The Executive Board's assessment

At its meeting on 2 March, 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 22 June. The final decision concerning the interval for the key policy rate for the period was taken at the Executive Board's meeting on 16 March.

The Executive Board has placed emphasis on the following developments:

Global economic growth has been somewhat higher than expected. Interest rate expectations abroad have increased. A sharp rise in prices for oil, food and other commodities have led to a faster rate of increase in consumer prices. Global economic prospects nevertheless remain uncertain. The economic effects of the earthquake in Japan are uncertain. Many European countries must reduce public sector deficits relatively rapidly. It would appear that global trade imbalances are not sustainable over time. There are prospects that global economic growth will slow somewhat over the next year.

Activity in the Norwegian economy is gathering momentum. Mainland GDP growth was 2.5% between 2009 Q4 and 2010 Q4. Net immigration has increased and is back at the same high levels prevailing prior to the financial crisis. This is boosting production capacity, but is also fuelling demand and pressures in the housing market. Higher prices for oil and other commodities, in conjunction with falling import prices, have again improved Norway's terms of trade. There are prospects for fairly strong growth in the Norwegian economy in the years ahead, driven by solid income growth, rising investment and high population growth. Overall, there are prospects that the economy will reach normal capacity utilisation somewhat earlier than projected in the October *Report*.

The krone is strong and prices for imported consumer goods have fallen at a slightly faster pace than projected in October. Underlying inflation is about 1¼% and there are prospects that inflation will remain low in the coming quarters. Looking ahead, cost inflation is likely to edge up, but at the same time high net inward migration will in isolation have a dampening impact on wage growth.

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. Low inflation and a strong krone suggest in isolation that the key policy rate should be kept low. So far, the low interest rate level has not led to a marked rise in household borrowing, but credit demand has risen. House prices and consumer spending have picked up. The consideration of guarding against the risk of future financial imbalances that may disturb activity and inflation somewhat further ahead suggests that the key policy rate should be increased in the near term.

The Executive Board notes that the projections and analyses in this *Report* suggest on balance that the key policy rate should gradually be raised and that developments since last autumn pull in the direction of increasing the key policy rate somewhat earlier than projected in October. The projections imply an increase in the key policy rate of ¾ percentage point in the period to the turn of the year and thereafter a gradual increase to a more normal level. Inflation is projected to pick up gradually to around 2.5% towards the end of the projection period.

In its deliberations at the meeting on 2 March, the Executive Board noted that growth in the Norwegian economy has now gained a firm footing. It was further noted that pressures may arise in some labour market segments despite high labour inflows because there are wide variations across sectors and occupational groups. This could lead to higher-than-expected wage growth. Rising price and cost inflation internationally has also led to somewhat higher interest rate expectations abroad. The Executive Board further noted that a low interest rate level over time could lead to financial instability. On the other hand, the strong krone may exert downward pressure on inflation and contribute to curbing activity in the Norwegian economy. Oil prices are high, reflecting both solid global economic growth and the unrest in the Middle East. High oil prices are probably one of the main factors behind the strong krone. When oil market conditions normalise, some of the krone appreciation can be expected to be reversed. At the same time, there is a risk of a further appreciation of the krone.

The Executive Board is of the view that the consideration of stabilising developments in output and employment must be weighed against the risk of a pronounced upward shift in interest rates that could lead to a situation where inflation is too low and the krone too strong. In the next round, this could lead to an unstable economic profile. An overall assessment suggests that the key policy rate should be increased before the end of the first half-year against the background of the current outlook and balance of risks. An unexpected strong increase in activity or price and cost inflation could lead to a more pronounced increase in the key policy rate than indicated in this *Report*. In the event of a pronounced slowdown in world economic growth, heightened financial turbulence or a further appreciation of the krone, the increase in the key policy rate could be deferred further ahead.

The Executive Board decided at its meeting on 16 March that the key policy rate should be in the interval 1¾% - 2¾% in the period to the publication of the next *Monetary Policy Report* on 22 June 2011 unless the Norwegian economy is exposed to new major shocks.

At its meeting on 16 March, the Executive Board decided to leave the key policy rate unchanged at 2 per cent.

Øystein Olsen

16 March 2011