

## European Watch

## Norges Bank Review: non-event

**25bp as expected, another 25bp likely**

Norges Bank hiked rates 25bp today as expected. They guided to another 25bp hike in June, which would be in-line with our forecast. They had previously said that higher rates would be needed to dampen inflation and with data roughly in-line with their forecast Norges followed through.

**NOK part of the equation**

The main inflationary news for Norges has been NOK's depreciation. Norges gave a standard explanation of how they take that into account. The currency matters for forecasting inflation but the currency is not a target. To the extent that NOK's fall does not reflect economic news that would dampen inflation (such as weaker demand) then we would expect Norges to react to a weaker currency with higher policy rates. As a guide the depreciation up to the last Norges forecasts added approximately 30bp to the policy path, all else equal (Exhibit 1-Exhibit 3). This is why we see risks skewed to (modestly) more hikes than our base case.

**NOK matters but no more than it used to**

Norges Bank's meeting was a non-event for NOK. Here we discuss four questions:

**1. Does NOK matter for Norges?**

Norges may have been explicit a weaker NOK would in isolation lead to a higher rate:

*"If the krone remains weaker than projected or pressures in the economy persist, a higher policy rate than envisaged earlier may be needed."* (Norges Bank, May 2023)

But this was almost identical to what it said in March, when a weaker than expected NOK added c. 30bp to its rate path:

*"If the krone proves weaker than projected, or pressures in the economy persist, a higher policy rate than currently projected may be needed to bring inflation down to target."* (Norges Bank, March 2023)

Still, Norges made no explicit reference to NOK in its January guidance:

*"If economic pressures persist and signs emerge that inflation will remain high for longer than projected, a higher policy rate may be needed than envisaged earlier. If inflation falls faster or unemployment rises more than projected, the policy rate may be lower than projected in December."* (January 2023)

Simply, the krone is one of several factors Norges considers when setting policy (Exhibit 3). Norges was less explicit on it in January (or many of its past meetings) because it considered other factors to be more critical at the time. **(cont'd on page 2)**

04 May 2023

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Put differently, Norges was more explicit on it this time and in March, not because its reaction function to it changed, but because the krone's deviation from its earlier projections stood out in importance vs. the other monetary-policy inputs.

Bottom line—NOK certainly matters to Norges Bank, but their reaction function to it does not seem to have changed.

## 2. Why the Riksbank's stance on SEK has been different

We think this is a key difference vs. the Riksbank: in February the Riksbank hinted the FX pass-through to inflation may have risen, implying a potentially different reaction function to SEK (i.e., suggesting less tolerance than previously):

For instance, Governor Thedéen said:

*"It is also reasonable to believe that the longer the krona remains weak, the greater the impact of earlier krona movements will be on prices in Swedish kronor. **Perhaps it is also the case that it is now easier to pass on rising costs from a weak krona to consumers.**"* (Riksbank monetary policy minutes, February 2023) (emphasis ours)

Deputy Governor Flodén said:

*"Normally, the pass-through from the exchange rate to consumer prices is quite modest but **I suspect that the correlation may have changed** when many companies raised their prices last year. There are many indications that companies then passed on their increased production costs, often in the form of higher import prices, fully to consumers. In that case, the krona depreciation also had a major impact on pricing."* (Riksbank monetary policy minutes, February 2023) (emphasis ours)

## 3. Does Norges matter for NOK?

Monetary policy's role and (statistical) significance to NOK seems to have fallen in recent months, but Norges still matters for NOK (we discuss this in [Sweden and Norway monthly: more hikes 23 February 2023](#)).

In fact, so far this year monetary policy has likely *prevented* more NOK weakness (see also our latest Nordics monthly (see Exhibit 4 and [Nordics monthly: different tolerance 26 April 2023](#)).

On the other hand, NOK's implied volatility spread has risen meaningfully this year (Exhibit 5), which has likely contributed to NOK's recent weakness (we define NOK's implied volatility spread as the spread between the equally-weighted average of the 3-mth EUR/NOK and USD/NOK implied volatilities and the equally-weighted average of the 3-mth EUR/USD, USD/JPY, EUR/JPY and EUR/CHF implied volatilities).

While the higher NOK implied vol spread likely reflects oil-price volatility, we think it may also reflect the widespread confusion among market participants around the conduct of Norges Bank's foreign exchange transactions on behalf of the Ministry of Finance. We do believe, therefore, that more clarity about their calculation could contribute to lower volatility and help NOK somewhat.

## 4. Where to from here?

We are constructive on NOK going forward, counting on (1) Higher oil prices in 2H, partly in anticipation of a pickup in China international travel; (2) Norges doing its part; (3) More favourable oil-related NOK flows by Norges and Norwegian petroleum companies combined, following May's revised budget and the start of 2023 oil tax payments in 2H.

### Exhibit 1: Norges Bank's policy-rate projections (percent)

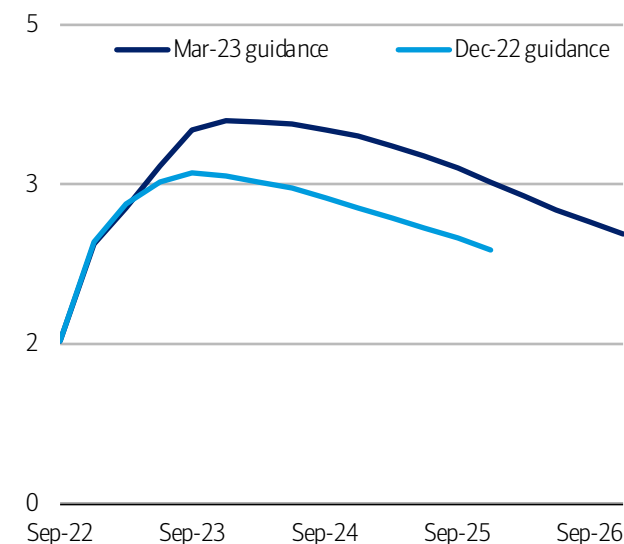
Norges terminal rate up by 49bp vs its December forecast, and reached a little later

	Sep-22	Dec-22	Mar-23	Jun23	Sep-23	Dec-23	Mar-24	Jun24	Sep-24	Dec-24	Mar-25	Jun25	Sep-25	Dec-25	Mar-26	Jun26	Sep-26	Dec-26
Mar-23 guidance	1.53	2.45	2.78	3.18	3.52	<b>3.60</b>	3.59	3.56	3.51	3.45	3.37	3.27	3.16	3.02	2.89	2.77	2.65	2.54
Dec-22 guidance	1.53	2.46	2.82	3.03	<b>3.11</b>	3.08	3.03	2.96	2.87	2.78	2.69	2.59	2.49	2.38				

Source: Norges Bank, MPR 1/23

**Exhibit 2: Norges Bank's policy rate path as of Mar-2023 (percent)**

Higher terminal, fewer cuts

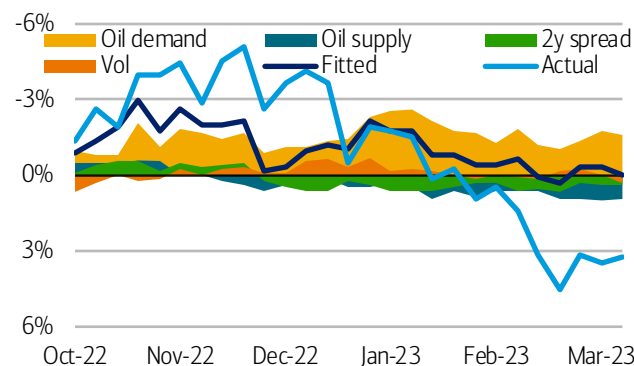


Source: Norges Bank, MPR 1/23

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**Exhibit 4: Fitted vs. actual NOK I-44 (inverted values)**

NOK in line with history until late-Feb, but its recent weakness overdone

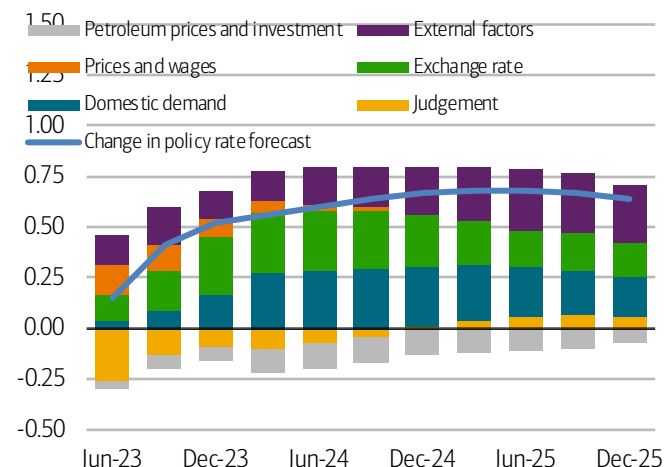


Source: BofA Global Research, Bloomberg, Federal Reserve Bank of New York, Oil Price Dynamics Report, [https://www.newyorkfed.org/research/policy/oil\\_price\\_dynamics\\_report.html](https://www.newyorkfed.org/research/policy/oil_price_dynamics_report.html). Lower values of the import-weighted krone index (NOK I-44) show a stronger NOK. Weekly data through Apr 7. Regression estimates are for Jan 2018- Sep 2022. We regress changes in (log) NOK I-44 (Norges's import-weighted krone index) on: demand-driven and supply-driven changes in (log) Brent crude spot prices as per the New Fed Oil Price Dynamics Report data; changes in Norway's 2-year trade-weighted swap spread; and changes in the idiosyncratic NOK implied-vol spread.

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**Exhibit 3: Decomposition of changes in Norges Bank's rate path**

"Judgement" pushed down rate path by 26bp near term but pulled it up slightly further out. NOK and external factors key drivers near term

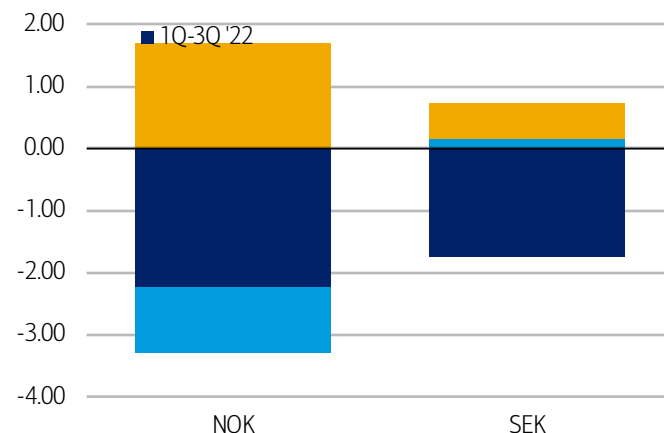


Source: Norges Bank, MPR 1/23, BofA Global Research. Note: Judgment is the difference (residual) between the rate-path changes and the cumulative contribution of the remaining five components.

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**Exhibit 5: Idiosyncratic 3-month implied volatility spreads**

Relative vol has likely weighed on NOK this year



Source: BofA Global Research, Bloomberg. Note: We define the idiosyncratic NOK (SEK) implied volatility spread as that between the equally weighted average of the 3-mth EUR/NOK and USD/NOK (EUR/SEK and USD/SEK) implied volatilities and the equally-weighted average of the 3-mth EUR/USD, USD/JPY, EUR/JPY and EUR/CHF implied volatilities. Data weekly through Apr 28.

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