INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/214

NORWAY

July 2016

2016 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 2016 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 29, 2016 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 29, 2016, following discussions that ended on May 19, 2016, 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 June 9, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Norway.

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

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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FOR IMMEDIATE RELEASE
July 5, 2016

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2016 Article IV Consultation with Norway

On June 29, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Norway.

The declines in oil prices and offshore investment have taken a toll on the Norwegian mainland economy: growth fell to 1 percent in 2015—the lowest level since the global financial crisis. The drag from private investment was offset by continued growth in household consumption, expansionary fiscal policy and a boost to traditional goods exports, aided by the weak krone. Unemployment has increased to 4.7 percent as of March 2016, with the rise mainly concentrated in oil-dependent regions. Core inflation reached 3.3 percent in April 2016 after peaking at 3.4 in February, above the 2.5 percent target, largely due to the effect of exchange rate depreciation on imported consumer goods prices. House price inflation accelerated recently after the slowdown throughout 2015, albeit with large regional variation, and household debt remains elevated at 220 percent of disposable income. Banks remain profitable and are well-positioned to meet regulatory capital requirements.

The 2015 structural non-oil deficit was 2.6 percent of the Government Pension Fund Global (GPFG) assets, equivalent to 6.25 percent of mainland trend GDP. This provided a fiscal impulse of .5 percent of mainland trend GDP. The structural non-oil deficit remains well below the 4 percent of GPFG assets that the fiscal rule targets, in part as the exchange rate depreciation

[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.

contributed to a substantial increase in GPFG assets measured in Norwegian krone. The revised 2016 budget envisions a rise in the structural non-oil deficit to 7½ percent of mainland trend GDP (2.8 percent of GPFG assets), which will provide a fiscal impulse of 1.1 percent of mainland trend GDP.

Economic activity is set to remain sluggish this year, with mainland GDP growth of 1.1 percent, supported by public sector demand and mainland exports, while private domestic demand is set to remain depressed. A recovery should take root in 2017 alongside a gradual upturn in oil prices and a slowing of the pace of decline in oil investment. As the oil-related parts of the mainland economy adjust to lower demand, unemployment is projected to rise further this year before declining in 2017. Headline inflation is projected to be 2.8 percent this year and is expected to return to the 2.5 percent target next year as low capacity utilization weighs on domestic inflation and the effect of the exchange rate depreciation abates.

Downside risks predominate. Lower than expected growth in key advanced and emerging economies would have negative implications for oil prices and traditional exports. Combined with a sharp property price correction, this would weigh on consumption and domestic firms, especially those in the retail and construction sectors. Similarly, a delay in the transition to a less oil dependent economy could lead to higher unemployment for longer, thereby weakening confidence and consumption. In a downturn, a rise in defaults on corporate loans would in turn put pressure on banks' balance sheets. In addition, tighter or more volatile global financial conditions could raise financing costs of Norwegian banks that are reliant on wholesale funding.

Executive Board Assessment[2]

Executive Directors noted that the Norwegian economy has suffered from the decline in oil prices, while the influx of refugees presents new challenges. A modest recovery is expected to take root next year, subject to downside risks, including weaker global growth and persistently lower oil prices. The broadly positive medium-term outlook hinges on a successful transition

[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 summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

away from oil dependence. Directors concurred that supportive macroeconomic policies and steadfast structural reforms to boost productivity and cost competitiveness would be necessary to facilitate this transition and place growth on a stronger footing.

Directors considered that the expansionary stance of fiscal policy this year is broadly appropriate, given the output gap, rising unemployment, and the ample fiscal space. They stressed the need for well-targeted temporary measures that also promote rebalancing the economy toward non-oil tradable sectors. Directors recommended a gradual shift to a more neutral fiscal stance as the economy returns to potential. They supported recent reforms to shift from personal and corporate income taxation to promote productive investment. Directors welcomed the ongoing review of the fiscal rule, aimed at ensuring continued prudent management of the country's oil wealth, taking into account the interests of future generations.

Directors agreed that, given the slack in the economy and well-anchored inflation expectations, monetary policy should remain accommodative until there are firm signs of durable recovery. In this regard, they welcomed the authorities' readiness to reduce the policy rate further if warranted. Directors acknowledged the challenge of balancing the need to support economic growth against the risk of inflation from a further exchange rate depreciation and financial stability concerns from rising house prices. They recommended that the authorities continue monitoring the development of household debt and house prices, and promptly tighten macroprudential measures to address emerging financial stability risks.

Directors observed that banking sector performance remains relatively strong, and welcomed the significant progress in implementing the recommendations of the Financial Sector Assessment Program. They encouraged further efforts to mitigate systemic risks that might arise from high household indebtedness and banks' reliance on external wholesale funding, including by further strengthening the framework for crisis management and resolution, as well as regional cooperation.

Directors emphasized the need for continuing structural reforms to support a successful transition and improve the efficiency of the economy. They saw merit in continued restraint in wage settlements and further reforms to reinvigorate productivity growth. Aligning public sector pensions with recent private sector reforms and reforms to sickness and disability pensions could increase labor force participation. Directors also saw scope for efficiency gains from reducing tax preferences for owner-occupied housing and relaxing supply restrictions in the housing market.

Directors commended the Norwegian government for its noteworthy efforts to absorb the increased number of refugees. They noted that further efforts to accelerate the integration of the newly arrived refugees into productive employment would help reduce fiscal costs and raise output.

Norway: Selected Economic and Social Indicators, 2010–17

Population (2015): 5.2 million
Per capita GDP (2015): US$ 74,500 — Quota (3754.7 mil. SDR/0.78 percent of total)
Main products and exports: Oil, natural gas, fish (primarily salmon) — Literacy: 100 percent

	2010	2011	2012	2013	2014	2015	Projections 2016	Projections 2017
Real economy (change in percent)								
Real GDP 1/	0.6	1.0	2.7	1.0	2.2	1.6	0.9	1.4
Real mainland GDP	1.8	1.9	3.8	2.3	2.3	1.0	1.1	1.7
Domestic demand	3.0	2.7	3.5	3.5	2.0	0.6	0.9	1.6
Unemployment rate (percent of labor force)	3.6	3.3	3.2	3.5	3.5	4.4	4.7	4.5
Output gap (mainland economy, - implies output below potential)	-1.3	-0.9	0.2	0.0	-0.1	-0.7	-1.4	-1.0
CPI (average)	2.4	1.3	0.7	2.1	2.0	2.2	2.8	2.5
Gross national saving (percent of GDP)	36.3	38.2	39.0	38.2	40.2	37.6	34.4	34.9
Gross domestic investment (percent of GDP)	25.4	25.8	26.5	27.9	28.3	28.6	28.8	28.4
Public finance								
Central government (fiscal accounts basis)								
Overall balance (percent of mainland GDP) 2/	8.3	12.6	12.8	9.5	6.0	1.3	-3.2	-2.7
Structural non-oil balance (percent of mainland trend GDP) 3/	-5.1	-4.5	-4.8	-5.1	-5.8	-6.3	-7.5	...
Fiscal impulse	0.0	-0.6	0.3	0.2	0.8	0.5	1.1	...
in percent of Pension Fund Global capital 4/	-4.1	-3.2	-3.4	-3.2	-2.9	-2.6	-2.8	...
General government (national accounts basis, percent of mainland GDP)								
Overall balance	13.6	17.1	17.5	13.3	10.5	6.5	3.6	4.0
Net financial assets	209.3	210.1	221.4	260.6	304.8	334.6	325.9	329.1
of which: capital of Government Pension Fund Global (GPF-G)	148.2	153.3	166.1	208.2	254.6	286.0	...	...
Money and credit (end of period, 12-month percent change)								
Broad money, M2	6.4	5.7	4.9	7.3	6.4	0.9	...	...
Domestic credit, C2	6.1	6.9	5.9	6.8	6.0	6.1	...	...
Interest rates (year average, in percent)								
Three-month interbank rate	2.5	2.9	2.2	1.8	1.7	1.3	1.0	1.3
Ten-year government bond yield	3.5	3.1	2.1	2.6	2.5	1.6	1.3	1.6
Balance of payments (percent of mainland GDP)								
Current account balance	13.6	16.0	16.1	13.0	14.9	10.8	6.6	7.7
Exports of goods and services (volume change in percent)	0.7	-0.8	1.4	-1.7	2.2	3.6	1.4	1.7
Imports of goods and services (volume change in percent)	8.3	4.0	3.1	4.9	1.5	0.7	2.2	2.6
Terms of trade (change in percent)	6.7	9.1	2.8	0.0	-5.3	-7.2	-6.8	6.5
International reserves (end of period, in billions of US dollars)	55.6	52.8	51.7	57.9	66.9	58.5	57.0	53.6
Fund position								
Holdings of currency (percent of quota)	76.6	71.4	71.1	78.2	85.6	89.8	...	...
Holdings of SDR (percent of allocation)	102.0	97.5	96.1	95.1	94.8	96.4	...	...
Quota (SDR millions)	1,672	1,884	1,884	1,884	1,884	1,884	...	...
Exchange rates (end of period)								
Exchange rate regime				Floating				
Bilateral rate (NOK/USD), end-of-period	6.0	5.6	5.8	5.9	6.3	8.1	...	...
Real effective rate (2010=100)	100.0	100.6	100.2	98.9	94.1	86.3	...	...

Sources: Ministry of Finance, Norges Bank, Statistics Norway, International Financial Statistics, United Nations Development Programme, and Fund staff calculations.
1/ Based on market prices which include "taxes on products, including VAT, less subsidies on products".
2/ Projections based on authorities's 2015 revised budget and 2016 budget proposal submitted to the parliament.

3/ Authorities' key fiscal policy variable; excludes oil-related revenue and expenditure, GPF-G income, as well as cyclical effects.
4/ Over-the-cycle deficit target: 4 percent.

NORWAY

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

June 9, 2016

KEY ISSUES

Context: It is a challenging time. The fall in oil prices has taken a toll on the mainland (i.e. non-oil and gas) economy, with growth falling to 1 percent in 2015 and rising unemployment. At the same time, the recent rise in the number of asylum seekers presents new challenges.

Fiscal policy: The fiscal stimulus planned for 2016 is justifiable, given the significant output gap, rising unemployment, and the ample fiscal space. Nevertheless, the composition of fiscal policy needs to avoid inhibiting the shift of resources to non-oil tradable industries. As the economy gathers steam, the authorities should move towards a neutral fiscal stance.

Monetary policy: Monetary policy should stay accommodative given weak growth and the stable inflation outlook. While inflation expectations are currently well-anchored, there is a risk that exchange rate-driven imported inflation could spill over to domestic inflation. Financial stability concerns should for now be addressed primarily through macroprudential and other measures.

Financial sector policy: While substantial progress has been made to address risks in the financial sector, staff encouraged the authorities to implement additional measures recommended by last year's FSAP Update to further mitigate systemic risks.

Structural policy: Wage restraint and labor market policies play key roles in improving cost competitiveness, as well as in integrating the extra inflows of asylum seekers into productive employment.

Approved By
Philip Gerson and Steve Barnett

Discussions took place in Oslo during May 9–19, 2016. The staff team was comprised of Messrs. Dorsey (head) and Arnold, and Mmes. Geng and Ho, supported by Messrs. Dowling and Scutaru, and Mmes. Ashour and Myaing at headquarters (all EUR). Ms. Sand (OED) joined the discussions. The mission met with Minister of Finance Jensen and ministry staff, Governor Olsen and the staff of the Norges Bank, and the staffs of other key ministries, the Financial Supervisory Authority, Statistics Norway, representatives of the Productivity and Fiscal Rule Commissions, labor and employer organizations, and private sector representatives.

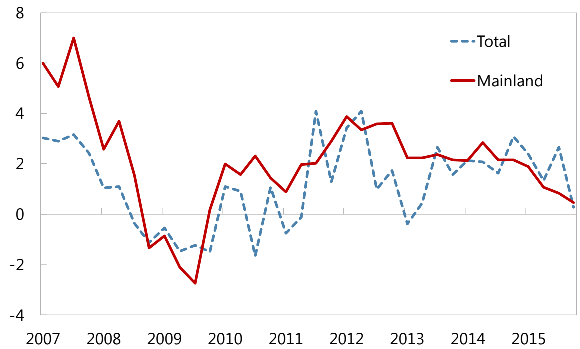
CONTENTS

ANNEXES

CONTEXT: AN OIL ECONOMY IN TRANSITION

1. **Growth has continued to slow in the mainland economy.** At the start of this year, oil prices had dropped by roughly 60 percent from their peak in June 2014 to less than US$40 per barrel. The adverse terms of trade movement has taken a toll on output in the mainland economy.[1] Mainland GDP growth fell to 1 percent last year—the lowest rate since the 2008–09 crisis. The mainland economy expanded by 0.3 percent (q/q) in the first quarter of this year, supported mainly by unusually high electricity production but also public and household consumption, while investment continued its declining trend. Within the mainland economy, there is growing divergence in performance between the more oil-dependent sectors (e.g., oil services) and the rest of the economy, with the former largely driving the slowdown in economic activity (Figure 1).

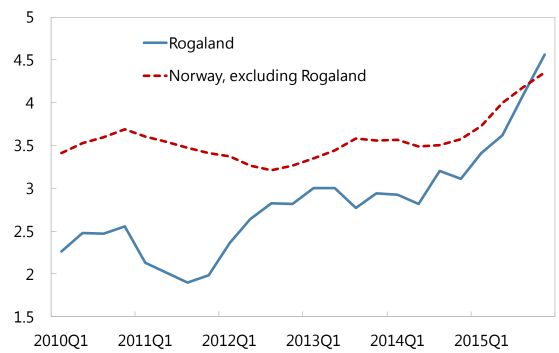
GDP Growth Slowed in Mainland Economy
(Y/Y percent change, SA)



Sources: Statistics Norway and Fund staff calculations.

2. **The labor market is feeling the sting of the oil price crash.** The seasonally-adjusted Labor Force Survey (LFS) unemployment rate reached 4.7 percent in March—the highest level in ten years. Rising unemployment is mainly driven by strong labor force growth, but employment started to falter in the fourth quarter (Figure 2). Unemployment is increasingly concentrated in oil-dependent parts of the country (e.g., Rogaland), while remaining stable or even falling in other parts.

LFS Unemployment Rising Fast in Oil Region
(Percent, 4-quarter moving average)



Sources: Statistics Norway and Fund staff calculations.

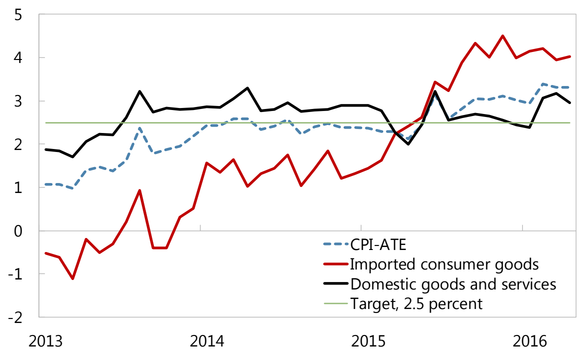
3. **Headline and core inflation have recently risen above the 2.5 percent target.** Core inflation was 2.7 percent on average last year but it reached 3.3 percent in April after peaking at 3.4 percent in February, largely due to the effect of exchange rate depreciation on imported goods prices.[2] Meanwhile, wage growth—2.8 percent last year—has been subdued and inflation expectations are stable (Figure 3).

[1] For previous analyses of the impact of oil sector developments on the Norwegian mainland economy, see e.g. 2013 and 2015 Selected Issues Papers (Chapter 3 of IMF Country Report No. 13/273 and Chapter 1 of IMF Country Report 15/250, respectively), and Technical Note on Bank Stress Testing for the 2015 FSAP Update (IMF Country Report No. 15/258).

[2] Core inflation in Norway is measured by change in CPI-ATE, i.e. adjusted for tax changes and excluding energy products.

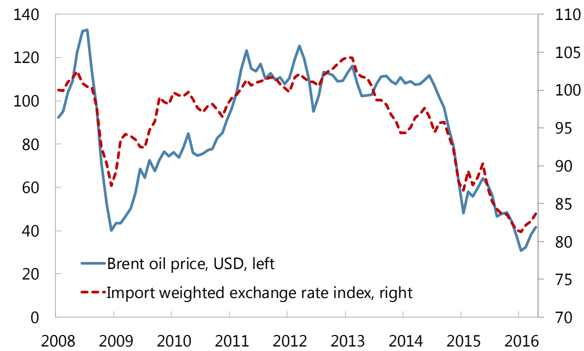
4. The krone has weakened substantially in parallel with the decline in oil prices. The import-weighted nominal exchange rate has depreciated by about 25 percent since early 2013, and the krone is assessed to be moderately undervalued relative to economic fundamentals and desirable policies (Annex I). The competitive exchange rate has helped reverse some of the long-term deterioration in Norway's unit labor cost (ULC) measured in common currency, boosting exports of traditional goods. Yet, the current account surplus narrowed in 2015, almost entirely due to the fall in the value of oil and gas exports (Figure 4).

Imported Goods Prices Accelerated...
(Y/Y percent change)



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

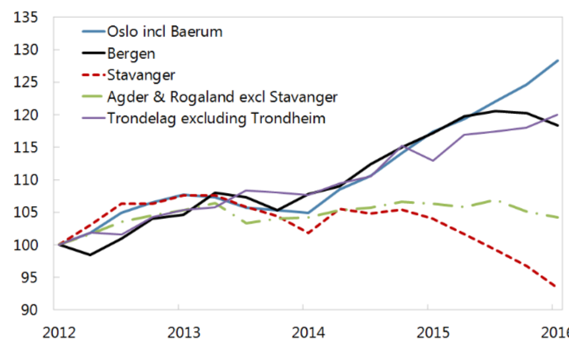
... Reflecting Exchange Rate Depreciation
(USD, left; Index Jan 08 = 100, right)



Sources: Haver Analytics and Fund staff calculations.

5. House price inflation accelerated recently after the slowdown throughout 2015, but with significant regional variation. House prices increased by 6.1 percent last year, but the pace tapered throughout the year in line with slowing income growth. The national figure masks wide regional variation, with prices rising robustly in the Oslo area while declining in areas most affected by falling oil prices (e.g., Stavanger). Household debt as a share of disposable income is largely unchanged at about 220 percent in mid-2015 (Figure 5).

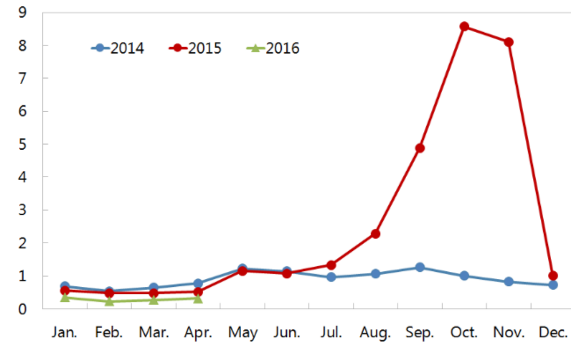
House Prices Exhibit Large Regional Variation
(Index: 2012Q1=100, SA)



Sources: Statistics Norway and Fund staff calculations.

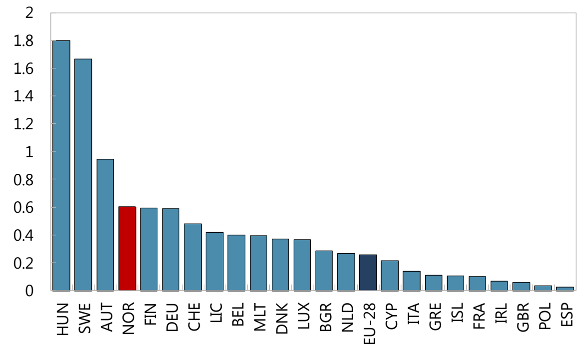
6. There was a surge in asylum seekers late last year (Annex III). Norway received over 27,000 first-time asylum applicants between June and December last year—almost four times as many for the same period in 2014. This brought the total number of applicants for the entire year to over 31,000 (0.6 percent of the population), a third of whom came from Syria. The government expects a slightly lower inflow in 2016 of about 25,000, although with a very large degree of uncertainty, and proposed a broadly budget-neutral increase in spending of about 0.4 percent of mainland GDP to handle the extra inflows of asylum seekers.

Asylum Applicants to Norway Surged in Late 2015
(Thousands)



Sources: Eurostat and Fund staff calculations.

Strong Influx Compared to Other European Destinations
(Inflows of asylum seekers in 2015, as percent of population)



Sources: Eurostat and Fund staff calculations.

OUTLOOK: GRADUAL RECOVERY CLOUDED BY RISKS

7. **A modest recovery should take root next year.** Mainland economy growth should be about 1 percent this year and pick up to close to 1¾ percent in 2017. Private consumption and investment are expected to remain slow this year, but offset by higher public sector demand and mainland exports. Expansionary fiscal and monetary policy, the lagged impact of the weak krone, a gradual upturn in oil prices, and a slowing of the pace of decline in oil investment are expected to support the recovery. Unemployment is projected to rise further this year to 4.7 percent before declining to 4.5 percent in 2017. Headline inflation is expected to stay above the 2.5 percent target at 2¾ percent this year, but should return to target next year as low capacity utilization weighs on domestic inflation and the effect of exchange rate depreciation wears off.

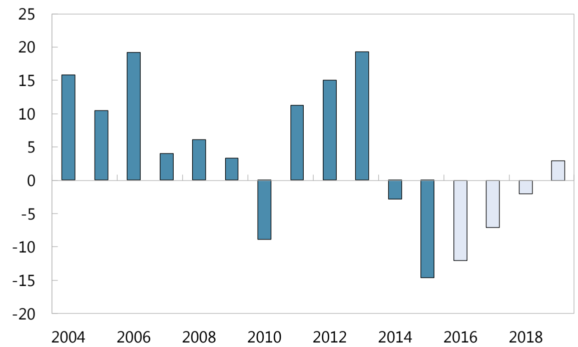
Norway: Selected Economic Indicators
(Y/Y percent change, unless noted)

		Projections	
	2015	**2016**	**2017**
Real GDP	1.6	0.9	1.4
Real mainland GDP	1.0	1.1	1.7
Domestic demand	0.6	0.9	1.6
Mainland exports	4.8	2.8	3.2
Unemployment rate (percent of labor force, LFS)	4.4	4.7	4.5
Output gap (percent of potential GDP)	-0.7	-1.4	-1.0
CPI inflation (average, percent)	2.2	2.8	2.5

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

8. Medium-term growth hinges on a successful transition away from oil dependence. Even before the plunge in oil prices, investment on the Norwegian continental shelf had been expected to trend downward. At the same time, the mainland economy has grown increasingly dependent on offshore demand, with about one in ten jobs being oil-related.[3] As the offshore sector no longer provides the impetus to mainland growth, the mainland economy faces the challenge of shifting its driver of growth from oil-related industries to non-oil tradable industries. Recent oil price developments make such a transition more urgent. A gradual recovery and continued growth into the medium term is conditional on the assumption of a smooth transition.

Oil Investment, Historical and Projection
(Y/Y growth rate, percent)



Sources: Norges Bank and Fund staff calculations.

9. Risks are skewed to the downside (Risk Assessment Matrix, Box 1).

- **A sharper-than-expected global growth slowdown or persistently lower oil prices could derail the projected recovery.** Slower growth in key advanced and emerging economies could hinder the recovery of non-oil-related exports, or put further downward pressures on oil prices. Persistently lower-than-projected oil prices could intensify the fall in oil investment and take further toll on oil-related demand for mainland goods and services, with adverse spillover effects on confidence and consumption in the rest of the economy.

- **A substantial correction in property prices could depress private demand and reduce output.** A large fall in house prices—caused by further negative shocks to the oil and gas sector, interest rate hikes, or a significant change in sentiment—could result in an abrupt reduction in consumption and residential investment with ripple effects on corporate earnings and banks. The staff's analysis suggests that a 10 percent decline in real house prices could reduce private consumption by 0.9 percent.[4] However, the probability of a sharp increase in the mortgage default rate is low and risks to financial stability are contained, as concluded by the 2015 FSAP Update.[5]

- **Tighter or more volatile global financial conditions could lead to liquidity strains and raise costs for Norwegian banks that rely on wholesale funding.** A bumpy QE exit in the United States, a British exit from the EU with potential widespread contagion, or Euro Area turbulence could raise volatility and wholesale funding costs.

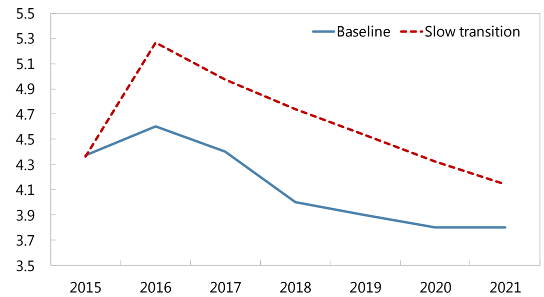
[3] See Annex 7 and also the first chapter of the Selected Issues.

[4] See IMF Country Report No. 15/429.

[5] The full-recourse nature of Norwegian mortgages and the ample social safety net has accounted for limited credit risks on household loans, as households have incentives to or are enabled to make payments.

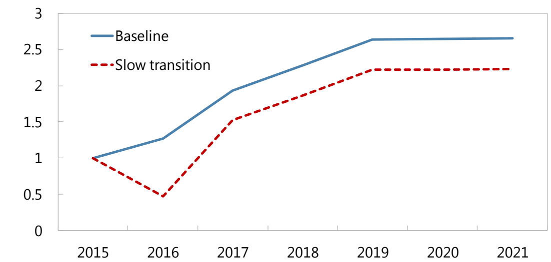
- **A hesitant or even stalled transition to a growth model less dependent on the oil and gas sector could lead to higher unemployment for a longer period, with adverse consequences for income and consumption.** If wages fail to adjust quickly or resources fail to move from oil-related sectors to non-oil tradable sectors efficiently, the expected pick-up in non-oil parts of the economy may not be enough to absorb the slack caused by lower oil prices.

Impact on Unemployment in Slow Transition Scenario
(Percent)



Sources: Fund staff estimates. Notes: The `slow transition' scenario assumes that out of 40,000 likely lost oil jobs, only a third would be replaced in 2016, and it would take the next five years to replace all lost jobs. Also see Chapter 1 of Selected Issues.

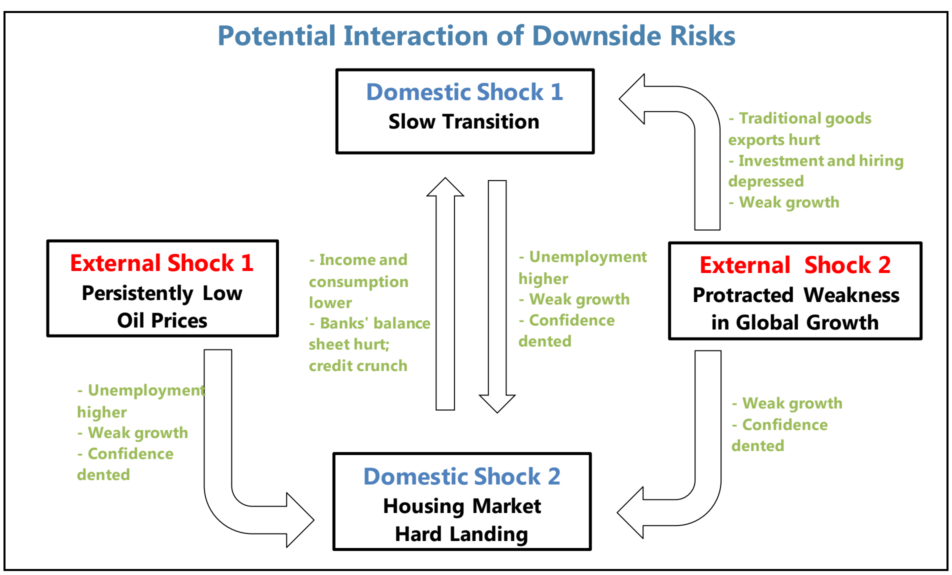
Impact on Mainland Growth in Slow Transition Scenario
(Percent)



Sources: Fund staff estimates. Notes: In estimating the growth impact, it is assumed that higher unemployment would subtract 1ppt from household consumption and private investment growth in 2016 and 0.5ppt for each year during 2017-21, using empirical relationship between employment and consumption/investment. Mainland exports would also be affected given lower investment. Also see Chapter 1 of Selected Issues.

- **The increased number of refugees, if not effectively integrated into the labor market, could weigh on the public finances and raise structural unemployment.**

10. Downside risks could interact. For example, persistently low oil prices could trigger a sharp correction in house prices through its deleterious impact on growth, employment, and consumer confidence. A housing market hard landing would in turn prolong the transition through negative wealth effects reducing household consumption and business demand, as well as through its potential implications for banking sector performance and credit supply. Protracted weakness in global growth could also slow the transition by dampening external demand for Norway's traditional goods exports, thereby depressing business investment and job creation.



Authorities' Views

11. **The authorities generally agreed with staff's assessment of the outlook and risks.** They noted the large regional variation in labor and housing market developments, reflecting, in part, different levels of dependence on oil and gas within Norway. They noted that lower consumer confidence may translate into lower consumption growth than expected, and high household debt can be a challenge if unemployment increases. However, they also pointed to shock absorbers, including supportive macroeconomic policies, the sound fiscal framework, the weaker exchange rate, flexible labor force, and the solid financial positions of Norwegian banks and households. On the risk of a British exit, the main direct links to the U.K. are in trade; banking system linkages are mostly to the euro area (long-term) and the U.S. (short-term). The authorities saw small direct impact on the Norwegian economy in a British exit scenario if a bilateral trade agreement can be put into place quickly and financial market disruptions do not severely affect euro area and U.S. financial markets.

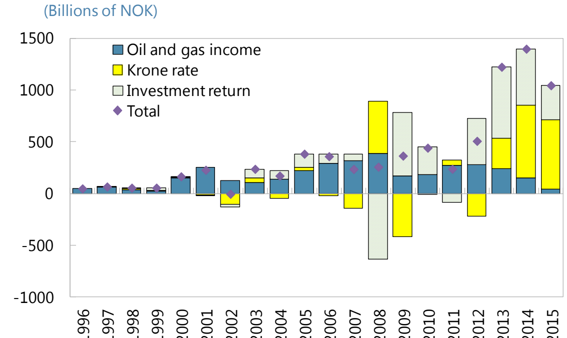
POLICY DISCUSSIONS

12. **Economic policies should aim to mitigate the downturn while facilitating the transition and strengthening the economy's productive capacity and resilience to shocks.** Macroeconomic policies should work together to support growth and employment, while preparing the economy for a "new normal" by smoothing the transition to a less oil-dependent growth model. Labor market policies will play a key role in fostering external competitiveness and integrating refugees into productive employment. Also, further measures are needed to mitigate risks in the financial sector.

A. Fiscal Policy: Promoting Employment and Structural Adjustment

13. **Fiscal policy was supportive last year with a fiscal impulse of ½ percent of mainland trend GDP.** The structural non-oil budget deficit amounted to about 6¼ percent of mainland trend GDP. This is equivalent to 2.6 percent of Government Pension Fund Global (GPFG) assets at year-end—well below the 4 percent "target" of the fiscal rule. GPFG assets have been growing rapidly in recent years, in large part due to the depreciation of the currency, which raises the krone value of foreign currency denominated assets.

Annual Change in GPFG Market Value, by Source
(Billions of NOK)

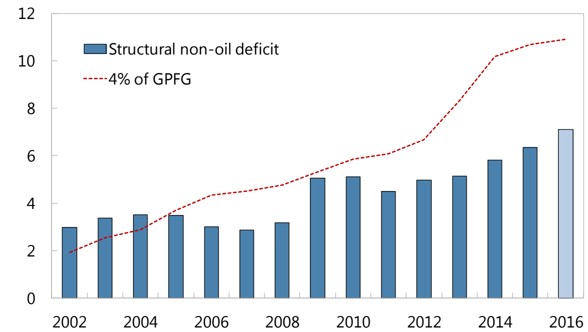


Sources: Norges Bank Investment Management Annual Reports and Fund staff calculations.

14. **The authorities are expecting a 1.1 percent fiscal impulse this year.** The revised 2016 budget forecasts a structural non-oil deficit of about 7½ percent of mainland trend GDP, or 2.8 percent of staff's projected GPFG assets at year end. An additional 0.4 percent of mainland GDP

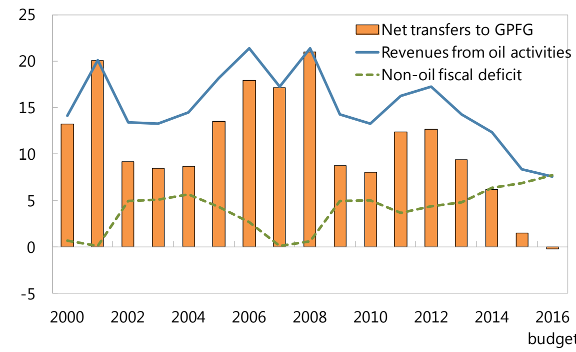
is included in a broadly budget-neutral manner to cover expenses related to the increased inflows of asylum seekers (see Annex III).

Structural Non-oil Deficit and 4% of GPFG Assets
(Percent of staff trend mainland GDP)



Sources: Ministry of Finance, IMF World Economic Outlook, and Fund staff calculations.

Net Transfers to GPFG
(Percent of mainland GDP)



Sources: Ministry of Finance and Fund staff calculations.

15. **The 2016 budget includes a package of special employment-enhancing measures and tax reductions.** Special measures amounting to NOK 4 billion (nearly 0.2 percent of mainland GDP) aim to create jobs in areas and sectors particularly affected by the downturn. The revised budget introduced new, targeted measures worth NOK 900 million (0.04 percent of mainland GDP) to support employment in southern and western Norway. As part of the government's tax reform proposal covering the 2016–18 period, net tax reductions worth NOK 8.3 billion (0.3 percent of mainland GDP) would be implemented this year, including a reduction of the statutory corporate income tax (CIT) rate from 27 to 25 percent and a reduction of the top marginal tax rate on personal income by 0.3 percentage points. The CIT rate would be reduced further to 23 percent by 2018.

16. **The expansionary fiscal stance this year is justifiable.** Staff views the level of fiscal stimulus planned this year as appropriate given the widening output gap (estimated by staff at -1.4 percent), rising unemployment, the ample fiscal space, and low risk to debt sustainability (see Annex II). The fiscal support would also complement monetary policy efforts at a time when there is arguably less monetary policy space, given that the key policy rate is approaching zero (see Section B).

17. **The composition of fiscal policy should strike a balance between counteracting the downturn and facilitating the necessary economic adjustment.** The proposed tax reductions, would promote private saving and investment and an efficient allocation of resources, while bringing Norway's tax system closer to international best practice. Public expenditure aimed at boosting the economy's productive capacity and external competitiveness would be conducive to the ongoing transition. On the other hand, public spending should avoid interrupting the shift of resources and employment to non-oil tradable production by increasing public employment or increasing expenditures on domestic goods and services.

18. **As economic growth gathers steam, the fiscal stance should gradually shift to neutral to relieve so-called "Dutch Disease" pressures.** Fiscal policy in Norway has generally been

prudent, with spending of oil revenues well below 4 percent of GPFG assets in recent years. Nevertheless, as the size of the fund has been growing much faster than mainland GDP, the fiscal rule's 4 percent target is no longer appropriate as a short-term operational guidance for fiscal policy, and a target more like the current transfer to the budget as a share of GPFG assets (2.5–3.0 percent) would be more appropriate. Such a target would also be closer to the likely returns for the next decade and would help conserve the GPFG's resources to address long-run aging-related costs. More importantly, there should also be a supplementary rule, such that the fiscal impulse would be neutral or negative when the economy is at or above capacity, respectively. This latter rule would help prevent crowding out of production of tradable goods and services.

Authorities' Views

19. The authorities agreed that fiscal policy should support employment and growth without inhibiting the necessary adjustment to a non-oil growth model. They noted that given the significant size of the shock that has hit the economy and the available fiscal space, the planned fiscal expansion this year can be justified, and the revised budget contains targeted measures to stimulate activity in the hardest hit regions. However, they agreed that it would not be a desirable outcome if the public sector rather than the competitive industries were to absorb a large part of the labor released from the oil-related sectors, or if fiscal expansion becomes a new norm.

B. Monetary Policy: Supporting Demand and Maintaining Price Stability

20. The Norges Bank reduced its key policy rate to ½ percent in March 2016 in view of weakened growth prospects and the subdued inflation outlook.

21. The outlook for inflation is stable (Figure 3). Wage growth in 2016 is expected to be about 2½ percent—down from 2.8 percent in 2015. With inflation expectations well anchored, this implies that the social partners assume approximately unchanged real wages in 2016. Inflation should stay slightly above target this year but return to target next year as low capacity utilization weighs on domestic inflation and the effects of the exchange rate depreciation unwind.[6]

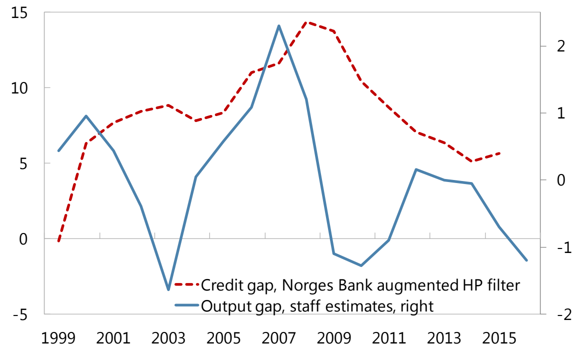
22. Monetary policy can stay accommodative for now, although wage developments and the potential spillover risk from imported inflation to domestic inflation merit continued monitoring. Further easing could be considered in the event that growth turns out to be significantly weaker than currently projected, provided that inflation expectations remain well anchored, and negative rates should not be ruled out in a more adverse scenario.

23. Financial stability concerns should be addressed primarily through macroprudential policy and structural measures. The output gap and the financial cycle have diverged as low interest rates helped push up asset prices. However, in view of the financial system vulnerabilities, greater caution may be warranted as the policy rate is lowered given risk of acceleration in property

[6] Exchange rate pass-through to inflation is discussed in the fourth chapter of the 2015 Selected Issues Paper (IMF Country Report No. 15/250).

prices and household debt growth. A gradual return from current negative real rates to the Norges Bank's estimated normal real interest rate of about 1½ percent—corresponding to a normal nominal interest rate of about 4 percent given the inflation target—will be needed over time.

Output and Credit Gaps
(Percent of potential output; percent of mainland GDP)



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

Authorities' Views:

24. The authorities shared the same perspective on the monetary policy stance. They emphasized that monetary policy can facilitate the transition by easing credit and avoiding appreciation and thereby expedite restoration of competitiveness, provided that confidence in stable inflation remained firm. They also noted that there is still room for maneuver and the possibility of negative key policy rate cannot be ruled out should the economy be exposed to new major shocks. Further easing will however be considered with greater caution as uncertainty with the effects of monetary policy increases. They agreed that the risk that lower interest rates could increase financial system vulnerabilities needs to be monitored closely and macroprudential policy is the first line of defense in maintaining financial stability.

C. Financial Sector Policy: Strengthening Resilience and Reducing Vulnerabilities

25. Banking sector performance remains relatively strong, and overall financial stability risks appear contained. Banks are profitable compared with peers, and the NPL ratio trended down to 1.1 percent of total loans (Figure 7). Banks' profitability positions them to meet the core equity (CET1) capital requirement. FSAP bank stress tests in 2015 suggest that banks' buffers render them well-positioned to withstand severe shocks—such as a combined shock of persistently low oil prices and a contraction in house prices.

26. However, there are vulnerabilities in the financial system. Elevated household debt, overvalued house prices, and banks' heavy reliance on external wholesale funding are the main sources of financial stability risks. In addition, persistently low oil prices could trigger a deterioration of household and corporate balance sheets, which will build up banks' credit risks.

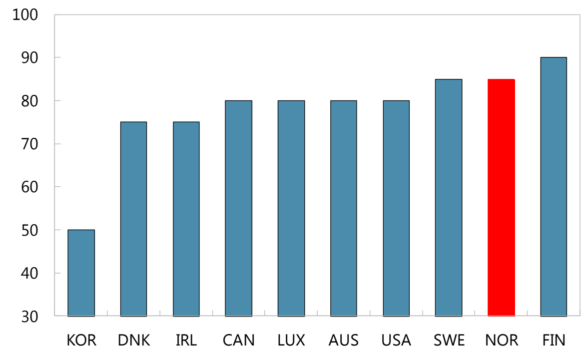
- **Household debt, house prices, and banks' real estate sector exposures are all high** (Figures 5 and 6). A large increase in interest burdens or severe deterioration in macroeconomic conditions could translate into losses on banks' loan portfolios.[7]

[7] In Norway, banks' losses are more likely to accumulate to the corporate (rather than household) portfolios, given that: (i) households have sound repayment buffers in view of their high financial asset holdings; and (ii) the full

(continued)

- **The use of external wholesale funding makes banks vulnerable to turbulence in foreign financial markets.** This exposure could be compounded by a potential inability to roll over the currency swaps used to hedge foreign currency funding risks.

Limits on LTV Ratios
(Percent)



Sources: Fund staff calculations.

- **Banks' direct exposure to the oil sector is small at 1 percent of banks' corporate lending portfolios, but their indirect exposure could be much higher.** When measured by the percentage of banks' equity returns attributable to oil-related firms, banks' total exposure to the oil sector could be as high as 30 percent.[8]

27. Progress has been made on several FSAP recommendations to address key risks (Annex IV). The countercyclical capital buffer will be increased to 1½ percent from July 1, 2016. Late last year, the authorities adopted new liquidity rules which set the minimum total "all currency" liquidity coverage ratio (LCR) requirement at 100 percent, effective from 2016 for the three systemically important banks and gradually phased in for other credit institutions.

28. The authorities have also implemented several housing sector-specific measures. These include introducing lending guidelines on new mortgages in 2010, which were converted into regulations in mid-2015 that are set to expire at end-2016. These measures should be made permanent and tightened if house prices and mortgage credit continue to grow faster than income. The FSA also tightened parameters for IRB model estimation of residential mortgage risk in 2014–15. Staff analysis suggests that these measures have had an impact on mortgage growth, but may not be enough to contain housing market vulnerabilities.[9]

29. Action on other key FSAP recommendations would help mitigate systemic risks.

- *Additional targeted measures could help contain systemic risks arising from the growth of house prices and household indebtedness.* The current loan-to-value (LTV) ratio cap of 85 percent is relatively high, and additional tools to be considered include: (i) higher mortgage risk weights; (ii) tighter LTV limits; and (iii) supplementing the affordability test by adding loan-to-income (LTI) or debt-service-to-income (DSTI) ratio limits. Given the divergent housing market developments across regions, some measures could be tailored towards individual regional markets.

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recourse nature of mortgages has typically meant that households prioritize mortgage payments over other payments.

[8] See Technical Note on Bank Stress Testing for Norway 2015 FSAP Update.

[9] See Annex 9 and also the third chapter of the Selected Issues.

- *Enhance stress tests to account for funding risks and take additional measures to monitor and possibly limit banks' wholesale funding* including on the mismatch between the maturity of currency swaps and underlying exposures.

- *Strengthen the generally well-developed legal and institutional framework for crisis management, safety nets, and bank resolution.* The authorities should finalize recovery plans, initiate resolution planning, and conduct resolvability assessments for the largest banks.

30. Regional cooperation on financial stability issues should be strengthened. This is particularly important as Swedish-based Nordea, the second largest bank in Norway, plans to convert its Nordic subsidiaries into branches. In response, the Nordic finance ministries and financial supervisors are negotiating a new Memorandum of Understanding on issues raised by systemic branches.

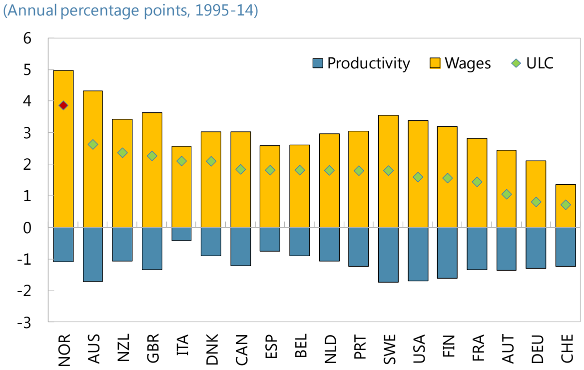
Authorities' Views

31. The authorities broadly agreed that there is scope to strengthen the policy framework. The authorities are monitoring housing market and household debt developments closely, and they are assessing the impact of existing macroprudential measures. On broadening the set of macroprudential instruments, they take the view that the current affordability test serves the same purpose as DTI or DSTI limits, and is more "granular." Further proposals on individual currency LCR requirements and the implementation of the BRRD are expected in the second half of 2016.

D. Supporting Transition and Improving Efficiency

32. Norway needs to improve cost competitiveness. Between 1995 and 2013, Norway's ULC measured in common currency has appreciated by over 70 percent relative to trading partners, driven by high wage growth—particularly in oil- and gas-related sectors—and subdued productivity gains (also see Figure 4 and Annex I). The recent weakening of the exchange rate has reversed some of the lost ground in cost competitiveness, providing a boost to traditional goods exports. Nevertheless, reducing Norway's high common currency ULC relative to trading partners in a sustainable way is crucial for non-oil tradable producers to compete in international markets.

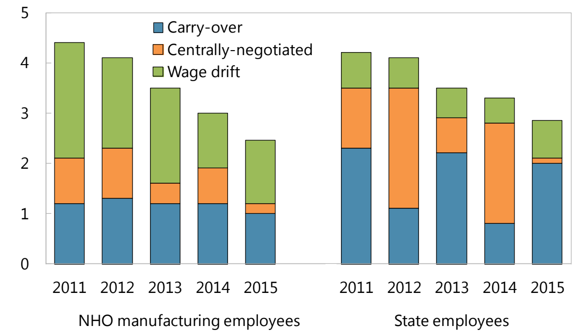
Contribution to Change in Unit Labor Cost
(Annual percentage points, 1995-14)



Sources: OECD and Fund staff calculations.

33. Curbing future real wage increases is particularly important in this regard. The social partners demonstrated the needed wage flexibility in this year's bargaining round by agreeing on a nominal increase in centrally-negotiated pay of only 0.3 percent—similar to last year and substantially lower than the years before. Economy-wide nominal wage growth for 2016 is estimated at about 2.4 percent, implying flat real wages. Continued restraint in wage settlements will be critical to deliver a sustained downward adjustment in ULC relative to trading partners.

Decomposition of Annual Wage Growth
(Percent)



Sources: Norwegian Technical Calculation Committee for Wage Settlements 2016 Report and Fund staff calculations.

34. Boosting productivity growth remains a challenge. Despite robust economic performance, productivity growth in mainland Norway has fallen considerably since the mid-2000s for both cyclical and structural reasons (e.g., rising labor immigration, resource reallocation as a result of booming oil prices).[10] The Productivity Commission's second-phase report outlined several recommendations in the areas of education, research and innovation, mobilization of the workforce, and public sector efficiency to improve productivity and help the Norwegian economy adapt to the ongoing structural changes. These include fostering better cooperation between the higher education sector and industries, softening regulation of working hours, making social security benefits more activity-oriented and enforcing activity requirements, and reforming local government organization, among others. The authorities should continue with the ongoing reforms, prioritizing and implementing measures that would likely generate large productivity payoffs.

35. Past labor market reforms have proven effective, but challenges remain. The 2011 pension reforms have resulted in higher labor force participation among older workers in the private sector. Now, the public sector pension reforms need to be completed along lines similar to those of the private sector in the context of current discussions with social partners. In addition, although Norway's labor force participation is enviable compared with that of peers, disability and sickness claims account for a large fraction of lost labor. Welcome changes were recently made to the disability benefits system to enhance incentives to work while receiving benefits, and pilot programs for new measures to enforce activity requirements for sickness benefits are showing encouraging results. Nevertheless, further reforms to sickness and disability benefits would help maintain labor force participation in the face of population aging, and relieve pressures on the welfare system at a time of rising unemployment and refugee inflows. In addition, active labor market policies can improve the efficiency of the search and matching process, thereby facilitating labor reallocation during the transition.

36. Other reforms would help promote efficiency and support the transition to a new growth model. Tax reforms should shift the burden of taxation from labor and corporate income to property and consumption. In particular, reducing tax preferences for housing would help channel new investment toward more productive uses, including in non-oil-related tradable sectors. The recently introduced tax reform contains welcome reductions in the corporate tax rate and the

[10] See Annexes 7 and 8, and also the first and second chapters of the Selected Issues.

marginal tax rate on personal income, but a shift to higher taxes on property has not been implemented. The recent political agreement for additional reductions in personal and corporate income tax rates would if implemented also be a step in the right direction. Additionally, relaxing constraints on new property construction, including at the municipal level, could boost the supply of housing, thereby taking some of the pressure off elevated housing prices. Reducing the level of protection and subsidy to agriculture would have positive distributional effects and also help free up resources for less expensive and more effective policies to preserve rural communities.

Authorities' Views

37. The authorities agreed with staff on the need to restore competitiveness and continue with structural reforms. They noted that the recent downward adjustment in unit labor costs due to the weak currency has been quite substantial, and they forecast wage growth to remain low by historical standard also for next year. They also pointed to ongoing reforms in the areas singled out by the Productivity Commission, including higher education, research and innovation, and local government organization. On reducing tax preferences for housing, the discount on the taxable values of second dwellings and commercial property has been reduced from 50 to 20 percent over the last three years.

E. Accommodating and Integrating Refugees

38. The recent influx of asylum seekers creates a number of challenges. In the short-run, the surge of refugees puts a strain on the systems for receiving them and for processing asylum applications, raising the fiscal cost. In the medium-run, there are concerns about the capacity to integrate large numbers of refugees into the fabric of Norway's economy and society, which in part depends on their success in the labor market. Just over half of non-Western immigrants, which includes most refugees, are employed, a rate that is 15 percentage points lower than that for natives. The recent economic slowdown, which has lowered labor demand, may also make it more difficult to absorb the recent wave of refugees into the labor market.

39. Successful integration of refugees would reduce fiscal costs and raise labor supply. Increasing the employment rate for refugees to the level of natives could temporarily increase the labor force growth rate by as much as 0.3 percentage points, which would in turn add as much as 0.1–0.2 percentage points to potential growth for a couple years.

40. Though Norway ranks highly in terms of integration policies, there is scope for improvement. The introductory program, which includes language training, social studies and other education, is required for most refugees. This program keeps them out of the labor force for up to two years, which can lead to an erosion of job related skills. When appropriate, combining language lessons and other training with work might help ensure a stronger and more rapid attachment to the labor force. Greater efforts could also be made to assess refugees' formal and informal qualifications, to improve matching of refugees with appropriate jobs and training. The likelihood of refugees being in work or education one year after the introduction course also varies substantially across municipalities, suggesting there is scope to improve outcomes by spreading the approaches used in the most successful municipalities. The White Paper introduced to Parliament in May 2016 takes several steps along these lines towards improving the introduction program and the integration of refugees into labor market. Finally, given the relatively compressed wage distribution and high effective minimum wage in Norway, greater wage flexibility in a temporary and targeted manner might be considered to incentivize the hiring of refugees.

Authorities' Views

41. The authorities emphasized the need to quickly integrate refugees into the labor market. The measures proposed in the White Paper sent to the Parliament in May should accelerate integration of high-skilled refugees and speed up processing of those asylum seekers who are more likely to obtain refugee status. They noted that efforts are underway to personalize integration plans and to learn from municipalities that have been more successful in integration of refugees.

STAFF APPRAISAL

42. The Norwegian mainland economy is feeling the impact of lower oil-related income, but a modest recovery is expected to take root next year. Mainland growth last year slowed to the lowest level since the crisis, alongside rapidly rising unemployment in oil-dependent regions. At the same time, exchange rate depreciation is providing a cushion for the economy, boosting external competitiveness of non-oil industries. The housing market is seeing continued upward price pressures—albeit with large regional variation, and household debt is at an elevated level. While consumer and business confidence remains weak, there are signs that the drag from declining offshore demand on mainland industries has bottomed out. On these trends, mainland growth is set to hold steady this year before picking up in 2017.

43. Policymakers are faced with intertwined challenges. In addition to the short-term task of curbing the downturn, there is the continuing challenge of managing the transition away from oil dependence. The past oil boom had a profound impact on the mainland economy, leading to an extended period of rapidly rising incomes while deepening mainland industries' reliance on offshore demand. The sound fiscal framework has helped keep public income and expenditure from crowding out of other tradable goods and services, but the growth of the oil-related parts of the mainland economy has nevertheless contributed to unsustainably high level of unit labor costs. These forces are weakening competitiveness and will need to be unwound, supported by policies that help facilitate a smooth transition to a new, less oil-dependent, growth model.

44. The expansionary fiscal policy stance this year is justifiable, but fiscal measures should avoid inhibiting the necessary economic adjustment. Fiscal stimulus can be an appropriate tool to smooth the transition to a new equilibrium, and Norway has ample fiscal space for such a policy. However, a permanent shock such as the expected decline in demand from the offshore economy requires permanent adjustment in the private sector growth model and new sources of net export earnings. In this context, any fiscal stimulus should focus on temporary measures that do not inhibit the necessary transition. In particular, non-oil-related tradable industries, rather than the public sector, should absorb a large share of the workers separating from oil and gas-related industries. As economic growth gathers steam, the fiscal stance should shift to neutral to relieve so-called "Dutch disease" pressures. In this regard, the staff would welcome a rethinking of the fiscal framework to provide better operational guidance to fiscal policy, avoid crowding out of production of tradable goods and services, and conserve the GPFG's resources for future generations.

45. Monetary policy should stay accommodative. The current monetary stance is appropriately supportive and should remain so given the slack in the economy and the stable inflation outlook. The policy tradeoff between different objectives arguably has eased; however, potential second-round effects on domestic inflation merit continued monitoring. Provided that inflation expectations remain well-anchored, further easing could be considered should growth turn out significantly weaker than projected. While financial vulnerabilities suggest greater caution may be warranted as the policy rate is lowered, financial stability concerns should be addressed primarily through macroprudential and other measures in the first instance.

46. Despite some progress, action on other key FSAP recommendations is needed to mitigate systemic risks. Norwegian banks are profitable and well-capitalized, and stress tests indicate that they are well-positioned to cope with severe shocks. The authorities have made progress on implementing the FSAP recommendations, including putting in place several measures to address risks in the housing sector. However, given still overvalued house prices, elevated household debt, and banks' heavy reliance on external wholesale funding, further measures to reduce risks are called for. In particular, the regulations on residential mortgages that went into effect on July 1, 2015 and are set to expire at end-2016 should be made permanent and tightened if the rapid household debt and house price growth of recent months continues. The authorities should also continue work on stress-testing for banks to improve liquidity monitoring and on recovery and resolution planning for the largest banks.

47. Continued implementation of key structural reforms is important to promote a successful transition and improve the efficiency of the economy in general. Although the depreciated exchange rate has temporarily improved Norway's cost competitiveness, curbing future real wage increases and reinvigorating productivity growth will be crucial to lowering unit labor costs relative to peers in a sustained manner. This would enable the non-oil tradable industries to strengthen their foothold in international markets. In addition, further reforms to the public sector pension system and sickness and disability benefits will help address labor market challenges and maintain labor force participation. There is also scope for efficiency gains from reducing tax preferences for owner-occupied housing, relaxing unnecessary supply restrictions in the housing market, and lowering the level of protection and subsidy for agriculture.

48. Timely integration of the newly arrived refugees into productive employment is crucial for reducing fiscal costs. Refugees can contribute to the Norwegian economy in the long run, but this potential is not realized until new arrivals become gainfully employed. Although Norway ranks highly in terms of refugee integration policy, there is scope for speeding up the integration process and making it more effective. For example, policies such as making the two-year introduction program more personalized and work-oriented – building on the experiences from the more successful municipalities – would be helpful. The proposals in the recent White Paper on accelerating integration of refugees into Norwegian society and providing access to employment are also welcome.

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

Box 1. Risk Assessment Matrix[1]

Potential Deviations from Baseline

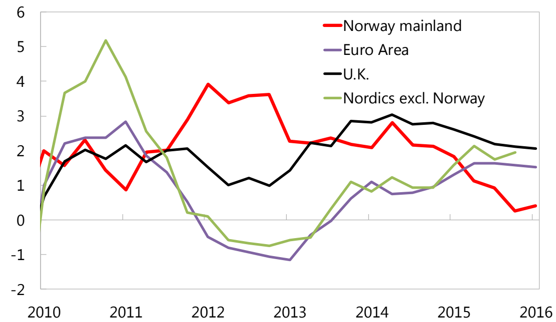
Source of Risks and Relative Likelihood	Expected Impact if Risk is Realized
High **Persistently lower energy prices,** triggered by supply factors reversing only gradually.	**High** • Prolonged low oil prices would undercut growth through a further reduction in the oil-related demand for mainland goods and services, and adverse spillover effects on confidence and consumption in the rest of the economy. **Policy response:** Ample fiscal space allows more supportive fiscal policy to facilitate the transition and monetary policy has some scope for further easing.
Sharper-than-expected global growth slowdown: • Significant China slowdown Low/**Medium** • Structurally weak growth in key advanced and emerging economies **High/Medium**	**High** • Sharp global growth slowdown would hurt the ongoing recovery of non-oil exports and further weaken oil prices. This would lead to lower output and higher unemployment. **Policy response:** When this risk materializes, ample fiscal space and the fiscal rule allow automatic stabilizers to fully operate and additional discretionary spending to support demand as needed.
Medium **Widespread and large reduction in house prices:** • House prices growth slowed in 2015 but accelerated recently and remain at high levels with a risk of significant overvaluation. • Household debt is elevated and keeps rising.	**High** • Substantial falls in house prices would dampen private consumption and reduce residential investment. Reduced corporate earnings could lead to an increase in default rates that would hurt banks' balance sheets. **Policy response:** Extend the temporary regulations on new mortgages beyond end-2016 and take additional preemptive and targeted macroprudential measures to contain risks from a further buildup of high household debt.
Medium **Tighter or more volatile global financial conditions:** • Sharp asset price decline and decompression of credit spreads	**Medium** • Renewed stress in global whole sale funding markets could lead to liquidity strains for Norwegian banks that rely on whole sale funding. The large presence of foreign-owned banks increases spillover risks. • Lower asset prices may have negative impact on GPFG's investment returns. **Policy response:** Introduce NSFR requirements and further strengthen monitoring of liquidity.
Medium **A failure of non-oil-related parts of the mainland economy to pick up slack resulting from lower oil prices.** • A shift to a less oil-dependent growth model could stall if wages fail to adjust or if exchange-rate induced inflation in imports becomes generalized inflation.	**Medium** • Resources need to shift from oil-related to non-oil related sectors, and labor market flexibility will be tested in the process. Exchange rate depreciation should also help the process unless offset by higher domestic inflation. **Policy response:** Avoid using public employment to replace declining oil-related demand in the mainland economy. Adopt competitiveness and productivity enhancing reforms.
High **Dislocation in capital and labor flows:** • **Heightened risk of fragmentation/security dislocation in part of the Middle East, Africa, and Europe,** leading to a sharp rise in migrant flows, with negative global spillovers.	**High** If not effectively integrated into the labor market, the increased number of refugees could weigh on medium to long-term growth and the public finances. **Policy response:** Take policy actions to support the integration of migrants into the labor force, e.g., strengthening refugees' access to ALMPs and accelerating the settlement process.
High **British voters elect to leave the EU** in their June 23rd referendum, with subsequent renegotiation of cross-border trade, financial, and migration relationships. A period of elevated financial volatility and heightened uncertainty could ensue, with potential contagion.	**Low** • If financial market disruptions following a British exit from the EU severely affect euro area and U.S. financial markets, this could lead to higher costs and liquidity strains for Norwegian banks that rely on whole sale funding. • If a British exit from the EU is accompanied by a significant slowdown in the UK, it could (i) hurt Norway's exports to the UK; and (ii) adversely affect the profitability of Norwegian banks, insurance companies, and real estate companies given their direct and indirect exposures, and may result in deterioration in asset quality. **Policy response:** Be prepared to supply liquidity in the event of system liquidity crunch and re-double efforts to reach new economic cooperation and trade agreements to minimize disruptions.

[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.

Figure 1. GDP and Activity Indicators

After a period of outperforming trading partners, the Norwegian economy has entered a downturn.

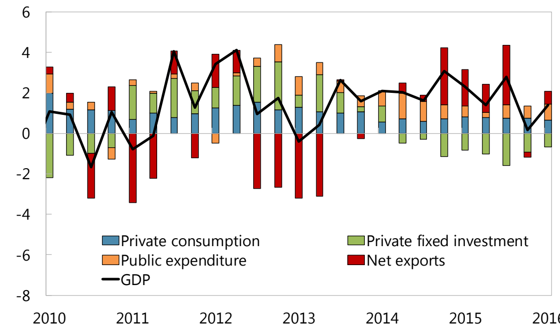
GDP Growth of Trading Partners
(Y/Y growth, percent)



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

Growth in 2015 is underpinned by household consumption and non-oil exports…

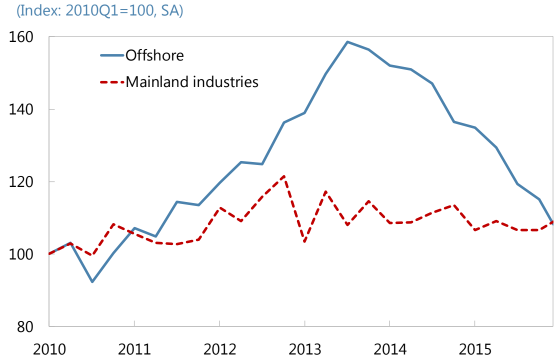
Contributions to Total Real GDP Growth
(Y/Y percentage points, SA)



Sources: Statistics Norway and Fund staff calculations.

…while being dragged down by offshore investment…

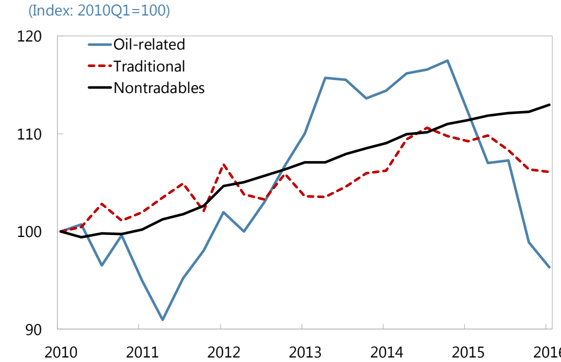
Real Investment
(Index: 2010Q1=100, SA)



Sources: Statistics Norway and Fund staff calculations.

…and oil-related parts of the mainland economy.

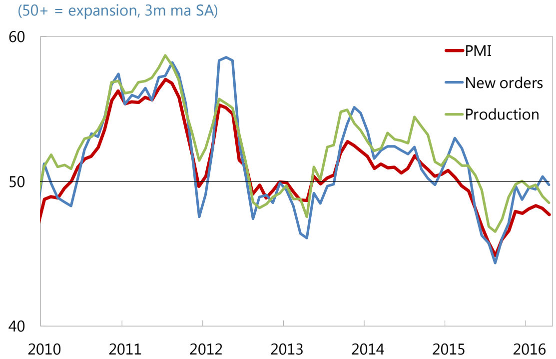
Real Value Added
(Index: 2010Q1=100)



Sources: Statistics Norway and Fund staff calculations.

PMI is still in contraction territory,

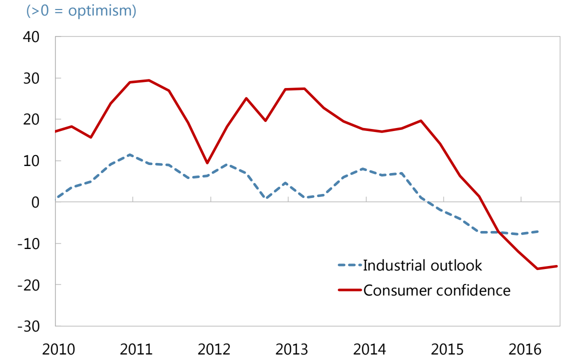
Purchasing Manager Index
(50+ = expansion, 3m ma SA)



Sources: Danske Bank and Fund staff calculations.

…while consumers are pessimistic.

Business and Consumer Sentiment
(>0 = optimism)

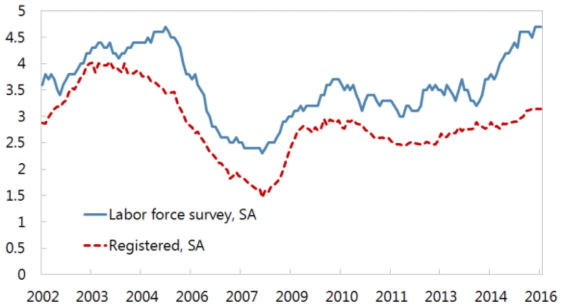


Sources: Statistics Norway, TNS Gallup, and Fund staff calculations.

Figure 2. Labor Market Developments

Unemployment is rising…

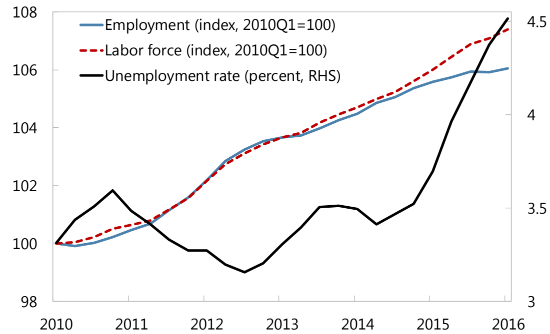
Unemployment Rate
(Percent of labor force)



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

… driven largely by strong labor force growth, but employment has recently weakened.

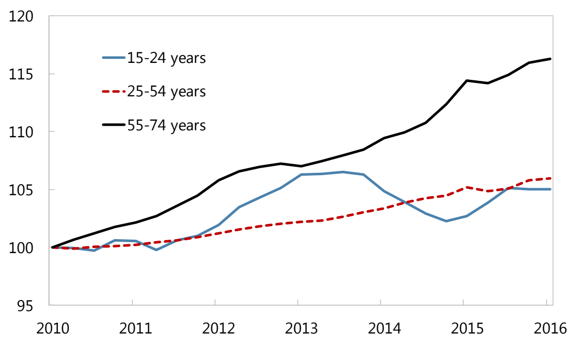
Labor Force, Employment, and Unemployment Rate
(4-quarter moving average)



Sources: Statistics Norway and Fund staff calculations.

Older workers are holding up labor force participation (LFP) rate…

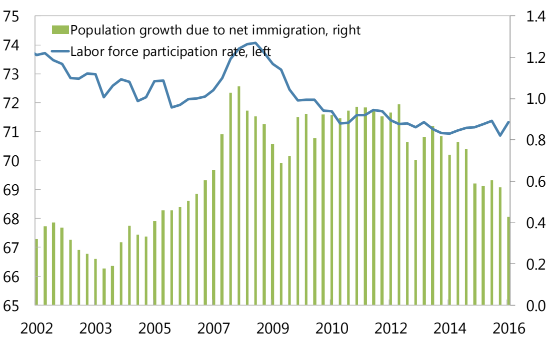
Labor Force by Age
(Index: 2010Q1=100, 4-quarter moving average)



Sources: Statistics Norway and Fund staff calculations.

…while net immigration—a major factor contributing to LFP in the past—is declining, given low oil prices.

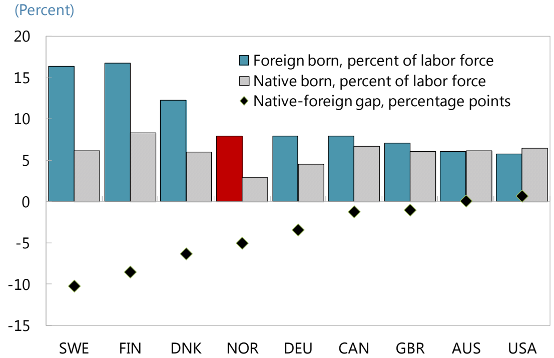
Labor Force and Net Immigration
(Percent of working-age population, left; 2 quarter annualized growth, right)



Sources: Statistics Norway and Fund staff calculations.

Norway's challenges include integrating immigrants into the labor market…

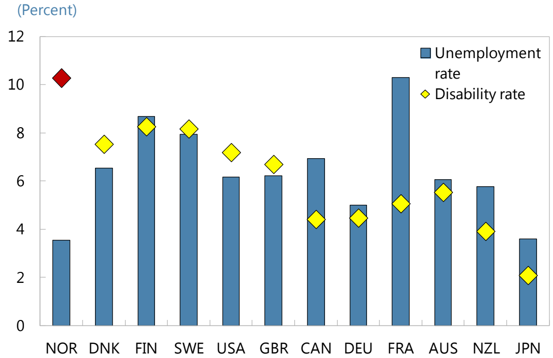
Unemployment Rate of Native and Foreign Born, 2014
(Percent)



Sources: OECD and Fund staff calculations.

…as well as reducing lost labor due to disability claims.

Unemployment and Disability, 2013
(Percent)

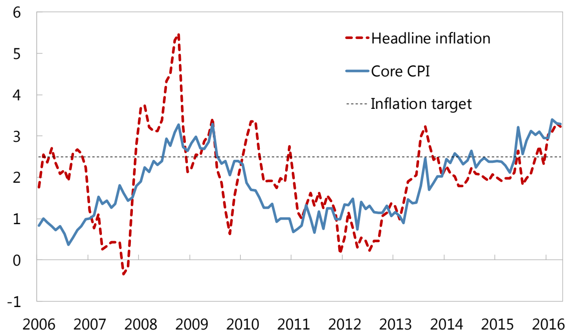


Sources: IMF World Economic Outlook, OECD, and Fund staff calculations.

Figure 3. Price Developments

Both headline and core inflation rose above the target…

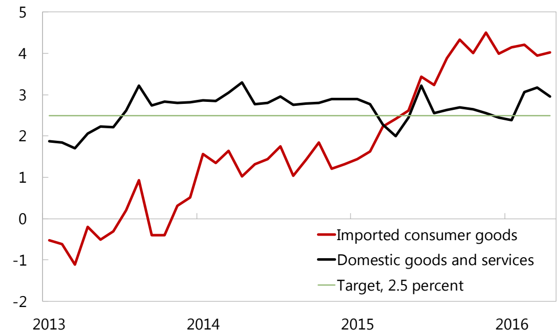
Annual Inflation
(Percent change)



Sources: Statistics Norway and Fund staff calculations.

…mainly due to exchange rate pass-through to prices of imported consumer goods.

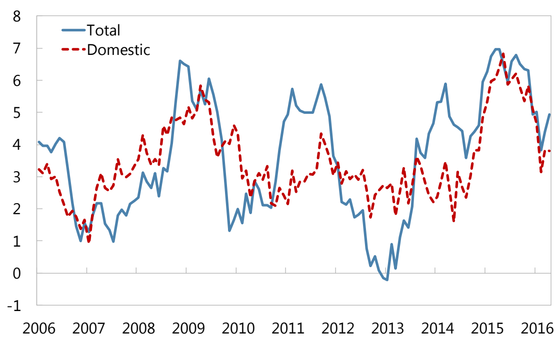
Domestic and Imported Prices
(Y/Y percent change)



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

However, domestic producer price inflation is trending down…

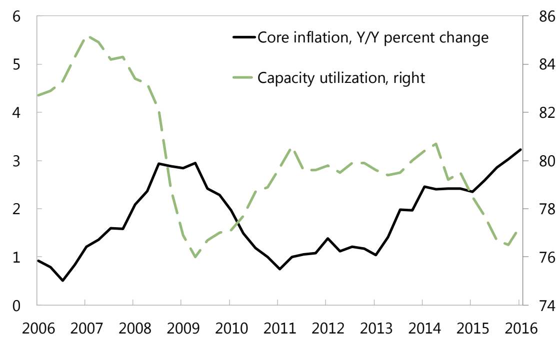
Producer Price Index: Consumer Goods
(Y/Y percent change)



Sources: Statistics Norway and Fund staff calculations.

…reflecting low and falling capacity utilization rate…

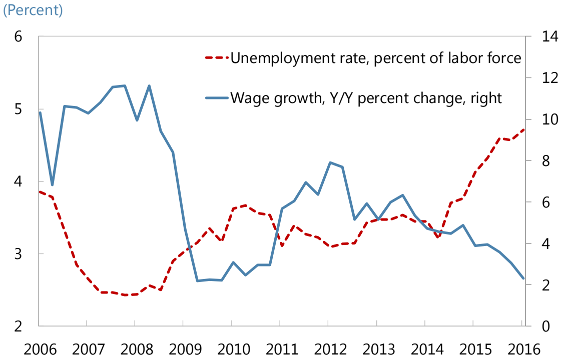
Inflation and Capacity Utilization Rate
(Percent)



Sources: Statistics Norway and Fund staff calculations.

…and soft labor market conditions.

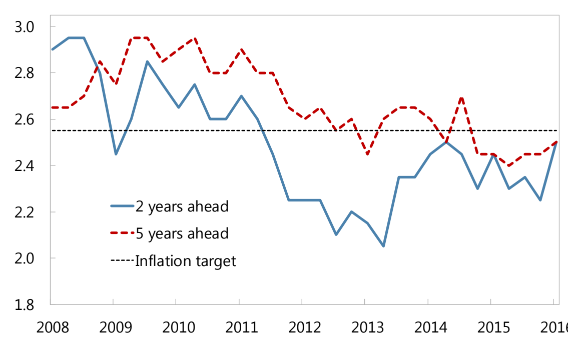
Wage Growth and Unemployment Rate
(Percent)



Sources: Statistics Norway and Fund staff calculations.

Meanwhile, inflation expectations are well anchored.

Survey-Based Inflation Expectations
(Percent)



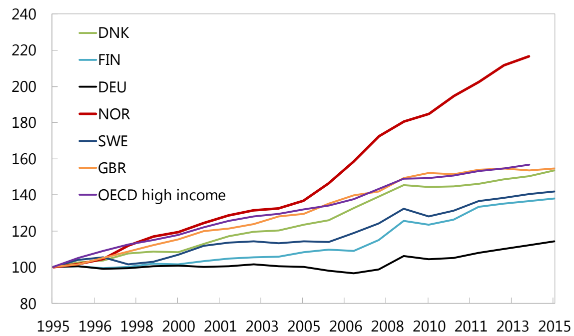
Sources: Norges Bank, TNS Gallup, and Fund staff calculations.

Figure 4. External Competitiveness

Although improved recently, Norway's cost competitiveness had been worsening for almost two decades…

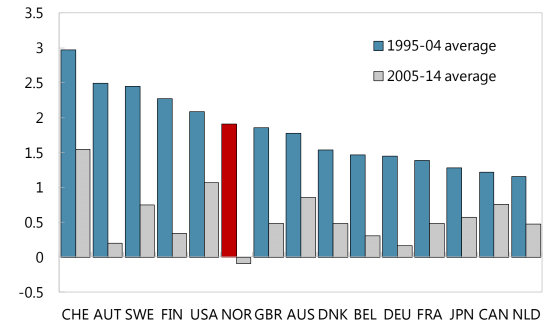
…especially in the post-2005 period as productivity growth disappeared.

Unit Labor Costs
(Index: 1995=100)



Sources: OECD and Fund staff calculations.

Productivity Growth Before and After 2005
(Percent change)

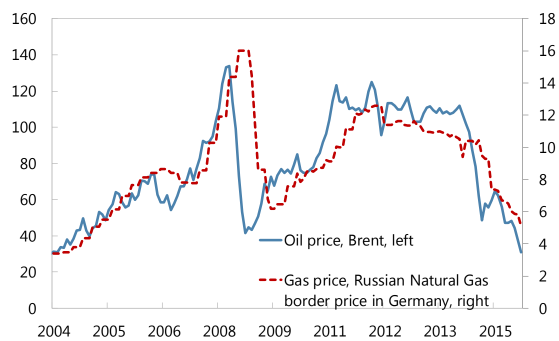


Sources: OECD and Fund staff calculations.

As oil and gas prices plummeted, …

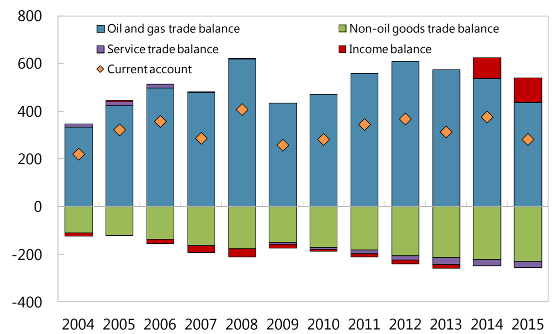
…Norway's current account surplus narrowed in 2015, driven by a deteriorated energy trade balance.

Oil and Gas Prices
(USD)



Sources: IMF Global Economic Assumptions and Fund staff calculations.

Composition of Current Account Balance
(Bil. NOK)

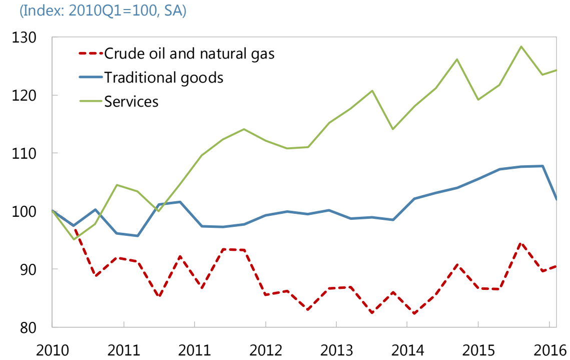


Sources: Statistics Norway and Fund staff calculations.

This is offset by service and traditional goods exports which are performing relatively well…

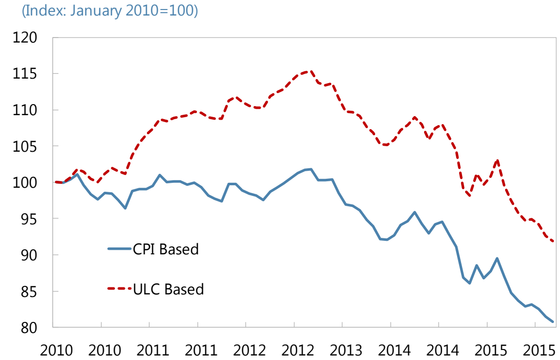
… thanks to the competitive krone driving down ULC measured in common currency.

Real Exports
(Index: 2010Q1=100, SA)



Sources: Statistics Norway and Fund staff calculations.

Real Effective Exchange Rates
(Index: January 2010=100)

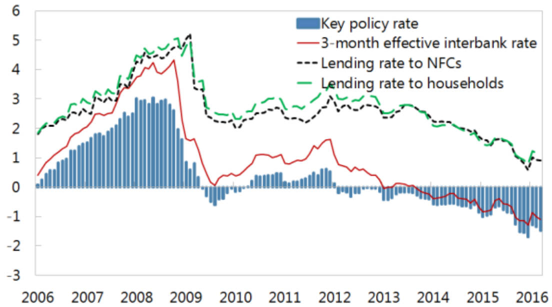


Sources: IMF Information Notice System and Fund staff calculations.

Figure 5. Credit Developments

Real interest rates are low.

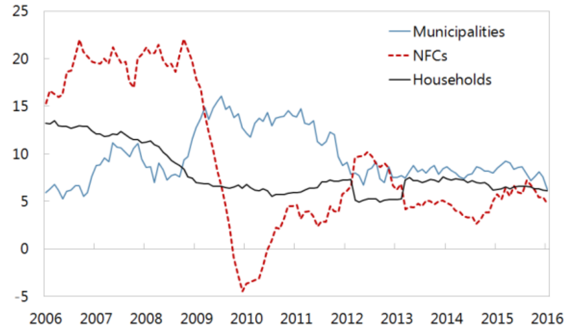
Real Interest Rates
(Percent, adjusted for Norway's 1 year ahead inflation)



Sources: Consensus Forecasts, Haver Analytics, Norges Bank, Oslo Bors, Statistics Norway, and Fund staff calculations.

Household credit growth remains largely unchanged whereas that for corporates started falling…

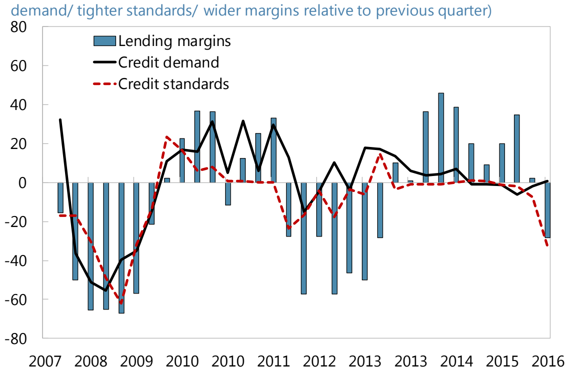
Growth in Domestic Credit
(Y/Y percent change)



Sources: Norges Bank and Fund staff calculations.

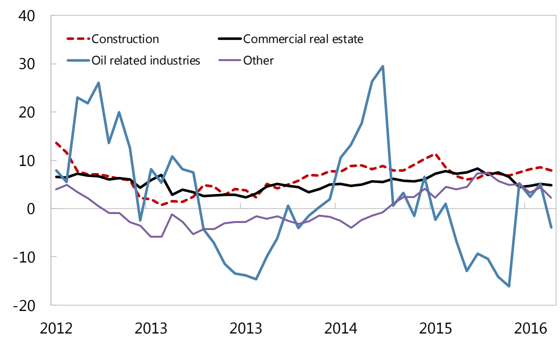
… partly due to tightened credit standards.

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



The slight slowdown in corporate credit growth is broad-based except for the construction industry.

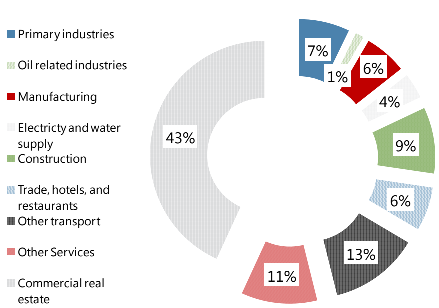
Credit to Nonfinancial Corporations
(Y/Y percent change)



Sources: Norges Bank and Fund staff calculations.

While direct credit exposure to oil-related industries is limited, …

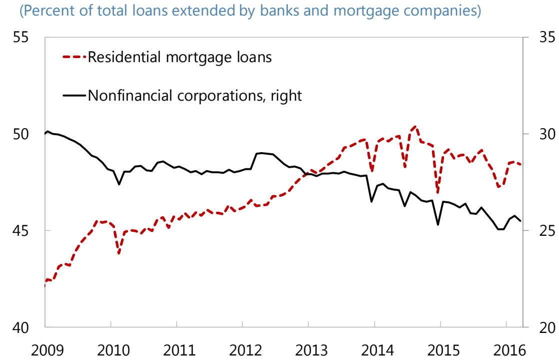
Corporate Lending by Borrower Industries
(Percent of total, 2016M1)



Sources: Statistics Norway and Fund staff calculations.

…lending is increasingly concentrated in housing.

Structure of Credit
(Percent of total loans extended by banks and mortgage companies)

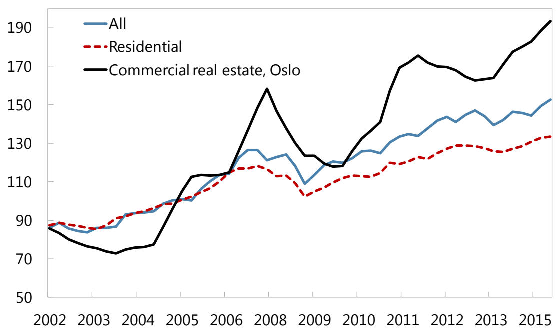


Sources: Statistics Norway and Fund staff calculations.

Figure 6. Household and Corporate Sectors

House price growth accelerated recently after the slowdown throughout 2015,...

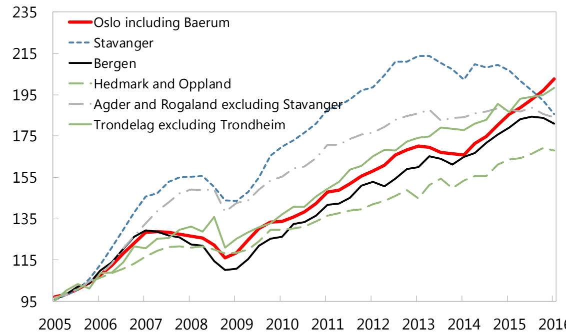
Real Property Prices
(Index: 2005=100)



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

... albeit with divergent development across regions.

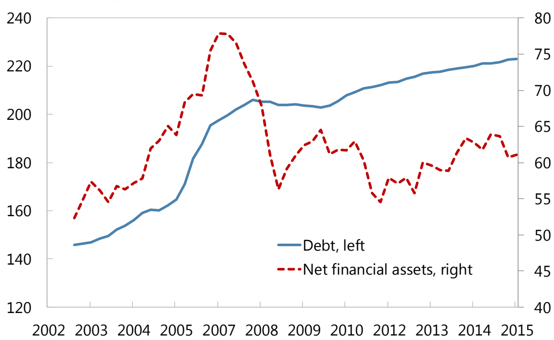
Regional House Prices
(SA Index: 2005=100)



Sources: Statistics Norway and Fund staff calculations.

Household debt remains elevated at about 220 percent of disposable income...

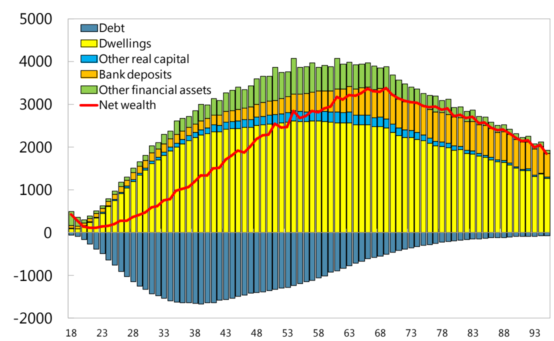
Household Financial Position
(Percent of disposable income)



Sources: Statistics Norway and Fund staff calculations.

... and debt is skewed toward younger households with limited liquid assets.

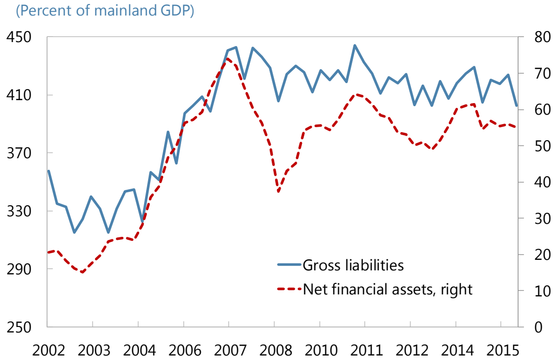
Balance Sheet by Age of Main Income Earner, 2012
(Thousands of NOK)



Sources: Norges Bank and Fund staff calculations.

Corporates' financial positions have been stable.

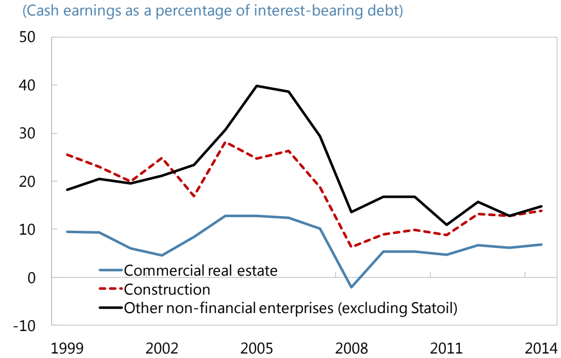
Nonfinancial Corporation Financial Position
(Percent of mainland GDP)



Sources: Statistics Norway and Fund staff calculations.

Their debt-service capacity has also been stable albeit at low levels.

Earnings-To-Debt Ratio of Nonfinancial Corporations
(Cash earnings as a percentage of interest-bearing debt)



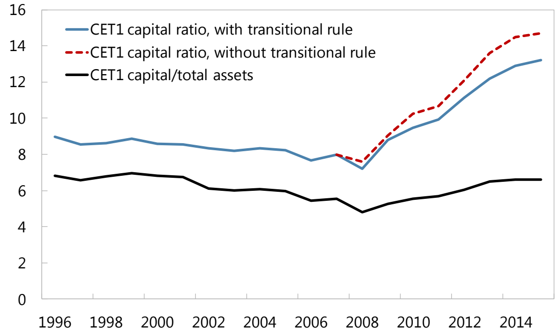
Sources: Norges Bank and Fund staff calculations.

Figure 7. Banking Sector Developments

Regulatory capital ratios have strengthened over recent years…

Tier 1 Capital Ratios

(Percent)

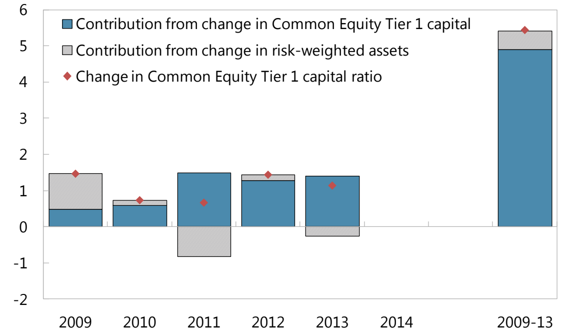


Sources: Norges Bank and Fund staff calculations.

… partly due to changes in risk weighted assets.

Contributions to Change in CET1

(Percentage points)

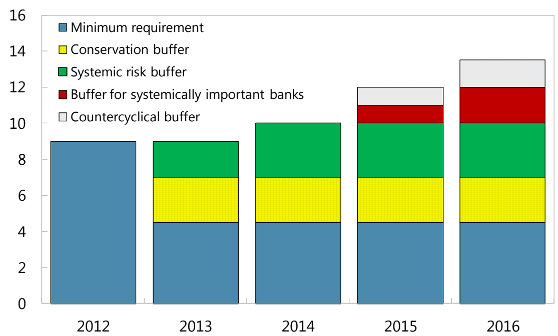


Sources: Norges Bank and Fund staff calculations.

Banks are well positioned to meet new capital requirements…

Tier 1 Capital Requirements

(Percent of risk-weighted assets)

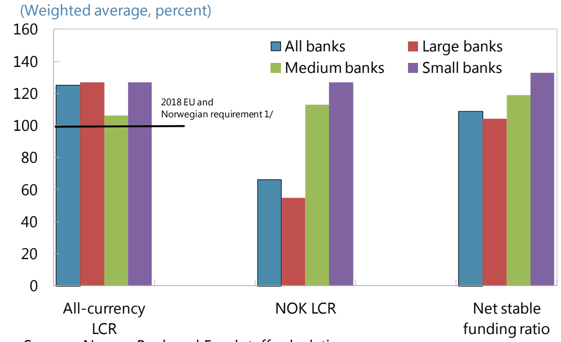


Sources: Norges Bank and Fund staff calculations.

… and new liquidity requirements, albeit with relatively low LCR in Norwegian krone.

Liquidity Coverage Ratio and Net Stable Funding Ratio

(Weighted average, percent)



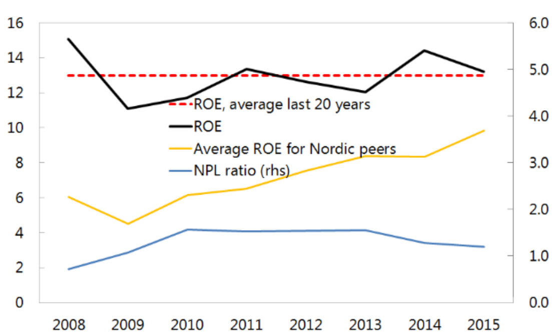
Sources: Norges Bank and Fund staff calculations.

1/ Norway set LCR requirement for three SIFIs at 100 percent, effective from 2016, and that for other credit instituions at 70, 80, and 100 percent, effective from 2016, 2017, and 2018, respectively.

Banks' profitability declined somewhat but remains high compared with peers, and nonperforming loans are low and declining.

Return on Equity and Nonperforming Loans

(Percent)



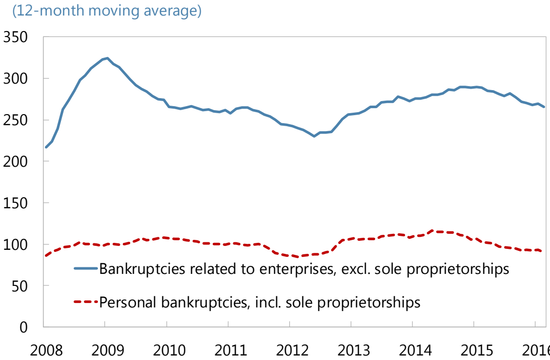
Sources: Norges Bank and Fund staff calculations.

1/ Nordic peers include Denmark, Finland and Sweden.

Meanwhile, corporate bankruptcies are gradually trending down.

Bankruptcies

(12-month moving average)



Sources: Statistics Norway and Fund staff calculations.

Table 1. Norway: Selected Economic and Social Indicators, 2010–17

Population (2015): 5.2 million
Per capita GDP (2015): US$ 74,500 — Quota (1883.7 mil. SDR/0.79 percent of total)
Main products and exports: Oil, natural gas, fish (primarily salmon) — Literacy: 100 percent

	2010	2011	2012	2013	2014	2015 est.	Projections 2016	2017
Real economy (change in percent)								
Real GDP 1/	0.6	1.0	2.7	1.0	2.2	1.6	0.9	1.4
Real mainland GDP	1.8	1.9	3.8	2.3	2.3	1.0	1.1	1.7
Domestic demand	3.0	2.7	3.5	3.5	2.0	0.6	0.9	1.6
Unemployment rate (percent of labor force)	3.6	3.3	3.2	3.5	3.5	4.4	4.7	4.5
Output gap (mainland economy, - implies output below potential)	-1.3	-0.9	0.2	0.0	-0.1	-0.7	-1.4	-1.0
CPI (average)	2.4	1.3	0.7	2.1	2.0	2.2	2.8	2.5
Gross national saving (percent of GDP)	36.3	38.2	39.0	38.2	40.2	37.6	34.4	34.9
Gross domestic investment (percent of GDP)	25.4	25.8	26.5	27.9	28.3	28.6	28.8	28.4
Public finance								
Central government (fiscal accounts basis)								
Overall balance (percent of mainland GDP) 2/	8.3	12.6	12.8	9.5	6.0	1.3	-3.2	-2.7
Structural non-oil balance (percent of mainland trend GDP) 3/	-5.1	-4.5	-4.8	-5.1	-5.8	-6.3	-7.5	...
Fiscal impulse	0.0	-0.6	0.3	0.2	0.8	0.5	1.1	...
in percent of Pension Fund Global capital 4/	-4.1	-3.2	-3.4	-3.2	-2.9	-2.6	-2.8	...
General government (national accounts basis, percent of mainland GDP)								
Overall balance	13.6	17.1	17.5	13.3	10.5	6.5	3.6	4.0
Net financial assets	209.3	210.1	221.4	260.6	304.8	334.6	325.9	329.1
of which: capital of Government Pension Fund Global (GPF-G)	148.2	153.3	166.1	208.2	254.6	286.0	...	...
Money and credit (end of period, 12-month percent change)								
Broad money, M2	6.4	5.7	4.9	7.3	6.4	0.9	...	...
Domestic credit, C2	6.1	6.9	5.9	6.8	6.0	6.1	...	...
Interest rates (year average, in percent)								
Three-month interbank rate	2.5	2.9	2.2	1.8	1.7	1.3	1.0	1.3
Ten-year government bond yield	3.5	3.1	2.1	2.6	2.5	1.6	1.3	1.6
Balance of payments (percent of mainland GDP)								
Current account balance	13.6	16.0	16.1	13.0	14.9	10.8	6.6	7.7
Exports of goods and services (volume change in percent)	0.7	-0.8	1.4	-1.7	2.2	3.6	1.4	1.7
Imports of goods and services (volume change in percent)	8.3	4.0	3.1	4.9	1.5	0.7	2.2	2.6
Terms of trade (change in percent)	6.7	9.1	2.8	0.0	-5.3	-7.2	-6.8	6.5
International reserves (end of period, in billions of US dollars)	55.6	52.8	51.7	57.9	66.9	58.5	57.0	53.6
Fund position								
Holdings of currency (percent of quota)	76.6	71.4	71.1	78.2	85.6	89.8	...	...
Holdings of SDR (percent of allocation)	102.0	97.5	96.1	95.1	94.8	96.4	...	...
Quota (SDR millions)	1,672	1,884	1,884	1,884	1,884	1,884	...	...
Exchange rates (end of period)								
Exchange rate regime				Floating				
Bilateral rate (NOK/USD), end-of-period	6.0	5.6	5.8	5.9	6.3	8.1	...	...
Real effective rate (2010=100)	100.0	100.6	100.2	98.9	94.1	86.3	...	...

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

1/ Based on market prices which include "taxes on products, including VAT, less subsidies on products".
2/ Projections based on authorities's 2015 revised budget and 2016 budget proposal submitted to the parliament.
3/ Authorities' key fiscal policy variable; excludes oil-related revenue and expenditure, GPF-G income, as well as cyclical effects.
4/ Over-the-cycle deficit target: 4 percent.

Table 2. Norway: Medium-Term Indicators, 2012–21
(Annual percent change, unless otherwise noted)

					Projections					
	2012	**2013**	**2014**	**2015 est.**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Real GDP	2.7	1.0	2.2	1.6	0.9	1.4	1.8	2.1	2.1	2.1
Real mainland GDP	3.8	2.3	2.3	1.0	1.1	1.7	2.3	2.6	2.6	2.7
Real Domestic Demand	3.5	3.5	2.0	0.6	0.9	1.6	2.2	2.5	2.5	2.5
Public consumption	1.6	1.0	2.9	1.9	2.8	2.1	1.8	1.8	1.8	1.8
Private consumption	3.5	2.7	1.7	2.0	1.3	1.8	2.6	2.8	2.8	2.8
Gross fixed investment	7.6	6.3	0.0	-4.2	-1.6	1.1	2.4	3.1	3.1	3.1
Stockbuilding (contribution to growth)	-0.3	0.4	0.5	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Trade balance of goods and services (contribution to growth)	-0.3	-2.0	0.4	1.0	0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Exports of goods and services	1.4	-1.7	2.2	3.4	1.6	1.7	1.8	2.0	2.0	2.1
Mainland good exports	-0.2	1.3	2.5	4.8	2.8	3.2	3.5	4.0	4.0	4.0
Imports of goods and services	3.1	4.9	1.5	1.1	1.8	2.6	3.1	3.1	3.1	3.1
Potential GDP	1.7	1.2	2.3	2.3	1.6	0.9	1.6	1.5	1.9	2.1
Potential mainland GDP	2.7	2.4	2.3	1.7	1.9	1.3	2.1	2.0	2.4	2.7
Output Gap (percent of potential)	0.2	0.0	-0.1	-0.7	-1.4	-1.0	-0.8	-0.2	0.0	0.0
Labor Market										
Employment	1.9	0.7	1.1	0.5	0.2	0.8	1.0	1.0	1.1	1.1
Unemployment rate LFS (percent)	3.2	3.5	3.5	4.4	4.7	4.5	4.2	4.0	3.8	3.8
Prices and Wages										
GDP deflator	3.4	2.5	0.5	-2.3	-1.1	3.9	3.6	3.3	2.6	2.1
Consumer prices (avg)	0.7	2.1	2.0	2.2	2.8	2.5	2.5	2.5	2.5	2.5
Consumer prices (eop)	1.4	2.0	2.1	2.3	2.5	2.5	2.5	2.5	2.5	2.5
Manufacturing wages										
Hourly compensation	4.8	5.3	2.8	2.5	...	...	...	...	...	...
Productivity	0.0	1.3	0.1	3.7	...	...	...	...	...	...
Unit labor costs	4.8	3.9	2.7	-1.2	...	...	...	...	...	...
Fiscal Indicators										
General government fiscal balance (percent of GDP)	13.5	10.5	8.4	5.5	3.0	3.4	3.9	4.3	4.3	4.1
of which: nonoil balance (percent of mainland GDP)	-4.5	-5.5	-6.8	-7.4	-8.2	-7.5	-7.5	-7.5	-7.5	-7.5
External Sector										
Current account balance (percent GDP)	12.4	10.2	11.9	9.0	5.6	6.5	7.0	7.8	7.7	7.4
Balance of goods and services (percent of GDP)	12.9	10.7	9.2	5.8	2.3	3.2	3.7	4.0	3.6	2.7
Mainland balance of goods 1/	-9.0	-8.9	-8.8	-8.9	-8.6	-9.6	-10.0	-10.3	-10.8	-11.5

Source: Statistics Norway, Ministry of Finance, and IMF staff estimates.
1/ Percent of mainland GDP.

Table 3. Norway: External Indicators, 2012–21

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
					Projections					
					Bil. NOK					
Current account balance	368.6	314.2	376.7	282.6	174.5	212.6	241.6	284.3	294.2	295.8
Balance of goods and services	383.3	328.2	289.6	180.8	71.3	105.4	129.7	146.0	137.0	108.9
Balance of goods	401.6	357.9	314.7	205.7	100.3	127.1	148.1	164.6	164.4	151.9
Balance of services	-18.3	-29.7	-25.1	-25.0	-28.9	-21.6	-18.4	-18.6	-27.4	-43.1
Exports	1204.4	1203.7	1219.2	1162.8	1116.5	1210.2	1302.9	1391.9	1460.1	1514.2
Goods	929.0	912.1	903.9	832.1	766.4	827.8	888.5	946.8	990.9	1025.2
of which oil and natural gas	610.8	581.3	551.0	450.0	332.2	396.2	439.8	480.2	509.5	535.1
Services	275.3	291.6	315.3	330.6	350.1	382.4	414.5	445.1	469.2	489.0
Imports	821.0	875.5	929.6	982.0	1045.1	1104.8	1173.2	1245.9	1323.2	1405.3
Goods	527.4	554.2	589.2	626.4	666.1	700.7	740.3	782.2	826.5	873.3
Services	293.6	321.3	340.4	355.6	379.0	404.1	432.8	463.6	496.6	532.0
Balance on income	-14.7	-14.0	87.1	101.8	103.1	107.2	111.9	138.3	157.2	186.9
Capital account balance	-1.3	-1.4	-1.1	-0.9	-0.9	-0.9	-1.0	-1.0	-1.0	-1.1
Financial account balance	254.3	272.8	420.1	261.3	173.6	211.7	240.7	283.3	293.1	294.7
Net direct investment	-5.2	40.5	115.8	190.8	111.8	147.8	161.8	152.7	168.7	175.8
Net portfolio investment	299.3	303.3	148.2	306.9	189.4	156.9	230.4	249.5	241.5	284.3
Net other investment	-48.5	-85.0	118.3	-188.7	-113.2	-69.6	-145.4	-101.6	-104.9	-141.9
Change in reserves (- implies an increase)	7.7	15.2	40.1	-45.6	-14.5	-23.5	-6.1	-17.4	-12.1	-23.5
Net errors and omissions	-113.0	-40.1	44.5	-20.4	0.0	0.0	0.0	0.0	0.0	0.0
					Percent of Mainland GDP					
Current account balance	16.1	13.0	14.9	10.8	6.6	7.7	8.4	9.4	9.3	9.0
Balance of goods and services	16.7	13.6	11.5	6.9	2.7	3.8	4.5	4.9	4.4	3.3
Balance of goods	17.5	14.8	12.5	7.9	3.8	4.6	5.2	5.5	5.2	4.6
Balance of services	-0.8	-1.2	-1.0	-1.0	-1.1	-0.8	-0.6	-0.6	-0.9	-1.3
Exports	52.5	49.8	48.3	44.5	42.2	44.0	45.4	46.3	46.4	46.1
Goods	40.5	37.7	35.8	31.9	28.9	30.1	30.9	31.5	31.5	31.2
of which oil and natural gas	26.6	24.0	21.8	17.2	12.5	14.4	15.3	16.0	16.2	16.3
Services	12.0	12.1	12.5	12.7	13.2	13.9	14.4	14.8	14.9	14.9
Imports	35.8	36.2	36.8	37.6	39.5	40.2	40.8	41.4	42.0	42.8
Goods	23.0	22.9	23.3	24.0	25.2	25.5	25.8	26.0	26.3	26.6
Services	12.8	13.3	13.5	13.6	14.3	14.7	15.1	15.4	15.8	16.2
Balance on income	-0.6	-0.6	3.5	3.9	3.9	3.9	3.9	4.6	5.0	5.7
Capital account balance	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	11.1	11.3	16.6	10.0	6.6	7.7	8.4	9.4	9.3	9.0
Net direct investment	-0.2	1.7	4.6	7.3	4.2	5.4	5.6	5.1	5.4	5.4
Net portfolio investment	13.0	12.5	5.9	11.7	7.2	5.7	8.0	8.3	7.7	8.7
Net other investment	-2.1	-3.5	4.7	-7.2	-4.3	-2.5	-5.1	-3.4	-3.3	-4.3
Change in reserves (- implies an increase)	0.3	0.6	1.6	-1.7	-0.5	-0.9	-0.2	-0.6	-0.4	-0.7
Net errors and omissions	-4.9	-1.7	1.8	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
					Percent of GDP					
Stock of net foreign assets (IIP)	93.0	125.3	166.9	199.2	205.2	201.4	197.8	195.4	194.2	193.6
Direct investment, net	1.0	1.0	-0.9	3.7	7.2	11.4	15.4	18.8	22.4	25.8
Portolio investment, net	94.2	127.1	162.0	195.2	201.7	196.3	192.7	189.6	187.4	186.8
Other investment, net	-12.0	-14.4	-9.7	-15.8	-19.5	-20.6	-23.7	-25.3	-26.9	-29.3
Official reserves, assets	9.8	11.6	15.4	16.2	15.8	14.3	13.4	12.2	11.3	10.3
Government Pension Fund Global, percent of mainland GDP	166.1	208.2	254.6	286.0	…	…	…	…	…	…

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

Table 4. Norway: General Government Accounts, 2006–14

(Percent of mainland GDP)

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Revenue	77.7	74.5	78.2	68.9	69.1	73.2	72.5	69.4	67.5
Taxes	45.7	42.9	44.0	39.1	40.7	42.5	41.6	39.3	36.5
Social contributions	11.4	11.2	11.6	11.9	11.7	12.0	12.1	12.1	12.4
Other	20.6	20.3	22.7	17.9	16.7	18.8	18.9	18.0	18.6
Expense	52.4	50.9	51.4	54.1	53.9	54.4	53.5	53.5	54.2
Compensation of employees	15.3	15.1	15.5	16.4	16.4	16.8	16.8	16.8	16.9
Use of goods and services	6.8	6.7	6.8	7.3	7.3	7.2	7.0	7.0	7.1
Consumption of fixed capital	3.2	3.2	3.3	3.5	3.5	3.7	3.8	3.8	3.8
Interest	3.3	3.4	2.8	1.8	1.5	1.5	1.2	1.1	1.0
Subsidies	2.4	2.2	2.3	2.5	2.5	2.5	2.4	2.4	2.3
Grants	1.1	1.2	1.3	1.4	1.5	1.4	1.3	1.4	1.4
Social benefits	18.7	17.6	17.8	19.3	19.4	19.7	19.5	19.3	19.7
Other	1.6	1.5	1.6	1.8	1.7	1.7	1.7	1.7	2.1
Gross operating balance	28.5	26.7	30.1	18.3	18.8	22.5	22.8	19.7	17.0
Net operating balance	25.3	23.5	26.8	14.8	15.3	18.8	19.0	15.9	13.2
Net acquisition of nonfinancial assets	1.3	1.5	1.7	2.0	1.5	1.4	1.1	1.5	1.9
					Net financing				
Net lending/borrowing	24.0	22.0	25.1	12.8	13.7	17.4	17.9	14.4	11.4
Net acquisition of financial assets	45.1	26.7	15.3	3.2	18.2	1.9	21.2	17.3	9.1
Currency and deposits	3.4	0.0	-0.8	-0.8	0.5	-2.3	2.9	-1.9	1.4
Securities other than shares	32.1	3.2	10.3	-17.0	8.5	0.7	6.9	14.3	3.0
Loans	3.9	7.7	-26.5	5.4	3.2	-9.1	1.4	2.8	-2.3
Shares and other equity	4.6	14.8	28.5	17.6	4.3	11.5	10.0	2.2	6.4
Insurance technical reserves	0.1	0.0	-0.1	0.0	0.1	0.0	0.0	0.1	0.1
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	1.1	1.0	3.9	-2.2	1.6	1.1	0.0	-0.2	0.5
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	21.7	4.6	-9.6	-9.5	4.5	-14.9	3.3	2.2	-2.3
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	1.3	-0.8	3.5	10.6	1.1	-3.8	2.5	-0.5	0.3
Loans	19.0	3.9	-14.7	-18.4	2.5	-10.2	1.1	2.4	-2.7
Shares and other equity	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
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	1.4	1.5	1.6	-1.7	0.8	-0.9	-0.3	0.3	0.1
					Balance sheet				
Net financial worth	175.9	176.4	163.4	188.3	201.8	203.8	215.5	259.2	302.5
Financial assets	253.0	247.7	236.1	247.7	262.2	247.5	260.0	303.5	343.2
Currency and deposits	13.9	12.7	11.6	10.6	10.6	7.8	10.3	7.9	9.0
Securities other than shares	73.5	64.3	86.2	59.8	64.6	65.6	66.8	80.4	95.6
Loans	53.2	51.5	31.1	35.7	37.0	26.5	26.4	28.3	25.2
Shares and other equity	95.7	102.8	91.9	127.4	135.2	131.9	141.2	172.0	198.5
Insurance technical reserves	1.2	1.2	0.7	0.9	1.0	1.5	1.6	2.2	2.5
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	15.4	15.1	14.5	13.4	13.8	14.2	13.8	12.8	12.5
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities	77.1	71.4	72.7	59.4	60.5	43.8	44.6	44.4	40.7
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	14.9	12.9	16.1	26.3	26.1	21.6	22.7	20.8	20.6
Loans	54.9	50.3	47.2	25.6	26.8	15.7	15.9	17.7	14.4
Shares and other equity	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
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	7.3	8.2	9.3	7.5	7.6	6.4	5.9	5.9	5.7
Mainland GDP	1661.7	1829.8	1943.3	1964.6	2074.0	2157.8	2295.4	2418.8	2524.9

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

Annex I. External Sector Assessment

Norway's terms of trade deteriorated further in 2015, but the external position remains solid. The current account (CA) balance fell from 14.9 percent of (mainland) GDP in 2014 to 10.8 percent of GDP in 2015. This was largely driven by the 36 percent decline in the value of oil exports as oil prices fell. In turn, the terms of trade shock has led to 27 percent depreciation in the nominal effective exchange rate (import weighted) since early 2013. The net international investment position (NIIP) rose 30 percentage points to 239 percent of GDP, partly due to the depreciation of the exchange rate raising foreign asset values in local currency terms. Banks remained net external debtors, with banks' net external liabilities at around 57 percent of GDP. Reserve assets held steady at just over 19 percent of GDP.

The different approaches of the IMF's External Balance Assessment (EBA) produce an unusually broad range of exchange rate misalignment estimates for Norway. The CA analysis suggests the REER is broadly in line with fundamentals and desirable policies. The REER *index* analysis indicates the REER is moderately undervalued, while the REER *level* analysis suggests it is highly undervalued. Meanwhile, the External Sustainability (ES) approach indicates strong overvaluation, despite the nearly 20 percent depreciation of the REER since early 2013.

External Balance Assessment (EBA) Methodologies 1/

Methodology	CA gap *(Percent of GDP)*	REER gap *(Percent)*
EBA CA Analysis	-1.3	3.7
EBA REER (Index) Analysis	--	-9.3
EBA REER (Level) Analysis	--	-29.7
EBA External Sustainability Approach	-10.5	29.6

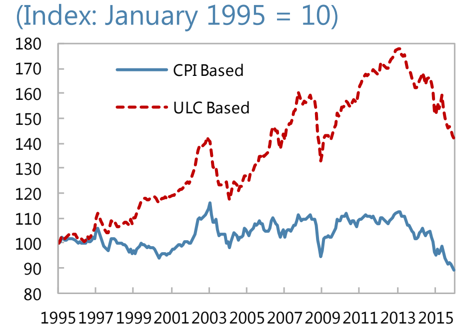
Source: Fund staff calculations.

1/ CA gaps: minus indicates overvaluation. REER gaps: minus indicates undervaluation. REER gaps between -5 and +5 percent are considered to indicate the REER is broadly in line with fundamentals. Estimates based on data available in April 2016.

Staff considers the CA and REER *index* analyses to be more reliable in Norway's case and concludes the exchange rate is not significantly undervalued. The large and opposing indications of exchange rate misalignment from the REER *level* and ES approaches raise questions about their suitability for Norway. For one, the model fit of the REER *level* is not very good in comparison with the CA and REER *index* analyses. Also, the fitted values of the REER *level* model would have the REER appreciating strongly when the country is suffering a negative terms of trade shock. At the same time, the ES approaches' estimate of the optimal current account balance suffers from several sources of uncertainty, including about future commodity prices and quantities.

The deterioration in cost competitiveness since the 2008–09 crisis has only recently been unwound by the krone's depreciation, which also suggests that the exchange rate is not substantially undervalued. During 1995–2013, the ULC-based REER appreciated more than 70 percent, while the CPI-based REER was essentially flat. The 20 percent depreciation of the ULC-based REER since early 2013 has only reversed the worsening of cost competitiveness since the crisis, but the rate is still 40 percent higher than it was two decades ago.

Real Effective Exchange Rates
(Index: January 1995 = 10)



Sources: IMF Information Notice System and Fund staff.

Annex II. Debt Sustainability Analysis

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

(In percent of GDP unless otherwise indicated)

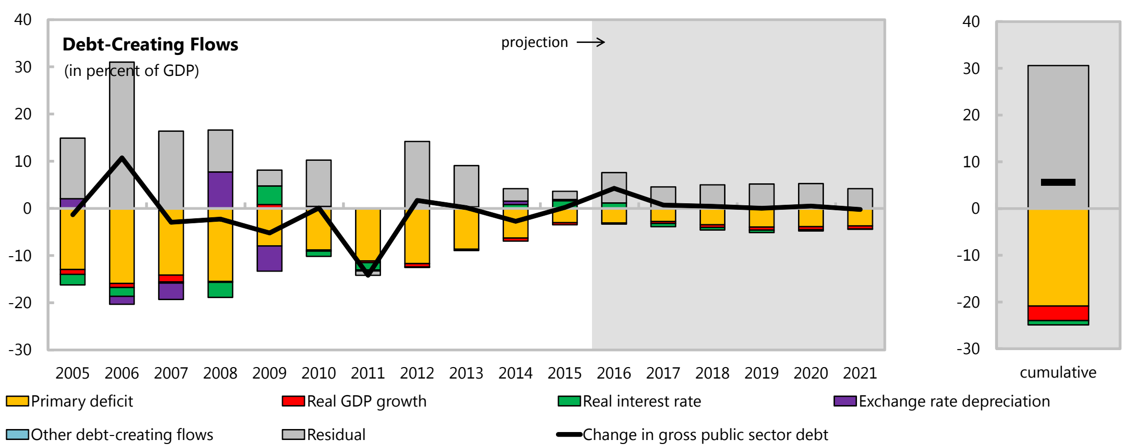
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	39.8	26.6	26.7	31.0	31.7	32.1	32.2	32.7	32.4
Public gross financing needs	-12.8	8.7	-4.6	-2.8	0.9	1.5	1.5	1.6	2.7
Real GDP growth (in percent)	1.3	2.2	1.6	0.9	1.4	1.8	2.1	2.1	2.1
Inflation (GDP deflator, in percent)	4.9	0.5	-2.3	-1.1	3.9	3.6	3.3	2.6	2.1
Nominal GDP growth (in percent)	6.4	2.7	-0.7	-0.2	5.3	5.5	5.4	4.7	4.3
Effective interest rate (in percent) [4/]	3.2	3.3	3.8	3.2	1.6	1.9	1.6	1.8	2.0

As of March 18, 2016		
Sovereign Spreads		
EMBIG (bp) 3/		104
5Y CDS (bp)		25
Ratings	Foreign	Local
Moody's	Aaa	Aaa
S&Ps	AAA	AAA
Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.5	-2.7	0.2	4.3	0.7	0.4	0.0	0.5	-0.2	5.7	
Identified debt-creating flows	-13.1	-5.4	-1.6	-2.2	-3.9	-4.6	-5.1	-4.8	-4.4	-24.9	
Primary deficit	-11.9	-6.3	-3.0	-3.1	-2.8	-3.5	-4.0	-3.9	-3.7	-20.9	-0.7
Primary (noninterest) revenue and grants	52.5	50.2	49.8	52.5	50.6	50.8	51.0	50.9	50.7	306.4	
Primary (noninterest) expenditure	40.6	43.9	46.8	49.4	47.8	47.3	47.0	47.0	47.0	285.5	
Automatic debt dynamics [5/]	-1.2	0.9	1.5	0.9	-1.1	-1.1	-1.2	-0.9	-0.7	-4.0	
Interest rate/growth differential [6/]	-1.1	0.2	1.2	0.9	-1.1	-1.1	-1.2	-0.9	-0.7	-4.0	
Of which: real interest rate	-0.7	0.8	1.6	1.2	-0.7	-0.5	-0.5	-0.2	-0.1	-0.9	
Of which: real GDP growth	-0.5	-0.6	-0.4	-0.2	-0.4	-0.5	-0.6	-0.6	-0.7	-3.1	
Exchange rate depreciation [7/]	0.0	0.7	0.3	…	…	…	…	…	…	…	
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 dep	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 Euroare	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/]	11.6	2.7	1.8	6.4	4.6	5.0	5.2	5.3	4.2	30.6	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

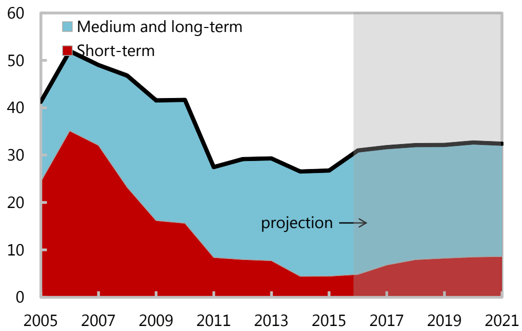
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

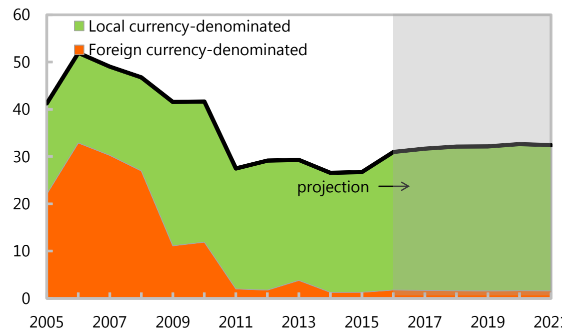
Norway Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



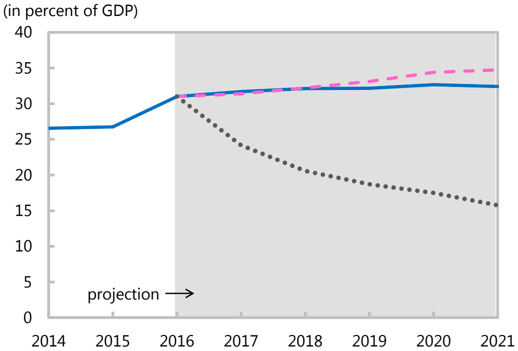
By Currency
(in percent of GDP)



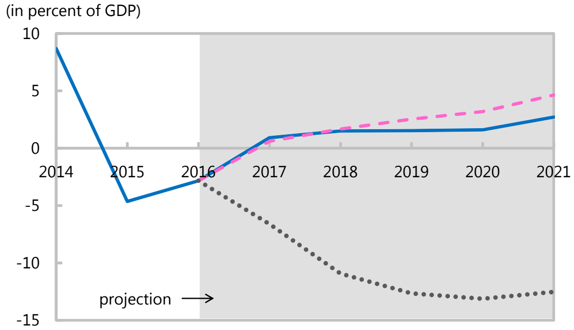
Alternative Scenarios

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	2016	2017	2018	2019	2020	2021
Real GDP growth	0.9	1.4	1.8	2.1	2.1	2.1
Inflation	-1.1	3.9	3.6	3.3	2.6	2.1
Primary Balance	3.1	2.8	3.5	4.0	3.9	3.7
Effective interest rate	3.2	1.6	1.9	1.6	1.8	2.0
Constant Primary Balance Scenario						
Real GDP growth	0.9	1.4	1.8	2.1	2.1	2.1
Inflation	-1.1	3.9	3.6	3.3	2.6	2.1
Primary Balance	3.1	3.1	3.1	3.1	3.1	3.1
Effective interest rate	3.2	1.6	1.9	1.6	1.8	2.0

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	0.9	1.3	1.3	1.3	1.3	1.3
Inflation	-1.1	3.9	3.6	3.3	2.6	2.1
Primary Balance	3.1	10.3	10.3	10.3	10.3	10.3
Effective interest rate	3.2	1.6	1.8	1.1	1.2	1.3

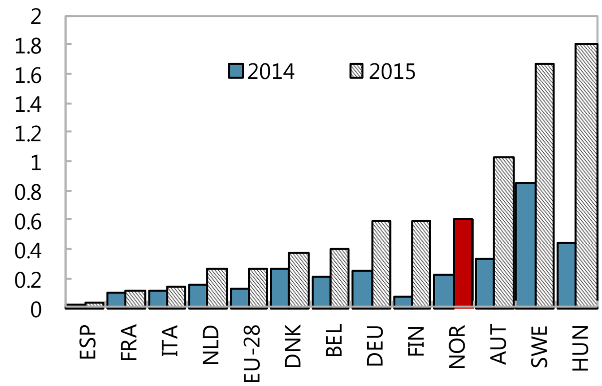
Source: IMF staff.

Annex III. Asylum Seekers

Until recently, Norwegian immigration was largely driven by economic migrants. In particular, the number of non-Nordic economic migrants to Norway boomed after the EU enlargements in 2004 and 2007, with much of those flows coming from New Member States (NMS), especially Poland and Lithuania (Ho and Shirono, 2015). Migrants from the NMS caused overall Norwegian immigration to more than double as a share of population between 2004 and 2007 (from 0.6 to 1.3 percent) and remained elevated throughout the global financial crisis. However, the flow of economic migrants began to slow after 2011.

The number of asylum seekers in 2015 was three times higher than in previous years. Norway received 31,145 asylum seekers (0.6 percent of the population) last year, up from 11,480 in 2014, with most of them arriving in August to November. While a substantial increase, in both relative and absolute terms it was much lower than in neighboring Sweden, which received over 160,000 refugees (1.7 percent of the population) in 2015. As a percentage of the population, the asylum seeker flow into Norway was higher than in Denmark (0.4 percent of the population) and similar to that of Finland and Germany. Statistics Norway currently assumes that about 60 percent of asylum applications will be accepted.

Asylum applicants
(Percent of population)



Sources: Eurostat and Fund staff calculations.

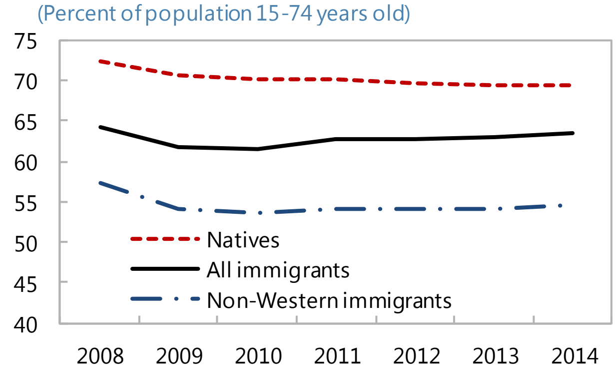
The latest forecast is for 25,000 refugees in 2016, though this is subject to significant uncertainty. While the government is projecting fewer asylum seekers this year compared to last year, it could be as low as 5,000 or as high as 50,000. The main reason for the expected tapering in the pace of arrivals is that other European countries, especially Sweden and Denmark, have tightened border controls. This has already contributed a sharp slowdown in arrivals in the first few months of 2016. Statistics Norway is projecting a further slowdown in the influx of refugees in 2017 and 2018, but the cumulative impact will raise population growth by a few tenths of a percent over the next few years.

The additional fiscal cost of refugees was initially expected to be around 0.4 percent of (mainland) GDP in 2016. However, that cost projection was based on expectations of 33,000 refugees in 2016, so it is likely the additional cost will be less than that since the government has revised down the number of refugees it expects. About half of the financing of additional refugee related fiscal costs for 2016 will come from a reallocation of overseas development aid to spending on refugees in Norway, while the rest will come from tax increases, other spending cuts, and dividends from state owned enterprises.

In late 2015 the government announced a number of measures to tighten the rules and benefits for asylum seekers. These changes include: (i) reducing benefits for those in reception centers by up to 20 percent; (ii) increasing the minimum eligibility period for permanent residence from 3 to 5 years; (iii) issuing more temporary residence permits and then facilitating a return to the home country if the situation there improves; (iv) using integration criteria to rule on requests for permanent residency; (v) limiting family reunification rights for refugees; and (vi) coordinating with Iraq to safely return asylum seekers from that country whenever possible. In addition to cutting benefits, the government is also replacing cash benefits paid to asylum seekers for food, clothing and other necessities with vouchers, which will make it more difficult for refugees to send money home.

While Norway ranks highly on overall integration policy, the employment rate of non-Western immigrants is substantially lower than of natives. Norway was ranked 4th (out of 38 countries) based on its overall Migrant Integration Policy Index (MIPEX) score in 2014. It was particularly highly ranked on measures of political participation, education, and labor market mobility. Despite this, only 55 percent of non-Western immigrants (which excludes immigrants from the EU/EFTA, North America, Australia, and New Zealand) aged 1–74 years old are employed. This compares to employment rates of nearly 70 percent for natives and 63 percent for all immigrants. In part the lower employment rates of non-Western immigrants is due to lower labor force participation, with 35 percent of non-Western immigrants aged 15–74 out of the labor force in 2015, compared to only 18 percent for Western immigrants. Non-Western immigrants' unemployment rate is also much higher at 15 percent compared to the overall unemployment rate of 4.4 percent in 2015.

Employment Rates
(Percent of population 15-74 years old)



Sources: Statistics Norway and Fund staff calculations.
Notes: Non-Western immigrants excludes immigrants from EU/EFTA, North America, Australia, and New Zealand.

This suggests there is a need to enhance integration programs targeted towards refugees. The introduction program many refugees are required to take lasts two years and delays their entry into the labor market (OECD, 2009). Combining language and other training with work experience earlier in the process could help. Additionally, quickly evaluating qualifications and past work experience could facilitate matching refugees with appropriate training or work opportunities.

Annex IV. 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	**Partly 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 will be continuously assessed in light of developments in the housing market, household borrowing, and competition between lenders. The regulation is part of a wider housing-market strategy that also addresses supply constraints.
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.** On 25 November 2015, the Ministry of Finance adopted new liquidity rules which set the total "all currency" LCR requirement at 100 percent for the three SIFIs and at 70 percent for other credit institutions, effective from end-2015. The requirement for other credit institutions will be increased from 70 percent to 80 percent from end-2016, and to 100 percent by end-2017. On the same day, the Ministry also asked the FSA to assess by end-August 2016 whether there should be LCR requirements for individual (significant) currencies. In addition, a NSFR requirement is expected to be introduced after final EU rules are adopted.
Improve the existing institutional structure for macroprudential policies. This should include more standardized and transparent procedures for giving advice to the MOF; a transparent "comply or explain" approach by decision-makers; and, in due course, greater delegation of decision-making powers over macroprudential instruments to NB or the FSA.	M	**Under consideration.**
Stress Tests		
Improve liquidity monitoring by performing liquidity stress tests using the structure of cash flows at various maturities; or applying customized versions of the LCR along the maturity ladder. Consider options to discourage cross-ownership of covered bonds.	M	**Partly done**. The FSA and Norges Bank have set up a joint working group on liquidity stress testing, e.g. using cash flow structure at various maturities, CRD IV data, Norges Bank's liquidity survey and the bank statistics database. Reporting of additional liquidity monitoring metrics is planned from September 2016, with

		cross-ownership of covered bonds taken into account in relation to a NOK liquidity requirement.
Enhance the stress test framework for the insurance sector. Allocate more resources to the FSA to assess the liability side risks and validate models and assumptions used in the bottom-up stress tests by insurance companies.	M	**Ongoing.** The Solvency II legislation entered into force on 1 January 2016. Norwegian undertakings will participate in the European Insurance and Occupational Pensions Authority (EIOPA) stress-test in 2016. The FSA is currently evaluating the models and assumptions used for calculating technical provisions (best estimate). This work is in its early stage.
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.** Capitalization and payouts policies are under discussion with the insurance companies, in particular with weakly capitalized companies.
Micro-supervision		
Enhance the FSA's de jure operational independence, powers (particularly in regard to corrective actions and sanctions), and supervisory resources. Strengthen the FSA's supervision of small banks through conducting comprehensive assessments more frequently.	M	**Unaddressed.**
Upgrade substantially the FSA's supervisory approach towards the AML/CFT issues, including by increasing supervisory activities and providing guidance on the topic.	S	**Ongoing.** The FSA increased its focus on AML supervision, and has planned thematic inspections and to publish new guidance in 2016. The authorities also aim to publish the national risk assessment by end-2016, and are drafting proposals to strengthen the AML/CFT legal framework.
Financial Market Infrastructure		
Strengthen operational risk management related to outsourcing in systemically important payment systems.	S	**Partly 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 will be implemented in 2016. 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	S, M	**Ongoing.** An official committee, the Banking Law Commission, is currently working on a proposal to implement the BRRD and the

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.		revised Deposit Guarantee Schemes (DGS) directive in Norwegian legislation. The proposal is expected to be submitted to the Ministry of Finance in October 2016. An implementation of the BRRD will encompass a framework for resolution planning and issues regarding branches and subsidiaries of foreign banks.
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	**Ongoing.** If all elements of the BRRD are properly transplanted into Norwegian law, the national law will ensure implementation of the FSB Key Attributes.
The BGF should adopt policies specifying under what conditions board members must recuse themselves, considering actual and prospective conflicts of interest.	S	**Done.** The BGF has adopted new policies specifying the following circumstances under which board members must recuse themselves: 1) When there is a possibility that a company the board member has an interest in would bid on a problem bank or part of its assets; 2) When there is a possibility that the whole bank in which the board member has an interest, or parts of its assets or its deposit portfolio may be sold. The board members must consider whether to recuse themselves based on these criteria before a meeting where support from the BGF will be discussed. When the problem situation is over, the board shall review how the recusal was handled. The policies are available on the BGF's website. (http://www.bankenessikringsfond.no/no/Hoved/Om-oss/Styre/ in Norwegian only.)

Annex V. Authorities' Response to Past IMF Recommendations

Fund Policy Advice from 2015 Consultation	Authorities' Actions
Fiscal Policy: A number of Directors considered that maintaining the fiscal impulse next year would be appropriate in view of the risks to economic growth. Over the medium term, a more neutral stance would be necessary to allow the shift of resources to other tradable industries. Directors welcomed the recent recommendations of the commission on the fiscal rule, which would help smooth the spending of oil revenues, and looked forward to the authorities' adoption of rules along those lines.	The revised 2016 budget forecasts a positive fiscal impulse of 1.1 percent of trend mainland GDP (compared to 0.5 percent in 2015), with measures to support employment in regions that are hardest hit by the oil price shocks. The authorities will provide a response to the recommendations of the Commission on the Fiscal Rule in the context of Spring 2017's White Paper on Long-Term Perspective.
Macroprudential Policy: Directors urged vigilance and prudent policies to safeguard growth and financial stability. Directors recommended the timely implementation of macroprudential measures to contain rising household credit, in order to leave room for monetary policy to support growth while pursuing the inflation target.	The countercyclical capital buffer will be increased to 1½ percent from July 1, 2016. On 25 November 2015, the authorities adopted new liquidity rules which set the minimum total "all currency" liquidity coverage ratio (LCR) requirement at 100 percent, effective from 2016 for the three systemically important banks and gradually phased in for other credit institutions. 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 will be continuously assessed in light of developments in the housing market, household borrowing, and competition between lenders.
Structural Reforms: Directors saw merit in reducing the preferential tax treatment for residential properties relative	The recently proposed tax reform reduces the discount on the taxable values for secondary dwellings and commercial property from 30 to 20 percent.

to productive investments, as well as further reforms to the pension system and sickness and disability benefits. They also stressed that investment in infrastructure, education, and research is key to raising productivity.	Negotiation on public sector's occupational pension scheme started among social partners but has recently been delayed. Further change was made to the calculation of disability benefits in early 2016 to enhance incentives to work while receiving benefits. Pilot programs for new measures to enforce the activity requirements for sickness benefits are underway in several counties and showing encouraging results. There are ongoing reforms in the higher education and research sectors.

Annex VI. The Operation of the Fiscal and Monetary Policy Rules in an Oil Price Shock

Norway introduced rules in 2001 that set quantitative targets for fiscal and monetary policy with an eye toward insulating the mainland economy from shocks to oil and gas revenue and prices. The sharp decline in oil prices starting in mid-2014, combined with the long-anticipated peak in demand for mainland goods and services from the offshore sector, put these rules to the test.

The Fiscal Policy Rule

The Fiscal Policy Rule—The fiscal policy rule provides that, "Fiscal policy is guided by the fiscal rule, stipulating a gradual phasing-in of oil revenues in the Norwegian economy in line with the expected real returns on the Government Pension Fund Global (GPFG), estimated at 4 percent. The fiscal rule permits spending more than the expected return on the Fund in a cyclical downturn, while the use of oil revenues should lie below the expected return when capacity utilisation in the economy is high."[1] Adherence to the fiscal rule has allowed the GPFG to grow to 286 percent of mainland GDP at end-2015. In recent years, the structural non-oil deficit (and therefore the transfer from the GPFG) has been kept well below 4 percent of the GPFG capital. In spite of this, the continued faster-paced growth of the GPFG relative to the mainland economy has allowed a widening non-oil deficit as percentage of mainland GDP and a positive fiscal impulse on average since 2001.

The fiscal rule operated largely as intended in response to the mid-2014 to early-2016 drop in oil prices and the decline in demand for goods and services from the offshore economy. The authorities responded to a modest slowdown in mainland GDP growth (from 2.3 percent in 2013–14 to 1.0 percent in 2015) by allowing structural non-oil deficits of 6.3 and 7.5 percent of mainland GDP in 2015 and 2016, corresponding to estimated fiscal impulses of 0.5 percent and 1.1 percent of mainland GDP respectively. Most of the increase in the headline deficit is explained by the operation of automatic stabilizers. Nevertheless, the structural deficits for both last and this year remain below 3 percent of the value of the GPFG.

The Monetary Policy Rule

The Inflation Targeting Rule—The Norges Bank defines the rule as follows: "The operational target of monetary policy shall be annual consumer price inflation of close to 2.5 per cent over time. Monetary policy shall also contribute to stabilising output and employment." Also: "Monetary policy influences the economy with long and variable lags. Norges Bank sets the interest rate with a view to stabilising inflation close to the target in the medium term. The relevant horizon will depend on disturbances to which the economy is exposed and how they affect the path for inflation and the

[1] 2012 National Budget: http://www.statsbudsjettet.no/upload/Statsbudsjett_2012/dokumenter/pdf/nb_summary.pdf

real economy ahead." Finally, it indicates how inflation should be measured in some detail: "In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account."[2]

The Norges Bank also sets out three criteria for setting the policy rate. The Bank sets an interest rate path to maintain inflation close to 2.5 percent such that: (i) the inflation target is achieved; (ii) the inflation targeting regime is flexible; and (iii) monetary policy is robust. The first weighs on the expected level of inflation. The second criterion gives weight to avoiding excessive fluctuations in output and employment. The last criterion seeks to mitigate the risk of a buildup of financial imbalances by adopting a gradualist approach to interest rate setting.[3]

The drop in oil prices and other developments pull monetary policy in different directions. Following the 2014 drop in oil prices, the exchange rate depreciated in parallel with the oil price although not by as large a proportion. Notwithstanding the insulation of the mainland economy from oil revenues, such a close link between movements in oil prices and the krone is the norm. The depreciation has pushed up imported consumer goods inflation, while domestic goods and services and wage inflation have remained more subdued. Growth slowed significantly in 2015 and early 2016 although it remained positive, under the twin effects of the slowdown in oil-related demand and the subsequent drop in oil prices. At the same time, house prices continued to grow strongly in real terms in the Oslo area, although not in those parts of the country most dependent on demand from the offshore sector.

Monetary policy has tried to balance its response to these diverging economic developments. The policy rate was reduced four times from 1.5 to 0.5 percent between December 2014 and March 2015. This has supported the economy and avoided an appreciation in a period when many neighboring economies (Denmark, the euro area, and Sweden) have reduced policy rates to negative levels. The Norges Bank has judged that the risk of medium term inflation in excess of the target is low given that capacity utilization is low, real wage growth is close to zero, inflation expectations are well anchored, and the influence of the exchange rate depreciation on consumer prices should be temporary. On elevated and rising house prices and household debt, they take the view that macroprudential policies should be the main instrument to address the risk that lower interest rates could further increase financial vulnerabilities.

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[2] Norges Bank website: http://www.norges-bank.no/en/about/Mandate-and-core-responsibilities/Monetary-policy-in-Norway/

[3] Norges Bank, Monetary Policy Report with financial stability assessment, 1/16. http://www.norges-bank.no/en/Published/Publications/Monetary-Policy-Report-with-financial-stability-assessment/116-Monetary-Policy-Report/

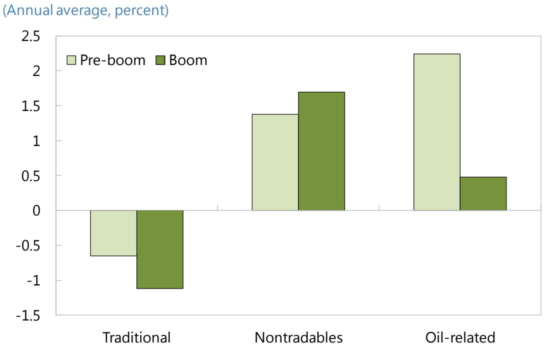
Annex VII. The Transition from Oil and Gas

The oil boom during the 2000s had a profound impact on the Norwegian economy. In particular, there is some evidence that resources reallocated toward the oil-related and nontradables sectors during the boom.[1] Industry-level data point to a clear pick-up in the growth rates of both employment and the capital stock in the nontradables sectors during the boom period, whereas they both declined in the traditional sector.[2] However, developments in the oil-related sector were rather mixed; while oil-related investment accelerated during the boom, the growth in oil-related employment seemed to have slowed. Resource reallocation during the oil boom may have contributed to lowering productivity growth. A decomposition of aggregate total factor productivity (TFP) growth suggests that within-sector productivity contributed about two-thirds of the decline in TFP during the boom, while sectoral reallocation contributed the remaining one third. In addition, a comparison of the economy's input-output structure between the mid-1990s and mid-2000s suggests that a number of mainland industries are increasingly dependent on the oil and gas sector.

Reallocation of Labor and Capital

Labor moved to nontradables sectors during the boom...

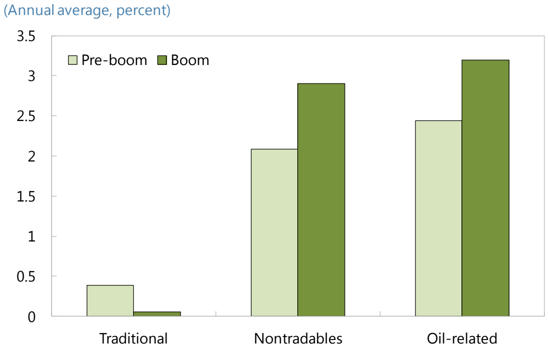
Growth in Labor
(Annual average, percent)



Sources: OECD STAN database and Fund staff calculations.

... and capital also reallocated to nontradables and oil-related sectors.

Growth in Capital Stock
(Annual average, percent)



Sources: OECD STAN database and Fund staff calculations.

As offshore investment drops from its peak and oil prices retreat from their high in 2014, the economy is going through a transition away from oil dependence. The preliminary data show an ongoing marked decline in oil-related production and investment, whereas activity in the traditional goods sector is holding up, but not yet sufficiently to pick up the slack. However, the

[1] The oil boom period is 2003–11, and the pre-boom period is 1990–2002.

[2] In our analysis, the "oil-related" sector consists of the oil and gas extraction industry (including services incidental to oil and gas if separately defined) and the manufacturing industries with close links to oil and gas (i.e. machinery and equipment, shipbuilding). The "traditional" sector consists of the remainder of manufacturing, and the "nontradables" sector corresponds to business services.

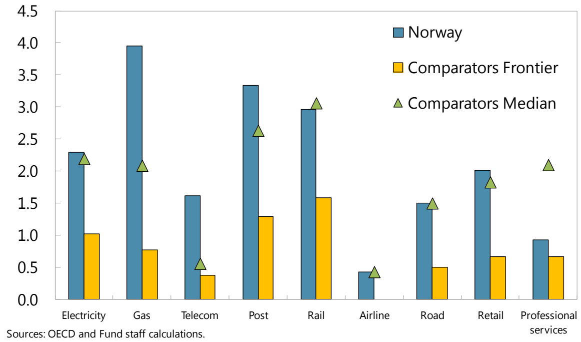
weak krone is providing significant cushion for mainland businesses, not only boosting traditional goods exports but also improving the adaptability of firms in the oil-related sector, enabling them to win contracts in alternative markets. Meanwhile, labor is inevitably being released from oil-related sector, and rising unemployment continues to be concentrated mainly in the oil-related parts of the economy. One mechanism that could dampen the rise in unemployment is flexible labor supply by immigrants, and net immigration—while still positive—has been trending down. In addition, labor mobility across sectors and regions, which generally is high in Norway, would also help with reabsorbing the oil-related unemployment**.**

A number of policies can help smooth the transition. Monetary policy should support demand and preserve price stability, thereby creating a favorable economic environment for private sector firms to thrive. Fiscal stimulus measures should best focus on expanding the economy's productive capacity while avoiding crowding out of tradable goods and services production. Wage formation will also play an important role in facilitating labor movement and ensuring international competitiveness, while active labor market policies can support the transition by improving the efficiency of the search and matching process. In addition, reducing the constraints to new housing construction particularly in big cities such as Oslo would help relieve pressures on housing prices and make it easier for people to move to areas where employment prospects are more favorable. Over the longer term, investing in research and innovation—an area where Norway lags peers—would help attract resources to the "knowledge-based economy" that would ultimately replace natural resources.

Annex VIII. A Firm-Level Analysis of Productivity in Norway

There is scope to further ease product market regulation (PMR) in Norway. Norway ranks favorably compared with peers in many indicators of business environment and entrepreneurship such as access to finance, bankruptcy legislation, and firm birth rates. However, the OECD's indicator of product market regulation at the sector level indicate that several sectors (such as electricity, gas, rail, postal services, and retail) remain more regulated compared with best practice in peer countries.[1] Barriers to entrepreneurship in general have declined more slowly than elsewhere. These factors could be constraining productivity growth and dampening private sector dynamics in the Norwegian mainland economy.

Norway: Product Market Regulation, 2013



Sources: OECD and Fund staff calculations.
Note: PMR indicators range from 0 to 6, increasing with restrictiveness. Comparator group include Austrialia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Island, Ireland, Italy, Japan, Korea, Luxemburg, Netherlands, New Zealand, Portugal, Spain, Sweden, Switzerland, and United Kingkom. Frontier refers to average best three countries in the comparator group.

An extensive firm-level dataset is employed to estimate the productivity payoffs of product market reforms. The Orbis database compiled by Bureau Van Dijk provides financial data at the firm level on value added, number of employees, and fixed assets, among other variables. The dataset for Norway consists of 80,474 public and private firms for the period between 2005 and 2014, resulting in over 125,000 firm-year observations. Different measures of firm productivity are calculated for the analysis, including both labor productivity (i.e., real value added per worker) and three measures of total factor productivity (TFP) for each firm using three different methodologies.

We measure the burden from PMR for all sectors in the Norwegian economy using input-output linkages between regulated and downstream sectors. As a measure of regulation, we use the OECD's indicators for seven network sectors, retail and professional services. Regulation in those industries can affect firms in other sectors of the economy (i.e. the downstream sectors) through their use of upstream inputs. For example, a manufacturer who relies more extensively on the use of rail and postal services would bear a heavier burden from regulation in those sectors, either through paying higher prices or enduring lack of or sub-optimal quality of services. We call this indirect burden from regulation *upstream PMR* and measure it by combining the PMR indicator with the intensity of upstream input usage calculated from Norway's input-output table for the year 2013.

Panel regression results suggest that regulation in upstream sectors significantly affects firm productivity in downstream sectors. The results point to a negative and significant correlation between *upstream PMR* and firm productivity in downstream sectors, and are robust to multiple

[1] The "best practice" or "frontier" is calculated as the average of the three best performing countries in the comparator group. For example, the frontier for network industries as a whole consists of the UK, Germany, and Australia, while for retail industry Sweden, Australia, and New Zealand.

specifications and different productivity measures. Firms operating in sectors that rely more heavily on inputs from the regulated industries are likely to be less productive than others. Our results also suggest that the impact of PMR on firm productivity varies by firm size: it is most pronounced for medium-sized firms and least pronounced for large firms, with the impact on micro and small firms being somewhere in the middle. For example, a one standard deviation reduction in *PMR* is associated with higher TFP by over 15 percent for medium-sized firms, but only by 6 percent for large firms.

We also find evidence that PMR affects innovation intensive firms disproportionately. We use Eurostat's taxonomy of high- and medium-technology manufacturing sectors and knowledge intensive services at the NACE 3-digit level to classify firms into two categories—`*HTKIS*' (high-tech and knowledge-intensive sector) firms and `non-*HTKIS*' firms. The idea is that a higher level of product market competition would be expected to spur innovation particularly for firms in technology or knowledge intensive sectors, thereby generating larger productivity gains. Our results indicate that *HTKIS* firms tend to bear a relatively heavier burden from anti-competitive regulation. The differential impact is again largest for the medium size class, about three times as large for *HTKIS* firms as for non-*HTKIS*.

Annex IX. The Housing Boom and Macroprudential Policy in Norway

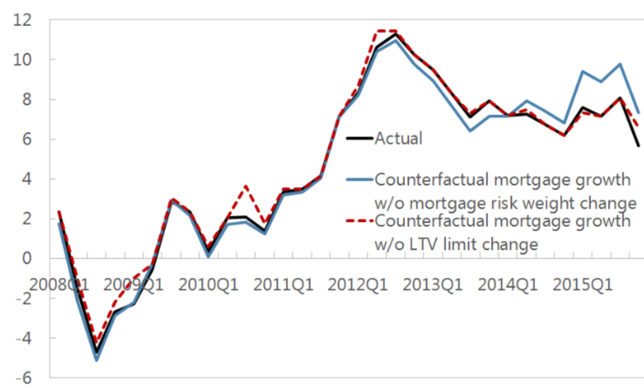
High and rising house prices and household debt in Norway pose important macro-financial stability risks. Real house prices have risen more than 80 percent in Norway since 2000. Currently, house prices are estimated to be 40 percent overvalued (averaged across three standard overvaluation measures). Household indebtedness has risen along with house prices, exceeding 220 percent of disposable income by end-2015, which is higher than in most comparator countries. High household debt and house prices increase the risk of a sharp house price correction, which could have a deleterious impact on consumption and output. In turn, this would adversely impact non-financial firms and increase loan defaults, stressing banks' balance sheets.

The authorities have introduced a number of measures targeted at the housing market in recent years. A number of guidelines related to mortgage lending were introduced in 2010–11 and were made temporary regulations in mid-2015 (effective until end-2016), perhaps the most important of which was the LTV ratio limit of 85 percent. Additionally, the FSA effectively raised risk weights on mortgages during 2014–15, in response to the marked decline in mortgage risk weights in banks using the IRB approach following the introduction of Basel II standards in 2007.

Empirical evidence suggests that LTV limits and mortgage risk weights can have significant effects on the growth of mortgage credit and house prices. Following Krznar and Morsink (2014), we assess the effectiveness of the existing demand and supply-side housing-related macroprudential tools in Norway controlling for other factors using two separate equations for the growth of mortgage credit and house prices. The estimation results suggest that a 10 percentage point increase in mortgage risk weights is estimated to significantly reduce mortgage credit growth by 2.4 percentage points. Tightening of LTV limits starts to have a statistically significant dampening impact on mortgage growth only after several months. A ten point change in the net balance measure of banks' tightening of their LTV limits over the next 3 months would reduce mortgage credit growth by 0.6 percentage points. The estimated parameters are used to calculate counterfactuals for mortgage credit growth without changes in mortgage risk weights or LTV limits, which show that recent credit growth would have been substantially higher without the rise in risk weights. Through their impact on mortgage credit growth, tightening of macroprudential instruments can significantly slow house price growth.

Mortgage Credit Growth, with and without Policy Changes

(Percent)



Sources: Statistics Norway and Fund staff calculations.

Results based on a DSGE model suggest that tightening macroprudential measures can reduce household debt ratios with relatively little impact on consumption over the medium-term. A DSGE model is calibrated to the Norwegian economy and used to illustrate the potential impact of tightening the LTV cap, increasing the amortization requirement, and reducing the tax deductibility of mortgage interest. The size of the impact and length of time it takes to achieve their full impact varies for the different instruments. The reduction in the tax deductibility achieves almost all of its steady state impact in 5 years and reduces the steady state debt-to-income (DTI) ratio by just over 11 percentage points. Tightening the LTV cap achieves about half the impact on the debt ratio after 5 years, while the new steady state DTI ratio is about 20 percentage points lower. Similarly, strengthening the amortization requirement leads to about a 20 percentage point reduction in the DTI ratio in the new steady state, but only achieves about one third of that after 5 years. In all cases, the impact on consumption is minimum and even slightly positive for most.

Systemic risks from overvalued house prices and high household debt levels suggest that macroprudential policy measures could be tightened further. Addressing structural factors contributing to high household debt and house prices, such as mortgage interest tax deductibility, would reinforce the impact of macroprudential policy measures.

INTERNATIONAL MONETARY FUND

NORWAY

June 9, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of May 31, 2016)

Membership Status

Joined: December 27, 1945; Article VIII

General Resources Account

	SDR Millions	Percent Quota
Quota	3,754.70	100.00
Fund holdings of currency	3,524.79	93.88
Reserves tranche position	229.93	6.12
Lending to the Fund		
New Arrangements to Borrow	347.38	

SDR Department	**SDR Millions**	**Percent Allocation**
Net cumulative allocations	1,563.07	100.00
Holdings	1271.80	81.37

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				
	2016	2017	2018	2019	2020
Principal					
Charges/Interest	0.10	0.20	0.20	0.20	0.20
Total	0.10	0.20	0.20	0.20	0.20

Implementation of HIPC Initiative

Not applicable

Implementation of Multilateral Debt Relief Initiative

Not applicable

Implementation of Catastrophe Containment and Relief (CCR)

Not applicable

Exchange Arrangements

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

Article IV Consultation

Norway is on the 12-month consultation cycle.

FSAP Participation

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

Technical Assistance

None

Resident Representative

None

STATISTICAL ISSUES

Statistical Issues Appendix (As of May 23, 2016)	
I. Assessment of Data Adequacy for Surveillance	
General: Data provision is adequate for surveillance.	
National Accounts: Breakdowns for oil-related parts of the mainland economy and other traditional sectors would be useful, in light of growing needs to better understand the impact of oil and gas activity on the mainland economy. The authorities are making progress in this area.	
II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since 1996. Uses SDDS flexibility options on the timeliness of the general government operations and central government debt. SDSS metadata are posted on the Dissemination Standard Bulletin Board (DSBB).	Data ROSC completed in 2003 is publicly available.

Norway: Table of Common Indicators Required for Surveillance

(As of May 24, 2016)

	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]	Data Quality – Accuracy and reliability[10]
Exchange Rates	05/24	05/24	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	04/16	05/16	M	M	M		
Reserve/Base Money	03/16	04/16	M	M	M	O, O,O, LO	O, O, O, O, O
Broad Money	03/16	04/16	M	M	M		
Central Bank Balance Sheet	04/16	05/16	M	M	M		
Consolidated Balance Sheet of the Banking System	04/16	05/16	M	M	M		
Interest Rates[2]	04/16	05/16	M	M	M		
Consumer Price Index	04/16	05/16	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2015	2016	A	A	A	LO, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	03/16	04/16	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4 2015	03/16	Q	Q	Q		
External Current Account Balance	Q4 2015	03/16	Q	Q	Q	O, O, O, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	Q4 2015	03/16	Q	Q	Q		
GDP/GNP	Q1 2016	05/16	Q	Q	Q	O, O, O, O	O, O, O, O, LO
Gross External Debt	Q4 2015	03/16	Q	Q	Q		
International Investment Position[6]	Q4 2015	03/16	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 ..., and based on the findings of the mission that took place during...) 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 Thomas Ostros, Executive Director for Norway, and Tove Katrine Sand, Advisor to Executive Director
June 29, 2016

On behalf of the Norwegian authorities, we would like to thank staff for the open and constructive discussions in Oslo and a well-written report on the Norwegian economy. The analysis of the current economic conditions and challenges, the forecasts and the policy recommendations in the staff report are broadly in line with those of the authorities.

Fall in oil price accelerates the need for a less oil-dependent growth model

The fall in oil prices have curbed economic growth in Norway. The petroleum sector and its supply industries are especially affected, but there have also been negative spillover effects to other parts of the economy. Last year, the growth in the mainland economy (excluding oil and gas) was 1.0 percent, which is significantly below the 2 percent trend growth. Growth is expected to stay around 1.0 percent this year, picking up to 1.7 percent next year. According to the Labor Force survey, the unemployment rate increased from 3.5 percent in 2014 to 4.6 percent in April this year. The increase has principally been in the more oil-dependent southern and western regions.

Already prior to the sharp fall in oil prices, demand impulses from the petroleum sector were expected to decrease, after several years of very high growth. The drop in the oil price accelerates and reinforces this development. As noted in the staff report, this makes it even more important to succeed in managing a smooth transition to a less oil-dependent growth model. According to the authorities' most recent forecasts, oil investments will continue to fall in the three coming years. The decline is dampened by large investments in a new petroleum field (Johan Sverdrup), the third largest field on the Norwegian continental shelf and the biggest when it comes to investments. Even so, an important growth engine for the Norwegian economy has lost its momentum.

The oil price has increased somewhat since a record low in January, and unemployment seems to have levelled off recently. This lowers the likelihood of a sharper contraction in the Norwegian economy. However, there is considerable uncertainty about future developments in the global economy. For example, a drop in demand from China or other emerging economies can affect both important commodity prices and the activities of export-oriented enterprises in Norway.

House price inflation accelerated recently after a slowdown throughout 2015, albeit with large regional variation. High house prices and a high debt level among households represent other key challenges to the economy. These pose a risk to financial stability. As pointed out in the staff report, household debt remains elevated at 220 percent of disposable income. The debt burden is unevenly distributed, and young households are vulnerable to adverse shocks. There is a risk that a fall in house prices can amplify or trigger a downturn in the Norwegian economy.

Monetary policy has dampened the downturn

The Norges Bank operates a flexible inflation targeting regime, giving weight in its interest rate setting to developments in output and employment as well as inflation. In the current situation, monetary policy will remain accommodative. Over the past two years monetary policy has responded to weaker growth, and the key policy rate is now 0.5 percent. According to the Norges Bank's assessment of the outlook in June, the policy rate may be reduced in the course of 2016.

The expansionary monetary policy is supportive of the needed structural adjustments in the Norwegian economy. A weaker Norwegian krone and a more moderate wage growth have improved cost competitiveness substantially. However, the cost level is still high compared with trading partners and productivity growth is subdued. Inflation has increased, but inflation expectations are well anchored. Capacity utilization in the mainland economy is expected to decline further in the period to autumn 2017, edging up thereafter. In an economy marked by restructuring, monetary policy cannot fully counteract the effects on output and employment.

Lower interest rates could increase financial system vulnerabilities. As the key policy rate approaches a lower bound, the uncertainty surrounding the effects of monetary policy increases. This suggests proceeding with greater caution in interest rate setting and reacting somewhat less to news that changes the economic outlook, whether this pulls in the direction of a lower or higher key policy rate. Should the Norwegian economy be exposed to new major shocks, Norges Bank will not exclude the possibility that the key policy rate may turn negative.

Fiscal policy is also growth supportive, with strong emphasis on long-term sustainability

The Norwegian fiscal framework is designed to handle the petroleum wealth, both in terms of the inherent oil price volatility and in terms of distribution between generations. The framework is flexible and gives ample strength to handle temporary setbacks in the economy. The framework has been put to the test by the significant drop in oil prices the last couple of years.

In the current situation, the fiscal stance is expansionary with an estimated impulse this year of around 1 percent of mainland trend GDP. Spending of petroleum revenues corresponds to 2.8 percent of the Government Pension Fund Global (GPFG), well under the 4 percent estimated long-term return on the Fund indicated in the fiscal framework.

The authorities share the key point in staff's report that the decline in oil-related activities is a structural trait that cannot merely be met by short-term fiscal policy measures. An overly expansionary fiscal policy would harm the private sector's competitiveness and therefore be counterproductive to the transition to a less oil driven economy. Still, the fairly rapid increase in unemployment justifies targeted measures in an attempt to ease the consequences for the affected individuals and regions, as well as for the economy as a whole.

Staff finds the fiscal stance for 2016 justifiable, but stress the need for a tighter fiscal policy once the economy gets back on track. To that end, two modifications to the existing fiscal framework are put forward by staff. One is that the yearly spending of oil money should be kept significantly below 4 percent of the Fund. The second is introducing a supplementary rule saying that the fiscal impulse should be neutral or negative when the economy is at or above capacity, respectively.

These modifications are to some extent similar to the proposals put forward by the government appointed Fiscal Rule Commission. However, staff's proposals go further in decoupling spending of oil revenues from the value of the Fund, implying a more severe revision of framework. Such revisions would risk undermining the fiscal rule as a long-term yardstick for phasing in the oil and gas revenues to the Norwegian economy. The Fiscal Rule Commission's recommendations will be addressed in the Government's white paper on Long-term Economic Perspectives early next year, and seen in connection with the advice from another government appointed commission which is set up to discuss the equity share of the Government Pension Fund Global.

Tax policy and structural reforms

The Norwegian authorities put strong emphasis on pursuing a fiscal policy that can increase the growth potential of the economy. A shift in spending towards lower taxes, increased infrastructure investments and increases on education and research are core in this strategy.

In May, a broad majority of the parties represented in the Norwegian parliament agreed on a tax reform that entails a reduction of the corporate income tax from 27 to 23 percent over the three-year period 2016–2018. The implementation started already in 2016 with a reduction to 25 percent. The authorities believe reducing the corporate tax will encourage investments and at the same time make it less beneficial to shift profits out of Norway to low-tax jurisdictions. To further secure the tax base, the Parliament has also requested several targeted measures to counter profit shifting. The tax reform will also reduce the overall marginal tax rate on personal income, thus making it more attractive to work.

The staff report also calls for further reduction of tax preferences for housing. The authorities point out that the discount on the taxable values of second dwellings and commercial property, with respect to the wealth tax, has already been cut from 50 to 20 percent over the last three years. In addition, the wealth tax rate has been cut from 1.0 to 0.8 percent.

In February, the Norwegian Productivity Commission published its second report. The Commission highlights higher education, research and innovation, a well-functioning labor market and efficiency in the public sector as areas where reforms could give large potential gains. The authorities concur with staff's assessment that continued implementation of key structural reforms is important to promote a successful transition and improve the efficiency of the economy in general.

As noted by staff, the disability reform in 2015 strengthened the incentives to work while receiving benefits. The focus on activity in the sickness benefit system is also strengthened. The authorities see further need for reforms to the early retirement scheme. Further, the occupational public sector pension scheme needs to be reformed in line with the reform that has been carried out in the private sector. A technical report, drawing up main principles of a new system, was established in cooperation with the social partners in December 2015. Further process to reach an agreement on a new pension model is not decided upon yet, and the Government has invited the partners to further cooperation during the second half of 2016.

Financial Sector Policy

The authorities generally concur with staff's assessment of Financial Sector Policy. As the staff report highlights, banking sector performance remains relatively strong and banks' profitability positions enable them to meet the core equity (CET1) capital requirement. Further, it finds that overall financial stability risks appear contained.

However, staff's assessment underlines the risks and vulnerabilities associated with Norwegian households' indebtedness, a possible house price reversal and banks' reliance on wholesale funding. Staff notes that the authorities have implemented several housing sector-specific measures. These include temporary regulations of loan to value ratios that are set to expire at the end of 2016 and permanently tightened parameters for internal ratings-based (IRB) model estimation of residential mortgage risk. Should house prices and mortgage credit continue to grow faster than income, the authorities agree with staff that these measures should be made permanent and possibly tightened. The authorities are monitoring the housing market and household debt developments closely. The new regulations will be continuously evaluated in light of future developments. In addition, measures are taken to increase the housing supply in order to dampen price growth.

The authorities also agree that Norwegian banks must continue their efforts to strengthen their capital base, assure more robust funding and improved liquidity. Loan losses are low, but banks should be prepared for the possibility of increased losses in the next few years. The authorities note that the micro and macro prudential supervision of liquidity risks in Norwegian banks have improved significantly since the international financial crisis, and that there are continuous efforts to improve the systems and procedures in place to supervise and monitor risks. This includes increased cooperation between the FSA and Norges Bank. In addition, proposals on individual currency liquidity coverage ratios (LCR) requirements and the implementation of the bank recovery and resolution directive (BRRD) are expected in the second half of 2016.

Staff notes that regional cooperation on financial stability issues should be strengthened, particularly in light of the Swedish bank Nordea's plans to convert its Nordic subsidiaries into branches. The authorities note that Nordea as a subsidiary is the second largest bank in Norway, and systemically important. This is the first time a branchification of this size is in question in the EU. It therefore raises some principle questions regarding financial stability in the host country. The authorities agree that there is need for stronger cooperation on financial stability issues beyond current EU rules, i.a. host country capital requirements and supervisory information sharing. Still, the full responsibility for both supervision and financing arrangements in a crisis situation for a branch remains in the home country. Work is in progress between the Nordic FSAs and the Ministries to agree on a MoU for significant branches/systemically important branches, which also includes more use of host country rules and information sharing.