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Norway: 2000 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of 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 2000 Article IV consultation with Norway, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **October 24, 2000** 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 December 26, 2000.** 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 statement of **January 26, 2001** updating information on recent economic developments.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its January 26, 2001 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of Norway.

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

A Selected Issues report prepared by IMF staff as background to the Airticle IV staff report has been released separately.

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 2000 Article IV Consultation

Prepared by Staff Representatives for the
2000 Consultation with Norway

Approved by C. Maxwell Watson and Martin Fetherston

December 26, 2000

- The consultation discussions were held in Oslo during October 17–24, 2000.
- The Norwegian Representatives included Mr. Karl Eirik Schjøtt-Pedersen, Minister of Finance; Mr. Svein Gjedrem, Governor of Norges Bank; Mr. Tore Eriksen, Secretary General, Ministry of Finance; other senior officials; and representatives of the Confederation of Labor Unions, Confederation of Norwegian Business and Industry; as well as representatives of private financial institutions and the academic community.
- The staff team comprised Mr. Thakur (head), Ms. Cerra, Mr. Horváth, (all EU1), and Mr. Canetti (TRE). Mr. Törnqvist, Alternate Executive Director for Norway, participated in the discussions.
- Norway has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, except for a few restrictions notified under Decision 144 (Appendix II).
- Norway has subscribed to the Special Data Dissemination Standard (SDDS) (Appendix III)
- The authorities released the staff team's Concluding Statement to the public and have agreed to the publication of the Staff Report.

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EXECUTIVE SUMMARY

Background: The Norwegian authorities' policy strategy has contributed to a prolonged upswing, and the coincidence of high oil prices, peak oil production, and a strong U.S. dollar has boosted oil revenues and demand through strong wealth and confidence effects at the same time that the economy is operating above potential. Solid economic growth in 2000 has been accompanied by a persistently tight labor market. On the background of a pronounced rise in headline inflation and asset prices over the past year, Norges Bank raised interest rates by 150 basis points, despite the strength of the krone against the euro. The current account and fiscal surpluses are both set to reach over 14 percent of GDP. A minority government faces elections in September 2001.

Key Policy Issues: Since the authorities' short-term policy framework is anchored to and, to a large extent, derives from their long-term strategy for managing oil wealth, the discussions focused on the design of short-term policies on the backdrop of the wider national debate about the soundness of the long-term approach to the utilization of resource wealth.

- On the **long-term fiscal outlook and policies**, the authorities and the mission broadly agreed that accommodating recent pressures to expand current public services could jeopardize the financing of pension programs and may also crowd out growth in the mainland economy at the same time as revenue from oil exports begins to decline.

- Cognizant of political constraints, the authorities argued that a neutral **fiscal stance** in 2001 was consistent with the role of cyclical management assigned to fiscal policy under the strategy. The staff noted that a moderately restrictive stance would be appropriate on strictly economic criteria. It was agreed that **incomes policy** would need to ease cost and price pressures by minimizing wage drift and would need to be supported by complementary structural measures in the labor market.

- The authorities were satisfied with the present **monetary policy** regime which allows for greater short-term exchange rate flexibility and emphasized their intention of bringing inflation down to the euro area inflation objective in a sustained but cautious manner. The staff argued that the credibility of monetary policy could be enhanced by clearer institutional arrangements.

The staff emphasized that the clamor to spend more oil wealth should not distract attention from urgently needed **structural reforms,** including in the pricing, management and incentive structures in public services, particularly in the health sector. The mission also argued for measures to increase labor supply, restrain public expenditure, and move forward with privatization initiatives. It stressed the risk of piecemeal tax changes that compromise the neutrality of the tax system.

I. Introduction

1. **Norway, one of the world's richest economies and its second largest oil exporter, is also notable for its prudent economic management of resource wealth in recent years.** The policy of investing abroad a substantial part of the government's revenue from the export of oil and gas through the State Petroleum Fund (SPF), pursued in the 1990s, has helped insulate the mainland (non-oil) economy from fluctuations in oil revenue. Coupled with a consensual incomes policy framework, this strategy has led to a generally successful management of the economic cycle. The exploitation of oil wealth has contributed to raising living standards markedly over the past quarter century and to the expansion of the welfare state.[1]

2. **The recent rapid and visible buildup of oil wealth has, however, stirred a public debate about the authorities' long-run economic strategy.** With oil output close to its peak and projected to decline sharply in the coming decade, easing the economy's transition to the post-oil era is a key objective of this strategy (Figure 1). The decision to save a part of the income from oil is also guided by considerations of long-run fiscal sustainability in the face of an impending demographic shift which presages a large and growing burden of the cost of pensions and health care services in the new century. The present windfall gains from high oil prices and the resultant build-up of the SPF have, however, led to growing popular calls for spending more of the oil wealth now, particularly on expanding public services.

3. **Buttressed by the surge in oil prices, the upswing has led to increasing strains on resources.** The authorities' policy strategy under the Solidarity Alternative—premised on wage moderation by the labor unions in return for the authorities' commitment to orient monetary policy toward stabilizing the exchange rate and fiscal policy toward smoothing aggregate demand—functioned well in the early phase of the upturn. Indeed, this policy framework helped sustain a long period of expansion which began in 1993 and contributed to economic fundamentals that are among the best in Europe (Figure 2), most notably virtual full employment despite a sharp rise in the participation rate. Nonetheless, as the cycle has matured, labor market conditions have tightened and pressures on capacity intensified, straining the solidaristic wage-setting framework.

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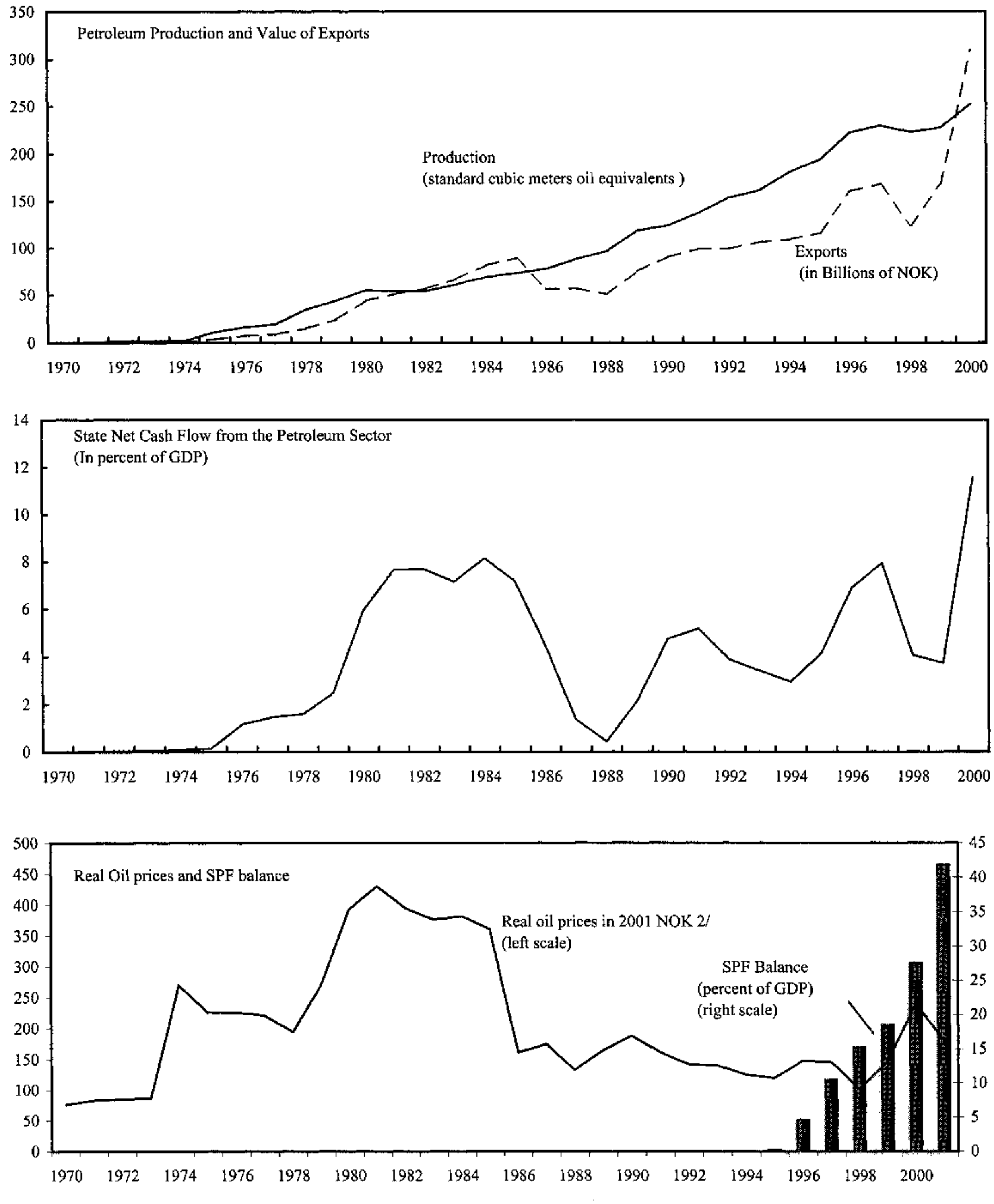
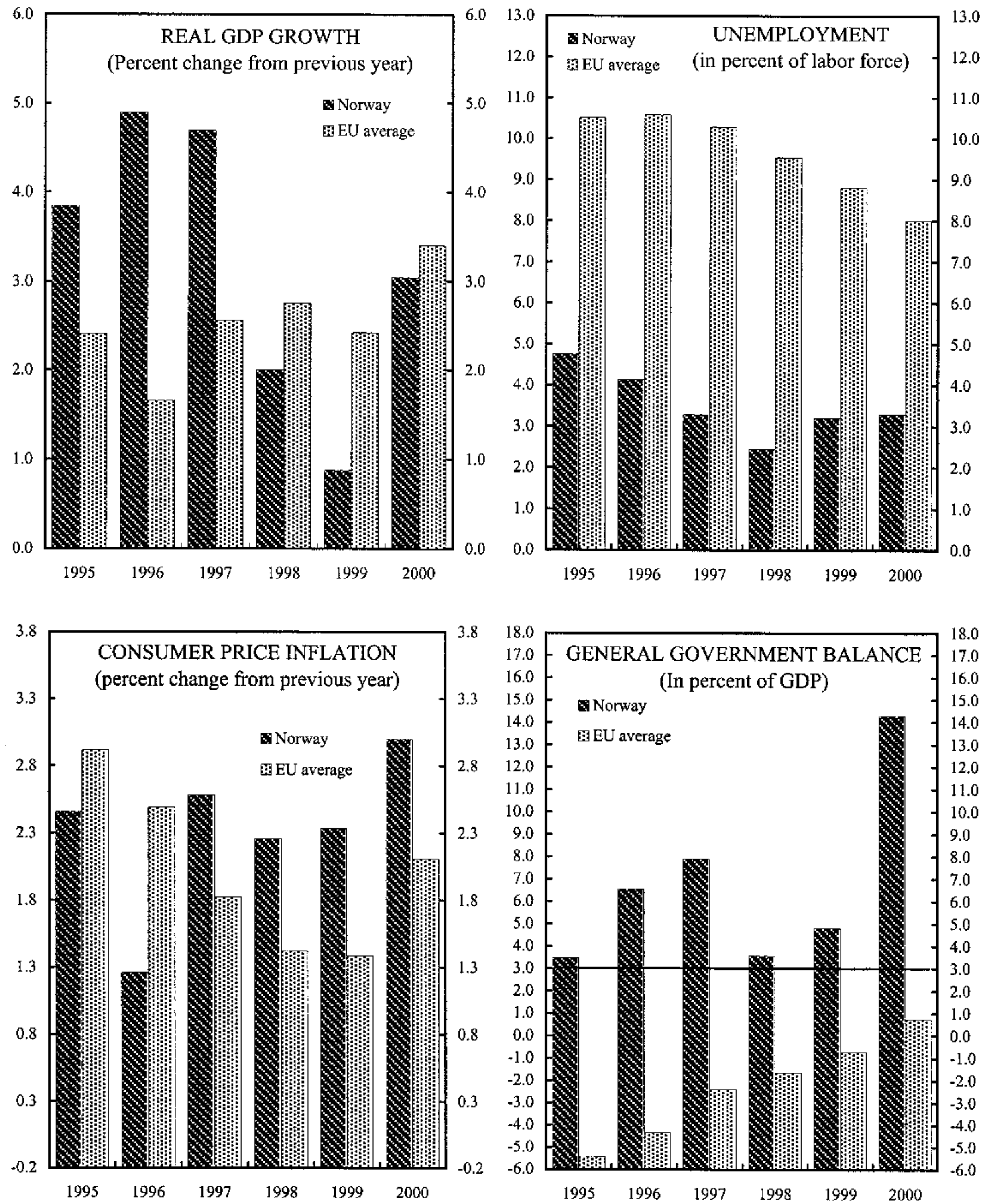
[1] Resource windfalls have often been associated with worsening economic performance and there is some evidence to suggest that economic growth is inversely related to the share of natural resources in exports. For example, see Sachs J. and A. Warner, December 1995, "Natural Resource Abundance and Economic Growth," NBER Working Paper 5398. For an assessment of the SPF in a comparative context, see the recent staff paper " Stabilization and Savings Funds for Nonrenewable Resources—Experience and Fiscal Policy Implications" (SM/00/270,12/1/00).

Figure 1. Norway: The Petroleum Sector 1/



Source: Ministry of Finance.
1/ Forecasts for 2000 and 2001.
2/ Deflated by CPI.

Figure 2. Norway: Economic Fundamentals, 1995-2000



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

4. **The tradition of consensual politics has ensured a stable policy framework despite a series of minority governments.** A minority Labor Party government replaced a minority centrist coalition in March 2000. Like its predecessor, the new government relies on issue-based support from the opposition parties. The role of compromise inherent in the minority status of governments is well entrenched in the legislative process and is illustrated by the annual parliamentary negotiations with the opposition over the budget proposals. Under the four-year electoral cycle, the next general elections are due in September 2001.

5. **In concluding the last consultation, Directors underscored the vital role of fiscal discipline, wage moderation and continued structural reform.** Directors commended Norway for its exemplary economic performance over the past decade, attested by strong economic growth, low rates of unemployment and inflation, and strong fiscal and external positions. Looking forward, Directors argued that in order to preserve these gains, the authorities should seek to bring inflation in line with the target in the euro area, and move forward with structural reform to enhance efficiency and provide the basis for sustained growth of the mainland economy in the post-oil era.

II. THE SETTING FOR THE DISCUSSIONS

A. Economic Background

6. **Economic growth strengthened in 2000, supported by buoyant consumption and a boost to confidence provided by the oil windfall.** After a brief pause in the first half of 1999, mainland GDP growth picked up to 3 percent in the first half of 2000 over the corresponding period in 1999 (Table 1). Private consumption, driven by large wage gains and positive wealth and confidence effects, rose by 3½ percent, with public consumption also providing a steady impetus to demand. The strength of residential and mainland business investment more than offset a continued contraction in petroleum investment which is driven by longer-term factors such as exhaustion of oil fields. Solid export growth and the lagged effects of the relaxed monetary stance of 1999 also underpinned economic activity.

7. **The labor market is characterized by persistent tightness** (Figure 3). The renewed expansion since late 1999 boosted the growth of employment, mostly in services, with the participation rate—already among the highest in the advanced economies—reaching a new high. While the rate of unemployment at 3¼ percent remained broadly unchanged from its level a year earlier, the vacancy ratio neared historical highs and acute labor shortages continued in sectors such as construction, health care services, and information technology. Increasing reliance on immigration both from the European Union (EU) and outside—running at a record but still comparatively modest level—has only partially eased bottlenecks.

8. **The incomes policy accord came under renewed strain in the 2000 wage round** (Box 1). With mounting labor shortages enhancing the bargaining power of unions, a settlement under the two-year centralized bargaining framework was reached in May 2000

Table 1. Norway: Economic Outlook

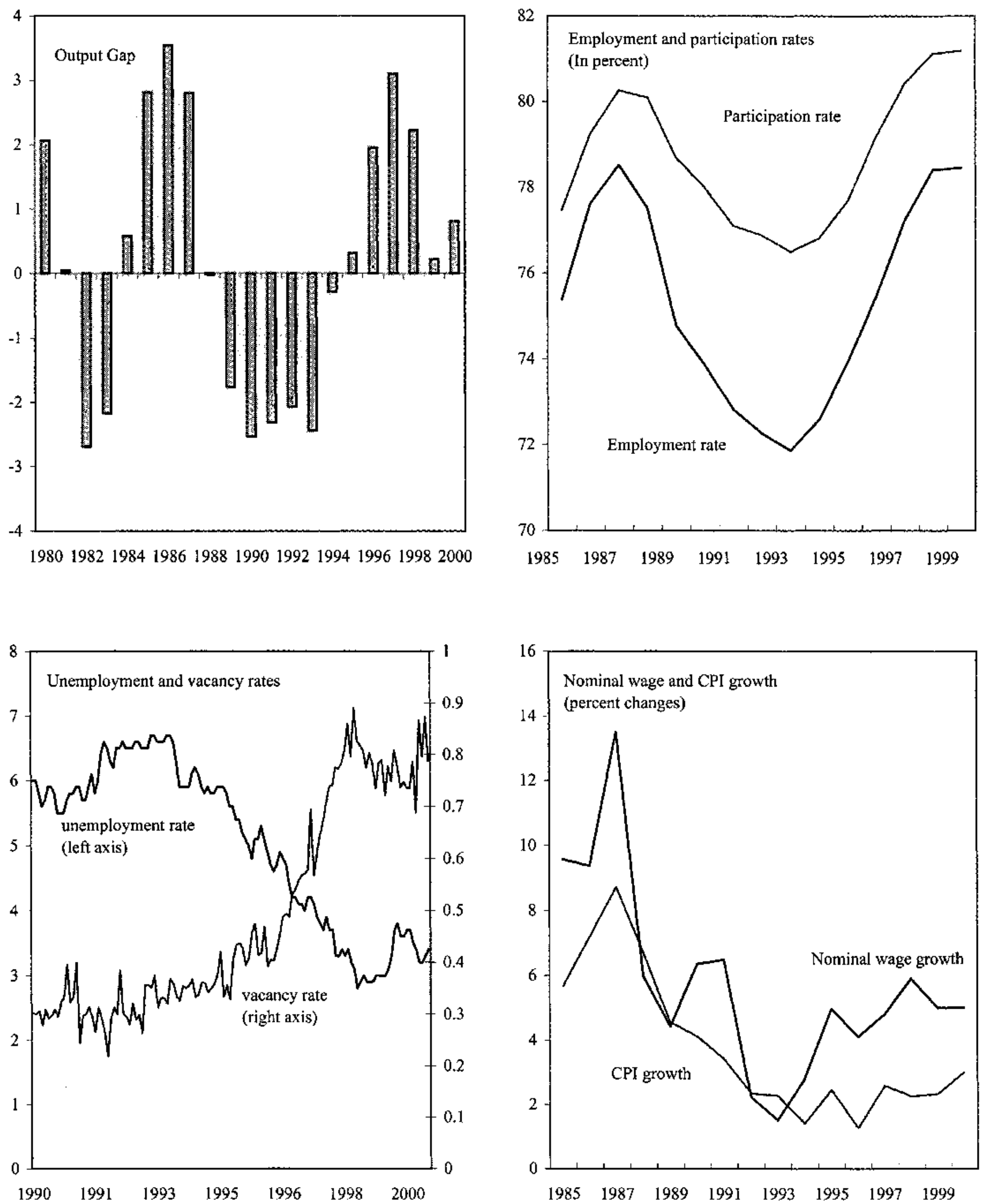
	1999 1st Half	1999 2nd Half	2000 1st Half	1999	Staff Forecasts 2000	Staff Forecasts 2001	Official Forecasts 1/ 2000	Official Forecasts 1/ 2001	Official Forecasts 1/ Annual average 2002-04
	(Percent change from previous year)								
GDP: Total	-0.4	2.1	3.5	0.9	3.0	2.4	3.4	2.6	1.4
Mainland	0.3	1.3	2.9	0.8	1.9	1.9	2.2	1.8	1.9
Private consumption	2.0	2.7	3.5	2.4	3.0	2.4	2.9	2.4	2.1
Public consumption	2.6	2.8	2.5	2.7	2.0	2.0	2.8	2.4	1.9
Gross fixed investment	-6.8	-4.6	1.3	-5.6	-4.9	-2.8	-3.8	-3.2	0.4
Oil activities	3.5	-19.2	-26.3	-12.6	...	...	-22.6	-15.9	-3.7
Mainland	-4.9	0.3	7.8	-2.1	...	...	3.0	-0.1	...
Domestic demand	-0.7	-1.2	3.2	-1.0	0.9	1.1	1.2	1.1	1.6
Exports	-2.2	5.9	2.3	1.7	6.6	5.8	6.8	6.0	2.4
Imports	-3.3	-2.9	1.2	-3.1	1.2	3.2	1.6	2.6	3.2
Consumer prices				2.3	3.0	3.0	3.0	3.0	2¼
Wages				4.9	4.8	4.6	4.5	4.0	...
Employment				0.7	0.8	0.6	0.8	0.6	0.5
Unemployment rate (Percent of labor force)				3.2	3.3	3.3	3.3	3.3	3.3
Output gap (Mainland) (Percent of potential GDP)				1.2	0.7	0.3	...	...	...
Current account balance (Percent of GDP)				3.9	14.3	13.3	14.6	11.3	8.7
Non-oil current acount balance (Percent of GDP)				-7.8	-5.7	-8.1	...	...	-6.3 2/

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

1/ Ministry of Finance's projections except for consumer prices (Norges Bank) and wages (Statistics Norway).

2/ Staff projections.

Figure 3. Norway : Indicators of Resource Pressures



Source: Statistics Norway and staff estimates.

Box 1. Norway: The Wage Bargaining System Under Strain

Norway has a long tradition of highly centralized wage negotiations with substantial government involvement. Since 1992, this system has been formalized in the so-called Solidarity Alternative which aims at safeguarding the competitiveness of the mainland economy by ensuring wage moderation in return for exchange rate stability and fiscal policy aimed at smoothing the cycle. The system, which worked well in the early stages of the economic recovery, is coming under increasing strain. Labor supply is poised to become a bottleneck at this advanced stage of the cycle, while looming demographic changes will tend to reduce the labor force in the long run.

The strains, which surfaced in 1998, intensified in the 2000 wage bargaining round. An erosion of fiscal discipline, consequent exchange rate pressures and tight labor market conditions led to average wage increases of 6¼ percent in 1998, double the level in the main trading partners. In 1999 (an off-year of the two-year wage bargaining framework), wage growth was held to 5 percent, somewhat higher than recommended by representatives of social partners in the Arntsen Committee convened to revive the consensus on wage policy. In return for wage moderation, the government launched a program of lifelong learning including the right to study leave and an adult education scheme. In the 2000 round, on the backdrop of an expanding economy, the package of wages and working conditions jointly proposed by the main labor and employer's organizations was initially rejected by the rank-and-file. The final wage settlement, reached after a nationwide general strike, doubled the centrally agreed general wage increase and also stipulated two additional holidays per year in both 2001 and 2002.

Norway's wage-setting system has diverged from those in many other advanced countries and has become increasingly fragile. The continued use of centralized wage bargaining reflects a strong social preference for low wage differentials and perhaps the belief that a partial move toward decentralization would be counterproductive. However, most factors that undermined centralized wage setting elsewhere—waning barriers to trade and labor mobility, increasingly competitive business environment, declining union coverage in the business sector, and the growing importance in employment of multinational enterprises—are also present in Norway. Moreover, economy-wide productivity growth has tapered off after 1998, and the public sector has become the source of all net employment gain.

Refinements to centralized bargaining and to welfare provisions critically affecting labor supply would be needed. Consistently high wage settlements imply a weaker internalization of the effect of wage settlements on macroeconomic conditions, reflecting the ongoing shift from manufacturing to the less-unionized service sector, the mismatch of skills and related shortages of skilled labor in parts of the public sector, and the fragmentation of trade union federations. Moreover, the benefits of wage moderation at the economy-wide level are offset in the long-run by potential distortions at the micro level. These include the compression in the wage structure, among the highest in the world, weakening work incentives and reduced returns to education. Non-wage aspects of working conditions may also need attention. In particular, effective measures to enhance labor market flexibility, stem the decline in the actual hours worked, and improve incentives to remain in the labor force would be needed. These measures could include easing strict restrictions on working hours, lowering the generous replacement ratios provided by welfare programs, and tightening access to sickness and disability benefits and early retirement.

only after a nationwide general strike. The settlement provided for an increase of 4½ percent and a fifth statutory week of holiday per year to be made effective within two years. The resulting increase in wage cost is projected to be about 5 percent in 2000 and at least 4½ percent in 2001, with the two extra vacation days contributing about ¾ percentage point to wage growth in each of the next two years.

9. **External and domestic impulses pushed headline inflation to its highest rate since 1991.** A pronounced rise in energy and import prices as well as rising labor costs were behind the increase of 3.1 percent in consumer prices in January–November 2000 over the same period a year earlier. Underlying inflation, excluding energy prices and indirect taxes, also increased but less sharply, to 2.3 percent, a percentage point above that in the euro area.

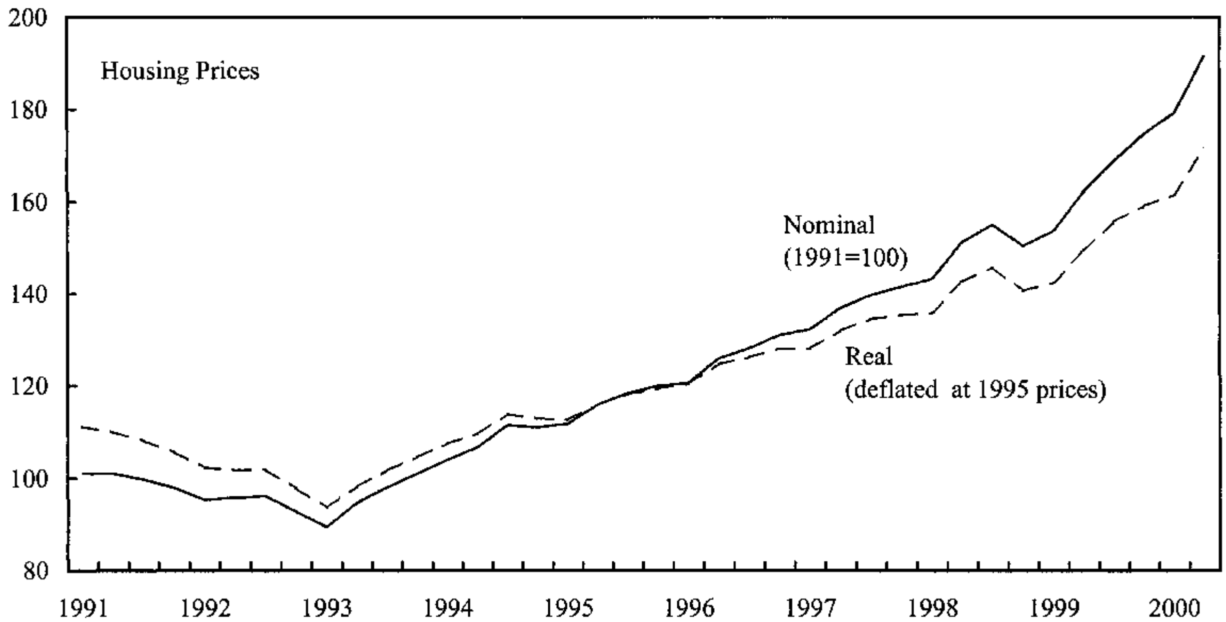
10. **Asset prices have risen steeply over the past year.** During the first three quarters of 2000, house prices rose by 13 percent over the same period a year earlier. Despite a sharp fall in new economy share prices, the Oslo share price index had risen by 21 percent in the year to November 2000 (Figure 4).

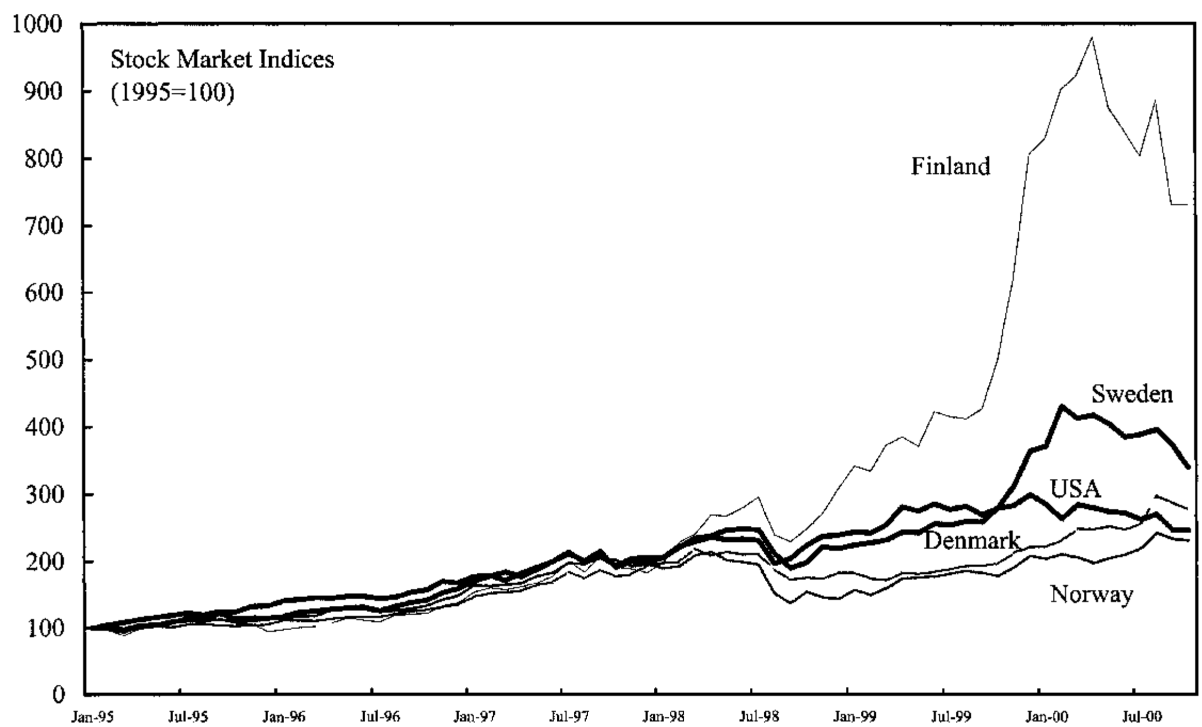
11. **Norway is approaching its peak years of oil output, with production expected to decline gradually over the next several decades.** While not a member of OPEC, Norway cooperated with the production cuts agreed by OPEC members and other oil producers, cutting back oil output by 0.2 million barrels a day (b/d) from March 1999 to about 3 million b/d. Effective July 2000, the authorities eliminated production restraints with a view to achieving more stable oil prices.

12. **The current account surplus is on course to reach over 14 percent of GDP—the largest in relation to GDP for an advanced economy at least since 1970.** The coincidence of a surge in oil prices, peaking oil output, and a strong U. S. dollar—which boosts the krone value of dollar-denominated oil exports—led to a doubling of oil export earnings in 2000. Exports of natural gas, of which Norway is one of the ten largest exporters, have also risen to a record level. Favorable prices for other staple raw material exports—fish and aluminum—have helped raise the average terms of trade by 27 percent in the year to June 2000 and, coupled with a strong recovery in the EU market which absorbs around three-fourths of Norway's exports, have contributed to the country's highest ever trade surplus (Figure 5 and Table 2). Net foreign assets are projected to grow from 11 percent of GDP at end-1999 to over 25 percent of GDP at the end of 2000.

13. **Despite some erosion vis-à-vis the euro area over the past three years, overall competitiveness has been sound.** The real effective exchange rate has declined by nearly 5 percent since 1997 as nominal depreciation of the krone, particularly against the U.S. dollar and the pound sterling, more than offset the adverse inflation differential. However, while the krone/euro exchange rate has returned to levels prevailing in 1997, Norwegian inflation has outpaced that in the euro area in the past three years. Wage costs will have risen by a cumulative 17 percent in 1998–2000, about double the rate of increase in the euro area, while productivity growth in Norway has been lagging in recent years (Figure 6).

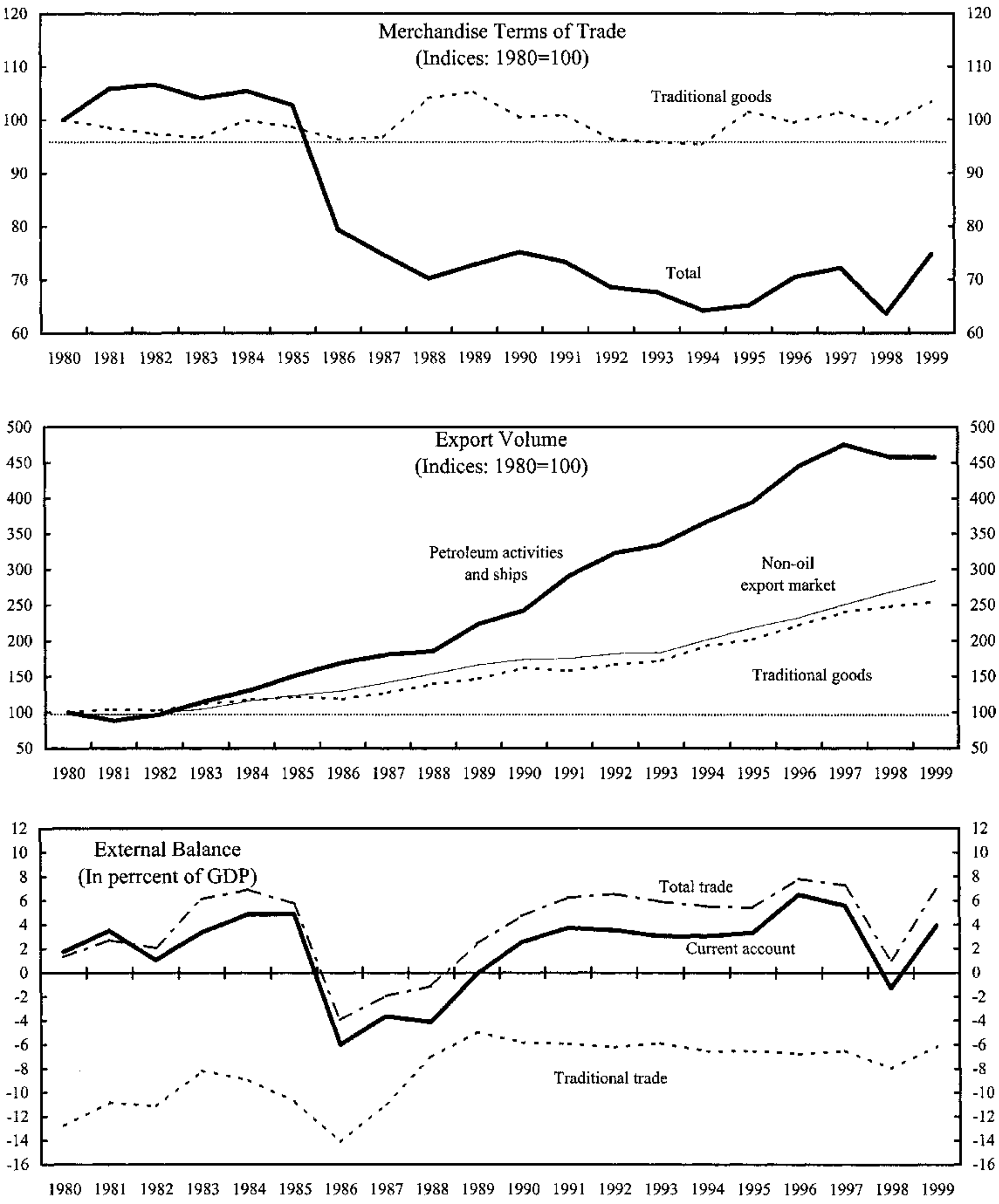
Figure 4. Norway: Asset Prices, 1990-2000





Source: Authorities; and Bloomberg.

Figure 5. Norway: External Developments 1980-1999



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

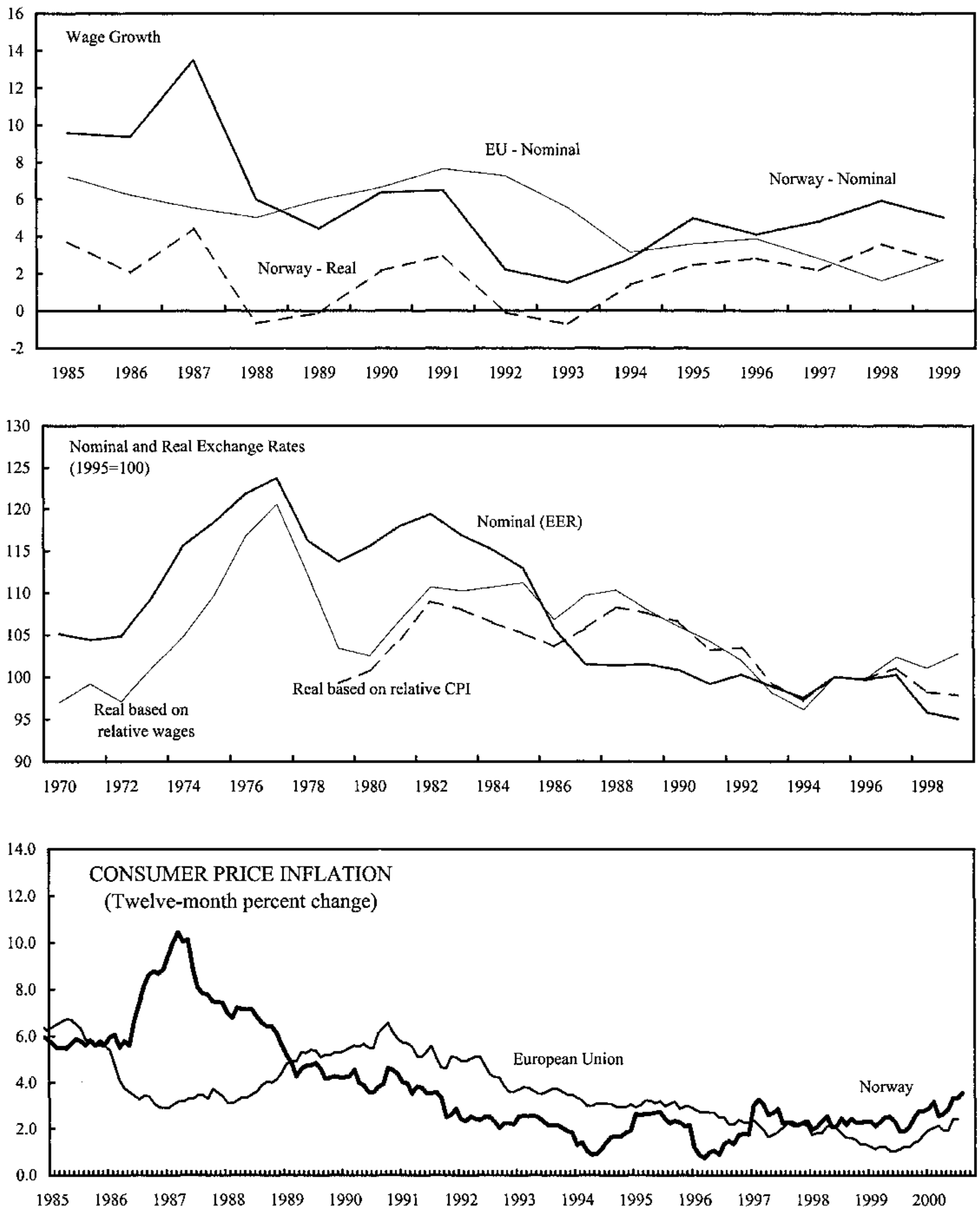
Table 2. Norway: External Indicators
(U.S. dollars billions, unless otherwise indicated)

	1994	1995	1996	1997	1998	1999	2000 1/
Balance of payments							
Goods and services							
Exports	47.2	55.8	64.3	63.3	54.6	59.7	47.0
Goods	34.8	42.2	49.9	48.9	40.6	45.6	37.0
Non-factor services	12.4	13.6	14.4	14.4	14.1	14.0	10.0
Imports	39.6	47.0	50.7	51.8	54.0	50.5	32.2
Goods	28.0	34.2	37.6	37.7	39.1	35.0	22.4
Non-factor services	11.5	12.7	13.2	14.1	14.9	15.4	9.8
Trade balance	6.8	7.9	12.3	11.2	1.5	10.6	14.7
Services balance	0.9	0.9	1.2	0.3	-0.9	-1.4	0.1
Balance of goods and services	7.7	8.8	13.6	11.6	0.6	9.2	14.8
Balance of factor payments	-3.9	-3.9	-3.3	-2.9	-2.5	-3.2	-1.7
Current account balance	3.7	4.9	10.2	8.7	-1.9	6.0	13.1
(In percent of GDP)	3.0	3.3	6.5	5.6	-1.3	3.9	12.6
Net capital flows	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1
Net financial flows	-1.3	-0.5	-1.7	-8.1	-0.5	-0.1	-6.3
Reserve changes	-0.3	-0.7	-6.5	1.3	6.5	-6.0	-1.5
Net errors and ommissions	-2.0	-3.5	-1.9	-1.6	-4.0	-2.9	-5.3
Memorandum items:							
Net foreign assets							
(In percent of GDP)	-2.6	0.8	5.2	8.4	8.1	11.1	24.7 2/
State Petroleum Fund							
(In percent of GDP)	...	0.2	4.6	10.5	15.2	18.5	27.5 2/
Nominal effective exchange rate (1995=100)	97.4	100.0	100.3	100.8	97.0	95.5	92.9
Real effective exchange rate (1995=100) 3/	97.2	100.0	99.8	101.1	98.2	97.8	96.0

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

1/ Jan-Aug.
2/ Official projection for end-2000.
3/ Based on CPI.

Figure 6. Norway: Indicators of Competitiveness



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

14. **The general government fiscal stance in 2000 is slightly expansionary.** Spending by local authorities in excess of budget estimates has contributed to an expansionary change in the general government non-oil structural balance of about 0.3 percent of GDP (Figure 7; and Table 3). This will mark the third year in a row that a slight tightening of the state budget has been more than offset by laxity in local government finances. Despite stronger-than-expected mainland growth compared with projections in the initial budget, the authorities did not tighten the fiscal stance of the revised state budget for 2000 as recommended by the staff and the Executive Board a year ago (SUR/00/9, 2/3/00).[2] With oil prices at a ten-year peak, the overall fiscal surplus is projected at over 14 percent of GDP, 6 percentage points above the 2000 budget projection, which was based on the assumption of an oil price of US$15 a barrel.

15. **The state budget for 2001, approved by parliament in November 2000, embodies a broadly neutral fiscal stance.** The budget includes an increase in the general VAT rate by one percentage point to 24 percent, a 11 percent tax on dividend income, to be offset by cuts in taxes on fuel as well as reduced VAT on food.[3] Spending initiatives in education and health care services contributed to the proposed rise of 2½ percent in underlying real spending. With lower projected growth of petroleum revenue, in line with the assumption of a fall in the average oil price from US$25½ a barrel to around US$20, the general government surplus is expected to decline to 12½ percent of GDP.

16. **Over the past two years, the conduct of monetary policy has gradually moved toward greater short-term flexibility in the exchange rate.** The official guidelines to Norges Bank, codified in the Royal Decree issued in May 1994, called for monetary policy to be "aimed at stable exchange rates against European currencies." In practice, this mandate has been interpreted to mean an implicit target range in terms of the euro of Nkr 8.25–8.40. However, the experience of 1997–98—when fluctuations in oil prices and international financial turbulence made it difficult to keep the krone within its range despite sharp changes in interest rates—solidified the domestic consensus that short-term exchange rate stability was not attainable. Nominal exchange rate stability is now aimed at as a medium-term goal rather than as a short-term operational target, and this goal is to be achieved by bringing inflation down to that aimed at in the euro area.

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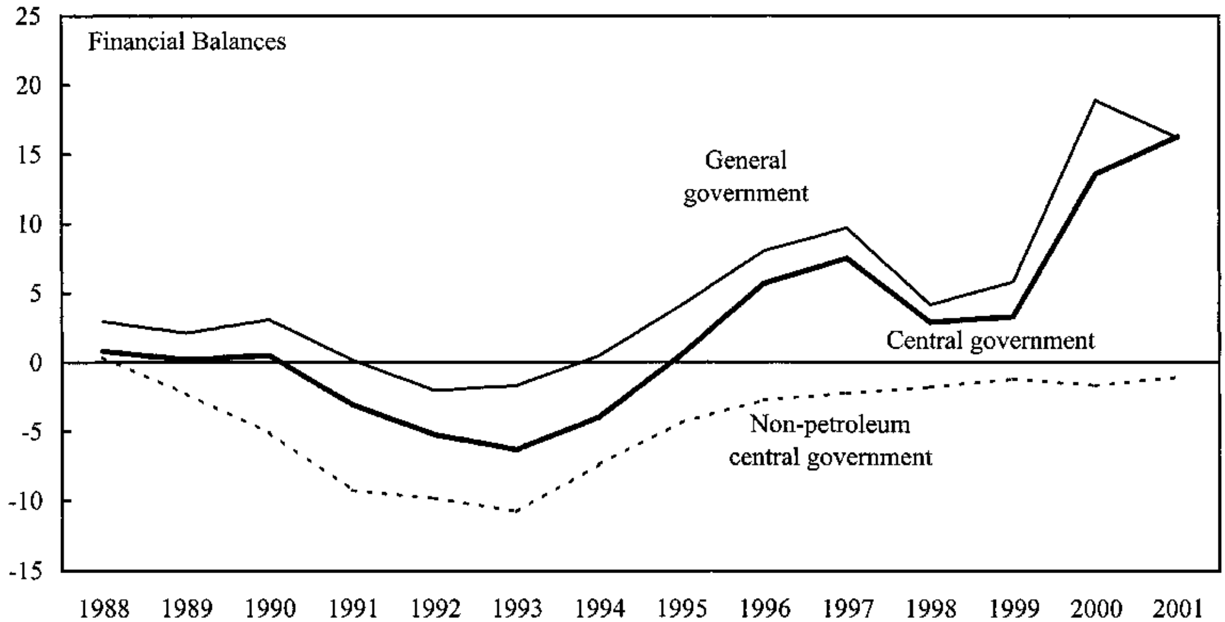
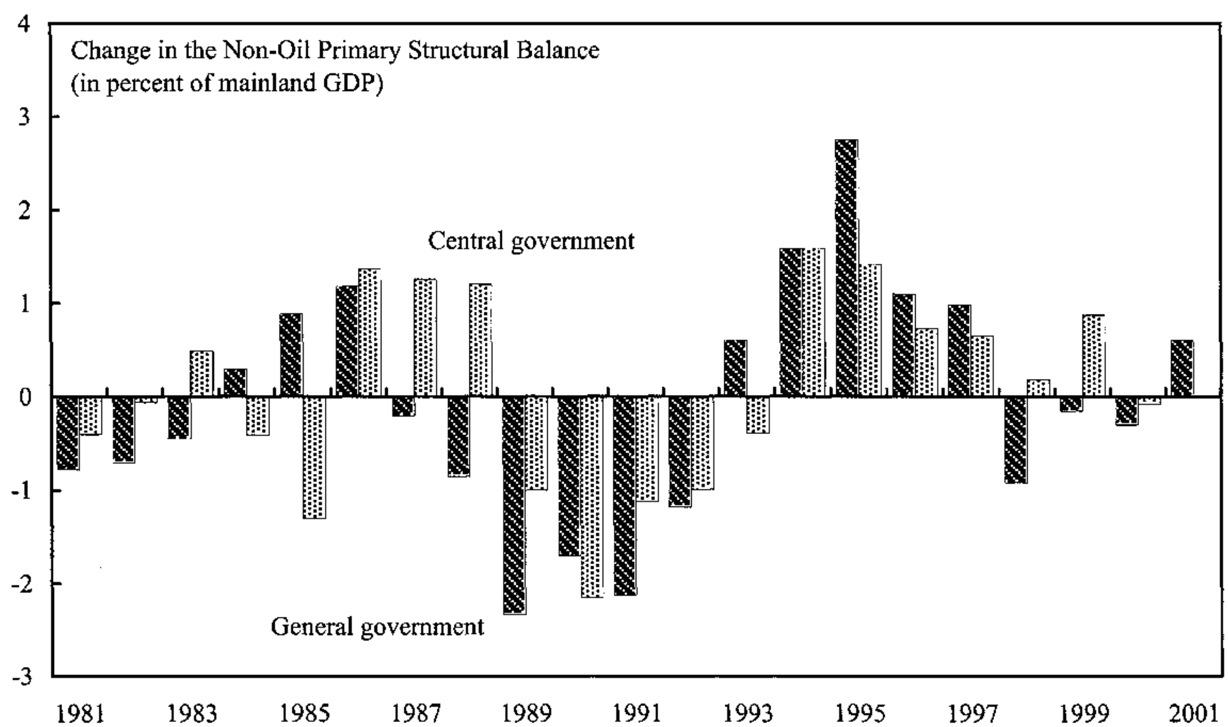
[2] The fiscal stance is measured by the change in the cyclically adjusted non-oil fiscal balance, net of net interest receipts. Budget proposals are presented to Parliament twice a year, with the initial budget for the following calendar year in October and a revised budget in May.

[3] Norway's post-tax fuel prices remain among the highest in Europe.

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





Source: Ministry of Finance and staff estimates.

Table 3. Norway: Financial Indicators

	1996	1997	1998	1999	Projections 2000	2001
			(In percent of GDP)			
State Budget:						
Revenue	42.6	43.6	42.5	41.9	45.6	48.2
of which : oil revenue	8.6	9.8	6.5	6.3	13.2	14.6
Expenditure	37.9	37.5	40.0	39.2	35.3	35.7
of which : oil investment	1.8	1.9	2.5	2.6	1.6	1.2
Balance	4.6	6.1	2.5	2.7	10.3	12.5
of which : non-oil balance	-2.2	-1.8	-1.6	-1.0	-1.3	-0.8
Cyclically adjusted non-oil balance 1/	-5.0	-4.3	-4.1	-3.2	-3.3	-3.3
Change from previous year	1.4	0.7	0.2	0.9	-0.1	0.0
General Government Budget:						
Revenue	52.1	51.8	50.1	51.1	56.4	56.2
Expenditure	45.5	43.9	46.5	46.3	42.1	43.7
Balance	6.6	7.9	3.6	4.8	14.3	12.5
Non-oil balance excl. interest	-3.1	-1.7	-2.3	-3.0	-3.1	-2.9
Cyclically adjusted non-oil balance excl. interest 1/	-4.1	-3.1	-4.0	-4.2	-4.4	-3.9
Change from previous year	1.1	1.0	-0.9	-0.1	-0.3	0.6
Gross public debt	31.1	28.6	27.0	23.5	22.0	16.6
Monetary Indicators:						
M2 2/	6.0	4.9	5.0	10.4	10.8 3/	...
Domestic credit 2/	6.2	10.2	8.3	8.4	12.2 3/	...
Three-month interbank rate 4/	4.9	3.7	5.8	6.5	6.6 5/	...
Ten-year government bond yield 4/	6.8	5.9	5.4	5.5	6.2 5/	...

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

1/ Percent of trend mainland GDP.
2/ End-period, percent change, national definition.
3/ September 2000.
4/ Period average, in percent.
5/ October 2000.

17. **Norges Bank raised interest rates in 2000 despite the appreciation of the krone to above its implicit band.** Since mid-1999, the krone has been nearly 1 percent above the edge of the implicit band vis-à-vis the euro (Figure 8). However, Norges Bank, after lowering policy interest rates in the first nine months of 1999 and then keeping them on hold, raised them by a total of 150 basis points to 7 percent during April–September 2000 to reduce inflation pressures (Figure 9). Nonetheless, although the krone has been strong relative to the euro, the nominal effective exchange rate has depreciated by 4 percent since mid-1999.

B. Short-Term Outlook

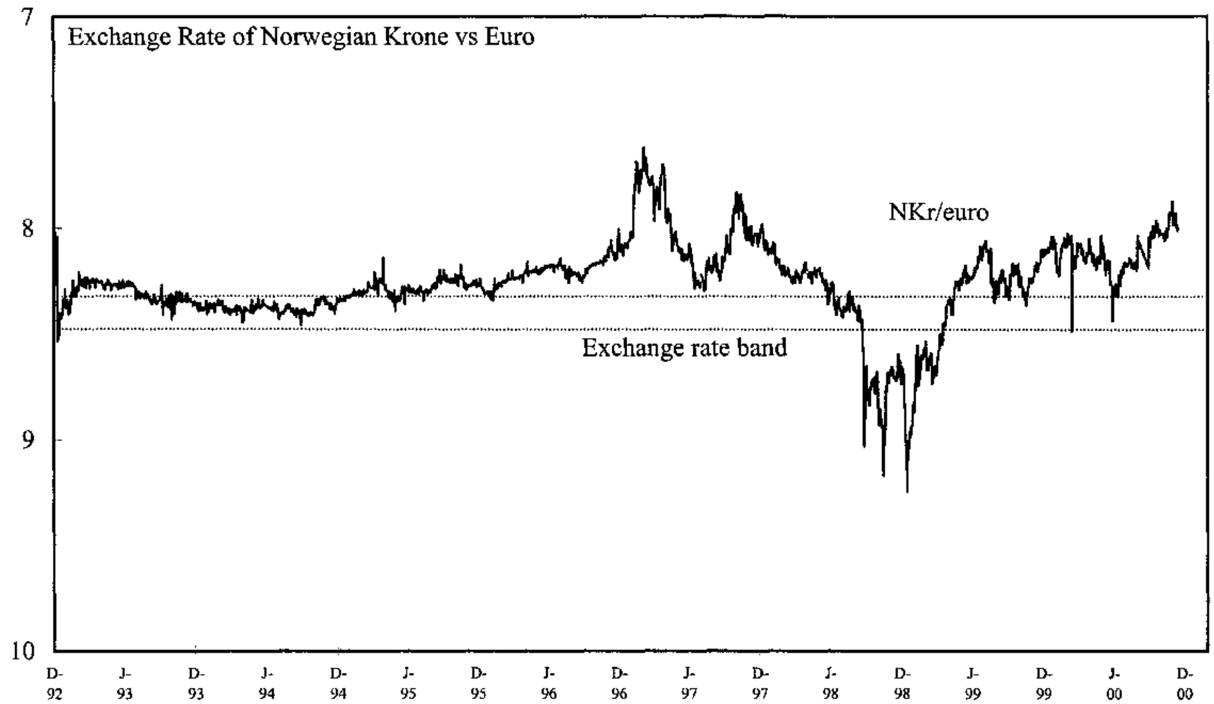
18. **Mainland output is expected to remain above potential in 2001.** Mainland GDP is projected to rise by around 2 percent, held below potential growth (2¼ percent) by the continued decline of oil-related investment. Despite the narrowing of the output gap, capacity and labor supply constraints across sectors are expected to persist and even intensify. With high home ownership and predominance of floating rate mortgages, higher interest rates in 2000 would partially offset the impact of generous wage growth on private consumption, but continuing wage pressures and higher import prices will keep headline inflation at around 3 percent.

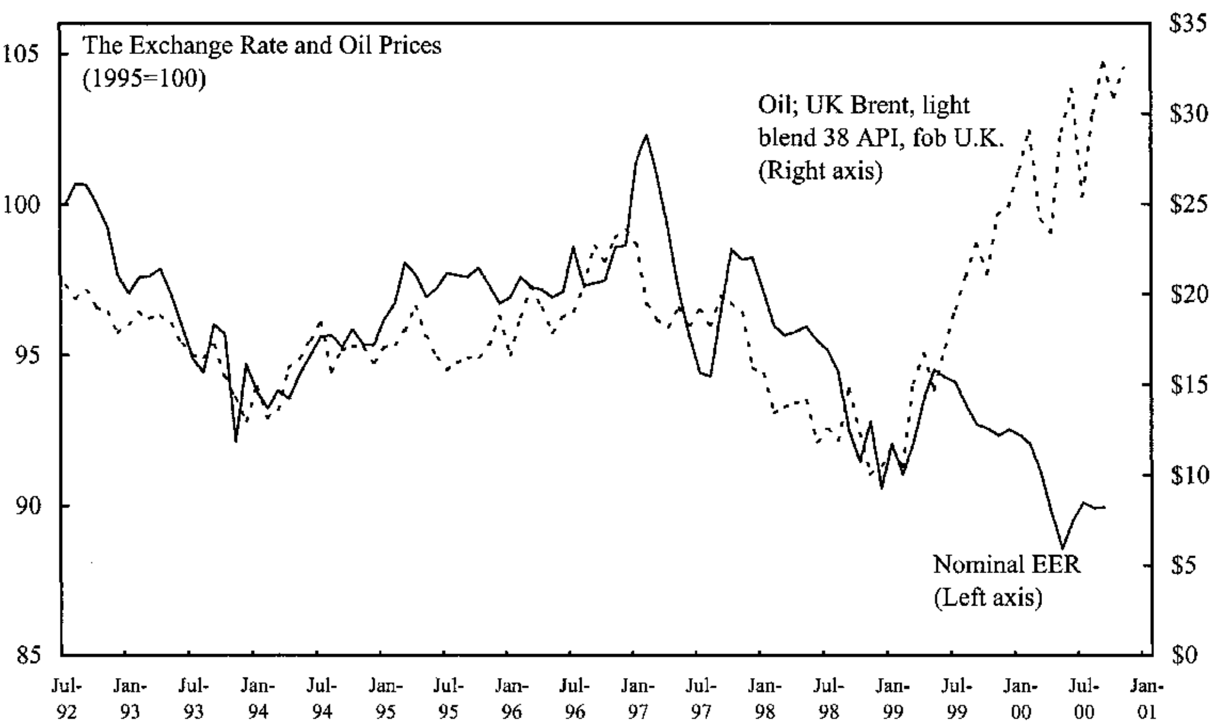
19. **The staff sees the risks to the projections for mainland growth as well as wage and price inflation to be mainly on the upside.** In contrast to the baseline assumption of a neutral fiscal stance, there remains a risk of an expansionary general government fiscal outturn (para 26). Additional upside risks arise from higher wage drift, second round effects of the oil price rise, stronger-than-expected confidence effects on household spending, and market uncertainty about how high policy interest rates can go, while the krone remains above its implicit band. These upside risks more than offset the main downside risk of a stronger-than-expected lagged impact of interest rate hikes in 2000. The external risks have recently tilted to the downside with the possibility of a mild slowdown in export markets and an easing of oil prices.

III. Policy Discussions

20. **The authorities face the challenge of containing excess demand and preserving their long-term economic strategy in the face of calls to spend more of the oil wealth.** The discussions focused on the design of short-term policies for the management of demand and incomes in 2001 against the backdrop of the wider national debate about the soundness of the long-term approach to the utilization of resource wealth. Indeed, since the authorities' short-term policy framework is anchored to, and, to a large extent, derives from their long-term strategy for managing oil wealth, the latter served both as the starting point for the policy dialogue and as the subtext for the discussion in four key areas:

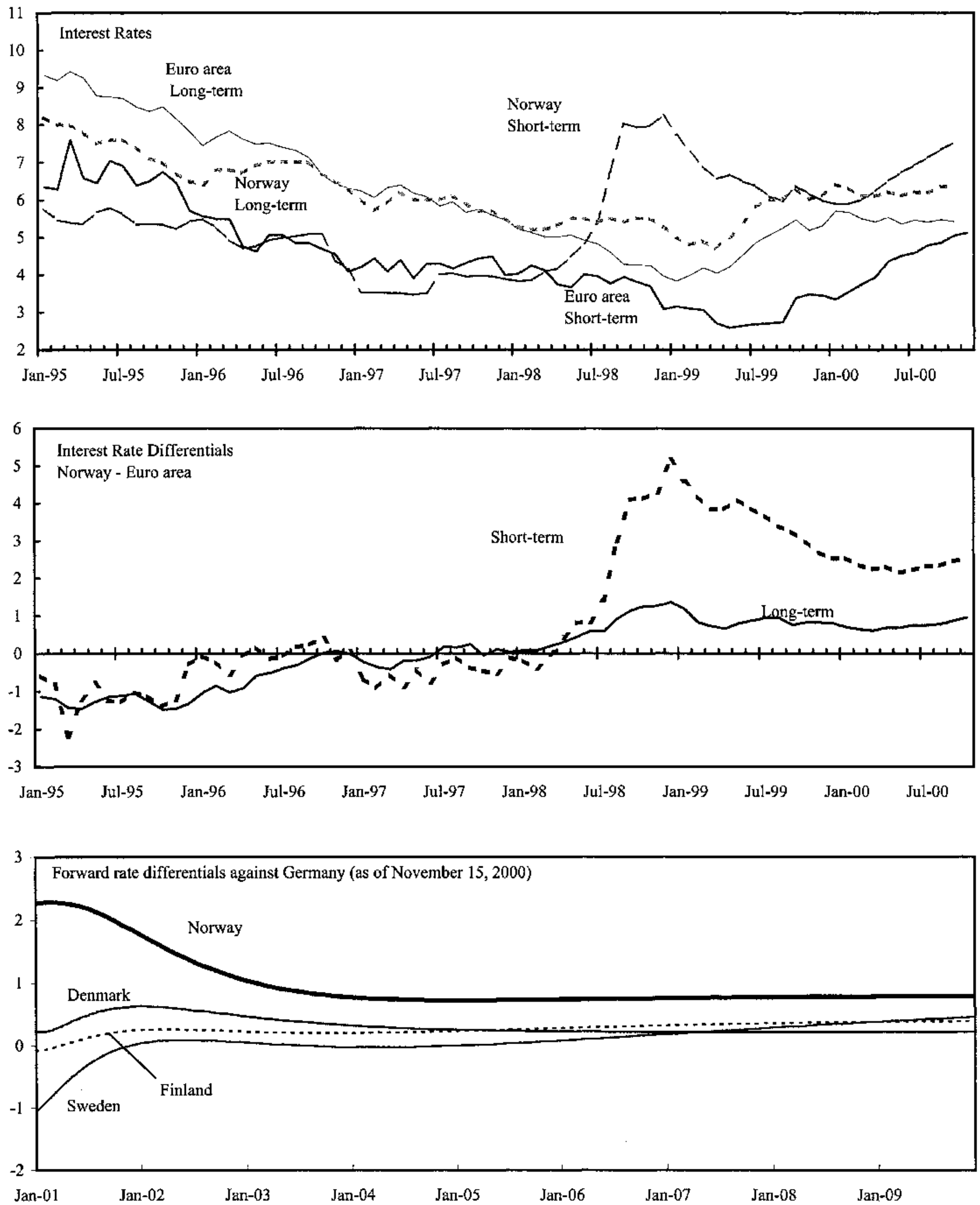
Figure 8. Norway: Exchange Rate Developments, 1992-2000





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

Figure 9. Norway: Interest Rate Developments.



Source: IMF, International Financial Statistics; and WEFA.

- The **long-term fiscal outlook and policies** in the context of the depletion of oil wealth and the coming demographic shift;
- the appropriate **stance of fiscal and incomes policies** in the face of persistent resource pressures, particularly in the labor market;
- the **options for monetary policy** in the face of internal and external risks to inflation and the unfinished task of bringing inflation down to the aim in the euro area; and
- **structural reform issues** such as tax and pensions policies, labor and product market reform and the privatization agenda.

A. The Long-run Macroeconomic Strategy

20. **The principle of sharing the oil wealth across generations and the goal of easing the transition to the post-oil era are at the heart of the authorities' long-term economic strategy.** The broad contours of this strategy have until recently commanded wide support in Norway. The strategy aims to guide policy on the balance between the use of resource wealth for competing ends: satisfying current demands; financing a demographic bulge in pension and healthcare costs over the medium to long run; and spreading the return on oil wealth over a still longer period to generations yet unborn. The critical issues underlying the strategy fall under three rubrics:

a. An equitable sharing of the oil wealth across generations;

b. Minimizing restructuring costs on the mainland economy when oil runs out;

c. Protecting the mainland economy from fluctuations in oil revenue.

Macroeconomic policies directed to smoothing the economic cycle are designed to prevent short-run economic and political pressures from eroding the authorities' policy options, while structural reforms should ensure that the benefits from oil wealth are maximized and extend to all sectors of society.

21. **A sustainable long-run macroeconomic strategy is intrinsically tied to the generosity and funding of the public pension system.**[4] Over the next quarter century, population ageing will require a substantial redistribution of income toward old-age pensions and public services to the elderly. The authorities have indicated their intention to use SPF assets in large part to fund these obligations. Yet, as wealth visibly accumulates in the SPF and oil prices attain ten-year high, pressures have mounted to use the resources to expand

[4] See Chapter 1 of the Selected Issues paper on the long-run fiscal and external sustainability.

current public services, especially for health care (Para 33). The officials and the staff agreed that accommodating such pressures may jeopardize the financing of pension programs and may also crowd out growth in the mainland economy at the same time as revenue from oil exports begins to decline.

23. **The fiscal and incomes policy arms of the Solidarity Alternative are assigned the tasks of cyclical management and alleviation of "Dutch disease."** The authorities were broadly satisfied that strong public finances had continued to enable fiscal policy to assist in smoothing the economic cycle and promoting long-run competitiveness of the non-oil tradable sector through maintenance of a sound structural fiscal position. As a result, Norway had managed to dampen the detrimental side effects of the exploitation of its oil reserves on the non-resource tradables sector.[5] In this context, officials underlined the key role assigned to the social partners in keeping wage costs in line with those in the trading partner countries.

24. **The authorities reaffirmed that long-term external and fiscal sustainability are key considerations underlying the strategy.** The staff and the authorities agreed that long-term projections, while highly sensitive to assumptions regarding oil prices, rates of return on SPF assets, and pension benefits, were useful in highlighting underlying trends and constraints (Box 2). Oil wealth—estimated at a present value of 177 percent of GDP—could be consumed at a rate of about 3 percent of GDP on a permanent basis. However, escalating public pension liabilities over the long run threaten to drain SPF assets by 2050 based on current policies. Reducing the generosity of the pension regime would help improve the financial soundness of the system. However, even if oil wealth were to be sufficient to pay for the demographic shock, its exhaustion by the middle of the century would prevent succeeding generations of Norwegians from sharing in the wealth. The staff's long-run projections also buttress the authorities' concern that a significant improvement in the competitive position of the non-oil exposed sector would be needed as oil exports decline. The current real exchange rate, although appropriate for the medium term given the petroleum sector's strong contribution to the current account, will need to depreciate in the long run to support an expansion of the non-oil tradables sector, barring any changes in other fundamentals.

B. The Policy Stance in 2001

25. **The authorities were cautiously optimistic about adhering broadly to the long-run framework and steering policy to ensure a soft landing.** While not disputing that on strictly economic criteria a good case could be made for a moderately restrictive fiscal stance in 2001, officials noted the hard political constraints under which the budget had to be

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[5] Over the past quarter century, Norway has nevertheless experienced a sharp relative contraction of the manufacturing sector, in conjunction with a pronounced rise in the value added captured by the public sector. See "Dutch Disease—A Norwegian Retrospective," Box 1 of the Staff Report for the1999 Article IV Consultation (SM/99/311).

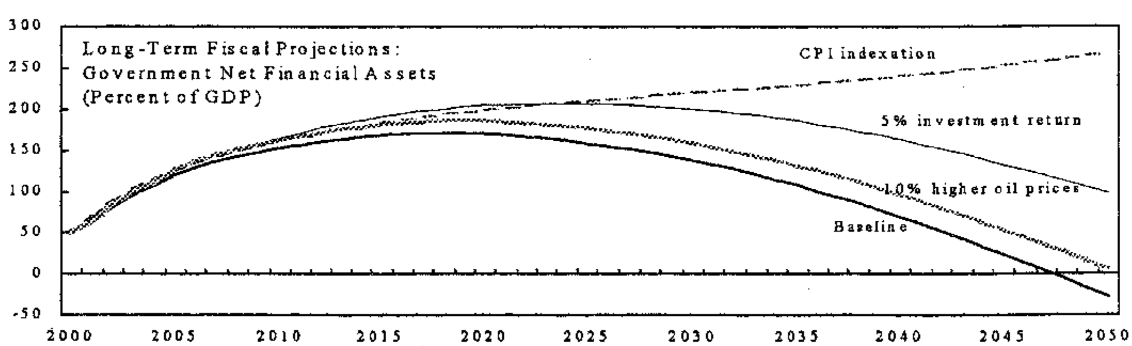
Box 2. Norway: Long-Term Fiscal and External Sector Profiles

Norway's long-run macroeconomic prospects depend on its decisions regarding the long-run use of its oil wealth. Notwithstanding the impressive fiscal consolidation achieved in the mid-1990s, fiscal policy may well face challenges over the long term from expected pressures on the public pension system and the eventual running down of petroleum reserves. As oil exports dry up and financial wealth is used to finance public expenditure needs, the external balance could move from a position of exceptional net foreign wealth to a position that would require significant strengthening of the non-oil sector.

In the long run, public finances face challenges posed by escalating pension liabilities. In fact, Norway's resolve in recent years to transfer budget surpluses into the State Petroleum Fund has been based in part on the need to pay for rapidly rising social security expenditures, in particular pensions, in future years as a result of demographic changes. Following the government's decision to raise pensions substantially in 1998, pension expenditures are expected to rise from 8 percent of GDP in 2000 to a peak of 19 percent of GDP around 2050. Oil revenues accruing to the budget, using WEO assumptions, are expected to rise from the 1999 low of 4 percent of GDP to around 19 percent of GDP in 2001, but then gradually decline to about 1 percent of GDP in 2050, as currently projected reserves are depleted. Using plausible assumptions and the authorities' current expenditure policies, a baseline scenario is constructed for net financial assets held by the public sector.[1/] Under the baseline long-term fiscal profile, net financial assets would be exhausted before 2050, without additional measures.

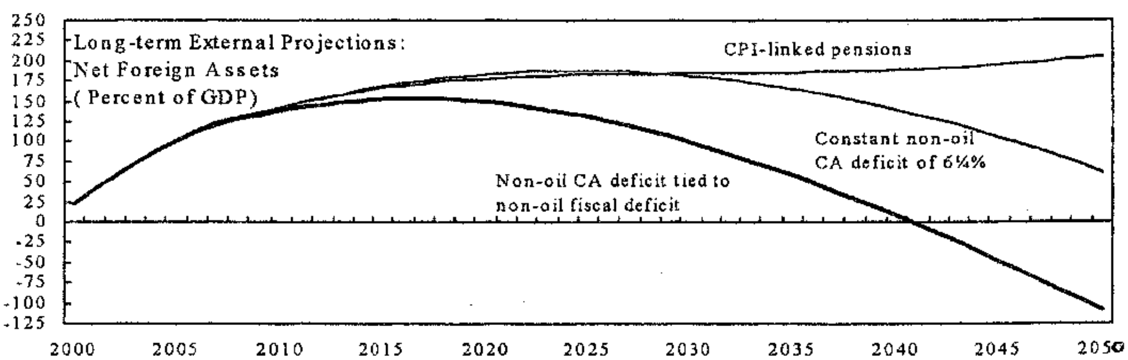
Favorable exogenous factors such as high oil prices or investment returns would improve the fiscal profile, but would not be likely to alter the assessment dramatically. Higher oil prices relative to the baseline by 10 percent would extend the government's positive financial position for a few years and a one percentage point increase in the average annual real investment return on financial assets would extend the positive fiscal position for as much as two decades. However, both scenarios would still likely result in the exhaustion of public wealth by some time in the mid-twenty-first century.

Policy changes such as lowering pension benefits, raising the average age of retirement or raising the participation rate could make the pension system financially more sound. Indexing future pensions to the CPI instead of wages, for example, would appear to be more than sufficient to generate a sustainable net asset position. This suggests that an indexation mechanism between the extremes of wage or CPI indexation could address the problem, but the feasibility of such a step may be open to debate. Alternative ways of addressing the public pension problem would be to raise the average retirement age, foster an increase in the participation rate or encourage greater movement to funded private pension schemes. The authorities have calculated that increasing the average retirement age by one year would have the same effect on national wealth as raising the oil price by Nkr 13 a barrel (about US$2). A permanent increase of 9 percent in average working hours would raise national wealth by an amount equivalent to the total oil wealth. These estimates underscore the importance of ensuring a high level of labor supply.



The sustainability of the non-oil current account depends on the future path of oil exports and SPF income. The non-oil current account deficit is projected at 6¼ percent of GDP in the medium-term. If oil wealth accruing to the government were converted to financial assets in the SPF, the wealth could be consumed at about 3 percent of GDP each year in perpetuity assuming a present value of oil wealth at 177 percent of GDP, a real rate of return of 4 percent on SPF assets, and potential mainland GDP growth of 2¼ percent. However, this constant rate of consumption is not realistic since the authorities intend to draw down the SPF to finance pension obligations.

Projections indicate that a significant improvement in the competitiveness of the non-oil exposed sector will be required based on current policies. Based on an arguable simplifying assumption that the non-oil current account deficit remains constant at 6¼ percent, net foreign assets in Norway would increase to nearly 190 percent of GDP by the year 2025, but would then begin declining as oil and gas exports dwindled and as the investment earnings on the SPF fell. In this scenario, net foreign assets of Norway would still be positive at the end of the projection horizon, but would be on a path toward exhaustion within a few decades. The constant non-oil current account assumption implies that the private sector accumulate substantial net foreign assets at the same time as the government reduces its net foreign wealth to pay for domestic obligations. The sale of the government's financial assets would be used in part to finance higher imports. The remainder would be converted to domestic currency, placing upward pressure on the exchange rate and inducing a greater level of private-sector net imports. The result would be a tendency of the non-oil current account deficit to rise in line with public-sector behavior. Based on the assumption that Norway's net foreign assets are drawn down in line with the reduction in government financial wealth, Norway's NFA would drop to zero much before 2050. Changes in public expenditure policy aimed at saving some of the wealth for future generations could also improve the external position, as would policies that strengthened the competitiveness of the non-oil export sector. For example, linking pension benefits to CPI growth rather than wage growth could help establish a sustainable external position as well as a sustainable fiscal position in the long-run.



1/ **The main assumptions underlying the projections consist of the following**: The scenario is based on the budget for 2001 and constant non-oil revenue and expenditure (excluding pensions) levels in relation to GDP subsequently. Pension expenditure includes old-age and disability pensions and also early retirement pensions and the public occupational pension. Future pensions are assumed to continue to be indexed to wage inflation, in accordance with government policies. Oil prices are assumed to follow WEO assumptions (that are based on data from the futures market) from 2000–2005, and then trend down to Norway's 2001 Budget assumption of Nkr125 kroner a barrel in 2001 prices by 2010 in response to a projected decline in oil demand associated with the implementation of the international Kyoto agreement on CO2 emissions. Oil production forecasts include a normal rate of discovery of new reserves, as provided by the Ministry of Oil and Energy. Net financial assets held by the public sector include net assets from a defunct government pension fund and assets held in the state banks, as well as assets held in the SPF. The real rate of return on SPF assets is assumed to be 4 percent. The oil current account consists of oil and gas exports, the income on total government net financial assets, and oil-related net investment income. The projections for the non-oil current account are based on a trade model through 2005, which includes lagged responses of imports and exports to exchange rate movements, and domestic and partner-country GDP.

framed and the very limited room for maneuver available to the minority government. Indeed, one could argue that in the face of insistent popular demands to spend more of the oil windfall, the proposed neutral budget represented an act of political courage on the part of the government. The authorities expressed cautious confidence that the budget proposals would emerge out of the parliamentary negotiations without compromising the broad neutrality of the fiscal stance—confidence that has been borne out by subsequent developments. The staff expressed the view that a restrictive stance may yet be needed and that despite the openness of the economy and the resulting likelihood of a lower fiscal multiplier, a tighter stance would help contain pressures in the sheltered sector and in the housing market. Officials noted that if demand pressures continued unabated, some modification of the fiscal stance was possible in principle in the revised budget in May 2001.

26. **The risk of the outturn at the general government level again turning out to be expansionary in 2001 remains.** Officials argued that the transfer of the corporate income tax revenue—the most procyclical component of local government revenue—to the central government in 1999 should help reduce the tendency of the local government fiscal stance to be procyclical. However, local governments would still be responsible for providing infrastructure, especially in health and education, which could be financed through borrowing and could be undertaken irrespective of the cyclical position and revenue developments. This spending would be employment-intensive and would likely generate stronger activity and price effects than other forms of public expenditure. Moreover, an equal increase in tax and spending levels could have expansionary effects, even if the indicator of the fiscal stance appeared to be neutral.

27. **The authorities continue to view the present monetary policy regime as the most suitable for Norway.** Norges Bank sets interest rates on the basis of its published forecast of inflation two to three years ahead, conditional on the path implied by market forward interest rates. In response to the staff's concerns about the potential tension between exchange rate and inflation objectives, the officials cited evidence of long-term real stability of the krone relative to the euro in support of their belief that convergence of inflation to the euro area level would be consistent with medium-term exchange rate stability. Notwithstanding this emphasis on meeting inflation objectives, Norway's regime differs from the inflation targeting approach. Two features special to Norway are the institutional set-up of the policy framework with emphasis on consensus in centralized wage-setting and the active role for fiscal policy. The authorities see a need to maintain the emphasis on medium-term stability of the nominal exchange rate in the context of the leading role of the exposed sector in the centralized wage bargaining rounds. By anchoring expectations of the future exchange rate, a close nexus can be established between wage moderation in the exposed sector and the level of competitiveness. Under inflation targeting, there would be no rationale for the lead role of the exposed sector. Moreover, the key role assigned to fiscal policy in stabilization might be jeopardized by a perception that monetary policy alone is supposed to perform that role. All in all, the authorities feel that their current pragmatic approach strikes the best balance between conflicting imperatives.

28. **The authorities aim at bringing inflation down to the euro-area target range in a sustained but cautious manner.** Norges Bank officials noted that in 2000, as inflation pressures gathered pace, they acted in a timely fashion to tighten monetary conditions. The rise in oil prices, apart from its usual direct and second round effects on prices, also seemed to influence aggregate demand through strong "Ricardian" effects on consumption related to higher national wealth and public saving, and compounded the impact of the wage round. The 150 basis point increase in interest rates in 2000 in conjunction with the strength of the krone was expected to help ease demand and price pressures. However, there was agreement that the rapid rise in credit and asset prices suggested that monetary conditions may not have been that tight, reflecting in part policy lags.

29. **The discussions focused on the appropriate speed of convergence of inflation to the euro-area target range**. Norges Bank's forecast envisages inflation coming down to 2½ percent in 2002 and 2¼ percent in 2003-04. In light of the persistently higher inflation than in the euro area, the staff questioned whether a more aggressive approach to achieving the authorities' objective would not be in order. The authorities noted that the cyclical desynchronization between Norway and the euro area was the main reason for the current inflation differential and that the financial markets' pricing decisions did not suggest a lack of credibility. Looking forward, Norges Bank was alert to the possibility that the sensitivity of households to shifts in interest rates may have increased, thereby raising the potency of monetary policy actions. This assessment, combined with the uncertainty about the prospective duration and effects of high oil prices, underlay their view that a more aggressive approach to reducing inflation to the euro area target would be risky and had guided their present neutral policy bias. Norges Bank has, nevertheless, publicly underscored that this neutral bias was conditional on the maintenance of a neutral fiscal stance for 2001. In particular, if the actual fiscal stance for 2001 were to be more expansionary than proposed, this might lead to expectations of a real appreciation of the krone, and in turn, if monetary policy is credible, a nominal appreciation. In such an event, Norges Bank would first recommend a change in the government budget or, failing that, a revision of the guidelines for monetary policy to alter the medium-term nominal exchange rate target, consistent with the desire for a larger public sector.

30. **With wage agreements in place until 2002, incomes policy is to be complemented by structural measures.** At this stage of the wage bargaining cycle, the main contribution of incomes policy to easing cost and price pressures would be by minimizing wage drift. Officials noted that wage drift had been historically stable at about ½ percent. While the rising share of wages in corporate earnings had reduced companies' capacity to pay, wage drift could well be influenced more by sectoral shortages, especially of skilled labor. Hence, structural measures to offset the looming adverse influences on labor supply and facilitate wage moderation would be critical to avoid worsening pressures on resources. Measures put in place so far go some way in this direction (para 38).

C. Structural and Other Issues

31. **A key issue, linked in part to the long-run vision of the post-oil economic structure, is the appropriate size of the public sector.** Over the past two decades, the

exploitation of oil wealth has helped finance a sustained expansion of the public sector. Expansive services and generous pension benefit schemes have the potential to raise the spending ratio to even higher levels. Such a development would prevent a much needed reduction in the relatively high tax burden on the mainland economy.[6] The mission argued that such a reduction would increase incentives for work, saving, and enterprise, and help the Norwegian economy compete in a globalized market for resources. Officials noted that Norway's tax burden was not out of line with other Nordic countries which had a similar view of the role of the public sector and that, in any case, there was no evidence of public discontent about the tax burden.

32. **The merits of a medium-term expenditure plan were debated.** Underlying spending exceeded the budget limit by ¾ percentage points a year on average in recent years. These overruns are not clawed back in subsequent budgets, exposing public spending to significant "base-drift," since Norway does not use a formal medium-term expenditure framework. The staff noted that such frameworks have been found useful in a number of advanced European economies in ensuring that spending restraint is achieved on a strategic basis and in forestalling annual re-opening of debates on priorities.[7] While not disputing that formalized medium-term frameworks might help insulate annual budgets from short-term political influences, officials were skeptical of the need for an additional disciplining device in the Norwegian context.

33. **The perceived crisis in public health services has been developing over a long period.** The rise in the demand for healthcare with rising incomes and an ageing population had resulted in a rapid expansion of the health sector which relies on public funding and provision of services at the local government level. While spending on health care is estimated to have risen to about 10 percent of GDP, from around 8 percent a decade earlier, the system has faced acute capacity shortages as evidenced, for example, by long waiting lines for hospital admission.[8] Officials acknowledged that the absence of a pricing mechanism made shortages and waiting lines inevitable. Imposition of user fees for some services and partial privatization could in principle offer solutions, but these were at present not on the policy agenda. The authorities are considering various options for altering the

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[6] Non-oil taxes were 48 percent of mainland GDP in 1999, representing a significantly heavier tax burden than in the European Union (41¼ percent) and a sharply higher one than the average of the OECD countries (about 37 percent).

[7] For a concise review and assessment of such frameworks, see Appendix II, "Medium-Term Expenditure Management," Spain—Selected Issues, SM/00/228, IMF at www.imf.org

[8] Notwithstanding widespread public discontent with the provision of health services, Norway ranks high on key indicators of the health care system. The World Health Report 2000 of the World Health Organization (WHO) ranks Norway third in the world in overall health system attainment despite being only the sixteenth in per capita health spending.

structure and functions of the local government sector, including a shift of responsibilities to the central level.

34. **The authorities expressed concern at the relentless rise in the cost of social insurance.** The take-up of the early retirement and disability pensions has increased sharply in recent years, imposing strains on the financial viability of age-related expenditures and threatening to reduce future labor supply. On present trends, the number of persons in the labor force per pensioner is projected to decline from 2.5 today to 1.8 in 2030, assuming immigration at current levels. Sickness absences are rising especially rapidly, with the corresponding 10,000 lost man-years in 2000 amounting to almost half the increase in the labor force. The Sandman Commission, appointed to inquire into the causes of rising sickness absence and disability pensions, suggested various corrective measures in its recent report (Box 3).

35. **The costly and extensive support for agriculture continues in the service of social and regional policy goals.** Public outlays for agricultural support are among the highest in the world. Aside from its high budgetary costs, amounting to about 1 percent of GDP in 1999, this policy has resulted in domestic consumer prices for agricultural products that are 110 percent above world market prices, but has failed to stem rural out-migration. While not disputing the economic rationale for a change in policy in this area, officials noted that the authorities had no plans to alter the current regime.

36. **The authorities plan to address some of the departures from neutrality that have crept into the tax system since the tax reform of 1992.** Officials noted that the tax policy measures in the 2001 budget represented an attempt to balance the need for higher spending in some critical areas with the imperative of a neutral budget. Tax neutrality had been improved by extending the VAT to some services that were earlier exempt and by limiting tax loopholes in the dual income tax system.[9] The extensive tax preferences that benefit primarily the energy-intensive and shipping industries continue to be an anomaly. In principle, the tax base could be broadened and the neutrality of capital tax enhanced by removing the preferential tax treatment of property and occupational pension funds vis-à-vis other forms of capital, although this measure was not at present on the agenda.[10] Officials explained that the tax on dividend income was motivated primarily by considerations of equity; it was a temporary measure, pending changes to the capital income structure to be

[9] A supplementary payroll tax, proposed in the initial budget with a view to easing labor shortages in the private sector, was withdrawn after the parliamentary negotiations.

[10] Statistics Norway estimates the revenue loss from lenient treatment of owner-occupied housing at about 3 percent of GDP, and the potential welfare gain resulting from a move to neutral taxation of housing vis-à-vis other forms of capital have been estimated to be as large as the gain achieved by the 1992 tax reform. See Holmoy and Vennemo, 1995, Journal of Policy Modeling, Vol. 17, pp 531–556.

Box 3. Norway: Impact of the Demographic Transition

Norway's long-term demographic challenge is broadly similar in scope to that faced by the rest of advanced Europe. The ratio of Norwegian citizens 67 or older to the labor force will increase from 26 percent now to 43 percent by 2050, while the share of this age group in the population is expected to increase from 14 percent to 21 percent over the same period.

The demographics have important implications both for long-term fiscal policy and labor force participation. The latter is a key determinant of potential growth and—by affecting the number of contributors to social insurance—also influences the fiscal position. These implications themselves will depend crucially on the main features of Norway's social insurance system which include:

- Old-age **public pensions, financed on a pay-as-you-go basis**, including both basic and supplementary benefits. Supplementary benefits, introduced only in 1967, are growing as new retirees have greater lengths of participation (up to an allowable maximum of 40 years) in the supplementary plan;
- liberal access to relatively **generous disability and early retirement** schemes with benefits comparable to those earned by workers who remain in the work force up to the retirement age of 67;
- other relatively **generous social benefits** including for sickness, childcare, and occupational pensions;
- **benefits informally indexed to wage growth**, which could instead be indexed to CPI growth (as in the U.S., the U.K.), or to an average of CPI and wage growth (as in Switzerland).

The fiscal cost of the public pension (including early retirement and government occupational pensions) and disability schemes under current policies will grow from about 8 percent of GDP now to 19 percent in 2050.

The generosity of social insurance benefits has begun to have a significant impact on labor supply:

- The number of disability pensioners is projected to increase from 11.5 percent of the labor force at end-1999 to 13.3 percent by 2005. Some 90 percent of workers who go on disability never return to work.
- The number of workers on early retirement has grown from under 0.2 percent of the labor force in 1993 to 1.3 percent of the labor force in 2000, in part because of the liberalization of qualification rules.
- As a result, the anticipated retirement age of 18-year olds has fallen from 61 to 59 years during 1995-99.
- Sickness absences are growing rapidly, with a further 20 percent increase projected in the next two years.

In addition, more labor resources will be drawn into services demanded by an aging population. According to official estimates, more than 60 percent of new entrants to the workforce in the next 10 years will work in welfare-related systems, especially in health and social services.

Notwithstanding the cushion provided by oil wealth, reforms to the social insurance regime are needed to address the impact of the demographic transition. With the fiscal impact exacerbated by benefits which tend to provide disincentives to labor force participation, reforms to social insurance schemes along the lines already suggested for Nordic and EU countries[1/] could help alleviate the terms of the tradeoff by:

- containing benefits for the pay-as-you-go public pension scheme;
- strengthening the link between retirement benefits and number of years in the work force, possibly through the tax system, to provide increased incentives for labor force participation;
- increasing the role of funded pension schemes, whether public or private;
- tightening eligibility rules for disability and early retirement schemes.

[1/] See Herbertsson, Orszag and Orszag, A Report prepared for the Nordic Council of Ministers, "Retirement in the Nordic Countries" (May 2000) and EU Economic Policy Committee, "Report to the ECOFIN Council on the Impact of Aging Population on Public Pension Systems" (October 2000).

introduced in 2002 and, since it applied only to Norwegian taxpayers and companies, was not expected to affect inward foreign investment.

37. **The authorities believe that recent initiatives to privatize some state companies represent major progress.** The decision to privatize the fully state-owned telecommunications company Telenor, and to sell the second largest commercial bank Christiania mark important steps in the long and at times difficult process of privatization. However, the pace of privatization has been gradual and officials acknowledge that state ownership remained extensive. The protracted Norwegian debate on whether to partially privatize the state oil company (Statoil) continues. Officials noted that the complex issues involved in the debate such as the allocation of new concessions, access to pipelines and the strategy for future gas exports explained the relatively slow progress of the debate.

38. **Labor market policies strive to ensure a balance between incentives and well-targeted safety nets.**[11] A variety of indicators such as low long-term, youth, and overall rates of unemployment, and high participation rates attest to the success of labor market policies. To further improve the functioning of the labor market, the authorities eliminated the monopoly on work referral of the state referral agency and removed restrictions on the use of contract and temporary labor. They also stepped up active labor market programs in response to downturns in the oil-related and shipping industries, emphasizing short-term, career-oriented training courses. The staff underlined that additional reforms that focus on easing constraints on labor supply and enhancing employment and wage flexibility were urgently needed, particularly in the light of the recent strains on the wage-setting arrangements. Officials noted that their medium-term plans include reforming unemployment and sickness benefits and the early retirement scheme to enhance work incentives; easing rules on fixed-term contracts and working hours; and increasing wage flexibility to avoid crowding young and low-skilled workers out of employment.

39. **A range of indicators appears to suggest that risks to the financial system are limited** (Figure 10). Profitability improved markedly in 1999, reflecting reduced costs and low loan losses; core capital ratios remain above the minimum by a good margin; the share of non-performing loans is low; and except for some weak sectors such as shipping, credit risk in the business and household sectors is considered low. The debt burden of enterprises relative to liquid assets has risen sharply, but strong earnings and moderate interest expenses suggest that enterprises are satisfactorily equipped to cope with a cyclical downturn. The growth of domestic credit has risen to an annual rate of over 12 percent and the household debt-income ratio is rising strongly, albeit from a low level. Nonetheless, household net assets have also risen and the households' repayment record remains good. The banks have a low exposure to market risk, given their small holdings of securities. Although the market risk of life insurance companies increased in the first half of 2000, they were considered to have sufficient buffer capital.

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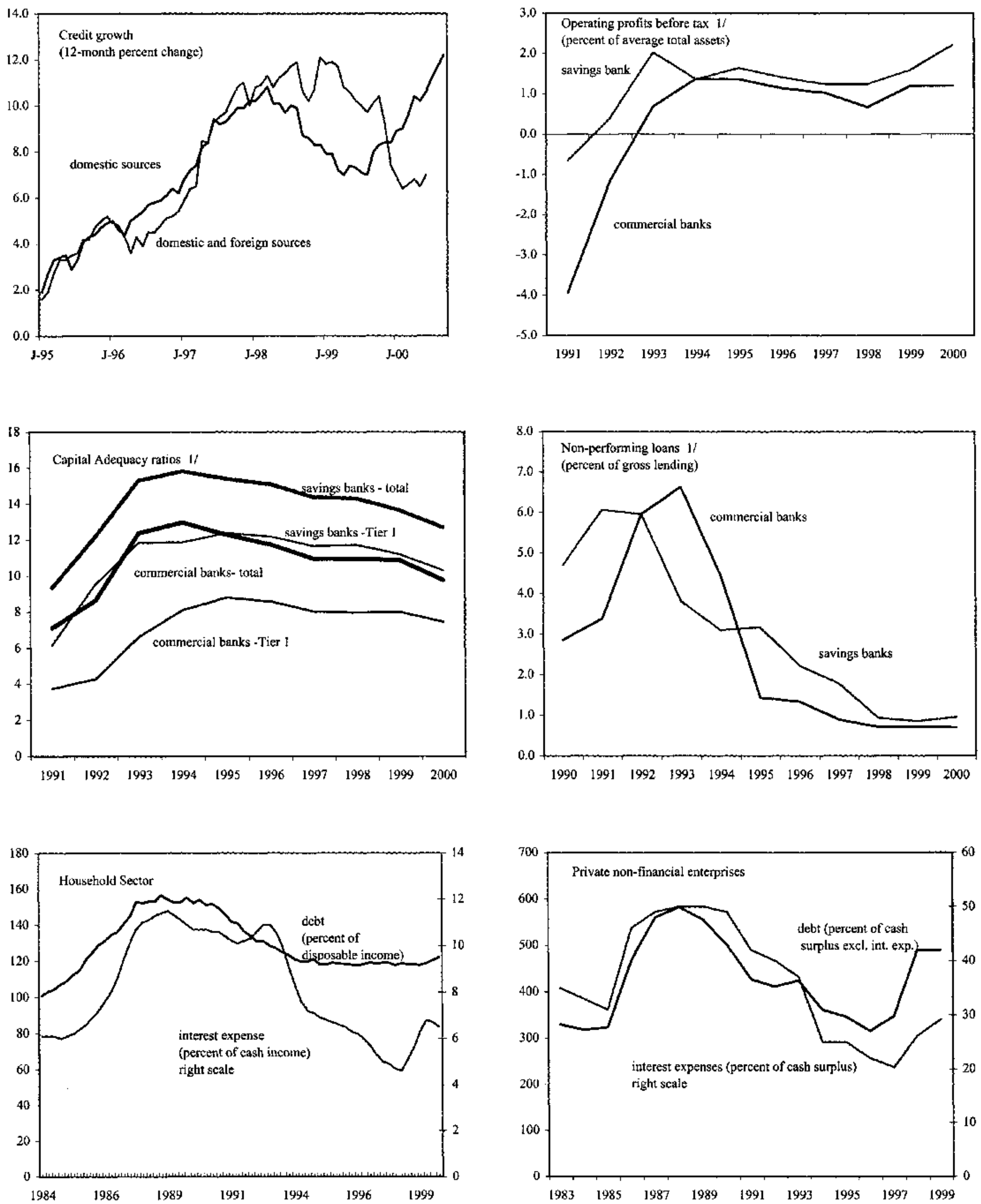
[11] See Chapter 2 of the Selected Issues paper on labor market issues.

Figure 10. Norway: Indicators of Financial Sector Health.



Source: Norges Bank and Banking, Insurance, and Securities Commission.
1/ Data for 2000 refer to June.

40. **The potential productivity gains from the emerging new economy could be significant.** Norway, along with its Nordic neighbors, ranks very high in terms of indices of internet connectivity and mobile telephony. Indeed, with its educated labor force, high penetration of information technology, and location in a region which is at the forefront of the development and use of the new technologies, Norway should be well positioned to exploit the sizeable productivity gains that the new economy seems to offer. The staff argued, however, that compressed wage differentials which reduce returns to education and a relatively high tax burden may prevent Norway from fully exploiting these gains. There was a consensus that a dynamic, risk-taking entrepreneurial culture could develop in Norway if tax and wage policies were conducive to rewarding high skills and enterprise, and labor and product markets more flexible.

41. **EU membership is not on the political agenda.** The electorate has twice rejected EU membership, the last time in 1994. With over 70 percent of trade with the EU, the economy is closely integrated with the single market and membership in the European Economic Area (EEA)—providing for free movement of goods, services, labor, and capital vis-à-vis the EU—confers on Norway many of the benefits of EU membership.

42. **The overall liberal trade regime is blemished by the high level of protection to agriculture and food processing.** The trade regime has a number of commendable features: an average tariff rate of only 2 percent on industrial goods; the distinctive position of being the only country to eliminate virtually all quantitative restrictions allowed under the Agreement on Textiles and Clothing; and no recourse to trade defense measures. However, Norway maintains one of the highest rates of agricultural protection in the world, with an average tariff of 38.5 percent.

43. **Norway's commitment to official development assistance (ODA)--at 0.9 percent of GDP, the second highest in the world--will be further strengthened** by the authorities' intention to increase ODA to 1 percent of GDP over the medium term.

44. **Economic statistics are adequate for surveillance purposes** in their coverage, quality, and timeliness (see Appendix III). Norway is in full compliance with the special data dissemination standard (SDDS) including the reserves template, and its metadata are included in the Dissemination Standards Bulletin Board.

IV. Staff Appraisal

45. **The Norwegian economy has experienced another year of solid economic growth in 2000 stretching further an exceptional upswing.** As the world's second largest oil exporter, Norway has benefited from sizeable windfall gains conferred by the sharp rise in its terms of trade, and these gains have in turn contributed to boosting confidence and demand. The generally sound macroeconomic management of recent years, premised on financial stability and a prudent husbanding of oil wealth, underlies the present strong economic fundamentals.

46. **A variety of indicators point to mounting pressures on resources.** Indeed, with the level of mainland output expected to remain above potential, resource constraints have become increasingly binding. They are evident in the low rate of unemployment, a historic high vacancy rate, and widening shortages of skilled labor reported across a range of sectors. Increasingly, cost and price indicators have begun to mirror these overheating pressures.

47. **The outlook for 2001 is for continuing solid growth, despite uncertainty about the price of oil.** On the assumption of an average oil price of around US$25 a barrel and strong growth in the main trading partners, the central forecast is for some moderation in the pace of expansion of the mainland economy but with a continuing low rate of unemployment and only a gradual decline in the rate of inflation. The continuing tight labor markets suggest that wage drift may be sizeable and would point to a rise in labor costs of about 5 percent, well above that in the main trading partners. The risks to the projections for mainland growth and inflation from domestic sources are mainly on the upside.

48. **Against this backdrop, both cyclical considerations and the logic of the Solidarity Alternative would clearly suggest a restrictive fiscal stance to contain demand and minimize pressures on the exposed sector.** While in the current climate of opinion the authorities have arguably done their best in sticking to a broadly neutral stance in the proposed state budget, there is a real risk that overruns in spending at the central, and especially at the local level, could lead to an expansionary fiscal outcome. Such an outcome would make the task of bringing inflation down to the level in the euro area more painful and could impose excessive strains on the policy framework of the Solidarity Alternative. The authorities should be prepared to tighten the fiscal stance if necessary in the revised state budget in May 2001.

49. **Credibility of monetary policy would be enhanced by clearer institutional arrangements.** Over the past year, Norges Bank has enhanced its reputation by judiciously exercising the greater scope for discretion flowing from the consensus that exchange rate stability is to be viewed as a medium-term goal rather than as an operational target, and by effectively communicating its forecasts and policy decisions. An explicit recognition of the objective of low and stable inflation in a revised mandate to Norges Bank would help enhance the transparency and credibility of the policy regime and reduce market uncertainty. The political authorities, as elsewhere, would decide on the choice of the objective for inflation--taking into account factors such as the desired level of competitiveness--and the time horizon under which it is to be attained, but giving Norges Bank full operational independence to implement policy. With Norway's actual and projected inflation remaining above that of the euro area and the risk that the fiscal stance in 2001 may fall short of the cyclical requirements of the economy, monetary policy may need to be tightened further to meet the authorities' inflation objective.

50. **The extension of the value added tax to cover more services and the closing of the loopholes in the dual income tax regime proposed in the 2001 budget are welcome measures that widen the tax base.** The attempt to offset the proposed sizeable boost to spending by other tax increases, however, entails undesirable side-effects. More importantly,

acquiescing to new taxes risks making them permanent and providing a rationale for a permanently higher level of public spending. Moreover, ad hoc increases in taxation to meet the exigencies of the annual budget risk undermining the solid achievements of the tax reform put in place in the early 1990s by introducing distortions into what is generally a clear and rational tax system. For instance, the new tax on dividends tilts the level playing field in the taxation of investment income and could, on the margin, hamper investment in Norway, including in the emerging new economy. More generally, future consideration of changes in tax policy should be consistent with the principle of neutrality underlying the earlier tax reform and, in particular, with keeping Norway attractive for investment in a world of rapidly integrating financial markets.

51. **The sustainable long-run economic strategy, grounded in the admirable Norwegian emphasis on sharing the benefits of the resource wealth across generations, should not be altered.** With oil production nearing its peak and the visible build-up in the State Petroleum Fund setting off a clamor for spending more of the oil wealth now, it is important to reaffirm the main rationale behind such a strategy. Since a sizeable portion of the oil income has been spent over the past quarter century to finance the expansion of public services, the balance between spending and saving the oil wealth has by no means been one-sided. The uncertainty inherent in any projections of wealth from the present vantage point of a peak in oil output, a strong U.S. dollar, and a high oil price—which was, after all, only a third of its current level less than two years ago—suggests that caution is in order. Indeed, it is an open question whether on current policies, oil wealth would be sufficient to cover the costs of the impending demographic shock, let alone spread the benefits to future generations consistent with the Norwegian ideal of intergenerational equity.

52. **The public preoccupation with spending the oil wealth should not distract attention from needed structural reform.** The impending demographic shift implies not only a large and growing burden of the cost of pensions as well as health care services, but perhaps more importantly, a likely sharp decline in the growth of effective labor supply and future potential output, undermining the economy's ability to provide an aging population with the needed services. A rise in public spending in the expectation of a permanent rise in oil income would be very difficult to cut back if oil prices were to reverse course later. An expansion of public spending would also risk increasing the layers of bureaucracy, diluting the focus on urgently needed reforms in the pricing, management and incentive structures in the public services and enlarging a constituency against reforms. Effective reforms may well show that the resource shortages in public services are largely artificial. More broadly, a preoccupation with spending the oil wealth risks diverting the public debate away from the imperatives of other structural reforms—particularly in the product and labor markets—which remain central to raising the potential growth of the mainland economy and easing its transition to the post-oil era.

53. **The long-run sustainability of public finances is intrinsically linked to the authorities' ability to rein in public spending.** The lack of a medium-term fiscal anchor, including a medium-term expenditure plan, has probably contributed to a ratcheting up of public spending, especially since the constraining effect of public debt present in many other

countries is absent. A medium-term fiscal framework would help ensure that spending restraint is achieved on a strategic basis. It could also help bring to the fore the tensions between the popular desire for a large public sector and the adverse incentive effects of the high tax burden needed to support it. Such tensions are likely to rise in an era of increasing competition to attract global resources.

54. **A key long-term challenge remains that of stemming the relentless increase in the cost of social insurance benefits.** Recent adverse trends in early retirement, sickness absences and disability are of concern and need to be reversed by appropriate changes in incentives. Such changes should encompass a tightening of eligibility rules for disability, restructuring of early retirement and pension benefit schemes to encourage remaining in work longer, and implementing a reform of sickness benefits. Even then, ensuring the long-run viability of the pension regime may require further changes such as a reduction in the value of pension benefits and a move toward a system of a publicly financed basic pension, supplemented by public or private defined- contribution plans.

55. **The renewed strains experienced by the centralized system of wage bargaining in the 2000 wage round highlight the fragility of the framework** and call into question its ability to deliver wage moderation in the upward phase of the economic cycle. Moreover, gains in wage moderation are offset by a gradual build-up of distortions at the micro-economic level. One indicator of these is the relatively high compression in the wage structure which acts as a disincentive to the supply of certain types of skilled labor and lowers the returns to education. The ongoing shift toward services, the shortages of skills in the public sector, and rapid international integration pose growing challenges to the wage determination framework. These would need to be addressed in the coming years by a gradual move to a more decentralized regime which would facilitate greater wage differentiation.

56. **The present prosperous times would seem well-suited for an acceleration of structural reform in labor and product markets.** To realize the potential productivity gains from the nascent new economy, appropriate incentives in the wage structure and tax policy would need to be in place, and the pace of deregulation and privatization in the product markets speeded up. In this context, recent decisions to sell the second largest public sector bank and to move fast to privatize telecommunications are welcome signals of the authorities' commitment, but it would be desirable to resolve the complex issues in reducing the public stake in the petroleum sector as well. Measures to improve flexibility in the labor market would help reduce bottlenecks and promote work and education incentives. Finally, the reform agenda would have to give priority to overhauling the extensive and costly regime of protection to agriculture. Trade liberalization in this sector, especially if coupled with liberalization of access to exports of least-developed countries, would aptly complement Norway's exemplary record of official development assistance.

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

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

Norway: Basic Data

Social and Demographic Indicators	
Area	323,878 square kilometers
Population (1999)	4.48m millions
Population growth (1998-99)	0.7 percent
GDP per capita (1998)	US$ 29,737
Population Characteristics and Health	
(most recent estimates as of December 1989)	
Life expectancy at birth: Overall	78
Female	81
Infant mortality (aged under 1, in percent)	0.5
Population per physician	451
Population per hospital bed	67

	1996	1997	1998	1999	2000 1/	2001 1/
	(Volume changes in percent)					
Private consumption	5.3	3.6	3.3	2.4	3.0	2.4
Public consumption	2.8	1.9	3.8	2.7	2.0	2.0
Gross fixed investment	9.9	13.9	5.8	-5.6	-4.9	-2.8
Export of goods and services	9.3	6.1	0.3	1.7	6.6	5.8
Of which: Oil and gas	-13.7	2.9	-3.6	-0.1	9.5	7.0
Import of goods and services	8.0	11.3	9.3	-3.1	1.2	3.2
GDP	4.9	4.7	2.0	0.9	3.0	2.4
Mainland GDP 2/	3.8	4.2	3.3	0.8	1.9	1.9
	(In percent of labor force)					
Unemployment 3/	4.1	3.3	2.4	3.2	3.3	3.3
	(Percentage changes)					
Consumer prices	1.3	2.6	2.3	2.3	3.0	3.0
Hourly labor cost in manufacturing	4.1	4.8	5.9	5.0	3.8	3.5
Effective exchange rate						
Nominal	0.3	0.5	-3.7	-1.6	...	...
	(Twelve-month percent change, end of period)					
Domestic credit	6.2	10.2	8.3	8.4	...	...
Broad money	6.0	4.9	5.0	10.4	...	...
	(In percent)					
Three-month Interbank rate	4.9	3.7	5.8	6.5	6.6	6.8
Ten-year government bond yield	6.8	5.9	5.4	5.5	6.4	6.4
	(In percent of GDP)					
State budget, including social security						
Revenues	42.6	43.6	42.5	41.9	45.6	48.2
Expenditures	37.9	37.5	40.0	39.2	35.3	35.7
Overall balance	4.6	6.1	2.5	2.7	10.3	12.5
General government financial balance	6.6	7.9	3.6	4.8	14.3	12.5
Current account balance	6.5	5.6	-1.3	3.9	14.3	13.3
International reserves (in months of imports of goods and services)	6.3	5.4	4.1	4.8	5.2 4/	...

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

1/ Staff estimates and projections as of October 2000.

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

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

4/ December 2000.

NORWAY: FUND RELATIONS
(As of October 31, 2000)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	1,671.70	100.0
Fund holdings of currency	1,210.26	72.4
Reserve position in Fund	461.46	27.6
Operational budget transfers (net)	-12.00	

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	167.77	100.0
Holdings	223.72	133.3

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

V. **Financial Arrangements**: None

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

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

In accordance with Decision No. 144(52/51), Norway has notified the Fund that it maintains exchange restrictions pursuant to UN sanctions against the Federal Republic of Yugoslavia (Serbia/Montenegro)(EBD/92/157, 7/21/92 and EBD/95/14, 1/25/95) Iraq (EBD/90/286, 9/10/90) and EBD/95/146, 11/1/95, and the Socialist People's Libyan Arab Jamahiriya (EBD/95/146, 11/1/95). It is expected that in due course the exchange restrictions against the Federal Republic of Yugoslavia will be eliminated as a result of recent political developments in that country.

VIII. **Article IV Consultation**: Discussions for the 1998 Article IV Consultation were held in Oslo, October 19-26, 1999. The Staff Report (SM/99/311) was considered by the Executive Board on January 28, 2000.

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

X. **Resident Representative**: None

Norway: Core Statistical Indicators

(As of December 4, 2000)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance 1/	GDP/ GNP	External Debt/Debt Service
Date of Latest Observation	12/4/00	8/30/00	10/31/00	10/31/00	10/31/00	12/4/00	Oct. 00	Oct. 00	Aug. 00	2000	2000 Q2	Sept. 00
Date Received	12/4/00	10/3/00	11/15/00	11/30/00	11/30/00	12/4/00	11/10/00	11/15/00	10/24/00	10/4/00	9/7/00	Dec. 00
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Variable
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Three times a year	Quarterly	Quarterly
Source of Update	Norges Bank	Norges Bank	Norges Bank	Norges Bank	Norges Bank	Norges Bank and WEFA	Statistics Norway	Statistics Norway	Statistics Norway	Ministry of Finance	Statistics Norway	Norges Bank
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Publication
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Three times a year	Quarterly	Quarterly

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

Statement by the IMF Staff Representative
January 26, 2001

The following information has become available since the staff report (SM/00/286) was issued. This information does not change the thrust of the staff appraisal.

1. **Growth in mainland GDP softened somewhat since mid-2000.** Preliminary national accounts data for the third quarter of 2000 show that mainland output declined over the previous quarter in seasonally-adjusted terms by 0.4 percent. The decline, reflecting sluggish private consumption and weak mainland investment, remains consistent with the staff projection of growth of 1.9 percent in 2000. Overall GDP rose by 0.3 percent on account of the growth in offshore oil and gas activities and shipping.

2. **The unemployment rate (at 3.3 percent) and the level of employment were unchanged** in October 2000 from their level in September on the basis of seasonally-adjusted Labor Force Survey data.

3. **Consumer price inflation in 2000 averaged 3.1 percent**, the highest annual rate since 1991.

4. **Domestic credit expansion continued to accelerate**, reaching 12.7 percent in the year to November 2000.

5. The preliminary estimate of **the external trade surplus in 2000 was about 16 percent of GDP** compared with 7 percent of GDP in 1999, reflecting mainly higher oil prices that led to a near doubling of oil exports to about $25 billion. The current account surplus in the first ten months of 2000 was estimated at $16 billion or about 12 percent of GDP on an annualized basis.

6. **The spot price of oil (U.K. Brent)**, after dipping to around $22 per barrel in late December, **rose to $27 per barrel in recent days.**

7. **The krone was at the upper end of its implicit target range in relation to the euro** in the third week of January 2001. The krone has appreciated by about 4 percent against the dollar and depreciated by about 1½ percent against the euro since the beginning of December 2000. Three-month interest rates have remained roughly constant in the same time period, with a widening of the short-term differential vis-à-vis the euro area from 2.3 to around 2.6 percentage points.

8. **The cabinet announced plans for partially privatizing the oil sector.** It proposed an initial public offering of between 10 and 25 percent of Statoil shares in mid-2001 and selling roughly 20 percent of the total value of the State Direct Financial Interest (SDFI).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 01/10
FOR IMMEDIATE RELEASE
February 5, 2001

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

IMF Concludes Article IV Consultation with Norway

On January 26, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the 2000 Article IV consultation with Norway.[1]

Background

Norway, one of the world's richest economies and its second largest oil exporter, has been a model of prudent economic management of resource wealth in recent years. The policy of investing abroad a substantial part of the government's oil and gas export revenue through the State Petroleum Fund, pursued in the 1990s, has helped insulate the mainland (non-oil) economy from fluctuations in oil revenue. Coupled with a consensual incomes policy framework, this strategy has been generally successful in managing the economic cycle and has helped raise living standards markedly over the past quarter century.

With the cycle maturing, labor market conditions have tightened and pressures on capacity intensified, straining the solidaristic wage-setting framework. After a brief pause in the first half of 1999, mainland GDP growth picked up to 3 percent in the first half of 2000 over the corresponding period in 1999. Private consumption, driven by large wage gains and positive wealth and confidence effects, rose by 3½ percent, with public consumption also providing a steady impetus to demand. The strength of residential and mainland business investment more than offset a continued contraction in petroleum investment. Solid export growth and the lagged effects of the relaxed monetary stance of 1999 also underpinned economic activity. The renewed expansion since late 1999 boosted employment growth, mostly in services, with the participation rate—already among the highest in the advanced economies—reaching a new high. With the rate of unemployment at 3¼ percent for over a year, acute labor shortages continued in construction and services, strengthening labor unions' bargaining position. The

[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. This PIN summarizes the views of the Executive Board as expressed during the January 26, 2001 Executive Board discussion based on the staff report.

settlement under the two-year centralized bargaining framework was reached in May 2000 only after a nationwide general strike, increasing wage costs by about 5 percent in 2000 and at least 4½ percent in 2001.

External and domestic impulses pushed headline inflation to its highest rate since 1991. A sharp rise in energy prices as well as rising labor costs raised consumer price inflation in the year to October 2000 to 3.1 percent, 0.7 percent above that for the euro area as measured by the harmonized index. Asset prices have also risen steeply, with house prices up by 18 percent in the year through the second quarter of 2000, and the Oslo share price index increasing by 21 percent in the year through November 2000.

The coincidence of a surge in oil prices, peaking oil output, and a strong U. S. dollar—which boosts the krone value of dollar-denominated oil exports—led to a doubling of oil export earnings in 2000. Exports of natural gas, of which Norway is one of the ten largest exporters, have also risen to a record level. Favorable prices for other staple raw material exports—fish and aluminum—have helped raise the average terms of trade by 27 percent in the year to June 2000. This, and a strong recovery in the EU market, has contributed to an expected current account surplus of about 15 percent of GDP for 2000—the largest in relation to GDP for an advanced economy since at least 1970. Net foreign assets are projected to grow from 11 percent to over 25 percent of GDP in the year through end-2000.

Despite some erosion vis-à-vis the euro area since 1997, overall competitiveness has been sound. The real effective exchange rate has declined by nearly 5 percent over the past three years as nominal depreciation of the krone, particularly against the U.S. dollar and the pound sterling, more than offset the adverse inflation differential. However, while the krone/euro exchange rate has returned to levels prevailing in 1997, Norwegian inflation has outpaced that in the euro area since 1997. Wage costs will have risen by a cumulative 17 percent in 1998–2000, about double the rate of increase in the euro area, while productivity growth in Norway has been lagging in recent years.

The general government fiscal stance in 2000 is slightly expansionary. Spending by local authorities in excess of budget estimates has contributed to an expansionary change in the general government non-oil structural balance of about 0.3 percent of GDP. This will mark the third straight year that a slight tightening of the state budget has been more than offset by laxity in local government finances. With oil prices at a ten-year peak, the overall fiscal surplus is projected at over 14 percent of GDP, 6 percentage points above the 2000 budget projection, which was based on the assumption of an oil price of US$15 a barrel.

The 2001 state budget, approved by parliament in November 2000, embodies a broadly neutral fiscal stance. It includes an increase in the general VAT rate by one percentage point to 24 percent, an 11 percent tax on dividend income, to be offset by cuts in taxes on fuel as well as reduced VAT on food. Spending initiatives in education and health care contributed to the proposed 2½ percent rise in underlying real spending. With lower projected growth of petroleum revenue, the general government surplus is expected to decline to 12½ percent of GDP.

Over the past few years, the conduct of monetary policy has gradually moved toward treating nominal exchange rate stability as a medium-term goal rather than as a short-term operational target, to be achieved by bringing inflation down to the level aimed at in the euro area. Norges Bank raised policy interest rates by a total of 150 basis points to 7 percent during April–September 2000 to reduce inflation pressures. Nonetheless, although the krone has been strong relative to the euro, the nominal effective exchange rate has depreciated by 4 percent since mid-1999.

Executive Board Assessment

Executive Directors commended Norway for its impressive track record of economic performance over the past decade, marked by sustained solid growth, low inflation and unemployment, and strong fiscal and external positions. This strong performance owed much to the authorities' successful macroeconomic strategy—anchored to the consensual framework of the Solidarity Alternative—that aims to ensure financial stability and competitiveness of the non-oil economy through prudent management of Norway's sizable oil wealth.

Directors noted that the outlook for 2001 was for continued solid economic growth, at a more moderate pace. With mainland output expected to remain above potential and continuing resource pressures, however, the balance of risks is on the upside. Directors therefore recommended the authorities to pursue appropriately tight fiscal and monetary policies, and to accelerate the pace of structural reform. This would strengthen the foundations for continued favorable economic performance in the medium term.

Directors noted that countercyclical fiscal management was a key pillar of the authorities' strategy, which had served Norway well in the past by helping to smooth aggregate demand. A number of Directors, noting the political constraints, supported the neutral fiscal stance of the 2001 budget, but recommended that the authorities be prepared to respond to any indications of continuing resource pressure by an appropriate tightening in the revised budget in May. A few other Directors, however, considered that a tighter budget for 2001 would have been desirable to avoid placing a disproportionate burden on monetary policy.

Directors welcomed the monetary authorities' timely policy tightening in 2000 to counter inflation risks. They endorsed the increased weight given to inflation in formulating monetary policy, and encouraged the authorities to continue to pursue their objective of bringing inflation down towards the corresponding euro area target range. A number of Directors felt that there was no compelling reason at this time to change the present monetary policy framework: they welcomed the authorities' efforts to promote transparency through comprehensive communication. A few Directors suggested that the authorities consider formally mandating Norges Bank to ensure low and stable inflation, and guaranteeing its full operational independence, as a means of improving the transparency and credibility of monetary policy.

Directors welcomed the measures to widen the tax base, including through the extension of the value added tax to cover more services and the closing of some tax loopholes. They emphasized the benefits of maintaining a neutral and predictable tax system, and recommended the authorities to adhere to the principles underlying the 1992 tax reform and refrain from ad hoc increases in taxes that could undermine Norway's generally efficient tax system.

Over the long term, Directors noted that the twin tasks for economic policy will be to facilitate the economy's transition to the post-oil era and to address the pressures on the public pension and health care systems implied by the impending demographic change. They commended the authorities on their ideal of intergenerational equity and their prudent management of Norway's oil wealth. Directors supported the authorities' adherence to a sound long run fiscal strategy, and stressed the importance of not easing fiscal policy during periods of windfall oil revenues. They underscored the need for measures to reform the pension regime and the social insurance programs to ensure that future generations will share in the benefits from oil wealth. Reforms in these areas should incorporate steps to improve incentives, including by tightening the eligibility requirements for disability and sickness benefits, and by restructuring of pension and early retirement schemes.

Some Directors encouraged the authorities to consider the potential benefits of adopting a medium-term expenditure plan that would contain growth in public spending within a strategic framework. They noted that expenditure restraint would reinforce the prospects for long-term fiscal sustainability and permit a reduction of Norway's tax burden over time.

Directors noted that Norway's centralized wage bargaining system has contributed to its long record of strong employment growth and low unemployment. They observed, however, that the system has become more fragile in recent years, and the wage structure is compressed by international standards, pointing to the need to improve employment and wage flexibility. Directors noted that recent employment expansion had been mainly in the public sector. They recommended the authorities to encourage the creation of private sector jobs and promote the acquisition of skills through greater wage differentiation.

Directors welcomed the recent structural measures in product markets, including the decision to sell the second largest public bank. They encouraged the authorities to move forward with the remaining agenda for deregulation and privatization, and to reduce Norway's high protection of the agricultural sector, including through trade liberalization.

Directors praised Norway's continued official development assistance, which is among the highest provided by advanced economies. They strongly welcomed the authorities' intention to increase such assistance to 1 percent of GNP over the medium term.

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

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

Norway: Selected Economic Indicators

	1998	1999	2000 1/	2001 1/
	(Volume changes in percent)			
Private consumption	3.3	2.4	3.0	2.4
Public consumption	3.8	2.7	2.0	2.0
Gross fixed investment	5.8	-5.6	-4.9	-2.8
Export of goods and services	0.3	1.7	6.6	5.8
Of which: Oil and gas	-3.6	-0.1	9.5	7.0
Import of goods and services	9.3	-3.1	1.2	3.2
GDP	2.0	0.9	3.0	2.4
Mainland GDP 2/	3.3	0.8	1.9	1.9
	(In percent of labor force)			
Unemployment	2.4	3.2	3.3	3.3
	(Percentage changes)			
Consumer prices	2.3	2.3	3.0	3.0
Hourly labor cost in manufacturing	5.9	5.0	3.8	3.5
Effective exchange rate				
Nominal	-3.7	-1.6	...	...
	(Twelve-month percent change, end of period)			
Domestic credit 3/	8.3	8.4	12.2 4/	...
Broad money 3/	5.0	10.4	10.8 4/	...
	(In percent)			
Three-month Interbank rate 5/	5.8	6.5	6.6 6/	...
Ten-year government bond yield 5/	5.4	5.5	6.2 6/	...
	(In percent of GDP)			
State budget, including social security				
Revenues	42.5	41.9	45.6	48.2
Expenditures	40.0	39.2	35.3	35.7
Overall balance	2.5	2.7	10.3	12.5
General government financial balance	3.6	4.8	14.3	12.5

Current account balance	-1.3	3.9	14.3	13.3
International reserves (in months of imports of goods and services)	4.1	4.8	5.2 7/	...

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

1/ Staff estimates and projections as of October 2000.

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

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

4/ September 2000.

5/ Period average, in percent.

6/ October 2000.

7/ December 2000.

Statement by Åke Törnqvist, Alternate Executive Director for Norway
January 26, 2001

On behalf of the Norwegian authorities, I would like to thank the staff for a thorough and well-written report on the 2000 Article IV consultation on Norway. The staff report covers important aspects of the Norwegian economy, in both the short and the long term.

The report acknowledges the favorable situation of the Norwegian economy. The economy is currently characterized by a low level of unemployment compared with most other countries, and large twin surpluses. Norwegian oil production is close to its peak and is expected to yield large fiscal and current account surpluses over the next ten years.

However, challenges do exist, as described in the staff report.

Economic outlook – recent projections

The labor force participation rate has reached an historical peak. The scarcity of labor will put a cap on growth in the Norwegian economy in the years ahead. The scope for further employment growth seems limited. Growth in potential output will thus, to a large extent, be determined by the rate of increase in productivity.

The latest projections provided by the authorities for mainland GDP indicate a growth rate of 1¼ - 1¾ per cent in 2001. Thereafter, GDP growth is expected to rise towards the underlying growth in potential output. The authorities expect unemployment to remain stable at the current low level over the next few years.

The tight labor market has resulted in an average annual growth in labor costs of 5½ per cent over the last three years. Consumer price inflation reached 3.1 per cent in 2000, the highest rate in nine years. Higher fuel prices have contributed directly to an increase of about 0.5 percentage point in overall consumer price inflation. Partly due to a tightening of monetary policy, and assuming that the oil price is past its peak, underlying consumer price inflation is projected to slow gradually, leveling off at around 2 per cent by 2002. Against this background, Norges Bank announced a neutral bias after the last interest rate increase in September 2000.

Economic policy

The staff believes that the credibility of monetary policy would be enhanced by clearer institutional arrangements. The authorities concur with the view that credibility and accountability facilitate monetary policy and help diminish uncertainty for all participants in the economy. The central bank promotes transparency in monetary policy by clarifying its pattern of reaction to market participants and the public. Also, the central bank has made it clear that the analysis in its Inflation Reports provides a basis for decisions regarding monetary policy. In addition, Norges Bank publishes the timetable for the Board's monetary policy meetings. Any decisions concerning interest rate changes or other important changes in monetary policy instruments will normally be taken at these meetings. As a consequence of this practice, movements in short-term interest rates have become smoother in the period before and after changes in the central bank's key interest rates.

The staff suggests an explicit recognition of the objective of low inflation for monetary policy. As expressed in the BUFF last year, the Norwegian authorities are of the opinion that the Norwegian monetary policy framework is appropriate and adequate. The formal objective of monetary policy is exchange rate stability. The authorities recognize that the krone exchange rate cannot be stabilized in the short term. In its conduct of monetary policy, the central bank thus places emphasis on fulfilling the fundamental preconditions for exchange rate stability over time against the euro: instruments must be oriented in such a way that price and cost inflation is brought down towards the corresponding aim for inflation set by the European Central Bank. At the same time, monetary policy must not in itself contribute to deflationary recessions, as this would undermine confidence in the krone. The central bank has stated that, in the present situation, there are no major differences in its actual conduct of monetary policy from central banks pursuing an explicit inflation target.

Over time, fiscal policy will determine the real exchange rate. Thus, there is an interplay between fiscal and monetary policy. Exchange rate stability over time requires low inflation. In addition, exchange rate stability requires that fiscal policy is oriented towards stabilizing the economy.

The staff questions whether the lack of a medium-term fiscal anchor, including a medium-term expenditure plan, has contributed to a ratcheting up of public spending, particularly since the constraining effect of public debt is absent in Norway. When assessing this question, it must be kept in mind that few countries place as much weight as Norway on long term issues when formulating fiscal policy. Norway was one of the first countries to use generational accounts as a tool for assessing the long-term sustainability of fiscal policy. The generational accounts are roughly in balance. This indicates that there has not been an unsustainable build-up of public spending. The Government Petroleum Fund is growing rapidly. Fiscal policy has clearly been non-expansionary over the past few years, in spite of high oil revenues. All in all, the evidence suggests that a rather cautious approach has been taken to the spending of oil revenues.

Moreover, the Norwegian authorities are of the opinion that any binding medium-term anchor for fiscal policy must include a commitment to stabilization of the real economy. Otherwise, there is the obvious risk that an expansionary fiscal policy, combined with a contractionary monetary policy, will crowd out growth in the business sector. This policy mix challenge is perhaps more evident in the case of Norway than elsewhere, as traditional budget constraints are not binding in the medium term and cannot constitute any effective limit to public spending. It should also be added that the medium-term outlook for the Norwegian economy and long-term prospects for public finances are presented in the annual Budget Bill and that it plays a paramount role in the formulation of the annual fiscal strategy.

Structural issues

The authorities concur with the staff that public finances are facing considerable challenges as a result of an aging population and an increase in early retirement, sick leave and disability pensions. The number of old-age and disability pensioners is forecast to rise by 50 per cent by 2030, and central government expenditure on old-age and disability pensions is expected to increase from approximately 7 per cent of GDP in 2000 to 15 per cent in 30 years time. Recent trends are a matter for concern and will negatively affect the public finances from two angles. An increase in the number of people leaving the work force will reduce the labor supply and the growth potential of the Norwegian economy. This, in turn, will impose strain on the budget in terms of both increased outlay and a diminishing tax-base. The authorities endorse the staff's view that structural reforms in the labor market should be continued with a view to maintaining as large a workforce as possible. Furthermore, a proposal for a more efficient tax system will be presented at the end of the year.

The Norwegian system of income policy cooperation is based on a high degree of wage coordination, with the tradable sector as wage-leader. The system has been conducive to keeping a low level of structural unemployment in Norway. A tight labor market, with increasing shortages in the service sectors, has recently put the system under pressure. The Holden Committee, comprising representatives of all the social partners, confirmed the consensus that the exposed sector should be the wage leader and that labor cost growth in Norway should, over time, be in line with that of trading partners. The Committee underscored income policy coordination as a tool to secure a moderate wage growth at the macro level but, at the same time, pointed at the need to increase micro wage flexibility, especially within the public sector. The authorities accordingly emphasize the need for fiscal and monetary stabilization to maintain a wage growth in line with Norway's trading partners.

When it comes to structural policy, Norway has generally put more emphasis on deregulation of markets than on privatization of publicly owned companies, thus encouraging competition and allowing for efficiency gains, even though there is still state ownership. For instance, the electricity market has been deregulated and developed into a fairly competitive market, although there is still substantial public ownership in the sector.

However, important privatization initiatives have also been undertaken or will be realized in the near future. Telenor, the telecommunications company, was partly privatized and listed on the Oslo Stock Exchange and the Nasdaq National Market in December 2000, and the Government has sold its stake in Christiania Bank. The government also plans to reduce its stake in Den Norske Bank to 1/3. In the petroleum sector, the Government has presented a proposal to reduce the state's ownership in Statoil to 2/3, initially selling shares accounting for 10-25 per cent of the value of the company in connection with an introduction on the stock exchange. The Government also proposes restructuring the state's direct financial interest in the petroleum sector (SDFI) by selling assets corresponding to 20 per cent of the asset value of SDFI.