

Concluding Statement of IMF Article IV Mission to Norway, May 24, 2013

1. **Norway's economy continues to perform well.** Over the last two years, mainland GDP has grown steadily at an annual pace of 2½-3 percent and looks likely to continue to do so over the near term. Demand has been driven by private consumption and investment, supported by rising house prices, improving terms of trade, low interest rates, and rising demand for mainland goods and services from the oil and gas sector. Inflation is more than one percentage point below the 2.5 percent target and unemployment has been low and stable at around 3 -3½ percent. The value of the krone seems broadly appropriate for current macroeconomic conditions.

2. **But good fortune and good economic management have created new economic challenges.**

- **Rising wages:** Increasing oil-related activity in the mainland economy has provided income and employment at high wage levels in Norway, but it is also pushing up unit labor costs and undermining the competitiveness of the rest of the mainland economy.
- **Increasing fiscal stimulus:** the high prices for oil and gas and new production have bolstered the already-strong assets of the Government Pension Fund Global (GPF – the sovereign wealth fund),. This gives room for large and increasing fiscal transfer from the GPF that is providing increasing stimulus to the Norwegian economy at a time when it is at or near capacity.
- **Rising housing prices and high household debt:** the housing boom has been in part supported by the booming oil and gas economy. Both the increased importance of oil to the mainland economy and the increasing fiscal transfer from the GPF have put upward pressure on wages and contributed to high and rising house prices. Housing prices are at record levels by many measures, and household debt remains elevated at 200 percent of disposable income.
- **Longer term challenges:** increasing life-expectancy resulting from the good health of the Norwegian population will contribute to higher long-run aging-related costs.

Near-and Medium-Term Outlook and Risks

3. **Our central forecast is positive.** We expect mainland GDP to remain near potential and grow at about 2¾ percent in 2013 and throughout the medium term. Inflation is expected to rise to the target level gradually, reaching 2.5 percent only in 2018. We expect unemployment to remain at about 3½ percent, and the current account surplus to decline modestly with a decline in oil and gas revenue.

4. **However, there are risks to this benign scenario.**

- **A substantial and prolonged reduction in oil prices** could occur if downside risks to the global growth outlook materialize. This would undercut growth directly, through a reduction in the oil-related demand for mainland goods and services, and indirectly,

through a possible reduction in demand for housing due to confidence effects or a reversal of immigrant inflows.

- **A significant reduction in housing prices** could be triggered by a reduction of oil prices or other shocks to demand or confidence. Given the elevated level of prices and high household debt, such a decline would likely reduce household consumption with adverse consequences for retail trade, construction, and commercial real estate and lenders to those sectors.
- **Stalled or incomplete delivery of euro area policy commitments or a protracted period of slower European or emerging market growth** could have negative impacts on oil prices and demand for Norwegian non-oil exports. This could also reduce foreign funding for Norwegian banks and tighten lending conditions.

Macroeconomic policies

5. **Monetary policy remains appropriate in light of below-target core CPI inflation.** Monetary policy is constrained by possible upward pressure on exchange rates and the lower-than-target inflation rate. A tightening of policy might help cool housing markets, but at the cost of likely exchange rate appreciation and additional pressure on the non-oil-related sectors of the mainland economy. In this context, risks from house prices should be addressed instead through macroprudential policies. The value of the exchange rate is broadly appropriate to current macroeconomic conditions. While there has been an erosion of competitiveness, and labor costs are rising faster than productivity, these would be better addressed through fiscal and structural policies.
6. **The government has used the flexibility in the fiscal rule prudently, with a structural non-oil deficit close to 3 percent of GPFG assets in 2011 and 2012 and projected at about this level for 2013.** Because the fiscal rule stabilizes the non-oil deficit relative to GPFG assets but not relative to mainland GDP, an overly strict interpretation would imply a large and rising stimulus to the economy that would further add to wage and cost pressures. A continuation of the prudent fiscal stance would not offset the pressures on competitiveness, but it would limit how much fiscal policies added to them. A still lower rate of spending in the 2014 budget and beyond would be appropriate in light of the wage pressures and other competitiveness concerns.
7. **The recently proposed tax measures to limit preferential tax treatment for residential investment and increase taxation of the oil sector should help slow the erosion of competitiveness.** The development of goods and services providers to the offshore sector and to oil and gas operations abroad has been a positive development for the mainland economy. However, this undermines competitiveness in those sectors that will need to provide income and employment after oil-related activity declines or in the event of a negative shock to oil and gas revenue. While both proposed tax changes are small, they remove some of the relative disincentive for productive investment in the non-oil-related sector of the mainland economy, and both are therefore moves in the right direction.

Financial Sector and Other Structural Policies

8. **The mission supports the proposed legislation to increase capital requirements for banks in line with, but ahead of, the Basel III requirements, including the proposed counter-cyclical buffer.** Financial sector balance sheets are improving and the funding structure of banks is now more robust, but they would still be vulnerable in the event of property price reversals or a disruption to external wholesale funding. More capital to support exposures will further strengthen banks and might encourage banks to appropriately tighten lending standards, including for housing. This should not be disruptive to credit as banks have already raised capital ratios in anticipation of higher capital requirements.

9. **The mission welcomes the proposals to reassess risk weights for housing.** Norway's risk weights on residential mortgages are relatively low, creating incentives to shift lending toward households rather than corporates, which generally have higher risk weights. The rapid rise of covered bonds for mortgage finance may create similar incentives and increase risks to unsecured creditors and depositors; the use of covered bonds should be monitored closely and limits on issuance should be considered for individual banks or the banking system if the issuance of covered bonds leaves too few high-quality assets on banks' balance sheets.

10. **There is also a need for cooperation within the Nordic region on macroprudential measures for banks.** The Norwegian authorities can tighten risk weights and other conditions for Norwegian banks (including subsidiaries of foreign banks), but a substantial part of the banking system in Norway consists of branches of foreign banks. Regional cooperation is needed to ensure that foreign-headquartered bank branches lend in line with Norwegian prudential policies.

11. **Reforms in disability benefits, lower trade barriers, and more efficient public services could improve cost competitiveness and improve the efficiency of the economy.**

- Labor force participation remains high for most of the working-age population, but total work hours are low and sickness leave and disability-related early retirement are at levels that seem inconsistent with Norway's otherwise excellent health indicators. We urge the authorities to complete the pension reform by fully aligning the rules for public sector pensions with the principles of the recent pension reform. Further reform to sickness and disability benefits should be considered, including strengthening the monitoring of eligibility for sickness benefits.
- Norway's trade policies compare favorably with peer countries. However, trade policies for agricultural products competing with Norwegian farms are even more restrictive than those of the EU and have recently become still more restrictive for some products. A recent study by Eurostat ranked Norway's food costs as the highest in Europe. Reduction of agricultural trade barriers could help contain the rising cost of living.
- There is scope for greater efficiency in the provision of public services, including making more and more effective use of cost-benefit, quality assurance, and other methods of assessing spending efficiency in prioritizing public current and capital expenditure.

Long-Run Fiscal Challenges

12. Norway's fiscal institutions, in particular the GPFG and the fiscal rule, are a model for other natural resource-exporters. The avoidance of off-budget spending or special purpose funds is also a positive feature of the Norwegian model that we strongly support. However, they are not sufficient to fully contain the pressures on competitiveness of the non-oil economy and address the long-run fiscal implications of an aging population. While there are considerable uncertainties about the path of hydrocarbon production and prices and long-run real returns, several issues merit discussion.

- The expected real return assumption of 4 percent could be too optimistic and a lower rate of return would have significant implications for the long-run value of the fund. The average rate of return over the life of the GPFG has been below 4 percent, and experience with similar asset portfolios over longer periods indicates that returns are likely to be lower.
- In the event of a prolonged decline in oil prices during the remaining years of near-peak production, the total long-run assets of the GPFG could be considerably lower than projected. The long-run value of the fund would be lower still to the extent that the fiscal transfers from the GPFG exceed the real rate of return.
- The long-run health, pension, and other costs associated with an aging population will entail costs far in excess of what could be financed from the GPFG. Unless taxes are raised – from already high levels -- or other expenditure is cut sharply, some additional measures are needed to contain health and aging-related expenditure. The recent pension reform is a substantial down payment on this very tall challenge, but it will be many years before its full impact on spending and labor force participation is clear.

In the view of this mission, all of these risks and future fiscal liabilities argue for a slower rate of spending than the strictest interpretations of the fiscal rule would suggest. A more conservative approach would not only guard against the risk to competitiveness for sharply rising transfers to the budget from the GPFG but would also provision against long-run downside risks. Further reform to sickness and disability benefits would likely improve the efficiency and competitiveness of the economy, but they are also important to contain the large contingent fiscal liabilities from an aging population. A slower rate of fiscal transfers from the GPFG would complement such reforms by better aligning long-run spending obligations with fiscal transfers.

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