

Economic trends

The Norwegian economy passed a cyclical trough in the first half of 2003 and has since experienced a pronounced upturn. The upswing has primarily been supported by the shift in the monetary stance in 2003 and to some extent by an increase in petroleum investment. In line with previous analyses, the Norwegian economy is projected to come above trend in early 2005. Our projections for growth in the mainland economy in 2005 have been revised up somewhat in relation to previous projections because new information from oil companies indicates sharp growth in oil investment in 2005. With continued monetary and fiscal stimulus, combined with moderate, albeit decelerating growth among our trading partners, the cyclical expansion in the Norwegian economy may continue throughout 2005. Our growth projections for 2005 and 2006 imply that the boom will not be as pronounced as towards the end of the 1990s. Nevertheless, it is worth recalling that Statistics Norway, like most forecasting institutions, underestimated the amplitude of the upturn at that time, particularly through 1997. This may also prove to be the case this time since so many of the driving forces in the economy are pulling in the same direction.

However, there are many important differences in relation to the situation prevailing in the 1990s with respect to the functioning of the economy. In the 1990s, monetary policy was solely oriented towards exchange rate stability, which resulted in a procyclical monetary stance in 1997, and which amplified the cyclical boom. Under the current monetary policy regime, monetary policy is tightened to prevent high inflation, particularly when inflation is driven by domestic demand growth. However, the experience of 2002 shows that such a policy orientation has some undesired effects because exchange rate changes can lead to a situation where the internationally exposed sector has to pay for a large share of the costs of cyclical stabilization. This is hardly consistent with long-term structural considerations regarding business and industry and balance on the external account, and hence with that implied by the phasing in of petroleum revenues into the Norwegian economy.

Our inflation projections indicate that the operational target of monetary policy can be reached in 2007, even with very low nominal interest rates ahead. However, this presupposes that interest rates do not rise in the euro area. This is based on the assumption of weak international downturn after 2005. Should the Norwegian economy be exposed to stronger domestic demand impulses than we have anticipated, there will no longer be a basis for such low interest rates even with low interest rates abroad. If international cyclical developments lead to a gradual rise in international interest rates, Norges Bank could tighten monetary policy with limited effects on the exchange rate. On the other hand, stronger international growth will generate stronger inflationary impulses to the Norwegian economy, particularly if commodity prices remain high and do not show a cyclical decline as we have assumed. This is because profitability in Norwegian manufacturing would then imply higher wage growth than we have projected. As a result, the inflation target will most probably not be reached in 2007, unless the central bank increases its key rates to a higher level than in the euro area. Our analyses show that the interest rate could then be doubled in relation to the current low nominal levels. In the first round, this will lead to weaker growth in consumption and investment in Norway, and the housing market could be particularly hard hit. The current account balance and government budget balances could, however, show further improvement as a result of terms-of-trade gains owing to higher prices for raw materials and semi-finished goods. In summary, income growth, combined with an interest rate increase, will lead to lower consumption and higher foreign financial investment. If politicians allow the improvement in the budget balance to lead to further tax relief, Norges Bank will have to respond with an even stronger tightening of monetary policy to reach the inflation target.

Norwegian economy

The cyclical upturn in the Norwegian economy has now lasted for a year and a half, with underlying annual growth in mainland GDP at 3.4 per cent over the past six quarters. The revision of the fourth-quarter national accounts (QNA), including the updating of the base year, has not changed the cyclical picture prevailing in September. The cyclical trough in spring 2003 was not deep, given an output gap at the cyclical trough of only 1.5 per cent of trend GDP. With the projections presented in this report, the Norwegian economy will be over the trend in early 2005. Such a moderate trough as the Norwegian economy will then have been through has not been observed since the

1970s. Important new information, compared with the information available to us in the beginning of September, includes revised figures and a quarter of new observations, in addition to an approved central government budget with a proposal for changes in taxes and excise duties. There were several new items here, not least the VAT changes, which have some influence on our 2005 projections. More importantly, however, it appears that oil investment will be considerably higher in the coming years than we assumed earlier. Against the background of high oil prices and prospects of persistently high prices (i.e. higher, rather than lower, than USD 30 per barrel), a large

Macroeconomic indicators 2002-2004. Growth from previous period unless otherwise noted. Per cent

			Seasonally adjusted			
	2002	2003	03.4	04.1	04.2	04.3
Demand and output						
Consumption in households and non-profit organizations	3.0	3.0	0.7	1.8	0.1	0.8
General government consumption	3.7	1.4	0.0	0.7	1.0	-0.1
Gross fixed investment	-1.0	-2.0	-6.4	9.2	1.8	4.4
Mainland Norway	2.5	-2.2	2.6	-0.2	3.4	3.6
Extraction and transport via pipelines	-5.3	16.9	-7.2	9.3	1.0	3.3
Service activities incidental to extraction	..	..	..	..	..	..
Final domestic demand from Mainland Norway ¹	3.1	1.6	0.8	1.2	0.9	1.1
Exports	-0.8	1.6	3.7	-1.4	0.4	-1.1
Crude oil and natural gas	1.9	-0.6	-1.9	7.2	-1.4	-2.6
Traditional goods	0.4	5.1	1.8	-2.1	-1.2	5.4
Imports	0.7	2.2	2.4	3.5	2.2	4.0
Traditional goods	3.4	4.3	2.1	4.8	3.9	3.7
Gross domestic product	1.1	0.4	0.3	1.1	1.2	-1.0
Mainland Norway	1.4	0.7	0.9	0.7	1.0	0.7
Labour market						
Man-hours worked	-1.1	-1.2	0.5	0.6	0.3	0.5
Employed persons	0.1	-0.6	-0.1	-0.3	0.4	0.2
Labour force ²	0.4	0.0	-0.1	-0.5	0.6	0.2
Unemployment rate, level ³	3.9	4.5	4.6	4.3	4.5	4.5
Prices and wages						
Wages per standard man-year ⁴	5.3	3.9	2.7	2.9	3.7	4.0
Consumer price index (CPI) ⁴	1.3	2.5	1.2	-1.4	0.9	1.2
CPI adjusted for tax changes and excluding energy products (CPI-ATE) ⁴	2.3	1.1	0.6	0.1	0.2	0.3
Export prices, traditional goods	-8.9	-2.2	2.5	4.9	-1.1	2.3
Import prices, traditional goods	-7.5	0.4	1.6	0.8	0.1	0.1
Balance of payment						
Current balance, bill. NOK	193.9	200.3	54.8	53.1	50.4	61.0
Memorandum items (unadjusted level)						
Money market rate (3 month NIBOR)	6.9	4.1	2.8	2.0	2.0	2.0
Lending rate, banks ⁵	8.5	6.6	4.7	4.4	4.1	4.1
Crude oil price NOK ⁶	197.5	204.7	203.2	221.0	242.5	283.1
Importweighted krone exchange rate, 44 countries. 1995=100	91.6	92.8	94.7	98.2	94.9	96.1
NOK per euro	7.51	8.00	8.22	8.63	8.26	8.39

¹ Consumption in households and non-profit organizations + general government consumption + gross fixed capital formation in Mainland Norway.

² Unemployed (Labour Force Survey) and employment (NA) excl. maritime personnel in ocean transport.

³ According to Statistics Norway's labour force survey (LFS).

⁴ Percentage change from the same period the previous year.

⁵ End of period.

⁶ Average spot price, Brent Blend.

Sources: Statistics Norway and Norges Bank.

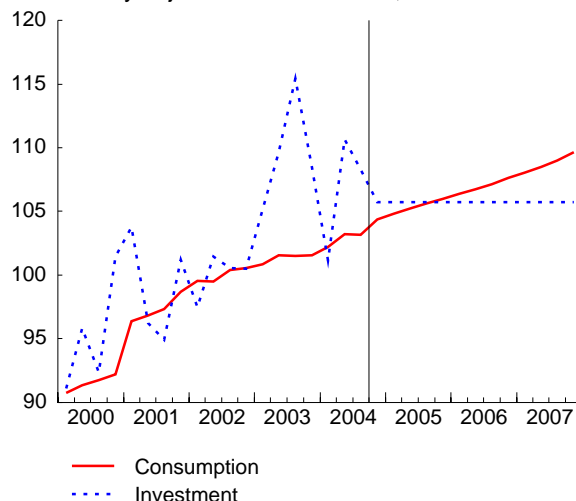
number of development projects are now looked upon as profitable. Typically, we see how oil companies revise up their oil price expectations in the light of observed events, i.e. how they update their expectations based on new information. We have thus revised up our investment projections in line with oil companies' investment plans.

Against this background, the cyclical upturn in the Norwegian economy is projected to be stronger in 2005 than expected earlier, and the economy will stay above trend longer, continuing beyond 2007. However, there is substantial uncertainty surrounding this scenario. During the previous period above trend, as from 1997, a surprising upward adjustment of oil investment was the main reason why all observers underestimated the strength of the upturn, and why the expansion spanned such a long period. This could very well recur during the current upturn, partly because cost overshoots in the oil sector most typically occur when there is high capacity utilization in the firms involved in development projects.

However, unlike in 1997, monetary policy is now oriented towards reaching an inflation target and not an exchange rate objective. If the global cyclical upturn moderates and shifts to a downturn towards the end of 2005, as we assume in our baseline scenario, it is not reasonable to assume that interest rates will increase in the euro area. In that case, it will probably be difficult for Norges Bank to raise Norwegian interest rates to counter the upturn in Norway. The krone exchange rate could then rapidly appreciate again, making it difficult to achieve the inflation target, in addition the Norwegian economy becomes even more dependent on oil. Export-oriented industries would then be faced with weakening foreign markets and even weaker cost competitiveness, not unlike the situation in 2002.

Our perception that the global cyclical upturn will shift to a downturn in the course of 2005 is not a consensus perception, however. Consensus forecasts are based on the assumption that growth in the US at most will moderate slightly between 2005 and 2006, while growth will accelerate in the EU. With this scenario, most observers assume a gradual rise in nominal interest rates in both the US and the euro area. In conjunction with a slight decline in inflation in the euro area, real interest rates will then be markedly higher than in 2004. The main driving force behind growth will be an increase in investment. In an alternative scenario, we show the implications for cyclical developments in Norway should growth continue abroad, combined with an interest rate increase towards the end of 2005 and into 2006. Such a scenario could ease the pressure on monetary policy, but will not prevent the Norwegian economy from remaining in an expansionary phase from 2005 to 2007. If oil investment proves to be even higher than we have

General government
Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

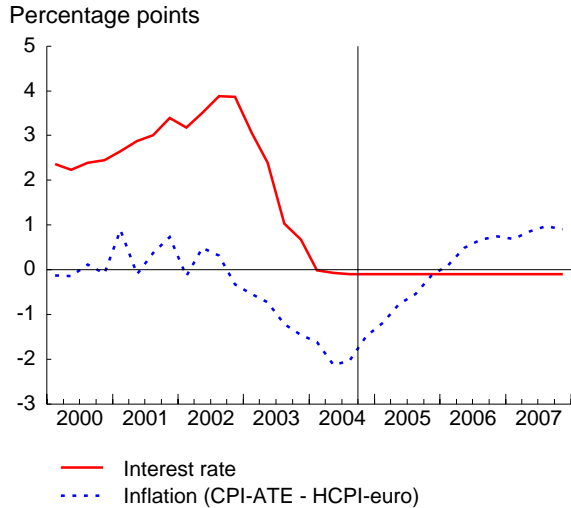
assumed, the Norwegian economy will again be faced with traditional dilemmas. The margin of manoeuvre in monetary policy will then be insufficient, and fiscal policy will have to support monetary policy, which is not the case with the fiscal stance for 2005. The experience of 1997 also shows that it will be difficult to tighten fiscal policy in the spring when the parties are heading for an election in autumn.

Slightly more expansionary fiscal stance

Fiscal policy has contributed to the cyclical upturn in the Norwegian economy that started in the first half of 2003. The fiscal stimulus in 2004 has been about the same as in the previous year, as measured by the structural, non-oil budget deficit as a share of the trend value of mainland GDP. The level of the budget deficit in 2004 is estimated to be 2 per cent higher than implied by a narrower interpretation of the fiscal rule. This is a rough indicator of the discretionary part of fiscal policy. As a result of lower tax revenues than previously assumed, the deficit for 2004 will be somewhat larger than estimated in the National Budget for 2005, while the fall in sickness absence has the opposite effect. For 2005, the Government's initial budget proposal had the same expansionary effect as in 2004, but the budget agreement in the Storting (Norwegian parliament) has increased the expansionary impact somewhat. While the budget deficit (non-oil and structural) increases in the years following 2001 could be justified on the basis of the need to counter the effects of the decline in the value of the Petroleum Fund, and also the subsequent need to conduct a countercyclical policy, these reasons no longer apply in 2005 now that the Norwegian economy is most likely entering an expansionary phase.

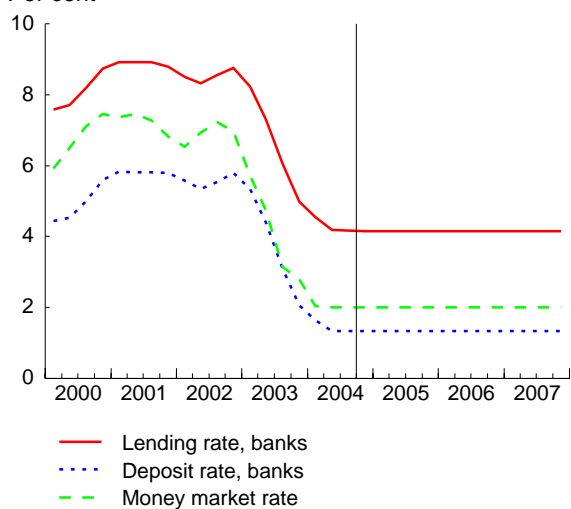
The tax programme for 2005 has been incorporated in our estimations, which have led to some changes in our projections compared with the projections in the September report. First, the general VAT rate will in-

Interest rate and inflation differential between NOK and the euro



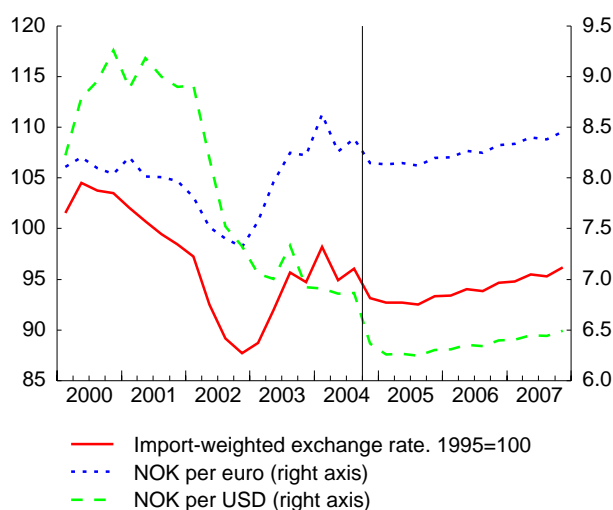
Sources: Norges Bank and Statistics Norway.

Norwegian interest rates



Source: Norges Bank.

Exchange rates



Source: Norges Bank.

creased from 24 to 25 per cent, while the VAT rate for food will be reduced from 12 to 11 per cent. There are also some other changes in VAT, for example for transport. The direct net contribution of these changes to total CPI inflation is 0.4 percentage point in 2005. If possible effects on wage growth, etc., are also taken into account, the contribution could be somewhat higher than 0.4 percentage point in 2005. The effects of the VAT changes on CPI-ATE inflation will probably be marginal as the direct effects are stripped out.

In addition to increased indirect taxes as a result of VAT changes, a number of excise duties will be changed. Not all the changes are a standard inflation adjustment as we assumed earlier, but the differences are moderate and have limited effects on our projections. The reduction in direct tax rates has a greater impact on our projections. They have been incorporated in our calculations and result in an increase in household disposable income. This nominal income growth is reduced, however, as a result of the overall tax programme. As regards general government purchases of goods and services for consumption and investment purposes, new estimates from the National Budget for 2005 have been incorporated, but these estimates do not differ considerably from those underlying our previous projections.

For 2006 and 2007 we have, as usual, assumed unchanged real taxes and excise duties. Growth in general government purchases of goods and services is broadly in line with that of 2005. This implies that fiscal policy is gradually, but fairly moderately, tightened in line with the estimates in the National Budget for 2005.

Interest rate increase called off?

In previous reports, an underlying assumption was that the interest rate would remain low throughout the projection period, but with a modest increase in 2005 and a comparable decrease in 2006. This was partly based on an expected increase in the ECB's key rate in the first half of 2005. The basis for such an interest rate increase now appears to have weakened. Growth in the euro area was sluggish in the third quarter, partly reflecting high oil prices and a strong euro, and various economic indicators for the fourth quarter suggest that growth may lose further momentum in the period ahead. The strong euro exchange rate may offset some of the inflationary effects that accompany high energy prices. Against this background, there seems to be a weaker basis for an interest rate increase in the euro area.

If the ECB leaves interest rates unchanged, an interest rate increase in Norway could have a pronounced impact on the exchange rate. Admittedly, we expect high oil investment to prolong the expansion in Norway into 2006 and 2007, but in our scenario inflation

remains relatively low up to 2007, even with an unchanged interest rate and a relatively stable exchange rate. It is thus difficult to find any basis for an interest rate increase peculiar to Norway. In an alternative calculation, we show the consequences for the Norwegian economy of strong global growth, combined with an increase in interest rates in the euro area and an interest rate increase in Norway.

Stronger krone, or only increased exchange rate volatility?

Since the previous report, the krone has strengthened appreciably against the euro in periods. It moved from a level between 8.30 and 8.40 in September, to levels below 8.10 at the end of November. In the press, it was reported that a number of analysts expected the exchange rate to move below 8. At the beginning of December, the krone depreciated from 8.07 to 8.25. These swings could be attributable to oil prices, which first rose and then fell in this period.

One should nevertheless be cautious about attributing krone movements to the oil price alone. The foreign exchange market has experienced a shift in recent months, in the sense that a period of dollar stability has been followed by a sharp depreciation of the dollar against two other major currencies, the euro and the yen, and particularly against the euro. In such periods, portfolio managers tend to seek new investment opportunities, which can result in volatility for small currencies that is not directly linked to assessments of the dollar and euro. For example, it can be noted that not only Norway, but several other inflation-targeting countries, such as Sweden and Australia, saw their currencies appreciate against the euro in October and November.

If the appreciation of the Norwegian krone reflects an international tendency towards investing in smaller currencies, rather than investing based on changes in local conditions, Norges Bank has limited scope for influencing the exchange rate. The negative interest rate differential against the euro should already, in isolation, reduce investors' interest in the krone. As mentioned, movements in oil prices may also have an influence on the krone. However, it is difficult from a historical perspective to identify a close relationship between the krone exchange rate and oil price movements. This is not surprising since it is also difficult to identify real economic reasons for a particularly strong relationship. After all, the revenues from petroleum wealth are largely invested directly in foreign currency. To the extent that the return on petroleum investment is converted to pay oil taxes, most of the effect is sterilized through foreign exchange purchases for the Petroleum Fund.

In no way can it be ruled out that the krone exchange rate will appreciate. As described in earlier reports, however, our projections are based on the assumption

that the exchange rate is largely steered by developments in purchasing power parity, i.e. the relative price differential between Norway and other countries, and the interest rate differential against the euro area. This implies that the krone will gradually depreciate as inflation in Norway edges up, while the interest rate differential remains narrow. However, the volatility of the krone may increase at least within a short-term horizon. If the dollar correction continues, markets may remain unstable. In such periods, capital flows may shift rapidly, and events that under other circumstances have little market influence may have considerable price effects. However, this type of volatility should not threaten exporters' and importers' scope for currency hedging. Against this background, it is unlikely that such volatility will have any considerably real economic consequences.

Investment record from 1998 set to be broken?

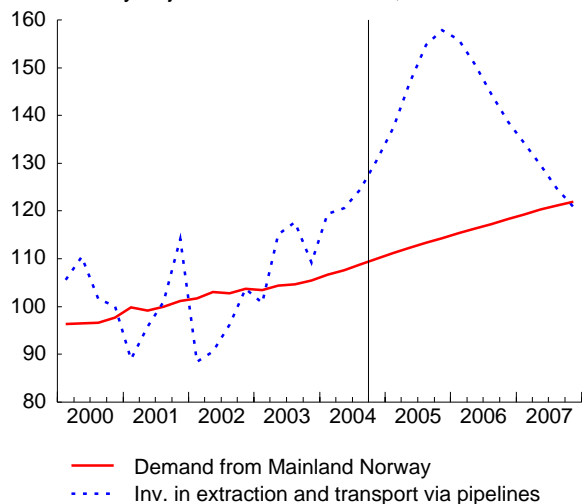
On the whole, seasonally adjusted QNA figures show a clear increase in the volume of investment in production and pipeline transport through the latter half of 2002 and up to the third quarter of 2004. Revised figures show that the level of investment increased by 16.9 per cent on an annual basis between 2002 and 2003. Statistics Norway's investment statistics are an important source of information for our investment projections. Statistics Norway's most recent survey indicates a lower investment level for 2004 than previously projected, particularly as regards investment in exploration and fields in operation. For the year as a whole, this implies that investment in volume terms is now projected to be a little less than 10 per cent higher than in 2003.

For 2005, we now assume that the investment level will be more than 23 per cent higher than in 2004. This is a substantial increase in relation to previous estimates, and primarily reflects oil companies' reported upward adjustments of investment estimates. We now assume that investment in both exploration, pipeline transport, development and fields in operation will increase markedly, while investment in on-shore installations will slow somewhat. Measured at constant prices, the investment level is estimated at around NOK 2 billion below the peak year in 1998 – a record that could be broken as early as next year. A persistently high oil price, combined with the positive response for oil companies in the most recent licensing round, is expected to result in a high investment level also in the last two years of the projection period.

For 2006, investment is projected to show a small decline, while in 2007 investment is expected to fall by close to 15 per cent, which implies that investment in volume terms will be somewhat higher than the level projected for 2004. Investment in exploration, fields in operation and field development is expected

Domestic demand

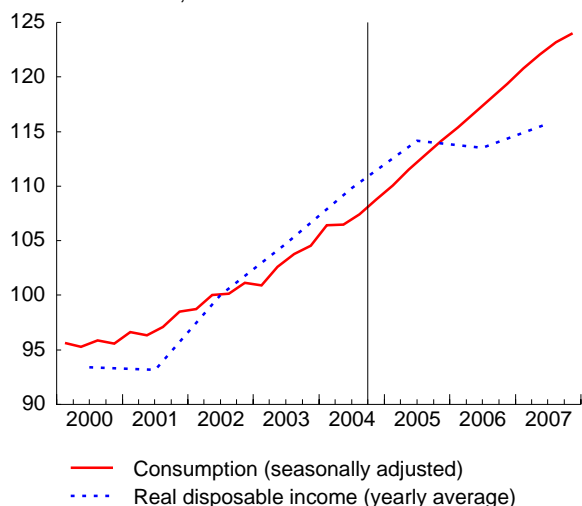
Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

Income and consumption in households

Volume indices, 2002=100



Source: Statistics Norway.

to be high, while investment in onshore installations and pipeline transport will gradually be phased out with the completion of Snøhvit and Ormen Lange. The effects of the increase in oil investment after 2004 are discussed further in a box in this report.

Measured in relation to the previous quarter, seasonally adjusted production figures show that gas and oil production increased by around 3 per cent in the first quarter of this year, and by an additional 1 percentage point in the second quarter. Major production disruptions due to planned maintenance activity on several fields, combined with technical problems on others, resulted in an estimated production decline of close to 7 per cent in the third quarter. Gas production was hardest hit, partly because of maintenance at the terminal Kårstø. For the fourth quarter, operating problems on the Snorre A-platform will continue to the end of the year, which will result in an estimated oil

production level that is about 4 per cent lower than in the same quarter in 2003. For the year as a whole, oil production is expected to be 1 per cent lower than in 2003, and total production of oil and gas at about the same level in the two years. During the projection period, total production is projected to show an annual increase of about 2 per cent. Gas production is projected to show an average annual increase of about 13 per cent, while oil production is expected to decline somewhat. This is broadly in line with the estimates in the National Budget for 2005, but with some upward adjustment as our projections are based on a higher investment level.

Strong consumption growth ahead

According to revised national accounts figures, consumption for households and non-profit institutions grew by 3 per cent between 2002 and 2003 at constant prices, while previously published figures showed growth of close to 4 per cent. At the same time, growth in household real disposable income has been revised up from about 2 per cent to more than 4.5 per cent in 2003, primarily reflecting a marked upward revision of dividend payments. The unusually high dividend payments this year can probably be ascribed to the removal of dividend tax in 2002 and adjustments to a possible re-introduction of dividend taxation (see the Skaug Commission's recommendation, Report no. 2003:9). The bulk of the dividend payments provides little consumer incentive for households, which is reflected in a mere 3 per cent increase in consumption and an increase in the saving ratio from a record-high level in 2002 to as high as 10 per cent in 2003.

:Seasonally adjusted QNA figures show that consumption for households and non-profit institutions grew by 0.8 per cent between the second and third quarter. Goods consumption grew, seasonally adjusted, at a somewhat slower pace than total consumption in the third quarter of this year. Goods consumption slowed primarily as a result of a decline in the consumption of books, tobacco and leisure goods. For the first three quarters of the year as a whole, household consumption was about 4.4 per cent higher than in the same period in 2003. The strong rate of growth in consumption, which has been a prominent feature since 2002, seems to be continuing through 2004, albeit at a somewhat more moderate pace than projected in our previous report.

Growth in household real disposable income is projected at close to 5 per cent in 2004. Underlying this projection is, among other things, wage growth in line with that of 2003, combined with some increase in employment. This implies stronger growth in wage income in 2004 than in 2003 when employment declined. Growth in self-employment income also appears to be stronger in 2004 than in 2003. Developments in net capital income are pushing up growth in

household income. Since households are in a net debt position when we look at interest-bearing assets and liabilities, a given reduction in interest rates will result in a smaller reduction in income from bank deposits than in debt expenses, which implies higher net capital income. Dividend payments are expected to be about the same in 2004 as in 2003. Very low consumer price inflation is making a substantial contribution to the relatively high rate of growth in real disposable income in 2004. For the years 2005, 2006 and 2007, growth in household real disposable income is projected at 4, -0.5 and 2 per cent, respectively. Real income growth will slow during the projection period in relation to 2004 as a result of weaker growth in self-employment income, lower growth in transfers, higher consumer price inflation and considerable reductions in dividend payments, particularly from 2005 to 2006. However, the dividend estimates are highly uncertain due to the approved re-introduction of dividend tax in 2006 and adjustments in the period preceding the re-introduction.

Growth in consumption for household and non-profit institutions is estimated at about 4.5 per cent in 2004 and in the three subsequent years. Together with the projection for growth in real disposable income, the saving ratio of a good 10 per cent in 2003 will remain virtually unchanged this year. In spite of lower growth in real disposable income ahead compared with 2004, consumption growth will not be affected to any significant extent. The removal of tax-motivated dividend payments is not likely to have any considerable impact on consumption. The strong rate of growth in consumption in the coming years primarily reflects developments in the real interest rate. Even if the nominal interest rate level is expected to remain virtually unchanged ahead, real interest rates will fall during the projection period as a result of higher consumer price inflation. A decline in real interest rates implies that consumption in the current period will be cheaper in relation to consumption in the next period, so that households will consume more in the current period at the expense of consumption in subsequent periods. On the basis of our estimates, the saving ratio will fall to around 2.5 per cent in 2007. The fall in the saving ratio, combined with brisk growth in housing investment, will be reflected in a marked fall in household net lending. In nominal terms, households are expected to reduce net lending from about NOK 53 billion in 2004 to almost -24 billion in 2007. Close to half of the decline can be attributed to dividend payments.

Continued growth in housing investment

After declining over several years, housing investment showed a turnaround in the fourth quarter last year, and housing investment has exhibited brisk growth through the first three quarters of this year. According to seasonally adjusted figures, the number of housing starts was about 12 per cent higher in the third quar-

Effects of higher oil investment in 2005-2007

If our assumptions concerning investments in extraction and pipeline transport for 2004 are correct, this implies a relatively high level of around NOK 68 billion at constant 2002 prices. Our projection for 2005-2007 are based on an investment level that is 16 billion, 14 billion and 2 billion higher in the three respective years than in 2004. In 2005, this will generate an impulse of around 1 per cent of mainland GDP. The macroeconomic effects of these higher investment levels are shown in the table below. The calculations are partial in that adjustments have not been made for fiscal and monetary policy and the exchange rate is assumed to remain unchanged.

Contribution from higher oil investment in 2005-2007

Percentage figures unless otherwise noted

	2005	2006	2007
Key real economic variables			
Investment in extraction and pipeline transport	23.1	19.9	2.9
Household consumption	0.1	0.2	0.4
Investment, mainland Norway	0.5	0.9	0.1
Exports	0.0	0.0	0.0
Imports	1.4	1.4	0.3
GDP, Mainland Norway	0.6	0.4	0.0
- Manufacturing	1.0	1.9	1.7
Employed persons	0.3	0.3	0.0
Unemployment (percentage point)	-0.2	-0.2	0.1
Prices			
Wages	0.2	0.5	0.6
CPI	0.0	0.2	0.2
In billions of NOK			
Current account	-6.6	-6.6	-0.8

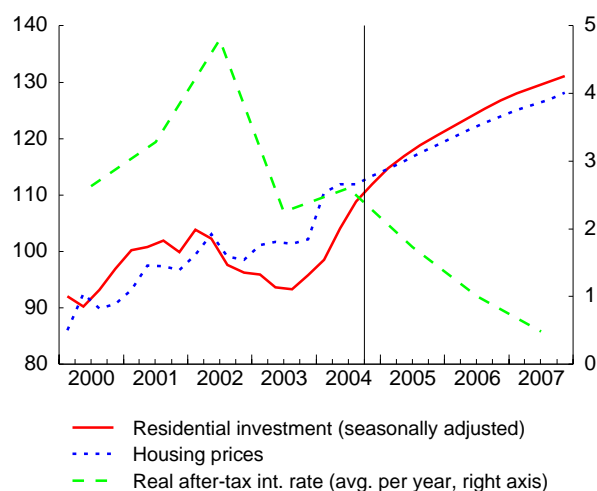
Oil investment relies heavily on imports, the types of investment that are expected to show the largest increase are those that are the most import-intensive. Moreover, higher mainland consumption and investment will gradually lead to higher imports. Domestically, oil investment provides impulses primarily to manufacturing and some service industries. Value added in manufacturing will thereby increase in 2005, primarily reflecting the direct effects, while consumption and rising investment will also make a contribution after a period. The increases in consumption reflect a rise in real wages and employment. Unemployment falls in the first years, which pushes up wage and prices. Since we have not incorporated assumptions of higher oil production in the calculation period, the current account balance weakens

ter of this year compared to the fourth quarter of the last year. For the first three quarters as a whole, statistics show that the number of housing starts was about 30 per cent higher than in the same period in 2003. Seasonally adjusted QNA figures show that housing investment, at constant prices, rose by 4.6 per cent from the second to the third quarter of this year. In the second quarter, growth was 5.7 per cent, while growth in the preceding quarter was close to 3 per cent.

The prospect of continued low real interest rates, falling unemployment and rising real prices for resale homes are the main factors behind the projected developments in the housing market in the coming years. Annual growth in housing investment is now projected at a little less than 12 per cent in 2004,

Residential market

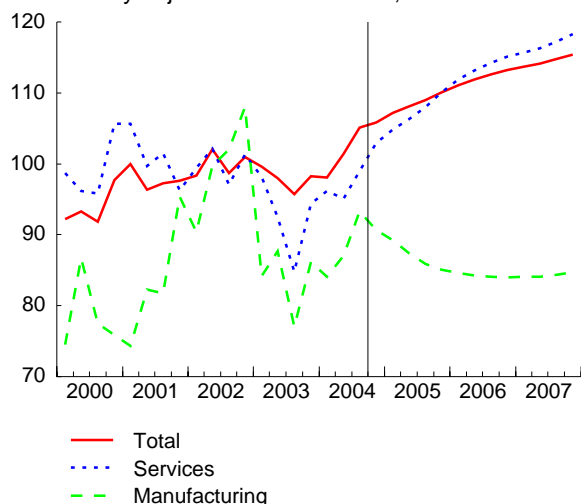
Left axis adj. indices, 2002=100, right axis per cent



Source: Statistics Norway.

Investment, Mainland Norway

Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

against a fall of a good 5 per cent in 2003. Housing investment will gradually decelerate during the projection period. Owing to a considerable carry-over from 2004, the annual increase in 2005 will be almost as high as this year, but considerably lower in the two subsequent years. Resale home prices are expected to increase by as much as 10 per cent this year and between 3 and 5 per cent in the following three years, i.e. a continued clear rise in real prices during the projection period, albeit at a clearly slower pace than the average rate over the past 10 years.

Growth in mainland business investment

Mainland business investment increased by 5.6 per cent in volume terms in the third quarter, according to seasonally adjusted, preliminary QNA figures. Investment has now expanded by 12.7 per cent after bottoming out in the third quarter of last year. Growth has been strong both for manufacturing and service

firms. According to QNA figures, manufacturing investment is still at such a low level in many manufacturing sectors that the volume of real capital is still falling, which implies that capacity is gradually being reduced. This applies to tech products, paper and pulp, the graphical industry, refinery, engineering, shipbuilding and oil platforms. The metal industry and some sectors of the food industry are the only industries where the stock of real capital has shown a steady increase over the past two years. On the other hand, in the service industry capacity is increasing in most segments, with the hotel and restaurant industry, services linked to transport and postal and telecommunications services as the main exceptions.

For 2004 as a whole, mainland business investment is projected to expand by 5.0 per cent, and by 7.1 per cent for manufacturing alone. For 2005, growth is projected at 4.2 and -6.1 per cent, respectively. The decline in manufacturing investment in 2005 primarily reflects an expected sharp decline in investment in the metal industry due to the completion of major investment projects in recent years. Statistics Norway's investment intentions survey for manufacturing shows an even stronger decline in 2005 than we have projected.

The decline in manufacturing investment is expected to continue in 2006, and then to level off later in 2007. Investment growth is also expected to decelerate for other mainland firms ahead, but growth is expected to be positive, particularly in some service sectors. For mainland firms as a whole, growth is projected at 3.6 per cent in 2006 and 1.5 per cent in 2007.

Moderate international downturn could put a brake on export growth

The volume of traditional merchandise exports increased by 5.4 per cent in the third quarter of 2004, according to seasonally adjusted QNA figures. With the exception of the volatile group refined oil products, growth was 3.8 per cent, which represents a sharp increase in relation to the preceding quarters. The increase was particularly pronounced for the export group fish and fish products, where growth was very weak in the preceding quarter.

Since the first quarter of 2003, when the US economy passed the cyclical trough, growth in Norwegian traditional merchandise exports has been 6.2 per cent annualized. A large share of the expansion took place as early as in the second quarter of 2003, partly as a result of increased capacity in the aluminium industry, but probably also as a result of a normalization of the krone exchange rate after the strong appreciation in 2002. Many Norwegian firms are still struggling because of a high cost level relative to foreign competitors, which explains why underlying export growth is still lower than growth in our export markets. For

Main economic indicators 2003-2007. Accounts and forecasts. Percentage change from previous year unless otherwise noted

	Accounts 2003	Forecasts									
		2004			2005			2006		2007	
		SN	MoF	NB	SN	MoF	NB	SN	NB	SN	NB
Demand and output											
Consumption in househ. and non-profit organizations	3.0	4.3	4.5	5	4.6	4.0	4 1/2	4.6	3 3/4	4.6	2 1/2
General government consumption	1.4	1.7	2.2	2	1.9	1.7	1 3/4	1.4	1 1/2	1.7	1 1/2
Gross fixed investment	-2.0	7.8	7.1	..	10.7	5.8	..	1.9	..	-2.3	..
Extraction and transport via pipelines ¹	16.9	9.7	9.4	12 1/2	23.1	13.2	15	- 2.6	5	-14.2	-7 1/2
Mainland Norway	-2.2	5.0	5.7	5 3/4	5.2	3.2	5	3.4	5	2.0	2 3/4
Firms	-4.9	5.0	4.3	..	4.2	3.7	..	3.6	..	1.5	..
Housing	-5.3	11.6	10.3	..	11.1	4.8	..	5.4	..	4.1	..
General government	9.2	-2.4	3.2	..	0.0	0.3	..	0.0	..	0.0	..
Demand from Mainland Norway ²	1.6	3.7	4.8	4 1/4	4.0	3.8	4	3.5	3 1/2	3.4	2 1/4
Stockbuilding ³	-0.8	0.8	..	..	0.0	..	..	0.0	..	0.0	..
Exports	1.6	1.2	1.2	..	3.6	3.2	..	2.9	..	2.9	..
Crude oil and natural gas	-0.6	0.6	- 0.6	..	3.0	3.0	..	1.7	..	2.7	..
Traditional goods	5.1	3.0	3.3	4	5.0	5.1	4 1/2	2.5	3	0.6	3
Imports	2.2	8.4	7.6	8 1/2	7.4	5.0	6	4.8	4	3.0	1 3/4
Traditional goods	4.3	10.3	8.0	..	7.2	5.2	..	5.4	..	3.9	..
Gross domestic product	0.4	2.8	2.4	2 3/4	3.9	3.1	3 1/4	2.5	2 3/4	2.4	2
Mainland Norway	0.7	3.5	3.2	3 3/4	3.6	3.1	3 1/2	2.3	2 3/4	2.0	2
Labour market											
Employed persons	-0.6	0.1	0.3	1/4	1.1	0.8	1 1/4	0.8	1 1/4	0.2	1/2
Unemployment rate (level)	4.5	4.4	4.4	4 1/2	4.0	4.1	4	3.7	3 3/4	4.0	3 3/4
Prices and wages											
Wages per standard man-year	3.9	3.8	3 3/4	3 3/4	3.7	4.0	4 1/2	3.8	4 3/4	4.0	4 3/4
Consumer price index (CPI)	2.5	0.5	1/2	1/2	1.2	2 1/4	2 1/4	2.0	1 3/4	2.5	2 1/4
CPI adjusted for tax changes and excluding energy products (CPI-ATE)	1.1	0.3	1/4	1/4	1.1	1 3/4	1 1/2	2.1	1 3/4	2.5	2 1/4
Export prices, traditional goods	-2.2	8.2	..	..	-0.4	..	..	-2.1	..	0.7	..
Import prices, traditional goods	0.4	3.6	1.9	..	-2.1	..	..	-0.4	..	1.8	..
Housing prices ⁴	1.6	10.0	..	..	4.3	..	..	4.8	..	3.3	..
Balance of payment											
Current balance (bill. NOK)	200.3	237.8	235.8	..	246.8	211.5	..	212.3	..	212.2	..
Current balance (per cent of GDP)	12.8	14.1	..	..	14.0	..	..	11.8	..	11.3	..
Memorandum items:											
Household savings ratio (level)	10.1	10.2	6.5	..	9.7	6.6	..	5.1	..	2.6	..
Money market rate (level)	4.1	2.0	2.0	2	2.0	2.5	2 1/4	2.0	3 1/4	2.0	4
Lending rate, banks (level) ⁵	6.6	4.3	..	..	4.2	..	..	4.2	..	4.2	..
Crude oil price NOK (level) ⁶	205	257	250	..	229	230	..	211	..	218	..
Export markets indicator	3.9	4.8	..	..	5.1	..	..	2.8	..	0.5	..
Importweighted krone exchange rate (44 countries) ⁷	1.3	3.0	..	3 1/4	- 2.9	..	2 1/2	1.3	- 1/2	1.5	0

¹ Forecasts from Ministry of Finance incl. service activities incidental to extraction.² Consumption in households and non-profit organizations + general government consumption + gross fixed capital formation in Mainland Norway.³ Change in stockbuilding. Per cent of GDP.⁴ Freeholder.⁵ Households' borrowing rate in private financial institutions. Yearly average.⁶ Average spot price, Brent Blend.⁷ Increasing index implies depreciation.

Sources: Statistics Norway (SN), Ministry of Finance, St.meld. nr.1 (2004-2005), (MoF), Norges Bank, forecasts based on forward interest and exchange rates, Inflasjonsrapport 3/2004 (NB).

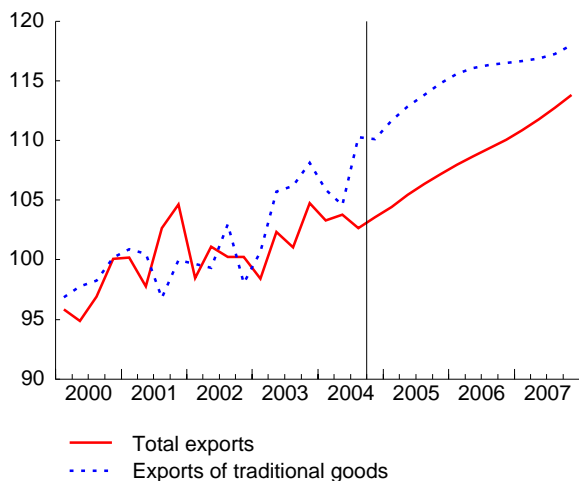
2004 as a whole, export growth is projected at 3.0 per cent against market growth of 4.8 per cent.

Export prices have also been on the rise over the past year and a half, but the rise has primarily been for cyclically sensitive industrial commodities and fish and fish products. For engineering products, prices have tended downwards. For 2004 as a whole, the rise in prices for traditional merchandise exports is projected at 8.2 per cent.

For the years ahead, we assume that the international economy will pass a cyclical peak in the course of 2005, shifting to a moderate cyclical downturn up to 2007, and then to a renewed upturn in the course of summer 2007. On an annual basis, export market growth is expected to fall from 5.1 per cent in 2005 to 0.5 per cent in 2007. At the same time, growth in the volume of traditional merchandise exports is projected to fall from 5.0 per cent in 2005 to 0.6 per cent in 2007. The cyclical downturn through 2005 is expect-

Exports

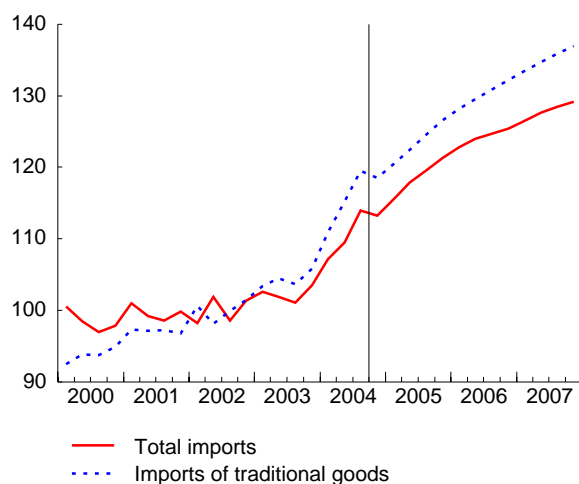
Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

Imports

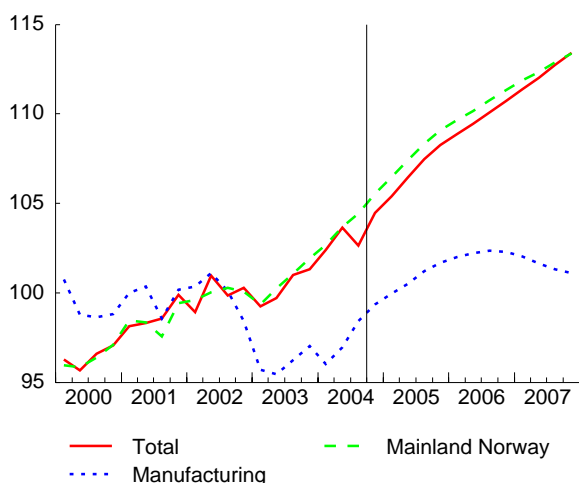
Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

Gross domestic product

Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

ed, as usual, to trigger a price fall for cyclically sensitive industrial commodities. Furthermore, prices for some other Norwegian export products are also expected to show a modest decline ahead. On an annual basis, prices for overall exports of traditional goods are expected to fall by 0.4 per cent from 2004 to 2005, by a further 2.1 per cent in 2006, followed by a rise of 0.7 per cent in 2007 as a result of a depreciation of the krone at that time.

Galloping import growth

Traditional merchandise imports continued to exhibit strong growth in the third quarter of this year. From the third quarter of 2003 to the third quarter of 2004, traditional merchandise imports expanded by as much as 14.6 per cent in volume terms, according to QNA figures. Over the past three quarters, seasonally adjusted growth has been as high as 17.6 per cent on an annual basis. By comparison, the volume of Norwegian firms' deliveries to the home market sank by an annualized 2.1 per cent in the same period. In the second quarter, traditional merchandise imports (both in value terms and at constant 2002 prices) exceeded a total market share of 50 per cent, i.e. we now import more traditional goods than we produce for the domestic market.

The sharp increase in import shares may to some extent reflect changes in the composition of goods owing to shifts in demand patterns, which are in turn ascribable to varying income developments, etc., among various consumers. For example, metal imports have increased sharply over the past year, which reflects increased imports of raw materials to the Norwegian metal industry. There is still evidence to suggest that a large and widening difference in relative prices for Norwegian and imported products is the main driving force. The price differences have triggered a shift in demand towards imported goods and have induced firms to outsource production of components used in Norwegian products (which leads to increased imports and intermediate consumption for Norwegian firms, while Norwegian production remains unchanged and the value added generated in Norway is reduced).

Prices for traditional merchandise imports are still moving on a considerably weaker trend than prices for comparable Norwegian goods. For example, import prices for engineering products, which account for 40 per cent of traditional merchandise imports, have declined by 1.4 per cent, while prices for domestically produced engineering products have risen by 1.1 per cent. This trend is expected to continue, albeit at a more moderate pace. As an average for the period 2005-2007, import prices for engineering products are expected to fall by close to ½ per cent in each year, while prices for domestically produced engineering products are expected to rise by 1 per cent.

All in all, traditional merchandise imports are projected to grow by 10.3 per cent this year, shrinking to 3.9 per cent in 2007, while total mainland demand is expected to increase by 3.7 per cent this year, shrinking to 3.4 per cent in 2007. The relatively low level of import growth in 2007 must be seen in connection with the assumption of an international downturn at the beginning of the year. Both import and export growth normally slow during a downturn.

More pronounced cyclical upturn

Mainland GDP expanded by an annual rate of 3 per cent in the third quarter, according to seasonally adjusted, preliminary QNA figures.

This is the sixth consecutive quarter with growth rates around 3-3½ per cent, which is considerably higher than trend growth for the Norwegian economy. In this period, growth has been particularly strong (6.1 per cent annualized) for non-manufacturing goods-producing industries, not only in the building and construction industry, but also in agriculture, forestry and fishery and fish farming. Growth has also been strong (4.3 per cent annualized) for mainland private service industries, while the hotel and restaurant industry have been the main exceptions with production declining during the period. The growth rate for manufacturing has been considerably weaker (1.9 per cent) and for general government entities (1.1 per cent).

Mainland production is expected to show continued strong growth in the coming year. On an annual basis, mainland GDP growth is projected at 3.6 per cent in 2005, against 3.5 per cent in 2004. Growth is projected to slow to 2.3 per cent in 2006 and 2.0 per cent in 2007. There are two main driving forces behind this growth path. First, the current international cyclical upturn, combined with increased capacity, is contributing to solid growth in raw-material-oriented manufacturing sectors. There will be a turnaround here in 2006 and 2007 if the international economy passes the cyclical peak and enters a new cyclical downturn in the course of next year, as we predict. Moreover, high oil investment this year and particularly next year will generate a substantial impetus to Norwegian manufacturing production, but also to some service sectors. These impulses will weaken markedly through 2006 and 2007.

According to our projections, this implies that the current cyclical upturn in the Norwegian economy that started in summer 2003, and which will bring the Norwegian economy into a moderate expansionary phase at the beginning of next year, will continue to the end of 2005 and then shift to a weak downturn through 2006 and 2007. Towards the end of 2007, the output gap will virtually close. An alternative scenario shows the effects on the Norwegian economy should global growth not come to a halt, but continue at a moderate pace throughout the projection period.

Clear growth in employment – more moderate fall in unemployment

The cyclical upturn that has continued since summer 2003 has not led to any significant decline in unemployment so far. According to seasonally adjusted figures from the Labour Force Survey (LFS), the number of unemployed stood at 106 000 (4.4 per cent) in September this year, measured as a three-month moving average, or a decline of only 5 000 since the unemployment peak in June 2003. The number of registered unemployed (Directorate of Labour) has exhibited the same tendency, with seasonally adjusted figures showing a decline of 5 000 from the end of June 2003 to the end of November this year. However, the number of persons participating in labour market programmes has increased somewhat.

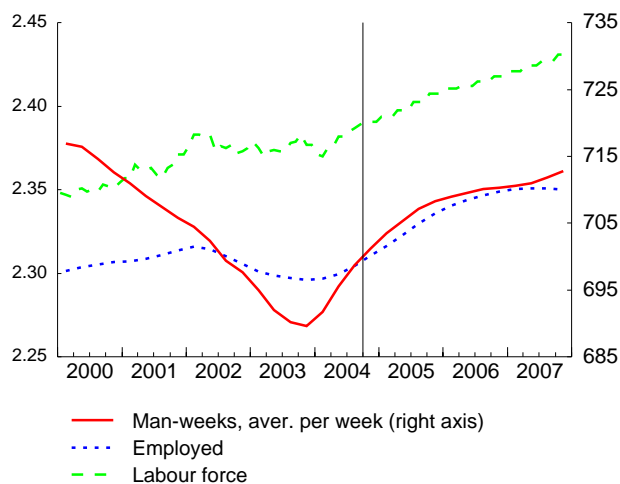
Seasonally adjusted QNA figures show that employment increased by 13 400 from the first to the third quarter of this year. As a result of a decline in sickness absence, the number of person-hours worked has increased. A fall in sickness absence had been observed for all industries, but employment growth has primarily taken place in distributive trades. QNA figures show that employment declined in cyclically sensitive manufacturing sectors and the building and construction industry in the third quarter. Moreover, employment is falling in the public sector. These sectors combined employ half of the labour force. Employment also declined in the post and telecommunications sector and in the financial services industry, while employment in commercial services remained virtually unchanged.

Developments in unemployment ahead depend on developments in hiring and redundancies. Furthermore, unemployment statistics will be influenced by developments in the labour force. So far in the upturn, the increase in demand oriented towards firms has primarily been accompanied by productivity growth as a result of surplus capacity rather than any considerable increase in employment. However, continued strong GDP growth, in conjunction with decelerating productivity growth and solid growth in the mainland business sector, may indicate that many firms are now experiencing capacity constraints in production. As a result, hiring activity may increase.

According to figures from the Directorate of Labour, the number of redundancies was halved at the end of November 2004 compared with one year earlier. In addition, the number of short-term unemployed is steadily declining, which also indicates that the number of redundancies is falling. In isolation, rising employment and falling redundancies point to a clear decline in unemployment, but in line with improved labour market conditions it is normal for persons that were previously not included in the labour force to become more active job-seekers. This tends to restrain

Labour force, employment and number of man-weeks

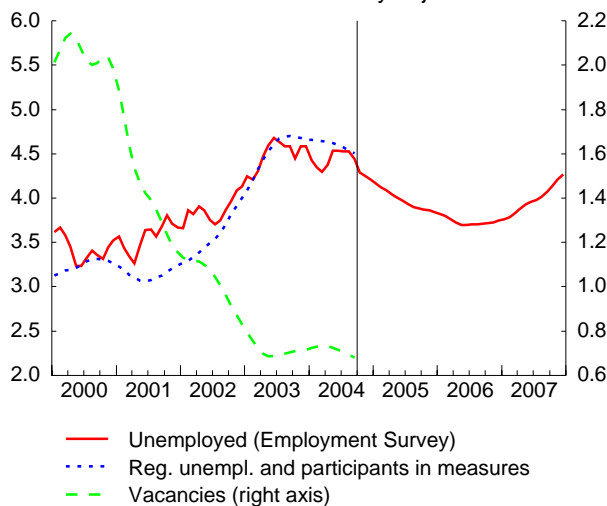
Millions. Seasonally adjusted and smoothed indices



Source: Statistics Norway.

Unemployed and number of vacancies

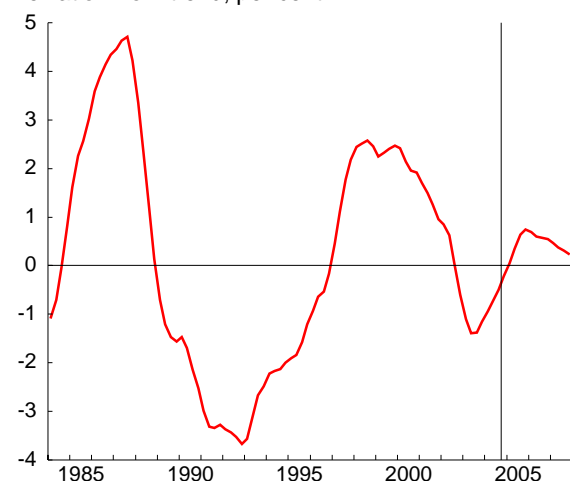
Per cent of labour force. Seasonally adj. and smoothed



Sources: The Directorate of Labour and Statistics Norway.

Output gap, Mainland Norway

Deviation from trend, per cent



Source: Statistics Norway.

the decline in unemployment figures during a cyclical upturn. Changes in age composition nevertheless imply a reduction in the labour force participation rate for the age group 16-74.

The effects of EU enlargement on 1 May this year will affect labour migration to Norway. We have chosen not to incorporate any marked increase in labour immigration in the projection period.

Overall, labour market conditions are expected to improve further in the period ahead. Employment growth will continue and unemployment is expected to fall at a faster pace. With annual employment growth of around 1 per cent, unemployment is projected to fall from 4.4 per cent this year to 4.0 per cent in 2005 and 3.7 per cent in 2006. As a result of the international downturn and lower oil investment towards the end of the projection period, the labour market may weaken again in 2007. Unemployment is projected at 4.0 per cent in 2007.

Continued moderate wage growth

QNA figures show that wages per normal person-year worked was 3.5 per cent higher in the first three quarters of this year than in the same period last year. Wage growth was 3.9 per cent between 2002 and 2003, compared with 5.3 per cent between 2001 and 2002. A sluggish labour market in 2003 and 2004, weak international competitiveness and low inflation explain the relatively low growth in wages over the past two years.

There was broad agreement between the social partners that this year's wage settlement should be limited to annual wage growth of about 3.5 per cent. We expect somewhat higher growth in wages per normal person-year worked since this wage concept also includes overtime pay. In the fourth quarter of last year, the use of overtime sank markedly in virtually all sectors of the economy. In manufacturing, this pushed down annual growth in wages per normal person-year worked by about 1 percentage point. QNA figures suggest an increase in the use of overtime in the first three quarters of the year, compared with the fourth quarter of last year, and that it was about the same as in the first three quarters of last year. The increase in overtime in the building and construction sector was particularly strong during this period. Overtime is expected to continue to increase in the fourth quarter, pushing up wage growth for the year as a whole. Growth in wages per normal person-year worked is projected at 3.8 per cent in 2004.

A trend of rising sickness absence that has persisted over many years seems to have been broken in 2004, and sickness absence is now falling. While sickness absence has an impact on growth in wages per person-hours worked, it has little effect on wages per normal person-year.

With prospects of a strong krone, particularly against the dollar, and later an international cyclical downturn, wage growth will continue to be relatively low in the years ahead. Higher inflation, high oil investment and lower unemployment will have the opposite effect, but will probably not generate strong impulses to wage growth.

In 2005, there is an interim wage settlement, with negotiations at a centralized level. These negotiations tend to be less conflictual and wage increases to be more moderate than in years with main settlements. Nevertheless, the carry-over from the previous year will push up overall wage growth also in years with interim settlements. In 2005, growth in wages per normal person-year worked is projected at 3.7 per cent, or the same as for this year. As a result of improved labour market conditions, wage growth is expected to somewhat higher in 2006 and 2007, at 3.8 and 4.0 per cent respectively.

Higher, but continued low inflation

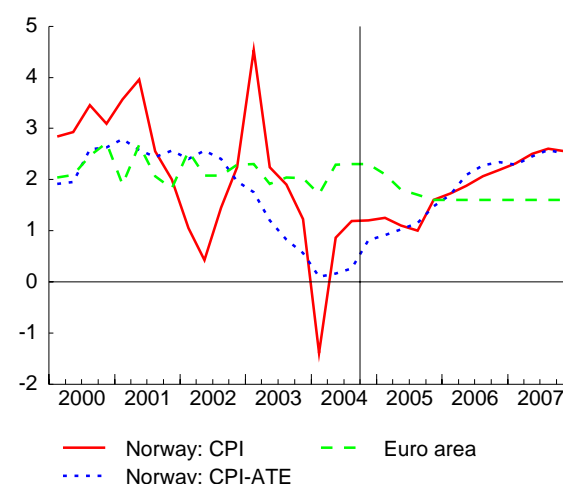
The rise in the consumer price index (CPI) was 1.2 per cent in November compared with the same month one year earlier. The direct effects of real indirect tax changes accounted for about 0.4 percentage point of the rise, while the contribution from energy products was -0.2 percentage point. The CPI adjusted for tax changes and excluding energy products (CPI-ATE) was thus 1.0 per cent higher than one year earlier. Since February this year when year-on-year CPI-ATE inflation reached a low of -0.1, it has shown a gradually rising tendency.

The tendency of rising, underlying inflation primarily reflects price developments for imported consumer goods. Prices for imported consumer goods have largely fallen over the past five years, and the price decline was particularly steep in the wake of the marked appreciation of the krone through 2001 and 2002. In June 2003, these prices pushed down year-on-year CPI inflation by as much as 1.1 percentage points. Thereafter, the contribution from the price decline has generally receded. In February, the contribution was still -0.8 percentage point, while in November it was approximately zero. Since May, developments in prices for other services have also exerted upward pressure on inflation.

In tandem with these developments, interest rate developments have contributed to a marked decline in the rise in house rents. In July 2002, the rise in house rents, including holiday homes, was close to 6 per cent annualized. In November 2004, the rate of increase had decelerated to 1.6 per cent, or a 0.7 percentage point decline in the contribution from these prices to CPI inflation. Price developments for domestically produced agricultural and fish products have also contributed to lower inflation.

Consumer price indices

Percentage growth from the same quarter previous year



Sources: Statistics Norway and Norges Bank.

At the beginning of next year, VAT on food will be reduced by 1 percentage point, while other VAT rates will be increased by 1 percentage point. In isolation, this change in excise duties will, given an immediate feed-through to consumer prices, push up CPI inflation by 0.35 per cent. Overall, developments in energy prices are estimated to push down CPI inflation by 0.3 percentage point next year. CPI inflation is projected at 1.2 per cent in 2005, while CPI-ATE inflation is expected to be somewhat lower than this in 2005. The effects of the changes in VAT on CPI-ATE inflation will be marginal as the direct effects of indirect tax changes are stripped out, but it must be noted that this adjustment is made on the assumption of full feed-through from January 2005.

The depreciation of the krone through 2003 and 2004 is expected to continue to exert upward pressure on underlying inflation in Norway for a period ahead. However, the appreciation of the krone since February this year to mid-December will gradually contribute to a lower rise in prices for imported consumer goods and hence to lower inflation for a period.

In spite of the prospect of a low interest rate level for a good period ahead, our calculations show a moderate increase in house rent inflation in 2006 and further ahead. The cyclical upturn will have an impact and productivity growth may thereby decline. As a result, in spite of virtually unchanged wage growth, domestic cost impulses may nevertheless lead to higher inflation.

In 2006 and 2007, energy prices are expected to rise in pace with the general rise in prices. Moreover, we have assumed that indirect tax rates will be adjusted for inflation in 2006 and 2007. Towards the end of 2005 and to the end of the projection period, the krone is expected to depreciate somewhat, with an at-

Sustained global upturn - an alternative scenario

As in previous economic reports, this report is based on the assumption that GDP growth among our trading partners will fall markedly from 2005 to 2006. This is based on an assumption that the US economy will pass a cyclical peak and shift into moderate downturn in the course of the first six months of 2005, and that the euro area will follow suit towards the end of the year. Even though doomsday prophecies are not exactly in short supply as regards developments in the US economy ahead, such a pessimistic view of the global outlook is not the consensus view among forecasting institutions. In its most recent report in November, for example, the OECD projects that growth will pick up both in the US and the euro area, which implies higher growth for Norway's trading partners between 2005 and 2006. The UK economic institute NIESR and the EU Commission also forecast rising growth among our trading partners between 2005 and 2006.

Our assumption of a moderate cyclical downturn through 2006 is primarily based on simple regularities as to the length and shape of a normal business cycle in the US and the euro area. But we can obviously not rule out the possibility that "everything is different this time". The current upturn has been so weak that there are no signs of bottlenecks of any importance. In this respect, there still is room for above trend growth over several years ahead. On the other hand, house prices in the US are record high, and the same applies to household debt accumulation for the US as a whole. This could trigger a far more pronounced downturn in the US than we have assumed. Overall, we are thus of the view that the assumption of a moderate cyclical downturn is relatively balanced. However, since our baseline scenario deviates markedly from that of other forecasting institutions, we have chosen to apply an alternative scenario, based on consensus forecasts of a sustained cyclical upturn in OECD countries.

In our alternative scenario, growth holds up in the US and gains momentum in the euro area. Market growth for Norwegian exports remains at around 5½ per cent throughout the projection period, while it decelerates to around zero in the baseline scenario. Oil prices stabilise at USD 40 per barrel, and other commodity prices show only a small decline. In the baseline scenario, oil prices fall to about USD 33 and commodity prices decline by about 7 per cent. Inflation in the euro area moves up to 1.9 per cent in 2007, while it falls to 1.6 per cent in the baseline scenario. Three-month euro interest rates gradually rise to 3.0 per cent in 2007, while they remain steady at 2.1 per cent in the baseline scenario.

Developments in the Norwegian economy under these changed assumptions are shown in the table and the charts. The calculations have been made using model-determined exchange rates. Fiscal policy is unchanged in relation to the baseline scenario, and monetary policy is oriented towards reaching the inflation target.

The upward adjustment of export market growth entails markedly higher export growth in the alternative scenario, although the increase in export growth is appreciably weaker than the increase in market growth. As a result, Norwegian firms' loss of market shares is amplified in the alternative scenario. Growth in manufacturing production is also stronger in the alternative scenario, and manufacturing investment is thus also higher than in the baseline scenario.

Owing to increasing return to scale, the increase in manufacturing employment is clearly smaller than the increase in production in the alternative scenario, with a marked increase labour productivity. Combined with more favourable prices for industrial commodities, this also results in clearly higher wage growth, which feeds through to general wage growth. This in turn leads to higher inflation, and an inflation rate that is higher than assumed for the euro area.

In order to prevent inflation from overshooting the target of 2.5 per cent in 2006 and 2007, it becomes necessary to increase interest rates also in Norway, and to such an extent that the krone appreciates as early as in 2005. The interest rate increase has to be so strong that it more than counters the effect of markedly higher inflation in Norway than in the euro area, which in isolation contributes to a weakening of the krone. We have therefore assumed that Norwegian money market rates, which are assumed to be 2.0 in the first quarter of next year, will gradually rise from the second quarter, to 4.5 per cent in the fourth quarter of 2006, followed by a fall to about 4.0 per cent in the second quarter of 2007.

This appreciable interest rate increase implies that real after-tax interest rates on loans will stabilise in the years ahead, while they continue to fall in the baseline scenario. This leads to slower house price inflation and slower growth in housing investment and consumption for households and non-profit institutions, which in isolation will curb demand impulses to Norwegian production. In spite of higher manufacturing production, mainland GDP growth is in line with growth in the baseline scenario. The same applies to unemployment.

The cyclical path in the alternative scenario is thus in line with the path in the baseline scenario. The difference is that with stronger global growth, growth will benefit exports and manufacturing to a greater extent, while growth in household demand and production in sheltered industries will be weaker. An improved cyclical environment for manufacturing will make it possible to raise Norwegian interest rates, without any serious adverse effects on manufacturing as a result of the appreciation of the krone. As a result, the monetary policy dilemma currently facing Norges Bank will be resolved.

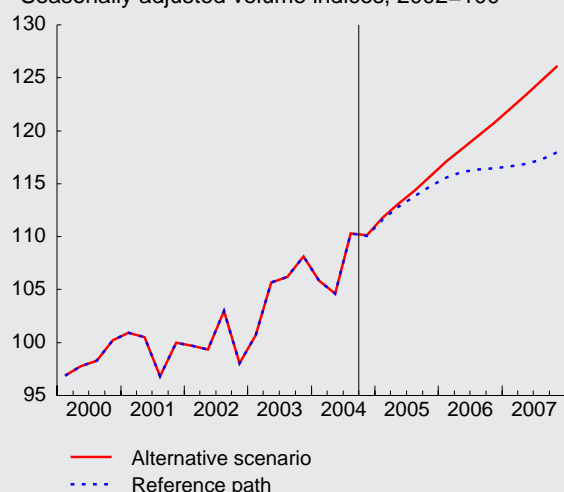
Alternative scenario: Key macroeconomic variables

Percentage change from previous year unless otherwise noted

	2005	2006	2007
Consumption, households and non-profit institutions	4.6	4.0	3.7
Investment, mainland firms	5.1	4.1	2.4
Manufacturing	-6.0	-1.5	2.7
Housing investment	10.9	3.8	0.9
Exports	3.7	4.4	3.4
Traditional goods	5.4	4.3	4.3
Imports	7.4	3.4	5.6
GDP, Mainland Norway	3.6	2.3	1.9
Manufacturing	3.2	2.3	0.2
Employed persons	1.1	0.9	0.2
Labour supply	0.6	0.6	0.6
Unemployment, level	4.0	3.7	4.0
Wages per standard man-year	4.0	4.3	4.8
CPI	1.4	2.3	2.7
CPI-ATE	1.2	2.4	2.6
Export prices, traditional goods	2.0	0.5	1.1
Import prices, traditional goods	-1.3	0.3	0.6
House prices	4.3	3.6	0.1
Household real disposable income	3.7	-1.3	2.3
Household saving ratio, level	9.6	4.8	3.6
Money market rate, level	2.4	4.0	4.1
Real after-tax interest rate, level	1.8	1.9	1.7
Import-weighted krone exchange rate	-2.7	0.9	-0.3
Current account, in NOK billions	274.8	280.8	296.8
Export market indicator	5.3	5.6	5.8
Inflation in euro area	1.8	1.8	1.9
3-month euro interest rate, level	2.1	2.7	3.0
Crude oil price in NOK, level	251	253	252

Exports of traditional goods

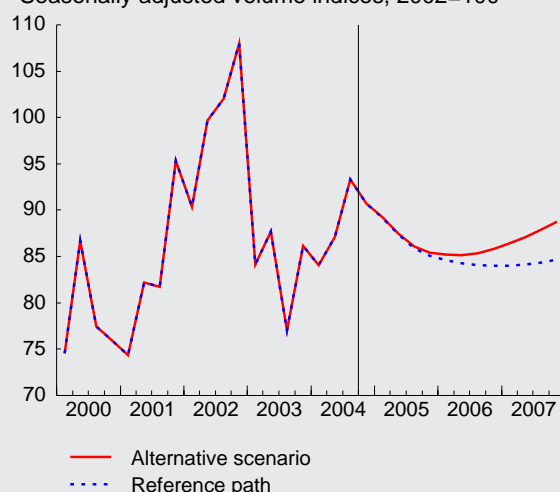
Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

Investment, Manufacturing

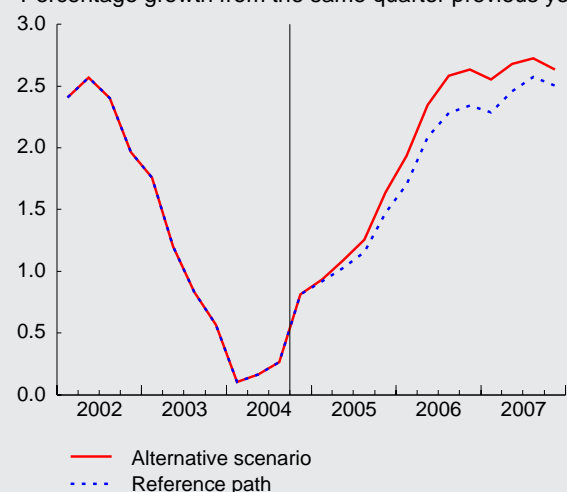
Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

Inflation (CPI-ATE)

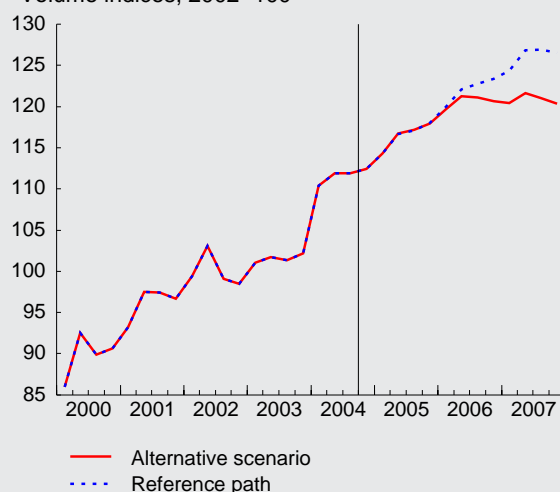
Percentage growth from the same quarter previous year



Source: Statistics Norway.

Housing prices

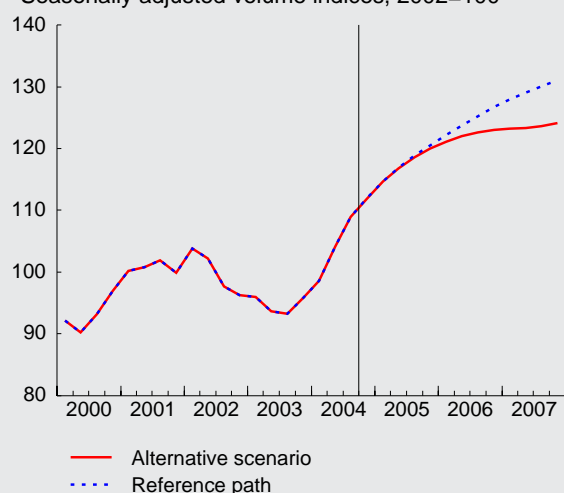
Volume indices, 2002=100



Source: Statistics Norway.

Residential investment

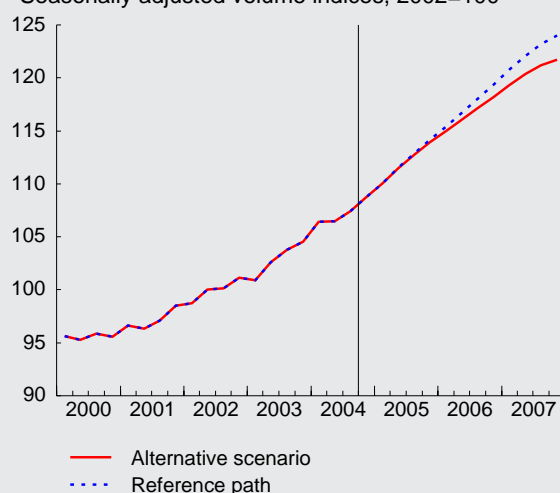
Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

Consumption in households

Seasonally adjusted volume indices, 2002=100



Source: Statistics Norway.

endant rise in prices for imported consumer goods. Against this background, inflation will edge up later in the projection period. Both CPI inflation and CPI-ATE inflation are projected to reach 2.5 per cent in 2007.

Terms-of-trade gains in 2004 followed by terms-of-trade losses ahead

Since early summer 2001 when the price of Brent Blend was well below USD 20 per barrel, oil prices have risen, reaching a record-high of more than USD 52. Thereafter, oil prices have fallen below USD 40 per barrel. Futures oil prices are also high, and for many years ahead. Our projections are based on an oil price of USD 44 in the fourth quarter of 2004, which implies an average oil price of USD 38 per barrel in 2004. Through 2004 and 2005, oil prices are assumed to show a gradual decline to about USD 32.5, followed by a gradual rise again through 2007 in line with the next international cyclical upturn. Given our exchange rate assumptions, this implies an oil price in krone terms of NOK 260 per barrel in 2004, falling gradually to NOK 210 in 2006 and then rising to NOK 215 per barrel in 2007.

It is not only the price of crude oil that has contributed to the substantial improvement in the terms of trade for Norway in 2004. In addition, prices for traditional export goods have increased considerably more than prices for import goods. This improvement is not solely attributable to the krone depreciation, but is a normal cyclical phenomenon. During the expansionary phase of the business cycle, commodity prices rise at a faster pace than prices for manufactured goods, while the opposite is normally the case during a downturn or a recession. In recent years, low-cost imports from China have also had an impact on developments in prices for manufactured import goods. Overall, Norwegian export prices are expected to increase by 13 per cent from 2003 to 2004, while import prices (in krone terms) are expected to increase by only 5 per cent. This considerable terms-of-trade gain has made a substantial contribution to an estimated current account surplus of close to NOK 238 billion, or 14 per cent of GDP.

In the coming years, however, developments in the terms of trade are expected to be in Norway's disfavour, and the main factor behind this is our oil price assumptions as presented above. For traditional merchandise, the terms of trade are expected to improve to some extent, but this tendency will be reversed in the latter half of 2005 and ahead. The reason is that when the international cyclical downturn takes hold, export prices for our cyclically sensitive export goods will fall relative to import goods that consist of a larger share of manufactured goods. This scenario may be modified if the increase in low-cost imports from China is higher than we have implicitly assumed.

Continued high growth in the Norwegian economy will be accompanied by rising import volumes, while a global slowdown will contribute to lower growth in Norwegian exports both in 2005 and 2006. In the recession in 2007, however, the differences are small. In spite of this, the current account surplus may show a small increase in 2005. This is because large surpluses entail an increase in net foreign assets and an improvement on the interest and transfers balance. Against this background, the current account surplus is projected to reach NOK 247 billion in 2005. On the other hand, continued strong import growth and weaker global growth will reduce the current account surplus markedly in 2006. The surplus is estimated at NOK 212 billion both in 2006 and 2007, or 11 per cent of nominal GDP in 2007.

National accounts: Final expenditure and gross domestic product. At fixed 2002 prices. Million kroner

	Unadjusted		Seasonally adjusted						
	2002	2003	03.1	03.2	03.3	03.4	04.1	04.2	04.3
Final consumption expenditure of households and NPISHs	680 681	700 911	171 681	174 581	176 529	177 825	181 026	181 191	182 704
Household final consumption expenditure	652 300	670 511	164 175	167 058	168 913	170 054	173 040	173 217	174 593
Goods	358 033	370 473	89 833	92 578	93 714	94 097	96 437	96 332	96 951
Services	285 196	289 095	71 435	71 941	72 460	73 191	73 496	73 824	74 406
Direct purchases abroad by resident households	27 344	29 451	7 324	7 130	7 416	7 574	8 087	8 144	8 149
Direct purchases by non-residents	-18 273	-18 507	-4 417	-4 592	-4 677	-4 808	-4 980	-5 083	-4 913
Final consumption expenditure of NPISHs	28 381	30 400	7 506	7 523	7 616	7 771	7 985	7 974	8 111
Final consumption expenditure of general government	338 466	343 136	85 377	85 965	85 925	85 943	86 510	87 374	87 312
Final consumption expenditure of central government	180 691	182 469	45 503	45 702	45 608	45 670	46 363	46 919	46 793
Central government, civilian	150 477	152 825	38 082	38 260	38 220	38 276	38 850	39 362	39 345
Central government, defence	30 214	29 644	7 421	7 442	7 389	7 394	7 512	7 557	7 448
Final consumption expenditure of local government	157 775	160 667	39 873	40 263	40 316	40 274	40 147	40 455	40 519
Gross fixed capital formation	274 679	269 218	68 822	68 621	68 079	63 695	69 563	70 840	73 976
Extraction and transport via pipelines	53 398	62 411	14 201	16 226	16 586	15 399	16 838	17 000	17 555
Service activities incidental to extraction	5 919	-2 003	585	353	87	-3 028	109	95	116
Ocean transport	3 811	1 878	1 384	257	828	-592	780	131	748
Mainland Norway	211 551	206 931	52 652	51 786	50 578	51 916	51 835	53 614	55 556
Mainland Norway excluding general government	169 049	160 540	41 497	40 156	38 339	40 414	41 107	41 878	44 073
Manufacturing and mining	22 674	18 916	4 777	4 979	4 372	4 888	4 770	4 943	5 296
Production of other goods	18 608	22 214	5 675	5 478	5 715	5 179	5 289	5 305	5 786
Dwelling services	55 332	52 394	13 277	12 960	12 904	13 258	13 635	14 408	15 068
Other services	72 435	67 015	17 768	16 740	15 347	17 090	17 413	17 222	17 923
General government	42 502	46 391	11 155	11 630	12 239	11 501	10 728	11 736	11 483
Changes in stocks and statistical discrepancies	17 774	3 365	4 194	-4 139	642	1 632	2 179	6 310	4 212
Gross capital formation	292 453	272 582	73 016	64 482	68 721	65 327	71 742	77 151	78 187
Final domestic use of goods and services	1 311 600	1 316 630	330 074	325 027	331 175	329 096	339 277	345 715	348 203
Final demand from Mainland Norway	1 230 698	1 250 978	309 709	312 331	313 032	315 684	319 370	322 178	325 572
Final demand from general government	380 968	389 527	96 531	97 594	98 164	97 444	97 238	99 110	98 795
Total exports	624 385	634 110	153 653	159 758	157 708	163 476	161 251	161 967	160 239
Traditional goods	183 508	192 944	46 193	48 488	48 715	49 603	48 569	47 991	50 595
Crude oil and natural gas	273 915	272 223	67 614	70 547	67 888	66 578	71 348	70 336	68 537
Ships and oil platforms	12 821	17 075	2 331	3 243	3 516	7 985	1 404	3 250	1 070
Services	154 141	151 868	37 514	37 480	37 589	39 310	39 930	40 390	40 038
Total use of goods and services	1 935 985	1 950 740	483 726	484 786	488 883	492 571	500 528	507 682	508 442
Total imports	416 853	425 921	106 845	106 049	105 262	107 743	111 567	114 023	118 639
Traditional goods	267 550	279 071	69 128	69 826	69 319	70 766	74 139	76 998	79 875
Crude oil and natural gas	1 634	1 796	838	344	278	342	272	447	537
Ships and oil platforms	15 052	12 255	3 789	2 817	3 061	2 588	2 333	2 083	3 145
Services	132 617	132 799	33 089	33 062	32 604	34 047	34 822	34 495	35 081
Gross domestic product	1 519 131	1 524 818	376 882	378 737	383 621	384 828	388 961	393 659	389 804
Mainland Norway (market prices)	1 212 624	1 221 253	301 177	303 901	306 370	308 998	311 282	314 282	316 594
Petroleum activities and ocean transport	306 507	303 565	75 705	74 835	77 251	75 830	77 679	79 376	73 210
Mainland Norway (basic prices)	1 063 473	1 069 674	263 879	266 312	268 205	271 017	272 799	275 356	277 571
Mainland Norway excluding general government	817 786	824 210	202 634	205 060	206 762	209 348	210 825	213 096	215 261
Manufacturing and mining	151 502	145 667	36 237	36 145	36 436	36 737	36 365	36 709	37 272
Production of other goods	115 323	111 257	27 083	27 692	28 190	28 318	29 200	29 430	29 595
Service industries	550 961	567 286	139 314	141 224	142 135	144 293	145 260	146 957	148 394
General government	245 687	245 464	61 245	61 252	61 443	61 669	61 974	62 260	62 310
Correction items	149 151	151 580	37 298	37 589	38 165	37 981	38 483	38 926	39 022

Source: Statistics Norway.

National accounts: Final expenditure and gross domestic product. At fixed 2002 prices. Percentage change from the previous period

	Unadjusted		Seasonally adjusted						
	2002	2003	03.1	03.2	03.3	03.4	04.1	04.2	04.3
Final consumption expenditure of households and NPISHs	3.0	3.0	-0.2	1.7	1.1	0.7	1.8	0.1	0.8
Household final consumption expenditure	3.1	2.8	-0.4	1.8	1.1	0.7	1.8	0.1	0.8
Goods	4.1	3.5	-1.1	3.1	1.2	0.4	2.5	-0.1	0.6
Services	1.1	1.4	-0.3	0.7	0.7	1.0	0.4	0.4	0.8
Direct purchases abroad by resident households	7.1	7.7	5.1	-2.6	4.0	2.1	6.8	0.7	0.1
Direct purchases by non-residents	-2.8	1.3	-4.3	4.0	1.8	2.8	3.6	2.1	-3.3
Final consumption expenditure of NPISHs	1.1	7.1	3.0	0.2	1.2	2.0	2.8	-0.1	1.7
Final consumption expenditure of general government	3.7	1.4	0.3	0.7	0.0	0.0	0.7	1.0	-0.1
Final consumption expenditure of central government	44.0	1.0	0.1	0.4	-0.2	0.1	1.5	1.2	-0.3
Central government, civilian	56.2	1.6	0.4	0.5	-0.1	0.1	1.5	1.3	0.0
Central government, defence	3.3	-1.9	-0.9	0.3	-0.7	0.1	1.6	0.6	-1.4
Final consumption expenditure of local government	-21.8	1.8	0.5	1.0	0.1	-0.1	-0.3	0.8	0.2
Gross fixed capital formation	-1.0	-2.0	-2.5	-0.3	-0.8	-6.4	9.2	1.8	4.4
Extraction and transport via pipelines	-5.3	16.9	-2.9	14.3	2.2	-7.2	9.3	1.0	3.3
Service activities incidental to extraction	80.9	..	-52.6	-39.7	-75.3	..	-103.6	-12.9	21.7
Ocean transport	-65.6	-50.7	0.8	-81.4	221.8	-171.4	-231.9	-83.2	469.6
Mainland Norway	2.5	-2.2	-1.3	-1.6	-2.3	2.6	-0.2	3.4	3.6
Mainland Norway excluding general government	2.9	-5.0	-2.8	-3.2	-4.5	5.4	1.7	1.9	5.2
Manufacturing and mining	18.8	-16.6	-22.1	4.2	-12.2	11.8	-2.4	3.6	7.1
Production of other goods	9.0	19.4	15.9	-3.5	4.3	-9.4	2.1	0.3	9.1
Dwelling services	-0.6	-5.3	-0.3	-2.4	-0.4	2.7	2.8	5.7	4.6
Other services	-0.1	-7.5	-3.1	-5.8	-8.3	11.4	1.9	-1.1	4.1
General government	1.0	9.2	4.7	4.3	5.2	-6.0	-6.7	9.4	-2.2
Changes in stocks and statistical discrepancies	-14.0	-81.1	89.1	-198.7	-115.5	154.3	33.5	189.6	-33.3
Gross capital formation	-1.9	-6.8	0.3	-11.7	6.6	-4.9	9.8	7.5	1.3
Final domestic use of goods and services	2.0	0.4	0.0	-1.5	1.9	-0.6	3.1	1.9	0.7
Final demand from Mainland Norway	3.1	1.6	-0.3	0.8	0.2	0.8	1.2	0.9	1.1
Final demand from general government	3.4	2.2	0.8	1.1	0.6	-0.7	-0.2	1.9	-0.3
Total exports	-0.8	1.6	-1.8	4.0	-1.3	3.7	-1.4	0.4	-1.1
Traditional goods	0.4	5.1	2.7	5.0	0.5	1.8	-2.1	-1.2	5.4
Crude oil and natural gas	1.9	-0.6	-4.3	4.3	-3.8	-1.9	7.2	-1.4	-2.6
Ships and oil platforms	-25.3	33.2	2.3	39.1	8.4	127.1	-82.4	131.5	-67.1
Services	-4.8	-1.5	-2.8	-0.1	0.3	4.6	1.6	1.2	-0.9
Total use of goods and services	1.0	0.8	-0.6	0.2	0.8	0.8	1.6	1.4	0.1
Total imports	0.7	2.2	1.2	-0.7	-0.7	2.4	3.5	2.2	4.0
Traditional goods	3.4	4.3	2.0	1.0	-0.7	2.1	4.8	3.9	3.7
Crude oil and natural gas	-21.1	9.9	115.0	-58.9	-19.2	23.1	-20.5	64.2	20.2
Ships and oil platforms	-13.4	-18.6	13.8	-25.7	8.7	-15.4	-9.8	-10.7	51.0
Services	-2.4	0.1	-2.7	-0.1	-1.4	4.4	2.3	-0.9	1.7
Gross domestic product	1.1	0.4	-1.1	0.5	1.3	0.3	1.1	1.2	-1.0
Mainland Norway (market prices)	1.4	0.7	-0.8	0.9	0.8	0.9	0.7	1.0	0.7
Petroleum activities and ocean transport	0.1	-1.0	-2.3	-1.1	3.2	-1.8	2.4	2.2	-7.8
Mainland Norway (basic prices)	0.8	0.6	-0.8	0.9	0.7	1.0	0.7	0.9	0.8
Mainland Norway excluding general government	1.0	0.8	-1.0	1.2	0.8	1.3	0.7	1.1	1.0
Manufacturing and mining	-0.1	-3.9	-2.8	-0.3	0.8	0.8	-1.0	0.9	1.5
Production of other goods	1.7	-3.5	-4.6	2.2	1.8	0.5	3.1	0.8	0.6
Service industries	1.1	3.0	0.3	1.4	0.6	1.5	0.7	1.2	1.0
General government	0.0	-0.1	-0.4	0.0	0.3	0.4	0.5	0.5	0.1
Correction items	5.8	1.6	-0.3	0.8	1.5	-0.5	1.3	1.2	0.2

Source: Statistics Norway.

National accounts: Final expenditure and gross domestic product. Price indices. 2002=100

	Unadjusted		Seasonally adjusted						
	2002	2003	03.1	03.2	03.3	03.4	04.1	04.2	04.3
Final consumption expenditure of households and NPISHs	100.0	102.6	103.0	101.9	102.4	102.6	102.6	103.3	103.7
Final consumption expenditure of general government	100.0	103.8	103.4	103.3	103.9	104.5	104.4	105.6	106.5
Gross fixed capital formation	100.0	100.7	99.6	100.2	100.7	102.7	102.0	103.7	102.1
Mainland Norway	100.0	100.3	99.6	99.9	100.1	102.3	102.4	103.9	101.4
Final domestic use of goods and services	100.0	102.5	101.7	102.1	103.9	102.2	102.8	104.2	105.5
Final demand from Mainland Norway	100.0	102.5	102.5	102.0	102.4	103.0	103.1	104.1	104.0
Total exports	100.0	101.7	104.9	96.8	98.7	106.3	110.0	109.7	115.3
Traditional goods	100.0	97.8	96.2	97.6	97.5	99.9	104.8	103.7	106.1
Total use of goods and services	100.0	102.3	102.7	100.4	102.2	103.6	105.1	106.0	108.6
Total imports	100.0	101.7	98.6	99.7	103.4	105.0	106.2	106.3	107.4
Traditional goods	100.0	100.4	98.6	98.7	101.3	103.0	103.8	103.9	104.0
Gross domestic product	100.0	102.4	103.9	100.6	101.9	103.2	104.8	105.9	108.9
Mainland Norway (market prices)	100.0	102.0	101.6	102.2	102.0	102.2	102.5	103.3	103.9

Source: Statistics Norway.

National accounts: Final expenditure and gross domestic product. Price indices. Percentage change from previous period

	Unadjusted		Seasonally adjusted						
	2002	2003	03.1	03.2	03.3	03.4	04.1	04.2	04.3
Final consumption exp. of households and NPISHs	1.4	2.6	2.3	-1.0	0.5	0.1	0.1	0.7	0.3
Final consumption expenditure of general government	3.7	3.8	1.5	-0.2	0.6	0.6	-0.1	1.2	0.8
Gross fixed capital formation	-0.6	0.7	0.3	0.7	0.5	2.0	-0.7	1.7	-1.5
Mainland Norway	-0.6	0.3	0.1	0.3	0.1	2.2	0.1	1.5	-2.4
Final domestic use of goods and services	1.6	2.5	1.4	0.4	1.8	-1.7	0.6	1.4	1.2
Final demand from Mainland Norway	1.7	2.5	1.7	-0.5	0.5	0.6	0.0	1.0	0.0
Total exports	-9.7	1.7	2.5	-7.7	1.9	7.8	3.5	-0.3	5.1
Traditional goods	-8.9	-2.2	-2.0	1.4	-0.1	2.5	4.9	-1.1	2.3
Total use of goods and services	-2.4	2.3	1.7	-2.3	1.9	1.3	1.5	0.8	2.5
Total imports	-5.3	1.7	-0.7	1.1	3.7	1.6	1.2	0.1	1.0
Traditional goods	-7.5	0.4	-0.3	0.1	2.6	1.6	0.8	0.1	0.1
Gross domestic product	-1.6	2.4	2.4	-3.2	1.3	1.2	1.6	1.0	2.9
Mainland Norway (market prices)	2.4	2.0	0.2	0.6	-0.2	0.1	0.3	0.8	0.6

Source: Statistics Norway.