

Concluding Statement of IMF Article IV Mission to Norway

May 28, 2015

Outlook and Risks

1. **The Norwegian economy grew steadily in 2014 despite the sharp fall in oil prices toward the end of the year.** Mainland economy grew at 2.2 percent with weaker oil investment demand being offset by stronger public spending and continued growth in private consumption. Unemployment stayed at a low level in 2014, but it has recently edged up. Inflation has been relatively stable and close to the target. The recent depreciation of the krone has offset some of the deterioration in unit labor cost (ULC) competitiveness over recent years. The housing market revived in 2014, and house prices grew at about 7 percent in the first quarter of 2015. Household debt continues to rise, reaching about 220 percent of disposable income.

2. **The near term outlook has weakened due to lower oil prices.** The impact of oil prices on the mainland economy has been limited so far, and the fiscal position is almost fully insulated from oil price volatility. Nevertheless, the mission expects mainland GDP growth to slow to 1.4 percent in 2015 with weaker private investment and consumption as demand for mainland inputs to the offshore sector declines. Mainland growth is projected to recover moderately in 2016 as private consumption rebounds in line with a modest increase in oil prices. Inflation is projected to increase slightly as import prices rise with the exchange rate depreciation but stay below the 2.5 percent target. Unemployment is expected to rise further but remain at a relatively low level.

3. **The medium and longer term presents complex challenges and uncertainties, particularly given lower oil prices and slowdown of offshore investment.** Steadily increasing oil and gas investment over the last decade has provided persistent demand stimulus to the increasingly oil and gas-focused mainland economy. However, investment declined in 2014-2015, and impulse from the offshore sector to the mainland economy has turned from positive to negative. Oil and gas production will continue for many decades to come, so the problems of managing oil dependency of the mainland economy are not yet over. However, they will abate, particularly if the recent drop in oil prices is sustained, and will be replaced by the challenges of managing a transition away from the oil-dependent growth model. The mission's central forecast is a recovery of growth in the medium term with somewhat higher unemployment in the transition process, and inflation that remains close to the target. However, this is based on a scenario in which the sources of growth shift smoothly away from supplying the oil and gas sector and move toward other tradable sectors of the economy or exports of oil-related goods and services.

4. **There are downside risks to this central scenario.**
- **Deceleration of global demand or excess oil and gas supply could lead to a protracted period of low oil prices.** This would undercut growth through a further reduction in the oil-related demand for mainland goods and services. A deceleration in global demand could also make it more difficult for non-oil and gas export industries to expand.
 - **A significant reduction in property prices could occur.** House prices rose rapidly over the last decade and most estimates suggest that house prices are significantly overvalued. The recent Financial Stability Assessment Program (FSAP) update finds that risks to financial stability are contained. However, with high household debt, a large fall in house prices could depress private demand with adverse consequences for retail trade, domestic services, construction and commercial real estate and lenders to these sectors.
 - **The expected decline in oil-related output in the mainland economy may not be offset by a pick-up elsewhere in the mainland economy.** Resources need to shift from oil-related to non-oil related tradable sectors to realize the transformation, and labor market flexibility in particular will be tested in the process.

Macroeconomic Policies

5. **The current monetary policy stance is appropriately supportive.** Inflation has been stable and close to the target. Lower wage growth this year is likely to reduce the risk of imported prices spilling over to higher domestic inflation. If growth turns out significantly weaker than currently projected, monetary policy needs to be the first line of defense against economic weakness, provided that inflation expectations are well anchored.

6. **Financial stability concerns need to be addressed primarily through macroprudential policy as a single policy rate cannot achieve multiple objectives.** However, Norway's inflation targeting framework contains an element of mitigating the risk of a buildup of financial imbalances, and monetary policy could take financial stability into account if macroprudential policies are slow to be implemented or have limited effect.

7. **Fiscal policy is broadly appropriate this year in light of the projected economic slowdown but could be more conservative in future years.** It has entailed repeated fiscal stimulus for an economy roughly at its capacity in recent years, but the risk of overstimulating the economy has abated somewhat this year and possibly next, given the drag on the economy from reduced oil-related demand. Nevertheless, a shift to a broadly neutral fiscal stance would be more appropriate in the medium-term on the basis of current projections. If growth is weaker than expected in 2016, the authorities should allow automatic stabilizers to operate, but they should stop short of using fiscal stimulus to replace

declining oil-related demand in the mainland economy. Replacing declining oil-related employment with public sector employment would inhibit the necessary shift of resources from oil-related to other tradable industries. Also, any fiscal stimulus would add appreciation pressures on the exchange rate.

8. The government's fiscal policy has generally been prudent with the non-oil structural deficit maintained well below 4 percent of GPFG asset in recent years.

However, the fact that GPFG is growing much faster than the economy has allowed widening non-oil deficits as a share of trend GDP. Also, as the size of GPFG grew, market returns, capital gains, and foreign exchange valuation effects have replaced oil and gas income as both the main sources of annual growth in the GPFG and the main contributors to its volatility. This may call for supplementary provisions for the fiscal rule. Some consideration of smoothing over asset price cycles and exchange rate volatility in addition to the business cycle would be in order. Consideration should also be given to a more explicit approach to avoiding fiscal stimulus at times when the economy is at or near potential. The mission would welcome proposals along these lines from the commission on the fiscal rule.

Financial Sector Policy

9. The FSAP update concluded that the Norwegian financial system is generally sound and well managed. The authorities have taken significant measures to address financial stability risk, including early implementation of the CRD IV. FSAP bank stress tests suggest that financial institutions' capital needs in the face of severe shocks would be nontrivial but manageable.

10. Nevertheless, there are important challenges with a potential impact on financial stability. High house prices and household debt, and banks' reliance on wholesale funding are areas of concern. House prices remain elevated, and the household debt-to-disposable income ratio is one of the highest among the OECD countries. To finance this, banks have relied extensively on wholesale funding. In light of these concerns, continued vigilance and proactive efforts toward mitigating systemic risks are warranted. The mission recommends further measures to reduce risks. In particular,

- *Bank stress tests.* Improve data on cross-border ownership of bank-issued unsecured and covered bonds, and resume regular monitoring of bank-to-bank direct and indirect exposures. Consider regional stress test exercises. Consider further steps in liquidity monitoring, such as performing liquidity stress tests using the structure of cash flows at various maturities.
- *Macroprudential policy.* Take additional measures to contain systemic risks from the growth of house prices and household indebtedness. These could include stricter LTV and amortization guidelines or regulation. In this context, new measures to tighten lending practice are currently under consideration, and the mission welcomes the

proposed policy direction. Take additional measures to contain risks related to bank's wholesale funding. Improve the existing institutional structure for macroprudential policies, including a transparent "comply or explain" approach by decision-makers. Consider greater delegation of decision-making powers over macroprudential instruments in due course to Norges Bank or the FSA.

- *Prudential supervision.* Ensure de jure operational independence of the FSA. Strengthen the FSA's supervision of small banks through the conduct of more frequent comprehensive assessments.
- *Crisis management and bank resolution.* Initiate resolution planning for the largest banks, including assessing impediments of resolvability, and make explicit delegations to the FSA regarding its role. Enhance legal framework for resolution to comply with the FSB Key Attributes with regard to certain areas including the resolution toolkit. The Bank Guarantee Fund should adopt policies specifying under what conditions board members must recuse themselves, considering actual and prospective conflicts of interest.

Structural Reforms and Competitiveness

11. Wages and unit labor costs measured in foreign currency will probably have to adjust downward relative to trading partners to facilitate the transfer of resources away from oil- and gas-related industries in the mainland economy. Such an adjustment would also improve the competitiveness of the oil- and gas-related parts of the mainland economy that supply both Norway's continental shelf and abroad. Ideally, an adjustment in common currency unit labor costs could be achieved mostly through increased productivity growth, but that is hard to deliver, especially in the short run. Instead, continued restraint in wage settlements may be necessary for several years. The collective bargaining system demonstrated the needed wage flexibility this year by delivering a substantial reduction in real wage growth with a nominal increase in the national negotiations of only 0.3 percent.

12. More neutrality in the tax system would help to promote efficiency and support the transition to a new growth model. A reduction in the extent to which the tax system promotes housing rather than productive investment would help redeploy new investment toward tradable industries that will need to replace oil- and gas-related industries as an engine of growth. This could include less preferential tax treatment for residential properties. The mission welcomes the recent recommendations of the Tax Commission to shift the tax burden toward indirect taxes and further reduce preferential tax treatment for residential real estate relative to other assets.

13. Further reform to the pension system and sickness and disability benefits is needed. The mission urges the authorities to complete the pension reform by fully aligning the rules of public sector pensions with the principles used in private sector pensions. Further

reforms to sickness and disability benefits would prevent people from dropping out of the labor market and maintain the participation rate in the face of aging population. In this context, the mission welcomes the Productivity Commission's focus on improved use of manpower resources and takes note of the authorities' recent measure of replacing disability pension with disability benefits which are designed to create incentives to work while receiving disability benefits.

14. **Other structural reforms would help to improve efficiency.** Restrictions on new real estate construction have slowed the building of new units and raised the cost of housing; these policies are under review, and the mission would welcome new measures that could take some of the pressure off of housing prices by relaxing unneeded supply restrictions. In addition, Norway's extremely high trade restrictions and subsidies in agriculture are diverting private and public resources away from more productive sectors and raising the cost of living, particularly for lower-income groups.

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