20 September: First hike since May 2011

- **We expect Norges Bank to raise policy rates by 25bs at this meeting**
- **The rate path is likely to be raised, indicating 2–3 hikes in 2019…**
- **…with the first of them taking place in March 2019**

Our expectation: We expect Norges Bank to increase policy rates by 25bp at the September meeting, in line with previous clear guidance. News since the June meeting broadly supports Norges Bank's view on the economic development. Furthermore, a weaker NOK, higher oil prices, inflation above forecasts and lower money market premiums are factors that contribute to lifting Norges Bank's rate path. A minor decline in the interest rate expectations abroad and judgement assessments are likely to dampen the rise in the rate path. The current path implies two 25bp rate hikes in 2019. We believe the new rate path will imply two to three rate hikes, probably closer to the latter in 2019.

Monetary policy announcement due on Thursday 20 September at 10:00 CEST: Along with the executive board's interest rate decision, the Monetary Policy Report 3/18 will be released. A press conference following the announcement will be held at 10:30 am, to be streamed on Norges Bank's website (in Norwegian).

The June meeting: Norges Bank kept the key policy rate unchanged at 0.50%, as was widely expected. The decision was unanimous. The interest rate path for Q4 2018 was unchanged, with an average rate at 0.76%. This is consistent with a rate hike in September to 0.75% and some probability of a rate hike in December. A full rate hike to 1.00% seems to be signalled in March next year and another hike in September. For Q1 and Q2, the rate path was unchanged compared to the March rate path, while the new path was increased by 3–7bp from Q3 2019 to Q4 2021. Norges Bank stated: "*The Executive Board's current assessment of the outlook and balance of risks suggests that the key policy rate will most likely be raised in September 2018*". **The August meeting** did not bring any new information to the table.

Developments since the previous meeting:

<u>Growth outlook abroad:</u> GDP growth forecasts from Consensus Economics have only been marginally changed from June to August. Also, inflation forecasts are marginally altered. We believe Norges Bank will keep forecasts for Norway's trading partners' GDP and inflation roughly unchanged. This factor is hence unlikely to contribute to moving the rate path.

<u>Interest rate expectations abroad:</u> 3m forward interest rates abroad have declined somewhat. From the week before Norges Bank's June meeting, foreign FRAs are roughly unchanged for 2018 and 2019, but have fallen 5–10bp for 2020 and 2021. Major trading partner currencies are the EUR, USD, SEK and GBP. The decline will contribute to a slightly lower rate path in 2020 and 2021 in our view.

<u>Exchange rate</u>: So far in Q3, the import-weighted foreign exchange rate, I-44, has been 2% above Norges Bank's forecast (implying a weaker NOK), while the current level is 2.4% above Norges Bank's quarterly forecast. Interest rate differentials, however, are slightly higher in 2019–2021 compared to the week before the June meeting. Oil prices have increased in the same period by roughly USD5/bbl for the relevant forward curve. Both oil prices and interest rate differentials are arguments for a stronger NOK than expected. Hence, the NOK should – according to Norges Bank's models – have been stronger, but instead a significantly weaker NOK has been observed. Thus, FX movements will contribute to a higher rate path.

<u>3m Nibor has been lower than expected</u>: So far in Q3, 3m Nibor has averaged 1.04%, versus Norges Bank's forecast of 1.10% for the quarter, due to lower money market premiums. Compared to Norges Bank's forecasts, the actual premiums have been around 10bp lower. Also on forward basis, premiums seem to be lower than the central bank's forecast. Compared to the corresponding difference between 3m USD Libor and 3m USD OIS, the markets price the NOK premiums too low in our view. We expect Norges Bank to assume that the premiums will increase from the current levels and hence not change the forecasts for 2020 to 2021 based on the latest development. We do however expect some short-term positive effects from money market premiums to the rate path.

<u>Capacity utilisation broadly in line with expectations</u>: Mainland GDP growth was 0.5% QOQ in Q2, 0.2%-points below Norges Bank's forecast of 0.7%. Furthermore, Q1 growth was adjusted down by 0.2%-points to 0.4%, and hence growth in H1 was clearly lower than Norges Bank assumed in June. The revisions of the GDP figures together with actual growth in Q2 contribute to lower the Mainland GDP forecast for 2018 by 0.2%-points. The monthly GDP-data showed that growth picked up in July. The petroleum investments survey suggests a modest downward risk for oil investments in 2018, but a minor upward revision for 2019. House prices started to pick up again in 2018 after falling during 2017, but have flattened in recent months. High electricity prices so far this year have eroded the growth in households' purchasing power, and households' confidence has moved lower. These

factors taken together increase the likelihood of modest consumption growth going forward in our view. With weaker growth through H1, we expect the central bank to revise the forecast for 2018 growth in Mainland GDP from 2.6% to 2.3%.

The Regional Network report showed that production growth was slightly below expectations for the previous three months, but the index still indicates broad-based growth above normal, which is expected to pick up slightly in the coming months. Indices for employment growth and capacity utilisation are stable at decent levels. Registered unemployment seems to have fallen slightly less than Norges Bank forecast in June, but that is partly due to methodological changes. Employment growth has been solid.

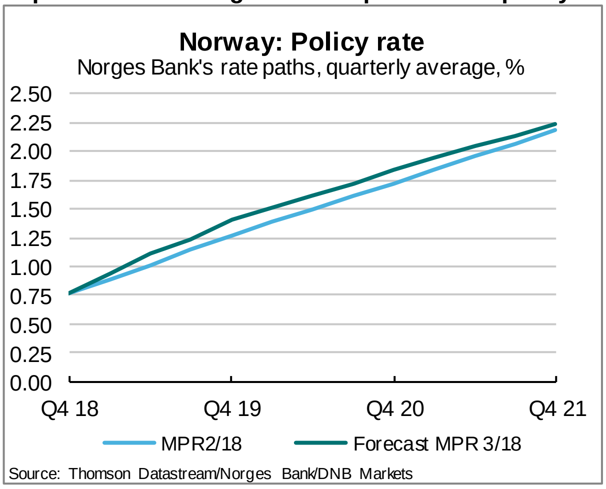
In total, we expect capacity utilisation to be revised modestly down in 2018, but to be little changed in 2019–2021. This factor is likely to contribute to a marginally lower rate path in 2018.

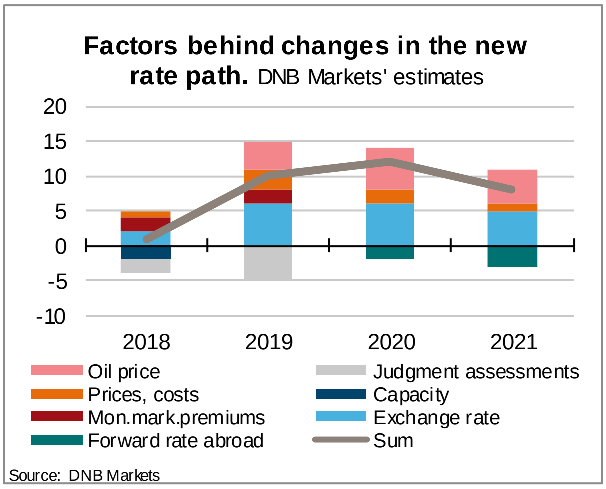
Inflation above expectations: Core inflation was 1.9% YOY in August, 0.4%-points above Norges Bank's forecast. Prices for clothing and footwear rose in August, while they normally decline due to summer sales. This might to some extent be reversed in September, when prices normally increase after the sales season is over. Higher-than-expected inflation will still probably affect 2018 and to an extent 2019 inflation forecasts, and contribute a few basis points to a higher rate path. Slightly increased long-term inflation expectations for the social partners despite the lowering of the inflation target may add to the policy rate curve in 2021.

Judgement assessments: Overall, we believe Norges Bank still wants to raise policy rates in September. We also interpret the sum of changes in relevant variables to indicate a higher policy rate path. But Norges Bank will move slowly, as stated in the June monetary policy report: "*In the light of the uncertainty surrounding the effects of a higher interest rate, it may be appropriate to assess the effects of a first rate hike before raising the key policy rate further. The interest rate path has therefore been adjusted up somewhat less at the beginning of the projection period than new information alone would indicate*". We therefore expect judgement assessments to contribute to a slightly lower rate path in 2018 and 2019. As we have stated earlier, we believe the next hike will take place in March. We expect the new policy rate path to indicate two or three hikes next year, possibly closer to three than two. For 2020 and 2021, we expect the pace of the rate hikes to be little changed.

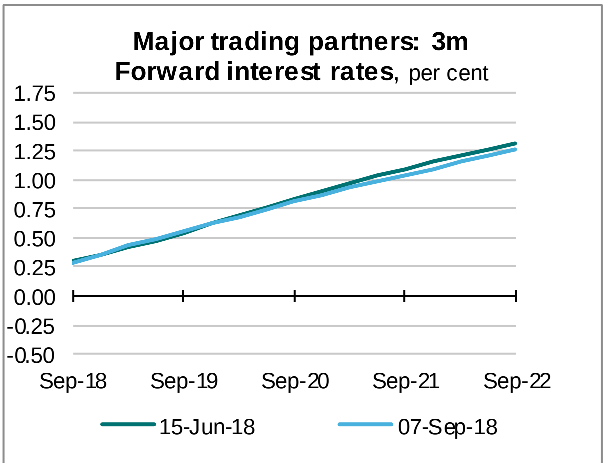
Jeanette Strøm Fjære and Kyrre Aamdal, DNB Markets

Expectations to Norges Bank's path for the policy rate



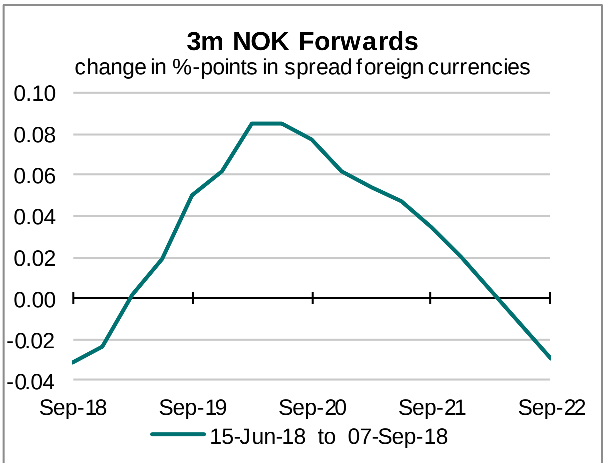


Lower rates abroad in 2020 and 2021 …



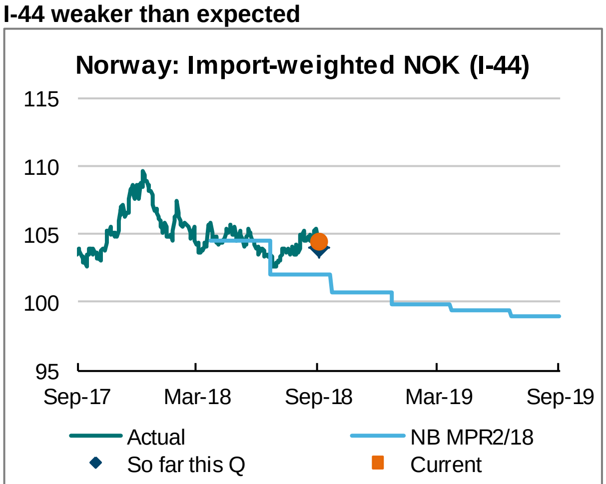
Source: DNB Markets

… and rate differential has widened somewhat



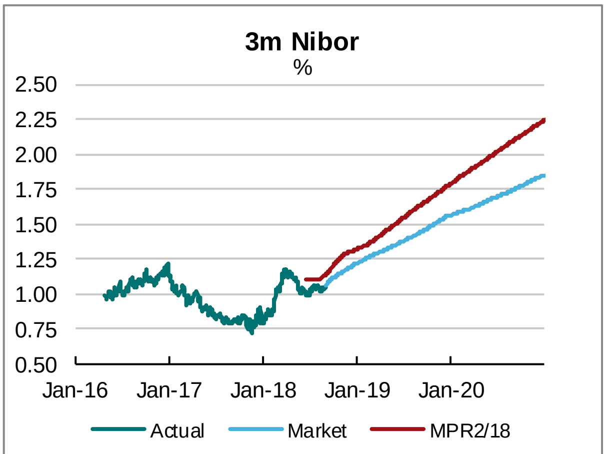
Source: DNB Markets

I-44 weaker than expected



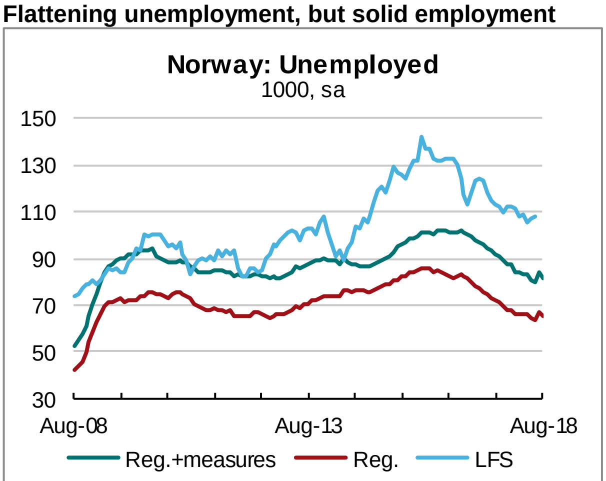
Source: Thomson Datastream/Norges Bank/DNB Markets

3m Nibor lower than NB's forecast



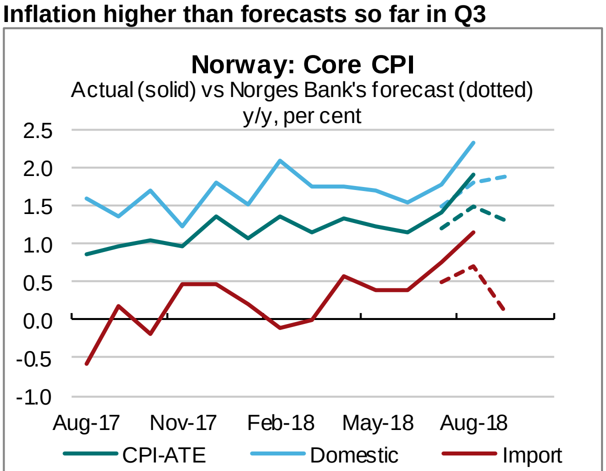
Source: Thomson Datastream/Norges Bank/DNB Markets

Flattening unemployment, but solid employment



Source: Thomsen Datastream/DNB Markets

Inflation higher than forecasts so far in Q3



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