NORGES BANK WATCH 2017 – EXECUTIVE SUMMARY

Section 2 reviews and comments on Norges Bank's monetary policy in 2016. After a cut in March, Norges Bank raised their interest rate forecasts throughout 2016. The Bank dropped a rather well-signalled interest rate cut in September and the general impression is that it will take much for Norges Bank to cut rates further. The stabilization and later rise in oil prices in 2016 worked together with a much stronger than expected growth in housing prices is part of the explanation. In our view, the surprisingly positive development in registered unemployment is of equal importance. In 2016, Norges Bank chose to believe that registered unemployment gave a more accurate picture of the situation in the labour market, or at least of the output gap, than Statistics Norway's Labour Force Survey's (LFS) unemployment, which had increased much more.

NBW share Norges Bank's view that registered unemployment gives the best picture of developments in unemployment and the output gap. We therefore have no problem understanding that Norges Bank ended the downward movement in rates in 2016. The limited rise in registered unemployment since the oil price drop is due to the downturn in oil related business and nothing Norges Bank either could or should try to offset.

Even if Norges Bank ended 2016 with a firm conclusion that registered unemployment gave the best picture, the Bank seems to have been in doubt throughout 2016 about how much weight to give LFS unemployment. The way this uncertainty was communicated was rather vague.

In our view, Norges Bank's forward guidance would have been better if the Bank had been consistently more open on how they judged developments in the labour market. The main communication challenge for Norges Bank in 2016 was not connected to the labour market, however. Norges Bank has over time become a good communicator, something earlier Norges Bank Watches have applauded. Norges Bank not only publishes an interest rate forecast, they also publish a numeric explanation of why forecasts change (interest rate account). The idea is that the market should be able to understand and anticipate changes in Norges Bank policy rate forecasts when the economy deviates from expectations.

Norges Bank's inflation targeting has become more flexible in recent years, which has also been appreciated by earlier NBWs. Increased flexibility poses challenges to communication, however, which became very clear in 2016. Due to the risks and uncertainties connected to low rates, Norges Bank said in March that they would react less to news than before. Therefore, the interest rate account was not "*an exact expression of Norges Bank's response pattern ahead*". This prompts one to ask why Norges Bank still publishes the interest rate account. One possible reason is that the account could still explain the different directions the news was pulling.

That worked well in September, which was perhaps the most challenging meeting in 2016. Norges Bank's interest rate path in June was fully in line with a cut in September. News over the summer was, however, clearly on the strong side. There was little doubt that the interest rate path should be revised up, but there was no certain way of saying whether removing the cut would suffice. Still, the market and nearly all analysts concluded that Norges Bank would most likely keep rates on hold, as it did.

Trying to forecast direction of the interest rate path in December based on previous interest accounts would nevertheless have been misleading. News clearly pointed to a cut even when taking into account the higher than expected rise in housing prices. The interest rate path was actually close to unchanged, however.

To explain why it kept the interest rate path unchanged, the Bank introduced a factor called "Financial imbalances and uncertainty" in the interest rate account. Following the logic of the account (how news contributes to changes in the path) this ought to mean that the risk of financial imbalances had increased. But the substance of the account indicated, very indirectly, that this was not the case, at least not the whole case. The factor should also reflect that "the effects of monetary policy are uncertain, particularly when the policy rate is close to a lower bound". That the factor not only reflected changes, but in one way also levels, was clarified at a meeting Norges Bank held with analysts. We think this information is important for Norges Bank's forward guidance and therefore Norges Bank should have explained it in more detail in the report.

Despite the news suggesting a lower path, the decision did not come as a surprise to the market. Norges Bank had stressed the risk and uncertainty connected to low rates. They had also indicated that its risk assessment had changed from a risk of a strong downturn in the economy to one of too strong growth in housing prices. Why, then, exacerbate the sharp upwards turn in the housing market with a possible new cut?

This raises some important questions regarding Norges Bank's communication. The interest rate path still has a bottom at 0.4%. Taken at face value, it should therefore not take much for the Bank to cut rates. Analysts we have spoken to do not believe this to be the case. The financial imbalances factor will be used again to prevent a rate cut, regardless of whether the risk of imbalances has increased or not.

NBW has met with analysts to discuss whether the whole interest rate account should be omitted from the monetary policy reports. The view seems to be that Norges Bank should keep the account, partly because it forces the Bank to act with some degree of consistency. It is also an effective way to communicate Norges Bank's views on what are important disturbances to the output gap and the rate of inflation. But the Bank should clarify the role of the interest rate account.

With increased importance given to verbal communication, Norges Bank should *consider* an old suggestion from Norges Bank Watch, i.e., to publish some kind of minutes from board meetings.

In section 3 we discuss several policy issues Norges Bank should attend to. First, we consider the criteria for an appropriate interest rate path. The Bank introduced the current criteria in MPR 1/2005 and we document some important changes over time in the way the criteria are formulated and explained, and how they are used to explain monetary policy. In particular, inflation targeting has become more flexible over time. In the first set of criteria, Norges Bank stated that the rate of inflation should be stabilized "*within a reasonable time horizon, normally 1–3 years*", but in their recent criteria, the Bank has no mention of any horizon.

In 2005 the Bank had six criteria. By 2012 they were reduced to the three criteria we know today. The first criterion is that Norges Bank achieves the inflation target; the second underscores the flexibility of inflation targeting and the Bank's wish therefore to avoid too large changes in the real economy when bringing inflation back to target following economic disturbances. Most of the discussion in section three relates to the last criterion, however. This criterion tells us that monetary policy should be robust. We document that Norges Bank puts more and more effort into discussing the robustness criterion and we discuss its three main elements: financial stability, uncertainty about economic mechanisms when interest rates are low, and the lower bound on policy rates.

NBW argues that Norges Bank should extend their set of criteria for an appropriate interest rate path with a new criterion advocating financial stability. We argue that financial stability should be an objective in itself and we encourage the Bank to develop further their understanding of the relationship between policy rates and the probability and the strength of a financial turmoil.

NBW is not convinced that uncertainty about the monetary policy transmission mechanism calls for a more cautious reaction by the central bank when policy rates are low. If the central bank fears that the policy rate has a weaker effect on real economic activity than before, they should use the instrument more, not less, we think.

There is a lower bound on policy rates, but the bound is not zero. NBW think Norges Bank should consider computing implied policy rates from the two first criteria, but under the condition of a somewhat negative lower bound. This will help market participants to understand the reaction pattern of the Bank at low rates.

The last issue we cover is the financial stability analysis that is prepared for the Bank's advice on the countercyclical buffer. Financial stability issues are complex and difficult to analyse and NBW welcomes the effort to sum up the analysis in the financial imbalances and buffer guide box, but we encourage the Bank to rethink their gap analysis and discuss other variables. Those variables should be more closely linked to the actual advice.