

## Assessment and recommendations

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*Norway was a major beneficiary of the booming world economy and will not be untouched by the current slowdown*

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Norway has seen several years of strong economic growth and very low unemployment. Low imported inflation has allowed Norwegians to enjoy large real wage gains with only modest increases in inflation until recently. A number of OECD countries have seen long booms brought to an end by an abrupt about-turn in housing and financial markets, while others have seen tentative upswings fade, with inflation rising under the influence of energy and commodity prices. Norway's upswing may be slowing but shows no sign of coming to an abrupt end. Pressures that act as negative supply shocks in some countries have beneficial effects for Norway. The rise in the prices of oil and some metals, and low or falling prices for many imports, have brought considerable terms of trade gains to Norway over the past few years. Increased income from oil and gas production both benefits public finances and stimulates demand in the oil-supporting sectors of the mainland economy, contributing to the excellent growth and productivity performance that mainland Norway has been showing. However, Norway is not untouched by the ongoing slowdown in the OECD, while domestically generated inflation has also begun to pick up. Macroeconomic policy is now facing a number of difficult challenges.

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*Progressive monetary tightening has been vindicated*

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In the short term, the rise in inflation might in one sense be greeted with relief by macroeconomic policy makers, as they had been anticipating it for some time. Between 2004 and 2005 the central bank kept interest rates very low: output had been below potential and inflation was subdued. Sustained low interest rates also encouraged a housing boom. The accompanying decline in the household saving rate (it was negative in 2007) has helped to sustain high consumption growth, although the resulting increased level of households' financial liabilities (almost entirely at floating interest rates) also poses a potential downside risk. Norges Bank began to raise interest rates in mid 2005 and, as it became more evident that demand pressure was building up, the pace of increases was stepped up slightly in 2006, a move supported by the last *Economic Survey*. Nevertheless, economic growth has remained strong, output has risen rapidly above potential and unemployment has fallen to a low level. In 2008, headline inflation picked up substantially and core inflation has been rising as well.

The policy interest rate is now at or perhaps above its neutral level. But with the spread between the policy rate and market rates having widened in the wake of financial turmoil, effective financial conditions are certainly somewhat tighter than the level of the policy rate would normally imply. At the time of its latest interest rate increase in June, the central bank was projecting a decline of headline inflation only after some further increase over the summer, and underlying inflation was also expected to rise for some time before beginning to fall back by the end of 2008. The bank still expects that headline inflation at the end of 2009 is equally likely to be above the 2.5% target as below. Although growth is moderating, rising core inflation and wage pressure, and the need to anchor inflation expectations led the Norges Bank to increase its policy rate in June, in line with OECD projections published in the June *Economic Outlook*, and it left open the possibility of a further increase later. In view of ongoing inflationary pressures, it is too early to say whether monetary policy has been successful in stabilising inflation close to the target.

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#### *Monetary policy is approaching the end of the tightening phase*

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*As always, the authorities need to monitor economic developments continuously and be ready to modify their projections as new information comes in. The possibility of a slowing economy, but continuing inflation pressure, will present different challenges from the environment of the last few years, in which Norges Bank has developed its techniques of flexible inflation targeting using innovative methods – including an informative method of publishing forecasts of the policy interest rate. For the moment, however, the continuing strength of the economy in early 2008 is certainly a reminder that the danger of overheating will not recede immediately and interest rates may need to go higher. It is also difficult to gauge the strength of the underlying supply response, but the OECD, Norges Bank and the Norwegian Ministry of Finance estimate output to have been substantially above potential by the end of 2007. Part of the supply response in recent years has been a much higher than expected increase in the working age population and labour force as flows of immigrant labour, attracted by Norway's low unemployment and high wages, have allowed the economy to grow at rates well above what potential would otherwise have been. Since Taylor rules are themselves based on estimates of the output gap, and the sensitivity of inflation to the measures of the output gap is uncertain, it is more important than ever for Norges Bank to continue to use a wide range of indicators in making its policy decisions.*

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#### *Intelligent policy design insulates the economy from oil market fluctuations*

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Oil and gas exports accounted for over 20% of total GDP in 2007, helping to make Norwegian per capita GDP the highest in the OECD apart from Luxembourg. But public and private consumption together account for only about 60% of GDP, compared with between 80 and 85% in G7 countries (except Canada, another important per capita oil producer, at 75%). This difference is due to the policy of transferring petroleum revenues directly into an offshore fund, known as the Government Pension Fund, Global (hereafter referred to as the Pension Fund).

The purpose of the Pension Fund is to support long-term management of petroleum revenues. Proceeds from the fund are used to finance the non-oil budget deficit and are not

earmarked for pension expenditures. Since 2001 this framework has been supplemented by the fiscal guideline stating that only the expected long run real returns can be channelled into the budget; long run returns are estimated using a 4% real rate of return, and over time the non-oil structural deficit should correspond to these returns. *Taken together, the Pension Fund and the 4% guideline have had a major, highly favourable impact on both the economy and public finances.* The benefits to the economy are twofold: first that the potentially destabilising impact of highly variable export revenues on the exchange rate and demand pressure on the mainland economy is almost entirely eliminated; secondly, what could have been a major aggregate demand shock for the mainland economy is spread over a number of years. *It is important that this approach be maintained.*

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#### *But oil wealth puts continuous long-term pressure on “mainland” supply*

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Although the Pension Fund and the “4% rule” bring some stability and make for a rational way to spread the benefits of petroleum wealth over a number of generations, the underlying challenge of adapting the economy to a trend increase in demand cannot easily be avoided. In a sense, fiscal policy is now always “expansionary” since it is the vehicle for transmitting the trend increase in income into demand. A drastic cut in petroleum production or a decision to consistently save much of the financial income from the Pension Fund would make a significant difference; while this might only postpone the challenge, it could smooth the impact of the fiscal impulse if it came at a time when the Pension Fund were growing more slowly, owing to declining production.

*Meanwhile, the application of the 4% rule to the structural budget deficit rather than the actual deficit is a sensible way to ensure that automatic stabilisers work fully, around this expansionary trend.* The rule allows some latitude for active demand management in specifying that the constraint on the non-oil structural deficit be met over the cycle. The planned structural deficit in 2007 was about in line with the 4% guideline, but the actual outcome was smaller. Given the size of the output gap and continuing though moderating growth, it would have been appropriate to maintain this tighter fiscal policy into 2008, rather than the quite large increase in the structural deficit in the revised budget; such tightness could also be thought of as continuing to compensate for structural budget deficits that exceeded the 4% rule in the earlier phase of the cycle. *On current OECD projections, the excess of total demand over supply will diminish substantially by 2009. But fiscal restraint – avoiding an increase in the structural deficit – would still be wise. Also, a strong case can be made for undershooting the 4% per cent rule in the medium term, when the oil price is high and the Fund is growing rapidly.* Such a policy would have a number of advantages: it would provide support to monetary policy in a period of inflationary levels of excess demand in the economy and upward pressure on interest rates and the exchange rate; it would reduce the risk of short term relaxation in, for example, already generous welfare spending programmes with long term fiscal costs and potential adverse incentive effects; and it would build up a greater cushion of pre-funding for the long-term fiscal gap that can be seen under current projections.

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### Despite oil wealth, long-term fiscal challenges persist

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In the medium term, over the next 10 to 20 years, public finances in Norway are in relatively good shape, partly because of increasing Pension Fund revenues, but also because the effects of the ageing of the population are coming somewhat later in Norway than in most countries. One measure of this, the level of taxation required to balance the budget while funding expected expenditures under current policies, is calculated to decline for the next few years, before turning up again only after 2015. From then onwards, however, Ministry of Finance projections made in the autumn of 2007 suggest that the situation will get quite significantly worse: they foresee a financing “gap” of 7% of GDP for the year 2060. While the size of this gap is sensitive to assumptions such as the oil price, and those projections assumed an oil price well below current levels, it seems likely that there will still be a shortfall even if oil prices remain high. The main contributors to the gap are old age pensions and age-related health expenditures.

The pension reform, due to be implemented as from 2010, will convert the state pension system into a notional defined contribution (and still unfunded) scheme, i.e. the expected value of retirees’ pensions will be equivalent to the notional accumulated value of their lifetime pension contributions. The new pension accrual rules will be phased in over time, with full effect from the 1963 cohort onwards, while the other reform elements (life expectancy adjustment and transition to wage/price indexation of benefits after retirement) are planned to take effect from 2010.

At present, by agreement between the social partners, a supplementary pension scheme (AFP), subsidised by the government, significantly reduces incentives to work after age 62 for a large majority of the workforce. In the 2008 wage round covering the private sector, it was agreed to reform the AFP as from 2010, making it an income supplement for people over age 62, thereby restoring work incentives. The wage round negotiations resulted in an increase in the AFP subsidy for the benefit of the oldest cohorts. At the same time the government agreed to a partial deferment of the life expectancy adjustment for pension benefits accumulated under the present pension system. The government estimates the total cost of these concessions as having a present value of about 6% of GDP, with a maximum yearly cost of 0.2% of mainland GDP in the late 2020s. In current expenditure terms this may seem small, but the principle of buying short-term industrial peace towards the peak of a cycle, with concessions that have long-term effects is a poor one (it was in such conditions that the original AFP scheme was introduced). With these measures, the government has gone a considerable way to shelter older cohorts from the full effect of the pension reform. *Such concessions should not be extended further, or given to younger cohorts. Furthermore, the remaining elements of the pension reform, notably concerning disability and public sector pensions, should be implemented in line with the key elements of the reformed main pension system.*

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### Demand for labour is strong; some policies inhibit its supply

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As demand pressure on the mainland economy continues to grow, adjustment takes the form of supply shifting away from the tradeable sector, where imports financed by Pension

Fund revenue can replace domestic production, to the non-tradeable sector where they cannot. A partial exception is agriculture where a highly protectionist policy inhibits this shift by preventing imports of certain foods when similar domestically-produced food is available, though at a much higher production cost. Labour shortages in the non-traded sector are reflected in high wages, by international comparison, and the high and increasing relative cost of living.

The 2007 *Economic Survey* pointed out that a number of policies in Norway act to reduce the supply of labour. Although labour participation rates are among the highest in the OECD, they are partially offset by average hours worked that are among the lowest. Low working hours and increased leisure would be a natural reaction to increasing wealth, so they are not to be criticised in themselves. But they may also in part be a reaction to a generous sickness benefit scheme. Reforms to this scheme were introduced in 2004, when the number of days lost initially diminished. Since then sick leave has been on an increasing trend, and further measures were introduced in 2007, but sick leave remains prevalent as the system retains incentives towards excessive use of the scheme. Proposals made in the 2006 *OECD Report on Sickness and Disability* and repeated in the 2007 *Economic Survey* should be implemented – notably to reduce benefit levels, and remove responsibility for assessments from family doctors. In fact, *there seems to be no strong reason why the culture of strict conditionality for which the unemployment benefit system is known, and which has in the past helped to maintain unemployment relatively low even in downswings, should not be extended to the sickness scheme, provided of course that its basic aim of protecting the genuinely sick is met. The same goes to some extent for disability pensions, which are frequently used as a supplementary early retirement scheme and are apparently also being awarded increasingly to young people.* Here again some reforms have been introduced, but while it is too early to assess their impact, it is a fairly safe assumption that further improvements to incentives to participate in the labour market within the objective limits of the disability scheme could be made. More recently, there have been some new policy initiatives to tackle these problems. *If the “NAV reform” (in which various labour market and welfare services are brought together under one roof) can be completed successfully, it should be used as an opportunity to try to impose the successful disciplines of the unemployment insurance system on the less strict welfare scheme.*

While the pension reforms will restore better incentives for older workers to remain in the labour market, slow progress in sickness and disability reform suggests that it is difficult for the government to increase domestic labour supply, despite the potential for this. It was estimated in the previous *Economic Survey*, for example, that a significant increase in labour supply could be achieved if Norway adopted reforms to increase working hours to a level in line with the average in the European Union.

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#### *Labour market reforms might increase the benefits from immigration*

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Some policies thus act to restrict the supply of labour. Meanwhile, high wages and the tightening labour market have attracted historically large migration inflows since 2004, boosting the labour supply substantially. This was facilitated by the increased freedom of movement of labour within the expanded European Economic Area. Along with most potential destination countries, Norway retained some restrictions on the inflow of labour from the “EU8” countries, and later on Romania and Bulgaria too; the need for a work permit was retained, but an offer of employment is essentially sufficient for a worker from

these countries to obtain a permit. Until 2007, workers from the “EU10” needed a permit before starting to work, but this restriction was abolished from 2008 – they can now start working once an application for a work permit has been submitted. With Norwegian employers eager to recruit, Polish workers in particular have taken advantage of this increased freedom of movement. As from 2009, the government is intending to remove the transitional arrangements with the EU8, and to relax some restrictions on non-EEA immigrants too.

Labour mobility generally improves welfare, so these plans are a welcome contribution, although one should beware of measuring the benefit from immigration simply in terms of the increased GDP that it certainly permits. The gains to existing residents are generally much less than this, since the migrants themselves are likely to receive much of the extra output in wages so the benefit comes mainly in the form of higher profits and tax revenue. In addition there are gains from improved availability of certain services when immigrants enter sectors where native labour supply is particularly limited. The policy of extending collective wage agreements beyond the parties to the original agreement, in order to force up wages paid to immigrants, tends to reduce the share of the gains accruing to natives. As part of a set of measures against “social dumping”, this may be the price for improved equity, *but it should not be allowed to be used as a disguised way of inhibiting competition among domestic companies and shutting out foreign ones.*

More generally, it is frequently observed that there are labour shortages in certain areas or professions in Norway. The construction boom means that this sector is sometimes cited, but also some engineering professions, teachers or scientific graduates. But the convention in the Norwegian labour market makes it unclear whether there really is a shortage of such labour, since the wage negotiating system seems to prevent a significant impact of relative demand and supply on relative earnings. In the current wage round, for example, despite very low unemployment and the suggestion of labour shortages just mentioned, the private sector settlement included a provision for low paid workers – in a system with one of the flattest wage distributions in the OECD – to be paid an additional amount on top of the general increase for all workers, thus further flattening the wage distribution. Plant-level bargaining introduces flexibility around the national agreements, but these do not seem to substantially increase wage differentials across sectors or types of labour. It may not be necessary to change a system that has overall worked quite well for some time, but *introducing freedom of labour movement beyond the common Nordic labour market probably necessitates, in the longer run, a greater willingness to accept that relative wages should reflect supply and demand for labour more directly.*

The benefits to natives from labour immigration, notably the fiscal benefits, generally last only as long as immigrants do well in the labour market. For as long as the boom lasts, this seems practically guaranteed, and even in a downturn there is no big problem if immigrants return home. However, given the generous nature of parts of the Norwegian welfare system discussed earlier, significant numbers may choose to stay; *this could provide an additional incentive for governments to reform the welfare system.*

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### Poor performance in school education is a cause for concern

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In the long run, and as in all countries, improving the quality of the supply of labour – creating human capital – is an important function of the education system. Of course, it is not the only one and there is room to differ on the relative importance that should be attached to economically “productive” aspects of education on the one hand and the social aspects of education that are particularly important in Norway, on the other. The special chapter in this Survey devoted to the compulsory education system presents strong evidence that this part of the Norwegian education system could do much better in developing human capital than it does, and that its relative performance may have been getting worse for pupils in lower-secondary education in recent years. This diagnosis may not hold for the education system as a whole, since it focuses on compulsory schooling and does not cover upper-secondary and tertiary education. However, given that the evidence for school children covers the only internationally comparable information available on education performance at the moment, and that this information focuses on competences and problem-solving ability rather than simple memory-based learning, it cannot be ignored.

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### Resources in education need to be spent more effectively

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Compulsory education in Norway is not cost-efficient regarding pupils’ achievement in reading, mathematics and science. Although there are different ways to compare costs per unit output across countries, it is clear that schools in Norway deliver below average results on the OECD’s international student assessment (PISA) scores, for expenditure per student which may be as much as 40% higher than average. Although per student costs have been growing more slowly in Norway than elsewhere, this is not much consolation since relative PISA performance seems to have declined between 2000 and 2006. Cost-efficiency can, in an abstract sense, be improved either by reducing expenditure for given results or improving results for given expenditure. This is a somewhat artificial separation since resources saved by cutting inefficient expenditure can, in principle, be used elsewhere to give improved results (unless there are strongly diminishing returns to resource use, which some international comparisons suggest may in fact be the case). However, *the government’s already stated intention to increase spending on education will produce disappointing results and even make future reforms more difficult if it is not accompanied by strong steps to improve the efficiency of resource use.*

Some sources of cost-inefficiency are quite clear: a large number of small schools and a low pupil-teacher ratio. Gaps in teachers’ competences are also apparent, and the number of hours that teachers are actually required to teach is low, as is the number of instruction hours that children receive. Other sources of inefficiency are more subtle, for example little use is made of mechanisms that give either teachers or schools any external incentive to improve performance; more fundamentally, there is also a lack of information on which such assessments can be based, although this situation is improving. There is evidence that some aspects of teaching practices are particularly ineffective too: in many cases this may be illustrative of lack of feedback on results. All of these points are taken up below.



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### *Small schools increase the cost of education, partly reflecting regional policy*

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In view of poor cost-efficiency, *the government could consider measures to close or merge small and medium sized schools.* However, the government has few instruments to directly affect this, because decisions on school closures are entirely delegated to local municipalities and central government funding is largely supplied through block grants, not earmarked for education. Nevertheless, block grants do take into account factors such as population density and geography deemed to be out of the control of local government, as part of the general policy of maintaining a larger population in rural and remote areas than would otherwise be the case. *Central and local government should review all mechanisms that may directly or indirectly encourage the underutilisation of economies of scale in education.*

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### *Improving teaching quality is the priority*

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Improved outcomes will only be achieved with improved teaching in classrooms. The analysis in this Survey is not designed to recommend detailed changes in teaching practice. Nevertheless, it highlights some explanations for the poor performance, notably gaps in teachers' competencies, the low number of teaching and instruction hours, the use of experimental teaching methods, which studies have found to be largely ineffective, and the apparently low standards that seem to be expected of children. *Hence, teachers should be encouraged to strengthen and update their competences, both in subjects taught and in teaching methods. Recent efforts to improve training programmes are on the right lines, but a shift towards training that leads to formal accreditation is necessary.* In the new White paper presented in June 2008 measures are proposed to put more weight on formal training programmes for both teachers and principals. Since increased instruction hours would also improve learning outcomes, municipalities and schools should be encouraged to consider this among their options for improving performance.

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### *Provision of better information would improve performance, and could also be used to improve incentives*

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Local government of course responds to the wishes of local electorates, but these need to be well-informed, which implies knowledge of the relative performance of different schools; municipalities have the power to publish this information, but few outside Oslo do so. *The government should consider publishing the results of national assessment tests school-by-school, provided steps are taken to adjust the scores for known exogenous influences on results, such as social background, (i.e. to publish the results in "value added" form) and to protect the identities of the children involved.* These assessment tests, only recently introduced, are intended to play an important role in giving schools and parents' information on the educational needs of individual children. But the results are not used systematically to give feedback to teachers on how well they have performed. *It should be part of school principals' duties to provide this information to teachers.*

A more radical change would be to use this information to provide direct monetary incentives for school teachers. The county and municipality of Oslo have already taken this



step and the Oslo administration is convinced that it has had beneficial effects on both results and cost-efficiency. In a country with Norway's traditions this might be too radical a reform to impose centrally, given the legitimate doubts about how such incentives really work. However, the example of Oslo should be studied closely with a view to adopting some of its practices elsewhere if they prove to be beneficial. The idea is less controversial for school principals or leaders, however; *school-wide results, including measures of cost-efficiency, should be used as part of the assessment and reward system for school leaders*, as is again already the case in Oslo.



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*The economic situation and policies of Norway were reviewed by the Committee on 16 June 2008. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 2 July 2008.*

*The Secretariat's draft report was prepared for the Committee by Paul O'Brien and Romina Boarini with Statistical assistance from Thai-Thanh Dang, under the supervision of Patrick Lenain.*

*The previous Survey of Norway was issued in January 2007.*

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## BASIC STATISTICS OF NORWAY

### THE LAND

Area (1 000 km <sup>2</sup> ):	Major cities (thousand inhabitants, 1.1.2008):		
Total (2005)	385.2	Oslo	560.5
Mainland (2005)	323.8	Bergen	247.7
Agricultural (2004)	10.4	Trondheim	165.2
Productive forests (2003)	74.7		

### THE PEOPLE

Population (thousands, 1.1.2008)	4 737.2	Total labour force (thousands)	2 507
Number of inhabitants per km <sup>2</sup> (1.1.2008)	12.3	Civilian employment (thousands)	2 443
Net natural increase (thousands, 2007)	16.5	Civilian employment (% of total):	
Net migration (thousands, 1.1.2007)	39.7	Agriculture, forestry and fishing	2.8
		Industry and construction	24.9
		Services	76.1

### PRODUCTION

Gross domestic product:	Gross fixed capital investment:		
NOK billion	227.7	% of GDP	20.8
Per head (USD)	82 016	Per head (USD)	17 043

### THE GOVERNEMENT

Public consumption (% of GDP)	19.8	Composition of Parliament (number of seats):	
General government (% of GDP):		Labour	61
Current and capital expenditure	32.2	Progressive	38
Current revenue	46.5	Christian Democrats	11
		Conservative	23
		Centre	11
		Socialist Left	15
Last general elections: 13.9.2005		The Liberals	10
Next general elections: September 2009		Total	169

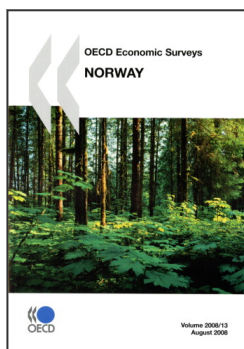
### FOREIGN TRADE

Exports of goods and services (% of GDP)	45.4	Imports of goods and services (% of GDP)	28.1
of which: Oil and gas	23.1		
Main commodity exports (% of total):		Main commodity imports (% of total):	
Fish and fish products	4.5	Ships	1.4
Base metals and products	10.6	Foods and animals	5.2
Machinery and transport equipment (excluding ships)	7.6	Chemicals and related products	8.8
Mineral fuels	64.5	Machinery and transport equipment (excluding ships)	35.6
Non-oil commodity exports by area (% of total):		Non-oil commodity imports by area (% of total):	
Denmark and Sweden	17.6	Denmark and Sweden	21.7
Germany	8.6	Germany	13.7
United Kingdom	8.4	United Kingdom	7.0
United States	8.3	United States	4.9

### THE CURRENCY

Monetary unit: Krone	2007		
		NOK per USD	5.86
		NOK per euro	8.03





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