2018 Article IV Consultation with Norway – Concluding Statement of the IMF Mission

June 7, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Norway is in the midst of a healthy recovery. With the economy on the verge of full employment, expansionary policies deployed during the downturn should now be gradually unwound. Despite the positive overall environment, however, risks remain. In particular, the combination of still elevated house prices and high household debt continues to be a concern. Expiring mortgage regulations should therefore be extended. More broadly, Norway has benefited for some time from both prudent management of its natural resource revenues and positive terms of trade developments. These have allowed the country to amass a sizable financial buffer and limit the effects of the deterioration in competitiveness in non-oil exposed sectors. Looking ahead, however, Norway is likely to confront a more complex environment: spending pressures are set to rise as the population is aging, oil revenues are likely to decline as production tails off, and terms of trade developments may prove less favorable. Now is therefore the time to begin implementing policies that would stop the trend expansion of non-oil fiscal deficits seen over the last fifteen years and preserve the wage moderation achieved by social partners during the most recent downturn. This will help ensure that the economy remains well positioned to address future challenges.

Outlook, Risks, and Challenges

1. **Norway is in the midst of a healthy recovery from the oil downturn.** After growing by 1.9 percent in 2017, mainland economic activity is expected to accelerate further and to grow by about 2½ percent this year and next. Recent positive trends in oil prices and a strengthening labor market should help support momentum in both exports and domestic demand.

2. **Risks to the recovery are two-sided.** Rising global trade tensions are not welcome news for a small, highly open economy like Norway. In addition, high and rising household debt—much of which is in the form of variable-rate mortgages—leaves households exposed to an abrupt tightening in financing conditions. On the upside, rising oil prices could have a bigger than expected impact on business investment and overall aggregate demand.

3. **But despite the generally positive short-term picture, Norway also faces important challenges to sustaining its prosperity into the future.** Population aging and falling labor productivity will weigh on potential growth going forward. In addition, non-oil fiscal deficits have risen steadily to high levels over the last fifteen years, even though Norway has yet to feel the impact of aging on entitlement spending. Finally, the solid income growth seen in the past two decades might not be repeated, as it was driven in good part by fortunate terms of trade developments. Preparing for these challenges was a central theme of this year's consultation.

Fiscal Policy

4. **This year's budget appropriately targets a neutral stance.** The economy was in no need of further stimulus, so shifting to a neutral stance in the original 2018 budget was the right thing to do. In this context, the authorities should be commended for sticking to this neutral stance in the revised budget, by not using the unexpected increase in the value of the sovereign wealth fund and windfall gains in the budget to increase spending. Moreover, we welcome the greater focus in helping the supply side of the economy, through shifting the tax burden from direct to indirect taxes, and promoting research and innovation.

5. **Next year's budget should target a modest consolidation while entrenching better budget composition.** With staff projecting output to exceed potential next year, the stimulus provided during the oil downturn should start to be unwound–a structural consolidation of ¼-½ percent of mainland GDP may be warranted. In terms of composition, we advocate a continued broadening of the VAT base and further reducing tax incentives on home ownership and leverage.

6. **From a longer-term perspective, it will be important to arrest the trend increase in non-oil fiscal deficits seen over the last fifteen years.** With the fiscal rule tied to the sovereign wealth fund's value, non-oil deficits have steadily increased from about 2 percent of mainland GDP in the early 2000s to some 7½ percent now. In the process, government consumption has increased by about 5 percentage points of mainland GDP. Such an expansion has put upward pressure on the real exchange rate above and beyond that coming from terms of trade gains, hurting competitiveness. Perhaps more importantly, in the coming years population aging will add to entitlement spending, leading to a further expansion of the

deficit in the absence of adjustment. The resulting future deficits would gradually erode and eventually more than deplete even Norway's high public net savings, which currently stand at 370 percent of mainland GDP.

7. **Given the above, we recommend that fiscal deficits stay below the 3 percent rule for the foreseeable future.** Ensuring long-term fiscal solvency will require 4-5 percent of mainland GDP in spending cuts or revenue increases at some point in the future. Norway's large savings give it the luxury to undertake this adjustment in a gradual manner, but there are gains to staying below the 3 percent line in the years to come, and the up-cycle provides an ideal setting to get started on structural consolidation. Allowing the deficit to drift upward would only increase the medium-term adjustment need, minimize the space to respond to negative asset price shocks that could affect the value of the sovereign wealth fund, and further increase pressure on the real exchange rate and hence competitiveness. The fact that the structural non-oil deficit is estimated at 2.7 percent of the sovereign wealth fund following several years of expansionary fiscal policy, below the long-term fiscal guideline of 3 percent, gives Norway a good starting point to address the challenges going forward.

8. **The authorities recognize the need to generate savings in the long term.** In this context, we welcome initiatives to strengthen value for money in the public sector. It will be important to ensure that, down the road, these initiatives actually lead to net savings and are not used to raise spending on other items. Similarly, the recently adopted public sector occupational pension reform is an important step forward to lengthen working lives. Preserving these incentives will require safeguarding the now actuarially fair nature of the private and public pension systems.

Monetary and Financial Sector Policies

9. **A gradual normalization of monetary policy is appropriate at this stage in the cycle.** The output gap is closing, the labor market is strengthening, and the recent negotiations point to an acceleration in wage growth. We project core inflation to gradually rise towards headline inflation, which already stands at the newly revised 2 percent target. In this context, the path of interest rate tightening projected by Norges Bank under the forward guidance appears appropriate. Moreover, Norway's inflation targeting framework provides the needed flexibility to adjust guidance should developments bring the baseline forecast into question. More generally, we do not expect the revised framework to lead to meaningful changes in the conduct of monetary policy, appropriately so.

10. **Banks are resilient.** Profitability remains high, asset quality is strong, and banks comfortably meet Norway's admirably stringent capital, leverage, and liquidity requirements. Stress tests suggest that banks' high capital buffers render them well positioned to withstand even severe macroeconomic shocks.

11. **However, vulnerabilities remain in the financial system:**

- Household debt keeps rising from already elevated levels and the high proportion of variable rate mortgages poses considerable risks for household consumption should financial conditions tighten abruptly. House prices are rising again and, despite the correction in 2017, price levels remain high, notably in Oslo and surrounding municipalities. In these areas, house prices are vulnerable to further correction.
- Commercial real estate (CRE) valuations have also seen rapid increases and this sector constitutes an important exposure for banks.
- Banks' reliance on external wholesale funding remains a long-standing vulnerability, although the funding profile has improved in the last decade including through the use of covered bonds.

12. **In this context, the mortgage regulations introduced in early 2017 should be extended, and be complemented by other risk-reduction policies.** A rich set of prudential measures has been implemented to contain risks associated with household debt, unsecured consumer lending and banks' exposure to CRE. These include the previously mentioned mortgage regulations, tighter capital requirements and macroprudential guidelines on consumer lending, and intensified oversight and Pillar II capital add-ons for banks with concentrated exposures to CRE. The mortgage regulations expire at the end of June, and should be extended. Even better, they should be made a permanent part of the prudential toolkit: specific parameters could then be adjusted up or down as the financial cycle requires. Moreover, if house price valuations and hence financial stability concerns continue to diverge across regions in Norway, more regionally differentiated mortgage regulations could be considered. To more durably address housing risks, action is also needed to further reduce tax incentives for home ownership, which remain generous by international standards.

13. **With the real and financial cycles now better aligned after having diverged over the last few years, tighter monetary policy could also help mitigate financial stability concerns.** Even though it is explicitly mentioned in the new monetary policy framework, financial stability is not the primary objective of monetary policy. But now that developments in the real economy warrant a gradual tightening of monetary policy, this might provide welcome reinforcement to other policies to allay concerns from high house prices and high household debt.

Wage Formation and Structural Policies

14. **The wage growth seen in last fifteen years might not be sustainable going forward.** Over the last two decades, Norway experienced wage increases in excess of

productivity in most sectors, and ahead of wages in trading partners. What made this possible without a disproportionate loss of competitiveness was that Norway benefitted from favorable terms of trade, not only in energy but in fisheries and metals as well. Even then, some tradeable sectors have suffered. Going forward, wage increases comparable to those in the past would not be sustainable unless Norway's terms of trade improve even further, which cannot be taken for granted. Instead, the wage moderation achieved by social partners during the recent downturn should be carried forward, as it would help build resilience in case of less positive trends in international prices.

15. **More can be done to sustain high labor participation amid growing demographic pressures and technological change.** While Norway's labor participation rate is among the highest across the OECD countries, prime-age participation has been falling since 2008 and challenges remain to integrate some under-represented groups into the labor force. More specifically:

- Given trends in sickness and disability, it would be important to further tighten eligibility requirements while reducing the schemes' disincentives to work.
- Notwithstanding the substantial achievements made so far to integrate women into the labor force, more could be done to expand working hours among women, for example by making child care even more flexible.
- Higher flexibility in temporary work contracts and wages might be needed to prevent some people from being permanently excluded from the labor market, though tradeoffs that such flexibility could pose to Norway's social model will need to be considered.
- Continued focus on aligning education with demand for skills in the private sector could help reverse the trend of decreasing employment rates among young cohorts.
- Well-designed training and integration programs are also important in increasing employment rates of immigrants and refugees.

16. **Reducing the level of protection and government support to the agricultural sector would enable more efficient resource allocation and benefit low-income groups, in particular through lower food prices**.

Norway's high education levels, its tradition of responsible policy making, and strong levels of social trust and consensus make the country well positioned to handle future challenges.

The mission team thanks the Norwegian authorities and other counterparts for the candid and insightful discussions and their warm hospitality.