Fiscal policy dilemma

Over the past two years Norges Bank has repeatedly highlighted the risk of rising pressures in the economy followed by a severe cyclical turnaround associated with continued sharp economic growth. Against this background, Norges Bank underlined in its submission to the Ministry of Finance last autumn the need to tighten fiscal policy in the order of 1½% of mainland GDP in order to bring growth into line with underlying growth in production capacity.

The Norwegian economy is now moving on a path which Norges Bank has advised against for some time. In line with expectations, rising pressures in the labour market have triggered an acceleration in wage growth, which implies that mainland enterprises may again be affected by rising costs and deteriorating competitiveness towards the end of this cyclical expansion.

In response to developments, market assessments have changed and the krone has depreciated, as feared. In accordance with the mandate of the central bank, Norges Bank has raised interest rates with a view to countering the depreciation of the krone. At present, monetary policy is thereby providing some contribution to stabilising the economy.

The formulation of policy in Norway is, however, such that fiscal policy and not monetary policy bears the main responsibility for stabilising the economy. When incomes policy fails to play its role and monetary policy's role is confined to stabilising the exchange rate, the stabilising policy component - fiscal policy - will have to be even more effective if possible. The deliberations on the Revised National Budget do not give the impression of fiscal policy as an appropriate and effective instrument for stabilising the economy.

Fiscal policy is increasingly faced with the dilemma of whether to focus on macroeconomic stability on the one hand or the high-priority considerations underlying distribution policy on the other. There are strong arguments in favour of a comprehensive review of fiscal policy as an instrument of demand management.

Kjell Storvik

Norges Bank's inflation report

Pursuant to the Norges Bank Act, the central bank has an advisory function in the area of monetary, credit and foreign exchange policy. In its executive capacity, Norges Bank shall ensure the stability of the krone's value measured against European currencies. Sustained low price and wage inflation in line with or lower than that of trading partners is a necessary condition for a stable krone exchange rate.

The *Inflation Report* provides a survey of price trends and factors that influence price and wage inflation. It contains a broad review of the situation in the Norwegian economy and provides Norges Bank's professional evaluation of the outlook for prices for the next two years. In the leader above, the Governor provides a summary of Norges Bank's assessment of the situation.

The cut-off date for the *Inflation Report* was 11 June 1998

1 SUMMARY

Norges Bank projects that consumer prices will rise by 2½% in 1998 and 3% next year. The projection for 1998 has been revised downwards by ¼ percentage point in relation to the two previous *Inflation Reports*, while the estimate for 1999 is unchanged. Underlying inflation, ie the rise in the CPI excluding changes in indirect taxes and electricity prices, is projected at 2¼% in 1998 and 3% in 1999.

Pressures in the Norwegian economy have intensified during the first five months of this year. High import growth, rapidly falling unemployment and substantial nominal pay increases in connection with the spring wage settlements point to steadily mounting constraints on domestic production. The pressure is being amplified by record high petroleum investment this year and sharp growth in private consumption.

The estimate for the current-account surplus in 1998 has been adjusted downwards to NOK 21bn, primarily reflecting substantially lower petroleum production than projected earlier but also a higher-than-expected deficit on the balance of traditional goods. The surplus for 1999 is estimated at NOK 54bn.

Thus far in 1998 employment growth has been stronger than assumed in the previous *Inflation Report*, and the labour force has also expanded by a greater margin than expected. Consequently, unemployment has moved in line with our projections. The projections for the real economy over the next 18 months suggest continued brisk growth in the demand for labour. Over the next year unemployment may be reduced to the lowest levels recorded during the previous cyclical peak.

Wage growth is now estimated at 6% in 1998 and 6¾% in 1999, which is an upward adjustment of ¾ percentage point for both years compared with the previous *Inflation Report*. The estimates are based on this year's wage negotiations and the empirical basis embodied in our macroeconomic model RIMINI. As a result of the considerable wage carry-over into next year, the estimate for 1999 implies that pay increases will be somewhat lower than this year.

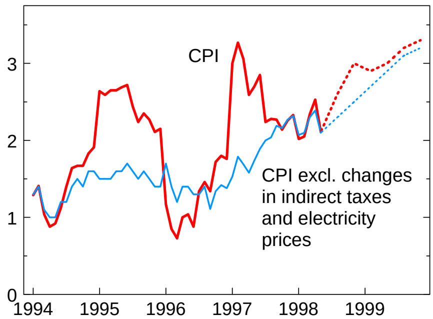
The projections in this report are largely based on the orientation of fiscal policy presented in the Revised National Budget. Although fiscal policy is not having a contractionary effect at present, the increase in interest rates from the second quarter of this year is expected to have some dampening impact in the course of next year. For 1999, central government expenditure is expected to be restrictive, whereas local government expenditure is expected to follow growth in the mainland economy.

Developments so far this year are compared with the various scenarios presented in the December 1997 *Inflation*

Report in a separate box. The projections in December suggested that stronger growth coupled with higher wage growth than in the baseline scenario could lead to a loss of confidence in the Norwegian economy with an attendant depreciation of the krone and rising interest rates in the first half of 1998. According to this scenario, the subsequent cyclical downturn might be more pronounced. Actual developments share several features with the December scenario.

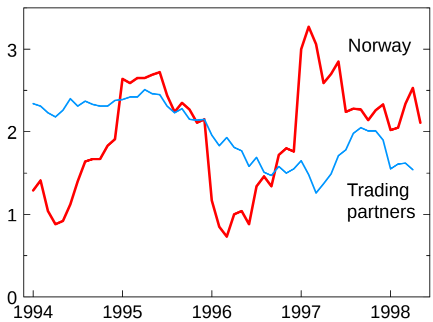
2 THE ECONOMIC NEWS

Chart 2.1 *CPI, total and excluding indirect taxes and electricity prices. Historical figures and projections. 12-month rise. Per cent*



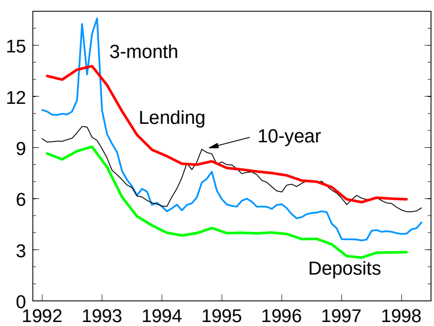
Source: Statistics Norway and Norges Bank

Chart 2.2 *Consumer prices in Norway and abroad. 12-month rise. Per cent*



Source: Statistics Norway and OECD

Chart 2.3 *Interest rate movements in Norway. Banks' average deposit and lending rates, 3-month Euro-krone rate and 10-year government bond yield*



Source: Norges Bank

2.1 Price trends

Price inflation has been moderate in recent months

The year-on-year rise in consumer prices edged up in March and April, but slowed again in May to 2.1%. The rise in prices since the beginning of the year has been slightly lower than assumed in the two previous *Inflation Reports*, primarily reflecting seasonal sales for clothing and footwear and lower-than-expected electricity and petrol prices.

The underlying rise in prices, ie excluding changes in indirect taxes and electricity prices, has also been weaker than expected. The year-on-year rate was 2.1% in May. The rise in service prices is still higher than for goods.

According to the EU's harmonised price index, which adjusts for various differences in methods for calculating national consumer price indices, prices in Norway increased by 1.8% in May, whereas the rise in EU countries was 1.6% in April.

2.2 Exchange rates, interest rates and monetary variables

Norwegian interest rates move up

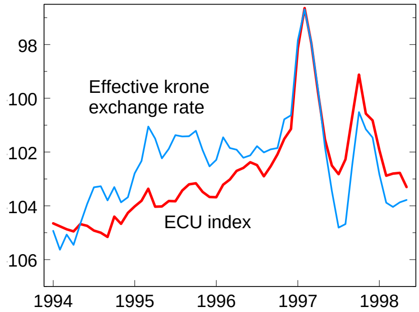
Since the previous *Inflation Report* Norwegian money market rates have risen. Whereas Norwegian rates were 0.4 percentage point lower than ECU rates in mid-March, rates are now 0.4 percentage point higher than ECU rates. The last time a positive interest-rate differential was recorded was in December 1996. Norges Bank raised its key rates by a quarter of a percentage point on 19 March and by a further half a percentage point on 25 May, pushing up three-month money market rates to 4.8% in June. Rates are now 0.8 percentage point higher than the level prevailing in March.

European rates are being influenced by the convergence process ahead of stage three of EMU. Several countries have lowered their key rates in recent months. The market has factored in a continued convergence of key rates over the remainder of the year.

Short-term money market rates in Norway are now 1 percentage point higher than one year ago. Banks have signalled that they will raise deposit and lending rates by the same margin as Norges Bank's rate increases.

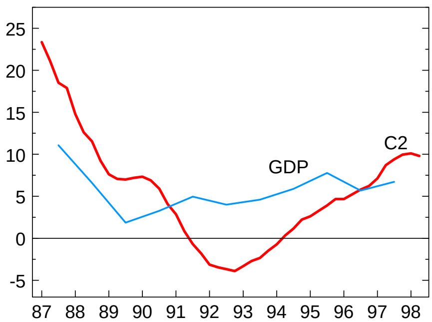
The downward trend in both international and Norwegian long-term interest rates was reversed in mid-April. Following a temporary rise in May, long-term rates have subsequently edged down. Long-term interest rates in Norway have, however, moved down by a smaller margin than European rates, with an attendant increase in the interest-rate differential. Since the beginning of the year the differ-

Chart 2.4 *ECU index and manufacturing industry's effective krone exchange rate. Rising curve denotes appreciation*



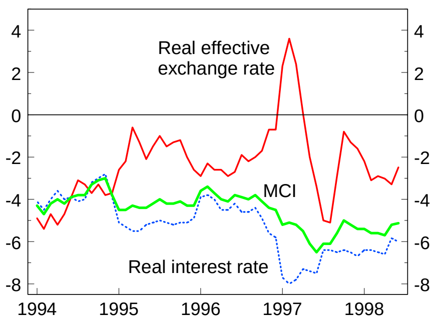
Source: Norges Bank

Chart 2.5 *Total domestic credit (C2)and nominal mainland GDP. Growth from same period previous year*



Source: Statistics Norway and Norges Bank

Chart 2.6 *Norges Bank's Monetary Conditions Index (MCI) and subcomponents. January 1992=0*



Source: Norges Bank

When aggregating, the real interest rate is given a weight of ¾ and the real effective exchange rate a weight of ¼.

ence between the yield on Norwegian 10-year government bonds and corresponding ECU yields has widened by about 0.4 percentage point to 0.4 percentage point. This may indicate that market participants have adjusted inflation expectations for the Norwegian economy upwards compared with other European countries.

The value of the krone measured against the ECU index weakened in the last half of May and hovered between index values of 103.2 and 104.3 in the first days of June.

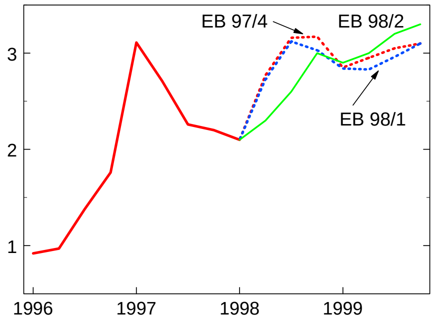
The growth in the money supply and the volume of credit has been rising over a longer period, reflecting both the high level of activity in the Norwegian economy and an expansionary monetary stance. Although banks have signalled their desire to restrain lending growth, credit statistics indicate continued expansion. Private and municipal gross domestic debt (C2) rose by around 10% in the 12 months to end-April. In the period to March, credit growth was strongest in the enterprise sector, which probably reflects the robust investment growth in this sector. Household credit growth has also risen in recent months, reaching 8% at end-March. The growth is primarily ascribable to the rise in resale home prices and the high level of housing investment.

Growth in the registered money supply (M2) also accelerated in the first months of the year. The growth rate of 8-9% is the highest growth rate recorded since 1992, but can partly be explained by low figures in the same period last year.

Norges Bank's Monetary Conditions Index (MCI) summarises the effect of changes in the real exchange rate and real interest rate on domestic demand. A fall in the index indicates that interest and exchange rate developments are having a more expansionary effect on the economy. Measured by the MCI, monetary policy is now slightly more contractionary than one year earlier. Since the publication of the March *Inflation Report*, the real exchange rate has been fairly stable, while real interest rates have increased.

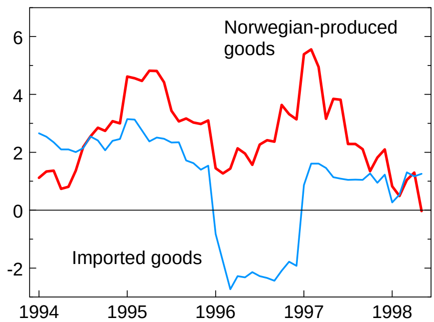
3 NORGES BANK'S INFLATION PROJECTIONS

Chart 3.1 *Current and earlier projections for consumer price inflation. 12-month rise. Per cent*



Source: Statistics Norway and Norges Bank

Chart 3.2 *Consumer prices. Norwegian-produced goods and imported goods. Per cent*



Source: Statistics Norway and Norges Bank

Table 3.1 *Consumer prices. Norges Bank's projections. Percentage change from previous year*

	1997	1998	1999
US	2.3	2	2½
Japan	1.7	¾	½
Germany	1.8	1¾	2
UK	2.8	2¾	2½
Sweden	0.9	1½	2
Finland	1.2	2	2¼
Denmark	2.2	2½	2½
Norway's trading partners	1.7	1¾	2
EU - 12 countries[1)]	1.9	2	2¼

[1)] ECU index weights

Source: Norges Bank and OECD

3.1 Norges Bank's inflation projections

Consumer prices are projected to rise by 2½% in 1998 and 3% in 1999. Underlying inflation, ie excluding changes in indirect taxes and electricity prices, is projected at 2¼% in 1998 and 3% next year. Price inflation was slightly lower than expected in the first five months of 1998, partly because the impulses from import prices were somewhat weaker than assumed earlier. Against this background, the projection for price inflation in 1998 has been revised downwards compared with the previous two *Inflation Reports*. The upward revision of the estimate for wage growth implies that price inflation will accelerate towards the end of the year. Price inflation in 1999 is therefore expected to be the highest recorded since 1991, with the inflation rate continuing to rise next year.

Indirect taxes will push up inflation rate this year

The projections in this report are based on the indirect tax programme approved last autumn. Changes in indirect taxes are therefore expected to push up inflation by about 0.4 percentage point this year. The projections are also based on the technical assumption that other indirect taxes are changed in pace with the overall rise in consumer prices, ie that these taxes will not make a direct contribution to price inflation next year.

External price impulses remain subdued

The international economic situation remains virtually unchanged compared with the conditions prevailing in March. With the exception of Japan, the spillover effects of the Asian crisis on the real economy have so far been relatively moderate and are partly being offset by stronger domestic demand in many countries and higher exports to Europe and the US. Consumer price inflation has subsided since the beginning of the year, reflecting falling commodity and import prices and lower interest rates. We expect price inflation to edge up through the remainder of the year and project that consumer prices among trading partners will rise by an average 1¾% this year and 2% next year, ie at a slightly slower pace than envisaged in the March *Inflation Report*.

The import-weighted krone exchange rate has been volatile, but on average has remained virtually unchanged on the March *Inflation Report*. As in previous reports, the underlying technical assumption is that the average exchange rate prevailing in the previous month will remain constant through the projection period. This implies an average depreciation of the Norwegian krone of 3% between 1997 and 1998. Overall, the rise in import prices is projected at ½% in 1998 and 1¼% in 1999. Externally generated price impulses in 1998 are therefore more moderate than assumed in the March *Inflation Report*.

Rising wage growth

Wage growth is now expected to be higher in 1998 than estimated earlier. Based on the wage settlements concluded so far, wage growth is now projected at 6% in 1998. As a portion of the pay increases will become effective in the second half of the year, the carry-over into 1999 will be far higher than usual, particularly in the public sector. Even with low pay increases, annual wage growth will therefore be relatively high next year. Based on the calculations in the RIMINI model, wage growth is projected at 6¾% in 1999, ie an upward revision of ¾ percentage point for both 1998 and 1999 compared with the March *Inflation Report*.

Wage trends are primarily influenced by labour market conditions. With continued sharp growth in the demand for labour and the lowest unemployment rate for more than ten years, wage growth will be decisive for price inflation in the period ahead.

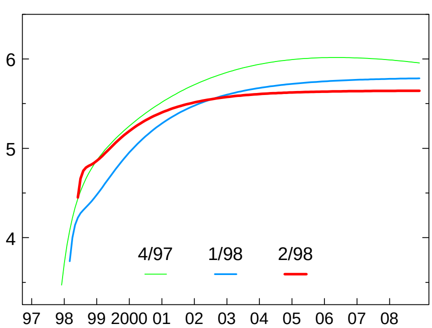
Considerable fluctuations in electricity prices

Electricity prices, which make up 4% of the CPI, have shown wide variations in recent years as a result of unstable precipitation levels and stronger competition in the power market. In the first five months of the year electricity prices were 8.4% lower than in the same period one year earlier. The decline in prices was steeper than expected. Our projections are based on approximately unchanged electricity prices in the period to autumn 1998, followed by a seasonal increase. For 1999, it is assumed that electricity prices will rise at a slightly slower pace than the overall rise in consumer prices.

House rents follow the overall rise in prices

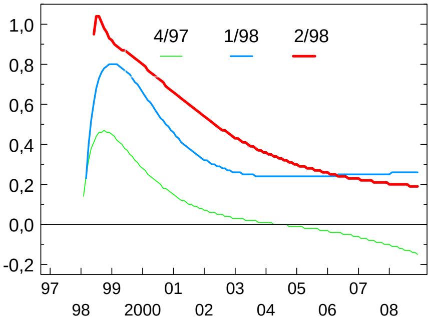
House rents are heavily influenced by interest rate movements, but changes in local government taxes, property taxes and expenditure on insurance and maintenance are also important factors behind the increase in house rents. House rents have risen at a faster pace than underlying inflation since mid-1997, partly reflecting growing pressures in the housing market. As in the March report, the estimates in the projection period are based on the assumption that house rents will increase in pace with the overall rise in prices.

Chart 3.3 *Forward rates in Norway. Expected short-term rates. Per cent*



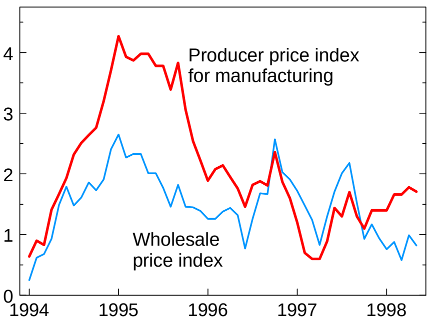
Source: Norges Bank

Chart 3.4 *Difference between expected short-term rates in Norway and Germany in percentage points*



Source: Norges Bank

Chart 3.5 *Wholesale and producer prices. 12-month rise. Per cent*



Source: Statistics Norway

Table 3.2 *Various institutions' projections for consumer price inflation in Norway in 1998 and 1999[1]). Percentage change from previous year*

	1998	1999
Ministry of Finance	2.6	–
Statistics Norway	2.5	2.8
OECD[2])	2.5	2.9
IMF	2.5	–
Norges Bank	2½	3
Private institutions[3])		
Highest estimate	3.1	3.7
Average	2.8	3.2
Lowest estimate	2.6	2.7

[1]) Latest official projections from the various institutions
[2]) Consumption deflator
[3]) Based on projections from 14 private institutions

3.2 Inflation expectations

High wage growth and passive fiscal policy fuel inflation expectations

The number of enterprises expecting higher prices has risen since the March *Inflation Report*. According to Statistics Norway's latest general business tendency survey, 58% expect higher prices in the second quarter of this year for products sold on the domestic market.

Inflation expectations in capital markets are also rising. The decline in long-term rates has been slower in Norway than in other European countries. Among EU countries, only the UK and Greece show higher long-term rates than Norway. The widening of the interest-rate differential may be associated with the higher-than-expected pay increases for a number of sectors and the absence of any substantial tightening measures in the Revised National Budget.

Forward rates may - under certain conditions - be viewed as the sum of the expected real rate of interest and expected future inflation. In the short term, the forward rate curve is largely dominated by market expectations concerning Norges Bank's key rates. Chart 3.3 indicates that market participants expect key rates to rise over the next year. Medium- and long-term forward rates are influenced by inflation expectations. Since the March *Inflation Report* these interest rates have edged up.

Forward rates can in the long term provide an indication of market confidence in the Norwegian economy and economic policy. Since long-term bond yields are heavily influenced by corresponding international yields, the forward rate differential against Germany, for example, may be the most pertinent. Chart 3.4 shows only minor changes in the differential between Norwegian and German forward rates in the long term.

Producer and wholesale prices can also provide an indication of future consumer price movements. The rise in producer prices in manufacturing has been moderate the past year, with prices for goods produced for the domestic market rising by 1.7%, see Chart 3.5. In recent months the rise in wholesale prices has been low. In May, wholesale prices rose by less than 1% compared with the same month one year earlier.

Norges Bank collects inflation projections from 14 private institutions. On average, these institutions expect prices to rise by 2.8% in 1998 and 3.2% in 1999, see Table 3.2.

All in all, the indicators above suggest that market participants expect rising price inflation next year.

3.3 The risks to the inflation outlook

Wage growth fuels inflation while external impulses have a dampening impact

The March *Inflation Report* underlined the uncertainty associated with the inflation projection for 1998 due to the unexpected, low price inflation in the first two months of 1998. Consumer price inflation was also fairly moderate in the last three months, partly reflecting the drop in electricity and petrol prices.

The projections in the *Inflation Report* are based on our macroeconomic model RIMINI. Our scenario of high and rising capacity utilisation and wage growth suggests rising price inflation through the remainder of this year and next.

However, pressures in the Norwegian economy may contribute to higher-than-projected price inflation:

- The wage settlements indicate that wage growth may be higher in 1998 than projected in March. Experience shows that a 1 percentage point higher wage growth pushes up inflation by 0.1-0.2 percentage point after one year. However, it must be taken into account that many enterprises will increase prices immediately in response to the relatively substantial pay increases. Buoyant demand in the sheltered sector will probably facilitate this spillover. A faster feed-through may push up price inflation.
- A portion of the pay increases becomes effective relatively late in the year, which means that the wage carry-over into 1999 will be substantial. Even with low pay increases next year, annual wage growth will be high. Our wage growth estimate for next year implies somewhat lower centrally negotiated pay increases than this year. However, this may not materialise as labour market pressures are expected to increase further next year.
- The surge in resale home prices may result in higher-than-projected house rents. It is uncertain what the impact of the rate rise earlier this year will be on house rents. Higher interest rates may lead to increased house rents, but will at the same time have some dampening impact on the rise in house prices.
- If an increase in indirect taxes is approved in order to tighten fiscal policy, this will feed through to price inflation fairly quickly.

Some forces may contribute to lower-than-projected price inflation:

- The impulses generated by import prices and growing foreign competition in Norwegian markets have contributed to reducing domestic price inflation in recent years. Despite the slight downward revision of the estimate for consumer price inflation among trading partners for 1998 and 1999, the impulses generated by import prices are expected to be somewhat weaker in relation to the March report. Although we have factored in a fall in import prices, calculated in foreign currency for 1998, commodity prices may have a further dampening effect on import prices.

- There is still little experience as to how electricity prices fluctuate under normal precipitation conditions and intensified competition in the power market. So far this year the fall in prices has been somewhat steeper than assumed.
- The vigorous growth in investment this year may contribute to higher productivity growth so that enterprises are able to absorb high wage growth without increasing prices. This may result in a smaller contribution from wage and productivity growth than estimated.

4 CYCLICAL DEVELOPMENTS

4.1 Main features of economic developments

Steadily growing pressures in the economy - rising imports

This report contains projections up to the end of 1999. The cyclical upturn now seems more pronounced than previously assumed. In the first months of the year activity has continued to expand, while imports seem to be accounting for a growing share of demand. This is confirmed by the quarterly national accounts from Statistics Norway. In the year to the first quarter of 1998 mainland GDP rose by a seasonally adjusted 3.8% and traditional merchandise imports by 13.2%. At the same time, the cost competitiveness of the enterprise sector is deteriorating as wage growth accelerates. This report underlines the supply constraints as the main factor behind these developments. As the economy approaches a situation where resources are insufficient to sustain a growth rate beyond its long-term potential, financial markets have shown signs of greater uncertainty than six months ago. A lower current-account surplus and a passive fiscal policy have probably contributed to deteriorating confidence in the Norwegian economy. Foreign exchange market developments also prompted two rate increases since the March *Inflation Report*. This has contributed to growing uncertainty as regards the projections for consumption and investment, particularly for next year.

Mainland GDP growth is estimated at 4% in 1998 and 2¾% in 1999. Traditional merchandise imports have been revised upwards in relation to the March report, primarily as a result of stronger-than-expected growth in private consumption and investment. In addition, oil production has been substantially lower than previously assumed. The current-account surplus is estimated to amount to NOK 21bn in 1998.

Household real disposable income and consumption are rising sharply this year. Growth in real income appears to be higher than the peak levels in the 1980s. Households seem to be using a substantial share of their income for housing investment, with the saving ratio remaining unchanged. The high growth in income still provides room for high growth in private consumption this year. We expect a fall in the saving ratio next year and continued brisk growth in consumption.

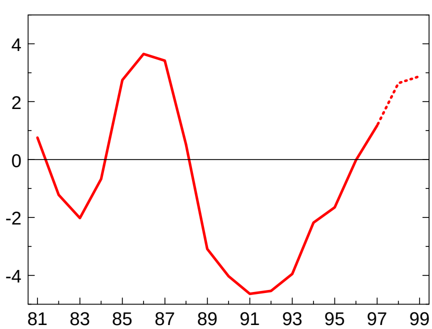
Unemployment (LFS) is estimated to fall to 3¼% this year, and according to our calculations the rate may be reduced to 2½% in 1999, bringing the unemployment rate down to the level prevailing at the previous cyclical peak by the end of the projection period. According to Statistics Norway's general business tendency survey, a rising num-

Table 4.1 *Supply and use of goods and services. Percentage growth from previous year*

	1997	1998	1999
Mainland demand	4.5	4	3
Private consumption	3.4	4½	4¼
Public consumption	3.0	2	2
Mainland fixed investment	9.7	5	–¼
Fixed investment in oil and pipeline transport	15.5	17	–10
Exports	5.8	4¼	8¼
Of which:			
Oil, gas and pipeline transport	2.3	1½	14¼
Traditional goods	8.0	7½	4¼
Imports	12.3	7½	2
Traditional goods	8.6	9	3
GDP	3.4	3½	4¼
Mainland GDP	3.7	4	2¾

Source: Statistics Norway and Norges Bank

Chart 4.1 *Output gap. Difference between actual and trend GDP in mainland Norway. Percentage points*



Source: Statistics Norway and Norges Bank

Lower current-account surplus and possible implications for capital movements

In this report, the current-account surplus is estimated to amount to NOK 21bn in 1998, ie a downward revision of almost NOK 70bn compared with the December 1997 *Inflation Report.* In this box we look more closely at the components underlying the downward revision and the implications for capital flows.

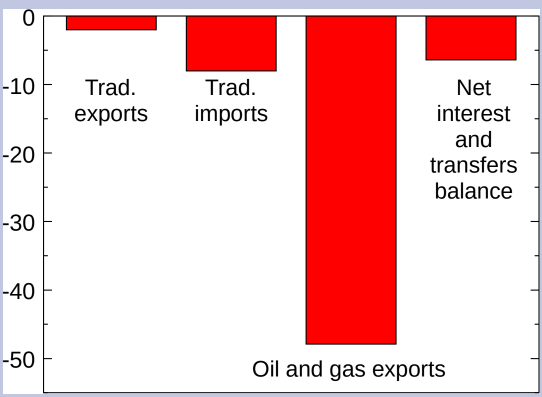
About two thirds of the downward revision reflects factors relating to oil exports. The oil price is now estimated at NOK 105 p/b in 1998, which is NOK 20 lower than the projection six months ago. The effect of a lower oil price on the current-account surplus implies in isolation a reduction in the surplus of a little more than NOK 31bn. Furthermore, the expected increase in oil production will occur at a later stage, thereby reducing oil exports by more than NOK 16bn.

Revised estimates for the balance of traditional goods have also contributed to reducing the estimate for the current-account surplus. Imports are now expected to rise at a considerably faster pace, partly due to sharper investment and consumption growth in the mainland economy and higher petroleum investment. Moreover, it appears that the deficit on the interest and transfers balance will be higher than previously expected.

Capital flows may serve as an indicator of underlying conditions in the foreign exchange market. By definition, the current-account surplus of NOK 21bn must be equal to the total net capital outflow for the country as a whole.

In accordance with the guidelines for the Government Petroleum Fund, the surplus on the central government budget shall be invested in foreign currency.

Contribution to deterioration in projected current account surplus in billions of NOK



Source: Norges Bank

In the Revised National Budget for 1998 this surplus is estimated at about NOK 47bn in 1998. The estimate is based on an oil price of NOK 110 p/b. In addition, the return on the Fund is estimated at a little more than NOK 5bn. All in all, this results in a net capital outflow of NOK 52bn through the Petroleum Fund.

As public capital outflows in connection with the Petroleum Fund are higher than capital outflows associated with the current-account surplus - about NOK 31bn this year based on estimates in this report - sectors outside the Petroleum Fund must be responsible for this capital inflow. The difference, however, is lower taking account of the assumption of a slightly lower oil price compared with the Revised National Budget. Some observers have pointed out that this difference may contribute to a weakening of the krone exchange rate if the private sector does not maintain this share of capital inflows.

There is, however, reason to believe that some sectors will automatically maintain a portion of the inflow of capital this year:

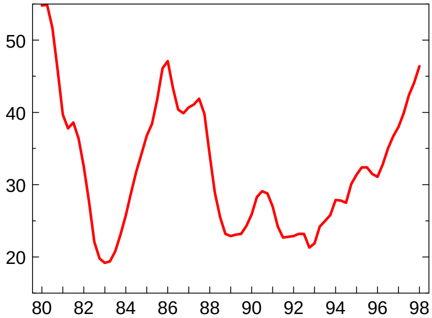
First, the estimate for petroleum investment in 1998 has been revised upwards by a substantial margin, and petroleum production is expected to remain approximately unchanged compared with the level in 1997. As a result, the petroleum sector will probably record a considerable increase in net debt this year, as we have seen during earlier investment peaks. The sector will finance part of this investment abroad, which may then result in capital inflows into Norway.

Second, net imports of ships will probably account for a share of these capital inflows. Net imports of new and second-hand ships are projected at a good NOK 7bn this year, and much of this will most likely be financed directly abroad.

In addition to these capital inflows, the banking sector is expected to show net capital inflows. For several years banks have been funding part of their lending growth abroad. In view of the continued sharp rise in lending this year, this trend will probably continue. In the period to end-May banks recorded net capital inflows of about NOK 25bn, according to preliminary figures based on foreign exchange statistics from Norges Bank.

In our assessment, the factors described here will ultimately contribute to offsetting the need to generate capital inflows into the private sector which would otherwise have been the case.

Chart 4.2 *Indicators of resource shortages in manufacturing industry according to the general business tendency survey. Percentage of enterprises experiencing production constraints*



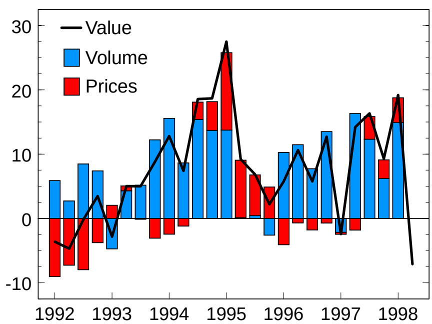
The indicator sums up the percentage of enterprises reporting contraints due to either full capacity utilisation, a shortage of labour or a shortage of input goods.
Source: Statistics Norway

Table 4.2 *Projected GDP. Percentage change from previous year*

	1997	1998	1999
USA	3.8	3¼	2
Japan	0.9	0	1¼
Germany	2.2	2½	2¾
UK	3.3	2	1¾
Sweden	1.9	2¾	2¾
Finland	5.9	4	3
Denmark	3.0	3	2¾
Norway's trading partners[1)]	2.8	2¾	2½

[1)] Weighted by export weights
Source: Norges Bank

Chart 4.3 *Traditional merchandise exports according to* External Trade Statistics. *Volume, price and value. Percentage increase on same quarter previous year*



The latest observation for the rise in value is the average rise so far in the second quarter compared with the same period last year.
Source: Statistics Norway

ber of manufacturing enterprises report that the supply of available resources is limiting production, see Chart 4.2.

4.2 The international environment and the balance of payments

The growth prospects for our trading partners have shown no substantial change since the March *Inflation Report*. The contagion effects of the Asian crisis continue to fuel the uncertainty associated with international economic developments, but the effects on the economies of our traditional European trading partners and the US are still more moderate than previously expected. Growth in the US is expected to be slightly stronger this year than assumed in the March *Inflation Report*. The UK, which has experienced many successive years of robust growth, is expected to show slightly slower growth in 1998 and 1999. In continental Europe and Sweden, growth is expected to pick up following a protracted period of low capacity utilisation and high unemployment. We assume that domestic demand, fuelled by higher investment growth, will take over as the primary driving force, thereby countering the negative implications for exports as a result of the Asian crisis. The outlook for the Japanese economy seems to have deteriorated substantially, however. This is partly due to the situation in the region, but also ebbing confidence and a substantial need for restructuring.

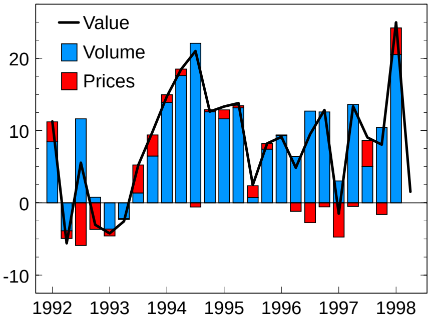
High imports and lower oil production reduce the current-account surplus in 1998

In 1997 the strong growth in Norwegian exports was primarily spurred by demand from our traditional European trading partners and the US. Norwegian export goods, which largely consist of commodities and capital goods, are expected to benefit from rising growth in investment in continental Europe this year. New orders for typical export industries have been buoyant in the last two quarters, reinforcing this assumption. Even though export trends are heavily influenced by production capacity in manufacturing, higher wage growth may gradually translate into a loss of market shares.

Following a rise in the period to August 1997, commodity prices have dropped sharply with the spreading of the Asian crisis. We assume that commodity prices will stabilise at the current level, drifting up in 1999. For the processed portion of Norwegian exports, prices are expected to show a moderate rise both in 1998 and 1999.

In the first four months of 1998, traditional merchandise imports rose in value by 18.1% compared with the same period last year. The price index for the first quarter shows a rise of 3-4% compared with the same period one year earlier. The price rise partly reflects the sharp depreciation of

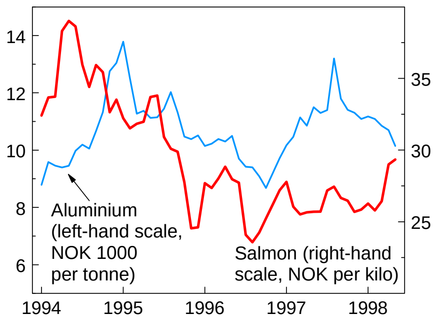
Chart 4.4 *Traditional merchandise imports according to* External Trade Statistics. *Volume, price and value. Percentage increase on same quarter previous year*



The latest observation for the rise in value is the average rise so far in the second quarter compared with the same period last year.

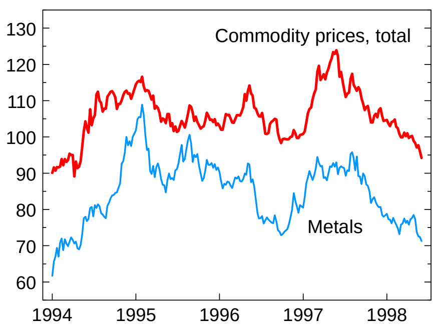
Source: Statistics Norway

Chart 4.5 *Prices for aluminium and salmon. In NOK*



Source: Statistics Norway and Financial Times

Chart 4.6 *Commodity prices measured in SDRs: total and metals. Index 1990 = 100*



Source: The Economist

the import-weighted exchange rate during the same period. Consequently, volume growth was substantial, and fairly evenly distributed among typical capital goods, such as machinery, consumer goods and input goods. As a result of higher estimated growth in domestic demand and petroleum investment, imports are also expected to increase by a greater margin than projected in the March report. In 1999, a contraction in investment, both in the mainland economy and in the petroleum sector, will contribute to considerably lower import growth.

The estimates for petroleum production for 1998 have been lowered by a substantial margin compared with the figures in the two previous *Inflation Reports*. This must be seen in connection with the delay in the production start-up of several fields and the Norwegian authorities' decision to support OPEC's measures to stabilise oil prices. Our projections are based on an oil price of NOK 105 p/b (1998 prices) in 1998 and 1999, ie the same price as in the March report and about the same level as the average oil price so far this year. Combined with lower surpluses on the traditional trade balance, the estimate for the current-account surplus for 1998 is reduced to NOK 21bn.

The production level in 1999 will only be marginally lower than assumed in the two previous reports. The current-account surplus is projected to rise to NOK 54bn as a result. A separate box shows how changed assumptions and estimates for developments in various components have influenced the estimate for the current-account surplus since the December 1997 *Inflation Report*. The box also contains a discussion of possible implications for capital movements as a result of lower current-account surpluses.

4.3 The labour market

Continued robust growth in employment, and a further decline in unemployment

Evidence suggests that the strong growth in employment over the last few years is continuing this year, and may be even more pronounced than estimated in the previous *Inflation Report*. So far the labour force has also increased by a greater margin than expected. The estimate for unemployment therefore remains unchanged on the March *Inflation Report*.

According to the quarterly national accounts, employment showed a rise of 3% in the year to the first quarter. Employment rose in most industries, particularly in construction, commercial services and distributive trades. We expect the demand for labour to remain high, and estimate growth in employment at 2¾% in 1998 and 1¾% next year.

So far during this cyclical upturn, the increased demand for labour has largely been accompanied by an increase in the labour supply, which has lifted labour force participa-

Pronounced cyclical fluctuations

Six months ago we presented medium-term projections for the Norwegian economy, which showed relatively pronounced cyclical fluctuations. The estimates pointed to high growth in the level of activity both in 1998 and 1999, with high demand for labour and a sharp decline in unemployment. Wage growth was then estimated at 5% in 1998 and 6% next year. In the projections, the subsequent deterioration in competitiveness contributed to lower profitability and a fall in employment in Norwegian industries exposed to competition. The growth impetus also shifted from investment and exports to private consumption. Slower growth in business fixed investment and a decline in petroleum investment in 1999 and later years implied a weaker demand impetus in the Norwegian economy. Employment growth would gradually come to a halt, with unemployment projected to increase after the turn of the century.

We indicated that this scenario involving pronounced cyclical fluctuations appeared to be fairly robust to moderate changes in the assumptions. The uncertainty was primarily related to the *amplitude* of the cycle. On this basis, we pointed to factors which might contribute to amplifying the cyclical trend over the next few years, and subsequently a more pronounced downturn. Along with the effects of a more expansionary fiscal policy, we highlighted three factors which we considered relevant in this connection, and which might result in an even more pronounced cycle:

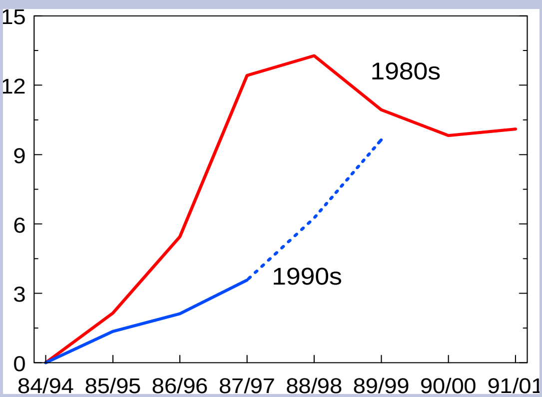
– Petroleum investment might be higher than estimated.
– The labour market might be tighter than anticipated, thereby resulting in higher-than-projected wage growth.
– A loss of confidence in the Norwegian economy might result in depreciation expectations and a rise in interest rates.

We also pointed to the possibility that several forces might come into play. For example, the likelihood of a loss of confidence in the Norwegian economy, with subsequent depreciation expectations and higher interest rates, was deemed to be greater if wage growth proved to be stronger than projected in the baseline scenario.

Even though the effects naturally deviate slightly from the underlying assumptions in December, the scenario of the more pronounced cycle shares several features with developments observed so far this year:

– The Government's estimate for petroleum investment in 1998 has been revised upwards by NOK 6-7 billion.

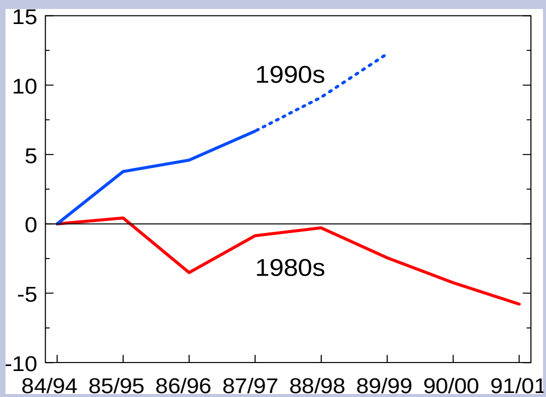
Chart 1 *Rise in hourly wages in manufacturing compared with our trading partners. Cumulative difference in percentage points[1]*



[1]Projections for 1998 and 1999

Source: OECD, IMF, Statistics Norway and Norges Bank

Chart 2 *Rise in relative labour costs in manufacturing in a common currency. Cumulative difference in percentage points[1)]*



[1)] Projections for 1998 and 1999

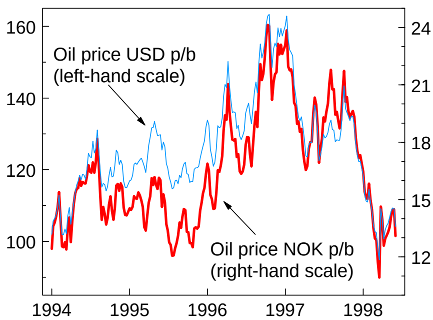
Source: OECD, IMF, Statistics Norway and Norges Bank

- Wage growth may reach about 6% this year, compared with the 5% projected in December.
- The krone exchange rate has depreciated by about 3% and money market rates are about ¾ percentage point higher.

In 1999, petroleum investment may also be higher than assumed in the baseline scenario in the December 1997 *Inflation Report*. In addition, our estimate for wage growth in 1999 has been revised upwards to 6¾%. Even though wage growth up to 1998 has been relatively moderate and more in line with earnings growth among trading partners than during the previous cyclical upturn, see Chart 1, it is too early to ascertain whether wage growth during this business cycle will be significantly different from developments in the 1980s, partly because labour market pressures are expected to reach new heights in the period ahead.

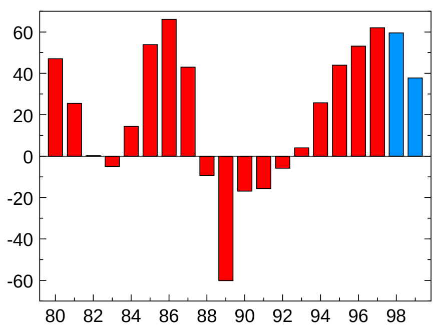
If we also take account of movements in the krone exchange rate, and our estimate for wage growth in 1999 materialises, Norwegian enterprises will record an increase in labour costs measured in a common currency of about 12 percentage points in relation to trading partners, see Chart 2. This should be seen in connection with a marginal *decline* in relative labour costs in the 1980s.

Chart 4.7 *Oil prices p/b in NOK and USD*



Source: Norges Bank

Chart 4.8 *Number employed. Change from previous year. 1000 persons*



Source: Statistics Norway and Norges Bank

tion to a record 72.5%. The potential for continued growth in the labour force has therefore probably been reduced, and may well be restricted by the phasing in of new welfare schemes, such as cash grants for families with small children and an expansion of early retirement schemes.

Unemployment has continued to fall. At the end of May there were close to 51 000 registered unemployed. If the decline continues at the rate seen during the past year, it will fall in 1999 to the levels recorded during the expansion in the latter half of the 1980s. A natural consequence of the fall in unemployment is a scaling back of labour market measures in 1998 and 1999 as proposed in the Revised National Budget. The LFS unemployment rate is projected to edge down to 3¼% in 1998 and 2½% in 1999. This corresponds to an average 40 000 registered unemployed next year.

At end-May vacancies were 45% higher than a year ago, bringing the current figure up to nearly 21 000. Manufacturing enterprises are still reporting that a shortage of labour will limit production in the period ahead.

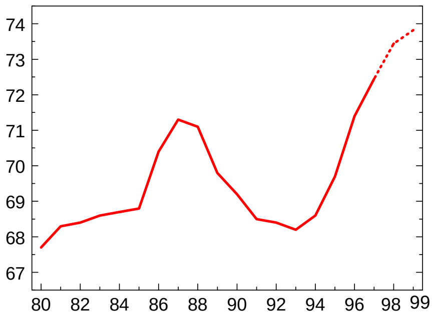
One interesting feature of the Norwegian labour market is that the number of long-term unemployed has declined in pace with overall unemployment. This contrasts with the situation in many other European countries, where the number of long-term unemployed rises even though unemployment falls.

4.4 Wages

Higher wage growth

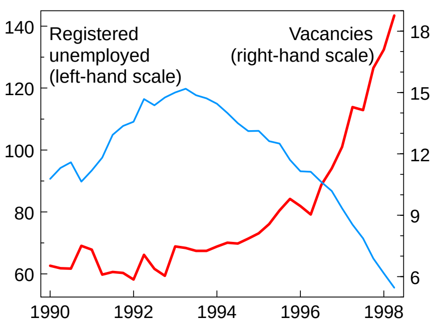
Wage growth is now accelerating. High pay increases have come particularly in cyclically sensitive sectors: In the construction sector, the carry-over from last year and the centrally negotiated increases point to annual wage growth of

Chart 4.9 *Participation rates. Labour force as a share of the working-age population*



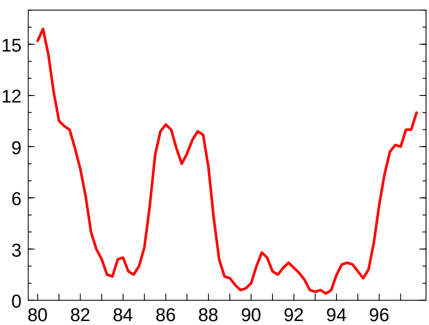
Source: Statistics Norway

Chart 4.10 *Number of registered unemployed and vacancies. 1000 persons. Seasonally adjusted*



Source: Directorate of Labour

Chart 4.11 *Indicator of labour shortages. Per cent*



Source: Statistics Norway

6½-7%. In manufacturing, the settlement resulted in an increase of a minimum of NOK 3 per hour. Given approximately the same contribution from wage drift as last year, annual wage growth for manufacturing may reach around 5%. However, robust corporate earnings and declining unemployment may result in higher wage drift this year. Earlier in the 1990s, unemployment and wage drift tended to show a negative co-variation. The wage settlements indicate that annual wage growth in the service and distributive trade sector and the public sector may be about 6%.

The results of the wage settlements suggest that overall annual wage growth may be about 6% in 1998. The results for manufacturing are consistent with those generated by the RIMINI model, whereas the model appears to have underpredicted wage growth in private services.

Estimated wage growth in 1999 is based on historical experience of wage formation, as embodied in the RIMINI model. Based on the model, wage growth is projected at 6¾% although the model has tended to underpredict wage growth in the main settlement and overestimate the interim settlement. On the other hand, a high wage carry-over - particularly in the public sector but also in the private sector - will contribute to pushing up wage growth next year. At the same time, a tighter labour market will probably continue to exert upward pressure on wage growth. It is important to note that the wage estimate implies lower nominal pay increases than those awarded this year.

Since 1994, wage growth in manufacturing has been higher than among our trading partners. Our estimates indicate that this trend will intensify over the next two years. As a result of exchange rate developments so far this year, however, the difference in a common currency will not be so great this year, but will increase substantially next year. The possible effects of pronounced cyclical fluctuations on relative labour costs are discussed in a separate box.

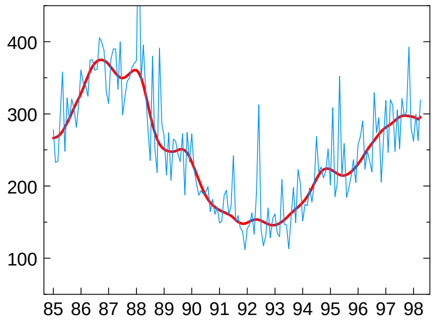
4.5 Domestic demand

Mainland business fixed investment expanding sharply this year followed by slower growth in 1999

The investment intentions survey for the second quarter indicates a marked increase in manufacturing investment this year. This is underlined by substantial imports of machinery so far this year. Higher capacity utilisation and solid corporate earnings reinforce this scenario. However, the survey indicates a sharp drop in manufacturing investment next year.

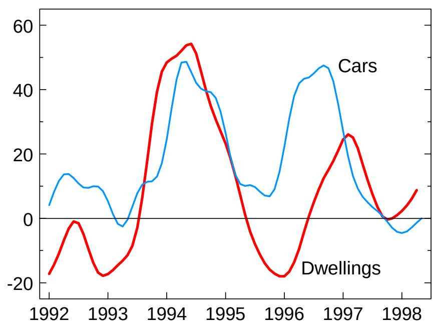
In the service sector, the completion of the new international airport at Gardermoen and the new National Hospital will slow investment growth both this year and next. At the same time, a fairly sharp reduction in petroleum investment is expected in 1999, which in isolation will also reduce

Chart 4.12 *Commercial building starts. 1000 sq.m. Seasonally adjusted and trend*



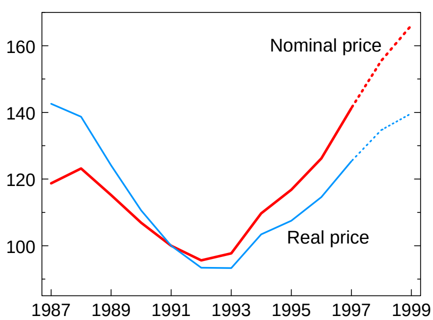
Source: Statistics Norway

Chart 4.13 *New car registrations and housing starts. Smoothed. 12-month growth. Per cent*



Source: Statistics Norway

Chart 4.14 *Resale home prices. Index 1991 = 100*



Source: Statistics Norway and ECON

investment requirements among mainland enterprises. After expanding by 6% this year, a marked slowdown in mainland business fixed investment to about 4% is expected next year.

On the basis of information in the Revised National Budget and investment intentions survey for the second quarter, petroleum investment is projected to expand by 17% this year, followed by a drop of 10% in 1999. This will provide virtually the same impulse to the mainland economy as assumed in the March *Inflation Report*.

Continued growth in employment and high real wage growth will contribute to strong growth in household real disposable income and consumption the next few years

Since the previous *Inflation Report*, Statistics Norway has revised the method used to calculate the retail sales index. Once again the index has understated the growth in retail sales during a cyclical upturn. In light of this, growth in private consumption in 1997 was revised upwards by 0.4 percentage point in relation to previously published figures, and is now estimated at 3.4%.

The revision has also resulted in a stronger-than-expected rise in retail sales in the first few months of this year. During the first four months of 1998, the volume of retail sales was 5.5% higher than in the same period in 1997. Moderate growth in services consumption in the first quarter resulted in 4.0% growth in household consumption compared with the same quarter one year earlier, according to quarterly national accounts figures. This figure has, however, not been adjusted for the fact that Easter occurred in different quarters in 1998 and 1997.

Households' financial position is stronger than ever. Income growth has been high for the past few years, and is expected to increase. The saving ratio is also high. The high level of saving partly reflects substantial housing demand and housing investment, as indicated by credit statistics. A high level of residential construction and vigorous activity in the resale home market also signal higher services consumption. Growth in services consumption is thus expected to accelerate in the near future.

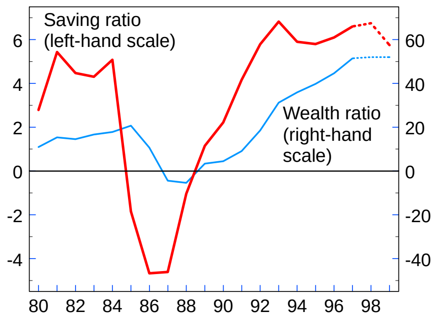
In the previous *Inflation Report*, growth in consumption was estimated at 4% in 1998. In the present report, the estimate for wage and employment growth has been revised upwards. As a result, growth in household real disposable income will rise by a greater margin than projected in the previous *Inflation Report*, and at a stronger rate than at any time in the 1980s and 1990s. .

Estimates put growth in household consumption at 4½% this year and slightly lower next year. The estimates imply an unchanged saving ratio in 1998. Next year, lower growth in real income, largely as a result of slower growth in employment and a negative contribution from net asset income, implies a slight decline in the saving ratio.

In isolation, the projections for household income and wealth point to an increase in residential construction in the period ahead. The same applies to a continued rise in resale home prices, as the price differential between new and existing homes narrows. Housing starts have been in line with our estimates for housing investment in the previous *Inflation Report*. The completion of the new international airport at Gardermoen and the new National Hospital will free up skilled workers, which suggests an increase in housing investment next year.

Various resale home price statistics show that prices rose sharply from the fourth quarter of last year to the first quarter of this year. The rise in house prices therefore appears to be continuing, after levelling off in the second half of last year. A similar seasonal development is expected in the period ahead, but house prices may still rise by an annualised 10% in 1998. The recent increases in interest rates are expected to dampen the rise in house prices next year.

Chart 4.15 *Household saving ratio and wealth/disposable income ratio*



Source: Statistics Norway and Norges Bank

Lower petroleum income reduces central government budget surplus and transfers to the Petroleum Fund

Our projections are based on the fiscal policy programme outlined in the Revised National Budget for 1998. Measured by the change in the non-oil cyclically adjusted budget surplus net of interest payments, the budget for 1998 as proposed in the Revised National Budget implies a tightening of domestic demand equivalent to almost half a per cent of mainland GDP. The budget adopted in December originally entailed a 0.25 per cent tightening. However, the increase is of a technical nature, primarily reflecting higher estimates for wage growth and employment. Overall, the demand impulses from fiscal policy therefore remain unchanged in relation to the approved budget.

In the Revised National Budget, the total surplus on the central government budget is estimated to amount to NOK 47bn this year, based on an oil price of NOK 110 p/b. Lower oil prices and oil production have substantially lowered the estimate in the approved budget. The underlying real growth in central government budget expenditure is estimated at a good 1¾% this year. This is slightly lower than in the approved budget, but must be seen in connection with higher price inflation and the attendant dampening impact on real expenditure growth.

In 1997 local government revenues increased sharply. Revenues will continue to expand sharply this year as a result of high tax revenues, thereby providing room for high activity in the local government sector. Gross investment in the local government sector increased by over 20% in 1997, primarily owing to the substantial investment associated with School Reform 94. There is considerable uncertainty attached to the investment level this year. A high level of investment in the health and care sector may suggest continued vigorous growth in investment in 1998, with investment showing only a moderate decline this year.

Aggregate public consumption is estimated to increase by about 2% in 1998 and 1999. Our projections for next year are based on tight central government budget spending, while local government expenditure is expected to shadow mainland growth.

MAIN MACROECONOMIC AGGREGATES

Percentage change from previous year, unless otherwise indicated

	1997	1998	1999
Real economy			
Private consumption	3.4	4½	4¼
Public consumption	3.0	2	2
Total gross investment	12.6	7½	–2¾
Oil extraction and pipeline transport	15.5	17	–10
Mainland Norway	9.7	5	–¼
Enterprises	9.1	6	–4
Dwellings	9.0	9¼	10¼
General government	12.1	–1	2¼
Mainland demand	4.5	4	3
Exports	5.8	4¼	8¼
Oil, gas and pipeline transport	2.3	1½	14¼
Traditional goods	8.0	7½	4¼
Imports	12.3	7½	2
Traditional goods	8.6	9	3
GDP	3.4	3½	4¼
Mainland Norway	3.7	4	2¾
Labour market			
Employment	2.9	2¾	1¾
Labour force, LFS	2.1	1¾	1
Unemployment, LFS	4.1	3¼	2½
Prices and wages			
Consumer prices	2.6	2½	3
Annual wages	4.3	6	6¾
Import prices, traditional goods	–1.1	½	1¼
Export prices, traditional goods	0.5	1	2¼
Crude oil prices, NOK (level)	134	105	108
External account			
Trade surplus, NOKbn (level)	76.6	39	71
Current account surplus, NOKbn (level)	56.1	21	54
Current account surplus, % of GDP (level)	5.5	1¾	4½
Memorandum item			
Household saving ratio	6.6	6¾	5¾

Source: Statistics Norway and Norges Bank