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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/30

10:00 a.m., March 1, 1991

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	B. R. Fuleihan, Temporary
	A. Raza, Temporary
	G. Lindsay-Nanton, Temporary
	Chen M., Temporary
	M. E. Hansen, Temporary
	J. Prader
	G. H. Spencer
	B. Bossone, Temporary
	A. F. Mohammed
M. Fogelholm	
	B. Esdar
J. E. Ismael	
	G. Bindley-Taylor, Temporary
	J.-L. Menda, Temporary
	M. J. Mojarrad, Temporary
	J. Mafararikwa, Temporary
	P. Wright
G. A. Posthumus	
	J. K. Orleans-Lindsay, Temporary
	R. Marino
A. Végh	
	N. Tabata

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

Also Present

European Department: M. Russo, Director; P. L. Hedfors, H. E. Jakubiak, J. Odling-Smee, T. O. Saavalainen, G. H. R. Tersman. Exchange and Trade Relations Department: S. Kanesa-Thasan. Legal Department: P. L. Francotte, R. B. Leckow. Middle Eastern Department: A. Knöbl. Advisor to Executive Director: A. Gronn. Assistants to Executive Directors: B. Abdullah, J. R. N. Almeida, C. Björklund, N. A. Espenilla, Jr., M. A. Ghavam, O. A. Himani, K. Ishikura, M. E. F. Jones, R. Meron, J. A. K. Munthali, J.-P. Schoder, N. Sulaiman, Tin Win, S. von Stenglin.

1. NORWAY - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Norway (SM/91/25, 2/1/91). They also had before them a background paper on recent economic developments in Norway (SM/91/37, 2/15/91).

Mr. Fogelholm made the following statement:

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

Background

Major changes in economic policies were implemented in 1986 to restore a balanced development in the Norwegian economy after the emergence of severe imbalances in the mid-1980s. The main elements comprised a contractionary fiscal policy in the period 1986-88, restrictive monetary policy, emphasis on incomes policy, changes in the tax system, and other structural reforms.

The economy subsequently strengthened. The loss of cost competitiveness in 1985-88 was reversed following favorable productivity developments in manufacturing industries in 1989 and 1990. Consumer price inflation was brought down from 10 percent in early 1987 to 4 percent today. A deficit on the current account of more than 6 percent of GDP in 1986 has turned into a surplus of nearly 4 percent of GDP in 1990. The differential between money market interest rates in Norway and in trading partner countries was reduced from 9 percentage points in the spring of 1986 to about 1 percentage point at present.

However, sharply increasing unemployment prompted a reversal in the fiscal policy stance in early 1989. Subsequently, in both 1989 and 1990, the fiscal impulse amounted to 2 percent of mainland GDP. A modest turnaround in the Norwegian economy took place in mid-1989, and recent data suggest that the upturn of the economy is becoming more broadly based.

Recent economic developments and the outlook for 1991

Preliminary national account figures indicate that demand for goods and services from the mainland economy--that is, excluding developments in the oil and shipping sectors--grew by 2.9 percent in 1990, following a strong decline in preceding years. Growth in 1990 was driven by non-oil exports, private and public consumption, and a rather strong increase in inventory, while private fixed investments showed signs of levelling off after the very strong decline since 1986. For the current year, positive growth is forecast for all major components of domestic demand. The total growth rate of demand in mainland Norway is expected to be around 3 percent. Contributions to growth, especially from stockbuilding and non-oil exports, are expected to be weaker than in 1990, but this development should be counterbalanced by an increase in business investments.

In 1990, growth in domestic demand led, in particular, to an increase in imports. Merchandise imports, apart from ships and oil platforms, grew by 9.4 percent, while mainland Norway GDP grew by only 1.2 percent. The strong import growth can partly be attributed to a large increase in goods that are not produced in Norway--such as military equipment, cars, and airplanes. This year, growth in imports is expected to be somewhat weaker, at 6 percent, while the growth of mainland Norway's GDP is expected to be 2 3/4 percent.

Following the substantial rise in unemployment in the course of 1988 and 1989, the labor market stabilized in 1990. In the current year, employment is expected to strengthen.

Following strong cyclical developments and discretionary fiscal policy actions in 1989 and 1990, the fiscal deficit--adjusted for the Government's net oil income--has increased sharply since 1988. Nevertheless, government finances remain healthy. The fiscal budget, including net oil revenues, showed a surplus in the years 1980-89, and net financial assets of the Central Government currently amount to almost NKr 80 billion, or 12 percent of GDP.

Economic Policies

Although there are some favorable economic trends, there is no room for complacency. Cost and price levels are still high, and except for the last few years, productivity growth has been low for quite some time. These developments must be improved if unemployment is to be reduced from its present

level, which is high by Norwegian standards. Underlying growth in public expenditure has exceeded overall growth of mainland GDP.

Fiscal policies are framed in a medium-term perspective, and are aimed at avoiding overly heavy reliance on oil revenues. An intermediate goal is to stabilize the oil-adjusted deficit as a share of GDP through expenditure restraint rather than by raising the overall tax level. However, in order to avoid a rise in unemployment, fiscal policies will be kept somewhat expansionary in the current fiscal year; the fiscal impulse in the 1991 budget is estimated to be 1 1/4 percent of mainland GDP.

The staff makes the point that the current fiscal policy stance is not compatible with the medium-term strategy of reducing Norway's dependence on oil revenues. My authorities agree that a conservative evaluation of sustainability of oil dependency is indeed warranted. However, the Norwegian economy as a whole is relatively robust and can withstand oil price volatility fairly well. Even with an oil price assumption of $17 per barrel (1990 dollars), the non-oil current account deficit is sustainable in real terms at present levels. The central government budget, though, is somewhat more dependent on high oil prices.

The Government acknowledges that the current fiscal policy stance should be temporary. Nonetheless, a slowdown in expenditure growth may take some time to bring about. Over the medium term, pending oil price developments, the budget may have to be somewhat strengthened. However, the present fiscal budget deficit partly reflects the low level of activity; for instance, in 1989 and 1990, the budget balance deteriorated by more than 2 1/2 percent of GDP owing to cyclical conditions. Thus the deficit will automatically be reduced when government revenues increase as economic activity picks up.

The Government regards incomes policy as an important part of its economic policy strategy to keep nominal income increases low and thereby strengthen cost competitiveness. In this context, the Government is prepared to cooperate closely with the social partners, inter alia, to review different aspects of the economic situation. The new Government's fiscal policy stance is also aimed at enhancing such cooperation. This holds true both for the measures designed to improve the distributional profile of the budget, and for the stronger emphasis placed on employment in the short term.

In labor market policy, the Government focuses on measures to enhance the efficiency of the labor market so as to reduce unemployment. A general goal is to upgrade the qualifications of the unemployed. The policy includes comprehensive measures, above all in the area of job training and education; inter alia, the number of students eligible for enrollment in higher education has been increased. To avoid a situation where labor market measures become substitutes for regular employment, the programs are of short duration and remuneration is less than for regular employment.

Monetary policy is geared toward maintaining a stable exchange rate. Since 1986, the exchange rate target has required the application of a tight monetary policy. The implementation of this policy has reduced the interest rate relative to other countries owing to the increased credibility of exchange rate policy as well as to a favorable price performance and improvement in the current account balance. On October 22, 1990, the policy was strengthened further by the unilateral linking of the Norwegian krone to the ECU. This measure underlined the Government's commitment to further price stability and moderate cost developments. The krone maintains a margin of ± 2.25 percentage points around the new central rate. Since 1989, the fluctuation of the krone has in practice been limited to a much narrower band. There has been little need for intervention by the central bank, since the krone was linked to the ECU.

The exchange rate policy pursued implies that future price and cost inflation has to be broadly in line with that of other countries within the ERM. The inflation rate is now 1.5 percentage points below that of Norway's trading partners, and is lower than the average of the ERM countries. Low cost and price developments will undoubtedly require a carefully designed mix of fiscal, monetary, incomes, and structural policies, but do not, according to the Government, exclude the possibility of a temporary use of fiscal policy in support of employment, in periods of labor market slackness. No wage cost pressures were experienced after the abolition of statutory incomes policies in 1988-89. No cost pressures are expected to emerge in 1991 either, as a result of the relaxation of the fiscal stance.

Structural policy is another important element of the Government's strategy. Let me briefly comment on some major elements:

The implementation of tax reform has been accorded top priority, and the Government expects that the new tax system

will take effect as of January 1, 1992. The aim is to reduce tax rates while keeping the tax level unchanged through a widening of the tax base. Corporate and capital income will be taxed at a common rate. Indirect taxation will be given increased weight relative to direct taxation. It is expected that the new tax system will cause fewer economic distortions, and that it will facilitate the necessary structural changes in all sectors of the economy.

Following the economic contraction in the late 1980s, financial markets and institutions experienced turbulent times. Losses on loans remained high last year, and several banks and other financial institutions had difficulty in complying with statutory capital requirements, and needed support from the private deposit guarantee funds. In some cases, solutions were found through mergers. To date, the problems of financial institutions have been managed without marked detrimental effects on the financial system as a whole. To further enhance confidence in the system, a new Government Bank Insurance Fund was established in January of this year. This fund has a capital base of NKr 5 billion and its purpose is to support the two private deposit guarantee funds.

Finally, with regard to trade policy, the Government accords high priority to reducing barriers in the trade of goods and services. At present, it is actively involved in negotiating an agreement between EC and EFTA countries in an effort to create an European Economic Area. Moreover, Norway, having an open economy, emphasizes the importance of a successful conclusion of the GATT negotiations. My authorities are prepared to accept the fact that agricultural production and subsidies will also be affected. This will undoubtedly pose particular problems for Norway, but it is, nevertheless, considered that an overall positive outcome of the negotiations, strengthening the multilateral trade framework, would benefit the Norwegian economy as a whole.

Mr. Posthumus made the following statement:

Norway is the largest net exporter of oil among the industrial economies. In 1990, the oil sector contributed 17 percent to Norway's GDP and petroleum exports were 30 percent of total exports. However, oil reserves are not inexhaustible. Norway's proven reserves are currently estimated to amount to some 20 years' production of oil and 100 years of gas. The staff report estimates that these reserves are the equivalent of between 150 percent and 350 percent of 1991 non-oil GDP. The fact that Norway's oil resources are

exhaustible in a finite time horizon has implications for its long-term economic policy, which should be oriented at reducing the economy's dependence on oil.

This is a premise which was accepted by the Norwegian authorities in the late 1980s, when they adopted a long-term policy of expanding the non-oil tradables sector. In practice, however, it seems that policies in the period under review fell short of these objectives, and, if anything, the long-term trend of the non-oil tradables sector to shrink in relative terms has accelerated. In particular, the non-oil fiscal deficit--as a percentage of mainland GDP--has increased from 0.5 percent in 1988 to almost 8 percent in 1990; it will increase to 8.6 percent this year, and Mr. Fogelholm mentions that 2 1/2 percent is cyclical, which means that almost 6 percent of the deficit is not cyclical. As the staff report points out, this fiscal stance is hardly consistent with the long-term strategy of reducing oil dependence, but the staff appraisal is, in my view, very cautious in its reaction to such a large fiscal stimulus. Furthermore, the guidelines of the newly established Petroleum Fund raise serious doubts concerning the long-term commitment to fiscal restraint. The overall objective of the Fund is to preserve the oil wealth of the Norwegian economy by limiting the use of oil revenues in financing public consumption. However, the guidelines are such that in practice they do not impose any constraint on public finances, and oil prices would have to be very high before any funds could accumulate in the Fund. Perhaps the Petroleum Fund's guidelines should be revised so that it can have the impact which it is intended to have.

In Appendix I to the staff report, the optimal long-term use of oil revenue is defined as that which will preserve the absolute level of oil wealth, namely, the current imputed value of oil reserves. The level of oil wealth will be preserved if no more than the real return on this wealth is consumed; given assumptions about long-term oil prices and long-term real interest rates, the real return on this wealth can actually be estimated, and the optimal long-term levels of aggregate demand can be projected. The staff has carried out this exercise but relegated the findings to an appendix, where it presents them rather diffidently, saying that "the difference between the actual (fiscal) deficit and the sustainable deficit ranges between about 4 percent and 2 percent of non-oil GDP depending on the assumption for the 1991 value of total oil wealth. Thus, over the longer run, the non-oil general government deficit may have to be reduced." Admittedly, the long-term estimate of the parameters for such a projection are subject to great uncertainty. Nonetheless, a range of long- or

medium-term scenarios could have been incorporated into the body of the report as the basis of our recommendations for Norway's fiscal policy. Or even better, as a deficit of not more than 2 percent of non-oil GDP would in any case be sustainable, such policy advice might give more body to the first paragraph of the appraisal, where the staff advice is to be "conservative."

In October 1990, Norway decided to peg the krone to the ECU. In the case of Norway, a fixed exchange rate regime has particular implications for policy in other areas: current account sustainability does not depend on competitiveness to the same degree that it does in other small industrial economies because of oil. Therefore, some of the mechanisms that can restore competitiveness in a fixed exchange rate regime--like the effects of a current account deficit--have less of an impact in the Norwegian case. A large disparity between the price of tradables and nontradables can develop before the emergence of any repercussions on the balance of payments--the "Dutch disease." This means that in order to prevent the erosion of the real exchange rate, not only fiscal restraint, but also an efficient wage formation process, is necessary. However, a rapid move to reduce the current level of unemployment through fiscal stimulus would result in increased wage pressures. However, if it were possible to aim at a fiscal deficit of 2 percent of non-oil GDP--the best answer to the problem--then the Petroleum Fund might absorb the shocks caused by Norway's highly volatile terms of trade, and thus lighten the burden on annual fiscal policies. But perhaps that is all just theory: politicians usually prefer to borrow, not to save.

I have two other remarks. On a technical matter related to the issue which I discussed, in a macroeconomic analysis of the Norwegian economy, it is of interest to separate the oil sector, but the staff does so in two ways, using the concept of mainland GDP and of non-oil GDP. There are good reasons to look at the non-oil economy, because the oil sector represents an extraordinary large part of the total economy, but attaches less significance to the difference between mainland GDP and non-oil GDP because the shipping sector is not a very special sector.

On monetary conditions, the paragraph on page 8 of the staff report is not clear to me because it begins by mentioning that growth rates for broad money and domestic credit exceeded the growth of nominal mainland GDP, but ends by indicating that while there was a target zone for credit growth of 5 percent to 9 percent, annualized credit growth had decelerated to below

4 percent. These two observations may still be compatible, but they give different messages, and I am therefore not sure what the message is.

Apart from the points I made earlier, I can support the staff appraisal.

Mr. Prader made the following statement:

Like the Norwegian authorities and Mr. Fogelholm, I broadly support the staff's main recommendations on the need for a correction of the fiscal stance. On the points of difference, it is refreshing to note Mr. Fogelholm's gradualistic position for a change. The staff analysis is relevant and concise as far as the imbalances in demand management that have emerged since 1989 are concerned, but the question is to what extent the focus on the need for tightening fiscal policy is in line with the Norwegian public's and authorities' actual perception of which problems are of major importance, currently and in the years ahead.

My impression is that in confining its appraisal basically to the issue of fiscal restraint, the staff's views are directed more to academic economic circles than to the real, current public policy debate in Norway, which is focused primarily on how the Government can steer Norway toward EC membership in 1994. Unfortunately, on the EC issue, both the staff appraisal and Mr. Fogelholm have remained silent. This silence is even more striking because the previous Government broke up over the extent to which Norway should forge links with the Community, and not over the fiscal issue.

I am not sure whether the staff document will really contribute to Norwegian policy discussions, because in an economy like Norway's, which is doing fairly well by most standards, only recommendations and advice which contribute to the current policy debate will have an effect. Calls for tighter fiscal policies without reference to the central economic and political agenda will be seen as rather theoretical nuances, which exert no real pressure and no real urgency. For instance, the points raised by the staff on the need to lower the non-oil fiscal deficit in order to be able to maintain the so-called harder currency option are well taken but open to interpretation and judgment. The experience of countries with a hard currency commitment has been that the markets have tolerated deviations of fiscal policy and the movement of fundamentals vis-à-vis the ERM participants for even longer periods of time as long as the underlying

commitment of the Government toward sound policies was credible and as long as there was certainty that the authorities would correct such imbalances over the medium term. In fact, we see this phenomenon also in the Norwegian case: the easing of fiscal policies has not led to any significant pressures on the exchange rate, because presumably the record of reducing dependence on oil and adjusting the economy has given the markets enough confidence about the underlying sustainability of Norwegian exchange rate policy.

In the framework of the major issue on the economic and political agenda of the Norwegian Government, I would like to have from the staff or Mr. Fogelholm an assessment of the chances for settling some of the major problems standing in the way of EC membership, which the Government hopes to achieve by November 1994. To what extent is the Norwegian economy prepared for EC membership? How does the Government intend to prepare and adjust the economy for the EC? In this context, the extensive subsidies, which have been obstacles for both the EC and EFTA in the discussions on the parameters for the European Economic Area, would be a major natural target for the Government's efforts. I assume that a number of adjustments and adaptations, such as in taxation and legislation, will also be needed. Although labor seems to have swung more in favor of eventual EC membership, one major impediment might lie in rising unemployment, which could strengthen and revive opposition to EC membership among the unions or economically depressed regions. The troubled banking sector, which was dealt with in the staff report, is definitely also a candidate for adjustment and reform, given the likelihood of higher exposure and vulnerability to more competition in a single European market. Also, from the perspective of joining the EC, an even tighter fiscal policy and an even harder exchange rate option than so far might be warranted. Likewise, Norway's edge in social security standards and environmental legislation may be somewhat at odds with EC norms and standards as well as the thinking of the European mainstream. Finally, there is the question how the authorities see the creation of a European Economic Area now that they have set their mind on early EC entry.

I would also like to comment on incomes policy, which the staff expects to have only limited success in offsetting a relaxation of fiscal policy. The staff's skeptical assessment is based on an interpretation of the experience of other Nordic countries, but it seems to me that in one way or another, most Nordic countries continue to practice some form of incomes policy. In his presentation of the Government's policy mix, which includes an important role for incomes policy,

Mr. Fogelholm cites the absence of wage/cost pressures following the abolition of statutory incomes policies in the current year. The staff report also recognizes the success of incomes policy in reducing wages and price inflation. This evidence seems to point to a strong institutional background for incomes policies in Norway which avoids the familiar negative effects associated with the use of specific limited types of incomes policies. In countries where the unions agree to incomes policies in exchange for some participation in the formulation of economic policies, incomes policy is generally more successful than in incomes policy arrangements which leave trade unions only with the task of controlling wage restraint, with the natural consequence that incomes policy soon becomes discredited as an effective policy instrument. Thus, care should be taken in our recommendations on incomes policy to be specific as to its nature. Thus, while I would tend to agree with the critique of a certain limited type of incomes policy, I would also argue for some differentiation in the evaluation of incomes policies and against a generalized view of the usefulness of incomes policies. An analysis of incomes policy made against the specific background of countries would also help to avoid the impression that not much can be done except to tighten fiscal and monetary policies. It would perhaps also be counterproductive to recommend the abolition of incomes policies where the implicit cooperation of unions has become part of the social and economic framework and where major change would disrupt the system to a larger than expected degree.

Mr. Tabata made the following statement:

Allow me to offer my sincere condolences on the demise of His late Majesty King Olav V.

At the outset, I would like to commend the authorities for their efforts to adjust the economy during the last couple of years. Real GDP growth has recovered, the inflation rate has come down, and the current account has a sizable surplus. Despite these relatively favorable results, there are still several uncertainties in the Norwegian economy. Therefore, I would like to comment on three points: the implementation of fiscal policy in 1991 and its effects on the real economy; oil wealth; and the exchange rate.

The Norwegian authorities continue to increase government expenditure to stimulate the economy; therefore, the deficit is estimated to be 8.6 percent of GDP in 1991. The critical point is whether this expansionary budget will have favorable effects

on the economy or not. Looking at the expenditure components of the budget, the relative weight of transfers is approximately 60 percent, and that of expenditure for goods is only 20 percent. Moreover, approximately 60 percent of private consumption is service expenditure. Therefore, the expansion of government expenditure will stimulate the service sector of the economy. Since the productivity of the service sector is low, the result will surely be an increase in wages in the service sector, which will push up wages in the manufacturing sector and, finally, decrease international competitiveness. If the Norwegian Government wants to increase expenditure, it would seem better to change its components, that is, to decrease the relative weight of transfers and increase that of goods. Increasing the relative weight of expenditure for goods could stimulate the manufacturing sector, raise the capacity utilization rate, and, finally, increase employment. Therefore, taking into account the expenditure pattern of the budget and private consumption, I am somewhat skeptical about Mr. Fogelholm's statement that "No cost pressures are expected to emerge in 1991...as a result of the relaxation of the fiscal stance."

On the relation between the government deficit and oil revenue, there seems to be some optimism that large fiscal deficits or current account deficits will be covered continuously by oil revenue. Needless to say, the reserves of oil and gas are not inexhaustible. Therefore, it has become a key policy to exploit oil wealth while avoiding its erosion. For this purpose, it is essential to allocate a part of the current oil revenues for investment in the non-oil productive sector. In this connection, I appreciate the staff's analysis of Norway's oil wealth.

At the same time, we welcome the establishment of the Petroleum Fund, although the guidelines do not seem to be sufficiently strict to ensure the efficient use of oil resources. In fact, as noted on page 27 of the background paper, no accumulation of resources in the Fund is projected in 1991. We share the staff's view that the guidelines of the Petroleum Fund should be strengthened to perpetuate the wealth from oil resources.

On exchange arrangements, the recent peg of the krone to the ECU is the main topic since the previous consultation. While the Norwegian krone had already been pegged to a basket of currencies, the new harder currency option seems to contribute to restraining inflation. However, for a small, open economy, this fixed exchange rate system, coupled with deregulated capital movements, limits the maneuverability of

the monetary policy. At the same time, the authorities can no longer rely on exchange rate operations to offset the weakening of external competitiveness.

In conclusion, I commend the Government's policy of maintaining openness and soundness in the economy. Also, we welcome the authorities' intention to make the new exchange arrangement a nominal anchor in the formation of price and domestic interest rates. At the same time, to maintain the credibility of the exchange rate, the authorities should be encouraged to keep a cautious stance in the implementation of macroeconomic policies, particularly in the fiscal area. Moreover, while oil revenue will continue to benefit the Norwegian economy, it should be kept in mind that Norway's main source of wealth is not its oil resources but the productive capacity of the non-oil sector, as the staff's analysis shows. Therefore, it seems that the authorities should consider allocating the return on the oil wealth to the non-oil productive investments.

Mrs. Hansen made the following statement:

The Norwegian economy overheated in the years up to 1986. The correction that followed successfully throttled inflation, but at a very high cost. GDP growth withered, with mainland GDP dropping in both 1988 and 1989 and rising only anemically in 1990. Domestic demand dropped even further, falling by progressively larger amounts in 1987, 1988,1989, and 1990. The drop in domestic demand in 1990 alone was 3.2 percent. With the flattening of the economy, inflation has dropped. It had reached 8.7 percent in 1987, and was down to 4.1 percent in 1990. With compressed demand, the current account, excluding oil, improved significantly.

The severe correction seems to be rooted in three developments. The drop in oil prices and oil revenue after 1986 set in train an economic retrenchment. Contractionary fiscal policy reinforced autonomous developments on the oil markets. Taxes were raised and expenditure growth moderated. Monetary policy was restrictive. The anti-inflation policy was reinforced by the commitment to a basket-pegged exchange rate. It is fairly clear that the stabilization program went on longer and cut deeper than the authorities anticipated.

The central issue posed by the staff report is whether the Norwegian authorities are now in the process of throwing away a large part of their hard-won adjustment gains. In our view, the evidence indicates that they are.

The course of fiscal policy has been dramatically reversed. The staff calculates that in 1989, there was an expansionary fiscal impulse equal to 1.8 percent of mainland GDP; in 1990, it was 3.3 percent of GDP, and a further stimulus amounting to 1.2 percent of GDP is estimated for 1991. The non-oil budget was in rough balance in 1987 but is expected to be in deficit to the tune of 8.6 percent of mainland GDP in 1991. Expanding credit to the Central Government is again putting upward pressure on the growth of broad money. The oil windfall of the second half of 1990 probably also gave a lift to activity. The compression and decompression of activity on this scale seems to us to be inherently unhealthy. Thus, we fully support the staff's numerous suggestions for a more cautious approach to economic policy in Norway.

While we share the view that Norway is running serious risks of excessive reflation, the staff report also left us with the sense that Norwegian macroeconomic policy was, in many fundamental respects, incoherent. Stated objectives are not synchronized with effective policies.

Diversification of the economy away from oil toward non-oil tradable goods is a stated objective of policy. Yet since the mid-1980s, the importance of oil has instead expanded. Investment in the non-oil private sector has contracted sharply. In the staff's judgment, external competitiveness would need to be improved to support a reorientation toward non-oil tradable goods. Yet a more demanding exchange peg makes the needed gain in competitiveness more difficult to achieve. It also makes it a little more difficult to sustain the recent trade balance improvement which, the staff notes, has been due to compressed demand and may be at risk if the demand gap is closed.

Neutralizing, or at least muting, the effect of oil price fluctuations on the budget and on activity is also indicated as one of the objectives of policy. Yet the trigger points for the Petroleum Fund appear to have been set at levels that will make it nonoperational.

Linking the krone to the ERM is seen as a technique for capitalizing on progress against inflation by tying the price level to a more secure anchor. With three years of reflationary fiscal policy, I wonder whether this heavy anchor has not been dropped in deep water. We share the staff's concern that voluntary incomes policy is likely to be a weak reed to contain wage pressures as labor market slack is taken up. Likewise, the staff correctly notes that terms of trade volatility will complicate exchange stabilization. Yet the

Petroleum Fund seems unlikely to be effective in insulating the exchange market from oil price fluctuations. These issues fall under the rubric of the "credibility" of the exchange rate commitment. Whatever the virtues of the ECU peg, I must confess the staff analysis did not enhance my confidence in the credibility of the authorities' commitment to the ECU peg.

Thus, there seems to be a mismatch between the authorities' stated objectives and their actions in important areas. I would appreciate any further observations the staff might like to make with respect to the overall coherence of the Norwegian economic strategy.

Likewise, I would appreciate clarification of the staff's thinking with respect to the near-term risks of rekindled wage and price inflation. By Norwegian standards, unemployment is now very high, although at 5.4 percent it is still well below that of other ERM countries. With fiscal stimulus, growth has improved a little but not yet enough to turn down the unemployment rate. Nor is an improvement expected in 1991. Estimates of a nonaccelerating inflation rate of unemployment (NAIRU) of 3 percent are reported but disparaged. Similarly, allusions are made to some econometric model evidence indicating that growth in labor demand in 1991 will not be strong enough to push up wages. The reliability of these estimates appears to be disputed. A transmission mechanism running from fiscal stimulus to wage expectations, with a possible detour via exchange rate credibility, is also discussed but not insisted upon. These diverging lines of argumentation left me a little confused about what wage developments the staff anticipates. My own sense is that the Norwegians are in uncharted waters and that caution is called for.

I would also appreciate some clarification from the staff about whether there are structural impediments to employment creation in Norway and, if so, what the Norwegian authorities are doing to address them. Here I have in mind such obstacles as restrictive laws on laying off workers and high benefit contributions by employers that might make employers reluctant to take on new labor. It would seem that the major attack on unemployment has been an expansion of local government payrolls.

On a more technical matter, could the staff elaborate a little on Norway's arrangements with the EMS? I note in the staff report that the Norges Bank has entered into an ECU 2 billion swap agreement with EC central banks. Is the pegging of the krone to the ECU a unilateral action, or is there a more formal association with the ERM?

Norway is a small, rich country with a complex economy. It sits on the economic, as well as the geographic, boundary of an integrating EC. I believe that we and the Norwegian authorities would benefit from a more frequent review of developments in Norway. I would like to suggest, therefore, that Norway be shifted from the bicyclic procedure to annual Article IV consultations.

Mr. Végh made the following statement:

I shall address only the question of the policy response to oil price volatility.

First, like other speakers, I should like to commend the quality of the staff report and the background paper. Of special interest is Appendix 1 of the latter paper on oil, national wealth, and the sustainability of consumption. The conceptual approach and model building will be useful for policymaking in other cases; for instance, in Mexico and Venezuela.

In his statement, Mr. Fogelholm makes the following remark: "The Norwegian economy as a whole is relatively robust and can withstand oil price volatility fairly well." I share Mr. Fogelholm's opinion, but in more general terms; and I would submit that the validity of his remark would stand even if the economy were not as robust as it is in the case of Norway and at the present time. In other words, my proposition would be that we should not be so concerned about the price of one commodity, even if it is an important commodity, as in the case of oil in the Norway economy. Stability in the general price level is one thing--and it should be attained through fiscal discipline and monetary restraint--but individual price stability is another thing altogether that should not be a matter of concern for economic policymaking. Individual prices should change in order that relative prices change; these changes are necessary for resource allocation. Apart from that, individual price movements contain an element of randomness that we have to accept as a fact of economic life. Otherwise, we get involved in a sort of "fair-price" doctrine as in the Middle Ages, contrary to the mechanism of price formation and market clearing in a capitalist economy.

On theoretical and practical grounds, I am very skeptical about the existence and operation of "stabilization funds." Mr. Posthumus and other speakers have mentioned some of the reasons for this skepticism. The choice of the reference or

baseline price is in itself an almost impossible task, as practical experience has shown in many specific cases.

Finally, let me say that this line of reasoning also applies to the so-called oil window element of the compensatory and contingency financing facility. The same rationale for creating an oil window could be used to propose other facilities, such as a copper window or a soybean window within the CCFF. In the context of Fund credit operations, such facilities would be similar to "stabilization funds" and have the same difficulties and dangers. For these reasons, and especially in the aftermath of the Persian Gulf war, I would welcome the opportunity of a general discussion and revision of this matter, as proposed by Mr. Goos and other Executive Directors in recent Board meetings.

Ms. Lindsay-Nanton made the following statement:

The Norwegian economy, after moving into a recession in 1988, improved modestly in 1990. The adjustment policies adopted by the Norwegian authorities over the 1986-88 period were successful in reducing inflation to around 4 percent in 1990. Favorable developments were also recorded in the external sector with a current account surplus of nearly 4 percent of GDP in 1990. Here I would like to join other Directors in complimenting the Norwegian authorities on these achievements. However, unemployment increased to almost 5 percent in 1989. Therefore, the authorities have been following a stimulatory fiscal policy over the past two years.

According to the staff report, the primary focus of the authorities remains that of reducing unemployment through expansionary fiscal policy. At the same time, their longer-term policy goal is to diversify exports away from dependence on petroleum products. Like other Directors, though, I am concerned that the use of fiscal policy to reduce unemployment may be inconsistent with this longer-term goal.

I fully support the authorities' longer-term strategy, particularly since proven recoverable oil reserves are expected to last only about another 20 years, and given the extra-ordinary uncertainty over oil prices and petroleum revenues. However, the degree to which diversification of the export base is successful depends on Norway's competitiveness vis-à-vis its main trading partners. This requires maintaining low inflation and keeping costs competitive. An overly expansionary fiscal policy could prove to be counterproductive to this goal by

overstimulating the economy, with resulting upward pressure on costs, particularly wages.

Norway's commitment to contain inflation as evidenced by the recent pegging of the exchange rate to the ECU within a narrow 2.25 percent fluctuation band could help foster price stability. However, continued improvement in inflation performance will depend on the credibility of the authorities' commitment to that objective. I am concerned that continued fiscal stimulus to the economy could well place excessive pressure on monetary policy to maintain the current exchange rate, with negative consequences on interest rates and private sector investment.

The staff papers point out that it is the authorities' intention to control price pressures that result from fiscal expansion through a more active incomes policy. However, while I have observed that experience with the Income Regulation Act appears to have been largely successful in limiting wage growth in the past, I share the staff's concerns about excessive reliance on incomes policy to offset an extremely expansionary fiscal policy. The staff report notes that recent estimates of the nonaccelerating inflation rate of unemployment (NAIRU) center around 3 percent. There appears to be considerable uncertainty over this rate. Given that unemployment stood at 5.4 percent during the first three quarters of 1990, compared with 4.9 percent for all of 1989, and that manufacturing wages are expected to increase to 5.5 percent from 4.2 percent in 1989, how does the staff view this estimate of 3 percent?

We would agree with the staff that it would be better for the authorities to wait and see the effects on unemployment of the fiscal action already taken before taking additional measures. Moreover, if further action is needed, structural reforms, particularly labor market reforms, could be a more efficient means of reducing unemployment without increasing price pressures. With this in mind, I share the staff's view that the authorities should place more emphasis on labor market policies which promote job training, as opposed to job creation. Investment in human capital in support of a more productive labor force is likely to be a more viable option than creating jobs that are dependent on continuing public expenditure. Other structural reforms, such as the planned reduction of the maximum marginal income tax rates from 58/60 percent to 50 percent, would seem to be appropriate, because the steeply progressive income tax structure has probably created disincentive effects.

There is another aspect of the authorities' diversification strategy on which I would like to touch. I have alluded to the uncertainty surrounding petroleum prices, and from this perspective, I welcome the recent establishment of a Petroleum Fund. The staff raises the question of the sustainability of the non-oil current account deficit were oil prices to decline significantly. My query is whether the staff would agree with Mr. Fogelholm that, with a real oil price of $17 per barrel, the non-oil current account deficit is sustainable at present levels. I would note that, even if Mr. Fogelholm is correct, over the longer term, with Kuwait and Iraq back into the production of oil, and with a need for substantial revenues for reconstruction, there is considerable risk that real oil prices will fall even further.

Under these circumstances, and given the Central Government's heavy reliance on oil revenues, I believe that fiscal restraint rather than expansion would be in order. Moreover, my concerns are heightened by the guidelines under which the Petroleum Fund operates. These require that regular transfers be made to the Central Government to meet its net borrowing requirements and to cover half the financing needs of the State Banks. It would appear that a good part of these resources will be used to finance public consumption rather than being channelled into increasing the productivity capacity of the economy. Furthermore, it would seem that oil prices would have to be exceptionally high before revenues could accumulate to assist the authorities in their longer-term diversification strategy. I would be interested in the staff's or Mr.Fogelholm's comments on this.

Mr. Menda made the following statement:

Let me first commend the authorities for the adjustment policies implemented between 1986 and 1989, which have enabled them to reduce Norway's inflation to the level of its trading partners and have brought some gains in external competitiveness and a dramatic decline in the interest rate differential. The authorities' decision to peg the krone to the ECU constitutes the keystone of this policy and is witness to their competitiveness through sound management policies and structural reforms.

The staff report also makes clear that the authorities have definitely put their action in a medium-term perspective, with the goal of progressively reducing the economy's dependence on the oil sector. It is certainly a coincidence that our discussion on Norway is taking place immediately

before the seminar on environmental issues, but the staff report is a clear illustration of how concerns about the exploitation of nonrenewable resources can be, or should be, an essential element of the macroeconomic framework. I must say that Appendix I to the staff report is very interesting and that the matter deserves fuller assessment.

At this stage of the discussion, and since I fully agree with the staff recommendations, I will concentrate my remarks mainly on the fiscal issue.

Like the staff, I am somewhat uneasy about the stop-go approach followed by the authorities in the past few years and recently. The concern about unemployment is certainly understandable, but it seems that the lack of responsiveness of wages to the level of unemployment indicates a significant proportion of structural unemployment. The significant fiscal impulse planned by the authorities may well result in a temporary diminution of unemployment, but without solving the underlying rigidities. Training programs could prove very useful to enhance the quality of the labor force; more generally, policies aiming at stimulating private investment, including a decline in the level of public expenditure in relation to GDP, the reduction of subsidies to certain sectors of the economy, and the streamlining of the extensive transfer system, could prove instrumental in enhancing the supply response of the economy. The reform of the tax system, which will take effect at the beginning of 1992, will certainly contribute to reduce distortions and enhance economic efficiency.

I share the staff's view that the recent stance could jeopardize the results obtained so far and endanger the hard currency policy pursued by the authorities. With monetary policy geared to the stability of the exchange rate, fiscal policy bears a special responsibility in the maintenance of macroeconomic balance.

Fiscal policy also appears to be in conflict with the medium-term objective of reducing the economy's dependence vis-à-vis the oil sector: in two years, the public deficit, excluding petroleum revenues, has risen to about 8 percent from a situation of near balance. Furthermore, Appendix I to the staff report suggests that such a level may not be consistent with the maintenance of Norway's oil wealth on a permanent basis. I would appreciate it if Mr. Fogelholm could comment on this issue.

I tend to agree that the authorities' medium-term objectives would be better served by a reduction in the non-oil deficit in relation to mainland GDP. The creation of the Petroleum Fund could become a useful tool in the long-run strategy. However, I am not entirely clear on the appropriate target for fiscal policy in the medium term, and I would appreciate some clarification from the staff on this issue. If the target ought to be the nonpetroleum deficit, fluctuations in oil prices would result in sharp fluctuations in the overall deficit that will be transmitted to the economy. If, on the contrary, the overall deficit should be considered the appropriate target, the Petroleum Fund could play a buffer role in the budget, accumulating assets when oil revenues are above the objective and disinvesting in the opposite case.

Let me say in conclusion that, given Norway's past record of sound macroeconomic management, we have no doubt that the authorities will pursue their cautious approach. I wish them well in their endeavors.

Mr. Bossone made the following statement:

I am in broad agreement with the general thrust of the staff's analysis and, in particular, I share the concerns raised by the staff with respect to the possible implications of the current economic policy setting. As I would like to strongly encourage the Norwegian authorities to strengthen their efforts toward greater economic and financial integration with the EMS countries, I intend to reinforce those concerns by offering, briefly, my views on the economic policy choices now facing Norway.

Let me say at the outset that this chair warmly welcomes the announced pegging of the krone to the ECU that followed the complete deregulation of capital transactions in mid-1990. Although such a policy retains the option of changing the rate or widening the margins of fluctuations, and is certainly less challenging than membership in the ERM or a peg to the deutsche mark, I am tempted to interpret it, maybe more optimistically than the staff, as a relevant change in Norway's exchange rate policy. First, the announced pegging to the ECU is more demanding in terms of cost and price stability than the previous basket and will therefore impose greater constraints on domestic economic policies. Second, the new pegging is a signal to the market that the required further economic adjustments will have to be implemented under restrictive monetary and exchange rate conditions.

The adjustment process in Norway is indeed far from complete. No significant progress has been accomplished in reducing the economy's oil-export dependence, investment activity has been reduced sharply in recent years, and unemployment has increased substantially.

To sustain demand and relieve unemployment, the Norwegian authorities have intensified the already expansionary fiscal stance adopted in 1989-90. Besides sharing the staff's doubts as to the effectiveness of the envisaged measures in reducing permanently the unemployment rate, I would like to comment on the general coherence of the present policy setting. First, I would note that the stimulative fiscal policy stance envisaged by the authorities, if protracted, is likely to exert pressures on wages and prices, especially in light of the Government's intention to end direct intervention in the wage-setting process. I would note as well that not enough has been done in recent years by Norway at the structural level to diversify export production. These two facts, combined with excessive reliance on oil as the major source of external revenue, may have unfavorable repercussions on the current account and the budget, also in terms of unstable trade flows owing to uncertain future developments in the price of oil.

If, under these circumstances, the commitment to peg the exchange rate were to be effectively pursued, an underlying, inappropriate macro and structural policy framework might compromise the competitiveness of the economy and eventually feed back negatively on growth and employment. If, on the other hand, an accommodating monetary and exchange rate stance were to be chosen, the loss of credibility would entail larger stabilization costs in the future and might delay the process of integration with the EMS countries.

In this sense, even a short-term trade-off between employment and credibility would vanish in the longer term as insufficient credibility, in an unbalanced policy setting, is likely to engender economic instability with negative effects on long-term employment. Indeed, should fiscal policy continue to be aimed at improving employment in the short run, the announcement of an ambitious exchange rate pegging could even be counterproductive if the peg were to prove unsustainable.

However, significant adjustment efforts in the past have made possible the implementation of the present exchange rate regime, which therefore incorporates already a substantial degree of credibility. Thus, this chair would encourage the Norwegian authorities to further pursue the successful stabilization efforts of the past years, even at the cost of

higher unemployment in the short run, and to aim at diversifying export production and increasing external competitiveness. This would substantially help the economy achieve a credible exchange rate pegging that would not generate domestic imbalances.

The adjustment will obviously require, at the outset, the correction of the current expansionary fiscal stance. Indeed, the experience of many other industrial countries in the 1980s has shown unequivocally that a prolonged expansion of output and employment has taken place only when it was accompanied by sound and protracted anti-inflationary policies. This is the main message this chair would like to convey to the Norwegian authorities, to whom I wish success.

Mr. Wright made the following statement:

I endorse the thrust of the staff appraisal, and will make a few comments without dwelling on those that others have made. I share the view that fiscal relaxation is an inappropriate response to concerns about unemployment in Norway. Like Mrs. Hansen and others, I believe that the authorities would do better to sustain the admirable adjustment record achieved in the late 1980s. It is significant in this connection that business confidence does not seem high, as can be seen in the expected rather slow recovery of investment from the declines of recent years, and the dependence of much of that recovery on one large project. I was also interested to see the sharp recovery in stockbuilding last year. I wonder how confident the staff is that this large buildup will not be run off this year, obviously with potentially rather significant implications for activity.

I also share the view of others that the role of transfer payments is worrying, not least because of its likely impact on the labor market, and particularly wage pressures. Recent performance of wages and prices has been satisfactory but it would be unfortunate if this were undermined. The authorities seem to have some confidence in the effectiveness of the trade-off between incomes restraint and fiscal expansion; the case for this is unproven and I note that the authorities themselves have differing views.

The interesting staff appendix on oil wealth and the sustainability of consumption highlights the uncertainties surrounding this sector, and the consequent uncertainties surrounding the sustainable fiscal stance. The current account seems to me to be less of a worry, although I would be more

sanguine if the mainland deficit was more clearly an indication of strong investment demand. Yet I note from Table 4 in the background paper that there has been a trend decline in gross investment as a share of GDP, and perhaps the staff could elaborate on whether fiscal policy has had a part to play in this development. With respect to use of oil and gas revenues, I have to say, along with others, that the Petroleum Fund does not seem to offer much of a way to accumulate assets, given the budget deficit's prior claim on it.

The adoption of the more demanding ECU peg is another factor pointing to the need for greater fiscal caution. Domestic monetary policy, of course, becomes largely subservient to it. I was struck by the staff's apparent acceptance of the authorities' comment that at present the impact of high domestic interest rates on businesses was mitigated by their access to overseas capital. This presumably is a reflection of the fact that the conditions for interest parity do not exist in Norway at the moment, given market imperfections. I take it that, as markets become more integrated as a result of the ECU peg, a scope for the authorities to operate an independent interest rate policy will be lower but the effects on interest rates on different sectors will be more uniform.

I was also struck by the authorities' confidence in exchange market intervention. In the ERM, of course, this has become much less of a feature, secondary to changes in interest rates, in preserving parities. I wonder how susceptible the krone is to intervention. The effects of intervention might be asymmetric. What I have in mind is that there may be few holders from whom to buy krone to defend the rate but any number of buyers when the rate is under upward pressure. I also wonder whether the authorities are confident of their ability to sterilize inflows, especially given the substantial domestic funding requirement.

Finally, I welcome progress in structural reform, particularly in the financial sector, and in taxation. And, like other speakers, I urge the authorities to make efforts to tackle subsidies in all areas. I might just note here that I was very concerned to learn that the authorities are considering action to help banks to meet Basle capital standards. I fully endorse the staff's call for a market solution to the problem. More generally, I am sure that the best way to encourage diversification is to create the appropriate free-market environment. But I would welcome staff comment on what it sees as likely growth areas in the years to come.

I should emphasize that these comments do not detract from the generally sound performance of the economy since the mid-1980s as reflected in low unemployment and low wage and price inflation. But I do agree with others that these achievements could easily be put at risk if a wrong turn in policy was taken.

Mr. Marino made the following statement:

Let me start by commending the staff for the interesting set of papers prepared for the Article IV consultation with Norway. Like other speakers, I found Appendix I on oil, national wealth, and the sustainability of consumption of particular interest; the methodology developed to assess the oil wealth of a country and the implications in terms of sustainable consumption, fiscal deficits, and current account deficits will be very useful not only for the Norwegian authorities, but also for those of other oil producing countries.

We are pleased to see that the turnaround in economic activity that started in mid-1989 is gaining momentum, that inflation has been considerably reduced, and that the current account has shifted to a surplus position. Unfortunately, these developments have been accompanied by a rise in unemployment. This situation poses a dilemma for the Norwegian authorities, since the short-run goals of output growth and full employment seem to run counter to the medium-term goals of diversification, price stability, and full integration into the European Community.

Faced with this dilemma, the staff makes the usual cautious recommendations based on the belief that there is considerable uncertainty regarding the sustainability of the present current account and budget structures, given the fluctuations in oil prices. Therefore, they recommend patience and a more restrained fiscal stance in order to ascertain whether the economy and unemployment will respond to the fiscal stimulus provided. In contrast, the authorities are more optimistic on the effectiveness of the fiscal policies they are pursuing and clearly give the highest priority to combating unemployment. Implicitly, the discussion boils down to what is "more" unsustainable: a rising unemployment rate or the fiscal stance.

For someone giving policy advice, it is perhaps important always to recommend the cautious route, the route that minimizes risks even though it might entail very high social

costs in terms of unemployment and lost output, but that assures exchange rate stability or real exchange rate stability. In this context, it seems to me that the staff might be implicitly advocating real exchange rate stability in a country that faces higher terms-of-trade volatility than ERM countries. I wonder whether this is possible or desirable.

Referring to Appendix I, a question that comes to mind is what to do with the oil money. There are several alternatives, including reducing government debt, buying securities, accumulating reserves or increasing government investment expenditure. For me, it is not evident that any one of these alternatives is superior under all circumstances. Under certain conditions perhaps the best use is to finance activities that promote needed structural changes, or retraining part of the labor force to avoid a problem of structural unemployment a few years down the road. It is an economic decision that has to be evaluated at every point in time, and not in a once-and-for-all fashion.

Along these lines, I would like to ask the staff whether the real interest rate is a good measure of the potential return that the oil wealth can have on a country. Would it not be better to use the social rate of return on public investment to assess the true opportunity cost of this wealth?

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

Mr. Esdar said that he was in broad agreement with the staff's analysis and recommendations.

While the Norwegian authorities' commitment to ambitious employment targets was understandable, Mr. Esdar said, he had some doubts whether the envisaged fiscal policy would support its objectives, especially if falling oil prices and related terms-of-trade losses further reduced the room for private sector activity, given the fiscal deficit. He shared the view of other speakers that the current fiscal policy might put monetary policy under additional strain to ensure the envisaged exchange rate stability. That policy mix might lead to increasing interest rates and, in the end, jeopardize the growth and employment orientation. On the other hand, a more lax monetary policy might result in inflationary pressures, leading to real appreciation and a loss of competitiveness of the mainland sector.

More generally, the relative increase in public sector spending restricted the scope for private initiative, which should be the driving

force in the necessary process of diversification to improve export opportunities in the non-oil sector, and to reduce dependence on oil revenues, Mr. Esdar observed. To add another point, he wondered whether the envisaged employment-oriented fiscal policy was in line with the objectives of incomes policy. It could be argued that the employment orientation of fiscal policy would strengthen the position of trade unions in the collective bargaining process, which might shift the responsibility for unemployment to the Government, with the consequence that possible trade-offs between income increases and effects on unemployment would be overlooked. Staff comment on that point would be helpful. In addition, it might be interesting to have the staff's opinion on the unemployment rate that might be economically feasible or achievable in the medium term in Norway.

Mr. Spencer observed that the policy mix of the authorities seemed essentially to be targeted at three objectives. Fiscal policy was targeted at unemployment; monetary policy at supporting the exchange rate peg; and incomes policy at controlling inflation, and indeed containing it below that of trading partners in order to improve competitiveness and encourage production in the non-oil sector. But as others had already mentioned, there seemed to be some factors at work that effectively reduced the number of independent policy instruments available to the authorities.

The first problem was with incomes policy, which, as the staff had mentioned, experience suggested might not be an effective instrument, at least in the long term, Mr. Spencer continued. Mr. Prader had suggested that perhaps there were special features in the Norwegian system that gave the authorities that further independent instrument. Yet the evidence from around the world suggested that incomes policies did not work unless they were supported by monetary and fiscal policies, which was essentially the same as saying that from a long-run perspective, incomes policy did not really add another string to the bow.

As to whether or not an independent fiscal policy could be pursued, again, Mr. Prader had indicated that the European experience was that countries could deviate to some degree from the norm in trading partner countries for substantial periods without coming under pressure, Mr. Spencer noted. He was less sure, and believed that it might be too early to make that judgment in the Norwegian case, particularly as the currency peg and the opening up of private capital were fairly recent moves. The Norwegian authorities could well be in for a shock in due course if they had to observe the market discipline that might come to bear if fiscal policy in Norway was perceived to be unsustainable. Certainly, the evidence that the staff had given suggested that that was the current situation with respect to fiscal policy. Essentially, three apparently independent instruments might be reduced effectively to one independent instrument, with macrofinancial policies being used to support the peg against the ECU.

Thus, it was a matter of where else to look for policies to help address the unemployment problem, Mr. Spencer went on. The answer lay no doubt in structural policies and labor market policies. Like Mrs. Hansen, he would be interested in learning from the staff or Mr. Fogelholm what the prospects in that area were for improving unemployment through, say, real wages or by affecting unemployment benefits.

While it was not clear from the staff papers, there might be some problem, for instance, with the interaction of fiscal policies, government benefits, and training subsidies, which might be keeping unemployment up in some respects as opposed to helping to reduce it.

On the other issue of insulating the non-oil economy, given the size and the volatility of the oil sector in the Norwegian economy, it seemed to make sense to try to insulate the non-oil sector from the swings in oil prices, Mr. Spencer considered. Pegging currency to the ECU would help to achieve that objective as well as provide a nominal anchor, but it was clear that with such large swings in the oil sector, other policies would have to support that strategy, if it was to work. In particular, for such an income-smoothing strategy to be sustainable, obviously it was important for the periods of saving to be matched to the periods of dissaving. In particular, fiscal policy must be seen to be sustainable over the longer term. It was apparent from the staff analysis in Appendix 1 that, under present oil price assumptions, the fiscal deficit was not sustainable. But it was also clear that there had been some very large swings in fiscal policy which seemed unlikely to be consistent with an effective stabilization policy through time.

The Petroleum Fund might potentially help to strengthen the strategy, Mr. Spencer noted, although, like Mr. Végh, he was a little skeptical about the usefulness of stabilization funds. The approach to the Petroleum Fund so far in Norway had done nothing to change his view. If some discipline was added to the guidelines, the Fund could be of potential use. It was also important to support that sort of income-smoothing strategy, during periods of upswing, by keeping monetary policy firm. In the down periods, it was fiscal policy that had to remain firm. In other words, during periods of savings, when reserves were accumulating, the potential risk was on the monetary policy side, and the banking system had to be insulated from the buildup in reserves; it might be possible to achieve that objective with the Petroleum Fund, if reserves were kept out of the domestic banking system.

Finally, in any income stabilization strategy, it was important, as mentioned in the staff report, to recognize when the scheme was no longer sustainable, Mr. Spencer concluded. In other words, if a large shift in oil prices was perceived to be permanent, the authorities had to be willing to adjust the parameters of the system, and allow a real exchange

rate movement, either upward or downward, and to start the process off again from a different level.

Mr. Chen made the following statement:

Since the 1988 Article IV consultation, the Norwegian economy has experienced moderate growth of 1.2 percent and 2.2 percent in the period 1989-90. Coupled with this steady recovery was the continued decline in the rate of inflation, both in terms of the mainland GDP deflator and consumer price index. There was also a remarkable improvement in the current account position. The economy as a whole seems to have recovered from the effects of the overheating of the mid-1980s.

Nonetheless, economic performance was not without some disappointments and weaknesses. In the authorities' view, the rising unemployment rate was viewed as the most unsatisfactory outcome so that, as also mentioned by the staff, the primary objective of macroeconomic policy is to lower unemployment. The issue is how to achieve that objective in the context of the recent pegging of the krone to the ECU.

The exchange rate regime in its new form attaches greater importance to the stability of prices and cost competitiveness of the economy which, in turn, ensure a stable exchange rate. It therefore merits our endorsement. What worries us at the moment is that the effectiveness of the pegging at the very outset depends on how fast credibility can be established and how it can be maintained. In this regard, the performance of prices and costs has a very important bearing on the establishment of credibility. But to us, the impatience of the authorities in using expansionary fiscal policy to lower unemployment seems to jeopardize the efforts made in the exchange rate regime because such policy would give rise to a higher rate of price and cost growth in the future.

An expansionary fiscal policy may lower the unemployment rate in the short run but not in the long run. We note that the current fiscal policy is not only incompatible with the medium-term strategy of reducing Norway's dependence on oil revenue, but also is not conducive to sustainable economic growth. Rather, this expansionary fiscal policy would increase the vulnerability of the economy. Even though the authorities acknowledge that the current fiscal policy stance should be temporary, serious consequences would nonetheless arise.

In this connection, the authorities are encouraged to deal with the issue of unemployment in a more patient manner, apart from the urgent need to consolidate the banking sector and the

successful implementation of the tax reform. It might also be advisable to cut down the growth in transfers to the private sector, thereby reducing the deficit burden. These areas remain a matter of concern. In this regard, it is encouraging to learn from Mr. Fogelholm's statement that progress has been made in formulating a relevant structural policy in that direction. More efforts should be made on the authorities' part to guard against any possible slippages in the process. Norway may still be confronted with serious challenges of sustaining enough confidence in the medium-term macroeconomic policy framework and of maintaining credibility in the satisfactory operation of the fixed exchange rate system and of eliminating the remaining rigidities in the economy.

On the demand side of the economy, it is interesting to note that domestic demand in 1990 was much stronger than in 1989, owing mainly to faster growth in private consumption and the demand for imports. However, this growth, together with the growth in GDP, did not produce any sizable positive impact on employment, whereas the unemployment rate showed an increase. The demand factors for 1991 are expected to maintain the momentum; in particular, a significant turnaround in gross fixed investment is forecast, and it would therefore be desirable to have an estimate from the staff of the unemployment rate for 1991, for which no figures were given.

Before concluding, I should like to commend the authorities for an excellent record of providing official development assistance over the past few years. Their exemplary contribution merits our admiration.

Mr. Mohammed made the following statement:

We are in broad agreement with the staff appraisal. The reduction of the relatively high rate of unemployment, at least by Norwegian standards, has emerged as a main policy objective for the authorities. We concur with the staff that it would be prudent to rely on structural policy, especially labor market measures, rather than fiscal stimulus, for two main reasons. First, the recent pegging of the krone to the ECU, and the opening up of the capital account, constrain the maneuverability of monetary policy; and it appears important for the authorities to protect credibility and enhance coordination with the European Community by demonstrating their determination to pursue fiscal consolidation. Second, and perhaps more important, the expansion of the non-oil fiscal deficit, which is being financed primarily through oil revenues, is hardly compatible with the objective of reducing dependence on oil

revenues over the medium-term, or with the objectives behind the establishment of the Petroleum Fund.

Norway, unlike many other oil-exporting countries, has a well-established industrial base, and it is therefore easier for the authorities to reduce dependence on oil revenues for financing the non-oil fiscal and current account deficits. Furthermore, heavy reliance on oil revenues, particularly at a time of continued uncertainty in oil markets, runs the risk of recreating the overall current account deficits registered in the pre-1988 period, if oil prices should fall further. I agree with Mr. Fogelholm that "the Norwegian economy is relatively robust and can withstand oil price volatility fairly well." But I join Mr. Végh in saying that this resilience makes it even more appropriate to undertake policy actions aimed at shielding the economy from future risks and to make an even larger contribution through an overall current account surplus to meeting the needs of the global economy for a higher level of savings, an issue the Board discussed earlier in the week.

The appendix in the staff report and in the background paper on oil wealth and the sustainability of consumption raises what is surely one of the most crucial questions facing oil exporting nations, namely, the optimal rate at which to exploit an exhaustible resource. The staff analysis underlines the importance of taking a long-term view of the management of oil and gas revenues in laying out a sustainable consumption path for the economy. In an international context, an analysis of this type, emphasizing, as it does, the dependence of additional consumption based on permanent income from oil wealth, on the price of oil and the level of physical reserves, underscores the importance of policy coordination among oil exporting nations for the benefit of all.

The staff representative from the European Department said that the description of monetary conditions referred to by Mr. Posthumus was intended to indicate that, with the weak economy, the actual credit increase in 1990 had been below the credit growth target zone suggested in the budget. With Norway's fixed exchange rate regime, the target zone was mainly indicative.

Conceptually, non-oil GDP was probably the preferable concept for analytical purposes, the staff representative said. However, the practice in Norway was to use mainland GDP in order to avoid data distortions arising from the volatility of shipping activity.

As to the target fiscal non-oil deficit GDP ratio, while the staff analysis in Appendix I was somewhat abstract, a 2 percent target would nevertheless probably be overly conservative, the staff representative considered. The analysis suggested that the non-oil deficit could be sustainable at a somewhat higher level.

On the issue of possible EC membership raised by Mr. Prader, the staff representative said that it was not clear what the final outcome would be. Following the announcement by Sweden that it would apply for entry to the EC, internal discussions in Norway indicated opposition to EC membership among some segments of the population. During the consultations, the main concern of the authorities as well as that of the public was the historically high level of unemployment. Thus, the question the staff report had tried to address was whether fiscal policy was the appropriate instrument for resolving the unemployment problem. The staff's conclusion had been that it was necessary to move more cautiously and perhaps preferably direct efforts toward active labor market programs. Given the high level of unemployment, the Government's training programs had been filled to capacity and the staff had suggested that the authorities might want to expand those programs. A more active reliance on fiscal policy posed a risk for wage inflation.

One reason for the success of incomes policy in containing wage increases in 1988-89 was that it had been statutory, the staff representative noted. When the policy was lifted in April 1990, the economy was in a weak position, with unemployment of over 5 percent, and wages might have been expected to behave moderately. But they had increased and unemployment had also risen. A question to consider was whether, after the three-year adjustment period, there had been a change in the behavior of the labor market. Structural rigidities may have developed that had not existed before.

With respect to the coherence of fiscal and exchange rate policy raised by Mrs. Hansen, the staff representative considered that a strongly expansionary fiscal policy could not be viewed as consistent with a fixed exchange rate policy. That the exchange rate had not been subjected to pressure was somewhat surprising. Perhaps the market's perception of Norway's external position, given its large exportable energy reserves, had not been adversely affected, and the credibility of the exchange rate had therefore not been weakened.

As to whether current policies could rekindle wage inflation, neither the staff nor the authorities were comfortable with firm projections of labor market developments, the staff representative noted. As indicated in the staff report, there was no historical precedent for unemployment of the magnitude being experienced in Norway, but the lack of response of the labor market to the fiscal stimulus already provided suggested increased rigidities and the possibility for wage pressures if the stimulus was intensified. The authorities were divided as to what to

expect from the expansionary fiscal policy. Some postulated changed behavior and foresaw strong wage pressures, whereas others did not hold that view. There was not sufficient statistical evidence to make a determination regarding increased labor market rigidities.

There were some structural impediments to employment in Norway, the staff representative explained. For instance, a regionally differentiated payroll tax had the effect of impeding labor mobility, as did subsidized housing. The subsidization of the agricultural and fishing sectors impeded the reallocation of labor among sectors, while budget transfers to the municipal sector to provide employment opportunities tended to have a lock-in effect. The authorities recognized the structural impediments, but corrective action was politically difficult to take.

It was not the staff's understanding that the authorities intended the ECU peg to signal Norway's immediate interest in a more formal association with the ERM, the staff representative commented; it was rather an indication of Norway's present interest in closer integration with the EC in general. In response to further questions by Mrs. Hansen, he noted that complete information regarding the swap arrangements with EC central banks and their relationship, if any, to the defense of the peg was not available.

The sustainability of the non-oil current account deficit at the oil price of $17 a barrel, as cited by Mr. Fogelholm, was a question of whether it was the level of the deficit or the ratio to GDP that was being evaluated, the staff representative noted. The calculation by Mr. Fogelholm related to the level, and that in Appendix I, to the ratio. At $17 a barrel, the deficit relative to GDP was not sustainable because, as the model utilized for the Appendix indicated, for the growth rate of consumption to be sustainable, wealth, non-oil GDP, and consumption would all have to grow at the same rate. The model suggested that for sustainability the oil price would have to be higher. For example, for a non-oil deficit of 6 percent of GDP to be considered sustainable, the per barrel price of oil would have to be about $21-22.

The Petroleum Fund guidelines, as indicated in the staff report, were not rigorous, as they allowed almost unlimited use of oil revenue for public consumption and, therefore, were out of line with the concept of the preservation of oil wealth, the staff representative noted. The staff would prefer to have rules that would guide the use of petroleum revenues for the budget which would be derived from the concepts presented in the Appendix, namely, the real return on oil wealth. The limit on the budget's recourse to oil revenue could be set for a number of years, and then reviewed with the oil wealth calculation redone to reflect changes in reserves and oil prices. That apart, controlling the drawdown of resources from the Petroleum Fund was of little use if the Government nevertheless incurred large deficits and borrowed to finance

them. Whatever the guidelines for the Fund, there had to be a realistic limit on non-oil deficits in the budget.

A feasible medium-term target for the budget deficit would be about 3 percent of non-oil GDP, as indicated in Chart 18 of the background paper, the staff representative said.

The rise in stock-building in 1990 noted by Mr. Wright was accounted for by oil platforms under construction, the staff representative from the European Department observed. When towed out to the fields in the North Sea, the platforms would show up as fixed investment.

Mr. Wright remarked that a complete rundown of an overall stock buildup of 3.3 percent of GDP, as a counterpart to an increase in investment in 1991, obviously had serious implications for the outlook for activity as a whole.

The staff representative from the European Department commented that the unemployment rate that could be achieved in the medium term depended upon the rigidities in the labor market. The Norweigian labor market appeared to have fewer rigidities than that in other European countries, and in the medium term, lower unemployment rates than in those countries might be expected. Basically, neither the staff nor the authorities were in a position to make a forecast with any great precision. The most recent indications from Norway were that, despite the fiscal stimulus, the employment situation had not improved.

The Acting Chairman suggested that any remaining questions could be taken up on a bilateral basis.

Mr. Fogelholm commented that while it was true to some extent that economic policy as a whole could be characterized, as Mr. Menda had observed, as stop-and-go, it must be remembered that that was partly because of political factors. Norway had had seven Governments since the early 1980s, which had, with the exception of one, been minority Governments. When another Government took over, it usually changed policy, and the present Government was no exception, having changed fiscal policy to make it more expansionary. But Mr. Menda also was right to point out Norway's economic situation should be put in perspective; the country clearly could afford a temporary deviation from a longer-term policy goal. The development of certain economic indicators had been favorable, as noted both in the staff report and in his opening statement. Despite what had been said about wage developments, inflation, and so on, he asked how many governments around the world had a net asset position of 12 percent of GDP. Also, the current account was strongly in surplus. That fairly good position was witness to the robustness of the economy.

When the present Government took office, its main policy emphasis was on reducing unemployment, which had been growing strongly and fast in

the late 1980s, with the objective of providing a solid basis for lowering unemployment both in the short and the long term, Mr. Fogelholm continued. Of course, in the short term, there was not much else to do than increase domestic demand. The authorities also felt that the policy would improve income distribution in the country as well. Interestingly enough, with regard to the seminar discussion to be held that afternoon, they had set as one of their goals that economic development should be sustainable in terms of the effects on the economic environment of the policies pursued.

The question, of course, was whether the authorities would succeed in reducing unemployment, Mr. Fogelholm added. There were some indications that they might not, because when employment opportunities were increased, the number of entrants into the market also increased, thereby reducing the total net effect. The likely impact on the policy mix was the concern of most Directors, starting from the assumption that that mix would be based on a strong commitment to gear monetary policy toward maintaining a firm and stable hard currency policy as an anchor for all economic policy. There was no reason to doubt the authorities' ability to meet that commitment.

As Mr. Prader had rightly remarked, the market had shown incredible understanding, bringing no pressure to bear on the Norwegian krone, when oil prices fell, Mr. Fogelholm remarked. But that was also perhaps a reflection of market participants' appreciation of Norway's economic situation as a whole.

As to what could be done in order not to create an inflationary situation, with monetary policy geared basically toward maintaining the foreign exchange rate goal, it was necessary to turn to structural policies and incomes policies, which was precisely the course being followed by the Government, Mr. Fogelholm stated. The authorities were pursuing the tax reform, which should help also to ease wage demands, and they were introducing many measures to increase the flexibility of the labor markets; it was a matter of both job creation and job training, to which considerable funds were being devoted. Also, the authorities agreed that it was necessary over the long term to transform and change the budget structure, thereby reducing subsidies.

Experience with income policies in Norway was mixed, as in many other countries, Mr. Fogelholm stated. The outcome had been not only negative but also positive on some occasions, although it had not been as successful as had been wished. It was too early to predict what the outcome would be in 1991. The NAIRU unemployment rate was still fairly low, at about 2 1/2-3 percent, which meant that there was considerable flexibility in the market. With the current unemployment rate of just over 5 percent, the authorities were fairly convinced that pressures on wages during 1991 would not be strong, but that such pressures could start to arise in 1992 if unemployment declined.

Taken together, if the perception of the authorities was one of a change of parameters in the economic and external environment, they would no doubt change their policies, Mr. Fogelholm said. The current fiscal stance was seen as being temporary, and it would be modified, if it became obvious that it was too expansionary. On the other hand, oil revenues from 1990, which would be cashed in during 1991, provided a buffer, so that there was no need to change the policies immediately.

On the issue of oil wealth and the Petroleum Fund, the staff had given the authorities a lot of material for thought, Mr. Fogelholm commented. By and large, they felt that the underlying assumption of maintaining a constant wealth/GDP ratio was fairly stringent, and they would be tempted to be a little less severe. Moreover, to maintain such a constant ratio would mean that Norway would have to run a consistent current account surplus over the years, and it was not certain that that would be desirable over the long term. The authorities had made calculations indicating that the current account deficit of the non-oil economy would be sustainable over the long term at the $17 per barrel price of oil. The authorities were also inclined to share the view of many Directors that the guidelines of the Petroleum Fund were not particularly helpful from the point of view of curbing the use of oil funds in the near term. But the more positive aspect of the Fund was that it increased transparency, in that the actual use of funds required a decision by the Parliament. In covering the budget, Parliament would recognize that it was drawing from the national wealth, and politicians might come to realize that perhaps they should be conducting a more stringent fiscal policy.

The new Government had not been faced yet with the political issue of Norwegian policy toward European integration, Mr. Fogelholm noted. It was clear that the Government was aiming for the time being at finalizing the negotiations on the European Economic Area (EEA); it had not laid down any formal policy with respect even to a request for entry into the EC. While the Prime Minister herself had indicated that she was in favor of Norway applying for membership, the party had not yet taken an official stance on the matter. The high degree of skepticism toward EC membership was evident from the most recent poll, which concluded that 40 percent of the population at large was in favor of membership, and 45 percent was against, with the rest being undecided. It would be recalled that Norway had held a referendum on EC membership at the time when Denmark had joined in the early 1970s, which had been defeated, but there was now a clear majority in favor of joining the European Economic Area.

The fact that the Government was preparing for Europe was evident in many ways, Mr. Fogelholm stated. The unilateral pegging to the ECU should be seen more as a signal than anything else, because it did not greatly affect movements in the foreign exchange rate, which in any event had been fairly stable over the past two years. Yet the peg had

increased confidence because of the positive developments to which he had referred relating to the closing of interest rate differentials. The Government was prepared to go further on cutting subsidies, and, in anticipation of both EEA and possibly an EC association, it was also changing legislation relating to real estate and foreign direct investment.

Finally, Mr. Fogelholm stated that the authorities were content to stay with the bicyclic procedure. Nothing prevented the Board from discussing the bicyclic report, which would be due in 1992, at roughly the same time of year as the current report.

The Acting Chairman made the following summing up:

Directors recalled the earlier adjustment effort in 1986-88, which included a reorientation of fiscal policy toward a more restrained stance. Directors considered that while there had been a setback to economic activity and employment, the improvements in price performance, competitiveness, and the external accounts had provided a sounder basis for sustained growth. Directors also noted and generally endorsed Norway's stable exchange rate policy and the recent peg to the ECU, which represented a stronger commitment toward exchange rate stability.

Directors observed that fiscal policy had been relaxed since 1989 as the primary focus of macroeconomic policy shifted toward alleviating unemployment. The non-oil budget deficit had risen sharply, and this fiscal stance had imparted a sizable stimulus to the economy. Nevertheless, employment had continued to weaken. Directors were critical of the present orientation of fiscal policy in view of the authorities' commitment to reducing oil dependence. The policies followed in the last two years fell clearly short of the Government's objective of reducing dependence on oil. The operational guidelines of the Petroleum Fund were not strict enough to ensure the budgetary discipline required to safeguard oil wealth. Furthermore, the new exchange rate peg would place greater demands on fiscal policy to ensure that the economy adjusted to external and domestic shocks.

The diversification strategy called for further improvements in external competitiveness and therefore also for wage and price moderation. Directors stated that while lowering unemployment was a legitimate objective, a continuation of the fiscal stimulus could put at risk the hard won gains of adjustment in 1986-88. The views of Directors on the effectiveness of incomes policy differed, but speakers generally noted that

in the social and economic framework of Norway, it remained an important element of the economic policy strategy, and that there was a strong tradition of cooperation between the Government and the social partners.

Directors noted Norway's objective of advancing cooperation with the European Community but doubted whether the economic strategy, and in particular fiscal policy, was supportive of that objective. Moreover, structural reform efforts should be continued in areas such as industrial and agricultural subsidies, and in addition, in removing remaining barriers to international trade and investment flows. Finally, Directors commended Norway for its generous assistance to developing countries.

Norway is on the bicyclic procedure, and the next consultation will be completed within 12 months on the basis of the interim consultation report.

DECISIONS TAKEN SINCE PREVIOUS MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/29 (2/27/91) and EBM/91/30 (3/1/91).

2. SDR DEPARTMENT - DESIGNATION PLAN FOR MARCH-MAY 1991

The Executive Board approves the designation plan for the quarterly period beginning March 1, 1991 as set out in EBS/91/23 (2/14/91).

Decision No. 9662-(91/30) S, adopted
February 28, 1991

3. OPERATIONAL BUDGET FOR MARCH-MAY 1991

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/91/24, page 2, footnote 1 and the operational budget for the quarterly period beginning March 1, 1991 as set out in EBS/91/24 (2/14/91).

Decision No. 9663-(91/30), adopted
February 28, 1991

4. SPOUSE AND DEPENDENTS' ALLOWANCES

The Executive Board approves, with one objection, the recommendation concerning adjustments in spouse and dependents' allowances set forth in EBAP/91/36 (2/22/91).

Adopted February 28, 1991

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/91/39, Supplement 1 (2/27/91), EBAP/91/40 (2/26/91), and EBAP/91/41 (2/27/91), by Advisors to Executive Directors as set forth in EBAP/91/41 (2/27/91), and by an Assistant to Executive Director as set forth in EBAP/91/37 (2/25/91) is approved.

APPROVED: October 28, 1991

LEO VAN HOUTVEN
Secretary