# 37. EFTA

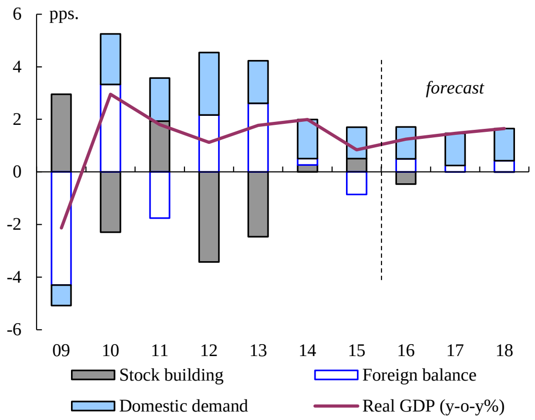
## Improving domestic demand as external vulnerabilities remain

*Economic growth among the EFTA countries remains positive, although to slightly varying degrees: Switzerland's economy is expected to undergo a modest rebound already in 2016; while continued drags from Norway's energy sector will delay recovery until next year; and, growth in Iceland remains robust and supported by tourism but also a rapid expansion in domestic demand. Vulnerabilities (exchange rate, crude oil prices) are largely external and will remain pronounced in the near term.*

### Switzerland

Switzerland's economy continues to improve in 2016 (GDP growth of 0.3% (q-o-q) in Q1 and 0.6% (q-o-q) in Q2) as both domestic and external demand support growth. The labour market's stagnation resulted in flat private consumption during the first half of this year, with this being mitigated by increasing public expenditures and fixed investment in transport equipment. With respect to trade, commodity trade and robust pharmaceutical exports have offset weakness among other core goods (watches, precision tools, machinery). Growth is expected to moderate in the second half of 2016 in line with a somewhat weaker outlook in the EU, with full year growth forecast to come in at 1.2%. In future years, growth is forecast to accelerate to 1.5% and 1.7% in 2017 and 2018, respectively, similarly driven by domestic and external demand.

*Graph II.37.1:* **Switzerland - Real GDP growth and contributions**




After falling to -1.1% in 2015 following the Swiss National Bank's (SNB) decision to abandon the exchange rate ceiling with the euro, inflation is forecast to increase slightly in 2016 (to -0.4%). Further improvement in growth prospects should generate positive price growth once again by 2018, although it is likely to remain below the SNB's official target of 2%. With respect to fiscal policy, public consumption growth in the first half of 2016 is expected to result in a minor budget deficit (0.4% of GDP) in 2016. It is anticipated that this will be gradually reduced during the forecast horizon before posting a modest surplus (0.2% of GDP) once again in 2018.

The slight increase (0.1 pps.) in the unemployment rate to 4.6% in 2015 is likely to broadly persist throughout 2016 and 2017. However, in line with improving growth prospects from 2016 onwards, the unemployment rate will fall towards the 4.0% level as employment growth picks up marginally in future years.

The current environment of low interest rates should support private consumption and investment in construction. However, as profit margins among Swiss firms remain somewhat weak, equipment investment is set to remain muted in 2017, before recovering in 2018.

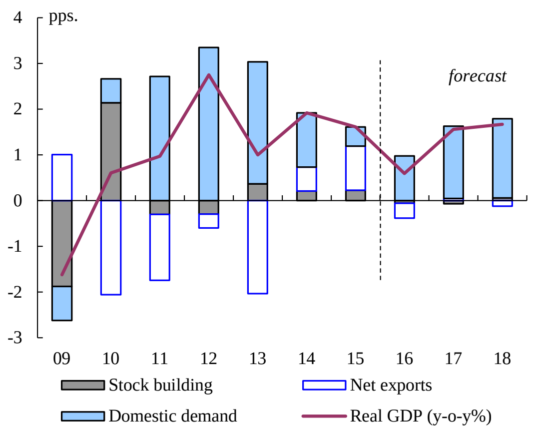
A more comprehensive recovery of exports (including machinery, electrical and metal industries) as well as tourism is forecast to be gradual, accelerating in 2018 in line with the fading effects of past exchange rate appreciation and a recovery in global trade. Nevertheless, the economy remains vulnerable to possible renewed volatility in financial markets, which once again could trigger safe-haven capital inflows and put upward pressure on the exchange rate.

Risks are tilted to the downside and relate to the uncertainty over the future of Switzerland's relations with the EU and a possible resurgence of global financial market volatility. The latter could spill over to the real estate market, where house prices are elevated and banks are exposed to mortgage lending.

### Norway

Norway's economy has continued to slow during 2016 (GDP growth of 1.0% (q-o-q) in Q1 followed by 0.0% (q-o-q) in Q2) due largely to declining fixed investment in the energy sector and weak exports. Other domestic demand components have remained broadly stable due to a supportive macroeconomic policy mix offsetting a weaker labour market. Going forward, the economy is expected to continue its reallocation of factors towards non-energy related sectors while being supported by fiscal stimulus measures (amounting to 0.3% of GDP) in 2017. It is anticipated that stimulus will wane slightly from 2018 onwards as the labour market improves, fixed investment accelerates and export growth picks up. Overall, GDP growth has been revised down to 0.7% in 2016 (from 1.6% in 2015) and is expected to accelerate modestly to 1.6% in 2017 as current drags begin to dissipate, and to be sustained at 1.7% in 2018.

*Graph II.37.2:* **Norway - Real GDP growth and contributions**




The macroeconomic policy mix continues to provide considerable impetus to growth, with interest rates remaining at historic lows (0.5%) and the government leaning on extra-budgetary funds. The space for further monetary policy easing in the near term appears constrained by consumer price inflation which is running above Norges Bank's 2.5% target. However, provisional budget plans for 2017 anticipate that the structural non-oil balance will deteriorate by an additional -0.3 pps. (to -6.4% of GDP). The headline fiscal balance will remain positive at over 3% of GDP in 2017. Fiscal stimulus is expected to ease from 2018 onwards as output begins converging towards potential.

The labour market's deterioration is forecast to subside during 2016, with expanding output in non-energy related sectors and stimulus measures boosting employment growth from 2017 onwards. However, growth rates will remain relatively subdued given the economy's broader adjustment to lower oil prices and the reallocation of factors which this requires. In addition, corresponding with the Norwegian krone's (NOK) depreciation since 2014, higher import prices and inflation have implied weak real wage growth. These dynamics are expected to persist as inflation declines only gradually during the forecast horizon. As such, private consumption growth will remain broadly steady at around 2%, notwithstanding the modest boost which increasing household wealth (driven by accelerating house prices) may provide.

Following further contraction this year, the drag from declining fixed investment in the energy sector is set to fully dissipate in 2017. A modest improvement in the domestic economy and low interest rates should support business investment in non-energy sectors. Added to this, increasing residential investment by households should see total fixed investment turn positive in 2017 following three consecutive years of contraction, before accelerating further in 2018.

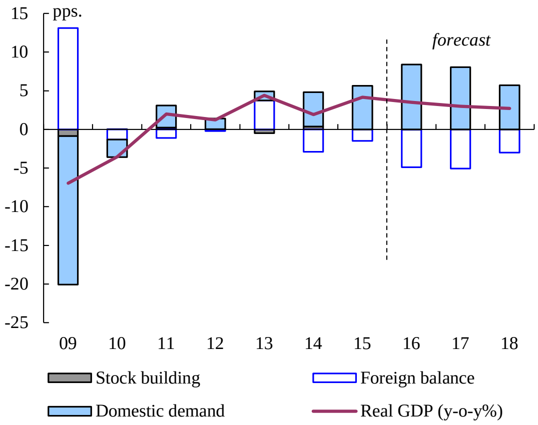
With respect to the external sector, weak import demand among Norway's key trading partners has imposed a substantial drag on growth so far in 2016. Exports are expected to recover in future years, although this is subject to uncertainties arising from future trajectory of oil prices given their pass-through to the NOK.

Risks are largely external (e.g. crude oil prices), but high household debt levels would have impacts on private consumption in the event of an asset price correction or an interest rate spike.

## Iceland

GDP growth in Iceland remained close to 4% during the first half of 2016, driven mainly by private consumption and investment, with tourism-related construction particularly strong. Fixed investment increased by 23% (y-o-y); while private consumption grew by 7.7%, reflecting high wage growth and low inflation. The labour market has also remained strong, with the unemployment rate (3.6%) falling well-below pre-crisis levels as jobs growth remained robust. During the forecasting period, key drivers of growth should continue to be strong private consumption, benefitting from low prices, continued employment growth and high wage agreements that were concluded in 2015. Investment is also expected to remain strong, particularly in the fishing industry and silicon-related projects, as well as further construction in the tourism sector. These drivers should moderate over the forecast horizon; while stronger domestic demand should lead to a widening of the trade deficit. The high import content of investment and private consumption has already resulted in a worsening of Iceland's trade balance, increasing the deficit to 7.1% of GDP by mid-2016.

*Graph II.37.3:* **Iceland - Real GDP growth and contributions**




A strong exchange rate (appreciating by 11% since end-2015) and low import prices have helped to keep inflation low (1.7% in the first eight months of 2016). Inflation is likely to rise, reflecting the lagged effects of high wage agreements which were finalised in 2015, but also due to strong demand from tourism. Wage agreements may dampen employment growth in the near term; although this may be offset by increased labour supply. This will increasingly have to come from abroad as domestic employment rates are already high, resulting in the unemployment rate falling at a moderate pace.

Following a small budget deficit last year, fiscal accounts for the first half of 2016 have recorded a surplus of some 16% of estimated end-year GDP. This has resulted from a one-off windfall gain due to the lifting of capital controls, and current plans are for this revenue to be used largely for debt reduction. If those funds are used primarily for lowering the debt burden, the debt ratio could drop well below 60% of GDP by end-2016, and below 45% of GDP by end-2018. The general government is likely to maintain largely balanced public sector accounts during the remainder of the forecasting period.

On 11 October, the parliament adopted new legislation to liberalise the capital account regime, taking effect from 1 January 2016. This has a positive effect on the country's medium-term outlook and safety clauses should prevent sudden swings in capital flows. However, there are risks that persistent capital inflows could further increase the upward pressure on Iceland's currency, further eroding the country's international price competitiveness.

*Table II.37.1:*

**Main features of country forecast - EFTA**

| | Iceland | | | | Norway | | | | Switzerland | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| (Annual percentage change) | 2015 | 2016 | 2017 | 2018 | 2015 | 2016 | 2017 | 2018 | 2015 | 2016 | 2017 | 2018 |
| GDP | 4.2 | 4.0 | 3.5 | 2.7 | 1.6 | 0.7 | 1.6 | 1.7 | 0.8 | 1.2 | 1.5 | 1.7 |
| Private Consumption | 4.3 | 7.3 | 5.0 | 4.0 | 2.1 | 1.9 | 1.8 | 2.1 | 1.1 | 1.0 | 1.3 | 1.4 |
| Public Consumption | 1.0 | 0.8 | 1.2 | 1.4 | 2.1 | 2.1 | 2.1 | 2.0 | 2.2 | 1.7 | 1.5 | 1.1 |
| Gross fixed capital formation | 18.3 | 20.0 | 8.0 | 5.0 | -3.8 | -1.4 | 1.3 | 1.8 | 1.6 | 2.0 | 1.4 | 1.8 |
| of which: equipment | : | : | : | : | -0.4 | 1.1 | 0.6 | 0.9 | 1.6 | 2.3 | 0.2 | 2.0 |
| Exports (good and services) | 9.2 | 6.6 | 4.5 | 4.5 | 3.7 | -0.6 | 2.4 | 2.1 | 2.3 | 3.7 | 3.2 | 3.7 |
| Imports (goods and services) | 13.5 | 15.6 | 7.2 | 6.8 | 1.6 | 0.1 | 2.5 | 2.9 | 4.5 | 3.6 | 3.4 | 3.9 |
| GNI (GDP deflator) | 5.0 | 4.5 | 3.6 | 2.7 | 1.6 | 0.7 | 1.6 | 1.7 | 0.8 | 1.2 | 1.5 | 1.7 |
| Contribution to GDP growth: Domestic demand | 5.6 | 7.6 | 4.6 | 3.5 | 0.4 | 1.0 | 1.6 | 1.8 | 1.2 | 1.2 | 1.2 | 1.3 |
| Inventories | 0.0 | 0.1 | 0.0 | 0.0 | 0.2 | -0.1 | -0.1 | 0.0 | 0.5 | -0.5 | 0.0 | 0.0 |
| Net exports | -1.5 | -3.6 | -1.1 | -0.9 | 1.0 | -0.3 | 0.0 | -0.2 | -0.9 | 0.5 | 0.2 | 0.4 |
| Employment | 3.4 | 2.8 | 2.5 | 2.0 | 0.3 | 0.0 | 0.6 | 1.0 | 1.5 | 0.1 | 0.4 | 0.7 |
| Unemployment rate (a) | 4.2 | 3.4 | 3.0 | 2.7 | 4.2 | 4.7 | 4.3 | 4.0 | 4.6 | 4.6 | 4.5 | 4.0 |
| Compensation of employee/head | 5.5 | 8.0 | 6.0 | 4.0 | 2.7 | 2.5 | 3.2 | 3.6 | -2.9 | -1.2 | 0.5 | 0.7 |
| Unit labour cost whole economy | 4.7 | 6.7 | 5.0 | 3.3 | 1.3 | 1.8 | 2.2 | 2.8 | -2.2 | -2.3 | -0.5 | -0.3 |
| Real unit labour cost | -1.1 | 3.6 | 1.1 | -1.5 | 3.7 | 0.0 | -1.2 | 0.2 | -1.7 | -1.6 | -0.5 | -0.6 |
| Saving rate of households (b) | : | : | : | : | 14.2 | 14.4 | 14.5 | 13.7 | 22.0 | 21.5 | 21.5 | 21.7 |
| GDP deflator | 5.9 | 3.0 | 3.8 | 4.8 | -2.3 | 1.8 | 3.4 | 2.6 | -0.6 | -0.7 | 0.0 | 0.3 |
| Harmonised index of consumer prices | 0.3 | 1.7 | 2.2 | 3.3 | 2.0 | 3.5 | 3.0 | 2.6 | -0.8 | -0.4 | 0.0 | 0.2 |
| Terms of trade goods | 10.6 | 0.7 | 0.3 | -0.1 | -15.5 | -5.7 | 2.0 | -0.4 | 1.2 | 0.1 | 0.0 | 0.0 |
| Trade balance (goods) (c) | -1.6 | -4.7 | -5.0 | -5.8 | 6.6 | 5.0 | 5.4 | 5.2 | 8.0 | 8.3 | 8.3 | 8.5 |
| Current account balance (c) | 5.1 | 2.4 | 1.2 | 0.2 | 4.7 | 3.1 | 3.6 | 3.2 | 12.3 | 12.4 | 12.6 | 12.9 |
| Net lending (+) or borrowing (-) vis-a-vis ROW | 5.0 | 2.4 | 1.2 | 0.1 | 4.7 | 3.1 | 3.5 | 3.2 | 11.6 | 11.7 | 11.9 | 12.3 |
| General government balance (c) | -0.8 | 1.2 | 0.5 | 0.0 | 6.4 | 4.1 | 3.4 | 3.7 | -0.6 | -0.4 | 0.0 | 0.2 |
| General government gross debt (c) | 66.0 | 52.5 | 48.0 | 44.0 | 31.8 | 31.9 | 31.8 | 30.0 | 35.3 | 35.4 | 34.9 | 34.0 |

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP.