Monitoring centrálních bank - prosinec 2015

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CENTRAL BANK MONITORING – DECEMBER

2015

Monetary Department
Monetary Policy and Fiscal Analyses Division

ČNB ČESKÁ NÁRODNÍ BANKA

In this issue

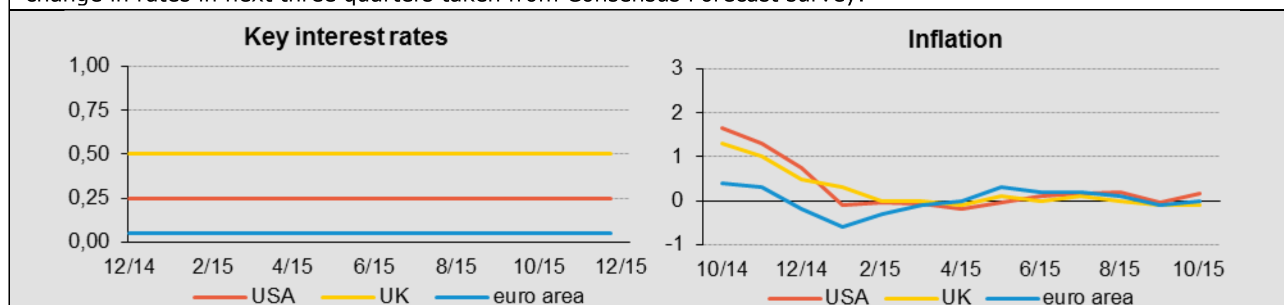
The Federal Reserve has yet to start increasing interest rates despite wide expectations that it would do so at its September meeting. Attention is now focused on the December meeting, at which the Fed is expected to start gradually tightening monetary policy (this meeting will be held after the cut-off date for this issue). The Bank of England is also expected to hike rates next year. By contrast, the ECB decided at its meeting in December to adopt measures to boost the euro area economy. The measures include a cut in the deposit rate further into negative territory and an extension and other adjustments to its asset purchase programme. The Norwegian central bank and the RBNZ both cut their policy rates because of slackening economic activity. The other monitored central banks kept their rates unchanged. However, the Hungarian central bank informally indicated the possibility of using unconventional tools to ease monetary policy and the Swiss central bank is ready to further intervene in the foreign exchange market. The current Spotlight *examines monetary and macroprudential policy coordination in Norway. In our* Selected Speech*, Stephen S. Poloz, Governor of the Bank of Canada, discusses this topic from the Canadian central bank's perspective.*

1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

Key central banks of the Euro-Atlantic area

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	2%[2]	2%
MP meetings (rate changes)	22 Oct (0.00) 3 Dec (-0.10)[3]	20–21 Sep (0.00) 1–2 Nov (0.00)	9–10 Sep (0.00) 7–8 Oct (0.00) 4–5 Nov (0.00)
Current basic rate	0.05%	0–0.25%	0.50%
Latest inflation	0.0% (Oct 2015)[4]	0.2% (Oct 2015)	-0.1% (Sep 2015)
Expected MP meetings	21 Jan 10 Mar 21 Apr	15–16 Dec[5] 26–27 Jan 15–16 Mar[5]	9–10 Dec 14 Jan[6] 4 Feb
Other expected events	3 Dec: publication of forecast	Feb 2016: publication of Monetary Policy Report	4 Feb: publication of Inflation Report
Expected rate movements[7]	→	↑	→

[1] ECB definition of price stability "below, but close to 2%"; [2] January 2012 definition of inflation target; [3] only the deposit rate was lowered, although it currently determines the path of market exchange rates; [4] flash estimate; [5] meeting associated with summary of FOMC economic forecasts and press conference given by FOMC Chairman; [6] 2016 data may change depending on adoption of bill reducing number of MPC meetings; [7] direction of expected change in rates in next three quarters taken from Consensus Forecast survey.



At its December meeting, the **ECB** cut its deposit rate to -0.30% (and left its repo rate and Lombard rate unchanged) and decided to extend its asset purchase programme (APP) until at least March 2017. It did not change the size of the purchases, but decided to include municipal bonds. Maturing bonds will be rolled over even after the APP ends. The changes were approved by a large majority, but not unanimously. The euro area economy is continuing to pick up gradually. Quarterly GDP growth was 0.3% in Q3 according to the flash estimate. The ECB's December projections foresee GDP increasing by 1.5% in 2015, 1.7% in 2016 and 1.9% in 2017. Inflation is expected to reach 0.1% in 2015. In comparison with the previous forecast, the inflation outlook was revised down slightly to 1.0% in 2016 and 1.6% in 2017.

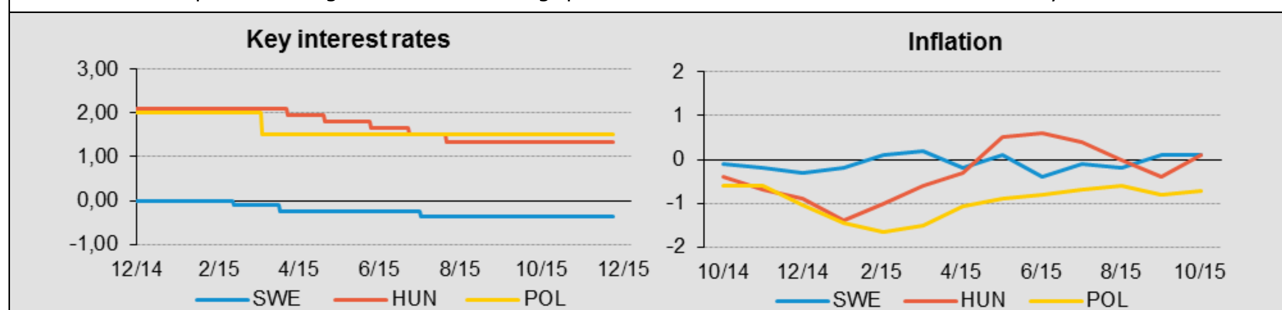
The **Fed** left interest rates unchanged at its meetings in September and October. The target range for the key interest rate therefore remains 0% to 0.25%. The Fed is also continuing to reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities. Maturing Treasury securities are being rolled over. An increase in interest rates is expected in December 2015, partly due to a faster-than-expected rise in the number of jobs and a related drop in the unemployment rate to 5% in October; however, any increase in rates is also conditional on other fundamentals. Quarterly economic growth in the USA – driven mainly by domestic demand – was 2.1% on an annualised basis in Q3 according to a revised estimate (as compared to 3.9% in Q2).

The **BoE** left its key interest rate at 0.50% and maintained the size of its securities holdings at GBP 375 billion. Inflation temporarily turned negative, standing at -0.1% in September. The BoE expects inflation to remain below 1% until the second half of next year. Economic growth slowed slightly (to 2.3% in Q3 according to the flash estimate), but is expected to accelerate gradually until mid-2016.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	27 Oct (0.00)	22 Sep (0.00) 20 Oct (0.00) 17 Nov (0.00)	5–6 Oct (0.00) 3–4 Nov (0.00) 1–2 Dec (0.00)
Current basic rate	-0.35%	1.35%	1.50%
Latest inflation	0.1% (Oct 2015)	0.1% (Oct 2015)	-0.7% (Oct 2015)
Expected MP meetings	14 Dec 10 Feb	15 Dec 26 Jan 23 Feb	13–14 Jan 2–3 Apr 1–2 Mar
Other expected events	15 Dec: publication of Monetary Policy Report	17 Dec: publication of Inflation Report	mid-Mar: publication of Inflation Report
Expected rate movements[1]	→	→	→

[1] Direction of expected change in rates in coming quarter taken from Consensus Forecast survey.



At its October meeting, the **Riksbank** extended its government bond purchase programme by an additional SEK 65 billion with effect from January to June 2016. The purchases will amount to SEK 200 billion in total. The bank left its key interest rate unchanged at -0.35% and deferred the first expected rate hike by approximately six months to 2017 H1. It justified its actions by uncertainty regarding global economic growth and expectations of a long period of low international interest rates. Annual CPIF inflation (i.e. consumer price inflation with a fixed mortgage rate) continued to rise gradually, reaching 1.1% in October. Annual CPI inflation was 0.1%. For 2016, the Riksbank expects CPIF inflation to be slightly lower than in the previous forecast, but still close to 2%. According to its statement, it is ready to further ease monetary policy if the inflation prospects deteriorate.

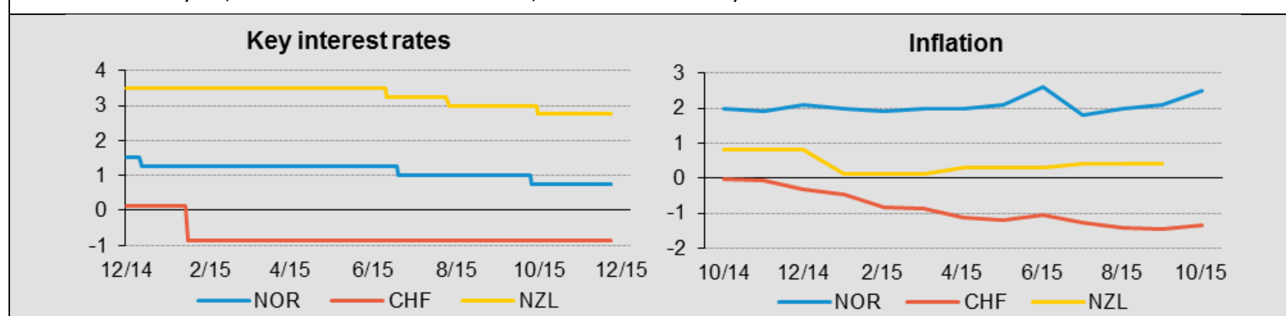
The **MNB** left its interest rate at 1.35% in the last quarter, thus ending the cycle of easing monetary policy by means of interest rates. At the same time, the bank indicated the possibility of using unconventional instruments. Annual GDP growth slowed slightly to 2.7% in Q2. According to preliminary data, it decelerated further to 2.3% in Q3, mainly because of falling external demand. A decrease in government investment, related to a drop in drawdown of EU funds, is expected, but this decline should be offset by the central bank's Growth Supporting Programme (GSP) (see *News* for more details). The MNB expects inflation to remain substantially below the 3% target and not approach it until the second half of 2017.

The **NBP** also kept its interest rate unchanged in the last quarter, at 1.50%. Economic growth continued (reaching 3.5% in Q3), driven mainly by consumption, supported by a robust labour market. Inflation remains negative (-0.7% in October), mainly because of low commodity prices. Inflation expectations are still very low. The NBP expects prices to start increasing slowly in the coming quarters. However, the possibility of a slowdown in emerging markets and the impact this may have on global economic activity, as well as the possibility of commodity prices persisting at low levels, remain sources of uncertainty about the pace of inflation returning to the target.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	0–2%	2%
MP meetings (rate changes)	24 Sep (-0.25) 5 Nov (0.00)	17 Sep (0.00)	10 Sep (-0.25) 29 Oct (0.00)
Current basic rate	0.75%	from -1.25 to -0.25%[1]	2.75%
Latest inflation	2.5% (Oct 2015)	-1.4 % (Oct 2015)	0.4% (2015 Q3)
Expected MP meetings	17 Dec 17 Mar	10 Dec 17 Mar	10 Dec 28 Jan 10 Mar
Other expected events	17 Dec: publication of Monetary Policy Report	16 Dec: publication of Monetary Policy Report	10 Dec: publication of Monetary Policy Statement
Expected rate movements[2]	↓	→	↓

[1] Chart displays centre of band; [2] direction of expected change in rates in coming quarter taken from Consensus Forecast survey or, in the case of New Zealand, from RBNZ survey.



The **NB** cut its interest rate by a further 0.25 pp to 0.75% in September owing to low economic growth. At its November meeting it kept the rate unchanged, as slightly lower-than-projected economic growth was being offset by a weaker-than-projected krone. Unemployment rose, while household consumption and house prices grew at a slower pace than projected by the central bank. Annual inflation was 2.5% in October. The bank expects it to edge down as the effects of the krone depreciation unwind. Monetary and macroprudential policy coordination in Norway is examined in *Spotlight*.

At its September meeting, the **SNB** left the target range for the key monetary policy rate (3M LIBOR) at between -1.25% and -0.25%. The interest rate on sight deposits remained at -0.75%. The SNB said in a statement that it was ready to further intervene as required in the foreign exchange market. According to analysts, a further rate cut in Switzerland is not ruled out given the expected further monetary policy easing by the ECB. The inflation outlook differed very little from the June forecast. Prices are now expected to decrease by 1.2% in 2015 and 0.5% in 2016. Inflation is expected to move back into positive territory at the beginning of 2017. The SNB expects economic activity to increase in the second half of the year, driven mainly by domestic demand. For this year, it expects growth of close to 1%.

The **RBNZ** lowered its key monetary policy rate by 0.25 pp to 2.75% in September and left it unchanged at its meeting in October. However, the bank said in a statement that some further reduction in rates seems likely. The low inflation (0.4% in Q3) is due largely to a combination of earlier strength in the New Zealand dollar and the fall in world oil prices. The RBNZ expects inflation to increase to levels within the tolerance band (1.0%–3.0%) by early 2016 as the effects of these anti-inflationary factors unwind. According to the bank, house price inflation in Auckland continues to pose a financial stability risk; macroprudential restrictions on lending to New Zealand's housing market came into effect in November (see the June CBM).

2. NEWS

MNB again prolongs cheap loans programme and supports lending to SMEs…

The MNB prolonged its Funding for Growth Scheme (FGS) supporting lending to small and medium-sized enterprises by one year. The scheme was launched in April 2013 and its final, phase-out stage will end in December 2016. During this final stage, the MNB will provide refinancing for credit institutions of HUF 600 billion, in equal amounts for loans in domestic currency and for foreign exchange loans.

Simultaneously with the phasing out of the FGS programme, the MNB announced a Growth Supporting Programme (GSP) designed to help domestic banks return to market-based financing in order to reduce risks of low lending activity and a slowdown in economic growth. Banks participating in the GSP will have to increase the stock of lending to SMEs by a given percentage in order to access the Market-Based Lending Scheme (MLS). Under this scheme, the MNB will supplement its instruments with an interest rate swap (of up to HUF 1,000 billion) and a preferential deposit facility (of up to HUF 500 billion) and is expected to lower its capital adequacy requirement.

…introduces Systemic Risk Buffer as from 2017…

The MNB decided to introduce a Systemic Risk Buffer (SRB) in January 2017. Credit institutions with a higher-than-allowed ratio of non-performing project loans in 2016 Q4 will be required to comply with the SRB. The SRB will be applied individually, between 0% and 2% of total domestic risk-weighted assets. According to the MNB, problem project loans, which currently total more than HUF 700 billion, pose a key financial stability risk.

…and buys Budapest Stock Exchange

The MNB bought a majority stake in the Budapest Stock Exchange (BSE) from two Austrian entities in November. The Hungarian stock exchange is therefore now effectively under state control. As the controlling owner of the BSE, the MNB plans to implement several unspecified strategic innovations to further the development of the currently underdeveloped Hungarian capital market. The transaction is another step towards increased state control of the Hungarian economy.

Riksbank criticises state proposal for amortisation requirement

The Riksbank published critical comments on the Swedish Ministry of Finance's proposal for a new legal provision introducing an amortisation requirement. The proposal is due to come into force in May 2016 and introduces obligatory payment of the value of a mortgage of 2% per year until 30% of the loan is repaid and then at least 1% until the 50% level is reached. According to the Riksbank, the proposal is a welcome step towards reducing the risks linked to the high levels of household debt in Sweden, risks that the bank has highlighted on several occasions, but the proposal does not go far enough (it only affects new mortgages, for example). The Riksbank also opposes the proposal that the Swedish Financial Supervisory Authority (Finansinspektionen, FSA) would need to obtain the consent of the government before being able to adopt the requirement, as this would effectively reduce the level of independence of the FSA. It also opposes an exemption for newly-built homes and too broad scope for banks to grant exemptions. At the end of October, the Swedish Administrative Court of Appeal rejected the proposal for the second time, this time because it does not think the FSA should be given the right to impose such measures on individual households.

ECB publishes principles for Executive Board members' communication with public...

In reaction to the inadvertent disclosure of market-sensitive information to a closed-door meeting of investors before it was released to the public (see the June CBM), and as affirmation of its transparency, the ECB in October published the existing guiding principles followed by its Executive Board (EB) members when communicating with private, academic or civil society representatives. These principles are based on three pillars: (i) no potentially market-sensitive information may be available to a selected audience before it is available to the widest possible public audience, (ii) no market-sensitive information may be divulged at non-public events or bilateral meetings, and (iii) a "quiet period" regarding speeches and public appearances should be observed for seven days prior to each scheduled monetary policy meeting; this principle was expanded before the most recent monetary policy meeting and now covers all meetings.

...and will publish EB members' meeting calendars

To increase its transparency, the ECB will in February 2016 start publishing the meeting calendars of all its EB members, including the President. The calendars will be released with a three-month lag. According to the Financial Times, which obtained the calendars for the last year from the ECB, EB members met frequently with members of the private sector days, or even hours, before monetary policy meetings.

Riskbank deputy governor suggests improvements to inflation targeting

In his December speech, Riksbank deputy governor Per Janssen proposed two changes to the implementation of inflation targeting in Sweden: (1) targeting a new measure of inflation from currently used CPI inflation, which in Sweden (in contrast to other countries) includes interest payments made by home owners with mortgages, and therefore immediately moves in the same direction as changed interest rates, which may create an impression of monetary policy failings; it also has a tendency to extreme and long-term fluctuations. Jansson proposes to target the CPIF inflation (i.e. CPI with a fixed interest rate) or HICP inflation used in the Eurozone. (2) reintroducing the tolerance band around the inflation target, together with obligatory publishing of a short explanatory report in case of deviation of inflation from this band. The aim of both proposed changes is basically improving the credibility of the central bank's monetary policy and reinforcing confidence in the inflation target that may be undermined by its long-time undershooting.

Swedish parliament to discuss Riksbank evaluation

Given the long-term undershooting of the inflation target in Sweden, the parliamentary committee overseeing the Riksbank formed a discussion panel to evaluate the bank's monetary policy. The panel does not have the objective of changing the Riksbank's monetary policy (some suggestions have been made, including lowering the inflation target, reintroducing a tolerance band or operating with a dual monetary policy mandate, but these would represent interference with the central bank's independence and the chairman of the committee has brushed them aside). The discussion should lead to better evaluation of the Riksbank's monetary policy in the current economic environment.

RBNZ publishes article on evaluating monetary policy

The RBNZ published an article "Evaluating monetary policy" in which it argues that monetary policy should not be evaluated solely on the basis of actual inflation, which can temporarily deviate from its medium-term target. Monetary policy should be evaluated in two steps,

ex ante and ex post. Ex-ante evaluation should be based on comparing the monetary policy decision and inflation forecast with relevant information available at the time. Ex-post evaluation should examine how the bank responded to new information and forecast errors and whether it communicated the developments effectively and therefore maintained the credibility of the monetary policy framework. The publication relates to the New Zealand legislation, but its principles are valid for inflation targeting in general.

Review of BoE's forecasting performance published

The Independent Evaluation Office (IEO), formed in September 2014 to help the BoE's Court of Directors better evaluate the bank, in November published a report evaluating the BoE's forecast performance. The report uses statistical methods to test the accuracy and bias of the forecasts and the systematic use of all available information. In its response to the review, the BoE's Monetary Policy Committee (MPC) says it plans to introduce the following steps based on the IEO's recommendations: (i) expand its suite of statistical models used for forecasting, (ii) engage more with other experts in the field, especially when expanding the range of models, (iii) undertake a more systematic statistical monitoring of the performance of the MPC's central projections and more systematically assess outturns relative to the MPC's fan charts, (iv) encourage economic experts to challenge the forecasts, and (v) provide more support for non-MPC internal users of the forecasts, including guidance on the level of oversight of forecast variables.

BIS has new chairman and vice-chairman

Jens Weidmann, President of the Deutsche Bundesbank, was elected Chairman of the Bank for International Settlements (BIS) by its Board of Directors. His term is for a period of three years, commencing on 1 November. He succeeds Christian Noyer, who retired as Governor of the Bank of France at the end of October. Raghuram Rajan, Governor of the Reserve Bank of India, was appointed Vice-Chairman on 10 November.

IMF decides to include Chinese renminbi in SDR basket

The IMF decided to include the Chinese renminbi in the basket of currencies on which the value of its reserve asset, the Special Drawing Right (SDR), is based. The decision resulted from the regular review of the SDR basket, which this time was focused on whether the Chinese renminbi met the existing criteria to be included in the basket. As from October 2016, the Chinese currency will be included in the basket as a fifth currency alongside the US dollar, the euro, the Japanese yen and the British pound.

3. SPOTLIGHT: COORDINATION OF MONETARY AND MACROPRUDENTIAL POLICY, NORWEGIAN STYLE

The global financial crisis showed that maintaining low and stable inflation is not sufficient to prevent the emergence of imbalances in the financial system and risks to macro-financial stability. The susceptibility of financial systems to excessive risk-taking in certain phases of the business cycle was also revealed in full. This experience is reflected in the mandate and instruments of macroprudential policy, in the pursuit of monetary policy and in the coordination of these two policies. This article examines the coordination of monetary and macroprudential policy in different phases of the business and financial cycle using the example of the Norwegian economy.

Introduction

Divergence of business and financial cycles[1] affects monetary and macroprudential policy coordination. The instruments of these two policies affect the price and availability of loans and thus credit growth in the economy. Systemic risk increases in the upward phase of the financial cycle as financial institutions create growing and correlated exposures (e.g. mortgage loans) sensitive to the same macroeconomic factors. If the economy subsequently slides into recession or other macroeconomic factors leading to default materialise, those correlated exposures may intensify the default and cause higher losses, which, moreover, tend to be only partly covered by provisions. At that moment, the riskiness of loans manifests itself in full.

If the effects of monetary and macroprudential policy are unidirectional, they can be mutually reinforcing. A more difficult situation arises for central banks if a monetary policy target is being enforced against macroprudential policy targets. This is the case in some inflation-targeting economies in the current macroeconomic conditions – there is a sustained economic recovery, but inflation pressures are very weak, inflation is below target and the economy is operating in an environment of very low nominal interest rates, which cannot be raised if the inflation target is to be hit. In these conditions, commercial banks perceive the risks as generally low and ease their credit conditions. If there is sufficient demand among customers, who also perceive the risks as low on average, credit growth rises. This is associated with growth in prices of assets (which simultaneously serve as loan collateral) followed by further growth in loans to finance asset purchases and further growth in asset prices until the situation becomes unsustainable. Once the true size of the (previously thought to be low) risk is perceived, asset prices (e.g. house prices) correct sharply. This leads to a fall in collateral value, a rise in the default rate and financial losses. In order to preventively reduce the risk of excessive credit and asset price growth, it is appropriate to use prudential policy instruments in the expansion phase of the financial cycle.

Monetary and macroprudential policy coordination can be illustrated on the example of Norges Bank and the steps it has taken in recent years. Norges Bank has been implementing monetary policy through flexible inflation targeting since 2001, i.e. it has been taking into account both inflation and output and employment in its decisions relating to ensuring low and stable inflation. Unlike in other banks (such as the Czech National Bank and the Riksbank), the inflation target is set by the Norwegian government (at 2.5%). The main monetary policy instrument is the interest rate, which can be changed every six weeks depending on the situation in the real economy. Interventions in foreign exchange markets, i.e. purchases (sales) of foreign currency to weaken (strengthen) the Norwegian krone, can also be employed to ease (tighten) monetary conditions.

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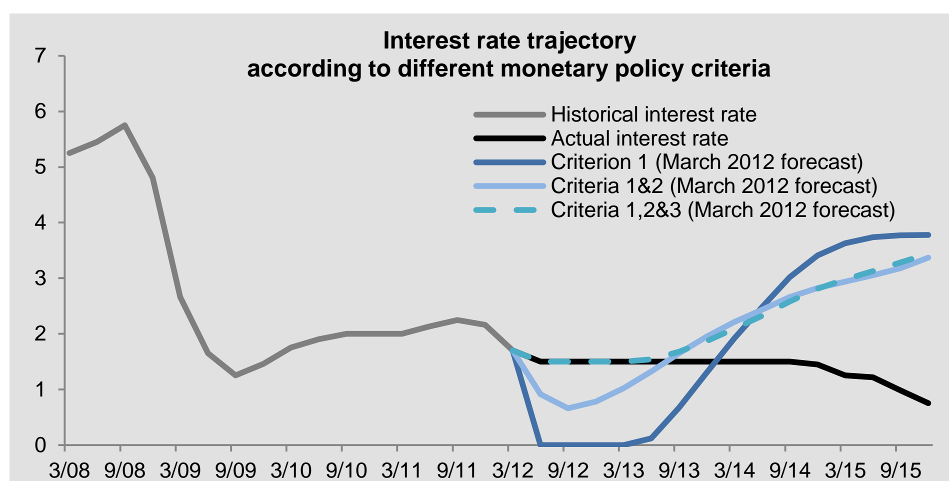
[1] The CNB defines the financial cycle as recurrent swings in the ability of market participants to recognise financial risk.

Norges Bank is additionally responsible for financial stability. In the case of macroprudential policy, it uses a combination of instruments aimed specifically at increasing the resilience of the banking sector and the financial system as a whole. The aim of both macro- and micro-prudential policy is to limit growth and materialisation of macro- and micro-financial risks.

Monetary and macroprudential policy coordination by Norges Bank

In March 2012, Norges Bank outlined three possible paths for the policy rate in the forecast scenario when taking account of different monetary policy objectives. If monetary policy gave weight only to hitting the inflation target (Criterion 1), the Taylor rule would imply a near-zero policy rate for some time. If the Norwegian central bank chose the optimal policy for both price stability and the real economy (taking into account the output gap and employment), the rate would be higher than in the previous case (Criteria 1&2). If interest rate considerations took into account not only price stability and the real economy, but also financial stability in the form of reducing the risks of financial imbalances, the rate would reach its highest level (Criteria 1,2&3). The actual policy rate path shows that Norges Bank took the macroprudential policy objective into account and followed this path for some time. This was confirmed by Governor Olsen in a speech given in April 2015 (here), in which he said that "the key policy rate in Norway has in recent years been kept slightly higher than implied by medium-term outlook for inflation and output, in order to mitigate the risk of a build-up of financial imbalances".



Note: March 2012 forecast. Source: Norges Bank

However, a deteriorating macroeconomic situation led to divergence from the above interest rate path and to a series of interest rate cuts starting in 2014. The Norwegian authorities thus responded to the risks to financial stability with macroprudential instruments (see the next section). Specifically, a sharp fall in oil prices in 2014 affected the price and growth prospects of the Norwegian economy. Norges Bank lowered the key policy rate by 0.25 pp to 1.25% in December 2014. At the time, the Norwegian economy was grappling with high household debt and rising house prices, but the macroeconomic situation took precedence over the growing macro-financial risks when it came to setting the interest rate for monetary policy purposes (household debt exceeded 200% of disposable income and is continuing to outpace it; house prices, which have long been rising, slowed but did not fall during the financial crisis and accelerated further, especially in cities, as monetary policy started to be eased in 2014[2]).

[2] The house price growth in cities is due to several demand-side factors: i) growing urbanisation, i.e. migration from towns and villages to cities; ii) immigration, especially from new EU countries (Poland and Lithuania) and non-EU countries. It is also due to the fact that Norway has a high percentage of property owners (most Norwegians buy their first home at around 30 years of age), who also enjoy tax breaks; people also like to invest in property at a time of low rates. The property supply side is sticky for administrative and time reasons; urban development is constrained by

Faced with a similar economic outlook as in December 2014, Norges Bank did not lower the key policy rate at its next meeting in March 2015. However, when communicating its decision, the bank admitted that the rate would be reduced in the period ahead, adding that monetary policy cannot take primary responsibility for financial stability and that prudential instruments, i.e. more effective instruments for reducing macro- (micro-)financial risks, should be used to curb growth in loans and property prices. At the time, the countercyclical capital buffer rate[3] was left unchanged at 1%, but the central bank recommended considering increasing it in summer 2016 (i.e. announcing a change in summer 2015) if house prices continued to rise. The buffer rate was increased from 1% to 1.5% in June.[4] The key policy rate was lowered in June and again in September to its current level of 0.75% in response to a further deterioration of the macroeconomic situation, despite the pro-growth effect of the depreciation of the Norwegian krone since the end of 2014.

According to Norges Bank's current (September) forecast, the outlook for the coming year suggests the key policy rate may be reduced further, even though this may fuel property price inflation and private sector debt growth. It seems that the effort to prevent an economic downturn via easier monetary conditions will not be affected by perceptions of current macro-financial risks.

Macroprudential measures taken by Norwegian central authorities

A wide range of instruments have been created and implemented for prudential policy purposes over the last few years and especially in response to the financial crisis. Since the Norwegian economy is facing substantial growth in property prices and property-backed loans, Norges Bank and the Ministry of Finance have deemed it appropriate to introduce selected macroprudential instruments, in particular a countercyclical capital buffer, an LTV limit and stricter rules for the calculation of risk weights.

The countercyclical capital buffer is one of the pillars of the new European-wide system of capital regulation. The objective of the buffer is to bolster the financial system's resilience to risks associated with strong swings in lending. Banks create this buffer on the orders of the regulatory authority at times of excessive credit growth, when systemic risk is built up. The buffer – created in a forward-looking manner – will be used by banks to cover losses at times of economic downturn accompanied by heightened financial tensions and rising loan losses. This will mitigate the credit crunch and reduce the reverse transmission of shocks from the financial sector to the real economy. This instrument was introduced in Norway and other European countries such as Sweden (1.5%) and Denmark (0%) as a consequence of the Basel III regulatory framework and its implementation via CRD IV.[5]

This capital buffer has been an important macroprudential policy instrument in Norway since December 2013, when its implementation was approved by the Norwegian parliament. The fact that it has been set at a non-zero level is due to increased credit growth in the economy and a regular assessment of the situation by the central bank.[6] The introduction of the buffer

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a lack of space for new builds (for example in Oslo and surroundings) and by regulations regarding the use of land, which lay down, for example, minimum plot sizes and standards for dwellings.

[3] A key macroprudential policy instrument in Norway, through which commercial banks create a capital buffer in times of economic prosperity and use it to cover losses in times of economic downturn. The size of the buffer is approved by the Norwegian Ministry of Finance on the recommendation of the central bank, which works in close cooperation with the supervisory authority (Finanstilsynet).

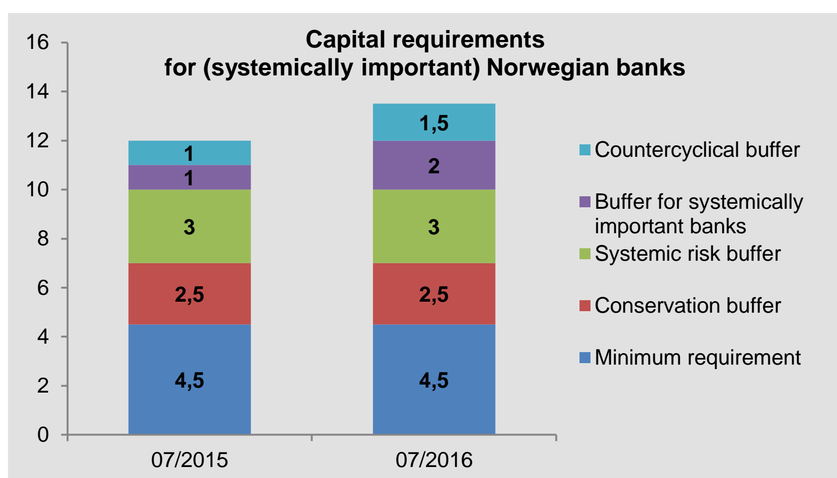
[4] Although the requirement to create this buffer does not come into effect until one year after the buffer rate is increased, banks adjust their strategies during this one-year period.

[5] This legislation applies to Norway even though it is not an EU Member State, as it is bound by the EEA Agreement.

[6] Norges Bank assesses the loan-to-GDP ratio, the ratio of house prices to disposable income, real commercial property prices and the ratio of wholesale funding to banks' total assets. The advice on the level of the buffer is issued

was preceded by the publication in March 2013 of a *Monetary Policy Report with Financial Stability Assessment* containing information on the buffer-setting and buffer-assessment procedures. All subsequent Monetary Policy Reports contain an extensive assessment of financial stability and present conclusions in an executive summary. These steps confirmed Norges Bank's interest in extending the flexible inflation-targeting framework to include maintenance of financial stability. A whole range of other measures were subsequently adopted and implemented in an effort to increase and enhance the capital of banks amid a wave of increases in capital requirements.

In 2014, the capital requirements were raised and capital buffers (filled with Common Equity Tier 1) were created, again under Basel III/CRD IV. Norway is currently using a minimum requirement of 4.5% and a conservation buffer of 2.5% of total risk exposure. It has also introduced a systemic risk buffer (to suppress systemic risk stemming from potential destabilisation of relevant banks) of 3% of total exposure and a buffer of 2% created by systemically important institutions for potential losses (on 1 July 2016; currently, i.e. in the first year, the buffer rate is 1% and applies to three banks – DNB ASA, Nordea Bank Norge ASA and Kommunalbanken AS[7]). The aim of this buffer is to mitigate risks arising from undesirable motivation of financial institutions and moral hazard. Overall, Norwegian banks are well capitalised, as in recent years they have increased their capital (CET1) via profits and simultaneously reduced their risk-weighted assets.[8]



Source: Norwegian Ministry of Finance and Norges Bank

LTV limits have been used since March 2015 to correct credit growth and property price inflation. These significantly limit the provision of loans exceeding 85% of the property value.[9] These limits were introduced earlier but have been tightened in response to sharp growth in loans and property prices. The rules for the calculation of bank-level risk weights attaching to risks associated with residential mortgage loans have also been tightened. Liquidity is also regulated by new EU legislation applying to Norway. The aim of the liquidity coverage ratio (LCR) is to ensure that a bank holds enough liquid assets to cover its needs for 30 days (this requirement takes effect on 1 January 2018 and is currently being phased in).

four times a year. The start of the creation of the buffer is announced 12 months ahead. Cancellation may be immediate. The buffer rate fluctuates in the range of 0%–2.5% of risk-weighted assets and applies to all banks operating in Norway.

[7] This bank is wholly owned by the state and grants loans to the municipal sector.

[8] Winje, H. and L. T. Turtveit (2014): "Norwegian banks' adjustment to higher capital requirements", Staff Memo 14/2014, Norges Bank.

[9] These limits may be exceeded to a limited extent, but further collateral is required.

4. SELECTED SPEECH: INTEGRATING FINANCIAL STABILITY INTO MONETARY POLICY

Stephen S. Poloz, Governor of the Bank of Canada, gave a speech at the Institute of International Finance Annual Membership Meeting in Lima in October 2015, in which he described how the Bank of Canada integrates financial stability into monetary policy.

The debate about using monetary policy to respond to financial imbalances has evolved rapidly since the pre-crisis era. Before the crisis, the Bank of Canada (BoC) straddled two camps, one arguing that monetary authorities should lean against imbalances such as asset-price bubbles, and the second saying that monetary policy should be reserved for cleaning up the mess after the bubble popped. The BoC argued that it is very difficult to identify an asset-price bubble and questioned the wisdom of using the blunt instrument of interest rates, which could end up causing the very economic damage it was trying to prevent. On the other hand, the BoC recognised that price stability was a necessary, but not sufficient, condition for financial stability. The BoC's decision to begin publishing its *Financial System Review* in 2002 showed its early commitment to promoting financial stability. According to Poloz, central banks have to cope with tremendous uncertainty regarding financial stability issues, and this is layered on top of the regular uncertainties of monetary policy concerning unobservable variables. Poloz believes that the proper response of the monetary authority is to acknowledge and accept all the things it does not know, gauge the risks facing the economy as best it can, and manage those risks as it conducts monetary policy. The BoC's view is that monetary policy should be the last line of defence against threats to financial stability.

Borrowers and lenders are the first line of defence, as they bear the ultimate responsibility for their own decisions. It is not the role of monetary policy to protect individuals from making bad choices. However, efforts to improve financial literacy can help consumers better understand the important decisions they make. The second line of defence is sound regulatory oversight of the financial sector. Basel III entails an ambitious task to implement a financial reform package consistently across jurisdictions while not impeding the ability of financial institutions to innovate and foster economic growth. Nonetheless, Basel III cannot prevent the formation of all financial imbalances, such as those in housing markets.

Macroprudential policy is the third line of defence. It has a relatively short history and there is not a lot of empirical evidence yet. But one set of tools that has been used more frequently and studied more extensively consists of those that deal with housing. Studies conducted by the IMF and several central banks (including the BoC) show that some macroprudential policies can moderate the growth of credit and house prices and improve the average creditworthiness of borrowers. If one accepts that properly implemented macroprudential policies can help strengthen resilience in the financial system and reduce systemic risk, authorities should look to these policies first when imbalances arise, before turning to monetary policy.

The last line of defence against threats to financial stability is monetary policy, in particular leaning against imbalances. Poloz defines this as choosing a different path for interest rates than would be optimal for the inflation target. However, the situation is complicated by the fact that macroeconomic and financial objectives are not always consistent, so it is necessary to deepen the understanding of their links and potential trade-offs. BoC officials choose their policy tactics so that their actions do not significantly worsen financial stability concerns by opting for a policy path that aims to return inflation to target over a longer time frame than normal. The BoC acted in this way even during the recent fall in oil prices. According to Poloz, the BoC will continue to use the flexibility in its inflation targeting framework as needed to integrate financial stability concerns into the conduct of monetary policy, while always keeping inflation control as its primary mission.

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