The Executive Board's assessment

At the time of the publication of the June 2012 *Monetary Policy Report*, the Executive Board decided that the key policy rate should be in the interval 1%–2% in the period to 31 October 2012, unless the Norwegian economy was exposed to new major shocks. Capacity utilisation was assessed to be a little above a normal level. The prospect of somewhat higher capacity utilisation and hence slightly higher cost growth suggested an upward drift in inflation from a low level further ahead. At the same time, the uncertainty surrounding developments in Europe was greater than observed for some time. The analysis in the June *Report* implied a key policy rate of 1.5% in the period to the turn of the year, followed by a gradual increase towards a more normal level.

In its discussion at the meeting on 29 August 2012, the Executive Board pointed out that developments among Norway's trading partners were broadly in line with the projections in the June *Report*, but that the expected upward shift in interest rates abroad had moved further out in time. There were signs of improvement in financial markets, although the level of uncertainty was still high. Markets had been calmed by the announcement by the European Central Bank (ECB) to purchase government bonds from highly indebted countries in the euro area. Equity prices had moved up and premiums in money and bond markets had fallen. Developments in the Norwegian economy appeared to be broadly in line with the projections in the June *Report*, but inflation had been slightly lower than projected. The Executive Board decided to keep the key policy rate unchanged at 1.5%.

At its meeting on 29 August, the Executive Board also discussed themes of relevance for the October 2012 *Monetary Policy Report*, including developments in the krone market and the relationship between household saving, house prices and credit.

In its discussions on 17 and 31 October, the Executive Board placed emphasis on the following developments:

- Growth among trading partners is low and approximately as expected. Euro-area activity is expected to fall in 2012 and unemployment in a number of euro area countries is at a very high level. Activity in the US is picking up at a moderate pace. There are signs of improvement in the housing market, but fiscal policy uncertainty may curb economic growth in the short term. In emerging Asia, activity appears to have held up, but altogether growth has slackened.

- Market expectations concerning key interest rates abroad have fallen further. Both the ECB and the Federal Reserve have communicated that key rates will be kept low for an extended period. Moreover, the ECB has announced measures to bolster confidence in the euro. Risk premiums in money and bond markets have declined and equity prices have increased.

- The krone, as measured by the import-weighted exchange rate (I-44), has appreciated and is now stronger than projected in the June *Report.*

- Premiums in money and bond markets have also fallen in Norway, but with little impact on interest rates on loans to households and enterprises.

- Growth in the Norwegian economy remains robust and is broadly in line with that projected in the June *Report.* Employment is rising at a brisk pace and unemployment remains low and stable. Capacity utilisation is assessed to be above a normal level. There is vigorous activity in the construction industry and in oil-related industries, while other manufacturing segments are feeling the impact of weak external demand and high costs. Household consumption is growing at a moderate pace and saving has increased further, while debt and house prices are still rising faster than income.

- Inflation in Norway remains low and has been lower than projected in the June *Report.* The underlying rise in prices has ranged between 1% and 1½% over the past year.

The point of departure for the Executive Board's assessment of monetary policy is that the key policy rate is set with a view to keeping inflation close to 2.5% over time. In order to attain this objective, stabilising inflation is balanced against stabilising output and unemployment. Monetary policy also seeks to take into account the risk of a buildup of financial imbalances. The key policy rate is low because inflation is low and interest rates abroad are very low. At the same time, there is a considerable spread between the key policy rate and the interest rates facing households and enterprises.

The Executive Board noted that the analyses now imply a key policy rate at today's level into next year, followed by a gradual increase towards a more normal level. The interest rate forecast for 2013 is slightly below the June forecast.

In its deliberations, the Executive Board pointed out that the uncertainty surrounding international economic developments remains elevated. Growth prospects for advanced economies have been lowered over a longer period. The world economy may be close to a cyclical trough, but growth is expected to remain low in advanced economies for a long period. Risk premiums in money and bond markets have moved down, but many countries are facing a very difficult debt situation. There is still considerable uncertainty linked to developments in Europe in the period ahead. At the same time, there is political disagreement in the US as to the proper fiscal tightening measures to be implemented.

The Executive Board considered the weak impetus from external prices to prices in Norway, both through lower imported inflation and increased competition. High labour immigration may also have contributed to dampening cost growth in some industries. In addition, the rise in costs domestically may not yet have fed fully through to prices. Experience shows that this may take time.

It was pointed out that the krone has appreciated, which may reflect foreign exchange market participants' stronger focus on search for yield and quality at present. At the same time, attention was called to the fact that themes in foreign exchange markets quickly change.

The Norwegian economy is growing at a solid pace despite weak external growth. Many industries are benefiting from the vigorous activity in the oil industry. At the same time, traditional manufacturing are showing a high degree of adaptability. Companies are increasingly finding niche areas or shifting activity towards the petroleum industry.

The Executive Board also discussed developments in household saving. Heightened uncertainty following the financial crisis may have induced households to be more cautious and pushed up the saving ratio. Moreover, demographic conditions and the pension reform may have influenced saving.

In its deliberations on the monetary policy situation, attention was focused on lower-than-expected inflation, the appreciation of the krone and a further fall in interest rates among trading partners. In isolation, this suggests a reduction in the key policy rate. At the same time, premiums in money and bonds markets have shown a marked fall. This suggests, in isolation, an increase in the key policy rate. Banks' lending rates have remained unchanged, however, which dampens the effect of the fall in money market rates.

It was pointed out that inflation remains low, but that capacity utilisation is above a normal level. Developments in the Norwegian economy give reason to believe that inflation will gradually pick up. This suggests that the key policy rate can be raised further out in the projection period. A long period of low interest rates can induce households and businesses to take excessive risk and accumulate excessive debt. Such imbalances could have spillover effects further ahead, such as a pronounced impact on output, employment and inflation. At the same time, the very low interest rates abroad are limiting how quickly the key policy rate in Norway should be raised. If the key policy rate is increased too quickly, there will be an increased risk that the krone will appreciate so that inflation remains low for a long time.

At its meeting on 31 October, the Executive Board decided to keep the key policy rate unchanged at 1.5%. At the same meeting, the Executive Board decided that the key policy rate should be in the interval 1%–2% until the publication of the next *Report* on 14 March 2013, unless the Norwegian economy is exposed to new major shocks.

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