Norges Bank preview: Still on track to hike in March but treading carefully

Despite the decent drop in oil prices, we think Norway's central bank remains just about on track to raise rates twice in 2019, with the first hike coming in March. But while near-term prospects for the Norwegian economy still look solid, the outlook further out is getting gloomier and we expect a bit more caution from policymakers

Source: Shutterstock

The domestic economy remains on track

The domestic economy has developed largely in line what the Norges Bank forecasted back in September.

3Q GDP came in a touch weaker than expected at 0.3% quarter on quarter, (vs the NB's forecast of 0.7%), consumption growth over the course of autumn has been on the soft side, employment growth has surprised to the upside, and the latest regional network survey indicated continued solid momentum in the economy heading into 2019.

Inflation has come in stronger than expected. Core inflation – which is what the central bank focuses on rose to 2.2% in November from 1.6% in October. This suggests the NB's forecast of 1.7%

on average for Q4 is likely to be revised upwards.

Some of the upside surprise is due to higher food prices caused by the poor harvest following this summer’s extreme heat wave. But underlying price momentum looks fairly robust, and this is likely to prompt an upward revision to the NB’s forecast, which is on the conservative side (core inflation doesn’t reach 2% over the forecast period).

But global developments have taken a turn of the worse

The most significant development since the last policy meeting is the sharp fall in oil prices since early October. Spot prices are down by around 20% since the central bank's September forecast, and almost 30% since the peak on 4 October. Across the curve, the average price over the first three years is down by 15% since the September forecast. This is plainly September news for the oil-dependent Norwegian economy.

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However, the latest survey of the oil industry showed that expected investment in 2019 actually increased from Q3. While this may be something of a lagging indicator, given the sharp fall over recent weeks, it is also the case that even at current prices around USD 60/barrel new development projects on the Norwegian shelf are likely to prove profitable.

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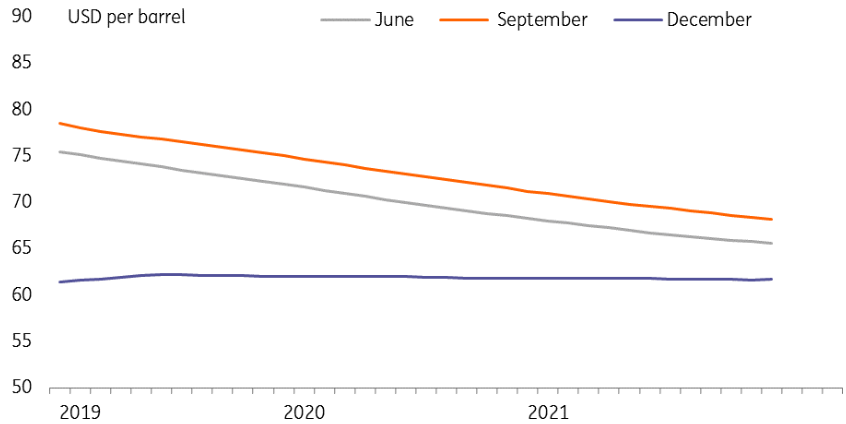
In addition to lower oil prices, market-implied expectations for foreign rate expectations have fallen over the past month. This will push down a bit on the NB’s interest rate forecast. Continued financial market volatility and uncertainty around trade tensions and global growth momentum will also weigh on policy-makers’ mind, though the explicit impact on the NB’s interest rate forecast is usually limited.

Price of Brent oil has fallen across the curve since the last central bank meeting



Source: Bloomberg

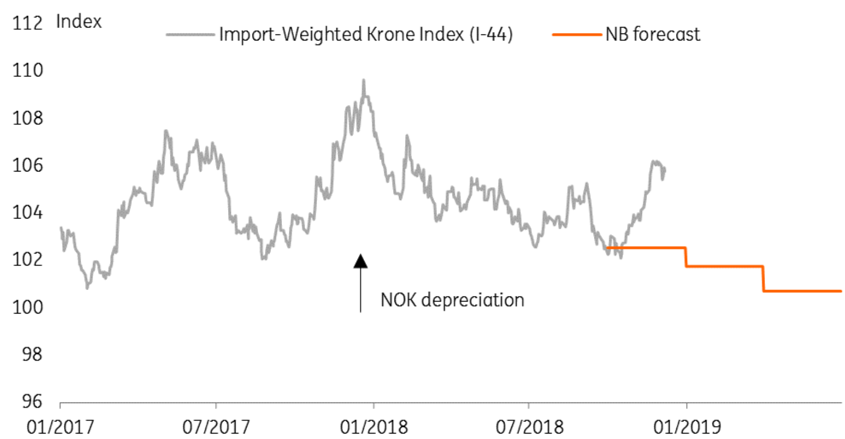
But currency weakness acts as an off-set

Against these negative developments, the krone trade-weighted index has weakened since early October. Currently, the index is about 3% weaker than expected in the NB's forecast for Q4, and 4% weaker than the expected Q1 average.

The krone trade-weighted index has weakened since early October and is about 3% weaker than the central bank expected in the 4Q forecast and 4% weaker than the expected 1Q average

For the central bank, this equates to a loosening of financial conditions and will contribute to a stronger core inflation forecast. Mechanically, this pushes the interest rate forecast upwards, off-setting much of the downward pressure from lower oil prices and the weaker global outlook.

The krone has weakened materially over the past two months



Source: Macrobond and Norges Bank

A near-term rate hikes remain likely

While lower oil prices and a weaker global outlook argue for a lower interest rate path, the increased oil investment, somewhat stronger price pressure, and the weaker krone push the other way. On balance, we think the NB is likely to keep signalling a Q1 hike, and one more hike in 2019. The policy statement may also specify that this means a hike at the March meeting (as the June statement did in advance of the September hike).

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But further out, we think somewhat of a lower interest rate path is likely. The current rate path indicates two rate hikes in 2019, 2020, and 2021. The projection for 4Q21 stands at 2.09% - suggesting a hike in October or December 2021. The new projection is likely to reduce the 2020-21 segment of the interest rate path to closer to three hikes for 2020-21.

Still, we believe this leaves the Bank as the relatively most hawkish central bank in Western Europe. And given the market is currently pricing only one rate hike for 2019, the balance of risks ahead of the NB's meeting is probably skewed towards somewhat higher rates and a stronger krone.