Ida Wolden Bache: The conduct of monetary policy

Introductory statement by Ms Ida Wolden Bache, Governor of Norges Bank (Central Bank of Norway), at the hearing of the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament) in connection with the Storting's deliberations on the Financial Market Report, Oslo, 7 May 2024.

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Charts accompanying the speech

Thank you for this opportunity to provide an account of the conduct of monetary policy.

The global economy has been shaped by the turbulence of recent years. In the wake of the pandemic and Russia's full-scale invasion of Ukraine, inflation reached multi-decade highs. Central banks worldwide responded by sharply raising policy rates. It has long been feared that the fight against high inflation would lead to a sharp increase in unemployment. Inflation has now slowed considerably, while employment is still running high.

Much the same can be said to describe the Norwegian economy. When I spoke here in May last year, the preceding year had been marked by a surge in inflation, and the policy rate had been raised sharply and rapidly. Today, the situation is different. Inflation is still higher than our 2 percent target but has slowed materially from its peak. At the same time, economic activity has held up better than we had anticipated, and unemployment remains low. These are welcome developments and make us more confident that we can bring down inflation without a pronounced rise in unemployment.

Let me turn to the year behind us and the assessments we have made.

Chart: Wide differences across industries

The economy gradually cooled down through 2023, and growth is now low. Labour market pressures have eased, and recruitment difficulties have diminished. At the same time, there are wide differences across industries. The construction industry has been particularly hard hit by the interest rate increases. Construction activity fell sharply last year and has continued to fall so far this year. On the other hand, petroleum sector investment remains buoyant. Industries supplying goods and services to the petroleum sector are still faring well. Strong growth in public demand has also contributed to sustaining economic activity.

Chart: Inflation markedly above target

Consumer price inflation hit 5.5 percent last year. The rate of increase in electricity and fuel prices gradually fell, but excluding energy prices, consumer prices continued to rise rapidly up to summer. Prices for both imported and domestically produced goods and services increased sharply, and inflation turned out to be higher than we had expected.

In the wage settlement, the social partners agreed on a wage norm of 5.2 percent for 2023, which also turned out to be the rate of overall annual wage growth. By a good margin, wage growth reached its highest level since 2008. Given the low growth in productivity, the pay increases led to higher business costs.

Chart: The krone depreciated

In spring of last year, international interest rates reached the highest levels since the 2008 financial crisis, and main trading partners' policy rates rose to higher levels than our policy rate. This likely contributed to a depreciation of the krone. Measured against a basket of currencies of countries from which we import goods, the krone has gradually lost value over recent years. If we look at developments against individual currencies, the picture is more mixed. The US dollar has appreciated against many currencies, including the krone. This illustrates that the krone depreciation is due not only to conditions specific to Norway.

In many situations, a floating exchange rate can act as a cushion for the Norwegian economy, as was the case when oil prices plummeted in 2014. At that time, the krone depreciated markedly and contributed to lifting activity in the tradable goods sector. The Norwegian economy could move on a different path than surrounding countries in the future too, and a floating krone will be of benefit to our economy. A floating exchange rate can reduce the cost of structural adjustments. Last year, however, amid weaker growth prospects and already too high inflation, the krone depreciation made the monetary policy trade-offs more challenging.

We do not have an exchange rate target for the krone. When we are concerned with the exchange rate, it is because a weaker krone means an increase in prices for imported goods. Moreover, a weaker krone can lead to higher activity and increased profits in the export sector, which can in turn lead to stronger wage growth and contribute to a longer period of high domestic cost inflation.

Chart: We have raised the policy rate more than envisaged

Our assessment at the beginning of 2023 was that we were approaching the policy rate peak. But, in the course of spring, it became clear that a higher rate was required. Unemployment had increased less than feared, while inflation had remained higher than expected. At the same time, high wage growth and a weaker krone would continue to push up inflation going forward. Towards summer, we therefore raised the policy rate further and adjusted up the policy rate forecast.

Chart: We are not seeking to bring down inflation as fast as possible

Norges Bank is tasked with keeping inflation low and stable, while helping to keep employment as high as possible. Low inflation and high employment are not conflicting objectives in the long term. Low and stable inflation over time is a precondition for a well-functioning economy, and in the long run it is not possible to achieve higher employment by accepting higher inflation. But in the short run, when setting the policy rate, there may be a conflict between the two objectives. Higher interest rates contribute to reducing inflation, but rate increases also contribute to dampening economic activity and can lead to higher unemployment. We are not attempting to bring down inflation as fast as possible. We have consistently emphasised the aim of avoiding a sharp rise in unemployment. The strong weight we give to employment is reflected in our forecasts where it takes a long time for inflation to come down to the target.

We know that the interest rate increases have a cost and that they can have uneven effects on different groups. Since we started raising the policy rate after the pandemic, interest rates on housing loans have roughly tripled. On top of higher interest rates, borrowers have faced steadily rising prices for most goods and services. Many people might feel that we have made the burden even heavier.

When we have raised the policy rate, it is because the cost of not doing so would have been greater. High and variable inflation entails substantial costs and adversely affects low-income groups in particular. Norges Bank must react when there are prospects of high inflation, independently of the source of the rise. If firms and the social partners become accustomed to high inflation, and it becomes embedded in their price and wage setting behaviour, inflation may become entrenched. If the FX market loses confidence in inflation returning to target, the krone exchange rate could depreciate substantially. More forceful tightening may then be needed later, with the risk of a severe downturn with an increase in job losses. By maintaining confidence in low and stable inflation over time, we are better equipped to deal with new shocks and periods of turbulence in the future.

Since last autumn, inflation has slowed, to a large extent due to the reversal of the conditions that triggered the rise in prices in the first place. International trade in goods is flowing close to normal again, and freight rates, energy prices and prices for many other commodities have fallen. But a tighter monetary policy has also contributed. If we had not raised the policy rate, inflation would have been higher, among other things, because the krone would have been weaker.

And, we have not yet reached the target. We still have a way to go before inflation is back to 2 percent. High wage growth and the krone depreciation are contributing to keeping inflation elevated. We must be prepared for the possibility that the last mile of disinflation may take time and that headwinds may arise.

Chart: Global disinflation has slowed

Global disinflation has slowed. This has led to a change in financial markets' assessment of interest rate prospects. While a few months ago there were expectations of early and rapid rate cuts, the market now expects major central banks to leave policy rates unchanged for longer in order to bring inflation down to their targets.

In December, we raised the policy rate to 4.5 percent, where it has since remained. When we set the policy rate, we seek to strike a balance between different considerations. An overly tight monetary policy will contract the economy more than necessary. That is something we want to avoid. But if the policy rate is lowered prematurely, prices may continue to rise rapidly, among other reasons, because the krone could depreciate.

In our assessment, the policy rate is sufficiently high to tackle inflation. At the same time, there will likely be a need to maintain the policy rate at today's level for some time ahead. If a further rate increase is judged necessary to bring inflation down to target within a reasonable time horizon, the Committee is prepared to raise the policy rate again.

As inflation recedes further and economic conditions so warrant, we can gradually lower the policy rate. Our latest forecast implied a policy rate of just below 3 percent at the end of 2027, which is a good deal higher than it was before the onset of the pandemic.

Developments in recent years have reminded us that the outlook can change abruptly. The future will also see unexpected events. Moreover, we must be prepared for the eventuality of larger and more frequent shocks than we experienced in the decades prior to the pandemic. The security policy backdrop is serious. Russia's war against Ukraine is a threat to peace and stability in Europe. A humanitarian catastrophe is unfolding in Gaza. Conflicts and political tensions between countries heighten the uncertainty surrounding economic developments. At the same time, the economy and financial markets are increasingly being impacted by climate change and measures to reduce climate emissions.

These trends will pose challenges to all areas of economic policy, including monetary policy. In my view, Norges Bank's mandate, with flexible inflation targeting, provides a sound basis for meeting potential challenges ahead. Extreme weather and measures to accelerate the climate transition can have a large impact on individual prices. With flexible inflation targeting, we can see through temporary changes in inflation. But ensuring low and stable inflation over time will continue to be the most important contribution monetary policy can make to supporting the transition.

Last week, we published an update of our monetary policy strategy. The strategy describes how the Committee interprets its mandate and how monetary policy will respond to different shocks that could hit the economy. When the strategy was first adopted in 2021, global interest rates and inflation had been low for an extended period of time. In recent years, monetary policy has faced a different set of challenges. The updated strategy articulates that we interpret our mandate to mean that considerable weight shall be given to employment – also at times when inflation deviates significantly from the target. Both this clarification and the overall strategy are consistent with our conduct of monetary policy in response to the cost shock that hit the economy two years ago and does not entail a change in the conduct of monetary policy.

Chart: Revised forecasts

Notwithstanding, there are lessons that both we and other central banks can take forward. We must acknowledge that our forecasts have not been that accurate in recent years. We are therefore exploring how we can improve our models and analyses. We are in the process of establishing a new data platform that will enable us to make better use of new data sources in our analytical work. We will also continue to reach out and listen to feedback going forward. The goal is to establish the best possible basis for making good decisions also when uncertainty is high, and to adapt monetary policy rapidly to a shift in the outlook.

Let me conclude.

Chart: In our assessment, the policy rate is sufficiently high

The past years have served as an important reminder. We cannot take low and stable inflation for granted.

Since inflation surged in the wake of the pandemic, we have raised the policy rate significantly, and it now appears that the inflation peak is behind us. Interest expenses will be high for a period, but most people will likely see an improvement in their purchasing power and an easing of debt burdens. Nonetheless, we must be prepared for a modest increase in unemployment and challenging times for some industries before the situation turns around. But our current assessment is that inflation will return to target without a pronounced increase in unemployment.

We consider that the policy rate is sufficiently high to bring inflation back to target within a reasonable time horizon. But the outlook is highly uncertain – not least amid elevated global political tensions. We can never make a promise as to the future path of the policy rate. What we can promise is to do our utmost to reach the objectives assigned to us.

I now look forward to answering any questions you may have.