Concluding Statement of IMF Article IV Mission to Norway
Oslo, May 23, 2014[1]

1. **Norway's economy has slowed modestly from its 2012 pace**. Mainland growth slowed in part due to weak private consumption and mainland investment while households have increased their savings rate significantly. Unemployment edged up slightly in 2013 but remains low at around 3.5 percent. Inflation has risen to the 2.5 percent target recently, reflecting in part the lagged effects of last year's exchange rate depreciation. House prices have stabilized in the last year, after sustained real growth that had pushed them to very high levels.

2. **The near-term outlook remains stable with moderate growth and inflation.** With the economy roughly at its potential, IMF staff expects mainland growth of 1.9 and 2.4 percent in 2014 and 2015. Inflation is projected to slow to about 2 percent in both years as the price effects of the recent depreciation wear off. Unemployment is projected to rise slightly through 2015.

3. **The medium and longer term presents new challenges and uncertainties, particularly because of expected slowdown in oil and gas investment.** Steadily increasing oil and gas investment over the last decade culminated in a 17 percent growth rate in 2013. This has provided persistent demand stimulus to the increasingly oil- and gas-focused mainland economy. With this investment expected to flatten out in 2014-15 before beginning a slow decline, new sources of growth are needed. The staff's central forecast is a continuation of growth with only a modest rise in unemployment in the next few years and inflation gradually rising back toward the target. However, this is based on a scenario in which the sources of growth shift away from supplying the oil and gas sector and toward other sectors of the economy or exports of oil-related goods and services.

4. **There are downside risks to this central scenario.**

- **A sustained decline in oil and gas prices** would have widespread effects in the Norwegian economy. This could occur because of developments in oil and gas markets themselves or slower global growth, particularly in major emerging markets. The fiscal rule and the Government Pension Fund Global (GPFG) would largely insulate the economy from the direct effects of lower oil revenue. However, a decline in oil and gas prices would undercut growth directly, through a reduction in the oil-related demand for mainland goods and services, and indirectly, through a possible reduction in private demand, including for housing, as a result of confidence and income effects.

- **A significant reduction in housing prices** could be triggered by a reduction of oil prices or other shocks to demand or confidence. While the level of house prices has stabilized in the last year, it is too early to declare an end to the housing boom or rule out a sustained price decline. Given the elevated level of prices and high household debt, such

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[1] Mission Concluding Statements describe the preliminary findings of IMF staff at the conclusion of Article IV and other missions.

a decline would likely reduce household consumption with adverse consequences for retail trade, construction, and commercial real estate and lenders to those sectors.

- **A more difficult transition to a growth model less dependent on supplying the oil and gas sector** could result in slower growth and higher unemployment during the shift. The staff's central scenario assumes that the transition will be relatively smooth, but competitiveness challenges from high wage levels compared to trading partners could make it more difficult to shift to a new growth model.

Macroeconomic policies

5. **Monetary policy is broadly appropriate in terms of the authorities' inflation targeting framework.** The economy remains at roughly its potential, and tensions between the various considerations in setting the policy rate have abated over the past year. The 12 month CPI-ATE is now at the inflation target after a sustained period below it. At the same time, the housing market has cooled somewhat, lessening concerns that low interest rates are fueling an unsustainable housing boom. This state of affairs is unlikely to be sustained; the CPI is likely to fall below the target later this year as the effects of last year's depreciation fade, and the policy rate will eventually have to normalize to a level somewhat above the inflation target.

6. **The government's fiscal policy has been prudent, but it has entailed repeated fiscal stimulus for an economy roughly at capacity.** While the non-oil deficit has been maintained well below 4 percent of GPFG assets in 2014 and recent years, the fact that GPFG is growing so much faster than the economy has allowed widening non-oil deficits as a share of GDP. This has in turn supported an expansion of government expenditure and fiscal stimulus in most years through 2013. The upward trend in government consumption and investment, together with the increasing labor demand from the oil and gas sector for goods and services from the mainland economy, has crowded out and increased labor cost pressure in other exposed industries. We endorse the government's policy of using the flexibility in the fiscal rule to keep the non-oil deficit well below 4 percent of GPFG assets, but we would urge a still more conservative use of the GPFG resources to maintain a more neutral fiscal stance so long as the economy remains near or above capacity. However, should the economy soften significantly, there is ample scope within the fiscal framework to support the economy.

Macroprudential policies

7. **The mission welcomes stronger capital requirements for banks in line with, and ahead of, the Basel III requirements.** Capital positions of Norwegian banks have strengthened by 4.4 percentage points since 2008 and all large Norwegian banking groups are compliant with the core equity tier 1 capital requirement. Banks' capital buffers will increase by an additional percentage point in mid-2015 as the countercyclical buffer will be phased in. Norway is only the second country in Europe to introduce this buffer, which is expected to vary over time to prevent a build-up of financial imbalances. The three most systemically important banks will also be subject to a separate capital surcharge in mid-2015 which will rise further one year later.

8. **The mission supports tighter capital standards for mortgage lending for both domestic and foreign banks and the efforts to harmonize prudential standards among**

Nordic countries. Risk weights on residential mortgages are relatively low and this has encouraged more lending to households. The recent increase in the loss-given-default floor on mortgage assets should raise the risk weights for residential mortgages, and its application to Norwegian branches of Danish and Swedish banks through agreements among the Nordic authorities is particularly welcome. This should result in these foreign branches lending in line with economic conditions and the regulatory framework in Norway. These tighter capital standards and loan-to-value limits on mortgages should be maintained in light of the vulnerabilities stemming from high house prices and household debt even if the housing market softens further.

Structural reforms

9. **More neutrality in the tax system could help to promote efficiency and growth.** A reduction in the extent to which the tax system promotes housing rather than productive investment would help redeploy new investment toward the exposed industries that will need to replace oil and gas suppliers as an engine of growth. This could include less preferential treatment for residential and commercial real estate. More generally, a simpler tax system with fewer exemptions and preferences (e.g., equalizing VAT taxes on services and removing exemptions for high-value electric cars) could create fiscal space for a reduction in overall tax rates, including the corporate income tax.

10. **Further reform to pension and sickness and disability benefits is needed.** Private sector employment of persons over 62 has risen as a result of the recent pension reform, but incentives for early retirement still remain in the public sector. The mission urges the authorities to complete the pension reform by fully aligning the rules for public sector pensions with the principles used in private sector pensions. Further reform to sickness and disability benefits would likely improve the efficiency and competitiveness of the economy and contribute to growth.

11. **Competitiveness and productivity concerns are becoming more pressing.** Robust oil-related growth and improved terms of trade have masked a deterioration in wage competitiveness relative to peer countries. Actions are needed to ensure that the mainland economy serves as a robust source of growth when offshore activity winds down in the medium to long term. The mission welcomes the authorities' initiatives in this area, including setting up a productivity commission to formulate specific policy recommendations. Some specific areas that deserve attention include:

- **Improvement in the provision of public services**, many of which are provided at the local level, is needed. There is scope for greater efficiency through the more systematic use of cost-benefit analysis, quality assurance, and other methods of assessing spending efficiency. In particular, individual municipalities struggle to achieve economies of scale as they are often small and serve sparsely populated areas. Improving the fragmentation of municipalities and municipal services through mergers would ensure the continuous provision of equal and high-quality access to services for all citizens.

- **Many public investment projects have social and economic benefits that are below their costs, particularly in transportation.** There is scope for greater efficiency by making more use of cost-benefit in the selection of the projects that are implemented.

- **Agricultural policy is constraining productivity**. Norway's extremely high trade restrictions and subsidies are diverting private and public resources away from more productive sectors and raising the cost of living, particularly for lower-income groups.

- **Labor market flexibility will be needed in order to facilitate the adjustment towards a new growth model.** Competitiveness and efficiency could be improved by relaxing the restrictions on working hours and schedules. On wage settlements, we note the strong commitment of the social partners to a labor model entailing highly similar wage growth rates across sectors and reliance on economy-wide wage restraint to maintain competitiveness. However, should the transition costs in terms of lower growth and higher unemployment be greater than anticipated, wage formation should allow for greater differentiation in compensation across sectors to better align wage developments with productivity in the private sector.

12. **Norway's state ownership is high compared with peers, but most enterprises are run on a commercial basis**. Large corporations with state ownership are subject to market discipline through partial private ownership in many cases and the need to sell in competitive markets. However, there may be some scope for more privatization or market discipline in some sectors. Particularly with banks, large government stakes create greater market expectations of a bailout in the event of financial difficulties and competitive advantages in funding to the extent that creditors assume there is a lower risk due to greater perceived government backing.

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We are grateful for the very warm welcome extended to us by the Norwegian authorities and representatives of private sector, labor, and academic institutions for the very constructive discussions.