



# Icelandic Economic Update

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## **Economic growth driven by capelin fisheries during Q1 2011**

- Seasonally adjusted GDP increased in real terms by 2% during the first quarter compared with the previous quarter. Economic growth measured 3.5% between years. The economic growth in Q1 2011 is particularly driven by an increase in inventories, which is due to some extent to the huge capelin catch - reflecting how brittle economic growth really is.

## Economic growth driven by capelin fisheries during Q1 2011

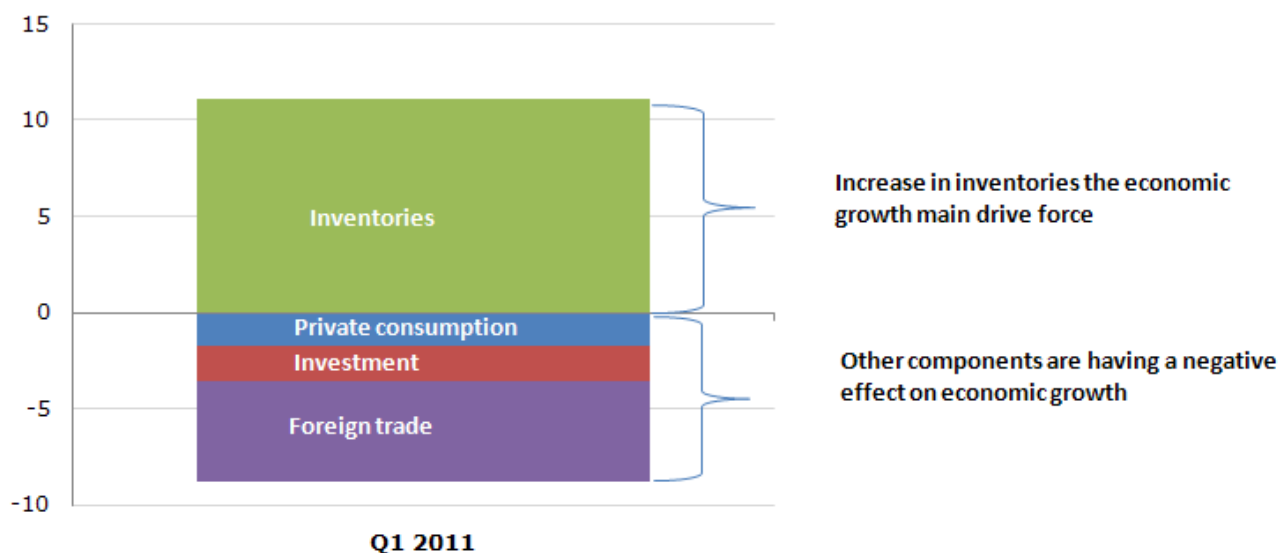
Seasonally adjusted GDP increased in real terms by 2% during the first quarter compared with the previous quarter. Economic growth measured 3.5% between years. The economic growth in Q1 2011 is particularly driven by an increase in inventories, which is due to some extent to the huge capelin catch - reflecting how brittle economic growth really is.

The economic growth figures can be interpreted both positively and negatively.

- The upside is that production in Iceland is on the increase again after a continuous two-year decline. The figures prove that the economic recovery has got underway and that the Icelandic economy is emerging from one of the most pronounced slumps in its history.
- The downside is that private consumption appears to be heading towards a double dip as household consumption slumped by 1.6% during the first quarter compared with the previous quarter (seasonally adjusted). Investments also decreased during the same period. It is also worrying to note that although the economy is growing, this growth is only being driven by one sector, the fisheries. Other areas of investment are showing weak signs of a turnaround.

**Growth in inventories.** As noted above, economic growth has been particularly fuelled by the huge growth in inventories. Normally this has had a minimal effect on economic growth figures but the opposite is true at the moment. The growth in inventories is chiefly attributable to the higher capelin catch, while inventories relating to heavy industry are also increasing. The growth in inventories can in fact be looked at as future exports as it reflects an increase in production in the economy. However, the goods have yet to be sold and therefore they are recognised as inventories. We are likely to see a reduction in inventories in the next set of figures from Statistics Iceland and an increase in exports when the goods are sold (which will materialise in Q2 2011 – and the net impact on economic growth will be zero during that quarter).

### Contribution of underlying economic growth - quarterly real changes, seasonally adjusted (ISK billion)



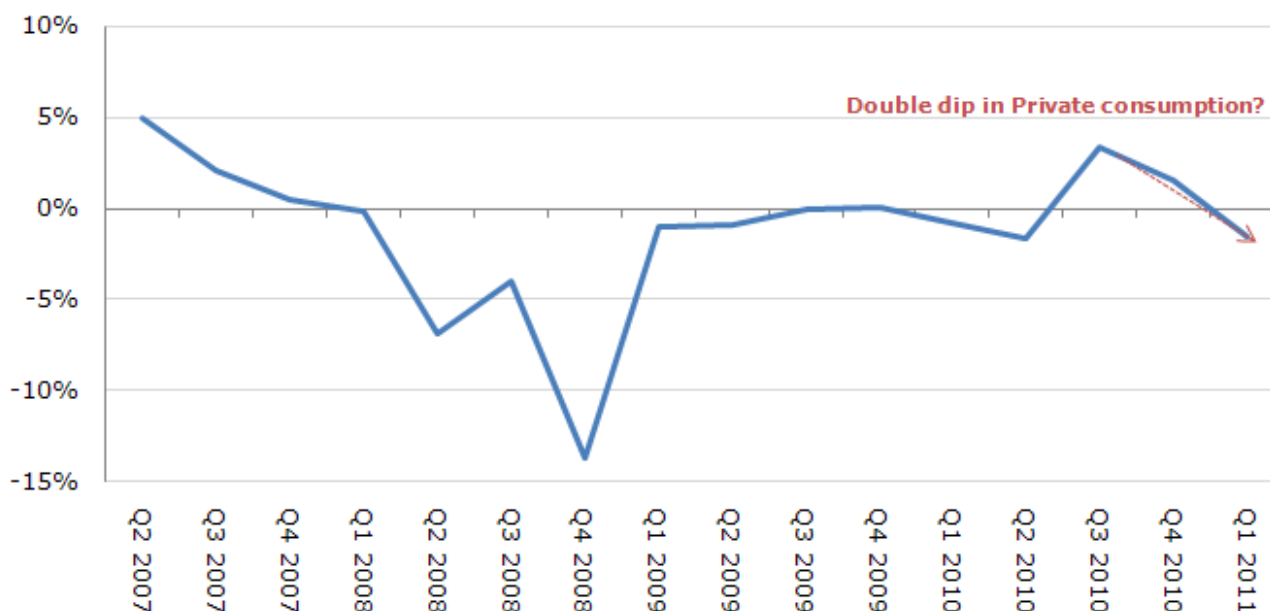
Source: Statistics Iceland

### Private consumption heading for another dip?

High unemployment, limited purchasing power and general pessimism by Icelandic households are factors undermining the consumption power (and consumption appetite) of households. Following signs that private consumption was staging a recovery last year, there has now been a set-back as it dropped by 1.5% during Q1 2011 compared with the previous quarter. As Arion Research has previously noted, actions taken by the authorities (such as freezing loans and private pension funds payouts) have sustained a higher level of consumption than otherwise would have been the case – this is why this drop in private consumption comes as no surprise now as most of these measures are at an end.

Private consumption is the largest component of GDP and represents more than half of domestic product at the present time. It is therefore critical for future economic growth household's recovery. However, there are clearly many obstacles to negotiate as households remain heavily in debt. It doesn't help that the wage agreements on the labor market could have some negative effects as it appears that inflation is rising – as the agreements contain significant pay rises, which will reduce household purchasing power even further and increase debt levels as a large proportion of household loans are inflation-indexed. There is therefore a risk that private consumption is heading for a double dip which would be detrimental to economic growth.

### Private consumption - quarterly real changes, seasonally adjusted



Source: Statistics Iceland

### Investments grew between years but dropped between quarters

Investments represent the most volatile component of GDP and often differ from the preliminary figures published by Statistics Iceland. There are signs however that investments are recovering from the post-crash slump during which investment levels have been extremely low. Investments have grown by more than 13% between years but still show a decrease between quarters (seasonally adjusted 7% drop). Increased investment is a prerequisite for economic growth as it creates both jobs and demand. Although there are certain signs of rising investments the situation is far from satisfactory; many investment projects have been on hold because of the uncertainty in the economy.

### Investment - yoy & qoq real changes, seasonally adjusted



Source: Statistics Iceland

### Foreign trade reducing economic growth

Exports are decreasing, both on a year-on-year basis and between quarters. This is hardly surprising given the low level of investments in the export sector. However, it is not unlikely that we will start to see exports grow next quarter when inventories have decreased. Imports grew slightly between years. Overall, foreign trade is having a negative impact on economic growth even though the real exchange rate is at a historic low.

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