DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/84/266

CONTAINS CONFIDENTIAL INFORMATION

December 3, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Norway - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Norway.

This subject has been tentatively scheduled for discussion on Friday, December 21, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Knöbl (ext. (5)8821) or Mr. Mitra (ext. (5)8825).

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

NORWAY

Staff Report for the 1984 Article IV Consultation

Prepared by Staff Representatives for the 1984 Consultation with Norway

Approved by L.A. Whittome and Eduard Brau

November 30, 1984

I. Introduction

A staff team consisting of Messrs. Brian Rose, A. Knöbl, W. Hemphill, H-J. Huss, and S. Mitra, with Mrs. Pamela Padmore as secretary (all EUR) held Article IV consultation discussions in Oslo from October 10 to October 22, 1984. The Norwegian representatives included officials from the Ministries of Finance and Customs, Commerce and Shipping, and from the Bank of Norway. The mission met with the Secretary General of the Ministry of Finance, Mr. Eivind Erichsen; the Governor of the Bank of Norway, Mr. Knut Getz Wold; and the Deputy Governor of the Bank of Norway, Mr. Hermod Skånland. Mr. John Tvedt, Executive Director for Norway, attended the meetings as observer. Norway formally accepted the obligations of Article VIII, Sections 2, 3, and 4 from May 11, 1967.

II. Background

Since the mid-1970s, Norwegian economic developments have been dominated by the rapid growth of its oil and gas sector during a period of generally rising oil prices, the absorption of part of the export proceeds in the domestic economy and the adjustment pressures that have ensued. The output of oil now accounts for a sixth of GDP. The exploitation of oil resources has produced a flow of income large enough to permit Norway to combine, in recent years, external current account surpluses with a rising standard of living, but the structure of domestic production and employment has felt the impact of the domestic absorption of part of the rise in oil export revenues (Charts 1 and 2). Thus, consequent to the substantial appreciation of the real exchange rate (about 20 percent between 1974 and 1983), the tradables sector (other than oil and shipping), particularly manufacturing, has been squeezed. Between 1974 and 1983, output in this sector fell by 5 1/2 percent, whereas that of the nontradables sector rose by 35 percent. Similarly, over this period employment in the former fell by 18 percent, but that in the latter rose by 14 1/2 percent, with public sector employment accounting for a large part of the increase.

In 1978, after a period of large current account deficits and rising inflationary pressures, economic policies were reoriented toward preventing a further deterioration in competitiveness and consequent squeeze on the manufacturing sector as well as to stabilizing the domestic absorption of oil proceeds. One measure of such absorption--the ratio of the fiscal budget deficit (excluding oil revenues) to the so-called "mainland" GDP (i.e., excluding oil and shipping), referred to as the "adjusted deficit"--has fluctuated between 6 and 7 percent since then. Norway now appears to be nearing the completion of the transition to an oil-dominated economy with relatively stable use of oil revenues. The external current account, aided by a sharp rise in oil exports, has been in surplus since 1980--strongly so since 1983--and external indebtedness has been markedly reduced.

In the area of inflation, however, performance has been less satisfactory. As Norway's inflation rate had been well above the average of that experienced in industrial countries, an important element of the policy shift of 1978 involved a tightening of financial policies and a restrictive position on wage settlements. Although inflation has exceeded that in partner countries in recent years, the gap has narrowed; inflation declined notably in the past two years and is currently running at an annual rate of 6-6 1/2 percent.

The Executive Board discussion of the last Article IV consultation (EBM/83/109, 7/22/83) took place against the background of projected external current account deficits in 1983 and 1984. Directors noted that the size and efficiency of the tradables sector had to be increased. Labor costs in the whole economy needed to be restrained, and they stressed the need to follow firm demand management policies. A majority of Directors felt that fiscal stimulus should not be increased beyond the amount provided in 1983, which had been influenced by recessionary conditions in 1982. Given the relatively high rate of inflation, the Norwegian authorities were advised to adopt a strict stance of monetary policy, and Directors, finding the system of monetary management over-complex, wished to see greater emphasis on the movement of monetary aggregates and on more flexible interest rates.

III. Recent and Prospective Economic Developments

While significant revisions to historical statistics have been made since the last consultation discussions, the general picture still holds good of an economy that was in moderate recession in 1982 and has since then experienced a steady, if unspectacular recovery. Total domestic demand contracted in 1983 (after a strong rise in 1982) owing to a sharp rundown in inventories, but a significant recovery in investment (especially in manufacturing) and a modest strengthening in private consumption is projected to lead to an expansion of 2 1/2 percent in 1984. Output was sustained in 1983 through a strong growth in exports of oil and gas and also of "traditional goods", while imports fell, implying a strong impetus to the growth of GDP. The net foreign balance has again improved in 1984 though on a more modest scale. Total GDP grew by over 3 percent in each year; "mainland GDP" grew by 2.2 percent and 2.4 percent, respectively.

The Norwegian authorities attach great, perhaps overriding, importance to the maintainance of full employment. However, the recent recovery has not seen employment grow commensurately with mainland GDP (oil, gas, shipping are of course all highly capital intensive). Total employment (persons) rose in 1982-83 and is projected to increase again in 1984. Continued rapid expansion in central government and municipal employment has offset labor shedding by the tradables sector, though the latter may occur at a diminished pace in 1984. With the continuing increase in the labor force and with one of the highest participation rates among the industrial countries unemployment rose to 3 1/4 percent of the labor force on average in 1983 (4 3/4 percent if persons employed as a result of labor market measures are included). In 1984 the rate of unemployment is projected to fall slightly in response to a strengthening mainland economy.

The rate of increase in consumer prices has decelerated steadily since the peak of about 15 percent in late 1980-early 1981. It fell on average from 11.3 percent in 1982 to 8.4 percent in 1983, and the authorities appear likely to achieve a figure somewhat below their objective (SM/83/120, 6/8/83, p. 6) of about 6 1/2 percent in 1984; in fact, the figure was down to 6.1 percent for the 12 months ended September 1984, about 1 1/2 percent higher than the average for industrial countries. The main contribution has come from a slowdown in the growth of wage costs as well as some moderation in import prices.

The big surprise since the last Board discussion has been the unexpected strength of the balance of payments. At that time the Norwegian authorities were projecting a small current account deficit for 1983 and, under certain assumptions, a move into limited deficit over the next few years. In fact, the current account, instead of showing a deficit equal to 0.5 percent of GDP in 1983, recorded a surplus of NKr 16 billion, equal to 4 percent of GDP. This was primarily the result of a strong export performance. Output of oil and gas reached 55 million tons (oil equivalent), 12 percent higher than in 1982, and higher than the amounts originally projected for 1984; the kroner unit price of oil rose by 2 3/4 percent, despite a falling dollar price owing to a sharp appreciation of the U.S. dollar. At the same time "traditional" exports grew in volume by 10 percent against a cumulative growth of less than 20 percent over the previous seven years; the cyclical recovery in world demand was surely helpful, as no doubt were the two downward adjustments of the krone in 1982 1/ (the effective rate of the krone declined on average by 3 percent in 1983, using the official weights, and in real terms--based on unit labor costs in manufacturing--it fell about 2 percent). For 1984 the official projections call for an increase in the surplus to NKr 27.5 billion (6 percent of GDP), though the Norwegian representatives cautioned that this might be on the high side. A further strong increase in exports of oil and gas is expected, with an increase in volume of over 11 percent, and the effects of the continuing strength of the U.S. dollar have again offset the rather weak trend in the U.S. dollar price of oil. With a

1/ The effective exchange rate was lowered by 3 1/2 percent on August 2 and by 3 percent on September 6.

moderation in the rate of growth of "traditional" exports and a sharp pickup in imports in response to rising domestic demand, the deficit on non-oil trade is projected to widen in 1984.

The large surpluses seen in recent years have made it possible for Norway to reduce external debt substantially, with virtually the entire central government debt due to be paid off by the end of the first quarter of 1985. Foreign exchange reserves have risen sharply to about US$8 1/2 billion in early October, or about 45 percent of estimated imports of goods and nonfactor services in 1984.

With no sharp changes in policy foreseen for 1985, the outlook remains favorable. Mainland GDP is again expected to grow by 2-2 1/2 percent. 1/ Private consumption is estimated to grow by 2 1/2 percent, largely owing to a rise in disposable incomes generated by tax cuts and increased employment. Total investment is projected to weaken significantly in 1985 as the sharp rise in oil-related investment in 1984 will not be repeated, but investment in the mainland economy is forecast to continue to be buoyant for cyclical reasons. For similar reasons, employment should rise faster in 1985, perhaps by as much as 25,000-30,000 (1 1/2 percent of the labor force), compared with a total of some 50,000 in the previous three years, but given the growth of the labor force, the rate of unemployment is unlikely to change. The Norwegian authorities are hoping for a further slight deceleration in inflation, with consumer prices rising at less than 6 percent.

The balance of payments is likely to remain strong. While emphasizing the great uncertainties attaching to the forecast the Norwegian authorities foresee a surplus of around NKr 20 billion (about 4 1/2 percent of GDP). Although imports for the mainland economy are expected to rise strongly in response to the rise in activity, non-oil exports are projected to increase by around 5 percent on the assumption of a continued international recovery. Thus Norway will maintain a healthy external position for the third year in a row.

IV. The Medium Term

Conditions in the international oil markets will exert a dominant influence on the medium-term outlook of the Norwegian economy. The price of oil, of course, directly affects export revenues; it also determines the economic feasibility of exploiting newly found reserves of oil and gas in the harsh conditions of the far North. In a recent White Paper, the Norwegian authorities have delineated several medium-term scenarios for the oil sector and its impact on the mainland economy based on varying assumptions concerning oil prices and output. The scenarios show the

---

1/ As a result of lower production from the aging Ekofisk field, the volume of oil production and exports is expected to fall, so that the growth in total GDP may be limited to 1 percent.

oil sector continuing to make an important contribution to Norway's GDP, though its precise size will depend, of course, crucially on the evolution of oil prices.

The authorities give careful consideration to the question of the degree to which the oil proceeds should be absorbed in the domestic economy. The Government takes the position that the domestic spending of oil income should be limited for three main reasons. First, oil resources represent Norway's international wealth and, for that reason, ought not to be fully used domestically; instead, at least a part of it should be invested abroad. Second, the absorption of oil income gives rise to adjustment pressures within the domestic economy stemming from an appreciation of the real exchange rate and a resulting squeeze on the non-oil tradable sector of the economy. Norway has experienced such pressures in the past decade when the manufacturing sector, in particular, has contracted. The economy now appears to have adjusted to the level of domestic use of oil incomes held more or less stable in the last few years, as measured by an "adjusted" fiscal deficit equal to 6 to 7 percent of GDP. Greater domestic use of the oil income would trigger off a further squeeze on the non-oil traded goods sector. The authorities take the view that the economy needs a competitive sector of at least its present size as a shield against the risk of a fall in oil incomes. They, furthermore, consider it desirable to have a diversified industrial base as an earner of foreign exchange. Third, the authorities believe it important to insulate the domestic economy from fluctuations in oil incomes that inevitably arise from changes in prices and output by fixing in advance the amount of oil revenues to be earmarked for domestic absorption.

An implication of the above-mentioned policy is that oil revenues in excess of the amounts spent in the domestic economy be invested in foreign assets. Thus far, Norway's gross international reserves have been rapidly built up and external public indebtedness markedly reduced. The authorities are giving consideration to the creation of a foreign exchange fund, separate from the reserve holdings of the Norges Bank, with wide freedom of choice as regards instruments and maturities. This fund would have the character of a "buffer" fund invested abroad, which would give a measure of protection to the domestic economy from vissicitudes of oil prices and output and could also be relied upon if and when oil revenues begin to fall. A further easing of controls on capital movements, especially those applied to potential outflows, may also be considered.

At end-1983 Norway's gross external debt had been reduced to NKr 140 billion, which corresponded to net external debt of 22 percent of GDP, substantially down from 46 percent of GDP in 1978. By end-1984, on present estimates, net debt will have fallen to the equivalent of 15 percent of GDP. Illustrative projections of Norway's external position over the medium-term prepared by the staff (Chart 3) under different sets of assumptions show that Norway would acquire a net external asset position around 1987 and would be able to build up its asset holdings rapidly thereafter. It is, of course, recognized that the results are highly sensitive to the underlying assumptions, in particular those concerning the relative price of oil and the degree to which the oil export proceeds are spent in the domestic economy.

V. Economic Policies

As noted in previous sections of this paper, it is a fundamental objective of the Norwegian authorities to maintain the tradables sector at least at its present size while retaining the target of very low levels of unemployment. The following section reviews the main policies used in an effort to achieve those ends.

1. Fiscal policy

Norway has traditionally followed a sound fiscal policy. Even before oil revenues began to be realized it was the general practice to aim at a surplus before loan transactions (that is, excluding lending to the private sector, especially for housing, and to the stateoil company as well as central government borrowing). Since 1980 such a surplus has been maintained, varying between 2 and 4 percent of GDP (Chart 4). When oil taxes are excluded, the budget shows a deficit; the size of this deficit, and changes in its size, are commonly regarded as the key indicator to measure the fiscal impact on the domestic economy; this deficit also provides a measure of the channelling of tax income from the oil sector into domestic spending.

The accounts in 1983 turned out to be closely in line with those foreseen in SM/83/120 (6/8/83)--an "adjusted" deficit equal to 7.2 percent of GDP and a surplus before loan transactions of 2 percent of total GDP. The original budget for 1984 provided for an increase in expenditure and revenue of 8 1/2 percent and 7 percent, respectively. The outcome for the adjusted deficit is expected to be an amount equal to about 7 percent of GDP, closely in line with the original intentions. Total revenues (including oil taxes) are, however, expected to be significantly in excess of initial estimates, largely because of greater oil production, so that the total surplus before loan transactions is likely to be much larger than both the initial estimate and the surplus in 1983.

Last year's Staff Report called attention to the very rapid increase in expenditures as a proportion of mainland GDP from 37 1/2 percent in 1973 to about 49 percent in 1982, largely on account of rising transfers to municipalities for the financing of increased spending on health and education. Furthermore, outlays on pensions have shown a sharp rise. In both 1983 and 1984 the proportion has been held at about 50 percent.

The budget for 1985, which has not yet been passed by Parliament, calls for an increase in expenditures of about 8 1/2 percent, with expenditures rising in real terms for defense, social security (partly owing to a rising number of recipients) and transfers to municipalities. The authorities have emphasized their determination to adhere to the budget estimates; should supplementary appropriations prove necessary they would generally be covered by equivalent reductions of other expenditures. Revenues (other than oil taxes) are estimated to rise by 7 1/2 percent (less than the growth in nominal GDP) chiefly reflecting a lowering of marginal income tax rates by 1/2 a percentage point and a real increase in allowances--measures which will especially benefit families. Taxation on corporations is also to be lowered, and taxation on dwellings, which is very low in Norway, is to be raised moderately. The "adjusted" deficit rises by only about one half of one percentage point to an amount equal to 7.4 percent of GDP, 1/ which against the background of a cyclical pickup in growth, provides a modest expansionary stimulus to the economy.

The Norwegian representatives stated that they had no fixed fiscal strategy over the medium term though the stabilization of the "adjusted" fiscal deficit had been a fairly deliberate policy in recent years; in general, they envisaged the maintenance of the present fiscal stance. They noted, however, that political decisions and statutory arrangements would tend to push up expenditure in the medium term, especially on pensions. A recent report stated that, with unchanged regulations on pensions, the increase in payments until 1990 would require--with an unchanged deficit--an increase in income tax rates by 4-5 percentage points. Modifications to the pension system affecting either benefits or financing or some combination of the two need to be considered.

The impact of the tax system upon the efficiency of the economy had recently been given greater attention. The Government has committed itself to lower income taxation in real terms, especially in the form of reductions in marginal rates, which had adversely affected incentives. The recent report of a tax commission also stressed the need to simplify the system as a complicated set of deductions (including the deductibility of interest payments) led to distortions and created unintended distributional effects. However, early action is not to be expected.

2. Monetary policy

In Norway monetary policy has traditionally not been used in an active fashion for demand management purposes; its stance in the past few years has generally been an accommodating one. Until recently, the authorities imposed direct ceilings on lending, exercised a variety of controls over interest rates, and the degree of direct regulation of money and securities markets was high. A gradual, but cautious, process of liberalization that began in 1980 was furthered in 1984 with the removal of direct controls on bank lending, the elimination of the bond-holding obligation of banks and an easing of certain other regulations. Even so, important interest rates continue to be tightly controlled. The money market rate is held narrowly within a half percent band through central bank intervention and the average interest rates on short-, medium-, and long-term bank loans are administered. Interest rates of nonbank financial intermediaries are not subject to direct control but are, of course, influenced by money market conditions. A controlled system of this kind provoked considerable disintermediation, particularly in late 1983 when bank lending was artificially held down, but since early 1984 reintermediation has taken place with some easing of controls over banks.

1/ The overall surplus, including estimated oil taxes and not allowing, as the Norwegian authorities do, a "safety margin" equal to 15 percent of estimated taxes, may amount to nearly 3 percent of GDP.

Under such circumstances, the interpretation of developments in the monetary and credit aggregates is bedevilled by changes in the control regime and the extent to which the controls may be circumvented. The authorities have an indicative target for the growth of public liquidity (essentially broad money) but the policy of holding money market and bank lending rates within a narrow inflexible margin is not geared toward quantitative targets. Taking 1983 and 1984 together--in order to even out fluctuations in intermediation--broad money is projected to rise by about 23 percent or significantly more than nominal incomes. The chief source of growth has been large surpluses on the external balance of payments, offset in part by the strong position of the fiscal budget (Chart 5).

The Norwegian representatives pointed out that although interest rates had declined since the last consultation (mid-1983), inflation had fallen more; however, in view of the existing tax deductibility of interest payments and high marginal tax rates experienced on the average by borrowers, after tax real interest rates had remained very low. They did not consider that developments in the money and credit aggregates thus far in 1984 had been such as to pose dangers to the price performance and no monetary tightening was justified at this stage. Certain rigidities in the money and securities markets remained and the authorities would wish to carry the gradual process of liberalization further. The 1985 indicative target for the rate of growth of public liquidity was set at 10 3/4 percent. The Norwegian representatives observed that this may be on the high side given the objective of securing a further slowdown in the rate of inflation to below 6 percent during 1985.

The mission stressed that the recent fall in velocity could not confidently be expected to be repeated in 1985, which suggested a shift toward a stricter monetary stance in order to secure a further fall in inflation. Moreover, wage pressures were likely to be less insistent and also more easily countered if credit conditions were to be tightened.

3. Inflation and the labor markets

The significant deceleration in inflation over the last two years has been aided by a slowdown in domestic wage increases coupled with improved productivity. In 1983, contractual settlements reached through centralized wage bargaining provided for a general rise of only about 1 percent, but settlements at the plant level and the carry-over from 1982 led to an increase in average hourly earnings of 8 1/2 percent. This was broadly in accordance with the guidelines set by the Government which takes a position of nonintervention in private sector settlements, relying on general macroeconomic policies for a suitable framework in which appropriate settlements could be struck. The Government is, however, directly involved in negotiations covering about a quarter of the labor force (300,000 public sector workers and 100,000 farmers). In 1984, the Government's target increase for public sector pay of 5 percent was modestly breached when a settlement of 6 1/4 percent was agreed.

Private sector settlements this year have again consisted of a contractual increase of about 1 percent; wage drift (defined to include increments obtained at local levels, and a rise in overtime earnings resulting from greater economic activity) would lead to a projected 7 percent rise in average hourly earnings.

The Norwegian representatives stated that the Government had set a guideline for average wage increases of 5 percent in 1985, which, in light of recent exchange rate actions (see the following section), would leave competitiveness unchanged. The Norwegian representatives observed that this target was likely to be very difficult to adhere to as it implied a substantial slowdown in drift as well as a very modest general contractual agreement at a time when economic activity was projected to further pick up.

The authorities put great emphasis on the importance of containing wage costs not only in order to support their inflation objectives and safeguard competitiveness but also because they believed that the present level of real wages constituted the most significant barrier to greater employment. In their view, unemployment was mainly of a classical or structural kind characterized by high real wages and lack of sufficient structural change in the economy. The rate of unemployment at around 3 percent of the labor force (with a further 1 1/2 percent being covered by labor market measures) was low by international standards but the Norwegian authorities considered it to be too high. While they gave priority to reducing it, they also wished to see a further deceleration in inflation at the same time. It had also been the objective in Norway to combine very high levels of employment with a highly egalitarian distribution of income.

There is, however, considerable doubt as to whether these goals can be reconciled with the objective of securing a further deceleration in inflation or with sustained low rates of inflation. While, under certain circumstances, centralized wage settlements may facilitate moderation, the moves toward decentralization in recent years has led to increased wage drift and could lead to greater unemployment as it would be more difficult to rein in wage costs. Some believe that the current rate of unemployment was at or below the point where inflation could be expected to accelerate.

4. Exchange rate policy

In managing the exchange rate of the Norwegian krone the authorities are guided by an index based on a basket of 14 currencies. In general, the authorities stabilize the index at a stated level for longish periods, with a margin of 2 1/4 percent on either side which is adhered to other than in exceptional circumstances. Following an appreciation of the effective rate between the middle of 1981 and the middle of 1982--the real rate (as measured by relative unit labor costs in manufacturing) rose by 8 percent--the Norwegian authorities took action in August and again in September 1982 which resulted in the value of the krone being brought to a level 6.3 percent below what it would otherwise have been; these changes, which were discussed in SM/83/120 (6/8/83), basically reflected concern over the developments in the export sector (Chart 7).

In July and again in September 1984, the authorities, through some technical changes which are described in the report on Recent Economic Developments (SM/84/267, 12/7/84) reduced the market value of the krone by amounts which together added up to a further 4 percent (the measure taken in July included a change in the calculation of the index from an arithmetic to a geometric average). If the index value of the basket is recalculated retroactively using a geometric average, the following picture of the movement in the effective exchange rate of the krone since the middle of 1981 is as follows:

(Change, in percent)

July 1981 - July 1982	+3.8
July 1982 - December 1983	-5.6
December 1983 - October 1984	-4.2

The staff mission accepted the basic contention of the Norwegian authorities that maintenance of the competitiveness of the Norwegian export sector was necessary to assure a sound balance of payments position in the medium term, but questioned whether the steps taken in July and September 1984 to reduce the value of the krone in the market were appropriate in view of Norway's strong balance of payments position. The Norwegian authorities presented a number of arguments in support of their action. First of all the use up until July of an arithmetic average had meant, given the appreciation of the U.S. dollar against the Norwegian krone up until the end of June, that the effective weight of the U.S. dollar was 16 percent instead of the nominal weight of 11 percent adopted in August 1982. This added to the difficulties for those sectors of the Norwegian economy which are dependent upon exporting to European countries or are exposed to competition from those countries in the Norwegian market. By September the U.S. dollar had appreciated in relation to the Norwegian krone by a further 8 percent and the Norwegian authorities felt that it was necessary to offset the resultant appreciation of the Norwegian krone against the EMS currencies. They agreed that the current account situation was very comfortable in the short run and stated that they were not aiming either at increasing the surplus or at maintaining large surpluses over any prolonged period of time; rather they were concerned to make it possible for traditional business enterprises to be run on an efficient basis even though they were located in an oil rich country. They believe that a basically satisfactory competitive position can only be secured, in the longer run, by domestic policies, i.e., through the avoidance of excessive nominal wage increases and the promotion of increases in productivity. However, exchange rate changes may, in their view, in certain circumstances and in the context of appropriate macroeconomic policies be justified. The Norwegian authorities do not currently entertain any plans either to devalue or to appreciate the Norwegian krone.

The staff mission noted that the Norwegian balance of payments position had been very strong in 1983 and 1984 and that, even though the current account surplus was projected to fall in 1985, the prospects were for an outcome which would again be strong. Exchange rates of smaller countries vis-à-vis each other (e.g., the relationship of exchange rates of the Nordic countries) were of considerable importance. It had also to be recalled that, as the Norwegian authorities had stated during the last consultation discussions, frequent changes in the exchange rate might prove to be self-defeating because of the effects on wages and prices. All in all the staff mission were not certain that the lowering of the value of the krone in 1984 had been required.

In reply, the Norwegian representatives, while acknowledging that it was natural from an international point of view to scrutinize exchange rate actions carefully, emphasized that Norway was in a unique position. It was a large energy exporter but was a fully industrialized country that was concerned to maintain a diversified production base. The durability of the current account surpluses could be in doubt--indeed, it was not difficult to construct plausible scenarios that indicated the transitory nature of the surplus. While agreeing that over the longer term it was highly important to contain the growth of domestic costs through the restraint of domestic demand, the Norwegian representatives said that the actions taken in 1984 were in part guided by fears of a fall in the current account surplus in 1985 and beyond. The experience of the 1970s had been of exchange rate moves made too late; moreover, there was a lag between a change in the rate and the consequent effects on the domestic economy, and the 1982 and 1984 actions were believed by the authorities to be timely.

5. Exchange controls

Following the report of an official commission, a number of controls on capital movements were eased or removed in June 1984, and some further steps were announced in the National Budget published in October; these changes are listed in Recent Economic Developments (SM/84/267, 12/7/84). Some of these measures amounted essentially to no more than a formalization of existing practice (greater freedom for outward direct investment, purchases of foreign residences, and the extension of trade credits to importers). Of more importance was the freedom for residents to buy foreign shares and, to some extent, bonds. It is not expected that the measures taken in June will involve large sums, and they should be regarded as a first step toward more complete liberalization, though no further action was to be expected in the near future (other than those foreshadowed in the National Budget).

6. Trade and foreign aid policies

The Norwegian authorities hold to the view that agreed rules for competition are the best hope for promoting the growth of world trade and for this reason they support greater use of GATT rules and the extension of GATT's activities to such areas as services. The

Norwegian representatives submitted a list of trade policy events since the last Article IV consultation, which is summarized in Recent Economic Developments (SM/84/267, 12/7/84).

Norway's trading system remains liberal except for trade in agricultural products and textiles. As to the latter, Norway had joined the Multifiber Agreement (MFA III) from July 1, 1984 and would therefore discontinue the system of global quotas. About a year would be needed to complete the bilateral agreements with the 14 countries concerned, of which about ten had been concluded so far. The Norwegian representatives thought that the MFA allowed for some liberalization compared with the global quota system, perhaps about 10 percent. A rationalization and a reduction in the number of other goods, chiefly textile items, subject to licensing arrangements had been implemented from January 1, 1984. The market share of the domestic textile industry had declined from 34 percent in 1979 to less than 25 percent in 1983. As to agriculture, there had been no change in policy but a study was under way to see how imports from LDCs could be increased, and some minor steps were expected for 1985.

In addition it is expected that as a result of a major review of the Norwegian GSP system, an increase will be made early in 1985 in the number of agricultural and industrial products subject to duty-free entry. As a result of the GSP system, the EFTA agreement and the free trade agreement with the EC about 80 percent of imports are duty-free.

Norway has acceded to all the agreements concluded in the Tokyo-round of multilateral trade negotiations and has complied with their provisions. The negotiations on tariff reductions resulted in an average cut in previously existing tariff rates, the reductions to be carried out in eight equal steps beginning in January 1980. A proposal is before the Norwegian Parliament to implement the three remaining steps in one operation on January 1, 1985 (most other OECD countries have advanced the implementation of tariff cuts by one year).

The Norwegian representatives said that no foreign banks had yet entered Norway, though six applications were pending. When they were admitted, they would be treated equally with domestic banks, i.e., they could undertake domestic credit operations. It was expected that they would offer foreign exchange transactions on somewhat more competitive terms than were currently available from Norwegian banks.

Total subsidies (including grants, loans, and tax deductions) to producing sectors remain large in Norway, amounting to about 4.5 percent of mainland GDP in 1983 about two thirds of which go to agriculture and fishing. They are equal to 89 percent of the value added in agriculture and 33 percent in fisheries. The balance is concentrated in shipbuilding, where subsidies have declined markedly since 1981 (and are scheduled to decline again in 1985) and some traditional sectors of manufacturing. The purpose of the subsidies is to maintain employment rather than to support the balance of payments. The goverment has stated that it will require documentation of wages developments in connection with applications for subsidies, and that excessive wage increases could indicate that particular support schemes should be phased out. Rough estimates suggest that subsidies as defined above will remain at roughly the same percentage of GDP in 1984 and 1985.

ODA disbursements have been stepped up from 0.82 percent of GDP in 1981 to 1.06 percent in 1983; in 1984, they are expected to amount to about 1.05 percent. Of the total 1984 amount about half is in the form of bilateral aid.

V. Staff Appraisal

Since the Executive Board last discussed Norway in July 1983, the performance of the economy has been broadly satisfactory. GDP has grown moderately if not spectacularly and inflation has continued to fall to a level just over 6 percent. The current account of the balance of payments showed substantial surpluses in both 1983 and 1984, averaging about 5 percent of GDP. The ratio of total net external debt to GDP should be down to about 15 percent by the end of this year and the external debt of the Central Government virtually fully repaid by the early part of next year. However, there are still some areas of concern. Wage and price inflation are on the high side. Secondly, while the increase in output has been associated with some rise in employment, unemployment is still over 3 percent of the labor force; this is of course far less than in most other industrialized countries but the Norwegian authorities perceive it as too high.

So far as the short-run management of the economy is concerned, the staff notes that since 1978 the "adjusted" 1/ budget deficit, which is generally regarded as the best measure of the impact of fiscal policy on the domestic economy, has ranged between 6 and 7 percent of "mainland" GDP. The budget proposed for 1985 calls for a slightly larger adjusted deficit, where a slightly smaller one might have been considered appropriate, given the needs of countercyclical policy. The staff therefore supports the Government's intention that the budget should not be weakened through the year. Partly, but not only, for fiscal reasons, the Government should do all it can to limit the increase in wage settlements in the public sector. The staff already pointed out last year that the claims of government expenditure upon domestic resources has reached very high proportions (about 50 percent of GDP). There is surely a need for the utmost restraint in this area, all the more so if the Norwegian authorities are to continue with the practice, surprisingly successful so far, of seeking to moderate the increase in wages by introducing tax reductions to support real disposable income. It will, as in other countries, be particularly important to exercise firm control over the growth of transfer payments which have in recent years showed the fastest rate of growth.

1/ That is to say, the deficit before loan transactions adjusted to exclude oil revenues.

The interpretation of monetary policy is made difficult by the use of interest rate and other controls but in the view of the staff, monetary policy in the last two years has been accommodating, with broad money rising significantly faster than money incomes--a policy stance which is also planned for 1985. Such a stance looks inconsistent with the objective of achieving a further slowdown in inflation, and the staff would like to see a tightening of policy. In addition, it would be desirable to make monetary policy a more effective instrument of demand management and also to improve the structural efficiency of the financial system in the long run. The basic requirements for these objectives are giving greater attention to developments in the monetary aggregates and--a closely allied point--a steady relaxation of the controls which presently apply in the monetary area, especially a much greater degree of flexibility in interest rates.

Although the increase in wage costs has slowed down markedly in recent years, the pace of wage inflation in Norway remains higher than that in its partner countries, and would remain so in 1985 even if the official wage objectives were realized. With the present set of financial policies, the prospects for this objective do not look good. This is another reason for keeping the lid on public sector settlements. The need for stricter demand management policies is also underlined by the Government's wish not to become directly involved in private sector negotiations.

Although the balance of payments is at the moment very strong, there is an element of doubt about the medium term, particularly because of uncertainties about oil and gas exports. The degree of "downside risk" perhaps looms larger in the minds of the Norwegian authorities than in the minds of the staff but in any event it seems prudent to continue for the time being to limit the domestic spending of oil revenues to an amount equal to an adjusted budget deficit of around 6 to 7 percent of GDP, and to consider running some sort of "buffer fund" into which "surplus" amounts of foreign exchange can be paid. Up to now the Government has used a considerable part of the current account surplus to pay off central government debt and since the last consultation it has begun the process of relaxation of controls on outward capital movements; the staff would favor early action to carry liberalization further or even to abolish the controls.

If in the medium term the foreign exchange proceeds from oil operations, and consequently the tax paid to the Government, turn out to be relatively depressed it will of course be necessary for Norway to increase its exports of traditional exports of goods and services over the years for it to achieve a reasonable balance of payments position while maintaining a satisfactory rate of growth of output. There are some obvious inefficiencies in the traditional sector which need to be tackled, e.g., the present scale of subsidies. While the needs of regional policy must be taken into account--Norway has a number of relatively small and isolated communities often dependent on a single company--greater priority should be given to adjustment programs to phase out subsidies. That being said, the tasks of maintaining competitiveness should be carried out through the control of domestic costs, and in this connection the staff would like to emphasize that such control would not only help to keep the export sector competitive but also to help future employment prospects in the sheltered sector--the sector that must provide the bulk of future employment opportunities. The body of this report contains a full exposition of the views put forward by the Norwegian authorities to support the actions taken in July and September 1984, which together resulted in a lowering of the value of the krone by over 4 percent since December 1983. The staff believes that in present circumstances, i.e., in view of the strength of the present external position, Norway should eschew the use of downward movements in the exchange rates to compensate for inability to bring about the necessary restraints in domestic costs. Such action can have domestic disadvantages and might also have disadvantages from an international point of view.

If the exchange rate is not changed, and if wage costs cannot be sufficiently dampened, the necessary alternative will be the implementation of a stricter demand management policy. This could lead, as it has done in other countries, to what one hopes would be no more than a transitional period of higher unemployment. While this is not an attractive possibility, the staff wonders whether present employment objectives can be achieved without running the risk of a higher rate of inflation--a self-defeating policy--or perhaps alternatively, if employment is boosted in artificial ways, of greatly increasing the structural inefficiencies and distortions within the economy.

The staff notes with satisfaction, as it did last year, that Norway's trading system has remained substantially open, and the excellent record on foreign aid has been maintained.

The Norwegian external position does not give ground for present concern and in those circumstances the staff recommends that the next Article IV consultation with Norway be concluded not later than July 1986.

Fund Relations with Norway

(As of end-October 1984)

I. Membership status

(a) Date of membership: December 1945.

(b) Status: Article VIII, as from May 11, 1967.

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 699.0 million.

(b) Total Fund holdings of kroner: SDR 271.3 million (38.8 percent of quota).

(c) Fund credit: none.

(d) Reserve tranche position: SDR 427.7 million.

(e) Current operational budget: Norway was included in the September-November operational budget for the amount of SDR 44.3 million on the transfer side and SDR 10 million, on the receipts side.

(f) Lending to the Fund: Norway has agreed to participate in the facility via the BIS.

III. Stand-by or extended arrangements and special facilities

None.

IV. SDR department

(a) Net cumulative allocation: SDR 167.77 million.

(b) Holdings: SDR 268.7 million or 160.2 percent of net cumulative allocation of SDRs.

(c) Current designation plan: not applicable.

V. Administered accounts

Norway has contributed SDR 1.4 million to the SFF Subsidy Account.

VI. Overdue obligations to the Fund

None.

VII. Norway has not used Fund resources to date.

B. Nonfinancial Relations

VIII. Exchange rate arrangements

The value of the krone has been maintained within narrow margins (2 1/4 percent) relation to a basket of currencies of major trading partners since December 1978, when Norway discontinued participation in the European common margins arrangement. In August 1982 the number of currencies included in the basket was increased from 12 to 14 and the weights of the individual currencies were changed. At the same time the krone was devalued by 3 percent in effective terms, and a further 3 percent devaluation followed a month later. On July 2, 1984, the basis for calculation of the effective exchange rate was changed from an arithmetic average to a geometric average in such a way that a further depreciation of 2 percent could be accommodated within the existing informal margins. In September, the authorities announced that the exchange rate would be maintained at a level 2 percent below than that seen in recent months although still within the established margins.

IX. Last Article IV consultation

Discussions for the 1983 Article IV consultation were held in Oslo during the period April 26-May 6, 1983. The Staff Report (SM/83/120, 6/8/83) was discussed by the Executive Board on July 22, 1983 (EBM/83/109). It was expected that the next Article IV consultation would be held by January 1985.

Norway - Statistical Issues

1. Coverage, currentness, and reporting of data in IFS

		Latest Date in Nov. 1984 IFS
Real sector	- National accounts	1983
	- Prices	September 1984
	- Production	August 1984
	- Employment	2nd Qtr. 1984
	- Earnings	2nd Qtr. 1984
Government finance	- Deficit/surplus	1982
	- Financing	1982
	- Debt	1982
Monetary accounts	- Central bank	August 1984
	- Deposit money banks	June 1984
	- Other financial institutions	July 1984
External sector	- Merchandise trade: Values	1st Qtr. 1984
	- Merchandise trade: Prices	1st Qtr. 1984
	- Balance of payments	4th Qtr. 1983
	- International reserves	September 1984
	- Exchange rates	September 1984

During the past year, the reporting record of the IFS correspondent has been excellent.

2. Outstanding statistical issues

Monetary accounts

Consolidated monetary accounts have thus far been made available with a greater lag than generally seen for industrial countries. Steps are being taken to shorten the lag.

National accounts

Quarterly national accounts will be available later this year.

Norway: Basic Data

Area: 323,883 square kilometers

Population: 4.1 million (end-1983)

GDP in 1983: NKr 401.8 billion; per capita SDR 12,450

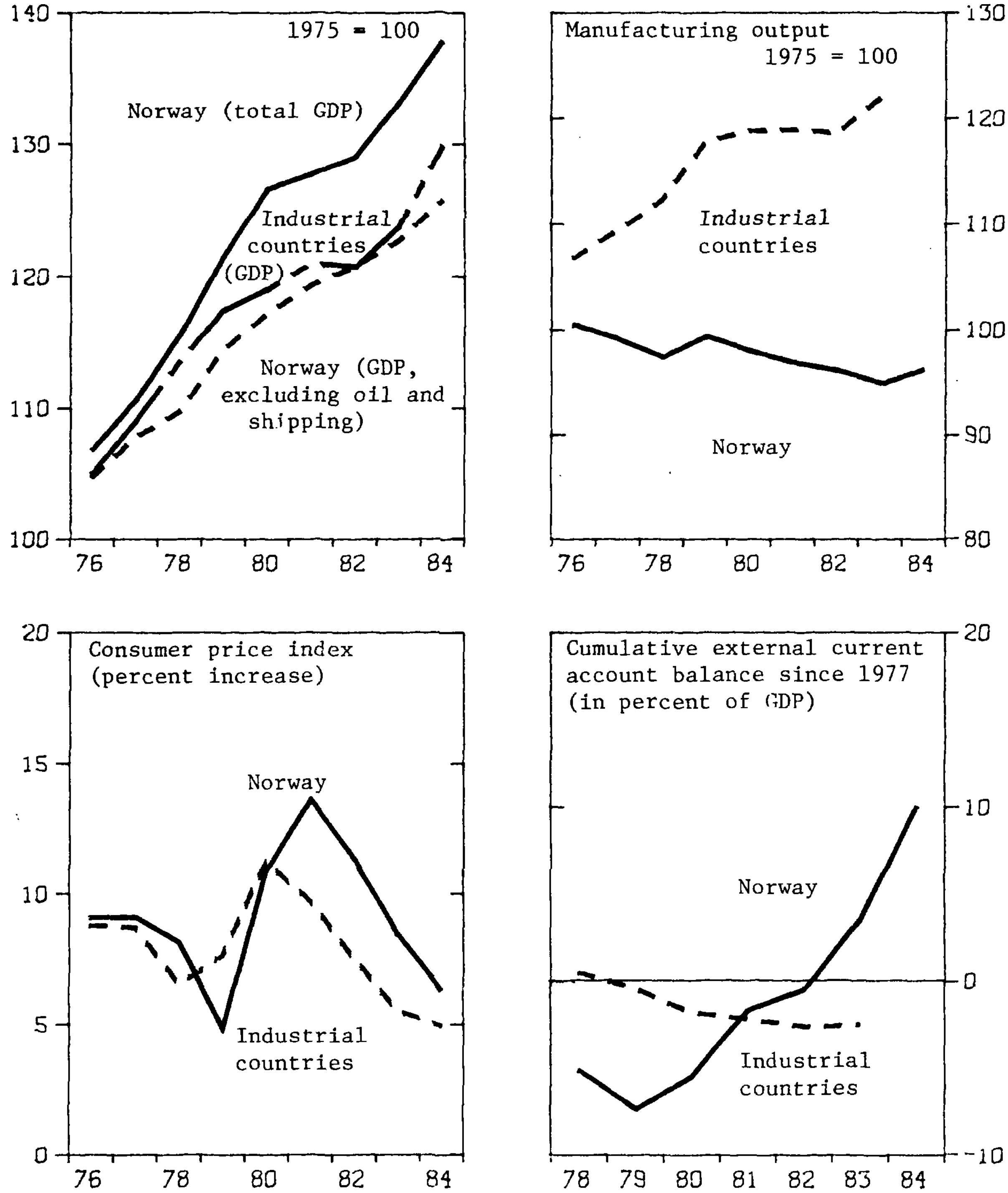
	1981	1982	1983	1984 1/	1985 2/
Demand and supply (volume changes in per cent)					
Private consumption	1.1	1.4	1.0	1.5	2.4
Public consumption	6.1	3.7	3.7	3.3	1.3
Gross fixed investment	17.9	-9.7	2.7	11.9	-7.1
Stockbuilding 3/	-5.3	4.0	-2.6	-2.0	--
Total domestic demand	0.9	2.8	-0.7	2.6	2.9
Exports of goods and services	1.4	0.2	7.0	5.6	-1.4
Imports of goods and services	1.5	4.2	-1.2	4.1	2.8
Gross domestic product	0.9	1.0	3.2	3.4	0.9
Excluding oil and shipping	(1.7)	(1.1)	(1.6)	(2.4)	(2.3)
Selected economic data (annual percentage change)					
Consumer prices	13.6	11.4	8.4	6 1/4	5 3/4
GDP deflator	14.0	9.9	7.1	...	...
Manufacturing sector					
Output	-1.1	-0.8	-1.2	1.5	2.3
Output per man-year	0.7	1.8	4.5	3.5	2.5
Unit labor costs	11.1	9.2	3.9	3.5	...
Oil and gas production (million t.o.e.)	48.7	48.9	55.0	60.0	58.0
Unemployment rate (in per cent)	2.0	2.6	3.3	3.1	...
Public finance (cash basis; in per cent of mainland GDP)					
Central government					
Revenue (excluding oil revenue)	42.8	42.1	42.5	43.0	42.6
Expenditure	49.2	48.9	49.8	50.0	50.0
Balance, excluding oil revenue	-6.4	-6.8	-7.2	-7.0	-7.4
Balance, including oil revenue (as percent of total GDP)	3.3	2.8	2.0	3.9	1.6
Money supply (percentage contributions to growth)					
Central government	0.1	-0.6	-2.0	-3.4 4/	...
Commercial banks, etc.	12.9	12.6	13.6	14.9 4/	...
Total domestic sources	13.0	12.0	11.6	13.3 4/	...
Change in foreign assets	3.5	3.0	0.8	5.8 4/	...
Increase in broad money (M2)	13.5	11.3	11.2	14.9 4/	...

	1981	1982	1983	1984 1/	1985 2/
Balance of payments (NKr billions)					
Exports, f.o.b.	106.9	114.8	133.1	153.7	154.4
Imports, c.i.f.	-90.5	-100.6	-101.9	-113.4	-123.2
Trade balance	16.4	14.2	31.2	40.3	31.2
Net services and transfers	-3.9	-10.1	-14.9	-12.8	-10.5
Current balance	12.5	4.2	16.3	27.5	20.6
(in billions of SDRs)	(1.8)	(0.6)	(2.1)	...	...
(in per cent of GDP)	(3.8)	(1.2)	(4.1)	(6.2)	(4.4)
Public sector long-term capital	-5.6	-9.3	-13.0	...	...
Private sector long-term capital	1.4	12.0	1.7	...	...
Short-term capital and errors and omissions	-5.7	-2.8	-5.7	...	...
Reserves (end-period) in billions of SDRs	5.4	6.3	6.4	8.4 5/	...
Reserves (end-period) in weeks of merchandise imports	21	25	27	32 5/	...
Competitiveness indicators (annual percentage change)					
Relative unit labor costs	3.2	4.3	-1.8	--	...
Relative export unit values	-2.7	-4.2	-1.4	...	...
Volume of traditional exports 6/	3.8	-1.2	9.7	5.0	4.0
Terms of trade, traditional goods	-0.5	-0.9	-1.2	4.2	0.1
Net external debt (in per cent of GDP)	26.7	26.8	22.2	15	...
Exchange rate (end-period)					
Norwegian kroner per SDR (end-period)	6.76	7.78	8.11	8.75 5/	...
Effective rates (December-on-December change in per cent)					
New official basket	3.7	-5.7	1.0	-4.2 7/	...
MERM weights	-0.6	-8.6	-1.7	-4.2 8/	...

1/ Official projections.
2/ Official forecasts.
3/ Change in per cent of previous year's GDP.
4/ Six months to end-June seasonally adjusted at annualized rate. Parts sum only approximately to whole.
5 End-September.
6/ Traditional exports exclude ships and oil rigs, and oil and natural gas.
7/ December 1983 to October 16, 1984.
8/ December 1983 to September 1984.

CHART 1

NORWAY IN AN INTERNATIONAL CONTEXT



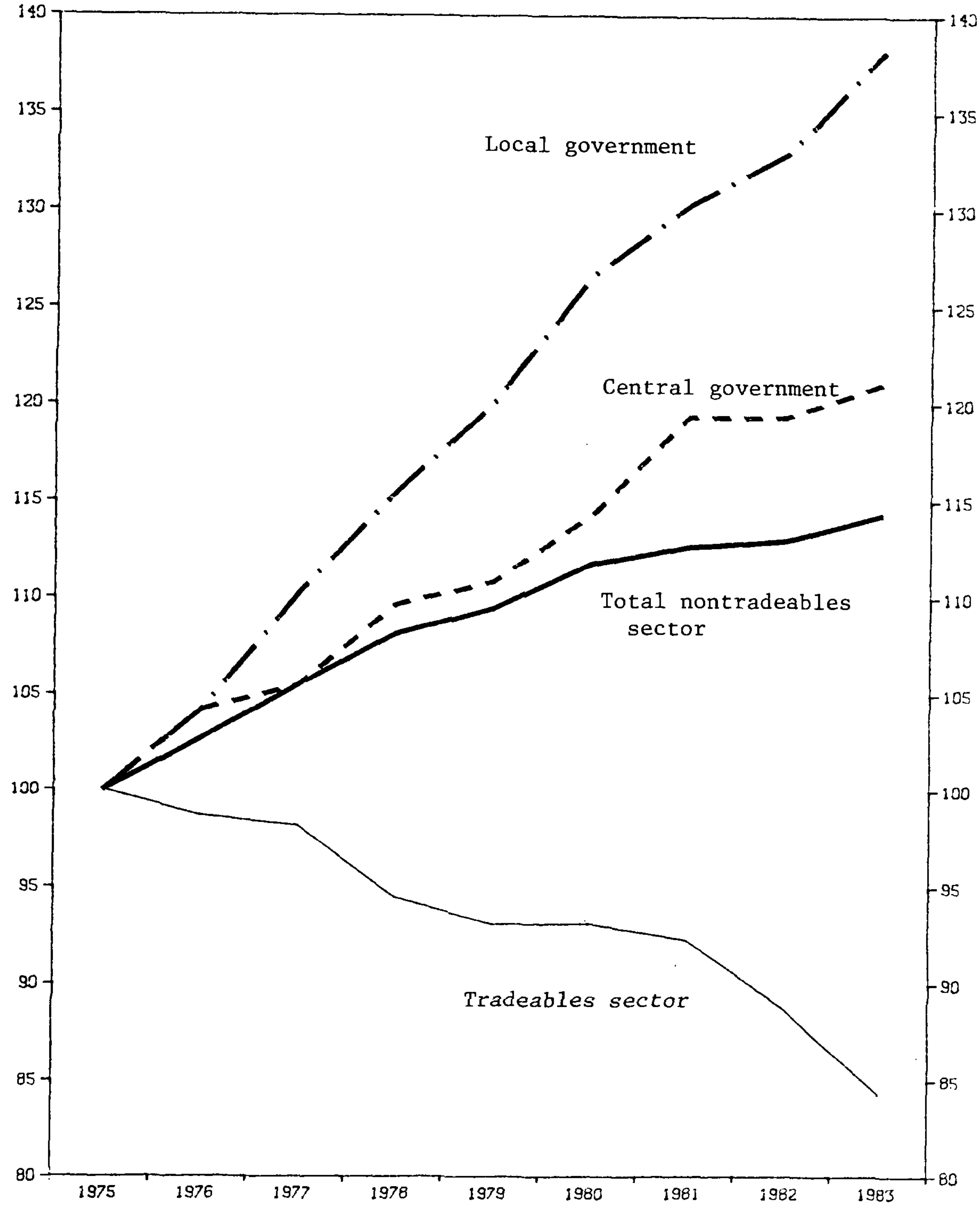
Sources: IMF, International Financial Statistics and World Economic Outlook; and data supplied by the Norwegian authorities.

CHART 2

NORWAY

DEVELOPMENTS IN EMPLOYMENT

(1975 = 100)

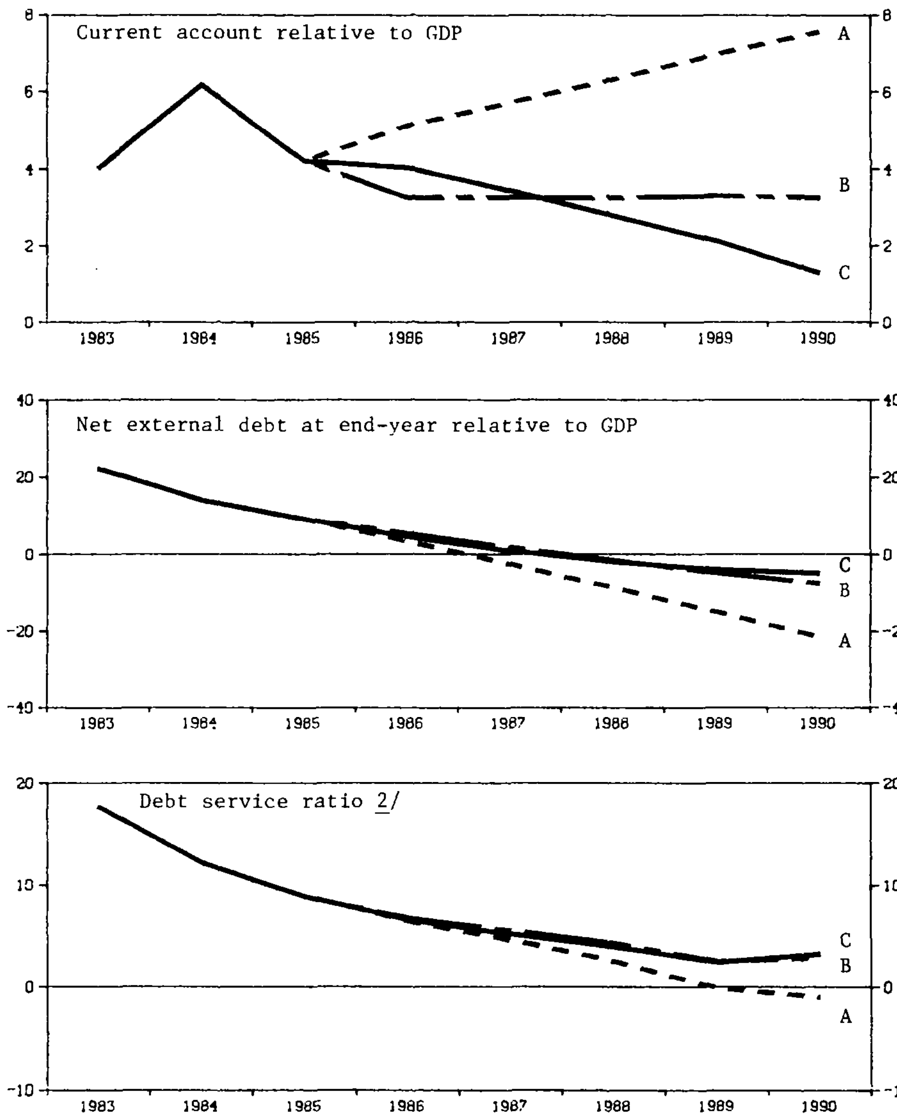


Source: Data supplied by the Norwegian authorities

CHART 3

NORWAY: ILLUSTRATIVE PROJECTIONS OF EXTERNAL DEBT 1/

(In percent)



Sources: Historical data (1983) and official forecasts (1984-85) provided by the authorities; and staff projections (1986-90).

1/ The illustrative medium-term projections for 1986-90 involve the assumptions that domestic demand in Norway and in its partner countries grows at 3 percent per year in real terms and that prices of domestic output except oil increase by 4 1/2 percent per year both in Norway and abroad. Interest rates on new borrowing are assumed to decline gradually from present levels to a real level of 4 1/4 percent by 1986 and 3 1/4 percent by 1989.

Three cases are shown in this Chart: (A) the relative price of "oil" (oil plus gas) remains at its mid-1984 level through 1990, while output grows in line with Statoil projections (5 percent per year) after a forecast fall of 4.4 percent in 1985; (B) a weaker oil price and/or production development, including a sudden drop of 10 percent at end-1985 and a further decline of 3 percent per year thereafter, and amounting by 1990 to 25 percent less oil export receipts than in Scenario (A); and (C) oil price and volume as in (A) together with the volume effects on traditional imports and exports of an appreciation of the real exchange rate by 2 percent per year after 1985. (Statoil is the Norwegian state oil company.)

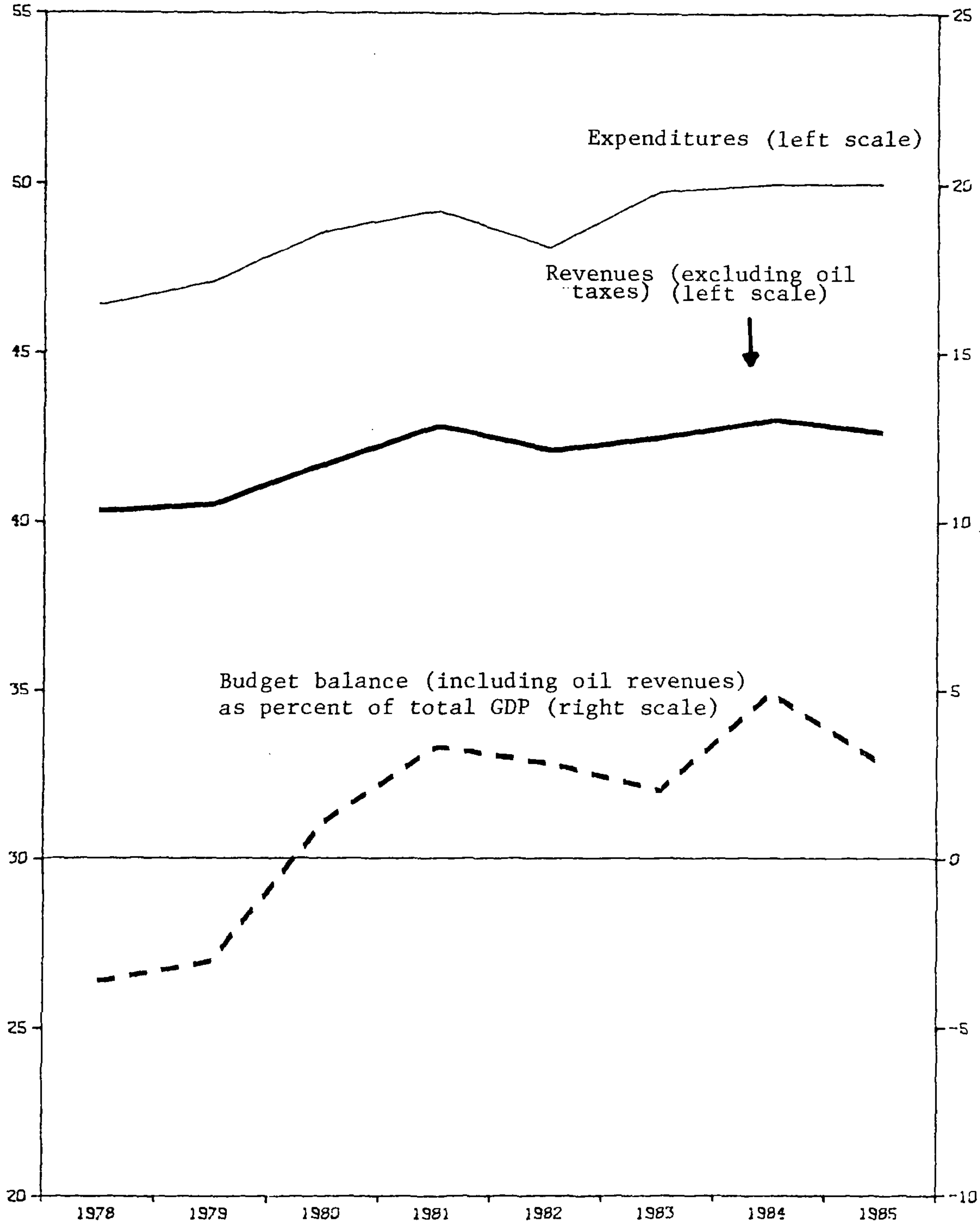
2/ Total interest payments plus amortization of medium- and long-term debt, the sum relative to exports of goods and services.

CHART 4

NORWAY

CENTRAL GOVERNMENT BUDGET

(As percent of mainland GDP)



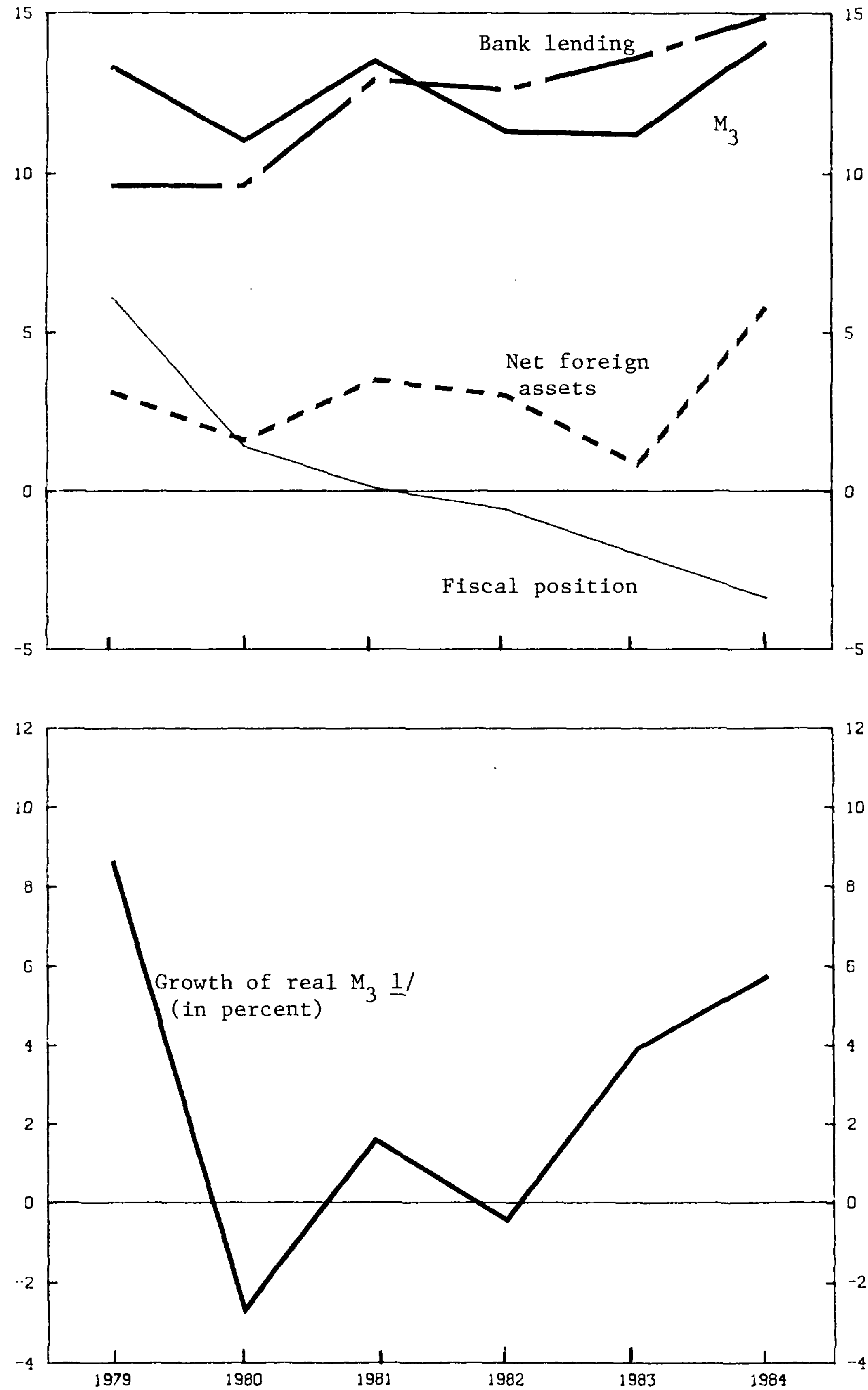
Source: Data supplied by the Norwegian authorities.

CHART 5

NORWAY

MONETARY DEVELOPMENTS

(Contributions to growth of M_3 in percent)



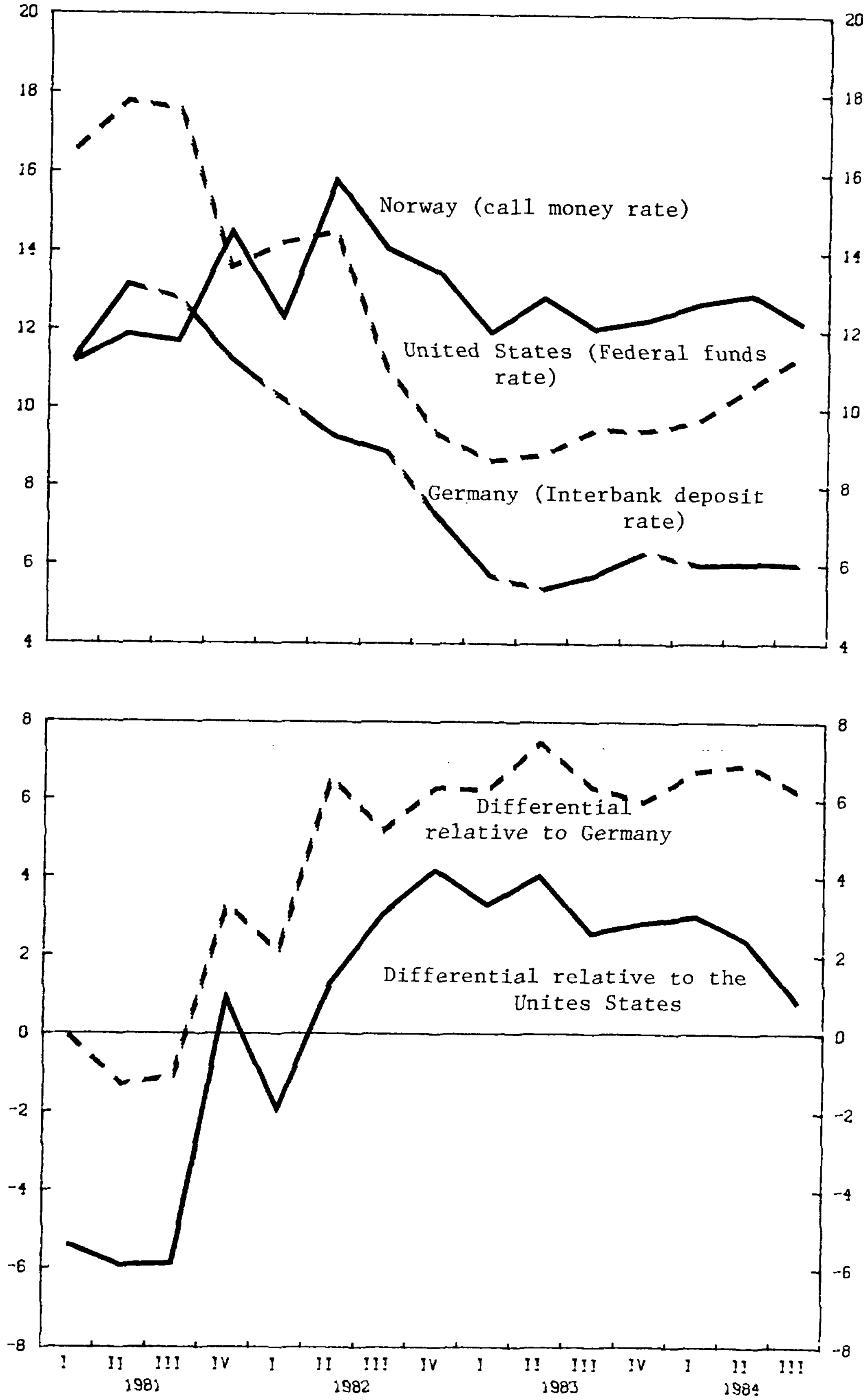
Source: Data supplied by the Norwegian authorities.

1/ Growth of broad money (M_3) during the year deflated by consumer price inflation.

CHART 6

NORWAY

INTEREST RATES
(In percent per annum)



Source: IMF, International Financial Statistics.

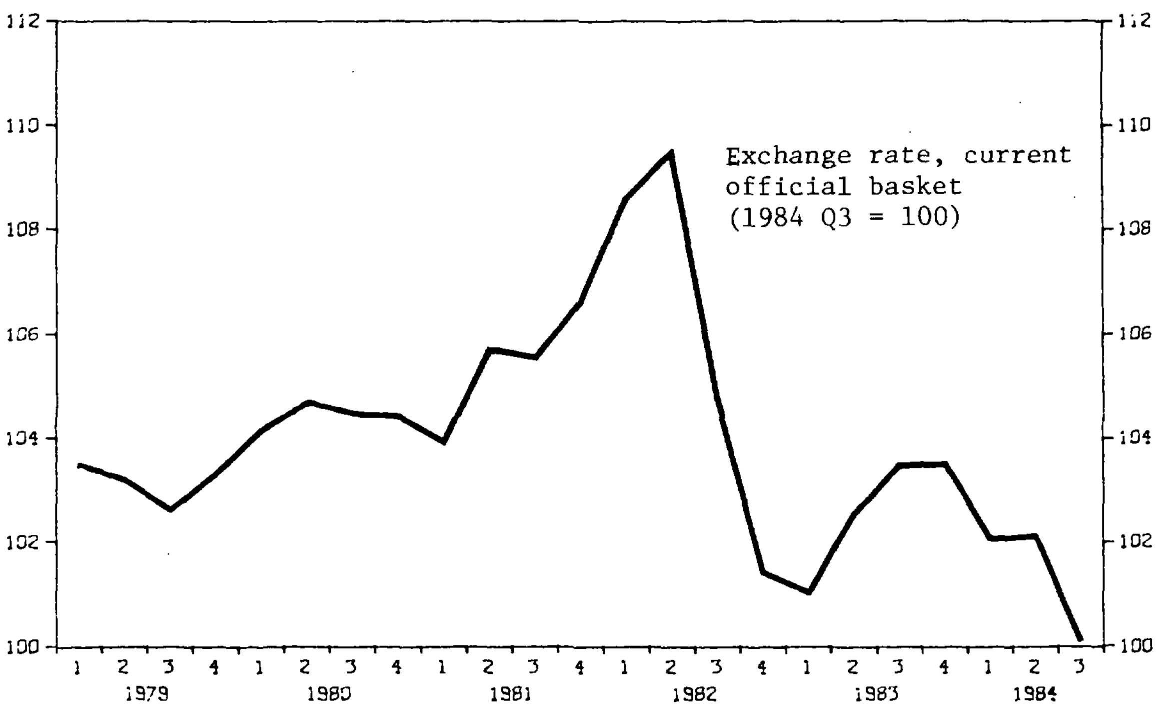
CHART 7

NORWAY

EXCHANGE RATE DEVELOPMENTS

(1980 = 100)

Source: IMF, International Financial Statistics.



Source: Data supplied by the Norwegian authorities.