February 2000

IMF Staff Country Report No. 00/15

Norway: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Norway on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Norway, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Norway; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

This Article IV staff report is published—both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project. To assist the IMF in evaluating the pilot project for release of Article IV staff reports, reader comments on the staff report are invited prior to October 5, 2000, and may be sent by e-mail to Pilotproject@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431

Telephone: (202) 623-7430 • Telefax: (202) 623-7201
Telex (RCA): 248331 IMF UR
E-mail: publications@imf.org
Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

NORWAY

Staff Report for the 1999 Article IV Consultation

Prepared by Staff Representatives for the
1999 Consultation with Norway

Approved by C.M. Watson and Carlos Muniz

December 23, 1999

- The consultation discussions were held in Oslo during October 19–26, 1999.
- The Norwegian representatives included Mr. Gudmund Restad, Minister of Finance, Mr. Svein Gjedrem, Governor of Norges Bank, Mr. Tore Eriksen, Secretary General, Ministry of Finance, other senior officials and representatives of the Confederation of Labor Unions, Confederation of Norwegian Business and Industry, as well as representatives of private financial institutions and the academic community.
- The staff team comprised Messrs. Thakur (head) and Thomas, Ms. Cerra and Ms. Koliadina (all EU1). Mr. Lehmussaari, Alternate Executive Director for Norway, participated in the discussions.
- Norway has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, except for a few restrictions notified under Decision 144 (Appendix II).
- Norway has subscribed to the Special Data Dissemination Standard (SDDS) (Appendix III).
- A minority coalition government has been in office since October 1997. The next elections are due in September 2001.
- The authorities released the staff team's concluding statement to the public and have agreed to participate in the pilot project for publication of Staff Reports.

Contents Page

Text Boxes

Appendices

EXECUTIVE SUMMARY

Background: The Norwegian authorities' policy strategy has contributed to a prolonged upswing, leaving the economy operating above potential and with generally strong fundamentals. However, the sharp fall in the price of oil in 1998 and a contraction in business investment dampened activity in 1999 and this slowdown is expected to continue into 2000.The current account is expected to post strong surpluses in 1999 and 2000, reflecting the sharp rebound in oil prices. The exchange rate, which fell below its implicit target range in 1998, has strengthened in 1999. Price inflation has been moderate despite a rapid rise in wage costs over the last two years. The robust growth trend in employment has trailed off in 1999, but the labor market remains tight.

Key Policy Issues: With broad convergence of views on the short-term policy stance, the discussions centered on how to adapt the successful policy strategy to changing circumstances and position the economy for an era when oil reserves are depleted.

- Norges Bank has tolerated greater short-run deviations of the exchange rate from its implicit target range, increasing the scope for discretionary policy to bring inflation down to the level in the euro area. The staff fully supported this orientation, but recommended that transparency could be increased through an explicit mandate to the Central Bank that recognized the benefits of this framework.

- The authorities and the mission agreed that a broadly neutral fiscal stance was appropriate for 2000 given the mixed economic outlook but the staff recommended that fiscal policy should focus more on the level of the general government. The staff stressed that prudent fiscal policy would need to be accompanied with wage moderation by the social partners in the upcoming negotiations.

- The long-run fiscal profile faces challenges posed by population aging despite the cushion provided by oil wealth to help defray public pension costs. Among other policy options, the staff recommended moving toward private supplementary pensions.

- The pace and scale of structural reforms were debated. While the authorities have followed a gradual course, the staff argued that a faster approach to reducing the role of the government and enhancing economic efficiency would be desirable. The staff urged moving ahead with initiatives to privatize state companies, including in the telecommunications, banking and oil sectors; supported measures to improve labor market flexibility; and argued for phasing out subsidies and tax preferences.

I. INTRODUCTION

1. **Norway's economic record over the past decade has been exemplary in many respects.** Prudent management of revenues from the exploitation of its large reserves of oil and gas, coupled with a broadly successful macroeconomic policy framework has enabled Norway to raise living standards substantially.[1] Indeed, over the past quarter century, Norway's per capita GDP (on a purchasing power basis) has risen from a level equal to the average of the European Union (EU) countries to a third above the EU average, approaching that of the United States. In notable contrast to many EU countries, Norway has succeeded in achieving virtual full employment and a sharp rise in the participation rate (Figure 1).

2. **The Norwegian polity continues to be governed by consensual traditions and Norway remains outside the EU.** The minority centrist coalition, in office since late 1997, commands only a quarter of the parliamentary seats but has sought and received issue-based support from the opposition parties, illustrated by the recent agreement with the main opposition Labor Party on the 2000 budget. Since the electorate has twice rejected EU membership—the last time in 1994—the issue of entry is not on the political agenda. Norway nevertheless maintains close economic links to the EU, mainly through its membership of the European Economic Area (EEA), which provides for free movement of goods, services, labor and capital vis-à-vis the EU. With over 70 percent of trade with the EU, the economy is closely integrated with its single market.

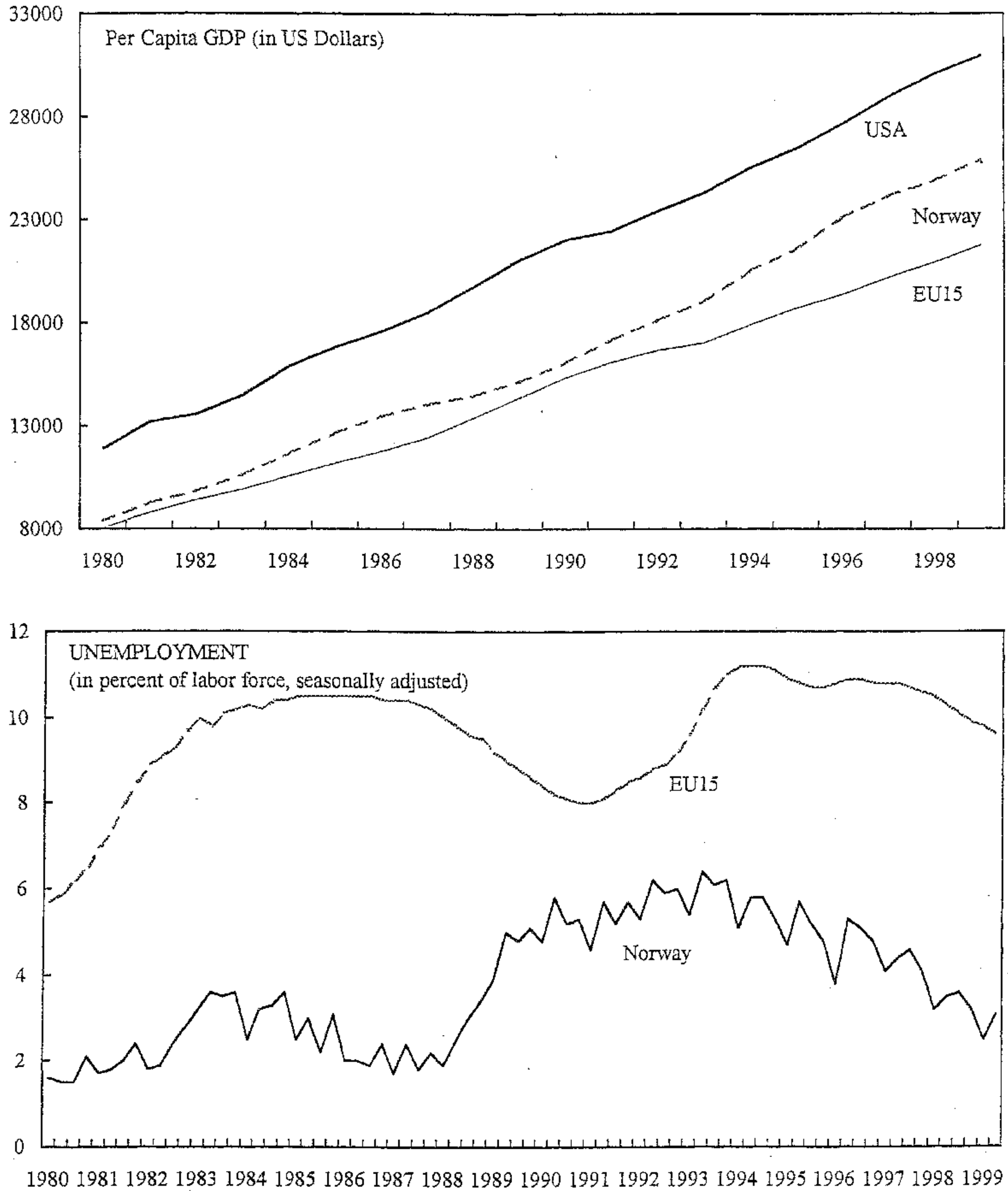
3. **The two distinctive features of Norway's approach to economic management are an incomes policy framework with centralized wage setting, and a strategy of re-investing oil revenues abroad.** The incomes policy regime in place since 1992—the Solidarity Alternative—rests on the consent of the labor unions to moderate wage settlements in return for the authorities' commitment to orient monetary policy towards stabilizing the exchange rate and fiscal policy towards smoothing the business cycle. Norway has also pursued a strategy to insulate the mainland (non-oil) economy from developments in the oil sector through a policy of re-investing abroad a substantial part of the government's oil revenues through the State Petroleum Fund (SPF) (Box 1). These policies have contributed to economic fundamentals that are among the best in the advanced industrial world (Figures 4–6).

4. **The policy framework came under considerable strain in 1998 in the face of an erosion of wage and fiscal discipline, and pressures on the exchange rate.** With the fiscal stance insufficiently restrictive to counter excess demand, and labor market conditions very

---

[1] Oil and natural gas accounted on average for 43 percent of merchandise exports and 13 percent of GDP in 1997-98, but only 1 percent of employment. Norway is the world's second largest oil exporter, after Saudi Arabia, and is a major exporter of gas.

Figure 1. Norway: Per Capita Gross Domestic Product (PPP based) and the Unemployment Rate



Source: IMF, World Economic Outlook.

Box 1. Dutch Disease: A Norwegian Retrospective

Norway stands out as an example of a resource-rich country which has managed its wealth rather well. Since the discovery of oil on the Norwegian continental shelf in 1967 and Norway's emergence as a net exporter of oil and gas in 1975, the production of oil has increased gradually to a level of about 3 million barrels a day in 1999. The exploitation of this tradable natural resource has subjected the economy to potential "Dutch disease" effects.1/ Norway has pursued a strategy—with the objectives of a) redistributing the income from oil between generations; b) protecting the mainland (non-oil) economy from the impact of oil, thereby also facilitating demand management; and c) spreading the benefits of oil widely—that has allowed it to mitigate these pressures.

Norway's economic strategy involves using fiscal policy to stabilize aggregate demand, monetary policy to aim at exchange rate stability, and incomes policies to ensure wage moderation. The use of fiscal policy for demand management could have faced major difficulties due to the volatility of oil prices and volumes which caused government revenues from petroleum to fluctuate widely (Figure 2). However, oil revenues had earlier been used to retire public debt and in 1990, Norway established the State Petroleum Fund (SPF) in an attempt to insulate fiscal revenue and the non-oil economy from the impact of oil by saving oil-related surpluses abroad. Fiscal policy has successfully played a counter-cyclical role over the last two decades. With fiscal policy free to support steady growth, the exchange rate anchor and moderate wage accords have protected the competitiveness of the non-oil exposed sector.

The early period of oil development has been accompanied by real appreciation. Indeed, there have been periods of sizeable real appreciation in the mid-1970s and early 1980s which would be expected to have a contractionary effects on the non-oil tradables sector.2/ Such effects would be unlikely to fully reverse themselves with the subsequent real depreciation. Moreover, despite the existence of the SPF, the nominal exchange rate has to some extent mirrored short-term oil price movements, particularly in the 1990s (Figure 3, Panel 2).3/ This may reflect the fact that some mainland industries provide goods and services to the oil sector and are therefore partly dependent on oil-related developments.

Nonetheless, over the longer run, the consensus-based regime has helped to mitigate the spillover effects from oil on the mainland economy. In particular, average wage growth in Norway since the early 1970s has been comparable to that of trading partner countries. The modest development in wages has been reflected in the relative trends in the consumer price index which has remained flat on average over the 1970-98 period. Most notably, the real exchange rate in the late 1990s has not deviated significantly from its level in the early seventies.

Exploitation of oil wealth has facilitated an expansion in the size of the public sector. Since the early 1970s, the public sector's share of mainland GDP has almost doubled to 19 percent. The upward trend in the size of the public sector in Norway has been more pronounced than in Denmark and Sweden (two countries with similar economic structures, but without significant oil resources) and the Netherlands (the classic Dutch disease country). However, if transfers were included, the trends in Norway and the Netherlands were similar in the 1970s. The sharp increase in the value added captured by the public sector parallels the relative decline in the share of the manufacturing sector, partly reflecting diverging price trends between the sheltered and exposed sectors. Indeed, as expected, compared with the other countries, the emergence of oil has led to a greater relative contraction of Norway's manufacturing sector.

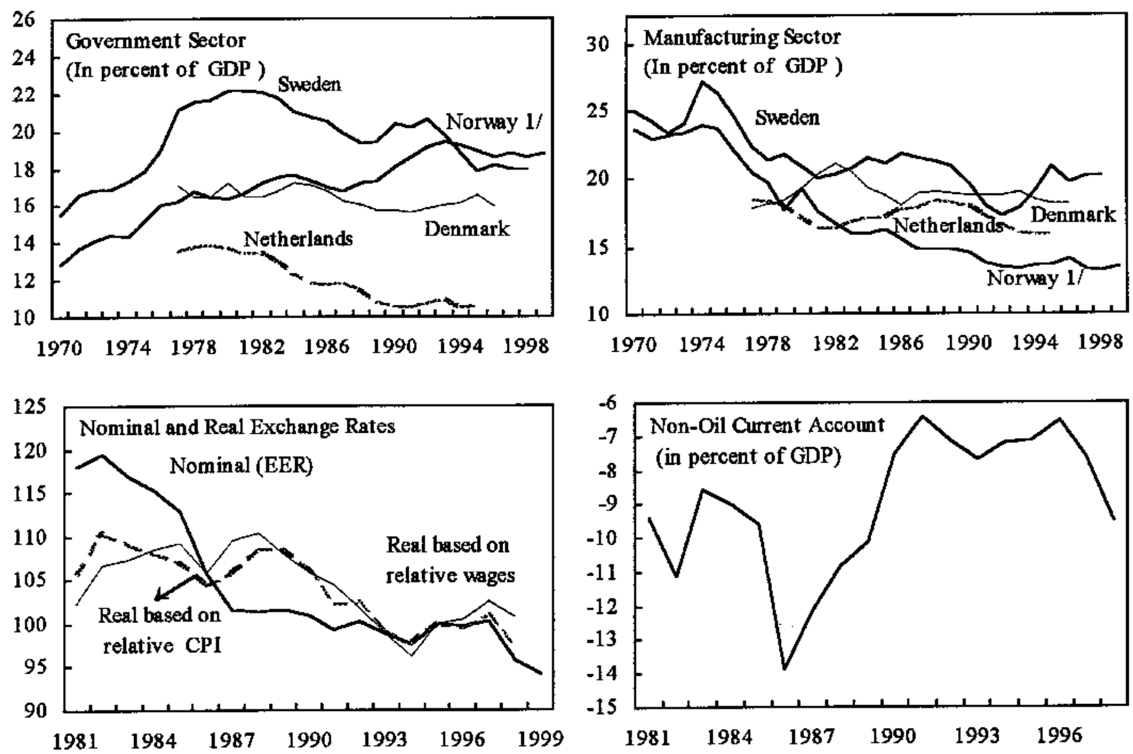
1/ Dutch disease refers to a crowding out of the non-resource tradeables sector as a result of increases in income and wealth associated with the export of oil or other resources. This crowding out is accompanied by an appreciation of the real exchange rate. See W. Max Corden, "Booming Sector and Dutch Disease Economics: Survey and Consolidation," Oxford Economic Papers, 36 (1984), pp 359–380.

2/ Hossein Samiei (SM/98/39) found that oil wealth was an empirically significant determinant of both nominal and real exchange rates over the period 1970-95.

3/ See, for instance, K.A. Mork "Oil Prices and the Norwegian Krone", Handelsbanken Markets, October 1998.

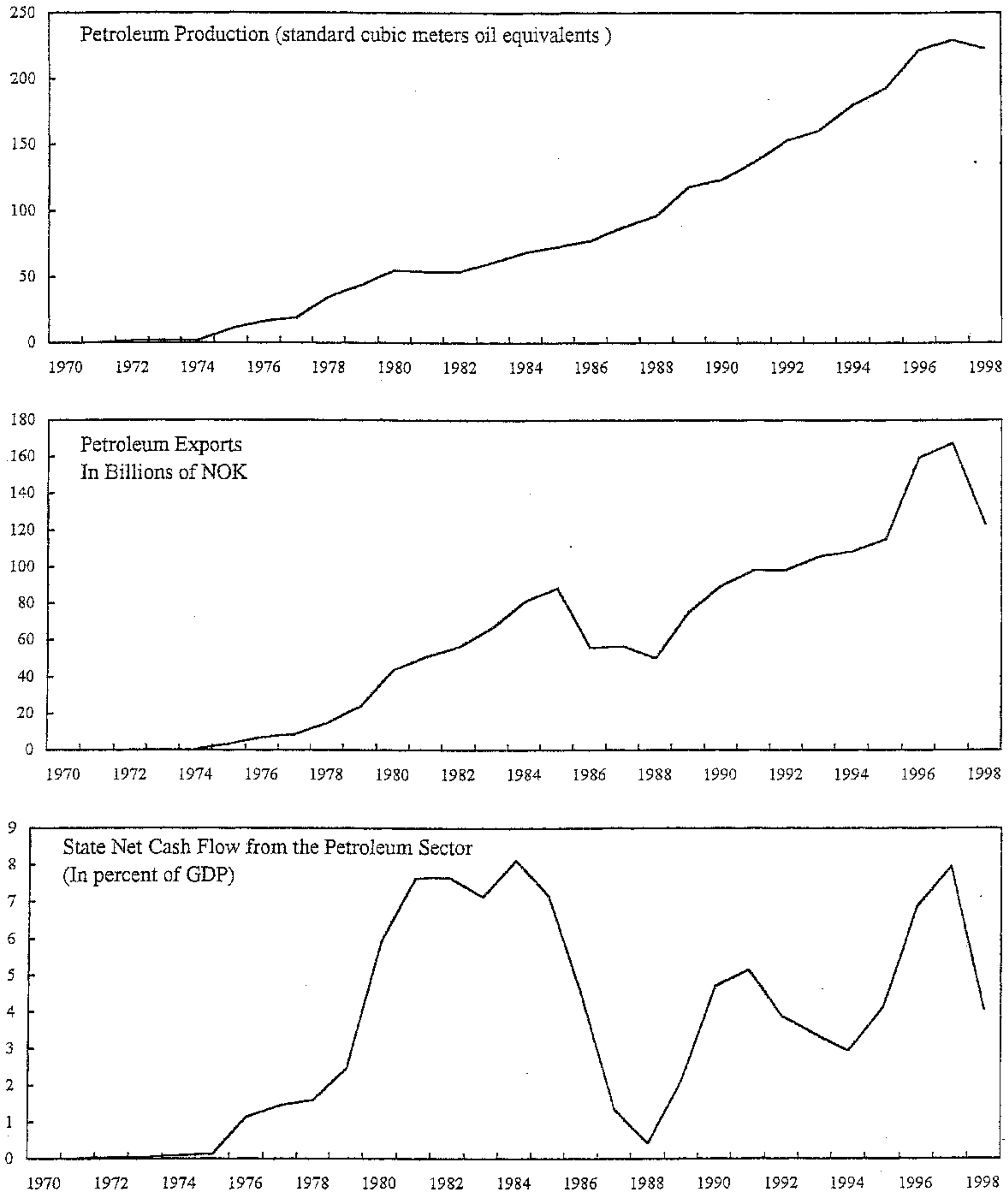
Box 1. Dutch Disease : A Norwegian Retrospective (continued)

Looking forward, the twin goals of ensuring intergenerational equity and the sustainability of the economy's savings-investment balance lie at the heart of Norway's management of oil wealth. The exploitation of an exhaustible resource such as oil represents a depletion of national wealth. To avoid excessive consumption of income from this source at the expense of future generations, it is appropriate to limit current consumption to levels that could be sustained indefinitely on the basis of a reasonable rate of return on the investment of the corresponding assets. Norway has been successful in saving and prudently investing the oil revenues, and has formalized this commitment by transferring accumulated budget surpluses into the SPF. Over the past 10 years, the non-oil current account deficit has averaged 7½ percent of GDP. However, the recent deterioration in the non-oil current account associated with the peak of the 1990s boom is expected to be reversed in coming years as real fixed investment declines to more normal levels. The medium term non-oil current account deficit is projected at around 6½ percent, consistent with the return on SPF assets. The building up of SPF assets will also help pay future pension obligations (Box 3), thereby smoothing differences in intergenerational tax burdens that would otherwise be required to fund the transfer payments for an aging population.



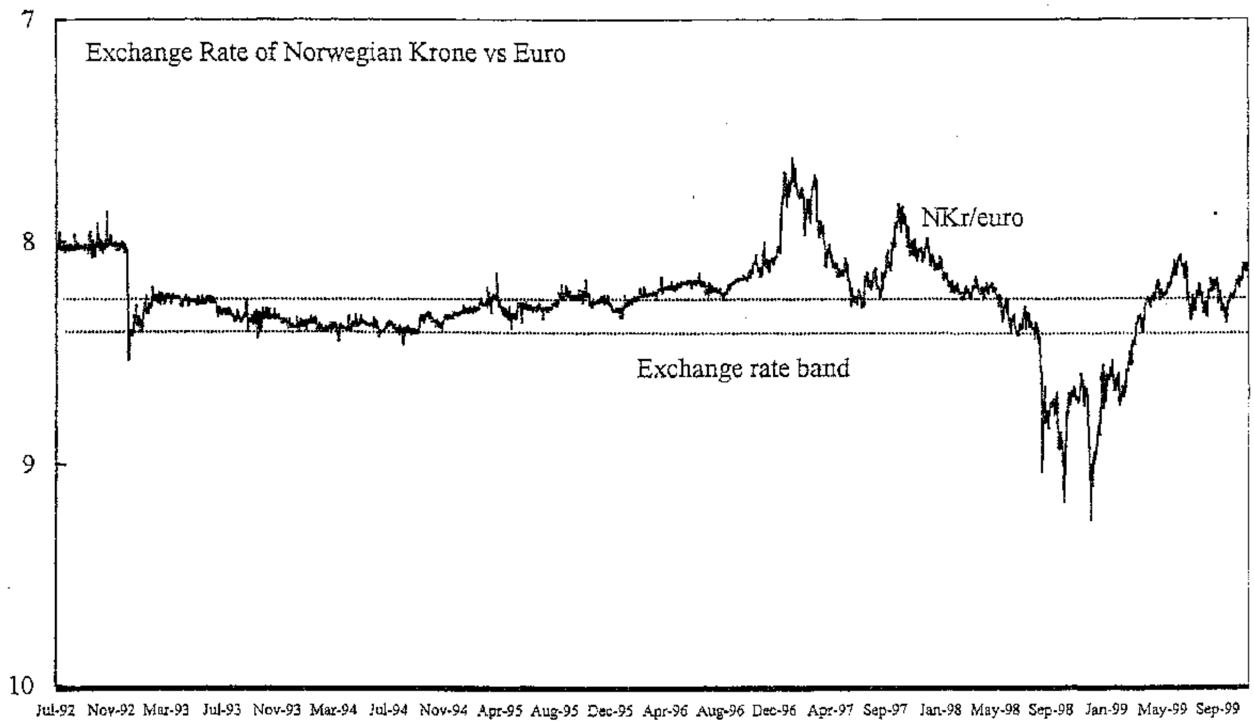
Norway has managed to dampen the detrimental side effects of the exploitation of its oil reserves, while allowing the population to share its benefits. Although the evidence discussed above suggests the presence of Dutch disease effects in Norway, the authorities' policy strategy has helped to avoid significant real exchange rate appreciation. Moreover, the expansion in the public sector permitted by the oil income accruing to the government may not have been entirely adverse since it provided some welfare-enhancing economic services and may have generated additional employment opportunities. Even if the mainland tradables sector has been partly crowded out, the non-oil current account balance appears sustainable over the long-run and the oil wealth will help offset the shock to future public expenditures posed by demographic changes.

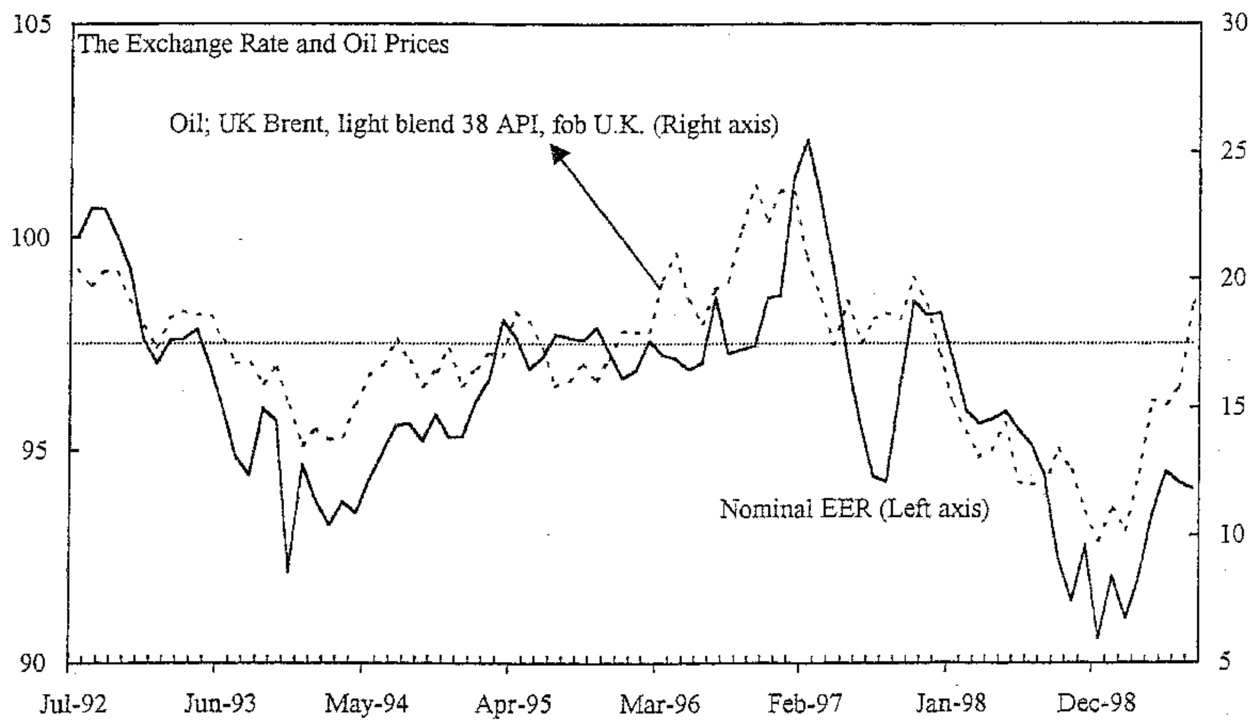
Figure 2. Norway: The Petroleum Sector



Source: Ministry of Finance.

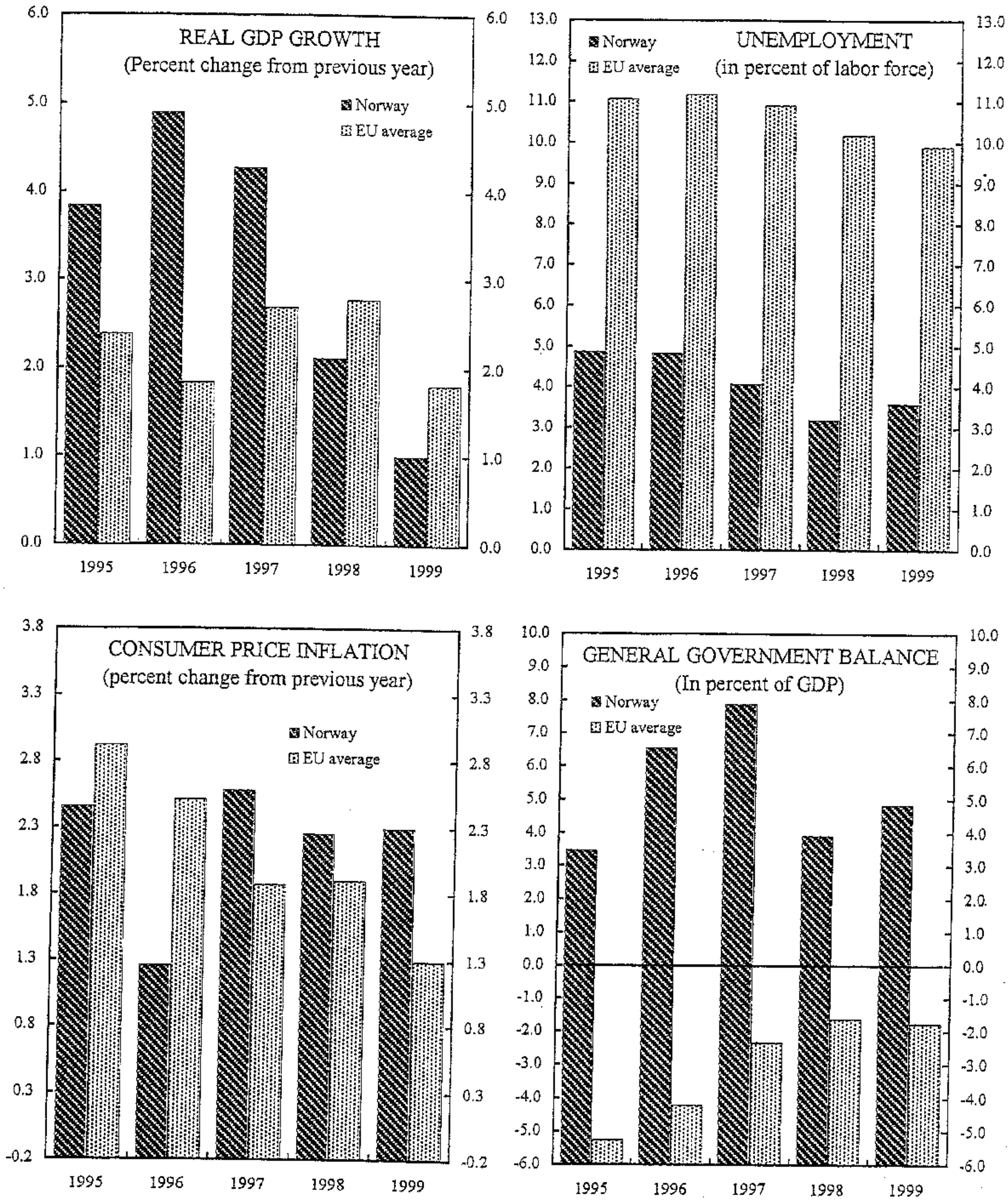
Figure 3. Norway: Exchange Rates Developments, 1990-1999





Source: WEFA, Intline Database; IMF, International Financial Statistics; and Norwegian authorities.

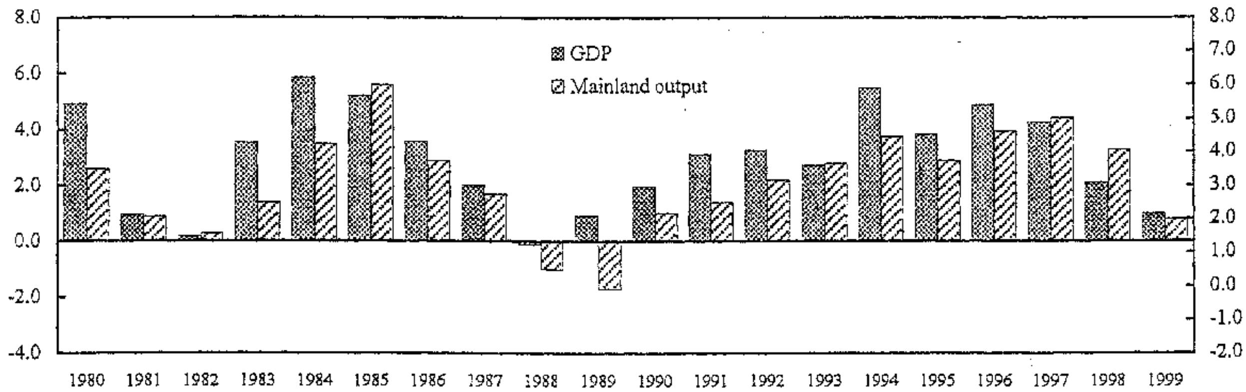
Figure 4. Norway: Economic Fundamentals, 1995-1999



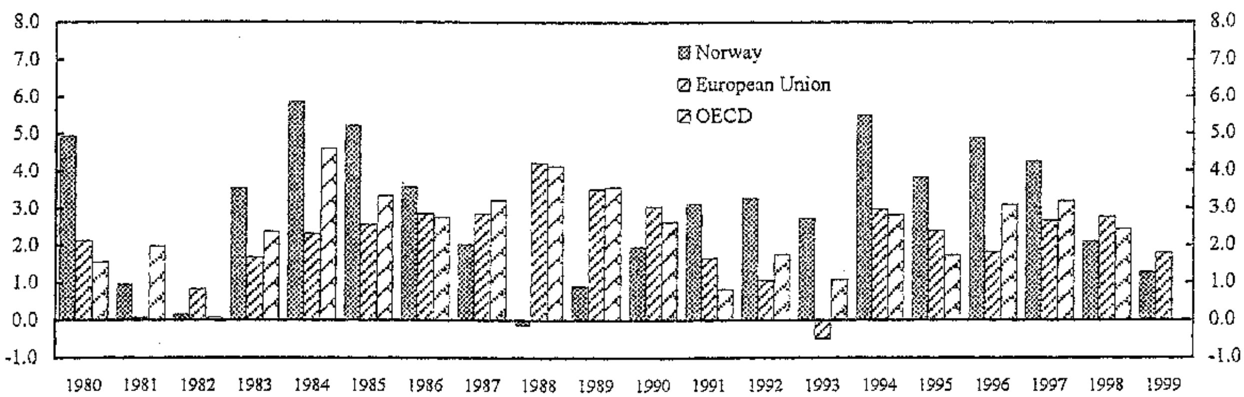
Sources: Ministry of Finance; and IMF, World Economic Outlook.

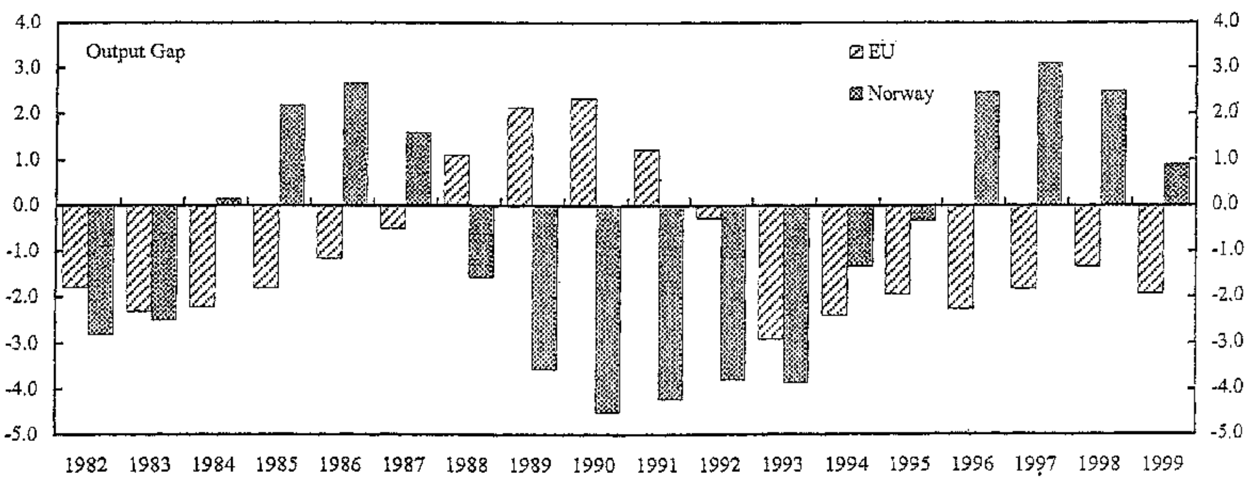
Figure 5. Norway: Output Growth
(Annual percentage change)

GDP and Mainland Output 1/



GDP Growth Comparisons

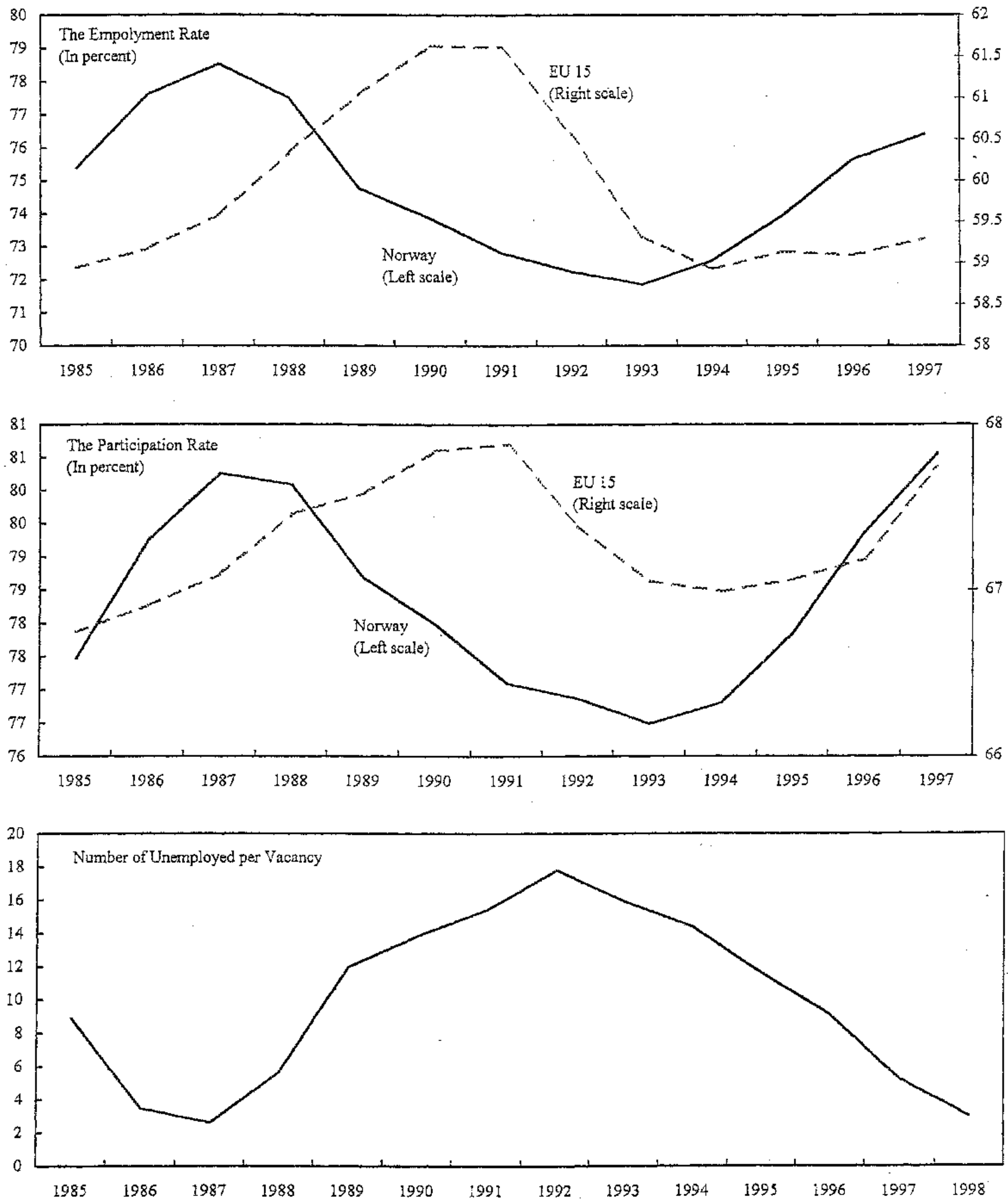




Sources: Statisitcs Norway; Ministry of Finance; IMF, World Economic Outlook; and OECD.

1/ Mainland output is GDP excluding petroleum extraction and ocean shipping.

Figure 6. Norway: The Labor Market



Source: OECD, Analytical Database; and WEFA, Intline Database; and Norwegian authorities.

tight, wage increases averaged around 6½ percent—double the level in main trading partners. At the same time, oil prices plunged by over 40 percent through 1998. In this setting, there was sustained downward pressure on the krone. Despite Norges Bank's effort to stabilize the exchange rate by raising its key interest rate by a total of 4½ percentage points to 8 percent, the krone fell to the bottom of its implicit target range and by end-1998, despite occasional intervention by the Bank, especially in the wake of renewed pressure after the Russian financial crisis, the krone fell to around 10 percent below the edge of its implicit band.[2]

5. **In concluding the last consultation in January 1999, Directors underscored that fiscal discipline and wage restraint were needed to restore a stable policy framework.** Directors commended Norway for its impressive recent record of economic performance, characterized by vigorous economic growth, low rates of unemployment and inflation, and strong fiscal and external positions. Directors noted, nevertheless, that emerging capacity constraints and rising wage pressures, coupled with the fall in the price of oil, had posed challenges to the Solidarity Alternative. In the view of Directors, continued fiscal discipline, centered on expenditure restraint, and wage moderation would help restore a stable policy framework. Directors also underlined the importance of structural reforms in order to improve efficiency and safeguard competitiveness.

II. The Setting for the Discussions

A. Recent Developments and Policies

6. **While economic activity slowed sharply during the first half of 1999, it rebounded in the third quarter and output remained above potential** (Table 1). Mainland GDP grew by 1½ percent in the third quarter of 1999 over the corresponding period a year earlier, while overall GDP rose by 2¼ percent. Business investment contracted, both in petroleum and manufacturing—which is closely linked to the offshore oil and gas sector—as high wage growth and stagnant productivity, with only moderate increases in producer prices, squeezed profits and depressed business sentiment. The downturn in investment also reflected completion of some large investment projects and followed several years of strong growth. Consumption, fueled by large wage gains and sustained by high household confidence,

---

[2] The official guidelines to Norges Bank, codified in the Royal Decree issued in May 1994, call for monetary policy to be "aimed at stable exchange rates against European currencies, based on the exchange rate maintained since the krone was floated" in December 1992, in the aftermath of the turmoil in the European Monetary System. In practice, this implicit target range, earlier defined in terms of the ECU and since January 1, 1999 in terms of the euro, is NOK 8.25–8.40 per euro. The guidelines also stipulate that "in the event of significant changes in the exchange rate, policy instruments will be oriented with a view to returning the exchange over time to its initial range." However, no fluctuation margins were established.

Table 1. Norway: Economic Outlook

	1998 1st Half	1998 2nd Half	1999 1st Half	1998	Staff Forecasts 1999	Staff Forecasts 2000	Official Forecasts 2000	Official Forecasts Annual average 2001-03
	(Percent change from previous year)							
GDP: Total	3.2	1.1	-0.3	2.1	1.3	3.3	2.9	1.9
Mainland	4.2	2.2	0.6	3.3	0.8	1.1	0.7	2.1
Private consumption	3.8	2.5	1.6	3.1	2.3	2.3	2.0	2.3
Public consumption	3.7	3.6	2.0	3.7	1.8	1.5	1.5	1.5
Gross fixed investment	5.2	10.9	-7.6	8.1	-8.0	-7.0	-11.6	2.6
Oil activities	12.0	34.3	-8.5	22.9	...	...	-34.1	6.2
Mainland	2.5	2.3	-7.2	2.4	...	...	-3.0	2.0
Domestic demand	5.8	5.1	-0.6	5.4	-0.8	0.2	-1.3	2.1
Exports	3.3	-2.2	-3.0	0.5	2.4	8.5	9.1	2.8
Imports	10.3	8.1	-4.1	9.1	-3.0	1.1	-1.1	3.6
Consumer prices				2.3	2.3	2.3	2.0	1.8
Wages				6.5	5.0	4.5	3.3	...
Employment				2.3	0.2	0.1	-0.3	0.4
Unemployment rate (Percent of labor force)				3.2	3.2	3.5	3.6	3.8
Output gap (Mainland) (Percent of potential GDP)				3.6	2.1	1.0	...	...
Current account balance (Percent of GDP)				-1.5	2.8	6.9	7.1	7.1
Non-oil current acount balance (Percent of GDP)				-9.9	-7.5	-6.5	...	-6.5 1/

Sources: Statistics Norway and staff estimates.

1/ Staff projection.

remained the engine of growth. In addition, net exports recovered strongly in the third quarter in the wake of an upturn in oil prices.

7. **Employment growth has tapered off since mid-1998, although the level of employment remains very high**. The rapid growth of employment in the recent upswing—13 percent over the seven years to 1999—has led to an employment rate (71 percent of the population aged between 16 and 74) that is among the highest in the OECD area. While employment has fallen in recent months in the exposed sector, associated with a decline in profitability, the ongoing expansion of the education and health sectors has boosted public employment. With the participation rate (73½ percent) near its record high, and the ratio of unemployed to the number of vacancies at historic lows, labor shortages are widespread, particularly in the construction and health sectors. Stable employment and labor force levels in 1999 are reflected in a leveling off of the unemployment rate at 3¼ percent, below the officially estimated NAIRU of about 4 percent. As labor markets in the other Nordic countries have tightened, the scope for boosting labor supply from this source has declined although efforts are under way to encourage immigration from elsewhere.

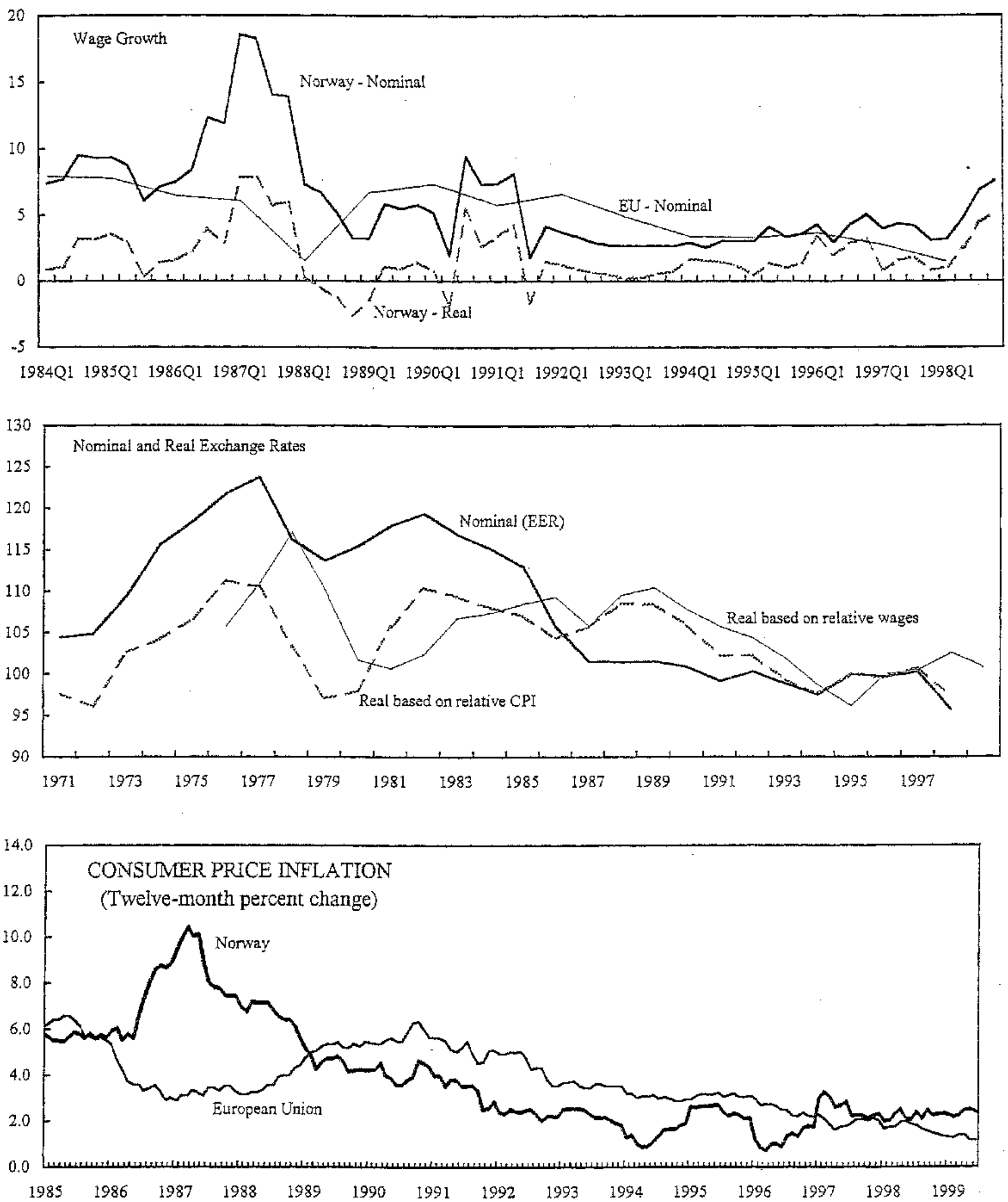
8. **Price inflation remained moderate despite a rapid rise in wage costs** (Figure 7). Consumer prices rose by 2.8 percent in the year to November 1999; the harmonized index of consumer prices rose by 2.6 percent, compared with an increase of 1.6 percent in the euro area. Falling import prices helped offset price increases for services, domestically produced goods, petroleum products, and electricity.

9. **Some asset prices have risen strongly** (Figure 8). Equity prices rose by over 35 percent in 1999 on firming commodity prices, more than fully reversing the sharp 1998 decline—oil and other commodity-related stocks account for a substantial part of the Norwegian stock exchange. Prices of existing houses rose by 9 percent in the year to the third quarter 1999. This rise partly reflected supply constraints resulting from tightened regulations on housing starts and the scarcity of approved construction sites, but also strong demand sustained by low unemployment, robust income growth, and expectations of falling interest rates. Commercial property prices, on the other hand, fell somewhat in 1999.

10. **Other indicators of financial and household sector health were generally favorable in 1999.** Bank profitability improved due to higher interest margins and low loan losses. Bank exposure to the real estate sector and the stock market was limited. Tier one capital ratios were close to 8 percent in commercial banks and above 10 percent in savings banks. Credit growth from domestic sources subsided, more than offsetting a rise in foreign borrowing, reflecting the high interest rate differential. Household net financial assets, at 54 percent of disposable income, were at peak levels, up from around 30 percent in 1993. Although household mortgage debt remained high, reflecting the very high level of home ownership, interest payments were a small share of disposable income.

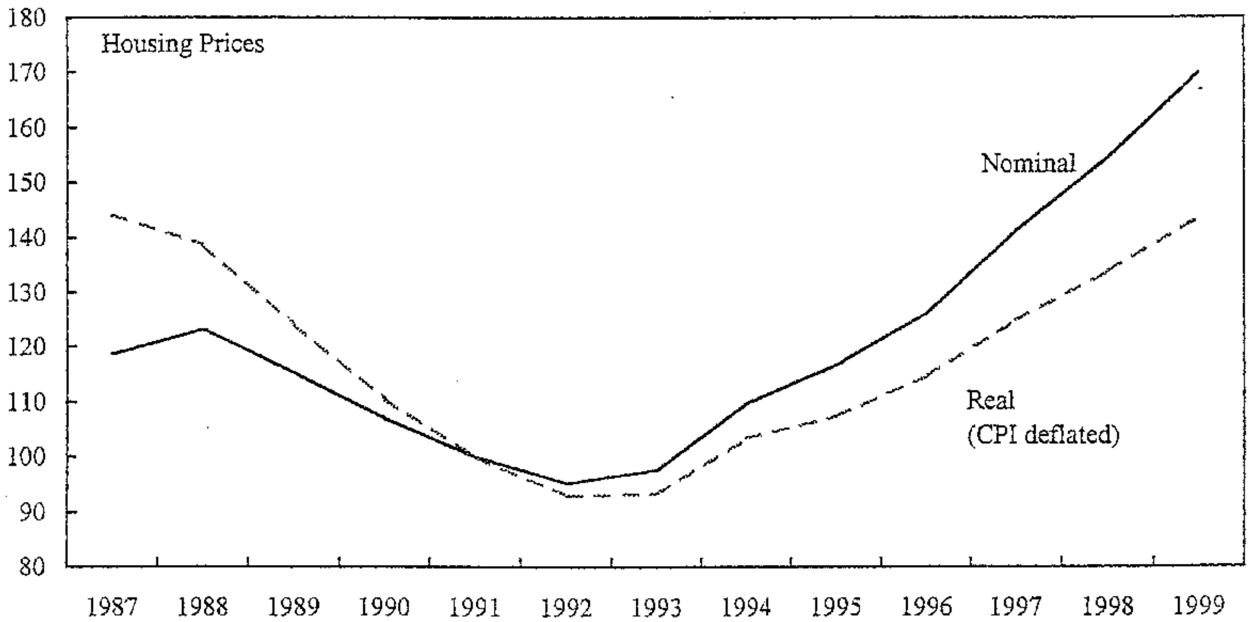
11. **The incomes policy accord survived major strains**. The large wage settlements of 1998 had a carry-over of about 3¼ percent into 1999—an off year of the two-year wage

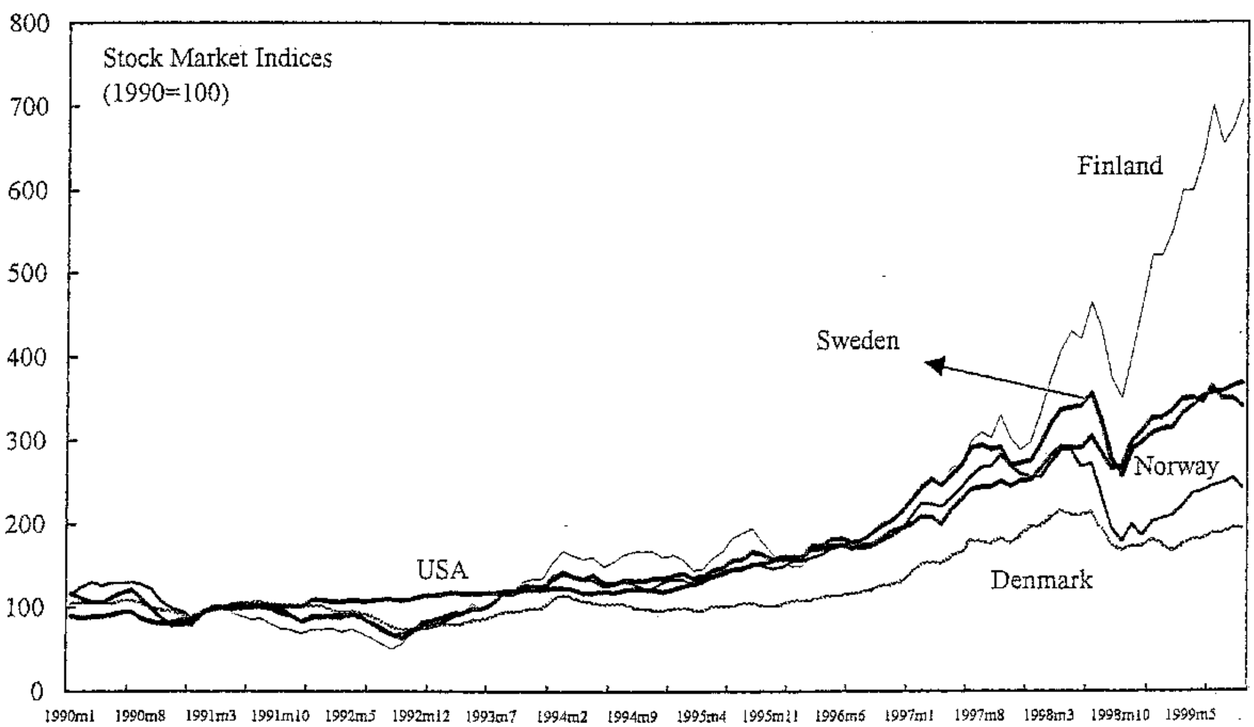
Figure 7. Norway: Wage and Price Inflation and the Real Exchange Rate



Source: WEFA Intline database; IMF, World Economic Outlook.

Figure 8. Norway: Asset Prices, 1990-1999





Source: Authorities; and Bloomberg.

bargaining framework. Against the backdrop of high wage growth and labor market pressures, the authorities set up a committee representing the social partners (the Arntsen Committee) with a view to revive the consensus on wage policy. The Committee reaffirmed the traditional leading role of the exposed sector in wage negotiations and recommended that wage growth in 1999 should not exceed 4½ percent and should be brought down in 2000 to the level of Norway's trading partners.[3] The outlook for average earnings in 1999 was broadly in line with this recommendation. However, even with this relatively moderate outcome, wages will have risen by a cumulative 11 percent in 1998–99—around 6 percent in real terms. With productivity growth slowing, unit labor costs were estimated to be up by nearly 5 percent in 1999.[4]

12. **The external balance recovered in the course of 1999** (Table 2 and Figure 9). The current account registered a deficit in 1998 for the first time this decade, due to the combined effects of strong domestic demand and the adverse terms of trade shock (-11½ percent). However, oil prices had risen by about 150 percent from below $10 per barrel at end-1998 and imports fell in conjunction with the sizeable decline in investment, thereby improving the non-oil trade balance. The stock of net foreign assets is estimated at about 9 percent of GDP at end-1999, including the assets of the SPF (18 percent of GDP), partially offset by external liabilities of the banking and government sectors.

13. **The fiscal stance has been moderately tight in 1999.** Unlike in 1998, when tightening in the central government budget was offset by an expansionary stance by local governments, the tightening at the central level in 1999 is reflected at the general government level. Both the central and general government stance imply a tightening of the cyclically adjusted non-oil fiscal position by ½ percent of GDP, with the general government fiscal surplus projected to increase by 1 percentage point to 5½ percent of mainland GDP (Table 3 and Figure 10).

---

[3] In return for moderation in wage claims, the government promised to help initiate and finance a program of lifelong learning including the right to study leave, basic education to individuals with little or no academic qualifications, and adult education schemes. The initial budgetary cost of these initiatives was estimated at 0.2 percent of GDP.

[4] Official estimates of productivity are based on the double deflation method for calculating real GDP with separate price indices for gross output and inputs. However, the majority of trading partners use a single output deflator. The authorities believe that this difference in methodology makes cross-country comparisons of productivity meaningless and also distorts the estimates of real exchange rate based on relative unit labor costs. The authorities therefore prefer to focus on relative wages as a more useful indicator of trends in competitiveness.

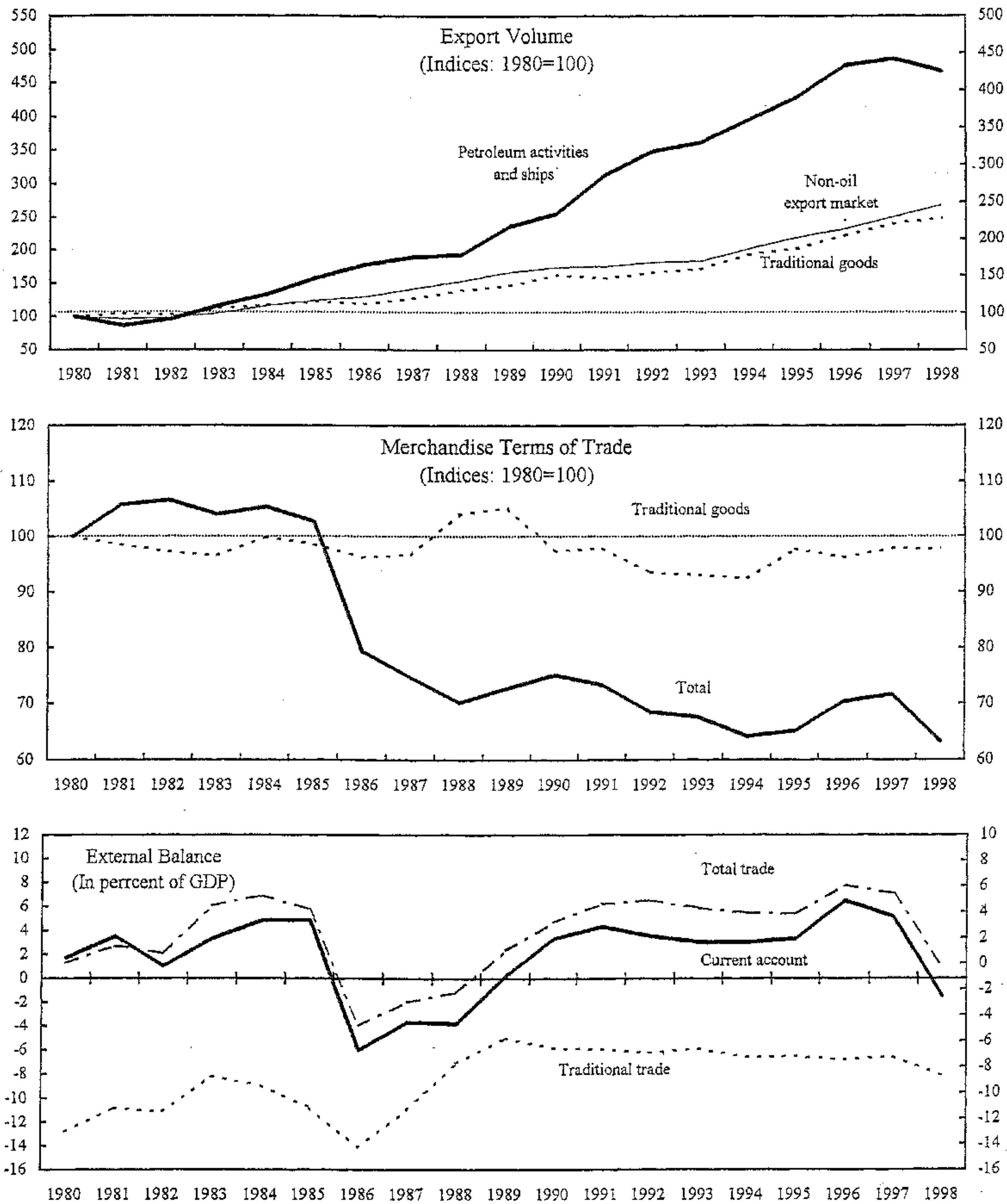
Table 2. Norway: External Indicators
(U.S. dollars billions, unless otherwise indicated)

	1994	1995	1996	1997	1998	1999
Balance of payments						
Goods and services						
Exports	47.2	55.7	64.3	63.5	54.8	57.4
Goods	34.8	42.2	49.9	48.6	40.5	43.3
Non-factor services	12.4	13.6	14.4	14.9	14.3	14.1
Imports	39.5	46.9	50.7	52.6	54.5	50.9
Goods	28.0	34.2	37.6	37.7	39.2	35.9
Non-factor services	11.5	12.7	13.2	14.8	15.3	15.0
Trade balance	6.8	7.9	12.3	10.9	1.3	7.4
Services balance	0.9	0.9	1.2	0.0	-1.0	-0.9
Balance of goods and services	7.7	8.8	13.6	10.9	0.3	6.5
Balance of factor payments	-3.9	-3.9	-3.3	-3.0	-2.5	-2.3
Current account balance	3.7	4.9	10.2	7.9	-2.2	4.2
(In percent of GDP)	3.0	3.3	6.5	5.2	-1.5	2.8
Net capital transfers	-1.1	-1.1	-0.8	-1.3	-0.8	...
Net capital outflows	-2.6	-3.8	-9.4	-6.7	2.9	...
Memorandum items:						
Net foreign assets						
(In percent of GDP)	-2.7	0.2	3.7	9.2	8.6	...
State Petroleum Fund						
(In percent of GDP)	...	...	5.0	10.9	15.2	18.2
Nominal effective exchange rate (1995=100)	97.6	100.0	99.7	100.3	95.8	96.3 1/
Real EER (CPI-based, 1995=100)	97.2	100.0	99.8	101.1	98.2	97.5 2/

Sources: Statistics Norway; and staff estimates.

1/ October 1999.
2/ September 1999.

Figure 9. Norway: External Developments 1980-1998



Source: Statistics Norway; and IMF, World Economic Outlook.

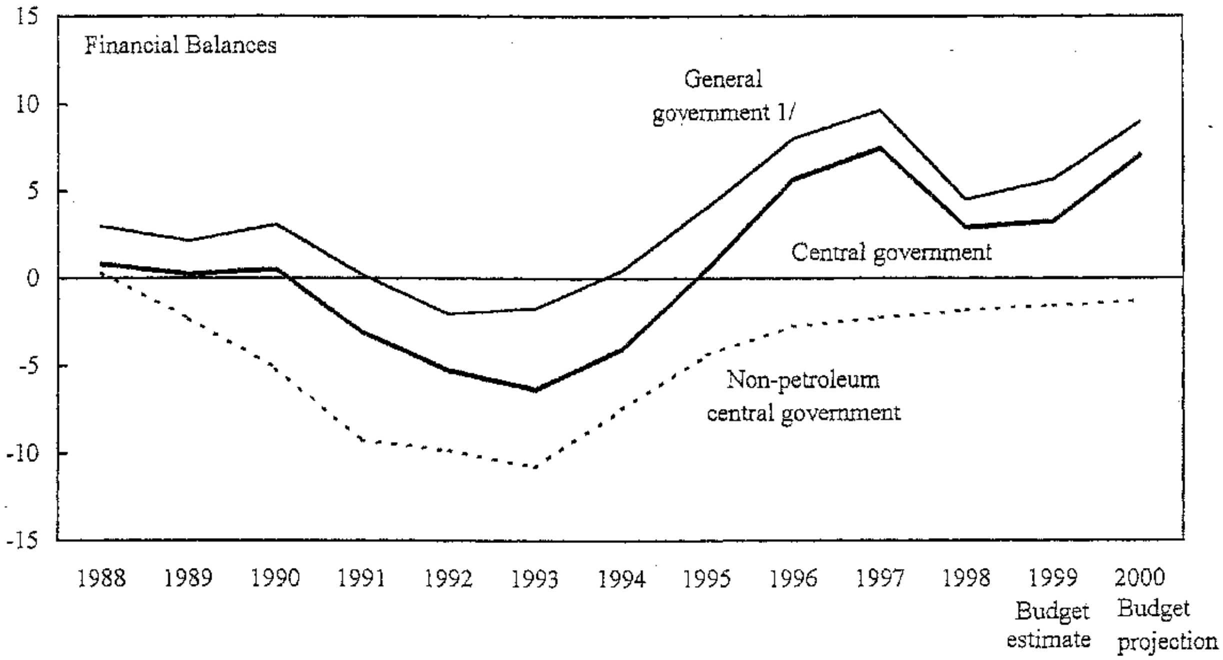
Table 3. Norway: Financial Indicators

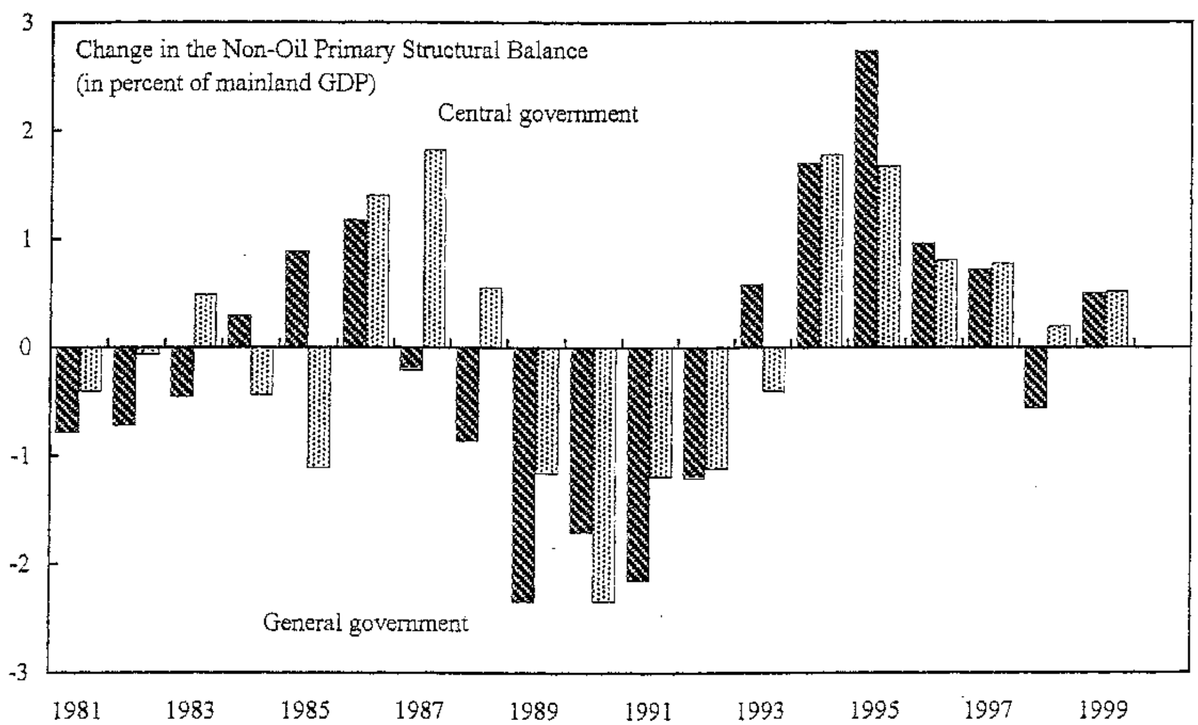
	1996	1997	1998	Projection 1999	2000
			(In percent of mainland GDP)		
State Budget:					
Revenue	51.9	53.5	49.0	49.9	53.7
of which : oil revenue	10.5	12.1	7.6	7.7	10.3
Expenditure	46.2	46.1	46.1	46.7	46.6
of which : oil investment	2.2	2.4	2.9	2.9	2.0
Balance	5.6	7.5	2.9	3.3	7.0
of which : non-oil balance	-2.7	-2.2	-1.8	-1.6	-1.3
Cyclically adjusted non-oil balance 1/	-4.8	-4.0	-3.8	-3.3	-3.4
Change from previous year 1/	1.2	0.8	0.2	0.5	-0.1
General Government Budget:					
Revenue	63.4	63.5	58.0	60.4	63.9
Expenditure	55.4	53.9	53.5	54.8	54.9
Balance	8.0	9.6	4.5	5.6	9.0
Non-oil balance exc. Interest	-4.2	-2.5	-2.6	-3.5	-3.8
Cyclically adjusted non-oil balance exc. Interest	-4.9	-4.2	-4.8	-4.3	-4.0
Change from previous year	1.0	0.7	-0.6	0.5	0.3
Gross public debt 2/	31.1	28.8	27.0	24.0	23.6
Monetary Indicators:					
M2 3/	6.0	4.5	5.4	9.9 4/	...
Domestic credit 3/	6.2	10.1	8.3	8 4/	...
Three-month interbank rate 5/	4.9	3.7	5.7	6.0 6/	...
Ten-year government bond yield 5/	6.8	5.9	5.4	6.1 6/	...

Sources: Ministry of Finance; Norges Bank; and staff projections.

1/ Based on actual GDP.
2/ In percent of total GDP
3/ End-period, percent change.
4/ October 1999.
5/ Period average, in percent.
6/ December 16, 1999.

Figure 10. Norway: Public Finances
(In percent of GDP)





1/ Consistent with Maastricht criteria.

14. **As inflation expectations moderated with the appreciation of the krone and the adherence to the wage agreement, monetary policy has been eased gradually since early 1999.** The krone appreciated by over 8 percent in response to the sharp reversal in oil prices and by mid-December was trading slightly above the implicit target range. Policy rates were reduced by a total of 2½ percentage points in five steps since the turn of the year—the latest on September 22—in view of Norges Bank's inflation projection of about 2 percent and the economic slowdown. The three-month krone Euro-deposit rate had fallen to around 6 percent, although it was 250 basis points above the corresponding euro area rate in mid-December 1999.The recent pickup in long-term bond yields in Norway mirrored the cyclical rise in yields in the euro area. The long-term differential of about 100 basis points vis-à-vis the euro area reflected the yield-curve effects of the relatively high short-term rates in Norway and a liquidity premium (Figure 11).

B. Short-Term Outlook

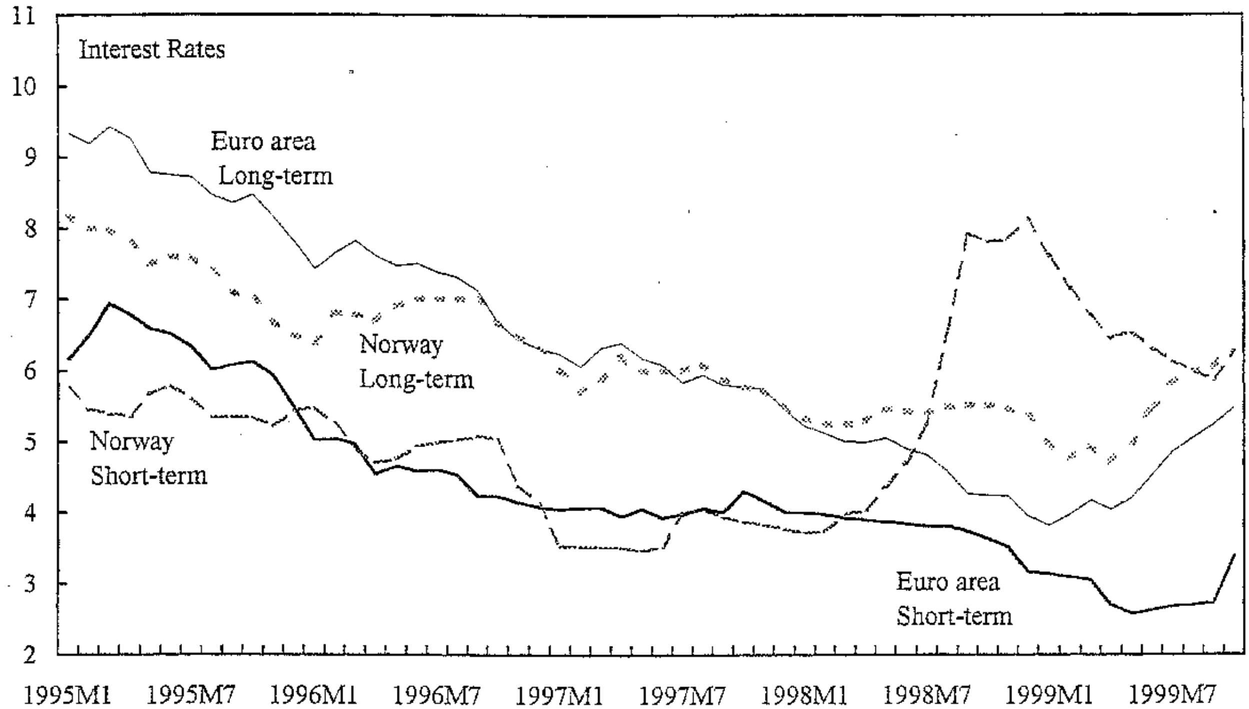
15. **The present slowdown in mainland economic growth is expected to continue into 2000**. On the assumption of a stable exchange rate and a broadly neutral fiscal stance, mainland GDP growth is forecast to remain below the potential rate of 2¼ percent. However, aggregate GDP is projected to grow considerably faster than mainland GDP, reflecting a resurgence in oil exports, associated with the continued strength of the price of oil. Private consumption is expected to grow by about 2 percent, in line with household income. Investment will continue to contract, especially in the oil sector due to higher exploration costs and the completion of major projects. As the positive mainland output gap is reduced, unemployment is projected to gradually edge up, closer to the estimated NAIRU. The recovery of petroleum exports combined with flat import growth is expected to restore a large current account surplus.

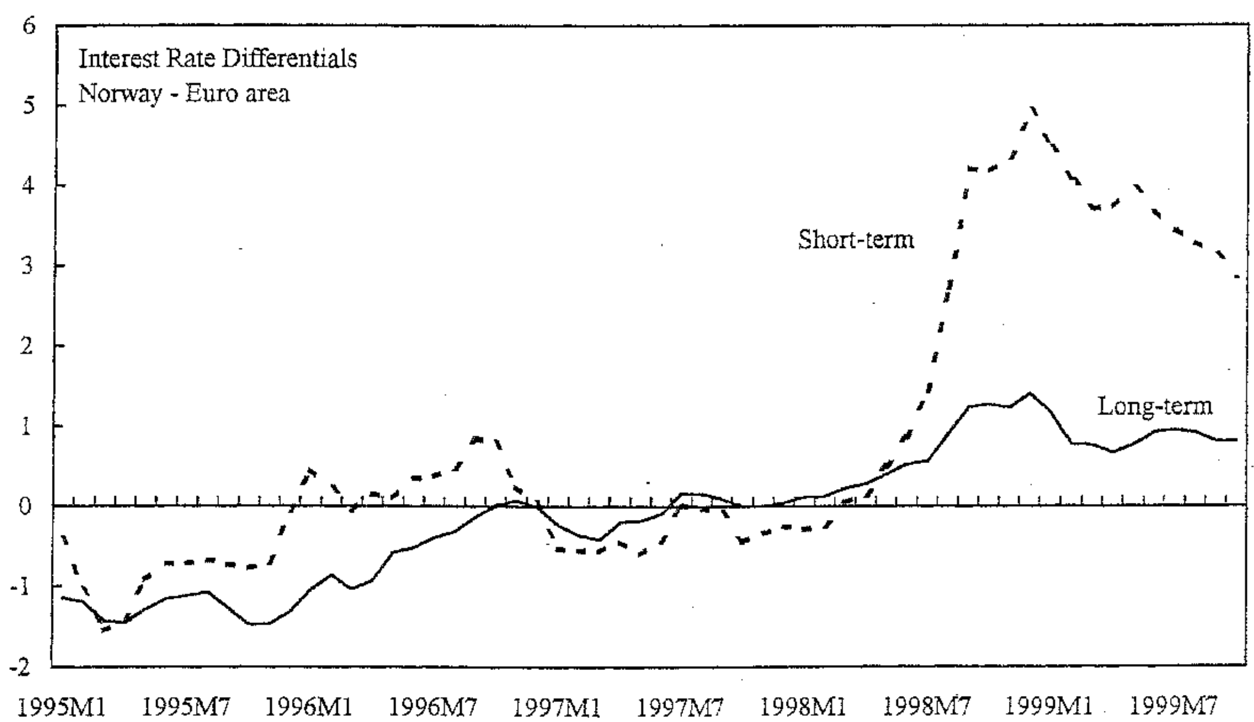
16. **In the staff's view, the risks to the projections are mainly on the upside.** Strong household income and wealth, and a pickup in consumer confidence, suggest that demand and output could be higher than projected. Indeed, the strength of activity in the third quarter of 1999 reinforced these upside risks. In addition, with major wage negotiations due to take place next spring in an environment of a continued tight labor market, the unions' renewed commitment to wage moderation remains to be tested. While average inflation in 2000 will benefit from a low wage carryover from 1999, another wage breakout could threaten price stability and undermine competitiveness in the years ahead.

III. Policy Discussions

17. **The authorities face the challenge of ensuring fiscal and wage discipline to facilitate the task of bringing inflation to the level in Norway's main trading partners, while moving forward with structural reforms.** They were broadly satisfied with the way the policy regime had responded to the risks stemming from external and domestic developments in 1998. They believed that—as Executive Directors had noted a year ago—occasional setbacks were a fact of life, and while the rebound in oil prices in 1999 had been

Figure 11. Norway: Interest Rate Developments 1995-1999





Sources: IMF, International Financial Statistics; and WEFA;

helpful, the fiscal restraint and the sense of responsibility displayed by the social partners were a testimony to the resilience of the basic policy framework. Looking ahead, the discussions centered on four key areas.

- The direction in which **the economic strategy** should evolve, including the operation of the monetary policy regime and its transparency, and the appropriate focus of fiscal policy for managing demand;
- The **stance of fiscal and incomes policies in 2000** against the backdrop of continued tight labor markets;
- The **long term fiscal outlook and policy** in the context of the depletion of oil reserves, the demographic impact on the pension system, and the role of state subsidies;
- **Structural issues** such as the scope and the speed of privatization and labor and financial market reforms.

A. The Macroeconomic Strategy

18. **The authorities characterized the recent greater emphasis on exchange rate flexibility as evolutionary and as flowing from a learning process.** Over the past year, Norges Bank had allowed the exchange rate to move beyond the implicit target range for extended periods. The authorities stressed that while the exchange rate remains the reference point for monetary policy, the guidelines to the Central Bank set out in 1994 allow for considerable flexibility in short-term management. From 1992–1996, there had been little pressure on the exchange rate from either external or domestic factors, but exchange rate variability increased significantly beginning in late 1996. In the summer of 1998, market uncertainty about the likelihood that the authorities would take sustained action to return the exchange rate back to its target range set off speculative pressures, undermining attempts to restore stability. The turbulence in financial markets in the wake of the Russian crisis may have amplified the krone's movements. Learning from this experience, Norges Bank has devoted considerable efforts to clarifying that exchange rate stability was to be attained *over time* and that this would best be achieved through maintaining inflation at the euro area level. The authorities believe that the short-run emphasis on inflation will limit adverse effects on the exchange rate resulting from market participants speculating on future interest rate movements when the exchange rate is near the boundaries of the target band.

19. **Short-term stability of the exchange rate is no longer considered feasible.** The emphasis on exchange rate stability has long historical roots in Norway and it has been the bedrock of the Scandinavian model of wage-price determination which has served as the intellectual foundation of the Norwegian policy debate. Over the past few years, however, there has been growing recognition across the spectrum of opinion in Norway that attempts to maintain the nominal exchange rate within narrow limits can be costly. In addition to the obvious role of Norway as a major oil exporter, the Norwegian business cycle has been

systematically out of sync with that of the euro area since the mid-1980s. The deepening integration of world financial markets and the krone's position as a minor currency on the edge of a large currency area may have made it more volatile, thereby compounding the difficulties of stabilizing the exchange rate in the short run. All in all, a gradual consensus has emerged around the view that exchange rate stability can and should be aimed at as a medium term goal rather than as a short term operational target. The staff and the authorities were in full agreement on this view.

20. **The staff, however, expressed the view that the transparency and credibility of the policy regime would be enhanced by an explicit recognition of the objective of low and stable inflation.** While the goal of bringing inflation down to the level in the main trading partners was appropriate and the efforts of Norges Bank to explain its conduct of monetary policy were welcome, market participants seemed to perceive a shift in the interpretation of the guidelines and were not entirely sure of the future policy regime. Moreover, although the social partners and the political class were supportive of the increased emphasis on inflation stability, this support had not yet been fully tested. While the recent interest rate cuts took place with the exchange rate close to its target band, future increases in interest rates to counteract inflation pressures may well be needed when the krone is at or above the appreciated end of its implicit target range. Formalizing the objective of low and stable inflation through a revised mandate to the central bank would preclude a return to the previous narrower interpretation of the mandate and thereby remove the residual market uncertainty. Officials felt that the current framework was sufficiently clear and transparent, at least to the domestic public.

21. **Officials emphasized that achieving price and exchange rate stability will require the support of both fiscal and incomes policies.** Incomes policy would need to ensure that wage costs are in line with trading partners to maintain competitiveness in the exposed sector. Fiscal policy would need to try and smooth the economic cycle, while avoiding Dutch disease tendencies and unsustainable expenditure pressures. A key element of the authorities' framework is the active stabilization role for fiscal policy. This has been made possible by the relatively strong position of the public finances. The authorities underlined that an active fiscal policy presupposed a strong medium-term orientation and, in particular, a tight fiscal stance during periods of positive and widening output gaps.

22. **The staff argued that the focus of fiscal policy should shift more explicitly to the general government level.** The undoing of the contractionary fiscal stance of the State budget by excessive local authority spending in 1998 pointed to the need for greater oversight of the finances of the municipalities (Box 2). Officials noted that since local governments had their own tax revenues and were able to borrow to finance capital spending, the central government had limited leverage over their finances. With about half of the local authority revenues coming from cyclically sensitive taxes—the other half consisted of transfers from the central budget—the recent strength of economic activity had boosted municipal tax revenues. The high cyclical sensitivity of local government revenues had in the past tended to generate procyclical fiscal outcomes. In an attempt to mitigate this sensitivity, the authorities had

Box 2. The Fiscal Stance and Fiscal Transparency

Fiscal policy plays an important stabilization role in the Norwegian policy framework. An important objective of the authorities has been to limit the influence of oil revenues on the fiscal stance. Since 1987 the authorities have used the non-oil cyclically adjusted budget balance at the central government level net of interest payments as a main indicator of the stance of fiscal policy. Revenues and expenditures from petroleum activities, interest payments abroad and to the Central Bank and transfers from the Central Bank are excluded from the balance calculation as well as estimated cyclical components of certain taxes and expenditures. While this indicator is by far the most widely used gauge of the fiscal stance in Norway, other fiscal variables are also utilized. The authorities also aim to keep the growth of real underlying expenditures of the central government at or below potential output growth on average over the cycle.

The stance of policy at the general government level has occasionally been the opposite of that at the central level. Selected Issues Paper I illustrates this fact by calculating a non-oil cyclically adjusted balance at the general government level. The staff's calculation is similar to the authorities' methodology for estimating the central government budgetary stance except that it excludes both interest income and expenditures because of the high variability of interest income over time. While the fiscal stance at the state and general government levels have been broadly similar over most of the period since 1980, major differences occurred in 1987–88 and again in 1998 (Panel 3 in Chart 8) mainly in response to strong revenue growth which was used to boost expenditures at the local authority level. In 1987–88 the cyclically adjusted stance at the central government level was contractionary to the tune of 1 1/4 percent of GDP per annum whereas the general government fiscal stance was stimulative in the amount of around ½ percentage point of GDP per annum. In 1998, a similar pattern recurred. While the fiscal stance at the central government level was contractionary at ¼ percent of GDP per annum, the fiscal stance at the general government level was expansionary at ½ percent of GDP per annum.

Given that the comprehensive measure of the fiscal stance is the general government position, it would be advisable to shift the focus of the policy debate on this indicator. While it could be argued that the budgetary position of the municipalities is not an instrument at the disposal of the central government, it seems clear that the budgetary position of the general government is the proper yardstick in assessing the extent of the fiscal stimulus and long-run sustainability of fiscal policy.

The recent initiatives of the authorities in enhancing fiscal transparency should contribute to an informed policy debate. The annual publication of the net present value of pension liabilities with the budget papers should increase public awareness of the cost of the pension regime. The decision to publish an exhaustive list of the tax preferences is likely to lead to a more thorough public scrutiny of the rationale and the fiscal cost of the preferences.

recently decided to shift corporate tax revenues from the local to the central government. However, they were reluctant to further limit the role of local governments.

B. The Policy Stance in 2000

23. **The authorities have set a neutral fiscal stance in the State budget for 2000 and this is likely to result in a broadly neutral stance at the general government level.** While the economy continued to operate above potential, with an estimated positive output gap of 1 percent in 2000, mainland GDP growth slowed in 1999 and was expected to remain significantly below potential in 2000. To achieve a neutral fiscal stance while allowing for real growth in underlying expenditures of about 2½ percent, the draft State budget—which is the main policy focus of the authorities—proposed increases in indirect taxes and only partial indexation of income tax brackets. The recent budget agreement with the main opposition party would maintain the neutral fiscal stance but also introduce a new threshold at the top end of the income tax scale to finance tax relief for low-income earners and provide additional day-care places and employment schemes. The staff agreed that a neutral fiscal stance was appropriate. Officials did not contest the staff's view that if activity turned out to be stronger into the year than expected, a restrictive fiscal stance in the revised State budget in May might well be needed.

24. **The discussions focused on the projected rise in the expenditure-GDP ratio and the repeated expenditure overruns since 1995.** Norwegian officials noted that increased transfers to households—heavily influenced by the unexpected rise in disability and early retirement pensions—were a major element in the projected increase in spending in 2000. In recent years, some of the heaviest pressures on public spending were in health and education—areas which were largely under the purview of the local authorities. These pressures were likely to continue. Officials emphasized, however, that while the expenditure-GDP ratio had increased over the past couple of years, it had fallen by 6 percentage points of GDP since 1992.

25. **The authorities have followed a cautious approach in easing monetary policy.** The mission was supportive of the authorities' recent decisions to lower interest rates, but cautioned that further cuts should take place only if a durable change in the inflation and wage outlook becomes evident and is underpinned by fiscal and incomes policy discipline. The monetary authorities are mindful of the upside risks to inflation and have reduced rates more gradually than anticipated by the markets.

C. Medium-Term and Structural Issues

Aging and Public Finances

26. **The objectives of ensuring intergenerational equity and a smooth adjustment to the post-oil era are at the heart of the authorities' medium-term framework.** Since 1995, oil-related budget surpluses are being saved in the SPF and invested in foreign securities.

Although the public finances are fundamentally sound over the medium term, and the smoothing of the use of the oil wealth is designed to ensure that they remain so in the long run, the impending demographic shock is likely to give rise to strains. The expected demographic shift would not only imply a large and growing fiscal burden of pension costs, but would risk reducing the effective labor supply and thereby potential output in future. Such a development would in turn adversely affect the Government's ability to provide quality public services that the aging population would require.

27. **Recent trends in retirement have led to an escalation of actual and potential pension costs.** A surge in pension expenditure growth in 1998–99 resulted mainly from a significant increase in the basic pension benefit and the earnings-related old age pension, as well as from an increase in early retirees and recipients of disability pensions (up 17 percent in 1998). The number of early retirees was boosted by the decision to lower the eligibility age from 64 to 62 in 1998—in line with the agreement during the 1997 wage negotiations—and currently about 60 percent of the workforce are covered by early retirement schemes. The number of recipients of disability pensions has picked up as eligibility requirements were somewhat eased, while benefits remained generous—set at the level of the old-age pension benefit. On present policies, public pension expenditures are expected to double from 8 percent of GDP in 1998 to almost 18 percent in 2040.

28. **Long-term fiscal projections point to potential fiscal tensions as a result of a buildup of pension costs**. In order to gauge the broad orders of magnitude of the likely fiscal tensions, the staff constructed long-term fiscal scenarios (Box 3). The scenarios suggest that under unchanged policies and plausible assumptions, fiscal strains are likely to emerge. Policy changes to stimulate higher participation rates, raising the effective retirement age or lowering pension benefits, may need to be considered to ensure the viability of the system. The Norwegian officials broadly shared the thrust of this analysis. It was noted however that such policy changes would not be easy since Norway's effective retirement age and the participation rate were already among the highest in the advanced countries.

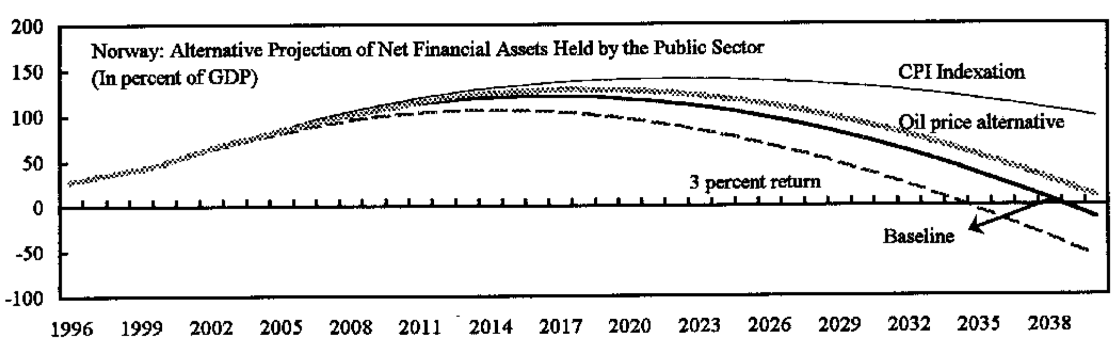
29. **As they set out to address these longer term issues, the authorities face a choice regarding the appropriate use of the oil wealth.** The issues in Norway revolved around the question of public versus private choice. In principle, scaling back public pensions would generate savings that could be devoted to meeting the increasing demand for public health and education or be returned to the public to be channeled into private pension plans. However, the authorities had not taken any decision to move to a partial funding of pension benefits. There was a clear split in public opinion on this issue: while employers were in favor of a partially funded compulsory pension system, unions were opposed to it. The mission noted that the present situation of a relatively low old-age dependency ratio and significant financial assets provided a clear opportunity to move to a system under which a publicly financed basic pension is supplemented by private defined contribution plans. An official assessment of the benefits of privatizing the pension system and the need to reduce pension costs is likely to be conducted in the next long-term program in spring 2001.

Box 3. The Long-Term Fiscal Policy

In the long run, public finances face challenges posed by escalating pension liabilities. In fact, Norway's resolve in recent years to transfer budget surpluses into the State Petroleum Fund has been based in part on the need to pay for rapidly rising social security expenditures, in particular pensions, in future years as a result of demographic changes. Recent changes in pension benefits make the long-run fiscal position less secure.

The baseline long run fiscal profile, which assumes the authorities' current expenditure policies, is worrisome. Using WEO assumptions, oil revenues accruing to the budget are expected to rise from the 1999 low of 5 percent of GDP to over 10 percent of GDP in 2001, gradually declining to less than 1 percent of GDP in 2050, as currently proven reserves are depleted. After 2003, oil prices are assumed to follow the path in Norway's 2000 Budget of a decline to Nkr 100 per barrel in 2000 kroner (about US$13.50 at 2000 prices) in 2010 in response to a projected decline in oil demand associated with the implementation of the international Kyoto agreement on CO_2 emissions. Following the government's decision to raise pensions substantially in 1998, pension expenditures are expected to rise from 8 percent of GDP in 1999 to 18 percent of GDP in 2040. Based on these projections for oil revenues and pension expenditures and an assumed real rate of return on SPF assets of 4 percent, a baseline scenario is constructed for net financial assets held by the public sector. 1/ The scenario is based on the budget for 2000 and constant non-oil revenue and expenditure (excluding pensions) levels in relation to GDP subsequently. Future pensions are assumed to continue to be indexed to wage inflation. On the above assumptions, net financial assets would be exhausted by 2040, without additional measures. Moreover, raising oil prices relative to the baseline by assuming that they remain at their 2003 level in real terms (equivalent to a 4½ US dollar increase) would not alter the assessment dramatically.

Policy changes such as lowering pension benefits or raising the average age of retirement or raising the participation rate would make the pension system financially more sound. Indexing future pensions to the CPI instead of wages would clearly be the most effective way of addressing the problem—it would generate a net asset position of about 100 percent of GDP in 2040—but the feasibility of such a step may be open to debate. Alternative ways of addressing the pension problem would be to raise the average retirement age or foster an increase in the participation rate. The authorities have calculated that increasing the average retirement age by 1 year would have the same effect on national wealth as raising the oil price by Nkr 13 per barrel (about US$2). A permanent increase of 9 percent in average working hours would raise national wealth by an amount equivalent to the total oil wealth. These estimates underscore the importance of ensuring a high level of labor supply.



1/ Net financial assets held by the public sector include net assets from a defunct government pension fund and assets held in the state banks, as well as assets held in the SPF.

Oil and the Real Economy

30. In addition to the long-term health of the public finances, a smooth adjustment of the exposed sector is a key medium-term and longer-term concern of the authorities. This concern is reflected in the desire for a broadly stable real exchange rate which successive governments have linked to the goal of preserving the competitiveness and structure of the exposed sector in the post-oil era. In this context, the most important element is the consistency between the projected non-oil current account deficit and the returns on oil wealth required to finance these deficits in perpetuity. On the basis of estimated trade elasticities, the staff projects that the exchange rate target would result in a non-oil current account deficit of 6–7 percent over the medium-term. A real rate of return of 4 percent on the present value of oil wealth equivalent to 155 percent of GDP implies that Norway could finance a non-oil current account deficit (excluding interest receipts) in this range indefinitely. These projections suggest that the current path of the real exchange rate is broadly compatible with the long-run savings-investment balance, barring large permanent shocks. In addition, a secular expansion of the sheltered sector to provide services to the growing elderly population may alter this assessment over the longer term.

Taxation and Subsidies

31. **Promotion of private activity over the medium term would also require supportive policies on taxation and the composition of public spending.** Although there was no political consensus to lower the aggregate tax burden, efforts were underway to make the tax system more neutral. While the tax burden was high in comparison with the OECD average, the authorities believed that Norway compared favorably with the EU countries in terms of the aggregate tax-GDP ratio.[5] The authorities were seriously considering broadening the scope of the value added tax to include services and eliminating the investment tax which was widely regarded as inefficient. There was also some support within Norway for eliminating the tax preferences accorded to the shipping industry and to unlisted joint-stock companies. The staff argued that expenditure restraint would allow a reduction in the relatively high tax burden on the mainland economy. Raising the low tax threshold for income and wealth taxes—which stood out in an international perspective—would help raise labor force participation and encourage the development of small businesses.[6] To limit the budgetary impact, the staff suggested reducing subsidies and tax preferences.

---

[5] The tax-GDP ratio was 43 percent in 1998 compared with tax revenues averaging 36½ percent of GDP for the OECD; the corresponding ratio for the EU was 41 percent of GDP. Non-oil taxes were 46½ percent of mainland GDP.

[6] Norway's marginal tax rate on low incomes (28 percent) and the rate of taxation of dividend and capital gains (also 28 percent) are moderate by international standards. However, at $3,300, Norway has one of the lowest income tax thresholds among the advanced countries,

(continued...)

32. **A regime of budgetary subsidies and state support to industry continues in the service of a variety of social and regional goals.** The extensive system of support and regulation for agriculture with the objective of producing a wide variety of traditional agricultural products has led to a producer subsidy equivalent of 70 percent, one of the highest in the world—second only to Switzerland in Europe and almost double that of the EU. Moreover, the very gradual trend of decline in support levels in the 1990s seemed to have reversed with the new support measures adopted in 1998. The staff argued that the regional and social objectives of the authorities should be sought through means other than price support and border protection. The officials noted that the authorities were committed to maintaining the current regime of farm support. Total budgetary support to industries, including that for agriculture, amounted to about 1¾ percent of GDP in 1998, apart from extensive tax preferences benefiting primarily the energy-intensive and shipping industries.

Labor Market Reforms

33. **Some progress in improving labor market flexibility is on the cards.** The authorities were pleasantly surprised at the positive response of the labor force to the strong upswing in recent years although they recognized the limited employment flexibility for those in work. The participation rate had risen by over 4 percentage points since 1992—2 percentage points above its previous peak of 1987—mainly on account of a sharp rise in the rate for women, helping to contain wage pressures during the recent economic boom. While restrictions on overtime and stringent lay-off requirements were an impediment to flexible work patterns, progress in the direction of greater labor market flexibility was likely with the introduction of legislation promoting the hiring out of labor.

34. **Rigidities in the wage structure have become entrenched.** The staff agreed that the performance of the Norwegian labor market in recent years had indeed been impressive by a number of yardsticks and acknowledged that the centralized wage bargaining structure had played an important role in this success. It noted, however, that the resulting compression of the wage structure had undesirable effects. In particular, the return to education had fallen by 2–3 percentage points over the past 20 years and was among the lowest in the OECD. In addition, generous social benefits (such as lowering of the early retirement age and setting up a life-long learning program) had been offered by successive governments in return for moderation in wage settlements. While the short-run costs of these programs were modest, the costs were likely to accumulate rapidly over time and could eventually become unsustainable.

---

and in contrast to the absence of wealth taxation in other countries, Norway imposes a wealth tax at a rate of 0.7–1.1 percent of taxable wealth, with a threshold of about $200,000.

Privatization Issues

35. **Notwithstanding some progress in deregulation and partial privatization, the pace of product market reforms has been gradual.**[7] Historically, Norway has had a strong tradition of state ownership in the financial, telecommunications, petroleum, rail transportation and power generation sectors. Mindful of the international trends toward consolidation and competition in some of these sectors, the authorities had decided to introduce gradual partial privatization. At the same time, the authorities intend to maintain a long-term Norwegian ownership in large strategically important companies. The authorities are currently assessing various options regarding their ownership in the petroleum sector. A White Paper, to be published in February 2000, will be discussed in Parliament and a decision is expected by spring.

36. **The authorities place considerable weight on ensuring that key decisions of the largest domestic banks continue to be made in Norway.**[8] With this objective in mind, they retain control of the two largest Norwegian banks so as to ensure that the headquarters are located in Norway. If the headquarters were to move outside of the country, strategic and employment decisions could, in their view, be detrimental to Norwegian households and small businesses and municipalities—those with the most information asymmetries and the least access to other financing sources—especially during cyclical downturns. Since Norwegian banks are small by international and even European standards—the largest Norwegian bank ranks 46th in terms of capital in Europe—it is felt that a sizable public ownership share (1/3 of the two largest banks) is required to block mergers with foreign entities.[9] The government therefore recently decided not to accept a bid from MeritaNordbanken (a large Finnish-Swedish bank) to purchase Christiania Bank (the second largest Norwegian bank). Officials pointed out that in accordance with the EEA Agreement, there were no limitations on the establishment of affiliates and branches of foreign banks in Norway and that the government did not otherwise interfere in the commercial decisions of the two state-controlled banks. In order to promote a stable and competitive financial system, the authorities favor a "Norwegian solution" involving domestic mergers, especially between banks and insurance companies. They also wish to ensure that banking services continue to be provided to all geographic regions. The government is currently discussing options for the future structure of the banking system, including a proposal to bundle the state's banking shares in one Norwegian bank with one-third state ownership.

---

[7] Selected Issues Paper 2 reviews the privatization record of Norway.

[8] Selected Issues Paper 3 explores the main issues in the financial sector.

[9] The government owns 60 percent of Den norske Bank(DnB),the largest domestic bank, following DnB's merger with Postbanken. The authorities aim to reduce this share down to about 33 percent. The government's share of Christiania Bank is 35 percent.

37. **The staff underscored that public ownership could limit the banks' response to foreign competitive pressures.** Public ownership, especially in the financial sector—where it is partly a legacy of the banking crisis of the early 1990s—could be an impediment to exploiting the efficiency gains offered by restructuring and growth possibilities at a time when both Europe in general and the Nordic region in particular are undergoing rapid changes brought about by cross-border consolidation, innovation and competition. Moreover, the creation of large domestic financial institutions, while affording scale economies, could risk the perception that they are "too big to fail."

Financial Stability

38. **Strengthened supervision of the banking system has helped Norway recover well from the banking crisis of the early 1990s.** A variety of financial indicators suggest little cause for concern over the current health of the banking system. Capital adequacy ratios are high, loan losses are low, and profitability of the sector is high. However, the banking supervisory authorities and the mission concurred on the importance of continued vigilance in responding to the emergence of new risks, such as those that could arise from high real estate prices or diminished corporate profitability.

Trade and Aid Policies and Statistics

39. **The trade regime, apart from the protection to agriculture, is generally liberal and Norway remains a leader in the provision of development assistance.** Official development assistance (ODA) at 0.9 percent of GDP is the second highest in the world and in striking contrast to the trend in some of the other advanced countries, the Norwegian authorities plan to raise ODA to 1 percent of GDP in the coming years.

40. **Norway's economic statistics are adequate for surveillance purposes in their coverage, quality, and timeliness** (see Appendix III). Norway has subscribed to the Special Data Dissemination Standard (SDDS) and its metadata are included in the Dissemination Standards Bulletin Board. Both annual and quarterly national accounts comply with the 1993 System of National Accounts (SNA 93); the data were revised since 1978 and Statistics Norway plans to extend the series back to 1968.

IV. The Staff Appraisal

41. **The current slowdown in the Norwegian economy has followed an exceptionally prolonged phase of expansion.** The fruits of this sustained expansion have been evident in major—and broadly shared—gains in employment and real incomes. Indeed, in notable contrast to many European countries, Norway has succeeded in achieving both virtually full employment and a sharp rise in the participation rate. At the same time, price inflation has remained low. The authorities' economic strategy based on the Solidarity Alternative has contributed to this exemplary record. The policy of reinvesting abroad a substantial part of the

oil revenues through the State Petroleum Fund has helped to insulate the mainland (non-oil) economy from developments in the oil sector.

42. **Against this background, the easing in activity which began in late 1998 is not unwelcome.** A cooling-off period was needed after years of rapid growth had propelled mainland output to a level that was significantly above the economy's productive potential. Indeed, despite the slowdown, the mainland economy at present continues to operate above the estimated level of its potential output with high levels of capacity utilization and persistent shortages of labor in the sheltered sector.

43. **The current slowdown in economic growth is expected to continue into 2000.** But with private consumption growing robustly in response to continued healthy growth in household income, and petroleum exports rebounding strongly, a soft landing is in prospect. Indeed, the risks to this scenario are primarily on the upside. With high household saving and wealth positions, a pick-up in consumer confidence, and improved export prospects, demand and activity may well be stronger next year than now projected.

44. **The mixed economic outlook suggests that the neutral fiscal stance proposed for 2000 is appropriate.** However, if activity appears to be stronger into 2000 than now expected and labor market conditions remain tight, a restrictive stance in the revised budget in May might well be needed. Staff believe, however, that the focus of fiscal policy from a demand management standpoint properly belongs at the level of the general government. Recent overruns in spending suggest that it is critical to contain expenditures within the budgeted amounts both at the state and local levels.

45. **The increased emphasis in Norges Bank's conduct of monetary policy toward greater tolerance of short-term deviations of the exchange rate from its implicit target range is welcome.** It recognizes the reality that trying to maintain the exchange rate within narrow limits entails heavy costs. This emphasis allows greater scope for monetary policy to bring inflation down to the level prevailing among the main trading partners—an objective that is essentially complementary to medium-term exchange rate stability, barring permanent shocks. This orientation will help limit adverse market speculation when the krone strays from its implicit target band. The sustained efforts of Norges Bank to clarify the policy framework and educate the public are to be commended. However, the transparency and credibility of the monetary regime would be enhanced by a mandate to the Norges Bank that accords explicit recognition to the objective of low and stable inflation. Formalizing such a mandate and ensuring the operational independence of the central bank to implement it would remove the lingering uncertainty about current and future monetary policy actions by providing a transparent foundation for the economic policy framework over the medium term.

46. **The cautious approach to easing monetary policy followed over the past year should continue, given the upside risks to activity and inflation**. Monetary policy should guard against a pickup in inflation either on account of domestic cost pressures or because of an unexpected rise in import prices. If fiscal and incomes policies play their parts in bringing

about a durable change in inflation, interest rates can gradually be brought down in the period ahead. The longer term objective of exchange rate stability at the current level is appropriate but is only credible as long as wages in the exposed sector are competitive and wage growth in the rest of the economy does not undermine low inflation. Once inflation is brought down to the level in the main trading partners, it would be the task of fiscal and incomes policies to ensure stable employment and income growth.

47. **The strains suffered by the Solidarity Alternative last year hold valuable lessons for the coming year**. The imbalances in the labor market and the rapid wage growth on average in 1998–99—almost double that in the main trading partners—suggest that the policy framework will face a renewed test in the major wage negotiations next spring. Wage moderation should not be achieved at the cost of generous increases in social and labor market programs, as in the past. These programs, while entailing only modest costs in the short run, can be expensive to the budget in the long run. A gradual accretion to non-wage costs can also be harmful to the competitiveness of the exposed sector in the medium term.

48. **Over the longer term, the public finances face challenges as oil revenues begin to run out and pension liabilities escalate** due to demographic trends which will sharply reduce the number of economically active Norwegians in relation to the number of pensioners. The recent sharp increases in early retirement programs and in pension benefits have already added to these potential fiscal pressures. Future growth in the relative importance of early retirees and those on disability benefits would put further strains on the system. While the State Petroleum Fund provides a cushion against these future liabilities unlike in other advanced economies facing similar pressures, there is a large risk of complacency. The authorities' current strategy to provide a comprehensive public pension to all citizens may prove unworkable in the long term unless strict discipline with respect to eligibility and the level of pension benefits is imposed. An attractive option would be to move to a system under which a publicly financed basic pension is supplemented by private defined-contribution plans.

49. **With restraint on public expenditure, a gradual reduction in the tax burden would be possible**. As Norway begins to contemplate its post-oil future in a globalized world economy, the task of designing an incentive structure to promote an internationally competitive, knowledge-based economy assumes growing importance. While in the past, Norwegians have accepted a relatively heavy tax burden to pay for a large public sector, the costs of this choice are likely to rise in the future. At a minimum, incentives to work, save and invest could be improved by raising the low thresholds for income and wealth taxes, and eliminating the investment tax. A partial revenue offset would be possible through broadening the tax base inter alia by eliminating some of the many tax preferences. In this respect, an early consideration of the proposal to extend the value-added tax to cover services would be welcome. The authorities are to be commended for enhancing fiscal transparency by publishing an exhaustive list of tax preferences in the 2000 budget.

50. **An overhaul of the regime of support to agriculture deserves high priority.** The extensive system of subsidy and regulation for agriculture entails high economic costs.

Clearly, the regional and social objectives of the support program could be sought through economically less costly and distortive measures. Such a reform of the regime would be consistent with Norway's generally rational approach to economic management.

51. **There is scope to improve the performance of the labor market by liberalizing regulations and allowing for greater wage differentiation.** An early passage of the amendment to the Employment Act to ease restrictions on hiring would be desirable. Consideration should also be given to reducing the limitations on the use of overtime. Such reforms would provide proper work and education incentives, reduce bottlenecks, and help sustain the rate of unemployment close to its current level.

52. **The continued vigilance being demonstrated by the supervisory authorities against the emergence of new risks is appropriate.** Norway's banking sector has recovered well from the crisis suffered in the early 1990s with strengthened and effective oversight by the supervisory authorities. Although there are no grounds for immediate concerns, it would be important to continue monitoring real estate prices for any signs of a bubble that could create risks for the financial system in the event of a negative shock.

53. **The privatization initiatives should be pursued vigorously in order to improve efficiency and corporate governance.** Public ownership, especially in the financial sector where it is partly a legacy of the banking crisis, can be an impediment to exploiting fully the efficiency gains offered by restructuring and growth possibilities. If the government retains some ownership, it should ensure that the enterprises are run on the basis of commercial principles without government interference. This will ensure that Norway is not left behind in a world of rapid changes in innovation and increased competitive pressures.

54. The authorities deserve to be applauded for their continuing exemplary record of official development assistance.

55. Norway's economic statistics are adequate for surveillance purposes in their coverage, quality, and timeliness.

56. It is recommended that Norway remain on the standard 12-month consultation cycle.

Norway: Basic Data

Social and Demographic Indicators	
Area	323,878 square kilometers
Population (1998)	4.42m millions
Population growth (1997-98)	0.6 percent
GDP per capita (1998)	US$27,700
Population Characteristics and Health	
Life expectancy at birth: Overall	77
Female	80
Infant mortality (aged under 1, in percent)	0.8
Population per physician	451
Population per hospital bed	67

	1995	1996	1997	1998	1999 1/	2000 1/
	(Volume changes in percent)					
Private consumption	3.4	5.3	3.7	3.1	2.3	2.0
Public consumption	0.3	2.8	2.8	3.7	1.1	1.5
Gross fixed investment	3.4	9.9	15.1	8.1	-9.0	-11.6
Export of goods and services	4.3	9.3	5.7	0.5	4.0	9.1
Of which: Oil and gas	8.2	11.0	2.6	-3.2	...	...
Import of goods and services	5.6	8.0	12.0	9.1	-1.0	-1.1
GDP	3.8	4.9	4.3	2.1	1.0	2.9
Mainland GDP 2/	2.9	3.9	4.4	3.3	0.3	0.7
	(In percent of labor force)					
Unemployment 3/	4.9	4.8	4.1	3.2	3.6	3.6
	(Percentage changes)					
Consumer prices	2.5	1.3	2.6	2.3	2.3	2.0
Hourly labor cost in manufacturing	4.6	2.5	2.5	4.3	4.7	3.7
Effective exchange rate						
Nominal	2.5	-0.3	0.6	-4.5	...	...
	(Twelve-month percent change, end of period)					
Domestic credit	6.3	9.2	6.1	10.4	8.0 4/	...
Broad money	5.1	6.0	4.5	5.4	9.9 4/	...
	(In percent)					
Three-month Interbank rate	5.5	4.9	3.7	5.8	6.4	5.0
Ten-year government bond yield	7.4	6.8	5.9	5.4	5.5	4.6
	(In percent of GDP)					
State budget, including social security						
Revenues	48.2	51.9	53.5	49.0	49.9	53.7
Expenditures	47.7	46.2	46.1	46.1	46.7	46.6
Overall balance	0.5	5.6	7.5	2.9	3.3	7.0
General government financial balance	4.1	8.0	9.6	4.5	5.6	9.0
Current account balance	3.3	6.7	5.2	-0.8	2.8	7.1
International reserves (in months of imports of goods and services)	5.8	6.3	5.5	4.4	4.5 4/	...

Sources: Ministry of Finance; Norges Bank; Statistics Norway; IMF, International Financial Statistics; and staff estimates.

1/ Official estimates and projections.

2/ Excludes items related to petroleum exploitation and ocean shipping.

3/ From 1996, definitional changes result in a half percentage point increase in the reported unemployment rate.

4/ October 1999.

NORWAY: FUND RELATIONS

(As of November 30, 1999)

I. **Membership Status**: Joined 12/27/45; Article VIII

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	1,671.70	100.0
Fund holdings of currency	1,050.50	62.8
Reserve position in Fund	621.23	37.2
Operational budget transfers (net)	-19.00	

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	167.77	100.0
Holdings	203.81	121.5

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**: The present exchange rate arrangement for the krone is classified as a managed float. In the medium-term, the Norges Bank seeks to maintain the exchange rate stable against the euro within a range equivalent to that in which the exchange rate moved vis-à-vis the ECU between December 1992 (when the krone was delinked from the ECU) and May 1994 (when the present arrangement was announced).

In accordance with Decision No. 144(52/51), Norway has notified the Fund that it maintains exchange restrictions pursuant to UN sanctions against the Federal Republic of Yugoslavia (Serbia/Montenegro)(EBD/92/157, 7/21/92 and EBD/95/14, 1/25/95) Iraq (EBD/90/286, 9/10/90) and EBD/95/146, 11/1/95, and the Socialist People's Libyan Arab Jamahiriya (EBD/95/146, 11/1/95).

VIII. **Article IV Consultation**: Discussions for the 1998 Article IV Consultation were held in Oslo, October 20-27, 1998. The Staff Report (SM/98/267) was considered by the Executive Board on January 15, 1999.

IX. **Technical Assistance**: Technical assistance missions organized by the MAE Department were conducted in March 1997 and September 1998.

X. **Resident Representative**: None

Norway: Core Statistical Indicators

(As of December 2, 1999)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP	External Debt/Debt Service
Date of Latest Observation	12/2/99	8/30/99	8/30/99	10/31/99	10/31/99	12/2/99	Oct. 99	Sept. 99	Sept. 99	1998	1999 Q3	June 99
Date Received	12/2/99	11/3/99	11/3/99	11/30/99	11/30/99	12/2/99	11/10/99	11/30/99	11/30/99	5/10/99	12/2/99	Sept. 99
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Variable
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Three times a year	Quarterly	Quarterly
Source of Update	Norges Bank	Norges Bank	Norges Bank	Norges Bank	Norges Bank	Norges Bank and WEFA	Statistics Norway	Statistics Norway	Statistics Norway	Ministry of Finance	Statistics Norway	Norges Bank
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Publication
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Three times a year	Quarterly	Quarterly

1/ Government finance figures are updated three times a year in connection with the presentation of next year's budget proposal (early October), the final budget proposals (late November), and the revised budget (early May).

Statement by the IMF Staff Representative
January 26, 2000

The following information has become available since the staff report (SM/99/311) was circulated to the Executive Board on December 27, 1999. This information does not change the staff appraisal.

1. Consumer price inflation (year-on-year) was 2.8 percent in December 1999, unchanged from the previous month. Rising electricity prices contributed the most to recent price increases. Underlying inflation, which excludes changes in electricity prices and indirect taxes, was in line with previous projections, showing a year-on-year increase of 2.5 percent. In its 1999 fourth quarter inflation report, Norges Bank revised its inflation projection for 2000 upwards by ¼ percentage point to 2 ¼ percent, primarily in view of the Parliament's decision to raise indirect taxes in the 2000 budget. Inflation was projected to decline to 1 ¾ percent in 2001.

2. Teachers and healthcare workers have reportedly been making substantial claims for this year's wage round, above the 3½ percent recommended by the Arntsen commission for 2000. However, several labor leaders have publicly distanced themselves from these wage claims.

3. The krone exchange rate has been slightly weaker in January, averaging Nkr 8.15 per euro, compared to Nkr 8.10 per euro in December. The long-term interest rate differential vis-à-vis Germany, measured by yields on 10-year bonds, fell to about 80 basis points at the end of the third week of January, from 100 basis points in mid-December 1999.

4. In the most recent meeting of its Executive Board on January 19, Norges Bank left its key interest rates unchanged. Noting that the risk of a pronounced downturn seemed to have receded compared with earlier assessments, the Bank stated that interest rates now appeared to be at or close to the bottom of the cycle.

5. The price of North Sea oil averaged $25.65 per barrel in December 1999 and fell slightly to $24.80 per barrel on average in the first three weeks of January.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/7
FOR IMMEDIATE RELEASE
February 15, 2000

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Norway

On January 28, 2000, the Executive Board concluded the Article IV consultation with Norway.[1]

Background

Norway's economic record over the past decade has been exemplary in many respects. Prudent management of revenues from the exploitation of its large reserves of oil and gas, coupled with a broadly successful macroeconomic policy framework has enabled Norway to raise living standards substantially. Indeed, over the past quarter century, Norway's per capita GDP (on a purchasing power basis) has risen from a level equal to the average of the European Union (EU) countries to a third above the EU average, approaching that of the United States. In notable contrast to many EU countries, Norway has succeeded in achieving virtual full employment and a sharp rise in the labor participation rate.

The policy framework came under considerable strain in 1998 in the face of an erosion of wage and fiscal discipline, and pressures on the exchange rate. With the fiscal stance insufficiently restrictive to counter excess demand, and labor market conditions very tight, wage increases averaged around 6½ percent—double the level in main trading partners. At the same time, oil prices plunged by over 40 percent through 1998, contributing to sustained downward pressure on the krone and the first current account deficit in the decade.

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described. As part of a pilot project, the staff report for the 1999 Article IV consultation with Norway is also available.

Economic activity was sluggish during the first half of 1999, but rebounded somewhat in the third quarter. Mainland GDP grew by 1½ percent in the year to the third quarter of 1999, while overall GDP rose by 2¼ percent. Business investment contracted, both in petroleum and manufacturing, as high wage growth and stagnant productivity with only moderate increases in producer prices squeezed profits and depressed business sentiment, and as some large investment projects were completed following several years of strong growth. Consumption, fueled by large wage gains and sustained by high household confidence, has been the engine of growth. The external balance has recovered in the course of 1999 in the wake of an upturn in oil prices by about 150 percent from below $10 per barrel at end-1998. Imports also fell in conjunction with the sizeable decline in investment, thereby improving the non-oil trade balance. Employment growth has tapered off since mid-1998, although the level of employment remains very high.

Consumer price inflation remained moderate despite a rapid rise in wage costs. The large wage settlements of 1998 had a carry-over of about 3¼ percent into 1999—an off year of the two-year wage bargaining framework. However, the Arntsen Committee, set up to represent the social partners, was instrumental in reviving the consensus on wage policy. The outlook for average earnings in 1999 is broadly in line with the committee's recommendation that wage growth in 1999 should not exceed 4½ percent. However, even with this relatively moderate outcome, wages will have risen by a cumulative 6 percent in real terms in 1998–99. Consumer prices rose by 2.5 percent in the year to October 1999. Falling import prices helped offset price increases for services, domestically produced goods, petroleum products, and electricity.

The present slowdown in economic growth is expected to continue into 2000. Mainland real GDP is forecast to grow by only about 1 percent while aggregate GDP is projected to rise considerably faster, reflecting the resurgence in oil exports. However, in view of strong household income and confidence and the strength of activity in the third quarter of 1999, and with major wage negotiations due to take place next spring, the risks to the projection are on the upside.

Monetary policy has been eased gradually since early 1999 as inflation expectations moderated with the appreciation of the krone and the adherence to the wage agreement. The krone appreciated by over 7 percent in response to the sharp reversal in oil prices and by early December was trading slightly above the implicit target range. Policy rates were reduced by a total of 2½ percentage points in five steps since the turn of the year in view of low inflation expectations and the economic slowdown.

The fiscal stance has been moderately tight in 1999. Unlike in 1998, when tightening in the central government budget was offset by an expansionary stance by local governments, the tightening at the central level in 1999 is reflected at the general government level. Both the central and general government stance imply a tightening of the cyclically adjusted non-oil fiscal position by ½ percent of GDP, with the general government budget surplus projected to increase by 1 percentage point to 5½ percent of GDP. The State budget sets a neutral fiscal stance for 2000, which is also broadly consistent with a neutral general government stance.

Executive Board Assessment

Executive Directors commended Norway for its exemplary economic performance over the past decade, as reflected in strong economic growth, and low inflation and unemployment. They noted the contribution to this performance of the Solidarity Alternative policy framework that is aimed at preserving the competitiveness of the non-oil economy and smoothing income and employment through a combination of consensual incomes policy and prudent management of the country's oil wealth. To further consolidate those achievements, Directors considered that priority issues facing the authorities were to bring inflation in line with the corresponding target in the euro area, and to move forward with structural reforms to enhance efficiency and provide the basis for sustained growth in the mainland economy.

Given the slowdown in mainland economic growth against the backdrop of capacity constraints and a tight labor market, Directors viewed the neutral 2000 fiscal budget as broadly appropriate. However, they generally considered that if growth were to pick up more quickly than expected, it would be advisable for the authorities to respond with a sufficiently tight revised budget in May. Directors also noted that the countercyclical fiscal stance of the central government had been offset at times by the procyclical fiscal tendencies at the municipal level. In this regard, they recommended that the authorities focus their countercyclical fiscal policy at the level of the general government.

Directors were of the view that the policy of nominal exchange rate stability had provided benefits to Norway throughout the 1990s. However, recent experience pointed to the difficulty that could arise in maintaining a stable exchange rate in the short run, especially in the face of large asymmetric external shocks that could affect Norway's prominent oil sector. Directors thus welcomed the fact that, in its conduct of monetary policy, Norges Bank had allowed greater short-term deviations of the exchange rate from its implicit target range. They also welcomed the authorities' efforts to enhance the transparency and credibility of their monetary policy framework, and some Directors observed that a more explicit mandate to the central bank affirming the objective of low and stable inflation could be useful. Directors stressed that fiscal and wage discipline would play a key role in maintaining economic stability, regardless of the monetary framework adopted. The cautious approach to monetary policy followed over the past year should continue, given the upside risks to activity and inflation.

Directors welcomed the authorities' aim to achieve wage moderation, but noted the risk stemming from rising wage pressures ahead of the spring negotiations. They observed that the already tight labor market and high level of labor participation have been testing the bounds of incomes policy and risked causing a pickup in inflation, which it was important to avoid since Norway's inflation rate was already above that of its partners. Some Directors cautioned that wage moderation should not be achieved at the cost of excessive growth in social and labor market programs whose long term fiscal cost could be substantial.

Directors commended Norway for consistently transferring oil-related revenues to the State Petroleum Fund. This had helped to insulate the economy from the effects of fluctuations in oil revenues, and to preserve the benefit of Norway's oil wealth for future generations. In a longer term perspective, Directors viewed with some concern the recent increases in early retirement programs and in pension benefits. They encouraged the authorities to seize the present opportunity to initiate reform of the public pension scheme. Options for doing so included policy changes to stimulate a higher labor force participation rate, adjusting pension benefits, and moving to a partial funding of the compulsory pension plan while introducing supplementary private pension schemes.

Directors considered that the long run challenge for the authorities would be to engineer a smooth transition to the post-oil era. They generally considered that measures to improve the functioning of product markets (including a review of agricultural subsidies) and of labor markets would help to sustain growth in the longer run. Some Directors observed that growth prospects would also be helped by restraining public expenditure so as to allow a reduction in the relatively high tax burden.

Directors encouraged the authorities to pursue the privatization process. Several Directors suggested that the authorities should not be inhibited in their privatization goals by the desire to preserve national ownership in key sectors. A few Directors stressed that in cases where the authorities' desire to preserve a national identity in an industry restricts options for complete privatization, the development of alternative policies to ensure an efficient and competitive market structure is all the more urgent.

Directors applauded Norway's continued development assistance, which was among the highest provided by advanced economies. They welcomed the authorities' intention to increase ODA to 1 percent of GDP over the medium term.

Norway: Selected Economic Indicators

	1997	1998	1999 1/	2000 1/
Private consumption	3.7	3.1	2.3	2.0
Public consumption	2.8	3.7	1.1	1.5
Gross fixed investment	15.1	8.1	-9.0	-11.6
Export of goods and services	5.7	0.5	4.0	9.1
Of which: Oil and gas	2.6	-3.2	...	...
Import of goods and services	12.0	9.1	-1.0	-1.1
GDP	4.3	2.1	1.0	2.9
Mainland GDP 2/	4.4	3.3	0.3	0.7
	(In percent of labor force)			
Unemployment	4.1	3.2	3.6	3.6
	(Percentage changes)			
Consumer prices	2.6	2.3	2.3	2.0
Hourly labor cost in manufacturing	2.5	4.3	4.7	3.7
Effective exchange rate				
Nominal	0.6	-4.5	...	...
	(Twelve-month percent change, end of period)			
Domestic credit	6.1	10.4	8.0 3/	...
Broad money	4.5	5.4	8.6 4/	...
	(In percent)			
Three-month Interbank rate	3.7	5.8	6.4	5.0
Ten-year government bond yield	5.9	5.4	5.5	4.6
	(In percent of GDP)			
State budget, including social security				
Revenues	53.5	49.0	49.9	53.7
Expenditures	46.1	46.1	46.7	46.6
Overall balance	7.5	2.9	3.3	7.0
General government financial balance	9.6	4.5	5.6	9.0
Current account balance	5.2	-1.5	2.8	7.1
International reserves (in months of imports of goods and services)	5.5	4.4	6.8	...

Sources: Ministry of Finance; Norges Bank; Statistics Norway;IMF, International Financial Statistics; and staff estimates.

1/ Official estimates and projections.
2/ Excludes items related to petroleum exploitation and ocean shipping.
3/ October 1999.
4/ November 1999.

Statement by O.-P. Lehmussaari, Executive Director for Norway January 28, 2000

On behalf of my Norwegian authorities, I would like to thank the staff for thorough and well-written reports for the 1999 Article IV consultation on Norway. The staff report covers important aspects of the Norwegian economy, both in the short and long term.

The period of strong growth in Norway that prevailed during the latter part of the 1990s was replaced by slower growth in 1999. Nevertheless, labor force participation is still at a record level and strong pressures on some parts of the labor market remain. Although consumer price inflation remained moderate in 1999, it is still higher than in the euro area.

The sharp rebound in oil prices in 1999 led to an improvement in the current account, following a deficit in 1998. Market observers have linked the strengthening of the krone exchange rate to the surge in oil prices. Continued high oil prices will put fiscal restraint to a test in the coming years. Long-term considerations concerning future pension liabilities and other expenses related to the aging of the population require that a considerable part of the oil revenues be set aside.

Economic outlook – recent projections

Mainland GDP growth is estimated at around 1 per cent in 1999. The slowdown in growth was unevenly distributed. Public and private consumption continued to show strong growth; on the other hand, in large parts of the manufacturing sector, fixed investment dropped for the first time since 1993. Furthermore, investment in the petroleum industry showed a marked contraction after several years of high and increasing investment in the North Sea.

Total employment growth in 1999 is projected at ½ per cent. There were, however, major differences between the various labor market segments. There was a considerable downturn in petroleum-related industries, whereas employment in the public sector and private service industries increased. Average unemployment was more or less unchanged from 1998, at 3¼ per cent.

The current account surplus for 1999 is estimated at just under 3 per cent of GDP. The current account is expected to improve to around 8 per cent of GDP in 2000, mainly due to increasing oil revenues and increasing net export of traditional goods. The surpluses will, to a large extent, be reflected in high outflows of capital through the Government Petroleum Fund.

The outlook for the Norwegian economy provided by the Ministry of Finance, as well as Norges Bank, points to a growth rate of ¾ per cent in mainland GDP in 2000. Thereafter, GDP is expected to pick up toward the estimated long-term trend rate of growth in the economy. Unemployment may increase slightly, but is expected to remain at a low level by international standards.

There are several risks to this outlook. First, although wage growth on average is expected to slow down, there are signs of strong wage demands ahead of this spring's negotiations in sectors with labor shortages. Second, one cannot exclude the possibility of a rebound in private consumption. Households have substantial financial leeway to smooth consumption over the business cycle. Third, changes in economic activity normally provide strong impulses to mainland business fixed investment. However, it is especially difficult to estimate this effect when the economy is at a turning point. Finally, the uncertainty associated with changes in petroleum investment is considerable.

A slower rise in wage costs is projected over the next two years, contributing to a slower rise in prices for Norwegian-produced goods and services, while higher international commodity and producer prices may result in slightly increased import prices. CPI inflation will most likely remain around 2¼ per cent in 2000, in line with the staff's estimate. The approved increase in indirect taxes in the fiscal budget for 2000 will contribute to an increase in the price projections of a quarter of a percentage point.

Economic policy

The main challenge for the economic policy is to bring down price and cost inflation in line with that of Norway's trading partners.

The Norwegian economy slowed down in 1999 following six years of strong recovery. Fiscal policy has been tight in response to the strong economic upswing. The budget for 2000 has a neutral fiscal stance, measured by changes in the non-oil, cyclically adjusted surplus net of interest payments. According to the staff, the economy will still operate above potential in 2000, with an estimated positive output gap of 1 per cent. The Norwegian authorities concur that the extent of free resources is limited, but would point out the uncertainty of the quantification of the output gap. Given the recent signs of slower growth - albeit somewhat mixed - the authorities believe that a neutral stance is adequate with respect to the pressures in the economy.

The authorities believe that monetary policy, after the interest rate hikes in 1998, has had a dampening effect on the real economy and domestic price and cost pressures. Monetary policy has gradually been eased in accordance with signs of dwindling growth. In conjunction with the presentation of the December Inflation Report, the central bank governor stated that interest rates now appear to be at or close to the trough in this business cycle.

In the staff's view, the transparency and credibility of the monetary policy regime would be enhanced by an explicit recognition of the objective of low and stable inflation. This recommendation springs from the fact that the Norwegian monetary policy framework differs somewhat from what seems to be international standards. The government deems that the Norwegian monetary policy framework is appropriate and adequate. The Norwegian authorities concur with the view that transparency and credibility play an important role in the implementation of monetary policy. Consequently, the monetary authorities have devoted considerable effort to clarifying the policy framework. The overall impression is that the policy framework is well understood by a majority of market participants.

According to the staff, market uncertainty as to whether the authorities would take sustained action to return the exchange rate back to its target range undermined the stability of the krone in the summer of 1998. In the authorities' view, the significant wage growth and the drop in oil prices were more important factors explaining the depreciation of the krone, together with international turmoil in financial markets.

The authorities wish to emphasize that the guidelines for monetary policy have taken into consideration that the exchange rate may deviate from its initial range. In the event of significant changes in the exchange rate, policy instruments will be oriented with a view to returning the exchange rate, over time, to its initial range. Norges Bank will continually assess the degree to which the use of policy instruments is appropriate in the light of conditions in the foreign exchange market and the economic situation in Norway.

Developments in recent years indicate that movements in the krone exchange rate cannot be fine-tuned. Thus, the Bank has stated that it will focus on two fundamental preconditions to achieve exchange rate stability over time: First, price and cost inflation must be brought down toward the corresponding goal for inflation of the European Central Bank. Second, monetary policy must not in itself contribute to deflationary recessions, as this would undermine confidence in the krone.

In Norway, fiscal policy has an important role in demand management. The fulfillment of this task is facilitated by the fact that the Norwegian government has greater financial leeway than most other countries due to positive net financial investments in 47 of the last 50 years. At the same time, high oil revenues make fiscal contractions more demanding. Against this background, fiscal policy has been fairly well adapted to the economic situation over the last decade.

Medium-term and structural issues

As noted in the report, public finances will be faced with challenges as oil revenues decline and pension liabilities escalate. The staff asserts that an attractive option would be to move to a system where a publicly financed basic pension is supplemented by private defined-contribution schemes. The government concurs with the staff that fiscal pressures will build up in the future. Total disbursements by the National Insurance Scheme for old age and disability pensions are estimated to increase from 8 per cent of GDP in 1995 to 15 per cent of GDP in 2030. It is the Government's view that funding parts of the National Insurance Scheme will not, by itself, address the long-term challenges to public finances. The issue of funding should be evaluated in conjunction with other measures aimed at creating better incentives for long working careers. The Government will continue to work on these important pension policy issues during the period prior to the long-term Program 2002–2005, which will be presented in early 2001.

We believe that the macroeconomic policy strategy pursued in the 1990s, formulated in the so-called Solidarity Alternative, has been crucial in bringing the structural unemployment rate in Norway down to a level among the lowest in the OECD area.

The Norwegian system of income policy cooperation is based on the wage-leading role of the tradable sector. However, a tight labor market, expectations of increased public spending and discontent with wage conditions among certain groups of public employees have put the centralized wage formation system under pressure the last couple of years, as was illustrated in the wage settlement in 1998. The authorities highlight the impact of the so-called Arntsen Committee in 1999, where the labor unions agreed on the need to restrict wage growth to the same level as that of trading partner countries. This agreement helped to curb wage pressures in 1999 despite the strains suffered by the wage formation system. The current orientation of fiscal and monetary policy is based on the assumption that the social partners support the overall economic policy framework.

As a response to these challenges, an official committee, with participation from the authorities and the social partners, has been formed to discuss. among other things, how income policy cooperation may contribute to this end. In particular, the committee will discuss how to ensure a credible and viable implementation of the recommendation from the Arntsen Committee in subsequent wage rounds.

In the staff's view, wage moderation should not be achieved at the cost of generous increases in social and labor market programs. The government recognizes that these programs, while entailing only modest costs in the short run, may have long-term effects on the budget and enterprises. Accordingly, the government has signaled the need to restrict the benefits of some early retirement schemes.

The state ownership in DnB and Christiania Bank was discussed in the Government's report to the Storting ("Kredittmeldinga" – report no 11 (1999-2000)). In its recommendation to this report, a majority of the Storting's Standing Committee on Financial and Economic Affairs states that the government should join its interests as an owner in one entity, to maintain national ownership by owning at least 1/3 of the shares. Such an entity should have flexibility for further development in Norway and in other Nordic countries. The majority is of the opinion that a sale, if any, of the shares in Christiania Bank cannot be made until a Norwegian solution has been considered.

Following Kredittmeldinga and the recommendation of a majority of the Standing Committee on Financial and Economic Affairs, the Ministry of Finance has issued a mandate for an assessment on DnB and Christiania Bank to be produced by the Government Bank Investment Fund. The Government Bank Investment Fund has been asked to consider the options of structural solutions for DnB and Christiania Bank, and it should consider viable solutions for DnB and Christiania Bank as institutions, as well as for the Government as an owner. The Government Bank Investment Fund is now working on the assessment.