Ida Wolden Bache: Need to keep the interest rate high

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, 15 August 2024.

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Presentation accompanying the speech

A very good morning to you all and thank you very much for the opportunity to present our interest rate decision here in Arendal, in these beautiful premises.

Chart 1: Policy rate kept unchanged at 4.5 percent

Norges Bank's Monetary Policy and Financial Stability Committee has decided to keep the key policy rate unchanged at 4.5 percent. The policy rate will likely be kept at that level for some time ahead.

Since the inflation surge a couple of years ago, we have raised the policy rate significantly, and since December last year the policy rate has been held at 4.5 percent. Borrowers have faced a sharp rise in interest expenses, on top of a rise in most prices. Many people have experienced tighter household budgets. But the interest rate increases have contributed to reducing inflation. This is a very welcome development. There are now prospects that wages will rise more than prices, and that most people will see an improvement in their financial position.

Let me say a few words about the assessments we made at this monetary policy meeting. We have not made new forecasts but have assessed new information about economic developments against the forecast in the June 2024 *Monetary Policy Report*.

Chart 2: Inflation has slowed considerably

Inflation ran at 7.5 percent in autumn 2022. Since then, inflation has slowed considerably, and last week incoming data showed an inflation rate of 2.8 percent in July this year. Excluding energy prices, which fluctuate widely, inflation was 3.3 percent in July, which was lower than we projected in June. The fall in imported goods inflation was particularly pronounced in recent months.

Chart 3: Unemployment has edged up

The Norwegian economy gradually cooled down through last year, and growth has since remained subdued. Higher living costs have reduced household consumption. Residential construction is at a low level, but in recent months new home sales have picked up a little. Activity in the secondary housing market has remained strong, and prices have risen a bit over the past year.

A high proportion of the population is employed, but unemployment has edged up from its low point two years ago. The number of unemployed is a little higher than expected in June.

Chart 4: International inflation has slowed

In other countries, central banks have also raised their policy rates significantly to curb inflation, and inflation has slowed considerably since the peak. The decline in inflation has prompted some central banks to start cutting interest rates.

Over summer, there have been wide fluctuations in international financial markets. The Japanese yen strengthened and equity indexes fell sharply after the Japanese central bank raised its policy rate. The turmoil intensified after the publication of weaker-than-expected US labour market data. Interest rates and broad equity indexes declined. Since then, the market turbulence has subsided. Global interest rates are nevertheless lower than in June, and market participants now expect more and faster rate cuts among our trading partners than before summer. Market interest rates have also fallen in Norway, but not to the same extent as abroad.

Chart 5: The krone has depreciated

At the same time, the krone has depreciated. Many Norwegian holidaymakers abroad experienced a surprisingly expensive summer holiday due to a weaker Norwegian krone against the euro, US dollar and British pound. Norwegian students abroad have noticed that their student loans do not stretch as far as before.

Measured by the import-weighted index, I-44, the krone has depreciated by around 3 percent since the previous monetary policy meeting. A weaker krone means an increase in the price of imported goods and services, and an increase in costs facing firms that rely on imported intermediate goods. At the same time, the Norwegian export sector's profitability increases. This could lead to higher wage growth, which in turn may result in higher inflation.

Many people ask why the krone is not stronger. There is no absolute answer to that question, but let me share some thoughts on the matter.

Chart 6: The Norwegian krone has primarily depreciated against the euro and the US dollar

The krone exchange rate is the price of other countries' currencies measured in Norwegian krone terms. Movements in the krone exchange rate are determined by a wide range of factors – both domestic and international. The krone has primarily depreciated against currencies such as the euro and the US dollar in recent years. It has depreciated less against smaller currencies like the Swedish krona. In other words, to find the reasons for the depreciation, we have to look beyond solely domestic conditions.

The krone exchange rate against the US dollar is influenced, for example, by global demand for Norwegian salmon or Norwegian oil company stocks but is also driven by global demand for US streaming services or technology stocks. Economic agents' preferences, whether relating to investments or goods and services, are in their turn shaped by a wide range of factors. It is therefore challenging to explain all exchange rate movements, as is also supported by a large body of research.

But we do know something. We know that the difference between Norwegian and foreign market interest rates matters for the krone exchange rate. Normally, the krone appreciates when this interest rate differential increases. If the Norwegian policy rate had not been increased in recent years, the krone exchange rate would have been weaker.

The krone exchange rate is also influenced by more long-term trends, both at home and abroad. Studies indicate, for example, that the development of the Norwegian petroleum sector, combined with high oil prices, contributed to strengthening the krone over a longer period. Over the past decade, the fall in oil prices and the oil industry's diminished importance for the Norwegian economy may have contributed to weakening the krone.

The krone exchange rate is also influenced by conditions in international financial markets. A substantial portion of trading in Norwegian kroner is between financial players such as banks and hedge funds. Some of the trades may be disconnected from the conventional economic mechanisms I just invoked. Experience shows that financial market turbulence, like we saw this summer, often coincides with a depreciation of the krone against major currencies.

In recent weeks, some observers have argued that Norges Bank should do more to strengthen the krone. Some have suggested that the central bank should be given more instruments and should intervene in the foreign exchange market by buying kroner to influence the exchange rate.

Norges Bank is tasked with keeping inflation low and stable while contributing to keeping employment as high as possible. It is our view that we have sufficient tools to deliver on the mandate we have been given. The policy rate is our most important monetary policy tool, and based on our current assessment of the outlook, inflation will return to target within a reasonable time horizon without a large increase in unemployment.

We do have large foreign exchange reserves. The foreign exchange reserves are Norges Bank's own stock of foreign currency that it holds for contingency purposes. We can intervene in the FX market by buying or selling kroner, for example to ensure the functioning of the NOK FX market as we did during the pandemic when the market seized up. The threshold for intervening in the FX market with the aim of influencing the krone exchange rate is very high. The effects of such intervention are uncertain. Research and international experience indicate that the effects are at best small and short-lived, a likely reason being that intervention cannot in the long run counter other economic forces driving exchange rates. There is also a risk that the use of intervention may raise doubts about the objectives of monetary policy.

With a floating exchange rate, as we have in Norway, we must accept that the krone exchange rate fluctuates. This imposes some costs on both businesses and households. The exchange rate may at times move in an undesirable direction. Exchange rate movements may make monetary policy trade-offs more challenging. But a floating exchange rate also offers some clear advantages. It provides leeway to set the interest rate based on the outlook for the Norwegian economy. A floating exchange rate can act, and has acted, as a buffer against downturns and can facilitate structural changes in the economy. This can also be of good use in the future.

Chart 7: The policy rate will likely be held at today's level for some time

When we set the policy rate, we must weigh different considerations against each other. If we lower the policy rate prematurely, inflation could remain above target for too long. On the other hand, an overly tight monetary policy could restrain the economy more than needed.

Inflation has slowed considerably. So, why do we still judge it appropriate to keep the interest rate high?

Inflation is still above target, and some factors could contribute to keeping inflation elevated ahead. One factor is the krone depreciation. The other is the sharp rise in wages in recent years. The wage increases have not been large compared with the increase in living costs. But, with modest productivity growth, wage increases result in higher business costs. This will likely slow further disinflation.

There is uncertainty about future economic developments. In its interest rate deliberations, the Committee was particularly concerned with developments in the krone exchange rate and the potential implications for inflation. If there are prospects that inflation will remain elevated longer than previously projected, the policy rate may be set higher. If there is a more pronounced slowdown in the economy or prospects suggest that inflation will return to target faster than projected in June, the policy rate may be lowered earlier than previously envisaged.

It is important that we go the last mile of disinflation. Doing our job of ensuring that inflation returns to the 2 percent target is critical to maintaining the credibility of the inflation target. By doing so, we will be able to reap the benefits of our efforts.