

37. EFTA

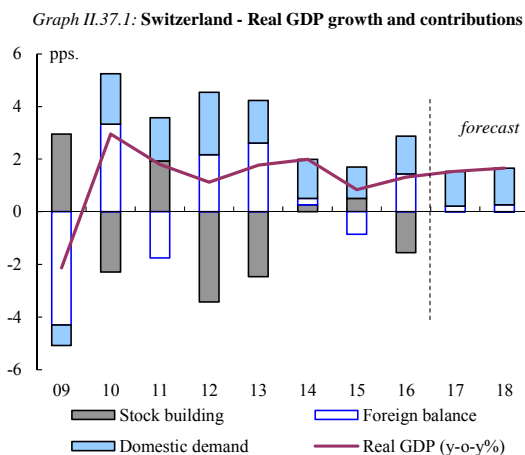
Growth underpinned by solid domestic demand

Growth prospects in Switzerland and Norway are converging towards relatively modest levels of around 1.5% over the course of the forecast horizon, with growth largely stemming from solid domestic demand. In Iceland, meanwhile, growth prospects remain robust but are expected to moderate somewhat from the exceptionally high levels experienced over recent years.

Switzerland

Due to weak economic activity in the second half of the year, full-year GDP growth came in at 1.3% in 2016. Growth was driven by the exceptionally strong performance of exports (4.5%), government consumption (1.9%) and investment in transport equipment (4.1%). However, despite the temporary fillip to disposable income stemming from negative inflation, private consumption remained sluggish at 1.2% due to stagnation in the labour market. Gross fixed capital formation expanded by 2.4%, mainly due to the commencement of previously planned public investment projects.

A moderate expansion is projected over the course of 2017 and 2018. Domestic demand is set to support growth over the forecast horizon on the back of a recovering labour market and immigration-led population growth, while wage growth remains weak. In the first quarter of 2017 consumers and business confidence indicators were optimistic with the strongest positive contributions coming from construction, private consumption and financial services. Fixed investment growth is set to normalise to 1.7% in 2017 and rise to 2.0% in 2018 supported by both construction and equipment investment.



The exceptional performance of Swiss exports in 2016 was driven by strong growth in chemical and pharmaceutical industries which are set to continue underpinning growth over the forecast period. Export recovery across other industries such as metals, precision tools, watches and jewellery is likely to proceed more gradually as activity picks up across advanced economies (especially in the EU) and emerging markets.

In 2016, Switzerland underwent a second year of negative inflation, driven by low energy prices and slowly fading effects of past currency appreciation. The expected recovery in 2017 is in line with the projected increase of oil prices, but no broad inflationary pressure is projected for 2018.

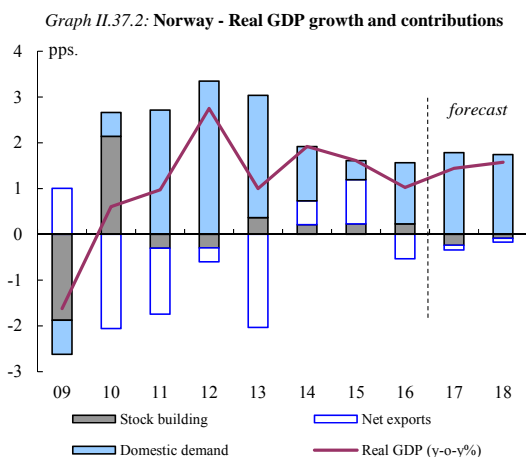
Employment growth is likely to remain moderate and occur mainly in services sectors such as education, social and health care; while internationally exposed sectors will remain under adjustment pressure due to a strong Swiss franc.

Due to windfall tax revenues and negative interest rates, the general government recorded a small fiscal surplus in 2016 as required by Switzerland's fiscal rule. In place since 2003, the "debt brake" rule requires that the federal government budget be in structural balance ex-ante and that any ex-post overruns be made up by running structural surpluses in subsequent years. The agreement on pension reform and partial VAT reform, aiming to expand the tax base, are set to support moderate surpluses during 2017-18.

The Swiss economy remains vulnerable to external political uncertainties which imply risks of safe-haven capital inflows and upward pressure on the exchange rate. Further external risks relate to protectionist trends amid the extensive integration of Swiss exporters into global value chains. Domestic risks stem from a possible slowdown in the construction sector which is now in the process of consolidating.

Norway

Norway's growth outturn for 2016 was better than anticipated, with full-year GDP growth coming in at 1.0%. However, the principal factor behind this positive outturn was a sharp 1.5% (q-o-q) contraction in imports in 2016-Q4 due to lower oil- and shipping-related imports. Elsewhere, domestic demand components and exports performed in line with expectations. As a result, while the outlook and anticipated drivers of growth are largely unchanged from the previous forecast round, the better-than-expected outturn in 2016-Q4 leads to carryover impacts on future years, resulting in upward revisions to GDP growth in 2017 (0.2 pps.) and 2018 (0.1 pps.) compared to the winter 2017 forecast.



The economy has already shown signs of steady recovery from declining oil prices throughout the course of 2016, with energy-related investment turning positive for the first time in three years in 2016-Q4. These dynamics are expected to remain in place over the forecast horizon, as rising oil prices provide support to investment in extraction and related industries; while increased activity is also set to lead to rising investment across other sectors. In addition, the strong performance of the construction sector is expected to be sustained further by robust house price growth.

Labour market conditions are expected to stabilise in 2017 in line with rising output, with this providing some minor support to private consumption. Real wage growth, which contracted in 2016 due to higher inflation resulting from the Norwegian krone's (NOK) depreciation and lower wage agreements, is forecast to turn positive again over the forecast horizon due to an expected moderation in inflation.

Concerning the macroeconomic policy mix, core inflation has already fallen below Norge's Banks 2.5% target. However, no further reductions in interest rates are expected at this stage due to continued concerns regarding monetary policy's interplay with house price increases. Fiscal policy, which so far has been proactive in offsetting the current slowdown, is expected to play a less supportive role going forward as the economy gradually recovers. Recent legislation to limit spending of the sovereign wealth fund to 3% of GDP annually further supports the expectation that fiscal stimulus will become a less important driver of growth, with public consumption growth moderating as a result.

External demand is forecast to recover in line with improving growth prospects among key trading partners. However, the recovery in domestic demand and a stabilising currency is expected to place upward pressure on imports, resulting in a negative net contribution from net exports throughout the forecast horizon.

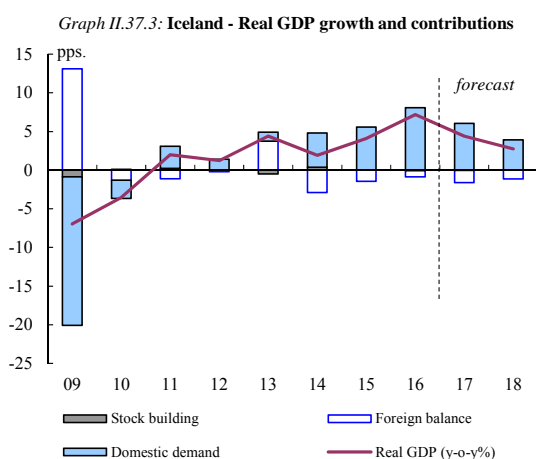
The principal domestic risk to the outlook remains the housing market and the potential for correction following an extended period of elevated house price growth and already-high high debt levels among Norwegian households. On the external side, the potential for lower exports due to political uncertainties (including those related to the UK's withdrawal from the EU) remains pronounced.

Iceland

Real GDP growth in Iceland accelerated to 7.2% in 2016, with the principal impetus coming from investment (22.7% y-o-y) and private consumption (6.9% y-o-y). These dynamics were underpinned by higher wages, a strong tourist season and a corresponding pick-up in tourism-related construction expenditure. Strong employment growth also contributed to a substantial rise in the import of foreign labour, while the unemployment rate (3.1%) fell further towards pre-crisis levels.

Following the exceptional performance in 2016, GDP growth should moderate in the remainder of the forecast period. Private consumption is expected to remain the key driver of growth due to further wage increases resulting from wage agreements concluded in 2015, as well as lower than expected inflation. Continued employment growth and strong demand generated by tourism are expected to provide further support.

Investment is set to moderate as its composition shifts from the large fishing industry and silicon-related projects towards construction of new residential and tourism capacities. Due to stronger domestic demand, Iceland's goods trade deficit increased to 4.2% of GDP in 2016 and is expected to widen further over the coming period.



Despite the nearly full liberalisation of capital flows in early 2017, the expected depreciation of the exchange rate (following an appreciation by 16% in 2016) has not materialised so far, thus contributing to lower import prices and overall inflation (1.8% in 2017-Q1). Nonetheless, inflation is forecast to rise on the back of rising wages and

tourism demand. Monetary policy will likely remain tight to ensure medium-term price stability. Labour supply will continue to rely on foreign workers, particularly as domestic employment rates are already high.

The government's fiscal surplus amounted to 17.2% of GDP in 2017, resulting from a tax imposed on all withdrawn financial claims following the lifting of capital controls. This revenue was largely used for debt reduction and produced a 21 pps. fall in the public debt-to-GDP ratio. This downward trend is expected to continue as the general government is likely to maintain largely balanced public sector accounts while nominal GDP increases further. New one-off revenue gains due to privatisation of currently state-owned banks could contribute to faster debt reduction than currently forecast.

The economy is showing signs of overheating (rising wages, limited labour supply, rising house prices) and this could present challenges over the near- and medium-term. In addition, large capital inflows to the financial sector could increase the sector's volatility due to sudden swings in capital flows. Upside risks include the potentially favourable impacts on the medium-term outlook from the new, more liberal capital account regime.

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	4.1	7.2	4.4	2.8	1.6	1.0	1.4	1.6	0.8	1.3	1.5	1.7
Private Consumption	4.3	6.9	5.9	4.3	2.1	1.6	1.7	1.8	1.1	1.2	1.3	1.4
Public Consumption	1.0	1.5	1.2	1.3	2.1	2.3	1.7	1.5	2.2	1.9	1.7	1.5
Gross fixed capital formation	17.8	22.7	13.6	6.4	-3.8	0.5	2.5	2.3	1.6	2.4	1.7	2.0
of which: equipment	-	-	-	-	-0.4	3.0	1.9	2.4	1.6	4.1	0.8	2.5
Exports (good and services)	9.2	11.1	5.7	4.4	3.7	-1.2	1.3	2.0	2.3	4.5	2.4	3.4
Imports (goods and services)	13.5	14.7	10.3	7.8	1.6	0.3	1.7	2.3	4.5	2.7	2.6	3.8
GNI (GDP deflator)	5.4	10.0	4.4	2.8	2.9	1.4	1.2	1.4	2.2	1.3	1.5	1.7
Contribution to GDP growth: Domestic demand	5.6	8.1	6.0	3.9	0.4	1.3	1.8	1.7	1.2	1.4	1.3	1.4
Inventories	0.0	-0.1	0.0	0.0	0.2	0.2	-0.2	-0.1	0.5	-1.6	0.0	0.0
Net exports	-1.5	-0.8	-1.6	-1.2	1.0	-0.5	-0.1	-0.1	-0.9	1.4	0.2	0.3
Employment	3.4	3.8	2.1	2.0	0.3	-0.1	0.3	0.8	1.5	0.1	0.3	0.5
Unemployment rate (a)	4.2	3.1	3.0	3.1	4.2	4.6	4.0	3.6	4.6	4.6	4.5	4.3
Compensation of employee/head	6.1	7.9	9.5	4.3	2.7	1.7	2.1	2.4	-0.9	0.5	0.5	0.4
Unit labour cost whole economy	5.4	4.4	7.1	3.5	1.3	0.6	1.0	1.6	-0.2	-0.8	-0.8	-0.7
Real unit labour cost	-0.6	2.4	3.2	-1.3	3.7	1.8	-1.0	-0.3	0.4	-0.2	-1.1	-1.0
Saving rate of households (b)	:	:	:	:	15.9	16.1	13.8	12.8	24.4	23.9	23.7	23.8
GDP deflator	6.0	2.0	3.8	4.9	-2.3	-1.2	1.9	1.9	-0.6	-0.6	0.3	0.3
Harmonised index of consumer prices	0.0	0.8	2.6	3.3	2.0	3.9	2.1	2.0	-0.8	-0.5	0.3	0.2
Terms of trade goods	10.6	-2.4	0.5	-0.1	-15.5	-11.9	0.4	0.3	1.2	0.1	-0.1	0.0
Trade balance (goods) (c)	-1.6	-4.2	-5.4	-6.3	6.6	3.5	3.6	3.6	8.0	8.7	9.1	9.3
Current account balance (c)	5.5	8.0	5.2	3.9	8.7	4.9	4.6	4.3	11.7	12.7	12.6	12.9
Net lending (+) or borrowing (-) vis-a-vis ROW	5.4	7.9	5.1	3.8	8.6	4.9	4.5	4.2	9.5	11.7	11.7	12.0
General government balance (c)	-0.8	17.2	0.7	0.4	6.0	3.1	3.6	4.0	1.1	0.2	0.4	0.5
General government gross debt (c)	67.3	46.2	41.9	38.5	31.8	32.2	32.5	30.8	35.3	34.8	33.8	32.7

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