Ida Wolden Bache: Policy rate kept on hold

Introductory statement by Ms Ida Wolden Bache, Governor of Norges Bank (Central Bank of Norway), at the press conference following Norway's announcement of the policy rate, Oslo, 20 June 2024.

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presentation accompanying the speech

Chart: Policy rate kept unchanged at 4.5 percent

The Monetary Policy and Financial Stability Committee decided to keep the policy rate unchanged at 4.5 percent.

Norges Bank is tasked with keeping inflation low and stable. The operational target is inflation of close to 2 percent over time. We are also mandated to help keep employment as high as possible and to promote economic stability.

We have raised the policy rate significantly in recent years in order to tackle high inflation. The economy has cooled and inflation has slowed. But we still have a way to go. Inflation is higher than our target, and the rapid rise in business costs will likely contribute to keeping inflation elevated ahead. It is, therefore, our judgement that there is a need to keep the policy rate at today's level for some time and somewhat longer than we had envisaged earlier.

Let me say a little more about the background for the rate decision and the Committee's assessments.

Chart: International inflation has slowed sharply

International price inflation has slowed markedly since the peak in 2022, and inflation in the euro area and Sweden is now below 3 percent. Goods inflation is low, while services inflation remains elevated in a number of countries.

In Sweden and the euro area, central bank interest rates have been lowered recently, while there are expectations that central banks in the US and the UK will start cutting rates later this year. Compared with March, when we last presented projections, the market expects fewer rate cuts this year. Norwegian policy rate expectations have also risen slightly.

The interest rate differential between Norway and other countries influences the krone exchange rate. We do not have a policy target for the krone exchange rate, but we are concerned with the krone exchange rate because it affects the outlook for the Norwegian economy. The krone has depreciated over the past couple of years. A weaker krone means an increase in imported goods prices. The past krone depreciation is still contributing to keeping inflation elevated. Since March, the krone has strengthened a little.

Chart: Low growth in the Norwegian economy

The Norwegian economy gradually cooled through 2023, and growth has remained low so far this year. But Norges Bank's Regional Network enterprises are a little more optimistic than they were earlier this year and expect some increase in activity ahead. There are still wide differences across industries. Companies supplying goods and services to the petroleum industry are still doing well. In the construction industry, activity is low and companies expect a further decline ahead. Sales of new homes are sluggish, but activity in the secondary home market is high and prices have risen markedly so far this year.

Labour market tightness has eased in recent years, as have recruitment difficulties facing businesses. Registered unemployment has increased somewhat from a very low level. At the same time, employment has continued to edge up and the employment-to-population ratio is high.

Chart: Wage growth is high

Wage growth has risen over several years. While pay increases have been high, they have not kept pace with the rise in prices. We expect wage growth to reach 5.2 percent this year, which is the same rate as last year.

Chart: Inflation has slowed, but is still above target

Inflation has fallen markedly since the end of 2022. In May, consumer prices were 3 percent higher than one year ago. Excluding energy prices, which have decreased, inflation is around 4 percent.

In Norway, like in other trading partner countries, goods inflation has fallen sharply, particularly imported goods inflation. Services inflation is still elevated, partly owing to the sharp rise in labour costs in recent years. With modest growth in productivity, higher pay increases mean that businesses are facing higher costs. This could contribute to keeping inflation elevated ahead.

Chart: The policy rate will probably be kept unchanged for some time

In order to bring inflation back to target within a reasonable time horizon, it will likely be necessary to maintain a tight monetary policy stance for somewhat longer than envisaged earlier. In recent months, inflation has been a little lower than expected. At the same time, the economy appears to be performing slightly better than we had expected, and wages appear to be rising faster. Both developments indicate that it will take longer to bring inflation back to target. If the policy rate is lowered prematurely, inflation could remain above target for too long.

If the economy evolves as we currently envisage, we will keep the policy rate at 4.5 percent to the end of the year before a gradual easing of monetary policy can begin. Towards the end of the projection period, the policy rate will be close to what we now assess to be a neutral range somewhat further out. The mortgage interest rate is projected to decline to just above 4 percent. Even though there is substantial uncertainty about the future level of the neutral rate of interest, we must be prepared for a higher interest rate level than we had been accustomed to over the past decade.

Chart: Inflation will slow and unemployment will increase somewhat

Given the current policy rate path, we expect inflation to slow further and approach 2 percent towards the end of 2027. Growth in the Norwegian economy is expected to pick up slightly in the years ahead, but we expect some increase in unemployment. The decline in some business sectors, especially the construction industry, may continue for a while longer before conditions turn around.

Many consumers have less money to spend, which has made it difficult for some people to make ends meet. Interest expenses are set to remain high, but wages are expected to rise faster than prices. Most households will then see their spending power increase and a debt burden that will be easier to bear.

The economy may move on a different path than we now envisage, and the policy rate path may then also change. The policy rate is now likely sufficiently high to bring inflation back to target within a reasonable time horizon. But we cannot say this with certainty. If capacity utilisation increases or the krone depreciates, wage and price inflation could remain elevated for longer. In that case, there may be a need to raise the policy rate. On the other hand, if unemployment rises more than expected or price inflation declines more rapidly, the policy rate may be lowered earlier than we now envisage.

Inflation has come down. This is good news. But we must keep in mind that the last mile of disinflation may take time. To maintain confidence in the inflation target, we must do our job and bring inflation back to the 2 percent target. We will then be able to reap the benefits of our efforts.