Projections in *Inflation Report* 3/06 and *Monetary Policy Report* 1/07

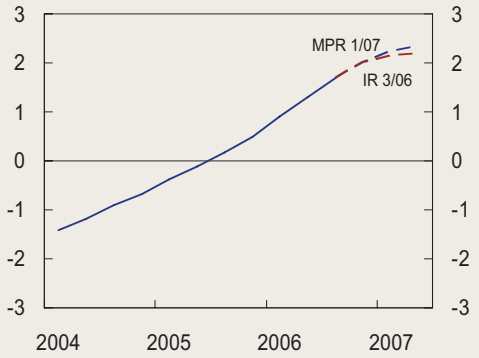
This box presents an analysis of the changes made to the projections in *Inflation Report* 3/06. New information since November influences both the picture of the current economic situation and the assumptions regarding the driving forces that will influence developments in the years ahead. On balance, new information points to a somewhat higher path for the interest rate forecast than that presented in *Inflation Repo*rt 3/06. Norges Bank's projections for 2007 are then compared with projections from other institutions.

New information since Inflation Report 3/06

The following points summarise developments in the economy that have led to changes in our projections for the current year and the period ahead.

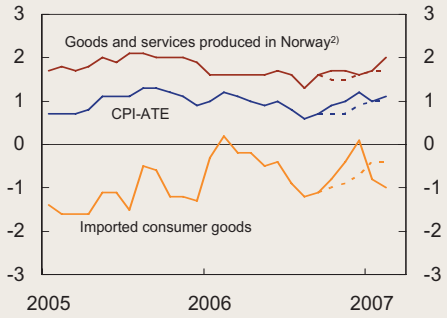
- The revised national accounts figures and the most recent quarterly national accounts figures indicate that growth in mainland GDP in the period 2004 – 2006 was somewhat higher than previously assumed. On the other hand, growth in inward labour migration was high in 2006. Preliminary figures also indicate that productivity growth has been higher than previously assumed over the past few years. The potential growth of the Norwegian economy has therefore probably been higher than previously projected. Our assessment of the output gap in 2006 is thus unchanged compared with *Inflation Report* 3/06 (see Chart 1).
- The level of resource utilisation in the economy is probably a little higher now than projected in *Inflation Report* 3/06. Since then, employment has increased more than projected, and a number of surveys indicate an increasing shortage of qualified labour and intermediate goods. There are signs that wage growth is now picking up faster than previously projected. The output gap at the beginning of 2007 and in the very near term has been revised slightly upwards (see Chart 1).
- Household real income has increased more than previously assumed, and is contributing to higher-than-expected growth in private consumption. Projections for petroleum investment ahead are somewhat higher than in the previous report.
- The krone has appreciated since November last year. Measured by the I-44, the exchange rate has been about 1½% stronger so far this quarter than assumed in *Inflation Report* 3/06.
- Inflation measured by the CPI-ATE was somewhat higher than expected at end-2006, but fell a little in January and is now at the same level as projected in autumn 2006 (see Chart 2).

Chart 1 Output gap estimates in the baseline scenario in IR 3/06 and MPR 1/07. Per cent. Quarterly figures. 04 Q1 – 07 Q2



Source: Norges Bank

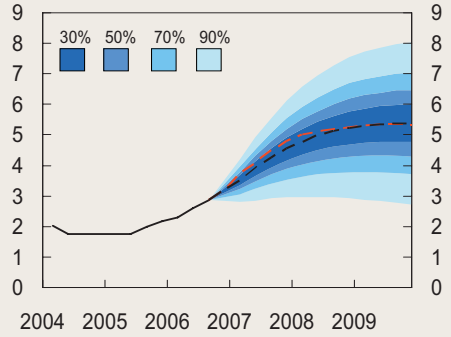
Chart 2 CPI-ATE.[1)] Total and by supplier sector. Projections from IR 3/06 (broken line) and actual 12-month change. Per cent. Monthly figures. Jan 05 – Feb 07



[1)] CPI-ATE: CPI adjusted for tax changes and excluding energy products. A further adjustment is made for the estimated effect of reduced maximum day-care rates in 2006.
[2)] Norges Bank's estimates.

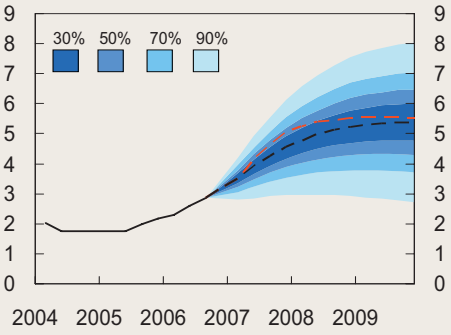
Sources: Statistics Norway and Norges Bank

Chart 3 Key policy rate in the baseline scenario in IR 3/06 with fan chart and key policy rate in the baseline scenario in MPR 1/07 (red line). Per cent. Quarterly figures. 04 Q1 – 09 Q4



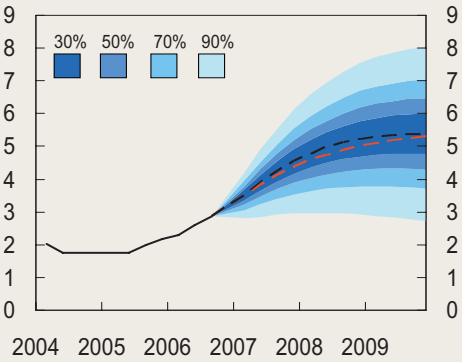
Source: Norges Bank

Chart 4 Key policy rate in the baseline scenario in IR 3/06 with fan chart and the isolated effect of increased capacity utilisation and higher external growth (red line). Per cent. Quarterly figures. 04 Q1 – 09 Q4



Source: Norges Bank

Chart 5 Key policy rate in the baseline scenario in IR 3/06 with fan chart and the isolated effect of stronger krone exchange rate (red line). Per cent. Quarterly figures. 04 Q1 – 09 Q4



Source: Norges Bank

- Growth among trading partners was stronger than projected at end-2006, and has also been revised upwards for the period 2007 – 2010.

Effects on the interest rate path

The interest rate path has been revised upwards by about ¼ percentage point at end-2007 compared with the path presented in *Inflation Report* 3/06 (see Chart 3).

Growth in the Norwegian economy is strong, and the high level of activity may persist somewhat longer than expected in the *Inflation Report* 3/06. There are signs that the strong pressures in the Norwegian economy are feeding through to price and cost inflation. At the same time, the global economic expansion continues. Growth among our trading partners has been more robust than expected since the previous *Report*. In isolation, these factors point to a higher interest rate path (see Chart 4).

On the other hand, the krone has appreciated. The interest rate differential against trading partners may widen somewhat further ahead in the projection period. Since such a development is already widely expected in financial markets, we have assumed that this will have limited effects on the krone exchange rate in the period ahead. A stronger krone exchange rate than assumed in the previous *Report* points to a lower interest rate path (see Chart 5).

Changes in the projections

The projections in this *Report* are based on the assumption that the interest rate will follow a path which, in the Executive Board's view, provides a reasonable balance between the objectives of monetary policy. Section 1 provides a more detailed account of assessments and interest rate developments ahead.

In this *Report*, growth in mainland GDP is projected to be somewhat higher than in *Inflation Report* 3/06. At the same time, the projection for potential output for mainland Norway has been revised up. On balance, this implies a somewhat higher output gap in 2007 than previously projected (see Chart 6).

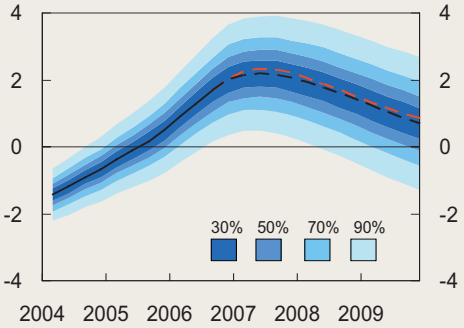
We expect the labour market to be somewhat tighter in the years ahead than assumed in the previous *Report*. Employment growth has been stronger than assumed in November. At the same time, LFS

unemployment has fallen faster than expected earlier, and economic growth is expected to be somewhat stronger in the years ahead. Unemployment projections have therefore been lowered slightly as from 2007. As a result of somewhat lower unemployment, the projection for wage growth in 2007 has been revised up.

The projection for inflation measured by the CPI-ATE has been revised up a little for 2007 (see Chart 7). Expectations of higher capacity utilisation and wage growth than assumed in the previous *Report* are contributory factors. The appreciation of the krone has led to a slight downward revision of the inflation projection for 2008. As previously, we expect that the gradual rise in the interest rate will in turn curb demand and employment and lead to slower wage growth. This will contribute to stabilising inflation close to target in the period to 2010.

No major changes have been made in the projections for the various demand components. As a result of high exploration investment in the petroleum sector in 2006 and expectations of a high level of exploration activity also in the current year, projected petroleum investment has been revised upwards slightly. Somewhat higher growth in household disposable income is expected. Coupled with higher asset prices, this contributes to somewhat higher projections for private consumption than assumed in the previous *Report*. Owing to somewhat lower public sector consumption than expected in 2006, the projections for public sector demand in 2007 are somewhat higher. Against the background of continued high growth among trading partners, export growth is projected to be higher in the near term. Higher projections for domestic demand and expectations of a somewhat stronger krone exchange rate contribute to slightly higher import growth than projected in November.

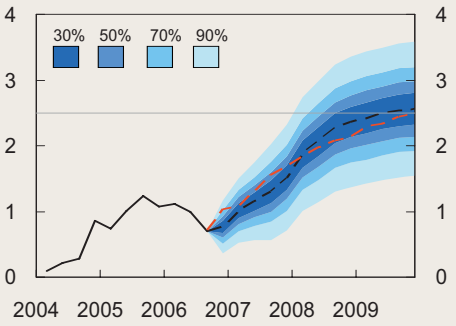
Chart 6 Estimated output gap in the baseline scenario in IR 3/06 with fan chart[1)] and output gap in the baseline scenario in MPR 1/07 (red line). Per cent. Quarterly figures. 04 Q1 – 09 Q4



[1)] Uncertainty surrounding the current situation is taken into account in the calculations.

Source: Norges Bank

Chart 7 Projected CPI-ATE[1)] in the baseline scenario in IR 3/06 with fan chart and CPI-ATE in the baseline scenario in MPR 1/07 (red line). 4-quarter change. Per cent. Quarterly figures. 04 Q1 – 09 Q4



[1)] CPI-ATE: CPI adjusted for tax changes and excluding energy products. A further adjustment is made for the estimated effect of reduced maximum day-care rates in 2006.

Sources: Statistics Norway and Norges Bank

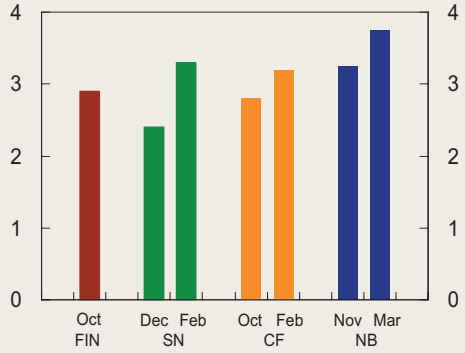
Table 1 Projections for main macroeconomic aggregates in *Monetary Policy Report 1/07*. Change from projections in *Inflation Report 3/06* in brackets.

	2007		2008		2009	
Mainland demand	4	(¼)	2¾	(¼)	2¼	(¼)
GDP mainland Norway	3¾	(½)	2¼	(¼)	2	(¼)
Employment	2¼	(¾)	¼	(0)	0	(0)
LFS unemployment (rate)	2¾	(-¼)	3	(-¼)	3½	(-¼)
CPI-ATE[1)]	1½	(¼)	2	(-¼)	2½	(0)
CPI	¾	(-½)	2½	(½)	2½	(0)
Annual wage growth	5¼	(¼)	5¼	(0)	4¾	(0)

[1)] CPI adjusted for tax changes and excluding energy products.

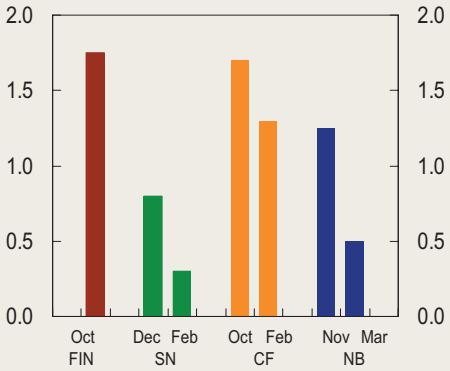
Source: Norges Bank

Chart 8 Mainland GDP. The last two projections published for 2007. Percentage rise



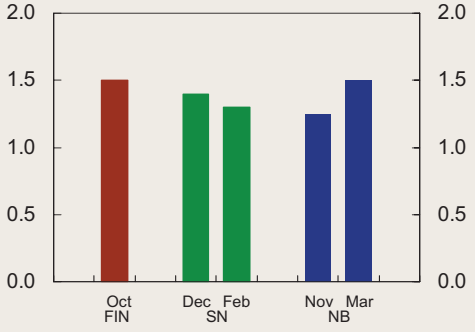
Sources: National Budget 2007, *Economic Survey* 4/2006 and 1/2007, *Inflation Report* 3/06 and *Monetary Policy Report* 1/07, *Concensus Forecasts* October 2006 and February 2007

Chart 9 CPI. The last two projections published for 2007. Percentage change



Sources: National Budget 2007, Economic Survey 4/2006 and 1/2007, *Inflation Report* 3/06 and *Monetary Policy Report* 1/07, *Concensus Forecasts* October 2006 and February 2007

Chart 10 CPI-ATE.[1)] The last two projections published for 2007. Percentage change



[1)] CPI-ATE: CPI adjusted for tax changes and excluding energy products. In Norges Bank's projection a further adjustment is made for the estimated effect of reduced maximum day-care rates in 2006.

Sources: National Budget 2007, *Economic Survey* 4/2006 and 1/2007, *Inflation Report* 3/06 and *Monetary Policy Report* 1/07

Forecasts from other institutions

Norges Bank's projections for economic growth in 2007 are somewhat higher than those of the Ministry of Finance[1] and Statistics Norway and the average forecast from *Consensus Forecasts* (see Chart 8). Norges Bank projects mainland growth of 3¾% in 2007. When Statistics Norway published its projections at the end of February this year, mainland GDP growth in 2007 was forecast at 3.3%, which is higher than the December forecast of 2.4%. In the National Budget for 2007, the Ministry of Finance puts GDP growth at 2.9% in 2007. The average forecast for GDP growth from Consensus Forecasts has been revised upwards since October 2006, from 2.8% to 3.2% in February this year.

In this *Report*, Norges Bank projects CPI inflation at ½% in 2007 (see Chart 9).The Ministry of Finance's projection for the rise in the CPI is 1¾% in 2007. Since December last year, Statistics Norway has reduced its forecast for CPI inflation in 2007 by 0.5 percentage point to 0.3%. The average forecast for CPI inflation from *Consensus Forecasts* has been revised down since October 2006, from 1.7% to 1.3% in February 2007. Norges Bank's projections for the rise in prices measured by the CPI-ATE is 1½% in 2007 (see Chart 10). For the same period, the Ministry of Finance also projects the rise in the CPI-ATE at 1½%. Since December 2006, Statistics Norway has reduced its projection for CPI-ATE inflation in 2007 by 0.1% to 1.3%. *Consensus Forecasts* does not collect projections for CPI-ATE inflation.

The Ministry of Finance's forecasts were published on 6 October 2006. Statistics Norway published its forecasts on 14 December 2006 and 22 February this year. *Consensus Forecasts* compiled its figures on 9 October 2006 and 12 February 2007. As the institutions publish projections at different times, the information on which the projections are based will differ.

[1] The Ministry of Finance did not publish projections for 2007 until October 2006.