Norges Bank

2024

Economic perspectives

Annual address by Governor Ida Wolden Bache
to the Supervisory Council of Norges Bank

Thursday 15 February 2024

Economic perspectives 2024

TILLIT at Økern © Lars Ø Ramberg / BONO 2023.

Along one of the major ring roads around Oslo stands an empty building.[1] On its façade the Norwegian word for trust (TILLIT) shines towards us. While the building has been empty for almost 20 years, the word is certainly not. It is replete with meaning and implications. Trust forms the leitmotif of my speech this evening – why trust is important and how we can preserve it.

1 The light installation TILLIT (trust) was created by Lars Ø. Ramberg for the ØKERN! project as a part of "Art in public spaces and urban development in Hovinbyen". TILLIT is supported by the City of Oslo Art Collection, KORO, Økern Sentrum ANS and Signify AS.

A well-functioning democracy is built on trust – political trust and institutional trust. International comparisons show that Norway enjoys a high degree of trust both between its people and between its people and government.[2] We are privileged to live in a country with such a high level of trust capital. Perhaps trust is the most important capital we have, which we also want to pass on to future generations.

Money is also grounded in trust. For thousands of years, economic life has involved various forms of *money*. Money makes the exchange of goods and services more efficient. What we are willing to accept as money has naturally evolved over time from the world's first known currency, cowrie shells, to today's electronic money. For money to function as a medium of exchange, there must be trust in its value.

This year we are celebrating the 750th anniversary of the Code of Magnus Lagabøte.[3] The King was also a reformer of the monetary system. He took seriously the importance of trust in the value of money. The reforms he implemented have come to stand as a watershed moment in Norwegian monetary history.[4]

In his time, the royal power was the guarantor of the value of money. Today, most governments have delegated the conduct of monetary policy to the central bank. By giving the central bank the task of ensuring monetary stability and sufficient autonomy, the promise of preserving the value of money becomes more credible. But that promise must be followed by action. In today's situation, that means bringing inflation back to the target of 2 percent.

Inflation is coming down

There are now clear prospects that many countries are succeeding in doing so. In the aftermath of the pandemic and Russia's invasion of Ukraine, inflation rose to the highest levels seen in multiple decades. Last year, inflation eased substantially (Chart 1), and contrary to what many had feared, unemployment has remained low so far. Euro area unemployment is in fact at an all-time low.

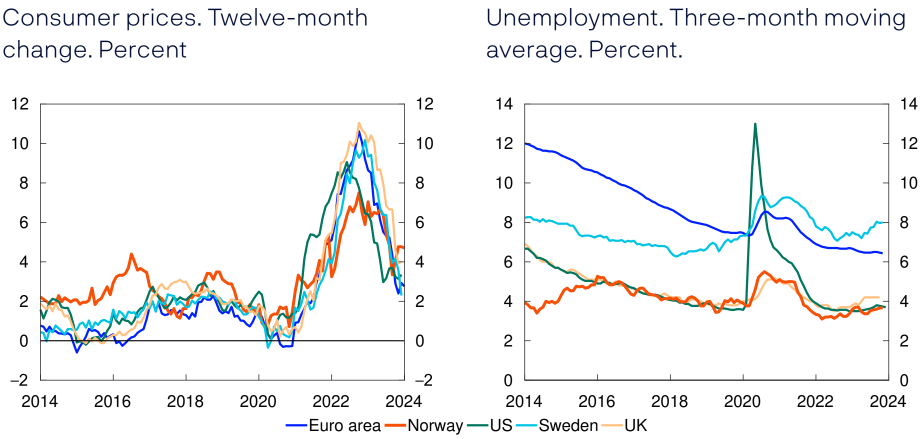
The inflation surge two years ago spurred international debate. Several well-known economists engaged in the debate and split into two groups. One group argued that high inflation would be short-lived and that inflation would by and large come down unaided. The group was spearheaded by Nobel laureate Paul Krugman and became known as "Team Transitory". The other group, by the name of "Team Persistent",

2 EVS/WVS (2022). European Values Study and World Values Survey: Joint EVS/WVS 2017-2022 Dataset (Joint EVS/WVS). JD Systems Institute & WVSA. Dataset Version 4.0.0.

3 The Code of Magnus Lagabøte was a national legal code covering the whole of Norway, issued by King Magnus VI of Norway between 1274 and 1276. The law was the first to apply to Norway as a whole and is one of the first examples of comprehensive national legislation implemented by a central authority in Europe.

4 Gullbekk, S. H. (2024). "Magnus Lagabøte - lovgiver og myntreformator [Magnus Lagabøte – legislator and monetary reformer], Special number of *Collegium Medievale*: "Landsloven 750 år" [Code of Magnus Lagabøte 750 years] (in preparation) (in Norwegian only).

Chart 1 Lower inflation without high unemployment



Sources: LSEG Datastream and Statistics Norway

argued that high inflation would linger, and that higher interest rates were needed to bring it down. The former US Treasury Secretary Lawrence Summers was a prominent member of this group.[5] He contended that a period of high unemployment was necessary in order to bring down inflation.

So who was right? Even if inflation has not yet declined to the targeted level, we now know part of the story. I would say neither Krugman nor Summers was entirely right.

Much of the disinflation was caused by a reversal of the initial inflation shock. Trade between countries is flowing more normally again, and prices for energy and many other commodities have fallen. That doesn't mean that monetary policy tightening was unnecessary. Inflation proved stickier than many economists had expected. The interest rate increases have eased pressures in the economy, and inflation would have been higher without the increases.[6]

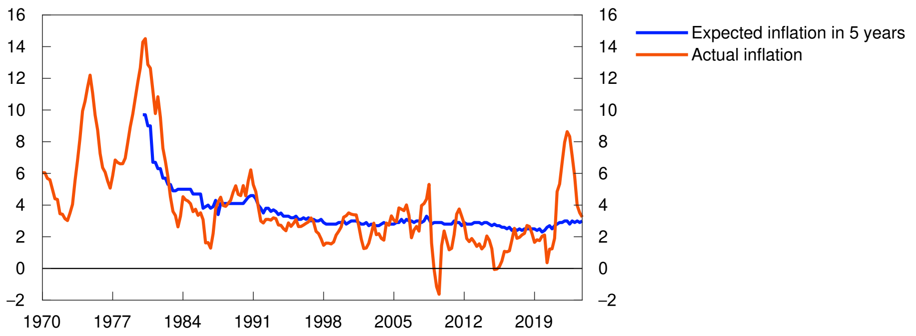
We are also benefiting from the preceding decades of low and stable inflation. When inflation surged in the wake of the pandemic, confidence in inflation targets was already pervasive, which may in and of itself have increased the speed of disinflation. If households and firms had expected inflation to remain high and had based their price and wage setting on that expectation, we might have seen a self-reinforcing inflation spiral. That would have required stronger monetary policy tightening to bring down inflation, which could also have led to higher costs in the form of increased unemployment.

5 See eg Economist (2024). "Has Team Transitory really won America's inflation debate?". *The Economist* and Guerrieri, V., M. Marcussen, L. Reichlin and S. Tenreyro (2023). "The Art and Science of Patience: Relative Prices and Inflation". *Geneva Reports on the World Economy* 26.

6 "Amatyakul, P., De Fiore, F., Lombardi, M., Mojon, B. and Rees, D. (2023). "The contribution of monetary policy to disinflation". *BIS Bulletin* 82/2023. BIS.

Chart 2 Confidence in low inflation

US consumer prices. Twelve-month change. Percent



Sources: LSEG Datastream and University of Michigan

US statistics for inflation expectations go back as far as the 1980s (Chart 2). At the beginning of the 1980s inflation was high, and people expected inflation to remain high for several years into the future. After a period of very tight monetary policy, inflation retreated. Since then, long-term inflation expectations have been low and stable, also after the recent years' surge in inflation. The situation is the same across many countries, including Norway.[7]

There is an academic debate about the significance of inflation expectations for actual price and wage setting.[8] Whether households and firms expect inflation to hit target precisely is not necessarily of material importance. History has shown, however, that if confidence starts to slip, the cost of bringing down inflation again may be substantial.

Therein lies a warning against loosening monetary policy prematurely when inflation falls. In a study of inflationary episodes since the 1970s, IMF economists find that countries that lowered interest rates early on when inflation showed signs of slowing, experienced a resurgence in inflation more often than other countries.[9] It pays to be patient.

The credibility of inflation targets has been built up over time. To maintain that credibility, the promise of returning inflation to target must be fulfilled. With confidence in low and stable inflation over time, we are better equipped to cope with future shocks and turbulent periods.

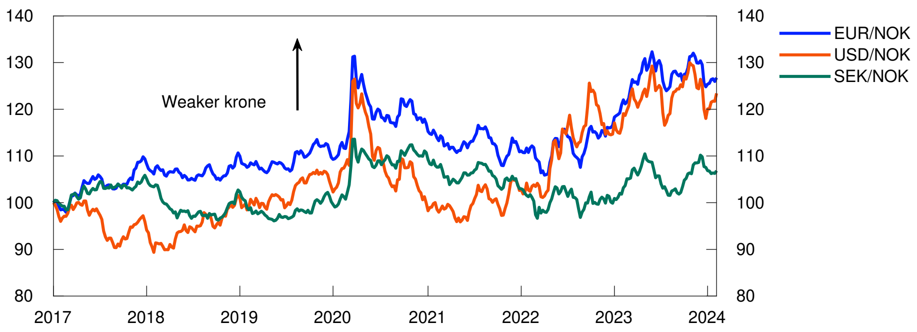
Developments in Norway and other countries are similar in several respects. Inflation has fallen, and unemployment remains low despite a moderate increase (Chart 1).

7 See box "Inflation expectations in a period of high inflation" in *Monetary Policy Report* 4/23 for a further analysis of inflation expectations in Norway.

8 See eg Rudd, J.B. (2022). "Why do we think that inflation expectations matter for inflation? (And should we?)" *Review of Keynesian Economics*, Edward Elgar Publishing, vol. 10(1), pp 25-45, January, and Werning, I. (2022). "Expectations and the Rate of Inflation". *NBER Working Paper* 30260.

9 Ari, A., C. Mulas-Granados., V. Mylonas, L. Ratnovski and W. Zhao (2023). "One Hundred Inflation Shocks: Seven Stylized Facts". *IMF Working Paper* No. 2023/190.

Chart 3 A weaker krone contributes to keeping inflation elevated
Exchange rates. Index. 6 January 2017 = 100



Source: LSEG Datastream

The external drivers of Norwegian prices are moderating. That will dampen inflation ahead. At the same time, there are factors that could contribute to keeping inflation elevated in Norway even amid falling inflation internationally. Domestic wage growth has increased and last year reached the highest level recorded in 15 years. Pay increases have not been large compared with the increase in living costs, but combined with low productivity growth and price increases for many intermediate goods, Norwegian firms are facing substantially higher costs.

The krone depreciation over the past year and a half has also contributed to keeping inflation elevated in Norway. The krone has depreciated primarily against major currencies, such as the euro and the US dollar, and less against smaller currencies such as the Swedish krona (Chart 3). The krone depreciation means that holiday travel and imported goods have become more expensive. Firms that rely on foreign suppliers have seen their costs increase. At the same time, the krone depreciation has also boosted profits in the export sector, which can in turn lead to higher wage growth and keep domestic cost inflation at a higher level for longer.

With weaker growth prospects and inflation that was already too high, the krone depreciation made monetary policy trade-offs more challenging last year.

A floating exchange rate

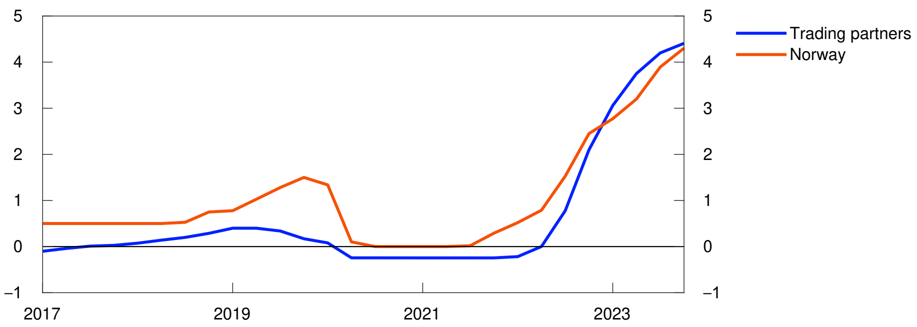
When the krone depreciated, the question arose as to whether the Bank should have done more to stabilise the krone. Some suggested foreign exchange market interventions in support of the krone. However, the experience of intervening in the foreign exchange market, as we did when we operated with an exchange rate target, is not satisfactory. The central bank may easily find itself in an undesirable game situation with market participants.[10] Moreover, research does not suggest that interventions have anything but small and short-lived effects. The threshold for intervening in the foreign exchange market to influence the krone exchange rate is therefore very high.

Under a floating exchange rate regime, we must accept that the krone fluctuates. This imposes some costs on both businesses and households. Sometimes the krone will move in an undesirable direction in the sense that monetary policy trade-offs become more difficult.

At the same time, there are also clear advantages to allowing the krone to float. A floating exchange rate means that we are not bound to keeping interest rates at the same level as in other countries and jurisdictions. This is particularly valuable when the Norwegian economy is not at the same stage of the business cycle as our trading partners. A floating exchange rate provides freedom of action to set the interest rate based on the outlook for the Norwegian economy and to engage in flexible inflation targeting whereby we can also contribute to supporting high employment.

Freedom of action nevertheless has some limits. Given free capital movements and an inflation target identical to our trading partners, the level of interest rates in Norway cannot deviate substantially from foreign rates over time. The fact that policy rates among trading partners rose faster and at one point were higher than the policy rate in Norway has likely contributed to the krone depreciation over the past year and a half (Chart 4).

Chart 4 The policy rate differential against other countries is of importance
Policy rate in Norway and among main trading partners. Percent



Sources: Bloomberg and Norges Bank

10 The literature does not provide any definitive conclusions on the effect of interventions, because the effects depend on the situation in the particular country and on structural factors in foreign exchange markets. The effects are often found to be small and short-lived. However, interventions can be effective when markets are not functioning. See Arango-Lozano, L., L. Menkhoff, D. Rodríguez-Novoa and M. Villamizar-Villegas (2020). "The effectiveness of FX interventions: A meta-analysis". *Journal of Financial Stability*, 100794. See also Filardo, A., G. Gelos and T. McGregor (2022). "Exchange-Rate Swings and Foreign Currency Intervention". *IMF Working Paper* No. 2022/158.

Moreover, we must maintain confidence in the inflation target. We must react when there are prospects that inflation will rise above target, even when the source of inflation is external. If monetary policy does not react, the krone may depreciate substantially, leading in turn to higher imported inflation, which could spill over into domestic price and wage inflation. If we do not raise the policy rate when inflation increases, the exchange rate may fuel a wage-price spiral.[11]

Within certain limits, a floating exchange rate provides leeway that we can use to stabilise economic developments. A floating exchange rate can also function as a shock absorber in a downturn and can support structural changes, as witnessed for example after the oil price fall in 2014 when the krone depreciated sharply. If the only means of strengthening competitiveness had been through a long period of lower wage and price inflation than among our trading partners, as a fixed exchange rate target would have required, we would probably have had to endure a larger increase in unemployment.[12]

Challenging trade-offs

High and variable inflation entails substantial costs to society. It increases uncertainty about future price developments and makes economic planning difficult. It can also lead to a situation where long-term investments have to give way to shorter-term investments. It is often those with low incomes and the smallest buffers that are hit hardest when prices rise rapidly and unexpectedly.

The operational target of monetary policy in Norway is inflation of close to 2 per cent over time. But we are not solely focused on inflation. Inflation targeting must be flexible, so that it can also contribute to high and stable output and employment.

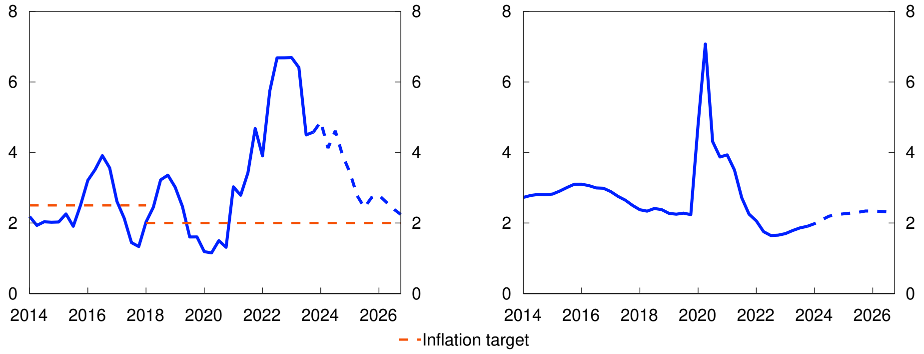
In the long term, there is no conflict between low inflation and high employment. Price stability is a precondition for an efficiently functioning economy. In the long run, we cannot trade off higher inflation for higher employment.

In the short term, however, there may be a conflict between these two considerations as we approach each policy rate decision. A trade-off must therefore be made between the objectives of low inflation and high employment. We interpret the mandate to mean that we must give considerable weight to employment also in the current situation with inflation markedly above the target.

11 Røisland, Ø. (2023). "Når kan lønns- prisspiraler oppstå? Om samspillet mellom pengepolitikken og lønnsdannelsen" [When can wage-price spirals arise? On the interaction between monetary policy and wage formation]. *Samfunnsøkonomen* Nr. 3 – 2023 (in Norwegian only).

12 Bergholt, D., Ø. Røisland, T. Sveen and R. Torvik (2023). "Monetary policy when export revenues drop". *Journal of International Money and Finance*, 137.

Chart 5 We make use of our monetary policy leeway



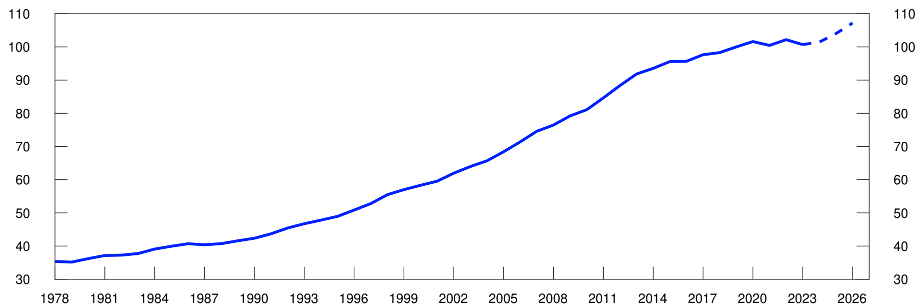
Sources: Norwegian Labour and Welfare Administration, Statistics Norway and Norges Bank

Since autumn 2021, we have raised the policy rate sharply and rapidly to tame inflation. Throughout, we have emphasised the need to avoid a sharp rise in unemployment. While we still have a ways to go, inflation is now heading down. We could have brought inflation down faster, but unemployment would probably have risen more. The trade-offs we make are expressed in our forecasts (Chart 5). We expect inflation to gradually approach target in the years ahead, with unemployment edging up to about its pre-pandemic level.

We know that the fight against inflation comes at a cost. The quick succession of interest rate hikes came on top of a rapid rise in prices. After several years of weak income growth, household purchasing power fell last year (Chart 6). Many people have less to spend, and some people are having difficulty making ends meet. If the economy evolves as we now expect, additional policy rate hikes will not be needed. Given lower inflation and prospects that wages will rise faster than prices further out, many people will see an increase in their purchasing power and lower

Chart 6 Weak income growth

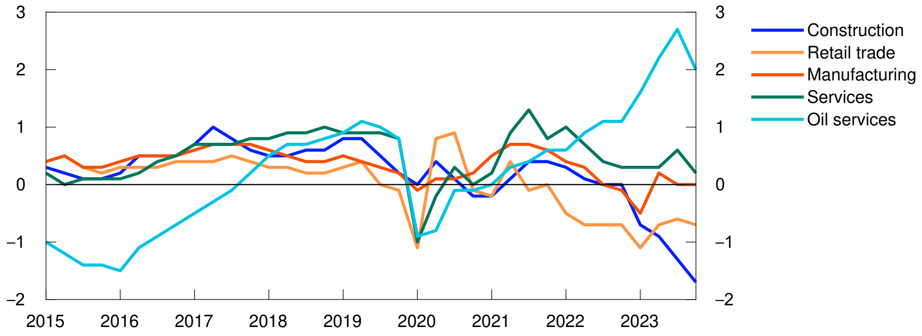
Real disposable income. Index. 2019 = 100



Sources: Statistics Norway and Norges Bank

Chart 7 Wide differences across industries

Output growth in the current quarter according to the Regional Network. Seasonally adjusted. Percent



Source: Norges Bank

debt servicing costs. At the same time, we must be prepared for somewhat higher unemployment.

The cost of reducing inflation is also being felt by businesses (Chart 7). The interest rate hikes have hit construction and retail trade particularly hard. The policy rate affects the economy broadly and cannot be used to fine-tune developments in individual sectors. Nevertheless, when we set the policy rate, we are conscious that pronounced impacts on individual industries can have more persistent effects which may weigh on the economic outlook. Even so, our primary objective remains the same. The easing of inflation is of benefit to the entire economy, including the most interest rate sensitive sectors.

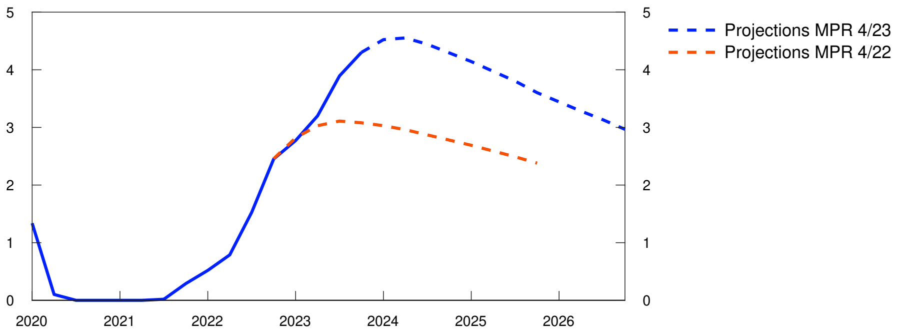
If developments turn out as we now expect, inflation will return to target without a sharp rise in unemployment, thanks in part to the effective interaction of economic policy. A system of coordinated wage determination, as is the case in Norway, where the parties give weight to employment, reduces the risk of wage-price spirals. In interaction with flexible inflation targeting, this reduces the cost of reducing inflation, as the Holden commission recently concluded in its report on challenges to wage formation and the Norwegian economy.[13]

A year ago, it was our view that the policy rate was close to peaking (Chart 8). That didn't happen. Demand held up longer than expected, and business costs rose more than anticipated. Moreover, the krone depreciated. The result was a further rise in inflation, which is why the policy rate has turned out to be higher than we projected one year ago.

We could always forecast the policy rate with perfect accuracy. But the policy rate is a tool, not an objective. Monetary policy must constantly be adjusted to the economic outlook.

13 Official Norwegian Reports (NOU 2023:30) *Utfordringer for lønnsdannelsen og norsk økonomi* [Challenges to wage formation and the Norwegian economy], p 18: "Given effective interaction of economic policy, it will be easier to bring inflation down towards the target while avoiding a substantial increase in unemployment" (in Norwegian only).

Chart 8 We have raised the policy rate to bring down inflation
Policy rate. Percent



Source: Norges Bank

We must be prepared for more pronounced and more frequent economic shifts than in the decades prior to the pandemic. The consequences of climate change are becoming increasingly visible, and a global transition is necessary to reach net zero. Geopolitical tensions and the desire to safeguard national supply lines are affecting trade and cross-border cooperation. At the same time, technological innovations and artificial intelligence may lead to an upheaval of the labour market.

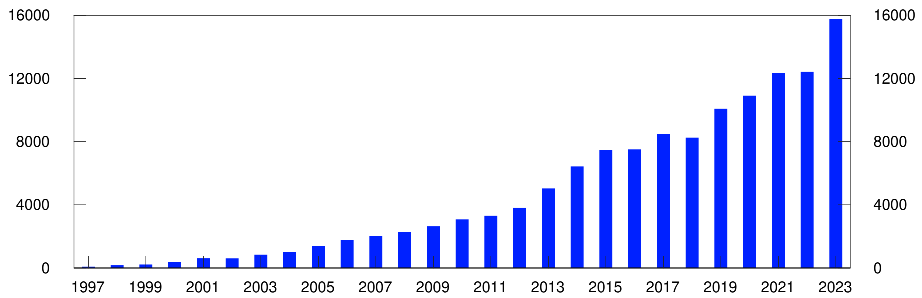
These developments will pose a challenge to all aspects of economic policy, including monetary policy. The job of ensuring price stability may become more demanding. Large changes in some prices may be necessary for the economy to adapt. With a flexible targeting regime, we can look through temporary changes in inflation. But the most important contribution monetary policy can make to support structural changes and employment is to ensure low and stable inflation. The monetary policy regulation was amended in 2018 following a thorough process. I believe our mandate provides a solid foundation for meeting the challenges we will face in the coming years.

The GPFG must be grounded in legitimacy

Exactly 50 years ago today, the Bratteli Government presented its white paper on the role of petroleum activities in Norwegian society. The report is both well-written and prescient. Even if only a few short years had passed since the first oil discovery in the North Sea, the report highlighted the necessity of investing a substantial portion of government petroleum revenues abroad. As successive governments have set money aside over nearly three decades, the Government Pension Fund Global (GPFG) is now among the world's largest sovereign wealth funds (Chart 9).

The GPFG's very size is testimony of the Norwegian public's trust in democracy and political institutions. That trust is based on broad support for the overall framework for GPFG investment management. As enshrined in law by the Storting, the objective of investment management is to achieve the highest possible return at acceptable risk. Within

Chart 9 Substantial revenues have been transferred to the GPFG
Market value. Government Pension Fund Global. In billions of NOK



Source: Norges Bank

this framework, lies the requirement of responsible investing and an important premise for what it should not be used for. It shall not be a tool for achieving political goals other than purely financial ones.

The investment strategy has been developed over time. All of the important changes to the investment framework have been approved by the Storting. The broad consensus has enabled us to stick to our strategy even in periods of substantial financial market volatility. This has served us well. Trust has paid off, financially too.

In its equity portfolio, the GPFG holds a stake in close to 9 000 companies in more than 70 countries. We own a small slice of just about everything. This is a sensible strategy for such a sovereign wealth fund. This strategy ties us to the global economy for better or for worse. Sustainable economic developments and well-functioning markets are therefore in the GPFG's long-term interest.

Being an active owner enables us to influence companies in a more sustainable direction. We let companies know what we expect and are in a dialogue with them. [14] We exercise our voting rights at general meetings.

In recent years, we have raised our ambitions for responsible investment, not least with regard to climate and the environment. When the Ministry of Finance amended the investment mandate in 2022, it was specified that the GPFG, while pursuing its long-term financial objective, was to deploy efforts to bring the activities of its portfolio companies into alignment with the goal of net zero in accordance with the Paris Agreement.[15]

Norges Bank has supported the new ambitions with a climate action plan.[16] We expect more of our portfolio companies and have reinforced our engagement efforts. We make an active contribution to the

14 *Responsible Investment* 2023. Norges Bank Investment Management. www.nbim.no.

15 *Management mandate for the Government Pension Fund Global.* www.regeringen.no.

16 Norges Bank Investment Management. *2025 Climate action plan.* www.nbim.no.

international work to develop binding standards and to improve climate disclosures.

We believe that the work that we and other investors are doing is making an impact. For instance, we note that the share of our portfolio companies with concrete and realistic plans for achieving net zero has increased. We also find that because the GPFG is large, the companies listen to us. And we see that when we publish our voting intentions in advance of general meetings, other investors follow.[17]

As owners we not only have rights but also obligations. For many companies, the GPFG is among the largest shareholders. This also entails responsibility. We cannot leave the task of ownership to others.

At the same time, there are dilemmas. We do not want the GPFG to be perceived as a political actor. But when we seek to influence companies, it may appear that way. As the Sverdrup commission pointed out in its report *The Fund in a changing world*, this balancing act may become more difficult ahead. A world of growing conflicts may blur the boundary between the economic and political spheres.[18] We already see that in some markets, responsible investment practices are being politicised. In the US, many large investors have therefore lowered their climate ambitions. In exercising our ownership rights we must therefore act responsibly ourselves. We must be ambitious, but our ambitions must be realistic. We must be transparent, reliable and predictable. Our expectations and views must be knowledge-based and rooted in internationally recognised standards and principles. We must be clear about the fact that the GPFG conducts its active ownership in pursuit of its long-term financial objective. This will contribute to preserving the GPFG's legitimacy globally and to fostering its growth and sustainability.

Conclusion

Let me conclude. The leitmotif today has been trust – the importance of trust in the value of money and trust in the GPFG and the way it is managed.

As an institution, Norges Bank is shown strong trust. The Bank manages vast assets on behalf of the Norwegian people and has been given a large degree of autonomy in interest rate setting.

In performing the tasks we have been given, we make judgements and choices that can have substantial consequences for people's finances. While central banks in earlier times were opaque about their reasoning, we try to be as transparent as possible about how we carry out our

17 Analyses have shown that when the GPFG publishes its voting intentions in advance of general meetings, the effect doubles. See Fahlenbrach, R., N. Rudolf and A. Wegeric (2023). "Leading by Example: Can One Universal Shareholder's Voting Pre-Disclosure Influence Voting Outcomes?", *European Governance Institute – Finance Working Paper* No. 958/2024.

18 Official Norwegian Reports (2022:12). *Fondet i en brytningstid – Statens pensjonsfond utland og endrede økonomiske og politiske utviklingstrekk* [The Fund in a changing world — The Government Pension Fund Global and new economic and political developments] (in Norwegian only).

mission.[19] It is important that you - the people and the political authorities - can assess and evaluate us. It is equally important that we listen and learn from others, even when they are critical of our choices.

Norges Bank's tasks are part of a greater whole. Together with other policy areas – fiscal policy and wage determination – the aim is to contribute to the highest possible level of welfare for our citizens.

The Norwegian word for trust is *tillit* and can be read both ways – from left to right and from right to left. Trust also goes both ways – we trust each other.

We trust that the political authorities and the social partners manage their responsibilities in the area of economic policy in a sound manner. In return, you can also trust that we will do our utmost to achieve the goals you have set for us.

19 See Qvigstad, J.F. (2009) "On transparency" Speech at the Norwegian Academy of Sciences and Letters, 10 November 2009, for a further discussion of transparency.