Need for higher interest rates in Norway

Norges Bank raises its policy rate to dampen inflation, writes Governor Ida Wolden Bache in an opinion piece first published at NRK Ytring.

Norges Bank's Monetary Policy and Financial Stability Committee has raised the policy rate from 0.75 to 1.25 percent and has announced that a further rate hike to 1.5 percent is likely in August. The policy rate will then be back at its pre-pandemic level.

Norges Bank is responsible for keeping inflation low and stable at around 2 percent over time. Our job is also to help keep employment as high as possible and the economy on a stable path.

Low and stable inflation is important for maintaining a well-functioning economy. Inflation tends to become more variable at high levels, making it more difficult for both businesses and households to plan ahead and make financial decisions. Those with low income and tight margins are likely to be hardest hit when prices abruptly increase. By keeping inflation low and stable, we help to ensure high economic activity and welfare.

Norges Bank uses the policy rate to influence prices and economic activity. When the pandemic hit, the policy rate was lowered from 1.5 percent to zero to dampen the downturn. Last autumn, when economic conditions were becoming more normal, we started raising the policy rate gradually.

Substantial labour shortages

Economic activity in Norway is now at a high level. More and more people are finding work, and unemployment is very low. At the same time, companies, local governments and hospitals are struggling to find enough workers, and many vacancies remain unfilled.

Prices are now rising faster than for a long time, and inflation is markedly above the 2 percent target. Some of the driving forces lie beyond Norway's borders. The pandemic and the war in Ukraine have led to higher global prices for energy and other goods. These conditions lie beyond the reach of Norges Bank. But prices for domestically produced goods and services are also rising faster than normal. This is because the prices companies pay for electricity, materials and intermediate goods have increased, as have employees' wages.

We expect wage and price inflation to remain high for a period ahead. The labour shortages we are now seeing normally lead to higher wages that are passed on through higher prices. Some firms can take advantage of the good times by raising prices a little more than necessary in order to maintain margins. Higher interest rates contribute to reducing demand for both labour and goods and services, which dampens wage and price inflation. In addition, higher interest rates can contribute to strengthening the krone, which can in turn curb the rise in prices for imported goods.

Faster rate rise

Pressures in the Norwegian economy have increased more than expected, and it now appears that inflation will remain higher for longer than we projected in March. We therefore find it appropriate to raise the policy rate faster than envisaged a few months ago.

I fully appreciate the concern some people may feel when we announce such a fast rate increase. People with loans will be facing a tighter financial situation when their interest payments rise. This may prove demanding for some households, but most of them have the financial margin to pay higher interest rates on their loans.

If we had not raised the policy rate, or raised it less, households' finances may have improved in the short term, but this would have come at the risk of economic pressures reaching such a high level that it would have caused inflation to move up even higher. In that case, we might have had to raise the policy more sharply at a later stage at the risk of triggering a downturn and a rise in unemployment.

If the economy evolves as we now expect, the policy rate will rise to around 3 percent next year. The average interest rate on residential mortgage loans, which is now about 2.2 percent, may then increase to around 4.3 percent. Even with higher interest rates going forward, we expect unemployment to remain low. Inflation is projected to be lower from next year, and wages will then rise faster than prices.

Substantial uncertainty

The economic outlook is highly uncertain. If prices rise more than we expect, it may be appropriate to raise the policy rate more than currently projected. On the other hand, household debt has increased markedly in recent years, and higher interest rates will bite harder than earlier. This is taken into account when we set the policy rate. Households may react by tightening consumption more than we expect, and the impact on the housing market may be stronger than assumed. In that case, we may raise the policy rate less than currently planned. Whatever happens, we will set the policy rate with the aim of maintaining low and stable inflation and a stable economy in the years ahead.