Norges Bank turns hawkish in fight against weaker krone

Norges Bank has not only hiked rates faster than expected this month, but is also signalling plenty more tightening to come. We suspect the newly forecasted peak rate of 4.25% will be hit by the end of the third quarter. This puts NOK in a stronger position, especially against its closest peer SEK

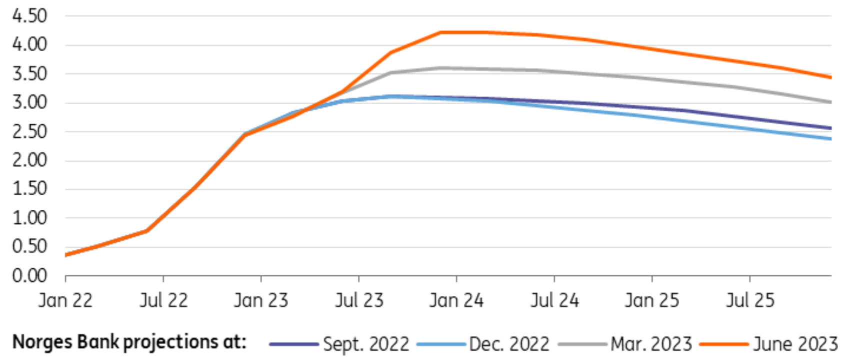
Norway's central bank has hiked rates by 50 basis points, more than the 25bp that was expected – although in truth the consensus was pretty divided. What really stands out is the new interest rate projection, which is the output of Norges Bank's model and shows where policymakers expect rates to go over the coming months. Back in March, that pointed to a peak rate of 3.5%, which implied the bank would have hiked by 25bp this month before pausing.

Not only has the central bank gone further than that at this meeting, but it is now signalling a peak rate of 4.25% later this year – some 60bp higher than previously anticipated. By historical standards, that's a pretty big revision.

To some extent that's not surprising, given that the last set of forecasts came amid the US banking crisis. Global interest rate expectations have since recovered, which mechanically pushes up

Norges Bank's forecast for its own policy rate. NOK was as much as 5.5% weaker at the end of May on a trade-weighted basis, relative to what the central bank had been assuming back in March, though that difference has narrowed over recent days. That weakness also requires higher rates, according to the bank's model.

Norges Bank has increased its interest rate projection – again



Source: Norges Bank

But the central bank also says that higher-than-expected inflation and wage growth will also force it to do more – and interestingly it's this which accounts for most of the upward revision to interest rate projections this year, according to a chart in the Monetary Policy Report.

The bottom line is that the central bank expects another 50bp of rate hikes from here, and whether we get that in one burst or two 25bp increments probably depends on whether the krone depreciates further from here. It's worth noting that the new forecasts assume a gradual appreciation over the coming quarters.

Either way, we suspect the newly-forecasted terminal rate of 4.25% will probably have been reached by the end of the third quarter. Further hikes over and above that can't be ruled out.

One more reason for NOK outperformance over SEK

The blowout hawkish surprise by Norges Bank today – both in the magnitude of the hike and the rate projection revisions – puts NOK in a relatively strong position against other high-beta peers. That is because monetary policy divergence has become an increasingly more relevant driver for FX, and if indeed we see the Federal Reserve cycle coming to an end and FX volatility decline, the search for carry will reward currencies with more attractive implied rates.

Looking at EUR/NOK, it is still too early to call for a sustained downward trend, despite Norges Bank's ultra-hawkish turn. That is because the ECB is keeping the euro idiosyncratically strong, NOK is still the least liquid G10 currency (so the most exposed to corrections in risk sentiment) and because Norges Bank has been less NOK-supportive on the FX purchase side (July announcement next week) than it has been on the monetary policy front.

We see NOK outperform SEK for now, considering the Riksbank should struggle to deliver a similar hawkish surprise given domestic economic woes. We might see a jump to 1.03 and even 1.04 in NOK/SEK in the near term, should the Riksbank fail to offer a floor to SEK. EUR/NOK remains, in our view, vulnerable to some upward corrections in the coming weeks, but if Norges Bank delivers on its plans to take rates to 4.25% (i.e. above our estimated ECB peak rate), then EUR/NOK can trade below 11.00 before the end of this year.

Authors

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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