

Arion Research Tourism Report

Arion Research recently published a report on the booming tourism industry in Iceland. Growth in tourist arrivals has been increasing rapidly since 2010 and this year seems to be no exception. Tourism's contribution to GDP growth is steadily rising and has now surpassed both fishing and metal production when it comes to foreign exchange earnings. Arion Research forecasts that over a million tourists will visit Iceland in 2015 via Keflavik International Airport.

The Treasury's 2015 Budget Proposal

The total balance of the Treasury's budget is projected to reach only 4.1 billion ISK next year, compared to 38.1 billion ISK in 2014. Excluding irregular items, the total balance is projected to be 14.9 billion ISK in 2014 and about 27.5 billion ISK in 2015. As it is the second consecutive year with a projected budget surplus the Treasury will be able to decrease domestic bond issuance and focus on lowering debt. Tax reforms are proposed, which will lower the price level by 0.2% according to the Budget Proposal's forecast.

Q2 2014 GDP growth below Arion Research projections

Year-on-year, gross domestic product in Q2 2014 increased by 2.4%, which was lower than projected. Private consumption and imports exceeded expectations while gross fixed capital formation and exports disappointed. The contribution of net exports in the first half of 2014 was negative by about 2.4%, compared to a positive contribution of 3.7% in 2013. However, we remain optimistic about GDP prospects for 2014 as a whole.

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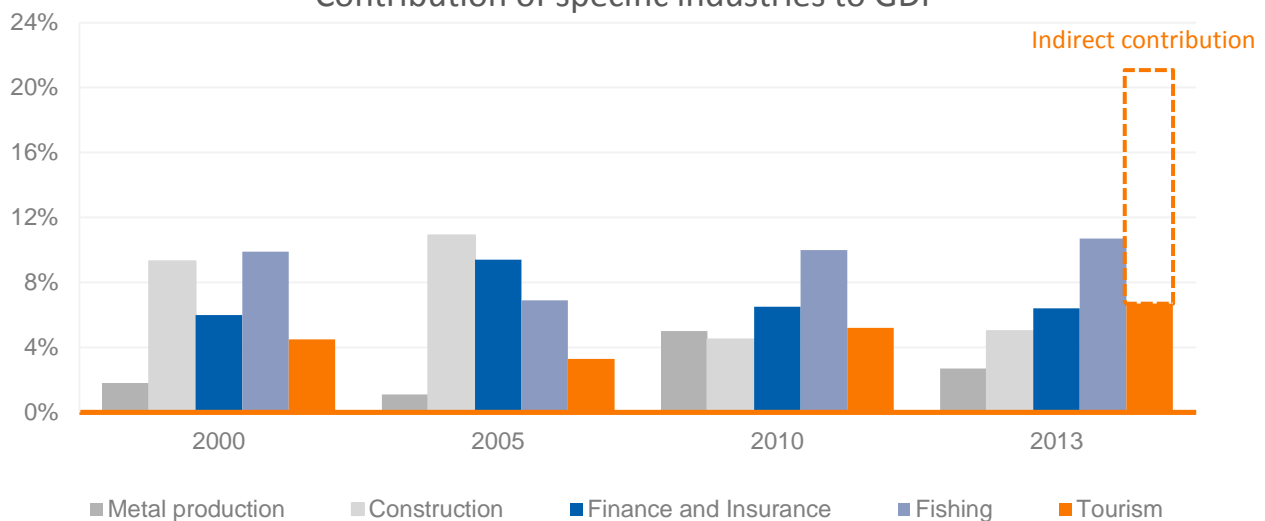
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Arion Research Tourism Report – We expect growth to continue

Arion Research published a report in September on Iceland’s booming tourism industry. Iceland saw a 70% increase in the number of tourist arrivals from 2010 to 2013. From the looks of it, this year will be no exception to the high growth numbers we have been witnessing. From January through August of this year the increase from the same period in 2013 is already 23.5%, making 2014 the fourth consecutive year with higher growth in tourist arrivals than the previous year, at least so far.

During the summer months of June, July and August tourists account for approximately one in every eight persons in Iceland and last August Iceland had the highest number of tourists arriving through Keflavik Airport ever. Hotels in most areas of the country have an occupancy rate of 90% or higher over the summer months, while over the winter months hotels in the countryside struggle with common occupancy rates of only 10-30%. In June of this year the average occupancy rate of hotels in the Reykjavik area was 95%, making little room for high relative growth over the summer unless the supply of hotel rooms increases considerably. Hitherto, the high seasonal effect and extremely low occupancy levels over the winter months may have deterred new investments. However, as seasonality is diminishing, especially in the capital region, and occupancy rates are increasing year by year more hotel construction projects are on the horizon.

Contribution of specific industries to GDP

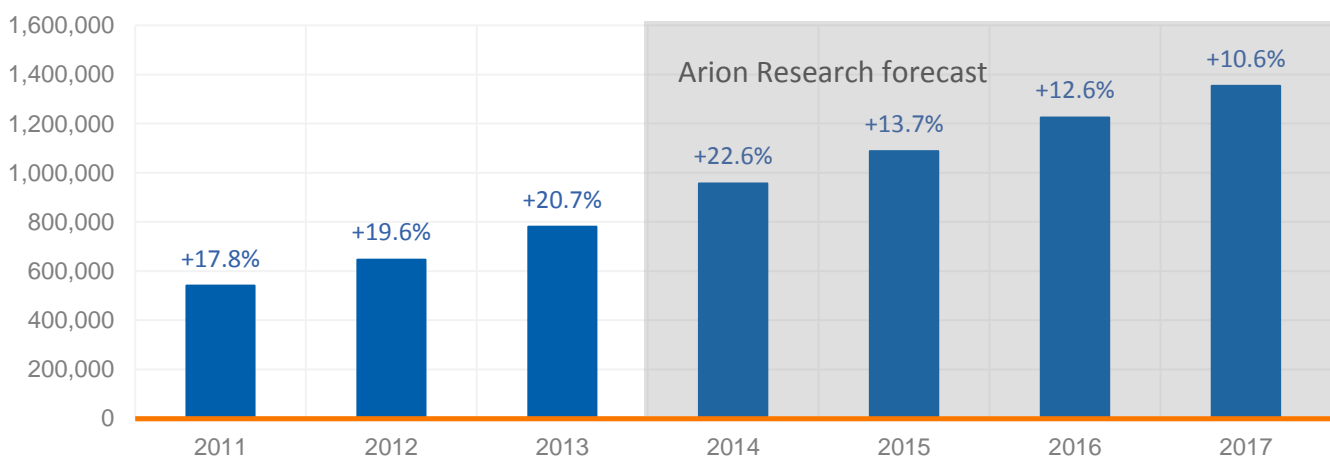


Sources: WTTC, Statlce

In 2013 tourism surpassed fishing and metal production as the largest export industry, accounting for 26.8% of the country’s foreign exchange earnings that year. Tourism’s contribution to GDP has grown to almost 7% of GDP with an estimated indirect contribution of over 20%.

Arion Research is cautiously optimistic about growth in tourist arrivals in coming years and is forecasting a 13.7% increase in 2015, which would mean over a million tourist arrivals via Keflavik Airport next year. We believe that off-season marketing efforts and lower prices will drive relative growth during off-season months while capacity constraints over the summer will restrict relative growth from June-August.

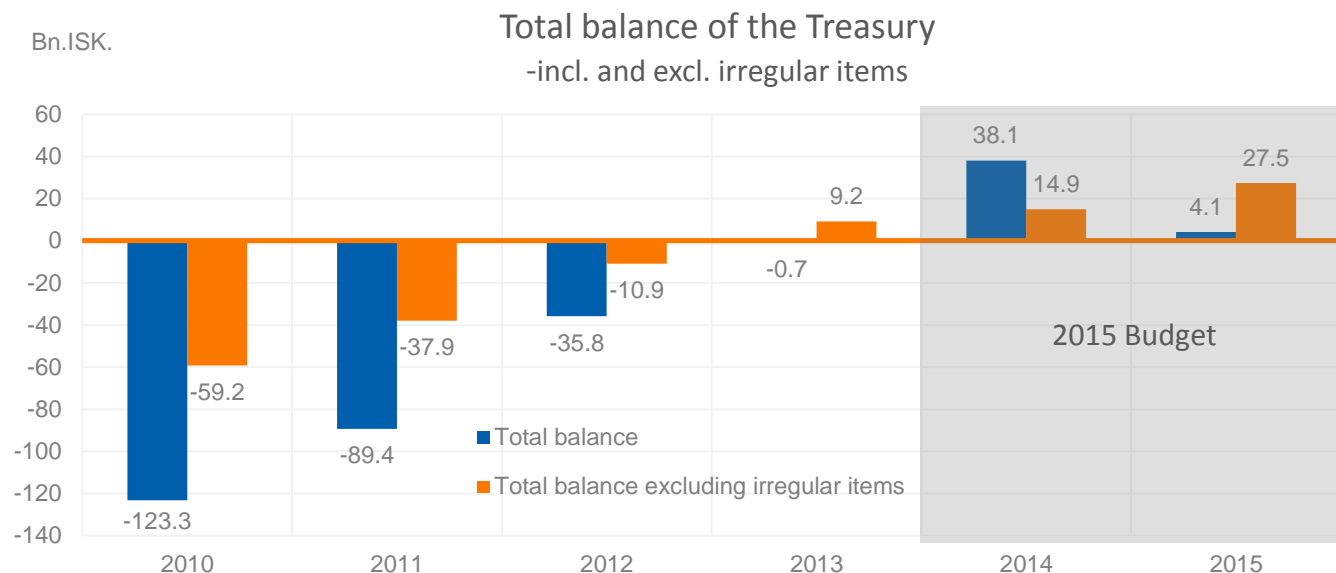
Number of tourists arriving via Keflavik International Airport
- annual numbers and % increase



Sources: Icelandic Tourist Board, Arion Research

The Treasury's 2015 Budget Proposal

The total balance of the Treasury's budget is projected to reach only 4.1 billion ISK next year, while it is assumed to be 38.1 billion ISK in 2014, according to the 2015 Treasury Budget Proposal. Irregular revenue items explain the substantially higher projected balance for 2014 when compared to 2015. Revenues from dividends were considerably higher than expected this year, including a dividend from Landsbankinn which was 20 bn.ISK, or 13 bn.ISK higher than assumed in the previous budget. Excluding these irregular items the total underlying balance is projected to increase moderately from 14.9 billion ISK this year to 27.5 billion ISK in 2015.



Sources: Ministry of Finance, fjarlog.is

According to Treasury finances main revenue sources in the year 2014 have been strengthening and a higher balance for 2015 can therefore be expected. Next year is the second consecutive year with a projected budget surplus and the credit balance is also expected to be positive. As a result, the Treasury will be able to decrease domestic bond issuance and focus on lowering its debt. A step towards lower debt is outlined in the Budget Proposal where the Treasury's 30% share in Landsbankinn is assumed to be sold for 70 billion ISK, the proceeds of which will be used to pay down the RIKH18 bond.

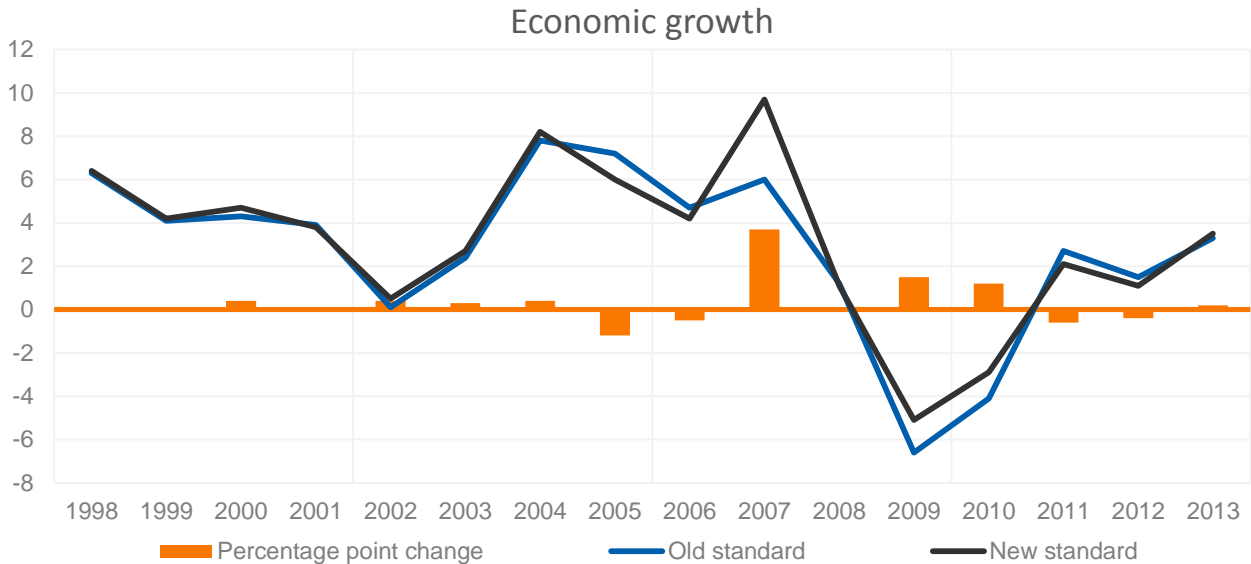
Tax reforms – changes to the VAT

Tax reforms are introduced in the proposal, such as changes to the VAT system. The standard VAT rate is to be lowered from 25.5% to 24% while the reduced rate will be increased from 7% to 12%. Removal of the commodity tax is also proposed for January 1st, 2015. In addition, ministries will pursue austerity measures and the unemployment benefit period will be shortened from 36 to 30 months. These reforms are expected to decrease the budget balance by 300 million ISK in total.

These tax reforms are expected to lower the price level by 0.2%, according to the Budget Proposal. The assumptions are that both the lowering of the standard VAT rate and the removal of the commodity tax will be fully reflected in price levels. However, debt relief measures will be implemented concurrently, as well as an increase of child benefits and the removal of the wealth tax. In total, these measures will serve to increase disposable income which can put upward pressure on the price level. In addition, in our view it is possible that the increase of the reduced VAT rate will have a larger relative impact on prices than the lowering of the standard rate, making the consequential price level higher than suggested in the Budget Proposal. Lastly, the proposed reforms might have an impact on upcoming wage negotiations.

Q2 2014 GDP growth below Arion Research projections

Gross domestic product in Q2 2014 increased by 2.4% year-on-year while Arion Research expected an increase of 3.9%. This is the first time Statistics Iceland releases national accounts according to the ESA2010 framework and therefore the numbers aren't fully comparable to our forecast. However, despite some changes to the data we should still be able to gauge material developments and assess the largest deviations from our expectations. Statlce released revised annual numbers dating back to 1997, the effects of which can be seen in the graph below. The main difference was in 2007 due to Financial Intermediation Services Indirectly Measured (FISIM) and the rapid growth of the banking sector that year.



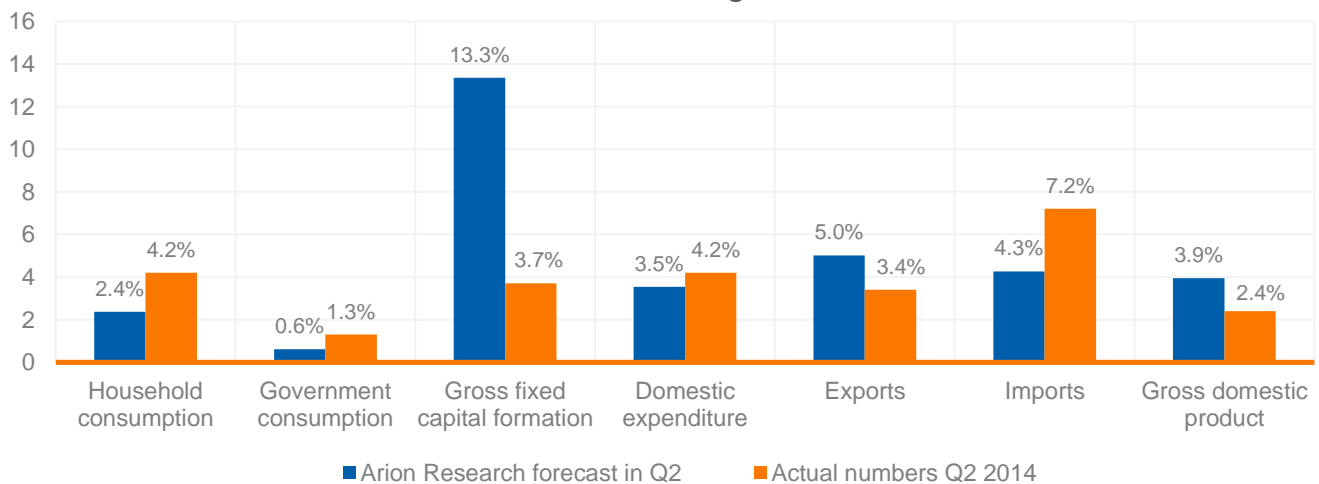
Source: Statlce, Arion Research

Consumption and imports exceeded expectations

In Q2 2014 private consumption and imports were higher than expected while production in the economy seems to be slowing down as investments and exports were below expectations. It should be noted that GDP values from 2013 were revised slightly upwards, resulting in base effects on GDP growth numbers for Q2 2014, which partially explains the low increase in investment and high increase in private consumption. Therefore we think that GDP prospects for this year as a whole are not as low as one might expect solely by looking at the Q2 results.

Subcomponents of GDP in Q2 2014

-YoY % change



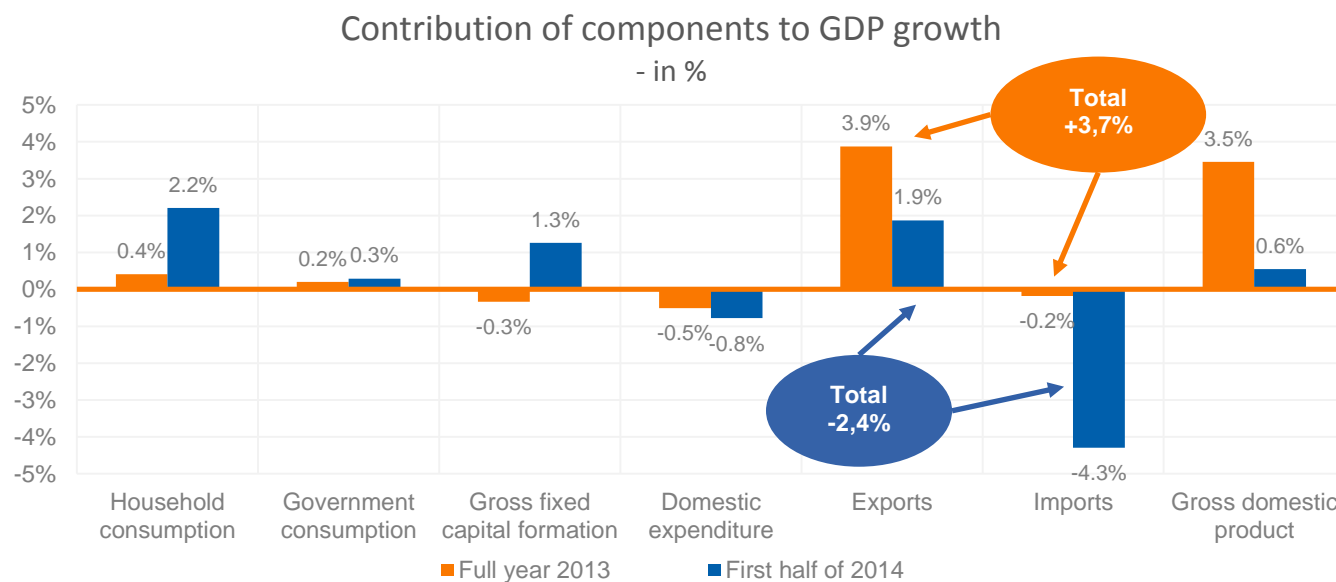
Source: Statlce, Arion Research

Private consumption increased by 4.2% in Q2 year-on-year, which was in line with high frequency indicators such as groceries and payment card turnover. Investment, while stronger than expected in Q1, was quite disappointing in Q2. Real estate and government investments were close to expectations while industry investment was considerably weaker. Investments in aircraft and/or shipping vessels have a relatively large impact on import and investment numbers resulting in a somewhat distorted picture of developments if the time frame is too short. That said, we do expect investments to pick up in the second half of the year.

Another interesting factor is the substantial growth in imports. Over the summer, there has been a significant increase in the imports of goods such as food, beverages and oil, which, to a certain extent, can be attributed to a meteoric rise in the number of tourists. However, the growth in imports largely comes from an increase in imported services. Mainly two factors account for that – Icelanders are traveling more abroad while “other business service“ has also grown substantially. Capital leases fall into that category, such as the rental of aircraft.

A large turnaround in the contribution of net exports

GDP growth in the first half of 2014 was only 0.6% year-on-year and the composition of growth has changed between years. Last year, net exports were one of the leading drivers of growth, while the opposite seems to be the case in 2014 - private consumption's contribution increased while net exports had a substantial negative impact on GDP.



Source: Statlce, Arion Research

Investments' contribution at 1.3% was below expectations. Investment in real estate was the main driver of growth in investments, increasing by 26.3% in the first half of the year, while public investment increased by 6.2%. Industry investment increased by a disappointing 3.8%. Imports contributed to a 4.3% decrease in GDP and exports to a 1.9% increase in the first half of 2014. The contribution of net exports in the first half of 2014 is therefore negative by about 2.4%, compared to a positive contribution of 3.7% in 2013 as a whole. As a result, net exports are mostly to blame for lackluster GDP growth in the first half of 2014.