FOR AGENDA

SM/00/9

CONTAINS CONFIDENTIAL INFORMATION

January 11, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Norway—Selected Issues**

This paper provides background information to the staff report on the 1999 Article IV consultation discussions with Norway, which was circulated as SM/99/311 on December 27, 1999.

Ms. Cerra (ext. 38596), Ms. Koliadina (ext. 34289), and Mr. A. Thomas (ext. 34317) are available to answer technical or factual questions relating to this paper prior to the Board discussion scheduled for Wednesday, January 26, 2000.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Thursday, January 20, 2000; and to the Food and Agriculture Organization, the Organisation for Economic Cooperation and Development, and the World Food Programme, following its consideration by the Executive Board.

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CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

NORWAY

Selected Issues

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Approved by European 1 Department

January 10, 2000

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Norway: Basic Data

Social and Demographic Indicators						
Area	323,878 square kilometers					
Population (1998)	4.42m millions					
Population growth (1997-98)	0.6 percent					
GDP per capita (1998)	US$27,700					
Population Characteristics and Health						
Life expectancy at birth: Overall	77					
Female	80					
Infant mortality (aged under 1, in percent)	0.8					
Population per physician	451					
Population per hospital bed	67					

	1995	1996	1997	1998	1999 1/	2000 1/
	(Volume changes in percent)					
Private consumption	3.4	5.3	3.7	3.1	2.3	2.0
Public consumption	0.3	2.8	2.8	3.7	1.1	1.5
Gross fixed investment	3.4	9.9	15.1	8.1	-9.0	-11.6
Export of goods and services	4.3	9.3	5.7	0.5	4.0	9.1
Of which: Oil and gas	8.2	11.0	2.6	-3.2	...	...
Import of goods and services	5.6	8.0	12.0	9.1	-1.0	-1.1
GDP	3.8	4.9	4.3	2.1	1.0	2.9
Mainland GDP 2/	2.9	3.9	4.4	3.3	0.3	0.7
	(In percent of labor force)					
Unemployment 3/	4.9	4.8	4.1	3.2	3.6	3.6
	(Percentage changes)					
Consumer prices	2.5	1.3	2.6	2.3	2.3	2.0
Hourly labor cost in manufacturing	4.6	2.5	2.5	4.3	4.7	3.7
Effective exchange rate						
Nominal	2.5	-0.3	0.6	-4.5	...	...
	(Twelve-month percent change, end of period)					
Domestic credit	6.3	9.2	6.1	10.4	8.0 4/	...
Broad money	5.1	6.0	4.5	5.4	9.9 4/	...
	(In percent)					
Three-month Interbank rate	5.5	4.9	3.7	5.8	6.4	5.0
Ten-year government bond yield	7.4	6.8	5.9	5.4	5.5	4.6
	(In percent of GDP)					
State budget, including social security						
Revenues	48.2	51.9	53.5	49.0	49.9	53.7
Expenditures	47.7	46.2	46.1	46.1	46.7	46.6
Overall balance	0.5	5.6	7.5	2.9	3.3	7.0
General government financial balance	4.1	8.0	9.6	4.5	5.6	9.0
Current account balance	3.3	6.7	5.2	-0.8	2.8	7.1
International reserves (in months of imports of goods and services)	5.8	6.3	5.5	4.4	4.5 4/	...

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

1/ Official estimates and projections.

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

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

4/ October 1999.

I. SELECTED FISCAL ISSUES[1]

A. Introduction

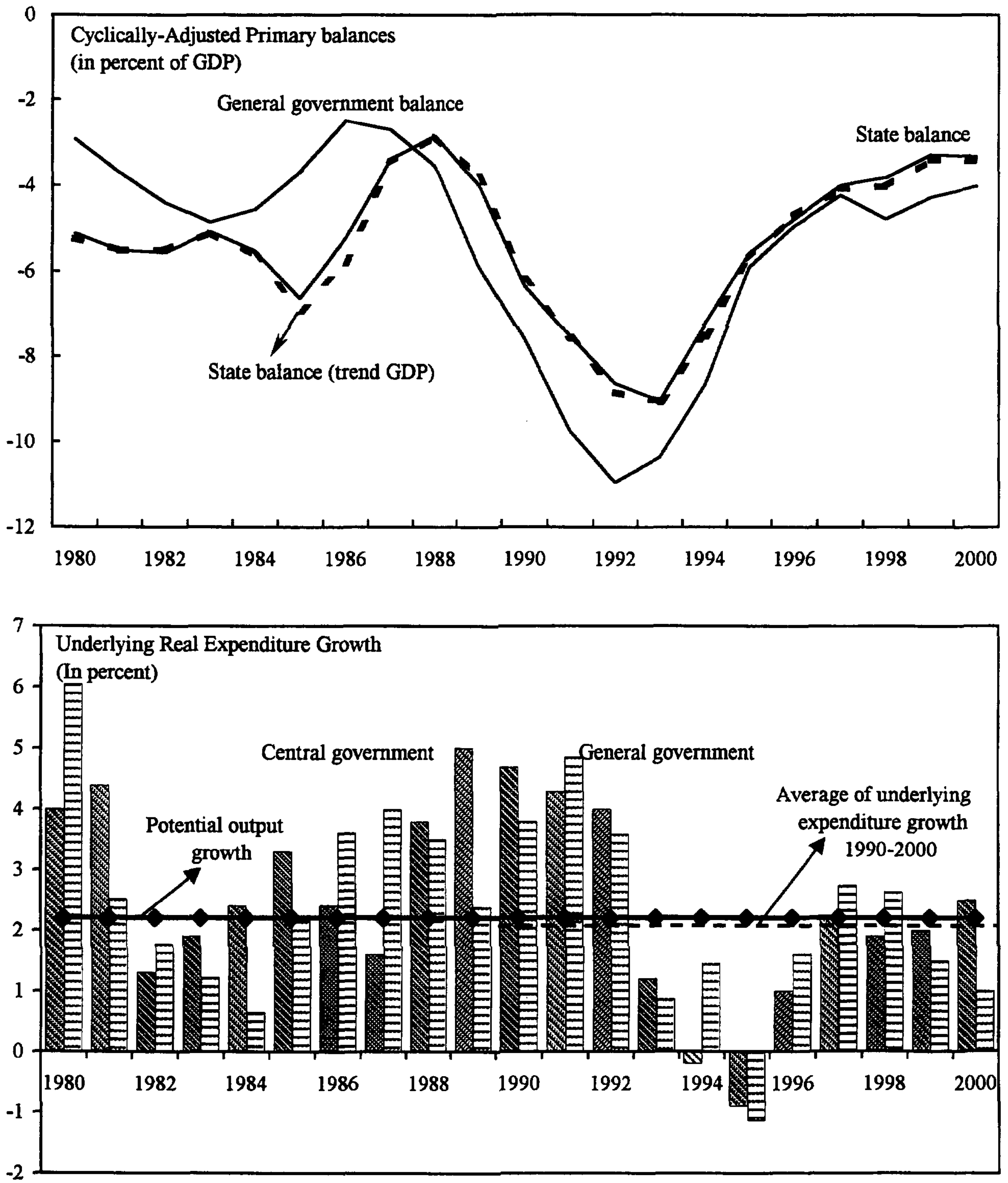
1. Since the early 1990s the Norwegian authorities have adopted a macroeconomic strategy known as "The Solidarity Alternative" in which fiscal policy at the central government level plays an active stabilizing role in the economy, monetary policy is geared toward maintaining a stable exchange rate, and the unions try to ensure moderate wage settlements. Fiscal policy has been generally effective in discharging the countercyclical role assigned to it. In the downturn of the late 1980s and early 1990s, the state budget was progressively loosened in order to stimulate activity. With the onset of the recovery in 1993, the direction of fiscal policy was reversed, and since then fiscal policy at the central government level has been contractionary, although less so in the most recent years.

2. In assessing fiscal policy, the Norwegian authorities have emphasized two measures. The first measure is the **cyclically adjusted non-oil budget balance net of interest payments** which was introduced in 1987 as the main indicator of the stance of fiscal policy. The second measure is the **growth in real underlying central government expenditures** relative to the growth in mainland GDP. Figure 1, panel 1 shows the cyclically adjusted central government (state budget) balance relative to GDP over the past two decades demonstrating the deterioration in the cyclically adjusted balances in the late 1980s and early 1990s and the substantial improvement since 1993. In the initial phase of the tight fiscal stance between 1993 and 1996, large expenditure cuts were made, lowering the expenditure ratio at the central government level by over 5 percentage points to 37 percent of GDP. Since then the expenditure ratio has risen slightly but the contractionary stance has been maintained through tax increases. The containment of real expenditure growth during the mid 1990s has helped to maintain the average expenditure growth at the central level below the estimate of potential output growth in the mainland economy of 2.2 percent (Figure 1, panel 2).

3. While fiscal policy at the central level in recent years has been contractionary, expenditure at the local authority level has remained strong, tipping the balance toward an accommodating stance at the general government level in 1998. **This paper develops a cyclical indicator of fiscal policy at the general government level and provides an updated assessment of the long-term fiscal position based on the future profile of the State Petroleum Fund (SPF).** Section B presents both the authorities' and the staff's methodology for calculating a cyclically adjusted non-oil budget position; section C presents fiscal impulse measures based on both estimates; section D discusses the budget for the year 2000, section E describes financing issues at the local authority level, and section F provides updated scenarios of the long-term fiscal position.

[1] Prepared by Alun Thomas.

Figure 1.1 Norway: Fiscal Indicators



Source: Ministry of Finance; and staff estimates.

B. Calculation of Cyclically Adjusted Budget Balances

4. The authorities' estimate of the cyclically adjusted non-oil budget balance excludes the following items from the aggregate budget balance:

- revenues and expenditures from petroleum activities;
- interest payments abroad and to the Central Bank and transfers from the Central Bank to the government;
- estimated cyclical components of certain taxes and expenditures;
- technical changes in budgets with no real economic impact.

5. *In the Revised Budget for 1999 the authorities presented some modifications to the* method of calculating the cyclical adjustment by linking various revenue components to their respective tax bases. In particular, the cyclical correction for direct taxes and social security contributions is now based on cyclical movements in employment, the cyclical correction for taxes on private consumption on the consumption of goods, the cyclical correction for taxes on purchases of investment products on cyclical movements in mainland business investment, and the cyclical correction for taxes on purchases of intermediate consumption on cyclical movements in selected services. The cyclical corrections for taxes on new cars and expenditures on unemployment benefits continue to be based on purchases of cars and the unemployment rate respectively. The cyclical components of each series are determined using HP filters.[2] Moreover, with the budget for 2000, **the authorities have begun presenting the cyclically adjusted budget balance relative to potential GDP rather than actual GDP** because of the greater variability in actual GDP. The difference between the two estimates is slight, however. For example, the fiscal impulse for 1999 based on potential GDP is 0.6 percent whereas the corresponding impulse based on actual GDP is 0.5 percent (Figure 1, panel 1).

6. The calculation of a cyclically adjusted non-oil budget balance at the general government level presented in this paper is based on a method which is broadly similar to the method adopted by the authorities. On the revenue side, interest income, oil-related production and income taxes and transfers from the state petroleum company and from Norges Bank were excluded while on the expenditure side, interest payments and transfers to

[2] In constructing indicators of cyclically adjusted balances for the Nordic countries, Braconier and Holden (1999) also split the tax base between pre-tax household income, the wage bill, and private consumption in calculating cyclical adjustments to the budget balance. They also distinguish between induced and discretionary changes in the budget balance; this distinction is ignored here.

the state petroleum company were excluded. The remaining revenue components were broken down between production and indirect tax receipts, social security contributions, and income taxes and transfers. Tax bases were chosen for each of these categories and the relationships between the tax bases and the tax receipts were estimated econometrically using an error-correction specification. The equations revealed a long-run elasticity of 0.99 of production taxes to consumption expenditure, a long-run elasticity of 0.93 of social security contributions to wages, and a long-run elasticity of 1.17 of income taxes and transfers to national income excluding oil (Table 1).

7. In order to control for cyclical movements in each of the tax bases it is necessary to consider how each relates to movements in mainland GDP. Table 2 presents error-correction relationships between each tax base and mainland GDP and reveals very strong relationships between both variables in each case. The resulting long-run elasticities were then used to identify an implicit elasticity between the various tax revenue categories and mainland GDP. Except for production and indirect taxes, the elasticities are similar in magnitude to those estimated by the OECD (Table 3). These elasticities were then used to obtain a cyclical correction for revenues based on changes in the mainland output gap. A similar cyclical adjustment was made for expenditures on unemployment benefits with the elasticity obtained from an error-correction relationship between unemployment benefits and the unemployment rate. The implied long-run elasticity for this relationship is 0.5.

C. Fiscal Stance at the Central and General Government Levels

8. Combining all the cyclical adjustments together into a cyclically adjusted non-oil budget balance shows that the cyclically adjusted general government balance has fluctuated considerably more that the corresponding State budget balance. From below 3 percent of mainland GDP, the general government deficit deteriorated to about 11 percent of GDP at the trough of the recession in the early 1990s (Figure 1, panel 1). Since then the deficit has improved significantly to about 4 percent in 1999. Moreover, **while the fiscal stance at the state and general government levels have been broadly similar over most of the period since 1980, major differences occurred in 1987-88 and 1998** (Figure 2, panel 1). In 1987-88 the cyclically adjusted stance at the central government level was contractionary to the tune of 1.2 percent of GDP per annum whereas the general government fiscal stance was stimulatory at about ½ percentage point of GDP per annum. In 1998, a similar pattern recurred: while the fiscal stance at the central government level was contractionary at about 0.2 percent of GDP per annum, the fiscal stance was expansionary at the general government level at about 0.6 percent of GDP per annum.

9. The focus on the primary balance distinguishes this calculation of the fiscal stance from the authorities' estimate of the central government budget stance which includes interest income while excluding interest payments. The drawback of this procedure is that since interest receipts fluctuate considerably from year to year, the fiscal stance is much more variable. Figure 2 panel 2 presents the general government fiscal stance including and excluding interest income and shows the increased variability of the estimate

Table 1. Norway: Sensitivity of Tax Revenues to Revenue Bases

Dependent Variable	Production Tax		Social Security Tax		Income Tax	
			% Change			
Constant	-0.61	(.40)	-0.17	(.24)	-0.74	(.40) *
ΔPTAX	0.78	(.19) *				
ΔCEX	1.39	(.32) *				
ΔCEX (-1)	-0.91	(.37) *				
PTAX (-1)	-0.40	(.11) *				
CEX (-1)	0.40	(.11) *				
ΔWAG			1.44	(.19) *		
SOCI (-1)			-0.22	(.13) *		
WAG (-1)			0.20	(.12)		
ΔITAX (-1)					0.36	(.19) *
ΔNINC					0.46	(.28)
ITAX (-1)					-0.24	(.12) *
NINC (1)					0.27	(.13) *
			Goodness of Fit Statistics			
R^2	0.88		0.85		0.51	
LM (AR2) stat	2.15		1.26		1.25	
Q (AR2) stat	1.83		0.83		0.53	

1/ Standard error in parentheses; an asterisk indicates that the coefficient is significant at the 10 percent level.

Table 2. Norway: Cyclical Sensitivity of Tax Bases

Dependent Variable	Consumer Expenditures		Wages		National Income		Unemployment Rate	
				% Change				
Constant	0.24	(.20)	-0.05	(.13)	-0.43	(.13) *	1.39	(.23) *
ΔMGDP	0.66	(.13) *						
CEX (-1)	-0.18	(.17)						
MGDP (-1)	0.16	(.18)						
ΔMDGP			0.86	(.19) *				
ΔWAG (-1)			0.17	(.12)				
WAG (-1)			-0.49	(.26)				
MDGP (-1)			0.47	(.24)				
ΔMDGP					1.28	(.10) *		
NINC (1)					-0.42	(.16) *		
MDGP (-1)					0.44	(.17) *		
ΔURATE							0.38	(.03) *
UNEMPI (-1)							-0.21	(.04) *
URATE (-1)							0.10	(.03) *
				Goodness of Fit Statistics				
R^2	0.85		0.92		0.94		0.95	
LM (AR2) stat	1.12		0.33		1.40		0.47	
Q (AR2) stat	2.35		1.57		2.44		1.02	

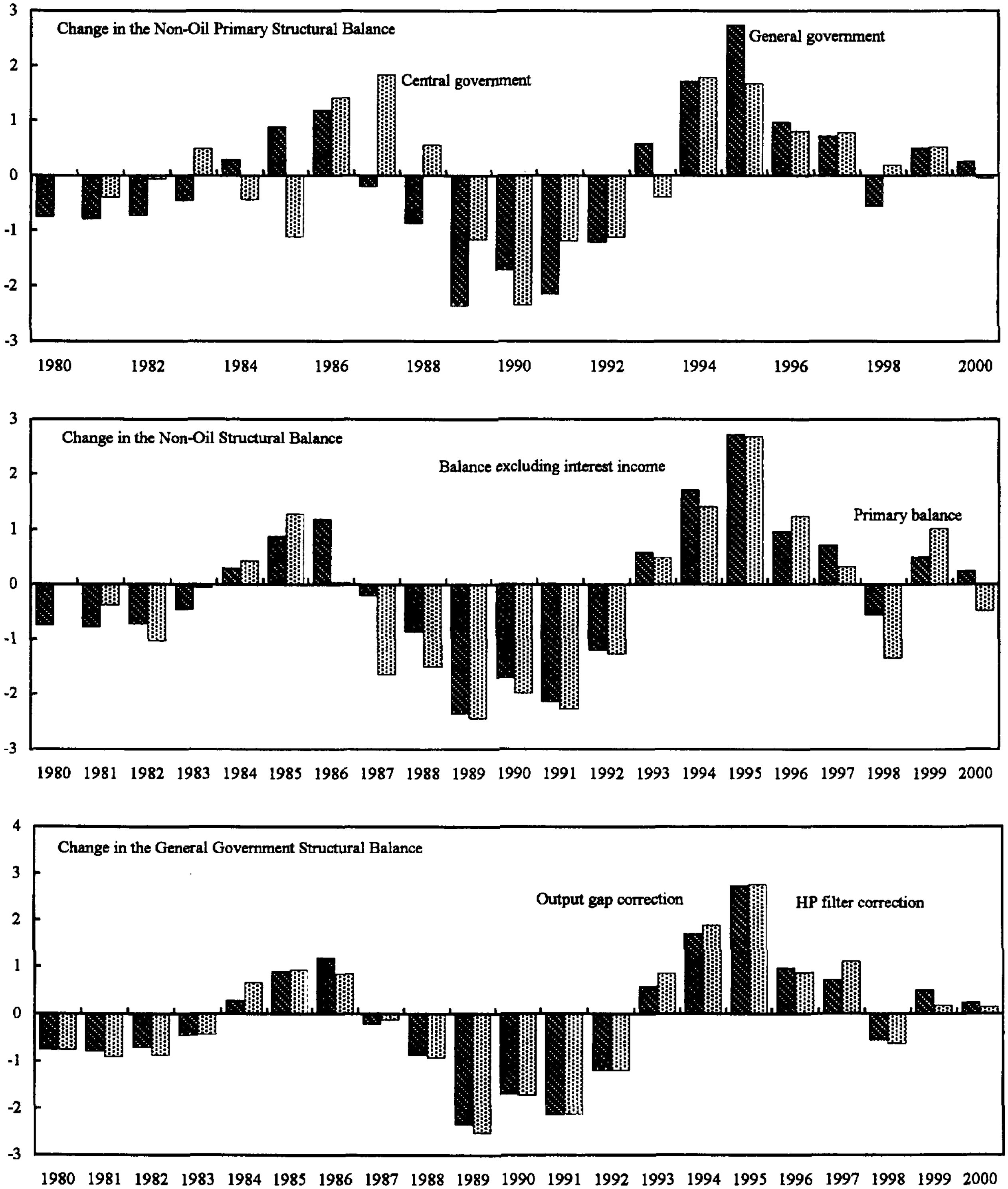
1/ Standard error in parentheses; an asterisk indicates that the coefficient is significant at the 10 percent level.

Table 3. Norway: Elasticities of the Revenue With Respect to Mainland GDP

	IMF	OECD
Production and indirect ta	0.89	1.60
Social security tax	0.90	0.80
Corporate Income Tax)	1.23	1.30
Personal Income Tax)		0.9

Sources: Staff calculations, OECD, Automatic Fiscal Stabilizers 1999.

Figure 1.2 Norway: Fiscal Stances
(In percent of mainland GDP)



Source: Ministry of Finance; and staff estimates.

with interest income included, especially in years when the direction of the stance changes sign (for example, in 1986-88 and 1998-2000).

10. Another difference between the staff's methodology for estimating the cyclically adjusted fiscal stance and the authorities' methodology is that this method treats cyclical variation in all the tax bases in the same way whereas the authorities estimate separate cyclical corrections for each tax base. A supplementary calculation was therefore carried out closer in spirit to the authorities' method of separating cyclical components for each tax base. The cyclical correction for production taxes was based on a HP filtered estimate of real consumption expenditure, the cyclical correction for social security contributions was based on a HP filtered series for employment, and the cyclical correction for labor and capital income taxes was based on a HP filtered series for national income excluding petroleum deflated by the mainland GDP deflator. Since both methodologies give similar estimates for the fiscal stance, filtering tax bases separately does not change the assessment significantly (Figure 2, panel 3).

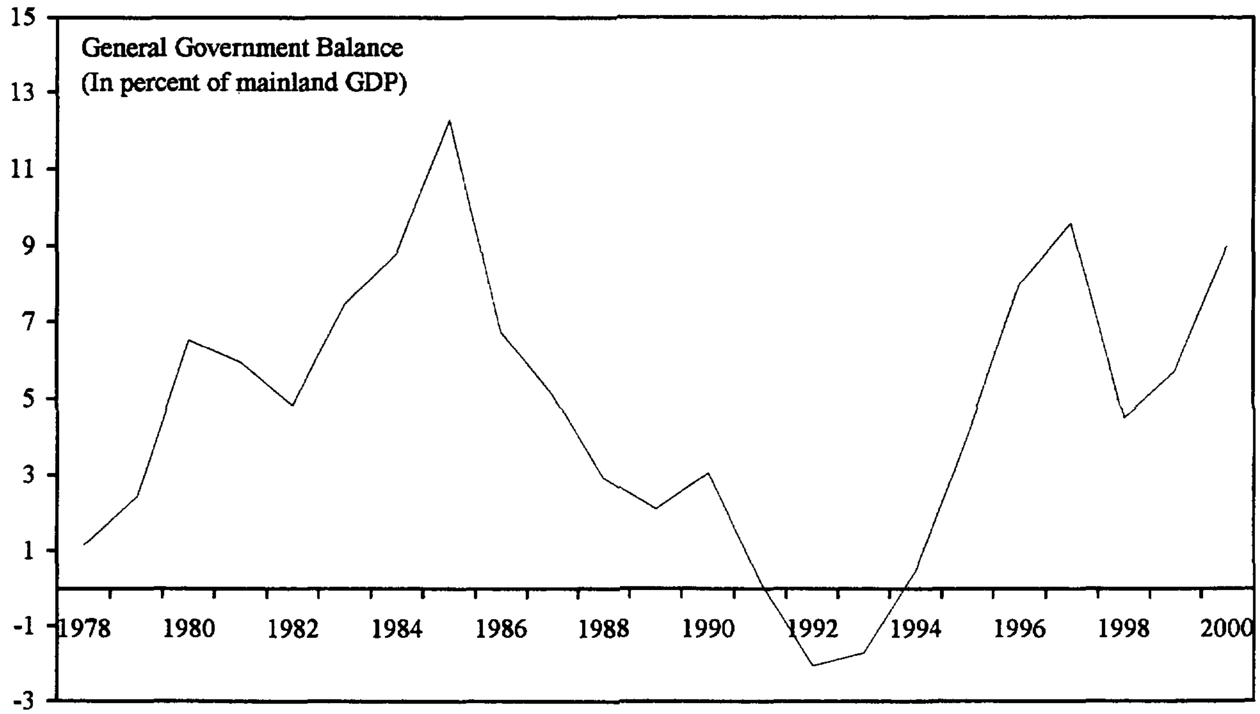
11. **The sizeable differences between the central and general government fiscal stances for some years suggests that increased emphasis should be placed on the general government budgetary position.** While the budgetary position of the municipalities is not a direct instrument in the macroeconomic policy of the central government, one can easily argue that the budgetary position of the general government is the proper yardstick for assessing the fiscal stance.

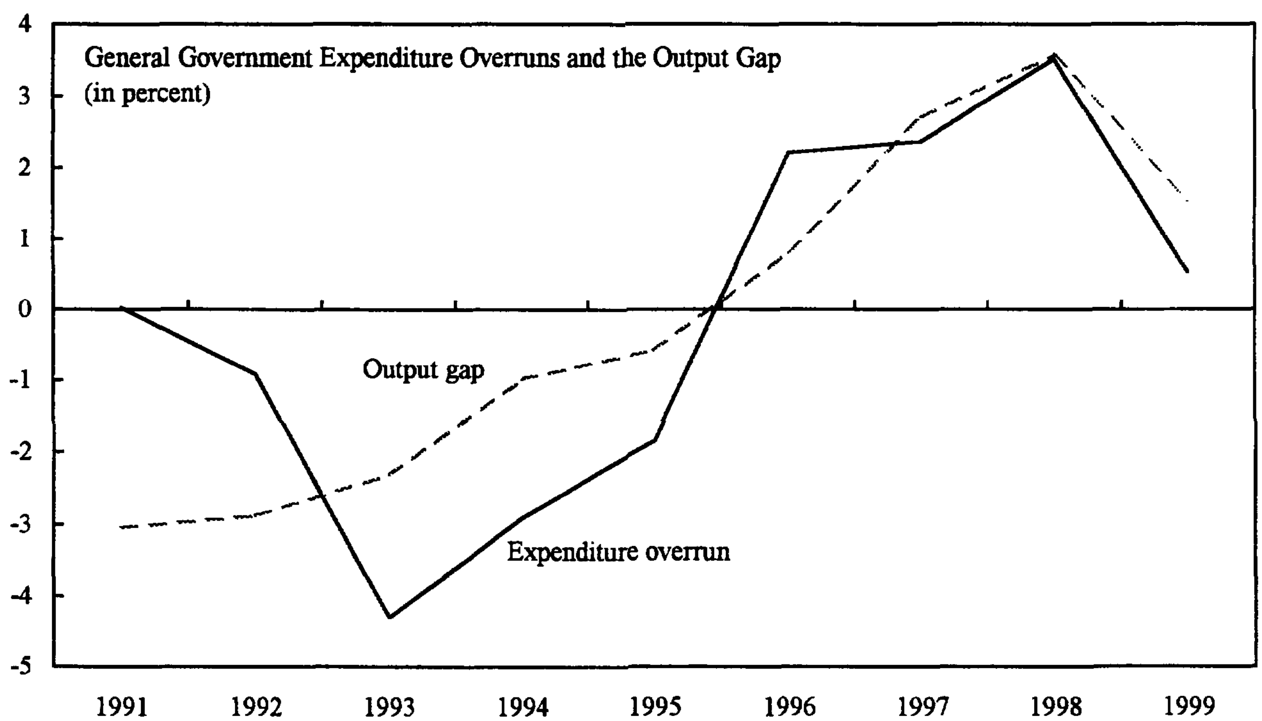
D. Year 2000 Budget

12. The budget for the year 2000 presented to Parliament in early October 1999 envisaged a neutral fiscal stance at the central government level. Real underlying expenditures were projected to increase by 2½ percent, slightly above the estimate of potential output growth, with transfers accounting for a sizeable fraction of the increase. To maintain the neutral stance, excise taxes on the consumption of electricity and gas were increased and income tax brackets were adjusted by 1.4 percent, about 1 percentage point below the rate of inflation. During the fall agreement was reached with the Labor party, the main opposition party, on a neutral fiscal stance with slightly higher expenditures on day-care places and employment schemes financed through a new threshold at the upper end of the income tax scale.

13. The general government budget surplus in 2000 is projected to improve by 3½ percentage points to 9 percent of mainland GDP as a result of higher oil revenues (Figure 3, panel 1). This estimate is based on an oil price of Nkr 125 per barrel (about $16 per barrel). However, the price at end-1999 was about $25 per barrel. If the dollar price for 2000 averages $20 per barrel, this could increase the general government budget surplus by an additional 3 percent of GDP. Based on the staff's methodology, the general government fiscal stance is projected to be slightly contractionary at about ¼ percent of GDP. The main contributing factor is the reduction in capital expenditures associated with the completion of a number of public sector investment projects.

Figure 1.3 Norway: General Government Position





Source: Ministry of Finance; and staff estimates.

E. Finances of the Local Government[3]

14. Since 1995, the local government budget position has been in deficit even though the economy has grown strongly through this period (Table 4). An important factor explaining this development is the substantial investment in health and education in recent years. The lowering of the school entrance age from 7 to 6 implied the need for extra school capacity to accommodate the new entrants. Moreover, the aging of the population has necessitated new investments in the health area. While it could be argued that these are one-off investment projects, capital expenditures have only declined slightly since their completion.

15. The major part of local government income is general and earmarked grants from the central government, and local income and property taxes. Some income is also received from user fees for services received by residents. In the mid-1980s Norway moved to a system where most of the support given to municipalities is in the form of a block grant which compensates municipalities for the difference between the municipality's own tax base and about 96 percent of the average tax base. There are also special grants directed to small municipalities, municipalities located in the north of the country, and municipalities with a decentralized settlement pattern. These schemes provide local governments in the periphery of the country with the largest revenue per capita.

16. Parliament has considerable influence over both the level and the composition of sub-central government revenues. Parliament sets the desired increase in sub-central government revenue based on the general economic situation and chooses income and wealth tax rates to achieve the overall revenue goals. General and earmarked grants are also decided by Parliament. Municipalities can impose their own property taxes with an upper limit of 0.7 percent of the assessed value of the property. However, this rule only covers about half of the municipalities because it is restricted to urban areas and certain facilities such as power stations.

17. Local authorities can prioritize the services on offer as long as provision is made for services assigned by parliament to local governments. For example, local authorities are required to provide education for children 6-15 years of age, elderly care, and social benefits. Although the Local Government Act makes provisions against budget deficits through a balanced budget rule, budget deficits are regularly observed in the accounts. The public investment boom at the local government level in recent years reflecting heavy demands for health and education services illustrates the leeway available to local governments in setting their spending priorities.

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[3] This section draws heavily on J. Rattso ed., Fiscal Federalism and State-Local Finance and OECD, Taxing Powers of State and Local Government, Paris 1999.

Table 4. Norway: Local Authority Finances
(In billions of krona)

	1994	1995	1996	1997	1998	1999
Incomes	148.1	151.2	157.8	168.8	178.4	189.9
(in percent of GDP)	17.1	16.3	15.5	15.5	16.1	16.5
Interest	2.5	2.9	3.1	3.9	4.5	4.8
Taxes	75.0	75.9	80.7	85.2	88.6	91.3
Transfer from Central Government	65.8	67.3	68.8	73.9	78.6	86.9
(in percent of GDP)	7.6	7.2	6.8	6.8	7.1	7.6
Other revenues	4.8	5.1	5.2	5.8	6.7	6.9
Expenditures	144.1	151.7	158.8	170.6	183.4	193.2
(in percent of GDP)	16.6	16.3	15.6	15.7	16.6	16.8
Current	136.2	142.9	150.1	156.4	169.9	179.6
Capital	7.9	8.8	8.7	14.2	13.5	13.6
Balance	4.0	-0.5	-1.0	-1.8	-5.0	-3.4
(in percent of GDP)	0.5	-0.1	-0.1	-0.2	-0.5	-0.3

Sources: Ministry of Finance and staff estimates.

18. The local government tax base is strongly pro-cyclical with local public spending increasing in booms and falling in recessions. During the early 1990s when unutilized resources were prevalent in the economy, the actual expenditure outcome at the general government level always under-performed the budgeted amount, partly on account of weak revenue growth. In contrast, since 1995 when the Norwegian economy began to operate above capacity, expenditure overruns at the general government level have occurred consistently (Figure 3, panel 2).

19. The strong pro-cyclicality of local government revenues (and, given the close association, expenditures) in Norway reflects the way taxes are paid to local authorities, the composition of the tax base, and the share of taxes in local government revenue. First, since taxpayers pay their local taxes directly to the local government, the national government cannot control the total amount of local taxes prior to the fiscal year. This stands in contrast to Denmark and Sweden where all taxes are paid to the central government, and local taxes are paid (in advance) to the local governments in the same way as block grants.

20. Second, while the property and corporate taxes represent respectively the most and least effective taxes in terms of stabilizing tax revenues over the cycle, the use of these taxes in Norway has not reflected this difference. The property tax is paid by homeowners and firms located in the community and therefore has the least mobile tax base. In addition, the fact that new construction is small compared to the existing base and that the tax assessment is typically not affected by short-term fluctuations in market prices helps to maintain a fairly stable tax base over the cycle. In contrast, the corporate income tax is strongly pro-cyclical and the freedom given to firms over the timing of tax payments makes it hard to predict revenues. In Norway, the property tax only generates revenue equivalent to about 9 percent of municipal taxes (Table 5). One way of mitigating the sharp cyclical fluctuations in revenue would be to increase revenues from this source, possibly at the expense of the wealth tax. Recently, the authorities have recognized the cyclical sensitivity of corporate income taxes at the local level by deciding to make the central government the collection agency for all corporate tax revenues.

21. Third, tax revenues at the municipal level are much more important in relation to aggregate revenues in the Scandinavian countries than in other countries with unitary structures. [4] The municipal tax ratios for all four Scandinavian countries are the highest among the OECD countries with unitary tax systems (Table 6).

22. One possibility for mitigating the cyclical sensitivity of local government revenues would be to offset the cyclically-driven growth in local government revenues through additional withdrawals/transfers in the revised budget in May of each year. If such an option

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[4] Countries with unitary structures have only one sub-national tax unit in contrast to federal countries which have two sub-national tax units representing state and local governments.

Table 5. Norway: 1997 Tax Revenue Categories as Percentage of Total Tax Revenues at the Sub-National Level

	Income and Profits	Property	General Taxes	Other Taxes 1/
		Federal Countries		
Australia				
State	25.2	30.9	--	43.9
Local	--	100.0		--
Belgium 2/				
State	51.6	5.4	38.7	4.3
Local	82.4	--	1.5	16.2
Canada				
State	55.9	6.4	19.4	18.2
Local	--	86.0	0.1	13.8
Germany 2/				
State	47.4	5.2	40.6	6.7
Local	77.1	21.7	--	1.1
Switzerland				
State	7.5	16.9	--	7.6
Local	84.4	15.0	--	0.5
United States				
State	39.5	4.3	33.1	23.1
Local	6.0	73.3	11.1	9.5
		Unitary Countries		
Denmark 2/	93.4	6.5	--	0.1
Finland 2/	95.8	4.0	0.0	0.1
France 2/	15.5	31.4	--	53.0
Ireland 2/	--	100.0	--	--
Italy 2/	18.1	34.4	--	47.5
Japan	52.6	30.4	2.2	14.8
Netherlands 2/	--	62.2	--	37.8
Norway	89.9	9.4	--	0.7
Portugal 2/	22.7	38.8	19.0	19.4
Spain 2/	26.4	34.9	10.9	27.8
Sweden 2/	99.7	--	--	0.3
United Kingdom 2/	--	99.1	--	0.9

Sources: OECD, Revenue Statistics 1998.

1/ Includes taxes on specific goods and services, taxes on use, and some residual taxes mainly on business.

2/ Payments to the European Union are excluded from these comparisons.

Table 6. Norway: 1997 Tax Revenue at the Sub-National Level as Percentage of Total Tax Revenue at the Economy Level

	Federal Countries
Australia	22.3
Belgium	28.3
Canada	44.9
Germany	28.8
Switzerland	35.2
United States	31.6
	Unitary Countries
Denmark	31.2
Finland	22.3
France	10.5
Ireland	2.1
Italy	5.8
Japan	24.9
Netherlands	3.0
Norway	18.3
Portugal	5.7
Spain	16.1
Sweden	30.5
United Kingdom	3.9

Sources: OECD, Revenue Statistics 1998.

is adopted, it would be necessary to avoid taking grants away from the municipalities with the weakest revenue growth so as to safeguard the tax equalization component of the transfers.

F. Long-Term Fiscal Considerations

23. While the fiscal objective of the Norwegian authorities is based on demand management, close attention is also given to the future sustainability of government expenditures. The Norwegian authorities aim for a sustainable long-run fiscal position through accumulating assets in the State Petroleum Fund during the period of peak production so that when oil and gas reserves run out, a sufficient buffer fund will be available to finance rising age-dependent expenditures. Over the past few years, the staff have estimated the future profile of net financial assets of the public sector based on assumptions about future oil prices, the rate of return on petroleum wealth, pension and non-pension expenditures. This section therefore, provides a brief update. [5] [6]

24. Since the last consultation, the authorities have made substantial downward revisions to the net cash flow from the petroleum sector accruing to the government budget which raises doubts about long-run fiscal sustainability based on current policies. The downward revisions are associated with a large reassessment of the future extraction costs of existing active oil fields. Figure 4, panel 1 presents a comparison of the net cash flow estimated in 1998 and 1999 and indicates that the yearly downward revision amounts to about 15 percent between 2000 and 2010 and 18 percent between 2030 and 2050. The major consequence of this downward revision is evident in Figure 4, panel 2. The baseline scenario uses WEO assumptions for oil prices through 2003, (averaging about Nkr140 per barrel) and subsequently assumes that oil prices decline to Nkr 100 per barrel in 2000 prices in 2010 in response to a projected decline in oil demand associated with the implementation of the international Kyoto agreement on CO2 emissions. The real rate of return is assumed to be 4 percent, budgetary assumptions are used for the year 2000, and non-oil revenues and expenditures (excluding pensions) are assumed constant in relation to GDP subsequently. Under these assumptions, net financial assets would be exhausted by 2040, without additional measures. Moreover, raising oil prices relative to the baseline by assuming that they remain at their 2003 level in real terms (equivalent to a 4½ US dollar increase) would not alter the assessment dramatically.

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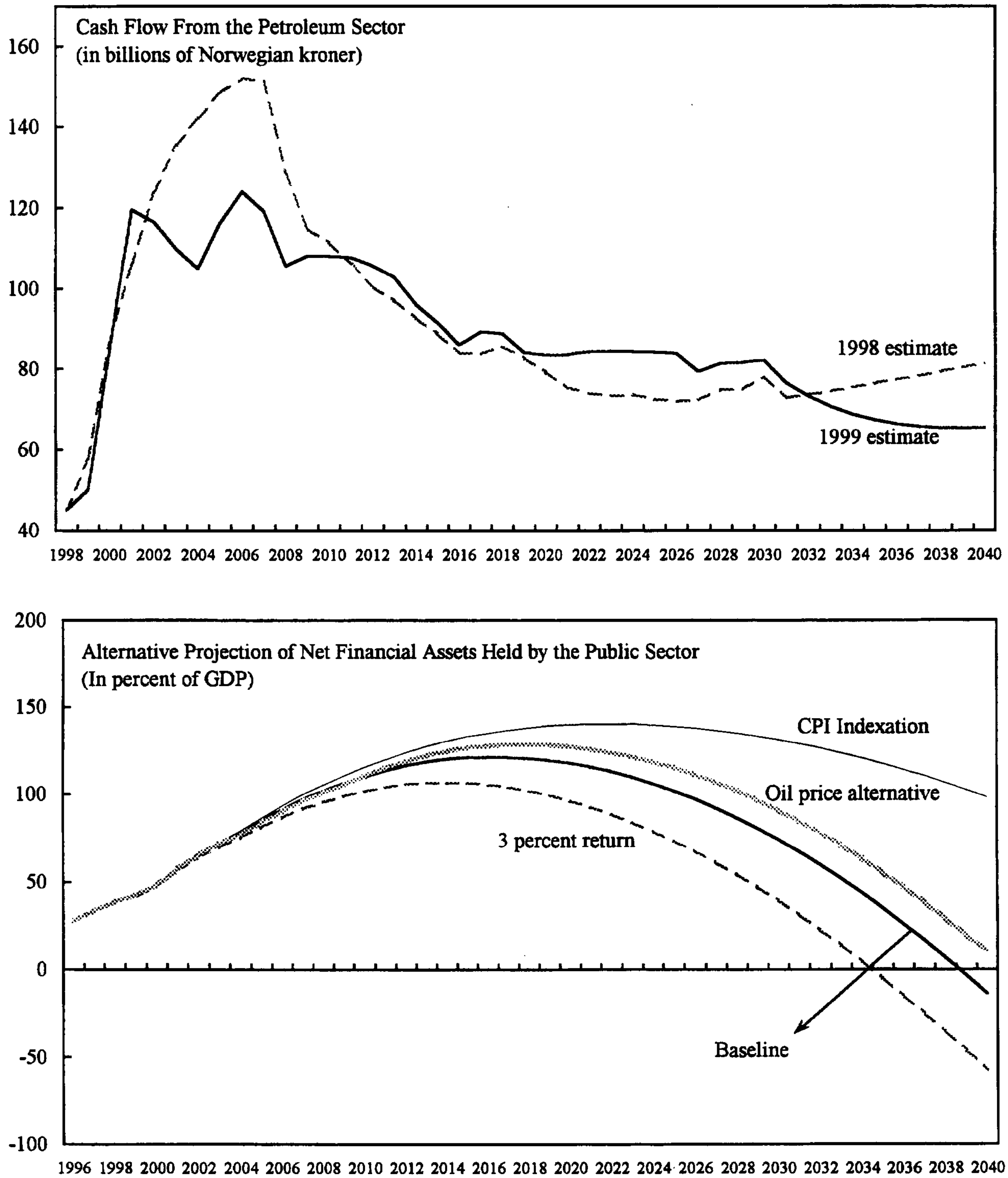
[5] See SM/98/270, 12/18/98, "Recent Developments and Long-term prospects of the State Petroleum Fund."

[6] Net Financial assets held by the public sector encompass the assets held in the state petroleum fund, assets from a defunct government fund, assets held in the state banks, and the valuation at cost of public enterprises.

Figure 1.4 Norway: Fiscal Sustainability



Source: Ministry of Finance; and staff estimates.

25. Policy changes such as lowering pension benefits or raising the average age of retirement or the participation rate would make the pension system financially more sound. For example, if future pensions are indexed to the CPI instead of wages, a net asset position of about 100 percent of GDP would materialize by 2040. Alternative ways of addressing the problem would be to raise the average retirement age or foster an increase in the participation rate. The authorities have calculated that increasing the average retirement age by 1 year would have the same effect on national wealth as raising the oil price by Nkr 13 per barrel (about US$2). A permanent increase of 9 percent in average working hours raises national wealth by an amount equivalent to the total oil wealth. These measures would maintain labor supply at a high level and moderate the need for cuts in benefits.

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II. NORWAY: A REVIEW OF PRIVATIZATION ISSUES[7]

A. Introduction and Summary

26. State ownership of enterprises in Norway—amounting to more than half of all productive assets, and exceeding 100 percent of GDP—is concentrated in the petroleum, financial, telecommunications, railway transportation, and power generation sectors.[8] The authorities have stated that they do not interfere in the day-to-day management of state companies, which are run on a commercial basis. Compliance with the Treaty of Rome ensures equal treatment of public and private companies. Although no comprehensive assessment of the performance of state-owned assets is available, they are generally regarded as well-managed, and capable of competing with private companies.

27. Privatization initiatives in Norway—the financial and petroleum sectors are just two examples—often come from individual companies facing competition with much larger multinational corporations. The authorities acknowledge the international trends toward concentration and consolidation in the telecommunications, financial, and petroleum sectors, and intend to diversify ownership composition in these industries, while retaining partial state ownership. The government has no comprehensive privatization program, and decisions are taken on a case-by-case basis. The authorities intend to follow a gradual approach toward divesting of state assets which they expect will contribute to an optimal use of national resources and distributional equity, without undermining high environmental standards. In its privatization decisions, the government has been taking into account market conditions and the importance of the state's participation in the industry. The authorities have been concerned about the national identity of companies in "strategic" industries, emphasizing the importance of long-term Norwegian ownership for the needs of the economy.

28. The authorities have made some progress in deregulation and privatization, but the pace of reforms has been slow. Even in the financial sector, where privatization has proceeded relatively more rapidly, economic goals were often sacrificed for non-economic considerations about losing the "national identity" of the company. Although privatization in the telecommunications and petroleum sectors has not begun, the government has made some progress toward improving competition in both markets. In the telecommunications sector, it would be important to encourage new entrants, while enhancing Telenor's ability to compete in the open market. In the petroleum sector, incentives to operate on the Norwegian Continental Shelf (NCS) could be strengthened through making licensing procedures more transparent and allowing the companies more freedom in utilization of licenses.

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[7] Prepared by Natalia A. Koliadina.

[8] OECD Economic Survey 1998–1999: Norway, p. 69.

29. This paper focuses on structural changes needed, and prospects for privatization of state assets in the telecommunications and petroleum sectors.[9] As suggested by the literature on privatization, the success of this process cannot be divorced from the market structure—its flexibility (free entry and exit), contestability, and the regulatory framework. Privatization, being an important device for raising cost efficiency at the company level, could be harmful to allocative efficiency if the market is monopolistic. In the presence of a monopoly, the deregulation of the market may not be sufficient for promoting competition, and the government's intervention may be warranted to facilitate free entry. Moreover, state assets are likely to be undervalued if the market is not attractive for investors, or if no comparable assets are being traded in the market. Section B provides background, Section C gives an overview of the history and existing privatization initiatives in the telecommunications and petroleum sectors; Section D tries to draw conclusions.

B. Theoretical Background

30. The consensus view is that the ownership—state or private—affects a company's performance, even though it is hard to assess the difference, partly because public and private owners have disparate objectives with respect to their assets, and partly because state assets are not publicly traded. Distinct objective functions—private agents usually maximize profits, while governments, social welfare—require different standards for assessing changes in ownership, in terms of private and social gains. Private and social gains from privatization would be the same under perfect competition with no externalities, but they would diverge in the presence of externalities and imperfect competition. In the case of competitive markets, gains from privatization can be measured by changes in internal efficiency—the change in costs of production for given output. Under monopolistic competition, gains from privatization should be measured by changes in internal and allocative efficiency, with the latter concerned with socially optimal pricing, i.e. equalization of prices to marginal costs.

31. The potential gains from privatization are often associated with resolving the principal-agent problem—the problem of setting the right incentives for an agent under asymmetrical information, when the principal and the agent have different objective functions. While the principal-agent problem can arise under any ownership when the owner is not directly involved in asset management, it is exacerbated in the case of state ownership, since the public, not the government, is the ultimate owner. In contrast with state-owned companies, private corporations are subjected to market discipline through public trading of equities and takeover or bankruptcy threats, which help to reconcile the objectives of shareholders, with those of managers.

32. Some authors argue that "the degree of product market competition and the effectiveness of regulatory policy typically have rather larger effects on performance than

[9] Privatization issues in the financial sector are discussed in Selected Issues paper 3.

ownership *per se*."[10] When state companies act as commercial bodies in a competitive environment, without pressures from the government, they can be as efficient as private firms: Wright notes that in the United Kingdom under the Thatcher government productivity growth in the public sector exceeded that of the private sector.[11] Vickers and Yarrow suggest that social welfare could be higher if the monopoly is state owned, rather than privatized, since the state monopoly would produce at the socially optimal level, with prices equal to marginal costs, while a private monopoly's output would be lower, to satisfy the profit-maximizing condition.[12]

33. Empirical evidence about the effects of privatization on a company's performance is not unambiguous. Apart from the lack of reliable data, Vickers and Yarrow identified two major problems with empirical work on privatization: (i) many studies focused on the effects of ownership changes, while neglecting the market structure, regulation, and other factors; and (ii) in measuring the company's performance, most studies relied on easily observable variables—attempts to estimate the sum of producers' and consumers' surpluses were often alternated by the assessment of profitability—which created a bias in favor of private ownership. Subject to the above qualifications, D'Souza and Megginson found that their sample of 85 firms from 28 industrialized countries privatized in 1990–96 experienced significant performance improvements after being privatized: the companies reported significant increases in profitability, output, operating efficiency, and dividend payments, and decreases in leverage ratios.[13] Vickers and Yarrow came to the conclusion that private companies on average are more efficient when markets are competitive, but they noted that under monopolistic competition little empirical justification was found in favor of either type of ownership.[14] If competition is imperfect, social gains from privatization would depend on changes in both internal and allocative efficiency, with the latter affected more by the market structure than the type of ownership.

C. Privatization in Norway: History and Prospects

34. Notwithstanding the first privatization effort of the 1980s, government stakes in commercial companies remain high (Table 1). The most significant progress so far has been in privatizing the state assets in the financial sector, where the state ownership in

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[10] Vickers and Yarrow, *Privatization: An Economic Analysis*, p. 3.

[11] Wright, ed., *Privatization in Western Europe*, p. 33.

[12] Vickers and Yarrow, *Privatization: An Economic Analysis*, p. 36.

[13] D'Souza and Megginson, "The Financial and Operating Performance of Privatized Firms during the 1990s," p.1433. The authors proxied operating efficiency by the sales efficiency, measured as a ratio of sales to employment.

[14] Vickers and Yarrow, *Privatization: An Economic Analysis*, p. 39, 40.

Kreditkassen was reduced to 34 percent.[15] Following the deregulation of the telecommunications sector in 1998, the government divested itself of some of its interests in non–financial companies, selling off its shares in Norsk Jetmotor AS and part of its stock in Norsk Medisinalderpot AS (a pharmaceuticals wholesaler).

Table 1. Selected Norwegian Government Assets
(In billions of Norwegian kroner)

Company	Industry	Turnover in 1998	Market value in 1999	State ownership (in percent)
Statoil	Oil	107.0	130.0	100.0
Norsk Hydro	Oil/energy/fertilizer	97.5	72.0	51.0
Telenor/Telia	Telecommunications	28.1	250.0	40.0 1/
DNB/Postbanken	Banking	n.a.	23.0	60.0
Christiania	Banking	n.a.	16.7	34.7
SAS Norge ASA	Airline	40.9	12.8	14.3
Posten Norge BA	Postal services	11.2 2/	n.a.	100.0
NSB	Railway	6.0 2/	n.a.	100.0
Norsk Medisinaldepot	Pharmaceuticals dist.	5.0	n.a.	100.0
Statkraft SF	Hydro power	4.8	n.a.	100.0

Source: *Financial Times*, August 19,1999, p.21.

1/ The share of the Norwegian state in the merged company.
2/ As of 1997.

35. As an integral part of the government's industrial policy, privatization is expected to generate "higher value added in order to achieve the overriding objectives of welfare and employment."[16] The authorities acknowledge that "ownership and business structure have implications for competition, access to capital and expertise in business and industry," and that the "exposure to competition and technological advances has changed the operating conditions for many of the enterprises in which the state has ownership interests."[17] The authorities' position toward privatization was formulated in National Budget 2000: "...the sale of ownership interests shall contribute to ensuring the continuation of the business, which implies that the new owner must be interested in and have financial strength to

[15] As a result of the government's intervention during the banking crisis of the late 1980s, the country's second- and sixth-largest commercial banks were effectively nationalized (Christiania & Kreditkassen, and Fokus Bank), and the government became the owner of 87.5 percent stake in the largest commercial bank (Den Norske Bank)(SM/98/39).

[16] The National Budget 2000, p. 28.

[17] *Ibid.*, p.28.

develop the business in Norway. Therefore, certain ownership sales will be thoroughly evaluated, and sharply defined frames for short-time implementation are not being considered."[18]

36. While the concept of partial privatization has been backed by politicians, social partners, and the general public, there is a general concern about losing control over state assets to foreigners. This concern was viewed as affecting the decision of the government against the takeover bid for Christiania Bank by MeritaNorbanken, a Swedish-Finnish bank; it was also a factor in the collapse of the merger of Telenor and Telia only eight weeks after it had been finalized, and is likely to affect the government's strategy of privatizing the state assets in the petroleum sector. Norway, however, is not unique in its apprehension about selling its assets to "foreigners" (Box 1).

Box 1. "Selling off the Family Silver"

Uneasiness over takeovers by "foreigners" was one of the factors that affected privatization in smaller European countries, like Portugal, Denmark, Finland and Austria, and even the United Kingdom was not immune to this sentiment, which had contributed to the decision against selling off the Austin-Rover car business to Ford. In some cases where governments were cash constrained, or the company in question was a heavy loss-maker, privatization eventually took place. Other governments, however, retained significant stakes, or blocking minority stakes (a "golden share") in privatized companies, which enabled them to block unwelcome takeover bids. One example is British Telecom (BT), in which the Articles of Association limit the share ownership to 15 percent of the company in order to prevent any attempted takeovers, while the government with less than 1 percent equity share has the right to veto any change to this provision through its "special share." 1/

To substitute for competition, the U.K. government stepped in and restrained BT's monopolistic behavior in three areas: interconnection, information, and cross-subsidization. BT was obliged to allow other operators to interconnect with its network. It was prohibited from using the information obtained as a part of its monopolistic activities in its operations in competitive markets. The rules on cross subsidization were designed to prevent BT from using profits from its monopolistic activities to subsidize services in areas with stronger competition. 2/

1/ Ryan Daniel J., ed., 1997, *Privatization and Competition in Telecommunications: International Developments*, p.73.
2/ *Ibid.*, p.75.

37. The Norwegian authorities have argued that state-owned companies are generally efficient.[19] However, if privatized, they would benefit from market discipline, freedom from

[18] The National Budget 2000, Structural Policy, p. 4.

[19] The White Paper evaluating the performance of the state-owned assets in the petroleum sector is slated for publication in February 2000.

potential political interference and better access to capital markets, which would be likely to boost their internal efficiency. Moreover, society in general is likely to gain from the government's reduced exposure to commercial risks, from a "deepening" of the capital market, and from greater investment opportunities.

Telecommunications: Deregulation and Forthcoming Privatization

38. The deregulation of the telecommunications sector in January 1998 opened the industry to competition, and formally abolished the state monopoly over Telenor. However, the company was able to retain its market power, thanks to its rights over the local grid and consumer costs associated with changing the service provider.[20] As suggested by the table below, Telenor dominates the Norwegian market in all telecom services, including mobile telephony which was deregulated in 1992 (Table 2).

Table 2. Norway: Market Structure in Telecommunications Sector

	Number of license holders	Share of Telenor (in percent)
Domestic long distance		100
International long distance		95
Mobile cellular (analogue)	1	100
Mobile cellular (digital)	3	75

Source: Regulations, Market Structure and Performance in Telecommunications (Tables and Figures). OECD, ECO/CPE/WP(99) 17. Paris, 1999, p.4.

39. Telenor has been aggressively lowering tariffs—which are among the lowest in Europe—virtually eliminating incentives to enter the Norwegian telecommunications market (Figure 1). Limited by the price cap mechanism and the terms of its license, Telenor's production has been set at the socially optimal level with tariff rates close to marginal costs.[21] In line with the terms of its license, Telenor is responsible for the provision of basic telecommunications services throughout the country at a single price, without regional differentiation.

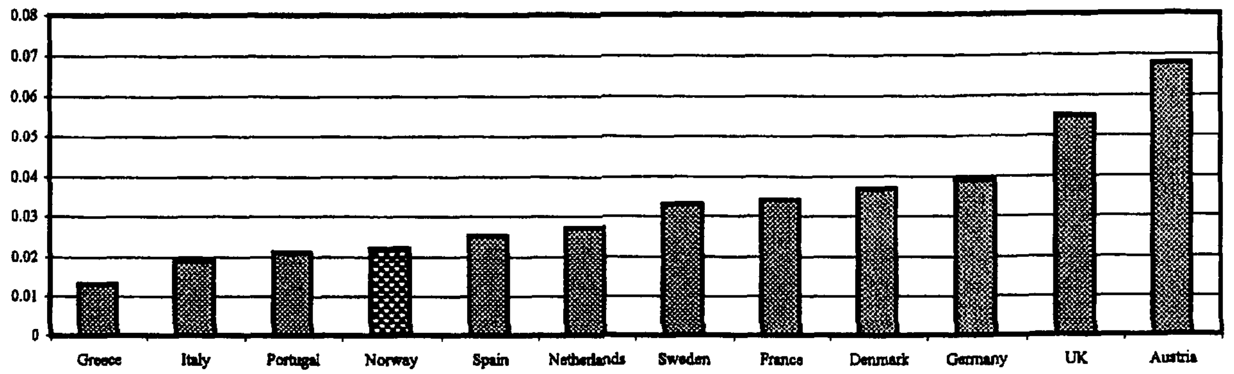
40. Although Telenor was among the best performers in terms of revenue growth, its profitability—lower than that of its European counterparts—was undermined by tariff cuts,

[20] Incentives for consumers to stay with Telenor have been boosted by the barriers such as the absence of telephone number portability and the need to dial a four-digit prefix in the case of an alternative provider.

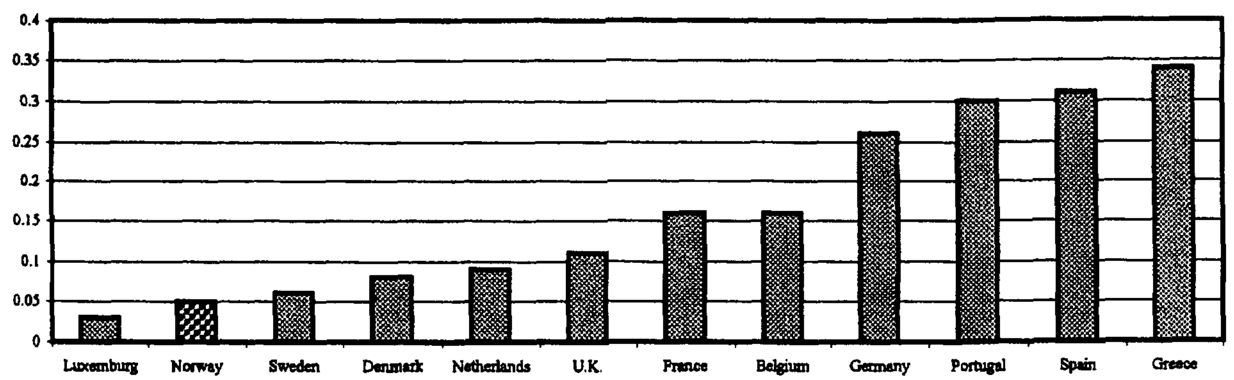
[21] Price caps control the average movement of prices, and if some prices change by more than the specified limit, this must be offset by cuts in other prices, so that the average change is within the limit. Only Telenor is bound by this mechanism.

Figure 1. Telecommunications Tariffs: Cross-Country Comparison

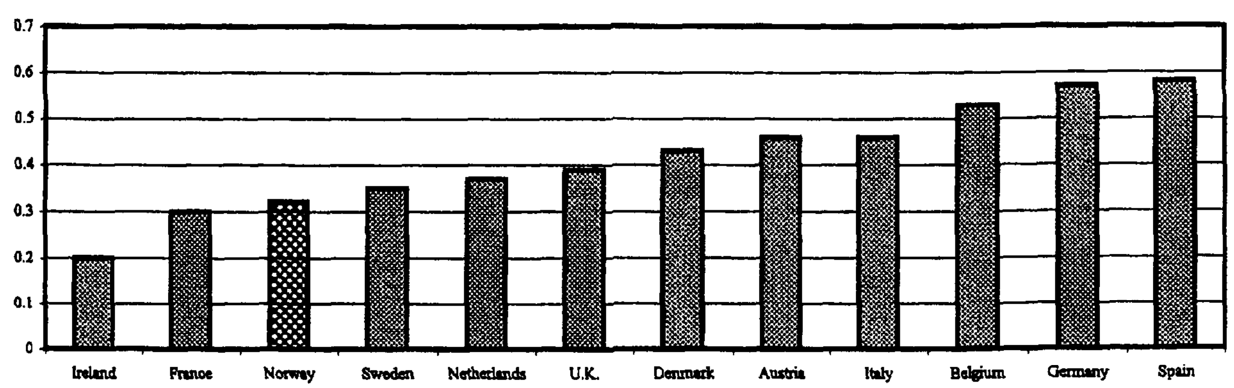
Local Tariffs



Long Distance Tariffs



Average International Tariffs



Source: G. Kristiansen et al., "Telenor: The Future is Now", Christiania Markets, p.58.

relatively high growth in labor costs, the cost of investment in high technology. While engineering wages in Norway have been lower than those in continental Europe, Telenor's wage bill is affected by a large proportion of employees (48.4 percent) engaged in developing high technology services which do not pay off immediately. Moreover, Telenor's profit margins have been affected by recent acquisitions of interests in European telecommunications companies. As suggested by the OECD, labor productivity and the quality of telecommunications services in Norway has been negatively affected by the market structure (Box 2).[22]

Box 2. Telecommunications Sectors in OECD Countries 1/

Telecommunications companies were long considered to be natural monopolies and their regulation covered the structure and the level of prices, the rates of return, and universal service obligations. As technology developed, the monopolistic characteristics in the telecommunications sector diminished, paving the way for deregulation and privatization. Early deregulations highlighted the inability of public telecommunications operators (PTOs) to innovate; facilitated by distortionary price regulations, however, they succeeded in their efforts to bar new entry into the market. Subsequent reforms led to the elimination of entry restrictions and the introduction of incentive-based regulatory techniques to deal with the remaining pricing and service restrictions. In most countries "price rebalancing" was designed to reduce the cross-subsidization of local services by long distance services.

Currently most telecommunications markets in the OECD area are characterized by free entry and rising competitive pressures on the PTOs, which nevertheless managed to retain their market power in many cases. The liberalization of entry and improved competition tended to raise productivity, lower prices, and improve the quality of services. Moreover, it was clear that "the lack of competition in telecommunication services was hampering innovation, product differentiation and the translation of lower costs into final prices." 2/ The most liberal regimes were found to be in Canada, Japan, the United Kingdom, the United States, Sweden, and Australia, while the most restrictive, in Greece, Switzerland, Austria, Luxembourg, Iceland, and Turkey. The prospect of competition, proxied by the number of years remaining before liberalization, was found to have a strong positive effect on productivity and the quality of services, and a strong negative effect on prices. However, it does not seem possible to identify the effects of ownership, proxied by the public share in PTOs and years remaining to privatization, on the performance of telecommunications companies.

1/ Summarizes findings and conclusions of the paper on *Regulations, Market Structure and Performance in Telecommunications*, 1999, OECD, ECO/CPE/WP(99) 17, Paris.
2/ *Ibid.*, p.7.

41. The deregulation of the monopolistic market itself does not pave the way for free entry, and it is not unusual that the incumbent retains its market power, unless a level playing

[22] OECD, *Regulations, Market Structure and Performance in Telecommunications*, ECO/CPE/WP(99) 17/ANN, p.14,16.

field is established for all market participants. Privatization of Telenor is likely to improve its cost efficiency, but given the company's market power, the effect on allocative efficiency would depend on the government's ability to restrain the incumbent's monopolistic behavior (Box 1). Telenor's ability to compete in the open market, in turn, could be enhanced by eliminating (i) the requirement to provide basic services across the country and (ii) the price cap mechanism. Although this would lead to an increase in prices of some services, consumers would benefit from improved competition as more services of better quality would become available.

42. Privatization of Telenor was expected to become the integral part of structural changes in the new company, created by the merger of Telenor and Telia in October 1999. The merged company was rated as the sixth largest in Europe with an estimated capital of US $50 billion, of which 60 percent was owned by Sweden, and 40 percent by Norway. Privatization of Telenor as a part of the merged company was likely to benefit Norway, as its assets would have risen in value on the expectation of scale economies, and the risk of asset undervaluation would have been lower with shares floated on several stock exchanges. However, the dispute over the location of the mobile service division led to the collapse of the deal only eight weeks after the agreement had been signed. As the joint statement of the prime ministers of Sweden and Norway noted: "even if the merger had been industrially and commercially correct for both companies and the two nations, developments in recent months have shown that it has been very difficult to complete."[23]

Privatization of the Petroleum Sector

43. The petroleum sector is a significant part of the economy, with production averaging at 13 percent of GDP, and exports of oil and gas amounting to 43 percent of merchandise exports. Norway's oil and gas resources—located on the continental shelves of the North, the Norwegian, and the Barents Seas—represent only 1 percent of total world oil and gas reserves; nevertheless Norway, thanks to its high extraction rate, is the second largest oil exporter in the world, after Saudi Arabia. Under the assumption of unchanged technology and a constant extraction rate, oil production is expected to peak in the early 2000s, tapering off thereafter, and to be depleted in 18 years. Gas reserves are expected to last for 85 years, and production to rise, as new fields are brought into commercial use.[24]

44. With the state the sole owner of petroleum reserves, the government has been heavily involved in the development and operation of the Norwegian petroleum sector. While the parliament (Storting) is in charge of opening new areas for commercial use and for the design of the legal framework, all the administrative responsibilities and license awarding rest with the Ministry of Petroleum and Energy. The government has also been involved in the production and transportation processes through its share in licenses and ownership of

[23] *Financial Times*, December 17,1999.

[24] OECD Economic Survey: Norway, p. 132.

pipelines. The government's petroleum policy aims at promoting high employment and securing social welfare, and it supports the intention of the Norwegian petroleum sector to expand internationally which could ensure that it remains in business after the depletion of reserves on the NCS.[25]

45. Although from the outset foreign companies dominated petroleum exploration and production on the NCS, the government was committed to developing a Norwegian-owned petroleum industry. As a result, the government decided to maintain a 50 percent state participation in each production license and created Statoil—the wholly state-owned oil company.[26] The government's participation in the petroleum sector was reorganized in 1985, when Statoil's interest in most licenses was split into one part controlled by Statoil and the other part transferred to the government in the form of the state direct financial interest in petroleum operations (SDFI)—a device that allows the government to extract all petroleum rents on its share of licenses. This reorganization separated revenues and costs incurred on state-held parts of licenses from those of Statoil. Under the SDFI arrangement, the government pays a share of all investment and operating costs in a project, and also receives a corresponding proportion of production and other revenues, similar to other licensees. Statoil has been the caretaker of the SDFI, responsible for extraction and sales of its petroleum. The SDFI obtained an interest in all new licenses awarded in 1985–93, gained shares in 16 out of 18 licenses awarded in 1996, and currently controls about 40 percent of the Norwegian petroleum reserves. The pipelines on the shelf are owned by licensees, of which Statoil and the SDFI have the largest share.

46. Although the transparency of the existing licensing process has been improved, the SDFI retains its preferential status with respect to participation in licenses. Licensing procedures were modified in 1995, when the parliament adopted the directive guaranteeing equal treatment of all applicants. As a result, in the fifteenth licensing round, Statoil had to compete for participation on a par with other companies, and subsequently gained shares in less than half of all awarded licenses. Although the average size of the SDFI share in licenses was reduced to 30 percent, the government has the discretion to change it. Production licenses are granted by the government to well–established companies on the basis of objective, nondiscriminatory, and published criteria during licensing rounds.[27] The authorities never considered license auctioning as an attractive option. The Ministry of Petroleum and Energy decides on the composition of consortiums for each license and appoints an operator, responsible for carrying out the terms of the license.

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[25] Speech by Erlend Grimstad, State Secretary, Ministry of Petroleum and Energy (June 22, 1999).

[26] Later this requirement was relaxed, allowing the government to have a participation in excess of, or below, 50 percent.

[27] The award criteria are in line with the EU Licensing Directive (94/22/EC).

47. The Norwegian petroleum market is relatively small and the degree of competition is limited, with Statoil and the SDFI dominating the market. As a caretaker, Statoil manages resources three times larger than its own resource base. As reported by Statoil, the average pre-tax returns on capital in 1992–97 amounted to 22 percent for the SDFI, 17 percent for Statoil, 11.4 percent for Norsk Hydro, and 13 percent for Saga Petroleum.[28] High capital returns reported by the SDFI were mostly brought about by its participation in the most profitable licenses, and lower overheads than those of commercial companies.

48. The Norwegian oil and gas sector is facing a need of restructuring, as the production on the NCS has been maturing, and the global petroleum industry has been going through a period of consolidation. With oil production in its "harvesting" phase and only limited prospects for new discoveries, the Norwegian petroleum sector has been facing increasing costs of exploration and extraction. In the future, as oil reserves run out, it would have to switch predominantly to gas production.

49. The operation on the NCS is relatively costly compared with other oil producing areas in the region. The average production costs in Norway—on a par with those in the United Kingdom—exceed those in the Netherlands and Denmark by close to 8 percent and 17 percent, respectively.[29] Production costs in Norway have been inflated by a high marginal rate of taxation of petroleum companies (78 percent) and stringent environmental standards. Although the effective tax burden in the petroleum sector has been comparable to that in other oil–producing areas, it is expected to increase as the eligibility for tax deductions diminishes with the maturing of fields.[30] Costs of exploration and production on the NCS have also increased in relative terms, as the petroleum industry around the world was cutting costs, prompted by the drop in oil prices in 1998. The increase in the costs of exploration and production has weakened incentives to invest in new oil and gas projects on the NCS—following the peak of 8 percent of GDP in 1998, investment is expected to start tapering off from 1999 onward.

50. Sweeping consolidation in the petroleum sector around the globe and the need for the Norwegian industry to improve its international standing have given rise to a call for restructuring and privatization of Statoil—the major Norwegian oil producer. Acknowledging that the financial performance of Statoil was not satisfactory in 1997–98, the Board of Directors stressed the need for the company's reorganization and subsequent

[28] Creating Value for Statoil and SDFI, p. 21.

[29] OECD, *Energy Policies of IEA Countries: Norway 1997 Review*, p.42.

[30] The marginal rate of taxation of 78 percent is composed of a universal corporate tax of 28 percent charged on profits net of the depreciation allowance, and a special surcharge of 50 percent of profits levied on oil and gas producers. Royalties—in the range of 8–16 percent of gross sales—are levied on production from fields approved for development before January 1, 1986.

privatization. In its report, "Creating Value for Statoil and SDFI," the Board noted that the state ownership of Statoil created disadvantages for the company, as it posed limitations on its strategic moves, such as mergers and acquisitions, and it was not exposed to market control. Moreover, the Directors stressed that it was not always profitable for Statoil to maximize the value of the SDFI, and that the current model of a caretaker imposed a complex structure of goals on Statoil. The report stressed, however, that the state's stake in Statoil should ensure that the "group maintains its national affiliation."[31] Privatization is expected to improve the incentive structure of the company, and provide it with the financial and commercial freedom of action.

51. Privatization of Statoil, however, is complicated by its caretaker role for the SDFI. How should the SDFI be managed if Statoil is privatized? Should the government retain the SDFI, transfer it fully or partially to Statoil, or sell it off? These questions are expected to be answered by the parliament in early March. In the meantime, both major Norwegian oil producers—Statoil and Norsk Hydro—have expressed their interest in obtaining at least part of the SDFI, anticipating that it would raise the market value of their companies. One of the options, currently being considered by the government, is for the SDFI to be divided into three parts, of which one would be transferred to Statoil before privatization; the second, sold to Norsk Hydro; and the last part to be retained by the government.[32] Both Statoil and Norsk Hydro have expressed their interest in managing the SDFI if the state decides to retain any part of it after the privatization of Statoil. The government has also been considering the formation of a company operating the oil transportation system, with the majority stake owned by the state through the SDFI.

52. Given the government's objective of maximizing the value of petroleum wealth, subject to social and environmental constraints, the issues related to privatization are complex. Privatization would be beneficial for Statoil, subjecting it to market discipline, and raise its internal efficiency. The current licensing framework does not guarantee fair competition with respect to production licenses, which is an impediment to improving allocative efficiency. The privatization of Statoil and the split of the SDFI would complicate the procedure of rent extraction for the government, creating incentives for transfer pricing. Moreover, the valuation of assets in the petroleum sector is particularly difficult, given the uncertainties related to the capacity of fields, costs of extraction, and oil prices, as well as uncertainty regarding the future tax regime.

D. Conclusion

53. Norway's government has made some progress in deregulation and privatization, but the pace of reforms has been slow. Privatization in Norway is warranted because of both external and domestic factors. Consolidation in the telecommunications and petroleum

[31] "Creating Value for Statoil and SDFI," p.6.

[32] As Norsk Hydro is partly private, the transfer of SDFI assets is out of the question.

sectors has put Norwegian companies at a disadvantage, forcing them to compete with companies operating on a much larger scale than they do. Benefits from privatization for both companies, Telenor and Statoil, are clear, and would include better access to capital markets and higher cost efficiency through the imposition of market discipline. The ability of these companies to make strategic decisions, however, is likely to be limited by the government's power to preclude mergers that would result in the change of the "national identity" of the company.

54. Privatization has to be considered as a part of broader reforms directed at the strengthening of competition in product markets and the deepening of the capital market. Regardless of deregulation, the telecommunications market in Norway remains monopolistic, hindering new entrants. It is important to level the playing field for all market participants. This would call for a limitation of Telenor's monopoly power, and also for a change of its license and the pricing mechanism to enhance its potential to compete in the open market. Unlike telecommunications, the Norwegian petroleum sector is open to new entrants, but Norwegian state companies were given the "first mover advantage" in obtaining license shares, which reduced incentives for foreign companies to enter the market. Moreover, the increasing costs of exploration and extraction weaken incentives for operation on the NCS in the future. Incentives could be strengthened if procedures were modified to ensure fair competition for production licenses, and if administrative requirements were relaxed, for instance, by allowing the companies to form consortiums and by appointing the operators for licenses. Privatization of Statoil is likely to be beneficial for the commercial future of the company, but entails complex issues of the government's rent extraction and the valuation of assets.

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III. Selected Issues in the Financial System[33]

55. This paper discusses key issues in the Norwegian financial sector. The paper first outlines recent financial developments and banking soundness indicators, followed by a discussion of the financial policy framework. An overview of the comparative recovery of the Nordic banking systems following the crisis in the early 1990s is presented along with the broad lessons provided by such experiences. The recovery sets the stage for the current international competitive position of Norwegian banks vis-à-vis other countries. Issues of competitiveness are important in light of rapid structural changes sweeping financial systems across Europe. These changes provide a new opportunity for the Norwegian government to assess its structural policy goals for the financial sector, as discussed in the final section of the paper.

A. Recent Financial Developments[34]

56. The weakness in commodity prices that started with the Asian downturn in 1997 contributed to a plunge in oil prices and the depreciation of the krone in 1998. This led to a sharp rise in short-term **interest rates** in Norway, with long-term rates moving in parallel with rates in other European countries (Figure 1). Short-term rates in Norway have eased somewhat in 1999, but were still above the levels prevailing at the beginning of 1998. Toward the end of 1999, short term rates edged up in part due to uncertainty about consequences of any Y2K computer glitches.

57. **Equity prices** recovered strongly in 1999 on firming commodity prices, recovering most of their sharp 1998 loss—oil and other commodity-related stocks account for a substantial part of the Norwegian stock exchange (Figure 2, bottom panel). Stock price increases represented a gain for life insurance companies since about 30–35 percent of their balance sheet assets consisted of equities, in contrast to less than 2 percent of bank balance sheet assets.

58. **Property prices** grew strongly in real terms since their trough in 1992 (Figure 2, top panels). The rise has been particularly strong in urban areas as a result of substantial in-migration. The upward trend in residential housing prices continued into 1999—prices of resale houses rose by 9 percent in the year to the third quarter. The price increases could be attributed to several factors. Supply constraints resulted from tightened regulations on housing starts and the scarcity of approved construction sites, especially in 1999. A steady

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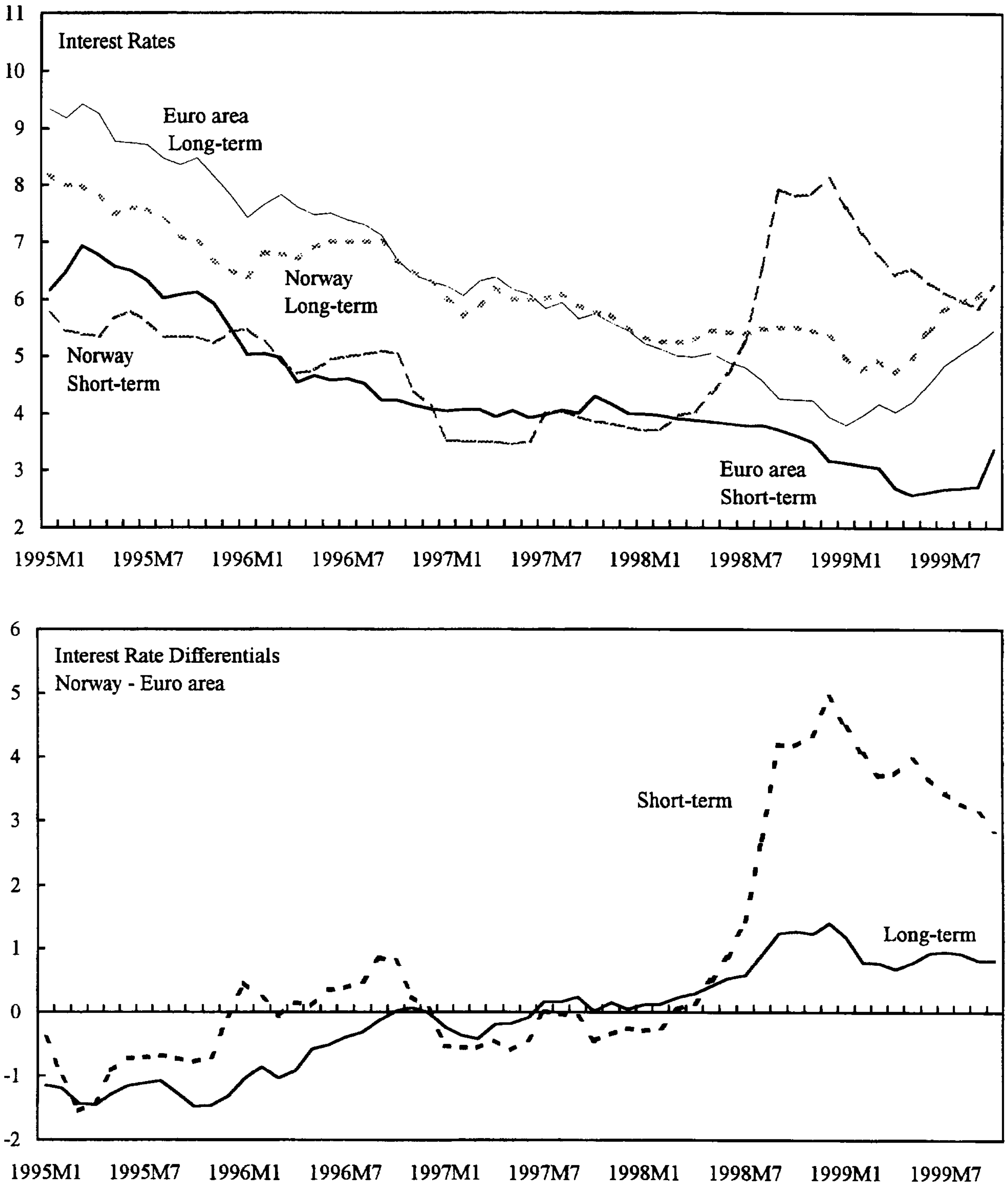
[33] Prepared by Valerie Cerra.

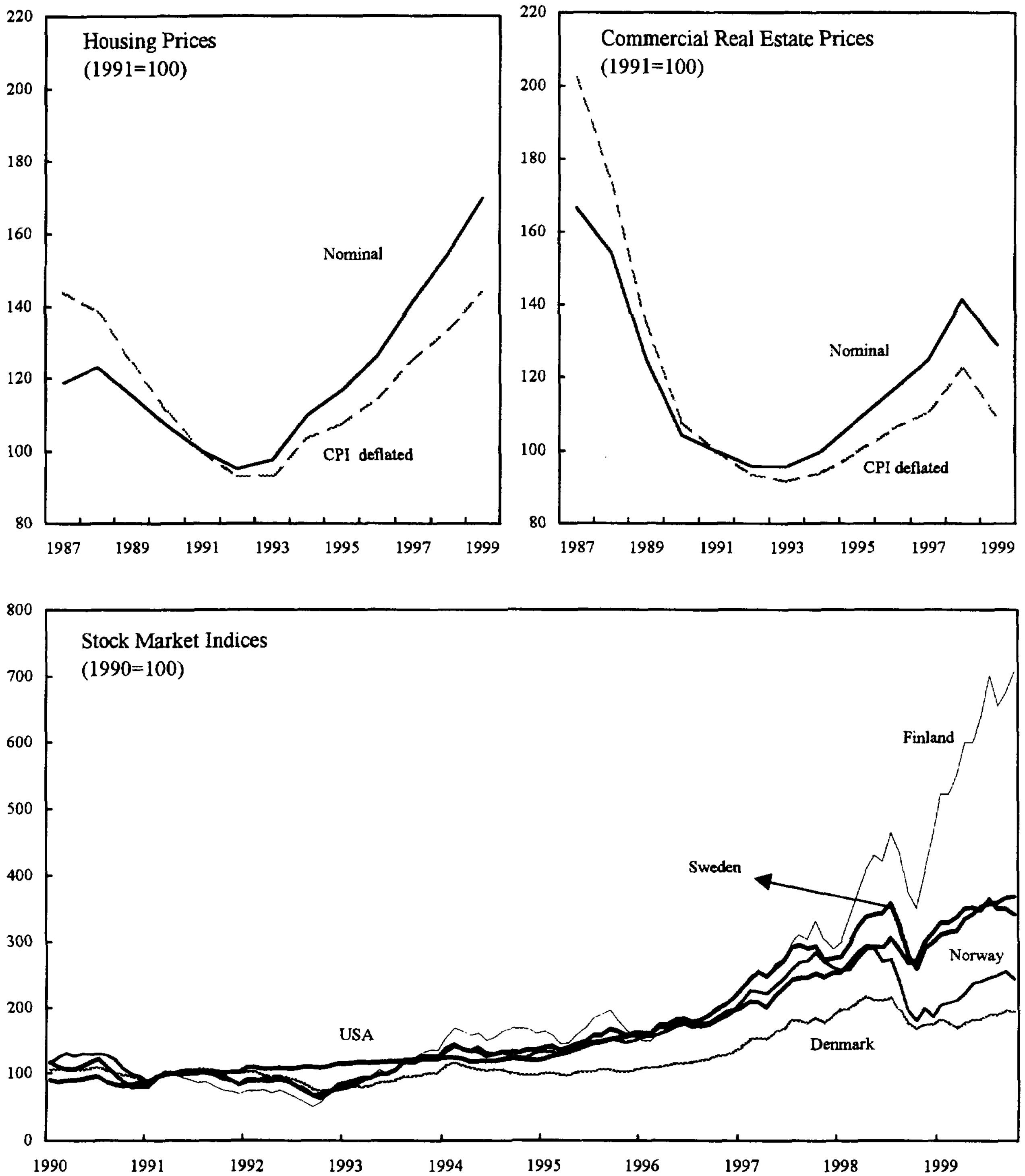
[34] Much of the information presented in this section and those following reflect discussions with the Banking, Insurance, and Securities Commission (BISC); Norges Bank; the Ministry of Finance; the Norwegian Bankers Association; and several Norwegian private financial institutions.

Figure 1. Norway: Interest Rate Developments, 1995-1999



Sources: IMF, International Financial Statistics; and WEFA.

Figure 2. Norway: Asset Prices, 1987-99



Source: National authorities; and Bloomberg.

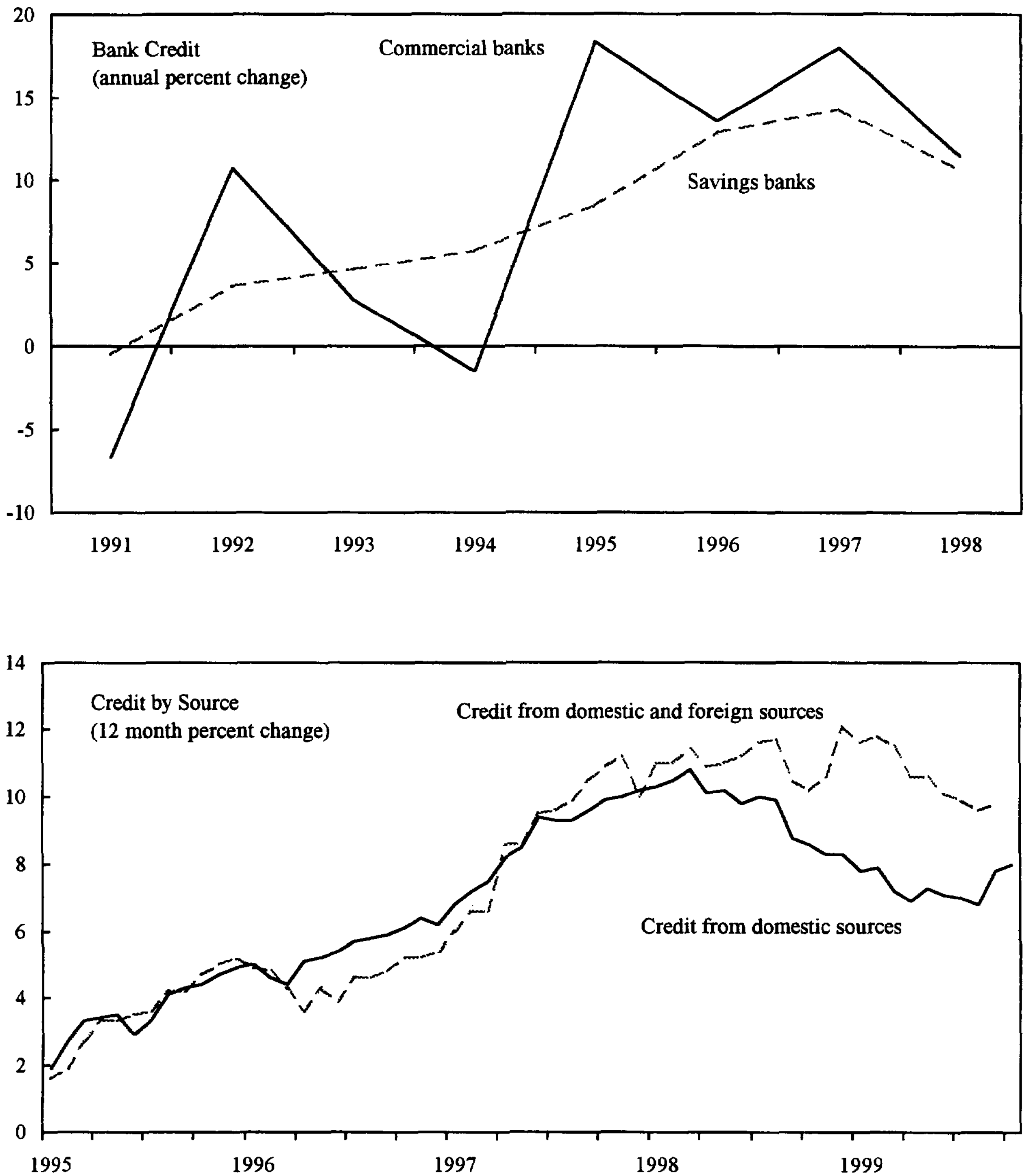
rise in disposable income, sustained low unemployment, and high household confidence boosted demand. Although real after-tax interest rates rose to about 4 percent following market turbulence in 1998, the increase was expected to be temporary. An easing of monetary conditions and expectations that rates would continue to decline may have also contributed to the buoyant prices. Commercial property prices also grew steadily after the crisis, but turned down slightly in 1999 as business prospects weakened.

59. **Credit growth**, which had been rapidly rising as the economy enjoyed several years of boom in the mid-1990s, subsided in 1999 (Figure 3). Strong credit growth by private banks had earlier reflected attempts to regain market share from the state banks. There had also been strong lending growth to state-owned oil companies. However, in 1999, total credit from domestic sources to municipalities, non-financial enterprises, and households fell to around 8 percent y-o-y from above 10 percent in early 1998. The largest banks have contributed the most to the recent easing of credit growth. At first, a reduction in the supply of loans for risk management reasons had reduced pressures; then, higher interest rates and slack investment played a role from the demand side. The contraction in business investment was partly oil-related, but also reflected completion of airport-related investment.

60. **Household net financial wealth** as a percent of disposable income was at a peak level of 54 percent in 1999 (Figure 4), extending the steady rise over the decade from 7 percent in 1990. Net wealth excluding insurance claims also improved, but the level remained negative throughout the period. Only about a quarter of household insurance claims is in the form of saleable life insurance policies, the rest being in collective pension schemes inaccessible to the claimant. Therefore, the negative ratio excluding the mostly illiquid claims represents a liquidity risk to household repayment of debt, of which mortgage loans constitute the largest part. Nonetheless, household interest expenses have fallen from about 11 percent of cash income in 1993 to around 7 percent in 1999, accompanied by a steady decline in non-performing loans. With gross borrowing increasing in line with disposable income, and low unemployment, household credit risk is likely to remain low for the near future.

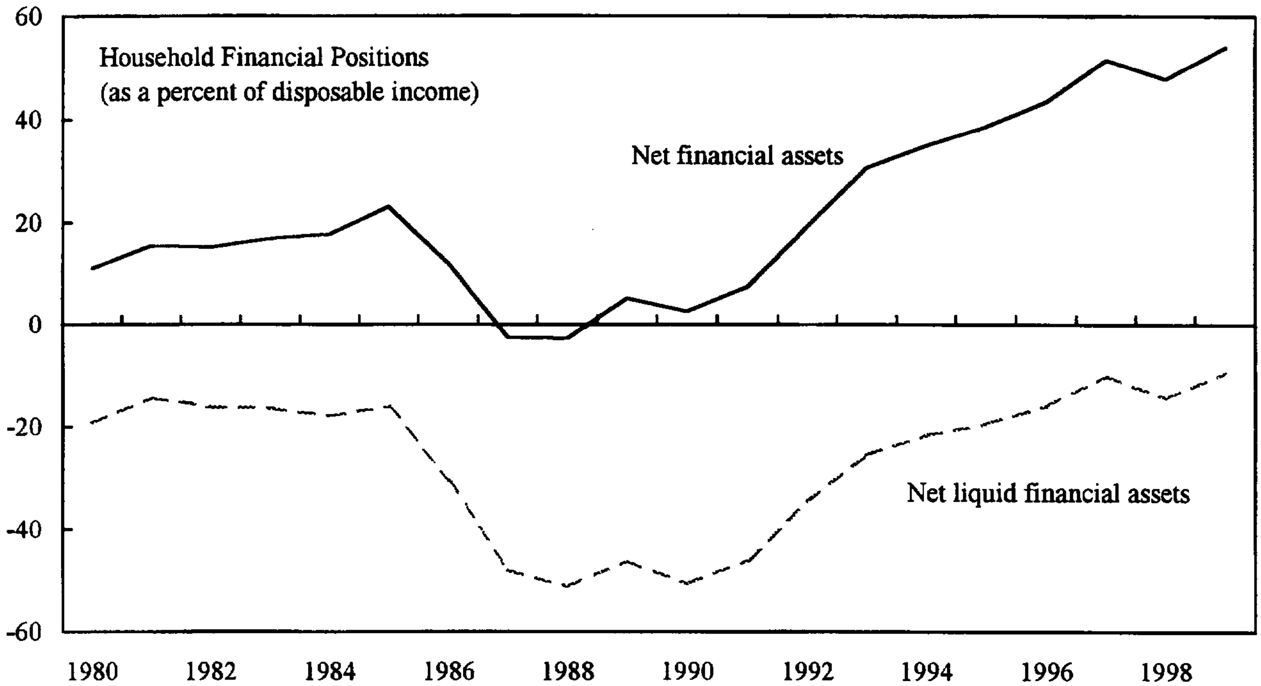
61. Credit risk has risen in the **corporate sector** where profitability has been low and investment has declined in some industries (Figure 5). Profitability in the enterprise sector deteriorated in 1998 and 1999 due to high wage growth, increased competition, and lower product prices. The growth in operating revenue declined sharply between 1997 and 1998 and the return on equity fell by over 2 percentage points. Enterprise debt was high and the proportion of long-term debt in high risk enterprises (those with negative earnings and equity shares) relative to total long-term debt had increased. Nonetheless, the number of enterprise bankruptcies has remained relatively unchanged since 1994, while non-performing loans have declined. The equity ratio in the corporate sector had increased to about 38 percent in 1999 from 28 percent in 1990.

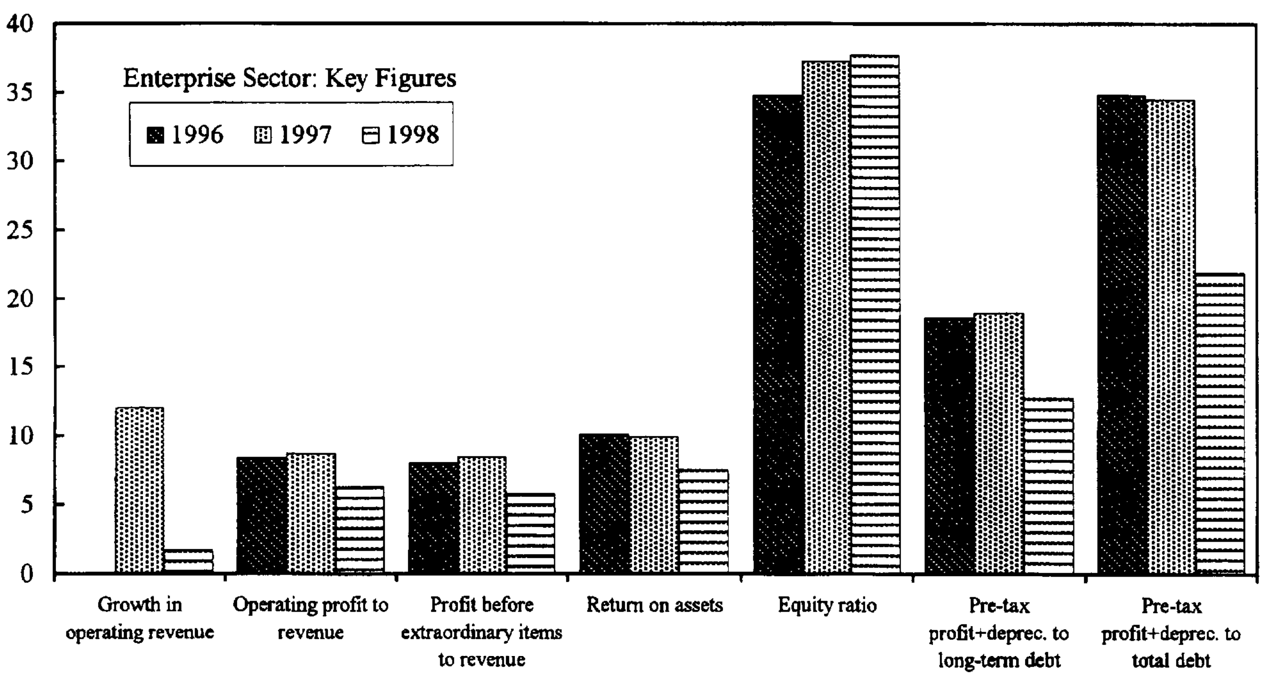
Figure 3. Norway: Credit Growth



Source: Norges Bank

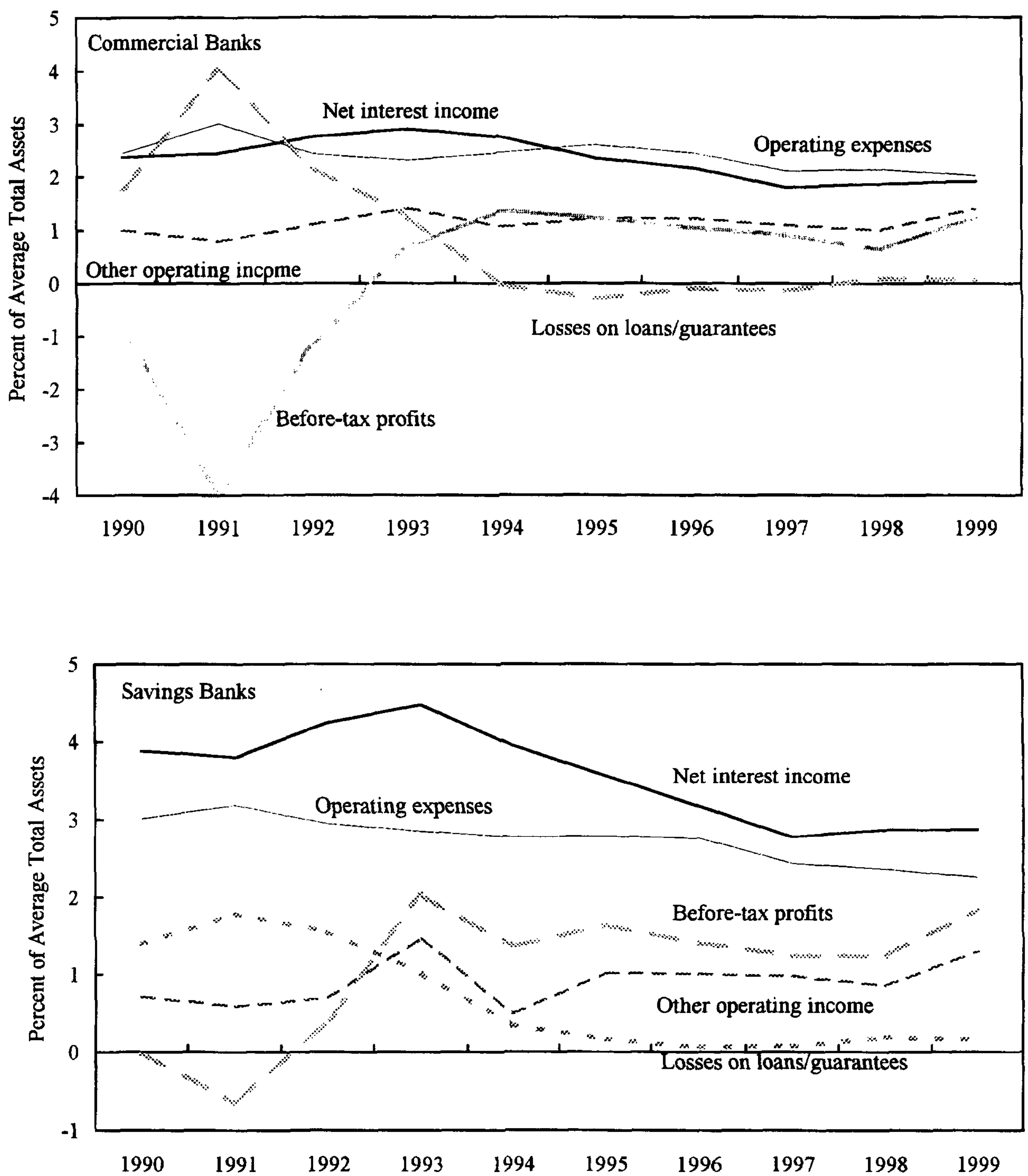
Figure 4. Norway: Position of the Non-financial Sector





Source: Norges Bank

Figure 5. Norway: Banking Profitability, 1990-99



Source: Norges Bank

B. Banking Soundness Indicators

62. Banks' **operating profits** and return on capital improved in 1999, with increases in net interest income and non-interest income, low loan losses, and a reduction in operating expenses (Figure 5). Interest rate margins, which had risen in mid-1998 as changes in deposit rates lagged increases in lending rates, declined in 1999 to levels above those prevailing in the early 1980s (Figure 6). Favorable developments in other operating income reflect strong returns on securities in the first part of 1999. Securities returns have been incorporated into earnings by accounting changes that required marking the trading portfolio to market. Negative loan losses in 1994–97 reflected the reassessment of loans previously recorded as non-performing. Current loan loss rates below 0.2 percent are expected to rise over time to a normal level of around 0.5–0.6 percent of gross loans.

63. The core **capital ratio** has been maintained at about 8 percent in commercial banks for the last several years, despite high credit growth, and has dipped slightly to 10¾ percent in 1999 in savings banks (Figure 7). Incentives to maintain high ratios of core capital have been strengthened in 1998 by a banking commission rule which requires core capital to be a minimum of 7 percent before the expansion of supplementary capital is permitted.[35] Total capital adequacy was 11 percent and 12¾ percent in 1999, for commercial and savings banks, respectively. However, strong capital ratios are advisable in Norway to serve as buffers against balance sheet shocks arising from the cyclical volatility of the Norwegian economy.

64. Despite the weaker recent performance in the corporate sector, there has been no increase in the stock of **non-performing loans** (Figure 8). Indeed, non-performing loans of commercial and savings banks have declined steadily from their cyclical peaks in the early 1990s. Non-accrual loans (using a 3-month reclassification period) represent about 80 percent of non-performing loans. The rest comprise loans secured above the nominal value of the loan, for which earnings can be recorded.

65. The stock of **loan loss provisions** as a percent of gross lending has fallen to about 1½ percent in both banking groups and loan loss reversals have flattened out (Figure 8). Banks raised non-specified provisions in 1998 in response to a pessimistic economic outlook. The banks have not shown any desire to further increase provisions since there had not been any effect from manufacturing weakness and even shipyards have remained solvent. An open question is whether provisions are sufficient to prepare for losses that might occur a few years ahead given the increased credit risk inherent in the corporate sector weakness. Some regional banks in particular will likely have to raise provisions somewhat in the future.

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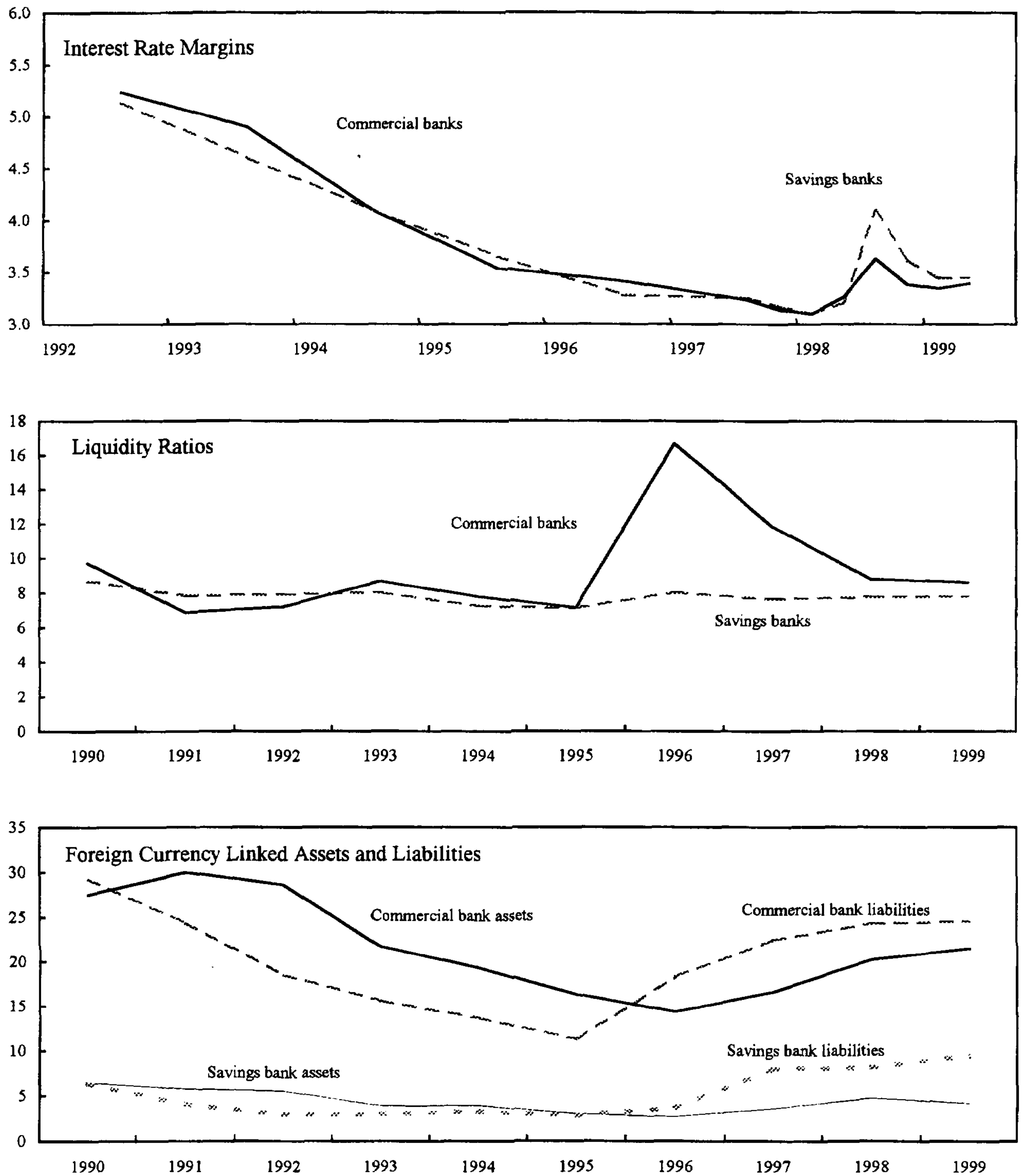
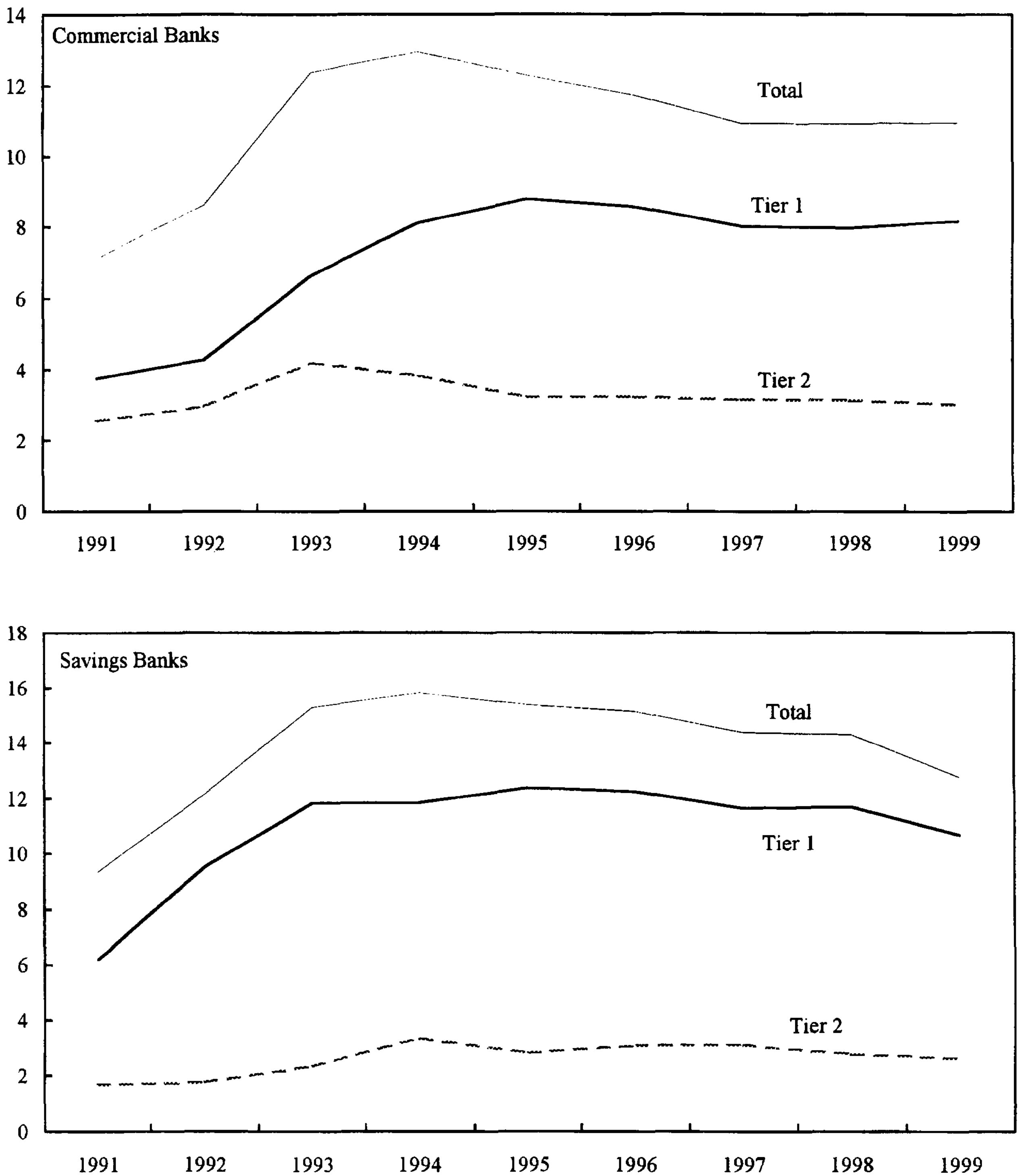
[35] As an exception, the banking supervisors can approve new subordinated capital for a bank with a Tier 1 capital ratio between 6½ and 7 percent, provided that the bank has a low-risk loan portfolio and good risk management system.

Figure 6. Norway: Banking Indicators, 1990-99



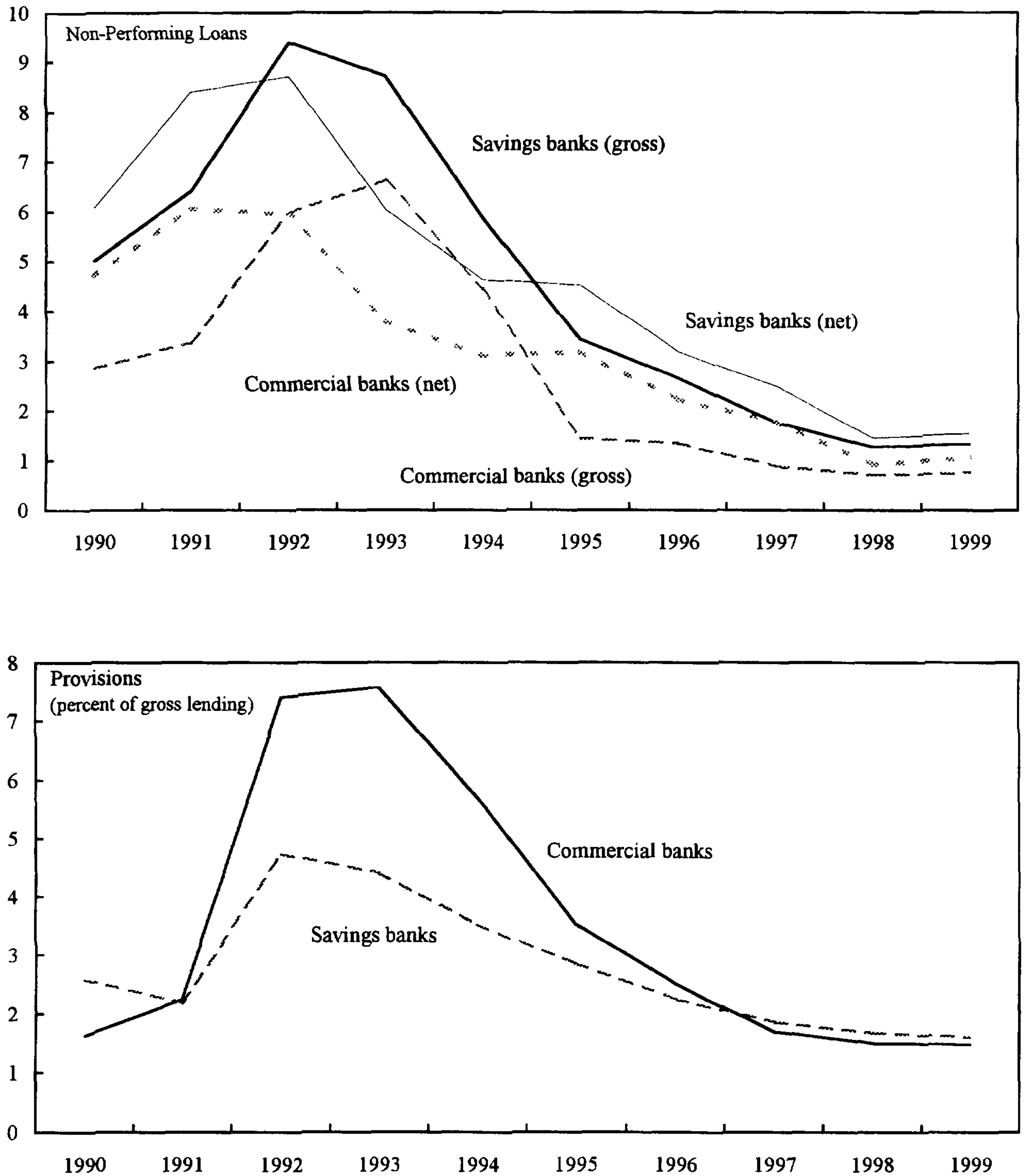
Source: Norges Bank

Figure 7. Norway: Capital Adequacy, 1991-99



Source: Norges Bank

Figure 8. Norway: Non-Performing Loans and Provisions, 1990-99



Source: Norges Bank

66. The proportion of deposits relative to bank liabilities has been declining, reflecting a portfolio balance shift of household financial assets into mutual funds. As a consequence, banks have had to obtain new **funding** sources and have responded by seeking greater amounts of long-term foreign funding. In addition, the interest rate differential with abroad widened in the second half of 1998, providing greater incentives to obtain credit from foreign sources. The **currency exposure** on the liability side has been mostly balanced by foreign-currency denominated assets (Figure 6), reflecting strict exposure limits. The rise in bank earnings from the management of mutual funds will require increased supervisory attention to off-balance sheet items.

67. Banking **exposure to risky sectors** has been limited. Commercial bank lending to the ship-building industry—currently one of the most troubled industries—is less than 1 percent and savings bank exposure is also low. This can be attributed to the fact that survivors from the severe downturn suffered by the shipping industry in the 1970s have mainly relied on reinvested earnings for funding investment. Bank exposure to other weak sectors is also insignificant—less than 2 percent. Real estate exposure was 10–13 percent in commercial banks and 8–16 percent in savings banks, with larger banks taking a greater share of the market. The performance of these loans has tended to reflect overall economic conditions.

68. The banking supervisory authorities undertook a **risk assessment** exercise in 1999 to study the possible implications of risky lending by banks. Using a risk classification model from Norges Bank and forecasts from Statistics Norway, BISC examined bank exposure to selected industries. They found that credit growth had been the fastest in the low-risk loan categories until 1998, after which the highest risk category grew the fastest.

69. An important recent prudential regulation has reduced the capacity of banks to take on risks associated with **large exposures**—defined as a loan to a single borrower that constituted more than 25 percent of own funds for savings banks (10 percent of total lending for commercial banks). A new reporting requirement for large exposures, connected to the EEA agreement, became effective at the beginning of 1998. In conjunction with the reporting rule, banks were not permitted to make new loans that would become large exposures and were given a transition period of 4–5 years in which to bring their existing portfolio in line with the limit. This regulation has already resulted in a spreading of lending risk across several small banks that had previously been individually exposed to one or two corporate clients and has kept at least one small bank solvent after the bankruptcy of a large client.

70. On the basis of the above financial market trends and indicators of banking vulnerability, the **overall current health** of the financial sector appears to be sound. There have been favorable developments in many indicators, such as household wealth, credit growth, banking profitability, and loan losses. However, the financial institutions and national authorities will need to maintain strong vigilance in responding to some increased risks—such as the higher credit risk associated with the low profitability in certain segments of the corporate sector—and in forestalling the emergence of new risks.

C. The Financial Framework

Supervision

71. Norway's Banking, Insurance, and Securities Commission (BISC), was established in 1986 through the merger of pre-existing institutions, as a comprehensive supervisory authority for all banks, insurance companies, securities firms, real estate agents, and accounting and auditing companies. In 1988 its jurisdiction was extended to cover other non-bank financial institutions and financial groups. Supervision of the stock exchange is expected to be transferred to BISC from the Ministry of Finance in 2000.

72. In the wake of the banking crisis, staff and other resources of the BISC were increased significantly—staff size doubled from 71 employees in 1986 to 143 in 1999. This expansion provided more resources for monitoring the financial system, *inter alia* to permit more frequent on-site examinations of banks and to strengthen supervision of insurance companies and conglomerates.

73. The BISC also tightened reporting and disclosure rules and developed a system of indicators for early warning of potential liquidity and solvency problems. A major focus of on-site examinations is the adequacy of banks' internal systems for risk assessment and management. In 1996 the BISC established new requirements under which the adequacy of banks' capital is assessed in relation to the risk of loss in their individual portfolios. Given the large and growing role of diversified conglomerates in the Norwegian financial system, the BISC has sought to base its supervision of the participating institutions increasingly on the comprehensive financial situation of the conglomerates.

74. Building on earlier practices, additional guidelines were established in 1993 for collaboration between the BISC and the Norges Bank in the exchange of information, contacts with financial institutions, development of regulations, economic and financial analysis, and statistical reporting (in cooperation with Statistics Norway). In 1994 the BISC and Norges Bank initiated a program of macroeconomic surveillance, intended to supplement supervision of individual institutions with an assessment of threats to the stability of the sector as a whole. Under this program, the BISC and Norges Bank each report twice a year (in alternating quarters) on economic and financial conditions in the sector, new developments and trends, and scenarios of the future financial strength of supervised institutions.

Deposit insurance

75. Deposit insurance had been in place for savings banks since the 1920s and for commercial banks since the 1950s. The contributory deposit guarantee funds have gradually rebuilt their balances that had been nearly depleted by the end of the banking crisis, although the commercial bank fund has been only partially paid-up, the rest taking the form of bank guarantees. In contrast to the trend in some other industrial countries, proposals to combine the commercial and savings bank guarantee funds, so as to ensure uniformity of treatment

and greater pooling of risk, have not been adopted in Norway. Savings banks had a stronger financial position after the banking crisis and were able to maintain their separate fund. The deposit insurance funds have traditionally played an active role in the financial system—especially for savings banks. In addition to support for troubled banks, fund resources can be used for merger guarantees. The board comprises 5 members elected by the banks and one representative each from Norges Bank and BISC. Under legislation that became effective in January 1997, each guarantee fund insures deposits up to a maximum of NOK 2 million per depositor.

The payment system

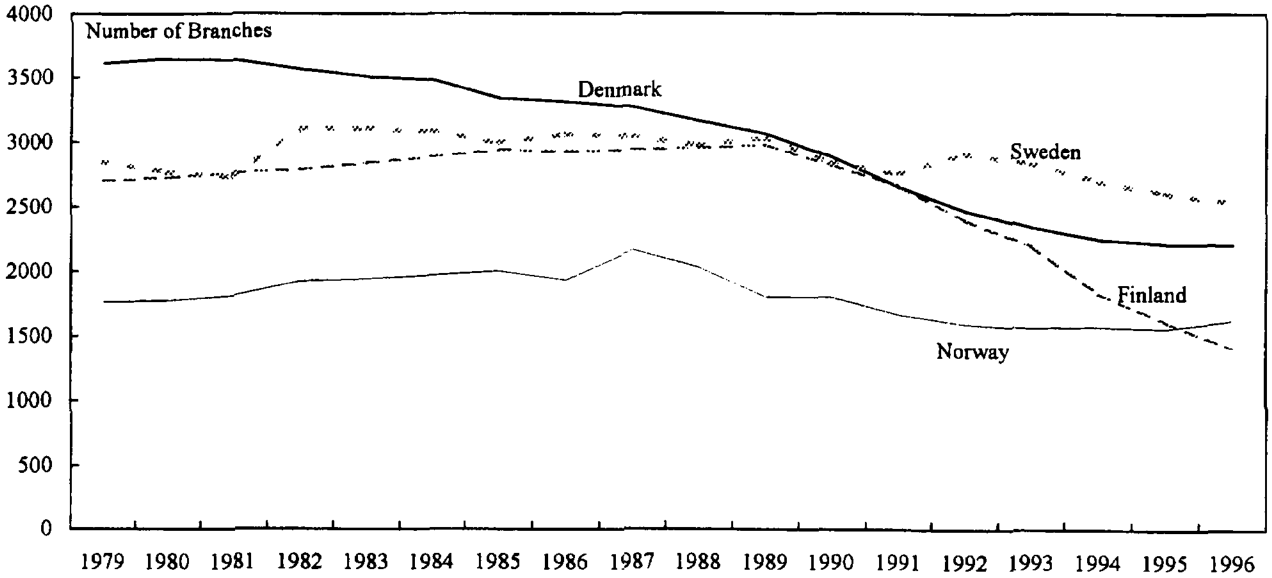
76. The authorities have also collaborated to improve the efficiency and security of the payments system. In 1989 the Norges Bank incurred losses in conjunction with its decision to settle the outstanding balances of a small Norwegian commercial bank, Norion Bank, that had been declared insolvent and placed under public administration. Subsequently the Bank clarified that it would carry out final settlements only at the end of the business day, and that it would not settle transactions for other banks under public administration. The banks, Norges Bank, and the BISC cooperated in the following years to establish a new joint clearing and information system and to develop a system for balance checks for transactions prior to settlement. During 1997 the separate payments system maintained by the Postal Savings Bank was integrated into the general interbank settlements system. To further reduce settlement risk, in November 1997 the Norges Bank began the phased introduction of a real-time gross settlements system for large-value transactions.

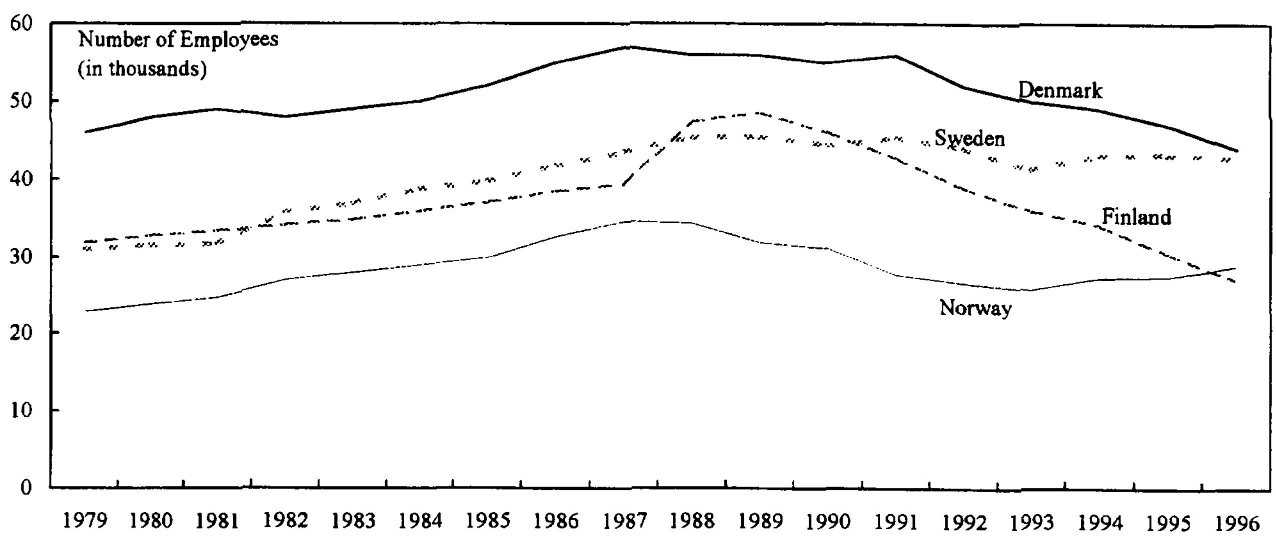
D. Recovery from the Nordic Financial Crisis: A Comparison

77. The recovery from the banking crisis began earlier in Norway and Denmark (1993) than in Sweden (1994) and in Finland (1996). One important requirement for recovery was to reduce capacity and costs. Finland had the most extensive downsizing of staff and branches (Figure 9), although downsizing prevailed in all of the countries. The number of institutions declined as mergers and acquisitions became common following the banking crisis (Figure 10). Mergers and buyouts were highest in the early 1990s and took on a Nordic-Baltic strategy to access a larger market and obtain a distribution network. The number of savings banks in particular fell sharply, although in Norway this continued a preexisting trend. Norway has had the least concentrated banking system of the Nordic countries in recent years, although concentration has been higher in the Nordic countries than in some major industrial countries (Table 1). In Norway, more merger attempts have failed than in the other countries. Mergers between some of the largest and smallest banks have been denied due to regional and other considerations and public policy reasons. Moreover, savings banks have resisted being dominated by larger banks.

78. In the 1980s, banks in Nordic countries were most concerned with expanding market share, so lending and deposit rates were set to attract customers. High interest rate spreads in Nordic banks following the banking crisis reflected the credit crunch period when the focus was on increasing profitability to strengthen the banks' balance sheets (Figure 11). Later, as

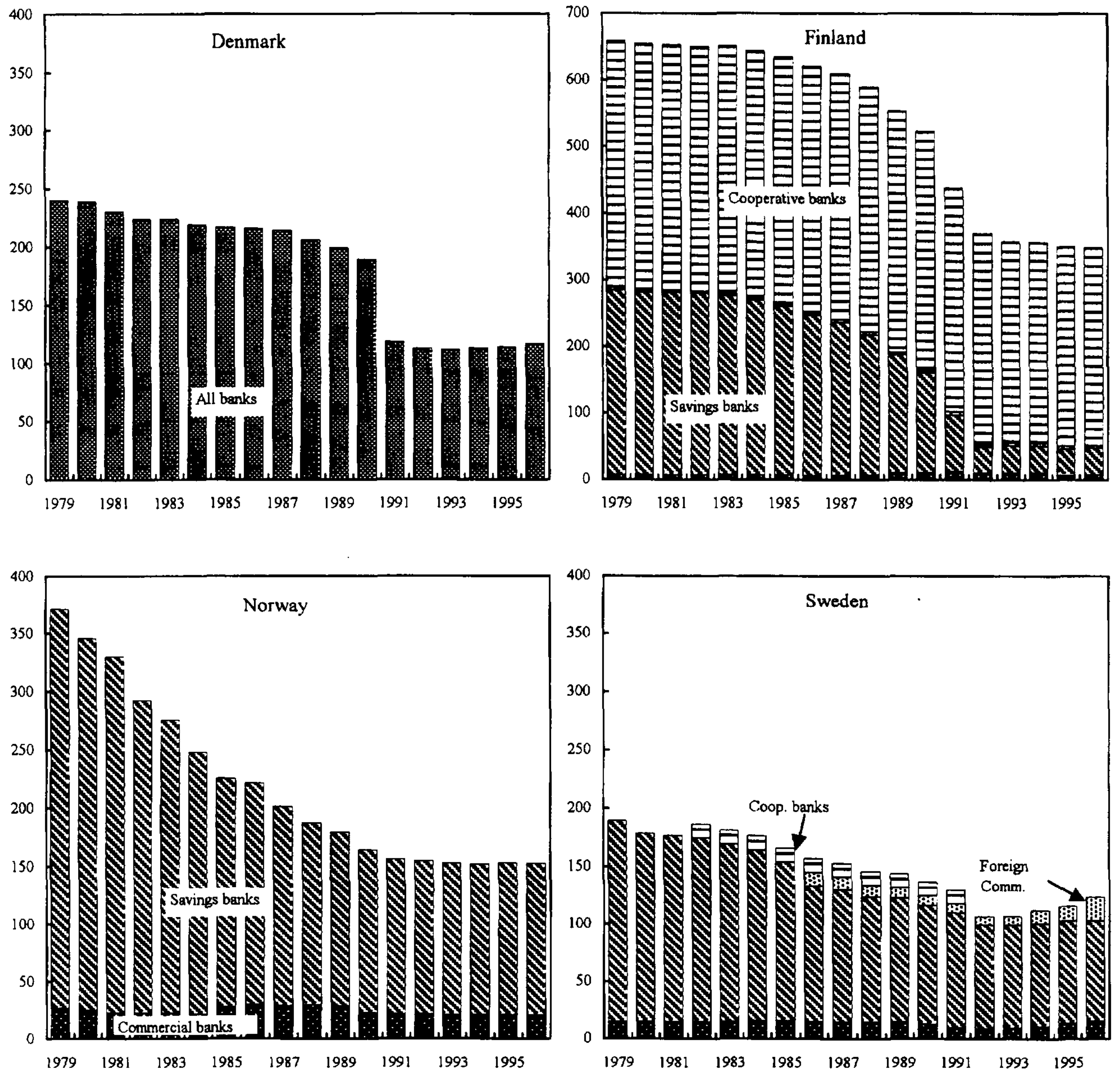
Figure 9. Nordic Countries: Number of Branches and Employees, 1979-1996





Source: OECD Bank Profitability, 1998

Figure 10. Nordic Countries: Number of Banking Institutions, 1979-1996



Source: OECD Bank Profitability, 1998

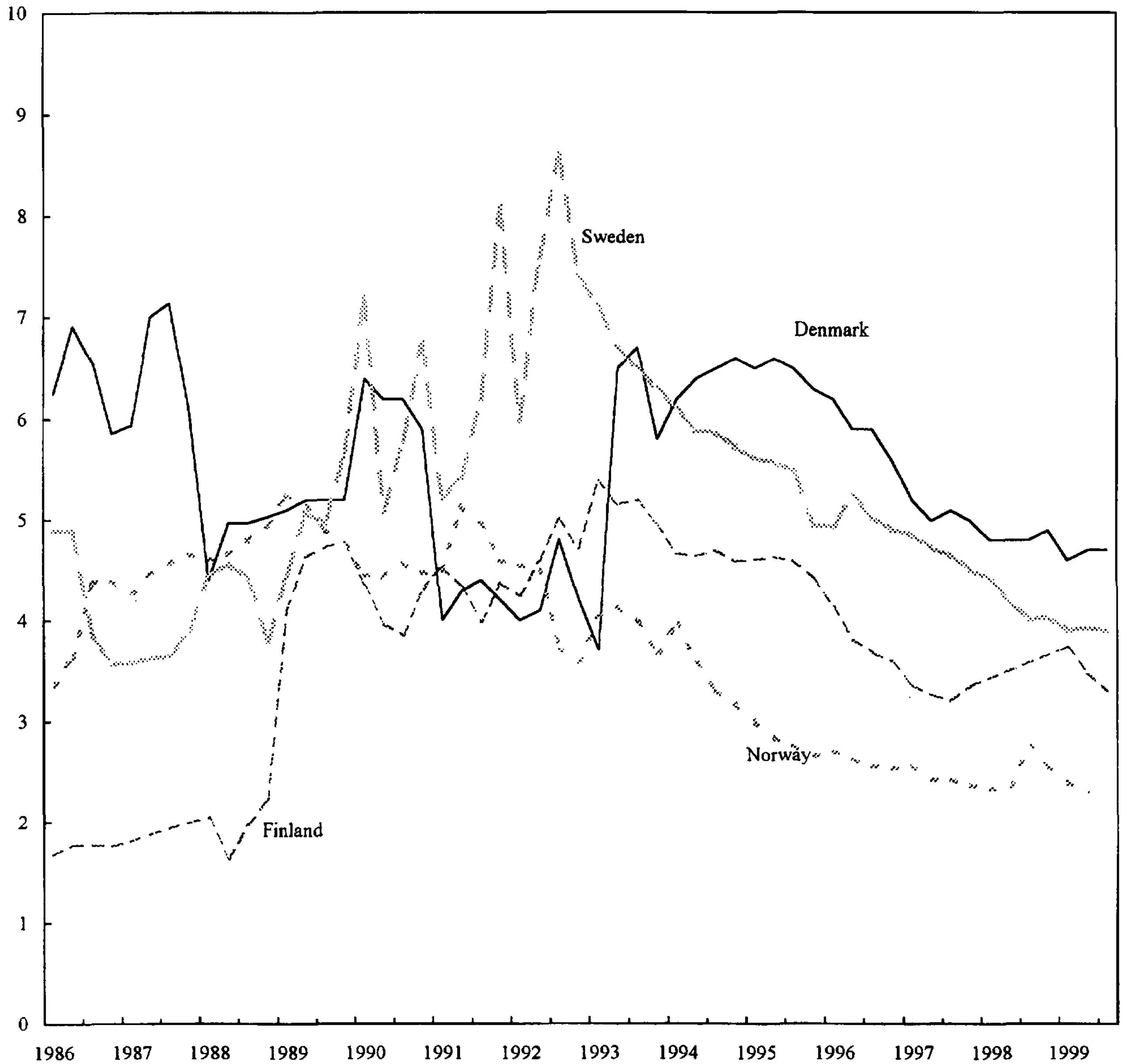
Table 1: Concentration of Banking Industry 1/

	Share of the five/ ten largest banks 2/						Number of Institutions		
	1990		1995		1997		1990	1995	1997
US	9	15	13	21	17	26	27897	23854	22140
Great Britain	49	66	--	--	47	68	665	560	537
France	52	66	47	63	57	73	786	593	567
Germany	--	--	17	28	17	28	4721	3487	3577
Switzerland	45	57	--	--	49	62	499	--	394
Italy	24	39	--	--	25	38	1067	--	909
Finland	65	69	74	83	77	80	498	352	341
Sweden	70	82	86	93	90	93	498	112	124
Norway	68	79	58	71	59	71	165	148	154

1/ Deposit-taking institutions, including commercial and savings banks, and other types of mutual and cooperative banks.
2/ Measured as a percent of total trust capital.

Source: Ministry of Finance; BIS 1996 and 1999.

Figure 11. Nordic Countries: Interest Rate Margins, 1986-1999



Source: International Financial Statistics

1/ The levels of interest margins are not comparable between countries since the underlying lending and deposit rates are based on different definitions in some cases.

the economies have recovered and competition has increased, margins have declined. Net interest income as a percent of assets has paralleled this development, but has also displayed a long run trend decline in Norway and Finland (Figure 12). Net non-interest income, while more volatile in some countries, has been steadier in the long run. Operating expenses rose during and following the banking crisis, but have fallen since (Figure 13). As the Nordic economies recovered in the mid-1990s, bank profitability has been restored.

E. Lessons from the Crisis and Recovery

79. Lessons drawn from the experience of previous banking crises are important for preventing the outbreak of new crises. In this respect, the Nordic banking crisis of the early 1990s has underscored the importance of several factors for maintaining financial system stability.[36]

Appropriate macro policy

80. Among other economic costs associated with an inability of macroeconomic policy to stabilize sharp economic fluctuations, systemic banking problems can arise from bank losses incurred during deep recessions, made worse by riskier loan portfolios acquired during strong booms. Against the backdrop of deregulation in the 1980s that heightened competition for deposits, banks undertook excessive risk in search of high-yielding assets that could exceed funding costs. Norway, Sweden, and Finland experienced a pronounced boom and bust cycle, exacerbated by accommodative macroeconomic policy. The strong upswings, initiated by favorable terms of trade shocks and reinforced by rapid credit expansion, were not sufficiently counteracted by fiscal policy and monetary policy options were constrained by fixed exchange rate regimes. Overheating increased the collateral values of real property, helping to justify risky lending behavior that increased the vulnerability of banks to economic reversals. Private indebtedness rose to unsustainable heights. Later, tax reforms combined with monetary tightening and lower inflation raised real interest rates sharply, leading to asset price deflation. Domestic demand slumped and bankruptcy rates surged. Losses and repayment problems in the nonfinancial sector and the decline in collateral values quickly translated into banking problems and a banking crisis.

Effective legislation and regulations

81. A framework for financial stability must deter excessive risk-taking through effective legislation and regulations. *Sound capital adequacy requirements* are needed to strengthen banks' capacity to bear unanticipated losses and to limit excessive lending growth. Capital adequacy regulations in Norway are more stringent today than they had been when the

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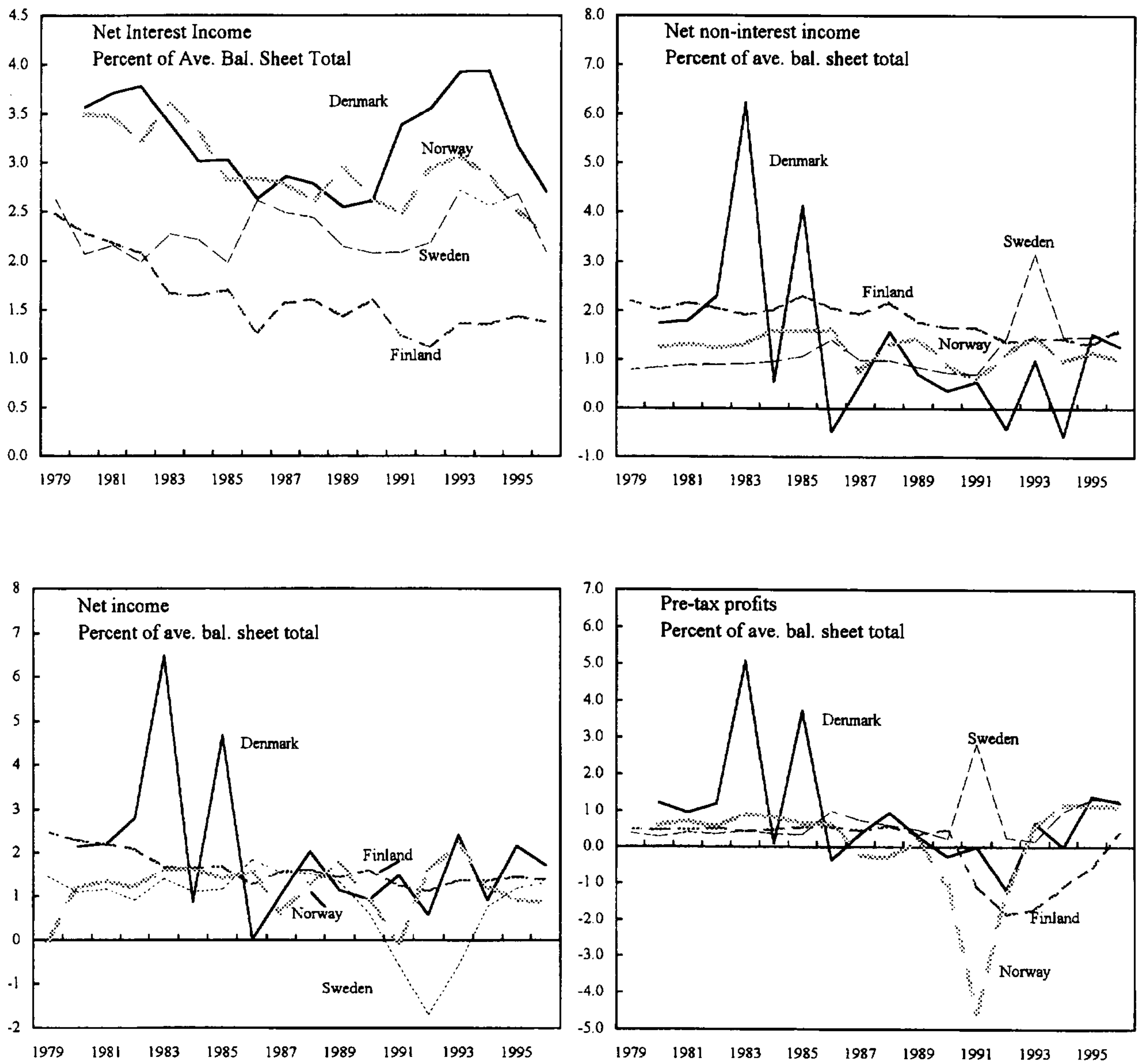
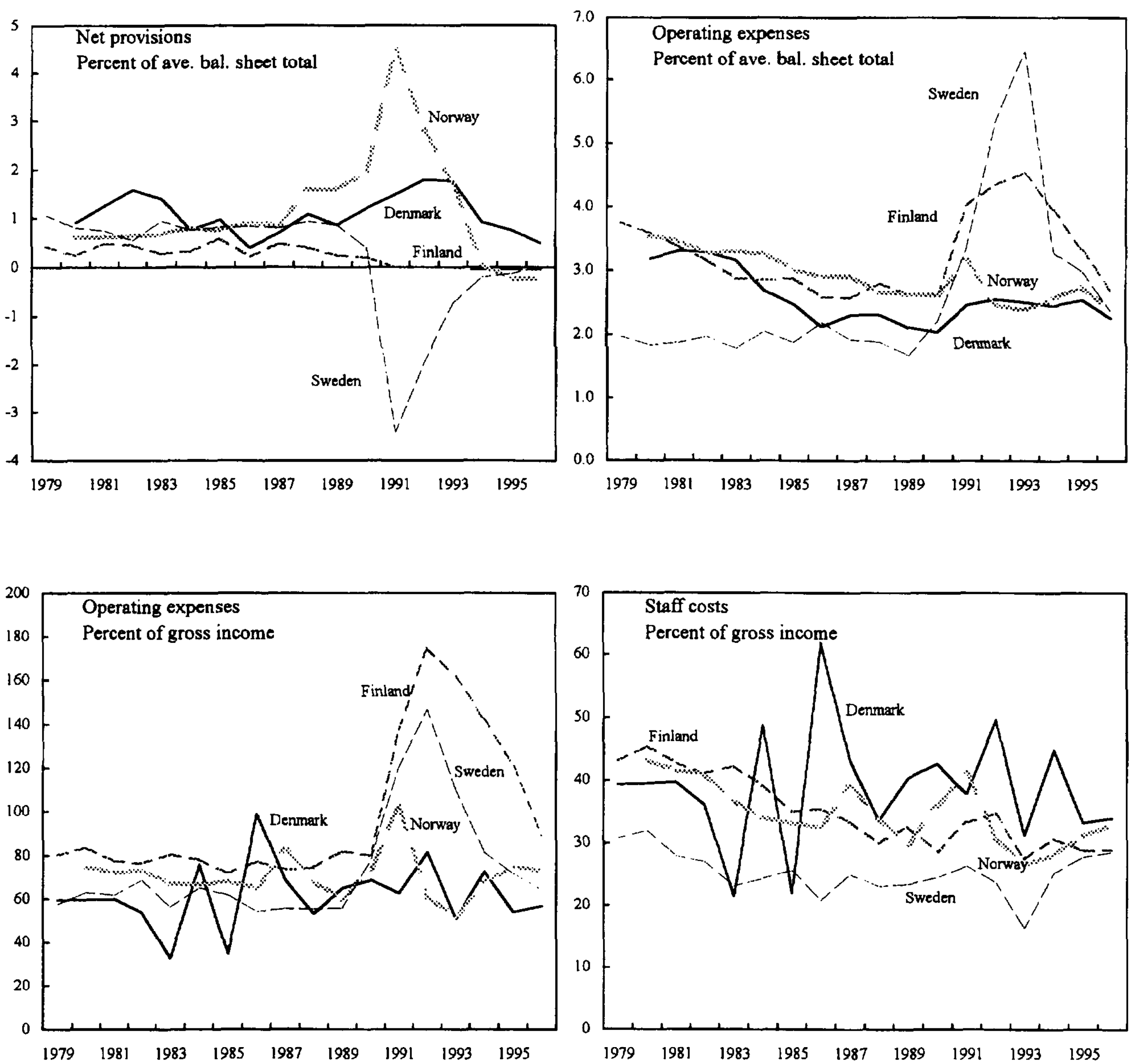
[36] Many of these lessons have been underscored by Norges Bank Governor Gjedrem in an October 1999 speech to the Norwegian Savings Banks Association, entitled "Financial Stability—Experience and Challenges."

Figure 12. Nordic Countries: Selected Profitability Indicators, 1979-1996



Source: OECD Bank Profitability, 1998

Figure 13. Nordic Countries: Selected Expense Indicators, 1979-1996



Source: OECD Bank Profitability, 1998

banking crisis erupted. It is also important to *set criteria for the use of subordinated capital* as an additional capital buffer. During the banking crisis, subordinated capital was not written down despite the provision of public support to ensure the continuation of banking operations. Under a new Bank Guarantee Act, subordinated capital can be drawn on to a certain extent while the bank is still operating. This also boosts market discipline since banks that take on excessive risk with insufficient capital must pay more for subordinated capital. A prudential framework also needs a consistent set of requirements including accounting, asset valuation, income recognition, risk management, bank governance, and entry and exit. These should follow best international practices.[37]

82. The framework should include safety nets for financial institutions but designed in a manner to *minimize moral hazard*. The use of bank capital and subordinated capital as first lines of defense can help reduce moral hazard. As a second line of defense, *deposit guarantee schemes* funded by the financial institutions can assist in peer monitoring and self-discipline. Industry funded schemes for commercial banks and savings banks were already in operation in Norway during the crisis, but the Act on Guarantee Schemes, which came into effect in 1997, has clarified the limits of the deposit guarantee. A limit of 2 million NOK per depositor, although generous in comparison to many other countries, represents a tightening of earlier statutory rules for savings banks and clarification of the rule for commercial banks in contrast to the practice of covering all deposits during the banking crisis. The guarantee funds have also been provided with support measures to ensure that a member can meet its obligations and continue operations, and if necessary to transfer its activity to another bank. Indeed, capital supplied from the guarantee funds during the banking crisis proved to be a lower cost and more effective means of resolving the crisis than referring solvency issues directly to the government.

83. After exhausting private and industry resources to deal with a crisis, *public support* may be required. The Nordic banking crisis underscored some important conditions for the provision of public support to reduce moral hazard. In Norway, prior to the use of public resources, banks' share capital was fully written down, management changes were required, and strict criteria for bank operations were applied to promote recovery.[38] The situation was dealt with swiftly and with broad political support. One key element of the official line of defense against financial instability is central bank liquidity support. In the event of systemic liquidity problems, the central bank can alter interest rates and supply large volumes of liquidity to the market. Regarding problems at individual institutions, Norges Bank can provide loans at a penalty rate to illiquid but solvent institutions. Norges Bank also has the capacity to provide loans on special terms, but has stressed its reluctance to use this

[37] A detailed treatment of these issues is contained in IMF (1998).

[38] However, Drees and Pazarbasioglu (1998) provide several reasons in support of their assessment that restructuring efforts were more successful in Sweden than in Norway or Finland.

instrument since it would weaken the incentives for banks to preemptively reduce risk or draw upon the resources of the interbank market or guarantee funds to solve their problems. Indeed, Norges Bank loans to banks are almost negligible and collateral requirements apply to all of the standard lending facilities.

Effective supervision of institutions and markets

84. Supervision has been strengthened since the banking crisis. Resources of the BISC have been increased. Greater emphasis has been placed on *on-site examinations*. *Internal control* routines have been enhanced. *International surveillance cooperation* has been strengthened. With the rise of large financial groups, greater attention has been played to monitoring *consolidated bank accounts*. In addition, the authorities have become more aware of the importance of identifying emerging tensions and possible sources of systemic failure at an early stage through heightened *monitoring* and simulation of risk.

85. *Coordination between central bank and supervisors* and regular *reporting* by the authorities are key elements of effective surveillance. Norges Bank and the BISC cooperate closely in their surveillance work, each producing regular reports with assessments of the financial outlook. In addition to monitoring indicators of financial soundness, these reports also analyze the potential impact of macroeconomic developments on the strength of the financial system. The Norges Bank report, Financial Sector Outlook, is published semi-annually in its Economic Bulletin and also submitted for discussion to the Ministry of Finance, with an indication of whether the financial situation will require the use of instruments not available to Norges Bank.

Robust payment and settlement system

86. Financial difficulties of one bank could be spread to others through the payment and settlement system, especially if banks credit the accounts of their customers before they receive settlement from the payer bank. An example of settlement losses in Norway is described above (e.g. the Norion Bank incident of 1989). Measures that can be taken to reduce settlement risk include (i) *settle large interbank transactions on real time gross basis*, and (ii) *introduce collateral requirements for banks' loans*. A large share of interbank transactions is settled continuously during the day through Norges Bank's settlement system. The largest interbank payments are settled individually and continuously on a gross basis. Prior to finalizing settlement, the sufficiency of funds is verified in the paying bank's account at Norges Bank. In addition, the introduction of collateral requirements for bank loans has lowered the risk assumed by Norges Bank. As international transactions become increasingly important, a high-priority task will be to ensure that the settlement systems have secure and effective international links.

F. Structural Changes

87. There have been many forces leading to change in financial systems in the Nordic countries and all of Europe in recent years. Deregulation in European countries since the

1980s has eliminated many controls, such as those on interest rates, credit growth, and access to money markets. Implementation of EU and EEA rules on the right to establish affiliates and cross-border operations has contributed to increased integration and competitiveness in financial markets. Globalization in connection with various free trade agreements has led corporate clients to require more international services. Advances in information technology have accelerated competition by providing low cost access to information and by permitting home delivery of financial services. The rapid aging of the population in conjunction with these developments has led to changing savings patterns: more savers have turned away from traditional bank deposits toward insurance products and securities funds. Consequently, there has been a trend toward hybrid financial institutions that offer both bank and insurance products. Nonbank financial institutions, such as securities firms and finance subsidiaries, have made competitive inroads. All of these forces have increased competition and led to financial sector restructuring and consolidation across Europe, which will likely be hastened as a result of the introduction of the euro. Competition among banks has driven down interest rate margins and required cost reductions, further increasing the need for bank restructuring.

88. In Norway, many of these same forces have resulted in consolidation over the last two decades. The number of commercial banks fell from 24 in 1980 to 14 in 1999 while the number of savings banks fell from 322 to 132 in the same period. There was also a steep drop in the number of general insurance companies.

89. In recent years, there has been significant merger activity, especially between banking and insurance markets. These two services have become dominated by integrated financial groups and conglomerates, with about two-thirds of domestic financial services accounted for by the nine largest conglomerates at end-1998. These institutions had market shares ranging from 40 percent of finance company business to more than 70 percent of banking, investment fund, and life insurance business.

90. Smaller Norwegian financial institutions (most of which are savings banks) have attempted to compete with the conglomerates by forming alliances that enable them to offer a fuller range of financial services. The savings banks (with 40–45 percent market share) have divided into three large cooperative groups. They have more of a regional orientation and are more heavily involved in mortgage lending than the commercial banks. Most of the savings banks are opposed to a recent proposal to convert savings banks into joint stock companies. Incorporation would make the savings banks, and their management, more vulnerable to hostile takeovers. There are also no tax or regulatory advantages since the regimes are the same for commercial and savings banks.

91. Despite this trend in consolidation, the Norwegian financial system is relatively small and competitive. At end-1998 the Norwegian banking system included the Norges Bank (the central bank), 13 commercial banks (one foreign-owned), 133 savings banks, and 6 Norwegian branches of foreign banks. Banking concentration is lower in Norway in comparison to banks in other Nordic countries.

92. Competition from foreign financial institutions has increased in recent years, especially following the EEA Agreement which permits cross-border operations and the establishment of affiliates. The share of loans to the public from foreign banks and affiliates established in Norway have been increasing, although the level is still small.[39] Of these, market shares to nonfinancial enterprises have been significantly higher than to households.

Loans to the Public from Foreign Banks and Affiliates in Norway 1/

	1995	1996	1997	1998
Public	2.6	2.9	3.2	4.0
Nonfinancial enterprises	5.0	5.9	6.2	8.0
Households	1.5	1.5	1.6	1.9

Sources: Ministry of Finance; Kredittylsynet

1/ As a percent of the total gross loans to the public and excluding direct loans from foreign banks located abroad. The public includes households, nonfinancial firms, and municipalities.

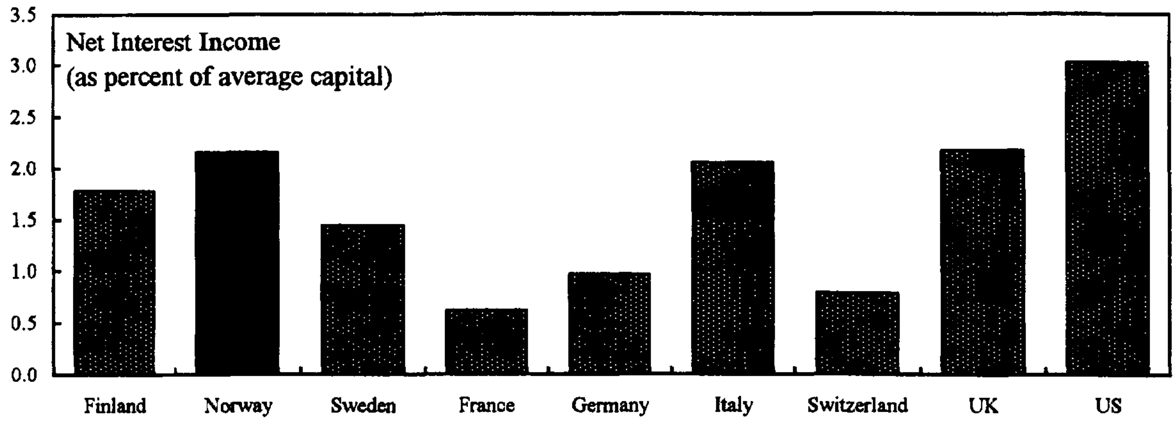
G. International Competitive Position

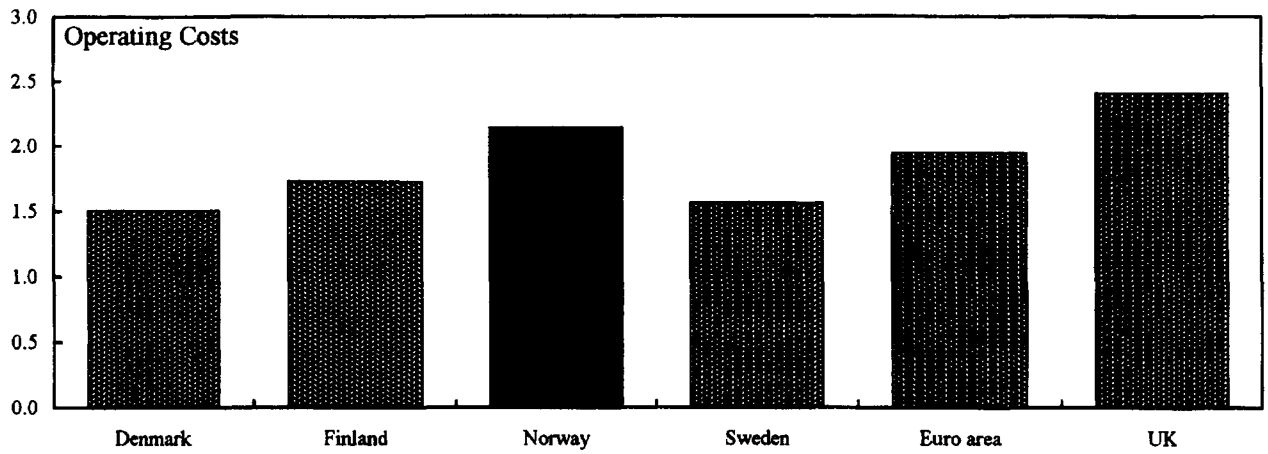
93. Norwegian banks have operated at average efficiency relative to banks in other European countries. Profitability levels in Norway, Denmark, and Sweden are close to the average in Europe, at about 0.9 percent. Finnish banks are among the best, with a profitability ratio of 1.2 percent. Core capital has been in line with other international banks and equity ratios have been high. According to data from the OECD, operating expenses in Norway have been similar to the other Nordic countries, measured both as a percent of average balance sheet assets or as a percent of gross income, as have staff costs as a percent of gross income (Figure 13). Employee costs have been the lowest in Sweden, although Finland has recently closed the gap. On the other hand, data for 1998 provided by the Ministry of Finance shows that operating costs in Norwegian banks were higher than in Denmark, Sweden, and Finland, but lower than in the UK (Figure 14).

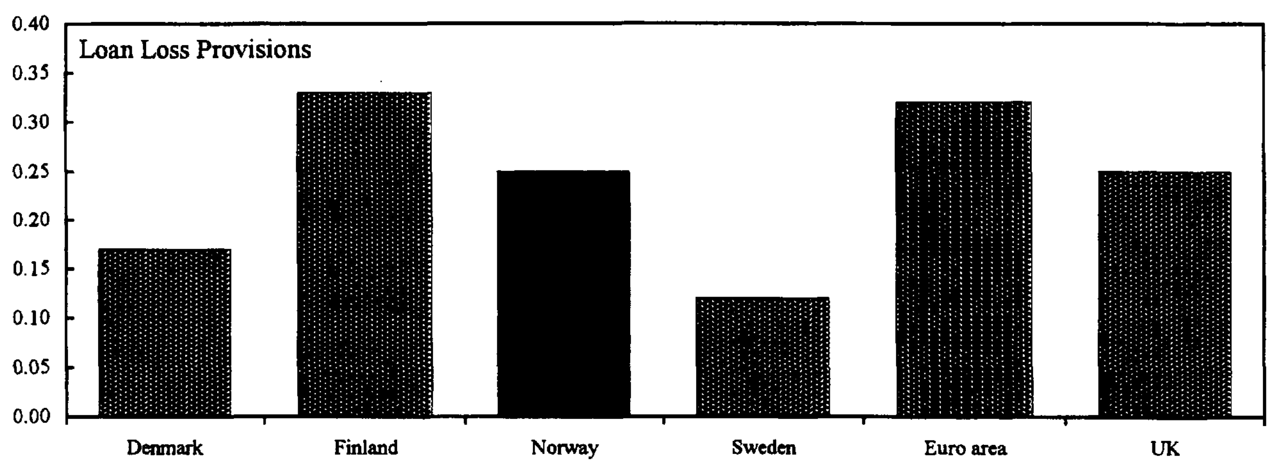
94. There are different indicators for assessing cost efficiency of banks, each with strengths and weaknesses. Using the cost to income ratio as a measure of efficiency can be inaccurate since banks with similar cost to income ratios could have different returns on equity or returns on assets. On the other hand, differences in operating expenses as a

[39] A study by Claessens, Demirguc-Kunt, and Huizinga (1998) suggests that an increase in the foreign share of bank ownership tends to reduce profitability and overhead expenses of domestic banks, so the general effect of foreign bank entry may be positive for bank customers. The number of foreign entrants seems to matter more than their market share, suggesting that local banks respond to the threat of competition.

Figure 14. Selected Industrial Countries: Banking Profitability, 1998







Source: Ministry of Finance; and other national authorities.

percentage of assets can give a distorted picture when used to compare banks with different balance sheet compositions. Higher cost banks may also have higher net interest rates.

95. Indeed, there are differences in the overall structure of the financial system in Norway compared to other Nordic countries. Banks in Norway have had a higher proportion of traditional loans relative to their balance sheet total, with less activity in asset management services (Figure 15). These traditional services are typically more costly (though the trend is toward lower costs), but the returns are more stable than those of other banks whose fortunes vary with financial market developments. However, there is also a greater extent of financing through bank deposits rather than through money markets (Figure 16), implying higher financing margins. In addition, bank operations in other Nordic countries have a greater degree of wholesale orientation than in Norway—accounts are larger, with lower costs but lower margins. Retail-oriented banks in Norway, along with those in Sweden, have had lower personnel costs as a share of income compared to other Nordic banks while Norwegian wholesale-oriented banks have been on par with other Nordic banks. Norwegian banks are also competitive when comparing cost-income ratios to other international banks. Another structural difference is that state housing banks take a large share of Norwegian mortgage lending, compared to the large proportion of mortgages in Danish banks for instance.

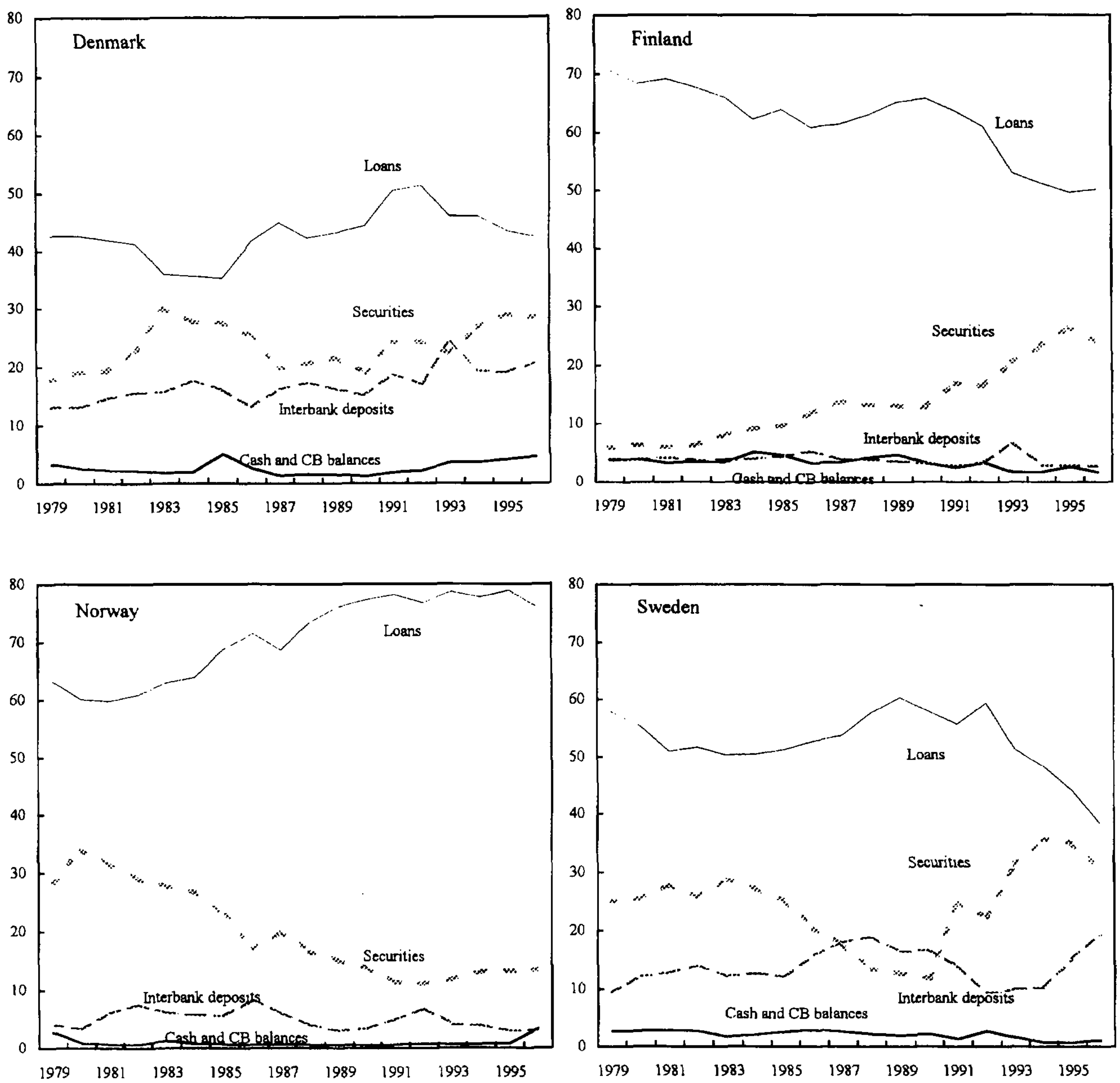
96. Using alternative measures of efficiency, which exclude non-core banking functions, banks in Norway had a higher core spread in the early 1990s, but there has been a significant drop in margins in recent years to levels prevailing elsewhere. Core costs are in line with banks in other countries and there have been favorable cost developments as new technologies allowed banks to handle larger volumes. Swedish banks have been leaders in core transactions. Some large banks in the United States have had high core costs since their focus has been on trading activities.

97. Norwegian financial institutions are small in an international context. At end-1998, the combined trust capital of DnB and Postbanken was only about 43 percent of the trust capital of Handelsbanken, the largest Nordic conglomerate (MeritaNordbanken was a close second), while Christiania Bank represented less than one-quarter of the size. Moreover, there is a substantial gap between the largest European and the largest Nordic institutions—Handelsbanken was ranked 44th in Europe.

98. There has been close cooperation between small banks on information technology and the payments system. Financial innovation and information technology in Norway have been on par with or ahead of the European average. Norwegian banks were ahead of others in electronic banking and other retail activities.

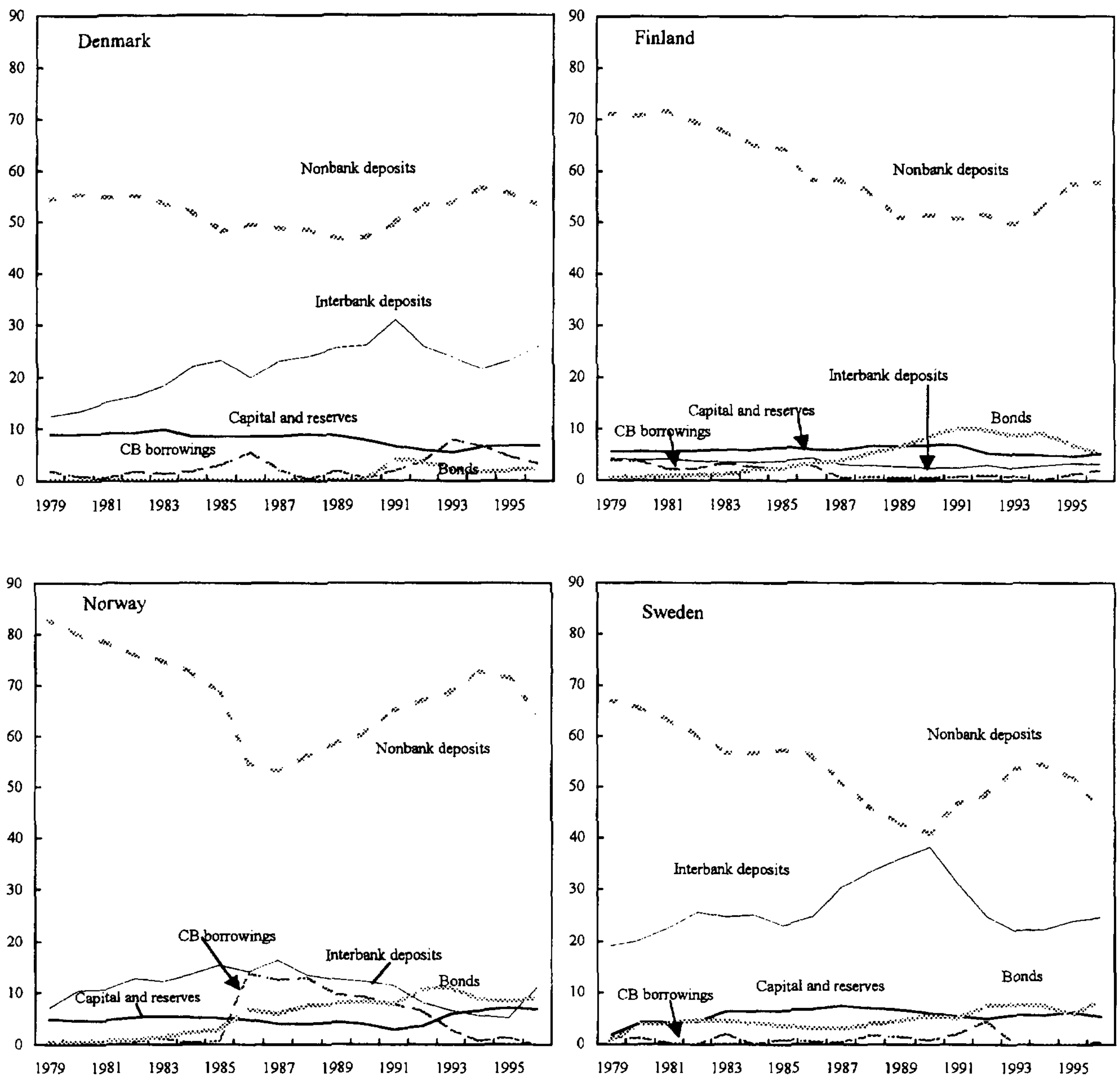
99. The competitive position of Norwegian banks has not been affected much by the introduction of the euro, although in the longer run the impact is expected to be significant. Banks must increasingly be able to provide their customers with excellent payment and financial services in euros. Currently, cross border payments are facilitated by correspondent banking relationships that provide Norwegian banks with access to the TARGET payments system. However, to reduce fees, the banks would prefer to obtain access directly through

Figure 15. Nordic Countries: Selected Bank Assets, 1979-1996
(Percent of Balance Sheet Total)



Source: OECD Bank Profitability, 1998

Figure 16. Nordic Countries: Selected Bank Liabilities, 1979-1996
(Percent of Total Balance Sheet)



Source: OECD Bank Profitability, 1998

Norges Bank. In addition to improving the payment system, consolidation in Norway and the other Nordic countries will need to be accelerated to keep pace with developments in euro area countries.

H. Structural Policy

100. This section considers key aspects of the government's structural policy in the financial sector. An important recent merger bid had been made by the Swedish-Finnish bank MeritaNordbanken for Christiania bank (Kreditkassen). This has given Norway's government (as the largest shareholder of this second largest Norwegian bank) the opportunity to assess its structural policy goals in the context of international financial trends, especially the trend toward consolidation.

Competition Policy

101. Current guidelines for structural policy in the Norwegian financial sector was set out in the Credit Report of 1997. According to the Report, "the chief objective of structural policy is to ensure that Norway has well-functioning and solid financial institutions and that there is strong competition between institutions." Policy should also maintain a satisfactory selection of financial services in all regions.

102. The emphasis on providing a choice of banks to customers in all regions is long-standing. This regional coverage was interpreted as requiring a network of local banks, but these had to be protected from competition by large national commercial banks with headquarters in Oslo or Bergen. The Odelstinget Proposition No. 41 (1986–87) stated that competitiveness required independent competitive entities so that any single company could not have monopoly power. The Proposition restricted the ability of the largest three commercial banks or largest four insurance companies to merge with other banks.

103. At the end of the 1980s, many financial institutions developed income problems and needed to reduce costs as part of their restructuring plans. The National Budget of 1993 therefore stressed that for the sake of reducing over-capacity in the banking industry, structural changes involving mergers could be required. Nonetheless, statements in the National Budget of 1996 and elsewhere found it undesirable that the government should contribute to further centralization and concentration in the financial sector. Regional considerations were important, for example, in the government's rejection of Den norske Bank's application to take over BN-Bank in 1998.

104. The government recognizes that cross border competition is intensifying and other types of financial institutions are steadily becoming more important as competitors to banks. The range of new products and services is increasing, while competition from these other sources is keeping prices low. In order to compete in the new environment, financial institutions must reduce costs while developing new products and services. Mergers or buyouts represent one strategy to accomplish this. However, the government views the

financial benefits of mergers and buyouts as ambiguous on the basis of available information. It also raises public policy concerns about mergers.

105. Regarding the benefits of mergers, there may be large scale advantages associated with the expansion and management of technological systems involving large investment. Size may facilitate the expansion into new products and services. Economies of scope could be important for distribution of a range of services, combining banking and insurance products, for example. Empirical literature in banking has analyzed the degree of cost-based and revenue-based economies of scale, cost-based and diversification-based economies of scope, and the degree of X-efficiency gained from bank mergers.[40] Economies of scale appear to exist up to a size of about 100 billion dollars. The evidence casts doubts on the significance of these benefits beyond that size. However, the most important competitive gain appears to be the improvement in operating efficiency that can arise from the acquisition of a bank by a more efficient one. Also, mergers can help reduce overcapacity and coordinate the closing of branches.

106. Apart from cost-reducing benefits, the trend toward large size might also be motivated by strategic considerations. A large institution may have greater options for buying out other institutions, and increasing future market share and profitability. It may also help reduce vulnerability to hostile takeovers that could threaten the position of current management. However, the costs of merger or buyout and the ensuing integration of distinct corporate cultures can be high. While risks can be diversified, new risks may be taken on without sufficient experience to handle them.

107. Public policy issues arising from bank mergers include an increase in concentration, a reduction in the attention paid to smaller customers, and systemic stability.[41] Concentration can provide market power, with potentially detrimental effects on the real economy through higher interest margins. However, the increased competition from foreign sources and other types of financial institutions has led to reduced margins across Europe, counteracting any tendency toward monopoly power from domestic bank mergers. Increases in competition are likely to continue for the medium-term, so that concerns about monopoly power should be mitigated. Recent evidence from the US casts doubt on concerns that small players would have reduced access to banking services since a diminution of attention by large banks have opened up opportunities to other financial service providers. Mergers may, however, increase systemic vulnerabilities since the failure of a large bank may endanger the solvency of other banks in the system. In addition, a large bank may be viewed as "too big to fail." This may require considerable public resources for bailout, especially if it is a large international bank

[40] Much of this evidence is based on the United States, with few complete studies covering Europe. Dermine (1999) elaborates in more detail on the empirical literature.

[41] See Dermine (1999) for an extensive treatment of the public policy issues in Europe concerning bank mergers.

located in a small country. For example, the cost of bailing out the largest Swiss bank has been estimated at 18 percent of Swiss GDP.[42] In Norway's case, the likelihood that greater concentration may take the form of combination with foreign entities raises the specter of losing national control of large banks. The next section considers this issue.

Public Ownership and National Control

108. Government ownership in Norwegian banks is partly a legacy of the Nordic banking crisis. In the initial phase of the crisis, the two industry-funded and operated deposit insurance funds—the Commercial Banks Guarantee Fund and the Savings Bank Guarantee Fund—assisted ailing banks and provided funds to facilitate mergers with stronger banks. However, by the end of 1990, the capital of the deposit insurance funds was virtually exhausted. In March 1991, the government established the Government Bank Insurance Fund to provide loans to the deposit insurance funds, which in turn could provide support to member banks conditional on implementing recovery plans. The mandate of the Government Bank Insurance Fund was extended in November 1991 to allow it to provide distressed banks with core capital. The Government Bank Investment Fund was established in November 1991 to participate on commercial terms along with private investors in bank equity issues. In 1991 it became evident that the positions of the three largest Norwegian banks—Den Norske, Christiania, and Fokus—were worse than previously believed despite earlier capital injections into the latter two. By the end of the year, the government had become the sole owner of Fokus Bank and owned 98 percent of Christiania Bank (CBK). Following capital injections in 1992, the government owned 55 percent of shares Den Norske Bank (DnB), and its ownership share increased to 88 percent in 1993. These three banks accounted for about 85 percent of the total assets of all commercial banks. The government also assumed an ownership claim of 48 percent in the savings bank, Sparebanken NOR in 1993.

109. The primary objective of public support during the banking crisis had been to recapitalize troubled banks and restore them to profitability. Accordingly, official financing had mainly been provided in conjunction with restructuring plans, including loan writeoffs, measures to increase efficiency, and changes in ownership and management. These restructuring efforts in the aftermath of the crisis eventually succeeded in restoring profitability as reflected in sharp dropoffs of loan losses and lower operating costs. Consequently, public ownership in the banks has been reduced. Fokus Bank and Sparebanken NOR were completely privatized in 1995 and 1996 respectively. By early 1999, public ownership interests in DnB and CBK were reduced to about 52 percent and 35 percent, respectively. The Budget of 1998 expressed the intention of reducing the government's share of DnB to 35 percent, but a pending merger with the fully state-owned Postbanken (which will increase the combined public stake to 61 percent) has postponed this action.

[42] Based on twice the book value as was required in the French bailout of Credit Lyonnais.

110. A policy for government ownership in the banking sector was first formulated in the Revised National Budget of 1992. Government ownership would play two distinct roles in the banking system. First, the Government Bank Insurance Fund was charged with providing an expedient method for safeguarding depositors and the financial system. Second, the Government Bank Investment Fund was assigned the role of managing the long-term state investment on a commercial basis and helping to secure national ownership in Norwegian banks.

111. The Government Report No. 39 (1993–94) stated that long-term government ownership would be desirable in the two largest Norwegian commercial banks to ensure that the main decision-making functions associated with bank headquarters remained in Norway. The government's current ownership interests in the two largest commercial banks are directed by the Government Bank Investment Fund. The guidelines for the operation of the Fund specify that the Fund shall not participate in the daily operations of the banks and the Fund must consider commercial criteria in its evaluations of prospective decisions, except those that relate to national interests wherein the Ministry of Finance must first consider the matter.

112. The level of public ownership, at 1/3 share in the largest commercial banks, permits the government to have negative control of the banks. Pursuant to the Corporation Act, changes in corporate bylaws require a 2/3 majority vote at shareholders' meetings. Therefore, shareholders voting one third of the company's capital can prevent changes in the bylaws such as those that specify the location of the headquarters. This negative control can also prevent a reduction of ownership shares through capital stock dilution or merger.

113. The MeritaNordbanken group offered to pay 44 krona per share, 29 percent above the market price, for shares in Christiania Bank. The bid was considered by the government, but it did not accept the offer by the October 29, 1999 deadline. MeritaNordbanken has extended the deadline several times, the latest to January 31, 2000. In December 1999, the government issued a mandate to the Government Bank Investment Fund to consider viable solutions for Den norske Bank and Christiania Bank as institutions, and for the government as owner. The mandate required that alternatives for strategic development be based on business criteria, but considerable weight would need to be given to retaining strong national ownership, and in particular, retaining headquarters in Norway. A majority of the Standing Committee on Financial Affairs of the Storting (the Norwegian parliament) further recommended that the government should combine its ownership interests into one entity and ensure national control by owning at least 1/3 of the shares. The majority also recommended that no sale of the shares of Christiania bank be permitted to foreign entities until a Norwegian solution has been considered.

114. Some of the interest that foreign institutions have been showing in taking over Norwegian institutions may also be connected to ownership rules. According to current rules, private ownership shares can not exceed 10 percent unless the firm is wholly owned. The government is considering increasing the allowable minority share to enhance possibilities for Nordic cooperative agreements and strategic alliances. The Banking Law Commission,

set up by the government to consider banking law revisions, suggested raising the limit to 30 percent—just under the 1/3 share that could give negative control by a foreign entity. However, the Ministry of Finance recommends a limit of 25 percent, since the typical lack of full attendance at shareholders' meetings permits negative control with an ownership share smaller than one third.

115. The policy of maintaining Norwegian ownership in the banking sector has been frequently stressed by the government. The main objective is to ensure that the control of decision making remains in Norway in order to meet national interests encompassing employment, development, and access to a full range of financial services in all regions. In this context, the government and the Norwegian authorities have expressed the following arguments in support of maintaining national ownership.

- The Nordic financial market is highly integrated, but banks in other Nordic countries are much larger than banks in Norway for historical reasons. While maintaining a high share price might sometimes be a barrier to corporate takeover, it cannot always deter strategic interest from financial institutions in neighboring countries. Continued government involvement will be required to maintain Norwegian ownership of large banks. Moreover, private owners are viewed as inappropriate for ensuring national ownership since they must constantly reevaluate their ownership interests and the strategic policy of their firm.

- Many countries have large financial institutions with national ownership.[43] State ownership has been declining in the Norwegian banks, down to levels required to exercise control and thereby ensure that national interests are met.

- The financial industry is more integrated into the economy than most other industries. Adverse effects can be huge if access to services is impaired, with repercussions on other sectors leading to real economic losses. In particular, foreign ownership by a large bank could hurt cyclical Norwegian industries (shipping, oil, fish) in a downturn since the large foreign bank would likely cut such marginal operations.

- The government does not interfere in the day-to-day decisions of the banks, such as by directing credit to favored industries. In addition, Norway is completely open for foreign banks to establish branches and affiliates. In these respects, market discipline is maintained. Indeed, the present policy focuses on promoting domestic competition and increasing choices available to users of financial services.

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[43] For example, the two largest sets of publically-owned banks in Germany controlled 32 percent of non-bank deposits and 29 percent of domestic lending to non-banks as of June 1999. See Kodres (1999) for more details.

116. The government's recent mandate to find a national solution to the need for further consolidation raises the possibility of a merger between the two largest domestic banks. However, some market participants have given a lukewarm reception to this idea. They point out that a merger between DnB and Christiania banks would produce an institution with monopoly power in the domestic market, but with a small size in the Nordic region. There would not be a significant expansion in the client base in Norway nor abroad and cost reductions would likely occur only through the reduction of staff.

117. The possibility of a continued large public ownership share in the financial sector raises other policy concerns. As earlier noted, large public financial institutions can be viewed as "too big to fail," which increases the likelihood of greater risk-taking. In addition, the possibility of regulatory capture arises. Indeed, the track record of state-owned banks has been poor in many countries. State-owned banks may distort the banking market through access to low-cost capital and fully guaranteed liabilities. They may also be exempted de facto from prudential regulations. However, state-owned banks may operate effectively if they operate according to commercial criteria, conform to the same prudential regulations, and if their quasi-fiscal undertakings are transferred to the budget. In Norway, many of these conditions appear to hold. Moreover, a case could be made that foreign acquisition of the large Norwegian commercial banks could result in a greater degree of asymmetric information, potentially leading to disruption of financial services to some enterprises under certain conditions. However, if loans to small enterprises are profitable, it is not clear why other smaller Norwegian banks would not take over the provision of such services. In the case of loans that do not meet market standards but generate other social benefits, these could be combined with other net lending activities by the government.[44] Finally, in the event of a large negative shock hitting Norway, a single nationally owned bank might be at least as impaired as an uncommitted multinational. Clearly, the debate on these issues in Norway, among other countries, has further to run. Irrespective of the final structure of the financial system that emerges, prudential and regulatory policies will need to be shaped in close co-ordination with the policy on financial supervision. This will be the key to ensuring that the financial sector seizes the opportunities and guards against the risks of the specific solution that Norway chooses to follow.

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[44] For example, net lending by the government recently comprised the Norwegian State Housing Fund (6.3 billion NOK), the State Education Loan Fund (3.1 billion NOK), the Norwegian Regional and Development Fund (100 million NOK), and the State Bank of Agriculture (80 million NOK), which contained some subsidy element.

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