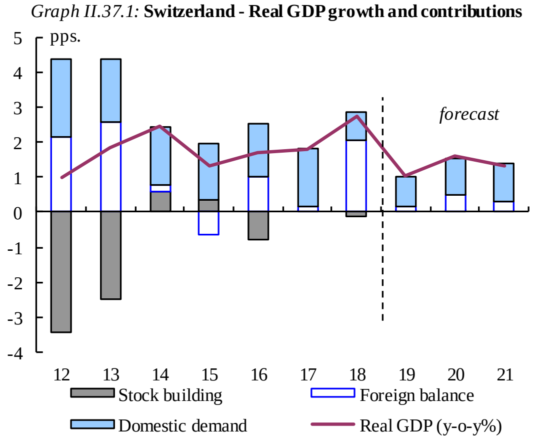
37. EFTA
Resilient growth amidst a deteriorating external environment

Iceland and Switzerland are experiencing a cyclical downturn amid a deteriorating external environment, while Norway benefits from a supply-driven growth acceleration. At this late stage in the cycle, labour markets have tightened and capacity constraints are becoming more binding in Switzerland and Norway, while unemployment has slightly increased in Iceland. External risks remain elevated and are largely on the downside.

Switzerland

Output growth during the first half of 2019 decelerated to 0.6% compared to 3.6% the year before. However, the lower year-on-year growth rate in the first half of 2019 was strongly affected by a base-year effect, related to international sports events in 2018, which are accounted for as Swiss service exports. A less favourable international environment and a recent strengthening of the exchange rate contributed to a weak performance of goods exports, in particular in the machinery and metal industry. Domestic demand remained subdued, reflecting moderate wage growth during the year, weak investment growth in view of the overall uncertain international environment and the end of a construction boom. Inflation remained low, benefitting from low import prices, in particular for energy. Despite weaker output growth in the first half of 2019, employment continued to increase by 0.9% in this period.

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



Going forward, annual real GDP growth is forecast to decelerate to about 1% in 2019, among others reflecting a less benign international environment, the negative effects of a stronger exchange rate on the country's price competitiveness and the base effect from last year's favourable impact of international sports events. In 2020, solid private consumption and the positive impact of the 2020 Olympic games on Swiss service exports should help to bring output growth to around 1½%, despite negative external headwinds. In 2021, domestic demand is expected to remain solid, although the negative base effect from the 2020 service export boom is likely to bring the year-on-year output growth rate down to around 1¼%, which is slightly below the country's trend growth.

Exports are expected to remain an important source of growth, among others benefitting from expanding export markets for pharmaceutical products and chemicals. Private consumption growth is set to remain stable on the back of continued employment growth and low inflationary pressures, which has a positive effect on real disposable income. The growth-supportive monetary stance is expected to remain in place. As underlying domestic price pressures are projected to remain weak, inflation is forecast to accelerate only slightly to around 1¼%, largely reflecting increasing import prices. The underlying solid growth momentum will help to keep public sector accounts close to balance.

Risks to the outlook are primarily on the downside and are mainly related to the external environment. Geopolitical turbulences and renewed volatility in financial markets could lead to safe-haven capital inflows, which could create an upward pressure on the exchange rate. A further downside risk relates to the uncertain global trade outlook.

Norway

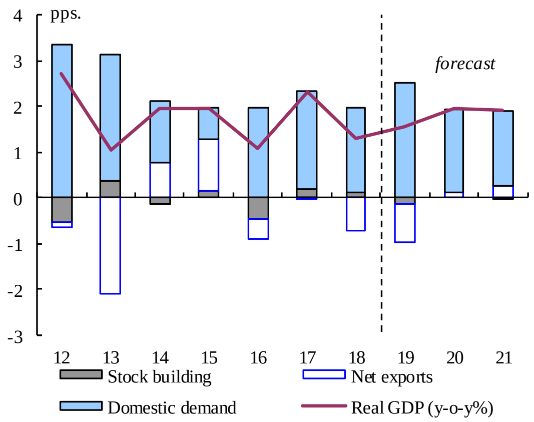
The Norwegian economy is in a moderate cyclical upturn. In the second quarter of 2019, real GDP growth slightly accelerated to 0.3% q-o-q compared to flat growth in the first quarter, mainly on the back of a pickup in domestic demand. This was largely driven by a surge of investment in the extraction and transportation sectors. Despite a tightening labour market and firming wage growth, there was a marginal slowdown in private consumption growth. Net exports continued to subtract from growth mainly due to a fall in exports of traditional goods such as engineering and refined petroleum products.

Robust petroleum-related investment will continue underpinning industrial production this year, while the strong wage growth as well as elevated consumer confidence should support household consumption. Because of robust domestic demand, net exports are set to remain a drag on growth in 2019. Residential investment growth was moderate in the first half of 2019, compared to a contraction the year before. In the same period, house prices have also risen moderately, although a recovery in housing investment will likely be slow due to concurrent headwinds including modest population growth and the ongoing rise in the interest rates.

In 2020, a return to a lower rate of investment growth is expected to be more than offset by higher growth of oil and gas exports as well as continued strong household spending.

Overall, real GDP growth is forecast to accelerate slightly to 1.6% in 2019, up from 1.3% in 2018, and to 1.9% in both 2020 and 2021.

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



Solid economic growth, a weak krone and an underlying inflation persistently above the 2% inflation target (at 2.1% y-o-y in August), triggered Norges Bank's Executive Board decision on 18 September to raise its key policy rate for the fourth time in a year, by 25 basis points to 1.5%.

The economy will receive less support from government spending in 2020 as the budget expects the structural non-oil deficit to narrow. The budget anticipates a fiscal impulse of -0.2% of GDP, resulting in a structural non-oil deficit of 7.6% of mainland GDP and spending of oil revenues equivalent to 2.6% of the sovereign wealth fund's assets (Government Pension Fund Global).

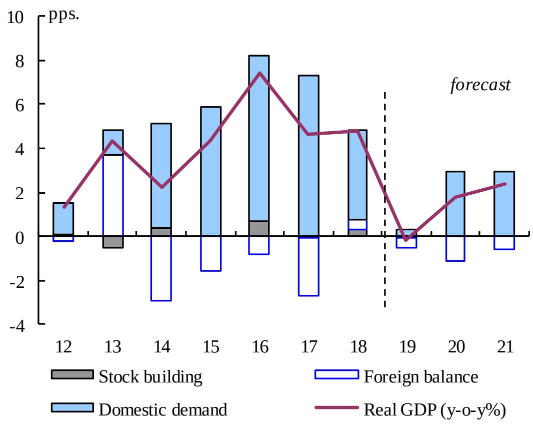
Domestic risks to the outlook mainly stem from the uncertainties in the property market and the historically high household debt levels leaving households vulnerable in the event of interest rates rises or a steep fall in house prices. A sustained increase in the debt burden indicates that financial imbalances have been building up. This is one of the most important vulnerabilities in the Norwegian financial system, which is however mitigated by the significant capital and liquidity buffers held by Norwegian banks. Regarding the external environment, the volatility of energy prices presents upside and downside risks, while a marked deterioration in growth prospects of some of Norway's main trading partners, continue to point to downside risks.

Iceland

After several years of robust growth, Iceland has entered a cyclical downturn. A sharp deceleration of GDP growth in the first quarter (to 1.7% y-o-y) was followed by a contraction of 1.0% in the second. Deteriorating developments in tourism (bankruptcy of domestic airlines, declining number of tourist arrivals) and shrinking business investment are the key factors behind an expected economic contraction of 0.2% in 2019. Further headwinds come from a poor start into the year of fisheries production, which is going to weigh on exports of goods. On the positive side, private consumption resilience and declining imports, partially due to lower investment spending, but also a shift towards domestic production, are growth supportive. Residential investment is projected to remain robust but to decelerate from the expansion recorded in 2017-2018.

The contraction is set to be short-lived with GDP growth turning positive in 2020 and 2021 on the back of recovering business investment and strengthening private consumption. Exports are projected to bottom out in 2020 and accelerate in 2021. Exports are expected to benefit from the increasingly longer tourist stays, which partly compensate a declining number of arrivals in Iceland. Exports of fishery products are set to recover due to high prices and large stocks of cod and assumed currency depreciation. Fiscal policy is shifting to a more growth-supporting stance. In June, the primary surplus target was revised downwards to 1.6% of GDP. The 2020 draft budget envisages tax cuts for low-income earners and increased public investment in infrastructure, education, housing and health.

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



The registered unemployment rate rose to 3.8% in the second quarter while for foreign workers it reached around 7%. The unemployment rate is likely to remain roughly stable in line with the expected short-lived nature of the downturn. The Central Bank cut the key policy rate four times in 2019, bringing it to 3.25% in September. Inflation stood at 3.1% in the third quarter, above the target rate of 2.5%. The latest wage agreement brought substantial rises for low-wage earners, while keeping the overall wage bill growth moderate, which led to a fall in inflation expectations. Going forward, inflation is set to ease in line with a moderately growing economy and decelerating house price inflation, but remain above the target due to depreciating currency and potential pass-through of import prices.

The balance of risks is tilted to the downside. Key external risks stem from trade tensions that would challenge the projected recovery of exports. The main domestic risk relates to wage increases, which could outpace productivity gains and weigh on price competitiveness.

Table II.37.1:

Main features of country forecast - EFTA

	Iceland				Norway				Switzerland			
(Annual percentage change)	**2018**	**2019**	**2020**	**2021**	**2018**	**2019**	**2020**	**2021**	**2018**	**2019**	**2020**	**2021**
GDP	4.8	-0.2	1.8	2.4	1.3	**1.6**	**1.9**	**1.9**	2.8	**1.0**	**1.6**	**1.3**
Private Consumption	4.7	**2.0**	**2.5**	**3.2**	1.9	**1.9**	**2.1**	**2.0**	1.0	**1.1**	**1.2**	**1.2**
Public Consumption	3.5	**2.2**	**2.3**	**2.3**	1.4	**1.8**	**1.6**	**1.6**	0.3	**0.4**	**0.4**	**0.4**
Gross fixed capital formation	4.0	**-5.3**	**5.0**	**3.3**	2.8	**5.3**	**2.2**	**1.6**	1.1	**0.8**	**1.4**	**1.6**
of which: equipment	-	**-**	**-**	**-**	7.8	**4.4**	**2.5**	**3.7**	2.7	**2.1**	**2.5**	**2.4**
Exports (good and services)	1.7	**-2.0**	**1.3**	**2.7**	-0.2	**1.9**	**2.5**	**2.4**	2.9	**2.0**	**2.8**	**2.4**
Imports (goods and services)	0.8	**-1.1**	**3.8**	**4.0**	1.9	**4.8**	**2.6**	**2.0**	-0.3	**2.3**	**2.4**	**2.4**
GNI (GDP deflator)	5.2	**-0.2**	**1.8**	**2.4**	1.3	**1.6**	**1.9**	**1.9**	4.8	**1.0**	**1.6**	**1.3**
Contribution to GDP growth: Domestic demand	4.1	**0.3**	**2.9**	**2.9**	1.9	**2.5**	**1.8**	**1.6**	0.8	**0.9**	**1.0**	**1.1**
Inventories	0.3	**0.0**	**0.0**	**0.0**	0.1	**-0.1**	**0.0**	**0.0**	-0.1	**0.0**	**0.0**	**0.0**
Net exports	0.4	**-0.5**	**-1.1**	**-0.6**	-0.7	**-0.8**	**0.1**	**0.3**	2.1	**0.1**	**0.5**	**0.3**
Employment	2.9	**-0.9**	**0.6**	**1.3**	1.6	**1.3**	**1.1**	**1.0**	0.9	**0.7**	**1.0**	**0.8**
Unemployment rate (a)	2.9	**3.6**	**3.8**	**3.7**	3.8	**3.5**	**3.5**	**3.6**	4.7	**4.6**	**4.8**	**5.0**
Compensation of employee/head	6.4	**3.7**	**3.9**	**3.7**	2.8	**3.3**	**3.4**	**3.4**	1.2	**0.2**	**1.0**	**1.2**
Unit labour cost whole economy	4.5	**3.0**	**2.7**	**2.7**	3.1	**3.0**	**2.5**	**2.5**	-0.6	**-0.1**	**0.4**	**0.6**
Real unit labour cost	1.8	**-1.0**	**-0.7**	**-0.7**	-2.5	**0.2**	**0.2**	**0.2**	-0.9	**-0.6**	**-0.6**	**-0.5**
Saving rate of households (b)	5.7	3.8	3.7	3.8	11.8	**12.4**	**13.2**	**13.9**	:	:	:	:
GDP deflator	2.7	**4.1**	**3.5**	**3.4**	5.8	**2.8**	**2.3**	**2.3**	0.2	**0.5**	**1.0**	**1.1**
Harmonised index of consumer prices	2.7	3.3	2.8	2.7	3.0	**2.3**	**2.0**	**2.0**	0.9	**0.8**	**1.3**	**1.3**
Terms of trade goods	-3.1	**-0.6**	**-0.1**	**-0.1**	12.6	**1.7**	**0.0**	**0.0**	0.3	**0.1**	**0.0**	**-0.1**
Trade balance (goods) (d)	-5.8	**-5.9**	**-6.8**	**-7.2**	7.0	**6.9**	**6.9**	**7.0**	8.6	**9.2**	**9.2**	**9.2**
Current account balance (d)	2.9	**2.5**	**1.3**	**0.6**	8.1	**7.5**	**7.6**	**7.8**	10.5	**10.1**	**10.4**	**10.5**
Net lending (+) or borrowing (-) vis-a-vis ROW	2.9	**2.5**	**1.2**	**0.6**	8.0	**7.5**	**7.5**	**7.7**	11.2	**9.3**	**9.6**	**9.7**
General government balance (d)	1.1	**0.9**	**0.4**	**0.6**	8.1	**8.4**	**8.5**	**8.6**	1.4	**0.0**	**0.0**	**0.0**
General government gross debt (d)	40.4	**39.0**	**37.7**	**37.0**	39.3	**36.7**	**33.8**	**30.7**	31.2	**30.8**	**30.0**	**29.3**

(a) as % of total labour force. (b) gross saving divided by adjustd gross disposable income. (c) for Iceland national consumer price index.
(d)as a % of GDP.