



CALM WATERS - CLOUDS ON
THE HORIZON
ECONOMIC OUTLOOK
2015-2017

ARION RESEARCH
APRIL 2015

POSITIVE OUTLOOK – BUT MODERATE GROWTH IN HISTORICAL COMPARISON

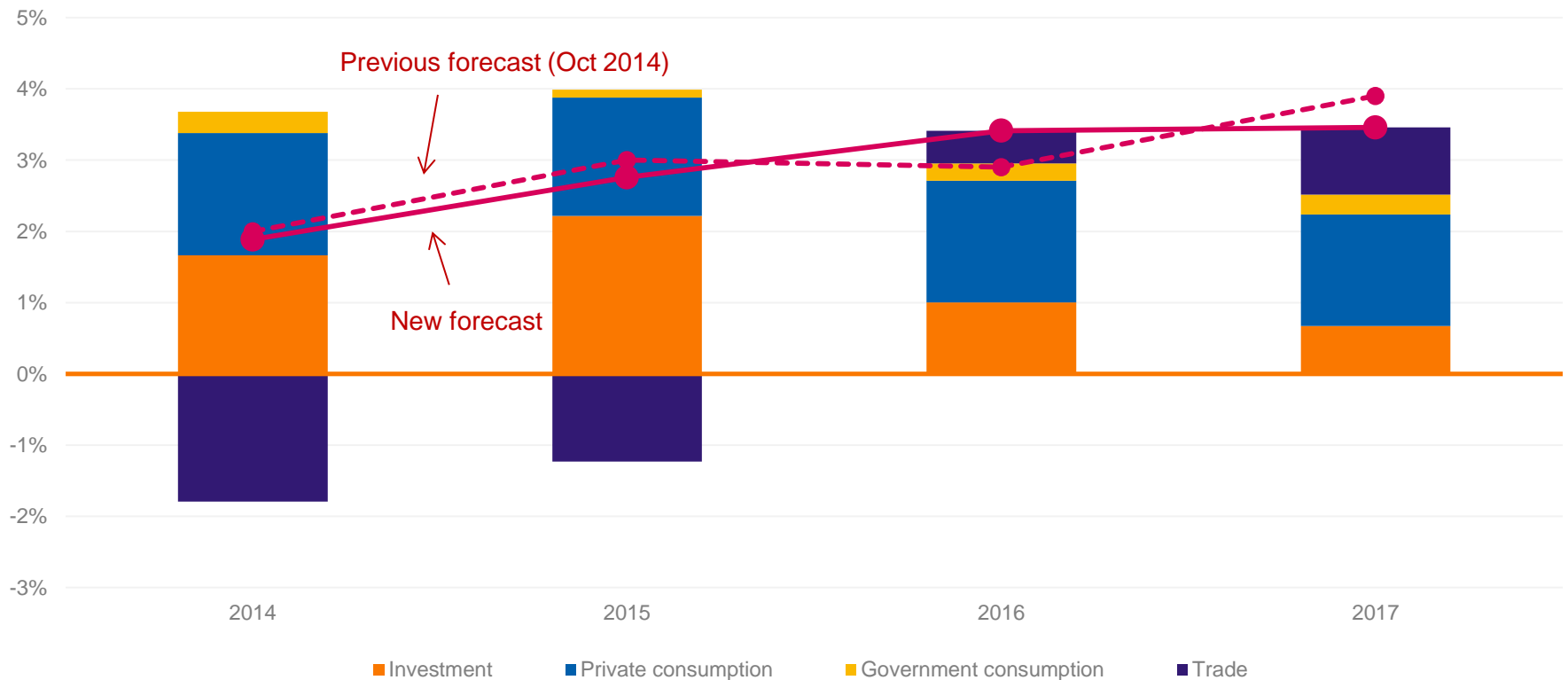
- Economic growth was only 1.9% last year. Nevertheless, there was healthy domestic demand.
- We are expecting economic growth to pick up this year and to grow in line with the long-term average over the next couple of years.
- Economic growth will initially be driven by domestic demand but increasingly by trade as time passes.
- We expect healthy growth in private consumption driven by increased purchasing power and improved equity positions of households.
- Investment is expected to grow strongly this year driven by strong business investment. Over the forecast horizon we are assuming investment in two silicon smelters, hotels, aeroplanes and several new ships to be the main driving factors. Still investment will remain below the historical average throughout the forecast horizon.
- Contribution of trade will be negative this year, due to high imports, but will return to positive next year.
- We assume a stable exchange rate throughout the period, but expect substantial pressure on inflation in the latter half of 2015, driven by continued increase in housing prices and substantial wage increases. Hence, we expect the CBI to increase its interest rates in Q3 2015 already in order to keep inflation in check.

<i>Change from previous year (%)</i>	2014	2015	2016	2017
Private Consumption	3.7	3.6	3.3	3.0
Government Consumption	1.8	1.4	1.1	1.2
Gross Fixed Capital Formation	13.7	16.5	5.5	3.9
Domestic Demand	5.3	5.0	3.1	2.6
Exports of Goods and Services	3.1	4.0	4.1	4.2
Imports of Goods and Services	9.9	8.0	3.9	2.7
Gross Domestic Production	1.9	2.8	3.3	3.5
Inflation (annual avg. %)	2.0	1.8	3.4	2.9
Wage Index	5.5	7.1	5.9	5.0
Real Wage Index	3.5	5.3	2.5	2.1
Unemployment (annual avg. %)	5.0	4.8	4.4	4.1
Exchange rate EURISK	154.9	150.38	150.38	150.38

INCREASED ECONOMIC GROWTH – BUT LOWER THAN LONG-TERM AVERAGE THIS YEAR

TRADE REDUCES GROWTH THIS YEAR BUT MAKES A POSITIVE CONTRIBUTION OVER THE NEXT COUPLE OF YEARS

Growth contribution of GDP components

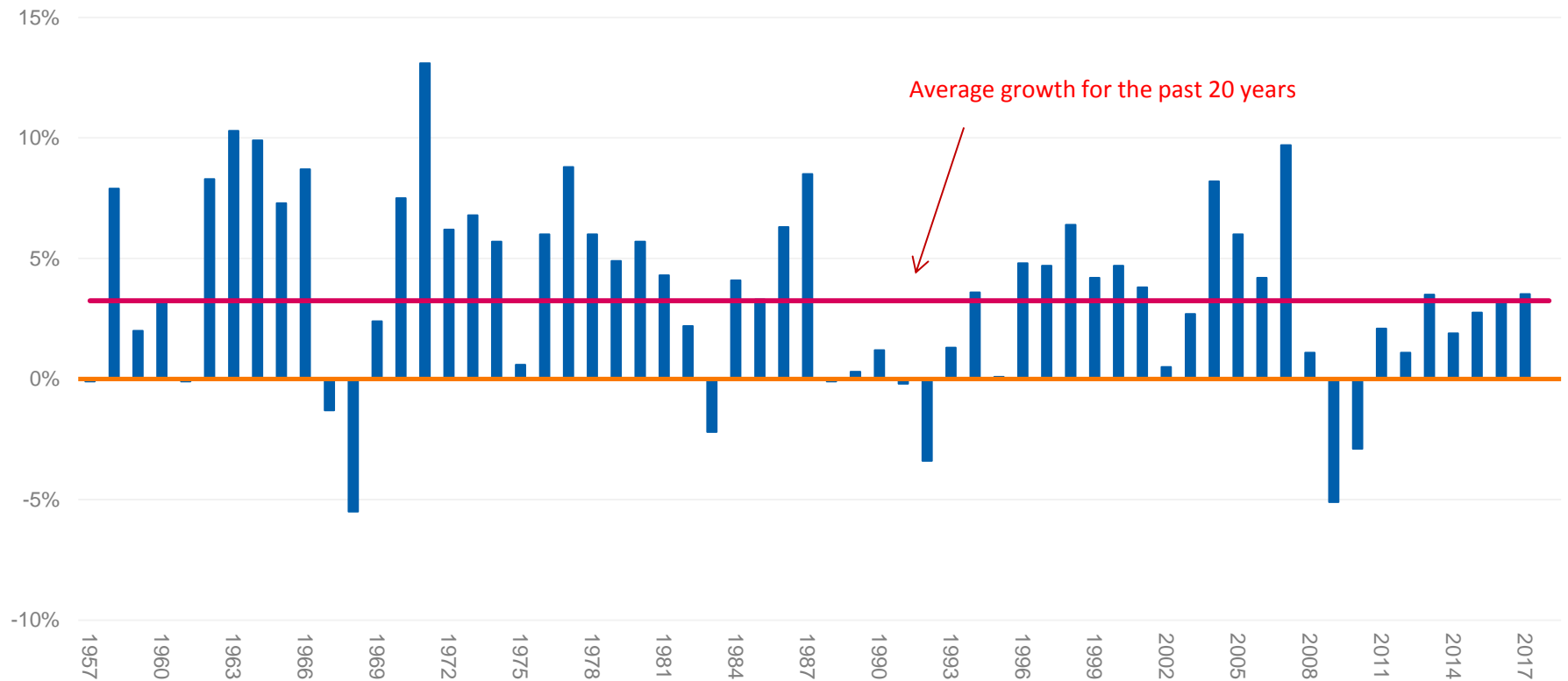


Sources: Statistics Iceland, Arion Research

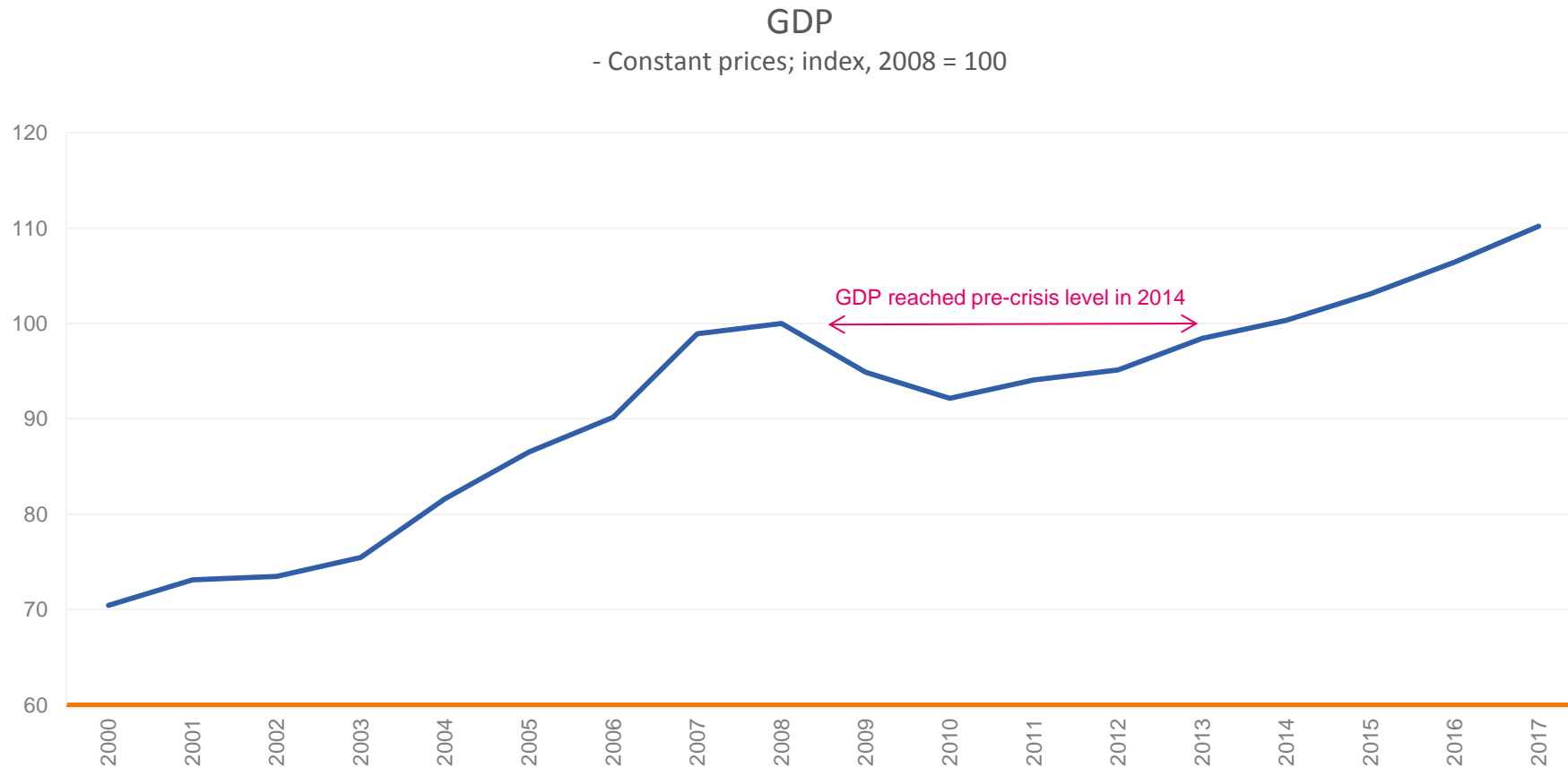
ECONOMIC GROWTH SIMILAR TO THE 20 YEAR AVERAGE

ALTHOUGH IT IS SLIGHTLY LOWER THIS YEAR

Growth 1957-2017
- Arion Research forecast 2015-2017



FINALLY WE HAVE REACHED THE PRE-CRISIS CAPACITY LEVEL

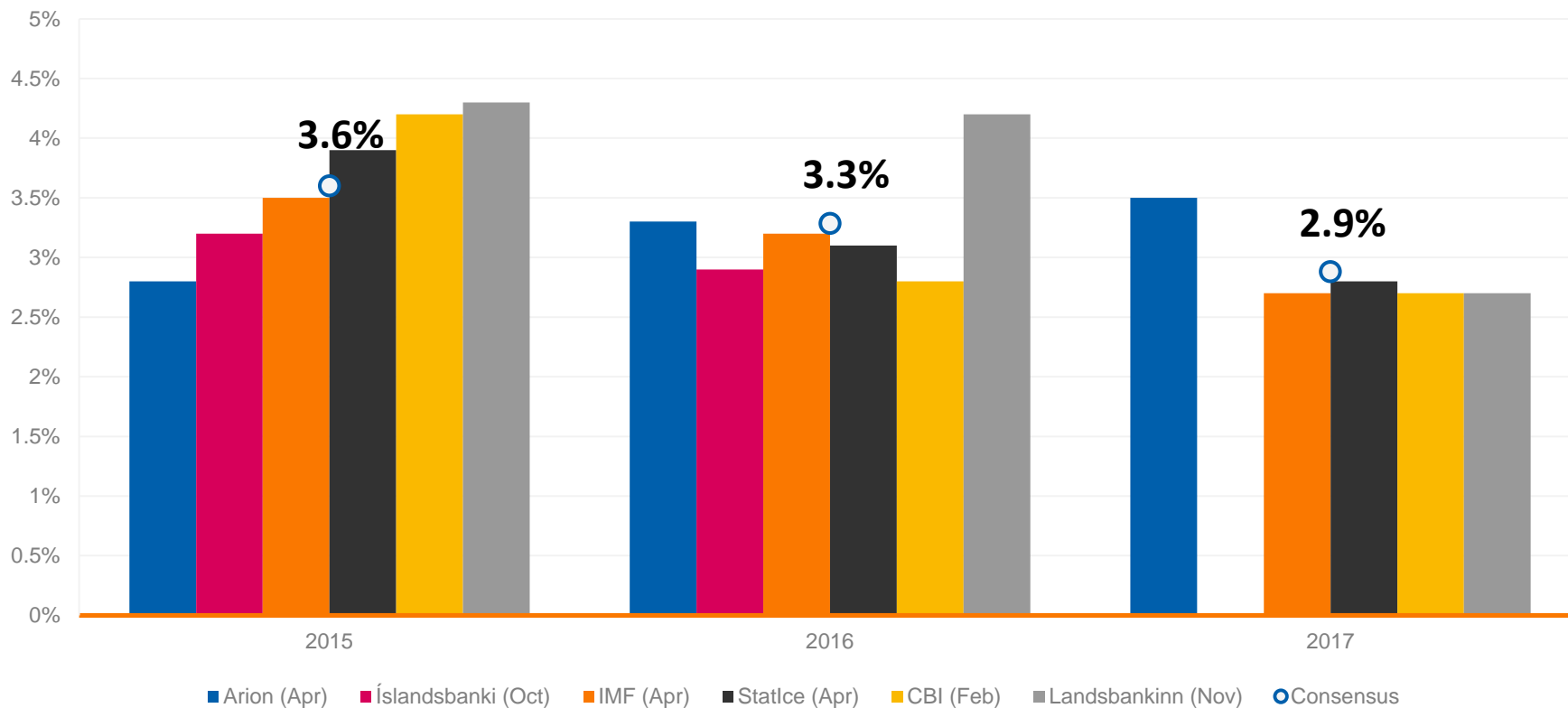


Sources: Statistics Iceland, Arion Research

SUBSTANTIAL SPREAD IN FORECAST OF MAIN ANALYSTS

OUR FORECAST SOMEWHAT BELOW THE CONSENSUS FOR 2015

GDP growth forecasts 2015 - 2017

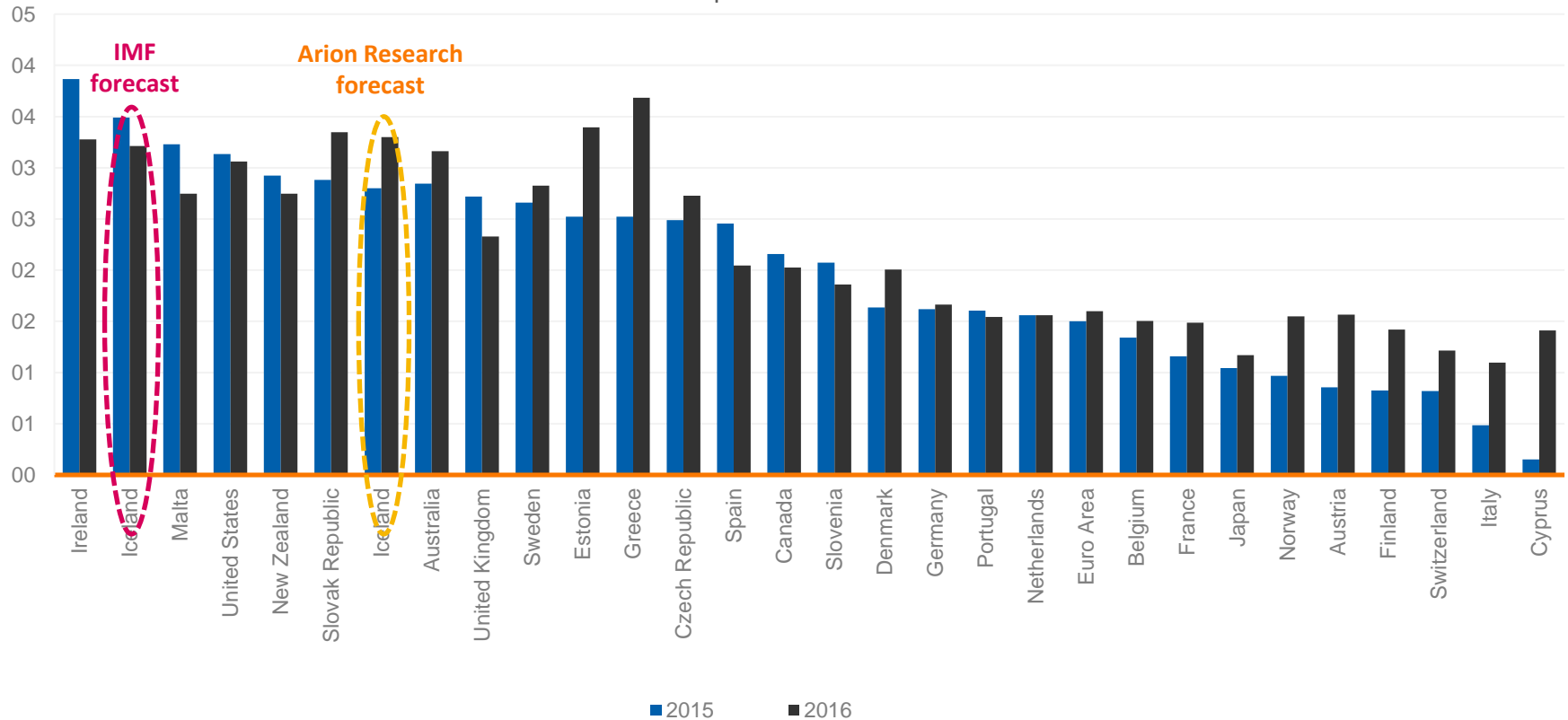


Sources: CBI, IMF, Statlce, Landsbankinn, Íslandsbanki, Arion Research

GROWTH PROSPECTS IN ICELAND VERY FAVOURABLE COMPARED WITH MAJOR TRADING PARTNERS

Near term growth prospects of major trading partners

- IMF April 2015 forecast

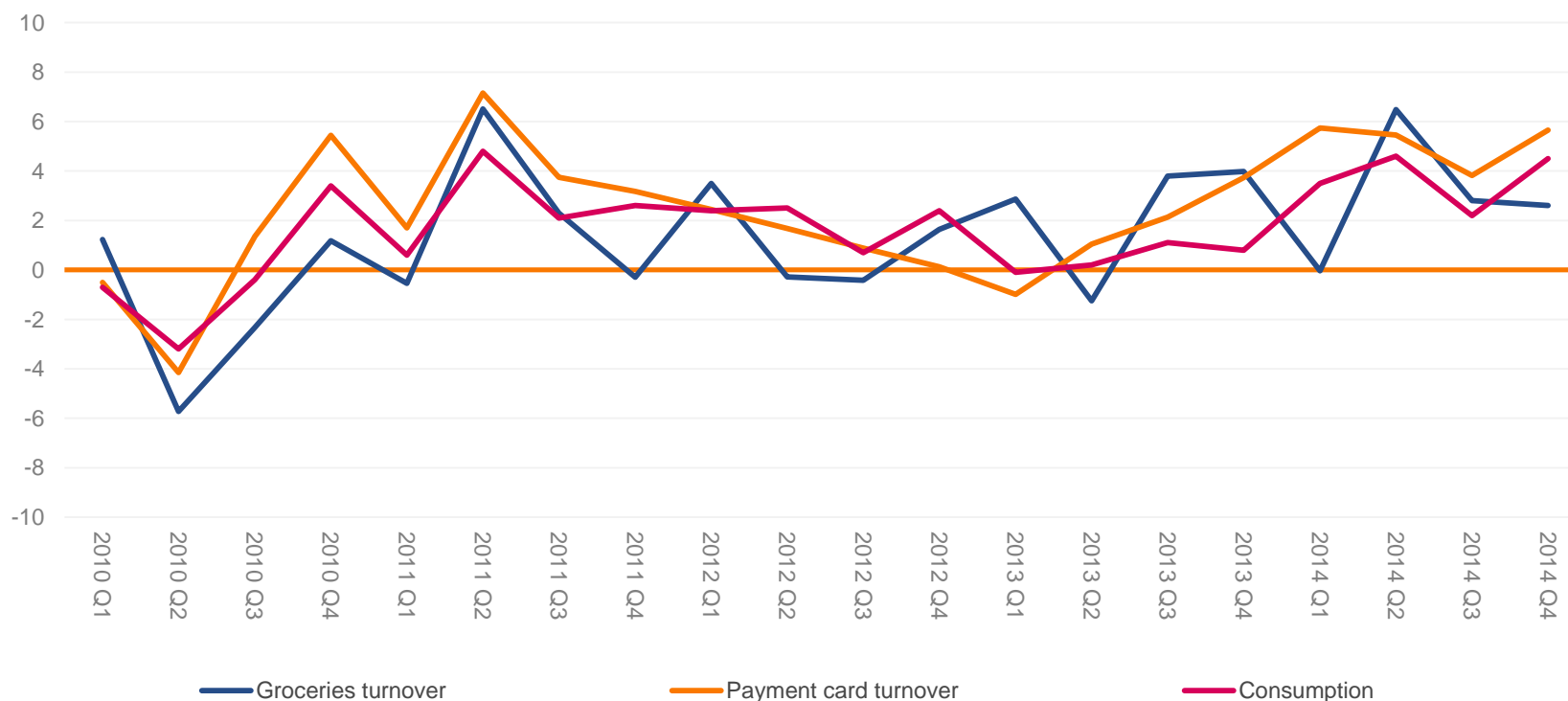


Sources: IMF, Arion Research

PRIVATE CONSUMPTION HAS STARTED TO PICK UP OVER THE PAST YEAR

INCREASED PURCHASING POWER, IMPROVED ECONOMIC SITUATION OF HOUSEHOLDS AND SPECIAL POST-CRISIS DISBURSEMENTS HAVE ALL SUPPORTED GROWTH

Private consumption, payment card and groceries turnover
- % change, YoY

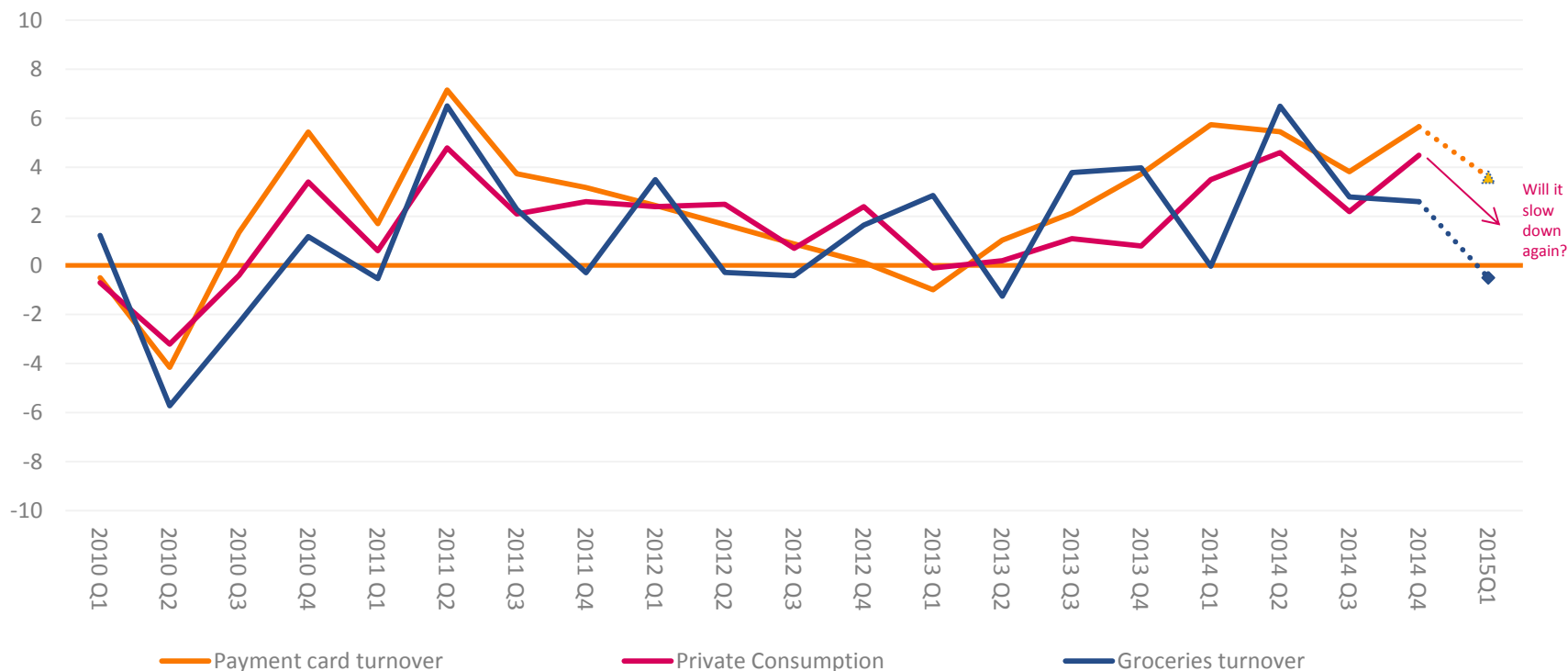


Sources: Central Bank of Iceland, Statistics Iceland, Arion Research

BUT THERE ARE INDICATIONS OF A SLOWER START TO THE YEAR

BOTH GROCERIES AND HOUSEHOLD CARD TURNOVER HAVE SLOWED DOWN AT THE BEGINNING OF THE YEAR

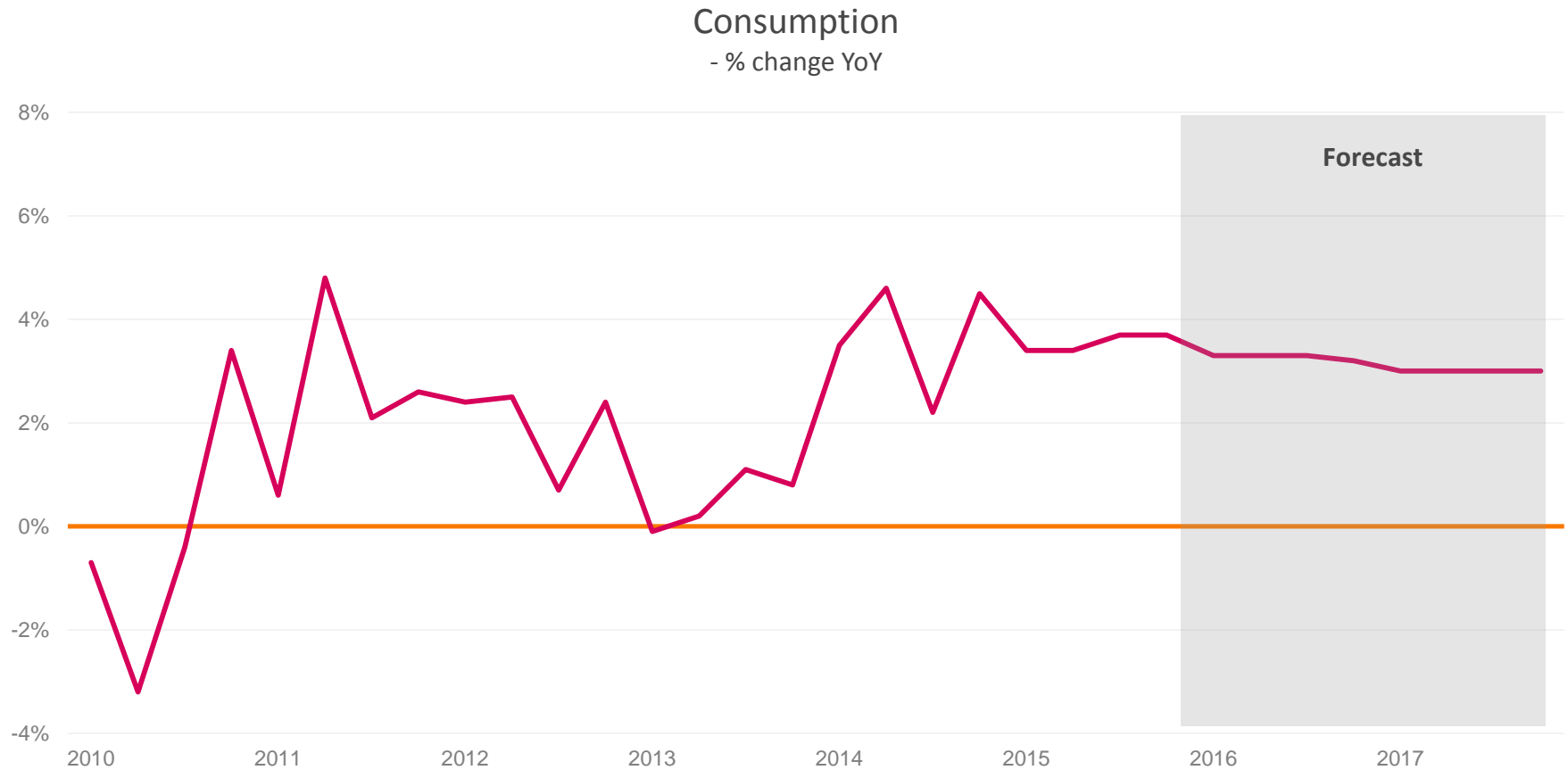
Private consumption, payment card and groceries turnover
- % change, YoY



*Dotted line indicates data for January and February only
Sources: CBI, Statistics Iceland, Arion Research

NEVERTHELESS, WE EXPECT HEALTHY CONSUMPTION GROWTH GOING FORWARD

IMPROVED EQUITY POSITION, THE DEBT FORGIVENESS PROGRAMME OF THE GOVERNMENT AND CONTINUED IMPROVEMENT IN PURCHASING POWER WILL SUPPORT CONSUMPTION

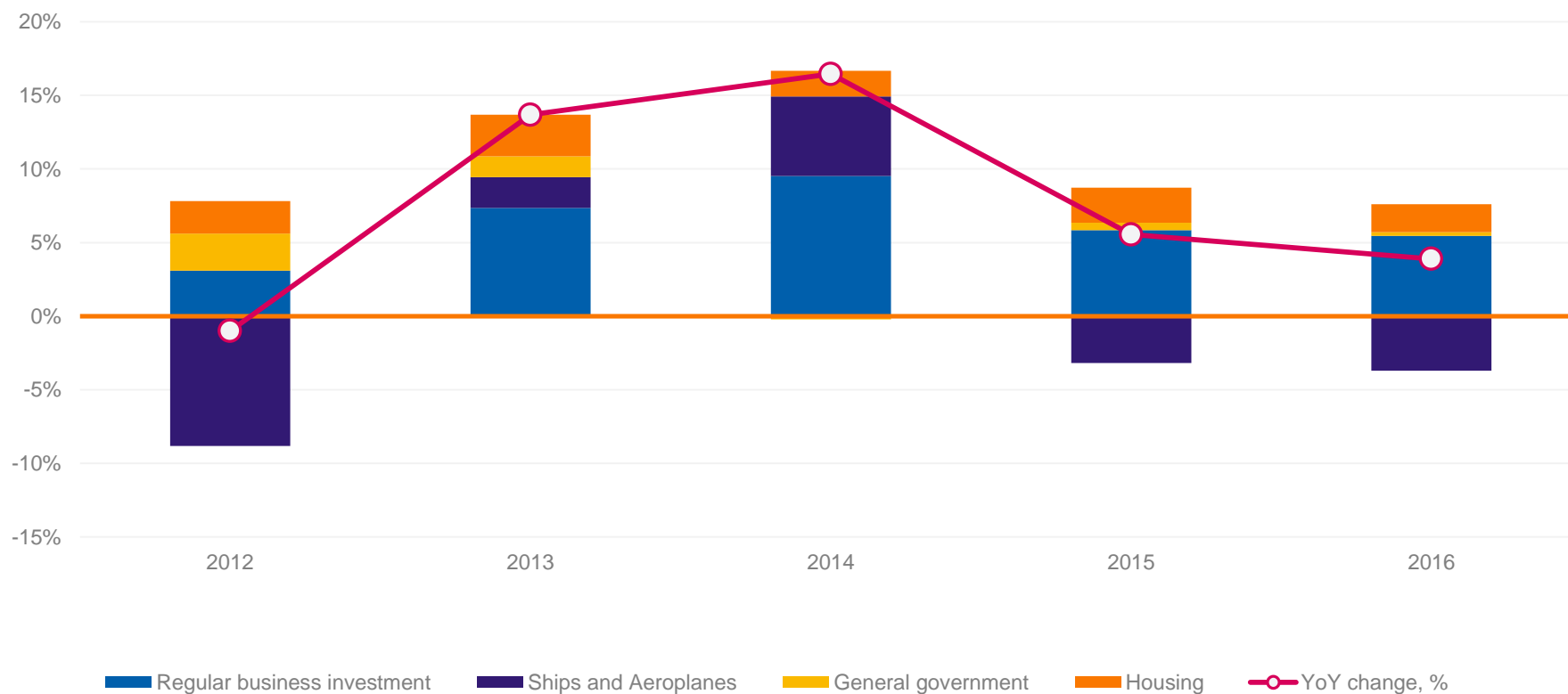


Sources: Statistics Iceland, Arion Research

BUSINESS INVESTMENT GOING STRONG

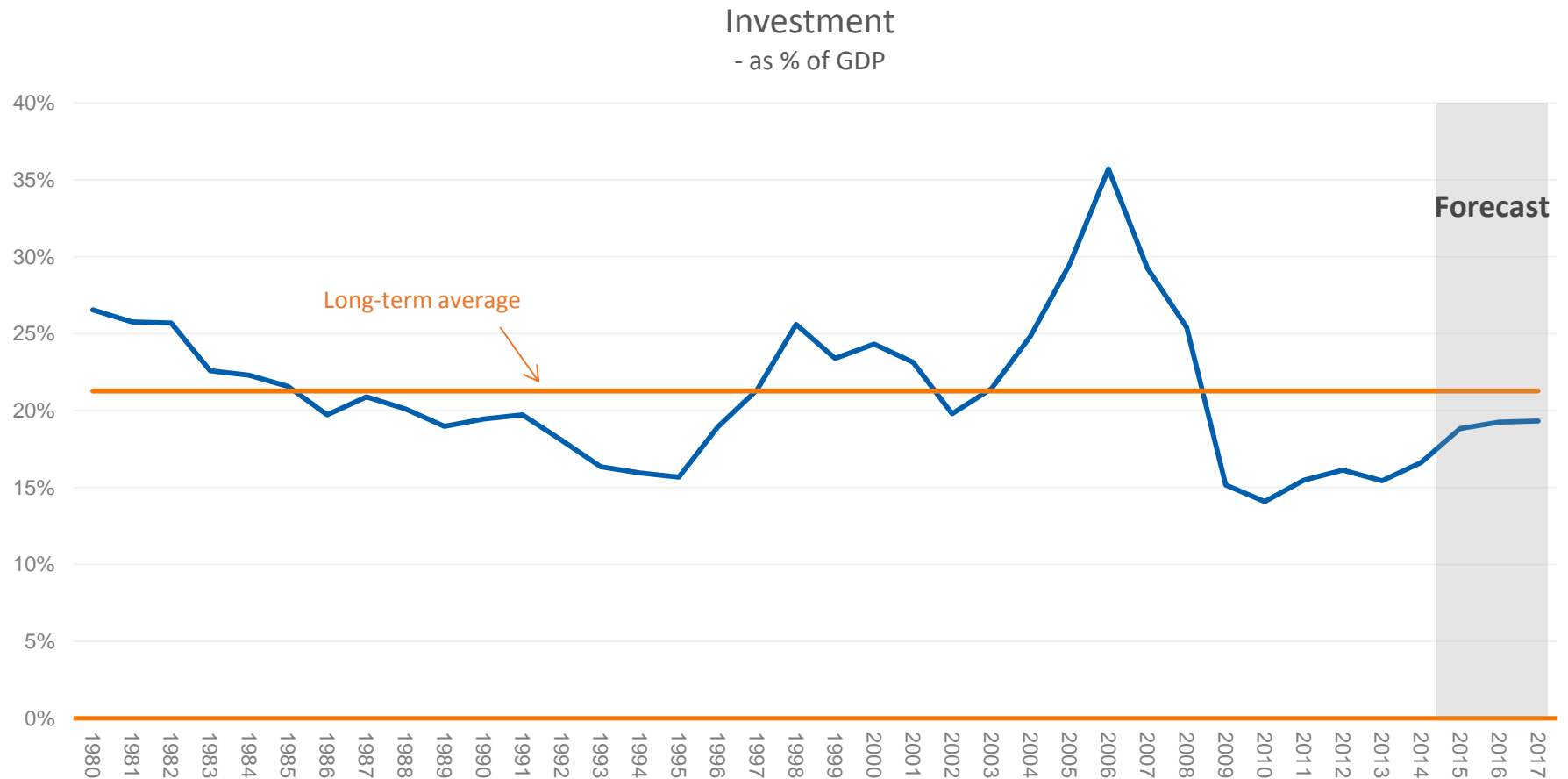
HOTELS AND SILICON SMELTERS DRIVE BUSINESS INVESTMENT

Growth contribution of investment components



Sources: Statistics Iceland, Arion Research

INVESTMENT AS % OF GDP REMAINS BELOW LONG-TERM AVERAGE

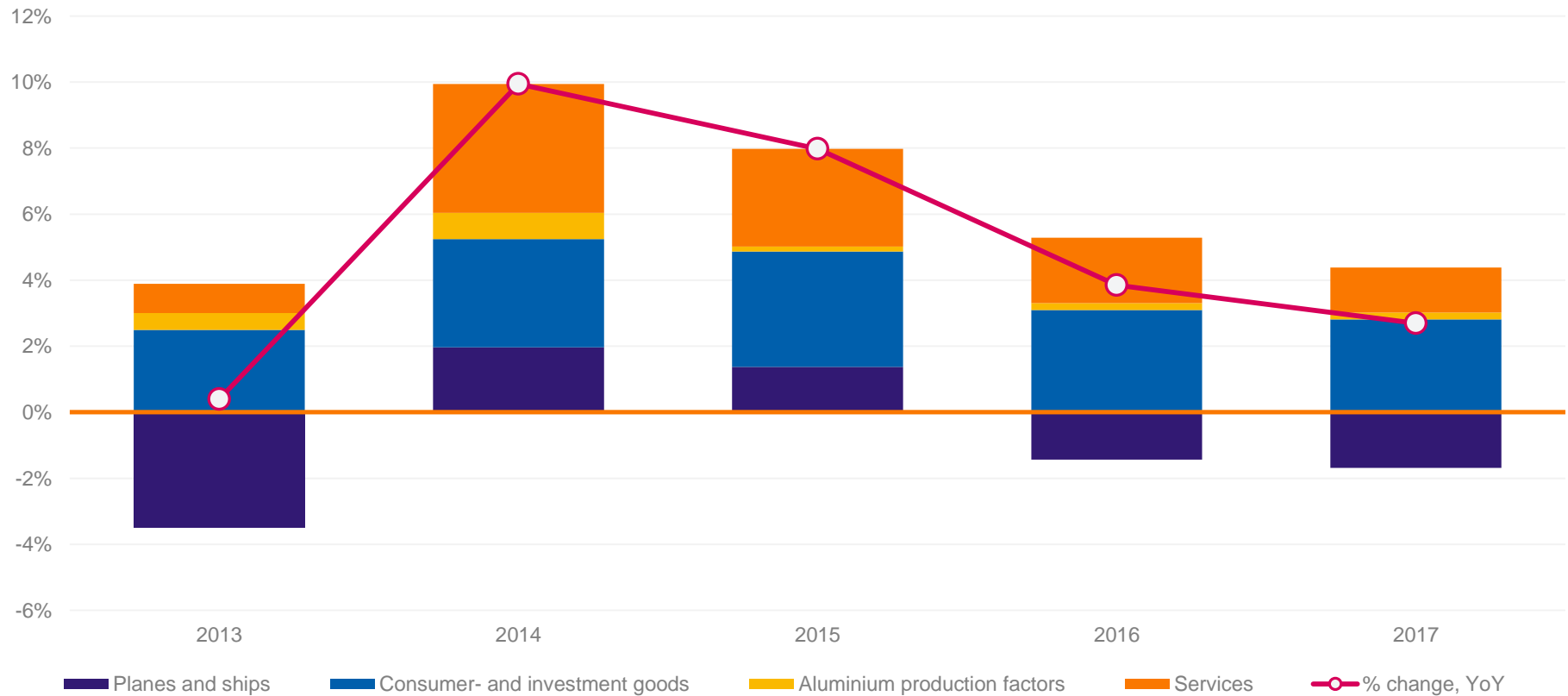


Sources: Statistics Iceland, Arion Research

ONGOING STRONG GROWTH IN IMPORTED CONSUMER AND INVESTMENT GOODS

IN LINE WITH INCREASED CONSUMPTION AND INVESTMENT

Growth contribution of imports components

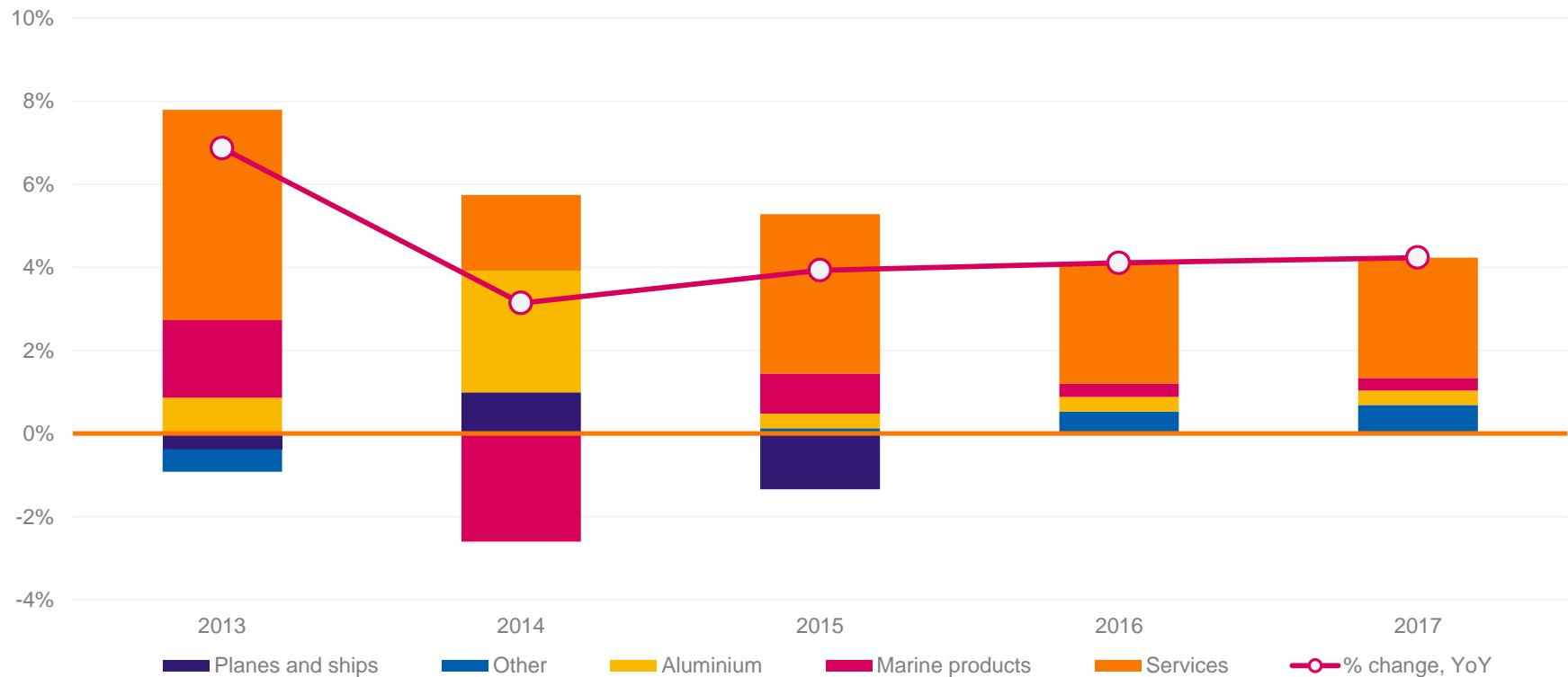


Sources: Statistics Iceland, Arion Research

EXPORTED SERVICES THE MAIN DRIVER OF EXPORTS OVER THE NEXT FEW YEARS

BUT "OTHER" EXPORTS WILL SUPPORT INCREASED EXPORTS IN 2016 AND 2017

Growth contribution of export components

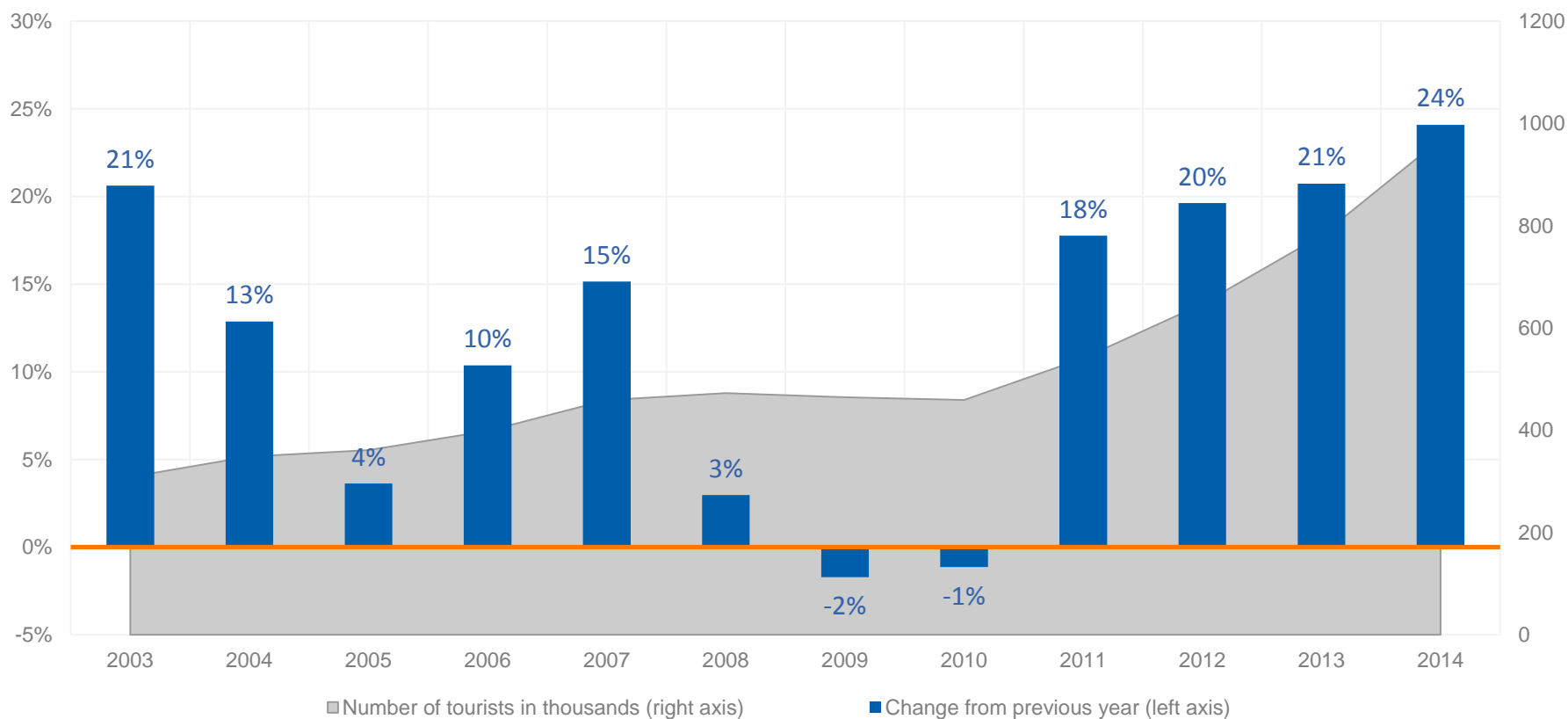


Sources: Statistics Iceland, Arion Research

RECORD RATE OF INCREASE IN TOURIST ARRIVALS LAST YEAR

31% YEAR ON YEAR INCREASE IN TOURIST ARRIVALS IN Q1 2015

Tourist arrivals via Keflavik International Airport

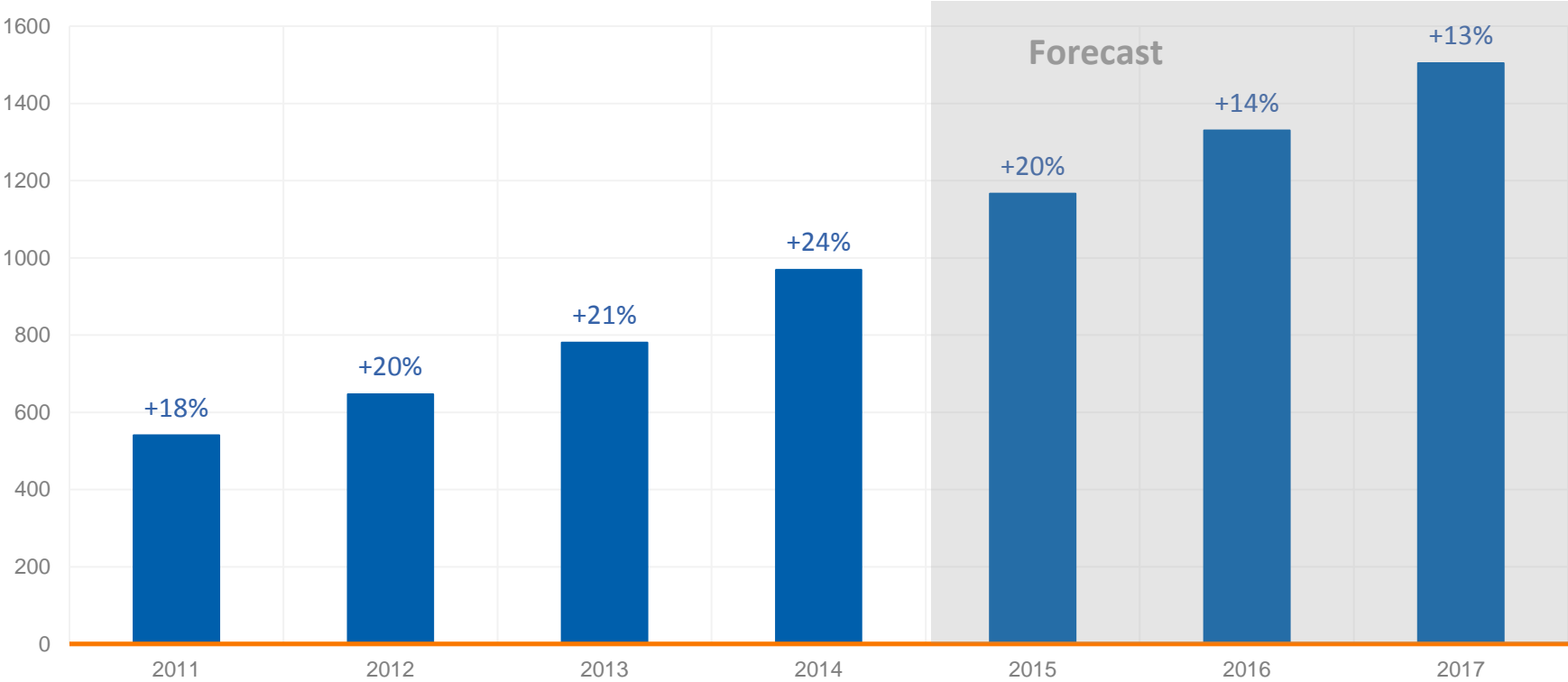


Source: Icelandic Tourist Board

ARION RESEARCH PREDICTS 20% GROWTH THIS YEAR

FORECASTING 1.5 MILLION TOURISTS IN 2017

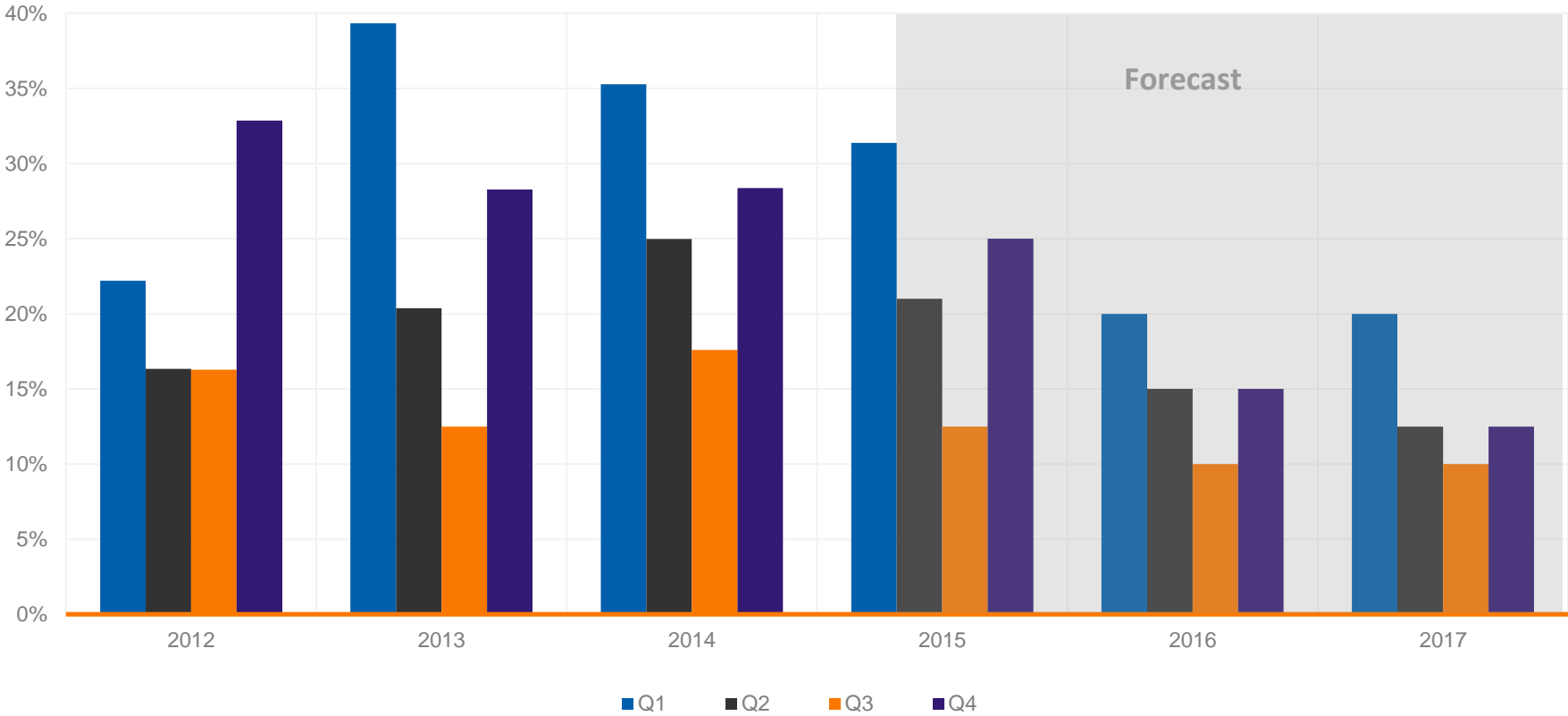
Tourist arrivals via Keflavik Int'l Airport
- annual numbers and growth



THE LARGEST RELATIVE INCREASE OUTSIDE THE SUMMER MONTHS

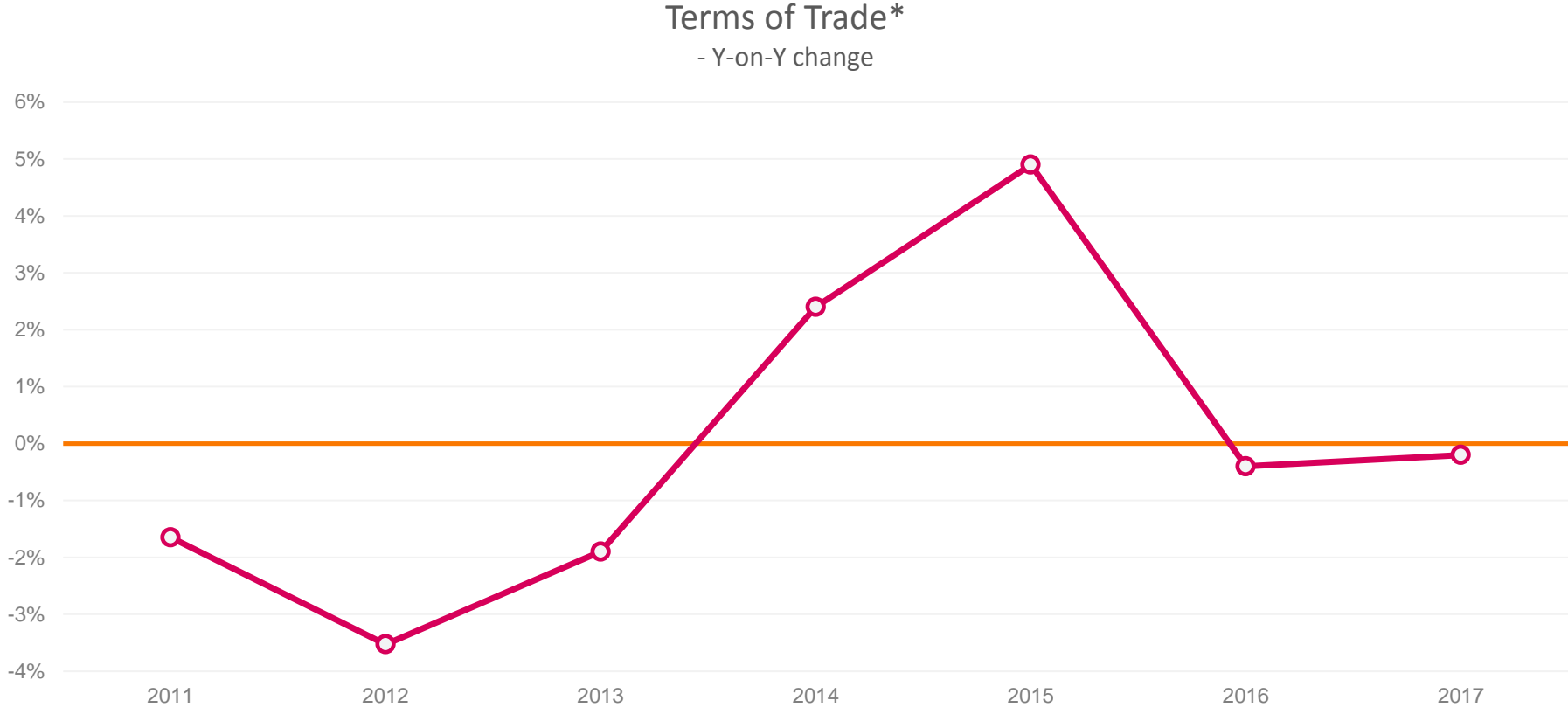
SEASONALITY SHOULD THEREFORE DECREASE FURTHER

Increase in foreign tourist arrivals via Keflavik Int'l Airport
- quarterly data



AT THE SAME TIME TERMS OF TRADE ARE IMPROVING

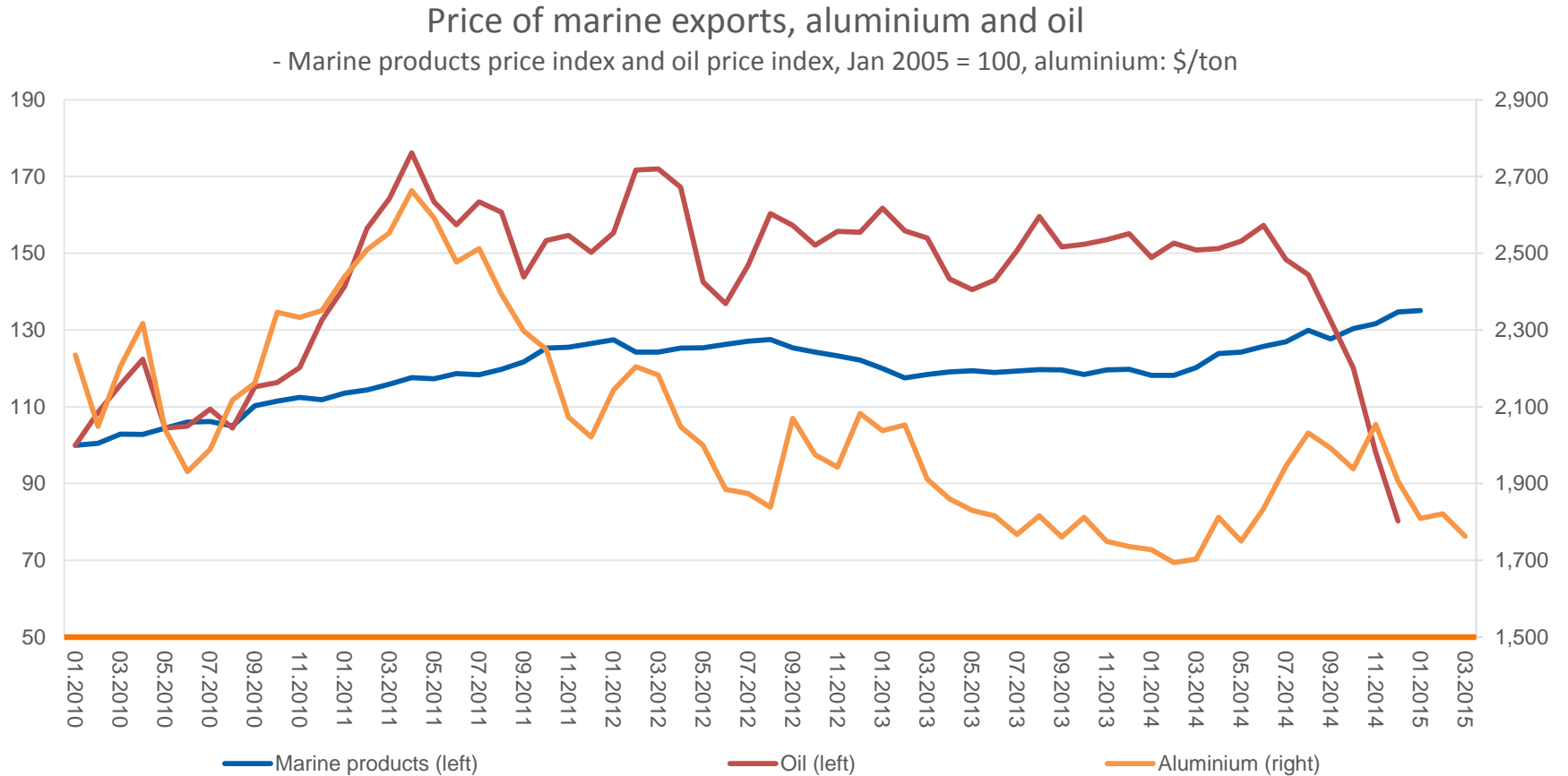
EXPORT PRICES ARE RISING AT THE SAME TIME AS IMPORT PRICES ARE DECLINING



*CBI forecast
Source: Central Bank of Iceland

MARINE PRODUCT AND ALUMINIUM PRICES HAVE BEEN INCREASING

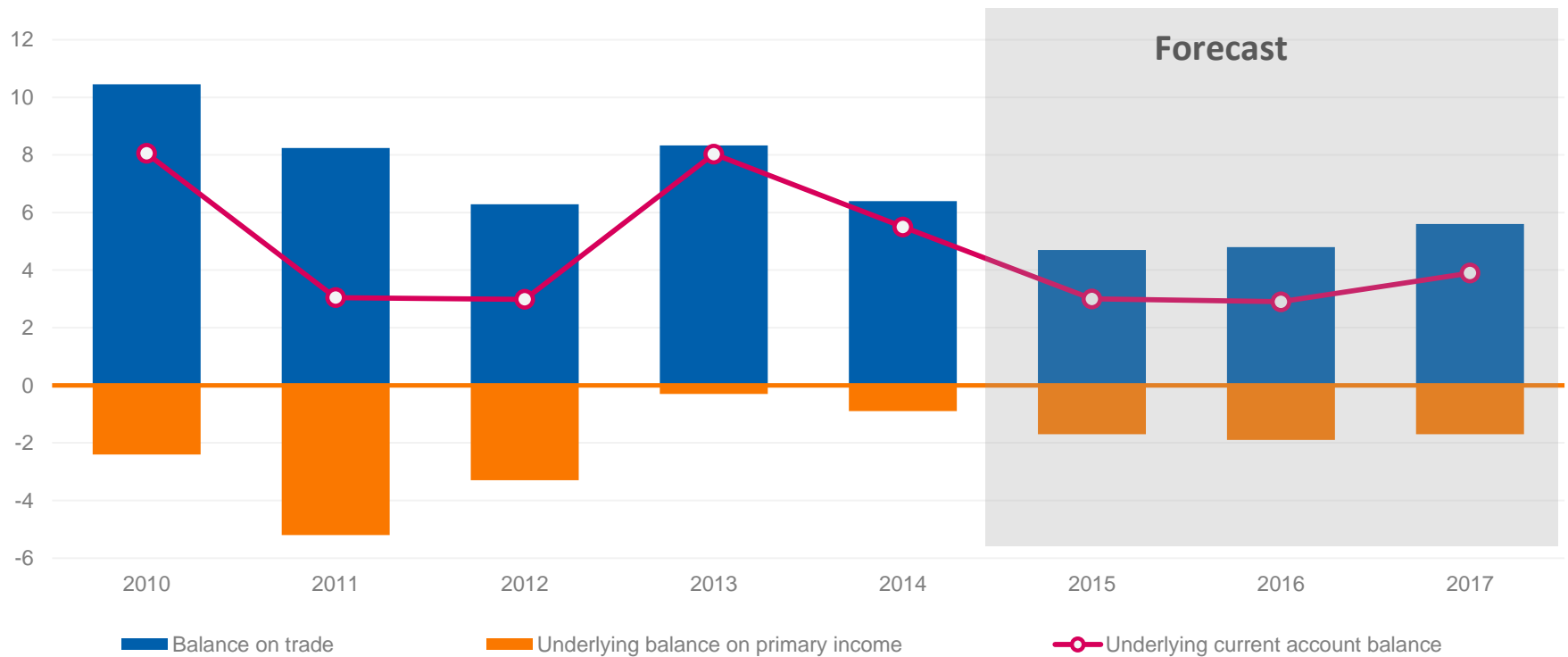
WHILST OIL PRICES HAVE PLUMMETED



Source: Central Bank of Iceland

IMPROVED TERMS OF TRADE SUPPORT CONTINUED CURRENT ACCOUNT SURPLUS

Underlying current account balance
- % of GDP

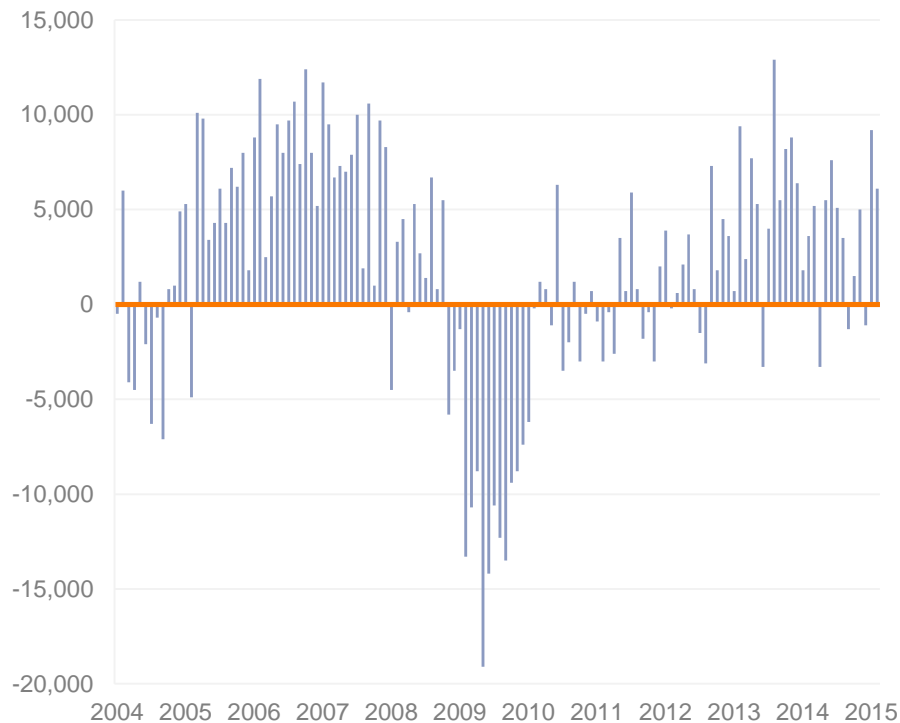


Sources: Central Bank of Iceland, Arion Research

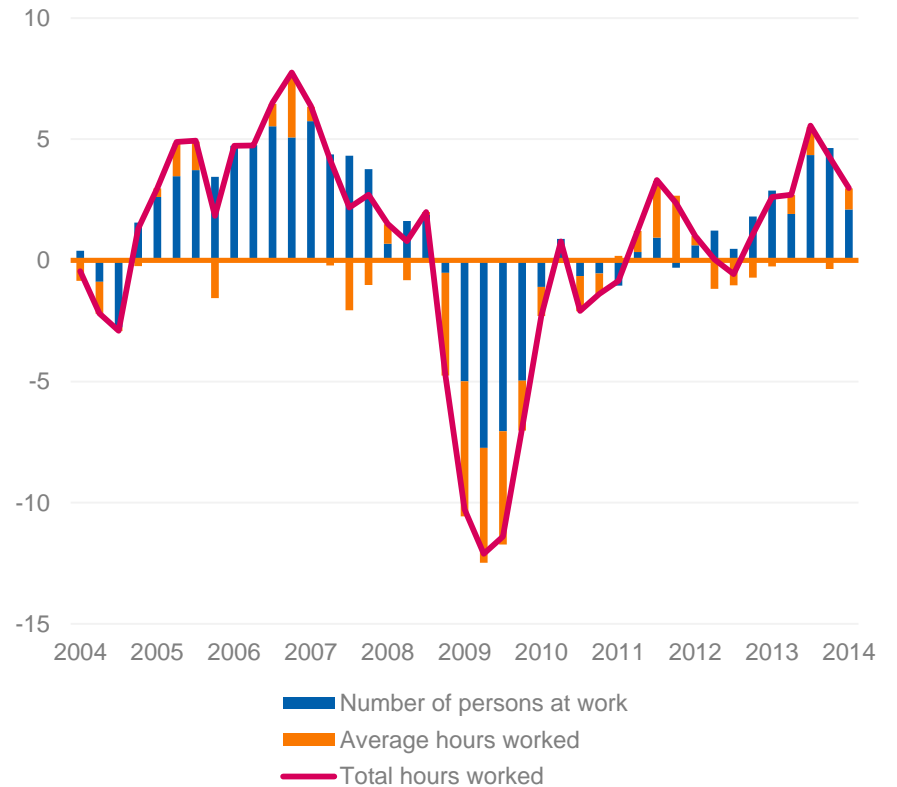
THE LABOR MARKET HAS CONTINUED TO IMPROVE

BOTH THE NUMBER OF JOBS AND TOTAL HOURS WORKED HAVE CONTINUED TO GROW

Change in number of jobs
- change from previous year



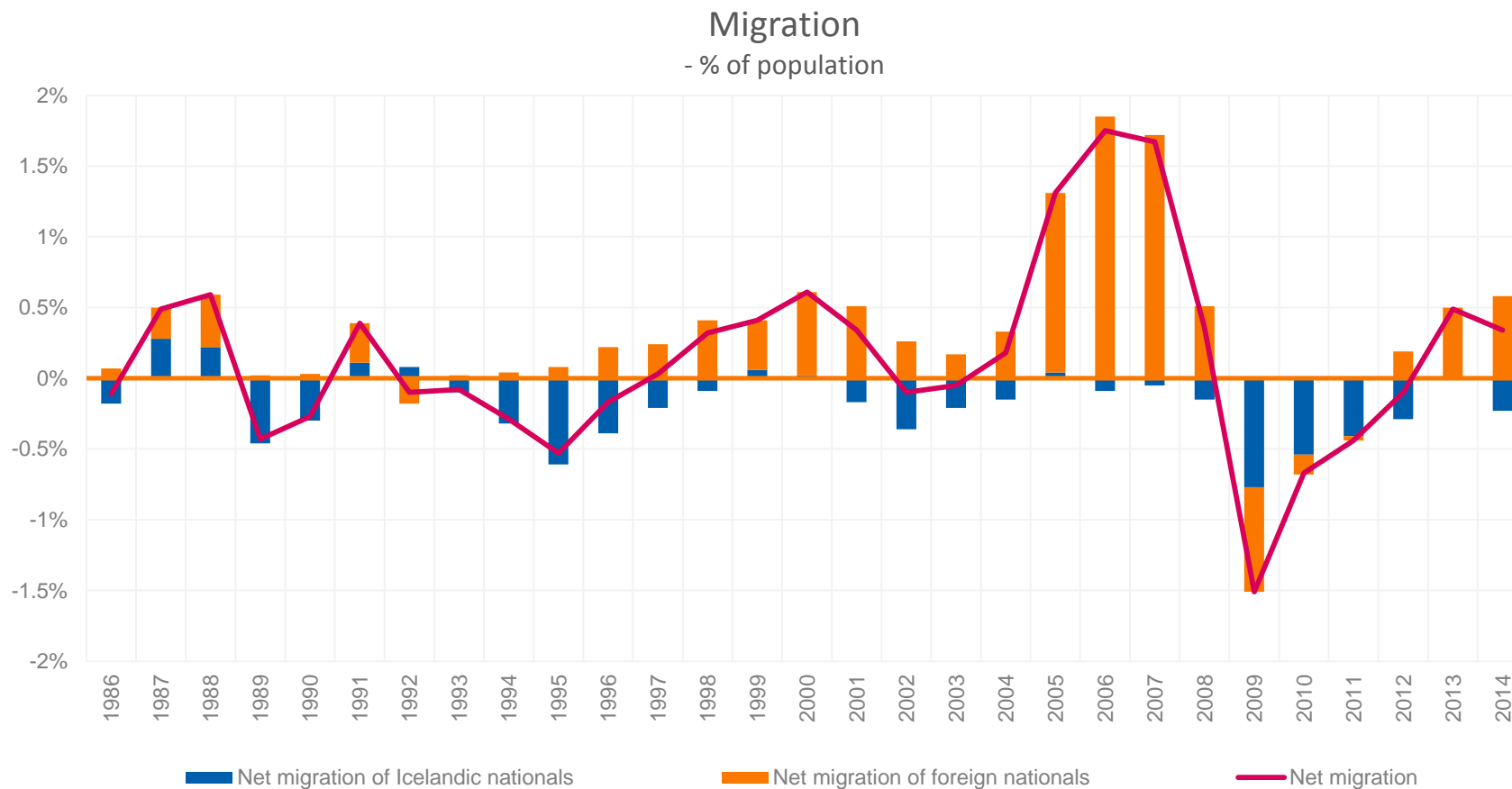
Change in employment and hours worked
- change YoY



Sources: Central Bank of Iceland, Statistics Iceland, Arion Research

NET IMMIGRATION TO ICELAND OVER THE LAST TWO YEARS

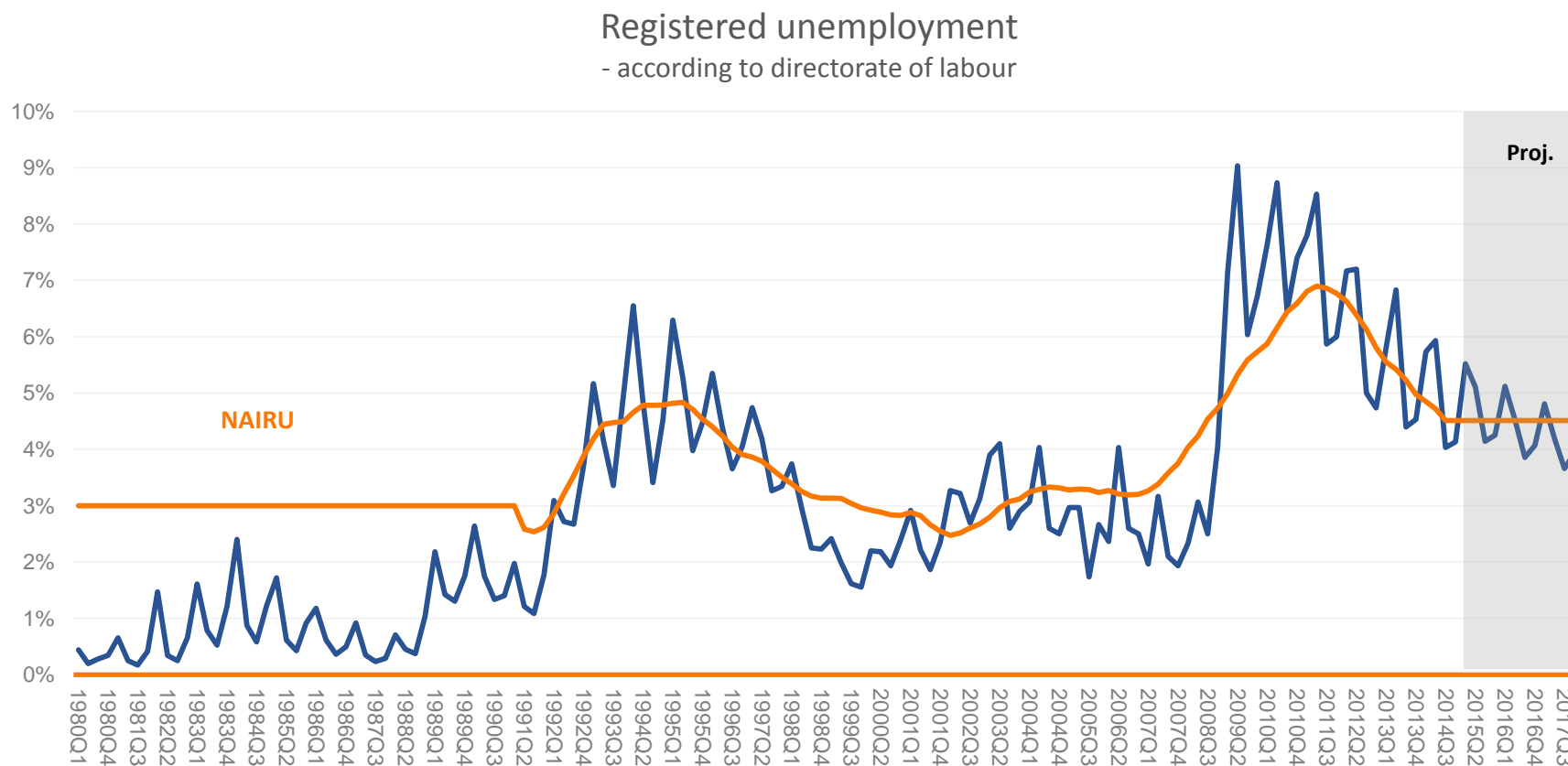
NET MIGRATION OF ICELANDIC NATIONALS REMAINS NEGATIVE



Sources: Central Bank of Iceland, Statistics Iceland, Arion Research

UNEMPLOYMENT HAS COME DOWN RAPIDLY

BUT IS PROJECTED TO ONLY DECREASE SLIGHTLY FURTHER THROUGHOUT THE FORECAST HORIZON



Sources: Central Bank of Iceland, Statistics Iceland, Arion Research

CONSIDERABLE WAGE INCREASES THROUGHOUT THE FORECAST HORIZON

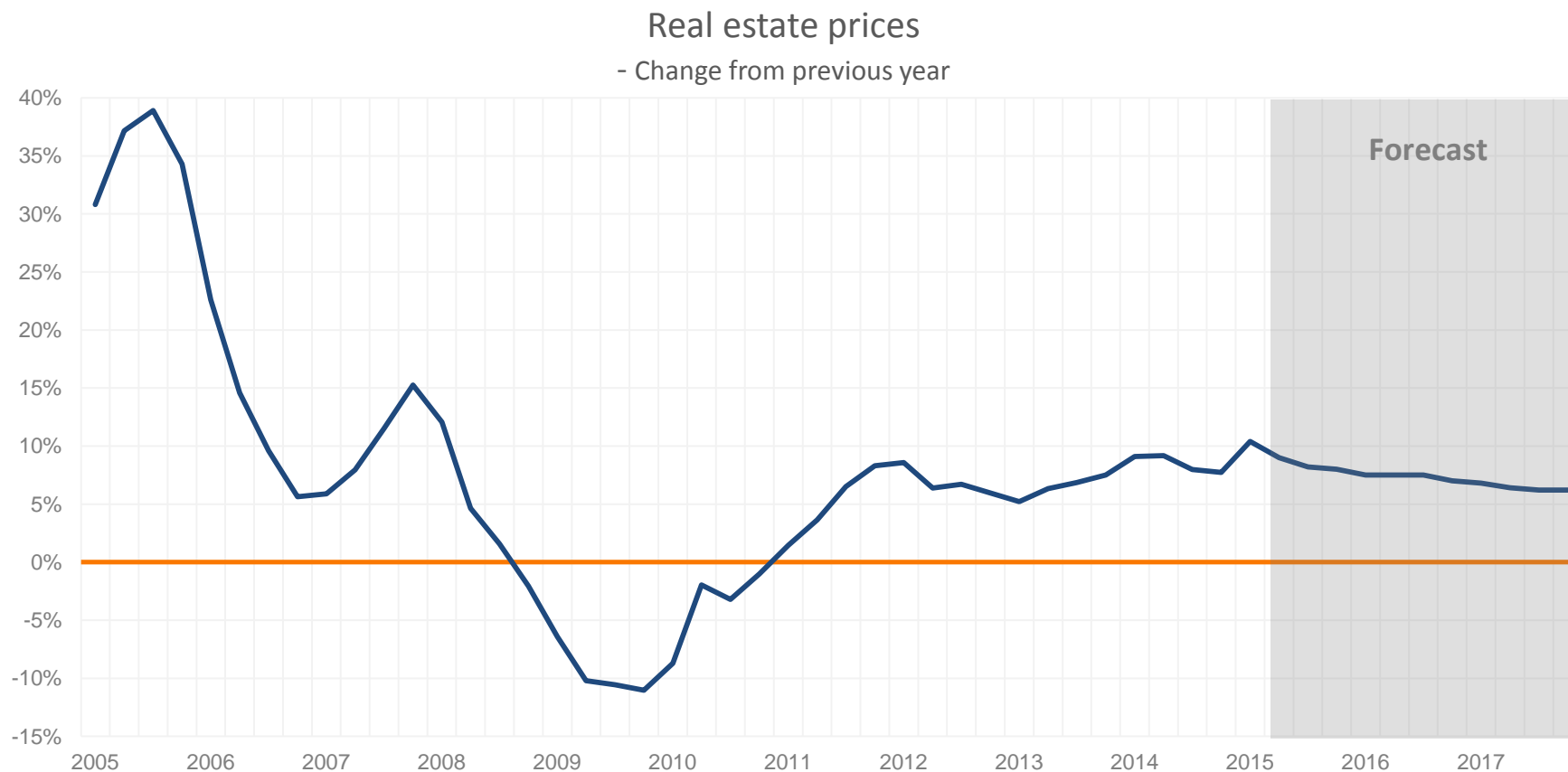
WELL BEYOND THE CBI'S INFLATION TARGET



Sources: Central Bank of Iceland, Statistics Iceland, Arion Research
Labor productivity forecast from CBI's Monetary Bulletin 2015/1

REAL ESTATE PRICES CONTINUE TO INCREASE

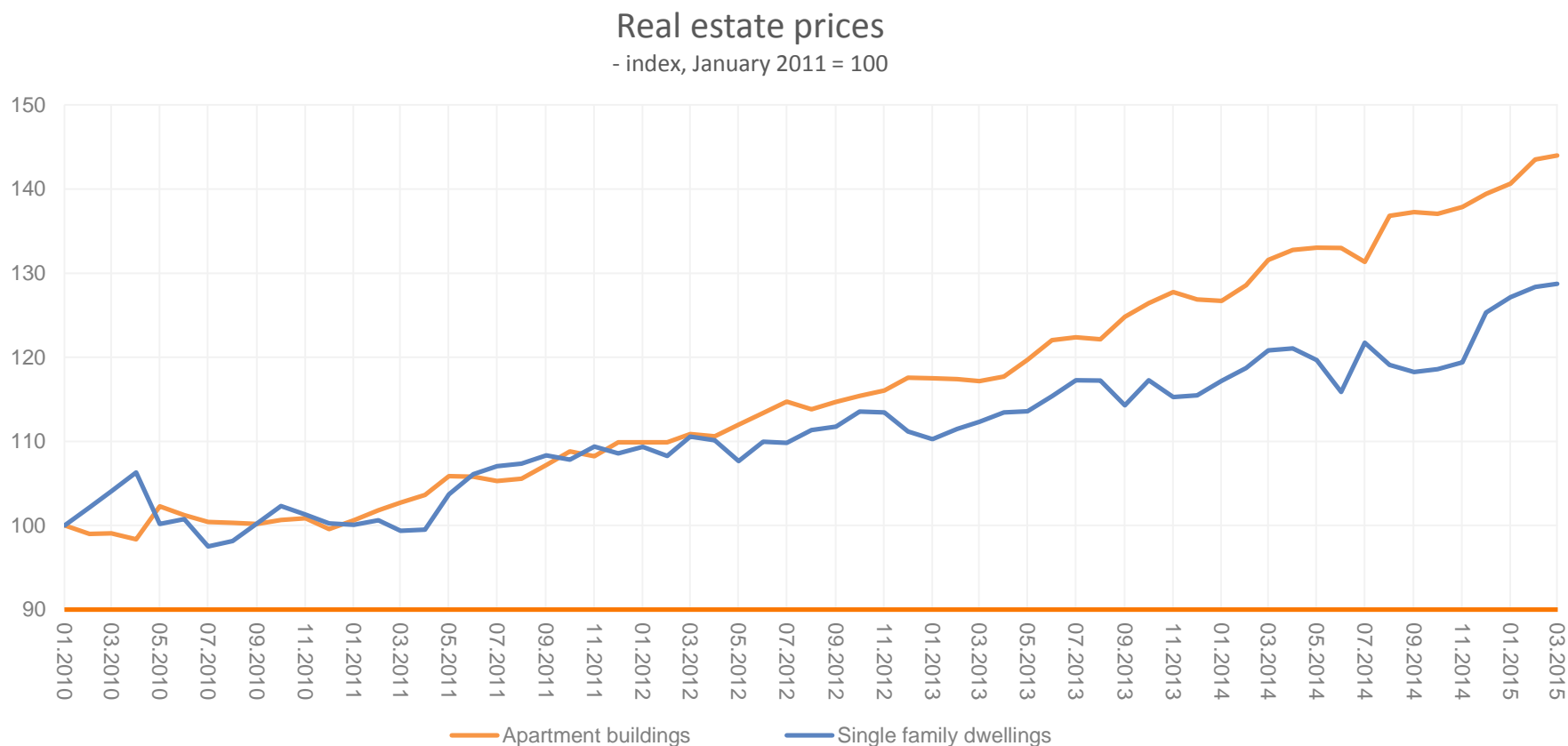
RATE OF INCREASE WILL SLOW, BUT HOUSING WILL CONTINUE TO CONTRIBUTE TO INFLATION



Sources: Registers Iceland, Arion Research

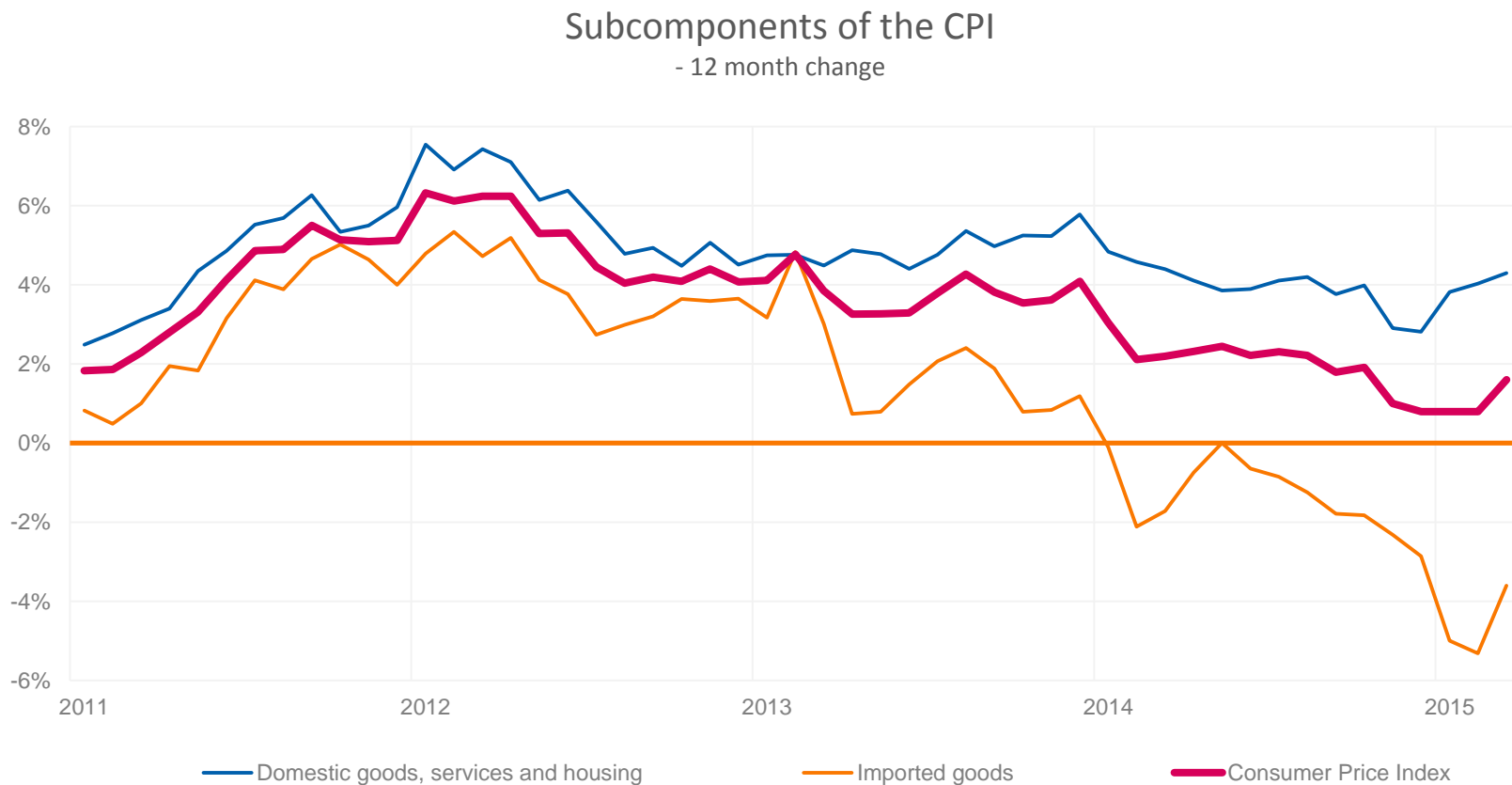
PRICE PRESSURE MOUNTS ON SINGLE FAMILY DWELLINGS

OVER PAST 12 MONTHS PRICE OF APARTMENTS IN APARTMENT BUILDINGS HAS INCREASED BY 9.4% WHILE THE PRICE OF SINGLE FAMILY DWELLINGS HAS INCREASED BY 6.5%



Source: Registers Iceland

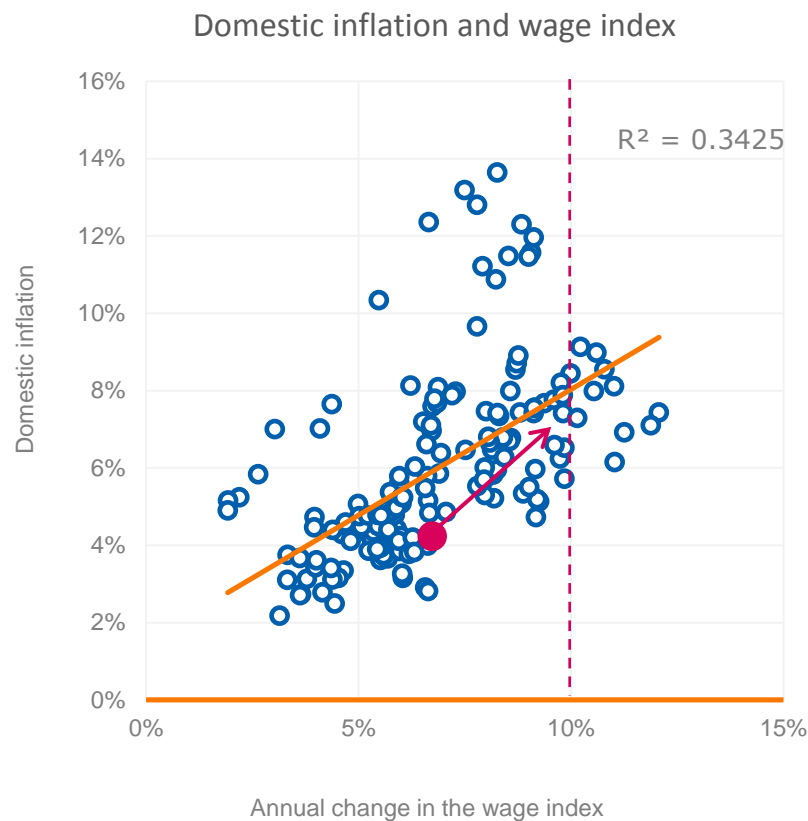
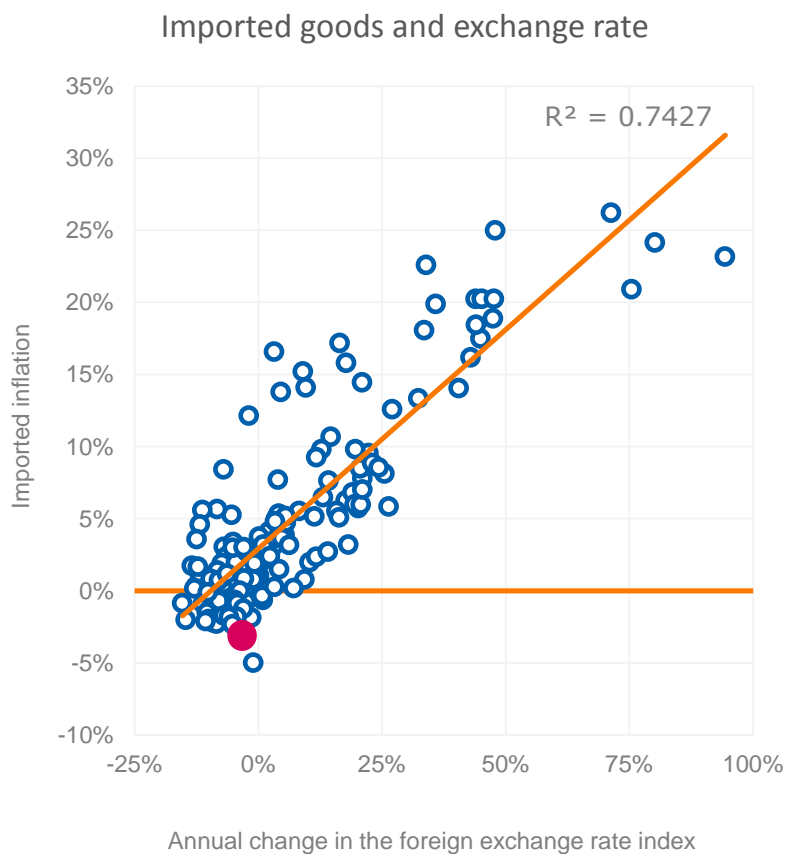
IMPORTED GOODS ARE KEEPING INFLATION AT BAY



Source: Statistics Iceland

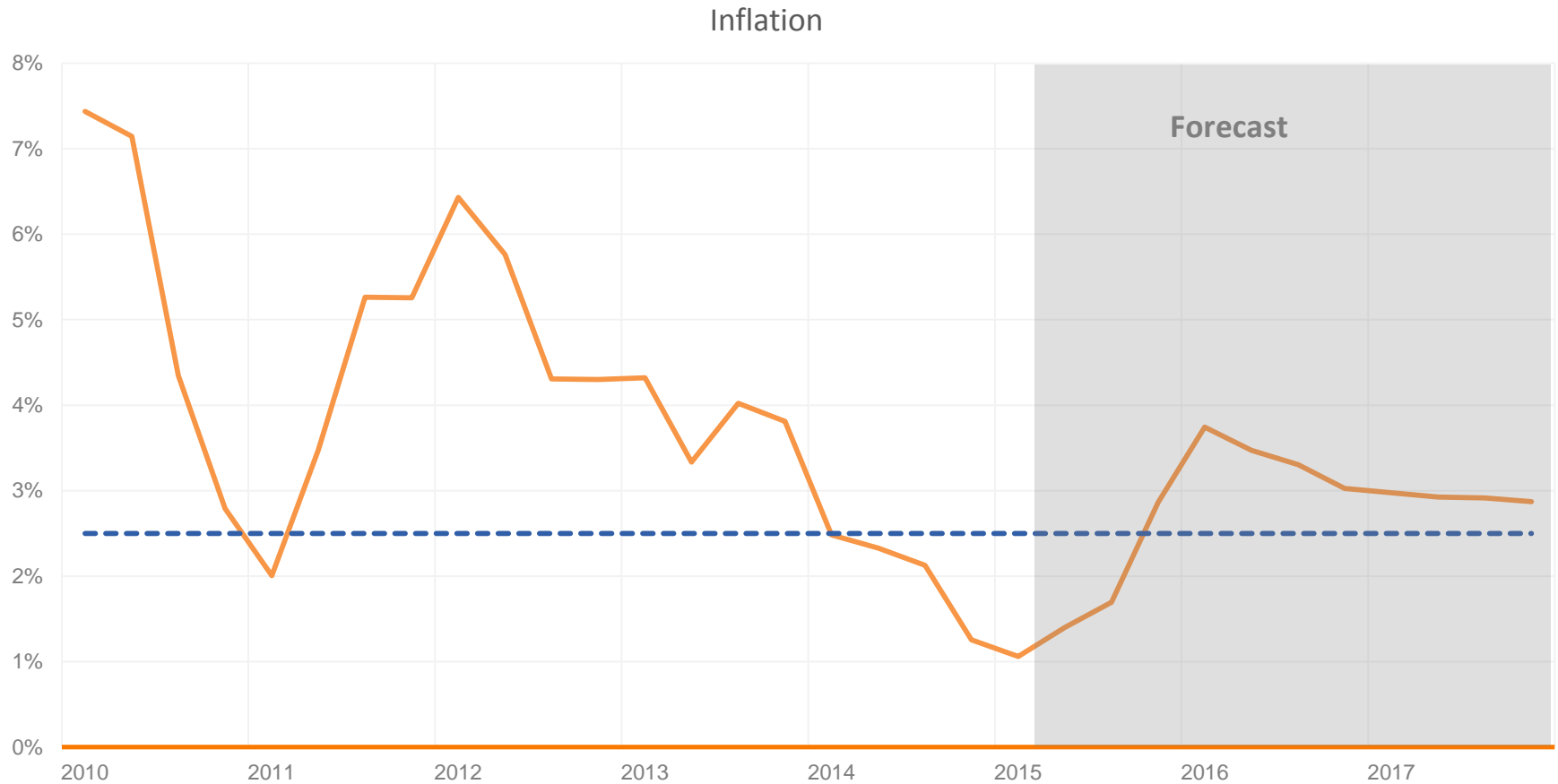
WAGE INCREASES COULD IMPACT THE CPI LATER IN THE YEAR

THE WAGE INDEX HAS INCREASED SOMEWHAT LATELY WHILE INFLATION HAS REMAINED LOW



INFLATION PRESSURES START MOUNTING LATER IN THE YEAR

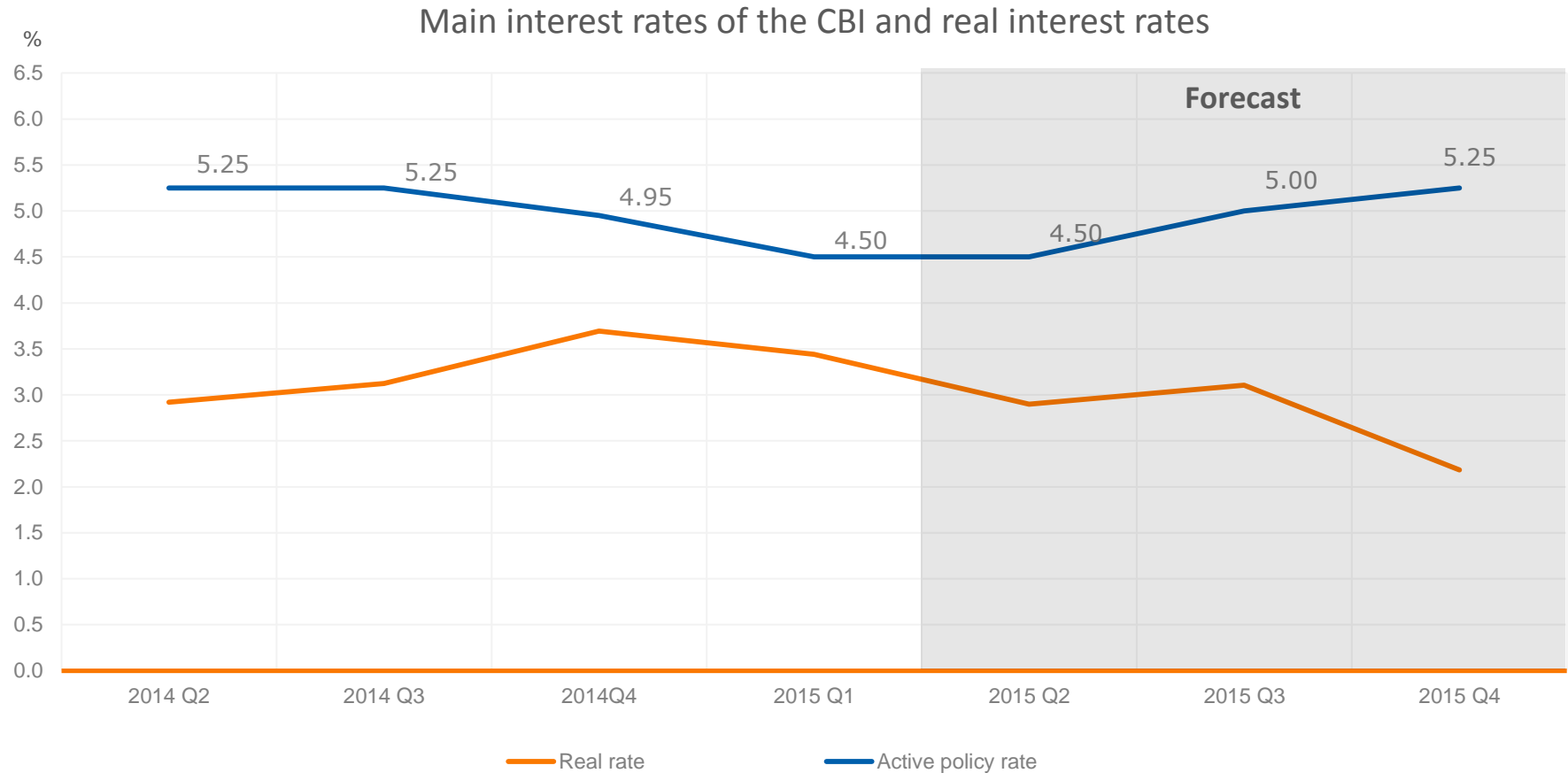
RISING WAGES AND HOUSING PRICES KEY DRIVER OF INFLATION



Sources: Statistics Iceland, Arion Research

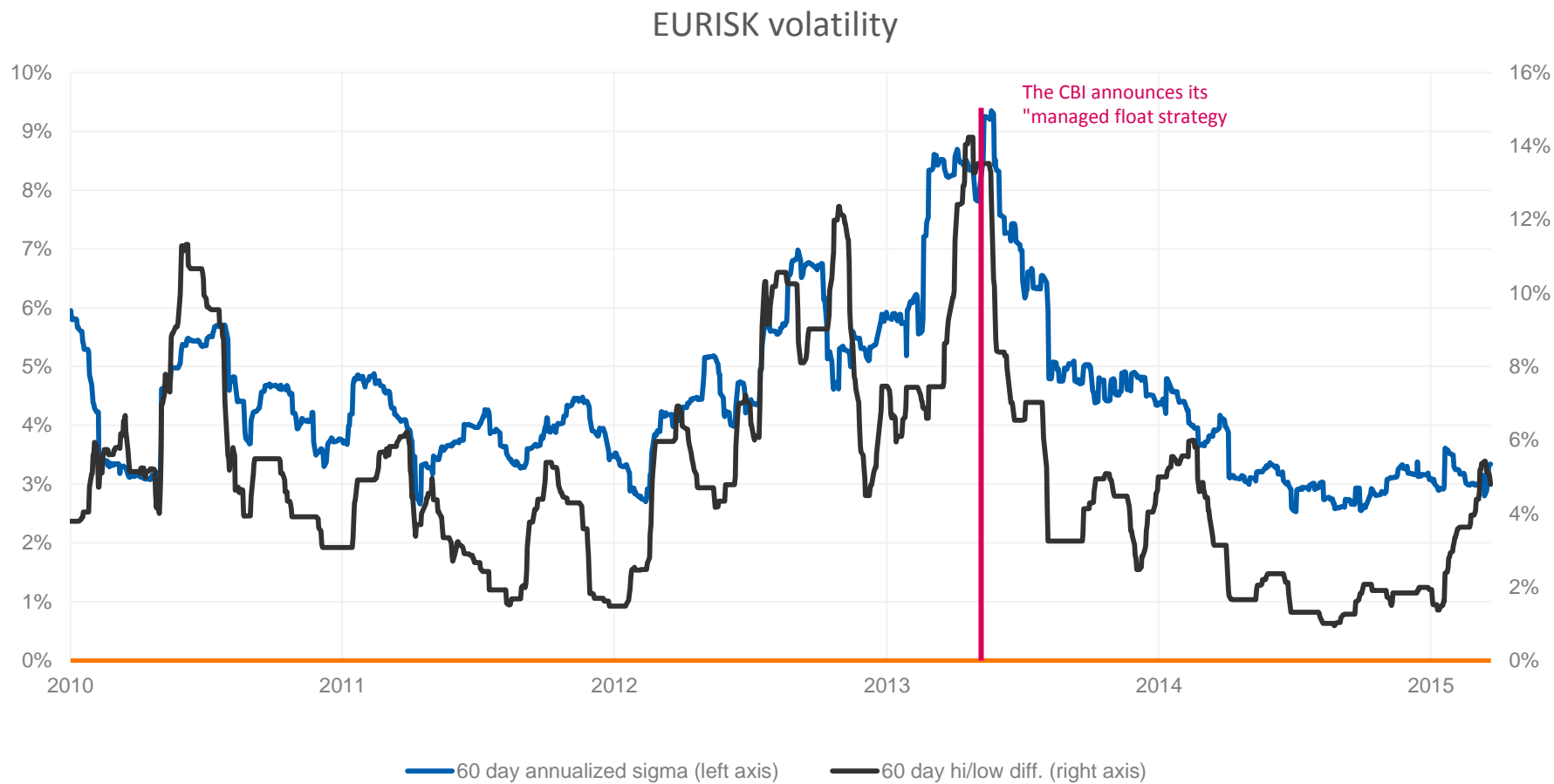
WE EXPECT THE CBI TO INCREASE THEIR INTEREST RATES IN Q3 ALREADY

GIVEN THE ASSUMPTION THAT WAGE NEGOTIATIONS END IN JUNE/JULY



Sources: Central Bank of Iceland, Statistics Iceland, Arion Research

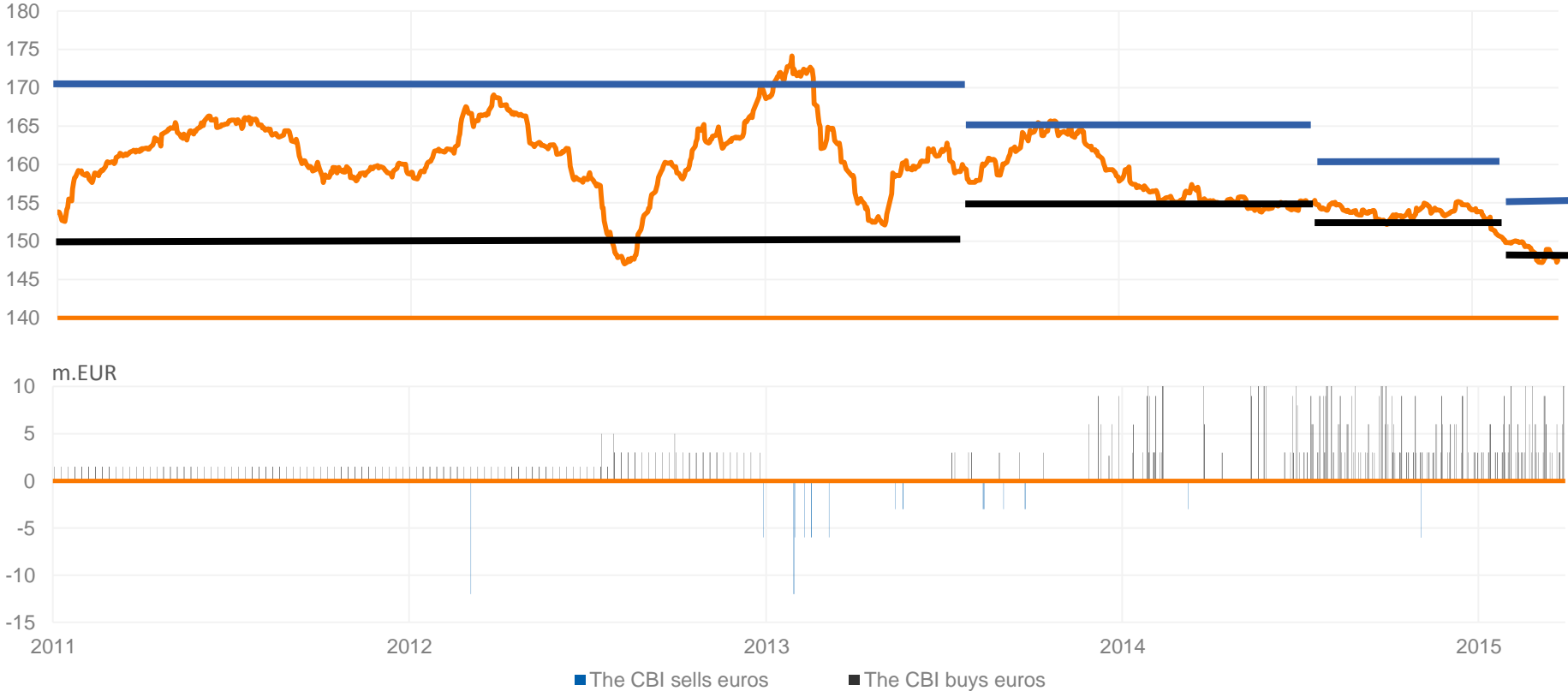
EURISK VOLATILITY HAS DECREASED



THE KRÓNA HAS STRENGTHENED AGAINST THE EURO DESPITE CBI INTERVENTIONS IN THE MARKET

WEAKENING OF THE EURO AGAINST THE DOLLAR ALSO PLAYS A ROLE

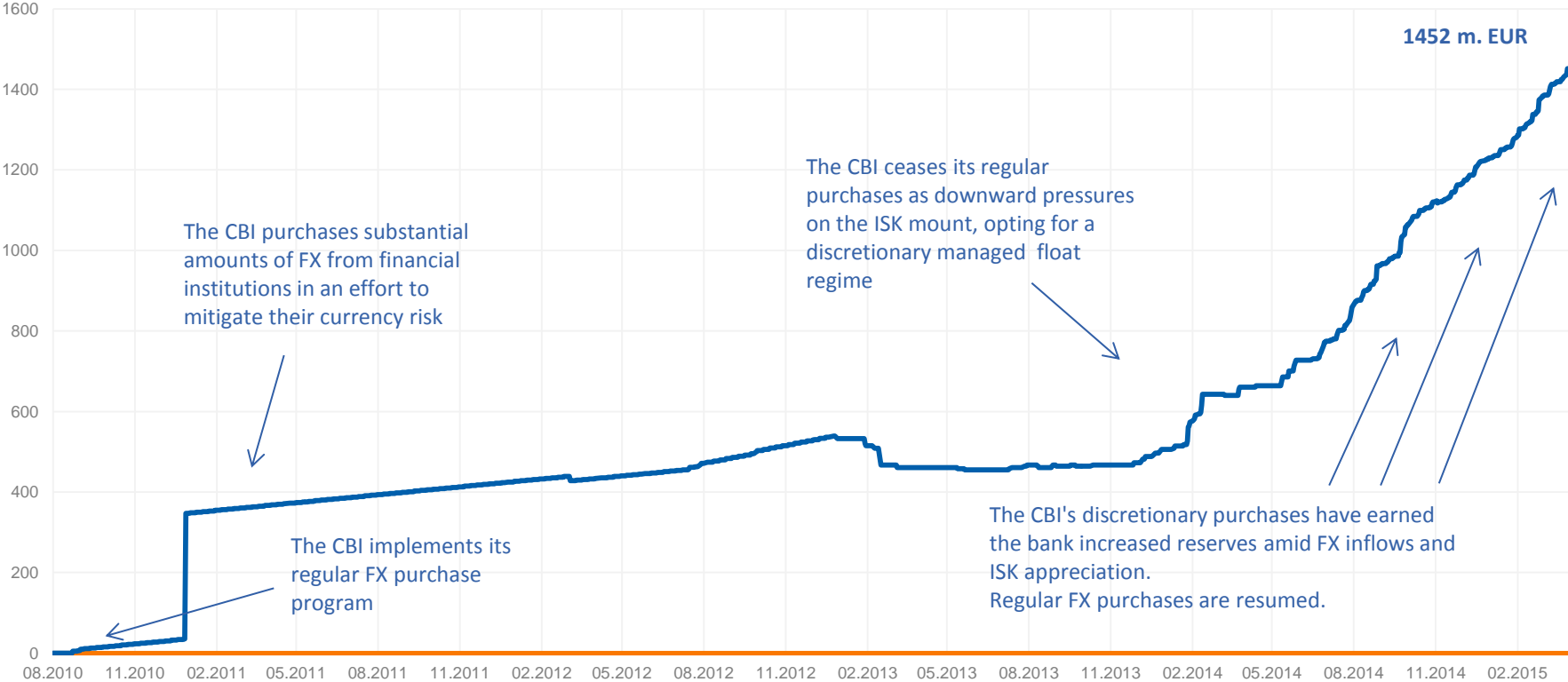
EURISK and the CBI's interventions in the interbank market



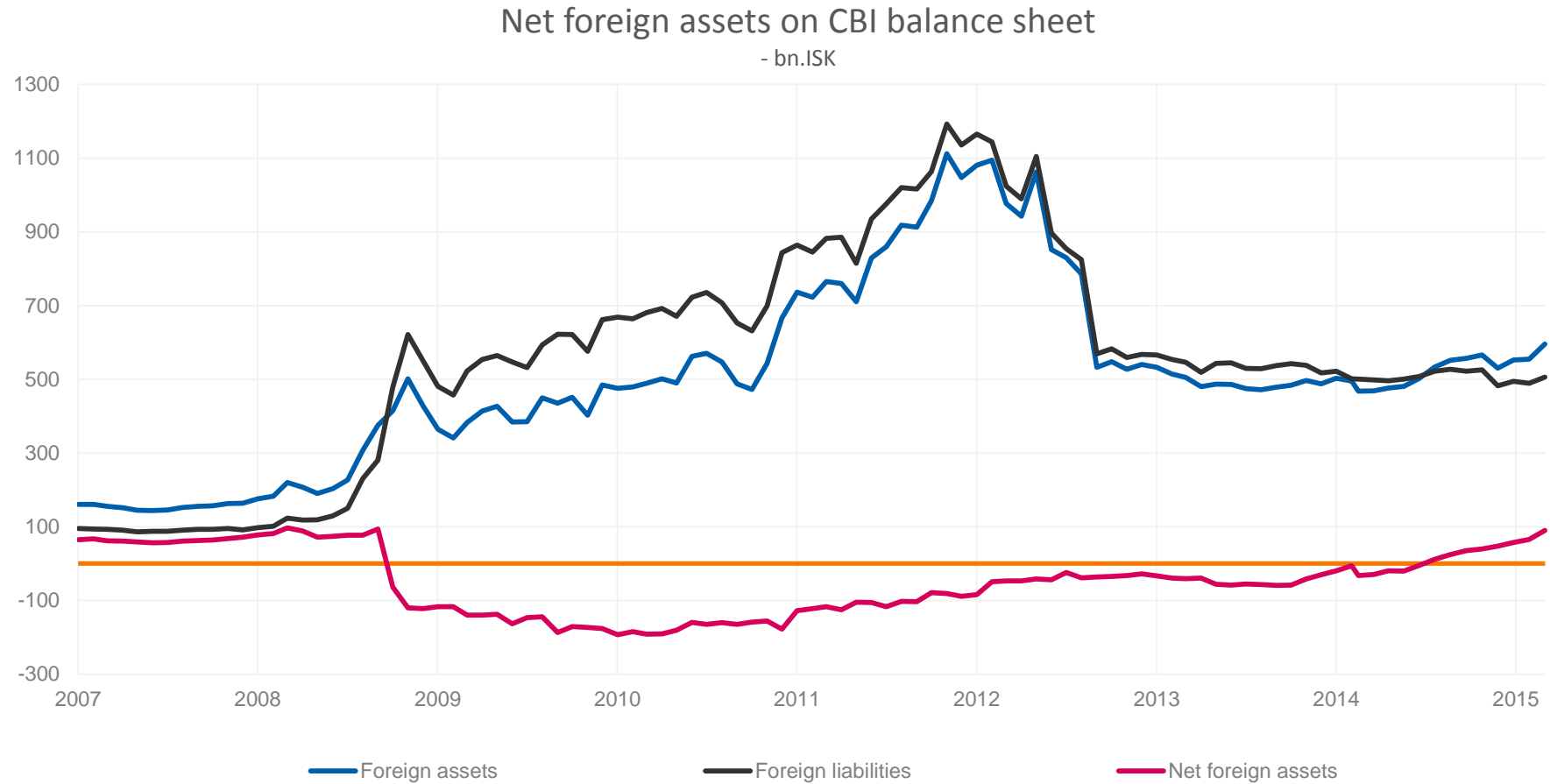
THE CBI HAS GOBBLED UP EUROS OVER THE PAST MONTHS...

CBI net FX purchases

- m.EUR, accumulated, sum of spot and forward agreements with market makers

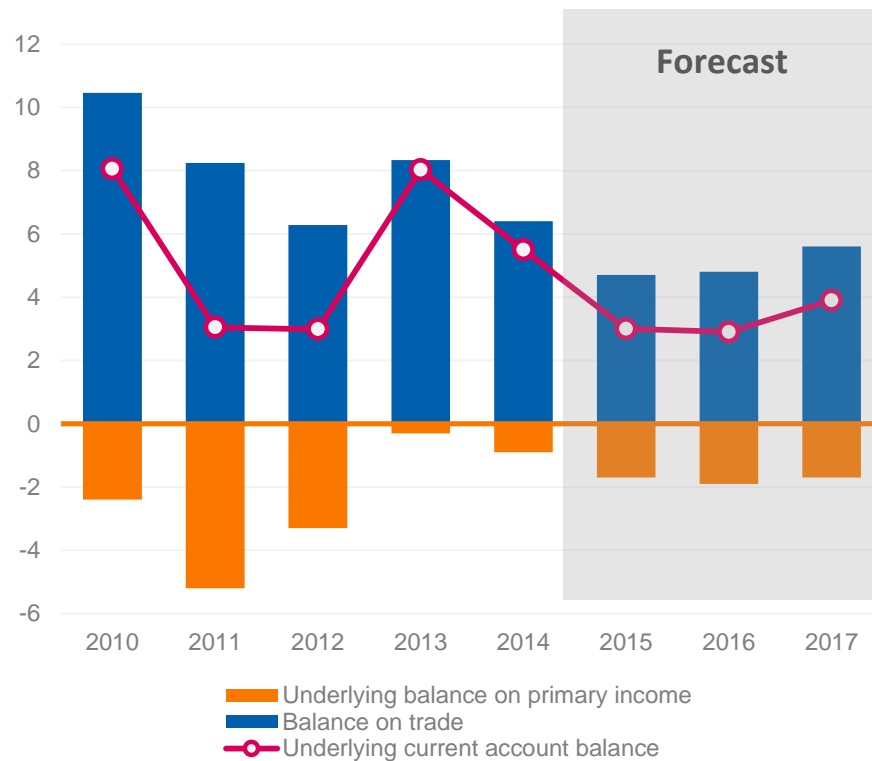


... MAKING THE CBI'S NET FOREIGN ASSETS POSITIVE BY 90 BN.ISK

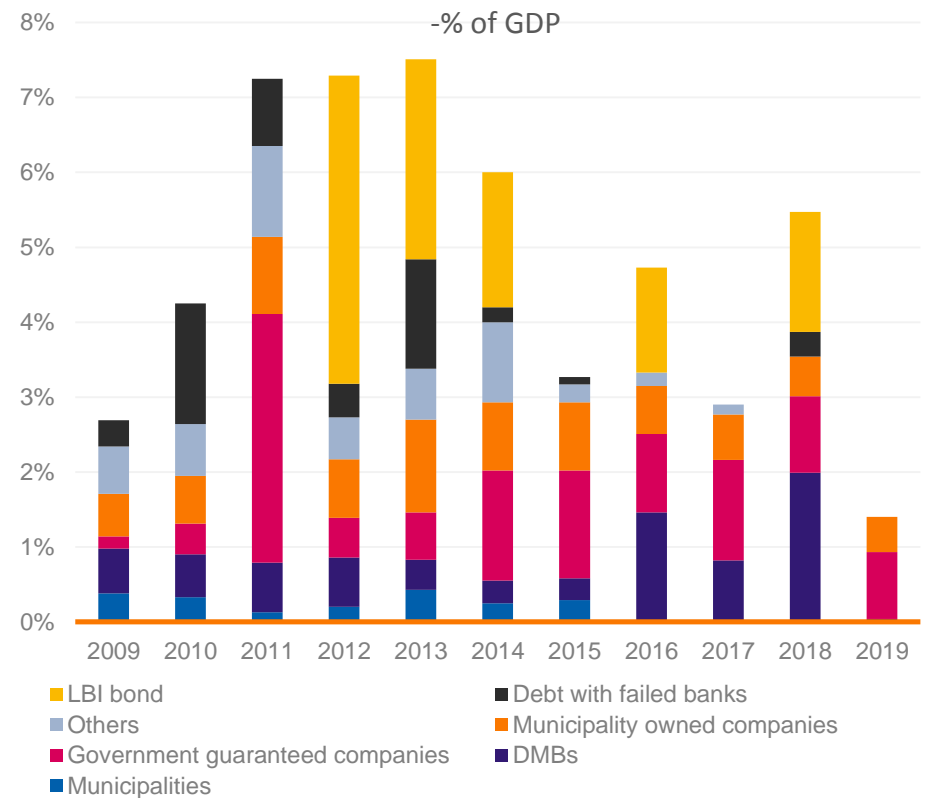


BALANCE OF PAYMENTS CRUCIAL TO THE DEVELOPMENT OF THE KRÓNA

Underlying current account balance
- % of GDP

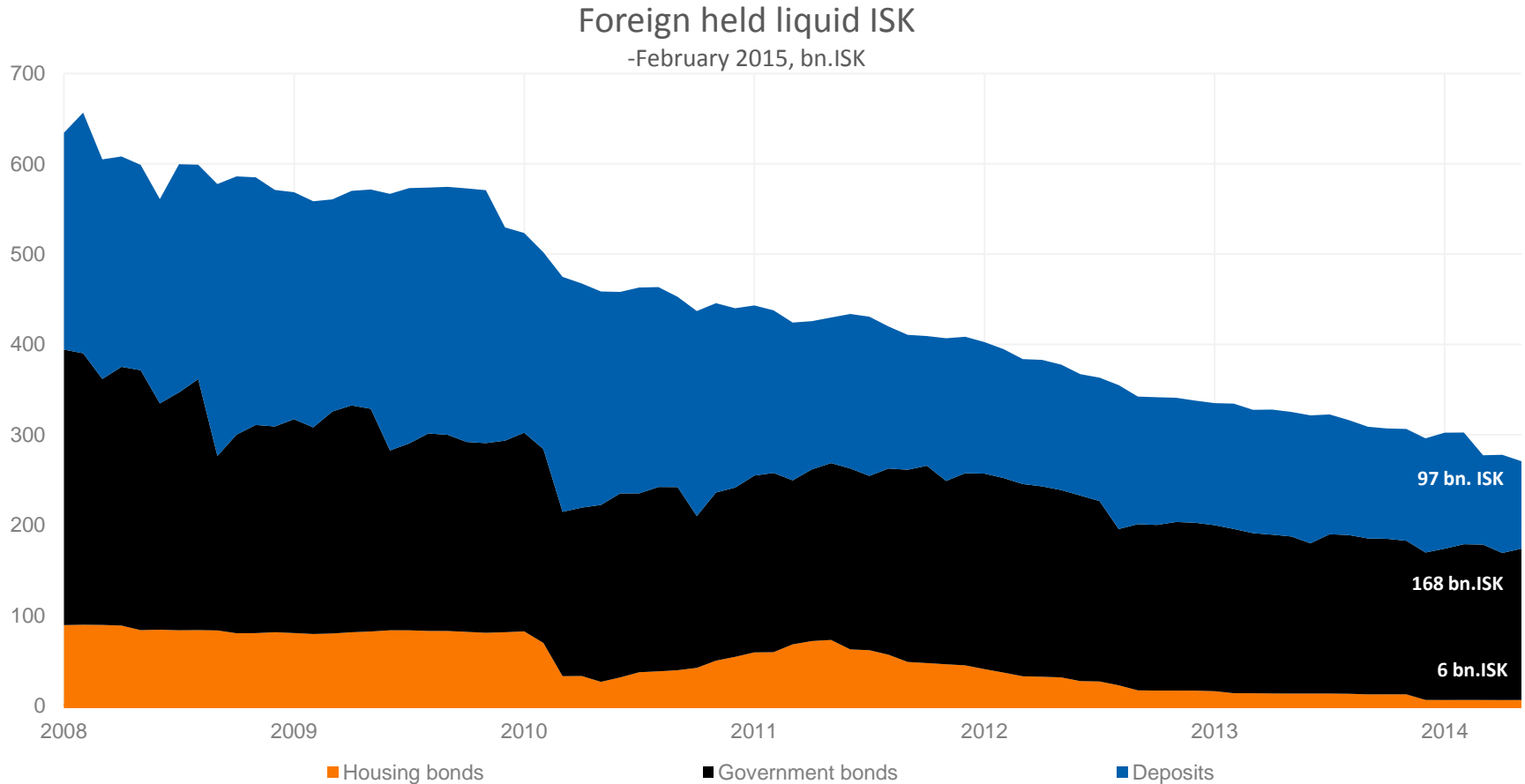


Estimated instalments of foreign debt
excl. the CBI and the gov't
- % of GDP



THE OVERHANG HAS COME DOWN AND LIMITATIONS HAVE BEEN SET

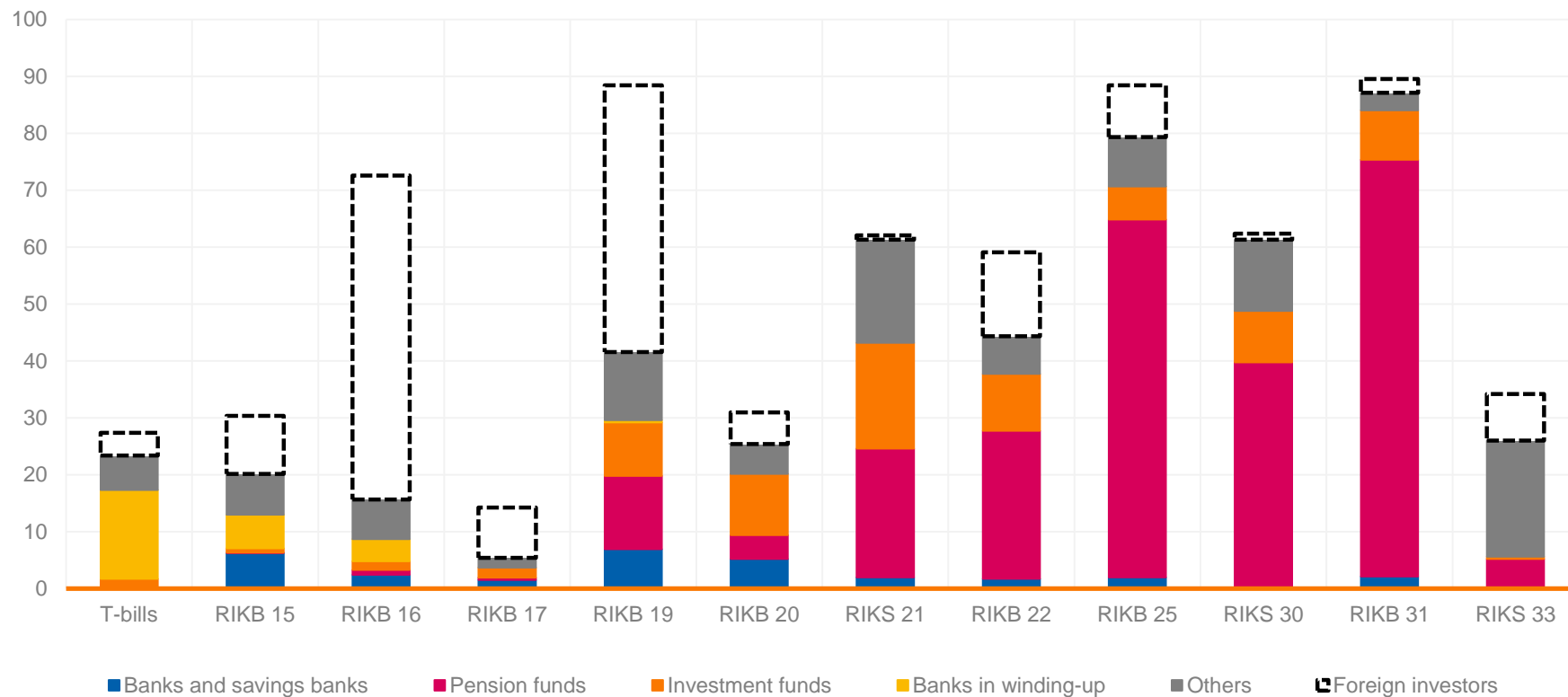
WILL FOREIGN INVESTORS BE DIRECTED TOWARDS MORE ILLIQUID ASSETS (FX BOND) / WILL AN EXIT TAX BE IMPOSED?



NOT CERTAIN WHO WOULD CHOOSE AN FX BOND OR EXIT TAX

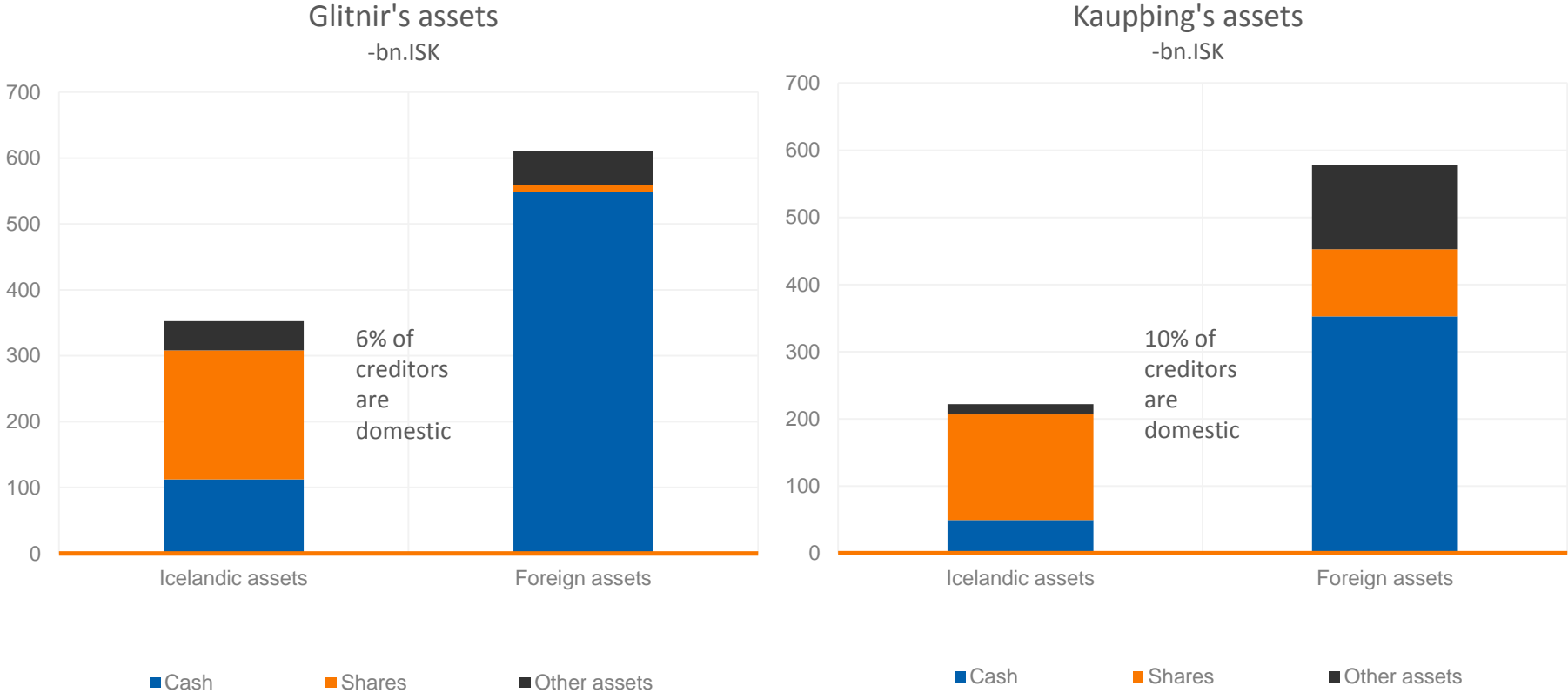
IF FOREIGN INVESTORS WERE TO EXIT THE MARKET IT WOULD ESPECIALLY IMPACT SHORTER TERM ISSUES

Owners of T-bonds and bills
-March 2015 (bn.ISK)



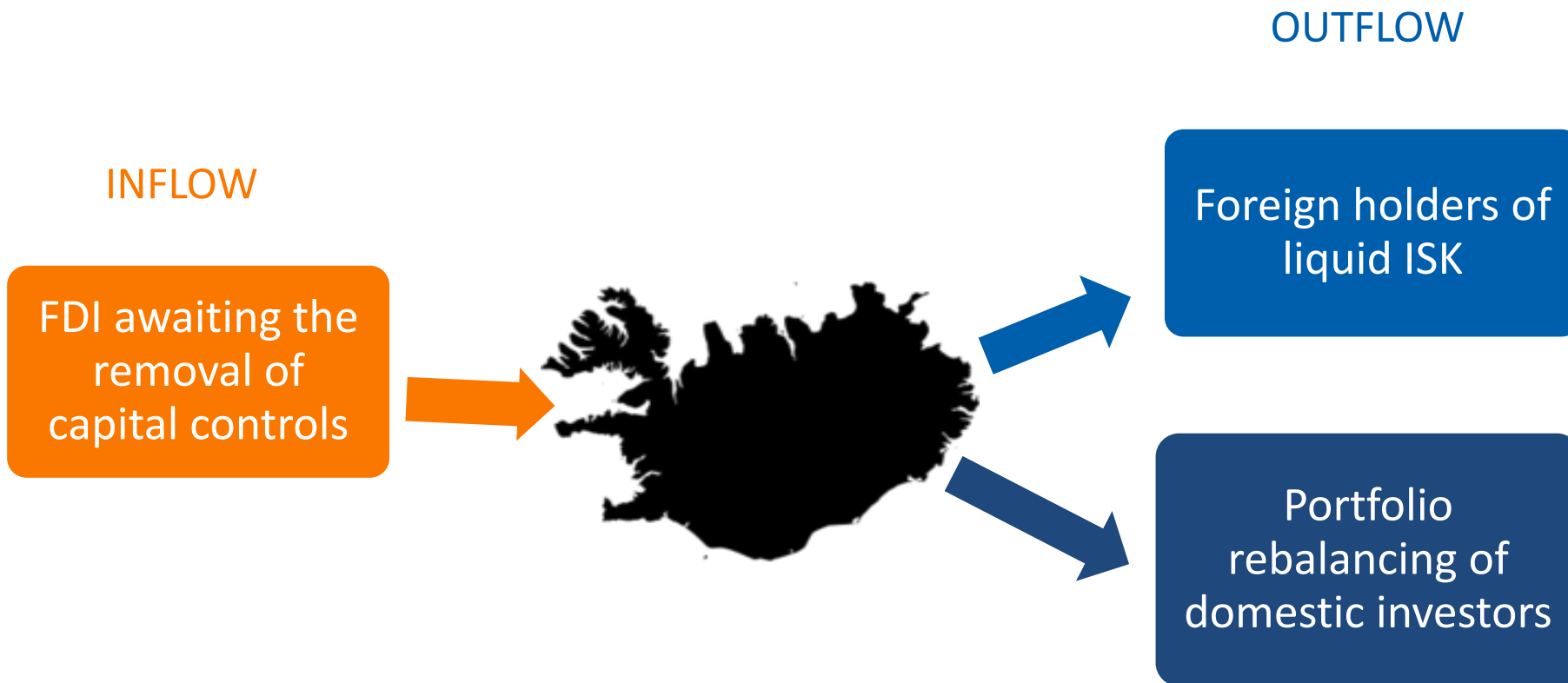
THE OLD BANK ESTATES STILL POSE A PROBLEM

DUE TO A CURRENCY MISMATCH IN THE ASSETS AND LIABILITIES OF THE OLD BANK ESTATES THEIR SETTLEMENT WILL HAVE A NEGATIVE EFFECT ON ICELAND'S EXTERNAL POSITION



SHORT TERM DETERMINANTS

ACCUMULATED NEED, LARGE CAPITAL MOVEMENTS



OUR EXPECTATIONS FOR MAJOR EXCHANGE RATE DETERMINANTS INDICATE THE KRÓNA MIGHT BE DUE FOR A STRENGTHENING

AT LEAST WHEN LOOKING BEYOND INITIAL TURBULENCE THAT MIGHT OCCUR AFTER THE LIFTING OF CONTROLS

- Terms of trade are developing favorably
- Government debt decreasing
- Improved ratings can be expected once controls are lifted
- Without CBI interventions in the currency market it is safe to assume the króna would be stronger already

MAIN UNCERTAINTY IN THE FORECAST

Wage increases

- likely to be higher than forecast
- which would result in higher inflation and possible higher interest rates



Investment

- forecast of investment cautious – could well be stronger
- Especially if Capital Controls are lifted



Lifting of Capital Controls

- In the long-run positive for the economy
- Although in the short-run could be bumps on the way



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