

International economy

As expected, the cyclical downturn in the US over the past year has had a pronounced effect on large parts of the world economy during the summer. Consensus Forecasts' 2001 GDP growth projections – which usually function as a good summary of recently published short-term data – have for the world as a whole been lowered from 2.2 per cent in May to 1.7 per cent in August. The forecast for 2002 has in the same period been reduced from 3.0 per cent to 2.6 per cent. The forecast for 2001 for all EU countries has also been revised down by half a percentage point to 2.0 per cent, while the forecast for 2002 has only been lowered by 0.2 percentage point to 2.5 per cent. However, accounts figures for some euro countries that were published in August indicated that at best growth stalled in the second quarter. The possibility that the forecasts will be revised down further in the period ahead can therefore not be ruled out.

On the basis of a traditional cyclical pattern, the US economy can be expected to reach a trough in the fourth quarter of 2001, and as discussed in our previous quarterly report it is likely that the subsequent recovery may be fairly sluggish. With a normal lag of a few quarters, a corresponding turnaround in western Europe will not take place until later in the spring of 2002. This probably means that growth among industrialized countries as a whole will remain subdued over the next six months and not pick up until the latter part of next year and into 2003. We assume that OPEC will continue to be able to keep oil prices within the interval USD 22-28, both though the period of lower economic growth now being experienced and during the subsequent upturn. We therefore assume that the oil market will not generate new impulses that influence the international economy. Hence, developments in the US economy will continue to determine to a large extent the further direction of international markets in the period ahead.

The oil market – OPEC has control

The spot price of Brent Blend fell from USD 33 to USD 22 per barrel from November 2000 to the beginning of January 2001. Oil prices have since fluctuated between USD 23-29, providing an average of a little more than USD 26 per barrel for the first eight months of the year. The most important reason for the fall in prices towards the end of last year was that stocks of heating oil and crude oil in the US started to increase following concern in the autumn about the ability to satisfy future consumption. High oil prices so far this year must primarily be viewed in connection with OPEC's decisions on three occasions to reduce production quotas by altogether 3.5 million b/d until the end of the year. So far, OPEC has satisfied

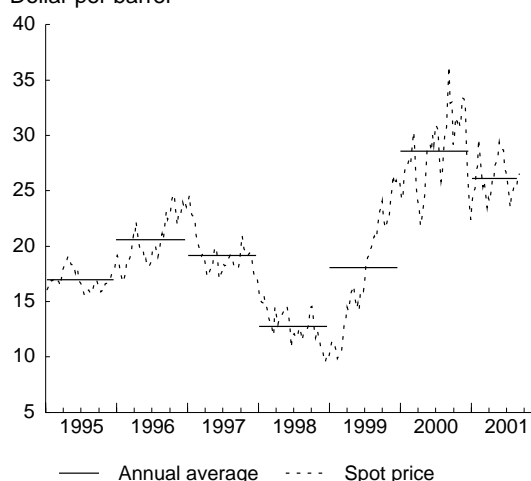
about 70 per cent of the announced cuts, i.e. reduced production by about 2.5 million barrels.

According to forecasts from the International Energy Agency (IEA), oil demand is only expected to show a marginal increase next year, primarily as a result of relatively low estimates for growth in the world economy. Despite high oil prices the last two years, the IEA expects non-OPEC oil production to rise only modestly. This means that the residual demand for OPEC oil is expected to remain fairly constant next year. These developments are contingent on a continuation of Iraq's exports at the current level within the oil-for-food agreement with the UN.

The IEA expects a small decline in stocks of crude oil in the third quarter, a period when stocks are normally built up. For the fourth quarter of 2001 and the first quarter of next year as a whole, the daily use of stocks is expected to be about 0.7 million barrels, which is not abnormal if the winter in the western hemisphere is normally cold with demand for heating oil rising sufficiently.

Over the last one and a half years OPEC has succeeded in keeping the oil price of a basket of OPEC oil within its targeted interval of between USD 22 to 28 per barrel. The price of a barrel of Brent Blend is USD 1-2 above this oil price. The latest decision by OPEC to cut production quotas was carried out by telephone, a factor that amplifies the impression of an effective cartel. Despite some uncertainty concerning stocks and the ability to satisfy future consumption, continued confidence in OPEC's ability to act is generating expectations of an average oil price in the middle range

Spot price, Brent Blend. 1995-2001
Dollar per barrel



Source: Norges Bank.

of the cartel's targeted interval, and we have therefore assumed a Brent price of USD 26 per barrel throughout the projection period.

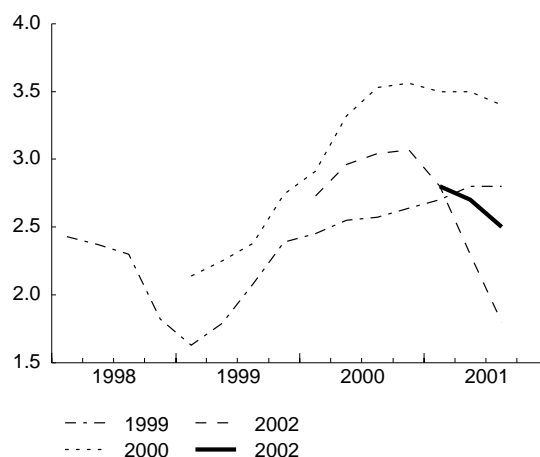
The US – now we just have to wait

During the so far moderate downturn in the US, considerable attention has been focused on the decline in manufacturing output and particularly the sharp contraction in the IT sector, in terms of production, investment and equity prices. Less attention has been given to the fact that the decline in manufacturing in the spring of 2000 started a completely different place, notably in the housing sector. Housing starts peaked at the beginning of 2000 and then fell markedly later in the spring. The peak for the building goods industry and the production of intermediate goods was reached in February, the production of consumer goods in June and the production of raw materials in September. It was not until November last year that the production of machinery and equipment passed a peak. The downturn in the US has therefore not been initiated by the decline in sectors linked to new technology, but rather followed the traditional cyclical pattern for the US where residential construction is the leading component. It is not inconceivable that special problems in the IT sector may play an important role in further developments, but it is still too early to say. The problems in this sector over the past year may also be due to business investment in machinery and equipment, which is primarily affected by a normal cyclical downturn; traditionally, this investment lags behind total production in time. Reference is also made to the previous quarterly report for a more thorough discussion.

It is also in the housing sector that signs of a rebound can be expected first. The fall in housing starts came to a halt as early as the summer of 2000 and picked up through the first half of this year. Even though the picture is not clear-cut, several other indicators for the housing market point in the same direction. Both sales of existing homes and house prices have moved on a rising trend over the past year, and many households are now using the opportunity to refinance consumer loans or in other ways increasing mortgages on their dwellings in order to benefit from low interest rates on housing loans. This will also provide the basis for stronger growth in private consumption in the period ahead. If this occurs, it will contribute to boosting the US economy as a whole as private consumption accounts for such a high share of aggregate demand and thus production.

Revised GDP figures showed annualized growth of only 0.2 per cent between the first and second quarter of 2001. It is not inconceivable that growth will also be subdued during the last two quarters of the year. Even though the Federal Reserve began to reduce its key rates as early as the beginning of this year, it was not until the summer that the cumulative reduction in

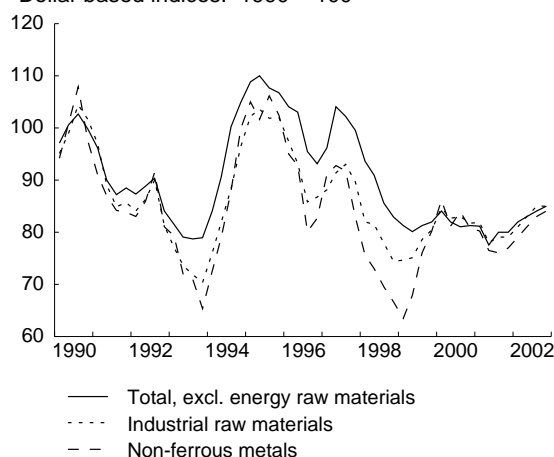
GDP growth forecasts for Norway's main trading partners for 1999 - 2002 given on different dates



Source: Consensus Forecasts.

Commodity prices on the world market 1990 - 2002

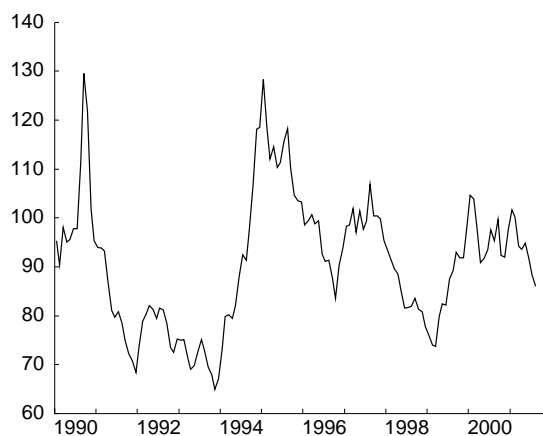
Dollar based indices. 1990 = 100



Sources: HWWA-Institut für Wirtschaftsforschung and AIECE.

Aluminium price. 1990 - 2001

Dollar based index. 1979=100



Source: Norges Bank.

Macroeconomic projections according to selected sources

Annual change in per cent

	GDP-growth				Inflation rate			
	1999	2000	2001	2002	1999	2000	2001	2002
USA								
NIESR	4.2	5.0	1.7	2.3	1.8	2.4	2.1	1.1
OECD	4.2	5.0	1.7	3.1	1.8	2.4	1.9	1.6
ConsF	4.1	4.1	1.7	2.8	2.2	3.4	3.2	2.4
Japan								
NIESR	0.8	1.5	0.6	1.3	-0.7	-1.1	-0.3	-0.2
OECD	0.8	1.7	1.0	1.1	-0.7	-1.2	-0.7	-0.5
ConsF	0.8	1.5	-0.2	0.6	-0.3	-0.7	-0.4	-0.5
EMU								
NIESR	2.5	3.5	2.1	2.4	1.1	2.3	3.0	2.1
OECD	2.6	3.4	2.6	2.7	1.2	2.2	2.3	1.9
ConsF	2.6	3.5	2.1	2.6	1.2	2.3	2.9	2.2
Trading partners								
NIESR	2.8	3.5	2.0	2.4	1.0	1.7	2.2	1.6
OECD	2.8	3.5	2.4	2.6	1.1	1.6	1.8	1.7
ConsF	2.8	3.4	1.8	2.5	1.2	2.0	2.4	1.9

Sources: NIESR from July 2001, OECD from April 2001 and Consensus Forecasts from August 2001. All the inflation projections from the OECD apply to the consumption deflator and the same applies to NIESR's estimates for the US and Japan.

interest rates became significant. So far, interest rates have been cut by 3 percentage points. Normally, it is assumed that it takes 6-9 months before interest rate changes have an effect on the real economy, i.e. the main impact on activity levels will not be seen until the end of the year. If that occurs, this will again be in line with a standard business cycle for the US economy as the cyclical downturn (measured as deviation from trend) will then have lasted 6 quarters, the normal duration of a cyclical downturn in the US.

Europe – substantial growth impetus from monetary policy unlikely

For Europe, considerable attention during the summer – in addition to the discovery of the importance of the US economy to European cyclical developments – has been focused on the European Central Bank's monetary policy. Whereas the Federal Reserve has reduced its rates aggressively through the year, the ECB has so far only delivered two modest interest rate cuts of percentage point each, admittedly from a lower interest rate level than in the US. Many seem to think that the ECB will be forced to reduce interest rates further and more strongly this autumn in response to sluggish economic growth later in the summer. One then disregards the fact that the ECB does not share the Federal Reserve's views on the role of monetary policy. There is every indication that the ECB has inherited its views from the Bundesbank, which in its history has exercised a far more cautious use of the interest rate instrument. This is not only due to differences in ideology. There are clear and genuine economic disparities between the US and most continental European countries which may explain a more cautious

monetary policy, where on the continent considerable emphasis is placed on inflation and to all appearances only little emphasis on economic growth. Whereas the US economy has been very sensitive to changes in short-term interest rates, borrowing by European households and the business sector has mostly been based on loans with a long fixed-rate period. This means that if the ECB is to influence the level of activity, it must influence long-term interest rates. And since long-term rates are largely determined by market participants' long-term inflation expectations, credible inflation targeting is absolutely essential.

In fact, the ECB has less leeway than the German central bank had as the Bundesbank could use the effect of short-term rates on the exchange rate. By tightening interest rates it could push up the Deutsche mark and reduce pressures in the economy; fortunately, the Bundesbank was largely spared from the need to stimulate the economy on its own. In order to achieve corresponding effects on the real economy, the ECB would have to use the interest rate instrument to a considerably greater extent since the euro area is far more closed with regard to international trade than Germany was alone. The "perverse" effects of interest rate changes on the exchange rate that we have seen signs of in recent years come in addition, where a decline in short-term rates is often rewarded by a stronger exchange rate, apparently because as international capital markets are gradually integrated greater emphasis is placed on economic growth and returns associated with direct investment and other investments with a long-term return. Even though this might mean that the ECB could achieve a stronger

euro by reducing interest rates, which would be favourable for inflation, a stronger currency would also have a contractionary effect on the real economy, which would probably counter any small positive effects of lower interest rates on the level of activity. In such an event, the measure would be unlikely to result in higher growth. Irrespective, such waves of sentiment in the foreign exchange market, even though they may last for a long time, are an unreliable ally, and the ECB is unlikely to take chances in its efforts to gain confidence in its inflation targeting and its new currency.

The most likely scenario for the euro countries is therefore that the ECB sees some scope for somewhat lower interest rates as it is gradually reassured that inflation is under control, and on the assumption that it manages to keep long-term interest rates at a low level; for some of the euro countries long-term rates are already slightly below the US level, but an aggressive reduction in interest rates is highly improbable. Consumer price inflation is still higher than the target zone of 0-2 per cent, and even though it is falling it will barely drop below the upper limit next year, according to estimates from Consensus Forecasts. In our calculations, we have therefore assumed a further 1/4 percentage point reduction this year followed by a cautious upward adjustment towards the end of next year, given that GDP growth picks up appreciably.

Japan

The growth forecasts for Japan have also been lowered through the summer and from an already low level. In August, negative GDP growth of -0.2 per cent was expected for 2001 followed by a weak expansion of 0.6 per cent next year. Experience shows, however, that the forecasts for Japan are of little interest other than representing sentiment reports. Inasmuch as Japan's problems are structural, and particularly reflect the strong demographic changes the country has experienced the last few decades, there is little reason to expect any sustained turnaround before it is seen.

Market growth

In addition to low growth in the US this year, growth is expected to be especially low in other important market countries for Norwegian exports, such as Germany and Denmark. Growth among our main trading partners will therefore be lower than e.g. the euro area as a whole, but will nevertheless pick up next year as a result of the projected upswing in the US. Price inflation among our trading partners will also be lower than price inflation in the euro area, both in 2001 and in 2002.