August 16, 2023

Norges Bank To Stay Hawkish

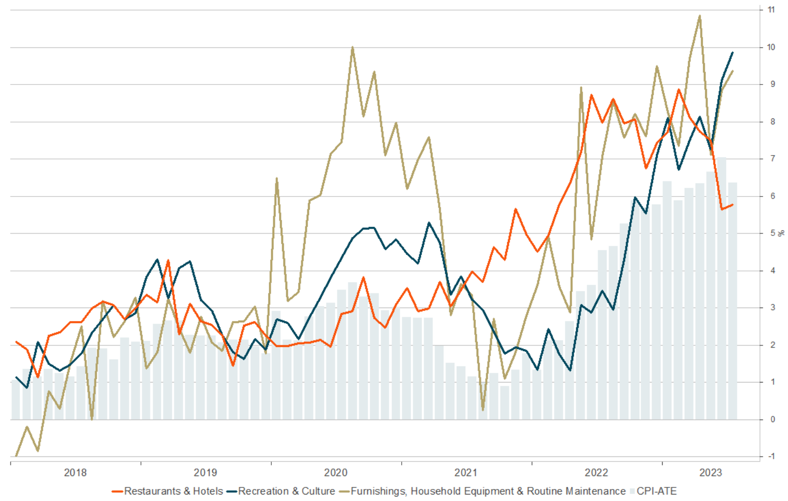
As the economic outlook throughout Europe continues to worsen, Scandinavia can finally look forward to some much-needed disinflationary pressures from the external front. It is unlikely that either Norges Bank or the Riksbank can hike rates independently well beyond the ECB, which we believe has already peaked. However, they will also need to acknowledge that over-optimistic expectations for low terminal rates established last year have contributed to excessive gains in realised inflation and inflation expectations. As a result, prices in Norway and Sweden – driven almost exclusively by domestic demand on a marginal basis – are still not decelerating to the same extent as in the Eurozone.

Last week's inflation numbers suggested easing headline risks, but we believe it is far too early for Norges Bank to call time on its cycle. Similar to the ECB, we see no need to pre-commit for the rest of the year after an expected 25bp hike to 4% tomorrow; every meeting through year-end will likely be 'live'. Perhaps even more so than the ECB, Norges Bank will likely acknowledge that headline inflation declining due to base effects has probably run its course. Energy prices have started to recover to the extent that the balance of opinion, at least in the short term, has started to shift towards monitoring upside risks to inflation globally. As a major oil producer, the income boost and potential for demand/investment recovery is also an idiosyncratic risk for Norway. Closer to home, however, we believe the market is still too optimistic on the path for underlying inflation.

CPI-ATE in Norway has printed 0.9% m/m for two months in a row. If we take the annualised level of the past three months, underlying inflation in Norway is running at over 10% y/y. The corresponding measure for US core inflation is barely 4%. Even in the UK and Sweden, assuming that the monthly pace of core CPI is unchanged in June, the annualised three-month core inflation level would still be at 4.6% and 8.0% annualised, respectively. If we take Norway's four-month sequential core inflation prints, the annualised rate is as high as 15%. In other words, Norway core inflation is presently the highest in G10, so it is difficult to justify a dovish outcome from tomorrow's release.

The main driver is high levels of household spending. As we can see below, some of the discretionary spending items have accelerated in July despite the softer headline print, though the changes are not uniform. We have previously highlighted the recent surge across Europe in items related to 'recreation and culture', and there will be seasonal aspects pertaining to hotel and restaurant prices as summer ends in the Nordic region. Regardless, Norway's aggregate income levels are generally high, and the initially slow policy response to demand resurgence means that the marginal household cashflow hits have been backloaded. According to BIS figures, Norway's household debt-servicing ratio only began to rise in Q4 2022. In contrast, the corresponding US level began to rise in Q2 2021.

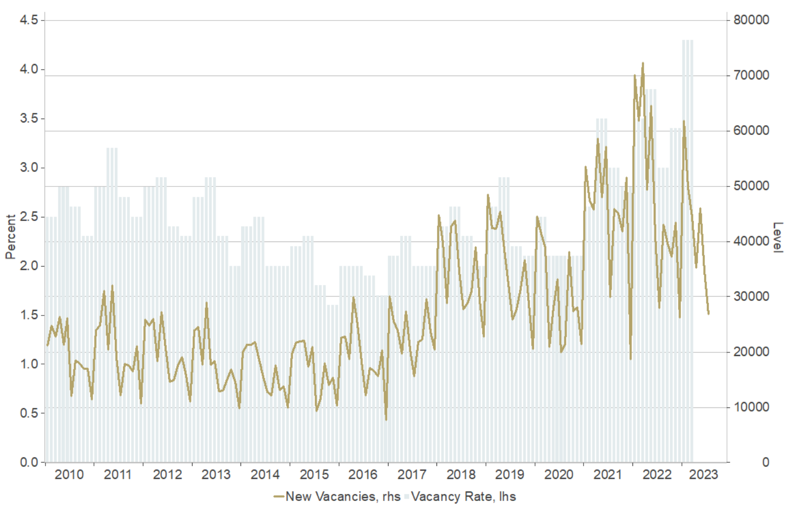
Discretionary Consumption Remains Firm



Source: Macrobond, BNY Mellon

The income side of household cashflow is similarly difficult to manage in a high-inflation environment where labour's bargaining power has strengthened. Like in much of Europe, we can see that new job openings have started to decline – in Norway's case quite sharply. Filtering out seasonal aspects, the six-month rolling average of new job openings is running well below the highs seen over the last two years, though still quite elevated compared to pre-pandemic levels. However, the vacancy rate remains at the highest levels on record, and if the stabilisation or even recovery in energy prices increases, a recovery is possible in the offshore sector. At best, we see very limited downside risk to wage growth, and this will require strong vigilance on the part of Norges Bank.

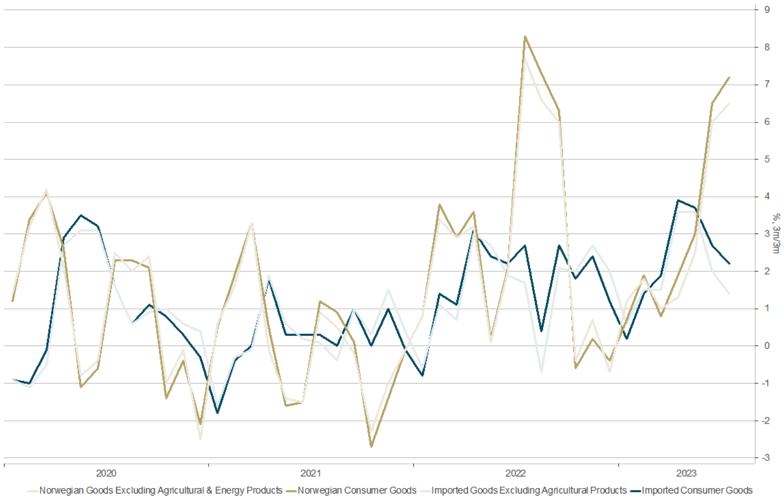
Openings Slow But Vacancies Stay High



Source: Macrobond, BNY Mellon

Outside of energy, the external sector will likely benefit from a Eurozone slowdown and somewhat perversely, Norges Bank may welcome sharp deterioration in Eurozone data. The only areas of growth in the Eurozone are in services, where there will be very limited transmission into Norway's economy. The adjustment in ECB expectations has also helped pushed the EUR into weaker ranges, without which underlying inflation would likely be even stronger. The pass-through impact is becoming obvious. We can see below that domestic core and consumer goods inflation has continued to rise, whereas there are clear declines in their imported counterparts. The divergence has come through only recently with the stabilisation in exchange rates. With clear evidence that exchange rate pass-through is effective, maintaining an elevated rate path in support of NOK is in Norges Bank's interests. Compared to EM central banks, those in G10 have been far more reticent to push for exchange-rate-based tightening. But for Norges Bank and the Riksbank, policy catch-up is still necessary and the currency is a valid way to accelerate convergence.

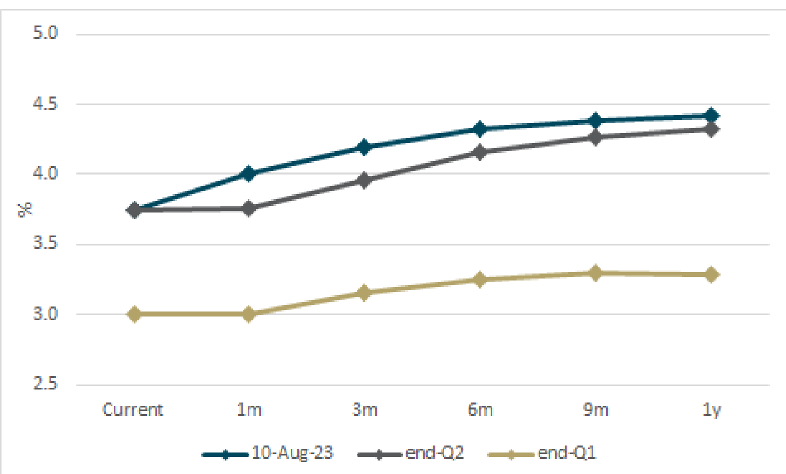
Import vs. Export Price Divergence Supports Pass-Through



Source: Macrobond, BNY Mellon

Fundamentally, we believe the market is erring on the conservative side regarding the Norges Bank outlook. An additional 25bp has been priced into the entire curve over the past two months but the bulk of the adjustment took place in Q2. Terminal pricing may be adequate, but we still see a strong chance of front-loading risk, whereby 4.5% by month-end is absolutely viable rather than in a year’s time. At least, a resolutely hawkish message should be provided at this week’s meeting. In our view, only severe downside forecasts to the Eurozone’s outlook in both growth and inflation in September could trigger some more caution at Norges Bank's meeting the following week.

Recent Reticence To Price Hawkishness



Source: Bloomberg, BNY Mellon

Finally, we note that Norway is in the enviable position of having more fiscal flexibility than any other developed economy. Norge Bank has greater space to over-react and price momentum fully justifies such an approach – subject to the usual financial stability assessments. If there are signs of a sharp slowdown, fiscal can be deployed quickly to provide an offset, and there will also be sufficient monetary space to complement proceedings. The market has a clear bias for dovish risk in central bank decisions, such as recent decisions in Australia and the UK. This is a natural extrapolation of policy peaks being reached in the US and Eurozone. Current data simply does not justify a similar turn in Norway, however.

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