CONCLUDING STATEMENT

Norway: Staff Concluding Statement of the 2024 Article IV Mission

FOR IMMEDIATE RELEASE

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC – June 28, 2024: *Real GDP growth slowed notably in 2023, as tight financial conditions dampened private consumption and investment. The labor market has remained resilient, despite a slight increase in unemployment. Growth is anticipated to strengthen gradually starting later this year as private demand recovers, supported by higher real incomes. While declining, inflation and inflation expectations are elevated. Systemic vulnerabilities remain significant, yet the financial system is stable, supported by robust banking system buffers. The fiscal position is strong, and the fiscal policy stance is expansionary. Against this backdrop, IMF staff's main policy recommendations are: i) monetary policy will have to remain contractionary in the near term to ensure that inflation returns durably to its target; ii) macroprudential policy should remain tight to mitigate systemic risks that could materialize from a sustained period of high interest rates or rising unemployment; iii) removing the fiscal stimulus in place would lower risks of fiscal-monetary policy miscalibration; and iv) a comprehensive structural reform agenda should be adopted to tackle the generous disability and sickness systems, raise productivity growth, and mitigate the impact of geoeconomic fragmentation. These reforms are key to boost labor participation, contain public expenditure pressures, and preserve Norway's high living standards for future generations.*

Context

Norway's economy is navigating a cyclical downturn amidst high uncertainty. Mainland real GDP growth slowed to 0.7 percent in 2023, as private consumption and construction investment declined due to tight financial conditions. Available data for the first half of 2024, including high frequency survey indicators, point to a stabilization in economic activity. The labor market has been resilient, notwithstanding a small increase in the unemployment rate. Headline inflation remains above the 2 percent target, sustained by persistent services inflation that keeps core inflation high. Inflation expectations, while declining, are elevated. IMF staff projects mainland real GDP growth to remain relatively soft at 0.8 percent this year as tight financing conditions continue to weigh on private demand. Over the medium-term,

growth is expected to strengthen gradually to about 1½ percent as financial conditions ease and real incomes recover further. Inflation is forecast to converge to the target by 2026. Risks to the growth and inflation outlook are balanced, amidst continued high uncertainty.

Policy recommendations

Monetary policy should remain contractionary, as reining in high inflation is the most pressing near-term policy challenge. To ensure a sustainable return of inflation to its target, a tight monetary policy stance should be kept in place for some time ahead. This would help mitigate risks of de-anchoring inflation expectations. Amidst high and persisting uncertainty, the setting of monetary policy should operate in a data-dependent approach, with Norges Bank remaining ready to adjust the monetary policy stance as needed.

The comprehensive tightening of prudential policy settings during 2022–23 has further strengthened the financial system. Collectively, the measures will enhance resilience by ensuring that banks maintain adequate buffers, adhere to prudent lending standards, and are prepared to withstand shocks. The expansion of loan-to-value limits to a broader range of loans will help contain risks from excessive borrowing. The recently-adopted law strengthening Finanstilsynet is a welcome development. Continued progress in addressing the remaining 2020 IMF FSAP recommendations, including making borrower-based measures a permanent feature of the macroprudential toolkit, will further help increase the financial sector's capacity to withstand shocks.

While systemic vulnerabilities have plateaued and financial stability risks appear manageable, macroprudential policy settings should remain tight. Household debt burdens have stabilized but a sustained period of high interest rates or rising unemployment could push some households into financial hardship. In turn, the real estate sector is facing complex challenges, notably the commercial real estate (CRE) segment, where debt-servicing costs have increased and valuations have declined. Firms outside the CRE sector are also facing a more difficult environment. As systemic risks remain elevated, any relaxation of macroprudential settings should be postponed until risks meaningfully subside.

The authorities should continue to closely monitor the financial system. In case risks to households materialize, targeted measures to support those at risk of financial distress should be considered (e.g., a selective relaxation of regulations that facilitate renegotiations between stressed households and banks). Given sustained pressures on the CRE sector, the immediate priorities should be to preserve bank buffers and to strengthen contingency planning, including at the Baltic-Nordic level, to mitigate any risks that could arise from cross-border exposures. Once the credit cycle turns, introducing borrower-based measures for CRE exposures (such as caps on loan-to-value ratios and floors on debt-service-coverage ratios) should be considered. Furthermore, the insurance sector's high CRE exposures call for introducing sector-specific capital surcharges, buttressing its risk and liquidity management strategies (including by broadening the investment portfolio to mitigate concentration risks), and conducting regular stress tests to assess the potential impact of adverse real estate market movements on solvency and profitability.

A neutral fiscal policy stance would be more supportive of the disinflationary effort and improve the cohesiveness of the macroeconomic policy mix. The structural non-oil fiscal deficit is projected to widen to about 10.4 percent of the mainland GDP trend this year, implying a fiscal impulse of about 0.7 percent of GDP. Leveraging the ongoing expenditure reviews to reprioritize spending and capitalizing on upside surprises in the growth outlook or

higher-than-expected revenues to build fiscal buffers would help reduce fiscal stimulus. The parameters of the 2025 budget should be set in a prudent manner, aiming for a neutral stance and ensuring that the role of fiscal policy in macroeconomic stabilization remains limited to the operation of the automatic stabilizers. Discretionary fiscal stimulus should be well-targeted and temporary and deployed only if large downside risks materialize.

A wide-ranging set of measures will be needed to accommodate additional defense and other multi-year public spending commitments. Fiscal planning needs to accommodate both immediate and long-term needs, such as the expected increase in ageing-related outlays and higher defense spending, while containing the public sector's reliance on oil and gas revenues. While the nominal value of the structural non-oil deficit has averaged just below the limit set by the fiscal rule during the 2017–24 period, expenditures and the structural non-oil deficit (as a share of mainland GDP) have increased significantly. To contain this drift, past IMF advice remains pertinent, specifically: i) reforming the tax system to increase its efficiency; ii) restructuring the pension and social protection regimes; and iii) complementing the fiscal policy framework with medium-term budgeting and an expenditure rule that caps the growth of aggregate spending.

Reforming the sickness and disability benefits systems will be important to boost labor supply and help contain public expenditure pressures. Norway currently has the largest proportion of the population on disability-related benefits among OECD countries, and reforming the costly and distortionary regimes is the most important reform pending. Participation in the programs is remarkably high, and the system lacks strong incentives for beneficiaries to re-enter the workforce. While the issue is a complex and long-standing one, the costs of inaction are rising. Among others, reform measures should include reintroducing caps on the total amount of benefits available to participants to incentivize returning to work, tightening requirements for entry and transitioning into the programs, reducing incentives for early retirement, and properly phasing other measures to curtail inflows and encourage outflows. Advancing these reforms will require deploying significant political capital to build the necessary social consensus.

A comprehensive and far-reaching set of reforms is essential to boost productivity growth and mitigate the repercussions of geoeconomic fragmentation. The reforms will be necessary to ensure continued strong economic performance and high living standards. Although Norway boasts one of the highest levels of labor productivity among its peers, productivity growth has slowed faster than in other Nordic countries. To reverse this trend, conditions should be improved to facilitate sectoral reallocation as well as innovation and technology adoption, mindful of minimizing the fiscal burden. Limiting the impact on the economy from geoeconomic fragmentation will require adopting a multifaceted approach that combines strategic policy initiatives to strengthen supply chain resilience, increase economic diversification, and foster economic alliances. Strong policy frameworks, a robust track record of policy implementation, solid fiscal and banking system buffers, and a comprehensive social safety net should allow Norway to successfully navigate the needed structural transformations.

The IMF team thanks the Norwegian authorities and other counterparts for their hospitality and the constructive and insightful discussions.