June 2005
IMF Country Report No. 05/196

Norway: 2005 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 2005 Article IV consultation with Norway, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 15, 2005, 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 12, 2005. 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 June 1, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 3, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Norway.

The documents listed below have been or will be separately released.

Financial Sector Stability Assessment
Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

NORWAY

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the 2005 Consultation with Norway

Approved by Reza Moghadam and Martin Fetherston

May 12, 2005

- Discussions were held in Oslo during March 7–15, 2005. The mission, comprising Mr. Ford (head), Mr. Jafarov, Ms. Sgherri (all EUR), and Mr. Moriyama (FIN), met with the Minister of Finance, the Governor of Norges Bank, other senior officials, representatives of labor and business organizations, private sector analysts, and academics. Mr. Swinburne (MFD) joined the mission for wrap-up meetings on the FSAP. Mr. Solheim, the Executive Director, participated in the discussions.

- Norway has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement. Its payment system is free of restrictions on current transactions. Norway's statistics are satisfactory for surveillance. Norway is a member of the European Economic Area (EEA), which provides for free movement of goods, services, labor, and capital with the European Union.

- A minority center right coalition took office in September 2001. National elections are scheduled for September 2005.

- At the time of the last consultation, concluded on March 22, 2004 (PIN 04/30), Executive Directors commended Norway's strong economic and policy record. Directors strongly encouraged the authorities to take advantage of the recovery to reduce the structural non-oil central government budget deficit to 4 percent of Government Petroleum Fund assets, in accordance with the fiscal guidelines. In view of population aging, they urged the authorities to reform pensions and examine further measures to ensure long-term sustainability. Directors welcomed recent measures to enhance labor supply while calling for reform of the sickness and disability programs.

- The authorities intend to publish this report.

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EXECUTIVE SUMMARY

Background

- Economic growth rebounded strongly from a brief slowdown that began in late 2002. GDP is expected to grow at above-potential rates in both 2005 and 2006. As a result, the output gap is expected to close this year, and inflationary pressures to begin to rise. In addition, declines in the prices of some domestic services and imported goods, which have held inflation well below the 2.5 percent target, appear to be waning.

- Petroleum revenues guarantee strong fiscal and current account surpluses for many years. However, the non-oil central government structural deficit has consistently exceeded the target set in Norway's fiscal guidelines, and the 2005 budget involves further slippage despite strong growth and high oil prices.

Policy discussions and assessment

- The monetary stance should begin to tighten in the course of this year. This is widely anticipated by private sector analysts, especially after Norges Bank, in late February, signaled a shift from a policy of maintaining low rates.

- The inflation targeting framework, in place since 2001, has been gaining credibility, and recent changes have further improved transparency. Nevertheless, exchange rate appreciation remains a concern of many in Norway, and the authorities should therefore continue their efforts to communicate both the framework and policy stance.

- The authorities should make a greater effort to close the gap between the deficit and the rule specified by the fiscal guidelines (which were also adopted in 2001). Otherwise, the credibility of the guidelines may be jeopardized, which could put unwanted upward pressure on the currency. In this vein, staff also recommended the adoption of a medium-term fiscal plan. Staff welcomed the tax reform in the 2005 budget, but argued for higher property taxes.

- The FSAP found the financial system in good health and well supervised. Concern was expressed that the high growth of consumer debt could, over time, pose an increasing risk. The FSSA makes a number of recommendations.

- Labor market performance, while strong by international comparison, may be threatened by the rapid growth of the sickness and disability programs. The former was tightened somewhat, and time lost from sickness fell last year, but more administrative measures will probably be needed and staff recommends the authorities re-examine very high replacement rates. Product markets are becoming more competitive, and the new competition law should help. However, progress in reducing the very high level of state ownership has been slow.

I. BACKGROUND

1. **Norway has enjoyed strong economic performance, underpinned by a sound macroeconomic policy framework** (Figure 1).

- Real GDP growth has generally outpaced the EU average and labor markets perform very well by international comparison, with relatively high employment and participation rates, and low unemployment rates (Table 1). Norway's policy initiatives have in many, though not all, cases been consistent with Fund recommendations (Box 1).

- Large oil and gas revenues—Norway is the third largest oil exporter in the world—ensure substantial fiscal and current account surpluses for many years (Table 2). The bulk of these revenues have been invested abroad by the Government Petroleum Fund (GPF), and fiscal guidelines are in place to control the non-oil fiscal deficit (Box 2), although the key 4-percent rule has not been met in the three years (2002–04) since its inception.

- Monetary policy has achieved low and stable core inflation. Since 2001, policy has been governed by a flexible inflation target.[1] Norges Bank (NB) aims for a core inflation rate of 2.5 percent over a 1-to-3 year horizon (changed last year from a 2-year horizon to allow for situations for which a somewhat larger horizon is appropriate).

2. **The economy has recovered strongly from a mild slowdown in late 2002**. In a successful bid to contain rising wage demands, NB held its policy rate near 7 percent through most of 2002, resulting in a significant appreciation of the krone and slower economic activity. With inflationary pressure easing, NB reversed course in late 2002 and cut interest rates sharply through 2003, unwinding the currency appreciation. In March 2004, the intervention rate was set at 1.75 percent, where it has remained since (Figure 2). This supportive monetary stance, high oil prices (which stimulated investment), rising house prices, strengthening consumer and business confidence, and an improved world economy all contributed to a 3.5 percent increase in real mainland GDP in 2004, well above the staff estimate of potential of 2½ percent.[2]

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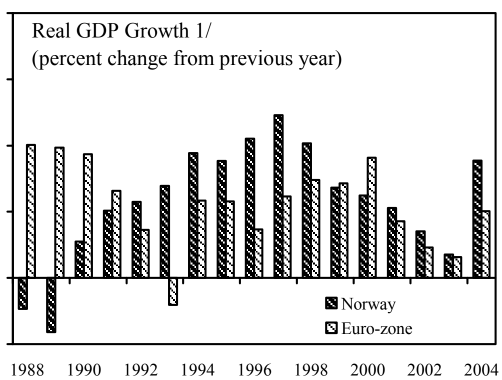
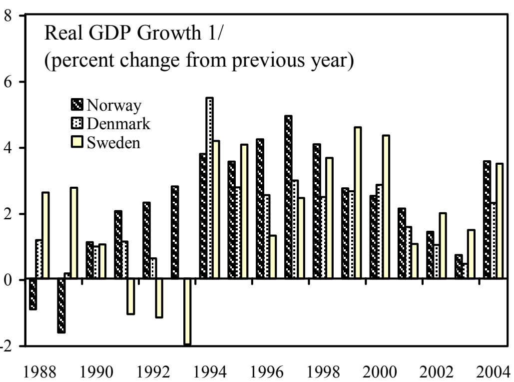
[1] See the 2002 staff report (IMF Country Report 03/77), Box 1; and J. Soikkeli "The inflation targeting framework in Norway" (IMF working paper 02/184).

[2] Henceforth, "GDP" will refer to mainland GDP—excluding the oil and gas sector. In 2004, total GDP grew less than (mainland) GDP because of planned oilfield maintenance and, to a lesser extent, brief strikes.

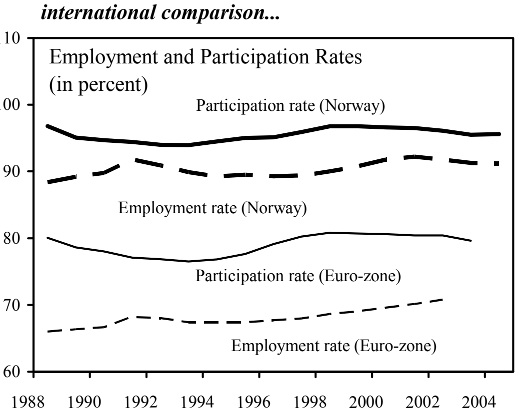
Figure 1. Norway: Selected Economic Indicators

Norway has enjoyed strong economic growth

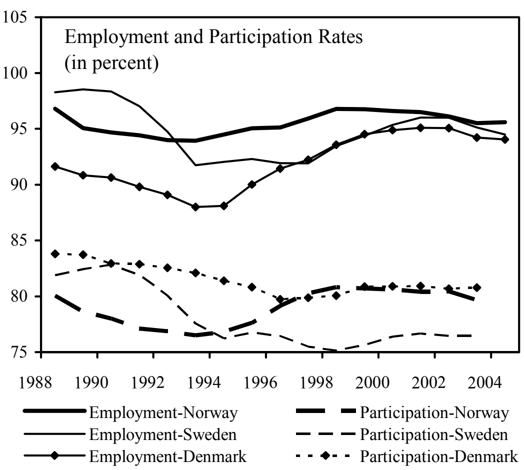




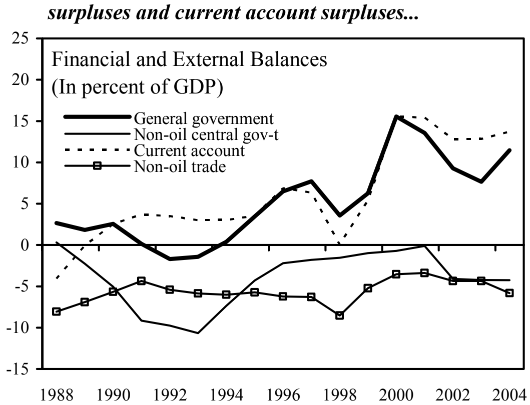
Employment and participation rates are high by international comparison...



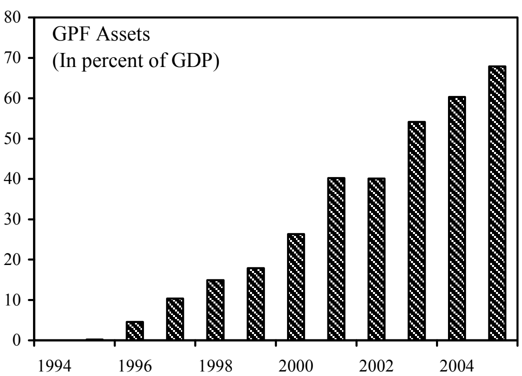
...including with respect to other Scandinavian countries.



Petroleum revenues ensure substantial fiscal surpluses and current account surpluses...



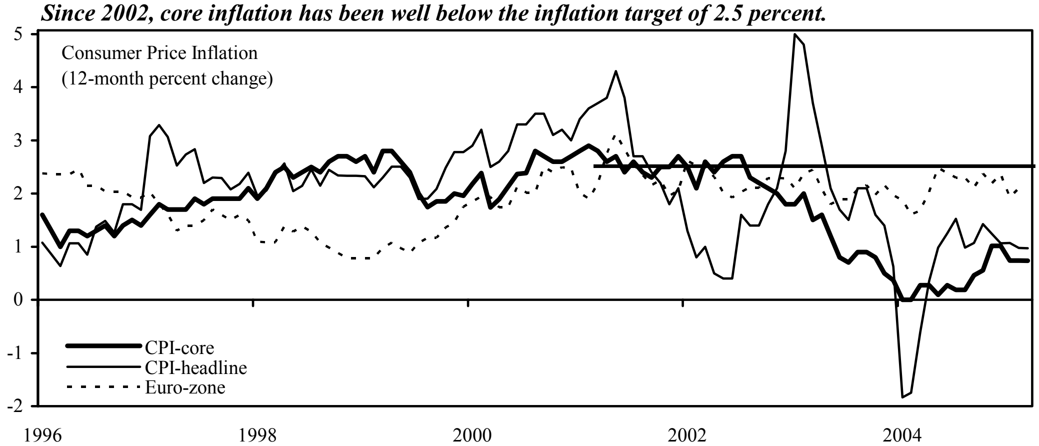
...and oil revenue has been saved abroad by the Government Petroleum Fund.



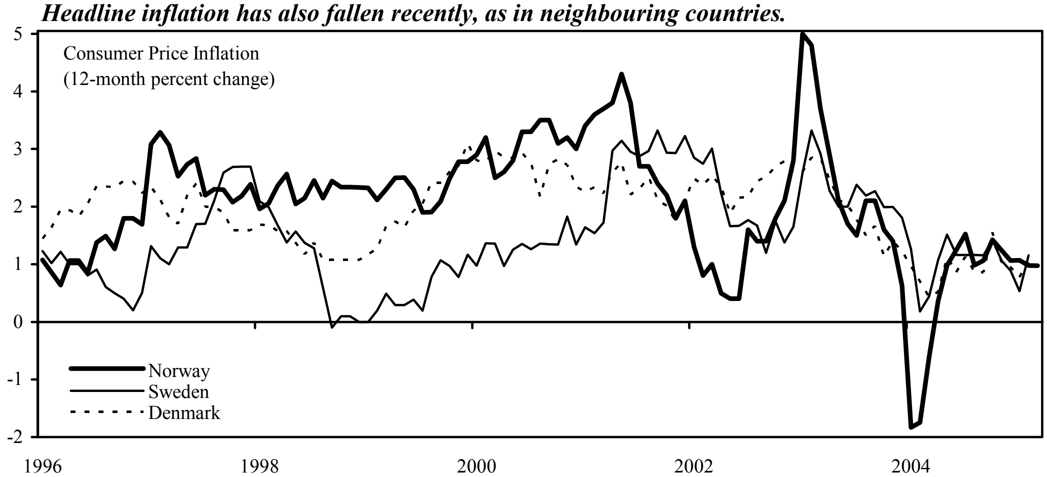
Source: Statistics Norway; OECD; and staff estimates.
1/ Mainland GDP for Norway.

Figure 1. Norway: Selected Economic Indicators (continued)

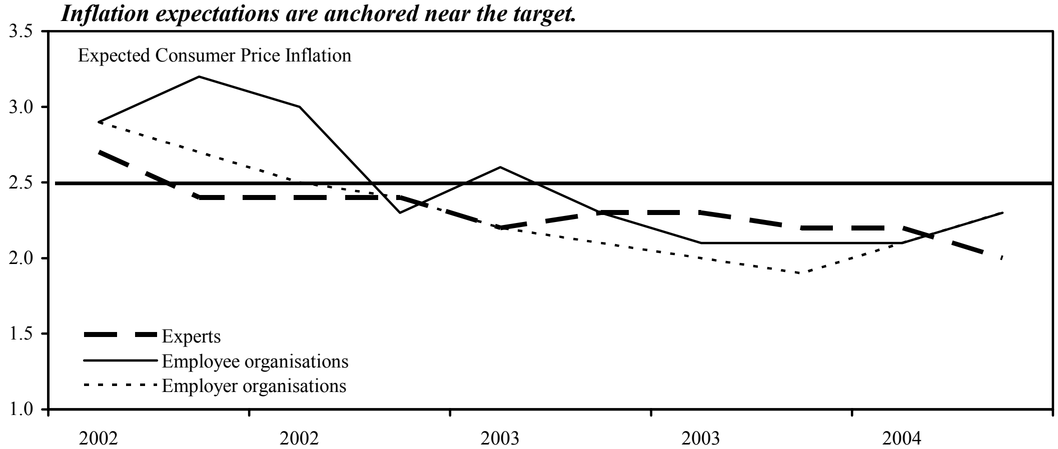
Since 2002, core inflation has been well below the inflation target of 2.5 percent.



Headline inflation has also fallen recently, as in neighbouring countries.



Inflation expectations are anchored near the target.



Source: Statistics Norway; and staff estimates.

Table 1. Norway: Selected Economic Indicators

	2001	2002	2003	2004	Proj. 2005 1/	Proj. 2006 1/
	(Annual percent change)					
Private consumption	1.8	3.0	3.0	4.3	4.5	4.0
Public consumption	5.8	3.7	1.4	2.0	1.8	1.8
Gross fixed investment	-0.7	-1.0	-2.0	8.9	10.0	5.0
Export of goods and services	5.0	-0.8	1.6	1.3	4.0	2.6
of which : Oil and gas	8.8	1.9	-0.6	0.9	2.8	1.1
Import of goods and services	0.9	0.7	2.2	9.0	7.9	5.0
GDP	2.7	1.1	0.4	2.9	3.7	2.8
Mainland GDP 2/	2.1	1.4	0.7	3.5	3.8	3.0
Unemployment (in percent of labor force)	3.5	3.9	4.5	4.4	4.0	4.0
Consumer prices	3.0	1.3	2.5	0.4	1.4	2.1
Wages (in full-time equivalents)	4.8	5.7	4.5	3.8	…	…
Nominal effective exchange rate	2.9	8.8	-3.3	-2.1	…	…
Broad money, M2 3/	9.3	8.3	1.9	7.6	…	…
Domestic credit 3/	9.7	8.9	6.8	8.8	…	…
Three-month interbank rate 4/	7.4	7.1	4.3	2.2	…	…
Ten-year government bond yield 4/	6.2	6.4	5.0	4.4	…	…
	(In percent of mainland GDP)					
Central government 5/						
Revenues	65.0	57.0	56.2	57.9	59.6	58.0
of which: Non-oil revenues	41.9	41.7	40.8	40.6	40.1	40.1
Expenditures	44.3	48.2	47.6	47.7	47.2	46.8
Overall balance	20.7	8.8	8.6	10.2	12.4	11.1
of which: Non-oil balance	-0.1	-5.1	-5.3	-5.5	-5.4	-5.1
General government financial balance 5/	17.7	11.5	10.5	14.6	15.6	14.3
of which: Non-oil balance	-0.6	-4.1	-5.7	-5.6	-5.5	-5.1
Current account balance	15.4	12.8	12.8	13.7	16.2	14.9
of which: Non-oil balance	-5.2	-5.3	-5.1	-6.3	-6.0	-6.0

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

1/ Staff projections as of March 2005.
2/ Excludes items related to petroleum exploitation and ocean shipping.
3/ End of period, in percent.
4/ Period average, in percent.
5/ Budget definition.

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

					Projections					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Balance of payments										
Goods and services										
Exports	77.6	78.7	91.2	109.5	128.9	125.6	123.0	121.1	119.9	119.3
Goods	59.2	59.3	68.6	82.5	99.1	95.7	93.1	91.2	89.9	89.4
o/w: oil and natural gas	34.9	34.5	39.7	50.1	63.4	60.4	57.7	55.8	54.6	54.1
Non-factor services	18.3	19.4	22.5	27.0	29.8	29.9	29.9	29.9	29.9	29.9
Imports	48.6	52.6	61.2	74.0	83.0	84.4	86.4	88.1	89.9	91.7
Goods	33.4	35.8	41.4	50.1	56.2	57.2	58.5	59.7	60.9	62.1
Non-factor services	15.2	16.7	19.8	23.8	26.7	27.2	27.9	28.4	29.0	29.5
Trade balance	25.8	23.4	27.2	32.4	42.9	38.5	34.5	31.4	29.0	27.3
Services balance	3.1	2.7	2.7	3.1	3.0	2.7	2.1	1.5	1.0	0.3
Balance of goods and services	29.0	26.2	29.9	35.5	46.0	41.2	36.6	33.0	30.0	27.6
Balance of factor payments	-2.8	-1.7	-1.6	-1.1	0.3	1.9	3.3	4.4	5.7	7.1
Current account balance	26.2	24.4	28.3	34.4	46.3	43.1	39.8	37.4	35.7	34.7
(In percent of GDP)	15.4	12.8	12.8	13.7	16.2	14.9	13.7	12.7	12.0	11.5
Net capital flows	-0.1	-0.2	0.7	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Net financial flows	-25.1	-15.6	-19.6	-26.2	-36.0	-33.4	-30.7	-28.4	-26.9	-25.9
Reserve changes	2.3	-5.8	-0.3	-5.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Net foreign assets										
(In percent of GDP)	39.1	35.9	51.9	64.3	78.2	88.9	98.6	106.1	112.2	117.1
Government Petroleum Fund										
(In percent of GDP) 1/	40.2	40.1	54.1	60.3	67.9	76.8	85.9	93.7	101.0	107.2
Nominal effective exchange rate (1995=100)	95.5	103.9	100.4	98.3	...	...	...	...	...	...
Real effective exchange rate (1995=100) 2/	99.7	108.1	104.4	102.1	...	...	...	...	...	...

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

1/ National Budget 2005 projection for end of years 2005-10.
2/ Based on CPI.

Box 1. Policy Recommendations and Implementation

Monetary policy. In light of very low inflation, the Fund recommended maintaining a supportive stance until the recovery took hold, a policy Norges Bank has followed. The Fund has also recommended policy transparency, which has been enhanced by the governor's appearances before parliament, continued outside evaluation of policy by Norges Bank Watch, and, more recently, publishing the monetary strategy document at the beginning of the strategy period.

Fiscal policy. The Fund recommended the non-oil central government structural budget deficit be reduced more rapidly to 4 percent of the Government Petroleum Fund (as specified in Norway's fiscal guidelines). However, the 2005 budget involved further slippage relative to that target. Nor have the authorities introduced a multi-year fiscal plan. On the other hand, consistent with Fund recommendations, they have submitted to parliament the package of reforms proposed by a high level pension commission, and have in the 2005 budget implemented most of the recommendations of a high level tax commission, including a reduction in labor taxation.

Structural policy. Consistent with Fund recommendations, somewhat tighter administrative controls were placed on the sickness program, but the authorities have not considered lowering the high replacement rates. On product markets, competition has increased, perhaps reflecting in part the new competition law, but progress in privatization has been limited.

Box 2. The Fiscal Policy Framework

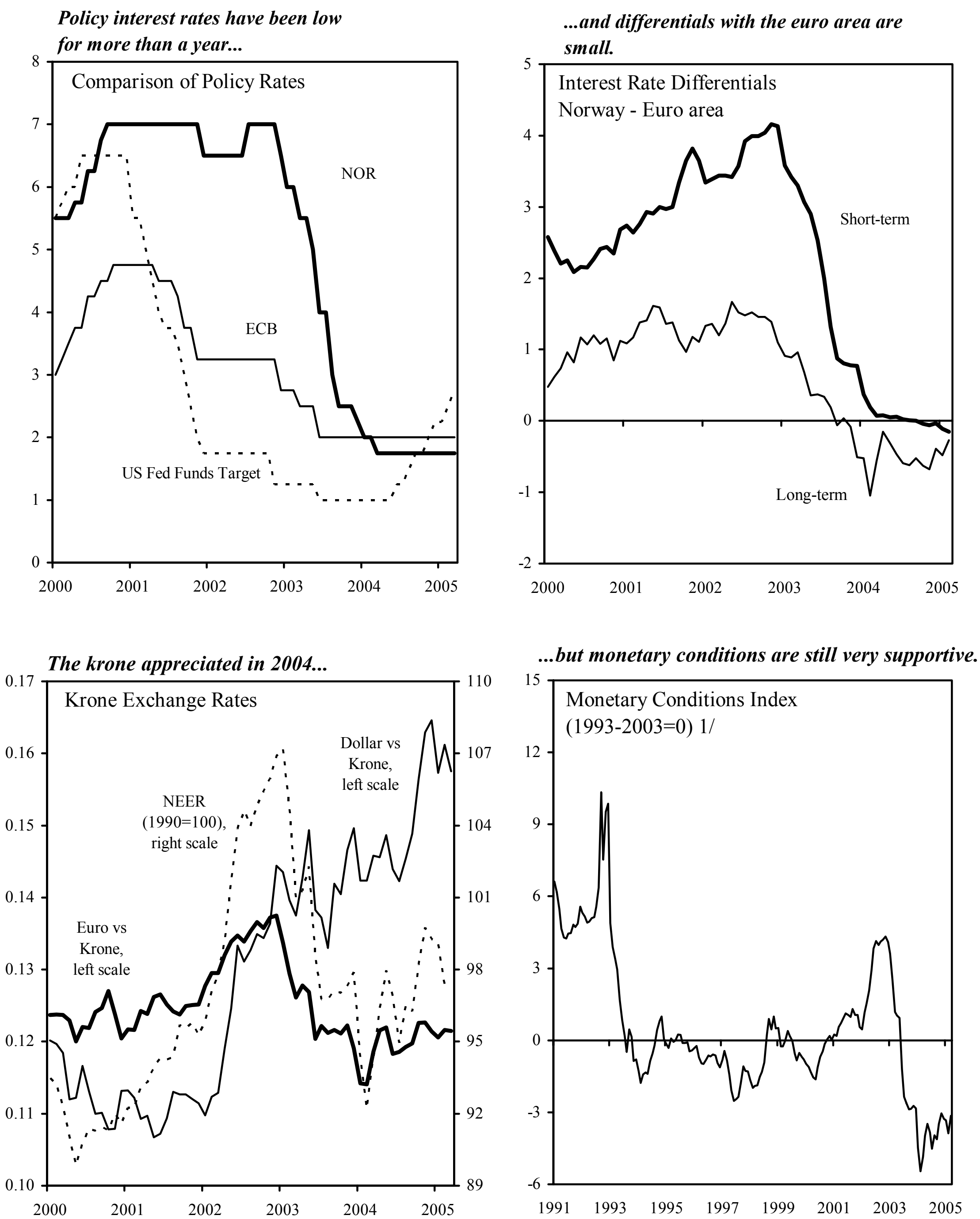
To deal with the very large and growing inflow of petroleum revenue, Norway established the Government Petroleum Fund (GPF) in 1990. Formally an account with Norges Bank, which manages it, the GPF has, since 1995, invested the bulk of petroleum revenue abroad in a portfolio of stocks and bonds. Annual reports detail the investment strategy and performance relative to a benchmark set by the government. In early 2005, the assets of the GPF were 78 percent of GDP.

Fiscal guidelines, adopted in 2001 and effective beginning with the 2002 budget, specify that the non-oil central government structural deficit be 4 percent (the assumed long-run real rate of return) of the assets of the GPF.[1] Temporary deviations from this 4-percent rule are permitted over the business cycle, or in the event of extraordinary changes in the value of the GPF.

The fiscal guidelines were designed to meet a number of policy objectives. The first is intergenerational equity. Petroleum extraction can be viewed as a transformation, rather than the creation, of wealth from natural resources to financial assets; the 4-percent rule preserves the real value of those assets. The second is to allow some current spending of oil revenue, in part to meet political pressures. Since the GPF will continue to grow for some decades, the guidelines imply the non-oil budget will have a small, but persistent, expansionary bias. The third is to mitigate the possible Dutch disease effects of spending oil revenues immediately; this also explains why the GPF is invested abroad. And the fourth is to insulate the annual budget from shifts in oil prices and the like, while maintaining a role for fiscal policy in macroeconomic stabilization; this explains the role of the temporary deviations.

[1] See the 2002 staff report (IMF Country Report 03/77), Box 1.

Figure 2. Norway: Monetary Conditions



Source: Norges Bank; Federal Reserve; ECB; Bloomberg; and IMF staff estimates.

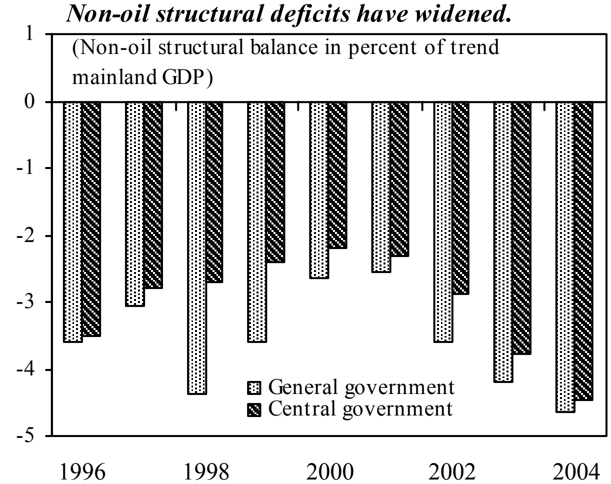
1/ A weighted average of 3 month (NIBOR) interest rates and the nominal effective exchange rate for the krone. Weighted by a factor of 1/3: a 1 percent change in the interest rate is considered to have the same impact on CPI as a 3 percent change in the exchange rate.

3. **The labor market is tightening, but wage pressures remain contained** (Figure 3). Employment has picked up, while the unemployment rate edged down to 4.4 percent in January 2005, from 4.6 percent in mid-2003. The economic slowdown, subsequent low inflation, and labor inflows from the enlarged EU reduced nominal wage increases to 3¾ percent in 2004, compared with more than 5 percent a year during 1999–2003. Real wages rose significantly because of very low rates of inflation, but productivity-improving rationalizations recently undertaken by enterprises left unit costs broadly stable. In a longer perspective, however, high wage increases relative to trading partners have caused a deterioration in competitiveness, raising concerns about the health of the export and import-competing sectors (the "exposed sector")

4. **Inflation has been surprisingly low, in part because of structural factors**. Core inflation has been near 1 percent, well below the inflation target, since late 2003. This development has surprised virtually all observers, including Fund staff and NB. While the emergence of excess capacity in 2003 reduced inflationary pressures, two structural factors played an unexpectedly important role in holding down prices. Import prices have been falling, reflecting trends in world prices of some manufactures (especially electronics and clothing) and an increasing share of imports from low-price countries (principally China and India); and domestic competitive forces intensified in the retail, air transportation, and telecommunication sectors, cutting margins and consumer prices.[3]

5. **The 2004 budget outturn and the 2005 budget were both somewhat procyclical**. For 2004, the central government non-oil deficit was 5.5 percent of GDP, somewhat higher than the budget target of 5.2 percent of GDP (Tables 3 and 4). This slippage reflected spending overruns, notably benefits to households and transfers to local government. For 2005, the deficit is set to narrow only very slightly, as stronger economic growth and lower interest payments are offset by tax cuts in a reform package (see below). On staff calculations, the structural non-oil budget deficit rose, compared to the previous year, by 0.6 percent of GDP in 2004 and is set to rise by another ½ percent of GDP in 2005.

Non-oil structural deficits have widened.



Source: Ministry of Finance; and staff estimates.

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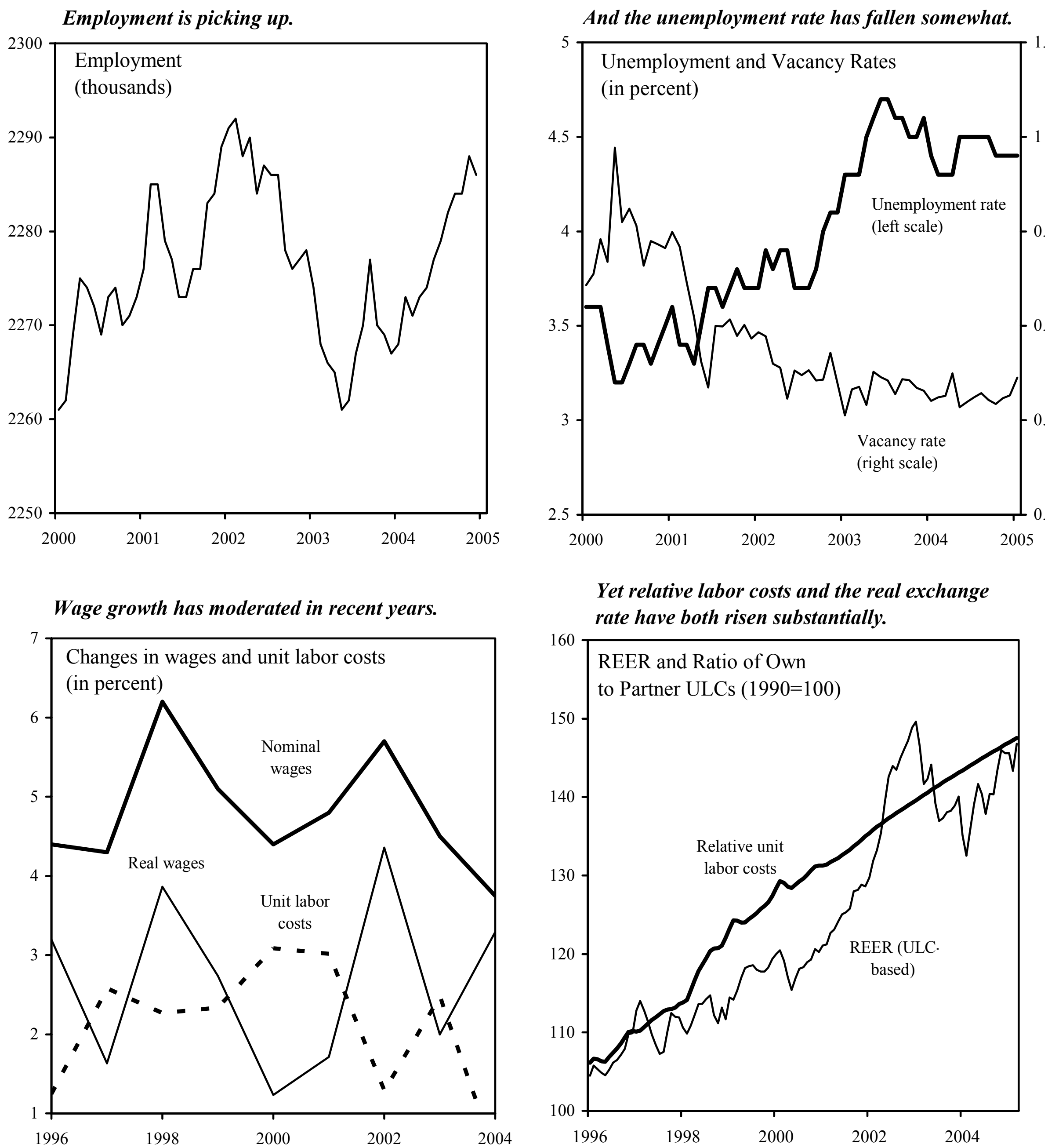
[3] Chapter 1 of the selected issues paper analyzes recent inflation developments and concludes that import price falls reduced annual inflation by more than ½ percentage point on average since 2002. See "Norges Bank Watch 2005" for a thorough analysis of NB's recent inflation forecasts.

Figure 3. Norway: Labor Market Developments



Source: Statistics Norway; and staff estimates.

Table 3. Norway: Fiscal and Monetary Indicators
(In percent of mainland GDP, unless otherwise indicated)

	2001	2002	2003	Est. 2004	Staff proj. 2005
Central Government 1/					
Revenue	65.0	57.0	56.2	57.9	59.6
of which : oil revenue	23.0	15.3	15.3	17.3	19.5
Expenditure	44.3	48.2	47.6	47.7	47.2
Balance	20.7	8.8	8.6	10.2	12.4
of which : non-oil balance	-0.1	-5.1	-5.3	-5.5	-5.4
less adjustments:					
Extraordinary items 2/	0.2	-1.8	-0.1	-0.1	0.0
Cyclical correction 3/	2.0	-0.5	-1.4	-1.0	-0.6
Structural non-oil balance	-2.3	-2.9	-3.8	-4.4	-4.9
In percent of trend mainland GDP	-2.4	-2.9	-3.7	-4.4	-4.8
General Government 4/					
Revenue	71.5	67.1	67.9	71.5	71.8
of which : oil revenue	18.3	15.6	16.1	20.2	21.1
Expenditure	53.8	55.6	57.4	57.0	56.2
Balance	17.7	11.5	10.5	14.6	15.6
of which : non-oil balance	-0.6	-4.1	-5.7	-5.6	-5.5
Cyclically-adjusted non-oil balance 5/	-2.6	-3.6	-4.2	-4.6	-5.0
Net assets 6/	71.9	71.3	83.8	89.1	93.8
Monetary Indicators:					
M2 7/	9.3	8.3	1.9	7.6	…
Domestic credit 7/	9.7	8.9	6.8	8.8	…
Three-month interbank rate 8/	7.4	7.1	4.3	2.2	…
Ten-year government bond yield 8/	6.2	6.4	5.0	4.4	…

Sources: Ministry of Finance; Norges Bank.

1/ Budget definition. Ministry of Finance. Oil revenue is modified reflecting revise in oil prices in WEO.
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.
5/ Percent of trend mainland GDP. Adjusted for cyclical effects (central government), estimated by Ministry of Finance.
6/ Percent of GDP.
7/ End-period, percent change, national definition.
8/ Period average, in percent.

Table 4. Norway: General Government Financial Accounts, 2001-2005

	2001	2002	2003	Est. 2004	Staff proj. 2005
	(In billions of krone)				
Total revenue	834.7	813.1	846.0	935.4	996.6
Oil revenue 1/	213.4	189.1	201.2	264.1	293.3
Non-oil revenue	621.3	623.9	644.8	671.3	703.3
Financial income	44.0	48.0	47.2	42.5	44.1
Tax revenue	556.7	564.9	582.8	617.3	647.3
Transfers	19.3	9.8	13.2	9.8	10.0
Capital revenue	1.3	1.2	1.5	1.8	1.9
Total expenditure	627.9	673.7	715.7	745.0	780.3
Oil expenditure	0.0	0.5	0.1	0.1	0.0
Non-oil expenditure	627.9	673.2	715.6	744.9	780.3
Financial expenditure	28.1	27.7	28.9	24.7	23.1
Consumption	314.8	336.8	353.3	369.6	387.6
Transfers	267.6	290.9	312.5	329.5	348.0
Capital expenditure	17.4	17.8	21.0	21.1	21.6
Overall balance	206.8	139.4	130.3	190.4	216.4
Non-oil balance	-6.5	-49.2	-70.8	-73.6	-77.0
	(In percent of mainland GDP)				
Total revenue	71.5	67.1	67.9	71.5	71.8
Oil revenue 1/	18.3	15.6	16.1	20.2	21.1
Non-oil revenue	53.2	51.5	51.7	51.3	50.7
Financial income	3.8	4.0	3.8	3.2	3.2
Tax revenue	47.7	46.6	46.8	47.2	46.7
Transfers	1.7	0.8	1.1	0.7	0.7
Capital revenue	0.1	0.1	0.1	0.1	0.1
Total expenditure	53.8	55.6	57.4	57.0	56.2
Non-oil expenditure	53.8	55.5	57.4	57.0	56.2
Financial expenditure	2.4	2.3	2.3	1.9	1.7
Consumption	27.0	27.8	28.3	28.3	27.9
Transfers	22.9	24.0	25.1	25.2	25.1
Capital expenditure	1.5	1.5	1.7	1.6	1.6
Overall balance	17.7	11.5	10.5	14.6	15.6
Non-oil balance	-0.6	-4.1	-5.7	-5.6	-5.5
Cyclically-adjusted non-oil balance 2/	-1.3	-4.2	-4.8	-5.3	-6.0
Memorandum items:					
Net public assets					
in billions of krone	1,097.5	1,082.8	1,308.2	1,501.2	1,718.7
in percent of GDP	71.9	71.3	83.8	89.1	93.8
Nominal GDP /3	1,526.2	1,519.1	1,561.9	1,685.6	1,832.9
Nominal mainland GDP /3	1,167.2	1,212.6	1,246.1	1,307.5	1,387.4
Trend nominal mainland GDP /3	1,150.7	1,209.5	1,265.1	1,313.4	1,376.8
Output gap /3	1.4	0.3	-1.5	-0.4	0.8

Source: Ministry of Finance, and IMF staff calculations.

1/ Includes Government Petroleum Fund dividends, modified from national budget reflecting revise in oil prices.
2/ Percent of trend mainland GDP. Adjusted for cyclical effects. IMF staff estimates and projections.
3/ IMF staff estimates and projections.

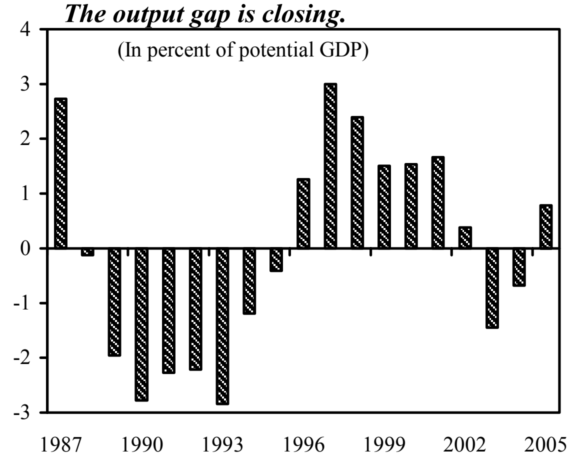
II. Policy Discussions

Discussions on macroeconomic policies focused on the appropriate monetary stance in view of recent and prospective economic developments, the need to adhere to the fiscal rule, and pension reform. Discussions on structural reforms centered on the sickness and disability programs and, for product markets, on competition and privatization.

A. Short-Term Outlook and Macroeconomic Policies

6. **There was agreement that the short-term outlook was bright, though the pace of growth is likely to slow somewhat in 2006**. The factors that had boosted growth in 2004 were expected to continue into 2005 and 2006. Accordingly, staff projects real mainland GDP growth of about 3¾ percent in 2005.[4] For 2006, however, the authorities judged that petroleum-related investment (much of which affects mainland GDP) would fall, though from very high levels, and it was widely thought that NB would begin raising interest rates at some point. For both these reasons, staff projects growth to slow to 3 percent. Nevertheless, three years of high growth would eliminate excess capacity—staff estimates the output gap will turn positive this year—and inflation is, therefore, projected to rise gradually.

The output gap is closing.

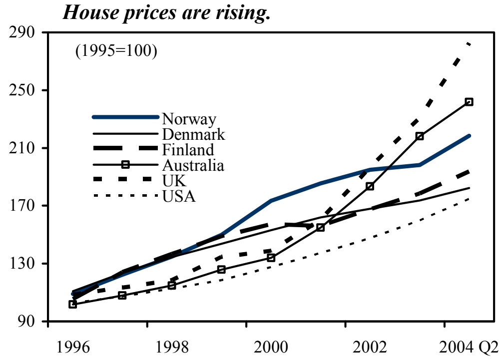


Source: Staff estimates.

[4] The budget, released in October, projects 3.1 percent; the April Consensus Forecast is 3.5 percent for 2005 and 2.6 percent for 2006.

7. **This outlook was viewed as balanced, with risks on both sides**. Household consumption, which has been strong, could be boosted further by recent rapid rises in house prices. If oil prices remain high or increase further, investment in that sector could prove stronger than projected. On the downside, sharply higher interest rates could cause significant house-price declines, although authorities and the mission agreed that this risk was limited for the time being, since debt-service burdens were below historical norms. A sharp slowdown in the world economy would, of course, adversely affect Norway, both through exports and, perhaps, falling oil prices. Finally, inflation could rise faster than expected should the structural factors that have restrained prices suddenly dissipate.

House prices are rising.

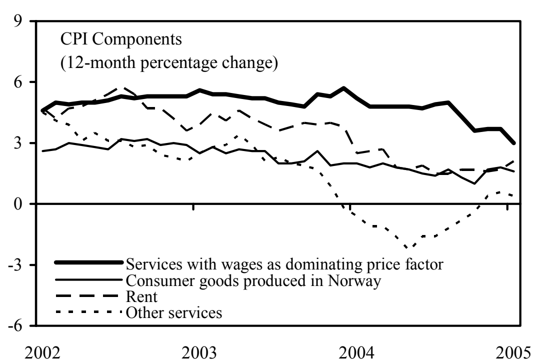


Source: Swedish Riksbank's Financial Stability Report 2004:2; and staff estimates.

Monetary policy

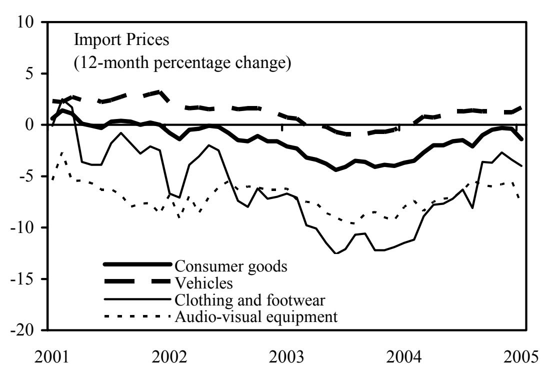
8. **The mission argued that inflationary pressures were beginning to surface and NB should therefore start withdrawing monetary stimulus during 2005**. With a closing output gap and tightening labor markets, pressures on prices and wages would rise. The baseline inflation forecast from the model developed in Chapter I of the selected issues paper is similar to that in NB Inflation Report 1/05. Contractual wages are governed by two-year settlements, and with 2005 being an interim year, wage increases were set to be moderate. However, continued robust growth would mean that the more important negotiations for 2006–07 would take place in the context of tighter labor markets. The mission noted that the substantial falls in import and service prices appeared to have largely come to an end, which would tend to boost the inflation numbers. Finally, low interest rates have helped fuel very high credit growth, especially to households, which provided a further impetus to growth and could eventually prove a risk to the financial system.

Domestic services prices are no longer falling.



Source: Norges Bank.

Import price declines are easing.



Source: Norges Bank.

9. **The authorities broadly agreed with this analysis, and private analysts were anticipating interest rate increases about mid-year**. The authorities emphasized that the period of very low rates had been appropriate, especially in order to prevent deflationary expectations from taking hold. However, in the governor's annual address in late February, NB signaled a shift toward a policy of gradual tightening by emphasizing that interest rates, which were well below normal, had succeeded in stimulating economic activity, and noting that other central banks had already begun to raise rates.[5] Private-sector analysts reacted to this speech by moving forward their estimate of when rates would begin to rise from September to mid-year.

10. **The flexible inflation targeting framework appears to have gained credibility**. Staff analysis suggests that NB successfully implemented the inflation target and the transition from the previous exchange-rate stabilization policy was smooth.[6] According to surveys, medium-term inflation expectations are anchored near 2.5 percent and in the authorities' view the framework was well accepted and understood. The mission's discussions with private-sector analysts revealed progress in this regard compared to past years, but also the perception that NB has been, and should be, careful to avoid an exchange rate appreciation.[7]

11. **Transparency has been further improved**. NB now publishes the monetary policy strategy document with the inflation report—that is, at the beginning rather than the end of the strategy period—and provides more details regarding the interest-rate decision in the press release following policy meetings. The mission suggested that transparency might be further enhanced by publishing minutes of the policy meetings, as some other central banks do. The authorities argued this would be inappropriate, noting that the practice is far from universal, NB press releases are already informative, and NB's Executive Board is composed mainly of part-time members.

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[5] The last point should be seen in the context of earlier statements by NB that it would not raise rates ahead of other central banks, which were meant to signal that the accommodative stance would continue.

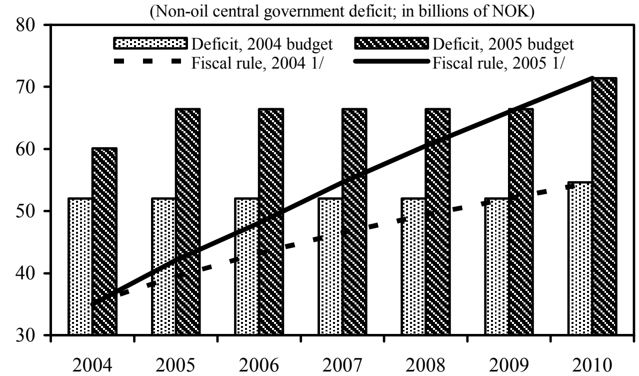
[6] Chapter 2 of the selected issues paper estimates monetary policy reaction functions for a number of inflation targeting countries, including Norway. It shows that NB has been targeting inflation, rather than output or the exchange rate, and its credibility has increased over time.

[7] See, for example, "Norges Bank Watch 2005," which argues not only for the primacy of the inflation target, but also that NB should apply it more flexibly in order to help stabilize the exchange rate.

Fiscal policy

12. **The key issue was the persistent deviation from the 4-percent fiscal rule, and the effect on fiscal credibility**. Since its inception in 2002, the rule has never been met. The mission agreed with the authorities that the stock market crash and the economic slowdown could, under the broader guidelines, justify temporary deviations in 2002 and 2003. However, with strong growth and a rapidly increasing GPF, this was not the case in 2004 or 2005. Indeed, the potential deviations in the 2005 budget are larger than in the 2004 budget, despite larger-than-expected inflows into the GPF, and are expected to last until 2010 (a year later than in the 2004 budget). By contrast, had the 2004 budget's medium-term deficit path been maintained, higher oil revenues would have closed the gap in 2007. The authorities agreed that this slippage was difficult to square with the guidelines.

Slippage of Fiscal Rule from 2004 to 2005
(Non-oil central government deficit; in billions of NOK)



Source: IMF staff estimates.
1/ Corresponds to 4 percent of GPF.

13. **Against this backdrop, the mission argued that slippage relative to the 2005 budget needed to be avoided**. Any increases in oil revenues should be used to narrow the gap with the 4-percent rule (rather than to increase the non-oil deficit), and savings from unexpectedly lower spending on sickness benefits should be used for deficit reduction. Also, the mission judged that restraint in the 2006 budget would be critical in ensuring the return to the 4-percent rule. The authorities agreed that slippage or further deviation from the rule next year would be difficult to reconcile with the fiscal guidelines.

14. **The mission recommended returning to the 4-percent rule sooner than envisaged in the budget**. In the mission's view, continued breaches of the rule, especially when not warranted by the circumstances envisaged in the broader guidelines, risked undermining the credibility of medium-term fiscal policy. This, in turn, could put unwanted upward pressure on the real exchange rate, aggravating possible "Dutch disease" effects, the evidence for which is somewhat mixed.[8] Wage increases have tended to outstrip those elsewhere and the real exchange rate, on a unit labor cost basis, has appreciated substantially in recent years. In 2004, the nominal exchange rate was about 33 percent overvalued compared to PPP (based on WEO data). On the other hand, staff equilibrium current account analysis suggests the krone is undervalued by 10–25 percent. Also, as stressed by the authorities, Norwegian

[8] Chapter 3 of the selected issues paper examines this issue in detail, and concludes that the fiscal policy framework has tended to mitigate these effects.

industry seems to have dealt with any pressures: while manufacturing has declined in importance over the years, this decline has not been larger than in other advanced economies. The authorities pointed out, however, that this benign outcome may reflect the degree of fiscal restraint in place: that is, Norway's (non-oil) deficit has not risen significantly more than in trading-partner countries. The authorities reported there were no adverse market reaction to the 2005 budget, and emphasized their commitment to return to the 4-percent rule.

15. **The mission recommended a medium-term fiscal plan to buttress the existing fiscal guidelines**. Many other countries, including Sweden and Denmark, have successfully used such frameworks to guide annual budgetary processes toward medium-term objectives. The details of these policies vary, but key components include multi-year spending ceilings and deficit objectives, as well as concrete measures to achieve them. The authorities replied that they had considered this option, but decided against opening up the issue of fiscal guidelines, in part because the outcome might be looser, not tighter, policy. They also noted that they publish three-year fiscal projections, though these are not binding targets, and that the current government had met its commitment to hold spending growth below the growth of mainland GDP.

16. **The 2005 budget also included a tax reform package**. The reform package, which largely follows the recommendations of a high-level advisory committee, addresses the growing problem of tax arbitrage between labor and capital income, in part by lowering labor taxes; exempts companies from taxation of dividends and capital gains on shares (which will fulfill the non-discrimination requirements of the EEA); and reduces the wealth tax. It also raises the normal and reduced VAT rates by 1 percentage point, to 25 and 7 percent (but the rate on food falls from 12 to 11 percent). However, the government did not implement the committee's recommendation to raise property taxes, which are low by international comparison, but instead increased the advantage of housing by eliminating the tax on imputed rent. The authorities noted that the imputed-rent tax was quite small and signaled a reform to allow municipalities more scope to raise property taxes. On an accrual basis, the reforms will reduce revenue by 0.3 percent of GDP in 2005.

B. Long-Term Fiscal Sustainability and Pension Reform

17. **The staff and the authorities agreed that the key long-term fiscal issue facing Norway, as in many other countries, is the rise in spending associated with population aging**. According to official estimates, aging-related spending, mainly pensions, will rise by almost 10 percent of GDP by 2050, one of the largest increases in Europe.[9] Also, on current

[9] The size of the increase mainly reflects the immaturity of the system. Many current pensioners are not earning full benefits because they did not contribute for the 40 years needed to qualify, but they are being replaced by those who did. Demographics are not particularly adverse. According to UN estimates, by 2050 the old-age dependency ratio will rise by 17 percentage points in Norway, compared to 24 percentage points in western Europe, 15 percentage points in Sweden, and 16 percentage points in Denmark. According to OECD data, replacement rates are slightly below the OECD average (68.7 percent for an average earner).

estimates the return from petroleum wealth will fall short of covering the increase, even if the 4-percent rule is followed (Appendix I). Against this backdrop, the mission emphasized the importance of adopting the government's pension reform package this year (Box 3).

18. **The proposed reform package would cut long-term outlays, while the provisions for life-expectancy adjustment and flexible retirement would also enhance work incentives**. To make these measures more effective, the mission recommended supporting them by: (i) realigning the replacement rates of the disability program with those of the new

Box 3. Pension Reform

Following the lead of other Nordic countries, notably Sweden, the government has proposed reforms to reduce costs and improve work incentives. These are based on recommendations of the Pension Commission, which reported a year ago. Key cost-cutting reforms are: (i) relating pension benefits to lifetime income instead of the best 20 years; (ii) linking pension payments to life expectancy; and (iii) indexing pensions to the average of wages and prices instead of wages. The first should also improve work incentives by making pensions more actuarially fair. To strengthen long-term fiscal discipline, the government also proposes to link the GPF and pensions by presenting in the budget developments in the GPF and the National Pension Fund in relation to pension obligations.

The Pension Commission estimated that these reforms would improve the fiscal balance by 2–3 percent of GDP by 2050. While much of the reduction is due to the cost-saving measures, about two-thirds was estimated by the authorities to be due to improved work incentives, including later retirement.

pension replacement rates for those choosing to retire early,[10] and (ii) phasing out the substantial government subsidy to early retirement programs. The mission agreed with the authorities that linking the GPF to pensions could help insulate it from political spending pressures, but emphasized the importance of continuing to invest the funds abroad to avoid "Dutch disease" effects. At the time of the consultation, both officials and private-sector analysts were optimistic that the reforms would pass largely as proposed before the September election.

19. **Analysis by the authorities and staff implies, however, that further measures will be required**. Although long-term estimates of petroleum wealth are subject to great uncertainty, official figures suggest that, if the 4-percent rule is followed, GPF assets could

[10] Disability and early pension replacement rates are now roughly equal, but the reform would reduce the latter.

rise to 145 percent of GDP in 2050, or almost 70 percentage points higher than today. However, the rise in pension spending would outstrip the extra income from the GPF by some 4 percent of GDP.

Pension Financing Shortfall

	2005	2050	Change
(In percent of trend mainland GDP)			
Pension expenditure without the reform	9.8	19.4	9.7
4 percent of GPF	3.1	5.8	2.7
Savings from reform proposal	...	...	3.0
Remaining financing gap	...	...	4.0
Memorandum item:			
GPF assets	77.4	145.0	67.6

Source: Ministry of Finance and IMF staff estimates.

C. Financial System

20. **Norway's financial system is well managed, well supervised, and sound overall.** The recent Financial Sector Assessment Program (FSAP) found that Norwegian banks are currently well positioned to deal with potential risk factors, with sound capital positions, strengthened risk management practices, and improved profitability (Figure 4). The insurance and pensions sectors have reinforced their financial positions, assisted by stronger global equity markets. However, life insurance companies and pension funds continue to face a challenging environment and remain susceptible to adverse market movements.

21. **The rising level of household debt may become, over time, an increasingly important risk factor**. While overall debt servicing costs relative to incomes are not currently high by historical standards, they are expected to rise; moreover, the distribution of both debt and household asset buffers point to some groups, such as the young, being more vulnerable than others. Given prospective increases in debt levels, a sharp rise in interest rates—especially if coupled with significant declines in house prices or in household incomes and employment—could hurt the banking sector. Since mortgage defaults are usually a last resort, the main transmission mechanism may be that higher mortgage interest payments will squeeze households, causing a fall in demand, which raises business-sector credit risk.

22. **The FSAP confirmed that Norway's main payments system and its supervisory arrangements compare very favorably with international standards**. Unified financial supervision is provided by the Financial Services Authority (FSA), which has adequate de facto powers to ensure financial stability. The FSAP did, nevertheless, recommend a number of measures (Box 4).

Box 4. FSAP: Summary of Key Recommendations[1]

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.
- Given the reduced risk weighting of mortgages under Basel II, carefully consider whether additional capital requirements for banks should be required under "Pillar 2."
- Continue to carefully monitor the risk of spillovers, in extreme events, resulting from the two-tier payments arrangements (many smaller banks settle through other banks rather than with NB), and examine the scope for increasing the use of collateral in interbank market exposures
- Further reduce market and liquidity risks in the securities settlement and retail payments systems.
- 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-owned bank, DNB-NOR.

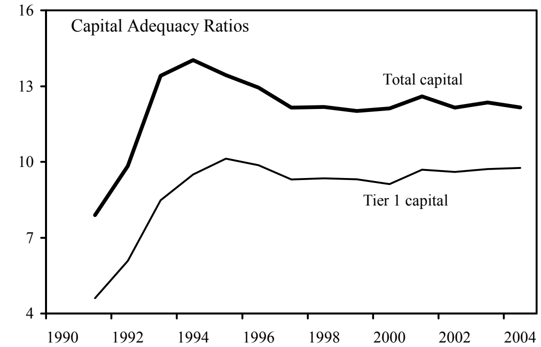
Structural and longer-term issues

- Reexamine key aspects of the deposit guarantee arrangements, including whether and how to achieve greater international comparability in coverage levels.
- Examine whether the netting of medium and smaller-sized interbank payments could be phased out.
- Review the continued desirability of state ownership in DNB-NOR. In the interim, consider further entrenching appropriate commercial autonomy and accountability for the bank.

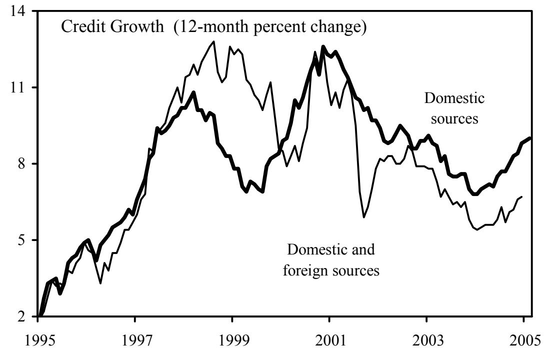
[1] See the Financial System Stability Assessment.

Figure 4. Norway: Financial Sector Indicators

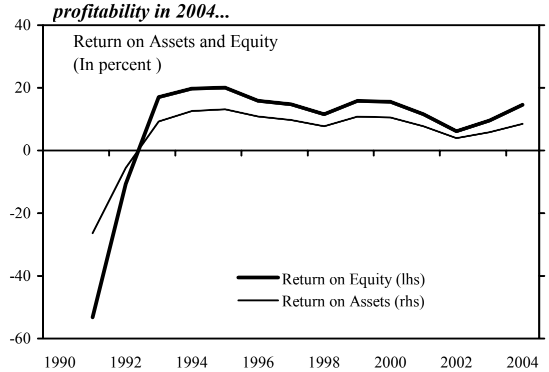
Capital adequacy ratios remain adequate.



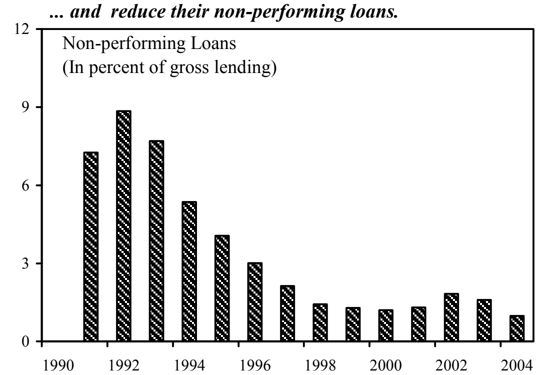
Credit growth is picking up.



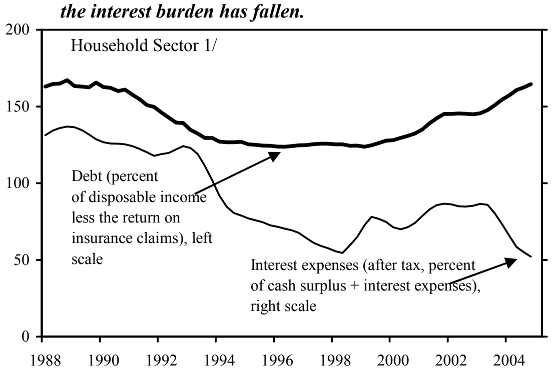
Improving economic conditions allowed banks improve their profitability in 2004...



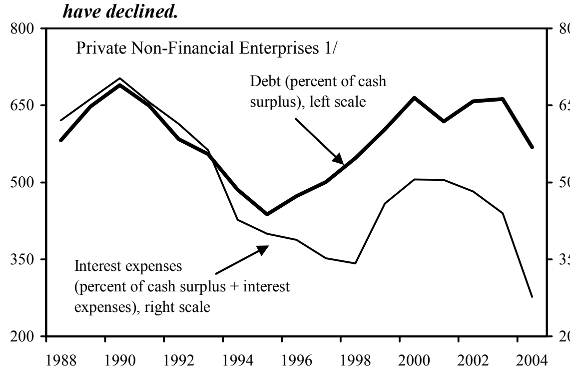
... and reduce their non-performing loans.



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



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



Source: Norges Bank

1/ Data for 2004 are estimates.

Table 5. Norway: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

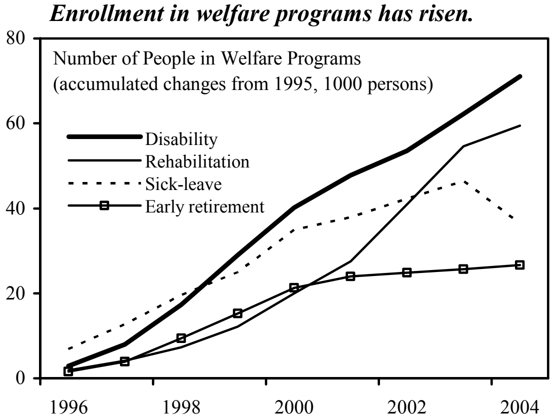
	1997	1998	1999	2000	2001	2002	2003	2004
External Indicators								
Exports of goods and services (annual percentage change, in U.S. dollars)	0.4	-13.3	10.2	25.3	-0.7	1.5	15.8	20.1
Imports of goods and services (annual percentage change, in U.S. dollars)	3.1	2.9	-6.1	-2.7	-1.1	8.1	16.5	20.8
Terms of Trade (annual percentage change)	1.6	-9.2	12.0	27.2	-3.5	-4.7	0.0	7.0
Current account balance	6.3	0.0	5.4	15.6	15.4	12.8	12.8	13.7
Capital and financial account balance	-3.5	4.3	-3.7	-10.5	-14.9	-8.2	-8.6	-10.5
Direct investment, net	-0.7	0.8	1.3	-1.6	1.8	-1.9	-0.2	-0.6
Portfolio investment, net	-6.3	-1.4	-1.8	-9.7	-16.7	-12.5	-2.7	-11.5
Central Bank international reserves (end of period, in billions of U.S. dollars)	23.4	19.1	23.8	27.9	23.5	32.4	37.7	44.3
Exchange rate against US dollar (NOK, period average)	7.1	7.5	7.8	8.8	9.0	8.0	7.1	6.7
Exchange rate against Euro (NOK, period average)	8.0	8.5	8.3	8.1	8.0	7.5	8.0	8.4
Real effective exchange rate (based on CPI, annual percentage change)	1.2	-2.8	-0.4	-1.8	3.8	8.4	-2.0	-3.8
Financial Markets Indicators								
Gross public debt (end of period)	27.5	26.2	26.8	30.0	29.2	36.1	44.9	44.9
3-month T-bill yield (eop, nominal, in percent per annum) 1/	3.7	7.9	5.6	7.2	6.9	6.8	2.4	1.8
3-month T-bill yield (eop, ex post real, in percent per annum) 1/	1.1	5.2	3.3	4.1	4.7	4.0	1.8	0.7
Spread of 3-month T-bill vs. Germany (percentage points, end of period) 1/	0.4	2.3	3.6	2.4	3.0	3.1	0.9	0.0
Spread of 10-year T-bill vs. Germany (percentage points, end of period)	0.2	0.8	1.0	0.9	1.3	1.3	-0.2	-0.1
General stock index (percentage change; end of period)	27.0	-25.8	42.3	9.8	-17.0	-31.8	40.3	39.5
Housing price index (percentage change; end of period)	10.8	6.8	18.6	9.8	7.7	2.8	4.1	10.5
Credit from domestic sources (percentage change; end of period)	10.2	8.3	8.3	12.4	9.8	8.7	110.5	113.2
Financial Sector Risk Indicators								
				(In percent)				
Loans to assets	80.1	80.8	79.7	80.3	80.9	80.5	79.5	81.3
Mortgages/total loans	46.1	46.1	46.8	46.3	47.0	49.2	52.0	55.6
Regulatory capital ratio	12.2	12.2	12.0	12.1	12.6	12.1	12.4	12.2
Tier 1 capital ratio	9.3	9.4	9.3	9.1	9.7	9.6	9.7	9.8
Return on assets	1.0	0.8	1.1	1.1	0.8	0.4	0.6	0.9
Return on equity	14.7	11.6	15.8	15.6	11.6	6.2	9.6	14.6
Foreign currency/total loans	9.5	11.0	10.9	12.0	11.7	10.0	10.3	8.4
Foreign currency liability and equity/total liability and equity	19.7	20.6	21.2	22.9	22.8	20.8	24.3	23.2
Foreign borrowing by banks/liability and equity	13.5	12.1	12.4	12.0	12.2	13.7	12.9	12.5
Household debt (in percent of disposable income less the return on insurance claims)	125.8	124.5	127.7	132.4	145.1	144.9	154.4	164.5
Private non-financial enterprise debt (in percent of cash surplus)	500.5	547.2	603.1	664.9	618.4	657.8	662.1	568.4

Sources: Norges Bank, IFS, and Fund staff calculations.
1/ For 1997-2000, refers to T-bill interest rate.

D. Structural Issues

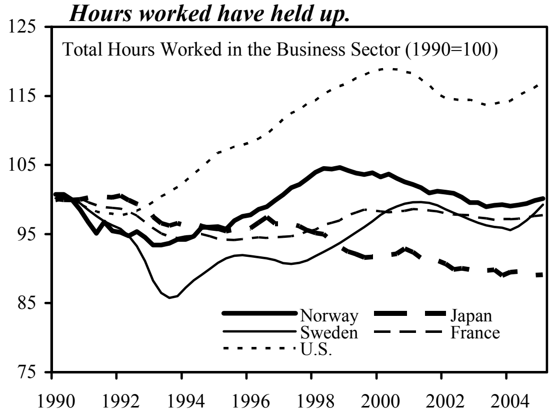
23. **Though the labor market performs well (Figure 5), the sickness and disability programs are an increasing cause for concern**. These programs have expanded substantially in the past decade, reducing available labor input (although total hours worked shows no clear trend) and placing an increasing strain on public finances: outlays of the National Insurance Scheme were 13.5 percent of GDP in 2004. Last year, hours lost to sickness fell, probably reflecting tighter medical examinations, which began in July, 2004. This fall, while encouraging, was small relative to past increases and the mission expressed concern that it might not be sustained. The mission, therefore, argued for a review of the very high replacement rates—100 percent for the sickness program—as well as tighter administrative controls. The authorities suggested that raising the share of employers' contributions to financing the sickness scheme would discourage firms from shifting employees into the scheme.

Enrollment in welfare programs has risen.



Source: Statistics Norway.

Hours worked have held up.



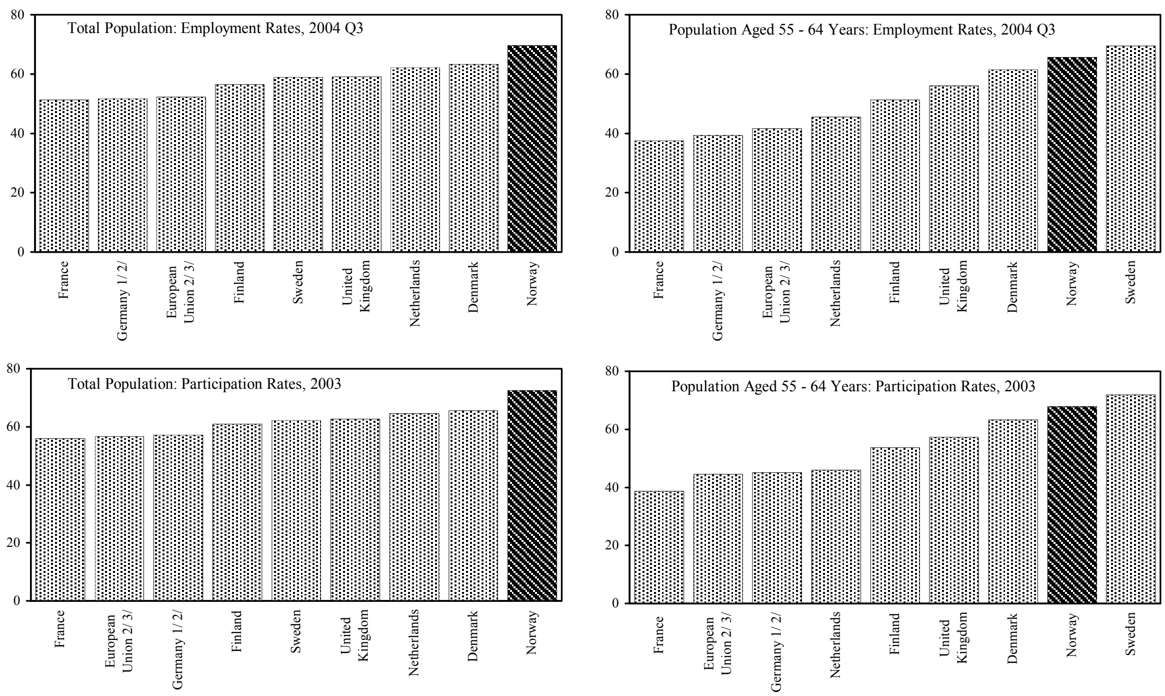
Source: OECD.

24. **The mission argued that further decentralizing wage bargains would enhance economic efficiency.** The narrow dispersion of wages may have impeded the reallocation of labor and blunt incentives to accumulate human capital.[11] The authorities argued that any decentralization should be part of a wider reform package, as it could otherwise intensify pressure for wage increases, leading to macroeconomic imbalances. They also noted that a committee was reconsidering the 1977 employment protection law with a view to allowing more flexibility in the labor market; new legislation was expected to be approved by the fall.

[11] See OECD "Economic Survey—Norway 2004: Reforms to Boost Labor Supply and Human Capital."

Figure 5. Norway: Employment and Participation Rates
(In percent)

Employment and participation rates are high by international comparison.



Source: Eurostat

1/ Including ex-GDR from 1991.
2/ 2003 Q2 data.
3/ 15 countries.

25. **Product market performance appears to be improving, as competition has increased**. Last year, the competition law was strengthened and aligned with relevant EU law. The Competition Authority has been active in a number of sectors, most recently restricting pricing agreements on books. Public ownership remains very high, however, including in a number of commercial enterprises. Significant institutional changes have been implemented in recent years to insulate state-owned enterprises from political influence and ensure that they operate on a purely commercial basis and on an equal footing with the private sector. Nevertheless, the mission argued that state ownership in the commercial sector should be reduced, since at levels prevalent in Norway it might lead to the perception of an uneven playing field and, in any case, precluded normal buyouts and takeovers, important mechanisms of corporate governance.

26. **Overall, Norway has a liberal external trade regime**. In the context of the Doha Development Agenda, Norway is seeking to improve market access for non-agricultural products through comprehensive reductions of tariffs, further liberalize the services sector, substantially reduce fisheries subsidies, and narrow the scope for protectionism under the Anti-Dumping Agreement. However, agriculture products produced in Norway (which tend

to compete with European rather than developing country exports) remain heavily protected, and the mission reiterated its long-standing advice to lower these barriers. The authorities argued that agricultural protection was key to addressing non-trade concerns, such as rural settlement, the environment, and food security. Norway's ODA for 2005 is expected to be about 1 percent of GNI, making it one of the few countries to exceed the UN target of 0.7 percent of GNI.

27. **The authorities expressed interest in a less frequent consultation cycle, in order to allow the Fund to redeploy resources**. The authorities emphasized the high value they place on Fund surveillance, given also that they are not subject to EC surveillance. At the same time, they judged that Norway is neither vulnerable nor systemically important, and noted that main policy requirements did not change significantly from year-to-year. They thus saw a case for moving from the current 12-month to an 18- or 24-month cycle. Staff agreed that conditions appear conducive to some resource savings in the conduct of surveillance over Norway in the coming years. In lieu of shifting to a longer cycle, with implications for the continuity of surveillance, it noted instead the possibility of adopting the less work-intensive procedure allowed under current guidelines and already used, to varying degrees, for some Nordic countries.[12] This consists in holding every other year shorter discussions focused on issues of more immediate concern (with a concluding statement), smaller mission teams, shorter staff reports, no other documentation, and lapse-of-time conclusion by the Board (as per SM/96/214, Supplement 1).

III. Staff Appraisal

28. **The Norwegian economy continues to perform well on all fronts, underpinned by a strong policy framework**. Growth picked up strongly in 2004, after slowing the previous year, and is expected to continue to be robust this year and next. Employment is also picking up and the unemployment rate has begun to edge down. Core inflation has been well below the 2.5 percent inflation target, reflecting the emergence of excess capacity during the slowdown and a consequent moderation in wage pressures, but also falling prices for some imported consumer goods and increases in domestic competition.

29. **The supportive monetary stance has been appropriate in view of very low inflation, but the process of gradually withdrawing monetary stimulus should begin in the course of the year**. Robust economic growth has all but eliminated available economic slack and indications are that the structural factors that have been holding prices down are waning. Looking forward, with the next two-year wage settlement being negotiated in 2006, it will be important to keep inflationary pressures in check. As Norges Bank raises interest rates, pressures for currency appreciation are likely to intensify somewhat. This would be part of the monetary transmission process and does not argue against a necessary tightening.

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[12] Finland and Sweden in 2000, and Sweden and Norway itself in 2002 (only as regards the lapse-of-time aspect in the latter case).

The size of the appreciation, however, would be muted if the policy tightening is steady and gradual, and is well communicated to markets.

30. **The framework of flexible inflation targeting and floating exchange rate is serving Norway well.** It is transparent and gaining credibility, although the authorities should continue their efforts to enhance communication. Inflation rate expectations, communications with market analysts, and the staff's own work all suggest the inflation targeting framework had become increasingly accepted. The authorities should continue to build on this success by consistently explaining policy to markets, in particular by emphasizing that the exchange rate is not an independent policy target. Recent measures to further improve policy transparency are welcome, including the decision to publish the monetary policy strategy document at the beginning of the strategy period and to provide a more detailed discussion of interest rate decisions.

31. **While fiscal policy has been broadly prudent, and has thus helped mitigate any "Dutch disease" problems, the recurring deviations from the key fiscal rule should be corrected sooner than now envisaged**. The real appreciation of the krone in recent years has tended to put pressure on the exposed sector, but policies to limit non-oil deficits and invest the bulk of petroleum revenues abroad appear to have mitigated Dutch disease effects. Nevertheless, overruns relative to the 4-percent rule in 2004 and, especially, 2005 are difficult to justify, either economically or in terms of the fiscal guidelines. If repeated or increased, such deviations could undermine the credibility of this successful fiscal policy. The authorities should, therefore, take advantage of current buoyant economic conditions to return to the rule significantly sooner than currently envisaged. In 2005, slippage relative to the budget should be avoided, any windfalls from higher oil prices should be used to narrow the gap with the 4-percent rule, and lower-than-expected outlays on the sickness program should be used to cut the deficit. The 2006 budget will also be crucial, as it offers an opportunity to recover some of the ground lost in 2005.

32. **The fiscal guidelines should be buttressed by a medium-term fiscal plan**. Key components of such a plan should include spending ceilings and deficit objectives, as well as concrete measures to achieve them. In Norway, a medium-term plan would at this point be particularly useful to map out a specific and credible path for returning to the 4-percent rule. Moreover, some of the building blocks are already in place: the Ministry of Finance has begun publishing multi–year fiscal projections; and the government has adhered to its policy of holding spending growth below GDP growth.

33. **The 2005 tax reforms are welcome, as they promise to reduce distortions and promote employment**. Nevertheless, they have resulted in housing becoming even more favored than before, an issue that needs to be addressed in the next round of reforms. Also, further tax reform should be accompanied by corresponding spending restraint, both to hasten the return to the 4-percent fiscal rule and, over the longer term, ensure the preservation of the GPF for future generations.

34. **The government's proposed pension reforms are commendable.** The measures will help to contain cost increases while safeguarding adequate standards of living for the retired. Perhaps more important, work incentives will improve, sustaining the tax base and easing the financial strain on the pension program. To ensure that such benefits materialize, complementary reforms to align disability and early retirement replacement rates and to withdraw public subsidies from early retirement programs should be implemented as soon as possible. Linking the GPF to pensions will help protect it from spending pressures, but to avoid "Dutch disease" effects the policy of investing the assets abroad should be continued. Finally, fully resolving the pension problem will require sustained effort beyond the current reforms, and the process of developing the necessary policies should begin as soon as possible.

35. **The Norwegian labor market performs well.** However, the expanding sickness and disability programs threaten to undermine the labor force and are burdening the public finances. The decline in hours lost to sickness in 2004 is encouraging, but may not be sustained. Continued progress in this area will, therefore, most probably require further tightening of administrative controls to ensure only those who are truly sick or disabled qualify, and a re-examination of the very high replacement rate.

36. **Regarding product markets, the increase in competitive forces and modernization of the competition law are welcome, although state ownership remains high.** Competition needs to be fostered further, through further deregulation, vigorous action by the strengthened Competition Authority, and greater progress on privatization of state-owned commercial enterprises. On this last point, the significant efforts in recent years to ensure that such enterprises are run on a purely commercial basis are welcome. Nevertheless, a perception that the playing field is not fully level is bound to remain, and, by precluding normal takeovers, state ownership frustrates an increasingly important mechanism of corporate governance. Therefore, further progress on privatization is warranted.

37. **The FSAP concluded that the financial system is sound and well supervised, but also offered recommendations to ensure continued strong performance**. One risk identified by both staff and the financial supervisor is the rapid rise in household debt, which over time will become an increasing risk factor. The authorities are monitoring developments very closely—their financial stability analyses and publications are exemplary—and will of course need to continue doing so. To ensure continued strong performance and supervision, the recommendations in the accompanying FSSA should be implemented as soon as possible.

38. **While Norway's trade regime is generally quite liberal, high agricultural trade barriers should be reduced**. The resulting trade distortions are minor in a global context, but the cost to Norwegian consumers, in terms of higher prices and limits on choice, is significant. Norway's commitment to official development aid, which exceeds the UN target of 0.7 percent of GDP, is commendable.

39. It is proposed that the next Article IV consultation with Norway be held on the standard 12-month cycle, but—subject to continued favorable economic conditions—the

staff would envisage reduced Board documentation and propose conclusion of the consultation on a lapse-of-time basis.

LONG-RUN FISCAL SUSTAINABILITY

1. In the next four decades or so, declining petroleum revenues and rising pension costs will increasingly threaten the long-run sustainability of Norway's public finances. The flow of income from oil and gas wealth will generate sizable fiscal surpluses for many years to come. However, government net cash flow from petroleum products is projected to begin to decline in the next few years, and to dwindle to about 1 percent of GDP after 2050.[13] (Figure 1). Pension expenditure, on the other hand, is projected to rise from 9¾ percent of GDP today to about 19½ percent of GDP in 2050.

2. This appendix summarizes the results of four simulations of long-run fiscal sustainability, based on the assumption outlined in the Box.

Technical Assumptions

Historical data are from official sources. Fiscal data are from the central government budget, which is on a cash bases and is therefore more consistent with net cash flows from oil and the GPF, and cash-based pension expenditure. The deviation from the 4-percent fiscal rule in the 2005 budget is assumed to be closed by policies in addition to those considered in these simulations. Non-oil revenues are assumed to be constant in relation to GDP at their 2005 level, as are non-pension expenditures (except in the final simulation). The potential growth rate of GDP is assumed to be 2¼ percent. The real return on the GPF is assumed to be 4 percent. The baseline assumes the 2005 budget oil projection; that is, the price in 2005 is about $37 per barrel. As an alternative, a price of $47 a barrel, consistent with the spring 2005 World Economic Outlook, is considered.

3. The first three simulations examine the sustainability of the public finances under different pension reform and oil price assumptions. Sustainability is described in terms of the "financing gap", which is the available flow of government revenue less pension expenditure. The available revenue is, in turn, non-oil revenue less non-pension expenditure plus the expected return (4 percent) on the GPF. So long as the financing gap is non-negative, pensions are affordable. But a negative financing gap, which is not sustainable, implies the 4 percent rule must be violated, either directly by dipping into the GPF, or indirectly by issuing government debt.

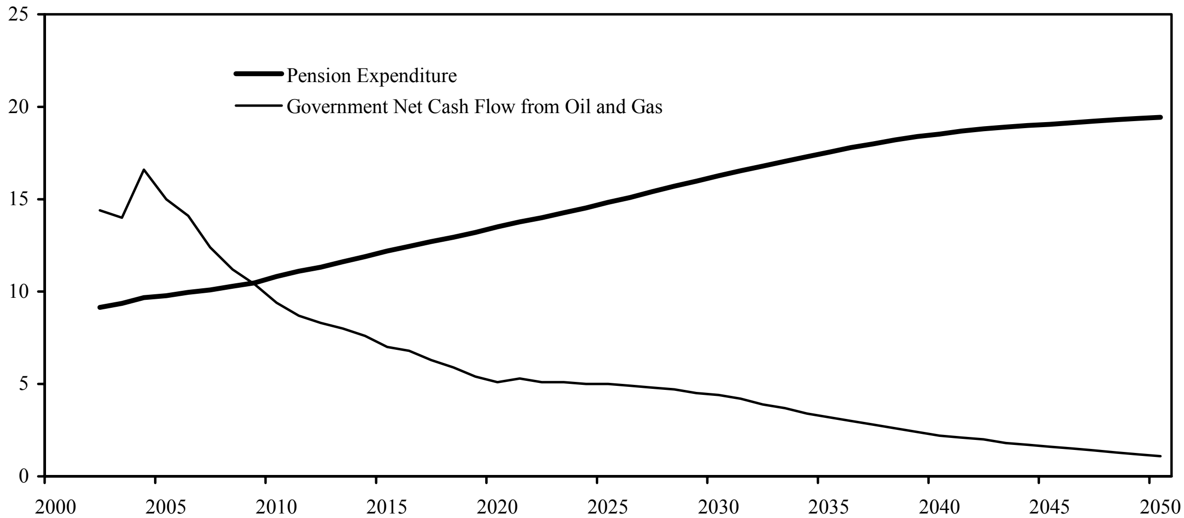
4. If the government's current reform proposal were not implemented, the financing gap would turn negative before 2020 (Figure 2, point A) and rise to about 7 percent of GDP by 2050. However, implementing the reform proposal would significantly reduce the size of the financing gap, which would turn negative in 2030 (Figure 3, point B) and rise to about 4 percent of GDP by 2050. If, in addition, future oil prices are assumed to be higher than the

[13] GDP refers to trend mainland GDP (that is, GDP is assumed to be at its potential level).

baseline, in line with the spring WEO, the financing gap does not turn negative until 2038 (Figure 3, point C) and is only about 2 percent of GDP in 2050.

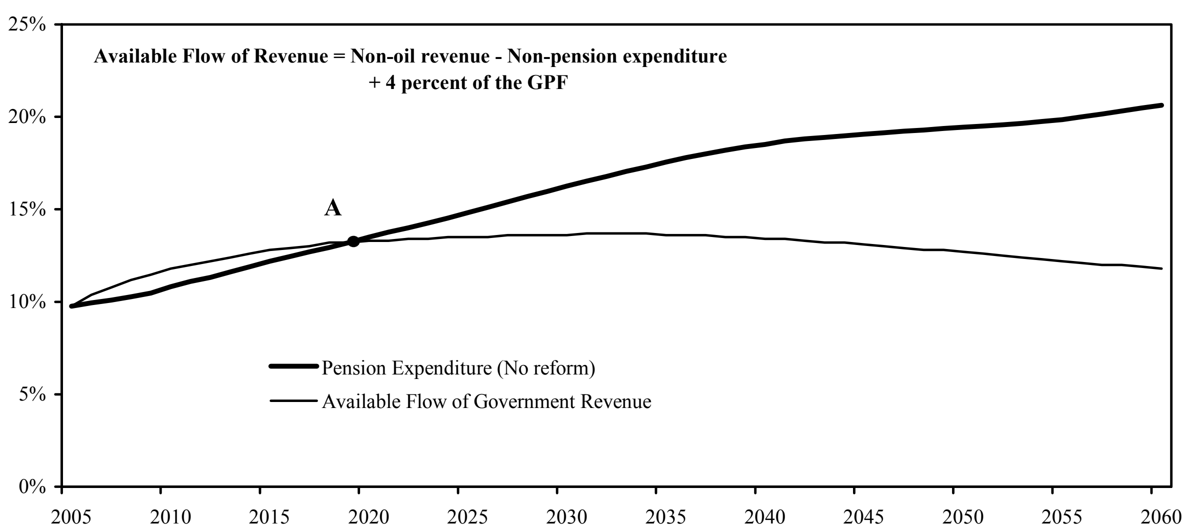
5. A final simulation considers the growth of non-pension spending needed to stave off a negative financing gap until 2050 (Figure 4, point D), assuming the current reform proposals are adopted and the current WEO oil prices. One such path is an annual growth rate of real non-pension expenditure of 1.6 percent from 2006 to 2015, and of 2.25 percent (that is, trend GDP growth) thereafter. Even in this case, however, the gap turns negative after 2050.

Figure 1. Cash Flow from Oil and Gas and Pension Expenditure
(In percent of trend mainland GDP)



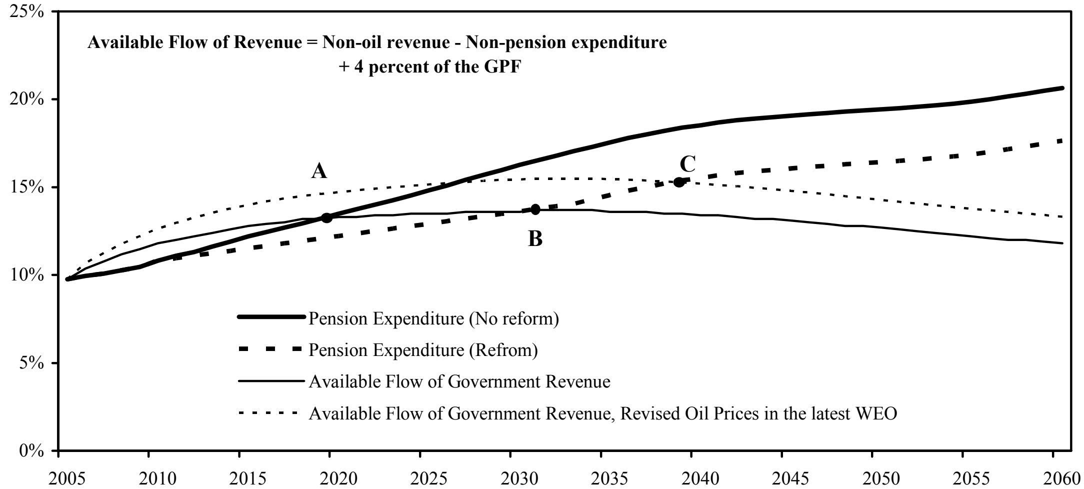
Source: Ministry of Finance

Figure 2. Long-run Fiscal Projections 2005-2060, No Pension Reform
(In percent of trend mainland GDP)



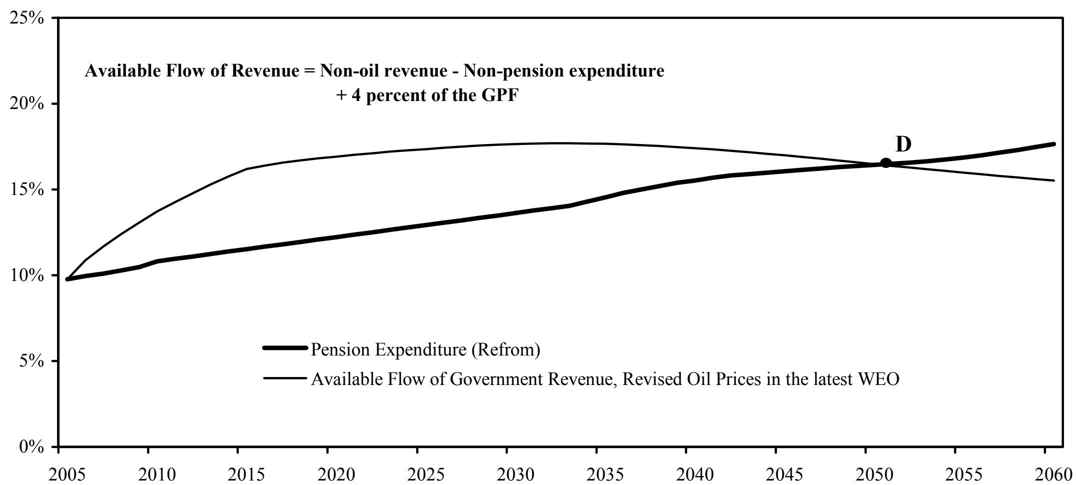
Source: Ministry of Finance, WEO and IMF staff estimates.

Figure 3. Long-run Fiscal Projections 2005-2060, with Pension Reform
(In percent of trend mainland GDP)



Source: Ministry of Finance, WEO and IMF staff estimates.

Figure 4. Long-run Fiscal Projections 2005-2060, Lower Non-pension Spending
(In percent of trend mainland GDP)



Source: Ministry of Finance, WEO and IMF staff estimates.

NORWAY: FUND RELATIONS
(As of February 28, 2005)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	1,671.70	100.00
Fund holdings of currency	1,122.51	67.15
Reserve position in Fund	549.19	32.85

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	167.77	100.00
Holdings	205.61	122.55

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

V. **Financial Arrangements**: None

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

VII. **Exchange Rate Arrangement**: The present exchange rate arrangement for the krone is classified as an independent float, following the adoption of an inflation targeting regime on March 29, 2001.

As of February 25, 2005, restrictions maintained by Norway for safety or security reasons pursuant to Decision No. 144(52/51) were limited to financial assets and economic resources belonging to selected individuals and entities of Burma (Myanmar), Zimbabwe, Iraq, the Federal Republic of Yugoslavia, Liberia, Cote d'Ivoire as well as financial assets of Usama bin Laden, Al Qaida, Taliban, and persons, groups, enterprises, and entities connected to them.

VIII. **Article IV Consultation**: Discussions for the 2003 Article IV Consultation were held in Oslo, December 1–9, 2003. The Staff Report was considered by the Executive Board on March 22, 2004.

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

X. **Resident Representative**: None

NORWAY: Statistical Issues

Norway's economic statistics are satisfactory for surveillance purposes. Norway subscribes to the Special Data Dissemination Standard. A data ROSC was published July 2003 (Country Report 03/207). The results are summarized in the accompanying TCIRS table.

NORWAY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF MAY 2, 2005

	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	May 2, 2005	May 3, 2005	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar. 2005	Apr. 2005	M	M	M		
Reserve/Base Money	Mar. 2004	May 2005	M	M	M	O, O, O, LO	O, O, O, O, O
Broad Money	Mar. 2004	May 2005	M	M	M		
Central Bank Balance Sheet	Mar. 2004	May 2005	M	M	M		
Consolidated Balance Sheet of the Banking System	Mar. 2004	May 2005	M	M	M		
Interest Rates[2]	May 2, 2005	May 3, 2005	D	D	D		
Consumer Price Index	Mar. 2005	Apr. 2005	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2003	Apr. 2004	A	A	A	LO, LNO, O, O	LO, O, O, O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Q4, 2004	Jan. 2005	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4, 2004	Jan. 2005	Q	Q	Q		
External Current Account Balance	Dec. 2004	Mar. 2005	M	M	M	O, O, O, O	LO, O, O, O,LO
Exports and Imports of Goods and Services	Dec. 2004	Mar. 2005	M	M	M		
GDP/GNP	Q4, 2004	Mar. 2004	Q	Q	Q	O, O, O, O	O, O, O, O, LO
Gross External Debt	Q4, 2004	Mar. 2005	Q	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 or the Substantive Update (published on July 3 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), not observed (NO), or not available (NA).
[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 2005 Article IV Consultation

Supplementary Information

Prepared by European Department

Approved by Reza Moghadam and Martin Fetherston

June 1, 2005

1. This supplement presents information on the revised 2005 budget, which was released on May 13, and on an agreement on pension reform concluded on May 26. Regarding the revised budget, a key change is that the fiscal rule is to be met in 2008, rather than 2010 in the original budget, in line with staff recommendations. Updated tables from the staff report are attached in Appendix I. The new information does not change the staff appraisal.

I. The Revised 2005 Budget

Underlying assumptions for 2005

2. Compared with the original 2005 budget, the revised budget assumes real mainland GDP growth to be ½ percentage point higher and incorporates significantly higher oil prices, which imply higher net petroleum revenue to the government (Table 1).[1]

The 2004 outturn

3. The central government non-oil budget deficit in 2004 was revised from 5.5 percent of GDP to 6.1 percent of GDP, mainly owing to downward revisions to non-oil revenues of ½ percent of GDP. These revisions involved transitory changes to corporate tax revenues and, as a result, the non-oil structural budget balance remained largely unchanged, at 4.5 percent of GDP. Spending was revised down by 0.1 percent of GDP. Oil revenues were revised downward by 0.3 percent of GDP.

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[1] Henceforth, GDP refers to mainland GDP.

Table 1. Norway: Underlying Assumptions in the Original and Revised 2005 Budgets

	2004	2005		2008-09	
		Original	Revised	Original (2008)	Revised (2009)
	(Volume change from previous year, in percent; unless otherwise specified)				
Total GDP growth	2.9	3.1	3.2	…	…
Mainland GDP growth	3.5	3.1	3.6	…	…
Exports	1.3	3.2	1.9	…	…
Oil and natural gas exports	0.9	3.0	-0.2	…	…
Traditional goods	3.0	5.1	4.9	…	…
Imports	9.0	5.0	5.4	…	…
Wage growth	3.6	4.0	3.3	…	…
Unemployment rate (in percent)	4.5	4.1	4.3	…	…
Current account (in billions of NKr)	231.2	211.5	248.9	…	…
Oil and gas					
Crude oil price (NKr per barrel)	257	230	300	190	225
Production (in millions of sm^3 oil equivalent)	264	271	264	288	278
Crude oil and NGL	188	189	184	170	162
	(In billions of NKr)				
Export value	346.4	347.5	403.7	301.7	330.3
Accrued taxes and royalties	140.6	120.9	174.4	102.2	122.5
Paid taxes and royalties	118.1	127.0	158.6	102.7	133.4
Net cash flow	203.4	204.5	260.1	175.5	215.3

Sources: Original and revised 2005 Budgets.

Changes for 2005

4. Compared with the original 2005 budget, higher oil prices result in an appreciably larger overall budget surplus (including petroleum revenues; Table 2). However, the non-oil budget deficit is expected to remain little changed, at Nkr 74 billion or 5.4 percent of GDP. An Nkr 4.8 billion (0.6 percent of GDP) decline in non-oil revenues was expected to be almost exactly offset by a decline in expenditures, mainly because of a reduction in transfers to households.[2] The non-oil structural budget deficit was revised downward very slightly.

5. Compared with the 2004 outturn, the revised 2005 non-oil deficit is expected to narrow by 0.7 percent of GDP, while the structural non-oil budget deficit will rise by ¼ percent of GDP. Non-oil revenues are expected to remain unchanged in percent of GDP, as strong economic growth offsets declines in tax revenues attributable to net tax cuts. Non-oil expenditures are expected to decrease by 0.7 percent of GDP owing to reductions in

[2] The decline in tax revenues in the revised budget, compared with the original budget, is in part related to a 1 percentage point reduction in VAT rate on food, instead of the 1 percentage point increase assumed in the original budget. This change is expected to reduce revenues by Nkr 1.2 billion in 2005.

Table 2. Central Government Fiscal Account, Budget Definition

	2004	2005			
		Original budget	Revised budget		
				Change from	
				2004	Original budget
			(In billions of Nkr)		
Total revenue	746.4	785.1	838.1	91.7	53.0
Oil Revenue	222.1	227.7	285.5	63.4	57.8
Non-oil revenue	524.3	557.4	552.6	28.3	-4.8
Tax revenue	480.0	516.8	510.3	30.3	-6.4
Other revenue	44.3	40.7	42.3	-2.0	1.6
Total Expenditure	622.2	655.0	652.1	29.9	-2.8
Non-oil expenditure	603.6	631.8	626.8	23.2	-4.9
Government purchases	108.8	109.0	110.1	1.3	1.1
Transfers	494.8	522.8	516.7	21.9	-6.1
To local governments	81.2	86.6	88.0	6.7	1.3
Other transfers	413.6	436.2	428.7	15.2	-7.4
Total Balance	124.2	130.1	185.9	61.8	55.8
Non-oil budget balance	-79.2	-74.3	-74.2	5.0	0.1
Non-oil structural budget balance	-58.8	-66.4	-65.3	-6.6	1.1
			(In percent of mainland GDP)		
Total revenue	57.1	57.4	60.8	3.8	3.4
Oil Revenue	17.0	16.7	20.7	3.7	4.1
Non-oil revenue	40.1	40.8	40.1	0.0	-0.6
Tax revenue	36.7	37.8	37.1	0.3	-0.7
Other revenue	3.4	3.0	3.1	-0.3	0.1
Total Expenditure	47.6	47.9	47.3	-0.2	-0.6
Non-oil expenditure	46.2	46.2	45.5	-0.7	-0.7
Government purchases	8.3	8.0	8.0	-0.3	0.0
Transfers	37.8	38.2	37.5	-0.3	-0.7
To local governments	6.2	6.3	6.4	0.2	0.1
Other transfers	31.6	31.9	31.1	-0.5	-0.8
Total Balance	9.5	9.5	13.5	4.0	4.0
Non-oil budget balance	-6.1	-5.4	-5.4	0.7	0.0
Non-oil structural budget balance	-4.5	-4.9	-4.7	-0.2	0.1
Memorandum item:					
Mainland GDP (in billions of Nkr)	1,307.5	1,367.3	1,377.3		

Source: Ministry of Finance, Statistics Norway and staff estimates.

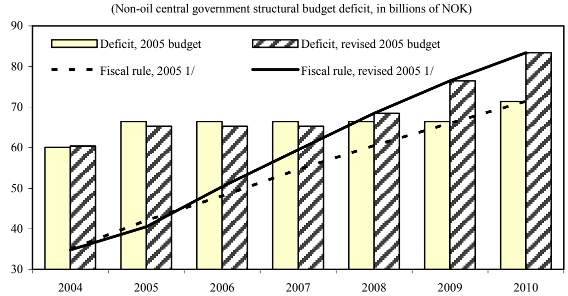
government consumption and benefits to households, which are partly offset by an increase in transfers to local governments

Medium-term projections and the fiscal rule

6. Higher oil prices and the higher overall budget surplus will result in more rapid growth in the Government Petroleum Fund, compared to what is assumed in the original budget (the solid line versus the dashed line in the accompanying figure). Since in 2005–08, the structural non-oil central government deficits are assumed to be little changed (the shaded bars versus the striped bars)—that is, the extra oil revenues are to be saved, not spent—the deviation from the fiscal rule would disappear in 2008, two years earlier than in the

The Fiscal Rule: 2005 Original and Revised Budget

(Non-oil central government structural budget deficit, in billions of NOK)



Source: IMF staff estimates.

1/ Corresponds to 4 percent of GPF.

original budget.[3] After 2008, the relevant deficit follows the 4-percent rule. This policy accords with the recommendations in the staff appraisal.

II. Pension Reform

7. On May 26, parliament agreed a pension reform which largely follows the government's proposal. In particular: benefits will be indexed to the simple average of wages and prices, rather than wages as now; benefits will be adjusted for life expectancy; benefits will be based on lifetime earnings; and the 40-year cap on insurable earnings will be abolished. However, benefits will be relatively higher for lower income workers, compared to the government's proposal, and, more importantly, the flexible retirement age was not adopted, but will be the subject of further study regarding its interaction with early retirement schemes. These measures will help to ease the future pension burden. However, it will be important to adopt the flexible retirement provisions to increase beneficial labor supply effects. Such effects would be further enhanced by withdrawing tax support for early retirement and insuring that disability and retirement benefits are aligned.

8. Though not strictly part of the public pension reform, it was also agreed to establish mandatory minimum requirements for second pillar (occupational) pensions, beginning on January 1, 2006. The resulting broader second pillar system will help to diversify retirement income, relieving some of the burden from the public scheme.

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[3] Recall that the fiscal rule sets the structural non-oil central government deficit to 4 percent of the assets of the GPF. The two lines in the text figure are 4 percent of the projected assets of the GPF.

Table 1. Norway: Selected Economic Indicators

	2001	2002	2003	2004	Proj. 2005 1/	Proj. 2006 1/
	(Annual percent change)					
Private consumption	1.8	3.0	3.0	4.3	4.5	4.0
Public consumption	5.8	3.7	1.4	2.0	1.8	1.8
Gross fixed investment	-0.7	-1.0	-2.0	8.9	10.0	5.0
Export of goods and services	5.0	-0.8	1.6	1.3	4.0	2.6
of which : Oil and gas	8.8	1.9	-0.6	0.9	2.8	1.1
Import of goods and services	0.9	0.7	2.2	9.0	7.9	5.0
GDP	2.7	1.1	0.4	2.9	3.7	2.8
Mainland GDP 2/	2.1	1.4	0.7	3.5	3.8	3.0
Unemployment (in percent of labor force)	3.5	3.9	4.5	4.5	4.0	4.0
Consumer prices	3.0	1.3	2.5	0.4	1.4	2.1
Wages (in full-time equivalents)	4.8	5.7	4.5	3.8	…	…
Nominal effective exchange rate	2.9	8.8	-3.3	-2.1	…	…
Broad money, M2 3/	9.3	8.3	1.9	7.6	…	…
Domestic credit 3/	9.7	8.9	6.8	8.8	…	…
Three-month interbank rate 4/	7.4	7.1	4.3	2.2	…	…
Ten-year government bond yield 4/	6.2	6.4	5.0	4.4	…	…
	(In percent of mainland GDP)					
Central government 5/						
Revenues	65.0	57.0	56.2	57.1	60.4	58.7
of which: Non-oil revenues	41.9	41.7	40.8	40.1	39.8	39.8
Expenditures	44.3	48.2	47.6	47.6	47.0	46.7
Overall balance	20.7	8.8	8.6	9.5	13.4	12.0
of which: Non-oil balance	-0.1	-5.1	-5.3	-6.1	-5.3	-5.1
General government financial balance 5/	17.7	11.6	9.5	14.8	18.9	17.3
of which: Non-oil balance	-0.5	-3.9	-6.5	-5.3	-4.8	-4.6
Current account balance	15.4	12.8	12.8	13.7	16.2	14.9
of which: Non-oil balance	-5.2	-5.3	-5.1	-6.3	-6.0	-6.0

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

1/ Staff projections as of March 2005. Fiscal projections are based on the revised 2005 budget, published on May 13, 2005.
2/ Excludes items related to petroleum exploitation and ocean shipping.
3/ End of period, in percent.
4/ Period average, in percent.
5/ Budget definition.

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

					Projections					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Balance of payments										
Goods and services										
Exports	77.6	78.7	91.2	109.5	128.9	125.6	123.0	121.1	119.9	119.3
Goods	59.2	59.3	68.6	82.5	99.1	95.7	93.1	91.2	89.9	89.4
o/w: oil and natural gas	34.9	34.5	39.7	50.1	63.4	60.4	57.7	55.8	54.6	54.1
Non-factor services	18.3	19.4	22.5	27.0	29.8	29.9	29.9	29.9	29.9	29.9
Imports	48.6	52.6	61.2	74.0	83.0	84.4	86.4	88.1	89.9	91.7
Goods	33.4	35.8	41.4	50.1	56.2	57.2	58.5	59.7	60.9	62.1
Non-factor services	15.2	16.7	19.8	23.8	26.7	27.2	27.9	28.4	29.0	29.5
Trade balance	25.8	23.4	27.2	32.4	42.9	38.5	34.5	31.4	29.0	27.3
Services balance	3.1	2.7	2.7	3.1	3.0	2.7	2.1	1.5	1.0	0.3
Balance of goods and services	29.0	26.2	29.9	35.5	46.0	41.2	36.6	33.0	30.0	27.6
Balance of factor payments	-2.8	-1.7	-1.6	-1.1	0.3	1.9	3.3	4.4	5.7	7.1
Current account balance	26.2	24.4	28.3	34.4	46.3	43.1	39.8	37.4	35.7	34.7
(In percent of GDP)	15.4	12.8	12.8	13.7	16.2	14.9	13.7	12.7	12.0	11.5
Net capital flows	-0.1	-0.2	0.7	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Net financial flows	-25.1	-15.6	-19.6	-26.2	-36.0	-33.4	-30.7	-28.4	-26.9	-25.9
Reserve changes	2.3	-5.8	-0.3	-5.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Net foreign assets										
(In percent of GDP)	39.1	35.9	51.9	64.3	78.2	88.9	98.6	106.1	112.2	117.1
Government Petroleum Fund										
(In percent of GDP) 1/	40.6	39.8	54.2	60.0	70.9	83.4	96.8	108.2	117.5	124.1
Nominal effective exchange rate (1995=100)	95.5	103.9	100.4	98.3	...	...	...	...	...	...
Real effective exchange rate (1995=100) 2/	99.7	108.1	104.4	102.1	...	...	...	...	...	...

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

1/ The revised National Budget 2005 projection for end of years 2005-10, published on May 13, 2005.

2/ Based on CPI.

Table 3. Norway: Fiscal and Monetary Indicators
(In percent of mainland GDP, unless otherwise indicated)

	2001	2002	2003	2004	Proj. 2005
Central Government 1/					
Revenue	65.0	57.0	56.2	57.1	60.4
of which : oil revenue	23.0	15.3	15.3	17.0	20.6
Expenditure	44.3	48.2	47.6	47.6	47.0
Balance	20.7	8.8	8.6	9.5	13.4
of which : non-oil balance	-0.1	-5.1	-5.3	-6.1	-5.3
less adjustments:					
Extraordinary items 2/	0.2	-1.8	-0.1	-0.1	0.0
Cyclical correction 3/	2.0	-0.2	-1.2	-1.5	-0.6
Structural non-oil balance	-2.3	-3.2	-4.0	-4.5	-4.7
In percent of trend mainland GDP	-2.4	-3.2	-4.0	-4.5	-4.7
General Government 4/					
Revenue	71.5	67.3	67.4	71.3	74.5
of which : oil revenue	18.3	15.6	16.2	20.1	23.8
Expenditure	53.8	55.7	57.8	56.5	55.6
Balance	17.7	11.6	9.5	14.8	18.9
of which : non-oil balance	-0.5	-3.9	-6.5	-5.3	-4.8
Cyclically-adjusted non-oil balance 5/	-2.5	-3.7	-5.2	-3.7	-4.2
Net assets 6/	71.9	71.3	83.8	87.2	96.2
Monetary Indicators:					
M2 7/	9.3	8.3	1.9	7.6	…
Domestic credit 7/	9.7	8.9	6.8	8.8	…
Three-month interbank rate 8/	7.4	7.1	4.3	2.2	…
Ten-year government bond yield 8/	6.2	6.4	5.0	4.4	…

Sources: Ministry of Finance; Norges Bank.

1/ Budget definition. Ministry of Finance. Fiscal projections are based on the revised 2005 budget, published on May 13, 2005.
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 2005 budget, publiched on May 13, 2005.
5/ Percent of trend mainland GDP. Adjusted for cyclical effects (central government), estimated by Ministry of Finance.
6/ Percent of GDP.
7/ End-period, percent change, national definition.
8/ Period average, in percent.

Table 4. Norway: General Government Financial Accounts, 2001-2005

	2001	2002	2003	2004	Proj. 2005
	(In billions of krone)				
Total revenue 1/	834.7	816.2	839.4	932.0	1,033.9
Oil revenue 2/	213.7	189.3	201.6	262.9	330.1
Non-oil revenue	622.1	628.1	640.3	670.7	704.6
Financial income	44.0	48.0	46.7	42.4	45.1
Tax revenue	556.7	567.7	576.2	614.1	643.9
Transfers	20.1	11.2	15.9	12.6	13.9
Capital revenue	1.3	1.2	1.5	1.7	1.7
Total expenditure 1/	627.9	675.3	720.6	739.1	771.8
Oil expenditure	0.6	1.3	1.3	1.2	0.7
Non-oil expenditure	628.4	675.2	721.8	739.4	771.8
Financial expenditure	28.1	27.7	28.8	25.0	24.4
Consumption	314.8	338.4	355.5	371.3	387.6
Transfers	268.1	290.6	316.8	325.1	340.8
Capital expenditure	17.4	18.5	20.6	18.1	18.9
Overall balance	206.8	140.9	118.8	192.9	262.1
Non-oil balance	-6.3	-47.1	-81.5	-68.7	-67.3
	(In percent of mainland GDP)				
Total revenue 1/	71.5	67.3	67.4	71.3	74.5
Oil revenue 2/	18.3	15.6	16.2	20.1	23.8
Non-oil revenue	53.3	51.8	51.4	51.3	50.8
Financial income	3.8	4.0	3.7	3.2	3.2
Tax revenue	47.7	46.8	46.2	47.0	46.4
Transfers	1.7	0.9	1.3	1.0	1.0
Capital revenue	0.1	0.1	0.1	0.1	0.1
Total expenditure 1/	53.8	55.7	57.8	56.5	55.6
Non-oil expenditure	53.8	55.7	57.9	56.6	55.6
Financial expenditure	2.4	2.3	2.3	1.9	1.8
Consumption	27.0	27.9	28.5	28.4	27.9
Transfers	23.0	24.0	25.4	24.9	24.6
Capital expenditure	1.5	1.5	1.7	1.4	1.4
Overall balance	17.7	11.6	9.5	14.8	18.9
Non-oil balance	-0.5	-3.9	-6.5	-5.3	-4.8
Cyclically-adjusted non-oil balance 3/	-1.3	-4.0	-5.7	-5.0	-5.3
Memorandum items:					
Net public assets					
in billions of krone	1,097.5	1,082.8	1,308.2	1,470.2	1,763.3
in percent of GDP	71.9	71.3	83.8	87.2	96.2
Nominal GDP 4/	1,526.2	1,519.1	1,561.9	1,685.6	1,832.9
Nominal mainland GDP 4/	1,167.2	1,212.6	1,246.1	1,307.5	1,387.4
Trend nominal mainland GDP 4/	1,150.7	1,209.5	1,265.1	1,313.4	1,376.8
Output gap 4/	1.4	0.3	-1.5	-0.4	0.8

Source: Ministry of Finance, and IMF staff calculations.

1/ Because of transfers between government sectors, the sum of oil revenue (expenditure) and non-oil revenue (expenditure) is not necessarily equal to the total revenue (expenditure).

2/ Includes Government Petroleum Fund dividends. Fiscal projections are based on the revised 2005 budget, published on May 13, 2005.

3/ Percent of trend mainland GDP. Adjusted for cyclical effects. IMF staff estimates and projections.

4/ IMF staff estimates and projections.

Norway: Selected Economic Indicators

	2001	2002	2003	2004	Proj. 2005 1/	Proj. 2006 1/
	(Annual percent change)					
Private consumption	1.8	3.0	3.0	4.3	4.5	4.0
Public consumption	5.8	3.7	1.4	2.0	1.8	1.8
Gross fixed investment	-0.7	-1.0	-2.0	8.9	10.0	5.0
Export of goods and services	5.0	-0.8	1.6	1.3	4.0	2.6
of which : Oil and gas	8.8	1.9	-0.6	0.9	2.8	1.1
Import of goods and services	0.9	0.7	2.2	9.0	7.9	5.0
GDP	2.7	1.1	0.4	2.9	3.7	2.8
Mainland GDP 2/	2.1	1.4	0.7	3.5	3.8	3.0
Unemployment (in percent of labor force)	3.5	3.9	4.5	4.5	4.0	4.0
Consumer prices	3.0	1.3	2.5	0.4	1.4	2.1
Wages (in full-time equivalents)	4.8	5.7	4.5	3.8	…	…
Nominal effective exchange rate	2.9	8.8	-3.3	-2.1	…	…
Broad money, M2 3/	9.3	8.3	1.9	7.6	…	…
Domestic credit 3/	9.7	8.9	6.8	8.8	…	…
	(In percent)					
Three-month interbank rate 4/	7.4	7.1	4.3	2.2	…	…
Ten-year government bond yield 4/	6.2	6.4	5.0	4.4	…	…
	(In percent of mainland GDP)					
Central government 5/						
Revenues	65.0	57.0	56.2	57.1	60.4	58.7
of which: Non-oil revenues	41.9	41.7	40.8	40.1	39.8	39.8
Expenditures	44.3	48.2	47.6	47.6	47.0	46.7
Overall balance	20.7	8.8	8.6	9.5	13.4	12.0
of which: Non-oil balance	-0.1	-5.1	-5.3	-6.1	-5.3	-5.1
Structural non-oil balance	-2.3	-3.2	-4.0	-4.5	-4.7	-4.8
General government financial balance 5/	17.7	11.6	9.5	14.8	18.9	17.3
of which: Non-oil balance	-0.5	-3.9	-6.5	-5.3	-4.8	-4.6
Current account balance	15.4	12.8	12.8	13.7	16.2	14.9
of which: Non-oil balance	-5.2	-5.3	-5.1	-6.3	-6.0	-6.0

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

1/ Staff projections as of March 2005. Fiscal projections are based on the revised 2005 budget, published on May 13, 2005.
2/ Excludes items related to petroleum exploitation and ocean shipping.
3/ End of period.
4/ Period average.
5/ Budget definition.

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FOR IMMEDIATE RELEASE
June 13, 2005

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

IMF Executive Board Concludes 2005 Article IV Consultation with Norway

On June 3, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Norway.[1]

Background

Norway's strong economic performance in recent years has been underpinned by a sound macroeconomic policy framework. In 2001 Norway adopted an inflation targeting framework, as well as fiscal guidelines (effective for the 2002 budget) designed to preserve petroleum revenue for future generations. This revenue, which guarantees substantial fiscal and current account surpluses for some years, is invested abroad in financial assets by the Government Petroleum Fund (GPF).

Real mainland GDP growth rebounded strongly in 2004, after a slowdown that began in late 2002. Very supportive monetary conditions—the central bank intervention rate as been 1.75 percent for over a year—high oil prices, rising house prices, strengthening consumer and business confidence, and an improved world economy all contributed to the pickup in activity. At the same time, core inflation has been well below the 2.5 percent target rate for some time, reflecting the slack that opened up during the slowdown, but also important structural factors: falling prices for some imports, because of a shift in imports toward low-cost countries, and for some domestic services, because of increased competition.

[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.

The outlook for 2005 and 2006 is promising, with most of the factors that propelled the economy forward last year expected to continue into the near future. Growth is likely to fall off somewhat in 2006, as very high levels of petroleum investment may not be sustained and there is a widespread expectation that the central bank will begin to tighten its policy stance. With the output gap closing and the structural factors that have been holding prices down waning, inflation is set to begin to rise. Nonetheless, wage increases so far in 2005 have been moderate, as inflation continued to be low and the unemployment rate has edged down only gradually.

The non-oil fiscal deficit has widened somewhat in the past two years on a structural basis, despite strong growth, and pressures for spending more of the petroleum revenue are strong. The 2005 budget foresaw a further deviation from fiscal rule setting the central government non-oil structural deficit at 4 percent of the assets of the GPF (part of the guidelines governing fiscal policy), despite higher oil prices, and therefore a larger stock of assets, than had been expected last year.

Executive Board Assessment

Directors commended Norway's strong fiscal and monetary policy framework and the success in avoiding any adverse effects of the oil wealth. Directors welcomed the economic recovery that has taken hold since 2004. They noted that robust growth and low unemployment have been underpinned by the accommodative monetary stance, rapid credit expansion, and high world oil prices. Inflation has remained low, with core inflation well below the inflation target, reflecting the lagged effects of the 2002–03 downturn and structural factors that have lowered the prices of some imports and domestic services. Looking forward, Directors agreed that the expansion would continue into next year and beyond, barring a downturn in the world economy or a large drop in oil prices.

Directors considered that the flexible inflation targeting regime has served Norway well, and welcomed the further refinements that were implemented in the past year. Publishing the monetary policy strategy document at the beginning of the strategy period and expanding the discussion of interest rate decisions should enhance transparency. Directors noted that inflation targeting has become increasingly credible and accepted, and encouraged the authorities to continue their efforts to explain the monetary policy framework and communicate policy decisions to markets.

Against the backdrop of strong growth, and consistent with the inflation targeting framework, Directors agreed that a gradual and measured withdrawal of monetary stimulus should begin in the course of this year. They noted that slack in labor and product markets is diminishing, and that the structural factors holding prices down may be waning. They also expressed concern that labor markets could become overheated in 2006, a year when two-year wage bargains would be concluded. Directors recognized that monetary tightening could put upward pressure on the currency, but did not see this prospect as justifying continued expansionary policies in the face of the current cyclical upturn.

Directors agreed that the fiscal guidelines—which require that the non-oil central government structural budget deficit be set equal to the long-run real return on the assets of the Government Petroleum Fund, assumed to be 4 percent—have helped to sustain broadly prudent fiscal policy. They appreciated the authorities' efforts to contain the non-oil deficit by restraining spending growth. In this regard, they welcomed the revised 2005 budget, which will use extra oil revenues to reduce the non-oil deficit, thereby bringing forward the date when the fiscal guidelines are achieved to 2008. At the same time, however, Directors emphasized the need for continued fiscal restraint, especially in the run-up to the elections later this year, to deal with the projected costs of population aging. They were concerned that the further breaching of the fiscal rule might damage the credibility of fiscal policy. They therefore called on the authorities to take advantage of the current favorable economic climate to comply with the fiscal guidelines as quickly as possible. Most Directors further recommended that the guidelines be reinforced by a medium-term fiscal plan, building on existing multi-year fiscal projections and ceilings for spending growth. Directors welcomed the 2005 tax reform, which eliminates some distortions and promotes employment. However, they noted that weaknesses in the tax structure remain—particularly the bias in favor of residential investment—and that spending restraint will be needed to offset the expected adverse revenue effect.

Noting that rising pension costs are the major threat to long-term fiscal sustainability in Norway, Directors welcomed the recent decision by parliament to adopt much of the government's reform package, which should help to contain costs and improve work incentives. They urged that that the flexible retirement age provisions of the package also be adopted, and agreed that the Government Petroleum Fund—which will be linked to pensions in the government's reform—should continue to be invested abroad. Finally, Directors noted that further measures beyond the current proposal will be needed to ensure long-term sustainability.

Directors welcomed the conclusion of the Financial System Stability Assessment (FSSA) that the financial system is sound, competitive, and well-managed. They commended the authorities on the strong system of financial supervision, and on the close coordination of financial supervision among the Nordic countries in view of the important cross-border financial linkages. They recommended that the authorities implement the reforms laid out in the FSSA, to help ensure continued financial-sector strength and resilience. Directors cautioned, however, that a continuation of the rapid pace of credit expansion, and the associated rise in household debt, could, over time, pose an increasing risk, and urged the authorities to continue to monitor credit developments closely.

Directors agreed that Norwegian labor markets perform very well. However, to check the expansion of sickness and disability programs, which could undermine employment, they recommended further tightening of administrative controls and reconsideration of very high replacement rates. Directors welcomed the new competition law and the increased competition in Norwegian product markets, and urged that this momentum be sustained, including through vigorous action by the competition authority. Directors considered that further privatization would be beneficial, in view of the still-high degree of state ownership, although they recognized that policies have been put in place to help to ensure that state-owned enterprises operate on a commercial basis.

Directors commended the generous level of Norway's development assistance, which is well above the UN target. They welcomed Norway's support for multilateral trade liberalization and its own generally low trade barriers, while encouraging reduction of still-high barriers to agricultural imports.

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

	2001	2002	2003	2004	Proj. 2005 1/	Proj. 2006 1/
			(Annual percent change)			
Private consumption	1.8	3.0	3.0	4.3	4.5	4.0
Public consumption	5.8	3.7	1.4	2.0	1.8	1.8
Gross fixed investment	-0.7	-1.0	-2.0	8.9	10.0	5.0
Export of goods and services	5.0	-0.8	1.6	1.3	4.0	2.6
Of which: Oil and gas	8.8	1.9	-0.6	0.9	2.8	1.1
Import of goods and services	0.9	0.7	2.2	9.0	7.9	5.0
GDP	2.7	1.1	0.4	2.9	3.7	2.8
Mainland GDP 2/	2.1	1.4	0.7	3.5	3.8	3.0
Unemployment (in percent of labor force)	3.5	3.9	4.5	4.5	4.0	4.0
Consumer prices	3.0	1.3	2.5	0.4	1.4	2.1
Wages (in full-time equivalents)	4.8	5.7	4.5	3.8	...	...
Nominal effective exchange rate	2.9	8.8	-3.3	-2.1	...	...
Broad money, M2 3/	9.3	8.3	1.9	7.6	...	...
Domestic credit 3/	9.7	8.9	6.8	8.8	...	...
			(In percent)			
Three-month interbank rate 4/	7.4	7.1	4.3	2.2	...	...
Ten-year government bond yield 4/	6.2	6.4	5.0	4.4	...	...
			(In percent of mainland GDP)			
Central government 5/						
Revenues	65.0	57.0	56.2	57.1	60.4	58.7
Of which: Non-oil revenues	41.9	41.7	40.8	40.1	39.8	39.8
Expenditures	44.3	48.2	47.6	47.6	47.0	46.7
Overall balance	20.7	8.8	8.6	9.5	13.4	12.0
Of which: Non-oil balance	-0.1	-5.1	-5.3	-6.1	-5.3	-5.1
Structural non-oil balance	-2.3	-3.2	-4.0	-4.5	-4.7	-4.8
General government financial balance 5/	17.7	11.6	9.5	14.8	18.9	17.3
Of which: Non-oil balance	-0.5	-3.9	-6.5	-5.3	-4.8	-4.6
Current account balance	15.4	12.8	12.8	13.7	16.2	14.9
Of which: Non-oil balance	-5.2	-5.3	-5.1	-6.3	-6.0	-6.0

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

1/ Staff projections as of March 2005.
2/ Excludes items related to petroleum exploitation and ocean shipping.
3/ End of period.
4/ Period average.
5/ Budget definition.

Statement by Jon A. Solheim, Executive Director for Norway
June 3, 2005

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 outlook – recent projections

After slowing around the beginning of 2003, growth in the mainland economy (i.e. excluding petroleum and shipping) picked up from the second half of 2003. The upswing in the mainland economy is reflected in the labor market. Employment has picked up, but at a slower pace than one should expect from the strong GDP-growth. In recent years, the number of persons on sick leave has increased substantially to a very high level. However, the sick leave fell appreciably through 2004, and has negatively affected the demand for labor. The EU enlargement last year has increased labor immigration to Norway. The increase in labor supply has dampened the decline in unemployment. The seasonally adjusted unemployment rate was 4.5 percent in the first quarter of this year.

The inflation rate continues to be low, but is expected to pick up again in the period ahead. Wage growth has declined markedly since 2002. It was 3.6 percent in 2004 and is expected to decline further in 2005.

In 2005, growth in the mainland economy is expected to continue well above trend. Household demand, housing starts and investments in the petroleum sector are the main driving forces in the expansion. The upswing has gradually become more broadly based, with a more positive outlook for the export sector and the manufacturing industries. Growth in mainland fixed business investment is also stronger than previously expected. Strong economic growth is expected to result in more pronounced employment growth and a gradual decline in the unemployment rate this year. Further out, growth in Mainland Norway GDP is forecasted to slow reflecting the projected fall in investments in the oil sector and gradually higher interest rates.

Monetary policy

My authorities note staff's assessment that the supportive monetary stance has been appropriate in view of a very low inflation. The advice that the process of gradually withdrawing monetary stimulus should begin in the course of the year is also noted. Norges Bank's key rate, the sight deposit rate, is at a historically low level. Since March 2004, the rate has been kept at 1.75 percent. Real interest rates are also low.

The monetary assessment presented in the Inflation Report in March indicated that the interest rate will rise after a period and at a gradual pace. The assessments were based on market participants' expectations that the interest rate would be increased in the summer. On the monetary policy meeting on May 25, the Executive Board of Norges Bank confirmed that the outlook for inflation and activity had not changed substantially since the March Inflation

Report. A development where the interest rate rises gradually – in small, not too frequent steps – was considered to provide a good balance between the different objectives.

According to the account of the background for the last monetary policy meeting on May 25, the Executive Board, as an alternative, considered increasing the interest rate already at that meeting. Nevertheless, the Executive Board did not find grounds – given the prospects of continued low inflation for a period ahead – to deviate from expectations in the money and foreign exchange markets at present.

As staff points out, Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment. In July 2004, Norges Bank adjusted the formulations as to the horizon for monetary policy.

The present formulation is: ”Norges Bank sets the interest rate with a view to stabilizing inflation at the target within a reasonable time horizon, normally 1-3 years. The relevant time horizon will depend on disturbances to which the economy is exposed, and how they affect the path for inflation and the real economy ahead.” While Norges Bank viewed the previous formulation as giving sufficient flexibility, the new formulation better expresses the prevailing conduct of monetary policy.

The selected issues paper on Implicit and Explicit Targets suggests that Norges Bank has reacted to inflation only, and not to the output gap. Norges Bank believes that the choice of data sample and the econometric method may have biased the results. In a similar study at Norges Bank, based on data from the beginning of 1999, the growth gap enters an estimated relation between the interest rate and macroeconomic variables.

My authorities note that staff welcomes recent measures to improve policy transparency, including the decision to publish the monetary policy strategy document at the beginning of the strategy period and to provide a more detailed discussion of interest rates decisions including a discussion of what interest rate options that were considered. In addition, the *Inflation Report*, web publication, press conferences and speeches provide an account of economic developments that are of importance to the Executive Board’s assessments and interest rate decisions. Underlying each interest rate decision is the monetary policy strategy drawn up by the Executive Board every four months. The strategy includes an assessment of the appropriate interest rate level in the four months ahead and is published in the Inflation Report without delay.

Fiscal Policy

As noted by staff, the Norwegian fiscal framework aims at a non-oil deficit that over time equals expected real return of the Government Petroleum Fund, estimated at 4 percent. This implies a gradual increase in the spending of petroleum incomes.

A gradual phasing in petroleum revenues towards a sustainable level is an important precaution against the Dutch disease. As noted by staff in the selected issues paper on the Government Petroleum Fund and the Dutch Disease, the decline in the Norwegian manufacturing share of (mainland) value added has so far not been significantly different from what is typically found in other developed countries.

The fiscal guidelines also aim at contributing to a stable development in the economy in the short and medium term. Therefore, the guidelines allow transitory deviations from the 4 percent path over the business cycle, and in the event of extraordinary large changes in the value of the Government Petroleum Fund. For some years now, the structural deficit has been larger than 4 percent of the Government Petroleum Fund, partly as a consequence of weak development in asset prices in 2002 and adverse cyclical conditions. The credibility of fiscal policy seems to have been generally unaffected, in part because there seems to have been a general acceptance that fiscal policy has been less expansionary than indicated by the change in the structural budget deficit. Indeed, fiscal policy has generally had a neutral effect on overall demand, marginally positive in 2002 and 2003, and neutral in 2004 and 2005.

As cyclical conditions now improve, my authorities share staff's view that spending of petroleum revenues should move towards the 4 percent track. The Government recently took a step in this direction by proposing to slightly reduce the structural deficit as part of the revision of the 2005 budget. In deciding how rapid this adjustment should be, the Government has to take into account the economic conditions and the fact that the income of the Petroleum Fund increases over time. Given present oil price forecasts, a constant level of the structural deficit in the years ahead will bring spending in line with expected return on the Government Petroleum Fund in 2008.

Staff argues for the introduction of a medium term fiscal plan to support the fiscal guidelines, for example in the form of multi-year spending ceilings. As noted by staff, the presentation of fiscal policy is now supplemented by medium term budget projections. This measure should be evaluated before contemplating specific moves towards a binding expenditure rule.

The fiscal rule sets a sustainable path for the non-oil structural deficit. Given this deficit, spending must adjust to income as ageing of the population sets in. A pension reform therefore is an important step to ensure long run fiscal sustainability, although it must be supplemented by additional spending restraint or increased revenues in the future.

Pension reform

The Storting (Parliament) reached on May 26 an agreement on a pension reform. Important proposals from the White Paper on the reform of the National Insurance Scheme are maintained in this agreement. The impact of the pension reform on the link between contributions and benefits will strengthen the elderly's work incentives and increase the pension system's financial sustainability. The agreement implies a need for more analysis before a final decision can be made on the flexible retirement scheme. The analysis should include further clarification of the interaction between the Contractual Early Retirement Scheme and the National Insurance Scheme.

The agreement will introduce some changes in the link between pre-retirement earnings and pension entitlements compared both to the original proposal and the current system, in the direction of a more compressed structure with lower replacement rates for higher incomes and higher rates for low incomes. It is also agreed that employers shall be required to provide supplementary occupational pensions which meet certain minimum standards. For the public sector occupational pension scheme, the agreement spells out that the current compensation ratio of two thirds of final pay should be kept unchanged. However, adjustments of these schemes to include the new life expectancy devisor and changed indexation, as in the new National Insurance, are supported by the Storting.

Tax reform
As noted by staff, the 2005 budget included the first step of a three-year tax reform. The reform is necessary in order to reduce the growing problem of tax arbitrage between labor and capital income and to address the possible conflict between present system for eliminating double taxation of share income and Norway's obligations to the EEA agreement (European Economic Area). Furthermore, the reform aims at making work more profitable and simplifying the tax system by scaling back some allowance schemes and special provisions.

The reform proposal includes lower marginal tax rates on labor income and increased marginal tax rate on share income exceeding a risk free rent. The goal is to solve the income shifting problem, without introducing a tax discrimination of investments in the corporate sector. Increased taxation of share income will be combined with a reduction of the wealth tax. The Government has promised to halve the wealth tax by 2007, with the aim of elimination subsequently.

As noted by staff, the tax on imputed rent from housing was abolished from 2005. The rules concerning this tax base have had arbitrary implications, and it would be most difficult to define a valuation system that would not have unreasonable implications.

The Government has proposed that the tax reform is accompanied by a cut in net tax on income and wealth over the fiscal years 2005 to 2007, corresponding to almost 0.8 percent of GDP in 2003. Apart from a net tax cut, the changes in the tax system in 2005 were partly financed by a 1 percentage point rise in normal and reduced VAT-rates.

Structural Policy
A large number of structural reforms have been implemented in Norway over the last two decades. The main objective has been to improve the efficiency of financial and product markets. In later years, more attention has been directed towards reforms in the production of public services. In some sectors, however, further deregulations are on the agenda. In December 2004, the Government submitted a proposal to the Storting for full liberalization of the postal market in Norway as of January 1, 2007. The proposal outlines the main principles for a new regulatory framework in the postal sector adapted to a fully liberalized postal market.

In general, and with the exception of agriculture and to some extent fisheries, product market deregulations have reached a stage where a vigorous and active application of competition policy may be more needed than large sector reforms. Further steps to strengthen the competition policy were, as mentioned by staff, taken when the new competition law came into force last year.

The Government shares staff's view that state ownership in the commercial sector should be reduced. Privatization has been pursued gradually and on a pragmatic basis. The Norwegian electricity market is one of the most competitive in the world, even if most companies are publicly owned.

It is noted that staff recommends to review the desirability of state ownership in DnB-NOR.

FSSA

The FSAP exercise confirms that the Norwegian financial system is well managed, well supervised and sound overall.

My authorities take note on the view that rising household debt levels represent a risk factor, and that the combination of guaranteed-return products and low interest rates represents a challenge for pension providers.

Staff concludes that the financial supervisory authority, Kredittilsynet, has operational independence. My authorities note that staff recommends increasing the level of powers delegated to Kredittilsynet in order to help ensure that effective operational independence is maintained in the future. The issue of delegating licensing and authorization authority is examined frequently. Norway's constitutional system, where the minister is responsible to the legislature for financial supervision, does, however, limit the possibilities for excluding ministerial oversight and decision-making.

Also, staff recommends considering formalizing somewhat further the coordination between the three institutions involved in financial stability; Norges Bank, Kredittilsynet and the Ministry of Finance. My authorities agree that the division of tasks related to financial stability between Kredittilsynet and Norges Bank could be examined. A contractual arrangement between the Ministry and two public institutions under the Ministry's authority is, however, not deemed appropriate within a constitutional system where the Minister of Finance is responsible to the legislature (Parliament) for financial stability.

Moreover, staff recommends reviewing key parameters of bank deposit insurance arrangements. As mentioned in the report, the Government maintains the position that the current Norwegian deposit guarantee system is well designed. The EU is currently discussing different issues related to deposit guarantee systems, and the corresponding EU directive in this field. As an EEA Member State, Norway participates in this process, and will have to take the outcome of the discussions into account.

Next Article IV consultation

My authorities duly note staff's proposal that the next consultation be held on a standard 12-month cycle, with reduced Board documentation and conclusion of the consultation on a lapse-of-time basis. Norway is neither vulnerable nor systemically important. A move to a longer cycle will allow all parties involved in Article IV consultations to deploy resources. Given this, my authorities maintain their interest of moving to an 18- or 24-month cycle.