Ida Wolden Bache: Time to ease monetary policy is approaching

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, 19 September 2024.

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Presentation accompanying the speech

Chart 1: Policy rate held unchanged

The Monetary Policy and Financial Stability Committee decided to keep the policy rate unchanged at 4.5%. Based on the Committee's current assessment of the outlook, the policy rate will most likely be kept at that level to the end of the year.

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.

After inflation surged 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. The interest rate has contributed to cooling down the economy and to dampening inflation.

Many central banks in trading partner countries have started cutting policy rates. One might wonder why we are not reducing the policy rate now.

Inflation has declined significantly from its peak but is still above our inflation target. The rapid decline in inflation observed in recent months is not expected to continue going forward. Further disinflation will be restrained by the krone depreciation combined with the high growth in business costs.

A restrictive monetary policy is still needed to bring inflation down to target within a reasonable time horizon. The Committee is concerned with the possibility that if the policy rate is lowered prematurely, inflation could remain above target for too long. On the other hand, an overly tight monetary policy could contract the economy more than needed. When we set the policy rate, we have to balance these trade-offs.

Chart 2: Gradual policy rate reduction from next year

Based on our current assessment of the outlook, the policy rate needs to be kept at today's level for a period ahead. At the same time, we are approaching the time to lower interest rates. If the economy evolves as envisaged, we will maintain the policy rate at 4.5 percent to the end of the year, before it is gradually reduced from the first quarter of next year. The policy rate forecast is little changed but implies a slightly faster rate reduction through next year than our previous forecast published in June.

Let me say a few more words about the background for the rate decision and the Committee's assessment.

Chart 3: Low growth in the Norwegian economy

Growth in the Norwegian economy was low through last year and has remained weak this year. High inflation and the rise in interest rates have reduced household purchasing power and consumption, and residential construction has shown a sharp decline. Economic activity is being supported by public sector demand and heavy investment in the petroleum industry.

Information from our regional network indicates that economic growth will pick up a little in the second half of this year. But there are wide differences across industries, with oil services expecting strong growth and the construction industry a continued decline.

Over the past couple of years, the labour market has become less tight, and firms are finding it easier to fill their recruitment needs. Employment is high, but the share of the population employed has fallen a little. Unemployment has edged up from a low level.

Chart 4: Inflation has declined markedly from its peak

At its highest, inflation was above 7 percent. According to last week's data, inflation is now running at 2.6 percent. Excluding energy prices, which are quite volatile, inflation is a little higher than 3 percent. Inflation has been lower than we expected in June.

International inflation has also fallen notably, and central bank rate cuts are now expected to be deeper and faster than before summer.

Chart 5: Wage growth is high

While wage growth is subsiding among many trading partner countries, it is still high in Norway. Wages increased by 5.2 percent last year, and a comparable increase is expected this year. We expect wage growth to moderate in the years ahead, but given weak productivity growth, business costs will continue to grow at a fast pace.

Chart 6: The krone has depreciated

The krone exchange rate has depreciated in recent years and is now weaker than at the time of the June monetary policy meeting. A weaker krone means an increase in prices for imported goods and services, and higher costs for firms that depend on imported intermediate goods. For the export industry, a weaker krone means increased profitability, which can lead to higher wage growth and, in turn, to higher inflation.

Movements in the krone exchange rate are determined by a wide range of conditions, in both Norway and internationally. This makes it difficult to explain all exchange rate movements, but we can safely say that the interest rate matters for the krone exchange rate. If we had not tightened monetary policy in recent years, the krone would have been weaker. Experience has also shown that the krone weakens when oil prices fall or, as we saw this summer, financial markets experience turbulence.

Chart 7: Inflation will slow and unemployment edge up

With the current policy rate path, inflation is projected to move down further and approach 2 percent towards the end of 2027. Unemployment will likely edge up to about the level prevailing before the pandemic.

Many people have experienced tighter household budgets in recent years, but most people will find that their budgets will stretch further going forward. Interest expenses will still be high, but we expect wages to rise faster than prices, and the debt burden will be easier to bear.

The economy may evolve differently than we now anticipate. If the outlook suggests that inflation will return to target faster or there is a more pronounced slowdown in the Norwegian economy, the policy rate may be lowered faster than currently envisaged. On the other hand, if the krone depreciates further or economic pressures increase, inflation could remain elevated for longer. A higher policy rate than currently envisaged may then be required.

Inflation has slowed sharply. That's welcome news, and now it's important that we go the last mile of returning inflation back to the target. By maintaining confidence in the inflation target, we are better equipped to deal with new shocks and periods of turbulence in the future.