NORWAY—2010 STAFF VISIT
CONCLUDING STATEMENT OF THE IMF MISSION
November 16, 2010

Recent developments and outlook

1. **The Norwegian economy continues to recover**. Following a comparatively mild recession in 2008-09, the economy has grown steadily for the last year, and unemployment has stabilized at a low level. Economic recovery has been assisted by an appropriately supportive policy environment, including fiscal stimulus and low policy rates. While the pace of recovery has been moderate so far—mainland GDP grew at an annual rate of 1¼ percent in the first half of 2010—this partly reflects transitory shocks related to adverse weather and the global market downturn earlier in the year.

2. **Economic activity is expected to pick up in the period ahead**. Although the recovery has so far been led by public demand and inventory dynamics, private final demand should reemerge as the main driver of growth, given continued low interest rates and improving confidence. As a result, mainland growth is projected to increase from around 1¾ percent in 2010 to 2½-3 percent in 2011. At the same time, underlying inflation, currently low at around 1 percent, is forecast to return only gradually to the 2.5 percent target, reflecting moderate wage growth and contained import prices.

3. **Nonetheless, there are risks to this forecast**. On the upside, positive surprises to global growth could give a greater boost to Norwegian exports. Private consumption growth could also surprise on the upside if recent gains in asset prices and consumer confidence cause households to lower their saving rate more than currently projected. On the downside, renewed market turbulence in the euro area could weigh on consumer confidence, investment, and exports. Meanwhile, elevated house prices and high household indebtedness remain major domestic vulnerabilities.

Fiscal policy

4. **Fiscal policy should be geared toward meeting the 4 percent deficit target over the cycle**. Adherence to the fiscal guidelines will help ensure that significant oil revenue is saved to address Norway's long-run fiscal challenges (see below). Fiscal discipline is also crucial to secure balanced, broad-based growth and contain risks of excessive exchange rate appreciation. In this context, the slight tightening of the fiscal stance in the 2011 budget is appropriate. Assuming the recovery continues apace, the structural nonoil deficit should be reduced moderately below the 4 percent target over the medium term in order to offset the stimulative stance taken during the recession, thereby ensuring the target is met on average over the cycle.

5. **Continued structural reforms are also necessary to address long-run fiscal challenges**. Population ageing and falling oil revenue will give rise to large fiscal deficits in

the long run under unchanged tax and expenditure policies. This puts a premium on timely structural reforms to boost labor supply and curb the growth of entitlement spending, while maintaining a strong safety net for those in need. We therefore welcome recent reforms of National Insurance Scheme old-age pensions to encourage longer working lives, tie benefits to longevity trends, and adjust indexation rules. However, to ensure the effectiveness of these reforms, it will be critical to make corresponding adjustments to the rules governing other benefit schemes, notably disability pensions. Otherwise, increased use of these schemes might undermine the gains from the reform of old-age pensions. More generally, further efforts are necessary to reduce the persistently high enrollment rates for sick leave and disability benefits. Such efforts could include improved incentives for employers and employees, greater use of partial and temporary benefit awards, and increased reliance on social security physicians in assessing eligibility.

Monetary and financial sector policies

6. **With inflation projected to return only gradually to the target, the current accommodative monetary stance is appropriate**. Although a prolonged period of low interest rates could heighten financial vulnerabilities—notably by inducing further house price appreciation and household borrowing—this concern is best addressed by prudential measures, as these can be targeted to the sectors most at risk. Indeed, the combination of low policy rates and sufficiently tight and targeted prudential policies appears most likely at the current juncture to achieve sustainable growth along with price and financial stability. In particular, low interest rates provide income relief to indebted sectors—helping to repair their balance sheets—while strong prudential standards avert a re-accumulation of excessive debt.

7. **Against this backdrop, financial sector policies should support a gradual reduction in vulnerabilities**. Specifically:

- We welcome the guidelines issued by the Financial Supervisory Authority (FSA) earlier this year to tighten credit standards for mortgage lending, given risks in the housing sector. Looking ahead, it will be important to carefully evaluate the effectiveness of this measure and further adjust prudential standards as necessary.

- In the same vein, the FSA should maintain pressure on financial institutions to bolster capital—including by restraining dividend payouts—and improve liability structures, with reduced reliance on short-term wholesale funding. Further progress in strengthening balance sheets will prepare banks for tighter regulatory requirements in the future, while building extra buffers to deal with financial stability risks.

- These efforts should be supported by a gradual reduction of the very large tax subsidy for housing (offset by tax reductions elsewhere), as the subsidy promotes overinvestment and high mortgage debt while disproportionately benefiting higher-income households.

8. **Looking beyond near-term measures, there may be a case for adopting a more formal framework for countercyclical macroprudential policy**. The key objective is to mitigate the amplitude of the credit cycle by using targeted instruments, such as time-varying capital risk weights, loan-to-income caps, or collateral requirements. In designing a macroprudential framework, it would be important to set out clear institutional responsibilities based on relevant expertise and in a way that ensures accountability and appropriate operational independence. Furthermore, cooperation with and support from foreign regulators, notably in the Nordic region, would be critical to ensure the effectiveness of some measures.

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We are grateful to all our counterparts for their kind hospitality and helpful discussions.