Higher interest rates keep global inflation subdued

Inflation remains moderate among our trading partners (see Chart 2.1). Looking ahead, a tightening of monetary policy in industrialised countries is expected to contribute to keeping inflation low. This is supported by current indicators and various measures of inflation expectations. CPI inflation is projected to remain around 2% among our trading partners (see Table 2.1).

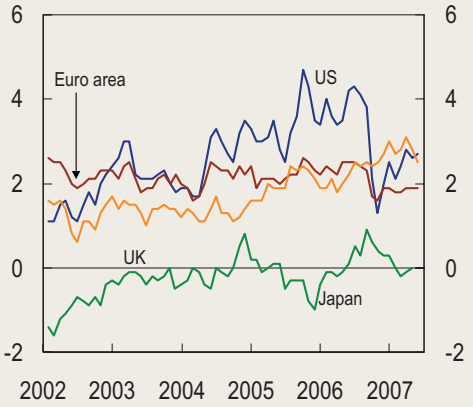
Since *Monetary Policy Report* 1/07, prices for oil and other commodities have increased from already high levels. In the US, the UK, Sweden and China, the increase in energy and food prices has contributed to a somewhat sharper rise in consumer prices than projected earlier. However, the effects on consumer prices in Germany from the increase in VAT at the beginning of 2007 were smaller than expected. In Japan, inflation has also been lower than expected.

In recent years, low long-term interest rates have contributed to higher property and securities prices and reduced credit risk premia in bond markets in large parts of the world economy. At the same time, as a result of spare production capacity and low consumer price inflation, monetary policy has been able to stimulate demand through low short-term interest rates for a long period. This has contributed to high money supply and credit growth (see Chart 2.2). Pressures on production capacity are now rising and monetary policy is being tightened internationally. Both short-term and long-term interest rates have risen markedly since the previous *Report*. However, this does not appear to reflect expectations of higher inflation to any extent. Both in the US and the euro area, the rise in interest rates has been driven by the rise in real interest rates while inflation expectations are stable (see Chart 2.3). Inflation expectations have risen somewhat in the UK. The inflation outlook for the world economy is discussed further in a box on page 41.

Market interest rates indicate that official policy rates among trading partners are expected to increase to about 4.7% in the first half of 2008, or close to ¾ percentage point higher than projected in the previous *Report*. In the US, interest rate cuts rate are no longer priced into the market. Interest rate increases are expected in most countries.

In bond markets, risk premia measured by yield differentials for bonds with different risk increased around the end of February. This was partly due to increased losses on subprime mortgages in the US, coupled with a temporary reduction in risk willingness in financial markets. Risk premia have since declined and are currently very low

Chart 2.1 Inflation. 12-month change in the CPI. Per cent. Monthly figures. Jan 02 – May 07



Sources: Reuters (EcoWin) and Norges Bank

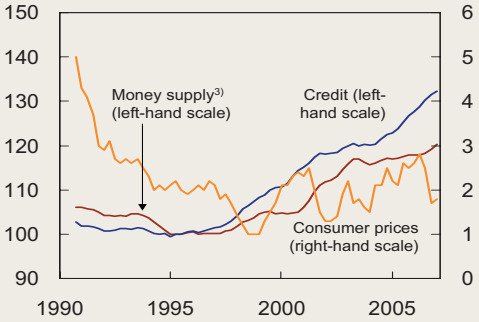
Table 2.1 Projections for consumer prices in other countries. Change from previous year.

	2007	2008	2009	2010
US	2½	2½	2¼	2¼
Japan	0	½	1¼	1¼
Germany	2	1½	1½	1½
France	1½	1¾	1¾	1¾
UK	2½	2	2	2
Sweden	2	2¼	2¼	2
China	3	3	3¼	3¼
Trading partners[1)]	2	2	2	2
Euro area[2)]	2	2	2	2

[1)] Import weights, 26 important trading partners
[2)] HICP. Weights from Eurostat (each country's share of total euro area consumption)

Sources: Eurostat and Norges Bank

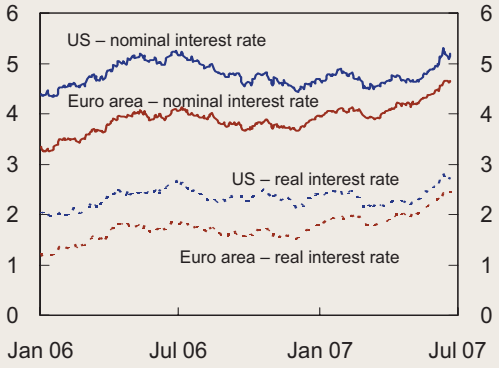
Chart 2.2 Consumer prices[1)], credit and money supply[2)] in the US, the euro area and Japan.[3)] Quarterly figures. 90 Q4 – 07 Q1



[1)] CPI: 12-month rise. Per cent.
[2)] Credit and money supply as a share of nominal GDP. Indices, 1995 = 100. Credit to private sector. Money supply: M3 for euro area and Japan, M2 for the US.
[3)] Weighted by GDP in 2000 and PPP exchange rates.

Source: Bank for International Settlements

Chart 2.3 Nominal and real interest rates on 10-year government bonds in the US and the euro area. Per cent. Daily figures. 2 Jan 06 – 21 Jun 07



Source: Reuters (EcoWin)

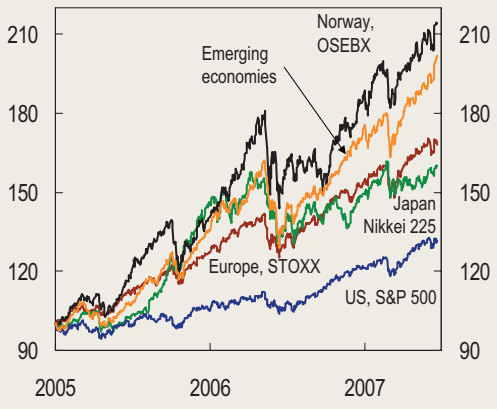
Table 2.2 Projections for GDP growth in other countries. Change from previous year.

	2007	2008	2009	2010
US	2¼	2¾	2¾	2¾
Japan	2¼	2	1½	1½
Germany	2½	2¼	2	1½
France	2¼	2¼	2¼	2¼
UK	2¾	2½	2½	2¼
Sweden	3½	3	2¼	2
China	10½	9¾	9	9
Trading partners[1)]	3	2¾	2½	2¼
Euro area	2½	2¼	2	1¾

[1)] Export weights, 26 important trading partners.

Source: Norges Bank

Chart 2.4 Developments in international stock indices. 2 Jan 05 = 100. Daily figures. 2 Jan 05 – 21 Jun 07



Source: Reuters (EcoWin)

from a historical perspective. Renewed risk willingness has also led to a renewed increase in carry trade activity. The Japanese yen and the Swiss franc have depreciated, while the Australian and New Zealand dollar have appreciated. Since the previous *Report*, the US dollar has depreciated, while the euro and pound sterling have appreciated.

Equity prices also fell markedly around the end of February. The decline was relatively short-lived and equity prices have rebounded in recent months (see Chart 2.4). Solid Q1 figures for listed companies in Europe and the US, coupled with expectations of continued solid earnings, have contributed to the rise. The uncertainty in the stock market has decreased, but remains higher than before the period of unrest (see Chart 2.5).

The benefits of globalisation are still being felt. China, India and some other countries in Asia and eastern Europe are expanding sharply. At the same time, globalisation is boosting growth in industrialised countries. Product and labour markets are becoming more efficient as a result of increased competition. Employment is still on the rise among all our main trading partners and unemployment is stable or declining.

On the whole, growth forecasts for the world economy in the previous *Report*, with continued high but gradually slowing growth are largely maintained. The slowdown in the US is pronounced, but current indicators suggest somewhat more favourable developments ahead. So far, the growth pause in the US seems to have had little impact on our European trading partners (see Table 2.2 and Chart 2.6). European manufacturing is concentrated on the production of machinery and transport equipment. These products are in demand among the heavily investing growth economies in Asia and eastern Europe. At the same time, lower prices for imported goods from these countries and inward labour migration are contributing to increasing the growth potential of western Europe, while curbing price and wage inflation. Reforms in product and labour markets in recent years – especially in Germany – are also increasing the growth potential.

Higher losses on mortgages and lower house prices in the US have so far had limited ripple effects. The decline in housing investment is slowing. There are signs that growth in private consumption is easing broadly in line with expectations. Higher energy prices will also contribute to lower growth in US private consumption, and probably more so than in other OECD countries. The slowdown is still expected to be moderate partly owing to continued growth in employment and income. Capacity utilisation among our main trading partners is expected to increase this year and next, and is already above the normal level, based on OECD estimates of the output gap and potential growth.

Oil prices have increased by about USD 13 per barrel since *Monetary Policy Report* 1/07 and are now just below USD 73. Oil futures prices for delivery in December have increased by about USD 6 to USD 72. Prices for other commodities have risen substantially during the period. Developments in energy and commodity markets confirm the picture of continued strong growth in the global economy. Developments in these markets are discussed in detail in a box on page 21.

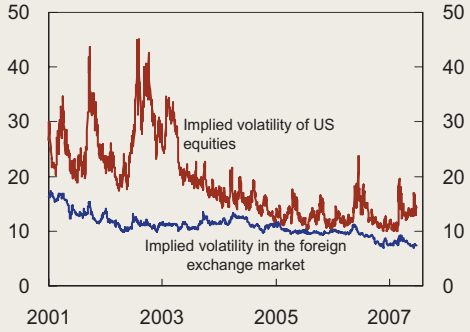
It is possible that we are underestimating the strength of the upturn in Europe and Asia. The high level of investment together with financial market reforms may lead to even higher growth in China in the years ahead than currently expected. In other Asian countries, investment may pick up from a level that has so far been low compared with the high rate of economic growth. Continued high inward labour migration from the new EU countries may lead to a higher growth potential in Europe, at the same time as exports and consumption pick up.

However, the decline in house prices and housing investment in the US may curb global economic growth more than expected. The housing supply remains very high in relation to sales and may increase further due to the rising number of homes that are repossessed by financial institutions and offered for sale (see Chart 2.7). The fall in house prices may continue for a period. This may lead to increased uncertainty, higher household saving and lower household consumption.

The US current account deficit is still large and there is still a risk that this may trigger sudden corrections in the foreign exchange market or in long-term interest rates. Recent developments, including slower growth in the US and a gradual depreciation of the US dollar, will counter and eventually reduce current account imbalances. The risk may therefore have been slightly reduced.

If the world economy is exposed to new disturbances, for example a further increase in commodity prices or a marked decline in productivity growth, there is a risk that high liquidity and growing pressures on production resources may also lead to higher labour costs and consumer price inflation. As long as such shocks are systematically countered through monetary policy, there appears to be little risk that inflation will pick up markedly (see box on page 41).

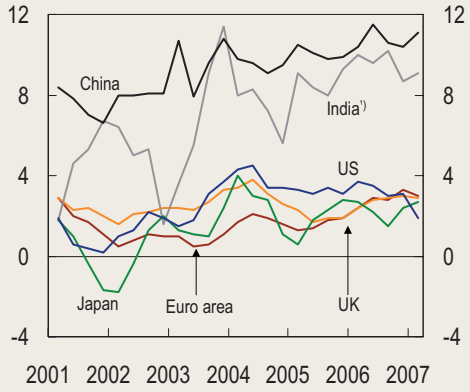
Chart 2.5 Implied volatility in the foreign exchange market[1] and the US equity market. Daily figures. 2 Jan 01 – 21 Jun 07



[1] Index that describes risk in the global foreign exchange market as reflected in option prices for EUR/USD, USD/JPY and EUR/JPY.

Sources: Reuters (EcoWin) and Norges Bank

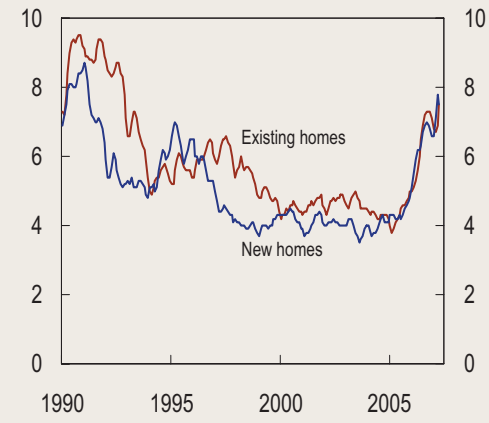
Chart 2.6 GDP. 4-quarter change. Per cent. Quarterly figures. 01 Q1 – 07 Q1



[1] Measured by factor price.

Sources: Reuters (EcoWin) and Norges Bank

Chart 2.7 US – homes for sale at month-end compared with the month's sales. 3-month moving average. Monthly figures. Jan 90 – Apr 07



Sources: Reuters (EcoWin) and Norges Bank

Developments in energy and commodity markets

Oil and natural gas

The price of Brent Blend oil has risen by USD 13 since *Monetary Policy Report* 1/07, and is now USD 73 per barrel. The increase can be attributed to the following:

- OPEC reduced oil production from 2006 Q3 to 2007 Q1.[1] At the same time, global demand for oil increased more than the supply from non-OPEC countries. This resulted in a sharp fall in total OECD oil inventories (see Chart 1).[2] OECD crude oil inventories nevertheless remain well over the average for the past five years.
- Petrol inventories in the US dropped to an unusual extent in the first part of 2007. Total petrol inventories in the OECD fell far below the average for the past five years, reflecting a generally tight petrol market. Record high petrol prices feed back to oil prices.
- Oil prices were again affected by various supply-side factors, including recurring problems in Nigeria and unrest in the Middle East.

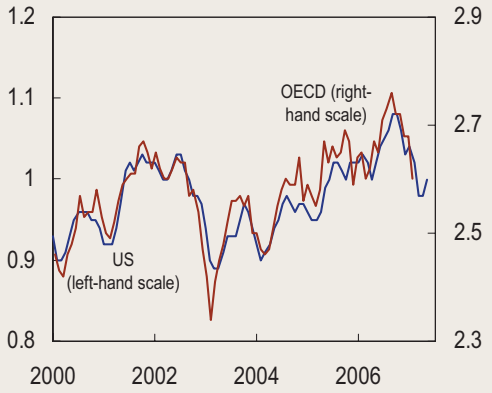
At the meeting on 15 March, OPEC decided not to cut production further. After bottoming out at a level of USD 50 per barrel in mid-January, oil prices rose to just over USD 60 in early March. The organisation did point out that there was an ample supply of oil, and that inventories were still high, but added that the general market situation could change rapidly. The next ordinary meeting is on 11 September 2007. Extraordinary meetings to discuss the need for production changes were not scheduled.

OECD oil inventories are expected to increase in the second quarter, but probably not by more than the normal seasonal pattern would suggest. Inventories will probably fall again in the third and fourth quarters, unless OPEC increases production.

Table 1 compares forecasts for demand for and actual OPEC production from the International Energy Agency (IEA), the US Energy Information Administration (EIA) and OPEC:

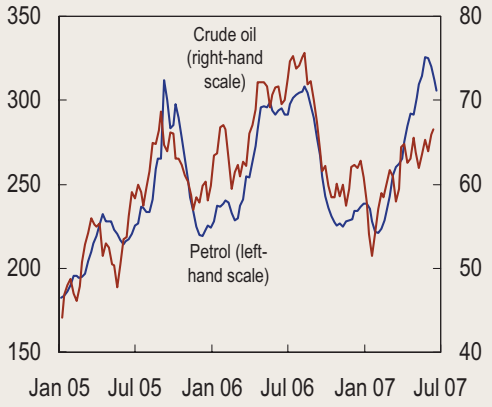
- The IEA estimates that the increase in the need for OPEC production from the second to the fourth quarter will be appreciably higher than the growth in the cartel's production capacity in the same period. If production is increased to meet demand – fully or partly - growth in OPEC's spare capacity may come to a halt in the course of 2007 (see Chart 3). [3] At the same time, oil inventories may fall, albeit from a high level.
- The EIA also estimates that OPEC will increase output markedly from today's level in the third and fourth quarters.[4] Even given such an increase, combined OECD inventories, measured in consumption days, are expected to fall to the lowest level in the past five years at end-2007. Like the IEA, the EIA does not envisage a substan-

Chart 1 Oil inventories. In billions of barrels. Monthly figures. Jan 00 – May 07



Sources: International Energy Agency (IEA), Energy Information Agency (EIA) and Reuters (EcoWin)

Chart 2 Price of crude oil (USD per barrel) and petrol (cents per gallon) in the US. Weekly figures. Week 1 2005 – Week 25 2007



Source: Reuters (EcoWin)

tial increase in spare capacity through the remainder of 2007. The EIA forecasts prices for West Texas Intermediate (WTI) in 2007 and 2008 at USD 64.1 and USD 64.8 per barrel, respectively. The forecast for 2007 is roughly in line with what actual prices and futures prices indicate, while the forecast for 2008 is somewhat lower than indicated by futures prices.

- OPEC, on the other hand, estimates that the need for OPEC production will not increase to any extent in the third and fourth quarters compared to actual production in May. OPEC forecasts both weaker growth in global demand for oil and stronger growth in the supply of oil from non-OPEC countries. This will result in higher spare production capacity in the OPEC countries.

Chart 3 Spare OPEC capacity. In million barrels per day. Monthly figures. Jan 00 – May 07

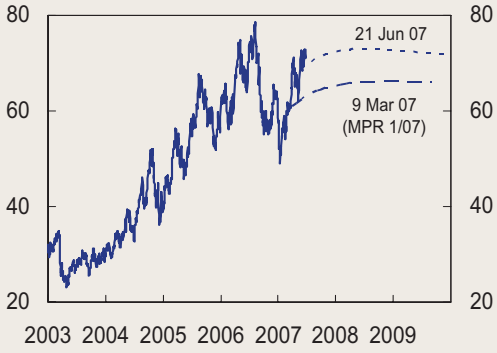


Source: International Energy Agency (IEA)

In 2007, the IEA and the EIA have repeatedly urged OPEC to increase production again. So far, OPEC has argued that the high oil price is largely due to conditions in the petrol market, including a shortage of refinery capacity and uncertainty regarding supply factors that OPEC has little control over. According to OPEC's assessment, the supply of crude oil is adequate.

The oil price path presented in this report is based, as previously, on futures prices. These prices now indicate an average oil price of USD 67 in 2007 and USD 73 in 2008, about USD 6 higher than in *Monetary Policy Report* 1/07 (see Chart 4). At the beginning of each month, Consensus Economics publishes forecasts of the most likely price for the US benchmark oil, WTI, three months and one year ahead.[5] Three months ahead, the forecast is some-

Chart 4 Oil price (Brent Blend) in USD per barrel. Daily figures. 2 Jan 03 – 21 Jun 07. Futures prices from 9 Mar 07 and 21 Jun 07 (broken lines). Monthly figures. Apr 07 – Dec 09



Sources: Reuters (EcoWin) and Norges Bank

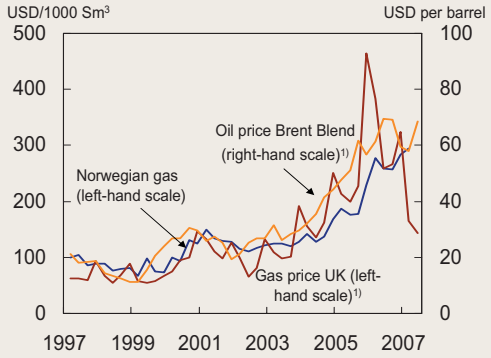
Table 1 Production of crude oil and call on OPEC in 2007, millions of barrels per day.[1), 2)] Projections in italics.

	Production[3)]		Call on OPEC			
	Q1	May	Q1[3)]	Q2	Q3	Q4
IEA	30.2	30.1	30.5	*29.8*	*31.5*	*32.3*
EIA	30.0	30.0	31.5	*30.4*	*31.6*	*32.6*
OPEC	30.0	30.0	31.1	*29.5*	*30.6*	*31.0*

1) The projections are based on the reports published by the different institutions in June.
2) Call on OPEC is the difference between global demand and non-OPEC supply. Non-OPEC supply includes crude oil, NGL (including from OPEC), condensates and oil from non-conventional sources.
3) The figures may vary as the institutions use different data sources.

Sources: Oil Market Report, International Energy Agency, June 2007; Short-Term Energy Outlook, Energy Information Administration, June 2007; Monthly Oil Market Report, OPEC, June 2007 and Norges Bank

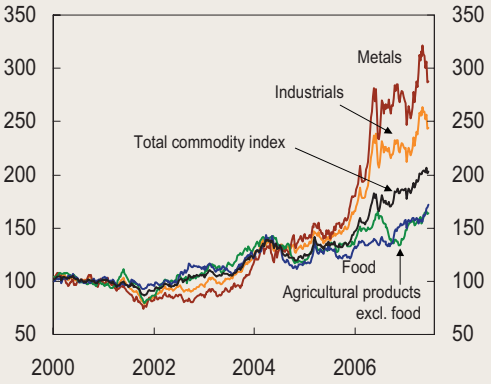
Chart 5 Average prices for crude oil (USD per barrel) and natural gas (USD per 1000 Sm^3). Quarterly figures. 97 Q1 – 07 Q2



1) The figures for 07 Q2 are the average of the daily figures so far in the period

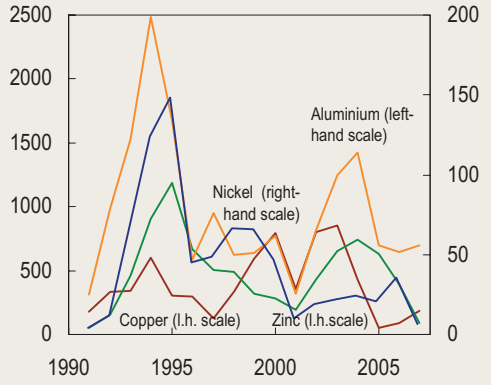
Sources: Statistics Norway, Reuters (EcoWin) and Norges Bank

Chart 6 International commodity prices in USD. Index, 2000 = 100. Weekly figures. Week 1 00 – Week 25 07



Sources: Reuters (EcoWin) and *The Economist*

Chart 7 Stocks of metals on the London Metal Exchange at year-end. In 1000s of tons. Annual figures. 1990 – 2006



Source: Reuters (EcoWin)

what lower than implied by futures prices. One year ahead, the forecast is just over USD 5 lower than implied by futures prices.

Prices for Norwegian gas are generally linked to prices for petroleum products, through indexing with a certain time lag in long-term sales contracts. A share of the gas is also sold in the UK spot market, where prices have fallen substantially (see chart 5). In the next few quarters, the price of Norwegian gas may reflect the fall in oil prices in 2006 Q4 and 2007 Q1. However, the recent rise in oil prices and stabilisation of gas prices in the UK will probably keep the average price of Norwegian gas at a high level.

Other commodities

Prices for commodities excluding energy have increased considerably since 2002 (see Chart 6). The rise in prices was particularly pronounced in spring 2006, when metal prices soared by a full 45% from March to May. Metal prices stabilised in the second half of 2006, but have increased further in 2007. Prices for food and agricultural products excluding food have also increased in recent years.

The rise in metal prices has been driven primarily by strong global economic growth, particularly in emerging economies. A number of these economies, China in particular, are in a growth phase, with rising demand for commodities (see Table 2). In recent years, investment in new production capacity has also been low, with the result that supply has not increased in pace with demand. Consumption of a number of metals has therefore been higher than production in recent years, resulting in record-low inventories (see Chart 7) and high prices. Low inventories also mean that prices are extra sensitive to changes in the market, as witnessed this winter, when fears of a recession in the US led to a sharp fall in zinc and copper prices. When fears subsided, prices for these metals rebounded.

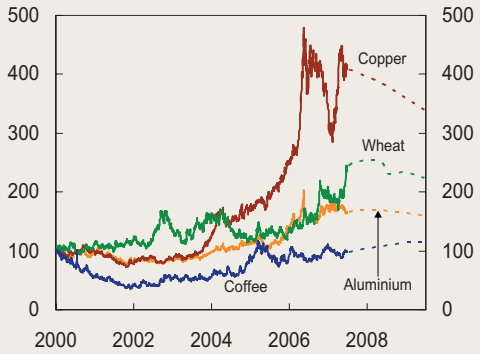
Prices for food and other agricultural products have also risen, partly as a result of higher energy prices, which have raised production costs for a number of agricultural products. In addition, increased prices for traditional energy products and measures to reduce greenhouse gas emissions have led to higher demand for biofuel. Some agricultural products are used as commodities in the production of biofuel. Income growth in emerging economies has probably also led to increased demand for meat, which requires more farmland for fodder production.

The *Economist*'s commodity price index has risen by 8% since the previous *Report*. All the sub-indices have increased during this period. The sub-index for industrial metals has risen by 8%, for non-food agriculturals 7%, and for food 10%. Production disruptions such as mining strikes in Peru, Indonesia and Canada led to a further rise in the price of metals early in the period, while new rules for trading on the London Metal Exchange have led to a sharp fall in the price of nickel in recent weeks. The rise in food prices since the previous *Report* is mainly due to adverse weather conditions, which have pushed up prices for wheat and coffee.

Growth in demand for commodities is expected to remain high in the years ahead. An increasing share of demand will come from emerging economies. China is one of a number of countries[6] that are in a growth phase with increasing demand for commodities. These countries will also play a more important part in commodity markets in the future.

The supply of commodities is also expected to increase in the years ahead as production capacity grows. An important question is whether this will be sufficient to meet growth in demand. In the past, periods of sharply rising commodity prices have tended to be followed by such a pronounced increase in capacity that prices have fallen back to previous levels. Periods of high commodity prices have thus often been of relatively short duration. Futures prices for the most important industrial metals indicate that metal prices will fall back somewhat in the years ahead (see Chart 8) but probably not to the levels recorded in 2002. Futures prices for food indicate that food prices will increase somewhat in the next few years.

Chart 8 Commodity prices. Index, 1 Jan 2000 = 100. Spot price: Daily figures. 4 Jan 00 – 21 Jun 07. Forward prices from 21 Jun 07 (broken line). Monthly figures. Jul 07 – Jul 09



Sources: Reuters (EcoWin), Chicago Board of Trade, New York Board of Trade and Norges Bank

Table 2 Consumption of raw materials in China and globally. Per cent.

	China's contribution to global consumption growth	China's share of world consumption	
	2002-2005	2002	2005
Copper	67	18	22
Aluminium	48	16	22
Nickel	87	8	15
Zink	113	19	29
Cotton	89	29	39
Rubber	45	17	22
Oil	28	6	8
Soya bean	59	13	17

Sources: UN Trade and Development Report 2006, IMF World Economic Outlook September 2006, Australian Commodity Statistics 2006 and Norges Bank

[1] OPEC decided in September and December 2006 to cut production by a total of 1.7 million barrels per day - 1.2 million barrels from November 2006, and a further 0.5 million barrels from February this year. Actual production has dropped by about 1.2 million barrels per day, i.e. less than the reduction in the quotas, according to the International Energy Agency.

[2] The fall in the first quarter of this year is the largest first-quarter fall since 1996.

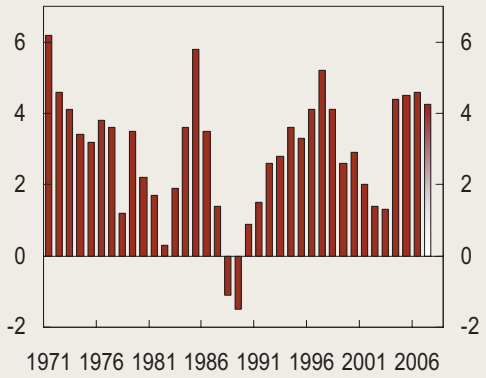
[3] In its June report, the IEA points out that growth in new capacity from the second to the fourth quarter will be around 0.7 million barrels per day. It is also pointed out that effective idle capacity is less than 4 million barrels per day, because Iraq, Indonesia, Nigeria and Venezuela cannot realistically be expected to have the capacity to increase their output beyond what they are actually producing. It is also stressed that a large share of the total effective idle capacity comprises low grade oil. Refineries still have limited capacity for refining this type of oil.

[4] Unlike the IEA and OPEC, the EIA publishes forecasts for OPEC production. They can therefore also forecast developments in oil inventories, which then form the basis for their price forecasts.

[5] The price of the US benchmark oil West Texas Intermediate has moved on a relatively weak trend recently, as a result of special regional conditions in the US. Whereas previously it was normally USD 1-2 more expensive than Brent Blend, it has at times this spring been up to USD 5 less expensive.

[6] Among them Argentina, Brazil, Chile, Egypt, the Philippines, India, Indonesia, Malaysia, Mexico, Singapore, Thailand, Turkey, Saudi Arabia and South Africa.

Chart 2.8 Mainland GDP. Annual growth in volume. Per cent. Annual figures. 1971 – 2007[1)]



[1)] Projection for 2007.

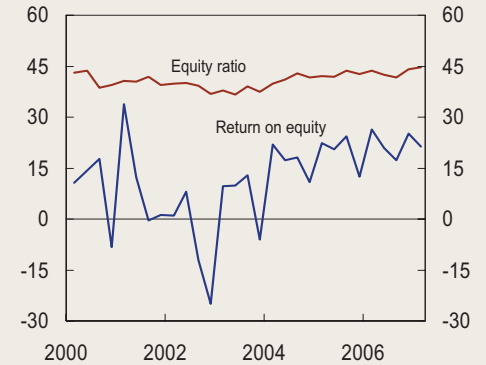
Sources: Statistics Norway and Norges Bank

Chart 2.9 Terms of trade. Index, 1995 = 100. Annual figures. 1995 – 2006



Sources: Statistics Norway and Norges Bank

Chart 2.10 Equity and return on equity before tax for some companies listed on the Oslo Stock Exchange.[1)] Per cent. Quarterly figures. 00 Q1 – 07 Q1



[1)] Excluding financial undertakings, Statoil and Hydro.

Sources: The undertakings' quarterly reports (group) and Norges Bank

Prolonged cyclical upturn in the Norwegian economy, but gradually slower growth

The cyclical upturn in Norway continues. Mainland GDP has grown by about 4½% annually for the past three years (see Chart 2.8). As a result of high productivity growth and an ample labour supply, the growth capacity of the economy has been high. Capacity utilisation has nonetheless reached a high level as a result of strong activity growth. Improved terms of trade, low interest rates, growth in public demand and in petroleum investment and high international growth have resulted in high income growth in the household and business sectors. Moreover, low interest rates have made it more profitable to bring forward consumption. These factors have increased demand for goods and services. Rising prices for many Norwegian export goods and falling prices for imports have improved our terms of trade by almost 40% since 2002 (see Chart 2.9). The improvement for traditional goods and services is almost 11%. In addition to the contribution to the increase in actual income, the sharp improvement in the terms of trade may have raised income expectations.

So far, there are few signs of an economic slowdown. Growth in demand is still robust and investment in the petroleum sector has increased further. High growth in other countries and high prices for Norwegian goods are still generating strong positive impulses to export-oriented mainland enterprises. A number of factors are buoying up growth in household demand this year. As a result of a continued increase in employment and rising wage growth, household real disposable income is growing at a faster pace this year than in 2006. Households are optimistic regarding their own financial situation and the Norwegian economy. However, it appears that growth in housing investment may be falling back somewhat. This may reflect rising construction costs and a growing share of capacity in construction sector being used for commercial buildings.

Information from our regional network indicates sustained growth in mainland fixed investment. Statistics Norway's investment intentions survey for manufacturing and the power sector indicates a continued solid increase in investment this year. Order backlogs for commercial buildings are growing rapidly. Many enterprises are operating at capacity limits, and have to invest in order to accommodate further demand growth. At the same time, some contacts in our regional network report that planned investment projects are not being realised or are being postponed because of problems with deliveries and rising prices for capital goods.

Enterprises have recorded very solid earnings in recent years. Profits for listed companies have improved every year since 2002 (see Chart 2.10). After weak developments early in the year, the share price indices for all the main industries on the Oslo Stock Exchange have risen again, and the bench-

mark index has increased more than the indices in Europe and the US over the past year (see Chart 2.11). Accounts data for 2007 Q1 from listed companies in Norway may indicate slower growth in profits ahead.

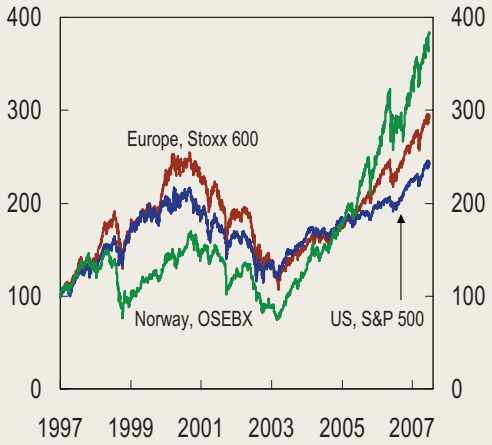
The regional network reports continued solid output growth in most sectors. Growth is particularly high in corporate services and among suppliers to the petroleum industry. Our contacts expect growth to remain buoyant in late autumn. The upturn in manufacturing output has moderated somewhat in recent months. On the other hand, order statistics point to continued solid growth. Construction activity, particularly in commercial buildings, is still on the increase. A sharp rise in imported goods indicates that an increasing portion of demand growth is being met by imports.

Projections for mainland GDP growth from various statistical models imply that growth is currently somewhat higher than previously projected, but may slow towards autumn (see Chart 2.12). The projections are based on current economic indicators and do not fully capture the effects of higher interest rates, capacity constraints and increased import shares. These factors will probably contribute to dampening growth ahead.

The labour market is tight. Employment has increased as rapidly as was the case in the years preceding the cyclical peaks in the 1980s and 1990s. Unemployment is now at a very low level, both measured by the number of registered unemployed and according to figures from Statistics Norway's Labour Force Survey (LFS) (see Chart 2.13). Enterprises report a shortage of qualified labour, and many positions are vacant. The number of vacancies per unemployed person has not been higher since the 1980s (see Chart 2.14). According to Statistics Norway's business tendency survey, the shortage of labour and intermediate goods is now greater than during the booms in the 1980s and 1990s. The regional network reports that there is a shortage of building materials.

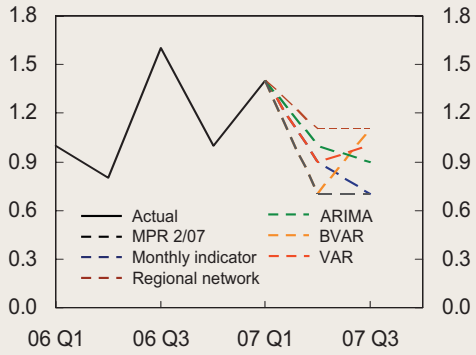
Productivity growth has been strong in recent years (see box on page 44). The high productivity growth can be partly attributed to structural factors such as increased specialisation, new technology, improved logistics and more efficient organisation of production. Our projections are based on the assumption that some of this growth represents a one-off shift. In recent years, the economic upturn has boosted productivity growth. The regional network reports that more efficient utilisation of labour and capital has contributed to productivity growth. It is assumed that this potential is now nearing its limit. The shortage of qualified labour may also be dampening productivity growth in some sectors. This is consistent with the tendency of productivity growth to fall somewhat as the cyclical peak is passed, as was the case in 1998 and 1999. On balance, productivity

Chart 2.11 Equity indices. 1 Jan 97 = 100. Daily figures. 1 Jan 97 – 21 Jun 07



Source: Reuters (EcoWin)

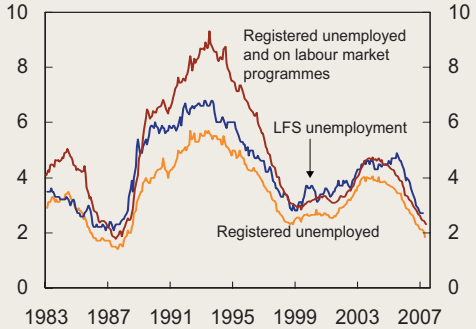
Chart 2.12 Mainland GDP. Growth on previous quarter. Seasonally adjusted. Per cent. Quarterly figures. 06 Q1 - 07 Q3[1)]



[1)] Projections for 07 Q2 and 07 Q3. See the box "Short-term projections for mainland GDP growth" in *Inflation Report* 2/06 for a description of the different models.

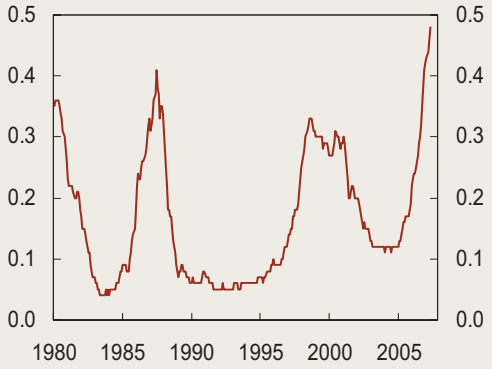
Sources: Statistics Norway and Norges Bank

Chart 2.13 Unemployed. LFS unemployment, registered unemployed and persons on ordinary labour market programmes. Percentage of labour force. Seasonally adjusted. Monthly figures. Feb 83 – May 07



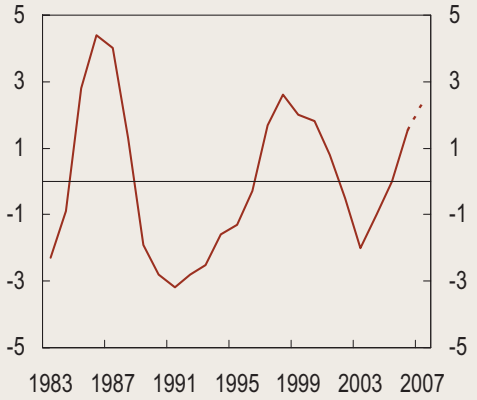
Sources: Statistics Norway, Norwegian Labour and Welfare Organisation (NAV) and Norges Bank

Chart 2.14 Number of vacancies per registered unemployed. 3-month centred moving average. Seasonally adjusted. Monthly figures. Feb 80 – Apr 07



Sources: Norwegian Labour and Welfare Organisation (NAV) and Norges Bank

Chart 2.15 Estimates for the output gap. Per cent. Annual figures. 1983 – 2007[1)]



[1)] Projection for 2007.

Source: Norges Bank

growth in 2007 and 2008 is assumed to be lower than the average since the recovery started. Thereafter, growth will probably pick up again to a level just under the average for the last 10-15 years.

It is uncertain to what extent structural changes will contribute to productivity growth going forward. If productivity growth shows a more permanent change, the reduction in productivity growth may be less pronounced than we have assumed. In that case, the potential for continued high economic growth may be greater than assumed.

Strong growth in the labour supply has also boosted the growth capacity of the Norwegian economy for a number of years. Inward labour migration has increased the supply of labour. Recently, the economic expansion has also led to a marked rise in the labour force participation rate. On the other hand, the increase in average working hours has been somewhat slower than the increase in the labour supply. The working-age population will increase markedly this year, which is one of the factors behind our projection of 3¼% growth in potential mainland GDP, or approximately unchanged on 2006. Growth in the working-age population is assumed to slow as changes in age composition lead to a reduction in participation rates. The potential growth of the Norwegian economy is expected to decline gradually to 2¾% towards the end of the projection period.

The output gap reflects our assessment of overall capacity utilisation in the economy compared with a normal level. The output gap in 2007 is estimated at 2½%, or approximately the same level as in 1998 (see Chart 2.15). The cyclical peak is expected to be reached in the course of 2007. It will take somewhat longer than projected in the previous *Report* before growth slows to the extent that the output gap begins to close. Whereas a shortage of spare capacity will contribute to curbing output growth later in the year, sustained global growth, some fiscal policy stimulus, higher petroleum investment, high order backlogs in enterprises and strong growth in household consumption will contribute to continued high demand for corporate goods and services.

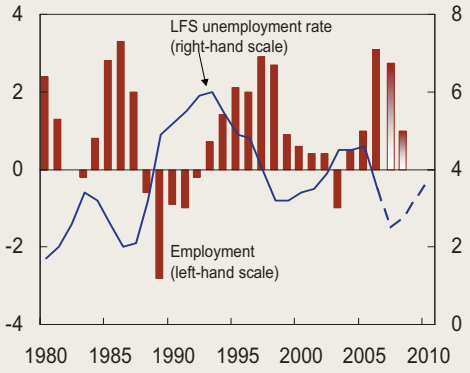
Increased capacity utilisation in the business sector will probably translate into somewhat higher wage and price inflation and a stronger-than-normal increase in the share of imported goods and services.

The increase in interest rates is expected to lead to slower growth in domestic demand through 2008, with a gradual easing of capacity utilisation. The output gap is expected to close gradually. Slower growth in household consumption, housing investment and investment in private enterprises will be the main factors behind slower growth in domestic

demand.[1] More moderate growth in other countries will probably also reduce export growth somewhat. The number of vacancies is high and unemployment will probably remain at a low level in 2008, and then increase gradually (see Chart 2.16).

The actual profile may differ from our assumptions. Demand growth may remain buoyant for longer than expected, in which case the fall in the output gap will be pushed further out in time. In isolation, this may pave the way for stronger domestic cost growth and deteriorating competitiveness, which in turn may result in a more pronounced economic downturn. On the other hand, household debt accumulation has long been high. In the baseline scenario, net lending is negative in the period ahead. If rising interest rates lead to a substantial increase in household saving, domestic demand growth may fall appreciably. The output gap will then close more rapidly than expected.

Chart 2.16 Change in employment on previous year (per cent) and LFS unemployment as a percentage of the labour force. Annual figures. 1980 – 2010[1)]



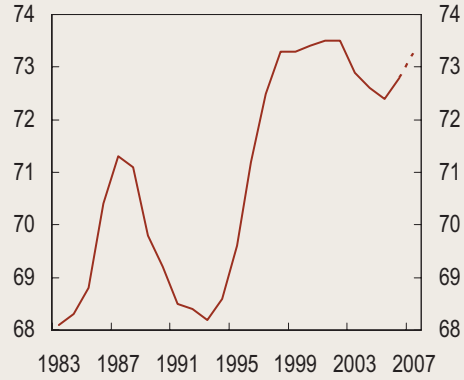
[1)] Projections for 2007 - 2010.

Sources: Statistics Norway and Norges Bank

Slower growth in labour supply ahead

Increased demand for labour has in part been accommodated by growth in the labour supply. This reflects a flexible labour supply in Norway, so that the labour force increases substantially when demand for labour is high. Labour force participation is rising, and it now appears to be approaching the record levels in the years around the turn of the millennium (see Chart 2.17). Adjusted for the 1.5 percentage point increase in the share of the working-age population on disability benefit or contractual early retirement schemes since 2000, these participation rates imply limited available resources in the economy.

Chart 2.17 Labour force participation rate for persons aged 16 to 74. Annual figures. 1983 – 2007[1)]



[1)] Projections for 2007.

Sources: Statistics Norway and Norges Bank

The number of available person-weeks from the underemployed may be an untapped reserve in a tight labour market. However, cyclical conditions have had little influence here. This may imply that the actual reserves represented by these person-weeks are limited.

In recent years, the working-age population (aged 15-74) is projected to increase by just over 1% annually (see Table 2.3). The youngest and oldest age groups, which feature low participation rates, will comprise a growing share of the population, thereby dampening growth in the labour supply. The impact will depend on factors such as whether older age groups choose work or leisure. The tendency towards increased labour force participation among older age groups has increased recently, but the number of person-hours provided by these workers is probably fairly low. Past experience also indicates that labour force participation falls relatively rapidly among older workers when demand for labour declines. The labour force is projected to grow by about ½% annually towards the end of the period.

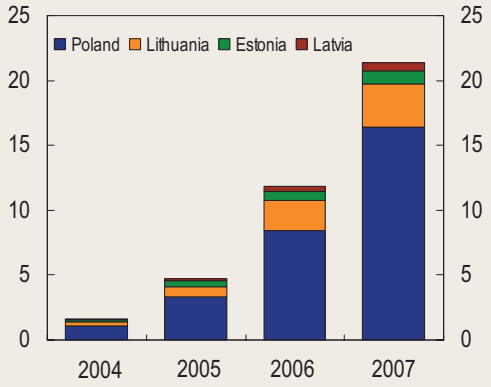
Table 2.3 Population and labour force growth

	2007	2008	2009	2010
Population growth in the age group 15-74 years	1,2	1,1	1,1	1,0
Contribution from change in population composition	-0,2	-0,3	-0,4	-0,4
Cyclical contribution	0,7	0,2	-0,2	-0,2
Labour force growth	1,7	1,0	0,5	0,4

Sources: Statistics Norway and Norges Bank

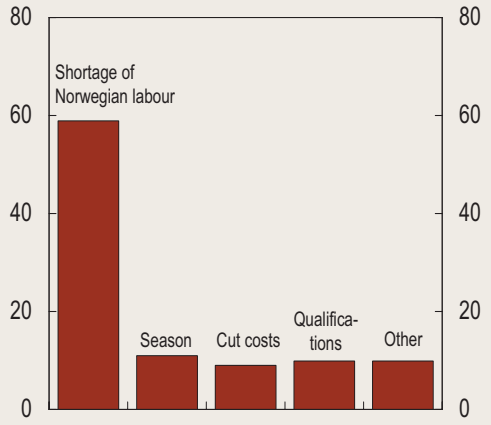
[1] Developments in the individual demand components are described in more detail further on in the report.

Chart 2.18 Registered employees from new EU countries. 1000s of persons in the period Jan – May



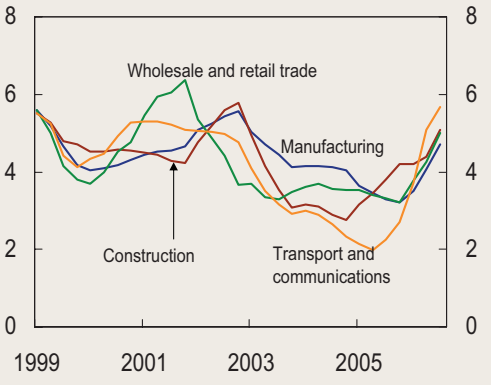
Source: Central Office - Foreign Tax Affairs

Chart 2.19 Reasons for use of foreign labour. Per cent



Source: Norges Bank

Chart 2.20 Average monthly earnings. Wage indices. 4-quarter change. 3-quarter centred moving average. Per cent. 99 Q2 – 06 Q4



Source: Statistics Norway

For the past three years, inward labour migration, particularly from the new EU countries, has increased the supply of labour. In 2006, the inflow of persons from the new EU countries to Norway on short-term assignments was probably about 15 000 higher than the previous year. This is equivalent to an additional labour supply increase of about ½ percentage point in excess of growth in the traditional labour force of 1.6%. So far this year, inward labour migration has continued to rise (see Chart 2.18). There appears to be a tendency for workers to stay for longer periods. A growing share is taking up residence in Norway, which is contributing to strong population growth. Our projection for growth in the labour force implies that this tendency will continue over the next few years.

Although a number of workers from the new EU countries choose to remain in Norway on a more permanent basis, the number of persons on short-term assignments is still growing. Demand for labour is now increasing in their home countries. This may curb inward labour migration in the period ahead. The number of foreigners on short-term assignments is still assumed to increase by about a further 15 000 in 2007. According to the regional network, 42% of enterprises responded that they are using foreign labour in 2007, or 12 percentage points higher than in 2006. The most common reason is the shortage of Norwegian labour (see Chart 2.19).

Tight labour market and high real wage growth

Wage growth has picked up slowly during the current expansion. High inward labour migration and the scope for relocating portions of production abroad have led to increased competition in the labour market and probably curbed wage growth. However, the wage settlement for 2007 confirms that wage growth is gathering pace.

The tight labour market will probably lead to higher wage drift. Pay demands are increasing and wages are being bid up for particularly sought-after labour in both private and public enterprises. Statistics Norway's quarterly wage statistics show that wages are rising rapidly in many industries (see Chart 2.20). Some of the wage growth may be due to high bonus payments, but monthly salaries are also rising rapidly. Wage growth estimates from our regional network have gradually been revised upwards through the year. These indicators imply that wage drift is increasing somewhat faster than projected in the previous *Report*. Overall growth in labour costs this year may therefore approach 5½% when the costs of mandatory occupational pensions are included. With a projected rise in consumer prices of ¾%, real wage growth will be 4¾% in 2007.

According to our projections, unemployment will remain low up to next year's wage settlement, with the result that nominal wage growth will remain at a high level (see Chart 2.21). Consumer price inflation varies somewhat from year to year due to large fluctuations in electricity prices. These fluctuations are not likely to be fully reflected in nominal pay increases. Nominal wage growth is projected at 5½% in 2008, while real wage growth will edge down. Real wage growth for 2007 and 2008 combined is projected at an annual 3½ % (see Chart 2.22). As resource utilisation in the economy declines and unemployment edges up through 2009 and 2010, wage growth is likely to moderate.

Increased wage growth and a higher rise in prices for a number of goods and services that are used in production may erode corporate profitability. The wage share in enterprises, which has fallen in recent years, will probably increase somewhat again. However, the wage share is not likely to be as high as in previous upturns (see Chart 2.23).

The wage settlement in 2008 is a main settlement, where conditions other than pay increases can be negotiated. There are prospects that a new framework for the contractual early retirement scheme will be an issue in this wage settlement. This makes it particularly difficult to anticipate wage and cost inflation prior to the next spring settlement.

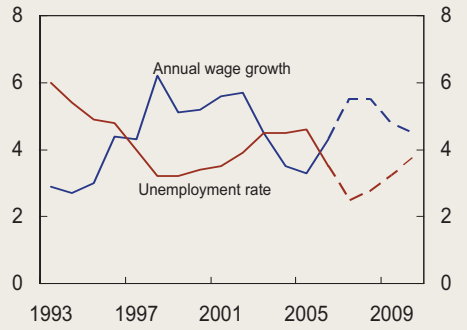
Labour shortages and high wage demands may result in higher-than-projected wage growth. On the other hand, foreign competition and the scope for relocating production may lead to a lower-than-projected rise in wages.

Low, but rising inflation

The rise in consumer prices measured by the consumer price index (CPI) was close to the inflation target through most of 2006, but in recent months inflation has slowed markedly. This is because electricity prices have been substantially lower this year than at the same time last year. In 2006, electricity prices were unusually high as a result of low precipitation, while in recent months electricity prices have been at the lowest seasonal level since 2002.

Inflation adjusted for tax changes and excluding energy products has gradually picked up since late summer 2006, but in the light of the economic situation, underlying inflation remains low. Our assessment is that underlying inflation is now in the interval 1 - 1½%. Different indicators of underlying inflation all lie within this interval, and the difference between the various indicators is now smaller than it has been in recent years (see Chart 2.24). Recent price developments are discussed in detail in a box on page 31.

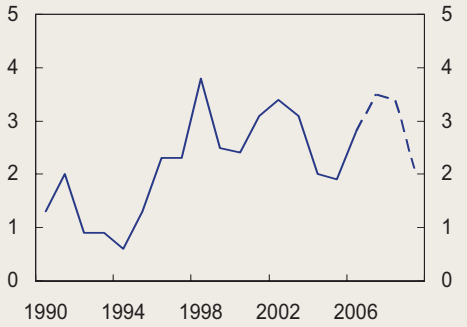
Chart 2.21 Annual wage growth[1)] and LFS unemployment. Per cent. Annual figures. 1993 – 2010[2)]



[1)] Average for all groups. Including estimated costs of increase in number of vacation days and introduction of mandatory occupational pension.
[2)] Projections for 2007 - 2010.

Sources: Technical Reporting Committee on Income Settlements, Statistics Norway and Norges Bank

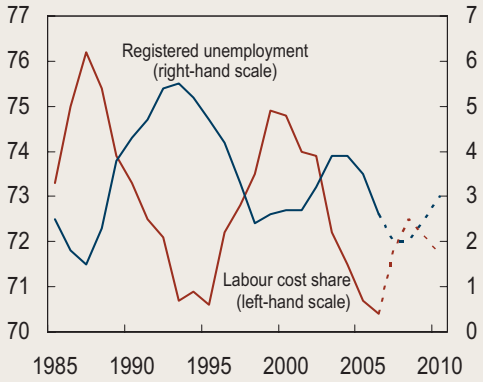
Chart 2.22 Annual wage growth[1)] deflated by the CPI[2)]. Per cent. Annual figures. 1990 – 2009



[1)] Average for all groups. Including estimated costs of increase in number of vacation days and introduction of compulsory occupational pension. Projections for 2007 - 2009.
[2)] 3-year centred moving average. CPI projections for 2007 - 2010.

Sources: Technical Reporting Committee on Income Settlements, Statistics Norway and Norges Bank

Chart 2.23 Labour costs as a share of factor income in mainland Norway and registered unemployment. Per cent. Annual figures. 1985 – 2010[1)]

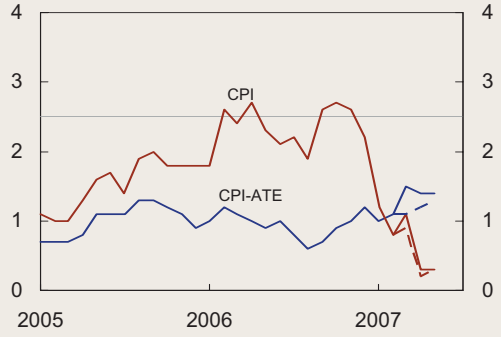


[1)] Projections for 2007 - 2010.

Sources: Statistics Norway, Norwegian Labour and Welfare Organisation (NAV) and Norges Bank

Recent price developments

Chart 1 CPI and CPI-ATE[1]. 12-month rise. Projections from MPR 1/07 (broken line) and actual. Per cent. Monthly figures. Jan 05 – May 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.

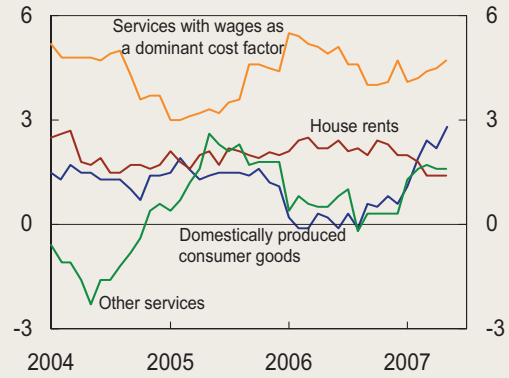
Sources: Statistics Norway and Norges Bank

Chart 2 Electricity prices. Nord Pool. NOK/MWh. Monthly figures. Jan 02 – May 07. Forward prices (broken line) from 07 Q3



Sources: Nord Pool and Norges Bank

Chart 3 Domestic supplier sectors in the CPI-ATE[1]. 12-month change. Per cent. Monthly figures. Jan 04 – May 07



[1] CPI-ATE: CPI adjusted for tax changes and excluding energy products.

Sources: Statistics Norway and Norges Bank

The 12-month rise in the consumer price index (CPI) has slowed markedly in recent months, in line with the projections in *Monetary Policy Report* 1/07 (see Chart 1). This is largely because electricity prices have been much lower this year than at the same time in 2006. In May, electricity prices in the CPI were 27.5% lower than in May 2006. The 12-month rise in the CPI was 0.3%. In the last few months of 2006, the year-on-year rise in the CPI was around 2.5%.

Inflation excluding electricity, other energy products and tax changes (CPI-ATE) has gradually risen since late summer last year. In May, the year-on-year rise in the CPI-ATE was 1.4%. However, other indicators of underlying inflation have declined compared with 2006. The year-on-year rise in May was 1.2% measured by both the trimmed mean and the weighted median.

Low electricity prices

Low electricity prices are attributable to unusually high inflows to water reservoirs since autumn 2006. At the same time, the mild winter contributed to relatively low electricity consumption. Electricity prices in Norway have also been pushed down by a fall in prices for CO_2 emission permits and for other energy products. In May, the spot price for electricity on the Nord Pool power exchange was the lowest since 2002 (see Chart 2). However, there are prospects of considerably higher electricity prices in early 2008, partly because prices for CO_2 allowances in 2008 appear to be much higher than this year. It is not possible to transfer allowances for 2007 to 2008.[1]

Increasing domestic inflation

The 12-month rise in the CPI-ATE has picked up in recent months, reflecting in particular the accelerating rise in prices for domestically produced goods and services. In May, prices for goods and services produced in Norway were 2.4% higher than in May 2006. This was the highest rate of inflation measured since December 2003. The year-on-year rise in prices for domestically produced goods and services in 2006 was 1.6% after adjusting for the estimated effect of the introduction of maximum day-care rates as from January 2006.

It is primarily the rise in prices for domestically produced consumer goods that has gathered pace since the previous *Report* (see Chart 3). In May, prices for goods and services produced in Norway were

2.8% higher than in May 2006. Prices for products for home maintenance and repair have shown a particularly strong rise. The year-on-year rise in prices for these products was 8.3% in May, up from 2.3% in January. This must be viewed in the light of the strong rise in prices for building materials generally. The rise in prices for various household articles, furniture and some food and beverages has also gathered pace.

Prices for services where wages are the dominant cost factor, such as services related to home and car maintenance services, are also rising rapidly. However, the 12-month rise in prices for services has remained stable at around 2.5% in recent months, curbed partly by a continued fall in prices for telecommunications services. A slow rise in insurance prices is also contributing to dampening the overall rise in prices for services.

The rise in house rents has abated, largely because of a slower increase in the estimated housing costs of owner-occupiers. Estimates of these costs are based on price developments in the rental market. Movements in estimated housing costs are normally closely related to the rise in actual house rents, but since the computation method was changed in August last year, estimated housing costs have risen less than house rents.

Variable rise in prices for imported consumer goods

The year-on-year rise in prices for imported consumer goods has varied substantially from month to month recently. In March, for example, prices for imported consumer goods were 0.1% higher than in the same month the previous year, whereas the twelve-month change had fallen to -0.9% in May. The large variations in the rise in prices for imported consumer goods may reflect increased sales activity, for example for clothing, and problems in measuring the rise in prices for certain types of goods, for example mobile telephones.

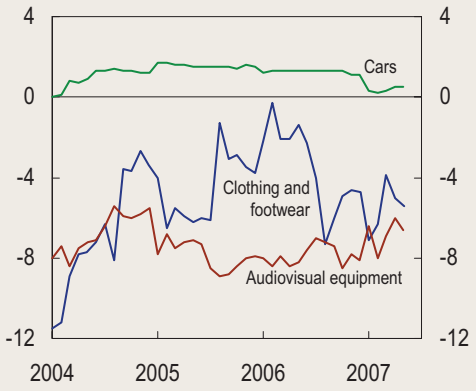
The rise in prices for imported consumer goods is still being pushed down by a fall in prices for audiovisual equipment and clothing and footwear (see Chart 4). In May, prices for both product groups were about 6% lower than in the same month in 2006. Since the beginning of the year, the twelve-month rise in prices for new cars has also been somewhat lower than in 2006 and 2005.

Other price indicators

The producer price index and the price index for first-hand domestic sales measure price developments at the production stage. In 2006, these indices showed a sharp rise in prices, but since the beginning of 2007, the year-on-year change in both indices has been negative with respect to the domestic market (see Chart 5). This development is attributable to the fall in prices for energy products. If energy prices are excluded, both indices have exhibited an upward trend in recent years. In recent months, producer prices for intermediate and investment goods have risen substantially. The rise in the construction cost index for dwellings has also accelerated sharply (see Chart 5). The rise in construction costs primarily reflects a rise in building material costs.

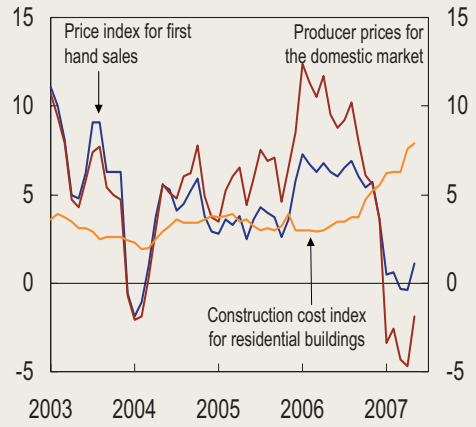
[1] Much of the power produced in continental Europe entails CO_2 emissions, and prices for CO_2 allowances will therefore influence electricity prices on the continent. As Norway is an integral part of the European power market, prices for CO_2 allowances also affect electricity prices in Norway.

Chart 4 Prices for product groups in the CPI that are largely imported. 12-month change. Per cent. Monthly figures. Jan 04 – May 07



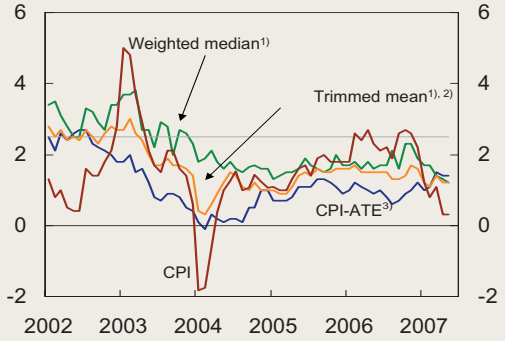
Source: Statistics Norway

Chart 5 Different price indices. 12-month change. Per cent. Monthly figures. Jan 03 – May 07



Source: Statistics Norway

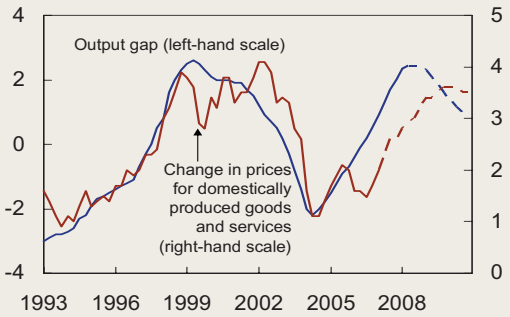
Chart 2.24 CPI and indicators of underlying inflation. 12-month change. Per cent. Monthly figures. Jan 02 – May 07



1) Estimated on the basis of 146 sub-groups of the CPI-AT.
2) Price changes accounting for 20 per cent of the weighting base are eliminated.
3) 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

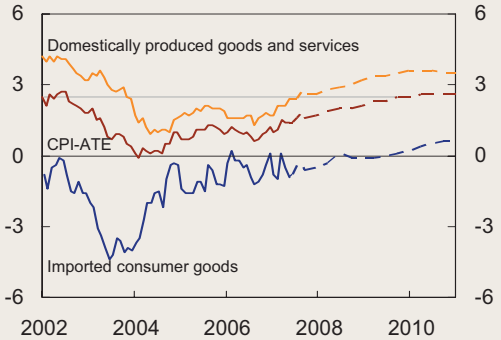
Chart 2.25 Change in prices for domestically produced goods and services measured by the CPI-ATE1) (4-quarter change) and output gap level (lagged by 4 quarters). Quarterly figures. 93 Q1 – 10 Q4 2)



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) Projections for period 07 Q2 – 10 Q4.

Sources: Statistics Norway and Norges Bank

Chart 2.26 CPI-ATE.1) Total and by supplier sector2). 12-month change. Per cent. Monthly figures. Jan 02 – Dec 10 3)



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.
3) Projections for June 2007 – December 2010.

Sources: Statistics Norway and Norges Bank

High cost inflation is reflected in prices for domestically produced goods and services …

There are probably several reasons why the rise in prices for domestically produced goods and services has picked up somewhat later in this cyclical expansion than the historical relationship between the rise in these prices and capacity utilisation would imply (see Chart 2.25). Productivity growth in many industries has been high, while wage growth has been moderate. It is likely that the subdued rise in prices for imported processed intermediate goods may also have exerted downward pressure on prices for domestically produced goods and services. Intensified competition in several product markets in recent years has probably also contributed to curbing inflation.

Since autumn 2006, the rise in prices for goods and services produced in Norway has gathered pace. In May, the year-on-year rise in prices for domestically produced goods and services was 2.4%. The accelerating rise in prices for goods and services produced in Norway is primarily attributable to a faster rise in prices for food and other domestically produced consumer goods. Prices for building materials, in particular, have increased sharply in recent months.

Because of rising labour costs and high capacity utilisation, the rise in prices for goods and services produced in Norway will continue to increase gradually in our baseline scenario (see Chart 2.26). Productivity growth is also expected to be somewhat lower than in recent years. Increased competition and a slow rise in prices for imported intermediate goods may continue to curb inflation, but probably to a lesser extent than previously.

Norges Bank recently conducted a survey on price-setting in Norwegian firms (see box on page 48). When asked what the main reasons for price increases have been, the firms pointed in particular to increased supplier prices and higher labour costs. Wage growth is now on the rise, and producer prices for many goods are climbing rapidly. Since the end of 2006, the rise in both the producer price index and the price index of first-hand domestic sales have been pushed down by the fall in energy prices, but the rise in the indices excluding energy products has nevertheless gathered pace in recent years.

Other surveys also point to rising inflation in the period ahead. According to TNS Gallup's quarterly survey, a growing share of business leaders expect the rise in their firm's selling prices to be higher in the next twelve months than in the twelve previous months. Regional network contacts also signal prospects of somewhat higher price increases ahead, particularly in building and construction and corporate services.

… and the fall in import prices is coming to a halt

As a result of trade liberalisation, low global inflation and a shift towards imports from low-cost countries, prices for imported consumer goods, measured in foreign currency, have broadly fallen since the mid-1990s. In 2006, prices for these goods rose for the first time since 2001 (see Chart 2.27). This reflected the strong rise in prices for oil and other major commodities, which pushed up prices for export goods among our traditional trading partners. The import shift in 2006 was also less pronounced than in the preceding years. The appreciation of the krone through 2004 and 2005 nevertheless contributed to a further fall in prices for imported consumer goods in the CPI in 2006, but the price fall was more moderate than in the preceding years.

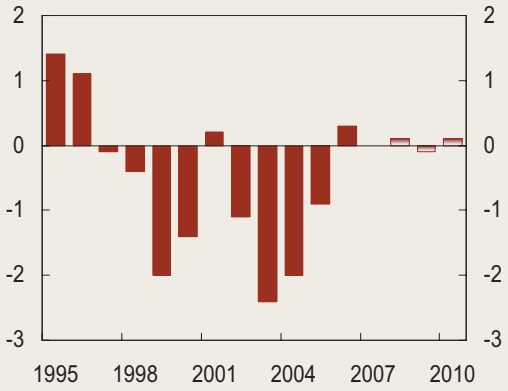
The fall in prices for imported consumer goods has continued in 2007, but the pace has shown considerably monthly variations. This may be attributable to more extensive sales activity than previously and problems in measuring price changes for some types of goods, such as mobile phones.

In the period ahead it is assumed that prices for oil and other commodities will remain at a high level, but prices are not expected to rise at the same pace as in recent years. The shift in imports is expected to abate gradually. On balance, we assume that prices for imported consumer goods, measured in international currency, will remain approximately unchanged in the next few years. A relatively stable krone exchange rate in recent years implies that past movements in the krone exchange rate will not have any material effect on developments in prices for imported goods ahead. Higher domestic price and cost inflation is expected to feed through gradually to selling prices, also via imported consumer goods. The fall in prices for imported consumer goods may continue through 2007. For the next couple of years, the price level for imported consumer goods will probably remain broadly unchanged, before the rise in prices begins to edge up to a more normal level.

On balance, there are prospects that consumer price inflation adjusted for tax changes and excluding energy products will gradually rise to about 2½% over the next three years. As the key policy rate gradually increases, growth in demand and employment will slow and wage growth will ease again. This will contribute to stabilising inflation around the target.

Overall consumer price inflation will probably move on a more variable path. Temporarily low CPI inflation this year may be followed by temporarily high inflation in 2008. Forward electricity prices indicate that electricity prices will remain low through summer. This will also keep CPI inflation at a low level. However, there are prospects of

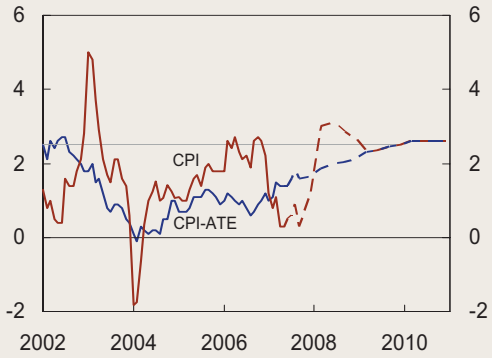
Chart 2.27 Indicator of external price impulses to imported consumer goods measured in foreign currency. Per cent. Annual figures. 1995 – 2010[1)]



[1)] Projections for 2007 – 2010.

Source: Norges Bank

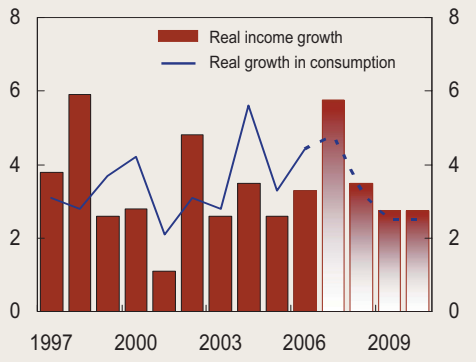
Chart 2.28 CPI and CPI-ATE[1)]. 12-month change. Per cent. Monthly figures. Jan 02 – Dec 10[2)]



[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)] Projections for June 2007 – December 2010.

Sources: Statistics Norway and Norges Bank

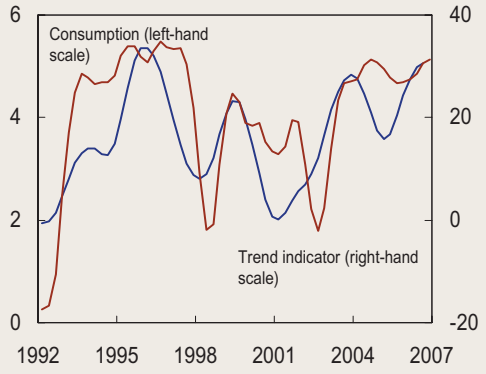
Chart 2.29 Household real disposable income[1)] and consumption. Annual rise. Per cent. Annual figures. 1997 – 2010[2)]



[1)] Adjusted for estimated reinvested share dividends for 2000 - 2005.
[2)] Projections for 2007 – 2010.

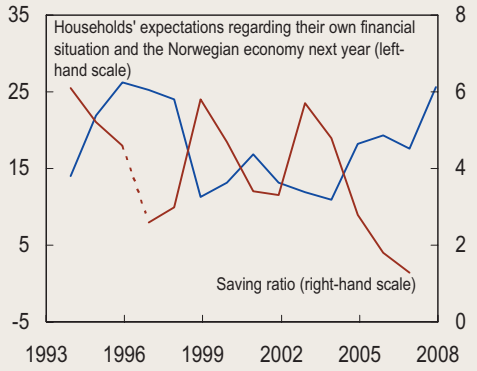
Sources: Statistics Norway and Norges Bank

Chart 2.30 Household trend indicator (seasonally adjusted diffusion index) and trend in private consumption (4-quarter growth). Quarterly figures. 92 Q3 – 07 Q2



Sources: Statistics Norway, TNS Gallup and Norges Bank

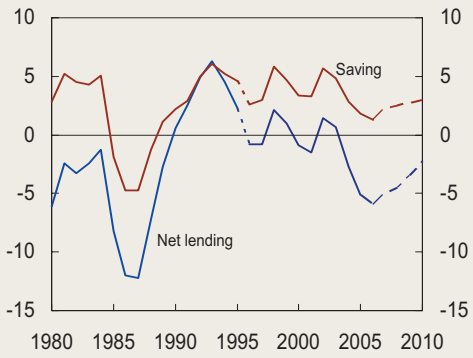
Chart 2.31 Household expectations and saving ratio[1, 2]. Annual figures. 1993 – 2007[3]



[1] There is a break in the series between 1995 and 1996.
[2] Adjusted for estimated reinvested share dividends for 2000 – 2005.
[3] Figures for household expectations for 07 H1.

Sources: Statistics Norway, TNS Gallup and Norges Bank

Chart 2.32 Household saving and net lending as a share of disposable income.[1.2] Annual figures. 1980 – 2010[3]



[1] There is a break in the series between 1995 and 1996.
[2] Adjusted for estimated reinvested share dividends for 2000 – 2005.
[3] Projections for 2007 - 2010.

Sources: Statistics Norway and Norges Bank

higher electricity prices next year. As a result, CPI inflation may increase faster than the rise in the CPI-ATE (see Chart 2.28). CPI inflation may exceed 3% in the first half of 2008. Uncertain variables such as temperature and precipitation levels will have a considerable impact on electricity prices, and hence on developments in the CPI. Our projections for the CPI are therefore shrouded in uncertainty. Towards the end of the projection period, energy prices are assumed to rise approximately in pace with other prices. After a period, CPI inflation and CPI-ATE inflation are expected to converge and stabilise near the inflation target.

Domestic demand

Higher interest rates lead to slower growth in household demand

Growth in household demand is still strong. Growth in private consumption is projected to increase from 4.4% in 2006 to 4¾% this year. Several forces have been driving growth in recent years. Household real disposable income is expected to increase by almost 6% from last year to this year because of high employment and real wage growth (see Chart 2.29). The job security offered by a tight labour market may also have generated optimism as to income growth ahead in the household sector (see Chart 2.30). It is likely that the improved terms of trade, which influence both household income and job prospects, have also boosted earnings expectations. The rise in asset prices is probably another factor behind growth in household consumption. Asset price movements may be driven by some of the same factors that are behind growth in household consumption. New loan products have facilitated households' scope for drawing on housing and financial wealth to increase borrowing and consumption.

An upward revision of income expectations will normally lead to a preference to increase consumption today. Saving is temporarily reduced (see Chart 2.31). The low interest rate level in recent years has also made it less attractive to postpone consumption. The strong growth in consumption is reflected in a falling household saving ratio. In the four quarters to 2007 Q1, households saved approximately 1% of disposable income. This is the lowest household saving ratio over a four-quarter period since the late 1980s.

The interest rate level is rising. Growth in household interest expenses has been moderate, despite strong debt accumulation and the increases in the key policy rate. So far, banks' lending rates have risen less than Norges Bank's key policy rate, partly owing to strong competition, adaptation to new capital adequacy requirements and low credit risk. The lending margin was fairly high at the outset. Further ahead, we expect the increase in the key policy rate to be passed on to lending rates to a greater extent. The rise in household

interest expenses will increase accordingly, and towards the end of the projection period the interest rate burden will be at the highest level since the early 1990s (see Chart 1.17 in Section 1). Higher interest expenses and higher inflation will gradually curb growth in household purchasing power. The higher interest rate level will also make saving more attractive. As lower demand growth dampens activity in the economy, slower employment and wage growth will further reduce growth in household purchasing power. In our baseline scenario, growth in household demand slows further out in the projection period, and the saving ratio increases somewhat (see Chart 2.32).

Activity in the housing market is expected to remain high this year, but capacity constraints, higher building costs and higher interest rates are expected to lead to a moderate decline in housing investment further ahead. House prices are still rising fairly rapidly, but the rate of increase has abated somewhat in recent months (see Chart 2.33). With an increased supply of new dwellings and higher interest rates, the rise in house prices may be somewhat slower ahead than in recent years.

Growth in household borrowing has been high for a long period, but has slowed somewhat through the past year. On balance, we expect credit growth to ease gradually through the projection period, and net lending to increase somewhat, but to remain negative in 2009-2010.

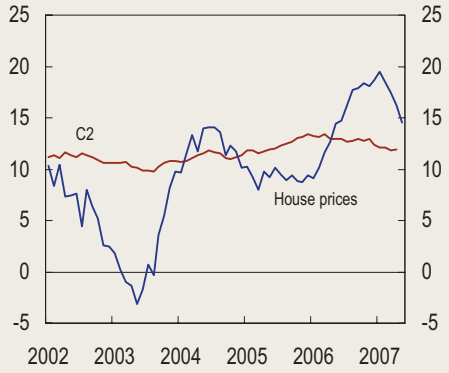
Expansionary fiscal policy

The central government accounts for 2006 show a surplus before capital transactions of NOK 311bn. In 2007, the surplus is projected at NOK 263bn in the Revised National Budget for 2007. Adjusted for petroleum revenues and capital income from the Government Pension Fund - Global, there was a deficit of NOK 44bn last year, while the deficit this year is estimated at NOK 39bn.

The cyclical upturn is boosting tax revenues and reducing spending on unemployment benefits. The Ministry of Finance has estimated that these factors have contributed to strengthening the budget by NOK 45bn or about 3% of trend mainland GDP from 2004 to 2006. The Ministry expects cyclical developments to strengthen the budget by an additional NOK 6.5bn in 2007. However, this estimate is based on slower growth in the mainland economy than projected in this *Report*. The reduction of purchasing power over the central government budget due to strong growth makes an important contribution to smoothing fluctuations in Norwegian economy.

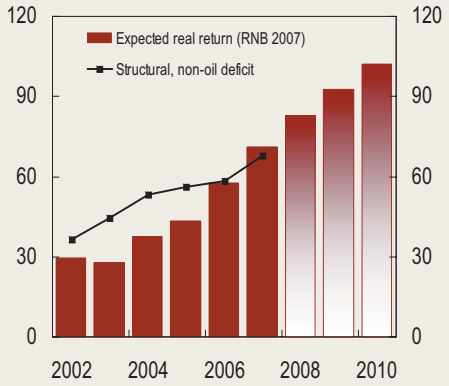
Government policy is based on a gradual increase in the use of petroleum revenues and capital income from the Government Pension Fund – Global. As a reference, the

Chart 2.33 House prices and credit to households (C2). 12-month change. Per cent. Monthly figures. Jan 02 – May 07



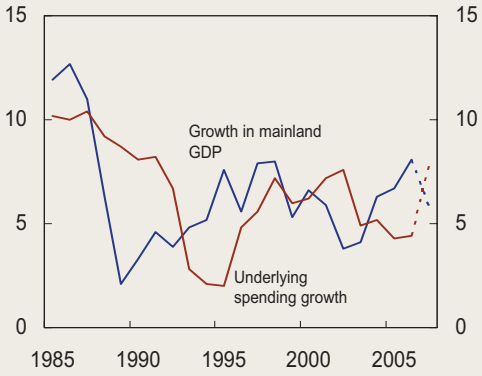
Sources: Norwegian Association of Real Estate Agents, Association of Real Estate Agency Firms, FINN.no, ECON and Statistics Norway

Chart 2.34 Expected real return on the Government Pension Fund - Global. In billions of 2007 NOK. Annual figures. 2002 – 2010



Source: Ministry of Finance (Revised National Budget 2007)

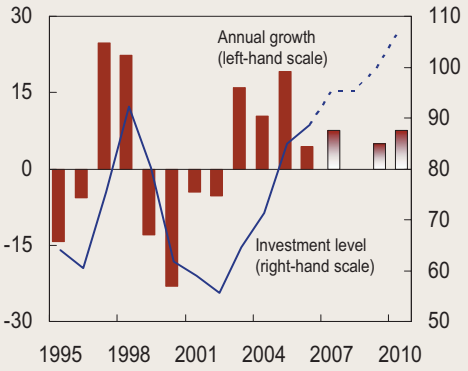
Chart 2.35 Underlying spending growth in the government budget and nominal growth in mainland GDP. Per cent. Annual figures. 1985 – 2007[1)]



[1)] Projections for 2007 from the Ministry of Finance.

Sources: Ministry of Finance (RNB 2007) and Statistics Norway

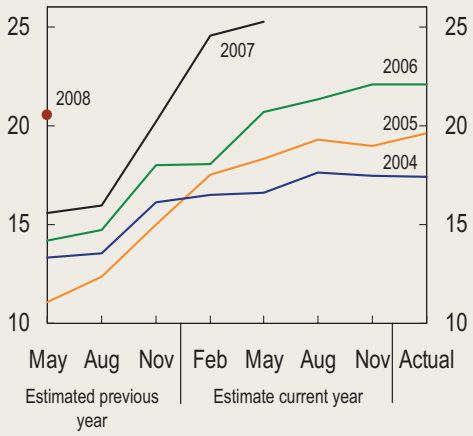
Chart 2.36 Investment in oil and gas production including pipeline transport. Investment level in billions of NOK (constant 2004-prices) and annual growth (per cent). Annual figures. 1995 – 2010[1)]



[1)] Projection for 2007 – 2010.

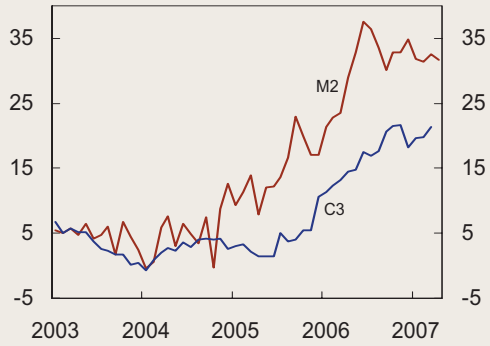
Sources: Statistics Norway and Norges Bank

Chart 2.37 Investment statistics for manufacturing. Estimated and actual investment (current prices). In billions of NOK



Source: Statistics Norway

Chart 2.38 Credit to enterprises[1)] and enterprises' liquid assets[2)]. 12-month change. Per cent. Jan 03 – Apr 07



[1)]Total debt non-financial enterprises mainland Norway (C3).
[2)] Non-financial enterprises' liquid assets (M2).

Source: Statistics Norway

annual government budget deficit, excluding these revenues and adjusted for cyclical fluctuations in some revenues and expenditure, should be the equivalent of the expected real return on the Fund, i.e. 4%. This structural deficit was 4% in 2006 and is expected to be 3.8% this year (see Chart 2.34). As the Fund's capital is rising sharply, the structural deficit will still increase by 0.6 percentage point as a share of mainland GDP from 2006 to 2007 after having been relatively stable in the previous two years. By this measure, fiscal policy is stimulating activity in the Norwegian economy this year. This is also reflected in underlying public spending growth, which is estimated at 7.8% this year, compared with 4.4% last year (see Chart 2.35).

In 2006, growth in local government revenues was at its strongest in 20 years, with total nominal revenue growth at 9.5%. Strong revenue growth reflected both higher government budget transfers and higher tax revenues than assumed earlier. As a result of unexpectedly high tax revenues in 2006, revenue growth will be low this year as compared with 2006. According to the Revised National Budget, nominal revenues will increase by more than 4%.

In the next few years, the structural non-oil budget deficit is projected to be somewhat smaller than the expected real return on the Government Pension Fund – Global. Public sector activity will continue to stimulate total demand and production through the period.

Continued high petroleum investment ahead

High petroleum investment has made a strong contribution to activity growth in the Norwegian economy over the past few years. Activity on the Norwegian continental shelf has now reached a very high level (see Chart 2.36). The large Snøhvit and Ormen Lange projects have contributed to the high level of investment. In the course of the year, these two large projects will be completed and production will begin. This will dampen investment growth.

However, investment is expected to remain high in the period ahead. Oil prices remain high and both futures prices and forecasts indicate that prices may remain high for a long period. A number of smaller fields are being developed and old fields are being upgraded. According to the investment intentions survey for oil and gas operations, there are plans to increase investment in the Ekofisk, Troll and Valhall fields.

The number of exploration wells is rising sharply. As a result of rig shortages, not all planned exploration drilling is being carried out. Exploration investment may rise later in the projection period when the supply of rigs increases.

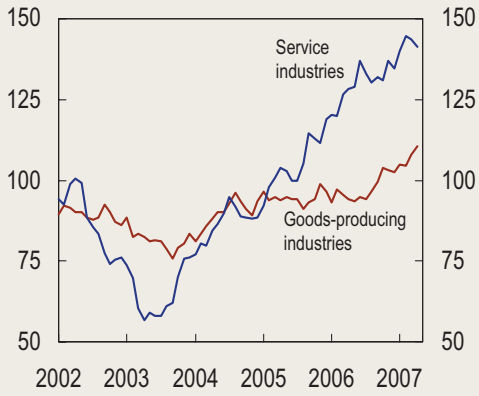
High, but gradually slower growth in fixed investment

Corporate investment has increased by nearly 10% annually over the past three years. Growth in fixed investment will probably remain at a high level again this year. Manufacturing investment statistics point to continued buoyant investment activity (see Chart 2.37). According to the business tendency survey and our regional network, business leaders believe that the market outlook is favourable. Many enterprises are operating at capacity limits and need to expand their production capacity. Favourable export prices, low interest rates and cost efficiency measures have contributed to solid corporate profitability. Credit growth is high, but the money supply is growing even faster (see Chart 2.38). The financial position of enterprises is solid and liquidity is high. This increases the probability that enterprises will realise their investment plans.

So far this year, commercial building starts have increased swiftly (see Chart 2.39). Employment in the service sector is rising rapidly and a number of international retail chains are being established in Norway. This points to continued investment growth in the commercial building industry. However, growth may be curbed by capacity constraints in the building industry.

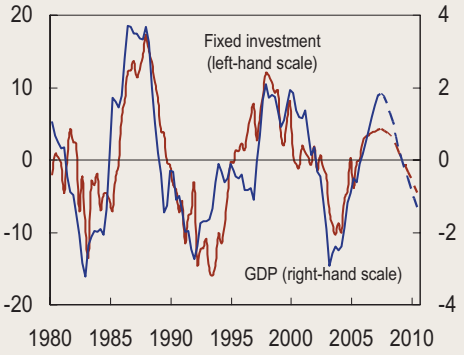
The regional network reports somewhat slower investment growth one year ahead. Following a period of high investment growth, the need for further investment will normally decline. A higher interest rate level and increased costs may reduce corporate profitability and thereby curb growth in production and investment. Investment normally fluctuates in pace with the level of economic activity, with wider fluctuations through the business cycle (see Chart 2.40). Further out in the projection period, lower capacity utilisation will also contribute to dampening investment.

Chart 2.39 Commercial building starts. In 1000 m². 12-month moving average. Jan 02 – Apr 07



Sources: Statistics Norway and Norges Bank

Chart 2.40 GDP and fixed investment. Mainland Norway. Percentage deviation from trend.[1] Quarterly figures. 80 Q1 – 10 Q2[2]



[1] Trend calculated using Hodrick-Prescott filter. See *Staff Memo* 2005/2 (www.norges-bank.no) for further details.
[2] Based on annual projections for 2007 - 2010.

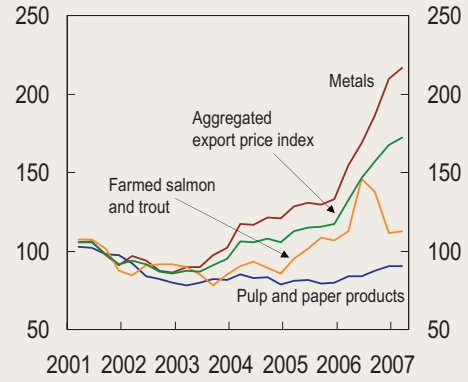
Sources: Statistics Norway and Norges Bank

Export growth will gradually ease

Robust growth in global markets has resulted in strong growth in demand for traditional Norwegian export goods and services. Since spring 2003, prices have risen by about 25%. In particular, metal prices have increased markedly (see Chart 2.41). A sharp rise in turnover, coupled with high productivity growth, has led to solid profitability in parts of the export industry. As a result of continued global economic growth, export prices are expected to remain at a high level in the years ahead.

In the next few years, export growth will probably be restrained by somewhat lower growth among our trading partners. Capacity constraints in some export industries may also dampen growth in the short term. In the longer term, investment and the re-opening of temporarily closed production facilities may lead to somewhat higher capacity, while weak competitiveness may contribute to dampening export growth.

Chart 2.41 Price indices[1] for Norwegian exports in NOK. 2001 = 100. Quarterly figures. 01 Q1 – 07 Q1



[1] Norges Bank's estimates based on world market prices.

Sources: Reuters (EcoWin), Statistics Norway and Norges Bank