FOR AGENDA

SM/86/138

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June 16, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Norway - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Norway.

This subject has been tentatively scheduled for discussion on Monday, July 7, 1986.

Mr. Knöbl (ext. 8821) or Mr. Abrams (ext. 8831) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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Department Heads

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INTERNATIONAL MONETARY FUND

NORWAY

Staff Report for the 1986 Article IV Consultation

Prepared by Staff Representatives for the
1986 Consultation with Norway

Approved by Brian Rose and J.T. Boorman

June 16, 1986

I. Introduction

A staff team consisting of Messrs. Hans Schmitt, A. Knöbl, R. Abrams, H.-J. Huss, and J. Khallouf, with Ms. Pettie as secretary (all EUR), held Article IV consultation discussions in Oslo from May 6 to May 16, 1986. A new Government was sworn in on May 9, 1986, and devalued the krone effective May 12, 1986. The Norwegian representatives participating in the discussions included officials of the Ministries of Finance, Petroleum and Energy, Trade and Shipping, and the Bank of Norway. The mission met with the outgoing Minister of Finance, Mr. Arne Skauge, with the Secretary General of the Ministry of Finance, Mr. Eivind Erichsen, with the Governor of the Bank of Norway, Mr. Hermod Skånland, and the Deputy Governor, Mr. Kjell Storvik. Mr. Hans Lundström, Executive Director for Norway, attended the meetings as an observer. Norway formally accepted the obligations of Article VIII, Sections 2, 3, and 4 from May 11, 1967.

The Executive Board discussion of the last Article IV consultation (EBM/84/188, 12/21/84) took place against the background of large current account surpluses coupled with rising output, decelerating inflation, and high employment. Directors were concerned that the envisaged widening of the "adjusted" fiscal deficit 1/ would exaggerate the cyclical upswing and urged expenditure restraint. Directors also stressed that, although exports of petroleum would keep the external balance strong for a time, the viability of the industrial sector would have to be safeguarded over the longer run. They thought that its competitiveness might best be protected by domestic cost restraint rather than by exchange rate measures. Moderation in wage settlements was also essential if domestic employment was to be kept high without inflation. Directors welcomed the liberalization of the money and securities markets in 1984, but observed that the system of monetary management still remained overly complex and excessively rigid as long as key interest rates remained subject to administrative control.

1/ The deficit excluding oil-related revenue and expenditure, and transfers from the Central Bank. Adjusted budget figures are expressed in relation to "mainland" GDP, i.e., GDP excluding oil and shipping.

II. Background

Economic developments in Norway over the past decade have been dominated by its emergence as a major oil producer and by the associated adjustment problems. The oil and gas sector grew in size from less than 1 percent of GDP in 1974 to 19 percent in 1985. The prospect of rising incomes from oil permitted the authorities to pursue expansionary domestic policies during the international recession of the mid-1970s. These policies produced large external current account deficits with a concomitant rise in foreign debt. The weakness of the external position, even with the prospective earnings from oil, led to a more cautious turn in financial policy in 1978. The revised stance was accompanied by a devaluation of the krone and an extended wage-price freeze which, for a brief period, reversed a persistent worsening in the competitive position of the non-oil sectors. The external current account swung back into surplus after the sharp rise in petroleum prices in 1979, though other exports remained sluggish, as the international economy slumped again.

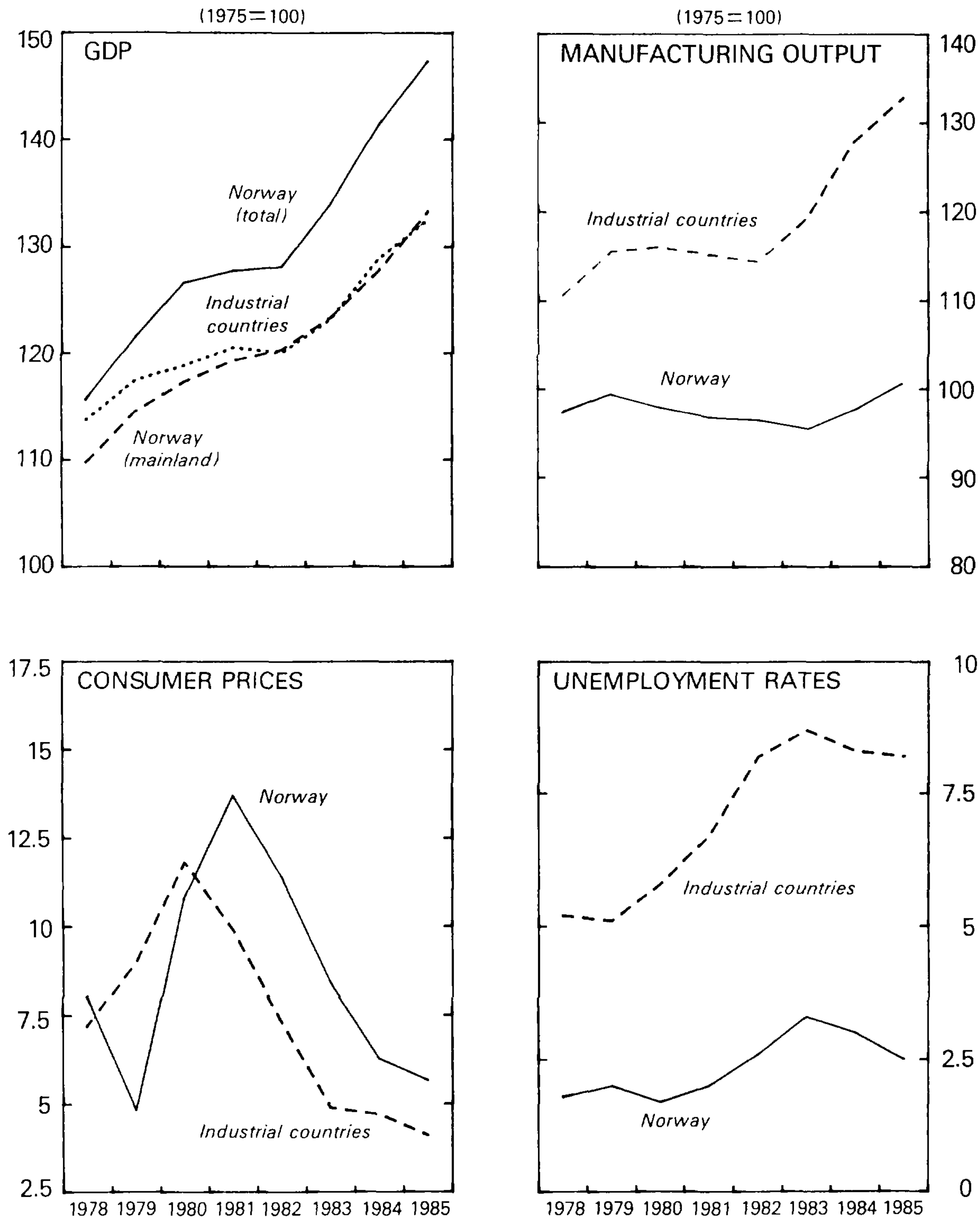
Domestic economic growth picked up in 1983 and 1984 (Chart 1). The new upsurge was initially concentrated in the export sector as the international recovery pulled up "mainland" exports along with exports of oil and gas. From 1984 domestic factors began to contribute significantly to economic growth. Private consumption and gross fixed investment both accelerated in response to rising real incomes and employment. The economy began to show clear signs of overheating in 1985. Mainland domestic demand rose by 8.3 percent, due in large part to an 8.2 percent increase in private consumption. 1/ An easing of fiscal policy contributed significantly to the strength of domestic demand. In retrospect it is clear that the rapid expansion of money and credit was also a contributing factor.

1/ Total domestic demand rose by only 2.7 percent, largely because of a technical disinvestment in the shipping sector. Much of this disinvestment took place because many ships were transferred from Norwegian flag companies to foreign flag companies controlled by the same ownership, in order to avoid certain Norwegian regulations. The counter-entry of the disinvestment was an increase in the export of ships.

CHART 1

NORWAY

NORWAY IN AN INTERNATIONAL CONTEXT



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

Table 1. Norway: National Accounts

(Percentage change)

	1983	1984	1985	1986 1/
	(Volume change per annum)			
GDP	4.5	5.6	4.2	4.3
GDP, excluding shipping and oil activities	2.5	3.6	4.3	3.4
Domestic demand	1.1	5.7	2.7	7.5
Private consumption	1.5	2.7	8.2	5.1
Public consumption	4.6	2.0	3.4	1.1
Gross fixed investment	5.8	8.7	-21.9	28.8
Exports of goods and services	7.3	7.5	10.0	2.3
Imports of goods and services	--	8.2	7.7	10.1
Memorandum items:				
Consumer prices (December on December)	7.1	5.9	5.6	5.8 2/
Hourly wage earnings in manufacturing	8.5	8.4	7.9	...
Unemployment rate in percent of labor force	3.3	3.0	2.5	1.8 3/

Source: Data provided by the Norwegian authorities.

1/ Forecast provided by the Norwegian authorities.
2/ April 1986/April 1985.
3/ First quarter 1986.

The strength of the recovery was especially evident in the labor market. Employment rose by 2 1/2 percent in 1985, while unemployment fell throughout the year. Registered unemployment, which averaged 3.0 percent of the labor force in 1984, declined to 2.5 percent in 1985; in April 1986, unemployment was down to 1.6 percent (seasonally adjusted). The rising demand for labor resulted in localized labor shortages and strong wage pressures such that in 1985 wages rose by almost 8 percent. Wage increases were almost wholly in the form of wage drift, since the central wage settlement was moderate, averaging 1 percent. The relatively high wage increases prevented a further decline in price inflation. Consumer prices rose in 1985 by

5 1/2 percent, little changed from 1984 despite favorable external factors. A small depreciation of the nominal effective exchange rate did not keep competitiveness from declining again.

The overall current account balance continued to strengthen because of rising exports of oil and gas. However, with import volumes rising by 12 percent, the "mainland" trade deficit widened from 8 1/4 percent of GDP in 1984 to 10 1/2 percent in 1985. The overall current account surplus rose in nominal terms to NKr 25 1/2 billion or to 5 percent of GDP. By end-1985, the total net external debt of the economy was down to 8 1/2 percent of GDP from 46 1/2 percent in 1978, with the central government external debt virtually repaid by the end of that year. Official reserves rose to SDR 13 billion, equivalent to 42 weeks of imports (Chart 2).

In the opening months of 1986 the prospect was for a further sharp increase in domestic demand, which was officially projected to grow by 7 1/2 percent on the strength of a 5 percent increase in private consumption and a 32 1/2 percent rise in gross private fixed investment. Much of the projected rise in investment reflected a temporary 73 1/2 percent increase in oil sector investment that was already in process. Mainland GDP was projected to grow by 3 1/2 percent and total GDP by 4 1/4 percent.

The continued overheating of the economy was already causing extremely tight conditions in the labor market. Wages were projected to rise by between 7 1/2 to 8 1/2 percent. As in 1985, these increases were expected to result primarily from wage drift, since central wage settlements were being kept to about 2 percent, even though in the private sector they were accompanied by widespread strikes, and the public sector had yet to settle. Buoyant economic conditions and high wage increases were again expected to offset the effect of favorable external factors on consumer prices, which were projected to rise by over 5 percent.

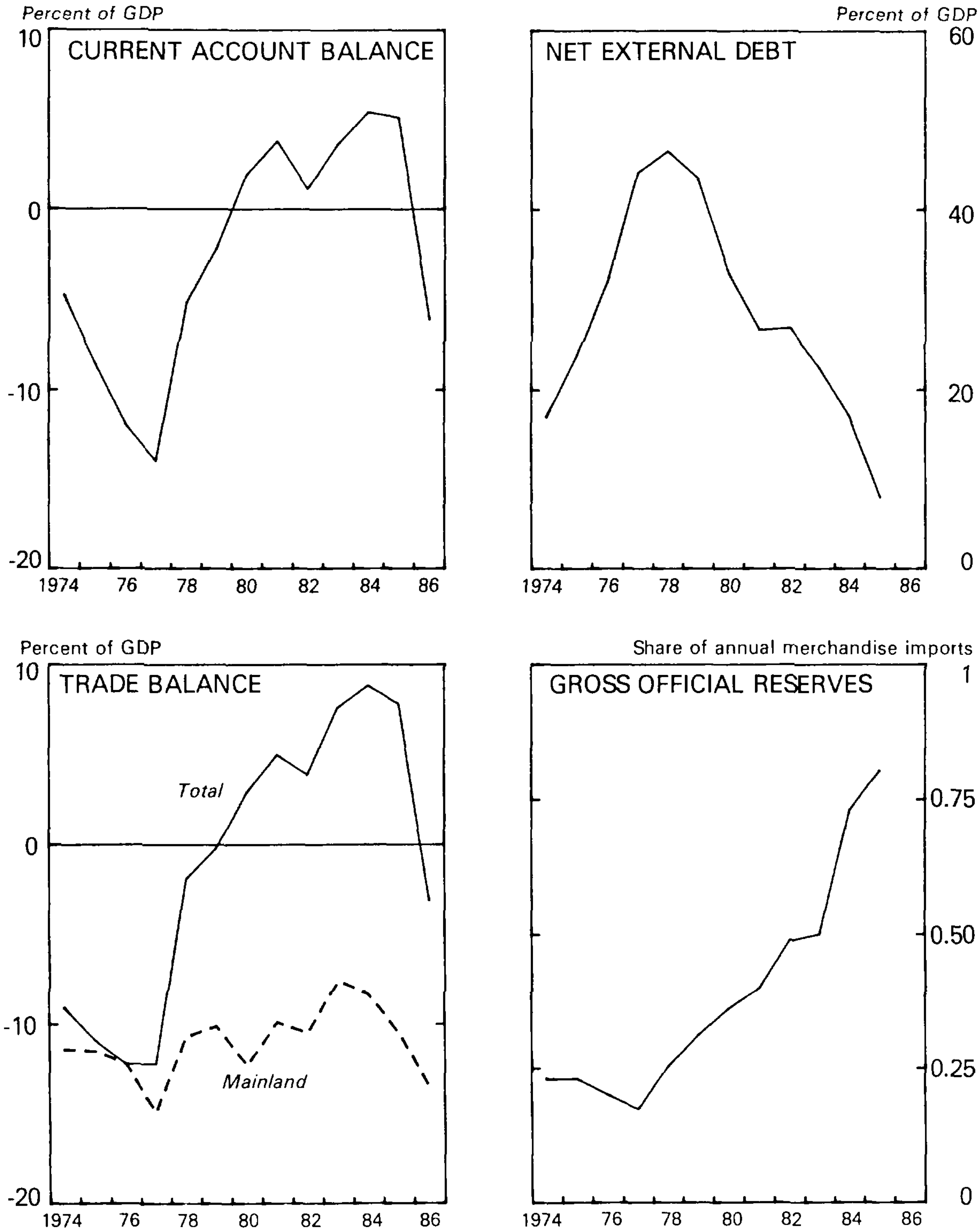
The external outlook seemed precarious even before oil prices dropped from about US$28.50 per barrel in the last quarter of 1985 to less than US$15 per barrel three months later (Chart 3). After registering a surplus of 5 percent of GDP in 1985, the external current account was now projected to record a deficit equivalent to about 6 percent of GDP in 1986, assuming an average spot oil price for the year of US$15 per barrel. 1/ Over half of the deterioration in the balance of payments was expected to result from a fall in oil and gas receipts, which are expected to decline by 40 percent despite a 9 percent increase in export volume.

1/ The actual average price will differ from the average spot price of oil because of lags built into contract prices.

CHART 2

NORWAY

EXTERNAL SECTOR DEVELOPMENTS



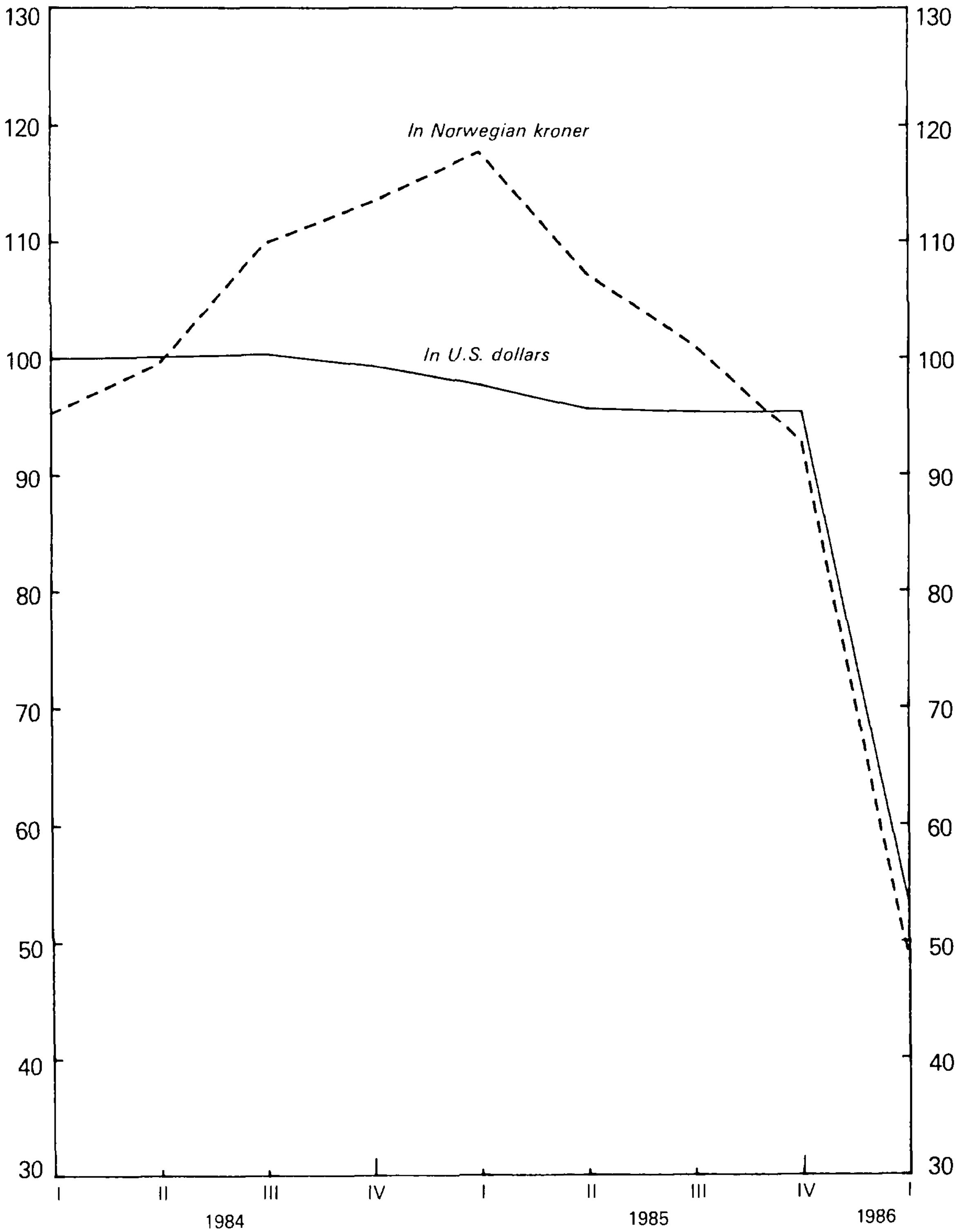
Sources: Central Bureau of Statistics, *Statistisk Arbok*: Ministry of Finance, *Nasjonalbudsjettet 1986*, Bank of Norway, *Annual Report*; information provided by the Norwegian authorities; IMF, *International Financial Statistics*; and staff estimates.

CHART 3

NORWAY

AVERAGE EXPORT PRICE OF NORWEGIAN CRUDE OILS

(End of period; January 1984=100)



Source: Statistisk Sentralbyrå, *Økonomiske analyser*, 1986 Nr5.

Table 2. Norway: Balance of Payments

(In billions of Norwegian kroner)

	1983	1984	1985	1986 1/
Exports, f.o.b.	133.2	157.0	172.6	133.4
Of which: oil and gas	(63.9)	(78.3)	(85.1)	(51.9)
Imports, c.i.f.	-102.5	-117.1	-133.7	-149.4
Trade balance	30.7	39.9	38.9	-16.0
Services and transfers	-16.1	-15.5	-13.3	-15.1
Of which: net interest	(-8.9)	(-8.4)	(-3.8)	(-5.4)
Current balance	14.6	24.4	25.6	-31.1
(in percent of GDP)	(3.6)	(5.4)	(5.1)	(-6.1)
Long-term capital	-10.8	-1.4	-6.9	...
Short-term capital 2/	-4.4	3.3	13.1	...
Overall balance	-0.6	26.3	31.8	...

Sources: Data provided by the Norwegian authorities; and staff estimates.

1/ Official projections and staff estimates.
2/ Includes errors and omissions.

III. Economic Policies

The juxtaposition of an overheated economy and a sharp fall in oil prices confronts Norway with a major adjustment problem once more. To be sure, external debt has been repaid, and official reserves have been built up to insulate the domestic economy against short-term fluctuations in price of oil. However, much of the drop in the price of oil now seems likely to persist for a while, so that it will have to be adjusted to, and demand pressure was already excessive. Without adjustment measures, the Norwegian representatives thought that a US$15 per barrel price of oil would raise the external current deficit from about 6 percent of GDP in 1986 to 9 percent in 1987. The discussions therefore focused on how adjustment could best be achieved without compromising the high levels of employment to which the authorities remain committed.

1. Competitiveness and labor market

The emergence of Norway as a major oil producer over the last decade, and the decision to spend a large part of the additional income domestically, put pressure on the traditional traded goods sector. International competitiveness of the manufacturing sector deteriorated more or less continuously after 1979 (Chart 4). By 1985, the real exchange rate, defined as relative unit labor costs adjusted for exchange rate changes, had reached a level 30 percent higher than in 1973. The real appreciation of the krone was brought about through more rapid cost increases in Norway than abroad, moderated by small periodic devaluations of the nominal exchange rate.

The deteriorating competitiveness of the traditional traded goods sector has become an increasing cause for concern to the Norwegian authorities in recent years. The external surplus was considered to be fragile if competitiveness could not be safeguarded. The sharp fall in oil prices in 1986 illustrates how quickly a large surplus can turn into an even larger deficit. With the fall in oil prices, the question now was not how to protect competitiveness, but how to improve it. Though uncertainties about the future price of oil abound, the Norwegian representatives generally believed that oil prices would be significantly lower in future than in the recent past, at least through the 1980s.

The need to improve competitiveness was unchallenged, but the means to achieve it were less certain. Attempts at influencing wage settlements, through tax concessions for example, may have kept central settlements low. However, strong wage drift, including increments obtained at the local level, had raised earnings by almost 8 percent in 1985, and was expected to raise them again by 7 1/2-8 1/2 percent in 1986. In fact, substituting for central wage settlements, wage drift now accounted for most of the increase in earnings. Wage determination was shifting from a centralized to a decentralized system making increases in earnings more responsive to conditions in the labor market. Thus it was the overheated economy which, by reducing the overall rate of unemployment to 1 1/2 percent, and by creating shortages particularly of skilled labor, was placing strong upward pressure on wages.

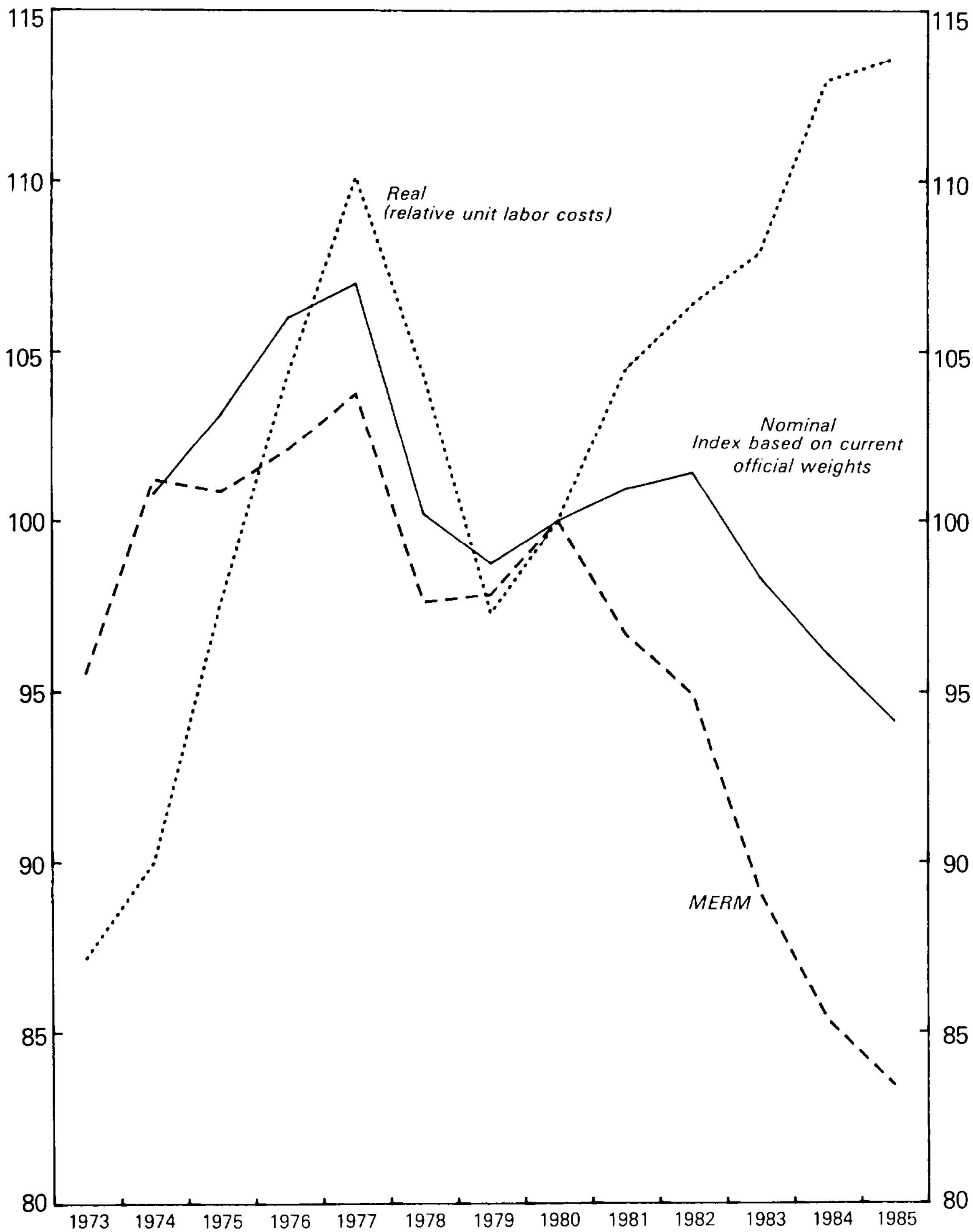
Rising wage pressures were helping to stall progress toward lower price increases in 1986, despite favorable external factors, widening the inflation differential with other countries. The Norwegian representatives projected that unit labor costs would in 1986 rise 3-4 percent faster in Norway than they would on average among partner countries. A reduction in working hours, recently agreed, would add a further 5 percent to labor costs in 1987. The need to improve competitiveness contributed to the decision to devalue the exchange rate

CHART 4

NORWAY

EXCHANGE RATE DEVELOPMENTS[1]

(1980=100)



Source: IMF, Data Fund.

[1] Rise in index indicates appreciation.

of the krone by 10.7 percent effective May 12, 1986. 1/ The competitive position of Norway was thought to be restored by it to about the 1984 level.

Following the last devaluation, policies needed to be formulated to support it. The Government and the trade unions agreed that compensation for the devaluation would neither be asked for, nor agreed to in the pending wage negotiations. Such restraint would also apply to incomes determined by public transfers. To restrain spending, and also to hold wage drift in check, fiscal and monetary policies would need to be tightened.

2. Fiscal policy

Helped by increasing oil revenues, the central government budget has been in surplus since 1980, by amounts varying from 2 to 5 percent of GDP. Surpluses of similar size were normal even before the development of the oil sector, except during the period of the so-called "bridging policy" in the mid-1970s, and were normally used for lending to the private sector, particularly for housing. Excluding oil revenue, the central government budget has swung into substantial deficit, however. This "adjusted" deficit has for some years hovered around 6 to 7 percent of GDP and in 1984 amounted to 6 percent (Chart 5). Central government spending rose sharply from 39 percent of "mainland" GDP in 1975 to 49 percent in 1980, with practically all the increase accounted for by higher transfers, including transfers to the municipalities. The ratio of central government spending to "mainland" GDP has been steady at around 49 percent since 1980. Non-oil revenue also rose moderately in relation to GDP over this period, in large part because of increased interest receipts.

Fiscal policy in the early 1980s was relatively neutral, in the sense that, net of oil revenues, the deficit of the Central Government was relatively stable in relation to income, after allowance for the business cycle. From the end of 1984, however, fiscal policy has become increasingly expansionary. The adjusted deficit did decline from 6 percent of GDP in 1984 to 4 1/4 percent in 1985, but this was more than accounted for by the cyclical buoyancy of revenues. Adjusted for the cycle 2/ the deficit rose. According to staff estimates, the central government budget exerted an expansionary impulse of close to 1 percent of GDP in 1985, thus contributing significantly to the overheating of the economy.

1/ The implied change in the central rate; the change in market rates was equivalent to a depreciation of 7 percent.

2/ And other, in part nonrecurrent, transactions. For details, see Recent Economic Developments report.

Table 3. Norway: Central Government Fiscal Data

(In percent of GDP, excluding oil and shipping)

		1975	1980	1984	1985	1986 Approved Budget
A.	Total revenue 1/	36.3	40.0	42.6	44.8	45.0
B.	Revenue, excluding oil and transfers from the central bank	39.6	41.9	43.0	44.7	45.0
	Of which: Tax and social security contributions	(34.5)	(36.3)	(34.7)	(36.0)	(35.7)
C.	Total expenditure 1/	35.5	38.9	37.9	39.8	44.6
D.	Expenditure, excluding oil	38.8	48.6	48.9	49.0	51.5
	Goods and services	(13.0)	(14.0)	(13.4)	(13.5)	(13.4)
	Transfers	(25.8)	(34.6)	(35.5)	(35.4)	(38.1)
A-C.	Balance before loan transactions 1/	0.8	1.1	4.7	5.0	0.4
B-D.	Adjusted balance	0.8	-6.7	-5.9	-4.3	-6.5

Source: Ministry of Finance.

1/ In percent of total GDP.

The budget for 1986 was framed to exert another strong expansionary impulse. In the final budget bill the adjusted deficit was projected to rise to 6 1/2 percent of GDP, adding the equivalent of about 1 1/2 percent of GDP to demand. Expenditures were budgeted to rise by 11 1/2 percent, well in excess of expected growth in GDP, with transfers rising particularly sharply. Revenues on the other hand were projected to rise by only 8 1/2 percent, slightly less than GDP, because of a reduction in income taxation to moderate wage demands. Although the extent of the eventual fall in oil prices was not foreseen, oil revenues were expected to decline substantially in 1986, and the overall budget surplus was thus projected to decline from 5 percent of GDP in 1985 to near balance.

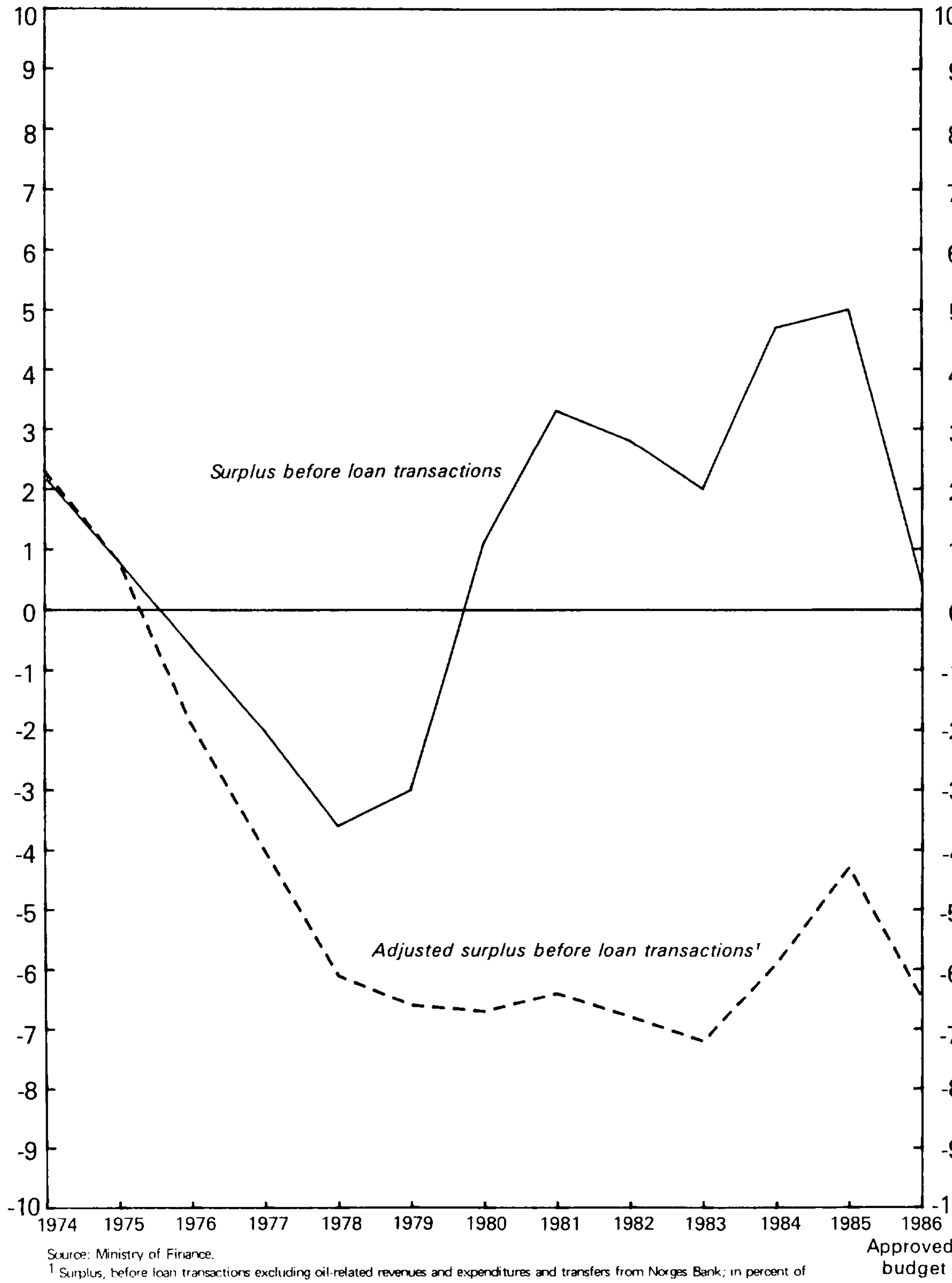
Since the budget was approved in late 1985 the economic outlook has changed significantly. First, the evidence of an overheated economy has become even stronger. Second, oil prices have declined much more

CHART 5

NORWAY

CENTRAL GOVERNMENT BUDGET BALANCE

(In percent of GDP; on a cash basis)



Source: Ministry of Finance.

1 Surplus, before loan transactions excluding oil-related revenues and expenditures and transfers from Norges Bank; in percent of GDP excluding oil and shipping.

sharply than anticipated. The Norwegian representatives calculated that, if oil prices were to remain at about US$15 per barrel through 1987, accrued oil revenues would decline from 10 1/2 percent of GDP in 1985 to 3 1/2 percent in 1986, and to 1 1/2 percent in 1987. 1/

The Government in power recognized that an adjustment of fiscal policy was urgent, and as early as late March proposed a small package of spending cuts, and of increases in specific duties including duties on gasoline, to reduce the 1986 budget deficit by somewhat less than 1/3 percent of GDP. They stated that substantially stronger action would be needed for 1987 to deal with the deteriorating economic situation. The proposed increase in gasoline taxes did not pass Parliament and the Government resigned in early May. The Norwegian representatives said that the need for a tighter fiscal policy was recognized also by the new Government that was sworn in on May 9, 1986. New budgetary measures in support of the devaluation of May 12, 1986 would be announced with the revised national budget at the end of the month. The new measures would seek to improve the budget by some 1/2 percent of GDP in 1986 or by 1 percent of GDP in a full year. While the magnitude of fiscal action had been decided, the exact measures had not. Stronger fiscal action would have to await the budget for 1987.

Oil revenues were likely to be only a little below budget estimates for 1986 on a cash basis, but would fall sharply in 1987. The Norwegian representatives reported that because of greater-than-expected buoyancy in the economy non-oil revenues might well come out 1 percent of GDP higher than foreseen in the approved budget. On the spending side, expenditure could turn out slightly lower than approved, but that would depend on the wage settlement for the public sector, which was still pending.

Until the new Government had formulated its program, the Norwegian representatives could say little regarding the medium-term budget outlook. A tax reform, aimed at widening the tax base and lowering marginal rates, had been foreshadowed by the previous government. In the new circumstances a move toward reducing the importance of tax deductions, including the deductibility of interest payments, was still likely. The financial difficulties of the social security system, which were likely to worsen not least for demographic reasons, would also need to be dealt with.

3. Monetary policy

The Norwegian authorities traditionally preferred to control credit expansion through rationing rather than by variations in interest rates. In recent years, however, it was increasingly recognized that disintermediation was making direct credit controls progressively less

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1/ Because of time lags, receipts on a cash basis would decline less, in particular in 1986.

effective. A process of liberalization was therefore begun in 1980, and substantially accelerated over the past two years. 1/ In 1984, quantitative controls on bank lending were abolished, and bond holding obligations of banks were eliminated. In late 1985, the practice of fixing bank interest rates was discontinued. Banks are now free to set their own lending and deposit rates, though the authorities continue to influence short- and long-term interest rates, through the Bank of Norway's open market operations in bank certificates and bonds. The Bank's interest rate objectives continue to be set by the Government.

The expansion of the money stock was very rapid in the last two years, broad money rising by 20 percent in 1984 and by 15 percent in 1985 (Chart 6). It was not very clear at first, to what extent such rapid growth reflected monetary ease, or the effects of reintermediation as direct controls were being relaxed. In retrospect there is no doubt that monetary policy accommodated an excessive expansion of domestic demand. Nominal interest rates were sufficiently high compared with those abroad to attract substantial inflows of capital, 2/ but not high enough to bring the demand for credit down to sustainable levels. A factor in maintaining this imbalance was the full tax deductibility of interest payments, which kept after-tax interest costs very low in domestic markets, despite the high before-tax interest yields that mattered for capital inflows from abroad. A post-tax interest rate high enough to restrict the demand for credit would have driven pre-tax interest rates higher than was deemed politically acceptable, leaving monetary policy more accommodating than it should have been. For this reason modifications in the tax treatment of interest payments were high on the agenda of the Norwegian representatives.

1/ For details see Recent Economic Developments report.

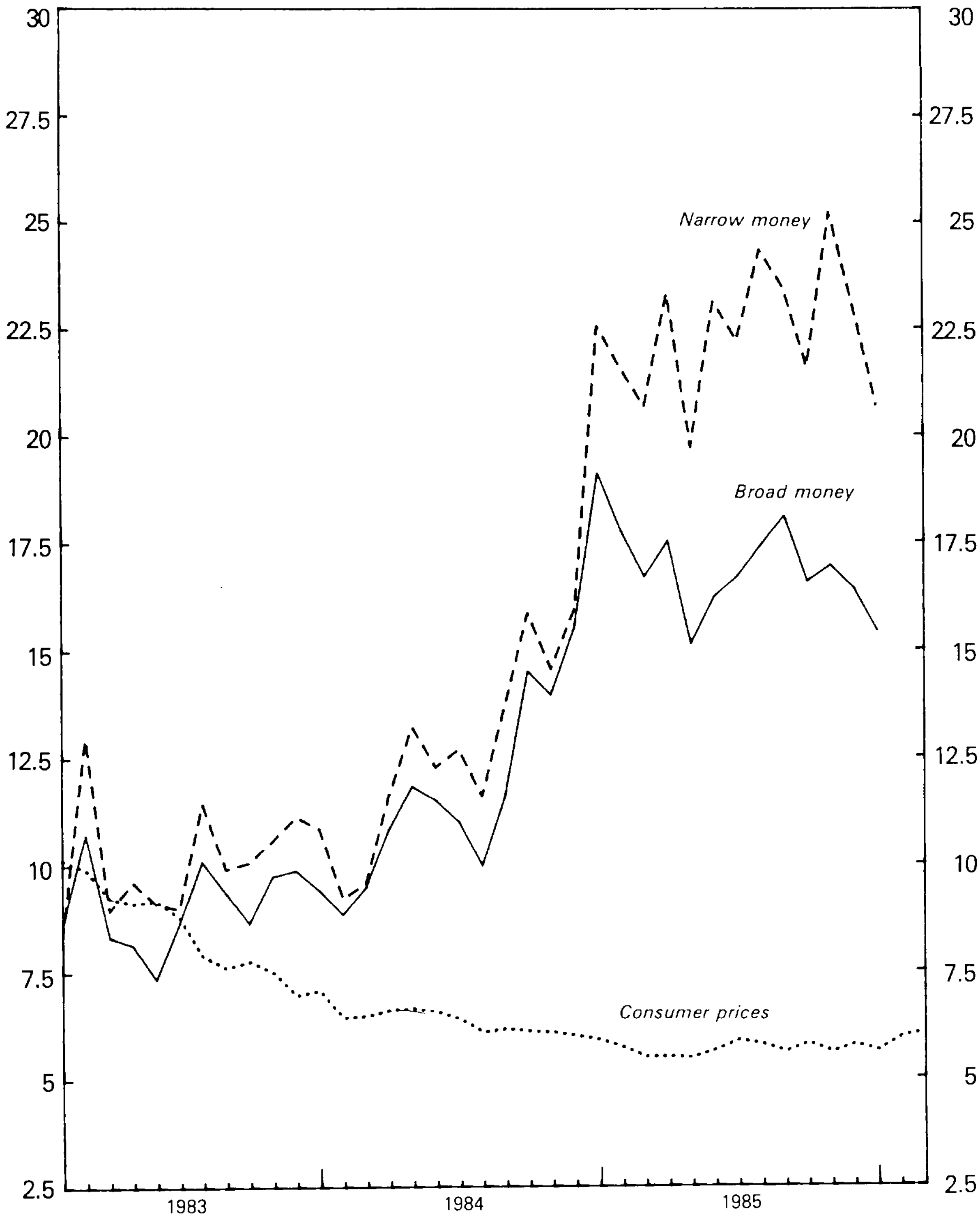
2/ In late 1984 nonresident purchases of domestic bonds were restricted to reduce capital inflows.

CHART 6

NORWAY

MONETARY DEVELOPMENTS

(Annual growth in monetary aggregates and consumer prices; in percent)



Sources: IMF, *International Financial Statistics;* and data supplied by the Norwegian authorities

Table 4. Norway: Growth of Broad Money

	1983	1984	1985	Feb. 1986 / Feb. 1985
	(Contributions to growth in broad money, in percent of previous year's money)			
Net sales of foreign exchange 1/ to the public	-5.9	-2.4	-8.0	-12.9
Change in net domestic credit	15.3	22.2	23.0	27.1
Central Government sector 2/	8.4	7.1	2.3	4.2
Private banking sector	6.9	15.1	20.7	22.9
Change in broad money	9.4	19.8	15.0	14.2

Source: Information provided by the Norwegian authorities.

1/ Excluding sales related to oil taxes.
2/ Including the proceeds from oil taxes as domestic credit.

Although interest rate differentials continued to favor Norway (Chart 7), capital flows reversed from October 1985 onward, placing downward pressure on the krone. The Norwegian representatives pointed to a number of factors to account for this development. Despite the high level of demand the budget proposal for 1986 promised to give an additional stimulus to activity that was further exaggerated as it passed through Parliament. Next came the sharp drop in oil prices to increase sharply the pressure on the balance of payments. The prospect of excessively high wage increases in the current negotiating round intensified pressure in the foreign exchange market even further. The change of government in early May 1986 raised it to crisis proportions. In response, the Bank of Norway was allowed to set short-term interest rates freely on a daily basis, and raised its key lending rate from 13 percent to 50 percent, but speculation did not diminish. All told, intervention in defense of the krone reduced official foreign exchange reserves (spot and forward) by almost 40 percent between mid-October 1985 and early May 1986.

Effective May 12, 1986, the index for the central rate was raised from 100 to 112. 1/ Before the devaluation the index of the krone had stood at about 102; when the market was reopened the index was fixed at 109.5. Following the devaluation, the interest rate on short-term lending by Norges Bank was lowered from 50 percent to 14 percent. It was felt that the devaluation would by itself induce capital reflows without maintaining the interest rate differential at crisis levels, and moderate capital reflows did in fact occur. However, to contribute to a cooling down of the overheated economy, it was decided to leave short-term interest rates one percentage point higher than before the exchange crisis.

As to the outlook for monetary policy in the remainder of 1986, the new Government announced that credit would be tightened in connection with the presentation of a revised national budget. The form of the envisaged tightening remained unclear. In particular, it was not known whether greater interest rate flexibility would be allowed.

4. Trade and aid policies

Norway's trade system remains liberal except for trade in agricultural products and in textiles. Few significant changes have been introduced since the last consultation. The most significant change was the completion of a major review of the Norwegian Generalized System of Preferences, which added 34 agricultural and 13 industrial tariff positions to the list.

In the recent negotiations for renewal of the Multifiber Agreement (MFA III), the Norwegian authorities stated their preference for placing the liberalization of international trade in textiles in a GATT framework. In present circumstances an extension of the MFA was recognized as the only feasible method for promoting world trade in textiles. Nevertheless, the Norwegian authorities favor leaving long-term solutions to be worked out in a new round of multilateral trade negotiations in the GATT.

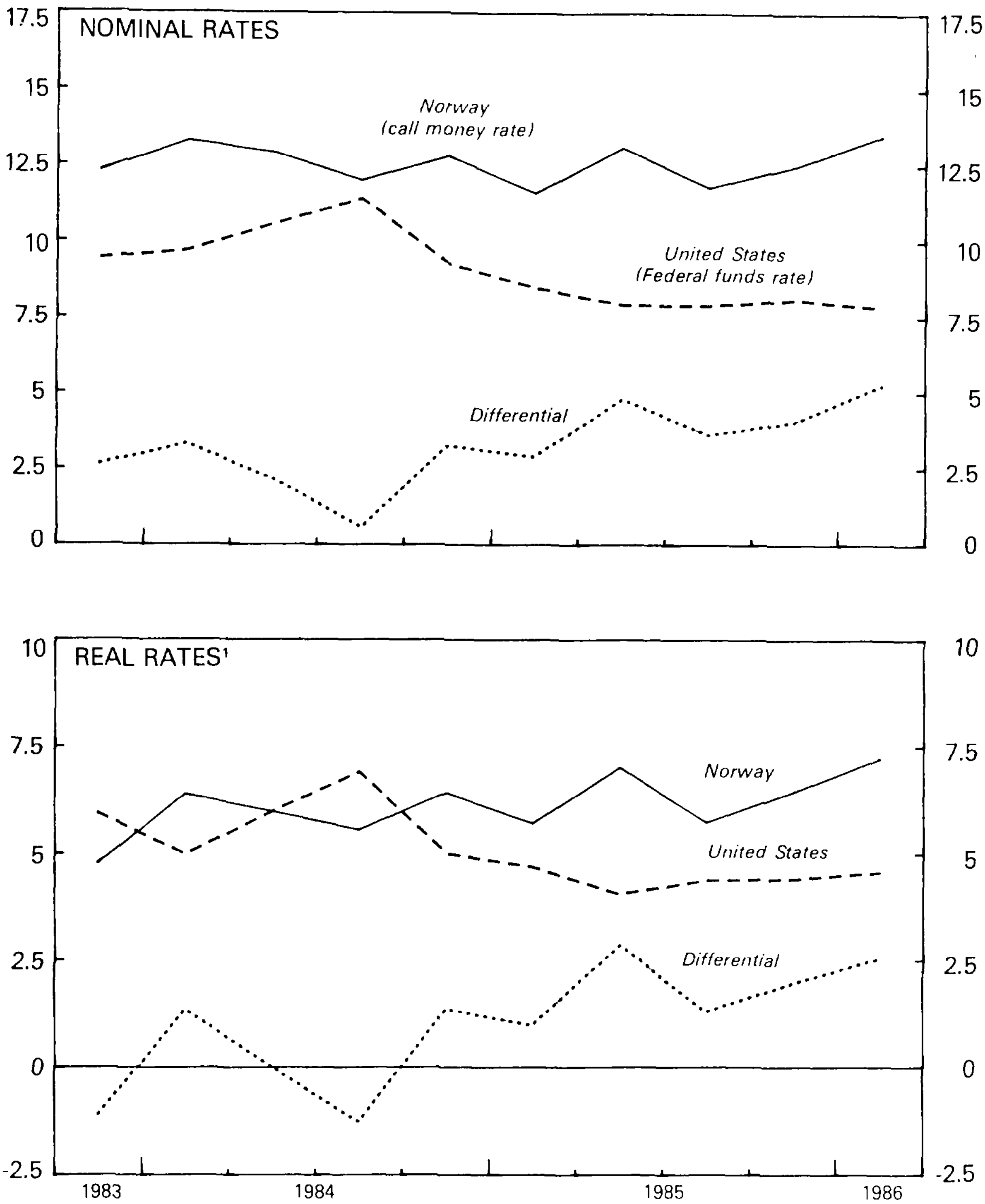
Norway's official development assistance amounted to 0.98 percent of GDP in 1984 and 0.99 percent in 1985. In 1986, ODA commitments are budgeted to increase by 5.1 percent to 1.15 percent of projected GDP. Over 40 percent of ODA is in the form of multilateral assistance, while virtually all bilateral aid is in the form of grants.

1/ The exchange rate of the krone is fixed against a basket of 14 currencies, with the weights similar to IMF competitiveness weights. A higher index number implies a lower exchange rate.

CHART 7

NORWAY

DEVELOPMENTS IN INTEREST RATES



Sources: IMF, *International Financial Statistics*; and data supplied by the Norwegian authorities and staff calculations.

[1] Deflated with consumer prices.

IV. Short-Term Outlook and Adjustment Issues

Because of the change in government, publication of the revised national budget was delayed, and specific policies remained to be worked out at the time the consultation discussions took place. Earlier official projections were rendered obsolete by the devaluation of the krone. In these circumstances, the staff mission elected to discuss the outlook for 1987 in terms of some quantified adjustment measures that the balance of payments position appeared to require.

The aim was to specify policies which would reduce the balance of payments deficit in 1987 while bringing economic growth back within the limits of capacity. Further progress in balance of payments adjustment beyond 1987 would require periodic reviews of policy in the light of changing circumstances (see Appendix I). The mission assumed that, to correct the overheating of the economy, the level of output would have to be kept unchanged at least in 1987. The Norwegian representatives were reluctant to quantify any target for GDP. They preferred to work to an external current account target, and possibly an inflation target, leaving the outcome for GDP unspecified. They did have a balancing problem in shaping their adjustment policies. On the one hand, the economy was overstretched and needed to be cooled off; on the other hand, large increases in unemployment were clearly undesirable. An outturn of zero growth for 1987 was therefore not ruled out.

As to the prospects for the external current account, the Norwegian authorities had recently updated their own projections, and come to the conclusion that a significant adjustment effort would be required. Fortunately, with the low level of external indebtedness and the high level of foreign exchange reserves, adjustment could be spread over a period of years. The Norwegian representatives projected that, with a US$15 dollar price of oil per barrel, the current account deficit in 1987 would rise to about 9 percent of GDP; reducing this figure to an underlying 4 percent would constitute a substantial adjustment effort in their view. The staff team stressed that even with this target the actual deficit would be higher than 4 percent, as the full effects of the devaluation would take time to come through, so that the decline in the current account deficit from 1986 to 1987 would still be fairly small.

Accepting both targets as a basis for discussion, two policy instruments to achieve them were then examined: the exchange rate and domestic demand restraint. Estimating the necessary degree of domestic demand restraint looked to be a straightforward exercise. The targeted improvement of the external balance would contribute 2 percent to GDP growth. With a zero growth target for GDP in 1987, that contribution from the balance of payments would have to be offset by a reduction in domestic demand. The required reduction would take domestic demand about 1 1/2 percent below its level in 1986.

Estimating the real exchange rate change needed to achieve the targeted improvement in the current account was a more difficult task. Based on elasticities that did not look unreasonable to either the Norwegian representatives or the staff team, a real depreciation of the exchange rate of about 2 percent seemed to be called for. That is, the full effects of a 2 percent real depreciation, in association with a 1 1/2 percent cut in domestic demand, should improve the external deficit from about 6 percent of GDP in 1986, to an underlying 4 percent of GDP in 1987. The exchange rate action with which the new Government had started its term of office looked sufficient to achieve this purpose. Taking account of the new exchange rate, the staff team projected the domestic demand deflator to increase by 7 percent in 1986, and by 9 percent in 1987. In the absence of any change in exchange rates, the expected increase would have been about 5 percent in both years.

The means to achieve a cut in real domestic demand to 1 1/2 percent below its 1986 level were considered next. The main instrument considered for the purpose was the budget of the general government. The Norwegian representatives saw virtually no scope for reducing government spending on goods and services, and such spending was therefore projected to remain constant in relation to GDP in 1987. The entire reduction in domestic demand had therefore to fall on the private sector. For the sake of neutrality the required cut was spread equiproportionately between private consumption and private investment. As oil sector investment was expected to decline by about 1 percent of GDP in 1987, a substantial increase in non-oil investment had to be assumed to make up the total.

The staff team noted that, if the proportion of private sector saving in private sector disposable income remained the same as in 1985, the supply of domestic and foreign saving in 1987 would fall short of the targeted level of investment. To raise domestic savings by fiscal means alone would require an increase in the ratio of net public revenues to GDP of 1.5 percentage points between 1986 and 1987. Net public revenues were defined as gross revenues less transfers, leaving open the choice between reductions in transfers and increases in gross revenues required to achieve the desired result. The staff team stressed that any further fall in accrued petroleum revenues between 1986 and 1987 would have to be fully made up within this figure, making the task rather more formidable than might appear at first. 1/

The Norwegian representatives observed that household savings were likely to increase in relation to disposable income in both 1986 and 1987. Such savings had been depressed in 1985 because of a surge in purchases of consumer durables caused by a general mood of prosperity

1/ At the assumed oil price of US$15 per barrel accrued oil revenues are estimated to decline by a further 2 percent of GDP in 1987. Discretionary fiscal action would need to compensate for this amount, too.

and easy consumer credit. As that mood subsided and consumer debt had to be repaid, savings would begin to rise again. It was an open question, however, whether this increase would be sufficient to match further declines in the saving of the petroleum sector, even if the positive effects of the devaluation on non-oil profits were also taken into account. Any shortfall would again increase the fiscal effort required to finance the postulated level of investment.

V. Staff Appraisal

Norway has adjusted fairly flexibly to its emergence as a major oil producer over the past decade. A large portion of the additional export earnings from oil was spent domestically not least to augment social welfare. To be sure, the traditional tradable goods sector was squeezed in the process, through a loss in its competitiveness, but an unusually high level of employment was nevertheless maintained, through vigorous expansion in sectors sheltered from external competition. The initial transition was eased by borrowing against the prospect of higher oil incomes and repaying the debt incurred when those incomes materialized. In addition reserves were accumulated to ease the later transition when the earning power of oil would eventually diminish.

In the last two years, however, the economy has become increasingly stretched. The present upswing in economic activity was initially export led, but since 1984 domestic demand has also expanded vigorously, carrying demand beyond the capacity of the economy to respond. An easing of fiscal policy contributed to this outcome, as did a rapid expansion of money and credit, the significance of which was difficult to judge in the context of a major liberalization of the financial system. Unemployment was pushed to a low of about 1 1/2 percent of the labor force. An excess demand for labor, reflected in increasing shortages particularly in the higher skills, has placed strong upward pressure on wages. The progress achieved earlier in reducing inflation was interrupted as a result, the inflation differential with abroad has begun to widen again, and external competitiveness continued to worsen.

The need for retrenchment became acute when the price of oil fell precipitously earlier this year. The balance on external current account is now expected to swing from a surplus of about 5 percent of GDP in 1985 to a deficit of perhaps 6 percent in 1986. The central government budget has also weakened substantially as public revenues accruing from oil are falling sharply. Nevertheless, the initial budget proposal for 1986 showed little prospect for restraint: indeed, it promised a further strong expansionary impulse on top of the boost to demand that the previous year's budget had provided. These pressures combined to bring a reversal in market sentiment toward the krone. Large reserve losses were incurred in an effort to defend the currency until a new Government in mid-May devalued it by 10.7 percent.

The devaluation of the krone should be seen as a first step in the implementation of a coherent adjustment policy. The external current account deficit will need to be reduced over time if the renewed growth in external debt is to be limited. The staff would consider a reduction in that deficit to some 4 percent of GDP in 1987 to be a reasonable first step assuming the price of oil remains in the vicinity of US$15 per barrel. In shaping policy the fact that the economy is already stretched beyond capacity needs also to be kept firmly in mind. To bring aggregate demand back within the limits of capacity it will need to be restrained for a while. Combined with a pause in the growth of output, the recent devaluation should be adequate in the view of the staff, to achieve the postulated reduction in the external deficit in 1987.

To restrain aggregate demand fiscal policy must be tightened sharply. A beginning will have been made with the measures to be proposed in the revised budget for 1986, but stronger fiscal action is likely to be necessary for 1987. The task for fiscal policy in this context is to ensure that domestic saving will be sufficient, together with the targeted external deficit on current account, to finance a sustainable level of investment. In calculating the necessary fiscal effort errors of judgment are bound to occur. The fiscal authorities will discover such errors in time, as the outturn for the current account begins to deviate from target, and they should make the necessary budgetary corrections in response.

Monetary policy must also play a role in restraining aggregate demand as in retrospect it did in carrying it to excess. The staff would focus on interest rates to determine what that role should be. Relying on fiscal policy alone to match the supply of savings to the requirements of investment, presupposes that domestic interest rates are adequate relative to those abroad, to attract sufficient capital to finance the target deficit on external current account. The net foreign assets of the banking system do not need to change any further in that event than they already have. If they do change, the monetary authorities must be free to correct the error, and thus ensure that domestic credit expansion will not rise to levels that might threaten the exchange rate and prices.

The staff commends Norway's exemplary record on foreign aid, and notes that Norway's trading system has remained substantially open.

The staff recommends that the next Article IV consultation with Norway be held on the standard 12-month cycle.

Note on Illustrative Medium-Term Scenarios 1/

The staff's illustrative medium-term scenarios are based on the following main assumptions, derived from the latest World Economic Outlook exercise. Industrial countries are assumed to grow in real terms by 3.0 percent in 1986, by 3.2 percent in 1987, and by 3.0 percent in 1988-91, while their GDP deflators are assumed to rise on average by 3.4 percent in 1986, by 3.3 percent in 1987, and by 3.7 percent in 1988-91. The non-oil terms of trade are assumed to remain constant over time. The real exchange rate is assumed to fall by 2.0 percent in 1986/87 and to remain constant thereafter. The short-term interest rate (LIBOR) is assumed to average 8.0 percent in 1986 and 7.5 percent in 1987-91; the interest rate on external borrowing is assumed to be 1/2 percent above the short-term interest rate.

The simulations cover the period 1987-91, with the outcome in 1986 constrained to be consistent with the official forecast made prior to the devaluation in May 1986. Measures to be taken are assumed to be sufficient to achieve a current account deficit equivalent to 4 percent of GDP in 1987, with a US$15 per barrel oil price. Four different medium-term scenarios are examined. Scenario 1 assumes that for the 1988-91 period, domestic demand growth in Norway equals demand growth in partner countries, and the oil price remains at US$15 per barrel in constant dollars. Scenario 2, uses the same domestic demand growth assumption, but the real price of oil is assumed to rise by US$1 per year from US$15 per barrel in 1986 to US$20 per barrel in 1991. In Scenarios 3 and 4, domestic demand is constrained during the 1988-91 period in order to achieve a balanced current account by 1991. In Scenario 3, the real price of oil is assumed to remain at US$15 per barrel, while in Scenario 4, the real price of oil is assumed to rise by US$1 per year from US$15 per barrel in 1986 to US$20 per barrel in 1991.

The importance of the oil price assumption is highlighted in Scenarios 1 and 2, where domestic demand growth is assumed to equal demand growth in partner countries (Chart 8). Under the constant real oil price assumption (Scenario 1), the current account deficit rises from 4 percent of GDP in 1987 to 5 1/2 percent in 1991; however, under the rising oil price assumption (Scenario 2), the deficit falls from 3 1/2 percent of GDP in 1987 to 2 1/4 percent in 1991.

The degree of demand restraint needed to eliminate the current account deficit by 1991 is also dependent on the oil price assumption. Assuming a constant real oil price of US$15 per barrel (Scenario 3), domestic demand growth must remain almost flat, rising by 1/2 percent per year over the 1988-91 period, to achieve external balance by 1991. On the other hand, under the rising oil price

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1/ The illustrative medium-term scenarios are presented in greater detail in an appendix to the Recent Economic Developments report.

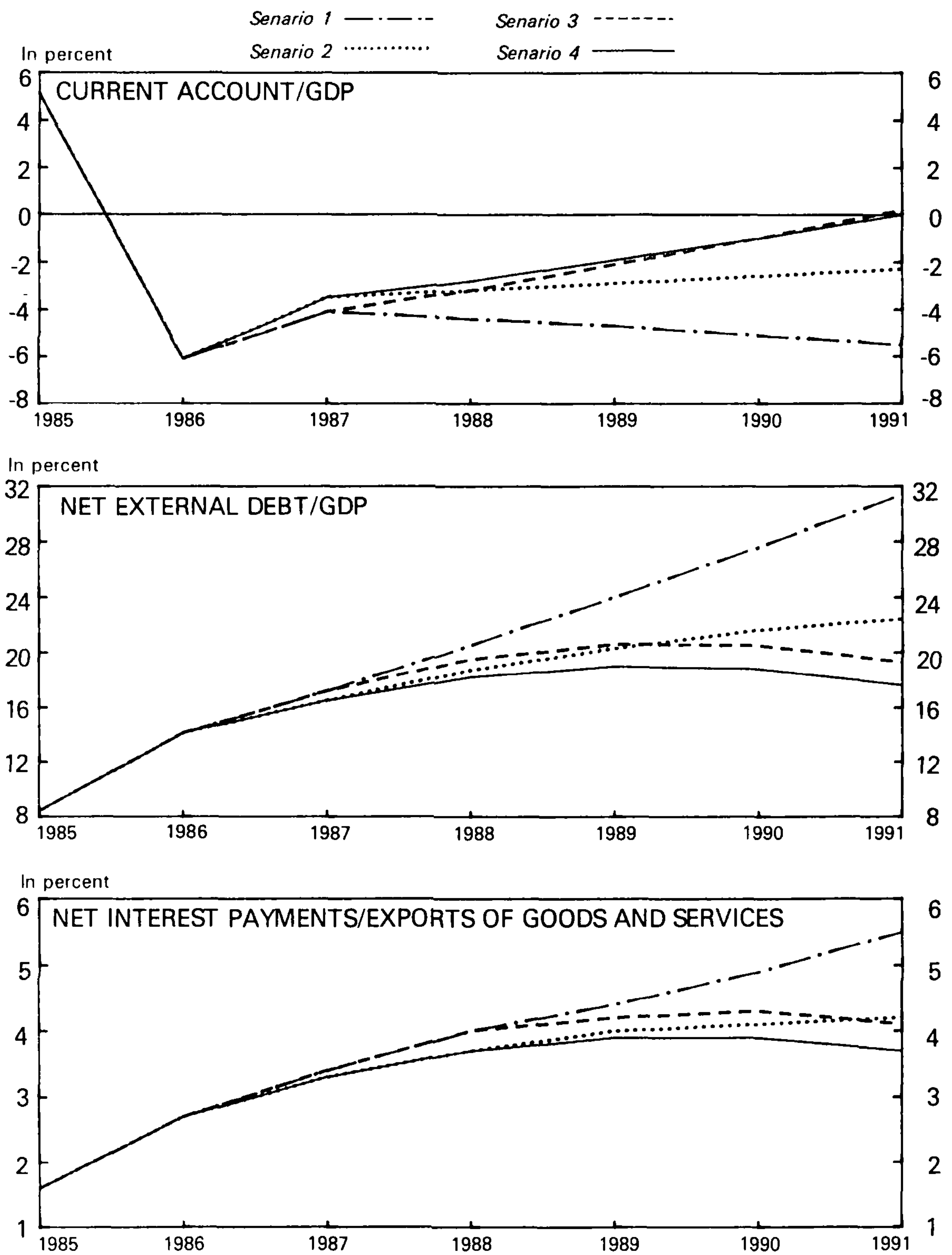
assumption (Scenario 4), domestic demand growth would have to be about 2 percent per year over the 1988-91 period, to achieve external balance by 1991.

A lower real exchange rate could substitute for demand restraint over the 1988-91 period. Based on the trade elasticities used in this model, another 2 percent real devaluation in 1988 sustained over the period could achieve about the same results by 1991 as reduction in real domestic demand to a 0.5 per annum below the rate of demand growth in partner countries.

CHART 8

NORWAY

MEDIUM-TERM SCENARIOS



Source: Data and projections provided by Norwegian authorities; and staff estimates, projections and calculations.

Fund Relations with Norway

(As of end-May 1986)

I. Membership status

(a) Date of membership: December 1945.

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

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 699.0 million.

(b) Total Fund holdings of kroner: SDR 221.46 million (31.68 percent of quota).

(c) Fund credit: none.

(d) Reserve tranche position: SDR 477.54 million.

(e) Current operational budget: Norway was included in the March-May 1986 operational budget for the amount of SDR 44.2 million on the transfer side and SDR 13.4 million, on the receipts side.

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

III. Stand-by or extended arrangements and special facilities

None.

IV. SDR Department

(a) Net cumulative allocation: SDR 167.77 million.

(b) Holdings: SDR 282.07 million or 168.13 percent of net cumulative allocation of SDRs.

(c) Current designation plan: not applicable.

V. Administered accounts

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

VI. Overdue obligations to the Fund

None.

VII. Norway has not used Fund resources to date.

B. Nonfinancial Relations

VIII. Exchange rate arrangements

The value of the krone has been maintained within narrow margins (2 1/4 percent) in relation to a basket of currencies of major trading partners since December 1978, when Norway discontinued participation in the European common margins arrangement. In August 1982 the number of currencies included in the basket was increased from 12 to 14 and the weights of the individual currencies were changed. At the same time the krone was devalued by 3 percent in effective terms, and a further 3 percent devaluation followed a month later. On July 2, 1984, the basis for calculation of the effective exchange rate index was changed from an arithmetic average to a geometric average and both the effective exchange rate and the central value of the swing range were in effect depreciated by 2 percent. In September 1984, the effective exchange rate was depreciated by an additional 2 percent. The effective exchange rate has remained stable until May 12, 1986, when the central value of the Norwegian krone was devalued by 10.7 percent.

IX. Last Article IV consultation

Discussions for the 1984 Article IV consultation were held in Oslo during the period October 10-22, 1985. The Staff Report (SM/84/266, 12/3/84) was discussed by the Executive Board on December 21, 1984 (EBM/84/188). It is expected that the next Article IV consultation will be held on the standard 12-month cycle.

Norway - Statistical Issues

The following information is based on reports sent to the Bureau of Statistics by the Bank of Norway and the Central Bureau of Statistics, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest data in June 1986 IFS
Real Sector	- National Accounts	Q1 1985
	- Prices: Industrial Share Prices	January 1986
	Home and Import Goods	March 1986
	Consumer Prices	March 1986
	- Production: Industrial Production	February 1986
	- Employment: Total Employment	Q3 1984
	- Earnings: Wages	Q4 1985
Monetary Accounts	- Monetary Authorities	February 1986
	- Deposit Money Banks	November 1985
	- Other Financial Institutions	November 1985
Government Finance	- Deficit/Surplus	1983
	- Financing	1982
	- Debt	1983
Interest Rates	- Discount Rate	October 1985
	- Bank Lending/Deposit Rate	Q2 1984
	- Bond Yields	February 1985
External Sector	- Merchandise Trade: Values	March 1986
	Unit Values	Q4 1985
	- Balance of Payments	September 1985
	- International Reserves	April 1986
	- Exchange Rates	April 1986

Norway: Basic Data

Area	323,883 square kilometers
Population	4.2 million (end-1985)
GDP in 1985	NKr 497.8 billion; per capita SDR 13,576

	1983	1984	1985	1986 1/
	(Volume change in percent per annum)			
GDP	4.5	5.6	4.2	4.3
GDP, excluding shipping and oil activities	2.5	3.6	4.3	3.4
Domestic demand	1.1	5.7	2.7	7.5
Private consumption	1.5	2.7	8.2	5.1
Public consumption	4.6	2.0	3.4	1.1
Gross fixed investment	5.8	8.7	-21.9	28.8
Exports of goods and services	7.3	7.5	10.0	2.3
Imports of goods and services	--	8.2	7.7	10.1
	(In percent of labor force)			
Unemployment rate	3.3	3.0	2.5	...
Including persons employed under labor market measures	4.6	4.7	4.3	...
	(Change in percent per annum)			
GDP deflator	6.2	6.6	5.7	...
Consumer prices	8.4	6.3	5.7	5 1/2-6.0
	(Change in average levels, in percent)			
Exchange rate (- is depreciation)				
Effective				
Official weights	-3.3	-2.0	-2.3	...
MERM	-6.2	-4.2	-2.2	...
Real (relative unit labor costs in manufacturing)	1.4	4.7	0.5	...
Terms of trade	-1.2	7.1	-1.7	...

Sources: Data provided by the Norwegian authorities; International Monetary Fund, International Financial Statistics; and staff calculations and estimates.

1/ Official projections and staff estimates.

Norway - Basic Data (Cont'd.)

	1983	1984	1985	1986 1/
	(Change in end-period values, in percent)			
Money (M_1)	10.8	23.4	20.7	...
Money plus quasi-money (M_2)	9.4	19.8	15.0	...
	(In percent of GDP, excluding oil and shipping)			
				Approved budget
Central government				
Revenues, excluding oil and transfers from the central bank	42.4	43.0	44.7	45.0
Expenditures, excluding oil expenditures	49.6	48.9	49.0	51.5
Balance	-7.2	-5.9	-4.3	-6.5
Balance, including oil revenues and expenditures	2.0	4.7	5.0	0.4
	(In percent of GDP)			
Current account balance	3.6	5.4	5.1	-6.1
Net foreign debt	22.4	17.0	8.4	...
	(In billions of Norwegian kroner)			
Exports, f.o.b.	133.2	157.0	172.6	133.4
Of which: oil and gas exports	(63.9)	(78.3)	(85.1)	(51.9)
Imports, c.i.f.	-102.5	-117.1	-133.7	-149.4
Trade balance	30.7	39.9	38.9	-16.0
Net services and transfers	-16.1	-15.5	-13.3	-15.1
Current balance	14.6	24.4	25.6	-31.1
(in billions of SDRs)	(2.0)	(2.9)	(2.9)	...
Gross reserves (end-period) (in billions of SDRs)	6.4	9.6	12.9	...
Gross reserves (end-period) (in weeks of merchandise imports)	26	38	42	...

1/ Official projections and staff estimates.