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Norway: 2007 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Norway

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 2007 Article IV consultation with Norway, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 26, 2007, 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 May 10, 2007. 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 staff supplement of May 30, 2007 updating information on recent developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 4, 2007 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Norway.

The document listed below has been or will be separately released.

Selected Issues Paper

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 2007 Article IV Consultation

Prepared by Staff Representatives for the 2007 Consultation with Norway

Approved by Juha Kähkönen and Adnan Mazarei

May 10, 2007

Executive Summary

Against a backdrop of strong growth and tightening capacity constraints, the discussions focused on policy requirements for continued noninflationary growth, longer-term fiscal sustainability, and key structural issues.

The authorities and staff agreed that further interest rate increases are warranted to head off inflationary pressures. The financial sector appears to be in good health, but risks have risen. The supervisor is closely monitoring the situation, although its scope for action is limited by the possibility that foreign bank subsidiaries will, if pressed, switch to branches, which would not be supervised by Norway.

Staff welcomed that the relevant fiscal deficit would, for the first time, be 4 percent of Government Pension Fund (GPF) assets. It was agreed that the deficit should be held below this benchmark until demand pressures ease. To manage increasing petroleum revenues, staff recommended tax cuts rather than spending increases, (current policy is to keep the revenue-GDP ratio at the 2004 level), and a medium-term fiscal framework, although the authorities viewed the existing fiscal guidelines as fulfilling this role.

Staff welcomed the recent parliamentary agreement on pension reform, and the intention to pursue complementary reforms. Staff argued that further reform should be considered to ensure long-term fiscal sustainability.

Norwegian labor markets perform well, but it was agreed that the challenge of the growing sickness and disability schemes was a high priority. The mission argued for continued aggressive enforcement of competition law, and that the strong governance system for state-owed enterprises be maintained and further privatization considered.

Data are adequate for surveillance, and in some instances very strong by international comparison. An improved labor force survey and an establishment survey would enhance the analysis of labor market developments.

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I. Background

1. **The economy is booming, while inflation has been moderate** (Table 1, Figure 1). Real GDP growth has been above potential (estimated at 2½–3 percent) for 3 years, and was 4.6 percent in 2006.[1] Activity is being driven by strong external demand, high world prices for petroleum products (Norway was the world's fifth largest oil exporter in 2006) and other Norwegian exports, supportive monetary conditions, and a somewhat expansionary fiscal stance. Despite rising pressure on capacity (Figure 2), core inflation was about 1 percent in 2006, well below the 2.5 percent inflation target, but ticked up to 1.5 percent in March (Figure 3). Falling import prices and increased domestic competition and productivity in some sectors have held prices down. Labor costs have also been moderate, reflecting labor inflows from the new EU member countries, a substantial cyclical increase in the participation rate, strong productivity growth, low inflation, and the credible inflation targeting framework.

2. **However, demand pressures are building, especially in labor markets**. Employment is rising very rapidly, the unemployment rate has fallen to near-record lows, and reports of labor shortages and wage drift are increasing. Labor markets could be very tight when the two-year wage settlement will be up for renegotiation in early 2008 and, although the main labor and employer organizations favor wage moderation, market pressures will be strong. An important uncertainty is the role of large inflows of migrant workers, notably from the new EU countries (Box 1). These flows are not well measured, since residents of Nordic countries can work in Norway without permits and thus are not recorded, and inflows from elsewhere are imperfectly captured.

3. **The external position is strong**. The overall current account has a large surplus, and the non-oil current account deficit has narrowed slightly, despite increased imports of investment goods, because of improving terms of trade (Table 2, Figure 4). On a range of indicators, the exchange rate seems broadly appropriate, and Norway does not intervene on the exchange market. Export market shares in value terms have changed little and exporters' profits are strong, suggesting international competitiveness has been maintained. The krone has been broadly stable in nominal effective terms and against the euro, although it has appreciated somewhat against the dollar (Figure 5). In real terms it has appreciated on a unit labor cost basis, but is not far from its long-term average on a consumer price basis.

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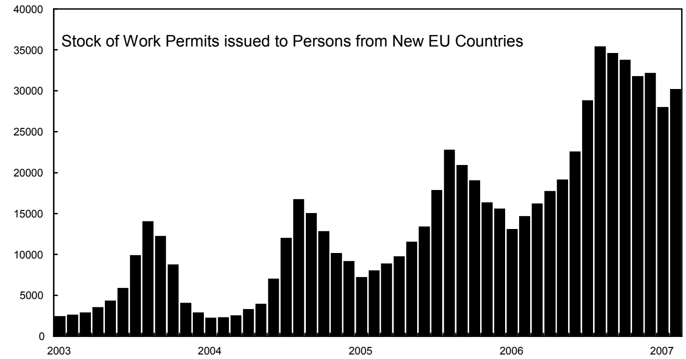
[1] GDP refers to mainland GDP, which is all domestic production except from exploration of crude oil and natural gas, services activities incidental to oil and gas, and transport via pipelines; and ocean transport.

Box 1. Labor Inflows and Inflationary Pressure

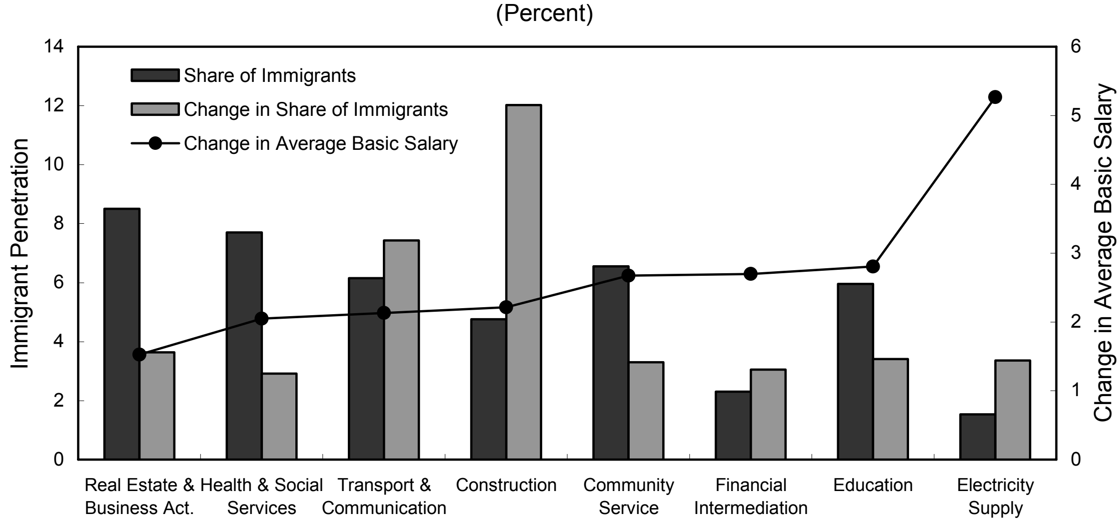
The influx of immigrants in Norway is widely believed to have moderated wage growth, allowing for easier monetary conditions than otherwise. A comparison across industries in Norway of the change in average basic salary and measures of immigrant penetration lends support to this view.



Source: Ministry of Finance

The chart below shows the top and bottom four industries in terms of average wage growth from 2001–05. Those with the lowest average wage growth tend to have either the highest share of resident immigrants (Real Estate and Health) or the highest growth rate (Construction and Transport and Communication). Particularly notable is the moderate wage increase in construction, which has expanded rapidly during the housing boom but also attracted the largest rise in immigrant workers.

Immigration and Wages in Norway (2001-05)
(Percent)



Source: Statistics Norway.

Owing to lack of comparable data, these figures exclude nonresident immigrants who work for six months or less, or commute across the border everyday. While the levels are smaller, growth of this type of immigrant has reportedly exceeded those of others.

Purchasing power parity calculations suggest the krone is overvalued, reflecting some Dutch disease effects, while staff cross-country estimates of fundamental exchange rates (using the CGER methodology) suggest undervaluation, reflecting the mitigation of those effects by the policy of investing petroleum revenue abroad.

4. **The well-developed macroeconomic policy framework has underpinned robust noninflationary growth**.[2]

- Fiscal guidelines, adopted in 2001 and effective since the 2002 budget, hold the central government structural non-oil deficit to 4 percent (equal to the assumed long-run real rate of return) of the assets of the Government Pension Fund-Global (GPF; formerly the Petroleum Fund). While the 4-percent rule has never been met, the guidelines have successfully restrained deficits, insulated the budget from oil-market shocks, resulted in the bulk of petroleum revenues being saved, and restrained the increase in real exchange rates that would have resulted had those revenues been spent instead. [3]

- Monetary policy has since 2001 been governed by a target of 2½ percent consumer price inflation and a flexible exchange rate. This framework has been strengthened by fostering transparency (annual testimony by the Norges Bank (NB) governor to parliament, annual external policy evaluation, and thrice-yearly policy reports), improved governance (a revamped executive board), and a well articulated policy framework (comprehensive press releases following interest-setting meetings and explicit forecasts, including of interest rates).

- The center-left coalition reaffirmed both policy regimes upon taking office in 2005, and the recent record of implementing Fund advice has been good (Table 3).

5. **Against this favorable policy backdrop and bright outlook, the challenges facing policymakers revolve around ensuring continued noninflationary growth and long-term fiscal sustainability**. The task for monetary policy is to allow inflation to rise back to its target while avoiding overshooting and a subsequent sharp rise in the policy interest rate. Indicators suggest the financial sector is sound, although it faces rising risks

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[2] For the fiscal guidelines, see http://www.regjeringen.no/en/ministries/fin/Selected-topics/Economic-Policy/Economic-Policy.html?id=418083. For the monetary regulation, see http://www.regjeringen.no/en/ministries/fin/Selected-topics/Economic-Policy/Monetary-policy.html?id=213274.

[3] See Etibar Jafarov and Kenji Moriyama, “The Norwegian Government Petroleum Fund and the Dutch Disease”, in the selected issues for the 2005 Article IV consultation (http://www.imf.org/external/pubs/ft/scr/2005/cr05197.pdf).

associated with rapid loan expansion. Fiscal restraint can play a role in easing demand pressure in the short and medium term. While petroleum revenue puts medium-term fiscal and external sustainability beyond doubt, population aging poses a long-term threat to fiscal sustainability.

II. Report on the Discussions

A. The Outlook

6. **The authorities and staff agreed that economic growth will remain strong, though moderating somewhat (Table 1).**[4] Strong employment and wages should help to sustain consumption, but rising interest rates are expected to slow house-price increases and ease residential investment growth. Petroleum investment growth is expected to fall off its 2006 peak. And with firms increasingly reporting hiring difficulties, lack of capacity may constrain output growth, notwithstanding continued inflows of labor, both from the Nordic region and the new EU member states. Inflation is projected by both staff and the authorities to rise gradually to the 2½ percent target.

7. **This outlook, while balanced, faces a number of risks**. Unexpected changes to oil prices or world growth would affect incomes, investment, and exports. While rapid credit growth may continue to fuel the economic expansion—total credit has doubled since end-1999—it also poses risks to households, some of which have become overextended, and to banks, if credit quality weakens (see Section C). On the supply side, capacity constraints pose the risk that inflation may rise faster than projected, especially if improving labor markets in eastern Europe restrain labor inflows to Norway.

B. Monetary Policy

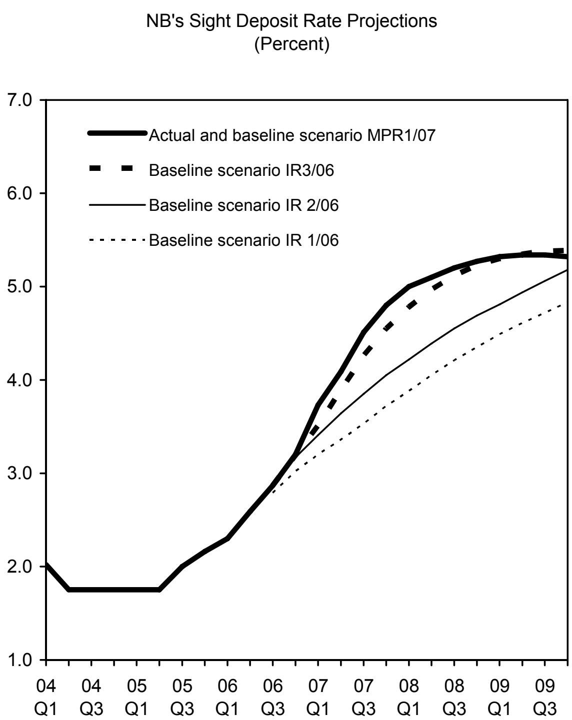
8. **The authorities and staff agreed that further interest rate increases were needed to head off inflationary pressures**. Although underlying measures of inflation are still below the inflation target, staff analysis suggests that core inflation may be underestimating underlying inflationary pressures.[5] NB recently stepped up the pace of interest rate increases, and in its March 2007 *Monetary Policy Report* (formerly the *Inflation Report*) raised slightly its interest rate forecast. The authorities noted that, in view of low inflation, real rates had already risen substantially, while nominal rates would have

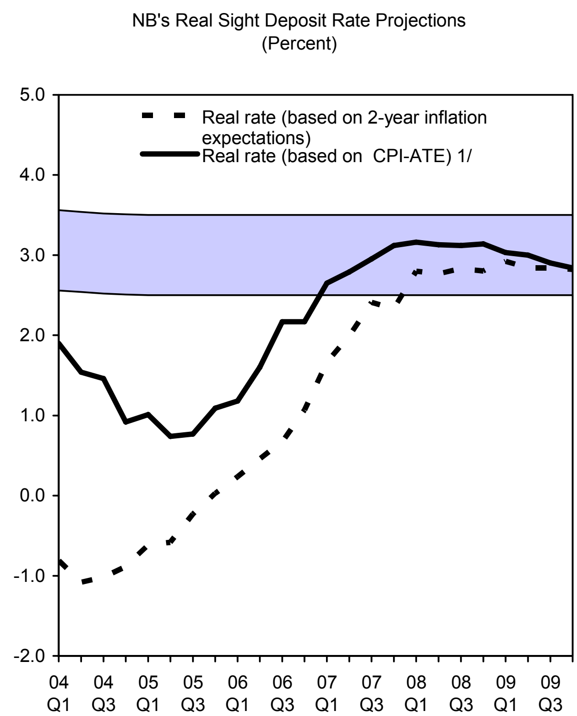
[4] The April Consensus Forecast for real GDP growth is 3.7 percent in 2007 and 2.8 percent in 2008.

[5] Chapter 1 of the Selected Issues paper uses a statistical technique to divide inflation into an "underlying" and an "idiosyncratic" component for a selection of advanced economies. For Norway, core inflation (CPI-ATE) has an idiosyncratic component implying that it will rise toward "underlying" inflation over time.

to rise further as inflation approached the target. The mission judged monetary conditions to have tightened substantially, but to be still somewhat expansionary. Exchange rates were not apparently misaligned; real interest rates calculated using expected (rather than actual) inflation were still below NB's estimated neutral band of 2½ to 3½ percent; and nominal interest rates were below what Taylor rules would suggest (Figure 6).

Norway: Sight Deposit Rate Projections





Sources: Norges Bank *Monetary Policy Reports* (previously *Inflation Report*), various isses; Bloomberg; and IMF staff estimates.
1/ For 2007-09, NB's projections in MPR1/07.

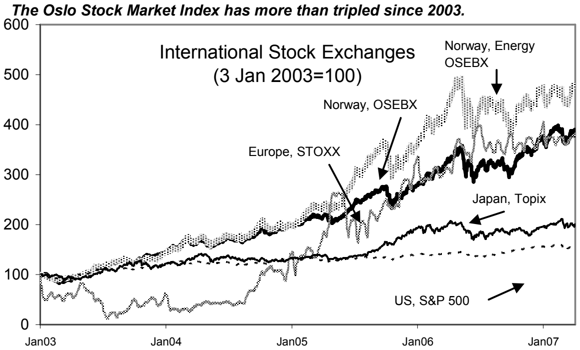
9. **The inflation targeting framework appears to have gained considerable credibility**. Surveys suggest that medium-term inflation expectations remain anchored at 2.5 percent (Figure 3), and the social partners seem well aware that excessive wage increases would trigger monetary tightening. However, some interlocutors in the private sector argued that policy should emphasize exchange rate stability more, which in some circumstances could conflict with inflation targeting. NB has always been clear that it considers exchange rate developments only insofar as they affect inflation, and the mission emphasized that policy should strive to meet the inflation target even if this meant some short-term appreciation of the krone. Staff argued for continued efforts to explain inflation targeting, including the monetary policy transmission mechanism.

C. The Financial System

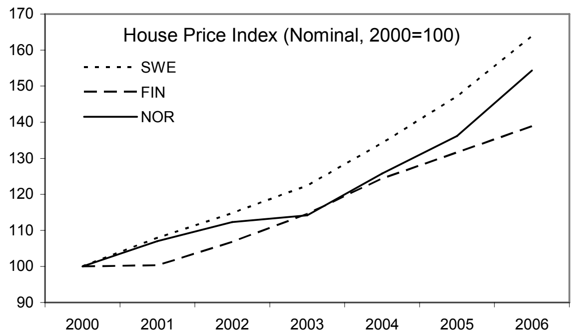
10. **The financial sector is thriving**. Banks remain well capitalized and profitable, with low nonperforming loans and loan losses (Tables 4–6 and Figure 7), and NB's latest Financial Stability Report suggests that banks have the capital to absorb large interest-rate shocks, although some would need to shore up their capital. Recently, international ratings of several banks, including the largest bank, have been upgraded. The bulk of the recommendations of the 2005 FSAP, which found the financial system sound and well supervised, have been implemented (Table 7).

11. **However, prolonged rapid credit growth, the steep rise in house prices, and increasingly aggressive mortgage lending practices pose increasing risks.** Measured against income, household debt (including that of young and poorer households) has risen sharply and stands at historically high levels. Much of the increase has been in mortgages, which historically have had low default rates, but a rise in interest rates or an economic slowdown would rapidly affect borrowers, since more than 90 percent of mortgages carry floating interest rates. More recently, lending to nonfinancial enterprises has also picked up sharply. Asset markets have also been booming. House prices have risen rapidly, with NB's December *Financial Stability* report suggesting they are some 10 percent above what could be explained by fundamentals (although the report stresses the uncertainty of these calculations), thus posing a risk of correction. Similarly, equity prices on the Oslo Stock Exchange, which has been more volatile than other exchanges, have more than tripled since the beginning of 2003, reflecting high oil prices and strong profits in the cyclical upswing.

The Oslo Stock Market Index has more than tripled since 2003.



House prices have increased rapidly.



Sources: Bloomberg; Statistics Norway, Statistics Sweden, Statistics Finland.

12. **The Financial Supervisory Authority (FSAN) is closely monitoring credit developments and has been urging more cautious mortgage lending practices.** The mission expressed particular concern that lenders seemed to be increasingly aggressive, with the proportion of mortgages carrying floating-rates, interest-only payments, or very high loan-to-value ratios (sometimes exceeding 100 percent) all rising. The authorities concurred, but noted that Norway does not have a "sub-prime" market, loan losses are very low, and some new instruments reflected catch-up to practices elsewhere. While emphasizing sound lending, FSAN argued that its scope for raising capital requirements was limited because foreign banks could easily change from subsidiaries (which are supervised by FSAN) to branches (which are not), which would blunt the effect of such a measure. The five Norwegian banks that have been given approval to use the internal ratings based (IRB) approach under Basel II are, according to the EU Directives, not allowed to reduce their capital to less than 95 percent, 90 percent, and 80 percent of that required under Basel I in 2007, 2008, and 2009, respectively.[6]

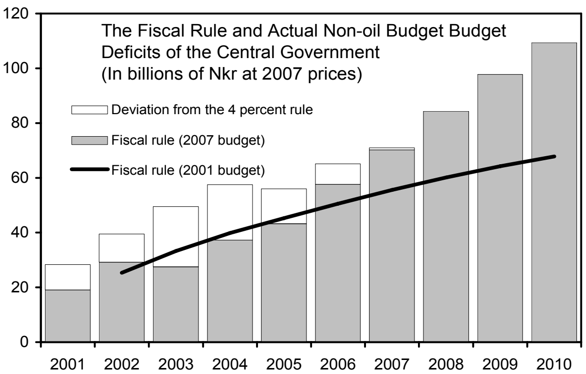
D. Fiscal Policy

13. **The 2007 budget outturn will most probably achieve the 4-percent rule, but the fiscal stance will nevertheless be somewhat expansionary**. The budget implies a central government non-oil structural deficit only marginally greater than 4 percent of the GPF, but staff estimates that the general government non-oil structural budget deficit is set to rise by about ½ percent of GDP in 2007 (Tables 8 and 9, Figure 8). Given the cyclical situation, the mission argued that any budgetary overperformance in 2007 be used for deficit reduction. Likewise, budgets for 2008 and beyond should aim for deficits well below 4 percent of the GPF until demand pressures ease. Such a policy is fully consistent with the fiscal guidelines, which explicitly allow for countercyclical policy. Indeed, in 2003 the deficit was allowed to exceed 4 percent of the GPF in the context of an economic

[6] Because mortgages constitute large shares of their assets, Norwegian banks using IRB can reduce their capital under Basel II by 35–45 percent, according to FSAN estimates.

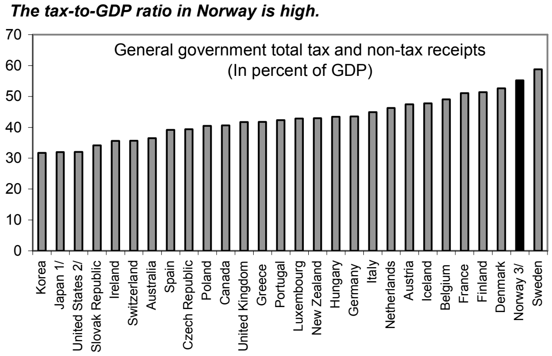
slowdown. The authorities agreed that countercyclical policy would be wise, but it was too soon to assess windfalls this year or discuss the details of the 2008 budget.

14. **The authorities and staff also discussed how to deal with the medium-term fiscal expansion implied by the guidelines**. With oil prices much higher than in 2001, when the guidelines were put in place, the 4-percent rule means the structural deficit will rise by some ¾ percent of GDP each year.[7] One possible response would be to shift to a fiscal rule that is more restrictive than that now in place, which could both limit the rise in spending in the next few years and provide more resources in the long term to meet the costs of population aging.[8] However, given the success of the current guidelines, neither the authorities nor staff argued for such a change. Within these guidelines, staff argued that tax cuts would promote growth, especially given the large size of government in Norway, but the authorities have announced that the ratio of revenue to GDP will be maintained at its 2004 level. In the absence of tax cuts, therefore, real government spending (using the GDP deflator) could rise by some 4 percent a year. Accordingly, the mission reiterated its advice to adopt a medium-term plan that would help to guide policy and reduce the risk of waste. The authorities argued that a spending ceiling, which



Sources: Ministry of Finance; and IMF staff estimates.

The tax-to-GDP ratio in Norway is high.



Source: OECD Economic Outlook 80 database, data as of year 2006. Note: Data refer to the general government sector, which is a consolidation of accounts for central, state and local governments plus social security. Non-tax receipts consist of property income (including dividends and other transfers from public enterprises), fees, charges, sales, fines, capital tranfers received by the general government, etc.
1/ Includes deferred tax payments on postal savings accounts in 2000, 2001 and 2002. In 2002 corporate pension funds were authorised to transfer back to the government the basic part of their employees' pension scheme. This resulted in a capital transfer to the government which reduced the general government financial deficit by 0.1 percentage point of GDP in 2003 and 1.2 percentage point in 2004. Further transfers are assumed for 2005 and 2006 worth 1.0 and 0.2 percentage point of GDP respectively.
2/ Excludes the operating surpluses of public enterprises.
3/ For Norway, non-oil revenue as percent of mainland GDP.

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[7] As a rule of thumb, a 10 percent increase in oil prices raises the annual fiscal impulse by 0.1 percentage point of GDP.

[8] Chapter 2 of the Selected Issues paper discusses the consequences of alternative fiscal rules for long-term fiscal sustainability and economic growth.

some other countries have adopted, might conflict with the current fiscal guidelines and the government's revenue policy, and noted that the finance ministry already produces three-year fiscal projections.

Norway: Central Government Fiscal Position Under Different Oil Prices
(In percent of mainland GDP; unless otherwise specified)

						Projections			
							Based on the 4-percent rule		
	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Based on the 2007 National Budget projections					
Structural non-oil balance	-3.2	-3.6	-3.9	-3.6	-4.0	-4.4	-5.2	-6.0	-6.6
4 percent of GPF assets	-2.0	-1.9	-2.5	-2.8	-3.6	-4.4	-5.2	-6.0	-6.6
Non-oil expenditures	46.4	45.1	44.5	43.5	42.1	43.1	43.8	44.8	45.7
Increase in real terms									
(applying mainland GDP deflator)	13.0	-1.5	3.1	2.0	1.3	2.8	4.4	4.5	3.9
Government Pension Fund (GPF) assets									
(in percent of mainland GDP)	49.4	66.4	74.6	96.1	114.1	135.6	153.8	170.6	…
Oil price assumption (in Norwegian krone)	197.9	204.4	254.1	343.5	411.8	390.0	357.0	334.6	323.0
				Higher oil price scenario (20 percent more than in the 2007 budget projections)					
Structural non-oil balance	-3.2	-3.6	-3.9	-3.6	-4.0	-4.4	-5.4	-6.3	-7.0
4 percent of GPF assets	-2.0	-1.9	-2.5	-2.8	-3.6	-4.4	-5.4	-6.3	-7.0
Non-oil expenditures	46.4	45.1	44.5	43.5	42.1	43.1	43.9	45.1	46.1
Increase in real terms									
(applying mainland GDP deflator)	13.0	-1.5	3.1	2.0	1.3	2.8	4.9	4.8	4.2
Government Pension Fund (GPF) assets									
(in percent of mainland GDP)	49.4	66.4	74.6	96.1	114.1	140.1	162.3	182.3	
Oil price assumption (in Norwegian krone)	197.9	204.4	254.1	343.5	411.8	468.0	427.0	398.6	383.0
					Based on WEO projections				
Structural non-oil balance (WEO)	-3.2	-3.6	-3.9	-3.6	-4.0	-4.4	-5.0	-5.8	-6.5
4 percent of GPF assets	-2.0	-1.9	-2.5	-2.8	-3.6	-4.4	-5.0	-5.8	-6.5
Non-oil expenditures	46.4	45.1	44.5	43.5	42.1	43.1	43.6	44.6	45.5
Increase in real terms									
(applying mainland GDP deflator)	13.0	-1.5	3.1	2.0	1.3	2.8	4.0	4.4	4.1
Government Pension Fund (GPF) assets									
(in percent of mainland GDP)	49.4	66.4	74.6	96.1	114.1	133.6	151.0	168.7	185.2
Oil price assumption (in Norwegian krone)	197.9	204.4	254.1	343.5	411.8	384.1	416.2	422.3	427.8

Sources: Ministry of Finance; and IMF staff estimates.

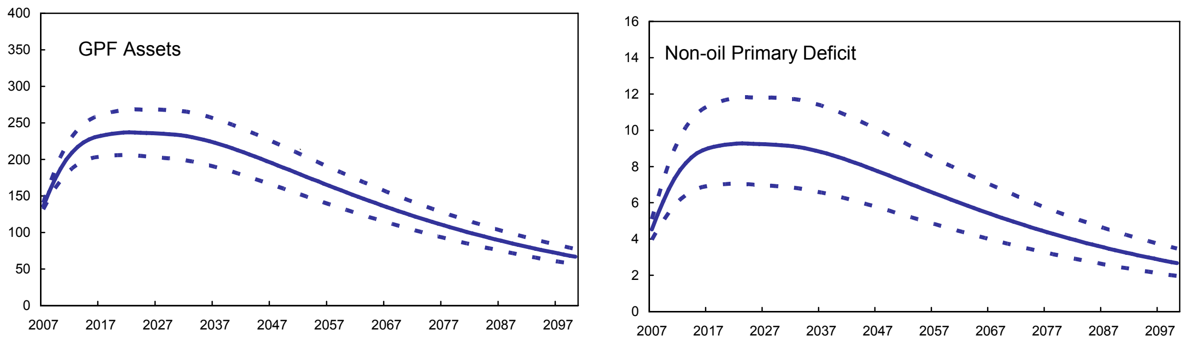
15. **The key long-term fiscal issue is the rise in spending related to population aging, and there was agreement that petroleum wealth will probably not cover these costs**. The 2007 budget projects pension spending will rise by about 10 percentage points of GDP by 2060, reflecting a system that is both generous and still maturing.[9] Staff calculations suggest that, on current policies and projections, in 2060, income from the GPF will cover only about 2 percentage points of this gap. Moreover, the fiscal guidelines imply that, as a percent of GDP, spending from petroleum wealth will rise until the early 2020s but then gradually decline thereafter (Box 2). Thus, in the long term, in the absence of pension reform, large cuts in nonpension spending (including any build-up during the deficit expansion, as discussed above) or tax increases would be required.

[9] See Chapter 2 of the selected issues paper. Aging could also cause additional spending on health and long-term care of 3.2 percent of GDP; see OECD, 2003, "Policies For An Ageing Society: Recent Measures And Areas For Further Reform," Economics Department Working Paper No.369 (ECO/WKP(2003)23.

Box 2. Non-Oil Budget Deficit Path Under the 4-Percent Rule

In percent of mainland GDP, the 4-percent fiscal rule implies a hump-shaped non-oil budget deficit. Under oil price and recovery assumptions of the 2007 budget, GPF assets are expected to peak at 240 percent of mainland GDP in 2022 and gradually decline thereafter. Similarly, the non-oil deficit allowed by the rule peaks at 9½ percent of mainland GDP in 2023 and declines toward zero thereafter.

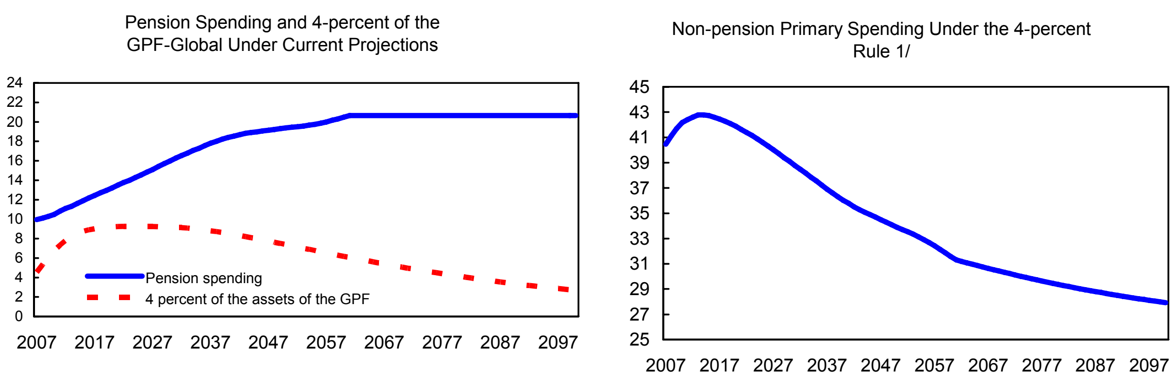
Fiscal Position of the General Government Under the 4-percent Rule, 2007-2100
(In percent of GDP)



Source: IMF staff estimates. Until 2030, the baseline scenario is based on the 2007 budget projections of oil prices and revenues. Thereafter, oil production is assumed to decline gradually. The upper/lower band corresponds to 20 percent higher/lower oil prices and 50 basis points higher/lower yield on government assets.

By contrast, projected pension spending rises steadily, requiring substantial cuts in non-pension primary spending or sharp increases in taxes under the 4-percent rule. In the absence of pension reforms, and assuming an unchanged revenue-to-GDP ratio, nonpension primary spending would have to be cut by more than 10 percentage points of GDP in the long run, but by about 3 percentage points less after the effects of the recently agreed pension reform are taken into account.

Yield on the Assets of the GPF - Global and Projected Pension Spending, 2007-2100
(In percent of GDP)



Source: The Norwegian authorities; and IMF staff estimates.
1/ Assuming no pension reform and unchanged tax-to-GDP ratio for mainland activities.

16. Parliament agreed a package of reforms that promises significant long-term budgetary savings, and staff urged its quick implementation (Box 3). A key advantage of the new system is its actuarial neutrality, as the replacement rate will rise with later retirement. This feature insulates pension spending from retirement decisions, and promises to expand labor supply. However, the latter benefit will only be fully realized if the early retirement scheme (AFP), run by the social partners but subsidized by the government, is reformed. The authorities will invite the social partners to a dialogue on the revision of the AFP-scheme. Also, disability pension benefits will have to be aligned with the overall system, especially as regards indexation. A commission is to report on disability pensions in the first half of 2007. The mission argued that the agreed package, while welcome, would probably not ensure pension-system solvency (leaving a gap of more than 4 percent of GDP by 2060), and therefore further reform should be considered.

Box 3. Pension Reform

In 2001, the government appointed an independent multi-party Pension Commission to propose reforms. The commission issued its final report in January 2004, on the basis of which the government submitted a white paper to parliament in December 2004. In May 2005, parliament reached agreement on the main principles for a pension reform. Another white paper, issued in October 2006, retained the key principles of the 2005 parliamentary agreement. In mid-March, 2007, parliament agreed a reform package that closely follows the 2006 white paper. The key features are:

- benefits will be based on lifetime earnings, instead of the best 20 years, as now;
- benefits will be adjusted for life expectancy;
- individual benefits will be actuarially neutral, with the replacement rate depending on retirement age: it will be 26 percentage points lower for retirement at 62 (rather than 67), and 24 percentage points higher for retirement at 70;
- benefits will be indexed to the simple average of wages and prices, rather than to wages as now (a minimum pension will be indexed to wages);
- pensioners can work without loss of pension; and
- compared to the 2004 white paper proposals, low and medium-income households will receive somewhat more generous pensions.

The authorities estimate this package, to be implemented by 2010, would reduce pension outlays by about 3 percent of GDP by 2050, largely reflecting the life-expectancy adjustment and the change to indexation. Actuarial neutrality is designed to encourage later retirement, which may raise general tax revenues, an effect not included in the cost-saving estimate.

Separately, occupational pension schemes, which supplement the public pension system, were made mandatory for enterprises, starting in 2006.

E. Structural Policy

17. **The Norwegian labor market performs very well by international standards (Figure 9), but rising enrollment in disability and sickness programs pose a risk**. These programs already account for a substantial fraction of the working-age population and are imposing a significant fiscal burden.[10] The Inclusive Workplace Agreement between the government and social partners, which has been in place since 2001 and was recently extended until end-2009, has led to better practices in some enterprises, but has not come close to meeting targets for lower sickness inflows. Administrative reform of the sickness program in 2004, involving stricter medical examinations, led to declines in days lost. At the end of 2005, however, sick leave began to increase. A commission, headed by the Prime Minister, has suggested new financial and accelerated activation measures with an aim to reduce sickness absence. The measures are to be implemented this year. The authorities noted that the new Public Employment and Welfare Service, combining three welfare agencies, will promote a more integrated and efficient approach. The mission agreed that better case management would be useful, and endorsed OECD proposals: rigor in assessing potential beneficiaries; more frequent use of partial disability; enhancing the responsibility of employers and employees;[11] intensified efforts for rehabilitation; and reduction of generous replacement rates, especially for sickness (with a 100 percent replacement rate), which is frequently the gateway to disability, but also for disability (the replacement rate can be high for some groups).

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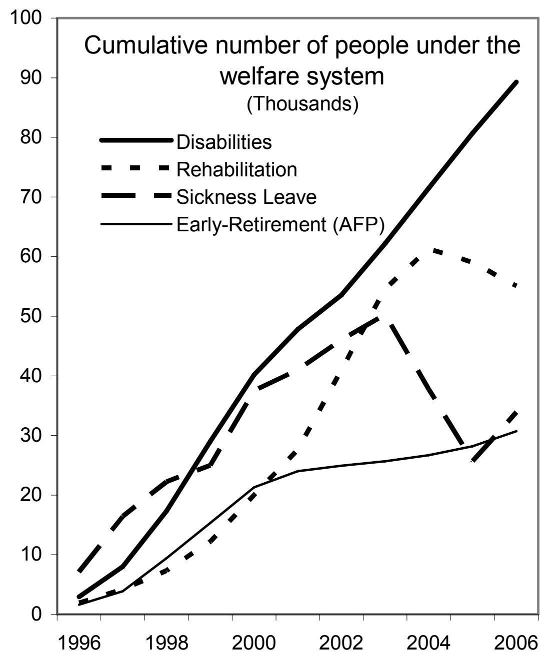
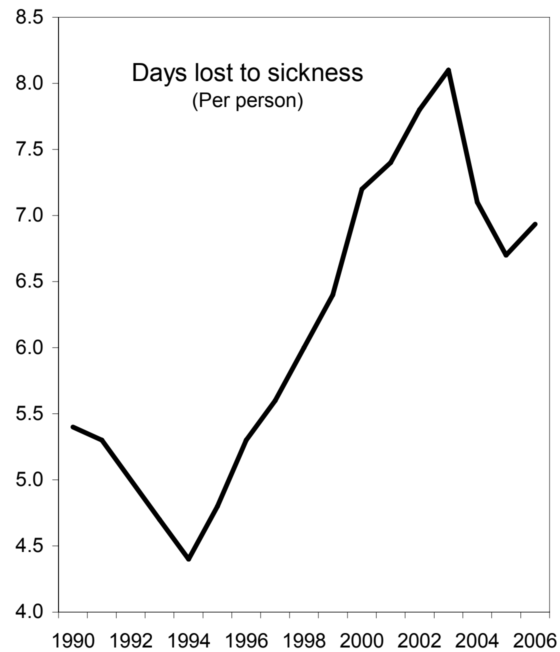
[10] See "Sickness, Disability and Work: Breaking the Barriers," Volume 1, OECD, 2006 for a discussion of these programs and reform proposals.

[11] However, the government's proposal to increase the share of employers' cofinancing met stiff resistance from both employers and employees.

Participation in welfare programs has increased...



...and days lost have started to increase again.



Sources: Ministry of Finance: The 2007 National Budget; Statistics Norway.

18. **There was agreement that governance of the large state-owned sector was strong**. Reforms to governance of state-owned enterprises (SOEs) in the past few years emphasized arms-length management, market-driven objectives, and transparency in meeting social objectives via explicit contracts. The authorities noted that they benchmark SOE performance and have concluded that they perform well with respect to peers, and that they have no plans for further privatization, arguing that public ownership is needed to ensure long-term economic development and control over natural resources. The authorities and the mission concurred that a competitive market environment would be an important discipline on SOEs. The mission argued that, nevertheless, state ownership itself could be distorting: to (actual and potential) competitors, SOEs might be perceived as having the advantage of government deep pockets, dissuading expansion or entry; and SOEs are not subject to the market discipline of takeover, which is becoming increasingly important with the rise in the size and sophistication of capital markets. The mission therefore suggested that privatization would be appropriate in some cases.

19. **Domestic competition is improving, and the Competition Authority (CA) has become better established**. Progress was visible especially in the financial and services sectors, holding prices down and raising productivity. Some CA decisions were being challenged in lower courts or overturned on appeal to the Ministry of Government

Administration and Reform (the legal appeals body), but the authorities, including at the CA, did not view these instances as undermining the competition law or the CA itself.

III. Staff Appraisal

20. **The Norwegian economy is entering its fourth consecutive year of above-trend growth, while wage and price inflation have been remarkably subdued and the exchange rate seems broadly in line with fundamentals**. This enviable performance has been underpinned by the two strong macroeconomic policy pillars of inflation targeting and the fiscal guidelines. Several factors have boosted demand and eased supply constraints: supportive monetary conditions following the 2002-03 slowdown; an expansionary fiscal stance; high world prices for petroleum products and other Norwegian exports and much weaker prices for imported goods; labor inflows, especially from the new EU member countries; and increased competition and productivity in some domestic sectors.

21. **However, indicators point to mounting underlying inflationary pressures, which seem set to intensify as the mainland economy is expected to grow strongly again in 2007**. Credit and house-prices have been rising rapidly for some time, and the credit expansion has moved beyond households with a sharp pick-up in business-sector borrowing. Capacity utilization is high. And, after a muted response early in the cycle, labor markets tightened significantly in the past year, with near record employment growth, a plunging unemployment rate, and increasing reports of labor shortages and, in some industries, rising wage drift.

22. **Against this backdrop, Norges Bank's (NB) decision to withdraw monetary stimulus, beginning in mid-2005, as well as the recent pick-up in the pace of interest rate increases, is welcome**. Given prospective inflationary pressures, NB should continue to raise interest rates, with the exact pace depending on economic developments. Monetary tightening may be accompanied by some temporary upward pressure on the exchange rate, a normal part of the monetary transmission mechanism.

23. **The inflation targeting framework, together with a flexible exchange rate, has proven effective and appropriate for the Norwegian economy**. A number of innovations have strengthened policymaking and communication, putting Norway at the forefront of inflation targeters. Nevertheless, to reinforce public understanding of inflation targeting, the authorities should continue to clearly explain the framework and how it governs specific policy decisions.

24. **The financial sector appears to be sound and well supervised.** However, the prolonged strong credit expansion, the steep rise in house prices, and aggressive mortgage lending practices pose risks, especially as interest rates rise or in the event of an economic slowdown. The Financial Supervisory Authority's close monitoring of these developments

is welcome, and it should continue to ensure that banks remain well capitalized and provisioned, and that their lending practices remain sound and their asset quality high.

25. **Fiscal policy remains prudent**. It is particularly welcome that in 2007, for the first time, the central government non-oil structural deficit is set to meet the target of 4 percent of the assets of the Government Pension Fund-Global (GPF), in line with the fiscal guidelines. As the guidelines explicitly recognize, fiscal policy has a role to play in economic stabilization. Accordingly, the 2007 mid-term budget review should seize any available opportunity to reduce the deficit, while the 2008 and subsequent budgets should aim for a deficit materially below 4 percent of the GPF until excess demand dissipates. Such policies would alleviate the burden on monetary policy and ease upward pressure on the real exchange rate.

26. **The fiscal guidelines have helped to restrain spending, but imply substantial deficit increases in the years ahead**. The policy of saving petroleum revenues abroad has blunted "Dutch disease" effects, but the deficit expansion under the guidelines warrants careful management. Tax cuts would be welcome, because of their desirable supply-side effects. Rapid increases in spending risk inefficient resource use, and will have to be reversed beginning in the early 2020s as oil revenues wane. An explicit medium-term fiscal framework would help to focus policy more on such medium-term considerations. In Norway, many parts of such a framework are already in place, notably the fiscal guidelines themselves and the finance ministry's multi-year budget projections.

27. **The most important long-term fiscal challenge is posed by the effects of population aging, expected to begin in the next decade**. The recent broad-based parliamentary agreement on pension reform is therefore welcome, as is the authorities' intention to deal with a number of outstanding issues, notably the early retirement scheme. Implementation of these reforms should take place without delay. However, the saving from the agreed reform will probably be insufficient to ensure long-term fiscal sustainability and therefore further reform should be considered.

28. **The Norwegian labor market performs well, but the sickness and disability programs pose risks**. High employment and participation rates, low unemployment rates, and the ability to absorb substantial numbers of immigrant workers testify to labor market flexibility. However, reform of the sickness and disability schemes is a high priority. The merger of welfare agencies is welcome, but further administrative reforms will be required, and high replacement rates should be reconsidered in order to sharpen beneficiaries' incentives to return to work.

29. **Product market performance is improving, but continuing efforts are needed to ensure strong competition**. The strong and appropriate system of governance of the large publicly owned sector needs to be maintained. But to ensure a level playing field and

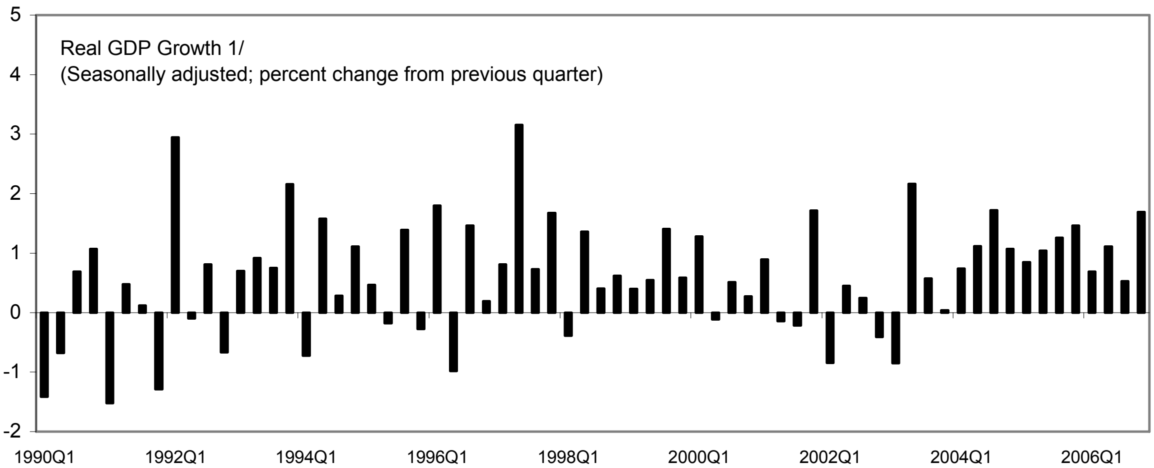
maximize the benefits of competitive markets, further privatization should also be considered. Domestic competition has increased, and further gains on this front should be pursued, notably through strong enforcement of competition and anti-cartel laws.

30. **Data are adequate for surveillance**. Indeed, in some instances, including the GPF and SOEs, transparency is very strong by international standards. The task of collecting financial sector data was recently moved from NB to Statistics Norway (SN), which the former viewed as increasing its focus on its core monetary policy mission. Assessment of labor market conditions would be strengthened by expanding the sample size of the labor force survey to allow publication of monthly estimates, and instituting an establishment survey to provide timely data on employment and wage developments.

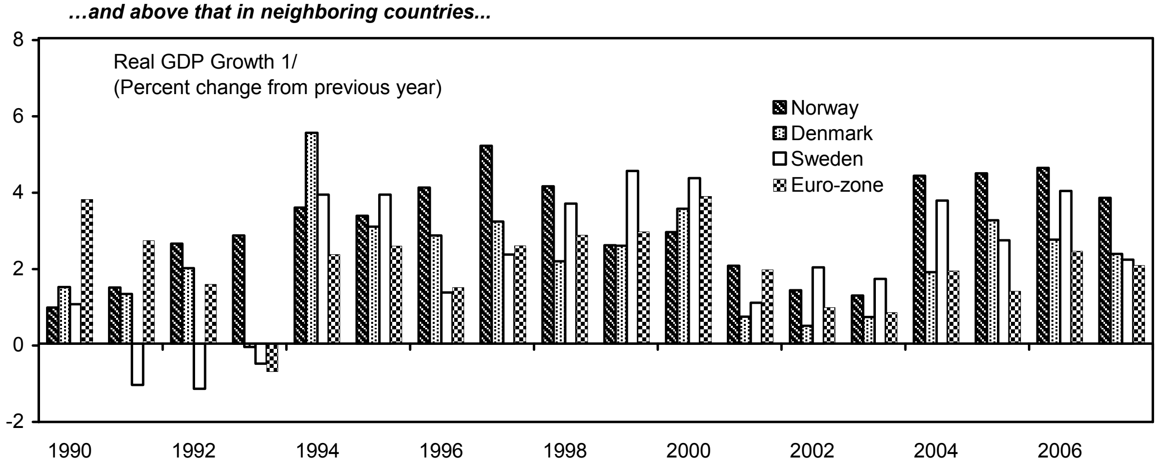
31. It is proposed that the next Article IV consultation be held on a 24-month cycle.

Figure 1. Norway: Economic Growth Indicators

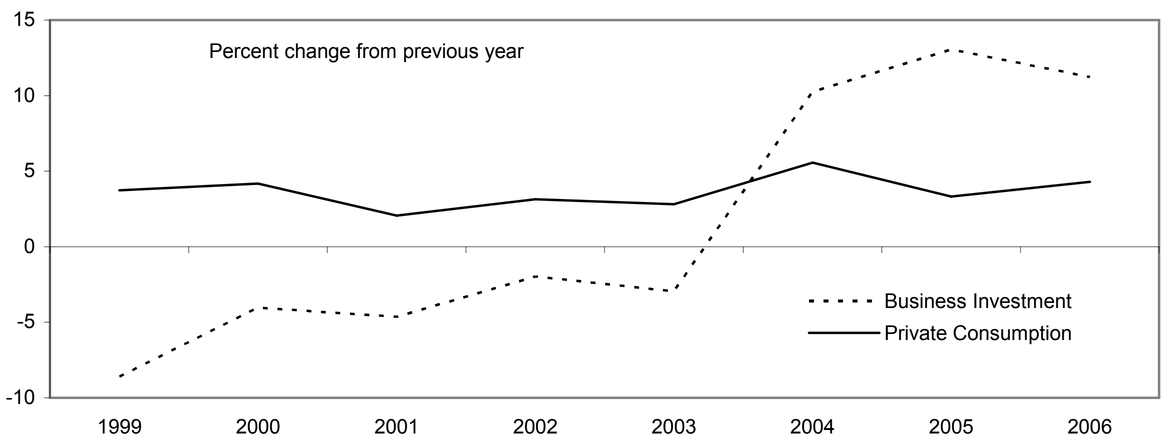
Growth has been very strong in the past three years...



…and above that in neighboring countries...

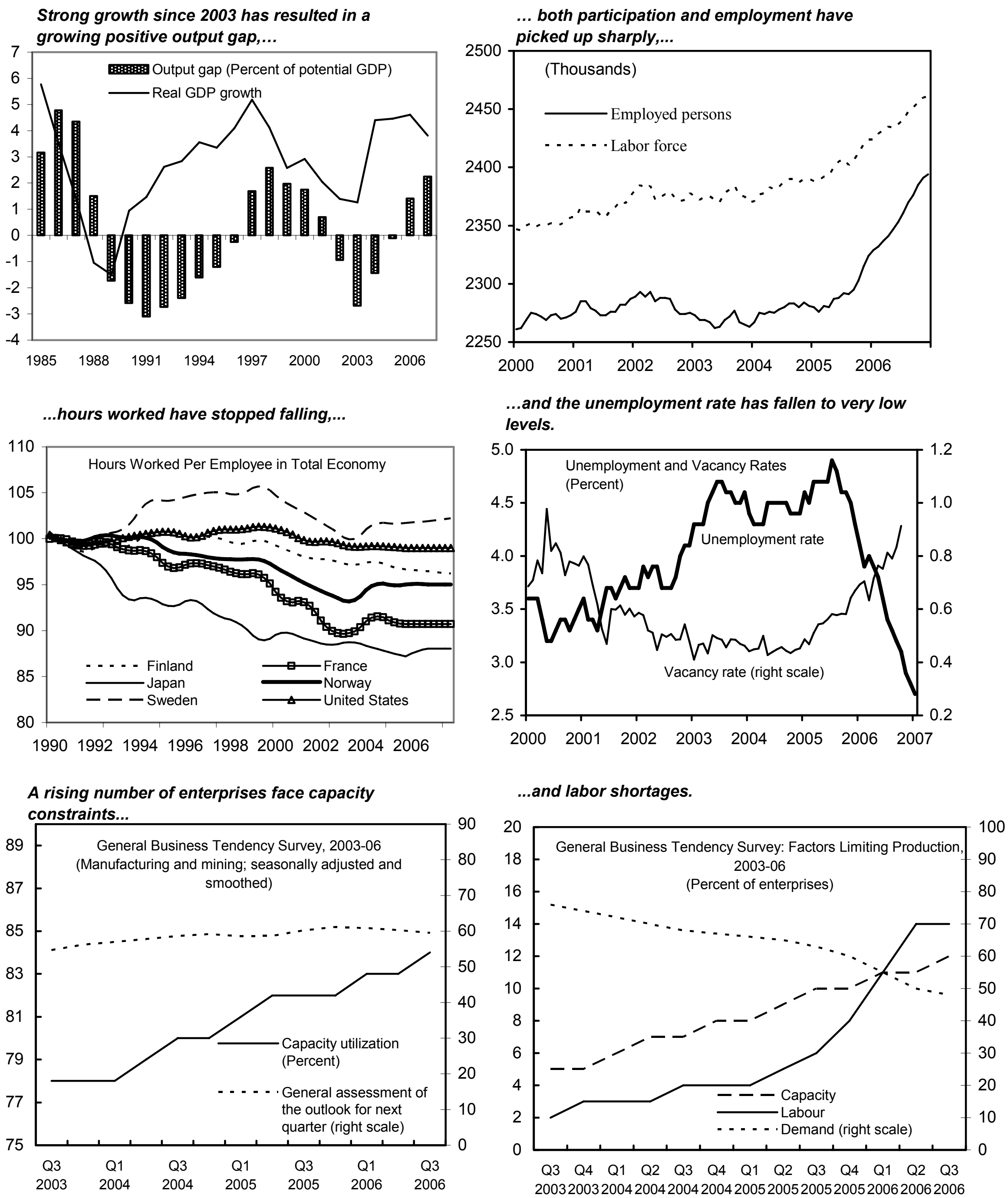


…reflecting strong investment and robust consumption.



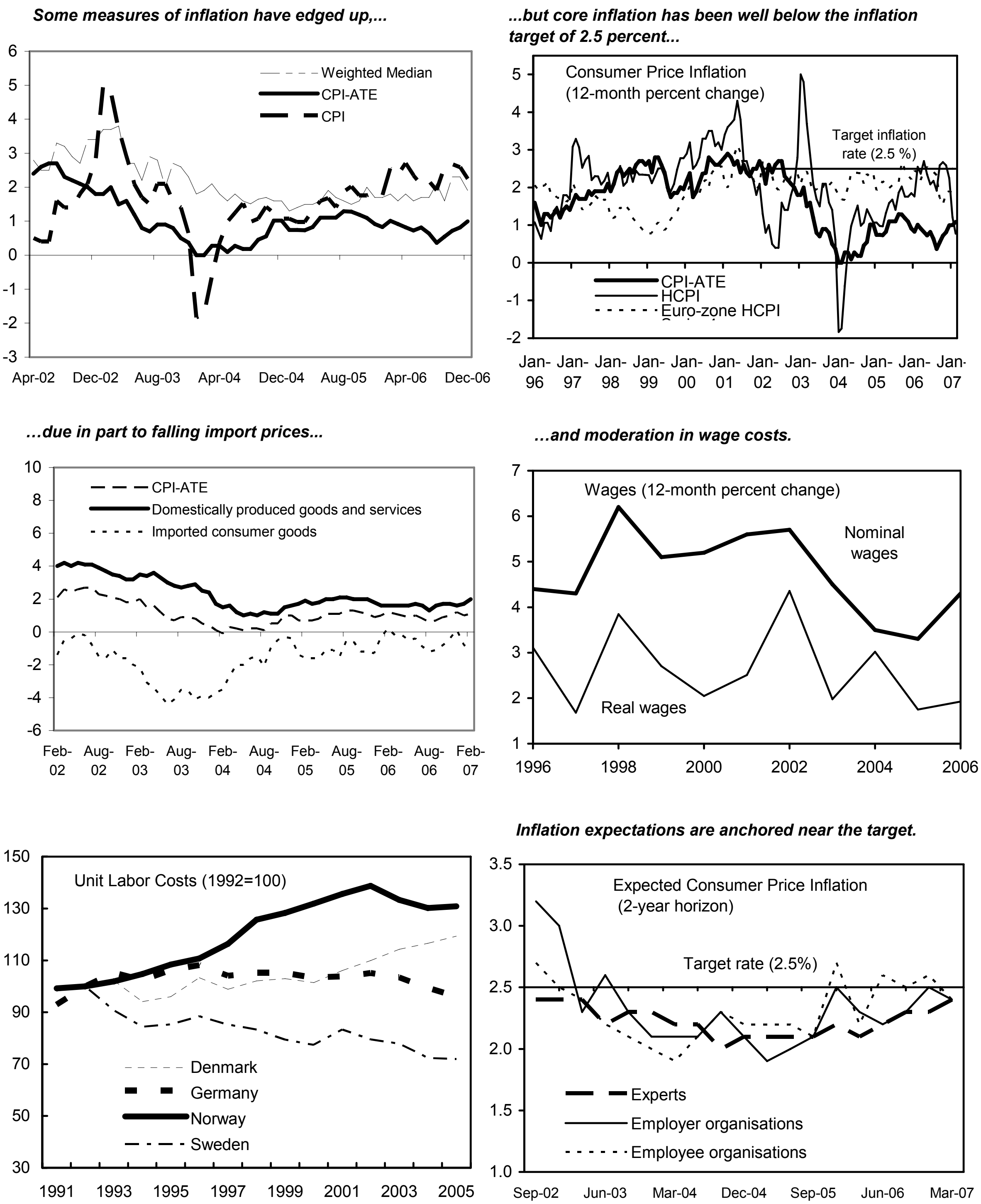
Sources: Statistics Norway; OECD; and IMF staff estimates.
1/ Mainland GDP for Norway.

Figure 2. Norway: Cyclical Indicators



Sources: Statistics Norway; OECD; and IMF staff estimates.

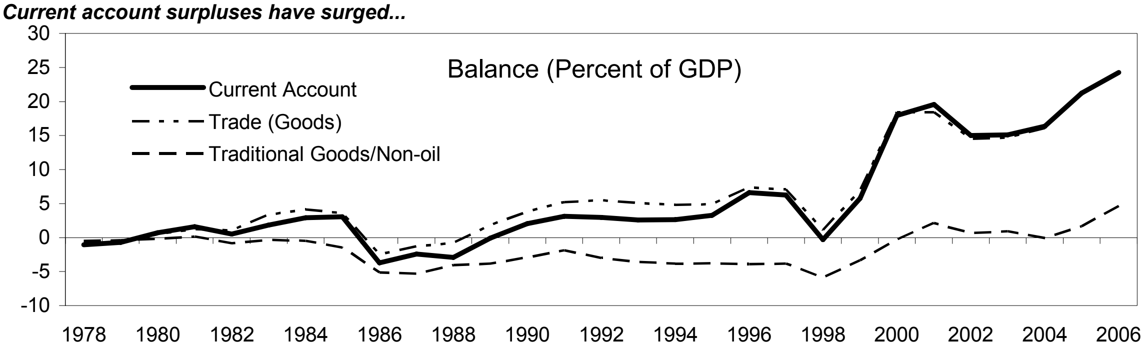
Figure 3. Norway: Inflation Developments



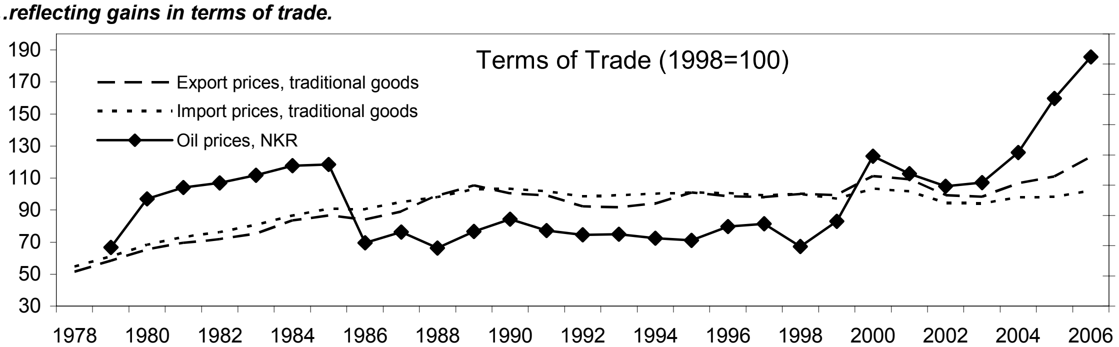
Sources: Statistics Norway; Norges Bank *Monetary Policy Report* 01/2007; and IMF staff estimates.

Figure 4. Norway: External Developments

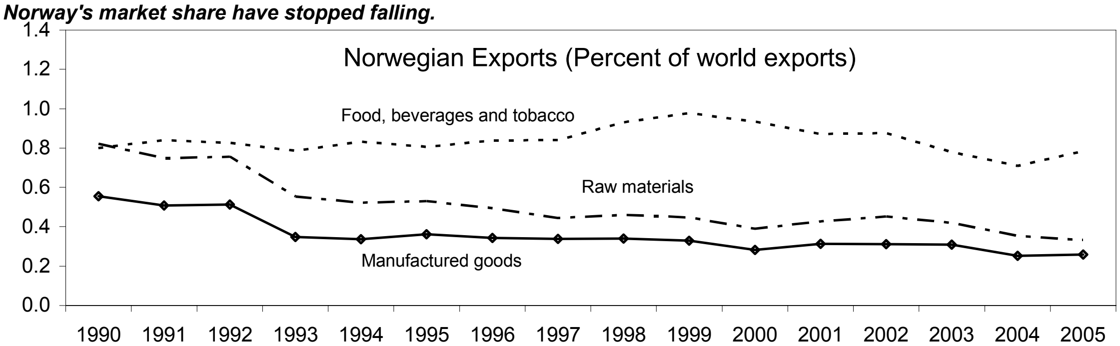
Current account surpluses have surged...



…reflecting gains in terms of trade.



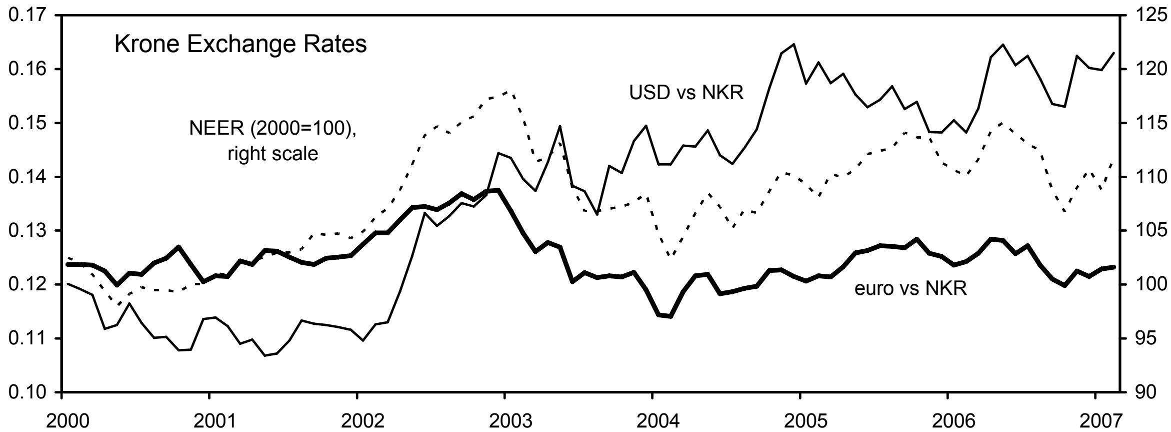
Norway's market share have stopped falling.



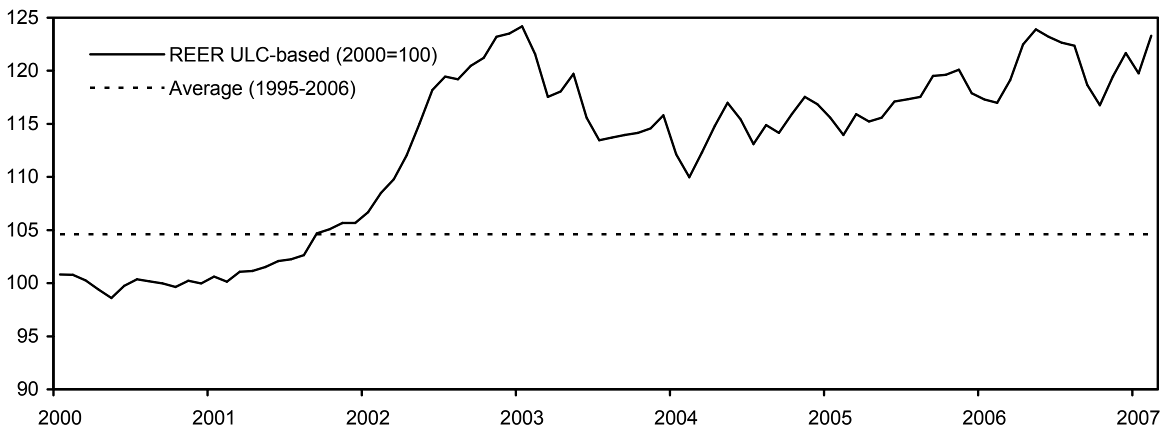
Sources: Statistics Norway; and IMF staff estimates.

Figure 5. Norway: Exchange Rate Developments

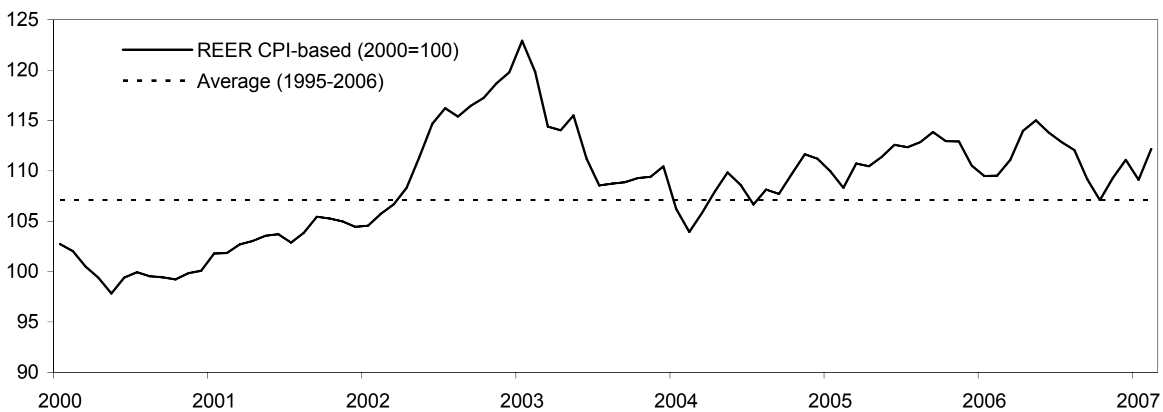
Both nominal...



..and ULC-based real effective exchange rate of the krone have recently drifted up,...



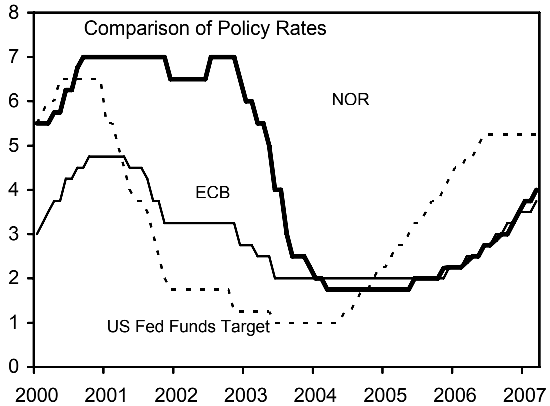
…although the CPI-based REER remains close to its average for 2000-06 period.



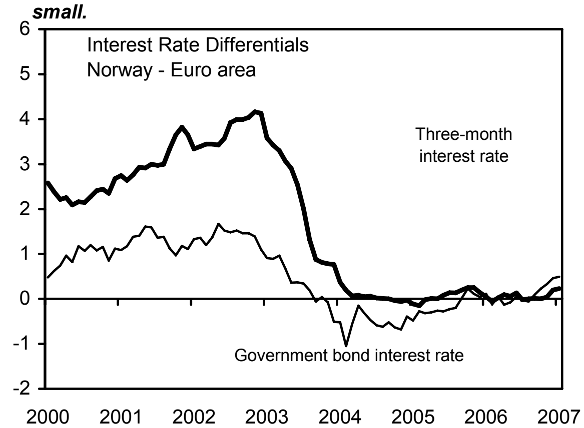
Sources: Statistics Norway; and IMF staff estimates.

Figure 6. Norway: Monetary Conditions

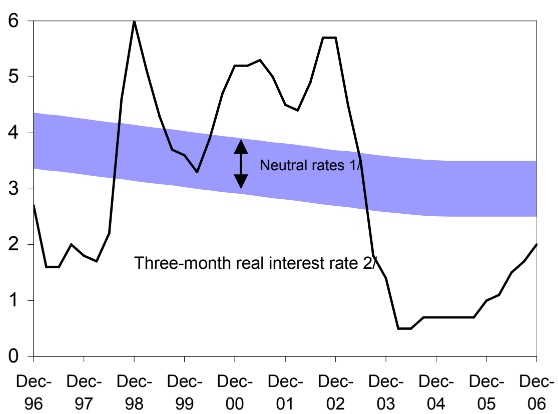
Policy interest rate has been increased nine times since June 2005.



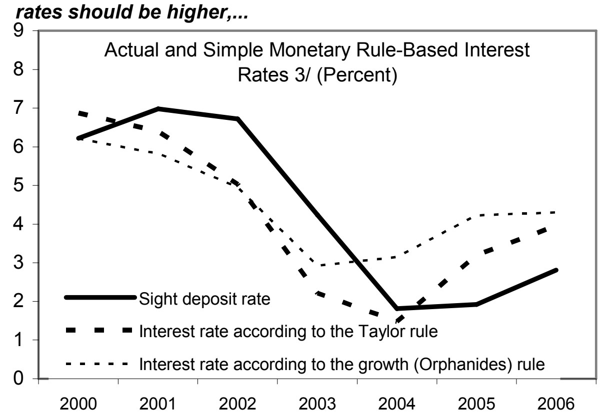
Interest rate differentials with the Euro area remain small.



Real interest rates are still below neutral levels,...



...simple monetory policy rules suggest that interest rates should be higher,...



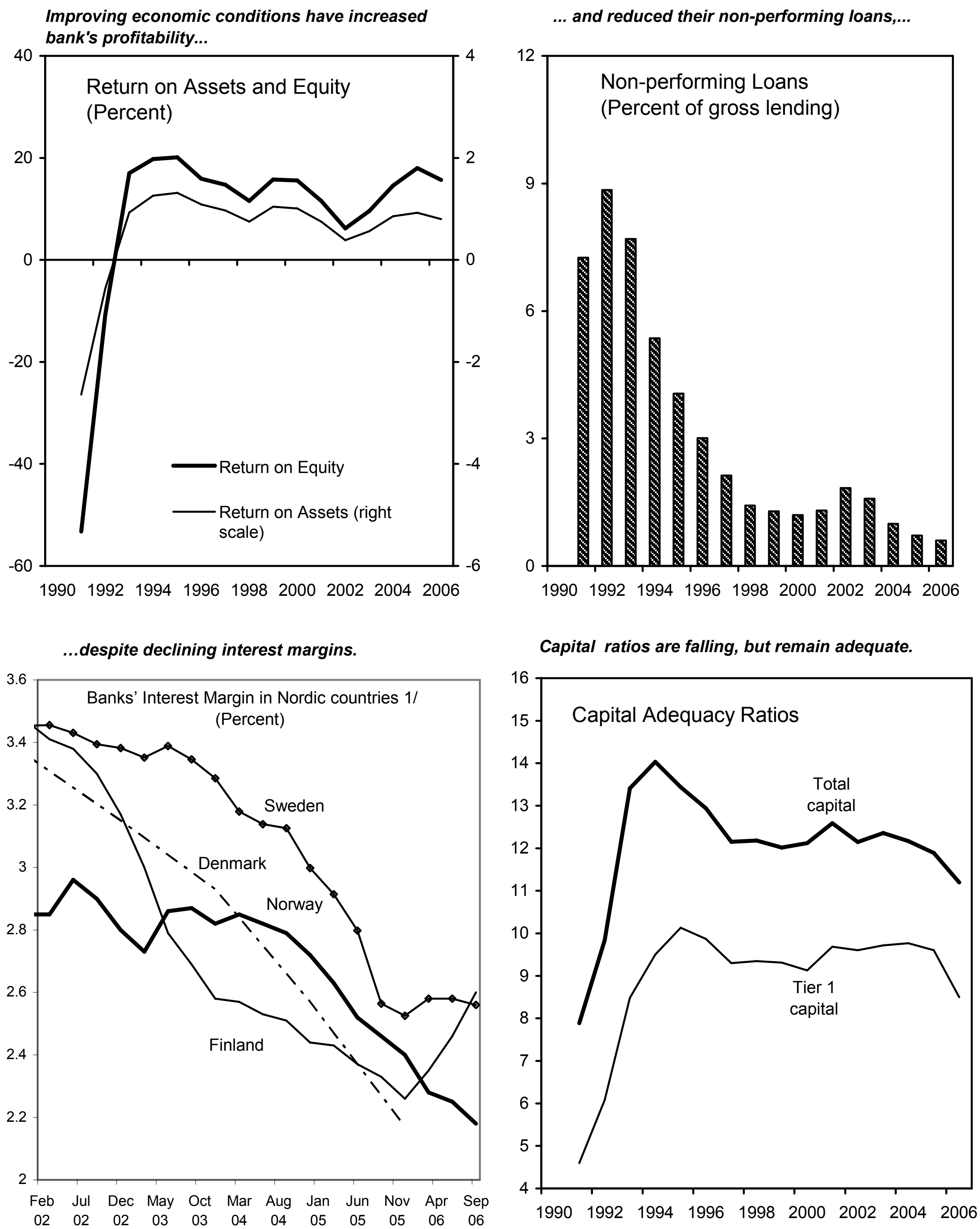
Sources: Norges Bank *Monetary Policy Report* 1/07; Federal Reserve; ECB; Bloomberg; and IMF staff estimates

1/ Estimates are from Norges Bank.

2/ Three-month money market rate deflated by inflation measured by the CPI-ATE.

3/ IMF staff projections for output gap and Norges Bank projection for inflation.

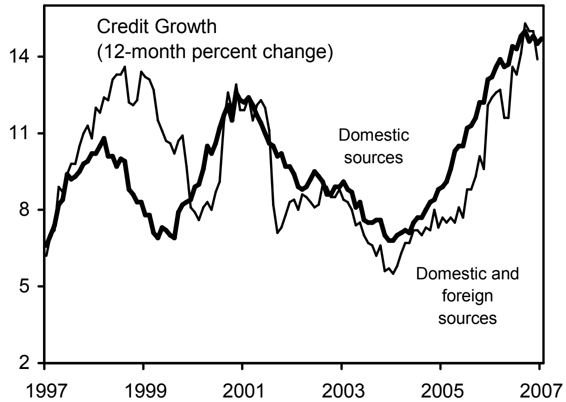
Figure 7. Norway: Financial Sector Indicators



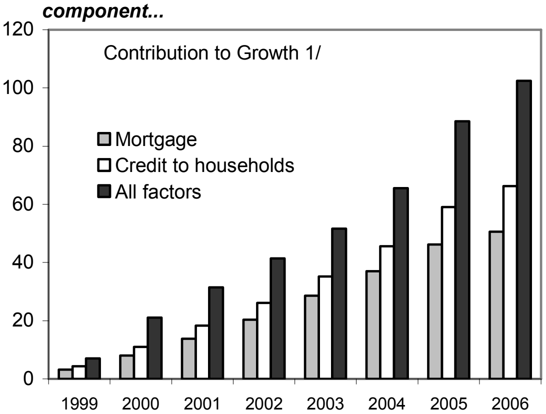
Sources: Statistics Norway; Norges Bank *Financial Stability Report* 2/06; and IMF staff estimates.
1/ All banks in Norway, Finland and Sweden. About 50 of the largest banks in Denmark.

Figure 7. Norway: Financial Sector Indicators (continued)

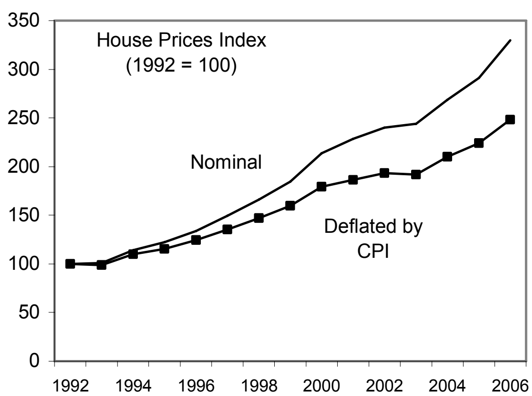
Credit growth has accelerated,...



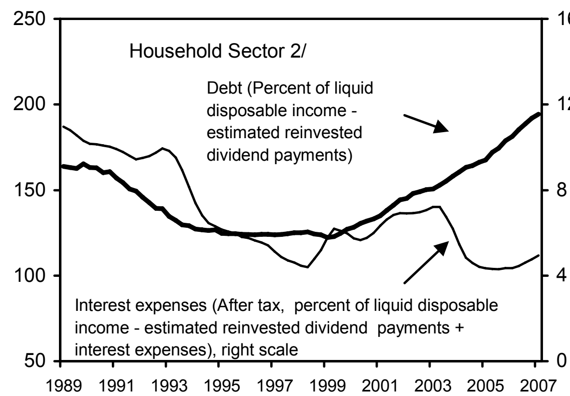
...with mortgage lending being the main component...



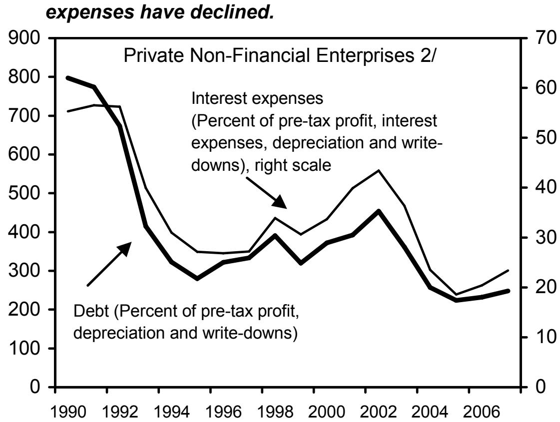
...due, in part, to rapidly growing housing prices.



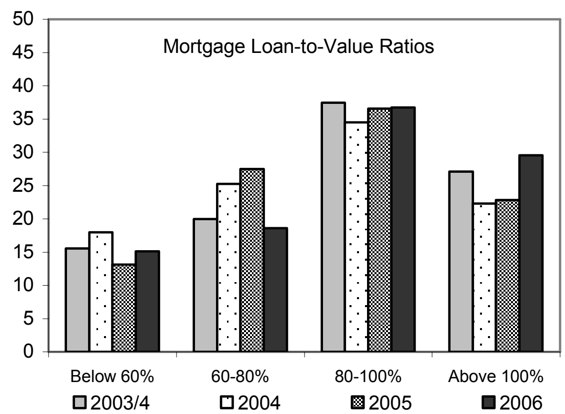
Higher home prices have pushed up household debt, but the interest burden has fallen.



Recently, the enterprise debt burden and interest expenses have declined.



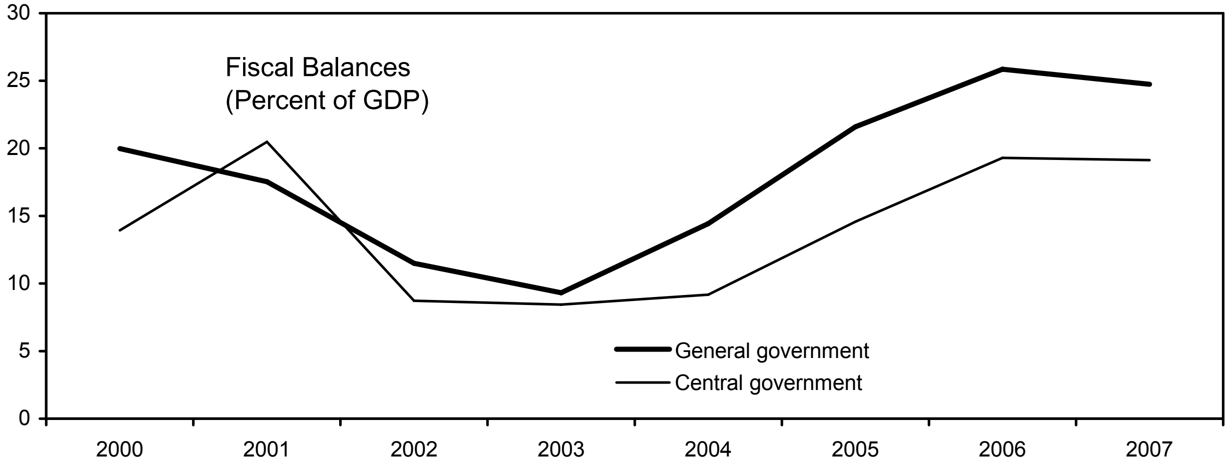
High loan-to-value ratios are significant.



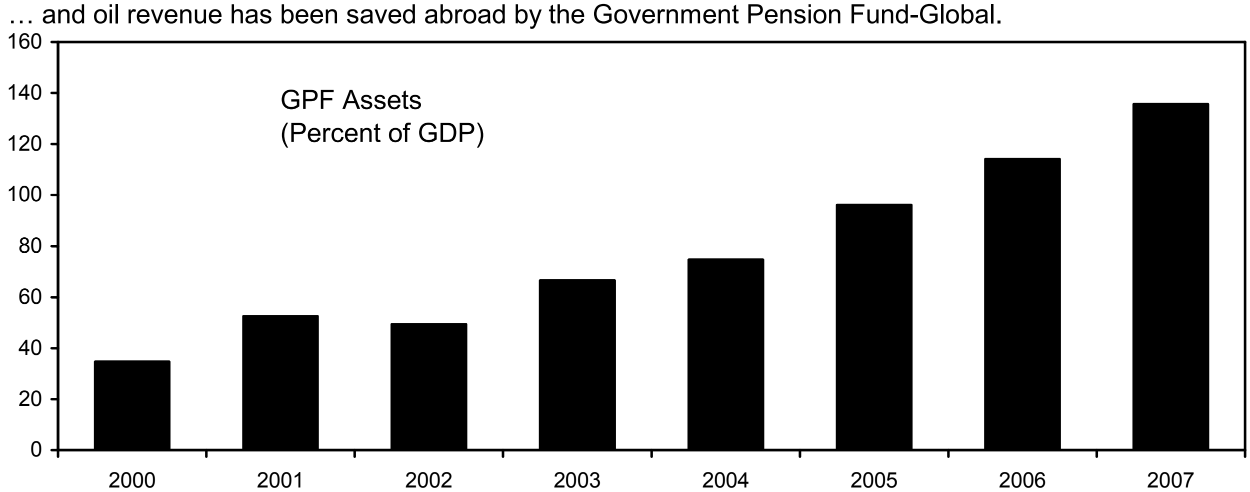
Sources: Statistics Norway; Norges Bank *Financial Stability Report* 2/06; and IMF staff estimates.
1/ Data for 2006 is as of second quarter
2/ Estimates for 2006-07

Figure 8. Norway: Fiscal Indicators

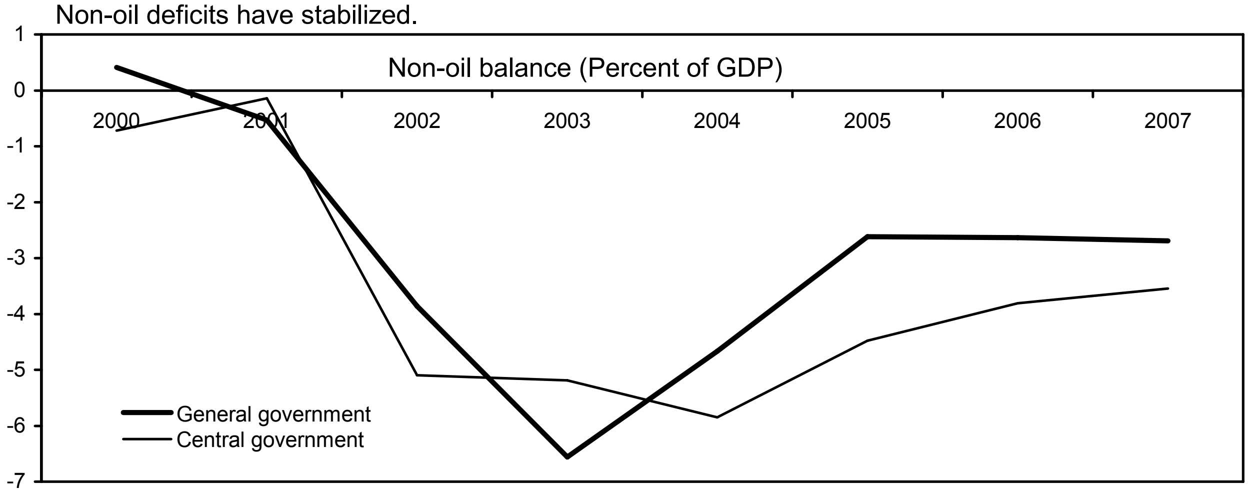
Petroleum revenues ensure substantial fiscal surpluses...



… and oil revenue has been saved abroad by the Government Pension Fund-Global.

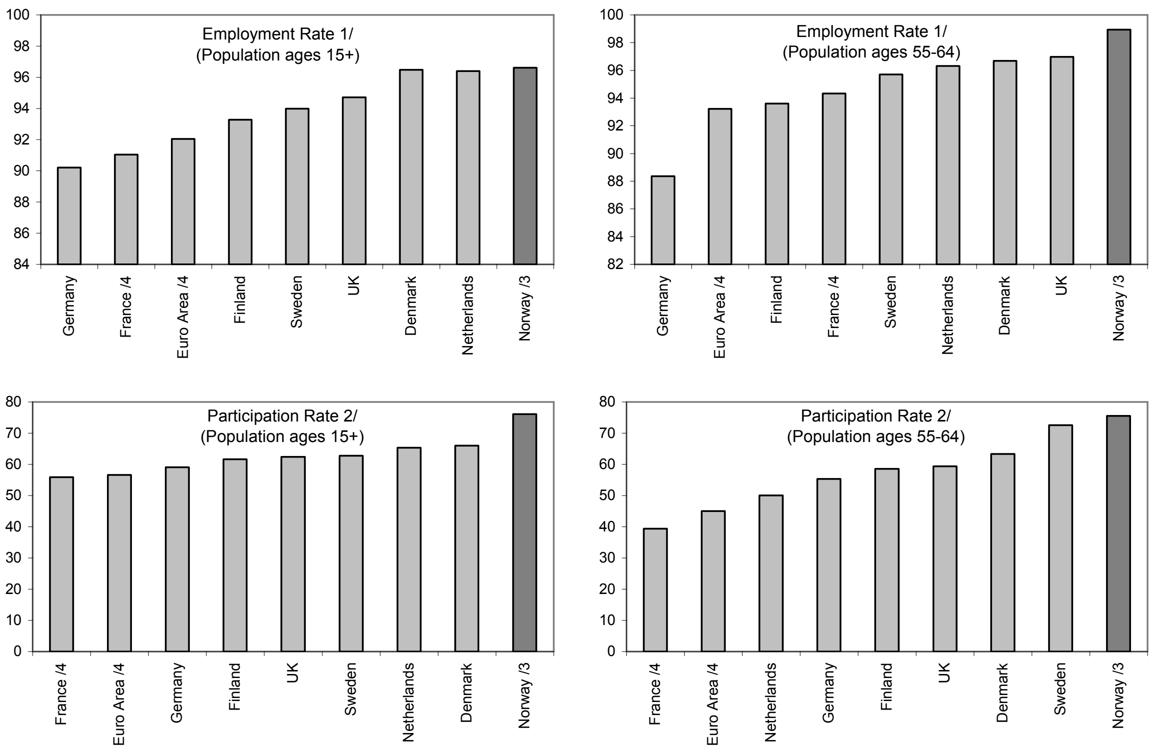


Non-oil deficits have stabilized.



Sources: Ministry of Finance; and IMF staff estimates.

Figure 9. Norway: Employment and Participation Rates
(Percent)



Source: Eurostat, Q4 2006 data
1/ Estimated as persons employed over labor force.
2/ Estimated as persons in the labor force over population.
3/ Q4 2006 data.
4/ Q2 2006 data.

Table 1. Norway: Selected Economic Indicators, 2002-08

	2002	2003	2004	2005	2006	Proj. 1/ 2007	2008
Real economy (change in percent)							
Private consumption	3.1	2.8	5.6	3.3	4.3	4.0	3.2
Public consumption	3.1	1.7	1.5	1.8	2.2	2.8	3.0
Gross fixed investment	-1.1	0.2	10.2	11.2	8.9	5.7	3.3
Export of goods and services	-0.3	-0.2	1.1	0.7	1.5	2.4	4.9
of which : Oil and gas	2.4	-0.6	-0.5	-5.0	-5.4	-1.3	7.3
Import of goods and services	1.0	1.4	8.8	8.6	9.1	5.5	3.8
GDP	1.5	1.0	3.9	2.7	2.9	2.8	3.6
Mainland GDP 2/	1.4	1.3	4.4	4.5	4.6	3.8	2.7
Consumer prices	1.3	2.5	0.4	1.6	2.3	0.8	2.5
Wages (Full-time equivalents)	5.7	4.5	3.8	3.3	4.3	…	…
Unemployment (percent of labor force)	3.9	4.5	4.5	4.6	3.4	2.8	2.9
Money and credit (end-period, 12-month percent change)							
Broad money, M2	8.6	2.3	7.8	11.3	13.3	…	…
Domestic credit	8.9	6.8	8.9	13.1	14.6	…	…
Interest rates (year average, in percent)							
Three-month interbank rate	6.9	4.1	2.0	2.2	3.0	…	…
Ten-year government bond yield	6.4	5.0	4.4	3.7	4.1	…	…
Public finance (percent of mainland GDP)							
Central government 3/							
Revenues	56.4	54.9	55.1	59.5	62.9	63.4	64.3
of which: Non-oil revenues	41.3	39.9	38.7	39.0	38.3	39.5	39.5
Expenditures	47.7	46.5	45.9	45.0	43.6	44.3	44.4
Overall balance	8.7	8.4	9.2	14.6	19.3	19.1	19.9
of which: Non-oil balance	-5.1	-5.2	-5.8	-4.5	-3.8	-3.5	-4.2
General government financial balance 4/	11.5	9.3	14.4	21.6	25.9	24.7	26.8
of which: Non-oil balance	-3.8	-6.5	-4.6	-2.7	-2.8	-2.9	-3.6
Balance of payments (percent of mainland GDP)							
Current account balance	15.7	15.4	16.4	20.8	23.0	18.9	21.5
of which: Non-oil balance	-6.5	-6.5	-8.4	-8.5	-8.7	-9.4	-9.5
Trade balance (goods and services)	16.7	16.2	17.4	22.1	24.5	20.0	22.6
Net exports of oil and gas	22.2	21.9	24.8	29.3	31.6	28.3	31.0
Exchange rates (percent change)							
Nominal effective exchange rate	9.0	-1.8	-2.4	4.2	-0.3	…	…
Real effective exchange rate	8.5	-1.2	-3.6	3.9	0.2		
Memorandum item:							
Nominal GDP (billions of NKr)	1,532	1,594	1,743	1,943	2,148	2,170	2,338
Nominal mainland GDP (billions of NKr)	1,225	1,275	1,355	1,446	1,563	1,609	1,705

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

1/ IMF staff projections as of March 2007. Fiscal projections are based on the 2007 budget, published on October 6, 2006.
2/ Excludes items related to petroleum exploitation and ocean shipping.
3/ Budget definition.
4/ National accounts definition.

Table 2. Norway: External Indicators, 2002-12

						Projections 1/					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Balance of payments					(Billions of USD)						
Goods and services											
Exports	79.5	90.8	108.9	134.4	155.6	155.3	164.5	165.9	166.7	167.2	167.7
Goods	59.3	68.3	82.7	103.9	121.6	119.0	128.7	129.6	129.8	129.7	129.6
o/w: oil and natural gas	34.5	39.7	50.1	66.5	77.5	72.3	82.6	82.9	82.5	81.6	80.8
Non-factor services	20.2	22.4	26.1	30.5	34.0	36.3	35.8	36.3	36.9	37.5	38.1
Imports	53.6	61.6	73.8	84.8	95.8	104.5	104.5	106.8	110.0	113.3	116.8
Goods	35.8	41.3	50.3	57.0	65.7	71.6	71.6	73.2	75.4	77.6	80.0
Non-factor services	17.8	20.2	23.5	27.9	30.2	32.9	32.9	33.6	34.6	35.7	36.8
Trade balance	23.4	27.0	32.5	46.9	55.9	47.4	57.1	56.4	54.4	52.1	49.6
Services balance	2.4	2.2	2.6	2.6	3.9	3.4	2.9	2.7	2.3	1.8	1.3
Balance of goods and services	25.9	29.2	35.0	49.5	59.8	50.8	60.1	59.1	56.7	53.9	50.9
Balance of factor payments	-1.6	-1.5	-2.1	-2.8	-4.9	-2.8	-2.9	-2.8	-2.6	-2.1	-2.0
Current account balance	24.2	27.7	32.9	46.7	56.1	48.0	57.1	56.3	54.0	51.8	48.9
Net capital flows	-0.2	0.7	-0.2	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Net financial flows	-17.9	-21.9	-27.8	-41.2	-40.6	-39.0	-48.2	-47.6	-45.4	-43.3	-40.5
Reserve changes	-6.8	-0.3	-5.5	-4.5	-5.4	0.0	0.0	0.0	0.0	0.0	0.0
					(Percent of GDP)						
Goods and services											
Exports	51.5	50.4	54.1	59.8	63.8	61.0	62.0	60.9	59.6	58.1	56.6
Goods	38.4	37.9	41.1	46.3	49.8	46.8	48.5	47.6	46.4	45.1	43.8
o/w: oil and natural gas	22.4	22.0	24.9	29.6	31.7	28.4	31.2	30.4	29.5	28.4	27.3
Non-factor services	13.1	12.5	13.0	13.6	13.9	14.3	13.5	13.3	13.2	13.0	12.9
Imports	34.7	34.2	36.7	37.8	39.3	41.1	39.4	39.2	39.3	39.4	39.4
Goods	23.2	22.9	25.0	25.4	26.9	28.1	27.0	26.9	26.9	27.0	27.0
Non-factor services	11.5	11.2	11.7	12.4	12.4	12.9	12.4	12.3	12.4	12.4	12.4
Trade balance (goods)	15.2	15.0	16.1	20.9	22.9	18.6	21.5	20.7	19.5	18.1	16.8
Services balance	1.6	1.2	1.3	1.2	1.6	1.3	1.1	1.0	0.8	0.6	0.4
Balance of goods and services	16.7	16.2	17.4	22.1	24.5	20.0	22.6	21.7	20.3	18.7	17.2
Balance of factor payments	-1.0	-0.8	-1.1	-1.3	-2.0	-1.1	-1.1	-1.0	-0.9	-0.7	-0.7
Current account balance	15.7	15.4	16.4	20.8	23.0	18.9	21.5	20.7	19.3	18.0	16.5
Net capital flows	-0.1	0.4	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net financial flows	-11.6	-12.2	-13.8	-18.4	-16.7	-15.3	-18.2	-17.5	-16.2	-15.0	-13.7
Reserve changes	-4.4	-0.2	-2.7	-2.0	-2.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Net foreign assets											
(Percent of GDP)	44.2	63.4	77.2	94.6	112.3	130.1	146.8	163.8	179.3	193.2	205.3
Government Pension Fund - Global (Percent of GDP)											
Based on the 2007 National Budget assumptions	49.4	66.4	74.6	96.1	114.1	135.6	153.8	170.6	…	…	…
Based on WEO oil price and exchange rate assumptions	49.4	66.4	74.6	96.1	114.1	133.6	151.0	168.7	185.2	200.2	213.6
Nominal effective exchange rate (1995=100)	103.0	101.1	98.7	102.9	102.6	…	…	…	…	…	…
Real effective exchange rate (1995=100) 2/	106.0	104.7	100.9	104.9	105.1	…	…	…	…	…	…

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

1/ IMF staff projections as of March 2007.

2/ Based on CPI.

Table 3. Norway: Recent Fund Staff Recommendations and Implementation 1/

Past Staff Recommendations	Implementation
Monetary policy	
Move toward a neutral stance as the recovery takes hold. As growth picked up and labor markets began to tighten, staff recommended to increase the pace of withdrawal of monetary stimulus.	NB kept its policy rate at a historically low of 1.75 percent from March 2004 to mid-2005. Since then, it raised the rate nine times. More recently, NB increased its intervention rate four consecutive times.
Inflation targeting framework	
Enhance transparency of policy making.	Policy transparency was improved by the governor's appearance before parliament, continued outside evaluation of policy by Norges Bank Watch, publishing the monetary policy strategy document at the beginning of the strategy period and providing a more detailed discussion of policy decisions.
Continue to explain the framework to the public.	NB has continued explaining the framework to the public and has taken a number of measures to increase the transparency of policy making.
Fiscal policy	
Adhere to the fiscal guidelines and reduce upward deviation from the 4 percent rule. Introduce a multiyear fiscal framework, with spending ceilings as an important component.	The rule has never been met since its inception in 2002. However, the upward deviation from the fiscal rule is projected to be very small in 2007. The Finance Ministry publishes its medium projections, but they are not binding.
Improve the tax structure through building on the recommendations of the tax commission, including a reduction in labor tax, reducing tax arbitrage possibilities, and raising tax rates on property.	Most of the recommendations of the tax commission has been implemented.
Implement a package of pension reforms proposed by the Pension Commission, and as agreed by the political parties in 2005.	Parliament agreed the main principles for a pension reform in May 2005 and a reform package in March 2007, which followed closely recommendations of the Pension Commission and the 2006 government white paper.
Financial system	
Monitor credit developments closely. Implement the recommendations of the 2005 FSAP.	The FSAN is closely monitoring credit developments and has urged more restrictive lending for housing purposes. The implementation of the FSAP recommendations have so far been good, but some recommendations, such as delegating more independence to the FSAN, are not likely to be implemented.
Competition policy	
Continue to foster competitive forces, including through further deregulation and vigorous action by the strengthened Competition Authority. Pursue privatization.	The incumbent government has put further privatization on hold. In 2006, the state increased its share in the energy sector, through the merger of Statoil and Norsk Hydro. There have been cases in which the competition authority has been overruled.
Welfare benefits and labor market policy	
Tighten administrative controls and review the very high replacement rates in both the sickness and disability schemes. Decentralize wage bargains and reduce the tax wedge.	The authorities tightened administrative controls in the sickness program in 2004, but have not lowered the replacement rates. The government's proposal in 2006 to increase the share of employers/social security in cofinancing the sickness bill has met strong resistance from both employers and employees. The tax wedge was reduced by lowering marginal labor tax rates. A commission, headed by the Prime Minister, has suggested new financial and accelerated activation measures to be implemented this year.

1/ See the Staff Reports for 2004 and 2005 (http://imf.org/external/pubs/cat/longres.cfm?sk=17307.0; http://imf.org/external/pubs/cat/longres.cfm?sk=18319.0) and
the concluding statement of the 2006 staff visit (http://imf.org/external/np/ms/2006/061206.htm).

Table 4. The Core Set of Financial Soundness Indicators for Deposit Taking Institutions, 1999−2006
(Percent)

	1999	2000	2001	2002	2003	2004	2005	2006 Q3
Regulatory capital to risk-weighted assets	12.0	12.1	12.6	12.1	12.4	12.2	11.9	11.2
Regulatory Tier I capital to risk-weighted assets	9.3	9.1	9.7	9.6	9.7	9.8	9.6	8.5
Nonperforming loans net of provisions to total assets	0.6	0.7	0.7	1.0	0.9	0.5	0.4	0.4
Nonperforming loans to total gross loans	1.3	1.2	1.3	1.8	1.6	1.0	0.7	0.6
Sectoral distribution of loans to total loans (enterprises and households, domestic and foreign residents)								
Loans to Insurance corporations	0.1	0.1	0.2	0.1	0.2	0.2	0.1	0.1
Loans to Domestic and foreign credit instituitions	5.9	6.5	7.0	8.1	8.8	6.8	6.4	7.2
Loans to Non-financial corporations	35.4	36.0	34.9	32.4	29.2	27.6	28.4	29.9
Loans to Households	56.7	56.0	56.7	58.2	60.5	64.4	63.8	61.5
Consumer credit (=all loans to households without mortgage on dwelling	11.3	11.1	11.2	10.8	10.3	10.7	10.0	9.5
Lending for house purchase	45.3	44.9	45.4	47.4	50.2	53.7	53.8	52.0
Return on assets (after tax)	1.0	1.0	0.8	0.4	0.6	0.9	0.9	0.8
Return on equity (after tax)	15.8	15.6	11.6	6.2	9.6	14.6	18.0	15.7
Net interest and credit commission income to gross income	27.1	24.8	23.5	25.1	28.0	33.1	29.8	26.6
Non-interest expenses to gross income	24.1	22.1	20.6	20.7	24.0	28.9	25.5	21.7
Liquid assets to total assets	15.9	15.6	14.8	15.7	16.8	15.4	15.9	17.9
Liquid assets to short-term liabilities	62.5	61.1	60.0	56.5	58.9	62.2	54.8	60.3

Source: Norges Bank.

Table 5. Norway: Financial System Structure, 1999−2006

	1999	2000	2001	2002	2003	2004	2005	2006 Q3
Number								
Banks	151	152	151	152	151	148	148	149
Commercial banks	12	11	12	13	12	10	8	9
Savings banks	130	130	129	129	129	127	126	126
Foreign-owned subsidiaries	0	2	2	2	2	3	6	6
Branches of foreign banks	9	9	8	8	8	8	8	8
Securities companies	…	…	…	…	…	122	…	…
Mortgage companies	10	12	11	11	11	12	13	13
Insurance companies	110	112	116	126	113	112	117	114
Pension funds	…	…	…	…	…	140	…	…
Other credit institutions	48	54	55	53	50	48	48	51
Concentration 1/								
Banks	10	10	10	10	10	12	11	11
Insurance companies	5	6	6	6	6	5	5	5
Assets 2/								
Banks	1,175.3	1,331.1	1,456.1	1,569.0	1,723.6	1,805.5	2147.1	2516.5
Commercial banks 3/	617.8	623.6	451.9	482.2	506.5	112.6	74.6	83.7
Savings banks 3/	488.5	559.3	624.6	681.3	744.9	1,206.1	1,409.6	1636.0
Foreign-owned subsidiaries	0.0	64.1	262.7	275.6	288.2	314.2	434.4	518.9
Branches of foreign banks	69.0	84.2	117.0	129.9	184.1	172.7	228.6	278.0
Insurance companies	463.8	477.0	513.2	528.3	587.0	651.7	739.7	784.3
Other credit institutions	419.0	465.1	530.2	566.8	617.0	664.7	730.6	786.6
Deposits 2/								
Banks	772.7	851.0	934.0	1,038.6	1,077.6	1,137.5	1,346.4	1,576.6
Commercial banks 3/	380.0	371.2	272.6	297.2	297.6	64.1	46.1	54.2
Savings banks 3/	337.6	366.3	394.5	440.8	460.9	715.9	825.0	912.3
Foreign-owned subsidiaries	0.0	42.2	166.4	193.4	200.8	232.4	327.2	390.8
Branches of foreign banks	55.1	71.3	100.5	107.3	118.3	125.1	148.1	219.3

Source: Norges Bank.

1/ Number of institutions with 75 percent of total assets.
2/ Billions of NKR.
3/ DnB and Gjensidige NOR Sparebank merged in 2004, and the bank was then moved to the savings banks sector.

Table 6. Norway: The Encouraged Set of Financial Soundness Indicators, 1999−2006
(In percent, unless otherwise specified)

	1999	2000	2001	2002	2003	2004	2005	2006 Q3 1/
Corporate Sector								
Total debt to equity	169.3	173.5	186.2	184.9	173.5	172.4	150.3	…
Return on equity	21.6	29.1	26.1	24.8	25.2	33.5	39.2	…
Number of bankruptcies	3,243	3,576	3,562	4,473	5,223	4,297	3,540	3,032
Deposit-taking institutions								
Capital to assets	6.6	6.5	6.5	6.2	5.9	5.9	5.2	5.0
Geographical distribution of loans to total loans (enterprises and households)								
Domestic	94.3	95.2	95.7	96.4	97.1	97.0	96.4	96.0
Foreign	5.7	4.8	4.3	3.6	2.9	3.0	3.6	4.0
Large exposures to capital	…	…	…	…	…	62.0	57.0	…
Trading income to total income	…	…	…	…	…	…	8.0	…
Personnel expenses to noninterest expenses	54.6	52.0	52.4	52.2	53.2	52.0	53.3	54.0
Customer deposits to total (non-interbank) loans	70.3	68.1	68.3	69.3	66.6	65.6	61.2	61.1
Foreign currency-denominated liabilities to total liabilities	22.7	24.5	24.4	22.2	25.8	24.7	26.8	29.7
Other financial corporations								
Assets to total financial system assets	42.9	41.4	41.7	41.1	41.1	42.2	40.6	38.4
Households								
Household debt to GDP	97.1	112.4	115.4	117.1	123.5	132.8	146.5	152.5
Household debt service and principal payments to income	8.8	8.8	10.3	10.5	9.1	6.3	6.2	…
Household net financial wealth to GDP	38.2	43.2	35.6	28.8	32.8	34.7	40.0	38.5
Real estate markets								
Residential 2/	13.1	15.1	7.7	6.7	1.8	12.3	9.3	15.0
Commercial 2/	1.8	9.2	11.0	-2.3	1.8	11.6	5.8	…
Residential real estate loans to total loans	38.0	37.0	37.0	39.0	41.0	44.0	43.0	…
Commercial real estate loans to total loans	13.0	14.0	14.0	14.0	13.0	13.0	13.0	…

Source: Norges Bank.
1/ 2006 for households and real estate prices
2/ Annual change in the index.

Table 7. Key FSAP Recommendations and Implementation

Recommendations 1/	Implementation
Shorter-term stability-related issues	
Continue carefully monitoring the evolution of household debt and the housing market; and examine whether banks have concentrations of exposures to more vulnerable sub-groups of household borrowers.	The FSAN and NB are closely monitoring credit and housing market developments. The FSAN has urged restrictive lending for housing purposes. It has continued examining banks' exposures to more vulnerable sub-groups of household borrowers and has published the results of its studies.
Given the reduced risk weighting of mortgages under Basel II, carefully consider whether additional requirements for banks should be required under "Pillar 2."	The five Norwegian banks that have been given approval to use the IRB approach under Basel II are, according to EU directives, not allowed to reduce their capital to less than 95 percent, 90 percent, and 80 percent of that required under Basel I in 2007, 2008, and 2009, respectively. Banks' preparedness for ICAAP (Internal Capital Adequacy Assessment Process) was examined in 2006 and the first evaluations of the ICAAP processes will take place during 2007.
Continue to carefully monitor the risk of spillovers, in extreme events, resulting from the two-tier payments arrangements, and examine the scope for increasing the use of collateral in interbank market exposures.	The technical platform for clearing of retail transactions is to be upgraded in 2008. At the same time, the rules for transactions that have to be settled on a gross basis will be changed. This will reduce risk. New rules for acceptance of collateral have been implemented.
Further reduce market and liquidity risk in the securities settlement and retail payments systems.	The securities settlement payment system is being reformed. Retail payment clearing is to be upgraded (see above). Delivery versus payment (DvP) at broker level will be implemented through an integrated model with simultaneous settlement of paper leg and money leg, also in the event of a bank failing to settle.
Continue working with other Nordic authorities to refine the framework for cross-border crisis management and coordination of last resort lending; domestically, ensure appropriately coordinated contingency plans in the unlikely event of a major problem at the largest, partly state-owner bank, DNB-NOR.	The authorities have continued working with other Nordic authorities and have achieved some progress in terms of-cross border crisis management. The Nordic countries are planning a crisis simulation for fall 2007. Cross-border issues are also being reviewed in an EU-context.
Formalize more regular high-level meetings between the MoF, NB, and FSAN.	Domestically, the MoF has decided to have biannual meetings focusing on the outlook for financial stability and coordination of the relevant institutions' (MoF, NB, and FSAN) work on contingency planning. The Contingency Committee for Financial Infrastructure, chaired by NB, promotes cooperation among financial sector participants.
Structural and longer-term issues	
Re-examine key aspects of the deposit guarantee arrangements, including whether and how to achieve greater international comparability in coverage levels.	The issue is being reviewed in an EU context.
Examine whether the netting of medium-sized and smaller interbank payments could be phased out.	The new retail payment settlement system (to be finalized in Q2, 2007) is expected to solve this issue.
Review the continued desirability of state ownership in DNB-NOR. In the interim, consider further entrenching appropriate commercial autonomy and accountability for the bank	The authorities have held that the bank is run on a purely commercial basis, but the likelihood of privatization is very small under the current government, which has put further privatization on hold.
Provide greater independence to FSAN.	The authorities explained that FSAN is an administrative agency acting under the general responsibilities of the Ministry of Finance, and that under general administrative law the parties concerned may submit decisions made by the FSAN for review by the ministry. Further, they pointed out that a constitutional system where the minister is responsible to the legislature (the Storting) for financial supervision limits the possibility for excluding ministerial oversight and decision making. The authorities also recalled that there is no clear distinction between supervisory issues and issues of a structural and political nature.

1/ See the 2005 FSSA Report (http://www.imf.org/external/pubs/cat/longres.cfm?sk=18324.0).

Table 8. Norway: Fiscal and Monetary Indicators, 2002-07
(Percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	Proj. 2007
Central Government 1/						
Revenue	56.4	54.9	55.1	59.5	62.9	63.4
of which : oil revenue	15.1	15.0	16.4	20.5	24.6	23.9
Expenditure	47.7	46.5	45.9	45.0	43.6	44.3
Balance	8.7	8.4	9.2	14.6	19.3	19.1
of which : non-oil balance	-5.1	-5.2	-5.8	-4.5	-3.8	-3.5
less adjustments:						
Extraordinary items 2/	-1.8	-0.1	0.0	0.0	-0.1	0.0
Cyclical correction 3/	-0.2	-1.5	-1.9	-0.9	0.3	0.9
Structural non-oil balance	-3.2	-3.6	-3.9	-3.6	-4.0	-4.4
In percent of trend GDP	-3.3	-3.6	-3.9	-3.6	-4.1	-4.5
General Government 4/						
Revenue	66.6	65.9	69.0	74.4	77.9	77.8
of which : oil revenue	15.5	15.9	19.1	24.4	28.7	27.8
Expenditure	55.1	56.6	54.5	52.8	52.1	53.1
Balance	11.5	9.3	14.4	21.6	25.9	24.7
of which : non-oil balance	-3.8	-6.5	-4.6	-2.7	-2.8	-2.9
Cyclically adjusted non-oil balance 5/	-3.8	-5.0	-2.7	-1.9	-3.2	-3.9
Net assets	88.4	102.7	111.3	134.4	150.2	170.6
Monetary Indicators:						
M2 6/	8.6	2.3	7.8	11.3	13.3	…
Domestic credit 6/	8.9	6.8	8.9	13.1	14.6	…
Three-month interbank rate 7/	6.9	4.1	2.0	2.2	3.0	…
Ten-year government bond yield 7/	6.4	5.0	4.4	3.7	4.1	…

Sources: Ministry of Finance; Norges Bank; and IMF staff estimates.

1/ Budget definition. Ministry of Finance. Fiscal projections are based on the 2007 budget, published on October 6, 2006.
2/ Includes exceptional transactions with local government and accounting discrepancies.
3/ Includes cyclical adjustments for transfers from Norges Bank and net interest income.
4/ National accounts definition. Ministry of Finance. Fiscal projections are based on the revised 2007 budget, published on October 6, 2006.
5/ Percent of trend mainland GDP (estimated by Fund staff). Adjusted for cyclical effects (central government), estimated by Ministry of Finance.
6/ End-period, percent change, national definition.
7/ Period average, percent.

Table 9. Norway: General Government Financial Accounts, 2002-07

	2002	2003	2004	2005	2006	Proj. 1/ 2007
			(Billions of NKr)			
Total revenue 2/	816.2	840.0	934.8	1,075.4	1,217.7	1,252.4
Oil revenue	166.7	177.0	225.7	315.6	400.0	371.3
Non-oil revenue	650.7	665.5	710.6	761.4	818.8	882.4
Financial income 3/	70.6	72.2	75.3	83.3	101.1	129.9
Of which, return on the GPF	22.6	25.8	33.3	36.9	49.0	75.3
Tax revenue	567.7	576.2	620.8	662.7	701.4	736.3
Transfers	11.2	15.5	13.0	13.6	14.4	14.3
Capital revenue	1.2	1.5	1.7	1.8	1.9	2.0
Total expenditure 2/	675.3	721.3	739.2	763.3	813.6	854.3
Oil expenditure	1.3	1.3	1.2	0.7	1.2	1.3
Non-oil expenditure	675.2	722.4	739.6	764.2	813.6	854.3
Financial expenditure	27.7	28.8	24.5	23.4	26.2	26.1
Consumption	338.4	354.3	370.8	387.5	409.8	432.2
Transfers	290.6	317.1	323.8	333.1	347.5	367.6
Capital expenditure	18.5	22.2	20.5	20.1	30.1	28.4
Overall balance	140.9	118.7	195.6	312.0	404.1	398.1
Non-oil balance 4/	-47.1	-82.7	-62.2	-39.7	-43.8	-47.2
Cyclically adjusted non-oil balance 4/ 5/	-41.6	-65.7	-52.2	-38.2	-54.6	-65.5
Cyclically adjusted non-oil primary balance 4/ 5/	-61.9	-83.4	-69.7	-61.2	-80.5	-94.0
			(Percent of GDP)			
Total revenue 2/	66.6	65.9	69.0	74.4	77.9	77.8
Oil revenue	13.6	13.9	16.7	21.8	25.6	23.1
Non-oil revenue	53.1	52.2	52.4	52.7	52.4	54.8
Financial income 3/	5.8	5.7	5.6	5.8	6.5	8.1
Tax revenue	46.4	45.2	45.8	45.8	44.9	45.8
Transfers	0.9	1.2	1.0	0.9	0.9	0.9
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure 2/	55.1	56.6	54.5	52.8	52.1	53.1
Non-oil expenditure	55.1	56.7	54.6	52.9	52.1	53.1
Financial expenditure	2.3	2.3	1.8	1.6	1.7	1.6
Consumption	27.6	27.8	27.4	26.8	26.2	26.9
Transfers	23.7	24.9	23.9	23.0	22.2	22.8
Capital expenditure	1.5	1.7	1.5	1.4	1.9	1.8
Overall balance	11.5	9.3	14.4	21.6	25.9	24.7
Non-oil balance 4/	-3.8	-6.5	-4.6	-2.7	-2.8	-2.9
Cyclically adjusted non-oil balance 4/ 5/	-3.4	-5.0	-3.8	-2.6	-3.5	-4.2
Cyclically adjusted non-oil primary balance 4/ 5/	-5.0	-6.4	-5.1	-4.2	-5.2	-6.0
Memorandum items:						
Net public assets						
Billions of NKr	1,082.8	1,309.3	1,508.6	1,943.0	2,347.1	2,745.2
Percent of GDP	88.4	102.7	111.3	134.4	150.2	170.6
Nominal GDP (billions of NKr) /6	1,224.6	1,274.8	1,355.3	1,446.0	1,563.1	1,608.9
Trend nominal GDP (billions of NKr) /6	1,236.3	1,310.0	1,375.1	1,447.5	1,541.3	1,573.6
Output gap /6	-0.9	-2.7	-1.4	-0.1	1.4	2.2

Sources: Ministry of Finance; and IMF staff estimates.

1/ Fiscal projections are based on the 2007 budget, published on October 6, 2006.
2/ Because of transfers between government sectors, the sum of oil revenue (expenditure) and non-oil revenue (expenditure) is not necessarily equal to total revenue.
3/ Includes the return on the Government Pension Fund (GPF).
4/ Excludes the return on the GPF.
5/ Percent of trend mainland GDP. Adjusted for cyclical effects. IMF staff estimates and projections.
6/ IMF staff estimates and projections.

Table 10. Norway: Indicators of External and Financial Vulnerability, 2002-06
(Percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006
External Indicators					
Exports of goods and services (annual percentage change, USD)	1.5	14.3	19.9	23.4	15.8
Imports of goods and services (annual percentage change, USD)	8.8	14.9	19.9	14.9	12.9
Terms of trade (annual percentage change)	-5.5	1.0	7.7	15.9	9.1
Current account balance	15.7	15.4	16.4	20.8	23.0
Capital and financial account balance	-11.7	-11.8	-13.9	-18.5	-16.7
Direct investment, net	-3.2	-1.4	-1.4	-6.5	-1.8
Portfolio investment, net	-15.5	-3.3	-14.1	-2.9	-32.0
International reserves (end of period, billions of USD)	32.4	37.7	44.3	47.0	56.8
Exchange rate against US dollar (NKr, period average)	7.9	7.1	6.7	6.4	6.4
Exchange rate against Euro (NKr, period average)	7.5	8.0	8.4	8.0	8.0
Real effective exchange rate (based on CPI, annual percentage change)	8.5	-1.2	-3.6	3.9	-0.7
Financial Markets Indicators					
Gross public debt (end-period)	35.8	44.0	45.6	43.8	43.8
3-month T-bill yield (end-period, nominal, percent per annum)	6.8	2.4	1.8	2.3	3.6
3-month T-bill yield (end-period, ex post real, percent per annum)	4.0	1.8	0.7	0.5	1.4
Spread of 3-month T-bill vs. Germany (percentage points, end-period)	3.1	0.9	0.0	0.2	0.3
Spread of 10-year T-bill vs. Germany (percentage points, end-period)	1.3	-0.2	-0.1	0.2	0.4
General stock index (percentage change, end-period)	-30.2	47.0	37.2	41.0	33.6
Housing price index (percentage change, end-period)	2.8	4.1	10.5	7.8	16.7
Credit from domestic sources (percentage change, end-period)	8.9	6.8	8.9	13.1	14.6
Financial Sector Risk Indicators					
			(Percent)		
Loans to assets	80.5	79.5	81.3	81.0	79.1
Mortgages/total loans	47.4	50.2	53.7	53.8	52.0
Regulatory capital ratio	12.1	12.4	12.2	11.9	11.2
Tier 1 capital ratio	9.6	9.7	9.8	9.6	8.5
Return on assets	0.4	0.6	0.9	0.9	0.8
Return on equity	6.2	9.6	14.6	18.0	15.7
Foreign currency/total domestic credit	6.1	6.0	4.8	4.4	5.5
Foreign currency liability/total liability and equity	20.8	24.3	23.2	25.4	28.2
Household debt (percent of pre-tax profit, depreciation and write-downs)	150.2	158.1	166.3	178.8	192.0
Private non-financial enterprise debt (percent of pre-tax profit, depreciation and write-offs)	453.5	361.1	256.9	223.6	232.1

Sources: Norges Bank, IFS, and IMF staff estimates.

INTERNATIONAL MONETARY FUND

NORWAY

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the European Department

May 10, 2007

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APPENDIX I: FUND RELATIONS

(As of February 28, 2007)

I. **Article IV Consultation**: Discussions for the 2005 Article IV Consultation were held in Oslo during March 7–15, 2005. The Staff Report was considered by the Executive Board on June 3, 2005.

The 2007 Article IV discussions were held in Oslo during March 15-26, 2007. The mission, comprised Mr. Ford (head), Ms. Bordon, and Messrs. Gagales and Rossi, while Mr. Jafarov was involved in pre-mission preparation (all EUR). The mission met with the Ministry of Finance, Norges Bank, senior officials of other ministries and Statistics Norway, representatives of labor and business organizations, private sector analysts, and academics. Mr. Bergundhaugen, from the Office of the Executive Director for Nordic-Baltic countries, participated in discussions.

Norway has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement. Norway subscribes to the Special Data Dissemination Standard, and its economic statistics are satisfactory for surveillance purposes. Norway is a member of the European Economic Area, which provides for free movement of goods, services, labor, and capital with the European Union.

The authorities intend to publish this report.

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

III. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	1,671.70	100.00
Fund holdings of currency	1,534.10	91.77
Reserve position in Fund	137.61	8.23

IV. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	167.77	100.00
Holdings	299.28	178.39

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

VI. **Financial Arrangements**: None

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

VIII. **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. Norway maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for exchange restrictions maintained for security reasons that have been notified to the Fund pursuant to Decision No. 144-(51/52) (August 14, 1952).

IX. **Technical Assistance:** None (since 1998).

X. **Resident Representative:** None.

Appendix II: Norway: Statistical Issues

Norway maintains high standards in the provision of economic data, which are adequate for surveillance purposes. In some instances, including oil wealth, in particular, the GPF—Global, and SOEs, transparency is very strong by international standards. For example, The Ministry of Petroleum and Energy and Statistics Norway regularly publish data on energy resources and activity (http://www.regjeringen.no/en/dep/oed/Documents-and-publications/Reports.html?id=35236; http://www.ssb.no/english/subjects/10/06/20/) while Norges Bank, the manager of the GPF – Global, regularly publishes detailed (quarterly and annual) reports on the portfolio and performance of the fund (http://www.norges-bank.no/nbim/pension_fund/). The Ministry of Trade and Industry regularly publishes state ownership reports (http://www.regjeringen.no/en/dep/nhd/Selected-topics/ownership/State-Ownership.html?id=382852). The task of collecting financial sector data was recently moved from NB to Statistics Norway (SN), which the former viewed as increasing its focus on its core monetary policy mission.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of April 26, 2007)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	Apr. 23, 2007	Apr. 24, 2007	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar. 2007	Apr. 2007	M	M	M		
Reserve/Base Money	Mar. 2007	Apr. 2007	M	M	M	O, O, O, LO	O, O, O, O, O
Broad Money	Mar. 2007	Apr. 2007	M	M	M		
Central Bank Balance Sheet	Mar. 2007	Apr. 2007	M	M	M		
Consolidated Balance Sheet of the Banking System	Mar. 2007	Apr. 2007	M	M	M		
Interest Rates[2]	Apr. 23 2007	Apr. 24, 2007	D	D	D		
Consumer Price Index	Mar. 2007	Apr. 2007	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005	Apr. 2006	A	A	A	LO, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Q4, 2006	Mar. 2007	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4, 2006	Mar. 2007	Q	Q	Q		
External Current Account Balance	Q4. 2006	Mar. 2007	Q	Q	Q	O, O, O, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	Q4. 2006	Mar. 2007	Q	Q	Q		
GDP/GNP	Q4. 2006	Mar. 2007	Q	Q	Q	O, O, O, O	O, O, O, O, LO
Gross External Debt	Q4. 2006	Mar. 2007	I	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government, including National Insurance Scheme, and local governments.
[5] Including currency and instrument composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in July 2003, and based on the findings of the mission that took place during November 11–26, 2002 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

NORWAY

Staff Report for the 2007 Article IV Consultation

Supplementary Information

Prepared by the European Department

Approved by Juha Kähkönen and Adnan Mazarei

May 30, 2007

1. This staff supplement reports on the Norwegian mid-term budget, released on May 15, 2007. It does not change the thrust of the staff appraisal. The PIN is also attached.

2. Revised 2006 fiscal estimates show that the central government non-oil structural deficit was only very slightly larger than 4 percent of the assets of Government Pension Fund-Global (GPF), by Nkr 0.5 billion. The difference with respect to the original budget, which had indicated a somewhat larger overshooting of Nkr 7.3 billion (0.5 percent of mainland GDP), reflects more buoyant revenue.

3. This deficit is set to be 3.8 percent of GPF assets in 2007, which will leave it below 4 percent for the first time since the fiscal guidelines were put in effect in 2002. This overperformance is in line with staff advice. Nevertheless, the rapid increase in GPF assets will make room for significant fiscal expansion, underscoring the authorities' and staff's concern regarding increases in fiscal deficits owing to rapidly rising GPF assets. In the absence of tax cuts, real government spending is set to rise by 3¾ percent in 2007, and the general government structural deficit, as estimated by staff, by ⅔ percent of GDP.

4. The attached tables have been updated in light of the revision to the 2007 budget.

Central Government Fiscal Position Under Different Oil Prices, 2002-10
(In percent of mainland GDP; unless otherwise specified)

						Projections			
							Based on the 4-percent rule		
	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Based on the 2007 revised National Budget projections								
Structural non-oil balance	-3.2	-3.6	-3.5	-3.6	-3.6	-4.2	-5.2	-5.7	-6.2
4 percent of GPF assets	-2.0	-1.9	-2.5	-2.8	-3.6	-4.4	-5.2	-5.7	-6.2
Non-oil expenditures	46.4	45.1	44.5	43.5	42.4	43.2	44.3	45.8	46.5
Increase in real terms									
(applying mainland GDP deflator)	13.0	-1.5	3.1	2.0	2.0	3.8	5.4	5.4	3.7
Government Pension Fund (GPF) assets									
(in percent of mainland GDP)	49.4	66.4	74.6	96.1	114.1	134.2	146.9	160.1	…
Oil price assumption (in Norwegian krone)	197.9	204.4	254.1	343.5	411.8	370.0	358.0	334.6	323.0
	Higher oil price scenario (20 percent more than in the revised 2007 budget projections)								
Structural non-oil balance	-3.2	-3.6	-3.5	-3.6	-3.6	-4.2	-5.3	-6.0	-6.6
4 percent of GPF assets	-2.0	-1.9	-2.5	-2.8	-3.6	-4.4	-5.3	-6.0	-6.6
Non-oil expenditures	46.4	45.1	44.5	43.5	42.4	43.2	44.5	46.0	46.9
Increase in real terms									
(applying mainland GDP deflator)	13.0	-1.5	3.1	2.0	2.0	3.8	5.7	5.6	3.9
Government Pension Fund (GPF) assets									
(in percent of mainland GDP)	49.4	66.4	74.6	96.1	114.1	138.0	153.8	169.9	…
Oil price assumption (in Norwegian krone)	197.9	204.4	254.1	343.5	411.8	444.0	429.6	401.5	387.6
	Based on WEO projections								
Structural non-oil balance (WEO)	-3.2	-3.6	-3.5	-3.6	-3.6	-4.2	-5.0	-5.8	-6.5
4 percent of GPF assets	-2.0	-1.9	-2.5	-2.8	-3.6	-4.4	-5.0	-5.8	-6.5
Non-oil expenditures	46.4	45.1	44.5	43.5	42.4	43.2	44.2	45.8	46.8
Increase in real terms									
(applying mainland GDP deflator)	13.0	-1.5	3.1	2.0	2.0	3.8	5.1	5.9	4.2
Government Pension Fund (GPF) assets									
(in percent of mainland GDP)	49.4	66.4	74.6	96.1	114.1	133.6	151.0	168.7	185.2
Oil price assumption (in Norwegian krone)	197.9	204.4	254.1	343.5	411.8	384.1	416.2	422.3	427.8

Sources: Ministry of Finance; and IMF staff estimates.

Table 1. Norway: Selected Economic Indicators, 2002-08

	2002	2003	2004	2005	2006	Proj. 1/ 2007	Proj. 1/ 2008
Real economy (change in percent)							
Private consumption	3.1	2.8	5.6	3.3	4.3	4.0	3.2
Public consumption	3.1	1.7	1.5	1.8	2.2	2.8	3.0
Gross fixed investment	-1.1	0.2	10.2	11.2	8.9	5.7	3.3
Export of goods and services	-0.3	-0.2	1.1	0.7	1.5	2.4	4.9
of which: Oil and gas	2.4	-0.6	-0.5	-5.0	-5.4	-1.3	7.3
Import of goods and services	1.0	1.4	8.8	8.6	9.1	5.5	3.8
GDP	1.5	1.0	3.9	2.7	2.9	2.8	3.6
Mainland GDP 2/	1.4	1.3	4.4	4.5	4.6	3.8	2.7
Consumer prices	1.3	2.5	0.4	1.6	2.3	0.8	2.5
Wages (full-time equivalents)	5.7	4.5	3.8	3.3	4.3	…	…
Unemployment (percent of labor force)	3.9	4.5	4.5	4.6	3.4	2.8	2.9
Money and credit (end-period, 12-month percent change)							
Broad money, M2	8.6	2.3	7.8	11.3	13.3	…	…
Domestic credit	8.9	6.8	8.9	13.1	14.6	…	…
Interest rates (year average, in percent)							
Three-month interbank rate	6.9	4.1	2.0	2.2	3.0	…	…
Ten-year government bond yield	6.4	5.0	4.4	3.7	4.1	…	…
Public finance (percent of mainland GDP)							
Central government 3/							
Revenues	56.4	54.9	55.1	59.5	63.7	60.9	64.1
of which: Non-oil revenues	41.3	39.9	38.7	39.0	39.6	40.8	40.8
Expenditures	47.7	46.5	45.9	45.0	43.7	44.5	44.6
Overall balance	8.7	8.4	9.2	14.6	19.9	16.3	19.5
of which: Non-oil balance	-5.1	-5.2	-5.8	-4.5	-2.8	-2.4	-3.2
General government financial balance 4/	11.5	9.1	14.3	20.4	25.0	20.9	24.1
of which: Non-oil balance	-3.8	-6.7	-4.7	-3.1	-2.0	-1.9	-2.7
Balance of payments (percent of mainland GDP)							
Current account balance	15.7	15.4	16.4	20.8	23.0	18.9	21.5
of which: Non-oil balance	-6.5	-6.5	-8.4	-8.5	-8.7	-9.4	-9.5
Trade balance (goods and services)	16.7	16.2	17.4	22.1	24.5	20.0	22.6
Net exports of oil and gas	22.2	21.9	24.8	29.3	31.6	28.3	31.0
Exchange rates (percent change)							
Nominal effective exchange rate	9.0	-1.8	-2.4	4.2	-0.3	…	…
Real effective exchange rate	8.5	-1.2	-3.6	3.9	0.2		
Memorandum item:							
Nominal GDP (billions of NKr)	1,532	1,594	1,743	1,943	2,148	2,170	2,338
Nominal mainland GDP (billions of NKr)	1,225	1,275	1,355	1,446	1,563	1,609	1,705

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

1/ IMF staff projections as of March 2007. Fiscal projections are based on the revised 2007 budget, published on May 15, 2007.
2/ Excludes items related to petroleum exploitation and ocean shipping.
3/ Budget definition.
4/ National accounts definition.

Table 8. Norway: Fiscal and Monetary Indicators, 2002-07
(Percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	Proj. 2007
Central Government 1/						
Revenue	56.4	54.9	55.1	59.5	63.7	60.9
of which: oil revenue	15.1	15.0	16.4	20.5	24.1	20.1
Expenditure	47.7	46.5	45.9	45.0	43.7	44.5
Balance	8.7	8.4	9.2	14.6	19.9	16.3
of which: non-oil balance	-5.1	-5.2	-5.8	-4.5	-2.8	-2.4
less adjustments:						
Extraordinary items 2/	-1.8	-0.1	0.0	0.0	0.1	0.0
Cyclical correction 3/	-0.2	-1.5	-2.3	-0.9	0.6	1.8
Structural non-oil balance	-3.2	-3.6	-3.5	-3.6	-3.6	-4.2
In percent of trend GDP	-3.1	-3.5	-3.5	-3.6	-3.6	-4.3
General Government 4/						
Revenue	66.6	66.0	69.2	73.6	77.5	74.7
of which: oil revenue	15.5	15.9	19.1	23.6	27.1	22.8
Expenditure	55.0	56.8	54.8	53.1	52.5	53.8
Balance	11.5	9.1	14.3	20.4	25.0	20.9
of which: non-oil balance	-3.8	-6.7	-4.7	-3.1	-2.0	-1.9
Cyclically adjusted non-oil balance 5/	-3.7	-5.2	-2.5	-2.2	-2.7	-3.8
Net assets	88.4	102.7	111.3	134.4	149.3	169.8
Monetary Indicators:						
M2 6/	8.6	2.3	7.8	11.3	13.3	…
Domestic credit 6/	8.9	6.8	8.9	13.1	14.6	…
Three-month interbank rate 7/	6.9	4.1	2.0	2.2	3.0	…
Ten-year government bond yield 7/	6.4	5.0	4.4	3.7	4.1	…

Sources: Ministry of Finance; Norges Bank; and IMF staff estimates.

1/ Budget definition. Ministry of Finance. Fiscal projections are based on the revised 2007 budget, published on May 15, 2007.
2/ Includes exceptional transactions with local government and accounting discrepancies.
3/ Includes cyclical adjustments for transfers from Norges Bank and net interest income.
4/ National accounts definition. Ministry of Finance. Fiscal projections are based on the revised 2007 budget, published on October 6, 2006.
5/ Percent of trend mainland GDP (estimated by Fund staff). Adjusted for cyclical effects (central government), estimated by Ministry of Finance.
6/ End-period, percent change, national definition.
7/ Period average, percent.

Table 9. Norway: General Government Financial Accounts, 2002-07

	2002	2003	2004	2005	2006	Proj. 1/ 2007
	(Billions of NKr)					
Total revenue 2/	815.1	840.9	937.3	1,063.8	1,211.9	1,202.0
Oil revenue	166.7	177.0	225.7	304.5	368.4	295.0
Non-oil revenue	649.6	666.4	713.2	760.9	845.2	908.1
Financial income 3/	75.1	80.2	84.7	90.8	118.4	142.0
Of which, return on the GPF	22.6	25.8	33.3	36.9	55.7	72.3
Tax revenue	563.7	571.5	617.1	658.6	714.5	753.7
Transfers	9.6	13.2	9.8	9.7	10.2	10.3
Capital revenue	1.2	1.5	1.7	1.8	2.1	2.1
Total expenditure 2/	674.0	724.7	743.2	768.2	821.1	866.4
Oil expenditure	1.3	1.3	1.2	0.7	1.2	1.1
Non-oil expenditure	673.9	725.9	743.5	769.1	821.5	866.4
Financial expenditure	27.7	28.8	24.6	23.5	32.8	26.9
Consumption	339.4	358.7	373.3	390.0	417.8	443.7
Transfers	291.0	318.5	327.0	337.6	348.2	369.6
Capital expenditure	15.8	19.8	18.7	18.0	22.7	26.1
Overall balance	141.1	116.2	194.1	295.6	390.9	335.6
Non-oil balance 4/	-46.8	-85.2	-63.6	-45.1	-32.0	-30.6
Cyclically adjusted non-oil balance 4/ 5/	-41.4	-68.4	-53.7	-43.6	-43.0	-48.8
Cyclically adjusted non-oil primary balance 4/ 5/	-66.2	-94.1	-80.6	-74.1	-72.9	-91.6
	(Percent of GDP)					
Total revenue 2/	66.6	66.0	69.2	73.6	77.5	74.7
Oil revenue	13.6	13.9	16.7	21.1	23.6	18.3
Non-oil revenue	53.0	52.3	52.6	52.6	54.1	56.4
Financial income 3/	6.1	6.3	6.2	6.3	7.6	8.8
Tax revenue	46.0	44.8	45.5	45.5	45.7	46.8
Transfers	0.8	1.0	0.7	0.7	0.7	0.6
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure 2/	55.0	56.8	54.8	53.1	52.5	53.8
Non-oil expenditure	55.0	56.9	54.9	53.2	52.6	53.8
Financial expenditure	2.3	2.3	1.8	1.6	2.1	1.7
Consumption	27.7	28.1	27.5	27.0	26.7	27.6
Transfers	23.8	25.0	24.1	23.3	22.3	23.0
Capital expenditure	1.3	1.6	1.4	1.2	1.5	1.6
Overall balance	11.5	9.1	14.3	20.4	25.0	20.9
Non-oil balance 4/	-3.8	-6.7	-4.7	-3.1	-2.0	-1.9
Cyclically adjusted non-oil balance 4/ 5/	-3.3	-5.2	-3.9	-3.0	-2.8	-3.1
Cyclically adjusted non-oil primary balance 4/ 5/	-5.4	-7.2	-5.9	-5.1	-4.7	-5.8
Memorandum items:						
Net public assets						
Billions of NKr	1,082.8	1,309.3	1,508.6	1,943.0	2,333.9	2,669.5
Percent of GDP	88.4	102.7	111.3	134.4	149.3	165.9
Nominal GDP (billions of NKr) /6	1,224.6	1,274.8	1,355.3	1,446.0	1,563.1	1,608.9
Trend nominal GDP (billions of NKr) /6	1,236.3	1,310.0	1,375.1	1,447.5	1,541.3	1,573.6
Output gap /6	-0.9	-2.7	-1.4	-0.1	1.4	2.2

Sources: Ministry of Finance; and IMF staff estimates.

1/ Fiscal projections are based on the revised 2007 budget, published on May 15, 2007.
2/ Because of transfers between government sectors, the sum of oil revenue (expenditure) and non-oil revenue (expenditure) is not necessarily equal to total revenue.
3/ Includes the return on the Government Pension Fund (GPF).
4/ Excludes the return on the GPF.
5/ Percent of trend mainland GDP. Adjusted for cyclical effects. IMF staff estimates and projections.
6/ IMF staff estimates and projections.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/65
FOR IMMEDIATE RELEASE
June 7, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Norway

On June 4, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Norway.[1]

Background

The Norwegian economy is set to grow strongly in 2007 for the fourth consecutive year. This economic performance is underpinned by strong monetary and fiscal policy frameworks. External demand, both for petroleum products and other Norwegian exports, is strong, and rapid credit growth, rising house prices, and tight labor markets are supporting domestic demand. Unit labor cost increases and core inflation have been subdued, although rapidly rising employment, an unemployment rate that has fallen to near record lows, and increasing reports of labor shortages and wage drift indicate intensifying pressures.

Although underlying inflation has been below the inflation target of a 2.5 percent increase in consumer prices, Norges Bank has been increasing interest rates since mid-2005 in response to robust demand conditions. Initially, Norges Bank raised rates gradually, but more recently has picked up the pace. As a result of these increases, monetary conditions have tightened substantially.

Fiscal policy is governed by guidelines, including a rule that the central government non-oil structural deficit should equal 4 percent of the assets in the Government Petroleum Fund-Global

[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.

(GPF), with temporary deviations for specific reasons. In 2006, for the first time the budget outturn came very close to meeting this rule. For 2007, the relevant deficit is set to fall below 4 percent of the GPF, although since the GPF itself is growing rapidly the resulting overall fiscal stance will be expansionary.

Parliament recently agreed to a significant package of pension reforms, which promises significant long-term containment of pension costs. Key elements of the package includes benefits based on lifetime earnings, adjustment for rising life expectancy, an actuarially neutral benefit structure to reduce early-retirement incentives, and lower indexation of benefits.

Executive Board Assessment

Executive Directors commended the Norwegian authorities for their strong rules-based monetary and fiscal policy frameworks and prudent management of oil wealth, which have promoted noninflationary growth and mitigated possible adverse effects of oil revenues. Directors welcomed the robust economic expansion of the past three years, which has been underpinned by strong markets for Norwegian exports, notably petroleum products, and supportive monetary conditions. Wage and price pressures have been moderate, in part reflecting favorable supply-side developments, including substantial labor inflows from new EU member countries. Directors noted that the key challenges facing Norway will be to ensure sustained noninflationary growth and medium-term fiscal sustainability.

Directors observed that short-term growth prospects remain promising but noted the increasing indications of demand pressures, including a falling unemployment rate and reports of labor shortages and wage drift. Against this backdrop, they commended the gradual increase in policy interest rates during the past two years, and considered that further increases would be appropriate in the period ahead. Several Directors suggested that the pace of interest rate increases should remain gradual, so that the effects of such increases and other new information on economic developments can be adequately assessed. Directors recognized that further tightening could put upward pressure on the exchange rate, but viewed this as part of the monetary transmission mechanism in an open economy.

Directors were of the view that inflation targeting and a flexible exchange rate have served Norway well. They welcomed innovations that have increased transparency and moved Norway to the forefront among inflation targeting countries. Directors recommended that the authorities continue to explain the policy framework to the public, in order to reinforce understanding and further cement its credibility.

Directors considered that the fiscal guidelines have contributed to prudent fiscal policy, and commended the authorities for bringing the central government non-oil structural deficit to close to 4 percent of the assets of Government Pension Fund-Global (GPF) in 2006. They welcomed the objective of reducing the deficit to below 4 percent in 2007, consistent with the fiscal guidelines. Looking ahead, Directors emphasized the need for continued fiscal restraint—in view of the cyclical economic boom, the prospect that deficits will expand significantly under the fiscal guidelines in the years ahead, and the projected large costs of aging. Directors encouraged the adoption of an explicit medium-term fiscal framework—building on the many parts of such a framework that are already in place—to increase the effectiveness of fiscal policy. Directors commended the authorities for the high level of transparency of the GPF, which has enhanced public ownership and support for it while strengthening government accountability.

Directors welcomed the recent parliamentary agreement on pension reform. They judged that the package would contain long-run pension costs and encourage people to stay in work longer through improved incentives. Directors urged that the reforms be implemented as quickly as possible, along with complementary reforms to the early retirement and disability schemes. They noted, however, that on current estimates these reforms will not be sufficient to ensure long-term fiscal sustainability, and therefore welcomed the authorities' consideration of further measures.

Directors considered that the financial sector appears sound and is well supervised, and welcomed the adoption of the bulk of the recommendations of the 2005 FSAP. Noting the risks posed by the prolonged credit expansion, the rapid rise in house prices, and aggressive lending practices, Directors urged the Financial Supervisory Authority to continue to ensure that banks remain well capitalized and provisioned, follow prudent lending practices, and maintain high asset quality.

Directors welcomed the impressive performance of the Norwegian labor market but recognized that the rapid growth in enrollment in sickness and disability poses challenges. Directors welcomed the recent reforms, including the merger of welfare agencies to improve case management. They considered, however, that further measures, including a review of the high replacement rates, would be required.

Directors welcomed the improving product market performance. To maximize the benefits of competitive markets, they stressed the need to maintain a level playing field between the private sector and the large state-owned sector through continued effective governance of the latter and suggested that, where appropriate, consideration could be given to further privatization. They also urged strong enforcement of competition and anti-cartel laws.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Norway: Selected Economic Indicators, 2002–07

	2002	2003	2004	2005	2006	Proj. 1/ 2007
Real economy (change in percent)						
Private consumption	3.1	2.8	5.6	3.3	4.3	4.0
Public consumption	3.1	1.7	1.5	1.8	2.2	2.8
Gross fixed investment	-1.1	0.2	10.2	11.2	8.9	5.7
Export of goods and services	-0.3	-0.2	1.1	0.7	1.5	2.4
of which: Oil and gas	2.4	-0.6	-0.5	-5.0	-5.4	-1.3
Import of goods and services	1.0	1.4	8.8	8.6	9.1	5.5
GDP	1.5	1.0	3.9	2.7	2.9	2.8
Mainland GDP 2/	1.4	1.3	4.4	4.5	4.6	3.8
Consumer prices	1.3	2.5	0.4	1.6	2.3	0.8
Wages (full-time equivalents)	5.7	4.5	3.8	3.3	4.3	…
Unemployment (percent of labor force)	3.9	4.5	4.5	4.6	3.4	2.8
Nominal effective exchange rate	9.0	-1.8	-2.4	4.2	-0.3	…
Money and credit (end-period, 12-month percent change)						
Broad money, M2	8.6	2.3	7.8	11.3	13.3	…
Domestic credit	8.9	6.8	8.9	13.1	14.6	…
Interest rates (year average, in percent)						
Three-month interbank rate	6.9	4.1	2.0	2.2	3.0	…
Ten-year government bond yield	6.4	5.0	4.4	3.7	4.1	…
Public finance (percent of mainland GDP)						
Central government 3/						
Revenues	56.4	54.9	55.1	59.5	63.7	60.9
of which: Non-oil revenues	41.3	39.9	38.7	39.0	39.6	40.8
Expenditures	47.7	46.5	45.9	45.0	43.7	44.5
Overall balance	8.7	8.4	9.2	14.6	19.9	16.3
of which: Non-oil balance	-5.1	-5.2	-5.8	-4.5	-2.8	-2.4
General government financial balance 4/	11.5	9.1	14.3	20.4	25.0	20.9
of which: Non-oil balance	-3.8	-6.7	-4.7	-3.1	-2.0	-1.9
Balance of payments (percent of mainland GDP)						
Current account balance	15.7	15.4	16.4	20.8	23.0	18.9
of which: Non-oil balance	-6.5	-6.5	-8.4	-8.5	-8.7	-9.4

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

1/ IMF staff projections as of March 2007. Fiscal projections are based on the revised 2007 budget, published on May 15, 2007.
2/ Excludes items related to petroleum exploitation and ocean shipping.
3/ Budget definition.
4/ National accounts definition.

Statement by Tuomas Saarenheimo, Executive Director for Norway
June 4, 2007

On behalf of my Norwegian authorities, I would like to thank staff for a thorough and well written report on the Norwegian economy. My authorities broadly concur with staff's analysis.

Economic developments
Increased globalization in recent years has benefited the Norwegian economy strongly. The terms of trade improvement is the strongest since World War I. Higher export prices, notably on petroleum and metals, have increased national income and business profits, and contributed significantly to the large fiscal surpluses. At the same time, lower import prices have benefited consumers and prevented inflation from picking up despite strong domestic demand growth and high capacity utilization. Labor immigration from the new EU countries has increased production capacity in several industries, in particular in building and construction, and dampened a pick up of wages.

Growth in the Norwegian economy has been strong for more than three years, with mainland-GDP expanding around 4½ percent annually. Domestic demand has been fuelled by private consumption, strong growth in petroleum investments and also an upswing in investments in the mainland business sector. The strong growth is expected to continue in 2007. In the Revised National Budget for 2007 presented on May 15, growth in mainland Norway (excluding petroleum and shipping) is forecasted at 3.7 percent in 2007.
The labor market has tightened significantly over the last couple of years. The unemployment rate is at a 20 year low and employment growth is strong. The unemployment rate is expected to decline from an average of 3.4 percent in 2006 to 2½ percent in 2007. Although inflow of workers from other countries has helped to ease labor market pressures so far in this upturn, demand for labor is still high and many companies face difficulties finding qualified labor.

Monetary policy
The Norwegian authorities generally concur with staff's assessment of monetary policy. The authorities take note of the view that further interest rate increases are needed to head off inflationary pressures. According to the latest assessments of Norges Bank's Executive Board, the key policy rate should be in the interval 4 – 5 percent in the period to the publication of the next *Monetary Policy Report* on June 27, 2007. The Bank has emphasized that there is considerable uncertainty surrounding its interest rate projections. In the Bank's analysis in the March *Report*, the overall outlook suggested that it would be appropriate to raise the interest rate gradually to about 5 percent in the course of this year and to a somewhat higher level in the period to the summer of 2008. The interest rate will be increased gradually so that the effects of interest rate changes and other new information on economic developments can be assessed.

Interest rate developments must be seen in the light of prospects for inflation, output and employment. It normally takes some time for interest rates to have an impact on prices via changes in expectations, exchange rates or capacity utilisation. The key policy rate has been raised in response to the strong increase in capacity utilisation and the associated inflation prospects. The interest rate has thus been increased well ahead of an actual rise in underlying inflation. Different measures of short- and longer-term real interest rates indicate that real interest rates have approached a more normal level. In the staff report, real interest rates are estimated by combining short-term interest rates and a longer-term measure of inflation expectations. Staff's judgement that real interest rates are still expansionary appears to be based on the combination of these different time horizons in the same calculation.

The report emphasizes that monetary policy should strive to meet the inflation target even if this would mean some short-term appreciation of the krone. Norges Bank believes that under an inflation targeting regime, it is important to be mindful of the effects of higher interest rates on the krone exchange rate when inflation is low.

The authorities take note of staff's assessment that the monetary policy framework has been strengthened by increased transparency, improved governance and a well-articulated policy framework. It is important that economic agents are able as far as possible to anticipate monetary policy decisions. Norges Bank regularly publishes assessments of the outlook for the key policy rate. The bank has emphasized that openness concerning its intended future interest rate may help market participants understand the central bank's response pattern so that the reaction of market rates to new information about economic developments has a stabilising effect. Staff's advice to continue efforts to explain inflation targeting, including the monetary policy transmission mechanism and how specific policy decisions are governed, has also been noted.

Fiscal policy

As noted by staff the Norwegian fiscal framework aims at a gradual increase in the spending of petroleum revenues to a sustainable level. Over time the structural non-oil deficit shall correspond to the expected real return on the Government Pension Fund – Global (GPF), estimated at 4 percent. Long-term budget challenges, due to future increases in pension costs in the National Insurance Scheme and other age-related expenses, underline the need for a prudent fiscal policy.

In light of the strong economic upturn and a tight labor market, the Government emphasizes in the Revised National Budget the need for fiscal policy to underpin a continued balanced development for the Norwegian economy. The Government proposes a revised Fiscal Budget for 2007 with an estimated structural, non-oil deficit somewhat lower than in the approved budget and NOK 3.5 billion (0.2 percentage points) below the expected 4 percent real return on the fund. Newly released state accounts also show that the use of petroleum revenues was on par with the 4 percent fiscal rule in 2006.

The proposed revised budget for 2007 implies a structural, non-oil budget deficit at 4.3 percent of mainland trend GDP, 0.6 percentage point higher than in 2006. This increase must, however, be seen in light of a major downward revision of the 2006 deficit in the final state accounts.

The Norwegian authorities agree with the assessment in the staff appraisal that 2008 and subsequent budgets should aim for a deficit below 4 percent of GPF until excess demand dissipates. The authorities take note of staff's view about an explicit medium-term fiscal framework as help to prevent a rapid increase in spending, and agree with staff that such a framework to a large extent already is in place, notably the fiscal rule, the government's commitment to a stable tax level and the multi-year budget projections.

The authorities note that given the success of the current guidelines for fiscal policy, staff does not argue for a change of fiscal guideline. Alternative fiscal rules, as explored in the Selected Issues paper, all imply that already substantial central government savings increase significantly for the next 50 years, to meet long-term fiscal challenges. The challenges may alternatively be met by curbing future expenditure growth, as exemplified by the ongoing pension reform, which incidentally is not included in the calculations in the paper on alternative fiscal rules. The paper also exaggerates the challenges when stating that the GPF will be exhausted in 5-6 decades.

Pension reform and benefit entitlements

Fundamentals in the Norwegian labor market are healthy with low unemployment and high participation rates, especially among women and older workers. A key to sustainable public finances in the long run is to keep labor supply high or preferably to increase it. This may be challenging with an ageing population and an increasing inflow into sick leave, disability and early retirement schemes.

Norwegian authorities share staff's concern about the high proportion of the working population on sick leave, disability and other health related benefits, and we agree that measures should be taken to bring these numbers down. A white paper on work, welfare and inclusion policies released last fall addresses these challenges and proposes a number of measures to bring people back to work. Several measures to reduce sick leave were also included in the 2007-budget and are now implemented.

As noted by staff, the Norwegian pension system is under revision, and there has been significant progress on the reform during the last two years. The Parliament has reached an agreement which settles the model for earning and drawing of old age pensions in the National Insurance Scheme as a foundation for the overall pension system. However, important elements of the reform are still to be decided on. These elements include a redesign of occupational pensions in the public sector and adjustments of disability pensions and the labor market based early retirement scheme (AFP). A Government-appointed commission has just released a report with proposals for reform of the disability pension system. The Government will soon invite the social partners to discuss the design of an adjusted early retirement scheme, in time to be included in the wage negotiations in 2008. The next phase of the reform will be challenging, but equally important, in establishing correct incentives for elderly people considering retirement and closing early exit routes. Hence, it is now more important to stress the need for completion of the ongoing pension reform than to recommend embarking on new ones.

Financial stability

The authorities agree with staff that the financial system in Norway is sound and well supervised. Over the last years Norwegian financial institutions have achieved very good results. In 2006 no overall losses were recorded in banks and, as in 2005, the cost trend in banks was favorable. Households' debt has risen sharply the last seven years, driven by strong growth in house prices, a favorable economic climate and low interest rates. Debt has risen at a far higher rate than incomes, spurring a sharp increase in the debt burden. Projections by Norges Bank show that by the end of 2009 the households' debt may exceed 230 percent of disposable income. Even if there are some circumstances in the economic development in Norway that may increase the risk, especially the households' debt burden, the outlook for financial stability is satisfactory.

Structural policy

Product markets have undergone considerable reforms through the 1990s and early 2000s. The principal objective of these reforms has been to improve efficiency of markets while securing service provision in all parts of the country. Competition has been enhanced by strengthening the competition law and competition authorities, and reform of sector regulation especially in network industries. Legal protection implies that decisions by the Competition Authority can be challenged through appeal and in the courts. The Ministry of Government Administration and Reform is the appeal body, but has the competence only to overrule a decision on the same legal basis as the Competition Authority. However, in certain cases of fundamental or great social importance, the full cabinet (King in Council) can overrule the competition provisions. There has been only one such decision under the Competition Act of 2004. Administrative fines can be challenged only in courts.

As noted by staff, state ownership is extensive. This is due primarily to the importance of the petroleum and hydroelectric power sectors in the Norwegian economy. Other state-owned companies have functions and obligations that could not be provided efficiently in competitive markets (electricity transmission, administration of national forests, etc.). Policy on state ownership was presented in a recent white paper. The Government aims at securing a strong public and national ownership.