NBW remarks that analysts were divided roughly in half according to the Reuters poll in the aftermath of the previous meeting, as mentioned above, and the divide prevailed until this meeting. Half interpreted the guidance in line with an unchanged policy rate, and half expected the policy rate to be increased. Therefore, the decision to increase the policy rate from 1.25 to 1.5 percent had an impact in the markets for interest rates and the Norwegian krone. NBW stresses that Norges Bank should be precise in its communication.

Norges Bank guided of a stable policy rate "the coming period". The latter could be interpreted as until the next meeting or until other guidance is provided.

24 October 2019 (no MPR and press conference)

Press release from Norges Bank:

> Policy rate unchanged at 1.50 percent
>
> Norges Bank's Executive Board has decided to keep the policy rate unchanged at 1.50 percent.
>
> In Monetary Policy Report 3/19, which was published on 19 September 2019, the Executive Board's assessment was that capacity utilisation in the Norwegian economy was somewhat above a normal level. Underlying inflation was close to the 2 percent inflation target. The policy rate was raised by 0.25 percentage point to 1.50 percent. The Executive Board's assessment of the outlook and balance of risks suggested that the policy rate would most likely remain at this level in the coming period.
>
> The Executive Board's assessment is that new information indicates that the policy rate outlook for the coming period is little changed since the September Report. The upturn in the Norwegian economy is continuing broadly in line with expectations in September. Underlying inflation has been as projected. Global uncertainty persists, and interest rates abroad are very low. At the same time, the weak krone may result in higher inflation ahead.
>
> "The Executive Board's current assessment of the outlook and balance of risks suggests that the policy rate will most likely remain at the present level in the coming period," says Governor Øystein Olsen.

NBW remarks that the decision to keep the policy rate unchanged at 1.5 percent was in line with previous signals, including the established routine of not changing the policy rate at the in-between meeting. Thus, it was in line with market expectations. Norges Bank guided a stable policy rate in the coming period.

19 December 2019 (MPR and press conference)

Press release from Norges Bank:

> Policy rate unchanged at 1.50 percent
>
> Norges Bank's Executive Board has decided to keep the policy rate unchanged at 1.50 percent.
>
> Since September 2018, the policy rate has been raised gradually. The monetary stance has become less expansionary. Inflation is close to the inflation target, and capacity utilisation is somewhat above a normal level. The krone depreciation will likely push up inflation somewhat, while it seems that wage growth will remain moderate ahead. Growth in the mainland economy is slowing. With a policy rate close to the current level, there are prospects that inflation will remain close to the inflation target, and that capacity utilisation will decline towards a normal level.
>
> In the Executive Board's assessment, the overall outlook and balance of risks suggest a policy rate at close to the current level ahead. The policy rate forecast is broadly unchanged from the September Report. A weaker-than-projected krone implies in isolation a higher policy rate path. On the other hand, the upturn in the Norwegian economy appears to be a little more moderate than previously assumed. In isolation, this suggests a slightly lower rate path. Should the economic outlook or balance of risks change, interest rate developments may also differ from the forecast.
>
> "The Executive Board's current assessment of the outlook and balance of risks suggests that the policy rate will most likely remain at the current level in the coming period", says Governor Øystein Olsen.

NBW remarks that the decision to keep the policy rate unchanged at 1.50 percent was in line with previous signals. The decision was therefore in line with market expectations. Norges Bank stated that the policy rate forecast was broadly unchanged, as a weaker-than-projected krone implied somewhat higher forecast. Still, the more moderate Norwegian economy implied somewhat lower forecast. At the last policy meeting of 2019, Norges Bank concluded that the policy rate will most likely remain at the current level in the coming period.

2.4 Three important speeches in 2019

Governor's Annual address 13 February 2019

The topics for the annual address were technological progress, trade tensions, climate change and structural adjustments and opportunities, the payment system, and monetary stability. The address touched upon a broad range of topics. Given that climate change was on the agenda, it was perhaps a bit surprising that there were no comments on the impact of climate change on monetary policy.

It emphasized that efficient global trade is particularly advantageous for small open economies, like Norway. The part on "climate change requires structural adjustments" focused on the need for action, i.e. effective GHG-tax, technological change and innovation, climate change represents new risks for the financial sector. Still, it stated that "The financial sector has to adapt to climate risk but does not have effective tools to address the climate issue. It is doubtful whether defining emissions from sectors or individual businesses as unethical will make a difference. The responsibility for measures to combat global warming must rest with the authorities. The solution lies in economic instruments that promote structural change."

Moreover, it was argued that earlier than planned reduction of Norwegian oil and gas production would have marginal climate impact on the climate, while the costs to Norway would be substantial. The evolving payment landscape was also discussed, and it was stated that cryptocurrencies are unsuitable as monetary units because no one is responsible for ensuring stability and confidence. Moreover, new digital alternatives are emerging, and it was stated that Norges Bank is considering whether the central bank should also offer the public central bank digital currency although the form is still uncertain.

Regarding monetary policy, previous guidance was broadly reiterated. However, the statement in the annual address -- "[i]f economic developments prove to be in line with expectations, the policy rate will be raised gradually and cautiously ahead" -- could be interpreted as slightly more uncertain when it comes to timing of the hike than the guidance in the 24 January 2019 meeting: "The Executive Board's assessment of the outlook and balance of risks suggested that the policy rate would most likely be raised in March 2019." Although these statements are not directly conflicting, NBW stresses Norges Bank to be consistent in its communication.

"The monetary policy toolkit". Speech by Governor Øystein Olsen at the Centre for Monetary Economics (CME) / BI Norwegian Business School on 8 October 2019

The speech addressed the space for Norwegian monetary policy.

When it comes to conventional monetary policy and policy rate, it was stated that: "We have more policy room for manoeuvre in Norway. (…) But in Norway it is difficult to envisage negative rates over a long period or monetary policy being stretched even further through unconventional measures." Regarding financial stability, Norges Bank argued: "In the wake of the fall in oil prices in 2014, the policy rate was lowered, but we stopped at 0.5 percent. The objective of financial stability was given weight."

Neither asset purchases (quantitative easing) nor longer-term loans to banks (TLTRO) were assessed to be relevant policy instruments due to the floating-rate nature of the financial system in Norway. More relevant for Norway would be central bank loans on extraordinary terms provided to bring down short-term money market rates closer to the policy rate. Regarding foreign exchange market measures, it was stated that "(…) this type of measure also exposes the central bank's equity to greater risk. In Norway, foreign exchange market intervention is not applicable in a normal situation."

NBWs interpretation is that there is some, but still limited, space in the monetary policy toolkit: policy rate could be lowered to 0.5 percent (perhaps to zero if financial stability is not a major concern), and banks could receive short-term loans. As the current level of the policy rate is 1.5 percent, there is limited room to reduce it. Therefore, as Norges Banks highlights, fiscal policy will be important if a downturn becomes severe. NBW agrees with Norges Bank that this is reasonable given Norway's fiscal space, but NBW encourage Norges Bank to explore scenarios where monetary policy can play a more prominent role.

Moreover, In MPR 4/19 the policy rate fan chart indicates roughly 15 percent probability of a zero or lower interest rate. Regarding the reluctance and wording in the CME-speech, NBW questions if this fan chart represents the "true" probability. In this case, the fan chart should be adjusted accordingly, and a related question is whether the uncertainty band is well calibrated.

"Climate change, climate risks and Norges Bank". Speech by Deputy Governor Egil Matsen at Norges Bank on 8 November 2019

The speech was related to the topic from the annual address but added nuances to implications on monetary policy. The speech stated that climate change can have an adverse impact on the production of goods and services, and that the agricultural sector is particularly vulnerable as well as disruptions to infrastructure and production chains. A dilemma was raised: how should monetary policy react if extreme weather events occur that increase inflation but dampen output prospects for the next few years.

Norges Bank's flexible inflation targeting regime implies that Norges Bank will usually not change the policy rate if a supply shock is transient. However, if a negative supply shock leads to a persistent rise in inflation in the next round, it may affect the policy rate. NBW remarks that Norges Bank could support market participants by providing information on the assessments of the potential for persistence in (current and) future shocks.

The speech emphasized that central banks and financial supervisory authorities can promote financial stability by ensuring that financial institutions include climate risks in their risk assessments. As a responsible investor, the Government Pension Fund Global works with the companies in the investment portfolio and changing the composition of the portfolio. NBW remarks that Norges Bank has a multi-faceted role regarding impacts and consequences of climate risks. Therefore, it is an open question how Norges Bank should be organized to address climate risk and sustainability in a broader sense.

2.5 *Factors behind changes in the policy rate forecast*

Norges Bank provides insight into key drivers and changes in the policy rate and forecasts through the interest rate account. Overall there were limited changes in the policy rate forecast during 2019 (from MPR 4/18 to MPR 4/19). The forecast was raised in the short-term, but slightly lowered in 2021 to 2022.

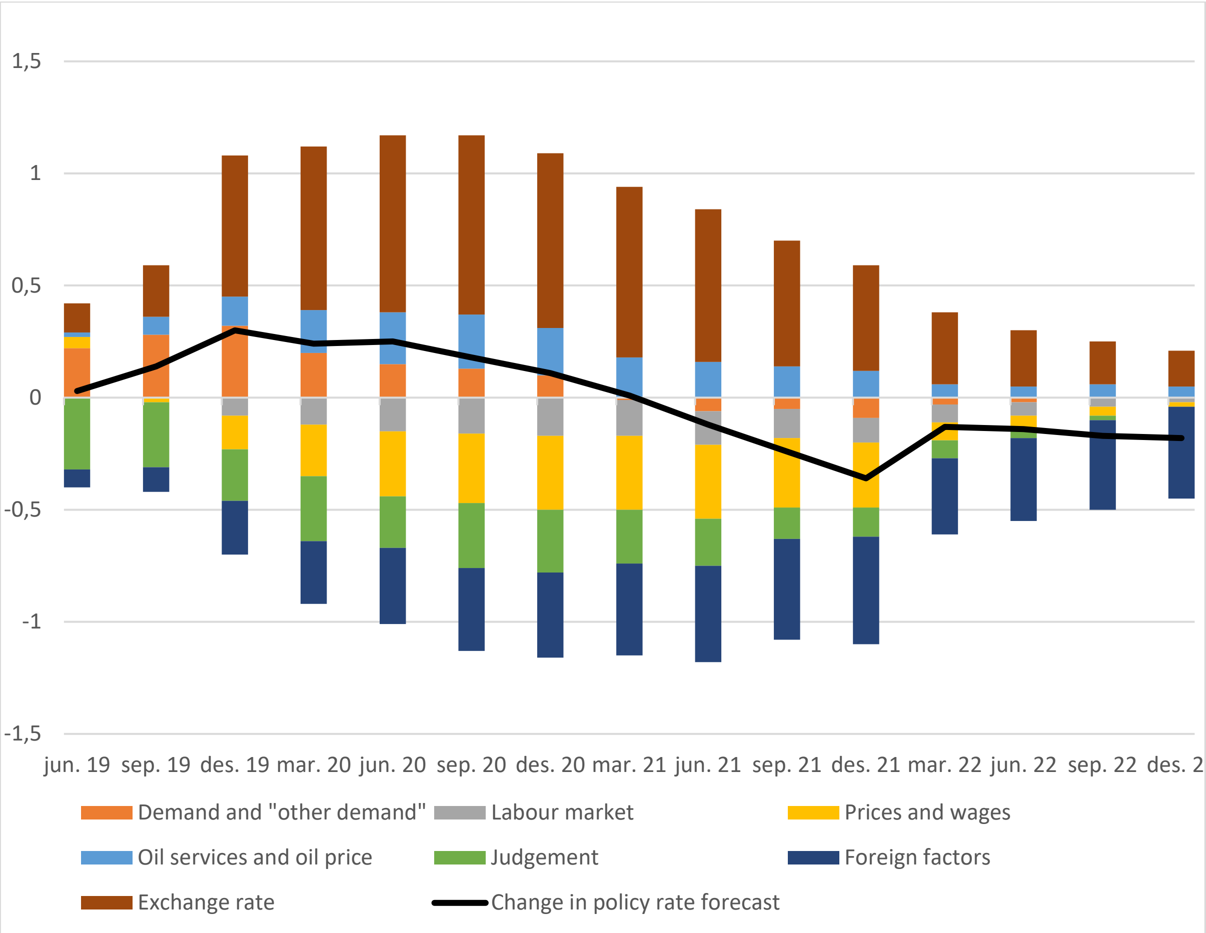

Figure 2.4: Factors behind changes in policy rate forecast from MPR 4/18 to 4/19. Source: Norges Bank.

Regarding the coverage of factors behind changes in the policy rate forecast in the MPR, previous NBW has encouraged Norges Bank to include a separate section (and box) on the interest rate account to increase transparency. Therefore, NBW 2020 applauds the revised setup from MPR 2/2019 with a separate box regarding the topic.

The key driver upping the interest rate path has been the weaker foreign exchange rate. This has been offset by weaker growth forecasts for the global economy, as well as more muted prices and wages. Besides, judgment in 2019 has lowered the interest rate path.

A comment from NBW is that it seems reasonable that volatile factors, like the exchange rate, to some extent are offset by judgment to dampen volatility in the policy rate.

The factor “Judgement” is by nature less transparent than the other factors as it depends on Norges Bank own judgement and there is no easy way to make it as strict and rule-based as the other ones. Still, Norges Bank provides limited insight and explanation in the MPR, as highlighted by previous NBW. In MPR 1/19 the judgement was more than 0.25 percentage points for some quarters. This was commented in the following way: “The uncertainty surrounding global developments and the effects of monetary policy suggests a cautious approach to interest rate setting. That judgement implies a somewhat smaller upward adjustment of the interest rate path than new information in isolation would indicate, as expressed by the light blue bars.”

NBW encourages Norges Bank to provide more information on what forms the “judgment” element. This would improve transparency and market participant's ability to form expectations on the future path for judgmental assessment. This includes both general and as well as specific situations where volatile factors such as the foreign exchange rate and inflation are key drivers for the judgmental assessment.

2.6 The output gap and potential growth

The output gap is a key monetary policy variable. The gap is the difference between actual output (GDP) and potential output. When setting the interest rate Norges Bank gives weight to smooth fluctuations in output and employment. The aim is to keep the output gap close to zero (normal capacity utilization). The output gap is thus an important indicator of future inflation and is related to Norges Bank’s objective of low and stable inflation.

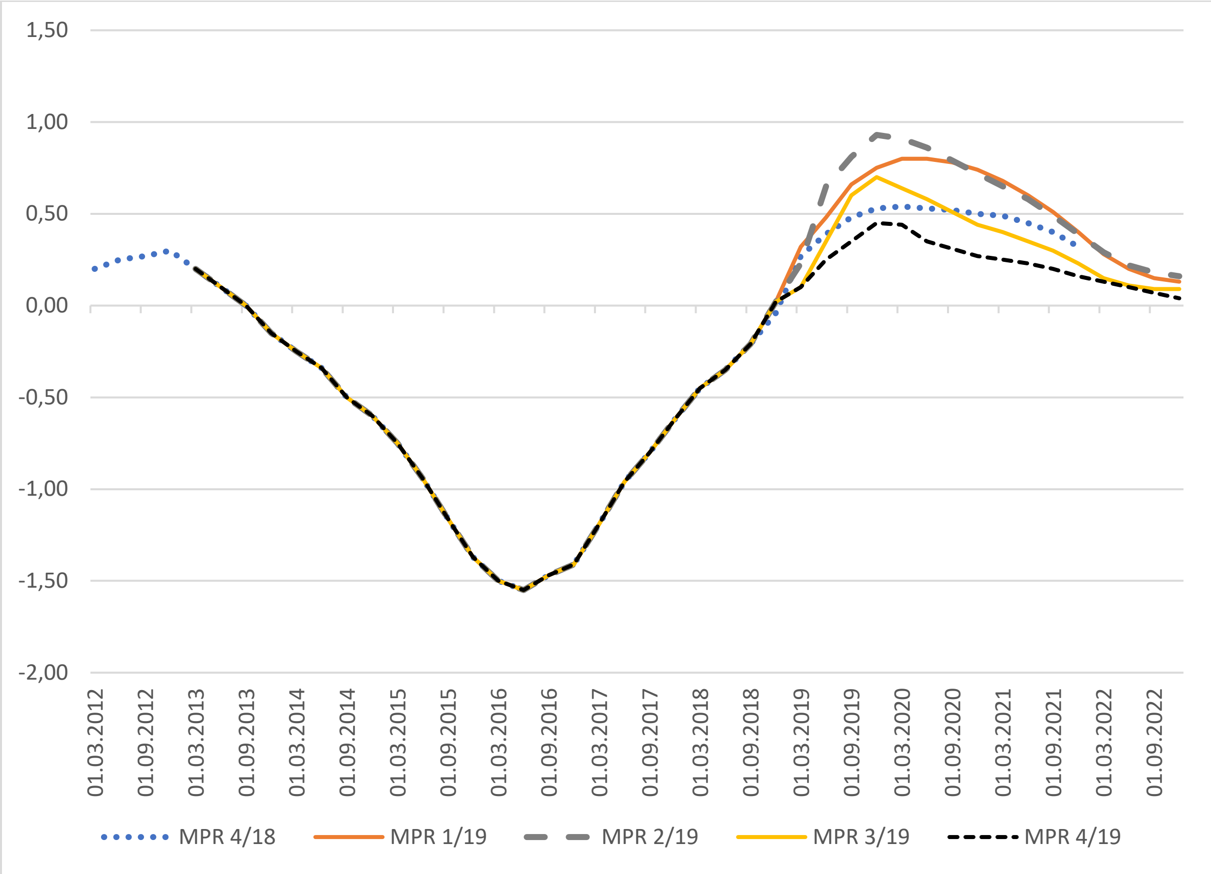

Figure 2.5 The output gap following MPR 4/18. Source: Norges Bank.

Due to the slower growth in the Norwegian economy due to lower oil activity, the output gap was negative from 2014 to 2018. By the start of 2019 the output gap turned positive for the first time in 5 years. During 2019, the output gap was positive, but the forecast was lowered somewhat.

Potential output and the output gap cannot be observed and must be estimated, and GDP is often revised. Norges Bank's output gap estimates are based on an overall assessment of several indicators and models. In this assessment, labour market developments are emphasized.

Analysis and forecast of the output gap are presented in each MPR. NBW applauds this regular and thorough setup. Estimates for several indicators for capacity utilization are presented.

A memo on modeling the output gap was presented in Norges Bank Staff Memo in 2018 (Norges Bank 2018c). There is no direct way of evaluating the estimated output gap, as the output gap cannot be observed. A good estimate of the output gap should provide information about future developments in GDP growth, inflation and unemployment. The memo concludes: "Measured this way, the models have good forecasting properties compared with simple trend estimations solely based on GDP data. The forecasting properties for an average of the models are shown to be better than for each individual model." Moreover the memo argues that more indicators can be included when there is more historical data.

The output gap estimate is a key measure for monetary policy. NBW stresses Norges Bank to explore improvements of the output gap indicator, as well as elaborating on the uncertainty of the indicator due to different approaches. Using several indicators of the output gap might lead to confusion, but it is important to communicate the uncertainty policymakers are facing regarding the state of the economy measured by the output gap. This calls for well-calibrated measures of uncertainty around mean estimates of the output gap.

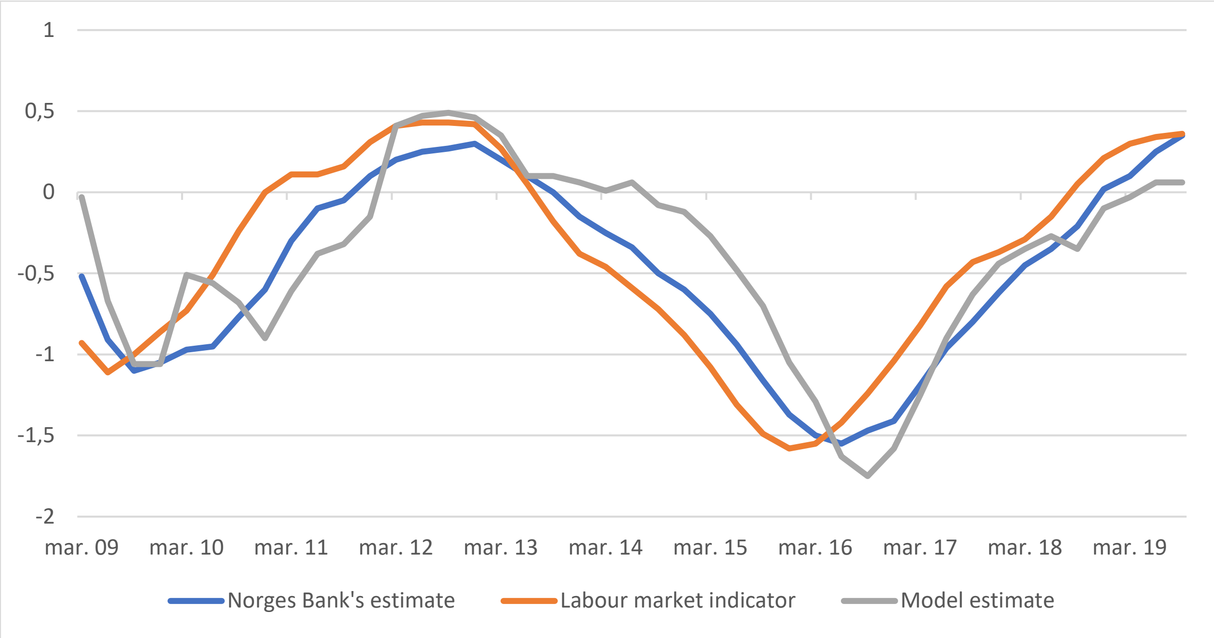

Figure 2.6 Output gap estimates. Source: Norges Bank.

Potential output growth is over time determined by trend employment growth and productivity. Norges Bank states that trend productivity growth has declined over time and that “Potential output is projected to grow by just over 1.5 percent annually from 2020 to the end of the projection period.” The basis is trend productivity growth of just under 1 percent and growth in potential employment of around 0.75 percent.

The outlook for the Norwegian economy is important for key stakeholders, including investors in Norwegian assets. Based on the assessments on potential growth mentioned above, Norges Bank forecasts growth in mainland-GDP for 2020, 2021 and 2022 at 1.9, 1.4 and 1.4 percent, respectively. Other public sector forecasters (Statistics Norway and Ministry of Finance) have forecasts that deviate from Norges Bank, and Norges Bank’s estimated trend growth lies clearly below the other estimates. To provide more nuances in the outlook for the Norwegian Economy, NBW believe it would be fruitful if Norges Bank commented and discussed key drivers behind diverging forecasts.

2.7 Foreign exchange rate, inflation and uncertainty

The Norwegian krone (NOK) has been freely floating and Norges Bank has not intervened in the market since 1999. The foreign exchange rate (measured by I-44) have since 1999 been in the range 85 to 111. By the end of 2019, I44 was at 111. This represent a depreciation of close to 30% from 85 at the start of 2013. This pronounced weakening of the Norwegian krone can be related to the reduction in the importance of petroleum sector. The following figure from Governor Olsen's annual speech shows that the share of the petroleum sector of mainland Norwegian GDP fell by more than five percentage points from 2013 to 2018, and is expected to decrease further in the future (see Norges Bank, 2020b).

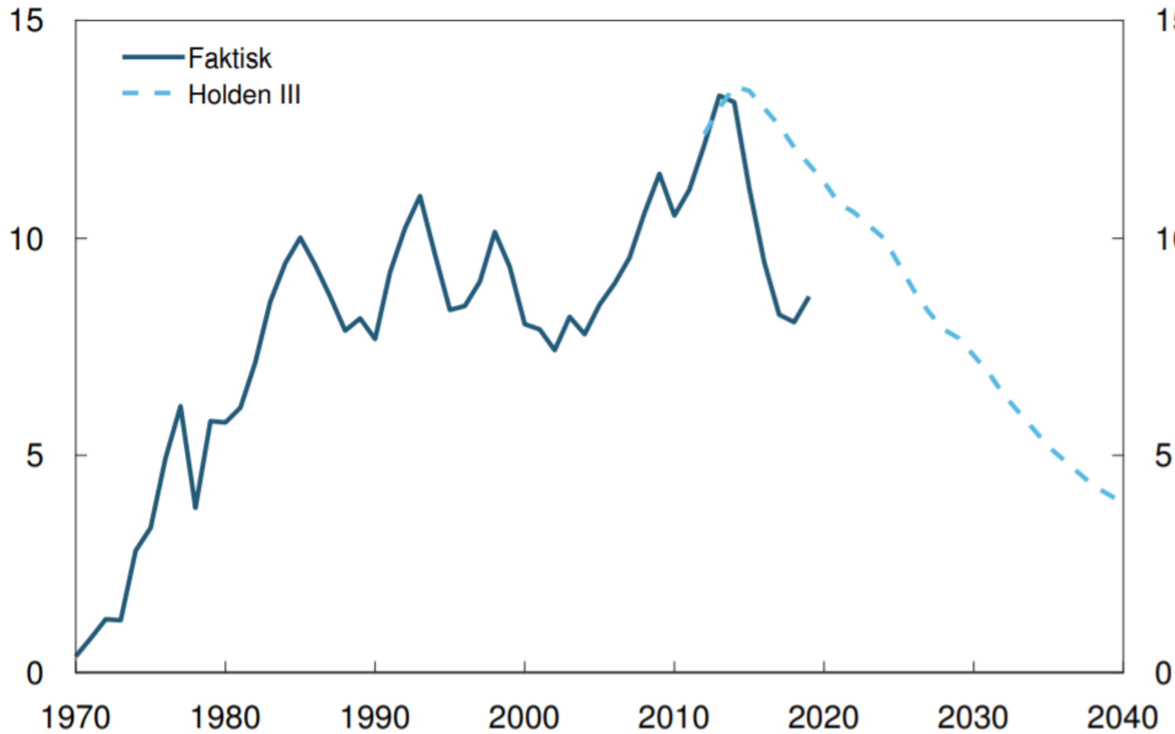

Figure 2.7: Demand from the petroleum sector in percentage share of mainland GDP. *Source: Norges Bank (2020b).*

Norway has a significant surplus on the balance of payments, including the trade surplus and assets abroad. Deprecation of the foreign exchange rate improves the terms of trade as well as impact through foreign assets and thus the government spending rule.

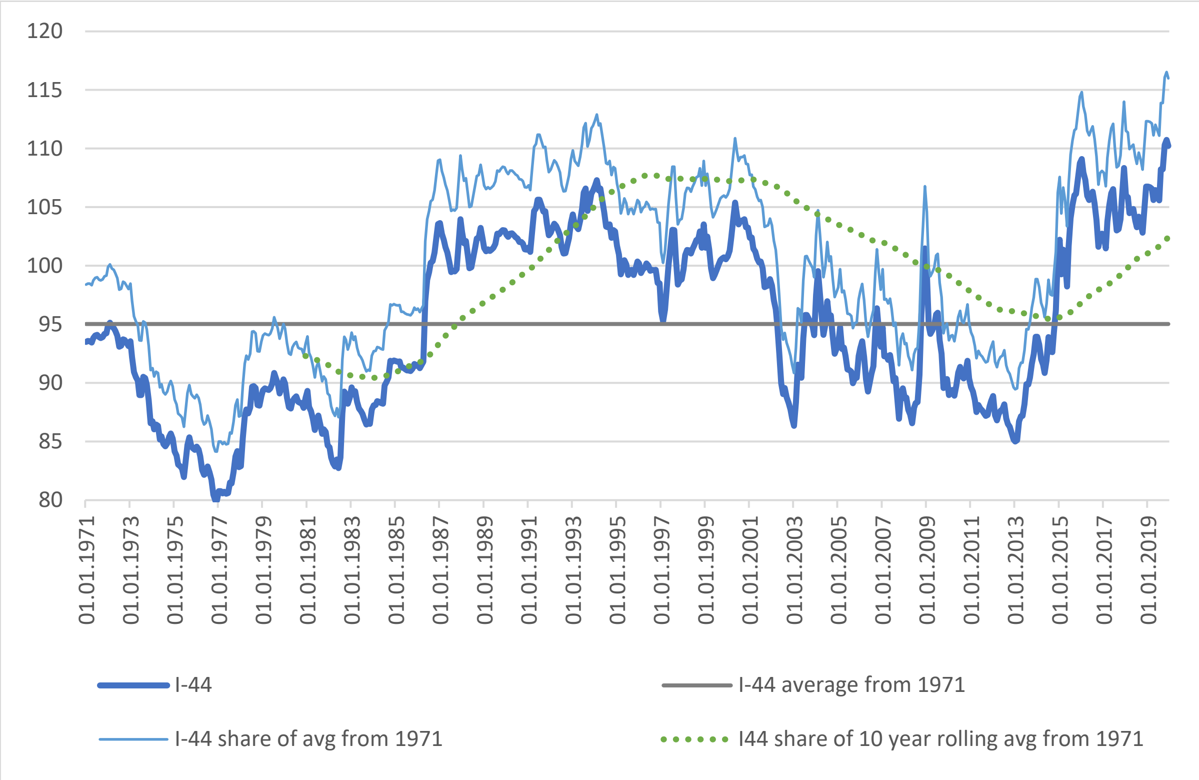

Figure 2.8: Import-weighted foreign exchange rate (I-44). Index and share of average. An increase of the index denotes a weaker krone exchange rate. Source: Refinitiv Datastream.

Although the depreciation of the foreign exchange rate has a positive impact on the economy overall, there are topics that should be watched closely. One relates to how depreciation (and volatility) impact imported inflation and the formation of inflation expectations. The other relates to impact on different sectors in the economy. The depreciation over the last years has implied challenges for retail trade. Another topic relates to whether the significant depreciation (and volatility) since 2013 has impacted interest for investments and activity in Norway. Also, models for weighted exchange rate I-44, which are based on interest rate differential and oil price, have for the last years failed to explain movements in the foreign exchange rate. NBW encourages Norges Bank to further explore these issues related to the foreign exchange rate.

2.8 Ongoing monetary policy review in ECB and Fed – implications for Norges Bank

There are ongoing monetary policy reviews in both the ECB and the Federal Reserve of US.

European Parliament (2019a) signaled in 2019 interest in a monetary policy review. The European Parliament recommended that the review should encompass quantitative formulation of price stability, monetary policy toolkit, economic and monetary analyses and communication practices. Other considerations, such as financial stability, employment and environmental sustainability, should also be part of review.

The Federal Reserve stated in October 2018: “The Federal Reserve next year will review the strategies, tools, and communication practices it uses to pursue its congressionally-assigned mandate of maximum employment and price stability. The review will include outreach to a broad range of interested stakeholders. "With labor market conditions close to maximum employment and inflation near our 2 percent objective, now is a good time to take stock of how we formulate, conduct, and communicate monetary policy," said Federal Reserve Chairman Jerome H. Powell.”

These policy reviews in key central banks may have implications for the conduct of monetary policy in other countries. This could impact monetary policy considerations in Norway in several ways, especially when it comes to scope and inflation target as well as broader assessment regarding the monetary policy toolkit. In general, it could also spur a similar review in Norway.

In this regard, the NBW would like to mention that the assessments from NBW 2019 regarding new regulation on monetary policy in 2019 may become relevant. NBW 2019 was concerned that this would reduce the scope for monetary policy and increase the costs of recessions in the future. It added that a reasonable change of the new regulation would be (1) reduce the policy rate more in downturns, and (2) keep the policy rate lower for longer emerging from a recession. NBW 2019 argued that Norges Bank should report their estimate of the maximum level of employment, which is consistent with price stability, as well as direct impact on the policy rate due to the financial stability consideration.

Although the framework for Norges Bank and monetary policy has been renewed over the last years, NBW believes the ongoing reviews in key central banks should encourage Norges Bank to assess how to relate to these policy reviews.

3. Regulation of monetary policy and financial stability

In this section, we discuss policy issues related to the implementation of the new regulation on monetary policy. The new regulation was passed by Royal Decree and announced on 2 March 2018, replacing previous regulation from 2001.[1] The discussion here focuses on monetary policy, and abstracts from other responsibilities of Norges Bank, such as the management of the oil fund.[2]

Norges Bank's mandate for the conduct of monetary policy:[3]

> §1 Monetary policy shall maintain monetary stability by keeping inflation low and stable.
>
> §2 Norges Bank is responsible for the implementation of monetary policy.
>
> §3 The operational target of monetary policy shall be annual consumer price inflation of close to 2 percent over time. Inflation targeting shall be forward-looking and flexible so that it can contribute to high and stable output and employment and to counteracting the build-up of financial imbalances.
>
> §4 Norges Bank shall regularly publish the assessments that form the basis of the implementation of monetary policy.

We will discuss the following topics for monetary policy: (1) inflation target -- implementation and consequences of lowering the inflation target from 2.5 percent to 2.0 percent, (2) contributing to high and stable employment, (3) counteracting the build-up of financial imbalances, and (4) the monetary policy and financial stability committee making decisions on monetary policy and contributing to financial stability.

3.1 Inflation Target

Norges Bank has received an operational target of achieving an annual inflation of consumer prices close to 2 percent. NBW 2019 commented in detail on potential costs of lowering the inflation target from 2.5 to 2.0 percent. The essential argument seems to be that a lower inflation target may well reduce the room for reducing nominal interest rates in downturns, in particular in the current phase where the neutral real rate of interest is expected to be low for the foreseeable future (see also the discussion in section 2.4 above).

Ben Bernanke (2020), the former chairman of the Federal Reserve, discussed in a Presidential Address at the American Economic Association conference whether the set of new tools

[1] https://www.regjeringen.no/en/aktuelt/new-regulation-on-monetary-policy/id2592551/. The Ministry of Finance (2018a) describes in more detail the new regulation for monetary policy, in accordance with the Central Bank Act, https://www.norges-bank.no/en/topics/about/Mission-core-responsibilities/Legislation/Norges-Bank-Act/

[2] See https://www.nbim.no/en/.

[3] https://www.norges-bank.no/en/topics/about/Mission-core-responsibilities/Legislation/Regulation-on-Monetary-Policy/. This is a English translation of the regulation in Norwegian in Ministry of Finance (2018a).

available to the US central bank (Fed), including quantitative easing and forward guidance, was sufficient to fight potential future recessions. Bernanke concludes that if the nominal neutral interest rate is much less than 2 percent, then fiscal policy and other measures to increase the policy space, including raising the inflation target, may be desirable.

There is renewed interest both among central banks and in the academic literature on the consequences of low (and potentially) negative nominal interest rates. Officials of the US Fed recently explicitly highlighting that they interpreted their mandate as “symmetric”. This implies that inflation should on average near the target level, but at times exceeding the target and other times falling below. Bernanke (2020b) summarizes the bottom-line lesson for all central banks as follows: “Keeping inflation and inflation expectations close to target is critically important.”

As commented in NBW 2019, the introduction of the new inflation target in 2018 generated debate in the Norwegian Parliament and some confusion in the media. We reiterate the recommendation to stick to the practice of delegating operational decisions about the monetary policy regime to the government.

Norges Bank (2019d, p. 38) estimates the neutral real interest rate to be close to 0 percent, with considerable uncertainty around the point estimate. Norges Bank was at the forefront in publishing expected developments in future policy rates, as well as the outlook for the economy (output gap) and inflation. Norges Bank (2019d, p. 39) describes in a box how to interpret the predicted policy path. Together with the discussion of the factors behind the changes in the policy rate path also discussed in section 2.5 this is an important tool to signal to individuals and markets the likely factors influencing current and future policy decisions. NBW supports the illustration of the main drivers of interest decisions and anchoring of expectations about future interest rates (guidance).

The chart below shows the expectations about annual inflation five years ahead reported by participants. Before the inflation target was reduced to two percent, Erlandsen and Ulvedal (2017) argued that inflation expectations were generally well anchored among participants in the Norwegian economy. Interestingly, inflation expectations by financial industry was below the inflation target from 2012 onward. Academic economists and employers appear to reduce their inflation expectation gradually once the lower target is announced, whereas employees organization respond more sluggishly (if at all). This might lead to nominal rigidities in wage setting in the future. SSB reports that annual growth of nominal wages in 2019 equals 3.7 percent, which slightly exceeds the forecast of 3.4 percent given by Norges Bank (2019d). More worrysome, local government employees lead with a 2019 wage growth of 4.1 percent.[4]

[4] https://www.ssb.no/en/lonnansatt.

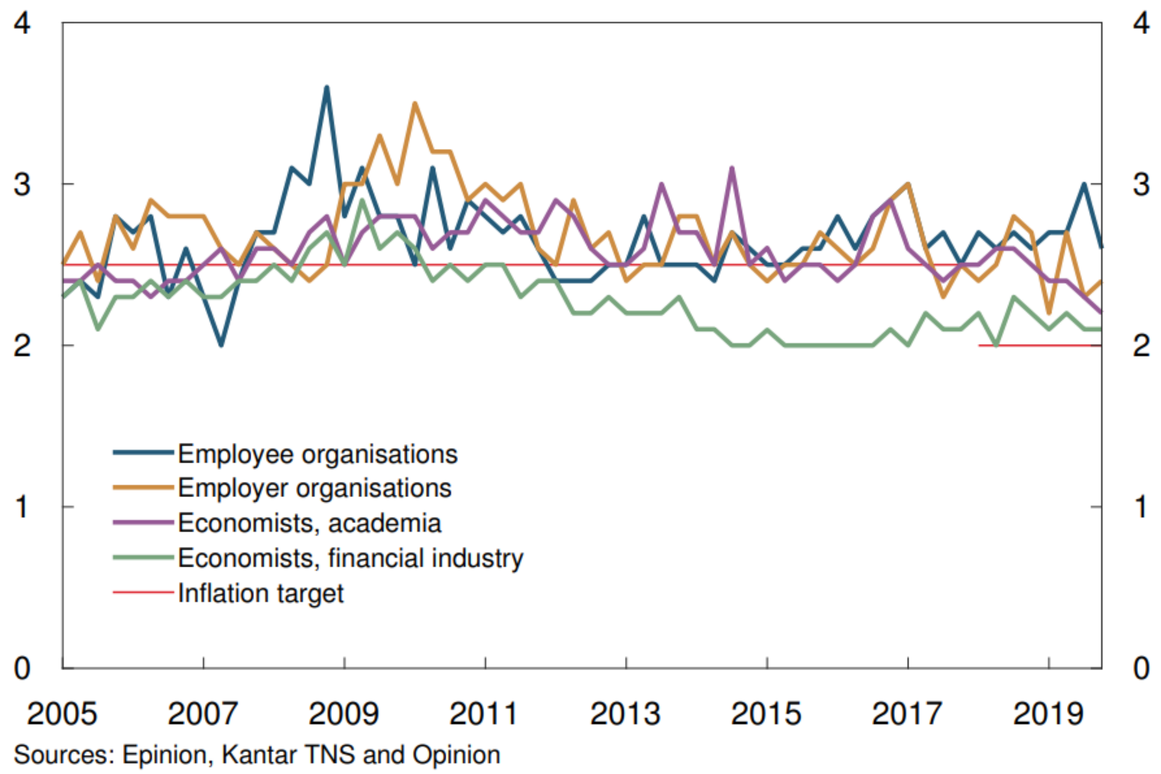

Figure 3.1: Expected twelve-month change in CPI five years ahead. Percent. 2005Q1-2019Q4. Source: Norges Bank (2019d).

This reiterates the importance of sending clear, consistent and understandable signals about future developments in prices (inflation) and real incomes to stakeholders in the economy. More generally, the introduction of the new inflation target seems to have been well communicated, and did not result in a slowdown in economic activity that might have been realised if the change in the target was not perceived to be credible.

3.2 High and Stable Employment

The mandate for monetary policy specifies that "inflation targeting shall be *forward-looking* and *flexible* so that it can *contribute to high and stable output and employment*." [our emphasis on key terms]. The mandate for monetary policy with emphasis on both price stability and the real economy (employment) was not how inflation targeting started.

Motivated by unstable macroeconomic performance of economies in the 1970s and 1980s and important policy mistakes, inflation targeting started by addressing the so-called inflation bias. Important contributions emphasised rule-based policy-making over discretion (Kydland and Prescott, 1977), the role of commitment and reputation to solve the inflation bias problem (Barro and Gordon, 1983) or the appointment of conservative central bankers with higher weight on price stability compared to the rest of the economy (Rogoff, 1985). Since then inflation targeting has been adopted as the prevalent regime for central banks.

A recent development is to allow the inflation targeting regime to be *flexible*. A very related concept is the "constrained discretion" coined by Ben Bernanke (2003) in a FRB speech. This implies that the central bank is committed to price stability in the long run, providing a nominal anchor and tying down inflation expectations, while having flexibility to reacting to shocks that hit the economy in the short run. Bernanke argues that this flexibility can improve the performance of the economy both in the short- and long-run. The commitment to price stability also implies that both deflation, as well as inflation are avoided.

In the context of Norges Bank, the emphasis on the flexibility of inflation targeting has been changing over time. Roisland (2017) points out that when inflation targeting was established in Norway in 2001, the time horizon for bringing inflation back to its target was two years. If the Central Bank failed to achieve the target, a formal explanation had to be given to the Ministry of Finance. This highlighted the issue of accountability of the central bank, which was especially important when establishing a reputation for sound monetary policy. In 2004, the horizon to stabilizing inflation was extended to "normally 1-3 years", and in 2007 the flexibility was extended further by "stabilizing inflation close to the target in the medium term" (Norges Bank, 2007).

Currently, the pendulum in the political debate (especially in the US) seems to be swinging even further towards saddling the central banks with more responsibility to ensure maximum employment. One should not forget some important and hard-earned lessons[5] about the benefit of having an operationally independent, but accountable central bank. Holden (2017) argues that the central bank cannot be held accountable for high employment because the central bank lacks the instruments to directly affect the natural rate of employment, such as taxes, welfare state regulation, functionality of labour market etc.

Norges Bank interprets its mandate flexibly and aims to bring inflation towards the target in the medium term, where the relevant horizon depends on the nature of the shocks and the state of the economy. When economic or financial shocks are not too large and the economy relatively stable, monetary policy can often be described by a simple rule (for example, the so-called "Taylor rule"). But in the face of sharp recessions, such as the slowdown resulting from the so-called "Great Recession" starting in late 2007, monetary policy might act much more aggressively to stabilize the economy, and prevent a lasting negative effects on the economy, for example through scarring effects of persistent unemployment or weakened banking sectors (see for example box in Norges Bank, 2018b and 2019d).

The practice of flexible inflation targeting appears to work well for monetary policy in Norway. A careful updating of information about the state of the economy (output gap), as well as expected developments of inflation and interest rates is important in order to anchor inflationary expectations and achieve credibility of monetary policy.

[5] For example, Abrams (2006) describes how US President Nixon pressured Fed Chairman Arthur F. Burns to use lax monetary policy to boost the economy (which ultimately won Nixon the reelection), and then use price controls to stem the resulting burst of inflation. The tweets fired off by US President Trump in direction of Fed Chairman Powell have an eerie ring to them. Romer and Romer (2004) go through the list of Fed Chairmen [until the appointment of Janet Yellen they were indeed all men] and discuss resulting policy actions.

Given the importance of the output gap for setting interest rates, NBW encourages Norges Bank to clarify how employment and other measures of capacity utilization are related to the estimated output gap (see for example Norges Bank 2018b, pp. 38-39). Does minimizing the output gap correspond to maximizing the level of employment, as suggested by NBW 2019? There could be important non-linearities in the economy, for example in the aftermath of (large) recessions compared to the normal (expansion) phase of the business cycle. The fan charts illustrating uncertainty around the expected path for future policy rates and key economic variables are not reflecting these potential non-linearities. A related critique is the relative high likelihood of encountering negative policy rates in the future, as the symmetric fan charts seem to indicate (see discussion in section 2.4 above).

NBW encourages Norges Bank to develop a framework for setting the optimal policy rate which is consistently reflecting possible non-linearities and asymmetric risks in the economy. A sizeable part of the "judgement" component that is currently applied when setting the current and future policy rates, could then be incorporated in the framework for optimal policy.

3.3 Financial Stability

Financial stability is an area of where the Ministry of Finance, Norges Bank and the Financial Supervisory Authority ("Finanstilsynet" in Norwegian) have joint responsibilities. Norway is also subject to the rules for financial stability from the Basel committee and EU regulation. Norges Bank is responsible to advise the Ministry of Finance about the level of countercyclical capital buffer for banks in a separate letter. Financial stability is analysed in a separate chapter of the Monetary Policy report. Norges Bank and Finanstilsynet exchange relevant information and judgement during the process. The Ministry of Finance publishes the decisions about countercyclical buffer the same day as the press conference for the Monetary Policy Report.

Norges Bank (2019e) outlines the following principles for advising about countercyclical capital buffers:

1. Banks should hold counter-cyclical buffers when financial imbalances are building up.
2. The buffer should be activated early with signs of increasing financial imbalance.
3. The buffer should make banks more resilient against contractions and should not be changed frequently to try to manage credit growth or asset prices.
4. Responding to strong contractions and clear reduction in credit, the buffer should be reduced to increase banks lending capacity.
5. The counter-cyclical capital buffer should generally fall between 0 and 2.5 percent, but can in special circumstances be set higher than 2.5 percent.
6. The buffer should be seen in light of banks adjustment to combined capital requirements.

The following figure shows the core equity ratios and counter-cyclical capital buffers for Norwegian banks from 2011-2021.

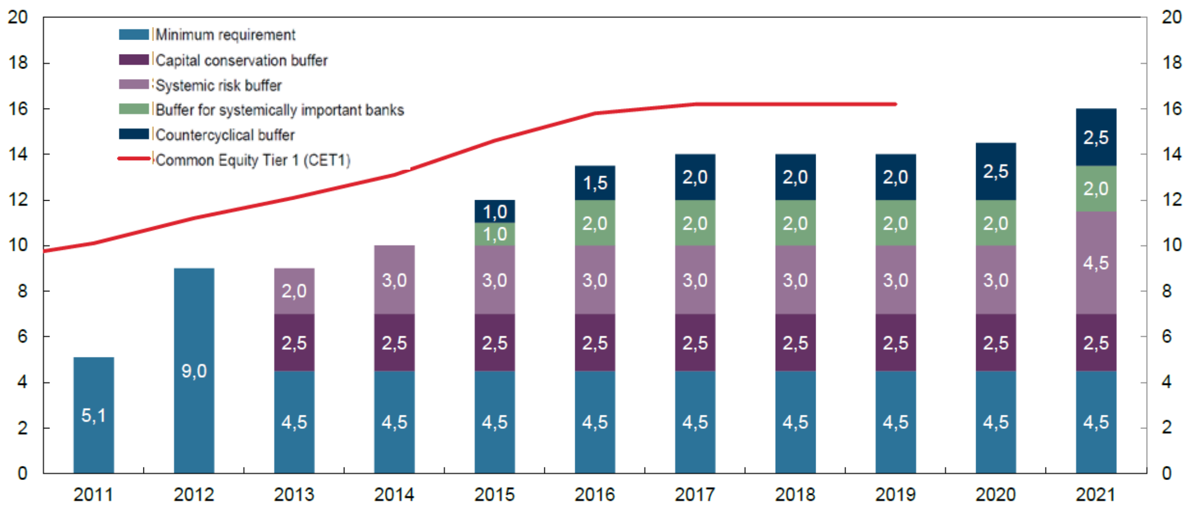

Figure 3.2: Core equity ratios (common equity Tier 1 (CET1) with transitional rule) and counter-cyclical and time-varying capital buffers for Norwegian banks (with exception of branches of foreign banks). Source: Norges Bank (2019e).

The decision about countercyclical buffers is formally taken by the Norwegian Ministry of Finance, based on analysis and recommendation in the quarterly Monetary Policy Report. The Ministry of Finance has always followed the recommendation by Norges Bank on the level of the countercyclical capital buffer (to the best of our knowledge). The Ministry of Finance announces the size of the buffer on the same day as the presentation of the Monetary Policy Report[6]. NBW is questioning whether the reputation of the government and Norges Bank could not suffer if the Ministry of Finance decided not to follow Norges Banks advice and analysis on countercyclical buffers. The decision about countercyclical buffers can via the objective of ensuring financial stability impact monetary policy. NBW argues that it would be logically consistent to make Norges Bank operationally responsible for both monetary policy, as well as the countercyclical capital buffer, which is the only time-varying capital requirement.[7]

NBW therefore suggests simplifying the process, by making Norges Bank operationally independent and responsible for setting the level of the *countercyclical* capital buffers, while being given an explicit mandate by the Ministry of Finance and the Norwegian parliament. This argument could be extended further by making Norges Bank responsible for the setting of all capital buffers, based on information exchanged between the Ministry of Finance, Finanstilsynet and Norges Bank and a mandate given by the government and the Norwegian Parliament. This would imply a more independent setting of capital buffers, similar to the operational independence of Norges bank in setting the key policy rate.

[6] Except the first time the buffer was set in 2013, when the Ministry of Finance chose a different date for the implementation then the advice from Norges Bank.
[7] The systemic risk buffer is also reviewed every second year.

Norges Bank is also contributing to the regulation on banks mortgage lending to households by informing the Ministry of Finance based on analysis of banks loan portfolio to households and firms based on micro data. Norges Banks also monitors indicators for financial fragility, systemic risks of banks and the importance of climate risk for financial stability. NBW notes the coordination of macroprudential policies between the Ministry of Finance, Norges Bank and Finanstilsynet, but encourages further discussion about the division of responsibilities.

More generally, NBW encourages a debate of whether Norges Bank should be responsible for all aspects of financial stability, including lending practices and lender of last resort.

Leaning against the wind – or rather not

As discussed earlier, Norges Bank practices flexible inflation targeting. The costs and benefits of "leaning against the wind" (LAW) and setting interests rates to contribute to the reduction of financial imbalances are strongly debated in the recent literature. The Bank for International Settlements (BIS) argues for an important role of LAW policies to counteract the buildup of financial imbalances thereby reducing the likelihood of financial crises and make the financial system more resilient if a crisis does occur (see for example BIS, 2016). Svensson (2017) is very critical of LAW by arguing that the economy is weaker if a crisis does not occur, but also weaker if a crisis occurs. Analysing the costs and benefits using numerical estimates, Svensson argues that the costs substantially exceed the benefits, and that these results are robust (see Svensson (2017) for details).

Svensson (2016) gives a simple example of a cost-benefit calculation of LAW policies for the Riskbank's policy during 2010-2011. Svensson (2016, p. 108) describes the Riksbank's policy decisions as follows:

> "… in June 2010, the Riksbank's forecast of CPIF inflation[8] was below the inflation target, and the unemployment rate and the forecast for unemployment were far above the Riksbank's estimate of a long-run sustainable rate of unemployment. Nevertheless, the Riksbank increased the policy rate from 0.25 basis points in June 2010 to 2 percent in July 2010 because of concerns about possible risks associated with rising housing prices and household debt. After this rapid rate increase, inflation fell to around zero, far below the target, and unemployment stayed up around 8 percent, far above any reasonable estimate of its long-run sustainable rate. In response to this, the Riksbank only slowly brought the policy rate down during 2012 and 2013. From the summer of 2014, the policy rate was brought down more quickly. In March 2015 it was lowered to -0.25 percent".

Svensson (2016, p. 108) criticizes that "[t]he dramatic tightening in 2010-2011 was done without any previous analysis of the impact of monetary policy on any risks associated with household debt." Furthermore, Svensson argues that the policy rate did not have a long-run effect on real debt and associated risks during this period in Sweden. However, the LAW

[8] CPIF is measured as consumer price inflation with homeowner's housing costs calculated with mortgage rates held constant.

policies resulted in inflation much below the target of 2.0 percent and (importantly) also below households' inflation expectations, implying that the real value of nominal debt has increased compared to expectations. Thus, Svensson (2016, p. 116) argues that "Riksbank policy has almost certainly increased real debt and actually been counterproductive."

This example of LAW policies implemented by Riksbank illustrates the danger of implementing aggressive policies using the interest rate without proper anchoring in a systematic, analytical policy framework. Macroprudential policies are likely to be better towards the aim of ensuring financial stability because they are directly aiming at underlying problem (financial instability) whereas the policy rate is affecting many aspects of the economy. Over-burdening the interest rate risks loosing sight of the primary objectives of price stability and stabilization of the real economy, thereby eventually compromising the credibility of the central bank (see Orphanides, 2013).

Norges Bank has at times referred to financial imbalances and the risk of buildups of vulnerabilities in interest rate decisions. The new legislation from 2018 formalised the setup. As argued above, the costs and benefits of LAW policies are very uncertain, and possibly counterproductive. In practice, Norges Bank is using "judgement" or discretion in choosing an interest rate narrowly based on price stability and output stabilization.

NBW encourages Norges Bank to provide sufficient information about the factors that are informing the "judgement" regarding the interest rate decision (see also section 2.5 above). In line with recommendation by NBW 2019, Norges Bank should state the direct impact on the policy rate due to the financial stability consideration.

3.4 Monetary Policy and Financial Stability Committee and Communication

According to the new central bank law, a "Monetary Policy and Financial Stability Committee" (henceforth "committee") was appointed and started to work 1. January 2020. The committee consists of three internal members -- the central bank governor and his two deputy governors – and two external members.

NBW agrees with the decision to appoint a separate committee that is responsible for setting the policy rate in line with the mandate of Norges Bank. This suggestion was made by many NBW committees in the past.

NBW 2019 commented that the committee size of five members might be too small to have sufficiently broad set of information in determining monetary policy (see for example the overview of monetary policy committees in other central banks in NOU 2017:13, p. 258). This problem of a potentially too narrow perspective might be aggravated by having only 20% positions for the two external members. Given the proposed workload of having to prepare for eight meetings of the committee, meeting with staff members during the preparation for the meetings, and discussing key issues with other committee members, a higher than 20% position for external members might be more realistic.

A second point is that internal members constitute the majority with three internal versus two external members. It can be argued that it may be difficult for the central bank governor to be in a minority position regarding the interest rate. Even though this could be theoretically possible under the setup decided in the new law, in practice it is very likely that the internal members will be decisive when setting the interest rate. Combined with the observation that internal members have full time positions, compared with only 20% positions for the two external members, this gives a very high weight to the internal committee members.

NBW therefore recommends considering the appointment of a third external member to the committee, representing a broad set of backgrounds from industry, financial markets and academia. The central bank governor could have a double vote to act as tiebreaker in case of a split committee, ensuring also that the governor’s view is strongly represented. Finally, an increase to a more realistic workload of external members than 20% may give them enough time and resources to play a significant role in determining monetary policy.

Regarding the transparency of information about deliberations and discussions in the committee, Norges Bank has adopted a relatively conservative approach that the majority (collegial) view is presented at a press conference. Dissenting (minority) opinions by committee members could be included in the statement, but in practice this puts a relatively high threshold on disagreeing with the majority of the committee. Also, only internal members of the committee are expressing views publicly.

In line with previous NBW reports, we also encourage Norges Bank to release detailed minutes from committee meetings, or at least provide more nuances about the discussions within the committee.

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Appendix: Summaries of Norges Bank Watch Reports

Members of each committee are in parenthesis.

NBW2000 (Hamilton, Thøgersen, M. Andreassen and H.M. Andreassen)

- The group states that there is uncertainty around the monetary policy regime. According to the group, Norges Bank has on own initiative begun to pursue the same inflation target as the ECB, which is a shift of monetary policy away from direct exchange rate control.
- The group recommends to introduce a flexible inflation target on 2 percent ±1 percentage point. The use of policy instruments should be aimed at reaching the target 2 years forward in time. In addition, it should be considered to introduce an "additional pillar" in the regulation that requires the bank to take into account factors such as asset bubbles (e.g. housing market) or excessive exchange rate fluctuations.
- The division of labor in economic policy should be changed such that fiscal and monetary policy together shall contribute to stabilize the economy.

NBW 2001 (H.M. Andreassen, De Grauwe, Solheim and Thøgersen)

- The group believes that Norges Bank should closely monitor developments in debt and asset prices. However, asset prices should not in itself be a target for monetary policy. The central bank should use a "lean against the wind" strategy.
- The communication with the public and participants in the financial markets is good.
- Members of the Executive Board should be appointed based on professional qualifications.
- The minutes from the meetings of the Executive Board should be published.

NBW 2002 (Svensson, Houg, Solheim and Steigum)

- The group recommends an institutional reform with a new law for Norges Bank which specifies a mandate for price stability, secures Norges Bank's operational independence, and clarifies what Norges Bank can be held accountable for.
- The reference to stability in the exchange rate should be removed from the guidelines for monetary policy.
- The candidates for the Executive Board should be experts on monetary policy or similar areas (e.g. macroeconomics and financial markets). The arrangement where the political parties appoint members to the executive board should cease to exist.
- The minutes from the meetings of the Executive Board should be published.
- The Ministry of Finance should include an evaluation of Norges Bank's exercise of monetary policy in the annual credit reports.
- Hearings about monetary policy in the Storting should be conducted regularly.
- A conference about monetary policy should be held annually or semiannually. This should be financed by Norges Bank, but organized by an independent actor (e.g. an academic institution).

NBW 2003 (Ekeli, Haug, Berg and Steigum)

- Norges Bank should base a more flexible horizon for achieving the inflation target.
- Norges Bank should replace the current "bias-sentences", with a formulation related to the likely direction of the next key policy rate change.

- The Executive Board should consider holding meetings more frequently, e.g. every fourth week.
- In the inflation prognoses, Norges Bank should base a development in the key policy rate based on the banks best estimate, instead of today's assumption of unchanged rate.

NBW 2004 (Bjørnland, Ekeli, Geraats, and Leitemo)

- Norges Bank should publish inflation reports four times a year.
- Unilateral focus on the growth in CPI-ATE may have given an overreaction in the key policy rate decisions.
- Norges Bank should publish its preferred reference path for the key policy rate.
- The practice of having monthly meetings with the Ministry of Finance should be abolished. The Ministry should be informed immediately after the Executive Boards' monetary policy meeting.
- The minutes from the meetings of the Executive Board should be published.

NBW 2005 (Holden, Dørum, and Isachsen)

- The practice of monthly meetings with the Ministry of Finance may reduce the external members of the Executive Board's ability to influence. In the report, the group discusses whether the external members should have own research assistants and more funds to work with monetary policy.
- The right of instruction should not be removed. The threshold to using it is high, and it is appropriate that it exists in the case of an unforeseen situation that requires prompt actions.
- The decision to leave the two-year horizon in July 2004, in favor of a more flexible horizon of 1-3 years, was sensible.
- The publication of the Executive Board's strategy report in the inflation reports have further improved Norges Bank's communication with the market.
- The group believes that Norges Bank is toning down the fact that monetary policy, according to regulations, is intended to stabilize the exchange rate.

NBW 2006 (Holden and Dørum)

- The regulations provide sufficient flexibility .
- There is a higher risk associated with raising the key policy rate too little too late, than raising it too much too early.
- The group approves Norges Bank's decision to produce its own key policy rate forecast, with effect from the Inflation Report 3/05.

NBW 2007 (Goodfriend, Mork, and Söderström)

- A new consumer price index should be made as a control parameter for Norges Bank's use of instruments. It must contain goods and services with sticky prices.
- Norges Bank should be more explicit in how they reach the forecast for the exchange rate developments.
- Norges Bank should publish minutes and voting from the Executive Board meetings.
- The external members of the Executive Board should have increased access to speak in public.

- The reference to the exchange rate should be removed from the regulations of monetary policy.
- The operational target for price increase should be reduced. 2 percent inflation targets have become the de facto international standard. The real appreciation argument is weaker because a good deal of the systematic fiscal expansion is likely to have taken place by the present time.
- The submission of confidentiality and the right of instruction should be removed.

NBW 2008 (Juel, Molnar, and Røed)

- Norges Bank should clarify how other asset prices than the Norwegian currency are taken into account in the key policy rate decision.
- Norges Bank should prioritize efforts to identify developments in the neutral real interest rate in Norway.
- The group is skeptical to the fact that Norges Bank put so much weight on the output gap in the assessments and communication of monetary policy.
- Norges Bank should consider publishing adjusted forecasts in connection with the monetary policy meetings where the bank does not submit a new monetary policy report.
- Norges Bank should develop better models for prognosis based on empirical criteria.

NBW 2009 (Bergman, Juel, and Steigum)

- The reports from the regional network should be published immediately as they present themselves.
- In situations with high uncertainty about the economic development, uncertainty should be reflected in the alternative scenarios presented in the 51 monetary policy reports. When Norges Bank's assessments change significantly in the short term, it should be communicated outwards as soon as possible.
- Norges Bank's flexible inflation targeting implies that the bank should take into account asset prices to the extent that such prices provide additional information about future developments in inflation and capacity utilization.
- CPIXE is not an optimal indicator for underlying inflation, and should not be used as a main indicator when exercising monetary policy.

NBW 2010 (Bjørnland, Clarida, Holvik, and Steigum)

- Norges Bank should continue to publish three monetary policy reports each year, but can consider to publish updated estimates on some main sizes in connection with monetary policy meetings where reports are not published.
- Minutes from the Executive Board meetings should be published. These should include which topics that are discussed, but not explicit information regarding who said what or how the members have voted.
- Members of the Executive Board should be able to express their opinions on the monetary policy in public debates.
- The group notes that in the autumn of 2009, Norges Bank highlighted developments in real estate prices as a specific factor in the press releases on key policy rate decisions, but does not consider it to be the case that developments in house prices or other asset prices are included among Norges Bank's target sizes.

- The group is critical to Norges Bank's indicator for the underlying inflation, CPIXE. The group believes that this indicator should not be used as a main indicator in the exercising of monetary policy and that CPI-ATE still should be used as an operational target.

NBW 2011 (Bjørnland and Wilhelmsen)

- Norges Bank should clarify to what extent the consideration for financial stability affects the monetary policy decisions.
- Minutes from the Executive Board meetings should be published. These should include the topics that are discussed, but not explicit information regarding who said what or how the members have voted.
- Norges Bank should continue to publish three monetary policy reports each year, but can consider to publish updated estimates on some main sizes in connection with monetary policy meetings where reports are not published. Given the current schedule for publishing reports, such an update should be done at the yearly meeting in December.
- The group is critical to Norges Bank's indicator for the underlying inflation, CPIXE. The group believes that this indicator should not be used as a main indicator in the exercising of monetary policy and that CPI-ATE still should be used as an operational target.

NBW 2012 (Torvik, Vredin, and Wilhelmsen)

- It is unclear whether financial stability is emphasized only to the extent that it affects the outlook on inflation and production in the future, or whether financial stability is an independent goal in the monetary policy. This should be clarified both in the banks official mandate and through clearer communication by the bank.
- Regardless of whether financial stability is an independent goal or not, Norges Bank should be clearer on how, for example, the size of risk premium affects the bank's economic forecasts and key policy rate decisions.
- Norges Bank, and not The Financial Supervisory Authority of Norway (Finanstilsynet), should be responsible for the macro-surveillance of the financial sector.
- The group argues for a greater degree of independence for Norges Bank from political authorities, and is critical to the obligation to refer and the right of instruction. The group points out that it is the Government that appoints both the central bank governor, the central bank deputy governor and the members of the Executive Board.
- The responsibility for the Executive Board is large, and not consistent with the external members being engaged on part-time basis.
- The group wants a more public debate about discussions in the Executive Board.

NBW 2013 (Boye and Sveen)

- The group questions the decision to reduce the key policy rate by 0.25 percentage points in March 2012, and the communication in connection with the decision.
- The group believes that Norges Bank should publish estimates of banks' lending rates, and not just the key policy rate.
- The right of instruction and the obligation to refer should be abolished.
- The working opportunities of the external members of the Executive Board should be strengthened.

- CPIXE has numerous weaknesses, and CPI-ATE should be used as a main indicator for underlying inflation.

NBW 2014 (Mork, Boye, and Dargallo)

- The group believes the key policy rate decisions in 2013 were correct. The decisions were largely as expected in the market.
- Norges Bank should publish the advice on the level of counter-cyclical capital buffer while giving the advice to the Ministry of Finance.
- The group is skeptical to the fact that Norges Bank's loss function from 2012 includes a link for the smoothening of interest rates and deviations from normal interest rates. With new instruments for financial stability (including counter-cyclical capital buffers), Norges Bank should return to a loss function where only deviations from potential production and the inflation targets are included.
- A monetary policy committee with responsibility for monetary policy and financial stability should be established.
- Candidates from other Scandinavian countries should be considered for the Executive Board.
- The communication of the bank can give the impression of excessive precision.
- The key policy rate path should be supplemented with so-called "forward guidance", such as the Federal Reserve and Bank of England.
- Norges Bank should make sure that the trust in the inflation target is not impaired, cf. inflation expectations two years ahead appeared to have decreased.
- Norges Bank should be under the Storting.
- The obligation to make a statement should cease.
- The reference to stability in the NOK should be taken out of the mandate.
- Norges Bank should publish minutes from the meetings of the Executive Board.
- External board members should be given the opportunity to express their personal views in public.

NBW 2015 (Lommerud and Aamdal)

- Norges Bank's routines for communication around key policy rate decisions are good.
- The group questioned the key policy rate cut of 0.25 percentage points in December 2014. According to the group, one could have chosen to postpone the rate reduction, and rather wait and see the economic development. At the same time, the group emphasized that they did not consider that Norges Bank had made a mistake, and that in this case there were arguments both for and against a key policy rate reduction.
- About the system for deciding on countercyclical capital buffer the group stated that "Generally speaking, we applaud the system." At the same time, the group pointed out that the system is relatively new and has not yet been tested in times of crisis.
- When the key policy rate is very low, and there has been a sharp rise in house prices, doubts in monetary policy should be inclined not to further reduce the key rate.
- Norges Bank should publish minutes from the monetary policy meetings shortly after the meeting has been held, where any dissent and important points that were presented in the discussion are presented.
- Norges Bank has provided thorough information on the mechanism that they now have to buy instead of sell NOK in the market in connection with the provisions for the

Government Pension Fund Global. Nevertheless, there may be some market players who misunderstand and perceive the transactions as part of the monetary policy. The group writes that they are aware that Norges Bank has limited opportunities to inform about calculations that lie behind the size of the monthly purchases. However, the group believes that the bank can point out which factors that contribute to changes in the size of the purchases, publish scheduled changes to the buffer portfolio, and publish a benchmark for monthly purchases.

NBW 2016 (Bruce, Gottfries, and Lommerud)

- A more clearly formulated monetary policy mandate can help make it more predictable. It should be stated more clearly how structural shocks and temporary disturbances are to be dealt with in monetary policy. Theoretically, there are good reasons for why monetary policy should aim at stabilizing domestic inflation, but the forward-looking inflation target should nevertheless be linked to consumer prices as of present. However, the conduct of monetary policy should be such that aggregate inflation for a period may deviate from the inflation target when the economy is hit by structural shocks and temporary disruptions.
- The group think one should discuss the present level of the inflation target at 2.5 percent. It is not clear that a small country to have an inflation target that differs from that of her neighbors.
- The group believes that the way Norges Bank incorporates the consideration that monetary policy should be robust in its alternative scenarios for the key policy rate path is too discretionary. Here, the mandate for monetary policy should be changed so that it becomes more clear whether, and in what way, monetary policy is to contribute to financial stability and a robust economic development.
- Although it may sometimes make sense to implement key policy rate changes gradually, there are no good reasons for this now, since the key policy rate is now kept so high that the output gap is not closed during the bank's forecast period (which runs until the end of 2018).
- In the medium term, the inflation target should be exercised flexibly. But for the credibility of the inflation target it is important to aim at reaching the goal in the end.
- Information on whether the bank considered another decision at a monetary policy meeting should be published in writing and not only be expressed orally at the press conference.
- At meetings where no monetary policy report is published, Norges Bank should be clearer about whether new information since the previous report draws in the direction of higher or lower key policy rates ahead.

NBW 2017 (Bruce and Sveen)

- Norges Bank should have financial stability as a separate goal, and should further develop an understanding of the relationship between the key policy rate and the probability of financial imbalances.
- Uncertainty about the impact of monetary policy when key policy rates approach a lower limit should speak for a stronger, and not more cautious, response from the central bank.

NBW 2018 (Sveen and Strøm Fjære)

- The group is in favor of the introduction of 8 key policy rate meetings, but calls for press conferences on the monetary policy meetings where a monetary policy report is not published.
- The group believes that the overall objective of monetary policy must be price stability, while the consideration for financial stability should be equated with the consideration for high production and employment.
- The group emphasize the possibility for Norges Bank to use the exchange rate as an instrument in special cases.
- The authors are also positive to the proposal for the establishment of a committee on financial stability and monetary policy, but questions that internals in Norges Bank will be in the majority.
- The group also expresses skepticism about the proposal that Norges Bank should set the level of the countercyclical capital buffer.

NBW 2019 (Knudsen, Wulfsberg)

- The group highlights that the first key policy rate hike in seven years was well prepared and implemented.
- The authors argue that in relation to the lowering of the inflation target from 2.5 to 2.0, there were some communicational challenges and unnecessary uncertainty in media.
- The group continues to ask for more complete minutes from the board, as well more analysis and press conferences at the “in-between” meetings.
- The group argues that lowering the new inflation target reduces the scope for monetary policy and increase the cost of recessions.
- The group welcomes the target of high employment.
- The authors reiterate previous NBW advise to Norges Bank to state how much the consideration of financial imbalances impacts the key policy interest rate.