



DET KONGELIGE
FINANSDEPARTEMENT

Royal Ministry of Finance

The National Budget 2014

A summary



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National Budget 2014

1 Introduction

With growth in line with the historical average and low unemployment, the current status of the Norwegian economy differs markedly from that of many of our trading partners. Strong demand from the petroleum industry and higher private consumption underpin growth. The number of people in employment is now about 3 pct. higher than when the business cycle peaked before the financial crisis and unemployment is well below the average for the last 25 years. A substantial inflow of immigrants from the EU has contributed to a large increase in the labour force in the Norwegian economy in recent years, lifting production capacity but also increasing demand for housing and infrastructure.

The oil revenues put Norway in a favourable position when compared to many other countries. Over time, welfare and living conditions in Norway are, nonetheless, primarily determined by developments in the mainland economy. Growth in the mainland economy, i.e. excluding petroleum extraction, pipeline transportation and international shipping, has rebounded after the setback during the financial crisis. If we also exclude electricity generation, which is almost solely based on hydro power and therefore heavily influenced by variations in precipitation, economic growth in the Norwegian mainland economy may be just below the average for the last 40 years this year and just above the said average next year.

The fiscal policy guidelines aim at a gradual phasing-in of oil revenues into the Norwegian economy on par with the expected real rate of return on the Government Pension Fund Global, estimated at 4 pct. The guidelines permit spending more than the expected return in cyclical downturns, whereas spending should be below the expected return when capacity utilisation in the economy is high. This room for manoeuvre was used in 2009 to mitigate the effects of the financial crisis on the economy. Economic growth in recent years has brought the spending of oil revenues well below the four-per cent path. In a period when the Fund capital is growing steeply, as is presently the case, spending of oil revenues in line with the expected return on the Fund (the four-per cent path) would have provided the economy with a strong boost. This would not have

been consonant with the objective of stable economic development.

Several years of high wage growth and the gradual appreciation of the Norwegian krone has increased the cost level in Norway. In a situation characterised by weak demand abroad, this makes many export firms vulnerable. We now see a number of examples of Norwegian businesses losing out to foreign competitors, also within petroleum-oriented industries. In the view of the Government this situation calls for caution in expanding oil revenue spending from 2013 to 2014.

The Government's budget proposal for 2014 provides a budget impulse of about $\frac{1}{4}$ pct. of Mainland Norway trend GDP, as measured by the change in the structural, non-oil deficit. When measured in fixed prices, this represents an increase of NOK 11 billion in oil revenue spending from 2013 to 2014. The estimated impulse is roughly in line with the average phasing-in over the years since the fiscal rule was introduced. The Government's budget proposal for 2014 entails oil revenue spending of NOK 135 billion, which corresponds to 2.9 pct. of the estimated capital of the Government Pension Fund Global. Taking account of the composition of the revenue and expenditure side of the proposed budget, model simulations indicate that it has a more or less neutral effect on production and employment.

2 Economic outlook

Activity in the Norwegian mainland economy rebounded swiftly after the downturn in 2009. Despite weak international development, strong demand from the petroleum industry and higher private consumption have contributed to sustained growth and low unemployment.

Last year, mainland GDP increased by 3.4 pct., cf. Figure 2.2A. However, growth abated towards the end of last year and in the first half of this year. Domestic demand developments have curbed growth over the last three quarters, and also traditional goods exports have developed weakly.

Mainland GDP growth is expected to be 2.2 pct. this year and 2.7 pct. next year, cf. Table 2.1.

Box 2.1 Mainland Norway and the total economy

Mainland Norway is defined as all economic activity in Norway, excluding petroleum activities and ocean transport. From a stabilisation policy point of view this is the most relevant sector definition.

Petroleum activities represent a major part of value added in the Norwegian economy. In 2012, about one fourth of total value added in Norway was accounted for by petroleum activities, while ocean transport accounted for only ½ pct., cf. figure 2.1. Petroleum activities constitute an even larger portion if we look at exports; about three fifths in 2012. The significance of the petroleum industry is less marked in terms of employment. The petroleum industry accounted for just over two pct. of total employment in 2012, whereas ocean transport accounted for just below two pct., mainly foreigners. The combination of substantial value added and rather low employment in the petroleum sector reflects the high level of productivity and the resource rent in this sector. Since production and income fluctuations in the petroleum industry and ocean transport have limited impact on the demand for labour in the Norwegian economy, these sectors are excluded from the analysis of cyclical developments.

Mainland Norway as a proportion of the total economy

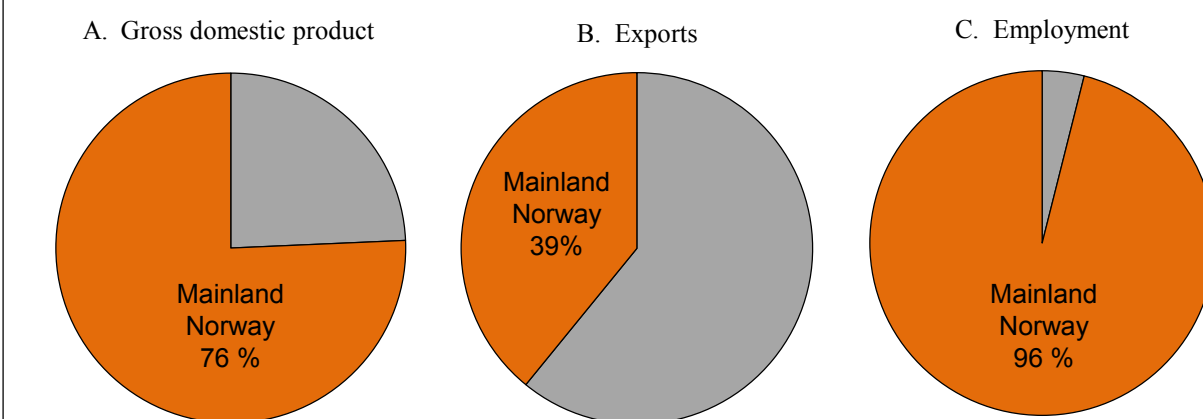


Figure 2.1 Mainland Norway as a proportion of the total economy

Sources: Statistics Norway and Ministry of Finance.

In comparison, average annual mainland GDP growth over the last 40 years was 2.6 pct. A decline in hydropower generation, which represents the main source of electricity in Norway, will dampen mainland GDP growth by an estimated 0.3 percentage point this year.

Following weak performance during the financial crisis, private consumption has over the last three years grown more or less in line with the 3-pct. average for the last 40 years. At the same time, high income growth has paved the way for an increase in savings. When measured as a proportion of disposable income, household savings last year were more than twice the historical average. Much of the savings are mirrored by residential investment, but financial savings have also increased relative to the negative levels before the international financial crisis. Financial savings are presently close to zero.

Developments in the first half of this year may indicate somewhat lower private consumption growth this year than last year. However, prospects for continued low interest rates and high wage incomes suggest that household consumption growth in 2014 will be close to normal.

Housing prices slumped in many countries in the wake of the international financial crisis. In Norway, housing prices contracted moderately from the autumn of 2007 until December 2008, but have thereafter increased steeply and reached record high levels, cf. Figure 2.2B. The price increases have levelled off recently, and the quarterly growth rate was negative in the 3rd quarter of this year. The sustained housing price increase has been accompanied by a significant increase in the level of household debts, cf. Figure 2.2C. The combination of high housing prices and a high level of household debt do increase the risk of a

housing market slump, which may have a negative impact on the Norwegian economy.

Housing construction remains high, but growth has abated somewhat since the middle of last year. However, continued high labour immigration contributes to the buoyant demand for housing.

Public sector demand increased significantly in 2009 in order to stabilise economic developments in the wake of the financial crisis. As economic growth has picked up, public sector demand growth has levelled off. The fiscal policy stance in this report implies somewhat stronger growth in public consumption and investment this year and next year, relative to the period 2010-2012.

Following a significant contraction during the financial crisis, mainland business investments increased somewhat in 2011 and 2012. The moderate expansion continued in the first half of this year, but at a somewhat slower pace than last year. This is mirrored by a levelling-off of business indebtedness, measured as a share of mainland GDP. The levelling-off comes in the wake of strong growth in the lead-up to the financial crisis, when both investment and economic activity expanded apace.

Petroleum investment increased by just over 14 pct. last year, following similar growth in 2011, and has been an important driver behind the upturn in the mainland economy in recent years, cf. Figure 2.2D. Survey information suggests that petroleum investment growth will continue this year and next year, although the growth rate is expected to be somewhat more moderate in 2014 than in the preceding years.

After a steep decline in the wake of the international financial crisis, traditional goods exports have fluctuated somewhat over the last three years. The level still remains lower than before the financial crisis. Growth in traditional goods exports is expected to increase as and when growth picks up amongst our trading partners.

Exports of services other than oil and international shipping have outperformed traditional goods exports in recent years and are expected to increase further this year and next year. Exports of services relating to oil activity in other countries are also expected to increase in 2013 and 2014. An expected decline in oil and gas exports this year means that overall exports are nonetheless expected to decline somewhat from 2012 to 2013, followed by an increase in 2014.

Growth in the volume of traditional goods imports has been moderate in recent years, and is expected to pick up gradually in coming years. Nonetheless, the estimates imply that growth in traditional goods imports will remain just below

the historical average until the end of 2014.

Higher prices for Norwegian exports since the turn of the millennium have contributed to a significant improvement in Norway's terms of trade, as measured by the ratio between export and import prices, cf. Figure 2.2E. The improvement in the terms of trade has been reinforced by falling prices for imported consumer goods during the period. Strong oil price growth has been by far the most important factor behind these developments, but non-oil price developments were also favourable before the financial crisis. Traditional goods export prices have fluctuated since then. This report is estimating that the terms of trade for both traditional goods and for all goods and services will deteriorate somewhat in the period 2013-2014.

Oil and gas revenues are contributing to a major surplus in Norway's current account balance. Over the last ten years, the current account surplus has fluctuated around a level corresponding to about 13-14 pct. of GDP. The current account surplus is estimated to decrease somewhat from 2012 to 2014, both due to an estimated decline in petroleum production (in value terms) and expectations of lower growth in traditional goods exports than in traditional goods imports.

The oil price has been high in recent months, which most likely has to do with mounting unrest in the Middle East. In early-October, the oil price was about USD 110 per barrel (NOK 650), more or less on par both with the average for last year and the average for 2013 so far. The budget for 2014 assumes an oil price of NOK 635 per barrel (108 USD) this year and NOK 600 per barrel (100 USD) next year, at 2014 prices. NOK 535 per barrel (90 USD measured with the exchange rate at the beginning of October) has been assumed for the subsequent years, in line with long-term price estimates in the 2013 White Paper on long-term perspectives for the Norwegian economy. The gas price follows a similar path.

Over the last 20 years, productivity growth in our mainland economy has been relatively high compared to that of a number of important trading partners. However, productivity growth declined somewhat from the middle of the previous decade, both in the Norwegian mainland economy and amongst most of our trading partners. This can partly be explained by, inter alia, labour hoarding during the slump in production in a number of countries in the aftermath of the financial crisis. In addition, business investment developments have been weak. The estimates in this report imply that productivity growth strengthen somewhat looking ahead.

A high cost level is squeezing the profitability of many Norwegian exporters, adding to the chal-

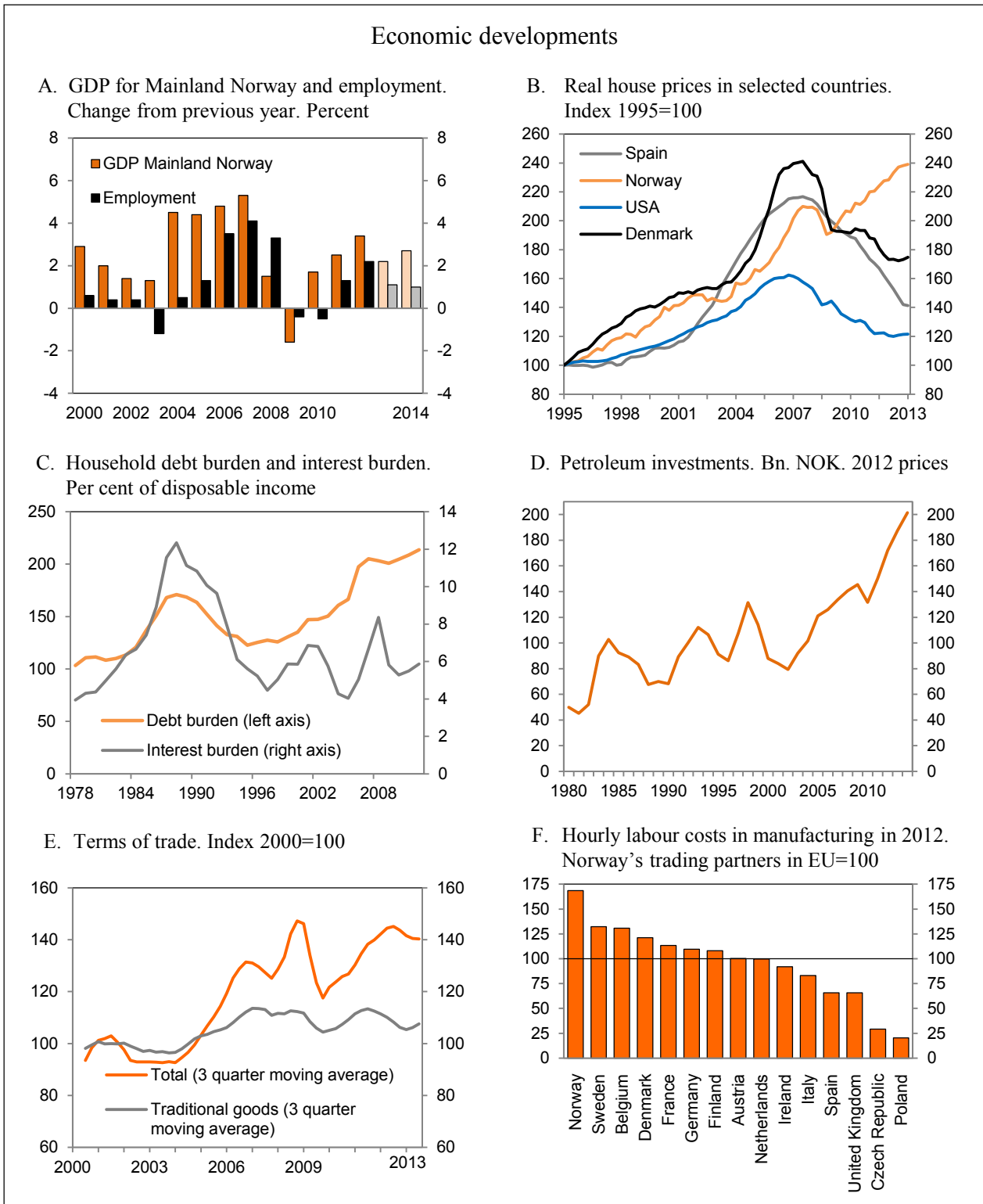


Figure 2.2 Economic developments

Sources: Statistics Norway, the Norwegian Technical Calculation Committee for Wage Settlements, Federal Reserve Bank of Dallas and Ministry of Finance.

lence of low demand internationally. In 2012, wages in manufacturing were on average almost 70 pct. higher than a weighted average of Norway's trading partners in the EU, and close to 30 pct. higher than in Sweden, measured in common currency, cf. Figure 2.2F. High costs may also partly explain the weak performance of mainland business investments in recent years.

Average annual wage growth was 4.0 pct. in 2012. Based on this year's wage bargaining and economic outlook assessments, annual wage is estimated to grow by 3½ pct. in 2013, as well as in 2014. These estimates imply that wage cost growth will remain higher in Norway than

amongst our trading partners. A depreciation of the Norwegian krone so far this year means that cost competitiveness may nonetheless improve slightly in 2013 and 2014, as measured by relative compensation per employee in common currency.

Following three years in which underlying consumer price growth, as measured by consumer price growth adjusted for tax changes and excluding energy products (CPI-ATE), has been less than 1½ pct., price growth has picked up in recent months. It is expected that CPI-ATE growth will be higher in 2013 than in 2012, and increase further next year. Electricity price devel-

Table 2.1 Key figures for the Norwegian Economy. Percentage change in volume from previous year

	Bn. NOK ¹			
	2012	2012	2013	2014
Private consumption	1 175,0	3,0	2,3	2,7
Public consumption	619,5	1,8	2,6	2,2
Gross fixed instruments	598,0	8,0	5,1	5,1
Of which: Petroleum extraction and pipeline	171,8	14,5	9,0	7,5
Businesses in mainland Norway	180,9	3,2	1,6	5,5
Housing	139,8	7,4	5,0	3,0
Public sector	89,2	-0,6	5,9	3,6
Demand from mainland Norway ²	2 204,4	2,8	2,6	2,8
Exports	1 183,0	1,8	-1,6	3,2
Of which: Crude oil and natural gas	604,4	0,9	-5,5	4,2
Traditional goods	310,3	2,6	0,1	2,6
Services excl. petroleum activities and shipping	135,4	1,3	3,0	2,1
Imports	798,8	2,4	3,3	4,3
Of which: Traditional goods	486,0	2,7	3,2	3,5
Gross domestic product	2 906,8	3,1	0,9	2,7
Of which: Mainland Norway	2 200,3	3,4	2,2	2,7
Mainland Norway excl. electricity	2 148,9	3,1	2,5	2,7
Other key figures:				
Employment, persons		2,2	1,1	1,0
Unemployment, LFS (level)		3,2	3,4	3,5
Annual wage		4,0	3½	3½
Consumer price index (CPI)		0,8	1,9	1,6
CPI adjusted for tax changes and excluding energy products (CPI-ATE)		1,2	1,5	1,8
Oil price. NOK per barrel ³		649	623	600
Current account balance (pct. Of GDP)		14,2	11,1	10,5
Gross national income, bn. NOK		2964	3028	3165
Three-months money market interest rate, pct. ⁴		2,2	1,8	1,9
Trade-weighted index, percentage change from previous year ⁵		-1,6	2,1	3,1
Household savings. pct of disposable income		8,5	8,4	8,6

1 Preliminary national account data in current prices.

2 Excluding changes in inventory.

3 Current prices.

4 Technical assumptions based on forward rates in September.

5 Positive figures indicate a weaker NOK.

Sources: Statistics Norway and Ministry of Finance.

opments have contributed to twelve-month increases in the overall CPI outpacing the corresponding CPI-ATE growth thus far this year. Expectations of weaker electricity price developments next year mean that growth in the overall price index is expected to decline somewhat from 2013 to 2014.

The Norges Bank policy rate path in the Monetary Policy Report from September estimates that the key policy rate will remain at 1.5 pct. until the summer of 2014, and thereafter be gradually increased to about 2¾ pct. towards the end of 2016.

There has been a general depreciation of the Norwegian krone since February of this year, when it was at historically strong levels. The Norwegian krone had by the beginning of October depreciated by about 9 pct. since the beginning of the year, as measured by the trade-weighted exchange rate index (TWD), which is about 6½ pct. below the average for last year, and more or less on par with the average since 2001 when the Government set an inflation target for the monetary policy.

3 Economic policy

3.1 Fiscal policy

3.1.1 The fiscal policy guidelines

The Government Pension Fund Global and the fiscal policy rule together constitute Norway's fiscal framework, cf. Appendix 1. The state's current net cash flow from petroleum activities is saved in the Fund, while concurrent spending over the fiscal budget follows the expected real return of the wealth already accrued in the Fund. Expected real return is estimated at 4 per cent. The framework is designed to promote a stable development of the Norwegian economy. It gives room for a gradual increase in the spending of petroleum revenues, yet also cushions exposed industries from rapid downscaling and ensures that resource wealth will benefit future generations.

The framework allows automatic stabilisers to play out fully, as the spending of oil revenues is measured by the non-oil, structural budget deficit. The fiscal policy rule determines withdrawals from the Fund over time, but does not prescribe the level of expenditure or other revenues in the fiscal budget. The Government will maintain the current level of taxation, in keeping with its political platform. The tax level defines, together with

the fiscal policy rule, a budget expenditure framework within which the Government must prioritise.

We are currently in a period of expected growth in the Government Pension Fund Global. This permits a gradual increase in the spending of petroleum revenues. At the same time, the Government attaches weight to the need for balanced economic development in its on-going formulation of fiscal policy. Fiscal policy was given a highly expansive orientation in 2009 in order to dampen the effects of the financial crisis and the international economic slump on the Norwegian economy. The structural, non-oil deficit was increased to a level in excess of the expected real return on the Fund. The cyclical downturn in Norway was swiftly reversed, and oil revenue spending has been below the expected real return on the Fund since 2010. In a period when the Fund capital is growing steeply, as is presently the case, spending of oil revenues in line with the expected return on the Fund (the four-per cent path) would have provided the economy with a strong boost. This would have been contrary to the objective of a stable economic development.

The difficult conditions faced by many industries exposed to international competition, as well as financial stability considerations, suggest that petroleum revenue spending should remain moderate in 2014.

Population developments in Norway over the last few decades have been fairly favourable from a public finance perspective, with a slight decline in the proportion of older people. Such developments have now been reversed, and will, with the onset of population aging, result in increased expenditure on pensions, health and care. The savings accumulated through the Government Pension Fund will help fund such expenditure. Nevertheless, long-term budget projections show that we will be faced with major fiscal policy challenges over time.

3.1.2 Fiscal policy in 2013

Last autumn, the National Budget for 2013 signalled a roughly neutral budget for 2013, i.e. that the structural, non-oil deficit would increase more or less in line with Mainland Norway trend GDP. The budget deficit was estimated at NOK 125.3 billion, when excluding the petroleum revenues of the State and adjusting for the impact of the business cycle.

The changes in connection with the Revised National Budget for 2013 reduced the structural, non-oil deficit for 2013 to NOK 124.6 billion. The reduction was caused by, inter alia, lower expenditure by the National Insurance Scheme. The estimated wage growth in the economy was reduced from 4 to 3½ pct., which reduces both revenues and expenditure under the fiscal budget by about the same amount. Apart from this, estimated tax revenues for 2013 remained unchanged.

The estimated structural, non-oil deficit for 2013 is now reduced to NOK 120.5 billion, primarily as the result of lower expenditure. The estimated structural, non-oil deficit is almost NOK 33 billion less than the expected return on the Fund, computed as 4 pct. of the Fund capital at the beginning of this year.

The overall tax revenues of the central government thus far this year have been roughly in line with expectations. However, high growth in payments of income tax from individuals indicates that the tax revenues of municipalities and counties may be somewhat higher this year than previously estimated.

The budget for 2013 is now estimated to provide a positive demand impulse of 0.5 percentage point, as measured by the change in the structural, non-oil deficit as a proportion of mainland trend GDP. One reason why the budget, as measured by this indicator, is currently perceived to be more expansionary than last autumn is that the estimated structural, non-oil deficit for 2012 is now lower than in the National Budget for 2013. The budget impulse for 2012 and 2013 as a whole

is roughly in line with last autumn's estimate.

The consolidated surplus in the fiscal budget and the Government Pension Fund in 2013 is estimated at NOK 357 billion. This is roughly as estimated in the Revised National Budget for 2013.

The market value of the Government Pension Fund Global is estimated at NOK 4,729 billion at the end of 2013. This is NOK 218 billion more than stipulated in the Revised National Budget. The upward revision is caused by favourable financial market developments in recent months, but also by a depreciation of the Norwegian krone. Norwegian krone depreciation increases the value of the Fund as measured in Norwegian kroner, but does not increase the international purchasing power of the Fund. Future developments in both the Norwegian krone exchange rate and international financial markets are subject to considerable uncertainty.

3.1.3 The fiscal budget and the Government Pension Fund in 2014

The proposed budget for 2014 is based on a structural, non-oil budget deficit of NOK 135 billion, which corresponds to 5.5 pct. of Mainland Norway trend GDP. About one tenth of spending via government budgets is obtained from the Government Pension Fund Global. This corresponds to about NOK 26,000 per capita. The deficit is NOK 54 billion less than the expected real return on the Government Pension Fund Global, computed as 4 pct. of the estimated Fund capital

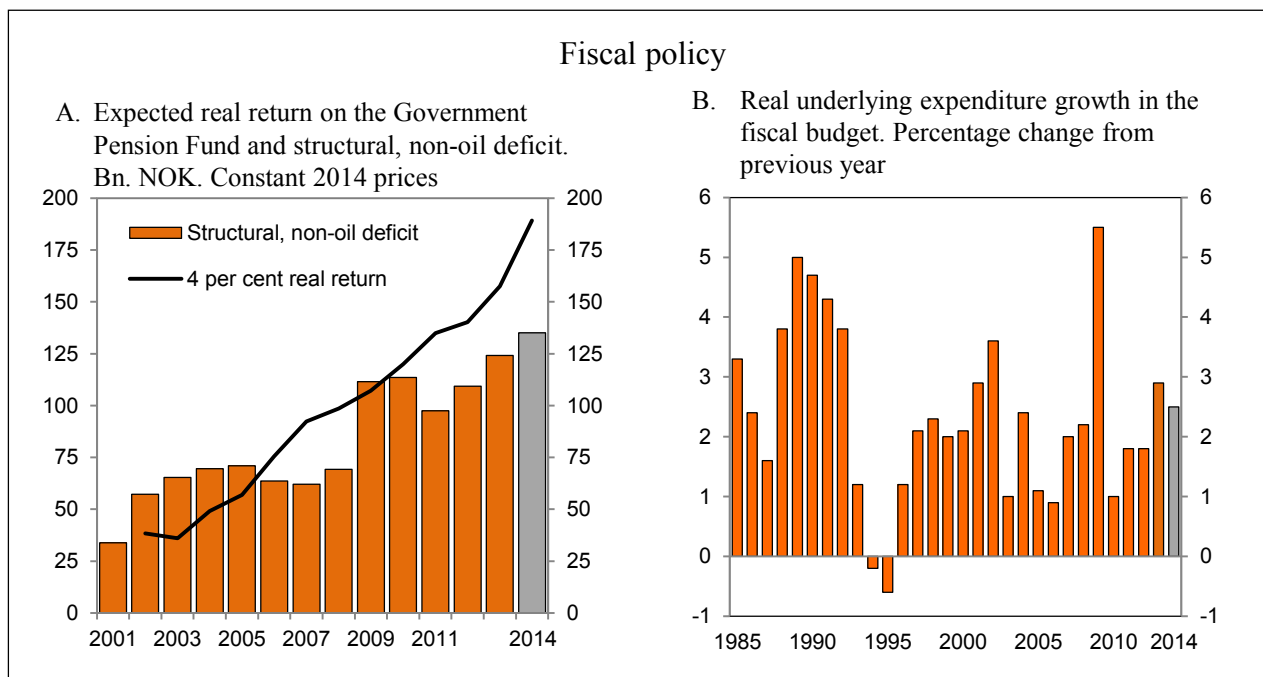


Figure 3.1 Fiscal policy

Source: Ministry of Finance.

at the beginning of the year.

Oil revenue spending is estimated at 2.9 pct. in 2014 when measured as a share of the Fund capital at the beginning of the fiscal year. This is the same level as in 2011, but somewhat lower than in 2012 and 2013. The growing distance to the path for expected Fund returns is due to strong growth in Fund capital, stemming from a combination of high petroleum prices, a favourable financial market and depreciation of the Norwegian krone.

The structural, non-oil deficit as a share of mainland trend GDP is estimated to increase by about ¼ percentage point from 2013 to 2014. However, macroeconomic model simulations indicate that the overall effect of the Government's budget proposal for 2014 on the economy is approximately neutral, when taking into consideration the composition of revenues and expenditures.

The last few years have brought a number of good news that have contributed to bringing the structural, non-oil deficit well below 4 pct. of the Fund capital. There has been strong growth in the Fund's capital. Tax revenues have been revised upwards, while expenditures have been

revised downwards. This has also impacted on the estimated structural, non-oil deficit, which has been revised downwards for seven of the last eight years. The main reason is that the underlying growth in the Norwegian economy has been stronger than anticipated. Some years have also seen significant changes on the expenditure side of the budget as the result of new appropriations by the Storting or lower expenditure than foreseen by the original budget appropriations.

Experiences from both Norway and other countries show that assessments of the underlying situation in the budget may change considerably in the event of an economic downturn. During the financial crisis, many countries came to learn that tax revenues they had believed to be stable and lasting, evaporated when the economy slumped. Revisions to the estimates of underlying tax revenues in the order of 1-2 pct. of GDP are not uncommon in times of recession. Such revisions have to do with the fact that it can be difficult, at any given point in time, to distinguish cyclical effects from the underlying trend developments in tax revenues.

In addition to the uncertainty associated with the structural budget balance, there is considera-

Table 3.1 Key figures for the fiscal budget and the Government Pension Fund. Bn. NOK

	Accounts		Estimates	
	2011	2012	2013	2014
Total revenues	1 223,5	1 290,7	1 286,0	1 295,0
1 Revenues from petroleum activities	372,2	421,1	373,9	344,1
1.1 Taxes and excise duties	209,7	232,7	206,5	186,5
1.2 Other petroleum revenues.....	162,6	188,4	167,4	157,6
2 Revenues other than petroleum revenues.....	851,3	869,6	912,0	950,9
2.1 Taxes and excise duties from Mainland Norway.....	777,5	807,4	855,2	896,9
2.2 Other revenues.....	73,7	62,2	58,8	54,0
Total expenditures	952,1	996,1	1 058,5	1 114,0
1 Expenditures on petroleum activities.....	21,4	25,6	30,0	30,0
2 Expenditures other than petroleum activities.....	930,7	970,5	1 028,5	1 084,0
Fiscal budget surplus before transfers to the Government Pension Fund Global	271,4	294,6	227,5	181,0
- Net cash flow from petroleum activities	350,8	395,5	343,9	314,1
= Non-oil surplus	-79,4	-100,9	-116,5	-133,1
+ Transfers from the Government Pension Fund Global	84,2	104,6	116,5	133,1
= Fiscal budget surplus.....	4,8	3,7	0,0	0,0
+ Net allocation to the Government Pension Fund Global.....	266,6	290,9	227,5	181,0
+ Interest earnings and dividends to the Government Pension Fund.....	103,0	115,3	129,4	146,6
= Surplus, fiscal budget and Government Pension Fund	374,4	409,9	356,9	327,6
Memo:				
Market value of the Government Pension Fund Global ¹	3 308	3 825	4 729	5 203
Market value of the Government Pension Fund ¹	3 437	3 970	4 882	5 366
National insurance scheme – old-age pension liabilities ¹	5 181	5 474	5 769	6 060

1 At year-end.

Sources: Statistics Norway and Ministry of Finance.

Table 3.2 Government Pension Fund Global, expected return on the Fund and the structural, non-oil budget deficit. Bn. NOK and per cent

	Current prices			Constant 2014-prices			Structural deficit	
	Government Pension Fund Global at the beginning of the year ¹	Expected return (4 pct. on the Fund capital)	Structural, non-oil budget deficit	Expected return (4 pct. on the fund capital)	Structural, non-oil budget deficit	Deviation from the 4 pct. trajectory	As pct. of Mainland Norway trend-GDP	As pct. of the Fund capital
2001	386,6	-	20,9	-	33,9	-	1,8	-
2002	619,3	24,8	36,9	38,4	57,3	18,9	3,0	6,0
2003	604,6	24,2	43,8	36,1	65,3	29,2	3,4	7,2
2004	847,1	33,9	48,0	49,1	69,6	20,5	3,5	5,7
2005	1 011,5	40,5	50,4	56,9	70,9	14,0	3,4	5,0
2006	1 390,1	55,6	46,8	75,5	63,6	-11,9	3,0	3,4
2007	1 782,8	71,3	48,0	92,4	62,1	-30,2	2,9	2,7
2008	2 018,5	80,7	56,8	98,6	69,3	-29,2	3,2	2,8
2009	2 279,6	91,2	94,9	107,2	111,6	4,4	5,0	4,2
2010	2 642,0	105,7	100,1	119,9	113,6	-6,3	5,0	3,8
2011	3 080,9	123,2	89,1	134,9	97,5	-37,5	4,2	2,9
2012	3 307,9	132,3	103,1	140,3	109,3	-31,0	4,7	3,1
2013	3 824,5	153,0	120,5	157,5	124,1	-33,4	5,2	3,2
2014	4 729,2	189,2	135,1	189,2	135,1	-54,0	5,5	2,9
2015	5 202,7	208,1	-	201,2	-	-	-	-
2016	5 594,5	223,8	-	209,2	-	-	-	-
2017	5 971,8	238,9	-	215,9	-	-	-	-
2018	6 353,0	254,1	-	222,0	-	-	-	-
2019	6 728,4	269,1	-	227,2	-	-	-	-
2020	7 126,5	285,1	-	232,6	-	-	-	-

1 The estimate for 2013 is based on the actual market value of the Fund at the beginning of September, with the addition of estimated net transfers from the fiscal budget to the Fund and 4 pct. annual real return until the end of 2013. As for the years from 2015 onwards, the estimate is premised on the technical assumption that annual withdrawals from the Fund correspond to 4 pct. of the Fund capital as per beginning of the year.

Sources: Statistics Norway and Ministry of Finance.

ble uncertainty about the future development of the capital in the Government Pension Fund Global, in both the short and the long run. Favourable financial market developments and depreciation of the Norwegian krone have resulted in steep growth in the Fund value over the last couple of years. It is currently estimated that the Fund will gain about NOK 900 billion in the course of 2013, cf. Table 3.1. In addition to the inflow of petroleum revenues and the high returns as measured in foreign currency, the Norwegian krone depreciation in recent months has contributed to an increase in the Fund capital as measured in Norwegian kroner.

Financial and foreign exchange market developments can be swiftly reversed. Both changes in the Fund capital and changes in the structural, non-oil deficit may result in major changes to the spending of oil revenues, measured as a portion of the Fund capital. This is illustrated by developments from 2008 to 2009, when the said portion increased from 2.8 to 4.2 pct.

The current discrepancy between the structur-

al, non-oil deficit and the expected return on the Fund provides us with a reserve for dealing with challenging times. If fiscal policy is to contribute to stabilising economic developments, deviations from the expected Fund return path may at times be considerable, measured in NOK billions.

The growth in the underlying expenditure of the fiscal budget from 2013 to 2014 is, in real terms, estimated at 2.5 pct. or NOK 26 billion, cf. Figure 3.1B. Underlying nominal expenditure growth in the fiscal budget is estimated at 5.5 pct. The real expenditure growth is slightly above the average for the last 25 years.

It follows from Table 3.1 that the total capital of the Government Pension Fund is estimated at NOK 5,366 billion at the end 2014, of which NOK 5,203 billion in the Government Pension Fund Global. In comparison, the value of accrued rights to future retirement pension payments from the National Insurance Scheme is estimated at about NOK 6,040 billion at the end of 2014. Government commitments in the form of disability pensions and dependants' pensions under the National Insurance Scheme come on top of this,

and are estimated at about NOK 1,300 billion at the end of 2014. Furthermore, the state has commitments in the form of accrued rights under the Norwegian Public Service Pension Fund, which amounted to about NOK 550 billion on 1 July 2013.

3.1.4 General government fiscal position

Since the mid-1990s petroleum revenues have contributed a substantial surplus to general government finances in Norway, whereas industrialised countries generally have posted deficits, cf. Figure 3.2A.

Norwegian general government net lending is estimated at NOK 315 billion in 2014, which corresponds to 10 pct. of GDP. This is slightly less than the estimate for 2013. The general government surplus is due to high revenues from the petroleum activities and high interest and dividend revenues in the Government Pension Fund, cf. Table 3.3. A high level of gross fixed investment in recent years has contributed to negative local government net lending. The reduction in general government net lending from 2013 to 2014 is, however, primarily caused by an estimat-

ed decline in the State's net cash flow from petroleum activities and by the increase in the non-oil budget deficit as the spending of petroleum revenues is gradually stepped up.

High revenues from petroleum activities and large allocations to the Government Pension Fund Global have resulted in a steep increase in general government net financial assets since the mid-90s. Developments in net financial assets are also influenced by changes in the market value of assets and liabilities. In 2008, the financial market slump resulted in a decline in the market value of assets, although transfers to the Government Pension Fund Global were substantial. Thus far in 2013, on the other hand, favourable financial market developments and Norwegian krone depreciation have contributed to a considerable increase in the market value of the Government Pension Fund. General government net financial assets are estimated at NOK 6,000 billion at the end of 2014, when including the capital of the Government Pension Fund and capital invested in government business operations. This corresponds to 195 pct. of GDP.

Public expenditure as a share of GDP is an indicator of the size of the public sector. Expendi-

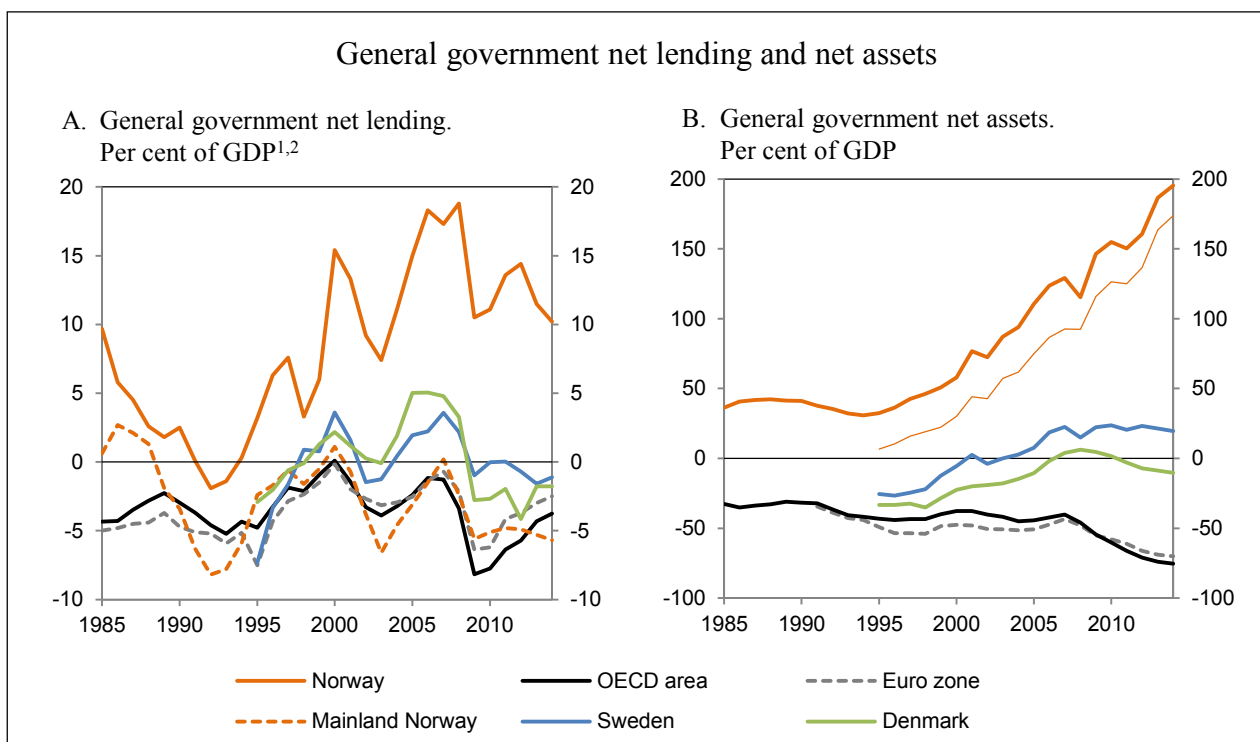


Figure 3.2 General government net lending and net assets

1 General government net lending is the surplus concept of the national accounts. General government net lending summarises the contribution made by financial transactions to changes in net financial assets. In addition, developments in net financial assets will depend on changes in asset valuations.

2 Mainland Norway represents general government net lending, less net cash flows to the State from petroleum activities and the return on the Government Pension Fund.

Sources: Statistics Norway, OECD and Ministry of Finance.

tures increased during the slump in 2009, but have subsequently remained fairly stable at close to the average for the last 25 years. However, the level is lower than during the recessions in the early 1990s and in 2003, cf. Figure 3.3A. The composition of public expenditure has also been altered somewhat during this period. Government transfers to the business sector, for example, have declined as a portion of mainland GDP, whereas public service provision expenditure has increased.

When measured as a share of mainland GDP, public expenditure appears to be fairly high in Norway in comparison with levels in other countries. Among the OECD countries, only Denmark has a higher level of public expenditure than Norway, by this measure. When measured as a share of overall GDP instead, public expenditure is somewhat lower than the average for the euro zone. The strong contribution from petroleum production to GDP is based on the depletion of a non-renewable resource, and will decline over time. Public expenditure relative to overall GDP therefore underestimates the long-term financing burden. Public expenditure as a share of mainland GDP will, on the other hand, overestimate the financing burden. This is partly because it disregards the funding contribution from the Government Pension Fund, and partly because it disregards the potential alternative use of the resources currently devoted to petroleum production.

Government expenditure needs to be funded.

The most important source of funding is revenues from taxes and excises. Other revenue sources are, inter alia, user fees and capital income. When measured as a portion of GDP, Denmark is the only OECD country with a higher tax level than the Norwegian mainland economy, cf. Figure 3.3B. Nonetheless, underlying growth in tax revenues has been good in Norway despite the relatively high tax level.

Norway's industrial structure is characterised by considerable value added in the petroleum sector. For purposes of international comparisons, the tax level of the Norwegian mainland economy is the most relevant indicator. Although a major part of the revenues from petroleum activities accrue to the State, the tax level of the overall economy is somewhat below that of the mainland economy. This is because revenues from the State's Direct Financial Interest (SDFI) in the petroleum activities accrue directly to the State, and hence are not subject to taxation.

Differences in public expenditure and tax levels between countries reflect differences in the division of labour between the public and the private sector. Public sector responsibility for retirement pensions does, for example, vary from country to country. Moreover, different countries tax pensions and other transfers differently. Countries also make varying use of tax deductions (tax expenditure) as an alternative to government transfers. Such differences influence gross figures with regard to both public expenditure and revenues. In addition, a number of coun-

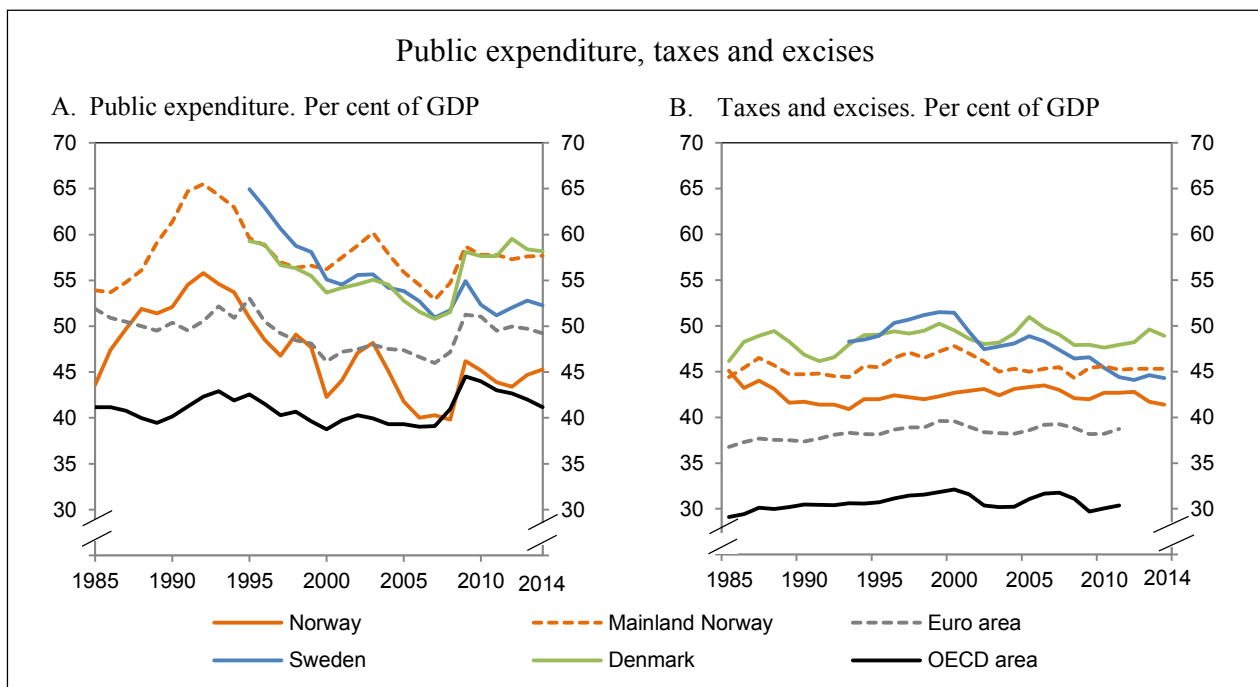


Figure 3.3 Public expenditure, taxes and excises

Sources: OECD, Statistics Norway and Ministry of Finance.

Table 3.3 General government net lending. Bn. NOK and per cent of GDP

	2012	2013	2014
A. Central government net lending, accrued value	440 232	366 436	338 753
Consolidated surplus in fiscal budget and Government Pension Fund	409 982	356 855	327 637
Non-oil fiscal budget surplus	-100 898	-116 475	-133 092
Net cash flow from petroleum activities	395 483	343 929	314 129
Interest and dividends on the Government Pension Fund	115 307	129 400	146 600
Surplus in other government and public pension accounts	1 288	3 085	3 107
Definitional discrepancies, central government accounts/national account ¹	29 052	6 496	8 009
B. Local government net lending, accrued value	-22 245	-23 695	-23 462
Local government surplus, book value	-17 395	-17 445	-17 210
Difference between accrued and book values, taxes	-4 850	-6 250	-6 252
C. General government net lending (A+B)	417 987	342 740	315 290
Measured as percentage of GDP	14,4	11,5	10,2

¹ Includes central government taxes accrued, but not booked, incl. tax revenue from the petroleum sector. Adjustments are made to address that capital contributed to state-run enterprises, including central government petroleum activities, are classified as net lending in the national accounts.

Sources: Statistics Norway and Ministry of Finance.

tries run fairly large structural budget deficits and have accumulated considerable government debt. Over time, these countries need to either reduce expenditure or increase revenues in order to strengthen public finances.

3.1.5 Fiscal policy in the medium run

Over time, the leeway in fiscal policy is primarily determined by developments in mainland economy tax revenues, by developments in the Government Pension Fund Global, as well as by expenditure and revenue commitments, including the growth in expenditure under the National Insurance Scheme. In addition, such leeway is influenced by whether the structural, non-oil deficit currently deviates from the estimated expected return on the Fund.

Despite a level of direct and indirect taxation that is relatively high from an international perspective, tax revenues from the mainland economy have grown healthily for many years. The tax system is characterised by broad tax bases, low tax rates and symmetrical treatment of income and expenses. At the same time, the Norwegian economy has undergone solid growth, helped by persistent growth impulses from the petroleum industry. In the decades to come, however, activity in the petroleum industry will level off and gradually decline.

For the coming years, the annual underlying real growth in tax revenue is estimated at about NOK 18 billion at 2014 prices, or just below 2 pct. Such strong underlying tax revenue growth should, however, not be taken for granted. A steep oil price decline, a reversal in the residen-

tial and commercial property markets or lower growth internationally may, for example, result in years of weaker growth in the Norwegian economy. This would also influence underlying developments in tax revenues from the mainland economy.

For the coming years, commitments under the National Insurance Scheme are estimated to increase annual expenditure by more than NOK 11 billion at 2014 prices, calculated as an average over the three-year period 2015–2017. Especially steep growth is expected in retirement pension expenditure. Such growth will continue for many years because the proportion of older people in the population is now increasing swiftly. Population developments will also, when taken in isolation, increase the expenditure of municipalities and health authorities. For the coming years, such annual expenditure growth is estimated to be in the region of NOK 4 to 5 billion at 2014 prices, assuming the continuation of the current standard and degree of coverage, and before taking into account any potential productivity gains. This implies that expenditure associated with population developments will absorb a considerable portion of the expected underlying growth in tax revenues. Furthermore, extensive expansion plans within transportation, defence procurement, etc., will increase budget commitments beyond those implied by pensions and demographics.

From around 2030 the expected real return on the Fund is estimated to gradually decline as a proportion of mainland GDP. Since oil revenue spending is currently below the expected return path of the Fund it is nonetheless possible, based on the current figures, to continue phasing in oil

revenues with a budget impulse of about $\frac{1}{4}$ pct. of mainland GDP for many years to come. Such a tempo corresponds to the average phasing-in of oil revenues over the twelve years during which fiscal policy has been guided by the fiscal policy rule. For the coming years, this represents an annual oil revenue expenditure increase of about NOK 9 billion at 2014 prices.

Economic policy needs to be examined in a long-term perspective. This is particularly important for Norway due to our temporarily high oil revenues. Pension, health and care expenditure will increase steeply as the population ages. Tax revenues from the mainland economy will continue to be the main source of funding for welfare schemes. The fiscal policy rule ensures, at the same time, that the return on the Government Pension Fund Global makes an important and lasting contribution. Over time, the size of the Fund will decline as a proportion of mainland GDP, as government petroleum revenues decline and GDP continues to grow. Assuming a fiscal policy in conformity with the fiscal policy rule, the Fund's financial contribution in 2060 will be roughly at the current level of withdrawals from the Fund, measured as a share of mainland GDP.

3.1.6 Fiscal policy challenges in the long run

Public social security provision in Norway is predominantly funded by taxes on the income generated by the working-age population, whereas children, youth and the elderly are net recipients of publicly-funded benefits, cf. Figure 3.4A. Funding of the social security schemes is critically dependent on high employment to give sufficiently high tax revenues. Increased labour force participation amongst women and an almost stable proportion of older people in the population have for several decades made it easier to fund such social security schemes. In addition, the increase in the spending of petroleum revenues has enabled the funding of social security scheme expansions without a corresponding increase in the tax level.

The proportion of older people (67 years and above) is estimated to increase from in excess of 22 per 100 persons of working age at present, to close to 25 in 2020 and then to over 40 in 2060, cf. Figure 3.4B. Although the high birth rates in the post-WWII years will contribute to considerable growth in the number of persons above the age of 67 years over the next few years, it is the increase in life expectancy that is the main driver behind the increase in the proportion of older people in the population over the long run. Life expectancy at birth has increased by more than 7 years in Norway since the adoption of the Norwegian Na-

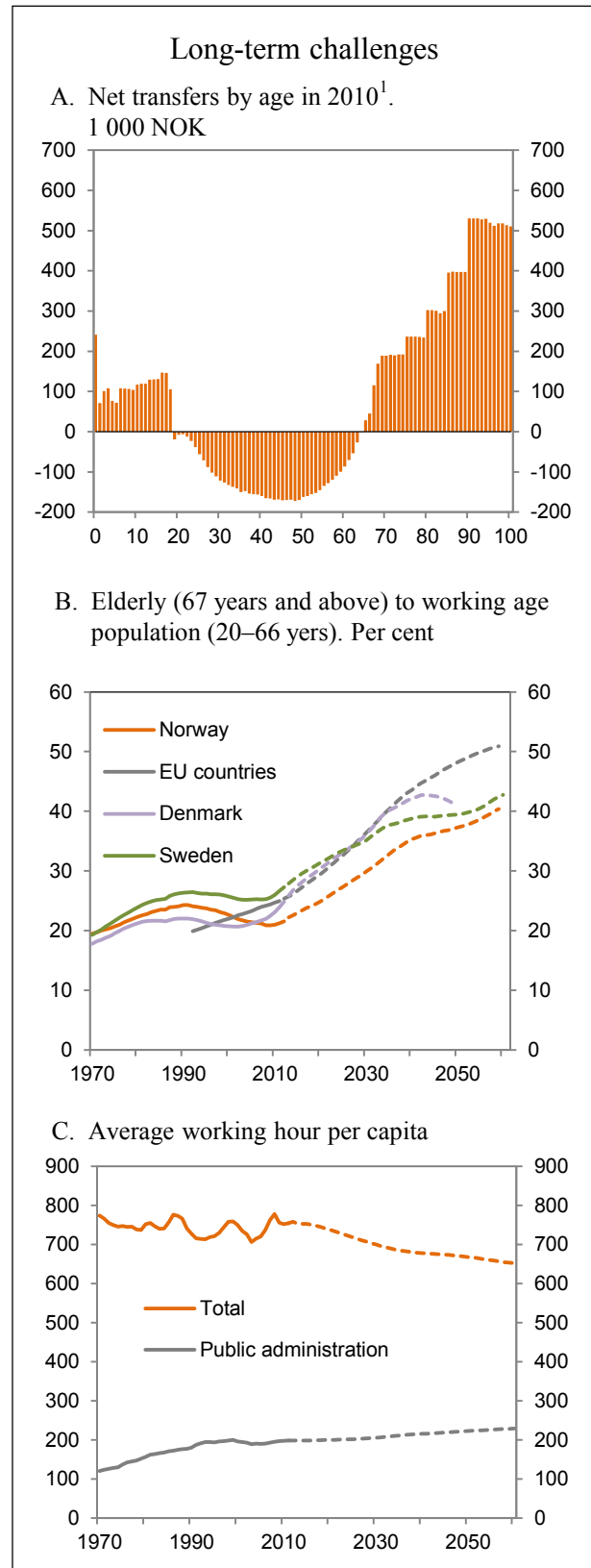


Figure 3.4 Long-term challenges

¹ Includes public sector expenditure on education, health, care and transfers to private individuals (including retirement pensions, sickness benefits and disability pensions), less personal taxes, value added tax and most other indirect taxes.

Sources: Statistics Norway, Eurostat, Statistics Sweden, Statistics Denmark and Ministry of Finance.

tional Insurance Act in 1967. Both the formal and the actual retirement age have declined over the same period. The population projections assume that life expectancy at birth will increase by a further 6½ years between now and 2060.

If labour market participation by age, gender and immigration status remains the same as at present, the changes in the composition of the population will result in a reduction in total labour effort per capita in coming years, cf. Figure 3.4C. This reduction will be more pronounced unless the decline in average working hours observed over the last 40 years does not come to an end. At the same time, the public sector labour effort will have to increase considerably in coming years in order to meet the growing need for health and care services resulting from the ageing of the population.

In coming decades the ageing of the population will contribute to public expenditure growth outpacing the growth in revenues from direct and indirect taxes on the mainland economy. Although future returns on the Government Pension Fund Global will make an important contribution to the funding of public sector expenditure, these will not be able to make up the growing shortfall. Continued expansion of public social security schemes or public services in step with general income growth will further exacerbate the fiscal policy challenges.

The White Paper on Long-term Perspectives for the Norwegian Economy 2013 provides estimates of what is required to sustain today's welfare systems for the next 50 years. The calculations indicate that continuation of the present welfare schemes will entail growth in age-related expenditure beyond the growth in tax revenues and returns on the Government Pension Fund Global. The fiscal shortfall will rise to about 6 per cent of mainland GDP by 2060, provided that the use of petroleum revenues follows the fiscal rule and unless labour supply increases in line with life expectancy. To cover the shortfall in 2060, Norway must either increase public sector income or identify sufficient savings that do not undermine the most important welfare systems.

In addition to the estimates of annual fiscal shortfalls, the Ministry of Finance also uses the so-called generational accounts in order to assess the long-term sustainability of public finances. With recent revisions to methodology, this indicator now corresponds to the S2 indicator in use by the European Commission. The indicator shows the adjustment to the current primary balance required to fulfil the infinite horizon intertemporal budget constraint. That is, current and future government revenue and net financial wealth matches current and future expenditure,

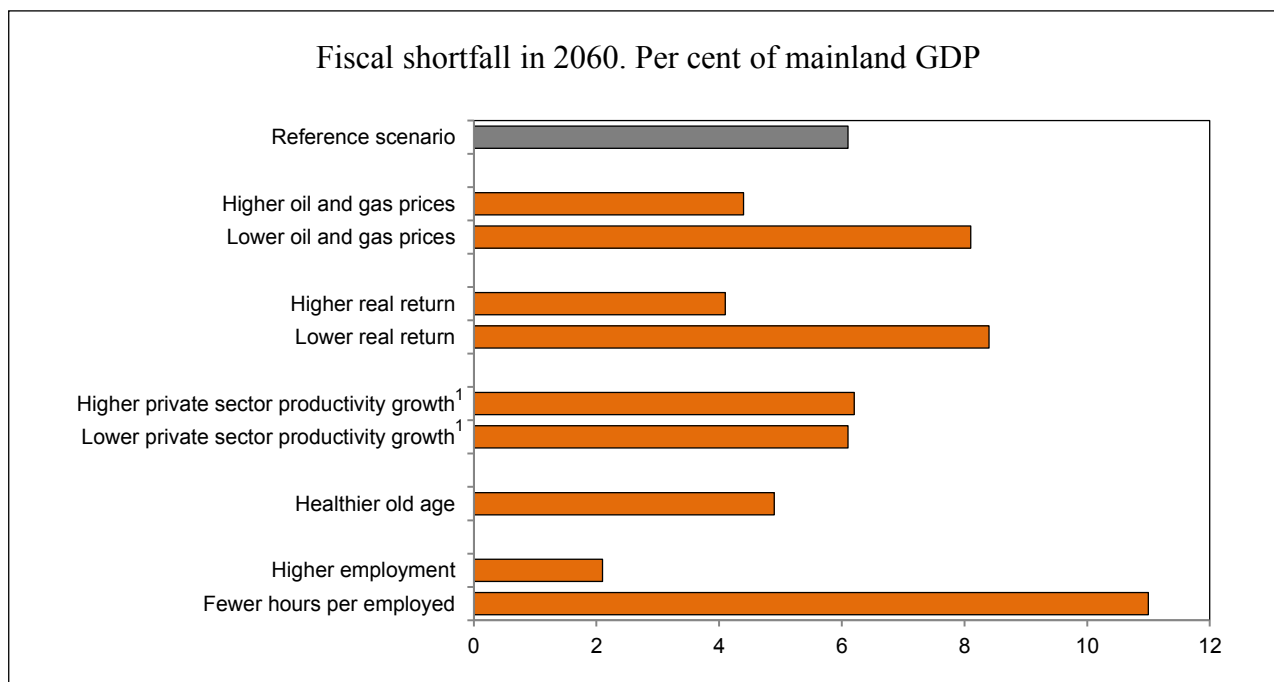
including paying for any additional expenditure arising from an ageing population. Based on the 2014 budget, this indicator shows a required adjustment corresponding to 3½ pct. of mainland GDP, which is about the same adjustment requirement as estimated in the White Paper on Long-term Perspectives.

The estimates of the long-term fiscal position are uncertain. They depend upon the underlying assumptions, and circumstances beyond political control may have a major effect on developments. However, the main conclusions are robust to reasonable variations in the underlying assumptions, cf. Figure 3.5.

High petroleum prices and high returns in international capital markets increase Norway's disposable income, and also contribute positively to public finances. Petroleum prices directly affect the State's net cash flow from the petroleum sector which is set aside in the Government Pension Fund Global. The returns on the Fund are determined in international capital markets. Norway's current high level of oil and gas production, together with the size of the Fund, makes the prices on petroleum and return on capital highly significant for the development of the financial contributions from the Fund, and thus for future public finances. Figure 3.5 illustrates the effect of an increase or decrease in petroleum prices by 25 per cent, relative to the baseline price of NOK 525 per barrel of oil, measured in 2013-prices. The figure also illustrates a return on the Fund of one percentage point above or below the reference scenario.

Higher productivity growth in the private sector increases overall prosperity and strengthens the economic foundation for funding public welfare benefits. However, it does not in itself contribute to better public finances. Higher productivity results in a higher wage level. This raises tax revenues, but also entails higher expenditures on wages, pensions and other transfers. On the other hand, higher productivity growth in the public sector creates leeway that can be used to strengthen public finances. As an example, if resource utilisation in the public sector is improved by ¼ per cent per year, the fiscal shortfall in 2060 will be reduced by approximately 3¾ per cent of mainland GDP. However, public sector productivity is difficult to measure, and consequently also to manage.

Labour supply developments are paramount to public finances. Tax on labour is an essential source of revenue. Higher employment will therefore expand tax bases and significantly bolster revenues. The figure shows the effect of an increase in labour supply in line with Statistics Norway's calculations of the potential long-term ef-



3.5 Fiscal shortfall in 2060

¹ Productivity shift covers private sector only.

Sources: Statistics Norway and Ministry of Finance.

fects of the pension reform. Given the other assumptions underpinning the reference scenario, such an increase will cover most of the fiscal shortfall. If increased labour supply decreases reliance on public benefits, there will be a double fiscal dividend, as expenditure also goes down. The calculations do not take into account any such reductions in outlays.

On the other hand, a shorter average working day has the same effect as a drop in employment. The figure illustrates the effect of a continued decline in the length of average working hours, in line with the developments seen in the past 20 years. In 2060, labour input will then be more than 10 per cent lower than in the reference scenario, and the fiscal shortfall will almost double. A longer average working day, however, would give a similar boost to public finances as higher employment.

The sustainability of public finance cannot be based on hopes of high petroleum prices and high returns on the Government Pension Fund Global, or on hopes that rising life expectancy will also result in a healthier older population. The supply of labour may, however, be influenced by policy. Policies for promoting employment should therefore be the principal strategy for addressing future fiscal challenges. High labour supply is a prerequisite for maintaining and further developing the welfare state.

3.2 Tax policy

Total accrued tax revenues in Norway will amount to about NOK 1,245 billion in 2013. This represents in excess of 40 pct. of overall GDP and forms the main basis for the funding of welfare goods. About 87 pct. of the tax revenues is paid to central government, whereas local government (municipalities and counties) receives 13 pct.

The Norwegian tax system is characterised by a relatively high share of indirect taxes. Value-added tax (VAT), excise duties and custom duties represent about 32 pct. of the central government's tax revenues. Personal income tax and the tax on net wealth levied on individuals represent about 25 pct. Corporate tax, including employers' social security contributions, amounts to approximately 22 pct. Taxes levied on petroleum activities (ordinary tax, special tax and environmental taxes) represent about 18 pct. of the central government's tax revenues.

The Government's objectives for its tax and fiscal policies are to safeguard public revenues, contribute to a fair income distribution and a better environment, promote economic growth and employment throughout the country and improve the functioning of the economy. The Government has stated that the level of taxation should be kept stable to ensure a good economic foundation for maintaining the welfare state.

The Government has strengthened the redistributive aspect of the tax system through more

stringent taxes on dividends and gains on equity investments, a more fair net wealth tax and inheritance tax and higher minimum deductions under both of these tax regimes. In addition, the tax system addresses environmental concerns more clearly. By continuing the systemic changes to the tax system within a stable tax level, the Government is ensuring a predictable tax system, making it attractive to invest and do business in Norway.

The Government keeps taxes at the 2004 level in line with the tax pledge. The tax proposal for 2014 includes features that will strengthen work incentives, close tax loopholes, simplify systems and improve the environment.

The Government is following up on the growth package for business announced in the Revised National Budget for 2013. The corporation tax rate will be reduced from 28 to 27 pct., and corresponding tax reductions will be introduced for the self-employed. These measures will improve competitiveness, promote profitability and strengthen investment in mainland businesses. In order to make the Norwegian tax base more robust, restrictions will be introduced in the deductibility of debt interest payable to close associates. It is proposed that the deductibility of interest costs to lenders that are close associates be limited to overall interest costs not exceeding 30 pct. of earnings before taxes, interest and depreciation. The proposal is in line with restrictions introduced in other countries, and is a first step towards protecting the Norwegian corporation tax base. A tax committee (the Scheel Committee) will examine Norwegian corporation tax in view of international developments and the tax system as a whole. The committee will deliver its report by 15 October 2014.

The rate structure of labour income taxation is maintained. The real progressiveness of labour income taxation is preserved by increasing the surtax thresholds, the personal allowance and the upper limits of the basic allowances in wage income and pension income in line with expected wage growth for 2014. The threshold triggering wealth tax is increased, and the wealth tax base is expanded. The threshold triggering inheritance tax is more than doubled, and the rate structure is simplified. The proposal will reduce the number of people paying inheritance tax by about two thirds.

The Government proposes that the tax exemption upon the sale of homes be restricted to a portion of the capital gain calculated by dividing the number of years the owner has lived in the home by the number of years the owner has owned such home. The proposal targets the fact that owners of second homes (i.e. homes in addi-

tion to the owner's own home, in which the owner lives) can currently avoid tax by moving into such home and living there for the last year before the said home is sold. Homes will remain exempted from capital gains tax to the extent that the owner has lived there.

The tax reform of 2006 and a number of changes to the tax and social security system in recent years have made work more profitable for many people. The Government is now proposing the abolition of tax class 2 for married couples, which is a tax rule from a time when it was common for one spouse to work at home. The abolition of tax class 2 will make it more profitable for spouses with low or no income to increase their labour supply, and will promote equal opportunities and integration.

The Government is strengthening the climate and environmental profile of indirect taxes. It is proposed that the CO₂ tax on mineral oil and gas and the tax on HFC and PFC be increased to about NOK 330 per tonne of CO₂ equivalents. Auto diesel is exempted from the tax increase, whereas the rates for domestic aviation are increased by about NOK 50 per tonne of CO₂. Furthermore, it is proposed that more weight be attached to CO₂ and NO_x emissions in the registration tax for passenger cars and that less weight be attached to engine power. The environmental profile will also be strengthened for heavy vehicles. It is proposed that the environmentally differentiated annual weight-based tax be increased, and that the re-registration tax be abolished, for motor vehicles with a total weight in excess of 7.5 tonnes. It is proposed that the electricity consumption tax be increased by 1.12 øre per kWh on top of price adjustments.

The Government is continuing its clean-up of sectoral taxes and overpriced fees. It is proposed, inter alia, that registration fees be further reduced in 2014, such as to reach a level reflecting costs.

For further details on the tax proposal for 2014, please see the English summary of Chapter 1 of the bill and draft resolution on taxes.

3.3 Monetary policy

Norges Bank's implementation of monetary policy shall be aimed at low and stable inflation, defined as an annual increase in consumer prices that remains close to 2.5 pct. over time. In the short and medium term, monetary policy shall weigh low and stable inflation against production and employment stability.

Norges Bank has kept the key policy rate unchanged at 1.5 pct. since March of last year, after reducing the rate by a total of 0.75 percentage point in the autumn of 2011 and the spring of

2012. The key policy rate will, according to the Norges Bank policy rate forecast, remain unchanged at 1.5 pct. until the summer of 2014, and subsequently be gradually increased to about 2¾ pct. towards the end of 2016.

The difference between the three-month money market rate and the market's key policy rate expectations for the same period provides an indication of the risk premium banks will require when extending unsecured loans to each other. The risk premium declined steeply in the summer and autumn of last year, and is now about ¼ percentage point. This has contributed to lower borrowing costs for banks. However, the lending rates banks offer to households have not kept up with these developments, and banks have thus increased their lending margins. Banks are now improving their capital adequacy in view of new capital adequacy requirements.

Monetary policy influences the Norwegian economy through the key policy rate, and also indirectly through the Norwegian krone exchange rate. The low interest rates abroad are also taken into account when Norges Bank is determining the key policy rate, as higher interest rates in Norway than in other countries may result in appreciation of the Norwegian krone. There has been an appreciating trend for the Norwegian krone over the last decade. When taken in isolation, this provides an impetus for lower inflation in Norway, while at the same time impairing the profitability of those Norwegian businesses that are exposed to international competition. However, the Norwegian krone depreciated rather significantly after Norges Bank revised its policy rate path downwards in June. This autumn has seen major fluctuations in the Norwegian krone exchange rate. The Norwegian krone had by primo October depreciated by about 9 pct. since the beginning of the year, as measured by the trade-weighted exchange rate index (TWD), which is more or less on par with the average since 2001 when the Government set an inflation target for the monetary policy.

3.4 Financial stability

3.4.1 Introduction

Financial markets play a highly important role in modern economies. A well-functioning and robust financial industry is of decisive importance to the stability of the Norwegian economy, as well as its capacity to generate growth. Recessions that originate in financial market problems are often especially deep and protracted. Consequently, preventing and avoiding finan-

cial crises is of great importance for unemployment and the real economy in general, as well as to prevent loss for businesses and individuals. The banking crisis in Norway in the early 1990s highlighted the costs associated with financial crises. Well-capitalized financial institutions are beneficial for society as a whole.

Norwegian authorities have for many years been committed to regulating the various parts of the financial market in a consistent and integrated manner. The same type of risk is regulated the same way, irrespective of its location. This contributes to robust financial institutions and prevents risk from accumulating where it is subject to the least regulation. Consolidation rules contribute to the solvency and liquidity of consolidated financial groups as a whole, as well as their constituent parts. Moreover, Norwegian authorities have emphasised that rules need to be consistent over time, thus preventing these from being made more lenient in prosperous times and having to be tightened when times are challenging. A single supervisory authority contributes to consistent supervision across the industry, makes it easier to keep track of financial industry development and provides a better basis for assessing risk within the financial industry as a whole.

3.4.2 Financial institutions' solvency and earnings

Norwegian banks have been less influenced by the turbulence in Europe than have other European banks. This is due to favourable economic conditions in Norway in general, as well as the integrated and consistent regulation and supervision of financial market. Norwegian banks had strong earnings in the first half of 2013. Banks' solvency and funding structure have been strengthened over the last couple of years. Earnings developments and outlooks indicate that banks are well placed to further improve their solvency. Norwegian banks do, however, have a substantial amount of funding in foreign currencies. This makes them vulnerable to disrupted access to international capital markets.

A favourable economic situation in Norway has, in combination with a low after tax interest rate level, contributed to a steep increase in housing prices and household debts in recent years. Persistently low interest rates may influence household expectations with regard to future developments and contribute to the continued escalation of housing prices and household debts. Experience from both Norway and other countries suggest that high housing prices and high debts pose a challenge to the financial system. Mounting defaults and declining asset values may for

instance add to banks' losses and exacerbate recessionary impulses. A housing market slump may also cause a general decline in household demand, which would impair businesses' profitability and ability to service their bank loans, and might trigger higher unemployment.

3.4.3 Capital requirements

Capital adequacy regulations have changed over time. Following the introduction of a harmonised international standard on capital adequacy provisions for banks by the Basel Committee on Banking Supervision (BCBS) in 1988 (Basel I), the standard has been revised twice. Basel II was presented in June 2004, and Basel III was presented in December 2010. Correspondingly, three revisions have been adopted to the EU Capital Requirements Directive (CRD); CRD II was adopted in September 2009, CRD III in November 2010 and CRD IV/CRR (also referred to as the CRD IV package) in June 2013.

Rules to introduce new capital requirements in line with the Basel III standards and the CRD IV package were adopted by the Storting on 10 June 2013, and came into force on 1 July 2013. The requirements will be gradually increased over a three-year period, and fully phased-in on 1 July 2016.

The new rules state that banks etc. (credit institutions and investment firms) shall have a CET1 capital ratio of no less than 4.5 pct. The total capital ratio minimum requirement of 8 pct. continues to apply. Moreover, requirements have been extended to include a capital conservation buffer of 2.5 pct. CET1 capital, as well as an initial systemic risk buffer of 2 pct. CET1 capital.

The systemic risk buffer requirement will increase from 2 pct. to 3 pct. CET1 capital on 1 July 2014. Furthermore, separate buffer requirements, of 1 pct. as per 1 July 2015 and 2 pct. as from 1 July 2016, will be added for systemically important institutions. The Ministry will issue further rules on, inter alia, criteria for determining which institutions shall be classified as systemically important. Against that background The Ministry has, in a letter of 8 May 2013, requested the Financial Supervision Authority to prepare draft rules on systemically important financial institutions by 1 November 2013.

The increase in the systemic risk buffer and the separate buffer requirement for systemically important institutions may require a gradual increase in banks' CET1 capital ratios. As per 31 December 2012, Norwegian banks had a combined CET1 capital ratio slightly in excess of 11 pct., following an increase of more than 1 percentage point during 2012. Given the same level

of earnings ahead, banks will easily be able to meet the 2016 minimum requirements.

The rules adopted by the Storting in June 2013 included statutory authority for the Ministry to issue further rules on the implementation of a counter-cyclical capital buffer requirement of between 0 and 2.5 pct. CET1 capital. The rules also include a requirement on the reporting of leverage ratios.

3.4.4 Risk-weighted assets

On 22 March 2013, the Ministry of Finance issued a public consultation with draft proposals on four possible alternatives to the current lower limit on IRB banks' risk-weighted assets, the so-called Basel I floor rule. In the Revised National Budget for 2013, the Ministry announced that it will get back to this issue in the autumn of 2013.

The Ministry of Finance has decided to maintain the current Basel I floor rule. Moreover, the Ministry has decided to raise the minimum requirement on IRB banks' "Loss Given Default" LGD estimates from 10 to 20 pct. This will also apply to branches of foreign institutions. A minimum LGD requirement of 20 pct. may give an average risk-weighting of residential mortgage loans of about 20 pct. The Basel I floor rule will still determine the actual level of risk-weighted assets for most Norwegian banks.

The Financial Supervision Authority of Norway is reviewing banks' IRB models with a view to, inter alia, raising the lowest estimates of "Probability of Default" (PD). This is likely to result in somewhat higher and more equal risk-weighting of residential mortgage loans in Norwegian banks. It is important not to abolish the Basel I floor rule until a satisfactory level has been established for banks' risk-weighted assets, i.e. at least the level currently defined by the floor rule.

3.4.5 Counter-cyclical capital buffer

The Ministry of Finance issued on 4 October 2013, by Royal Decree, a regulation on the implementation of a counter-cyclical capital buffer requirement; cf. above. Four times a year, and no later than at the end of each quarter, Norges Bank shall provide advice to the Ministry with regard to the determination of the counter-cyclical capital buffer level, including a basis for decision-making. Norges Bank and the Financial Supervision Authority of Norway shall exchange relevant information and assessments in connection with Norges Bank's preparation of the basis for decision-making. The Ministry of Finance shall determine the counter-cyclical capital buffer level. The Ministry of Finance will publish the advice from

Norges Bank simultaneously with the publication of the Ministry's decision.

On 14 March 2013, Norges Bank published a detailed description of how Norges Bank will prepare the decision-making basis underpinning its advice to the Ministry of Finance; cf. Norges Bank Memo No. 1/2013 on criteria for a good counter-cyclical capital buffer. Norges Bank will, as a main rule, focus on four key indicators: Total credit to households and non-financial enterprises as a proportion of mainland GDP, housing prices relative to household disposable income, commercial property sales prices and the portion of market funding for Norwegian credit institutions. There will be no mechanical link between the indicators and the buffer advice. Such advice will be based on the Bank's professional assessment and be considered in view of other requirements applicable to banks. The indicators are likely not well suited for providing signals as to when the buffer requirement shall be reduced. Other information, like market turbulence and the loss prospects of banks, will be more relevant for such purposes.

3.5 Employment policy

3.5.1 Recent developments in the labour market

Last year, the number of people in employment was about 2.5 pct. above the level in 2008, when the business cycle last peaked, and no less than 16 pct. above the level in 2003, at the begin-

ning of that cyclical upturn, cf. Figure 2.2A. Strong population growth as the result of net immigration implies that employment measured as a share of the population has remained stable over the last decade. In 2012, 69.2 pct. of the population aged 15-64 years was in employment; 0.2 percentage points higher than in 2003.

The private sector accounted for about three fourths of the increase in employment last year. After bottoming out in 2010, employment growth has been especially strong in the building and construction industry, in offshore-related parts of manufacturing industry, as well as in some service industries.

Immigrants have accounted for two thirds of employment growth in Norway since the expansion of the European Economic Area (EEA) in 2004, cf. Figure 3.6B. Extensive labour immigration has resulted in strong population growth and cleared bottlenecks in the Norwegian economy. Increased immigration from the EU member states in Eastern Europe explains about half of the increase since 2004, with the main countries of origin being Poland and Sweden. The number of employed immigrants increased by almost 40,000 from the 4th quarter of 2011 to the 4th quarter of 2012, which represents about three fourths of the employment growth last year.

The labour force has also grown markedly in recent years in line with the increased demand for labour. The labour force expanded by 1.8 pct. from 2011 to 2012. The labour force has continued to grow this year, more or less in line with

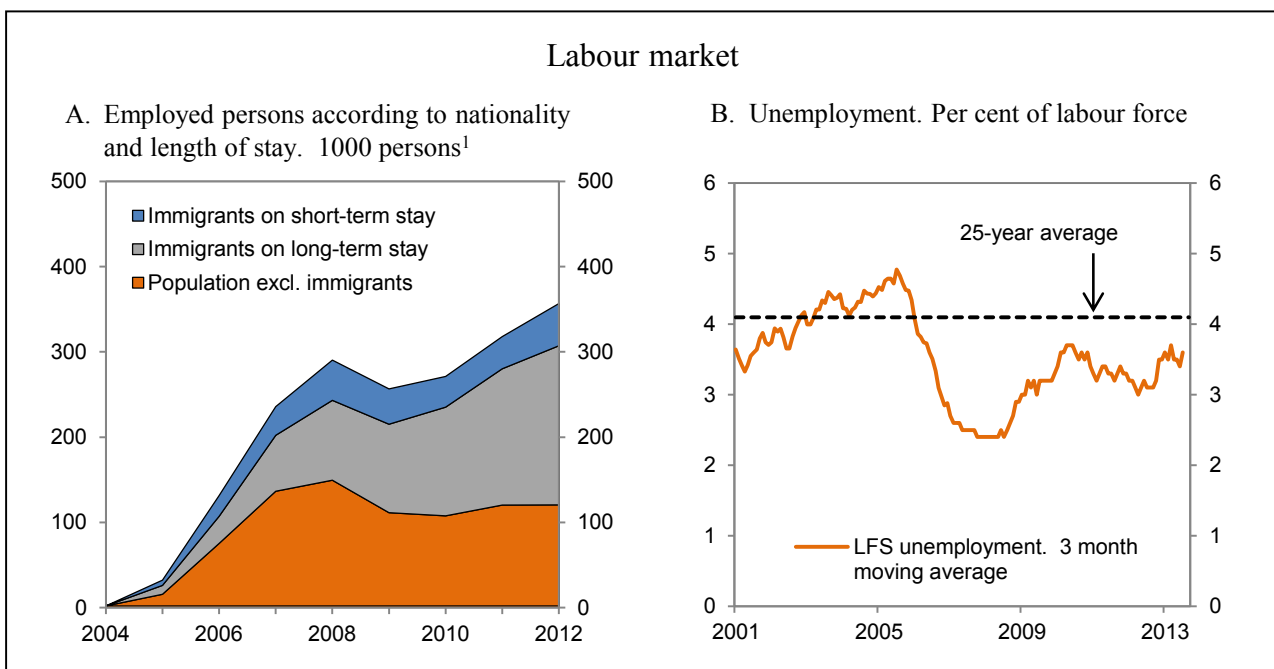


Figure 3.6 Labour market

¹ Accumulated growth from 2004 (4. quarter each year).

Sources: Statistics Norway and Ministry of Finance.

the increase in employment.

Labour force developments ahead will depend on, *inter alia*, the scale of labour immigration. With favourable developments in the Norwegian economy, in combination with low growth and high unemployment in much of Europe, it is likely that Norway will remain attractive for labour immigrants in the coming years. Moreover, changes in the population composition have, all in all, contributed to an annual reduction in overall labour force participation in Norway of about $\frac{1}{4}$ percentage point from 2008 to 2012. This is largely caused by an increase in the proportion of older people. Ageing will also in the coming years contribute to a reduction in overall labour force participation, although increased employment amongst older people as the result of, *inter alia*, the pension reform may somewhat abate such reduction.

Unemployment is low in both historical and international terms. The unemployment rate as measured by the Labour Force Survey (LFS) was 3.2 pct. in 2012, cf. Figure 3.6A. Unemployment increased moderately towards the end of last year, but only minor fluctuations have been observed thus far this year. In July (the three-month period from June to August), 3.6 pct. of the labour force was unemployed, when adjusting for normal seasonal variations.

3.5.2 Policies

Despite that Norway enjoys higher labour force participation and lower unemployment than most other OECD countries, too many people are receiving health-related social security benefits and not participating in working life. Recent years have seen the implementation of a number of reforms and measures that may have an impact on employment. The pension reform is the most important of these. Many reforms and measures have only been in effect for a short period of time. It is too early to draw conclusions with regard to long-term effects, but there seems to be a clear tendency of increased work participation among people aged 62 years and above.

As per yearend 2012, almost one fifth of people aged 18-66 years received a health-related social security benefit. However, some of these benefit recipients are employed, and thus are not completely excluded from working life. Sickness absence declined by close to 5 pct. from 2010 to 2012. The decline came to a halt in mid-2012, and sickness absence has increased moderately since then. About half of all sickness absence is caused by muscle and skeletal disease or mental disorder.

For many people, long-term sickness absence is the first step towards a permanent disability

pension. In 2012, one sixth of those who had claimed sickness benefits for the maximum period available returned to work, whereas the vast majority went on to receive work assessment allowance or disability pension. There is a close follow-up of sickness benefit recipients, with a view to preventing long-term sickness absence, through both the Inclusive Working Life Agreement (IA-agreement) and other measures. Such measures have included facilitation in the workplace and expanded use of graded sickness benefits. Research indicates that the expanded use of graded sickness benefits has reduced sickness absence and exclusion from working life. However, an evaluation of the IA-agreement from May 2013 finds that the follow-up of sickness benefit recipients imposes a significant administrative burden on employers, on the Norwegian Labour and Welfare Service (NAV) and on physicians, without any documentable effect on sickness absence. The evaluation notes that many sickness benefit recipients do not return to work even if their health improves, as the result of, *inter alia*, a problematic relationship with their workplace and poor prospects for finding a new job.

The number of work assessment allowance recipients has declined by about 2 pct. from August last year to August this year. The total proportion of the population aged 18-66 years that receives work assessment allowance currently stands at 5 pct. The number of disability pension recipients has declined by just over one pct. in the last year. The overall disability rate has remained stable at about 9.5 pct. for a number of years.

Labour market measures have long been used to reduce passivity and exclusion amongst the unemployed. The labour market measures are partly targeted at jobseekers and partly at people with a reduced capacity for work. In 2013, it is intended that on average 16,000 measures will be provided for jobseekers and 55,000 for people with an impaired work capacity.

Employment policy is tailored to the labour market situation. The increase in unemployment from the autumn of 2008 and the uncertainty characterising the subsequent years paved the way for a temporary increase in labour market measures for jobseekers. Labour market outlook remains favourable. As a result the Government proposes that measures be scaled back to 14,000 for jobseekers in 2014 on average. At the same time, the Government would like to expand measures targeting people with a reduced capacity for work to on average 56,700 measures, i.e. 1,700 more than is planned for this year.

4 Management of the Government Pension Fund

4.1 Introduction

The purpose of the Government Pension Fund is to facilitate government savings to finance rising public pension expenditure and to support long-term considerations in the spending of government petroleum revenues. Sound long-term management of the Fund contributes to ensuring that the petroleum wealth will benefit both current and future generations.

The Government Pension Fund comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN).

The Government Pension Fund does not have any board or management of its own, and is not a legal entity. The operational management of the two parts of the Fund is carried out by Norges Bank and Folketrygdfondet, respectively, under mandates laid down by the Ministry of Finance.

The investment strategy of the Government Pension Fund is premised on the objective of the Fund, assumptions with regard to the functioning of the financial markets, as well as the special characteristics and comparative advantages of the Fund. There are distinct differences between the two parts of the Fund in this respect. The GPFN is a relatively large investor in a small capital market, whereas the GPFG is, in relative terms, a smaller investor in large international markets.

Box 4.1 Properties of the Government Pension Fund Global portfolio

The investment strategy of the Fund seeks to maximize the international purchasing power of the fund capital, given a moderate level of risk. The long-term investment strategy of the Fund stipulates that 60 per cent of the portfolio be placed in equities and up to 40 per cent in fixed-income securities. In 2010 it was decided that up to 5 per cent of the Fund be invested in a separate real estate portfolio, reducing the fixed-income allocation.

The investments are diversified across several asset classes and, at the end of 2012, included investments in about 7 400 equities and fixed-income securities from approximately 1 200 issuers. The Fund aims at small ownership shares, with an absolute limit to ownership of 10 per cent in one company. The average ownership share was 1.2 per cent at the end of 2012. From 1 January 1998 to 30 June 2013 the GPFG had an annualized gross nominal return of 5.25 per cent, measured in international currency. This gives an annual net real return of 3.2 per cent after management costs and inflation. When measured from 1 January 1997 to 1 June 2013, inclusive, the average annual net real rate of return is calculated to be 3.4 per cent.

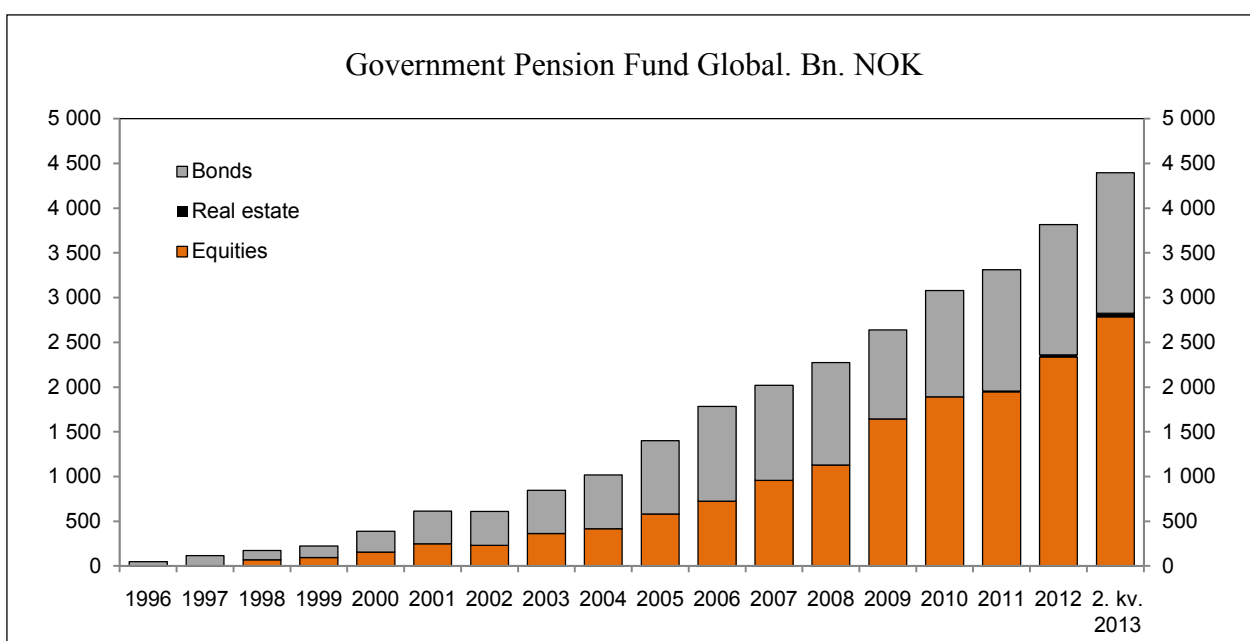


Figure 4.1 Government Pension Fund Global. Bn. NOK

Sources: Norges Bank and Ministry of Finance.

The strategy of both the GPFG and the GPFN seeks to achieve the highest possible return over time, subject to a moderate level of risk. The investments are spread across different asset classes and a broad range of countries, sectors and companies. The investment strategy has been developed over time, on the basis of professional analyses and assessments.

The Government Pension Fund has a very long time horizon. The Fund does not have clearly defined liabilities, and it is unlikely that the State will be withdrawing large amounts from the Fund over a short period of time. These characteristics mean that the Fund is, generally speaking, better positioned to absorb risk than are many other investors. Consequently, the investment strategy does not aim for fluctuations in the value of the Fund to be minimised in the short run. A strategy predicated on such an objective would have offered a considerably lower expected return over time.

Experience from the management of the GPFG and the GPFN in recent years shows that one needs to be prepared for considerable fluctuations in the value of the investments of the Fund. Broad-based support for how the Government Pension Fund is managed provides a solid foundation for the long-term strategy, especially during periods of considerable market turbulence.

The Ministry emphasises the Fund’s role as a responsible investor. Good long-term financial return is assumed to depend on sustainable development in economic, environmental and social

terms, and on well-functioning, efficient and legitimate markets. Responsible investment, including the exclusion mechanism of the Fund and the exercise of ownership rights by Norges Bank and Folketrygdfondet, forms an integrated part of asset management. The responsible investment activities take place within the framework the Fund’s role as a financial investor. The Government Pension Fund is not a suitable vehicle for attending to all forms of obligations, and the Fund shall not be a foreign policy tool.

The Government aims for the Government Pension Fund to be the best managed fund in the world. This requires identifying and reaching for international best practice with regard to all aspects of fund management. Transparency is a prerequisite for securing widespread confidence in the management of the Fund. Operational management performance is reported by Norges Bank and Folketrygdfondet on a regular basis. The Ministry reports on the management of the Fund in the National Budget and in an annual report to the Storting during its spring session, cf. Report No. 27 (2012 – 2013) to the Storting – The Management of the Government Pension Fund in 2012.

The Ministry will, in seeking to further develop the investment strategy, attach special weight to exploiting the special characteristics of the Fund, as a large investor with a long time horizon and limited liquidity needs. This will aim to further improve the ratio between expected risk and return. Chapter 4.2 discusses financial market developments and the performance of the GPFG

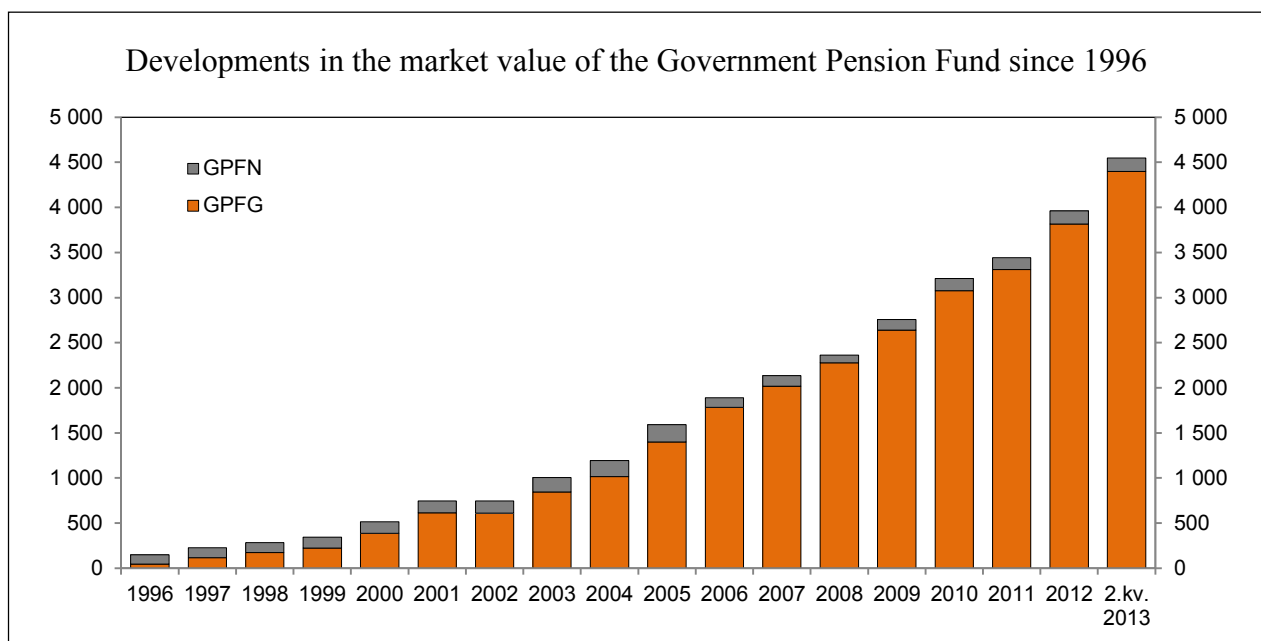


Figure 4.2 Developments in the market value of the Government Pension Fund since 1996. Market value from 1996 to 2. quarter of 2013. Bn. NOK

Sources: Norges Bank, Folketrygdfondet and Ministry of Finance.

and the GPFN during the first half of this year. Chapter 4.3 discusses certain current issues relating to the management of the Government Pension Fund.

4.2 Asset management performance

4.2.1 The market value of the Government Pension Fund

The total market value of the Government Pension Fund was NOK 4,548 billion at the end of the first half of 2013; an increase of NOK 587 billion on the value at the beginning of the year. The GPFG accounted for almost 97 pct. of total assets. Figure 4.2 shows developments in the market value of the Fund over the period from 1996 until the first half of 2013.

4.2.2 The return on the Government Pension Fund Global (GPFG)

The market value of the GPFG was NOK 4,397 billion at the end of the first half of 2013. This represents an increase of NOK 581 billion since the turn of the year. The inflow of new capital to the Fund during the first six months of the year was NOK 121 billion and the return accounted for NOK 237 billion. Changes in the Norwegian krone exchange rate entailed, when taken in isolation, a NOK 225 billion increase in value. Asset management costs were somewhat in excess of NOK 1 billion.

At the end of June, 63.4 pct. of the Fund was invested in equities, 35.7 pct. in fixed-income securities and 0.9 pct. in real estate.

The return on the GPFG during the first half of the year was 5.5 pct., as measured in the currency basket of the Fund. When measured in Norwegian kroner, the return on the Fund was 15.9 pct. The difference between the return in Norwegian kroner and in the currency basket of the Fund

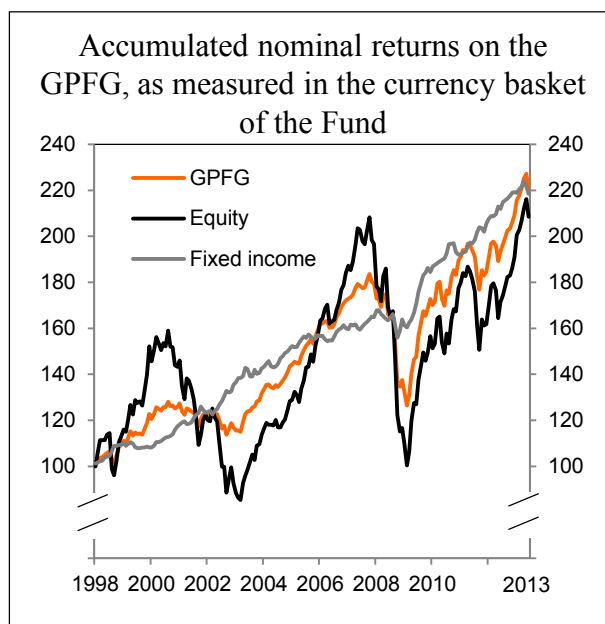


Figure 4.3 Developments in the nominal value of the sub-portfolios of the Government Pension Fund Global, as measured in the currency basket of the Fund. Index value at the end of 1997=100

Sources: Norges Bank and Ministry of Finance.

was caused by depreciation of the Norwegian krone relative to the currency basket of the Fund over this period. However, the return in international currency is the relevant measure with regard to developments in the international purchasing power of the Fund.

The return on the equity portfolio was 9.2 pct., the return on the fixed-income portfolio was -0.4 pct., and the return on the real estate portfolio was 3.6 pct., as measured in the currency basket of the Fund. The establishment of the real estate portfolio is still in an early phase. Hence, the currency composition of the real estate portfolio deviates significantly from the currency basket of the Fund. Exchange rate fluctuations may therefore affect the measured return. However,

Table 4.1 Key figures for the Government Pension Fund Global as at 30 June 2013. Annual data as measured in the currency basket of the Fund. Per cent

Government Pension Fund Global	Last 12 months.	Last 3 years	Last 5 years	Last 10 years	Since 1 January 1998
Nominal return.....	14,21	9,16	5,87	5,95	5,25
Inflation	1,74	2,29	1,70	2,17	1,92
Asset management costs	0,06	0,08	0,09	0,10	0,09
Net real rate of return	12,18	6,64	4,00	3,61	3,17
Excess return (equity and fixed income investments, gross)	0,83	0,46	0,28	0,24	0,31

Source: Norges Bank.

this effect was close to zero for the first half of 2013 as a whole. Figure 4.3 shows developments in the value of the equity and fixed-income portfolios since 1 January 1998.

The return on the equity and fixed-income portfolios is evaluated against a benchmark index. All in all, Norges Bank achieved a return in the first half of 2013 that exceeded the return on the benchmark index by 0.65 percentage point. Excess returns were generated in both equity management and fixed-income management. Over the last three years, the active management of the equity and fixed-income portfolios generated an annual gross excess return of 0.46 percentage point. Since yearend 1997 the annual gross excess return is 0.31 percentage point, cf. Table 4.1.

The average annual net real rate of return since year-end 1997, i.e. the return net of asset management costs and inflation, is calculated to be 3.2 pct., as measured in the currency basket of the Fund. When measured from 1 January 1997 to the first half 2013, inclusive, the average annual net real rate of return is calculated to be 3.4 pct.

4.2.3 The return on the Government Pension Fund Norway (GPFN)

The market value of the GPFN was NOK 151.1 billion at the end of the first half of 2013. This represents an increase of NOK 5.9 billion since the beginning of the year. At the end of June, 59.1 pct. of the Fund capital was invested in equities and 40.9 pct. was invested in fixed-income securities.

The return on the GPFN in the first half of 2013 was 4.1 pct., as measured in Norwegian kroner. The return on the Norwegian equity portfolio was 4.6 pct., while return on the Nordic equity portfolio was 12.9 pct. The Norwegian fixed-income portfolio delivered a return of 0.2 pct. and return on the Nordic fixed-income portfolio was 6.3 pct. The high return on the Nordic fixed-income portfolio is primarily caused by changes in the Norwegian krone exchange rate.

In the first half of 2013, Folketrygdfondet generated a return on the GPFN that was 0.31 percentage point lower than the return on the benchmark index stipulated by the Ministry. Equity management underperformed the benchmark index, whereas fixed-income management generated a positive excess return. Active management has generated an annual gross excess return of 0.52 percentage point over the last three years. Since year-end 1997 the annual gross excess return is 0.46 percentage point, cf. Table 4.2.

4.3 Current issues in the management of the Government Pension Fund

4.3.1 Review of Norges Bank's management of the GPFNG

The Ministry announced, in Report No. 10 (2009-2010) to the Storting – The Management of the Government Pension Fund in 2009, its intention to conduct regular and broad reviews of the active management of the GPFNG at the beginning of each term of the Storting. It was noted, moreover, that such reviews may lead to upwards or downwards adjustments in the scope of active management.

The Ministry has, in line with this, embarked on a comprehensive review of Norges Bank's management of the GPFNG. The Ministry has, as part of such a review, requested Norges Bank to submit analyses and assessments of its management of the GPFNG, including assessments as to whether the current limits to the management are appropriate and tailored to the asset management strategies pursued.

Furthermore, the Ministry has appointed a group comprising three internationally recognised experts with broad knowledge and experience from both academia and practical asset management: Professor Andrew Ang (Columbia Business School), Professor Michael Brandt (Duke University) and David Denison (former head of the Canadian pension fund manager CPPIB). The group will be analysing the active management

Table 4.2 Key figures for the Government Pension Fund Norway as at 30 June 2013. Annual data as measured in Norwegian kroner. Per cent

Government Pension Fund Norway	Last 12 months.	Last 3 years	Last 5 years	Last 10 years	Since 1 January 1998
Nominal return.....	11,55	10,26	6,04	7,34	6,64
Management costs	0.10	0.09	0.09	0.06	0.05
Excess return (gross)	-0,16	0,52	0,95	0,45	0,46

Source: Folketrygdfondet.

performance of Norges Bank and assess whether the continued delegation of asset management tasks to the Bank may improve the ratio between return and risk beyond the benchmark index stipulated by the Ministry. The mandate of the expert group and the letter from the Ministry of Finance to Norges Bank are available on the Ministry website (www.regjeringen.no/spf).

Norges Bank's review and the report from the expert group will form part of a decision-making basis to be presented to the Storting in the spring of 2014.

4.3.2 The Strategy Council for the GPF

In January this year, the Ministry of Finance instructed the Strategy Council for the GPF to prepare a report on the overall responsible investment strategy, cf. the discussion in Report No. 27 (2012-2013) – The Management of the Government Pension Fund in 2012. The Strategy Council will be submitting its report during the autumn of this year.

The Strategy Council shall, inter alia, assess how the collective resources and expertise of the Ministry of Finance, the Council on Ethics and Norges Bank can best be utilised to strengthen responsible investment practices. The report shall build on the experience of the work so far and comparisons with other funds. The Council shall examine how one may eliminate any deviations from international best practices, so that the Fund actively contributes to the development of good international standards in the area of responsible investments and active ownership. The Strategy Council may propose changes it deems suited to strengthen responsible investment, including operational and institutional changes. The report shall not evaluate Norges Bank's operational management of the Fund or the Council on Ethics' recommendations on observation and exclusion.

The Ministry has outlined a process that includes open discussion, with various stakeholders being invited to present assessments and suggestions. The Strategy Council has during this process held two conferences on responsible investment.

The Strategy Council for 2013 has five members. Elroy Dimson (London Business School and Cambridge Judge Business School) chairs the

Council and has extensive experience from the Strategy Council. Other members are Idar Kreutzer (Chief Executive Officer of Finance Norway), Rob Lake (former Head of Responsible Investment at PRI), Hege Sjo (Hermes Fund Management) and Laura Starks (Professor of Finance at the University of Texas).

Any changes to the responsible investment strategy proposed by the Council will, in line with ordinary practice, be subjected to open discussion.

4.3.3 Other current issues

OECD Guidelines for Multinational Enterprises

As an OECD member state, Norway is obliged to promote the OECD Guidelines for Multinational Enterprises, including the establishment of a national contact point. The contact point is a non-judicial mediation mechanism charged with resolving disputes concerning alleged violations of the OECD Guidelines, as well as furthering compliance with the OECD Guidelines. The Norwegian contact point is not part of the OECD, and is organised as an independent body with its own secretariat. The members of the contact point are appointed by the Ministry of Foreign Affairs and the Ministry of Trade and Industry on the basis of recommendations from the Confederation of Norwegian Enterprise (NHO), the Norwegian Confederation of Trade Unions (LO) and the Forum for Environment and Development.

The OECD Guidelines for Multinational Enterprises have served as part of the basis for exercising ownership rights of the GPF since 2004. The mandate of Norges Bank requires the Bank to have internal guidelines specifying how these principles are integrated in its exercise of ownership rights.

Questions have been raised, in the context of a complaint filed against Norges Bank, whether and, if relevant, how these guidelines are applicable to investors in their role as minority shareholders of a company.

In a letter of 12 September 2013, Norwegian authorities have asked the OECD to clarify how the guidelines should be interpreted and the extent to which these are tailored to sovereign wealth funds like the Government Pension Fund. The Ministry will follow up on this process.

Appendix 1

Norway's fiscal framework

Norway's petroleum industry presents particular challenges for fiscal policy in ensuring a stable economic development. The public revenues from petroleum are large, vary considerably from year to year, and will be depleted over time. Many countries have found that temporary large revenues from natural resource exploitation produce relatively short-lived booms that are followed by difficult adjustments as production and revenues diminish. Moreover, income from non-renewable resources like oil and gas should also benefit future generations.

The Government Pension Fund Global and the fiscal rule for the use of oil revenues address these challenges, and are designed to support a stable development of the Norwegian economy in both the short and long term. The Government Pension Fund Act stipulates the transfer of the State's net cash flow from the petroleum industry to the Government Pension Fund Global. The fiscal rule specifies that the transfers from the Fund to the central government budget shall, over time, reflect the expected real return on the Fund, which is estimated at 4 per cent of the Fund's capital at the beginning of the year. This framework delinks the earning and use of petroleum revenues, reducing the costs of future restructuring and the risk of a sharp decline in industries exposed to international competition.

The fiscal rule was presented in the White Paper Guidelines for Economic Policy (Report No. 29 (2000–2001) to the Storting), and received the support of a broad parliamentary majority. The White Paper pointed out that the question was not whether more petroleum revenues should be used in public budgets, but rather when and how quickly this should happen. The fiscal rule envisages a gradual increase in the use of this revenue, but also ensures that it will benefit future generations.

The fiscal rule is a long-term guide for the use of the money in the Government Pension Fund Global. It also puts emphasis on evening out economic fluctuations to contribute to good capacity utilisation and low unemployment. Several mechanisms have an effect in this regard.

The fiscal rule allows automatic stabilisers to play out fully. Accordingly, the yearly use of petroleum revenues is measured using the structural, non-oil deficit, not the actual non-oil deficit. The structural, non-oil deficit is corrected for

fluctuations in the business cycle and other temporary changes in public expenditure and income. This means that the transfers from the Fund to the budget may be higher than the expected return on the Fund during a downturn and lower during an upturn. The automatic stabilisers in the budget are estimated to be stronger in Norway than in many other countries due to Norway's well-developed welfare systems.

The spending rule also allows budget policy to be used actively to stabilise production and employment. However, experience indicates that fiscal policy has a limited capacity for fine-tuning of the business cycle. Since 2001, monetary policy has been the first line of defence in the policies for economic stabilisation.

Together, the fiscal rule and the Government Pension Fund Global comprise a fiscal framework that insulates the fiscal budget from fluctuations in petroleum revenues, stemming either from volatile oil and gas prices or from changing production in the petroleum sector. Through the Fund, a large proportion of the State's oil and gas income is invested in other countries. Investing foreign exchange earnings abroad protects the

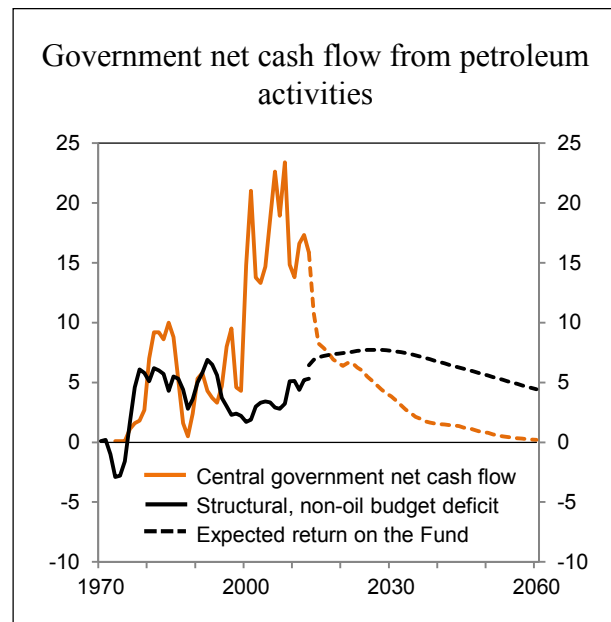


Figure A.1 The State's net cash flow from the petroleum sector, the structural, non-oil deficit and expected real return from the Government Pension Fund Global. Per cent of trend GDP for Mainland Norway

Sources: Ministry of Finance and Statistics Norway.

kroner against the large, varying foreign exchange earnings generated by the petroleum industry. The fiscal policy framework thus supports Norway's monetary policy, and lays a foundation for more stable expectations in the currency market.

Following a decline in the second half of the 1990s, the use of petroleum revenues has increased again in the last 10 years, see figure A.1. Nevertheless, measured as a share of trend GDP for Mainland Norway, the level remains lower now than in the 1980s and early 1990s. The figure also shows how the spending rule helps Norway

to convert substantial, yet temporary and fluctuating, income from the petroleum industry into more stable spending over public budgets. Norway has managed the most intensive harvesting phase fairly successfully. The contribution of Fund returns to the national budget as a proportion of mainland GDP is expected to increase slightly in the next 15 years, and then peak. The proportion will then fall gradually as flows into the Fund diminish and the mainland economy continues to grow.

Appendix 2

The structural, non-oil budget balance

The overall central government budget deficit may change significantly from year to year without reflecting any fiscal policy changes. In order to form the best possible impression of the underlying fiscal stance, it is appropriate to study developments in the budget balance exclusive of revenues and expenditures associated with petroleum activities, i.e. the non-oil budget balance. In addition, it is appropriate to make corrections for, inter alia, cyclical fluctuations in tax revenues and employment benefits.

Since the National Budget of 1987, the Ministry of Finance has used the change in the structural, non-oil budget balance as an indicator of the fiscal stance. In addition, with the introduction of the fiscal rule in 2001, the level of the structural, non-oil deficit has become a measure of the underlying use of petroleum revenues over the fiscal budget. It is this deficit measure that over time shall equal the expected real return on the Government Pension Fund Global.

Automatic stabilisers are allowed to operate fully when the fiscal stance is measured against the structural, non-oil deficit. This benchmark also helps maintain net public wealth over the business cycle. Structural budget balance indicators also play a key role in the fiscal policy frameworks of a number of other countries, including the EU countries.

The non-oil budget deficit excludes revenues and expenditures linked to petroleum activities. The following adjustments are made to get from the non-oil budget deficit to the structural, non-oil budget deficit:

- The deviations of various tax revenues from trend levels are calculated and corrected for. Moreover, the cyclical component of unemployment benefits is taken into account. The estimated adjustments for 2013 and 2014 in Table 3.4 reflect the fact that tax revenues from the mainland economy are estimated to be close to trend.
- The difference between the actual levels and the estimated normal levels of interest rates and transfers from Norges Bank is adjusted for. As part of the strengthening of the equity of Norges Bank, no capital was transferred from the Bank to the fiscal budget for a period from 2002 onwards. An adjustment for the discontinuation of Folketrygdfondet's mandatory deposits with the State from 2007 onwards has the opposite effect.
- Adjustments are made for accounting changes and for changes to the distribution of functions between central and local government that do not

affect the underlying budget balance developments. The adjustments for 2013 and 2014 relate to the introduction of VAT for public roads a corresponding increase in appropriations in 2013 and 2014 to compensate municipalities and counties for the additional VAT expenditure. The adjustment accounts for an estimated accrual discrepancy due to a certain time lag in VAT payments.

The classification of public revenues and expenditure into a cyclical and a structural part cannot be based on direct observations, but needs to be estimated on the basis of analysis of accounting figures, economic statistics and projections for coming years. The distinction between cyclical and structural changes is usually made on the basis of estimated trend levels for the relevant variables. The findings may be influenced by new economic development data, and are subject to revision long after the government's accounts has been finalised.

The calculation of structural tax revenues is based on data on actual revenues recognised in the central government accounts, as well as forecasts for the projection period. The calculations also include taxes on income and wealth that accrue to local government, and essentially cover data from the period 1960-2012 and projections to 2020. The assumptions may be summarised under the following headings:

- *Direct taxes on labour.* This category includes employers' contributions to the National Insurance Scheme and personal taxes, inclusive of wealth tax levied on individuals. The underlying development in the number of man-years employed are an important indicator of developments in employers' contributions to the National Insurance Scheme and in total personal taxes. The projections assume an average annual growth in the number of normal man-years of about 1 pct. from 2014 to 2020. The estimates are based on population projections from Statistics Norway, which assume, inter alia, high immigration from the EEA.
- *Direct taxes on capital.* This category includes taxes paid in arrears by corporations and other non-individual taxpayers outside the petroleum sector. It also includes withholding tax and inheritance tax. It has been assumed that taxes from enterprises outside the petroleum sector will remain approximately unchanged as a portion of Mainland Norway GDP after 2014. This corresponds to an average nominal growth rate of just below 5½ pct. per year. As far as inheritance tax is concerned, the assumption is an

average nominal increase of about 8 pct. per year until 2020.

- *Indirect taxes.* This category includes value added tax, motor vehicle excise duties and other indirect taxes, including stamp duty and miscellaneous sectoral duties. It also includes the investment tax until its abolition in 2002. Private consumption developments are an important influence on indirect taxes, and it has been assumed that the average consumption growth will be 3¼ pct. per year from 2014 to 2020.

The adjustment on the expenditure side of the budget relates to unemployment benefit expenditure. The cyclical correction of unemployment benefit expenditure is based on estimated trend deviations for the number of unemployment benefit claimants.

Developments in the non-oil and the structural, non-oil fiscal budget balance are shown in table A.1. With the exception of the years 1987-1988, 2001 and 2007, all of which came at the end of lengthy and robust cyclical upturns, the fiscal budget after 1975 has generally registered a significant actual deficit when excluding revenues and expenditure relating to petroleum activities, although with major variations over this period. This has to do with the spending of petroleum revenues being expanded rapidly during the 1970s. Since then, both the non-oil and the structural, non-oil deficit have fluctuated around a level corresponding to about 4 pct. of Mainland Norway GDP.

The fluctuations in the structural, non-oil deficit have to do with the budget having at times

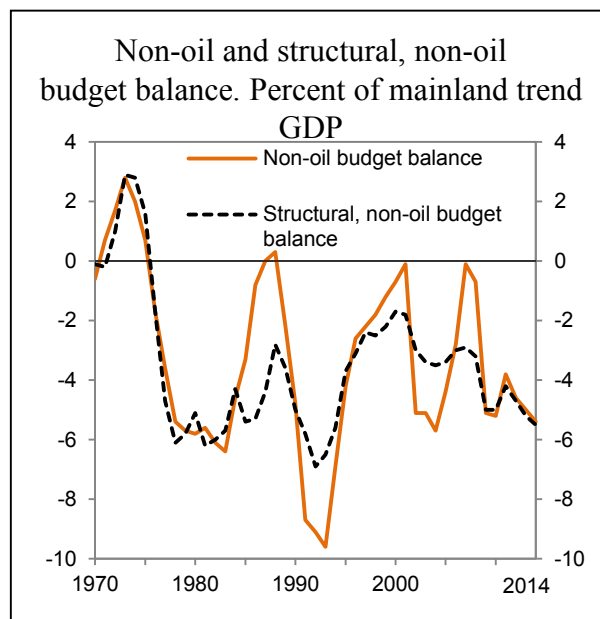


Figure A.2 Non-oil and structural, non-oil budget balance. Percent of trend GDP Mainland Norway

Sources: Statistics Norway and Ministry of Finance.

been used actively to stabilise production and employment developments. Figure A.2 shows that the fluctuations in the non-oil deficit are considerably larger than the fluctuations in the structural, non-oil deficit. This is because one has sought to prevent cyclical fluctuations in mainland economy tax revenues from triggering fluctuations on the expenditure side of the budget. The estimated activity adjustments are shown in Figure A.3.

Table A.1 The structural, non-oil budget deficit. Bn. NOK

	2011	2012	2013	2014
Non-oil budget deficit	79 399	100 898	116 475	133 092
+ Net interest payments and transfers from Norges Bank.				
Deviations from estimated trend level.....	3 492	1 634	789	1 374
+ Accounting technicalities.....	3 480	0	-400	400
+ Taxes and unemployment benefits. Deviations from trend.....	2 697	-577	3 660	266
= Structural non-oil budget deficit.....	89 068	103 109	120 523	135 132
Measured in pct. of Mainland Norway trend GDP	4,2	4,7	5,2	5,5
Change from previous year in percentage points ¹	-0,8	0,4	0,5	0,3

¹ The change in the structural, non-oil budget deficit as a percentage of the trend GDP for Mainland Norway is used as a rough indicator of the budget's impact on the economy. Positive figures indicate that the budget has an expansionary impact.

Sources: Statistics Norway and Ministry of Finance.

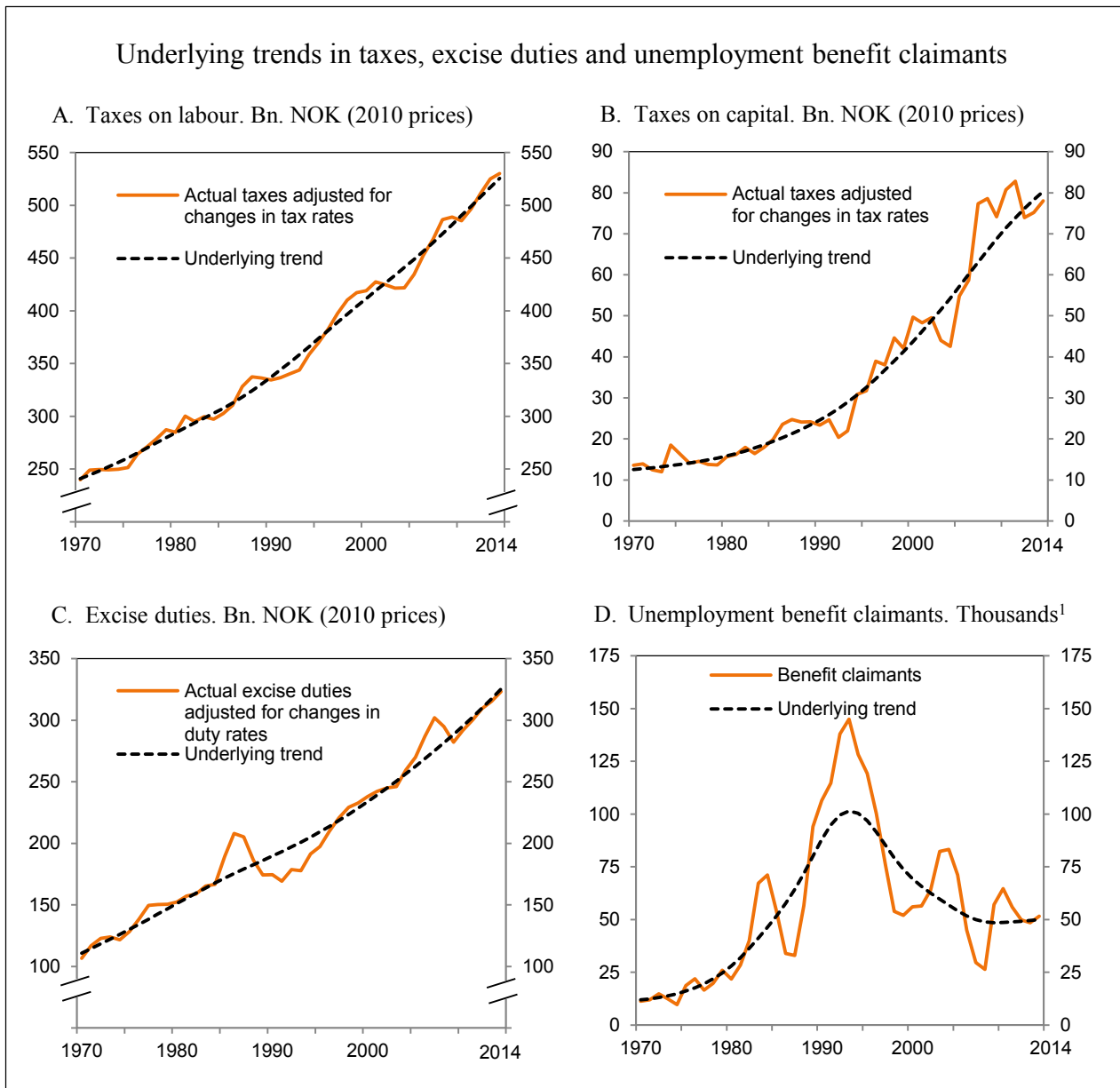


Figure A.3 Underlying trends in taxes, excise duties and unemployment benefit claimants

¹ Correction is made for unemployment benefit recipients who may be partly unemployed by converting the number of recipients into full-time equivalents.

Source: Ministry of Finance.

Appendix 3

Capital transactions and the government's balance sheet

Government capital transactions are not included in Central Government budget deficit. Such transactions are funded by government borrowing, and represent a reallocation of government financial assets, and not expenditure funded by government revenues. Capital transactions may nonetheless influence activity in the economy, e.g. if the financial system is not performing its regular function.

Capital transactions influence the composition of government assets as recorded in the central government's balance sheet. Government equity accounted for 21 pct. of Mainland Norway trend GDP at the end of 2012, when excluding the Government Pension Fund, cf. figure A.4A. This portion has remained reasonably stable in recent years, suggesting that the savings accumulated in the Government Pension Fund have not been countered by a reduction in other equity. Government debt has trended downwards since the early 1990s, but increased temporarily after 2008 due to the measures to deal with the financial crisis.

The main government assets, apart from the Government Pension Fund, are in the form of lending, primarily to households and private enterprises, cf. figure A.4B. Government lending via, inter alia, the state banks (the Norwegian State Housing Bank, the Norwegian State Educa-

tional Loan Fund and Innovation Norway), as well as Export Credit Norway and the residential mortgage scheme of the Norwegian Public Service Pension Fund (NPSPF), account for the majority of overall capital transactions in the fiscal budget in recent years. Such lending declined gradually after peaking in the early 1990s, but has increased again somewhat in recent years. This increase is inter alia linked to the establishment of Export Credit Norway and the steep growth in the NPSPF residential mortgage scheme. For 2013 and 2014, it is estimated that annual new net lending from the NPSPF corresponds to about 1 pct. of mainland GDP. At the end of 2012, lending from the state banks, Export Credit Norway and the NPSPF residential mortgage scheme accounted for close to 9 pct. of the aggregate gross debt of households and non-financial enterprises in Mainland Norway. This share is almost halved since the mid-1990s.

The state also has significant assets in government enterprises and ownership shares in other companies. This is primarily financial capital, which is normally recognised in the balance sheet at its acquisition cost on the transaction date. Such capital corresponded to about 8 pct. of mainland GDP in 2012, and has remained fairly stable since the late 1990s. However, book values

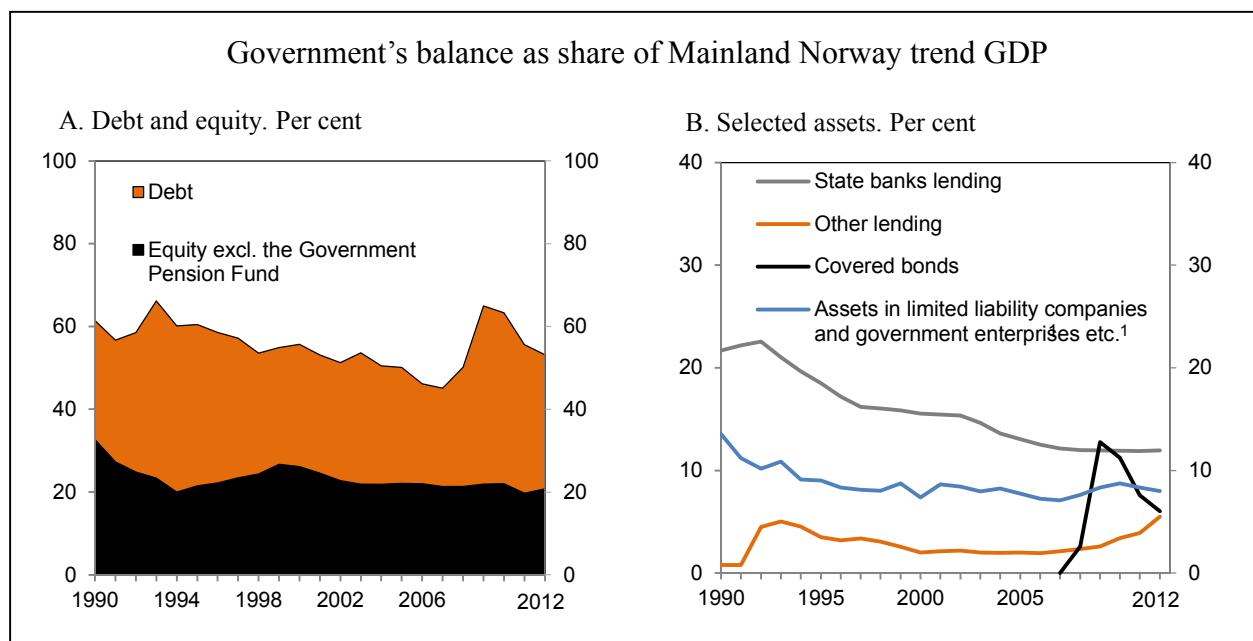


Figure A.4 Government's balance as share of Mainland Norway trend GDP

¹ Excluding the State's Direct Financial Interest (SDØE)

Sources: Statistics Norway and Ministry of Finance.

may deviate considerably from actual values. At the end of 2012, the market value of direct government holdings on the Oslo Stock Exchange was about NOK 430 billion higher than the book value. This corresponds to 19 pct. of mainland trend GDP and is additional to the equity recognised in the central government accounts.

The effects on economic activity of lending via the state banks or the operations of government-owned enterprises depend, inter alia, on the situation in the economy. If lending by the state mainly replaces loans from private providers, as one would expect when the financial markets work as intended, the impact on economic activity will be less than if such loans are additional to other funding. The transfer of loans from private to government lenders may, for example, take place if the state offers more favourable loan terms than do private lenders, as has been the case with the NPSPF in recent years. All government capital transactions are also included in government funding needs, and financed by corresponding government borrowing. Hence, the state does not add to the net capital available in the economy through such capital transactions. This cushions their impact on economic activity.

When the financial markets do not work as intended, as exemplified by the financial crisis, the demand effects of government lending will be greater. The objective of the swap arrangement, which was introduced in the autumn of 2008, was indeed to contribute to keeping the normal channels for credit to households and enterprises open. The arrangement enabled banks to swap covered bonds (OMF) for government securities. In 2009, the OMF holdings of the state corresponded to almost 13 pct. of Mainland Norway trend GDP. These holdings have been gradually reduced since then, and the last swap agreements will mature in the course of 2014. The swap arrangement is visible on both sides of the government balance sheet.

At the end of 2012, the State had furnished explicit state guarantees in the total amount of NOK 144 billion, which corresponds to about 6 pct. of mainland trend GDP. Guarantees administered by the Norwegian Guarantee Institute for Export Credits (GIEK), as well as guarantees for certain multilateral development banks, account for the predominant part of this amount. Such guarantees are not included on the government balance sheet, but are described in the central government accounts.

Appendix 4

The role of the petroleum sector in the Norwegian economy

The petroleum sector generates large, but fluctuating, revenues for Norway. From 1970 until the present day, an industry has been developed whose production value has only in the last decade varied between 25 and 40 pct. of mainland GDP. The petroleum industry contributes, through its demand for goods and services, to considerable activity and to a range of jobs in the remainder of the Norwegian economy as well. The tax system and the State's Direct Financial Interest (SDØE) ensure that most of the extraction revenues accrue to the State. Such revenues make a major contribution to the funding of the welfare state and the strengthening of public finances. The State's net cash flow from petroleum activities has represented about 30 pct. of the State's total income since 2000. How the petroleum revenues are handled in fiscal policy is discussed in Appendix 1. This appendix covers the more direct effects of the oil and gas activity.

Direct mainland economy demand from the petroleum sector may be grouped into two elements:

- investments
- intermediate inputs, which include all mainland deliveries to petroleum sector operations, from repairs and maintenance to ca-

tering

Growth in aggregate demand from the petroleum sector was particularly steep from the mid-1970s to the mid-1980s, cf. Figure A.5A. Subsequently, demand from the sector fluctuated around a fairly stable level as a percentage of mainland GDP, before picking up significantly again over the period 2005-2010.

Investments corresponded to just below 8 pct. of mainland economy value added in 2012. Surveys indicate that these will increase further this year and next year. Whereas investments in the beginning of the Norwegian oil and gas era were principally devoted to the development of new production fields, investments in fields that are already in operation have become more dominant over time, cf. Figure A.5B.

Intermediate inputs have increased gradually. This partly reflects the fact that offshore production has increased over time relative to mainland economy production, and partly that it becomes more difficult to extract oil and gas from the fields as these mature.

High productivity in the extraction of oil and gas results in the sector generating large profits without having to employ a lot of people. Direct petroleum industry employment accounts for

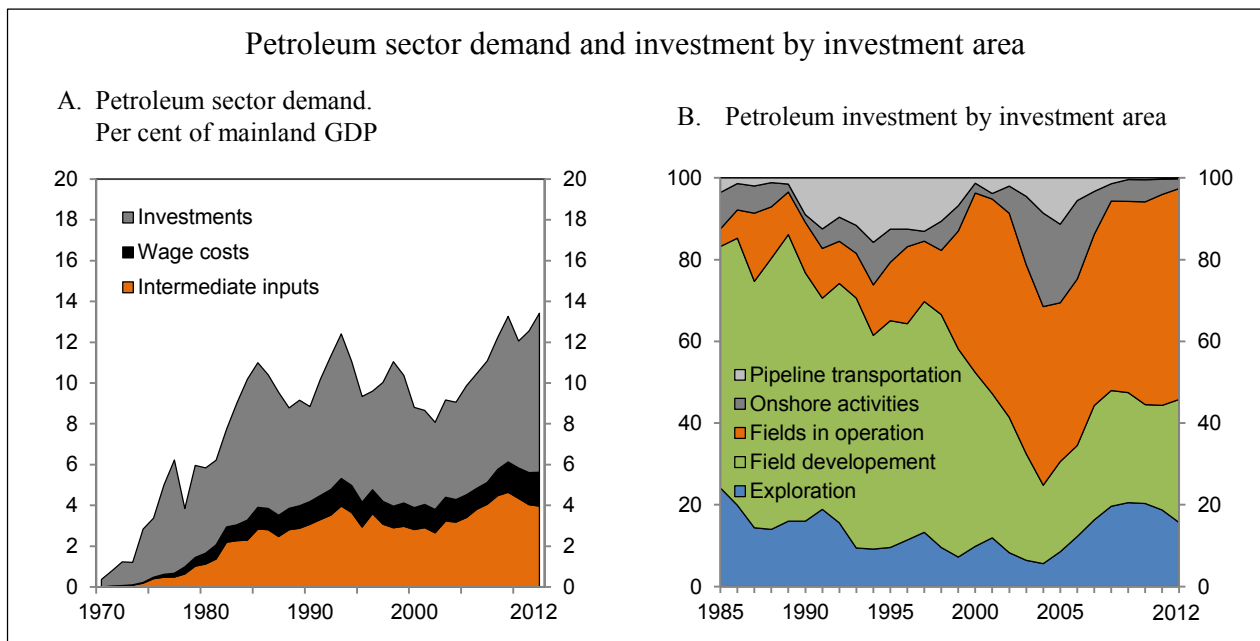


Figure A.5 Petroleum sector demand and investment by investment area

Sources: Statistics Norway and Ministry of Finance.

about 2 pct. of overall employment in Norway. Consequently, wage costs are low relative to the costs associated with investments and intermediate inputs. Yet the wage level is distinctly higher than the average level within the mainland economy.

Development of the petroleum activities has given rise to a large Norwegian supply industry. Calculations made by Statistics Norway researchers indicate that in 2009 the sector accounted, directly and indirectly, for about 8 pct. of employment in the Norwegian economy. The highest concentration of such employment is likely to be found in coastal areas, but supply enterprises are found in large parts of the country. Moreover, petroleum revenue spending via the fiscal budget results in a higher level of public sector employment.

Thus far, petroleum industry demand has largely correlated with the mainland economy business

cycle. This tendency is especially notable in investments, which are significantly more volatile than intermediate inputs. Nonetheless, certain periods have deviated from this pattern. Investments have, for example, grown also in the wake of the financial crisis, which has resulted in favourable mainland economy developments despite weak export market performance. A larger Norwegian supply industry means that mainland economy activity is more sensitive to offshore demand fluctuations than was previously the case. A reduction in the proportion of petroleum sector supplies accounted for by imports has the same effect. Imports account, directly and indirectly, for about 40 pct. of petroleum sector investments on average. The import content of intermediate inputs is somewhat lower than this.