INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/279

NORWAY

September 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR NORWAY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Norway, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 12, 2018 consideration of the staff report that concluded the Article IV consultation with Norway.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 12, 2018, following discussions that ended June 8, 2018, with the officials of Norway on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 24, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Norway.

The document listed below have been or will be separately released.

Selected Issues

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INTERNATIONAL MONETARY FUND

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September 17, 2018

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2018 Article IV Consultation with Norway

On September 12, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation[1] with Norway.

Norway is in the midst of a healthy recovery from the oil downturn, supported by positive trends in oil prices and a strengthening labor market. In addition, banks remain profitable and well capitalized. However, household debt continues to increase and house prices have resumed their rise, especially in the Oslo area, after a correction during 2017.

Mainland growth is projected to increase from 2 percent in 2017 to 2½ percent in each 2018 and 2019, underpinned by solid consumption, stronger business investment and an export recovery. Petroleum investment will also pick up. As a result, output will likely start to exceed potential in 2019. Unemployment, which has already fallen below 4 percent, is expected to decrease somewhat further as labor market slack continues to diminish. Headline inflation is already above the 2 percent revised target, and core inflation is slowly converging towards it.

Risks to the outlook are broadly balanced. Externally, global trade tensions could be damaging to a highly open economy such as Norway. Domestically, the most prominent downside risk is related to high household debt and elevated house prices. With over 90 percent of mortgages being variable rate, highly-leveraged households and consumption are vulnerable should financial conditions tighten abruptly. Relatedly, a sharp decline in house prices could curb private consumption and create negative spillovers to banks’ balance sheets. On the upside, the economic upswing may prove stronger than expected, not least through the impact of higher oil prices on consumption and investment.

The 2017 fiscal outturn implied a stimulus of 0.2 percent of mainland trend GDP. The non-oil structural balance stood at 7.5 percent of mainland trend GDP (equivalent to 2.8 percent of the GPFG). The revised 2018 budget maintains a neutral stance by saving stronger-than-expected gains from oil, and focuses on boosting long-term growth potential. Its key measures

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

aim at scaling back and shifting the tax burden from direct to indirect taxes, improving public sector efficiency, enhancing infrastructure, and promoting innovation.

Executive Board Assessment[1]

Executive Directors agreed with the thrust of the staff appraisal. They commended the Norwegian authorities for the skillful deployment of countercyclical policies during the last downturn, which set the stage for the current recovery. Directors noted that economic growth is running above potential thanks to firm improvements in the labor market and favorable oil prices. Nevertheless, Directors cautioned that global trade tensions and an abrupt tightening of financial conditions could adversely impact Norway. Over the longer term, population ageing and slowing labor productivity could weigh on potential growth. Against this background, Directors recommended calibrated macroeconomic policies and structural reforms to sustain prosperity, by boosting productivity and promoting a successful transition away from oil.

Directors welcomed the decision in the revised 2018 budget to save the higher-than-expected oil windfall. They also advised that the 2019 budget should target a modestly contractionary stance to begin unwinding the significant fiscal stimulus provided during the last downturn. Arresting the rise in non-oil deficits of the last two decades would help relieve pressure on the real exchange rate, thus preserving competitiveness. It would also give Norway a headstart on long term consolidation needed to address challenges from population ageing.

Directors welcomed the new monetary policy framework, which is not expected to result in major policy changes. They emphasized that the inflation outlook warrants a gradual tightening, as signaled by Norges Bank in its forward guidance. Directors noted the high levels of capital and liquidity in the banking sector but cautioned against financial stability risks, including from a combination of high household debt and fast rising house prices. In this context, Directors welcomed the recent extension of the macro-prudential measures but underscored the need to tighten policies further, and on a regionally differentiated basis, if risks were to intensify. Further progress should also be made in relaxing constraints on housing supply and in reducing tax incentives in favor of home ownership.

Directors underscored the need for Norway to underpin competitiveness further. In this context, they recommended that the wage moderation achieved by social partners in recent years be carried forward to facilitate the needed transition of the economy out of oil and reinforce resilience against adverse developments in international prices. Reforms in recent years to support innovation and productivity growth should also be continued.

[1] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors noted that Norway's social model requires high labor participation to be sustainable. Recent agreements on private and public sector pensions will commendably lengthen working lives and foster labor mobility. However, reforms are still needed to enhance work incentives, notably changes in the sickness and disability schemes. There is also room to improve the integration of vulnerable groups into the labor market.

Table 1. Norway: Selected Economic and Social Indicators, 2013–19

	2013	2014	2015	2016	2017	Projections 2018	2019
Real economy (change in percent)							
Real GDP 1/	1.0	2.0	2.0	1.1	1.9	2.1	2.1
Real mainland GDP	2.3	2.2	1.4	1.0	1.9	2.5	2.4
Domestic demand	3.5	1.6	0.7	2.7	2.5	2.3	2.2
Unemployment rate (percent of labor force)	3.8	3.6	4.5	4.7	4.2	3.8	3.7
Output gap (mainland economy, - implies output below potential)	0.5	0.6	0.0	-0.9	-0.6	-0.2	0.2
CPI (average)	2.1	2.0	2.1	3.6	1.8	1.9	2.0
Gross national saving (percent of GDP)	38.1	38.6	35.5	33.1	34.3	36.1	36.4
Gross domestic investment (percent of GDP)	27.9	28.1	27.6	29.3	28.8	28.3	28.7
Public finance							
Central government (fiscal accounts basis)							
Overall balance (percent of mainland GDP) 2/	9.4	6.0	1.3	-3.1	-2.0	-0.7	-0.7
Nonoil balance (percent of mainland GDP) 3/	-4.8	-6.3	-7.1	-7.7	-8.0	-8.4	-8.5
Structural non-oil balance (percent of mainland trend GDP) 4/	-5.2	-5.9	-6.6	-7.3	-7.5	-7.6	-7.6
Fiscal impulse	0.4	0.7	0.6	0.7	0.2	0.1	0.0
in percent of Pension Fund Global Capital 5/	-3.3	-3.0	-2.7	-2.7	-2.8	-2.7	-2.8
General government (national accounts definition percent of mainland GDP)							
Overall balance	13.7	10.8	7.2	4.6	5.2	6.9	6.9
Net financial assets	262.6	305.6	335.4	325.3	350.3	333.2	328.9
of which: capital of Government Pension Fund Global (GPF-G)	207.7	253.2	284.6	276.4	302.8	287.6	285.6
Money and credit (end of period, 12-month percent change)							
Broad money, M2	7.3	6.4	0.6	5.1	6.0	…	…
Domestic credit, C2	6.8	6.0	6.1	4.7	6.3	…	…
Interest rates (year average, in percent)							
Three-month interbank rate	1.8	1.7	1.3	1.1	0.9	1.1	1.4
Ten-year government bond yield	2.6	2.5	1.6	1.3	1.6	1.9	2.1
Balance of payments (percent of mainland GDP)							
Current account balance	13.0	13.0	9.4	4.4	6.5	9.5	9.4
Exports of goods and services (volume change in percent)	-1.7	3.1	4.7	-1.8	1.1	2.0	2.4
Imports of goods and services (volume change in percent)	5.0	2.4	1.6	2.3	2.8	1.9	2.9
Terms of trade (change in percent)	0.0	-6.3	-11.7	-9.9	4.9	1.1	0.8
International reserves (end of period, in billions of US dollars)	57.9	66.9	58.5	60.9	65.1	73.3	78.7
Fund position							
Holdings of currency (percent of quota)	78.2	85.6	89.8	93.9	93.5	…	…
Holdings of SDR (percent of allocation)	95.1	94.8	96.4	88.3	102.7	…	…
Quota (SDR millions)	1,884	1,884	1,884	3,755	3,755	…	…

Exchange rates (end of period)							
Exchange rate regime		Floating					
Bilateral rate (NOK/USD), end-of-period	5.9	6.3	8.1	8.4	8.3	…	…
Real effective rate (2010=100)	99.0	94.2	86.5	86.6	87.4	…	…

Sources: Ministry of Finance, Norges Bank, Statistics Norway, International Financial Statistics, United Nations Development Programme, and Fund staff calculations.

1/ Based on market prices which include "taxes on products, including VAT, less subsidies on products".

2/ Projections based on authorities' 2018 budget.

3/ Projections based on authorities' 2018 budget removes both petroleum revenues and expenditures.

4/ Authorities' key fiscal policy variable; excludes oil-related revenue and expenditure, GPFG income, as well as cyclical effects.

5/ Over-the-cycle deficit target: 3 percent of Pension Fund Global Capital

INTERNATIONAL MONETARY FUND

NORWAY

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

July 24, 2018

KEY ISSUES

- **Context:** Norway is in the midst of a healthy recovery from the 2015–16 oil-driven downturn. After growing by 1.9 percent in 2017, mainland economic activity is expected to accelerate further and to grow by about 2½ percent this year and next. But population aging and labor productivity will weigh on potential growth going forward. Norway also faces important challenges to sustaining its prosperity into the future: securing competitiveness in non-oil sectors as the contribution from oil wanes, and dealing with high and rising non-oil fiscal deficits, which will only worsen as aging pressures start to bite. More immediately, high household debt is an ongoing source of concern.

- **Fiscal policy:** The 2018 budget appropriately targets a neutral stance, which is commendably being maintained despite oil windfall gains. But, even under the tightened fiscal rule, non-oil deficits could remain on the order of 8 percent of mainland GDP. With the output gap turning positive by next year, the fiscal stance should then become contractionary. This would also provide a head start on longer-term adjustment needs—staff analysis shows that, in absence of adjustment, deficits would eventually more than deplete Norway's very high savings.

- **Monetary and financial sector policies:** A gradual normalization of monetary policy, as envisaged by Norges Bank, is appropriate at this stage in the cycle. While banks are healthy, vulnerabilities related to high household debt, commercial real estate, and reliance on external wholesale funding remain and need to be closely monitored. The mortgage regulations of 2017 have reduced high-risk borrowing and their extension this June was essential. However, analysis suggests that housing remains overvalued, especially in the Oslo area. Further structural measures, including reduction in tax incentives for housing, are also needed.

- **Structural policies:** Competitiveness, especially in non-oil tradable sectors, is a concern in light of high wage increases during the oil boom, which are being only partly offset by more recent wage moderation and krone depreciation. Continued wage restraint by social partners will be important. The recently-agreed public sector pension reform fosters work incentives, but more is needed to support the high employment and innovation necessary for Norway to support its social model over the long term.

Approved by
Philip Gerson (EUR) and Daria Zakharova (SPR)

Discussions took place in Oslo from May 29 to June 8. The staff team was comprised of E. Cabezon, L. Górnicka, C. Henn, and J. Miniane (head), and was supported by R. Jarin, N. Kumar, L. Yang, and Y. Zhang from headquarters (all EUR). T. Sand (OED) joined the discussions.

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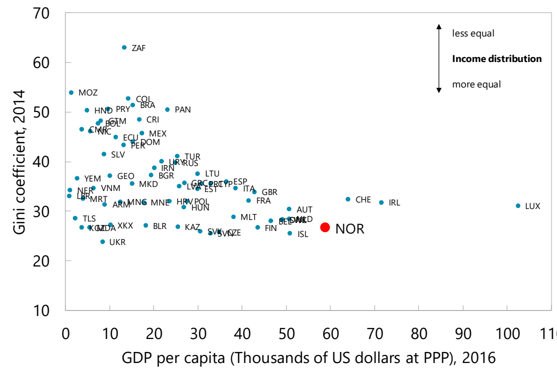
ANNEXES

CONTEXT: MANAGING OIL WEALTH AND COMPETITIVENESS

1. Norway has leveraged its oil wealth to become one of the most prosperous and equitable countries in the world. The discovery in the 1960s of oil and gas in the continental shelf transformed the country's fortunes. Today, Norway has one of the world's highest levels of GDP per capita, while enjoying high income, wealth, and gender equality. This would not have been possible without strong social consensus, including on how to manage the oil wealth (Annex III). Specifically, there was—and remains—broad agreement on three key points:

Income Level and Income Distribution



Source: World Bank World Development Indicators.

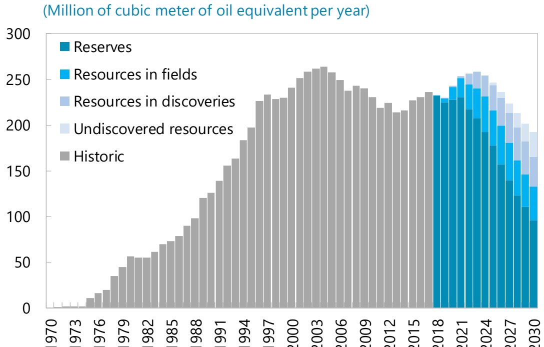
- The oil[1] rents should be widely shared. Most of the oil revenue flows back to the State, either directly through the State's energy company or through high corporate tax rates on private oil companies. Private capture of the State has never been an issue.

- Much of the oil rent should be saved for future generations by only spending the real return on the accumulated oil savings. Limiting inflows into the domestic economy (so called mainland Norway) while keeping most savings abroad has also helped contain Dutch Disease effects.

- The wage bargaining system should ensure that terms of trade windfalls are shared fairly equally across all sectors of the economy (Annex I).

2. However, the contribution of oil to economic growth is peaking. Oil production in the last 15 years has outperformed expectations, notably because improvements in technology allowed more to be extracted from existing fields and rendered once marginal fields profitable. A large new field will come onstream around 2020, leading to a further projected peak in production in the mid-2020s. However, thereafter petroleum production, which currently constitutes about ⅛ of output, is set to decrease.[2]

Petroleum Production
(Million of cubic meter of oil equivalent per year)



Source: Norwegian Petroleum Directorate Report "The Shelf in 2017".

[1] The term "oil" in this report refers to both oil and gas, unless explicitly specified.

[2] The decrease is foreshadowed by more limited potential for further efficiency improvements and more subdued exploration activity during the last years (it takes about a decade to bring new discoveries into production).

3. Sustaining high incomes as oil-related activity ebbs will require addressing three important challenges. These provided the focus for this year's Article IV consultation.

- **Competitiveness** (Annex I and Selected Issues Paper).[3] During the past two decades, wages in Norway have grown faster than productivity and more rapidly than wages in peer countries. Terms of trade gains helped to cushion aggregate competitiveness to some extent. But competitiveness, especially for non-oil related tradable sectors, remains a concern. The External Balance Assessment suggests that Norway's external position in 2017 is weaker than implied by medium-term fundamentals and desired policies (Annex V).

External Balance Assessment (EBA) Methodologies[1] - 2017

Methodology	CA gap *(Percent of GDP)*	REER gap *(Percent)*
EBA CA Analysis[2]	-5.9	17.0
EBA REER (Index) Analysis	--	4.7
EBA REER (Level) Analysis	--	-20.1
EBA External Sustainability Approach	-1.0	3.0
Staff's assessment[3]	-3 to -4	10 to 15

Source: Fund staff calculations.

1/ CA gaps: minus indicates overvaluation. REER gaps: minus indicates undervaluation. Estimates based on data available in April 2018.

2/ Since the analysis was carried out, Statistics Norway revised the actual 2017 current account surplus from 5.1 to 5.5 percent of GDP. This would likely lower the current account gap.

3/ Includes staff adjustment for Norway specific features not included in EBA framework.

- **High non-oil fiscal deficits and aging.** The fiscal rule ensured that most of the oil windfall since the mid-1990s was saved. Given high global asset prices, the sovereign wealth fund has grown large (at 303 percent of mainland GDP as of end-2017). Spending its projected 3 percent real return, as envisaged under the fiscal rule, now amounts to a non-oil fiscal deficit of close to 8 percent of mainland GDP. In contrast, non-oil deficits amounted to less than 2 percent of mainland GDP in the early 2000s. Staff analysis shows that, without adjustment in response to aging pressures, these deficits will gradually erode and eventually deplete the country's large public savings.

- **Financial stability.** More immediately, vulnerabilities remain in the financial system, with a sizable household debt burden and high real estate valuations.

4. The center-right coalition of Prime Minister Solberg, in power since 2013, was reelected in September 2017. The coalition has made it a priority for Norway to remain a dynamic economy outside of oil, but it now has minority status in parliament and this could limit the scope for difficult reforms.

[3] Cabezon, E. and C. Henn (2018), "Wages and Competitiveness in Norway," IMF Selected Issues Paper.

RECENT DEVELOPMENTS

5. The economic upturn is gaining momentum (Figure 1). Following the 2015–16 downturn, there was a solid upward trend in the growth of mainland GDP (i.e. non-oil and gas output) throughout 2017 and early 2018. Annual growth reached 1.9 percent in 2017 and 2.6 percent in 2018:Q1, driven by stronger private consumption, business investment and exports, while housing investment growth slowed from its 2016 peak. Also, there has been less drag from reduced oil investment. The upturn was supported by improved competitiveness following the krone depreciation of 2013–15, as well as accommodative monetary and fiscal policies (a cumulative fiscal impulse of about 2.5 percent of mainland potential GDP since 2014).

Norway: Selected Economic Indicators

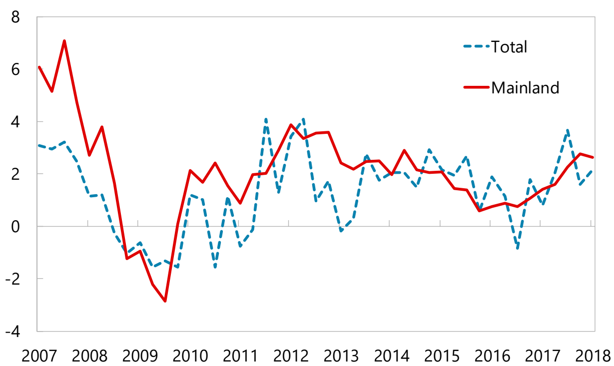
(Y/Y percent change, unless noted)

		Projections	
	2017	**2018**	**2019**
Real GDP	1.9	2.1	2.1
Real mainland GDP	1.9	2.5	2.4
Domestic demand	2.5	2.3	2.2
Mainland exports	2.1	3.5	4.0
Unemployment rate (percent of labor force, LFS)	4.2	3.8	3.7
Output gap (percent of potential GDP)	-0.6	-0.2	0.2
CPI inflation (average, percent)	1.9	1.9	2.0

Sources: IMF World Economic Outlook, Statistics Norway, and Fund staff

GDP Growth

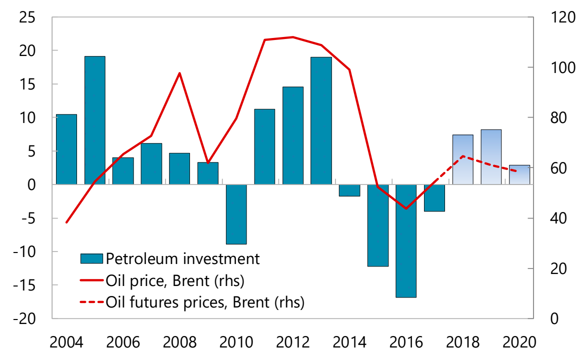
(Y/Y percent change, SA)



Sources: Statistics Norway and Fund staff calculations.

Oil Price and Oil Investment, Historical and Projection

(Y/Y growth rate, percent)

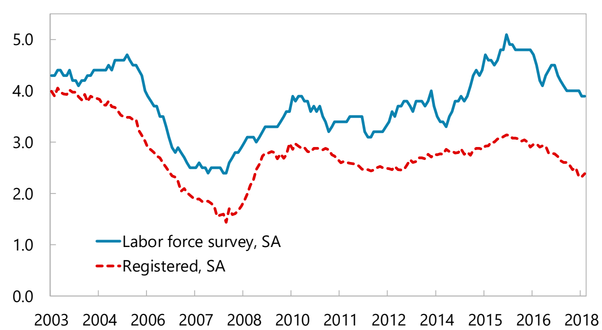


Sources: Norges Bank and Fund staff calculations.

6. The labor market is strengthening (Figure 2). The seasonally-adjusted Labor Force Survey unemployment rate has trended down from its mid-2016 peak of around 5 percent to 3.9 percent in March 2018.[4] Job vacancies are also increasing rapidly. Wage growth remained moderate in 2017 at 2.3 percent, broadly unchanged from its 2015–16 average, but recent wage agreements suggest an acceleration to just below 3 percent this year.

Unemployment Rate

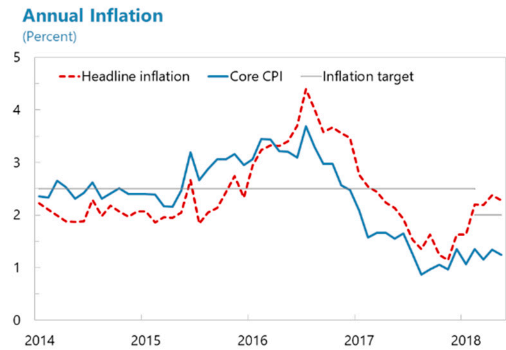
(Percent of labor force)



Sources: Labor and Welfare Administration, Statistics Norway, and Fund staff calculations.

[4] Registered-based statistics show a faster decline in unemployment, possibly due to an increase in wage earners on temporary contracts (Norges Bank Monetary Policy Report, March 2018).

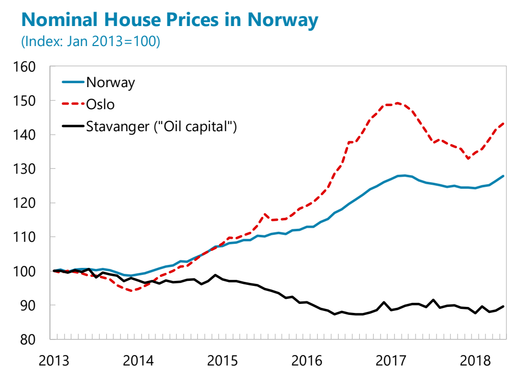
7. Headline inflation is edging up, though core inflation remains subdued (Figure 3). Headline inflation has risen since November 2017 and is now slightly above the 2 percent revised inflation target (¶23), largely on account of higher energy prices and changes in indirect taxes.[5] However, core inflation has continued to hover around 1¼ percent. Domestic producer inflation has also remained weak owing to moderate wage growth in the most recent years. Inflation expectations had been well anchored around the previous 2.5 percent inflation target; no survey has been conducted since the target was lowered.



Sources: Statistics Norway and Fund staff calculations.

8. Norway's external position has improved somewhat (Figure 4). Owing to the oil price plunge, the current account surplus fell sharply from 13 to 4½ percent of mainland GDP between 2014 and 2016. It recovered to 6½ percent of mainland GDP in 2017 on the back of higher oil prices. Non-oil exports have remained stagnant despite the large real depreciation, partly due to subdued demand in the oil service industry given low global oil investment.[6]

9. A temporary correction in house prices appears to have ended. After rapid house price inflation since early 2015, national house prices fell by about 5 percent in nominal terms in the second half of 2017. However, the correction is now over: in Oslo prices rebounded by 7.5 percent on a seasonally-adjusted basis during the first five months of 2018.



Sources: Real Estate Norway and Fund Staff calculations.

10. Traction of Fund advice remains good (Annexes VIII and IX). Most Fund recommendations have been implemented from the 2017 and earlier Article IV consultations, and from the 2015 Financial System Stability Assessment (FSSA). Notably, since the last Article IV consultation, an important reform to public-sector pensions has been agreed, incapacity benefits have been further reformed, the mortgage regulations have been extended, and liquidity coverage ratios for banks' exposures in foreign currencies have been introduced.

[5] The reduced VAT rate was increased from 10 to 12 percent effective January 2018.

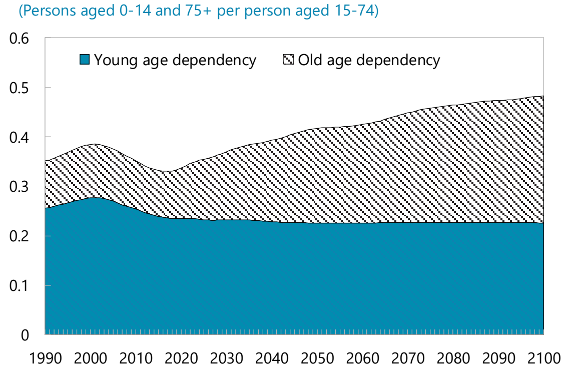
[6] The oil services industry, which also comprises parts of the manufacturing sector, accounts for close to one third of mainland Norway's exports.

OUTLOOK AND RISKS

11. The mainland economy is expected to grow above potential in the near-term. Following the strong rebound in 2017, the economy is gathering steam. Mainland growth is projected to increase to around 2½ percent this year and next, underpinned by solid consumption, stronger business investment and an export recovery. Petroleum investment will also start rising on the back of higher oil prices. As a result, staff expect the output gap to turn positive in 2019. Solid global demand should support the growth momentum, but the upswing would be moderated by the planned normalization of monetary policy. The unemployment rate is expected to diminish further.

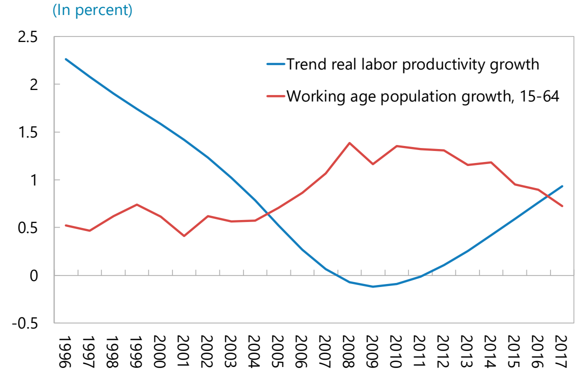
12. Medium-term growth hinges on rebalancing to a less oil-dependent growth model. To support medium-term output growth, it is important to boost productivity growth in the non-oil sector and underpin labor participation to stem three adverse trends. First, labor productivity growth in Norway has been slow since the global financial crisis, as in other advanced economies.[7] Second, after positive aging trends during the past two decades, the demographic profile is now deteriorating. Third, the projected contribution from oil to output growth is declining. On the upside, the tax system has become more growth-friendly, and the pension reform will enhance incentives for labor supply (see below). All in all, staff project potential mainland growth to be around 2 percent over the medium term, below the 2½ percent average of the last 20 years.

Dependency Ratio
(Persons aged 0-14 and 75+ per person aged 15-74)



Sources: Statistics Norway and Fund Staff calculations.

Underlying Drivers of Potential Growth
(In percent)



Sources: Eurostat and IMF staff calculations.

13. Risks to the outlook are broadly balanced (Annex VI). Domestically, the most prominent downside risks are related to household debt and housing. With over 90 percent of mortgages being variable rate, highly-leveraged households and consumption are vulnerable should financial conditions tighten abruptly. Relatedly, an abrupt decline of house prices could curb private consumption and create negative spillovers to banks' balance sheets, especially if an economic downturn ensued. Growing trade protectionism could also dampen exports and growth in this highly

[7] The recent recovery in labor productivity largely reflects a rebound from the sharp decline during the GFC, but productivity growth remains well below pre-crisis levels. Labor productivity growth in many other advanced economies also shows a similar U-shape.

open economy. On the upside, the economic upswing may prove stronger than expected, not least because oil prices could surpass projections.

Authorities' Views

14. The authorities shared staff views on the macroeconomic outlook and risks. They also forecast mainland growth to pick up to about 2½ percent this year and next, and see the output gap closing in late 2018 or the first half of 2019. They view risks as broadly balanced with high household debt as the key vulnerability. Their assessment of medium-term potential growth is around 2 percent (mainland economy) weighed down by aging and labor productivity.

POLICY DISCUSSIONS

Given favorable economic conditions, expansionary fiscal and monetary policies should be gradually phased out. The upcycle would constitute a good opportunity for fiscal savings. In addition, policy priorities should focus on containing risks related to high household debt and safeguarding competitiveness in the non-oil sector.

A. Fiscal Policy

15. With the output gap closing, the fiscal stance has appropriately converged to neutral. Last year's fiscal outturn implied a 0.2 percent fiscal impulse, with the structural non-oil deficit increasing to 7.5 percent of mainland trend GDP. The 2018 budget set a broadly neutral stance and focused on boosting long-term growth potential. The key measures aim at scaling back and shifting the tax burden from direct to indirect taxes,[8] improving public sector efficiency, enhancing infrastructure, and promoting innovation. More recently, the supplementary 2018 budget approved by parliament commendably saves some 1¼ percent of GDP in additional oil revenues relative to the original budget, so as to preserve the neutral stance. The projected deficit under the supplementary budget represents 2.7 percent of the GPFG's value, slightly below the long-term fiscal guideline of 3 percent (Annex III).

16. Next year would be the right time to start withdrawing some of the stimulus provided during the downturn. With staff projecting the output gap to turn slightly positive in 2019, a structural consolidation of ¼–½ percent of mainland GDP would seem appropriate. In terms of composition, a continued broadening of the VAT base and a reduction of tax incentives for home ownership and leverage would be welcome. Beyond realizing efficiency gains, this could also create space for enhancing R&D tax incentives and for reducing labor tax wedges.

17. More generally, the current fiscal rule may be too loose from a competitiveness perspective. Favorable financial market developments have caused the balance of the sovereign

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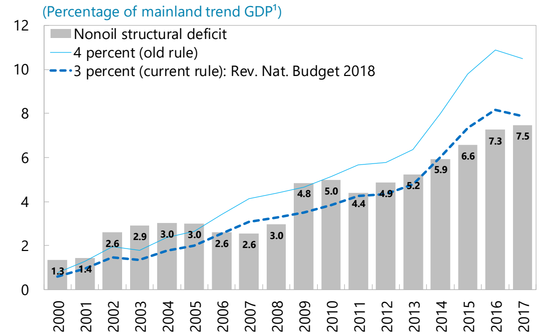
[8] The 2016–18 tax reform tilted taxation away from income and labor to taxes on goods. For 2018, tax changes include the reduction of corporate and personal ordinary income tax rates from 24 to 23 percent, as well as a more progressive personal income tax as thresholds and allowances are increased. In addition, a hike in the reduced rate of the VAT from 10 to 12 percent and increases in environmental taxes are being phased in.

wealth fund to persistently outpace projections for the last 15 years.[9] With the fiscal rule tied to the fund's value, this has meant a steady increase in non-oil fiscal deficits, including during periods of positive output gaps, to a current 8 percent of mainland GDP. The steady expansion of government consumption has most likely added pressure on the real exchange rate, above and beyond the appreciation stemming from terms of trade gains over the past 20 years. Over the same period, public sector wages have failed to act as a counterweight to the rapid expansion in private sector wages; on the contrary, they also grew rapidly.

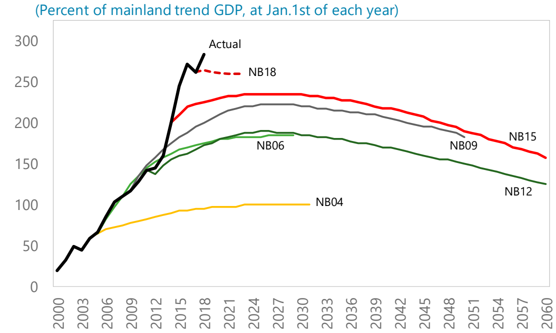
Norway: Secular Fiscal Trends

Central Government: Structural Balance
(Percentage of mainland trend GDP[1])



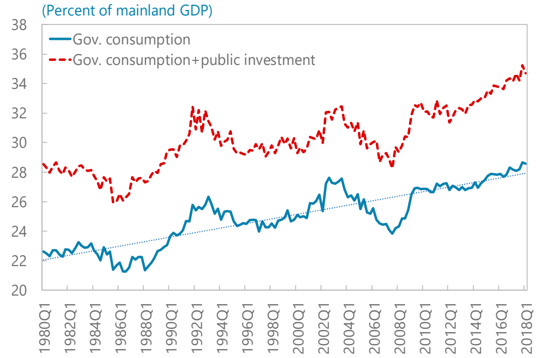
1/ MOF estimate of mainland trend GDP.
Sources: Norwegian Ministry of Finance and Fund Staff estimates.

Historical Forecasts for the GPFG Asset Stock
(Percent of mainland trend GDP, at Jan.1st of each year)



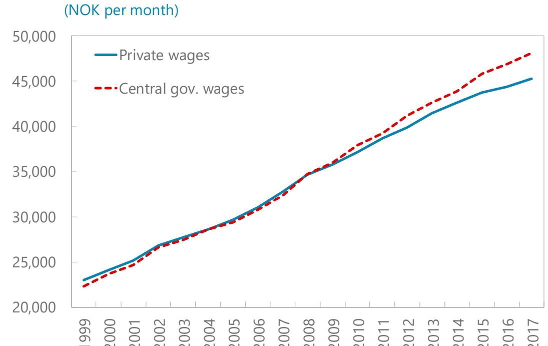
Note: NB denotes National Budget.
Sources: Norwegian Ministry of Finance and IMF staff estimates.

Government Footprint on the Economy
(Percent of mainland GDP)



Sources: Statistics Norway; and IMF staff estimates.

Norway: Average Wages
(NOK per month)



Sources: Statistics Norway; and IMF staff estimates.

18. **In addition, high non-oil deficits would—in the absence of adjustment—eventually erode even Norway's large savings** (Selected Issues Paper).[10] Staff analysis of an intertemporal public sector balance sheet for Norway shows that the public sector has a static net worth of

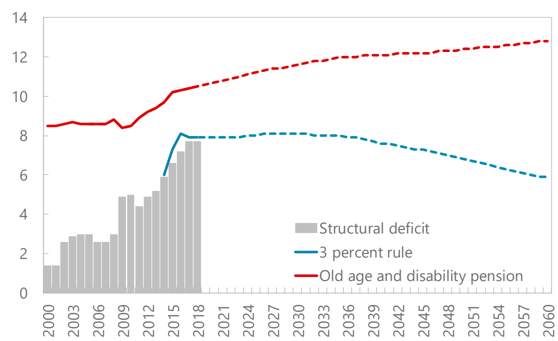
[9] Forecast errors due to an underestimation of oil production have been minor in comparison.

[10] Cabezon, E. and C. Henn (2018), "Norway's Public Sector Balance Sheet and Fiscal Implications," IMF Selected Issues Paper.

340 percent of mainland GDP, undoubtedly one of the strongest such positions in the world.[11] But the current high non-oil deficits, gradually declining oil revenues, and increasing aging pressures will weigh on public finances—health care and pension expenditures are expected to grow by about 1 percent of mainland GDP every decade. In the absence of adjustment to contain the resulting increase in deficits, Norway's *intertemporal* financial net worth (IFNW)—its current assets minus both its current liabilities and the net present value of its future deficits—would be *minus* 240 percent of mainland GDP. The comparison with a peer like Finland is stark: Finland has much weaker static net savings, but its significantly lower starting deficits result in a stronger intertemporal position. For Norway, ensuring intertemporal solvency would require a permanent, cumulative fiscal adjustment of about 4–5 percent of mainland GDP in the future. While Norway can afford to extend the adjustment over a long period to minimize its impact, delaying its start would only add to the final cost by running larger deficits for a longer period.

Structural Deficit and Pensions Expenditures

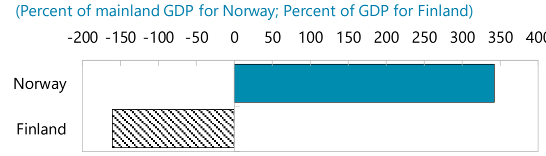
(Percent of mainland GDP)



Source: Ministry of Finance.

Static Net Worth, 2017

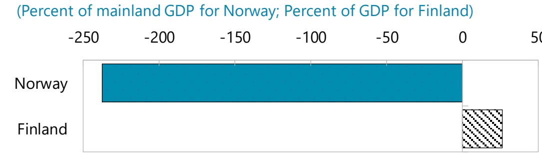
(Percent of mainland GDP for Norway; Percent of GDP for Finland)



Sources: Norwegian Authorities, IMF Staff calculations and estimations, Brede and Henn (2018).

Intertemporal Financial Net Worth, 2017

(Percent of mainland GDP for Norway; Percent of GDP for Finland)



Sources: Norwegian Authorities, IMF Staff calculations and estimations, Brede and Henn (2018).

19. Given the above considerations, the government should use the flexibility embedded in the fiscal rule to stay below the 3 percent line for the foreseeable future. The ongoing up-cycle provides an ideal setting to get started on structural consolidation. Allowing the deficit to drift upward towards the "allowed" 3 percent line would stimulate the economy when it is not needed and increase the long-term adjustment need. It would also minimize space to respond to negative asset price shocks that could affect the value of the sovereign wealth fund and further increase pressure on the real exchange rate and hence competitiveness. The fact that the structural non-oil deficit is still below the long-term guideline of 3 percent of the sovereign wealth fund despite several years of expansionary fiscal policy gives Norway a good starting point to address the challenges going forward.

20. Recent agreement on public sector occupational pension reform is important, including for long-term fiscal sustainability (Annex IV). The reform, agreed between the government and unions in the first half of 2018, aligns the public with the private occupational

[11] The static net worth represents the public sector current assets minus current liabilities, including pension liabilities for work already performed. The intertemporal financial net worth adds to it by accounting for the present value of all future primary balances, thereby representing an intertemporal budget constraint.

pension scheme. The reform, once put into law, will be phased in by 2020 and is expected to foster labor mobility between the private and public sectors, but also support labor participation among older public sector employees—an effect already observed among private employees, whose occupational pensions were reformed in 2011.

21. There appears to be potential, in various public spending areas, for the authorities to extract more value for money (Figure 5). The authorities are in the initial stages of designing systematic public expenditure reviews. The first spending reviews have been undertaken during the last two years, but these have been modest in scale. Going forward it will be important to widen their scope and to forge political agreement to realize and bank the identified savings, instead of reallocating spending to more efficient initiatives.

Authorities' Views

22. The authorities agreed on the amount of fiscal savings required in the long term, but pointed to difficulties in budget consolidation at this point in the cycle. They agree that the economy is no longer in need of fiscal stimulus, and have therefore adjusted fiscal policy towards a neutral stance in the latest budgets. Further consolidation will be made in light of developments in the output gap. They acknowledge and exploit the embedded flexibility in the fiscal rule to stay below the 3 percent benchmark, not least to provide a buffer against potential asset price fluctuations given the size of the GPFG. Regarding long-term trends, they have made efforts to educate the public that return on Norway's large savings will not continue expanding forever, and that sticking to the 3 percent rule will require consolidation in the future. They expect to minimize the needed consolidation and improve growth by expanding labor participation (on which they see room for improvement despite Norway still ranking very favorably by international standards), and by improving value for money in the public sector through more systematic public expenditure reviews.

B. Monetary and Financial Sector Policies

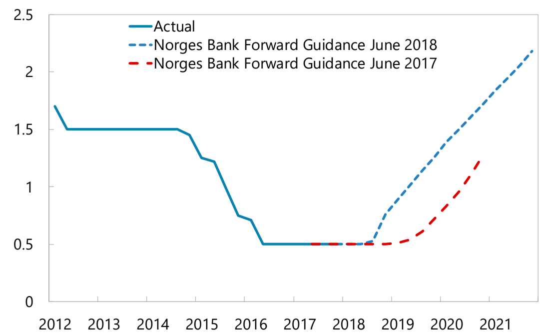
23. A new monetary policy framework was adopted by the government in March. It formalizes Norges Bank's established practice of flexible inflation targeting whereby, in addition to achieving the inflation target, monetary policy should also contribute to high and stable employment and output and counteract the buildup of financial imbalances. In addition, the inflation target was lowered from 2.5 to 2 percent.[12] In the view of staff the changes are expected to have a marginal impact on monetary policy conduct; in practice, inflation has oscillated around 2 percent since the early 2000s. Work remains ongoing on a new Central Bank Act. It could move

[12] The original motivation for a higher target, set in 2001, than in trading partners had been the phasing-in of oil revenues (which would drive up prices), but this phasing-in has now been largely concluded.

management of the GPFG from a unit inside Norges Bank to a separate entity, but it would remain sheltered from political influence under all proposals under consideration.[13]

24. The inflation outlook warrants a gradual phasing in of tighter monetary policy. Norges Bank's forward guidance projects a hike in the policy rate from its current level of 0.5 percent by late this year, and further increases to 2¼ by end 2021. The tightening stance is appropriate: with economic slack diminishing and the recent wage negotiations pointing to an acceleration in income growth, core inflation should gradually rise towards headline inflation, which already stands at the newly revised 2 percent target. Should any risks materialize and bring the baseline forecast into question, Norway's inflation targeting framework provides the needed flexibility to adjust guidance.

Key Monetary Policy Rate
(Percent)



Source: Norges Bank.

25. Banks' balance sheets are strong (Figure 7). Profits have been solid compared with institutions in peer countries, loan losses are low, and banks comfortably meet higher capital requirements in effect from 2018: their average CET1 capital ratio is high (16.8 percent of risk-weighted assets at end-2017).[14] In addition, strong Pillar II requirements are levied especially on banks with concentrated exposures in commercial real estate and consumer lending (¶28). Banks' average leverage ratio stood at 8 percent at end-2017, with all institutions exceeding the 5 percent requirement. Finally, liquid reserves exceed the liquidity coverage ratio (LCR) and prospective net stable funding ratio (NSFR) requirements by ample margins. The forthcoming headquarters move of Nordea from Sweden to Finland this October is not expected to affect Nordea's Norwegian operations.

26. However, vulnerabilities remain in the financial system:

- **Overvalued housing prices and highly-indebted households** (Figures 8 and 9). Despite the 2017 correction, staff analysis shows that house prices are still overvalued, particularly in the Oslo region (Annex II and Selected Issues Paper).[15] Household debt, at 224 percent of disposable income, remains among the highest in OECD countries and is still gradually rising. Despite low interest rates, the debt service-to-income ratio is close to its pre-crisis peak of the late 1980s. With most debt being in the form of variable-rate mortgages, households are exposed to an

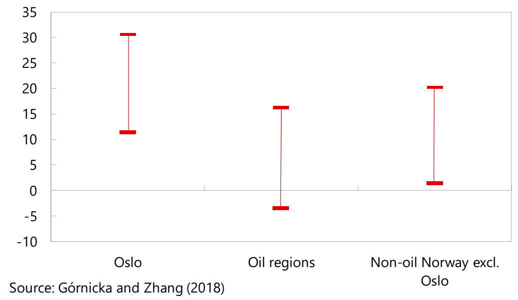
[13] The main benefits of moving management of the GPFG outside of Norges Bank would be operational, chiefly to reduce demands on Norges Bank's senior management.

[14] A higher countercyclical buffer requirement of 2 percent (1.5 percent before) became effective at the start of 2018.

[15] For regional house prices, see: Górnicka, L. and Y. Zhang (2018), "House Prices and Labor Mobility in Norway: A Regional Perspective," IMF Selected Issues Paper. For national house prices, see: Geng, N. (2017), "Are House Prices Overvalued in Norway," Selected Issues, IMF Country Report 17/182.

abrupt tightening in financing conditions (Figure 10).[16] Beyond the macroeconomic risks, implications for bank solvency are relatively limited. Bank stress tests by the FSAP mission in 2015, by the Norges Bank, and by the FSA suggest that banks' high capital buffers render them well positioned to withstand even severe shocks.

Estimated House Price Overvaluation by Region, 2017
(In percent; range implied by staff analysis[1])

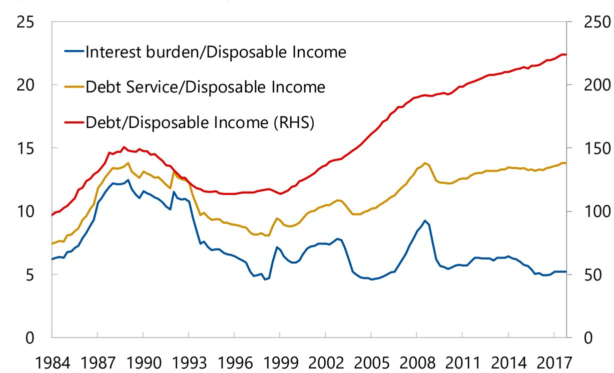


Source: Górnicka and Zhang (2018)
1/ Staff attribute greater weight to the lower end of each range for reasons detailed in Górnicka and Zhang (2018).

- **Commercial real estate (CRE) valuations.** In level terms, CRE prices are in the upper end of peer countries/cities but do not yet stand out. Nevertheless, they continue to increase rapidly, rising by about 10 percent annually in real terms (Figure 11). CRE exposures now amount to 15 percent of total bank assets, with branches of foreign banks more exposed (Figure 12). However, a sizable part of these relate to property management companies, which would be only gradually affected by shocks given an average initial lease duration of seven years. While construction and property development companies would be more exposed to declines in CRE prices, risks are somewhat mitigated by more than half of any property generally being leased before construction commences.

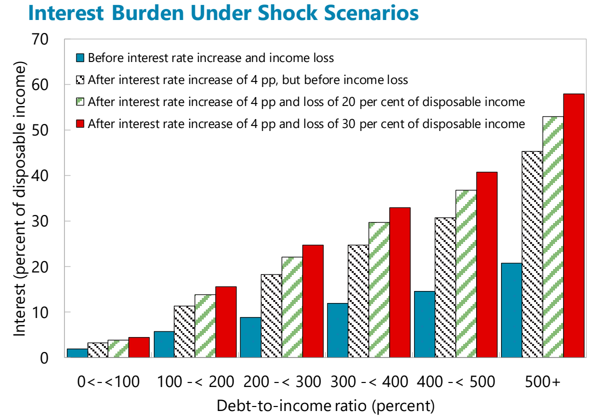
- **Banks' reliance on external wholesale funding is a long-standing vulnerability.** About half of banks' funding still comes from the market, and more than half thereof from foreign sources. While reliance on wholesale funding has slightly decreased in recent years and maturities have lengthened, covered bond issuance has increased. A housing crisis could thereby hamper banks' access to wholesale financing, if deterioration of collateral quality hinders further covered bond issuance. Also, large cross-holdings of covered bonds within the domestic banking system pose contagion risks.

Household Debt and Debt Service
(Percent, 1983 Q1 - 2017 Q4)



Sources: Statistics Norway and Norges Bank.

Interest Burden Under Shock Scenarios

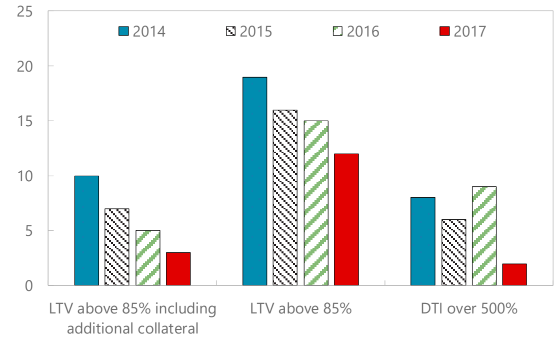


Sources: Statistics Norway and Finanstilsynet.

[16] More than 90 percent of mortgages in Norway are variable rate. Recent Norges Bank studies suggests that private consumption could fall by 0.4 percent for every 1 percentage point increase in mortgage rates.

27. The authorities have actively deployed prudential policies to contain financial vulnerabilities. In June, the Ministry of Finance extended until end-2019 the mortgage regulations that were due to expire in mid-2018.[17] This was appropriate, as these regulations have clearly reduced the incidence of risky mortgages. Actions on unsecured consumer lending (Figure 6)—where default risks may be most immediate in a downturn—include tighter capital and consumer protection requirements and introduction of risk-based contributions to the deposit insurance and bank resolution funds (starting 2019).[18] The authorities have responded to the risks related to CRE with intensified oversight and Pillar II capital add-ons for banks with concentrated exposures. New rules requiring provisioning for prospective loan losses are being phased in, in line with international standards. Legislation corresponding to the EU's BRRD has been adopted and will become effective in January 2019.[19] Finally, the licensing process to establish credit registries is underway and there has also been continued progress on implementing FSAP recommendations.

Share of New Mortgage Loans with Risky Loan Terms
(Percent)



Source: The Norwegian FSA.

28. The authorities should stand ready to tighten prudential policies further if risks intensify. This includes the parameters underpinning the mortgage regulations, but also Pillar II add-ons for CRE. More generally, the mortgage regulations should be made a permanent part of the prudential toolkit—parameters would then be adjusted up or down as the financial cycle requires. In addition, although measures like the 500 percent DTI limit are much more binding in Oslo than elsewhere in Norway, expanding the regional differentiation of measures should be considered if house price overvaluation diverges further across regions. To more durably address housing risks, action is also needed to reduce still-generous tax preferences for housing,[20] and to further relax constraints on new property construction to underpin the supply of housing (¶34).

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[17] The regulations, initially effective from beginning of 2017, include a DTI limit of five times the borrower's gross annual income, tightened conditions for applying an amortization requirement, and lowered the LTV limit for secondary homes in Oslo to 60 percent. The permitted share of mortgages that may violate any of these criteria ("speed limit") is 8 percent for Oslo and 10 percent outside of Oslo. The June 2018 extension left these regulations virtually unchanged.

[18] For instance, Pillar II capital requirements have been set in the 4 and 5.5 percent range for banks specialized in consumer credit, well above those for other banks (1.5–2 percent). Also, an interest rate cap on consumer loans is under consideration in parliament, mainly for purposes of consumer protection.

[19] This new legislation designates the FSA as the resolution authority and gives it most resolution authority powers. However, the Ministry of Finance retains the last say in the most important decisions, including decisions on whether a bank meets the conditions for resolution. The new legislation stipulates that the existing capital in the large Norwegian Banks' Guarantee Fund, shall be transferred to two new funds: a deposit guarantee fund and a resolution fund.

[20] Zhang, Y. (2017), "Closer to Best Practice —Tax Reform in Norway," Selected Issues, IMF Country Report 17/182.

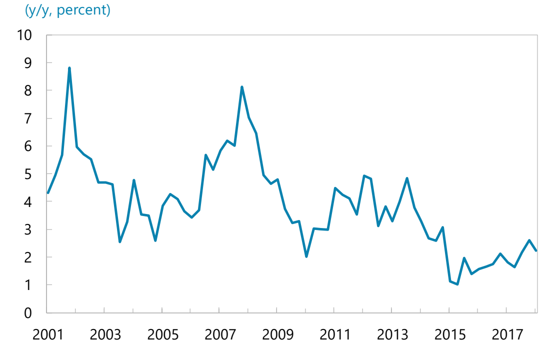
Authorities' Views

29. The authorities agreed with staff on financial stability risks, but cautioned against overreach with prudential regulations. They agreed that economic developments call for a gradual unwinding of monetary policy stimulus and that this also could help calm concerns about financial imbalances in the household sector. They also agreed that the mortgage regulations had been effective, resulting in tighter lending practices and lower issuance of high-risk mortgages. At the same time, their usefulness and design should be reassessed regularly in the context of household credit and housing market developments. The authorities also emphasized that these regulations should be used as warranted by financial stability considerations, and be balanced against banks' room for exercising their core competence of assessing credit risks. In this context, further regional differentiation of measures should be assessed against risks of micromanaging the market. There was agreement that banks' shock absorption capacity was high, given their solid capital and liquidity positions. There are presently no plans to further reduce the tax deductibility of mortgage interest. Nevertheless, the authorities noted that its effective value has shrunk with the lowering of the ordinary income tax rate over the past years. The authorities moreover pointed out that changes in the net wealth tax in 2014–18 and the recent increase in the number of municipalities collecting property taxes have also contributed to lowering the tax bias in favor of housing investment.

C. Structural Policies

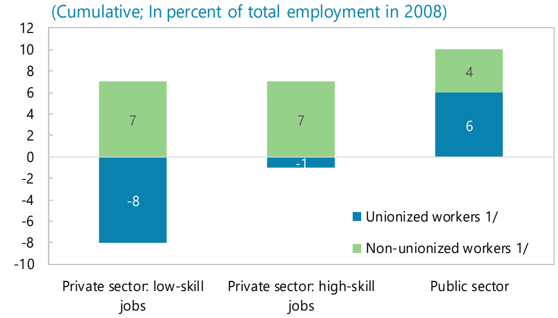
30. The wage growth seen in the last 15 years might not be sustainable going forward without compromising Norway's competitiveness (Annex I and Selected Issues Paper).[21] Over the last two decades, Norway experienced wage growth that exceeded productivity growth in most sectors, as well as wage growth in trading partners. This transpired without a disproportionate loss of competitiveness thanks to terms of trade gains, which were shared broadly across society via the wage bargaining system. Even then, some tradeable sectors that did not benefit from positive terms of trade shocks have struggled to adjust, as seen by these sectors' declining shares of value added. These tradable sectors will gain in importance as the role of oil diminishes. Moreover, high prevailing wages are leading to the emergence of a dual labor market in non-tradeable sectors, with an increasing share of workers not covered by collective agreements.

Wage Growth
(y/y, percent)



Sources: Statistics Norway and IMF staff calculations.

Employment Growth between 2008-2014
(Cumulative; In percent of total employment in 2008)



Source: The Norwegian Confederation of Trade Unions.
1/ Due to data constraints, unionized and non-unionized workers had to be proxied by the native and immigrant labor force, respectively.

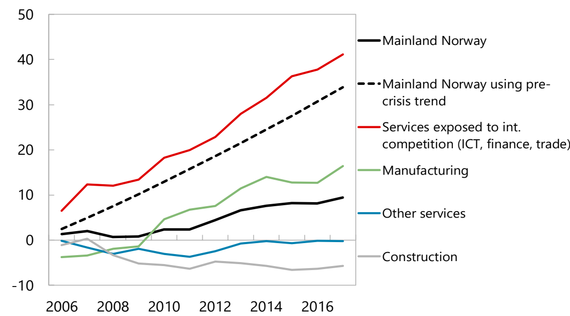
[21] Cabezon, E. and C. Henn (2018), "Wages and Competitiveness in Norway," IMF Selected Issues Paper.

The impact of such developments on the high level of trust underpinning Norway's collective bargaining system remains to be seen.

31. Going forward, society may need to downwardly adjust its expectations of future wage increases. Gains comparable to those in the past would not be sustainable unless Norway is again fortunate on its terms of trade. Even then, wage moderation as achieved by social partners during the recent downturn should be carried forward, as it would help build resilience in case of less positive trends in international prices and facilitate the gradual transition out of oil. The government, nominally a follower in the wage bargaining system, will have a key role to play in moderating society's expectations.

32. Ongoing reforms to boost productivity should continue. Productivity growth has fallen considerably since the mid-2000s, especially among the non-oil sectors less exposed to international trade and competition. The authorities are working to implement reform proposals highlighted in the Productivity Commission report to promote innovation, improve labor skills, and expand product market reforms.[22] Some reforms are already underway, mainly in the areas of improving the effectiveness of tax incentives for R&D and innovation and boosting the quality of vocational and higher education. The latter measures are important to better integrate the young, immigrants and refugees into the labor market. The authorities should continue to prioritize and implement the proposed reforms to generate further productivity gains.

Gross Value Added Per Hour Worked in Selected Sectors
(Cumulative Change Since 2005)

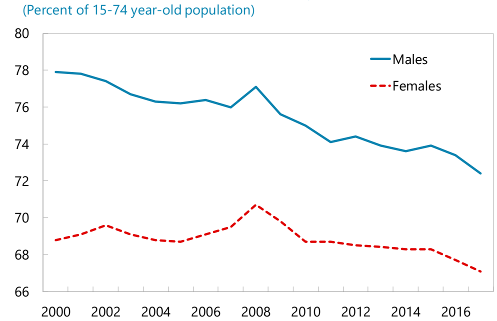


Sources: Statistics Norway, IMF staff calculations.

33. More can be done to sustain high labor participation amid growing demographic pressures and technological change. While Norway's labor participation rate remains among the highest in the OECD, participation has been falling since 2008, especially among prime-age cohorts and men, and challenges remain to integrate some under-represented groups into the labor force. More specifically:

- **Sickness and disability.** Effective in January 2018, the maximum duration of extended sickness leave ("Work Assessment Allowance") has been shortened and requirements for its extension tightened. But sickness and disability schemes require further and substantial reforms. While

Labor Force Participation Rates by Gender
(Percent of 15-74 year-old population)



Source: Statistics Norway.

[22] Productivity Commission (2015), "Productivity – Underpinning Growth and Welfare," *Official Norwegian Reports*, NOU: 2015:1.

disabled individuals in Norway are more likely to be employed than those in other countries, the country has one of the highest disability rates among its peers (Figure 2). Tightening the benefits eligibility criteria and increasing the grading scale of disability,[23] while creating more incentives to work for the disabled, could help bring more people back into labor market. Similarly, reforming sick leave benefits to incentivize employers to bring employees back to work earlier—for example through more equal sharing of long-term sick leave costs with the state—should be considered. Upcoming opportunities to forge consensus on such reforms should be used.[24]

- **Female participation.** Notwithstanding the substantial achievements so far in integrating women into the labor force, more could be done to expand working hours among women, for example by making child care even more flexible.[25]

- **Labor market flexibility.** Higher flexibility in temporary work contracts and wages might be needed to prevent some people from being permanently excluded from the labor market, though tradeoffs that such flexibility could pose to Norway's social model will need to be considered.

34. Regional housing policies could better benefit internal labor mobility. Job-to-job flows in Norway are high by international standards, suggesting a dynamic labor market. However, there is some evidence of growing net outflows of prime-age cohorts from big cities, where housing affordability has deteriorated in recent years. Studies in other countries suggest that rising house prices represent a barrier to interregional migration of low-skilled workers, and to regional income and productivity convergence.[26] Norway's construction and urban planning regulations are perceived as quite strict, especially in the Oslo area. The authorities have taken several efficiency measures aimed at lowering construction costs and time,[27] and the supply of new housing in Oslo is now increasing considerably after lagging population growth for several years. However, more active use of region-specific housing policies, including relaxing local regulations where they are excessively stringent, and further lowering preferential tax treatment of housing should be also considered.

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[23] Roughly 80 percent of all disabled receive a full 100 percent disability grade, which disqualifies them for undertaking any work.

[24] The upcoming expiration of an agreement on working conditions between government and social partners, last reviewed in the early 2000s, is an opportunity. So is the Employment Committee, which has been tasked with examining the impact of current social security schemes on employment rates.

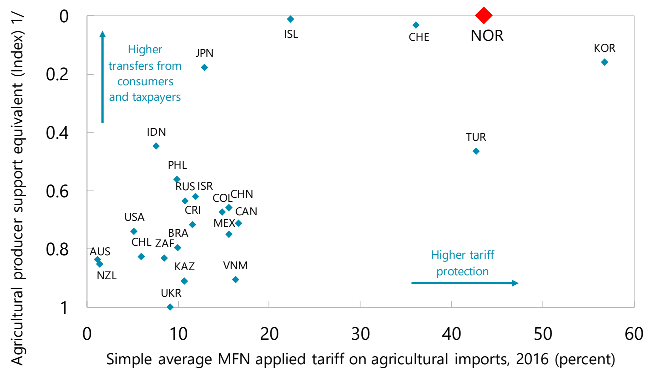
[25] Henn, C. (2017), "Gender at the Frontier: Policies to Underpin High-Quality Labor Supply in Norway," Selected Issues, IMF Country Report 17/182.

[26] Hsieh, C. and E. Moretti (2017) "Housing Constraints and Spatial Misallocation," NBER Working Paper 21154; Ganong P. and D. Shoag (2015), "Why Has Regional Income Convergence in the U.S. Declined?", Journal of Urban Economics vol.102, p. 76–90.

[27] For example, the construction permit application process has been simplified. In July 2017, the government has further tightened deadlines for public authorities to approve applications. In January 2018, a digital platform for submission and approval of construction applications was launched.

35. Reducing the level of agricultural protection would enable more efficient resource allocation. Agricultural reforms have progressed, for example, with the parliamentary vote to phase out export subsidies for agricultural products by 2020, and to free up price setting. However, action is needed to reduce high agricultural domestic subsidies and tariffs. Beyond increasing efficiency, this would benefit low-income groups through lower food prices.

Agricultural Protection



Sources: OECD and WTO World Trade Profiles 2017.
1/ Comprises market price support, budgetary payments and the cost of revenue foregone. Indexed from 0 to 1 with lower numbers denoting higher support.

Stakeholders' Views

36. The authorities agreed that competitiveness should be reinforced further, building on recent achievements. However, they emphasized that the consequences of wage growth in excess of productivity growth or of wage growth in trading partners should not be overstated, given Norway's terms of trade gains leading up to 2014. In addition, they noted that the declining shares of some non-tradeable sectors could simply reflect an optimal reallocation of resources towards more productive areas. The authorities also pointed at the important role the floating exchange rate had played in adjusting relative prices and improving competitiveness after the oil price drop in 2014. Nevertheless, they agreed that the country's high cost levels leave it vulnerable to a reversal in the terms of trade, and that wage moderation might thus be necessary going forward. In this context, they were encouraged by developments in 2014–17, during which social partners showed they could deliver wage discipline when needed, following a re-commitment in 2013 among the social partners to let wage growth primarily be determined by non-oil manufacturing. The authorities view high employment rates and productivity as essential for underpinning Norway's social model. As a result, they plan to continue to implement the proposals of the Productivity Commission—with a view to enhancing work incentives. Regarding housing supply, the authorities noted that various efficiency measures introduced since 2015 to ease housing construction had seemingly borne fruit in reducing growth in construction costs.

37. Labor unions emphasized the threats posed by the dual labor market to Norway's social model. Union representatives agreed that maintaining competitiveness was important. Nevertheless, they expressed concern about the increasingly dual nature of the labor market: rising shares of workers are not covered by collective agreements and receive considerably lower wages. This is especially the case in sectors such as services, industry, and construction that are exposed internationally through labor migration. Unions called for an increased focus on vocational training and lifelong learning, to avoid workers becoming permanently excluded from the labor market.

38. The Confederation of Norwegian Enterprises agreed on the need for wage moderation going forward. While rapid income growth in the past 20 years was made possible by strong terms of trade gains, such gains are unlikely to be repeated. This being said, employers were confident that social partners will be able to deliver restraint when needed, as was the case during 2014–17 when wage growth was kept in line with that of trading partners in response to a downturn. Changes to the wage formation process introduced in 2014, which among other things give greater prominence to wage developments abroad, are a positive development.

STAFF APPRAISAL

39. The ongoing healthy recovery from the oil downturn is expected to continue. The mainland economy is expected to grow by 2½ percent this year and next, while core inflation would converge to 2 percent. Recent positive trends in oil prices and a strengthening labor market should help support momentum in both exports and domestic demand and could cause growth to exceed expectations. On the downside, high and rising debt—much of which is in the form of variable-rate mortgages—leaves households exposed to an abrupt tightening in financing conditions. These vulnerabilities could increase if this year's housing price rebound continues unabated, with house prices already overvalued in some regions. Rising global trade tensions are another concern for a small, highly open economy like Norway.

40. But despite the generally positive short-term picture, Norway also faces important challenges to sustaining its prosperity. With the contribution from the oil sector projected to wane, Norway will have to gradually transition to new growth sectors. In addition, non-oil fiscal deficits have risen steadily to high levels over the last 15 years, even though Norway has yet to feel the adverse impacts of aging on entitlement spending and potential growth.

41. Competitiveness should be underpinned further, including to facilitate rebalancing to a less oil and gas dependent growth model. Staff assesses the external position as weaker than implied by medium-term fundamentals and desired policies. Over the last two decades, Norway experienced wage increases that exceeded productivity growth in most sectors, and outpaced wage rises in trading partners as well. What made this possible without a large loss of competitiveness was that Norway benefitted from favorable terms of trade, not only in energy but in fisheries and metals as well. Tradable sectors not benefiting from higher sales prices have suffered, however, and certain non-tradable sectors have shifted hiring away from unionized workers. Going forward, rapid wage growth as in the past will only be possible if Norway is again fortunate on its terms of trade. Even then, the wage moderation achieved by social partners during the recent downturn should be carried forward: it will facilitate the needed transition away from oil and build resilience in case of adverse developments in international prices. Moreover, the authorities should continue reforms to support innovation and productivity growth. Finally, sustaining high labor participation is crucial to support Norway's social model, whereby the agreement on public sector occupational pension reform constitutes an important advance by lengthening working lives and fostering labor mobility. However, continued progress will be needed to enhance work incentives, including through more substantial reform of sickness and disability benefit schemes, and better integration of vulnerable groups into the labor market.

42. Fiscal policy should gradually reverse the trend increase in non-oil fiscal deficits seen over the last 15 years. This would help alleviate pressures on the real exchange rate and provide a head start on aging-related consolidation needs over the long term that are well recognized by the authorities. This year's budget appropriately targets a neutral stance, which is commendably being maintained in the face of windfall gains. Going forward, the authorities should continue to use the flexibility inherent in the fiscal rule to keep non-oil deficits below the rule's long-run benchmark level of 3 percent of sovereign wealth fund assets. This would also generate space to respond to negative asset price shocks that could affect the value of the sovereign wealth fund. Specifically, next year's budget should target a modest structural consolidation of ¼–½ percent of mainland GDP, given that output is likely to exceed potential in 2019. To address longer-term fiscal sustainability, a permanent 4–5 percent of GDP consolidation will be needed, though Norway has the luxury to extend the adjustment over a long period to minimize its impact. In this context, the authorities' efforts to realize more efficiency in public services provision are well taken; they should be scaled up in the future and resulting gains should be largely saved to pre-finance age-related spending needs.

43. Significant action has been taken to mitigate financial stability risks, but continued vigilance is needed. Banks are resilient and comfortably meet Norway's admirably stringent capital, leverage, and liquidity requirements. The recent extension of the mortgage regulations, which have proven effective at limiting issuance of high-risk mortgages, is welcome. The envisaged gradual normalization of monetary policy is appropriate at this stage in the cycle. Given that real and financial cycles have become more aligned, the monetary policy tightening called forth by the projected path of inflation can now reinforce the effectiveness of macroprudential and structural policies in mitigating financial stability concerns. Going forward, the mortgage regulations should be made a permanent part of the prudential toolkit: its parameters could still be adjusted as needed. If house price valuations and hence financial stability concerns continue to diverge across regions in Norway, more regionally differentiated mortgage regulations could be considered. To more durably address housing risks, action is also needed to further address supply constraints and reduce tax incentives for home ownership, which—despite reductions—remain generous by international standards.

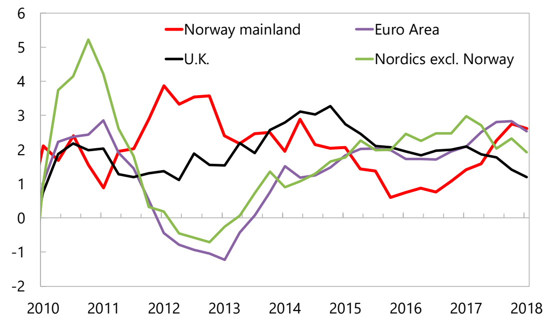
44. It is proposed the next Article IV consultation with Norway be held on the standard 12-month cycle.

Figure 1. Norway: GDP and Activity Indicators

The economic rebound is gathering steam….

GDP Growth of Trading Partners

(Y/Y growth, percent)

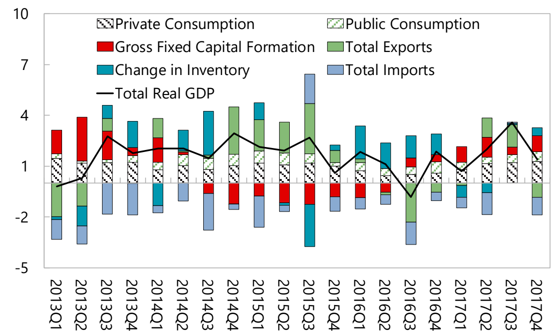


Sources: Eurostat, Statisitics Denmark, Statistics Finland, Statistics Norway, Statistics Sweden, U.K. Office of National Statistics, U.S. Bureau of Economic Analysis, and IMF staff calculations.

… driven by stronger private consumption, business investment and, most lately, exports.

Growth Decomposition

(Contribution to real GDP growth, y/y, in percent)

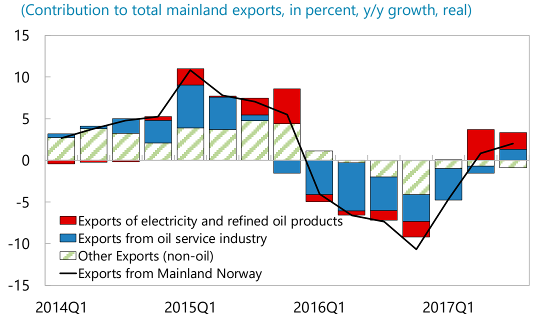


Sources: Statistics Norway

The recovery of exports is largely led by oil products and services, while non-oil exports are still lagging.

Exports from Mainland Norway

(Contribution to total mainland exports, in percent, y/y growth, real)



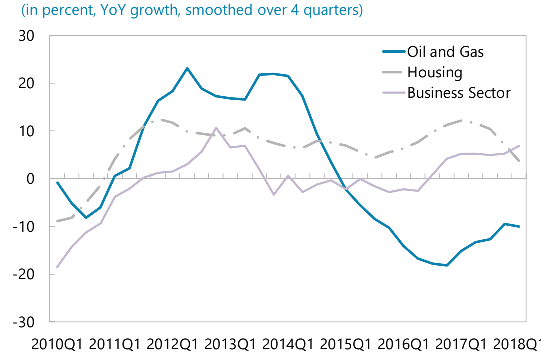
Source: Statistics Norway.

Note: "Exports from oil services industry etc." consist of fabricated metal products, machinery and other equipment, supply services, technical services, repairs and installation of machinery and equipment and various petroleum services.

Business and oil investment strengthened throughout 2017, but housing investments softened somewhat.

Investment Growth, by Industries

(in percent, YoY growth, smoothed over 4 quarters)

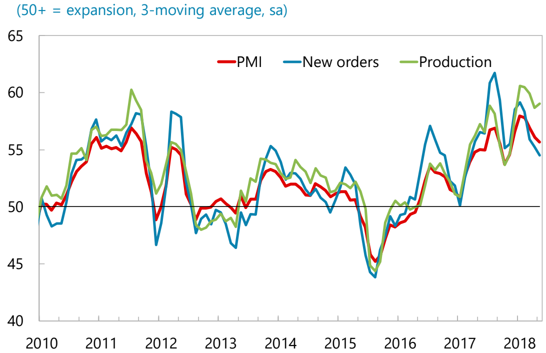


Sources: Statistics Norway and IMF staff calculations.

The PMI continues to trend up.

Purchasing Manager Index

(50+ = expansion, 3-moving average, sa)

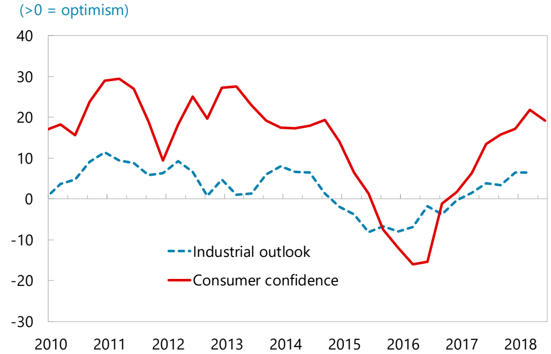


Sources: Danske Bank and IMF staff calculations.

Businesses and consumers are gaining confidence.

Business and Consumer Sentiment

(>0 = optimism)



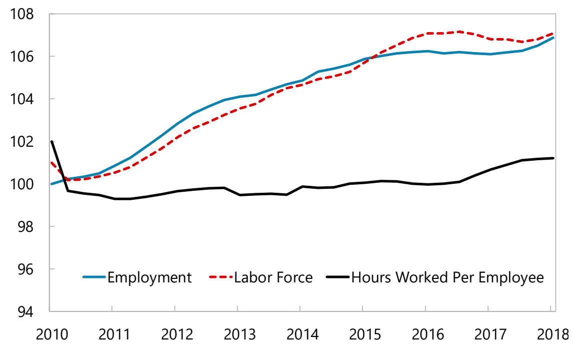
Sources: Statistics Norway, TNS Kantar, and IMF staff calculations.

Figure 2. Norway: Labor Market Developments

So far, the increasing demand for labor has been filled to a considerable extent through more working hours…

Labor Force, Employment, and Total Hours Worked

(4-quarter moving average, 2010=100)

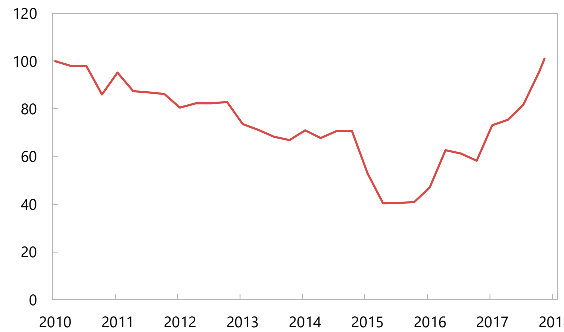


Source: Statistics Norway.

… but the growing number of vacancies should translate into higher employment going forward.

New Vacancies

(2010=100; 4-quarter average)

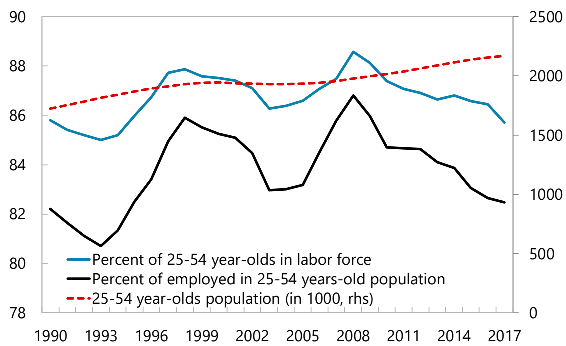


Sources: Statistics Norway and Haver Analytics.

However, participation and employment rates of the prime age cohorts continue to decline.

Labor Market Participation of the Prime Age Cohort

(In percent)

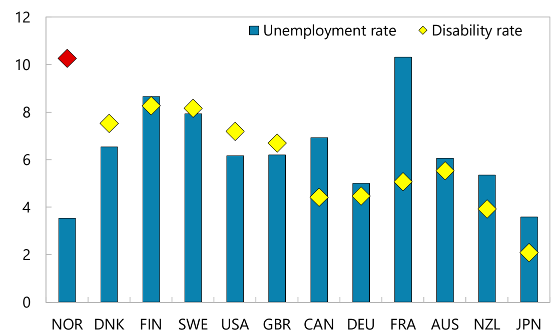


Source: Statistics Norway.

The disability rate is high in international comparison.

Unemployment and Disability, 2013

(Percent)

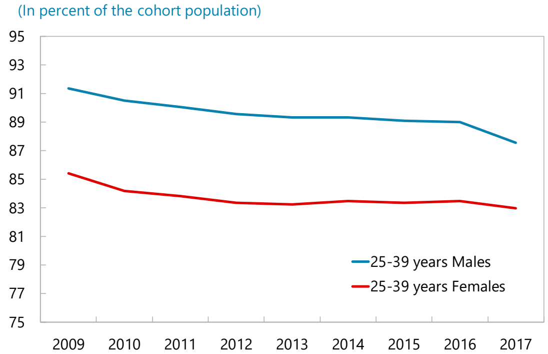


Sources: IMF World Economic Outlook, OECD, and IMF staff calculations.

The gap between male and female participation rates is narrowing, but mostly due to declines among males.

Labor Force Participation Rates By Gender

(In percent of the cohort population)

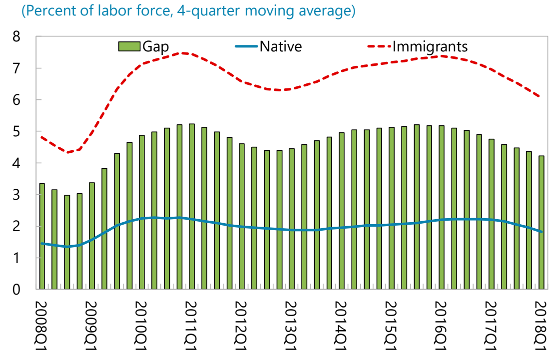


Source: Statistics Norway.

Integration of immigrants into the labor market remains a challenge.

Unemployment Rate by Immigration Status

(Percent of labor force, 4-quarter moving average)



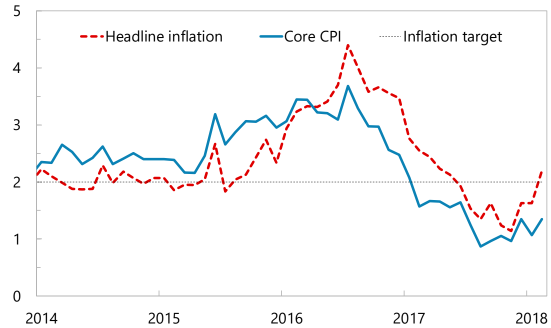
Source: Statistics Norway.

Figure 3. Norway: Price Developments

Headline inflation has reached the revised target, but core inflation remains subdued…

Annual Inflation

(Percent)

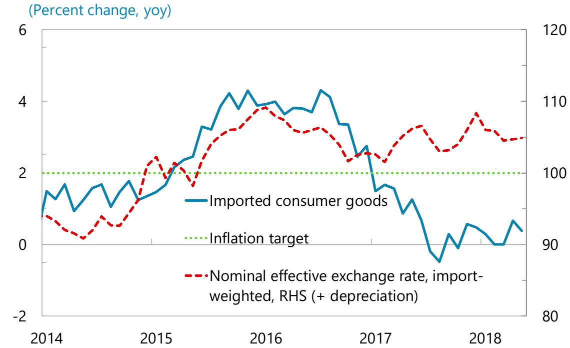


Sources: Statistics Norway and IMF staff calculations.

… which reflects incomplete exchange rate passthrough to import prices…

Exchange Rate and Imported Price

(Percent change, yoy)

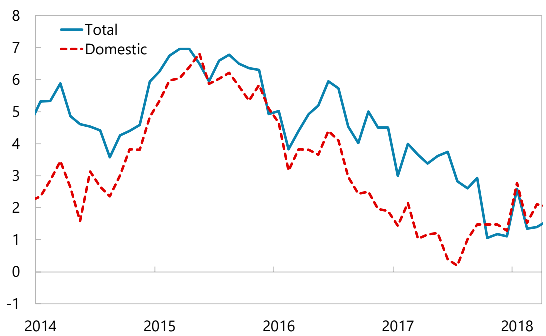


Source: Haver Analytics and IMF staff calculation.

… and weakening producer prices…

Producer Price Index: Consumer Goods

(Y/Y percent change)

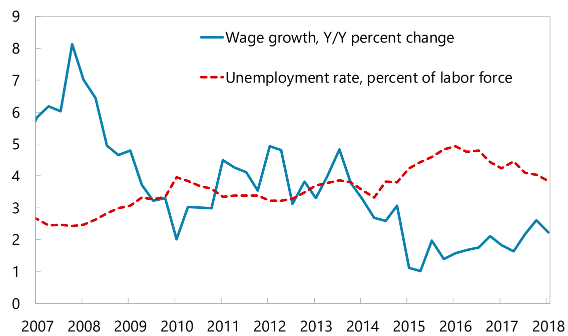


Sources: Statistics Norway and IMF staff calculations.

… amid subdued wage growth …

Wage Growth and Unemployment Rate

(Percent)

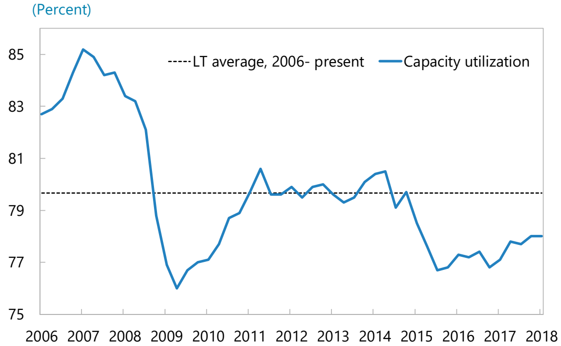


Sources: Statistics Norway and IMF staff calculations.

…and a slowly rising capacity utilization rate.

Capacity Utilization Rate and Wage Growth

(Percent)

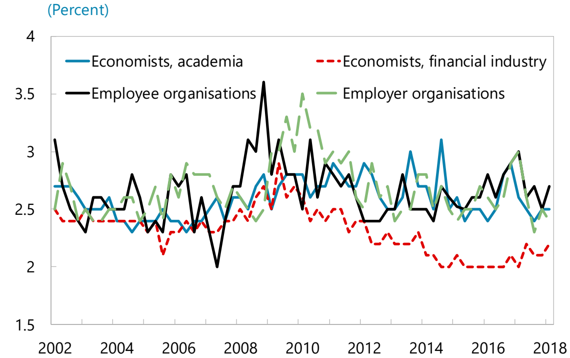


Sources: Statistics Norway and IMF staff calculations.

Inflation expectations remain well anchored.

Survey-based 5-year Inflation Expectations

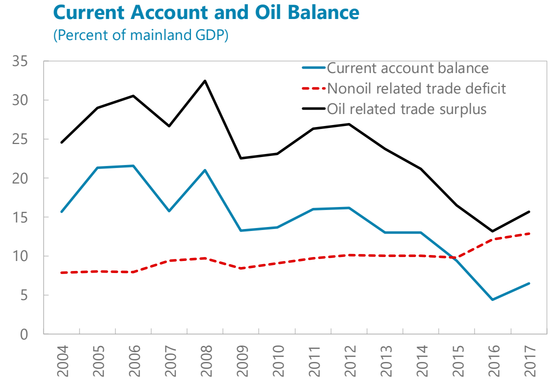
(Percent)



Source: Norges Bank.

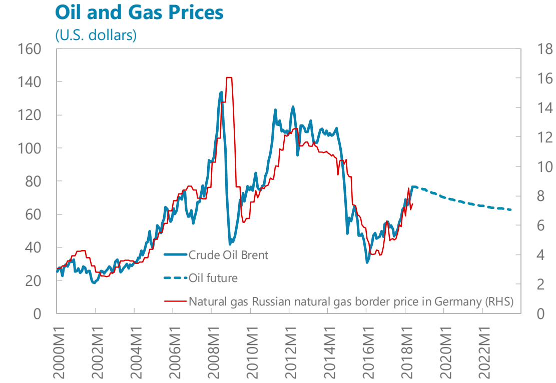
Figure 4. Norway: External Sector Developments

Norway's current account improved marginally in 2017 driven by an improvement in the oil trade balance…



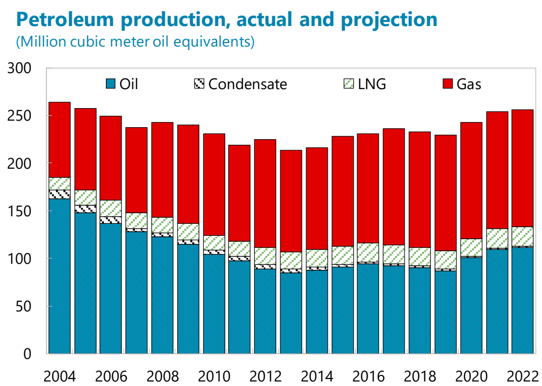
Source: IMF staff estimates.

…as oil prices edged up…



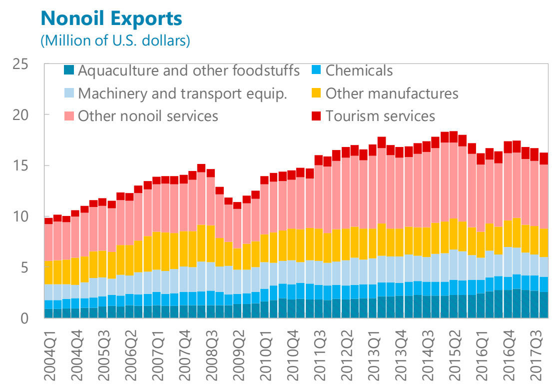
Sources: IMF, Global Economic Assumptions, and IMF staff calculations.

The volume of petroleum production has been stable.



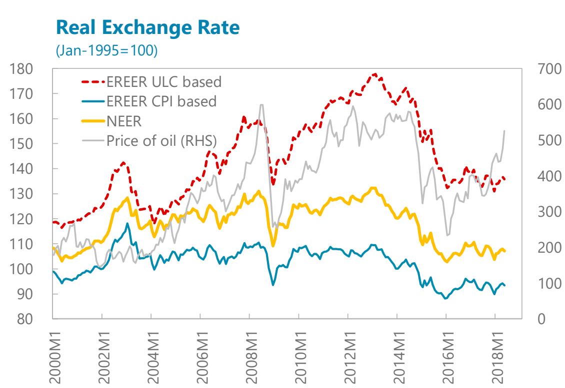
Sources: Nordic Petroleum Directorate.

Non-oil exports have declined slightly…



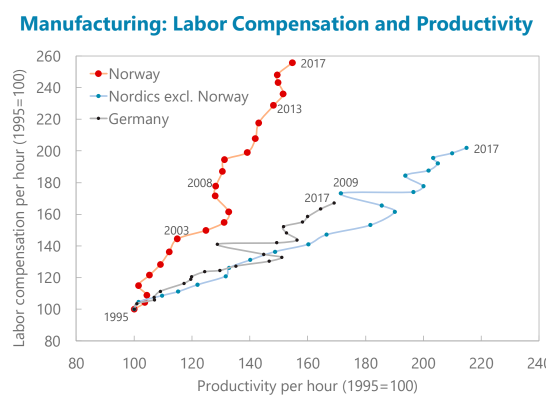
Sources: Statistics Norway and IMF staff estimates.

… despite the Krone depreciation in 2015…



Source: IMF staff estimates.

…within a context of Norway losing ground in competitiveness during the last 15 years.

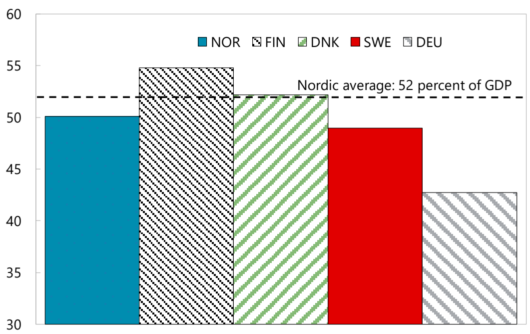


Sources: OECD and IMF staff estimates.

Figure 5. Norway: Primary Expenditure Composition and Aging

Norway's fiscal expenditure ratio is about 2 percentage points of GDP lower than that of Nordic peers, when measured in percent of total GDP (including oil production).[1/]

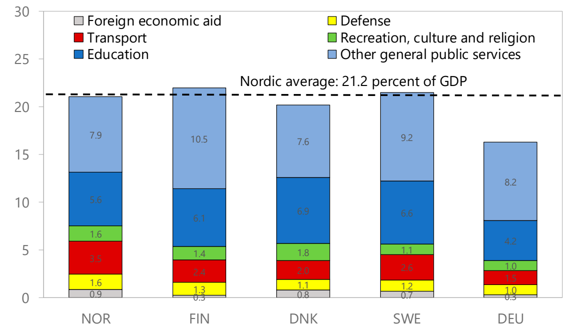
General Government Primary Expenditure, 2016
(Percent of GDP)



Sources: Eurostat, IMF World Economic Outlook, and Fund staff calculations.

Norway's expenditure on general services is in line with other Nordics, although transport and defense spending is higher.

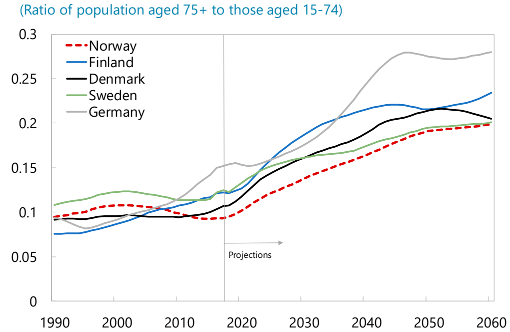
Expenditure on General Public Services, 2016
(Percent of GDP)



Source: Eurostat, IMF World Economic Outlook and IMF Staff calculations.
General public services are defined here as COFOG categories 01-06 and 08-09.

Unlike in some peers, the dependency ratio in Norway has not increased yet, but this is about to happen…

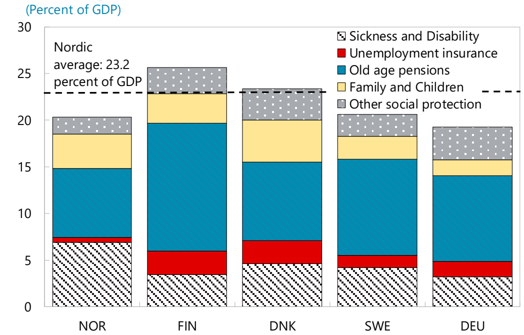
Old Age Dependency
(Ratio of population aged 75+ to those aged 15-74)



Sources: National Statistics Institutes, United Nations, Haver, Fund Staff calculations.

… so pension spending is lower for now than in peers, but spending on sickness and disability is significantly costlier.

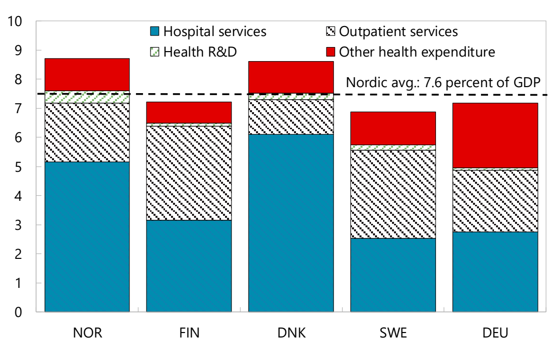
Social Expenditure, 2016
(Percent of GDP)



Sources: Eurostat, IMF World Economic Outlook, and Fund Staff calculations.

Despite fewer old-age people, Norway's health spending is higher than most peers, partly due to higher domestic wages and preferences for decentralized provision of services.

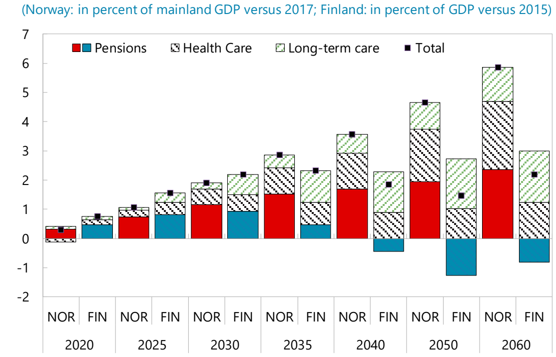
Public Health Care Expenditure by Category, 2016
(Percent of GDP)



Sources: Eurostat, IMF World Economic Outlook, and Fund Staff calculations.

As aging progresses, related expenditures are forecast to rise significantly more than in Nordic peers.

Increases in Age-Related Expenditures
(Norway: in percent of mainland GDP versus 2017; Finland: in percent of GDP versus 2015)



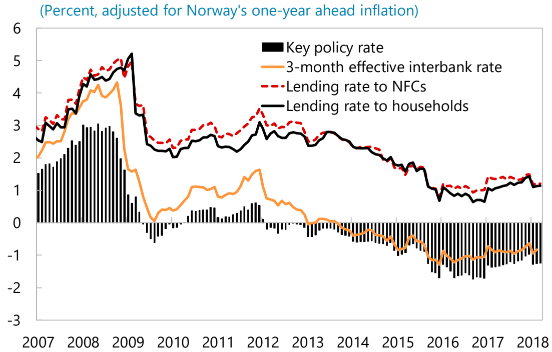
Sources: Norwegian Authorities, Finnish Ministry of Finance (2017) and Fund staff calculations.

1/ Normalized by total rather than mainland GDP for the purpose of cross-country comparison. If expressed as a percentage of mainland GDP, Norway's primary expenditure would be 7½ percentage points higher than Nordic peers'.

Figure 6. Norway: Credit Developments

Real interest rates remain low for now, but the Norges Bank has suggested that tightening may start before year end.

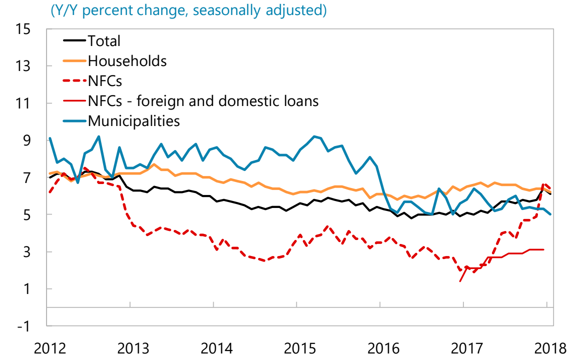
Real Interest Rates
(Percent, adjusted for Norway's one-year ahead inflation)



Sources: Norges Bank, Haver Analytics, and IMF staff calculations.

Nominal credit growth has remained stable around 5–6 percent.

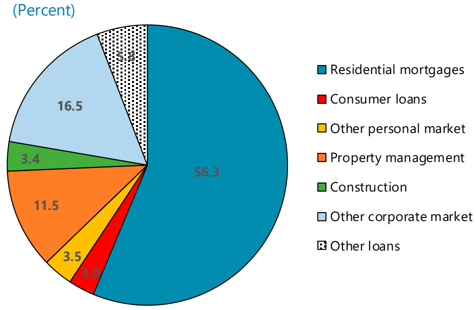
Growth in Domestic Credit
(Y/Y percent change, seasonally adjusted)



Source: Statistics Norway.

Banks' portfolios are heavy on real estate exposures. Consumer credit still makes up a small share, ...

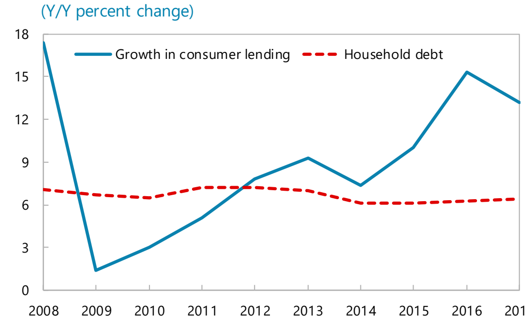
Banks' Loan Portfolio, 2017Q3
(Percent)



Source: Finanstilsynet.

... but has been growing rapidly.

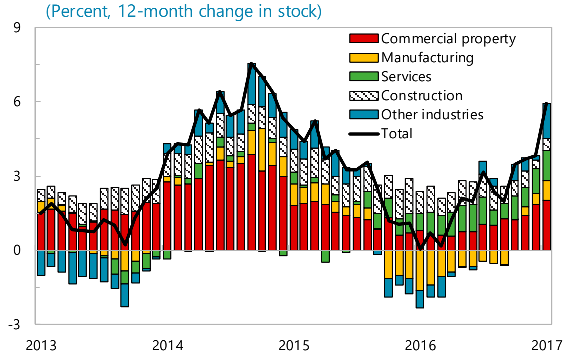
Growth in Consumer Lending and Household Debt
(Y/Y percent change)



Sources: Finanstilsynet and Statistics Norway.

Corporate credit is being driven by property management, services, and, most recently, the recovering oil sector.

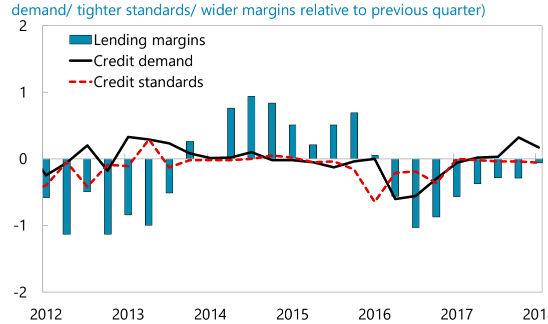
Bank and Mortgage Company Lending to NFCs
(Percent, 12-month change in stock)



Source: Norges Bank.

Corporate credit standards have stopped tightening as the economic recovery strengthens.

Corporate Loans: Demand and Credit Standards
(Percent of responses, negative net percentage balances indicate lower demand/ tighter standards/ wider margins relative to previous quarter)

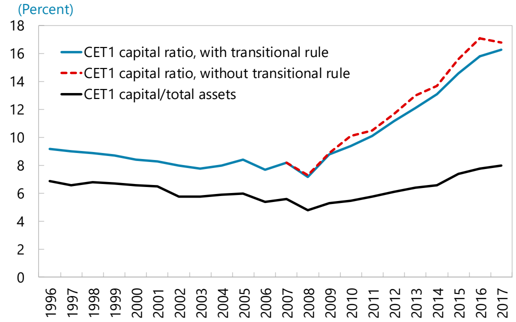


Source: Haver Analytics.

Figure 7. Norway: Banking Sector Developments

Banks have continued to strengthen their capital ratios …

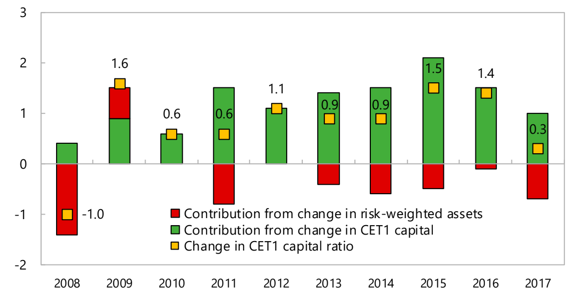
Tier 1 Capital Ratios
(Percent)



Sources: Norges Bank, Finanstilsynet, and IMF staff estimates.

… on the back of higher equity from retained earnings …

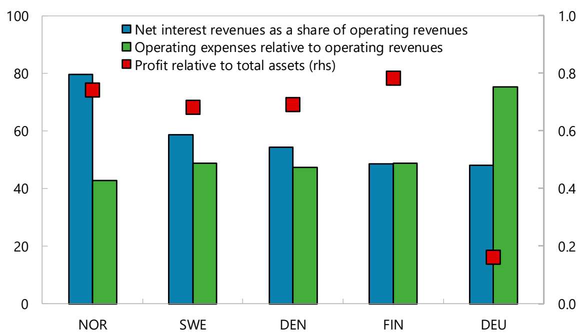
Change in CET1 Ratio of all Banks and Banking Groups
(Percentage points)



Source: Finanstilsynet.

… given solid profits. Profits are underpinned by low operating expenses, but dependent on interest revenues.

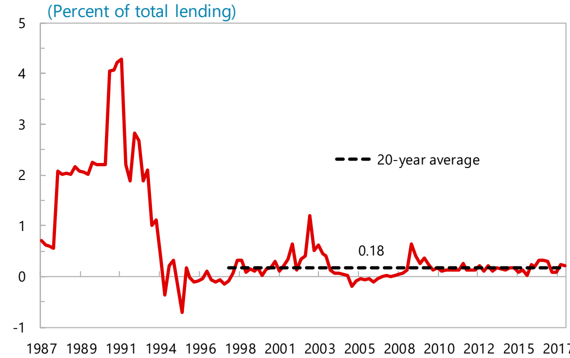
Select Bank Ratios



Sources: Finanstilsynet.

Nonperforming loans and associated losses remain low.

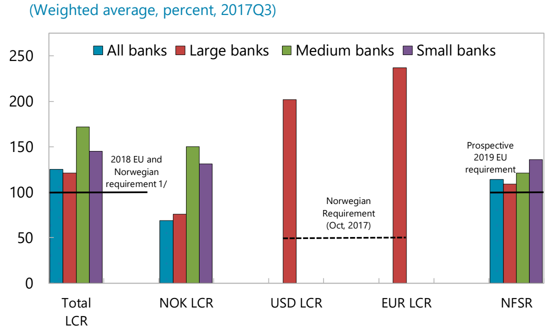
Loan Losses
(Percent of total lending)



Source: Norges Bank.

Banks have responded to the phasing-in of liquidity requirements by strengthening their liquidity positions.

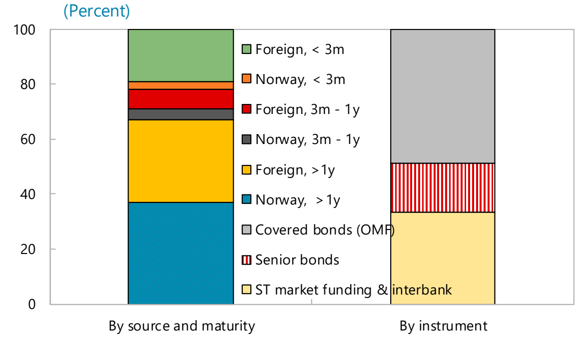
Liquidity Coverage Ratio and Net Stable Funding Ratio
(Weighted average, percent, 2017Q3)



Sources: Norges Bank and Finanstilsynet.

However, banks remain vulnerable to global financial turmoil as half their funding comes from wholesale sources.

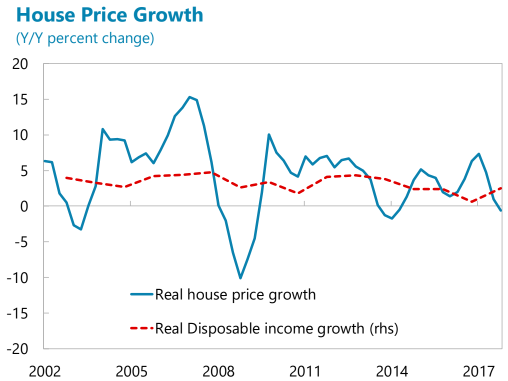
Market Funding
(Percent)



Sources: Finanstilsynet.

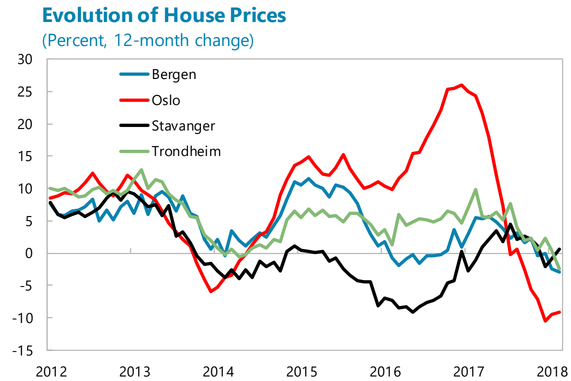
Figure 8. Norway: Housing Developments

After outpacing incomes for most of the post-crisis period, house prices have slowed since early 2017 …



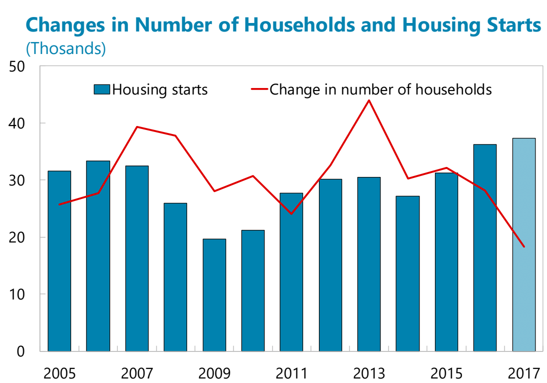
Sources: Norges Bank, Statistics Norway, and IMF staff calculations.

… driven largely by declines in the Oslo market …



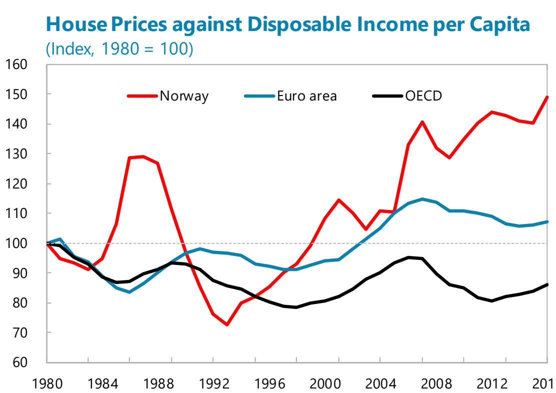
Source: Norges Bank.

… as supply has started to catch up and as the tighter mortgage regulations, first introduced in 2017 and recently extended, had an effect.



Source: Norges Bank.

Nonetheless, house prices remain high.



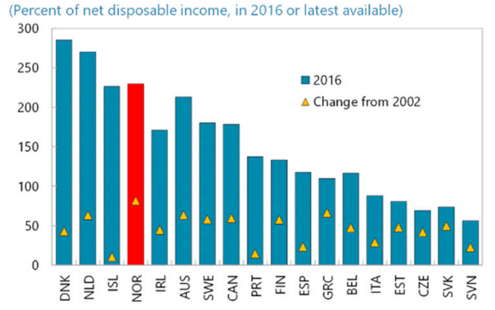
Sources: Finanstilsynet and OECD.

Figure 9. Norway: Household Debt and the 2017 Mortgage Regulations

Household debt is high in international comparison.

Household Debt

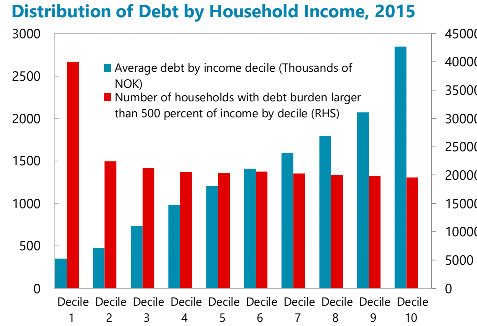
(Percent of net disposable income, in 2016 or latest available)



Sources: OECD and IMF staff calculations.

Households aged 30–59 with high incomes (8–10 decile) account for close to 40 percent of household debt …

Distribution of Debt by Household Income, 2015

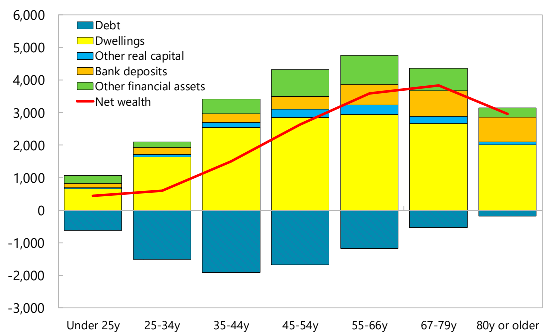


Source: Statistics Norway.

… and especially young households only have limited financial assets.

Balance Sheet by Age of Main Income Earner, 2015

(Thousands of NOK)

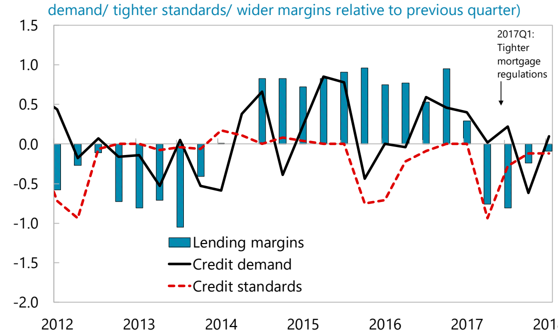


Sources: Norges Bank and IMF staff calculations.

The mortgage regulations, first introduced in early 2017, were associated with tighter credit standards for households.

Household Loans: Demand and Credit Standards

(Percent of responses, negative net percentage balances indicate lower demand/ tighter standards/ wider margins relative to previous quarter)

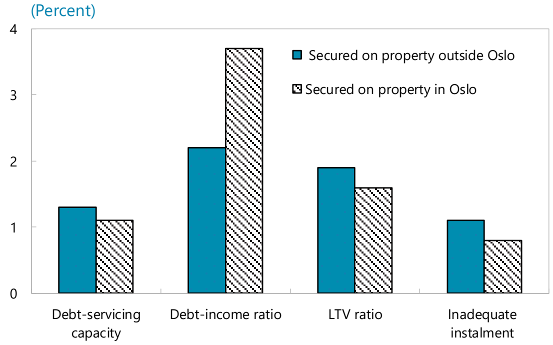


Source: Haver Analytics.

Particularly the debt-to-income limit of five has been binding, especially in Oslo…

Non-compliant Mortgages by Cause, 2017

(Percent)

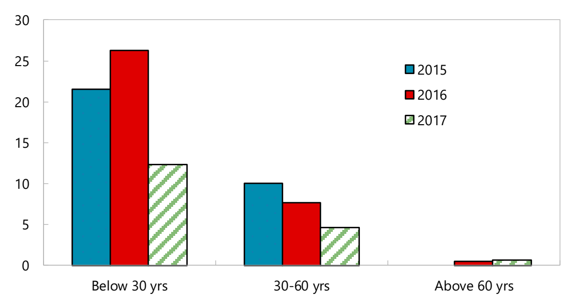


Source: Finanstilsynet.

… and also led to lower LTV ratios for newly-granted mortgage loans.

New Mortgage Loans with High LTV

(Mortgages with LTV>85% as share of total)

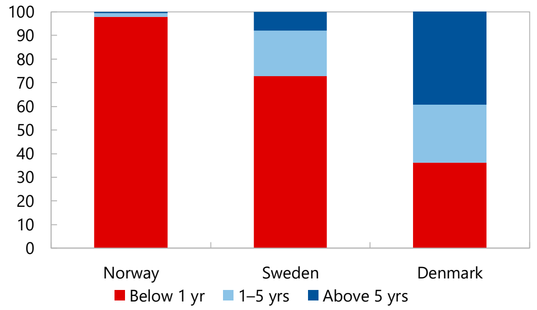


Source: Finanstilsynet.

Figure 10. Norway: Household Vulnerabilities to Interest Rates and House Prices

Virtually all mortgages are variable rate, including those made in 2017, despite prospects for higher interest rates.

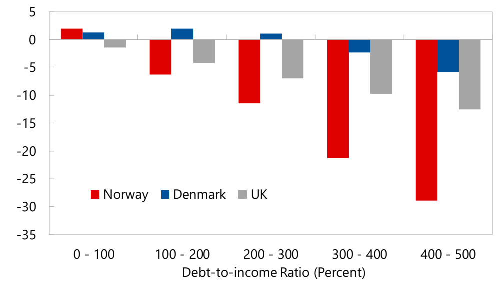
New Mortgage Loans by Interest Lock-in Period
(Percent of total during Jan - Sep 2017)



Sources: Finanstilsynet, Statistics Sweden, and Statistics Denmark.

As a result, Norwegian households tend to cut consumption more strongly in response to shocks.[1/]

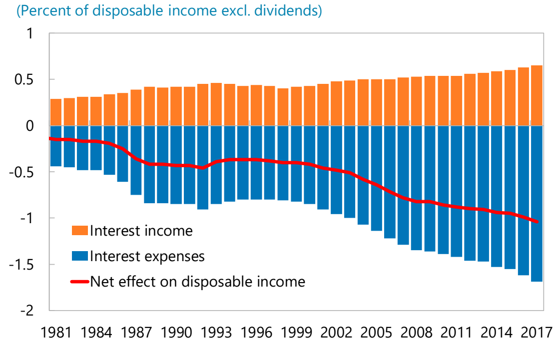
Estimates of Change in Household Consumption, 2007-09
(In percent of 2007 household income)



Sources: Bank of England Financial Stability Report, June 2017; Fagereng and Halvorsen (2016).

Given higher indebtedness, higher interest rates would now lead to stronger falls in disposable incomes …

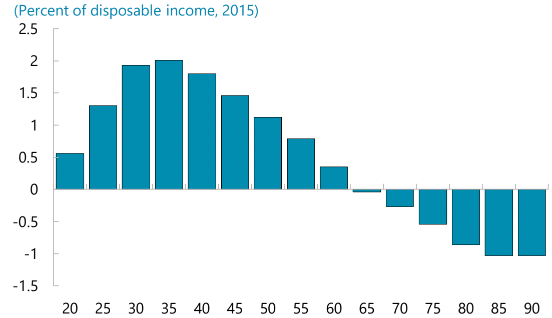
Effect of a 1 Percentage Point Increase in Lending and Deposit Rates
(Percent of disposable income excl. dividends)



Sources: Statistics Norway and Norges Bank.

… particularly for young households.

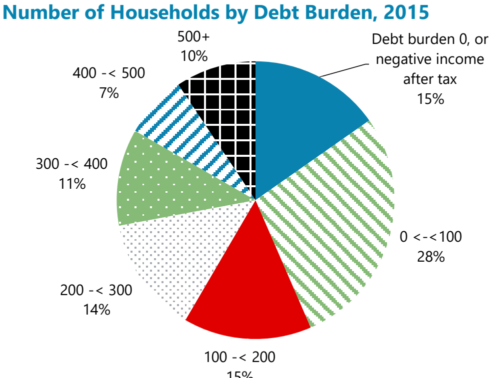
Change in Net Interest Expenses Following a 1 Percentage Point Interest Rate Increase by Age Cohort
(Percent of disposable income, 2015)



Sources: Statistics Norway and Norges Bank.
Note: Median share of each age cohort.

Many households among those with debt ratios of 300 percent or more …

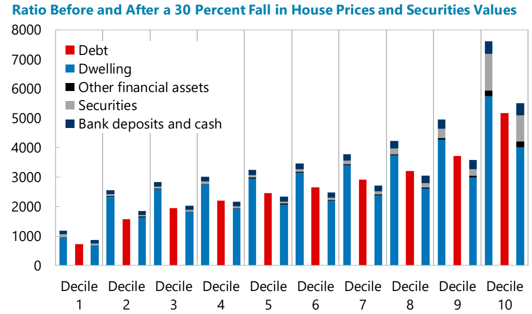
Number of Households by Debt Burden, 2015



Source: Statistics Norway.

… would have negative net worth if house prices dropped substantially.

Assets and Debt for Households with a 400 - 500 Percent Debt-to-income Ratio Before and After a 30 Percent Fall in House Prices and Securities Values



Sources: Statistics Norway and Finanstilsynet.
Note: For each decile, the left colum shows households' wealth before the shock; the middle colum shows the size of debt; and the right column shows wealth after the shock.

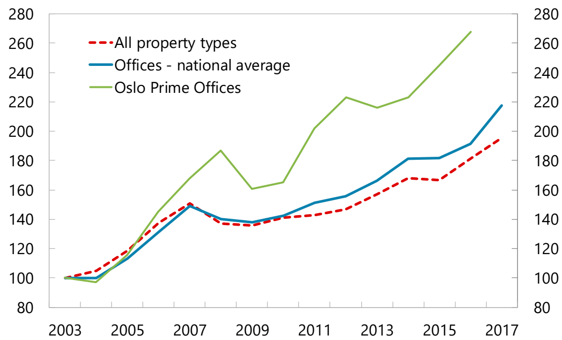
1/ These results, from Fagereng and Halvorsen 2016, use tax return data and cannot be mapped one-to-one to private consumption in the national accounts.

Figure 11. Norway: Commercial Real Estate Developments

Commercial property prices doubled in real terms over the past 15 years; increases were higher in prime locations.

Real Prices of Commercial Property

(Index: 2003 = 100; per square meter)

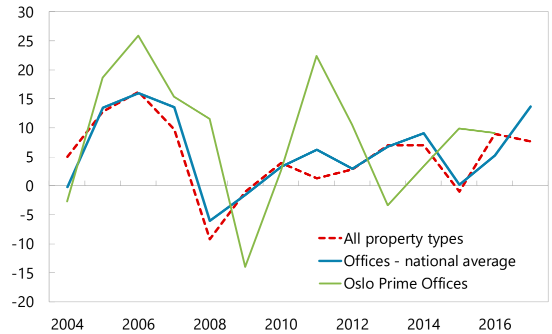


Source: MSCI IPD database and Norges Bank Monetary Policy Report.

Available data, though limited in coverage, suggest that real CRE prices rose by another 10 percent or so in 2017 …

Real Prices of Commercial Property

(Annual percentage change; per square meter)

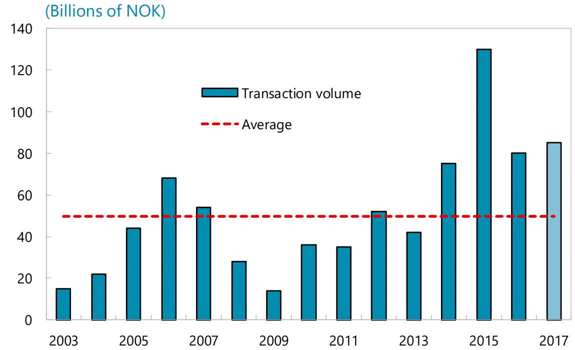


Source: MSCI IPD database and Norges Bank Monetary Policy Report.

… amid high transaction volume.

Transactions in Commercial Property

(Billions of NOK)

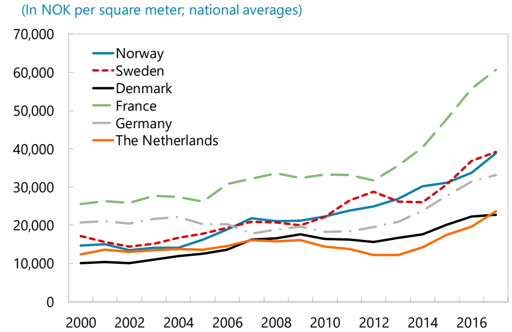


Sources: Finanstilsynet and DNB Næringsmegling.

Office prices in Norway have trended toward the upper end of the range spanned by peers, but are no outlier …

Nominal Price of Office Space

(In NOK per square meter; national averages)

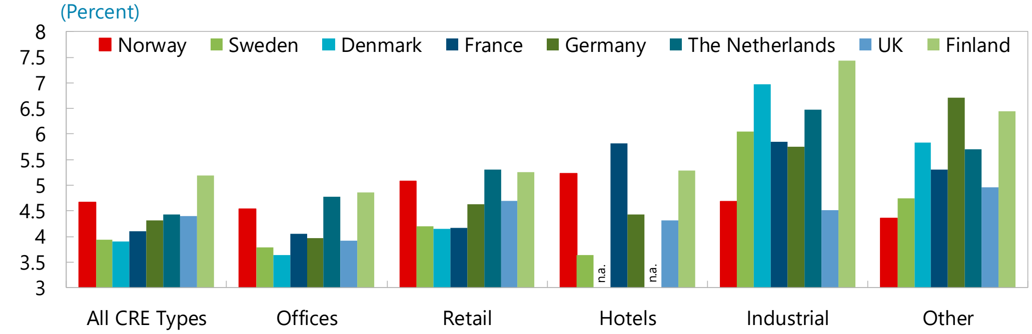


Sources: MSCI IPD database, Norges Bank, and IMF staff calculations.

… and higher prices may be justified given that yields remain solid relative to peers in the most prominent CRE segments. Norges Bank research suggests that solid yields have increasingly attracted foreign investors in recent years (Hagen, 2016).

CRE Net Operating Yields by Property Category, 2017

(Percent)



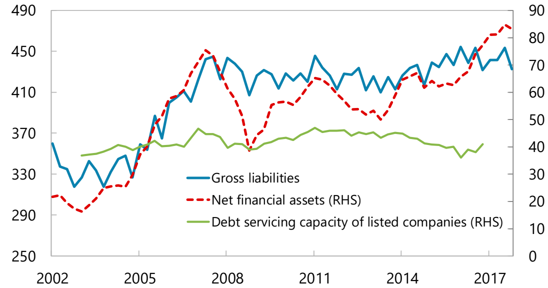
Sources: MSCI IPD database.

Denmark data for the segments retail, industrial and other refer to 2016.

Figure 12. Norway: Corporate Sector Developments

Corporates' financial positions have strengthened further…

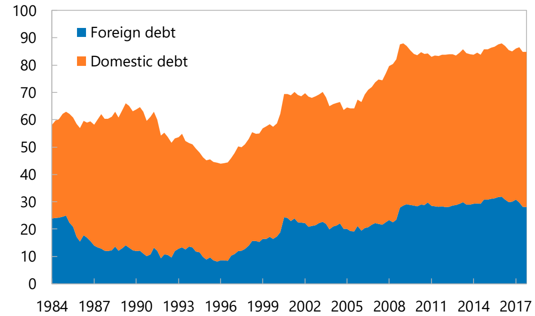
Nonfinancial Corporation Financial Position
(Percent of mainland GDP)



Sources: Statistics Norway, Norges Bank, and IMF staff calculations.
Note: Pre-tax profit plus depreciation and amortization of the previous 4 quarters as a percent of interest-bearing debt for non-financial enterprises.

… and corporate debt remained constant.

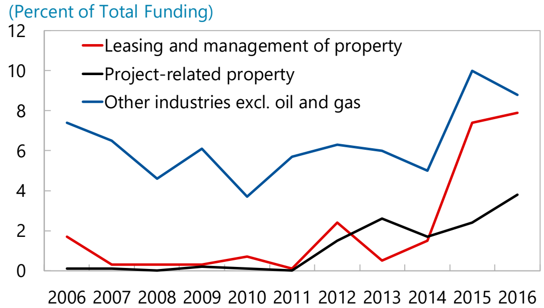
Credit to Non-financial Corporations
(Percent of mainland GDP)



Sources: IMF, Statistics Norway, and Norges Bank.
Note: Preliminary figures on foreign debt for 2017 Q4.

The real estate sector has started to increasingly seek market funding in the recent past, but …

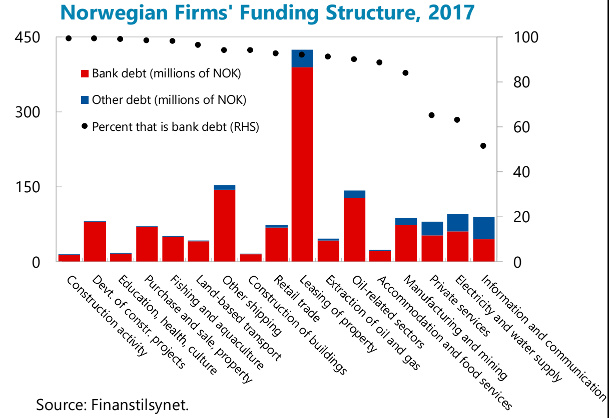
Market Funding
(Percent of Total Funding)



Source: Finanstilsynet.

… remains a large exposure for the banks.

Norwegian Firms' Funding Structure, 2017



Source: Finanstilsynet.

Table 1. Norway: Selected Economic and Social Indicators, 2013–2019

Population (2017): 5.3 million
Per capita GDP (2017): US$ 75,389 — Quota (3754.7 mil. SDR/0.78 percent of total)
Main products and exports: Oil, natural gas, fish (primarily salmon) — Literacy: 100 percent

						Projections	
	2013	2014	2015	2016	2017	2018	2019
Real economy (change in percent)							
Real GDP 1/	1.0	2.0	2.0	1.1	1.9	2.1	2.1
Real mainland GDP	2.3	2.2	1.4	1.0	1.9	2.5	2.4
Domestic demand	3.5	1.6	0.7	2.7	2.5	2.3	2.2
Unemployment rate (percent of labor force)	3.8	3.6	4.5	4.7	4.2	3.8	3.7
Output gap (mainland economy, - implies output below potential)	0.5	0.6	0.0	-0.9	-0.6	-0.2	0.2
CPI (average)	2.1	2.0	2.1	3.6	1.8	1.9	2.0
Gross national saving (percent of GDP)	38.1	38.6	35.5	33.1	34.3	36.1	36.4
Gross domestic investment (percent of GDP)	27.9	28.1	27.6	29.3	28.8	28.3	28.7
Public finance							
Central government (fiscal accounts basis)							
Overall balance (percent of mainland GDP) 2/	9.4	6.0	1.3	-3.1	-2.0	-0.7	-0.7
Nonoil balance (percent of mainland GDP) 3/	-4.8	-6.3	-7.1	-7.7	-8.0	-8.4	-8.5
Structural non-oil balance (percent of mainland trend GDP) 4/	-5.2	-5.9	-6.6	-7.3	-7.5	-7.6	-7.6
Fiscal impulse	0.4	0.7	0.6	0.7	0.2	0.1	0.0
in percent of Pension Fund Global Capital 5/	-3.3	-3.0	-2.7	-2.7	-2.8	-2.7	-2.8
General government (national accounts definition percent of mainland GDP)							
Overall balance	13.7	10.8	7.2	4.6	5.2	6.9	6.9
Net financial assets	262.6	305.6	335.4	325.3	350.3	333.2	328.9
of which: capital of Government Pension Fund Global (GPF-G)	207.7	253.2	284.6	276.4	302.8	287.6	285.6
Money and credit (end of period, 12-month percent change)							
Broad money, M2	7.3	6.4	0.6	5.1	6.0	...	...
Domestic credit, C2	6.8	6.0	6.1	4.7	6.3	...	...
Interest rates (year average, in percent)							
Three-month interbank rate	1.8	1.7	1.3	1.1	0.9	1.1	1.4
Ten-year government bond yield	2.6	2.5	1.6	1.3	1.6	1.9	2.1
Balance of payments (percent of mainland GDP)							
Current account balance	13.0	13.0	9.4	4.4	6.5	9.5	9.4
Exports of goods and services (volume change in percent)	-1.7	3.1	4.7	-1.8	1.1	2.0	2.4
Imports of goods and services (volume change in percent)	5.0	2.4	1.6	2.3	2.8	1.9	2.9
Terms of trade (change in percent)	0.0	-6.3	-11.7	-9.9	4.9	1.1	0.8
International reserves (end of period, in billions of US dollars)	57.9	66.9	58.5	60.9	65.1	73.3	78.7
Fund position							
Holdings of currency (percent of quota)	78.2	85.6	89.8	93.9	93.5	...	...
Holdings of SDR (percent of allocation)	95.1	94.8	96.4	88.3	102.7	...	...
Quota (SDR millions)	1,884	1,884	1,884	3,755	3,755	...	...
Exchange rates (end of period)							
Exchange rate regime		Floating					
Bilateral rate (NOK/USD), end-of-period	5.9	6.3	8.1	8.4	8.3	...	...
Real effective rate (2010=100)	99.0	94.2	86.5	86.6	87.4	...	...

Sources: Ministry of Finance, Norges Bank, Statistics Norway, International Financial Statistics, United Nations Development Programme, and Fund staff calculations.

1/ Based on market prices which include "taxes on products, including VAT, less subsidies on products".
2/ Projections based on authorities's 2018 budget.
3/ Projections based on authorities's 2018 budget removes both petroluem revenues and expenditures.
4/ Authorities' key fiscal policy variable; excludes oil-related revenue and expenditure, GPFG income, as well as cyclical effects.
5/ Over-the-cycle deficit target: 3 percent of Pension Fund Global Capital

Table 2. Norway: Medium-Term Indicators, 2013–2023
(Annual percent change, unless otherwise indicated)

						Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real GDP	1.0	2.0	2.0	1.1	1.9	2.1	2.1	1.9	1.9	1.8	1.8
Real mainland GDP	2.3	2.2	1.4	1.0	1.9	2.5	2.4	2.2	2.1	2.0	2.0
Real Domestic Demand	3.5	1.6	0.7	2.7	2.5	2.3	2.2	1.8	1.7	1.6	1.6
Public consumption	1.0	2.7	2.4	2.1	2.2	1.5	1.3	1.2	1.2	1.2	1.2
Private consumption	2.8	2.1	2.6	1.5	2.5	2.3	2.4	2.2	2.1	2.0	2.0
Gross fixed investment	6.3	-0.3	-4.0	-0.2	4.9	3.7	3.1	2.0	1.6	1.6	1.6
Stockbuilding (contribution to growth)	0.3	0.1	0.0	1.4	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Trade balance of goods and services (contribution to growth)	-2.1	0.3	1.2	-1.4	-0.5	-0.1	-0.1	0.2	0.3	0.2	0.3
Exports of goods and services	-1.7	3.1	4.7	-1.8	1.1	2.0	2.4	2.9	3.0	3.0	3.0
Mainland good exports	1.3	3.1	6.9	-8.2	2.1	3.5	4.0	4.1	4.3	4.2	4.3
Imports of goods and services	5.0	2.4	1.6	2.3	2.8	2.7	2.9	2.7	2.5	2.6	2.6
Potential GDP	0.8	1.9	2.5	2.0	1.7	1.7	1.8	1.9	1.9	1.9	1.8
Potential mainland GDP	2.1	2.1	2.0	1.8	1.7	2.0	2.1	2.2	2.1	2.1	2.0
Output gap (percent of potential mainland GDP)	0.5	0.6	0.0	-0.9	-0.6	-0.2	0.2	0.2	0.1	0.0	0.0
Labor Market											
Employment	0.7	0.9	0.6	-0.1	0.3	0.8	1.1	1.1	1.1	1.1	1.1
Unemployment rate LFS (percent)	3.8	3.6	4.5	4.7	4.2	3.8	3.7	3.7	3.7	3.7	3.7
Prices and Wages											
GDP deflator	2.5	0.3	-2.8	-1.1	3.8	5.7	2.3	2.0	2.0	2.0	2.0
Consumer prices (avg)	2.1	2.0	2.2	3.6	1.9	1.9	2.0	2.0	2.0	2.0	2.0
Consumer prices (eop)	2.0	2.1	2.3	3.5	1.6	1.8	2.0	2.0	2.0	2.0	2.0
Manufacturing sector											
Hourly compensation	5.3	3.2	3.0	1.7	2.4	...	...	...	...	...	...
Productivity	1.4	0.5	4.8	5.2	3.7	...	...	...	...	...	...
Unit labor costs	3.9	2.7	-1.7	-3.5	-1.3	...	...	...	...	...	...
Fiscal Indicators (national accounts definition percent of mainland GDP)											
General government fiscal balance (percent of mainland GDP)	13.7	10.8	7.2	4.6	5.2	6.9	6.9	6.3	5.9	5.5	5.4
of which: nonoil balance (percent of mainland GDP)	-5.5	-6.8	-7.1	-7.3	-8.6	-8.4	-8.6	-8.6	-8.6	-8.6	-8.6
External Sector											
Current account balance (percent of mainland GDP)	13.0	13.0	9.4	4.4	6.5	9.5	9.4	9.1	8.8	8.5	8.3
Balance of goods and services (percent of mainland GDP)	13.7	11.2	6.7	1.0	2.8	6.9	6.7	6.3	6.1	5.8	5.5
Mainland balance of goods (percent of mainland GDP)	-8.9	-8.8	-8.9	-9.5	-10.0	-9.5	-8.8	-7.5	-6.6	-5.9	-5.5

Source: Statistics Norway, Ministry of Finance, and IMF staff estimates.

Table 3. Norway: External Indicators, 2013–2023
(Percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
						Projections					
						Bil. NOK					
Current account balance	315.5	330.9	246.5	118.3	182.0	278.0	288.8	293.2	298.9	303.6	307.8
Balance of goods and services	331.7	283.2	175.4	26.9	79.9	200.8	204.7	204.5	205.7	206.0	205.7
Balance of goods	357.9	313.3	197.3	98.6	154.7	288.0	300.4	310.2	318.8	327.3	335.9
Balance of services	-26.2	-30.1	-21.9	-71.7	-74.9	-87.1	-95.8	-105.7	-113.0	-121.3	-130.2
Exports	1203.7	1220.4	1176.1	1064.1	1170.2	1346.7	1418.5	1488.2	1561.4	1638.3	1719.2
Goods	912.1	904.5	830.9	746.4	854.3	1019.1	1071.3	1123.1	1176.0	1231.6	1290.0
of which oil and natural gas	581.3	551.4	445.2	408.0	505.5	653.6	660.1	638.4	627.0	621.2	623.0
Services	291.6	315.9	345.2	317.6	316.0	327.5	347.2	365.1	385.5	406.7	429.2
Imports	872.1	937.2	1000.7	1037.1	1090.4	1145.8	1213.8	1283.7	1355.7	1432.3	1513.5
Goods	554.2	591.3	633.6	647.8	699.5	731.1	770.9	812.9	857.2	904.3	954.1
Services	317.8	345.9	367.1	389.3	390.9	414.7	442.9	470.8	498.5	528.0	559.4
Balance on income	-16.1	47.7	71.1	91.4	102.2	77.1	84.1	88.7	93.2	97.6	102.1
Capital account balance	-1.4	-1.1	-0.9	-0.8	-0.8	-0.8	-0.8	-0.9	-0.9	-1.0	-1.0
Financial account balance	294.4	346.1	55.0	330.8	152.6	277.2	288.0	292.3	298.0	302.6	306.8
Net direct investment	55.6	129.5	122.4	222.7	79.7	153.0	166.6	145.8	171.9	178.0	180.7
Net portfolio investment	349.6	125.5	266.2	50.4	140.4	222.1	192.3	202.2	194.0	204.4	219.7
Net other investment	-125.0	53.2	-285.7	28.1	-64.0	-154.2	-119.8	-89.1	-87.3	-90.1	-92.8
Change in reserves (- implies an increase)	14.2	38.0	-48.0	29.6	-3.5	56.3	48.9	33.4	19.5	10.4	-0.9
Net errors and omissions	-19.8	16.5	-190.6	213.4	-28.5	0.0	0.0	0.0	0.0	0.0	0.0
						Percent of Mainland GDP					
Current account balance	13.0	13.0	9.4	4.4	6.5	9.5	9.4	9.1	8.8	8.5	8.3
Balance of goods and services	13.7	11.2	6.7	1.0	2.8	6.9	6.7	6.3	6.1	5.8	5.5
Balance of goods	14.8	12.3	7.5	3.6	5.5	9.9	9.8	9.6	9.4	9.2	9.0
Balance of services	-1.1	-1.2	-0.8	-2.6	-2.7	-3.0	-3.1	-3.3	-3.3	-3.4	-3.5
Exports	49.7	48.1	44.9	39.2	41.8	46.1	46.2	46.0	45.9	46.0	46.1
Goods	37.6	35.6	31.7	27.5	30.5	34.9	34.9	34.7	34.6	34.6	34.6
of which oil and natural gas	24.0	21.7	17.0	15.0	18.0	22.4	21.5	19.7	18.4	17.4	16.7
Services	12.0	12.4	13.2	11.7	11.3	11.2	11.3	11.3	11.3	11.4	11.5
Imports	36.0	36.9	38.2	38.2	38.9	39.2	39.5	39.7	39.9	40.2	40.6
Goods	22.9	23.3	24.2	23.8	25.0	25.0	25.1	25.1	25.2	25.4	25.6
Services	13.1	13.6	14.0	14.3	13.9	14.2	14.4	14.5	14.7	14.8	15.0
Balance on income	-0.7	1.9	2.7	3.4	3.6	2.6	2.7	2.7	2.7	2.7	2.7
Capital account balance	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	12.1	13.6	2.1	12.2	5.4	9.5	9.4	9.0	8.8	8.5	8.2
Net direct investment	2.3	5.1	4.7	8.2	2.8	5.2	5.4	4.5	5.1	5.0	4.9
Net portfolio investment	14.4	4.9	10.2	1.9	5.0	7.6	6.3	6.2	5.7	5.7	5.9
Net other investment	-5.2	2.1	-10.9	1.0	-2.3	-5.3	-3.9	-2.8	-2.6	-2.5	-2.5
Change in reserves (- implies an increase)	0.6	1.5	-1.8	1.1	-0.1	1.9	1.6	1.0	0.6	0.3	0.0
Net errors and omissions	-0.8	0.6	-7.3	7.9	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
						Percent of GDP					
Stock of net foreign assets (IIP)	126.8	167.9	197.3	203.0	221.3	212.9	211.6	211.2	210.8	210.3	209.8
Direct investment, net	1.1	0.4	2.7	8.5	10.3	13.8	17.7	20.8	24.3	27.7	30.9
Portolio investment, net	128.2	162.5	195.0	194.9	213.6	204.2	200.7	198.3	195.8	193.6	191.6
Other investment, net	-14.1	-10.5	-16.6	-17.2	-19.0	-21.9	-24.2	-25.6	-26.8	-28.0	-29.1
Official reserves, assets	11.5	15.5	16.3	16.7	16.4	16.8	17.4	17.6	17.4	17.0	16.4
Government Pension Fund Global, percent of mainland GDP	207.7	253.2	284.6	276.4	302.8	...	...	...	...	...	...

Sources: Statistics Norway; Ministry of Finance; and IMF staff calculations.

Table 4. Norway: General Government Accounts, 2007–2016
(Percent of mainland GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenue	74.4	78.1	68.9	69.0	73.1	72.4	68.6	66.7	64.3	61.9
Taxes	42.9	43.9	39.1	40.6	42.4	41.5	38.6	35.8	33.3	32.4
Social contributions	11.2	11.6	11.9	11.7	12.0	12.1	12.1	12.3	12.4	12.2
Grants and other revenues	20.3	22.6	17.9	16.7	18.7	18.9	18.0	18.6	18.6	17.3
Expense	50.9	51.3	54.1	53.8	54.3	53.5	53.3	54.0	55.4	55.4
Compensation of employees	15.1	15.5	16.4	16.4	16.8	16.7	16.8	16.9	17.1	17.0
Use of goods and services	6.7	6.8	7.3	7.3	7.2	6.9	7.0	7.1	7.4	7.4
Consumption of fixed capital	3.2	3.3	3.5	3.5	3.7	3.8	3.6	3.7	3.9	4.0
Interest	3.4	2.8	1.8	1.5	1.5	1.2	1.1	1.0	0.9	0.8
Subsidies	2.2	2.3	2.5	2.5	2.5	2.4	2.4	2.4	2.4	2.5
Social benefits	17.6	17.8	19.2	19.3	19.7	19.5	19.3	19.6	20.2	20.3
Granth and other	2.7	2.9	3.2	3.2	3.1	2.9	3.1	3.3	3.4	3.4
Gross operating balance	26.7	30.0	18.3	18.8	22.5	22.7	18.9	16.4	12.8	10.5
Net operating balance	23.5	26.8	14.8	15.2	18.8	19.0	15.3	12.7	9.0	6.6
Net acquisition of nonfinancial assets	1.5	1.7	2.0	1.5	1.4	1.1	1.6	1.9	1.7	2.0
Net financing										
Net lending/borrowing	22.0	25.0	12.8	13.7	17.4	17.9	13.7	10.8	7.2	4.6
Net acquisition of financial assets	26.7	15.3	3.2	18.1	1.9	21.6	16.6	8.9	13.9	9.0
Currency and deposits	0.0	-0.8	-0.8	0.5	-2.3	2.9	-1.9	1.4	-0.5	3.0
Securities other than shares	3.2	10.3	-17.0	8.5	0.7	6.9	14.2	3.1	5.5	1.8
Loans	7.7	-26.4	5.4	3.2	-9.1	1.4	2.7	-2.3	3.4	0.8
Shares and other equity	14.8	28.5	17.6	4.3	11.5	10.2	2.2	6.6	5.2	3.1
Insurance technical reserves	0.0	-0.1	0.0	0.1	0.0	0.0	0.2	0.1	0.2	0.1
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.0	-0.1
Other accounts receivable	1.0	3.9	-2.2	1.6	1.1	0.1	-0.9	-0.4	0.1	0.3
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	4.7	-9.7	-9.6	4.4	-15.5	3.7	3.0	-2.0	6.7	4.4
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-0.8	3.5	10.6	1.1	-3.8	3.1	-1.2	-0.3	1.0	1.3
Loans	3.9	-14.7	-18.4	2.5	-10.2	0.5	3.0	-2.2	4.6	2.9
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.3	0.0	-0.1
Other accounts receivable [1]	1.6	1.5	-1.8	0.8	-1.5	0.2	1.2	0.2	1.1	0.3
Balance sheet										
Net financial worth	179.4	166.2	190.8	204.6	206.8	218.0	263.0	308.3	338.9	332.0
Financial assets	250.7	238.8	250.2	264.9	250.4	263.2	307.9	349.6	385.2	381.0
Currency and deposits	12.7	11.6	10.6	10.6	7.8	10.3	7.9	9.0	8.2	10.9
Securities other than shares	64.3	86.1	59.8	64.5	65.5	66.7	80.2	95.1	106.3	101.1
Loans	51.5	31.1	35.7	36.9	26.5	26.3	28.2	25.1	28.1	27.5
Shares and other equity	105.9	94.8	129.9	138.1	135.1	144.2	177.0	206.1	228.0	226.7
Insurance technical reserves	1.2	0.7	0.9	1.0	1.5	1.6	2.2	2.7	3.1	3.5
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.3	0.4	0.5
Other accounts receivable	15.1	14.5	13.4	13.8	14.1	14.0	12.3	11.3	11.0	10.8
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities	71.3	72.6	59.4	60.4	43.7	45.3	44.9	41.3	46.3	49.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	12.8	16.1	26.3	26.1	21.6	23.1	20.4	19.5	19.7	20.0
Loans	50.3	47.2	25.6	26.7	15.7	15.9	18.2	15.4	19.5	21.7
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.5	0.4	0.3
Other accounts receivable	8.2	9.3	7.5	7.5	6.4	6.1	6.1	5.9	6.7	7.1
Mainland GDP (billions of NOK)	1831.0	1946.7	1966.1	2077.6	2161.6	2298.4	2423.2	2539.6	2621.0	2717.3

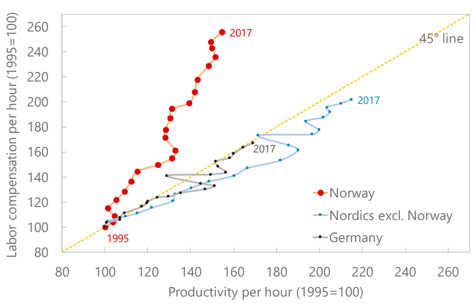
Sources: IMF *Government Finance Statistics,* Ministry of Finance, and Fund staff calculations.

1/ Includes statistical discrepancy.

Annex I. Norway's Competitiveness Challenges

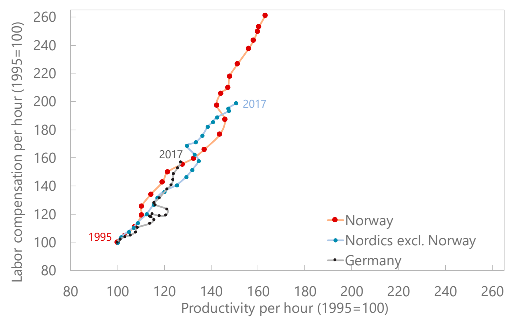
1. Over the last two decades, wages in Norway have outpaced both productivity growth and wages in trade partners. Since 1995, nominal manufacturing wages in Norway rose by 160 percent, compared to less than 100 percent in other Nordics and less than 80 percent in Germany. At the same time, labor productivity in manufacturing productivity lagged that of peers during the same period: Norway's only grew by 50 percent while that of other Nordic peers more than doubled. Similar trends are observable for services, though the magnitudes of differences are less stark (see Selected Issues Paper for more details).[1] This led to a large increase in aggregate unit labor costs. The deterioration in unit labor costs was particularly pronounced during 2005–13, when global commodity prices spiked.

Manufacturing: Labor Compensation and Productivity



Sources: OECD; and IMF Staff estimates.

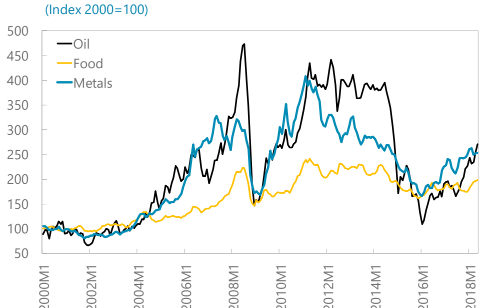
Services[1]: Labor Compensation and Productivity



1/ Excluding real estate activities.
Sources: OECD; and IMF Staff estimates.

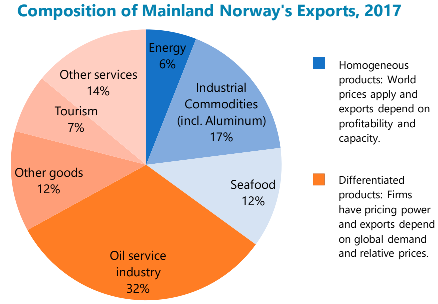
2. High terms of trade gains limited aggregate competitiveness losses. Export prices rose considerably for most of Norway's key exports—oil, aluminum, and fisheries. In addition, these terms of gains also spilled to related sectors. For instance, higher worldwide oil-related investment activity also resulted in terms of trade gains for Norway's oil-related industries, which have grown over the past decades to make up 1/3 of mainland exports. While referred to as the oil service industry, it includes both manufacturers of goods as well as service suppliers to oil producers worldwide. Manufactured goods include specialized machinery and vessels, and services are geared towards engineering.

Price of Key Norwegian Exports
(Index 2000=100)



Source: IMF, WEO.

Composition of Mainland Norway's Exports, 2017

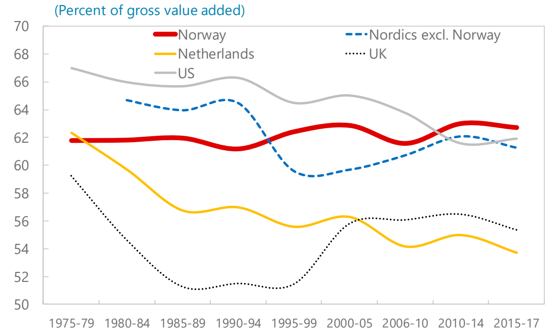


Source: Statistics Norway.

[1] Cabezon, E. and C. Henn (2018), "Wages and Competitiveness in Norway," Selected Issues Paper.

3. Another way to see that wage gains may not have been unsustainable *in the aggregate* is to note that wages have remained constant as a share of GDP. At a time when several other advanced countries experienced falling labor shares, Norway's remained constant. It likely played a role that maintaining a stable share of labor compensation in domestic income is an important objective of collective wage bargaining in Norway. Collective agreements cover much of the economy: Seventy percent of employees are covered by collective agreements in Norway. This is high in global comparison, though low compared to Nordic peers. Collective wage agreements in Norway are negotiated through a decentralized, two-tiered system. In this framework, wages are negotiated at the sector level first, while leaving considerable room for supplemental agreements within companies under a peace clause. In Norway, the sector-level bargaining of wage growth rates takes place each year, while other benefits are negotiated every two years.

Labor Compensation Share
(Percent of gross value added)

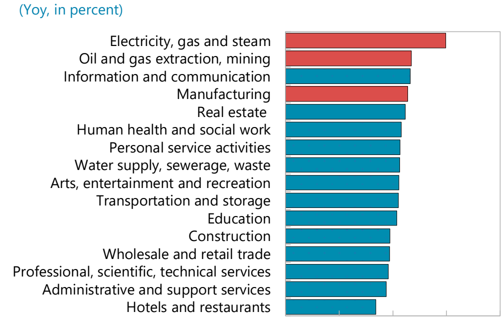


Sources: Eurotat; country authorities; and IMF staff estimates.

4. In Norway's collective bargaining model, the machinery sector—which experienced considerable terms of trade gains—traditionally led wage negotiations. Much of the machinery sector in Norway serves as a supplier to oil-extraction companies worldwide. Therefore it was also favored by positive oil price shocks; such shocks increase demand for the sector's products and these are sufficiently specialized to give firms pricing power. Norway's sector-level bargaining negotiations follow the so-called "pattern bargaining" process: The machinery sector, which is deemed the most exposed to international competition, agrees on a wage target. This target is then applicable to the other sectors as well. The blue-collar workers in the machinery sector traditionally (i.e. up to 2014) negotiated their wages first, setting a starting point for the wage agreement for all workers in the manufacturing sector. The wage norm agreed in manufacturing, in turn, serves as a target for the *average* wage rises in the rest of the economy, including the public sector.

5. High wage increases were also passed onto sectors that had not experienced terms of trade gains. While there are no laws preventing different sectors from deviating from the norm established by the manufacturing sector, social partners have historically complied with the central agreements. Given this close adherence of follower sectors, the manufacturing sector's high wage increases—of above 4 percent during 2001–13—permeated throughout the economy. Arguably, social partners' traditional objective to contain wage dispersion in the economy also played a role.

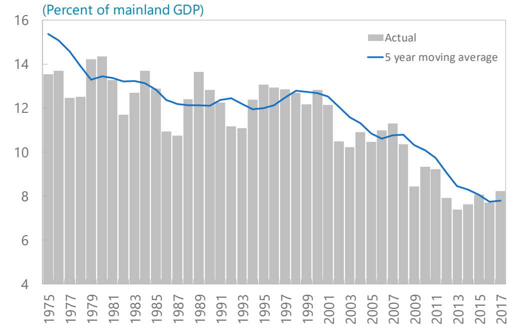
Nominal Wage Growth by Sector, 2001-2013
(Yoy, in percent)



Sources: Eurostat, IMF Staff Calculations

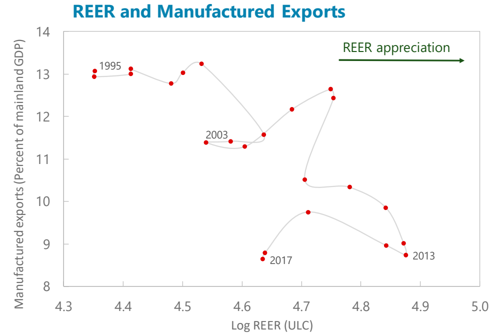
6. As a result, competitiveness is a challenge in several sectors. In particular, non-oil related manufactures have struggled, with their share in mainland GDP declining by about 5 percentage points since the late 1990s. True, this trend can be interpreted benignly, as an optimal reallocation of resources to the sectors benefiting from terms of trade gains. However, this reallocation will likely make diversification away from oil, which is ultimately needed over the longer term, more difficult. Also, manufactured exports as a whole have not responded to the 20 percent real exchange rate depreciation of the 2014–16 oil downturn, though this may partly be related to weak global demand for oil-related manufactures until most recently. Finally, also in services, unit labor costs have increased considerably more than in trade partners. As a result, many services and other nontradables sectors (such as construction) have experienced considerable labor inward migration. Migrants often accept lower wages and tend not to be covered by collective agreements, unlike most native workers. Therefore, union coverage in certain sectors has been decreasing quite rapidly (Staff Report ¶30). The consequences of the rise of non-unionized employment on Norway's tight social compact remain to be seen.

Manufacturing: Nonoil Related Exports
(Percent of mainland GDP)



Sources: Statistics Norway; and IMF staff estimates.

REER and Manufactured Exports



Sources: Haver Analytics, and IMF staff estimates.

7. Going forward, Norway may have to shift its expectations for wage growth downward. The only reason Norway was able to afford very high wage growth in the past (notwithstanding the noted challenges in several sectors) was because of good fortunes in its terms of trade. Going forward, it would be prudent not to count on being fortunate twice: wage moderation would help build resilience in case of less favorable trends in international prices. It would also help facilitate the needed transition out of oil.

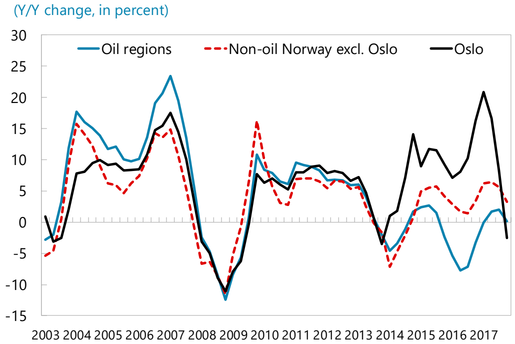
8. Developments since 2014 assuage concerns regarding competitiveness to some extent. Social partners have been able to deliver wage moderation since the onset of the oil downturn. Wage growth in the manufacturing sector was less than 2 percent on average during 2014–17, with other sectors reducing their average wage growth from above 4 to 2.3 percent during the same period. This helped prevent further deterioration of cost competitiveness, although losses from the past decade have not been reversed. In addition, there have been encouraging changes in the wage bargaining process since 2014, with social partners heeding wage developments in trade partners more closely and the broader manufacturing sector—instead of machinery—now leading wage negotiations.

Annex II. Regional House Price Overvaluation in Norway

1. House prices have been growing fast in recent years, notwithstanding a recent correction that has now ended. Nominal house prices in Oslo and nationwide now stand 85 and 55 percent, respectively, above their 2010 levels. The national house price to income ratio remains historically and internationally high (Figure 9). House prices fell in 2017 particularly in Oslo, which saw nominal house price declines of 10.5 percent during 2017.[1] However, the correction was short lived. House prices have risen again by 7.5 percent during January–May of this year on a seasonally-adjusted basis.

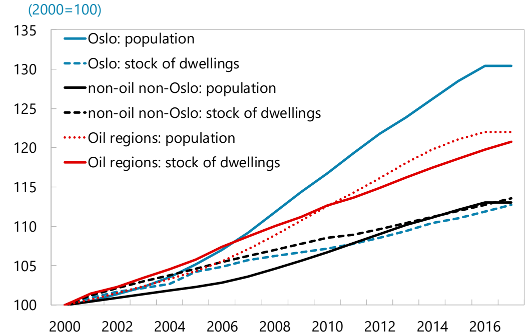
2. There has been a significant regional divergence of house price trends since 2013. This represents a contrast to the period of rapid house price appreciation before the global financial crisis, when house prices grew evenly across Norway. However, since 2013, prices have declined in the oil regions (in good part due to the oil downturn), they have grown modestly in the non-oil, non-Oslo regions, but they have increased very rapidly in Oslo. There is evidence that during the latest run-up, fundamental factors have played a part for this divergent trend—for instance, while the supply of houses has kept up with population growth outside of Oslo, it has trailed well behind in the capital.

Norway: Real House Price Growth by Region
(Y/Y change, in percent)



Sources: Haver Analytics, IMF staff calculations

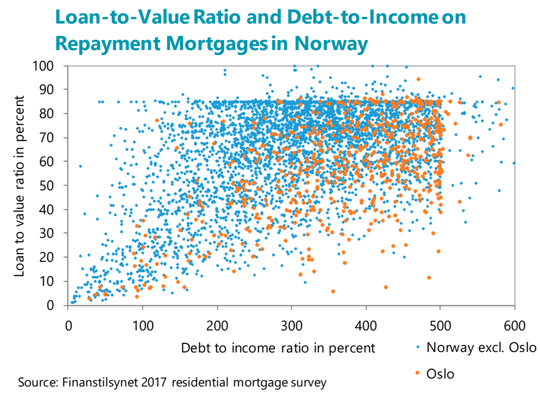
Population and Residential Building Stocks in Regions
(2000=100)



Sources: Statistics Norway, IMF staff calculations.

3. The recent correction happened not long after new mortgage regulations entered into force in January 2017. In addition to previous regulations that included among other things tight loan-to-value ratios, the new measures added: (i) a debt-to-income (DTI) limit of 5; (ii) tightened conditions for applying an amortization requirement; and (iii) a lower limit for the maximum percentage of new mortgage lending in Oslo that was allowed to deviate from one or more of the regulatory requirements (the so-called "speed limit"). There is evidence that the regulations,

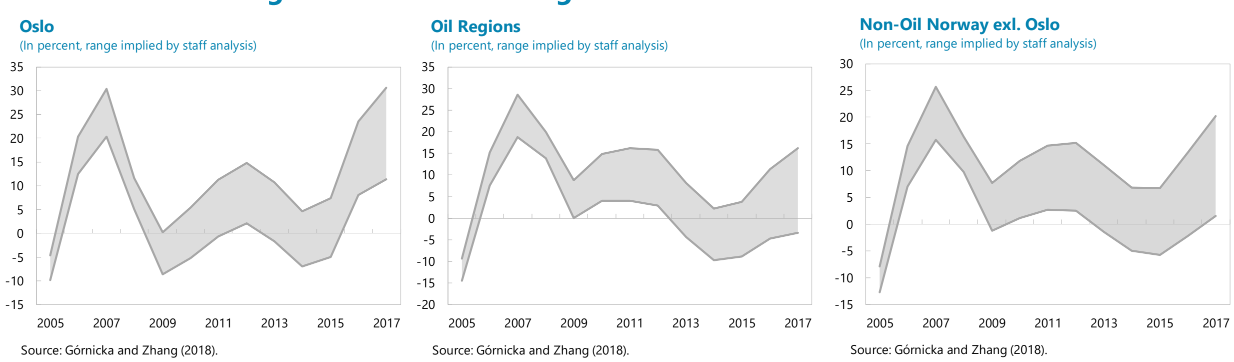
[1] Note that the annual average of real house prices in 2017 was nonetheless 10 percent higher than the average observed during 2016 for two reasons: (i) house price increases cumulated during 2016, reducing that year's average figure; and (ii) the correction in 2017 mostly occurred in the second half of the year, thereby not pulling down the 2017 annual average by that much.



especially the DTI limit, have been binding. This is particularly true in Oslo, where many mortgages are hitting the DTI limit.

4. **Given diverging trends across regions, it is worth asking whether house prices are above their equilibrium levels not just at the national but also at the regional level.** Previous Fund consultations had shown a possible overvaluation of about 15 percent at the national level. Taking the analysis one step further and looking at regional prices in relation to the regional equilibrium, we find that Oslo prices are some 10–20 percent overvalued, non-oil, non-Oslo prices about 0–10 percent overvalued, and prices in oil regions in equilibrium or even slightly undervalued.[2] This would indicate that the potential for a price correction is greater in the Oslo region. It also signals that Oslo is where financial stability concerns might be greatest, and hence where the focus of macroprudential policies should be.

Figure II.1 Estimated Regional House Price Overvaluation



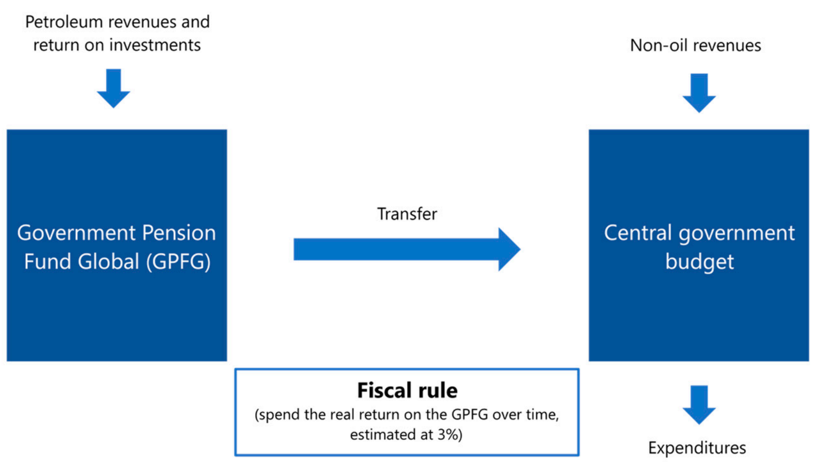
5. **In addition, the rising dispersion of house prices is starting to impact internal labor mobility.** Region-to-region flows are relatively small contributors to net population changes, which are dominated by net births and external immigration. Nevertheless, they have played an important equilibrating role in labor market dynamics when shocks have been asymmetric across regions. Staff estimates show that the rising dispersion of house prices is starting to limit internal labor mobility, in line with evidence from other advanced economies. This being said, the effects are modest for now: a 25 percent increase in house prices in a given region relative to the national average is estimated to reduce internal net flows to this region by about 10 percent.

[2] For details see: Górnicka, L. and Y. Zhang (2018), "House Prices and Labor Mobility in Norway: A Regional Perspective," IMF Selected Issues Paper.

Annex III. Norway's Institutions to Manage Oil Revenues

1. In 1990, Norway set up a sovereign wealth fund—named Government Pension Fund Global (GPFG)—to administer oil revenues. All oil revenues have been transferred to the GPFG since 1996. The GPFG undertakes its investments overseas and therefore limits Dutch Disease concerns. In addition, Norway introduced a fiscal rule in 2001, which helps smooth any fluctuations in fiscal policy that could be induced by oil revenues. It determines that—on average over the cycle—only the expected real return of the GPFG can be spent and additional flexibility can be used if it helps safeguard exposed sectors from symptoms of Dutch Disease. The expected real return was set at 4 percent until 2017, when it was revised to 3 percent. Only spending the expected return of the GPFG has phased in oil revenues gradually into the Norwegian economy and ensures that much of the benefits of oil revenues are preserved for future generations. However, with the GPFG's assets currently amounting to about 300 percent of mainland GDP, the rule now allows for an average fiscal non-oil deficit of 8 percent of mainland GDP.

Norway: Fiscal Institutions



Source: Norges Bank.

Annex IV. Pension Reforms in Norway

1. Norway's pension system is composed of three pillars: (i) a basic pension provided by the National Insurance System; (ii) the occupational pension schemes that provide supplementary pensions (there are separate occupational pension schemes for private workers and for public employees); and (iii) additional and voluntary private pensions savings.

2. The 2011 reform of the National Insurance System and the private occupational pension scheme fostered incentives for lengthening working lives. As life expectancy increases, higher savings are needed. The reform encouraged workers to stay longer at work before retiring to compensate for longer life expectancy. Before the reform, the retirement age was 67 years. The reform introduced the flexibility to retire at any point between age 62 and 75, and replacement rates are adjusted up or down in an actuarily fair manner for earlier or later retirement. Thereby, the scheme incentivizes pensioners to take up work (again) after they begin receiving pensions; therefore, it will be important to safeguard the actuarially-fair nature of the system. The reform also links the pensions to earnings in each year worked and adjusts pensions by life expectancy.

3. In 2018, the authorities and unions agreed to reform the public sector occupational scheme. As the public scheme was not included in the 2011 reform, public employees had less incentives to lengthen their working lives. The agreed reform aligns the public scheme with the private occupational scheme addressing key pending issues of the 2011 reform. While pension expenditures will increase moderately—as the reform provides incentives to stay longer at work in exchange for higher pensions afterwards—the overall reform is expected to also increase fiscal revenues through higher income tax collections as workers stay longer at work. This would be in line with experience from private employees after the 2011 reform.

4. Despite this important progress, reform efforts should continue. The authorities are now planning to advance reform to a special scheme applicable to ⅓ of public employees and allowing for earlier retirement; the scheme covers e.g. police, military, firefighters, prison guards, and health workers. Also, integration of the old-age pension scheme for public employees on disability into the current framework is still pending.

<table>
<tr><th></th><th>Norway</th><th></th></tr>
<tr><td>Foreign asset and liability position and trajectory</td><td>Background. Norway's net international investment and reserve position remains strong. At end 2017, the net international investment position (NIIP) reached 260 percent of mainland GDP which represents an increase of 100 percent of GDP in the last 5 years (¾ explained by transactions and ¼ by valuation effects). The general government is the main external creditor with net external assets of 287 percent of mainland GDP, driven by the Government Pension Fund Global (GPFG), with assets of 303 percent of mainland GDP. The financial sector remains the largest net external debtor given reliance on wholesale funding; its net external liabilities stand at 58 percent of mainland GDP. International reserves have remained stable at a comfortable 19 percent of mainland GDP.

Assessment. The NIIP position is expected to remain stable due to the sound management of the GPFG. The negative revaluation risks are mitigated by GPFG asset diversification and the solid capital position of Norwegian banks.</td><td rowspan="5">Overall Assessment:
The external position of Norway in 2017 was weaker than implied by medium-term fundamentals. The assessment is confirmed by the current account, REER index, and external sustainability approaches. While the current account was weaker due to cost competitiveness challenges, Norway has sizable external buffers with a NIIP of more than 2½ times mainland GDP. As of July 2018, developments do not point to a clear change in the external position.

Potential policy responses:
Norway's external buffers provide significant time to address competitiveness issues. Fiscal and structural policies should aim to foster productivity growth and wage growth more in line with productivity developments across tradable sectors. It is critical to enhance non-oil sector competitiveness as the contribution from oil and gas to GDP starts tapering.</td></tr>
<tr><td>Current account</td><td>Background. The current account surplus bottomed out at 4½ percent of GDP in 2016 after it declined from 13 percent of mainland GDP 2014, as exports plunged in response to lower oil prices. Despite the krone depreciation during 2013-15, non-oil exports have remained flat. While this likely partly reflects supply constraints in some export sectors and low demand for oil-related service and manufacturing exports, it is likely that non-oil tradables face competitiveness challenges due to high labor cost and high taxes. In 2017, the current account recovered marginally as oil prices edged up and it is expected to gradually to converge to 8 percent of GDP over the medium term.

Assessment. The current account is weaker than suggested by the fundamentals and desirable policies. The cyclically-adjusted 2017 CA was 6.1 percent of GDP, while the EBA regression-estimated norm was 12 percent of GDP. This being said, the EBA regression norms do not fully capture some specific features of Norway: in particular, Norway is a significant outlier in the sample in terms of oil production relative to the size of the economy, and its stock of foreign assets also distinguishes it from other countries. Therefore, the cyclically-adjusted current account is presently assessed to be 3–4 percent weaker than implied by medium-term fundamentals and desirable policies. Looser than desirable fiscal policy, as well as above-optimal health spending and credit levels, are contributing 0.8 percentage points to the current account gap. (The latest upward revision of the 2017 current account surplus by 0.4 percentage points of GDP due to higher oil exports could not be reflected in this assessment. But it would likely only slightly reduce the current account gap, because the current account norm would also be expected to increase.)</td></tr>
<tr><td>Real exchange rate</td><td>Background. Norway's real effective exchange rate (REER) appreciated by 0.7 percent in 2017. Norway's exchange rate is highly correlated with oil prices, the main driver of the terms of trade. Following the substantial depreciation of 12.6 percent during 2013–15, the krone has been moderately fluctuating around end-2015 levels as the forecast for oil prices have been broadly stable. Since the last assessment based on June 2017 data, the REERs (both ULC and CPI) are about 2 percent stronger (as of March 2018).

Assessment. Using EBA elasticities, the 3–4 percent of GDP current account gap would imply a real exchange rate overvaluation of 8½–11½ percent, but the recent stickiness of the current account in response to the krone depreciation suggests the EBA elasticity may be overstated. Separately, the real exchange rate index approach suggests that the real exchange is 5 percent stronger than its norm in 2017. The alternative norm using a real exchange level approach points to an undervaluation of 20 percent, but this approach is historically a poor fit for Norway. Based on all of the above, staff assess the real exchange rate to be overvalued relative to fundamentals and desired policies by about 10–15 percent.</td></tr>
<tr><td>Capital and financial accounts: flows and policy measures</td><td>Background. In 2017, FDI and portfolio flows constituted about 1/3 and 2/3, respectively, of the capital and financial account balance. Flows, both outgoing and incoming, are mainly to other Nordic and EU countries. With banks' heavy reliance on wholesale funding—accounting for about half of total banks' funding—and 60 percent of wholesale funding from foreign sources, banks are vulnerable to turbulence in foreign financial markets.

Assessment. Financial account vulnerability is low, but the banking sector's reliance on external wholesale funding is a source of vulnerability.</td></tr>
<tr><td>FX intervention and reserves level</td><td>Background. The krone floats freely and independently against other currencies. While the Norges Bank has not intervened since 1999 to influence the exchange rate, it could intervene if the exchange rates were deemed to deviate substantially from fundamentals. At end 2017, Norges Bank reserves were at 19 percent of mainland GDP (636 percent of imports of goods and services) and the GPFG reached 303 percent the mainland GDP. The GPFG's size has been increasing during the last two decades but is expected to stabilize relative to GDP in the coming years.

Assessment: Reserves are comfortable even considering the exposure of banks to wholesale funding and risks of regional contagious. In 2017, private sector short term external debt reached 14 percent of mainland GDP in 2017 (financial sector: 9 percent and nonfinancial: 5 percent).</td></tr>
</table>

Annex VI. Risk Assessment Matrix [1]

Potential Deviations from Baseline

Source of Risks and Relative Likelihood	Expected Impact if Risk is Realized
Downside Risks	
High **Sharp tightening of global financial conditions.** Tighter financial conditions could be triggered by a sharper-than-expected increase in U.S. interest rates (prompted by higher-than-expected inflation) or the materialization of other risks.	Medium/ High Increasing costs of borrowing and debt servicing could lead to lower spending by highly-leveraged Norwegian households, and hinder corporate investment. Credit availability could become constrained if Norwegian banks experience liquidity stress given their high dependence on wholesale funding. **Policy response:** Relax the countercyclical capital buffer, bring to bear countercyclical monetary and fiscal policy if needed.
Medium **Sizeable downside deviations from baseline energy prices.** Risks to oil prices are broadly balanced, but prices could drop significantly if downside global growth risks materialize or supply exceeds expectations, possibly due to faster-than-expected U.S. shale production growth, or, over the medium term, higher OPEC/Russia production.	High If energy prices were to decrease significantly, this could weigh on the economic recovery through a reduction in demand for oil-related mainland goods and services, as happened in 2014–16. **Policy response:** Allow automatic stabilizers to operate fully. Delay monetary policy normalization and relax fiscal policy in the event of a larger slowdown. Make further progress on labor market and productivity-enhancing reforms, and target any temporary expenditure measures to boost long-term growth potential.
Medium **Widespread and large reduction in house prices,** followed by deleveraging from historically high household debt levels.	Medium Substantial falls in house prices could dampen private consumption, while creating negative spillover effects on banks' balance sheets. **Policy response:** The countercyclical buffer can be reduced and monetary policy eased further to mitigate a possible credit crunch and contain spillovers. Automatic fiscal stabilizers and, if needed, discretionary fiscal policy can also be called upon.
High **Rising protectionism and retreat from multilateralism.** Global imbalances and fraying consensus about the benefits of globalization lead to escalating and sustained trade actions and spreading isolationism.	Low/Medium Higher trade barriers could dampen growth in Norway's trading partners, leading to reduced demand for exports and weaker investment, translating in turn into lower domestic growth. **Policy response:** Re-double efforts to reach new economic cooperation and trade agreements to minimize disruption; make further progress on labor market and productivity-enhancing reforms, and target any temporary expenditure measures to boost long-term growth potential.
Upside Risks	
Medium **Stronger than expected recovery of the Norwegian economy,** amid improving domestic confidence and oil prices. There is a possibility that oil prices could rise further, e.g., if there were steeper-than-anticipated export declines in some producers.	Medium **Policy Response:** Bring forward fiscal policy tightening and interest rate hikes if signs of overheating emerge.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex VII. Debt Sustainability Analysis

Norway Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

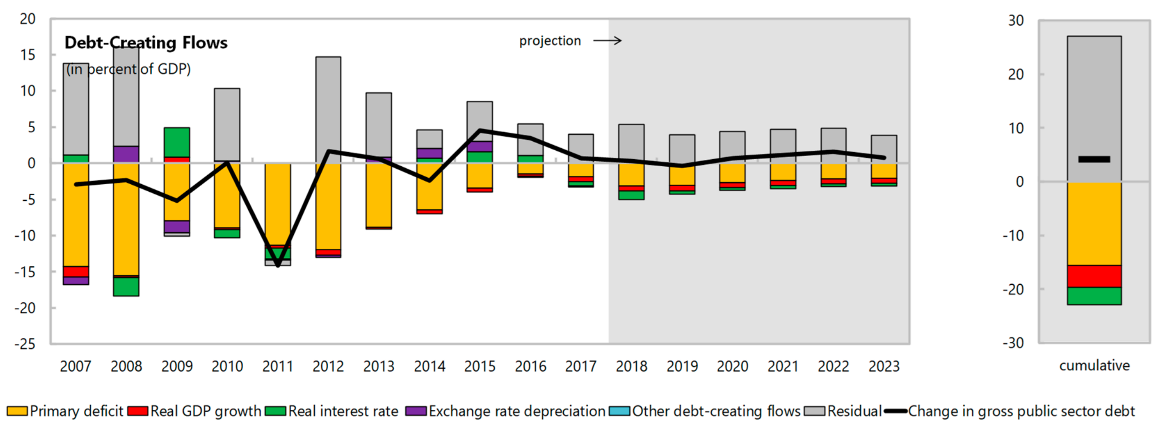
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of June 21, 2018		
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023	Sovereign Spreads		
Nominal gross public debt	36.0	35.3	36.0	36.3	35.9	36.6	37.8	39.4	40.1	EMBIG (bp) 3/		147
Public gross financing needs	-10.0	-2.1	0.7	-3.7	-3.0	-3.5	-3.7	-3.5	-3.0	5Y CDS (bp)		10
Real GDP growth (in percent)	1.2	1.1	1.9	2.1	2.1	1.9	1.9	1.8	1.8	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.7	-1.1	3.8	5.7	2.3	2.0	2.0	2.0	2.0	Moody's	Aaa	Aaa
Nominal GDP growth (in percent)	4.0	0.0	5.8	7.9	4.4	3.9	3.8	3.8	3.8	S&Ps	AAA	AAA
Effective interest rate (in percent) [4/]	3.5	2.2	2.1	2.2	0.9	1.0	0.7	0.8	1.0	Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing
Change in gross public sector debt	-2.2	3.5	0.7	0.3	-0.4	0.7	1.2	1.6	0.7	4.2	primary
Identified debt-creating flows	-9.7	-0.9	-3.3	-5.0	-4.3	-3.7	-3.5	-3.2	-3.1	-22.9	balance [9/]
Primary deficit	-9.9	-1.5	-1.9	-3.1	-3.1	-2.7	-2.4	-2.2	-2.1	-15.5	-1.1
Primary (noninterest) revenue and grants	52.1	50.7	50.4	49.8	49.2	49.5	49.7	49.9	50.2	298.3	
Primary (noninterest) expenditure	42.2	49.3	48.5	46.6	46.1	46.8	47.3	47.8	48.1	282.8	
Automatic debt dynamics [5/]	0.2	0.6	-1.5	-1.9	-1.2	-1.0	-1.1	-1.1	-1.1	-7.3	
Interest rate/growth differential [6/]	-0.1	0.7	-1.2	-1.9	-1.2	-1.0	-1.1	-1.1	-1.1	-7.3	
Of which: real interest rate	0.3	1.1	-0.6	-1.2	-0.5	-0.3	-0.4	-0.4	-0.4	-3.3	
Of which: real GDP growth	-0.4	-0.3	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-4.1	
Exchange rate depreciation [7/]	0.3	-0.1	-0.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (1) (e.g., drawdown of deposits) (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	7.4	4.3	4.0	5.3	3.9	4.4	4.7	4.8	3.9	27.0	

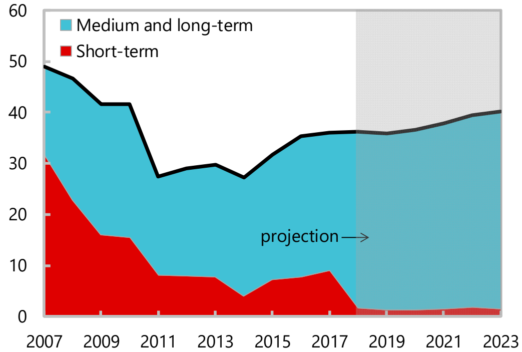


Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.
7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

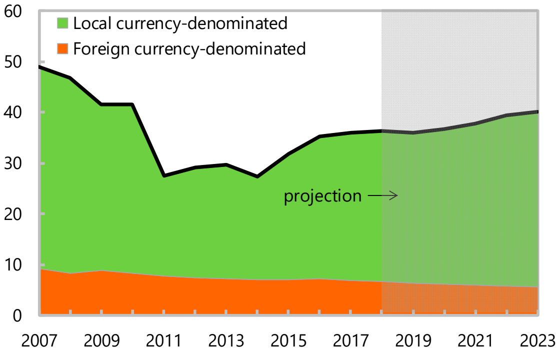
Norway Public DSA – Composition of Public Debt and Alternative Scenarios (concluded)

Composition of Public Debt

By Maturity
(in percent of GDP)



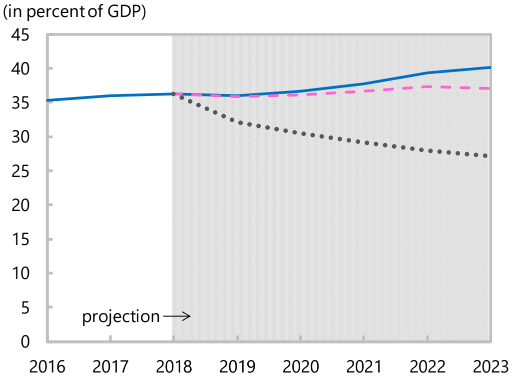
By Currency
(in percent of GDP)



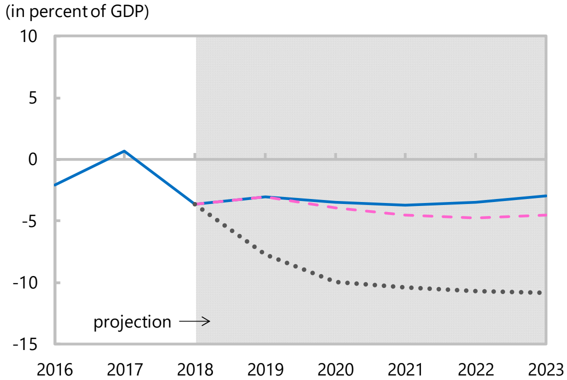
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	2.1	2.1	1.9	1.9	1.8	1.8
Inflation	5.7	2.3	2.0	2.0	2.0	2.0
Primary Balance	3.1	3.1	2.7	2.4	2.2	2.1
Effective interest rate	2.2	0.9	1.0	0.7	0.8	1.0
Constant Primary Balance Scenario						
Real GDP growth	2.1	2.1	1.9	1.9	1.8	1.8
Inflation	5.7	2.3	2.0	2.0	2.0	2.0
Primary Balance	3.1	3.1	3.1	3.1	3.1	3.1
Effective interest rate	2.2	0.9	1.0	0.7	0.8	0.9

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	2.1	1.1	1.1	1.1	1.1	1.1
Inflation	5.7	2.3	2.0	2.0	2.0	2.0
Primary Balance	3.1	7.8	7.8	7.8	7.8	7.8
Effective interest rate	2.2	0.9	1.0	0.6	0.6	0.6

Source: IMF staff.

Annex VIII. Authorities' Response to Past IMF Recommendations

Fund Policy Advice from 2017 Consultation	Authorities' Actions
Fiscal Policy: As growth gathers steam, the fiscal stance should converge to neutral to help contain Dutch Disease effects. Further tax reforms should be considered to promote an efficient allocation of resources and sustain longer term growth.	The 2018 budget set a moderate stimulus of +0.1 percent of GDP to support the recovery. The 2018 budget reduced corporate and personal income taxes to improve the business environment. Also, the wealth tax valuation discount for shares and operating assets was increased to 20 from 10 percent. In addition, amendments were introduced to broaden the tax base.
Macroprudential Policy: 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 (LTV) limits and/or a sectoral CCB, should be biased to being ahead of the curve. 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.	The Ministry of Finance decided in June 2018 to extend the mortgage regulations until end-2019, in virtually unchanged form. The regulations originally took effect on January 1, 2017. Among other measures, the regulation implemented a LTI limit to complement the affordability test and tightened the condition for applying an amortization requirement. CRE risks are being addressed by maintaining banks' capital robust underpinned by general capital requirements. Relatedly, the countercyclical capital buffer was increased to 2 percent from December 31, 2017. Sound lending practices on CRE are underpinned by on-site inspections and granular stress testing. Liquidity coverage ratio requirements in significant currencies were introduced effective September 30, 2017 and set at 100 percent effective December 31, 2017. Stress tests have been enhanced to better account for funding risks.
Structural Reforms: Further reforms to the public-sector pension system and sickness and disability benefits will help promote labor force participation. Wage restraint and labor market reforms should continue to improve cost competitiveness, facilitate economic rebalancing, and support labor supply. Reviving the growth engine in the non-oil sector also hinges on promoting high-quality employment and boosting productivity through reforms to education, innovation, and product market regulations.	The important reform to public-sector pensions has been agreed in June 2018. Its design contains strong incentives for employees to lengthen their working lives. Furthermore, the reform aligns the public pension scheme with its private counterpart that had undergone reform in 2011, thereby ensuring portability of benefits. Social partners remain committed to maintaining moderate wage increases going forward: the nominal wage growth for 2018 has been agreed at 2.8 percent, and the expected growth in the medium-term is 3 percent.

Fund Policy Advice from 2017 Consultation	Authorities' Actions
	Programs to address youth unemployment have been extended. Reforms to the "youth guarantee" program are being rolled out this year, including a plan to guarantee access to ALMPs to young unemployed within 8 weeks after they contact relevant institutions. The government has proposed to amend the Qualification Program (for unemployed and inactive not qualifying for disability and sickness benefits), including by expanding education and training options in the scheme. The government is also working on a nation-wide program to promote inclusion of youth into employment, which is expected to launch in summer 2018. Within the program, the public sector has committed to increase the share of youth and disabled in the public work force to 5 percent. Reforms to the work assessment allowance (an extended incapacity benefit)—including shortening of its maximum duration and stricter requirements for extension of benefits—were passed by the parliament in June 2017 and came into effect in January 2018. Finally, the authorities have established an Employment Committee, tasked with examining the impact of current social security schemes on employment rates, particularly among prime age cohorts. The Committee is expected to publish its first report by the end of 2018.

Annex IX. Status of FSAP Recommendations

Priority Recommendations	Time	Status
Macroprudential Policies and Framework		
Consider additional measures to contain systemic risks arising from the growth of house prices and household indebtedness (e.g., stricter loan-to-value (LTV) ratios, and loan-to-income or debt service ratio to supplement the affordability test)	S	**Mostly done.** In June 2015, the Ministry of Finance adopted a regulation on requirements for residential mortgage loans, which converted FSA guidelines into explicit requirements, effective from 1 July 2015 to end-2016. The requirements were retained in a new regulation from 1 January 2017, which also introduced a debt-to-income limit, tighter down-payment requirements, and a lower "speed limit" for Oslo (the percentage of new mortgages that can deviate from mortgage requirements). The Ministry of Finance extended in June 2018 these regulations until end-2019.
Consider measures to contain risks related to banks' wholesale funding (e.g. limits could be placed on the mismatch between the maturity of currency swaps (and other hedging techniques) and the maturity of the underlying exposures)	S	**Partly done.** LCR regulation was introduced in Norway in 2015, and the phase-in period was completed by the end of 2017. The regulation imposes LCR requirements for all currencies in total (of 100 percent), In addition, LCR requirements for significant currencies have been introduced. Banks and mortgage companies with EUR or USD as significant currencies must have LCR in NOK of at least 50 percent. In addition, a NSFR requirement is expected to be introduced after final EU rules are adopted.
Improve the existing institutional structure for macroprudential policies. This should include more standardized and transparent procedures for giving advice to the MOF; a transparent "comply or explain" approach by decision-makers; and, in due course, greater delegation of decision-making powers over macroprudential instruments to NB or the FSA.	M	**Under consideration.** The Central Bank Law Commission's proposal includes a proposal to establish a committee for monetary policy and financial stability at Norges Bank. The Commission proposes that the committee be assigned responsibility for the use of monetary policy instruments and efforts to promote financial stability, and chaired by the Governor of Norges Bank. The proposal also includes somewhat more independence than today, by for example raising the threshold for when government instructions can be issued to Norges Bank. The proposal has been publicly heard and is now under consideration in the Ministry of Finance.

Priority Recommendations	Time	Status
Stress Tests		
Improve liquidity monitoring by performing liquidity stress tests using the structure of cash flows at various maturities; or applying customized versions of the LCR along the maturity ladder. Consider options to discourage cross-ownership of covered bonds.	M	**Partly done**. The FSA and Norges Bank have set up a joint working group on liquidity stress testing. The set up uses cash flow structures at different maturities and funding gaps are calculated under three different stress scenarios. The work is currently in its final stages. Since September 2016, credit institutions have reported Additional Liquidity Monitoring Metrics (ALMM, CRD IV). The maturity ladder in the ALMM framework was implemented in March 2018.
Enhance the stress test framework for the insurance sector. Allocate more resources to the FSA to assess the liability side risks and validate models and assumptions used in the bottom-up stress tests by insurance companies.	M	**Ongoing.** The Solvency II legislation entered into force on 1 January 2016. Norwegian undertakings participated in the European Insurance and Occupational Pensions Authority (EIOPA) stress-test in 2016. The FSA conducted thematic on-site inspections at the three largest life insurance undertakings during the autumn of 2016, and a further three inspections at medium sized undertakings during March to May 2017. The focus of the inspections was calculation and validation of the technical provisions and the solvency capital requirement. The inspections covered governance, documentation and validation on an overall basis, as well as more detailed issues on methods, assumptions and data used. In 2018, the FSA is conducting a survey that includes all life insurance companies, where the purpose is to compare and challenge the calculated levels of the best estimate of technical provisions.
Achieve recapitalization of weakly capitalized insurance companies in the current environment. Continue to restrict dividend payouts by the companies with weak capital adequacy.	S	**Ongoing.** In a January 2017 letter to all life insurance undertakings the FSA stated that life insurance undertakings should not pay dividends as long as surplus on the insurance policies are used to strengthen reserves according to new requirements (new mortality tables). The letter stated further that where life insurance undertakings have been allowed to use the transitional rule for technical provisions, FSA assumes that the board of insurance undertakings make proper reviews of the need for capital accumulation in the undertaking both in the short and long term.

Priority Recommendations	Time	Status
Stress Tests		
	S	Today, capitalization of life insurance companies is more satisfactory overall, partly due to higher interest rate levels. Nevertheless, the FSA continues to challenge certain companies' target levels for when dividends can be paid.
Micro-supervision		
Enhance the FSA's de jure operational independence, powers (particularly in regard to corrective actions and sanctions), and supervisory resources. Strengthen the FSA's supervision of small banks through conducting comprehensive assessments more frequently.	M	**Unaddressed.**
Upgrade substantially the FSA's supervisory approach towards the AML/CFT issues, including by increasing supervisory activities and providing guidance on the topic.	S	**Ongoing.** The FSA assesses the ML/TF risk in the institutions subject to supervision on a yearly basis. The risk assessment for 2017 formed the basis for the FSA's prioritization of its work against ML/TF in 2017, and in 2018 the risk assessment will form the basis for the prioritization for 2018. In the last year, the FSA has conducted AML/CFT on-site inspections in several institutions, including, banks, insurance and insurance intermediaries, investment firms, real estate agents, auditors and external accountants. AML/CFT is also part of all ordinary on-site inspections. In 2016, the FSA updated the AML/CFT guidance paper from 2009, and published a new guidance paper regarding AML/CFT targeting real estate agents. In 2017, the FSA published guidance papers regarding AML/CFT targeting auditors and external accountants. The private sector has provided input to all the different guidance papers in an effort to ensure a more practical approach. The guidance papers will be updated regularly, including when the new act on ML/TF is set into force. The FSA has in cooperation with the Ministry of Foreign Affairs, the Ministry of Justice and Public Security, the Norwegian Police Security Service, The Norwegian National Authority for

Priority Recommendations	Time	Status
Micro-supervision		
	S	Investigation and Prosecution of Economic and Environmental Crime and the private sector, published a guidance paper regarding terrorist financing and proliferation financing. The guidance paper has a practical approach and includes an appendix with key questions and answers (Q&As). There will be regular updating of the guidance paper (the latest update was in April 2018). The government published a new national risk assessment in September 2017, and the process of updating it is currently underway. The Ministry of Finance sent a draft proposal for a new AML/CFT Act to Parliament in February 2018, which was adopted by Parliament in May 2018. The Act contains new powers for the FSA to react to breaches of key provisions, including powers to impose administrative fines and to ban individuals from holding certain positions in AML/CFT obligated entities.
Financial Market Infrastructure		
Strengthen operational risk management related to outsourcing in systemically important payment systems.	S	**Done.** The risk management framework for the NICS (clearing) system has been improved, and is now fully compliant with the CPMI/IOSCO principles for financial market infrastructures. Organizational changes and plans for some increased resources for the NICS system ownership function have been implemented. A new operational set-up for the NICS system is under preparation. An enhanced contingency solution for the NBO (RTGS) system was implemented in November 2015.
Safety Nets		
The MOF should initiate resolution planning for the largest banks, including assessing impediments to resolvability, and delegate specific responsibilities to the FSA, and define expectations for the Norway-specific elements of the recovery and resolution plans of foreign bank subsidiaries and branches.	S, M	**Ongoing.** In March 2018, the Storting adopted a new legal framework corresponding to the EU's BRRD framework, including rules on resolution planning. Preparations for new requirements on planning etc., which enter into force on 1 January 2019, is well underway. The FSA is designated as the resolution authority in Norway.

Priority Recommendations	Time	Status
Safety Nets		
Enhance the legal framework for resolution to comply with the FSB Key Attributes, in particular with regard to the resolution toolkit, operational independence, legal protection for the resolution authorities and administration boards, establishing earlier triggers for resolution, cross-border resolutions, and the distinction between going concern and gone concern resolution.	S	**Done.** As all essential elements of the BRRD have been implemented, the Norwegian legal framework will comply with the FSB Key Attributes.
The BGF should adopt policies specifying under what conditions board members must recuse themselves, considering actual and prospective conflicts of interest.	S	**Done.** The BGF has adopted new policies specifying the following circumstances under which board members must recuse themselves: 1) When there is a possibility that a company the board member has an interest in would bid on a problem bank or part of its assets; 2) When there is a possibility that the whole bank in which the board member has an interest, or parts of its assets or its deposit portfolio, may be sold. The board members must consider whether to recuse themselves based on these criteria before a meeting where support from the BGF will be discussed. When the problem situation is over, the board shall review how the recusal was handled. The policies are available on the BGF's website. (http://www.bankenessikringsfond.no/no/Hoved/Om-oss/Styre/ in Norwegian only.) Further, at the time of entry into force of the legislation corresponding to the BRRD, the board of the BGF will be appointed by the MoF rather that elected by the member banks.

INTERNATIONAL MONETARY FUND

NORWAY

July 24, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared by European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of May 31, 2018)

Membership Status

Joined: December 27, 1945; Article VIII

General Resources Account

	SDR Millions	Percent Quota
Quota	3,754.70	100.00
Fund holdings of currency	3,510.19	93.49
Reserves tranche position	244.53	6.51
Lending to the Fund		
New Arrangements to Borrow	208.44	

SDR Department	**SDR Millions**	**Percent Allocation**
Net cumulative allocations	1,563.07	100.00
Holdings	1,493.33	95.54

Outstanding Purchases and Loans

None

Latest Financial Arrangements

None

Projected Payments to the Fund

(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2018	2019	2020	2021	2022
Principal					
Charges/Interest	0.33	0.68	0.68	0.68	0.68
Total	0.33	0.68	0.68	0.68	0.68

Implementation of HIPC Initiative

Not applicable

Implementation of Multilateral Debt Relief Initiative

Not applicable

Implementation of Catastrophe Containment and Relief (CCR)

Not applicable

Exchange Arrangements

The de jure and de facto exchange rate arrangements in Norway are classified as freely floating. The exchange system is free of restrictions on the making of payments and transfers for current international transactions other than restrictions notified to the Fund in accordance with Decision No. 144–(52/51).

Article IV Consultation

Norway is on the 12-month consultation cycle.

FSAP Participation

A review under the Financial Sector Assessment Program (FSAP) was completed in 2015.

Technical Assistance

None

Resident Representative

None

STATISTICAL ISSUES

(As of June 30, 2018)

I. Assessment of Data Adequacy for Surveillance	
General: Data provision is adequate for surveillance.	
National Accounts: Breakdowns for oil-related parts of the mainland economy and other traditional sectors would be useful, in light of growing needs to better understand the impact of oil and gas activity on the mainland economy. Ability to monitoring the economy also would be enhanced by better data on commercial real estate markets, including as banks' exposures in this area are considerable. The authorities are continuing to make progress in these areas.	
II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since 1996. Uses SDDS flexibility options on the timeliness of the general government operations and central government debt. SDSS metadata are posted on the Dissemination Standard Bulletin Board (DSBB).	Data ROSC completed in 2003 is publicly available.

Norway: Table of Common Indicators Required for Surveillance

(As of June 30, 2018)

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8] Data Quality – Methodological soundness[9]	Memo Items:[8] Data Quality – Accuracy and reliability[10]
Exchange Rates	30/06/18	30/06/18	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/18	06/18	M	M	M		
Reserve/Base Money	05/18	06/18	M	M	M	O, O, O, LO	O, O, O, O, O
Broad Money	05/18	06/18	M	M	M		
Central Bank Balance Sheet	05/18	06/18	M	M	M		
Consolidated Balance Sheet of the Banking System	05/18	06/18	M	M	M		
Interest Rates[2]	05/18	06/18	M	M	M		
Consumer Price Index	05/18	06/18	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2017	2018	A	A	A	LO, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	05/18	06/18	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1 2018	06/18	Q	Q	Q		
External Current Account Balance	Q1 2018	05/18	Q	Q	Q	O, O, O, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	Q1 2018	05/18	Q	Q	Q		
GDP/GNP	Q1 2018	05/18	Q	Q	Q	O, O, O, O	O, O, O, O, LO
Gross External Debt	Q1 2018	06/18	Q	Q	Q		
International Investment Position[6]	Q1 2018	06/18	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.
[9] This reflects the assessment provided in the data ROSC or the Substantive Update (published on July 15, 2003, and based on the findings of the mission that took place during November 11–26, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[10] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Kimmo Tapani Virolainen, Alternate Executive Director for Norway and Tove Katrine Sand, Senior Advisor to Executive Director
September 12, 2018

On behalf of the Norwegian authorities, we would like to thank staff for candid discussions and an insightful report on the Norwegian economy. We attach great importance to IMF's assessments of our economy. Your reports help us gain an outside perspective and challenge us to identify shortcomings and to evaluate economic policies.

Growth is strong and employment increasing

The Norwegian economy has recovered from the downturn induced by the 2014 drop in the oil price and is now characterized by optimism and solid growth. The labor market continues to improve. We see a continued decline in unemployment, and the employment rate is now rising and is expected to continue trending upwards over the next couple of years.

The Norwegian government forecasts growth in the mainland economy (excl. oil, gas and shipping) to outpace trend already this year and increase further next year. Higher purchasing power is supporting consumption growth. Solid growth abroad and improved cost competitiveness pave the way for a rise in business investment and a recovery in exports.

Petroleum investment is likely to increase over the next couple of years, following a sharp decline after the oil price fall. Higher oil prices and major cost-reducing measures implemented by the oil companies have made this increase possible. Over the next years, investment in this sector may boost mainland? growth more than projected. In the medium term, the challenge of managing a smooth transition to a less oil-dependent growth model remains, as petroleum production and related activities will eventually decrease.

House prices are again rising and financial stability remains at the fore

After several years of rapid growth, house prices fell in 2017. In the first half of 2018, house prices have risen again and are now slightly above the peak level from last year. The price growth has been particularly strong in Oslo, while other cities have experienced a more moderate growth.

A steady build-up of household debt, associated with the continued rise in house prices, increases household vulnerability and poses a risk to financial stability and economic growth. On average, Norwegian households hold a debt that is more than twice the size of their disposable yearly income. This high debt burden makes households vulnerable to changes in income, interest rates and house prices.

The government has a broad policy approach to address housing market issues and has recently presented a revision of its housing market strategy, that emphasizes supply side efficiency, consumer protection, and a sustainable development in household debt.

The authorities put strong emphasis on containing risks and vulnerabilities in the financial sector. As noted in the staff report, Norwegian banks' balance sheets are strong, profits are solid and loan losses are low. Banks comfortably meet strict capital, leverage, and liquidity requirements. As a result, banks' shock absorption capacity is high, and has improved significantly over the last years.

In June this year, the Ministry of Finance extended the mortgage regulations, retaining the previous regulation's requirements, including the caps on loan-to-value and total debt. Like the previous regulations, it is set to expire after 18 months. The government has not identified a need for further regional differentiation, beyond the requirements specific to Oslo. Should risks intensify or change character, the authorities stand ready to amend the regulation and other macroprudential measures accordingly. The authorities agree with staff that the mortgage regulations have been effective, resulting in tighter lending practices and lower issuance of high-risk mortgages.

A gradual rise in the key policy rate lies ahead

On March 2, 2018, the Norwegian government laid down a new regulation on monetary policy. The operational target of the monetary policy is now an annual consumer price inflation of close to 2 percent over time. The new regulation explicitly states that inflation targeting shall be forward-looking, contribute to high and stable output and employment and counteract the build-up of financial imbalances. It also underpins the flexible approach to inflation targeting and is consistent with how monetary policy has been conducted. Thus, the new inflation target will not result in significant changes in Norges Bank's conduct of monetary policy.

Following the sharp fall in oil prices in 2014, Norges Bank cut the key policy rate to historically low levels. For more than two years, the key policy rate has remained unchanged at 0.5 percent. During this period, monetary policy has facilitated the needed restructuring in the Norwegian economy. The economic outlook is now favorable. Underlying inflation is below the inflation target, but the driving forces indicate that it will rise.

According to Norges Bank's assessment of the outlook in June, the policy rate will most likely be raised in September 2018. However, there is uncertainty surrounding the effects of higher interest rates, with the household sector vulnerable to increases in interest rates due to high debt burden. This suggests proceeding with great caution in interest rate setting. Increases in the key policy rate will therefore be conducted gradually.

Fiscal policy is returning to neutral as the recovery gains traction

After having buttressed the setback since 2014, the fiscal policy stance is now broadly neutral, as growth again is solid and unemployment low. Spending of petroleum revenues corresponds to 2.7 percent of the Government Pension Fund Global (GPFG), which is well in line with our fiscal rule of spending 3 percent of the Fund over time.

The Norwegian fiscal framework is designed to handle our petroleum wealth. The petroleum income fluctuates strongly and will run out in the long run. All petroleum revenues are transferred into the Government Pension Fund Global, and, over time, spending is guided by the estimated real return of the fund. The framework ensures a sustainable management of resource revenues, while at the same time providing flexibility to handle temporary setbacks in the economy or fluctuations in the oil price. Now that growth in the non-oil economy is solid and unemployment low, it is necessary for fiscal policy to ease off for two reasons: First, to avoid overheating and hampering a healthy recovery. And second, to be better prepared to handle future shocks and, in the long run, costs associated with an aging population.

Tax policy is geared to increasing the growth potential of the economy

We are now in the final stage of implementing the 2016 tax reform. As part of the reform, the corporate income tax rate was reduced from 27 to 23 percent, a level closer to our neighboring countries. The reform also includes important measures to curb base erosion and profit shifting. In addition, the overall marginal tax rate on personal income was reduced, making it more attractive to work.

The staff report calls for enhancing R&D tax incentives. The Norwegian R&D tax subsidy scheme, called Skattefunn, has in recent years been made more generous. A recent independent evaluation of the scheme shows that Skattefunn significantly stimulates private R&D investment. Certain adjustments to the scheme to better target subsidies and avoid misuse of the scheme were pointed out. The government is now assessing the report.

Ensuring a sustainable development in public finances will require several measures

Petroleum income will not shelter Norway from fiscal challenges in the decades to come. Age related expenditures are projected to increase significantly, while transfers from the Fund to the budget will stabilize over the next decades and, measured against the economy, decline over the long run. The government has pointed out two main strategies in order to secure sufficient spending on welfare without increasing the level of taxation: Expanding labor participation and improving value for money in the public sector.

To expand labor participation, part-time workers may increase their labor supply, while groups outside the labor market could be mobilized. In particular, immigrants from low-income countries often struggle to get foothold in the labor market, as do groups with reduced employability. The share of people receiving sick leave and disability benefits in Norway is also high, suggesting there is a potential for increasing labor supply.

A lower share of the working age population is employed now than ten years ago. This poses a concern, as high employment participation is a prerequisite for a sustainable welfare state. The government promotes policies that increase employment and takes several initiatives to include more people in the labor market. A public commission is due to present its first report next year about ways to increase labor participation.

Expanding labor participation has also been an important goal for the pension reform since 2011. This spring, the government reached an agreement with the social partners on a pension reform in the public sector with similar work incentives for lengthening working lives as in the private sector. Better work incentives counteract the decrease in employment due to ageing.

Ongoing work on the pension system includes abolishing or reforming the scheme of early retirement for specific groups of public employees within the police, ambulance service, military and fire service, and to make the collectively bargained pension scheme ("AFP") in the private sector financially more solid.

The authorities are pursuing several regulatory processes with a view to ensuring efficient management of pension assets until these become payable, whilst at the same time attending to the main consideration behind the regulation of pension providers, the safeguarding of future pensions.

An efficient public sector is also crucial to handle future ageing costs. As noted in the report, the government has taken several initiatives to improve efficiency and service delivery. Increasing value for money in governmental institutions requires broad and continuous efforts. The government introduced the Deregulation and Efficiency Reform in 2015 as a permanent part of the annual budget process. The reform provides a reminder and gives incentives for ministries and central government agencies to introduce and maintain measures to increase productivity. The reform also increases the annual fiscal space for new initiatives by collecting an efficiency dividend of 0.5 percent on all governmental institutions' current spending in the annual fiscal budget.

The government has also adopted a more systematic approach to public expenditure reviews as a method for initiating larger reforms and efficiency efforts. Efforts will aim to modernize public organizations and identify obsolete spending items. Nevertheless, we acknowledge that budget consolidation will encompass increasingly difficult choices.

Rising protectionism internationally puts strain on the economic outlook

The Norwegian economy relies heavily on open and well-functioning international markets. As a small economy with a narrow resource base, Norway has, for centuries, experienced the gains from access to foreign markets. In combination, improved access to imports and rising demand for exports has lifted our income and standard of living. We have seen how exposure to global competition has triggered a transition of the economy towards more productive activities.

Tendencies towards rising protectionism around the world may cause considerable headwinds over the medium term. Rising trade tensions would weigh on global growth and represent a threat to the global rules-based order. To prevent a self-inflicted wound on the Norwegian economy and avoid adding pressure on the multilateral trading system, we find no economic rationale for raising national trade barriers.