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Norway: 2001 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Norway

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with Norway, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 6, 2001,** with the officials of Norway on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 5, 2002.** 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 **March 1, 2002** updating information on recent developments;

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 1, 2002 discussion** of the staff report that concluded the Article IV consultation;

- a statement by the Executive Director for Norway.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

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

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NORWAY

Staff Report for the 2001 Article IV Consultation

Prepared by Staff Representatives for the
2001 Consultation with Norway

Approved by Alessandro Leipold and Martin Fetherston

February 5, 2002

- The consultation discussions were held in Oslo during November 28–December 6, 2001.
- The Norwegian Representatives included Mr. Per Kristian Foss, 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, and Mr. Soikkeli (all EU1). Mr. Fidjestøl, Advisor in the Nordic-Baltic Executive Director's Office, participated in the meetings.
- Norway has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange system is free of restrictions on payments and transfers for current international transactions, except for a few restrictions, related to UN sanctions, notified under Decision 144 (Appendix II).
- Norway has subscribed to the Special Data Dissemination Standard (SDDS).
- The authorities released the staff team's Concluding Statement to the public and have agreed to the publication of the Staff Report.
- A new minority coalition government took office following elections in September 2001.
- Norway is a member of the European Economic Area (EEA)—providing for free movement of goods, services, labor and capital vis-à-vis the European Union (EU)—but has twice rejected EU membership in two national referenda.

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I. Introduction

1. **A consensual policy framework supported Norway's strong economic expansion since 1993.** The authorities' strategy—the Solidarity Alternative—centered on wage moderation by the labor unions in return for the commitment to orient monetary policy toward maintaining a stable exchange rate and fiscal policy toward smoothing aggregate demand. The policy of investing abroad a large part of oil revenues has continued to underpin stability by insulating the economy from the fluctuating fortunes of the oil sector and has helped build the foundation for an equitable sharing of oil wealth with future generations of Norwegians. The strategy contributed to achieving among the best economic fundamentals in Europe, most notably virtually full employment despite a sharp rise in the participation rate (Figure 1). Nonetheless, as the cycle matured in the late 1990s, sectoral capacity and labor market constraints emerged, straining the solidaristic wage-setting framework. Exchange rate stability became increasingly difficult to maintain on a short-term basis, and booming oil revenues led to mounting public demands to boost public spending (Figure 2).

2. **The economic policy landscape has undergone significant shifts during the course of 2001.** The strains on the policy framework in recent years led the government to adopt an inflation targeting regime and a new long-term fiscal program in spring 2001. Moreover, a minority center-right coalition government took office following national elections in September. The coalition of Conservatives, Christian Democrats, and Liberals, headed by Prime Minister Bondevik, will rely on the support of the Progress Party which favors both tax cuts and higher spending. The elections reflected gains at the expense of the Labor Party both by parties favoring an expansion of the welfare state, and by those favoring tax cuts. The new government set in train a policy redirection toward reducing Norway's high tax burden.

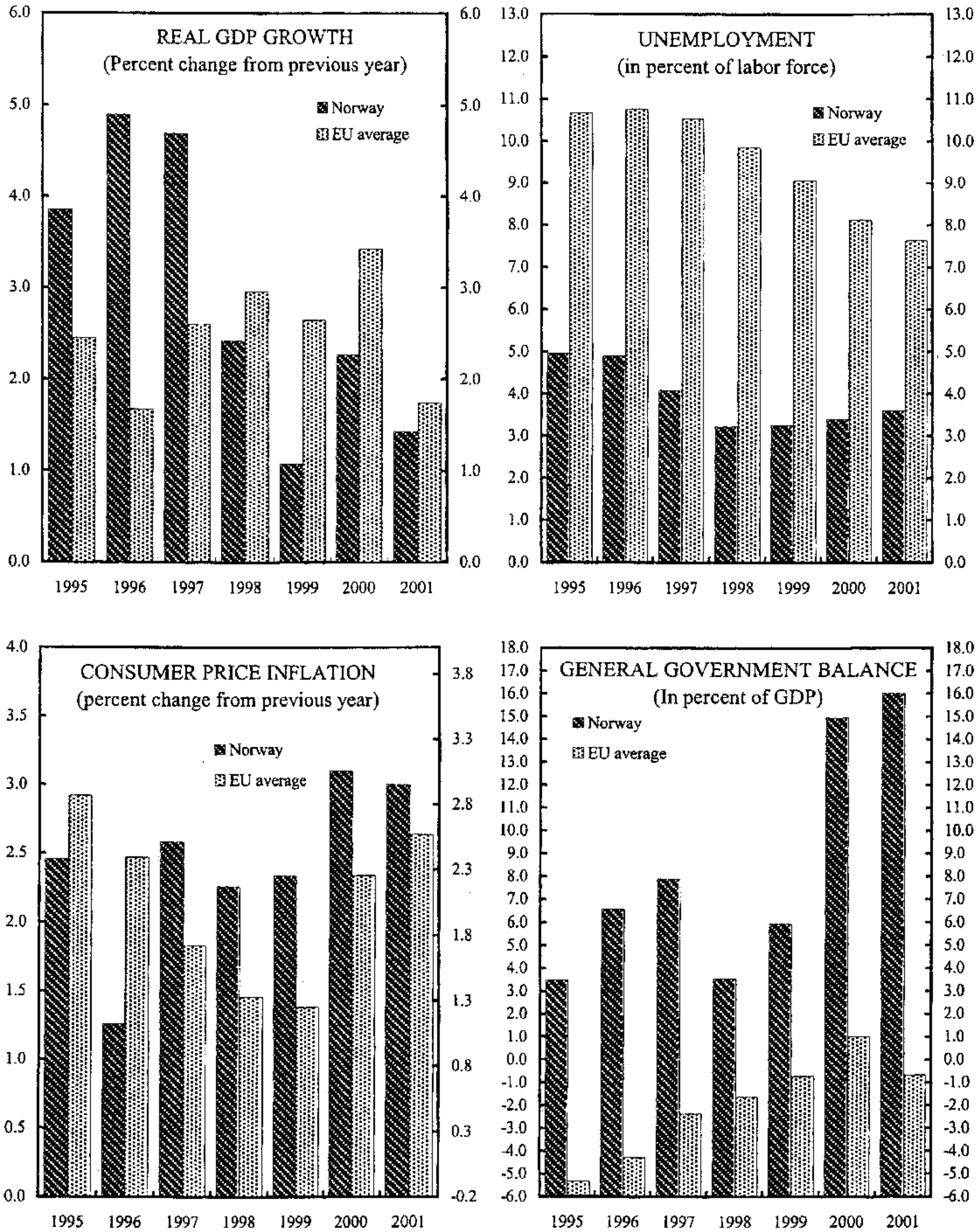
3. **Directors concluded the last consultation by commending Norway for its impressive economic performance marked by sustained solid growth, low inflation and unemployment, and strong fiscal and external positions.** Directors endorsed the increased weight given to inflation in formulating monetary policy, and the authorities' objective of bringing inflation down toward the corresponding euro area target range. They also encouraged the authorities to move forward with structural reforms and to reduce Norway's high protection of agriculture. Directors noted that over the long term, the twin tasks for policy would be to facilitate the economy's transition to the post-oil era and to address the pressures on the pension and health care systems implied by the impending demographic change.

II. Background

A. Economic Developments

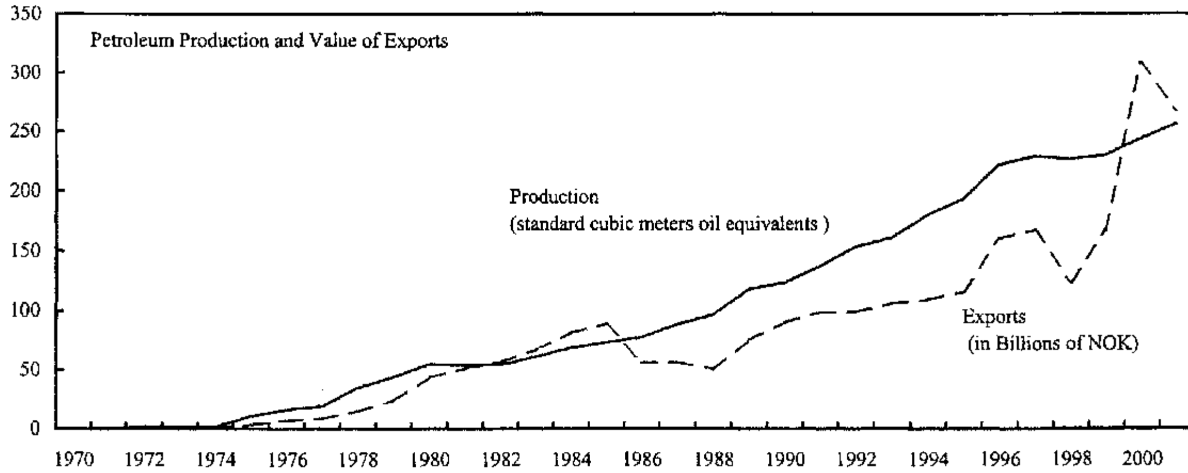
4. **Economic growth moderated in 2001, but output remained somewhat above potential.** Real GDP growth in the mainland (nonoil) economy is estimated to have slowed

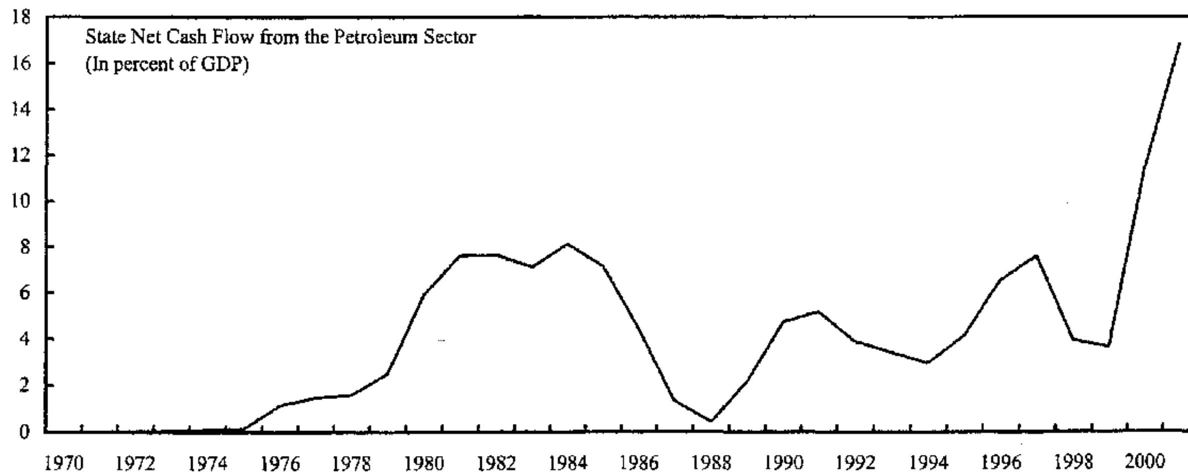
Figure 1. Norway: Economic Fundamentals, 1995-2001

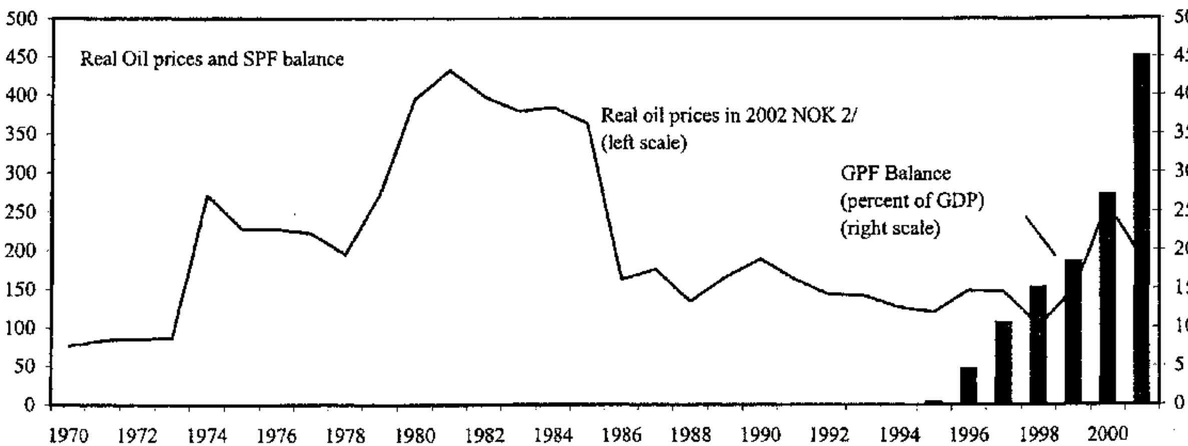


Sources: Ministry of Finance; Statistics Norway; World Economic Outlook; and IMF staff estimates.

Figure 2. Norway: The Petroleum Sector 1/







Source: Ministry of Finance.
1/ Forecasts for 2001 and 2002.
2/ Deflated by CPI.

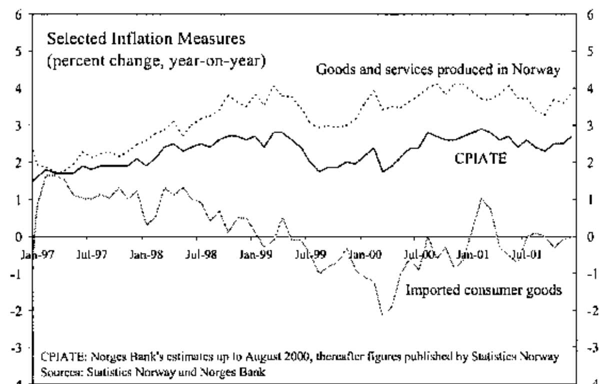
to 1¼ percent in 2001. Private consumption was tempered by the increase in interest rates in 2000, and oil-related investment continued its trend decline, reflecting long-term factors such as the exhaustion of oil fields. However, excluding electricity production—which benefited substantially from heavy rainfall in 2000—mainland GDP growth accelerated in 2001. Moreover, high oil prices through September supported domestic activity through confidence and wealth effects on consumption from strong public finances. Housing investment remained strong, and public consumption and the foreign balance also provided an impetus to activity (Table 1).

5. **The global downturn has started to have its ripple effects on Norway.** Until recently, Norway seemed largely immune to the fall-off in world growth. Consumer confidence was strong through the summer and household spending was stable. Housing starts have picked up markedly in the last two years, and continue at a high level. However, following September 11, oil prices dropped, and some traditional exports such as aluminum have been hit, affected by the problems in the aviation industry.

6. **Labor market conditions remain tight, especially in service sectors.** Driven by services and construction, employment grew by ½ percent, keeping the unemployment rate broadly unchanged at 3½ percent in 2001 and raising the participation rate to 81 percent, exceeded only by Switzerland and Iceland (Figure 3). Immigration, especially from the common Nordic labor market helped ease labor shortages in some sectors. Nevertheless, labor constraints remain severe in sectors such as construction and health care. The lack of mobility between the public and private sectors—severely limited by highly generous government pensions effectively locking in most employees over 40—also hampered the functioning of the labor market. Norway's public sector employment—approaching a third of total employment—is the highest among the advanced economies, while the average annual hours worked per employed person are among the lowest.

7. **The increase in overall wage costs continues to outpace that in trading partners by 1½-2 percentage points despite weaker productivity growth in Norway.** Wages are estimated to have grown by over 4½ percent in 2001, with a contractual rise in vacation days contributing an additional ¾ percentage points in labor costs. Business profitability has been under some pressure due to high labor costs, the strengthening krone, and "Dutch disease" effects on the nonoil exposed (tradeables) sector (Box 1). Adherence to the centralized wage-setting system has weakened, with some public employees obtaining wage hikes outside the framework.

8. **Despite high domestic cost increases, consumer price inflation has been held in check by low krone import prices.** Consumer prices rose by 2.1 percent in the year through December 2001, down significantly from 3.8 percent in June (Figure 4). Headline inflation has been



Box 1. The Structural Changes in the Norwegian Economy

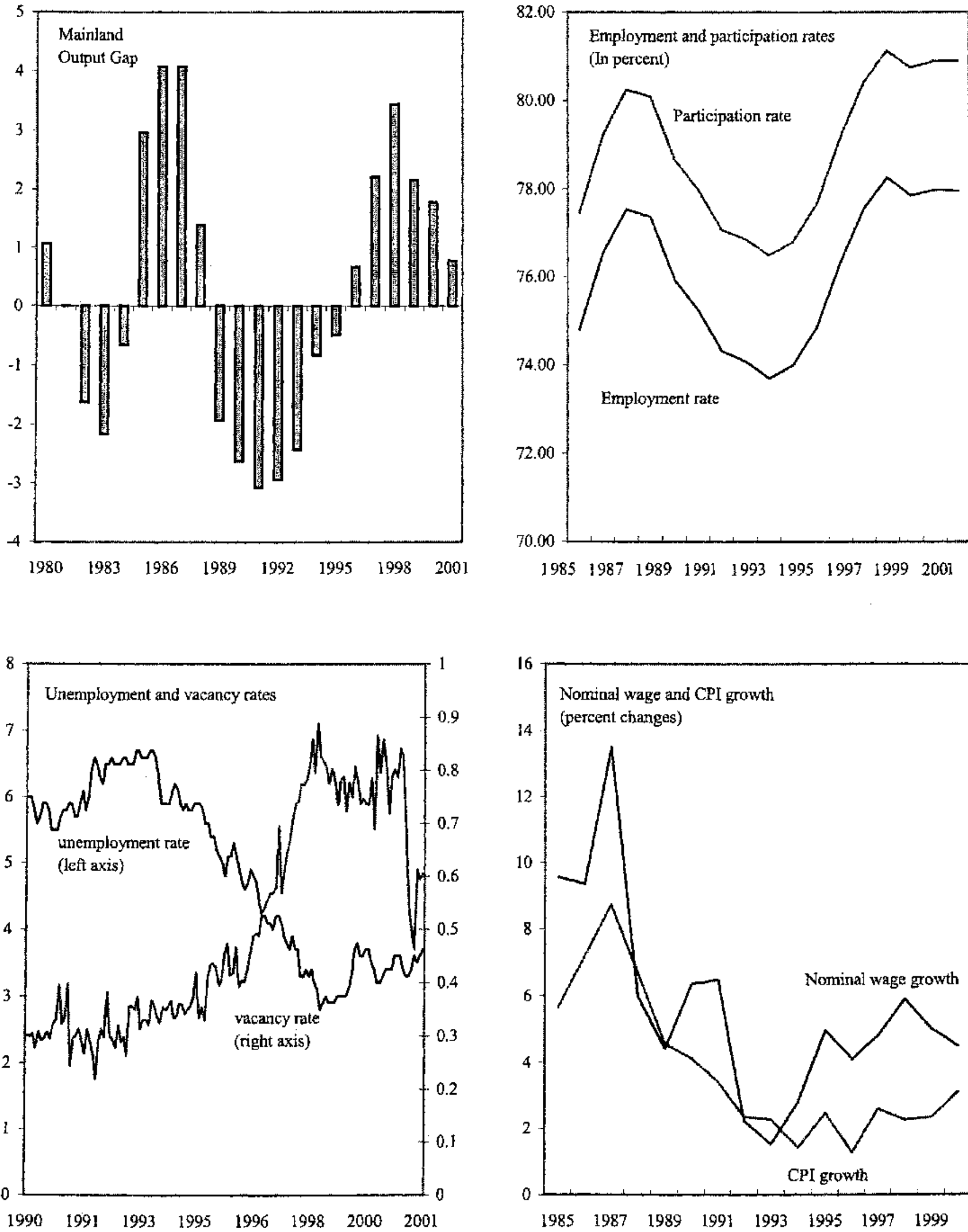
The structure of the Norwegian economy has been greatly affected by the discovery and exploitation of large oil and gas resources since the 1960s and 1970s, respectively. By 2001 Norway had become the world's third largest oil exporter, with energy products accounting for almost two-thirds of exports and a quarter of GDP. These developments have had a major impact, not only on the export sector, but also on the overall structure of the Norwegian economy. Thus the formulation of a long-term strategy to protect the non-petroleum exposed sector from the potential threat of "Dutch disease" while at the same time redistributing the oil wealth evenly between generations and across society continues to be the main challenge for Norwegian economic policy making.

More intensive use of natural resources has been accompanied by an expansion of the public sector. While the size of the public sector as a percent of GDP has remained somewhat smaller than in most other Nordic countries, it has expanded more rapidly than, for example, in Denmark and Sweden over the recent decades. Similarly, the share of the public sector in total employment, which has increased continually over the last 30 years, is currently the highest in the OECD, having surpassed that in Sweden. While the relative number of public sector workers in other Nordic countries has either stabilized (Denmark) or started to decline (Finland and Sweden) in the 1990s, in Norway the corresponding share continued to rise and is projected to grow as a result of increased demand for public services, largely due to growing demand for health and other elderly care services as the population ages.

The manufacturing sector has suffered from accelerated wage increases and a crowding out of resources. The growth in the manufacturing sector has been sluggish during the last quarter of a century averaging an annual 0.4 percent and the relative size of the sector has more than halved to about one-fifth of GDP between 1970-2000. The modest growth in the manufacturing sector has partly reflected greater use of resources by the petroleum and service—especially the public—sectors and the increase in relative labor costs compared with Norway's trading partners. Simultaneously, manufacturing employment as a percentage of total employment has also fallen considerably since the advent of oil production in 1975. Recently, tightness in the labor market has resulted in higher wage demands and has eroded the leading role of the internationally exposed sectors in the national wage negotiations[1], thereby limiting the discipline imposed by the global market on the Norwegian wage setting process. At the same time, other developments in the labor market—such as shorter working hours, increased use of sick leave, easier access to early retirement and disability pensions—have further limited the effective labor supply available for the manufacturing sector.

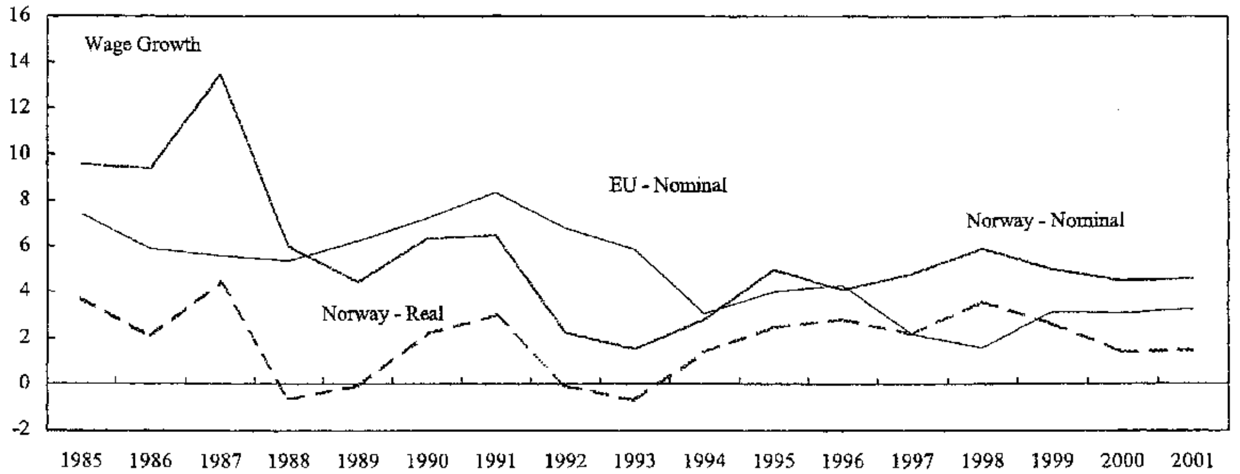
[1] The leading role in the national wage negotiations was given to sectors that are exposed to foreign competition particularly to counteract excessive wage increases which would erode international competitiveness.

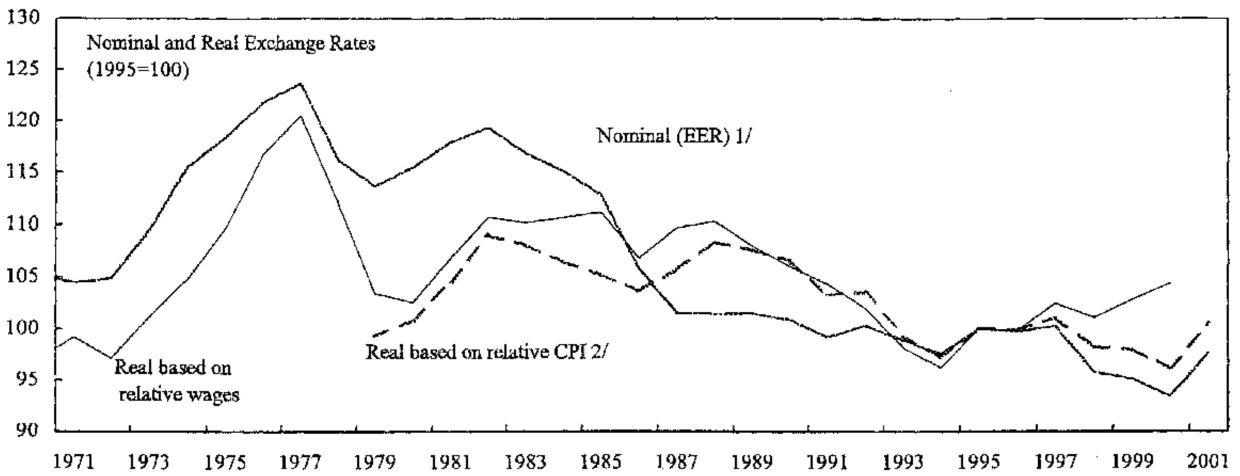
Figure 3. Norway : Indicators of Resource Pressures

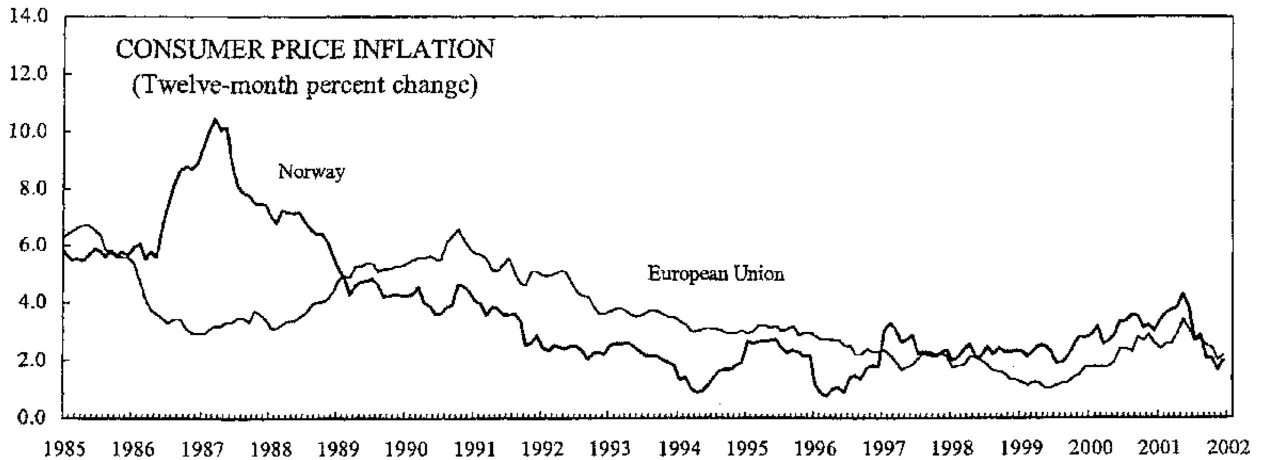


Source: Statistics Norway; and IMF staff estimates.

Figure 4. Norway: Indicators of Competitiveness







Source: WEFA Intline database; IMF, World Economic Outlook.
1/ Nominal effective exchange rate data for 2001 is as of November 2001.
2/ Real effective exchange rate data for 2001 is as of October 2001.

heavily influenced by the mid-2001 halving of the VAT rate on food to 12 percent—dampening the CPI by about 1 percentage point on an annual basis—and a temporary surge in electricity prices. Underlying inflation, excluding changes in energy prices and taxes, has slowed to 2.7 percent in December, reflecting offsetting domestic and external influences. Prices of home-produced consumer goods facing the least competition from foreign products and the prices of services with wages as the dominant cost factor rose by 7.8 percent and 5.6 percent, respectively, in the year through December. On the other hand, the global economic slowdown and an appreciation of the krone have kept imported goods prices stable.

9. **Stock prices have slumped and other asset price inflation has eased.** Although Norway, with its Nordic neighbors, is at the forefront of the use of new-economy technologies, its production in this sector is confined to niche areas, aimed mostly at the domestic market. Therefore, the impact of the global tech downturn has been less pronounced in Norway than in Finland and Sweden (Figure 5). The stock market decline in September 2001 and the prior bursting of the technology bubble are likely to have limited wealth effects since equity ownership accounts for only about 10 percent of household wealth. The growth in housing prices and credit has tapered off through the year, although the latter remains at a high level.

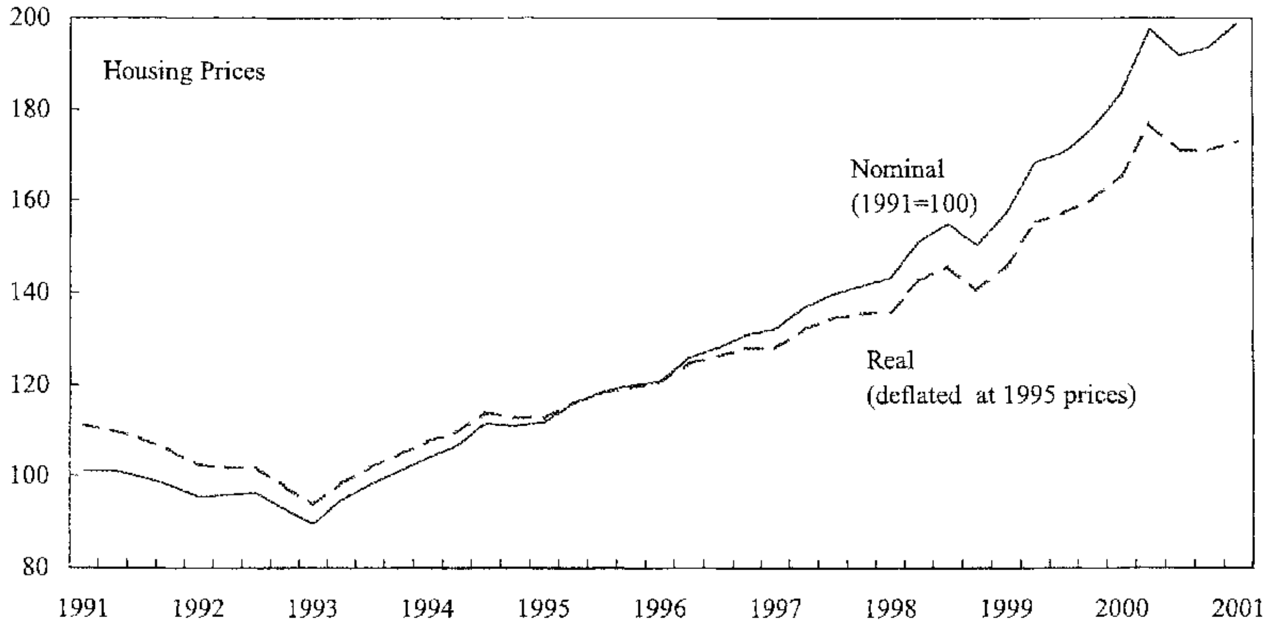
10. **The continued strength of the external position reflects peak oil production and high oil prices through most of the year.** The nonoil current account is expected to register a deficit of 7½ percent of GDP. However, Norway—the world's third largest oil exporter—is approaching its peak years of oil production, which is expected to decline gradually over the next several decades. Oil prices fell to $19 per barrel in the fourth quarter of 2001 (Figure 6), pushing down the annual average to around $24 per barrel, still substantially above the authorities' long-term oil price assumption. Oil and gas exports are estimated to exceed 20 percent of GDP, leading to a projected current account surplus of around 12 percent of GDP (Figure 7). Net foreign assets are projected to rise from 23 percent of GDP at end-2000 to 35 percent of GDP at end-2001 (Table 2).

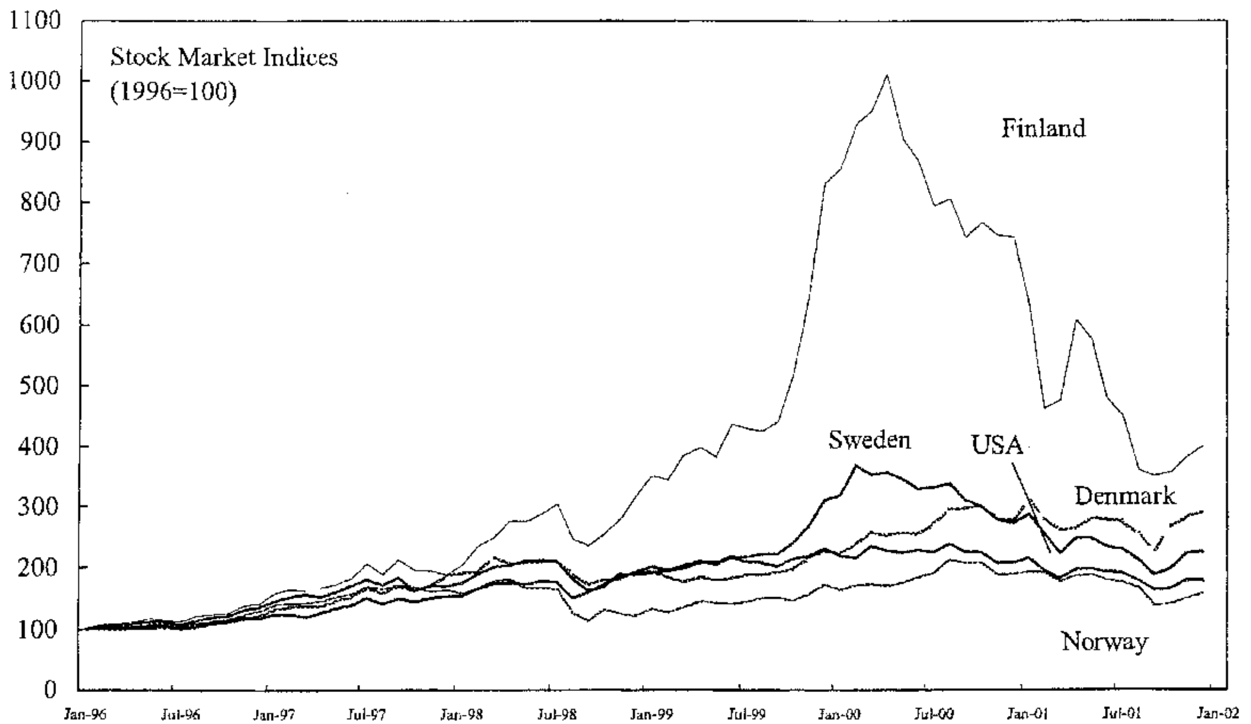
11. **The krone has appreciated in effective terms over the past year and a half.** Real and nominal effective exchange rates, based on consumer prices, have appreciated by more than 6 percent since spring 2000. The strength of the krone can be attributed partly to the rising interest rate differential since 2000—induced in part by the planned fiscal expansion—and to a favorable shift in the terms of trade (Figure 8).

B. The Policy Setting

12. **Norway's prudent management of its resource wealth has contributed to solid public finances.** Much of the fiscal revenue from past petroleum extraction has been used to finance nonoil fiscal deficits. However, the policy of investing abroad a substantial part of the government's oil and gas revenues (through the Government Petroleum Fund (GPF))

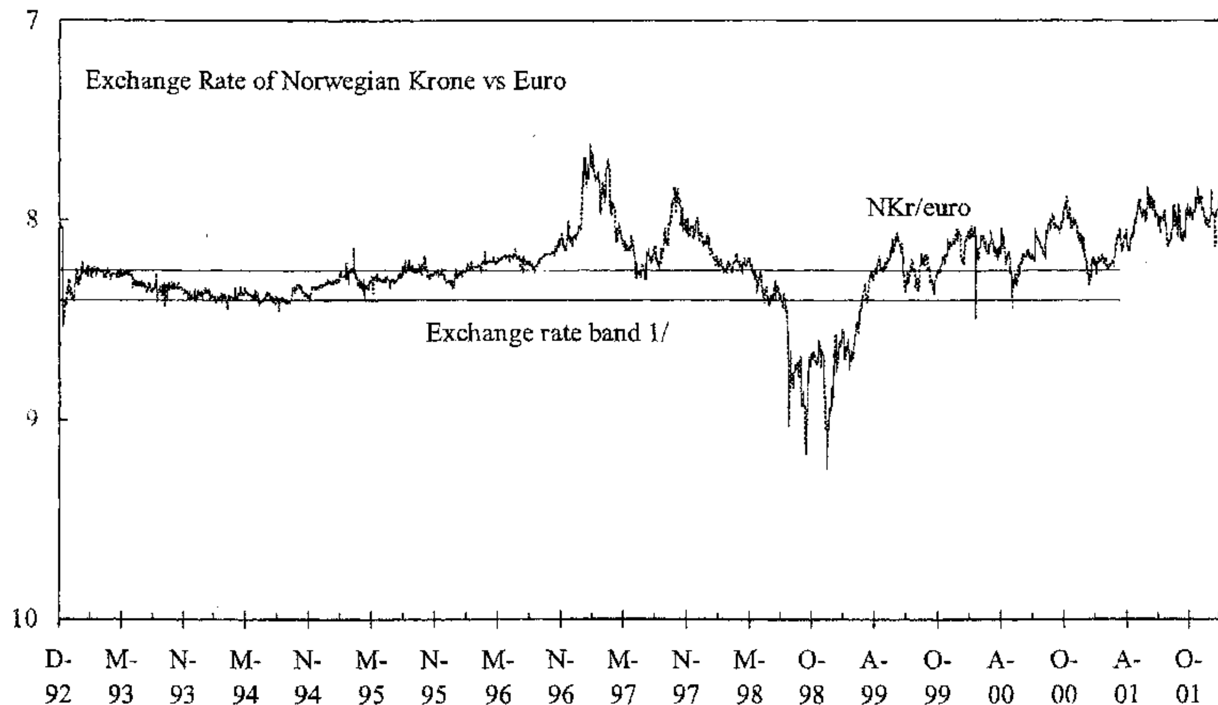
Figure 5. Norway: Asset Prices, 1991-2001

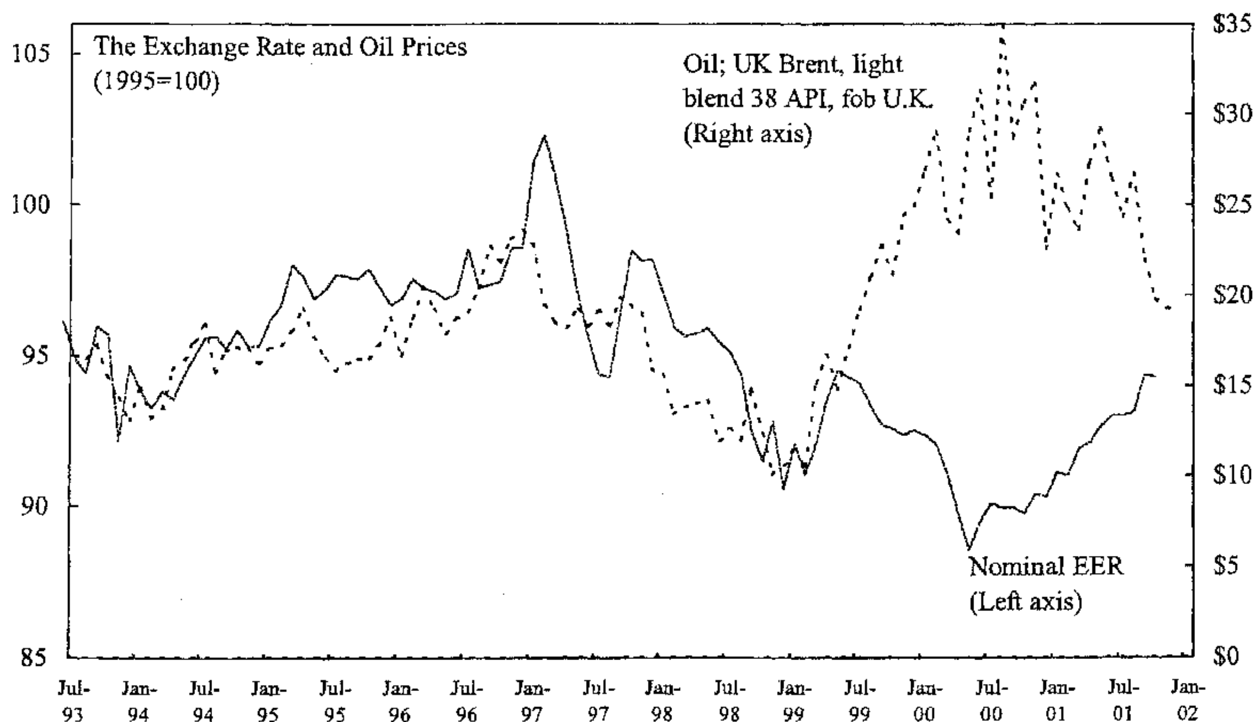




Source: Statistics Norway; and Bloomberg.

Figure 6. Norway: Exchange Rate Developments, 1992-2001

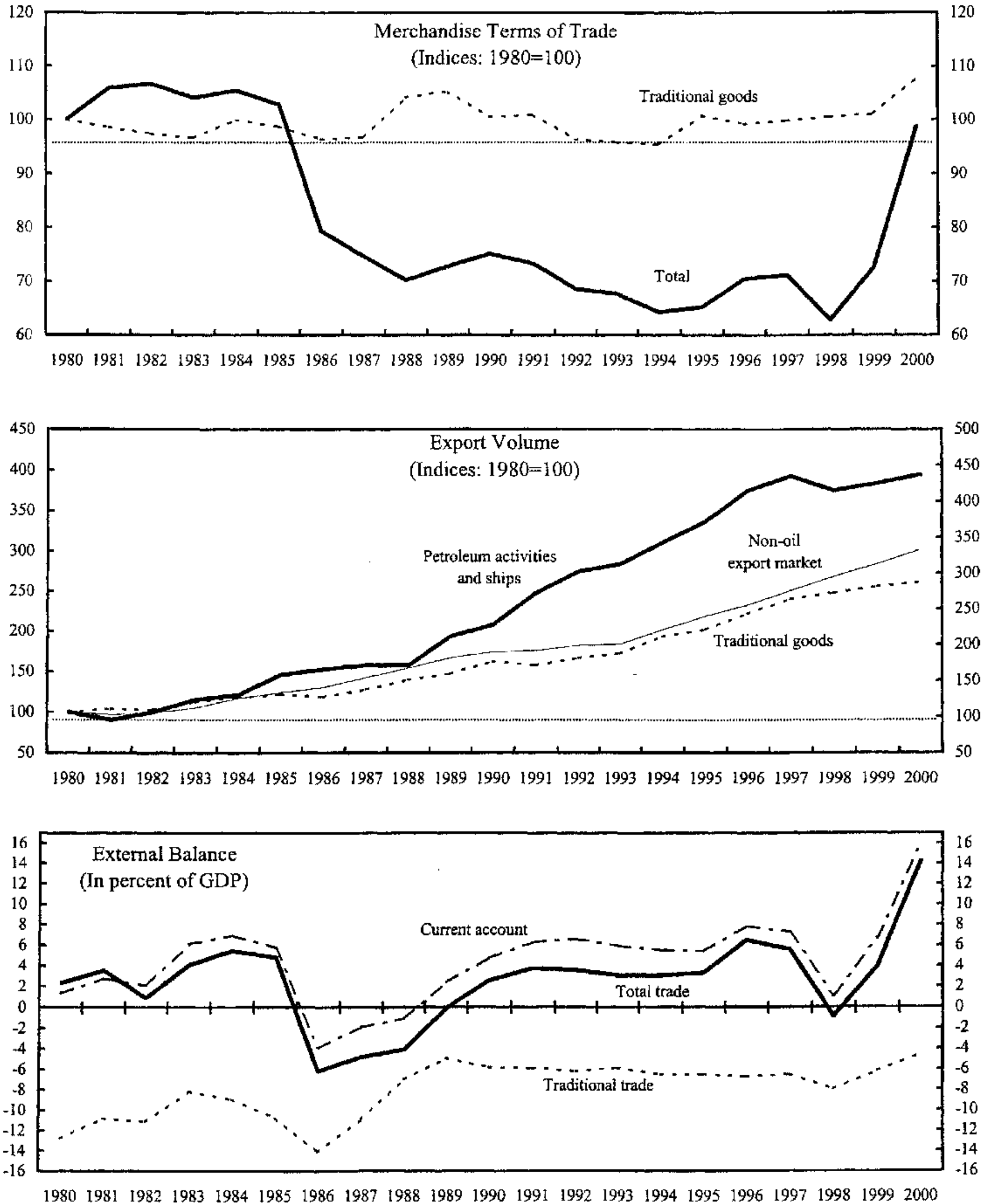




Source: WEFA, Intline Database; and International Financial Statistics.

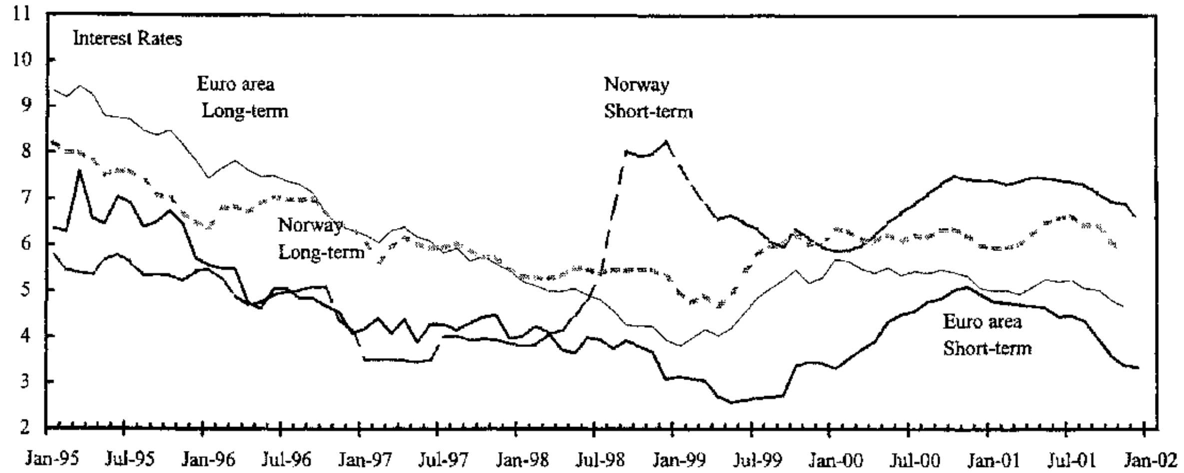
1/ An inflation targeting regime was adopted on March 29, 2001, replacing the former implicit exchange rate band.

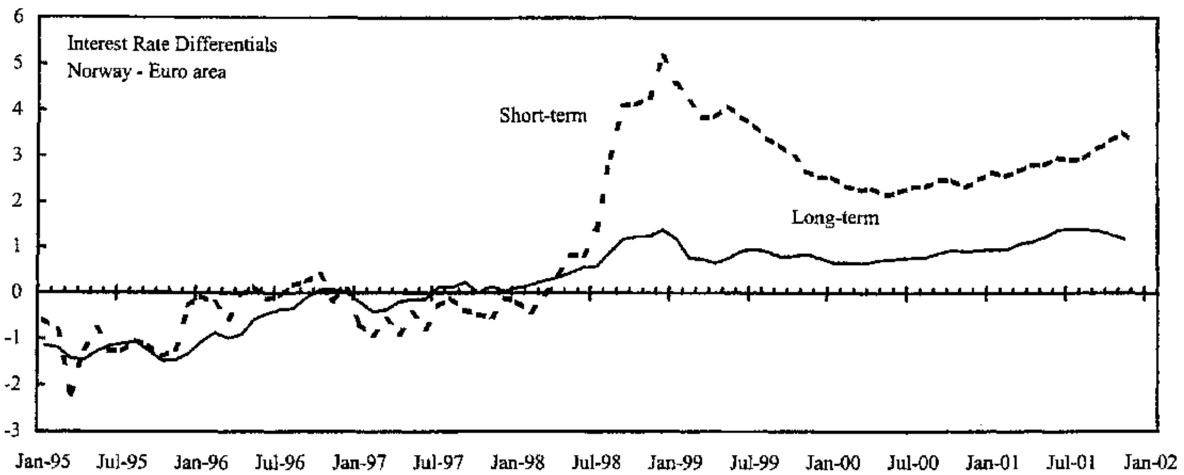
Figure 7. Norway: External Developments 1980-2000

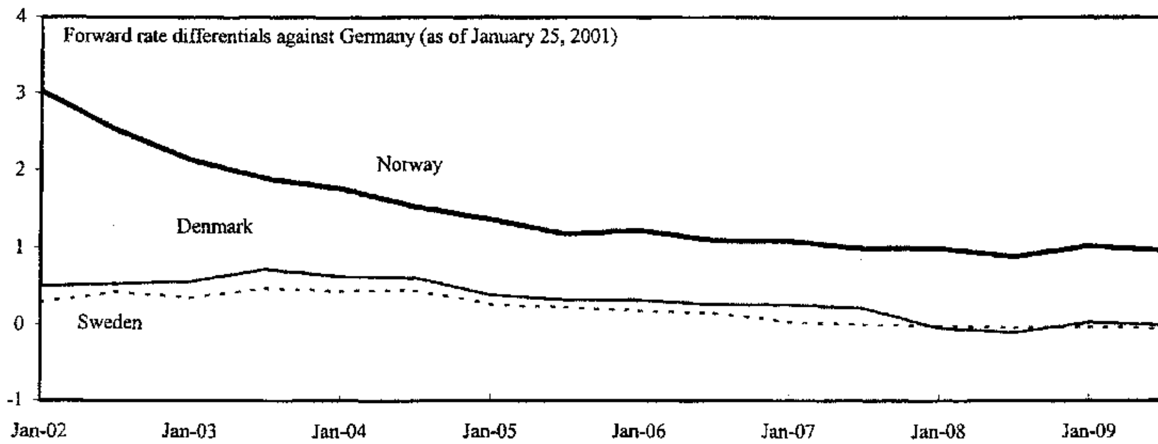


Source: Statistics Norway; and IMF, World Economic Outlook.

Figure 8. Norway: Interest Rate Developments.





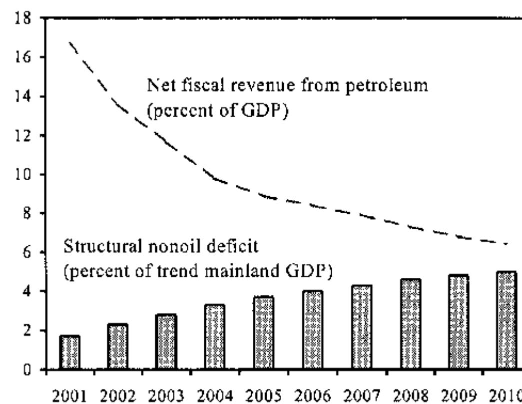


Source: IMF, International Financial Statistics; and WEFA.

introduced in the 1990s, has helped to mitigate "Dutch disease" effects.[1] Oil revenues are also contributing to a general government fiscal surplus estimated at 16 percent of GDP in 2001 (Table 3).

13. **Pressures on public spending continue, driven partly by perceptions of rising oil wealth.** These pressures have been felt especially by local governments, responsible for the bulk of spending on health and education. Indeed, a broadly neutral fiscal stance of the state budget was undermined by a rapid rise in the wage bill of local governments in 2001, leading to a general government stimulus close to 1½ percent of GDP (Figure 9). The general government fiscal stance is expected to be more expansionary than the state budget in 2002 as well, with the stimulus projected at ¾ percent of GDP.[2]

14. **A policy to accelerate the use of oil revenues was adopted in 2001, implying a cumulative fiscal stimulus of over 3 percent of GDP over this decade.** A broad consensus for the policy change, announced in March 2001 in the Long-Term Programme (LTP) 2002-2005, had been building up and gathered steam in the run-up to the Parliamentary elections.[3] The LTP stipulates a structural nonoil central government deficit each year corresponding to the expected real return on the market value of GPF assets at the beginning of the year. This rule amounts to raising the nonoil deficit by an additional 0.4 percentage points of mainland GDP on average each year to reach 5 percent of GDP in 2010.



Source: Amended National Budget 2002, Ministry of Finance.

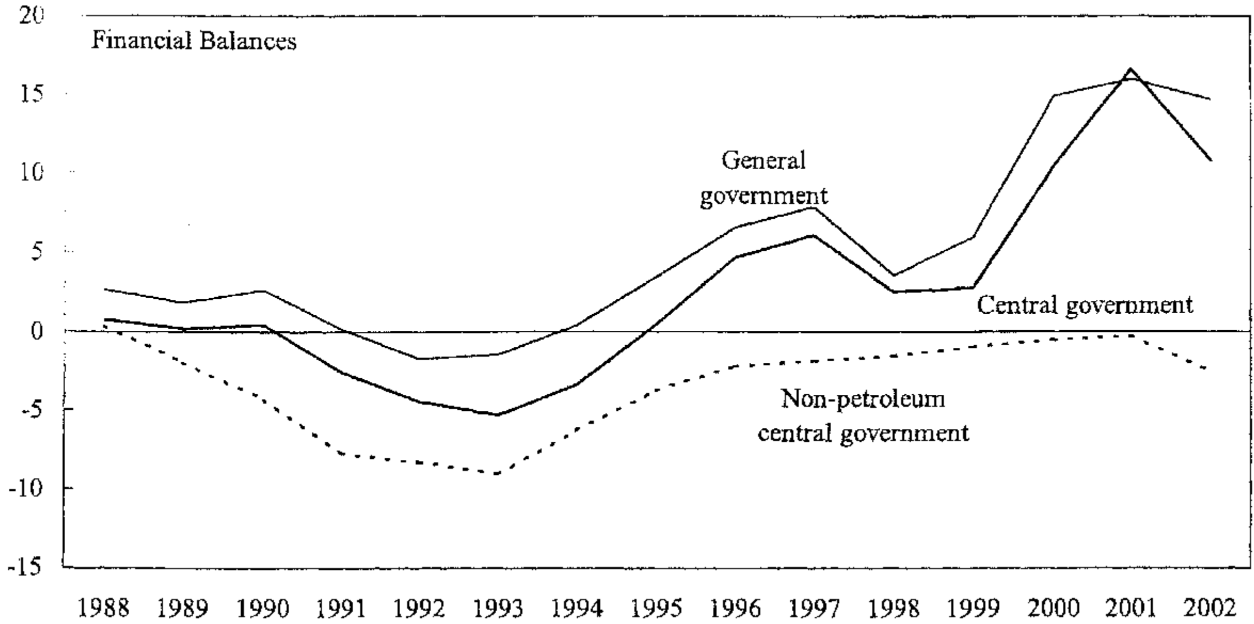
15. **The new government adhered to the fiscal rule in the budget for 2002, but shifted the balance towards reduced taxation.** The room for fiscal expansion is used to cut

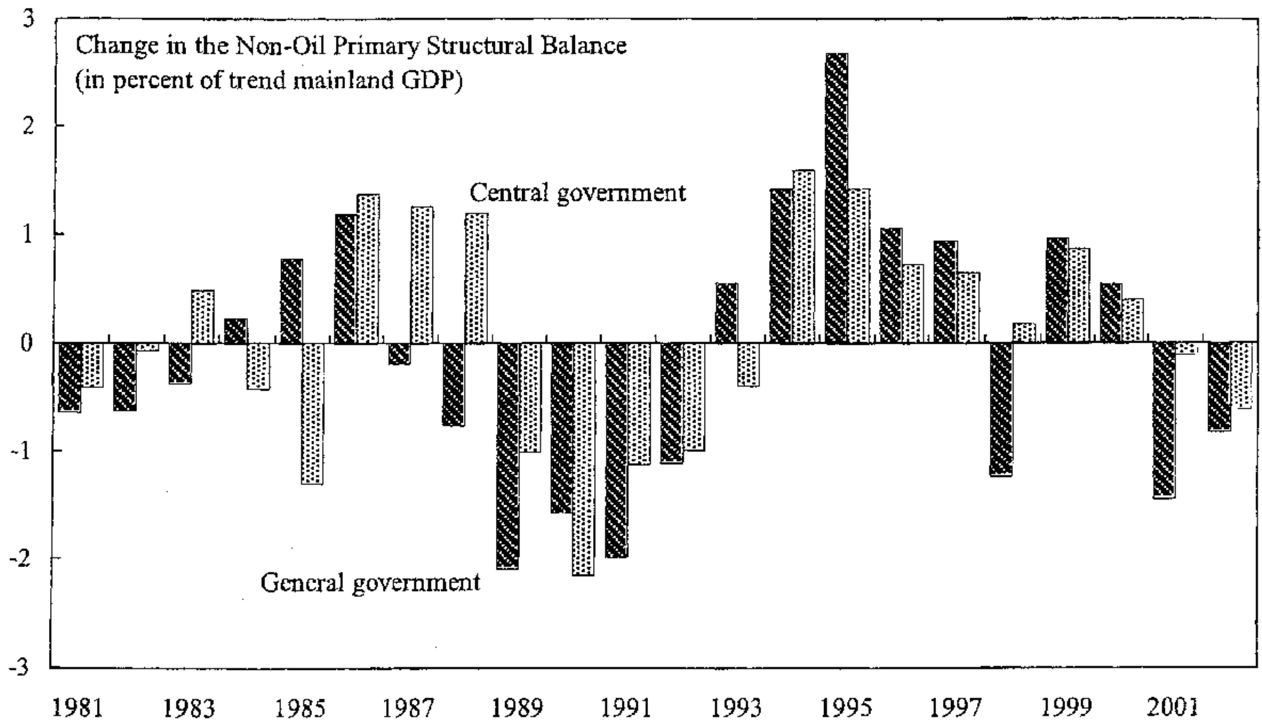
[1] In many countries, resource windfalls have been associated with worsening economic performance and some evidence suggests that economic growth is inversely related to the share of natural resources in exports (Sachs J. and A. Warner, December 1995, "Natural Resource Abundance and Economic Growth," NBER Working Paper 5398).

[2] The fiscal stimulus is measured by the change in the cyclically adjusted nonoil balance excluding interest payments, transfers from Norges Bank, and extraordinary items of a one-off nature.

[3] The government, in conjunction with Parliament, formulates a Long-Term Programme once every four years. These fiscal guidelines are used as an input in the annual budget process.

Figure 9. Norway: Public Finances
(In percent of GDP)





Source: Ministry of Finance and IMF staff estimates.

taxes, rather than the equal mix of tax and spending measures envisaged in the draft budget of the previous government.[4] Moreover, the rise in real spending is to be kept below the growth in mainland GDP. These policies are consistent with the new government's announced priorities, which include tax cuts of about 1½ percent of GDP over four years, to modernize the public sector and accelerate privatization.

16. **An inflation targeting regime was formally adopted in March 2001.** The new mandate to Norges Bank calls for monetary policy to aim at ensuring low and stable inflation (see Selected Issues Paper). The operational target is defined as an annual increase in consumer prices of 2.5 percent. In general, inflation is expected to be within a 1 percentage point deviation from either side of the target. Monetary policy is to be forward looking and the direct effects on consumer prices stemming from changes in interest rates, taxes, excise duties, and extraordinary temporary disturbances would be generally excluded. Over the two-year period prior to the change in regime, Norges Bank had gradually moved toward allowing greater short-term flexibility in the exchange rate, reinterpreting its previous guideline for exchange rate stability as a medium-term goal rather than as a short-term operational target.

17. **Monetary policy has been eased somewhat in recent months, but overall monetary conditions remain relatively tight.** In keeping with its new mandate for targeting inflation, Norges Bank held policy interest rates unchanged at 7 percent for most of 2001, following increases totaling 150 basis points in 2000 to stem price pressures. However, it cut policy interest rates by 50 basis points on December 12, 2001 and indicated a bias towards further easing. In January, Norges Bank left the rates and the easing bias unchanged. Ex-post real interest rates exceeded 5 percent before the December interest rate cut, and the nominal appreciation of the krone also contributed to tight monetary conditions.[5]

C. Short-Term Outlook

18. **Mainland GDP growth is expected to remain sluggish in 2002.** The sharp fall in oil prices toward the end of 2001 contributed to a decline in household confidence in Norwegian economic prospects that is likely to persist this year. Weak overseas demand and recent losses of competitiveness are expected to hold back nonoil exports. Sustained high real interest rates, weak business profitability, and the continued decline of oil-related investment would also dampen demand. However, the economic slowdown in Norway is expected to be contained, assuming that the WEO forecast of an upturn in the world economy in the second half of 2002 materializes. Moreover, growth is underpinned by solid income gains and a continued high level of employment. On balance, mainland GDP is projected by staff to grow

[4] The annual draft budget is presented to Parliament in October, while an updated budget providing a mid-year review is presented in May.

[5] Based on headline consumer price inflation. The corresponding real interest rates using the underlying index that forms the basis for monetary policy decisions (CPIATE) were around 4.5 percent prior to the monetary easing.

continued high level of employment. On balance, mainland GDP is projected by staff to grow by 1¼ percent in 2002. Double-digit external and fiscal surpluses as a percent of GDP, although declining, are expected to persist.

19. **Despite continuing sectoral wage pressures, headline inflation is expected to remain subdued.** Notwithstanding the projected closing of the positive output gap, capacity and labor supply constraints in several sectors are likely to persist, adding to wage pressures in those areas. Particularly strong pressure is expected in healthcare where hospital staff will be transferred from the local to the better-paid central government in January 2002 as part of health sector reform. However, the baseline projection assumes that the weak position of the exposed sector, traditionally the lead sector in wage bargaining, will restrain wage growth. Moreover, the decline in headline inflation will allow real income gains without excessive nominal wage increases. The halving of VAT for food in mid-2001 will lead to a lower average price level throughout 2002 for this component. In addition, the unusually high electricity prices of early 2001 will drop out of 12-month inflation. These influences are expected to keep average headline inflation subdued at around 1½ percent in 2002, then rising to 2½ percent in 2003 as they fade out.

20. **While less pronounced than a few months earlier, downside risks to mainland growth persist, given the possibility of weaker-than-projected oil prices and world growth.** In particular, a sustained fall in oil prices below 15 U.S. dollars per barrel could trigger a sharp contraction in oil-related investment and activity. Moreover, the transmission of the international slowdown to the Norwegian economy was delayed until the decline in oil prices in autumn 2001, but could gather pace this year. If this scenario were to transpire, a deeper contraction in traditional exports and weaker consumption would lead to a sharper slowdown across the economy. If, on the other hand, the international recovery in 2002 were to prove stronger than now expected, inflation pressures could resume, given the still tight labor market and sectoral capacity constraints.

Staff's Economic Projections (percent change)

	2001	Baseline 2002	Worse Case 2002
Domestic Demand	0.6	1.4	0.5
Exports	3.2	2.0	0.0
of which: traditional goods	2.0	-0.5	-4.0
Mainland GDP	1.2	1.3	0.5
Total GDP	1.4	1.8	1.5
Output gap (percent of pot. GDP)	0.8	-0.1	-1.2
Oil prices (USD per barrel)	24.3	20.0	16.0

III. The Policy Discussions

21. **The discussions centered on the new macroeconomic policy framework following the decision to accelerate the use of oil wealth.** In particular, the main topics included:

- The rationale for the **decision to accelerate the use of the oil wealth** over the next decade and the implications of this shift for long-term fiscal sustainability and short-term stabilization policy.
- The adoption of a **formal inflation targeting framework** in the context of the new fiscal strategy and the increased onus placed on monetary policy for stabilization.
- **Structural reforms**—of the tax and pension systems, management of the large public sector, and the wage bargaining framework—needed to ease the adjustment of the exposed sector and to ensure economic growth as oil resources are depleted and demographic pressures mount.

Officials and staff concurred that while Norway's record of managing its oil wealth was generally laudable, the authorities now faced the challenge of shaping policies in the new framework so as to ensure macroeconomic stability and long-term fiscal sustainability. This challenge, on the backdrop of the impending demographic transition and the national commitment to an equitable sharing of the oil windfall with future generations of Norwegians, provided the key theme of the discussions.

A. The Macroeconomic Framework

22. **The authorities viewed the changes in the fiscal and monetary regimes as integrally linked.** Officials, noting the long-standing attachment of the trade unions to exchange rate stability, felt that the change in the monetary policy regime would not have been accepted by all of the social partners if it had not been accompanied by an accelerated use of oil wealth. Likewise, the change in monetary regime was partly intended to contain potential concerns about the impact of the expansionary fiscal policy implied by the new long-term fiscal strategy on inflation prospects.

23. **The primary discretionary role in stabilization will shift from fiscal to monetary policy.** Under the Solidarity Alternative, fiscal policy was assigned the task of actively smoothing the economic cycle through discretionary measures. Officials noted that since the new fiscal rule was stipulated in terms of structural deficits, automatic fiscal stabilizers would continue to operate. Moreover, the new fiscal rule allows for the use of discretionary measures around a trend increase in nonoil structural budget deficits. Nevertheless, the authorities thought the scope for such discretionary action was likely to be limited in practice by the need to ensure the credibility and discipline of the new rule, by the political constraints faced by the minority government in adjusting the budget, and by the prospective difficulty of counteracting any deviation from trend in one year with offsetting action in later

years. These factors were seen to place a greater onus for stabilizing economic cycles on monetary policy. The new inflation targeting regime was viewed as providing sufficient flexibility to this end. The mission noted that discretionary stabilization efforts through the state budget were often thwarted by local government expansion, and saw merit in basing tax and expenditure plans on medium-term considerations.

24. **The sustained fiscal expansion is expected to entail real appreciation over the long term due to "Dutch disease" effects.**[6] The authorities recognized that the new fiscal strategy—recently endorsed by the electorate—could lead to protracted real appreciation (which they assumed would broadly parallel Norway's inflation differential with trading partners) and a further contraction of the nonoil exposed sector. They agreed that this prospect underlined the urgency of pushing forward with structural reforms to ease the burden placed on this sector. As for the level of the real exchange rate, officials, stressing the high degree of uncertainty, saw it roughly at its equilibrium level, while the IMF's macroeconomic balance approach points to some limited room for real appreciation. Officials and staff concurred that the expected cyclical weakness created room for a moderate macroeconomic stimulus in 2002, and that the implied policy mix of a modest fiscal stimulus and some reduction in the high interest rates was not problematic based on any near-term exchange rate considerations.

B. Fiscal Policy

25. **The authorities viewed the new fiscal guideline as a useful clarification and a reasonable political compromise in the face of the clamor to spend the oil wealth.** Officials noted that the public pressure to use more oil resources in the near-term had proven politically difficult to resist, with the visible accumulation of wealth in the GPF blunting public awareness of Norway's large public pension liabilities. Under the Solidarity Alternative, fiscal stabilization was seen to imply that the budget had to maintain a neutral fiscal stance on average and this was interpreted as meaning that one could *never* phase in the use of the GPF. The authorities hailed the new fiscal rule as a simple way to communicate how and when such use will occur, a step toward discipline, and politically viable as it provided more room for popular spending increases or tax cuts. They noted its theoretical underpinning in the permanent income hypothesis and its conservative bias since it took into account only verifiable accumulated financial assets, rather than uncertain income flows from

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[6] Historically, the exploitation of resource wealth has been accompanied by an appreciation of the real exchange rate, see Corden (1984, "Booming Sector and Dutch Disease Economics", Oxford, Economic Papers #36, pp. 359-380). Montiel (1997, "The Theory of the Long-run Equilibrium Real Exchange Rate," Williams College Working Paper), and Edwards (1989, Real Exchange Rates, Devaluation and Adjustment, Cambridge: MIT Press) demonstrate in theoretical models that increasing government spending directed mainly toward non-traded goods and services would lead to an appreciation of the long-term real exchange rate.

petroleum extraction. However, they cautioned that keeping nonoil structural deficits on a trend implied by the rule over the next ten years was by no means easy as assets continued to build up in the GPF.

26. **The moderate fiscal stimulus implied by the Long-Term Programme for 2002 was viewed as fortuitously supportive of activity.** Given the easing of demand and inflation pressure expected in 2002—and the plausible risk of a weaker-than-expected international recovery leading to a negative output gap—the ½ percent of GDP fiscal stimulus in the state budget was viewed as being in line with cyclical requirements. Officials considered that the projected economic slowdown might have justified increasing the structural deficit beyond that implied by the new fiscal rule, but the government wished to avoid undermining the credibility of the rule, particularly in its initial year. Some of the budgeted stimulus would take effect late in 2002 and into the next year due to the timing of tax cuts, implying a carryover of the stimulus into 2003. This carryover, combined with continued fiscal expansion, could contribute to excess demand pressures as activity gathers speed, and together with compositional effects—since tax cuts would likely produce lower initial stimulus than spending increases—could complicate demand management slightly. Nevertheless, the staff saw the shift to reduced taxation as clearly desirable from the standpoint of long-run growth and efficiency.

27. **The mission stressed that the policy of using more of the oil wealth in the near-term had raised the risk to the long-term sustainability of public finances.**[7] Over the next quarter century, population ageing will entail substantial outlays for public pensions. Long-term projections—while highly sensitive to a variety of assumptions—illustrate the tenuous viability of the long-run fiscal position, even before taking account of the new fiscal rules (Box 2).[8] The authorities acknowledged that the Programme's assumption that future non-pension public spending could be squeezed to make room for the expected surge in pension liabilities was ambitious, especially given the prospect that the public sector would be called upon to provide increased health and elderly care services for an ageing population. They were optimistic that a future change in public sentiment would allow increasing tax rates on pensions to the same level as those on working income, which would help fill the gap. They, however, agreed that this did not detract from the need to reform the public pension system.

28. **Pension reform has at long last been put on the policy agenda.** A high-powered commission will evaluate options for pension reform by 2003. The mission discussed some of these options with a broad cross-section of the policy community. Many recommended

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[7] Based on concerns about long-term fiscal sustainability due to the impending demographic transition, the staff and the Executive Board had last year advised against raising nonoil deficits.

[8] See Chapter 1 of Norway—Selected Issues 2000 (SM/01/12) for an analysis of the sensitivity of the long-run projections to alternative assumptions.

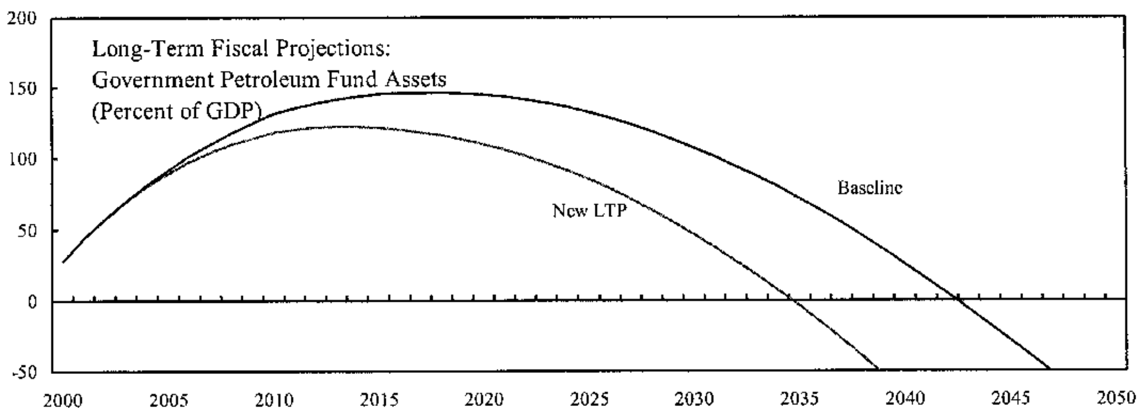
Box 2. Implications of the New Fiscal Guidelines

New fiscal guidelines are intended to increase the use of Norway's oil wealth over the next 10 years. The new rules were presented in the government's Long-Term Programme 2002-5, and are reflected in the 2002 budget. The new fiscal guidelines are as follows:

- Each fiscal year, the structural, nonoil, central government budget deficit shall approximately correspond to the expected real return on the Government Petroleum Fund at the beginning of the fiscal year. This rule amounts to raising the deficit by an additional 0.4 percentage points of mainland GDP on average per year to 5 percent in 2010.
- The expected real return on the GPF is estimated at 4 percent.
- The spending rule for oil revenues should take into consideration the stage of the economic cycle, providing restraint if the economy is at risk of overheating and stimulus if a downturn is expected.
- In the event of extraordinarily large changes in the GPF's capital or in factors behind the structural, nonoil deficit from one year to the next, the change in the use of oil revenues should be spread over several years on the basis of an estimate of the size of the real return on the GPF some years ahead.

The expected depletion of oil revenue and the surge in social security expenses threatens long-term fiscal sustainability, despite large current general government surpluses. Gross contingent obligations for old-age and disability pensions are estimated at over two and a half times GDP. An increase in the number of elderly persons will also require additional resources for health and old-age care services. At the same time, net cash flow from petroleum activities is expected to decline sharply to negligible levels over the next several decades.

GPF assets would be used up much faster under the new fiscal guidelines. While long-term projections involve a high degree of uncertainty, using reasonable assumptions, GPF assets would be exhausted before 2050 without additional measures, even before accounting for the new fiscal guidelines.1/ Under the new rules, GPF balances would be depleted roughly 10 years earlier.



1/ **The main assumptions underlying the projections consist of the following.** The scenario is based on the budget for 2002 and constant non-oil revenue and expenditure (excluding pensions) levels in relation to GDP subsequently, except the non-oil deficit increases by 0.4 percent of mainland GDP in the new LTP scenario. 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 from 2001-2006, and then trend down to Norway's 2002 Budget assumption of 135 kroner per barrel in 2002 prices by 2010. Oil production forecasts include a normal rate of discovery of new reserves, as provided by the Ministry of Oil and Energy. The real rate of return on GPF assets is assumed to be 4 percent.

using the Petroleum Fund to introduce an element of funding—in part to help develop the thin Norwegian financial markets—but noted that oil wealth alone could not cover the surge in public pension liabilities expected over the next decades. Therefore, substantive reform would be required to put the generous pension system on an actuarially sound footing. The mission inquired whether switching the pension system to a funded basis using GPF balances would lessen pressures for further fiscal expansion. The authorities feared that any incomplete reform involving partial funding could be misread to mean that the system had been fixed, and thereby lead to even higher pressure to spend any residual oil wealth. The authorities underlined that the pension reform should also address the strong incentives in the current system for early retirement that would, if unchecked, lead to a dramatic decline in effective labor supply. Indeed, they noted that some groups earn less by working than by retiring. Liberal access to disability pensions also contributed to a rapid exit from the labor force.

29. **The government underlined its commitment to further reducing the tax burden over the medium-term and to a comprehensive tax reform.** The mission welcomed the goal of reducing Norway's tax burden, which is high by international standards.[9] The authorities noted recent measures to enhance tax neutrality and efficiency, including the abolition of the investment tax—effective October 2002—and the elimination of last year's temporary tax on dividend income. In addition, the plan to increase the standard income tax allowance and the threshold for the surtax would help reduce marginal tax rates for some income groups. The government saw broad political support for the principles of neutrality and tax efficiency embedded in the 1992 tax reform and pointed out that a reduction of the differential between the top marginal tax rates on capital and labor income would help tighten loopholes associated with the dual income tax regime. The mission also suggested ending the extensive tax preferences that benefit primarily the energy-intensive and shipping industries. The government's policy agenda also included cuts in unpopular indirect taxes. The mission advised that while some reductions in rates may be necessary due to international tax competition, changes that narrow the tax base should be avoided. In the same vein, the VAT base should be expanded to cover most of the remaining services. Staff also stressed the importance of reducing the discrimination currently in favor of wealth held in the form of real estate and against financial assets, especially since Norway's tax burden on real estate is relatively low in an international context.[10] Such a change would reduce

[9] Nonoil taxes were 49½ percent of mainland GDP in 2000, compared to an average tax burden of 37½ percent of GDP in the OECD countries and 41½ percent for the European Union.

[10] Statistics Norway estimates the revenue loss from lenient treatment of owner-occupied housing at about 1 percent of GDP per year, and the potential welfare gains 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.

incentives for overinvestment in real estate, help develop Norwegian financial markets and help channel more savings to risk capital.

C. Monetary Policy and Financial Sector

30. **The inflation targeting regime commands support from all social partners.** There was a broad consensus that the legitimacy of the new regime rested on the formal change in the monetary mandate initiated by the government. The gradual shift during 1999-2000 away from attempts to manage short-term exchange rate movements and Norges Bank's effective efforts to communicate its policies to the public had facilitated the shift to the new regime. Indeed, most observers did not anticipate any major alteration in the operation of monetary policy, as Norges Bank had already focused on bringing inflation down to the level aimed at in the euro area as a means of obtaining medium-term exchange rate stability.[11] The discussions centered on the details of the new framework (see Box 3), including the following:

- **By setting the level of the inflation target at 2½ percent, the government hopes to minimize the transition costs of the expected real appreciation.** The authorities viewed the target as being consistent with the recent Norwegian experience. Adoption of a lower target would have implied tighter monetary conditions in the transition period, which could hinder the absorption of redundant labor of exposed industries into the sheltered (nontraded) sector as the real exchange rate appreciates. The authorities expected the average inflation differential relative to trading partners to be on par with the real appreciation anticipated as a result of the planned fiscal expansion, facilitating medium-term nominal exchange rate stability. Moreover, higher inflation, rather than nominal appreciation, was expected to lead to a more gradual and less volatile path of real appreciation. Finally, a higher inflation target was expected to facilitate real wage flexibility in the presence of downward nominal wage rigidities.

- **The authorities viewed the inflation targeting regime as sufficiently flexible.** By targeting future inflation, monetary policy would also help stabilize output and employment. While Norges Bank had announced a target horizon of 2 years, the flexibility built into its mandate allowed the Bank the option to extend the horizon—which they would announce in advance—to ease the costs of returning inflation to target after an unusually large shock.

- **Medium-term exchange rate stability is viewed by the authorities as a desirable side-effect of inflation targeting.** While exchange rate stability continues to be included as an objective in the monetary policy regulation, the authorities strongly underlined their commitment to the medium-term inflation forecast as the operational target. By achieving

[11] In previous consultations, staff had stressed the economic advantages of inflation targeting, given Norway's exposure to large terms of trade shocks and its asynchronous business cycle relative to trading partners.

Box 3. The Norwegian Inflation Targeting Framework

Norway adopted a new inflation targeting framework on March 29, 2001. In accordance with the new regulation on monetary policy, the central bank aims at implementing monetary policy that is oriented towards low and stable inflation with a **target for consumer price inflation set at 2½ percent**. Thus, the new regime replaced the previous managed float system aimed at keeping the exchange rate stable against European currencies. However, the practical conduct of monetary policy is not likely to change markedly as the ultimate goal of the previous system was to be achieved by bringing inflation down to the level aimed at in the euro area.

Institutional set-up for the inflation targeting regime

- Norway has an institutional framework conducive to an efficient conduct of monetary policy. The government sets the inflation target for the central bank, thus increasing society's "ownership" in the framework (**goal dependence**). At the same time, the central bank has the right to use its monetary policy instruments in the way that it believes is the best for achieving its goal of low inflation (**instrument independence**). The central bank's main policy instrument is the sight deposit rate. The Executive Board of the central bank is responsible for the practical implementation of monetary policy.

Accountability, transparency and communication with the public

- The central bank is accountable for its conduct of monetary policy and would need to provide an explanation in the case that it is not able or willing to bring the inflation rate back to its target within the two-year target horizon. The central bank's inflation forecast is presented its ***Inflation Report*** which is published three times a year. Further assessment is presented every six weeks in connection with the Executive Board's rate setting meetings. The central bank issues a press release with the Board's decision after every monetary policy meeting. The Board speaks with unanimous voice and no minutes from the meetings are published.

The design of the framework and operational issues

- The principal target of monetary policy is low and stable inflation with an **operational target for annual consumer price inflation set at 2½ percent**. The inflation target is slightly higher than the corresponding targets in Canada, the euro area, and Sweden, but equivalent to the targets in Australia and the United Kingdom. The target is also broadly in line with the average inflation rate in Norway in the 1990s.

- Due to various lags in monetary policy transmission, the central bank applies a **two-year horizon for achieving its inflation target**. The analysis done in the central bank suggest that most of the effects of interest rate changes are expected to occur within this period, owing largely to the widespread use of flexible short-term interest rates on loans to households. The regime can be characterized as "flexible" inflation targeting framework designed to limit excessive changes in output and employment.

- The central bank focuses on an **underlying measure of consumer prices**, that excludes the direct effects arising from the changes in real taxes and energy prices (CPIATE) [1 2].

- The central bank uses a **point target with an expected margin of +/- 1 percentage point.** The range of the margin also signals in advance the central bank's tolerance for deviations from the target's midpoint, while relatively narrow range provides clear focus for inflation expectations.

- The central bank has well-developed inflation forecasting capabilities. It bases its inflation projections presented in the ***Inflation Report*** on a macroeconomic model that is supported by smaller models and actively monitors additional information that becomes available between projections. The central bank's inflation forecasts are considered to be reliable, which is essential given the forward-looking nature of the inflation targeting framework.

The Norwegian framework draws from the previous experiences of the countries that had adopted inflation targets. While the design of the framework reflects several special characteristics of the Norwegian economy, such as the new fiscal framework as well as the small size and openness of the economy, the regime shares several institutional and operational features that have already been applied in industrial countries operating inflation targets.

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[1] Statistics Norway started publishing this series in November 2001 which is likely to strengthen the credibility and transparency of the regime.

[2] Since housing costs are measured through a rent survey—instead of using mortgage costs—and interest expenses are not directly included in other parts of consumer price survey either, no adjustments are needed to exclude the direct effect of interest rates changes from consumer prices.

low and stable inflation, the authorities hope to provide a medium-term anchor to the nominal exchange rate (consistent with medium-term purchasing power parity, albeit with some real appreciation). Labor unions continue to view exchange rate stability as an important goal, but believe that the forward-looking and flexible regime will help promote a stable currency.

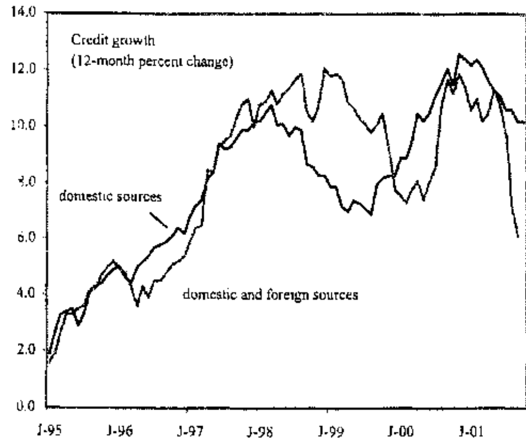
- **Norges Bank focuses on an underlying inflation index.** Officials noted that at the time the new regime was adopted, energy prices and tax changes had been the most volatile components of inflation, prompting the choice of the underlying index. However, future developments could induce a review of this choice. The mission cautioned against frequent changes in the index.

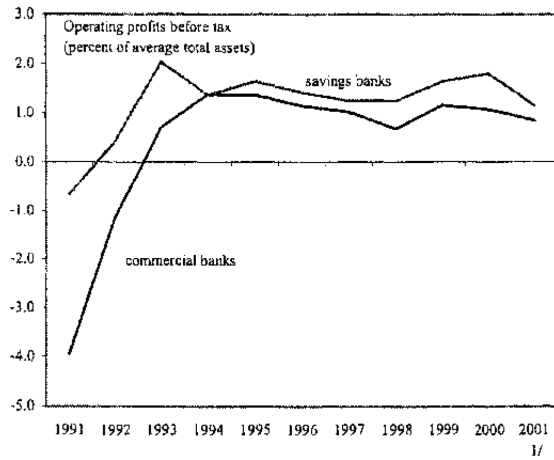
- **The institutional framework is seen as suitable for Norway.** The authorities, as well as staff, were satisfied that the institutional framework provided both the independence of monetary policy as well as the accountability for its performance to Parliament. The publication of three inflation reports per year and frequent communication with the public strengthens the transparency of the framework.

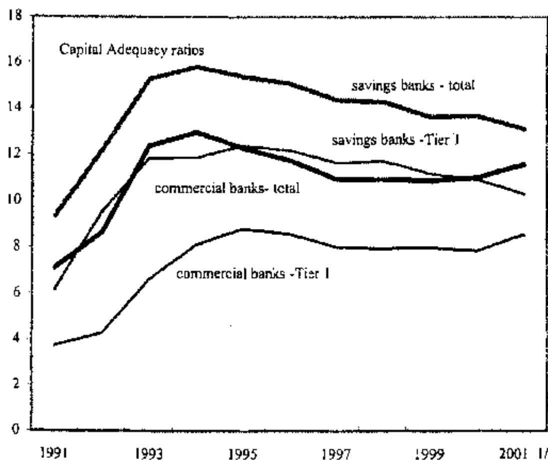
31. **As inflation pressures softened, room for interest rate cuts became evident.** Norges Bank noted that business profitability had weakened in recent years, some export industries had become increasingly affected by the decline in external demand, and unemployment had begun edging up. The authorities were also concerned about the risk of a deeper and more prolonged global downturn, and of significantly lower oil prices. On the upside, they noted the continued strength of the household and sheltered sectors and the fiscal stimulus slated for 2002. Staff view Norges Bank's recent rate cut of 50 basis points, which was more than most analysts expected, to be appropriate. Indeed, at the time of the discussions, the mission had seen timely monetary relaxation as useful to counter near-term risks to growth stemming from the external sector.

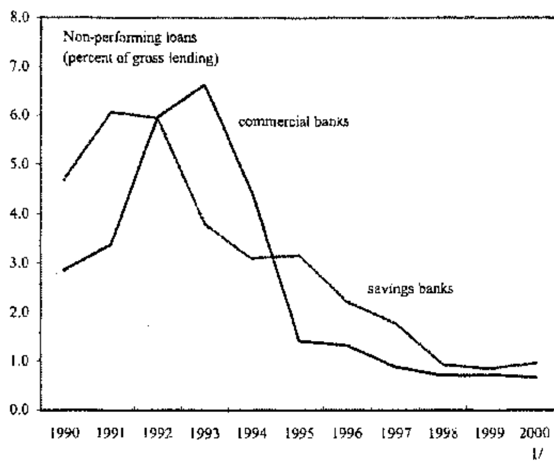
32. **The financial system remains stable, but the outlook has become more uncertain.** Although rapid domestic credit growth is currently leveling off, it has led to high indebtedness both in the enterprise and household sectors (Figure 10). While credit risk in the household sector is still relatively low reflecting increased housing wealth and moderate interest expenses, enterprises have become more vulnerable to a possible economic downturn. Declining earnings have added to risks involved in lending to mainland export enterprises. The credit quality of some industries may also be affected by structural changes associated with the transfer of resources to the public and other sheltered sectors. While banks' financial strength is still satisfactory, risks could also be amplified in Norway's concentrated financial system, with its increasingly important linkages across business areas and countries. The recent Financial Stability Report indicates that the financial supervisors are actively monitoring these risks. Norway was one of the first countries to adopt the Financial Action Task Force principles concerning anti-money laundering and anti-terrorist activities, and plans to fully implement the EU's anti-money laundering directive by summer 2002. The authorities said they would welcome an FSAP mission in the near future.

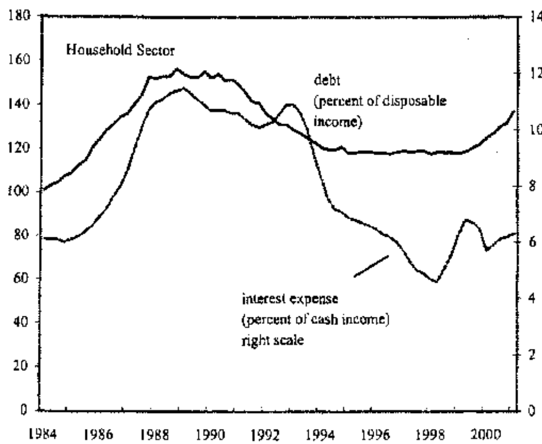
Figure 10. Norway: Indicators of Financial Sector Health.

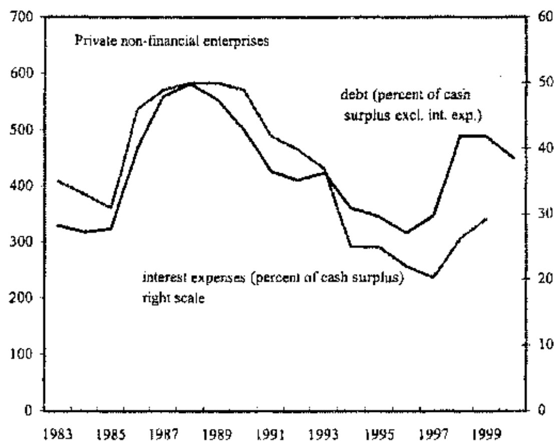










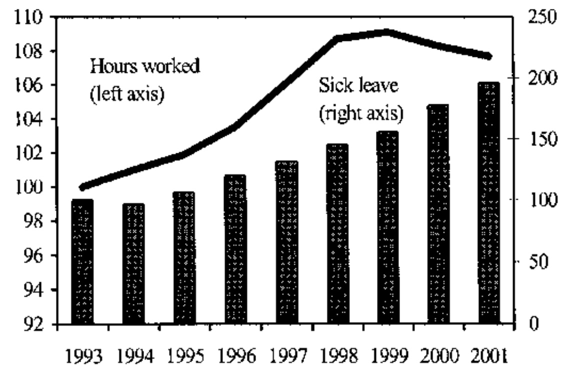


Source: Norges Bank and Banking, Insurance, and Securities Commission.
1/ Data refer to September 2001.

D. Labor Market Issues

33. **The authorities see a risk that the wage bargaining system would come under strain in 2002.** With the sheltered sector now dominant in size, the prospect of a continued lead role for the exposed sector was increasingly questionable; indeed it was viewed by some as akin to "a very short tail wagging a huge dog." Key additional pillars of the Solidarity Alternative were weakened by the formal introduction of the new policy framework and years of wage increases in excess of those in trading partners. The unbalanced labor market expected by spring—with job losses in the exposed sector combined with continued labor shortages in service industries—will reinforce these trends. The authorities agreed that there was a risk—as suggested by theory and experience in other countries—that moving to the middle ground between centralized and decentralized bargaining could further undermine wage restraint without eliminating the rigidities associated with centralized bargaining, most notably the compressed wage scale.

34. **Measures to increase effective labor supply need to be stepped up.** Despite steady increases in the labor force, the number of hours worked has declined since 1999. While the effective retirement age is still high by international comparison, disability retirement has increased by a sixth since mid-1997 to a level of 12 percent of the labor force in mid-2001. Effective labor supply has been constrained by this surge, as well as by increasing early retirement (up 183 percent in the last four years), a steady rise in the number of sick days taken, additional holidays agreed in centralized bargaining rounds, and restrictive labor market rules. A three-year agreement aimed at arresting the rising trend in exits from the active labor force involves trade unions pressing their members for restraint in availing themselves of sickness leave, early retirement and disability pensions. Unfortunately, the agreement fails to implement the key recommendation of the Sandman committee—charged with suggesting remedies—to reduce the high replacement ratios of these social programs. While concurring that ageing will worsen the underlying trends and thus economic incentives needed to improve, the authorities noted that the agreement remains in place for at least two years. The safety valve of higher inflow of foreign labor had been only partially effective in easing shortages in recent years. However, the authorities were hopeful of political support for a significant liberalization of immigration.



Source: National Budgets 2001 and 2002. (1993=100)

35. **The authorities aim to streamline policies to ensure labor market flexibility.** To enhance labor market efficiency and flexibility, the authorities will implement simplified rules for temporary employment, and have set up a Commission on the Working Environment—due to report in a year—to propose amendments for regulations concerning

hiring and firing, and hours worked. All job-search services are now delivered by the private sector. The authorities emphasized that it was critical to modernize the public sector, which employs a large part of the skilled labor force (see paragraph 37).

E. Structural Policies and Other Issues

36. **High current account surpluses mask the need for major structural adjustment as oil exports and income dwindle in the long run.** Export earnings and returns on the GPF are expected to more than offset the nonoil deficit, and net foreign assets are expected to grow to about 50 percent of GDP by end-2002. In the long run, Norway's oil wealth could finance a nonoil current account deficit of about 2¾ percent of GDP in perpetuity,[12] whereas it is projected at 7 percent over the next few years. The expansion of the public sector associated with the Long-Term Programme is likely to lead to sizeable long-run real exchange rate appreciation, further reducing competitiveness of traditional export industries. As oil production ebbs and GPF assets are drawn down to finance pension obligations and other expenditures, the nonoil current account will need to strengthen considerably.[13] Therefore, while the petroleum sector will contribute to strong current account balances over the medium term, the authorities were cognizant of the need for structural measures to ensure the long-run viability of the nonoil tradeables sector.

37. **While constrained by a tenuous political process, the new government has high hopes to modernize the public sector during its period in office.** The key measures include (i) establishing a single overriding objective for each public agency, (ii) clearly delineating the role of government and separating the public provision of services from their public production, (iii) raising local autonomy and complementing it by deregulation and strengthened central surveillance, and (iv) devising a more result-oriented public sector wage structure to enhance labor mobility both within the public sector, and between it and the private sector. These reforms often involve high initial costs, and active participation of government employees is a prerequisite for their success. The authorities indicated the need for revising transfer rules to subnational governments, and in due course reassessing the role of regional governments following the reallocation of health service provision—two-thirds of their activities—to central government. They noted that much of the discontent with the current health care system can be traced to rationing of services through queuing and rent-seeking supply restrictions.

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[12] Assuming a present value of oil wealth at 160 percent of GDP in 2001, a real rate of return of 4 percent on GPF assets, and potential mainland GDP growth of 2¼ percent.

[13] As discussed in detail in last year's Selected Issues Paper (SM/01/12), oil and gas exports are expected to decline to under 10 percent of GDP by the end of the decade, and to around 2 percent of GDP by mid-century.

38. **The government seeks to improve the functioning of product markets through privatization and deregulation.** The state oil and telecom companies, Statoil and Telenor, were partially privatized in 2001, and Christiania Bank was sold to the Nordea Group. The government has also awarded four nationwide licenses for third generation mobile communication systems, deregulated taxi services, and made entry requirements for pharmacies less restrictive. The authorities emphasized that the sale of remaining stakes in non-strategic public enterprises would proceed on a case-by-case basis. The government plans to strengthen the competition authority, streamline economic regulations and legislation, and substantially deregulate government procurement—a large component of aggregate demand—to provide room for private service providers on an equal footing with public ones.

39. **The trade system is generally liberal, but agricultural policies are highly protectionist.** Norway follows the EU's lead in trade policy. Least developed countries will effectively face zero tariffs following the government's proposed lifting of import duties and quotas on imports from the 49 poorest countries from July 2002. The authorities emphasized that Norway was pleased with the inclusion of fishing and antidumping on the agenda of the upcoming WTO round, and would like negotiations to also cover competition rules. The authorities argued that positive externalities (landscaping, biodiversity, and national food security) provided a rationale for agricultural subsidization, which stood at 1.4 percent of GDP in 2001. As for the longer term, the authorities noted that farming would remain sheltered as part of the government's objective to support sparsely populated regions, but they intended to reduce subsidies for downstream agricultural activities, such as food processing, toward the average EU level.

40. **Norway will cooperate with plans to reduce oil production to ensure price stability.** In December 2001, Norway decided to cut its oil production by 150,000 barrels per day in order to make its contribution to a joint effort by OPEC and non-OPEC members to stabilize the price of oil. The cut represents almost 5 percent of Norway's daily oil production, although the authorities did not expect it to have any impact on employment.

41. **Norway's official development assistance as a percent of GNP is one of the highest in the world.** The authorities intend to raise ODA further to 0.92 percent of GNP in 2002 from 0.85 percent of GNP last year.

42. **Norway has adopted the OECD's Anti-bribery Convention.** Implementing legislation entered into effect in January 1999.

43. **Norway's economic statistics are adequate for surveillance purposes** in their coverage, quality, and timeliness (see Appendix III). Norway has subscribed to the special data dissemination standard and its metadata are included in the Dissemination Standards Bulletin Board.

IV. Staff Appraisal

44. **Norway has begun a transition to a new macroeconomic policy framework.** This framework is intended to cope with the long-term pressures stemming from the exploitation of natural resources. While the new long-term fiscal program clarifies the strategy regarding the use of oil wealth, it raises concerns about long-term fiscal sustainability. The new inflation targeting regime provides a suitable framework to respond to shocks, including those from volatile terms of trade. Looking ahead, a successful transition to the post-oil era would hinge on significant progress on the structural front.

45. **The global slowdown is expected to affect Norway in 2002, albeit modestly.** The exposed sector—already feeling the impact of softer demand and slumping prices—is likely to slow down, while sheltered sectors continue to grow and experience constraints on capacity and labor supply. On balance, mainland growth is projected to be sluggish early in 2002, but gather pace along with the expected world recovery in the second half of the year. However, the risk of even weaker growth than is now projected cannot be discounted, particularly if oil prices were to weaken sharply. Given the expected cyclical slowdown and the downside risks, the modest fiscal stimulus in the budget for 2002 implied by the Long-Term Programme is fortuitous.

46. **The adoption of an inflation targeting framework is a welcome affirmation of the authorities' commitment to low and stable inflation.** The government has rightfully taken the responsibility for choosing the level of the inflation target, and has thereby indicated its preferred balance between inflation and nominal exchange rate appreciation in the event of the anticipated real appreciation. The target of 2½ percent for inflation is appropriate, given the economic adjustment implied by the use of oil resources. In implementing the framework, it will be important for Norges Bank to react to movements in the exchange rate only to the extent that they affect the inflation forecast at its target horizon. The decision to exclude temporary influences from the price index to prevent a volatile interest rate path is appropriate, but Norges Bank should abstain from frequent changes to its definition of the underlying price index so as to avoid any perception that attempts were being made to justify deviations of inflation from its target level.

47. **The recent monetary easing by Norges Bank was appropriate, but a lasting reduction in interest rates is contingent on fiscal policy and wage moderation.** During the course of 2001, even as interest rates abroad fell, Norges Bank held a steady hand, reflecting Norway's tight labor market and cyclical divergence from its trading partners. Indeed, with inflation running significantly above target in the first half of the year and strong domestic inflationary impulses, Norges Bank is to be commended for its commitment to bringing inflation back to its target path. The success in dampening underlying inflation and the subdued outlook for growth that emerged at the end of 2001 provided some room for monetary easing, which the authorities have been using. However, staff would see limited further scope for easing, in part because the Long-Term Programme places an added burden on monetary policy and thus on the inflation targeting framework. Indeed, as the negative impulses and downside risks associated with the global outlook recede and the stimulus from

fiscal policy begins to add to demand pressures from late 2002 on, renewed monetary tightening would likely be required in the present policy setting. A more enduring relaxation of the current high interest rates would be possible only if the social partners are able to ensure wage moderation in the upcoming bargaining round.

48. **The new Long-Term Programme, calling for spending more of the oil revenues over the next decade, reinforces concerns about long-term fiscal sustainability.** While the new Programme presents a simple fiscal rule, without a substantive reform of the pension regime, its implementation implies a drastic squeeze on non-pension public spending in the future. Absent an early pension reform, a desire to maintain the current share of non-pension public spending in GDP in the future—let alone to allow it to rise in line with the demands of demography—would force Norway to violate the fiscal rule and could thus result in the exhaustion of the fund before mid-century. Such exhaustion would be at odds with the admirable Norwegian principle of solidarity across generations. An alternative fiscal rule that would allow for a larger build-up of resources in the Petroleum Fund, would help mitigate the future squeeze on non-pension spending. A balanced strategy of public finance is called for—one that stimulates potential growth through tax reform, frees up additional resources by improving labor market incentives and public sector efficiency, and designs a long-term plan to address the variety of needs of an ageing population while preserving a fair share of the oil wealth for future generations.

49. **The economic restructuring associated with increased spending of oil wealth creates an urgent need for structural measures to improve microeconomic efficiency and the viability of the nonoil export sector.** Economic costs implied by the long-term fiscal expansion, especially if it takes the form of higher public spending, may begin surfacing soon in the form of a further real appreciation and pressures on the nonoil exposed sector. Structural reform, including privatization and deregulation to foster competition, will be required to help counter these forces and ensure viable industries.

50. **Tax cuts to raise growth and efficiency could help mitigate the detrimental impact of the new fiscal rule on the private economy.** In this context, the new government's decision to shift the balance of fiscal action toward larger tax cuts rather than higher spending and to aim at a medium-term reduction in the public spending ratio is in the right direction. A comprehensive tax reform should aim to restore the principles underlying the reform of 1992, including tax neutrality and efficiency. Such measures would help raise growth and thereby alleviate the economic costs of the fiscal expansion.

51. **An overhaul of the pension system as part of an adequate response to the demographic transition is long overdue.** The popular perception of Norway's large oil wealth has regrettably delayed serious effort to address its unsustainable social insurance system. While oil wealth could play a role in easing the cost of the demographic transition, a policy change that ignores the need for substantive pension reform and relies solely on renaming the Government Petroleum Fund should be avoided. The recently-appointed pension commission should aim at a comprehensive reform. The financial viability of the pension system would need to be ensured. A closer link between benefits and contributions

should be established to foster a sense of ownership in the system, such as by creating an automatic adjustment mechanism to balance the present value of the pension system's liabilities with its contributions and assets. To provide for private choice and help deepen Norwegian financial markets, a small defined contribution element could be accumulated gradually through annual savings. The reform should also reduce the major disincentive effects of the current pension and tax regimes on labor supply, and address the increased health and elderly care costs resulting from the demographic transition.

52. **The emphasis of the strategy for public spending should be on increasing its efficiency, rather than its level.** Announced intentions to reform the public sector are welcome. These reforms will require stronger incentives and substantial market elements, including improved pricing mechanisms, more extensive privatization, result-based financial management and salary structures, and better intra-governmental transfer mechanisms. Further growth in public employment should be reined in by reducing excessive bureaucracy and reallocating labor to its most efficient uses. The authorities also need to act quickly to restrain the rapid rise in costs in some social insurance programs, especially in sickness leave and early retirement.

53. **Wage moderation and more vigorous structural measures are needed to ensure competitive and flexible labor markets.** An excessive rise in public sector wages, which could fracture the social consensus for maintaining competitiveness, should be avoided. The authorities should implement the Sandman commission's recommendations, including the reduction of the replacement ratio for extended sickness absence. Labor supply constraints could be eased by reforming the unemployment benefit structure, and by easing rules on fixed-term contracts, working hours, and hiring and dismissals. The government's intention to liberalize the inflow of immigrant labor is a welcome step toward easing labor shortages. Allowing increased wage flexibility would reward investment in education and in productive industries, and ensure that the young and low-skilled are not crowded out of employment.

54. **Norway should complement its generous aid to the developing world with reduced budgetary and trade protection of agriculture.** The intention to raise official development assistance as percent of GNP is commendable. However, the subsidy to agriculture, which costs over one percent of output and has failed to achieve the objective of preventing the depopulation of rural areas, is damaging to the exports of developing countries that have a comparative advantage in this sector. Direct budget transfers that are not linked to output or trade would be a more appropriate means of supporting rural communities.

55. It is expected that Norway will remain on the standard 12-month consultation cycle.

Table 1. Norway: Economic Outlook

	1999	2000	Staff Est. 2001	Staff Forecasts 2002	Staff Forecasts 2003-05	Official Forecasts 1/ 2002	Official Forecasts 1/ 2003-05
	(Percent change from previous year)						
GDP: Total	1.1	2.3	1.4	1.8	2.0	2.7	1.6
Mainland	1.0	1.8	1.2	1.3	2.1	1.6	2.0
Private consumption	2.2	2.4	1.9	2.2	2.4	2.7	2.8
Public consumption	3.3	1.4	2.3	2.0	2.5	1.5	2.2
Gross fixed investment	-8.2	-1.1	-4.0	-1.0	1.5	0.5	-1.2
Oil activities	-19.8	-17.1	...	...	...	-2.3	-11.6
Mainland	-2.6	1.4	...	...	...	0.9	0.9
Domestic demand	-0.7	2.2	0.6	1.4	2.2	2.0	1.7
Exports	2.8	2.7	3.2	2.0	2.5	3.8	2.4
Imports	-1.6	2.5	1.2	1.0	3.0	1.9	2.8
Consumer prices	2.3	3.1	3.0	1.5	2.5	1.5	2.5
Wages	5.0	4.5	4.6	4.5	4.5	4.3	...
Employment	0.7	0.5	0.5	0.2	0.5	0.3	0.4
Unemployment rate (Percent of labor force)	3.2	3.4	3.6	3.8	3.7	3.6	3.3
Output gap (Mainland) (Percent of potential GDP)	2.2	1.8	0.8	-0.1	-0.1	...	...
Current account balance (Percent of GDP)	4.1	14.3	12.4	10.2	9.8	11.1	7.6
Non-oil current acount balance (Percent of GDP)	-9.2	-7.2	-7.4	-7.2	-6.9	...	-7.8

Sources: Ministry of Finance and staff estimates.

1/ Forecasts for 2002 are based on the Amended National Budget for 2002, as published on November 9. Forecasts for 2003-05 are based on the National Budget published on October 11.

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

	1996	1997	1998	1999	2000	2001 1/
Balance of payments						
Goods and services						
Exports	64.3	63.3	54.6	59.8	75.4	64.2
Goods	49.9	48.9	40.6	45.7	60.1	49.7
Non-factor services	14.4	14.4	14.0	14.1	15.3	14.5
Imports	50.7	51.8	53.2	50.4	49.3	40.9
Goods	37.6	37.7	38.9	35.5	34.4	27.9
Non-factor services	13.2	14.1	14.3	14.9	14.9	13.0
Trade balance	12.3	11.2	1.6	10.2	25.7	21.8
Services balance	1.2	0.3	-0.3	-0.8	0.4	1.5
Balance of goods and services	13.6	11.6	1.3	9.4	26.1	23.3
Balance of factor payments	-3.3	-2.9	-2.6	-3.1	-3.0	-2.0
Current account balance	10.2	8.7	-1.3	6.3	23.1	21.3
(In percent of GDP)	6.5	5.6	-0.9	4.1	14.3	...
Net capital flows	-0.1	-0.2	-0.1	-0.1	-0.2	-0.1
Net financial flows	-1.7	-7.3	0.0	0.4	-11.7	-22.7
Reserve changes	-6.5	1.3	6.5	-6.0	-3.4	0.7
Memorandum items:						
Net foreign assets						
(In percent of GDP)	5.2	8.4	8.1	11.1	23.0	34.6 2/
Government Petroleum Fund						
(In percent of GDP)	4.6	10.5	15.1	18.4	27.2	45.0 2/
Nominal effective exchange rate (1995=100)	100.3	100.8	97.0	95.5	92.8	95.2
Real effective exchange rate (1995=100) 3/	99.8	101.1	98.2	97.9	96.1	99.3

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

1/ Jan-Oct.
2/ Official projection for end of year.
3/ Based on CPI.

Table 3. Norway: Financial Indicators

	1997	1998	1999	2000	Est. 2001	Proj. 2002
			(In percent of GDP)			
State Budget:						
Revenue	43.6	42.3	41.7	45.2	52.5	50.0
of which: oil revenue	9.8	6.5	6.3	13.0	18.7	14.2
Expenditure	37.5	39.8	39.0	34.4	35.9	39.5
of which: oil investment	1.9	2.5	2.6	1.6	1.9	1.1
Balance	6.1	2.5	2.7	10.8	16.6	10.4
of which: non-oil balance	-1.8	-1.6	-1.0	-0.6	-0.3	-2.6
Structural non-oil balance 1/	-3.1	-3.0	-2.0	-1.6	-1.7	-2.3
Change from previous year	0.7	0.2	0.9	0.4	-0.1	-0.6
General Government:						
Revenue	51.8	49.9	51.7	55.7	58.8	59.6
Expenditure	43.9	46.4	45.8	40.8	42.8	44.9
Balance	7.9	3.5	5.9	14.9	16.0	14.7
Non-oil balance excl. interest	-1.7	-2.3	-1.9	-1.5	-2.1	-2.9
Structural non-oil balance 1/	-3.2	-4.4	-3.5	-2.9	-4.4	-5.2
Change from previous year	0.9	-1.2	1.0	0.5	-1.4	-0.8
Gross public debt	28.6	27.0	23.5	22.0	21.5	22.0
Monetary Indicators:						
M2 2/	2.5	4.6	10.9	9.0	7.7 3/	...
Domestic credit 2/	10.2	8.3	8.3	12.4	9.8 3/	...
Three-month interbank rate 4/	3.7	5.8	6.5	6.7	7.2 3/	...
Ten-year government bond yield 4/	5.9	5.4	5.5	6.2	6.2 3/	...

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

1/ Percent of trend mainland GDP.
2/ End-period, percent change, national definition.
3/ November 2001.
4/ Period average, in percent.

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

	1996	1997	1998	1999	2000
External Indicators					
Exports of goods and services (annual percentage change, in U.S. dollars)	17.3	8.1	-8.1	13.3	42.3
Imports of goods and services (annual percentage change, in U.S. dollars)	9.9	12.0	9.7	-2.1	10.3
Terms of Trade (annual percentage change)	8.1	1.0	-11.8	15.6	36.0
Current account balance	6.5	5.6	-0.9	4.1	14.3
Capital and financial account balance	-5.2	-4.0	4.3	-3.7	-9.7
Direct investment, net	-1.7	-0.8	0.7	1.4	-1.4
Portfolio investment, net	-6.1	-6.5	-1.5	-1.9	-10.3
Central Bank international reserves (end of period, in billions of U.S. dollars)	26.4	23.4	18.7	24.1	27.8
Exchange rate against US dollar (NOK, period average)	6.3	6.5	7.1	7.6	8.8
Exchange rate against Euro (NOK, period average)	8.2	8.0	8.5	8.3	8.1
Real effective exchange rate (based on CPI, annual percentage change)	-0.2	1.3	-2.8	-0.3	-1.8
Financial Markets Indicators					
Gross public debt (end of period)	31.0	28.6	27.0	23.5	22.0
3-month T-bill yield (nominal, in percent per annum)	4.9	3.7	5.8	6.5	6.7
3-month T-bill yield (ex post real, in percent per annum)	3.6	1.2	3.1	4.2	3.7
spread of 3-month T-bill vs. Germany (percentage points, end of period)	1.6	0.4	2.3	3.6	2.4
spread of 10-year T-bill vs. Germany (percentage points, end of period)	0.5	0.2	0.8	1.0	0.9
General stock index (annual percentage change)	30.8	27.0	-25.8	42.3	9.8
Real estate price index (annual percentage change)	9.2	8.1	6.3	17.0	10.1
Credit from domestic sources (growth rate in percent)	6.2	10.2	8.3	8.3	12.4
Financial Sector Risk Indicators					
Loans to assets, commercial and savings banks (in percent)	78.3	81.1	82.2	81.2	82.2
Tier 1 capital ratio, commercial banks	8.6	8.0	8.0	8.0	7.8
Tier 1 capital ratio, savings banks	12.2	11.7	11.7	11.2	10.9
Share of foreign exchange loans 1/	4.9	5.4	7.2	7.1	8.6
Share of foreign exchange deposits 1/	4.1	4.0	3.6	3.4	3.5
Operating profits before tax, commerical banks (in percent of average total assets)	1.1	1.0	0.7	1.2	1.1
Operating profits before tax, savings banks (in percent of average total assets)	1.4	1.2	1.2	1.6	1.8
Household debt (in percent of disposable income)	118.4	119.0	118.3	122.0	132.0
Private non-financial enterprise debt (in percent of cash surplus excluding interest expense)	316.0	347.0	489.0	489.0	450.0

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

Norway: Basic Data

Social and Demographic Indicators	
Area	323,878 square kilometers
Population (2000)	4.49 millions
Population growth (1999-00)	0.7 percent
GDP per capita (2000)	US$ 35,508
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	2001
	(Volume changes in percent)					
Private consumption	5.3	3.6	3.4	2.2	2.4	1.9 1/
Public consumption	2.8	1.9	3.8	3.3	1.4	2.3 1/
Gross fixed investment	9.9	13.9	10.6	-8.2	-1.1	-4.0 1/
Export of goods and services	9.3	6.1	0.3	2.8	2.7	3.2 1/
Of which : Oil and gas	-13.7	2.9	-3.6	-0.1	6.4	5.5 1/
Import of goods and services	8.0	11.3	8.0	-1.6	2.5	1.2 1/
GDP	4.9	4.7	2.4	1.1	2.3	1.4 1/
Mainland GDP 2/	3.8	4.2	3.6	1.0	1.8	1.2 1/
	(In percent of labor force)					
Unemployment	4.9	4.1	3.2	3.2	3.4	3.6
	(Percentage changes)					
Consumer prices	1.3	2.6	2.3	2.3	3.1	3.0
Hourly labor cost in manufacturing	4.1	4.8	5.9	5.0	4.5	4.6
Effective exchange rate						
Nominal	0.3	0.5	-3.7	-1.6	-1.8	4.5
	(Twelve-month percent change, national definition, end of period)					
Domestic credit	6.2	10.2	8.3	8.3	12.4	9.7
Broad money	6.0	2.5	4.6	10.9	9.0	8.6
	(In percent)					
Three-month Interbank rate	4.9	3.7	5.8	6.5	6.7	6.6
Ten-year government bond yield	6.8	5.5	5.3	6.1	6.0	6.2
	(In percent of GDP)					
State budget, including social security						
Revenues	42.6	43.6	42.3	41.7	45.2	52.7 1/
Expenditures	37.9	37.5	39.8	39.0	34.4	35.9 1/
Overall balance	4.6	6.1	2.5	2.7	10.8	16.6 1/
General government financial balance	6.6	7.9	3.5	5.9	14.9	16.0 1/
Current account balance	6.5	5.6	-0.9	4.0	14.3	12.4 1/
International reserves (in months of imports of goods and services)	6.3	5.4	4.1	4.8	5.2	4.1

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 January 2002.

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

NORWAY: FUND RELATIONS

(As of December 31, 2001)

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	1,094.38	65.5
	Reserve position in Fund	577.33	34.5

III.	**SDR Department**:	**SDR Million**	**% Allocation**
	Net cumulative allocation	167.77	100.0
	Holdings	282.06	168.1

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

V. **Financial Arrangements**: None

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

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

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

VIII. **Article IV Consultation**: Discussions for the 2000 Article IV Consultation were held in Oslo, October 17-24, 2000. The Staff Report (SM/00/286) was considered by the Executive Board on January 26, 2001.

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

X. **Resident Representative**: None

Norway: Core Statistical Indicators

(As of January 16, 2002)

	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	01/16/02	12/31/01	11/30/01	11/30/01	11/30/01	01/16/02	Dec. 01	Dec. 01	Oct. 01	2001	2001 Q3	Jun. 01
Date Received	01/16/02	01/08/02	01/12/02	01/04/02	01/04/02	01/16/02	01/10/02	01/15/02	12/21/01	11/09/01	12/06/01	Oct. 01
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
March 1, 2002

Information on economic and financial developments that has become available since the release of the staff report (SM/02/36, 2/6/02) does not change the thrust of the staff appraisal.

1. **Norges Bank held policy interest rates unchanged at its monetary policy meeting on February 27.** The policy bias was shifted from its earlier easing signal to one of neutrality.

2. **The growth of output slowed in the final quarter of 2001.** Preliminary national accounts data confirms the deceleration, with mainland output growth of 0.2 percent in the fourth quarter of 2001, mainly due to a negative contribution from net exports. Mainland GDP grew by 1 percent in 2001, marginally below the staff's estimate. Overall GDP growth, at 1.4 percent, was in line with expectations.

3. **Recent indicators point to a rise in consumption and consumer confidence.** Private goods consumption picked up towards the end of last year. The Norsk Gallup overall consumer confidence index rose sharply in the first quarter of 2002, with a particularly marked increase in households' confidence in their own financial situation.

4. **Both headline and underlying inflation fell in January 2002.** The sharp decline in headline inflation, from 2.1 percent in December 2001 to 1.3 percent in January, was mainly due to the phasing out of previous increases in some indirect taxes and electricity tariffs and to aggressive after-Christmas sales. Underlying inflation—the consumer price index adjusted for changes in indirect taxes and energy prices—also declined, to 2.5 percent from 2.7 percent in December.

5. **The krone has continued to appreciate in exchange markets since the beginning of the year.** The krone has risen over the past two months by about 1½ percent against the U.S. dollar and by about 2½ percent against the euro.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/23
FOR IMMEDIATE RELEASE
March 7, 2002

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

IMF Concludes 2001 Article IV Consultation with Norway

On March 1, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Norway.[1]

Background

A consensual policy framework supported Norway's strong economic expansion since 1993. A policy of investing abroad a large part of oil revenues through the Government Petroleum Fund has continued to underpin stability by insulating the economy from the fluctuating fortunes of the oil sector and has helped build the foundation for an equitable sharing of oil wealth with future generations of Norwegians. The macroeconomic strategy contributed to achieving among the best economic fundamentals in Europe, most notably virtually full employment despite a sharp rise in the participation rate. A new coalition government, elected in September, set in train a policy redirection toward reducing Norway's high tax burden.

Real mainland (nonoil) GDP is estimated to have grown well below potential in 2001, at 1¼ percent. Although high oil prices supported household confidence and domestic activity through most of the year, the global slowdown has recently begun to affect Norway. Labor market conditions remain tight in service sectors, but weakened in technology and traditional export industries. Employment grew by ½ percent, keeping the average unemployment rate broadly unchanged at 3½ percent. A decline in competitiveness and slowing external demand impaired nonoil exports, but peak oil production and high oil prices through most of the year

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

contributed to an expected current account surplus in excess of 12 percent of GDP. High oil revenues also contributed to a general government surplus of around 16 percent of GDP.

Despite high domestic cost increases, consumer price inflation has been held in check by low krone import prices. Consumer prices rose by 2.1 percent in the year through December 2001, down significantly from a mid-year peak of 3.8 percent. Labor costs continued to outpace that in trading partners by 1½-2 percentage points despite weaker productivity growth in Norway, and contributed to high inflation rates for home-produced consumer goods. However, global competition and an appreciation of the krone have kept imported goods prices stable.

Mainland GDP growth is expected to remain sluggish in 2002. The sharp fall in oil prices toward the end of 2001 contributed to a decline in household confidence in Norwegian economic prospects that is likely to persist this year. Weak overseas demand and recent losses of competitiveness are expected to hold back non-oil exports. Sustained high real interest rates, weak business profitability, and the continued decline of oil-related investment would also dampen demand. However, the economic slowdown in Norway is expected to be contained, assuming that the World Economic Outlook forecast of an upturn in the world economy in the second half of 2002 materializes and the level of employment remains high. On balance, mainland GDP is projected to grow by 1¼ percent in 2002, but downside risks remain. Double-digit external and fiscal surpluses as a percent of GDP are expected to persist. Various temporary factors are projected to restrain average headline inflation to around 2 percent in 2002, which is then expected to rise to 2½ percent in 2003 as these influences fade out.

An inflation targeting regime was formally adopted in March 2001. The operational target is defined as an annual increase in consumer prices of 2.5 percent. In general, inflation is expected to be within a 1 percentage point deviation from either side of the target. Monetary policy is to be forward looking and the direct effects on consumer prices stemming from changes in interest rates, taxes, excise duties, and extraordinary temporary disturbances would generally not be included. Norges Bank cut policy interest rates by 50 basis points on December 12, 2001 to 6½ percent.

A policy to accelerate the use of oil revenues was adopted in 2001, implying a cumulative fiscal stimulus in excess of 3 percent of GDP over this decade. The policy stipulates a structural nonoil central government deficit each year corresponding to the expected real return on the market value of Government Petroleum Fund assets at the beginning of the year, and would raise the nonoil structural deficit by an average of about 0.4 percent of nonoil GDP each year until 2010. The new government maintained a fiscal stimulus of about ½ percent of GDP, but shifted the balance of the fiscal strategy for 2002 toward reduced taxation.

Executive Board Assessment

Executive Directors noted that a macroeconomic strategy anchored in wage moderation and a policy of investing abroad a large part of oil revenues had contributed to a strong performance, and commended Norway for its solid economic expansion since 1993, marked by virtually full employment and low inflation.

Directors noted that the outlook for 2002 was for weak economic growth as a result of the fall in oil prices and the slowdown in global output growth. They saw the balance of risks to growth as being on the downside, although labor constraints in some service sectors would persist. Directors therefore considered the fiscal stimulus in the 2002 Budget—resulting from the policy to accelerate the use of oil revenues—to be supportive of economic activity. However, they cautioned that a continuation of the stimulus into 2003 could add to demand pressures as growth recovers.

Directors noted the recent change in the authorities' fiscal strategy to increase nonoil structural deficits in line with the expected real return on the Government Petroleum Fund. They observed that the accelerated use of public wealth, combined with Norway's generous public pension system, could have adverse implications for Petroleum Fund assets over the next few decades, as the rising costs of a demographic transition emerge. This could pose risks to long-term fiscal sustainability and Norway's objective of ensuring intergenerational equity. Directors therefore called for timely public pension reform and an appropriate buildup of assets in the Petroleum Fund. Some Directors suggested that the authorities adopt a medium-term expenditure plan to anchor the budget and to underpin fiscal sustainability. Directors expressed concern over the spending level of local government.

Directors welcomed Norway's adoption of a well-designed inflation targeting framework in 2001 to anchor monetary policy in pursuit of low and stable inflation. While welcoming the focus on underlying inflation, several Directors cautioned against frequent changes to the definition of the underlying price index. They also welcomed the recent easing of monetary policy, but noted that a lasting reduction in high interest rates will only be possible if wage moderation is achieved in the upcoming bargaining round and if fiscal policy is not excessively stimulatory when economic activity picks up.

Directors supported the shift in medium-term policy priorities toward reducing Norway's high tax burden. They agreed with the authorities' intentions to restore the principles of tax efficiency and neutrality and to close loopholes in the tax system: such measures could alleviate the economic costs imposed on the private sector by the planned fiscal expansion.

Directors endorsed the authorities' efforts to modernize the public sector, noting the desirability of a strategy to increase the efficiency of public spending through better pricing, management and incentives structures. They expressed concern at Norway's high level of public spending and the high share of its labor force employed in the public sector, and encouraged the authorities to reduce bureaucracy and increase the use of private participation in the provision of public services.

Directors encouraged the authorities to consider a comprehensive reform of the public pension system aimed at ensuring financial viability, by establishing a closer link between contributions and benefits. The reforms should also remove the major disincentive effects of the current tax and pension system on labor supply, and prepare for the increased health and elderly care costs expected as the population ages.

Directors noted that Norway's wage bargaining system had contributed to strong labor market outcomes by assigning a lead role in negotiations to the internationally exposed sector. Noting that this lead role may now be eroding, Directors encouraged the social partners to ensure that wage increases do not harm competitiveness. They underscored the need for structural measures to ease labor supply constraints, and welcomed the authorities' intention to liberalize immigration. Directors recommended that the authorities address the rise in costs and the decline in labor supply associated with the over-generous disability and early retirement programs, and the steep increase in sickness leave.

Directors recommended significant further progress in structural reforms including privatization and deregulation to foster competition. They encouraged the authorities to reform Norway's protectionist agricultural policies, by lowering subsidies and trade protection to this sector.

Directors applauded Norway's continued generous official development assistance, which was among the highest provided by advanced economies. They strongly welcomed the authorities' intention to further raise such assistance to 0.9 percent of GNP, as well as the proposed lifting of import duties and quotas on imports from the poorest countries from July, 2002.

Directors commended Norway for being at the forefront in combating money laundering and anti-terrorist financing. They welcomed Norway's intention to participate in a Financial Sector Assessment Program, noting that the financial sector appears resilient, although some concerns were raised about the increased indebtedness of enterprises and households.

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. The Staff Report for the Article IV Consultation with Norway is also available.

Norway: Selected Economic Indicators

	1998	1999	2000	2001	2002 1/
	(Volume changes in percent)				
Private consumption	3.4	2.2	2.4	1.9	2.2
Public consumption	3.8	3.3	1.4	2.3	2.0
Gross fixed investment	10.6	-8.2	-1.1	-4.0	-1.0
Export of goods and services	0.3	2.8	2.7	3.2	2.0
Of which: Oil and gas	-3.6	-0.1	6.4	5.5	6.5
Import of goods and services	8.0	-1.6	2.5	1.2	1.0
GDP	2.4	1.1	2.3	1.4	1.8
Mainland GDP 2/	3.6	1.0	1.8	1.2	1.3
	(In percent of labor force)				
Unemployment	3.2	3.2	3.4	3.6	3.8
	(Percentage changes)				
Consumer prices	2.3	2.3	3.1	3.0	1.5
Hourly labor cost in manufacturing	5.9	5.0	4.5	4.6	4.5
Nominal effective exchange rate	-3.7	-1.6	-1.8	4.5	...
	(Twelve-month percent change, end of period)				
Domestic credit 3/	8.3	8.3	12.4	9.7 4/	...
Broad money 3/	5.0	10.8	9	8.6 4/	...
	(In percent)				
Three-month interbank rate 5/	5.8	6.5	6.7	7.2	...
Ten-year government bond yield 5/	5.4	5.5	6.2	6.2	...
	(In percent of GDP)				
State budget, including social security					
Revenues	42.3	41.7	45.2	52.5	50.0
Expenditures	39.8	39.0	34.4	35.9	39.5
Overall balance	2.5	2.7	10.8	16.6	10.4
General government financial balance	3.5	5.4	14.8	16.0	14.7
Current account balance	-0.9	4.1	14.3	12.4	10.2
International reserves (in months of imports of goods and services)	4.1	4.8	5.2	4.1	...

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

1/ Staff estimates and projections as of January 2002.

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

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

4/ November 2001.

5/ Period average, in percent.

Statement by Ólafur Ísleifsson, Executive Director and Asbjorn Fidjestøl, Advisor to the Exectuive Director for Norway
March 1, 2002

On behalf of the Norwegian authorities we would like to thank the staff for a thorough and well written report on the 2001 Article IV consultation on Norway. The staff report covers important aspects of the Norwegian economy, both in a short and long term perspective. As a response to the changes in guidelines both for fiscal and monetary policy on March 29, 2001, this report is particularly interesting.

Economic outlook - recent projections

Norway's terms-of-trade weakened considerably as a result of the decline in oil prices following the global downturn last year. Prices for Norwegian export goods have shown a downward trend since spring 2001, and exports declined towards the end of last year. However, the effects on the activity level in the Norwegian economy have been limited. The negative demand impulses from exports have, to a large extent, been counteracted by growth in private and public consumption and in housing investment. Moreover, the fall in oil prices has not deterred oil companies from revising planned investments upward. Thus the Norwegian economy may weather the downturn with a substantially smaller impact on the level of activity and employment than most other countries. The latest projections for mainland GDP provided by the authorities indicate a growth rate of around 1½ percent in 2002. Thereafter, GDP growth is expected to pick up towards 2 percent.

Unemployment has edged up in the last few months, while employment growth has been limited. Still, the labour market remains tight. Long-term unemployment is low, and spells of unemployment are generally brief. Hence, there is a risk of high growth in labour costs following this spring's wage negotiation round.

Fiscal policy

Regarding the transition to a new macroeconomic policy framework in Norway, the staff generally commends a more explicit rule based approach to macroeconomic policy. However, concerns are expressed about the long-term sustainability of the new fiscal policy guidelines. The new fiscal policy rule implies that oil revenues will be phased into the budget in accordance with the expected real return (estimated at 4 percent per year) on the Petroleum Fund. When assessing this rule several concerns should be taken into consideration.

Due to the very high oil revenues at present, the total budget surplus is more than 15 percent of GDP and the Petroleum Fund is rapidly building up. The experience of other countries in similar situations is that strict fiscal rules may support sound macroeconomic policies. But such rules have to be clear and easy to understand – otherwise they will not be credible. Such considerations have been important when establishing the present policy guidelines:

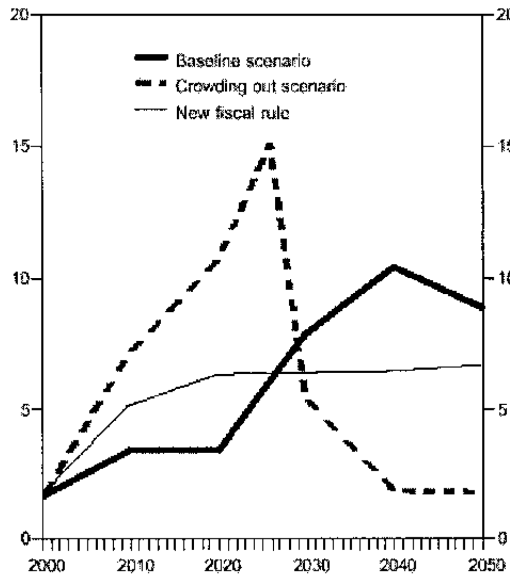
- All oil revenues are transferred to the Petroleum Fund. The Fund is invested abroad with about 40 percent in equity markets and 60 percent in bond markets. Thus, the economy is insulated from the large swings in petroleum revenues.
- The new fiscal rule limits the use of petroleum revenues to the expected real return on the capital in the Fund. This rule implies a gradual and cautious increase in the spending of petroleum revenues. Ten years ahead the non-oil deficit is estimated at just above 5 percent of GDP. This is lower than the corresponding deficit at the beginning of the 1980s. The fiscal rule is based on spending the real return on the Fund – the real value of the Fund is thereby preserved for future generations.

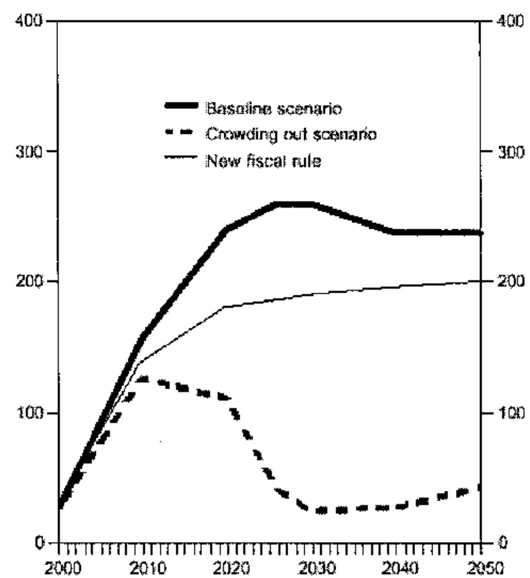
By most comparisons the Norwegian policy approach must be regarded as quite cautious. The new fiscal rule states that the use of oil revenues shall equal the return on capital already accumulated in the Petroleum Fund, and not depend on uncertain future proceeds. The Norwegian authorities would like to emphasize that the fiscal policy rule implies continued growth in the Government Petroleum Fund. The Fund has grown to USD 70 billion (42 percent of GDP) at the end of 2001, and is expected to reach 100 percent of GDP through 2009. The policy framework allows the Fund to serve as a buffer against fluctuations in petroleum receipts.

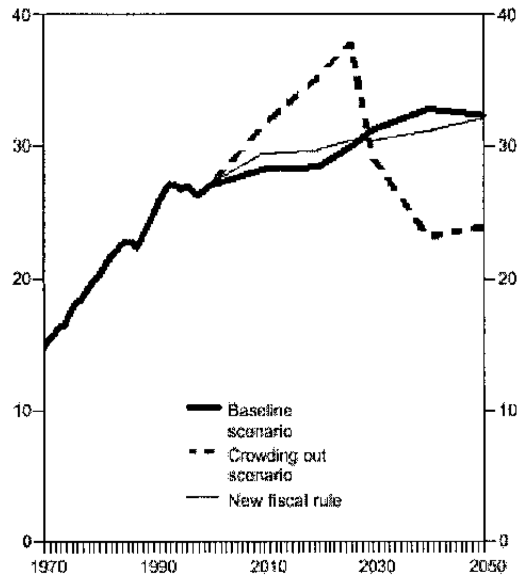
The consequences for economic stability were strongly emphasized when the new policy guidelines were introduced. Chart A-D illustrates three long-term scenarios for economic developments in Norway. The assumptions regarding oil prices, oil production, productivity growth and interest rates are the same as in the IMF staff calculations. The three scenarios differ in the following ways:

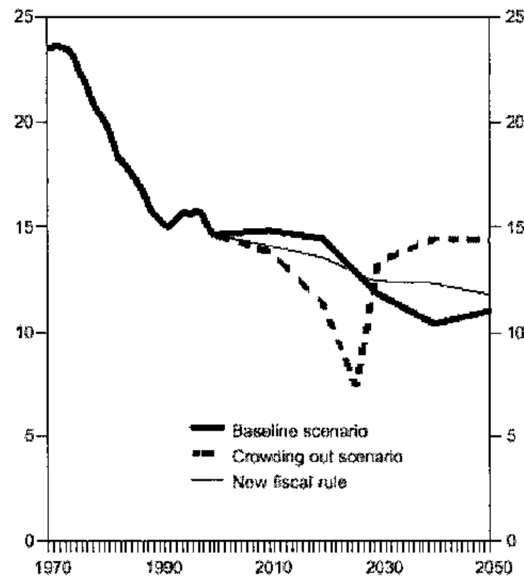
- The baseline or reference scenario is characterized by an unchanged tax system, and it is assumed that no new social reforms are introduced over the whole projection period.
- The unsustainable policy scenario is equal to the baseline scenario with one exception – the growth in public employment continues at the same pace as in the 1990s (1½ percent per year). In this scenario, a need for tightening of policy is building up. Technically, the change in policy is postponed for 20 years, i.e. until the budget deficit has passed 10 percent of GDP.
- The new fiscal rule scenario implies that oil revenues are phased into the economy in line with the expected real return on the Petroleum Fund (4 percent per year).

The new fiscal rule scenario implies a somewhat more expansionary budget policy than in the baseline scenario over the first decade and a somewhat tighter one from around 2020. But the phasing in of oil revenues is smoother and more gradual under the new fiscal rule than in the baseline. This is also reflected in the charts showing employment paths of the public and manufacturing sectors. Finally, in both scenarios the Petroleum Fund will stabilize at a high


A. Fiscal Budget non-oil deficit.
Per cent of mainland GDP
Baseline scenario
Crowding out scenario
New fiscal rule
20
15
10
5
0
2000
2010
2020
2030
2040
2050


B. The Government Petroleum Fund
Per cent of mainland GDP
Baseline scenario
Crowding out scenario
New fiscal rule
400
300
200
100
0
2000
2010
2020
2030
2040
2050


C. Public sector employment
Share of total man-hours worked
Baseline scenario
Crowding out scenario
New fiscal rule
40
30
20
10
0
1970
1990
2010
2030
2050


D. Employment in manufacturing industry.
Share of total man-hours worked
Baseline scenario
Crowding out scenario
New fiscal rule
25
20
15
10
5
0
1970
1990
2010
2030
2050

level, even if the level is slightly lower in the fiscal rule scenario than in the baseline.

The authorities concur with the staff that the Norwegian economy is facing considerable challenges to public finances as a result of an ageing population and increasing pension expenditures. However, due to the petroleum revenues, Norway is in a better position to deal with these challenges than most other countries. This requires that a significant part of petroleum revenues is set aside to cover pension obligations. But still, a pension reform is needed in order to achieve a better balance between contributions and benefits. Moreover, efforts to make public services more efficient should be undertaken in order to dampen the upward pressure on expenditures other than pensions.

Until the new guidelines were introduced, fiscal policy should be neutral over the business cycle, regardless of the size of petroleum revenues. Given the strong increase in financial wealth in the Petroleum Fund, it was clear that this framework was not credible. There was a need to clarify how and when the petroleum revenues accumulated in the Petroleum Fund should be used. In the view of the authorities, the staff report does not adequately recognize the importance of making the policy framework credible in a situation with high oil revenues and a rapid build-up of financial wealth in the Petroleum Fund.

There is a strong tradition in Norway in emphasising long-term issues when formulating fiscal policy. The long-term horizon of the announced spending plan is in accordance with previous IMF recommendations. The Norwegian authorities are of the view that the fiscal guidelines make a crucial contribution to a sustainable macroeconomic development. A policy based on using the expected real return on the Government Petroleum Fund ensures that the value of the Fund is preserved in real terms. The chart in Box 2 on Page 23 in the staff report, and in particular the sentence "*GPF (Government Petroleum Fund) assets would be used up much faster under the new fiscal guidelines.*", are therefore somewhat misleading.

Monetary policy

The changes in the monetary and fiscal policy regimes were co-ordinated. Monetary policy shall now be oriented directly towards low and stable inflation. The Norwegian authorities note the staff's view that an inflation target of 2.5 percent is appropriate given the economic adjustment implied by an increased domestic use of petroleum revenues.

In the description of the new framework the staff refers to a 1 percentage point tolerance limit on either side of the inflation target. The Norwegian authorities would like to emphasize that such a tolerance limit is not included in the regulation. The inflation target is a point target and not a target band. We would like to note that the Ministry of Finance stated in Report no. 29 to the Parliament, 2000-2001 *Guidelines for Economic Policy* that consumer price inflation in general is expected to remain within an interval of +/- 1 percentage point around the inflation target. Norges Bank has stated that it will place special emphasis on analyzing the causes when underlying inflation deviates from the target by more than +/- 1 percentage point.

The staff points out that the central bank should abstain from frequent changes to its definition of the underlying price index so as to avoid any perception that attempts were being made to justify deviation of inflation from its target level. However, the decision to omit temporary influences from the price index is set out in the official monetary policy guidelines issued by the Government. As a response, Statistics Norway started to publish an official separate index for inflation adjusted for tax changes and excluding energy products. Moreover, with a two-years ahead inflation targeting approach the discussion between headline inflation and underlying inflation is irrelevant.

Structural issues

In Norway, the employment rate is among the highest in the OECD area. This reflects both high labour force participation and low unemployment. The picture becomes more mixed when average working hours are taken into account, which are lower in Norway than in many other countries. However, this is partly due to a very high labour force participation rate for women working part-time. Moreover, sickness absence is high in Norway. The authorities endorse the staff's view that structural reforms in the labour market should be continued with a view to maintaining as large a workforce as possible.