Statement by Mika Pösö, Executive Director for Norway and Bjornar Slettvag, Advisor to the Executive Director
September 14, 2022

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

Economic growth is strong and employment increasing

The Norwegian economy is in a marked cyclical upturn. Economic growth is strong, and registered unemployment has not been at lower levels for decades. Many businesses across the country report that growth prospects are good, and that labor shortages constrain production. At the same time, inflation rates are the highest since the 1980s, and core inflation has not been higher since recordings began in 2001. Wage growth is picking up. There are clear indications of overheating in the economy, and there is substantial risk of enduring high inflation.

Growth in the mainland economy (excluding petroleum production and shipping) has been strong since containment measures were removed in February. The Ministry of Finance forecasts growth in the mainland economy to outpace trend both this and next year, and unemployment is expected to remain low.

Norway is a reliable energy provider. With the current situation in Europe, gas production has been increased substantially since last year. The increase partly comes from a shift in production mix from oil to gas in fields where that is possible and partly from shortening the maintenance shutdowns. Gas production is at its maximum, and it will take years to develop new fields. Still, in the medium to long term, the challenge of managing a smooth transition to a less oil-dependent growth model remains.

Fiscal consolidation is needed

To counteract negative economic impacts from the pandemic, fiscal spending increased significantly in 2020 and 2021. The original budget for 2022 outlined a normalization of spending, towards pre-pandemic levels. Since then, extraordinary measures have been approved to address the increase in electricity prices, the omicron-wave and measures related to Russia's war in Ukraine. In the revised budget, the Government proposed significant cutbacks to reduce the non-oil deficit in 2022. The current economic situation, with a high positive output gap and high inflation, calls for fiscal restraint to avoid overheating an of the economy. Spending should normalize to pre-pandemic levels to be better prepared for future economic shocks, a possible decline in the oil fund (Government Pension Fund Global), and fiscal challenges from an aging population

The Norwegian fiscal framework is designed to ensure a sustainable management of resource revenues from the petroleum sector. At the same time, the fiscal framework provides flexibility to handle temporary setbacks in the economy and fluctuations in the oil price and the value of the oil fund. All petroleum revenues are transferred into the fund, and, over time, spending is guided by the expected real return of the fund, estimated at 3 percent.

Norwegian authorities would emphasize that there are no plans to alter the fiscal rule. The fiscal guideline has served Norway well for more than 20 years. To handle the risk of a fall in the fund value, the transfer from the fund to the budget has been budgeted significantly below the 3-percent guideline, to have sufficient room for maneuver if the downside risk for the fund materialises.

The staff report recommends expanding the fiscal framework with a medium-term expenditure framework. The authorities are not convinced of the value added in this proposal. There are already guidelines for both the tax level and the budget deficit, and an additional guideline on expenditures may result in an overdetermined system.

The Central Bank will carefully watch inflation pressures going forward

Norges Bank started to increase the monetary policy rate from 0 percent in the second half of 2021, as a normalising economy suggested a gradual normalisation of the policy rate.

In June 2022, Norges Bank's Monetary Policy and Financial Stability Committee decided to increase the policy rate by 0,5 percentage point to 1.25 percent, and the forecast implied a further rise to around 3 percent by summer 2023.

In August 2022, the Committee decided to raise the policy rate further to 1.75 percent, and its assessment was that a markedly higher policy rate is needed to ease the pressures in the Norwegian economy and to bring inflation down towards the target. The Committee was concerned with the large degree of uncertainty surrounding the outlook. There is a risk that little spare capacity in the Norwegian economy and persistent global price pressures will lead to a further acceleration in inflation. On the other hand, the rise in interest rates may cool down the housing market and curb household consumption faster than currently envisaged. There is also a risk of a sharper slowdown in global growth. As pointed out in the report, household debt in Norway is high, and with a large proportion of mortgages with floating interest rate, households are sensitive to interest rate increases.

Risks to financial stability appear to be manageable.

The Government has a broad policy approach to address housing market issues. The mortgage regulation includes caps on the loan-to-value ratio and debt-to-income ratio. The regulation expires at the end of 2024, with an evaluation this fall. The Ministry of Finance has asked the Financial Supervisory Authority to evaluate the regulation and its effects, and to give advice on the need for changes in the regulation, including whether the scope should be extended to include other types of loans. The authorities take note that staff recommends to permanently preserve tighter mortgage regulation limits for Oslo, ease restrictions on the supply of new housing, alter regulations to boost construction efficiency, and curb demand through a gradual phasing out of mortgage interest deductibility.

We agree with staff that banks' exposure to commercial real estate (CRE) remains an important vulnerability. The current prudential toolkit to mitigate financial stability risks remains quite comprehensive to address the vulnerabilities and has adapted well to the challenges brought by the pandemic. High bank capital ratios mitigate the risks to stability.

Ensuring a sustainable development in public finances will require several measures

As described by staff, Norway will soon face fiscal challenges due to an ageing population and lower revenues from oil and gas production. 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 has increased significantly after the pandemic and is now at its highest level in ten years. Still, many remain outside the labor force. This poses concerns, as high employment is a prerequisite for a sustainable welfare state.

Norway has carried through a major pension reform based on a broad political consensus to expand labor participation among elderly workers. The reform has recently been evaluated by a public commission which has concluded that it seems to work as planned, alleviating costs and improving incentives to work. The commission has proposed to link all formal pension age-limits to longevity, to improve the sustainability of the pension system, both economically and socially.

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.