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No 1/2007

Monetary Policy Report

1
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March

Monetary Policy Report

The Report is published three times a year, in March, June and October/November. The Report assesses the interest rate outlook and includes projections for developments in the Norwegian economy, analyses of selected themes and a summary of Norges Bank's regional network reports.

At its meeting on 13 December, the Executive Board discussed relevant themes for the Report. At the Executive Board meeting on 28 February, the economic outlook was discussed. On the basis of this discussion and a recommendation from Norges Bank's management, the Executive Board adopted a monetary policy strategy for the period to the publication of the next Report on 27 June 2007 at the meeting held on 15 March. The Executive Board's assessment of the economic outlook and the monetary policy strategy are presented in Section 1. In the period to the next Report, the Executive Board's monetary policy meetings will be held on 25 April, 30 May and 27 June.

The *Monetary Policy Report,* together with *Financial Stability,* is part of Norges Bank's series of reports. The report is also available on Norges Bank's website:
http://www.norges-bank.no.

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Monetary Policy Report 1/2007

The *Monetary Policy Report* is based on information
in the period to 9 March 2007
The monetary policy strategy in Section 1 was approved by the Executive Board
on 15 March 2007

Monetary policy in Norway

Objective

The operational target of monetary policy is low and stable inflation, with annual consumer price inflation of approximately 2.5 per cent over time.

Implementation

Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment. In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances are not taken into account.

Monetary policy influences the economy with a lag. Norges Bank sets the interest rate with a view to stabilising inflation close to the target in the medium term. The horizon will depend on disturbances to which the economy is exposed and the effects on prospects for the path for inflation and the real economy.

The decision-making process

The main features of the analysis in the *Monetary Policy Report* are presented to the Executive Board for discussion at a meeting about two weeks before the Report is published. Themes of relevance to the Report have been discussed at a previous meeting. On the basis of the analyses and discussion, the Executive Board assesses the consequences for future interest rate developments, including alternative strategies. The decision to adopt a monetary policy strategy is made on the same day as the Report is published. The strategy applies for the period up to the next Report and is presented at the end of Section 1 in the Report.

The key policy rate is set by Norges Bank's Executive Board. Decisions concerning the interest rate are normally taken at the Executive Board's monetary policy meeting every sixth week. The analyses and the monetary policy strategy, together with assessments of price and cost developments and conditions in the money and foreign exchange markets, form a basis for interest rate decisions.

Communication of the interest-rate decision

The monetary policy decision is announced at 2pm on the day of the meeting, and the Bank holds a press conference at 2:45 pm on the same day. The press release provides an account of the main features of economic developments that have been of importance for the interest rate decision and the Executive Board's assessments. The press release and the press conference are available on www.norges-bank.no.

Reporting

Norges Bank reports on the conduct of monetary policy in the *Monetary Policy Report* and the *Annual Report*. The Bank's reporting obligation is set out in Section 75c of the Constitution, which stipulates that the Storting shall supervise Norway's monetary system, and in Section 3 of the Norges Bank Act. The *Annual Report* is submitted to the Ministry of Finance and communicated to the King in Council and to the Storting in the Government's Kredittmeldingen (Credit Report). The Governor of Norges Bank provides an assessment of monetary policy in an open hearing before the Standing Committee on Finance and Economic Affairs in connection with the Storting deliberations on the Credit Report.

Editorial

Balancing risks

Inflation is low. Underlying inflation has ranged between 1 and 1½% for some time. In spite of strong growth in output and employment, inflation has not picked up so far. Productivity is rising rapidly. Competition is restraining inflation and contributing to an efficient use of resources. Inward labour migration is increasing capacity in the Norwegian economy and curbing cost inflation.

Monetary policy operates with a lag. It is appropriate to raise interest rates before inflation starts to rise. The cyclical upturn is in a mature phase. The enterprises in our regional network report that capacity constraints are now limiting further growth. Unemployment has fallen markedly over the past year. Wage growth appears to be rising, but so far only gradually. Prices for many inputs and services and building materials are rising markedly. Consumer price inflation is also expected to pick up further ahead. Thus, interest rates are rising.

The experience of previous business cycles has shown that wage and price inflation may increase markedly in a late phase of the upturn. Higher interest rates will counter such a development. However, we must also prevent inflation from becoming entrenched well below 2.5%. We will therefore be mindful of the effects of higher interest rates on the krone exchange rate when inflation is low. Positive supply-side conditions that have held down inflation so far suggest a gradual approach, so that we can assess the effects of interest rate increases and other new information on economic developments.

Norges Bank's Executive Board has today decided that the key policy rate should lie in the interval 4-5% in the period to the publication of the next *Report* on 27 June, conditional on economic developments that are broadly in line with projections. The key policy rate is expected to move up to about 5% around the end of 2007, but such projections are shrouded in considerable uncertainty.

The title of the Report has been changed from *Inflation Report* to *Monetary Policy Report*. The new title better reflects the purpose of the Report. The Report presents Norges Bank's strategy for interest rate setting for coming months. Furthermore, Norges Bank's monetary policy assessments are reflected in our forecast for the key policy rate. As a tool in the work on producing an appropriate future interest rate path, we have drawn up a set of criteria. In this *Report*, the criteria have been revised and simplified. The most important criterion is that the interest rate should be set with a view to stabilising inflation near the target in the medium term.

15 March 2007
Svein Gjedrem

1 | Monetary policy assessments and strategy

The economic situation

Consumer price inflation is low and stable even though growth in the Norwegian economy remains high. Inflation, wage growth and capacity utilisation are broadly consistent with the projections in the previous *Report*.

Consumer prices show monthly variations. Lower electricity prices have contributed to a fall in total CPI inflation in recent months (see Chart 1.1). Underlying inflation has been fairly stable over a longer period and is estimated at between 1% and 1½% (see Chart 1.2). Price developments in recent years have generated some uncertainty about the inflation outlook. After a period of very low inflation in 2004, inflation was on the rise through 2005. Thereafter, domestic inflation showed an unexpected drop in 2006 and is still low (see Chart 1.3). Strong competition, high productivity in the business sector and moderate wage growth have held down the rise in prices for domestically produced goods in spite of strong growth and limited available resources in the economy. At the same time, wage growth is picking up and, in particular, prices for some services, intermediate goods and building materials are rising.

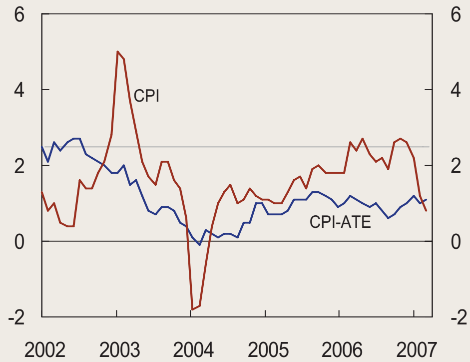
Growth in the Norwegian economy is strong and the high level of activity may hold up somewhat longer than expected in the previous *Report*. Demand in the business and household sectors is still rising and income growth in public enterprises is high. Employment has risen at a faster-than-expected pace. At the same time, growth in labour productivity has been high. Unemployment has shown a further decline and is now on a par with the levels prevailing around previous cyclical peaks (see Chart 1.4). A shortage of labour and some important inputs is a considerable problem in many industries. This will curb growth and is likely to translate into somewhat higher wage and cost inflation this year and next. Increased labour inflows may have a dampening impact, but given the current tightness of the labour market it is likely that wage growth will continue to pick up.

Since summer 2005, there have been prospects that strong growth in the Norwegian economy would be accompanied by rising consumer price inflation excluding energy prices. Norges Bank has therefore gradually raised the interest rate by a total of 2.25 percentage points. The real interest rate is now approaching a more normal level (see Chart 1.5).[1]

Growth among our trading partners has been stronger than expected in the previous *Report*. So far, the weakening of

[1] The calculations may on an uncertain basis indicate that the normal real interest rate for Norway is currently in the lower end of the interval 2½-3½%.

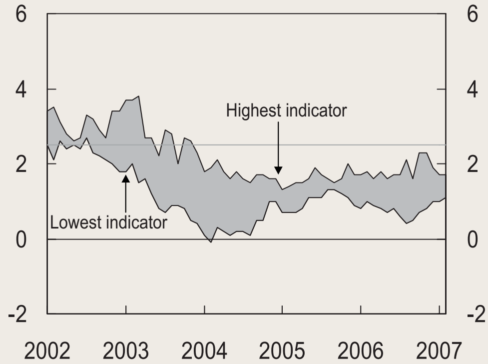
Chart 1.1 CPI and CPI-ATE[1)]. 12-month change. Per cent. Monthly figures. Jan 02 – Feb 07



[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.

Sources: Statistics Norway and Norges Bank

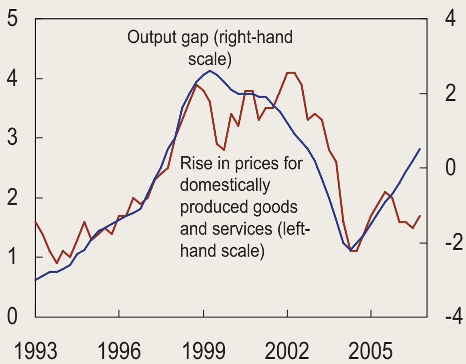
Chart 1.2 Interval of uncertainty for underlying inflation. Highest and lowest indicator.[1)] 12-month change. Per cent. Monthly figures. Jan 02 – Feb 07



[1)] Highest and lowest indicator of CPI-ATE, weighted median and trimmed mean. See box on recent price developments.

Sources: Statistics Norway and Norges Bank

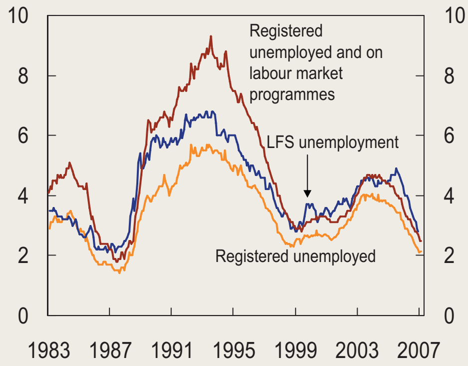
Chart 1.3 Rise in prices for domestically produced goods and services[1)] and output gap level (lagged by 4 quarters). Quarterly figures. 93 Q1 – 06 Q4



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

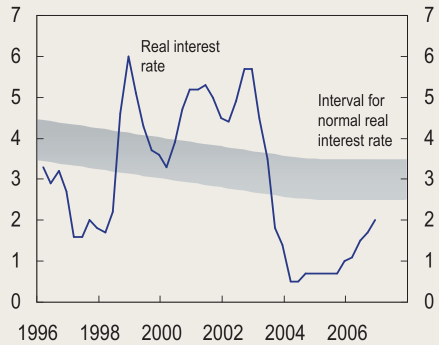
Sources: Statistics Norway and Norges Bank

Chart 1.4 Unemployed. LFS unemployment, registered unemployed and persons on ordinary labour market programmes. Per cent. Seasonally adjusted. Monthly figures. Feb 83 – Feb 07



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

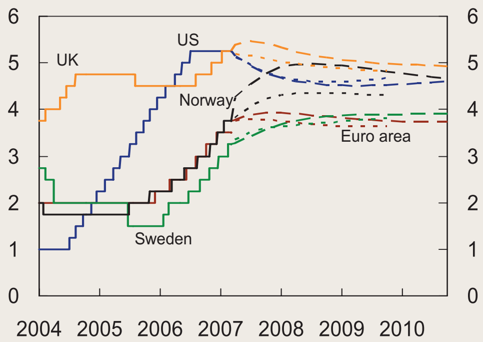
Chart 1.5 3-month real interest rate[1)] and the normal real interest rate in Norway. Per cent. Quarterly figures. 96 Q1 – 06 Q4



[1)] 3-month money market rate deflated by the 12-quarter moving average (centred) of inflation measured by the CPI. Projections for the CPI from this report form the basis for this estimate.

Source: Norges Bank

Chart 1.6 Policy rates and forward rates at 26 Oct 06 and 9 Mar 07.[1)] Per cent. Daily and quarterly figures. 1 Jan 04 – 31 Dec 10



[1)] Broken lines show forward rates on 9 March 2007. Dotted lines show forward rates on 26 October 2006. Forward rates are based on interest rates in the money market and interest rate swaps.

Sources: Reuters (EcoWin) and Norges Bank

the US housing market has not had pronounced spillover effects. Growth in China and India is strong and the euro area is experiencing a broad-based upturn. Global growth is probably less dependent on demand for goods and services in the US than was the case earlier. Nevertheless, there is a risk that imbalances in payment flows between major economies may have a substantial adverse impact on global growth and result in exchange rate volatility and higher risk premia in financial markets. The recent fall in equity prices and financial market turbulence have generated uncertainty concerning future economic developments.

Oil and energy prices remain virtually unchanged since the previous *Report*, but are still markedly lower than last summer. This is having a dampening impact on consumer price inflation. Metal prices have edged down. Prices for other commodities have edged up however, particularly food prices.

Since November, prospects for continued growth have also contributed to higher interest rate expectations in a number of countries (see Chart 1.6). In European countries, where interest rates have been on the rise for a period, interest rates may continue to rise for a somewhat longer period than expected last autumn. In the US, interest rate expectations in the near term have been lowered somewhat, however.

In Norway, forward interest rates have increased as a result of signs of stronger growth in the Norwegian economy. Forward interest rates have increased somewhat more in Norway than among trading partners. This has probably contributed to the strengthening of the krone since November.

Baseline scenario

Monetary policy is oriented towards CPI inflation of close to 2.5% over time. Inflation in Norway decelerated markedly from the end of the 1980s to the mid-1990s and has since been low and stable, and fairly close to 2.5%, with considerably lower variability than earlier (see Chart 1.7). Over the past 5-10 years, inflation has averaged around 2%, i.e. somewhat lower than the inflation target. Since the upturn started in the Norwegian economy in summer 2003, inflation has been low and income growth in the business and household sectors has been high. This reflects the influence of a number of positive supply-side conditions in the Norwegian economy, such as strong productivity growth, ample supply of foreign labour and a low rise in prices for imported goods. Combined with low interest rates, this has resulted in strong growth in demand in the business sector, the household sector and in turn the public sector. Idle labour resources have been employed and available real capital has been put to use. The growth capacity of the Norwegian economy has been high, and higher than expected.

As in the previous *Report*, the projection for demand growth in 2007 has been revised up compared with the November *Report*. Constraints on future growth have also come into clearer evidence, particularly in the labour market. There are prospects that capacity utilisation will remain high somewhat longer than previously assumed.

Somewhat lower productivity growth and higher wage growth are expected to reduce business profitability further ahead. Companies will then have to pass on higher costs to prices to a further extent. High capacity utilisation is expected to push up inflation through the latter half of 2007 and into 2008.

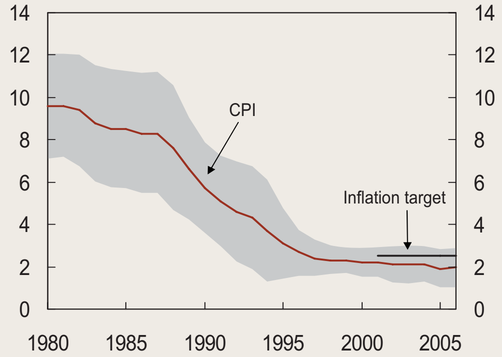
It may still take time for higher wage growth to feed fully through to consumer prices. Already high margins in many enterprises may dampen the impact. Moderate underlying consumer price inflation combined with rising wage growth and high business profitability, may indicate that productivity is still rising rapidly. In conjunction with a continued increase in the share of imports from low-cost countries, this may keep inflation at a moderate level in 2007. Price developments for imported goods will probably continue to restrain inflation in the period ahead, but to a lesser extent than earlier.

High oil prices over a longer period have boosted oil investment. There are prospects that the high investment level will be sustained also in the coming years. A strong increase in the value of the Government Pension Fund - Global implies a substantial increase in the funds available under the fiscal rule in the coming years. It is likely that public enterprises will encounter problems using their income to increase employment and service production without an attendant rise in wage growth in the light of prevailing labour shortages.

Monetary policy cannot fine-tune developments in the economy, but can prevent the largest effects of disturbances to the economy. In some situations, it may be appropriate in monetary policy assessments to guard against particularly adverse developments.

The aim of preventing inflation expectations from becoming entrenched well below target was one of the main reasons behind the interest rate reductions to a very low level in 2003 and 2004. In spite of several years of low inflation, inflation expectations have held up (see Chart 1.8). Inflation expectations have increased somewhat in recent months and are now close to the inflation target. According

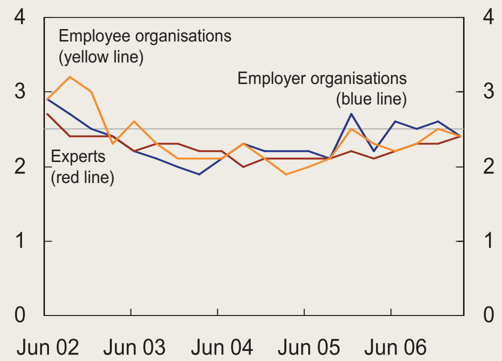
Chart 1.7 CPI. 10-year moving average[1)] and variation[2)]. Per cent. Annual figures. 1980 – 2006[3)]



[1)] The moving average is calculated 7 years back and 2 years ahead.
[2)] The band around the CPI is the variation in the average period, measured by +/- one standard deviation.
[3)] Projections for 2007 and 2008 in this report form the basis for this estimate.

Sources: Statistics Norway and Norges Bank

Chart 1.8 Expected consumer price inflation 2 years ahead. Employer/employee organisations and experts[1)]. Per cent. Quarterly figures. 02 Q2 – 07 Q1



[1)] Employees in financial industry, macroanalysts and academics.

Source: TNS Gallup

Monetary policy since the previous report

Norges Bank's projections for economic developments in *Inflation Report* 3/06, which was presented on 1 November 2006, implied a key policy rate in the interval 3¼ - 4¼% in the period to 15 March. The monetary policy strategy was conditional on economic developments being broadly in line with the projections. The Executive Board's assessment was that the interest rate should gradually be raised to a more normal level at a somewhat faster pace than envisaged earlier, although it was unlikely that rates would be raised at every monetary policy meeting. The Executive Board's assessment was that the interest rate would thus continue to be raised in small, not too frequent steps. It was assumed that this interest rate path would provide a reasonable balance between the objective of bringing inflation up towards the target and the objective of stabilising developments in output and employment.

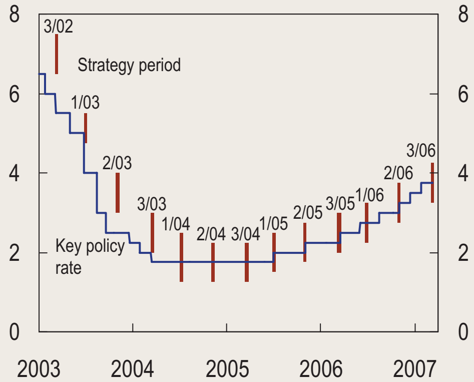
In *Inflation Report* 3/06, it was pointed out that more pronounced trade shifts, increased competition, weaker global growth or a stronger krone could result in lower inflation. It was also pointed out that the low real interest rate or a further depreciation of the krone might lead to a higher-than-projected rise in output and inflation.

At the monetary policy meeting on 1 November, the key policy rate was increased by 0.25 percentage point to 3.25%, after being left unchanged in September. The Executive Board noted that underlying inflation had been lower than expected in recent months. However, several factors pointed to gradually higher inflation ahead. Capacity utilisation was high and there was little spare capacity in the Norwegian economy. Employment was rising rapidly and unemployment had fallen markedly. There were signs of higher wage growth and expectations of rising inflation. At the same time, the krone exchange rate had depreciated from strong values. The monetary policy strategy, coupled with new information up to November, implied that the interest rate should be increased at this meeting.

At the monetary policy meeting on 13 December, the Executive Board pointed out that new information since the beginning of November had been broadly in line with projections in *Inflation Report* 3/06. Employment was rising rapidly and unemployment had fallen markedly. A steadily rising number of enterprises were facing labour shortages. Wage growth appeared to be on the rise. The rise in prices had been somewhat higher than projected. The krone exchange rate was somewhat stronger than assumed. The strategy published in the *Inflation Report*, coupled with new information, implied that the key policy rate should be increased by 0.25 percentage point to 3.50%.

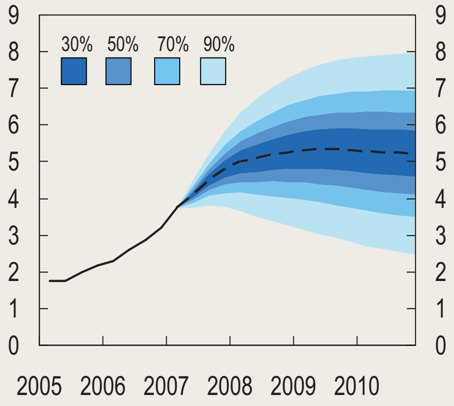
The interest rate was increased by 0.25 percentage point to 3.75% at the monetary policy meeting on 24 January. The Executive Board noted that new information since *Inflation Report* 3/06 indicated that growth in the economy might be higher than projected. There were signs that wage growth was rising at a somewhat faster pace than expected. The rate of increase in house prices and debt growth remained high. The rise in consumer prices measured by the consumer price index (CPI) was lower than expected, but inflation adjusted for tax changes and excluding energy products (CPI-ATE) was higher than projected in the *Inflation Report*. The risk of an imminent slowdown in the world economy was judged to be somewhat smaller than earlier. The Executive Board had considered the alternative of leaving the interest rate unchanged. On balance, however, new information indicated that the key policy rate should be raised at this meeting

Chart 1 Interval for the key policy rate at the end of each strategy period and actual developments. Per cent. Daily figures. 2 Jan 03 – 9 Mar 07



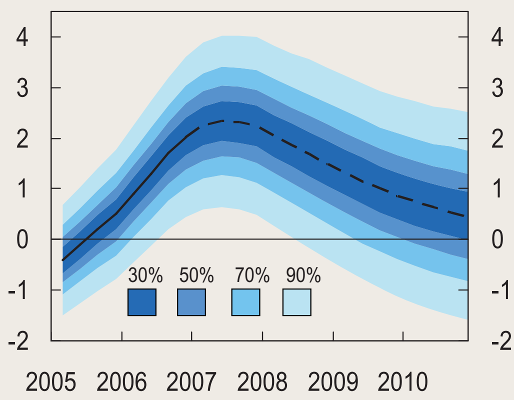
Source: Norges Bank

Chart 1.9a Projected key policy rate in the baseline scenario with fan chart. Per cent. Quarterly figures. 05 Q1 – 10 Q4



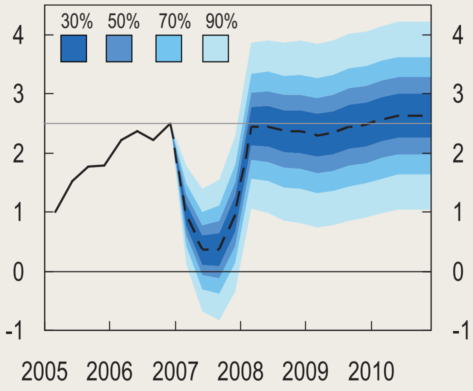
Source: Norges Bank

Chart 1.9b Estimated output gap in the baseline scenario with fan chart. Per cent. Quarterly figures. 05 Q1 – 10 Q4



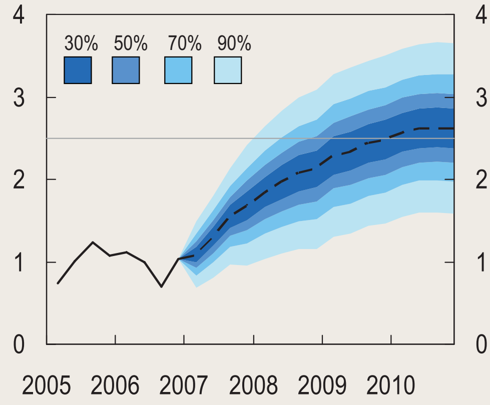
Source: Norges Bank

Chart 1.9c Projected CPI in the baseline scenario with fan chart. 4-quarter change. Per cent. Quarterly figures. 05 Q1 – 10 Q4



Sources: Statistics Norway and Norges Bank

Chart 1.9d Projected CPI-ATE in the baseline scenario with fan chart. 4-quarter change. Per cent. Quarterly figures. 05 Q1 – 10 Q4

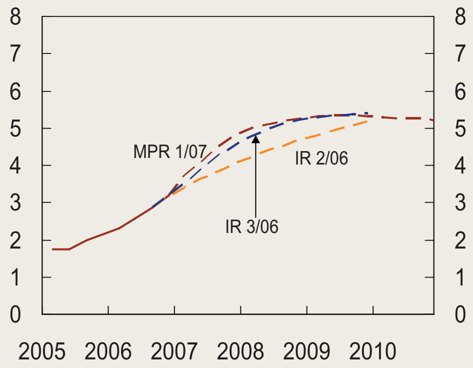


Sources: Statistics Norway and Norges Bank

to TNS Gallup's business sentiment survey, a rising share of enterprises expect higher purchase prices. Our regional network also reports that enterprises expect a higher rise in selling prices ahead, particularly in the building industry. Developments indicate that the economy is fairly robust to a sustained fall in the price level. In spite of continued low underlying inflation, the risk of a downturn and deflation now seems small.

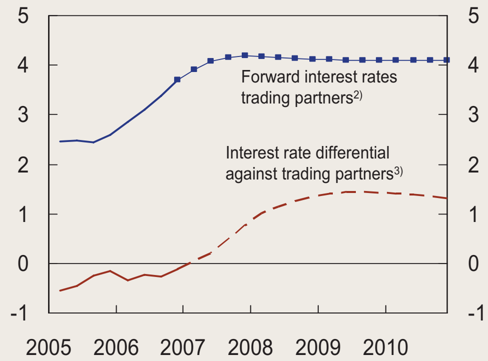
At this juncture, it may be more appropriate to guard against a rapid acceleration in cost inflation given a tight labour market. Pronounced and rapid interest rate hikes may then be necessary to prevent inflation from becoming too high. In order to guard against such a development and contribute to a more gradual slowdown in economic growth, a pre-emptive and more pronounced increase in the interest rate might, in isolation, be appropriate.

Chart 1.10 Key policy rate in the baseline scenario in IR 2/06, IR 3/06 and MPR 1/07. Per cent. Quarterly figures. 05 Q1 – 10 Q4



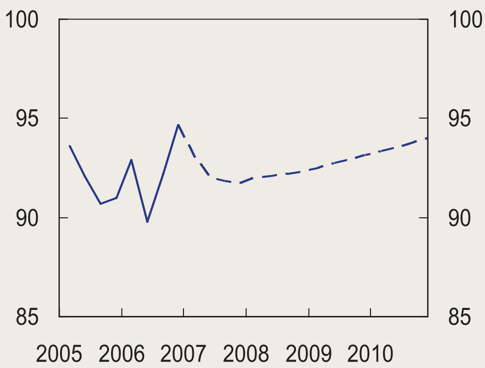
Source: Norges Bank

Chart 1.11 Forward interest rates for trading partners and projected interest rate differential. Money market rates[1]. Quarterly figures. 05 Q1 – 10 Q4



[1] Money market rates are approximately 0.2 percentage point higher than the key policy rate.
[2] Weighted average of trading partners' forward rates on 9 March.
[3] Interest rate differential in the baseline scenario from 07 Q1 (broken line).

Chart 1.12 Import-weighted exchange rate (I-44)[1] in the baseline scenario. Quarterly figures. 05 Q1 – 10 Q4



[1] A rising curve denotes a weaker krone exchange rate.

Source: Norges Bank

On the other hand, low consumer price inflation suggests that monetary policy should not be tightened too rapidly. CPI inflation is expected to be very low this year and a fall in energy prices may curb the rise in prices for other goods and services. Developments in the krone exchange rate will also influence the pace of interest rate hikes because a considerably stronger krone may result in inflation that is too low. Under an inflation targeting regime, it is important to be mindful of the effects of higher interest rates on the krone exchange rate when inflation is low. The interest rate differential between Norway and other countries may influence the krone exchange rate. Interest rate developments in other countries are therefore of importance for interest rates in Norway. There are already expectations in financial markets that the Norwegian interest rate level will increase more than that of our trading partners, and moreover the interest rate level in several other countries such as the US, the UK and New Zealand is now considerably higher than in Norway. Nevertheless, a rapidly widening interest rate differential may result in an appreciation of the krone. This may warrant a gradual approach in interest rate setting.

Overall, the outlook and the balance of risks suggest that it would be appropriate to raise the interest rate gradually to about 5% in the course of this year and to a somewhat higher level in the period to summer 2008 (see Charts 1.9a-d). Compared with *Inflation Report* 3/06, the interest rate path has been adjusted upwards by about ¼ percentage point around the end of 2007 (see Chart 1.10). The interest rate differential against trading partners may widen somewhat further ahead in the projection period (see Chart 1.11). 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 (see Chart 1.12). There is considerable uncertainty surrounding future developments in inflation and output and hence interest rate developments (see Chart 1.9a and further discussion of uncertainty below).

Capacity utilisation in the Norwegian economy is expected to remain high through 2007. The output gap is estimated at 2¼% in 2007, but will then gradually slow to around ½% in 2010. CPI inflation is expected to fall markedly this spring and remain low in the period to autumn. The fall in electricity prices from the high levels in 2006 is the main reason behind low consumer price inflation. As the effects of the fall in electricity prices unwind and cost inflation rises, inflation will also pick up. CPI inflation is projected to near the inflation target of 2.5% as from 2008. CPI inflation adjusted for tax changes and excluding energy products is projected to show a more gradual rise. A further description of the assumptions and projections are presented in Section 2.

The trade-off between bringing inflation back to target and stabilising developments in output and employment is illustrated in Chart 1.13. The interest rate path is now sufficiently low for the rise in consumer prices adjusted for tax changes and excluding energy products to pick up so that consumer price inflation gradually rises to 2.5%. Moreover, the increase in interest rates will gradually reduce capacity utilisation. Such an interest rate path is consistent with Norges Bank's previous response pattern. The box in the margin overleaf presents criteria for an appropriate future interest rate path. The wording of the criteria has been adjusted and simplified somewhat.

Higher interest rates will reduce growth in household liquidity, boost saving incentives and restrain growth in household consumption. Mainland investment growth is expected to slacken. Slower external growth, in conjunction with higher wage growth, will lead to slower growth in mainland exports. Output growth may also slow as a result of limited available resources in the Norwegian economy. Capacity constraints may give rise to a period where imports account for a larger share of demand growth. On the whole, mainland GDP growth will be lower than growth in production capacity as from 2008, with a gradual decline in capacity utilisation.

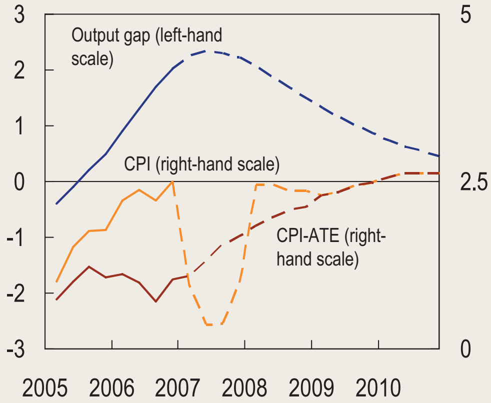
With a tight labour market and rising wage growth, house prices and credit to households are expected to continue to move up. Higher interest rates and a high level of residential construction will eventually lead to slower house price inflation. Household debt growth is expected to remain higher than income growth over the next few years, with the debt burden rising to a historically high level (see Chart 1.14). The interest burden, which is still relatively low, will also increase gradually as the interest rate level normalises. At the same time, the proportion of fixed-rate mortgages is low and falling, while the share of interest-only loans is rising. Many households are therefore more vulnerable to unexpected interest rate hikes.

Uncertainty surrounding the projections

The projections for inflation, output, the interest rate and other variables are based on an assessment of the current situation and a perception of the functioning of the economy. The fan charts illustrate the uncertainty surrounding our projections for the interest rate, inflation and the output gap (see Charts 1.9a-d).[2] The wider the fan charts are, the more uncertain the projections. The width of the fan charts is based on historical disturbances.[3] The uncertainty interval around the interest rate reflects the fact that monetary policy reacts to disturbances to other variables.

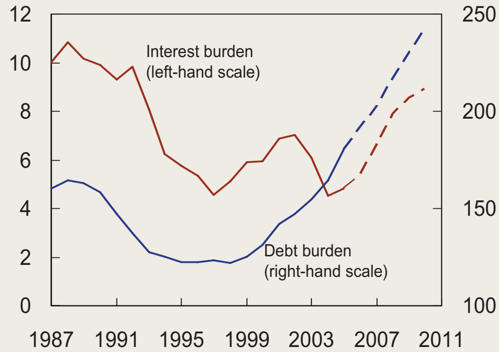
[2] There is also uncertainty about the current situation (see boxes in *Inflation Report* 3/05 and *Inflation Report* 3/06)
[3] A further description of the fan charts is provided in *Inflation Report* 3/05.

Chart 1.13 Projected inflation and output gap in the baseline scenario. Per cent. Quarterly figures. 05 Q1 – 10 Q4



Sources: Statistics Norway and Norges Bank

Chart 1.14 Projections of household interest burden[1)] and debt burden[2)]. Per cent. Annual figures. 1987 – 2010



[1)] Interest expenses after tax as a percentage of disposable income adjusted for estimated reinvested dividends less return on insurance claims and plus interest expenses.
[2)] Loan debt as a percentage of disposable income adjusted for estimated reinvested dividends less return on insurance claims.

Sources: Statistics Norway and Norges Bank

Criteria for an appropriate interest rate path

The operational target of monetary policy is low and stable inflation, with annual consumer price inflation of approximately 2.5 per cent over time. In interest rate setting, the forecast for future interest rate developments should satisfy the following main criteria:

1. The interest rate should be set with a view to stabilising inflation close to the target in the medium term. The horizon will depend on disturbances to which the economy is exposed and the effects on the prospects for the path for inflation and the real economy.

2. The interest rate path should provide a reasonable balance between the path for inflation and the path for capacity utilisation.

In the assessment, potential effects of asset prices, such as property prices, equity prices and the krone exchange rate on the prospects for output, employment and inflation are also taken into account. Assuming the criteria above have been satisfied, the following additional criteria are useful:

3. Interest rate developments should result in acceptable developments in inflation and output also under alternative, albeit not unrealistic assumptions concerning the economic situation and the functioning of the economy.

4. Interest rate adjustments should normally be gradual and consistent with the Bank's previous response pattern.

5. As a cross-check for interest rate setting, it should be possible to explain any substantial and systematic deviations from simple monetary policy rules.

This increases the uncertainty surrounding future interest rates, but also limits the uncertainty surrounding the other variables.

If economic developments are broadly in line with projections, economic agents can also expect interest rate developments to be approximately as projected. On the other hand, the interest rate path may shift in relation to that projected in this *Report* if economic prospects change or if the effects of interest rate changes on output, employment and prices are different from that projected.

Charts 1.15a-c show developments under two alternative scenarios for the economy. The projections in the charts are based on the assumption that Norges Bank's response pattern is known and consistent over time.[4] Interest rate setting must be assessed in the light of the reasons for and the expected duration of the disturbances. The later monetary policy responds to such disturbances, the wider the fluctuations in output and inflation will be. On the other hand, it may be difficult to distinguish between erratic statistical effects and more long-lasting disturbances. It may therefore take time before interest rate setting can be based on economic developments that differ from the projected path.

The Norwegian economy is in an upturn. However, it may be that inflation will again be surprisingly low. The shift in trade patterns may be more pronounced than assumed and it may take longer for prices for imported consumer goods to pick up. Strong domestic competition or sustained high productivity growth may curb the rise in prices for domestically produced goods and services. A stronger-than-assumed krone exchange rate will also curb inflation.

Moreover, growth among our trading partners may slow more rapidly than projected in this *Report*. Growth expectations for the world economy have been revised up somewhat since the previous *Report*, but there is uncertainty linked to developments in the US. Should the US economy experience a pronounced downturn, the spillover effects on the rest of the world will be greater than assumed here. Markedly slower global growth may also contribute to a fall in commodity prices and lower consumer price inflation among our trading partners. Norwegian export industries may be adversely affected by lower demand and lower selling prices. Both inflation and output growth may then edge down further ahead.

[4] A further account of this is provided in Bergo, J. (2007): "Interest rate projections in theory and practice", speech at the Foreign Exchange Seminar of the Association of Norwegian Economists at Sanderstølen on 26 January 2007.

Charts 1.15a-c (yellow lines) illustrate a path where inflation is about ½ percentage point lower than in the baseline scenario through autumn 2007.[5] If there is a risk of a permanent fall in inflation to a considerably lower level than target, monetary policy must place emphasis on holding up inflation expectations and bringing inflation back to target. In isolation, this suggests an interest rate path that is lower than the central projection. As a result of a lower interest rate, the krone may depreciate and growth in the economy may be higher than in the baseline scenario further ahead. Inflation will then pick up, but be lower than in the baseline scenario in the next few years.

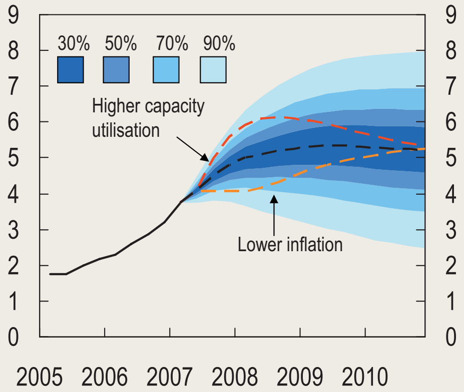
On the other hand, we may have underestimated the pressures in the economy and a situation may arise where price and cost inflation rises rapidly. For a long period, the real interest rate was considerably lower than what we consider to be a normal level, and we may have underestimated the effects of low real interest rates on employment and output growth. Capacity utilisation has increased markedly over the past year. Labour inflows have increased labour market flexibility and this is expected to continue to restrain wage growth to some extent. However, unemployment has declined to a very low level and there are considerable labour shortages. In previous upturns, this combination has often led to abrupt shifts in the pace of wage and price inflation. Productivity growth has been high for several years, but is now expected to moderate. Productivity growth may also slow to a further extent than assumed. It is not unusual for productivity growth to fall back markedly when capacity utilisation is high and the labour market is tight.

Charts 1.15a-c (red lines) illustrate a scenario where capacity utilisation in the economy proves to be higher than projected.[6] In isolation, this would warrant a faster increase in interest rates than in the baseline scenario to prevent inflation from overshooting the target by a considerable margin. A higher interest rate could lead to an appreciation of the krone and curb growth in the economy. Capacity utilisation would then gradually move down to the level in the baseline scenario.

[5] Several factors that may contribute to low inflation, will also have an impact on the real economy. As a technical assumption, the projections for the real economy are initially held constant. It is also assumed that we apply the interest rate in the baseline scenario the first months and do not react to disturbances until autumn 2007. Other market participants, households and enterprises are also uncertain whether the economy will follow a different path before that time. The background for the delayed reaction is that it may take time to realise that the economy is moving on a different path.

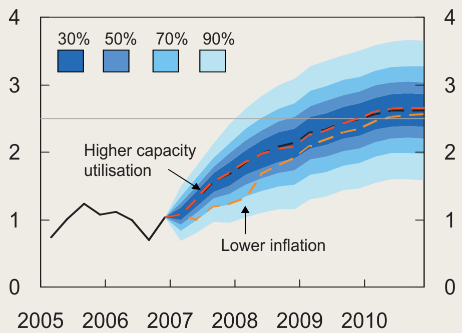
[6] This alternative is also based on the assumption that it takes time to reveal the causes and to adjust monetary policy. The output gap is initially assumed to be ½ percentage point higher than in the baseline scenario.

Chart 1.15a Key policy rate in the baseline scenario and in the alternatives with lower inflation and higher capacity utilisation. Per cent. Quarterly figures. 05 Q1 – 10 Q4



Source: Norges Bank

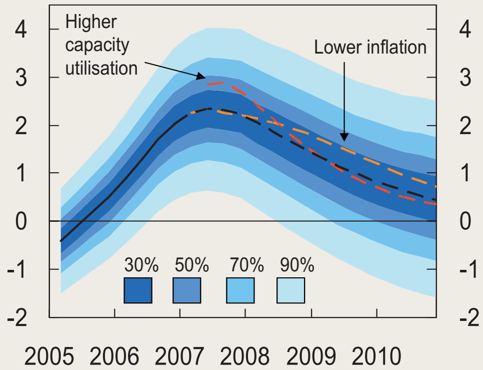
Chart 1.15b Projected CPI-ATE[1)] in the baseline scenario and in the alternatives with lower inflation and higher capacity utilisation. 4-quarter change. Per cent. Quarterly figures. 05 Q1 – 10 Q4



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.

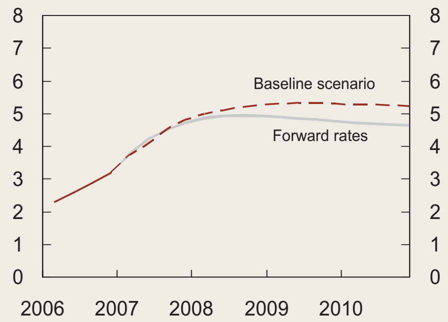
Sources: Statistics Norway and Norges Bank

Chart 1.15c Estimated output gap in the baseline scenario and in the alternatives with lower inflation and higher capacity utilisation. Per cent. Quarterly figures. 05 Q1 – 10 Q4



Source: Norges Bank

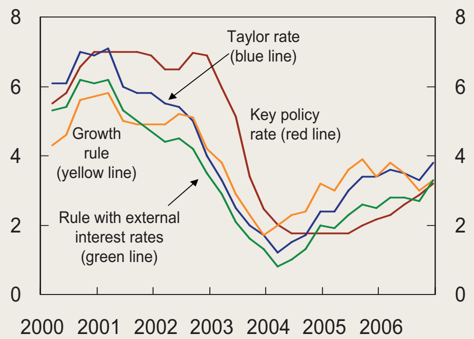
Chart 1.16 Key policy rate in baseline scenario and estimated forward rates[1)]. Per cent. Quarterly figures. 06 Q1 – 10 Q4



[1)] A credit risk premium and a technical difference of 0.20 percentage point have been deducted to make the forward rates comparable with the key policy rate. The grey, shaded interval shows the highest and lowest interest rates in the period 26 Feb – 9 Mar 2007.

Source: Norges Bank

Chart 1.17 Key policy rate, Taylor rate, growth rule and rule with external interest rates.[1)] Per cent. Quarterly figures. 00 Q1 – 06 Q4



[1)] The CPI-ATE adjusted for the estimated effect of reduced maximum day-care rates has been used as a measure of inflation. Other measures of underlying inflation that have been higher than the CPI-ATE would have resulted in a higher interest rate path.

Source: Norges Bank

Cross-checks

Forward interest rates provide a cross-check of Norges Bank's interest rate forecast. Under certain assumptions about risk premia, forward rates may reflect market expectations about future interest rate developments. Long-term forward rates in Norway have risen by about ¼ percentage point since *Inflation Report* 3/06. Short-term forward interest rates have risen markedly by nearly ¾ percentage point in one year's time. Forward rates may now point to an increase in the policy rate to 5% in 2008 (see Chart 1.16). The interest rate forecast in this *Report* is broadly in line with short-term forward interest rates in the period to autumn 2008. Thereafter, Norges Bank's interest rate forecast is somewhat higher than forward rates. Market participants may have a different perception of the outlook for inflation and output. Higher demand for long-term debt securities as a result of adaptation to new capital adequacy requirements may also have pushed down international long-term interest rates, which may also have reduced long-term rates in Norway. Forward rates may thus underestimate interest rate expectations among financial market participants. As a result of the rise in forward rates, the difference between Norges Bank's projections and forward interest rates has nevertheless been reduced considerably since *Inflation Report 3/06.*

Through 2005 and in periods of 2006, simple monetary policy rules implied somewhat higher interest rates than Norges Bank's policy rate. Since the latter half of 2006, there have been no major differences between the sight deposit rate and the simple rules (see Chart 1.17). The Taylor rule[7] applies the output gap and inflation. The growth rule[8] instead applies observed GDP growth and inflation. Simple monetary policy rules do not take account of the economic outlook but focus solely on the economic situation today.[9]

The Taylor rule and the growth rule have some limitations as a reference for a small, open economy. They do not take

[7] The Taylor rule: Interest rate = inflation target + equilibrium real interest rate +1.5·(inflation – inflation target) + 0.5·output gap. See Taylor J.B. (1993): "Discretion versus policy rules in practice", Carnegie-Rochester Conference Series on Public Policy 39, pages 195-214.

[8] Growth rule: Interest rate=inflation target + equilibrium real interest rate + 1.5·(inflation - inflation target) + 0.5·growth gap. Athanasios Orphanides proposes to replace the output gap with the difference between actual growth and trend growth in the economy (growth gap). One reason for this is that the Taylor rule is sensitive to errors in the measurement of the output gap. See Orphanides A. (2003): "The quest for prosperity without inflation". Journal of Monetary Economics, vol. 50, no. 3, pp. 633-663.

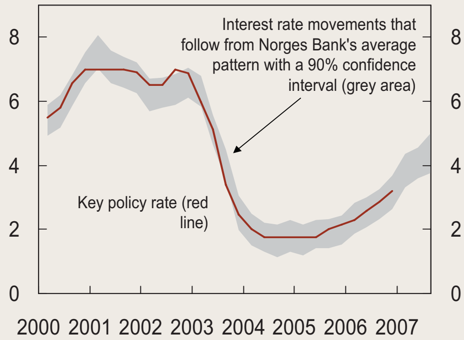
[9] In the calculations, we use the rise in the CPI-ATE as a measure of inflation. It is our assessment that underlying inflation has in periods been higher than shown by the indicator. Simple interest rate rules would then suggest somewhat higher interest rates than shown in the chart.

into account that changes in the interest rate may result in changes in the exchange rate, thereby influencing the inflation outlook. In principle, the rule involving external interest rates is better suited for a small, open economy.[10] This rule implies a somewhat lower interest rate than the other rules.

Norges Bank has estimated a simple interest rate rule on the basis of its previous interest rate setting (see box in *Inflation Report* 3/04). Such a rule suggests a gradual increase in the interest rate ahead (see Chart 1.18). It is primarily as a result of high GDP growth and prospects for higher CPI inflation adjusted for tax changes and excluding energy products that this interest rate rule implies higher interest rates ahead.

Other cross-checks compare the interest rate with money supply growth and growth in nominal GDP. For a detailed account of cross-checks for interest rate setting, see Norges Bank's *Annual Report* 2006 (to be published in spring 2007).

Chart 1.18 Key policy rate and interest rate developments that follow from Norges Bank's average pattern for the setting of interest rates[1)]. Per cent. Quarterly figures. 00 Q1 – 07 Q3



1) The interest rate movements are explained by developments in inflation, mainland GDP growth, wage growth and 3-month interest rates among trading partners. See *Inflation Report* 3/04 for further discussion.

Source: Norges Bank

10 The external real interest rate rule: Interest rate = inflation target + equilibrium real interest rate + 1.5·(inflation – inflation target) + 0.5·output gap + 1.0·(real interest rate among Norway's trading partners – real interest rate in Norway).

Conclusions – monetary policy strategy

The Executive Board's assessments:

- Inflation, wage growth and capacity utilisation are broadly in line with the projections in *Inflation Report* 3/06. Underlying inflation has been relatively low in recent months in line with expectations, and a fall in electricity prices has pushed down CPI inflation. There are nevertheless several factors indicating that inflation will gradually pick up. Capacity utilisation is high. Employment is rising at a faster-than-projected pace and unemployment has fallen to a low level. There are signs that consumer price inflation may approach the target as from 2008, but the projections are uncertain. New information may reveal aspects of economic developments that indicate that the Norwegian economy is moving on a different path than projected. On the one hand, major shifts in trade patterns, stronger competition, sustained high productivity growth, weaker global growth or a stronger krone exchange rate may result in lower-than-expected inflation. On the other hand, high capacity utilisation or higher cost inflation may lead to a higher-than-projected inflation.

The Executive Board's strategy:

- The interest rate path presented in this *Report* reflects the Executive Board's trade-off between bringing inflation up to target and stabilising developments in output and employment. In the light of this trade-off, the interest rate will be increased gradually so that we can assess the effects of interest rate changes and other new information on economic developments.

- The key policy rate should be in the interval 4 – 5% in the period to the publication of the next *Monetary Policy Report* on 27 June 2007, conditional on economic developments that are broadly in line with projections.

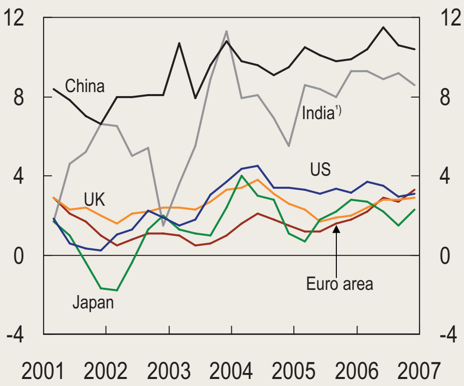
Table 2.1 Projections for GDP growth in other countries. Change from previous year. Per cent

	2007	2008	2009	2010
US	2¼	2¾	2¾	2½
Japan	1¾	1¾	1½	1½
Germany	1¾	2¼	2	1½
France	2¼	2¼	2½	2¼
UK	2½	2½	2½	2¼
Sweden	3½	2¾	2¼	2
China	9¾	9½	9	8½
Trading partners[1)]	3	2¾	2½	2¼
Euro area	2¼	2¼	2	1¾

1) Export weights, 26 important trading partners

Sources: Eurostat and Norges Bank

Chart 2.1 GDP. 4-quarter growth. Per cent. Quarterly figures. 01 Q1 – 06 Q4



1) Measured by factor price.

Source: Reuters (EcoWin)

Table 2.2 Projections for consumer prices in other countries. Change from previous year. Per cent

	2007	2008	2009	2010
US	2	2½	2¼	2¼
Japan	½	1	1¼	1¼
Germany	2¼	1½	1½	1½
France	2	2	1¾	1¾
UK	2¼	2	2	2
Sweden	1½	2	2	2
China	2	2½	3¾	3½
Trading partners[1)]	2	2	2	2
Euro area[2)]	2¼	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

Continued solid growth in the global economy

Demand for goods and services has so far remained high among our main trading partners. This can be partly attributed to the fall in oil prices since summer 2006. Growth picked up towards the end of 2006 and is stronger than projected in *Inflation Report* 3/06 (see Table 2.1 and Chart 2.1). International financial markets have been marked by some unrest in recent weeks.

High international activity has contributed to employment growth and a decline in unemployment. This has boosted household optimism and supported private consumption. Solid corporate profitability and favourable funding conditions are expected to contribute to a further increase in the investment rate. Robust growth in China and India is helping to sustain global economic growth. Reforms in European product and service markets are also expected to lead to higher domestic demand. The softening of the US housing market has so far only had limited spillover effects on both the wider US economy and the world economy as a whole. However, growth in private demand is likely to slow somewhat due to a weaker housing market. This will lead to a short period of below-trend growth in the US economy.

Growth forecasts imply full capacity utilisation in 2007 for Norway's trading partners as a whole, based on OECD estimates of potential growth. Capacity utilisation will increase somewhat in 2008, before levelling off and then declining in 2010. Globalisation is still one of the most prominent driving forces behind international economic developments. The global labour supply has seen a sharp rise as China and other emerging economies have become increasingly integrated into the world labour market. Changes in international production and trade patterns are fuelling economic growth and inflation is easing among our trading partners. The strong expansion in Asia has probably reduced other countries' dependence on the US (see box on page 40).

Inflation is projected to remain around 2% among our main trading partners (see Table 2.2). Core inflation is moderate in most countries (see Chart 2.2). Projections for economic growth imply higher capacity utilisation than previously projected. In isolation, this will contribute to higher inflationary pressures. In the US and the UK, a tight labour market is expected to contribute to somewhat higher wage growth. We also expect wage growth to pick up somewhat from low levels in e.g. Germany. However, structural factors such as globalisation, increased labour mobility and stronger competition in European goods and service markets will restrain inflation and contribute to continued moderate wage growth for our trading partners as a whole.

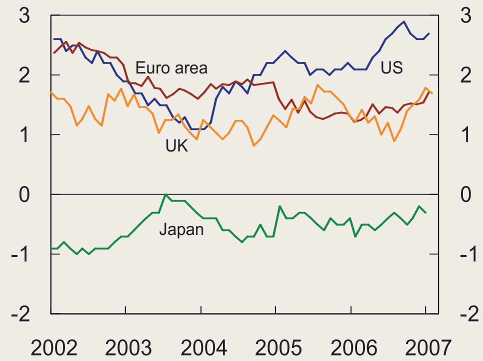
Following a long period of expansion, international financial markets were marked by unrest around the end of February. Equity prices fell markedly and are now only slightly higher than at the time of the November *Inflation Report*. The decline has been broadly based (see Chart 2.3). Risk premia have been reduced in recent years. This may partly reflect market participants' optimistic assessment of the global macroeconomic outlook. Structural features, such as more integrated and liquid markets combined with improved possibilities for risk diversification, may also have contributed. At the same time, risk willingness has been high. In fixed income markets, the premium on corporate bonds has been historically low, and in foreign exchange markets, market participants have largely borrowed in currencies with a low interest rate and then invested in currencies with a high interest rate.

Financial market turbulence has contributed to reducing risk willingness and triggered an unwinding of high-risk positions. The reduction in these positions has led to a higher pricing of risk on a broad range of securities, and the yield spread between corporate bonds and government bonds has widened. Uncertainty, as measured by implied volatility, has increased in bond, foreign exchange and stock markets (see Chart 2.4). So far, however, the recent increase in risk premia appears to be relatively modest from a historical perspective.

Interest rates among trading partners have fluctuated considerably, but have on the whole increased somewhat since *Inflation Report* 3/06. Increased optimism concerning the growth outlook led to a broad yield increase through December and January. Yields have declined again since the beginning of February as a result of e.g. rising oil prices, renewed uncertainty regarding the housing market in the US and weak indicators for US industry. In February, yields showed a steeper decline in the US than in Europe and Asia, where uncertainty concerning economic developments has not increased to the same extent. The recent fall in global stock markets has led to increased demand for government bonds and the yield decline has been reinforced (see Chart 2.5).

Key commodity prices have moved on different paths since *Inflation Report* 3/06, and overall commodity prices remain broadly unchanged. Prices for agricultural products have drifted up, while metal prices are now slightly lower. However, oil and energy prices remain virtually unchanged. The levels are still markedly lower than last summer. Both

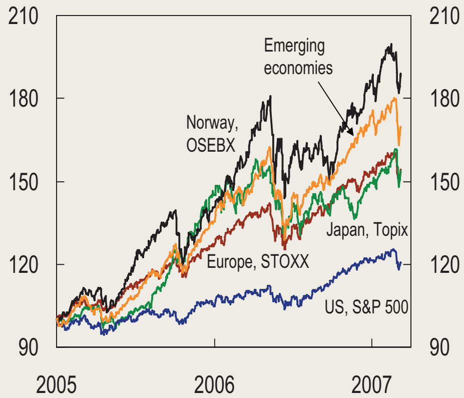
Chart 2.2 Core inflation.[1] 12-month change. Per cent. Monthly figures. Jan 02 – Jan 07



[1] US and Japan: CPI excl. food and energy. Euro area and UK: CPI excl. energy, food, alcohol and tobacco.

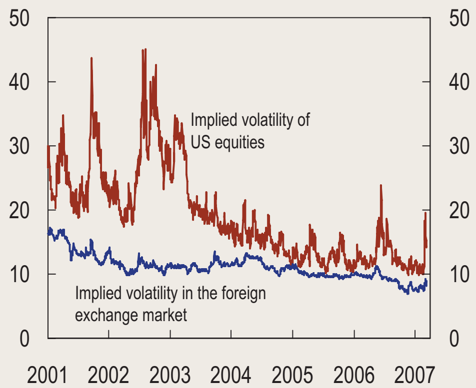
Source: Reuters (EcoWin)

Chart 2.3 Developments in international equity indices. 2 Jan 05 = 100. Daily figures. 2 Jan 05 – 9 Mar 07



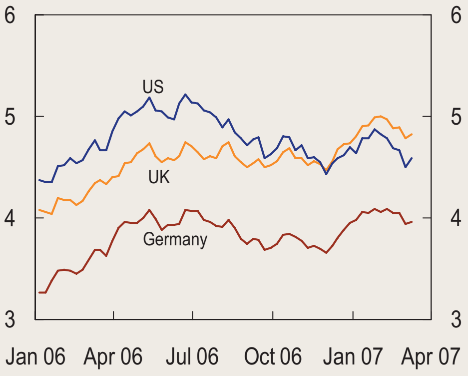
Source: Reuters (EcoWin)

Chart 2.4 Implied volatility in the foreign exchange market and the US equity market. Daily figures. 2 Jan 01 – 9 Mar 07



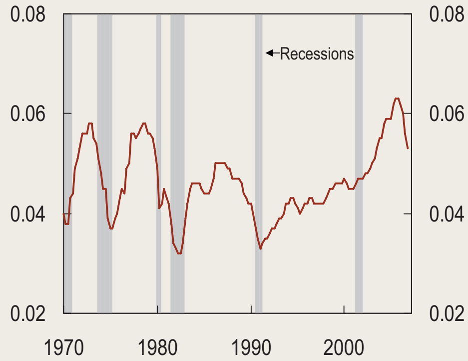
Sources: Reuters (EcoWin) and Norges Bank

Chart 2.5 10-year government bond yields. Per cent. Weekly figures. Week 1 2006 – Week 10 2007



Source: Bloomberg

Chart 2.6 Housing investment as a share of US GDP. Current prices. Quarterly figures. 70 Q1 – 06 Q4



Sources: US Department of Commerce, Reuters (EcoWin) and Norges Bank

spare OPEC capacity and oil stocks in OECD countries have increased. For a period, energy prices were heavily influenced by mild winter weather, while metal prices were affected by the withdrawal of financial investors from the market. Developments in energy and commodity markets are discussed in detail in a box on page 22.

Underlying growth may be stronger than assumed in this report, following the strong global expansion of recent years. The growth engines in Asia are becoming increasingly important for overall developments in the global economy. It may be that we are underestimating the impulses from structural changes such as globalisation, high productivity growth in China and intensified competitive pressures in European product markets. If this proves to be the case, growth may be stronger than projected. There is also a risk that we are underestimating the resulting price pressures from the increase in capacity utilisation.

Nevertheless, it is uncertain whether the US housing market will recover as quickly as expected and whether it will eventually adversely affect other parts of the US economy (see Chart 2.6). The US still has a substantial balance-of-payments deficit, while many oil exporters and a number of Asian countries have large surpluses. Stronger growth outside the US has eased global imbalances, but they are still pronounced. A disorderly unwinding of global imbalances might have strong negative spillover effects on the world economy, particularly through sizeable changes in exchange rates. The US housing market and global imbalances are still the main sources of uncertainty with regard to the projections ahead.

Developments in financial markets at around end-February have brought into evidence the uncertainty associated with risk premia in bond, equity and foreign exchange markets. An abrupt and sharp reduction in risk willingness may lead to strong and negative effects on growth. There is also considerable uncertainty surrounding oil prices. The risk of oil production disruptions, for instance due to unrest in the Middle East, may again exert upward pressure on oil prices.

Developments in energy and commodity markets

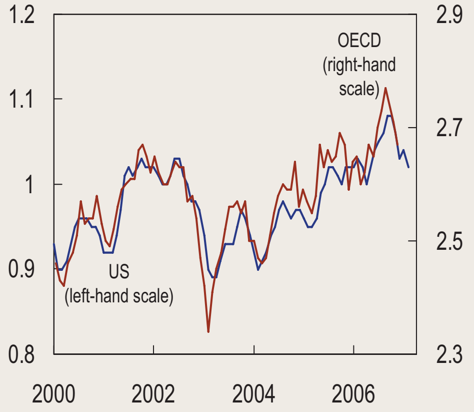
The average oil price so far this year is USD 56 per barrel, about USD 9 lower than the average in 2006. The price rose to over USD 75 in summer 2006, reflecting uncertainties about oil production in several regions. Later in autumn, prices fell as unrest in the Middle East subsided, BP's production problems in Alaska were resolved more rapidly than expected and the hurricane season in the Gulf of Mexico passed without major destruction.

Oil inventories increased in pace with high production in both OPEC and non-OPEC countries, while demand slackened (see Chart 1). OPEC therefore decided 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. Lower demand for heating oil as a result of a record-mild winter in the US and Europe contributed to a further fall in prices.

High inventories and an increase in spare OPEC capacity following the production cuts also influenced price expectations in the oil futures market, where participants unwound their positions substantially at the beginning of 2007 (see Chart 2). A less tight oil market also reduced the impact on oil prices of news that would normally have received considerable attention – for example a halt in Russia's transport of oil exports through Belarus, increased government involvement in oil activities in Venezuela and recurring problems in Nigeria.

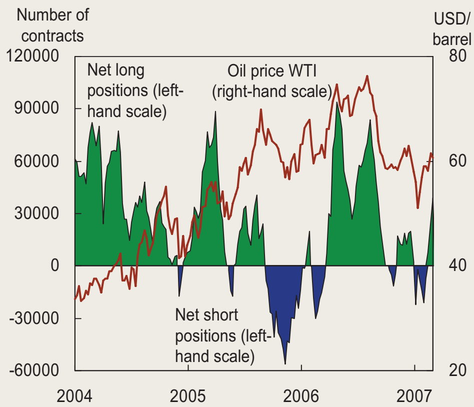
The underlying balance in the oil market changed later in January. Demand for oil rose as more normal winter weather set in. A somewhat brighter world economic outlook and the price fall in the second half of 2006 also boosted demand. The supply of oil was reduced because OPEC continued to implement the approved production cuts, while growth in production in non-OPEC countries was somewhat lower than expected. The US plan to double its strategic oil reserves over time also pushed up prices. This was not only due to the effect on demand for oil.[1] The plan was interpreted by some market participants as indicating that the US was increasing stockpiles to guard against possible further reductions in oil production, particularly in the Middle East.

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



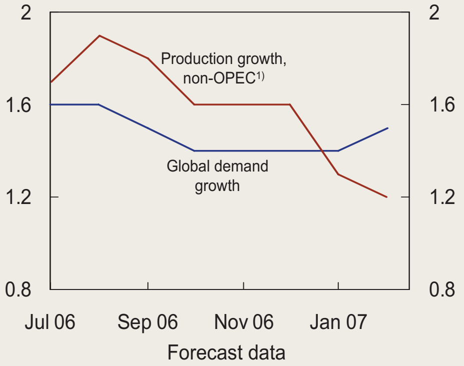
Sources: International Energy Agency (IEA), Energy Information Agency (EIA) and Reuters (EcoWin)

Chart 2 Oil price (WTI in USD per barrel) and net positions of non-commercial traders in the futures market for WTI (number of contracts). Weekly figures. Week 1 2004 – Week 10 2007



Sources: Reuters (EcoWin), Commodity Futures Trading Commission (CFTC) and NYMEX

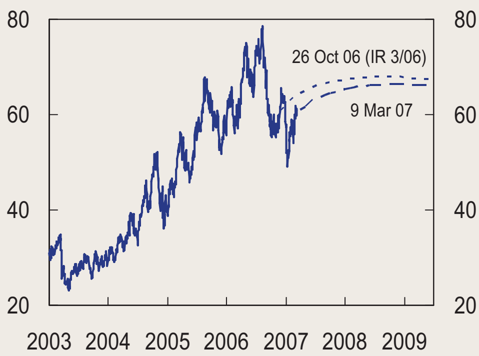
Chart 3 IEA's forecasts for growth in demand and production in 2007. Change in million barrels per day from previous year. Monthly figures. Jul 06 – Feb 07



1) See notes to Table 1 below.

Sources: International Energy Agency (IEA) and Norges Bank

Chart 4 Oil price (Brent Blend) in USD per barrel. Daily figures. 2 Jan 03 – 9 Mar 07. Futures prices from 26 Oct 06 and 9 Mar 07. Monthly figures. Dec 06 – Sep 09



Sources: Reuters (EcoWin) and Norges Bank

Whether OPEC decides on further production cuts – particularly at the beginning of the second quarter, when demand for oil shows a seasonal decline – will primarily depend on whether prices fall again. In addition, OPEC will place emphasis on developments in oil inventories, projected growth in global oil demand and growth in supplies from non-OPEC countries.

According to statements from a number of member countries, OPEC will seek to keep the oil price over USD 50, possibly close to USD 60 per barrel. Although spot prices and short-term futures prices have fallen to USD 50 – 55 in periods, the longer futures prices have remained at over USD 60 per barrel for the most part. Thus, market participants appear to believe that OPEC is willing and able to defend its price ambitions. Oil inventories have fallen since OPEC reduced production in November last year. Growth in global demand for oil appears to remain firm, while estimated growth in the supply of oil from non-OPEC countries has been revised down recently (see Chart 3). This would indicate that the need for further OPEC cuts to prevent an increase in oil inventories in the period ahead has declined.

In the table, forecasts from the International Energy Agency (IEA) are compared with those of the US Energy Information Administration (EIA) and OPEC.

The forecasts of the various institutions indicate that there is no need for further OPEC production cuts in 2007 as a whole, as crude oil production in

Table 1 Global demand and supply from non-OPEC countries in 2007.
Growth in millions of barrels per day from 2006, unless otherwise specified.1)

	IEA	EIA	OPEC
Global demand	1.5	1.6	1.2
Supply from non-OPEC2)	1.2	0.7	1.2
Call on OPEC, level3)	30.6	30.5	30.2
OPEC's crude oil production, January 2007, level4)	30.2	30	30

1) The projections are based on the different institutions February reports. As of January, Angola is a member of OPEC, and is therefore not included in non-OPEC. The growth in supply from this group is thus considerably smaller than earlier, as Angola has had and is expected to have high production growth. Angola is not yet covered by OPEC's quotas.
2) Non-OPEC supply includes crude oil, NGL (including from OPEC), condensates and oil from non-conventional sources.
3) Call on OPEC is the difference between global demand and non-OPEC supply. OPEC's production quotas only include the cartel's crude oil production.
4) The figures may vary as the institutions use different data sources.

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

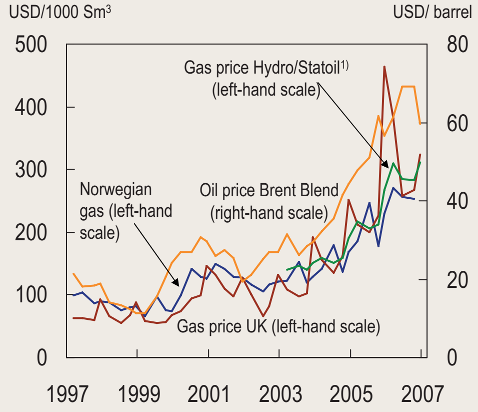
January 2007 was lower than the average need for OPEC production in 2007. Both the IEA and the EIA envisage a tighter oil market than OPEC.

Futures prices are used in this report as a technical assumption (see Chart 4). These prices now indicate an oil price of USD 62 in 2007 and USD 66 in 2008, somewhat lower than in *Inflation Report* 3/06. At the beginning of each month, *Consensus Forecasts* publishes a forecast for the most likely price of US benchmark oil West Texas Intermediate (WTI) three months and one year ahead. These forecasts are currently fairly consistent with corresponding futures prices. Oil options prices at the beginning of March show a much higher probability that the price of WTI will be over USD 90 in December 2008 than that it will be under USD 30. This may reflect some concern about possible supply disruptions. However, the potential for a dramatic fall in oil prices is limited by a fairly positive outlook for the world economy and by OPEC's central market position.

The price of Norwegian gas follows the oil price with a certain lag because gas is largely sold under oil-indexed contracts (see Chart 5). However, some of the gas is sold in spot markets, particularly in the UK. The gas price in the UK fell through 2006 as a result of higher import capacity, mild weather and lower oil prices. However, the price of Norwegian gas is expected to hold up in tandem with oil prices.

A fall in prices in a number of commodity markets at the beginning of 2007 raised the question of whether the pronounced price rise of recent years was being reversed (see Chart 6). The experience of previous commodity price cycles indicates that rising prices gradually lead to increased supply and reduced demand. This in turn leads to a fall in prices. Futures prices that are lower than spot prices for several industrial metals indicate expectations of a price fall, which is consistent with a moderate slowing of the global economy. This development may also reflect lower risk premia on prices as a result of somewhat higher inventories and increased supply-side capacity. However, prices for food and other agricultural products have showed some increase recently, reflecting two factors in particular. Increased demand for biofuels leads indirectly to higher food prices. Climatic conditions have also resulted in poor harvests in some regions.

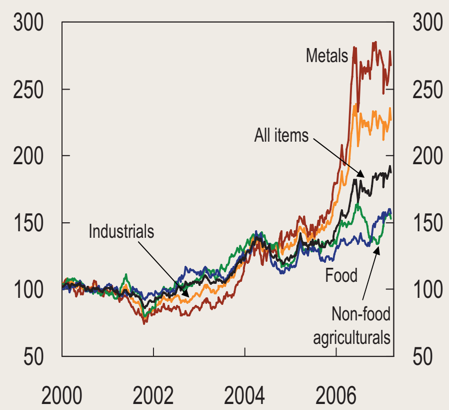
Chart 5 Prices for crude oil and natural gas. Gas price in USD/1000 Sm³. Oil price in USD/barrel. Quarterly figures. 97 Q1 – 06 Q4



1) Weighted average gas price. Statoil weighted with 0.7, Hydro weighted with 0.3.

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

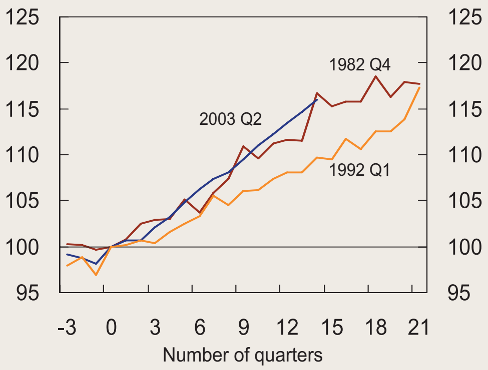
Chart 6 *The Economist* commodity price index. 2000 = 100. USD. Weekly figures. Week 1 2000 – Week 10 2007



Sources: Reuters (EcoWin) and *The Economist*

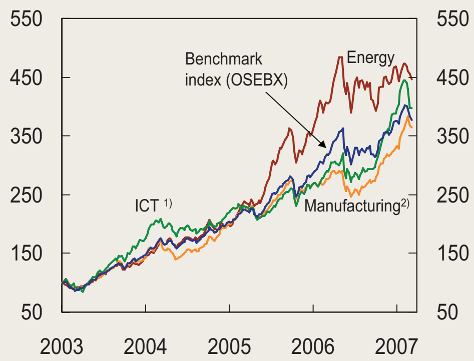
1 In his State of the Union address, President Bush proposed increasing strategic oil reserves to 1.5bn barrels by 2027. At end-January 2007, reserves totalled 688m barrels. The proposal requires congressional approval. Approval will imply an increase in demand for oil of about 110 thousand barrels per day up to 2027, according to the US Department of Energy's Energy Information Administration.

Chart 2.7 Mainland GDP. Developments after the start of a cyclical upturn. Index. Quarter 0 = 100. Seasonally adjusted



Sources: Statistics Norway and Norges Bank

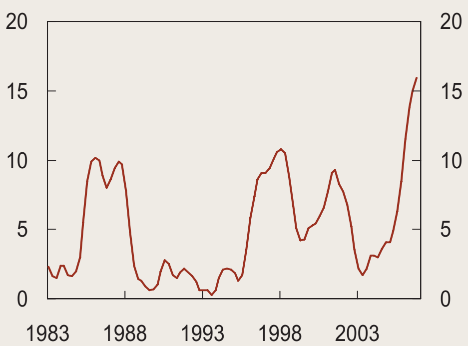
Chart 2.8 Developments in some sub-indices on the Oslo Stock Exchange. Week 1 2003 = 100. Week 1 2003 – Week 10 2007



1) Average of IT and telecommunications indices.
2) Average of industrials and materials indices.

Sources: Reuters (EcoWin) and Norges Bank

Chart 2.9 Business tendency survey. Labour shortages in manufacturing.[1] Smoothed. Per cent. Quarterly figures. 83 Q1 – 06 Q4



1) Share of companies reporting that labour shortages are a production constraint.

Source: Statistics Norway

Strong growth and high capacity utilisation in the Norwegian economy

Since summer 2003, economic activity in Norway has picked up markedly. Growth has been stronger than during the economic upturn in the mid-1990s (see Chart 2.7). The continuous growth period of recent years is the longest ever recorded in the quarterly national accounts, which includes figures back to 1978. At the same time, the growth capacity of the economy has been high. Strong productivity growth and in turn also the supply of labour have contributed to high growth in potential output.

The upturn is broad-based. The global expansion of recent years has resulted in strong growth in export industries and high prices for many Norwegian export goods. Norway's terms of trade have improved by almost 40% since 2002. Investment in the petroleum sector has risen sharply. Strong demand growth and solid profitability have gradually also resulted in higher business fixed investment. Statistics Norway's business tendency survey and order statistics show high order reserves, and a high level of new orders suggests that both manufacturing investment and output may rise further through winter and spring 2007. Low interest rates and high real income growth have contributed to strong growth in housing investment and household consumption. Increased employment and wage growth continue to contribute to high growth in household demand, as indicated by the most recent goods consumption figures from Statistics Norway. Information from Norges Bank's regional network indicates that growth in general government demand has also picked up somewhat. However, the rise in housing investment is levelling off, primarily as a result of capacity problems in the building sector.

The upturn has resulted in high activity growth in many sectors of the economy, including the industries supplying goods and services to the petroleum sector, shipbuilding, construction and service production. Companies listed on the Oslo Stock Exchange have reported solid results. The energy index has shown the strongest rise, but the sub-indices for manufacturing and ICT have also contributed to the gains in the benchmark index (see Chart 2.8).

The use of economic resources has increased markedly since summer 2003, and capacity utilisation is now very high in most industries. In the most recent rounds of the regional network, a large share of companies reported that they would have difficulty accommodating an increase in demand. The labour market has tightened further in recent months. Employment increased sharply last year, and growth was also strong towards the end of the year. Such a high a level of employment growth from one year to the next has not been recorded since 1985-1986 and 1997-1998.

Unemployment has fallen further since the previous *Report*. Since September 2006, seasonally adjusted registered unemployment has been lower than around the previous cyclical peak. In February, seasonally adjusted registered unemployment was 2.1 per cent of the labour force.

The number of unfilled vacancies is rising, and a growing number of enterprises report a shortage of qualified labour (see Chart 2.9). There were signs of accelerating wage growth through autumn. In the business tendency survey, the manufacturing indicator that shows shortages of intermediate goods and electricity is about twice as high as in previous expansions. The regional network reports that the building industry is having problems procuring building materials.

The output gap reflects our assessment of overall capacity utilisation in the economy in relation to a normal level (see Chart 2.10). New national accounts figures show that activity in the Norwegian economy increased at a faster-than-projected pace in the period 2004 – 2006. The figures also indicate that productivity growth, and hence potential growth, have been higher than expected. As a result, the output gap was somewhat more negative in 2003 than envisaged earlier. The low rise in prices for domestically produced goods and services in spite of a high level of activity also points to high productivity growth. Considerable labour inflows have also added to the growth potential of the economy. On balance, we assume that the output gap through 2006 was approximately as estimated in *Inflation Report* 3/06.

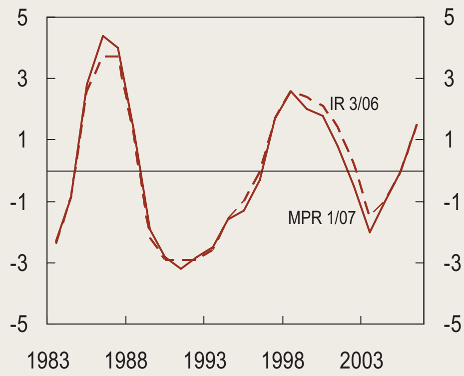
On the basis of current economic indicators, various statistical models indicate that GDP growth may remain solid in the first half of 2007 (see Chart 2.11). The enterprises in the regional network report continued growth in demand and production. On the other hand, unemployment has now declined to a very low level, and limited slack in the economy is probably exerting downward pressure on growth. It is our assessment that the output gap will be somewhat higher in the first half of the year than projected in *Inflation Report* 3/06 (see Chart 2.12), but still lower than around the previous cyclical peak.

High activity level, but gradual slowdown up to 2010

Petroleum investment at a high but stable level

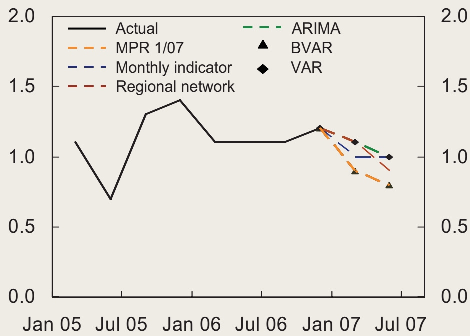
Increased investment activity on the Norwegian continental shelf has accounted for a large share of growth in domestic activity in recent years. The investment intentions survey in 2007 Q1 indicates that growth in petroleum investment will be a little higher in 2007 than projected earlier.

Chart 2.10 Estimates for the output gap. Per cent. Annual figures. 1983 – 2006



Source: Norges Bank

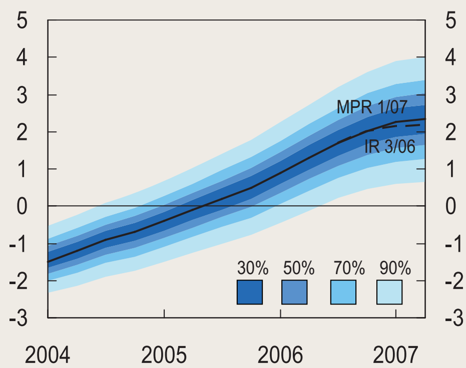
Chart 2.11 Mainland GDP. Growth on previous quarter. Seasonally adjusted. Per cent. Quarterly figures. 05 Q1 – 07 Q2[1)]



[1)] Projection for period 07 Q1 – 07 Q2. See box "Short-term forecasts for mainland GDP in Norway" in *Inflation Report* 2/06 for a description of the different models

Sources: Statistics Norway and Norges Bank

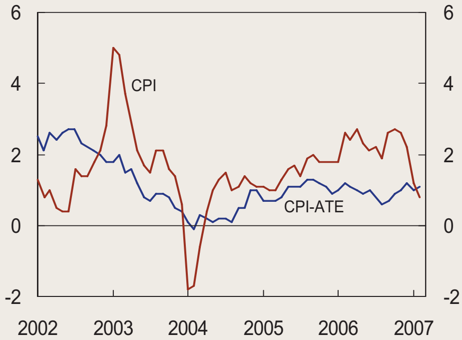
Chart 2.12 Estimates for the output gap in IR 3/06 and MPR 1/07 with fan chart. Per cent. Quarterly figures. 04 Q1 – 07 Q2



Source: Norges Bank

Recent price developments

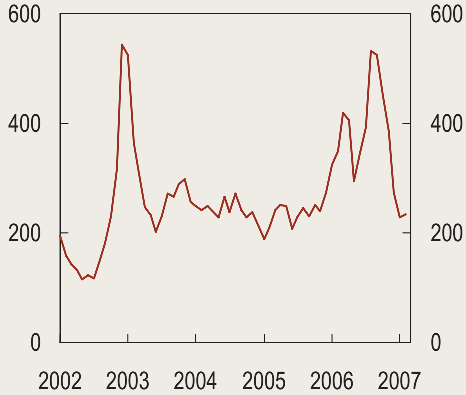
Chart 1 CPI and CPI-ATE[1]. 12-month change. Per cent. Monthly figures. Jan 02 – Feb 07



[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.

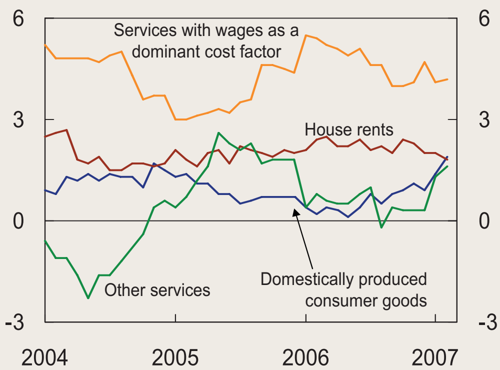
Sources: Statistics Norway and Norges Bank

Chart 2 Electricity prices. Nordpool. NOK/MWh. Monthly figures. Jan 02 – Feb 07



Source: Nordpool

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



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

Source: Statistics Norway

The 12-month rise in the consumer price index (CPI) was 0.8% in February 2007 (see Chart 1). CPI inflation has been considerably lower than projected in the previous report, primarily reflecting a stronger-than-expected fall in electricity prices (see Chart 2).

Our assessment is that underlying inflation is now in the interval 1 – 1½%. Inflation adjusted for tax changes and excluding energy products (CPI-ATE) was somewhat higher than expected last autumn, but has been broadly in line with projections so far in 2007. The year-on-year rise was 1.1% in February, and has picked up from 0.7% in September. Adjusted for the reduction in day-care rates in January 2006, inflation was 0.7% in September. Inflation measured by a trimmed mean was 1.6% in December, but slowed to 1.2% in January and fell further to 1.1% in February. Inflation measured by a weighted median has varied somewhat in the past six months, however. In October and November 2006, inflation measured by this indicator was 2.3%, while it was 1.7% in January and February this year.

Increasing domestic inflation

After ranging between 1.6% and 1.7% since September 2006, the 12-month rise in prices for domestic goods and services moved up to 2.0% in February. The rise in prices for domestically produced consumer goods has accelerated markedly since September (see Chart 3).

The VAT rate for food was increased from 13% to 14% from December to January. While food prices in the CPI only rose by 0.4% from December to January, the rise was 1.2% from January to February. This may indicate that some grocery chains did not price in the VAT increase for food until February.

The 12-month rise in prices for services where wages are the dominant cost factor was 4.2% in February. The rise in house rents has varied between 2.0% and 2.5% over the past year, but the annual rate of increase slowed to 1.8% in February. The rise in prices for other services (services with dominant price components other than wages) has increased somewhat so far in 2007. In February, the year-on-year rise was 1.6%. The introduction of lower maximum day-care rates contributed to a lower rise in prices for this group in 2006.

Fall in prices for imported consumer goods

The 12-month rise in prices for imported consumer goods increased sharply in the last months of 2006, but fell markedly in January 2007. Some of the fall from December to January is probably attributable to extraordinary sales activity. In February, prices were 1% lower than in the same period one year earlier. In *Inflation Report* 3/06, the price fall was projected to be somewhat smaller.

Clothing prices rose by 1.5% in February, after falling sharply by 12.0% in the previous month. The fall in these prices in January is the steepest fall ever recorded. According to Statistics Norway, some clothing sales were still recorded in February and clothing prices were then 6.3% lower than the same month one year earlier (see Chart 4). Furniture prices rose by 5.9% in February, after declining by 3.8% in January.

Fall in electricity prices

The rise in electricity prices was very high through the first six months of 2006 and peaked in September when electricity prices in the CPI were 48% higher than in the same month one year earlier. Mild weather and high precipitation levels through autumn led to a marked fall in electricity prices. In February 2007, electricity prices were 11.5% lower than one year earlier.

Petrol prices have edged down over the past six months. In February, petrol prices were 0.5% lower than in the same month one year earlier.

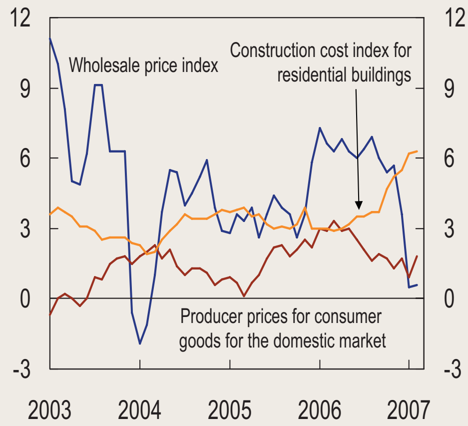
Other indicators of inflation

Lower energy prices through autumn 2006 pushed down the rise in both the producer price index and the wholesale price index (see Chart 5). However, the rate of increase in these indices edged up again in February 2007. Since September the annual rate of increase in producer prices for consumer goods slowed from 1.9% to 1.8% in February 2007. The rise in wholesale prices slowed from 6.9% to 0.6% in the same period. The construction cost index for residential buildings increased in the last six months of 2006, and was 6.3% higher in February 2007 than in the same month one year earlier.

Chart 4 Prices for clothing and footwear. 12-month change. Per cent. Monthly figures. Jan 05 – Feb 07

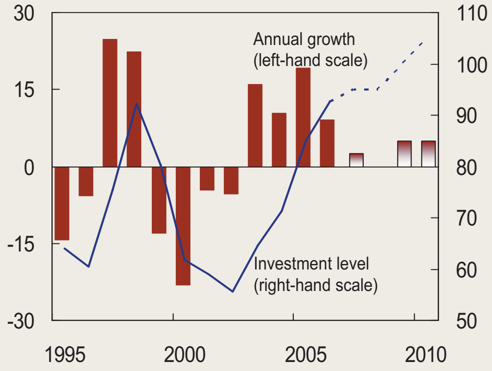
Source: Statistics Norway

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



Source: Statistics Norway

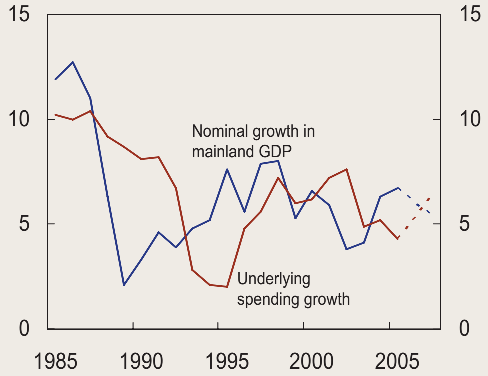
Chart 2.13 Investment in oil and gas recovery including pipeline transport. Investment level in billions of NOK (constant 2004-prices) and annual growth (per cent). Annual figures. 1995 – 2010[1)]



[1)] Projections for 2007 – 2010.

Sources: Statistics Norway and Norges Bank

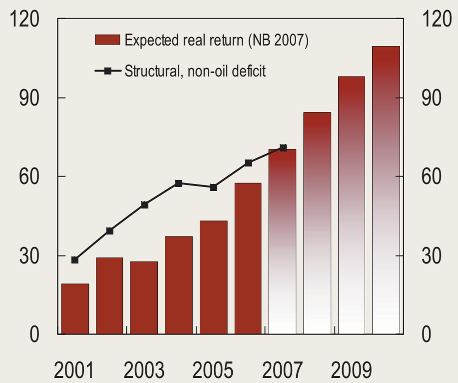
Chart 2.14 Underlying spending growth in the government budget and nominal growth in mainland GDP. Per cent. Annual figures. 1985 – 2007[1)]



[1)] Projections for 2006 and 2007 from the Ministry of Finance.

Sources: Ministry of Finance (National Budget 2007) and Statistics Norway

Chart 2.15 Expected real return on the Government Pension Fund - Global. In billions of 2007-NOK. Annual figures. 2001 – 2010



Source: Ministry of Finance (National Budget 2007)

The number of exploration wells increased twofold between 2005 and 2006, and the number will probably increase again this year. The large number of wells is making a positive contribution to the resource base, and may in turn underpin investment activity. Fewer-than-planned wells are nevertheless being drilled owing to a shortage of rigs. The supply of rigs will increase during the projection period, which may boost investment in exploration.

Petroleum investment is expected to remain at a high level in the years ahead, but growth is expected to be moderate compared with recent periods (see Chart 2.13). Oil prices are lower than in summer 2006, but are still substantially higher than the prices on which oil companies normally base their investment plans. The number of companies with interests on the Norwegian continental shelf has increased in recent years. The emergence of new, smaller companies will probably contribute to a steady level of investment in the period ahead, with a number of small and medium-sized projects.

There is substantial uncertainty associated with future petroleum investment. Major new projects may be launched sooner than expected and result in stronger-than-expected growth in investment. New forecasts from the Norwegian Petroleum Directorate indicate that oil production on the Norwegian continental shelf may be appreciably lower in the next few years than indicated by earlier forecasts. At the same time, the large oil companies have high production targets, which may demand higher investment than previously assumed. Nevertheless, it is uncertain whether companies will decide to invest more on the Norwegian continental shelf or whether they will prefer to increase investment in foreign fields.

Public sector underpins demand

Public sector demand is still contributing to supporting domestic demand (see Chart 2.14). According to the final budget bill, the structural, non-oil government budget deficit was NOK 62.5bn in 2006. This implies nominal underlying spending growth in the government budget of 5.2%. Local government nominal revenue growth can be estimated at 8.5%. Tax revenues in 2006 probably increased more than previously estimated, entailing an upward revision in growth in local government revenues.

According to the supplementary budget proposition, changes in the proposal to tighten the sick pay scheme will result in a higher-than-expected increase in government expenditure in 2007 compared with that estimated in the National Budget. However, the estimate for tax revenues has also been revised up. The estimate for the structural, non-oil government budget deficit has not been changed.

According to preliminary national accounts figures, growth in public demand in 2006 was a little lower than budgeted. Norges Bank's projections are based on the assumption that some of the underspending in 2006 will result in higher public sector demand in 2007.

According to the fiscal rule, petroleum revenue spending shall be limited to the expected real return on the capital in the Government Pension Fund – Global. According to the government budget for 2007, petroleum revenue spending will be close to this level (see Chart 2.15). In the National Budget for 2007, it is estimated that the expected real return on the Government Pension Fund – Global will increase sharply in the years ahead. Oil futures prices are higher than assumed in the National Budget. In isolation, the capital transfers to the Pension Fund, and hence the real return, may be somewhat higher than estimated in the National Budget. On the other hand, new forecasts from the Norwegian Petroleum Directorate show that petroleum production in the next few years may be significantly lower than assumed in the National Budget. As from 2008, this will push down the expected real return to about the level estimated in the National Budget.

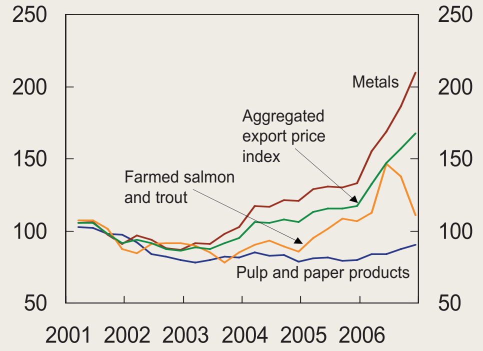
In a situation with a high level of domestic economic activity, petroleum revenue spending in the period ahead will be consistent with the fiscal rule if it increases at a slower pace than the expected real return on the Fund, which is estimated at 4%. In the next few years, growth in the structural, non-oil budget deficit is therefore assumed to be somewhat lower than implied by the 4% rule. However, public sector demand is still expected to make a positive contribution to total demand and production through the projection period.

External developments point to continued solid export growth

Strong growth in global markets and a high rise in prices for a number of our traditional export products have resulted in solid earnings for the export industry in recent years (see Charts 2.16 and 2.17). Prices will probably remain high, but will increase at a more moderate pace. There has been some unrest in metal markets since the beginning of the year, but prices for Norway's main metal exports have remained relatively stable.

Growth among our trading partners remains strong, providing a basis for high prices and continued strong growth in mainland exports. Capacity constraints in some export industries may dampen growth. On the other hand, investment and the re-opening of temporarily closed production facilities may add to capacity. In the period ahead, weak competitiveness may contribute to dampening export growth.

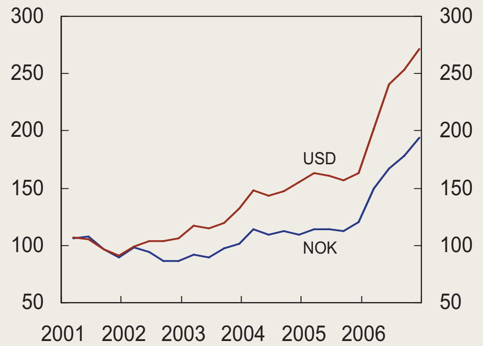
Chart 2.16 Price indices[1)] for exports from Norway in NOK. 2001 = 100. Quarterly figures. 01 Q1 – 06 Q4



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

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

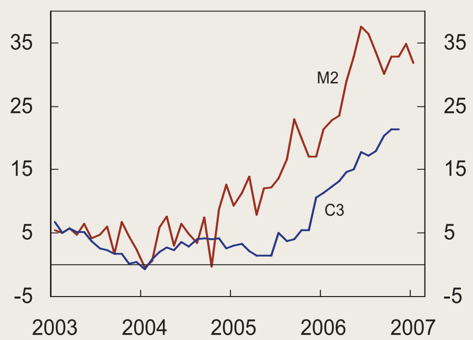
Chart 2.17 Price index[1)] for exports of non-ferrous metals[2)] from Norway in USD and NOK. 2001 = 100. Quarterly figures. 01 Q1 – 06 Q4



[1)] Norges Bank's estimates based on world market prices.
[2)] Aluminium, nickel, copper and zinc.

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

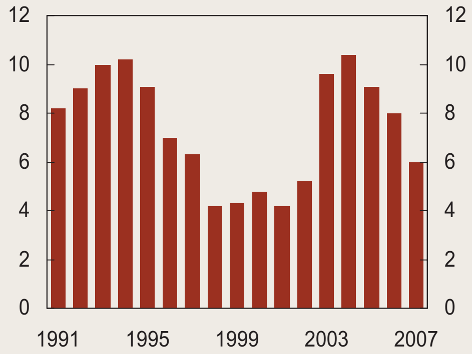
Chart 2.18 Credit to enterprises[1)] and enterprises' liquid assets[2)]. 12-month change. Per cent. Jan 03 – Jan 07



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

Source: Statistics Norway

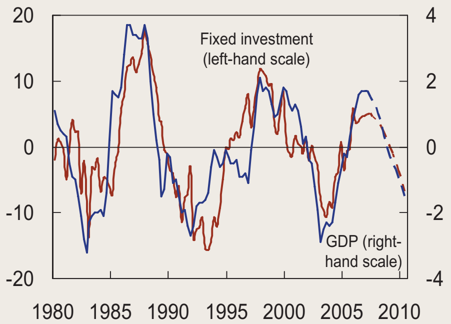
Chart 2.19 Vacant office premises in Oslo, Asker and Bærum. Share of total real estate stock. Annual figures.[1] 1991 – 2007



[1] As at February.

Source: Eiendomsspar AS

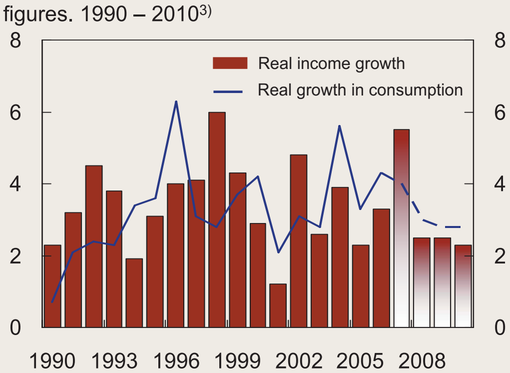
Chart 2.20 Mainland GDP and fixed investment. Percentage deviation from trend.[1] Quarterly figures. 80 Q1 – 10 Q2[2]



[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

Chart 2.21 Household real disposable income[1,2] and consumption. Annual rise. Per cent. Annual figures. 1990 – 2010[3]



[1] There is a break in the series between 1998 and 1999.
[2] Adjusted for estimated reinvested share dividends for 2000 – 2005.
[3] Projections for 2007 – 2010.

Sources: Statistics Norway and Norges Bank

Slower growth in business investment

Growth in business fixed investment will probably remain at a high level again this year. High export prices, low interest rates and cost efficiency measures following restructuring during the previous downturn have contributed to strong profitability growth. Preliminary accounts figures for the largest companies on the Oslo Stock Exchange indicate some levelling off in operating margins, but at a high level. Growth in credit to enterprises is on the rise. The stock of liquid assets is growing even faster (see Chart 2.18). The financial position of enterprises appears to be solid. A number of surveys, including the investment intentions survey for manufacturing, Statistics Norway's business tendency survey and the regional network, show that enterprises generally expect continued solid production growth and a high level of new orders. One exception is suppliers to the petroleum industry, where lower growth in petroleum investment may curb investment growth.

Strong growth in employment has reduced the excess capacity in the commercial property market, and there is now relatively limited vacant office space in some parts of Norway (see Chart 2.19). Figures for commercial property starts point to continued growth in investment in commercial buildings in the near term. After a period, however, growth may stagnate as a result of limited capacity in the building industry.

Business investment normally fluctuates in pace with the level of economic activity, with wider fluctuations through the business cycle (see Chart 2.20). After a period, a higher interest rate level and lower mainland GDP growth will probably reduce investment growth. Profitability will decline as a result of a higher rise in costs. Towards the end of the projection period, business investment will probably decline.

Interest rate hikes will curb growth in household consumption

High employment and real wage growth are contributing to strong growth in private consumption again this year (see Chart 2.21). Low unemployment and a high level of job security are bolstering growth in consumption. This also applies to higher asset prices, particularly for dwellings (see Chart 2.22). According to TNS Gallup's trend indicator, households are optimistic with regard to the outlook for their own financial position and the Norwegian economy.

Further out in the projection period, the gradual rise in interest rates is expected to restrain growth in household demand. Growth in household disposable income will slacken when interest rates rise and employment growth slows. With higher interest rates, it will be less attractive to debt-finance consumption and more attractive to save. In

2006 Q3, household debt came to 190% of household disposable income. The high debt level amplifies the impact of higher interest rates on household disposable income. More intense competition in the financial sector and adaptation to new capital adequacy requirements have reduced bank lending margins. Household borrowing rates have risen less than Norges Bank's policy rate for the past two years. It is assumed that a larger share of interest rate increases will be passed on to lending rates in the period ahead.

The household saving ratio is low and was negative in the second half of 2006, probably for the first time since the 1980s. Household net lending has fallen over the past few years and is now negative (see Chart 2.23). It is assumed that the saving ratio will remain at a low level in the period ahead and that net lending will level off around the current level.

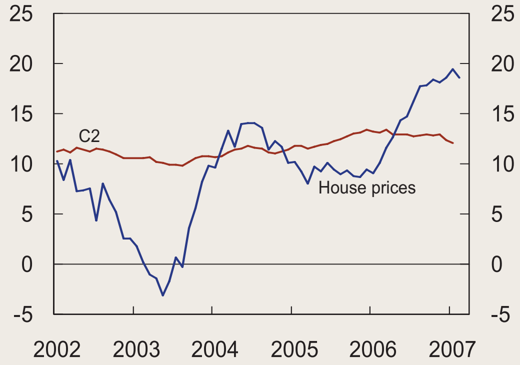
High demand for dwellings has contributed to a sharp rise in prices for both new and existing dwellings. House prices are expected to remain high over the next few years, but to rise more slowly as a result of higher interest rates. There is a substantial need for new dwellings, partly because of rapid population growth and increased urban migration. Because of capacity problems in the building industry and higher construction costs, growth in housing investment is expected to slow. Housing investment may drop towards the end of the projection period.

Tight labour market and little spare production capacity

So far, the sharp growth in demand for labour has been accommodated by both an increase in the labour supply and a decline in the number unemployed. Labour force participation has increased in recent years, but is still somewhat lower than during the previous expansion. Over a longer period, the share of the population on early retirement or disability benefit has been on the rise. In isolation, this leads to lower participation rates. After adjusting for this factor, labour force participation rates are now just below the levels recorded during the previous economic boom. There are still some available person-hour resources as a result of underemployment.

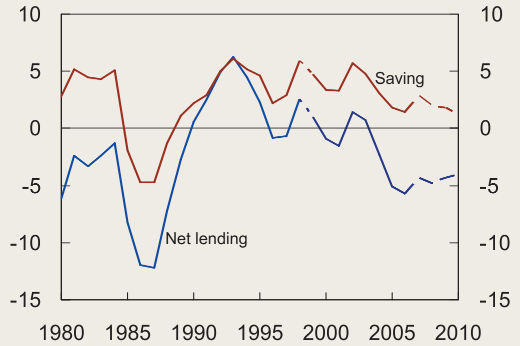
Labour force growth is expected to slow in the period ahead. The working-age population (16-74) is expected to increase by about 1% each year until 2010. The youngest and oldest age groups, which feature low participation rates, will account for a growing share of the labour force. In the case of the oldest groups, a high propensity towards disability benefit pushes down labour force participation. From 2008, the large post-war cohorts will gradually approach the age when they can retire under the contractual early retirement scheme (see Chart 2.24). The change in age composition will contribute to curbing labour force growth.

Chart 2.22 House prices and credit to households (C2). 12-month change. Per cent. Monthly figures. Jan 02 – Feb 07



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

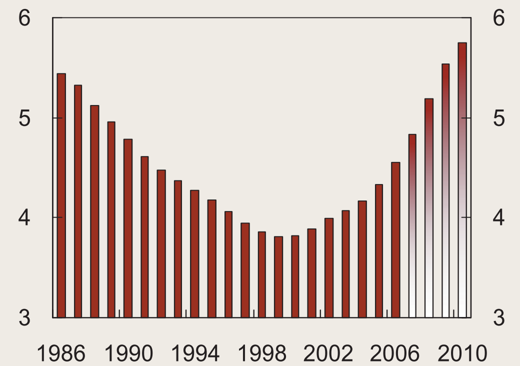
Chart 2.23 Household saving and net lending as a share of disposable income.[1,2] Annual figures. 1980 – 2010[3]



[1] There is a break in the series between 1998 and 1999.
[2] Adjusted for estimated reinvested share dividends for 2000 – 2005.
[3] Projections for 2007 – 2010.

Sources: Statistics Norway and Norges Bank

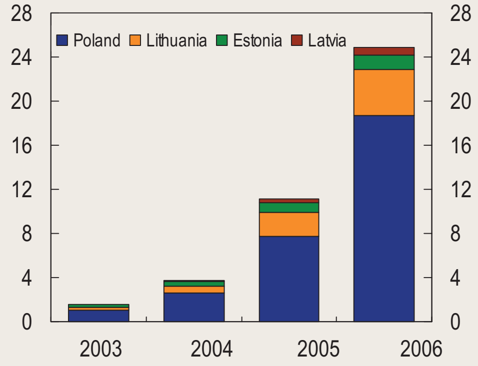
Chart 2.24 Population aged 62 to 67. Share of total population. Mean population. Annual figures. 1986 – 2010[1]



[1] Projections for 2007 – 2010.

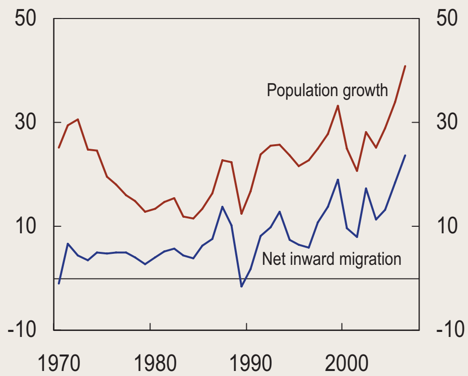
Sources: Statistics Norway and Norges Bank

Chart 2.25 Registered employees from new EU countries. In thousands. Annual figures. 2003 – 2006



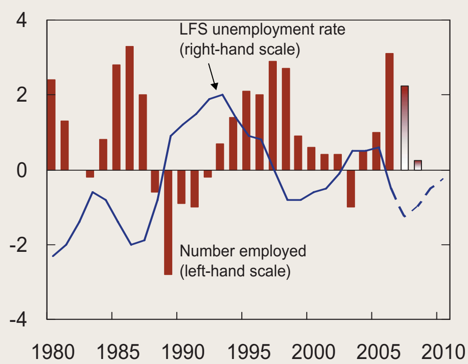
Source: Central Office - Foreign Tax Affairs

Chart 2.26 Population growth and net inward migration. In thousands. Annual figures. 1970 – 2006



Source: Statistics Norway

Chart 2.27 Percentage change in employment on previous year and unemployment (LFS) as a percentage of the labour force. Annual figures. 1980 – 2010[1)]



1) Projections for 2007 – 2010.

Sources: Statistics Norway and Norges Bank

In periods of high employment growth, favourable conditions for finding employment will in itself contribute to increasing the labour supply. This makes a cyclical contribution to labour force growth. It is assumed that this effect will taper off in the course of 2007, but will still contribute to growth in the labour force from 2006 to 2007.

In the past three years, inward labour migration, particularly from the new EU member states, has increased the supply of labour and eased pressures in the labour market. In 2006, the number of persons from new EU member states on short-term assignments in Norway was 15 000 higher than in 2005 (see Chart 2.25). This is equivalent to an increase in the labour supply of about ½ percentage point in excess of growth in the traditional labour force of 1.6%. However, some of this inflow is not defined as employment in the national accounts. Work in the form of short-term assignments carried out by foreigners who are employed in foreign enterprises is defined as imported services. Irrespective, these workers increase the supply of labour in Norway.

It is assumed that the number of foreigners on short-term assignments may increase further by about 10 000 persons in 2007. In addition, a number of those on short-term assignments have decided to settle here, resulting in population growth that is higher than previously assumed in Statistics Norway's population projections (see Chart 2.26). If this trend continues, the working-age population will increase faster than indicated by Statistics Norway's current population projections.

Demand for labour is now increasing in the countries of origin of this labour. At the same time, it is assumed that demand for labour and employment growth in Norway will moderate (see Chart 2.27). With an already high number of workers on short-term assignments, the growth rate will probably abate gradually.

Capacity utilisation may peak in 2007

A lack of spare capacity will probably dampen output growth later in 2007. Despite high growth in the labour supply and inflows of labour from other countries, a shortage of labour will probably act as a constraint on further growth in a number of enterprises. Many enterprises report shortages of qualified labour as well as a shortage of intermediate goods and electricity.

To what extent growth in demand in 2007 can be met by higher growth in domestic production depends on productivity growth and the labour force. Both these variables have increased sharply in recent periods. After growing at a fast pace, productivity growth will normally edge down. Productivity growth has also slowed earlier when approaching the cyclical peak, for example in 1998 and

1999. It is assumed that productivity growth in 2007 will be somewhat lower than the average for the last 15 years. Coupled with somewhat lower labour force growth, this will lead to somewhat lower potential GDP growth in 2007 than in 2006.

Data shortcomings make it difficult to measure productivity growth. National accounts figures are highly uncertain and prone to extensive revision over time. For several of the years between 2000-2005 productivity growth has later been revised up (see Chart 2.28). The high productivity growth registered in the Norwegian economy since the end of the 1990s may be an expression of a more permanent shift (see Chart 2.29). In the event, the potential for sustained high economic growth will be greater than assumed, and the output gap, which is an expression of capacity utilisation in the economy, will be somewhat lower.

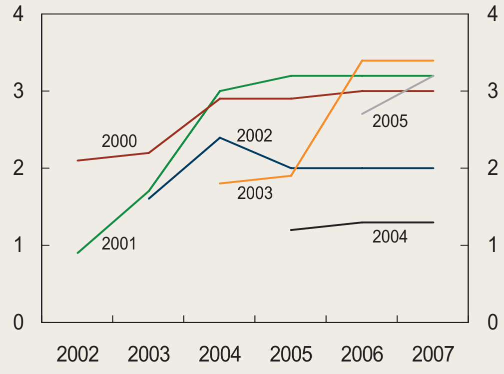
The output gap will show a further increase from 2006 to 2007 and the cyclical peak will be reached in the course of 2007 according to our projections. Economic growth remains buoyant, supported by robust demand growth. In the light of the constraints on further growth in domestic production, imported goods and services will probably account for a rising share of demand. It is therefore assumed that import shares in 2007 will increase at a somewhat faster pace than trend.

The number employed also increased sharply in 2006 (see Chart 2.30), and employment growth will also be high this year. According to the regional network, all industries are planning to increase employment, but at a somewhat slower pace than at the end of 2006. It is estimated that unemployment will reach its lowest level in this cyclical upturn in the course of the year.

As from 2008, slower growth in domestic demand and the gradual rise in the interest rate will result in production growth that is below potential growth. Unemployment may thus increase somewhat, but will probably remain at a low level up to 2010. The output gap will gradually close. Slower growth in private consumption and housing investment and lower investment growth in private enterprises are the primary forces behind slower growth in domestic demand towards the end of the projection period. Weak competitiveness may gradually depress growth in export-oriented industries.

It is assumed that growth in private consumption and investment will ease towards the end of 2007. If growth in these demand components remains at a high level for a longer period than expected, the decrease in the output gap may come at a later time than expected. In isolation, this might lead to a stronger rise in domestic costs and a

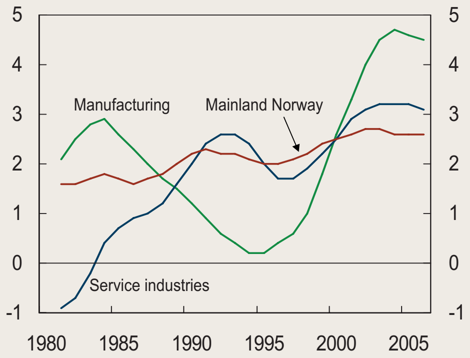
Chart 2.28 Mainland productivity growth.[1)] Per cent. Annual figures. 2002 – 2005



[1)]Value added per person-hour from 2000 to 2005 from different versions of the national accounts published in the period 2002 – 2007.

Sources: Statistics Norway and Norges Bank

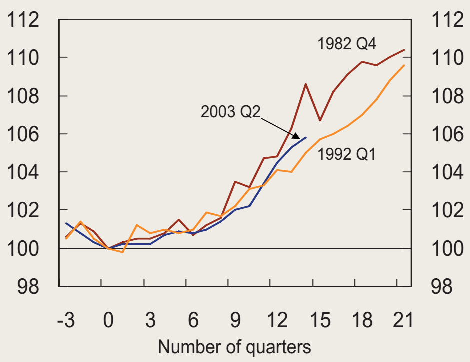
Chart 2.29 Productivity growth in manufacturing, service industries and mainland Norway. Trend.[1)] Per cent. Annual figures. 1981 – 2006



[1)] Trend calculated using Hodrick-Prescott filter. See Staff Memo 2005/2 (www.norges-bank.no) for further details.

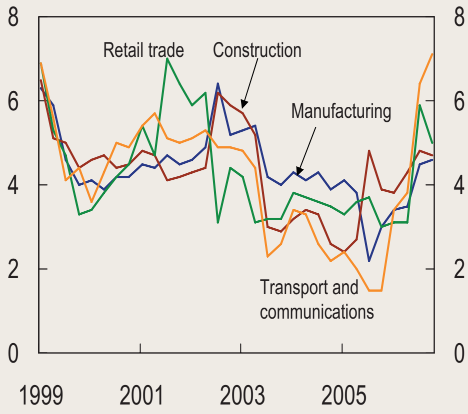
Sources: Statistics Norway and Norges Bank

Chart 2.30 Number employed (from quarterly national accounts). Developments after the start of a cyclical upturn. Index. Quarter 0 = 100. Seasonally adjusted



Sources: Statistics Norway and Norges Bank

Chart 2.31 Monthly pay. 4-quarter change. Per cent. Quarterly figures. 99 Q1 – 06 Q4



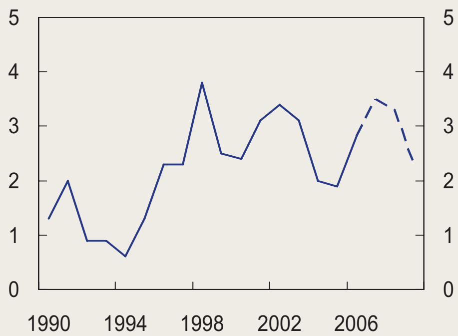
Source: Statistics Norway

Chart 2.32 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 2.33 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 mandatory occupational pension. Projections for 2007 – 2009.
2) 3-year centered moving average. CPI projections 2007 – 2010.

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

loss of competitiveness, which in turn may contribute to closing the gap and reducing demand for labour. On the other hand, household debt accumulation has been high for a long period. Further ahead, it is assumed that investment in financial assets will be negative. A rapid increase in household saving could result in markedly lower growth in domestic demand. The output gap will then close more rapidly.

Wage and price inflation will pick up

Wage growth is picking up

In recent years, increased inward labour migration and possibilities for relocating parts of production abroad have led to increased labour market competition. It is likely that this has contributed to restraining wage growth (see box on page 44). Last years' negotiated pay increases do not appear to fully reflect labour market tightening through the year. This may also be attributable to the fact that unemployment did not fall markedly until after the wage negotiations had begun. A tight labour market is likely to contribute to higher wage demands in 2007 and prompt companies to offer higher pay to many groups. Wage growth is now high in industries with solid profitability and in industries that make extensive use of bonuses, such as the petroleum sector and the financial sector (see Chart 2.31). Wage drift through 2006 was relatively high in several industries, especially for sought-after labour such as engineers and other workers with technical skills. The wage carry-over into 2007 is slightly higher than projected in *Inflation Report* 3/06.

The wage share in Norwegian companies has fallen in recent years and is now at the level prevailing in the mid-1990s. Unemployment is low. The number of job vacancies is increasing, while productivity growth in the business sector remains high. These factors, together with the decline in unemployment through the second half of 2006, form the basis for our current projection of some increase in wage growth this year (see Chart 2.32). With consumer price inflation of an estimated ¾%, real wage growth may prove to be very high. The increase in net interest expenses will curb growth in household real disposable income. 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. In 2008, nominal wage growth is projected at 5¼%, while real wage growth will moderate somewhat. For the two years as a whole, annual real wage growth is projected at 3½% (see Chart 2.33), which is higher than projected growth in productivity.

In that case, wage growth in 2007 and 2008 implies deteriorating profitability and an increase in the wage share in the business sector. In addition, rising prices for a number of intermediate goods and services, such as building materials and transport services, will contribute to an erosion of profitability in parts of the business sector. As resource utilisation in the economy declines and unemployment rises somewhat through 2009 and 2010, wage growth is also likely to decline.

Foreign competition, combined with possibilities for relocating production, may contribute to curbing wage growth ahead. However, it cannot be ruled out that labour shortages and expectations of high income growth may result in higher-than-projected wage growth.

Higher inflation from 2008

Consumer price inflation remained around 2.5% through much of 2006 (see Chart 2.34). The high rate of increase in electricity prices and oil prices pushed up the consumer price index (CPI). At the beginning of 2007, CPI inflation fell sharply owing to lower electricity prices.

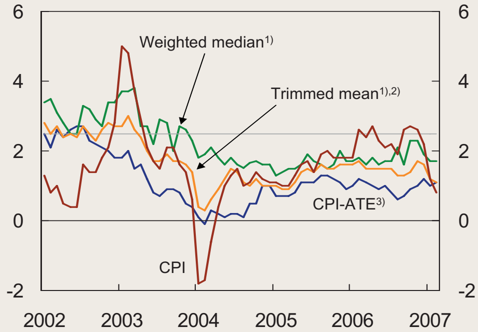
Following a period of slightly higher-than-projected inflation, underlying inflation is now approximately at the same level as projected in *Inflation Report* 3/06. Our overall assessment is that underlying inflation is now in the interval 1 – 1½%. Adjusted for tax changes and excluding energy products, the year-on-year rise in consumer price inflation (CPI-ATE) was 1.1% in February. CPI-ATE inflation has remained around this level in the past year. The rate of increase in prices measured by a trimmed mean of the rise in the sub-indices in the consumer price index was 1.1 per cent in February. As measured by the weighted median, the rate of increase was 1.7 per cent in February.

Forward electricity prices point to considerably lower electricity prices in 2007 than in 2006. This may result in very low inflation measured by the CPI through summer (see Chart 2.35). Fluctuations in electricity prices contribute to considerable uncertainty regarding CPI developments. Uncertain variables such as temperature and precipitation levels ahead will have a large impact on forward prices, and hence on our projections.

Consumer price inflation adjusted for tax changes and excluding energy products shows a more stable path. In the baseline scenario, the rise in the CPI adjusted for tax changes and excluding energy products gradually picks up towards 2½% over the next three years.

As the policy rate is gradually raised to a more normal level, demand and employment growth will abate, and wage growth will again moderate. This contributes to stabilising inflation close to target in the period to 2010.

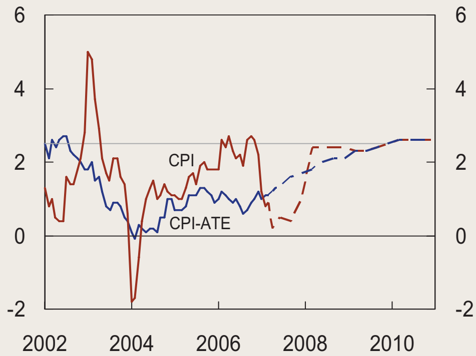
Chart 2.34 CPI and indicators of underlying inflation. 12-month change. Per cent. Monthly figures. Jan 02 – Feb 07



1) Estimated on the basis of 146 sub-groups of the CPI-AT
2) Price changes accounting for 20% 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

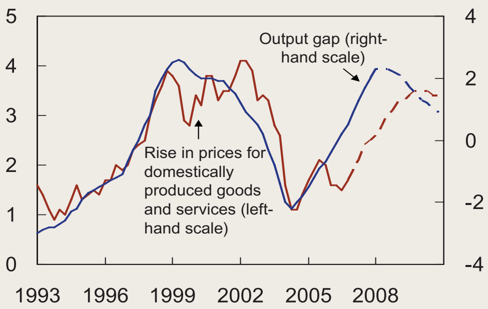
Chart 2.35 CPI and CPI-ATE[1]. 12-month change. Per cent. Monthly figures. Jan 02 – Dec 10[2]



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 March 2007 – December 2010.

Sources: Statistics Norway and Norges Bank

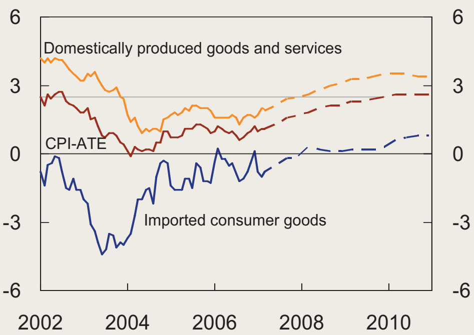
Chart 2.36 Rise in prices for domestically produced goods and services measured by the CPI-ATE1) (4-quarter rise) and output gap level (lagged by 4 quarters). Quarterly figures. 93 Q1 – 10 Q42)



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 2007 Q1 – 2010 Q4.

Sources: Statistics Norway and Norges Bank

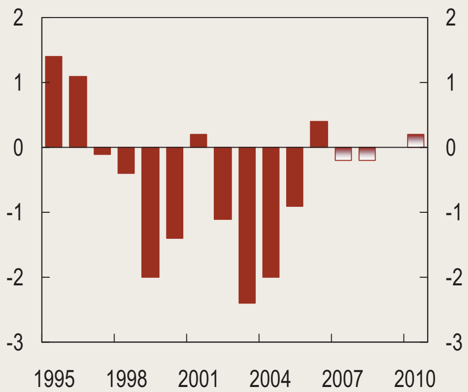
Chart 2.37 CPI-ATE.1) Total and by supplier sector2). 12-month rise. Per cent. Monthly figures. Jan 02 – Dec 103)



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 March 2007 – December 2010.

Sources: Statistics Norway and Norges Bank

Chart 2.38 Indicator of external price impulses to imported consumer goods measured in foreign currency. Per cent. Annual figures. 1995 – 20101)



1) Projections for 2007 – 2010.

Source: Norges Bank

Adjusted for the introduction of maximum day-care rates, the rise in prices for domestically produced goods and services was around 1.6% through most of 2006. In February 2007, domestic inflation rose to 2.0 per cent. There are probably several reasons why the rise in prices for domestically produced goods and services is picking up somewhat later during this cyclical expansion than the historical relationship between the rise in these prices and capacity utilisation would imply (see Chart 2.36). Moderate wage growth has contributed to low price increases in recent years, and accelerating wage growth through 2006 is probably not yet fully reflected in prices. It is likely that the subdued rise in prices for imported, processed intermediate goods has curbed the rise in prices for goods and services. In recent years, competition has increased in many product markets (see box on page 46). In many industries, high productivity growth has also had a dampening impact on inflation.

Some of these factors may continue to influence inflation in the period ahead, albeit to a lesser extent than earlier. While higher wage growth and more moderate productivity growth are contributing to increasing unit labour costs, continued strong competition may prevent this cost increase from fully feeding through to prices. However, it is assumed that competition will curb inflation to a lesser extent, and that high capacity utilisation along with accelerating wage growth will gradually push up the rise in domestically produced goods and services ahead (see Chart 2.37).

Developments in producer and wholesale prices may provide information on developments in consumer prices ahead. In the course of 2006, producer prices for consumer goods and the wholesale price index rose more than the rise in prices for domestically produced goods that are included in the CPI. Towards the end of 2006, the rise in both the producer price index and the wholesale price index was pushed down by the fall in energy prices. According to the regional network, expectations of a rise in selling prices ahead have increased in a number of industries, particularly in building and construction, domestically oriented manufacturing and corporate services. The rise in prices for these products may gradually be passed on to prices for household goods and services.

Imported consumer goods will continue to curb inflation

Trade liberalisation and a shift in imports towards low-cost countries have over a longer period resulted in negative price impulses from imported consumer goods, measured in foreign currency (see Chart 2.38). However, the shift in imports was somewhat less pronounced in 2006 than in previous years. This may indicate that price effects from trade shifts will be more moderate ahead. In 2006, the rise in prices for oil and other commodities over several years led to a somewhat sharper rise in producer and export prices among our traditional trading partners. Price impulses from imported goods, excluding the effects of exchange rate changes, were therefore positive.

We assume that the shift towards imports from low-cost countries will continue, but that it will gradually diminish through the projection period. Lower energy prices and a stabilisation or fall in other commodity prices will lead to slightly weaker imported price impulses in 2007 than in 2006. On balance, it is assumed that price impulses from imported consumer goods, measured in foreign currency, will be close to zero in the years ahead.

The krone appreciation through 2004 and 2005 contributed to cheaper imported consumer goods in 2006. The krone depreciated through the latter half of 2006, and on the whole previous exchange rate movements will have limited influence on price developments for imported goods in 2007. Further ahead, the krone is expected to be relatively stable. We project that higher domestic cost and price inflation will also lead to higher selling prices for imported goods. Selling prices for imported consumer goods will probably fall a little this year. These prices are expected to increase by between ¼% and ¾% in each year between 2008 and 2010.

Boxes

Will the global economy be affected by a slowdown in the US?

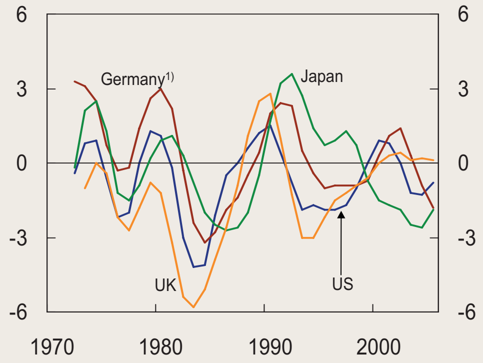
Historically, there has been a high degree of business cycle correlation across industrialised countries (see Chart 1). The correlation may result from exposure to the same type of shocks or the spread of shocks from one country or region to other parts of the world. Economic downturns in the US can spread to other countries via trade, financial markets and expectations.

In spite of slower growth in the US in recent years, the world economy has expanded at a sustained rapid pace (see Chart 2). An important driving force is the integration of China and other emerging economies into the world economy. These countries have accounted for a large share of global GDP growth in recent years. Potential production in the world economy has increased as a result of increased availability of highly competitive labour from these countries. Integration has led to higher real income both in emerging economies and in the US and Europe, generating considerable impetus to the world economy. In the euro area, growth has also picked up. An important question is whether the driving forces behind the expansion in Asia and Europe are sufficiently strong to sustain global growth should the growth in the US economy slow significantly.

Lower growth in the US will reduce demand in the US household and business sector, which will push down demand for import goods. Via the *trade channel*, this will dampen the activity level in countries that export to the US. In addition, a downturn in the US may lead to a depreciation of the US dollar, which will then amplify the adverse effects on exports from other countries.

Euro-area direct exports to the US as a share of GDP are low and have fallen somewhat since 2000 (see Chart 3). Exports to other EU countries and Asia have increased. Via the direct trade channel, the euro area is thus less vulnerable to a slowdown in the US than few years ago. At the same time, growth in the euro area is stronger than it has been for a long time. Through 2006, the contribution from domestic demand has increased (see Chart 4). Investment growth is solid. Household demand is expected to increase as a result of lower unemployment.

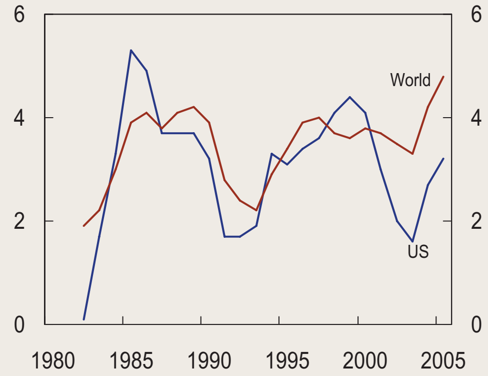
Chart 1 Output gap. 3-year moving average. Per cent. Annual figures. 1972 – 2005



[1] Estimated on the basis of data for West Germany in the period 1970 – 1990 and Germany in the period 1991 – 2005.

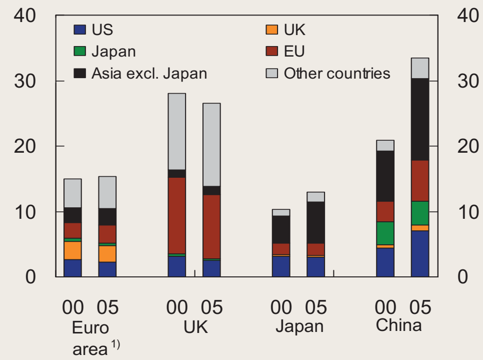
Sources: OECD *Economic Outlook* and Norges Bank

Chart 2 GDP. Annual rise. 3-year moving average. Per cent. Annual figures. 1982 – 2005



Sources: IMF *World Economic Outlook* September 2006 and Norges Bank

Chart 3 Exports as a share of GDP. Per cent. Annual figures. 2000 and 2005



[1] Exports to the EU cover only exports from the area to other EU countries.

Sources: Reuters (EcoWin) and Norges Bank

The emerging economies in Asia have long been dependent on exports. In recent years, the share of exports to the US and the EU has declined, while intraregional trade has increased (see Table 1). China has grown into a trade and production centre in Eastern Asia. Goods flows from Eastern Asia to western countries increasingly go via China. On the whole, Asia's exports still seem to be highly dependent on the US, but also on developments in China. However, growth is also robust in sectors other than the exports sector in many Asian countries.

After China joined the WTO in 2001, exports as a share of GDP increased considerably (see Chart 3). China is now the economy in Eastern Asia that accounts for the largest share of US imports. (see Chart 5). In isolation, this may imply increased vulnerability to a slowdown in the US. On the other hand, the strong growth in Chinese exports is being driven by rapidly rising capacity and substantial cost advantages, which have boosted the competitiveness of Chinese goods. China has thus won market shares across a broad range of products and in many countries (see Table 2). In the event of a fall in demand in the US, China may gain further market shares, reducing China's vulnerability to a US downturn. A fall in demand will then be felt to a greater extent in other regions such as Europe and other Asian countries.

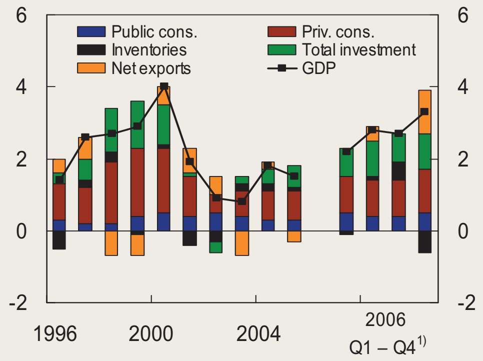
Equity prices and long-term interest rates covary to a large extent across countries. Financial market integration has increased over time. This indicates that the *financial channel* has become an increasingly important source of transmission of economic disturbances across countries. The recent weeks' global financial market turbulence is a clear example of this. A downturn in the US will normally lead to both a fall in equity prices and long-term

Table 1 Chinese and Asian exports to other countries. In percent of total exports.

	China		Emerging markets in Asia	
	2000	2005	2000	2005
US	20.9	21.4	21.3	17.4
EU 25	16.4	18.9	15.5	15.7
Japan	16.7	11.0	11.8	9.3
China	-	-	8.7	12.8
Emerging markets in Asia	33.2	32.8	39.1	43.0

Sources: IMF Direction of Trade Statistics Yearbook 2006 and Norges Bank

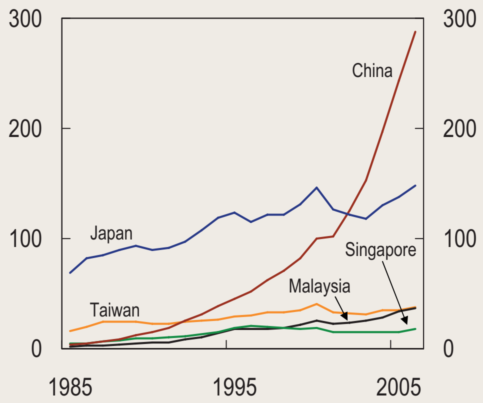
Chart 4 The euro area. Contributions to annual growth in volume. Per cent. Annual figures. 1996 – 2005. Quarterly figures. 06 Q1 – 06 Q4



1) 4-quarter growth.

Sources: Reuters (EcoWin) and Norges Bank

Chart 5 US. Imports from some countries in Asia. In billions of USD. Annual figures. 1985 – 2006



Source: Reuters (EcoWin)

Table 2 Chinese exports of different product groups. As a share of the worlds total exports of these product groups.

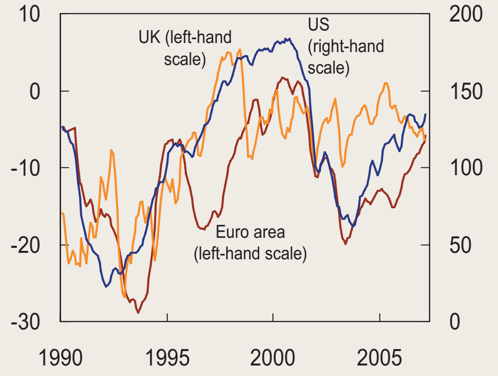
	2000	2005
Agricultural products	3.0	3.4
Energy and mining products	1.4	1.8
Iron and steel	3.1	6.1
Chemicals	2.1	3.2
Office and telecommunication equipment	4.5	17.7
Cars	0.3	1.1
Textiles	10.3	20.2

Sources: WTO Statistical Database 2006 and Norges Bank interest rates. A fall in world equity prices may increase the cost of and reduce the supply of equity finance, dampening global investment. Lower long-term interest rates would have the opposite effect, stimulating both global consumption and investment. The yield differential between government bonds in emerging economies and the US tends to widen when there is disturbances in major financial markets. Lower long-term interest rates may thus provide less impetus to Asian economies than to the euro area.

A downturn in the US may also influence growth *expectations* in other countries. This could translate into weaker growth in private consumption and business investment. Studies show that European confidence is influenced by developments outside the individual country. There is a high degree of correlation between business confidence in the US and the euro area. Consumer confidence indicators in the US and the euro area have in periods shown a strong correlation (see Chart 6). The degree of correlation seems to be highest when the US and the euro area are affected by the same type of shock, as in 2000/2001.[1] Consumer expectations do not seem to be an important source of contagion in the event of country-specific shocks. The degree of correlation between consumer confidence in the US and the euro area has been lower in recent years than around the turn of the millennium.

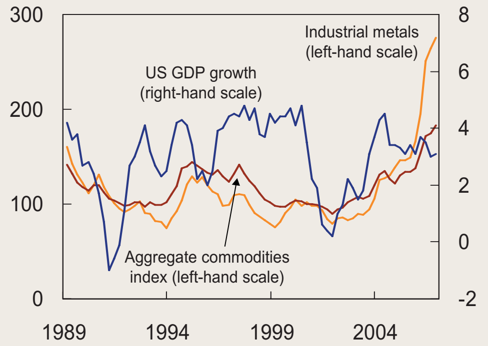
Developments in the US are also important for Norway. The Norwegian economy is influenced through exports both to the US and US trading partners. Norwegian exports are to a large extent commodity-based. The most import effects of developments in the US will thus come through prices for our main commodity exports. In recent years, Norway has reaped considerable benefits from the rise in prices for oil and industrial metals as a result of the global expansion. Weaker growth in the world economy normally leads to lower commodity prices, which have a particularly strong adverse affect on the Norwegian economy. Metal prices are particularly sensitive to cyclical fluctuations (see Chart 7). In recent years, demand for oil and other commodities has increased steadily in China and other emerging economies. In the period 2000-2005, China alone accounted for 30% of the global increase in oil demand and for more than 50% of the increase in global demand for industrial metals.

Chart 6 Consumer confidence indicator. Index values. 3-month moving average. Monthly figures. Jan 90 – Feb 07



Sources: Reuters (EcoWin) and Norges Bank

Chart 7 US GDP growth[1)] and commodity prices[2)]. Quarterly figures. 89 Q1 – 06 Q4



1) 4-quarter growth.
2) *The Economist*'s commodity price indices. 2000 = 100.

Sources: OECD *Economic Outlook*, Reuters (EcoWin) and *The Economist*

Estimates published by the IMF[2] and the UN[3] indicate that a slowdown in the US will have a considerably stronger impact on growth in China than in the euro area and Japan. In the UN report published in January this year, calculations show the impact on the global economy of a 1.7 percentage point decline in US growth in 2007 as a result of a weak housing market. Growth in China would then decelerate by 1.9 percentage points, while growth in both the euro area and Japan would slow by 0.4 percentage point.

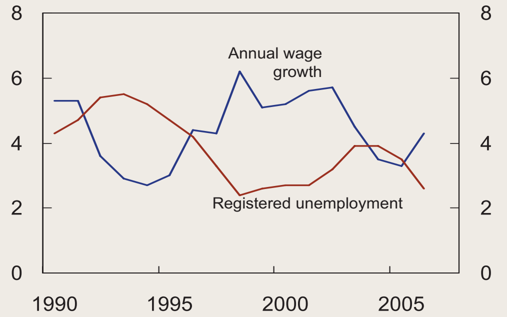
These calculations are based on historical data. The world economy has changed considerably in recent years, however. China has grown in importance for all of Asia. The country has substantial cost advantages and can take market shares elsewhere if exports to the US fall. Moreover, growth in domestic demand in Asia is solid. Even if Asia is still heavily reliant on exports to the US, we therefore expect the effects of a slowdown in the US on Asia to be less pronounced than implied by the estimations above. In addition, the euro area has to some extent shifted exports away from the US, and lower exports may be counteracted by higher domestic demand in this region as well. The effects via the financial channel are not clear, but owing to increasing financial integration economic turbulence may spread more rapidly and with greater intensity across countries.

Even though a downturn in the US will affect the world economy, the global economy appears to be more robust than earlier. Hence, the Norwegian economy also seems to be less vulnerable to a downturn in the US than a few years ago.

[1] The downturn in 2000/2001 was triggered by a correction in the IT sector in the beginning of 2001. The IT bubble burst, which had a negative impact on equity prices in many countries.
[2] IMF Country Report No. 06/279; "United States: 2006 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion", 2006.
[3] UN World Economic Situation and Prospects 2007.

Uncertainty surrounding wage growth ahead

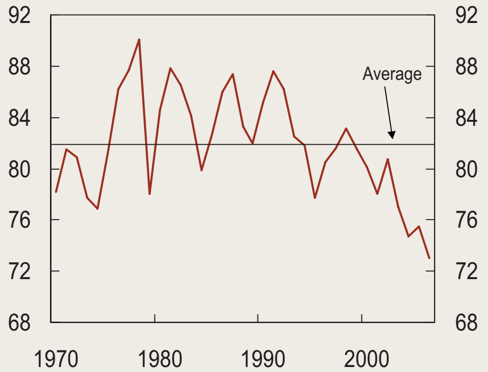
Chart 1 Annual wage growth[1)] and LFS unemployment. Per cent. Annual figures. 1990 – 2006



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

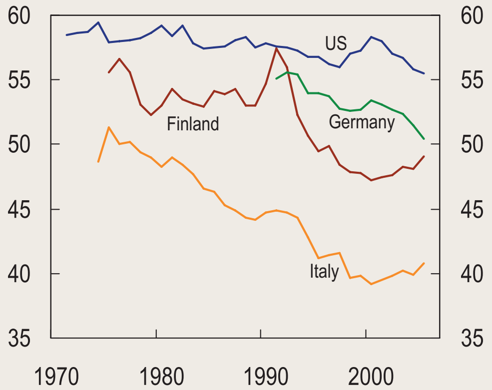
Sources: Technical Reporting Committee on Income Settlements, Norwegian Labour and Welfare Organisation (NAV) and Norges Bank

Chart 2 Labour costs as a share of factor income in manufacturing. Per cent. Annual figures. 1970 – 2006



Sources: Statistics Norway and Norges Bank

Chart 3 Labour costs as a share of GDP. Per cent. Annual figures. 1971 – 2005



Sources: Eurostat and Norges Bank

Moderate wage growth in recent years

The Norwegian economy has expanded sharply over the past three years. Corporate profitability has been solid. Unemployment has declined markedly (see Chart 1). During the expansion, wage growth has nevertheless remained moderate and lower than projected, partly reflecting a later-than-expected increase in employment and the effects of increased globalisation on the labour market and wages.

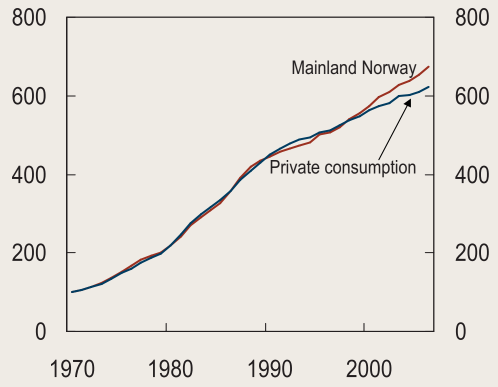
An important force that has held down wage growth is the marked increase in labour inflows from the new EU member states as from 2004. In 2006, the number of persons from EU member states on short-term assignments in Norway was estimated at about 35 000, accounting for about 30% of growth in the total supply of labour in Norway. Inward labour migration delayed the fall in unemployment in this expansion. It has also reduced bottlenecks in the economy and curbed the impact of the fall in unemployment on wage growth. Labour inflows have also had a dampening effect on wage growth, probably because the wage level of foreign workers is somewhat lower than for Norwegian labour.

Moderate wage growth contributed to reducing labour costs' share of mainland business-sector income, particularly in tradable goods sectors. In manufacturing, the wage share has shown a trend fall since the mid-1990s and the level has been the lowest since 1970 in the past few years (see Chart 2). The wage share has also fallen in many other OECD countries (see Chart 3). Emerging economies' entry into global trade has resulted in a sharp increase in the supply of low-cost labour. This has led to a fall in the global price of labour relative to the return on capital. The wage share equilibrium may therefore have been reduced. The scope for relocating production abroad may have weakened labour's bargaining power and moderated pay demands.

First and foremost, some labour-intensive production is being transferred from industrialised countries to emerging economies so that the capital intensity of the remaining production rises. This will in itself reduce the wage share in industrialised countries.

Moderate wage growth in Norway in recent years also reflects a decline in prices for imported consumer goods. This has increased labour's purchasing power without high nominal pay increases. At the same time, high global demand for commodities and energy products has resulted in higher prices for Norwegian export goods. Norway's terms of trades have increased by about 40% since 2002. The rise in prices for domestically produced goods and services, as measured by the mainland GDP deflator, has been 1% higher than the rise in prices for consumer goods since 2000 (see Chart 4).

Chart 4 Deflator for mainland GDP and private consumption. Index. 1970 = 100. Annual figures. 1970 – 2006



Sources: Statistics Norway and Norges Bank

Wage growth ahead

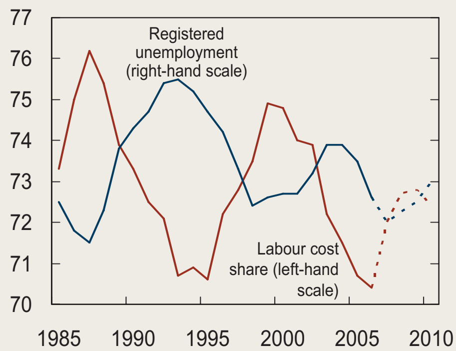
Nominal wage growth is on the rise. Bonus payments have been high in the recent past. Owing to competition for qualified labour, wages are being bid up in some industries, which seems to be generating expectations of higher wages in other industries. The experience of earlier periods of sharp declines in unemployment would indicate that wage growth may pick up fairly quickly.

Capacity constraints have now come into clearer evidence also in industries where labour inflows into Norway have been particularly high, such as the building industry. Foreign labour inflows are expected to continue to rise somewhat ahead, but competition for this labour is intensifying both because the labour market in their home countries is tightening and because several of the old EU countries have relaxed restrictions on labour immigration from the new EU countries. As a result of language barriers and other conditions that require purely Norwegian labour skills, capacity constraints are not as easily overcome in all industries. Against this background, labour inflows are not expected to moderate wage growth to the same extent ahead. The possibilities for transferring parts of production abroad may, on the other hand, contribute to holding down wage growth also in the years ahead, particularly in the internationally exposed sector in Norway. Higher wage growth in more sheltered industries as a result of solid profitability and labour shortages may then exert pressures on wage capacity in enterprises exposed to foreign competition.

The social partners' experience of strong increases in wage growth leading to higher interest rates may also have a moderating effect on pay increases in centralised settlements.

The forces that have influenced wage growth in previous years make the prospects for wage growth highly uncertain. Our projections are based on the mechanism that low unemployment leads to upward pressures on wages, resulting in high real wage growth in 2007 and 2008. This implies an increase in the wage level in relation to our trading partners. The wage share in the mainland economy is expected to show a renewed increase, but as demand in the Norwegian economy slackens and unemployment picks up again, wage growth is expected to slow. The wage share is not expected to be as high as in previous expansions (see Chart 5).

Chart 5 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

Competition and prices

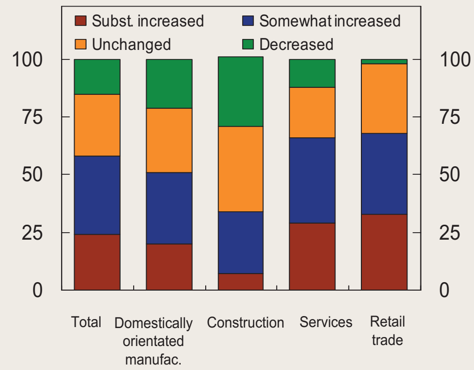
Underlying inflation has been low in recent years, partly reflecting low import prices, high productivity growth and moderate wage growth. Norges Bank has pointed out that increased competition in product markets may have curbed inflation.[1] It was also pointed out that the rise in prices for domestically produced goods and services has been lower than implied by historical relationships between inflation and wage and productivity growth.

Competition is difficult to measure. One method is to link competition to various indicators of product market regulation, the application and formulation of competition legislation, number of firms in a market or the degree of openness of an economy. The relationship between such indicators and competition may be uncertain. In this box, we use the results of a survey of Norges Bank's regional network to shed light on developments in competitive pressures and the effects of increased competition on firms' prices. The results are based on interviews of 220 enterprises which primarily supply goods and services to the domestic market. The industries surveyed comprise domestically oriented manufacturing, building and construction, retail trade and services. The survey was conducted in January and February 2007.

In the survey, 58% of companies responded that competition has increased in the past 2-3 years, while only 15% reported that competition has decreased (see Chart 1). In retail trade and services, almost 70% responded that competition has intensified. About half of the enterprises in domestically oriented manufacturing report increased competition. In the building industry, the share that reported increased competition is about as large as the share that reported reduced competition.

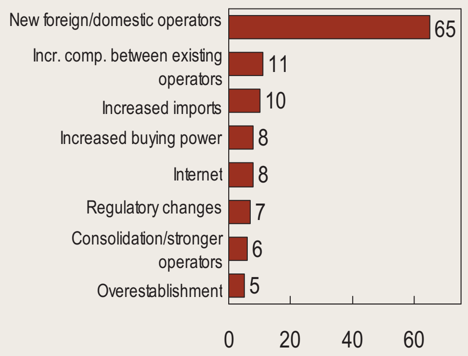
Two-thirds of the companies that report increased competition attribute this to the entry of more operators, including foreign operators, into the market (see Chart 2). Increased competition between existing companies, higher imports, increased buying power, growing online sales and the scaling back of competition regulations are also cited as factors behind increased competition. In the building industry, 9 of 10 companies report that the main factor is an increase in the number of companies. Higher imports are cited by a good 30% of companies in domestically oriented manufacturing. Some companies also report that increased buying power is an important reason. In services, many companies report that they are faced with increased competition from existing companies as a result of improved technical possibilities for offering IT services nationally, for example. In retail trade, many companies report that they are facing increased competition from online sales. Three-fourths of companies that report declining competition explain that higher demand has contributed to reducing competitive pressures. In particular, higher demand seems to have contributed to reduced competition in the building industry.

Chart 1 Developments in competition in the past 2 – 3 years. Per cent



Source: Norges Bank

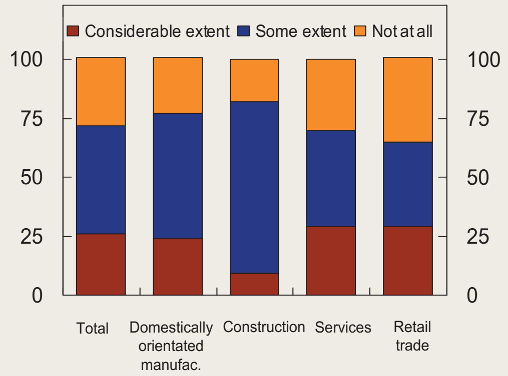
Chart 2 Factors behind intensified competition.[1)] Per cent



1) Each enterprise can list several factors. The percentages therefore add up to more than 100.

Source: Norges Bank

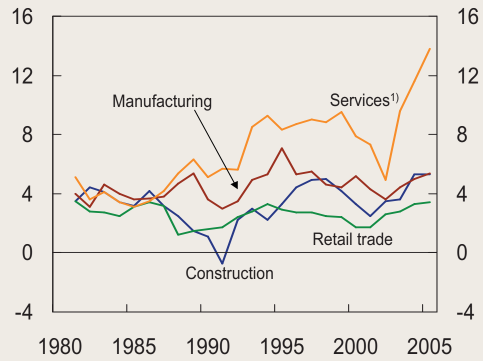
Chart 3 Curbed rise in prices among enterprises due to stronger competition.[1)] Per cent



1) Among enterprises that report stronger competition.

Source: Norges Bank

Chart 4 Operating margins in selected industries. Per cent. Annual figures. 1981 – 2005



1) Hotel and restaurant, transport, telecoms, ICT, commercial services, travel and tourism and property management

Source: Norges Bank (Sebra database)

The survey via the regional network indicates that increased competition has had a dampening impact on price increases over the past 2-3 years. Among the companies that report increased competition, 71% indicated that it has curbed the rise in prices. In retail trade and services, the figures were 64% and 70%, respectively (see Chart 3).

Information about price developments from the regional network seems to be consistent with developments observed in CPI components:

- Price for food and other grocery products fell sharply through 2004 ahead of Lidl's entry into the Norwegian market. However, the rise in prices for these goods picked up again towards the end of 2004 and through 2005 after the entry of Lidl. The rise in food prices in the CPI-ATE fell sharply again towards the end of 2005 and into 2006. Earlier reports from our regional network indicate that this may have been the result of increased competition in the grocery trade. It was reported that the chains in the grocery trade managed to exert increasing downward pressure on Norwegian supplier prices.

- The rise in the prices for many services has been subdued in recent years. For example, telecom services have shown a marked price fall. High productivity growth in the production of these services has made a contribution, but strong competition from a rising number of operators has probably also had an impact. Airfares fell markedly from the beginning of 2002 to May 2004. Competition in the financial industry also seems to have increased in recent periods.

A lower rise in prices as a result of intensified competition will in isolation be reflected in lower margins in enterprises. However, operating margins[2] in most industries have increased since 2002 (see Chart 4). Higher operating margins may indicate that price competition has been countered by lower cost growth. Increased competition may have contributed to cost reductions via rationalisation and by restraining wage demands.[3] Moreover, some companies have probably increased imports of processed intermediate goods from low-cost countries. In an upturn, companies may also have to increase margins after being exposed to pressures in the preceding downturn.

Overall, the companies surveyed also report that gross margins[4] have shown an overall improvement over the past 2-3 years. Among the companies reporting increased competition, however, 38% reported a fall in margins, while 29% reported an increase. Domestically oriented manufacturing, services and the building industry reported lower margins (see Chart 5). In retail trade, however, more companies reported an increase in margins than a reduction in spite of strong competition.

The survey from the network shows that companies expect competition to intensify further in the next 2-3 years (see Chart 6), but that it will increase somewhat less than in the past 2-3 years. 58% report stronger competition in recent years, while 47% expect stronger competition in the period ahead. 24% report a marked increase in competition, while only 8% expect a marked increase ahead. Companies expect competition to intensify as a result of an increase in the number of domestic and foreign operators, stronger competition among existing companies, higher imports and growing online sales (see Chart 7).

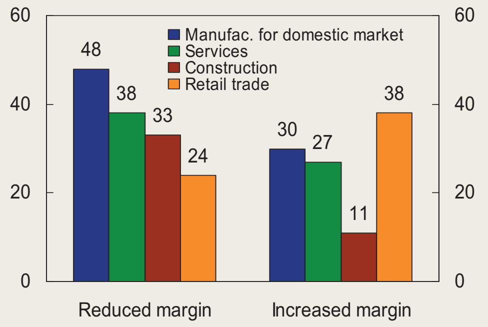
The expected increase in foreign competition must be seen in connection with the high price level in Norway. Norwegian consumer prices were about 45% higher in 2005 than the average for EU member states.[5] The high price level reflects among other things a high level of excise duties and income, but may also indicate that there is limited competition in some goods producing sectors. Owing to technological developments, a rising number of services are exposed to international competition. This trend will continue, and in addition the EU services directive will increase competition facing Norwegian service providers. A breakthrough in the Doha negotiations and a new WTO agreement could increase competition in the food market.

Many Norwegian industries are attracting both domestic and foreign operators thanks to high profits and operating margins, which may increase competition and push down margins and prices.

On the other hand, there are some factors suggesting that competition will not increase in the period ahead. Capacity utilisation in the Norwegian economy is high and increased demand may result in higher prices. In some sectors, there is a relatively high degree of concentration that may limit competition. High productivity and market power in those sectors may be an entry hurdle for other operators even if profitability in the industry is high.

[1] See articles evaluating Norges Bank's projections in Economic Bulletin 1/05, 2/06 and 2/07 (to be published in July 2007).
[2] Operating margin is defined as turnover less operating expenses as a share of total turnover.
[3] See box in this report on uncertainty surrounding wage growth ahead.
[4] Gross margin is defined as sales revenues less purchasing costs as a share of sales revenues.
[5] Price level relative to 25 EU member states.

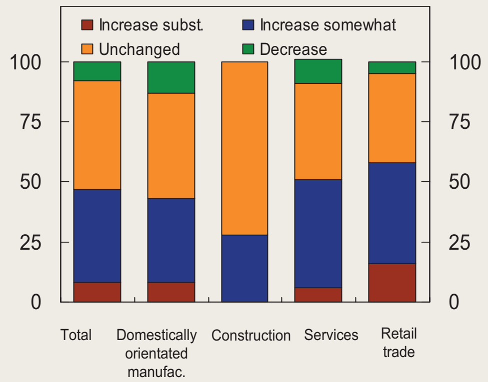
Chart 5 Developments in gross margins[1)] in the past 2 – 3 years among enterprises that report stronger competition. Per cent



1) Sales revenues less purchasing costs as a share of sales revenues.

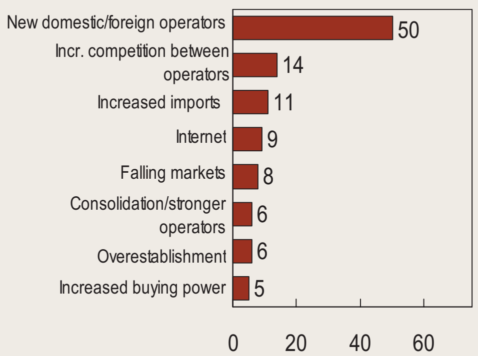
Source: Norges Bank

Chart 6 Expected developments in competition in the next 2 – 3 years. Per cent



Source: Norges Bank

Chart 7 Factors behind expectations of intensified competition.[1)] Per cent



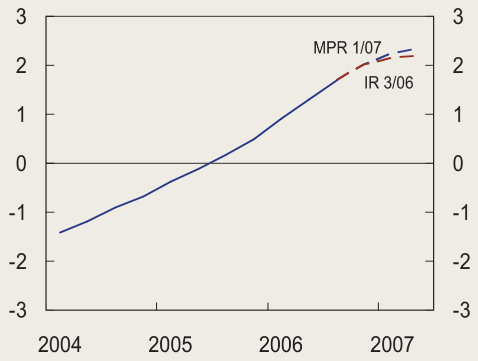
1) Each enterprise can list several factors. The percentages therefore add up to more than 100.

Source: Norges Bank

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

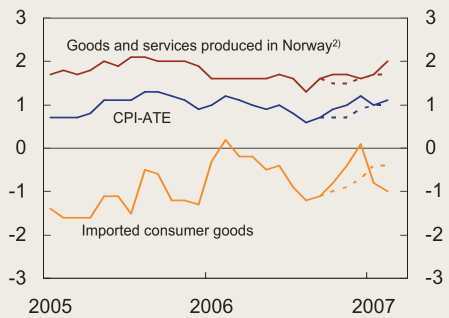
This box presents an analysis of the changes made to the projections in *Inflation Report* 3/06. New information since November influences both the picture of the current economic situation and the assumptions regarding the driving forces that will influence developments in the years ahead. On balance,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

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.

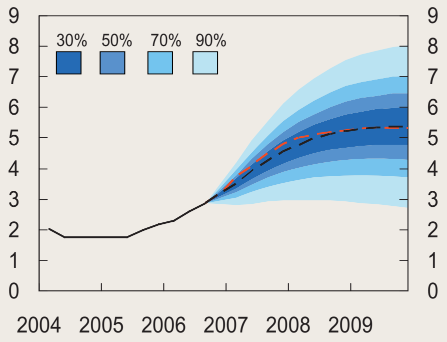
Sources: Statistics Norway and Norges Bank

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.

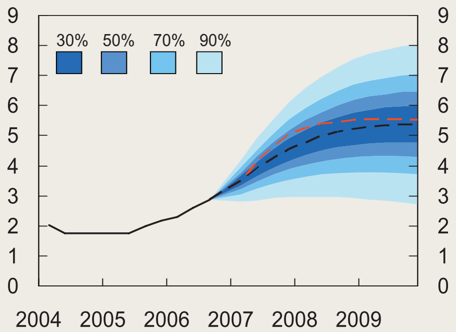
- The revised national accounts figures and the most recent quarterly national accounts figures indicate that growth in mainland GDP in the period 2004 – 2006 was somewhat higher than previously assumed. On the other hand, growth in inward labour migration was high in 2006. Preliminary figures also indicate 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 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



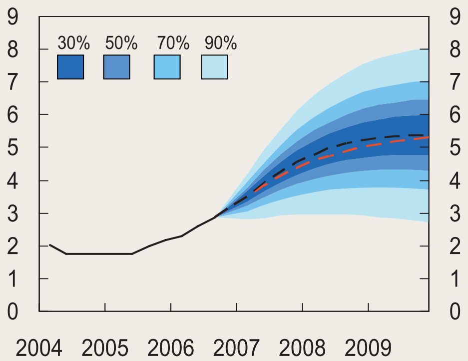
Source: Norges Bank

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.

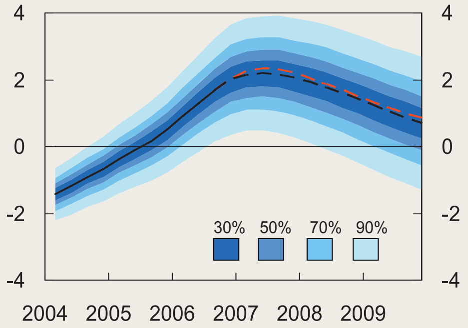
In this *Report*, growth in mainland GDP is projected to be somewhat higher than in *Inflation Report* 3/06. At the same time, the projection for potential output for mainland Norway has been revised up. On balance, this implies a somewhat higher output gap in 2007 than previously projected (see Chart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

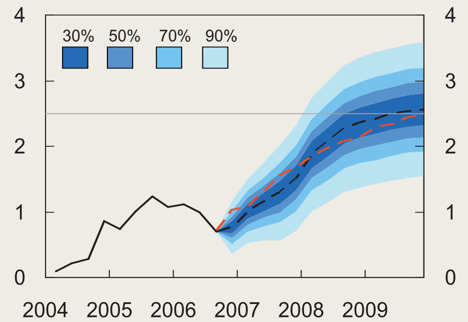
Chart 6 Estimated output gap in the baseline scenario in IR 3/06 with fan chart[1)] and output gap in the baseline scenario in MPR 1/07 (red line). Per cent. Quarterly figures. 04 Q1 – 09 Q4



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

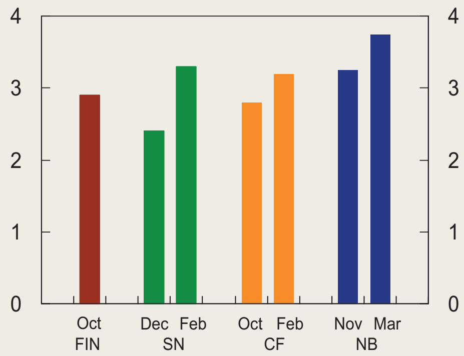
Table 1 Projections for main macroeconomic aggregates in *Monetary Policy Report 1/07*. Change from projections in *Inflation Report 3/06* in brackets.

	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.

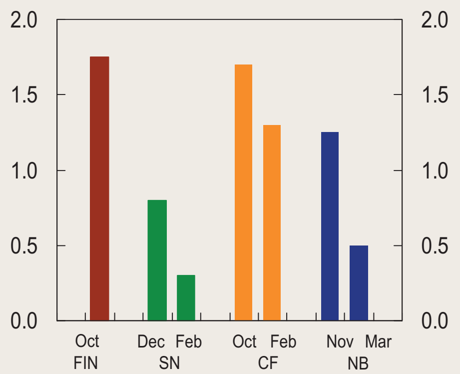
Source: Norges Bank

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



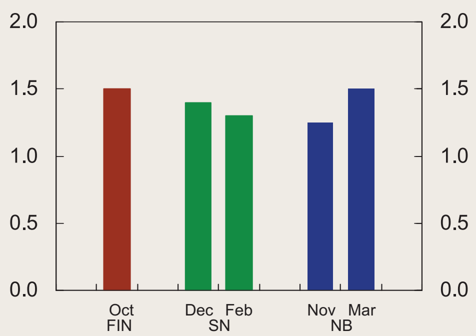
Sources: National Budget 2007, *Economic Survey* 4/2006 and 1/2007, *Inflation Report* 3/06 and *Monetary Policy Report* 1/07, *Concensus Forecasts* October 2006 and February 2007

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.

Evaluation of projections for 2006

Monetary policy influences the economy with a lag. Within a horizon of one year, monetary policy decisions will only influence projections for employment, output and inflation to a limited extent. At the same time, Norges Bank's projections for the next few quarters play an important part in our assessments of developments in the economy and interest rate setting ahead. This box provides an evaluation of projections published by Norges Bank through 2005 and in 2006 for developments in 2006.[1]

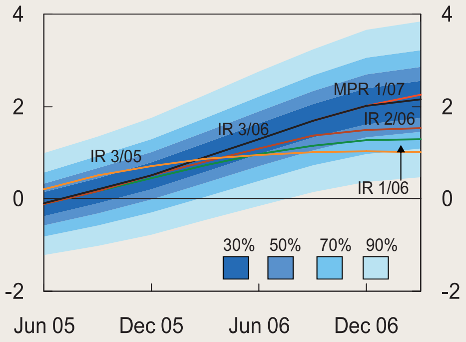
In 2006, growth in output and employment was appreciably stronger than projected. As a result, the estimate for the output gap in 2006 was revised up (see Chart 1). Consumer price inflation was 2.3% in 2006. i.e. somewhat higher than Norges Bank's projections through 2005 and up to *Inflation Report* 2/06 (see Chart 2). Consumer price inflation adjusted for tax changes and excluding energy products was lower than projected (see Chart 3). Developments in the sight deposit rate in 2006 were approximately in line with the interest rate path in *Inflation Report* 3/05.

Output gap higher than expected

Growth in mainland GDP in 2006 was substantially higher than Norges Bank's projections. The projection was revised gradually upwards from end-2005 to 4% in *Inflation Report* 3/06. Preliminary national accounts figures show annual growth of 4.6%. A number of other forecasters also underestimated growth in the mainland economy in 2006 (see Chart 4).[2] This may partly reflect the subsequent upward revision of current national accounts figures on which the projections for 2006 were based.[3]

Compared with the projections in the last *Inflation Report* in 2005, growth in all the main components of mainland GDP in 2006 was higher than expected (see Table 1). This can be partly attributed to effects from stronger-than-expected growth of a number of variables over which monetary policy has little influence, such as investment on the Norwegian continental shelf and GDP among Norway's main trading partners. Unexpectedly strong global growth may have contributed to higher-than-expected exports of traditional goods. Prices for many Norwegian export goods were also

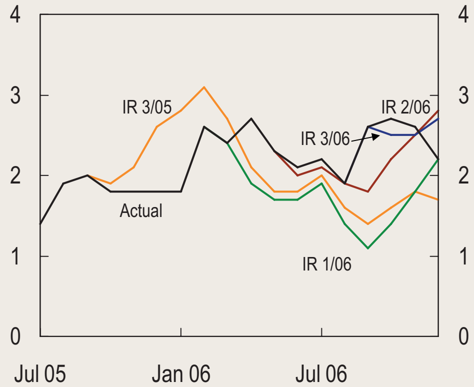
Chart 1 Estimated output gap in the baseline scenario in IR 3/06 with fan chart1) and estimated output gap in other reports. Per cent. Quarterly figures. 05 Q2 – 07 Q1



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

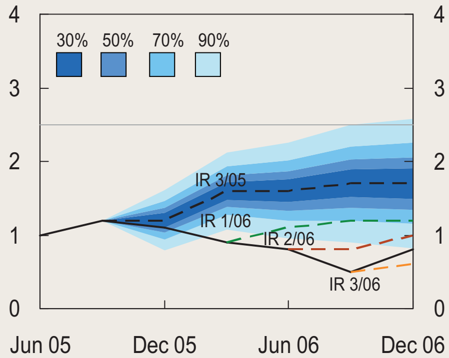
Source: Norges Bank

Chart 2 CPI. Projections in different reports and actual developments. Per cent. 12-month change. Monthly figures. Jul 05 – Dec 06



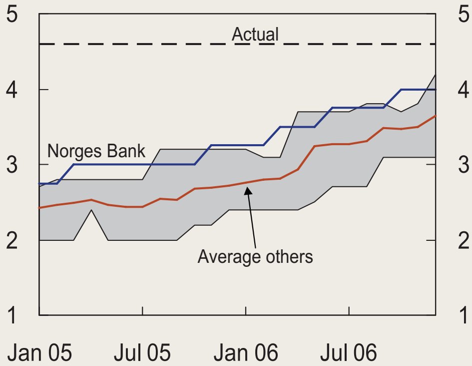
Sources: Statistics Norway and Norges Bank

Chart 3 CPI-ATE. Projections in different reports and actual developments. Fan chart from IR 3/05. Per cent. 4-quarter change. Quarterly figures. 05 Q2 – 06 Q4



Sources: Statistics Norway and Norges Bank

Chart 4 Mainland GDP. Projections for annual growth in 2006 published at different times.[1] Per cent. Monthly figures. Jan 05 – Dec 06



[1] Highest and lowest projections from forecasters other than Norges Bank are shown by the grey shaded area. The red line is an average of the other forecasters' projections.

Sources: Norges Bank and reports from the different forecasters

particularly high. At the same time, the real interest rate has for a long period been lower than what Norges Bank considers to be a normal level, and we may have underestimated the effect this has had on output and employment.

Revisions of national accounts figures have also led to an upward revision of productivity growth in recent years. At the same time, a larger supply of foreign labour has helped to increase the output potential of the economy. The overall effect has been a considerable increase in the potential output level, and potential growth has probably been higher than previously projected. The estimate for the output gap in 2006 has therefore not been revised to the same extent as the unexpectedly high growth of the mainland economy would imply.

The output gap estimate for 2006 may still be changed in the light of further revisions of national accounts figures or new assessments based on other information.

Table 1 Projections and assumptions for main economic aggregates for 2006. From *Inflation Report 1/05* to *Inflation Report 3/06*.

	IR1/05	IR2/05	IR3/05	IR1/06	IR2/06	IR3/06	Prelim. national accounts
Mainland demand	3¾	3¾	3¾	3¾	4¼	4¼	4.5
- Private consumption	3¾	3¾	3½	3¾	3½	4	4.3
- Public consumption	1½	1½	2	2½	3	2¾	2.2
- Fixed investments in mainland Norway[1]	6½	6	6	6	8	7¾	7.5
Petroleum investment	-5	-5	2½	5	5	5	9.1
Traditional exports	3½	3½	3¼	6	6¼	6½	6.5
Imports[1]	3½	3½	4½	6	6¼	6¼	8.5
GDP mainland Norway	3	3	3¼	3½	3¾	4	4.6
Potential growth in mainland Norway	2½	2½	2½	2½	2½	2½	3¼
Output gap in mainland Norway	1¼	1	1	1	1¼	1½	1½
Employment	1½	1½	1½	1¾	2¼	2¾	3.1
Labour force (LFS)	1	1	1	1	1½	1½	1.6
LFS unemployment (rate)	3½	3¾	4	3¾	3¾	3½	3.5
CPI	2	1¾	2	1¾	2¼	2¼	2.3
CPI-ATE	1¾	1½	1¾	1	¾	¾	0.8
Annual wage growth	4½	4¼	4	3¾	3¾	4	4.1
Sight deposit rate	3	2½	2¾	2¾	2¾	2¾	2.7
Exchange rate	93,1	91,1	91,0	92,8	90,3	92,5	92.5
GDP, trading partners	2¼	2¼	2½	2¾	3	3¼	3½
International price impulses	-¼	-½	0	-½	-¼	1	0.4
Oil price	49.5	59.0	60.5	62.1	68.2	64.8	64.7

[1] Excluding imports of a frigate in 2006.

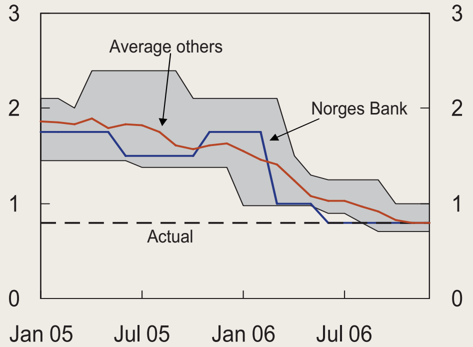
Sources: Statistics Norway, TBU and Norges Bank

Consumer price inflation higher than expected, but low underlying inflation

Consumer price inflation in 2006 was pushed up by an unexpectedly sharp rise in prices for energy products. This was due to a particularly strong rise in prices for electricity as a result of abnormally low inflows to water reservoirs through summer. The rise in prices for imported consumer goods in 2006 was broadly in line with projections. This is because the exchange rate did not deviate appreciably from the assumptions in the Reports, and movements in prices for imported consumer goods, measured in foreign currency, were approximately as projected. On the other hand, the rise in prices for domestic goods and services, adjusted for tax changes and excluding energy products, was appreciably lower than projected, even though wage growth in 2006 was approximately in line with projections. In *Inflation Report* 3/05, Norges Bank projected the rise in prices for domestically produced goods and services at about 2½%, whereas the outcome shows an annual rise in prices for domestically produced goods and services of 1.6%, when adjusting for the estimated effect of the introduction of maximum day-care rates as from 1 January 2006. As a result of the low rise in prices for domestically produced goods and services, inflation measured by the CPI-ATE was also lower than projected. A number of other forecasters overestimated the rise in the CPI-ATE for 2006 (see Chart 5).

The rise in prices adjusted for tax changes and excluding energy products was lower than expected, while growth in output and employment was surprisingly high. This may indicate that there are unforeseen factors on the supply side of the economy which influenced developments. Unexpectedly high inward labour migration eased labour shortages and contributed to growth in potential output. In many industries, unexpectedly high productivity growth also contributed to low inflation. At the same time, the slow rise in prices for imported, processed intermediate goods, and strong competition in some product markets probably curbed the rise in prices for domestically produced goods and services to a greater extent than assumed by Norges Bank.

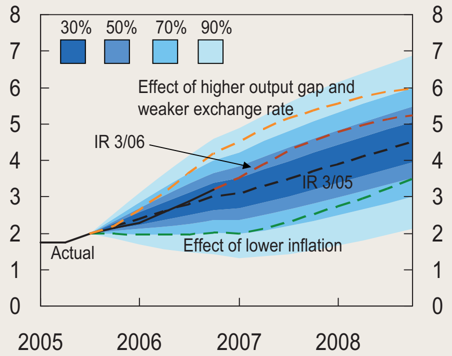
Chart 5 CPI-ATE. Projections for annual rise in 2006 published at different times.[1] Per cent. Monthly figures. Jan 05 – Dec 06



[1] Highest and lowest projections from forecasters other than Norges Bank are shown by the grey shaded area. The red line is an average of the other forecasters' projections.

Sources: Norges Bank and reports from the different forecasters

Chart 6 Key policy rate in the baseline scenario in IR 3/05 with fan chart and baseline scenario in IR 3/06 and isolated effects of higher output gap and a weaker exchange rate and of lower inflation. Per cent. Quarterly figures. 05 Q1 – 08 Q4



Source: Norges Bank

Interest rate path in line with projections

The sight deposit rate was raised by 0.25 percentage point at five of nine monetary policy meetings in 2006. Towards the end of the year, the interest rate was somewhat higher than projected in the baseline scenario in *Inflation Report* 3/05.[4] In isolation, unexpectedly low inflation, excluding energy products, and hence also prospects of lower inflation ahead, has suggested a lower interest rate than implied by the baseline scenario. However, this was more than offset by a higher-than-expected output gap, which implied a higher interest rate. Through its impact on inflation and output, a somewhat weaker krone exchange rate also contributed to pushing up the interest rate path towards the end of 2006 (see Chart 6).

[1] See also the article "Evaluation of Norges Bank's projections for 2006" (to be published in *Economic Bulletin* 2/07).
[2] Forecasters: The Ministry of Finance, Statistics Norway, DnB NOR, Nordea, Fokus Bank, SEB and Handelsbanken. The chart with CPI-ATE projections also includes projections from a simple model developed by Professor Ragnar Nymoen at the University of Oslo. Nymoen has published semi-annual CPI-ATE projections since summer 2004. See http://folk.uio.no/rnymoen/forecast_air_index.html.
[3] For example, the first published figures showed mainland GDP growth of 3.7% in 2005. According to the most recent figures, growth was 4.5%.
[4] *Inflation Report* 3/05 was the first in which projections were based on Norges Bank's best judgement of future interest rate developments. Interest rate assumptions had previously been based on forward interest rates in the market.

Boxes 2002-2007

1 / 07:
Will the global economy be affected by a slowdown in the US?
Uncertainty surrounding wage growth ahead
Competition and prices
Evaluation of Norges Bank's projections for 2006

3 / 06:
Output gap

2 / 06:
Money, credit and prices – a monetary cross-check
Foreign labour in Norway
Short term forecasts for mainland GDP in Norway

1 / 06:
Choice of interest rate path
Productivity growth in Norway
The yield curve and economic outlook in the US
Evaluation of Norges Bank's projections for 2005

3 / 05:
Uncertainty surrounding future interest rates developments
Accuracy of short-term interest rate expectations
Output gap uncertainty
Increased imports from low-cost countries
The Effects of high oil prices on the global economy

2 / 05:
Developments in the krone exchange rate

1 / 05:
Criteria for an appropriate future interest rate path
Why are long-term interest rates so low?
Low inflation in the Nordic countries
Developments in household debt
Evaluation of Norges Bank's projections for 2004

3 / 04:
Estimated relationship for interest rate setting
Developments in household debt
Norges Bank's foreign exchange purchases for the Government Petroleum Fund
The current account surplus and demand for Norwegian kroner

2 / 04:
Increase in number of working days in 2004
Financial stability
Norges Bank's estimate of the output gap
A change in inflation expectations?
What are the factors behind the rise in oil futures prices?

1 / 04:
Low external price impulses to the Norwegian economy
The pass-through from the krone exchange rate to prices for imported consumer goods
The effects of the reduction in interest rates on household income
The krone exchange rate and exchange rate expectations
Evaluation of Norges Bank's projections for 2003

3 / 03:
Direct effects of interest rates on house rents
Imbalances in the US
Assumptions concerning the exchange rate
Flexible inflation targeting and indicators of pressures in the real economy

2 / 03:
Low consumer price inflation
Evaluation of inflation reports in countries with inflation targets
Why does household debt growth remain high?
Levels of real capital in enterprises still too high?

1 / 03:
Factors behind the development in the krone exchange rate
Output gap
Imported price inflation and the exchange rate - the UK experience
Evaluation of Norges Bank's projections for 2001 and 2002

3 / 02:
The Scandinavian model of inflation-revisited

2 / 02:
Why has the krone excange rate appreciated?
New expectations survey
Why have clothing prices fallen?
The impact of higher oil prices
How does the krone exchange rate influnce the CPI?

1 / 02:
Evaluation of Norges Bank's projections for 2000
Wage growth
Have Norges Bank's interest rate decisions been expected?

Annex I
Regional network

Norges Bank's regional network

Norges Bank's regional network was established in autumn 2002 and consists of enterprises, local authorities and regional health enterprises throughout Norway. Five times a year, we talk to business and community leaders concerning developments in their enterprises and industries. Each round of talks comprises about 290 visits. The contacts reflect the production side of the economy, both in terms of industry sector and geographic area. The network comprises approximately 1500 individuals who are contacted about once a year.

The primary purpose of the regional network is to obtain up-to-date information on the state of the Norwegian economy. Regular communication with local contacts in Norway's business and community life provide us with information earlier and more frequently than available official statistics. It also provides us with supplementary information about areas not covered by other statistical sources, and we learn which issues are of particular concern to enterprises. In addition, the regional network will provide us with insight into the effects of specific events and enable us to study relevant issues. Official statistics will continue to form the main basis for our perception of the state of the economy, but the time lags and revisions associated with these statistics make supplementary sources, such as our regional network, useful.

The information obtained from the regional network, along with other available information on economic developments, will provide a basis for Norges Bank's projections as presented in the *Monetary Policy Report* and other published material.

We have divided Norway into seven regions, and for six regions we have engaged regional research institutions to be responsible for the network in their respective regions and to have meetings with contacts on behalf of Norges Bank. The following institutions have been selected:

Region North (Nordland, Troms, Finnmark)	Kunnskapsparken Bodø
Region Central Norway (Nord-og Sør-Trøndelag)	Center for Economic Research at the Norwegian University of Science and Technology
Region North-West (Møre og Romsdal, Sogn og Fjordane)	Møreforsking in Molde
Region South-West (Rogaland and Hordaland)	International Research Institute of Stavanger
Region Sør (Aust- og Vest-Agder, Telemark, Vestfold)	Agderforskning
Region Inland (Hedmark and Oppland)	Østlandsforskning
Region East (Buskerud, Akershus, Oslo, Østfold)	Covered by Norges Bank

Summary of contact rounds since *Inflation Report 3/06*

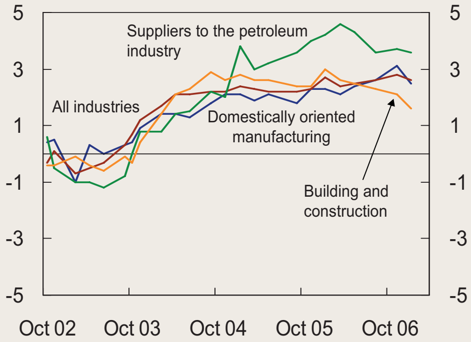
In the contact rounds since *Inflation Report* 3/06, conducted in November and January, approximately 570 regional network contacts have been interviewed. A national summary and summaries from each region from the January round is published on Norges Bank's website. The summary below is based on regional reports from the institutes responsible for the various regions and does not necessarily represent Norges Bank's view of economic developments.

Demand, output and market outlook

Companies in the regional network report that growth in demand and output remains solid (see Chart 1). Growth picked up towards the end of last year and has remained stable into 2007. Growth is strongest for petroleum-related activities, but is also rising markedly in manufacturing and the service sector. The market outlook for the next six months is favourable, even though the majority of companies expect growth to slacken somewhat. A lack of spare capacity is an important factor contributing to expectations of slower growth.

Growth in *domestically oriented manufacturing* picked up through autumn and the contacts continue to report solid growth at the beginning of 2007. Suppliers of furniture and home furnishings largely report strong growth owing to the completion of a large number of residential and commercial buildings projects. Suppliers of building materials report continued solid growth, although for some companies growth is limited due to capacity constraints. In addition, growth is solid for suppliers to the petroleum and offshore industry. Activity remains high in the engineering industry, but an increasing number of companies now report that they are producing at full capacity and that room for further growth is limited.

Chart 1 Norges Bank's regional network. Growth in demand and production. Index[1]). Oct 02 – Jan 07



[1]) The scale runs from -5 to +5, where -5 indicates a large fall and +5 indicates strong growth. See article "Norges Bank's regional network" in *Economic Bulletin 3/05* for further information.

Source: Norges Bank

The export industry reports solid growth. As in the domestic market, demand is high for furniture, office equipment and other home furnishings as a result of a growing building market in Europe. Suppliers of metals and industrial raw materials report high global market prices and demand. Exports of fish and seafood are rising, with increasing demand from Russia. There are also reports of strong growth for various equipment suppliers to the offshore industry, both domestic and foreign.

Suppliers to the petroleum industry report continued high activity and strong growth in many areas. There has recently been a sharp rise in shipping and leasing of vessels as a result of a shortage of supply ships and special purpose vessels in the North Sea. Larger shipping companies are still ordering new vessels, reflecting expectations of a continued strong market. Activity is high in engineering and shipbuilding industries that supply the petroleum industry, but growth is being curbed by capacity constraints. Many companies expect a levelling off or a decline in demand resulting from the phasing out of large projects such as Ormen Lange and Snøhvit in spring. Increasing exploration investment, new rigs for the Norwegian continental shelf and increased activities on existing fields may, however, contribute to keeping demand high, and the market outlook ahead is still characterised as favourable.

Building and construction report a high level of activity throughout the country. However, growth has been slowing over the past year and is now approaching a more moderate level. Demand in the market is still characterised as solid, and many participants report that capacity, and not demand, is curbing growth. Several regions now report that growth in residential construction is slowing, while private and public commercial building activity is still rising. The construction sector is also experiencing solid growth, reflecting increasing investment in transport and communications.

There is solid growth in *retail trade*. The furniture and clothing industries report solid sales towards the end of 2006 and a very good beginning of 2007. Brown and white goods also show strong growth. Especially the sale of flat screen TVs is increasing markedly. Reports are mixed from the car industry, where sales for the individual importers to a large extent have been affected by tax changes from 1 January 2007. Sales of campers and caravans have increased, along with vehicles for the corporate sector. Growth remains high in building materials.

Activity is high and growth is solid in *corporate services*. The picture is clear-cut, with positive signals from all sectors across the country. Many companies in commercial services report generally strong growth. This applies to services such as recruitment, legal services, consulting, advertising and IT services. Solid growth is also reported in transport, hotel and travel industries.

Household services continue to grow, albeit at a somewhat slower pace than corporate services. There is strong growth in broadband and telecom services. There is also continued strong credit growth. Strong demand in the housing market is resulting in high activity in the real estate business, but this sector is also marked by strong competition, which means that many operators are not increasing volumes. There is solid growth in the hotel and travel industries.

Capacity utilisation and supply of labour

Capacity utilisation remains high. 56% of companies report that they would have some or considerable difficulty in accommodating an increase in demand, while 47% report that the supply of labour would limit output growth if demand increased. These shares are at approximately the same level as in the September round.

Capacity utilisation and labour shortages are highest in building and construction and in petroleum-related industries. Companies report that machinery and production facilities are fully utilised. Many companies also report shortages and long delivery times for materials. Labour shortages are particularly prominent for labour with higher education, such as engineers, architects, economists and IT-personnel, but there is also a lack of drivers and mechanics. In the municipal sector, there is an increasing shortage of labour for technical agencies, primarily engineers.

Employment

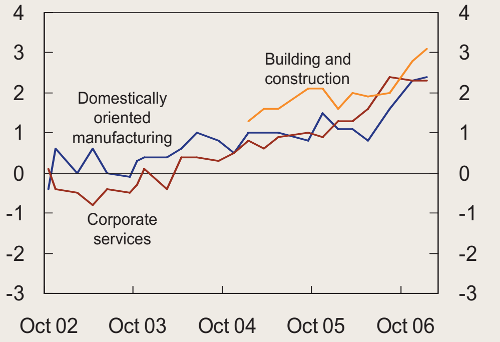
Employment increased sharply towards the end of last year and has continued to rise so far in 2007. Growth is strongest in services, followed by building and construction and manufacturing. Continued employment growth is expected in the next 3 months, even though growth appears to be slowing. Many companies report that planned employment growth is conditional on being able to find labour resources. Given the tight labour market and the sharp rise in employment last year, it may appear that the rise in employment has now peaked.

Costs and prices

Estimated annual wage growth this year is 4.5% as a weighted average. This is markedly higher than expectations at the beginning of 2006. Expectations have increased for manufacturing and retail trade in particular compared with last year. Annual wage growth expectations in retail trade are approaching the level prevailing in the rest of the service sector.

The rise in prices quickened throughout last year and at end-2006 was at the highest level since the establishment of the network in 2002. In building and construction, the rise in prices is clearly accelerating as a result of increased labour and input costs. There is also a marked rise in prices in domestically oriented manufacturing and in corporate services (see Chart 2). In the next 12 months, 44% of our contacts expect prices to remain unchanged, 37% expect a higher rise in prices, while 20% expect a lower rise in prices. Expectations of a sharper rise in prices are higher than in the previous rounds. Building and construction and domestically oriented manufacturing expect the sharpest rise in prices. Increased costs, high levels of activity and capacity constraints are pushing up prices.

Chart 2 Norges Bank's regional network. Changes in selling prices over the past 12 months. Index[1]. Oct 02 – Jan 07[2]



[1]The scale runs from -5 to +5, where -5 indicates a large fall and +5 indicates strong growth. See article "Norges Bank's regional network" in *Economic Bulletin* 3/05 for further information.
[2] Building and construction only from January 2005.

Source: Norges Bank

Enterprises and organisations that have been interviewed in the work on this *Report*

ABB AS
ABB Flexible Automation
Accenture ANS
Acta
Active Nurse AS
Adecco Nordland
Adecco Troms
Advokat Ole Morten Husmo
Air Products AS
Aker Brattvåg AS
Aker Kværner
Aker Kværner IPEC AS
Aker Seafoods Finnmark AS
Aktietrykkeriet
Albert E. Olsen AS
Alfred Nesset AS
Alléen Auto AS
Alu-rehab
Alvdal Skurlag Al
Alvdal Tynset Sport AS
Amfi Namsos
Amneus Boghandel AS
A-Møbler AS
Anleggsgartnerfirma Strandman AS
Arctic Seafood AS
Arendal Auto AS
Arki Arkitektar AS
Arkitektfirmaet C. F. Møller
Arntzen de Besche
Artec Aqua AS
Asko Midt-Norge AS
Aukra Auto AS
Aure kommune
Avantor ASA
Avisa Glåmdalen
Baker Hughes Inteq
Bakers AS
Bardu kommune
Bates AS
BBL Eiendomsmegling AS
BearingPoint
Bedriftskompetanse AS Bodø
Beitostølen Resort AS
Berg Hansen NOR AS avd. Bodø
Berg-Hansen Reisebureau AS
Bertil O. Steen
Betong Øst AS
Bilalliansen AS
Bilsenteret Namsos AS
Biotec Pharmacon ASA
Bjørge-Gruppen AS
Blefjell sykehus
Bloch Bygg og Materialhandel AS
Boarch Arkitekter AS
Bohus Interiør AS
Bohus Møbelhuset AS
Bomek Consulting AS
Box Delivery
Bravida ASA
Bravida Geomatikk AS
Bravida Sørøst AS
Brevik Construction AS
Brilleland AS
Brude Safety AS
Brunvoll AS
Brødrene Dahl AS
Brødrene Dyrøy AS
Brødrene Flaarønning AS
Brødrene Reme AS
Busengdal Transport AS
Bussbygg AS
By the Way AS
Byggholt AS
Byggkjøp Kåre Abelsen AS
Byggma ASA
Byggmester Fritzøe
Byggmo Eiendom AS
Byggservice Nord- Østerdal AS
Byhaven kjøpesenter
Bøhmer Entreprenør AS
Børset og Bjerkset AS
Børstad Transport AS
Båtservice Holding ASA
Båtsfjordbruket AS
Cad Net Øst AS
Capinor AS
Central Drift Hotel AS
CHC Norway
Chriship
City Syd AS
Clas Ohlson
Color Line AS
Comrod AS
Conoco Phillips Norway
Coop Sunndalsøra
Coop Trondheim og omegn BA
Coop Økonom BA
Corrocean AS
Cowi AS
CSC Solutions
Dagligvareleverandørenes Forening
Dahle Libris
Daldata AS
Dale Bruk AS
Dark Arkitekter AS
Delitek AS
Den Nationale Scene
Den Norske Høyttalerfabrikk AS
DnB NOR Kongsvinger
Dolly Dimple
Domstein Bodø AS
E. Flasnes Transport AS
EFD Induction AS
Egersund Trål AS
Eidsvoll kommune
Eiendomsmegler 1 AS
Eiendomsspar AS
EKA Chemicals Rana
Ekornes ASA
Elektro AS
Elektro Bodø AS
Elektrotema Agder AS
Elkem Aluminium ANS
Elkem Aluminium Mosjøen
Elkem ASA Materials
Elkjøp Finnsnes AS
Elkjøp Giganten Forus
Elkjøp Norge AS
Elkjøp Stormarked Bodø AS
Elkjøp Stormarked Skien
Elverum kommune
Enger Lefsebakeri AS
Engerdal kommune
Enghav Domstein
Engum Elkjøp AS
Enskilda Securities
Entreprenør M. Kristiseter AS
Eramet Norway
Ergo Group Region Øst
Erling Moen AS
Esko Graphics Kongsberg AS
Esmeralda AS
Evensen & Evensen AS
Evje- og Hornnes kommune
Ewos AS
Fabelaktiv AS
Fagbokforlaget
Fauske kommune
Felleskjøpet Rogaland og Agder
Felleskjøpet Trondheim
Fesil ASA
Fesil Rana Metall AS
Finnøy Gear & Propeller AS
Finsbråten AS
Flekkefjord kommune
FMC Technologies
Fokus Bank ASA
Fosen Mekaniske Verksteder AS
Fosen Trafikklag AS
Fossberg Hotell AS
Fredrikstad kommune
Friele kaffehus
Frost Entreprenør AS
Fædrelandsvennen AS
Gaupen Henger AS
GE Health Care AS
Gjensidige Nor Forsikring
Gjestal Spinneri ASA
Gjøco AS
Gjøvik kommune
Glamox ASA
Glomsrød AS
Glåma Bygg AS
Goldfish Boat AS
Goman bakeriet Trondheim AS
Granit Kleber AS
Gravdahl AS
Grieg Logistics AS
Gro Industrier AS
Grunnarbeid AS
Grytnes Entreprenør AS
Gudbrandsdalens Uldvarefabrik AS
Gunnar Hippe AS
H. Mydland AS
Hagen og Godager AS
Hagen Treindustri AS
Halden kommune
Hammerfest kommune
Hamworthy AS
Handelsbanken
Handicare Produksjon AS
Hans H. Iversen
Haram kommune
Harstad Marina Båt AS
Harstad Mek. Verksted AS
Harstad Sparebank
Havanna Bade- og Lekeland
Havila AS
Heimdal Gruppen AS
Helgelandssykehuset HF
Hellvik Bygg
Helse Nordmøre og Romsdal HF
Helse Sunnmøre HF
Hennes& Mauritz AS
Hennig-Olsen Is AS
Herregalleriet AS
Holmen Fjordhotell
Hotel Continental AS
HTH kjøkkenforum Oslo
Hustadmarmor AS
Huurre Norway AS
H-vinduet Vatne AS
Hydro Polymers AS
Hydrotech-gruppen AS
Håg ASA
Hålogaland Reisebyrå AS
Hålogaland Revisjon AS
Håndverkscompagniet AS
Ibas AS
ICA Distribusjon AS
ICA Norge AS
Idecon AS
Iittala AS
Ikea Forus
Ingeniør Gunnar M. Backe AS
Interfil AS
Island Offshore AS
ISS Facility Services AS
ISS Norge AS
Itet AS
Ivar Mjåland AS
Jadarhus
Jangaard Export AS
John Galten AS
Johs Lunde Transport
Jotun AS
Jotunheimen og Valdresruten Bilselskap AS
K. Lund AS
Kaffebrenneriet AS
Kantega AS
KENO reklame AS
Kirkestuen Transport AS
Kitron Arendal AS
Kitron Microelectronics AS
KLP Eiendom Trondheim
Klaastad Brudd DA
Knutsen OAS
Komplett ASA
Kongsberg Automotive Raufoss
Kontali Analyse AS
KPMG AS
Kraft Foods Norge AS
Kristiansand Cementstøperi AS
Kristiansund kommune
Kroken Caravan AS
Kruse Smith
Kvadrat Steen & Strøm
Kvalitet & Ledelse AS
Kviknes Hotel
Laerdal Medical AS
Landskapsentreprenørene AS
Langmorkje Almenning
Langset AS
Larvik kommune
Leif Gromstads Auto AS
Leiv Eriksson Nyformidling AS
Lenvik kommune
Leo Burnett
Leonhard Nilsen Sønner AS
Lerum Fabrikker
Lians Caravan & Fritid AS
Lillehammer kommune
Linjebygg Offshore AS
Lkab Norge AS
Lofotprodukt AS
Lom Møbelindustri AS
Lom og Skjåk Sparebank
Luxo Industrier AS
Lørenskog kommune
Løvold AS
M2 Eiendomsmegling AS
Majas Salong
Malermester Jan Andreassen AS
Manpower AS
Maxit
Melby Snekkerverksted AS
Melhus kommune

Melhus Sparebank
Melvær & Lien
Mesna Bruk AS
Mesta AS
Meyergården Hotell AS
Mills DA
Minde Sjokolade
Mjosundet Båt og Elektronikk AS
Mo Mekaniske Verksted AS
Modern Design
Moderne Byggfornyelse AS
Moelven Eidsvold Værk AS
Moelven Limtre AS
Moelven Nordia AS
Moelven Van Severen AS
Moelven Våler AS
Moelven Wood AS
Moen Slip AS
Moldjord Bygg og Anlegg AS
Moxy Engineering AS
Multi Elektro AS
Multiconsult AS
Møllergruppen
Møre og Romsdal Kornsilo ANS
Mørekjøtt AS
Mørenot AS
Nammo AS
Namsos kommune
Naper Informasjonsindustri AS
Narvik Megler'n AS
NAV Aust-Agder
NAV Nord-Trøndelag
NAV Sør-Trøndelag
NAV Telemark
NAV Vestfold
NCC Roads AS
Nedre Eiker kommune
Nesje AS
Nestle-Norge AS
Netcom AS
Nexans Norway AS
Nobø Electro AS
Norac AS
Norbook AS
NorDan AS
Nord-Aurdal kommune
Nordea Bank Norge ASA
Nordfjord Hotell
Nordfjord og Sunnmøre Billag AS
Nordic Paper
Nordlaks AS
Nordox AS
Norfolier AS
Norges Råfisklag
Norgestaxi Trondheim AS
Norisol Norge AS
Norpower Brødr. Malo AS
NorSea AS
Norsk Stein AS
Norsk Stål
Norsk Tipping AS
Norske Skogindustrier ASA
Nor-Sport Bodø AS
Norwegian
Notar Eiendom Telemark og Vestfold
Nymo AS
Nøsted Kjetting AS
O.L. Engen & Co AS
Oddstøl Elektronikk AS
Officelink AS
Oppegård kommune
Optimera Engros AS
Optimera Vest
Opus AS
Oras AS
Os kommune
OSK Elektrotilbehør AS
Oslo kommune
Oslo Sportslager AS
Ottadalen Mølle AL
Overhalla Cementvare AS
Owens Corning Fiberglas Norway AS
Paulsen Eiendom AS
Per Solem Arkitektkontor AS
Per Aaland AS
Personec AS
Petters Sjømat AS
Pitney Bowes
Plasto AS
Polimoon AS
Pon Power AS
Porsgrunds Porselænsfabrik AS
PriceWaterhouseCoopers Norge AS
Primahus AS
Proffice AS
Q-Free ASA
Quality Hotel Røros AS
Quality Spa & Resort Holmsbu
Radisson SAS Caledonien Hotel
Radisson SAS Lillehammer Hotell
Ragasco AS
Rambøll Norge AS
Rana Trevarefabrikk AS
Randaberg kommune
Reber Schindler Heis AS
Refa Frøystad Group AS
Reitan Servicehandel
Renés Barnevogner AS
Renseriet
Rescon Mapei AS
ResLab Reservoir Labaratories AS
Rica Hotel Norge AS
Rikshospitalet - Radiumhospitalet HF
Rio Doce Manganese Norway AS
Risør kommune
Rogaland Elektro
Rogaland fylkeskommune
Rogaland Kunnskapspark
Rogaland Taxi
Rogne Bygg AS
Rolls-Royce Marine AS
Røros kommune
Røros Tweed AS
Saga Fjordbase AS
Salten Bredbånd AS
Sandnes kommune
Sarpsborg kommune
SAS Braathens
SAS Royal Garden Hotel AS
Scanbridge AS
Schibsted ASA
Selfa Arctic AS
Sentrum Bygg
Siemens
Sigdal Kjøkken AS
Simon Møkster Shipping AS
SINTEF konsernstab
SIVA Selskapet for industrivekst SF
Sjøvik AS
Skanska Norge AS
Skarvik AS
Skien kommune
Skipsteknisk AS
Skodje Byggvare AS
SMV Hydraulic AS
Sortland Entreprenør AS
Sortland kommune
Spar
Sparebank 1 Midt-Norge
Sparebank 1 Nord-Norge
Sparebank 1 Vestfold
Sparebank Sør
Sparebanken Indre Sogn
Sparebanken Møre
Sparebanken Pluss
Sparebanken Vest
Spenncon AS
Spis Norge AS
Spitsbergen VVS AS
Sports Club Stavanger AS
Sportshuset AS
Stallgården Restauranthus AS
Stange kommune
Stavanger Aftenblad
Stavanger Toyota
Stavanger Universitetssykehus
Stavangerske AS
Stella Polaris AS
Stjern AS
Stjørdal kommune
Storebrand ASA
Strand Hotell Sortland
Strandtorget Kjøpesenter
Strømsholm Fiskeindustri AS
Støren Trelast AS
Sulland Gruppen AS
Surnadal kommune
Sykehuset Asker og Bærum HF
Sykehuset Østfold HF
Synnøve Finden ASA
Systembygg Kirkenes AS
Søgne og Greipstad sparebank
Sørco AS
Sørensen Maskin AS
Tandberg Data ASA
Taubåtkompaniet AS
Technor ASA
Teeness ASA
Teknisk Bureau AS
Tele 2 Norge AS
Tele-Team AS
Terra Skadeforsikring AS
Thon Hotel Arendal
Thon Hotel Gjøvik
Thon Hotels
Thrane & Thrane Teknikk AS
Thrane-Steen
Ti Group Automotive Systems AS
Tibe Reklamebyrå AS
Tide
Time kommune
Tine Meierier Vest
Tine Midt-Norge AS
Tinn kommune
TNS Gallup
Tohn Hotel Bryggen
Top Temp bemanning
Tor & Bjørns Autoservice AS
Toten Bygg og Anlegg AS
Trafikk & Anlegg AS
Trebetong AS
Trelleborg Viking AS
Trondheim Aktivum AS
Trondheimsfjorden interkommunale havn
TV Nordvest
Tysvær kommune
Tønsberg kommune
Ulstein Verft AS
Universal Sodexho
Universal Spedisjon
Universitetssykehuset Nord-Norge HF
Valdres Anlegg AS
Valdres Auto AS
Valdres Last AS
Valdres Regnskap AS
Vann og Varme AS
Varner-Gruppen AS
Vegdirektoratet
Veidekke ASA
Vest Inkasso AS
Via Travel Trondheim AS
VIBO Entreprenør AS
Vik-Sandvik Group
Vindafjord kommune
Vinn
Visma Services Norge AS
Vital Forsikring ASA
Voice Norge AS
Volmax AS
Volvat Medisinske Senter
Vågan kommune
Vågå kommune
Wenaas AS
West Contractors AS
Westnofa Industrier AS
Westres Bakeri AS
Widerøe's Flyveselskap ASA
Wikborg Rein
Windy Boats AS
WM-data Norge
YIT Building Systems AS
Yngvar Christensen AS
Ø.M. Fjeld AS
Økonor Flisa AS
Øster Hus Bygg
Østereng & Benestad AS
Åmot kommune
Aarsland Møbelfabrikk AS
Aas Mek. Verksted AS
3T Produkter AS

Annex II
Statistics, charts and detailed projections

Monetary policy meetings in Norges Bank
with changes in the key policy rate

Date	Sight deposit rate[1)]	Change
Future meetings		
27 June 2007		
30 May 2007		
25 April 2007		
Previous monetary policy meetings		
15 March 2007	4	+0.25
24 January 2007	3.75	+0.25
13 December 2006	3.50	+0.25
1 November 2006	3.25	+0.25
27 September 2006	3	0
16 August 2006	3	+0.25
29 June 2006	2.75	0
31 May 2006	2.75	+0.25
26 April 2006	2.5	0
16 March 2006	2.5	+0.25
25 January 2006	2.25	0
14 December 2005	2.25	0
2 November 2005	2.25	+0.25
21 September 2005	2	0
11 August 2005	2	0
30 June 2005	2	+0.25
25 May 2005	1.75	0
20 April 2005	1.75	0
16 March 2005	1.75	0
2 February 2005	1.75	0
15 December 2004	1.75	0
3 November 2004	1.75	0
22 September 2004	1.75	0
11 August 2004	1.75	0
1 July 2004	1.75	0
26 May 2004	1.75	0
21 April 2004	1.75	0
11 March 2004	1.75	-0.25
28 January 2004	2	-0.25
17 December 2003	2.25	-0.25
29. October 2003	2.5	0

[1)] The sight deposit rate is Norges Bank's key policy rate. The sight deposit rate is the interest rate on banks' deposits in Norges Bank. The sight deposit rate forms a floor for money market rates. By managing banks' access to liquidity, the central bank ensures that short-term money market rates are normally slightly higher than the sight deposit rate.

Table 1 Main macroeconomic aggregates

Percentage change from previous year/ quarter		GDP	Mainland GDP	Private con- sump- tion	Public spending on goods and servi- ces	Mainland fixed inv.	Petroleum inv.[1]	Exports trad. goods	Imports
1998		2.7	4.1	2.8	3.4	9.4	22.2	6.5	8.8
1999		2.0	2.6	3.7	3.1	0.2	-13.0	3.5	-1.6
2000		3.3	2.9	4.2	1.9	-1.4	-22.9	4.6	2.0
2001		2.0	2.0	2.1	4.6	3.9	-4.6	0.2	1.7
2002		1.5	1.4	3.1	3.1	2.3	-5.4	-1.7	1.0
2003		1.0	1.3	2.8	1.7	-3.6	15.9	2.1	1.4
2004		3.9	4.4	5.6	1.5	9.3	10.2	4.8	8.8
2005		2.7	4.5	3.3	1.8	9.1	19.1	6.7	8.6
2006		2.9	4.6	4.3	2.2	8.9	9.1	7.9	9.1
2006[2]	Q1	0.8	1.1	2.1	1.6	-5.5	-10.6	2.8	-0.1
	Q2	0.4	1.1	1.4	0.3	8.8	5.5	2.3	3.8
	Q3	1.3	1.1	0.8	0.0	-3.8	11.4	-0.8	0.4
	Q4	0.5	1.2	0.8	0.0	6.3	12.4	3.3	4.7
Level 2006, in billions of NOK		2148	1563	873	415	287	100	272	614

[1] Extraction and pipeline transport.
[2] Seasonally adjusted quarterly figures.

Source: Statistics Norway

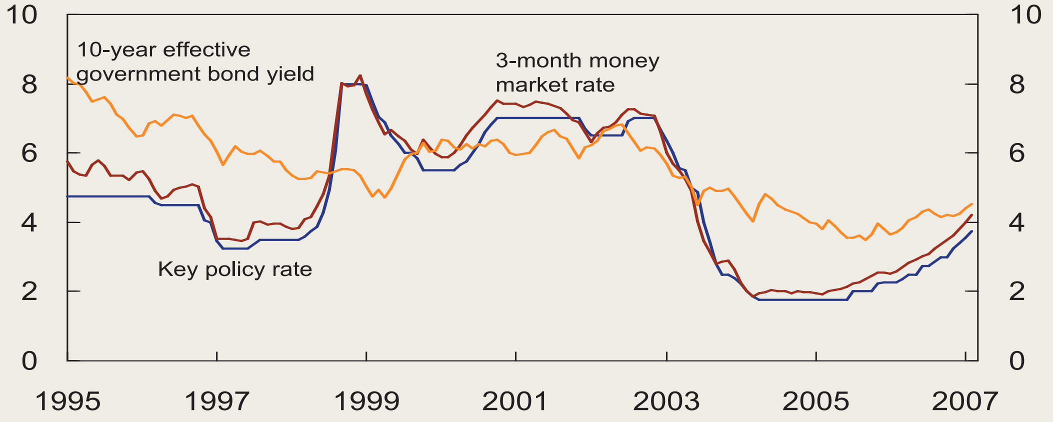
Table 2 Consumer prices

Twelve-month rise. Per cent		CPI	CPI-ATE[1]	CPI-AT[2]	CPI-AE[3]	HICP[4]
1998		2.3			2.9	2.0
1999		2.3			2.3	2.1
2000		3.1			2.3	3.0
2001		3.0	2.6	3.2	2.4	2.7
2002		1.3	2.3	2.2	1.6	0.8
2003		2.5	1.1	2.5	1.0	1.9
2004		0.4	0.3	0.0	0.8	0.6
2005		1.6	1.0	1.2	1.4	1.5
2006		2.3	0.8	2.0	1.0	2.5
2006	Jan	1.8	0.8	1.5	1.1	1.8
	Feb	2.6	1.0	2.3	1.2	2.7
	Mar	2.4	0.9	2.2	1.1	2.4
	Apr	2.7	0.8	2.6	1.1	2.8
	May	2.3	0.7	2.1	1.0	2.5
	Jun	2.1	0.8	1.9	1.1	2.1
	Jul	2.2	0.6	1.9	1.0	2.3
	Aug	1.9	0.4	1.6	0.5	2.1
	Sep	2.6	0.5	2.4	0.8	3.0
	Oct	2.7	0.7	2.3	1.0	3.0
	Nov	2.6	0.8	2.2	1.1	2.8
	Dec	2.2	1.0	1.8	1.2	2.2
2007	Jan	1.2	1.0	1.1	1.1	1.2
	Feb	0.8	1.1	0.6	1.3	0.8

[1] CPI-ATE: CPI adjusted for tax changes and excluding energy products.
[2] CPI-AT: CPI adjusted for tax changes.
[3] CPI-AE: CPI excluding energy products.
[4] HICP: The Harmonised Index of Consumer Prices. The index is based on international criteria drawn up by Eurostat.

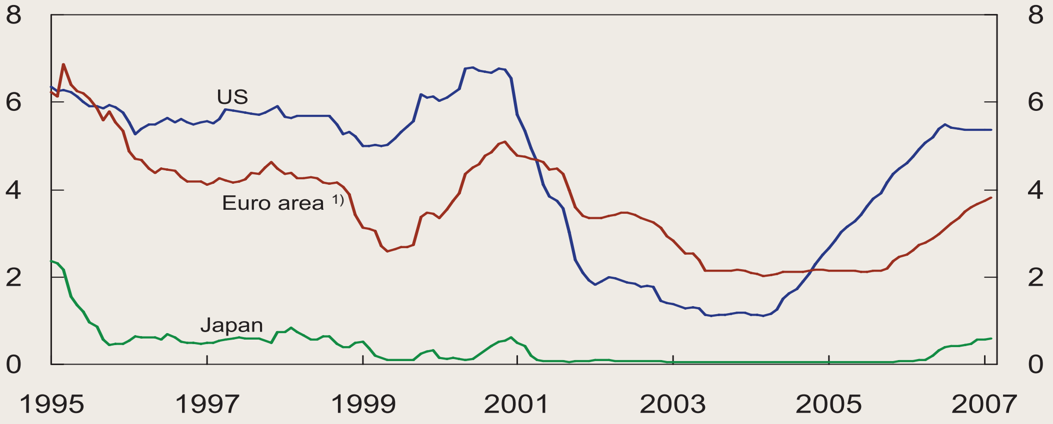
Source: Statistics Norway

Chart 1 Norwegian interest rates. 3-month money market rate, key policy rate and 10-year government bond yield.
Per cent. Monthly figures. Jan 95 – Feb 07



Source: Norges Bank

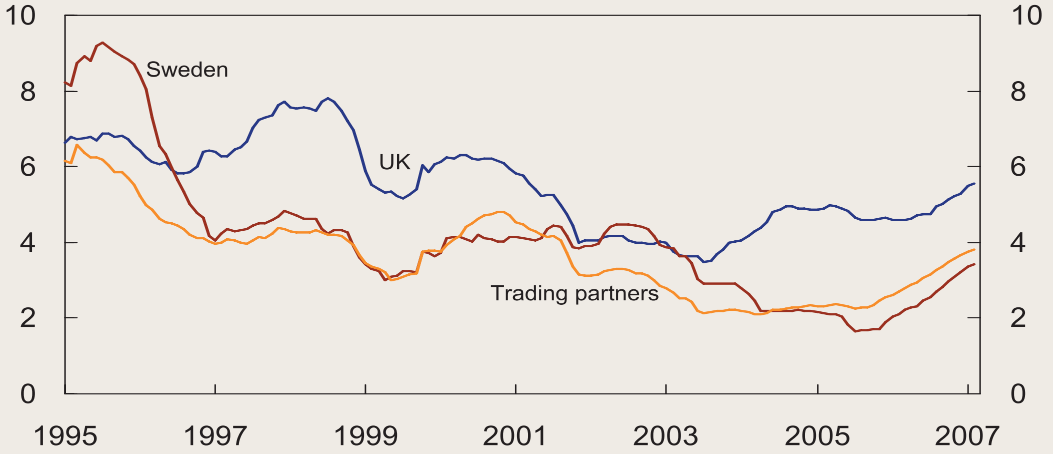
Chart 2 3-month interest rates in the US, the euro area and Japan.
Per cent. Monthly figures. Jan 95 – Feb 07



1) Theoretical ECU rate up to and including December 98.

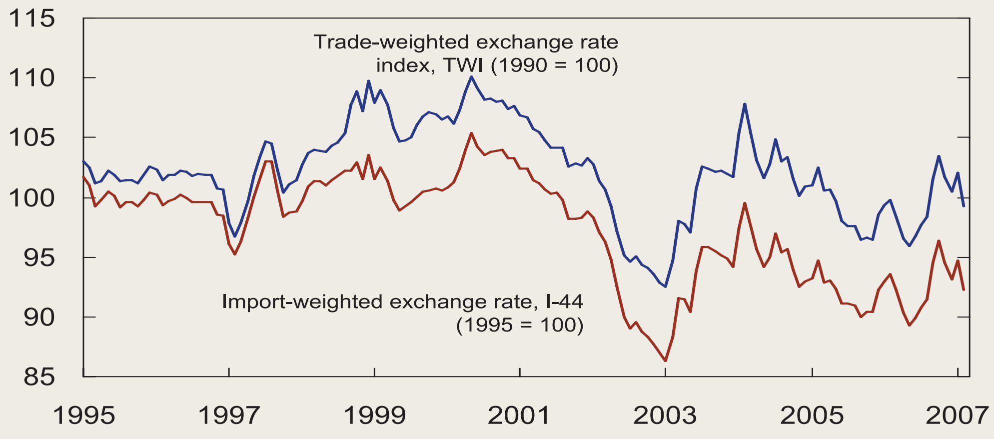
Source: Reuters (EcoWin)

Chart 3 3-month interest rates in the UK, Sweden and among Norways trading partners. Per cent. Monthly figures. Jan 95 – Feb 07



Sources: Reuters (EcoWin) and Norges Bank

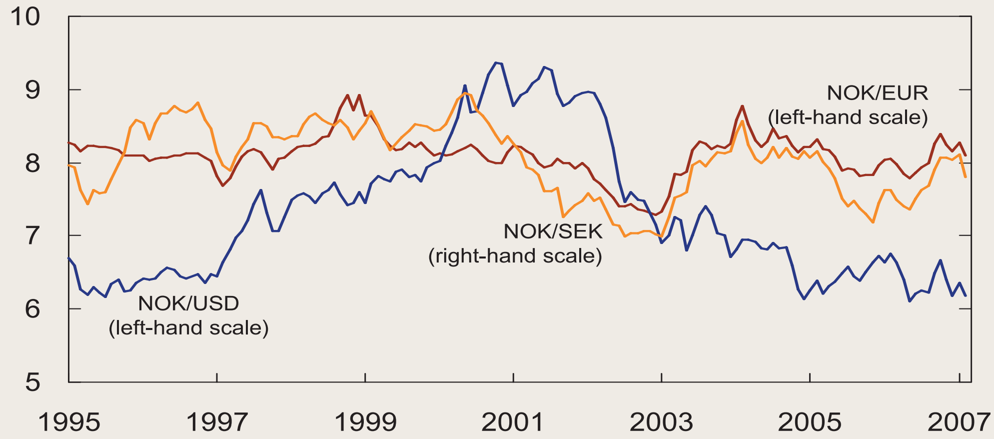
Chart 4 Trade-weighted exchange rate index and import-weighted exchange rate.[1)] Monthly figures. Jan 95 – Feb 07



1) A rising curve denotes a weaker krone exchange rate.

Source: Norges Bank

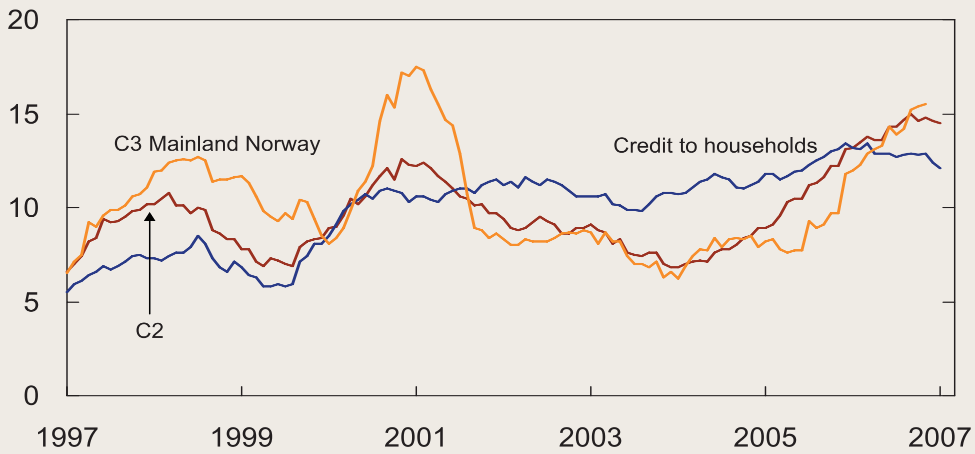
Chart 5 Bilateral exchange rates.[1)] Monthly figures. Jan 95 – Feb 07



1) A rising curve denotes a weaker krone exchange rate.

Source: Norges Bank

Chart 6 The credit indicator (C2), credit to households and total credit mainland Norway (C3). 12-month change. Per cent. Monthly figures. Jan 97 – Jan 07



Source: Statistics Norway

Table 3 GDP growth in other countries

Percentage change from previous year
Projections for 2007 – 2010

	US	Japan	Germany	France	UK	Sweden	Trading partners[1)]	Euro area
2006	3.3	2.2	2.7	1.9	2.7	4.4	3.5	2.7
Projections								
2007	2¼	1¾	1¾	2¼	2½	3½	3	2¼
2008	2¾	1¾	2¼	2¼	2½	2¾	2¾	2¼
2009	2¾	1½	2	2½	2½	2¼	2½	2
2010	2½	1½	1½	2¼	2¼	2	2¼	1¾

1) Export weights, 26 important trading partners.

Sources: IMF, OECD, Eurostat, national sources and Norges Bank

Table 4 Consumer prices in other countries

Percentage change from previous year
Projection for 2007 – 2010

	US	Japan	Germany	France	UK	Sweden	Trading partners[1)]	Euro area[2)]
2006	3.2	0.2	1.8	1.9	2.3	1.4	1.9	2.2
Projections								
2007	2	½	2¼	2	2¼	1½	2	2¼
2008	2½	1	1½	2	2	2	2	2
2009	2¼	1¼	1½	1¾	2	2	2	2
2010	2¼	1¼	1½	1¾	2	2	2	2

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

Sources: IMF, OECD, Eurostat, national sources and Norges Bank

Table 5 Main macroeconomic aggregates

	In billions of NOK	Percentage change (unless otherwise stated)				
			Projections			
	2006	2006	2007	2008	2009	2010
Real economy						
Mainland demand[1)2)]	1572	4.3	4	2¾	2¼	2¼
- Private consumption	873	4.3	4	3	2¾	2¾
- Public consumption	415	2.2	3	3	·	·
- Fixed investment[2)]	284	7.5	5¾	1¼	·	·
Petroleum investment[3)]	100	9.1	2½	0	5	5
Traditional exports	376	7.9	7	3½	·	·
Imports[2)]	610	8.5	5½	3¼	·	·
GDP[4)]	2148	2.9	2¾	3¼	1¾	1¼
Mainland GDP[4)]	1563	4.6	3¾	2¼	2	2
Potential mainland GDP		3¼	3	2¾	2¾	2½
Output gap, mainland Norway[5)]		1½	2¼	1¾	1	½
Labour market						
Employment		3.1	2¼	¼	0	0
Labour force, LFS[6)]		1.6	1¼	½	½	½
LFS unemployment (rate)[6)]		3.4	2¾	3	3½	3¾
Prices and wages						
CPI		2.3	¾	2½	2½	2½
CPI-ATE[7)]		1.0	1½	2	2½	2½
Annual wage growth[8)]		4.3	5¼	5¼	4¾	4¼
Interest rate and exchange rate						
Sight deposit rate (level)		2.74	4¼	5¼	5¼	5¼
Import-weighted exchange rate (I-44)[9)]		92.41	92¼	92¼	92¾	93¾

1) Private and public consumption and mainland gross fixed investment.
2) The projections do not include the import of two frigates in 2006, and the import of one frigate in each year in the period 2007-2009. Each frigate is estimated to cost NOK 3.5 billion.
3) Extraction and pipeline transport.
4) Fluctuations in the production of electricity are excluded from the GDP estimates.
5) The output gap measures the percentage deviation between mainland GDP and projected potential GDP.
6) Comprises all groups 16 - 74 years.
7) CPI-ATE: CPI adjusted for tax changes and excluding energy products. In addition, it is adjusted to take into account that the reduction in maximum day-care rates pushes down the rise in the CPI-ATE by an estimated 0.2 percentage point in 2006.
8) Annual wage growth is based on the Technical Reporting Committee on Income Settlements' definitions and calculations. The projections include estimated costs in 2006 and 2007 related to the introduction of mandatory occupational pensions.
9) Level. The weights are estimated on the basis of imports from 44 countries, which comprises 97% of total imports.

· No data available

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

B-blad/Economique

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