CONCLUDING STATEMENT

NORWAY: Staff Concluding Statement of the 2021 Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC – April 26, 2021: *The pandemic has had major health, social, and economic impacts in Norway, but the strong policy response has helped the country to experience one of the lowest infection rates and among the smallest economic contractions in Europe. The positive outcome reflects unprecedented fiscal, monetary and financial sector policies and a strong social safety net, as well as structural features of the economy. Norway looks to be headed for a strong economic recovery this year, though substantial risks and uncertainties remain, including some related to the pace of vaccinations and infection rates. Fiscal policy should focus on facilitating the economic recovery, tapering as private sector activity rebounds and targeting support to those households and (viable) firms most affected by the crisis, while avoiding disincentives to economic activity. Monetary and financial policies need to strike the right balance between supporting economic recovery and addressing risks to financial stability (especially from rising housing prices) while remaining alert to potential inflationary risks. Structural reforms remain decisive to facilitate green and inclusive growth through strengthening labor productivity and participation, including among vulnerable groups, and allowing for greater efficiency in resource allocation. The authorities should continue to pursue policies to ensure long-run intergenerational fiscal equity.*

The Norwegian economy is expected to rebound strongly this year, but risks remain. Economic activity and hiring are anticipated to accelerate as restrictions are eased and the majority of adults are vaccinated by late summer. Real mainland GDP growth is projected to be 3.2 percent in 2021, supported by domestic demand and continued policy support. GDP will surpass its pre-pandemic level by year-end and is projected to be only slightly below its pre-pandemic trajectory in the medium-term, suggesting that economic scarring remains limited. The outlook is subject to substantial risks, including a slower-than-expected vaccine rollout or setbacks in the evolution of the pandemic and external conditions, but which can be mitigated by deploying Norway's ample policy space.

Extraordinary fiscal support should gradually be reduced and become more targeted as the recovery gathers traction, but policymakers should remain ready to deploy new measures should the pandemic unexpectedly worsen. Fiscal support in 2021 is appropriately calibrated to the rebound in economic activity this year and remains substantial. Staff projects the structural non-oil deficit to exceed 3 percent of the GPFG for a second consecutive year in 2021, albeit by less than was the case last year. Staff welcomes the 2021 budget's mix of support for private sector activity, for employment and for creating a more educated and inclusive society, with an emphasis on green and digital technologies. Getting the incentives right to promote economic activity is an important component of ongoing changes to the policy mix. In this context, the changes to taxation of individuals and corporates should help boost labor participation and private investment. As economic activity rebounds, fewer businesses and households will need to rely on government support, which will result in a smaller fiscal stimulus and progressively less engaged automatic stabilizers.

The reversion to a neutral fiscal stance is appropriate once the Covid crisis is behind Norway, provided downside risks do not materialize. The stimulus should become smaller and more targeted as the recovery gathers traction, while ensuring those hit worst get support. The government's objective to integrate vulnerable groups into the workforce and improve the provision of education and skill-enhancing programs is especially noteworthy and should remain a priority. Finally, the continued support for municipalities and the health sector will help to deal with the social and health ramifications of the pandemic. The authorities should remain flexible and closely calibrate policies to changing circumstances.

As the pandemic recedes, the authorities can once again turn their attention to longer term fiscal policy challenges. The coming decades will require Norway to make some hard choices to close the gap between revenues and expenditures in a manner consistent with intergenerational fairness objectives. This gap is driven by the future demographic deterioration (which will inflate age-related expenditures) and declining oil revenues after the mid-2020s. To counteract these forces, and in light of the high level of government expenditure—which reached an historic high as a share of GDP in 2020—the authorities should take a closer look at the composition of government spending (possibly via an expenditure review by an external committee). Social partners should pursue further changes to the sickness and disability benefit system, which remains an outlier relative to peer countries. Reforming the VAT, through broadening and simplification, remains a priority. Demographic pressures ahead also reinforce the importance of boosting labor participation and transitioning away from oil towards green technologies.

Monetary policy is supporting the recovery while countering financial stability risks. Norges Bank (NB) entered the crisis with significant monetary policy space and strong monetary policy transmission, which allowed the swift implementation of a large and effective monetary policy response to the crisis. Provided the economy continues to recover in line with NB's projections, the projected gradual tightening of monetary policy is appropriate. However, should the recovery and inflation expectations falter, NB should stand ready to step up support. NB's continued exploration of Central Bank Digital Currency (CBDC) is welcome.

The acceleration in housing prices should be contained through a mix of monetary, tax, structural and financial sector policies aiming at easing housing supply while curbing demand. The authorities are rightly concerned about financial stability risks from the acceleration in housing prices. Accommodative monetary policy together with potential pandemic-induced shifts in housing preferences have led to increased housing demand and could lead to further increases in household debt. The expiration of the crisis-related relaxation of borrower-based requirements, the eventual hikes in the policy rate and the planned increases of the countercyclical capital buffer will help curb house price growth going forward. However, the authorities should consider tightening mortgage regulations if house price growth does not slow and if other targeted measures, including easing restrictions that constrain the supply of new housing (e.g. related to land use) and a gradual phasing out of mortgage interest deductibility to curb demand are not implemented in a timely manner.

Banks have weathered the crisis well so far, but the full impact of the pandemic on the financial sector remains uncertain. Banks entered the pandemic with strong capital buffers and high profitability levels, bolstered by prudent macro-prudential policies prior to the crisis. Banks' performance has remained strong during the crisis, with only modest increases in non-performing loans and still-contained bankruptcies. But long-standing financial vulnerabilities related to high household debt and exposure to commercial real estate (CRE) have been exacerbated by the crisis, not least because the demand for office, retail and hotel space could be permanently lower going forward. Initiatives to upgrade data collection that will allow for enhanced monitoring of CRE-related risks are welcome, while broadening the toolkit for mitigating CRE vulnerabilities could be considered. Bank balance sheets could also suffer if bankruptcies increase following the phasing out of support and will depend on institutions' exposure to crisis-affected sectors.

The recent progress in addressing AML/CFT deficiencies is welcome, though there is room for further improvement. This concerns the tools, and methodologies of financial supervision, including the frequency and coverage of inspections.

Once the recovery is firmly in hand, policy attention can more firmly shift to advancing structural reforms to boost inclusive growth. These include boosting labor force participation, including among vulnerable groups and non-oil productivity, and supporting green growth amid the decline in the offshore sector. The authorities' plans to strengthen investment in R&D, physical infrastructure and green technologies and efforts to promote digitalization, technology adoption and upskilling of the vulnerable parts of the population are all welcome but more can be done. The policy support provided during the pandemic has sustained the economy, but prolonged support could impede structural transformation.

Norway remains a global leader in climate mitigation policy, but more can be done. Current efforts to achieve climate mitigation objectives through 2030, centered on carbon taxation and other important initiatives such as research and development of carbon capture, are welcome. Looking further ahead, Norway's commitment to become a low emission country by 2050, with net negative emissions when the uptake of carbon of Norwegian forests and other land is taken into account, are also welcome, and the focus is now on implementation. Norwegian policies regarding the adoption of electric vehicles provide an important example to other countries. However, they could be recalibrated to strengthen their cost effectiveness, including by steps aimed at accelerating the replacement of the most polluting cars by EVs.

The mission thanks the Norwegian authorities and other counterparts for the very constructive policy dialogue and productive collaboration.