Need for higher policy rate to bring down inflation

Chart 1: Policy rate raised by 0.5 percentage point

Norges Bank's Monetary Policy and Financial Stability Committee decided to raise the policy rate by 0.5 percentage point to 3.75 percent.

Norges Bank’s task is to keep 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.

Chart 2: Inflation markedly above the target

Consumer price inflation is now 6.7 percent, and markedly above the target. The high level of inflation is reducing purchasing power, and low-income groups and those with the smallest margins are being hit hardest.

Prices for both imported goods and domestically produced goods have risen at a fast pace. Inflation is markedly higher than the previous projections we provided in March. At the same time, there are prospects that wage growth will be higher and the krone weaker than we expected at that time, which will push up inflation ahead. Given these developments, the Committee judges that a higher policy rate is needed than projected in March.

Chart 3: Larger rise in interest rates abroad than in Norway

Norges Bank was among the first central banks to raise interest rates in autumn 2021 following the pandemic. But as inflation took off internationally, policy rates were raised sharply in many countries. Over the past year, foreign interest rates have risen more than domestic interest rates and interest rates are now higher in some trading partner countries than in Norway. This is likely a main reason behind the krone depreciation. Since March, interest rates have risen further internationally.

Chart 4: Weaker-than-projected krone exchange rate

The krone exchange rate has been weaker than we projected in March, but the krone has regained some strength recently, likely because markets participants have revised up their expectations for policy rate in Norway.

We have a floating krone exchange rate, and Norges Bank does not have a goal of stabilising the exchange rate at a specific level. Developments in the krone exchange are nonetheless of importance for the economy, and hence for monetary policy. A weaker krone increases the prices for imported goods in krone terms.

Chart 5: Inflation past the peak in many countries

Inflation has passed the peak in many of our trading partner countries. Prices for a range of commodities, such as metals and food, have fallen. Weaker external inflationary impulses will dampen imported goods inflation. At the same time, given a weaker-than-projected krone, imported inflation will likely prove higher ahead than we foresaw in March.

Chart 6: Economic activity remains high

Activity in the Norwegian economy is still strong, and the employment rate is high. The pace of economic growth has recently slowed. Following a marked rise towards the end of 2022, household consumption has fallen so far this year. Unemployment has edged up.

Norges Bank's Regional Network enterprises expect cautious growth in activity through summer, but there are wide differences across industries. Growth in oil services is strong thanks to vigorous investment in the petroleum industry. Some firms report that the krone depreciation has strengthened their competitiveness and boosted tourism. Others indicate that a weaker krone is weighing on activity owing to higher costs. Retail trade and the construction industry expect a fall in activity ahead

Wage growth is set to be higher than projected in March. Annual wage growth is projected at 5.5 percent this year which is still lower than our inflation projection for 2023 which has been revised up to 6 percent.

The Committee judges that a higher policy rate is needed to bring down inflation. The Committee is seeking to balance the risk of tightening too much against the risk of tightening too little. We have still not seen the full of effects of the past rate hikes, and there is a risk that further rate increases will lead to a sharper slowdown in the Norwegian economy than needed to tackle inflation, which is to be avoided. But insufficient monetary tightening raises the risk of a continued rapid rise in prices and wages. If the high level of inflation becomes entrenched, it may prove more costly to bring it down again.

The Committee judges that these risks are best balanced by raising the policy rate to 3.75 percent now.

Chart 7: Policy rate will most likely be raised further in August

The policy rate will most likely be raised further in August, and the current path indicates a rise to 4.25 percent in the course of autumn. Mortgage rates may then move up towards 5½ percent further ahead.

Borrowers are facing higher interest expenses on top of higher prices for many goods and services. For a period ahead, many people will have to cope with tighter budgets and a portion might have to reduce spending. This will be hard on some people. But by raising the policy rate, we are helping to reduce inflation.

Chart 8: Prospects for lower inflation and somewhat higher unemployment

Given the current policy rate path, inflation is projected to recede and move towards the target of 2 percent over the medium term. Unemployment will likely edge up to a slightly higher level than during the last few years before the pandemic.

The outlook is highly uncertain. If the economy evolves differently from that envisaged, the policy rate path may also change. But there is no uncertainty about the objective. We will set the policy rate so that inflation stabilises at close to 2 percent. By doing so, we are helping to restore households' purchasing power and promote high employment and economic stability over time.