ASI ECONOMIC OUTLOOK

GROWTH FORECAST 2017-2019




Iceland Confederation of Labour

OCTOBER 2017

Highlights

ASI Economic Outlook

Annual changes	*bn. ISK* 2016	2016	*Projections* 2017	2018	2019
Household Consumption	1.211,7	7,1	7,5	5,5	3,2
Government Consumption	557,2	1,9	2,1	2,0	1,9
Gross fixed capital formation	521,6	22,8	9,0	5,2	3,1
Business investment	376,7	*26,4*	*4,5*	*0,1*	*-0,5*
Housing investment	80,8	*29,4*	*26,5*	*21,7*	*14,9*
Public sector investment	64,1	*-1,0*	*9,3*	*6,2*	*5,9*
National expenditure	2.293,4	8,9	6,2	4,6	2,9
Exports of goods and services	1.186,7	10,9	8,3	4,4	3,6
Imports of goods and services	1.031,3	14,5	10,9	7,5	4,0
Gross national product	2.448,8	**7,4**	**5,3**	**3,3**	**2,8**
Inflation [1]		1,7	1,8	2,6	2,9
Unemployment [2]		2,3	2,3	2,5	2,9
Exchange rate index [3]		180	161	165	166
Balance of trade [4]		6,3	6,2	4,4	3,7

[1] CPI, change in annual average

[2] % of estimated labour force

[3] Annual average of narrow trade indexed exchange rate

[4] % of GDP

Following strong economic growth in recent years the economy gives indications that it will slow down in 2017–2019. This means the Icelandic economy has reached the peak of the economic cycle. Nevertheless, there will be a satisfactory economic growth during the forecast period, but it will increasingly be driven by growing private consumption rather than increased export or capital formation. The forecast is for a 5.3% economic growth this year and a 3% average in 2018–2019.

Economic prospects are in many respects good and it may be expected that the present period of economic growth could last for nine years, if the Economic Department forecast holds. We expect a slower growth in the tourism sector and we also assume a relatively stable exchange rate for the Icelandic krona over the period. The forecast describes the economic development considered most likely by the Economic Department, but there are many factors of uncertainty, allowing for different scenarios. A more rapid cooling of the tourism sector may thus have a considerable effect in many areas, for example in the labour and real-estate markets and consequently dampen growth in private consumption and investment.

There are not many changes from the Department's last forecast. We do, though, expect more export this year, or 8.3% in lieu of 6.6% in the spring forecast. Next year there will be a visibly slower export growth, with an expected average of 4% 2018–2019. High export growth in 2016 is due to one more record year in the number of tourists in Iceland. Last year export grew 10.9%, of which export of services grew 18.6%, whereas export of goods grew only 3.7%. The total number of tourists arriving in Iceland was 1.8 million in 2016, an increase of over half a million year-on-year, which represents a 40% increase. According to economic indicators tourism sector growth will now slow down, with 17% more tourists in the period from May to August compared to a 32% growth in the same period last year. The Central Bank of Iceland also points out that tourists spend less on average and stay for a shorter time.

Private consumption will grow 7.5% this year, reaching a peak, but will nevertheless be considerable in the next few years, or 5.5% in 2018 and 3.2% in 2019. Capital formation will slow down and residential investment will be the main driving force for investment during the forecast period. High ongoing industry sector investment growth in recent years will slow down and we expect a 4.5% growth in industry sector investment this year, followed by a relatively stable development throughout the forecast period. Capital formation may be expected to be between 21.5%–22.3% of GDP over the forecast period.

The price of housing has reached an historic high following a great rise in prices in recent years. This is due to low supply of new housing, population growth and an increase in household spending power. Circumstances in the housing market are therefore risky for those who are considering buying housing on credit. There are signs that activities in the housing market have slowed down, but such circumstances may be temporary as households still have some leeway for increased indebtedness.

The above-mentioned housing market development is also the main driving force of inflation during recent semesters. Inflation measured at 1.4% in August, but when housing prices are excluded prices have fallen by 3%. Should economic development be according to our forecast, inflation may be expected to remain within the target limits for the next few years, 2.6% next year and 2.9% in 2019.

We expect little changes in public consumption growth during the forecast period, or approximately 2% annually. However, public consumption as percentage of gross domestic product will continue to fall and be lower than the average of the last twenty years. When adjusted for the economic cycle, the treasury is running a tight ship, especially due to concessions on the income side of the budget, with policy restraint focusing on holding back on essential welfare projects. Other things being equal, treasury income will not suffice to finance present expenses when the economy slows down, and we will be faced with cut-backs or increased taxes across the economic cycle.

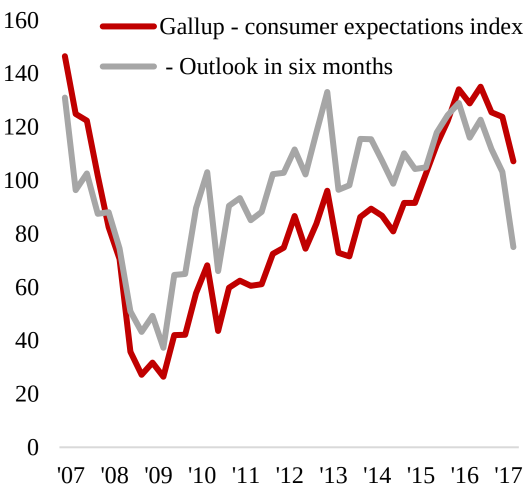
The labour market gives clear signals that the economic cycle has peaked. We expect average unemployment to be 2.3% this year, to rise somewhat for the next two years, reaching 2.5% in 2018 and 2.9% in 2019. Increased activity in tourism has been a major contributing factor in creating jobs, but in the last few months fewer tourism related jobs have been created than in recent years. It is noteworthy that demand for workers (especially in the building industry) is now met with a greater import of foreign labour than previously known in Iceland.

Private consumption growth will peak this year

Private consumption increased by 7.1% last year and was thereby comparable to that of 2007 for the first time. The powerful increase in private consumption did not come as a surprise, with most economic indicators suggesting that households could increase spending on consumption. Last year household disposable income increased 10.2% and purchasing power of disposable income per capita grew by 6.9%. Of this, total household wages went up by 11.6%.

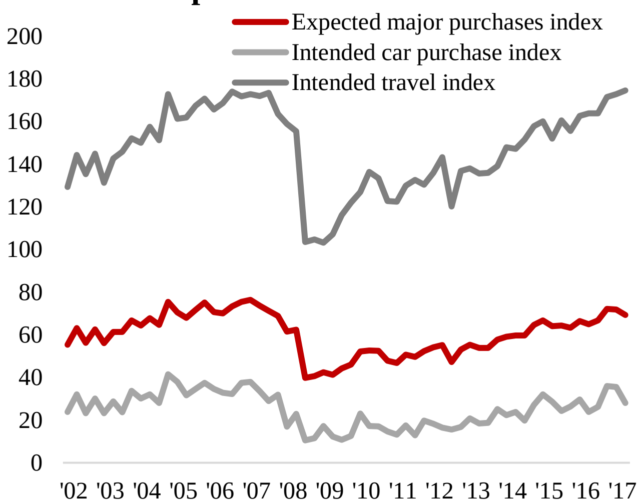
The Gallup Consumer Confidence index peaked at the end of last year at 135 points and had not been higher since 2007. Since then confidence has fallen, both for this period and the next six months. However, Major Purchase Indices show that households will not let confidence assessments hold back their major purchases in coming semesters. Gallup's Major Purchase Index is similar to what it was in 2007, the index for intended travels abroad is higher than at that time and the index for intended car purchases is moving closer to previous highs.

Consumer expectations



Source: Gallup

Consumer expectations

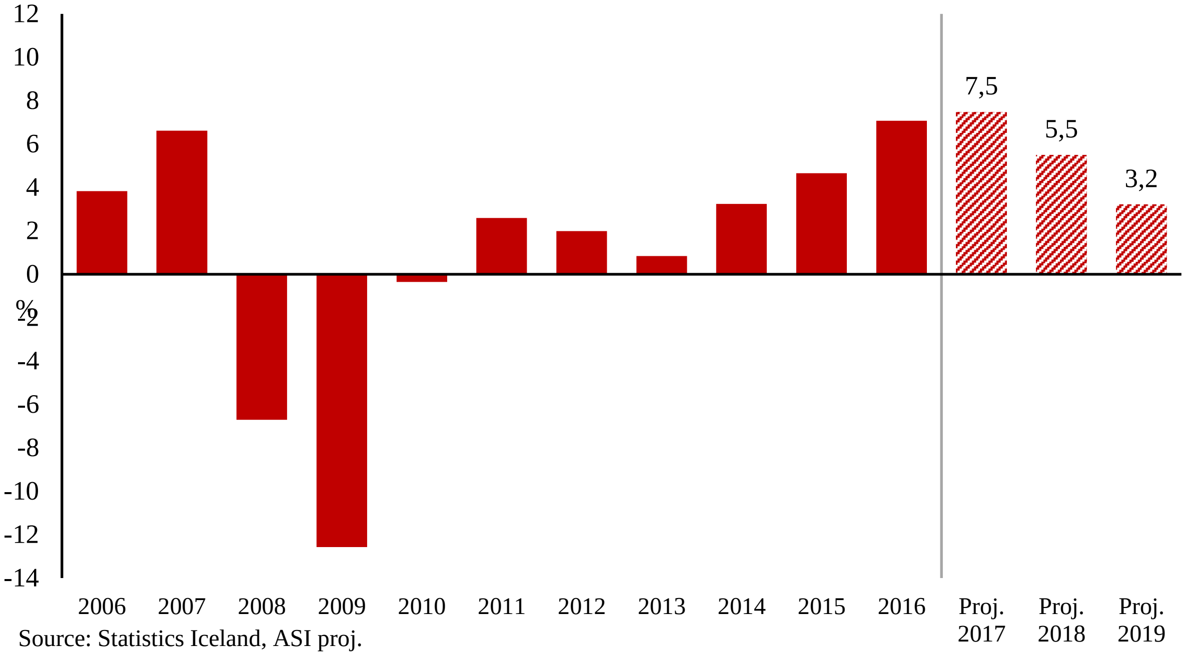


Source: Gallup

Household debt burden has improved in recent years but in the first six months of this year their debt began to increase again. The development is mostly attributed to an increased indebtedness due to private housing purchases. The latest *Financial Stability* [a Central Bank publication] gives an account of this development, pointing out that a greater number of households in the rental market explains in part the falling debt percentage during the past decade.

An improved household financial position is reflected in the 2016 national accounts and major purchases are among the items driving private consumption last year. Household expenses for purchase of electric appliances increased 14%, furniture and household goods 18%, restaurant cost 27%, cost of accommodation 31% and cars purchased 32%.

Household consumption - Annual changes

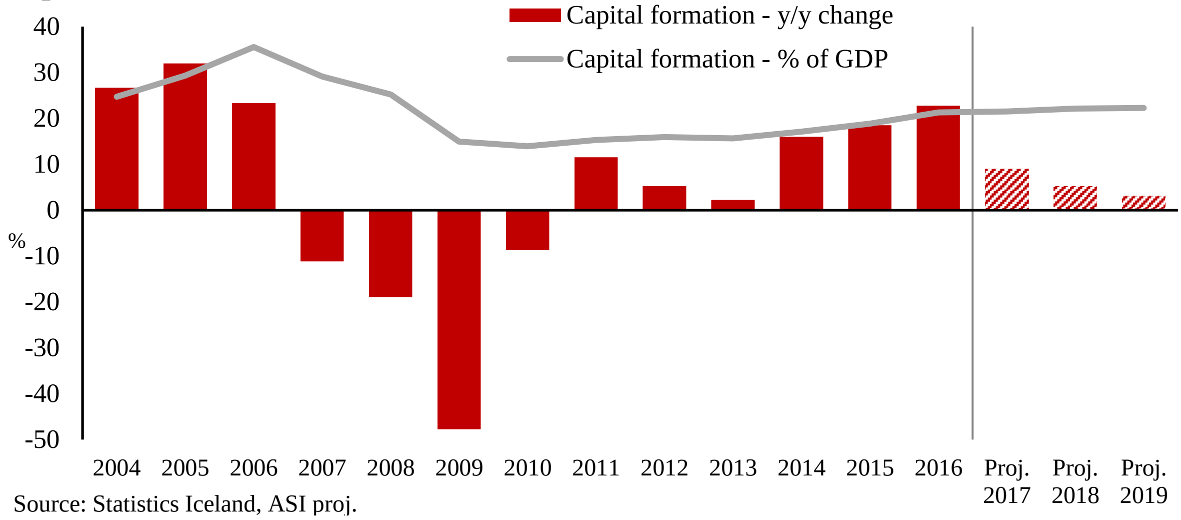


Source: Statistics Iceland, ASI proj.

The information above indicates that there are grounds for a vigorous growth in private consumption over the forecast period. However, we consider likely that the growth will peak this year. During the first six months of this year, private consumption grew by 8.3% and figures for payment card turnover show no signs of falling expenditure in the third quarter. At the end of this year we expect private consumption to have increased by 7.5% for the whole year. We forecast a 5.5% growth in 2018, but 2019 will see slowing down with the growth of private consumption falling to 3.2%.

Residential investment will maintain the investment level for the next few years

Capital formation



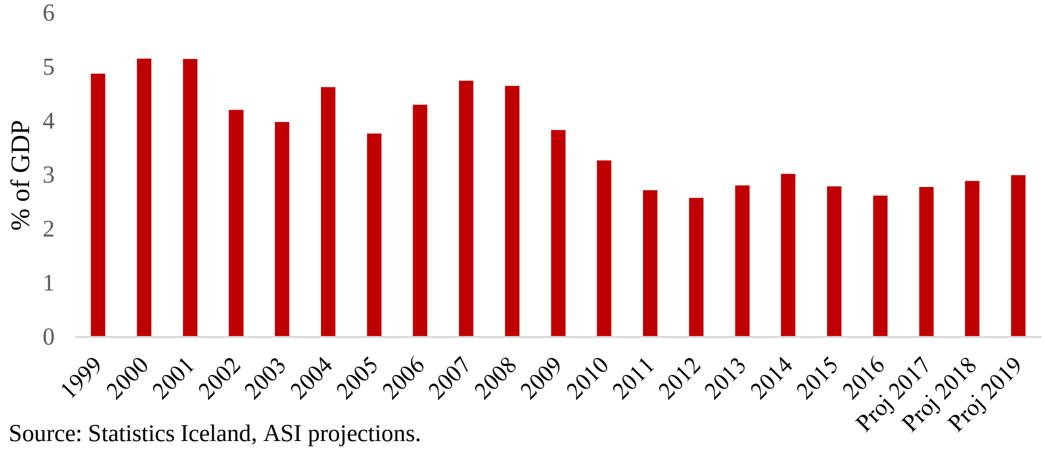
Source: Statistics Iceland, ASI proj.

Capital formation has grown almost continually from its low in 2010, or by 13.9% of GDP. The largest part of this growth is a robust increase in industry sector investments, growing on average 25% annually 2014–2016. Following this the investment level has reached the historic average, was 21.3% of GDP last year, and will remain relatively stable over the forecast period. The main driving force of capital formation in the next few years will be increased investment in private housing.

Industry sector investment grew 26.4% last year, where growth is not bound to a single sector, even though tourism has had a major effect with extensive investments in hotels, guesthouses and car rentals. Industry sector investment growth may be expected to fall during the forecast period, with an annual growth rate of only 1.3% during the first six months of this year. According to SA-Confederation of Icelandic Employers, confidence of managers in the largest Icelandic companies has waned, with approximately a third expecting less favourable economic circumstances in the next six months.[1] Corporate investment plans have also been stepped down and an approximately equal number of managers expect investment to increase as decrease. The Economic Department forecasts a 4.7% growth in the business sector this year, a 0.3% increase next year and a 0.4% recession in 2019.

[1]http://sa.is/frettatengt/frettir/stjornendur-400-staerstu-telja-adstaedur-godar-en-blikur-a-lofti

Public investments

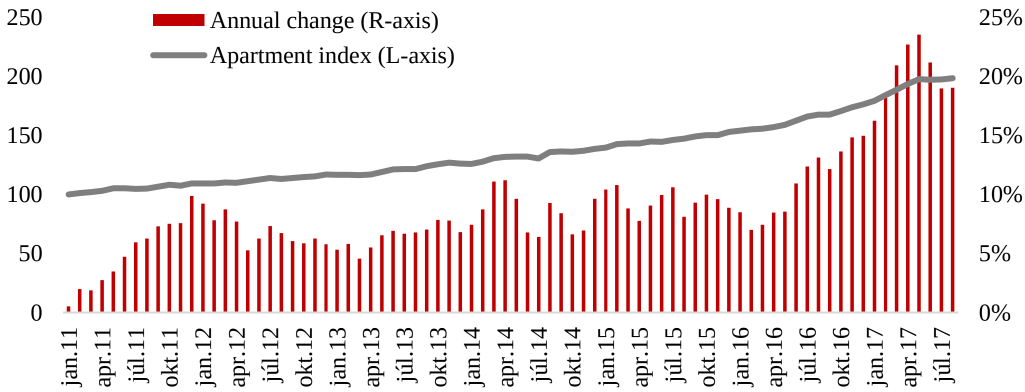


Source: Statistics Iceland, ASI projections.

Public investment has fallen for the past two years, by 2.6% in 2015 and 1% last year. As a percentage of GDP, public investment was 2.6% last year and has only been measured lower in 2012 after a considerable reduction following the economic crisis. This development is critical as low public investment leads to lack of maintenance and replacement as well as infrastructure improvement. Thus investment in transport infrastructure has been about a third lower in the period 2011–2016 than it was in 1994–2003. The fact that investment is lower in the latter period is a cause for concern because the population has grown greatly in the period, the number of tourists has sky-rocketed and there is a cumulated need following the economic crisis that needs to be addressed. According to a recent report from the Federation of Icelandic Industries, the cumulated maintenance needed for the highway network is ISK 70 billion, for municipal roads approximately ISK 55–65 billion and public buildings approximately ISK 76–86 billion. If the Economic Department's forecasts proves true the percent of public investment during the forecast period will only be about 3% of GDP in 2019. Annual growth will, therefore, be only about 7% on the average and public investment far from meeting the present accumulated need.

Housing prices at an historical high – but supply is rising

Housing prices

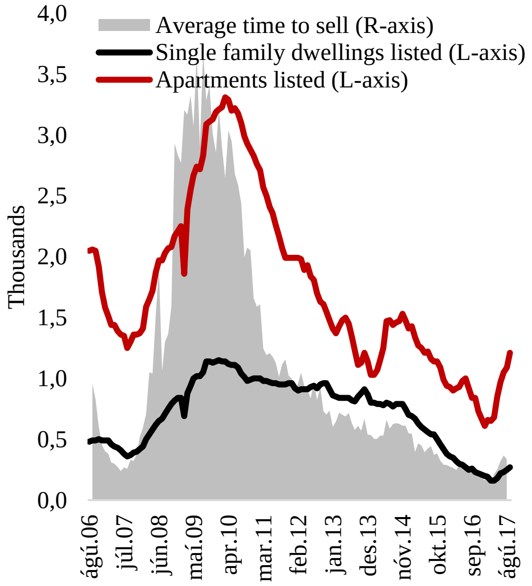


Source: Registry Iceland

Having seen a practically continuous rising of real-estate prices since 2011 there are now signs of prices growing at a slower rate. The Economic Department's last forecast warned of the risk of a housing bubble, with housing prices having gone up almost 23% year-on-year when the forecast was published. Prices are now rising at a much slower rate. In the semesters ahead conditions will allow for slowing down the expansion in the housing market as a growing number of new buildings meet a heavy demand. There are not many signs of housing prices falling. We can look to Sweden for comparison, where housing prices have risen practically continuously from the turn of the century, excluding short periods of falling prices in 2007–2008 and 2011–2012.

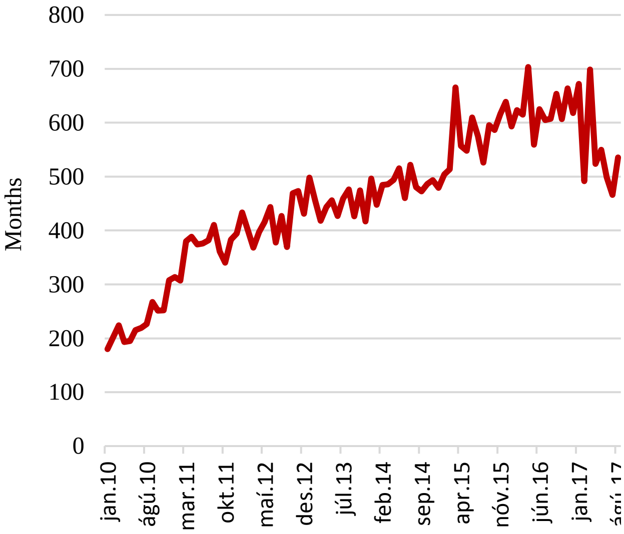
In August, housing prices had risen 19% for the past twelve months, with the price of housing in multiple household buildings rising 18%, and single family houses 21%. In the present circumstances of low inflation this is a considerable real increase in housing prices. At the same time building cost has only risen 3%. The increase is therefore considerable, real prices are historically high and buyers of first property in an unfavourable position, as they are vulnerable to falling real-estate prices if their indebtedness is high. Even though such a scenario may not be likely, it could nevertheless take place if development elsewhere in the economy were unfavourable, for example if there would be a sharp recession in tourism.

Housing activity



Source: Central Bank of Icelamd

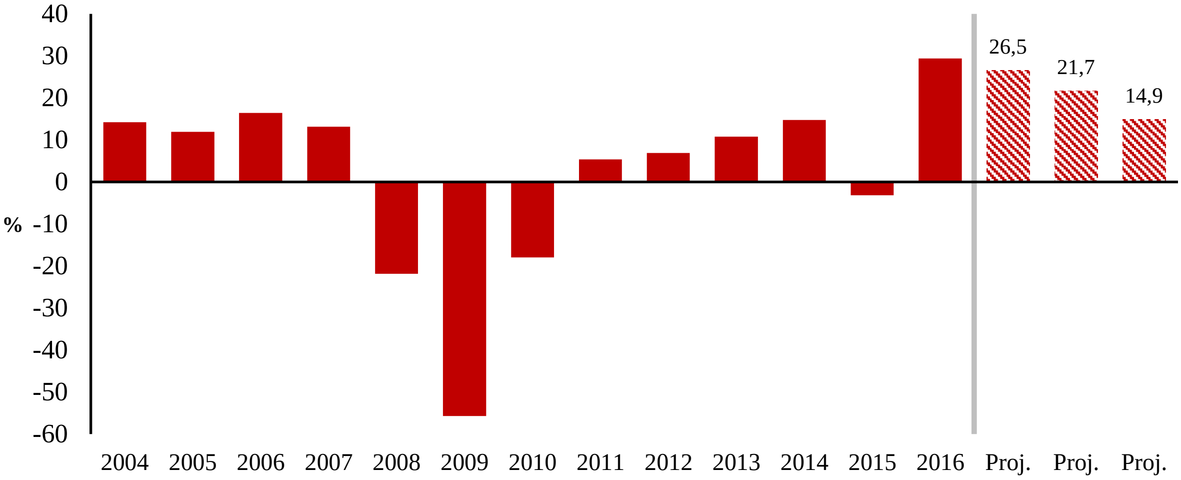
Housing activity (monthly transactions)



Source: Central Bank of Iceland

Real-estate activities have slowed down and there were 12% fewer purchase agreements in the capital area this summer than the year before. The slowdown is lowest in Reykjavík and increases as you go further away from the city centre. The average time of sale is also longer and sellers may expect two and a half months to sell a real-estate, compared to just over one month at the beginning of the year. At the same time, there are more properties for sale and have not been so numerous since 2015. This is explained first and foremost by increased offer of multiple household buildings, with not much increase in advertised single family houses.

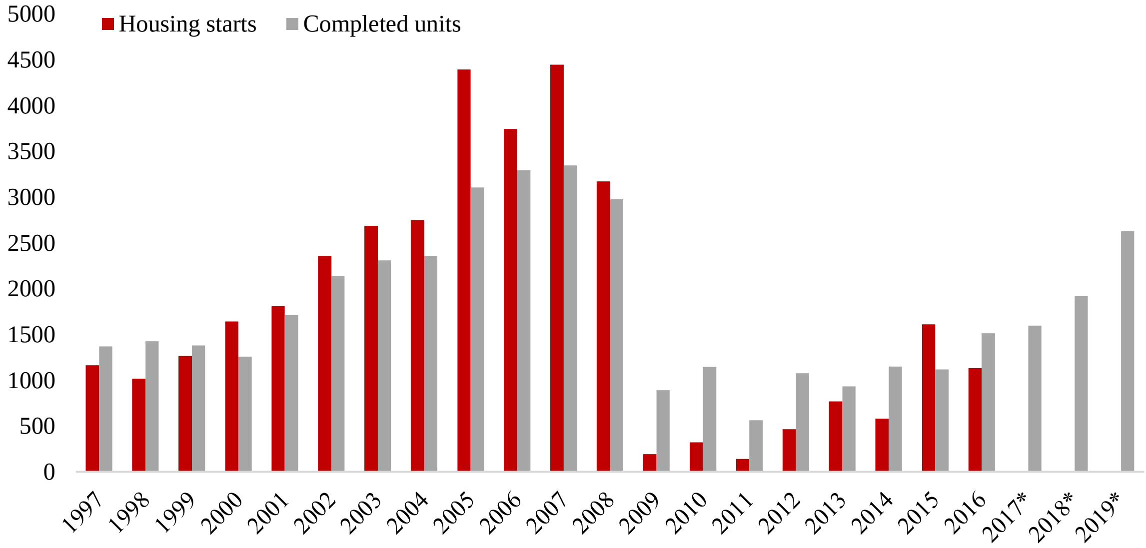
Housing investment - y/y change



Source: Statistics Iceland, ASI proj.

In our last economic forecast we assumed that increased activity in construction would go a long way in meeting the annual need for housing over the forecast period. We are still of this opinion and consider it likely that the rise in housing prices will continue to slow down, as new buildings are completed and the market moves closer to equilibrium at the end of the forecast period.

Housing supply



Source: Statistics Icelandic

However, in the short run the development could go either way, as a good household financial position, favourable terms for loans and a strong capital position could easily maintain the continued rise in prices. The Economic Department's forecast provides for a 26.5% growth in housing investments this year, which accords with our spring forecast. Investment in housing will go up 21.7% next year and 14.9% in 2019, coming to about 5.3% of GDP at the end of the forecast period, similar to what it was in 2005 and close to meeting the market's annual need, even though it will be considerably short of meeting the accumulated need.

Uncertainty in fiscal policy

For the second year in a row the economic forecast is published in unusual circumstances with respect to the state's fiscal position. In 2016 the finance bill was not submitted to the parliament until beginning of December due to parliamentary elections at the end of October that year. This year the finance bill was submitted at the appointed time but the first round of parliamentary debate was not completed as elections were called at a short notice. Therefore, the 2018 finance bill will most likely be changed before being submitted again after the parliamentary elections on 28 October.

The present finance bill now accords with the framework set in the fiscal policy and fiscal strategy plan for 2018–2022 last spring. It provides for the state treasury having a ISK 44 billion surplus and the treasury's debt to be lowered by ISK 36 billion in 2018 down to ISK 859 billion, or about 27% of the domestic product.

The financial position of municipalities is improving and the first six month statements for the four largest municipalities, representing over 60% of the population, show a positive result from operations, or 5.3% of income, which was just shy of 1% for the same period in 2016.

We therefore expect little changes in public consumption during the forecast period, or approximately 2% annually. On the other hand, public consumption as percentage of gross domestic product will continue to fall. In 2016 public consumption was 22.8%, this year approximately 22.7% and 22.6% in 2018. This is an important change from 2010–2015 when it was 24.3% on average. Looking all the way back to 1996 average public consumption has been 23.3% of GDP.

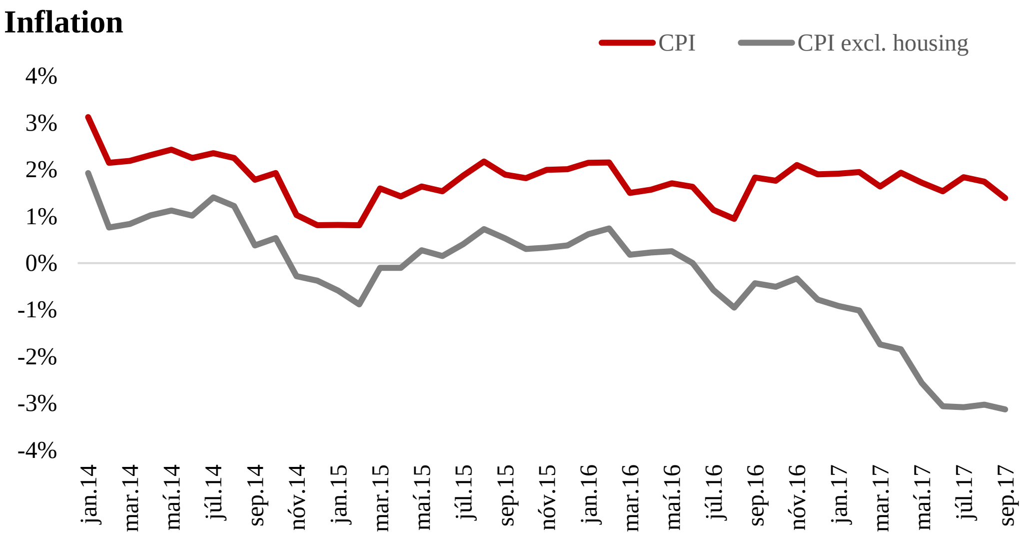
In assessing the government budgetary position it should be borne in mind that no account is taken of the effect of the economic cycle on the state's operations. Both the International Monetary Fund and the Fiscal Council have pointed out this weakness in their comments. If the economic cycle is taken into account the effect of government finance fuels expansion at the same time the economic cycle is peaking.

The expansion is mostly due to concessions on the income side of the budget, with policy restraint focusing on holding back on essential welfare projects. The consequence is predictable. When the economy slows down, treasury income will not suffice to finance present expenses, and we will be faced with cut-backs or increased taxes across the economic cycle. The government is aware of the position as indicated in the following text in the finance bill:

> On the expenditure side of the state treasury, changes in expenses have first and foremost been in unemployment benefits, as well as child benefits and the interest subsidy, which have been adjusted to accord with the economic cycle, but in other respects the expenses are essentially resistant to change in the short run. Fewer sources of income in recent years [customs duty and excise duty discontinued] means that the principal tax sources bear a much greater burden, such as VAT, personal income tax and the social security contribution. This means that when the economy slows down, income falls much more than expenses, with associated effects on the fiscal position for the worse, and debts begin to accumulate again.

Once a new government presents a reviewed finance bill after the election, it will become apparent whether this serious weakness in the state finances will be addressed. The political parties have given extensive promises concerning a powerful build-up of infrastructure and increased expenditures. Ideas on how to finance the election promises can roughly be divided in two, on the one hand are a few parties that intend to meet the financing need by withdrawing equity from banks held by the state and on the other hand, parties that intend to use that method in part along with increased taxation. It is important to use one-time income, such as withdrawal of bank equity, to lower debt and for building up infrastructure because an increase in expenditure must be met with an increased income as the state treasury is running a tight ship when adjusted for the economic cycle.

Grounds for a continued price stability



Source: Statistics Iceland

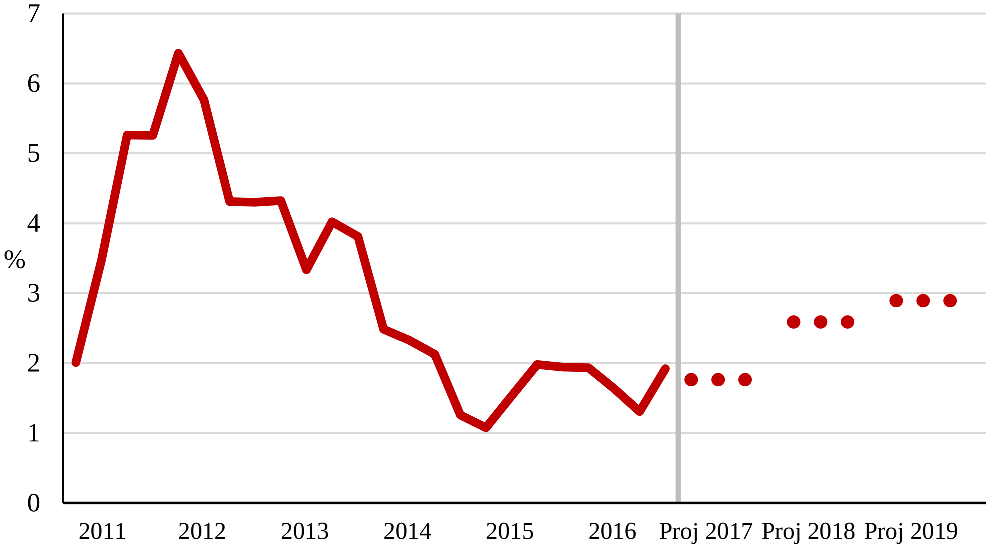
When inflation was measured at 1.4% in August this year it was the forty third consecutive month where inflation was below the Central Bank's target limit of 2.5%. The past twelve months average inflation has been 1.8% and has been 1.8% on average going back to the beginning of 2014. This period of price stability is also interesting because prices have been stable during an extensive economic upswing, labour market expansion and considerable wage increases. Wage development has therefore not had a dominant influence on inflation in recent semesters, but chiefly changes in housing prices. Housing forms about one third of the consumer price index and this explains why changes in housing prices can have a great effect on inflation.

Leaving out housing from the consumer price index, prices in Iceland have fallen by 3% during the last twelve months. There has been a deflation since the middle of 2016 and this is therefore not only a short term phenomena. While housing prices have been the largest single driving force behind inflation in recent years, many of the index sub-items have had a lowering effect on inflation.

Most of these items have in common that they have fallen due to a higher exchange rate for the Icelandic krona, which has a positive effect on imported prices. Economic Department forecasts have provided detailed reports of this development. The krona has, however, become weaker since the Department's last forecast was released, even though changes in prices have been favourable. This may be because competition in the domestic market has increased as Icelanders travel more abroad, there is increased competition from internet commerce and with the entry of foreign commercial giants onto the Icelandic retail market, i.e. Costco and H&M. When Costco opened in May this year this appears to have surprised many competitors. Not only were consumers offered a cheaper option in many product categories, but companies were also offered prices that were lower than those of Icelandic wholesalers.

The effect of increased competition can be seen in many of the consumer price index sub-items. Prices of perishable goods have fallen by 5.5% year-on-year, domestic foods and beverages 3.4%, imported food and beverages 9% and vegetables about 12%. Due to increased competition, the price of imported product items has also fallen despite the depreciation of the krona.

Inflation



Source: Statistics Iceland, ASI proj.

We believe that price prospects are good for the forecast period even though such a forecast is subject to great uncertainty. There is uncertainty concerning the exchange rate of the krona, as the forecast premises assume a considerable stability in the exchange rate, a 2.6% weakening next year and a rather stable rate in 2019. On the other hand, developments in the housing market have considerable effect on the inflation prospects in the semesters to come. Should the real-estate market develop as we expect, with the rise of real-estate prices slowing down over the forecast period, we expect that inflation may be close to the target next year, or 2.6% and 2.9% in 2019.

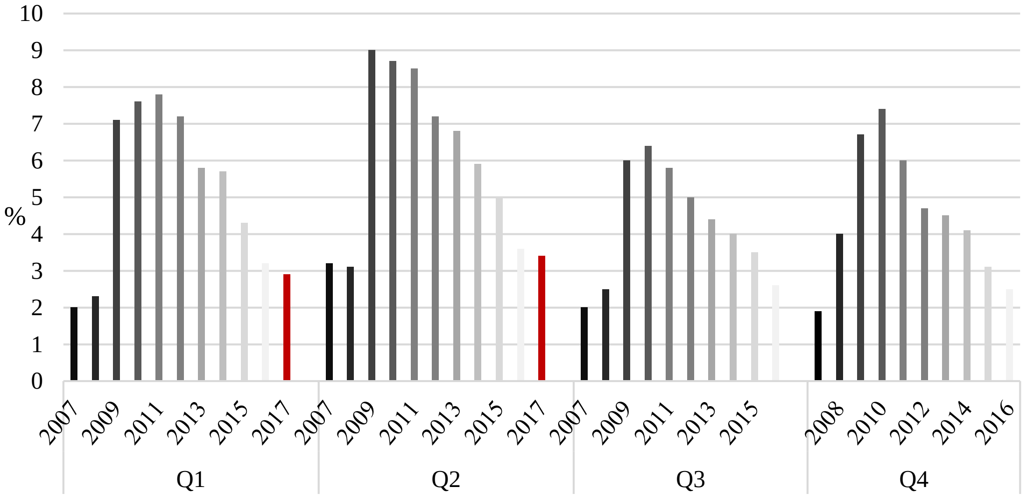
More jobs but more unemployment

Labour market developments in the past months give clear evidence that the economic cycle has reached its peak and indicate that growth is slowing down. In 2017 the unemployment rate has fallen slower than during the past five years and the employment participation rate is slightly lower. The number of employees in tourism has increased rapidly since 2010 but in the last few months the increase has slowed down. Expansion in construction and civil engineering work has also increased the number of jobs, but the number of employees in those sectors is considerably lower than at the peak of the last business cycle. This may be partly explained by the rapidly increasing number of foreign workers in Iceland. As a large part of foreign employees are temporary agency workers and dwell for only a limited period, the data used here may not cover the total number of workers in these sectors. In the same manner, a rising proportion of foreign citizens in the job market may explain why working hours appear not to have increased much since they fell following the economic crisis in 2008.

Unemployment and employment participation

Unemployment has continued to fall, but slower than in recent years and even though there are many indications that the labour market is cooling down, unemployment has not fallen as low as in the last boom, when it was measured at 1.9% in 2007.

Unemployment 2007-2017

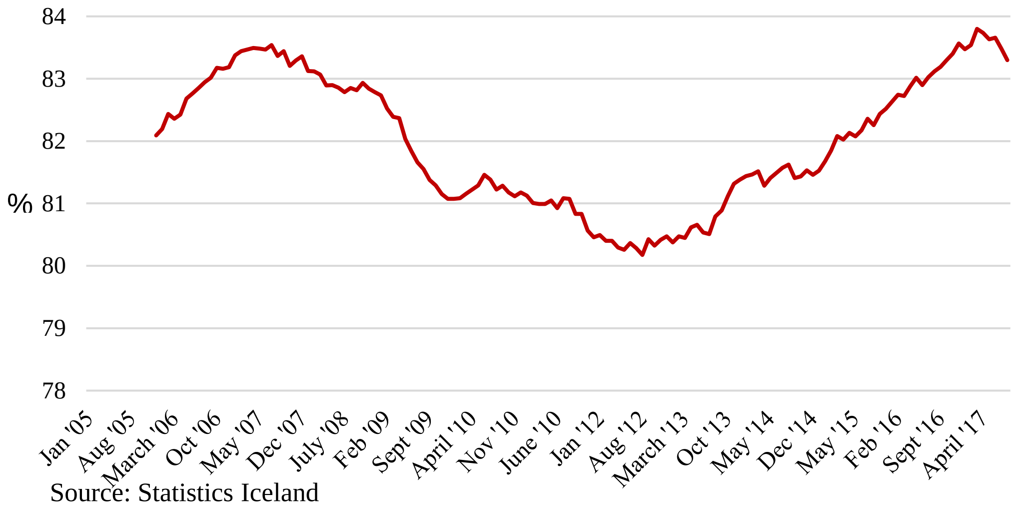


Source: Statistics Iceland

In the second quarter of 2017 unemployment was 3.4% and had contracted by 0.2% compared to the same quarter of 2016 when it was 3.6%. By comparison unemployment fell 1.4% between the second quarters of 2015 and 2016. Unemployment has fallen more slowly during the past few months, for both genders and across all age groups. Unemployment among women remained stable at 2.5% between the first quarters of 2016 and 2017, with men's unemployment rising by 0.2% between the second quarters of 2016 and 2017, from 3.2% to 3.4%. Unemployment among young people aged 16–24 has increased since last year, but unemployment in other age groups has fallen slightly.

According to the Directorate of Labour the number of collective dismissals has increased in the last two years. From 2014 to 2016 the number of individuals who lost their jobs in collective dismissals rose from 231 to 493. Most collective dismissals announced in 2016 were put into effect over the period between March and June 2017 and affected jobs in fish processing, industry and production, as well as in information technology and telecommunications.

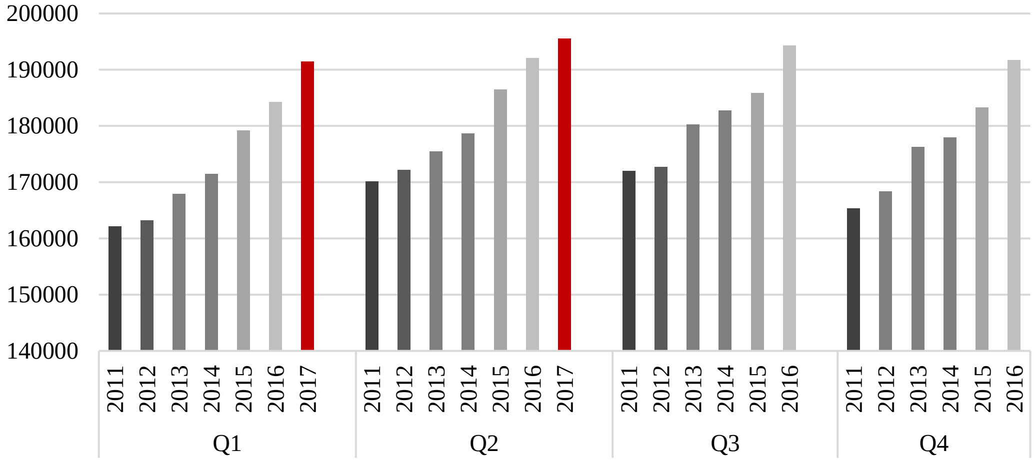
Labour force participation rate 2005-2017



Source: Statistics Iceland

The employment participation rate increased steadily from the beginning of 2012 and was higher at the end of last year than during the economic boom in 2007. It has, however, fallen somewhat in the past few months.

Number of employed individuals 2011-2017



Source: Statistics Iceland

Changes in unemployment and employment participation have corresponded to a slower increase in the number of new jobs in the first six months of this year, than during recent years. In the first half of 2017 the number of individuals employed had risen by 5,350 since the first half of 2016. The number of individuals employed rose more last year; in the second half of 2016 it had increased by an average of 8,400 since the second half of 2015.

A slower increase in the number of individuals employed and a practically unchanged unemployment percentage this year can partly be explained by the increased demand for labour in labour intensive sectors, which has increasingly been met with import of foreign labour through temporary worker agencies. However, it is worth noting that with unemployment this low, the rate falls more slowly even though the demand for labour is increasing.