March 2003
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Norway: 2002 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Norway, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 11, 2002,** with the officials of Norway on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 20, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 7, 2003 discussion** of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

NORWAY

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation with Norway

Approved by Alessandro Leipold and Martin Fetherston

February 20, 2003

- The 2002 Article IV consultation discussions were held in Oslo during December 4 –11. The mission, comprising Mr. Thakur (head), Ms. Cerra, and Mr. Soikkeli (all EU1), met with Mr. Per Kristian Foss, Minister of Finance; Mr. Svein Gjedrem, Governor of Norges Bank; other senior officials; representatives of the Confederation of Labor Unions and Confederation of Business and Industry; and members of the financial and academic communities. Alternate Executive Director, Mr. Andersen, participated in the meetings.

- The authorities intend to publish this staff report.

- Norway has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement, and its payment system is free of restrictions on current transactions. Norway has subscribed to the Special Data Dissemination Standard (SDDS). Norway is a member of the European Economic Area—providing for free movement of goods, services, labor and capital vis-à-vis the European Union (EU)—but has twice rejected EU membership in national referenda.

- A minority coalition government has been in office since September 2001. New elections are due in 2005.

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I. Background and Short-term Outlook

1. **Norway enjoyed a decade of sustained economic expansion in the 1990s, aided by prudent resource management and a tradition of consensual policies.** The strategy of investing abroad the bulk of revenues from the export of oil and gas has helped insulate the economy from fluctuations in the petroleum sector, thereby affording a far greater degree of policy flexibility than is typical for many resource-intensive economies (Figure 1). A policy framework built around centralized wage coordination, nominal exchange rate stability, and fiscal policy devoted to managing aggregate demand was successful in restoring full employment with low inflation by the mid-1990s (Figure 2). However, this policy strategy came under severe strain in the late 1990s as monetary policy turned pro-cyclical, short-run stability of the exchange rate became elusive, and fiscal policy was unable to reconcile public demands for greater use of booming oil revenues with effective management of the economic cycle. Moreover, a persistently tight labor market undermined efforts at wage moderation.

2. **In response to mounting economic and political pressures, new policy guidelines were adopted in March 2001, including a program of accelerated use of oil wealth and inflation targeting (Box 1).** As government oil revenues skyrocketed in the last few years and the Government Petroleum Fund (GPF) balances began to build up rapidly, the resistance to spend more could no longer be sustained. The new fiscal guidelines enabled a gradually greater use of oil revenues accumulated in the GPF, by raising the non-oil structural fiscal deficit of the central government to an estimated 5 percent of mainland GDP by 2010. This would imply a fiscal expansion of about 3 percentage points of mainland GDP over the present decade, or nearly 0.4 percent of mainland GDP per year on average. Fiscal policy thus ceded more of the onus for stabilization to monetary policy. Norges Bank was assigned an explicit objective to target medium-term inflation, although output, employment, and exchange rate stability were also specified as desirable goals. The Fund has welcomed the shift to inflation targeting, but underlined the importance of fiscal discipline (see Box 2). Economic developments over the past two years have reflected the effects of the prospective fiscal expansion and the tighter monetary policy thus required to achieve the inflation target.

3. **The moderate economic growth and the shift in the composition of demand in 2002 reflected the combined influences of fiscal expansion and the global slowdown.** The slight pickup in mainland GDP growth to an estimated 1½ percent in 2002, from 1¼ percent in 2001, was mostly driven by strong growth in consumption, in response to solid gains in disposable income and public spending (Table 1 and Figure 3). In contrast, mainland investment and traditional exports slackened, as a result of weak external demand, high real interest rates, and the strong krone.[1]

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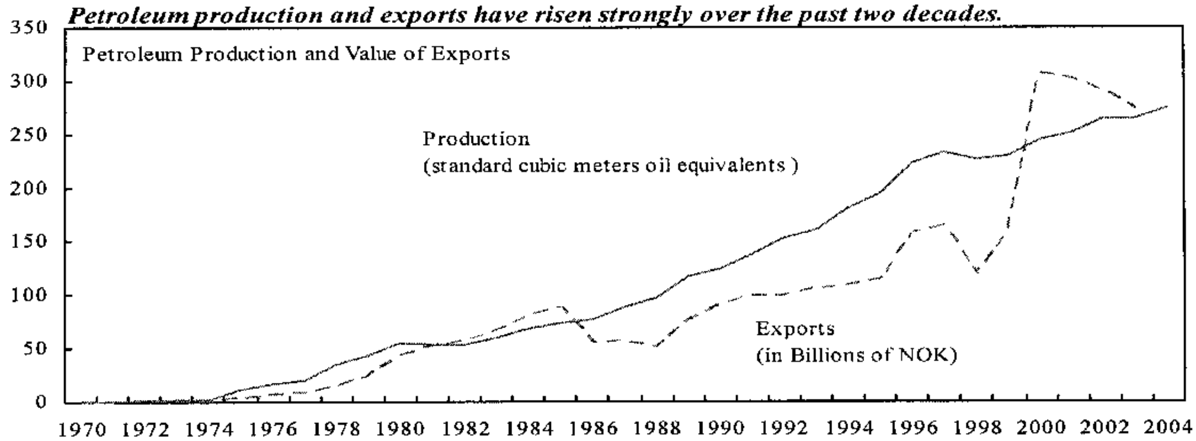
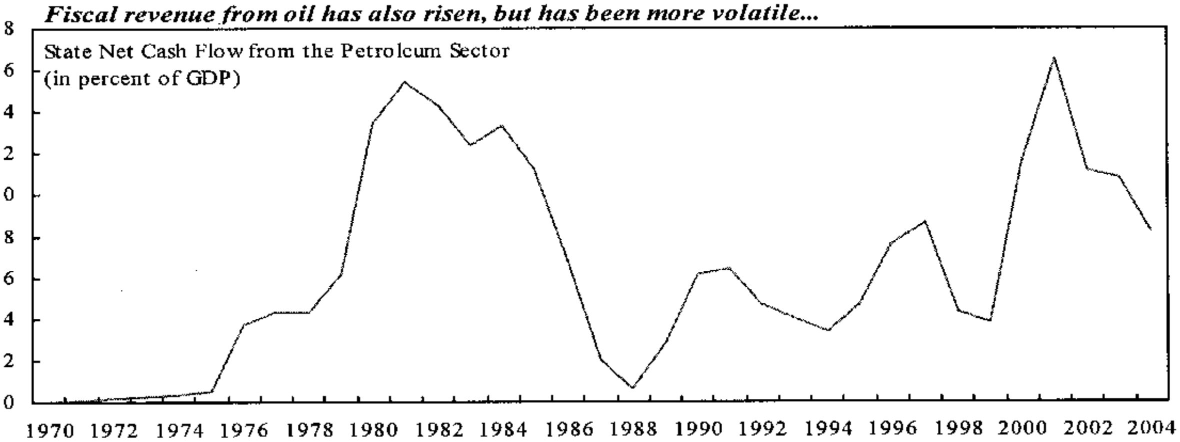
[1] Mainland investment contracted by almost 5 percent in the first three quarters of 2002 compared with the corresponding period of the previous year.

Figure 1. Norway: The Petroleum Sector 1/

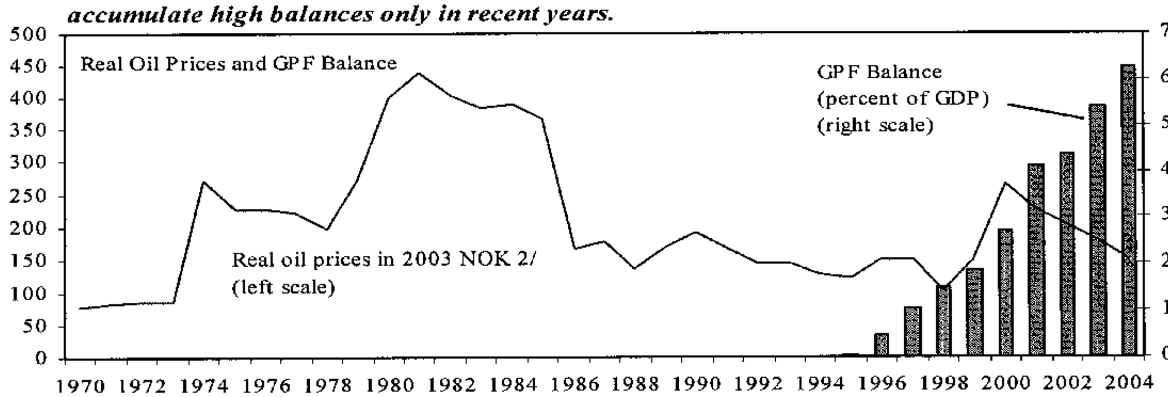
Petroleum production and exports have risen strongly over the past two decades.



Fiscal revenue from oil has also risen, but has been more volatile...

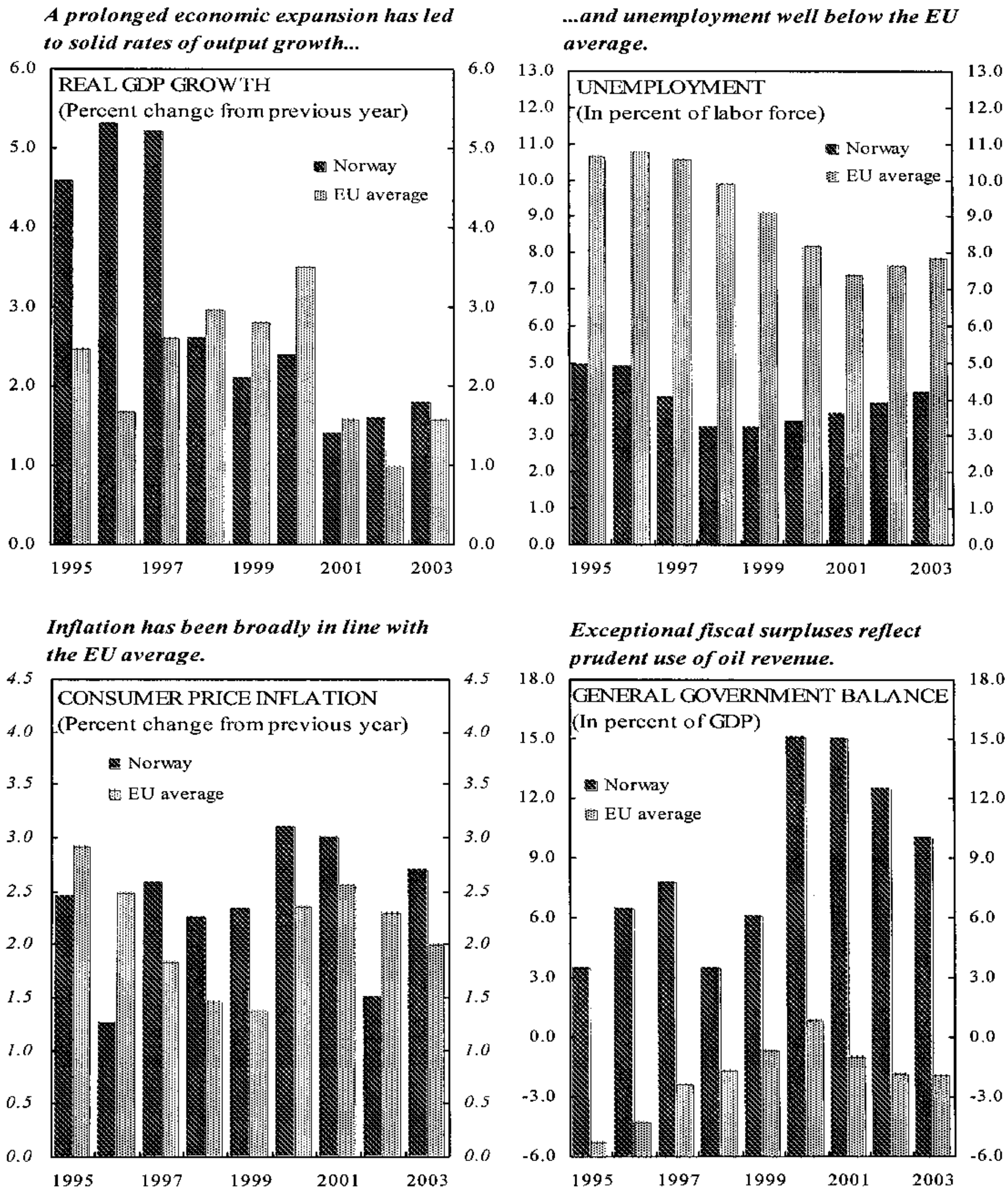


...partly due to fluctuating oil prices. The GPF was established in 1990, but has begun to accumulate high balances only in recent years.



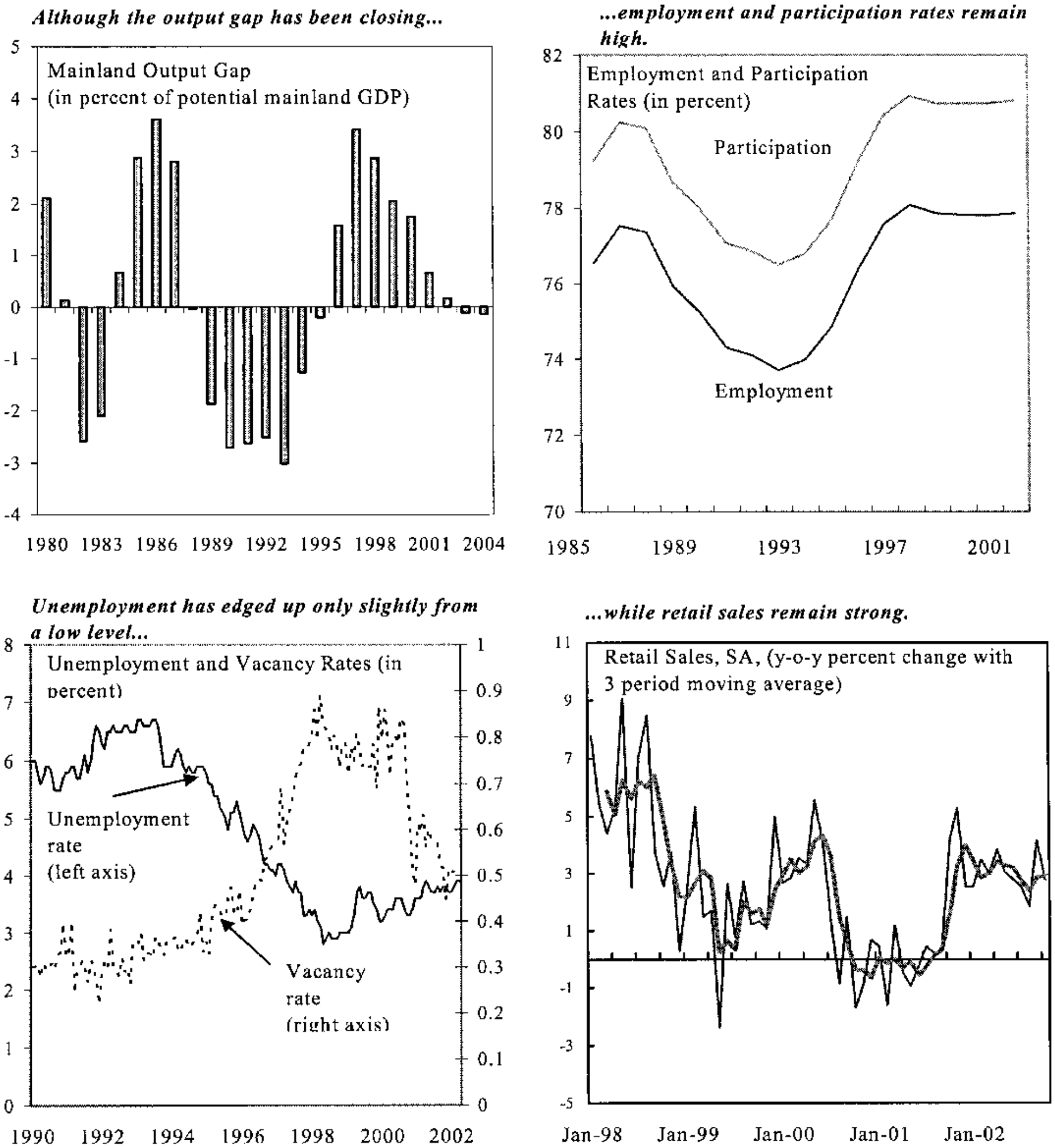
Source: Ministry of Finance.
1/ Forecasts for 2002 through 2004
2/ Deflated by CPI.

Figure 2. Norway: Economic Fundamentals, 1995–2003



Sources: Ministry of Finance; Statistics Norway; World Economic Outlook; and IMF staff estimates.

Figure 3. Norway: Indicators of Resource Pressure



Sources: Statistics Norway; WEFA; IMF staff estimates and projections.

Box 1. Fiscal and Monetary Policy Guidelines

The Norwegian parliament (the Storting) set out in March 2001 the following guidelines for the conduct of fiscal and monetary policies.

Guidelines for Fiscal Policy:

For each year, the structural, non-oil budget deficit should approximately correspond to the expected return on the Petroleum Fund at the start of the fiscal year. The expected real rate of return is estimated at 4 percent.

The point of reference for the spending rule for oil revenues is a normal cyclical situation. In a situation of particularly high capacity utilization in the economy, fiscal policy restraint should be shown, whereas in a cyclical downturn, somewhat higher spending of oil revenues may be needed.

In the event of extraordinarily large changes in the Petroleum Fund's capital or in factors influencing the structural deficit from one year to the next, any change in oil revenue spending should be smoothed over several years with a basis in the projected return on the Petroleum Fund some years ahead.

The Regulation on Monetary Policy:

Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2½ percent over time.

In general, the direct effects on consumer prices resulting from change in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

Box 2. Policy Recommendations and Implementation

The Fund has in recent years framed its policy advice in the context of the exploitation of Norway's large energy resources and its implication for the overall structure of the Norwegian economy. It has endorsed the authorities' basic objectives of smoothing the adjustment of the non-oil exposed sector in the face of "Dutch disease" effects while sharing equitably the oil wealth between generations and across society.

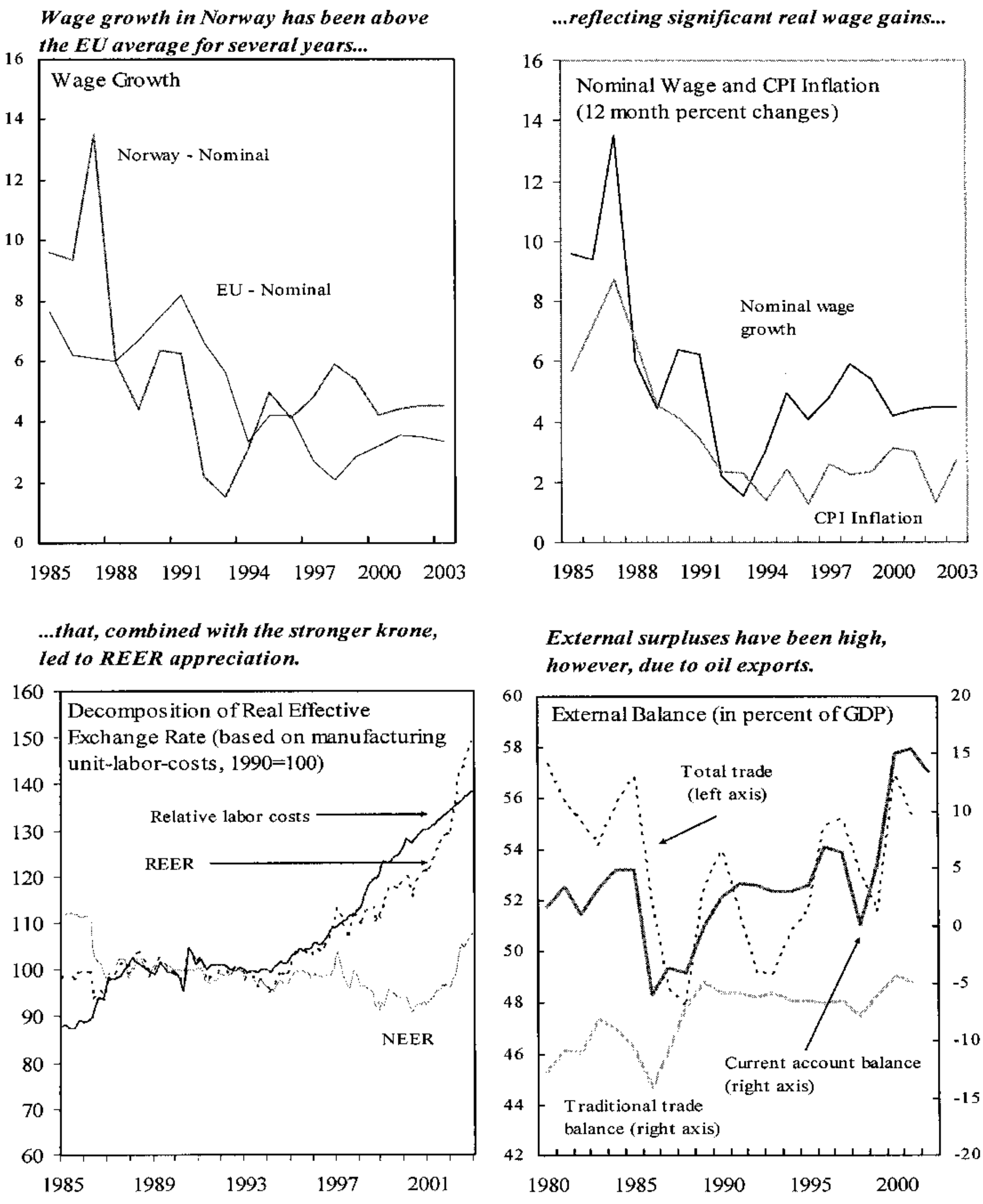
In this light, the Fund has called for fiscal discipline to minimize pressures on the exposed sector through excessive real appreciation so as to engineer a smooth transition to the post-oil era. While the authorities have generally shared these concerns, they have also faced strong popular pressures for greater use of the growing oil fund. The new fiscal guidelines of 2001 (see Box 1) try to address these pressures by allowing additional spending of the oil revenues over the medium term, while at the same time limiting the fiscal expansion to the expected level of real return on the Government Petroleum Fund. At the conclusion of the last consultation in March 2002, Directors noted that the change in the fiscal strategy could, in the absence of timely public pension reform, pose risks to long-term fiscal sustainability and the authorities' stated objective of intergenerational equity.

The Fund has also called for wage moderation and more vigorous labor market reforms to promote flexibility. Again, while in agreement, the authorities have pursued a gradualist and consensual approach, and the progress in fostering flexibility as well as in restricting the take-up of sick leave, disability and early retirement has so far been limited.

The Fund has supported greater flexibility in the conduct of exchange rate policy, and suggested that a more explicit mandate to Norges Bank affirming the objective of low and stable inflation was desirable. The authorities' decision in 2001 to adopt an inflation targeting framework was consistent with this advice and was welcomed by the Board.

4. **Unemployment remained fairly stable as the expansion of the sheltered sector offset employment losses in the exposed sector.** Unemployment has edged up in recent months. In the fourth quarter of 2002, the unemployment rate based on the labor force survey was slightly above 4 percent. In the first part of 2002, layoffs were primarily in information and telecommunications industries, hit by the global slowdown, while labor shortages in some other service industries and the public sector continued. Since then, the weakening of the labor market has been more broad-based. Nominal exchange rate appreciation and wage increases—in excess of productivity gains and substantially higher than among the main trading partners—have led to significant losses in manufacturing competitiveness in 2002, compounding losses over the previous several years (Figure 4). Firms have so far responded to these losses mainly by reducing profit margins rather than employment, as manifested by a rise in the manufacturing wage share from 75 percent in 1995 to about 87 percent in 2001.

Figure 4. Norway: Indicators of Competitiveness



Sources: Statistics Norway; IFS; and IMF staff projections.

5. **Underlying inflation has eased, aided by the strong krone (Figure 5).** A marked appreciation of the krone during 2002—by 25 percent and 9½ percent against the U.S. dollar and the euro, respectively—helped dampen imported inflation (Figure 6). Price increases of domestically produced goods and services moderated in the second half of 2002, further dampening inflation. However, a sudden spike in electricity prices in late 2002 contributed to a sharp rise in headline inflation. Nevertheless, the underlying measure of inflation targeted by Norges Bank—the consumer price index adjusted for tax changes and excluding energy products (CPI-ATE)—eased to 1.8 percent.

6. **With prospects for lower underlying inflation and weakening activity, Norges Bank cut interest rates by 100 basis points in two rapid steps.** The reduction by 50 basis points with a shift to an easing bias announced on December 11, 2002 was followed by another cut of the same magnitude in January 2003, bringing the policy rate down to 6 percent. Looking ahead, Norges Bank maintained the easing bias, reflecting the downside risks to its medium-term inflation forecast. These risks stemmed mainly from the weakening global economic outlook, rising domestic unemployment, and the sustained strength of the krone, and were likely to mitigate the adverse impact of the large settlements negotiated in the spring 2002 wage round. The inflationary impact of higher electricity prices was expected to disappear by the end of Norges Bank's two-year target horizon.

7. **Substantial current account and fiscal surpluses reflect peak oil production and high oil prices, but the Petroleum Fund has sustained losses in its equity holdings.** The current account and general government surpluses are estimated to be at least 12 percent of GDP in 2002, and net external assets about 45 percent of GDP at end-2002. (Tables 2 and 3, and Figure 7). The balances on the GPF at the end of 2001 and 2002 are now estimated to be about 4 percent and 20 percent, respectively, lower than projected in the 2002 Budget as a consequence of the asset losses.[2] The provisional outturn for the non-oil structural deficit in 2002 is higher than originally budgeted, mostly due to higher expenditure growth. The magnitude of the fiscal expansion to 2010—implied by the fiscal guideline on the use of oil revenue—has diminished by 1 percentage point as a result of the asset losses. The implied non-oil structural deficit for 2003 has similarly declined by around 0.6 percentage points of mainland GDP.

8. **The budget for 2003 implies a broadly neutral fiscal stance.** This stance emerged unchanged from the minority coalition government's protracted negotiations with its partners. The budget proposes growth in real underlying expenditure below the rate of mainland output growth, and tax reductions of about 1 percent of mainland GDP, mostly reflecting decisions made in the 2002 budget.

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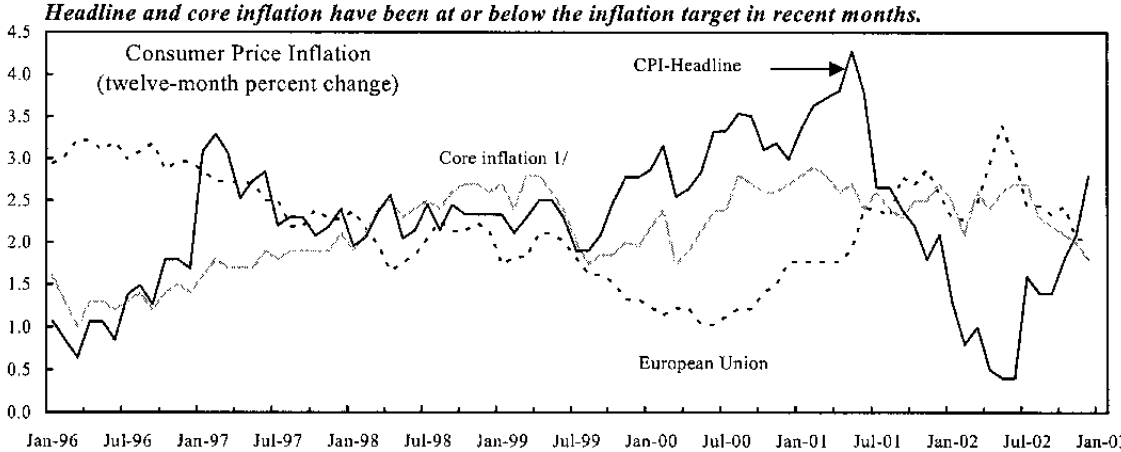
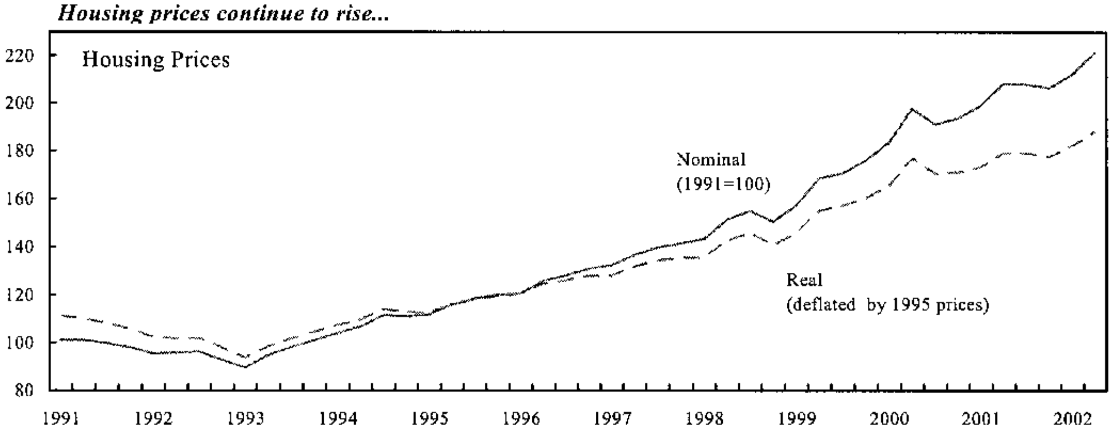
[2] The Government Petroleum Fund is invested in international equities—with an allowable asset mix of 30–50 percent of the portfolio—and interest bearing securities.

Figure 5. Norway: Price Developments

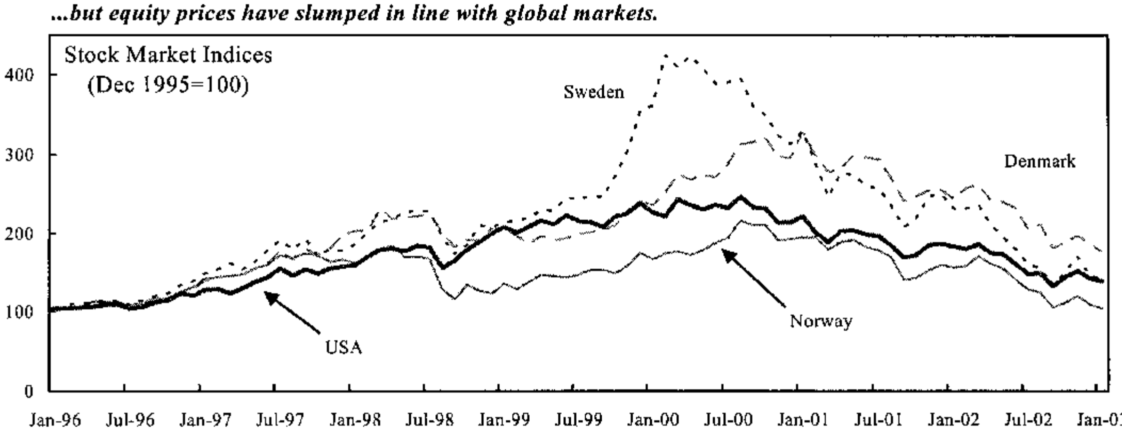
Headline and core inflation have been at or below the inflation target in recent months.



Housing prices continue to rise...



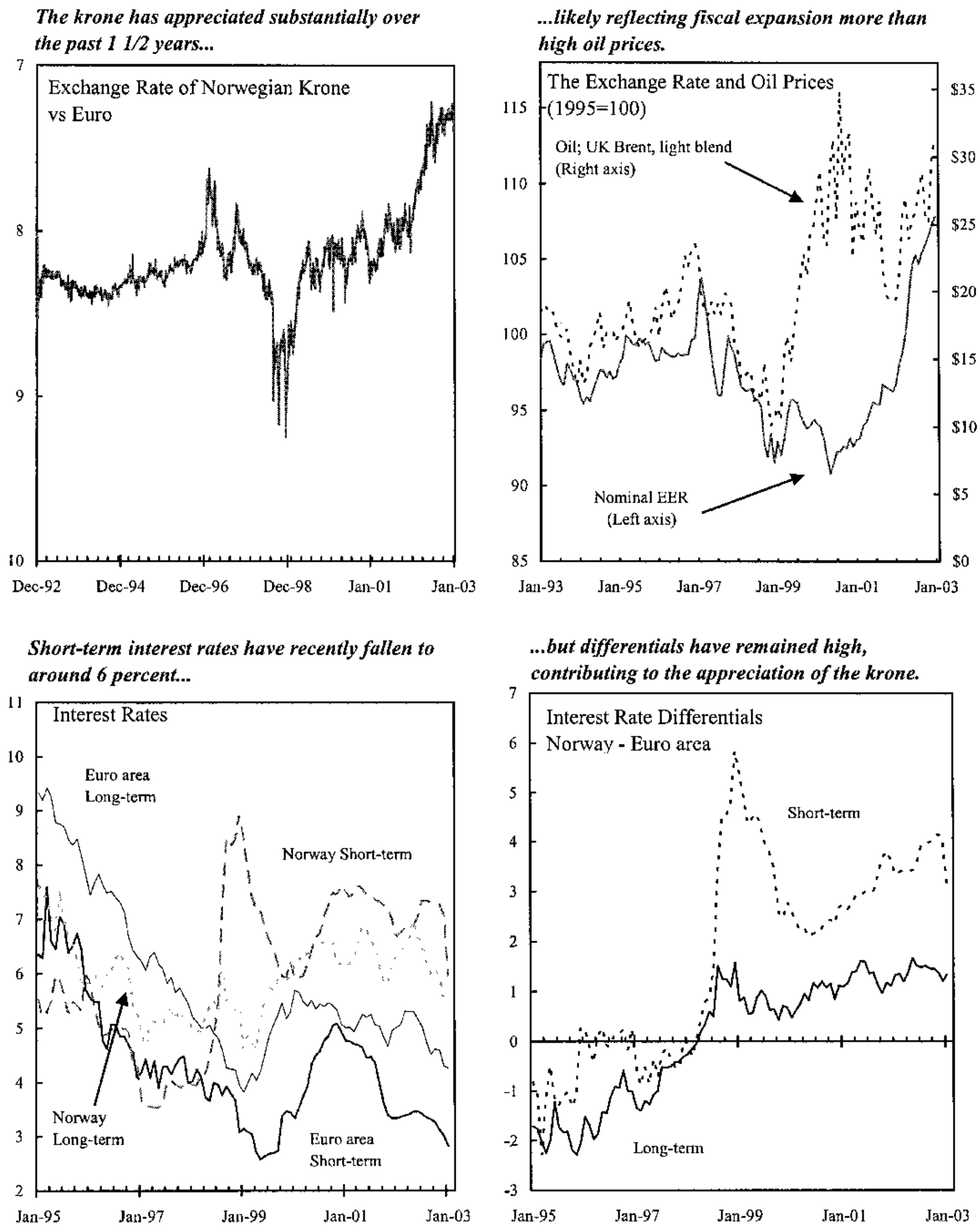
...but equity prices have slumped in line with global markets.



Sources: Bloomberg; Statistics Norway; and WEFA

1/ CPI-ATE: Norges Bank's estimates up to July 2000, thereafter figures published by Statistics Norway.

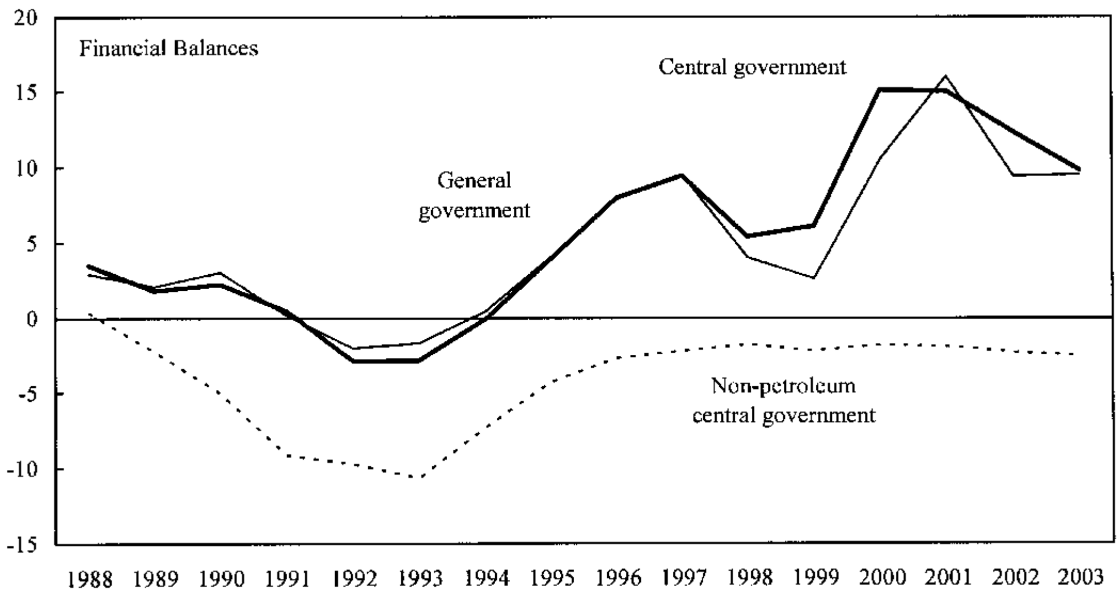
Figure 6. Norway: Exchange and Interest Rate Developments



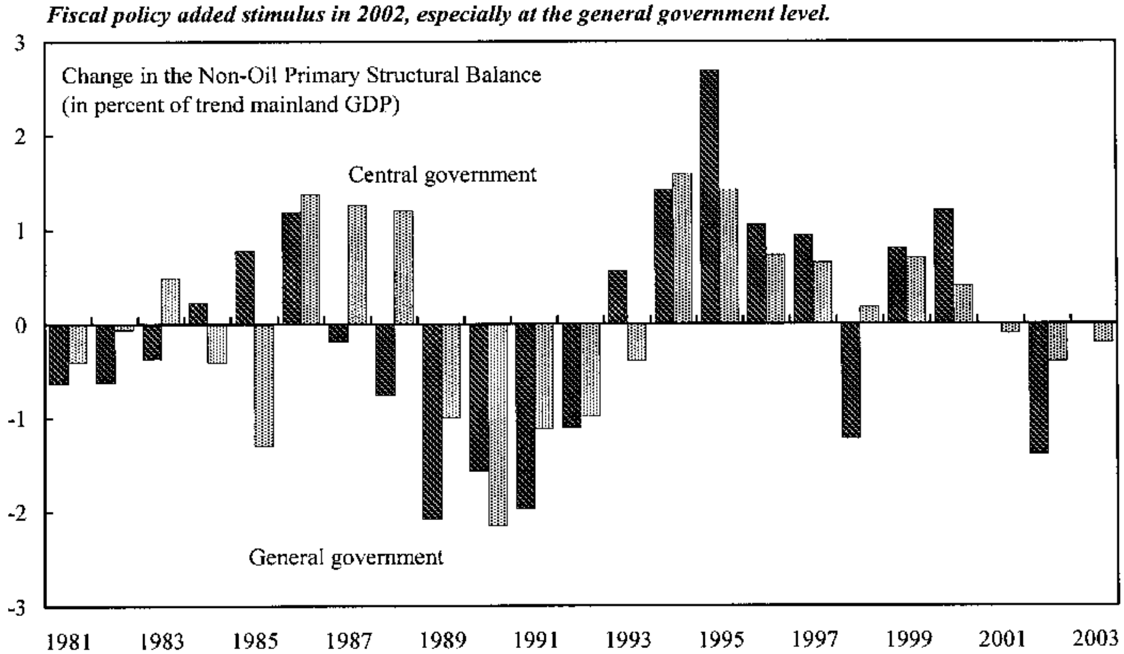
Sources: Bloomberg; IFS; and Statistics Norway

Figure 7. Norway: Public Finances
(In percent of GDP)

High fiscal surpluses reflect peak oil production.



Fiscal policy added stimulus in 2002, especially at the general government level.



Sources: Ministry of Finance and IMF staff estimates.

9. **Global economic weakness, high oil prices, and the policy mix are the key influences on the outlook for 2003.**[3] Weak international demand and low profitability in manufacturing are expected to continue to hamper private investment, traditional exports, and employment, and also constitute the key downside risks. Unemployment is projected to increase as manufacturing firms adjust to the squeeze on profitability by laying off workers. High wage carryover and tax cuts are expected, however, to support disposable income and private consumption, offset only partly by rising unemployment and high electricity prices. A strong expansion in petroleum investment is also planned. On balance, staff project mainland output growth at 1½ percent in 2003, close to the consensus. An international rebound starting late in the year is expected to add to the continued strength of consumption to quickly push mainland output growth up to its trend rate of about 2¼ percent in 2004. Headline inflation is projected to rise this year due to a spike in electricity prices, but core inflation should remain below the inflation target.

II. Report on the Discussions

A. The Main Themes and the Policy Setting

10. **The discussions centered on the economic consequences and key policy challenges posed by the decision to accelerate the use of oil wealth, and on enhancing public understanding of the implications of the new policy framework.** In particular, the main issues included:

- What are the implications of the global slowdown and the current policy mix for the short-term outlook and the viability of the exposed sector?
- How can long-run fiscal sustainability be ensured in the face of demographic pressures and the depletion of the oil wealth, and how can further attempts to erode public savings in response to current spending pressures be prevented?
- How can the inflation targeting framework and its implementation be improved, especially in the context of a sustained fiscal expansion and real appreciation?

[3] The current geopolitical tensions have contributed substantially to the uncertainty regarding the price of oil in the near term. The staff's sensitivity analysis (Table 2a) indicates that a permanent drop in the price of oil to its 10-year average in 2004 would not prevent Norway from continuing to run considerable external and fiscal surpluses over the forecast period.

- How can structural reforms be accelerated, particularly in labor and product markets, to ensure a smooth economic restructuring as well as economic vitality in the post-oil era?[4]

11. **The decision to accelerate the use of oil wealth has implied the need for a relatively tight monetary policy stance and contributed to a sharp appreciation of the krone**. The long-term program of fiscal expansion has required a somewhat higher level of interest rates in the context of inflation targeting. However, the speed and magnitude of the recent exchange rate appreciation had taken policy-makers and analysts by surprise, and most believed that the exchange rate had overshot any reasonable estimate of the equilibrium effects of the fiscal expansion. Temporary factors such as Norway's relative cyclical strength, a shift to interest-bearing securities in the context of weak global equity markets, and Norway's appeal as an investment hedge in the event of oil price spikes may have also contributed to the appreciation. The mission broadly concurred with this assessment, but stressed that the decision to use more oil revenue now, despite large unfunded public pension liabilities, may have reinforced popular over-estimation of national wealth. The resulting pervasive sense of euphoria had adversely affected the wage bargaining climate, leading to excessive wage demands that required even tighter monetary policy, widening Norway's positive interest rate differential and intensifying pressures on industries exposed to international competition.

12. **The authorities considered the policy mix to be more benign in 2003, as a broadly neutral fiscal budget would facilitate a relaxation of monetary policy relative to the path implied by fiscal plans one year ago.** They also anticipated greater efforts at wage moderation. Indeed, a joint declaration in January 2003 by the Liaison Committee—comprised of the heads of all major trade unions and employers as well as the government—signaled that wage growth in 2003 should be adapted to levels compatible with competitiveness in the exposed sector. The mission accepted that the external environment could have some dampening effect on wage growth in 2003, but cautioned against a resurgence of spending and wage pressures once a solid recovery takes hold.

B. Fiscal Policy

13. **The authorities viewed the budget for 2003 as adhering to the broad guidelines of the fiscal rule on the use of oil revenue.** The non-oil structural deficit budgeted for 2003 (30.7 billion kroner) was somewhat higher than that indicated by the fiscal rule adopted last year for use of the Government Petroleum Fund (26.6 billion kroner, see text table for

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[4] The government's latest projections are for oil production to peak later this decade before starting to decline gradually.

details). However, the authorities considered the deviation to be within the guidelines for smoothing the budgetary impact of large fluctuations in the capital value of the Fund.[5]

	2002 Amended Budget 1/	2003 Budget 2/
	(in billions of kroner)	
Market value of GPF at year-end 2001	646.5 3/	619.3 4/
Implied non-oil structural deficit for 2002	25.9 5/	24.8 5/
Actual non-oil structural deficit for 2002	...	27.6
Market value of GPF at year-end 2002	837.7 3/	666.0 3/
Implied non-oil structural deficit for 2003	33.5 5/	26.6 5/
Budgeted non-oil structural deficit for 2003	...	30.7

Source: Ministry of Finance

1/ Presented in December 2001.
2/ Presented in October 2002.
3/ Estimated for the budget before the end of the year.
4/ Actual year-end balance as presented in the revised national budget in May 2002.
5/ Calculated as 4 percent of actual or estimated market value of GPF as shown in the line immediately above.

14. **Staff suggested a greater clarification of the fiscal guidelines to prevent frequent asymmetric deviations from undermining their credibility.** Despite market losses on the GPF, a strict adherence to the fiscal rule in 2002 and 2003 would have allowed a slight increase in the non-oil structural deficit in the 2003 budget, as new revenue from petroleum continued to flow into the fund. However, staff noted that the slippage in the structural deficit in 2002 implied the need for a clawback in 2003.[6] In this sense, the leeway provided in the guidelines to smooth the effects of asset losses on the budget appeared to have been used in 2003 mostly with a view to "smoothing" the required clawbacks. Nevertheless, since the extent of such smoothing was relatively limited, the mission viewed the budget as being broadly in line with the fiscal guidelines. It stressed, however, that the guidelines were already too expansionary given: (i) the threat that long-run pension pressures posed for fiscal sustainability, and (ii) the impact of the policy mix on the exposed sector.

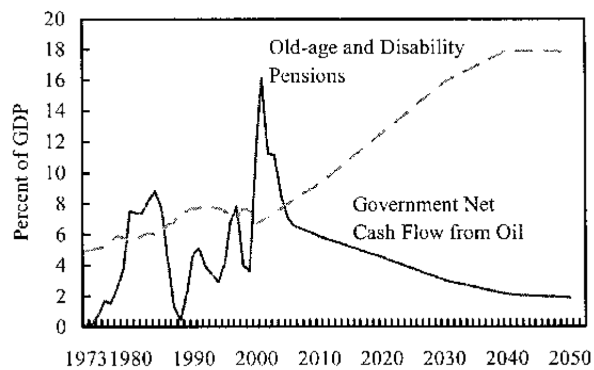
[5] A strict application of the guideline that requires setting the non-oil structural fiscal deficit in line with the 4 percent expected return on the GPF would have entailed a reduction in the deficit by 0.2 percent of GDP in 2003. The budget instead increases this deficit by 0.2 percent of GDP, in order to smooth the effects of large changes in the GPF's capital, followed by a return to the deficit level implied by a strict application of the rule in 2004.

[6] The actual outturn for the non-oil structural deficit for 2002 was estimated at 27.6 billion kroner in the 2003 National Budget, which was higher than the deficit required by the fiscal rule. If the authorities had wished to adhere strictly to the fiscal rule in setting the deficit for 2003, they would have had to lower it to 26.6 billion kroner.

The mission suggested strengthening the fiscal guidelines by clarifying the conditions under which the impact on the budget from fluctuations in the GPF could be smoothed. The authorities believed that the guidelines struck the right balance between rules and discretion, and viewed further refinements as neither needed nor practical at this time.

15. **The discussions covered expenditure pressures and ways to improve the efficiency of the public sector.** The authorities did not dispute that the large wage increases for public employees and the rising use of transfer schemes were driving the growth of nominal spending, thereby threatening to reduce sharply the room available for real increases in public services. Spending growth would also likely intensify the stimulatory effects of fiscal expansion and lead to higher interest and exchange rates relative to tax cuts aimed at increasing potential growth. Although the authorities regarded their fiscal guidelines as a suitable medium-term fiscal anchor, the staff recommended using expenditure ceilings as means of controlling spending growth. The ongoing efforts to raise the efficiency of the public sector continue, but had so far not yielded notable results.[7]

16. **A reform of Norway's generous public pension system was at long last on the policy agenda.** An expected surge in social security expenses due to the demographic transition and maturing of Norway's generous pension system, as well as the expected depletion of oil revenue, threaten long-run sustainability, despite large current fiscal surpluses.[8] A high-powered commission is studying the options for pension reform and is expected to deliver a final report in October 2003. The public debate on the preliminary report of the commission has been focused on the distributional effects of alternative reform options. However, the authorities agreed that a reduction in the very generous public pensions was needed to make the system financially viable, and that using the Petroleum Fund to fund the pension system in itself would not address the intergenerational inequity of the system. The Norwegian policy community was divided on the issue of providing an element of private choice in annual savings, reflecting the difficult trade-offs between the benefits for capital market development versus the higher



Sources: Statistics Norway and Ministry of Finance

[7] For an extensive analysis on enhancing the effectiveness of public spending, see the OECD 2002 Annual Review of Norway.

[8] See Box 2 of IMF Country Report No. 02/44, Box 2 of IMF Country Report No. 01/33 and IMF Country Report No. 01/34 for a discussion of long-run fiscal sustainability scenarios.

administrative costs and the possibility that large capital injections could lead to overinvestment and asset price bubbles.

17. **The authorities intended to continue the program of tax cuts and the agenda for tax reform launched in the 2002 budget.** The elimination of the investment tax had taken effect in autumn 2002. A reduction of some indirect taxes, to bring the level of Norway's indirect taxation in line with neighboring countries, was also on the agenda. In addition, a commission was expected to deliver suggestions for tax reforms. These suggestions were expected to include a reduction in the top marginal income tax rate—to reduce the differential with the capital income rate and the associated opportunities for tax evasion. The mission argued for a particular focus on reducing the high tax burden on labor income, in order to raise incentives to work and returns to education and training. The mission also suggested improving the generally neutral tax system by reducing the lenient tax treatment of property and the bias toward accumulating wealth in the form of housing.

C. Monetary Policy and Financial Sector Issues

18. **Abating underlying inflation pressures provided room for monetary easing.** Norges Bank noted that spillovers from the weaker world economy and the stronger exchange rate were dampening activity in the internationally exposed sectors. Moreover, rising unemployment, weakening consumer and business confidence, as well as gradually slowing credit expansion indicated that growth in the mainland economy was likely to remain subdued, thereby gradually alleviating domestic cost pressures. The pass-through effect resulting from the appreciated krone would also continue to curb inflation. Against this backdrop, the staff saw the need for easing monetary policy. The staff noted, however, that sustained fiscal expansion and resource constraints in the sheltered sector limited the room for monetary easing over the medium term and that the scope for it depended crucially on the ability of the social partners in containing wage increases in line with productivity gains.

19. **The authorities viewed the current institutional framework for monetary policy as broadly appropriate.**[9] The main issues discussed included:

- The staff recommended that the reference to exchange rate stability be dropped from the monetary policy regulation to dispel any public confusion about the monetary policy objective. The authorities stressed that the reference was simply a preamble to the definition of the operational target for monetary policy (i.e., low and stable

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[9] For more detailed discussion of these issues, see "The Inflation Targeting Framework in Norway," by J. Soikkeli (WP/02/184). A study sponsored by the Centre for Monetary Economics at the Norwegian School of Management by a group headed by Lars Svensson ("An Independent Review of Monetary Policy and Institutions in Norway," September 2002) sets out recommendations which are broadly consistent with current and previous Fund advice on the monetary policy framework.

inflation) and that there was broad understanding of the ultimate goal of monetary policy. Moreover, frequent changes to the framework should be avoided.

- The authorities noted that the established reporting guidelines—Norges Bank's annual self-assessment of the conduct of monetary policy in its *Annual Report* and a White Paper by the Ministry of Finance—ensured sufficient accountability to parliament. The staff recommended that the formal accountability of the central bank could be further fostered, for example, by introducing regular independent expert assessments and parliamentary hearings on the conduct of monetary policy.

- To promote transparency and improve communication, Norges Bank had recently decided to publish the *Strategy Documents*[10] (Strateginotat) with a four month lag following the release of the *Inflation Report*. Moreover, Norges Bank had recently initiated two independent expert reviews on its *Inflation Report* and *Strategy Documents*, respectively. The staff argued that depoliticizing the process of nominating members to the Executive Board and appointing professionals with suitable expertise could further strengthen the Bank's decision-making process. Transparency would be enhanced by the publication of the Executive Board's meeting minutes and voting records.

20. **The financial system remains stable, although the outlook has deteriorated somewhat.** Sustained, rapid credit growth in the mainland economy has resulted in high indebtedness of both enterprises and households (Table 4 and Figure 8). In the enterprise sector, the global downturn, high domestic interest rates and falling profitability have contributed to rising debt and interest burdens, with the former reaching, and the latter remaining well below, the levels that prevailed during the banking crisis of the early 1990s. At the same time, household debt and interest burdens have stayed below the levels during the banking crisis, and households' financial assets (excluding insurance claims) in relation to debt are considerably higher than in the early 1990s. Despite falling bank profits, the banks' overall financial position still appears sound. The authorities have conducted stress tests to assess vulnerabilities, including to a potential decline in property prices following the rapid house price increases over the last several years and to a higher rate of wage growth

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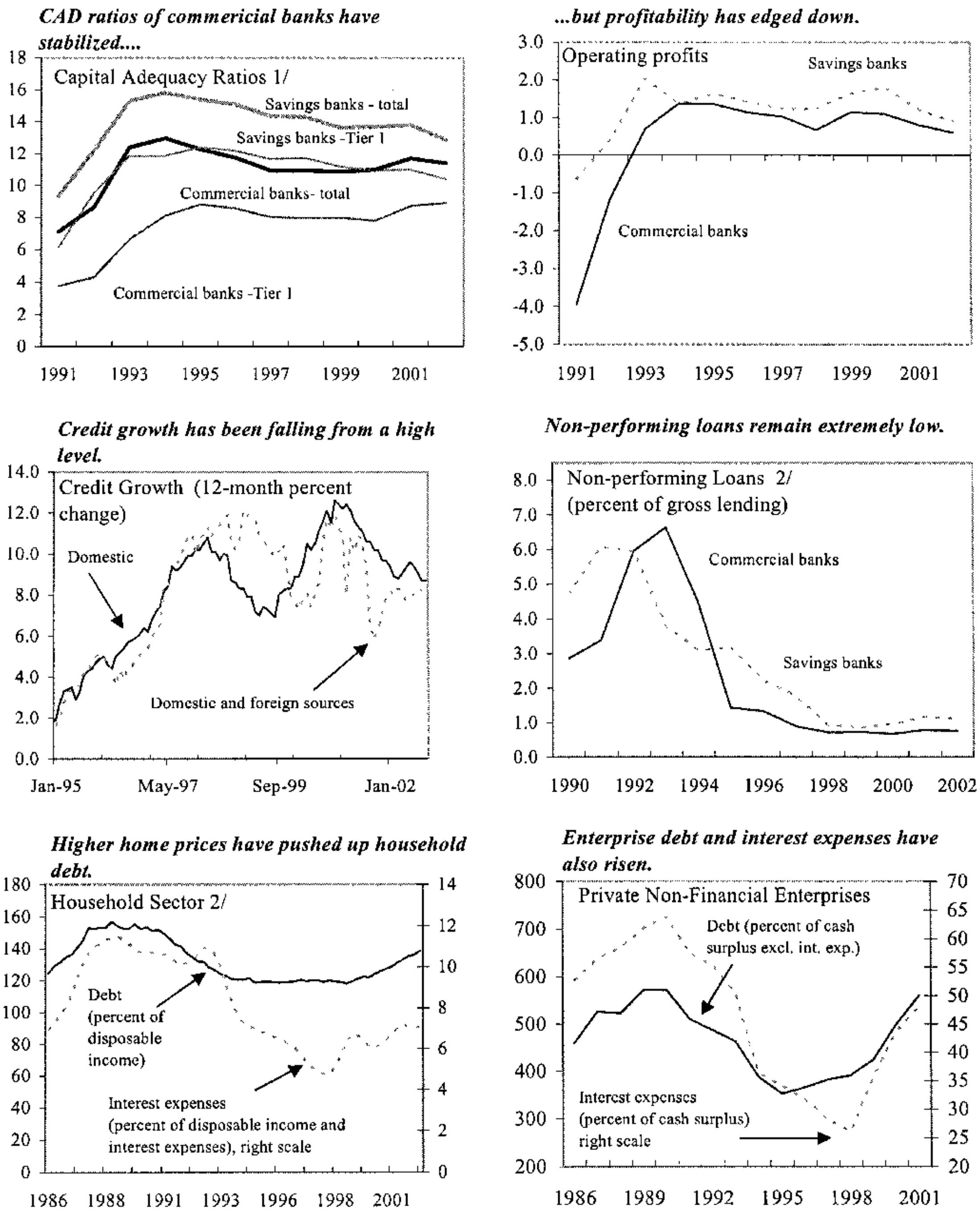
[10] Norges Bank's *Strategy Documents*—including the central bank's assumption for the optimal interest rate path required to bring inflation back to its target by the end of the two year horizon—are prepared for the Executive Board's monetary policy meeting three weeks prior to publication of the *Inflation Report*.

Figure 8. Norway: Indicators of Financial Sector Health



Sources: Norges Bank; and Banking, Insurance, and Securities Commission

1/ Data for 2002 refer to third quarter.

2/ Data for 2002 refer to second quarter 2002.

compared with their baseline scenario.[11] However, given the prolonged rapid credit growth, the sharp real appreciation of the krone and increased uncertainty about the economic outlook, the authorities were open to the staff's suggestion to also explore the impact of an unexpected sharp downturn resulting in a marked increase in unemployment and prolonged deterioration of profitability in the exposed sector.

D. Structural Policies and Other Issues

21. **There was agreement that wage moderation was essential to reverse the rapid decline in competitiveness.** The authorities stressed that continued rapid wage growth would result in higher unemployment, higher interest rates, as well as a stronger krone, thus aggravating the strains of economic restructuring stemming from the greater use of oil wealth.[12] Therefore, it would be crucial to re-establish wage moderation and ensure the leading role of the export industries in the wage bargaining process. The staff agreed and urged that real pay rises above those justifiable by productivity gains and increases in trading partners should be resisted. The authorities also considered that the large rise in public sector pay in 2002 represented some catch-up effects and were therefore hopeful that subsequent wage settlements would be more moderate.

22. **How to raise effective labor supply while ensuring employment and wage flexibility remains a key issue.** Despite a high labor participation rate, average hours worked are low and falling, owing partly to the surge in the take-up of sickness leave. Moreover, increased participation in disability and early retirement schemes is limiting effective labor supply, and indeed, labor shortages are likely to remain a binding constraint on growth in the years ahead. The government's measures to reform the unemployment benefit, disability pension, and vocational rehabilitation schemes; to alleviate caps on overtime; and to liberalize immigration policy are expected to ease these shortages. The current agreement among the social partners based on voluntary measures aimed at reducing sick leave has not prevented the rising trend in the take-up. Indeed, the authorities acknowledged that the sick leave benefit scheme may need to be tightened if the voluntary measures fail to achieve the targeted sick leave levels by the second half of 2003.

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[11] The stress test scenario with a 25 percent decline in property prices had the most negative—but still manageable—effect on financial institutions' losses, particularly losses on loans to enterprises, which would rise by 1.2 percentage points of enterprise debt after three years. In contrast, higher wage inflation had only a marginal impact on loan losses of financial institutions. See Norges Bank's Economic Bulletin Q3 2002.

[12] Wages in the manufacturing and petroleum sectors rose by almost 5 percent and 10 percent, respectively, in the first three quarters of 2002. The authorities estimated that public sector wages grew by about 6 percent in 2002.

23. **Continued structural reforms were seen as important for raising potential growth and alleviating the strains of economic restructuring.** The petroleum sector will contribute to impressive current account surpluses over the medium-term, but the current peak levels of production are expected to dwindle sharply over the next several decades. Moreover, traditional industries exposed to international competition—which are a key source of technological advancement and spillover from abroad—are already under pressure from the program of sustained fiscal expansion and the recent appreciation of the exchange rate. Product market reform would thus be indispensable to help spur private sector initiative. The authorities planned to further reduce the high level of public ownership, but noted that the slump in stock markets had contributed to a slowdown in privatization efforts. Nevertheless, the authorities had focused on measures to foster competition.

24. **The authorities noted that trade protection was generally low, and that the high protection and budget support of agriculture were intended to address domestic non-trade concerns.**[13] The authorities noted that they attach great importance to the ongoing negotiations under the Doha agenda, and support the inclusion of rules on investment and competition in the World Trade Organization. The authorities acknowledged that improved market access for agricultural products is of vital importance to many developing countries as a vehicle for economic growth and poverty alleviation. However, they emphasized the need for flexibility in national policy design to address domestic non-trade concerns, such as the support of sparsely populated areas. They had no immediate plans to extend the coverage of the duty- and quota-free access initiatives beyond least developed countries.

25. **The authorities reaffirmed their continued commitment to official development assistance (ODA).** The 2003 budget set out further increases in ODA, which, at 0.9 percent of GNP, is already among the highest in the world.

26. **Norway's economic statistics are adequate for surveillance purposes** in their coverage, quality, and timeliness (see Appendix I). The authorities also publish comprehensive information on the composition of assets in the Government Petroleum Fund. A Fund mission from the Statistics Department conducted a data module Report on the Observance of Standards and Codes (ROSC) in November 2002, which is expected to be published by mid-2003.

27. **Norway's system for anti-money laundering and combating terrorist financing is generally comprehensive and well-integrated into the system of the European Union**

[13] An estimated two thirds of Norwegian farm revenue is derived from measures to support agriculture, which amounts to about one percent of mainland GDP. Moreover, consumer prices of agricultural products are over 100 percent above world prices (see the OECD 2002 Annual Review of Norway). More generally, the relative price level of private consumption is 29 percent higher in Norway than the EU average (Statistics Norway Economic Survey 4/2002).

(EU). Norway shares information under the Schengen Agreement and is bound by EU directives on money laundering. The authorities therefore plan to adopt a general requirement for non-financial institutions to report suspicious transactions.

III. Staff Appraisal

28. **The Norwegian economy has showed resilience during the past year.** Inflation has remained low, and fiscal and external surpluses continue to be large and robust. Much of this success can be credited to sound economic policies and prudent resource management, including the policy of saving and investing abroad a large part of the revenue from petroleum, currently near peak levels. The new long-term fiscal program put in place in 2001 has helped to clarify the parameters of the policy regime and has been appropriately complemented by the adoption of an inflation targeting framework, affirming the commitment to maintain low and stable inflation.

29. **The fallout from the global slowdown is expected to be temporary, but the process of economic restructuring resulting from the increased use of oil wealth is bound to continue.** A rebound in activity later this year, in line with the expected global recovery, would add to the already high level of domestic resource utilization. The macroeconomic policy mix will continue to exacerbate the strains on the exposed sector over the medium term, unless the social partners exercise wage restraint. Indeed, the program of medium-term fiscal expansion and the related euphoria that has led to excessive wage demands have required high real interest rates, dampening the outlook for mainland investment. Moreover, a continued high interest differential, necessary to offset inflationary impulses from fiscal expansion and lack of wage moderation, would continue to put upward pressures on the external value of the krone, intensifying strains on the exposed industries.

30. **The authorities have broadly adhered to the fiscal rule in 2003, despite significant pressures to increase further the non-oil fiscal deficit.** Looking ahead, a clear and consistent implementation of the fiscal guidelines is essential. Attempts to deviate from the stipulated structural deficit path in an asymmetric fashion or to smooth, and thereby accommodate, previous fiscal slippages risk eroding GPF balances and undermining the discipline of the fiscal rule. Thus, it is necessary to clarify the precise conditions allowing for deviation from the fiscal rule. The clarification should include specifying both the threshold for changes in the market value of the GPF beyond which a deviation from the fiscal rule is permitted as well as the timeframe for smoothing the budgetary impact of such changes. The fiscal rule should continue to be implemented by using a consistent and transparent definition of the structural balance.

31. **The conduct of monetary policy in 2002 was appropriate.** Given the fiscal stimulus in place and the unexpectedly high outcome of the spring wage round, Norges Bank's relatively tight stance in 2002 was justified. Indeed, a relatively high level of interest rates will continue to be needed to ensure low and stable inflation in the context of the decision to phase in greater use of the oil wealth. Recently, as the prospects for underlying inflation and activity moderated, Norges Bank appropriately eased monetary policy. Looking

ahead, the lackluster global economic environment may well have a further adverse impact on the Norwegian economy. However, the scope for lowering interest rates would be seriously undermined if social partners were to engage in another round of excessive wage increases.

32. **Norges Bank's operation of inflation targeting has drawn on best international practice, but further improvements to the framework would be desirable.** Norges Bank's continued efforts to enhance transparency are welcome. In addition, formal accountability could be improved, for example, by introducing regular independent expert reviews and parliamentary hearings on the conduct of monetary policy. Also, the process of nominating members to the Executive Board could be depoliticized and the appointment of professionals with suitable expertise encouraged. Most importantly, the reference to exchange rate stability in the monetary policy regulation continues to divert public attention from the inflation objective. The reference should therefore be deleted at the earliest convenience, perhaps in the context of a further refinement of the monetary framework.

33. **Pension reform should ensure financial viability and incentives to work.** Given demographic trends, the current public pension system is not financially viable, even with the Petroleum Fund. The generous pensions of upcoming retirees can be supported only by a sharp increase in contribution rates of wage earners, which is implausible given the already high level of taxation in Norway. Financial sustainability could be achieved, for instance, by indexing benefits to prices rather than wages. In addition, addressing the disincentive effects of the current pension and tax regimes would improve financial sustainability and stimulate labor supply by raising the average effective retirement age.

34. **Tax reform should focus on measures to raise growth and economic efficiency.** Norway's dual income tax system is generally neutral and supportive of investment. However, ad hoc changes have introduced distortions in recent years. It is to be hoped that the Tax Committee would provide a comprehensive framework for improving the system, including a restoration of the principles of neutrality and efficiency enshrined in the 1992 tax reform. A central focus of reform should be on vigorous pursuit of a reduction in the high tax burden on labor.

35. **Strong efforts to stem expenditure pressures and improve the efficiency of the public sector are imperative.** Rapid expenditure growth would risk derailing the opportunity to lower Norway's high tax burden. Multiyear budgeting and expenditure ceilings could provide one means of controlling expenditure growth. Moreover, increasing the efficiency of the public sector—including by improving pricing mechanisms and ensuring performance-oriented financial management and salary structures—would be a more durable way to increase delivery of public services.

36. **A restoration of Norway's earlier tradition of wage moderation is crucial.** Restraint in wage claims would ease the required level of interest rates, and thereby also reduce pressure on the exchange rate. Wages in the private sector should be set with an eye to maintaining the growth of unit labor costs in line with that in trading partners, and indeed

some additional efforts are required to reverse the significant loss of competitiveness suffered over the past several years. The lead role of exposed industries in the bargaining process should thus be safeguarded. It is essential that public sector employees abstain from excessive wage claims—unrelated to demonstrable improvements in efficiency—both to help contain domestic cost pressures and to ensure that increased public sector outlays will materialize in real increases in services to the public.

37. **Labor market policies should aim at increasing effective labor supply.** Measures underway to reform social benefit systems, to liberalize immigration policy, and to ease working time regulations can help alleviate labor shortages. In addition, economic incentives or tighter eligibility criteria would be required to lower sick leave, as the voluntary agreement among the social partners has failed to stem the sharp rise in the take-up of sickness benefits. Reductions in labor taxation would also help to stimulate labor supply.

38. **Continued structural reforms will be essential to raise potential growth and ameliorate the pressures on the beleaguered exposed sector.** Product market reform will be indispensable to help spur private sector initiative and dynamism. Measures to enhance competition are welcome, but should be complemented by continued progress in deregulation and reducing the high level of public ownership.

39. **The financial system remains sound, although the outlook has deteriorated somewhat.** The authorities are alert to emerging risks and are monitoring the financial system closely, actively using stress testing to assess vulnerabilities. Stress testing should continue to examine emerging risks on an ongoing basis, and the tests should be extended to cover a variety of scenarios most relevant to the weaker economic outlook.

40. **A reduction in the budgetary support and trade protection to agriculture is long overdue.** A reduction in subsidies and trade protection to agriculture would not only alleviate the burden on Norwegian consumers and taxpayers, but help exports of farm products from developing countries, an outcome which would aptly complement Norway's generous official development assistance. Non-trade policy concerns should be addressed in less distortionary ways, such as through direct income support.

41. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Norway: Economic Outlook

	1999	2000	2001	Proj. 2002	Staff Forecasts 2003	Staff Forecasts 2004–06	Official Forecasts 1/ 2003	Official Forecasts 1/ 2004–06
	(Percent change from previous year)							
GDP: Total	2.1	2.4	1.4	1.6	1.8	2.0	1.9	2.0
Mainland	2.7	1.9	1.2	1.4	1.6	2.2	1.8	2.2
Private consumption	3.3	3.5	2.5	3.1	2.9	2.4	3.5	3.4
Public consumption	3.2	1.2	2.0	2.0	2.0	2.3	0.5	1.4
Gross fixed investment	-5.6	-1.5	-4.6	-2.1	2.2	2.0	3.2	-0.4
Oil activities	-17.4	-21.4	-7.4	...	...	...	12.2	-8.0
Mainland	-1.1	6.1	0.7	...	...	...	-1.0	2.2
Domestic demand	0.3	2.5	-0.4	1.7	2.5	2.3	2.7	2.1
Exports	2.8	2.9	4.2	1.4	1.2	2.1	0.8	2.0
Imports	-1.8	3.2	0.0	1.6	3.0	3.0	2.9	2.4
Consumer prices	2.3	3.1	3.0	1.3	2.7	2.5	2.3	2.5
Wages	5.4	4.2	4.4	4.5	4.5	4.5	5.0	4.5
Employment	0.7	0.5	0.4	0.2	0.5	0.5	0.4	0.5
Unemployment rate (Percent of labor force)	3.2	3.4	3.6	3.9	4.2	4.0	4.0	3.8
Output gap (Mainland) (Percent of potential GDP)	2.9	2.0	1.3	0.8	0.2	0.2	...	...
Current account balance (Percent of GDP)	5.4	15.0	15.4	13.4	12.6	9.1	11.5	9.2
Non-oil current acount balance (Percent of GDP)	-7.5	-5.9	-4.5	-4.8	-5.0	-4.7	...	...

Sources: Ministry of Finance and staff estimates.

1/ Forecasts are based on the National Budget for 2003, as published on October 3.

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

	1999	2000	2001	2002 1/	2003	2004	2005	2006
Balance of payments								
Goods and services								
Exports	62.3	78.0	77.8	72.6	91.1	87.8	86.3	85.6
Goods	46.1	60.4	59.4	55.0	70.0	65.4	63.6	62.5
o/w: oil and natural gas	20.4	34.8	33.6	30.9	39.4	33.0	30.6	28.9
Non-factor services	16.3	17.6	18.3	17.6	21.2	22.4	22.8	23.2
Imports	50.5	50.0	49.2	47.9	60.7	62.8	64.3	65.7
Goods	35.4	34.3	33.7	32.1	41.5	43.0	44.0	45.0
Non-factor services	15.1	15.7	15.5	15.8	19.1	19.8	20.3	20.7
Trade balance	10.7	26.1	25.8	22.9	28.4	22.4	19.6	17.5
Services balance	1.2	1.9	2.8	1.8	2.0	2.6	2.5	2.4
Balance of goods and services	11.9	28.0	28.6	24.6	30.5	25.0	22.1	19.9
Balance of factor payments	-3.3	-3.1	-2.6	-1.1	-2.3	-2.1	-1.9	-1.9
Current account balance	8.5	25.0	26.0	23.6	28.2	22.9	20.2	18.0
(In percent of GDP)	5.4	15.0	15.4	...	12.6	10.3	9.0	7.9
Net capital flows	-0.1	-0.2	-0.1	0.0	-0.1	-0.1	-0.1	-0.1
Net financial flows	0.4	-13.6	-23.9	-9.1	-28.1	-22.8	-20.1	-17.9
Reserve changes	-6.1	-3.4	2.1	0.5	0.0	0.0	0.0	0.0
Memorandum items:								
Net foreign assets								
(In percent of GDP)	11.1	23.0	38.9	45.4 2/	...	...	...	...
Government Petroleum Fund								
(In percent of GDP)	18.4	27.2	41.0	43.7 2/	54.2 2/	...	...	...
Nominal effective exchange rate (1995=100)	95.5	92.8	95.5	103.3	...	...	...	...
Real effective exchange rate (1995=100) 3/	97.9	96.1	99.6	107.1	...	...	...	...

Sources: Statistics Norway; Ministry of Finance; and staff estimates.

1/ Jan-Nov.
2/ National Budget 2003 projection for end of year.
3/ Based on CPI.

Table 2a. Norway: Oil Price Sensitivity Analysis
(As percent of GDP unless otherwise indicated)

	2003	2004	2005	2006	2007	2008
Baseline (WEO)						
Oil price ($ per barrel)	28.0	23.5	22.0	21.0	21.0	20.0
Oil exports, gross	17.6	14.9	13.6	12.7	12.4	11.5
Current account	12.6	10.3	9.0	7.9	7.4	6.4
General Government Balance	10.0	8.2	7.6	7.1	7.0	6.6
Lower oil price scenario						
Oil price ($ per barrel)	28.0	19.8	19.8	19.8	19.8	19.8
Oil exports, gross	17.6	12.8	12.5	12.1	11.8	11.4
Current account	12.6	8.2	7.8	7.3	6.8	6.3
General Government Balance	10.0	6.8	6.8	6.7	6.6	6.5

Source: Staff estimates.

Table 3. Norway: Financial Indicators

	1999	2000	2001	Est. 2002	Proj. 2003
			(In percent of GDP)		
State Budget:					
Revenue	40.5	43.9	50.2	46.9	45.6
of which : oil revenue	6.1	12.6	17.8	12.5	12.0
Expenditure	37.9	33.5	34.2	37.5	36.0
of which : oil investment	2.5	1.6	1.8	1.1	1.0
Balance	2.6	10.5	16.0	9.4	9.5
of which : non-oil balance	-1.0	-0.5	0.0	-2.0	-1.4
Structural non-oil balance 1/	-2.2	-1.8	-1.9	-2.3	-2.5
Change from previous year	0.7	0.4	-0.1	-0.4	-0.2
General Government:					
Revenue	50.9	55.5	56.2	56.3	54.0
Expenditure	44.8	40.4	41.3	43.8	44.0
Balance	6.1	15.1	15.0	12.5	10.0
Non-oil balance excl. interest	-1.9	-1.4	-2.0	-2.8	-2.7
Structural non-oil balance 1/	-3.7	-2.5	-2.4	-3.8	-3.8
Change from previous year	0.8	1.2	0.0	-1.4	0.0
Net assets	52.7	60.8	73.4	85.8	92.4
Monetary Indicators:					
M2 2/	10.8	9.2	8.6	8.2	...
Domestic credit 2/	8.3	12.4	9.8	8.9	...
Three-month interbank rate 3/	6.5	6.7	7.2	6.9	...
Ten-year government bond yield 3/	5.5	6.2	6.2	6.4	...

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

1/ Percent of trend mainland GDP.

2/ End-period, percent change, national definition.

3/ Period average, in percent.

Table 4. Norway: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	2002	
External Indicators								
Exports of goods and services (annual percentage change, in U.S. dollars)	17.3	8.1	-8.1	13.3	42.3	1.8	2.8	
Imports of goods and services (annual percentage change, in U.S. dollars)	9.9	12.0	9.7	-2.1	10.3	0.4	5.9	
Terms of Trade (annual percentage change)	8.1	1.0	-11.8	15.6	36.0	7.0	...	
Current account balance	6.5	5.6	-0.9	4.1	15.0	15.4	13.4	
Capital and financial account balance	-5.2	-4.0	4.3	-3.7	-9.7	-12.6	-4.6	
Direct investment, net	-1.7	-0.8	0.7	1.4	-1.4	2.0	-1.7	
Portfolio investment, net	-6.1	-6.5	-1.5	-1.9	-10.3	-16.1	10.9	
Central Bank international reserves (end of period, in billions of U.S. dollars)	26.4	23.4	18.7	24.1	27.8	20.6	28.2	
Exchange rate against US dollar (NOK, period average)	6.3	6.5	7.1	7.6	8.8	9.0	8.0	
Exchange rate against Euro (NOK, period average)	8.2	8.0	8.5	8.3	8.1	8.0	8.5	
Real effective exchange rate (based on CPI, annual percentage change)	-0.2	1.3	-2.8	-0.3	-1.8	4.5	10.2	
Financial Markets Indicators								
Gross public debt (end of period)	31.0	28.6	27.0	23.5	22.0	21.0	...	
3-month T-bill yield (nominal, in percent per annum)	4.9	3.7	5.8	6.5	6.7	7.2	7.1	
3-month T-bill yield (ex post real, in percent per annum)	3.6	1.2	3.1	4.2	3.7	6.2	5.8	
spread of 3-month T-bill vs. Germany (percentage points, end of period)	1.6	0.4	2.3	3.6	2.4	3.0	3.1	
spread of 10-year T-bill vs. Germany (percentage points, end of period)	0.5	0.2	0.8	1.0	0.9	1.3	1.3	
General stock index (annual percentage change)	30.8	27.0	-25.8	42.3	9.8	1.4	-26.1	
Real estate price index (annual percentage change)	9.2	8.1	6.3	17.0	10.1	7.2	6.4	
Credit from domestic sources (growth rate in percent)	6.0	10.2	8.3	8.3	12.4	9.8	8.7	
Financial Sector Risk Indicators								
Loans to assets, commercial and savings banks (in percent)	78.3	81.1	82.2	81.2	80.0	79.8	80.0	Sep-02
Tier 1 capital ratio, commercial banks	8.6	8.0	8.0	8.0	7.8	8.7	8.9	Jun-02
Tier 1 capital ratio, savings banks	12.2	11.7	11.7	11.2	10.9	11.0	10.4	Jun-02
Share of foreign exchange loans 1/	4.9	5.4	7.2	7.1	8.6	8.5	7.8	Sep-02
Share of foreign exchange deposits 1/	4.1	4.0	3.6	3.4	3.5	3.7	2.9	Sep-02
Operating profits before tax, commerical banks (in percent of average total assets)	1.1	1.0	0.7	1.2	1.2	1.1	0.9	Jun-02
Operating profits before tax, savings banks (in percent of average total assets)	1.4	1.2	1.2	1.6	1.8	1.2	0.9	Jun-02
Household debt (in percent of disposable income)	119.4	120.1	118.9	122.3	127.1	135.3	138.7	Jun-02
Private non-financial enterprise debt (in percent of cash surplus excluding interest expense)	366.0	383.0	392.0	425.0	499.0	560.0	...	

1/ Percent of commercial and savings banks loans to / deposits from the private sector and municipalities.
Sources: Norges Bank; IFS; and staff calculations.

Norway: Basic Data

Social and Demographic Indicators	
Area	323,878 square kilometers
Population (2002)	4.54 millions
Population growth (2001-02)	0.6 percent
GDP per capita (2002)	US$ 39,805
Population Characteristics and Health	
(most recent estimates as of December 1989)	
Life expectancy at birth: Overall	78
Female	81
Infant mortality (aged under 1, in percent)	0.5
Population per physician	451
Population per hospital bed	67

	1997	1998	1999	2000	2001	2002
	(Volume changes in percent)					
Private consumption	3.2	2.7	3.3	3.5	2.5	3.1 1/
Public consumption	2.5	3.3	3.2	1.2	2.0	2.0 1/
Gross fixed investment	13.9	10.6	-5.6	-1.5	-4.6	-2.1 1/
Export of goods and services	7.7	0.6	2.8	2.9	4.2	1.4 1/
Of which: Oil and gas	2.9	-3.6	-0.1	6.4	7.3	3.3 1/
Import of goods and services	12.4	8.5	-1.8	3.2	0.0	1.6 1/
GDP	5.2	2.6	2.1	2.4	1.4	1.6 1/
Mainland GDP 2/	4.9	4.1	2.7	1.9	1.2	1.4 1/
	(In percent of labor force)					
Unemployment	4.1	3.2	3.2	3.4	3.6	3.9
	(Percentage changes)					
Consumer prices	2.6	2.3	2.3	3.1	3.0	1.3
Hourly labor cost in manufacturing	4.8	5.9	5.4	4.2	4.4	4.5
Effective exchange rate						
Nominal	-1.1	-7.3	3.1	-1.9	3.9	11.5
	(Twelve month percent change, national definition)					
Broad money, M2	2.5	4.6	10.8	9.2	8.6	8.2
Domestic credit	10.2	8.3	8.3	12.4	9.8	8.9
	(In percent)					
Three-month Interbank rate	3.7	5.8	6.5	6.7	7.2	6.9
Ten-year government bond yield	5.5	5.3	5.5	6.2	6.2	6.4
	(In percent of GDP)					
State budget, including social security						
Revenues	43.6	42.3	40.5	43.9	50.2	46.9
Expenditures	37.5	39.8	37.9	33.5	34.2	37.5
Overall balance	6.1	2.5	2.6	10.5	16.0	9.4
General government financial balance	7.9	3.5	6.1	15.1	15.0	12.5
Current account balance	6.3	0.0	5.4	15.0	15.4	13.4
International reserves (in months of imports of goods and services)	5.4	4.1	4.8	5.2	4.1	4.4

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

1/ Staff estimates and projections as of February 2003.

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

NORWAY: FUND RELATIONS
(As of December 31, 2002)

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

II.	**General Resources Account**:	**SDR Million**	**% Quota**
	Quota	1,671.70	100.00
	Fund holdings of currency	941.92	56.34
	Reserve position in Fund	729.81	43.66

III.	**SDR Department**:	**SDR Million**	**% Allocation**
	Net cumulative allocation	167.77	100.00
	Holdings	232.07	138.33

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 an independent float, following the adoption of an inflation targeting regime on March 29, 2001.

On February 27, 2002, the Norwegian authorities notified the IMF of measures taken to freeze the accounts of the Taliban and of listed individuals and organizations associated with terrorism, in accordance with the relevant UN Security Council resolutions. Restrictions are imposed on financial transactions with Iraq. Blocked accounts and restrictions on financial transactions with respect to the Federal Republic of Yugoslavia are limited to certain Yugoslav citizens.

VIII. **Article IV Consultation**: Discussions for the 2001 Article IV Consultation were held in Oslo, November 28-December 6, 2001. The Staff Report (SM/02/36) was considered by the Executive Board on March 1, 2002.

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 January 30, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance 1/	GDP/ GNP	External Debt/Debt Service
Date of Latest Observation	1/30/03	12/31/02	11/30/02	11/30/02	11/30/02	1/30/03	Dec. 02	Dec. 02	Nov. 02	2002	2002 Q3	Sep. 02
Date Received	1/30/03	1/08/03	12/15/02	12/15/02	1/09/03	1/30/03	1/10/03	1/15/03	1/28/2003	10/03/02	12/12/02	Dec. 02
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).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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

IMF Concludes 2002 Article IV Consultation with Norway

On March 7, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Norway.[1]

Background

Norway enjoyed a decade of sustained economic expansion in the 1990s, aided by consensual policies and prudent resource management centered on the strategy of investing abroad the bulk of revenues from the exploitation of petroleum resources. As government oil revenues skyrocketed in the last few years and the Government Petroleum Fund (GPF) balances began to build up rapidly, mounting political pressure for greater use of the oil revenues in the near-term led to the adoption of guidelines for a new macroeconomic policy framework in March 2001. The new fiscal guidelines implied a rise in the non-oil structural fiscal deficit by about 3 percentage points of GDP from 2001 to 2010. By linking the budgetary use of oil revenue to the real return on GPF balances, fiscal policy thus ceded more of the onus for stabilization to monetary policy. Norges Bank was assigned an explicit objective to target medium-term inflation, although output, employment, and exchange rate stability were also specified as desirable goals. Economic developments over the past two years have reflected the effects of the prospective fiscal expansion and the tighter monetary policy thus required to achieve the inflation target.

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[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 discussions are described.

Mainland GDP growth edged up to an estimated 1.4 percent in 2002, from 1.2 percent in 2001, driven by strong consumption growth. Mainland investment and traditional exports slackened, as a result of weak external demand, high real interest rates, and an appreciation of the nominal effective exchange rate by 11.5 percent during 2002. Unemployment remained fairly stable through 2002 as the expansion of the sheltered sector offset employment losses in the exposed sector, although it rose to about 4 percent at the end of the year. Manufacturing competitiveness declined as wage increases were in excess of productivity gains and substantially higher than among the main trading partners, and the nominal exchange rate appreciated markedly.

Underlying inflation eased in 2002, aided by low inflation of imported goods. With a deterioration in the economic outlook leading to prospects for lower underlying inflation, Norges Bank cut interest rates in December 2002 and January 2003 by 50 basis points each, bringing the policy rate to 6 percent. Looking ahead, Norges Bank maintained an easing bias, reflecting the downside risks to its medium-term inflation forecast. These risks stemmed mainly from the weakening global economic outlook, rising domestic unemployment, and the sustained strength of the krone, and were likely to mitigate the adverse impact of the large settlements negotiated in the spring 2002 wage round.

Current account and general government surpluses estimated above 12 percent of GDP in 2002 reflect peak oil production and high oil prices. However, the balance on the GPF at the end of 2002 is now estimated to be around 26 percent lower than projected in the 2002 budget due to losses sustained by the Petroleum Fund in its equity holdings. Consequently, the magnitude of the fiscal expansion to 2010 implied by the fiscal guideline on the use of oil revenue has diminished by 1 percentage point and the allowable non-oil structural deficit for 2003 has similarly declined by around 0.6 percentage points of mainland GDP. The budget for 2003 implies a broadly neutral fiscal stance, with an emphasis on maintaining the growth in real underlying expenditure below the rate of mainland output growth, and a continuation of the program of tax reductions begun in the 2002 budget.

Global economic weakness, high oil prices, and the policy mix are the key influences on the outlook for 2003. Weak international demand and low profitability in manufacturing are expected to continue to hamper private investment, traditional exports, and employment, and also constitute the key downside risks. Unemployment is projected to increase as manufacturing firms adjust to the squeeze on profitability by laying off workers. High wage carryover and tax cuts are expected, however, to support disposable income and private consumption, offset only partly by rising unemployment and high electricity prices. A strong expansion in petroleum investment is also planned. On balance, mainland output is projected to grow at 1.6 percent in 2003. An international rebound starting late in the year is expected to add to the continued strength of consumption to quickly push mainland output growth up to its trend rate of about 2.3 percent in 2004. Headline inflation is projected to rise this year due to a spike in electricity prices, but core inflation should remain below the inflation target.

Executive Board Assessment

Executive Directors endorsed the thrust of the staff appraisal. They commended the authorities for the resilience of the Norwegian economy during 2002, marked by the maintenance of low inflation, virtually full employment, and sizeable fiscal and external surpluses. Directors considered that the policy strategy centered on investing abroad the bulk of petroleum revenues in the Government Petroleum Fund, the gradual phasing in of the use of oil revenues, and the commitment to low inflation had contributed to this favorable economic performance. In the long run, the process of economic restructuring resulting from the increased use of oil wealth is likely to continue.

Directors noted that the economic outlook for 2003 had deteriorated. The weak global economic environment, high real interest rates, and the strong krone were expected to hold back mainland investment and traditional exports. High wage growth would support disposable income and private consumption, but would further erode business profitability and the competitiveness of the non-oil exposed sector. Directors cautioned against the risk of high wage increases, which could lead to a continuation of high interest rate differentials and exchange rate appreciation that would exacerbate strains on the exposed sector.

Directors welcomed the recent relaxation of monetary policy, but cautioned that the scope for further easing could be undermined if social partners were to obtain another round of excessive wage increases. Directors encouraged continued efforts to promote transparency and accountability of the inflation targeting framework. They noted that improvements could include deleting the reference to exchange rate stability in the monetary policy regulation, introducing regular independent expert reviews and parliamentary hearings on the conduct of monetary policy, and appointing professionals with appropriate expertise to the Executive Board of Norges Bank.

Directors considered that the authorities had broadly adhered to the fiscal rule for the use of oil revenues in setting the budget for 2003. They cautioned, however, against asymmetric deviations from the rule in the future, especially those intended to ease the fiscal stance beyond the path implied by the rule. Caution was warranted not only to preserve the credibility of the rule, but also because the fiscal path under the rule did not provide sufficient savings to accommodate the large public pension obligations associated with the coming demographic transition. Directors therefore recommended that the authorities clarify the conditions for smoothing the budgetary effects of changes in the market value of the Government Petroleum Fund.

Directors supported the authorities' intention to reduce Norway's high tax burden, and encouraged tax reform focused on the principles of tax neutrality and efficiency. Directors considered that strong efforts would be required to modernize the public sector and curb expenditure pressures to ensure that room remained for tax reductions. Directors suggested the adoption of multiyear budgeting and expenditure ceilings as a means of establishing spending control. They advised introducing pricing and performance-based mechanisms to improve public sector efficiency.

Directors noted that the public pension system needed to be reformed to ensure the financial viability and intergenerational equity of the system. This objective could be achieved in a variety of ways, such as by indexing benefits to prices rather than wages. Directors also encouraged the authorities to address the disincentive effects of the pension and tax regimes to raise effective labor supply.

Directors encouraged the social partners to make strong efforts to restore competitiveness by containing wage demands, and by safeguarding the lead role of exposed industries in the wage bargaining system. Directors welcomed the authorities' measures to increase labor supply by reforming social benefit systems, liberalizing immigration, and easing working time regulations, but considered that economic incentives and tighter eligibility criteria would likely be required to stem the steep rise in sickness leave.

Directors welcomed efforts to foster competition in product markets, and called for further progress in privatization and deregulation. They urged the authorities to reduce Norway's budgetary support and trade protection to agriculture, by attempting to address their non-trade policy concerns through less distorting measures.

Directors commended the authorities for their ongoing efforts to monitor financial sector soundness through stress-testing. The weak economic environment called for a continuation and intensification of such supervisory vigilance. Directors also noted Norway's generally comprehensive system for anti-money laundering and combating terrorist financing.

Directors praised Norway's continued generous official development assistance, which, at about 0.9 percent of GNP, stands among the highest in the world. They warmly welcomed the authorities' intention to raise such assistance even further.

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

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Norway: Selected Economic Indicators

	1999	2000	2001	2002 1/	2003 1/
Private consumption	3.3	3.5	2.5	3.1	2.9
Public consumption	3.2	1.2	2.0	2.0	2.0
Gross fixed investment	-5.6	-1.5	-4.6	-2.1	2.2
Export of goods and services	2.8	2.9	4.2	2.4	1.2
Of which: Oil and gas	-0.1	6.4	7.3	3.3	1.8
Import of goods and services	-1.8	3.2	0.0	1.6	3.0
GDP	2.1	2.4	1.4	1.6	1.8
Mainland GDP 2/	2.7	1.9	1.2	1.4	1.6
Unemployment	3.2	3.4	3.6	3.9	4.2
Consumer prices	2.3	3.1	3.0	1.3	2.7
Hourly labor cost in manufacturing	5.4	4.2	4.4	4.5	4.5
Nominal effective exchange rate	3.1	-1.9	3.9	11.5	...
Broad money, M2	10.8	9.2	8.6	8.2	...
Domestic credit	8.3	12.4	9.8	8.9	...
Three-month interbank rate 3/	6.5	6.7	7.2	6.9	...
Ten-year government bond yield 3/	5.5	6.2	6.2	6.4	...
	(In percent of GDP)				
State budget, including social security					
Revenues	40.5	43.9	50.2	46.9	45.6
Expenditures	37.9	33.5	34.2	37.5	36.0
Overall balance	2.6	10.5	16.0	9.4	9.5
General government financial balance	6.1	15.1	15.0	12.5	10.0
Current account balance	5.4	15.0	15.4	13.4	12.6
International reserves (in months of imports of goods and services)	4.8	5.2	4.1	4.4	...

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

1/ Staff estimates and projections as of February 2003.

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

3/ Period average, in percent.