INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/159

NORWAY

June 2019

2019 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 2019 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 June 10, 2019 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 June 10, 2019, following discussions that ended on May 6, 2019, 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 May 24, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Norway.

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INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 19/210
FOR IMMEDIATE RELEASE
June 12, 2019

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2019 Article IV Consultation with Norway

On June 10, 2019, the Executive Board of the International Monetary Fund (IMF) concluded its 2019 Article IV consultation[1] with Norway.

Norway's economic momentum remains strong, supported by higher oil prices, competitiveness gains stemming from the weaker krone, and a robust labor market. After growing by 2.2 percent in 2018, mainland economic activity is expected to accelerate further and rise by about 2.5 percent this year, before growth slows to 2.1 percent in 2020.

Risks to this outlook are broadly balanced. Global trade tensions persist, as does uncertainty about European growth. On the domestic side, risks from residential house price growth have abated, but not disappeared, while valuations in commercial real estate (CRE) prices are growing strongly and appear stretched in some segments. On the upside, resilient oil prices could lead to stronger-than-expected oil-related investment and exports.

The 2019 budget deficit is likely to be mildly expansionary, following the better-than-expected outturn (and related small contraction) last year. Overall, the structural non-oil deficit is expected to be broadly unchanged over the 2017–19 period. This contrasts with the previous upswing, during which the non-oil deficit grew fast in tandem with the sovereign wealth fund and related space under the fiscal rule. The tax reform continues to shift taxation away from direct taxes toward less-distortionary indirect taxes.

With both headline and core inflation now above target, Norges Bank has started its process of normalizing policy. The main policy rate has been raised by 50 basis points since August last year and is now at 1 percent. The central bank's forward guidance suggests further rate hikes ahead.

Banks remain liquid, profitable, and well-capitalized. A new anti-money laundering, financing of terrorism law approved in parliament gives the Financial Supervisory Authority greater sanctioning powers against breaches by supervised banks.

[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.

An expert commission has recently issued proposals for reforming sickness and disability schemes, within a broader remit on how to raise employment levels. The social partners will convene to discuss the commission's proposals.

Executive Board Assessment[2]

Executive Directors welcomed Norway's solid economic performance, supported by stronger terms of trade, competitiveness gains, and a robust labor market. Despite the positive near-term outlook, Directors noted that Norway faces a challenging external environment, as well as longer-term headwinds from demographic pressures and a declining contribution from oil to the economy. They encouraged the authorities to use the current favorable environment to implement further reforms, which will be important to sustaining prosperity, managing transition to a less oil dependent economy, and increasing productivity.

Directors commended the broadly neutral fiscal policy in recent years and welcomed the move away from the earlier pro-cyclical fiscal policy stance. They encouraged the authorities to target a modest consolidation next year to minimize risks of overheating, be consistent with the ongoing monetary policy normalization, and help build additional buffers to respond to future shocks.

Directors noted that spending pressures from worsening demographics together with slower growth of the sovereign wealth fund would reduce space under the fiscal rule in the medium-term, requiring expenditure savings or new sources of revenue to accommodate new policy initiatives. They welcomed the authorities' strategies to address these issues and encouraged measures to make the tax system more efficient, in particular, lowering tax incentives on housing and broadening the VAT base. They also highlighted the importance of reforming the sickness and disability schemes. Directors noted that these measures may have to be offset with well targeted transfers, to protect the most vulnerable.

Directors supported the ongoing normalization of monetary policy as it strikes the right balance between containing inflation and minimizing risks of a self-induced slowdown. They noted that faster tightening would also risk appreciating the krone, compounding downward pressures on inflation. Directors advised the authorities to stand ready to adjust the pace of normalization if circumstances require.

Directors noted that despite recent slowdown in credit growth, household debt continues to rise. In this context, they encouraged the authorities to exercise caution against loosening mortgage regulations when these are reviewed at end 2019, barring unexpected changes in the second half of the year. Directors also noted that commercial real estate valuations (CRE) appear stretched in some segments and pose increasing risks. While monetary policy normalization should help restrain price growth in the sector, they supported the planned increase in the counter-cyclical

[2] 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.

buffer to increase resilience to CRE risks. Directors encouraged the authorities to close existing data gaps on CRE.

Directors underscored that full compliance with the new AML/CFT framework is paramount given the regional context. They welcomed the broadening of the FSA’s sanctioning powers under the new law, as well as the increase in budgetary resources for supervision of AML/CFT compliance.

Noting the challenges arising from population aging and dwindling oil and gas reserves, Directors called for enhancing both labor supply and overall competitiveness. They considered reform of sickness and disability benefits as the most pressing labor market reform. Directors underscored that priority should be given to tighten eligibility and improve incentives to work as well as to better education and training of beneficiaries and other measures to boost their employment opportunities. They underscored the need to carefully weigh the distributional consequences of these reforms. Continued wage restraint is also needed to underpin competitiveness.

Norway: Selected Economic and Social Indicators, 2016–2020

Population (2018): 5.3 million

Per capita GDP (2018): US$ 81,848 | Quota (3754.7 mil. SDR/0.78 percent of total)

Main products and exports: Oil, natural gas, fish (primarily salmon) | Literacy: 100 percent

				Projections	
	2018	2019	2020	2021	2022
Real economy (change in percent)					
Real GDP 1/	1.2	2.0	1.4	2.2	1.8
Real mainland GDP	1.1	2.0	2.2	2.5	2.1
Domestic demand	2.0	2.6	2.0	2.4	1.8
Unemployment rate (percent of labor force)	4.7	4.2	3.9	3.7	3.7
Output gap (mainland economy, -implies output below potential)	-0.9	-0.6	-0.2	0.5	0.7
CPI (average)	3.6	1.9	2.8	2.3	1.7
Core inflation	3.1	1.4	1.5	1.9	1.9
Gross national saving (percent of GDP)	32.7	33.8	35.7	35.7	35.6
Gross domestic investment (percent of GDP)	28.7	28.2	27.6	28.3	28.6
Public finance					
Central government					
Non-oil balance (percent of mainland GDP) 2/	-7.7	-8.0	-7.5	-7.5	-7.0
Structural non-oil balance (percent of trend mainland GDP) 3/	-7.4	-7.6	-7.2	-7.7	-7.7
Fiscal impulse	7.4	0.2	-0.4	0.5	0.0
in percent of Government Pension Fund Global 4/	-2.7	-2.9	-2.5	-2.9	-2.7
General government (percent of mainland GDP)					
Overall balance	4.6	5.8	8.8	9.0	9.9
Net financial assets	326.1	350.9	329.4	346.1	348.4
of which: capital of Government Pension Fund Global (GPF-G)	276.8	303.2	283.5	302.6	306.5
Money and credit (end of period, 12-month percent change)					
Broad money, M2	5.1	6.0	5.3	…	…
Domestic credit, C2	4.6	6.4	4.8	…	…
Interest rates (year average, in percent)					
Three-month interbank rate	1.1	0.9	1.1	1.6	2.1
Ten-year government bond yield	1.3	1.6	1.9	2.1	2.6
Balance of payments (percent of mainland GDP)					
Current account balance	4.6	6.7	9.8	8.8	8.4
Current account balance (percent of GDP)	4.0	5.6	8.1	7.4	7.1
Exports of goods and services (volume change in percent)	1.1	-0.2	-0.8	2.4	2.8
Imports of goods and services (volume change in percent)	3.3	1.6	0.9	2.9	2.7
Terms of trade (change in percent)	-9.9	4.9	1.1	0.8	-0.9
International reserves (end of period, in billions of US dollars)	60.9	65.1	63.8	63.6	62.4
Crude Oil Price	42.8	52.8	68.3	59.2	59.0
Fund position					
Holdings of currency (percent of quota)	93.9	93.5	88.0	…	…
Holdings of SDR (percent of allocation)	88.3	102.7	97.9	…	…
Quota (SDR millions)	3,755	3,755	3,755	…	…
Exchange rates (end of period)					
Exchange rate regime	Floating				
Bilateral rate (NOK/USD), end-of-period	8.4	8.3	8.1	…	…
Real effective rate (2010=100)	86.6	87.4	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 the authorities' revised budget; excludes all oil-related revenues and expenditures.

3/ The authorities' key fiscal policy variable; excludes oil-related revenue and expenditure, GPFG income, as well as cyclical effects. Non-oil GDP trend estimated by MOF.

4/ Over-the-cycle deficit target: 3 percent of Government Pension Fund Global

INTERNATIONAL MONETARY FUND

NORWAY

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

May 24, 2019

KEY ISSUES

- **Context:** While many advanced economies are experiencing slower growth, Norway's output has continued to expand strongly, helped by a robust labor market, positive terms of trade, and some competitiveness gains. Core inflation has picked up to close to 2¼ percent. Residential house price growth has softened significantly but prices remain overvalued, and household debt continues to rise. Commercial real estate risks are also intensifying and combine with mounting external risks to cloud the outlook. The Christian Democrats have recently joined Prime Minister Solberg's governing coalition, which now enjoys a majority in parliament.

- **Fiscal policy:** Strong cyclical growth justifies targeting a modest ¼–½ percent of GDP structural consolidation in the 2020 budget. The longer-term adjustment needs could be secured via a combination of VAT base broadening and reform of sickness and disability benefits.

- **Monetary policy:** Norges Bank's recent rate increases and associated decision to slightly steepen its interest rate trajectory are appropriate, given the outlook for inflation and growth.

- **Financial sector policies:** Despite the recent stabilization of house prices, it is too early to loosen macro-prudential measures given remaining overvaluation and still rising household leverage. The increase in the countercyclical buffer is appropriate in light of mounting risks from commercial real estate valuations. Full compliance with the recently improved AML/CFT legal framework will be paramount.

- **Structural policies:** Reform of sickness and disability benefits could prove the most important measure to boost employment. Continued wage restraint will be important to secure recent competitiveness gains.

- **Contingency policies:** Should downside risks materialize, there is policy space to mitigate any downturn.

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

Discussions took place in Oslo from April 25 to May 6. The staff team was comprised of J. Miniane (head), F. Misch, V. Pillonca and Y. Zhang, supported by R. Jarin, N. Kumar, N. Romanova, L. Yang and H. Zhang from headquarters (all EUR). S. Evjen (OED) joined the discussions.

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ANNEXES

CONTEXT

1. **Sustaining economic prosperity will require a continued commitment to good policies, as well as using these good times to tackle longer term challenges.** The economy has enjoyed a solid recovery from the oil downturn and has been growing above potential for two consecutive years (Figure 1). Current indicators suggest that growth in 2019 might in fact be stronger than last year. This being said, inflation is now slightly above target, house prices remain overvalued (though they are now growing at a much more sustainable pace), and household leverage is still rising. Commercial real estate valuations also appear stretched in some segments.[1] The current context thus highlights the need to avoid complacency that would contribute to a further buildup of imbalances. Moreover, the upturn provides an opportunity to tackle long-term challenges in the following areas:

- ***Long term fiscal savings:*** Without further adjustment, high non-oil deficits mean that the nation's large savings may prove insufficient to cover future spending obligations from an aging population.[2] And while, from a solvency perspective, Norway can afford to spread the adjustment over decades, a continued commitment to the fiscal rule will require adjustment sooner. This is because age-related spending will outpace transfers from the sovereign wealth fund,[3] putting increasing pressure on the annual budget outturn despite a still-healthy asset position.

- ***Labor force participation:*** Population aging will put the onus on sustaining labor supply. Despite high participation rates by international standards, labor market distortions remain. In particular, the use of sickness and disability benefits is much higher in Norway than in other Nordic peers; a particular concern is the growing share of young people (particularly males) in these schemes, which risks trapping them out of the labor force for decades.

- ***Competitiveness:*** The looming decline in oil and gas production is a reminder of the need to further diversify the economy. The sustained depreciation of the currency post-2014 has helped boost non-oil sector competitiveness, but there is growing consensus in society that the gains realized so far are insufficient.

RECENT DEVELOPMENTS

2. **The Norwegian economy has been resilient, despite slower growth in many advanced economies.** Mainland growth reached 2.2 percent in 2018 despite a weak Q3[4], up from 2 percent in 2017. Coincident indicators suggest that the economy is growing at about 2½–2¾ percent in the

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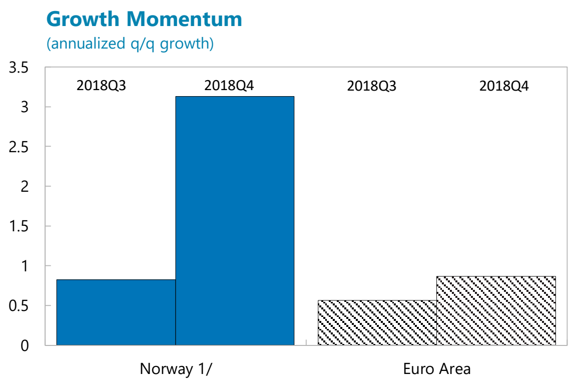
[1] All these issues are addressed in more detail later on.

[2] See 2018 Norway Staff Report.

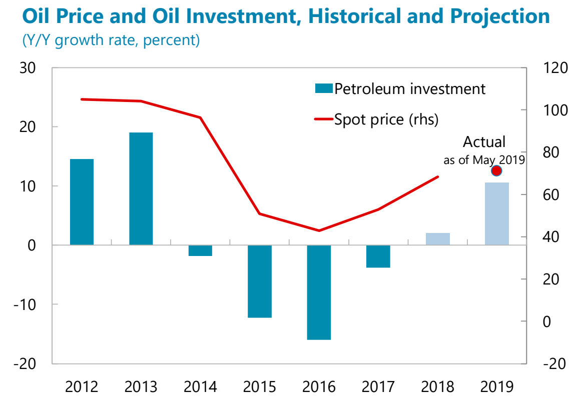
[3] Declining oil and gas revenues (as a share of GDP) will put a lid on how fast the sovereign wealth fund can grow.

[4] Due to a weather-related fall in agricultural production.

first half of 2019. Growth has been broad-based, supported by a solid labor market (¶3), improving competitiveness (¶5), and still-accommodative monetary policy. Stronger oil prices also contributed to a recovery in the oil sector, aided by a noticeable decline in the break-even price for exploration and extraction.

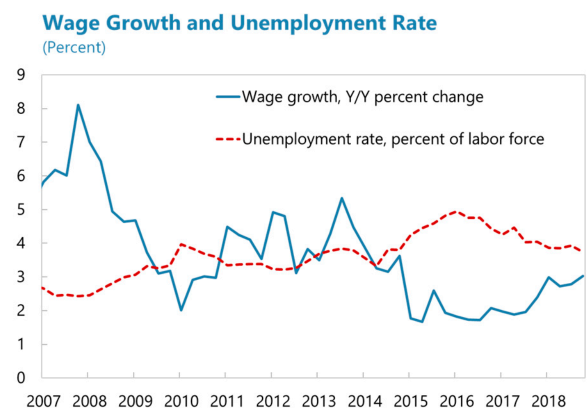


Sources: Haver, Statistics Norway, IMF Staff Calculations
1/ Mainland GDP



Sources: Norges Bank; and IMF staff calculations.

3. The labor market continues to improve (Figure 2). The seasonally-adjusted Labor Force Survey unemployment rate is trending down from its mid-2016 peak of around 5 percent to 3.8 percent now, as employment continues to grow strongly at around 2 percent. The employment rate has also picked up despite a negative impulse from population aging, not least thanks to the recent pension reform[5]. Wage growth, which was still reeling from the overhang of the 2014 oil shock, has now started to trend up (Annex II).



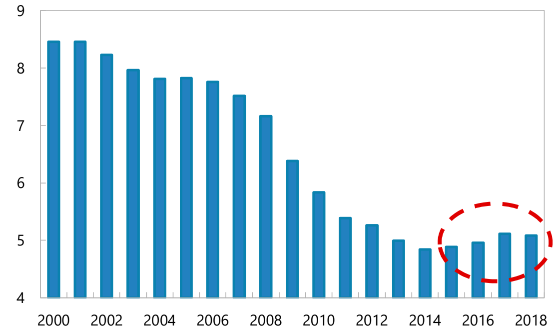
Sources: Haver, IMF Staff calculations.

4. Inflation has risen above target, but it is now moderating (Figure 3). Headline inflation has been materially above the 2-percent target for more than a year, not least due to pass-through from the weak krone and a pickup in foreign producer prices (Annex VI). At the same time, headline also came under pressure because of strong weather-related hikes in electricity prices whose impulse is now waning. Core inflation was weak until mid-2018 but has now picked up, reflecting rising capacity constraints. As a result, the central bank has begun normalizing policy, raising rates by a cumulative 50bps since August last year.

[5] The government and unions agreed on the reform in early 2018, to better align the public and private occupational pension schemes. The latest reform is expected to foster labor mobility between public and private sectors and support labor participation among older public sector employees–an effect already observed among private employees after the private occupational pension reform in 2011.

5. Norway's external position has strengthened (Figure 4). The current account surplus surged last year to 8.8 percent of mainland GDP, from under 7 percent in 2017, in good part thanks to the continued recovery in the terms of trade. Despite this improvement in relative prices, the NEER and REER[6] have not appreciated as they tended to do in the past whenever oil prices increased. The ULC-based REER remains well below its 2014 peak, leading to a welcome, albeit modest, revival in non-oil exports. Consistent with the above, staff assess the current account surplus to be between 2 and 3 percentage points of GDP weaker than implied by fundamentals and desirable policies (versus 3 to 4 percentage points last year), and the REER to be between 5 to 10 percent stronger (versus 10 to 15 percent last year).[7]

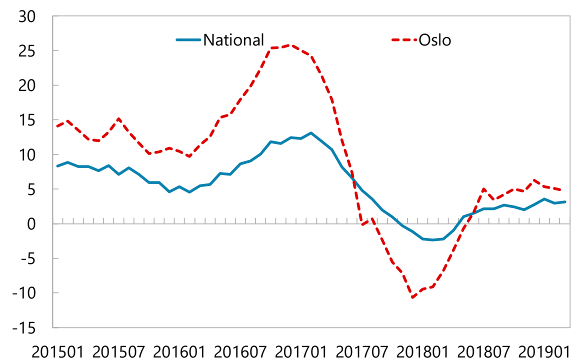
Norway: Non-Oil related Manufacturing Gross Value Added
(Percent of mainland gross value-added, 3-year moving average)



Sources: Statistics Norway; and IMF stuff calculations.

6. House price growth has softened significantly (Figure 7). House prices are now rising at a much more sustainable pace of around 2.5 percent, compared to over 10 percent y/y during the boom. Oslo's house price growth has also slowed significantly from over 20 percent at the peak to around 5 percent y/y in recent months. The slowdown reflects a combination of factors, mainly rising supply, the tightening of macro-prudential regulations in early 2017, and the ongoing monetary policy normalization.

House Price Growth
(nominal, in percent, y/y)



Sources: Haver, IMF Staff Calculations

7. The traction of Fund advice remains good (Annexes IX and X). Most Fund recommendations from the 2018 and earlier Article IV consultations as well as from the 2015 Financial System Stability Assessment (FSSA) have been implemented. Notably, since the last Article IV consultation, fiscal policy has remained tighter than in previous upswings, and a new AML/CFT Act has been passed that addresses many of the identified shortcomings in the previous framework. An expert commission has recently proposed changes to improve employment levels including via reform of sickness and disability schemes, a longstanding Fund recommendation.

[6] There are two relatively more compelling explanations – rising risk premium and Norwegian Krone remaining stronger than equilibrium despite recent depreciation.

[7] See Annex I.

OUTLOOK AND RISKS

8. Norway's near-term outlook is positive. The recent upturn is expected to continue into 2020. Barring any large swings in commodity prices, oil investment should remain strong with positive spillovers to mainland industries. Forecasts for investment by the global oil industry, to which Norway exports both manufacturing and services, are also positive. Housing investment is also recovering after its softness in 2017/18. Ongoing employment growth, together with negotiated wage growth of 3.2 percent in manufacturing[8] should support household incomes and consumption. Staff project mainland GDP growth of 2.5 percent in 2019, before easing to 2.1 percent in 2020. This would bring the output gap, which is currently at around zero, into positive territory later in the year (Table 1). Inflation is also expected to come down despite the rising output gap as the impulse from electricity and the pass-through from a weaker krone wane.

9. Overall risks are balanced. Global trade tensions and uncertainty over European growth persist. Separately, global market turbulence and higher risk premia could raise debt service costs, curbing consumption among highly-indebted households. Domestically, commercial real estate (CRE) prices are also growing strongly and bear watching, not least due to the banks' exposure to CRE.[9] On the upside, oil has been materially above the WEO baseline underpinning staff's forecasts and could lead to stronger-than-projected investment and oil-related exports. The recent decline in house price growth and related overvaluation has also lowered risks of an abrupt price reversal.

10. Boosting growth in the medium-term hinges on increasing labor force participation and productivity. Working age population growth continues to trend down due to aging. In parallel, trend labor productivity has only partially recovered from its post-crisis trough, as in other countries. Absent reforms, medium-term mainland growth is estimated at 1.8 percent, slightly lower than in the past (Table 2).[10]

Underlying Drivers of Potential Growth
(In percent)

Sources: Eurostat and IMF staff calculations.

Authorities' Views

11. The authorities broadly shared staff's views on the outlook and risks. They expect growth to accelerate in 2019 to around 2.4–2.7 percent depending on the institution. They agree on the individual risks and also see them as balanced overall. On the external sector assessment, the authorities concur that the large post-2014 depreciation was in good part driven by permanent changes in fundamentals, but they do not necessarily share the assessment that the real exchange rate is overvalued. They emphasized that the muted response of non-oil exports to the depreciation owes to some degree to capacity constraints. Notably, fisheries' output is constrained by the

[8] This is the wage-leading sector in the collective bargaining system.

[9] See below and Annex VIII for more details.

[10] This is because projections for population/labor force growth have been revised down.

number of licenses granted, and recent investments in the aluminum sector are only now coming on stream. There is no disagreement that potential output growth is set to decline gradually going forward barring reforms: enhancing both labor supply and productivity is at the center of the governing coalition's platform.

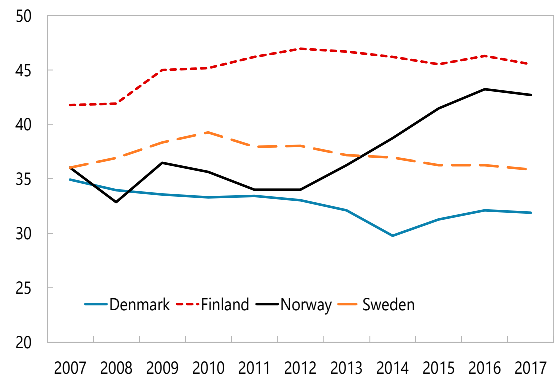
POLICY DISCUSSIONS

A. Fiscal Policy

12. Fiscal policy has been broadly neutral over the last three years, a marked improvement relative to the procyclicality of policy in previous upswings. The 2019 deficit target implies an impulse of about ½ percent of GDP, following a negative impulse of 0.4 percent last year.[11] As a result, the structural non-oil deficit is expected to remain broadly unchanged over 2017–19. This contrasts markedly with the previous upswing, during which the non-oil deficit increased because space under the fiscal rule was increasing. In addition, the ongoing tax reform has made the system more growth-friendly by shifting the burden from direct to less distortionary indirect taxation, for example through lowering personal and corporate income tax rates and broadening the VAT base.

Share of Goods and Service Tax in Overall Tax Revenue

(Percent, total excl. social contributions)

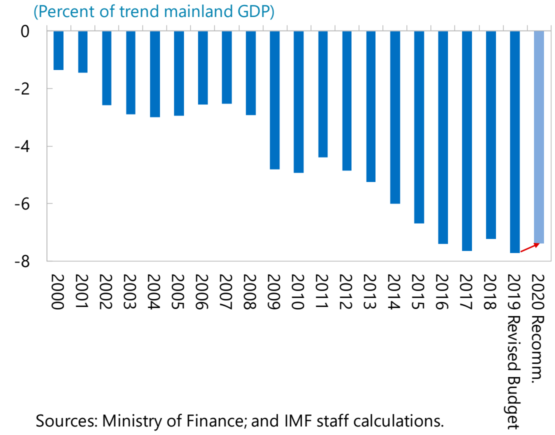


Sources: OECD; and IMF staff calculations.

13. This being said, the authorities should go beyond a neutral stance and target some consolidation next year. With growth projected to be above potential in 2019 and 2020 and the output gap turning positive, the authorities should target a ¼ to ½ percent of GDP structural consolidation in the 2020 budget. This would have various benefits: (i) it would help contain aggregate demand and thus minimize any risks of overheating; (ii) it would be consistent with and supportive of the ongoing monetary policy normalization; and (iii) it would help rebuild fiscal space for the next cyclical downturn.[12]

Structural Non-oil Balance

(Percent of trend mainland GDP)



Sources: Ministry of Finance; and IMF staff calculations.

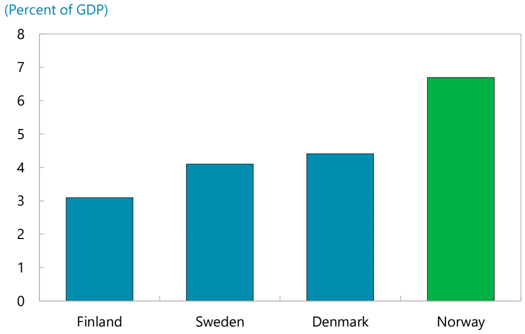
[11] The positive impulse this year is a direct consequence of the better-than-expected outturn last year, as the authorities were targeting a zero impulse in both the 2018 and 2019 budgets.

[12] See below section on contingent policies.

14. Going forward, Norway will face fiscal challenges to which it has not been accustomed. Past staff analysis showed that, although Norway's public sector has a static net worth in excess of 350 percent of GDP[13], the combination of increasing demographic pressures, dwindling oil and gas reserves, and already high non-oil deficits will eventually push the intertemporal net worth into negative territory.[14] From a strict solvency perspective, Norway can afford to spread the needed adjustment (estimated at 4–5 percent of GDP in total) over many decades. However, space under the fiscal rule will shrink in the coming years, as the size of the oil fund grows more slowly and automatic age-related spending rises. This means that Norway's budget will soon face increasingly hard choices, which will require finding new sources of revenues or savings to accommodate new spending initiatives. Adjustment could focus on the following:[15]

- ***Reform of the sickness and disability benefit scheme***[16], while aimed primarily at increasing employment levels, would also have a positive budgetary impact. Spending on sickness and disability benefits is higher than in other Nordic countries, where benefits are already generous by advanced economy standards.

General Government Expenditure on Sickness and Disability
(Percent of GDP)



Source: Eurostat.

- ***Broadening the VAT base***.[17] The efficiency of the VAT system is undermined by a range of exemptions and multiple rates. While some of these exemptions and lower rates are motivated by social objectives, the VAT system is a blunt and inefficient instrument to redistribute incomes, and better-targeted and more sophisticated tools are available. Calculations show that improved VAT efficiency through base broadening could yield an additional 1½ percent of GDP in annual revenue.

- ***Improving housing-related taxation.*** It is important to further lessen generous tax incentives for home ownership and household leverage[18], by further reducing the valuation discount on houses for the net wealth tax and reducing or ideally eliminating the mortgage interest deduction.

The distributional consequences of the measures proposed above should be assessed; any negative impact on vulnerable households could be offset with better-targeted measures.

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[13] The static net worth captures the public 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. Cabezon and Henn (2018), IMF Working Paper.

[14] Unlike other Nordic countries, demographic pressures in Norway are only starting to increase. Notably, health care and pension expenditures are expected to grow by about 1 percent of mainland GDP every decade, while tax collections from the working population are set to decline.

[15] See Annex IV.

[16] See Annex V.

[17] See Annex IV.

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

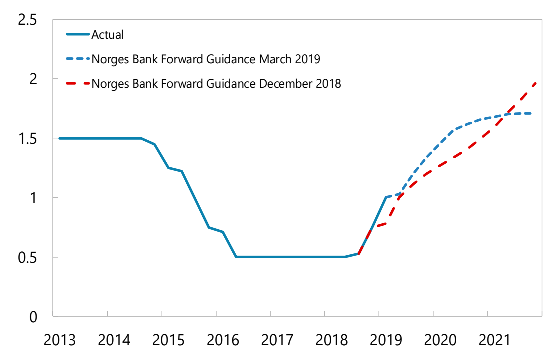
Authorities' Views

15. The authorities agree with staff's views, although they emphasized political constraints weighing against some of the recommendations. They noted that policy had been significantly less pro-cyclical than in the previous upswing, adding that spending itself is growing significantly more slowly than in the past. They acknowledged the case for a tight fiscal stance next year, but they pointed to political difficulties in achieving consolidation when there is still room for deficits to increase under the fiscal rule. They fully agree that Norway's budget will face increasing pressures in the years to come. The authorities see strong merit in reforming sickness and disability benefits, mainly because of its positive effect on labor supply. They appreciated staff's comparative analysis of the VAT system, and see merit in considering further steps to harmonize VAT rates, though with limits given sensitivities around VAT on items such as food. Their estimates also show positive payoffs from VAT reform, though not as large as staff's. Finally, the authorities emphasized their strategic focus on improving the use of public resources. To this end, they have introduced spending reviews as a tool to achieve more efficient resource use and more effective policy instruments.

B. Monetary Policy

16. Monetary policy has been tightened at a moderate pace since last September. The Norges Bank raised the key policy rate by 25 basis points in last September and again in March. The policy rate is now at 1 percent, thus negative in real terms. With the real neutral rate between 0 to 1 percent[19], the monetary stance remains accommodative.

Key Monetary Policy Rate
(Percent)



Source: Norges Bank.

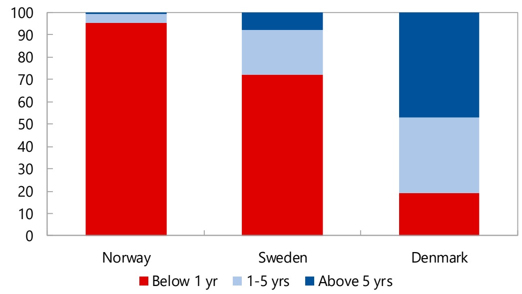
17. The tightening as per the latest forward guidance is appropriate given the current outlook. The central bank now forecasts higher interest rates relative to the forward guidance given last December, at least for the period up to end-2020[20]. Both the tightening and the steepening are appropriate, given that headline inflation is above target, that core inflation now provides a more acceptable floor on headline, and that strong GDP, employment, and wage growth are projected into next year.

[19] Monetary Policy Report 2018:Q2.

[20] Norges Bank justifies the flattening at the tail end of the projection period by invoking lower growth and more gradual interest rate increases among trading partners.

18. Conversely, faster tightening does not seem warranted. Inflation expectations remain well anchored, as shown by the inflation forecast agreed upon by social partners during the wage negotiations.[21] In addition, given that more than 95 percent of mortgages have variable rates with short lock-in periods[22], household consumption in Norway is very sensitive to interest rate changes. Thus, there is a not-inconsiderable risk of overdoing the tightening and precipitating a self-induced slowdown, or finding that the tightening needs to be reversed if other downside risks materialize. Finally, tightening faster at a time when other central banks are pausing their own tightening cycles would widen interest rate differentials and lead to unwanted exchange rate apreciation, with rapid pass-through to inflation.

New Mortgage Loans by Interest Lock-in Period
(Percent of total during Jan - Sep 2018)



Sources: Finanstilsynet, Statistics Sweden, and Statistics Denmark.

19. Digitization has had a significant impact on Norway's payments system. Cash usage has been gradually falling and has now reached levels that are very low in international comparison. At the same time, the number of Vipps users, an innovative mobile phone-based payment system primarily used for person-to-person transfers, has dramatically increased over the last few years. Staff welcomes Norges Bank's ongoing and sophisticated evaluation of the merits and risks of issuing central bank digital currency in response to the decline in cash usage. The report on phase II of this evaluation should be issued in late spring.

20. The new draft central bank act has clear merits. In particular, it codifies into law the independence that the central bank has enjoyed in practice, thereby providing additional safeguards.

Authorities' Views

21. The authorities agree with staff's assessment. In particular, they believe that a too-rapid tightening could stifle the upturn and induce exchange rate appreciation, putting excessive downward pressure on inflation. At the same time, they noted that the inflation targeting framework is flexible, thereby allowing for inflation to be above target for some time. With respect to digitalization, they emphasized that they are still evaluating potential costs and benefits of introducing a CBDC. These evaluations will continue for some time further, and there are currently no specific plans to introduce CBDC.

[21] This forecast shows inflation declining to 2.1 percent in Q4.

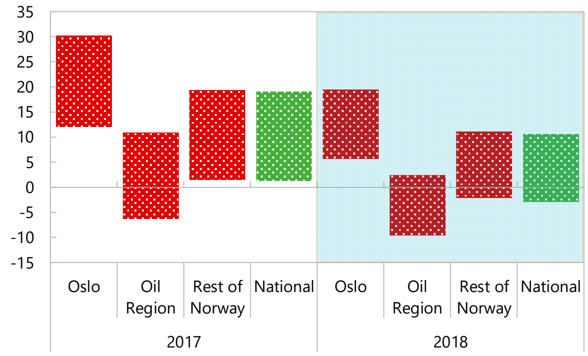
[22] This appears to reflect cultural preferences rather than any market distortions.

C. Financial Sector Policies[23]

22. Norway confronts substantial financial sector vulnerabilities (Figure 6):

- ***House prices remain overvalued, albeit less so than last year, and household debt continues to rise from an already elevated level*** *(Figure 8)*. The house price moderation discussed earlier has improved housing affordability and correspondingly lowered the risks of a price crash. Nevertheless, house prices remain above fundamentals per staff estimates (0–10 percent at the national level and 5–20 percent in Oslo). Moreover, household indebtedness continues to increase from already high levels, leaving households vulnerable to sharp interest rate rises. Besides mortgages, the rapid growth of consumer credit also warrants close watch, even if it starts from a small base.

Housing Market Overvaluation, Regional
(in percent)



Sources: Haver, Statistics Norway, IMF Staff Calculation

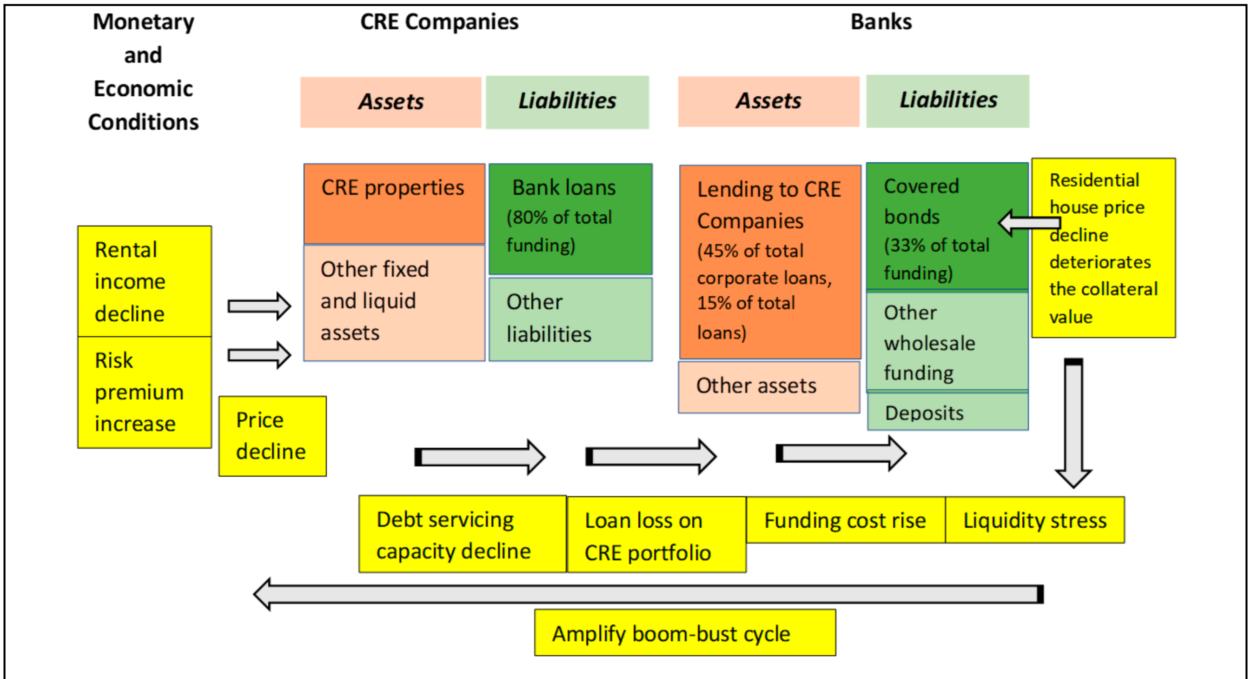
- ***Risks from commercial real estate are rising*** (Annex VII). Commercial real estate prices have increased by about 60 percent since 2000 in real terms, and more than twice that in prime Oslo. Although yields in Norway are not especially low, Oslo's prime market has the lowest yield compression among major European cities[24]. Banks have substantial exposure to CRE loans[25] which account for 15 percent of banks' loan portfolio (23 percent of GDP), higher than peer countries.

- ***Banks' strong reliance on wholesale funding and substantial cross-holding of covered bonds remains a long-standing vulnerability*** (Figure 6). About half of banks' funding still comes from the market, of which more than half is from foreign sources. And while increasing reliance on covered bonds has helped diversify sources and lengthen maturities, these bonds are typically collateralized with mortgages, linking housing with bank liquidity. Banks' cross-holdings of covered bonds are also rising.

[23] The forthcoming FSAP planned to coincide with the 2020 Article IV consultation will delve into these issues.

[24] Norges Bank's Monetary Policy Report (2018 December).

[25] Both real estate management and development.



Sources: Norges Bank, Statistics Norway, and IMF Staff Calculation

23. **Banks hold significant capital and liquidity buffers against these risks.** They comfortably meet the capital requirements[26], with average common equity tier 1 (CET1) of 15.7 percent (2018:Q3). Average leverage ratios across banks have also increased to above 8 percent, with all institutions meeting the leverage requirements.[27] The FSA has recently proposed reclassifying six large regional banks as systemic, which would lead to higher requirements for them; no decision has been taken yet. Banks' liquidity position is also strong, with the aggregate LCR at 140 percent and the net stable funding ratio at 115 percent, exceeding both requirements by ample margins. Recent stress tests by the FSA show that it would take a very large shock (one exceeding that of the 1990s banking crisis) and coordinated across various asset classes (residential, CRE, equity) to significantly dent the capital position of banks, and with no bank coming close to reaching negative capital.

24. **The current prudential toolkit to mitigate financial stability risks is quite comprehensive and should not be loosened at this stage.**

- ***Residential housing:*** The current mortgage regulations, renewed last year, consist of both capital and borrower-based measures such as maximum LTV and DTI ratios, and are well-targeted to areas with higher risks such as Oslo.[28] Together, they have contributed to containing

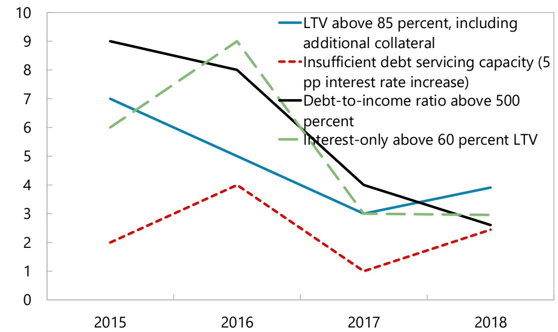
[26] Tier 1 capital requirements include a 4.5 percent minimum requirement, 2.5 percent conservation buffer, 2 percent countercyclical buffer, 3 percent systemic buffer, 2 percent buffer for SIBs, and a 1.5 percent additional Tier 1 buffer. The countercyclical buffer will be increased to 2.5 percent from end-2019.

[27] Three percent minimum Basel requirement, plus buffer of 2 percent for normal banks, and 3 percent for SIBs. Banks with total assets corresponding to at least 10 percent of mainland GDP, or a market share of at least 5 percent of the credit market, shall be regarded as SIBs.

[28] For instance, the share of mortgages that is allowed to deviate from one or more regulation (the so-called speed limit) is 8 percent in Oslo, vs. 10 percent nationally.

the incidence of risky mortgages, not least in the capital. Given that prices are still overvalued, and that household debt continues to rise, the regulations should be extended as is when reviewed at year-end, barring large unexpected developments in the coming months. The tighter limits for Oslo should be preserved. As recommended in previous years, the mortgage regulations could also be made permanent; the parameters could then be adjusted as needed over the financial cycle.

High Risk Mortgages
(in share of total loans outstanding)



Sources: Finanstilsynet

- ***Consumer credit:*** A new, more stringent regulation on prudent consumer lending practices was introduced in February and took effect in May. Moreover, banks with consumer lending as their core business are subject to a higher fee from the deposit guarantee fund and additional capital requirements. Following these measures, consumer credit growth has slowed noticeably since 2018. The licensing process for new debt information service providers (including debt registries) was completed in June 2018. The service providers should become operational this summer.

- ***Commercial real estate:*** Prudential measures on CRE have been bank-based, including higher risk weights (100 percent) and Pillar II capital add-ons for banks with concentrated exposures. The increase in the countercyclical buffer from 2 to 2.5 percent at year-end, partly as a response to rising CRE risks, is welcome. Beyond prudential measures, monetary policy normalization should help dampen rapid price growth in the sector by boosting yields. Finally, the authorities should step up efforts to collect and disseminate comprehensive CRE data for better monitoring of risks.

25. In the context of recent allegations of money laundering in several Nordic banks, a solid de-facto and de-jure Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) framework is paramount. Parliament has recently approved a new AML/CFT law that remedies some of the previously-identified shortcomings in the legal framework and grants sanction powers to the FSA, broadening its toolkit. It is also timely that the FSA has received higher budgetary resources to step up supervision of AML/CFT compliance. Going forward, ongoing efforts to close remaining gaps in the AML/CFT framework, as well as to strengthen regional cooperation on AML/CFT issues, are welcome.

Authorities' Views

26. The authorities agreed with staff on the need to mitigate any further build-up of vulnerabilities in the household sector and contain risks from CRE exposure. They concur with staff that the regulations have been effective in containing risks from residential real estate. Some agencies such as the FSA would prefer that speed limits be unified at the lower Oslo level, to avoid micro-managing the market. On CRE, risks are well-acknowledged, and have contributed to the increase in the countercyclical buffer and led to a strong supervisory focus on banks' risk management practices. A strongly capitalized banking sector more generally is a priority for the authorities. The authorities noted that certain features of the CRE market, such as the heterogeneity and complexity of borrowers, greater difficulties in objectively assessing valuations, etc. make it more challenging to operationalize borrower-side measures for CRE compared to residential real estate. Further, the authorities noted that a stronger statistical basis for the CRE market would be beneficial. Separately, there are no plans to further reduce the tax incentives on housing. Regarding AML/CFT, the authorities' priority focus is on ensuring banks' full compliance with the new law and enhancing international cooperation notably with regional peers.

D. Contingent Demand Policies

27. Should downside risks materialize, there is policy space to respond. Specifically:

- ***Exchange rate and monetary policy:*** The floating krone has historically served as the first line of defense. If more is needed, Norges Bank has some room to cut rates. In the event of a sharp downturn, quantitative easing, which has not been used so far, could be considered.

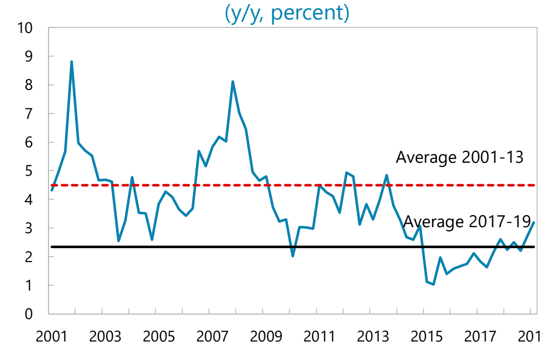
- ***Fiscal policy:*** Currently, Norway has room to expand the non-oil deficit by about 1 percent of GDP and still be within the 3 percent fiscal rule limit, which at any rate only applies *on average over the cycle*. This would provide space for automatic stabilizers to operate fully, and for some discretionary stimulus if needed. On the negative side, fiscal space under the rule is smaller than before the previous downturn, both because the rule was tightened in 2017 and because non-oil deficits have risen in the meantime.[29]

- ***Other policies:*** Should bank credit suffer in a downturn, regulators could release the counter-cyclical capital buffer. Macro-prudential policies could also be loosened if house prices were to fall enough to change the balance of financial stability risks.

E. Structural Policies

28. Ensuring durable longer-term growth requires a continued rebalancing of the economy away from oil and gas. Responsible management of oil revenues has allowed Norway to diversify its economy to a considerable extent. However, the fact that oil and gas production are projected to start declining in the coming years is a stark reminder of the task at hand. The weak krone is gradually helping competitiveness in non-oil and gas sectors. Beyond the weak krone, restraint in wage settlements will be important to sustain recent gains. The social partners have again demonstrated their commitment to

Wage Growth
(y/y, percent)



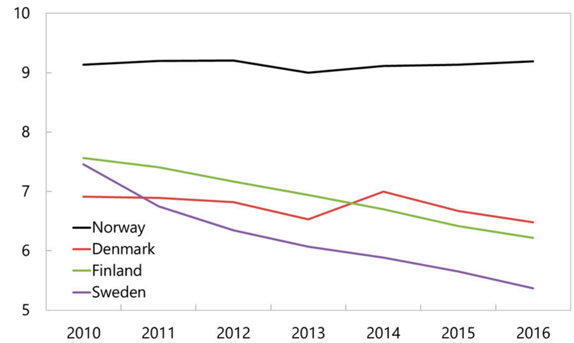
Sources: Statistics Norway and IMF staff calculations

[29] Also, as suggested in ¶13, space will shrink further over time, highlighting why consolidation now is important.

moderate but fair wage increases in this year's bargaining round, settling nominal wage growth to around 3.1–3.2 percent. It will be important to preserve this sense of shared responsibility.

29. To sustain high employment levels in the face of population aging, reform of sickness and disability benefits is a key priority.[30] More than 9 percent of the working age population receives permanent disability pensions, and still more are on temporary disability. This is much higher than in Nordic peers. There is also an increasing number of young beneficiaries, many of whom are at risk of remaining trapped in the system and out of the labor force over the long term as they will lack on-the-job experience. A government-appointed commission has made recommendations to reform these schemes, which will now be discussed by the social partners. In line with reforms carried out in peer countries, a suitable reform package would ideally consist of a combination of measures aimed at achieving three key elements: (i) tightening eligibility criteria and certification procedures; (ii) enhancing education and retraining programs for beneficiaries, in particular those with more limited employment opportunities; and (iii) reducing benefit levels, which are high compared to peer countries, especially for the young (who often earn more through the benefits than through work). As was emphasized by the expert commission, less educated people are more likely to be on sickness and disability benefits, hence the distributional consequences of any reform will have to be carefully weighed.

Recipients of Permanent Disability Benefits
(Percent of working age population)



Sources: Eurostat; and IMF staff calculations.

30. The integration of other vulnerable groups into the labor force could also be deepened. Beyond mobilizing the young trapped in the sickness and disability benefit system, better alignment of education with demand for skills in the private sector, and better coordination of follow-up to limit high dropout rates from vocational training could also help reverse decreasing employment rates among young cohorts. In addition, efforts to increase employment rates among non-OECD immigrants and refugees should continue. Norway scores relatively highly on the integration of these groups into the labor market among international peers. Nevertheless, the planned standardization of the curriculum under the Integration Program is likely to further enhance its effectiveness, as will efforts to make duration more flexible depending on individual circumstances.

31. Boosting productivity is important but difficult. Norway scores highly in terms of its business environment, the labor market has given proof that it can strike a good balance between efficiency, stability, and equity, and there do not appear to be stifling product market regulations/protections as in other European countries.[31] Hence, there is no obvious "low hanging fruit" to boost productivity growth. The authorities have upped tax incentives for R&D and

[30] See Annex V.

[31] High tariffs and domestic subsidies on agriculture are an important exception. But the sector is small relative to GDP, and deep-seated opposition to reform in this area ought to be acknowledged.

innovation; firms' R&D spending has increased in tandem, although it is difficult to establish a causal link. Similarly, the recent reform of higher education, which will lead to a consolidation of tertiary institutions, could deliver on its intended goal of increasing research quality and building closer links between research institutions and industry. Finally, given the significant size of the state-owned enterprise sector, the ongoing reassessment of the rationale for state ownership—particularly for companies with purely commercial objectives—is welcome.

Stakeholders' Views

32. The authorities consider reforms to increase employment levels a priority. Overall, they agree with the concerns raised by staff's assessment of the sickness and disability pension system and also emphasized by the government-appointed expert commission on employment. In particular, they see important long-term gains from unlocking labor from the schemes, especially the young who could be trapped permanently. However, they will wait for the outcome of the discussions between employer associations and labor unions on the findings of the commission before considering major steps for reforms. In addition, they continue to see broad social consensus for more moderate wage growth going forward.

33. Labor unions disagree with staff's assessment on sickness and disability. In their view, eligibility is not too lax, benefits are not too high, and disincentives to work are not material. They see the large number of recipients as evidence of disguised unemployment, a symptom that the economy is not generating enough jobs for people with lower skills and education. As such, priority should be given to generating greater employment opportunities for them through training, wage subsidies, and more jobs in the public sector. They are also concerned about the differential impact of reducing benefit levels on blue- and white-collar workers because the latter are able to work part time from home, helping them to more easily offset any loss in income from reduced benefits. Finally, labor unions expressed concern about the future of the collective bargaining system because non-unionized workers now account for a large share of net employment growth in various sectors.

34. The Confederation of Norwegian Enterprises opposes any reform of sickness and disability benefits that would result in higher costs for their members. It broadly supports the current system of sickness benefits where the state covers the full costs after around two weeks of absence at no costs to the employer. They continue to appreciate the constructive relationship with labor unions as seen during the 2019 wage round.

STAFF APPRAISAL

35. Norway's economic momentum remains strong with balanced risks around the outlook. The terms of trade recovery and associated pick up in oil investment, competitiveness gains from the weaker krone, and a robust labor market explain why mainland growth is projected to accelerate to 2.5 percent in 2019 from 2.2 percent last year, before slowing to a still positive 2.1 percent in 2020. This outlook is clouded by rising external risks as well as mounting concerns over CRE valuations in some market segments. Against these downside risks, oil investment could surprise on the upside given higher-than-projected oil prices. Risks from residential real estate have also abated relative to last year.

36. The economy faces longer term challenges. With the oil contribution to growth projected to fall, the economy will have to rely more and more on other sectors. Competitiveness has improved somewhat but there is more to go. The external position is assessed to be weaker than implied by medium-term fundamentals and desirable policies. Moreover, the working-age population has been growing more slowly given the aging demographics, and productivity remains disappointing.

37. Fiscal policy should target a modest consolidation next year given the strong cyclical upturn. The broadly neutral stance over 2017–19 has been an improvement in comparison to the growing non-oil deficits during the previous economic upswing. However, a small consolidation in 2020 will help contain aggregate demand and minimize any risks of overheating; be consistent with the ongoing monetary policy normalization; and help build additional fiscal space for the next downturn.

38. Norway will gradually face mounting fiscal challenges. Despite large current assets, a permanent fiscal adjustment of 4–5 percent of GDP will be needed to secure intertemporal solvency. And while from a pure solvency perspective Norway can afford to spread this adjustment over decades, space under the fiscal rule will narrow much sooner. This will require finding new sources of revenue or expenditure savings over the coming decade to accommodate any new spending initiatives. This could be achieved through a combination of VAT base broadening (with targeted transfers to compensate the most vulnerable households), reform of sickness and disability schemes, and lower tax incentives on housing.

39. Further monetary tightening as per the latest forward guidance is appropriate given the inflation outlook. The planned pace of normalization charts the right course between containing inflation on the one hand and minimizing risks of a self-induced slowdown on the other. Tightening faster than announced when other central banks are pausing their cycles would also risk appreciating the krone, which would compound downward pressures on inflation.

40. Despite some cooling in house prices, financial sector risks continue. House prices remain overvalued albeit less than last year, and household debt is still rising from elevated levels. Thus, barring large unexpected changes in the coming months, mortgage regulations should not be loosened when reviewed at end-2019. Moreover, these regulations could be made permanent instead of simply extended; parameters can always be adjusted as needed over the financial cycle. Action is also needed to reduce tax incentives for home ownership, which—despite reductions—remain generous by international standards. In addition to residential real estate, risks from commercial real estate (CRE) are mounting. In this context, the increase in the counter-cyclical buffer at end-2019 is welcome, while monetary policy normalization should also help dampen price growth in the sector. Existing data gaps on CRE should be remedied for a better assessment of risks in the sector.

41. Full compliance with the recently improved AML/CFT framework is paramount in light of events elsewhere in the region. The new AML/CFT law grants sanction powers to the FSA, a welcome broadening of its toolkit. The FSA has also received higher budgetary resources to step up supervision of AML/CFT compliance. Going forward, we welcome ongoing efforts to close the remaining gaps in the AML/CFT framework and to strengthen regional collaboration on AML/CFT issues.

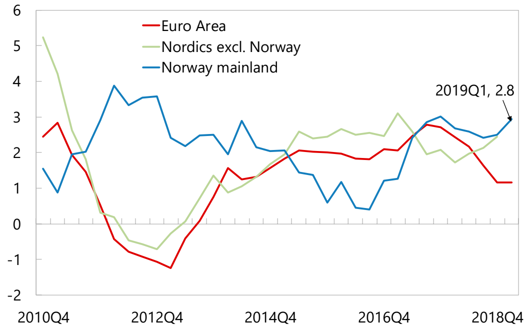
42. Sustaining prosperity will require greater gains in competitiveness, as well as tackling challenges from declining labor supply and productivity. In addition to the weak krone, wage moderation as seen in recent years will be important, underpinned by trust among social partners. Reform of the sickness and disability benefit system is, by far, the most pressing labor market reform pending. In line with successful reforms of these systems in peer countries, this will require tightening eligibility and improving incentives to work, but also higher training of beneficiaries and other measures to boost their employment opportunities. As the expert commission has emphasized, the less educated are disproportionately represented in these schemes, hence the distributional consequences of any reform will have to be carefully weighted. Other reforms to better integrate the young and non-OECD immigrants into the labor force are also needed; recent changes to the integration program for the latter go in the right direction.

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

Figure 1. Norway: GDP and Activity Indicators

Growth remains solid…

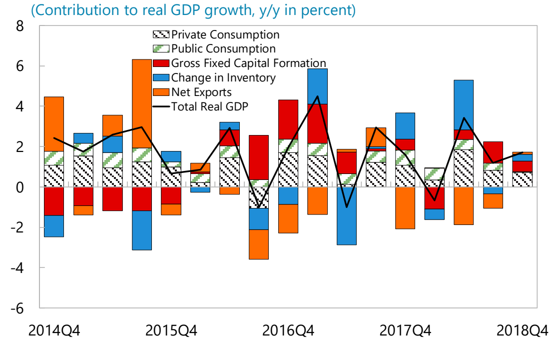
GDP Growth
(Percent, yoy)



Sources: Haver Analytics; and IMF staff calculations.

… supported by robust domestic demand.

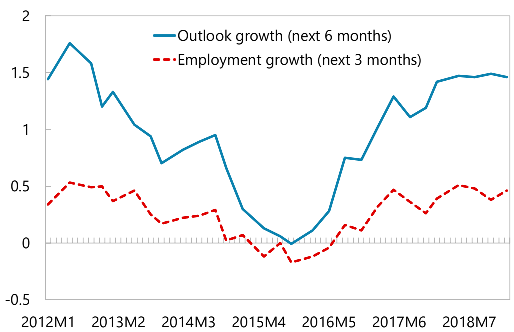
Growth Decomposition (Total Economy)
(Contribution to real GDP growth, y/y in percent)



Source: Statistics Norway, IMF Staff Caculations.

The Regional Network Survey points to strong growth ahead…

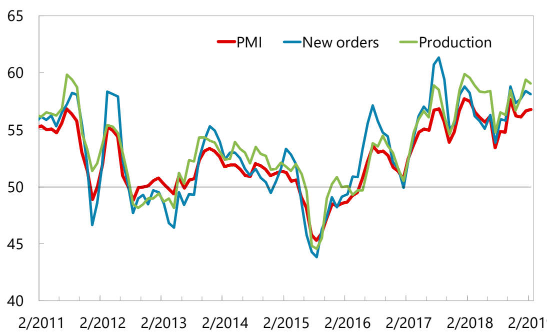
Survey-based Near Term Outlook
(Index)



Source: Regional Network Survey.

…as do the various PMIs…

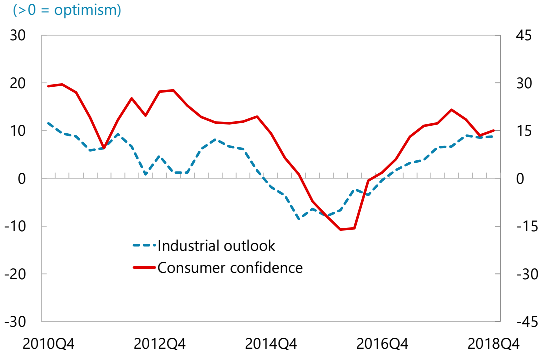
Purchasing Manager Index
(50+ = expansion, 3-moving average, sa)



Sources: Danske Bank; and IMF staff calculations.

…and business and consumer confidence.

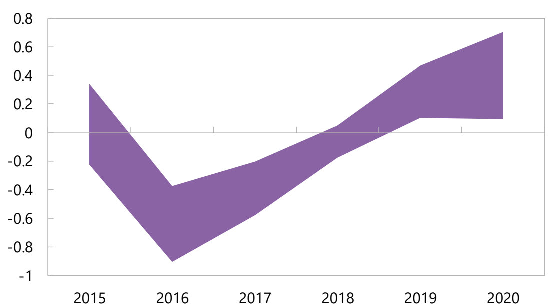
Business and Consumer Sentiment
(>0 = optimism)



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

The output gap will turn positive this year.

Estimate of Output Gap 1/
(Percent)

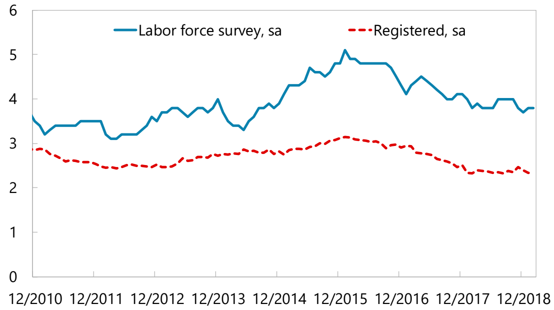


1/ Shaded area shows the range calculated based on Production Function, Borio et al (2013), and IMF RES models.
Sources: Statistics Norway, and IMF staff calculations.

Figure 2. Norway: Labor Market Developments

The unemployment rate continues to fall,

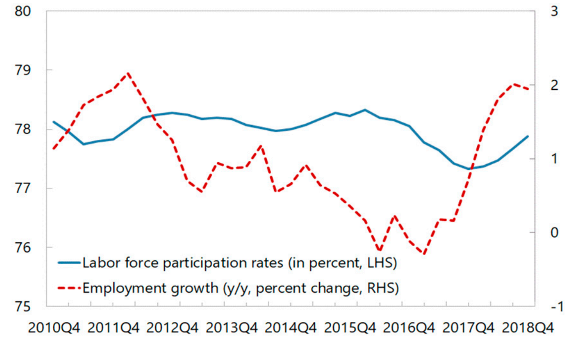
Unemployment Rate
(Percent of labor force)



Sources: Norwegian Labor and Welfare Administration, Statistics Norway, and IMF Staff calculations.

... driven by strong employment growth.

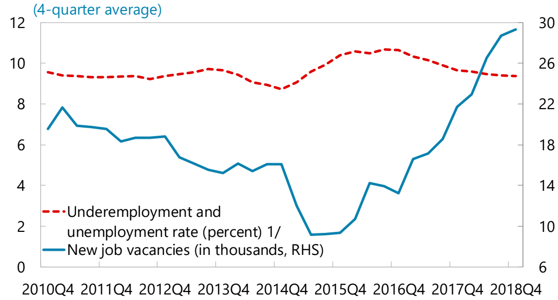
Labor Force Participation and Employment



Sources: Eurostat and Statistics Norway.

Other indicators also point to shrinking labor market slack.

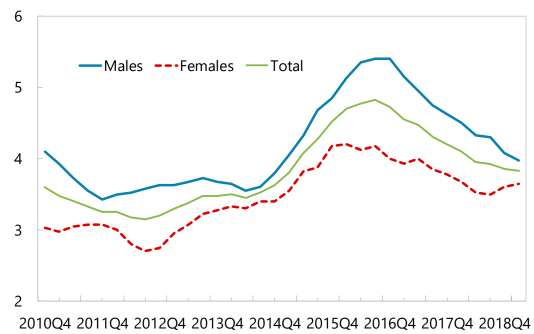
Labor Market Slack Indicators
(4-quarter average)



1/ Sum of total unemployed persons, all persons marginally attached to the labor force and total employed part-time for economic reasons, as a percent of the labor force plus persons marginally attached to the labor force.
Sources: Haver Analytics, Eurostat and Norwegian Labor and Welfare Administration.

The unemployment gap between male and females has narrowed since the oil shock.

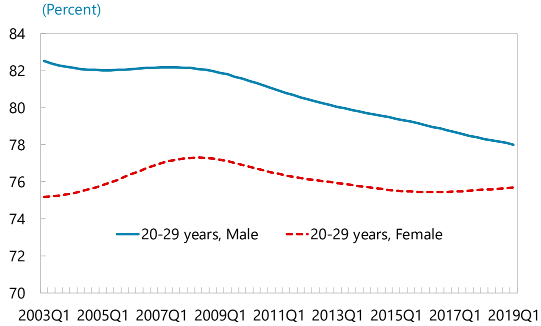
Unemployment Rates by Gender
(Percent, 4-quarter average)



Sources: Statistics Norway; and IMF staff calculations.

But labor participation among young males continues to decline steadily.

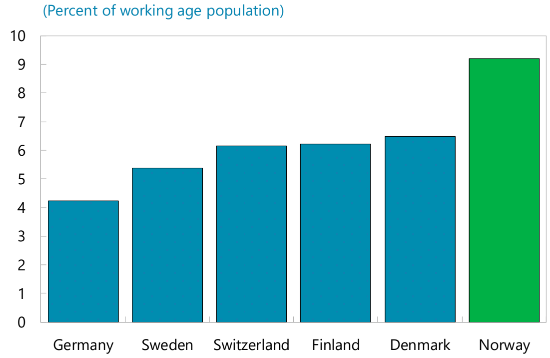
Labor Force Participation of Young Age Cohorts
(Percent)



Sources: Statistics Norway, IMF Staff Calculations
Note: The series are smoothed using an HP filter

And the recipiency rate of permanent disability benefits is very high by international standards.

Permanent Disability Recipiency Rate, 2016
(Percent of working age population)

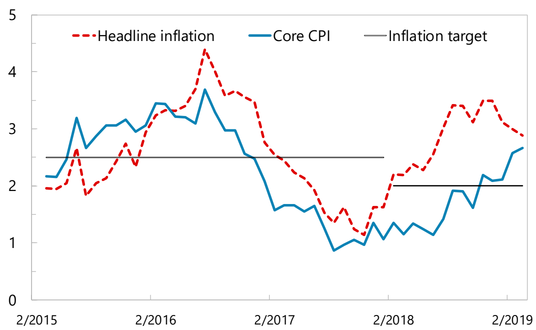


Sources: Eurostat; and IMF staff calculations.

Figure 3. Norway: Price Developments

Both headline and core inflation are above target, in part due to a temporary surge in electricity prices.

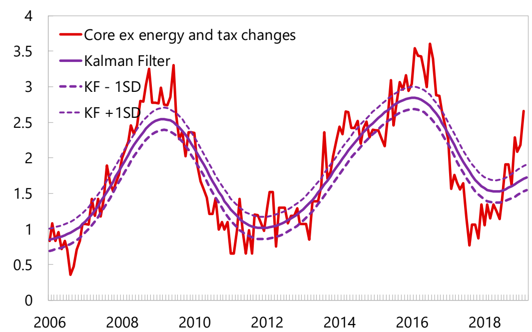
Annual Inflation
(Percent)



Sources: Statistics Norway and Fund staff calculations.

The pick-up of underlying inflation is early in the cycle.

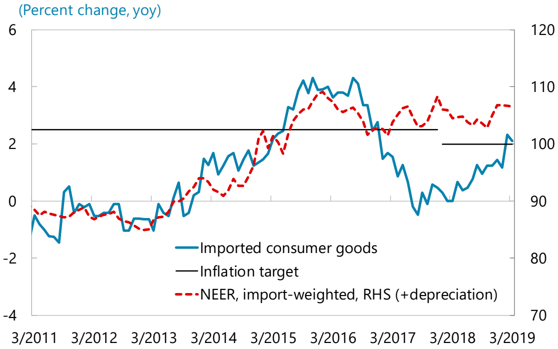
Core Inflation and Trend
(Percent change, y/y)



Sources: Haver, IMF staff calculations

The weak exchange rate has finally had some lagged effect on import prices.

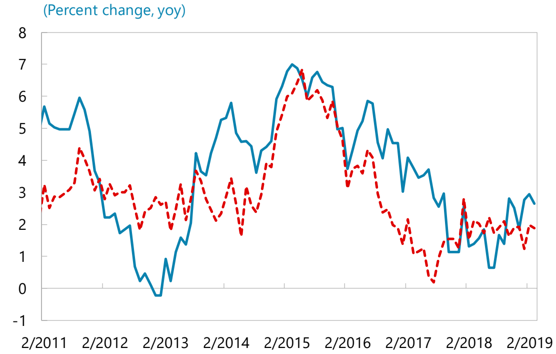
Exchange Rate and Imported Price
(Percent change, yoy)



Source: Haver Analytics; amd IMF staff calculations.

Producer prices also show early signs of pick-up.

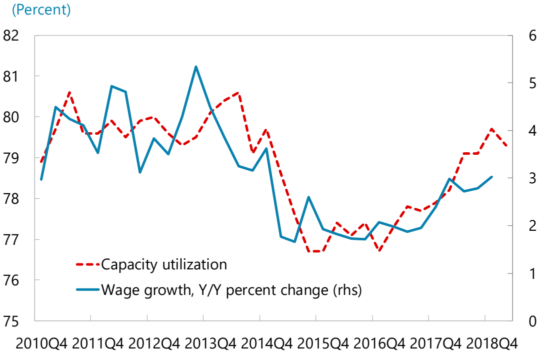
Total Producer Price Index: Consumer Goods
(Percent change, yoy)



Sources: Statistics Norway and Fund staff calculations.

Wages are growing faster as capacity utilization rises…

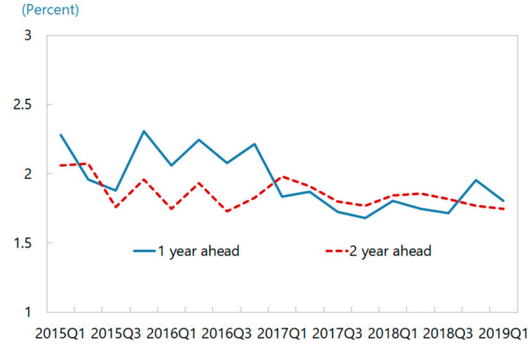
Capacity Utilization Rate and Wage Growth
(Percent)



Sources: Statistics Norway; and IMF staff calculations.

…but inflation expectations remain anchored.

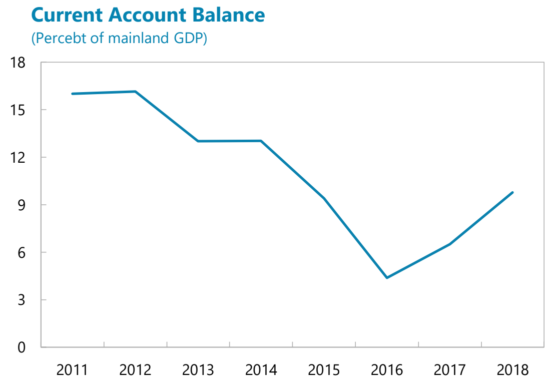
Inflation Expectations
(Percent)



Source: Consensus Economics.

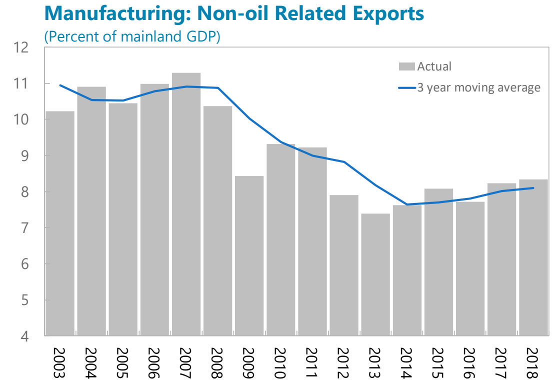
Figure 4. Norway: External Sector Developments

The CA balance strengthened in 2018, benefitting from positive terms of trade.



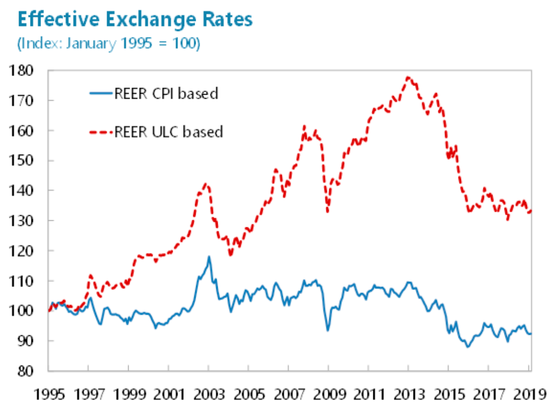
Sources: Statistics Norway; and IMF staff calculations.

Oil exports rebounded sharply, but non-oil related exports have also been recovering albeit slowly.



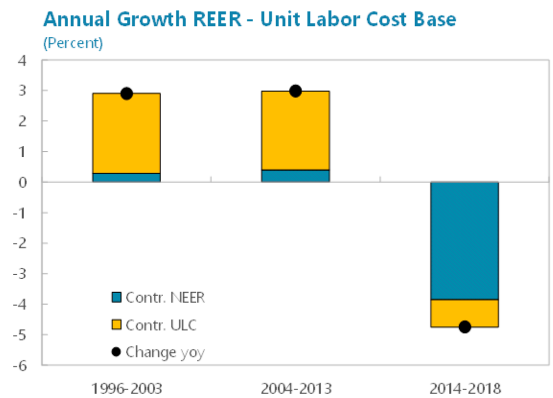
Sources: Statistics Norway; and IMF staff estimates.

This improvement in external balances reflects broadly stable REERs despite terms of trade gains…



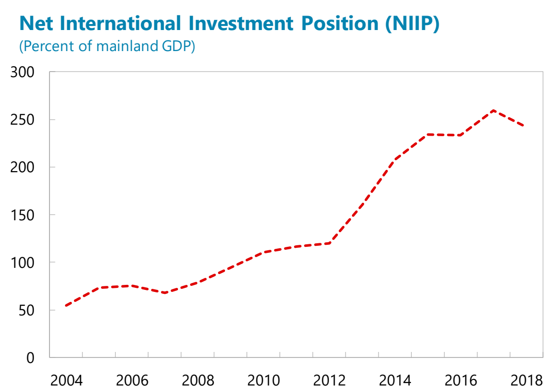
Sources: IMF World Economic Outlook, Information Notice System and Fund staff.

…but also the fact that ULCs are no longer inflating the REER



Sources: IMF staff estimates.

Norway has one of the highest NIIPs in the world…

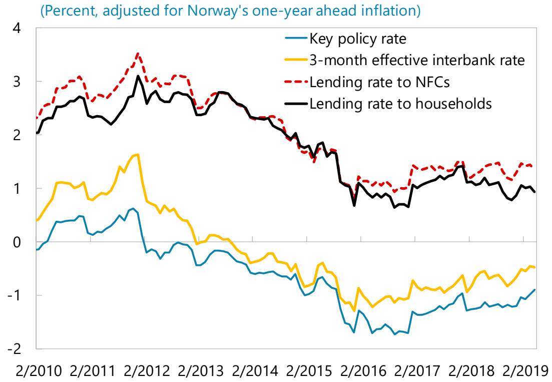


Sources: Statistics Norway; and IMF staff calculations.

Figure 5. Norway: Credit Developments

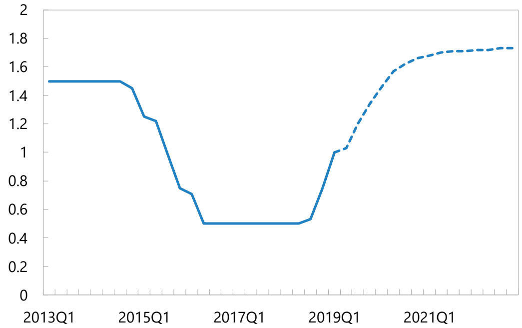
Real interest rates remain low…

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



…but will gradually rise as the Norges Bank continues to normalize the monetary policy.

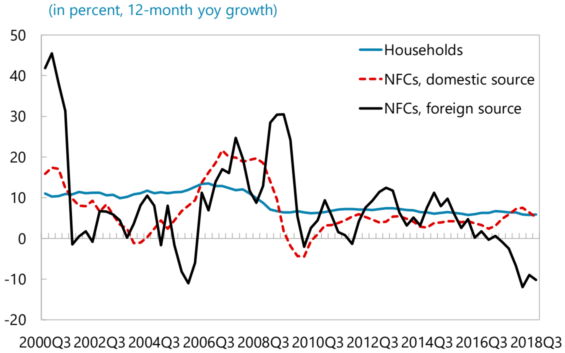
Key Policy Rate
(Percent)



Source: Norges Bank.

While household credit remains broadly stable, credit to NFCs has fallen reflecting lower debt accumulation in the oil industry.

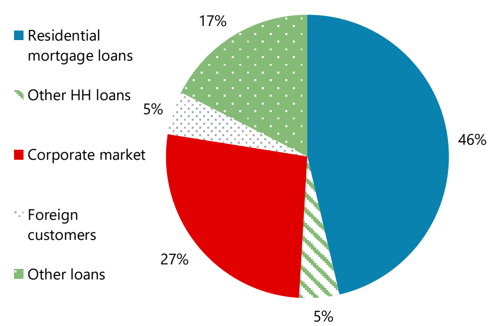
Domestic Credit
(in percent, 12-month yoy growth)



Sources: Statistics Norway

Housing mortgages continue to account for a majority of the bank credit outstanding.

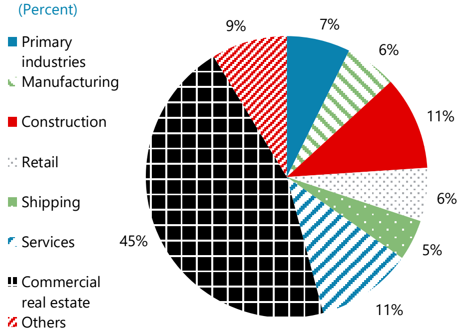
Structure of Credit by Borrowers, June 2018
(Percent)



Source: Norges Bank.

A majority of corporate credit goes to commercial real estate (CRE).

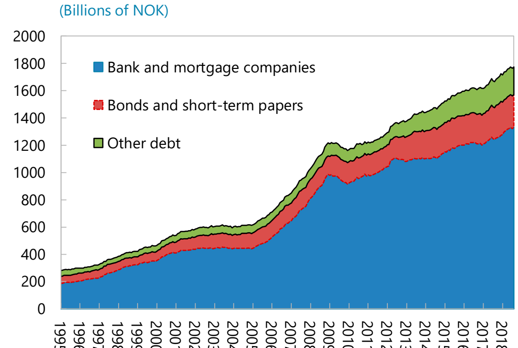
Structure of Lending to Corporates, June 2018
(Percent)



Source: Norges Bank.

CRE companies are increasing market funding, albeit from a low level.

Domestic Credit to Non-financial Corporates
(Billions of NOK)



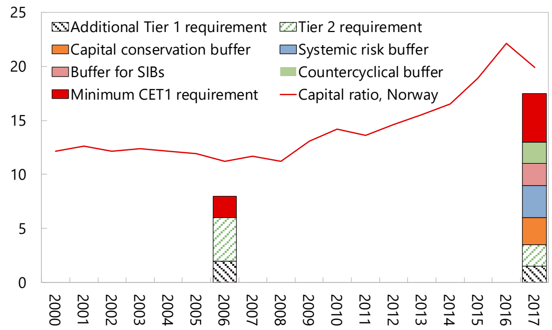
Source: Norges Bank.

Figure 6. Norway: Banking Sector Balance Sheet

Capital buffers are strong.

Capital Requirements and Actual Adequacy

(Percent)

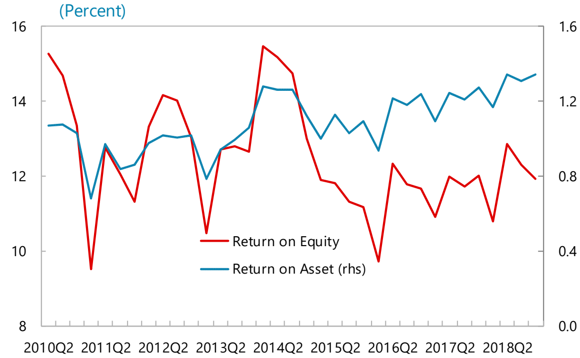


Sources: Norges Bank, IMF, Ministry of Finance, and Finanstilsynet

Profitability remains solid…

Profitability

(Percent)

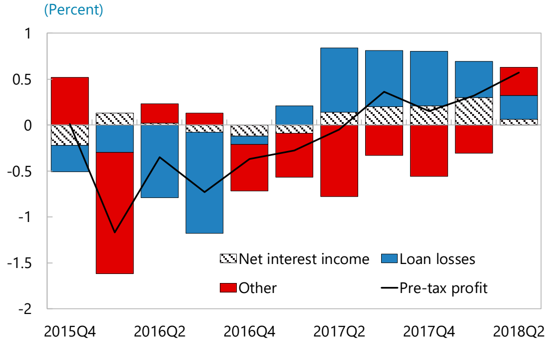


Source: IFS

…thanks to reduced loan losses and higher interest income.

Contributions to Banks' Return on Equity

(Percent)

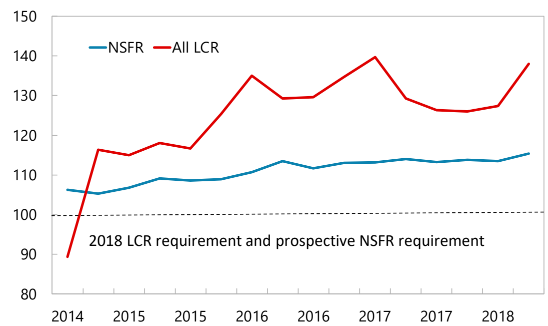


Source: Norges Bank.

Liquidity has strengthened further, exceeding both LCR and prospective NSFR requirements by an ample margin.

Liquidity Coverage and Net Stable Funding Ratio

(Percent)

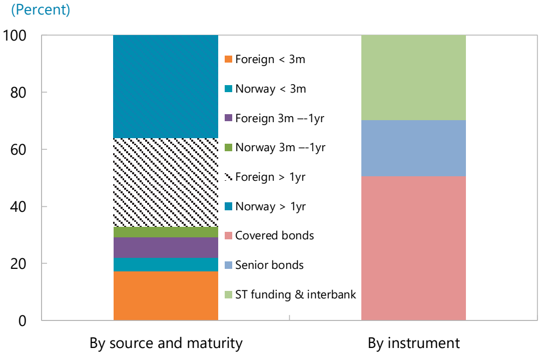


Sources: Norges bank; and Finanstilsynet.

Banks continue to rely heavily on wholesale funding.

Market Funding, 2018

(Percent)

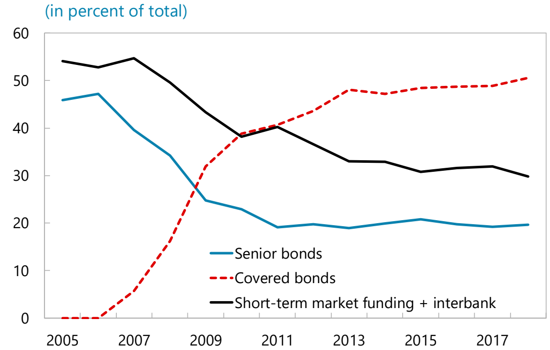


Source: Finanstilsynet.

Rising issuance and cross-bank exposure to covered bonds makes banks more vulnerable to house price declines.

Banks and other FI's Market Funding Structure

(in percent of total)

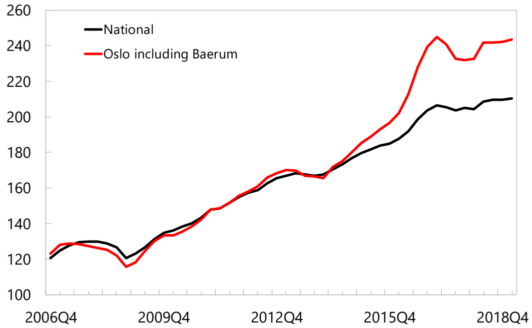


Sources: Finanstilsynet

Figure 7. Norway: Housing Market Developments

House prices have stabilized, both in Oslo...

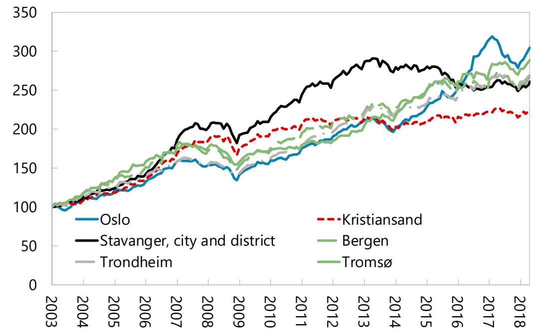
Regional House Prices
(SA Index: 2005=100)



Sources: Statistics Norway, Haver Analytics and Fund staff calculations.

... and other regions in Norway.

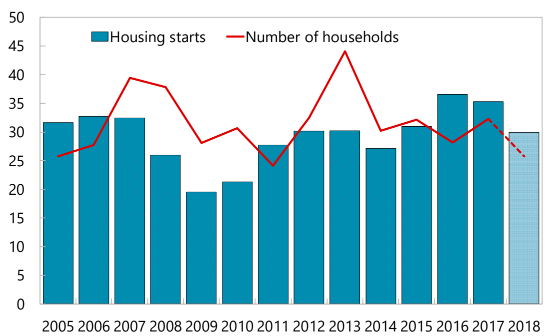
Regional House Prices
(Index, 2003=100)



Sources: Finanstilsynet; and Thomson Reuters.

...partly because supply is now exceeding household formation,

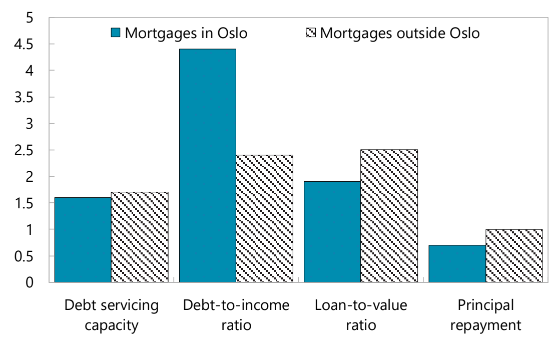
Housing Starts and Households in Norway
(Thousands)



Source: Norges Bank.

... along with comprehensive and binding macroprudential policies.

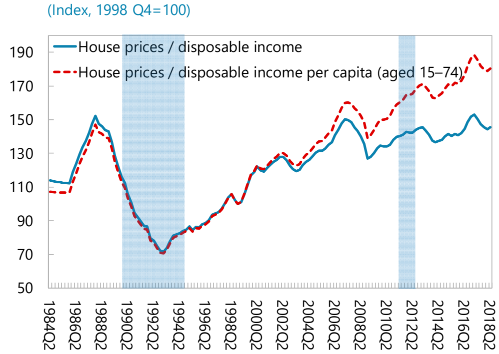
Non-compliant Mortgages by Cause, 2018Q3
(Percent)



Sources: Finanstilsynet

But house prices continue to rise in relation to per capita disposable income, surpassing the historical high.

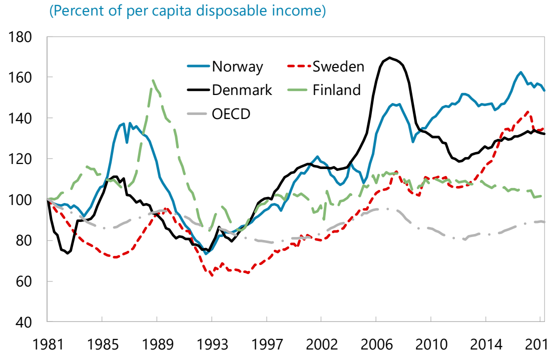
House Prices Relative to Disposable Income
(Index, 1998 Q4=100)



Source: Norges Bank.

.. and they are higher than in other OECD countries.

Nordics and OECD: House Prices
(Percent of per capita disposable income)

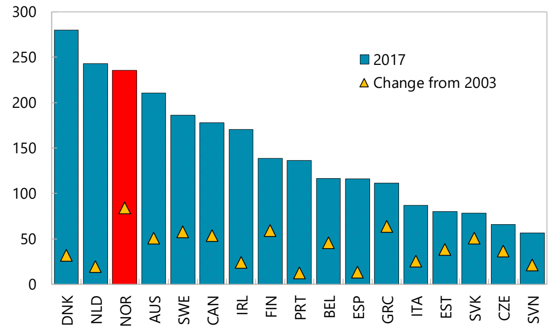


Source: Finanstilsynet.

Figure 8. Norway: Household Vulnerabilities

Household debt is high by international standards…

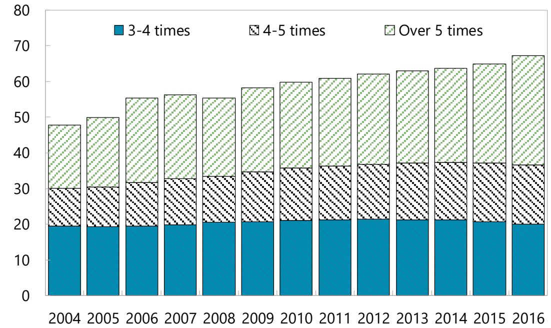
Household Debt
(Percent of net disposable income, in 2017 or latest available)



Sources: OECD; and IMF staff calculations.

… and the proportion of highly-indebted households is rising.

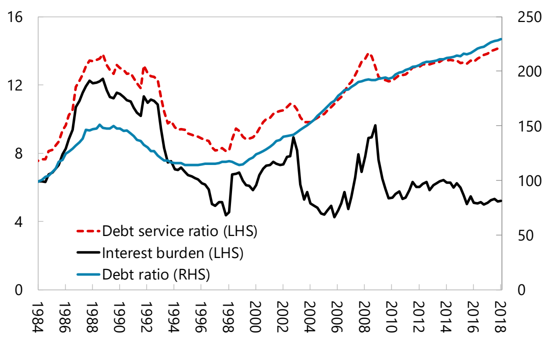
Households With Debt Higher Than Three Times of After-tax Income (Percent, share of total debt)



Sources: Statistics Norway; and Finanstilsynet.

Although low rates have kept the interest burden low, debt service ratios are high and rising.

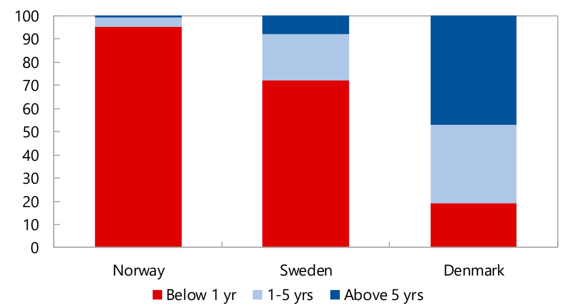
Household Debt Service Burden
(Percent of net disposable income)



Sources: Norges Bank

The high share of debt at variable rates makes households vulnerable to interest rate hikes…

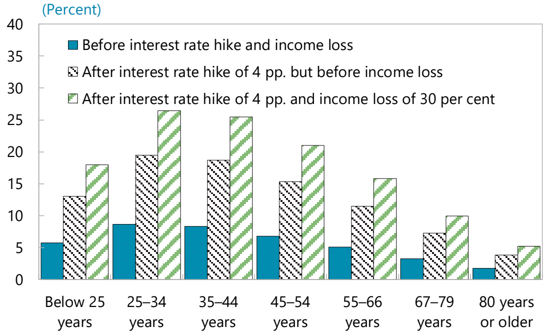
New Mortgage Loans by Interest Lock-in Period
(Percent of total during Jan - Sep 2018)



Sources: Finanstilsynet, Statistics Sweden, and Statistics Denmark.

… particularly the prime age group (25-44).

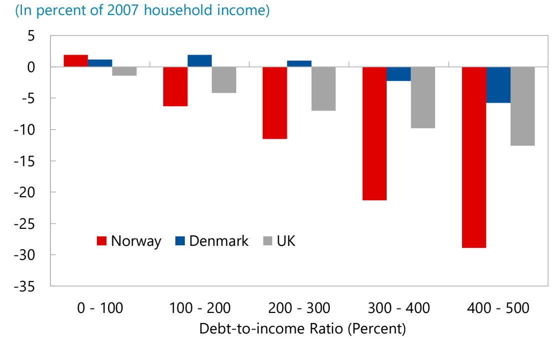
Estimated Effect of Interest Rate Hike and Income Loss on Households' Interest Burden, by Age
(Percent)



Sources: Statistics Norway; and Finanstilsynet.

Not surprisingly, household consumption in Norway is very sensitive to interest rate shocks.

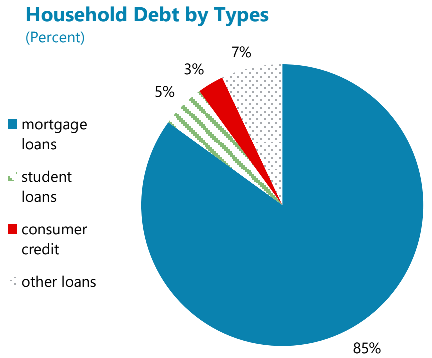
Estimates of Change in Household Consumption, 2007-09
(In percent of 2007 household income)



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

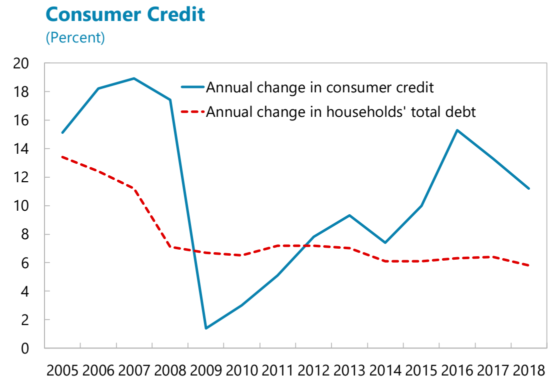
Figure 9. Norway: Consumer Credit and Prudential Regulations

Although consumer credit only accounts for 3 percent of total household debt,



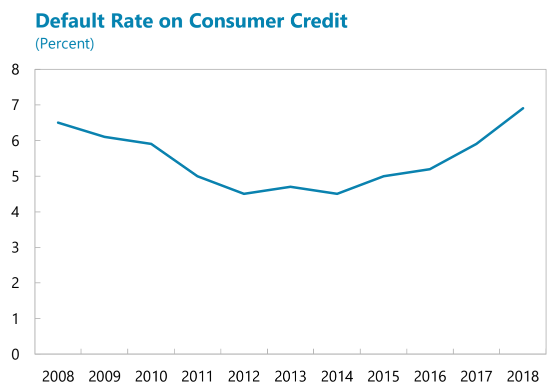
Source: Norges Bank.

.. it has grown rapidly recently.



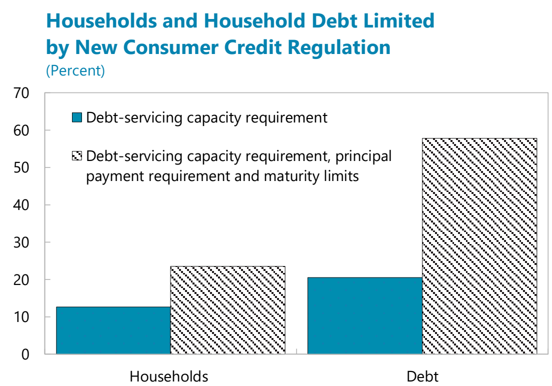
Sources: Norges bank

There also seems to be a rising default rate.



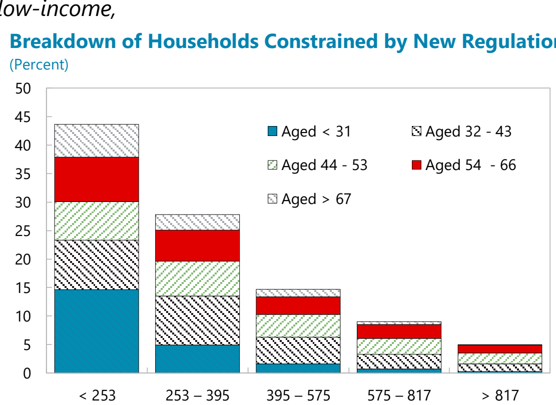
Source: Finanstilsynet.

Prudential measures are binding for a significant share of households and total consumer debt.



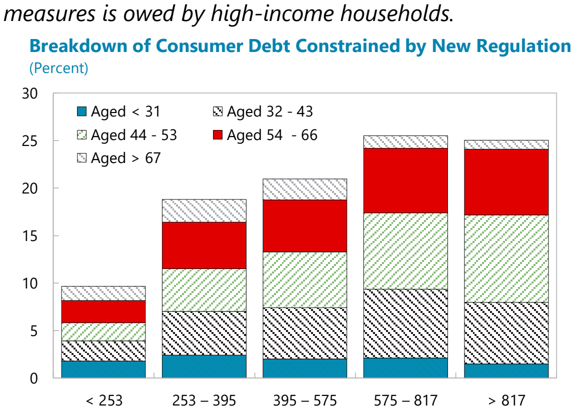
Sources: Norges Bank, National Institute for Consumer Research, Statistics Norway.

A majority of households constrained by the measures are low-income,



Sources: Norges Bank, National Institute for Consumer Research, Statistics Norway.

... but most consumer debt constrained by the new measures is owed by high-income households.

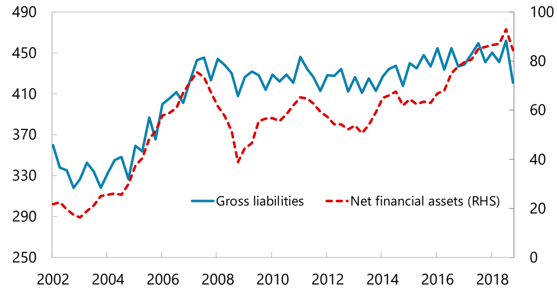


Sources: Norges bank, National Institute for Consumer Research, Statistics Norway.

Figure 10. Norway: Corporate Sector Developments

Corporates' financial position has strengthened in recent years…

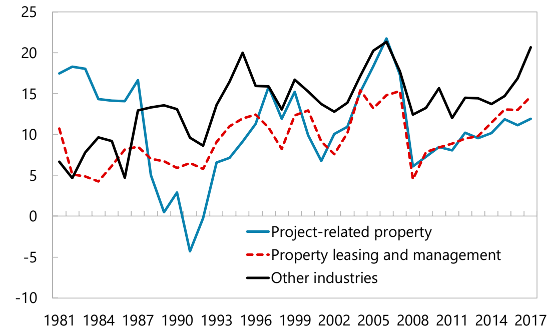
Non-financial Corporations' Financial Position
(Percent of mainland GDP)



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.

…with debt servicing capacity improving across industries…

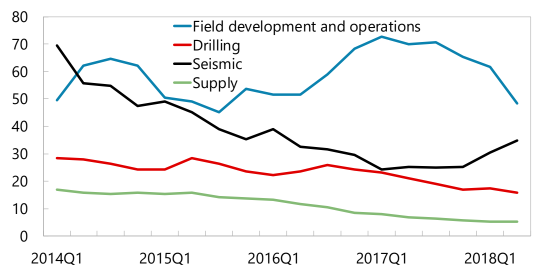
Debt Servicing Capacities
(in percent)



Sources: Finanstilsynet

…except the oil-service industries.

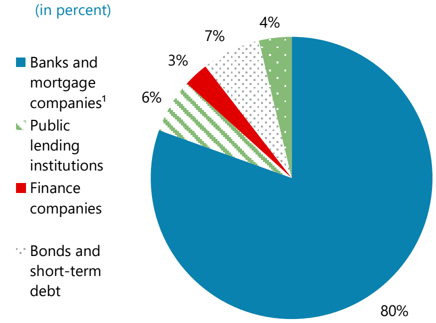
Debt-serving Capacity 1/ in the Oil Service Industry
(In percent, 2014Q1-2018Q2)



Sources: Bloomberg and Norges Bank.
1/ Earnings before interest, taxes, depreciation and amortisation (EBITDA) for the last four quarters as a percentage of net interest-bearing debt. The EBITDA Measure has been standardised by Bloomberg. Manual adjustments for EBITDA have been made where erroneous registrations appear in Bloomberg's measure.

Banks remain the primary funding sources for non-financial corporates…

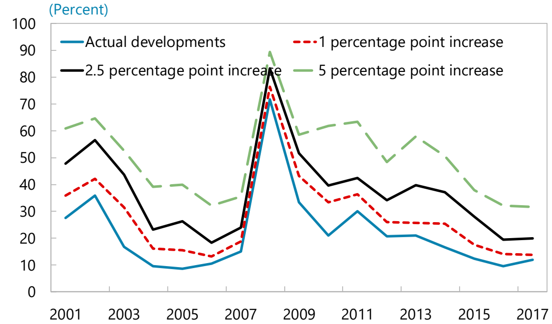
Funding Sources of Corporates
(in percent)



Sources: Norges Bank, Statistics Norway

…which makes corporates vulnerable to substantial interest rate rises.

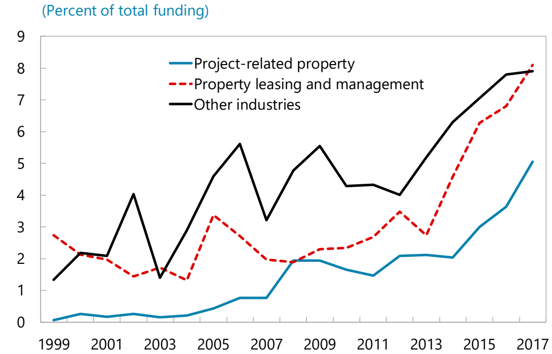
Share of Corporate Debt with Negative Earnings in the Event of Interest Rate Rises
(Percent)



Sources: Norges Bank

Market funding is growing in importance (albeit from low levels) across sectors, including CRE.

Market Funding
(Percent of total funding)



Sources: Finanstilsynet

Table 1. Norway: Selected Economic and Social Indicators, 2016–2020

Population (2018): 5.3 million
Per capita GDP (2018): US$ 81,848 | Quota (3754.7 mil. SDR/0.78 percent of total)
Main products and exports: Oil, natural gas, fish (primarily salmon) | Literacy: 100 percent

				Projections	
	2016	**2017**	**2018**	**2019**	**2020**
Real economy (change in percent)					
Real GDP 1/	1.2	2.0	1.4	2.2	1.8
Real mainland GDP	1.1	2.0	2.2	2.5	2.1
Domestic demand	2.0	2.6	2.0	2.4	1.8
Unemployment rate (percent of labor force)	4.7	4.2	3.9	3.7	3.7
Output gap (mainland economy, - implies output below potential)	-0.9	-0.6	-0.2	0.5	0.7
CPI (average)	3.6	1.9	2.8	2.3	1.7
Core Inflation	3.1	1.4	1.5	1.9	1.9
Gross national saving (percent of GDP)	32.7	33.8	35.7	35.7	35.6
Gross domestic investment (percent of GDP)	28.7	28.2	27.6	28.3	28.6
Public finance					
Central government					
Non-oil balance (percent of mainland GDP) 2/	-7.7	-8.0	-7.5	-7.5	-7.0
Structural non-oil balance (percent of trend mainland GDP) 3/	-7.4	-7.6	-7.2	-7.7	-7.7
Fiscal impulse	7.4	0.2	-0.4	0.5	0.0
in percent of Government Pension Fund Global 4/	-2.7	-2.9	-2.5	-2.9	-2.7
General government (percent of mainland GDP)					
Overall balance	4.6	5.8	8.8	9.0	9.9
Net financial assets	326.1	350.9	329.4	346.1	348.4
of which: capital of Government Pension Fund Global (GPF-G)	276.8	303.2	283.5	302.6	306.5
Money and credit (end of period, 12-month percent change)					
Broad money, M2	5.1	6.0	5.3	...	...
Domestic credit, C2	4.6	6.4	4.8	...	...
Interest rates (year average, in percent)					
Three-month interbank rate	1.1	0.9	1.1	1.6	2.1
Ten-year government bond yield	1.3	1.6	1.9	2.1	2.6
Balance of payments (percent of mainland GDP)					
Current account balance	4.6	6.7	9.8	8.8	8.4
Current account balance (percent of GDP)	4.0	5.6	8.1	7.4	7.1
Exports of goods and services (volume change in percent)	1.1	-0.2	-0.8	2.4	2.8
Imports of goods and services (volume change in percent)	3.3	1.6	0.9	2.9	2.7
Terms of trade (change in percent)	-9.9	4.9	1.1	0.8	-0.9
International reserves (end of period, in billions of US dollars)	60.9	65.1	63.8	63.6	62.4
Crude Oil Price	42.8	52.8	68.3	59.2	59.0
Fund position					
Holdings of currency (percent of quota)	93.9	93.5	88.0	...	...
Holdings of SDR (percent of allocation)	88.3	102.7	97.9	...	...
Quota (SDR millions)	3,755	3,755	3,755	...	...
Exchange rates (end of period)					
Exchange rate regime	Floating				
Bilateral rate (NOK/USD), end-of-period	8.4	8.3	8.1	...	...
Real effective rate (2010=100)	86.6	87.4	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 the authorities' revised budget; exludes all oil-related revenues and expenditures.

3/ The authorities' key fiscal policy variable; excludes oil-related revenue and expenditure, GPFG income, as well as cyclical effects. Non-oil GDP trend estimated by MOF.

4/ Over-the-cycle deficit target: 3 percent of Government Pension Fund Global

Table 2. Norway: Medium-Term Indicators, 2016–2024
(Annual percent change, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Projections					
Real GDP	1.2	2.0	1.4	2.2	1.8	1.6	1.4	1.5	1.5
Real mainland GDP	1.1	2.0	2.2	2.5	2.1	1.9	1.8	1.8	1.8
Real Domestic Demand	2.0	2.6	2.0	2.4	1.8	1.4	1.2	1.3	1.3
Public consumption	2.1	2.5	1.5	1.5	1.4	1.2	1.0	0.8	0.8
Private consumption	1.3	2.2	2.0	2.1	2.2	2.0	2.0	2.0	2.0
Gross fixed investment	5.2	3.6	0.9	4.2	1.7	0.9	0.1	0.5	0.7
Stockbuilding (contribution to growth)	-0.5	0.1	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Trade balance of goods and services (contribution to growth)	-0.7	-0.6	-0.6	-0.2	0.1	0.2	0.2	0.2	0.2
Exports of goods and services	1.1	-0.2	-0.8	2.4	2.8	3.1	3.0	2.9	2.9
Mainland good exports	-8.6	1.7	2.5	3.5	3.8	4.0	3.9	3.8	3.8
Imports of goods and services	3.3	1.6	0.9	2.9	2.7	2.6	2.6	2.4	2.4
Potential GDP	2.1	1.7	1.0	1.5	1.6	1.6	1.3	1.5	1.5
Potential mainland GDP	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Output gap (percent of potential mainland GDP)	-0.9	-0.6	-0.2	0.5	0.7	0.7	0.8	0.7	0.7
Labor Market									
Employment	-0.1	0.3	1.8	1.1	1.1	1.1	1.1	1.1	1.1
Unemployment rate LFS (percent)	4.7	4.2	3.9	3.7	3.7	3.7	3.7	3.7	3.7
Prices and Wages									
GDP deflator	-1.1	3.9	5.6	1.8	1.7	1.9	2.0	2.0	2.0
Consumer prices (avg)	3.6	1.9	2.8	2.3	1.7	1.9	2.0	2.0	2.0
Consumer prices (eop)	3.5	1.6	3.5	1.7	1.8	1.9	2.0	2.0	2.0
Core inflation	3.1	1.4	1.5	1.9	1.9	2.0	2.0	2.0	2.0
Manufacturing sector									
Hourly compensation	1.6	2.5	2.4	…	…	…	…	…	…
Productivity	5.2	3.6	-0.7	…	…	…	…	…	…
Unit labor costs	-3.6	-1.2	3.1	…	…	…	…	…	…
Fiscal Indicators (percent of mainland GDP)									
Central government non-oil balance	-7.7	-8.0	-7.5	-7.5	-7.0	-7.0	-7.1	-7.1	-7.2
General government fiscal balance	4.6	5.8	8.8	9.0	9.9	9.9	9.9	10.1	10.3
of which: overall revenue	62.0	64.0	67.1	66.2	66.6	66.7	66.6	66.9	67.2
of which: overall expenditure	57.4	58.2	58.3	57.2	56.7	56.7	56.8	56.8	56.9
External Sector (percent of mainland GDP)									
Current account balance	4.6	6.7	9.8	8.8	8.4	8.3	8.1	7.9	7.8
Current account balance (percent of GDP)	4.0	5.6	8.1	7.4	7.1	7.0	6.8	6.8	6.7
Balance of goods and services	1.9	3.7	6.8	5.7	5.3	5.1	4.9	4.8	4.7
Mainland balance of goods	-9.7	-10.0	-9.7	-8.2	-8.2	-7.8	-7.6	-7.5	-7.4
Crude Oil Price	42.8	52.8	68.3	59.2	59.0	58.1	57.6	57.6	58.0

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

Table 3. Norway: External Indicators, 2016–2024

	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Projections					
			Bil. NOK						
Current account balance	124.6	186.2	284.9	271.0	268.9	274.6	279.1	285.8	292.5
Balance of goods and services	51.2	104.2	196.3	174.2	168.3	170.0	170.1	172.5	174.6
Balance of goods	90.0	155.8	243.8	232.9	234.0	240.3	245.8	252.9	260.2
Balance of services	-38.8	-51.6	-47.5	-58.6	-65.7	-70.3	-75.7	-80.5	-85.6
Exports	1098.6	1196.9	1347.5	1394.2	1458.2	1532.4	1609.8	1690.8	1775.9
Goods	746.6	855.0	994.4	1026.7	1071.3	1123.5	1177.8	1235.3	1295.6
of which oil and natural gas	373.7	459.5	556.5	512.4	522.0	528.2	535.9	549.3	565.6
Services	352.0	342.0	353.0	367.6	386.9	408.9	431.9	455.4	480.2
Imports	1047.4	1092.7	1151.1	1220.0	1289.9	1362.5	1439.7	1518.3	1601.2
Goods	656.6	699.2	750.6	793.8	837.3	883.2	932.1	982.4	1035.4
Services	390.8	393.5	400.6	426.2	452.6	479.2	507.6	535.9	565.8
Balance on income	73.4	82.0	88.6	96.7	100.5	104.7	109.0	113.4	117.8
Capital account balance	-0.8	-0.8	-0.8	-0.9	-0.9	-1.0	-1.0	-1.0	-1.1
Financial account balance	322.4	87.3	268.9	270.1	267.9	273.7	278.1	284.8	291.4
Net direct investment	207.8	-13.1	155.5	128.5	96.5	139.1	131.4	132.0	145.3
Net portfolio investment	56.0	162.9	256.0	268.9	303.2	324.6	311.8	339.2	351.6
Net other investment	28.9	-61.6	-137.4	-126.0	-126.9	-183.7	-158.1	-179.4	-198.2
Change in reserves (- implies an increase)	29.6	-1.0	-5.2	-1.2	-4.8	-6.4	-7.0	-7.1	-7.3
Net errors and omissions	198.6	-98.1	-15.2	0.0	0.0	0.0	0.0	0.0	0.0
			Percent of Mainland GDP						
Current account balance	4.6	6.7	9.8	8.8	8.4	8.3	8.1	7.9	7.8
Balance of goods and services	1.9	3.7	6.8	5.7	5.3	5.1	4.9	4.8	4.7
Balance of goods	3.3	5.6	8.4	7.6	7.3	7.2	7.1	7.0	7.0
Balance of services	-1.4	-1.8	-1.6	-1.9	-2.1	-2.1	-2.2	-2.2	-2.3
Exports	40.5	42.8	46.3	45.4	45.7	46.1	46.5	46.9	47.4
Goods	27.5	30.6	34.2	33.4	33.5	33.8	34.0	34.3	34.6
of which oil and natural gas	13.8	16.4	19.1	16.7	16.3	15.9	15.5	15.3	15.1
Services	13.0	12.2	12.1	12.0	12.1	12.3	12.5	12.6	12.8
Imports	38.6	39.1	39.6	39.7	40.4	41.0	41.6	42.2	42.8
Goods	24.2	25.0	25.8	25.8	26.2	26.6	26.9	27.3	27.7
Services	14.4	14.1	13.8	13.9	14.2	14.4	14.7	14.9	15.1
Balance on income	2.7	2.9	3.0	3.1	3.1	3.1	3.1	3.1	3.1
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	11.9	3.1	9.2	8.8	8.4	8.2	8.0	7.9	7.8
Net direct investment	7.7	-0.5	5.3	4.2	3.0	4.2	3.8	3.7	3.9
Net portfolio investment	2.1	5.8	8.8	8.8	9.5	9.8	9.0	9.4	9.4
Net other investment	1.1	-2.2	-4.7	-4.1	-4.0	-5.5	-4.6	-5.0	-5.3
Change in reserves (- implies an increase)	1.1	0.0	-0.2	0.0	-0.2	-0.2	-0.2	-0.2	-0.2
Net errors and omissions	7.3	-3.5	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
			Percent of GDP						
Stock of net foreign assets (IIP)	203.1	219.6	199.2	198.8	198.9	199.0	199.2	199.2	198.9
Direct investment, net	8.6	9.0	12.7	15.6	17.6	20.6	23.1	25.4	27.9
Portolio investment, net	194.9	213.7	192.4	192.2	193.5	195.0	196.2	197.5	198.7
Other investment, net	-17.2	-19.5	-21.3	-23.9	-26.4	-30.2	-33.0	-36.2	-39.4
Official reserves, assets	16.7	16.4	15.5	14.9	14.2	13.6	13.0	12.4	11.8
Government Pension Fund Global, percent of mainland GDP	276.8	303.3	283.9	...	...	...	...	...	...

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

Table 4. Norway: General Government Accounts, 2007–2017

(Percent of mainland GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	74.4	78.1	68.9	69.0	73.1	72.4	68.6	66.7	64.3	62.0	64.0
Taxes	42.9	43.9	39.1	40.6	42.4	41.5	38.6	35.8	33.3	32.3	33.7
Social contributions	11.2	11.6	11.9	11.7	12.0	12.1	12.1	12.3	12.4	12.2	12.2
Grants and other revenues	20.3	22.6	17.9	16.7	18.7	18.9	18.0	18.6	18.6	17.5	18.1
Expense	50.9	51.3	54.1	53.8	54.3	53.5	53.3	54.0	55.4	55.4	55.9
Compensation of employees	15.1	15.5	16.4	16.4	16.8	16.7	16.8	16.9	17.1	17.1	17.3
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	7.7
Consumption of fixed capital	3.2	3.3	3.5	3.5	3.7	3.8	3.6	3.7	3.9	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	0.7
Subsidies	2.2	2.3	2.5	2.5	2.5	2.4	2.4	2.4	2.4	2.5	2.5
Social benefits	17.6	17.8	19.2	19.3	19.7	19.5	19.3	19.6	20.2	20.3	20.2
Granth and other	2.7	2.9	3.2	3.2	3.1	2.9	3.1	3.3	3.4	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	10.6	12.1
Net operating balance	23.5	26.8	14.8	15.2	18.8	19.0	15.3	12.7	9.0	6.6	8.1
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	2.1
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	6.0
Net acquisition of financial assets	26.7	15.3	3.2	18.1	1.9	21.6	16.5	9.1	13.4	9.5	9.2
Currency and deposits	0.0	-0.8	-0.8	0.5	-2.3	2.9	-1.9	1.4	-0.5	3.0	1.0
Securities other than shares	3.2	10.3	-17.0	8.5	0.7	6.9	14.2	3.1	5.5	1.8	-0.7
Loans	7.7	-26.4	5.4	3.2	-9.1	1.4	2.7	-2.3	3.4	0.8	2.1
Shares and other equity	14.8	28.5	17.6	4.3	11.5	10.2	2.0	6.6	5.3	3.4	5.6
Insurance technical reserves	0.0	-0.1	0.0	0.1	0.0	0.0	0.2	0.1	0.0	0.2	0.0
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.0	-0.1	0.2
Other accounts receivable	1.0	3.9	-2.2	1.6	1.1	0.1	-0.8	-0.2	-0.4	0.4	1.0
Monetary gold and SDRs	0.0	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	2.8	-1.8	6.1	4.9	3.2
Currency and deposits	0.0	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	3.0	-1.0	0.0	0.6	1.3	0.6
Loans	3.9	-14.7	-18.4	2.5	-10.2	0.5	3.0	-2.2	4.6	3.0	2.6
Shares and other equity	0.0	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	0.0
Financial derivatives	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.3	0.0	-0.1	0.0
Other accounts receivable [1]	1.6	1.5	-1.8	0.8	-1.5	0.3	0.8	0.1	1.0	0.7	0.0
Balance sheet											
Net financial worth	179.4	166.2	190.8	204.6	206.8	218.1	263.1	308.2	338.7	332.8	364.2
Financial assets	250.7	238.8	250.2	264.9	250.4	263.2	307.9	349.9	384.9	381.7	415.1
Currency and deposits	12.7	11.6	10.6	10.6	7.8	10.3	7.9	9.0	8.2	10.9	11.5
Securities other than shares	64.3	86.1	59.8	64.5	65.5	66.7	80.2	95.1	106.3	101.3	98.1
Loans	51.5	31.1	35.7	36.9	26.5	26.3	28.2	25.1	28.1	27.6	29.2
Shares and other equity	105.9	94.8	129.9	138.1	135.1	144.2	177.0	206.1	228.0	227.3	260.3
Insurance technical reserves	1.2	0.7	0.9	1.0	1.5	1.6	2.2	2.7	3.1	3.5	4.1
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.3	0.4	0.5	0.5
Other accounts receivable	15.1	14.5	13.4	13.8	14.1	14.0	12.4	11.5	10.7	10.7	11.3
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities	71.3	72.6	59.4	60.4	43.7	45.1	44.9	41.7	46.2	48.9	50.8
Currency and deposits	0.0	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	23.0	20.4	19.9	19.7	19.9	19.7
Loans	50.3	47.2	25.6	26.7	15.7	15.8	18.1	15.3	19.5	21.7	23.7
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	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	0.0
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.5	0.4	0.3	0.3
Other accounts receivable	8.2	9.3	7.5	7.5	6.4	6.1	6.1	6.0	6.7	7.0	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	2712.8	2798.1

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

1/ Includes statistical discrepancy.

Annex I. External Sector Assessment

	Norway	
Foreign asset and liability position and trajectory	**Background**. Norway's net international investment and reserve position remain strong. NIIP reached 242 percent of mainland GDP at end-2018, marking a significant increase from 207 percent in 2014. The general government is the main external creditor with net external assets of 270 percent of mainland GDP, notably the Government Pension Fund Global (GPFG), with assets under management of 300 percent of mainland GDP. The financial sector remains the largest net external debtor given reliance on wholesale funding, at over 50 percent of GDP. International reserves have remained stable at a comfortable 21 percent of mainland GDP. **Assessment**. The NIIP position is expected to remain strong and stable due to the sound management of GPFG's assets. Negative revaluation risks are mitigated by asset diversification.	**Overall Assessment**: The external position of Norway in 2018 was weaker than implied by medium-term fundamentals and desirable policies, based on both the current account and REER assessments. Against this, Norway has sizable external buffers with a NIIP of almost 2½ times mainland GDP. Moreover, developments point to some improvement in competitiveness relative to last year's consultation **Potential policy responses**: Norway's external buffers provide significant time to address competitiveness issues. Fiscal and structural policies should aim to foster productivity growth, high labor market participation, and wage moderation. It remains of high importance to enhance non-oil sector competitiveness.
Current account	**Background**. Despite the substantial krone depreciation during 2013–15, non-oil exports have only begun to recover recently. This highlights that Norway has made some progress on non-oil competitiveness, but further gains are needed to strengthen non-oil exports further in a sustainable way. The current account rose more than expected in 2018, reaching 8.1 percent of GDP from under 7 percent in 2017. This improvement reflects solid external growth, positive terms of trade, and a broadly flat REER. The recent moderation of ULCs and signs of improvement in non-oil exports suggest Norway's external position should improve further in coming years. **Assessment**. The current account is weaker than implied by fundamentals and desirable policies. The cyclically-adjusted 2018 CA was 7.5 percent of GDP, while the EBA regression-estimated norm was 11.9 percent of GDP. However, the EBA regression norms do not fully capture specific features of Norway: (i) productivity of the non-oil sector is lower than implied by average productivity,[1/] (ii) oil affects the norm considerably (5 percentage points of the norm are attributed to the oil trade) but the adequacy of the econometric specification is doubtful;[2/] (iii) the revaluation of foreign assets creates a higher stock of assets relative to dividend and interest income.[3/] Staff assesses that the adjusted norm accounting for these effects is around 9½ –10½ percent of GDP, implying a current account gap of *minus* 2–3 percent of GDP. Similarly, the EBA-Lite consumption model finds a gap of *minus* 2.9 percent of GDP. However, this model's results are very sensitive to parameter values given the infinite horizon projection: sensitive parameters yield a range for the gap of -1 to -5 percent of GDP. All in all, staff assess the current account to be 2–3 percent weaker than implied by fundamentals and desirable policies, though with considerable uncertainty around this range.	
Real exchange rate	**Background**. Norway's real effective exchange rate (REER) depreciated by around 0.1 percent in 2018. Since the last assessment based on June 2017 data, the REERs (both ULC and CPI) are about 2 percent stronger as of March 2018, despite a significant increase in export prices over the same period. **Assessment**. The real exchange rate is moderately overvalued relative to fundamentals and desirable policies. The real exchange rate was 10½ percent stronger than the real exchange index norm in 2018. The alternative norm using a real exchange level approach points to an undervaluation of 17 percent, however this approach is not adequate for commodity exporters like Norway. Using the EBA's standard semi-elasticity of the current account to the real exchange rate of 0.36, the *minus* 2 to 3 percent current account gap implies a REER overvaluation of 6 to 9 percent. All in all, staff assess the real effective exchange to be 5–10 percent stronger than implied by fundamentals and desirable policies.	
Capital and financial accounts: flows and policy measures	**Background**. Flows, both outgoing and incoming, mainly span 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 remains a source of vulnerability. The increase of duration in part of the funding structure is a positive development.	
FX intervention and reserves level	**Background**. The krone floats freely and independently against other currencies. Norges Bank has not intervened since 1999 to influence the exchange rate, but it could intervene if the exchange rate was deemed to deviate substantially from fundamentals. At end 2018, Norges Bank reserves were at 21 percent of mainland GDP and the GPFG assets stood at 300 percent the mainland GDP. **Assessment**: Reserves are comfortable even considering the exposure of banks to wholesale funding and risks of regional macro-financial shocks.	
Technical Background Notes	1/ Staff estimates that non-oil productivity is about 12–15 percentage points lower than the average productivity. 2/ The norm uses a 5-year backward looking average of oil exports which fails to capture sharp variations of oil prices. 3/ About 25 percent of the GPFG return is due to revaluation, signaling the NFA in the regression may be overstated relative to the dividend and interest income.	

Annex II. Risk Assessment Matrix[1]

Potential Deviations from Baseline	
Source of Risks and Relative Likelihood	**Expected Impact if Risk is Realized**
Downside Risks	
Low/Medium **Sharp tightening of global financial conditions** due to a sustained rise in risk premia (concerns about debt levels in some euro area countries, a disorderly Brexit).	**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:** If needed, relax the countercyclical capital buffer, and bring to bear countercyclical monetary and fiscal policy if needed.
Medium **Weaker than expected global growth**.	**Low/Medium** Norway's economic cycle is more related to commodity prices than to external demand *per se*, though weaker growth abroad would naturally have an impact. **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. **Sharp increases in risk premia in the CRE sector**, triggering debt defaults and widespread bankruptcies.	**Medium** Housing: Substantial falls in house prices could dampen private consumption, while creating negative spillover effects on banks' balance sheets. CRE: With large exposure to CRE, banks could incur substantial losses from CRE loans and bond holdings issued by CRE companies, affecting the broader economy through tighter funding conditions. **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** threatening the global trade system, regional integration; reducing growth and stability both directly and through adverse confidence effects.	**Low/Medium** Higher trade barriers could dampen growth in Norway's trading partners (most notably the UK following Brexit), 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	
Low/Medium **Large swings in energy prices.** Risks to prices are broadly balanced, reflecting offsetting—but large and uncertain—supply and demand shocks.	**Medium/High** Oil prices have now been above the WEO baseline underpinning staff's forecasts for some time. This could spur higher than expected petroleum investment in Norway and abroad, which in turn could have broader implications given important linkages to the oil-related manufacturing and service sectors. **Policy Response:** Bring forward fiscal policy tightening and interest rate hikes if signs of overheating emerge. Save the additional fiscal revenues or lower automatic spending.

[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 III. Debt Sustainability Analysis

Figure 1. Norway: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

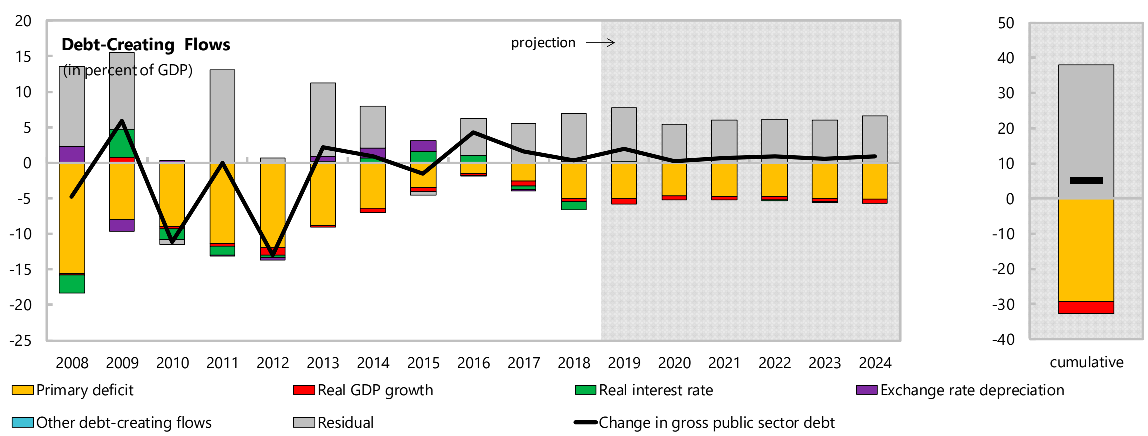
	Actual			Projections					
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	34.9	33.3	33.6	35.6	35.7	36.5	37.3	37.9	38.8
Public gross financing needs	-8.6	-3.3	-2.8	-5.4	-3.8	-4.5	-4.9	-5.6	-6.3
Real GDP growth (in percent)	1.0	2.0	1.4	2.2	1.8	1.6	1.4	1.5	1.5
Inflation (GDP deflator, in percent)	2.2	3.9	5.6	1.8	1.7	1.9	2.0	2.0	2.0
Nominal GDP growth (in percent)	3.3	5.9	7.0	4.1	3.6	3.6	3.4	3.5	3.6
Effective interest rate (in percent) [4/]	3.1	2.1	1.9	2.4	2.0	2.0	2.0	2.0	2.5

As of March 26, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		159
5Y CDS (bp)		11
Ratings	Foreign	Local
Moody's	Aaa	Aaa
S&Ps	AAA	AAA
Fitch	AAA	AAA

Note

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.9	1.6	0.3	2.0	0.2	0.7	0.9	0.6	0.9	5.2	
Identified debt-creating flows	-8.1	-4.0	-6.4	-5.6	-5.2	-5.3	-5.2	-5.5	-5.6	-32.3	
Primary deficit	-8.4	-2.6	-5.0	-5.1	-4.6	-4.7	-4.7	-4.9	-5.2	-29.2	-0.4
Primary (noninterest) revenue and grants	51.9	51.1	52.1	52.0	51.5	51.8	52.2	52.7	53.1	313.3	
Primary (noninterest) expenditure	43.4	48.5	47.1	47.0	46.8	47.1	47.5	47.7	48.0	284.1	
Automatic debt dynamics [5/]	0.3	-1.4	-1.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.4	-3.1	
Interest rate/growth differential [6/]	-0.1	-1.2	-1.6	-0.5	-0.5	-0.5	-0.5	-0.5	-0.4	-3.1	
Of which: real interest rate	0.2	-0.6	-1.2	0.2	0.1	0.0	0.0	0.0	0.1	0.4	
Of which: real GDP growth	-0.3	-0.6	-0.4	-0.7	-0.6	-0.6	-0.5	-0.5	-0.6	-3.5	
Exchange rate depreciation [7/]	0.4	-0.2	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/]	6.2	5.5	6.7	7.6	5.3	6.0	6.1	6.1	6.4	37.5	



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 $ae(1+r)$.

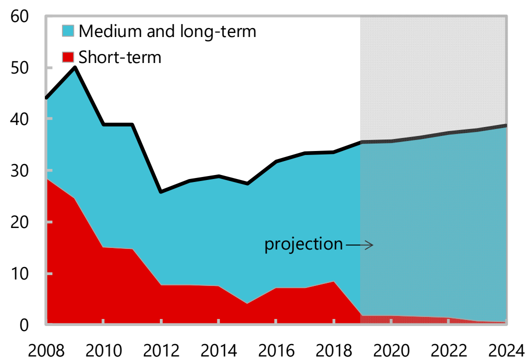
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

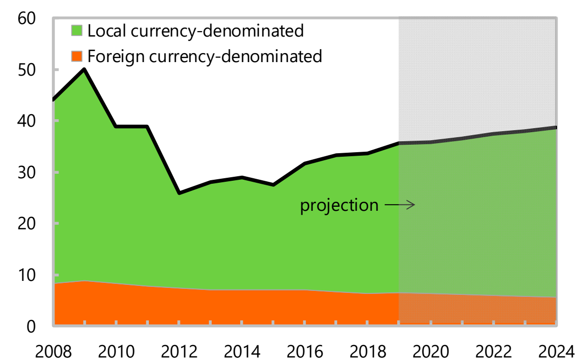
Figure 2. Norway: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



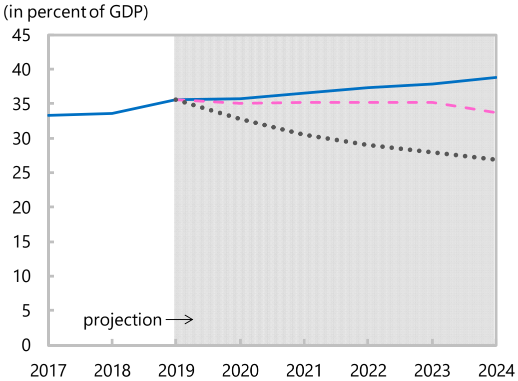
By Currency
(in percent of GDP)



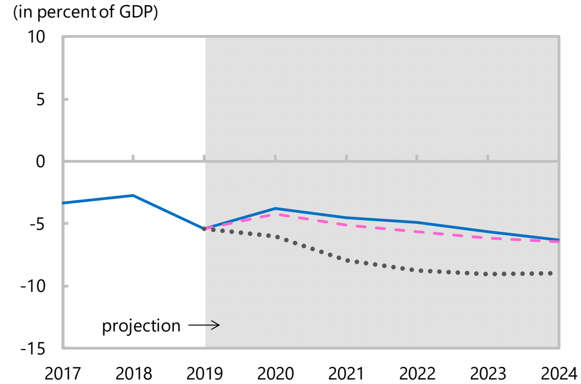
Alternative Scenarios

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	2019	2020	2021	2022	2023	2024
Real GDP growth	2.2	1.8	1.6	1.4	1.5	1.5
Inflation	1.8	1.7	1.9	2.0	2.0	2.0
Primary Balance	5.1	4.6	4.7	4.7	4.9	5.2
Effective interest rate	2.4	2.0	2.0	2.0	2.0	2.5
Constant Primary Balance Scenario						
Real GDP growth	2.2	1.8	1.6	1.4	1.5	1.5
Inflation	1.8	1.7	1.9	2.0	2.0	2.0
Primary Balance	5.1	5.1	5.1	5.1	5.1	5.1
Effective interest rate	2.4	2.0	2.0	2.0	2.1	2.5

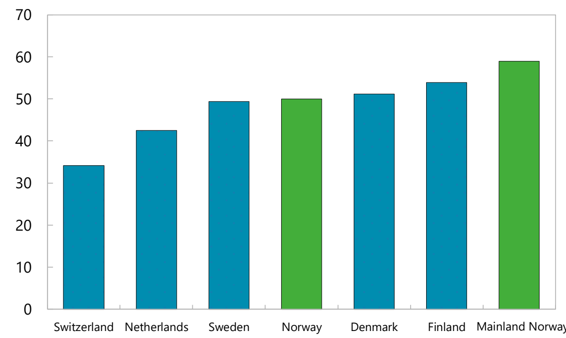
Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	2.2	1.2	1.2	1.2	1.2	1.2
Inflation	1.8	1.7	1.9	2.0	2.0	2.0
Primary Balance	5.1	6.8	6.8	6.8	6.8	6.8
Effective interest rate	2.4	2.0	2.1	2.2	2.2	2.8

Source: IMF staff.

Annex IV. Expenditure and Revenue Composition in Norway

1. The level of total expenditure in Norway is broadly in line with its Nordic peers. However, Norway's expenditure is much higher than that of Switzerland, one of the few countries with comparable levels of per capita incomes. In addition, when expressed in terms of mainland GDP, expenditure is significantly higher than in all comparator countries.

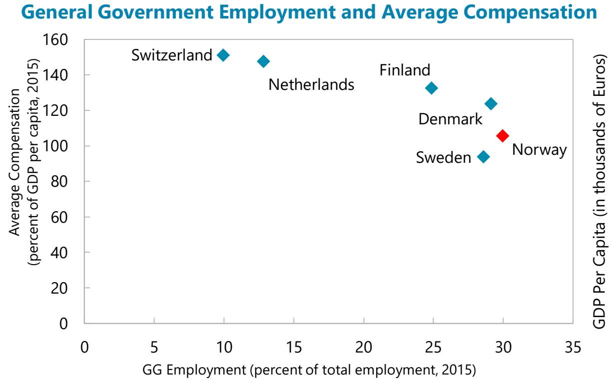
General Government Expenditure, 2017
(Percent of GDP)



Sources: Haver Analytics; Eurostat; and IMF staff calculations.

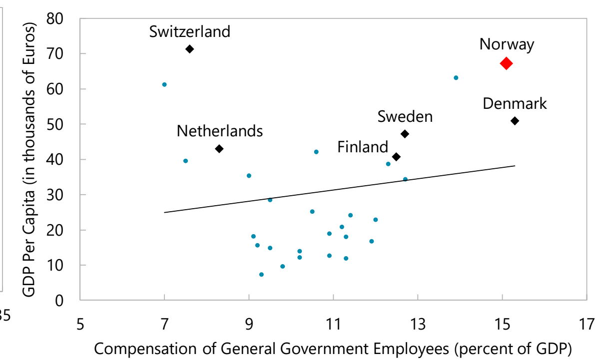
2. The government wage bill contributes to the high level of total expenditure. The wage bill is around 15 percent of GDP, which is higher than that of any other comparator except Denmark. Norway's wage bill also appears high even after accounting for the positive association between per capita incomes and the size of the wage bill observed for European countries. Both average government salaries and the level of employment appear to contribute equally to Norway's wage bill.

General Government Employment and Average Compensation



Sources: Eurostat; OECD; and IMF staff calculations.
Note: 2014 for Switzerland general government employment data.

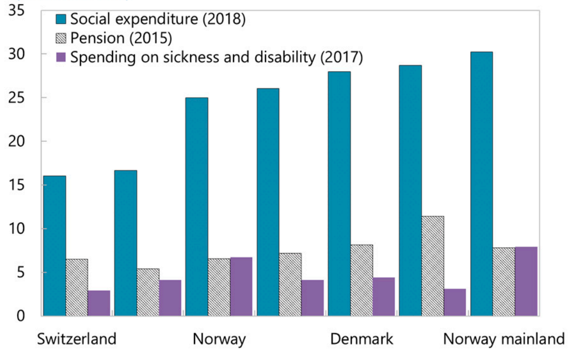
Compensation of Employees and GDP Per Capita, 2017



Sources: Haver Analytics; Eurostat; and IMF staff calculations.

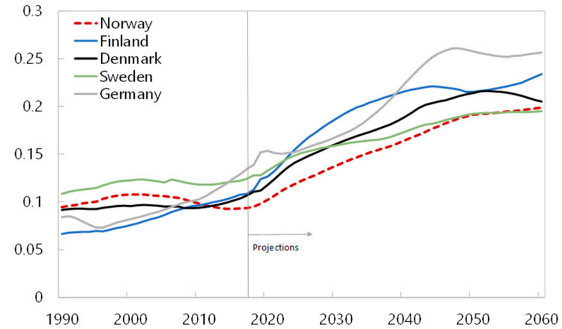
3. While overall social spending is at around the regional average when measured in terms of overall GDP, Norway spends more (by far) on sickness and disability benefits than its peers. Combined spending on sickness and disability spending is at 6.7 percent of GDP, which is more than 2.5 percentage points higher than spending in Sweden, the country which ranks second. The difference is even larger when spending is expressed in terms of mainland GDP. By contrast, spending on survivor and old-age pensions remains low as the dependency ratio in Norway has not increased yet unlike in international peers. However, this will change, given the projected increase in old age dependency ratio that is about to happen.

General Government Social Expenditure
(Percent of GDP)



Sources: OECD and Eurostat.

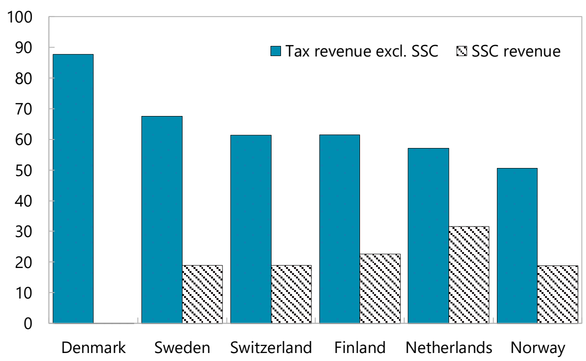
Old Age Dependency
(Ratio of population aged 75+ to those aged 15-74)



Sources: National Statistics Institutes; Haver Analytics; and IMF staff calculations.

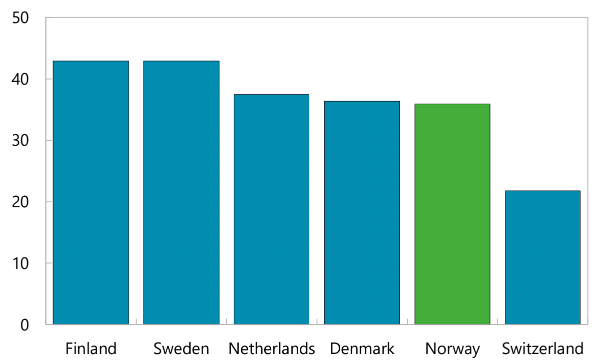
4. Norway's oil revenues allow it to have a relatively low tax burden measured in terms of the share of total revenue. The share of tax revenue in total general government revenue is at roughly 50 percent of GDP, which is below that of comparator countries, whereas the share of social security contributions is roughly at the average of Norway's peers. This, in turn, contributes to a tax wedge equal to or below that of Nordic peers, though much higher than Switzerland's.

Shares of Tax Revenue Excl. SSC and SSC in GG Revenue
(Percent of total general government revenue)



Sources: OECD; and IMF staff calculations.

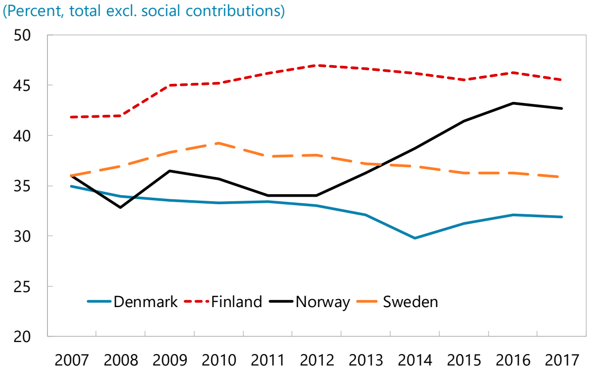
Tax Wedge, 2017
(Percent)



Source: OECD.

5. Norway's recent shift from direct to less distortionary indirect taxes is also a positive change. The share of indirect tax revenue in overall tax revenue (excluding social security contributions) has increased from less than 35 percent to about 43 percent since 2012, above Denmark and Sweden but still (slightly) below Finland.

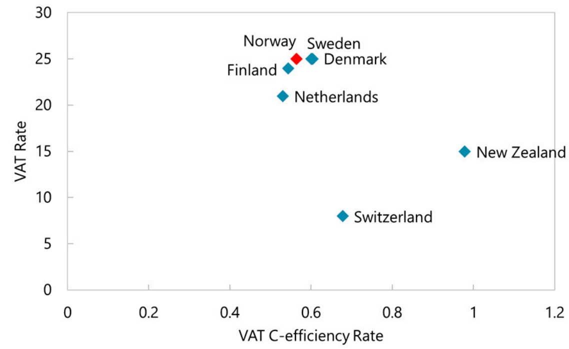
Share of Goods and Service Tax in Overall Tax Revenue
(Percent, total excl. social contributions)



Sources: OECD; and IMF staff calculations.

6. There is scope for Norway to increase VAT revenue through improving the design of its VAT. Norway's standard VAT rate is among the highest in OECD countries, implying that the possibility to increase the share of indirect taxes through rate increases is limited. However, the efficiency of VAT in Norway–measured by the c-efficiency ratio–is in line with regional comparators but far below that of New Zealand, generally considered to have one of the most efficient VAT systems in the world (mostly thanks to a single rate with very limited exemptions). Base broadening measures that would realistically reduce Norway's c-efficiency gap to New Zealand by just a quarter could result in additional revenues of around 1½ percent of GDP, holding private consumption, GDP and the standard VAT rate constant.

Statutory Value-added Tax Rate and C-efficiency Rate
(2016)

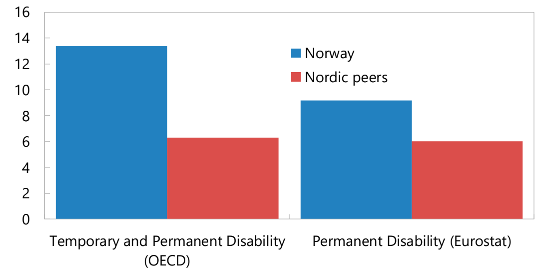


Sources: Eurostat; and IMF staff calculations.

Annex V. Reforming Sickness and Disability Pensions

1. Mirroring the high fiscal costs, recipiency rates of disability pensions are elevated relative to international peers. Norway has more than 13 percent of its working age population receiving temporary and permanent disability benefits, which is around twice as high as in Nordic peers. In addition, 9 percent of Norway's working age population receive permanent disability benefits, which is some 3 percentage points higher than in Nordic peers. Moreover, these peer countries have seen the number of recipients of permanent disability benefits fall over time thanks to reforms of their systems, while Norway has not.

Disability Recipiency Rate, 2016
(Percent of working age population)

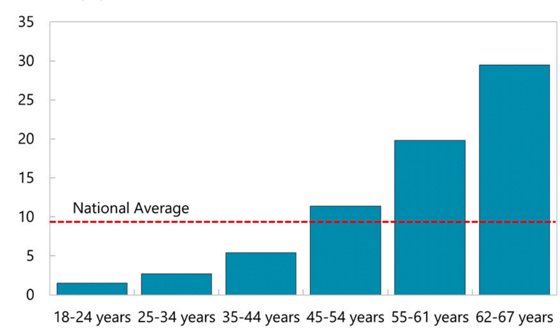


Sources: Eurostat, OECD and IMF staff calculations.
Note: The OECD and Eurostat data are not directly comparable. Hence, one should not conclude for instance that Nordic peers have almost no beneficiaries of temporary disability benefits.

2. Generous sickness and temporary disability benefits make transitioning to long-term disability benefits likely. Most Norwegian employees are fully compensated during the first year of their sickness, contrary to other Nordic countries where the level of compensation as a share of the salary can be much lower (as shown by the expert commission's report). In addition, the share of young people that receives benefits has significantly increased over the last 15 years, in part reflecting that young beneficiaries of (mostly temporary) disability pensions receive higher incomes that their working peers, a point also made by the commission. By disincentivizing the return to work and promoting long-term absence from the labor market, sickness and temporary disability pensions increase the likelihood that beneficiaries transition to permanent disability benefits. In the case of young beneficiaries, this could mean being out of the labor market for decades.

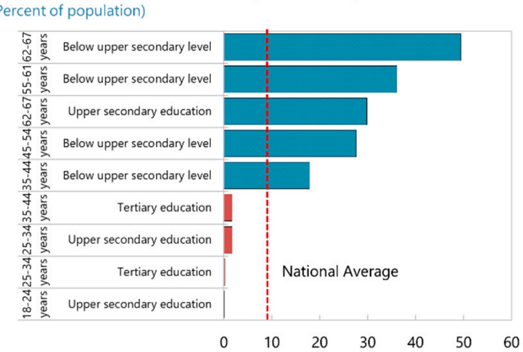
3. Age and education level are important predictors for the likelihood of becoming a beneficiary of long-term disability benefits. The recipiency rate among individuals who have not attended upper secondary school is five times higher than among those with a university degree. The recipiency rate among the 62–67 year old is 30 percent, which is six times higher than that of the 35–44 old, potentially suggesting that some individuals use sickness and disability benefits as a

Recipients of Permanent Disability Benefit by Age Group
(Percent of population)



Source: Statistics Norway.
Note: National definition of average used.

Recipients of Permanent Disability Benefits, by Education Level
(Percent of population)

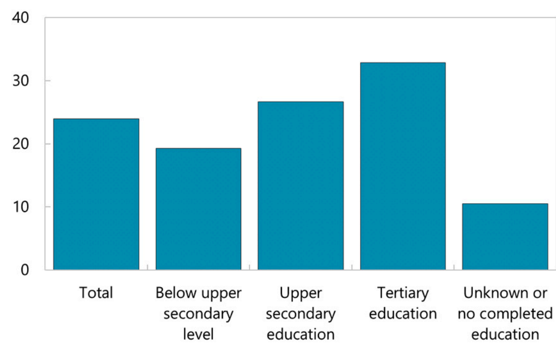


Sources: Statistics Norway; and IMF staff calculations.
Note: National definition for averaged used.

vehicle for early retirement. Almost half of the 62–67 old without upper secondary education receive disability benefits.

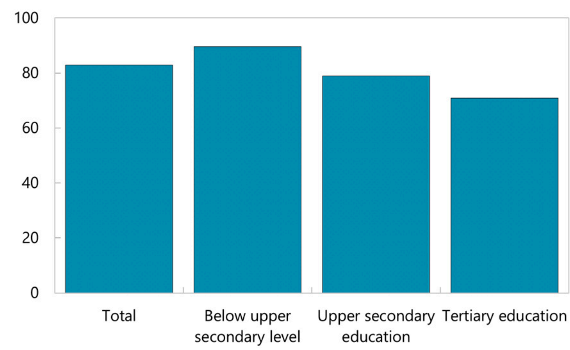
4. The majority of the beneficiaries are not working. Almost 80 percent of all beneficiaries are not working, whereas almost 70 percent of those beneficiaries with a university degree pursue some type of work. This largely mirrors differences in the percentage of the disability degree among beneficiaries with different educational attainments.

Permanent Disability Recipients Working by Education Level
(Percent)



Source: Statistics Norway.

Recipients of Permanent Disability Benefits by Education Level
(Percent of population, 100 percent disability)



Source: Statistics Norway.

5. A successful reform is key, as it would go a long way in helping sustain labor supply amid growing demographic pressures. The government-appointed commission's recent recommendations, which will now be discussed by the social partners, are welcome. In staff's view, a suitable reform package would ideally consist of a combination of measures, many of which build from those proposed by the commission:

- ***Reforming sick pay:*** Under the present system, employers have disincentives to encourage employees to return to work after a period of prolonged sickness as the cost is fully born by the state, and sick employees are rarely required to work part time. It is therefore important that employers and employees participate in the financial cost of prolonged sick leave, and that doctors more often issue partial absence certificates which requires sick employees to work part time as shown by recent research.

- ***Reforming work assessment allowance:*** There can be significant gains from requiring beneficiaries of the work assessment allowance to attend full-time training programs, but the number of participants remains low. Greater state-level financial support for such programs can therefore be a worthwhile investment over the long term.

- ***Tightening eligibility and certification:*** Eligibility criteria for the full disability pension are somewhat more generous in Norway compared to some international peers. The share of applicants that are rejected also appears to be relatively low in international comparison, and recent research has also questioned whether family doctors can be able 'gatekeepers'. Reviewing eligibility criteria and procedures for certification are therefore important.

- ***Reducing disability benefit levels:*** Both minimum and maximum disability benefit levels are high in international comparison, even after controlling for average incomes. If across-the-board reductions prove difficult politically, at a minimum, benefit levels should be reduced for younger age groups where the benefit levels are oftentimes higher than wages of working peers.

- ***Increasing work incentives:*** Under the present system, there are strong disincentives to earn more than 40,000 kroner, given the loss of benefits beyond that level. This threshold level could be increased, and the loss of benefits from other income could be smoothed and made more gradual up to the new threshold level.

6. Efforts to reform the system of sickness and disability pensions would need to take into account distributional effects. As shown above, less educated people with fewer opportunities on the labor market are more likely to benefit from sickness and disability pensions. Hence the distributional consequences of any reform will have to be carefully weighted and if necessary offset through more efficient and better targeted measures. In addition, the increasing take-up of sickness and disability by the less educated is a symptom of limited demand for marginal workers at prevailing wages. This would call for a significant step-up of training and other active labor market policies to boost their employment opportunities.

7. The commission also proposes to introduce productivity-adjusted wages. The experts argue that demand for the labor of beneficiaries of disability pensions is likely to be low, given that their productivity is impaired for various reasons. They therefore propose the possibility to significantly reduce wages for the disabled in line with the productivity differentials between the latter and other employees to create incentives for employers to hire them. While this proposal is appealing from a theoretical perspective, the challenges to implement such a system would need to be carefully evaluated.

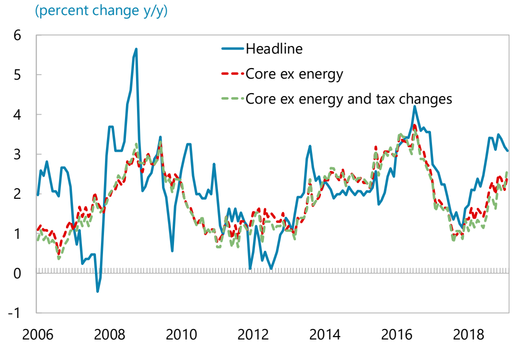
8. Reforms in peer countries show that success hinges on a combination of tighter eligibility, better incentives, and boosting employment opportunities of potential beneficiaries. For instance, Switzerland tightened medical certification by moving from assessments by general practitioners to a more centralized and uniform evaluation. In Finland, reform put greater emphasis on supporting beneficiaries to remain employed or find work, while accompanying this with a *de facto* tightening of eligibility criteria–rejection rates are now substantially higher than in Norway. Similarly, the 2008 reforms in Sweden also combined stronger incentives (for instance, through a reduction in the cash value of sickness benefits for those who did not return to work) with enhanced support to help them return to work.

Annex VI. Assessing Inflation Developments and Underlying Drivers

Inflation had been subdued since the oil downturn until recently, reflecting lagged exchange rate pass-through, remaining slack in the economy and moderate wage growth. Weak wage pressure can be primarily explained by the drag on the terms of trade from the oil shock, spillovers from weak foreign wages and other domestic factors including lower productivity growth and remaining labor slack. As terms of trade improve further along with stronger labor market conditions, wages are expected to rise faster. Stronger economic activity would also imply wider profit margins, contributing to higher underlying inflationary pressure going forward.

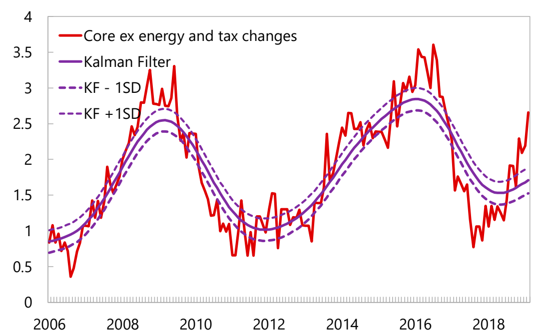
1. **Inflationary pressures had remained weak since the oil downturn, before finally picking up in late 2018.** Following the oil shock, core inflation declined sharply from 4 to below 1 percent, and hovered around low levels before finally picking up in recent months. Kalman-filtered trend inflation suggests that the rise in core inflation is still early in the upswing. Headline inflation picked up faster as energy prices began to rise in late 2017.

Key Inflation Measures
(percent change y/y)



Sources: Haver, IMF staff calculations

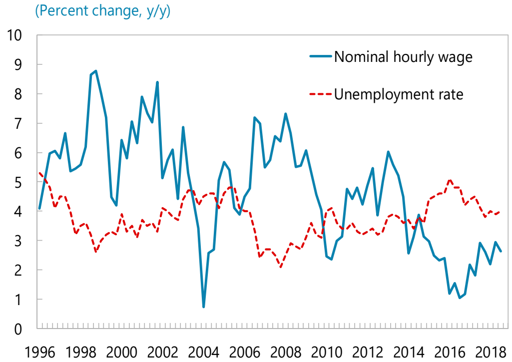
Core Inflation and Trend
(Percent change, y/y)



Sources: Haver, IMF staff calculations

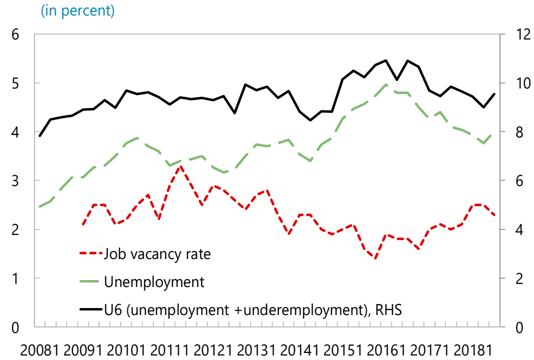
2. ***Prima facie,* it would be tempting to conclude that standard Phillips Curve has flattened in Norway.** The unemployment rate based on the labor force survey has fallen below 4 percent, from its peak above 5 percent after the oil shock. Broader labor slack indicators, such as

Wage growth and Unemployment
(Percent change, y/y)



Sources: Haver, IMF Staff calculations

Labor market slack indicators
(in percent)



Sources: Haver, Eurostat, IMF staff calculations underemployment rate and job vacancy also confirm a tight labor market. However, core inflation was until recently much lower than historic levels when the labor market was in comparable conditions.

3. **The analysis here will investigate factors that explain the wage and inflation moderation before the most recent pickup, using a two-step approach.** First, a standard price Phillips curve is estimated, with nominal effective exchange rate, nominal wage growth, output gap, and euro area inflation being the key determinants of core inflation. Second, wage dynamics, a key determinant of inflation, are analyzed separately using an error correction approach to capture both long run and short run driving factors.

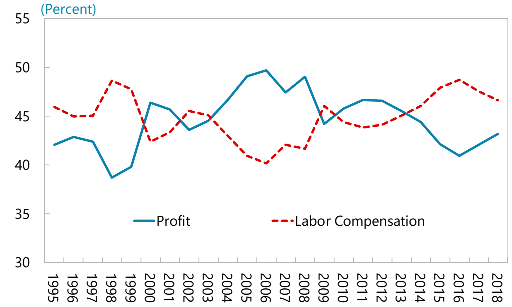
4. **The estimation of the Phillips curve suggests that the slow pick-up of core inflation was mostly due to weak/lagged exchange rate pass-through, subdued wage growth and some remaining slack in the economy** (Table A1).

- ***Exchange rates:*** Historically, the correlation between exchange rates and inflation was very strong, and the exchange rate had been the key determinant of inflation dynamics. The oil downturn resulted in a large Krone depreciation that pushed core inflation above 3 percent. But core inflation dropped rapidly after this, without any meaningful change in the exchange rate.

- ***Wages/labor market conditions:*** Labor market conditions are also an important determinant for core inflation through their impact on wages. Wages typically lead core inflation by about 1 to 4 quarters. Controlling for other factors, a one percentage point increase in wage growth raises core inflation by about 0.1 percent. Subdued wage growth (driving forces are analyzed later) partly explains weak inflation dynamics then.

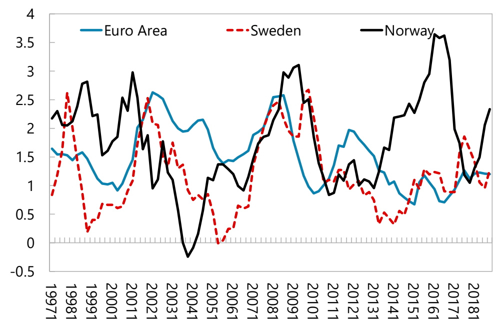
- ***Economic slack:*** Broader economic slack, which is often associated with lower profit margins, could also weigh on inflation. Using the output gap as a proxy, a one percentage increase (decline) in the output gap is

Profit and Wage Share
(Percent)



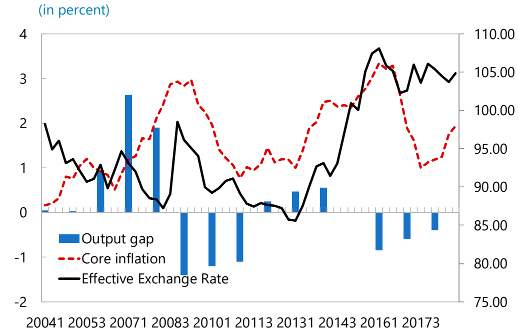
Sources: Haver, IMF Staff Calculation
Note: Profit share = (net operating surplus +capital consumption)/total GDP

Cross Country Core Inflations
(Percent, yoy)



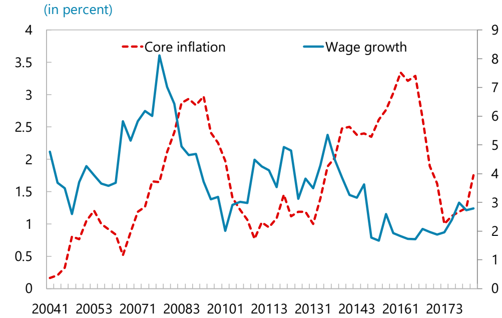
Sources: Statistics Norway

Core Inflation and Underlying Drivers
(in percent)



Sources: Statistics Norway, IMF Staff Calculations

Wage and Core Inflation
(in percent)



Sources: Statistics Norway, IMF Staff Calculations estimated to raise (lower) core inflation by close to 0.2 percent. The still negative output gap in 2018 partly contributed to inflation weakness.

- ***Foreign inflation:*** Given large trade exposure to the Euro Area, subdued inflation there could also have negative spillover effects on inflation in Norway. It is found that foreign inflation operates partly operate its impact through wages (see below), and partly through other imported prices (significant coefficients on both IPC indices[1] and euro area producer prices).

5. To investigate the key drivers of slow wage growth, an error correction model is used (Zhang 2019[2]). The model consists of a real wage level equation that determines its long run equilibrium, and a nominal wage growth equation that captures the short run wage dynamics. Real wages are expected to grow in pace with trend productivity in the long run, allowing for temporary deviations. The short run wage dynamics can be affected by expected inflation, labor market slack, productivity growth, and self-correction of temporary deviations from the equilibrium that cannot be explained by fundamentals. In our model, we use two-year expected inflation since one-year expected inflation tracks mainly actual inflation, and longer-term expected inflation follows mainly the inflation target. Labor slack indicators include unemployment and underemployment rates; we also test capacity utilization for robustness.

Long run: $\ln RW_t = \alpha + \beta \ln TP_t + \varepsilon_t$, where residual captures the error correction process.

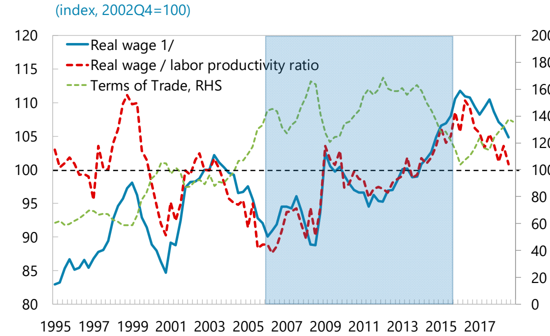
Short run: $d\ln W_t = \alpha + \beta_1 d\ln TP_{t-4} + \beta_2 dEInf_{t-4} + \beta_3 U_{gap,t-4} + \beta dU_{t-1} + ECM_{t-4} + \upsilon_t$

6. Results indicate that recent wage moderation was largely due to the drag from weakened terms of trade after the oil shock, and to a lesser extent to subdued foreign wages, remaining labor slack and slower trend productivity growth (Table A2, A3).

- ***Labor slack:*** Both the standard unemployment rate and nonemployment rates (REO 2018[3]) have a significant effect on wage growth, although the non-employment rate, which captures broader lack slack, seems to have a higher explanatory power. A one percentage point increase in the unemployment or nonemployment rate lowers wage growth by about 1.2 and 0.7 percent respectively.

- ***Terms of trade:*** Real wages outpaced labor productivity substantially during the oil boom (highlighted area in the chart below), with export prices exceeding import prices by a large margin. The oil downturn, followed by a sharp correction in the terms of trade, also led to a decline of real

Real Wage, Labor Productivity, and Terms of Trade
(index, 2002Q4=100)



Sources: Haver, IMF staff calculations
1/ nominal wage is deflated by GDP deflator

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[1] Indicator of international inflationary impulses to consumer goods. Source: Norges Bank.

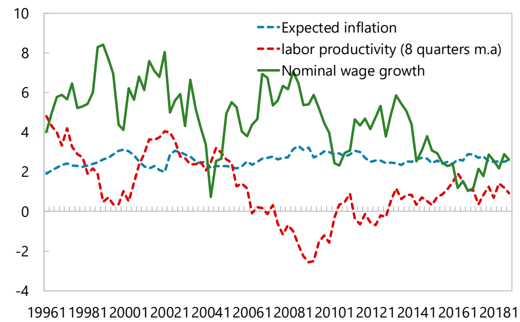
[2] Zhang (2019), "European Wage Dynamics and Spillovers", IMF forthcoming working paper.

[3] International Monetary Fund, 2018, "Chapter 2: European Wage Dynamics and Labor Market Integration, "Regional Economic Outlook: Europe, May 2018, Washington, D.C.

wages, a self-correction from previous years of wage overhang. The terms of trade, captured both by the error correction term and as a separate variable in the short run regression, are significant and explain about half of the wage slowdown during the oil downturn, and continued to weigh on the wage recovery after it.

- ***Expected inflation:*** Wage growth also reacts to expected inflation; consistent with it being a key factor in the wage negotiation process.

Nominal Wage Growth and Fundamentals
(in percent)



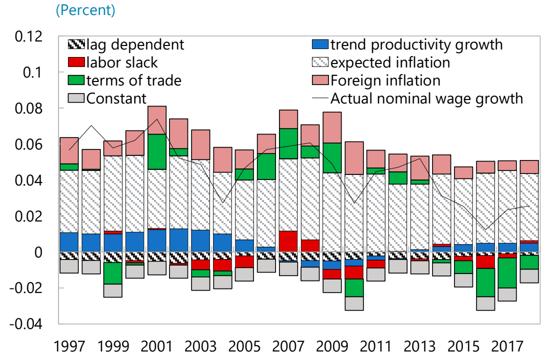
Sources: Statistics Norway, IMF Staff Calculation

- ***Lower trend productivity growth:*** Trend productivity growth has recovered from the oil crisis but is still much lower than before the global financial crisis. A decomposition exercise suggests that lower trend productivity growth also explains the slow wage growth in recent years.

- ***Foreign wages:*** Being a small open economy, wage growth in key trade competitors often serve as an important benchmark for setting domestic wages, so as to maintain its international competitiveness. Estimations suggest that euro area wage growth have a significant impact on wage growth in Norway after controlling for all other factors.

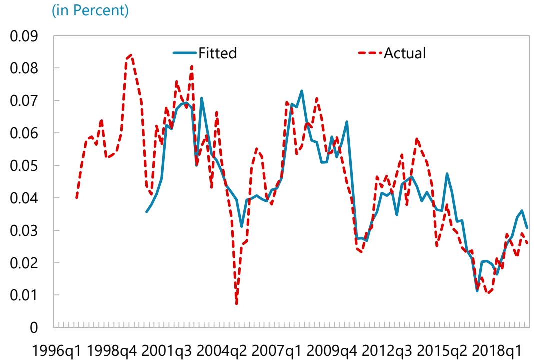
7. **In short, the recent wage moderation in Norway has some common features to that observed in other advanced European countries, but it also has unique features.** Wage moderation is not unique to Norway; wage growth has remained subdued either because fundamentals are still weak, or wages are self-correcting to their long-term trend (Zhang 2019). Like in other European countries, wages respond to labor slack, expected inflation, and trend productivity, even if the sensitivities are found to be stronger in Norway than elsewhere. Norway's domestic wage formation also reacts to wage developments abroad; other countries are also reacting to wages abroad, which explains broad wage moderation across advanced European countries (REO 2018). But a key distinguishing factor in Norway is that terms of trade dynamics play a big role in driving wage developments. During the oil price boom that ended in 2014 (notwithstanding the sharp but short-lived correction in 2008–09), real wages grew much faster than

Decomposition of Nominal Wage Growth
(Percent)

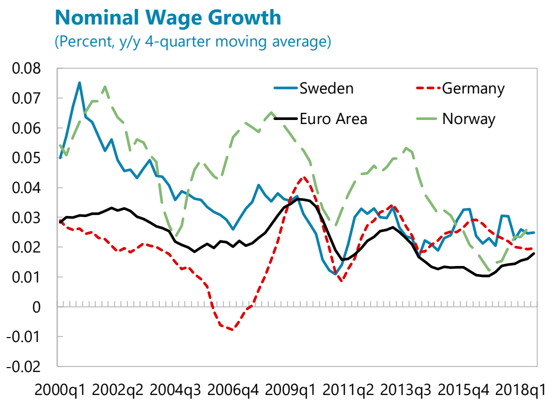


Sources: Haver Eurostat, IMF staff calculation

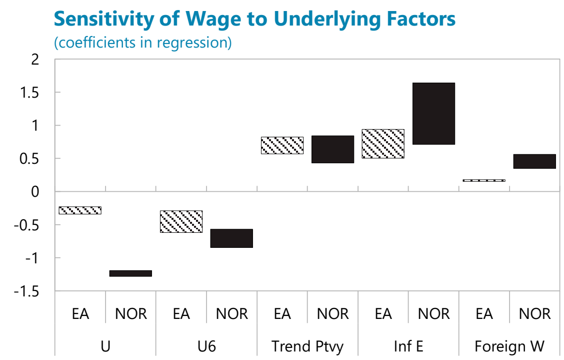
Actual and Fitted Wages
(in Percent)



Sources: Eurostat, Statistics Norway, and IMF staff calculations implied by trend productivity; moderate wage growth in recent years could thus be seen as a correction towards the long run relationship. More recently, the apparent pick-up in wage growth in Norway could signal an end to this self-correction.



Sources: Haver, Eurostat, IMF Staff calculation



Sources: Eurostat, Statistics Norway, and IMF Staff Calculations

Table 1. Price Phillips Curves

	Core inflation				
VARIABLES	(1)	(2)	(3)	(4)	(4)
L4. dependent	0.34***	0.24**	0.30***	0.30***	0.28***
	(0.10)	(0.09)	(0.10)	(0.09)	(0.08)
L1-4. wage growth	0.08*	0.07*	0.07*	0.13***	0.09**
	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)
L3. exchange rate changes		0.06***	0.07***	0.06***	0.06***
		(0.01)	(0.01)	(0.01)	(0.01)
L3. euro area producer inflation			0.06*		
			(0.03)		
L3. trading partner ipc				0.16***	0.12*
				(0.06)	(0.06)
L4. output gap					0.13***
					(0.05)
Constant	0.01***	0.01***	0.01***	0.01***	0.01***
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Observations					
R-squared					
Standard errors in parentheses	87	87	87	87	87
*** p<0.01, ** p<0.05, * p<0.1	0.14	0.27	0.29	0.39	0.44

Table 2. Long Run Wage Equations

	log real wage			
VARIABLES	1995-2005	2006-2018	1995-2018	1995-2018
logPtvyq	0.67***	2.06***	0.85***	1.37***
	(0.09)	(0.46)	(0.09)	(0.23)
logtotq				0.31***
				(0.04)
Constant	-8.88***	-15.29***	-9.69***	-13.54***
	(0.41)	(2.14)	(0.39)	(0.89)
Observations	44	51	95	95
R-squared	0.56	0.29	0.51	0.83

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Table 3. Short Run Wage Equations

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
L4. dependent	-0.09	-0.13	-0.13	-0.18	0.06	-0.05	-0.01	-0.08	0.07	-0.02	0.01	-0.08
	(0.10)	(0.10)	(0.11)	(0.11)	(0.09)	(0.09)	(0.09)	(0.09)	(0.09)	(0.10)	(0.10)	(0.11)
L4. trend productivity growth	0.72***	0.84***	0.83***	0.79***	0.43***	0.64***	0.55***	0.48***	0.64***	0.82***	0.76***	0.72***
	(0.12)	(0.14)	(0.15)	(0.15)	(0.12)	(0.14)	(0.14)	(0.14)	(0.13)	(0.16)	(0.16)	(0.16)
L4. unemployment gap	-1.28***	-1.20***	-1.19***	-1.26***								
	(0.25)	(0.25)	(0.26)	(0.26)								
L. change of unemployment rate	-1.02***	-1.02***	-1.01***	-1.20***								
	(0.21)	(0.21)	(0.21)	(0.24)								
L4. nonemployment gap					-0.75**	-0.57*	-0.65**	-0.85***				
					(0.33)	(0.32)	(0.32)	(0.32)				
L. change of nonemployment rate					-0.73***	-0.77***	-0.67**	-0.97***				
					(0.27)	(0.26)	(0.26)	(0.28)				
L4. capacity utilization gap									0.25***	0.24***	0.24***	0.35***
									(0.07)	(0.07)	(0.07)	(0.09)
L. 2-year ahead expected inflation		0.84	0.85	0.71		1.58***	1.64***	1.48***		1.19**	1.28**	1.04*
		(0.54)	(0.55)	(0.55)		(0.55)	(0.53)	(0.52)		(0.60)	(0.60)	(0.60)
L4. terms of trade			0.00	0.00			0.02**	0.03**			0.02	0.02*
			(0.01)	(0.01)			(0.01)	(0.01)			(0.01)	(0.01)
L4. Euro area wage growth				0.35				0.51**				0.56*
				(0.22)				(0.22)				(0.28)
L4. error correction term	-0.20***	-0.22***	-0.22***	-0.19***	-0.20***	-0.24***	-0.18***	-0.14***	-0.18***	-0.20***	-0.17***	-0.11**
	(0.03)	(0.03)	(0.04)	(0.04)	(0.03)	(0.03)	(0.04)	(0.04)	(0.03)	(0.03)	(0.04)	(0.05)
Constant	0.04***	0.02	0.02	0.02	0.04***	-0.00	-0.00	-0.01	0.04***	0.01	0.00	0.00
	(0.00)	(0.01)	(0.01)	(0.01)	(0.00)	(0.01)	(0.01)	(0.01)	(0.00)	(0.01)	(0.02)	(0.01)
Observations	87	87	87	87	77	77	77	77	87	87	87	87
R-squared	0.66	0.67	0.67	0.68	0.62	0.66	0.68	0.70	0.55	0.58	0.58	0.60

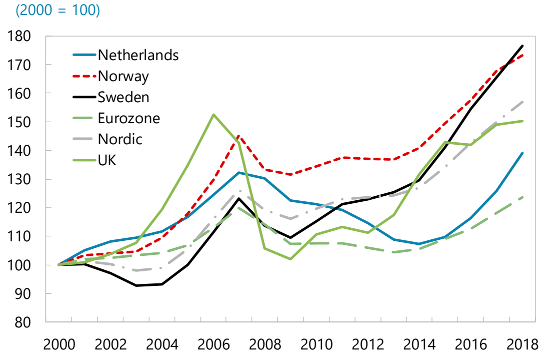
Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Annex VII. Commercial Real Estate in Norway

Risks in the commercial real estate sector have risen significantly following a prolonged price boom, outpacing international peers. Banks are vulnerable to a CRE price correction given their large exposure to CRE loans and the CRE sector's strong cyclicality. The recent increase in non-bank financing mitigates banks' direct exposure to the CRE sector, but the latter becomes more susceptible to the volatility from financial markets.

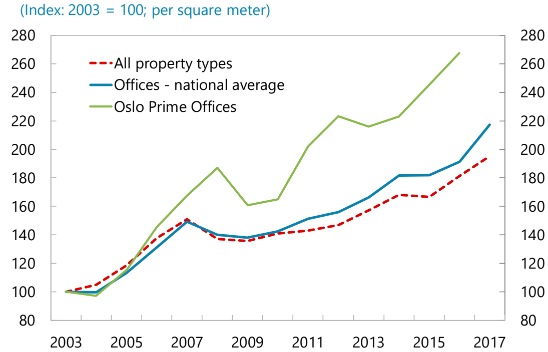
1. **Commercial real estate prices have risen significantly in Norway since the global financial crisis, particularly prime offices in Norway.** Real CRE prices have increased by more than 50 percent since 2000, outpacing most international peers including Sweden and UK, which are also experiencing a commercial real estate boom. Within Norway, price increases have not been uniformed across CRE segments and regions–adjusting for inflation, prime offices in Oslo are two and half times more expensive now than in the early 2000s, while other regions or types of property experienced slower price increases.

Commercial Real Estate Capital Growth Index
(2000 = 100)



Sources: MSCI IPD

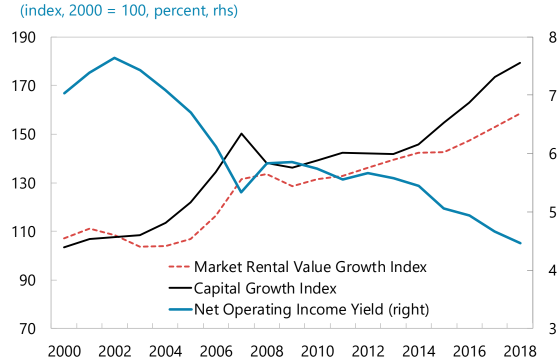
Real Prices of Commercial Property
(Index: 2003 = 100; per square meter)



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

2. **Strong demand, by both domestic and foreign investors, has fueled the CRE boom given limited new supply.** Market transactions have more than doubled since the global financial crisis. In the prime Oslo office segment, vacancy rates have been falling in recent years and are projected to decline further until 2020, while rents are on a solid upward trajectory. Demand has been driven by the

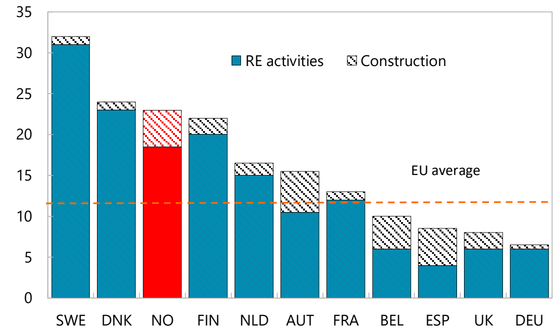
Norway: CRE Growth and Value Indices and Yield
(index, 2000 = 100, percent, rhs)



Source: MSCI IPD

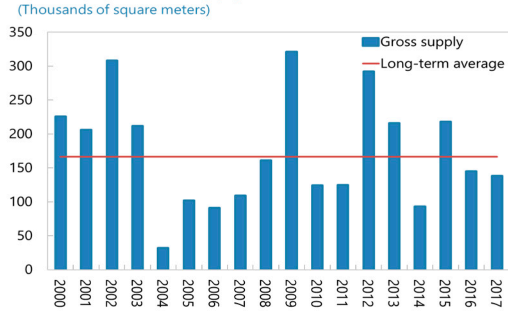
overall strong economic environment[1] and the search for yield in a low interest rate environment. The share of foreign investors involved in transactions is roughly 20 percent, mostly through investment funds (e.g., REITs). The share rose rapidly in 2016-17, and slightly decreased more recently. New supply of office space, on the other hand, has been falling since 2015 and remains below the long-term average.

Banks' Lending for Real Estate and Construction
(in percent of GDP)



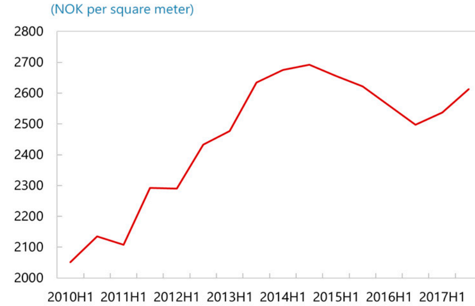
Sources: ESRB and IMF Staff Calculations

Oslo Office Gross Supply
(Thousands of square meters)



Sources: Pangea Research; Arealstatistikk; and Eiendomsspar.

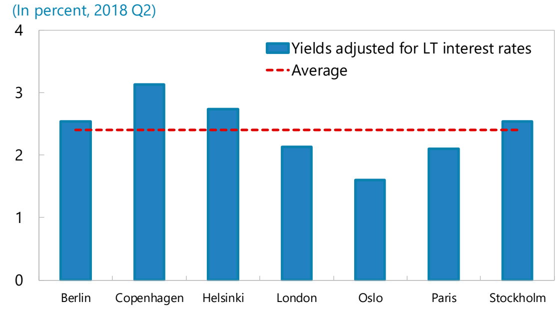
Oslo Real Gross Rent (Prime)
(NOK per square meter)



Sources: Pangea Research; Arealstatkstikk; and Eiendomsspar.

3. The prolonged price boom implies a significant risk of a sharp and substantial price correction. Except for a mild and brief correction, CRE prices have increased for 9 consecutive years, with yields falling to historically-low levels. The Norges Bank estimates that yield spreads in prime office space in Oslo are now far below those in other large European cities. A significant increase in the risk premium could trigger an abrupt correction of commercial property prices. While data for Norway is not available, evidence from Sweden (Sweden 2019 Article IV) suggests that the combination of low yields and rapidly rising prices have historically been an indicator of future price falls. The yields currently observed in Norway are close to the levels observed in Sweden in the early 1990s, just ahead of the property bust.

Yields on Prime Office Space in Large European Cities Adjusted for Long-term Interest Rates 1/
(In percent, 2018 Q2)



Sources: CBRE, OECD and Norges Bank.
1/ The 10-year government bond yield is used as the long-term interest rate for each country.

4. In the past, exposure to CRE has been shown to be correlated with the failure of individual banks, and bubbles in commercial real estate prices have often preceded financial crises. Using historical data from the U.S. covering the 1980s and early 1990s, Freund et al.

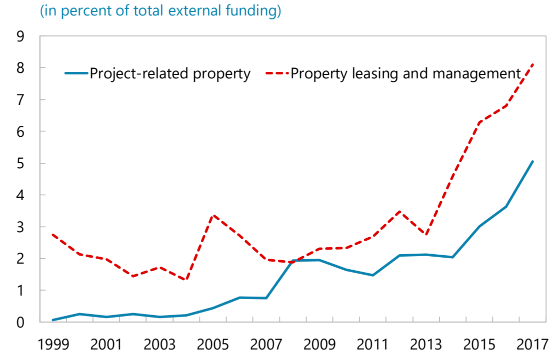
[1] Hagen 2016, "Commercial real estate in Norway", Norges Bank Economic Commentaries.

(1997)[2] showed that banks which failed had significantly larger CRE loans portfolios compared to banks that survived. D'Erasmo (2019)[3] also found similar results during the global financial crisis. In Norway, CRE prices declined by about 70 percent from their peak in 1987 to 1993, the end of its banking crisis. Commercial real estate bubbles have also played important roles in the Swedish banking crisis (Sweden Selected Issues Papers, 2019), in the savings & loans crisis in the U.S. (Freund et al., 1997), as well as in the Asian crisis and Japan's lost decade (Crowe et al., 2013).[4]

5. Commercial real estate has important implications for financial stability in Norway given banks' large exposure to CRE loans. In Norway, bank lending to real estate and construction companies is high both in terms of GDP and [share of the loan portfolio] relative to international peers. As of June-2018, banks' lending to commercial property companies (real estate and construction) represented 56 percent of total corporate loans (15 percent of all bank loans) in Norway. On the positive side, Norwegian banks have large loss-absorbing buffers against this exposure, and recent stress tests by the FSA show banks could withstand significant price declines without need for recapitalization.

6. Financing of CRE in Norway has somewhat shifted away from banks. Non-bank financing has been rising steadily since the global financial crisis similarly to other European countries but remains relatively small in level terms. Although this mitigates banks' direct exposure to the CRE sector, the latter becomes more susceptible to the volatility of market financing. Macro-prudential policies on CRE are currently only targeted at banks and could leak with the rise in non-bank financing.

Market Funding
(in percent of total external funding)



Sources: Finanstilsynet

7. Going forward, closely monitoring the risks associated with CRE developments remains essential, and this requires filling data gaps. Precise assessments of these risks are hampered by shortcomings in available data. Most CRE data comes from private providers and is often incomplete, not representative and not comparable across different data sources. Hence, greater efforts from the authorities to collect and disseminate better quality data may be warranted.

[2] Freund, Curry, Hirsch, and Kelley (1997), "Commercial real estate and the banking crises of the 1980s and early 1990s", Federal Deposit Insurance Corporation.

[3] D'Erasmo (2019), "Estimating today's commercial real estate risk", Banking trends.

[4] Crowe, Dell'Ariccia, Igan, and Rabanal (2013), "How to deal with real estate booms: lessons from country experiences", Journal of Financial Stability

Annex VIII. Authorities' Response to Past IMF Recommendations

Fund Policy Advice from 2018 Consultation	Authorities' Actions
Fiscal Policy: With the output gap turning positive in 2019, the authorities should target a modest consolidation. Further tax reforms should be considered to promote an efficient allocation of resources and sustain longer term growth.	The authorities have targeted a neutral stance over 2018 and 2019. This is better than the pro-cyclical stance in the previous upturn but falls short of staff's recommended (modest) consolidation. The 2019 budget continues to feature incremental reductions to corporate and personal income taxes, and small changes to broaden the tax base further. Valuation discounts for shares and operating assets on net wealth taxes have been further increased.
Macroprudential Policy: The mortgage regulations should not be loosened, and the regional differentiation of the "speed limit" should be maintained. The regulations should be made a permanent part of the prudential toolkit—parameters could 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.	The Ministry of Finance decided in June 2018 to extend the mortgage regulations until end-2019, including the differential speed limit. The regional differentiation in prices has recently narrowed, which justifies not pushing the regional differentiation further. The regulations have not yet been made permanent.
Structural Reforms: Wage moderation as achieved by social partners during the recent downturn should be carried forward, to help build resilience in case of less positive trends in international prices and facilitate the gradual transition out of oil. Further reforms are needed to sustain high labor participation amid growing demographic pressures and technological change, including reforming sickness and disability schemes.	Social partners remain committed to moderate wage increases: for this year they agreed on 3.2 percent nominal wage growth in the wage-leading sector. Other sectors are expected to fall close to this value. An Employment Commission has issued recommendations on sickness and disability reform along with other labor market measures. Social partners are now expected to meet to discuss the commission's proposals. Changes to the integration system for immigrants (notably non-OECD immigrants) have been introduced, standardizes the curriculum and making participation more flexible depending on individual circumstances.

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). In June 2018, the Ministry of Finance extended 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. Even though the NSFR requirement has not yet been introduced, the NSFR is implemented as a reporting requirement. All Norwegian banks had a NSFR ratio of at least 100 percent per Q3:2018.
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 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	**Done/Under consideration**. The FSA and Norges Bank have finalized a framework for liquidity stress testing. The set up uses cash flow structures at different maturities and funding gaps are calculated under three different stress scenarios. Stress tests of the seven largest Norwegian banks were conducted in the fall of 2018 and the results were (anonymously) published in the FSA's Risk Outlook report in December 2018. Norges Bank also published results from the stress test in its Fincial Stability report in October 2018. The framework has been used in a few on-site inspections. There are plans to further develop the framework with regards to feedback effects, systemic dimensions and possibly linking solvency and liquidity stress testing. With regards to cross-ownership of covered bonds, the FSA has started a project to look into the concentration of covered bonds in Norwegian banks' liquidity buffer (LCR).
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 January 1, 2016. Norwegian undertakings participated in the European Insurance and Occupational Pensions Authority (EIOPA) stress-test in 2016 and 2018. 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. Similar inspections have been conducted in the remaining undertakings in 2018 and in the first half of 2019. In 2018, the FSA conducted a survey that includes all life insurance companies, where the purpose was to compare and challenge the calculated levels of the best estimate of technical provisions. A similar survey will be conducted in 2019.

Priority Recommendations	Time	Status
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. 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. As of the first quarter of 2019, all Norwegian life insurance companies are satisfactorily capitalized.
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	**Partly done.** The FSA has been given substantial sanctioning powers under the AML/CFT regulatory framework (see also below). Further, the FSAs budget has seen steady increases over the last years, in particular for 2019. This has among other things been allocated to supervision in relation to AML/CFT.
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. Risk assessments are updated annually and form the basis for the FSA's prioritization of its work against ML/TF. In the last year, the FSA has conducted AML/CFT on-site inspections in several institutions, including, banks, insurance undertakings and insurance intermediaries, investment firms, real estate agents, auditors and external accountants. The inspections are partly general inspections where AML/CFT is covered as one of several topics, and partly where AML/CFT is the main or sole topic. AML/CFT is also part of some off-site inspections. The number of inspections covering AML/CFT is rising, and more resources have been allocated to this work. As a result of increases in resources and supervisory activity, the FSA has

Priority Recommendations	Time	Status
		decided to set up a dedicated Section for AML, which is planned to be operational from April 2019. A new AML Act was passed by the Norwegian Parliament in June 2018. It entered into force on October 15, 2018, together with a new AML regulation. The AML Act implements the EU's Fourth Anti-Money Laundering Directive (2015/849) and the 2012 FATF Standards. The Act, i.a., gives the FSA powers to sanction non-compliance with administrative fines. The FSA has published general and sector-specific guidance papers on AML/CFT in 2016 and 2017. New guidance tailored to the new AML Act is under way, with a planned publication before the summer 2019. The government published a new national risk assessment in November 2018.
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.** On January 1, 2019, the new legal framework corresponding to the EU's BRRD framework, including rules on resolution planning, entered into force. The FSA is designated as the resolution authority in Norway and has started resolution planning for the largest banking groups in accordance with the BRRD framework.
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.

Priority Recommendations	Time	Status
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.) Effective from January 1, 2019, a new Board was appointed to the BGF. The new Board was appointed by the MoF rather than elected by the member banks. The new Board has adopted the same principles as the previous Board regarding recusal and conflict of interest.

INTERNATIONAL MONETARY FUND

NORWAY

May 24, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(in consultation with other departments)

CONTENTS

FUND RELATIONS

(As of April 30, 2019)

Membership Status: Joined: December 27, 1945; Article VIII

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	3,754.70	100.00
Fund holdings of currency	3,228.88	86.00
Reserve tranche position	525.83	14.00
Lending to the Fund		
New Arrangements to Borrow	149.31	

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	1,563.07	100.00
Holdings	1,567.16	100.26

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				
	2019	2020	2021	2022	2023
Principal					
Charges/Interest	0.03	0.02	0.02	0.02	0.02
Total	0.03	0.02	0.02	0.02	0.02

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).

Monetary and Financial Statistics:
Monetary statistics compiled by the authorities are consistent with the methodology of the 2016 Monetary and Financial Statistics Manual and Compilation Guide (MFSMCG). Norway reports regular and good quality monetary statistics for publication in IFS, although there is room for improving the timeliness of the data on other financial corporations.

Financial Sector Surveillance:
Norway reports Financial Soundness Indicators (FSIs) to the Fund, which are published on the IMF's FSI website. All core FSIs for deposit takers are reported on a quarterly basis. Only one of the encouraged FSIs for deposit takers is reported but many of the encouraged FSIs for other sectors are provided.

Norway reports data for some basic series and indicators in the Financial Access Survey (FAS), including mobile money and the two indicators adopted by the United Nations to monitor Target 8.10.1 of the Sustainable Development Goals (SDGs).

Article IV Consultation: Norway is on the 12-month consultation cycle.

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

Technical Assistance: None

Resident Representative: None

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance	
General. Data provision is adequate for surveillance. The quality, timeliness, and comprehensiveness of data in Norway is excellent. One specific exception is the commercial real estate sector, where better data could better help monitor growing risks.	
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).	A *Report on the Observation of Standards and Codes (ROSC)* data completed in 2003 is publicly available.

Norway: Table of Common Indicators Required for Surveillance
(As of May 31, 2019)

	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	30/05/19	30/05/19	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	04/19	05/19	M	M	M		
Reserve/Base Money	04/19	05/19	M	M	M	O, O, O, LO	O, O, O, O, O
Broad Money	04/19	05/19	M	M	M		
Central Bank Balance Sheet	04/19	05/19	M	M	M		
Consolidated Balance Sheet of the Banking System	04/19	05/19	M	M	M		
Interest Rates[2]	04/19	05/19	M	M	M		
Consumer Price Index	04/19	05/19	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2018	2019	A	A	A	LO, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	04/19	05/18	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4 2018	04/19	Q	Q	Q		
External Current Account Balance	Q4 2018	03/19	Q	Q	Q	O, O, O, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	Q4 2018	03/19	Q	Q	Q		
GDP/GNP	Q1 2019	05/19	Q	Q	Q	O, O, O, O	O, O, O, O, LO
Gross External Debt	Q1 2019	06/19	Q	Q	Q		
International Investment Position[6]	Q1 2019	06/19	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 Jon Sigurgeirsson, Alternate Executive Director for Norway and Snorre Evjen, Senior Advisor to Executive Director
June 10, 2019

On behalf of the Norwegian authorities, we would like to thank staff for candid discussions during the Article IV mission and an insightful report on the Norwegian economy. The Norwegian authorities attach great importance to IMF's assessments as they see them as helpful for identifying shortcomings and evaluating economic policies.

Economic growth is strong and employment increasing

The Norwegian economy is performing well. Employment growth is high, and unemployment has come down across the country. The employment rate is rising after falling for several years.

Growth in the mainland economy (excluding petroleum production and shipping) has picked up in recent years and was above trend last year for the first time in three years. The Government forecasts growth in the mainland economy to continue to outpace trend this and next year. Capacity utilization is expected to increase further and unemployment to go further down.

The upswing is broad-based. Activity is increasing in retail, manufacturing, construction, and among suppliers to the petroleum industry. Improved cost competitiveness paves the way for increased exports and non-oil business investments. Higher purchasing power supports consumption growth.

Petroleum investments are likely to increase markedly this year, following a sharp decline after the oil price fall in 2014/15. Higher oil prices and substantial cost-reducing measures implemented by the oil companies have made this increase possible. In the medium term, the challenge of managing a smooth transition to a less oil-dependent growth model remains.

The Norwegian economy relies heavily on trade and well-functioning international markets. Tendencies towards rising protectionism around the world may cause considerable headwinds. On the other hand, growth could edge up if higher oil prices combined with the cost reductions in oil field developments boost petroleum investments.

Fiscal policy has been broadly neutral in recent years

Due to the pick-up in the mainland economy, the Government has held back public expenditures and kept fiscal policy broadly neutral over the 2017-2019 period. Spending of petroleum revenues in 2019 corresponds to 2.9 percent of the Government Pension Fund Global (GPFG), which is in line with Norway's fiscal rule of limiting spending to 3 percent of the Fund over time. Spending of petroleum revenues has been at or below 3 percent of the Fund since 2014. The fiscal impulse in 2019 is, according to the latest figures from May this year, estimated at ½-percentage point of GDP. The revised impulse for 2019 mainly reflects a downward revision of spending in 2018. Taken together 2018 and 2019, still show a neutral impulse.

The Norwegian fiscal framework is designed to ensure sustainable management of resource revenues from the petroleum sector, while at the same time providing flexibility to handle temporary setbacks in the economy or fluctuations in the oil price and the market value of GPFG. All petroleum revenues are transferred into the Fund, and, over time, spending is guided by the estimated real return of the Fund. Strong growth and low unemployment now call for fiscal restraint to avoid overheating and to better prepare for future shocks and fiscal challenges from an aging population.

Monetary policy entails a gradual increase in the key policy rate

Following solid GDP growth, improving labor market conditions, and higher price and wage inflation, Norges Bank raised its key policy rate for the first time in seven years in September 2018. The policy rate was raised further in March of this year and is now at 1 percent. In March, Norges Bank projected a gradual increase in the policy rate to 1.75 percent at the end of 2022, commenting that the uncertainty surrounding global developments and the effects of monetary policy suggested a cautious approach to interest rate setting. In May, Norges Bank's assessment was that the outlook and balance of risks continue to imply a gradual increase in the policy rate, and that the next hike will most likely be in June. Norges Bank further noted that capacity utilization is slightly above normal level and continues to increase. Underlying inflation is a little higher than the 2 percent inflation target. At the same time, the uncertainty surrounding global developments persists.

Household debt remains a concern and financial stability remains at the fore

After several years of rapid growth, house prices fell in the course of 2017. They started increasing again in the first half of 2018, with a moderate pace since last summer. Nationally, house prices are now slightly above their peak in 2017, while house prices in Oslo are still somewhat lower than their peak. Activity remains high in the market for existing homes, with high turnover and a large number of dwellings listed for sale.

Despite a recent slowdown in credit growth, the debt burden of households is still on the rise. On average, Norwegian households hold debt that is more than twice the size of their annual disposable income, ranking among the most indebted in the world. The steady build-up of household debt increases household vulnerability and poses risks to financial stability and economic growth.

The Government has a broad policy approach to address housing market issues. Last year it presented a revision of its housing market strategy, which emphasizes supply side efficiency, consumer protection, and household debt-sustainability.

The current mortgage regulation includes caps on the loan-to-value ratio and debt-to-income ratio. The regulation is temporary and expires at the end of this year. The Ministry of Finance has asked the Financial Supervisory Authority to evaluate the regulation and its effects, and to give advice on whether the Ministry should adopt a continued regulation. The authorities have noted that the IMF staff recommends not to loosen the requirements, barring large unexpected changes in the coming months.

The authorities agree with staff that the mortgage regulations have been effective, resulting in tighter lending practices and lower issuance of high-risk mortgages. Should risks intensify or change character, the authorities stand ready to amend the regulation and other macroprudential measures accordingly. Moreover, the Ministry recently enacted a regulation on consumer lending, largely mirroring the mortgage regulation, in order to curb financial stability risks from over-indebted households and to halt unhealthy credit practices. It is not on the political agenda to increase tax levels for property in general, and housing specifically.

The authorities put strong emphasis on containing risks and vulnerabilities in the financial sector. As noted by the staff, Norwegian banks have robust liquidity and capital buffers. This is confirmed by Q4 numbers, where the average common equity tier 1 (CET1) came in at 16.2 percent, up from 15.7 percent in Q3. The banks' shock absorption capacity is high, and has improved significantly over the last years. Last December, the Ministry of Finance decided to increase the countercyclical capital buffer rate to 2.5 percent, effective from year-end 2019. There has been a build-up of financial imbalances over the last years, mainly as a result of the high household debt and continued property price growth. More recently, the persistent and sharp rise in commercial property prices is seen to contribute to the build-up of financial imbalances. In May, the Ministry announced that it would not change the criteria for identifying systemically important banks, but instead conduct a public consultation on possible adjustments of the systemic risk buffer.

Ensuring a sustainable development in public finances will require several measures

As described by staff, Norway will soon face fiscal challenges. The authorities' two main strategies for ensuring sufficient room for spending on welfare going forward without increasing the level of taxation, is to expand labor force participation and to improve value for money in the public sector.

The Norwegian employment rate is rising. Still, a lower share of the working age population is working now than ten years ago. This poses concerns, as high employment is a prerequisite for a sustainable welfare state.

Earlier this year, a government-appointed expert commission presented proposals aiming at increasing labor force participation, with particular emphasis on the sickness and disability schemes. Representatives from the social partners have now joined the commission. The enhanced commission is scheduled to present its recommendations early next year. Norwegian authorities agree that there are large long-term gains from expanding labor market participation. Unlocking labor from the sickness and disability schemes is important in this regard, and in particular to reduce the risk that young people end up as long-term recipients of disability benefits. The authorities will wait for the recommendations from the enhanced commission before considering major steps for reform.

Norway has carried through a major pension reform to expand labor participation among elderly workers, and the authorities have recently put forward a proposal to the Parliament for a corresponding reform of the public sector pension scheme. They will also work to reform the early retirement schemes that applies for specific public sector professions, to make it more in line with the rest of the pension system.

An efficient public sector is crucial to handle future ageing costs. Several initiatives have been taken to improve efficiency and service delivery. Spending reviews have been introduced as a tool to achieve more efficient resource use and more effective policy instruments. Further efforts will aim to modernize public organizations and identify obsolete spending items.

Several measures will be needed to secure sustainability in public finances in a long-term perspective, and my authorities recognize that this will require increasingly difficult choices.

The Government is continuously working to make the tax system more efficient

The Norwegian authorities have just completed the implementation of a tax reform. Key objectives have been to increase growth and productivity through significant corporate tax rate reductions, and to tackle challenges related to base erosion and profit shifting. We welcome staff's assessment of the VAT system. The recommendations to simplify and reduce the number of VAT rates coincide with the recent recommendations from a Government appointed expert committee. The Committee's report will now be subject to a public consultation, and the Government will assess the proposals.

Countering the threats from money laundering and terrorist financing is fundamental

Recent money laundering cases among Norway's Nordic and Baltic neighbors illustrate the necessity for authorities to remain vigilant. Going forward, Norwegian authorities will continue to follow the development of the private sector's compliance closely, particularly in light of the FSA's new powers to sanction non-compliance.

As an FATF-member, Norway is engaged in international AML/CFT policy and standard development. The Nordic and Baltic supervisory authorities announced in May that they will step up their regional cooperation, inter alia by establishing a permanent working group and formalize their cooperation through a Memorandum of Understanding. Continued international coordination and standard setting is key in the globalized economy, as well as regional cooperation when cultural, economic and political ties indicate that there is benefit to be gained.