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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/48-1

11:55 a.m., June 10, 2019

1. Norway—2019 Article IV Consultation

Documents: SM/19/120 and Correction 1; Supplement 1

Staff: Miniane, EUR; Zakharova, SPR

Length: 30 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	**Alternate Executive Directors**
D. Mahlinza (AE)	
	S. Bah (AF), Temporary
G. Lopetegui (AG)	
	G. Preston (AP), Temporary
	P. Fachada (BR)
	P. Sun (CC)
	M. Mulas (CE), Temporary
	A. McKiernan (CO)
	S. Benk (EC)
	A. Castets (FF)
S. Meyer (GR)	
	M. Siriwardana (IN)
	C. Collura (IT), Temporary
	Y. Saito (JA)
	M. Daïri (MD)
	M. Choueiri (MI), Temporary
	J. Hanson (NE), Temporary
	S. Evjen (NO), Temporary
	A. Tolstikov (RU), Temporary
	F. Rawah (SA), Temporary
A. Mahasandana (ST)	
	P. Trabinski (SZ)
	D. Andreicut (UK), Temporary
	P. Pollard (US), Temporary

G. Bauche, Acting Secretary
H. Malothra, Summing Up Officer
V. Sola, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
European Department: J. Bricco, P. Gerson, J. Miniane, F. Misch, V. Pillonca, N. Romanova, M. Segoviano Basurto, L. Yang, H. Zhang, Y. Zhang. Legal Department: D. McDonnell. Strategy, Policy, and Review Department: R. Cartaxo Mano, D. Zakharova.
Executive Director: A. Mozhin (RU). Alternate Executive Director: J. Sigurgeirsson (NO), M. Siriwardana (IN). Senior Advisors to Executive Directors: M.Gilliot (FF), Z.Mahyuddin

(ST), E. Rojas Ulo (AG). Advisors to Executive Directors: S. Buetzer (GR), D. Crane (US), G. Khurelbaatar (AP), P. Mooney (CO), F. Rivadeneira (BR), N. Vaikla (NO), A. Tola (SZ).

1. NORWAY—2019 ARTICLE IV CONSULTATION

Mr. Sigurgeirsson and Mr. Evjen submitted the following statement:

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

Economic growth is strong and employment increasing

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

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

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

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

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

Fiscal policy has been broadly neutral in recent years

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

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

Monetary policy entails a gradual increase in the key policy rate

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

Underlying inflation is a little higher than the 2 percent inflation target. At the same time, the uncertainty surrounding global developments persists.

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

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

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

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

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

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

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

Ensuring a sustainable development in public finances will require several measures

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

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

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

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

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

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

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

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

Countering the threats from money laundering and terrorist financing is fundamental

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

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

Ms. Levonian and Mr. Ray submitted the following joint statement:

We thank staff for the comprehensive set of reports, and Mr. Sigurgeirsson and Mr. Evjen for their candid buff statement. Remarkably, Norway is one of the few resource rich countries that has been able to successfully harness its natural endowments for the future prosperity of all Norwegians. This success, in addition to Norway's commitment to inclusive growth and long-term sustainability, offer valuable lessons for the membership. We agree with the staff appraisal and welcome the strong traction of Fund advice and solid record of implementation.

As a small open economy, trade has delivered a significant and sustained increase in living standards for Norwegians. Domestic policy settings have ensured the gains from trade have been shared so that Norway is not only one of the most prosperous countries in the world but also one of the most equitable. The upswing in current economic conditions and balanced risk outlook offers an opportunity to refocus on long-term challenges, like aging, by increasing labor force participation and boosting productivity.

Pro-cyclical fiscal policy should be avoided. We welcome a move away from the pro-cyclical stance of fiscal policy in previous upswings. We support staff's arguments that the Norwegian authorities should target fiscal consolidation next year and acknowledge that the authorities are fully aware that Norway's budget will face increasing pressure in years to come without policy action. We note the authorities' concerns regarding the political difficulties in achieving consolidation when there is still room for deficits to increase under the fiscal rule. In this circumstance, is it the case that the optimal policy path is not supported by the fiscal rule? Does this suggest that some recalibration of the fiscal rule might be necessary? Staff comments are welcome.

Looking ahead, we support staff's views on potential areas for adjustment to support long-term fiscal sustainability. Reforms of the sickness and disability benefit scheme appear promising both to improve spending efficiency and labor supply. We also note staff's suggestion to improve housing-related taxation. Presumably, such reforms would impact a very large segment of the population. Can staff comment on the prospects for delivering on reforms to housing-related taxation?

Given Norway's capacity and financial resources, we would expect full adherence to international standards for AML/CFT. We welcome that a new AML/CFT Act has been passed that addresses many of the identified shortcomings in the previous framework. Staff note that ongoing efforts are required to close remaining gaps. Can staff elaborate as to whether there are any factors that could constrain full compliance with AML/CFT standards?

Finally, we would be interested as to whether Staff considered using Lapse-of-Time procedures for this Article IV assessment and would encourage them to actively consider this option in future, especially in country cases where economic policy settings are broadly on track.

Mr. De Lannoy, Mr. Meyer, Mr. Buetzer and Mr. Hanson submitted the following joint statement:

We thank staff for an informative report and Mr. Sigurgeirsson and Mr. Evjen for their insightful buff statement. Norway enjoys a fairly solid growth momentum, supported by a number of positive developments in terms of a robust labor market, favorable terms of trade, and some competitiveness gains. Nevertheless, the country faces a number of downside risks and challenges, including the uncertain external environment, overvalued real estate prices, high household leverage, and longer-term pressures emanating from an ageing society. Against this backdrop, efforts should be intensified to aid the economy’s transition towards a more competitive non-oil sector and to undertake structural fiscal adjustment.

The current fiscal situation is sound, but there is room for a slight tightening in the next year given the economy’s cyclical position. This would duly reflect the outlook of the output gap turning positive and preserve some additional policy space. Taking on the looming long-term fiscal challenges, however, will require making more sizeable, albeit gradual structural adjustments in the budget, encompassing efficiency gains on both the revenue and expenditure side.

In order to decrease the budget’s reliance on oil revenues over the long-term, it is of paramount importance to tap non-oil revenues as efficiently as possible. For this purpose, we note that staff appears to have a preference for VAT base broadening. This implies revoking VAT exemptions and reduced rates. Could staff provide some further details on areas where this might be considered and if so, whether compensatory measures to most affected vulnerable households would be considered as well?

We have confidence in the social partners’ ability to find a balanced solution concerning a reform of sickness and disability schemes. The main objectives should be alleviating fiscal pressures and mobilizing currently under-utilized labor supply while preserving social cohesion. We take note of labor unions’ remark that the large number of recipients likely point to the presence of disguised unemployment as also alluded to in the buff statement by Mr. Sigurgeirsson and Mr. Evjen. Therefore, a stronger focus on the features of the unemployment support scheme might be worth considering. As unemployment support schemes are typically better suited to improve their recipients’ employability (e.g. via ALMP), it should be ensured that de facto-unemployed are automatically directed towards this scheme and not become recipients for sickness and disability support in the first place.

The banking sector holds significant capital and liquidity buffers that mitigate the stability risks emanating primarily from the real estate sector. Households continue to be relatively vulnerable due to comparatively high and rising indebtedness. In addition, the high share of debt at variable rates exposes households to the risk of interest rate changes. Against this backdrop, we subscribe to staff’s recommendation to the authorities not to loosen the current prudential measures despite some moderation in the overvaluation of house prices. As mentioned by staff, this recent cooldown in house price growth is driven by various factors, with rising housing supply playing a major role. With this in mind, we would be interested in the outlook for a further expansion of housing supply?

Mr. Lopetegui and Mr. Rojas Ulo submitted the following statement:

We thank staff for the reports and Mr. Sigurgeirsson and Mr. Evjen for their helpful buff statement.

The Norwegian economy is performing well, with strong economic momentum and balanced risks to the outlook. A recovery in the terms of trade, competitiveness gains driven by a weaker currency, and strong labor market developments have resulted in mainland GDP growth rising to 2.2 percent in 2018 and 2.5 percent in 2019, with projections remaining over 2.0 percent over the medium term. Nevertheless, the economy faces long term challenges arising from lower oil GDP growth and demographic headwinds, making it necessary to maintain high productivity growth, including strengthening the external position. In the short term, it appears appropriate that fiscal and monetary policies reduce macroeconomic support to reduce the risks of overheating and rebuild room for maneuver to face possible downturns. Meanwhile, financial sector risks should be closely monitored. Over the medium term, we support structural reforms focused on enhancing both labor supply and productivity to boost competitiveness and contain fiscal risks.

A moderate fiscal consolidation adjustment in 2020 is suitable. The structural non-oil balance is expected to remain unchanged over this year and next, conserving the neutral stance of the fiscal policy in the upswing. The projected positive output gap implies that the authorities could proceed with a moderate fiscal consolidation to contain aggregate demand and build fiscal space for the next downturn. Over the medium term, we welcome the authorities' plan to make space for spending on welfare by enhancing labor force participation and seeking a more efficient use of resources, including on sickness and disability schemes, although base broadening of the VAT could be considered as well, as suggested by staff.

We concur with the announced monetary policy strategy given the inflation outlook. Headline and core inflation are above the 2 percent target, including due to the pass-through from the weak krone and the temporary surge in electric prices. We also concur with the planned pace of policy normalization, as described in the buff statement, and agree that the cautious approach in interest rate setting highlighted by Norges Bank is warranted in the face of the uncertainty surrounding global developments.

While the financial system's soundness indicators are positive, risks remain, and further efforts are needed to overcome vulnerabilities. The staff report shows that financial stability indicators such as capital, leverage, and liquidity are strong, while a recent stress test by the FSA reports that banks are resilient against a range of shocks. On the other hand, overvalued houses prices and rising household debt call for vigilance, while containing risk from Commercial Real Estate exposures is necessary. We welcome the envisaged increase in countercyclical buffers and encourage the authorities to maintain efforts to strengthen the regulatory and supervisory framework to reduce risks, including preventing the loosening of mortgage regulations. We encourage the authorities to continue efforts to ensure full compliance with the AML/CFT framework.

With these comments, we wish Norway and its people success in their future endeavors.

Mr. Geadah and Ms. Choueiri submitted the following statement:

We thank staff for the interesting report and Mr. Sigurgeirsson and Mr. Evjen for their informative buff statement. Norway's growth remains solid, supported by a robust labor market, higher oil prices and competitive gains. At the same time, the external position strengthened in the past year, the growth in residential house prices softened significantly, and banks remained well-capitalized and profitable. Rising household leverage and emerging risks in commercial real estate cloud the near-term outlook, while boosting non-oil sector competitiveness and addressing challenges stemming from population aging remain the main medium-term policy challenges.

The structural non-oil deficit is expected to remain unchanged over 2017–19, which, we agree with staff, is a marked improvement relative to the procyclicality of policy in previous upswings. The authorities rightly note that spending is growing significantly more slowly than in the past. We also commend the authorities for carrying out tax reforms that shifted the burden to less distortionary taxation, including through lowering personal and corporate income tax rates, broadening the VAT base, and raising net wealth taxes. The authorities and staff agree that Norway's budget will face increasing pressures in the years to come. In this connection, the recent pension reforms and the ongoing initiatives to improve spending efficiency and service delivery are important steps. The openness to looking into the sickness and disability benefit scheme and the VAT base is also encouraging. We note the difference of views between the authorities and staff on further reducing the tax incentives for housing and would be grateful for staff's elaboration on the reasons for this difference.

Norwegian banks are well-capitalized, profitable, and have ample liquidity, while residential house price growth moderated significantly since our last discussion. Nonetheless, financial sector risks continue, with house prices still overvalued and household debt still rising from elevated levels. To this end, we welcome the revision of the authorities' housing market strategy, emphasizing the supply side, consumer protection, and household debt-sustainability, as mentioned in the buff. Risks from commercial real estate (CRE) are mounting. Staff's work in Annex VII suggests that banks are vulnerable to a CRE price correction given their large exposure to CRE loans and to funding from covered bonds which are typically collateralized with mortgages. Accordingly, the increase in the counter-cyclical buffer at end-2019 is welcome, while monetary policy normalization should also help dampen price growth in the sector, as noted by staff. The authorities acknowledge that existing data gaps on CRE should be remedied for a better assessment of risks in the sector.

Sustaining growth will require greater gains in competitiveness, as well as addressing challenges from declining labor supply and productivity. We appreciate staff's candid recognition that there is no obvious "low hanging fruit" to boost productivity growth. Norway scores highly in terms of its business environment, the labor market provides a good balance between efficiency, stability, and equity, and there are no pressing product market regulations/protections. Ongoing initiatives are welcome, including the increased tax incentives for R&D and innovation, the recent reform of higher education, and the reassessment of the rationale for state ownership. We concur with staff that the reform of the sickness and disability benefit system is the most pressing labor market reform. The expert commission indicated that the less educated are disproportionately represented in these schemes; we therefore agree with staff that the distributional consequences of any reform will have to be carefully weighted. We also concur with staff on the need for reforms to better integrate the young and non-OECD immigrants into the labor force.

Mr. Psalidopoulos and Ms. Collura submitted the following statement:

We thank staff for the paper and Mr. Sigurgeirsson and Mr. Evjen for their candid buff statement. We broadly agree with the staff appraisal and offer the following comments.

Financial sector policies. We agree with staff on the need to maintain the current prudential toolkit to mitigate substantial financial vulnerabilities. We welcome the favorable results of the recent stress tests conducted by the Financial Stability Authority. On the back of the allegations of money-laundering that have recently affected several Nordic banks, we encourage the authorities to continue improving their AML/CFT framework. We are confident of their commitments in this direction. In light of the importance of the issue, we are surprised that the report devoted relatively little attention to the authorities’ anti-money laundering policies. We look forward to the findings of the forthcoming FSAP on this matter. Nevertheless, we would have welcomed a more granular assessment of the recently adopted measures and clearer indications on further steps the authorities should take going forward. Could staff elaborate on this matter?

Fiscal policy. Staff and the authorities concur on the long-term fiscal challenges, but they do not seem to quite agree upon whether to start fiscal consolidation immediately or delay it. We agree with staff that the current favorable momentum provides a good opportunity to start consolidating the fiscal position. However, we fully understand the rationale behind the authorities’ plans that give priority to expanding labor force participation and improving “value-for-money” in the provision of public services. The ample available fiscal space allows the authorities to take all the necessary time to mitigate possible trade-offs; thus, they can afford starting with expanding opportunities before putting in place adjustment measures. We would appreciate more details about the quantification of the possible contribution expected from each of the adjustment measures suggested by staff.

Structural reforms. We note that staff has devoted much attention to the need to reform the sickness and disability system. A recent OECD survey[1] found that Norwegians are most worried, in the short run, about becoming ill or disabled. The political economy dimension of the sickness and disability system makes the process adopted by the authorities reasonable, because it helps to build up social consensus. In our view, however, other issues affecting longer-term growth, such as the declining labor participation among young males or lesser productivity in the non-oil and gas sectors, also deserve attention. Finally, we note with favor staff's appreciation of the benefits from a collective bargaining system that does not allow wage differentiations across either sectors or regions. Indeed, this system has delivered favorable wage dynamics by fostering social partners' "sense of shared responsibility".

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the report and Mr. Sigurgeirsson and Mr. Evjen for the helpful buff statement. Norway's economy is performing well, as noted in the buff, making this an opportune time to address longer-term challenges. We are encouraged by the authorities' efforts to consider reforms to social benefits, where merited, and to restrain wage growth to help maintain competitiveness. Continued vigilance will be required on financial stability risks, including those in the real estate sector. We agree with the thrust of the staff appraisal and would like to highlight several points for emphasis.

Macro Policy Mix. Fiscal and monetary policy appear to be well calibrated. Norway has maintained a neutral fiscal policy over the past three years, even as returns to the sovereign wealth fund have been strong. This is a marked improvement relative to the procyclicality in previous upswings, as staff note, even if it does not go as far as staff's recommendation for a modest consolidation to provide for a smoother transition to long-term conditions of reduced oil production and population aging. On monetary policy, the Norges Bank's continued gradual tightening plan, taking account of domestic and external developments, is appropriate.

Financial Stability. Financial stability risks appear manageable, though ongoing vigilance is required. We welcome the strong capitalization and liquidity positions of Norway's banking sector. We encourage close

[1] Risks That Matter, OECD - March 2019.

monitoring of risks stemming from high household debt, and the banking sector's reliance on foreign wholesale funding. Norway's macroprudential policy measures (MPMs) seem to be working to curb risks. We note IMF staff's preference for geographic granularity for housing MPMs, while Norway's FSA seems to prefer one national speed limit at the (lower) Oslo level to avoid micro-managing the market. Given that there are no established best practices in this area, we would tend to defer to the national authorities' preference. In the meanwhile, we look forward to IMF research on the use of MPMs particularly in housing markets and how best they can be applied. We appreciated the annex on commercial real estate, showing indications of rising risks but also substantial loss-absorbing buffers; we encourage the authorities to address related data gaps, as recommended by staff.

Structural Reforms. We welcome the authorities' proactive steps to increase labor force participation, including policies to more effectively integrate immigrants and refugees into the labor market. The staff paper makes a strong case for reforming the sickness and disability benefit to increase incentives to work, especially for the young. We are encouraged by the authorities' initial steps toward reform and recognize the importance of finding social consensus before moving forward. The use of an expert commission followed by engagement with social partners seems to be a sound approach to a politically sensitive issue. Finally, we note staff's support for Norway's ongoing reassessment of the rationale for the large state enterprise sector. This is an interesting topic that could be useful for staff to pursue further in the next Article IV, particularly if there is interest from the authorities.

Mr. Saito and Mr. Minoura submitted the following statement:

We thank staff for the comprehensive reports and Mr. Sigurgeirsson and Mr. Evjen for their informative statement. We welcome that Norwegian economy exhibits strong expansion helped by a robust labor market and positive terms of trade. However, Norway faces important challenges, including stagnant competitiveness, high non-oil fiscal deficit, aging demographics, and substantial financial sector vulnerabilities. In order to sustain its prosperity, the authorities are encouraged to continue their efforts to advance fiscal consolidation and implement structural reforms to boost productivity and increase resilience for the next downturn. As we agree with the thrust of the staff appraisal, we will limit our comments to the following points:

Fiscal Policy

With growth projected to be above potential in 2019 and the output gap turning positive, the authorities are encouraged to go beyond a neutral stance and target some consolidation next year to prevent procyclicality and rebuild fiscal space for the next downturn. Going forward, given the slower growth of the oil fund and increasing pressures of age-related spending, further adjustment would be needed in the longer-term, including VAT base broadening and reform of sickness and disability benefits. The latter reform is also important to sustain high employment levels in the face of population aging. Nevertheless, we also see oppositions to the reform from labor unions and the Confederation of Norwegian Enterprises. We would like to know staff’s suggestions on how the reform of sickness and disability benefits can get broader social consensus, in light of experiences in other countries. In addition, generous tax incentives for home ownership and household leverage call for reform of housing-related taxation to address financial risks related to the housing market.

Monetary Policy

We concur with staff that the tightening suggested in the latest forward guidance is appropriate given the current outlook. As inflation expectations remain well anchored and household consumption is very sensitive to interest rate changes, faster tightening does not seem warranted. We invite staff’s elaboration on how the monetary policy decision and the forward guidance have been affected by the new monetary policy framework, which also aimed at preventing buildup of financial imbalances in addition to achieving the inflation target.

Financial Sector Policy

While we positively take note that banks hold significant capital and liquidity buffers, we share the concerns on vulnerabilities related to high household debt, commercial real estate (CRE), and reliance on external wholesale funding. We commend that the authorities have actively deployed prudential policies such as maximum LTV and DTI ratios and more stringent regulation on prudent consumer lending practices. However, despite the recent slowdown, house prices remain overvalued and household debt continues to rise from an already elevated level. Against this background, we agree with staff that the regulations could be extended as is when reviewed at year-end, barring large unexpected developments in the coming months. In this light, we note of the authorities’ comment that some agencies such as the FSA would prefer that speed limits be unified at the lower Oslo level, to avoid micro-managing the market. Could staff elaborate on difference of views on the regional regulation among authorities and staff's view on it?

As for CRE, we welcome that prudential measures including higher risk weights, Pillar II capital add-ons for banks with concentrated exposures and the increase in the countercyclical buffer have been in place. We also encourage the authorities' further efforts to collect and disseminate comprehensive CRE data for better monitoring of risks. As for banks' strong reliance on wholesale funding and substantial cross-holding of covered bonds, we would appreciate it if staff could share measures that have already been taken and views on possible addressing measures.

We also welcome that the new AML/CFT law grants sanction powers and give higher budgetary resources to the FSA, and encourage ongoing efforts to close the remaining gaps in the AML/CFT framework and to strengthen regional collaboration on AML/CFT issues.

Mr. Sylla, Mr. Bah and Mr. Ondo Bile submitted the following statement:

We thank staff for their well-written report and Mr. Sigurgeirsson and Mr. Evjen for their informative buff statement.

The Norwegian authorities should be commended for their sound policies implemented in recent years which have led to an overall good economic performance despite the challenging external environment. We note in particular that growth in the mainland economy increased in 2018 and will continue to strengthen in 2019. We also note that the unemployment rate has markedly declined. Fiscal policy stance has been broadly neutral in recent years while the current account surplus has strengthened.

Notwithstanding these achievements and the positive near-term outlook, risks stemming notably from population aging and real estate market developments remain significant. Vulnerabilities in the pension system and elevated household indebtedness add to long-term challenges. Against this backdrop, we share the view that preserving the growth momentum will require continued implementation of sound policies and far-reaching structural reforms to preserve macroeconomic and financial stability and enhance resilience. We broadly agree with staff's policy recommendations and would limit our comments to the following points.

We encourage the authorities to take advantage of the current ample fiscal space to undertake necessary fiscal adjustments over the long-term. We note that with the current neutral fiscal policy, the Norwegian's intertemporal net worth will be pushed into negative territory driven notably by automatic expenditures in the health care and pension systems. To address this issue, we see merit in a permanent fiscal adjustment to secure the intertemporal solvency. The gradual fiscal consolidation envisaged for the 2019 and 2020 budgets seem appropriate. In this context, revenue efforts should be geared at broadening the VAT base, improving housing taxation and diversifying the sources of income away from oil and gas. We also welcome the expenditure reviews to ensure more efficient resource use and more effective policy instruments. These measures should be accompanied by structural reforms in the pension system. Indeed, reforming the sickness and disability benefits scheme—with the needed support of all relevant stakeholders –should help reduce structural expenditures.

The recent tightening of monetary policy is warranted given that inflation has risen above target. However, going forward monetary policy should continue to be driven by data as well as the outlook for inflation and growth. We agree that further tightening would widen interest rate differentials with trading partners, lead to unwanted exchange rate appreciation and hamper growth. We welcome the progress made by Norway in the digitization of payments system and encourage them to finalize the evaluation of costs, risks and benefits of issuing a central bank digital currency in response to the decline of cash usage. We look forward to the outcome of this evaluation.

Regarding the financial sector, we encourage to tackle steadfastly the vulnerabilities within the sector. These vulnerabilities include overvalued house prices, rising risks in commercial real estate, and banks' strong reliance on wholesale funding should be tackled steadfastly. To this end, the authorities should remain vigilant and maintain a tight macroprudential regulation. In this vein, the recent more stringent regulation on prudent consumer lending practices is welcome. The authorities should also pursue the rapid operationalization of the debt registry completed in 2018. In addition, we welcome the newly approved AML/CFT law and urge the authorities to ensure its full implementation and strengthen regional collaboration on AML/CFT.

Achieving sustainable growth requires continued implementation of structural policies to promote employment, enhance competitiveness and further diversify the economy. Given that oil and gas production is projected to decline in the coming years, we agree on the need to rebalance Norway's economy through a bold diversification policy and structural reforms.

Moreover, the desired reform of the pension system benefits should be consistent with sustaining the high employment levels in a context of population aging. There is also a need to further increase the employment rates among non-OECD immigrants and refugees along with efforts aimed at scaling up training among unskilled workers to boost productivity.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their insightful set of documents and Mr. Sigurgeirsson and Mr. Evjen for their informative buff statement. The expansion of economic activity in Norway this year will be supported by the recovery in the oil sector, sustained by stronger oil prices and oil investment, and growing domestic demand amid an improvement in labor market and a moderation of inflation. Growth is also still benefiting from the strengthening of the country's external position with the continued recovery in the terms of trade. While we commend the authorities for the strong performance of the economy and the adequate policy-mix implemented, we agree that the economy faces long term challenges arising from aging demographics and labor supply. We, thus, broadly agree with staff's views on the necessary diversification of the economy to raise potential growth while reducing the country's dependence on oil revenues. We wish to add the following remarks for consideration.

Fiscal policy

Strong General government's overall balance and increasing net financial assets including the large sovereign wealth fund in the coming years would indeed allow for a slight structural adjustment given the wide structural non-oil deficits which have been stable since 2017. Rising demographics pressures and deceleration in the oil fund's growth advocate for a change in fiscal stance. Although there is still space for deficits to expand under the 3 percent fiscal rule limit, there is also room of maneuver to start addressing growing fiscal constraints in the coming years and rebuilding fiscal space not only for the next downturn but also to cover age-related spending. While reform of the sickness and disability benefit scheme and improvement in property taxation appear to be consistent adjustments, the broadening of the VAT base and its potential distortionary effect should be carefully contemplated given Norway's already high standard VAT rate. We would have expected a deeper analysis in Annex IV of the various trade-offs – not only from a tax effectiveness point of view – between VAT base increases and a rationalization of exemptions regimes and the multiple rates.

Financial sector

We commend the authorities for the continuous strengthening of the regulations in the residential housing, consumer credit and commercial real estate sectors, including capital and borrower-based macroprudential measures, stringent consumer lending practices and an increase in the countercyclical buffer from 2 to 2,5 percent at the end of 2018. Nevertheless, household indebtedness has kept on rising from an already high level amid improvement in house price moderation and consequently housing affordability. Could staff provide us with some updated data on the level of household indebtedness in foreign currency as it has been a source of risk in the past (on CHF namely and regarding the krone depreciation)? Banks' exposure to CRE loans remain substantial accounting for 23 percent of GDP. Despite significant capital and liquidity buffers in the banking sector, we encourage the supervisory authorities to closely monitor the evolution of the risks in these sectors without relaxing the regulatory framework as suggested in the report. Would the monetary policy stance need to be normalized more rapidly, this latter recommendation would be seen as even more critical. We thank staff for the detailed Annex VIII which provides useful information on commercial real estate risks. However, given the importance of the sector for Norway's financial stability, we would have appreciated more data on the non-bank financing sector's exposure as the latter are not subject to macroprudential supervision. Staff additional information would be welcome. Finally, remaining gaps in the AML-CFT framework should be addressed and regional cooperation enhanced. We however salute the recent adoption of an upgraded framework which bestows the FSA more power and higher budgetary resources.

Structural policies

While Norway's external position is still comfortable, greater momentum should be given to step the efforts to diversify further the productive and export bases of the economy. The significant non-oil public deficit and the weaker-than-implied by fundamentals external position highlight the scope for progress to boost exports and enhance competitiveness further in non-oil sectors against the weakness of the krone which is currently helping. In this regard, steps must be taken to face declining labor supply and productivity through improving incentives to work, training of beneficiaries, increasing employment opportunities and aligning wage growth with stronger economic activity and productivity gains. On the latter, we feel that there is room to increase competition and accelerate liberalization of non-oil sectors, especially farming, B to B, B to C and retail to enhance their competitiveness while decoupling wage growth and negotiations in these sectors from those in the oil sector. We would be pleased if staff could share its assessment on the need for further markets deregulation.

We note the reform of sickness and disability benefits to tighten eligibility criteria, increase education and retraining of recipients. We agree with staff's recommendation on a combination of measures including efforts to improve skills profiles and reduce mismatches, especially among the young unemployed and the Integration program's beneficiaries, would work as a suitable solution while considering distributional effects.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its insightful report and commend it for the novel analysis on traction of Fund advice which we found interesting. We also thank Mr. Sigurgeirsson and Mr. Evjen for their helpful buff statement. We broadly share the thrust of staff's appraisal and would like to add the following comments.

The Norwegian economy has been resilient—despite slower growth in many advanced economies—supported by a solid labor market, still accommodative monetary policy and strong oil prices. Moreover, the near-term outlook is positive, with the recent upturn expected to continue into 2020 and overall risks balanced, which is commendable given the current context of heightened global uncertainty. As Norway is a small open economy highly dependent on external demand, with policy and political risks recently increased, we wonder whether staff should change its balance of risk assessment. Additionally, the government has recently achieved a majority in parliament. All this provides a favorable background for addressing longer-term challenges, such as boosting productivity growth, increasing labor force participation and ensuring sustainable public finances.

We concur with staff that the fiscal policy stance has improved over the last three years, as it has avoided a procyclical impulse. Going forward, the authorities should pursue a more countercyclical stance to contain aggregate demand pressures. In addition, the ongoing tax reform has made the system more growth-friendly, by shifting taxation to less distortionary sources. However, there is room to further fine-tune the tax system so that it creates additional fiscal savings while, at the same time, strengthening resilience and improving efficiency. To this end, a reduction of tax incentives for home ownership and leverage would be welcome and serve the dual purpose of withdrawing fiscal stimulus and addressing the booming housing sector. Regarding the broadening of the VAT base, we see some merit in this proposal, but we note the fact that the standard VAT rate is among the highest in the world. Thus, this measure can have an important impact on tax pressure—indeed, staff estimates an additional 1 ½ percent of GDP in annual revenue—and on the distribution of income. In this context, we wonder whether it would be desirable to broaden the tax base while at the same time cutting the standard VAT rate. Staff's comments are welcome. The distributional consequences of the measures proposed should be assessed and adequately offset with better-targeted measures.

We tend to concur with staff's view that the current pace of monetary tightening seems adequate given the evolution of inflation and economic activity. However, despite the numerous prudential measures adopted by the authorities over the last years, which have allowed banks to build significant capital and liquidity buffers, substantial financial sector vulnerabilities continued to accumulate. House prices continued to increase in relation to per capita disposable income, surpassing historical highs and becoming the highest among OECD countries. Household debt is still rising from already elevated levels. Risks from commercial real estate are also growing. In this context, we strongly support staff's recommendation not to loosen the prudential stance. However, one cannot but wonder whether something else is missing—apart from additional fine-tuning of MPMs. We do not mean to solve this conundrum exclusively with a tighter pace of monetary policy, but we wonder whether a narrow focus on inflation could be significantly detrimental for financial stability in the Norwegian case. This is another case where we would expect the forthcoming Integrated Policy Framework to provide imaginative solutions. Staff's comments are welcome.

To sustain labor supply in the face of population ageing, reform of sickness and disability benefits is crucial, given the relatively large share of the working age population receiving these benefits. According to findings in Annex V, it seems that the system of sickness and disability benefits is generous. Thus, staff's proposals for reform go in the right direction. However, as highlighted by Mr. Psalidopoulos and Ms. Collura, there seems to be a genuine preoccupation among Norwegians about becoming ill or disabled, which would hint to other underlying reasons for a high benefit take-up beyond moral hazard and incentives. Could staff elaborate whether there are some non-economic trends behind this high benefit take-up, e.g. health-related ones?

We note staff's appraisal that boosting productivity is difficult in Norway, because there are no obvious "low-hanging fruits." There seems to be no stifling regulations in labor or product markets and the business environment is good. Moreover, support for firms' innovation activities is relatively elevated. Given these favorable circumstances, could staff comment on why productivity growth is low? In this vein, we welcome recent reforms in the higher education system and the current assessment exercise of the role of state-owned enterprises, which should pave the way for further private investment and enhanced efficiency. Regarding the assessment exercise on SOEs, could staff provide more details?

Ms. Mahasandana and Mr. Mahyuddin submitted the following statement:

We thank staff for the comprehensive report and Mr. Sigurgeirsson and Mr. Evjen for the helpful buff statement. The Norwegian economy has been resilient, supported by robust labor market, improving competitiveness and stronger oil prices. The recent upturn and positive near-term outlook provide an opportune timeframe to address longer term challenges. We agree with the thrust of the staff appraisal and offer the following comments for emphasis.

With the persistently high commercial property prices, rising household debt and overvalued house prices, heightened financial stability risks remain. To this end, the current comprehensive prudential toolkit to mitigate financial stability risks should not be loosened at this stage. We encourage authorities to extend current mortgage regulations when reviewed at end-2019. We welcome staff's comprehensive assessment of the commercial real estate (CRE) sector in Norway and agree with staff on the need to step up efforts to collect and disseminate comprehensive CRE data for better monitoring of risks. We also welcome the possible adjustments of the systemic risk buffer to address the risks from commercial real estate as highlighted in the buff statement.

A moderate fiscal consolidation is welcome given the strong cyclical upturn, structural non-oil deficits and narrowing fiscal space under the fiscal rule. To this end, we note the authorities' concerns on the political difficulties in achieving faster consolidation when there is still room for deficits to increase under the fiscal rule. Therefore, it is crucial that recommendations on fiscal adjustments appropriately account for country specificities and consider the effect of these proposals on the vulnerable segments of society. While we agree with staff that there is a scope for Norway to increase VAT revenue, we also note that the share of indirect tax revenue in overall tax revenue has been increasing and higher than most regional peers at about 43 percent. The efficiency of VAT in Norway is also in line with regional comparators. Therefore, we welcome further comments from staff on the reason for emphasizing VAT as one of the main policy tools despite the potential political challenges it may impose as highlighted by authorities.

Staff analysis of the sickness and disability pensions schemes is insightful and we support the reform package proposal. Reforming the sickness and disability benefit schemes and undertaking greater support for active labor market policies to boost employment opportunities are important to avoid disincentivizing the return to work and promoting long-term absence from the labor market among the young people that receives benefits. We welcome authorities' consideration to reform the schemes upon the outcome of the discussions between employer associations and labor unions on the findings of the commissions.

We appreciate staff's recommendation on contingent demand policies should downside risks materialize. However, in the event of downturn, Norway must also address the high household leverage and other financial stability related issues. Given the policy space, how can fiscal policy play more role under Norway's specific circumstances and what other policies mix would be important for Norway? We also welcome further elaboration on the appropriateness of loosening macro prudential policies if the house prices were to fall, given the high household indebtedness situation in Norway.

Mr. Trabinski and Mr. Tola submitted the following statement:

We thank staff for their informative report and Mr. Sigurgeirsson and Mr. Evjen for their informative buff.

The Norwegian economy is expanding at a solid pace, growing above potential for two consecutive years. This is to a large extent thanks to the sound policies implemented by the authorities. Growth has been broad-based, with the non-oil sector also witnessing solid growth and the labor market and competitiveness building on last year's improvements. This performance compares favorably to the fading growth momentum in many advanced economies. The authorities should use the current positive momentum to address the long-term challenges facing the country, such as demographic pressures and dwindling natural resources.

Gradual fiscal consolidation is advisable, considering the economic upswing and in view of upcoming fiscal challenges. The current growth momentum represents an opportunity to start fiscal consolidation. As staff pointed out, this would be consistent with the ongoing monetary policy normalization and would help prepare for the next cyclical downturn. Consolidation would also address longer-term challenges linked to demographic pressures and decreasing oil and gas reserves. In this context, we support staff's proposals regarding the housing-related tax incentives and the reform of the sickness and disability benefit scheme. Regarding gradually increasing demographic pressures, could staff shed some light on the authorities' views about the preferable policy options for addressing this issue?

We consider the current monetary stance as appropriate and agree with staff on maintaining a cautious approach with regard to future policy tightening. The current stance is justified, given that headline inflation is above target and the output gap is turning positive. At the same time, we share staff's call for prudence with regard to faster tightening, considering that this would lead to appreciation of the krone via the wider interest rate differential and the vulnerability of households to interest rate rises. Therefore, the authorities should stand ready to adjust the tightening pace as circumstances require.

We commend the authorities for taking the capital- and borrower-based macroprudential measures aimed at reducing systemic risk related to real estate developments. The high share of mortgage lending in banks' assets and the overvaluation of real estate prices represent the main risks to the banking system. Hence, we agree with staff that mortgage regulations should not be loosened when reviewed at the end of 2019.

Regarding banks' funding model, we note an increase in covered bond issuance and the large cross-holdings of covered bonds in the banking system. How does staff assess the risk from increased interconnectedness as a result of rising cross-holding of banks' debt instruments?

Also, does staff see a concentration and duration risk related to the holding of Norwegian covered bonds by foreign investors?

Mr. Mahlinza and Mr. Nakunyada submitted the following statement:

We thank staff for a comprehensive report as well as Mr. Sigurgeisson and Mr. Evjen for their helpful buff statement.

We commend the Norwegian authorities for the prudent macroeconomic management that has supported solid recovery and employment creation. The broad-based upswing in economic activity was realized on the back of a robust labor market, favorable terms of trade, and competitiveness gains. Nevertheless, housing and commercial real estate risks, population aging, rising household debt, and external vulnerabilities continue to cloud the outlook. Against this background, we urge the authorities to focus on containing financial sector risks emanating from the real estate sector, implementing structural reforms, and tightening fiscal and monetary policies. We share staff's appraisal and provide the following remarks for emphasis.

Fiscal consolidation would be important to create fiscal space and help build buffers to attain intertemporal solvency. To this effect, the authorities should leverage the current growth trend to prioritize fiscal consolidation. We also urge the authorities to build fiscal buffers to cushion the economy against the expected rise in age-related spending and materialization of risks to growth. Further, we encourage the authorities to streamline VAT exemptions and rationalize multiple rates to enhance the effectiveness of these tax instruments. While we agree on the need to downsize the generous housing-related tax incentives, we stress the need to cushion vulnerable households. That said, we welcome the authorities' efforts to improve tax efficiency and the shift from direct taxes to growth-friendly indirect taxes.

Monetary policy normalization efforts should be coordinated with fiscal policy to achieve inflation and growth objectives. In this regard, we urge the authorities to carefully balance the burden of adjustment between fiscal consolidation measures aimed to dampen aggregate demand and inflation, and monetary policy adjustments. Further, the undesirable effects of monetary policy unwinding on the interest rates and capital flows should be well-managed to avoid excessive exchange rate volatility. On the other hand, we note the authorities' initiative to explore a central bank digital currency and wonder what the Fund's role has been in this exercise. Staff comments are welcome.

Efforts to contain financial risks should be sustained, despite the recent stabilization of housing prices. In this context, we urge the authorities to maintain the comprehensive prudential toolkit currently in place, to mitigate financial stability risks stemming from elevated household indebtedness and commercial real estate prices. That said, we commend the authorities for adopting prudent consumer lending practices, strict mortgage regulations, and the re-assurance provided by the robust capital and liquidity buffers in the banking sector. We also welcome remarkable progress made in addressing remaining deficiencies in the country's AML/CFT framework, and efforts to strengthen regional cooperation.

Structural reforms remain essential to rebalance the economy away from oil and gas and make further competitiveness gains. To this end, we urge the authorities to persevere with efforts to further diversify the economy ahead of the expected decline in oil production and related activities. Furthermore, the impending aging of the working population underscores the need to sustain high employment levels and unlock labour from beneficiaries of the sickness and disability schemes. We, however, note resistance by the labour unions to effect these changes and wonder if there is sufficient political traction to undertake these far-reaching reforms. Staff comments are welcome.

Mr. Sun and Ms. Cai submitted the following statement:

We thank staff for the informative report and Mr. Sigurgeirsson and Mr. Evjen for the helpful buff statement. The Norwegian economy is gaining momentum with a rising employment rate and a robust labor market, although vulnerabilities in the household sector remain. We broadly agree with staff's appraisal and offer the following points for emphasis.

Gradual fiscal consolidation is needed to build further fiscal buffers against the challenges facing the authorities. Slower growth of the oil fund and rising age-related spending could squeeze policy space under the fiscal rule. We welcome the authorities' strategies to expand labor participation and improve public sector efficiency, which are helpful to increase room for spending in the future. We take note of the different views regarding the sickness and disability schemes and look forward to the recommendations from the Norwegian expert commission. The initiatives to improve public sector efficiency and service delivery are welcome steps, and we encourage the authorities to further modernize public organizations and ensure sustainability in public finance in the long term.

The remaining vulnerabilities stemmed mainly from the overvalued house prices in the financial sector should be addressed. We commend the authorities for their strong actions to make the banking system more resilient. It is good to note that banks still hold significant capital and liquidity buffer and the stress test result is assuring. Nevertheless, household debt continues to increase and is vulnerable to an abrupt tightened financial condition. Overvalued housing prices also requires vigilance. That said, we agree with staff that the prudential toolkit should not be loosened at this stage, and we encourage the authorities to closely monitor the development of the housing market and introduce additional macroprudential measures when necessary.

Rebalancing to a new growth model that is less dependent on oil and gas is essential for long-term prosperity. Continued efforts are needed to boost productivity, including promoting innovation, improving labor skills and expanding product market reforms. Wage growth should be better aligned with the growth of productivity. In this regard, we agree with staff that restraint in wage settlements will be important, and welcome social partners' commitment to moderate wage increases this year. Staff's analysis of contingent demand policies in Norway has provided a comprehensive picture on the authorities' policy space going forward, and we encourage more country teams to include similar analysis in their reports.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Benk and Mr. Reininger submitted the following statement:

We thank staff for their informative reports, and Mr. Sigurgeirsson and Mr. Evjen for their helpful buff statement.

Norway's economy is set for robust growth this year and the next, with slight growth acceleration expected for this year and slightly slower pace next year. We commend the authorities for their strong policy framework to manage the impact of the oil-related sector on the economy. Against the backdrop of current growth forecasts, we consider the current economic situation as a window of opportunity for pro-active management of longer-term challenges with respect to ongoing demographic changes and the transformation towards a non-oil economy.

On fiscal policy, the authorities have aptly avoided embarking on a procyclical policy during the upswing in recent years, and we encourage them to consider a structural consolidation for next year, if the evolving external risks and recently increased level of uncertainty permit. We take note of the authorities' view that there is still room for larger deficits under the fiscal rule and we wonder whether staff see a case for an adjustment of the fiscal rule going forward.

We appreciate staff's presentation of three elements for longer-term structural fiscal adjustment, i.e. (1) reform of the sickness and disability benefit scheme; (2) broadening the VAT base; and (3) gradually eliminating housing-related tax incentives. We encourage the authorities to consider this third option as it would combine a positive budgetary impact with reducing the elevated risk of household leverage contributing also to financial stability. As for broadening the VAT base, we appreciate staff's recommendation to compensate vulnerable households with targeted transfers.

On monetary policy, we agree with staff and the authorities that the tightening as per the latest forward guidance is appropriate given the current outlook. Nevertheless, the authorities should stand ready to reevaluate their stance contingent on evolving external risks and the further conduct of monetary policy by other central banks, considering also the potential impact on the exchange rate.

Concerning financial sector policies, we welcome parliament's recent approval of a new AML/CFT law and the allocation of higher budgetary resources to the FSA to step up supervision of AML/CFT compliance.

We commend the authorities for their active use of macro-prudential policy tools, which has contributed to the softening of house price increases. In view of banks' exposure to CRE, we concur with staff's advice to collect CRE data for better monitoring of risks. More generally, we support the recommendation to avoid loosening the macroprudential policy stance at this stage.

We welcome the social partners' commitment to responsible wage bargaining, as this approach of common responsibility will play an important role in fostering the competitiveness of the non-oil sector and thus in facilitating the transformation towards a non-oil economy.

As for the proposed reform scheme of sickness and disability benefits, (i) tightening eligibility criteria and certification procedures; and (ii) enhancing education and retraining programs for beneficiaries, in particular those with more limited employment opportunities and the young, appear warranted, while we are not fully convinced by the suggested reduction of benefit levels, if and when the aforementioned two measures are implemented. Moreover, we place high premium on measures intended to increase work incentives, akin to earned-income-tax-credit (EITC) measures (Annex V, p.43), and we believe the main paper would have benefitted from including it in the list of key elements of a suitable reform package.

More generally, the Annexes would have benefited from more information on further elements of the social system in order to better understand the overall context. Against the backdrop of an old-age spending-to-GDP ratio that is far lower in Norway than in Nordic peers and a high share of disability benefits recipients among the 62–67 year old, it would be very relevant to know the legal and average effective retirement age and the scope of early retirement in Norway compared to peers. Similarly, the question arises how the general minimum social safety net in Norway compares to that of peers, as there might be some substitution effects at play, given that overall social spending relative to GDP in Norway is around the regional average. We would like ask staff for comments.

On further measures to foster labor supply, we support staff's recommendations to address skills mismatch and the high drop-out rates from vocational training.

On measures to raise productivity, we commend the authorities for their efforts to enhance R&D, and support the ongoing reassessment of the rationale for state ownership in the enterprise sector, particularly for companies with purely commercial objectives.

Mr. Mouminah, Mr. Alkhareif and Mr. Rouai submitted the following statement:

We thank staff for a well-written report and Mr. Sigurgeirsson and Mr. Evjen for their helpful buff statement. We broadly agree with the staff appraisal and will limit our remarks to a few areas for emphasis.

Macroeconomic developments in Norway remain positive and risks are balanced. Economic growth is solid, exceeding potential, the outlook is positive, and risks are balanced. As a small open economy, Norway continues to benefit from its strong fundamentals and we therefore agree with staff that the country should use this upturn to address the long-term challenges related to population aging and improve competitiveness.

Fiscal policy has been prudent, but consolidation could be helpful to address long-term challenges. We welcome the recognition by the authorities that the budget will face increasing pressures in the coming years. For 2019, we note the authorities' concerns about political difficulties to conduct fiscal consolidation at a time when the option of fiscal deficit is still available under the fiscal rule. However, as the fiscal space will decline over the longer term, we encourage the authorities to give due consideration to staff recommendation to target a permanent fiscal adjustment of 4-5 percent of GDP to safeguard fiscal sustainability. In this regard, we welcome the indication by the authorities that they see strong merit in reforming sickness and disability benefit system, introducing further steps to harmonize VAT rates, and improving the use of public resources. We note, however, the concerns expressed by the social partners regarding reforms to the sickness and disability benefits and we welcome their participation in the expert commission and look forward to the commission's recommendations next year. Could staff clarify if the positions expressed by social partners and detailed in ¶33-34 of the staff report represent their views before or after joining the commission?

The financial sector is well capitalized, and the prudential toolkit is comprehensive, although financial vulnerabilities remain. We note that banks' balance sheets are strong, with significant capital and liquidity buffers. We agree, however, with staff that the country could be confronted with substantial vulnerabilities that could originate from risks associated with the housing sector, the commercial real estate, and banks' reliance on external wholesale funding. We therefore encourage the authorities to remain vigilant and stand ready to address vulnerabilities that could endanger financial stability and we look forward to the 2020 FSAP for a more comprehensive assessment of risks and related policy recommendations.

Finally, we welcome that the traction of Fund advice is good in Norway. We welcome staff recommendations for contingent demand policies to confront downside risks if they materialize. We take note of staff suggestion for the potential use of quantitative easing by Norges Bank. The recent IEO evaluation of IMF Advice on Unconventional Monetary Policies has shown that IMF engagement with small states on monetary policy issues, including some Nordic countries, was relatively limited and we encourage staff to further engage with the authorities as part of the forthcoming FSAP.

With these comments, we wish the authorities further success.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for the interesting report and Mr. Sigurgeirsson and Mr. Evjen for their informative buff statement. The Norwegian economy has recovered from the oil shock-related slowdown and has been growing above potential over the last two years. Mainland economy growth was supported by improving competitiveness and accommodative monetary policy, while oil-related sector was helped by higher oil prices and efficiency gains. Inflation has risen above target. Unemployment has declined to a low 3.8 percent level, while wage growth started to pick up. Robust performance of the economy and strong policy buffers created favorable conditions for reforms to address long-term structural challenges, while containing near-term risks.

High household debt and elevated house prices constitute the most substantial internal risk, which can be triggered by rising debt service costs in case of turbulence on the global financial markets. The authorities also need to address long-term fiscal sustainability challenges, as well as to diversify the economy and improve competitiveness. Overall, we agree with the staff appraisal and policy recommendations and would like to make a few comments for emphasis.

On the fiscal side, we welcome a broadly neutral fiscal policy of the past few years. The authorities are well advised to gradually tighten fiscal stance, as economy operates above potential and, over the long-term, the budget is facing increasing pressures due to a combination of deteriorating demography, declining hydrocarbon reserves and high non-oil deficits. The recent tax reform reduced corporate tax rates and mitigated incentives for base erosion and profit shifting. It is important to follow up with the improvements in the VAT system as recommended by staff. In view of high household indebtedness, we also see merit in the proposals to strengthen housing-related taxation, reducing incentives for household leverage. On the expenditure side, the introduction of the spending reviews to achieve more efficient resource use is welcome. We recall that, until recently, the scope of the reviews was narrow, and their impact was assessed as limited. Could staff update us on the progress in this area?

The tightening of monetary policy stance is appropriate given strong economy, increasing headline inflation and emerging wage pressures. However, we agree that the pace of future tightening should take into account high sensitivity of households to the interest rate changes due to large variable-rate debt. We note with interest the ongoing evaluation of the introduction of the central bank digital currency and look forward for its conclusions.

Taking into account substantial financial sector vulnerabilities from elevated real estate prices and growing household debt, additional measures are needed to contain these risks. It is encouraging that Norwegian banks have robust liquidity and capital buffers, and the authorities continue efforts to strengthen the financial sector. However, the build-up of household debt continues, and commercial real estate sector also shows the signs of overheating. Macroprudential and mortgage regulation need to be strengthened, and we also advise the authorities to examine ways to reduce tax incentives for house ownership and household debt accumulation. We also note high dependence of Norwegian banks on external wholesale funding. We would welcome staff comments on the ways to reduce this vulnerability.

Rebalancing the economy to a more diversified growth model remains a key challenge. It will require continued efforts to improve competitiveness, including steps to contain wage increases and reforms to boost productivity. In is also important to improve labor participation. The government put a special emphasis on the reform of sickness and disability benefits (SDB), which are substantially higher in Norway than in the Nordic peers. However, labor unions oppose the tightening of the SDB criteria, arguing that the economy is not generating enough jobs to absorb people with lower skills. We note that number of recipients of SDB rapidly declined in Finland and Sweden (page 16) after their SDB reforms. Could staff comment why the SDB reforms were successful in Finland and Sweden, and what are the differences that may prevent Norway to replicate their success?

The Acting Chair (Mr. Furusawa) made the following statement:

The Norwegian economy is performing well, and the economic upswing is broad-based. As some Directors have noted, it is one of the few resource-rich countries that has been successfully harnessing its natural resources for the future generations.

Directors' gray statements noted that Norway's near-term outlook is positive, and risks are overall balanced. However, the economy does face some long-term challenges. As Directors noted, it is important that the authorities use the current favorable environment to implement further reforms, which will be important for sustaining prosperity, transitioning to a less oil-dependent economy, and boosting productivity.

Mr. Daïri made the following statement:

We broadly agree with the staff's appraisal and note with satisfaction that, in the case of Norway, the traction of the Fund's policy advice is good. Against this background, we would like to limit our comments to the following points.

We agree with the staff that the current good macroeconomic environment in Norway and its strong fundamentals offer a window of opportunity for the authorities to agree on a comprehensive agenda of structural reforms to address the long-term challenges of population aging and the prospects of lower oil and gas production.

We appreciate the inclusion in the staff report of a section on contingent demand policies. While we note that overall risks are balanced and that the economy is resilient, with sufficient policy space to mitigate any downturn, like Mr. Moreno and Mr. Montero, we wonder what the policy mix would be in case of a major change in the balance of risks.

We agree with the staff on the need to initiate a gradual fiscal consolidation. In this regard, we welcome the authorities' recognition that there is a case for a tight fiscal stance going forward, pointing, however, to political difficulties. In this regard, we welcome the involvement of social partners in the identification of reforms, particularly in the areas of sickness and disability benefits.

Banks in Norway are well capitalized, although the housing and commercial real estate sectors and banks' reliance on external wholesale funding are sources of vulnerability. Therefore, we encourage the authorities to remain vigilant and look forward to the forthcoming Financial Sector Assessment Program (FSAP) for a comprehensive assessment of risks and related policy recommendations, including on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) issues.

With these comments, we wish the authorities continued success.

Ms. Andreicut made the following statement:

We thank staff for the comprehensive report and Mr. Sigurgeirsson and Mr. Evjen for their informative buff statement. We welcome the report and support the staff analysis.

I would like to pick up on one of staff's recommendations, namely, that ensuring durable long-term growth requires a continued rebalancing of the economy away from oil and gas. One particular concern that staff notes in this context is that age-related spending will likely outpace transfers from the sovereign wealth fund and, thus, put increasing pressure on the annual budget. This is supported by the fact that declining oil and gas revenues as a share of GDP are limiting the sovereign wealth fund's pace of growth. I would be interested to hear from staff on this topic. In particular, what shape should the rebalancing of the economy take to ensure adequate long-term financing of pensions?

Mr. Saito made the following statement:

> We welcome that Norway's economy enjoys a strong expansion and encourage the authorities to take this opportunity to address long-term challenges, in particular, population aging.
>
> As we have issued a gray statement, we would like to offer two comments for emphasis.
>
> First, on the reform of sickness and disability benefits, as the staff pointed out, the reform of these benefits are key priorities to create fiscal space and to also sustain high employment in the face of population aging. However, we also see the opposition from the labor unions and the Confederation of Norwegian Enterprises. In this context, we welcome the setup of the expert committee, followed by the engagement with social partners. Going forward, we urge the staff's continued analysis and advice on how sickness and disability benefits reforms can receive broader social support in light of successful experiences in other countries. We are looking forward to hearing the staff's comments on this issue.
>
> Second, on monetary policy. We welcome that the monetary policy decision has been conducted in a well-communicated way and support the staff's comments that a further tightening is appropriate, given the inflation outlook. However, under the new monetary policy framework, which also aimed at preventing a buildup of financial imbalances, a conflict of the policy objectives could emerge. We encourage the central bank to keep clear communications on this front. We want to hear the staff's comments on the relationship between the new mandates and the recent policy decisions.

The staff representative from the European Department (Mr. Miniane), in response to questions and comments from Executive Directors, made the following statement:[2]

> I thank the authorities for the excellent cooperation during the Article IV consultation. We greatly appreciate it. We thank Directors for the thoughtful gray statements. There was a larger-than-usual number of policy questions, so I will try to be brief but also to be fair in my answers.
>
> There were some questions on the balance of risks, specifically, whether we should not change our balance of risks, given developments in the

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

past two weeks. It is true that trade tensions have increased. It is true that oil prices have corrected in the past two weeks. But we should not make too much of this either. Despite the correction, oil prices remain well above break-even levels that matter for investment decisions. Even with the recent correction, the oil price average for the year is above the World Economic Outlook (WEO) average assumed in the baseline. This has to be noted.

In addition, forward-looking indicators remain very strong. The recently released GDP data that was released after circulation to the Board, with monthly GDP up to April, shows that GDP is well on track to meet the 2.5 yearly forecast that staff has. At this stage, we do not see enough material to suggest that the forecast is really at risk.

There were a few questions on the contingency policies in case of a shock. Let me first answer the question on the sequence and the policy mix. For us, it is fairly clear.

First, the exchange rate should be the first line of defense, as it has been traditionally. After that, there is room for automatic stabilizers on the fiscal side and for the central bank to cut rates, if needed. Beyond that, there is room for discretionary fiscal stimulus, if and only if needed. We see relaxing macroprudential measures as a third line of defense.

There was a question about whether macroprudentials should be relaxed, given the high household debt. We are clear in the report that they should only be relaxed if the balance of financial risk changes—basically, if the shock is so strong as to change that balance of risks. Specifically, they should only be relaxed if the risk from declining house prices now becomes greater than the risk from high household debt. There is not a scientific way to ascertain where that crossover point lies. We need to use judgment, but we need a big, big risk to get there.

There were many questions on sickness and disability. What can reforms elsewhere teach us on how to gather consensus? If you look at the successful reforms elsewhere, they were fairly balanced. They tightened eligibility, they tightened benefits, but they also put great emphasis on improving retraining and improving the re-employment possibilities for beneficiaries. One needs that balance because if the social partners do not see their concerns addressed, they will not support the reform. That is why we emphasize all these different aspects in our recommendations.

In terms of what the authorities are doing, they could not have done a better-thought-through, more inclusive process. First, they formed an expert commission. Then they convened the social partners to discuss the proposals by the commission. Third, they committed to not proposing a reform that is not agreed ex ante by the social partners. This is a very inclusive process. Will it succeed? We do not know. Every country has a reform that it finds difficult to enact. Norway has tried before with sickness and disability. Hopefully it will work this time.

There was a question about how the social safety net compares to regional peers. It compares very well. It is equally or more generous. If Norway spends as much or less than its peers despite higher spending on social and disability, it is only because its demographics have been better, so age-related spending has been lower.

There were some questions on the VAT. Why do we emphasize the VAT? It is a big tax, so if one wants a big tax yield, one needs to focus on the big taxes. The authorities have ruled out increasing distortionary direct taxes. In fact, they have reduced them. If they move to indirect taxes, they do not have many choices. Excise taxes and green taxes are already high, and the authorities do not want to increase them further. Their priority is to broaden the VAT, despite the social concerns or political economy concerns related to the VAT.

There were some questions on monetary policy. We do not believe that the new framework is impacting decisions or forward guidance because the new framework merely codifies into law what was practiced before. Norges Bank already incorporated financial imbalances into its rate cut decisions or rate decisions, so this has not changed.

Regarding the question of whether an excessive focus on inflation has contributed to financial imbalances, the staff feels that this is not a fair characterization. When one looks at 2014, Norges Bank was very focused on financial imbalances when cutting rates because of the downturn. Now the slow pace of tightening is not because of inflation but it is because of concerns that mortgages are at variable rates and would react strongly to a fast tightening. One could hardly find a central bank in the world which has incorporated financial imbalances into its decisions as thoroughly as Norges Bank.

On the question of whether having different mandates creates tradeoffs, not so because, in Norges Bank’s interpretation and our interpretation, there is a hierarchy of mandates: first of all, it's low and stable inflation; second, it's full employment and output; third, it's financial imbalances.

On Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), it is important to know that, unlike other countries in the region, Norway has not had a scandal so far. This does not mean that it cannot or that it will not happen, but it is an important distinction. It is also worth noting that the exposure of Norwegian banks to high-risk jurisdictions is less than that of other regional peers. Again, it does not mean that it cannot or will not happen, but it is a relevant fact. Because a full-blown Financial Action Task Force (FATF) assessment is happening in October and because the Financial Sector Assessment Program (FSAP) is in full swing in the coming months, all these considerations validate our choice to spend an appropriate but not excessive amount of resources on this issue.

On the AML/CFT priorities going forward, we believe the new legal framework is in great stead, so the priority should be on ensuring full compliance with the framework through tight supervision.

Another priority should be going back and, on a very granular basis, looking at flow by flow and making sure that there were not flows that violated the law. I believe the Financial Supervisory Authority (FSA) is already doing this, but Mr. Evjen can confirm.

Finally, on demographic pressures, there were questions on how the authorities intend to address this. The authorities have been very explicit. In their view, a country with a strong social safety net is a country where everyone that can work should work. Demographic pressures make this imperative even more pressing. Their intent is to remove any obstacle to expanding to labor supply. This explains their pension reforms of recent years, which have led to a noticeable increase in labor participation among older cohorts. This explains their renewed focus on sickness and disability reform.

Finally, there was a question on what shape should the rebalancing away from oil and gas take? First, let us note that Norway has done a better job diversifying away than other oil exporters. One can see this because GDP growth in the mainland economy has become very uncorrelated from developments in the continental shelf. This is already very good.

In terms of what shape it should take, we do not believe our comparative advantage is to say Norway should specialize in this sector or that sector. Our advice is on the policies that will ensure strong competitiveness outside of oil, and to ensure that productive resources can move freely from oil to these other sectors. We believe those policies are in place, but there are things to do at the margin. In particular, wage restraint should continue to preserve those competitiveness gains.

Mr. Daïri made the following statement:

Does the staff see the proposal that the exchange rate should be the first line of defense as applicable in all cases? Even if there is fiscal space or at least room to let automatic stabilizers work? What is the advice given to the authorities? Is it to let the exchange rate adjust? Or when there are these automatic stabilizers, whether these should be used first? What is the sequencing?

The staff representative from the European Department (Mr. Miniane), in response to further questions and comments from Executive Directors, made the following additional statement:

The authorities have not intervened in foreign exchange markets for more than 20 years, so any shock will immediately translate to the exchange rate. We saw that in 2014, where the krone depreciated by close to 30 percent in the space of one or two months. In terms of sequencing and the authorities' longstanding policy not to intervene in foreign exchange markets, that is what is going to happen. We what theory should tell us is the best way to respond and their preferred way of responding.

If that exchange rate movement is not enough to buffer the shock, they will surely let automatic stabilizers operate, but we will know quickly because the foreign exchange depreciation in case of a shock will happen automatically and very quickly.

Mr. Evjan made the following concluding statement:

On behalf of my authorities, I thank the staff for their high-quality interactions during the discussions in Oslo and for the insightful report. There is a broad consensus between the staff and the authorities on the main policy issues, and my authorities will carefully consider the policy advice.

The Norwegian economy is performing well. Growth is robust, at around 2.5 percent. Employment growth is high. Unemployment is declining across the country. Inflation is a little higher than the 2 percent target.

In the revised budget, the spending of oil and gas revenues is in line with the fiscal rule, and fiscal policy is neutral, if we consider the last two years as a whole. However, we are aware that contentment can foster complacency. There are significant risks to the current economic outlook, and longer-term challenges are looming.

First, on the current economic outlook. The steady buildup of house prices and household debt increases households' vulnerability and poses risks to financial stability and economic growth. We agree that the macroprudential measures have been effective, resulting in tighter lending practices and, in turn, curbing house prices. Should risks intensify, the authorities stand ready to amend the measures accordingly. On the persistent sharp rise in commercial property prices, we welcome the analysis from the staff. The related risks are well acknowledged, and they have contributed to the increase of the countercyclical buffer. The banks have robust capital buffers.

Second, the authorities are fully aware of the more structural challenges that lie ahead. A fiscal adjustment is needed, as age-related spending is expected to increase and outpace the transfers from the government pension fund. Let me underscore that the fiscal rule implies that these challenges must be handled without tapping the principal of the sovereign wealth fund. There is a strong commitment among politicians to stick to the fiscal rule and safeguard our good net wealth position.

Bearing in mind the need for fiscal adjustment, we appreciate the advice from the staff, such as improving the VAT efficiency and reforms in the sickness and disability benefit schemes. Unlocking labor from the sickness and disability schemes is important, not only to increase employment but also due to the positive long-term budgetary impact. An expert commission has presented proposals, aiming at increasing labor participation, with an emphasis on these schemes. My authorities will wait for the final recommendations from an enhanced expert commission, which also includes the social partners, before considering major steps. Despite the divergent views on the appropriate measures, we expect the social partners to seriously discuss possible reforms in the enhanced commission.

Finally, on AML, I agree with the assessment of Mr. Miniane. The recent money laundering cases among Nordic and Baltic neighbors illustrates the necessity for the authorities to remain vigilant. The Nordic and Baltic supervisory authorities have announced that they will step up their regional cooperation.

Let me end by thanking Mr. Miniane and his team for the excellent interactions with the authorities and for answering the technical questions. I would also like to thank Directors for offering valuable input. I look forward to bringing the key messages to my authorities.

The Acting Chair (Mr. Furusawa) noted that Norway is an Article VIII member, and no decision was proposed.

The following summing up was issued:

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

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

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

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

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

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

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

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

APPROVAL: April 22, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***As Norway is a small open economy highly dependent on external demand, with policy and political risks recently increased, we wonder whether staff should change its balance of risk assessment.***

- Staff will respond to this question during the Board meeting.

2. ***We appreciate staff's recommendation on contingent demand policies should downside risks materialize. However, in the event of downturn, Norway must also address the high household leverage and other financial stability related issues. Given the policy space, how can fiscal policy play more role under Norway's specific circumstances and what other policies mix would be important for Norway? We also welcome further elaboration on the appropriateness of loosening macro prudential policies if the house prices were to fall, given the high household indebtedness situation in Norway.***

- Staff will respond to this question during the Board meeting.

Fiscal Policy

3. ***Can staff comment on the prospects for delivering on reforms to housing-related taxation?***

-and-

4. ***We note the difference of views between the authorities and staff on further reducing the tax incentives for housing and would be grateful for staff's elaboration on the reasons for this difference.***

- There have been efforts in recent years to reduce the tax incentives. For instance, the authorities reduced the valuation discount in calculating the net wealth tax on housing.

- This being said, the authorities were clear that at this stage they see no political scope for major overhauls of housing-related taxation, although they did not dismiss the possibility of smaller tweaks at the margin.

5. ***In this circumstance, is it the case that the optimal policy path is not supported by the fiscal rule? Does this suggest that some recalibration of the fiscal rule might be necessary? Staff comments are welcome.***

-and-

6. ***We wonder whether staff see a case for an adjustment of the fiscal rule going forward.***

- Norway's fiscal rule has resulted in a very significant amount of fiscal savings over the last two decades, as a result of which Norway now enjoys one of the highest levels of public sector net-worth globally.

- As to whether the rule should be changed, our view is a clear no: (i) its design aligns closely with the theoretical consumption-smoothing ideal; (ii) the rule is very intuitive and easy to communicate to the public and as such enjoys broad public support; (iii) the recent tightening of the fiscal rule in 2017 marked an important and commendable recalibration, notably the assumption of lower and more prudent rates of returns for the sovereign wealth fund. The rationale for revising the rule at this stage is therefore weak.

- The fact that the fiscal rule allows for slightly higher deficits than staff would recommend at this particular stage should not be seen as an argument against the rule. The high levels of savings prove the rule has been extremely prudent; making the rule even tighter would risk making it tighter than optimum and would risk jeopardizing its support.

7. ***Could staff provide some further details on areas where this might be considered and if so, whether compensatory measures to most affected vulnerable households would be considered as well?***

- Many goods and services are taxed at a reduced rate including foodstuffs, passenger transport and letting of rooms among others.

- In some cases, it would be possible to increase the rate and obtain significantly higher revenue without implications for vulnerable households (for instance because the consumption of these items by vulnerable households is typically limited, for instance in the case of staying at hotels).

- Increasing the rate of taxation on other items including food would yield extra revenue, but as implied in the report the politics of raising VAT on food are more difficult; it may also require compensatory measures such as targeted transfers to the most vulnerable households.

8. ***We would appreciate more details about the qualification of the possible contribution expected from each of the adjustment measures suggested by staff.***

- Base broadening of VAT could realistically increase revenue by around 1.5 percent of GDP under the very realistic assumption that the authorities close ¼ of the c-efficiency gap relative to the best countries. Compensatory measures could reduce this yield somewhat.

- The revenue from reforming sickness and disability benefits could vary broadly depending on the exact parameters of the reform, as there are many possible constellations of benefits. Given spending elsewhere, we know that potential annual savings could reach 2-3 percent of GDP, but we see this very much as an upper bound, not the most realistic target.

- Staff has not quantified additional revenue from improved housing taxation.

9. ***We would like to know staff's suggestions on how the reform of sickness and disability benefits can get broader social consensus, in light of experiences in other countries.***

- Staff will respond to this question during the Board meeting.

10. ***In this context, we wonder whether it would be desirable to broaden the tax base while at the same time cutting the standard VAT rate. Staff's comments are welcome.***

- The standard VAT rate is higher than in countries outside of the region, but it is not high by regional standards which may be the most relevant metric.

- While base broadening combined with a reduction of the standard rate is possible, this would lower the revenue yield from VAT reform which would be an important objective.

11. ***While we agree with staff that there is a scope for Norway to increase VAT revenue, we also note that the share of indirect tax revenue in overall tax revenue has been increasing and higher than most regional peers at about 43 percent. The efficiency of VAT in Norway is also in line with regional comparators. Therefore, we welcome further comments from staff on the reason for emphasizing VAT as one of the***

main policy tools despite the potential political challenges it may impose as highlighted by authorities.

- Staff will respond to this question during the Board meeting.

12. ***Regarding gradually increasing demographic pressures, could staff shed some light on the authorities' views about the preferable policy options for addressing this issue?***

- Staff will respond to this question during the Board meeting.

13. ***Could staff clarify of the positions expressed by social partners and detailed in para33-34 of the staff report represent their views before or after joining the commission?***

- These positions represent their views before joining the extended commission to discuss the expert group's recommendations.

14. ***Could staff update us on the progress in this area [the introduction of the spending reviews to achieve more efficient resource use]?***

- Staff have not looked into this issue in the current consultation but will update the Board in the coming days.

Monetary and Exchange Rate Policies

15. ***We invite staff's elaboration on how the monetary policy decision and the forward guidance have been affected by the new monetary policy framework, which also aimed at preventing buildup of financial imbalances in addition to achieving the inflation target.***

- Staff will respond to this question during the Board meeting.

16. ***We do not mean to solve this conundrum exclusively with a tighter pace of monetary policy, but we wonder whether a narrow focus on inflation could be significantly detrimental for financial stability in the Norwegian case. This is another case where we would expect the forthcoming Integrated Policy Framework to provide imaginative solutions. Staff's comments are welcome.***

- Staff will respond to this question during the Board meeting.

17. ***[on the other hand, we note the authorities' initiative to explore a central bank digital currency and wonder what the Fund's role has been in this exercise.] Staff comments are welcome.***

- Staff has not been actively involved in the authorities' analysis of a central bank digital currency, but the authorities have noted that they benefitted from previous Fund work in this area. Moreover, we do not rule out collaboration on this issue in the future.

Financial Sector

18. ***With this in mind, we would be interested in the outlook for a further expansion of housing supply?***

- There have been various efficiency measures introduced since 2015 to ease housing construction; for example, through simplifying construction permit application processes; tightening deadlines for public authorities to approve applications; and launching a digital platform for submission and approval of construction applications. These have all contributed to making housing supply more price-elastic in recent years, which contributed to the recent easing in house prices. The authorities, as pointed out in buff, remain committed to continue addressing housing issues from the supply side, to ensure a more balanced market going forward.

19. ***Can staff elaborate as to whether there are any factors that could constrain full compliance with AML/CFT standards?***

- Staff will respond to this question during the Board meeting.

20. ***Nevertheless, we would have welcomed a more granular assessment of the recently adopted measures and clearer indications on further steps the authorities should take going forward] Could staff elaborate on this matter?***

- Staff will respond to this question during the Board meeting.

21. ***Could staff elaborate on difference of views on the regional regulation among authorities and staff's view on it?***

- It is important to note that different institutions (MoF, Norges Bank, FSA) have different views on this issue, the authorities' views are therefore not monolithic. The FSA in particular would like to see a unification of parameters, as they see the regional differentiation as micro-managing the market.

- Staff agree with this position in principle. Nevertheless, unifying parameters at this juncture would de fact mean either loosening regulations in Oslo or tightening them elsewhere, neither of which seems justifiable in our view given market developments in the respective regions.

22. ***As for banks' strong reliance on wholesale funding and substantial cross-holding of covered bonds, we would appreciate it if staff could share measures that have already been taken and views on possible addressing measures.***

-and-

23. ***We would welcome staff comments on the ways to reduce this vulnerability [wholesale funding]***

- The authorities contend rightly that the best way to address this vulnerability is to ensure banks maintain strong liquidity and capital buffers, which exceed prudential requirements by ample margins; in addition, Norway's capital standards are much tighter than the Basel requirements. In addition, note that the countercyclical buffer can be raised if banks' exposure to wholesale funding signals rising vulnerabilities.

- It should be noted that during the GFC the Norwegian authorities introduced a raft of measures that successfully alleviated stress coming from the external wholesale funding channel, and which allowed banks to more easily roll-over their obligations. In turn, this buffered the impact on credit provision and the overall economy

24. ***Could staff provide us with some updated data on the level of household indebtedness in foreign currency as it has been a source of risk in the past (on CHF namely and regarding the krone depreciation)?***

- Household debt in FX is negligible, accounting for only 0.3 percent of total HH debt.

25. ***[however, given the importance of the sector for Norway's financial stability, we would have appreciated more data on the non-bank financing sector's exposure as the latter are not subject to macroprudential supervision.] Staff additional information would be welcome.***

- Non-bank financing by CRE is largely through market financing, not through non-bank financial institutions. Issuance by CRE companies is a tiny fraction of bond market volumes.

26. ***[similarly, the question arises how the general minimum social safety net in Norway compares to that of peers, as there might be some substitution effects at***

play, given that overall social spending relative to GDP in Norway is around the regional average.] We would like ask staff for comments.

- Staff will respond to this question during the Board meeting.

27. ***How does staff assess the risks from increased interconnectedness as a result of rising cross-holding of banks' debt instruments?***

- This may intensify liquidity stress for Norwegian banks if funding dries up and banks are forced to liquidate large covered bond holdings simultaneously. The impact can be further amplified if house prices fall concurrently, since covered bonds are collateralized with residential mortgages.

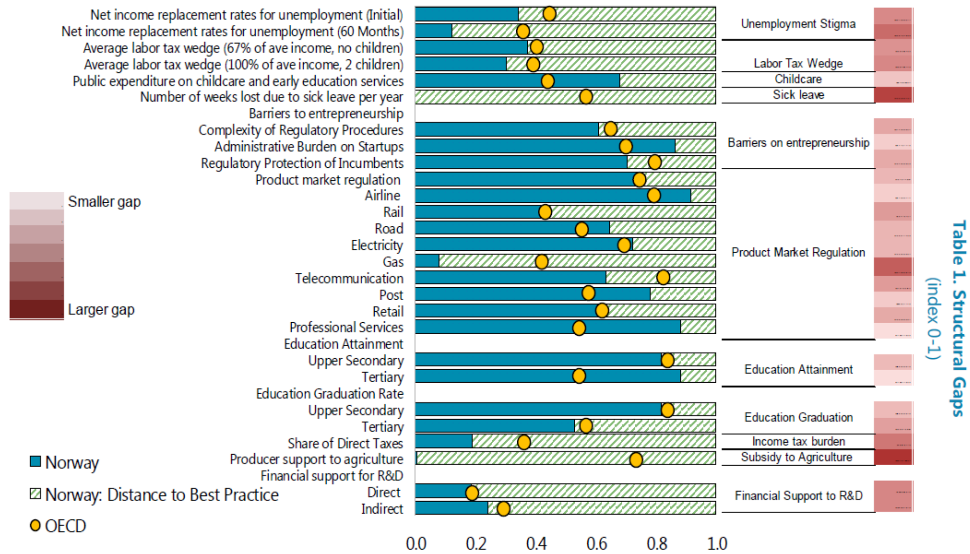
28. ***Also, does staff see a concentration and duration risk related to the holding of Norwegian covered bonds by foreign investors?***

- The use of covered bonds has contributed to lengthening the maturity of banks' wholesale funding, which is positive. Also, the involvement of foreign investors diversifies the banks' funding exposure, though it also increases their exposure to global financial risks. During periods of financial turbulence, covered bonds' market liquidity has typically deteriorated less than that of unsecured bank bonds owing to high collateralization.

Structural Policies

29. ***We would be pleased if staff could share its assessment on the need for further markets deregulation.***

- OECD indicators do not suggest a pressing need for deregulation outside of agriculture (which we note in the report) and the gas sector.



Note: 1/ Gap is calculated as the average of the distance to best practice and the distance to OECD from Norway.
The worst and best practice of each indicator is normalized to 0 and 1 respectively. For example, lowest number of sick leaves or largest financial support for R&D in percent of GDP are considered best practice, which are normalized to 1.
Source: OECD Database, staff calculation

30. ***[we, however, note resistance by the labour unions to effect these changes and wonder if there is sufficient political traction to undertake these far-reaching reforms.] Staff comments are welcome.***

- Staff will respond to this question during the Board meeting.

31. ***Regarding the assessment exercise on SOEs, could staff provide more details?***

- The new white paper in preparation by the Ministry of Trade and Industry will review the ownership rationale SOE by SOE, with a focus on those where non-economic rationales do not argue strongly in favor of state ownership. This review is in preparation and the results are not ready yet.

- Separately, the Ministry has done extensive evaluations comparing the performance of SOEs with private sector comparators along a variety of metrics (for those SOEs with a commercial bent where such comparisons are valid). They have found that SOE performance is on part with private comparators. Staff has not seen the details of the calculations, but the results are *prima facie* not implausible given the very strong governance framework around the SOE sector.

32. ***Could staff elaborate whether there are some non-economic trends behind this high benefit take-up, e.g. health-related ones?***

- There has been an increase in mental health-related benefits, but it is unclear whether this is predominantly reflected by a factual worsening of mental health conditions in Norway or whether it is also significantly affected by the difficulty of diagnosing mental health condition. For these reasons, staff doesn't see benefits in tightening the certification and evaluation process related to sickness and disability benefits.

33. ***Given these favorable circumstances, could staff comment on why productivity growth is low?***

- Trend productivity may be lower than before the crisis, but it is higher than in various other advanced economies including Sweden. In fact, given that Norway has a much higher GDP/capita than most other countries, it is surprising that income growth remains on par or higher than in these peers.

34. ***Could staff comment why the SDB reforms were successful in Finland and Sweden, and what are the differences that may prevent Norway to replicate their success?***

- Staff will respond to this question during the Board meeting.

Other Questions

35. ***Finally, we would be interested as to whether Staff considered using Lapse-of-Time procedures for this Article IV assessment and would encourage them to actively consider this option in future, especially in country cases where economic policy settings are broadly on track.***

- Staff had considered using Lapse-of-Time, but the authorities were keen to have an Executive Board discussion.