Norway: Krone's weakness remains central ahead of another rate hike

Last week's cut in daily FX purchases by Norges Bank came in short of expectations and added pressure on the battered krone. A well-telegraphed 25bp rate hike this week, and a larger reduction in FX purchases ahead, are necessary moves for the Bank to help NOK, but external factors remain key, and we think a sustained NOK recovery can only be a story for 2H23

The Norwegian krone has been persistently weak since the start of the year

An unsurprising 25bp hike this week

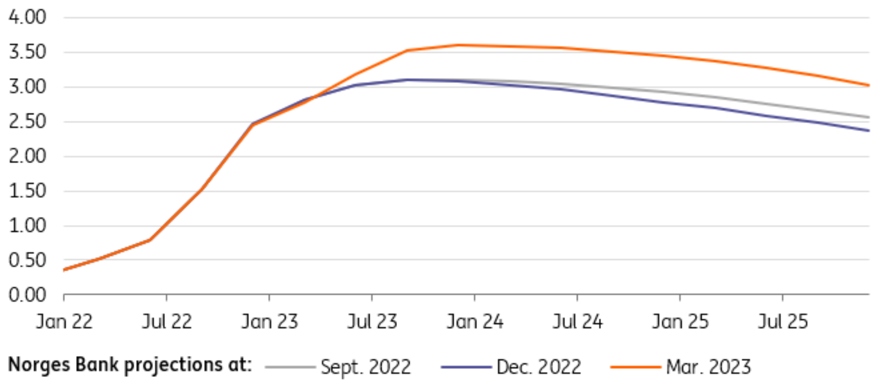
Norway's central bank is poised for another 25 basis point rate hike on 4 May, which would take the policy rate up to 3.25%. None of this should come as any surprise, given that's exactly what policymakers told us they were planning last time. They also expect to do another hike in June, and the March interest rate projections also indicated there was a small chance of another such move later in the year.

The motivation is fairly clear. On a trade-weighted basis, the Norwegian krone (NOK) was 7% weaker by the time of the March meeting compared to the start of the year. Coupled with some concerns about recent wage data, that was enough to trigger a material upgrade to Norges Bank's rate projections.

Since then, not a lot has changed the "big picture". The Bank creates its interest rate forecasts in a fairly mechanical and transparent way, and the variables that matter haven't really moved. Trade-weighted NOK is fractionally weaker than the Bank had predicted last time around. Oil is a little higher across the curve, though probably not enough to make a huge difference. Core inflation came in line with Norges Bank's recent forecasts too.

Admittedly, we don't get any new forecasts this week, and the Bank will probably do little more than signal its intention to hike again in June. Further NOK weakness and additional hawkish re-pricing among major economies could conceivably convince Norges Bank to go one step further later in the year. But with a US recession looming and given our call for significant Fed rate cuts by year-end, we're comfortable with our call that the tightening cycle is likely to end in June.

Norges Bank rate projections



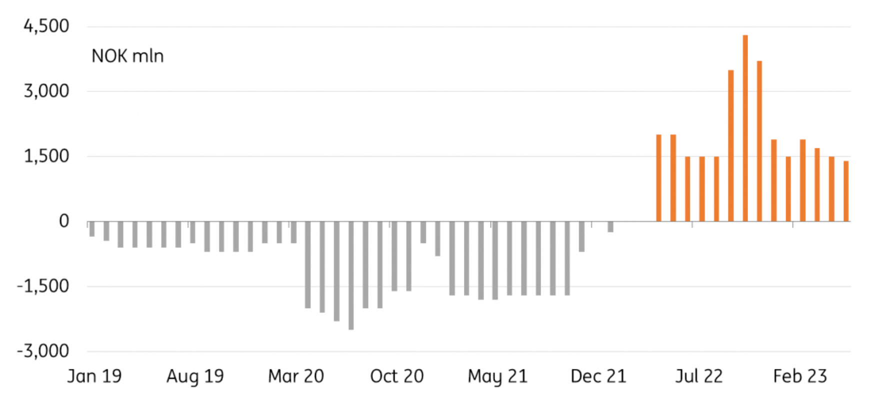
Source: Norges Bank, ING

Markets expected larger cuts to daily FX purchases...

Some factors behind the krone's weakness are well beyond Norges Bank's control, in particular the recent market turmoil and reduced liquidity conditions in FX which specifically hit NOK given that it is the most illiquid currency in the G10. At the same time, some of Norges Bank's tools are arguably holding back NOK's recovery.

Back in November, we made the case for a declining path for daily FX purchases by Norges Bank as a tool to support an already underperforming domestic currency. This has indeed materialised, although at a slower pace than markets would consider as truly supportive of the currency. A case in point was NOK's sharply negative reaction to last week's announcement of a further trimming of daily FX purchases from NOK 1.5bn to 1.4bn, which were likely deemed insufficient.

Norges Bank daily FX purchases



Source: Norges Bank, ING

... but external factors are in the driver's seat

In our view, external factors remain the overwhelmingly predominant factor for NOK. Despite disappointing market expectations, the reduction in daily purchases is by itself a supportive factor for NOK, and while a sharper reduction in FX purchases – which may well materialise around a government budget revision in June – would be welcome, it would not be sufficient to compensate for a non-supportive external environment for the krone.

A risk sentiment stabilisation would, in our view, still allow the krone to emerge as an outperformer in the G10 space, thanks to good fundamentals, a more attractive rate profile given the recent Norges Bank's hawkish turn, and undervaluation.

Such sentiment stabilisation may, however, only materialise in the second half of the year, when we target a break below 11.00 in EUR/NOK, which remains vulnerable to the upside (up to the 11.90/12.00 area) in the near term, in line with our long-standing call for the krone to remain highly volatile due to its low-liquidity character for the first half of this year.

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