The Executive Board's assessment

At the time of the publication of the October 2011 *Monetary Policy Report*, the Executive Board decided that the key policy rate should be in the interval 1¾%–2¾% in the period to 14 March 2012, unless the Norwegian economy was exposed to new major shocks. The analysis in the October *Report* indicated that the key policy rate would remain unchanged for about a year and then gradually rise to around 4% towards the end of 2014. The *Report* also presented an alternative where the key policy rate declined to 1.5% in the period to summer 2012. The low interest rate alternative assumed continued turbulence in financial markets, sustained high money market premiums and a deeper and more prolonged downturn abroad than in the baseline scenario.

In its discussion at the meeting on 14 December 2011, Norges Bank's Executive Board pointed to the intensified turbulence abroad and greater risk of a new recession, especially in Europe. As a result of the debt crisis in the euro area, it was more difficult and more costly for European banks to obtain funding in the market. Norwegian banks were also affected. Developments resulted in prospects for lower output and employment growth and lower inflation in the Norwegian economy. The Executive Board noted that money market premiums had risen and that money market rates were higher than assumed in October. The Executive Board decided to lower the key policy rate by 0.5 percentage point to 1.75% to guard against an economic setback and even lower inflation.

At its meetings on 29 February and 14 March, the Executive Board discussed the monetary policy stance and the outlook for the key policy rate. The Executive Board has placed emphasis on the following developments:

The situation in international financial markets has improved since December 2011. Long-term loans from the European Central Bank (ECB) to banks have boosted liquidity and reduced risk premiums in the European banking system and in the sovereign debt market. Funding has become more accessible, also for Norwegian banks. Norwegian money market rates have recently fallen back slightly. Nevertheless, there are prospects that money market rates will be well above the key policy rate and that this premium will remain higher than projected in October.

There is still considerable uncertainty surrounding economic developments in Europe, even though actions taken by the ECB have eased market turbulence. It seems likely that euro area output will decline this year and that growth among Norway's trading partners as a whole will be fairly moderate. In addition, central bank key rates among Norway's main trading partners are expected to remain very low even longer than anticipated in autumn 2011.

In Norway, growth in petroleum investment and the oil sector is sustaining economic activity. In January, the enterprises in Norges Bank's regional network reported higher growth in production, but also that the weak prospects abroad would weigh on growth ahead. The export industry is being affected by developments in Europe and by a strong krone. Owing to high money and credit market premiums, the decline in the key policy rate in December has not resulted in lower bank lending rates. In January, banks announced some tightening of credit standards for households. A high level of uncertainty is causing households and enterprises to be more cautious in their consumption and investment decisions. Nevertheless, current statistics show a pickup in spending on consumer goods. The low key policy rate is stimulating demand for goods and services, but no more than what is necessary to sustain overall capacity utilisation in the economy as a whole.

Inflation is low. It is likely that underlying inflation will remain around 1¼% and 1½% through 2012. The krone has recently appreciated considerably and is now strong. Wage growth appears to be slackening.

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. A separate box in this *Report* describes how financial stability considerations may influence interest rate setting.

The Executive Board notes that the analyses in this *Report* call for a considerable downward revision of the interest rate forecast compared with the projections in October 2011.

The Executive Board judges that weak growth prospects abroad and the strong krone are contributing to keeping inflation low and dampening economic growth in Norway, even if activity in some industries in Norway remains buoyant. If the interest rate is set too high, the krone may appreciate further, inflation may continue to fall and growth in output and employment may become too low. This suggests that the key policy rate should be reduced further. On the other hand, there is virtually normal capacity utilisation in the Norwegian economy. Moreover, low interest rates over time may induce households and enterprises to take excessive risks and accumulate excessive debt. Such imbalances may have spillover effects further ahead, with substantial effects on output and employment.

The Executive Board decided at its meeting on 14 March that the key policy rate should be in the interval 1%–2% until the publication of the next *Report* on 20 June 2012, unless the Norwegian economy is exposed to new major shocks. Should uncertainty abate and growth and inflation pick up, the interest rate may be raised. Conversely, a deterioration of the European debt crisis or other major shocks may result in a reduction in the interest rate. A substantially stronger krone may also result in further interest rate cuts.

At the same meeting, the Executive Board decided to reduce the key policy rate by 0.25 percentage point to 1.5%.

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