Concluding Statement of the IMF Article IV Mission to Norway

Oslo, May 19, 2016

Norway's economic institutions have proven their effectiveness in the face of a long-anticipated decline in demand from the offshore sector compounded by a very sharp drop in oil and gas prices over the past two years. Monetary policy has allowed the exchange rate to absorb some of the shock and help improve cost competitiveness relative to peer countries. The fiscal rule and the careful management of the Government Pension Fund Global (GPFG) have helped insulate the mainland economy from petroleum price volatility and excessive reliance on oil and gas revenues. Nevertheless, more needs to be done to ensure a successful transition to a growth model less dependent on demand from the oil and gas sector.

Developments, Outlook, and Risks

1. **The declines in oil prices and offshore investment have taken a toll on the Norwegian mainland economy.** Mainland growth fell to 1 percent last year—the lowest level since the global financial crisis. The drag from private investment was offset by continued growth in household consumption, expansionary fiscal policy and a boost to traditional goods exports, aided by the weak krone. Unemployment is rising, although it is still at a low level and the rise is mainly concentrated in oil-dependent regions. Inflation has risen above the 2.5 percent target, largely due to the effect of exchange rate depreciation on imported consumer goods prices. House price inflation accelerated recently after the slowdown throughout 2015, albeit with large regional variation, and household debt remains elevated at 220 percent of disposable income.

2. **Economic activity is set to remain sluggish this year.** The mission expects mainland GDP growth of about 1 percent this year, supported by public sector demand and mainland exports, while private domestic demand is set to remain depressed. A recovery should take root in 2017 alongside a gradual upturn in oil prices and a slowing of the pace of decline in oil investment. As the oil-related parts of the mainland economy adjust to lower demand, unemployment is projected to rise further this year before declining in 2017. The mission expects headline inflation to stay above the 2.5 percent target this year, but to return to target next year as declining capacity utilization weighs on domestic inflation and the effect of the exchange rate depreciation wears off.

3. **Policymakers are faced with intertwined challenges.** In addition to the short-term task of curbing the downturn, there is the continuing challenge of managing the transition away from oil dependence. The past oil boom had a profound impact on the mainland economy, leading to an extended period of rapidly rising incomes while deepening mainland industries' reliance on offshore demand. The sound fiscal framework has helped insulate public income and expenditure from crowding out of other tradable goods and services, but the insulation is not complete. In particular, the growth of the oil-related parts of the mainland economy had contributed to a high and unsustainable level of unit labor costs relative to peer countries. These forces will need to be unwound, supported by policies that help facilitate a smooth transition to a new, less oil-

dependent, growth model. The mission's forecast of a gradual recovery and continued growth into the medium term is conditional on this smooth transition.

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

- Slower-than-expected growth in key advanced and emerging economies could hinder the recovery of non-oil-related exports, or put further downward pressures on oil prices. Persistently lower-than-projected oil prices could intensify the fall in oil investment, and take a further toll on oil-related demand for mainland goods and services, with adverse spillover effects on confidence and consumption in the rest of the economy.
- A substantial correction in property prices —caused by further negative shocks to the oil and gas sector, interest rate hikes, or a significant change in sentiment —could result in an abrupt reduction in consumption and residential investment, with ripple effects on corporate earnings and banks.
- Tighter or more volatile global financial conditions could lead to liquidity strains and raise costs for Norwegian banks that rely on wholesale funding.
- A hesitant or even stalled transition to a growth model less dependent on the oil and gas sector could lead to higher unemployment for a longer period, with adverse consequences for income and consumption.
- The increased number of refugees, if not effectively integrated into the labor market, could weigh on the public finances and raise structural unemployment.

Macroeconomic Policies

5. **The expansionary fiscal policy stance this year is justifiable, but fiscal measures should avoid inhibiting the necessary economic adjustment.** Fiscal stimulus can be an appropriate tool to smooth the transition to a new equilibrium, and Norway has ample fiscal space for such a policy. However, a permanent shock such as the expected decline in demand from the offshore economy requires permanent adjustment in the private sector growth model and new sources of net export earnings. In this context, any fiscal stimulus should focus on temporary measures that do not inhibit the transition. In particular, non-oil-related tradable industries, rather than the public sector, should absorb a large share of the workers separating from oil and gas-related industries. A failure to manage the envisaged transition would leave the Norwegian economy vulnerable to shocks to the oil and gas industries and fluctuations in the value of assets in the GPFG even as the contribution from oil and gas declines.

6. **Accordingly, as economic growth gathers steam, the fiscal stance should shift to neutral to relieve so-called "Dutch disease" pressures.** Fiscal policy in Norway has generally been prudent, with spending of oil revenues well below 4 percent of GPFG assets in recent years. Nevertheless, as the size of the fund has been growing much faster than mainland GDP—in part

due to exchange rate depreciation in recent years—and its volatility has increased, the fiscal rule's 4 percent target is no longer appropriate as short-term operational guidance for fiscal policy, and a target more like the current transfer to the budget as a share of GPFG assets would be more appropriate. Such a target would also be closer to the likely returns for the next decade and would help conserve the GPFG's resources to address long-run aging-related costs. There should also be a supplementary rule, such that the fiscal impulse would be neutral or negative when the economy is at or above capacity, respectively. This latter rule would help prevent crowding out of production of tradable goods and services.

7. **Monetary policy should stay accommodative.** The current monetary stance is appropriately supportive and should remain so given the slack in the economy and the stable inflation outlook. The policy tradeoff between different objectives arguably has eased; however, potential second-round effects on domestic inflation merit continued monitoring. Provided that inflation expectations remain well-anchored, further easing could be considered should growth turn out significantly weaker than projected. While greater caution may be warranted as the policy rate is lowered in view of the financial vulnerabilities, financial stability concerns should be addressed primarily through macroprudential and other measures.

Financial Sector Policy

8. **Norway's banking sector performance remains relatively strong, and overall financial stability risks appear contained.** Banks are profitable compared with peers, and are well prepared to meet the core equity capital requirement. In addition, bank stress tests from the 2015 Financial Sector Assessment Program (FSAP) Update indicate that banks' buffers render them well-positioned to cope with severe shocks, largely due to the authorities' early adoption of the higher capital requirements in the EU framework.

9. **However, important vulnerabilities in the financial system persist.** These include elevated household debt, overvalued house prices, and banks' heavy reliance on external wholesale funding. In addition, continued low oil prices could trigger a deterioration of household and corporate balance sheets, which will build up banks' credit risks.

10. **In this context, additional action on key FSAP recommendations is needed to further mitigate systemic risks.** The authorities have made progress on implementing the FSAP recommendations, including putting in place several measures to address risks in the housing sector. However, in light of structural vulnerabilities, the mission recommends further measures to reduce risks. In particular, the regulations on residential mortgages that went into effect on July 1, 2015 and are set to expire at end-2016 should be made permanent and tightened if the rapid growth of household debt and house prices of recent months continues. The authorities should also continue work on stress-testing for banks to improve liquidity monitoring and on recovery and resolution planning for the largest banks.

Supporting Transition and Improving Efficiency

11. **Curbing future real wage increases and reinvigorating productivity growth are crucial to restoring Norway's cost competitiveness**. The recent weakening of the exchange rate has reversed some of the lost ground in cost competitiveness, providing a boost to traditional goods exports. The social partners have also demonstrated "collective common sense" by agreeing to historically low wage increases in both 2015 and 2016. Continued restraint in wage settlements will be critical to deliver a substantial downward adjustment in unit labor costs relative to peer countries, enabling the non-oil tradable industries to strengthen their foothold in international markets. This should be complemented by longer-term measures to boost Norway's stagnant productivity growth. In this regard, the mission encourages the authorities to continue reforms in the areas identified by the Productivity Commission, including education, research and innovation, mobilization of the workforce, and public sector efficiency.

12. **Past labor market reforms have proved effective, but challenges remain.** The 2011 pension reforms have resulted in higher labor force participation among older workers in the private sector. Now, the public sector pension reforms need to be completed along similar lines to that of the private sector in the context of current discussions with social partners. In addition, although Norway's labor force participation rate is enviable compared with that of peers, disability and sickness claims account for a large fraction of lost labor. Welcome changes were recently made to the disability benefits system to enhance incentives to work while receiving benefits, and pilot programs for new measures to enforce activity requirements for sickness benefits are showing encouraging results. Nevertheless, the mission urges further reforms to sickness and disability benefits that would help maintain labor force participation in the face of population aging, and relieve pressures on the welfare system at a time of rising unemployment and refugee inflows. In addition, active labor market policies can improve the efficiency of the search and matching process, thereby facilitating labor reallocation during the transition.

13. **Other reforms would help promote efficiency and support the transition to a new growth model.** Tax reforms should shift the burden of taxation from labor and corporate income to property and consumption. In particular, reducing tax preferences for housing would help channel new investment toward more productive uses, including in non-oil-related tradable sectors. The recently introduced tax reform contains welcome reductions in the corporate tax rate and the marginal tax rate on personal income, but a shift to taxes on property has not been implemented. The recent political agreement for additional reductions in personal and corporate income tax rates would if implemented also be a step in the right direction. Additionally, relaxing constraints on new property construction, including at the municipal level, could boost the supply of housing, thereby taking some of the pressure off of elevated housing prices. Reducing the level of protection and subsidy to agriculture would have positive distributional effects and also help free up resources for less expensive and more effective policies to preserve rural communities.

Accommodating and Integrating Refugees

14. **Timely integration of the newly arrived refugees into productive employment is crucial for reducing fiscal costs.** Refugees can contribute positively to the Norwegian economy in the long run, but this potential is not realized until new arrivals become gainfully employed members of the labor force. Although Norway ranks highly in terms of refugee integration policy, there is scope for speeding up the integration process and making it more effective. For example, policies such as making the two-year introduction program more personalized and work-oriented – building on the experiences from the more successful municipalities – would be helpful. We welcome also the proposals in the recent White Paper on accelerating integration of refugees into Norwegian society and providing access to employment.

The mission thanks the Norwegian authorities and other counterparts for their warm hospitality and for the candid and high-quality discussions.