

## Unchanged interest rates

The monetary policy committee (MPC) of the Central Bank decided to keep its key interest rates unchanged in November, in line with our expectations. In general, local analysts had predicted either a rate cut of 25 bp. or unchanged rates. Alongside the rate decision the Central Bank published its fourth and last Monetary Bulletin of the year where the Bank revised its GDP forecast upwards and inflation forecast downwards, amongst other things.

## Economic Outlook 2016-2019: Strong growth alongside tourism boom

In November Arion Research published its Economic Outlook for the years 2016-2019. We expect robust growth in the coming years, or 4.7% in 2016, 5.2% in 2017, 3.1% in 2018 and 2.2% in 2019. Like previous years, growth continues to be driven by private consumption and investment.

## It takes... three to tango? - Outcome of parliamentary elections 2016

On October 29 parliamentary elections were held in Iceland. As expected the center-right coalition government lost its majority in the elections. Now, one month later there has yet to be formed a majority government. Two parties have been given the mandate to form a government, one tried to center-right and the other to center-left, without being successful. In the aftermath the President decided not to give the mandate to any particular party, but rather encouraged the parties to try to find a solution amongst themselves. Media is reporting that informal talks are currently taking place between The Independence Party (Sjálfstæðisflokkur) and Left Greens (Vinstri grænir) to form a government along with Revival (Viðreisn) and/or Bright Future (Björt framtíð).

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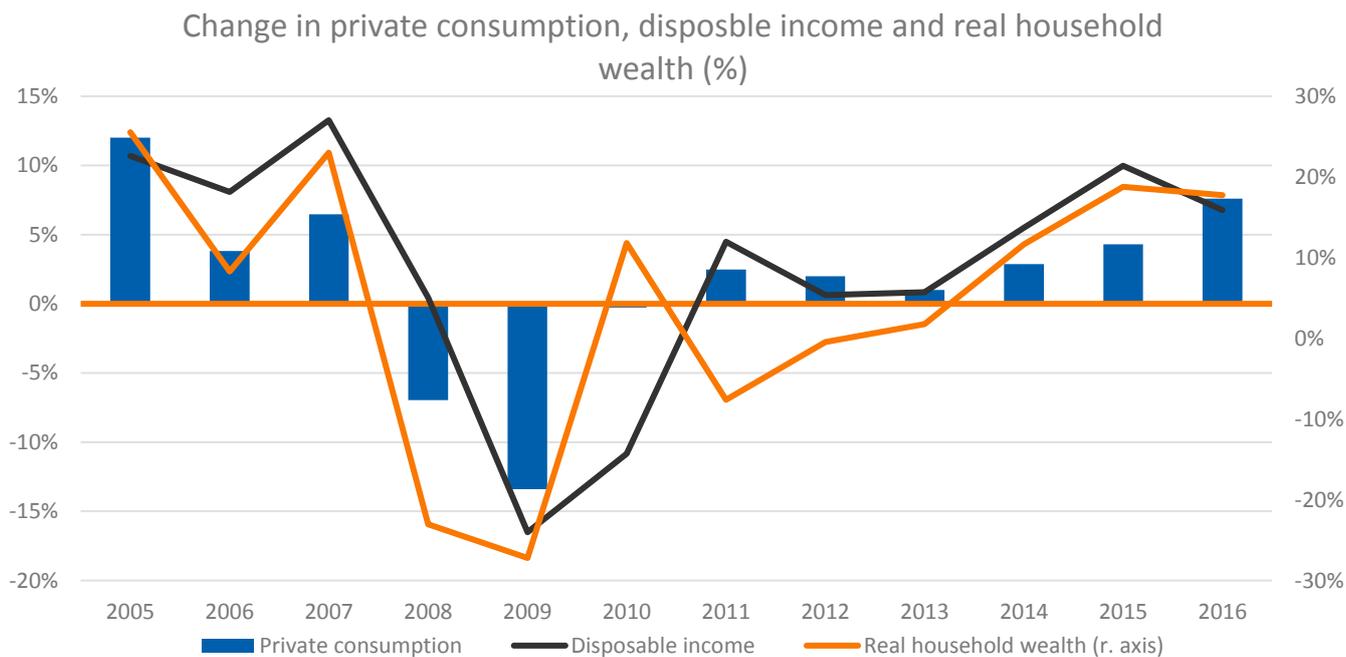
### **Provisional release:**

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## Unchanged interest rates

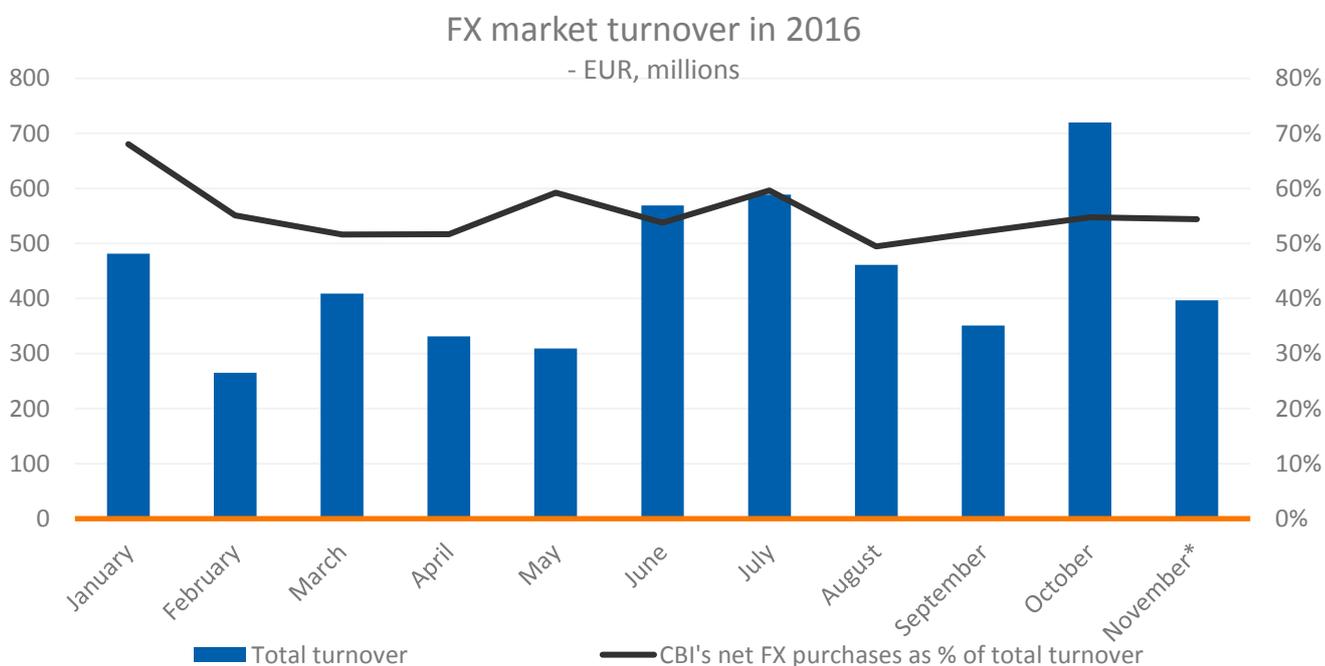
In accordance with our expectations the Monetary Policy Committee (MPC) of the Central Bank of Iceland decided to keep its key interest rate unchanged in November. Analysts had either predicted unchanged rates or a 25bp cut, although the general consensus tilted towards a 25 bp cut.

The MPC supported its decision by stating more robust GDP growth in 2016 and 2017 than previously forecast, which is supported by domestic demand (which grew by nearly 10% in the first half of 2016), strong job creation, and declining unemployment. Moreover, there are clearer signs that rapid demand growth is straining domestic resources, which is however somewhat offset by accelerating importation of foreign labor. Furthermore, real household wealth has risen markedly in recent times, there is considerable uncertainty around easing of the fiscal stance along with unrest on the labor market. Finally, there is continued uncertainty surrounding the next step in liberalization of capital controls.



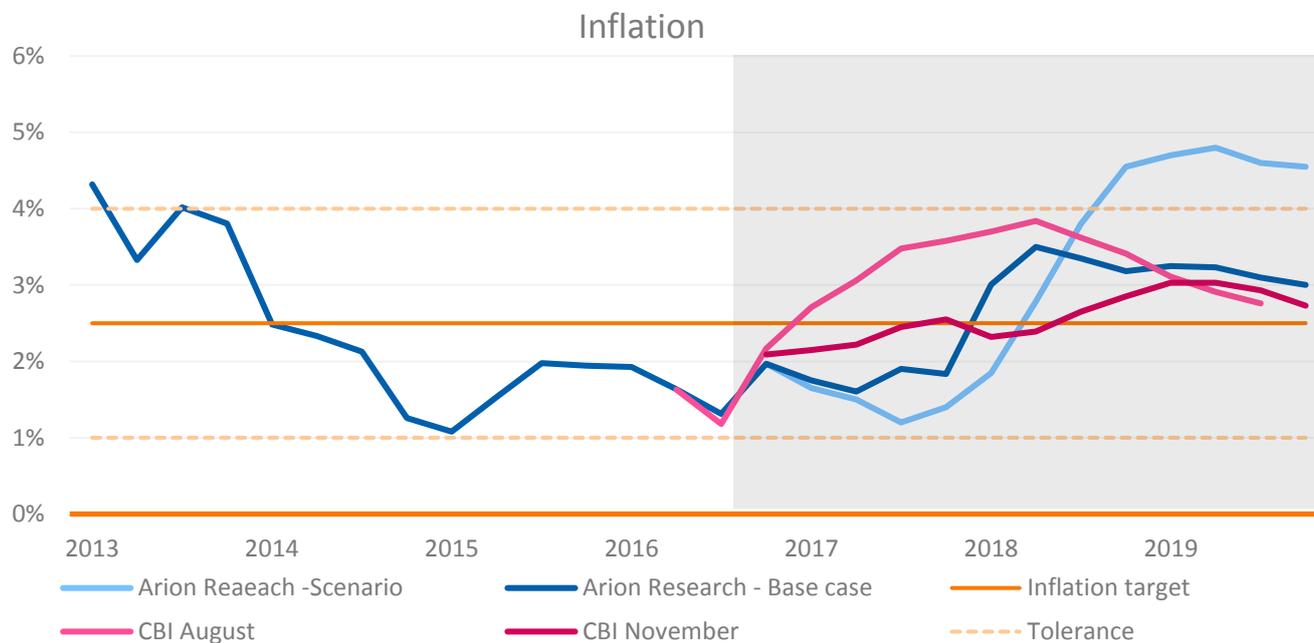
Sources: Central Bank of Iceland, Arion Research

In a statement from the MPC following the decision, it stated that “In recent months, the Central Bank has purchased a smaller share of foreign currency inflows than it did earlier in the year. The MPC is of the view that, other things being equal, it is appropriate to continue in this vein.” In a meeting following the statement Governor Már Guðmundsson added that this is not a major change and that changes will be taken cautiously, due to various uncertainties e.g. the next step in the capital controls liberalization process.



The claim that the CBI has intervened to a relatively less extent as of late comes as a surprise, given the Bank's FX interventions in the past two months. The CBI bought foreign currency worth EUR 720 million billion ISK in October alone, as shown in the figure above, and excluding January, the share of the CBI in FX market turnover seems to have been relatively stable over the course of the year.

Alongside its interest rate decision, the Central Bank published the [fourth and last Monetary Bulletin](#) of the year. In the Bulletin, the Bank revised its inflation forecast downwards, but this is the first forecast it publishes with the exchange rate of the króna as an endogenous variable. The Bank now predicts that inflation will stay below the upper tolerance limit throughout the forecast horizon.



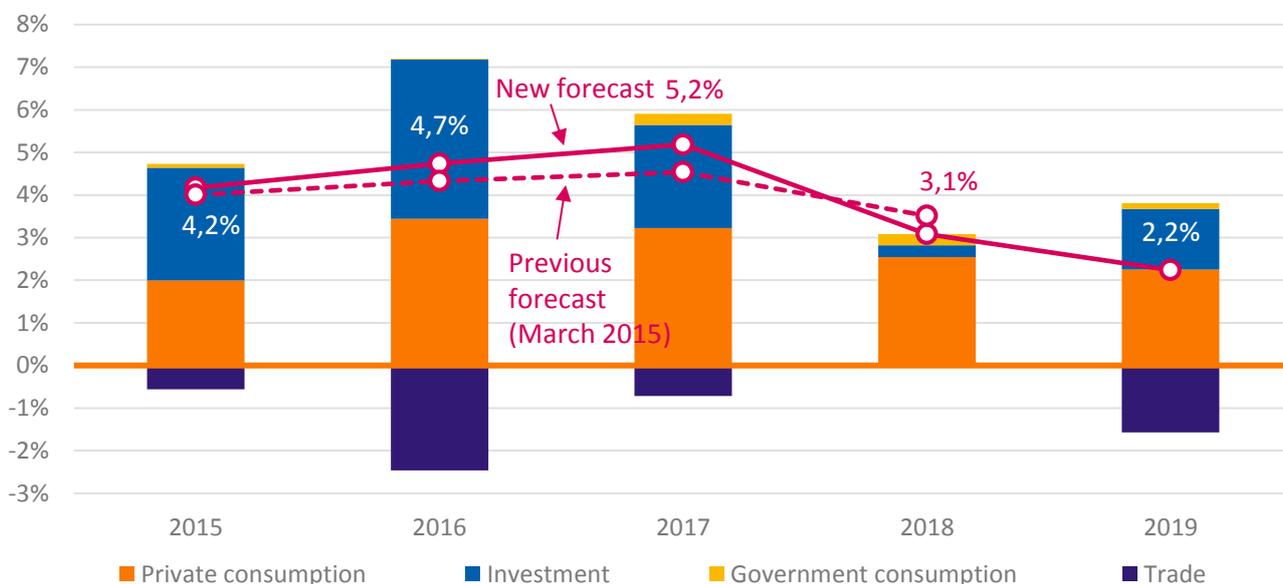
Sources: Central Bank of Iceland, Arion Research

## Economic Outlook 2016-2019: Strong growth alongside tourism boom

In November Arion Research published its Economic Outlook for the years 2016-2019. We expect robust growth in the coming years and revised our March forecast upwards for 2016 and 2017. Our forecast measures GDP growth at 4.7% in 2016, 5.2% in 2017, 3.1% in 2018 and 2.2% in 2019. Like previous years, growth continues to be driven by private consumption and investment.

The full report, titled “Don’t fly too close to the sun”, may be found [here](#).

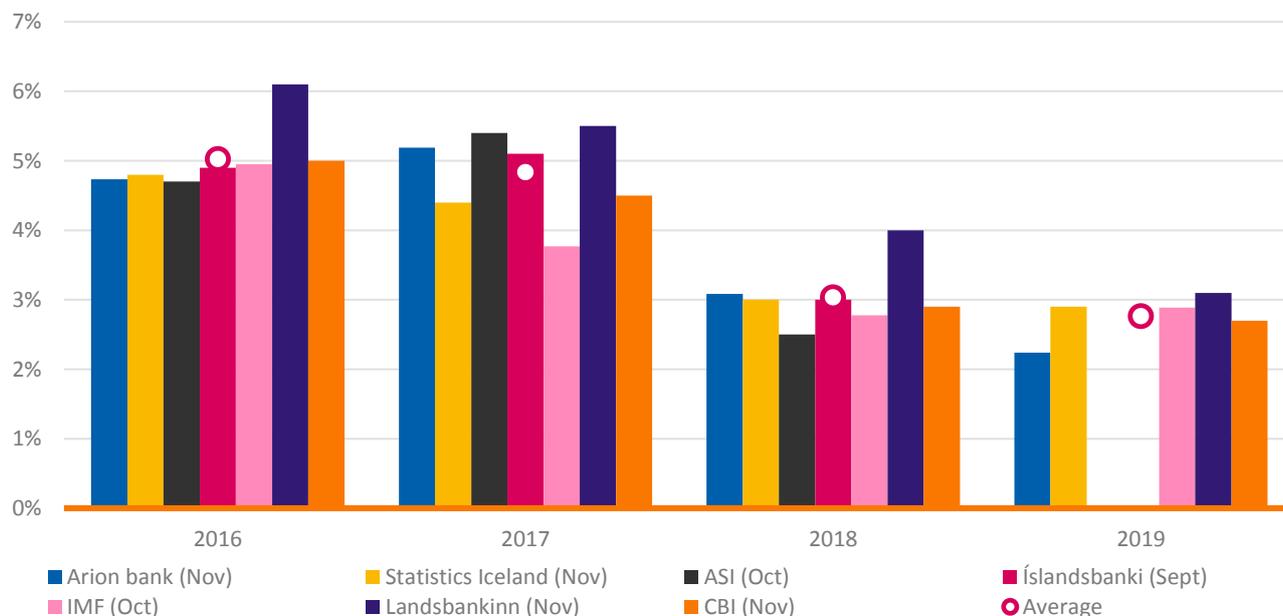
### Growth contribution of GDP components



Sources: Statistics Iceland, Arion Research

In general, analysts expect robust growth over the course of the next two years.

### Growth forecasts 2016-2019

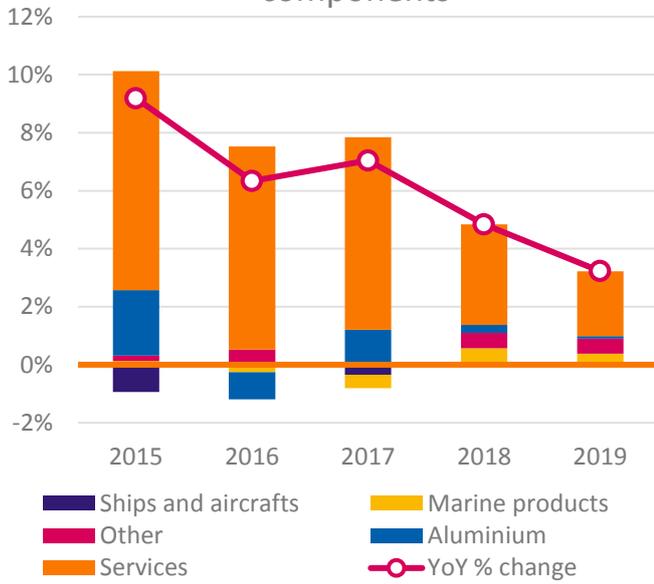


Sources: Arion Research, Statistics Iceland, ASI, Íslandsbanki, IMF, Landsbankinn, CBI

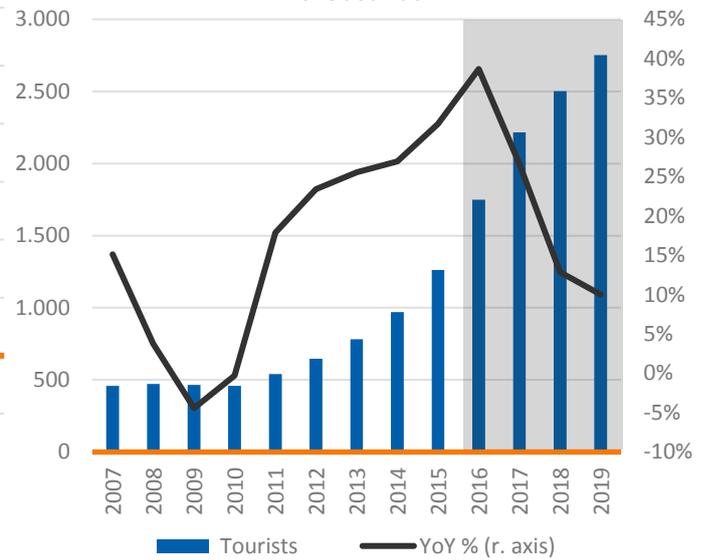
Tourism has been the main driving factor behind strong export growth in recent year. As stated in our report on the tourism industry, we expect continued growth of the sector in coming years, although the growth rate will begin to slow down after a record breaking year in 2016. In line with our forecast of continued growth in tourist arrivals, exports will continue to grow, albeit at a slower pace.

In line with the surge in tourism in recent years and continued growth of the sector in coming years, according to our forecast, exports will continue to grow.

### Growth contribution of export components



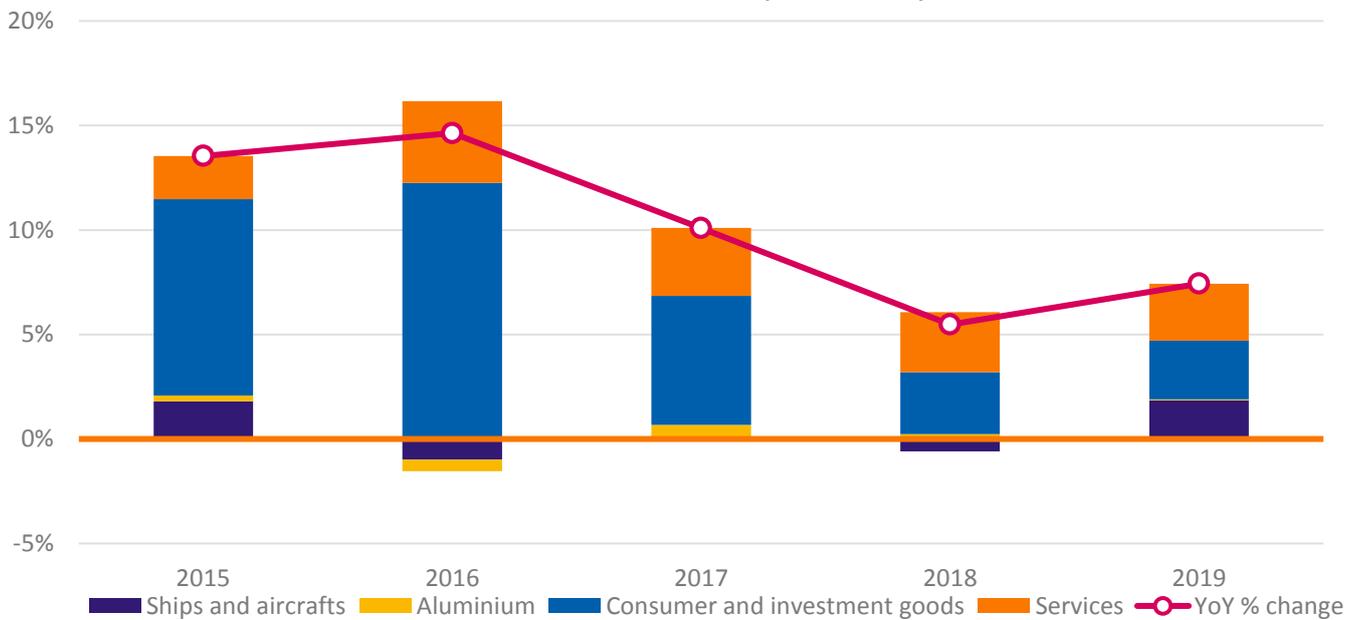
### Number of tourist arrivals\* - thousands



Sources: Statistics Iceland, Arion Research, Tourist Board \*forecast for 2016-2019

However, we project that imports will grow faster than exports, resulting in negative contribution to GDP growth.

### Growth contribution of imports components

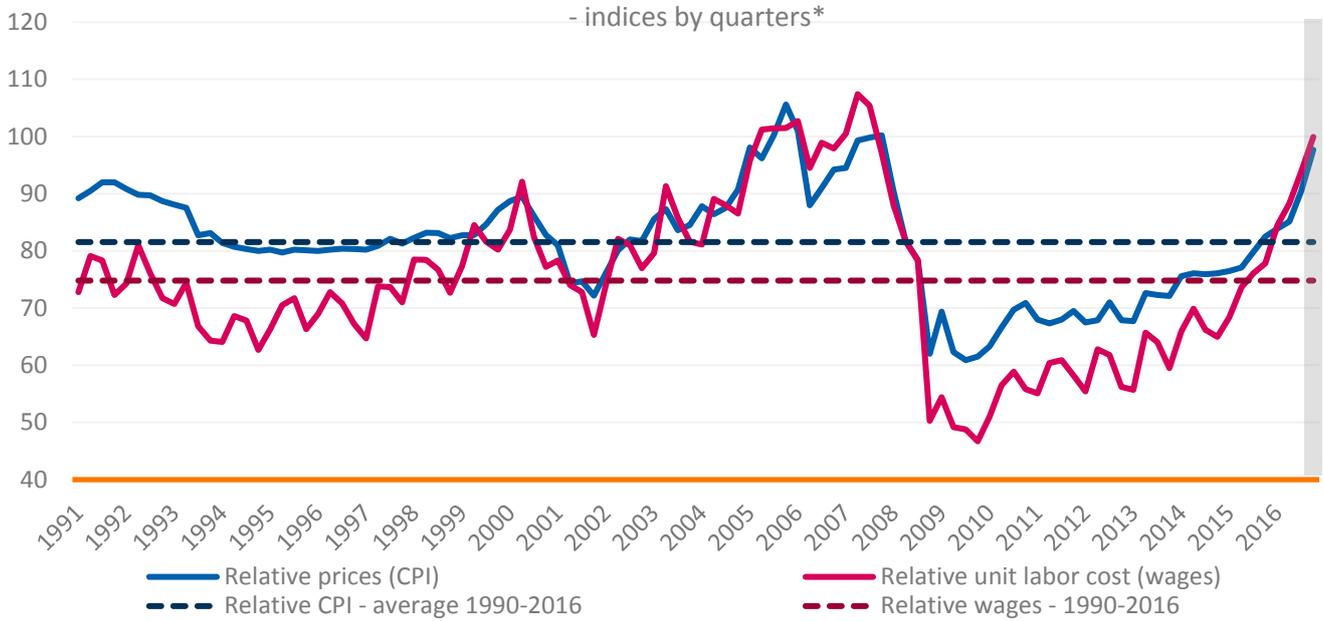


Sources: Statistics Iceland, Arion Research, Tourist Board \*forecast for 2016-2019

One of the main risk factors affecting our forecast is the domestic currency, the Icelandic Króna. The ISK has appreciated substantially in recent quarters and the real exchange rate is now at its 2007 level. Real exchange rate based on wages is now 34% above long-term average and 20% above long-term average based on price levels. In the short-term many indicators point towards further appreciation, but we question if that real exchange rate will be sustainable in the long-term.

## Real exchange rate of the króna

- indices by quarters\*

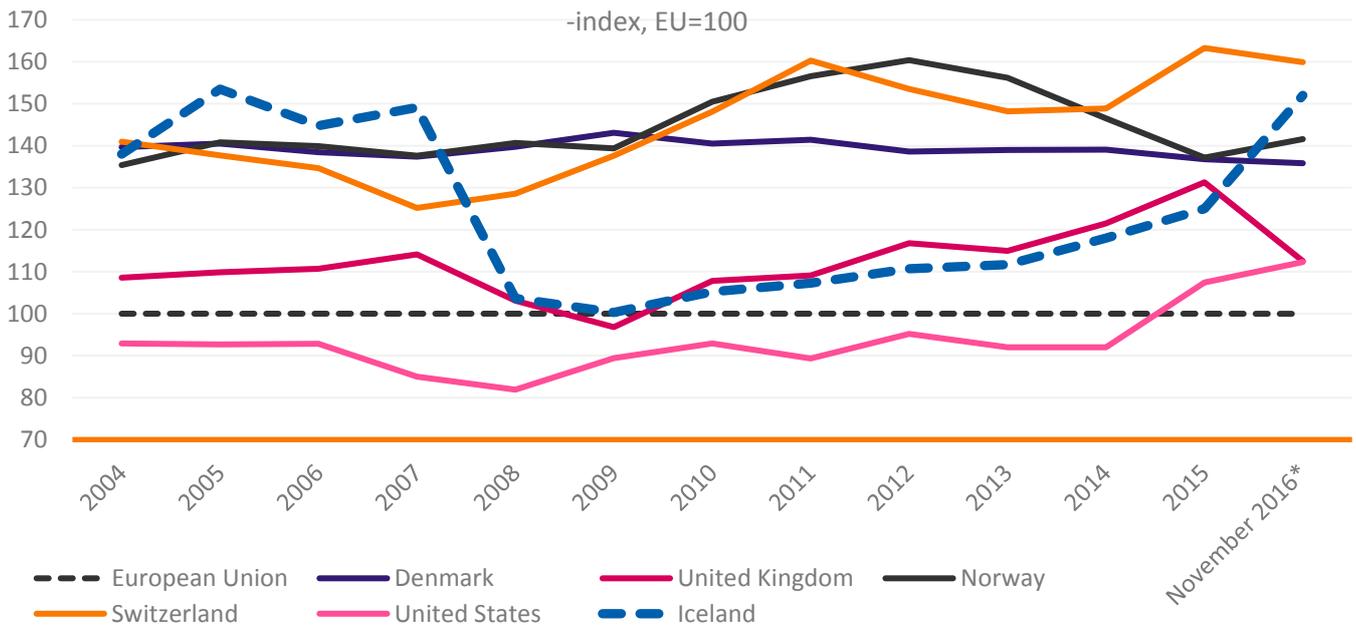


Sources: Central Bank of Iceland. \*2016 Q4 is as in our forecast, the nominal exchange rate is now (2 Nov) within 1% of the level assumed there.

Prices in Iceland are 5% lower than in Switzerland, the world's most expensive country according to the IMF. Iceland has become more expensive than both Norway and Denmark.

## Relative prices

-index, EU=100



Sources: Eurostat, Central Bank of Iceland, Arion Research. \*Assumes same CPI growth as in November 2016 and exchange rate as of 29 November

## It takes... three to tango? - Outcome of parliamentary elections 2016

On October 29, parliamentary elections were held in Iceland. Before the elections, polls showed the incumbent government of the Independence Party (IP) and Progressive Party (PP) losing its majority in parliament, which proved to be the case. For the PM's Progressive Party the elections turned out to be disastrous as the PP lost 11 of its 19 seats in parliament. The IP on the other hand was the winner of the election with 21 seats in parliament, up two seats from the elections in 2013. Both the Pirate Party and newcomer Revival (Viðreisn) gained the most seats in parliament, going from 3 to 10 and 0 to 7, respectively.

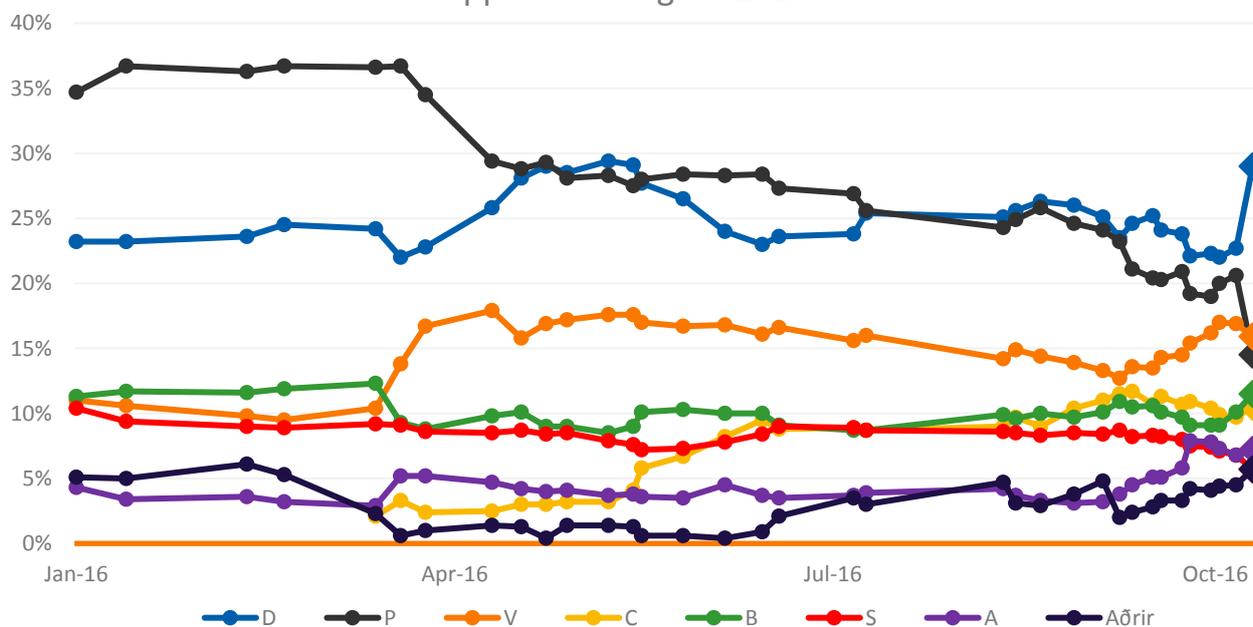
One of the biggest parties in previous elections, The Social Democratic Alliance, fared terribly in the elections and lost 6 seats, leaving them with a total of 3 seats. Shortly after the elections, Oddný Harðardóttir, announced her resignation as leader of the party.

Party	Votes	% of votes	Seats 2016	Seats 2013	Change
 Independence Party	54,990	29.0%	21	19	+ 2
 Left-Green movement	30,166	15.9%	10	7	+ 3
 Pirate Party	27,449	14.5%	10	3	+ 7
 Progressive Party	21,791	11.5%	8	19	- 11
 Revival	19,870	10.5%	7	0	+ 7
 Bright Future	13,578	7.2%	4	6	- 2
 Social Democrats	10,893	5.7%	3	9	- 6
Other	10,893	5.7%	0	0	
<b>Total</b>	<b>189,630</b>	<b>100%</b>	<b>63</b>	<b>63</b>	

Before the elections some of the foreign media had portrayed them as a historical event where the Icelandic parliament would be taken over by Pirates. That was hardly the case as the vote for the Pirate Party was substantially lower than polls had indicated. After having measured at around 35% approval rating in the beginning of the year the approval ratings gradually decreased for the Pirates and eventually dropped substantially in the elections themselves.

The Independence Party fared considerably better than polls had suggested, receiving 29% of votes compared to measuring at around 22-25% in polls.

Approval ratings in 2016 and results



Now, one month after the elections, there has yet to be formed a majority government. The mandate to form a government was initially given to the head of the IP which resulted in coalition discussions between the IP, Revival and Bright Future. Their discussions ended a few days later, resulting in the mandate to form a government being handed over to the head of Left-Green movement. The ensuing discussions included five parties; Left Greens, Pirate Party, Revival, Social Democrats and Bright Future. Their efforts were futile and the President ultimately decided that no one would receive the mandate from here. Rather, the President encouraged the elected parties to talk amongst themselves and possibly make compromises in order to form a functional majority government.

Going back to the drawing table, the IP, Revival and Bright Future have held informal discussions amongst themselves again. The previous discussions stranded on different opinions towards fisheries reform, but that seems to be the major stepping stone towards forming a government between the three at the moment. Today, November 29, the momentum has shifted towards coalition talks between the IP and Left-Greens and the parties are scheduled to meet later today. Parliament is to be set on December 6.