INTERNATIONAL MONETARY FUND

Norway: Staff Concluding Statement of the 2017 Article IV Mission

May 24, 2017

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's macroeconomic framework has proved resilient and well equipped to tackle the economic downturn following the oil price decline. The economy is beginning to recover, supported by strong domestic demand and accommodative macroeconomic policies. But there are some downside risks and medium-term growth hinges on a successful transition from an oil-and-gas-oriented growth to a more balanced one. Macroeconomic policies should aim to return inflation to target and growth to potential; while macroprudential policies could be reinforced by tax and housing market reforms to contain risks from the housing market. With lower oil prices possibly becoming the new norm, concerted policy efforts are needed to restore competitiveness and foster a new growth model less dependent on oil and gas. Further structural reforms to promote productivity growth and high-skilled labor supply are important in this context.

Developments, Outlook, Risks and Challenges

1. **The mainland economy is slowly recovering from the oil price shock.** Mainland growth fell to just below 1 percent in 2016, the lowest level since the global financial crisis. However, growth has bottomed out last year, underpinned by supportive monetary and fiscal policies and improving sentiment; and unemployment has started falling. Inflation expectations remain well anchored despite recent declines in inflation driven by slow wage growth and pass-through from earlier krone appreciation. However, housing market vulnerability has increased alongside growing household debt and rising house prices. The current account surplus narrowed significantly in 2016 due to decline in exports.

2. **The ongoing recovery is expected to continue at a modest pace.** The mission expects mainland growth to pick up to 1¾ percent this year and 2¼ percent in 2018, supported mainly by private demand and a recovery in mainland exports. Unemployment is expected to gradually decline to just below 4 percent by 2018. Accommodative monetary conditions and an improving global economic outlook are expected to support the recovery, while fiscal policies should be less expansionary. The mission projects inflation to decline further in the near term with earlier krone appreciation still passing through, before converging to the 2.5 percent target as wage growth and trading-partner inflation rise.

3. **Risks remain tilted to the downside.** Weaker-than-projected global growth could hinder the recovery of non-oil exports and put further downward pressure on oil prices. This would exacerbate the oil sector downturn, leading to adverse spillovers to the rest of the economy. Re-emergence of European bank stress could lead to liquidity strains in banks with high dependence on wholesale funding. Domestically, a sharp and widespread correction of house prices could lower consumption and residential investment with ripple effects on corporate earnings and banks. In addition, a stalled transition toward the non-oil sector could undermine longer-term growth. On the upside, growth could accelerate more rapidly given further fiscal stimulus and accommodative monetary policy; unwinding the stimulus too late can pose overheating risk to the economy.

4. **Structural impediments in the labor, product, and housing markets are main obstacles to sustaining long-term growth and protecting financial stability.** Labor force participation rates have been falling, especially among immigrants, men, and the young given the structural slowdown of the oil sector as well as high dropout rates and disability claims. Restrictions on temporary employment and limited downward wage flexibility represent impediments particularly for the low skilled and long-term unemployed, in addition to lock-in effects from generous contributions and social benefits. Productivity growth is low and cost competitiveness, though improving, still compares unfavorably with peers. Overvalued house prices and elevated household debt make the economy more vulnerable to shocks.

Fiscal Policies

5. **The fiscal stimulus in 2017 is appropriately supportive for the budding recovery, provided the measures are pro-transition.** Given the significant output gap and ample fiscal space, fiscal policy should remain supportive until the recovery is on a more solid footing, especially given the limited monetary policy space. We expect the 2017 budget to generate a fiscal impulse of a half percent of mainland GDP, which includes special measures to combat unemployment from the oil regions and industries, spending on

infrastructure and research and development (R&D), and the continued implementation of the tax reform.

6. **As the output gap closes, the fiscal stance should converge to neutral.** Positive fiscal stimulus when the economy is approaching full capacity should be avoided to contain further oil dependency. Should growth fall short of expectations, automatic stabilizers shall be allowed to operate freely.

7. **The mission welcomes the recently tightened fiscal rule.** The tighter fiscal rule reflects lower expected returns of the GPFG in light of the new norm of “low for long” global interest rates. This will help conserve oil revenue for long-term aging-related fiscal challenges.

8. **Further tax reform should be considered to ensure an efficient allocation of resources and support the transition and longer-term growth.** The 2016-2018 tax reform contains welcome steps to shift the tax burden away from direct taxes, including stepwise reduction of corporate and personal ordinary income tax rates, and increases in various indirect taxes. Additional reform measures are needed to reduce tax preferences for housing, including by phasing out mortgage interest deductibility and removing the housing valuation discount for taxation. This could promote efficiency and help channel new investment toward tradable industries that will need to rebalance towards a less oil and gas dependent growth model. Also, there is room to further improve incentives to work by narrowing labor tax wedges—especially for low-wage earners, reduce lock-in effects from social benefits, and consider increasing tax incentives for R&D and entrepreneurship.

Monetary Policy

9. **Monetary policy should stay accommodative.** Given the slack in the economy and weakened inflation outlook, maintaining an accommodative monetary policy stance is appropriate pending a durable recovery. Further easing could be considered should growth or inflation fall significantly below projections. Financial stability concerns arising from the “low for long” interest rate environment warrant close monitoring, but they should be addressed primarily through macroprudential measures as well as tax and housing market reforms.

Financial Sector Policies

10. **Vulnerabilities in the financial system have increased.** High and overvalued house prices continue to rise robustly especially in the Oslo area, albeit at a slower pace in recent months. Elevated household debt continues to grow. Bank lending to the commercial real estate (CRE) sector accounts for a sizable share of banks’ lending portfolios, and CRE valuations for the Oslo area have increased more rapidly than

residential house prices. Moreover, banks are subject to risks from turmoil in global financial conditions given their continued heavy reliance on external wholesale funding.

11. **But the overall banking system remains resilient.** Banks' profitability remains high compared with peers and non-performing loan ratios remain low. Moreover, banks have substantially strengthened their balance sheets in line with regulatory steps, and are well positioned to meet the core equity capital requirement, including the upcoming leverage ratio requirements. Bank stress tests by both the FSAP in 2015 and the Norges Bank in 2016 suggest that banks are sufficiently resilient to withstand severe shocks.

12. **Significant progress has been made to contain financial stability risks, but continued vigilance and further measures are needed.** Important steps have been taken to cope with the build-up of financial imbalances, including recent decisions to raise the countercyclical capital buffer (CCB), tighten mortgage regulations, and hereunder introduce the debt-to-income limit and leverage ratio requirements. The recently concluded Nordic MoUs on the supervision of systemically-important branches have strengthened the basis for regional cooperation on financial stability issues. However, continued vigilance is needed and further targeted measures should be considered if vulnerabilities in the housing sector intensify. The close supervision on banks' risk management and underwriting standards in the CRE sector, as well as efforts to increase CRE risk weights and to apply capital add-ons on banks with high concentration on CRE lending, should continue. Deployment of macroprudential tools to contain banks' CRE exposures, such as loan-to-value limits and/or a sectoral CCB, should be biased to being ahead of the curve. Moreover, macroprudential policies should be reinforced by tax and housing market reforms, including reducing tax preferences for housing, relaxing constraints on new property construction, and developing the rental market. The authorities should also implement the liquidity coverage ratio requirements in significant currencies—currently under consideration—and continue to enhance stress tests for banks to take account of funding risks.

Structural Policies

13. **Continued wage restraint and productivity growth are crucial to fully restoring Norway's cost competitiveness.** The weakening of krone and slower wage growth in recent years have helped partially restore Norway's external competitiveness. In particular, the "social partners" have demonstrated flexibility in wage settlement for three consecutive years to facilitate the economy's structural transition. However, Norway remains less competitive than peers in terms of unit labor costs and its external position is assessed to be moderately weaker than implied by fundamentals. Continued wage restraint and reforms to raise labor productivity growth are pivotal to improving the competitiveness of non-oil tradable sectors and facilitate the economic transition. In this

regard, the authorities are encouraged to continue reforms identified by the Productivity Commission, including on education, R&D, and public sector efficiency.

14. **Sustained longer-term growth also hinges on policies underpinning high-quality employment in the face of aging.** Labor participation among immigrants, men, and the young has been falling. Reintegrating these groups into employment requires improving their work incentives and employability. There is also potential to expand hours worked by women and enhance their upward mobility. In this context, policy efforts are needed on several fronts:

- Making unemployment benefits more activity-oriented and further tightening the eligibility checks on sickness and disability benefits.

- Given the relatively high effective minimum wage, allowing for greater wage flexibility in a targeted manner and further curbing restrictions on temporary employment might be considered to incentivize the hiring of new entrants and the low skilled. In addition, strengthening refugees' use of active labor market policies (ALMPs) and promoting affordable housing would help successful integration into productive employment.

- Education reforms should target enhancing job-related skills and lowering dropout rates. Measures should be considered to further increase the focus on science, technology, engineering, and math (STEM) fields throughout education and boosting the number of university graduates specialized in these fields.

- Broadening efforts to further expand childcare to the youngest children and make childcare hours more flexible. The authorities could consider addressing sectoral gender segregation by incentivizing women to enter more male-dominated professions.

15. **Other structural reforms would improve efficiency and further raise growth potential.** While private sector pension reform has been effective in raising labor force participation among the elderly, it will be important to complete similar reforms to the public-sector retirement system. Additionally, 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.

The mission team thanks the Norwegian authorities and other counterparts for the excellent discussions and greatly appreciates their kind hospitality.