

Norway

Norges Bank to Stay Sidelined in August

- We expect Norges Bank to keep its key policy rate stable at 1.50% and issue a neutral statement, balancing a strong domestic outlook on the one hand versus increased downside risks from abroad and very subdued domestic inflation on the other at the upcoming 29 August monetary policy meeting. In other words, the Bank is likely to repeat its main conclusions from June; although the strong domestic economy carries a larger weight in the Bank's overall assessment, downside risks from the uncertain global economic outlook and the ongoing EMU crisis in particular continue to feature high on the Bank's agenda.
- Since June, economic activity globally has weakened, while the situation on financial markets is about unchanged; market uncertainty remains high and key policy rates abroad are very low and expected to fall further. Meanwhile, risk appetite has improved slightly (i.e. VIX is below the June level).
- In Norway, on the other hand, strong domestic data has confirmed the positive ongoing momentum in the economy and the outlook is still markedly better than for most other European countries. The domestic data and survey releases have been strong, driven by the ongoing recovery in private consumption and high activity in the oil sector.

Tina Mortensen

+44-20-7986-3284

tina.mortensen@citi.com

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Norges Bank to Stay Sidelined in August

Although the global economic outlook has deteriorated since the June meeting and domestic inflation undershot Norges Bank's (NB) forecast, we reckon firm domestic activity data will keep NB from cutting rates further. In other words, we expect a confirmation of the policy rate at 1.50% at the upcoming 29 August policy meeting and a neutral statement where the Bank weighs a strong domestic outlook against increased downside risks from abroad and very subdued domestic inflation. Such an outcome would be in line with the Bank's latest MPR and conditional interest rate path, which puts the policy rate on hold for the remainder of 2012, and then indicates a gradual rise to 2.0% by end-2013 and 3.0% in late-2014 (see chart 1).

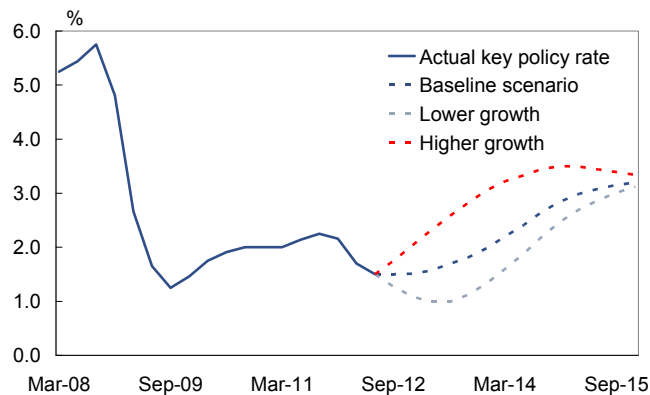
At the June meeting, NB kept the key policy rate stable at 1.50%, but appeared to put more emphasis on the strong domestic economy as it lifted the conditional interest rate by up to 15bn in 2013, signaling a 25bp rate hike in 2Q 2013 with a 50/50 probability of an even earlier rate hike (March report signaled a hike in 2Q/3Q 2013). Although, the strong domestic economy now carries larger weight in the bank's overall assessment, downside risks from the uncertain global economic outlook and the ongoing EMU crisis in particular continue to feature high on the bank's agenda. This was clear from the opening paragraph of the June policy statement: *"The level of uncertainty surrounding developments in Europe is now higher than it has been for some time. Although domestic developments have been slightly stronger than expected, the turbulence and weak growth prospects abroad suggest the key policy rate should be kept on hold"*.

Since June, economic activity globally has weakened, while the situation on financial markets is broadly unchanged from June; 1) market uncertainty remains high, but 10y government yields on European and US bonds are around the levels in June, 2) key policy rates abroad are very low and expected to fall further, and 3) risk appetite has improved marginally (VIX is slightly below the June level). The deterioration in recent data is evident in the weakening of the Citi G10 Economic Surprise Indices. The aggregate G10 ESI for the month of July was at its lowest since Sep-11 and the euro area ESI ducked deeper into negative territory in July, but has improved slightly, so far, in August (on a daily basis, see chart 3).

In Norway, on the other hand, strong domestic data has confirmed the positive ongoing momentum in the economy and the outlook is still markedly better than for most other European countries. The domestic data and survey releases have been strong, driven by the ongoing recovery in private consumption and high activity in the oil sector. Mainland GDP (excl. oil/gas and shipping) expanded by an above-trend 1.0% Q/Q (3.7% Y/Y) in 2Q and the latest report from NB's regional network (resembles Beige Book) suggests that economic activity only will slow marginally near term (see chart 4). The outlook for manufacturing, though, is mixed. While the export-related intermediate goods sector (in particular producers of basic chemicals, metal industries and paper and paper products) is struggling, the capital goods sector is thriving, reporting strong growth and rising investment ahead. However, capacity constraints are building.

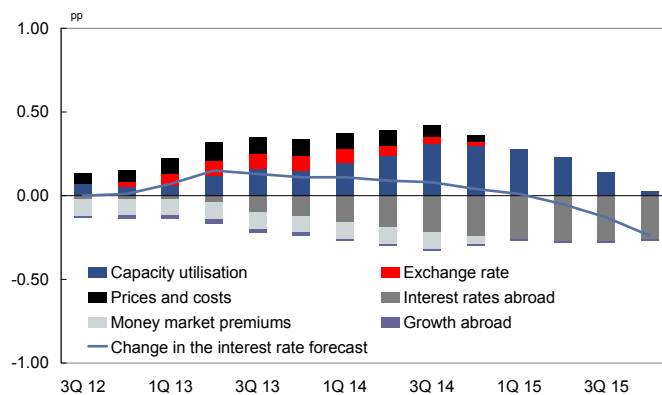
Conditions on the labour market remain firm (employment on an annual basis has exceeded 2% in the last six months and accelerated to 2.6% Y/Y in May, the strongest annual gain, so far, in this upturn, and the LFS jobless rate stood at 3.0% in 2Q, the lowest quarterly average since 4Q 2008 and well below the long-term average of 4%, see chart 5). Moreover, wage agreements suggest that pay growth will be little changed from last year's 4.2% Y/Y, indicating firm private spending growth ahead. House prices continue to climb, rising 7.8% Y/Y in July, and have now increased in the last 38 months by an average annual rate of 8.3%. Household credit growth, however, has stabilized around its long-term average of 7.1% Y/Y and is basically on par with the very solid increase in nominal disposable income in 1Q. Admittedly, CPI is low (0.2% Y/Y in July) and although the core inflation gap (actual inflation vs. NB's forecast) narrowed to 0.1pp in July from 0.5pp in June, we reckon core inflation very well could undershoot NB's forecast by a wider margin in coming months. Finally, the NOK (in TWI-terms) is, on average, in line with NB's June forecast.

Figure 1. Norway – Key Policy Rate in Baseline and Alternative Scenarios (Pct.), 1Q 2008-4Q 2015



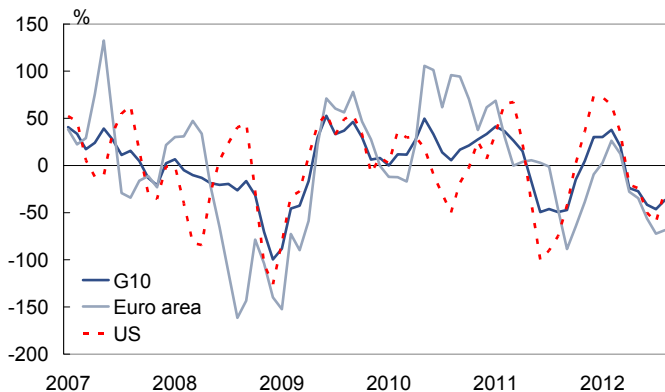
Sources: Norges Bank and Citi Research

Figure 2. Norway – Factors behind Changes in the Interest Rate Path since MPR 3/11 (Accum. Contribution, %-Points), 3Q 2012-4Q 2015



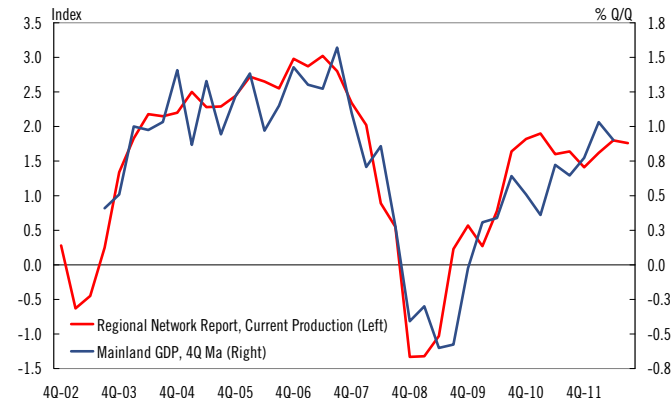
Sources: Norges Bank and Citi Research

Figure 3. Advanced Economies – Citi Economic Surprise Index, 2007-Aug 2012



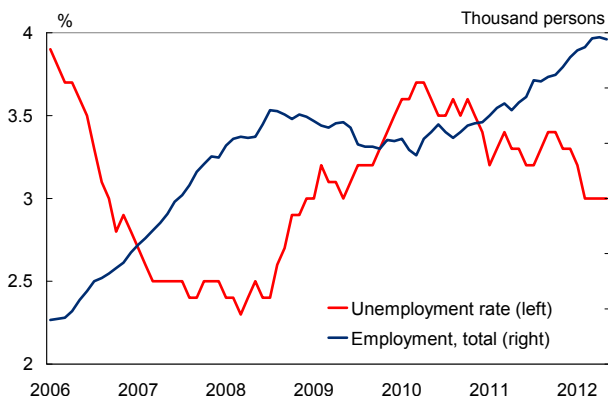
Note: August is an average of 1-17 August. Sources: Haver and Citi Research

Figure 4. Norway – Mainland GDP and Regional Network Output Indicator, 4Q 2002-3Q 2012F



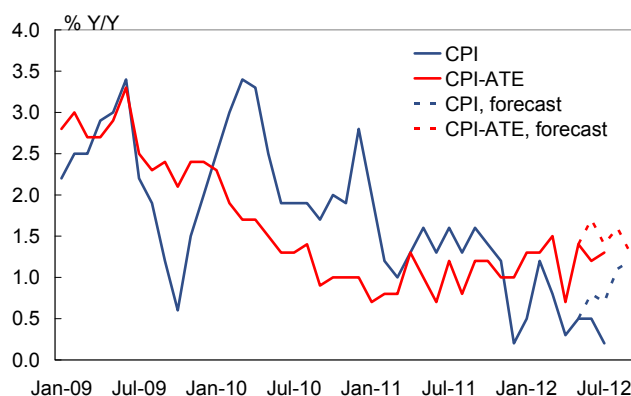
Sources: Norges Bank, Ecowin and Citi Research

Figure 5. Norway – Jobless Rate (Pct.) and Total Employment (Thousand Persons), Feb 2006-May 2012



Sources: Ecowin and Citi Research

Figure 6. Norway – Actual and Norges Bank Forecast for Headline and Core Inflation (Yr.-Yr.), Jan 2009-Dec 2012



Sources: Norges Bank and Citi Research

Appendix A-1

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