The Executive Board's assessment

At its meeting on 8 June, Norges Bank's Executive Board discussed the monetary policy stance and the interval for the key policy rate in the period to the publication of the next *Monetary Policy Report* on 19 October. The final decision concerning the interval for the key policy rate for the period was taken at the Executive Board's meeting on 22 June.

The Executive Board has placed emphasis on the following developments:

Sovereign debt problems in some euro area countries and signs of slower growth in the US economy have caused renewed financial turbulence. Overall, global economic growth seems to be maintaining its momentum, but there are wide differences across regions and countries. There has been high growth in Asia and South America and in demand for commodities. In Europe, developments are mixed. There has been a fairly strong upturn in many northern European countries. Higher commodity prices have resulted in rising consumer price inflation, and both the European Central Bank and Sveriges Riksbank raised their key rates in April. On the other hand, there are prospects of lacklustre growth or a downturn in southern European countries and Ireland. In the US and the UK, growth in the period ahead may moderate because fiscal policy will have to be tightened. Unemployment is still high in many OECD countries. Interest rate expectations among Norway's trading partners are overall somewhat lower than they appeared to be in March. The projections in this *Report* are based on the assumption that the debt problems facing Greece will be resolved without significant spillover effects on other euro area countries.

In Norway, underlying inflation is expected to remain low for a few quarters, though a number of factors indicate that inflation will pick up further ahead. Capacity utilisation in the Norwegian economy has risen and now seems to be close to a normal level. Unemployment has fallen somewhat more than expected, and wage growth is on the rise. There are also signs that rising external inflation is feeding through to Norwegian consumer prices.

The point of departure for the Executive Board's deliberations is that the key policy rate should be set with a view to keeping inflation close to 2.5% over time. The Executive Board notes that the analyses in this *Report* suggest that the key policy rate should be raised further. The increase in the key policy rate is expected to broadly follow the projections presented in the March *Report*, but may occur slightly earlier. Inflation is expected to pick up towards 2.5% in the course of the next two years. Growth in the Norwegian economy is expected to be between 3% and 4% in the same period, partly reflecting a marked upturn in investment. Capacity utilisation is projected to rise further before returning to a normal level towards the end of the projection period.

In its deliberations, the Executive Board gave weight to signs of a tightening labour market, even though inward migration is high. Unemployment is declining somewhat more rapidly than projected, and wage growth is rising slightly more than expected. There are also signs of labour shortages in some occupational groups, such as engineers in manufacturing and construction. At the same time, high population growth will fuel demand for goods and services, including housing services. House prices are rising and rents are moving up in urban markets, and housing investment is accelerating. On the other hand, figures from Norges Bank's regional network suggest that for the time being enterprises are not experiencing any substantial labour shortages. This may be related to the ample supply of some labour skills from abroad. The outlook for the world economy now appears to be more uncertain, despite a somewhat stronger recovery so far than expected earlier. The decline in interest rate expectations among Norway's trading partners and recent weaker figures for the US economy reflect a risk of weaker growth. The debt situation in Europe reinforces this impression.

The differences between the Norwegian and international economy entail a risk of a krone appreciation, leading to inflation that is too low. This suggests proceeding with caution in interest rate setting. On the other hand, experience shows that wage and price inflation may rapidly accelerate when capacity utilisation becomes high. The risk that a low interest rate may result in imbalances in the real economy and a sharp rise in wage and price inflation somewhat further ahead suggests that the key policy rate should be raised further.

Overall, the Executive Board is of the view that the key policy rate should gradually be raised through the latter half of 2011, against the background of the current outlook and balance of risks. An unexpected jump in activity or in price and cost inflation may lead to a more pronounced upward shift in the key policy rate than currently projected. Should the turbulence in financial markets lead to considerably weaker growth or a marked krone appreciation, the increase in the interest rate may be deferred further ahead.

The Executive Board decided at its meeting on 22 June that the key policy rate should be in the interval 2¼–3¼% in the period to the publication of the next *Report* on 19 October 2011, unless the Norwegian economy is exposed to new major shocks.

At its meeting on 22 June, the Executive Board decided to leave the key policy rate unchanged at 2.25%.

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