The Executive Board's assessment

At the time of the publication of the June 2011 *Monetary Policy Report,* the Executive Board decided that the key policy rate should be in the interval 2¼–3¼% in the period to 19 October 2011, unless the Norwegian economy was exposed to new major shocks. The analysis in the June *Report* indicated that the key policy rate could increase to 2¾–3% in the period to the turn of the year.

In its discussion at the meeting on 10 August, Norges Bank's Executive Board pointed to the recent intensified turbulence in financial markets and indications of weaker global growth. The Board noted that high sovereign debt and large fiscal deficits among a number of Norway's trading partners would make it difficult to implement measures designed to boost growth. Developments in the Norwegian economy had been approximately as expected, but inflation was low. The Executive Board noted the considerable uncertainty prevailing at that time and the impact on the prospects for the Norwegian economy of weaker external growth. The Executive Board came to the conclusion that it was appropriate to keep the interest rate unchanged and take a wait and see approach until the next monetary policy meeting. The key policy rate was kept unchanged at 2.25%.

In its discussion at the meeting on 21 September, the Executive Board gave weight to the increased level of uncertainty surrounding developments in the global economy. The risk that the debt crisis in the euro area would become worse and have a severe and long-term impact on economic developments appeared to have increased. Volatility had been high in equity, bond and foreign exchange markets and bank counterparty risk in Europe had risen. There were signs that growth was also slowing in emerging economies. In Norway, output and demand had been somewhat lower than projected, even though growth maintained momentum. The housing market showed high activity and the rise in house prices had picked up. At the same time, inflation was lower than expected. The Executive Board was of the view that, in the light of developments, the interest rate should be kept low for a longer period than projected in June and decided to keep the key policy rate unchanged.

At their meetings on 5 and 19 October, the 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 14 March 2012. The Executive Board has placed emphasis on the following developments:

Advanced economies are likely facing an amplified and prolonged downturn. Unemployment in the US and the euro area is still high. Rising sovereign debt and large fiscal deficits are constricting the economic room for manoeuvre.

Uncertainty related to sovereign debt problems and the increased risk of a renewed downturn in the global economy are reflected in financial markets. Government bond yields in countries with weak public finances have risen. Equity markets and yields on long-term US and German government bonds have shown a marked fall. Money market premiums have risen and bank funding costs have increased. Market key rate expectations have shown a pronounced fall. There are prospects that central bank key rates abroad could remain low for a long period.

Growth in the Norwegian economy remains robust, but the enterprises in Norges Bank's regional network expect somewhat lower growth ahead. Private consumption has been weaker than expected. It seems that capacity utilisation in the Norwegian economy is slightly lower than projected in the June *Report*, even though employment is still rising rapidly. Inflation is low. It is likely that underlying inflation will be between 1¼% and 1½% in the period to summer 2012.

The point of departure for the Executive Board's deliberations is that the interest rate is set with a view to stabilising inflation close to 2.5% over time. The

Executive Board notes that the analyses in this *Report* entail a considerable downward revision of the interest rate path.

The Executive Board gives weight to the unusually high level of uncertainty regarding global developments ahead, particularly in Europe. This uncertainty is reflected in financial markets. The economic unrest abroad is also affecting the outlook for the Norwegian economy, particularly the internationally exposed sector. Activity in the petroleum sector and the housing market is still strong and housing investment is rising rapidly. High money and credit market premiums will probably result in some increase in bank lending rates. High demand and a shortage of housing in the major cities may nonetheless continue to generate pressures in the housing market ahead. On the other hand, inflation is lower than expected. The prospects of both somewhat weaker growth and lower inflation suggest that the key policy rate should not be raised further in the coming months.

Low interest rates abroad affect the interest rate in Norway. An appreciably faster rise in the interest rate at home than abroad would increase the risk of a krone appreciation, resulting in inflation that is too low. Low inflation suggests in isolation that the key policy rate should be lowered. But the key policy rate is already low. Capacity utilisation is close to a normal level. Low interest rates over time entail the risk of a buildup of imbalances. This suggests that the key policy rate should gradually be raised towards a more normal level.

The Executive Board is of the view that the outlook and the balance of risks now suggest that the key policy rate should be kept at the current level for some time ahead. If the economic unrest abroad intensifies, money market premiums remain high and the outlook for growth and inflation weakens further, the key rate may be reduced. If financial market turbulence subsides and there are prospects of higher growth and inflation, the key rate may rise.

The Executive Board decided at its meeting on 19 October that that the key policy rate should be in the interval 1¾%–2¾% in the period to the publication of the next *Report* on 14 March 2012, unless the Norwegian economy is exposed to new major shocks.

At the same meeting on 19 October, the Executive Board decided to leave the key policy rate unchanged at 2.25%.

Øystein Olsen
19 October 2011