The Executive Board's assessment

At the time of the publication of the March 2012 *Monetary Policy Report*, the Executive Board decided that the key policy rate should be in the interval 1% – 2% in the following three-month period, unless the Norwegian economy was exposed to new major shocks. Inflation was low and the krone had appreciated considerably. There were prospects that weak growth abroad and the strong krone would act as a brake on both inflation and growth in some segments of Norwegian business and industry going forward, even though capacity utilisation in the economy was assessed as close to normal. The key policy rate was reduced by 0.25 percentage point to 1.5%. The analysis in the *Report* indicated that the key policy rate would remain unchanged for about a year and then gradually rise to around 3½% towards the end of 2015.

At its meeting on 26 April, the Executive Board discussed the economic situation and possible themes for the June *Report*, including the functioning of the money market, developments in the global economy and commodity prices and the impact of uncertainty on economic developments domestically and abroad.

In its discussion at the meeting on 10 May 2012, Norges Bank's Executive Board pointed out that developments among Norway's trading partners had been broadly in line with expectations, but that financial market turbulence had intensified. Yields on Spanish and Italian government bonds had risen and global equity indices had moved down, particularly in Europe. The Executive Board noted that there were signs of somewhat stronger developments in the Norwegian economy. The krone depreciated after the monetary policy meeting in March and had since remained at a fairly stable level. At the same time, the Executive Board gave weight to the low level of inflation and weak growth prospects in Europe. The Executive Board concluded that, on balance, the economic situation did not significantly change the outlook for the key policy rate and decided to keep the rate unchanged at 1.5%.

At its meetings on 5-6 June and 20 June, the Executive Board discussed the monetary policy stance and the outlook for the key policy rate.

The Executive Board has now placed emphasis on the following developments:

– The turbulence in international financial markets has increased further. Attention is particularly focused on Spain, with its weak economy, substantial budget deficits and problems in the banking sector. The Spanish authorities have requested financial assistance from the other euro area countries in order to recapitalise the banks. The unclear political situation in Greece has fuelled doubt as to the country's ability and willingness to honour its debt obligations. Interest rates on long-terms loans to debt-laden countries in Europe have moved up again, while yields on presumably safe government bonds have fallen to record-low levels.

– Uncertainty about prospects abroad has increased. The euro area may experience a decline in activity in 2012, and unemployment is high and rising in a number of countries. In the US, the moderate recovery continued in the first quarter, but unemployment remains high. Growth is slowing in several emerging market economies in Asia. Global equity prices and oil prices have dropped. Economic growth abroad is expected to be even lower than previously projected. At the same time, the risk of a worsening of the debt crisis in the euro area, with serious and long-term consequences for economic developments, appears to have increased.

– Central bank key rates are close to zero in many countries and are likely to be kept very low for longer than previously expected. Money market rates have fallen further from already low levels.

– The krone exchange rate weakened after Norges Bank's key policy rate was reduced in March and has since remained fairly stable. So far in the second quarter, the krone exchange rate measured by the I-44 has been somewhat weaker than projected in the March *Report*. The krone exchange rate is still strong, however.

– Money market premiums are high and have increased slightly recently. Credit premiums on covered bonds and senior bank bonds issued by Norwegian banks remain elevated, and recently premiums in the senior market in particular have increased. A number of Norwegian banks are now also signalling that long-term market funding is somewhat more difficult to obtain.

– So far in 2012, growth in the Norwegian economy has been slightly stronger than expected. Both employment and the labour supply are growing at a brisk pace. In May, contacts in Norges Bank's regional network reported somewhat higher production growth and increased capacity utilisation. Growth in oil-related industries is vigorous, while export-oriented manufacturing segments are feeling the adverse impact of low external demand and a strong krone. Unemployment is low and it appears that wage growth may be somewhat higher than previously projected. Capacity utilisation is now projected to be a little above normal.

– Inflation remains low. Underlying inflation has ranged between 1% and 1½% over the past year. Somewhat higher capacity utilisation and slightly higher cost growth may lead to an upward drift in inflation further out.

The point of departure for the Executive Board's deliberations is that the key policy rate is set with a view to stabilising inflation close to 2.5% over time. When setting interest rates, stabilising inflation is balanced against stabilising output and employment. Monetary policy also seeks to take into account the risk of a buildup of financial imbalances.

The Executive Board notes that the analyses in this *Report* imply a key policy rate at today's level in the period to the turn of the year. The forecast for the key policy rate in 2013 is slightly higher than the forecast in the March *Report*.

In its discussion, the Executive Board referred to the contrast between domestic developments and external developments. Growth in the Norwegian economy is slightly stronger than expected and household income growth is high. In spite of a low key policy rate, household saving has increased. Should consumption growth be more in line with income growth, private consumption may rise more than projected in this *Report*. The Executive Board also highlighted the reports from the enterprises in Norges Bank's regional network in April/May which indicated that market prospects had improved somewhat, while the turbulence has actually increased in recent weeks. Experience shows that both households and enterprises in Norway are affected by weakening confidence abroad. At the same time, oil prices have declined, but petroleum investment is still expected to show strong growth. The Executive Board pointed out that there is growing uncertainty as to the potential effects of the financial market turbulence and weak external growth on the Norwegian economy.

Furthermore, the Executive Board considered the consequences of the flexible labour supply on capacity utilisation in the Norwegian economy. Employment is rising rapidly, partly reflecting high labour immigration. The Executive Board pointed out that the rapid growth in the supply of labour is fuelling demand, but also that potential output is rising.

The Executive Board also looked at developments in money market premiums. Premiums in the Norwegian money market are influenced by a number of factors, such as the risk linked to European banks, liquidity in interbank markets and forward foreign exchange markets. The turbulence in Europe has kept premiums at a higher level for a longer period than previously assumed.

In its deliberations on the monetary policy situation, the Executive Board gave weight to the fact that the low rate of inflation suggests a low key policy rate in order to bring inflation up towards the inflation target. At the same time, the public is facing interest rates that are considerably higher than the key policy rate, owing to the high level of money market and credit premiums.

The Executive Board pointed out that developments in the Norwegian economy suggest an upward drift in inflation further ahead. This implies an upward shift in the key policy rate further out. The consideration given to mitigating the risk of a buildup of financial imbalances pushes in the same direction. Weak external growth prospects, financial market turbulence and expectations of low central bank key rates for a prolonged period nevertheless place limits on the timing and extent of an interest rate increase domestically. The reduction in the key policy rate in March helped counter an appreciation of the krone, but the krone is still strong. These conditions, in conjunction with weak external growth, are holding down inflation at a low level. If the key policy rate is raised too rapidly, the krone may appreciate further so that inflation remains low for a long period. The level of uncertainty surrounding developments in Europe is now higher than it has been for some time. This suggests that the key policy rate should be kept on hold.

At its meeting on 20 June, 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 31 October 2012, unless the Norwegian economy is exposed to new major shocks. Should the uncertainty abate and growth and inflation pick up, the key policy rate may be raised. If the international turbulence increases and domestic growth and inflation prospects weaken, the key policy rate may be reduced.

Øystein Olsen

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