August 14, 2024

NOK Requires Norges to Hold On

Market gently pricing in easing amid broader growth declines

- Domestic demand clearly softening but wage growth firm
- Inflation expectations holding well, limiting space for a pivot
- Weak NOK valuations present upside risk to inflation

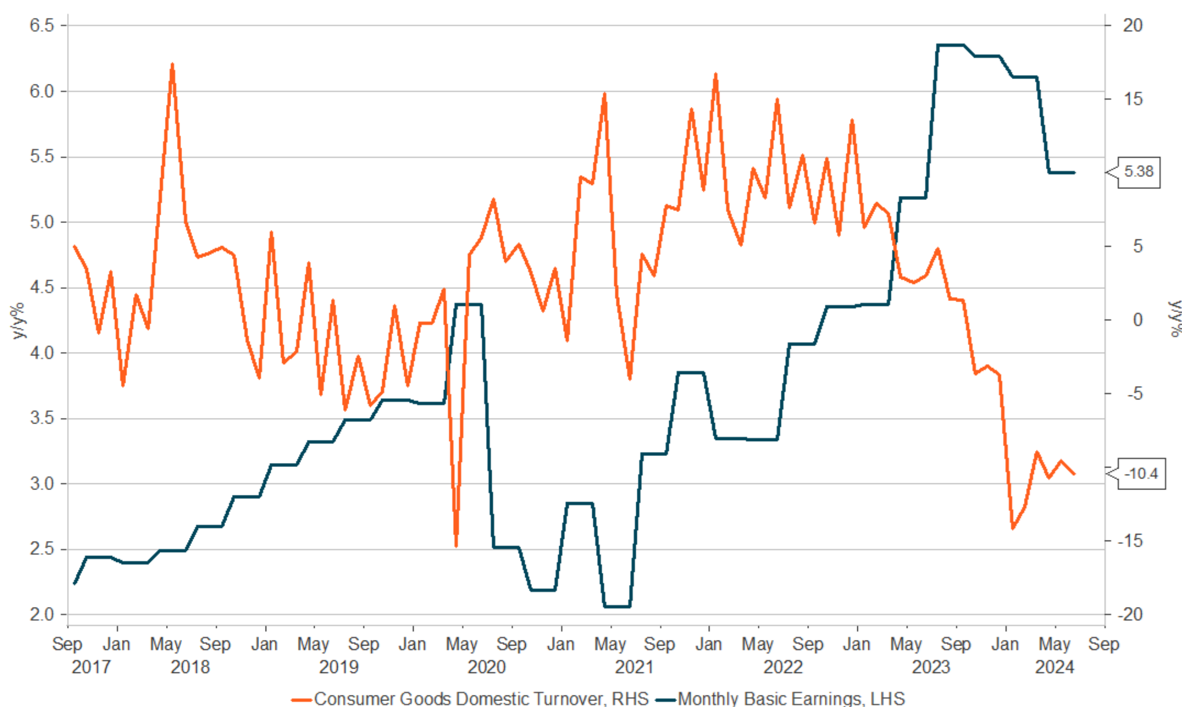
Norges to hold hawkish line but positioning problematic

The market unanimously expects Norges Bank to remain on hold tomorrow. However, whether the central bank can maintain its current forecast of keeping rates on hold for the remainder of this year and easing by only 50bp next year is a different proposition. Global interest rate expectations have repriced aggressively in the wake of recent turmoil, and the US inflation print this week could inject further volatility into the process. Norges has not escaped unscathed, and the market is now expecting one cut by year-end, which remains relatively conservative by European and global standards. On balance, we would give Norges the benefit of the doubt as there is scope for them to countenance a wider rate spread between themselves and peers – if anything, NOK's recent weakness has solidified the case for doing so, but additional vigilance is required over domestic demand.

Unsurprisingly, Norges Bank's hawkishness stems from wage growth. In their June monetary policy report (there is no report this month), the central bank highlighted that wage growth will "be higher in 2024 and 2025 than projected in March." Stagflation is also a pressing risk as productivity growth also remains weak. Regional Network enterprises "have revised up their wage growth expectations" for next year, and this has likely contributed to long-term inflation expectations remaining above target.

The latest data (Exhibit #1) support Norges Bank's concerns regarding wages. Since the highs seen last year, the fall in wage growth has been relatively subdued and growth looks set to remain above 5%y/y – in line with Norges Bank's expectations. However, we have cautioned for some time that across Europe, higher wage growth – even in real terms – is not necessarily translating into strong demand which would keep core inflation elevated. Recently we highlighted how the UK's savings rate has risen to levels not seen during the global financial crisis. While marginal increases in household disposable income have contributed to the gain, forward expectations in anticipation of economic weakness could also have played a role and generated disinflationary pressures. This has been the case in Norway as well over the past year as consumer goods turnover continues to contract sharply.

Exhibit #1: Wage Growth vs. Consumer Spending



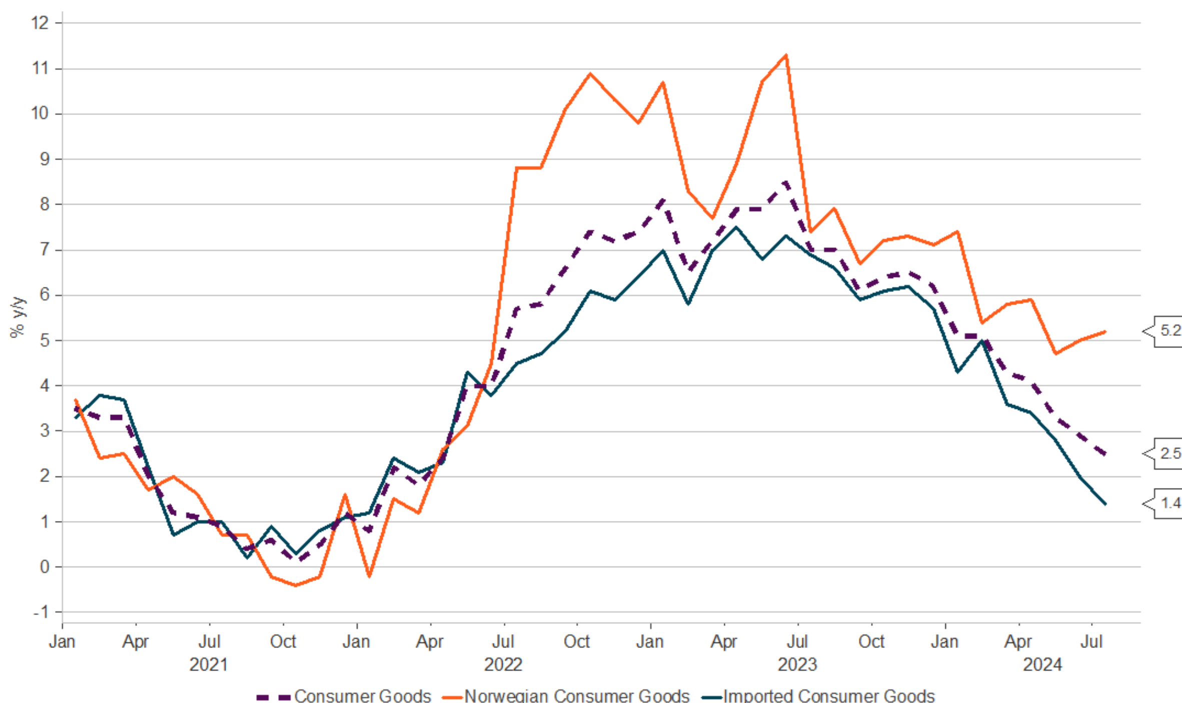
Source: Macrobond, BNY

The evident demand weakness is now being reflected in consumer goods price growth, which has fallen to 2.5%y/y. However, decomposing reveals a more complex picture and requires careful calibration of monetary policy. Firstly, Norwegian (domestically produced) consumer goods inflation remains very high at 5.2%y/y. As this component would have heavier exposure to changes in Norwegian wages, further declines would be tied to the labor market, which in turn Norges Bank expects to remain tight. Based on this component's lack of declines, a more hawkish policy stance is required. On the other hand, imported consumer goods price growth has fallen sharply to 1.4%y/y. This has taken place while global wage growth is still robust and while NOK has weakened. In theory, both factors should have

pushed up imported consumer goods price growth, so the sustained decline can only be attributed to a demand story, which is consistent with turnover figures indicated above. Norway's economic exposures means that imported consumer goods would have a higher weighting in spending baskets. Based on this approach, it is possible that household demand is far weaker than what inflation numbers would indicate and justify a pivot toward easing. On balance, Norges Bank will likely lean toward inflationary factors and there is always government demand to fall back on. FX purchases by the central bank have fallen in July but remain above Q1 levels, indicating sufficient fiscal space if needed.

Furthermore, Norges Bank highlighted that a weak exchange rate is still contributing to elevated inflation expectations for households and higher wage settlements. Although this is not supported by the imported goods inflation data, expectations are more stubborn and Norges will hope that a stronger exchange rate can help reduce the pass-through contribution, as wage and productivity matters are beyond their control. Based on this measure, NOK valuations are starting to look unanchored and would certainly represent upside risk to inflation throughout their forecast horizon.

Exhibit #2: CPI-ATE Decomposition

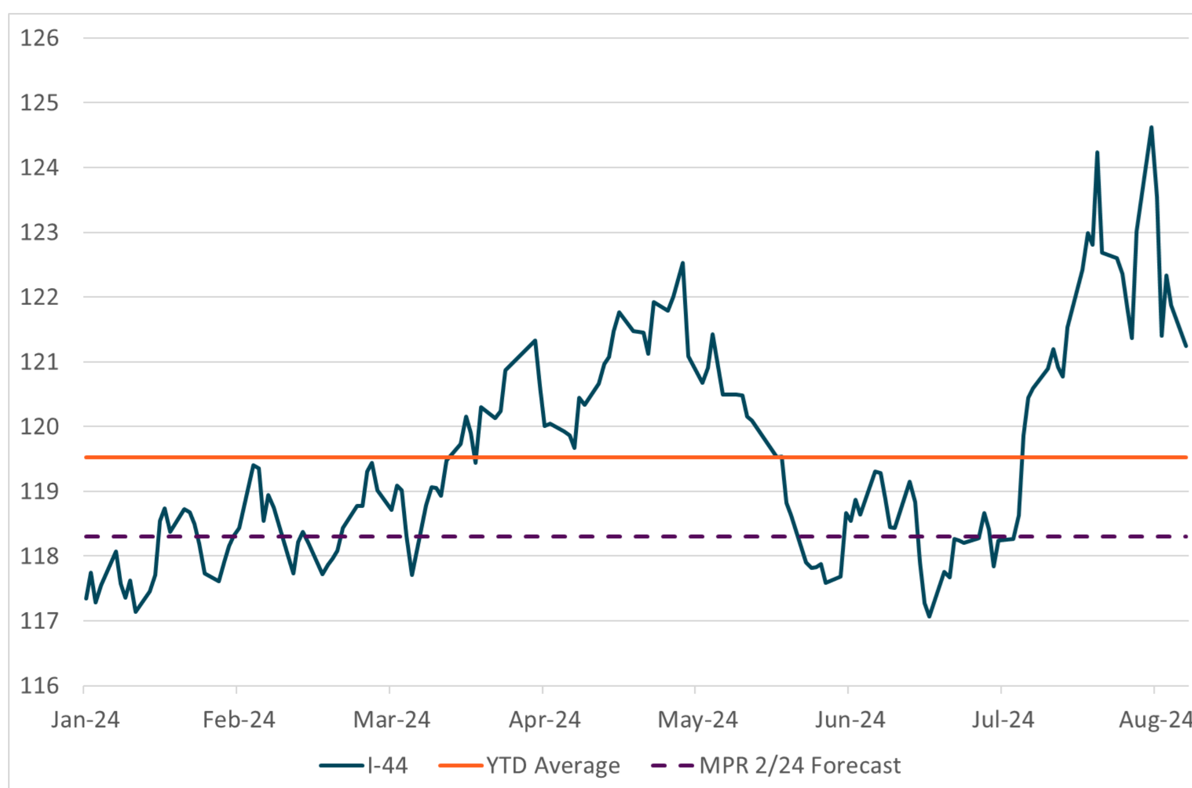


Source: Macrobond, BNY

As of Tuesday, the I-44 Import Weighted Price index (essentially their own Nominal Effective Exchange Rate measure) is running at 2.5% above expectations for the year, and the year-to-date average is also more than 1% higher. If Norges requires the I-44 to fall back to the

current 2024 average, then for the remainder of the year NOK's average NEER would need to be 2.5% higher than the current average at 116.6, and close to 4% above the current level. We note that the I-44 has not touched this level at all over the past 12 months and is a very tall order, barring material divergence in rate differentials in Norges' favor. Compared to the Riksbank, Norges has not been as strident in calling for valuations to adjust, mostly because during the oil surge this was less of an issue. The scale of the reversal must have come as a surprise and pushing for a stronger currency at this point in the global policy cycle lacks credibility. This is where, as stated above, government spending comes in: the demand component itself will support inflation expectations and the need for rate resilience, while FX purchases would ease further and help the balance of flow.

Exhibit #3: I-44 vs. Forecast

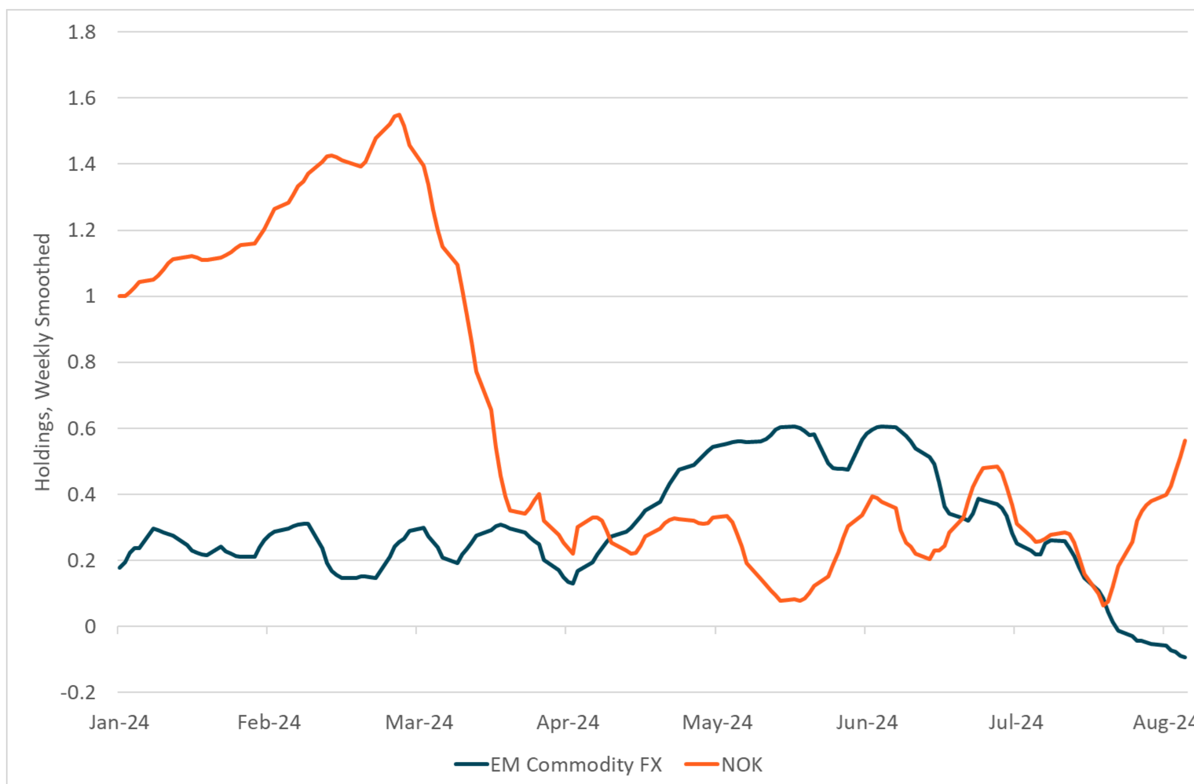


Source: Bloomberg, BNY

One final factor which could be inhibiting further NOK strength is positioning. NOK is the only G10 currency to have consistently maintained overheld positioning among cross-border investors. While rate differentials have not been as supportive, valuations for a savings-heavy economy such as Norway have always been a deterrent against over-hedging the currency. Exposure to real "assets" has been an additional factor, which explains why for the most part of this year both NOK and higher-yielding commodity bloc EM currencies have also been overheld. However, divergence has come through with the latter now moving toward underheld territory as carry positions are unwound (Exhibit #4). NOK would not count as a

carry name but if the entire “real protection” argument begins to soften amid global growth weakness and lower nominal yields, adding to NOK holdings does not offer good risk reward on either account. If pursuing sustained NOK strength is a policy objective, then Norges will need to push back against easing expectations in the market forcefully.

Exhibit #4: Holdings Change, NOK vs. EM Commodity FX



Source: BNY

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Please direct questions or comments to: iFlow@BNY.com

Geoff Yu

EMEA MACRO STRATEGIST

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