Norges Bank

2025

# Economic perspectives

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

Thursday 13 February 2025

# Economic perspectives 2025

"Some of the richest countries in the world are small. They are also outward looking."

So starts the first chapter of Victor Norman's textbook on a small open economy.[1] This is also an apt description of our country. Openness and trade have been essential to our prosperity.

Victor Norman passed away last year, and with that Norway lost a leading researcher and an outstanding communicator. The first edition of Victor Norman's book was published in 1983. The quotation I just cited is taken from the expanded edition released ten years later. That was more than 30 years ago, but the book bears its age well. The insights it provides are no less relevant today.

The framework conditions for international cooperation and trade are in play. There is war in Europe, and the governments of many countries see a need for rearmament. In today's world, emphasis must be placed on national security and preparedness considerations.

But the gains from trade with other countries are still there in full, especially for a small economy like ours. Norman points out that small countries often have a narrow resource base as they tend to cover a small part of the earth's crust. Norway, for example, is abundant in energy resources, but poor in arable land and the crop season is short. Norman posits in his textbook that if we shut ourselves out, such a resource base would have left us sitting hungry in overly heated homes. Trade with other countries allows us to decouple consumption from production. Small countries also have small markets, which means that the cost of producing some things domestically is higher than importing them. International trade expands markets. We can sell aluminium and buy aircraft.

1 Norman, V. D. (1983) "*En liten, åpen økonomi" [A small open economy]* Universitetsforlaget. Expanded edition: Norman, V. D. (1993) "*Næringsstruktur og utenrikshandel i en liten, åpen økonomi" [Industry structure in a small open economy]*. Universitetsforlaget.

But as Norman writes: “Open economies are not without their problems. Small countries must (almost by definition) take the world as it is – with minimal possibility of influencing international developments.” This is something we have experienced, most recently during the pandemic and the subsequent global surge in inflation.

### Five turbulent years

We have five turbulent years behind us (Chart 1). Monetary policy has had to navigate in uncharted territory. When the pandemic broke out and Norway went into lockdown, unemployment rose from 2 to 10 percent within a couple of weeks. The uncertainty was unusually great. To dampen the downturn, we set the policy rate at zero.

When economic conditions became more normal in autumn 2021, we began to raise the policy rate gradually. But as global activity rebounded, inflation also accelerated. Freight and commodity prices rose rapidly, and Russia’s invasion of Ukraine amplified the price rise. After a few months, inflation also shot up in Norway. We understood that the interest rate level was too low, and we had to tighten faster. Inflation repeatedly proved higher than forecast. Interest rates among our trading partners rose rapidly, and the krone depreciated. We didn’t want to restrain the economy more than needed. Employment considerations weighed heavily. At the same time, we had to prevent a continued rapid rise in prices with the risk of inflation becoming embedded in the economy.

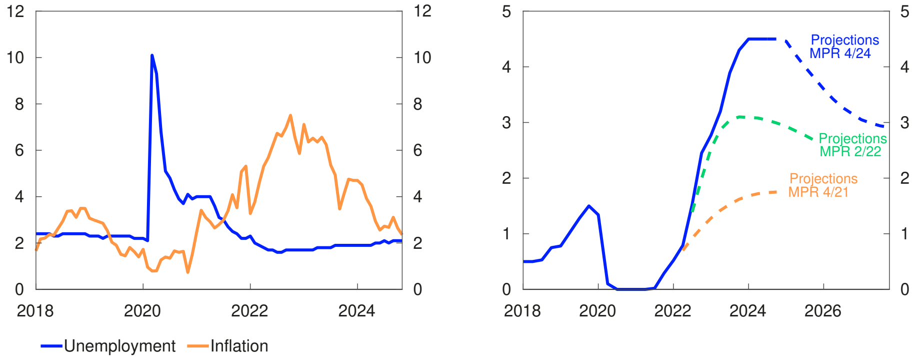
The trade-offs were demanding. How high did we have to set the policy rate to counteract a stronger krone depreciation and stop adding fuel to the inflation fire? Would this require a higher interest rate than highly indebted Norwegian households could bear?

In December 2021, our forecast indicated that the policy rate would increase gradually to a peak of just below 2 percent. The outcome three years later was a policy rate of 4.5 percent.

**Chart 1 Monetary policy had to be adjusted along the way**

Consumer price index. Twelve-month change. Registered unemployed as share of labour force. Percent

Policy rate. Percent




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

International experiences from the 1970s and 1980s gave reason to fear that the path to low inflation was via high unemployment. This fortunately seems not to be the case this time around. Inflation has slowed and approached our target of 2 percent without a large increase in unemployment. The employment rate is higher now than in the years before the pandemic, as it also is among many of our main trading partners.

Since I stood here a year ago, inflation has declined further internationally. Inflation has also slowed in Norway, with total consumer price inflation at 2.3 percent in January. But the fact that inflation is approaching target does not mean that our job is done, even if inflation in certain months were to drop below 2 percent. Our task is to keep inflation close to 2 percent over time. Wage growth is high, and new figures show that it accelerated further last year, which will contribute to stoking inflation ahead.

Policy rates have been lowered in many countries. Policy rate expectations fluctuated widely last year. International rate expectations rose through autumn, and fewer rate cuts are now expected than was the case last summer.

International long-term interest rates are higher than in the period prior to the pandemic (Chart 2). Our policy rate is set based on conditions in the Norwegian economy. But as recent years have reminded us, the interest rate level in Norway cannot over time differ significantly from the level among our trading partners.

We are approaching the time when we can ease monetary policy a little, but a restrictive stance is still needed. And we must be prepared for a higher interest rate level than we had been accustomed to over the past decade.

**Chart 2 Long-term interest rates are higher than before the pandemic**
Ten-year US government bond yields. Percent


Source: LSEG Datastream

### Lessons

The job of bringing inflation down is not finished. However, I would like to take this opportunity to pause for a moment and ask what we can learn from the experiences of the past five years.

A question both we and other central banks have raised is whether we should have foreseen the post-pandemic surge in inflation.

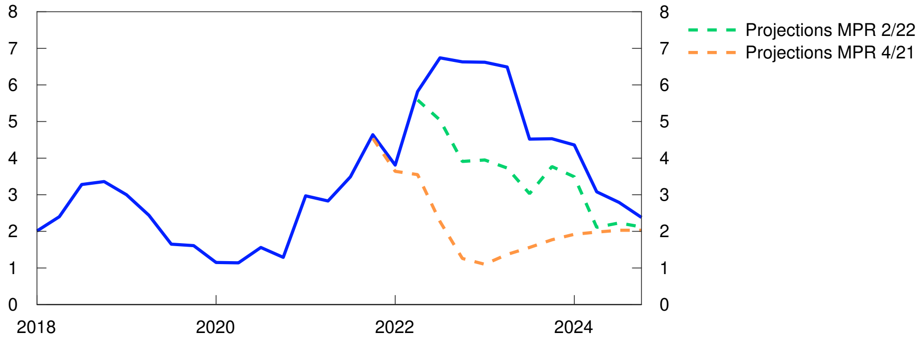
In retrospect, both our models and assessments were probably influenced by the many years of low inflation we had behind us. We underestimated the intensity of inflation impulses that would arise from the interplay between the pandemic-related supply-side shocks and the very expansionary economic policies in both Norway and a range of other countries (Chart 3).[2]

At the same time, it is important, also in retrospect, to recall the great uncertainty that prevailed. History has shown that severe economic downturns can leave permanent scars on the labour market,[3] and we gave weight to the risk of unemployment becoming entrenched at a high level. When we began to tighten monetary policy gradually in autumn 2021, the pandemic had still not been defeated, and naturally our forecasts did not take into account Russia's invasion of Ukraine.

So, what have we learned? We have learned that we need data and models that better capture abrupt shifts in the economy, and that our analyses must take greater account of international impulses – also from the supply side. Monetary policy must also be able to turn around quickly when the outlook changes. This means we must continue being careful about to tying ourselves to the mast by making promises about the policy rate ahead or by implementing other measures that are difficult to reverse. Extreme situations may require forceful measures, but a sound

**Chart 3 We underestimated inflation**

Consumer price index. Four-quarter change. Percent



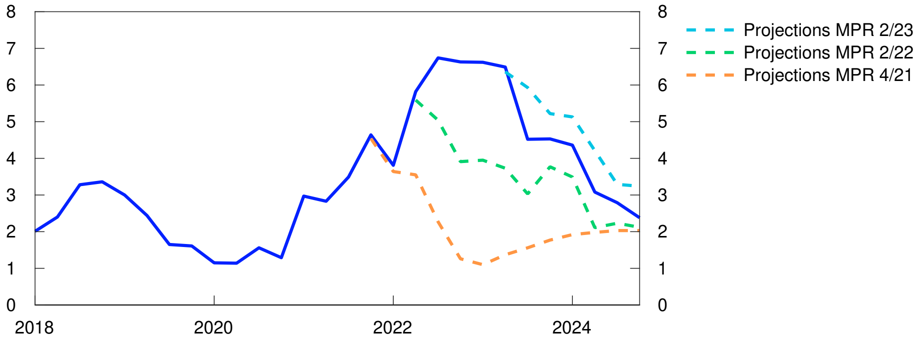

Sources: Statistics Norway and Norges Bank

2 Powell, J.M. (2024) *Review and Outlook*, Jackson Hole Economic Symposium, 23 August 2024.

3 See N. Ellingsen and Galaasen, S., (2021) "Long term consequences for the labour market". *Staff Memo* 1/2021. Norges Bank (In Norwegian only).

**Chart 4 The speed of disinflation was faster than expected**

Consumer price index. Four-quarter change. Percent




Sources: Statistics Norway and Norges Bank

plan for measures must also include an exit plan.[4] This is also a lesson for other areas of economic policy.

Inflation increased faster in the wake of the pandemic than we had expected, but it has also decreased faster than envisaged (Chart 4). At the same time, unemployment has risen less than expected.

The costs of bringing down inflation appear to be smaller than in earlier periods of high inflation. Why is that so? Part of the explanation lies in the special shocks that hit us this time. When the pandemic was brought under control, people could return to work. As services production resumed, the pressure on goods production eased. A globally synchronised tightening of monetary policy[5] also factored in. The bottlenecks in the economy gradually eased, which paved the way for inflation to decline without a pronounced impact on activity.

We are unlikely to experience the exact same shocks again. But one important takeaway is the value of effective economic policy interaction. We have a system of coordinated wage determination where the social partners place emphasis on employment. Norges Bank has a clear responsibility for ensuring price stability. And the political authorities can take into account known reaction patterns of the central bank when determining fiscal policy. Thanks to those economic policy interactions, we have not experienced the same self-reinforcing wage price spirals as in the 1970s and 1980s. Another takeaway is the importance of anchored inflation expectations. Confidence that inflation would return to target in and of itself helped prevent inflation from spiralling out of control. But we still couldn't take that confidence for granted. When it emerged that inflation would prove to be higher, we had to translate words into action and respond by tightening monetary policy.

4 Bank for International Settlements (2024). "Monetary policy in the 21st century: lessons learned and challenges ahead". *Annual Economic Report*, June 2024.

5 This has been the most globally synchronised tightening of monetary policy in at least fifty years. See Forbes, K., J. Ha and M. A. Kose (2024) "Rate cycles" *Policy Research Working Paper* 10876. World Bank

We took account of the lessons from the past years when we updated our monetary policy strategy last year. The aim has been to make the strategy more robust. When the work began, we had to acknowledge that the strategy from 2021 was marked by the preceding period of low global inflation and interest rates. The updated strategy also describes how monetary policy will respond to international cost shocks, a krone depreciation and high inflation.

The strategy sets out how monetary policy will be oriented to achieve the monetary policy objectives as defined by the political authorities. Since 2001, we have operated an inflation targeting regime. After a thorough review, the mandate was further specified in 2018 and the inflation target adjusted from 2.5 to 2 percent. In our view, we currently have a sound mandate for monetary policy. The fact that the Storting and government stood by the mandate through the past period has been important. To successfully return inflation all the way back to target, there should be no doubt about our mission.

By that I don't mean that the mandate should never be subject to evaluation. A number of other countries regularly review their mandates. In Canada, the central bank and the government review the framework every five years.[6] Perhaps it would be sensible to conduct more regular reviews of our mandate, as proposed by the commission headed by former Governor Svein Gjedrem in 2017.[7] Regular reviews would provide an opportunity to take on board new insights and strengthen the democratic anchor for the monetary policy mandate. Reviews that are scheduled in advance enhance predictability and avoid doubt as to the central bank's independence to set interest rates.

**Many people saw their spending power decline**

Even though unemployment remained low, many households experienced a budget squeeze when both prices and interest rates rose rapidly. Wages also rose sharply, but until last year wage growth was not sufficient to keep pace with inflation.

Cost inflation was particularly high in 2023. When looking at household data across different income groups,[8] we see that purchasing power declined for many households that year, but not for all of them (Chart 5). The data show that purchasing power increased for most households at the lower end of income distribution, partly thanks to the rise in employment, but also due to other factors such as the increase in minimum pensions. Those who were worse off in 2023 had, across the board, a high interest burden. This group includes households with high income and large loans, but also young people with starting salaries and newly purchased homes.

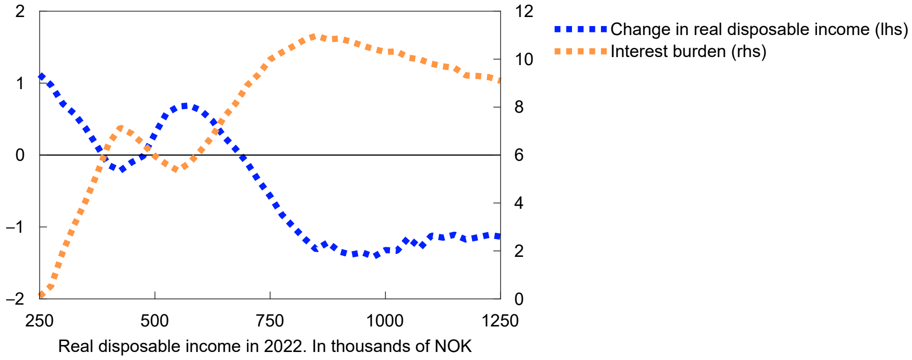
6 See Bank of Canada (2021). *Monetary Policy Framework Renewal*, December 2021.

7 Official Norwegian Reports (NOU) 2017:13. *New central bank act. Organisation of Norges Bank and the Government Pension Fund Global*.

8 Available figures to date from the Norwegian Tax Administration.

**Chart 5 Many households saw their spending power decline**

Change in disposable real income from 2022 to 2023. Interest burden in 2023. Percent




Sources: The Norwegian Tax Administration, Statistics Norway and Norges Bank

Last year, the trend turned. Wages increased appreciably faster than prices, which brought real wages back to the 2021 level. Wages are also expected to rise more than prices in the coming years, and most households will be better off.

**Rising protectionism**

It wasn't higher wages that triggered the initial surge in inflation. But we still had to respond by raising the policy rate. Had we not done so, prices could have continued to rise rapidly, in part because the krone could have depreciated substantially. Such situations could arise again.

A full-out trade war where all countries raise tariffs in unison could act as a global cost shock and lead to lower economic activity and higher inflation.[9][10]

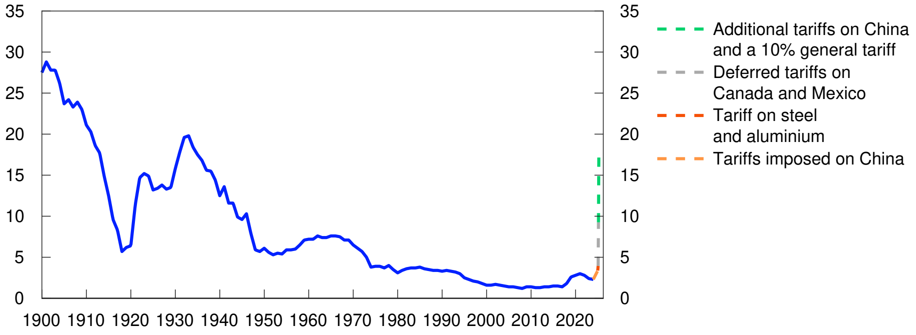
But it is still uncertain what the new global trade regime will look like. The US has raised tariffs on Chinese goods and announced higher tariffs against other countries (Chart 6). Some countries have announced retaliatory tariffs. Higher trade barriers could dampen global economic activity. At the same time, for the countries that impose higher tariff rates, the result may be higher prices that can spread to other countries through global supply chains. On the other hand, lower economic activity could dampen inflation. It is also possible for goods that are subject to a tariff in one market to be sold at lower prices in another.

Increased trade barriers will affect the Norwegian economy both directly and indirectly. Norway's exports to the US are relatively limited. But companies in some industries export large volumes of goods to the US, such as aircraft components, construction machinery and furniture. Norwegian companies that produce intermediate goods for other countries' exports to the US may also be affected. For Norway, the

9 Barattieri, A., M. Cacciatore and F. Ghironi (2021) "Protectionism and the business cycle". *Journal of International Economics*, Volume 129, March. 27.

10 Bergin, P. and G. Corsetti (2023) "The macroeconomic stabilization of tariff shocks: What is the optimal monetary response?" *Journal of International Economics*, Volume 143, July.

**Chart 6 Tariff rates on the rise**
Effective tariff on imports to the US. Percent




Sources: US international Trade Commission, US Census Bureau and Norges Bank

indirect effects via other trading partners may nevertheless be greater. Close to 70 percent of our goods exports go to the EU. The effects on EU countries and their response could have a significant impact on Norwegian exports.

The global economy could be hit hard by a large-scale trade conflict. For the time being, the potential effects of an altered trade regime on the inflation outlook, and hence the interest rate outlook, in Norway are uncertain.

With flexible inflation targeting, where we place considerable emphasis on employment, we are well equipped to deal with what may come.

**We do not have a target for the krone exchange rate**

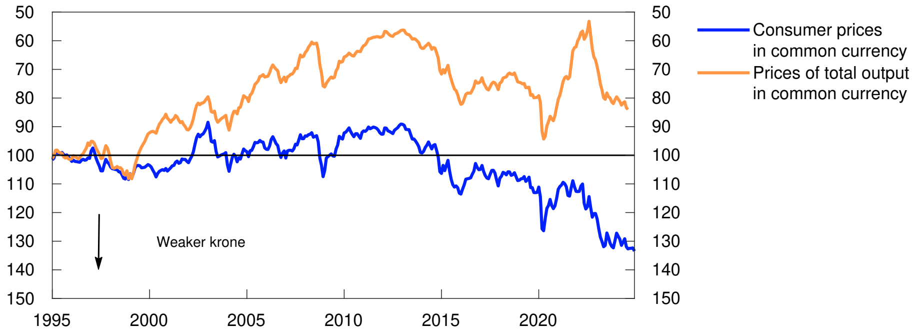
The krone exchange rate could also be affected by changes to the trade regime. The krone depreciation in recent years has received much attention. Many people have experienced that the strong purchasing power we Norwegians had abroad for a long time is no longer as strong. One might sometimes wonder whether our nation's self-esteem fluctuates with the krone exchange rate. Victor Norman also touches on this in his book. He points to 1982 when the Norwegian krone became worth more than the Swedish krona, and Norwegian media described it as finally getting revenge for all the football losses at Råsunda.[11]

The krone exchange rate is the price of other countries' currencies measured in our currency. It is influenced by a myriad of decisions, made by economic agents all over the world. Some of them make FX transactions to settle trades in goods or services, others to invest and make money. Movements in the krone exchange rate can be difficult to explain and do not always reflect macroeconomic conditions. At the

11 Råsunda was a football stadium in the Stockholm suburb of Solna where the 1958 World Cup final match between Sweden and Brazil took place. In the period between 1938 and 2005, the Norwegian men's national team participated in 16 national team matches against Sweden in Råsunda, of which 10 were losses. For the period up to 1982, there were 14 matches and 9 losses. The Norwegian women's national team won the World Cup final against Germany in Råsunda in 1995. Råsunda was demolished 2013.

**Chart 7 How weak is the real krone exchange rate? – Different measures give different answers**

Real krone exchange rate. Index. 1995 = 100




Sources: Statistics Norway, LSEG Datastream and Norges Bank

same time, the exchange rate is perhaps the most important relative price for a small open economy.

Market exchange rates do not provide the full picture of the strength or weakness of the krone exchange rate. To obtain an expression for the cost of goods and services across countries, the exchange rate must be seen relative to the price levels across comparison countries. If we look at domestic and foreign consumer prices in a common currency, the krone is now weaker against our main trading partners than it has been over the past 30 years (Chart 7). If, on the other hand, we use a broader measure, such as the price of total output in Norway relative to abroad, the real krone exchange rate is slightly stronger now than it was 30 years ago.[12] The difference reflects a much larger rise in domestic producer prices than in domestic consumer prices relative to abroad in this period.

Developments that affect the Norwegian economy and foreign economies differently may entail the need for an adjustment of relative prices. In his book, Norman offers the example that Norway receives a currency gift from abroad in the form of oil revenues. The gift allows us to use labour that we would otherwise have had to use to melt aluminium, to care for the elderly and ill. The adjustment occurs by a decrease in the prices of tradable products relative to the prices of non-tradable products. The appreciation of the krone through much of the 2000s entailed such an adjustment, together with higher wage growth in Norway than abroad.

On the other hand, if the prices for the raw materials we export were to fall, or our manufacturing productivity lags behind, our capacity to finance imports will diminish. If this is to be counteracted, the cost level in Norwegian companies must decline relative to abroad, which can occur by means of a weaker krone. If the exchange rate shows little reaction, more of the adjustment to a lower cost level will have to take place

12 Over time, the real krone exchange rate by this measure, based on relative GDP deflators, has evolved fairly closely in line with the real krone exchange rate measured by relative labour costs.

through lower wage growth in Norway than abroad, and perhaps higher unemployment. The change that *causes* the krone to depreciate may be undesirable, but once it has occurred, a depreciation can be an advantage because it supports the adjustment to a new economic reality. The economic realities are inescapable, regardless the exchange rate regime.

**A small country with substantial financial assets**

Even though our economy is small, our financial assets are substantial. In December last year, the value of the Government Pension Fund Global (GPFG) surpassed 20 trillion Norwegian kroner for the first time (Chart 8). Over the past five years, the GPFG has doubled in value. It is easy to think of the fund as a cork that always floats back up no matter what hits us. But that is not something to be taken for granted.

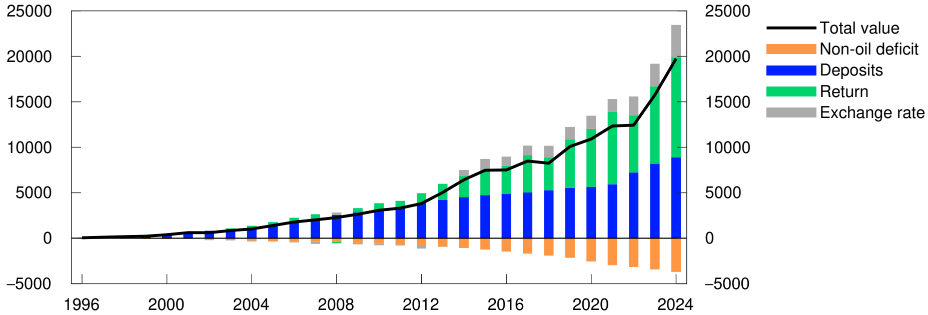
The value increase in recent years has been extraordinary. First, the doubling only occurs in Norwegian krone terms. It is the value in foreign currency terms that is important for the GPFG's purchasing power. Second, transfers to the GPFG have been particularly high owing to a sharp rise in natural gas prices – largely the result of Russia's war against Ukraine. This source of value gains is something we will hopefully be spared in the future.

Last year, the equity portfolio returned 18 percent, partly owing to strong returns on technology stocks. With the rise of new technologies and artificial intelligence, the world's ten largest listed companies now account for almost 20 percent of the GPFG's equities benchmark index (Chart 9). Our equity holdings in some of the largest US technology companies are worth more than all our equity investments in France or Germany, and a steep fall in value of only one of these companies could entail big losses.

Even though many have said so before, it bears repeating: We must be prepared for the possibility that a substantial decline in the value of the GPFG could occur, and that a rapid decline is not always followed by a

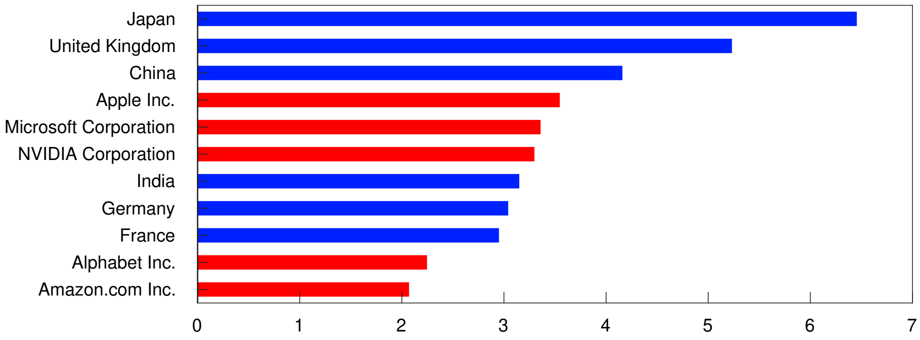
**Chart 8 The value of the GPFG has increased substantially**

Government Pension Fund Global. In billions of NOK




Sources: Ministry of Finance and Norges Bank

**Chart 9 Certain companies account for a large share of the equity portfolio**
Share of the GPFG's equity portfolio. Percent




Source: Norges Bank

sharp rebound. As the GPFG currently finances more than one fifth of the central government budget, a sharp decline in the value of our financial assets will have considerable consequences for the government's fiscal policy space.

A world of growing conflicts may blur the boundary between the economic and political spheres.[13] That was a theme in my speech last year and is unfortunately no less relevant today. We cannot take for granted that the outside world will make a sharp distinction between Norwegian foreign policy and the GPFG as a financial investor. Norges Bank's answer as the manager of the GPFG is to adhere to the mandate as defined by the political authorities. The management of the GPFG has one objective, which is to achieve the highest possible return at an acceptable risk level. Solid returns over time depend on sustainable development. Climate risk management and grasping the opportunities of climate transition are and will be an integral part of fund management.

Since 2004, the GPFG has been subject to guidelines to prevent it from being invested in companies that violate fundamental ethical norms. Prior to issuing advice on exclusion, the Council on Ethics performs a thorough assessment of the company that has been complicit in violating norms. The value of such thoroughness is no less important in a more turbulent world. Thoroughness is also absolutely necessary if the ethical guidelines are to be changed. Confidence in the framework could weaken if the guidelines are frequently changed. At the same time, we must be open to the possibility that what is considered to be ethically acceptable may change as the world again becomes marked by military rearmament and growing tensions between countries.

### More turbulence ahead

Let me conclude. We have five turbulent years behind us and more turbulence is in the offing. The big headlines are centred on war, trade conflicts and political tensions within and between countries. In many

13 Official Norwegian Reports (NOU) 2022:12. The Fund in a changing world – The Government Pension Fund Global and new economic and political developments.

countries, the gains from trade have not been shared by all. In the background, there are other changes taking place, but more slowly – global warming, ageing populations and rising government debt, against the backdrop of low productivity growth in many countries. The question is how a small open economy like ours can best prepare for what comes.

I'm fairly certain of what is not the answer. The answer is not to shut ourselves out. Norway has much to gain from an open, rules-based trading system. We must cooperate with other countries and show our support for international institutions and agreements.

We have a solid starting point for meeting the challenges to come. We have a clear division of roles in economic policy. The workforce is highly educated, and we have a tradition of cooperation between the social partners and across political divides. Our nation's sizeable financial wealth makes it easier – not more difficult – to meet the challenges.

The confidence in the framework and institutions we have built up over time must be preserved. This also applies to the central bank's monetary policy independence. Since autumn 2021, my colleagues and I have met the with the leaders of the Ministry of Finance 14 times to inform them of our decision to raise the policy rate. Each time, they politely received our message and took due note of our decision. That is not necessarily a given in other countries.

Thank you for your attention.