

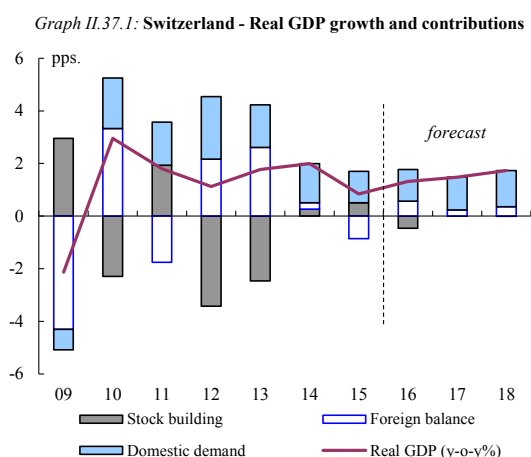
37. EFTA

Solid domestic demand continues to offset external fragilities

Growth prospects remain positive among EFTA countries and appear to be slowly moving towards solid trajectories in the forecast's outer year: Switzerland and Norway, following earlier slowdowns, are beginning to recover modestly; while growth in Iceland is robust but set to moderate slightly.

Switzerland

The Swiss economy continued on its recovery path during 2016, with GDP growth picking-up following deceleration in 2015. Growth has mainly been led by robust government consumption and foreign trade, where the largest gains came from chemical and pharmaceutical exports. Despite ample liquidity, private investment has remained subdued and increases in gross fixed capital formation have been dominated by public investment in transport equipment and civil engineering construction. Stagnation in the labour market contributed to lacklustre private consumption growth. Economic growth decelerated again during the second half of 2016 following the exceptionally strong 2016-Q2 GDP reading of 0.6% q-o-q (which was driven by increases in public spending). Growth stagnated at 0.0% q-o-q in 2016-Q3 on the back of negative net exports and contracting government consumption.



Going forward, a moderate pace of expansion is projected to continue into 2017 and 2018, supported by domestic demand and foreign trade. More specifically, the labour market's recovery and immigration-led population growth are set to support private consumption. Due to squeezed profit margins of Swiss firms, equipment investment is set to remain muted in 2017 before bottoming-out in 2018.

Strong performance of pharmaceuticals together with weak growth of other core goods (watches, machinery, precision tools) suggests an uneven adjustment across Swiss exporters to past currency appreciation (due to Swiss National Bank's 2015 decision to abandon the exchange rate ceiling with the euro). A gradual recovery of exports across a more comprehensive set of sectors including tourism, mechanical engineering and metal industries, is forecast for 2018.

Consumer prices fell by 0.2% (y-o-y) in 2016-Q3, with the largest negative contribution coming from import prices (oil products in particular), while the prices of domestic goods and services seem to be approaching the end of the deflationary phase. In line with recovering oil prices, inflation is forecast to become slightly positive in 2017 and 2018.

The outlook for the labour market remains roughly unchanged from the autumn forecast. In line with accelerating GDP, employment growth is projected to strengthen, with the unemployment rate falling to 4% by 2018.

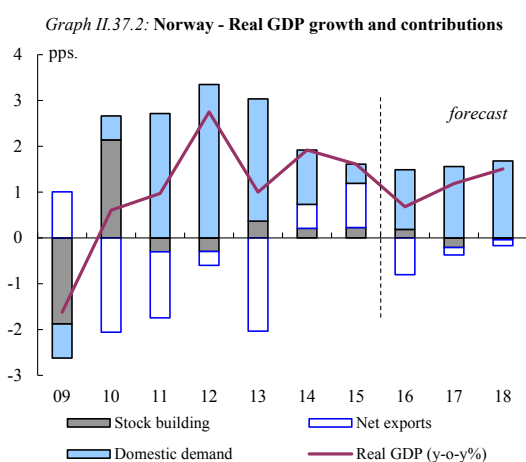
Strong public consumption growth is likely to result in a small budget deficit (-0.2% of GDP) in 2016. However, it is forecast that the budget will gradually return to surplus (driven by pension reform, VAT rate increases and more restrictive spending due to the 2017 referendum on lower corporate taxes) in line with Switzerland's fiscal rule which requires budget overruns be made up by structural surpluses in subsequent years.

The Swiss 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. Extensive integration with global value chains also implies significant risks arising from external political uncertainties and rising protectionism.

Norway

Norway's economy continued to slow throughout 2016, with GDP growth contracting by -0.5% (q-o-q) in 2016-Q3 (following 0.0% q-o-q in

2016-Q2) amid the ongoing decline in fixed investment in the oil and gas sector and weak external demand weighing on exports. The slowdown is, however, expected to have bottomed-out in 2016, largely due to earlier drags on growth (energy sector, exports) beginning to dissipate. The authorities' provision of stimulus measures in order to offset the economy's slowdown will continue to provide modest support to growth, although further easing is not anticipated as the domestic economy begins to gain momentum. On the external side, export growth is anticipated to be lower than previously forecast as the Norwegian krone's (NOK) recent appreciation will weigh on demand, while simultaneously providing for solid import growth. Overall, GDP growth is expected to come in at 0.7% in 2016, before picking-up to 1.2% and 1.5% in 2017 and 2018, respectively.



The macroeconomic policy mix has so far been responsive to the slowdown, with fiscal stimulus measures (tax cuts, labour market activation programmes) being deployed. However, these measures are set to be scaled back in the near term as domestic demand recovers, resulting in a minor moderation of public consumption growth from 2017 onwards. On the monetary policy side, Norges Bank's key policy rate was already lowered to 0.5% in early 2016 and upward pressure on inflation dynamics had prevented further easing since then. There has been a sustained decline in core inflation towards Norges bank's 2.5% target (helped in part by NOK appreciation) over more recent months. However, growing concerns regarding robust house price growth and consumer debt levels are likely to limit the space for additional easing going forward.

Against the backdrop of policy stimulus being slowed, the economy continues to adjust to the

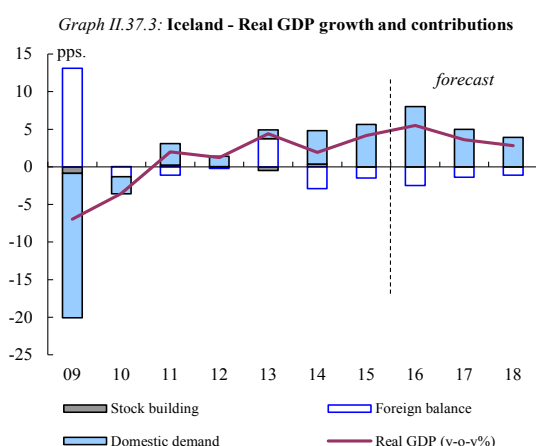
current environment of lower oil prices and the reallocation of factors this requires. Nonetheless, after contracting at double-digit rates during the past two years, the decline in energy-related investment is set to moderate substantially in 2017 as oil prices stabilise. In other sectors, investment remains relatively strong, with robust house price growth supporting residential investment and the recent surge in public fixed investment (to 7.5% q-o-q in 2016-Q3) having material carryover impacts on 2017 also.

The labour market has also undergone a period of adjustment and its recovery in the near term is expected to be gradual due to the relatively subdued prospects for domestic demand over the forecast horizon. The unemployment rate is projected to fall slowly towards 4% by end-2018, while gains in real wages are also set to remain muted. Private consumption is therefore projected to grow at around 1½-2%, supported by a return to modest employment growth and earlier tax cuts. The NOK's appreciation over recent months should contribute to solid import demand.

External risks to the outlook include the future trajectory of oil prices (given their impact on fixed investment), as well as the political uncertainties surrounding the Brexit process going forward given the economy's high exposure to UK trade channels. The housing market is the principal domestic risk facing the economy, with the recent extension of macroprudential measures reflective of growing concerns regarding a correction.

Iceland

GDP growth in Iceland accelerated above 6% during the first nine months of 2016, driven mainly by private consumption (benefitting from rising real wages) and tourism-related construction pushing up fixed investment. The labour market has remained strong, with robust job growth contributing to the unemployment rate (at 3%) falling well-below pre-crisis levels and wage growth remaining elevated. During the forecast period, private consumption is expected to remain a key driver of growth as it benefits from low inflation, 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; while further construction in the tourism sector is also expected to proceed.



The high import content of investment and private consumption goods has already resulted in a worsening of Iceland's goods trade balance, increasing the deficit to 4.3% of GDP in 2016 before deteriorating further in future years.

A strong exchange rate (appreciating by 16% in 2016) and low import prices have helped to keep inflation low (1.7% throughout 2016). Going forward, inflation is likely to rise, reflecting the lagged effects of high wage agreements and strong demand from tourism sectors also. Wage agreements may dampen employment demand in the near term; while increasing 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.

Fiscal accounts for the first nine months 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. The funds will likely be used for lowering the debt burden, so the debt ratio could drop sharply in the coming years. The downward trend in the debt to GDP ratio is expected to continue as the general government is likely to maintain largely balanced public sector accounts while nominal GDP is expected to increase further.

While growth is expected to remain robust, the economy is showing signs of overheating (rising wages, limited labour supply, rises in house prices) Strong domestic demand and further currency appreciation should lead to a widening of the trade deficit. From 1 January 2017 a new, more liberal capital account regime is in place, facilitating free in-and-out capital flows. This has a positive effect on the country's medium-term outlook and safety clauses should prevent sudden adverse swings. However, there are risks that persistent capital inflows could place further upward on Iceland's currency, further eroding the country's international price competitiveness.

Table II.37.1:

Main features of country forecast - EFTA

(Annual percentage change)	Iceland				Norway				Switzerland			
	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018
GDP	4.2	5.5	4.2	2.5	1.6	0.7	1.2	1.5	0.8	1.3	1.5	1.7
Private Consumption	4.3	6.3	5.4	4.2	2.1	1.5	1.7	1.8	1.1	0.9	1.3	1.4
Public Consumption	1.0	1.5	1.7	1.8	2.1	2.2	1.9	1.9	2.2	2.1	2.0	1.7
Gross fixed capital formation	18.3	24.0	8.0	5.3	-3.8	0.6	1.5	1.8	1.6	2.0	1.4	1.8
of which: equipment	-	-	-	-	-0.4	-0.2	1.0	2.0	1.6	2.3	0.2	2.0
Exports (good and services)	9.2	10.0	4.5	4.5	3.7	-1.3	1.7	1.9	2.3	3.7	3.2	3.6
Imports (goods and services)	13.5	17.1	6.6	7.8	1.6	1.0	2.4	2.5	4.5	3.5	3.4	3.8
GNI (GDP deflator)	5.0	6.0	4.3	2.6	2.9	-0.8	0.8	1.1	2.2	1.3	1.5	1.7
Contribution to GDP growth: Domestic demand	5.6	8.0	4.9	3.8	0.4	1.3	1.5	1.7	1.2	1.2	1.2	1.4
Inventories	0.0	0.0	0.0	0.0	0.2	0.2	-0.2	0.0	0.5	-0.5	0.0	0.0
Net exports	-1.5	-2.5	-0.7	-1.2	1.0	-0.8	-0.2	-0.1	-0.9	0.6	0.2	0.4
Employment	3.4	3.8	3.0	1.9	0.3	0.2	0.4	0.9	1.5	0.1	0.4	0.6
Unemployment rate (a)	4.2	3.0	2.5	2.6	4.2	4.8	4.5	4.2	4.6	4.6	4.5	4.1
Compensation of employee/head	5.5	8.4	6.1	4.0	2.7	2.4	2.5	2.7	-0.9	-1.1	0.1	0.5
Unit labour cost whole economy	4.7	6.7	4.9	3.4	1.3	1.9	1.7	2.1	-0.2	-2.3	-0.9	-0.7
Real unit labour cost	-1.1	4.5	1.1	-1.3	3.7	0.9	-0.6	-0.4	0.4	-1.6	-1.1	-1.0
Saving rate of households (b)	:	:	:	:	15.9	17.0	15.7	14.8	22.5	22.1	22.1	22.2
GDP deflator	5.9	2.1	3.7	4.8	-2.3	1.0	2.3	2.4	-0.6	-0.7	0.1	0.3
Harmonised index of consumer prices	0.0	0.8	2.4	3.2	2.0	3.6	2.6	2.3	-0.8	-0.4	0.1	0.2
Terms of trade goods	10.6	-2.4	0.5	-0.1	-15.5	-0.8	0.5	0.6	1.2	0.1	-0.1	0.0
Trade balance (goods) (c)	-1.6	-6.5	-6.1	-7.1	6.6	6.2	6.0	6.1	8.0	8.3	8.4	8.6
Current account balance (c)	5.1	2.6	1.7	0.3	8.7	6.3	5.8	5.4	11.7	11.8	11.9	12.3
Net lending (+) or borrowing (-) vis-a-vis ROW	5.0	2.6	1.7	0.3	8.6	6.2	5.7	5.4	9.5	10.9	11.0	11.4
General government balance (c)	-0.8	15.0	0.8	0.3	6.4	4.6	4.4	4.7	-0.2	-0.2	0.1	0.2
General government gross debt (c)	66.0	38.4	34.5	31.2	31.8	31.7	31.1	28.4	35.3	35.2	34.6	33.7

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