Economic perspectives

Address by Governor Ida Wolden Bache to foreign embassy representatives in Oslo, 31 March 2022.

Intro

Your Excellencies, ladies and gentlemen. It is a great pleasure for me to welcome you to Norges Bank for the first time since 2019.

Today's event is taking place against the backdrop of the dark shadow cast over Europe by Russia's invasion of Ukraine. Russia's invasion has caused large-scale destruction and immense human suffering. On behalf of all the staff at Norges Bank I would like to express my deepest sympathy for the suffering of the Ukrainian people.

The economic situation

The war is also having an impact beyond Ukraine's borders. The invasion has led to volatility in financial markets and heightened uncertainty about the global economic outlook. Prices for energy, metals and agricultural products are soaring. Poor countries are being hard hit by the rise in commodity prices, and higher living costs are causing unrest in some countries.

At the same time, the global Covid-19 pandemic, which has been affecting the world economy for two years now, is by no means over. This week, parts of Shanghai went into lockdown.

Chart: Higher interest rates

When the pandemic hit Norway in spring 2020, we cut the policy rate to zero. The aim was to cushion the downturn and mitigate the risk that the pandemic would leave lasting scars on the labour market. Now that we can look at the years 2020 and 2021 in the rear view mirror, we can see that economic activity in Norway picked up more quickly than expected. Employment exceeded the pre-pandemic level in autumn 2021, and the same degree of monetary policy stimulus was no longer needed. In September, we started a gradual normalisation of the policy rate.

Activity in the Norwegian economy has continued to rise after containment measures were lifted in February, and labour demand is high. At the same time, price and wage inflation has been higher than projected, and wage expectations have risen. Rising wage growth and imported goods inflation are expected to push up underlying inflation ahead.

Norges Bank's primary objective under our mandate is low and stable inflation, and our target is inflation of close to 2 percent over time. Our inflation targeting regime is flexible. This means that in addition to maintaining price stability, we also set monetary policy to support high and stable output and employment. However, there is a limit to how high output can be and how far unemployment can fall before prices and wages start to accelerate.

In our assessment, the objective of stabilising inflation around the target somewhat further out suggests a higher interest rate. Last week, the policy rate was raised from 0.5 to 0.75 percent. As the chart shows, we also signalled that we intend to raise the policy rate further. If the economy develops roughly in line with our projections, the policy rate will reach 2.5 percent by the end of next year. Higher interest rates will ease the pressures in the Norwegian economy, but employment will likely remain elevated.

Chart: High inflation in many countries and higher commodity prices.

Inflation among our trading partners has risen sharply. In the US and the UK, inflation has not been as high for decades.

Higher inflation and higher inflation expectations have led to expectations of a rise in global policy rates. Some countries have already started tightening monetary policy.

Globally, inflationary pressures were already on the rise before Russia's invasion of Ukraine. Demand for energy and commodities has rebounded as the global economy started to recover from the pandemic. An increase in the pace of climate transition has also pushed up demand for many metals used in, for example, car batteries, solar panels and wind turbines.

With Russia's invasion of Ukraine, already rising energy and commodity prices have risen further. Russia is a major exporter of a range of commodities and is not least a main supplier of oil and gas to Europe. Russia is a leading exporter of industrial metals such as aluminium, nickel and steel. And Russia and Ukraine are major exporters of agricultural products such as corn and wheat.

The outlook for commodity prices is highly uncertain. Futures prices suggest that energy and other commodity prices will eventually fall, but that they could remain at a higher level than before the pandemic for quite some time.

The expansionary monetary and fiscal policies of recent years are still making a positive contribution to activity in most countries. On the other hand, high inflation, disruptions in export markets and greater uncertainty among households and firms are expected to weigh on growth ahead, especially in Europe.

Chart: Norway: Rise in inflation

In Norway, 12-month consumer price inflation has risen well above 2 percent. Unusually high electricity prices through winter were a key driver, resulting in large electricity bills for households and firms alike.

In the conduct of monetary policy, we ‘look through’, or disregard, temporary changes in inflation. Our focus is on underlying inflation, which excludes prices that tend to show temporarily large variations, such as energy prices. In the chart, underlying inflation is illustrated by the index called the CPI-ATE, which is the consumer price index adjusted for tax changes and excluding energy products.

Underlying inflation has picked up from the low levels of last autumn. Prices for both imported goods and for domestically produced goods and services are rising more rapidly, and we expect underlying inflation to continue to rise ahead.

Chart: Economic activity expected to rise

Since the Covid-19 outbreak in spring 2020, activity in the Norwegian economy and the number of unemployed have fluctuated in step with changes in infection rates and the scale of containment measures. Higher infection rates and containment measures led to a dip in activity in the Norwegian economy around the turn of the year. But activity rebounded as the containment measures were removed in winter. The sectors most affected by restrictions, such as tourism, hospitality and entertainment, have recovered rapidly, and we expect the upswing in the Norwegian economy to continue.

However, the war in Ukraine has led to heightened uncertainty about the economic outlook. Although our trade with Ukraine and Russia is limited, the war is still affecting the Norwegian economy. On the one hand, high energy prices provide large government revenues and may boost petroleum investment and exports related to electricity and oil and gas extraction. But on the other hand, high energy prices also mean higher costs for household and firms. Some firms may also face supply problems and faltering foreign demand or be more reluctant to invest when price developments and other market conditions are uncertain.

Chart: Low unemployment

Unemployment has fallen to a low level. In fact, unemployment is at its lowest level since before the 2008 financial crisis. At the same time, the number of employed has risen considerably and the employment rate has increased to the highest level in more than ten years. Norwegian firms are now reporting capacity constraints. For many firms, production is being constrained by labour shortages. Never before has the number of registered job vacancies been so high. As I mentioned earlier, with a tight labour market and higher inflation, wage expectations have increased.

Chart: Strong consumption growth, but moderate house price inflation ahead

Over the past two years, the pandemic has restricted consumers’ spending options. Many consumers have shifted spending away from services and towards goods. Many households have also saved more than usual. As society has gradually reopened, spending has picked up, and not least services consumption has increased. This year, solid growth in private consumption is expected to boost domestic activity. Looking further ahead, growth in private consumption will likely be dampened by higher interest rates. House price inflation and credit growth are also expected to moderate.

Chart: Business investment expected to grow

Over the coming years, activity in the Norwegian economy will also be supported by growth in business investment. In particular, I want to mention investment in battery factories and hydrogen plants, which is expected to pick up strongly ahead.

This will not only boost output and employment but is also a sign that the transition to a more sustainable economy is underway. The transition will probably lead to higher and more volatile energy prices than we have been used to. At the same time, higher prices for carbon-based energy may spur the transition to a net-zero economy.

Climate change and central banks

Chart: Climate change and central banks

And the transition *is* necessary. Climate change is one of the greatest challenges of our time.

The prime responsibility and the most effective tools to mitigate climate change lie with governments. However, carbon emissions and the increased frequency and severity of extreme weather events will affect our economy and the financial system. As such, climate change is relevant to Norges Bank's core responsibilities as central bank.

Like other central banks, we have over the past few years intensified our efforts to understand the effects of climate change and manage the risks from the physical effects of climate change and the transition to a low-carbon economy.

In the years ahead, climate change and the transition to net-zero economies will involve structural changes and periods of considerable uncertainty. Delivering on the objectives of price stability and economic stability will then be more important than ever.

Structural changes in the payment system

Chart: Structural changes in the payment system

In addition to promoting economic and price stability, the Bank's responsibilities also include ensuring that the payment system is safe and efficient. The payment system is now undergoing a deep transformation driven by digital technology and increased competition. Money and payments are evolving rapidly. Norway is one of the countries where the use of physical cash has declined most. Most of us prefer digital alternatives such as payment cards and apps on our mobile phones.

Internationally, competition among financial service providers is intensifying. Payment intermediation is no longer the sole preserve of banks. Competition comes from both specialised Fintech companies and from global tech giants such as Apple and Google.

Traditional money is also meeting competition from new forms of money such as e-money, stablecoins and cryptocurrencies. Lately, the invasion of Ukraine and the sanctions against Russia have brought cryptocurrencies into the spotlight.

Norges Bank wants to be a driving force for change that enhances the efficiency and safety of the payment system. As the central bank, we take a precautionary approach and keep a close eye on the potentially far-reaching implications for the financial system of some of the changes that are underway.

Among other things, we must ask ourselves whether measures will be needed to ensure that we can continue making payments in Norwegian kroner efficiently and safely in the future.

A key issue in that context is whether Norges Bank should launch a central bank digital currency. We have not yet reached a conclusion, but we want to be ready to launch it, should it be necessary to do so.

Conclusion

Norges Bank will do its part to ensure that paying in Norwegian kroner will continue to be an attractive and safe alternative in the future. Being adaptive and responsive to technological developments in the payment system is one necessary condition. Keeping inflation low and stable is another.

Chart: Inflation to move close to target

With last week’s policy rate hike and the further increases indicated by our policy rate forecast, we expect inflation in Norway to move close to target somewhat further out.

Our projections are uncertain. The war in Ukraine has triggered volatility in financial and commodity markets. There is considerable uncertainty as to how severe the economic consequences of the war will be and how long they will last – in Norway as well as among our trading partners. Growth may turn out to be slower than projected while inflation accelerates. There is also a risk that capacity constraints in the economy and persistent global price pressures will lead to higher wage and price inflation than currently expected.

If developments in the economy should differ from our current projections, then the policy rate forecast may also be adjusted. But our mandate remains unchanged: to keep inflation low and stable and contribute to high and stable output and employment.

Thank you for your attention.