

International economy

Global economic developments are weak. GDP growth is still low and unemployment is increasing on both sides of the Atlantic. High oil prices and considerable uncertainty in the period preceding the war in Iraq may have placed a damper on economic activity in the first quarter, but there are few signs of an upturn so far in the second quarter. As a result of a slower rate of inflation in both the euro area and in the US, the risk of deflation has increased in many countries, although the IMF still considers the risk of general deflation to be limited. In Germany, however, this risk is considered to be fairly substantial, and in Japan prices have fallen over the past four years. On the positive side, equity markets have picked up since the beginning of March, and oil prices have dropped. Geopolitical uncertainty has been reduced since the war in Iraq, but fears of terrorism and SARS are still constraining trade and tourism.

The US economy showed unsteady developments in 2002, and growth has been subdued in the last two quarters. Household consumption is still making a positive contribution, but growth has slowed. Investment declined in the first quarter this year. Unemployment is still rising, and has now passed 6 per cent. An expansionary economic policy has boosted growth, but large government budget deficits are a cause of concern. Monetary policy leeway has also been reduced. The imbalances in the US economy are a source of uncertainty concerning developments in the somewhat longer run. The probability of an imminent upturn in the US economy is now considered to be less than when our last report was published in March. It is assumed, however, that growth will pick up next year.

In the euro area, economic activity is still subdued, and Germany in particular is struggling with sluggish growth. Low inflation will contribute to higher real disposable income which along with low interest rates will underpin household consumption. A weak labour market environment points to the opposite, and may reduce consumption growth. Increased stimulus from fiscal policy is not expected in the period ahead. The appreciation of the euro is having an adverse impact on competitiveness and is reducing the potential for an export-led upturn. It is assumed that growth will edge up somewhat next year.

The Japanese economy is still struggling. It does not appear that domestic demand is generating higher growth, and appreciation tendencies since the end of 2002 are having an adverse impact on export industries. Unemployment is at a record-high level and rising, prices are moving down for the fifth consecutive year and GDP growth is close to zero.

Developments in the oil market

The spot price of Brent Blend fell from about USD 34 per barrel in mid-March to USD 24 per barrel at the end of April. The oil price has edged up since then, and stood at about USD 27 in mid-June. As an average for the first five months of the year, the price has been a little less than USD 30 per barrel, compared with about USD 25 in 2002.

The most important reason for the fall in oil prices through March and April was the resolution of the conflict in Iraq with the toppling of the former regime in a relatively short time. Fears of a prolonged war and the possibility that oil production in other countries in the region would be affected were thereby removed.

So far this year, OPEC has decided to increase production three times, by a total of 3.7 million b/d. This was partly to compensate for the halt in Iraqi exports of a little less than 2 million b/d. In addition, production in Venezuela was lower, particularly in the first quarter, as a result of unrest in connection with the strikes in December last year and January 2003. This affected oil exports to the US, and as a result US stocks of crude oil in January were at their lowest level for 27 years.

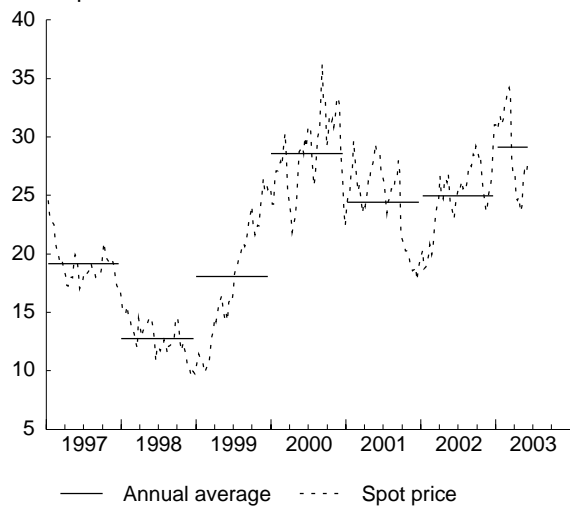
At the moment, Iraq is not covered by OPEC's quota system. Even though UN sanctions against Iraq have now been lifted, it is uncertain to what extent the country will manage to increase exports this year. If it is assumed that OPEC and Iraq maintain their production at a constant level in the period ahead, global stocks of crude oil may increase by more than 2.5 million b/d in the second and third quarters combined. This is a period when stocks in the OECD area usually increase by between 0.5 and 1 million b/d, first to replenish stocks of petrol for the summer season and then to ensure that supplies of heating oil are sufficient for the winter.

According to the International Energy Agency, stocks of crude oil and petrol in the OECD are now at their lowest level for more than 5 years. In particular, many analysts point to the low level of petrol stocks in the US prior to the driving season in coming months. It therefore appears that oil prices may remain high in the period ahead, while stocks of crude oil and finished products will be restored to normal levels.

When stocks increase later in the second half of 2003, it is likely that OPEC will have to cut production to prevent the price from falling below the desired interval of USD 22-28. Irrespectively, oil prices have been

Spot price crude oil, Brent Blend

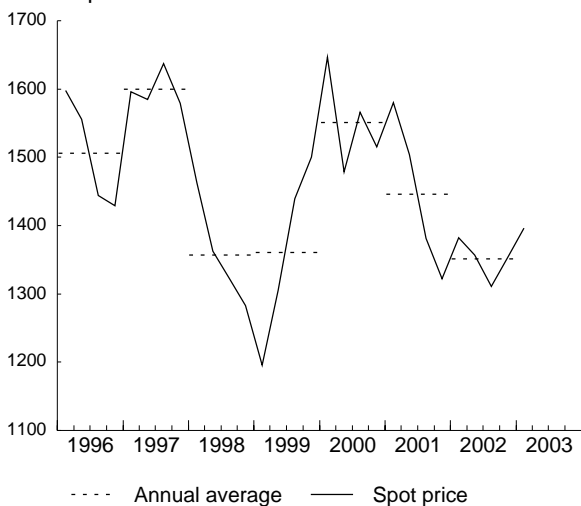
Dollar per barrel



Source: Norges Bank.

Spot price aluminium. 1996 - 2003

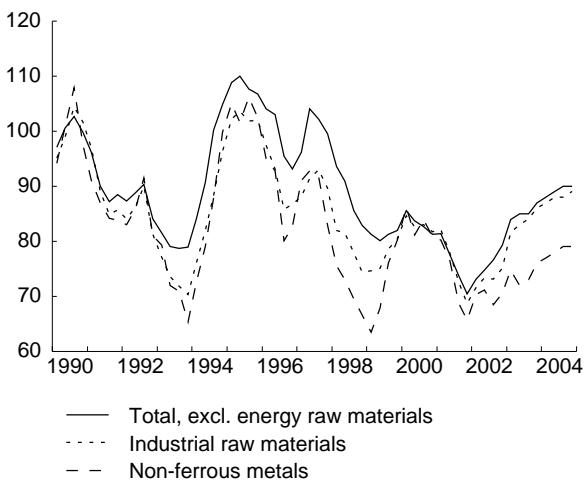
Dollar per 100 lbs.



Source: IMF.

Commodity prices on the world market 1990 - 2004

Dollar based indices. 1990 = 100



Sources: HWWA-Institut für Wirtschaftsforschung and AIECE.

particularly high over a longer period this year, and it appears that the average price for 2003 as a whole may be in the upper interval of OPEC's price band.

If it is assumed that in the next two years Iraq does not manage to increase production to a level that is significantly higher than the pre-war level, and that the cartel does not lose market shares to other producers, OPEC is likely to succeed in keeping the oil price within its price band. An oil price of USD 25 per barrel has been assumed throughout the projection period.

Other commodity prices

Commodity prices rose sharply in the first quarter. Measured in dollar terms, HWWA's commodity price index rose by 13 per cent from the previous quarter. Most of the rise in prices is ascribable to the increase in oil prices. The index for commodity prices, excluding energy products, rose by 6 per cent in the same period. This must be seen in connection with the sharp depreciation of the dollar against the euro. Measured in euros, the commodity price index rose by 6 per cent, and excluding energy products it fell by 2 per cent. The fall in oil prices in the wake of the war in Iraq has since pushed down commodity prices, towards the level prevailing last autumn, measured in dollars, and somewhat more measured in euros.

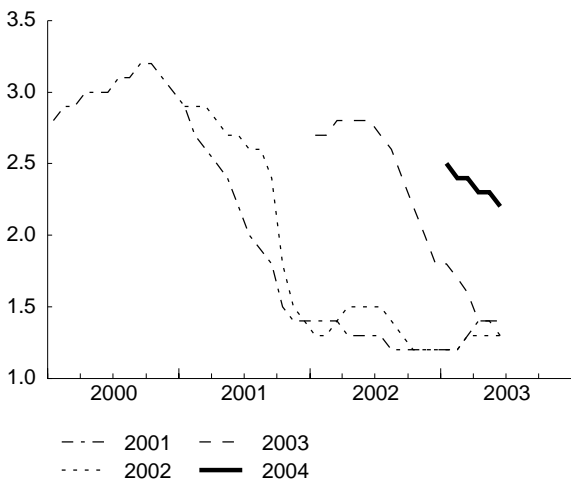
Aluminium prices moved on a sluggish trend through most of 2002, but rebounded in the fourth quarter and at the beginning of 2003. Growing geopolitical uncertainty contributed to stockbuilding and rising prices. Prices fell prior to the war in Iraq, but picked up again afterwards, and at the beginning of June were at approximately the same level as in February this year. It has been assumed that aluminium prices will remain at approximately the current level until end-2003, measured in dollar terms, and then edge up next year as a result of a pick-up in global demand.

US

Following the trough year 2001, with close to zero annual growth, growth edged up in 2002. However, developments were unsteady, and there are few signs that a new period of vigorous growth, as in the 1990s, is imminent. The first quarter of 2003 was the second consecutive quarter of GDP growth below 2 per cent. Growth was restrained by uncertainty, low consumer and business confidence in the economy and high oil prices. The sluggish developments appear to have persisted in the second quarter. Figures from the Bureau of Economic Analysis indicate that productivity growth is moving down.

Household consumption has been the most important growth factor during the period of sluggishness in the US economy over the last few years. In conjunction with high housing investment, this has contributed to high household debt. A sharp rise in house prices has

GDP growth forecasts for Norway's main trading partners for 2001 - 2004 given on different dates



Source: Consensus Forecasts.

also given rise to concerns that a price bubble is developing in the housing market. Growth in consumer spending has been relatively low in the last two quarters, and purchases of consumer durables have fallen for two consecutive quarters. A weak labour market and high debt point to moderate consumption growth ahead. Unemployment has now passed 6 per cent, the highest level since 1995.

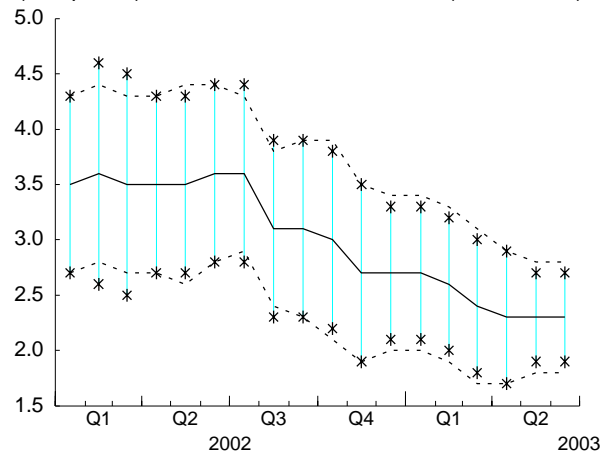
The weak economic environment is also reflected in industrial output, which fell in both March and April. Investment growth slowed through 2002, but rose slightly in the fourth quarter of last year. In the first quarter of 2003, investment fell by 3.3 per cent. Investment in machinery was the component that showed the most pronounced decline, while housing investment continued to make a positive contribution. The Bureau of Economic Analysis estimates that IT equipment has a life of less than four years, and a large share of the equipment acquired prior to the transition to the new millennium is ripe for replacement. This may contribute to a pick-up in investment in the period ahead.

Oil prices have fallen this spring and are expected to remain at approximately the current level in the period ahead. Both petrol prices and heating oil prices are moving down, which will benefit households, manufacturing and the transport industry. Equity prices have also increased in recent months. The S&P 500 index has risen by about 20 per cent since the beginning of March.

The imbalances in the US economy are fuelling concerns. The large government budget and current account deficits are not sustainable in the long term, but it appears that they will persist over the next few years. Reversing the government budgets now would entail an undesired tightening of fiscal policy. If there is a lack of confidence in fiscal policy, the expansion-

GDP growth forecasts for the US for 2003 at different points in time

Average forecast (solid line) with +/- 2 standard deviation (star points) and +/- 2 "normal" deviation (dashed line)



Source: Consensus Forecasts.

ary effect might be offset by higher saving and reduced household consumption.

The US dollar has depreciated sharply since the beginning of 2002. On a trade-weighted basis, it depreciated by about 18 per cent, and by 32 per cent against the euro. In mid-June, one euro cost about USD 1.18. It is assumed that the dollar will remain at this level against the euro through the projection period. The depreciation of the dollar may partly be ascribed to the current account deficit and low interest rates. A weaker dollar will in the longer term contribute to higher exports and reduced imports, and to an improvement in the balance of trade. Higher foreign demand for US goods and services may help to sustain overall demand if household consumption declines. More expensive imports will also contribute to holding up the rise in prices, but may in the short run increase the trade deficit.

The year-on-year rise in prices was 2.2 per cent in April 2003. Core inflation, which has eased since the end of 2001, was 1.5 per cent. The IMF considers the risk of deflation in the US to be low. Interest rates in the US are now at their lowest level in more than 40 years. Since winter 2001, the key rate has been reduced from 6.5 to 1.25 per cent. The Federal Reserve has also supplied liquidity by buying bonds, and long rates are now at a record-low level. The depreciation of the dollar also entails an easing of monetary policy. There is still room for monetary policy relaxation – short rates can still be reduced somewhat and additional liquidity can be supplied to the market – but the Federal Reserve's scope for manoeuvre is now limited.

The recovery following the recession in 2001 has taken a longer time to materialize than expected. Sluggish growth so far this year shows that the turnaround has not taken hold. We do not expect a pro-

Macroeconomic projections according to selected sources

Annual change in per cent

	GDP-growth						Inflation (consumer prices)					
	1999	2000	2001	2002	2003	2004	1999	2000	2001	2002	2003	2004
USA												
NIESR	4.1	3.8	0.3	2.4	2.5	3.5	1.6	2.5	2.0	1.4	2.0	2.0
ConsF	4.1	3.8	0.3	2.4	2.3	3.6	2.2	3.4	2.8	1.6	2.4	2.0
EC	4.1	3.8	0.3	2.4	2.4	2.5	2.2	3.4	2.8	1.6	2.0	1.7
OECD	4.1	3.8	0.3	2.4	2.5	4.0	2.2	3.4	2.8	1.6	2.4	1.7
Japan												
NIESR	0.8	2.4	0.4	0.3	0.8	0.5	-0.5	-1.1	-1.5	-1.5	-0.7	-0.1
ConsF	0.8	2.4	0.4	0.3	0.8	0.8	-0.3	-0.7	-0.7	-0.9	-0.6	-0.6
EC	0.7	2.4	0.4	0.3	1.5	1.3	-0.3	-0.7	-0.6	-0.9	-0.6	-0.7
OECD	0.7	2.6	0.4	0.3	1.0	1.1	-0.3	-0.7	-0.7	-0.9	-0.9	-1.0
EMU												
NIESR	2.8	3.5	1.4	0.8	1.2	1.9	1.2	2.2	2.5	2.3	1.6	1.2
ConsF	2.8	3.5	1.4	0.8	1.0	2.0	1.1	2.2	2.7	2.3	2.0	1.6
EC	2.8	3.5	1.5	0.9	1.0	2.3	1.1	2.4	2.5	2.2	2.1	1.7
OECD	2.8	3.6	1.5	0.9	1.0	2.4	1.1	2.4	2.5	2.4	2.0	1.6
Trading partners												
NIESR	3.0	3.6	1.3	1.3	1.3	2.1	1.2	1.8	2.1	1.9	1.5	1.2
ConsF	3.1	3.5	1.3	1.3	1.4	2.3	1.3	2.2	2.5	2.0	2.1	1.8
EC	3.1	3.5	1.3	1.3	1.4	2.3	1.2	2.0	2.4	1.9	2.0	1.6
OECD	3.1	3.5	1.3	1.3	1.4	2.5	1.4	2.1	2.5	2.1	2.0	1.6

Sources: NIESR, EC and OECD from April and Consensus Forecasts from May 2003 . All the inflation projections from the NIESR apply to the consumption deflator.

nounced upturn in the US economy in the near future, but assume that growth will pick up next year. This is consistent with the projections in Consensus Forecasts.

Europe

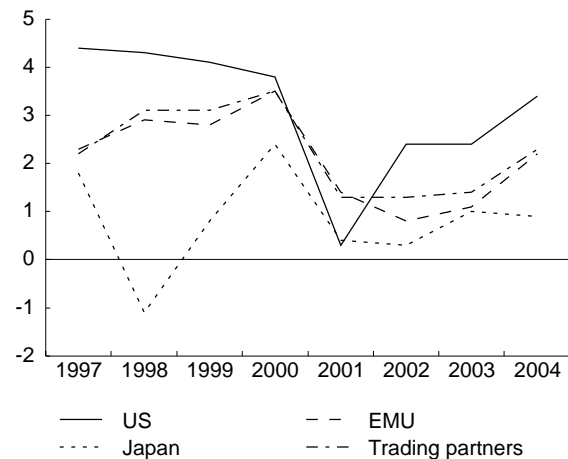
Economic developments remain weak in the euro area and there are few signs that a turnaround is imminent. Competitiveness has deteriorated as a result of the appreciation of the euro. A slower rate of inflation will contribute to higher real disposable income, which combined with low interest rates will underpin household consumption. Unemployment has continued to edge up and stood at 8.7 per cent in March. The sluggish labour market may dampen household demand.

The public budget deficit for the euro area as a whole rose to 2.2 per cent of GDP in 2002, against 1.6 per cent in 2001. The EU Commission projects a further increase, to 2.5 per cent, this year. Sluggish economic developments have contributed to the increase, but the structural deficit, which reflects the budget balance adjusted for cyclical factors, also increased according to calculations from the EU Commission. The increase in the structural deficit may in particular be ascribed to Germany and France. Along with Portugal, these countries are set to exceed the Stability and Growth Pact's budget deficit ceiling of 3 per cent of GDP. Italy is also at risk. The Stability and Growth Pact will limit the possibilities for a more expansionary fiscal policy in most euro area countries in the period ahead.

The European Central Bank has emphasized that its goal is an inflation rate that is close to the upper limit of the inflation target, which is 0-2 per cent, in order to have a buffer against deflation. Inflation has been above the target for some time, but is now moving down to less than 2 per cent. The subdued rise in prices in the service sector and non-energy-intensive manufacturing sectors has been offset by a sharp rise in energy prices. Lower oil prices in the wake of the war in Iraq, weak global growth and the strong appreciation of the euro are now pushing down inflation, and fears that the euro area will be facing deflation have increased this spring. The rise in prices varies considerably across member states. In Germany, inflation is low and it appears that it may fall further. Inflation in other countries, such as Portugal and Ireland, has been appreciably higher than the target for some time, but has also been edging down in these countries over the past six months.

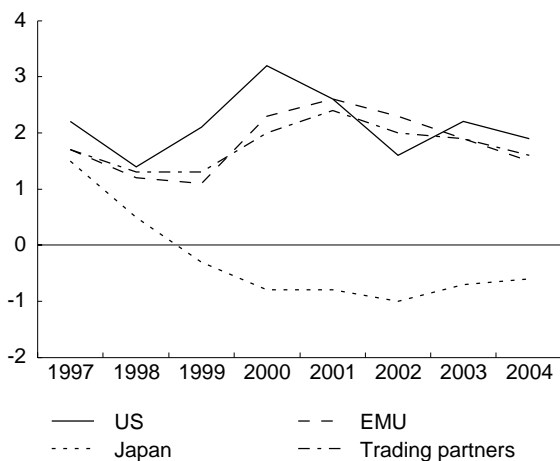
The sharp appreciation of the euro is having an adverse impact on the internationally exposed sector. Competitiveness has particularly deteriorated against the US and countries that have pegged their currency to the US dollar, such as China and to some extent Japan, but also against the UK. The appreciation is also increasing the risk of deflation through lower import prices. The European Central Bank has reduced its key rate by a total of 1.25 percentage points since December 2002, most recently by half a percentage point on 5 June. The key rate is now 2 per cent. The appreciation of the euro has negated a large part of the easing of monetary conditions provided by the

GDP growth for the US, Japan, the euro area and Norway's trading partners



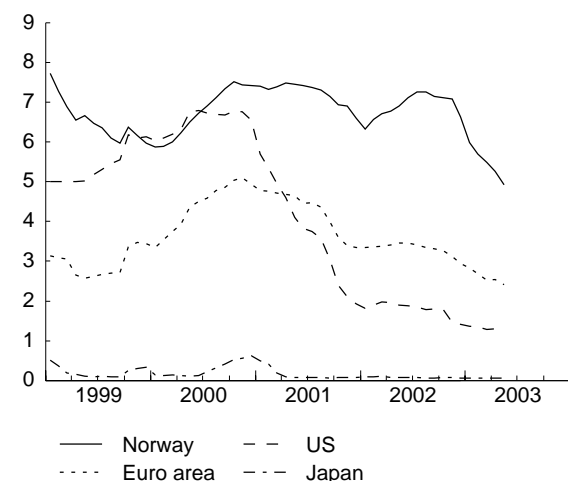
Sources: Average of projections from the NIESR in April 03, CF in May 03 and the EC and the OECD in April 03.

Consumer price inflation for the US, Japan, the euro area and Norway's trading partners



Sources: Average of projections from the NIESR in April 03, CF in May 03 and the EC and the OECD in May 03.

**International interest rates
3-month Eurorate**



Source: Norges Bank.

interest rate cuts so far. Interest rates may therefore be reduced further in the period ahead.

In *Germany*, GDP contracted by 0.2 per cent in the first quarter after having stagnated in the fourth quarter of 2002. Compared with one year earlier, GDP expanded by 0.5 per cent. Retail trade fell in April, reflecting low consumer spending as a result of heightened uncertainty in the labour market and rising unemployment. Industrial output remains weak. Capacity utilization is low and an upswing in investment has not materialized. Unemployment continues to rise, reaching 10.7 per cent in May. Consumer and business confidence in the economy is low. The appreciation of the euro is affecting exports from the euro area and weakening the business sector's competitiveness. Domestic demand is also soft. Inflation is subdued and the appreciation of the euro will contribute to a low rate of inflation in the period ahead. Consumer prices fell by 0.1 per cent from April to May. The year-on-year rise in prices was 0.8 per cent. If the German economy experiences a deflationary spiral, there is a considerable risk of contagion effects on the rest of the euro area. The IMF considers the risk of deflation in Germany to be high.

The restructuring capacity of the German economy has proved to be limited during the international downturn. The need for structural reforms seems obvious, but it has proved difficult to gain acceptance for reforms both internally in the Government and in the Bundestag. Chancellor Gerhard Schröder has now managed to gain the backing of the Social Democrats for a proposal, called Agenda 2010, in which key points include cutbacks in social security schemes, such as sick pay and unemployment benefits, and a relaxation of job-protection rules. Such reforms may have an expansionary effect in the longer term without weakening government budgets. The proposals are to be deliberated in the Bundestag and Bundesrat in the near future, but have encountered considerable resistance, particularly from the trade unions. The probability that the reforms will be approved this year has increased, but the proposals may be watered down.

Large government budget deficits and high government debt are placing constraints on fiscal policy. The downturn has weakened the budget balance further as a result of reduced tax revenues and higher expenditure on unemployment benefits. Germany may breach the Stability and Growth Pact for the second consecutive year by exceeding the budget deficit ceiling of 3 per cent of GDP. Interest rates in the euro area have not been adapted to the cyclical situation in Germany and have contributed to sluggish growth and low inflation. The outlook is still weak, and GDP growth is set to be less than 1 per cent for the third consecutive year.

Germany accounts for one third of the euro area economy and is an important trading partner for most countries in the region. Sluggish growth thus has negative spillover effects on the rest of the euro area. Higher international demand is essential if growth is to pick up, but the appreciation of the euro is reducing the potential for an export-led recovery. 2003 is expected to be another year of weak growth in the euro area, but we assume that activity will pick up somewhat next year.

The *UK* has recorded higher economic growth than the euro area throughout the international downturn. Unemployment has remained low, down towards 3 per cent in the last two years. Buoyant household consumption, fuelled by the sharp rise in house prices, combined with public demand has been the most important driving force. However, growth has slowed somewhat since the beginning of the year, partly reflecting weak global demand and more moderate growth in consumer spending. The rise in house prices also appears to be slowing, which may contribute to curbing household consumption in the period ahead. Government spending will underpin domestic demand over the next few years. The authorities are planning to invest heavily in such sectors as health, education and transport.

Inflation has moved up since last summer. Towards the end of 2002, it exceeded the inflation target of 2.5 per cent, and passed 3 per cent in the first quarter. This largely reflects rising house rents and oil prices. Oil prices have since declined and the rise in house prices has abated somewhat in recent months. The pound has depreciated sharply since the beginning of the year, by about 9 per cent against the euro and 6 per cent on a trade-weighted basis. The depreciation will push up inflation through higher prices for imported goods. Lower consumption growth will have the opposite effect. Manufacturing has been struggling with weak productivity and developments in this sector have been unfavourable over a longer period. However, the depreciation of the pound will result in improved competitiveness, which will improve the outlook for manufacturing industry.

Like the *UK*, *Sweden* and *Denmark* have fared better than most countries in the euro area. In Sweden, sluggish international developments have led to falling exports, but private and public demand has helped to fuel growth. Investment exhibited a weak trend towards the end of 2002, but the projected upswing has not yet materialized. Following a period of high inflation as a result of a sharp rise in oil and electricity prices, inflation has been moving down since February, and the Swedish central bank reduced its key rate by 0.5 percentage point, to 3 per cent, on 4 June. GDP growth has also slowed in Denmark. Unemployment has risen from 5 to 5.8 per cent over the past year.

Competitiveness has deteriorated as a result of the appreciation of the Danish krone, which shadows the euro. In conjunction with low global demand, this is weakening the outlook for growth.

Japan

The Japanese economy is still struggling. Prices have fallen over the last four years, and GDP growth is marginally positive. Domestic demand is not sufficient to generate higher growth. The Japanese central bank has intervened in the foreign exchange market repeatedly to prevent an appreciation of the yen against the US dollar, which particularly affects exports of cars and electronics to the US. The yen has nevertheless strengthened since the end of 2002. Structural problems in the financial sector and the labour market are still unresolved. Weak growth and a continued fall in prices are expected in the period ahead.