

**Statement by O.-P. Lehmussaari, Executive Director
for Norway
January 28, 2000**

On behalf of my Norwegian authorities, I would like to thank the staff for thorough and well-written reports for the 1999 Article IV consultation on Norway. The staff report covers important aspects of the Norwegian economy, both in the short and long term.

The period of strong growth in Norway that prevailed during the latter part of the 1990s was replaced by slower growth in 1999. Nevertheless, labor force participation is still at a record level and strong pressures on some parts of the labor market remain. Although consumer price inflation remained moderate in 1999, it is still higher than in the euro area.

The sharp rebound in oil prices in 1999 led to an improvement in the current account, following a deficit in 1998. Market observers have linked the strengthening of the krone exchange rate to the surge in oil prices. Continued high oil prices will put fiscal restraint to a test in the coming years. Long-term considerations concerning future pension liabilities and other expenses related to the aging of the population require that a considerable part of the oil revenues be set aside.

Economic outlook – recent projections

Mainland GDP growth is estimated at around 1 per cent in 1999. The slowdown in growth was unevenly distributed. Public and private consumption continued to show strong growth; on the other hand, in large parts of the manufacturing sector, fixed investment dropped for the first time since 1993. Furthermore, investment in the petroleum industry showed a marked contraction after several years of high and increasing investment in the North Sea.

Total employment growth in 1999 is projected at ½ per cent. There were, however, major differences between the various labor market segments. There was a considerable downturn in petroleum-related industries, whereas employment in the public sector and private service industries increased. Average unemployment was more or less unchanged from 1998, at 3¼ per cent.

The current account surplus for 1999 is estimated at just under 3 per cent of GDP. The current account is expected to improve to around 8 per cent of GDP in 2000, mainly due to increasing oil revenues and increasing net export of traditional goods. The surpluses will, to a large extent, be reflected in high outflows of capital through the Government Petroleum Fund.

The outlook for the Norwegian economy provided by the Ministry of Finance, as well as Norges Bank, points to a growth rate of ¾ per cent in mainland GDP in 2000. Thereafter, GDP is expected to pick up toward the estimated long-term trend rate of growth in the

economy. Unemployment may increase slightly, but is expected to remain at a low level by international standards.

There are several risks to this outlook. First, although wage growth on average is expected to slow down, there are signs of strong wage demands ahead of this spring's negotiations in sectors with labor shortages. Second, one cannot exclude the possibility of a rebound in private consumption. Households have substantial financial leeway to smooth consumption over the business cycle. Third, changes in economic activity normally provide strong impulses to mainland business fixed investment. However, it is especially difficult to estimate this effect when the economy is at a turning point. Finally, the uncertainty associated with changes in petroleum investment is considerable.

A slower rise in wage costs is projected over the next two years, contributing to a slower rise in prices for Norwegian-produced goods and services, while higher international commodity and producer prices may result in slightly increased import prices. CPI inflation will most likely remain around 2¼ per cent in 2000, in line with the staff's estimate. The approved increase in indirect taxes in the fiscal budget for 2000 will contribute to an increase in the price projections of a quarter of a percentage point.

Economic policy

The main challenge for the economic policy is to bring down price and cost inflation in line with that of Norway's trading partners.

The Norwegian economy slowed down in 1999 following six years of strong recovery. Fiscal policy has been tight in response to the strong economic upswing. The budget for 2000 has a neutral fiscal stance, measured by changes in the non-oil, cyclically adjusted surplus net of interest payments. According to the staff, the economy will still operate above potential in 2000, with an estimated positive output gap of 1 per cent. The Norwegian authorities concur that the extent of free resources is limited, but would point out the uncertainty of the quantification of the output gap. Given the recent signs of slower growth - albeit somewhat mixed - the authorities believe that a neutral stance is adequate with respect to the pressures in the economy.

The authorities believe that monetary policy, after the interest rate hikes in 1998, has had a dampening effect on the real economy and domestic price and cost pressures. Monetary policy has gradually been eased in accordance with signs of dwindling growth. In conjunction with the presentation of the December Inflation Report, the central bank governor stated that interest rates now appear to be at or close to the trough in this business cycle.

In the staff's view, the transparency and credibility of the monetary policy regime would be enhanced by an explicit recognition of the objective of low and stable inflation. This recommendation springs from the fact that the Norwegian monetary policy framework differs somewhat from what seems to be international standards. The government deems that

the Norwegian monetary policy framework is appropriate and adequate. The Norwegian authorities concur with the view that transparency and credibility play an important role in the implementation of monetary policy. Consequently, the monetary authorities have devoted considerable effort to clarifying the policy framework. The overall impression is that the policy framework is well understood by a majority of market participants.

According to the staff, market uncertainty as to whether the authorities would take sustained action to return the exchange rate back to its target range undermined the stability of the krone in the summer of 1998. In the authorities' view, the significant wage growth and the drop in oil prices were more important factors explaining the depreciation of the krone, together with international turmoil in financial markets.

The authorities wish to emphasize that the guidelines for monetary policy have taken into consideration that the exchange rate may deviate from its initial range. In the event of significant changes in the exchange rate, policy instruments will be oriented with a view to returning the exchange rate, over time, to its initial range. Norges Bank will continually assess the degree to which the use of policy instruments is appropriate in the light of conditions in the foreign exchange market and the economic situation in Norway.

Developments in recent years indicate that movements in the krone exchange rate cannot be fine-tuned. Thus, the Bank has stated that it will focus on two fundamental preconditions to achieve exchange rate stability over time: First, price and cost inflation must be brought down toward the corresponding goal for inflation of the European Central Bank. Second, monetary policy must not in itself contribute to deflationary recessions, as this would undermine confidence in the krone.

In Norway, fiscal policy has an important role in demand management. The fulfillment of this task is facilitated by the fact that the Norwegian government has greater financial leeway than most other countries due to positive net financial investments in 47 of the last 50 years. At the same time, high oil revenues make fiscal contractions more demanding. Against this background, fiscal policy has been fairly well adapted to the economic situation over the last decade.

Medium-term and structural issues

As noted in the report, public finances will be faced with challenges as oil revenues decline and pension liabilities escalate. The staff asserts that an attractive option would be to move to a system where a publicly financed basic pension is supplemented by private defined-contribution schemes. The government concurs with the staff that fiscal pressures will build up in the future. Total disbursements by the National Insurance Scheme for old age and disability pensions are estimated to increase from 8 per cent of GDP in 1995 to 15 per cent of GDP in 2030. It is the Government's view that funding parts of the National Insurance Scheme will not, by itself, address the long-term challenges to public finances. The issue of funding should be evaluated in conjunction with other measures aimed at creating

better incentives for long working careers. The Government will continue to work on these important pension policy issues during the period prior to the long-term Program 2002–2005, which will be presented in early 2001.

We believe that the macroeconomic policy strategy pursued in the 1990s, formulated in the so-called Solidarity Alternative, has been crucial in bringing the structural unemployment rate in Norway down to a level among the lowest in the OECD area.

The Norwegian system of income policy cooperation is based on the wage-leading role of the tradable sector. However, a tight labor market, expectations of increased public spending and discontent with wage conditions among certain groups of public employees have put the centralized wage formation system under pressure the last couple of years, as was illustrated in the wage settlement in 1998. The authorities highlight the impact of the so-called Arntsen Committee in 1999, where the labor unions agreed on the need to restrict wage growth to the same level as that of trading partner countries. This agreement helped to curb wage pressures in 1999 despite the strains suffered by the wage formation system. The current orientation of fiscal and monetary policy is based on the assumption that the social partners support the overall economic policy framework.

As a response to these challenges, an official committee, with participation from the authorities and the social partners, has been formed to discuss, among other things, how income policy cooperation may contribute to this end. In particular, the committee will discuss how to ensure a credible and viable implementation of the recommendation from the Arntsen Committee in subsequent wage rounds.

In the staff's view, wage moderation should not be achieved at the cost of generous increases in social and labor market programs. The government recognizes that these programs, while entailing only modest costs in the short run, may have long-term effects on the budget and enterprises. Accordingly, the government has signaled the need to restrict the benefits of some early retirement schemes.

The state ownership in DnB and Christiania Bank was discussed in the Government's report to the Storting ("Kredittmeldinga" – report no 11 (1999-2000)). In its recommendation to this report, a majority of the Storting's Standing Committee on Financial and Economic Affairs states that the government should join its interests as an owner in one entity, to maintain national ownership by owning at least 1/3 of the shares. Such an entity should have flexibility for further development in Norway and in other Nordic countries. The majority is of the opinion that a sale, if any, of the shares in Christiania Bank cannot be made until a Norwegian solution has been considered.

Following Kredittmeldinga and the recommendation of a majority of the Standing Committee on Financial and Economic Affairs, the Ministry of Finance has issued a mandate for an assessment on DnB and Christiania Bank to be produced by the Government Bank Investment Fund. The Government Bank Investment Fund has been asked to consider the options of structural solutions for DnB and Christiania Bank, and it should consider viable solutions for DnB and Christiania Bank as institutions, as well as for the Government as an owner. The Government Bank Investment Fund is now working on the assessment.