Strategy Document 2/03

Monetary policy in the period to October 2003.

Discussed by the Executive Board at its meeting of 4 June 2003. Approved by the Executive Board at its meeting of 25 June 2003.

Background

Norges Bank's operational conduct of monetary policy shall be oriented towards low and stable inflation. The inflation target is set at 2½%. Monetary policy influences the economy with long and variable lags, and the Bank must therefore be forward-looking in interest rate setting. The key rate (the sight deposit rate) is set on the basis of an overall assessment of the inflation outlook, normally two years ahead. This time horizon also means that emphasis is placed on dampening fluctuations in the real economy. The key rate will normally be changed gradually so that we can assess the effects of an interest rate change and other new information about economic developments. However, in situations where there is a risk that inflation may deviate from the target over a longer period or when there is considerable turbulence in financial markets or a wage-driven cost shock indicates that monetary policy credibility is in jeopardy, a rapid and pronounced change in the key rate may be appropriate. Inflation may, for example, deviate from the target to a considerable extent over a longer period if international growth and inflationary impulses are weak for a long period.

In the monetary policy discussion of 5 March, the Executive Board deemed that a sight deposit rate in the interval 4¾ – 5½% would be appropriate at the end of June 2003. The interval was conditional on developments in the krone and economic projections. The sight deposit rate was reduced by ½ percentage point at each of the monetary policy meetings on 5 March and 30 April 2003. The press release following the monetary policy meeting of 30 April stated: "With an interest rate of 5.0%, Norges Bank's assessment is that the probability that inflation two years ahead will be lower than 2½% is greater than the probability that it will be higher."

Economic developments, uncertainty and the inflation outlook

The analyses in this section formed the basis for the Executive Board's discussion of 4 June. The analyses were prepared at the end of May.

Developments

Global economic developments are weaker than assumed when the previous strategy discussion was held. In many countries, efforts have been made to sustain activity through low interest rates and an expansionary fiscal stance. Further interest rate reductions are expected. Bond yields are very low. The period of low short-term interest rates is expected to span a longer period.

Economic growth is also low in Norway. Business sentiment indicators for manufacturing have fallen sharply. Norges Bank's regional network reports falling demand and profitability in many industries. Activity is low in both management and service industries. Mainland investment has contracted to a further extent than projected. However, petroleum investment is holding up demand. Public consumption is exhibiting low real growth. Households seem less optimistic about the domestic economy than earlier, and house prices have fallen. Private consumption is growing broadly in line with previous projections. Credit demand in the household sector is high and households are still building up debt.

Employment growth is weaker than projected. The increase in unemployment is broad-based, both across occupations and regions. Employment in the internationally exposed sector, particularly in manufacturing and their sub-contractors, is falling in line with that projected. Developments in other segments of the labour market have been somewhat weaker than anticipated. Earnings are weakening in the service industries, with increased redundancies. Industries such as IT and telecommunications are severely marked by the after-effects of the bubble that burst. Global consultancy firms have scaled down capacity in Norway. The airline industry is restructuring and cutting costs. It also appears that the public sector is increasing its focus on cost-cutting and reducing employment growth compared with previous years.

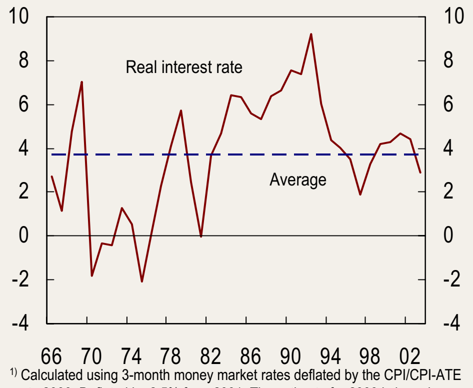
Fiscal policy is less expansionary than assumed in the previous *Inflation Report*. Measured using the traditional budget indicators, the Revised National Budget (RNB) for 2003 will be more or less cyclically neutral.

A positive feature is that this spring's wage settlements resulted in moderate pay increases. This may imply that particular emphasis was placed on weak labour market developments and the situation in the internationally exposed sector. This spring's wage settlement was an interim settlement, however, and next year's main settlement will provide a better indication of whether a more long-lasting shift towards lower pay increases has taken place. For manufacturing, pay increases will have to remain low for a longer period in order to catch up in terms of competitiveness.

Underlying inflation is low. The feed-through from the krone appreciation has been somewhat stronger recently than assumed in the previous *Inflation Report*. CPI-ATE inflation has been lower than projected, reflecting the low rise in prices for imported consumer goods. Inflation expectations, as measured by Norsk Gallup's expectations survey, seem to be well anchored at 2½% in the long term.

Monetary policy has been eased to a considerable extent over the past half-year. The real interest rate is now below its historical average (see Chart 1). The interest rate reductions and expectations of further cuts have led to a weakening of the krone. Around end-May/beginning of June, the krone was a little more than 5% weaker than the peak level in January. This is moderating the contraction in the internationally exposed sector and will lead to higher import price inflation ahead. The real exchange rate is still high from a historical perspective, both measured in terms of relative wages and prices (see Chart 1). International interest rate developments have reduced the effects of domestic interest rate cuts on the krone.

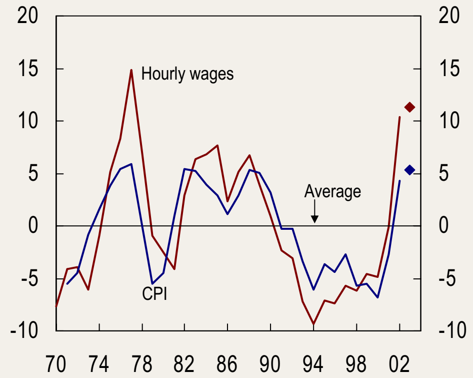
Chart 1a Real interest rate before tax. 1996-2003[1)]



[1)] Calculated using 3-month money market rates deflated by the CPI/CPI-ATE up to 2000. Deflated by 2.5% from 2001. The estimate for 2003 is based on the average of interest rates over the year (the most recent observation is used for the last part of 2003).

Source: Norges Bank

Chart 1b Real exchange rate. 1970-2003[1)]



[1)] Figures for 2003 based on TWI in May and projections for the CPI and wages.

Source: Norges Bank

Outlook for the global economy

Global growth is assumed to pick up toward the end of this year and through next year. An expansionary monetary and fiscal policy in several countries, lower oil prices and improved corporate earnings in the US point to a pick-up in growth. However, the upturn is projected to occur at a later stage than anticipated in the previous *Inflation Report* and the projections for economic growth among trading partners in 2003 have been revised downwards. Inflation is expected to remain subdued.

It is still uncertain when global growth will be self-driven and sufficient to increase capacity utilisation. The effects of the sharp decline in equity prices up to March of this year and earlier overinvestment may prove to be more pronounced than previously assumed. Moreover, house prices have exhibited a marked rise in the UK and US in recent years. A correction in the housing market could have a considerable impact on household saving and reduce consumption growth. In the US, there is a risk that consumption growth will fall to a further extent before investment rebounds. The fall in the value of the dollar will, however, have positive effects on growth in the US, but have a negative impact in Europe and Japan. The fear of SARS is adversely affecting tourism, trade and production, particularly in Asia. Against this background, there is a risk that the world economy may be facing a fairly long period of weak growth or stagnation. This is reflected in the low long-term yields in the US and Europe. Such a development could be particularly inauspicious in today's situation with low key rates and sizeable public budget deficits as it gives rise to the risk of deflation.

However, it is possible that the fall in oil prices, economic policy stimulus and the conclusion of the Iraq war will lead to a faster revival of growth than assumed. Spare capacity in the US is not as high as earlier, and inventories have been scaled down. Many US companies have considerable uncovered pension obligations, but they have improved their balance sheets and profitability, as reflected in higher share prices.

The outlook for the Norwegian economy

Even if economic developments have been somewhat weaker than projected, growth in private consumption may hold up. Lower interest rates are making a positive contribution, but weak labour market developments are having a dampening impact on consumption growth and the housing market.

Mainland investment appears to be falling markedly this year. Investment may remain low ahead even with lower interest rates and a weaker krone. Weaker competitiveness at home and the global downturn are hampering manufacturing investment. Earlier overinvestment, low demand for business services and vacancy rates in the commercial property market are also contributing to sluggish investment in service industries. Even though the feed-through from petroleum investment to the mainland economy may be more limited than previously as a result of the high import content, a sharp increase in investment will still contribute to sustaining activity in oil-related industries.

The Revised National Budget (RNB) for 2003 implies a neutral fiscal stance over the next years in order to keep the structural deficit in line with the real return on the Petroleum Fund. Growth in public consumption is projected to be somewhat higher than this. The estimates in the RNB are conditional on a reduction in local government deficits. Given the strong pressure on local government welfare services, this may be somewhat optimistic. High wage growth has limited the scope for increasing production and employment in the local government sector, however.

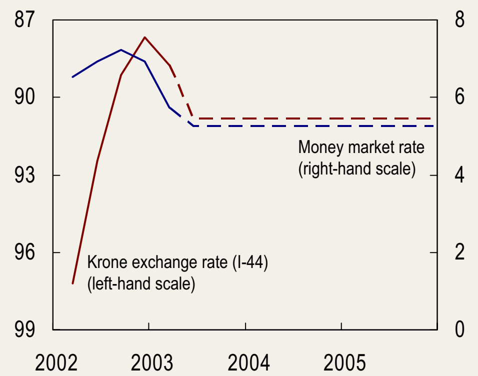
The oil price is assumed to fall gradually to about USD 20 in the period ahead. This is based on the assumption that it will take time for Iraq to build up its production capacity, and commercial stocks are still low.

The projections for inflation and economic developments ahead are conditional on our interest rate and exchange rate assumptions. Prospects given different assumptions are discussed below.

Unchanged interest rate and constant exchange rate

Without an easing of monetary policy, it appears that GDP growth in Norway will be lower than trend growth this year and next. The output gap will close this year and then turn clearly negative.

Chart 2a Scenario 1: Sight deposit rate of 5% and import-weighted exchange rate (I-44) of 90.8[1)]

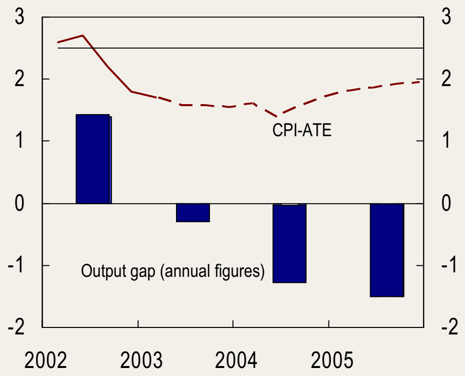


[1)] Corresponds approximately to the average in May.

Source: Norges Bank

The increase in unemployment will then continue, and wage growth is projected to be lower than the level that is in line with the inflation target over time. Inflation will remain low. This is partly due to the appreciation of the krone through last year, with an attendant low rise in import prices over a longer period. The effects will gradually unwind. However, moderating wage growth will under these assumptions keep inflation below target also in 2004 and 2005. A negative output gap may indicate that capacity utilisation is too low and that there is stronger competition in product markets. This may exert downward pressure on inflation through smaller margins (see Chart 2 and Table 1).

Chart 2b Scenario 1: Sight deposit rate of 5% and import-weighted exchange rate (I-44) of 90.8[1)]



[1)] Corresponds approximately to the average in May.

Source: Norges Bank

Table 1 Scenario 1: Projections based on assumptions of a constant sight deposit rate of 5.0% and krone exchange rate equal to 90.8[1)]. Percentage change on previous year. Changes in relation to baseline scenario in previous Inflation Report in brackets.

	2003	2004	2005
Mainland demand	¾ (-½)	2 (-½)	2¼ (-¼)
Private consumption	2¾ (0)	3 (-¼)	2¾ (-¼)
Public consumption	¾ (0)	1½ (-½)	1¾ (-¼)
Fixed investment	-6 (-2)	½ (0)	2 (0)
Net exports (contribution to growth)	-1 (0)	-½ (¼)	-½ (¼)
Mainland GDP	¾ (-½)	1½ (-½)	2¼ (0)
Output gap	-¼ (-¼)	1¼ (-1)	-1½ (-1)
Employment	-1 (-½)	-¼ (-¼)	¼ (-¼)
Reg. unemployment[2)]	4¼ (¼)	4¾ (½)	5 (¾)
Oil price, USD	26 (-4)	22 (-2)	20 (0)
Annual wages	4½ (-½)	4 (-½)	4 (-½)
CPI	2¾ (-½)	1 (0)	2 (-¼)
CPI-ATE	1½ (-¼)	1¾ (-¼)	2 (-¼)

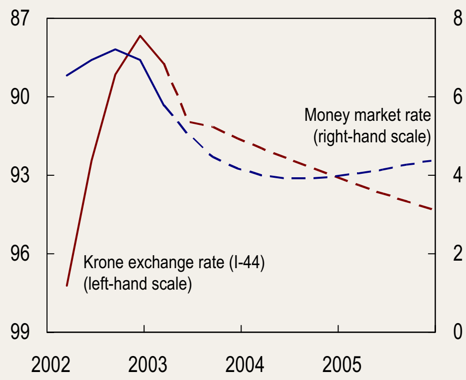
[1)] Corresponds approx. to average of I-44 for May.
[2)] Percentage of labour force

Source: Norges Bank

Market interest rate and exchange rate expectations

There are expectations of an easing of monetary policy ahead. At end-May, the money market expected an interest rate reduction of about 1¼ percentage points through the year. According to the hypothesis of uncovered interest parity, the interest rate expectations correspond to a gradual weakening of the krone by about 5% in the period to end-2005.

Chart 3a Scenario 2: Forward rate at end-May and gradual exchange rate depreciation (I-44) of about 5%



Source: Norges Bank

Our analyses suggest that an easing of monetary policy of this order may lead to more balanced developments in the real economy. The decline in interest rates has relatively strong positive effects on private consumption partly as a result of lower interest rate expenses and partly through higher house prices and thereby higher real wealth. In addition, lower interest rates may boost household optimism, particularly among households in a net debt position.

A weaker krone will gradually improve profitability in the internationally exposed sector. Demand for goods supplied by sub-contractors will gradually be higher than in the scenario with a constant exchange rate. Combined with lower interest rates, this may curb the fall in fixed investment.

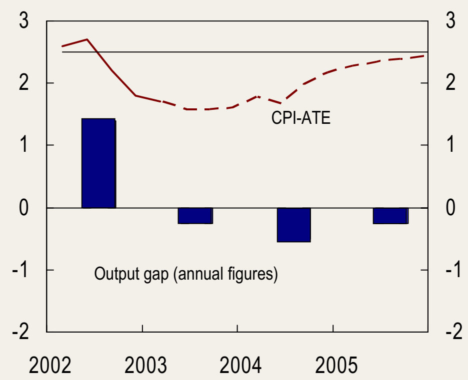
Given these assumptions, the rise in unemployment will gradually level off and edge down toward the end of the projection period. Given this path for labour market developments, wage growth may remain between 4½ and 4¾%. Low consumer price inflation next year may, however, reduce the social partners' inflation expectations. This may entail lower wage growth than we have projected. On the other hand, the low pay increases awarded in this year's interim wage settlement may be motivated by the desire to prevent a further loss of competitiveness. When it becomes clear that the low pay increases and the zero pay increases in many industries are improving competitiveness, there is a risk that wage growth will again exceed 5% after next year's main settlement.

Wage growth in line with our projections will exert continued upward pressure on the rate of increase in prices for domestically produced goods. In addition, a gradual depreciation of the krone will push up import price inflation. On balance, inflation two years ahead will then be about ½ percentage point higher than if the monetary stance had been left unchanged.

At the two-year horizon, inflation, as measured in terms of the CPI-ATE, will be a little less than 2½% (see Chart 3 and Table 2). The output gap will slightly negative in 2005. However, inflation will be about 1 percentage point below target one year ahead. The uncertainty surrounding the inflation projections entail a risk that underlying inflation may be considerably lower than 1½% over the next year.

Beyond the two-year horizon, it appears that GDP growth will be higher than trend growth. The driving force behind growth is a low real interest rate through 2003-2005. In addition, the real exchange rate will also be more conducive to a balanced economy. World economic growth will probably have moved up to trend with a normalisation of external demand. This scenario may imply excess demand, which may gradually result in an inflation rate that is higher than 2½%.

Chart 3b Scenario 2: Forward rate at end-May and gradual exchange rate depreciation (I-44) of about 5%



Source: Norges Bank

Table 2 Scenario 2: Projections based on forward interest rate and forward exchange rate at end-May.[1)] Percentage change on previous year. Changes in relation to baseline scenario in previous Inflation Report in brackets.

	2003	2004	2005
Mainland demand	1 (-¼)	3 (½)	3 (½)
Private consumption	3 (¼)	3¾ (½)	3½ (½)
Public consumption	¾ (0)	1½ (-½)	1¾ (-¼)
Fixed investment	-5½ (-1½)	1¼ (¾)	4 (2)
Net exports (contribution to growth)	-1 (0)	-¾ (0)	-½ (¼)
Mainland GDP	¾ (-½)	2¼ (¼)	2¾ (½)
Output gap	-¼ (0)	-½ (-¼)	-¼ (¼)
Employment	-¾ (-¼)	0 (0)	¾ (¼)
Reg. unemployment[2)]	4¼ (¼)	4½ (¼)	4½ (¼)
Oil price, USD	26 (-4)	22 (-2)	20 (0)
Annual wages	4½ (-½)	4½ (0)	4¾ (¼)
CPI	2¾ (-½)	1¼ (¼)	2½ (¼)
CPI-ATE	1½ (-¼)	2 (0)	2½ (¼)

1) Sight deposit rate falls to approximately 3¾% towards the end of the year and the krone exchange rate (I-44) depreciates by about 5% in period to end-2005.
2) Percentage of labour force

Source: Norges Bank

A sharper interest rate reduction

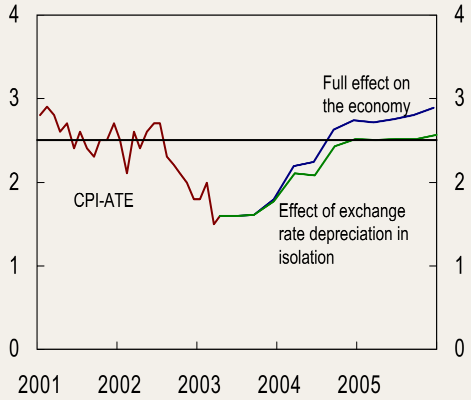
If the interest rate is reduced to a level that is below market expectations, this might have an impact on inflation through a swifter depreciation of the krone than implied by forward rates.

Norway has been among the countries with the highest short-term rates. The key rate in Norway is now 5%. Key rates are higher in Poland, New Zealand and Iceland. In Australia, the UK and Sweden, key rates are 1/4 -1¾ percentage points lower than in Norway. With lower interest rates in Norway, it will become less attractive to maintain short-term krone holdings. This means that a marked interest rate reduction could trigger a depreciation of the krone.

With a technical assumption of an interest rate that is 2% lower and an exchange rate depreciation of 5% over the summer, domestic demand will be higher and the labour market tighter. Wage growth may not change in the short term as a result of an interest rate reduction of this order. If wage growth remains at about 4½%, inflation may move up towards the inflation target in the latter half of 2004 and remain at that level. Inflation would then be about 2½% two years ahead.

With these interest rate and exchange rate assumptions, unemployment may fall to about 4½ in 2005. There is a risk that this may lead to an increase in wage growth. A box in the June 2002 *Inflation Report* describes a simple model for wage formation for mainland Norway. In the model, a fall in unemployment will in isolation contribute to higher wage growth. With inflation expectations of 2.5%, the model predicts that wage growth will be close to 5½% in 2005. With this path for wage growth, inflation will accelerate and exceed the inflation target in 2005 (see Chart 4).

Chart 4 CPI-ATE with 2% lower interest rate and rapid depreciation of 5%.



Sources: Statistics Norway and Norges Bank

Outlook for financial stability

Weaker developments in the Norwegian economy and a sharp rise in the number of bankruptcies have resulted in higher losses and weaker results in the banking sector. Losses are still moderate in a historical context, but are on the rise. In spite of the deterioration in bank performance, capital adequacy ratios remain virtually unchanged.

Growth in household debt remains high at an annual growth rate of close to 11% in March 2003. This partly reflects the preceding long period of house price inflation and continued high turnover in the housing market. With prospects for continued weak growth in the Norwegian economy, growth in household debt is expected to slow somewhat in the period ahead.

Credit growth in the enterprise sector is moderate. In spite of the marked interest rate decline since last autumn, higher bankruptcy figures and somewhat higher bank losses are expected in the period ahead against the backdrop of continued weak economic growth in Norway.

Banks are reasonably well poised to cope with weaker macroeconomic developments. Anecdotal evidence points to the need for stricter credit assessment procedures in the banking sector. At the same time, some banks are seeking to increase their private market share. All in all, supply side conditions in the credit market are not likely to curb credit growth in the period ahead.

Further interest rate reductions from today's level will improve enterprises' debt servicing capacity in the short run, or provide room for higher pricing of risk. The direct effect of lower interest interests on bank earnings is expected to be limited. In the longer term, lower interest rates may sustain growth in household debt.

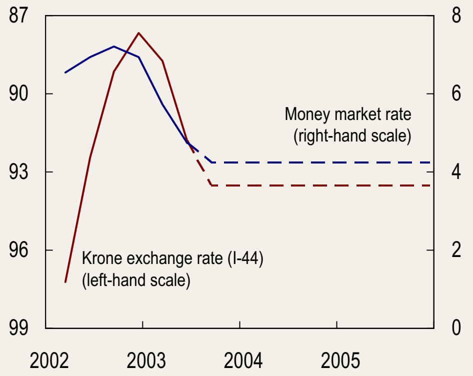
New information and further analysis following the strategy discussion on 4 June

Since the discussion on 4 June, key rates have been lowered in Sweden, Denmark, the euro area and New Zealand. Since the Central Bank Governor's address at the Centre for Monetary Economics at the Norwegian School of Management on 3 June, the krone has weakened by 3-4%, and the money market has factored in expectations of considerably lower key rates in Norway.

Inflation was very low in May. The fall in prices for imported consumer goods pushed down the year-on-year rise in consumer prices adjusted for tax changes and excluding energy products (CPI-ATE) to 1.2%. As a result of lower energy prices, CPI inflation fell from 2.9% in April to 2.1% in May. In isolation, the low rate of increase in prices in spring may influence inflation expectations ahead and contribute to curbing wage growth further.

On the basis of this information, further analyses of the economic outlook were carried out. With an interest rate of 4% and an exchange rate at about the average since 6 June, inflation is expected to remain low. The output gap will be slightly negative through the last part of the period and unemployment will remain at 4½% from 2004. The depreciation of the krone since January of this year will gradually ease the subdued price impulses from the krone appreciation last year. Unemployment will have a dampening impact on wage growth ahead. With wage growth in the area 4-4½%, a neutral contribution from the exchange rate, moderate external price impulses and approximate balance in the real economy, inflation will reach 2% one year ahead, but remain below target two years ahead (see Chart 5 and Table 3).

Chart 5a Scenario 4: Sight deposit rate of 4% and import-weighted krone exchange rate (I-44) of 93.5[1)]

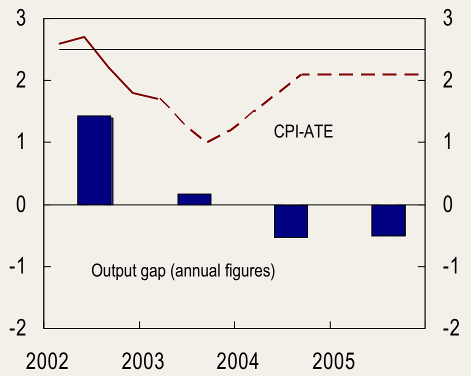


[1)] The average for 3-19 June.

Source: Norges Bank

Further analyses have been made applying the forward interest rate and forward exchange rate prevailing in mid-June. Forward interest rates imply a reduction in the sight deposit to about 3% towards the end of this year, followed by a moderate rise in the period to end-2005. The krone depreciates gradually by about 3% in the period to end-2005. The marked relaxation of monetary policy may also lead to fairly high level of activity in the Norwegian economy, particularly in sectors supplying goods and services to households. This suggests lower unemployment and somewhat higher wage growth. With a weaker krone and wage growth between 4½-5%, inflation may be somewhat higher than in the scenario with a constant interest rate and exchange rate[1]. Inflation may reach the inflation target in 2005 in this scenario (see Chart 6 and Table 4).

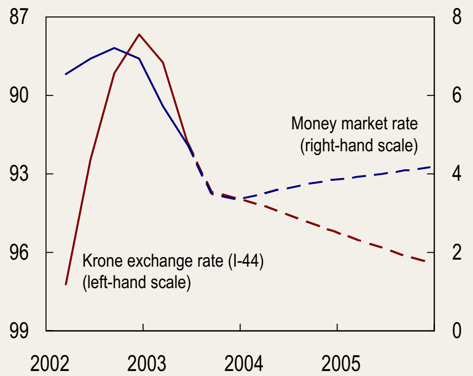
Chart 5b Scenario 4: Sight deposit rate of 4% and import-weighted krone exchange rate (I-44) of 93.5[1)]



[1)]The average for 3-19 June.

Source: Norges Bank

Chart 6a Scenario 5: Forward rate in mid-June and gradual exchange rate depreciation (I-44) of about 3%



Source: Norges Bank

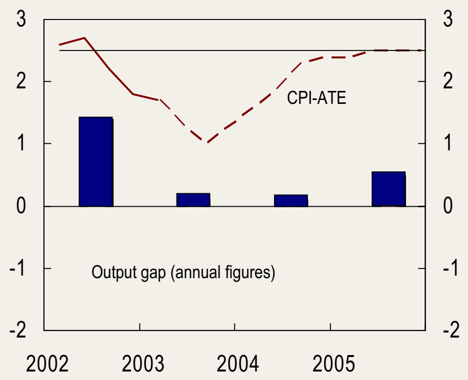
Table 3 Scenario 4: Projections based on assumptions of a constant sight deposit rate of 4.0% and krone exchange rate equal to 93,5[1)]. Percentage change on previous year. Changes in relation to baseline scenario in previous Inflation Report in brackets.

	2003	2004	2005
Mainland demand	1 (-¼)	2½ (0)	3¼ (¾)
Private consumption	3 (¼)	3½ (¼)	3½ (½)
Public consumption	¾ (0)	1½ (-½)	1¾ (-¼)
Fixed investment	-5½ (-1½)	1¼ (¾)	4 (2)
Net exports (contribution to growth)	-1¼ (-¼)	-½ (¼)	-1 (-¼)
Mainland GDP	1 (-¼)	2 (0)	2½ (¼)
Output gap	0 (0)	-½ (-¼)	-½ (0)
Employment	-¾ (-¼)	0 (0)	½ (0)
Reg. unemployment[2)]	4¼ (¼)	4½ (¼)	4½ (¼)
Oil price, USD	26 (-4)	22 (-2)	20 (0)
Annual wages	4½ (-½)	4 (-½)	4½ (0)
CPI	2¼ (-1)	1¼ (¼)	2 (-¼)
CPI-ATE	1¼ (-½)	1¾ (-¼)	2 (-¼)

[1)] Correspnds to average I-44 in the period 3/6 - 19/6.
[2)] Percentage of labour force

Source: Norges Bank

Chart 6b Scenario 5: Forward rate in mid-June and gradual exchange rate depreciation (I-44) of about 3%



Source: Norges Bank

[1]Compared with the figures from 4 June (Scenario 3 with sight deposit rate of 3% and immediate krone depreciation of 4%), the projections for wage growth have been revised downwards somewhat. This is partly due to a stronger krone and lower inflation expectations for the period ahead.

Table 4 Scenario 5: Projections based on forward interest rate and forward exchange rate at mid-June.[1] Percentage change on previous year. Changes in relation to baseline scenario in previous Inflation Report in brackets.

	2003	2004	2005
Mainland demand	1¼ (0)	3½ (1)	3¾ (1¼)
Private consumption	3¼ (½)	4½ (1¼)	4¼ (1¼)
Public consumption	¾ (0)	1½ (-½)	1¾ (-¼)
Fixed investment	-5 (-1)	3 (2½)	5¼ (3¼)
Net exports (contribution to growth)	-1¼ (-¼)	-¾ (0)	-1 (-¼)
Mainland GDP	1 (-¼)	2½ (½)	3 (¾)
Output gap	0 (0)	0 (¼)	½ (1)
Employment	-¾ (-¼)	¼ (¼)	¾ (¼)
Reg. unemployment[2]	4¼ (¼)	4½ (¼)	4¼ (0)
Oil price, USD	26 (-4)	22 (-2)	20 (0)
Annual wages	4½ (-½)	4½ (0)	5 (½)
CPI	2¼ (-1)	1½ (½)	2½ (¼)
CPI-ATE	1¼ (-½)	2 (0)	2½ (¼)

[1] Forward interest rates imply that the sight deposit rate falls to 3% at end-2003, and increases somewhat towards the end of 2005. The exchange rate depreciates by about 3% in the period to end-2005.
[2] Percentage of labour force

Source: Norges Bank

Monetary policy ahead

The task of smoothing cyclical fluctuations and inflation primarily rests with monetary policy. The Government focuses on the long-term priorities of budgetary policy and places emphasis on the guideline for phasing in petroleum revenues. According to the Revised National Budget for 2003, this implies a neutral fiscal stance this year and next. This means that the conditions can be put in place to avoid locking in a tight monetary policy and a corresponding krone that is too strong.

Following a long period of expansion, the Norwegian economy was marked by a shortage of real economic resources and strong domestic cost inflation over several years up to autumn 2002. House prices had risen sharply and household borrowing was high. In late autumn 2002, however, new information provided fairly clear indications that the prospects for the international and Norwegian economy had weakened. The weaker prospects have been confirmed, but also amplified by new information in recent months.

Monetary policy has been relaxed markedly since December 2002. The sight deposit rate has been cut on four occasions by a total of 2 percentage points. The exchange rate (I-44) has weakened by about 8% since the beginning of the year, and is now at about the level prevailing at the end of April 2002. The monetary policy easing is stimulating private consumption and sustaining demand in spite of sluggish developments in investment and exports.

With the apparent moderation in wage growth ahead to a level more in line with that of our trading partners, the room for manoeuvre in monetary policy may increase. This increases the possibility of a convergence between interest rates in Norway and other countries.

Without a further easing of monetary conditions, inflation is expected to remain considerably lower than the inflation target throughout the projection period. The output gap closes in 2003 and turns clearly negative through 2004 and 2005. This indicates that monetary policy is too tight.

A rapid interest rate decline of about 1 percentage point and an unchanged exchange rate do not appear to be sufficient to bring inflation up towards the target. A sharper interest rate reduction during the strategy period therefore seems to be appropriate.

There is uncertainty associated with the projections and a risk that inflation may also be lower than projected. A long period of very low inflation may influence inflation expectations. This may make it more difficult to orient monetary policy towards achieving the inflation target at a later stage.

The prospect of low inflation ahead may warrant a rapid and substantial reduction in the key rate. On the other hand, there is a risk that such low interest rates will lead to a renewed rise in house prices, high consumption growth and continued strong debt growth in the household sector. However, higher unemployment and uncertainty as to labour market developments suggest slower debt growth in the household sector.

There is also a risk that the interim wage settlement will not result in a shift in wage developments and that wage growth may follow the path observed after the Arntsen settlement in 1999, when wage growth accelerated again. However, greater vigilance among public employers and a low activity level in many industries would imply that this risk is now limited.

On balance, it is our assessment that the risk of persistently low inflation and low economy activity is predominant. Such a path may influence inflation expectations and weaken confidence in monetary policy. This implies a markedly lower sight deposit rate by the end of October 2003. On the basis of the assessments above, an interval of 3-4% would seem appropriate.

Strategy

- Norges Bank's operational conduct of monetary policy shall be oriented towards low and stable inflation. The inflation target is set at 2½%.
- The key rate is set on the basis of an overall assessment of the inflation outlook, normally two years ahead. The key rate will normally be changed gradually so that we can assess the effects of interest rate changes and other new information on economic developments.
- With financial market confidence in the inflation target, Norges Bank has greater scope for promoting stability in the real economy. This scope will increase further as the inflation target is incorporated as an anchor for wage formation.
- Economic developments broadly in line with projections and the current balance of risks imply a sight deposit in the interval 3-4% at the end of October 2003. Developments since 4 June, with interest rate cuts in other countries and low inflation, may warrant a further reduction in the interest rate.
- Developments in the krone exchange rate and the effects of the appreciation of the krone on inflation and output are uncertain. If the krone remains strong or appreciates further, it may be appropriate to reduce the interest rate to the lower range of the interval or below the interval. If the krone depreciates sharply it may be appropriate with an interest rate in the upper range of the interval or higher than the interval. Any interest rate reaction must be based on an analysis of exchange rate movements and an assessment of the duration of the change in the exchange rate.