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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/82

10:00 a.m., June 11, 1993

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
T. C. Dawson	M. E. Hansen, Temporary
	J. B. Wire, Temporary
	J. Prader
I. Fridriksson	J. A. Solheim
H. Fukui	N. Tabata
	L. E. N. Fernando
	T. P. Thomas, Temporary
J. E. Ismael	
D. Kaesar	
A. Kafka	
K. Kagalovsky	
G. Lanciotti	
	I. Martel
	D. Desruelle, Temporary
	G. Torres
A. Mirakhor	O. Kabbaj
	H. Golriz, Temporary
L. Mwananshiku	B. Dlamini
	J. Dorrington
	O. Havrylyshyn
C. V. Santos	A. R. Ismael, Temporary
S. Schoenberg	
A. S. Shaalan	Y. Y. Mohammed
	G. F. Murphy
E. L. Waterman	
	Wei B.
A. Zoccali	A. F. Jiménez de Lucio
	L. E. Breuer, Temporary

J. W. Lang, Acting Secretary
K. S. Friedman, Assistant

Also Present

IBRD: M. H. Cordeiro, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; C. V. Callender, A. S. Franco, E. G. Kpodar, G. G. Moser, R. H. van Til. European I Department: J. R. Artus, Deputy Director; M. C. Deppler, Deputy Director; B. Arnason, B. Drees, L. P. Ebrill, R. F. Krieger, S. Öberg, M. J. Stephenson, H. Vittas. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; J. L. Hagan, Jr., J. M. Ogoola. Policy Development and Review Department: A. Basu. Secretary's Department: R. S. Franklin, A. Leipold, A. Mountford. Treasurer's Department: D. Williams, Treasurer; K. Boese. Advisors to Executive Directors: M. B. Chatah, B. R. Fuleihan, G. Y. Glazkov, J. Jonas, Y.-H. Lee, A. Raza, B. A. Sarr, J. W. van der Kaaij, Yang X. Assistants to Executive Directors: H. M. Al-Atrash, S. E. Al-Huseini, M. C. B. Arraes, D. A. Barr, G. M. Blome, C. D. Cuong, M. Dzervite, R. Ferrillo, L. Fontaine, A. Galicia, N. P. Hahnemann, K. M. Heinonen, V. Kural, K. J. Langdon, B. M. Lvin, S. C. McDougall, F. Moss, S. Narube, R. K. W. Powell, P. Rubianes, S. Shimizu, F. A. Sorokos, R. Thorne, S. Vori.

1. YUGOSLAVIA - MEMBERSHIP IN THE FUND OF SUCCESSOR STATES - EXTENSION OF PERIOD FOR FULFILLMENT OF REQUIREMENTS

The Acting Chairman noted that two Executive Directors had proposed an extension of the period for the fulfillment of the requirements with respect to membership in the Fund of the successor states of the former Socialist Federal Republic of Yugoslavia (SFRY) and had requested that the matter be placed on the agenda. In that connection, he had been advised by the General Counsel that equal treatment should be given to the successor states with respect to extending the period. Accordingly, a date to which the Board might extend the period was December 14, 1993, the anniversary of the date on which the Board had taken the initial decision on succession to the membership of the former SFRY.

The Executive Board approved the following decision:

The period under paragraph 3(d) of Decision No. 10237-(92/150) of December 14, 1992 within which a successor may succeed to the membership of the Socialist Federal Republic of Yugoslavia in the Fund is extended through December 14, 1993.

Decision No. 10387-(93/82), adopted
June 11, 1993

2. NORWAY - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with Norway (SM/93/103, 5/13/93). They also had before them a background paper on recent economic developments in Norway (SM/93/118, 6/3/93).

Mr. Solheim made the following statement:

On behalf of my Norwegian authorities I would like to express appreciation to the staff for the excellent reports and the useful discussions during the recent Article IV consultations. My authorities are in broad agreement with the staff's analysis and appraisal.

After a debt-financed expansion in domestic demand and a consequent overheating in the mid-1980s, by 1989 financial consolidation in the private sector and tight economic policies had ensured a return to external balance and a price and wage inflation below that of Norway's trading partners. Since 1990, the current account has shown substantial surpluses, and the external competitiveness of manufacturing industry has improved significantly. Interest rates gradually converged to the European level and, from mid-1990, were within 1 percentage point of the ECU rate. The Norwegian krone was linked to the ECU in October 1990, and, during early 1992, Norwegian short-term interest rates were below the ECU rate. However, as a result of external forces, the krone was forced off the ECU peg in December 1992, and is now floating.

Unemployment started to increase sharply in 1988, and had by the first half of 1992 reached a level of 6 percent. As a consequence, fiscal policy was given an expansionary stance in 1989 and the accumulated demand stimulus from the fiscal budget has been 6 3/4 percent of mainland GDP over the period 1988-92.

The Norwegian economy has been growing moderately since the second half of 1991. The main stimulus to economic growth has been an expansionary fiscal policy and a sharp rise in investment in the petroleum sector. Revised national accounts show an increase in mainland GDP from 1991 to 1992 of 2 percent. Total GDP has also been influenced by continued strong growth in oil exports, and thus expanded by 3.3 percent in 1992. The growth in private consumption was 1.8 percent in 1992. An increase in transfers from the government budget, and tax relief in connection with the 1992 tax reform, have contributed to a strong growth in household real incomes, thus allowing both an increase in consumption and a rise in the household savings ratio from 0.9 percent in 1990 to 5 percent in 1992. Housing investment has contracted by 39 percent over the last two years. Consequently, household savings now consist only of financial savings, while the housing stock is depreciating.

Private business investments in the mainland economy started to fall in 1988 and have remained weak owing to overcapacity, an imbalance in real estate markets, and the sharp rise in the real interest rate. However, an increase in mainland investments of 4.6 percent was recorded in 1992.

The authorities' present forecasts are based on continued moderate growth in private demand in 1994, while fiscal policy is assumed to remain virtually neutral. Private consumption will grow broadly in line with household disposable income. Private investments will be stimulated by the expected pickup in international activity and a winding down of imbalances in the real estate markets, both for residential and commercial buildings. Petroleum investments will increase on the order of 1 percent of mainland GDP in 1993, but are expected to fall somewhat in 1994. Altogether, mainland GDP is estimated to grow by 1 1/4 percent in 1993 and 1 1/2 percent in 1994. This will provide room for a rise in employment, but is not expected to make any inroad into unemployment. Total GDP is projected to grow by 3/4 percent and 2 percent in 1993 and 1994, respectively.

Norway entered early into recession, as economic activity started to weaken substantially in 1988. The structural imbalances that arose from a high cost level and insufficient adaptation to changing conditions in export markets on the part of traditional industries were reinforced by the strong need for financial consolidation in households and companies as well as weak profitability and heavy losses in the banking sector.

These imbalances have, to a substantial degree, been addressed. As a consequence, the Norwegian economy is, together with the Anglo-Saxon countries, growing again. However, substantial challenges remain, both for the medium and the long term. The strong financial position of the public sector reflects large revenues owing to a high level of extraction of Norway's oil and gas resources. Unemployment has not responded to the renewed growth in the mainland economy. This reflects inflexibility in the Norwegian labor market that has to be addressed in the face of increased international competition in the years ahead.

Fiscal policies will be framed in a medium-term perspective. The 1994-97 Long-Term Program of the Government is based on restraining the growth in government expenditure to, or below, the growth rate of the mainland economy. The deficit of the public sector, according to the Maastricht definition, was 2.8 percent in 1992, but is estimated to increase to 3.6 percent in 1993. Nevertheless, Norway remains among the best performers in Europe. The gross debt of the public sector is estimated at 43 percent of GDP by the end of 1992. However, taking into account the sizable capital deposits in public enterprises, primarily in oil and gas extraction, and the substantial claims on the household sector owing to government participation in house financing, the net asset position was estimated at 28 percent of GDP.

The Norwegian authorities have also undertaken an assessment of the composition of the government budget. On the recommendation of the Employment Commission, proposals for a reduction of transfers, and a corresponding increase in expenditure for infrastructure, have been tabled. This will increase the employment-creating part of the budget.

However, as the staff points out, this favorable fiscal situation reflects the high level of oil revenues. According to the calculations of my authorities, the permanent cash flow from the Government's share of the oil resources amounts to about 6 percent of GDP, while the non-oil deficit amounts to about 9 percent of GDP. On this calculation, which my authorities consider as the most relevant approach to evaluating the question of fiscal sustainability, a correction of 3 percent of GDP is required to bring the budget back into a sustainable position. The Long-Term Program aims at a gradual reduction of this magnitude to take place during the current and next program periods. This will ensure that the financial position of the Norwegian Government will remain in substantially better shape than in most other industrial countries.

In the view of my authorities, a crucial economic policy issue is to avoid delaying the start-up of the adjustment process that has to take place in public finances. The proposal for a restructuring of the expenditure side of the budget, and the way these proposals have been received, have clearly illustrated that this will be a long and arduous process. Nor will it be facilitated by the existence of significant surpluses on the current account. With financial investments, both in households and in companies, at an historically high level, the non-oil deficit on the current account is below the permanent income from oil and gas. Thus, the high level of private financial investments makes financing public deficits less of a problem in the short run.

One of the reasons for the divergence between the staff's calculations and the Government's, as to the implied fiscal and current account corrections, is the way the present high level of oil investment influences these measures, i.e., by reducing cash income and giving rise to high imports.

In concluding on fiscal policy, it can be argued that the need for a substantial tightening of fiscal policy and a reduction of deficits is less pressing in Norway than in other industrial countries, although the exposure to the shifting balance in the oil market remains uncomfortably high.

Prior to the floating of the Norwegian krone, the guidelines for monetary policy stated that the central bank should set interest rates so as to maintain the fixed exchange rate. Following the forced floating of the Norwegian krone, new guidelines for monetary policy were put forward in a statement by the Minister of Finance to Parliament in December last year. The guidelines were further elaborated in the Revised National Budget in May, drawing on recommendations from the central bank, in a letter published together with the Revised National Budget.

Monetary policy continues to emphasize the need for continued low inflation. The Government has emphasized that in a small open economy, low inflation--preferably lower than in Norway's trading partners--is hardly possible over time without a high degree of exchange rate stability. At the same time, the Government acknowledges that low inflation is a prerequisite for a stable exchange rate.

The Government aims to return to a fixed exchange rate regime when international conditions so permit. No timetable has been indicated. In the meantime, monetary policy will aim at maintaining stable conditions in the Norwegian currency market.

Monetary policy has thus followed a cautious line since December 1992. Interest rates have been lowered gradually on the basis of a strong and stable krone. Short-term interest rates have fallen by 4 1/2 percentage points since the turn of the year, and they are now lower than the theoretical ECU rate by 2/3 percentage point and below German rates by close to 1/2 percentage point. At the same time, the outflow of foreign exchange in late November and early December has been fully recovered.

A key to a stable development of the Norwegian economy in the years ahead is a strengthening of the traditional industries. The improvement in competitiveness, by 7 percent from 1988 to 1992 and a further 4 percent this year, is an important contribution to stabilization, primarily by stopping the strong shedding of labor that has taken place these last few years. The improvement this year is partly due to a reduction in payroll taxes, which is financed by an increase in the VAT.

Incomes policies will play an important role in securing a rise in prices and wages below that of Norway's trading partners in the years ahead. Incomes policy, through legislative means, played an important part in shifting down wage inflation in the years 1988-89. Obviously, the strong rise in unemployment played a significant role in keeping wage increases at a low level after wage controls had been lifted. It is fair to say, however, that the new structure of wage settlements, where wage increases at the local level are related to, and constrained by, the centrally negotiated wage increases, has also contributed to restraining wage drift.

Structural reform has been an important part of economic policies. Norway's participation in the European Economic Area (EEA) and the application for EC membership are reflections of this, implying that structural adjustment owing to increased international competition will continue. On the other hand, this will secure market access for Norway's products and prevent a dislocation of industrial investment. The tax reform that was enacted in 1992 will ensure a higher rate of return on investment.

Active labor market policies and measures to improve the school-to-work transition have played an important part in keeping total unemployment down and reducing youth and long-term unemployment. A new division of responsibility between labor market and social policy authorities has been established in order to reduce sickness and disability benefits and to stop the discouragement of older workers from labor force participation.

The banking crises have been dealt with in a way that has maintained incentives to recover losses, reduce costs, and improve profitability within banks. Accordingly, the costs to the public purse have also been contained, as the comparisons with other countries indicate. The savings banks, which cater mainly to the personal market, were back in surplus in 1992. Commercial banks, which were more exposed owing to their larger portfolio of business lending, were able to improve results in 1992 and in the first quarter of 1993, and may, after three years of negative results, show a small surplus this year. On present trends, the assessment of the Norwegian authorities is that a gradual reprivatization of the three major commercial banks can be contemplated, and the first steps in this direction will be taken later this year.

Finally, with regard to trade policy, the Government confirms Norway's commitment to a multilateral trading system based on clear rules and transparent procedures. The priorities have, inter alia, been dispute settlement, subsidies/countervailing duties, and antidumping. Safeguarding and improving the multilateral trading system is essential in order to revive growth and create new employment opportunities. Therefore, a multilateralization and conclusion of the Uruguay Round is more urgent than ever before, and Norway is ready to contribute in a constructive way to this process. Norway has therefore offered to present, on short notice, a revised offer as regards market access, i.e., in agricultural goods. In order to promote growth, many countries, including Norway, have entered into regional trading arrangements. These arrangements should be seen as complementary to, and consistent with, the multilateral trading system.

Mr. Schoenberg made the following statement:

Similar to the conclusions drawn by the staff, we see the main objective for economic policy in Norway being further improvement in the efficiency of the mainland economy in order to enhance employment prospects and reduce the dependence on oil. This requires, above all, continued wage moderation, structural reform, and a further strengthening of the fiscal consolidation efforts. The staff has explained in detail what should be done in this regard, and I broadly support its recommendations. I can thus limit myself in my statement to some points of emphasis and to some issues on which we would put the emphasis slightly differently.

First, on fiscal policy, I am quite concerned about the fact that the petroleum-adjusted deficit is expected to widen further in 1993 to 12.7 percent of mainland GDP, despite recent consolidation efforts. The deficit targets for the medium term are not overly ambitious either, as the staff has rightly pointed out in its analysis. I would thus encourage the authorities to consider further expenditure cuts, especially in the area of subsidies and transfers to the private sector, which amounted to nearly 52 percent of total public expenditure in 1992, according to our calculations (see page 59 of the background paper), and which are substantially higher than in many other European countries.

The objective of fiscal policy should be to reduce the non-oil deficit over the medium term to a level not exceeding by more than 2-3 percent the Government's permanent revenue from oil (which is projected to amount to around 6 percent of GDP). This would constitute a convincing consolidation effort and would at the same time preserve Norway's option to join the EMU, if and when it so desires. In any event, I would not go as far as the staff, which appears to advocate the elimination of any oil-adjusted deficit exceeding the permanent cashflow from oil. I do not see convincing reasons why the budget should aim at a zero deficit as long as that part of the oil revenue that is included in the revenue calculation can be considered truly sustainable. I would agree with Mr. Solheim's conclusion that fiscal tightening in Norway is necessary, although it is less pressing than in other industrial countries.

Concerning the recent changes in the tax system, I note that the new value-added tax rate, increased to 22 percent this year, seems to be considerably above the European average, while the substantially reduced corporate tax rate of 28 percent may be regarded as relatively low in comparison with the rates in most EC countries. In Germany, for example, the corporate tax rates are around 50 percent. The existing tax structure in Norway, with a relatively low corporate tax rate, which has been partly compensated for by a shift to indirect taxation and also to some extent by the country's oil revenues, might give Norway's enterprises a certain competitive edge on its external competitors and--as I do not hesitate to admit--can be regarded as a growth-enhancing structural advantage. In view of Norway's Euro-aspirations, however, such a structure may not be sustainable over the medium term. The implementation of the EEA and Norway's probable accession to the EC might force adjustments in the area of indirect taxation. It could become necessary, therefore, to compensate for these adjustments by an increase in direct taxes, including an increase in corporate taxes to levels prevailing in other EC countries.

Let me now turn to monetary and exchange rate policies. Here, I am somewhat surprised by the staff's recommendation not to resist a possible depreciation of the krone as long as this would not threaten to rekindle wage and price inflation, as such a depreciation would strengthen external competitiveness. In my view, external competitiveness is at present not one of Norway's major problems. Relevant external indicators, like the relatively large current account surplus, averaging more than 3 percent of GDP in 1990-92 and enabling Norway to rapidly reduce its foreign indebtedness, and the real effective exchange rate, which is below its 1985 level (see Chart 8 on page 8a), do not indicate that there is a need for any devaluation. Mr. Solheim, in his opening statement, appears to support this view in stating that "the external competitiveness of manufacturing industry has improved significantly" since 1990. More generally, I think that the Fund should be careful to avoid giving advice that could be misinterpreted as advice to seek competitive devaluation. This holds true, of course, not only for Norway, but also for some other European countries in a similar situation. In my view, the issue, under the present weak world economic conditions, is not whether Norway could benefit from a devaluation in terms of gaining some expansionary effect on its economy; obviously, in times of a global recession, not everybody can successfully strive for export-led growth at the same time. Rather, the issue is whether there is a stronger case for a devaluation of the krone than there is, on average, for the currencies of Norway's main trading partners. I suppose that such a case could hardly be constructed. Most of Norway's trading partners, including those that have recently aborted the exchange rate constraints of the EMS, presumably would be quite happy to be in Norway's balance of payments position.

A devaluation of any currency inevitably means a revaluation of one or more other currencies. As I recently remarked in the context of the Board's discussion of the Article IV consultation with Canada, it appears somewhat difficult to detect among the various industrial, and in particular European, countries we have discussed during recent months in the Board, many countries that the staff would consider potential candidates for a revaluation.

I would thus encourage the Norwegian authorities to aim, rather, at greater exchange rate stability. Such a commitment would be in the interest of not only Norway's trading partners, but also the country itself, as this would further strengthen public confidence in the authorities' anti-inflationary strategy. In this respect, I very much welcome Mr. Solheim's statement that in a small open economy, low inflation is hardly possible without a high degree of exchange rate stability, and that the authorities aim at returning to a fixed exchange rate regime when international conditions so permit. As we have learned recently, market pressure on exchange rates has frequently been the result not of weak fundamentals but rather of insufficient policy credibility. To enhance policy credibility, the authorities could, for example, consider announcing their targeted exchange rate band to the market, to limit its width and to defend with determination the targeted exchange rate level against speculative attacks. Such a policy could be complemented by a further strengthening of the institutional autonomy of the central bank. This has already been done in several EC countries (for example, France) in the recent past, and it may be helpful for Norway to follow their example.

Concerning labor market policies, I am somewhat concerned about the fact that the number of persons employed in labor market programs increased from 0.9 percent of the labor force in 1988 to 2.9 percent in 1992, while at the same time the share of the public sector in total employment rose from 25.7 percent to 29.5 percent (see the first paragraph on page 6 of the background paper). Although public job creation schemes of this kind may temporarily reduce unemployment, they can also contribute to a further increase in structural rigidities in the economy, thereby making a lasting solution of labor market problems more difficult. I would therefore encourage the authorities to review the public job creation schemes. The key elements of the authorities' employment strategy should be structural reforms, as outlined in the staff paper, with the aim of enhancing wage differentiation and raising productivity.

Let me finally add one remark concerning the banking crisis. While welcoming, in principle, the rescue operations undertaken by the authorities, I note that the Government now has a dominant influence on credit allocation. Moreover, I learned from the recent OECD country report and from newspaper articles that the implementation of rationalization measures has become more difficult, in particular as far as measures to reduce employment and the number of branches are concerned. This underlines the need for further efforts to encourage the investment of new private capital in the commercial banking sector, including foreign participation. In this context, I wonder whether foreign investment in the financial sector could not be liberalized earlier than currently envisaged, i.e., before 1995.

Mr. Ismael made the following statement:

The Norwegian economy, in my view, has performed relatively well, and the Government must be given the credit for the reduction in inflation to its lowest level since 1960, the significant cut in indebtedness from 20 percent to 8 percent of GDP, the strong external balance despite fluctuations in the terms of trade, and the remarkable improvement in competitiveness. While I share the staff's concern that fiscal consolidation should be the focal point of Norway's medium-term adjustment program, I do not agree with its assessment that the figures should be more ambitious than what is currently envisaged by the authorities in the immediate term. Given these favorable economic developments, the country should be encouraged to address its major concern, which is the historically high level of unemployment.

The rising unemployment since 1988 can, to a large extent, be attributed to the decline in net, fixed capital investment. At this time, GDP was on the way up, but primarily riding on the back of the improvement in the terms of trade in the energy sector alone. This disinvestment, which was largely in response to the drop in asset prices, led to the reduction in productive capacity and labor shedding, which spilled into higher unemployment while the economic cycle swung upward. However, there were two favorable side effects to these developments. First, the large buildup in external reserves afforded a sizable reduction in the country's indebtedness, and, second, the shedding of labor and the reduction in capacity vastly improved competitiveness. I believe that these two factors now provide the needed flexibility for the authorities to address the unemployment overhang.

Given the preoccupation of the government budget with employment support, which, I must say, is not uncommon in this region, the rising unemployment numbers were quickly translated into higher government spending--and, without offsetting reductions in other categories of expenditure or additional revenue measures, the fiscal deficit expanded. These unemployment benefits commonly incorporate ingredients of long-term income support and are, therefore, not entirely focused on encouraging employment.

Measures to alleviate the unemployment situation should, however, be sustainable and in the long run be able to facilitate the efficient operation of the labor market, the reduction in government intervention, and the more efficient utilization of taxpayers' funds. I think that several other measures should be considered. First, the Government should switch to employment-generating expenditures and provide more incentives to investment, particularly in the nonenergy sector. This shift could be easily accommodated through the reduction in government transfers to households and the cutting back on subsidies--thus maintaining the medium-term program of fiscal consolidation. In this regard, the Maastricht Treaty's 3 percent ratio of the budget deficit to GDP should not be regarded as a floor. I welcome the switch from income to indirect taxes, which is supportive of the central theme of providing greater incentives to employment. Furthermore, the Government should plan to divest its equity holdings in the commercial banks back to the private sector as soon as the banks' balance sheets improve and, perhaps more importantly, put in place adequate supervisory, monitoring, and institutional safeguards to avoid such a financial crisis from recurring.

Second, while I agree with staff that competitiveness is an important factor in boosting economic growth and, hence, employment, I must caution against focusing exclusively on wages. Supportive efforts should also be directed at improving productivity through manpower training and technological progress. Any wage movement could then simply reflect productivity gains.

Third, it is paramount that the remaining structural constraints be removed from the labor market so as to maximize the impact of the new government policy on unemployment in the shortest possible time. On this, I refer to decentralizing the system of wage bargaining and cutting back on the generous income support schemes.

Fourth, I agree that monetary policy should be primarily aimed at inflation, and that the exchange rate should not be used as an instrument to gain competitiveness at this time. The substantial narrowing of interest rate differentials in Norway has reflected the improved economic fundamentals and the de-linking of the krone from the ECU. I would urge the authorities to take the opportunity to reduce interest rates further once fiscal consolidation is under way, or if the krone appreciates, whichever comes first.

Finally, I would like to praise the Norwegian authorities for their generous official development assistance, which is the largest, in relation to GDP, of all the industrial countries.

Mr. Lanciotti made the following statement:

The economic strategy in Norway, since the mid-1980s has had a twofold orientation: an attachment to stable exchange rates to help achieve low inflation; and the implementation of supply-side reforms in all sectors and, more recently, in the financial sector, which, like in other countries in the region, was hit by systemic crisis.

On the inflation front, progress has been made, leading to a narrowing of interest rate differentials vis-à-vis major trading partners. At the same time, mainland economic activity has remained sluggish, despite the expanding oil and gas activity and the expansionary thrust of fiscal policy since 1989, which has led to a marked deterioration in the Government's financial position. The productivity gap of the mainland economy vis-à-vis major competitors has not narrowed significantly, and non-oil exports have lost market shares. Despite the large expansion of labor market programs and the rapid growth in the Government's share of total employment, which now counts for more than 30 percent, the goal of maintaining a high level of employment has proved elusive, with unemployment rising to record levels for Norway and projected to further increase in 1993. Against this background, the staff report and the background paper cast serious doubt on Norway's medium-term economic prospects on account of current policies. I fully concur with the staff's views on the serious downside risks that surround the authorities' macroeconomic scenario. I will center my comments on three issues: the fiscal policy stance; structural policies; and the current banking structure.

As the staff analysis shows, a sizable fiscal adjustment is necessary to ensure lower non-oil budget and current account deficits. If the net financial position of the Treasury was to be maintained, the primary deficit in 1993 should be kept in the range of 0.5-1.0 percent of GDP. Against this requirement, the budgeted primary deficit for this year was set at 8.5 percent of GDP. Clearly, the fiscal position is out of line, calling for an adjustment of 7 to 8 percentage points of GDP to stabilize the Government's financial position. Instead, the medium-term fiscal plan envisages an adjustment of the non-oil budget balance of no greater than 1 percent of GDP over the next four years. This implies that planned non-oil deficits will be well in excess of the permanent income flow from oil extraction, which does not serve the need to preserve the oil-generated wealth of future generations. If the aging population and the expected increase in social expenditure are also taken into account, the fiscal adjustment that is required far exceeds what is currently planned by the authorities for the period ahead. I fully support the staff's argument that the Maastricht deficit criterion is not an appropriate benchmark for a country that relies heavily on a depletable natural resource.

With respect to the implementation of structural policies, much room remains for further initiatives. One of the areas that stands out the most is subsidies, which have tended to protect ailing parts of the mainland economy. It was estimated by the EC Commission last year that, even excluding food subsidies and subsidies administered by local governments, the ratio of remaining subsidies to GDP was more than 7 percent in 1992, compared with 2 percent on average for the industrial countries. Also, there is large scope for efficiency gains through a simpler regulatory framework as well as reforms and reorganization to improve productivity in the public sector. In addition, the sphere of forbidden restrictions on competition should be extended, along with parallel steps to strengthen antimonopoly surveillance. At the same time, fundamental labor market reform is required to improve the flexibility of the market and facilitate the reintegration of unemployed persons. In fact, market rigidities have intensified in recent years: the "natural" unemployment rate gradually increased; the relationships between unemployment and vacancies and between unemployment and capacity utilization have worsened; and the low and decreasing interindustry wage dispersion does not augur well for job prospects, especially for the young and the long-term unemployed.

The recent banking crisis, which has led to considerable turbulence in the Norwegian financial system, also had important structural implications. The main factors behind the crisis have been rectified, to some extent, but at the cost of a general involution of the system, symbolized by greater intervention in it by public finances, in sharp contrast to what is happening worldwide, especially in the EC, which the country plans to join. State control now extends to the three largest commercial banks, several large savings banks, which have received preference capital from the state, and the largest mortgage company (Realkreditt), while the reorganization of the Postal Savings Bank into the Post Bank has extended even further the state's role in the allocation of credit.

Despite the improved risk-adjusted capital ratios resulting from the repeated injections of public funds, the general picture of the banking sector still leaves much to be desired, with many banks still incurring sizable loan losses. The projected weak economic growth will likely tend to sustain these losses, keeping capital ratios under pressure for some time. While prudential supervision may partially address the problem of risk exposure, little can be done under public ownership to ensure that bank assets are deployed efficiently. Efficiency issues will become important, particularly in view of the abolition of the so-called Concession Rule by January 1, 1995, with the branches of foreign banks being able to draw fully on the capital base of their foreign parent.

In summary, against the background of poor economic performance in recent years, the authorities' economic strategy seems now to have two aims: to contain the budget deficit while reallocating government expenditure to support employment; and to address the need for more flexible goods and labor markets as part of the structural policy challenge facing an economy with high natural resource endowment. On both fronts, the prospects are not encouraging, owing to a lack of ambitious policies to support an appropriate framework of macroeconomic and fiscal planning. At the same time, the banking sector remains fragile, and has developed an organizational structure that will sustain inefficiencies and complicate the implementation of monetary and credit policy.

Mr. Tabata made the following statement:

I appreciate the efforts made by the authorities to adjust the imbalances of the Norwegian economy in the past couple of years. However, some effort remains to be made. The economic targets to be aimed at by the authorities are to boost the economy on a noninflationary sustainable growth path, to reduce unemployment, to make the financial system healthy and stable, and to reduce the heavy dependence on the oil sector. In order to attain these various targets, the implementation of an adequate policy mix is all the more important.

On the fiscal front, as the consolidated central government deficits, including social security, and the state budget deficit, excluding the oil sector, have expanded in recent years and are expected to reach 5.4 percent and 12.7 percent of GDP, respectively, this year, additional expenditure cuts, particularly in social security-related outlays and subsidies to agriculture, should be executed. At the same time, it is necessary to assign part of the saved money to an increase in public works expenditures to stimulate the economy, to the extent that the total deficit would be reduced below the projected level.

With respect to monetary policy, it seems necessary to reduce interest rates to stimulate the domestic economy. A slight depreciation of the krone against the major currencies may be allowed. The relaxation of monetary policy, in particular, by lowering interest rates, will not only boost the economy but also surely widen the spread, increase profits, strengthen the capital base of banks, and finally allow them to write off bad loans.

In this respect, the injection of official money into the banking sector should be limited. The idea of the establishment of a "bad bank" is not necessarily invalid, if its character is similar to that of the Resolution Trust Corporation, which played a prominent role in coping with the difficulties of the U.S. savings and loan problems. While the official money is not necessarily adequate to rescue individual banks, it can be useful in strengthening the capital of a corporation that buys the collateralized nonperforming loan. In addition, in order to solve the problems of the financial system in Norway, gradualism is likely to be adequate, taking into account the urgency to reduce the unemployment.

With regard to the reduction of the unemployment rate, it is welcome that the authorities are trying to reorient public expenditures from income transfers to training and other active labor programs; at the same time, continuing to lessen the wage increase is all the more important.

I would like to make a brief comment on the structure of the Norwegian economy. More than 60 percent of real growth is contributed by the oil sector, and approximately one half of export goods consists of petroleum. It is urgent to reduce the heavy dependence on the oil sector. Tax incentives or accelerated depreciation for specific industries are necessary to increase productivity and to strengthen export competitiveness.

Finally, the floating of the krone should be continued. Once the krone is pegged to the ECU or another strong currency, the authorities surely lose the maneuverability of monetary policy. Taking into account the fact that the fiscal deficit is still large and there is little room for stimulating the economy, reserving the free hand of the implementation of monetary policy is all the more important.

Mr. Desruelle made the following statement:

Norway's economy is showing signs of recovery. Overall GDP growth last year reached its highest level since 1987. Mainland GDP growth, which excludes growth in the buoyant oil sector, was also better last year than any year since 1987. Other positive developments in 1992 include a decline in inflation to its lowest level in more than 30 years and a continuing strong external position, with a current account surplus in excess of 3 percent of GDP.

GDP growth was nevertheless insufficient to prevent an increase in unemployment. While the present level of unemployment would be considered quite low in many, if not most, countries of the OECD, it is understandably a source of serious concern for the authorities, given the much lower rates of unemployment that prevailed until the middle to late 1980s. This rise in unemployment led, in part, to the continuation in 1992 of the expansionary fiscal policy followed since 1989. As a result, the fiscal deficit increased further.

In other policy areas, one notes the particular importance of the December 1992 change in exchange rate policy and of the ongoing resolution of the banking crisis.

From 1989 to 1992, fiscal policy has been expansionary, as state budget expenditures increased from 45 to 50 percent of GDP. An important part of this increase in expenditures was due to increases in transfers to households. Also, public consumption increased faster than GDP.

These measures supported economic activity. However, given that fiscal impulses were significantly positive during four consecutive years, the upturn in mainland GDP may appear moderate. A partial explanation for this phenomenon can be found in Table A3 of the background paper. This table shows that large increases in income transfers from the Government to households did not result in increases in private consumption of the same magnitude. This is primarily because, first, increases in the main component of income, i.e., wages, were limited, and, second, households were increasing their savings rate, which had sharply dipped in the mid-1980s.

One can note, as well, that there has been no sign that the fiscal expansion had a negative impact on price developments or on Norway's external position. In fact, between 1988 and 1992, consumer price inflation declined by nearly 4 percent, traditional exports grew faster than traditional imports, and the current account balance moved from a deficit to a surplus.

Overall, the expansionary fiscal policy appears to have made a positive, if possibly moderate, contribution to the recovery of growth without generating the negative short-term impact on inflation and on the external position often associated with this type of policy.

For 1993, the authorities have indicated that fiscal expansion would come to an end, and that non-oil outlays would grow approximately at the same rate as mainland GDP. Furthermore, in the 1993 budget, expenditure priorities were modified in favor of education, infrastructure investment, and active labor programs, while transfer payments to households were reduced. These measures are expected to lead to a slight widening of the Central Government's financial deficit.

In view of the still relatively weak macroeconomic outlook, on the one hand, and, of the already fairly high level of the deficit on the other hand, the authorities' fiscal strategy appears appropriate. Furthermore, given that one of the authorities' main goals is to reduce unemployment, the increased use of measures directly in support of investment in human and infrastructure capital seems beneficial.

Beyond 1993, the authorities anticipate that the petroleum-adjusted deficit will decline to less than 12 percent of mainland GDP, and that, by 1997, the general government financial deficit will comfortably meet the 3 percent of GDP Maastricht criterion. The staff raises the question of the sustainability of this fiscal policy. In Appendix I, various approaches to evaluating fiscal sustainability are presented. Particular attention is paid to one approach, under which a non-oil budget deficit is found sustainable if it does not exceed the permanent income from oil and gas revenues. Using this approach, a medium-term fiscal adjustment on the order of 5 percent of GDP, according to the staff's estimates, or on the order of 3 percent, according to the authorities' calculations as given in Mr. Solheim's comprehensive statement, would be called for.

This definition of sustainability corresponds roughly to the obligation of keeping, over the medium term, the general (oil-inclusive) budget in balance, after adjusting it for the temporal variation in the oil revenues received by the state. One can argue that this definition of fiscal sustainability is too restrictive. In this regard, I support the comments made by Mr. Schoenberg on the medium-term fiscal deficit goal. Like some other oil producing or non-oil producing countries, Norway may be able to sustain a small budget deficit (adjusted for the fluctuation in oil revenues), leading over the long term to a stable and manageable ratio of debt to GDP. In this respect, I would be interested to know what would be the dynamics of Norway's public debt if the fiscal policy announced in the 1994-97 program were followed over the medium to long term.

The possibility of sustaining a small deficit does not mean, of course, the necessity of incurring one; nor does it mean that the merit of proposed expenditures should not be carefully examined. One notes also that an oil producing country may be particularly subject to large external shocks. Therefore, it may be prudent to generally limit the government deficit and public debt levels to give the authorities more flexibility to respond to adverse shocks.

Since 1986 and until December 1992, monetary policy was conditioned by the strong currency policy followed by the authorities. This policy took the form of a peg to a trade-weighted basket of currencies until 1990 and then of a peg to the ECU.

The strong currency policy produced good results. I agree with the staff that it contributed materially to the decline in inflation that has occurred since the late 1980s. In parallel with the decline in inflation and until the appearance of tensions in the ERM, short-term and long-term interest rates declined as well--almost continuously for five years. One notes as well that the strong currency policy did not damage Norway's competitiveness. On the contrary, moderation in labor cost increases, coupled with gains in productivity, have led, since 1988, to a significant improvement in competitiveness.

The staff report states that "external developments have recently necessitated a shift to a floating exchange rate mechanism." I share this assessment of the importance of external factors for the authorities' decision to abandon the peg of the krone to the ECU. This view is, I believe, supported as well by the evolution of the krone parity since the move to a float. After a relatively small initial devaluation (5 percent), the krone has appreciated with respect to the ECU and is now only 3.5 percent of its parity under the peg.

I note the authorities' objective of returning in the medium term to a fixed exchange rate system, and their strategy, in the meantime, to use an unannounced, implicit exchange rate band, subject to periodic review, as a nominal anchor for monetary policy. While an implicit band may be a weaker anchor than an explicit band, this change in the conduct of monetary policy should not lead to adverse consequences on inflation in the current circumstances. The credibility gained by the monetary authorities since the implementation of the strong currency policy, the present limited demand pressures, and the current restraint on wage increases should all help prevent any surge in inflation.

Finally, I will make a few brief remarks on the labor market and the resolution of the banking crisis. As noted in the report, labor costs are high in Norway. Furthermore, (according to OECD data), labor costs have increased relatively faster in Norway in the 1980s than in many of its main economic partners. This may, of course, be one manifestation of the so-called Dutch disease. Therefore, efforts to limit wage increases, especially given the high level of unemployment, are welcome. Efforts to facilitate the introduction in the labor market of school-leavers and the reintroduction of low-skilled workers, and, in general, the increased emphasis on active labor market policies, are also welcome.

During our recent discussion on international capital markets, we had the opportunity to look at recent banking crises in a number of countries. The very interesting Appendix III of the background paper gives a clear and concise account of both the general and country-specific factors that gave rise to the Norwegian banking crisis. These factors include the large domestic credit expansion following credit deregulation, the increased riskiness of the banks' loan portfolios, the insufficient capitalization of banks, the inadequate supervision of the banking sector, the dependence of nonfinancial enterprises on borrowed funds, and the sharp boom and bust macroeconomic cycle of the early 1980s.

The authorities must be commended for the actions they have taken to avoid a systemic crisis. I nevertheless agree with the staff that important challenges remain to be addressed to reestablish a financial system that functions well. Given the importance of an efficient financial system and the increased competition the domestic financial system will become subject to, as a result of the EEA agreement and in the perspective of membership in the EC, these challenges must be quickly and forcefully met.

Mrs. Hansen made the following statement:

Norway is still absorbing the aftershocks of economic dislocations that took place in the early and mid-1980s. The credit-fed inflation of the first half of the 1980s has been quelled by the firm monetary policy required by the hard-currency policy launched in 1986. Unwinding inflation was pushed along by the end of the oil boom. Asset price deflation has been part of the process and has prompted rising household savings rates as the overspending of the early 1980s has been reversed. The delayed cumulative impact of asset price deflation resulted in major bank failures, requiring expensive government bailouts. Parallel to the financial side rescues, the Government has stepped in to try to shore up weakening activity with greater public sector spending and expanded transfer payments.

One result of these developments has been a major rechanneling of the flow of funds in the Norwegian economy. As the household and corporate sectors have restored their financial positions, the government sector balance has been undermined. The deterioration in the general government budget balance since 1988 has been about 6 percentage points of GDP. Simultaneously, the current account was undergoing a shift from deficit to surplus amounting to over 7 percentage points of GDP.

The repositioning of the sector balances in the past few years has taken place in an environment of weak demand and moderating inflation. Last year, the GDP deflator was under 2 percent, and the core rate is expected to remain moderate this year, although measured indexes will be higher as a result of a 2 percentage point increase in the value-added tax rate. The fiscal deterioration of the past few years has been pronounced, but so far there is no indication it has been inflationary.

The rebalancing that has been accomplished in the Norwegian economy in the past few years has been quite dramatic, but it is doubtful that a new, stable balance has been achieved. Private sector investment is in the doldrums, the government sector is financially secure but overextended, jobs need to be found for the enlarged pool of unemployed, and the large external surplus is unlikely to be sustained if activity improves.

The Norwegian authorities have made several sensible policy adjustments, but it is not yet clear that they are on the way to re-establishing sustainable low inflation or high employment growth.

On the fiscal side, the authorities are on the right track in their tax reforms, which have shifted the tax burden away from payroll taxes, with their disincentives to employment, and more toward value-added taxation. It is also noteworthy that the unions have agreed not to try to achieve compensatory wage increases. This should help the tax reforms achieve their intended effect of improving competitiveness. Likewise, the authorities' intention to shift spending priorities away from transfer payments and redirect them more toward training and education should also benefit the supply side of the economy.

As yet, however, no momentum has been generated toward reducing the government sector deficit. Norway is fortunate that its oil wealth provides such a large cushion that government spending has been able to rise strongly to support activity without the government sector shifting into large deficit. Nevertheless, the deterioration that has taken place over the past few years is quite large, and we agree with the staff that the long-run prosperity of the economy calls for pacing expenditures so as to preserve the long-run wealth provided by the depletable oil base. This means reducing the budget's current reliance on oil revenues. Norway has some flexibility in the timing and pace of its fiscal adjustment, but starting the process should not be delayed much longer.

Improving cost competitiveness is an important and appropriate objective of the authorities. This is needed not so much to improve the external accounts, which, thanks to oil activity, are comfortably in surplus, but rather to make Norway a more attractive site for investment, particularly for non-oil investment. At the moment, Norway is suffering a mild case of the Dutch disease, and some home remedies are needed if investment and employment are to be reactivated.

The authorities are aiming for a gradual improvement in external competitiveness of 10 percent over five years based on better than average inflation performance, wage restraint, and steady advances in productivity in an environment of generally stable exchange rate relations. Based on recent experience, this is a plausible scenario. But it is also a scenario that promises only a slowly developing incentive to private sector-led growth, and it is a scenario that is subject to external disruptions. Close competitors may not stand by in the face of encroaching real competitiveness gains by Norway. It is going to be difficult to generate much of a growth dynamic if the policy framework requires a working down of unit costs in a stable price environment at the same time there is fiscal retrenchment and no external tailwind.

Norway was unavoidably caught up in the European exchange rate upheavals of the past several months. The discussion of these developments in the recent economic developments paper goes to some trouble to argue that, based on its own performance, Norway's fundamentals did not point toward the need for a realignment of the exchange rate. We think this is true but a little beside the point. Norway had been following a firm monetary policy for almost five years and had systematically brought inflation down to below the average of other ERM countries. The Norwegian cost structure had been improving, although there appears to be a residual disadvantage relative to its major trading partners. Evaluated on its own merits, this was an excellent performance. Nevertheless, as page 31 of the recent economic developments paper makes clear, currency movements in neighboring countries had a substantial adverse impact on Norwegian trade competitiveness. Thus, it is not surprising that market pressure developed for some devaluation of the krone relative to the deutsche mark.

A break with the ECU peg became unavoidable and the krone was floated on December 10. It is a mark of the credibility that Norwegian policy had gained that there has been so little net depreciation in the krone since then--an adjustment of only about 3 percent--and that interest rates have been able to continue to decline with no adverse currency reaction. In fact, from the looks of things, disengagement from the ECU peg has allowed Norway to consolidate the lower interest rates that its steadfast monetary policy had already earned. So far, there has been no evidence of adverse reaction to floating. If anything, our concern would be that the small cumulative depreciation has left the krone with some slight undesirable net loss in krone competitiveness as a result of the series of European realignments.

The staff report points toward this same conclusion. The staff report recommends that, if, as capital flows re-equilibrate, there is some tendency for market depreciation of the krone, the authorities ought to tolerate such a movement. We agree with this recommendation.

The exchange rate analysis in the recent economic developments paper goes somewhat beyond the recommendation in the staff report. In the recent economic developments paper it is argued that repegging to the ECU at the moment would be inappropriate because of unsettled monetary conditions in the core economies. This much of the analysis we agree with. But then the analysis goes on to suggest that the authorities might want to informally shadow the ECU. We fail to see any attraction for such a policy. If the monetary policies of the core ERM countries are too unsettled to warrant pegging to them, no credibility gains would attach to shadowing those currencies. Self-reliance has more to recommend itself than does groping for a misplaced anchor. Norway's experience over the last six years with a variety of exchange rate-oriented monetary policies demonstrates it has both the skill and the determination to manage its monetary affairs in a way that produces satisfactory price stability. In our view, repegging formally or informally ought to wait until more settled economic conditions emerge in the core ERM countries.

Mr. Havrylyshyn made the following statement:

I would like to welcome this first full-fledged Article IV consultation with Norway since March 1991. Since then, the performance of the economy has been mixed. After the protracted recession of the mid-1980s, economic growth recovered to 2.9 percent in 1992, inflation decreased to 2.3 percent, and competitiveness improved markedly. However, the upturn in mainland GDP was subdued, notwithstanding a very expansionary fiscal policy, and unemployment continued to rise, to almost 6 percent in 1992.

The main task ahead for the authorities is the revitalization of the so far very weak mainland economy by increasing mainland investment and productivity. Macroeconomic policy, including the utilization of depletable petroleum resources, should be conducted in such a way that the petroleum wealth of Norway will support this task instead of being a liability. It is, of course, appropriate that Norway's citizens benefit from the greater wealth of exploitable oil resources even before they are depleted. The delicate judgment that needs to be made--as Mr. Solheim's statement and the staff describe--is to find the balance between the level of permanent income implied in the existing exploitable oil wealth, and the use of revenues from oil for current consumption. Unfortunately, the dramatic deterioration of the state budget balance since 1989 may have tipped this balance too far in the wrong direction, and there is no disagreement that an adjustment is needed. Mr. Solheim and other Directors have suggested it is less than the staff recommends. I agree with Mr. Schoenberg that the staff may have erred on the magnitude of adjustment needed, not only because a zero non-oil deficit may be unduly tight, but perhaps also because the concept of permanent income and different budgetary definitions impart a margin of error to the calculations. But unless one can be assured that a positive non-oil deficit is contributing to the strengthening of the mainland economy, a second-best solution may be to err on the side of fiscal conservatism.

The budgetary developments since 1989 are not comforting in this regard, and the sharp increase of the non-oil budget deficit, illustrated in Chart 2 of the staff report, can be seen as the domestic reflection of the Dutch disease. The resulting increase of income transfers to households no doubt also contributed to continued rigidity in labor markets, and other structural problems, and may have had spillover effects even on mainland investment. An adjustment is needed, not only in the magnitude of the deficit but also in the nature of budgetary and structural policies.

Looking ahead, I agree with the staff recommendations on fiscal policy to cut the deficit substantially and to redirect expenditures toward education, training, and investment.

The external competitiveness of Norway, as measured by relative labor costs in manufacturing, has improved markedly since 1988. An important part of this success can be attributed to the fixed exchange rate policy, from late 1990, vis-à-vis the ECU, which at that time used to be a harder currency than nowadays. Although a return to a fixed exchange rate system rightly remains a key medium-term policy objective because of its important advantages for a small and open economy and Norway's intentions to join the EC, the timing of this return has become uncertain and will be delayed longer than earlier planned. Meanwhile, according to staff, monetary policy will be conducted under a floating regime, with a nominal anchor provided in the form of an unannounced exchange rate band. This choice appears to be a substitute for an explicit inflation target, which authorities felt was not yet feasible. I am a little unclear on how an unannounced band can be used as a credible nominal anchor for the economy. Would it not in fact be better to move as quickly as possible to an anchor that is clear and transparent--either an approved band or an inflation target? Could the staff comment on advantages of alternative choices of monetary strategy?

The central assumption underlying the Government's macroeconomic projections is that Norway will improve its competitiveness by 10 percent over the five-year period to 1997, by, inter alia, wage-cost moderation. I doubt whether the labor unions will continue their supportive attitude if they are not convinced about the hard-currency policy of the authorities. The staff seems to make the reduction of high interest rates in Europe a prerequisite for the return to the fixed exchange rate regime. Chart 11 in the background paper indeed seems to suggest that government bond yield differentials with Germany have decreased rapidly since the abandonment of the ECU peg. However, if we extend the reference period to the summer of 1992, before the turmoil started, then the decrease in the differential is less pronounced. Moreover, countries like the Netherlands and Austria, which maintain a close peg to the deutsche mark within or outside the ERM, have also closed the differential with Germany substantially, and even turned it sometimes into a negative one.

On structural policies, I agree emphatically with the staff recommendations. I would only caution against overoptimism about the effects of a tightening of eligibility and enforcement provisions with regard to disability and sickness schemes, as experience in the Netherlands has taught us.

Finally, I would like to commend Norway on its generous level of development assistance.

The staff representative from the European I Department recalled that a number of Directors had commented on the appropriate stance of fiscal policy and had noted that there were some differences in the estimates by the staff and the authorities of the desirable size of the medium-term adjustment. He would not argue that the staff's estimates were superior to those of the authorities. It was difficult to make precise estimates in that area, and much depended on whether one focused on the state budget deficit or the general government budget deficit, allowed for cyclical factors, and focused on the gross or net debt of the public sector. In addition, the concept of a sustainable position in the medium term was open to different interpretations, as the comments of some Directors had suggested. The staff certainly would not wish to argue that it was important for Norway to aim at a non-oil deficit that did not exceed the permanent income from oil. A somewhat larger deficit, as Mr. Schoenberg had suggested, would certainly be sustainable over time. The important point in that connection was that, on the basis of any reasonable estimates of the desirable size of adjustment, it would be difficult to avoid the conclusion that the authorities' objectives for the coming four to five years were not very ambitious, and that a more ambitious medium-term fiscal adjustment program was warranted.

As to how urgent the need for adjustment was in Norway, the staff representative continued, on one level he agreed with Mr. Solheim that the need was perhaps not very pressing, given that the private sector was experiencing significant financial surpluses, there was sizable slack in the economy, and the Government itself had a relatively comfortable financial position. However, there were two reasons why adjustment should not be delayed. The first was the vulnerability of the economy in general, and the budget in particular, to fluctuations in the price of oil. It was obviously desirable to reduce the budget's dependence on oil revenues; in principle, that could be accomplished either by slowing the rate of extraction of oil, or by aiming for a non-oil budget deficit that was significantly smaller than at present. The second reason for early adjustment was that, assuming that the present volume of spending was excessive, the excess had the effect of shifting relative prices against the non-oil tradables sector, giving rise to the Dutch disease phenomenon to which some Directors had alluded. It followed that the authorities' goal of improving the competitiveness of the non-oil tradables sector would be difficult to achieve unless there was significant fiscal adjustment at the same time.

To place the staff's position on monetary policy and the exchange rate in context, it was important to keep in mind that, at the time of the discussions and the drafting of the staff report, there had been a possibility that the krone would tend to weaken somewhat once the capital reflows associated with the earlier pressure on the krone had been completed, the staff representative commented. In the circumstances, the question had been what the appropriate policy response should be if that weakening were to occur. The staff had taken the position that it would not have been appropriate for the authorities to resist any tendency for the krone to weaken by raising interest rates. In addition, there was the question whether the floating of the krone provided the authorities with any additional room for maneuver that would not be available under alternative arrangements. The staff felt that, under the present, still somewhat unsettled conditions in European currency markets, there was a slight margin in favor of floating; he would not wish to overemphasize the significance of that margin, but the present exchange rate arrangement did allow the authorities to aim at controlling inflation per se rather than at stabilizing the exchange rate as a means of curbing inflation. For the reasons outlined in the staff report, the authorities did not feel that they could announce an inflation target at present, but they clearly did intend to maintain a low rate of inflation. Their experience so far under floating suggested that it was possible to take advantage of the room that was available for lowering interest rates without risking a rekindling of inflationary pressures. Wage developments had indeed remained quite moderate since the floating of the exchange rate. Without wishing to overemphasize the difference between the previous exchange rate arrangements and the present one, he would be inclined to argue that there was temporarily an additional degree of freedom provided by the present arrangement that might prove useful.

It had been suggested by Mr. Schoenberg that competitiveness might not be as serious a concern as other policy objectives, the staff representative recalled. Both the authorities and the staff would agree that there had been some improvement in competitiveness over the past few years, but that it was still desirable to go beyond that achievement. At the same time, the staff and the authorities agreed that the gains in competitiveness should not be achieved through aggressive reductions in interest rates or a competitive depreciation of the currency, but rather through policies conducive to wage restraint and improved productivity performance. Any role for the exchange rate to play in that context was a marginal one.

The question had been raised as to whether the present practice of using an announced exchange rate band provided a sufficiently clear anchor, the staff representative noted. Obviously, an unannounced band was not very useful for the markets, but it was still a useful anchor to the authorities insofar as it provided the basis for making judgments about interest rate policy. As the present exchange rate arrangements were expected to be temporary, there was not much advantage in moving to announce either the exchange rate band or an inflation target. The authorities expected to return to the peg to the ECU as soon as international conditions permitted.

In commenting on the banking crisis, a number of Directors had correctly noted that state involvement in the banking sector was extensive, the staff representative from the European I Department remarked. The authorities intended to begin reprivatizing the banks in the course of 1993. The staff was not confident that the conditions for a more aggressive reprivatization policy were already in place and, therefore, had not argued strongly for such a policy in its report. The restrictions on foreign investment in the banking sector were to be removed, at the latest, when the EEA agreement came into force. The staff agreed with Mr. Schoenberg that it would be desirable to remove the restrictions earlier, if possible.

Mr. Schoenberg commented that, with respect to the budget deficit, he tended to agree with Mr. Havrylyshyn that a country like Norway had to keep in mind what would happen if oil revenues ceased to flow in the long term. In the event of any doubts about the future, it was better to err on the side of fiscal conservatism. However, in view of the staff's explanations, in assessing the outlook for the medium term it was not more conclusive to exclude the oil revenue component from total public revenue if it was really permanent than to exclude any other revenue item; that was the reason for calculating the permanent component rather than excluding any revenue component in keeping with the possible serious decline in oil revenues in 20 or 25 years.

He basically agreed with the staff's comments on the exchange rate issue, Mr. Schoenberg said. Some speakers had mentioned that there might be a case for devaluing the krone at the present stage, given the existence in Norway of some economic slack. In fact, however, Norway currently enjoyed a substantial current account surplus, an unemployment rate that was considerably below the unemployment rate in other European countries, and a fiscal deficit that was smaller than the deficit in other European countries. Hence, there did not appear to be other countries that were in a position to revalue their currencies in response to the devaluation of Norway's. If Norway did face a problem of competitiveness, it should be tackled by improving domestic efficiency and productivity.

Mr. Havrylyshyn said that his question to the staff concerning the word "notwithstanding" on page 5 of the staff report was, of course, rhetorical, but what lay behind that question was not rhetorical. He welcomed many of the staff's comments, but one additional observation might be called for. The staff had focused on the quantity of adjustment, including the difficulties in making the choice about the appropriate quantity, but the quality of adjustment should also be addressed. He wondered whether the staff felt that the quality of the incentive and other structural measures in the medium-term program was sufficient for an oil economy like Norway's.

The staff representative from the European I Department replied that the authorities' intentions spelled out in their long-term program went in the right direction, but the staff doubted whether they went far enough. Certainly further reforms in the direction of reducing subsidies and social spending on benefits for various schemes, including the unemployment and disability schemes, would be desirable.

The adjustment that the authorities intended to achieve by 1997 would not be sufficient to stabilize either the ratio of gross debt to GDP--or the net asset position of the Government--by that year, the staff representative commented. A larger adjustment would be required to achieve stabilization. In that connection, it was useful to bear in mind that, compared with other countries, Norway started from a very favorable position: the Government enjoyed a positive net asset position. The pressure to stabilize the situation in Norway was not as great as in other countries, but the economic dynamics worked in the same way.

Mr. Mohammed made the following statement:

I am in broad agreement with the staff's appraisal. The fiscal balances have deteriorated markedly over the past few years in Norway, owing mainly to sharp increases in government outlays. Expenditures (excluding those related to petroleum activities) as a share of mainland GDP increased from 47 1/2 percent in 1988 to almost 58 1/2 percent in 1992. Clearly, this is not sustainable, and the recent reorientation of policy away from the strongly expansionary fiscal stance of the preceding several years is therefore welcome.

A central issue for policy in Norway is the unemployment situation, although I recognize that the extent of the problem is far less severe than elsewhere in Europe. It is arguable whether fiscal policy is the appropriate instrument for solving this problem. The lack of response of the labor market to the fiscal stimulus already provided suggests, if anything, that the authorities should focus more on further structural reforms in the labor and product markets rather than on fiscal stimulus. In particular, greater emphasis needs to be placed on strengthening the skills of the unemployed and on providing for greater labor market flexibility. This is probably one of the most important challenges facing the Norwegian policymakers at present. The authorities are cognizant of this, and I believe that the recent reorientation in policy, which places greater emphasis on education and training, will go some way toward addressing the unemployment problem.

Turning to other issues, Norway, unlike many other oil-exporting countries, has a well-established industrial base, and it is therefore far easier for the authorities to reduce dependence on oil by expanding the non-oil tradable sector. The emphasis that is being placed on improving competitiveness and productivity will go a long way in this regard. Yet, the expansion of the non-oil fiscal deficit, which is being financed primarily through oil revenues--and the attendant risks associated with such a policy--are not compatible with the objective of reducing dependence on oil revenues over the medium term.

On the banking crisis, I particularly enjoyed reading Appendix III of the background paper on this subject. I believe that a key lesson of the Norwegian case is that bank supervision may need to be restructured prior to financial market liberalization so as to cope with the new challenges and risks that liberalization entails. This should be kept in mind by countries contemplating financial deregulation.

Finally, I would like to commend the authorities for their generous level of development assistance. I note that the Government issued in 1992 a report on "Trends in North-South Relations," which proposed adjustments to Norway's assistance policies in light of experience over 20 years. Can the staff or Mr. Solheim share with us the main conclusions of that report?

Mr. Prader made the following statement:

The Norwegian economy has made impressive progress in the past few years in terms of the inflation rate, the current account, external indebtedness, and, especially during the past year, the productivity of manufacturing.

In addition to wage moderation and weak demand, the authorities' policy of keeping the krone stable was a major factor in bringing down the inflation rate, a goal that could not have been achieved with a soft exchange rate policy. But because of market perceptions during the exchange market turbulence of the latter half of 1992 about the negative consequences for Norway's competitiveness of devaluations by her major trading partners, the authorities felt forced to abandon the ECU peg they had adopted in October 1990. This was unfortunate not only from the standpoint of the short-term movement of the inflation rate, but also for other reasons, not the least of which is the length of time it will take to rebuild the credibility needed for a fixed rate to withstand prolonged pressures.

Despite the low level of Norway's present inflation rate (2.3 percent in April), the risk of an accelerating inflation rate has not disappeared, and the authorities must be cautious about any further depreciation of the krone. Of course, a depreciation of about 3 percent vis-à-vis the ECU and 8 percent vis-à-vis the deutsche mark since June 1992 will not put tremendous pressure on prices, especially in times of weak demand, and apparently the Norwegian authorities have been very prudent in managing the floating exchange rate and have allowed only a slight decline in the external value of their currency. But even if this policy's practical results or the implicit unannounced exchange rate band more or less approximate those of a stable exchange rate policy, it sends to the economic agents a signal different from that sent by a formal commitment to a hard-currency policy. Under the present noncommittal policies, trade unions and entrepreneurs will always be under the impression that, in the end, if the going gets tough, competitiveness and growth gains can be obtained the easy way, by exchange rate changes, instead of the hard way, via wage moderation and structural reforms.

It is not only the inflation problem that argues for a hard-currency approach. Given the unsatisfactory state of Norway's structural development, there is another argument in favor of a stable exchange rate: a credible hard currency supports structural reforms in the long run.

To be credible, a fixed exchange rate policy has to have the backing of all economic partners and ultimately depends on the soundness of economic policies. This means, inter alia, unit labor costs and consumer price increases that are largely similar to those of the anchor currency, a moderate budget deficit, and an internationally competitive tax system. Once these policies gain credibility, interest rates can be reduced to the level, or even below the level, of the anchor currency. Examples are furnished by the Netherlands, Belgium, and Austria.

For instance, the Austrian experience of the past 20 years shows that a credible hard-currency policy forces the nonsheltered sector to adapt to international market standards, that is, to become more competitive. The effect will even extend to parts of the sheltered sector, which will be forced by the nonsheltered sector to match its new efficiency.

For these reasons, I think a stable exchange rate would be an appropriate long-run policy for Norway to support its needed structural reforms. Such a policy must go hand in glove with deregulation in various areas. There appears to be room to increase efficiency by simplifying the regulatory framework and improving productivity in the large public sector. Programs of the type, together with the Government's "national strategy for increasing employment in the 1990s"--particularly training and apprenticeship schemes for unskilled workers and the long-term unemployed--should lead to increases in competitiveness, corporate profitability, and employment.

The removal of the commitment to the exchange rate target significantly reduces the chances of effectively attacking the problem of an overexpansionary fiscal policy. It has been the experience of hard-currency countries that fiscal discipline is much easier for the authorities to enforce when it is seen as a requirement for maintaining a quasi-objective fixed exchange rate, than under conditions in which there is no currency constraint.

I understand from the staff paper that the Norwegian authorities perhaps intend to delay their return to a fixed exchange rate system until after the terms of EC membership have been agreed. The staff itself feels that a fixed exchange rate arrangement may not achieve the necessary credibility until progress has been made toward a sustainable level of external competitiveness and a sustainable fiscal position. However, the chain of cause and effect could also run the other way: it seems more likely that the absence of a fixed exchange rate commitment will seriously hinder progress toward these goals. It goes without saying that I share Mr. Schoenberg's reservations about the staff's recommendations in favor of using exchange rate depreciations, even small ones, to improve Norway's competitiveness.

Finally, if the authorities intend to repeg the currency at some future moment, as stated by Mr. Solheim, their deliberations should include consideration of whether a currency basket is actually an appropriate exchange rate target--whether for the purpose of shadowing, as suggested by the staff, or as the basis for a future hard-currency commitment. Robert Mundell has argued sharply against the use of a basket on the grounds that basket calculations are too complex and insufficiently transparent for most investors, who clearly prefer to use a more concrete comparator for their decision making. Hans Genberg has also recently argued against a basket peg on the grounds that the use of a basket peg is frequently aimed not at achieving price stability but rather at insulating the tradable goods sector to a certain degree from fluctuations in third-country exchange rates. Such a multiplicity of goals could make it more difficult to establish the credibility of the fixed rate as an anti-inflation policy.

Mr. Waterman made the following statement:

Norway is of particular interest to this constituency, given that it is a relatively small industrial country with a strong reliance on a single commodity export and depends, as it does, for its prosperity on growth in the world economy and the openness of the world trading system. Like a number of countries of this constituency, it has also gone through the problems and challenges of deregulating its financial system.

I agree with previous speakers that there are many positive features to Norway's recent performance. There has been continued improvement in inflation and the external position remains strong. Although the staff describes recent growth as sluggish, Norway's economy has continued to grow, while other industrialized nations' economies have not.

Like many of us, Norway is still getting over the excesses of the 1980s, including the impact of the asset price boom and the associated excessive level of borrowing by both the corporate and personal sector (and the reaction and overreaction to that). The banking sector's performance in Norway was of course one of the examples identified in our recent discussion of international capital market developments.

It is of course always easier looking back. We can see where we went wrong and what we might do if we had our time again. Given developments of recent years, the Norwegian authorities may have had no alternative but to take over the major banks that were experiencing such great difficulties. In this constituency the general trend is for governments to get out of commercial banking, while still working to retain adequate prudential supervision. If the experience of the past decade demonstrated anything, it is that intermediation is a very skilled business and one that governments are not particularly suited to. Accordingly, we would hope that the process of reprivatization of the banks will proceed as soon as practicable.

For countries like Norway, New Zealand, and Australia, one thing we have in common is that we can be subject to very large terms of trade shocks that can generate large additions to, or subtractions from, national income. It is an ongoing challenge for all of us to deal with those income fluctuations. It puts a premium on flexible economic structures. Part of that flexibility probably needs to come from the exchange rate system. Paradoxically though, while a flexible exchange rate can assist in moderating the capital flows associated with large terms of trade fluctuations, it can also mean that, when times are good, the benefits associated with higher commodity prices are distributed quite broadly through the community; it is often hard to cut back when commodity prices ease. The implications for the competitiveness and activity levels for other areas of the economy of sharp exchange rate changes are, of course, well known.

It is particularly important for smaller open economies to have flexibility in their wage determination systems. New Zealand and Australia have moved in recent times to address weaknesses in this area, and this appears to be an important issue for Norway as well. Related to this issue, it is pleasing that Norway has moved to consider ways to strengthen work incentives and raise productivity as part of its strategy to increase competitiveness. Consideration of the current structure of the social security system is clearly an important issue. I note from the papers and Mr. Solheim's statement that policy is focusing on a reduction of transfers and some tightening in the administration of disability and sickness schemes. Further comment in the staff paper about the operation of the current social security system, especially the disability allowance, and the impact of current measures on effectiveness of labor market operations would have been of interest.

There is also a stronger case that economies like Norway should focus particularly on medium-term settings for fiscal policy and ensure that, when times are good, the benefits are taken, in part at least, in the form of reduced public deficits and lower debt levels as a precautionary move for those times when things will not be as good. I note that, along with many countries, Norway recognizes the need to consolidate on the fiscal side as the present recovery proceeds. The heavy reliance on oil revenue, as shown by the size of the difference between the oil-exclusive and oil-inclusive fiscal measures, shows the potential vulnerability of the fiscal position to adverse terms of trade movements. Like the staff, I wondered whether more could be done to restrain non-oil outlays, which are expected to grow broadly in line with GDP growth. I would be interested to know from the staff what pressures underlie this continued growth in expenditure.

Inflation control is also very important to open, vulnerable economies such as Norway's. Markets can come and go and--as Mr. Solheim recognizes--it is essential to do at least as well if not better than major trading partners in terms of inflation performance. Norway's recent inflation performance has represented a great improvement; the challenge will be to sustain it as the recovery proceeds and to develop a stronger anti-inflation constituency within the community.

Finally, I would like to end on a note of support for Norway's desire for a much-improved and more open and transparent multilateral trading system, and I would encourage further steps to reduce remaining agricultural subsidies.

Mr. Dorrington made the following statement:

There are four issues I wish to address, and the first one is fiscal policy. I welcome the recent structural changes in taxes and public expenditure, and I will not go into details on that. Certainly, Norway should be able to fulfill the Maastricht convergence criteria on fiscal policy by 1997, although I would note that the staff and Mr. Solheim differ on the extent that the fiscal deficit needs to be reduced to be sustainable on a long-term basis. It is clear that Norway needs to make a significant adjustment in the medium term, but, given, for example, the debt level and the current inflation performance, it can afford to do this in a measured way. What is unclear to me, at least, is exactly how large the adjustment needs to be. The staff calculations are certainly interesting, but there is no magic formula. It would certainly be wrong for non-oil fiscal policy to adjust erratically to every movement in the oil price. Having said this, I would agree with the staff that a more rapid fiscal consolidation than is planned would leave Norway less exposed to movements in oil prices and would potentially free up resources for increased investment elsewhere. Certainly, to place excessive reliance on oil revenues could prove to be imprudent. In the long term, oil revenue may be uncertain, and the authorities might need to diversify production.

I would congratulate the Norwegian authorities on their inflation performance. The aim of monetary policy now must be to ensure that this is sustained. Norwegian inflation has been above the OECD average for much of the past 20 years. It is now below it. To maintain low inflation, the authorities need to act prudently to avoid any rekindling of inflationary expectations.

I agree that it is premature to return to the ECU peg or, indeed, any other peg. I agree with those who find that the unannounced peg is not a very credible policy option. Returning to a peg as soon as financial conditions permit might not imply a very early return. In these circumstances, an explicit inflation target has clear advantages. The staff report says that the authorities thought that the adoption of an explicit target for the rate of inflation was not a feasible option for the time being partly because Norway did not have the traditional attachment to low inflation that some other countries enjoyed. While I agree that credibility would be greater if there had been this traditional attachment, the past cannot be changed, and a target now is perhaps the best of the available alternatives. I would say that, as European interest rates fall generally, there should be some scope for further falls in Norwegian interest rates without threatening inflation.

On structural reforms, it is most welcome that the Government is moving in the direction of a reorientation of support to the unemployed--away from passive income transfers and toward active labor market policies. This is very important, but it is also crucial to improve the working of the labor market itself.

Greater wage flexibility is needed to ensure that wages properly reflect the local labor market conditions. In this respect, an incomes policy may be unhelpful. It tends to impede flexibility and may not ensure wage moderation over the medium term as the economy recovers.

Like Mr. Desruelle and Mr. Mohammed, I thought that the annex on the banking crisis was very helpful as well as being commendably concise. There are lessons here for any country seeking to liberalize its financial markets, particularly with regard to asymmetric regulation, capital adequacy, taxation of financial flows, and the importance of overall macroeconomic stability at the time of deregulation. I certainly accept the necessity of the banking support operations the authorities have undertaken, and I note that their timing helped avert the spread of any systemic problems while containing the total cost to the state.

Mr. Wei made the following statement:

We are in general agreement with the staff's appraisal and do not have much to add. However, I wish to stress the following points.

The performance of the Norwegian economy has continued to be mixed since the previous Article IV consultation. Growth recovery was relatively strong, with an important contribution from the fast-growing oil sector. A downward trend in inflation and strengthening of the current account position continued. Cost competitiveness improved. At the same time, however, the problem of unemployment, which was high by Norwegian standards, remained. Conditions in the non-oil sectors were not satisfactory. Despite actions taken so far, difficulties in the banking sector remain to be tackled.

Improving the employment situation still poses an important policy challenge. A deterioration in the employment situation has been evident over the past two years. On the one hand, the unemployment figures rose, despite various measures taken during the period. On the other hand, participation in the labor market declined, as is described in the background paper. During the previous discussion on Norway, this chair emphasized the importance of dealing with the unemployment problem in a medium-term context. It is therefore encouraging to note that the authorities are moving in this direction and are paying increased attention to more active labor market programs, as reflected in the budget. Meanwhile, it is critical that further reform in the labor market be carried out to increase participation.

Better functioning of the labor market is also called for to improve and maintain cost competitiveness in the medium and long term. The recent recovery in competitiveness, although substantial, has not brought the economy back to the level of competitiveness it enjoyed before becoming a major energy producer. In addition, such a recovery has been achieved partially by labor shedding and reduction of unproductive capacity. Wage restraint has been important in bringing about the improved competitiveness. However, continued efforts are required to make wage restraint sustainable in the medium term, especially now that the krone is floating. In this connection, particular importance should be attached to increasing wage flexibility.

On fiscal policy, we share the staff's view on the government policy changes reflected in the 1993 budget. We agree that the changes are compatible with the medium-term objective of improving competitiveness as well as the functioning of the labor market. Meanwhile, the authorities are encouraged to fully tap the potential, especially on the expenditure side, to ensure the success of deficit consolidation both to reduce budgetary dependence on oil and to sustain the decline in inflation.

Regarding the banking sector, the action taken so far has served to avoid a crisis in the financial system. The authorities are now strongly encouraged to devote their continuous efforts to the fundamental improvement of the functioning of the financial system by creating a more healthy and competitive environment and strengthening supervision. Although an injection of public funds was unavoidable to save the banking sector from crisis, future recourse to such action should be avoided as much as possible in view of both the burden placed on public finances as well as the message sent to the banking sector and the public at large.

Finally, I wish to express our appreciation for the sound record of the authorities in providing official development assistance.

Mr. Torres made the following statement:

As the staff report states, the performance of the Norwegian economy over the past years has been mixed. On the positive side, we have considerably low rates of inflation and interest, and a good balance on the external current account. On the negative side, we have a growing dependence on oil, a very weak rate of growth, and an important fiscal imbalance.

In the medium term, the growing fiscal deficit is the most worrisome of all the problems. The fiscal position has moved from a surplus of 0.5 percent of GDP in 1990 to a deficit of 2.9 percent of GDP in 1991 and 5.7 percent in 1992, and it is projected to be of the order of 7.3 percent of GDP in 1993. These numbers became worse when corrected by the oil factor. Given these figures, the goals set for 1993 and the medium term look certainly very modest and may even jeopardize the fulfillment of the criterion embodied in the Maastricht Treaty. As I understand it, the reason for such modest goals is political--the fear of a rising unemployment rate.

But, on the other hand, the attempt of the authorities to reduce the unemployment rate through an expansionary fiscal policy may soon negatively affect one of the main achievements of the economic policy of Norway, the low rate of inflation. So, I think that it is very important for the Norwegian authorities to explain to Norwegian society the trade-off between the short term and the long term in terms of unemployment and inflation.

In the long term, the main reason for concern is the growing dependence on the oil sector. This dependence is problematic for two reasons: first, because oil is a depletable natural resource, whose output in the case of Norway will peak in the first years of the next century and then immediately start to decline; and second, because of oil's price instability in the international markets. Such instability may be reflected fully in internal economic activity, making it extremely difficult for Norway to maintain a steady rate of growth.

These characteristics of the oil sector make the fiscal deficit a potentially more disruptive disequilibrium, as the ability of the Government to correct it may be considerably affected in the context of an external shock that may take place at any moment. These potential contingencies call for a very conservative fiscal stance and even for the creation of institutional mechanisms, like a macroeconomic stabilization fund, which may avoid inconvenient fiscal swings.

Turning to the exchange rate policy, I agree with the authorities and the staff that it is not advisable now to repeg the krone to the ECU. But to me this is so for only one reason: the differences in interest rates between Norway and the rest of Europe. I tend to disagree on the other two reasons mentioned in the staff report, which are the fiscal position and external competitiveness. Contrary to the staff reasoning, it is my belief that the repegging of the krone to the ECU would be a strong factor in forcing the fiscal equilibrium and the adjustment in the labor market. This would be a good signal of the willingness and commitment of the authorities to deal with these two problems.

On the banking crisis, it is not clear to me what the reasons are for postponing the reprivatization of the major banks. The restructuring of troubled banks may be done efficiently by the private sector if there is a set of sound policies for the banking system. If those banks to be privatized have serious problems with nonperforming loans, that will be reflected in the price the investors are going to pay for them. But it does not mean that there will no interest in buying them, as seems to be believed by the authorities, according to the staff report.

Finally, I consider it necessary to commend the Norwegian authorities for their permanent and generous level of development assistance.

Mr. Mwananshiku made the following statement:

I broadly share the conclusions and recommendations made by the staff in the report on Norway, and I will confine my remarks to a few issues.

First, I wish to note the increasing role being played in the Norwegian economy by the oil sector. All the positive developments in the economy, including the increase in aggregate growth in 1992, the fall in the rate of inflation, and the marked strengthening of the external position since 1989, are basically accounted for by the oil sector.

However, the labor market situation has deteriorated, with unemployment reaching nearly 6 percent. In addition, and mainly as a result of the fiscal actions taken to stem unemployment and assist the banking sector, the fiscal position has deteriorated.

We welcome the fact that the authorities are alive to those problems and are in the course of doing something about them.

In our view, the authorities should make every effort to reduce excessive dependence on the oil sector by strengthening the role of the industrial sector and its competitiveness. This is the only way of creating expanded employment opportunities. At the same time, a more ambitious program should be adopted to achieve fiscal consolidation; however, care should be taken not to aggravate the unemployment situation. These measures assume added importance in view of Norway's desire to join the European Community.

In concluding, I wish to express my appreciation to the Norwegian authorities for committing themselves to maintaining a high level of development assistance.

Mr. Thomas made the following statement:

In recent years, the Norwegian authorities have made considerable efforts to adjust the economy. Inflation has fallen, the current account has recorded a sizable surplus, and net foreign indebtedness has been substantially reduced. The economy has shown signs of recovery, with overall growth approaching an annual rate of 2 1/2 percent. The authorities are to be commended for their performance.

But progress in the macroeconomic area is trailed by structural impediments that threaten to undermine the stability gains achieved so far. Unemployment has risen to historically high levels, and the return of capital in the non-oil sector has been unsatisfactory. Business bankruptcies have increased, and the country's dependency on oil to drive its economy forward has increased substantially. Given this background, we wish to support the general thrust of the staff paper. As most of the points raised in the staff paper have already been covered by previous speakers, I wish to mention a few points for emphasis.

The authorities must focus on diversification of the economy away from oil and toward non-oil tradable goods. Investment in the non-oil private sector, which has contracted sharply, must be increased and external competitiveness in the non-oil traded goods sector improved. Prospects for employment must be enhanced through structural reforms in the goods and labor market that encourage incentives to work, save, and invest. Growth in productive jobs, along with improvement in cost competitiveness, is central to rebalancing the prospects for the future.

Regarding the floating exchange rate system, we wish to commend the authorities on the cautious manner in which they have managed their monetary policy under the floating regime. Here, we would urge the authorities to continue to focus on keeping inflation in check as a priority when formulating their monetary policy.

We note that the successful conclusion of the GATT negotiations would benefit the Norwegian economy as a whole.

Lastly, I would appreciate staff comment on the time frame for Norway to join the EC, in particular in relation to issues in fisheries, energy, and agriculture.

Mr. Breuer made the following statement:

I would like to recognize the staff for the excellent analysis of a most interesting case study. As a small, open economy, Norway has achieved considerable economic sophistication while becoming highly dependent on the petroleum sector. Moreover, economic developments in the past decade have been quite striking and have been affected by sharp increases in petroleum production, severe terms of trade variations, a profound crisis in the banking sector, and large swings in asset markets, to name but a few. In addition to these country-specific developments, the economy has had to adapt to the requirements of greater regional and world integration in both product and financial markets. Against this background, the performance of the Norwegian economy has been relatively satisfactory.

I will address three related issues: the policy mix, the banking crisis, and the new exchange arrangement.

I share the staff's view that, while the policy mix can be considered appropriate in general terms, additional fiscal tightening is desirable. This would enable further loosening of monetary policy, which seems warranted in light of recent developments in exchange markets, sluggishness in growth of output and aggregate demand, and the low level of inflation. Further moderate reductions in interest rate can provide the stimulus that the rigidities in fiscal policy cannot. Moreover, I believe that the recommendation not to oppose market-induced exchange depreciation is still valid.

As noted by previous speakers, the fiscal situation presents a number of challenges. First, it seems clear that the overall fiscal expansion, particularly in the period 1989 to 1992, cannot be sustained and should actually be reversed. The disequilibrium in the fiscal accounts is significant, and the size of the public sector seems greatly exaggerated. Indeed, preliminary figures for 1992 show that total revenues of the General Government approached two thirds of GDP, while total expenditures exceeded 70 percent of GDP. Moreover, the public sector's share in total employment jumped from 23 percent in 1980 to 30 percent in 1992.

Also noted by previous speakers is the need for comprehensive reform in the composition of public expenditures, which are heavily concentrated in transfer payments to the private sector. Recent measures directed at reallocating expenditure priorities toward investment in physical and human infrastructure are moves in the right direction, although more forceful action is called for. This issue is closely related to the need to introduce greater flexibility in the labor markets.

The crisis in the banking sector has already resulted in considerable financial costs to the Government and could potentially have long-term implications for the Norwegian economy. While the decision to take complete control or a majority stake in the three largest banks can be understood in terms of systemic considerations, the determination to hold on to these institutions could seriously impact on the efficiency of financial intermediation. Moreover, there have been ample examples of moral hazard problems in nationalized banking systems, including in Latin America, for there is seldom a better indication of the government's willingness to bail out banks than public ownership. In this regard, while welcoming the measures to improve supervision, reduce costs, and capitalize banks, I do not feel that the presence of large nonperforming loans in these banks is an argument for postponing their privatization. The distribution of the costs of the banking crisis, and management and ownership of the banking system, are two distinct issues. I took note of the staff representative's comments in this regard.

Turning to new exchange arrangements, it seems that the abandonment of the peg to the ECU and the adoption of an unannounced band have so far served Norway well. Interest rates have been reduced considerably, without either a corresponding sharp drop in the exchange rate or an increase in the rate of inflation. In fact, there seems to be some scope for additional interest rate reductions, particularly if the latter are complemented by a tightening of fiscal policy. The authorities' decision to take a wait-and-see attitude toward resuming the peg seems to be most reasonable in light of current conditions in Norway and Europe.

Lastly, this chair would like to acknowledge Norway's generous contributions to official development assistance and its support for a rapid conclusion to the Uruguay Round.

In closing, as noted by Mr. Waterman, small, open economies, regardless of the level of income, must be flexible if they are to adapt to a rapidly changing international economy. Norway can ill afford the rigidities in public finances or labor markets that affect some of its partners in Europe and elsewhere. Recent trends in economic policies seem to indicate that the authorities have realized this, and this chair wishes them well in their endeavors.

Mr. Murphy made the following statement:

I agree with the principal outline of analysis and policy critique contained in the staff report for the 1993 Article IV consultation. In particular, I support the analysis and policy prescription, which suggests engaging in reduced dependence, on a phased basis, on fuel revenues, and the establishment of some accepted target to guide medium-term policy in this transition to a new fiscal stance, following the abandonment of public spending as an unemployment-inhibiting policy. I will confine my remarks to a couple of points of particular interest.

The Norwegian authorities had some success, until the peg to the ECU was abandoned recently, with an anti-inflation policy that consisted of the exchange rate objective supported by an appropriate level of interest rates.

I can readily appreciate that the authorities had second thoughts about repegging the exchange rate until after the return of stable market conditions in Europe. I doubt very much that this was critically related to Norway's "inadequate access to financing resources," the first reason put forward in the staff report. Far more credible is the "continuing uncertainty about the future evolution of the currencies of some important trading partners," the second reason.

Equally, I cannot accept the first reason for the staff to understand "not repegging of the krone to the ECU" or anything else until concerns about the "high" level of interest rates in Europe recedes. External competitiveness and the need for fiscal adjustment, the second and third reasons, are more plausible, as would be uncertainty about the policy reactions of neighbors and others further afield while the markets are settling down.

Reading the subsequent paragraphs of the staff report's exchange rate section, I cannot help feeling that the advice amounts to saying, at the same time, keep pegging the exchange rate, but do not peg it. The authorities' apparent position when the staff report was written, wondering about the "unclear" relationship between inflation and policy instruments, is more understandable but is also disturbing, particularly given the fact that they think that "Norway did not have the traditional attachment to low inflation that some other countries enjoyed." In short, the exchange rate, while still being regarded as a policy instrument in Norway, seemed from the staff report to be where it ought not to be, that is, called upon to serve a potential range of objectives, in the absence of a belief about what purpose, if any, it should serve. All that said, I note from Mr. Solheim's statement that thinking appears to have moved on, and I draw a different message from it: the exchange rate and monetary policy more generally will serve some anti-inflation objective that will be clearer when the authorities peg the currency in some way in the near future.

I join Mr. Schoenberg in his criticism of the staff report for appearing at one point to prescribe a depreciation, based on Norway's external position at present.

The evolution of the labor market is correctly a focus of this staff report. The unemployment statistics certainly underestimate the extent of the problem, as the detail on pages 5 and 6 of the background paper shows, particularly its comments on participation rates, training, and the growth in public sector employment. The authorities seem fortunate, in the short term at least, in that labor relations seem particularly good at present in Norway. This may facilitate progress in the early part of the planned protracted period of wage restraint. However, the staff is not so sanguine about the prospects for the labor market in the face of a resumption of economic growth. There are references to structural measures to go with wage restraint, and "fundamental labor market reform." More broadly, the staff has comments on centralized wage bargaining. There is, however, little in either the staff report or the background paper to pinpoint what the structural problems in Norway are, in any detail, and what should be done to tackle them. There are comments on income compression, centralized income determination, and some data spring from the changing pattern of fiscal policy, e.g., a move from transfer payments to more training and education, but the market anomalies are not elaborated. Given the fact that structural problems in labor markets are assuming such relevance at the moment for many countries because of the growth of unemployment, and that there is considerable discussion about the cyclical/structural composition of unemployment, I would wish to see more substance in staff papers on the issues and prescriptions for remedial action where serious problems are identified.

I welcome the description in the background paper of the difficulties experienced in the banking sector leading to the 1991 government interventions. I note the authorities' concern throughout to minimize moral hazard. At this stage, the sooner the private sector can again be involved in such a way as to permit the Government to stand back from a situation in which it necessarily has immense conflicts of interest, the better. This would improve efficiency and restore a competitive framework, with all the benefits of better price signaling and healthier allocation mechanisms.

Mr. A. R. Ismael made the following statement:

We are in general agreement with the staff appraisal and policy recommendations. Like others, we note that important progress has been achieved in containing cost and price pressures in Norway over the past few years, and that significant structural reform measures have been implemented in many areas of the economy. In particular, we welcome the measures intended to reduce nonwage labor costs and expand education and training programs, while containing the growth of transfer payments to households. These reform measures will undoubtedly improve the efficiency and the competitiveness of the Norwegian economy over the medium term. However, as noted by the staff, there are some areas of policies where progress has been uneven, namely, in the fiscal and banking sectors.

Over the past few years, fiscal policy has been expansionary, in response to the increase in unemployment and the problems in the banking system. As regards the 1993 budget, we note that, despite the efforts of the authorities to contain expenditure, the deficit as a percentage of mainland GDP will continue to widen. We note also that the measures that the authorities intend to follow over the medium term, although in the right direction, may not be enough to achieve the goals set. Moreover, from Appendix I of the background paper, it seems that the non-oil budget deficit over the longer term will remain much larger than the estimates of permanent income from oil, and the assumptions on which the projections are based are subject to considerable downside risks. In the circumstances, we share the staff's view that a substantially larger adjustment in the size of the fiscal deficit is warranted, and the authorities' efforts need to be concentrated on reducing further budgetary expenditure.

As regards the banking sector, we welcome the steps taken by the authorities to strengthen banking regulation and to introduce more stringent accounting standards, which have led to a significant improvement in their performance. However, we note that their reprivatization is being delayed by the high level of nonperforming loans in their portfolios. Moreover, the staff report indicates that some of the policies toward the banking system may be somewhat contradictory, especially as regards the Post Office Savings Bank. In view of the potential adverse effects of these policies on the efforts of the commercial banks to attract deposits, and to reprivatize quickly, we would encourage the authorities to review these policies, and to take steps that will accelerate the process of reprivatization of the commercial banks under sound supervision. In this context, could the staff give some indication of the efforts of the authorities to attract private capital into the banks and also indicate whether the authorities have a timetable for reprivatization of the major banks?

To conclude, I would like to commend the Norwegian authorities for their excellent record on official development assistance.

Mr. Golriz said that he broadly agreed with the thrust of the staff's analysis and recommendations. However, he wished to emphasize one point relating to external competitiveness. Although improved recently, competitiveness remained, in the words of the staff, "substantially worse than prior to Norway's emergence as a major energy producer." In other words, the growing reliance on the oil sector seemed to have impaired the overall productivity of the economy. Considering Norway's intention to join the EC, he wondered whether its competitive position would not be a disadvantage. Finally, he, too, wished to commend the authorities' continued generous development assistance.

The staff representative from the European I Department commented that the North/South Report recommended that, inter alia, development assistance should concentrate on a small number of countries, especially in Africa and Asia, that an effort should be made to strengthen the coordination between development assistance and trade policies, and that the dialogue between Norway and the governments of the recipient countries should be improved.

In commenting on exchange rate policy, a number of speakers had focused on the issue of credibility and the relative merits of announced exchange rate objectives versus unannounced exchange rate or other possible targets, the staff representative recalled. He would certainly agree that an unannounced objective did not carry the same weight as a clear, publicly announced commitment. Nevertheless, he shared the view that the time had not yet come for the authorities to return to a pegged exchange rate, or to spell out in precise terms an alternative target. Moreover, the staff would point out that a commitment to a low rate of inflation and a demonstrated record of adhering to that commitment would, in themselves, help to strengthen the authorities' policy credibility.

There were various advantages and disadvantages to a peg to a single currency, the ECU, or another currency basket, the staff representative remarked. The advantages for Norway of pegging to a single currency did not seem as decisive as, for example, the advantages for Austria, as the trade patterns of the countries were somewhat different: the dependence on a single trade partner was not as pronounced in Norway as in other small industrial countries, and the same consideration broadly applied to the commodity composition of trade. In the final analysis, the choice of a peg would not be determined by purely economic considerations alone; political factors would have a significant influence. Given Norway's wish to join the EEC, the exchange rate arrangement choices available to the authorities would of course be limited.

He did not necessarily agree with Mr. Waterman that the fact that Norway was subject to terms of trade shocks argued for some flexibility in its exchange rate policy, the staff representative commented. In fact, it could be argued that the possibility of such shocks strengthened the case for a cautious fiscal policy so as to provide room for adjusting to changes in the terms of trade.

Speakers had mentioned the possibility of setting a target for the rate of inflation, the staff representative remarked. The staff doubted whether there was sufficient support in Norway for such a target to make it credible. Moreover, certain technical issues would need to be addressed before the authorities could contemplate announcing such a target. The relationship between inflation and policy instruments had to be analyzed, and judgments on whether clear rules could be established to guide policy would have to be made.

In 1992 the authorities had tried to return to the previous owners a portion of the shares of one of the major banks that the Government had taken over, the staff representative said. By all accounts, the offer price had been attractive, but the response had been limited, partly because the general conditions in the economy were not conducive to strong private interest in obtaining shares in the banks, and partly because of the uncertainties about the banks' nonperforming loans and how they were to be dealt with.

At the time of the consultation discussions, the authorities had hoped that the negotiations on EEC membership would proceed quickly and perhaps be completed by the end of 1993 or in early 1994, the staff representative from the European I Department noted. The current indications were that the negotiations were likely to take longer than the authorities had expected. Some of the issues that still needed to be addressed in the negotiations were difficult ones--such as licensing for oil and gas operations, and fisheries policy--and, of course, there was a need for the negotiations between the EEC and Norway to proceed in line with the EEC's negotiations with other prospective members.

Mr. Prader noted that, in commenting on the choice of a possible peg, the staff had suggested that the current exchange rate arrangement for Norway was understandable, given the diversified composition of its trade and the smaller dependence on one single trading partner, compared with

Austria. In choosing among the pegging options, much depended on what the authorities wanted to achieve with their exchange rate policy. Switzerland's trade was much more diverse than Austria's, and yet the Swiss authorities had decided to link, on an informal basis, their exchange rate to the deutsche mark. Governments had to consider whether the objective of exchange rate policy was to support anti-inflation policies or to insulate the country from changes in trade fluctuations and competitiveness.

The staff representative from the European I Department commented that each pegging option had particular advantages and disadvantages. In the case of Norway, the objective of containing inflationary pressures, plus political considerations, would argue for pegging eventually--not necessarily to the deutsche mark--but to the ERM currencies in the EEC.

Mr. Dorrington said that the staff's comments on inflation targeting could be interpreted in two possible ways. First, there were circumstances in which the Norwegian authorities would feel it appropriate for there to be a significant rise in inflation, an approach that he would find disappointing. Second, the relationship between policy instruments and inflation was uncertain--an assessment with which he would agree. In Norway at present, it was difficult for the private sector to draw confidence about the prospects for inflation from what could be observed about the authorities' use of available policy instruments. A clear commitment by the authorities to a low rate of inflation would therefore be particularly helpful.

Mr. Solheim made the following statement:

> At the outset, I thank Directors for their interesting and useful comments on Norway. My authorities will be duly informed about the views expressed today.
>
> Although the staff representative has dealt comprehensively with most of the questions, I should like to comment on some of the main issues focused on in the discussion. It is interesting to observe that Directors' views differ somewhat on the main policy issues. This is, however, not very surprising, and this is certainly also the situation in Norway, where the differences of opinion, however, are particularly marked on the question of EC membership.
>
> As expected, the stance of fiscal policy has resulted in a number of comments, of which some are fairly critical. While I can concur with many of the comments made, it should be underscored that the 1993 budget signals that an important change in the stance of fiscal policy is in the process of being implemented. A significant budget weakening has taken place over the last four years, and a reversal of this represents, in the Norwegian context, an accomplishment in itself. While it may be argued that the Government's approach is not ambitious enough, it has proved difficult to obtain broad political support for a more

restrictive policy, given the relatively comfortable financial position of the Government and of the economy as a whole.

As touched upon by Mr. Ismael, a main policy objective of the Government has been, and remains so for the 1990s, to find work for everybody and to secure the welfare society. This explains the countercyclical fiscal policy and the future gradual fiscal approach of my authorities. In accordance with this, my authorities have also, in the context of the recent policy meetings of the OECD and between EFTA and the EC, actively advocated a policy aimed at stimulating international activity.

At this stage, I do not want to reopen a technical discussion about the appropriate definition of the Norwegian budget deficit. Taking into consideration the estimated permanent oil income component, to bring the budget back in balance would require a budget strengthening of about 3 percentage points. In a situation with a gradual upswing in the economy, a reduction in the fiscal deficit of about 3 percentage points over a number of years may not be regarded as a formidable task. In fact, as many speakers, not least Mr. Schoenberg, have underscored, the internationally high level of public revenue and expenditure may constitute more of a problem in the coming years. Nevertheless, significant steps in the right direction have been taken in recent years to address the structure of public revenue and expenditure, such as tax system reforms and changes in the composition of expenditure. I agree, however, that formidable challenges may remain in the years ahead in order to harmonize the Norwegian tax system to that of the EC.

With regard to monetary and exchange rate policy, different views have been expressed by Directors. As stated by the staff representative, the main objective is to return to a fixed exchange rate regime. I have noted Mrs. Hansen's comments on the exchange rate policy, but it is my authorities' clear view, based on previous years' experience, that small countries in the long run have little to gain from floating exchange rates. To the extent that a relatively stable exchange rate is compatible with declines in interest rates, such declines should be allowed to occur. Although my authorities have not adopted an explicit target for the rate of inflation, a stable exchange rate will contribute to a low inflation rate. The recent developments of interest rates (short and long term) and of the exchange rate underscore the strong international confidence in the Norwegian monetary policy.

Many Directors have touched upon the labor market policies. In Norway, labor market measures have mainly been supply oriented by reducing various types of rigidities. An important objective has been to strengthen incentives to work, and a number of measures in this direction have been introduced. I have noted

Mr. Havrylyshyn's cautioning on the effectiveness of labor market measures, based on experience in the Netherlands. My authorities are also considering means to ease entry of first-time job applicants, e.g., by reducing their starting salaries (apprenticeship systems like those in Austria, Germany, and Switzerland). A system resulting in substantially more wage flexibility within and between industries and regions would not be in accordance with the policy goals of a more equitable society. However, owing to the widespread use of part-time work, the Norwegian labor market functions in a relatively flexible way.

At this stage, I do not intend to dwell extensively on the Norwegian income system. It is a matter of fact, however, that during recent years the relatively centralized Norwegian wage system has contributed markedly to the low wage increases and the gains in competitiveness. The recommendations of the Employment Commission are to proceed with the existing regime in order to combine wage restraint with structural measures, and thus achieve the intended improvements in competitiveness. This approach is broadly in line with the views expressed by Mr. Prader, although one has to admit that the Norwegian income system is less advanced than the Austrian system. I agree with some of the speakers that it is going to be a formidable task to achieve the planned 2 percent annual unit labor cost improvement in the next five years through superior Norwegian wage and productivity performance.

The banking problems in Norway have also attracted the interest of Directors. In fact, the banking problems started to become really serious around the time of the previous Board meeting, while the worst seems to have passed at the time of this meeting. Even though I agree with Mr. Mohammed that a key lesson from Norway is the importance of strengthened supervision, I should like to stress that this is only one of many factors that led to the crisis. In short, the main factors behind the dismal development can be summarized in three phrases: bad banking (excessive risk taking, unsatisfactory control systems, etc.); bad policies (overly expansionary economic policy at the same time as financial deregulation, wrong tax incentives, etc.); and bad luck (50 percent reduction in oil prices, collapse of the real estate market, etc.). This is comprehensively dealt with in the recent economic developments paper and will be covered in a forthcoming Fund Occasional Paper.

Not surprisingly, many Directors were concerned about the degree of government intervention and ownership in the banking sector. It is my view, however, that the authorities have followed a fairly restrictive--and consistent--line, e.g., required complete write-downs of equity capital, new managements, substantial cost cuts, etc. The commitments of the authorities have, on the whole, been in broad accordance with the textbook principles--

solvency support has been provided by the Guarantee Funds authorities, while the central bank has acted as a lender of last resort.

Within the restrictions imposed by the Government Insurance Fund, the three present state-controlled major commercial banks are operating like private banks. Nevertheless, it is the clear intention of my authorities to reprivatize these banks. The timing of it will, inter alia, depend upon the actual performance of the banks.

As to the questions raised on prospective EC membership, it should be clear that the EEA agreement will secure equal access to EC markets for sectors like industry, services, and finance, but will, at the outset, not influence sectors like agriculture, fishing and energy. The EEA agreement is likely to be effective toward the end of this year.

The staff representative has responded to most of Mr. Thomas's EC questions, but the referendum about EC membership is to be held after the conclusion of the negotiations. This may not take place before some time during 1995. So far, the polls have shown a significant majority of "no" votes.

The following three areas may prove to be particularly difficult in the EC negotiations: agriculture (Arctic, remote areas with high transport costs, regional issues, low population density, etc.); fishing (access to fishing territories, regional issues, and minke whales); and energy (control over own resources, and priority to a state-owned company).

It is thus apparent that the authorities aim at maintaining control of oil resources and arriving at satisfactory solutions for the primary sectors and the regional policy.

Finally, I have noted that a number of Directors have praised Norway for its generous official development assistance contributions. According to a poll recently taken in Norway, 85 percent supported the present Norwegian aid policy. This may indicate that Norway will remain in the lead in this area, although we would appreciate being joined by other industrial countries.

The Acting Chairman made the following summing up:

Directors noted that, after a long period of recession, the performance of the Norwegian economy had recently begun to improve. Economic activity was expanding, although at a modest pace, inflation was low, and the external position was strong. Many Directors pointed out, however, that Norway's improved economic performance was largely the result of the rapid growth of the oil sector and had not prevented unemployment from rising to historically high levels, although it was pointed out that unemployment is still lower than in most other industrial countries. Mainland economic activity had remained sluggish, reflecting the comparatively high level of domestic costs and the impact on demand of financial consolidation by households and the corporate sector. Moreover, the short-term outlook was uncertain, as it depended, inter alia, on the stabilization of the debt consolidation process in the private sector and the strength of the international recovery.

Directors pointed to a number of achievements in the implementation of economic policy, but also singled out some remaining challenges. Monetary policy had played a key role in bringing down inflation. Significant structural reforms had also been implemented, including a major simplification and rationalization of the tax system. However, much remains to be done to ensure the transition to a well-functioning financial system, to reduce rigidities in the labor market, and to lay the ground for the fuller integration of the Norwegian economy with that of the rest of Europe. Moreover, the expansionary stance of fiscal policy since 1989 had contributed to a weakening of public finances and a relatively high level of expenditures and revenues to GDP.

In reviewing policies in the fiscal area, many Directors welcomed the structural measures that had been adopted--or were proposed--to reduce nonwage labor costs and improve the composition of government outlays, including in particular the measures to contain the growth of transfer payments to households. However, several Directors expressed concern at the relatively high level of subsidies, which are a heavy burden on the budget. Most speakers agreed with the staff that the authorities' goals for the reduction of the central government deficit over the medium term could be more ambitious. Directors pointed out that the announced fiscal adjustment plans through 1997 would fail to arrest the erosion of the Government's asset position and would leave the oil adjusted deficit substantially above the level that can be sustained over the longer run. In view of these considerations, many Directors urged the authorities to aim for greater fiscal consolidation over the medium term. At the same time, there were Directors who supported the authorities' medium-term fiscal objectives as being adequate for Norway in light of Norway's overall fiscal position.

Directors endorsed the cautious monetary policy that the authorities had pursued under the floating rate regime; this had contributed to the rebuilding of international reserves while simultaneously allowing an appreciable reduction in interest rates and the maintenance of a stable exchange rate. Many Directors stressed that monetary policy should be geared to keeping inflation in check and should continue to be aimed at maintaining stable conditions in the Norwegian currency market. A number of speakers felt, however, that resistance to downward pressures on the exchange rate would not be necessary, except if there was clear evidence of a rekindling of wage and price inflation. These Directors had in mind the recent loss in competitiveness, as measured particularly against some of the European currencies. Other Directors, however, supported the authorities' strategy of targeting the exchange rate band and the objective of eventually returning to a fixed exchange rate regime. Some of these Directors questioned whether an implicit or unannounced exchange rate band would be useful in that context and expressed preference for an explicit and transparent band. Several Directors stressed the need for ensuring the operational autonomy of the central bank in conducting monetary policy.

Directors noted that the bank rescue operations undertaken by the authorities had succeeded in averting a systemic crisis. However, they observed that the state now played a major role in credit allocation and urged the authorities to seek ways to decrease state involvement in the banking sector and to facilitate the infusion of new private capital into the banks. In this regard, they welcomed the authorities' intention to take the first steps in the gradual reprivatization of the commercial banks later this year, and, indeed, some Directors encouraged an acceleration of the privatization.

Directors emphasized that wage moderation and reductions in nonwage labor costs, along with prudent budget and monetary policies, were required to improve competitiveness, while containing inflation. In this regard, the commitment of the social partners to wage restraint was seen as a good omen. Several Directors underlined the contribution that a shift away from support schemes could make to enhancing the flexibility of the labor market. Directors also stressed the importance of scaling down subsidies to agriculture and ailing industries in order to improve the functioning of product markets and resource allocation.

Directors commended Norway on its continuing generous level of development assistance.

It is expected that the next Article IV consultation with Norway will be held on the standard 12-month cycle.

3. SAO TOME AND PRINCIPE - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with Sao Tome and Principe (SM/93/89, 4/26/93).

They also had before them a background paper on recent economic developments in Sao Tome and Principe (SM/93/96, 5/7/93).

The staff representative from the African Department noted that a staff mission that had recently returned from Sao Tome and Principe had found that, during the first four months of 1993, developments in the fiscal area, inflation, and the foreign exchange market had been less favorable than had been envisaged earlier. The Government had approved a package of salary increases for civil servants averaging 25 per cent for 1993, which could jeopardize the targeted increase of 15 per cent in the civil service wage bill. Inflation, estimated at 9 per cent for the first four months of 1993, was higher than targeted, and the spread between the official and parallel market exchange rates had widened significantly. By contrast, the external sector outlook for 1993 appeared to be slightly more favorable than earlier envisaged, partly because of increased foreign financing and partly because of a reduction in the debt service following a downward revision of the estimate of the outstanding debt stock.

Mr. Santos made the following statement:

The economic and financial performance of Sao Tome and Principe improved in 1992, reflecting the adjustment measures introduced by the Government in late 1991 and in 1992. Real GDP is estimated to have increased moderately, the rate of inflation as well as the external current account deficit was reduced, the current fiscal position, on a commitment basis and excluding external interest obligations, shifted from a deficit to a surplus equivalent to 2.1 percent of GDP, and the macroeconomic targets of the indicative program were met. However, despite these encouraging developments, the economic and financial situation of Sao Tome and Principe remains difficult, as the collapse of the price of cocoa, the country's main export commodity, and the heavy external debt burden continue to constrain the authorities' adjustment efforts.

Against such a background, the restructuring of the economy has taken on added importance, and the authorities have prepared a medium-term adjustment program to help them deal with the challenges facing Sao Tome and Principe. Their strategy is to speed up the pace of macroeconomic adjustment and structural reforms over the medium term so as to achieve a real rate of economic growth of about 4 percent, to reduce the internal and external financial imbalances significantly, and to address effectively the external debt problem. In the pursuit of these objectives, wide-ranging measures in the different sectors of the economy are being implemented.

In the real sector, the measures have focused on improving productivity in the cocoa sector and eliminating the financial losses of the state-owned plantations through private management contracts. In addition, the authorities have introduced a number of incentives to increase production by the small private producers and have allowed private exporters to retain a substantial part of their foreign earnings. A revised labor code has been passed, which gives managers flexibility in wage and employment decisions. The Government is also encouraging agricultural diversification toward the production of basic foodstuffs and nontraditional exports. The program for the distribution of land, the new investment code, and the establishment of a free trade zone this year are other elements of the authorities' strategy to diversify and improve the competitiveness of the economy.

On the structural front, substantial progress has been achieved. Price liberalization, which has been an essential element of the Government's adjustment strategy, has now been completed with the lifting of the remaining profit margins on a few basic commodities. The policy of price and market liberalization, together with tighter financial policies, contributed to reducing the inflation rate from 45 percent in 1989 to 27 percent in 1992, despite the large depreciation of the dobra during that period. The authorities' policies have also contributed to the improvement in the competitiveness of the economy, as reflected in the substantial decline in real wages. The restructuring of the public enterprise sector has been an important element of the authorities' economic reform program.

In this respect, based on the action plan prepared in 1989, a number of enterprises have been partially privatized, liquidated, or restructured. However, the authorities recognize that the pace of reform of the public enterprises and their privatization have been slower than envisaged, and they are taking steps to speed up the process. To this end, a law was passed in 1992 that allows the Government to sell public enterprises, and a technical commission has been set up to oversee the privatization process. The authorities have also made progress in the reform of the financial sector. A new central bank was established in August 1992, and early this year a new commercial bank, with foreign participation, started operations.

In the fiscal sector, the revenue measures implemented in 1991 as well as those introduced in 1992, and which included discretionary taxes, the simplification of income tax collection procedures, and the strengthening of tax administration, have resulted in a substantial increase in revenue, which now stands at 23.1 percent of GDP. On the expenditure side, the Government continued its efforts to reduce real spending, primarily through cuts in the wage bill. Over the medium term, the authorities will accelerate the program of tax reforms and implement additional revenue-raising and expenditure-reducing measures, which are expected to shift the primary fiscal balance from a deficit of 2.2 percent of GDP in 1992 to a surplus of 4 percent by 1995.

Monetary and credit policies in 1992 were restrained and aimed at containing pressures on prices and the balance of payments. Interest rates were kept positive in real terms. Net bank credit to the Government fell sharply in 1992, and total domestic credit was within the program target. For 1993, the authorities are maintaining the same restrictive stance on monetary and credit policies. With the government continuing to make net repayments to the banking system, domestic credit expansion will be limited to less than 14 percent.

In the external sector, the balance of payments position has been strongly influenced by developments in the cocoa sector, which accounts for 85 percent of foreign exchange earnings. From 1988 to date, the world price of cocoa has fallen by almost half and production has declined by about 30 percent. Moreover, the other export crops, such as copra and coffee, have also experienced a large fall in prices. As a result, export earnings have decreased by over 50 percent and account to a large extent for the widening of the external deficit, and the difficulties in meeting external obligations. In the face of such developments, the authorities are implementing policies to diversify exports and improve competitiveness, as described above. Moreover, they have used the exchange rate instrument actively in the adjustment process. During 1992, significant progress was made in narrowing the differential between the parallel and the official exchange rates. The value of the dobra was again adjusted, and the authorities have now introduced a crawling peg mechanism. They are also continuing with the program of trade and payments liberalization.

The size of the external debt and the growing amount of external arrears are of major concern to the Sao Tome and Principe authorities, and they have continued their efforts to address them. In this context, they are undertaking, with World Bank assistance, a debt buy-back scheme, and at the same time they are proceeding with a debt-equity swap program with commercial banks. The authorities are also actively seeking debt relief from bilateral creditors. The Sao Tome and Principe authorities feel confident that these efforts will be successful and will lead to a virtual elimination of the financing gap.

My authorities would like to draw attention to the wide range of measures they have already taken to reform the economy and to the additional measures envisaged for 1993, as described in the staff report. While they recognize that administrative bottlenecks and other difficulties have delayed progress in some areas, it should be stressed that, given the limited administrative capacity of the country, much has been done toward restructuring the economy and putting it on the path of sustainable growth. To consolidate these gains, the authorities have launched a medium-term program of adjustment for which they would like to receive Fund support. The bold measures already taken attest to the determination and commitment of the authorities to such a program, and they hope that the Fund and the international community will support their efforts. In this regard, my authorities have requested a follow-up mission in October to reassess progress under the staff-monitored program and to agree on a policy framework paper that could form the basis for an arrangement under the ESAF.

Mr. Wire made the following statement:

The authorities deserve credit for their continued efforts to stick with the reform effort initiated in 1991. Nevertheless, only modest progress was made under the shadow program implemented during 1992. On the structural side, little or no progress occurred on key issues. Macroeconomic developments were more positive but still mixed. Inflation fell more than expected, but growth was slightly under target. Government revenues increased, but a smaller overall fiscal deficit proved elusive. The current account remained stable in dollar terms but widened relative to GDP.

With the medium-term strategy outlined in the staff paper, the authorities appear to recognize that their reform effort needs to be reinvigorated, although the developments in early 1993 just described by the staff representative clearly cast a shadow. Sao Tome continues to face a significant external financing gap, and, as the staff has stressed, the investment necessary for medium-term growth will have to come from external assistance. Significant donor support, in turn, will depend on the vigor with which the authorities pursue sound macroeconomic policies and structural reforms.

Furthermore, according to the staff paper and the elaboration provided by Mr. Santos in his statement, the authorities intend to seek an ESAF arrangement later this year. We endorse this objective. However, we look to the authorities for action in the near term that could demonstrate a strong commitment to a sustained reform effort. I think this need for action would be underscored by the macroeconomic developments thus far in 1993.

In this regard, we would note that less than six months remain until expiration of the present ESAF facility. While we are all working to ensure a smooth and speedy transition to an ESAF successor, Sao Tome and other eligible members should not overlook the advantages of using ESAF resources that are currently available, rather than waiting to use funds that are not yet in place.

Set against the need to demonstrate progress in the near term, the authorities' macroeconomic objectives for 1993 do not seem overly ambitious. Growth is expected to increase to 2.5 percent, inflation to fall to 17 percent, and the current account to remain stable in dollar terms while rising somewhat relative to GDP. Attainment of these objectives by year-end could prove attainable, provided strong action is taken in key policy areas, although, again, developments in early 1993 cast a shadow. In this regard, we are in broad agreement with the strategies set forward by the authorities and staff.

Fiscal consolidation clearly heads the policy agenda. On the revenue side, tax administration needs to be strengthened and additional revenues generated from new sources and from higher rates on tax measures. On the expenditure side, costs need to be reduced and civil service reform implemented, especially in view of the absence of any progress during 1992. In addition, subsidies to state-owned enterprises need to be reduced and the privatization effort accelerated.

Further efforts to strengthen the external sector will also be critical. In this connection, we welcome recent and planned efforts to diversify the export base while improving agricultural production. In connection with an effort to boost exports, the recent consolidation of a number of export taxes is a welcome step, but we would urge that these revenue measures be replaced entirely as soon as circumstances permit. We also agree with the need to take steps to reduce external obligations through debt-relief and restructuring operations. On the latter issue, we would appreciate some clarification from the staff with regard to the debt operations under way or envisaged.

With regard to the exchange rate system, we welcome the intention of the authorities to eliminate the parallel exchange market, although the widening differential in early 1993 may pose a problem. We would encourage the authorities to eliminate the remaining trade and exchange restrictions under Articles VIII and XIV.

With respect to monetary policy and financial sector reform, the establishment of a separate central bank and a commercial bank during 1992 were noteworthy accomplishments, but the restructuring of the former national bank remains incomplete and positive real interest rates need to be maintained. Moreover, with only one commercial bank in operation, it appears to us that there might be sufficient scope for the establishment of more private domestic or foreign commercial banks to engender competition and ensure the availability of credit to support private sector activities.

Taken together, greater macroeconomic stability, further financial sector reforms, privatization of state-owned enterprises, and improved external policies could combine usefully to give a boost to private sector development and increase the likelihood of increased employment and growth in real incomes.

Finally, we welcome assurances that, in the context of the adjustment effort, the authorities are cognizant of the risks of environmental degradation and are seeking external assistance to manage and protect their forests.

In conclusion, we hope that the authorities can firmly implement their macroeconomic and structural agenda and take steps to reduce external indebtedness, so that a closer relationship with the Fund might be possible.

Mrs. Martel made the following statement:

The staff report for the 1993 Article IV consultation with Sao Tome and Principe provides a candid assessment of the present economic situation and a good opportunity to review the performance under the 1992 shadow program.

Overall, the authorities have taken a number of decisive steps since 1991 to turn around the economic decline and the financial deterioration of the country and have substantially enhanced their track record of policy implementation, especially on the stabilization front.

The Government of Sao Tome and Principe indeed deserves credit for having met the main macroeconomic targets of the indicative program. The inflation rate slowed down from 36 percent to 27 percent, below the targeted level, and the current fiscal balance (excluding interest payments on external debt) shifted from a deficit in 1991 to a surplus of 2.1 percent of GDP in 1992. Although the pace of structural reforms in 1992 remained constrained by limited administrative capacity, a number of far-reaching reforms were implemented, with the support of external technical assistance, namely, the land distribution program, the financial reform, and the revision of the labor code.

For the period ahead, tight fiscal and monetary policies should remain the authorities' top priority to further reduce financial imbalances and abate inflation.

In the context of the 1993/94 budget, a number of reforms and technical assistance programs, already under way, should help the Government to improve revenue collection and expenditure control. As indicated by the staff, revenue rose significantly in 1992, as a result of the depreciation of the dobra. However, courageous revenue measures, especially the increased tax on petroleum products, and the growth in social security receipts, also contributed to those good results. The acceleration of the tax reform program now being implemented should reap the expected benefit in the coming months, provided the tax and customs administration is strengthened as intended.

On the expenditure side, performance was mixed, primarily because of increased interest on external debt and higher than expected outlays on goods and services. Government efforts to control other current expenditures are nevertheless particularly commendable, especially on the wage bill, which steadily declined in real terms between 1988 and 1992. As rightly noted by the staff in the background paper, the policy of reducing real wages over this period has been one of the key components of the Government's adjustment program to enhance external competitiveness and to reduce the inflation rate. It is very important that such a prudent stance on salary increases be pursued, especially considering what we have heard from the staff today, but the Government should also embark forcefully on a more comprehensive civil service reform designed to streamline the different ministries and restructure the pay scale in order to enhance the motivation of civil servants. This is, in my view, particularly important, as limited implementation capacity remains one of the major constraints to the reform process.

Monetary policy was broadly in line with the program's targets: nominal interest rates rose substantially; net bank credit to the Government fell sharply; and the increase in domestic credit remained below the projected level of the shadow program. It is welcome that the authorities maintain the same restrictive stance as in 1992 on monetary and credit policies in 1993/94, ensuring that interest rates remain positive in real terms and that counterpart funds are sterilized in order to further reduce the Government's indebtedness vis-à-vis the central bank.

The progress made in 1992 and early 1993 in financial sector reform is also welcome, and I noted with satisfaction the decisive steps taken toward the establishment of an effective two-tier banking system. The strengthening of the central bank's operations, and the establishment of a new commercial bank and of a new Caixa Nacional should contribute to improving the allocation of resources and facilitating domestic savings collection over time.

As regards structural policies, the results achieved so far have been mixed and delays have been encountered. As rightly noted by the staff, Sao Tome will remain highly dependent on technical assistance, and the pace of reform is therefore constrained by the availability of such technical support. As a case in point, UNDP assistance for the civil service reform arrived in the field just last March. Therefore, I can join the staff in urging the authorities to accelerate the pace of structural reforms, while taking into account the administrative constraints of this country.

Concerning, more specifically, public enterprise reform, decisive steps have already been taken, with the liquidation of the two trading monopolies, the implementation of private management contracts for state-owned cocoa estates, and the restructuring of public utilities. Also noteworthy are the establishment of a legal framework for privatization and the action plan that has been agreed upon with the World Bank for the few enterprises that remain to be privatized.

Turning now to the external sector, the viability of the balance of payments for the medium term remains, as the staff puts it, "problematic." The weakness of the external sector is clearly compounded by the very heavy debt burden. The two main priorities for the medium term are therefore the diversification of the economy and the solution to the debt problem. Concerning the former, I agree with the staff that the ongoing efforts to rehabilitate the cocoa sector and diversify the export basis will take time to translate into improvements in the level of exports. However, the ongoing restructuring in the cocoa sector could have a substantial impact in the medium term on alleviating the current substantial imports of foodstuffs.

As far as the debt is concerned, the country clearly faces a debt overhang, with rising debt-service obligations reaching nearly 150 percent of exports in 1992. As this is clearly the main hurdle to overcome, I particularly welcome the recent approval by the World Bank Board of a commercial debt buy-back operation, supported by the IDA facility. I understand this operation could be completed by the end of 1993. It is very reassuring to hear from Mr. Santos that the authorities are actively seeking debt relief from bilateral creditors, and that they feel confident that these efforts will be successful and will provide scope for a bridging of the projected residual financing gaps over the medium term.

In conclusion, the efforts made by the authorities are quite commendable, and the overall progress in adjustment, even though it needs to be consolidated, appears to be substantive. Provided the authorities follow this path, the Fund could play a critical role in providing financial support so as to help the authorities strengthen their efforts at this crucial stage of their adjustment process.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/93/81 (6/4/93) and EBM/93/82 (6/11/93).

4. ADMINISTRATIVE BUDGET, FY 1993 - TRANSFER OF APPROPRIATIONS

The Executive Board approves the proposals set forth in the memorandum attached to EBAP/93/36 (6/1/93).

Adopted June 8, 1993

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/93/104 (6/3/93), EBAM/93/106 (6/4/93), and EBAM/93/108 (6/8/93), by Advisors to Executive Directors as set forth in EBAM/93/106 (6/4/93) and EBAM/93/108 (6/8/93), and by Assistants to Executive Directors as set forth in EBAM/93/103 (6/2/93) and EBAM/93/105 (6/3/93) is approved.

APPROVED: November 23, 1993

LEO VAN HOUTVEN
Secretary