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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/110

3:00 p.m., July 7, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	
	L. Hubloue, Temporary
M. Finaish	
	M. Sugita
G. Grosche	
	Yang W., Temporary
J. E. Ismael	
	J. Hospedales, Temporary
	R. Fox, Temporary
H. Lundstrom	
	W. N. Engert, Temporary
	W. K. Parmena, Temporary
	C. A. Salinas, Temporary
Y. A. Nimatallah	
	J. E. Rodríguez, Temporary
	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
	B. Tamami, Temporary
A. K. Sengupta	A. S. Jayawardena
	A. Vasudevan, Temporary
	F. Di Mauro, Temporary

L. Van Houtven, Secretary
R. S. Franklin, Assistant
L. Collier, Assistant

Also Present
IBRD: A. C. Tsantis, South Asia Regional Office. Asian Department: H. Neiss, Deputy Director; F. Le Gall, A. K. McGuirk, D. A. Scott. Central Banking Department: C.-J. Lindgren. European Department: L. A. Whittome, Counsellor and Director; R. K. Abrams, J. Khallouf, A. Knöbl, S. Mitra, A. Mountford, H. O. Schmitt. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director, J. T. Boorman. Legal Department: P. L. Francotte, L. Maktouf. Middle Eastern Department: S. M. Thakur, S. Thayanithy. Secretary's Department: A. P. Bhagwat. Bureau of Statistics: M. R. P. Salgado. Advisors to Executive Directors: W. R. Bengs, M. B. Chatah, L. P. Ebrill, G. Nguyen, A. Ouanes, I. Puro, M. Z. M. Qureshi. Assistants to Executive Directors: J. R. N. Almeida, O. S.-M. Bethel, B. Bogdanovic, V. Govindarajan, A. R. Ismael, M. Lundsager, T. Morita, D. Saha, S. Simonsen, H. van der Burg.

1. SRI LANKA - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/109, 7/7/86) their consideration of the staff report for the 1986 Article IV consultation with Sri Lanka (SM/86/139, 6/16/86). They also had before them a report on recent economic developments in Sri Lanka (SM/86/143, 6/23/86).

Mr. Alfidja said that as he was in broad agreement with the staff appraisal, he could support the proposed decision and would limit his remarks to comments on economic developments in 1985 and prospects for 1986. In spite of adverse domestic and external factors, Sri Lanka had been able to achieve a rate of real economic growth of 5 percent in 1985, or about the average of the previous three years. At the same time, inflation had been substantially reduced. The deterioration in Sri Lanka's terms of trade in 1985 had contributed not only to a worsening of the external balance but also to a reduction in earnings from export taxes, which had caused the fiscal deficit to increase. Like other countries dependent on only a few export commodities for the major part of their foreign exchange earnings, Sri Lanka was constrained in its efforts to raise additional budgetary revenue and build up external reserves, a fact which made it all the more important for the authorities to intensify their diversification efforts. Some success in that area had apparently been achieved, according to Mr. Jayawardena. Earnings from nontraditional exports in 1985 had been slightly higher than earnings from traditional exports, which indicated that the policies being followed by the authorities to induce economic development by encouraging foreign investment in export industries were succeeding and should be vigorously pursued. The creation of the Industrial Policy Committee to review the current system of incentives and develop an overall strategy for the industrial sector was welcome.

Remarking on the outlook for 1986, Mr. Alfidja observed that real GDP was projected to increase in the range of 4-5 percent, with the agricultural recovery continuing its contribution to growth. The deficit on both the budget and the external current account was expected to climb. On the budget side, he welcomed the measures the authorities were taking to contain expenditure and increase revenue. While improved elasticity for the tax system and further reductions in expenditures--including adherence to strict expenditure controls--were essential, he agreed with the authorities that in the present political climate, it might be difficult to introduce stronger measures that might turn out to be counterproductive. Nevertheless, he encouraged the authorities to keep the fiscal situation under close scrutiny. As for the external sector, he welcomed the review of customs and administrative procedures aimed at reducing the cost of exports and the other measures being adopted by the authorities to increase export volume. However, in view of the uncertainties surrounding export prices, the authorities needed to keep the situation under constant review and must be prepared to take appropriate measures, should those become necessary.

Mr. Rodríguez noted that since 1977, the Sri Lanka authorities had embarked on a program of economic reform that, within a framework of measures geared to a more market-oriented economy, had been successful in promoting a stable economic growth averaging approximately 6 percent per year. The deregulation of the private sector and the expansion of investment by the public sector had led to a wide range of favorable results in the area of import substitution. New productive land had been created through the implementation of irrigation projects, and the completion of the Mahaweli Power Project had increased the capacity for hydroelectric power generation, making economic production less vulnerable to shortages of imported energy, a primary requirement for industrial development.

The Sri Lanka authorities must be commended for having successfully maintained the high level of economic growth in recent years at a time when most economies in the world had been experiencing stagnation or quite sluggish growth, Mr. Rodríguez continued. Significant progress had been achieved in 1984 after the successful implementation of corrective economic policies under which the authorities had been able to reduce the rate of inflation, the fiscal deficit, and the external current account. Unfortunately, the recent decline in the price of tea in the world market had affected export receipts and, consequently, government revenues. In addition, domestic political disturbances had forced the authorities unexpectedly to increase expenditures, thus making it more difficult to reduce the fiscal deficit.

Noting that he was in general agreement with the staff appraisal, Mr. Rodríguez said that he would limit his comments to the fiscal stance in Sri Lanka, which he considered quite improved. Following a temporary relaxation of budgetary discipline in 1985, prospects for the fiscal deficit seemed more favorable for 1986, due to the strengthening and rationalization of revenues and, more important, to the authorities' intention to limit nominal expenditure to the level reached in 1985. In particular, he welcomed the authorities' intention to proceed with reform of the food stamp program and to implement the new excise tax, business turnover tax, and withholding tax on interest income. Also welcome were the steps already adopted to restrain expenditures. The disciplinary actions undertaken by the authorities with regard to expenditure by ministries were appropriate. Moreover, the establishment of monitoring committees to improve economic performance in the public enterprises and the effort to reduce subsidies were admirable steps toward adjustment in an economy with a very low per capita income. The objective of reducing the fiscal deficit in 1986 by the equivalent of 3 percent of GDP was commendable in present circumstances; nevertheless, because the current imbalance in the fiscal area was unsustainable, it would be necessary gradually to make further efforts to avoid a disruption in economic growth that would be vitally important for the absorption of the incoming labor force and for the long-term development program.

The staff representative from the Asian Department observed that both the staff and the Sri Lanka authorities were agreed that, for the medium term, the lack of a more dynamic export sector limited the prospects for future growth and formed the basis for concern about the evolution of Sri Lanka's debt profile. There were no important differences between the staff and the authorities with respect to the medium-term scenario; and the concerns outlined on page 24 of the staff report were meant to identify the most important areas for reservations about the assumptions underlying the baseline scenario, particularly the assumptions relating to exports and imports.

There were important reasons for assuming a restraint on imports in the period ahead, particularly given the changing pattern of public sector capital formation, the staff representative continued. As the Mahaweli Project neared completion, it was only natural to expect a decline in the capital output ratio and in the import intensity of public sector investment expenditure. However, while the direction of change was clear, the magnitude of change in those factors over the next two to three years was uncertain. What was clear was that the burden of debt servicing for Sri Lanka would rise, and a financing gap would emerge to the extent that presently identifiable sources of long-term capital flows were not sufficient to meet the financing needs. The authorities expected that the financing gaps would be filled in large part through export credits--from a number of donor countries--linked in some way to investment projects supported by the donors. In that respect, the authorities were not anticipating having to fall back on resources from the commercial banks and the international capital markets. However, if export performance were to be less satisfactory than assumed or if imports were to be higher than anticipated, the additional burden might require significant recourse to the financial markets. And such an approach might prove difficult in circumstances where the export and import developments were evolving less favorably than assumed in the medium-term scenario.

A number of Directors had touched forcefully on what the staff foresaw as two of the major issues with which the Sri Lanka authorities must deal effectively to achieve a better medium-term outlook, the staff representative recalled. The first concerned the fiscal situation. At present, the public sector was absorbing such a large share of domestic financial resources that there was little left with which to promote more vigorous private sector activity. In that respect, the role of the public sector and the pressure placed by it on the balance of payments was one of the fundamental problems to be faced by Sri Lanka over the medium term. Another problem was related to the failure over the past six to seven years to achieve a more diversified export sector. In the first few years following the reforms of 1977, the industrial sector in Sri Lanka had showed promising export-oriented growth, but that growth had slowed appreciably of late, in part because of a lack of support at a high political level from what might be called the "export constituency."

A number of Directors, while commenting on the need to strengthen the revenue effort, had noted the current high revenue/GNP ratio and had wondered how much more of the burden of ameliorating the fiscal deficit could be borne by revenue increases, the staff representative noted. The staff and the authorities were generally agreed that it would not be easy in the short term to push revenues beyond 20-21 percent of GNP in the absence of unexpected developments in commodity prices of the sort that had emerged in 1983 and 1984. There was some scope for improving tax administration and the structure of taxes, but a reduction in the fiscal deficit must by and large be a matter of reducing expenditures and improving efficiency in the public sector enterprises.

In response to those who had asked about the evolution of the revenue structure in Sri Lanka, the staff representative observed that the structure was not quite as elastic as might be hoped. Beginning in the 1970s, exports--particularly primary commodity exports--had been heavily taxed, mainly through the instrument of the multiple exchange rate. While the rates had been unified in 1977, export taxes had continued to play an important role in the Sri Lanka economy because of the commodity price boom. Since 1977, the burden of taxation on exports had been reduced as a matter of policy, and alternative sources of revenue from taxes on manufacturing and on imports had been developed. However, in the staff's view, any further increases in revenue would probably have to come from improved tax administration. To put the matter in perspective, it should be noted that the import duty on sugar alone in 1985 had yielded about the same revenue as the total of the individual income tax. That revenue item would be a transitory one in view of the costly arrangements the government had entered into for the development of the domestic sugar industry.

Questions had been raised with respect to the consistency with historical trends of the monetary targets for 1986, particularly the projected expansion in total monetary liabilities in relation to the growth in those liabilities in 1985, taking into account the expectation that domestic prices would rise somewhat more rapidly in 1986, the staff representative said. In 1985, there had been a pronounced slowing of inflation, together with a fairly substantial growth in monetary liabilities; for 1986, the projected relationships between inflation and the growth in the monetary liabilities were quite consistent with longer-term historic trends.

A number of Directors had wondered whether the fiscal situation might not place greater pressure on monetary policy than had been suggested in the staff report, the staff representative recalled. The question was a difficult one to answer because, historically, decisions had been taken on an ad hoc basis throughout the year to support development projects and programs, which meant that it was not easy to define a pattern for supplementary expenditures. As a result, it was difficult to be more specific on the likely evolution of the budget and the domestic financing of the budget for 1986 than the staff had been in its report.

The flexible management of the exchange rate by the authorities in 1985 and through the first half of 1986 had been a great help in correcting the appreciation that had emerged in the first four years of the current decade, the staff representative considered. The staff would encourage the authorities not to rely on any particular target in relation to an effective exchange rate index based on 1980 or some similar year. The security problem which had emerged most forcefully had fundamentally altered factors affecting the balance of payments. A more important concern should be the competitiveness of the export sector and the balance of payments outlook in a medium-term context. Of course, the staff welcomed the degree to which the overvaluation of the rupee seemed to have been ameliorated over the past 15 months.

Finally, the staff representative observed that a number of Directors had referred to the recent work of a Central Banking Department team on a range of issues in Sri Lanka's financial system. The study had been broadly based, with experts having spent several man-months looking at the efficiency and cost effectiveness of the two major state commercial banks. Those banks accounted for more than 80 percent of the total assets of the commercial banks in Sri Lanka, and their operating and administrative costs were important elements in the level of interest rates. One of the findings of the staff team was that the administrative costs in the two state banks--including reasonable provision for doubtful loans--were sufficiently high as to have raised the level of interest rates on lending appreciably above the cost of funds in the marketplace to the state commercial banks; and a number of recommendations had been put forward to help the Government and the banks improve the efficiency and cost structure of their operations.

The staff representative from the World Bank observed that some of the projects recently undertaken in Sri Lanka involved the implementation of a number of policy measures. For some two years, the Bank had been actively involved with the Government of Sri Lanka in substantive discussions on the management of the plantations, and the authorities had implemented measures affecting the financial liabilities and structural management of those plantations as well as wage incentives to workers. Many of the measures had been implemented in advance of an appraisal by the Bank on the understanding that policy reform would have to be under way before the project went to the Board. Similarly, a power rehabilitation project that would soon go to the Bank Board for approval had been designed on the basis of a report reviewing the structure and level of tariffs and financial conditions existing in the sector. More generally, a number of projects that were current or that had gone to the Board over the past few years had involved substantive analyses and discussions with the Government as well as the implementation of a number of policy measures in the sectors in which the projects were situated.

For the future, the staff representative continued, a number of projects were on line. In May 1985, the World Bank Executive Board had approved the second industrial development project, one element of which was the call for a comprehensive industrial development strategy by the Government. It was expected that as part of that strategy the Government would implement further reforms on tariffs, introduce production and export incentives, and attempt to address the problems in the public enterprises by proposing measures to rationalize, restructure or even close down some of those enterprises. The Bank was prepared to propose to the Executive Board an industrial sector loan for Sri Lanka if the Government was willing to come forward with an integrated industrial development strategy of the sort he had described. Similarly, the Bank would be discussing with the authorities over the next few months its agricultural sector report. The hope was that it would then be possible to develop a package of policy measures for agricultural development and diversification that could be supported through an agricultural sector loan.

Mr. Jayawardena noted that his Sri Lanka authorities had kept in close contact with the Fund over the years; indeed, apart from technical advisory missions on fiscal, statistical, and financial aspects, there had been two staff visits to Sri Lanka since the previous consultation and the subsequent deterioration in the external position, and those visits had been helpful in the effort to identify problems and find solutions to them. It was to be hoped that the close relationship between the Fund and Sri Lanka could be maintained in the difficult period ahead.

As all Directors had highlighted, the Sri Lanka authorities were grappling with a difficult economic situation, Mr. Jayawardena continued. The problems would have been insurmountable if not for the retirement of short-term commercial debt and the buildup of reserves during the two previous years, when the terms of trade had improved after a long period of deterioration. Moreover, the high investment and open economic policies during the post-1977 period had left Sri Lanka in a somewhat stronger position to withstand external difficulties than might otherwise have been the case. Continuing economic growth essentially reflected the dynamism of the relatively unfettered private sector, which had benefited greatly from the rehabilitation and improvement in infrastructure and from the progressive elimination of distortions in the economy. Understandably, many Directors were disappointed at the pace of reform of the public sector. The authorities had experienced unanticipated difficulties in that area and felt that while the progress achieved thus far had been below their own expectations, it was not inconsiderable.

The main focus of Directors' comments had been fiscal policy and the need to contain the fiscal deficit within reasonable limits, Mr. Jayawardena recalled. As the staff and Mr. Dallara had clearly pointed out, the fiscal deficit was a structural problem that had been compounded by recent difficulties. The authorities saw a long road ahead in the effort to correct the imbalance. Government revenue was already running 20-21 percent of GDP, which was a high ratio indeed; and any increase would be difficult, especially given the degree of external trade dependence on revenue. The point that the tax base had not been adequately widened was well taken, although some progress had been made. The Sri Lanka authorities believed that much could be gained by further improving tax administration. At present, a Fund fiscal advisor was in Sri Lanka assisting the tax department, and one of the major tasks to be accomplished was the computerization of the tax process, which would no doubt enhance verification and the effectiveness of tax collections. Moreover, most of the generous tax exemptions referred to in the staff paper and by several Directors had been withdrawn, so that only a few incentive-related exemptions remained. Marginal income tax rates had been reduced to encourage greater compliance, but there was a need to translate transient types of revenue to revenue from more permanent and reliable sources.

As most Directors had emphasized, adjustment would need to focus on the expenditure side, Mr. Jayawardena commented, and he understood that every effort would be made to contain the fiscal deficit to the level forecast for 1986 so that that outturn could be taken as a starting point for the medium-term fiscal exercise. While economic imperatives dictated the need to take a medium-term view of the expenditure situation, the task was an enormous one; and his authorities were still in the process of evolving a general consensus on the matter. For the sake of preventing slippages in policy, the Sri Lanka authorities would push forward as strenuously as possible in a number of areas, including public enterprise reform. Of course, judging by past performance, success in that area would not come easy; however, draft legislation had been prepared with a view to converting public enterprises to public companies with share capital, a measure that would enable the Government to divest ownership in stages by disposing of shares to the public. Also, one of the major public sector enterprises that had placed a strain on the budget--the Central Transport Board--had been scheduled for closure on August 1.

The Sri Lanka authorities had undertaken a number of measures to strengthen expenditure control, Mr. Jayawardena commented. The weakening of expenditure control had arisen mainly because of the speeding up of a massive public investment program commencing in 1977, when some projects planned for implementation over a 30-year period had been telescoped into a 5-year perspective. With the winding down of that program, the authorities had been reinforcing public expenditure controls, especially with respect to "advance accounts" and other fiscal slippages. Also, the proposed Public Administration Reform was intended to improve the quality of public servants in expenditure appraisal and control mechanisms.

On monetary policy, most Directors expressed the need for an early transition to a market-related system, Mr. Jayawardena recalled. One of the important reforms made some years previously had been the opening of the banking sector to competition, especially from foreign banks. Also, government borrowing rates had been raised nearer to market levels. Still, some structural rigidities remained, and two state banks continued to account for three quarters of banking activity in Sri Lanka. Recently, his authorities had permitted the establishment of an indigenous commercial bank, which might introduce greater and more effective competition in a local context than small branches of foreign banks. In addition, the interest subsidy to the National Savings Bank had been reduced; in that context, it should be noted that a rapid move away from regulatory controls might not be advisable, given the difficult fiscal situation and the need to keep imports in check, at least until the exchange rate could take care of that aspect of the problem. With some rise in inflation in 1986 from the very low levels registered in 1985, the Sri Lanka authorities were not likely to push interest rate below inflation in the current year. The need for a stringent monetary policy and positive real interest rates, given the fiscal problems and the need to prevent capital flight, was well understood.

The Sri Lanka authorities were well aware of the downside risks involved in the medium-term outlook, Mr. Jayawardena remarked. There was little to add to the remarks by the staff representative from the Asian Department except to note that export income and capital flow assumptions were relatively conservative in the staff's scenario. In 1977-78, when the first reforms had been undertaken, similar uncertainty had existed, and it had been far from clear at that time how export growth would materialize and how imports would behave in a liberalized milieu; and the current situation was not dissimilar.

In response to those who had questioned the forecast for imports, Mr. Jayawardena remarked that the assumption of reduced import intensity of investment had been made on the basis of a sharp fall in capital output ratios observed in Sri Lanka as a result of the winding down of the large public investment program. Of course, the situation would be kept under review. On the exchange rate, he was thankful that his colleagues had recognized that the authorities had managed the rate flexibly in the recent past. Indeed, if one were to employ the Fund's real effective exchange rate index, it would be seen that there had been a virtual elimination of the appreciation of the Sri Lanka rupee since 1980; and his authorities' own statistics showed a real effective exchange rate index of 97, with 1980 as the base. Some Directors had queried the perceived appreciation before 1980. In that respect it should be recalled that in 1978, the rupee was depreciated more than had been warranted, in anticipation of the subsequent and immediate inflationary impact. In general, his Sri Lanka authorities saw that the flexibility of the exchange rate must be based on a variety of economic variables, including the competitiveness of the export sector and the pattern of imports. From that perspective, they were determined to maintain a flexible exchange rate policy with a view to strengthening the balance of payments and improving incentives in the domestic economy.

The Acting Chairman made the following summing up:

Executive Directors noted with concern that although economic growth in Sri Lanka was maintained at 5 percent in 1985 and inflation declined, large fiscal and external imbalances had re-emerged. The major factors contributing to those imbalances--sharply lower export prices and increased defense spending--were likely to persist for some time, and the authorities would therefore need to strengthen economic policies in order to meet their objectives for 1986 and beyond. Many Directors, after recalling the favorable impact of the economic reforms of the late 1970s, noted that remaining structural rigidities and distortions inhibited the growth potential of the country.

Directors viewed the large fiscal imbalance as a major source of financial instability and the most difficult problem facing the authorities. Improved fiscal control was thus essential for the authorities to achieve their monetary and inflation targets and to strengthen the balance of payments.

Directors were especially concerned about the large expenditure overruns incurred in 1985 and the potential for slippage again in 1986. The need to establish effective budgetary control and discipline was clear: expenditures would need to be reduced to a level more consistent with potential revenue and concessional foreign financing. The authorities' objective of reducing the budget deficit, primarily through expenditure restraint, was commendable but may be difficult to achieve. Given the increase in national security expenditures, Directors noted that reductions in other expenditures would involve difficult choices and would require an unwavering commitment to the objective of reducing the fiscal deficit by the equivalent of 3 percent of GDP in 1986. To that end, the authorities should stand ready to take additional action, as needed, to offset slippages that might develop in outlays or revenues.

Directors stressed that in order to achieve effective control over expenditures, the problems of inefficiency and overstaffing in the public sector must be tackled. The authorities were urged to act more decisively to improve the economic performance of the public enterprises, including the further closing of unprofitable enterprises and privatization where appropriate.

Although in the short run the brunt of fiscal adjustment may have to be borne largely by expenditure restraint, a strengthening of the revenue effort was also called for. Directors agreed with the staff that the new tax measures in the 1986 budget did not go far enough toward reducing the many exemptions and exclusions that weakened the tax system. The authorities were urged to take comprehensive measures to broaden the tax base, strengthen tax administration, and improve private sector incentives. In that regard, it was hoped that the technical assistance provided by the Fund to review the tax system and to advise on ways to improve tax administration would establish the basis for a sustained effort to raise revenue and increase public sector savings.

Directors encouraged the authorities to pursue financial reforms that would improve the efficiency of savings mobilization and resource allocation. While broadly concurring with the authorities' monetary targets for 1986, Directors urged an increase in the role of market forces in the determination of interest rates. They also encouraged more active use of open market operations, a decrease in reliance on selective credit ceilings, and the elimination of the subsidy to the National Savings Bank.

The outlook for growth, the balance of payments, and external debt was worrisome, some Directors observed. With tea prices weak, the external current account deficit might well be higher in 1986 than presently forecast. With foreign reserves low, there was little cushion to absorb potential adverse shocks to the balance of payments. In addition, the slower growth of exports, the expected decline in workers' remittances, and the relatively weaker climate for investment and tourism pointed to steadily mounting external constraints and lower economic growth over the medium term. In the circumstances, Directors stressed the importance of measures that would restore business confidence and strengthen and diversify exports. Such measures would require a renewed commitment by the authorities to increasing economic efficiency in industry and agriculture by reducing protection and improving incentives for export growth and efficient import substitution. Some Directors felt that Sri Lanka's efforts to promote export growth would be greatly helped by a lessening of protectionist tendencies abroad. Directors commended the authorities for their role in the liberalization of the coconut industry and the rehabilitation work in the public estates. Directors welcomed the depreciation of the rupee during the past year and urged continued flexibility in the management of the exchange rate in order to offset the erosion of profitability in the export sector and the weakness in other elements of the balance of payments. Continued restraint in commercial borrowing abroad was also recommended.

In conclusion, Directors stressed that the restoration of business confidence and Sri Lanka's future growth prospects would depend on the authorities' determination to strengthen fiscal policy and export performance and on the introduction of measures that would reduce structural rigidities. The unsettled security situation made it all the more important that the authorities demonstrate their ability to take corrective policy actions at an early date.

It is expected that the next Article IV consultation with Sri Lanka will be held on the standard twelve-month cycle.

The Executive Directors then took the following decision:

1. The Fund takes this decision in concluding the 1986 Article XIV consultation with Sri Lanka, in the light of the 1986 Article IV consultation with Sri Lanka conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Sri Lanka continues to maintain an exchange system which, with the exception of certain limitations on the availability of foreign exchange for personal travel abroad, is free of restrictions on payments and transfers for current international transactions.

Decision No. 8324-(86/110), adopted
July 7, 1986

2. NORWAY - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Norway (SM/86/138, 6/16/86; and Sup. 1, 7/2/86). They also had before them a report on recent economic developments in Norway (SM/86/149, 6/25/86).

Mr. Lundstrom made the following statement:

The Norwegian authorities recognize the growing underlying imbalances in the economy. A sharp fall in oil prices, a more vigorous expansion in domestic demand than intended, and strong price and cost pressures have made corrective measures all the more necessary. Without a reorientation of economic policy, the current account of the balance of payments was expected to swing from a surplus of about 5 percent of GDP in 1985 to a deficit of 6 percent in 1986, with even larger deficits in prospect for the late 1980s if oil prices remain low. In fact, it was recognized that a sustainable balance of payments position would be difficult to attain if oil prices were not to rise from the average 1985 level.

The latest balance of payments figures bear out the dismal projections. In the period January-May 1986, the trade deficit, excluding ships and oil platforms as well as exports of oil and gas, amounted to NKr 32 billion, while a deficit of about NKr 19.8 billion was registered for the same period last year. When exports of oil and gas are included, the trade balance showed a deterioration of NKr 25 billion: from a surplus of NKr 17.6 billion in January-May 1985 to a deficit of NKr 7.4 billion in the same period this year. The current account is estimated to have been in approximate balance in the first quarter of 1986 but is projected to show a large deficit in the second quarter.

Against the background of growing imbalances in the economy, the Norwegian authorities decided on an effective devaluation of the Norwegian krone by 10.7 percent as a first step in an adjustment of economic policy. Without this exchange rate adjustment, which took place on May 11, price competitiveness, measured by unit labor costs, would have deteriorated by 10 percent in 1985-87, after an annual average rise of 1 3/4 percent in relative unit labor costs in the period 1981-85. The timing of the devaluation was largely determined by the pressure against the krone in the last two weeks before the change of government.

The second important element in the reorientation of policy was a tightening of fiscal policy by 1 percent of GDP on an annual basis, amounting to NKr 5-6 billion. For the current fiscal year--corresponding to the calendar year--the fiscal measures represent a policy tightening of NKr 3.5 billion. Expenditures are cut by NKr 620 million, of which one half if related to reductions in labor market measures. Premiums paid to the social security system are being raised by 0.7 percent of gross salaries and wages, amounting to NKr 1,290 million, while increases in excise duties--mainly gasoline tax--are expected to augment government revenues by NKr 1,000 million. In addition, reductions in some tax allowances are calculated to increase revenues by NKr 540 million.

The adjusted central government deficit is now estimated at 3 percent of mainland GDP in 1986, compared with 6 1/2 percent projected earlier. This reduction is the result of not only the fiscal policy measures implemented recent but mainly the higher rate of GDP growth than projected previously and the resultant larger increase in tax revenues.

Credit policy has also been tightened. It is projected that these measures will reduce the money supply growth, broadly defined, from 10.5 percent--as estimated in the national budget for 1986--to 7.5 percent.

The Norwegian authorities stress the importance of improving income policy cooperation in order to dampen price and wage pressures while maintaining high employment and, toward this end, the Government has declared its intention to enter into discussions with the labor market organizations. The authorities have already indicated that priority should be given to a more equitable income distribution and to tax reform.

The fourth element of the Government's economic strategy is structural measures that can improve the efficiency of the economy. In this context, industrial policies and the form and extent of subsidies/loans to different industries will be reviewed. Such measures now amount to nearly 4 percent of GDP excluding oil and shipping activities. The various support schemes to the agricultural sector, the shipbuilding industry, and public enterprises will be reassessed. However, research and development activities will be stimulated. Labor market policies will also be reviewed in order to reduce the rigidities of the market.

The Norwegian authorities emphasize that the above-mentioned measures are the first step in the reorientation of economic policy. A more comprehensive and extensive package to underpin the devaluation will be presented in the autumn. Further cuts in government expenditures will be included in the budget for 1987. Tax reform will be part of the autumn measures. Such a reform is considered essential in order to attain a more equitable income distribution, to reduce price and cost pressures, and to make monetary policy more effective. In designing the 1987 budget, the Government will pay special attention to measures to help reduce private consumption. In view of the great imbalances in the

Norwegian economy, the expressed intention of the Government is that most of the necessary adjustments must take place in 1986 and 1987.

The Fund staff has suggested that a pause in production growth and a 2 1/2 percent reduction in domestic demand may be appropriate in 1987. Moreover, the staff has indicated a target for the current account deficit of 4 percent of GDP in 1987. The Norwegian authorities believe that a strong reorientation of economic policy is needed, but they doubt whether a zero growth target for 1987 is appropriate.

With the policy measures now implemented, the Government's forecast for the current account deficit is of the order of NKr 25 billion in 1986 and NKr 33 billion in 1987. These forecasts are based on an oil price of $15 a barrel and an exchange rate of NKr 7.50 = $1.

The latest figures indicate that the strong growth in the Norwegian economy in recent years has continued in 1986. The labor market is now very tight. Unemployment was down to 1.8 percent, seasonally adjusted, at the end of June. If persons benefiting from vocational training schemes or employed through official employment schemes are included, the unemployment rate would be 3 1/2 percent. Although the number of man-hours worked is increasing more strongly than ever, the number of vacancies has increased and equals 1/2 percent of the labor force. Several sectors--such as building and construction, health care, and, to some degree, manufacturing--are experiencing shortages of skilled workers.

The growth impulses are now coming mainly from fixed investment. In the manufacturing sector, the companies' own investment plans for 1986 show volume increases of 16-35 percent. In the oil sector, investments are expected to rise by 16 percent in 1986. However, with full capacity utilization in most of the branches producing investment goods, it is doubtful whether all the investment plans will be implemented.

As described in the staff report, the growth in private consumption was extraordinarily large in 1985, partly because of a fall in the savings ratio of households. The figures for the first months of 1986 indicate a somewhat lower rate of growth in private consumption. A further dampening of the growth rate is expected throughout the rest of the year. Despite a marked increase in real wages, the growth of private consumption is expected to decelerate during the rest of 1986 because of increased debt servicing and more pessimistic expectations for economic development in general as a result of the fall in oil prices and the tightening of economic policy.

Consumer prices were on average 5.8 percent higher in the first five months of this year than in the same period of 1985. Price developments in the months ahead will to a large extent be influenced by the impact of the devaluation and the large wage increases recently negotiated. The rate of inflation is therefore expected to accelerate in the coming months, and the inflation differentials between Norway and other industrial countries will widen further.

The Norges Bank has estimated that wages and salaries in manufacturing industry may rise by 7-8 percent between 1985 and 1986. If, moreover, the exchange rate index is kept at 112 for the rest of the year, the price competitiveness--measured by unit labor costs--of Norwegian manufacturing industry should improve by 2 3/4-3 3/4 percent in 1986. However, this estimate is based on the assumption that no compensation is granted for the price effects of the devaluation. To avoid a new deterioration in price competitiveness in 1987, a substantial slowdown in the wage drift in the remainder of 1986 and in 1987 is essential, and the shortening of the workweek next year must be accompanied by increased productivity.

The latest figures indicate that the money supply increased by 13.1 percent in the 12-month period to the end of May. The domestic credit supply to the private sector and municipalities showed a steep rise in both April and May. This was primarily a result of a strong growth in lending by commercial banks and savings banks, but it was also due to the fact that the credit supply from other institutions was higher than projected in the revised national budget for 1986.

To limit the increase in lending by the private banks, the supplementary reserve requirements were increased as of June. However, when credit policy is tightened, credit usually finds new channels and liquid assets are held in nontraditional forms. As a result, the usual measures of the trend in credit and liquidity do not completely reflect actual developments. Thus, there are indications that the registered figures for money and credit expansion underestimate the real growth in these aggregates.

Norway will continue to pursue a liberal trading policy, and further measures in favor of the developing countries are being planned. Official development assistance, which in 1986 is estimated to equal 1 percent of GDP, will be kept high in the years to come.

Mr. Grosche commented that like other oil exporting countries, Norway faced the difficult task of adjusting to steeply declining oil prices and export revenues. He commended the new Government for having recognized the need for firmer action, and he fully endorsed its four-part economic strategy, which was directed at reducing Norway's external and internal imbalances while maintaining full employment.

The first element of the strategy was the devaluation of the krone, Mr. Grosche continued. The devaluation in May had become necessary to restore some of the competitiveness that Norway's traditional export goods had lost during the period of booming oil exports and a rising exchange rate. Although the devaluation was sizable it could be considered appropriate, provided its gains were not lost in inflation and were properly used in the framework of a broader financial package aimed at reducing domestic demand to a sustainable level.

Despite the new program, questions remained concerning the strategy's second and most important element--the tightening of fiscal and monetary policies, Mr. Grosche noted. The budget for 1986 presented by the previous administration had fallen short of what was needed, and he welcomed the Government's prompt review. Nevertheless, doubts remained, particularly about the emphasis in the revision on revenue increases over expenditure reductions. Moreover, he shared the staff's view that the fiscal package passed by Parliament resulting in a deficit of 4 percent of GDP was obviously insufficient to take full advantage of the devaluation. Significant additional adjustment measures were likely to be needed in the coming year, especially if oil prices remained low. The authorities' tax reform proposals would be presented later in 1986. The direction of that reform was a subject of debate in Norway, and he would only comment that additional budgetary measures should emphasize expenditure cuts over revenue increases. Among those items where cuts could help to foster adjustment were subsidies, particularly to enterprises. Those cuts should be easier to implement at present because of the competitive edge provided by the large devaluation. He asked the staff or Mr. Lundstrom to indicate any other areas where more expenditure restraint could be displayed.

Monetary policy in 1984 and 1985 had largely accommodated the steep--and even excessive--increase of domestic demand, Mr. Grosche remarked. The full tax deductibility of interest payments resulted in low after-tax interest costs and thus did not sufficiently restrict demand for credit, leading to a highly accommodating monetary policy. The staff indicated that modifications in the tax treatment of interest payments would be considered promptly by the Norwegian authorities; such modifications would be welcome. He commended the reduction in monetary targets in the revised national budget.

The third element of the economic strategy was incomes policy, Mr. Grosche continued. Although he appreciated the good intentions of the authorities to maintain full employment, he was concerned that too smooth an adjustment strategy might produce precisely what gradualism had sought to avoid--higher unemployment. Fears of rising unemployment did not seem well founded, particularly when the staff reported that "rising demand for labor resulted in localized labor shortages and strong wage pressures" and data indicated that in the first quarter of 1986 unemployment had declined even further to 1.8 percent. While unemployment was not a pressing problem, it could become one if adjustment failed to produce new jobs in time. He therefore welcomed the intention of the authorities to bring about an incomes policy that would help to maintain domestic employment by reducing the growth of domestic prices and costs. He was unsure whether that could be accomplished through cooperation between the social partners alone, aided by a reform of the tax system, but the Government should make it clear to both parties that the responsibility for unemployment lay primarily with them.

The fourth element was a revision of industrial, structural, and labor market policies, all aiming at improved efficiency of the economy, Mr. Grosche noted. Not many details had been provided--a more comprehensive and extensive package would be presented in the fall--but he welcomed the statement that the form and extent of subsidies to different industries would be reviewed.

The authorities were to be commended for having embarked on a reorientation of policies, Mr. Grosche commented. He nevertheless urged the authorities to undertake significant additional adjustment efforts. In the absence of a recovery of oil prices or of additional measures, particularly in the fiscal area, the authorities expected a possible widening in the current account deficit in 1987 and a loss of the competitive gains of the May 1986 devaluation. He supported the staff's Scenario 3, which suggested a pause in the growth of output that should bring about a reduction in the current account deficit to 4 percent of GDP in 1987. The price of oil was an important factor, but if it remained as low as $15 a barrel, as assumed in the scenario, the authorities should reconsider their position of aiming at a growth target of higher than zero in 1987. A somewhat higher growth rate in the short run could result in sluggish growth in the medium term.

Mr. Hubloue made the following statement:

> The challenge the Norwegian economy faces today is twofold: first, to adjust to the lower income resulting from the sharp fall in oil prices, and second, to cope with the inflationary and balance of payments pressures resulting from overheating in the business cycle. Indeed, the more serious of Norway's present difficulties appear to be less directly related to its status as an oil exporter than to the strong expansion in domestic demand which that status has fueled; the sharp deterioration of Norway's external trade position over the first five months of 1986 is due as much to the rapidly increasing deficit of the non-oil sector as to the shortfall in oil revenues. It is encouraging to note from Mr. Lundstrom's statement that the authorities are fully aware of the situation and that they implicitly recognize that Norway would probably be experiencing unsustainable financial imbalances even if oil prices had not changed. I therefore welcome their intention to attack these imbalances vigorously.
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> During the previous Article IV consultation discussion on Norway (EBM/84/188, 12/21/84), the Executive Board was generally not in favor of using exchange rate action as a means of protecting

the country's external competitiveness. From the staff's present analysis, I am inclined to conclude that last May's devaluation opens the prospect of a successful adjustment only if it is supported by the implementation of firm financial policies that should lie at the core of the authorities' economic program. Indeed, I have some doubts that the devaluation of the krone will be as effective as the Government could hope in safeguarding Norway's external competitiveness in the coming years. Since the effective devaluation of 10 percent is intended to offset an expected deterioration of similar magnitude in price competitiveness, it seems to leave little room for accommodating the additional wage and price pressures that will be generated by the devaluation itself. To contain these inflationary pressures, the authorities should be encouraged to supplement the modest steps already taken by further tightening their monetary policy and considering firm incomes policy.

The latest money supply figures show a much steeper rise in domestic credit expansion that projected by either the national budget or the recent policy package, and I would be glad to learn from Mr. Lundstrom what measures his authorities have at hand to achieve the targeted tightening of the credit supply.

As to incomes policy, I welcome the Government's intention to open discussions on future wage negotiations with the labor market organizations. The tightness of the labor market provides so little implicit incentive toward wage moderation that close monitoring of the wage formation process will be needed to preserve the benefits of the devaluation. I was therefore somewhat surprised by the announced shortening of the workweek, which should logically be expected to intensify existing labor market pressures. Some explanation of the reasoning behind this decision would be welcome.

Fiscal retrenchment is probably the most promising policy reorientation for redressing Norway's balance of payments situation. At the very core of the country's present difficulties is a strong, domestically oriented expansion of economic activity, supported since the end of 1984 by highly expansionary fiscal policies. To restore a viable external situation without hampering Norway's present growth and investment momentum, fiscal policy will have to be given a key role in redirecting resources from household consumption toward the productive and export-oriented sectors of the economy. Given the high share of public transfers in total government spending and the fact that the present stage of the business cycle is characterized by full employment, there seems to be no convincing argument for further delaying public spending cuts designed to dampen private consumption in favor of business investment. While I welcome the first steps already taken in this direction, I would urge the authorities to begin executing a much more comprehensive fiscal adjustment plan based on spending cuts rather than on further increases in tax revenues as embodied in the recently revised budget. Such a policy reorientation could usefully include revising the present system of interest payment deductibility in such a way as to boost domestic savings. There is no valid alternative to this course if further deterioration of internal and external imbalances, or squeezing of the non-oil export sector, is to be avoided.

The Norwegian economy has shown a number of remarkable strengths in past years, especially its record of high employment, which is the envy of many countries. If these achievements are to be preserved for the future, the authorities must take full advantage of the unique conditions resulted from the devaluation by supporting their exchange rate decision with a strong financial program. Finally, I join the staff in commending Norway for its strong commitment and remarkable record with respect to foreign aid and for the openness of its trade system.

Mr. Wijnholds noted that during the staff mission to Norway, there had been not only a change of government but also a large devaluation of the krone. Subsequently, the authorities had taken additional measures as described by Mr. Lundstrom. Norway had followed a successful strategy of investing heavily in energy production while borrowing externally to finance the current account deficit then repaying most of the borrowing as revenues were received from offshore activities. However, the economy had picked up excessive speed, and signs of overheating had occurred in 1985. Growth of private consumption had surged to 8 percent, labor shortages and wage pressures had appeared, and inflation had not followed the downward trend experienced in other industrial countries. The fall in oil prices at the beginning of 1986 had greatly affected the outlook for Norway's economy in the coming years.

The terms of trade loss was large, Mr. Wijnholds continued. However, a prosperous country such as Norway could withstand that situation better than most countries and should be able to implement the needed adjustment efforts without too much difficulty. It could also be argued that the current situation strongly reinforced the need for policies that had been called for before the oil price decline--namely, demand restraint, the maintenance of competitiveness, and improvement of the efficiency of the mainland non-oil economy. The staff noted that the external outlook had become increasingly precarious before the events of early 1986. In fact, the change in the current account position by 10 percent of GDP to a deficit of about 5 percent of GDP in 1986 was not fully attributable to the fall in oil and gas receipts.

The authorities had chosen a combination of expenditure-switching and expenditure dampening policies to redress the present imbalances, Mr. Wijnholds observed. The devaluation of 10.7 percent was sizable and should promote a considerable shift in resources to the external sector; it should also enable the authorities to proceed swiftly with a reduction in industrial subsidies and loans to industry, which amounted to nearly 4 percent of GDP. He welcomed the Government's plan to review policies in that area; lower subsidies could also contribute significantly to an improvement of the budgetary situation.

Fiscal policy needed to be tightened sharply in order to dampen demand and support the devaluation, Mr. Wijnholds continued. The new Government had introduced a package of fiscal measures that relied mainly on revenue measures, including higher excise taxes on gasoline. While it was understandable that the Government had difficulty in assembling a comprehensive package, both the overall size--0.7 percent of GDP on an accrual basis--and the small contribution of expenditure cuts were disappointing. He hoped that the budget for 1987, to be presented in the autumn, would contain a further adjustment effort. The outlook for the external current account for 1987--assuming no rebound of oil prices--and for government finances would otherwise be unfavorable. He could sympathize with the authorities' view that there was virtually no scope for cutting government expenditure on goods and services, which constituted 12.7 percent of GDP under the revised 1986 budget. However, there seemed to be considerable opportunity for reducing government transfers, which included subsidies to industry, amounting to 35.7 percent of GDP under the revised budget.

A tightening of monetary policy had also been effected as part of the adjustment effort, Mr. Wijnholds remarked. A deceleration of the money supply seemed to be occurring, which was a welcome development after the rapid earlier increases. Nevertheless, Mr. Lundstrom had stated that there were indications that the recorded increases in money and credit were likely to underestimate the actual growth in the aggregates. Therefore, the monetary authorities should remain vigilant and take additional measures if monetary aggregates did not come down sufficiently.

Incomes policy was also part of the economic strategy of the new Government, Mr. Wijnholds observed. The aim to reduce increases in domestic costs and prices through cooperation between the social partners was commendable but might be hard to achieve. With unemployment below 2 percent and the number of vacancies rising, pressures for further large wage increases were strong. The fact that inflation was expected to accelerate in 1986 and 1987 did not augur well for wage restraint. The Government could set an example in setting wages for the public sector. The shortening of the workweek scheduled for 1987 appeared inappropriate in view of the current labor market situation. Perhaps the staff could comment on that point and on incomes policy in Norway in general.

Finally, Norway's development assistance effort was exemplary, Mr. Wijnholds stated.

Mr. Nimatallah made the following statement:

> Over the past decade, Norway has further modernized its economy, maintained a high level of employment, and substantially increased social services. It has also reduced its external

indebtedness significantly and has built up a comfortable level of reserves. Like that of other oil exporting countries, Norway's economy was stretched beyond its normal capacity during the oil price boom. Mainly as a result of continued expansionary financial policies, the economy overheated and by 1985 it was operating at an abnormal and unsustainable level. In the short term, this was reflected in weak fiscal and external positions. In the medium term, structural imbalances emerged, and the competitive position deteriorated with a consequent loss in Norway's traditional export markets.

The important question is whether the decline in oil revenues is temporary or lasting. While this is an open question, the authorities would be well advised to consider the decline lasting; if the situation should improve later, reserves can be built up and adjustment made easier. It is important to bring the economy down to a more normal and manageable level. To achieve this, emphasis should be placed on government expenditure retrenchment. More specifically, however, actions are needed to reverse the excessive growth in aggregate demand caused by expansionary fiscal and monetary policies as well as an overvalued krone. Action on the exchange rate has already been taken in the right directions; I will therefore concentrate my comments on fiscal, monetary, and medium-term export diversification policies.

First, the tightening of the budgetary stance in support of the exchange rate devaluation should help restrain aggregate demand and cool off the economy. I particularly welcome the intention of the authorities to reduce expenditures on public works and on labor market support; such cuts are both appropriate and timely. Nonetheless, the measures to reduce the fiscal deficit fell disproportionately on increases in revenues rather than on expenditure reductions. Given the already heavy burden of taxation, expenditure cuts should be emphasized more in future fiscal retrenchment. In particular, there is scope for containing the growth in transfers because, first, transfer payments have outpaced GDP growth--increasing their share of GDP to 36 percent compared with only 25 percent a decade earlier--and second, the share of transfers in total government spending increased to 79 percent in 1985 and is expected to increase to 80 percent in 1986. More important, as transfer payments are indexed they are likely to engender automatic increases, resulting in a loss of flexibility in the conduct of fiscal policy.

I welcome the authorities' intention to review subsidies and to reassess support schemes for industry and public enterprises. However, improving control over government spending would require a general review of the present mechanism of indexation. I therefore urge the authorities not only to accord more emphasis to expenditure reductions but also to reassess the structure of their expenditures with a view to introducing more flexibility. I would appreciate comments by Mr. Lundstrom or the staff.

Second, I welcome the tightening in monetary and credit policies. Restrictive monetary policy should support the dampening effect on aggregate demand of fiscal and exchange rate actions, thus enhancing the effectiveness of both. However, I wonder to what extent the efficacy of the interest rate as a monetary policy tool is undermined by a taxation system that allows full interest deductibility. In this connection, the recent liberalization of the financial system should be supported soon by tax reforms. The revision of full interest deductibility should be considered in line with the experience of neighboring countries. There appears to be a trend toward reducing full interest deductibility in industrial countries.

Third, the high buoyancy in economic activity since 1984 has brought unemployment to one of the lowest levels in the world. In the process, however, strong upward pressures have been exerted on costs--particularly labor costs--resulting in cost-push inflation. The combination of cost misalignment and the widening in the inflation differential between Norway and its trading partners eroded the country's competitive position and put strong pressures on the krone.

These developments give cause for concern as they might compromise the authorities' objective of diversifying the economy. In particular, there are already strong indications that the traditional sector is suffering from a weak competitive position. The authorities are aware of the importance of safeguarding the traditional sector's competitive position and of diversifying Norway's exports, and they have taken appropriate measures. I agree with the authorities that a substantial slowdown in the wage drift in the remainder of 1986 and 1987 is essential and that the shortening of the workweek expected to take effect next year must be accompanied by corresponding increases in labor productivity. More generally, a meaningful improvement in Norway's competitive position lies in strengthening the link between wage rewards and productivity gains in wage settlements. A realignment of Norway's cost structure with that of its trading partners depends, to a large extent, on the pursuit of fiscal and monetary policies that ensure that GDP growth remains in line with the country's potential; in this connection, I welcome the May 1986 devaluation. I was particularly impressed by the authorities' efforts in reaching an agreement with the trade unions not to compensate for the effects of this devaluation in pending wage settlements. Such restraint should enhance the effectiveness of the exchange rate action.

In conclusion, I praise the authorities for taking a more realistic attitude domestically and internationally. I also commend them for their generous foreign assistance and their liberal trade policies.

Mr. Dallara made the following statement:

Today's discussion provides an opportunity for an interesting analytical exercise--consideration of the adjustment needs of an oil exporter that is as developed and industrialized as Norway, in contrast to the adjustment problems and possibilities facing many other oil exporters--as well as the review of an important Northern European economy. The similarities and differences that emerge in each country in dealing with its adjustment tasks can be noted in various ways.

Performance in the Norwegian economy in 1985 was in many respects favorable, with real growth slightly exceeding 4 percent; a considerable rise in employment and fall in unemployment; a further modest decline in inflation; a substantial surplus on current account; a reduction in the fiscal deficit; and a further reduction in foreign debt and in the debt ratio.

Economic prospects appear more uncertain and less favorable than they were at the time of the previous Board discussion of the Norwegian economy. While the decline in world oil prices was obviously a key factor, the staff report makes a convincing case that the overheating of the economy has created an unfavorable environment in some respects for the initiation of a stronger program of adjustment to lower world oil prices. Empirical evidence throughout the world tends to suggest that the combination of a serious exogenous shock at the time of domestic overheating can ultimately be very damaging for an economy if not dealt within an aggressive manner at the outset. At the same time, the overheating that we have observed, while perhaps contributing to some problems in the adjustment effort, also reflects another perspective.

Some positive developments might enable the authorities to move more aggressively in tackling their problems. Low unemployment, high foreign reserves, and low foreign debt give the authorities some room to maneuver that might not otherwise have existed to make stronger adjustment efforts. The adjustment strategy adopted by the authorities has been well described by the staff and in Mr. Lundstrom's statement, and the supplement to the staff report outlines the precise measures that have recently been taken in the fiscal and monetary areas to implement that adjustment effort. The helpful summary of those recent measures and the brief appraisal at the end of the staff's supplement were welcome; on some occasions, recent economic developments were not appraised. In the present circumstance, that brief appraisal was helpful in placing these measures in perspective.

One issue that arises in looking at the period ahead is the level of economic growth that might realistically, reasonably, or appropriately be expected during the latter half of 1986 and in 1987. We can appreciate Mr. Lundstrom's statement that his authorities doubt whether a zero growth target for 1987 is appropriate. However, taking into account the staff analysis and the statements of the authorities and Mr. Lundstrom on the external position, one is left with the impression that, in the absence of a significant rebound in the price of oil, such an outcome may be more consistent with the long-term sustainable evolution of the Norwegian economy.

We welcome the fiscal measures that have been taken recently, but we wonder why a cut in public consumption has been excluded from the adjustment scenario; we also noted that the fiscal measures that have been taken are focused largely on the revenue side. Given that the ratio of revenues to GDP in Norway is already 45 percent for the central government and 56 percent for general government, we are not comforted by this initial approach to the fiscal adjustment process. Similarly, an increase in transfer payments for health and social services seems questionable in current circumstances, not only because of the immediate effect on the budget but because the growth of transfer payments in coming years may well create further budgetary problems. An approach that was skewed more in the direction of expenditure restraint might have been more appropriate. We recognize that this has been an initial step in the adjustment effort, leading up to a more comprehensive package anticipated for this autumn. We hope that in that package the authorities will consider the possibility of shifting the burden of their effort in the direction of expenditure restraint.

The growth of credit and money in 1985 was overly expansionary in the circumstances, even taking into account the effects of reintermediation as a result of financial market deregulation. Both the growth of net domestic credit this year and the growth range need to be reduced in the remainder of 1986 and in 1987 if Norway is to resume closing the inflation gap with its major trading partners. Therefore, we welcome the reduction in this year's target for the growth of M2 from 10.5 percent to 7.5 percent.

We also welcome the liberalization of direct monetary controls, in particular the elimination of controls on deposit and loan interest rates last year, and the new commitment not to reduce interest rates until demand pressure in the economy eases. In the difficult period of adjustment that may well lie ahead, interest rate policy can be a particularly important instrument to help foster domestic savings and to facilitate the international capital flows that will be needed to help finance the targeted current account deficit.

With respect to the balance of payments outlook, where a dramatic shift is under way, the targeted 4 percent deficit on current account for 1987 may be somewhat ambitious, given the Government's other objectives and given the fiscal and monetary posture evidenced to date--in the absence of a further recovery of world oil prices. The recent devaluation of the krone and the new fiscal and monetary measures should contribute to the achievement of that balance of payments outcome.

On the exchange rate, it is not clear to us--given the steady rise in relative unit labor costs in prior years--that the move has gone far enough. For example, the staff report notes that competitiveness of traditional exports was affected by a real effective cumulative appreciation of the currency of 30 percent based on relative unit labor costs between 1973 and 1985. We would welcome any comments the staff or Mr. Lundstrom may have on this interesting issue.

In the medium term, the balance of payments outlook is uncertain--indeed, unfavorable--as projected in the four scenarios contained in Appendix I of the staff report, at least to the extent that the outlook is based on a constant real price of oil of $15 a barrel. In that circumstance, if Norway is to grow as rapidly on average over time as its trading partners, there appears to be little prospect of a decline in the current account deficit relative to GDP, ranging to around 5.5 percent in 1991 compared with 6.1 percent envisaged in 1986. Alternatively, if current account balance were to be achieved by 1991, then real growth in the four-year period 1988-91 would have to be limited to the modest 1.5-2 percent range. We recognize the difficulty in reaching any precise judgment about what is a sustainable balance of payments position in Norway in current circumstances. But, in looking at the measures that are contemplated for this fall's budget, we have some concern about the approach taken, bearing in mind the difficult balance of payments prospects over the medium term.

Regarding the structural elements of the Government's adjustment plan, we welcome the policies that are either under way or in many cases being reviewed, and we look forward with interest to seeing the precise articulation of those policies later this year.

The economic adjustment problem facing Norway has obviously been greatly exacerbated by oil price developments. But it is clear that Norway is dealing with more than just a temporary external shock. Fortunately, in this particular case, the prescriptions that the authorities are considering and that the staff suggests go in the same direction, although perhaps the precise timing and extent of change may not, in all cases, be viewed identically by the staff and the authorities. On the whole, however, the prescription for dealing with the immediate problem facing the economy is also consistent with the policies that are needed to address the potential medium-term problems as well. A start has been made in this economic adjustment effort through the devaluation in May and through the more recent fiscal and monetary measures. We welcome them, but, like a number of other Directors, we are not entirely confident at this point that the macroeconomic policy actions taken to date will be sufficient to deal with the problem. Therefore, we look forward to the upcoming budget and structural measures.

Mr. Leonard made the following statement:

In looking at the Norwegian economy, I wonder to what extent the analysis should distinguish between oil and non-oil activities. Insofar as it is based on the view of oil as a depletable resource, the distinction is largely artificial for most practical purposes as even at the expected 1990 production rate of 80 million tons of oil equivalent a year, present known reserves should last for over half a century, which is close enough to Keynes's "long run."

In such circumstances, it would be understandable, if regrettable, for successive elected governments with life expectancies of four or five years to regard oil operations as integral to the economy as a whole and to use the "oil rent" to maximum shortterm advantage within their periods of office. But to the credut of the Norwegian authorities, they are instead seeking to use oil and gas resources for longer-term economic and social purposes. On that account, and in view of present oil price uncertainties, it is useful in the analysis of developments in Norway to set oil operations to one side so as to bring more clearly to light current trends in the rest of the economy and what may need to be done to preserve internal and external balance on a durable basis.

The staff report has done so and presents clear evidence of overheating in the economy in 1985 and so far in 1986, with a strong rise in domestic demand supported by an easing of fiscal policy and an expansion of money and credit. As a result, the authorities are now faced with predictable consequences in the form of a shift from a current external account surplus to a deficit, a widening underlying fiscal deficit, when oil revenues are excluded; accelerating price rises; labor shortages; significant wage drift; and waning competitiveness.

Fortunately, the new Government, which took office in May 1986, has already acted to effect adjustment of the economy. The actions taken are timely and in the right direction, and I can support them subject to some qualifications and differences in emphasis.

I agree with the authorities that the measures proposed for 1986 will not achieve the required degree of adjustment and that further action will be required in 1987. According to the staff report, however, the authorities appear to prefer to focus the attention of policy on the external deficit on current account rather than on fiscal policy, a position which is also reflected in Mr. Lundstrom's statement. Such an approach seems wrong as it is concerned with a result rather than a cause. Present imbalances in Norway stem from the efforts of the authorities to run the economy at a high degree of utilization of labor and plant capacity achieved through fiscal and monetary action. The necessary cooling off of the economy will depend on corrective measures in the same areas, with the brunt of correction being borne by tight fiscal policy. Supportive action will be required of monetary policy; but with liberalization of the financial system it is not clear that a less accommodating monetary stance as a result of higher interest rates would not, at least in part, be offset by capital inflows, not to speak of the effects of tax deductibility of interest charges. I would, therefore, support an even greater tightening of fiscal policy than the authorities has so far outlined and would wish to see it come about through expenditure cuts rather than revenue increases.

One must also have some reservations about the weight being placed by the authorities on improving incomes policy cooperation in order to dampen price and wage pressures. While in the past, as witnessed by moderate centralized pay settlements, there has been laudable cooperation from labor market participants in their institutional capacity, the high degree of wage drift indicates just how hard it is to prevent market forces from bidding up local additions to these settlements. In the circumstances, some loosening of the labor market by reducing domestic demand appears to be an indispensable condition for containing the growth of domestic costs and retaining the competitive edge given to Norwegian export prices as a result of the currency devaluation. If that is accepted, an obvious start in meeting the condition would be by cutting back on government support for the labor market through public works and other such programs, although an exception should be made for well-focused training measures aimed at correcting mismatches of particular skills' supply and demand.

The illustrative medium-term scenarios prepared by the staff are instructive. To some extent they underscore the artificiality of separating the oil and non-oil activities of the economy, but they do make clear the extent to which changing fortunes in the oil market will make the task of the authorities in managing the economy easier or harder. In the light of the projections, the staff is right in erring on the conservative side in framing their advice to the authorities to concentrate on getting the economic fundamentals right at the present juncture when there is still room for maneuver. That is the best assurance for the future.

Finally, I congratulate the authorities on their exemplary record in foreign aid.

Mr. de Forges commented that the present meeting took place at a time when measures were being comtemplated or implemented by the new Government to address the situation of emerging weaknesses. Therefore it was not easy to make a full assessment, as time was needed to take stock of the policy response.

Since the previous Board discussion of Norway's economic situation, the international environment had changed considerably, Mr. de Forges continued. Given the importance of oil in Norway's exports, the most important feature of that change was the drop in oil prices, with obvious consequences for the Norwegian external accounts. However, the results achieved in 1985 had been enviable, in particular the continued steady growth of the economy, despite a negative contribution by shipping and oil activities; a further deceleration of prices and unemployment; and the surplus of the current account--5.1 percent of GDP--which gave an opportunity to nearly eradicate external indebtedness.

In light of those achievements, it was perhaps surprising that the situation could be greatly affected by a sole exogenous factor, Mr. de Forges commented. However, the sudden decrease in international oil prices had struck the Norwegian economy at a time when the authorities had not yet perceived the fact that overheating of the economy called for policy decisions. The economy had been functioning at full capacity, as demonstrated by a low unemployment rate and high wage increases, fueled by an increasingly expansionary fiscal policy.

The Norwegian authorities seemed to be in agreement with the staff on the necessary short-term adjustment, as the first two parts of their economic strategy--exchange rate and demand management--addressed these issues of mainland and external imbalances, Mr. de Forges commented. The devaluation of the krone, with a view to restoring external competitiveness, appeared appropriate. Its effect would be all the more valuable as no compensation would be allowed in wage negotiations. The demand-management policy decisions, taken in the wake of the devaluation, went in the right direction. The 1986 budget implied a restrictive fiscal impulse of about 0.5 percent of GDP. However, most of the improvements would come from higher than projected tax revenues. He urged the authorities to contemplate a further tightening of fiscal and monetary policies should circumstances turn out to be less favorable. He asked Mr. Lundstrom to comment on his authorities' intentions for 1987, particularly with respect to tax reform.

With respect to the medium-term strategy, he agreed with the authorities' focus, in a second stage, on incomes policy and on structural reforms of taxation, industries, and the labor market, Mr. de Forges continued. Those policies would help to strengthen the industrial base. Given the need to restore the structure of the trade balance, the traditional traded goods sector must be revived and made more competitive. The staff's medium-term scenarios highlighted the sensitivity of the country to oil developments and thus the need to move away from such a dependency. He asked the staff whether those scenarios took into account the huge long-term contract on gas recently concluded with several European countries.

The devaluation had been a first step, Mr. de Forges remarked. It was important at present to control production costs. To do so, a mix of two instruments was called for: a reduction in public transfers and control of wage pressures, which could be facilitated by the slack in oil and shipping activities.

During years of ease, the authorities had pursued wise management of their economy by isolating as much as possible the impact of oil revenues, by striving to preserve the existence of a traditional traded goods sector, and by continuously providing generous foreign aid, Mr. de Forges observed. They had reacted firmly to adverse circumstances; that attitude boded well for the future. He was confident that, should the necessity arise, they would use the same determination. Finally, in view of recent uncertainties, he supported the staff recommendation to hold the next Article IV consultation on the standard 12-month cycle.

Mr. Finaish made the following statement:

> Since we are in broad agreement with the staff appraisal, and in view of the ground already well covered by previous speakers, I shall confine myself to just a few remarks relating to the oil sector.
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> The staff reports that a major factor underlying the recent weakening of Norway's domestic and external financial positions, and the consequent need for a set of tighter financial positions, is the sharp fall in oil prices that took place earlier this year. By the same token, the stance of policies that needs to be adopted in the period ahead is also said to depend a good deal on the outlook for the international oil market. In recent years, the oil sector has contributed a little under 20 percent to Norway's GDP and central government revenues and about 30 percent to its export proceeds. These ratios, while fairly high, are still much lower than corresponding ratios for most other major oil exporting countries; for most of these other countries, they are two to three times as large. The fact that oil market fluctuations and uncertainties can significantly complicate economic and financial management in Norway serves to suggest how much stronger the effect could be on countries with a much heavier dependence on oil. Greater stability in the behavior of the oil market would clearly facilitate the task of policymaking, especially medium-term policymaking, in all of these countries. The attainment of greater stability in the international oil market, however, would require cooperative efforts from all major participants in that market.

Given the uncertainties in the outlook for the international oil market, the staff has appropriately cast its medium-term analysis of Norway's external financial position in terms of alternative scenarios based on differing assumptions with respect to the oil price. As regards oil export volume, a single set of growth rates over the scenario period 1987-91 has been projected. With respect to the projected growth rates for oil export volume, the staff's comments on the following two points would be appreciated.

First, in recent years, while oil export volumes for most major oil exporting countries have fallen substantially, those for Norway have continued to increase rapidly. For instance, Norway's oil export volume is reported to have risen by 25 percent in 1984 and 7 percent in 1985. For the medium-term scenario period, it is not possible to work out precisely from the information provided by the staff the projected growth rates for Norway's oil export volume. However, rough estimates from the information provided suggest that growth in Norway's oil export volume in the years ahead is projected to remain significant, with growth rates of 6 percent a year or more up to 1990. The question that arises is whether such growth rates in oil export volume can realistically be expected given the current and prospective situation of the international oil market.

Second, the staff supplement indicates that the authorities have now revised downward their projection for growth in oil export volume for 1986, although the projected growth rate remains significant. Would one be correct in understanding that growth in oil export volume for the period 1987-90 is also being revised downward from the growth rates assumed in the staff's medium-term scenarios?

Mr. Vasudevan made the following statement:

Norway's recent efforts to contain domestic demand, wage and price pressures, and the adverse effect of the decline in oil prices are commendable. As stated by Mr. Lundstrom, the authorities regard the devaluation of the krone, the reduction of the adjusted central government deficit, the tightening of credit policy, and the strategy to review industrial policy, the various support schemes, and labor market policies as only the first step in the reorientation of economic policy. This is a very positive approach. It is worth recalling that the staff regarded devaluation as the first stage and tightening of fiscal and monetary policies as the second stage of adjustment. From Mr. Lundstrom's statement, it can be gathered that the authorities would go further, and they will present a more comprehensive and extensive package in the autumn to underpin the devaluation. Tax reform to attain more equitable income distribution and to reduce inflationary pressures would be a part of the package. Mr. Lundstrom also indicated that the authorities intend to bring about most of the necessary adjustments and to reduce private consumption within the two years 1986 and 1987. We welcome the measures taken so far and the policy intentions.

We also have some sympathy for the viewpoint of the authorities that, to bring about a reduction in domestic demand that is commensurate with the reduction in the current account deficit from 5.1 percent of GDP in 1985 to 4 percent of GDP in 1987, it is not necessary that output remain unchanged in 1987, as the staff has argued. We are encouraged that growth in private consumption is expected to decelerate in 1986, owing to increased debt servicing and more pessimistic expectations engendered by the fall in oil prices and the tightening of economic policy.

It is essential for the success of the strategy to have a substantial slowdown in wage drift and significant gains in productivity. The recent increase in prices, owing to large wage increases recently negotiated and to the impact of the devaluation, indicates that the price differentials between Norway and its trading partners could widen further. In this context, we attach importance to improving cooperation between the Government and labor market organizations on the one hand and between the social partners on the other.

We welcome the continuance of the liberal trade policy and the addition of agricultural and industrial tariff positions to the Generalized System of Preferences. We congratulate the authorities on increasing official development assistance in 1985 to 0.99 percent of GDP, with virtually all bilateral aid given in the form of grants.

Mr. Tamami made the following statement:

The economy of Norway expanded rapidly during the last decade on account of substantial earnings from the newly developed petroleum export sector. The economy has been able to achieve so far a high level of employment with low inflation, but during the last two years it seems to have generated excessive demand pressure that through upward wage demands, has eroded the competitiveness of the traditional industrial export sector. The safeguarding of this sector is important as a hedge against downswings in the petroleum export market.

The Norwegian authorities appear to be aware of this need and have sheltered the economy through the buildup of substantial reserves as well as repayment of external debt. Nevertheless, the downward change in oil prices seems to have contradicted some of the assumptions underlining the expansionary outlook of the 1986 budget, which did not correlate very well with the rapid deterioration of the situation at both the domestic and external levels.

On the fiscal front, the adjusted budget for 1985 recorded a deficit of 4.5 percent of GDP, a 1.5 percentage point improvement over 1984. However, in 1986, owing to the expansionary stand and declining oil revenues, the budget deficit is estimated to be higher.

While the growth of expenditures is expected to be higher than that of GDP, the decline in oil receipts at the start of 1986 sharply reduced the contribution of oil revenue in terms of GDP. This calls for urgent adjustment of fiscal policy through expenditure cuts and revenue measures. The full impact of the adjustment measures would have to be aimed at the budget situation for 1987 when the reduction in oil receipts will be felt more seriously. Under the new circumstances, the possibility of a tax reform may not be far removed, especially with respect to the deductibility of interest payments.

In support of the fiscal measures, Norway needs to apply a firm monetary policy to control the expansion of credit. The move to market mechanisms in the determination of monetary policy will add a qualitative approach to bank lending and help dampen some of the excessive demand that has been accommodated in the past. An interest rate differential favored Norway but did not seem high enough to lower the level of domestic demand. High wages also put pressure on the exchange rate, which had to be supported by a drawdown of reserves and finally devalued by 10.7 percent in 1986.

While the external position in 1985 seemed favorable with the Central Government's debt repaid, the surplus in the current account was reduced owing to the drop in oil prices and, at current oil prices, seems to be heading for a deficit in 1986. This implies a wider balance of payments deficit for 1987 as the time lag carries forward the effect of the oil price decrease. The Norwegian authorities seem to be aware of the need for strong adjustment measures to reduce the projected external current account deficit. This calls for action affecting the level of domestic demand through a compression of private spending and investment. The recent devaluation of the krone should also contribute to domestic demand restraint. At the same time, the need to improve the competitiveness of the tradable goods sector through wage moderation and cost minimization remains urgent.

Finally, Norway's role in international trade has been played in the context of a liberal trade system. Its official development assistance has been exemplary and will reach 1.15 percent of GDP in 1986; most of the aid is in the form of multilateral assistance, and grants represent the totality of bilateral aid. For this, Norway should be commended.

Mr. Hospedales made the following statement:

I wish to associate myself with the remarks of the staff and of other Directors who have complimented the excellent and generous performance of Norwegian official development assistance, whose ratio to GDP is approximately 1 percent. I welcome the authorities' intention to raise that ratio to 1.15 percent; their commitment to keep the ratio high in the years ahead represents an exemplary approach to international economic cooperation. This commitment is all the more commendable in the light of current adjustment measures: a four-point economic strategy aimed at alleviating external and internal imbalances stemming from a combination of an overheated economy and a sharp fall in oil prices.

The authorities' decision to utilize the accumulated foreign exchange surpluses as a cushion to ease the burden of adjustment over a number of years is well placed. Of course, Norway is in a position similar to that of a number of oil exporting countries in adopting this particular stance of policy, but in the case of Norway its production structure is much more diversified and resilient to external shocks. Production structures are in the process of development and diversification in many other oil exporting countries, but this process is now being constrained by an insufficiency of financial resources, and in these countries economic management is becoming increasingly complicated. It would be important, therefore, that these countries make every effort to strike an appropriate balance between financing and adjustment to ensure that their growth prospects are not unduly interrupted. In this connection, the role of the international financial community cannot be overemphasized.

The staff representative from the European Department noted that speakers had commented that the devaluation of the krone was the first step in the implementation of Norway's comprehensive adjustment program and that supporting fiscal measures should emphasize expenditure cuts over revenue increases. It was, however, difficult to prescribe the Government's scope for further expenditure cuts in the 1987 budget, although some leeway existed in the area of transfer payments. In fact, the Government had already agreed with the labor market organizations that the increase in prices resulting from the devaluation should not be passed through to higher wages or adjustments in the nominal value of a number of transfer payments. In addition, transfers should be reduced in those areas where they reduced the efficiency of production or the allocation of resources, notably industry and agriculture where subsidies had been substantial, and the authorities were reviewing those transfers. Those actions would be at the discretion of the Norwegian Parliament.

The major increase in government spending in relation to GDP resulting from the oil sector's revenue windfall had been for transfers, the staff representative continued; the nontransfer element of government spending had remained constant. Thus, the authorities had stated that it should be easier to cut transfers than to reduce direct government expenditures. The level of taxation was already so high that further tax increases were problematic, even when oil revenues were excluded.

Another supporting measure of the adjustment program was monetary policy, and speakers had wondered whether the target for money supply growth of 7.5 percent was not unrealistic, the staff representative recalled. Restraining the growth of the monetary aggregates would call for severe credit restraint. Nevertheless, that restraint would be necessary to support the devaluation. More important, interest rate policies should be more flexible; consequently, the authorities had not reduced nominal interest rates to the level before the speculative wave. However, it might become necessary to allow interest rates to rise somewhat, given the need to dampen the overheating of the economy, which continued to proceed. In that connection, income tax deductibility of interest costs would have to be addressed in the 1987 budget, to be considered in the fall.

The third supporting measure of the devaluation was incomes policy, and speakers had wondered whether it would be possible to restrain the increase in nominal wages by a firmer application of that policy, the staff representative said. Agreement had been reached between the Government and the trade unions and between labor market participants not to pass through to wages any of the price increase effects of the devaluation. Although that step was welcome, the staff tended to wonder about its effectiveness in terms of actually restraining wage increases in the economy, as in the past the larger share of wage increases had been traceable to wage drift rather than to centrally agreed wage limits. Presumably, as long as the economy remained overheated, wage drift would continue to be substantial and difficult to correct because it took place on local levels and was not subject to central agreement unless legislated. Therefore any wage policy initiative would be more effective if, at the same time, the overheating of the economy were reduced.

As to whether the recent devaluation had been sufficient, staff calculations in the medium-term scenarios assumed that the real exchange rate would change by 2 percent on average between 1986 and 1987 and that that real depreciation of the krone would be maintained through 1991, the staff representative noted. The staff assumed that to the extent inflation rates in Norway continued to exceed those in its trading partners, the nominal effective exchange rate would be adjusted to safeguard the real devaluation that had been built into the scenarios. The staff was somewhat disappointed by the authorities' statement that the devaluation was likely to restore the competitiveness of the economy to its 1985 level only. Presumably that statement was based on different assumptions regarding the inflationary impact of the devaluation or the underlying inflation rate. The staff considered that there should be a pause in the growth of GDP--at least in 1987--before it resumed its capacity growth rate. That was an important element in judging the adequacy of the devaluation; to the extent that the growth of GDP and domestic demand exceeded that aim, pressure on the external balance would be greater.

The staff scenarios had not taken into account the new gas contract that had recently been concluded with several European countries, the staff representative noted. The effect of the contract would result in increased export earnings only after the scenario period. Meanwhile, increases in investment in gas production and in imports of capital goods would affect balance of payments prospects up to 1990.

Only one time path for oil export volume had been included in the staff's scenarios, although different assumptions had been included for oil prices, because the staff believed that volume would be largely determined by investment in process to increase capacity, the staff representative explained. The assumption was that the oil industry in Norway would produce at capacity, but changes in investment--which would continue so long as the price of oil was in excess of $10 a barrel--would take time to work their way through. The growth rate for 1986 had been adjusted by the authorities to reflect the strike in the oil fields; however, they hoped production would recover to capacity levels.

The staff scenarios had not been adjusted in light of the revised oil production figures or of recent stabilization policies, the staff representative stated. Rather, the scenarios gave objectives for current account improvement and the path of domestic demand within the limits of capacity growth. Except for 1987, all scenarios assumed that the economy as a whole would grow at capacity--about 3 percent. Within that constraint, the staff had calculated the contribution to GDP growth that would result from an improvement in the balance of payments and had deduced the necessary restraint on domestic demand from the difference. Thus, within the framework produced by the scenarios, the objectives of policies were determined but not the policies themselves, although the adequacy of policies could be judged. Like the Norwegian authorities, the staff considered the policies inadequate, and it looked forward to the measures in the 1987 budget. He cautioned, however, that the scenarios presented orders of magnitude only and not precise guides for conduct.

Mr. Lundstrom made the following concluding remarks:

> Two main themes ran through most of the interventions made: first, how could such an overheated domestic demand situation be allowed to develop? The central government budget, for instance, exerted a considerable expansionary impulse not only in 1985 but also, in its original version, in 1986. Second, are the authorities sufficiently ambitious in their cooling-off and retrenchment efforts? The staff's medium-term scenarios, even if purely illustrative, have apparently given rise to some concern in this respect.

On the first question, it may be recalled that as late as October 1985, when the 1986 budget was presented to Parliament, it was still difficult, if not impossible, to foresee the dramatic fall of oil prices that would radically change the Norwegian economic scene. More important, the statistical evidence available at that time may have failed to give an accurate perception of the strength of domestic output and demand growth. The fall in the savings ratio of households, for instance, came as a surprise. Against this background, it is understandable that the corrective policy actions taken in 1985 and early 1986 followed the traditional pattern of "too little, too late."

To this, I would like to add a personal reflection: 1985 was an election year and in addition the election resulted in a very fragile parliamentary situation with a government lacking a parliamentary majority. This is not the ideal situation for a tightening of economic policy, nor is it a situation where the parliamentary opposition is likely to be very helpful. In a way, this is an illustration of the well-known fact that economics would be much simpler if not constrained by politics.

As for the question about the adequacy of the corrective measures taken and envisaged, which was raised by practically all speakers, I would first like to note that my authorities have no fundamental objections to the staff's illustrative projections for Norway's balance of payments, external debt, and debt service and the conclusions that most speakers have drawn from them. As should be clear from my statement, the authorities do not underestimate or conceal the seriousness of the situation or the difficulties ahead, nor do I have any quarrel with the many Directors who echoed the staff's concerns and warnings in this regard; but let me make a few points.

The staff should be commended not only for presenting its medium-term analysis as such but also for underlining the illustrative character of the analysis and indicating clearly the assumptions on which it is based. The scenarios resulting from such projections provide a good basis for the assessment of different policy options and, thereby, enhance the value--and perhaps even the impact--of consultation discussions.

Having said this, I admit that, like other Directors, I have certain difficulties with the basic assumption of measures sufficient to reduce the current account deficit from perhaps 5 percent of GDP in 1986 to 4 percent in 1987, with a $15 a barrel oil price. According to the Government's latest forecast, an increase to 6-7 percent would seem more likely. The main problem is that it may be difficult to achieve the 1.5 percent reduction in domestic demand implied in the staff's assumptions and, consequently, the assumed zero growth. The savings ratio of households is one of the big question marks.

However, it is the Government's expressed intention to make the necessary adjustment program front-loaded. My conclusion is that, should the first step in the reorientation of economic policy appear to be insufficient, the second step--the autumn package--will be correspondingly more restrictive. The revised national budget cautions that in 1987 it may be necessary to tighten fiscal policy further to about 1 percent of GDP, on top of this year's tightening of the same magnitude on an annual basis.

To the many Directors who emphasized that a devaluation is never, in and by itself, a solution and that it has to be followed up by fiscal and monetary restraint, I can only answer that this uncontestable truth is particularly applicable in the present Norwegian situation, that the Norwegian authorities are keenly aware of this, and that such action has already been taken and will be further reinforced. What has already been achieved has been referred to as "Norway's biggest public spending cuts since the Second World War."

On the question of expenditure cuts versus revenue increases, several Directors noted that the fiscal measures passed by Parliament two weeks ago had their main impact on the revenue side of the budget and recommended that expenditures be cut further. In this connection, reference was made to the relatively high proportion of fiscal revenue to GDP. In a Nordic context, such a reference is not very persuasive. For instance, Norway has a long way to go to challenge the position of Sweden in this respect. More important, perhaps, central government current disbursements and total outlays as a proportion of GDP are not higher in Norway than in several comparable countries; they are in fact of the same magnitude as those in the United Kingdom.

The new Norwegian Government may therefore feel less restrained in raising revenues than in cutting expenditures, at least when compared with many other governments. This is personal speculation. It is clear, however, that a fiscal tightening will take place and that it is being and will continue to be designed in such a way as to distribute the burden as equitably as possible. Private consumption is the obvious main target, but it is explicitly stated in the national budget that "groups with relatively comfortable incomes and forms of consumption with low priority" will be particularly targeted. The importance of an equitable distributional profile of the fiscal and monetary restraint now initiated is a recurrent theme in the national budget and other policy declarations. These measures applying to net changes of expenditures do not mean that substantial cuts could not be expected, especially with regard to certain transfers--for example, subsidies to industry. As suggested by some Directors, such expenditure reductions are likely to be directed and designed so as to contribute toward increasing the efficiency of the economy.

I would agree that deteriorating competitiveness and declining market shares, largely as a result of strong wage drift, have been some of the most difficult problems besetting the Norwegian economy. To a considerable extent they are a consequence of the general overheating and should be remedied by the fiscal and monetary restraint that is being introduced. But this may not be enough. Improved incomes policy cooperation between the Government and the labor market organizations is to be expected. At present I am not in a position to give any details about the form such cooperation may take, but I agree with those Directors who contended that bringing wage developments in line with those of the main competitor countries is a necessary condition for a stabilization of the Norwegian economy.

In this connection, the question was raised about the wisdom *of reducing work hours from 40 to 37.5 a week as of January 1987.* The moment may not be the best one; but the effect will not be as strong as might be expected, since many firms have already started to reduce work hours. To some extent, therefore, what will happen on January 1, 1987 is the formalization of a practice already applied.

The Acting Chairman made the following summing up:

Executive Directors expressed concern about the recent overheating of the Norwegian economy. Since 1984, domestic demand has expanded vigorously, carrying demand beyond the capacity of the economy to fully respond. Directors attributed this development to an easing of fiscal policy as well as to excessively expansionary money and credit policies. The overheating has resulted in tight labor market conditions, which have been reflected in increasing labor shortages and strong upward wage pressures. These wage pressures have interrupted progress in reducing domestic inflation, caused a renewed widening of the inflation differential with countries abroad, and weakened the external competitiveness of Norwegian industry.

Directors observed that the need for retrenchment became acute following the sharp fall in oil prices in early 1986. The balance on the external current account is projected to swing from a surplus of 5 percent of GDP in 1985 to a deficit of 5 percent or more in 1986. The central government budget has also been weakened substantially because of a sharp fall in oil revenues accruing to the public sector.

Noting the May 1986 devaluation of the krone, Directors expressed serious concern that unless measures were taken to eliminate the overheating in the domestic economy, the authorities risked rapidly losing the benefits of the devaluation through a surge in inflation. Directors stressed that the fiscal and monetary measures introduced so far in 1986 were limited and that much stronger measures, particularly in the area of fiscal policy, would be needed to bring about an improvement in the external balance in 1987. Directors considered the adjusted fiscal deficit forecast in the revised budget excessive; they urged the authorities to exercise fiscal restraint with emphasis on expenditure reductions--given the size of the public sector in Norway and the recent growth of transfer outlays--rather than revenue increases. Several Directors singled out transfers to enterprises, currently equivalent to some 4 percent of GDP, as a major category of expenditure to be cut, especially in light of the favorable impact of the devaluation on many enterprises.

Monetary policy could play an important role in restraining aggregate demand, Directors commented. They believed that monetary policy should be tightened and that greater flexibility in interest rate policy was required.

Directors stressed that external competitiveness should now be defended through the containment of domestic costs, but they observed that the tightness of the labor market was not conducive to wage restraint and progress against inflation. They welcomed the authorities' intention to restrain domestic cost pressures through a combination of incomes, industrial, and labor market policies; however, they warned that such policies were likely to be frustrated unless fiscal and monetary policies were sufficiently tightened. Thus, Directors stated that resolute and comprehensive adjustment policies--rather than the present gradualist approach--were called for to safeguard Norway's high employment objective in the longer run.

Norway's generally open trade policy was noted with satisfaction, and Directors commended Norway for maintaining an exemplary record in foreign aid.

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

APPROVED: March 26, 1987

LEO VAN HOUTVEN
Secretary