

Updated Economic Outlook 2019-2021

Bumpy, but passable



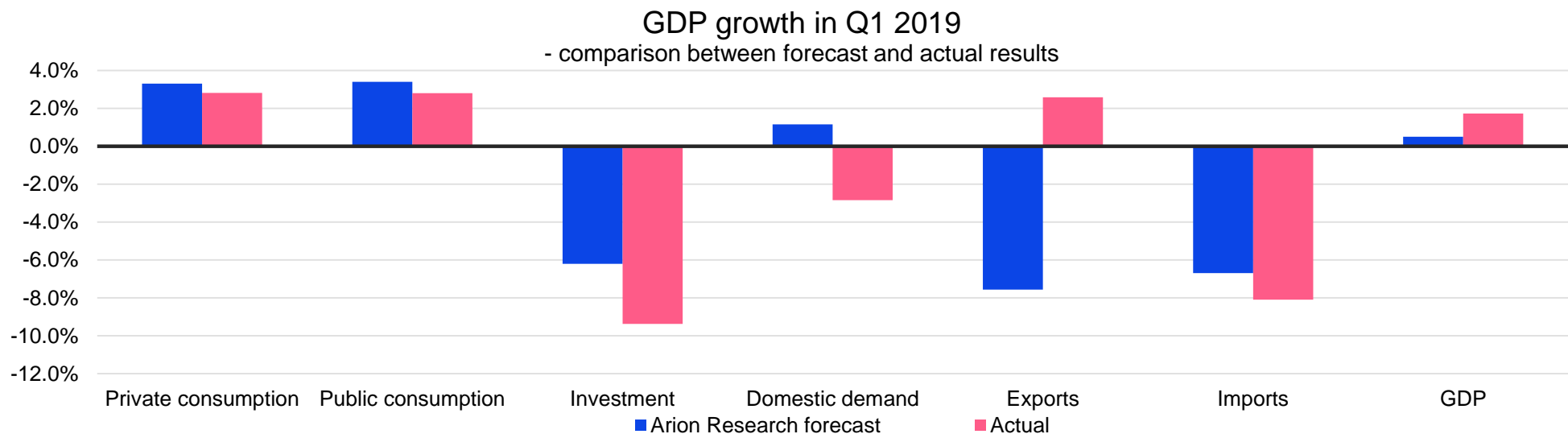
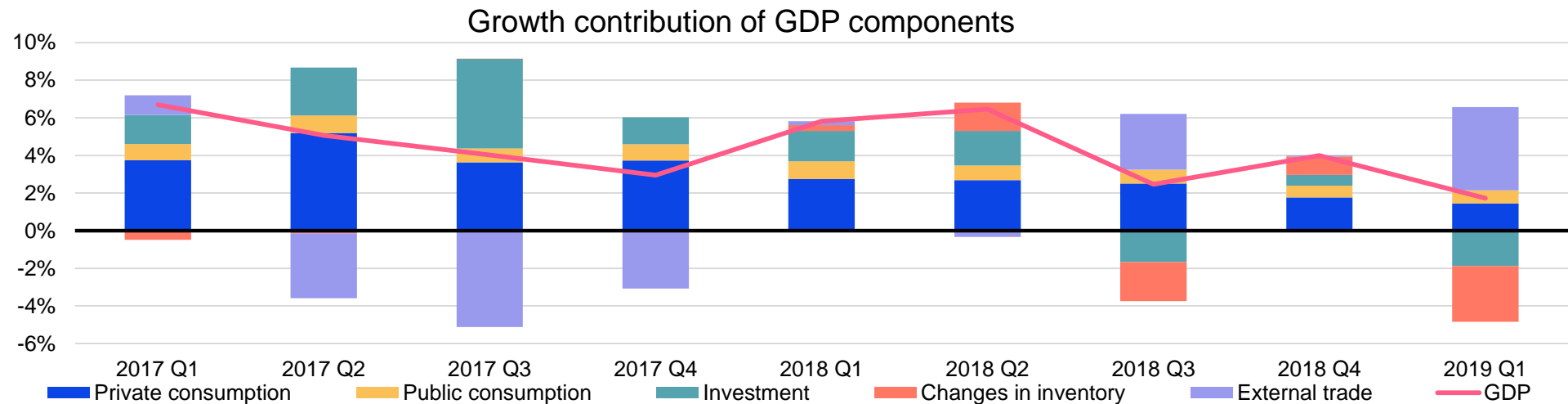
Key findings

- We expect economic development in 2019 to be more favorable than we anticipated in March. **We forecast a 0.9% economic contraction this year, primarily due to falling exports.** In comparison, economic output was forecast to contract by 1.9% in March. Since then various economic indicators have developed more favorably than we originally anticipated.
- The most significant changes from the last economic forecast are **smaller income decline in tourism** than we feared, **private sector wage agreements were more moderate** than expected and the Central Bank's revised **payment card turnover figures suggest stronger private consumption growth** than we anticipated. In addition, GDP growth in Q1 exceeded our expectations.
- We expect a **gradual turnaround, with 1.0% GDP growth next year.** Private consumption will be the main driver behind economic growth, bolstered by rising real wages while increased unemployment acts as a break.
- Our tourist arrivals forecast hasn't undergone any major changes since March. According to our forecast, **tourist arrivals will drop by 15% in 2019.**
- Despite strong growth in housing investment this year, we expect **total investment to decline in 2019,** primarily due to a contraction in business investment. **Negligible investment growth is expected over the forecast period.**
- We forecast a **positive current account balance** throughout the forecast period. **Falling imports in 2019** reflect slower domestic consumption growth.
- **The króna is expected to fluctuate within a narrow range throughout the year,** as the economic contraction has already been priced into the exchange rate. **The exchange rate of the króna is assumed to appreciate in 2020,** as the economy gets back on its feet.
- **The inflation outlook has improved markedly since March,** both due to a stronger króna and moderate wage agreements. Although inflation is forecast to stay above the Central Bank's inflation target, **it remains well within the tolerance limit (2.5% +/- 1.5%), which opens up the possibility for further interest rate cuts.**



The way it was: 1.7% GDP growth in Q1

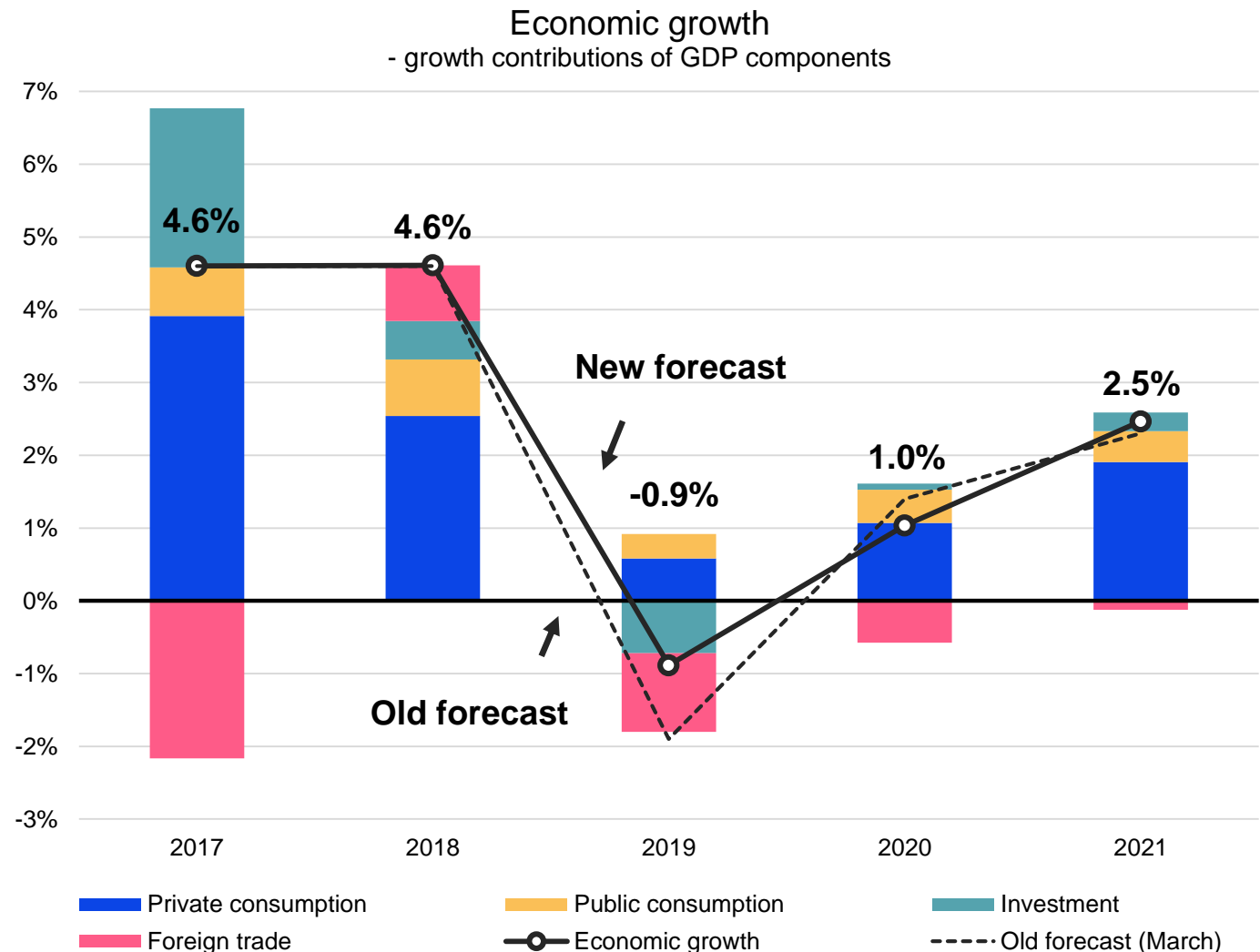
Even though 1.7% GDP growth is low in historical context, it still managed to exceed our expectations, mainly due to extraordinary housing investment growth and resilient goods exports. For further discussion on the Q1 figures, see [here](#).



Smaller contraction than previously expected

Despite brighter outlook for this year, the message remains the same: Falling exports will bring about economic contraction, followed by a gradual turnaround.

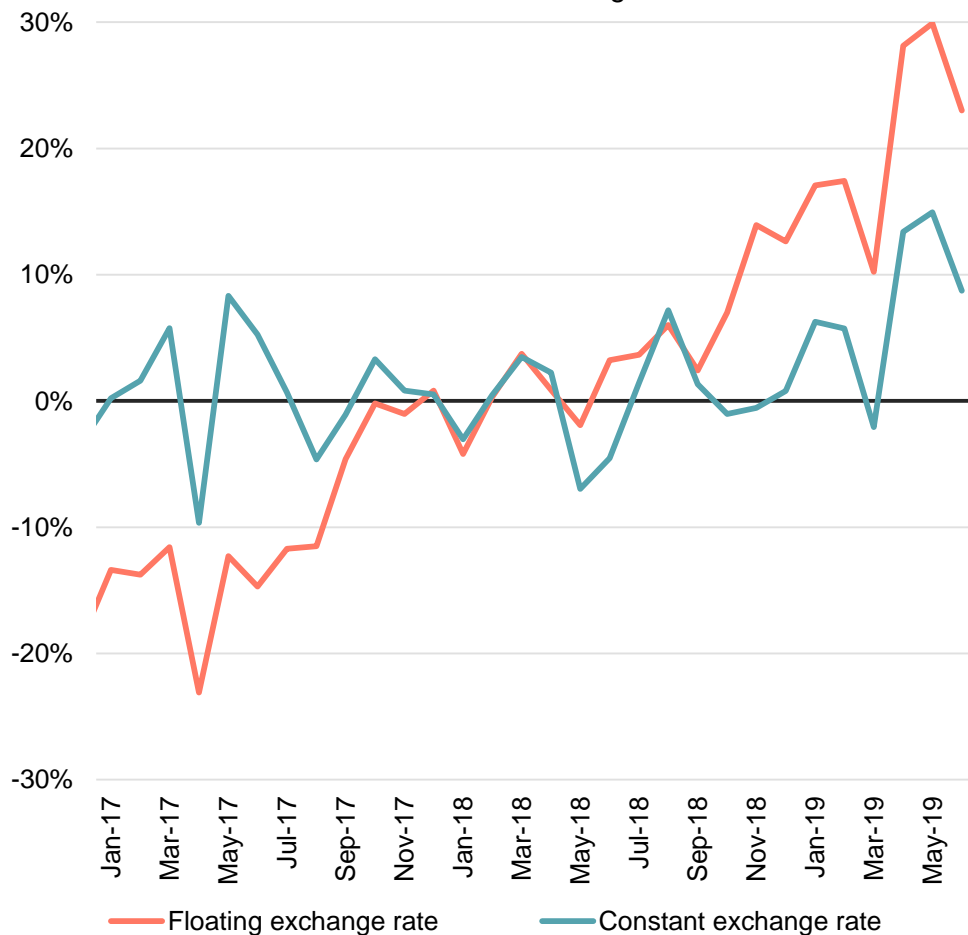
- Our last economic forecast was presented the day before WOW air was declared bankrupt, and published a week later, meaning it was prepared in the middle of the storm. A lot has come to pass since then, indicating a more favorable economic development than expected.
- The largest changes from the previous forecast are:
 - Income decline in tourism appears to be less than we feared and Icelandair's route system more flexible than we hoped.
 - Private sector wage agreements were more moderate than anticipated.
 - Revised payment card turnover figures indicate stronger private consumption growth than previously thought.
- Together these factors largely explain why we forecast a smaller contraction in 2019 than we did in March.
- Keep in mind that the following economic outlook is an update, not a new forecast from scratch.



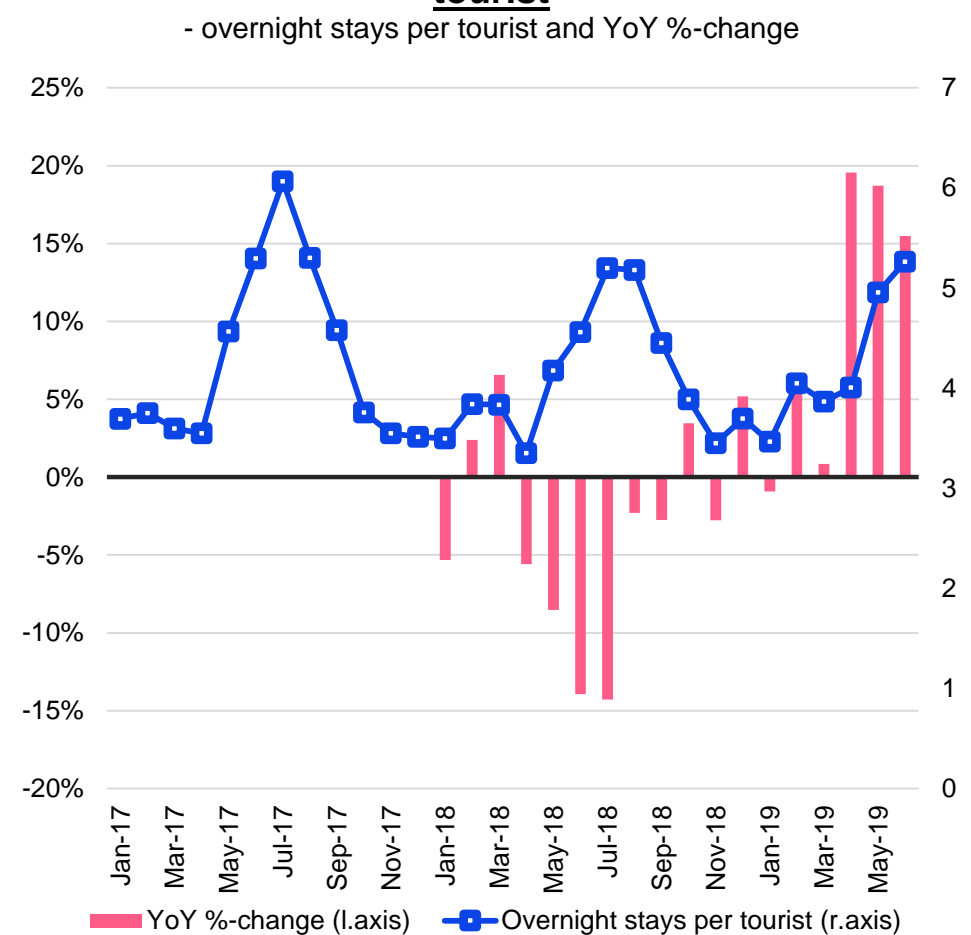
Icelandic tourism fights back

Tourism's high frequency date indicates that each tourist is staying for a longer period of time in the country, compared to last year, and spending more, both in ISK and foreign currency. This development should soften the economic blow of WOW air's bankruptcy.

Foreign payment card turnover per tourist
- YoY %-change



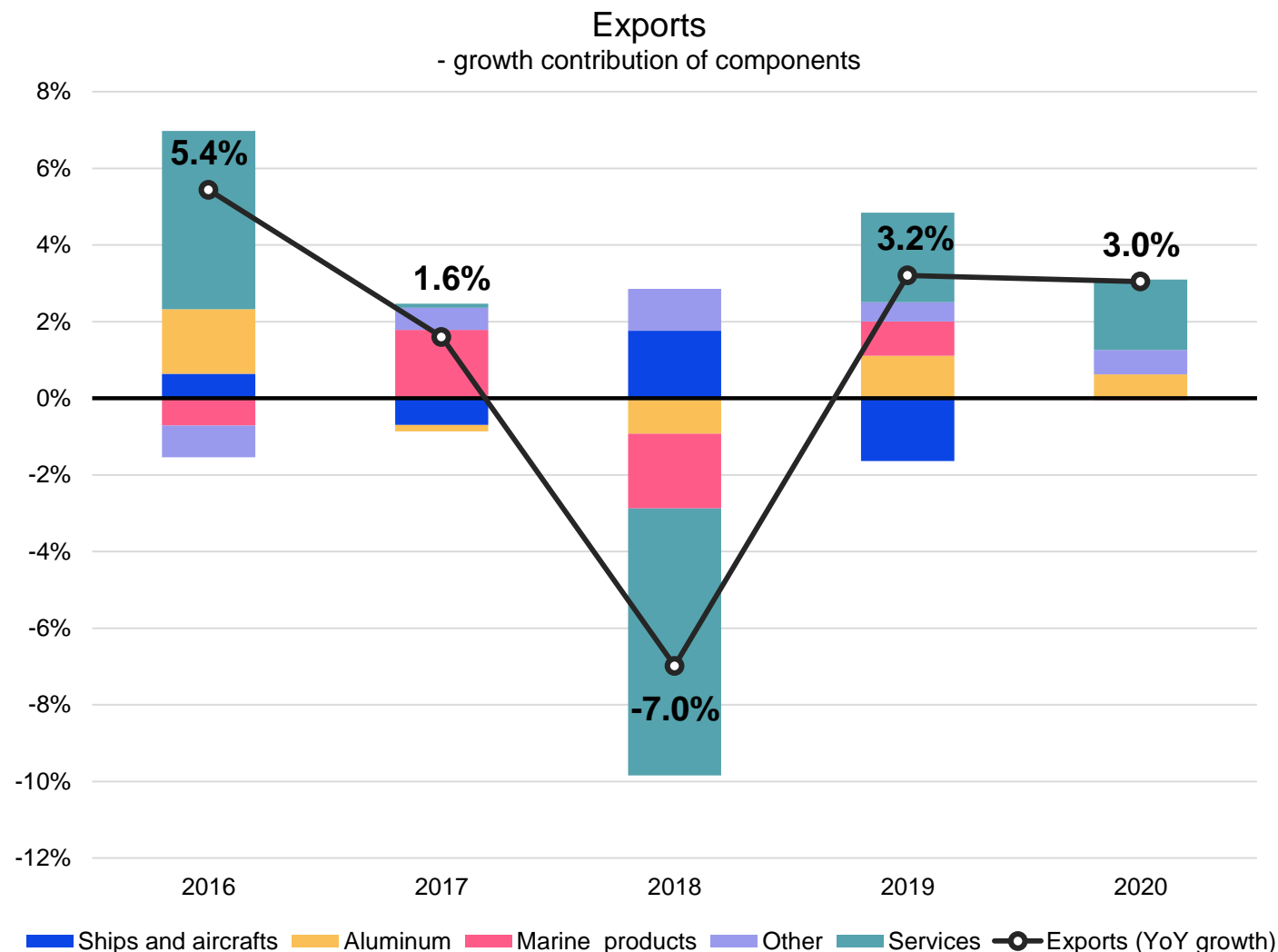
Registered and unlisted overnight stays per tourist
- overnight stays per tourist and YoY %-change



Misery loves company: Contraction in the largest export sectors

The three largest export sectors are hard pressed this year

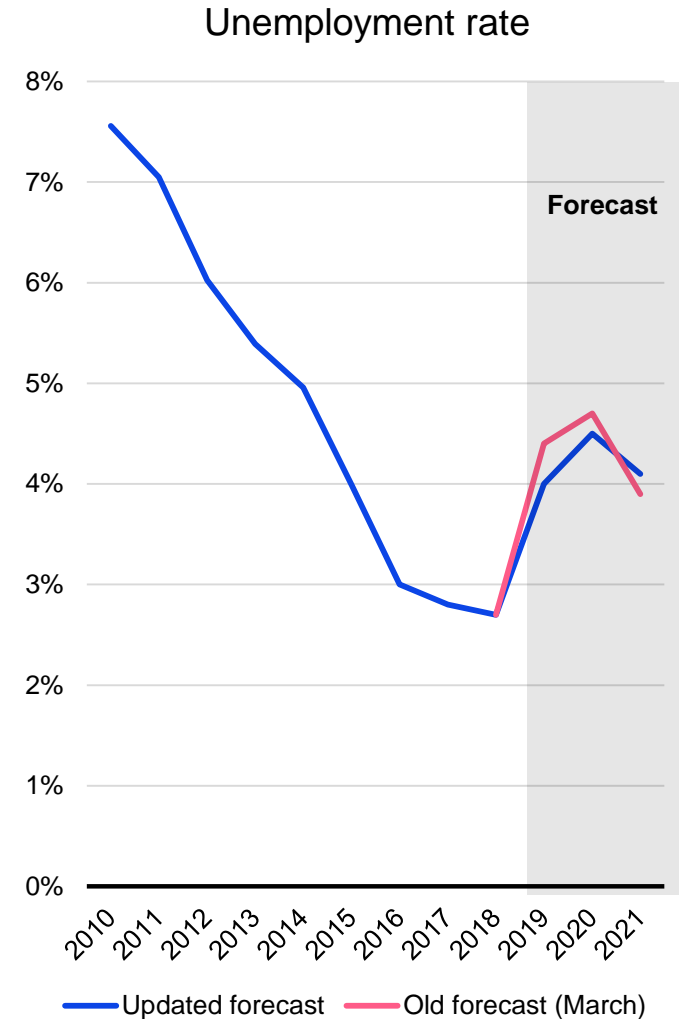
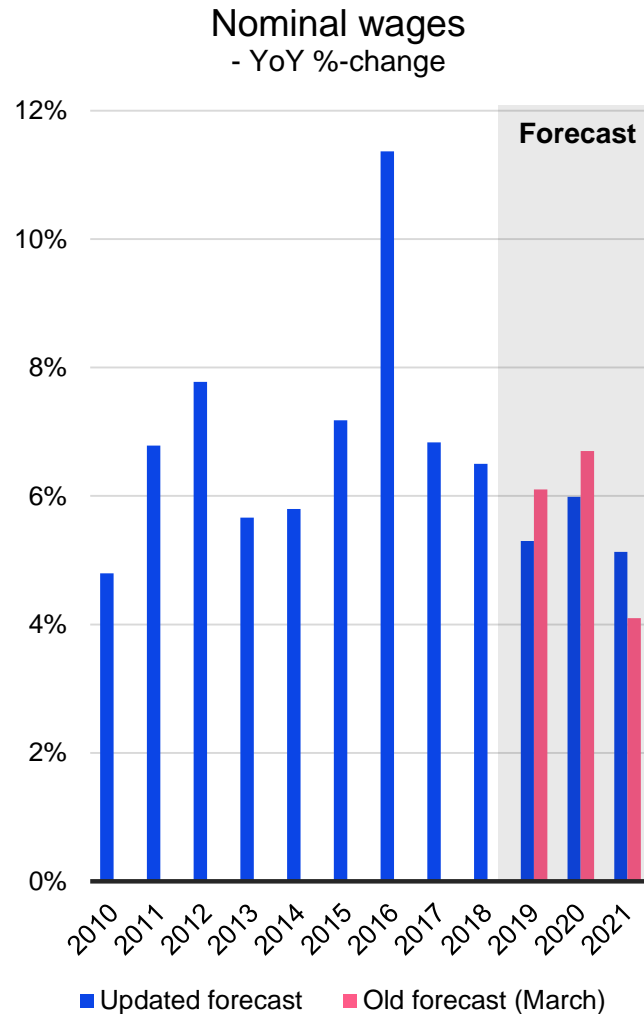
- The export contraction is mainly due to a drop in tourist arrivals.
- Our tourist arrivals forecast hasn't undergone any major changes since March. According to our forecast, tourist arrivals will drop by 15% in 2019.
- The lack of capelin quota weighs heavily on fisheries, as high export revenues are at stake, or 1.3% of total exports last year.
- The latest export shock came this summer, when one of the three potlines at Rio Tinto Group's aluminium smelter was shut down. The aluminium sector has been struggling in the wake of high alumina prices and falling aluminium prices.
- Moderate export growth next year reflects deteriorating global economic outlook and increased probability of a hard Brexit.



Labor market in the shadow of exports contraction

The warring parties took notice of the economic environment and settled on moderate wage increases this year

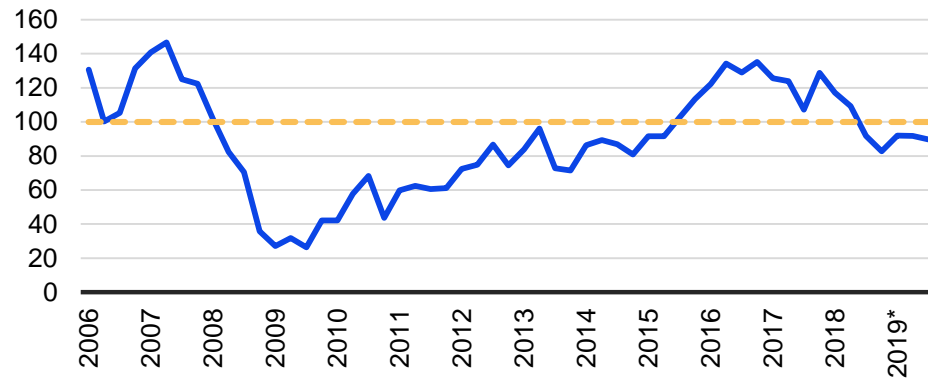
- The steps that were taken when the private sector wage agreements were signed are, in our opinion, positive. The results were better for the economy as a whole than we feared, easing inflationary pressures, depreciation of the króna and opens up the possibility for further rate cuts.
- Conservative wage increases, especially in 2019 when the exports sectors are struggling, cushion corporate cost increases and the need for layoffs. Smaller income decline in tourism should help as well.
- There is still tension on the labor market as wage agreements for the public sector have not yet been signed.
- The updated wage forecast assumes a negligible wage drift, a rare sight on the Icelandic labor market.



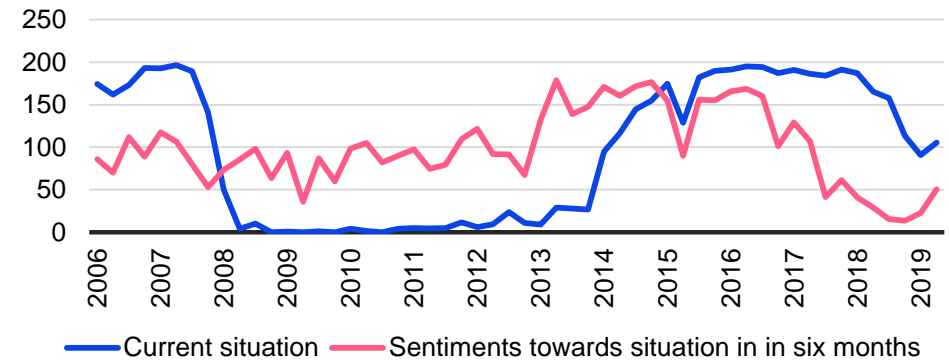
When it hasn't been your day, your week, your month, or even your year

News of WOW air's bankruptcy, struggling tourism and a number of layoffs, to name but a few, have effected the expectations of both households and corporations

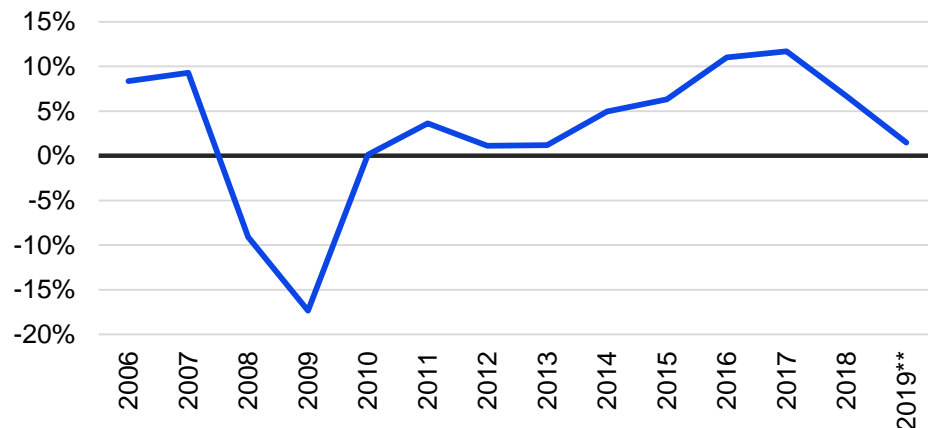
Consumer confidence
- quarterly data



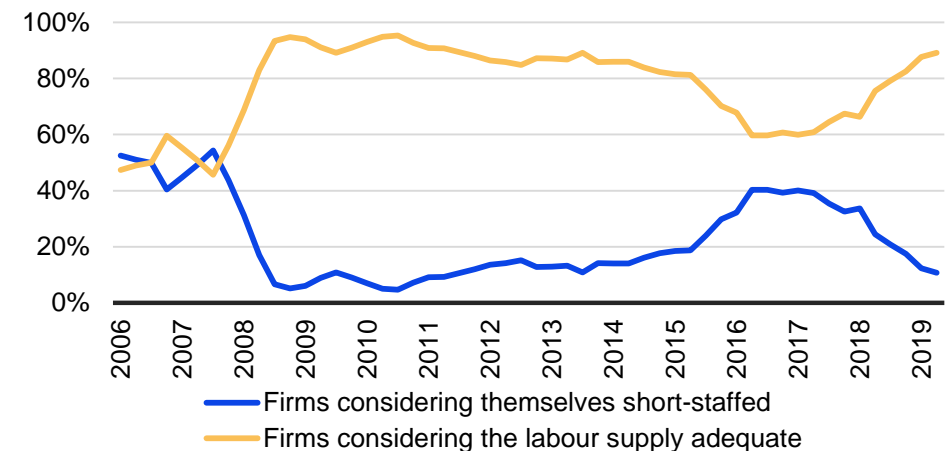
Corporation expectations towards the economic situation and outlook



Payment card turnover
- YoY %-change at constant prices and exchange rate

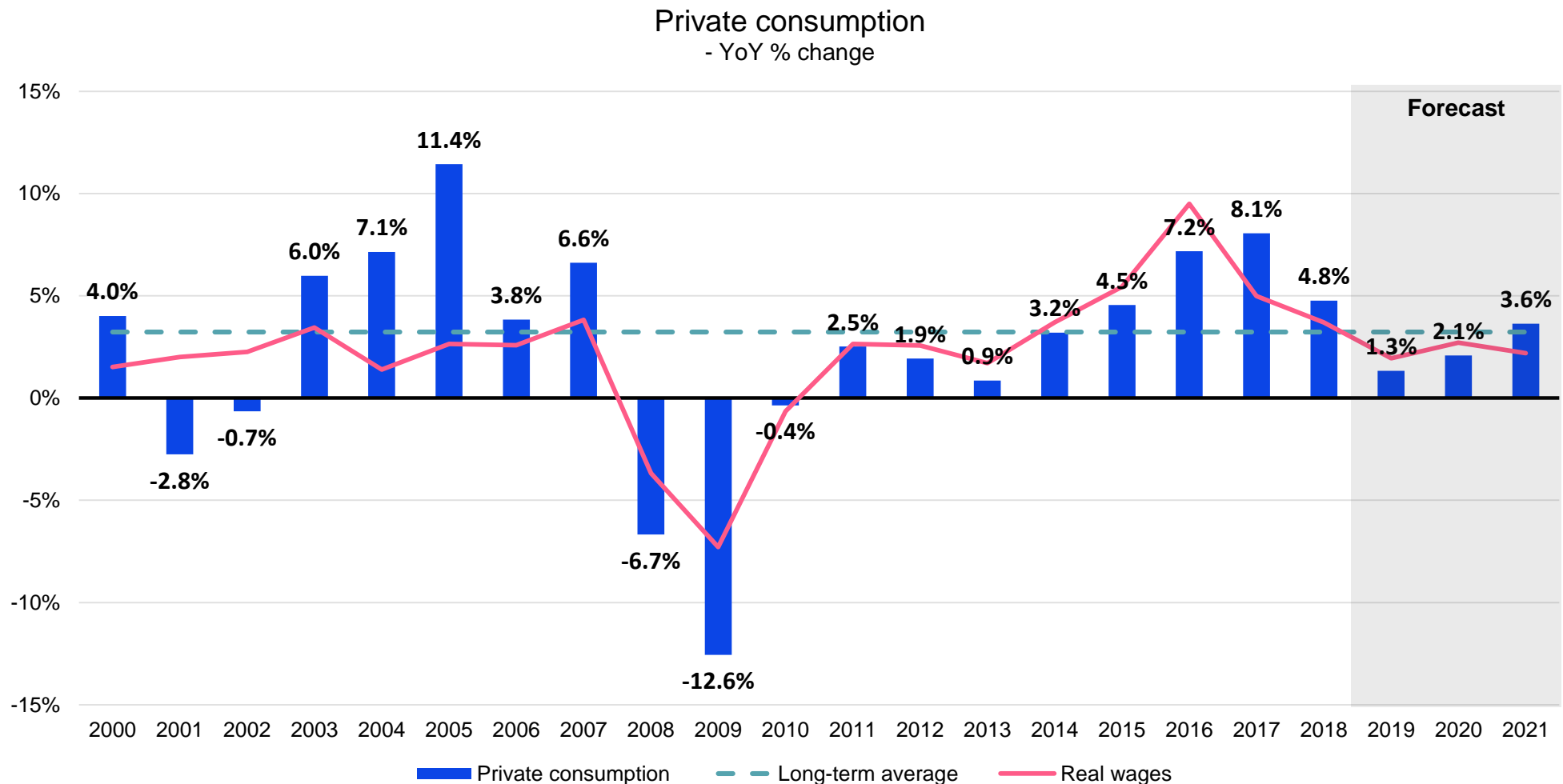


Labour supply



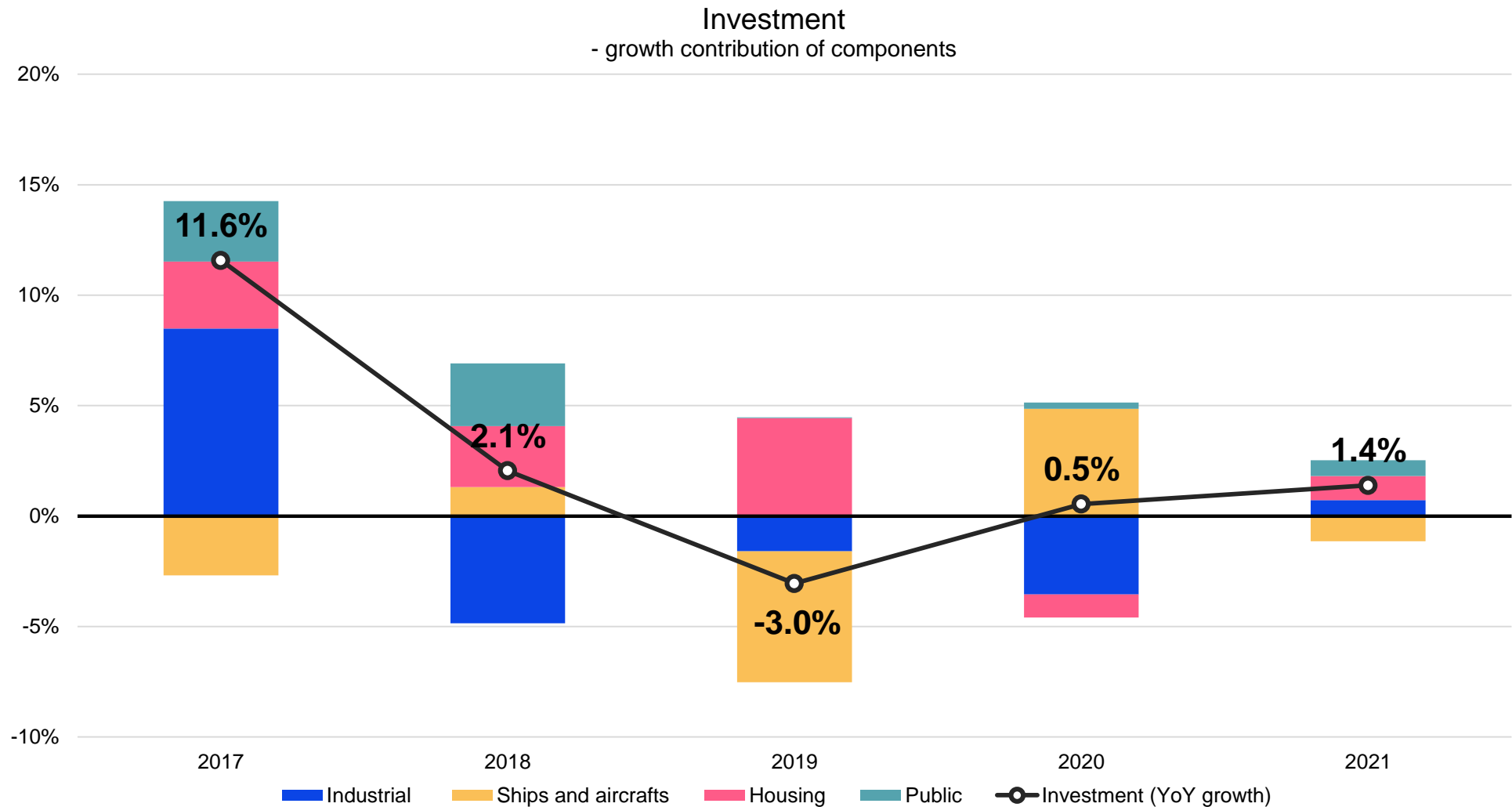
Slight private consumption growth in the (payment) cards

Private consumption growth is expected to slow down significantly this year, in line with increasing unemployment and slower real wages growth. However, household debt is low in historical context and the financial system's net lending to households is increasing, which can boost private consumption growth for the year.



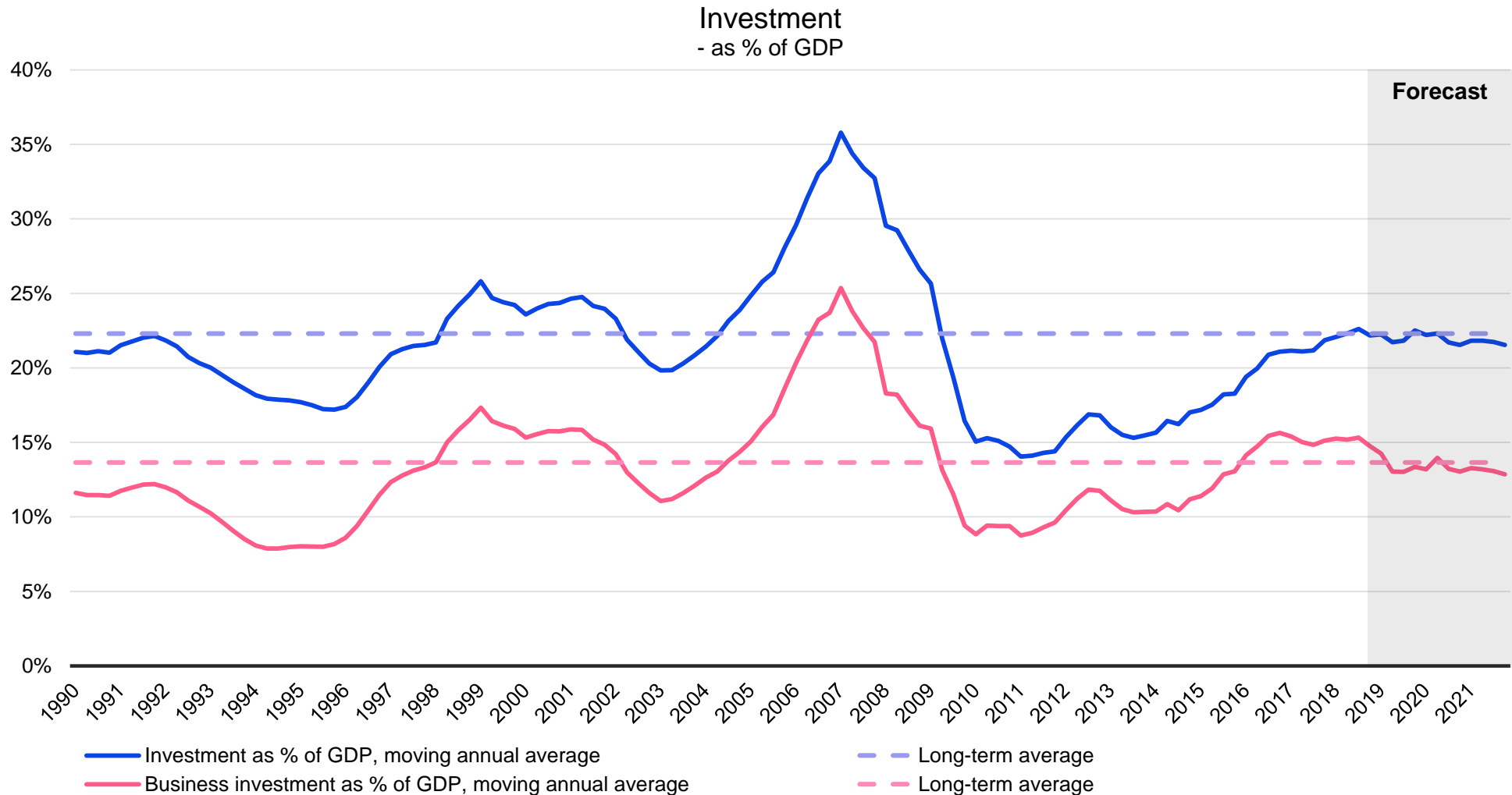
Investment contracts for the first time since 2010

Even though housing investment is soaring, the sale of four WOW air aircraft at the beginning of the year weighs more, dragging down the total change between year below zero



The investment level treads water

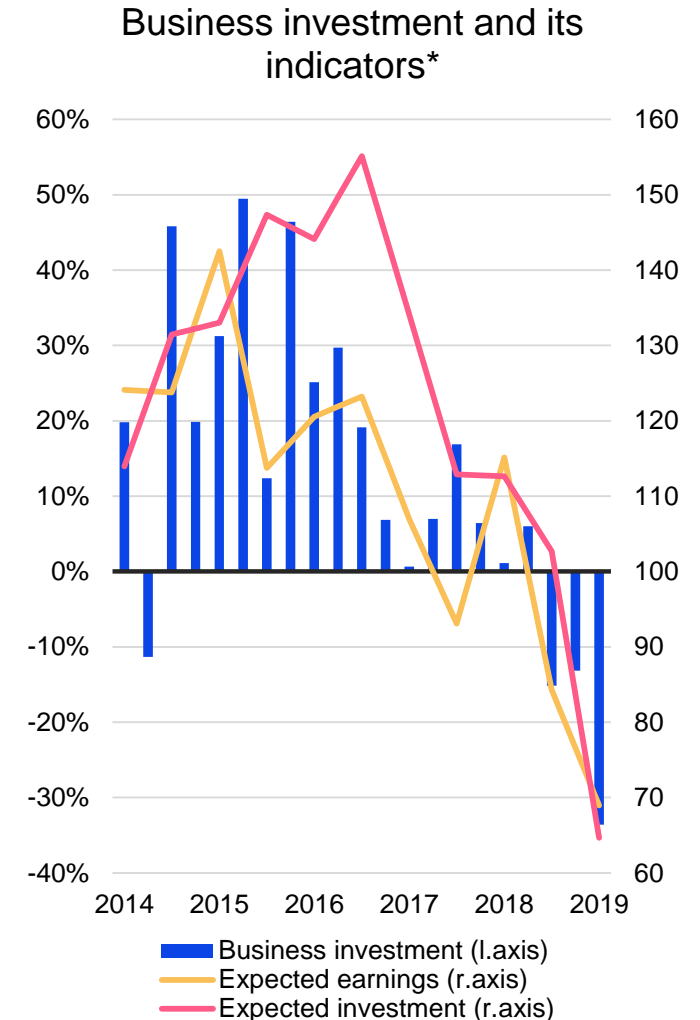
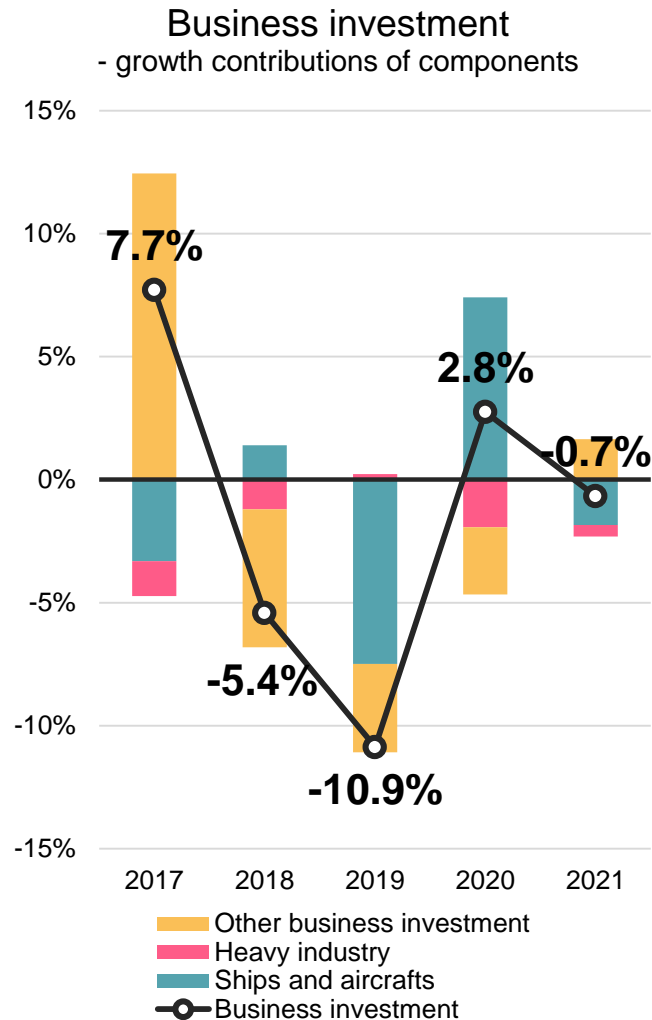
Although investment is forecast to contract this year, followed by a minor growth in 2020, the investment level holds steady at its long-term average throughout the forecast period.



Business investment dances to the beat of ships and aircrafts

The business investment forecast for this year and the next is colored by investment in ships, and mainly aircrafts

- WOW air's sale of four aircrafts to Air Canada at the beginning of the year largely explains the decline in investment in ships and aircrafts, and the strong bounce-back next year.
- Regular business investment contracted by 5.4% YoY in Q1, contrary to our expectations, the fifth quarter in a row. According to our new forecast, regular business investment will continue to contract. Gallup's survey results among the country's 400 largest firms supports that view.
- We believe that the current economic situation, as well as the uncertainty regarding WOW air and wage agreements for the past couple of quarters, will have an impact on today's investment plans and decisions, and thus next year's investment.



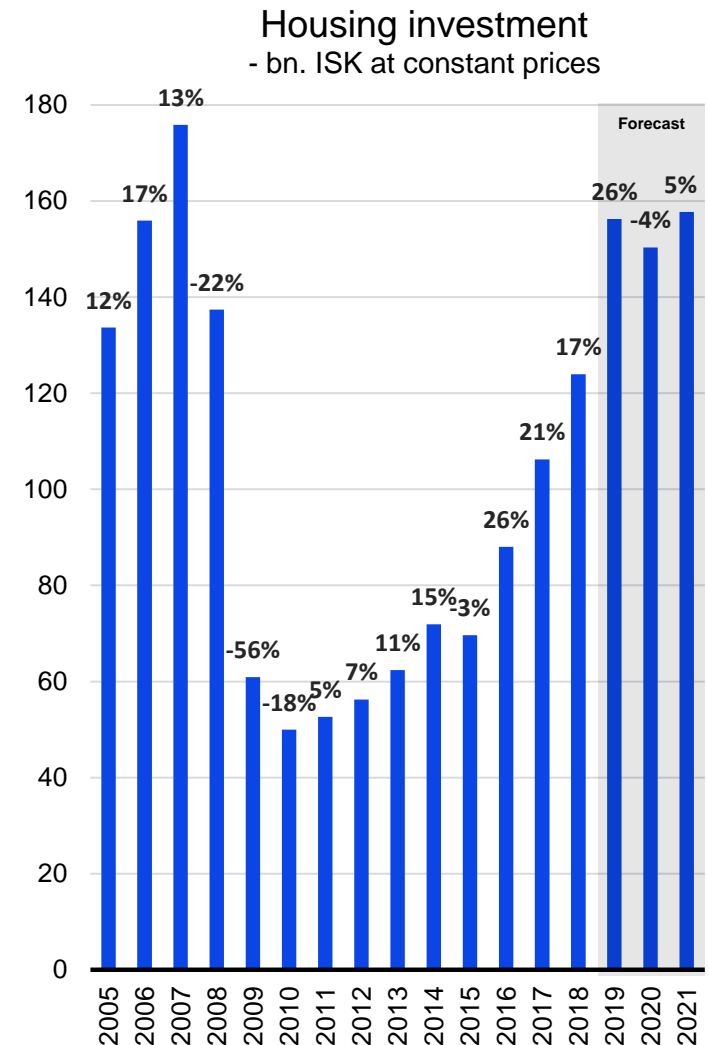
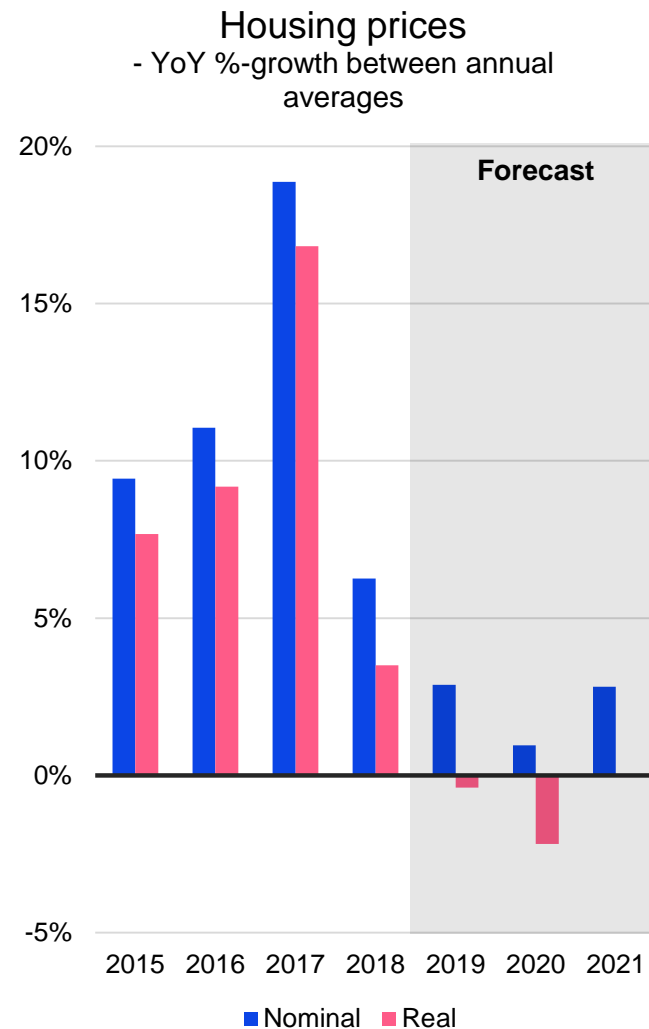
Sources: Statistics Iceland, CBI, Arion Research. *The indexes for expected margins and expected investment are based on Gallup's survey results among the country's 400 largest firms.



Increased supply constrains housing prices

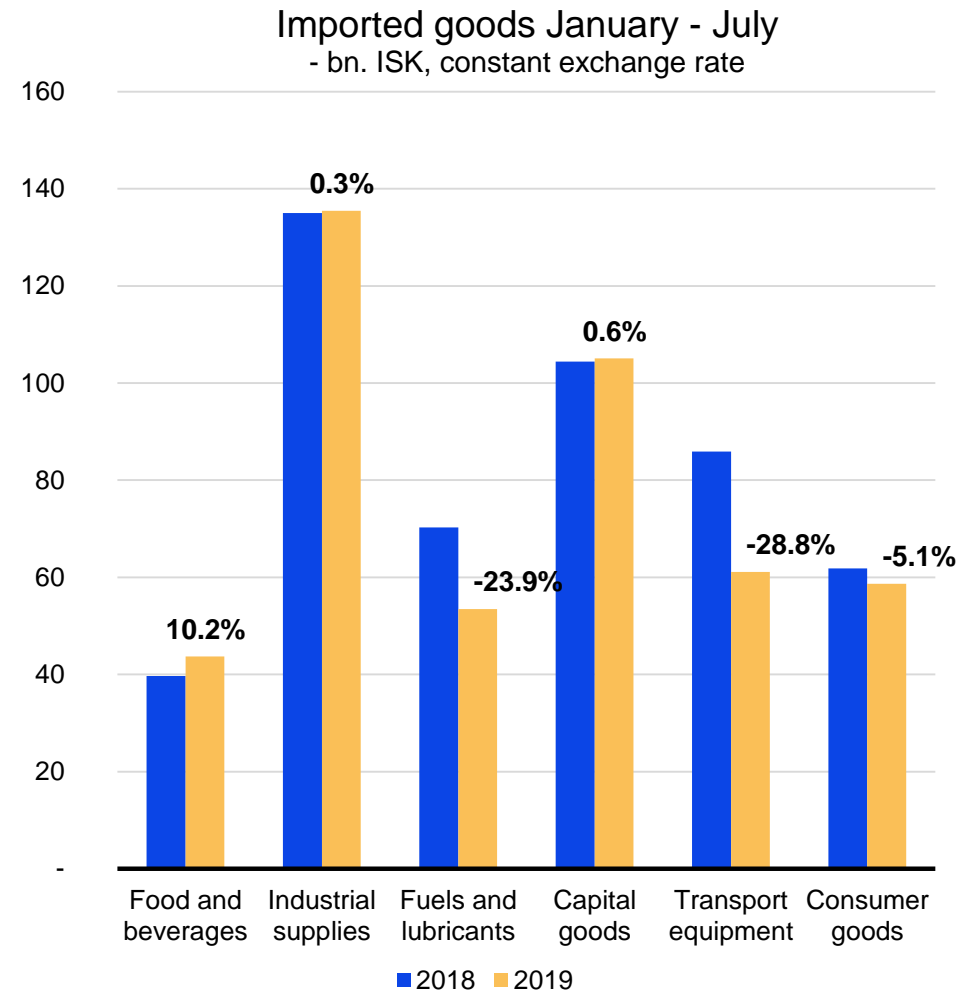
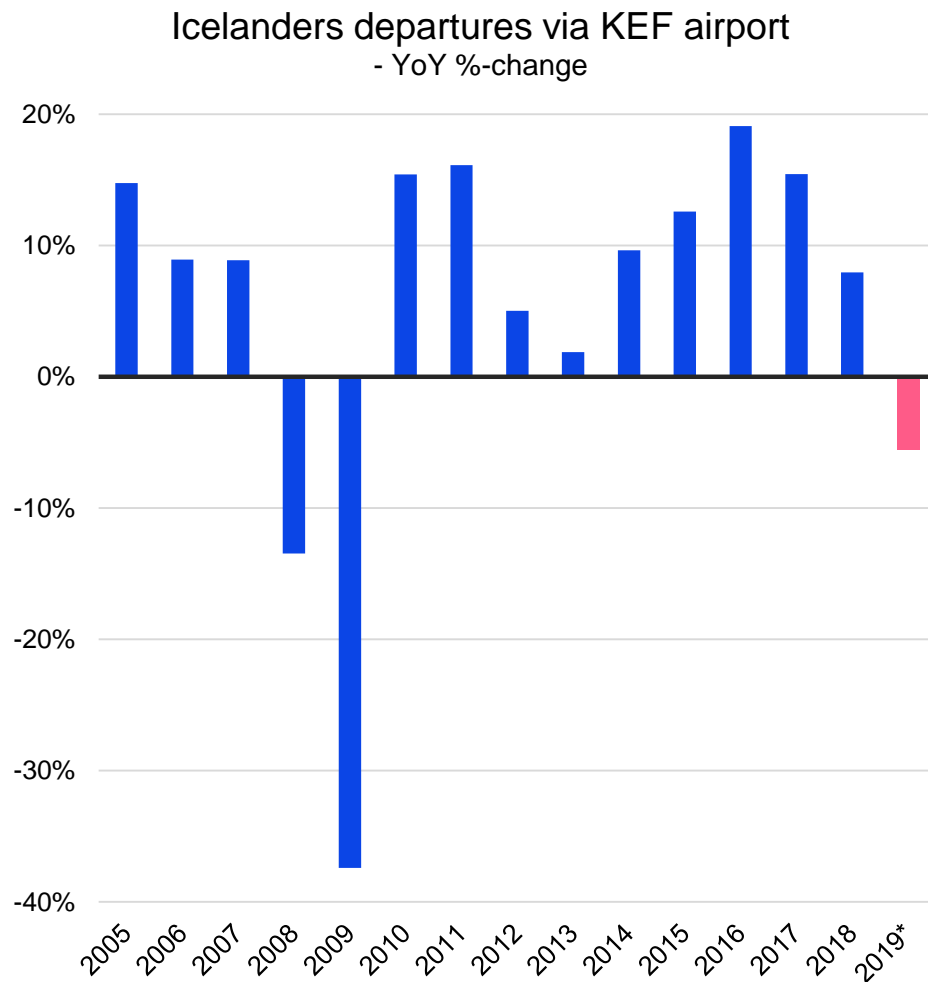
We expect little or no housing price increases in the second half of the year, compared to mid-year housing prices.

- The curious case of the missing housing investment in 2H 2018 was finally explained in Q1 2019, when the YoY increase amounted to 58.4%.
- The strong growth in Q1 affects the entire year, leading to a 26% expected growth in housing investment this year. The higher base level than before also affects next year, causing contraction between years even though the investment level remains high.
- We expect little to no housing price increases in the near term, as unemployment is rising and wage growth slowing down, while at the same time housing supply is increasing.
- The housing price forecast is based on annual averages, meaning that the lion's share of this year's increase has already materialized.



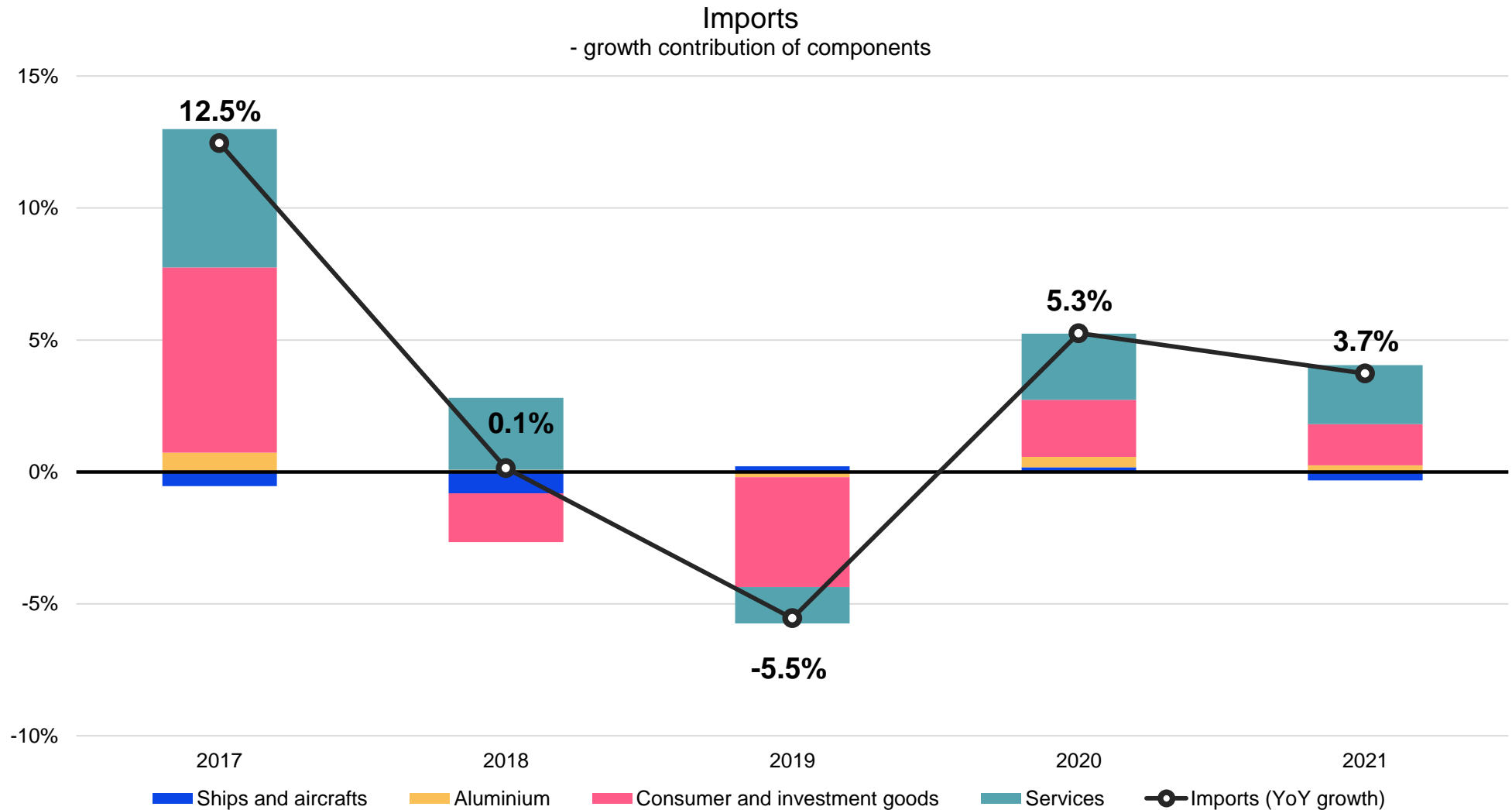
Soak up the Icelandic sun

Icelanders are taking far fewer trips abroad this year, unsurprisingly given WOW air's bankruptcy, which indicates a decline in imported services. Statistics Iceland monthly import of goods figures are also influenced by the economic situation, as only three subcategories are increasing between years.



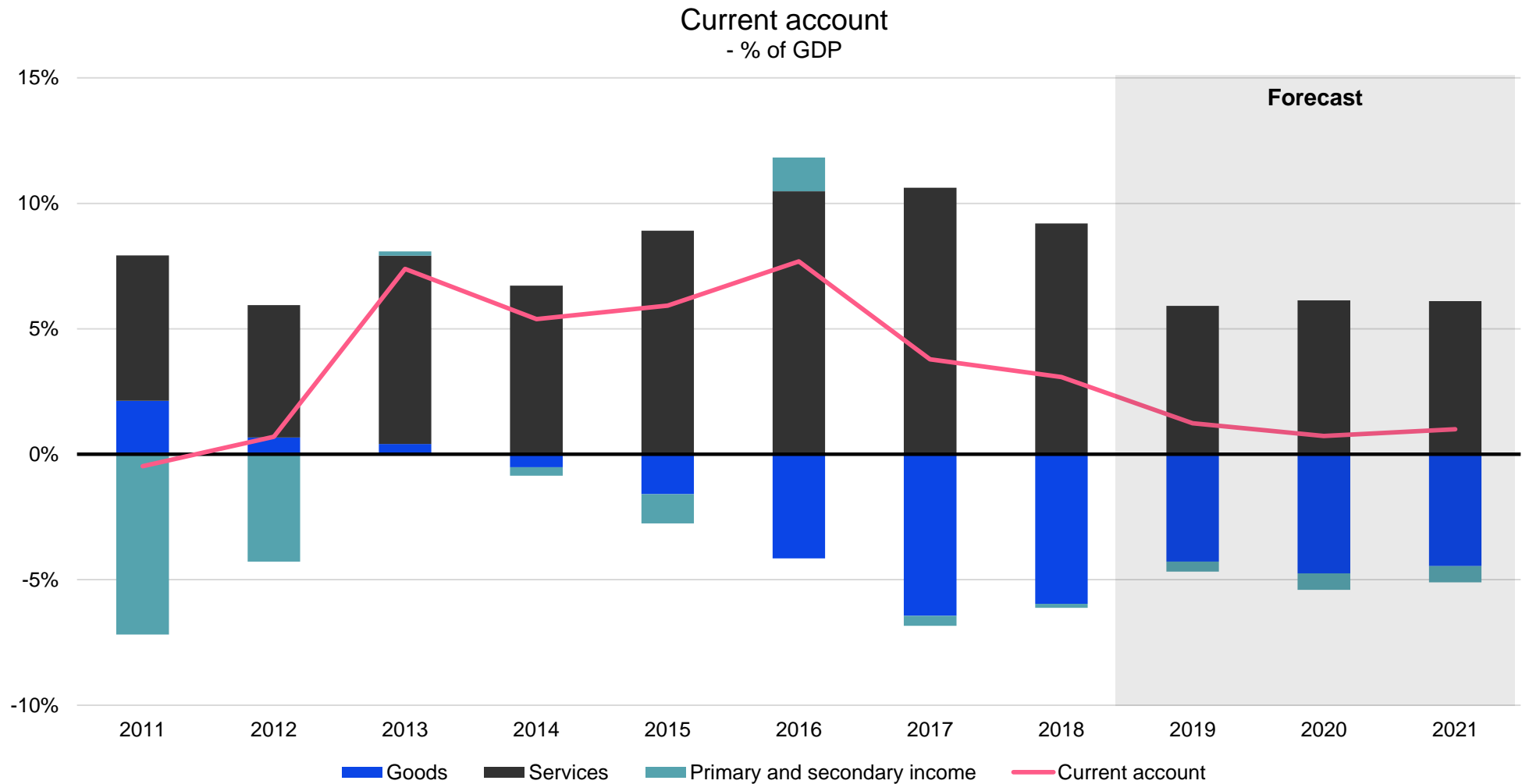
Declining imports

Reflecting slower private consumption growth, contracting investment, drop in tourist arrivals and fewer trips abroad by Icelanders



The current account balance floats above zero

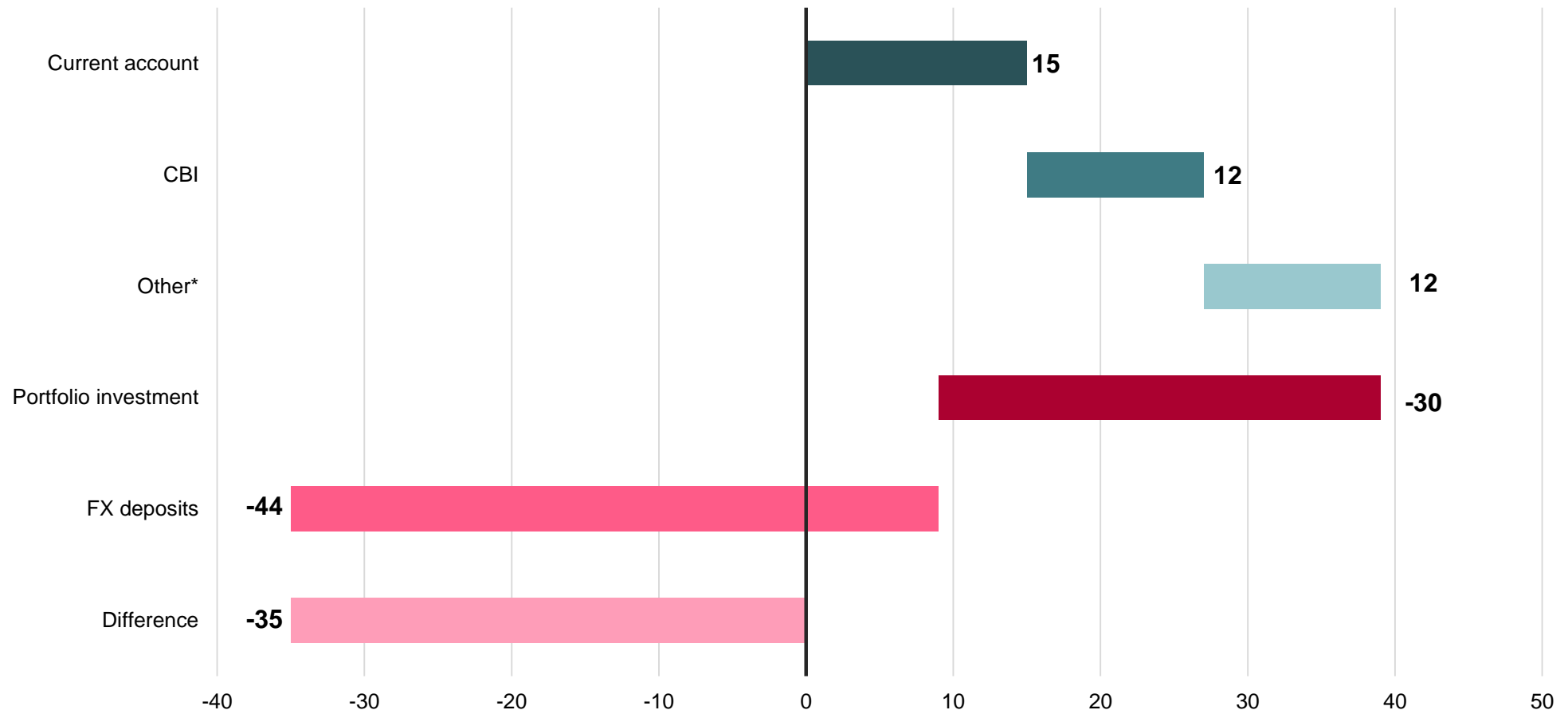
Despite the contraction in the largest export sectors, the current account balance remains positive, as imports contract as well. The aircraft sale in Q1 account for a large part of the current account surplus, or about 17 bn. ISK.



Foreign currency outflow exceeded inflow in 1H

In 1H, increased deposits in foreign currency and portfolio investment led to a significant outflow. In all likelihood, the Icelandic pension funds are responsible for the lion's share of the outflow. If the FX deposits are used for securities investment in 2H, it's likely that the FX outflow, and thus the depreciation effects stemming from the pension funds, will be smaller in 2H compared to 1H.

Estimated foreign currency flows in 1H 2019

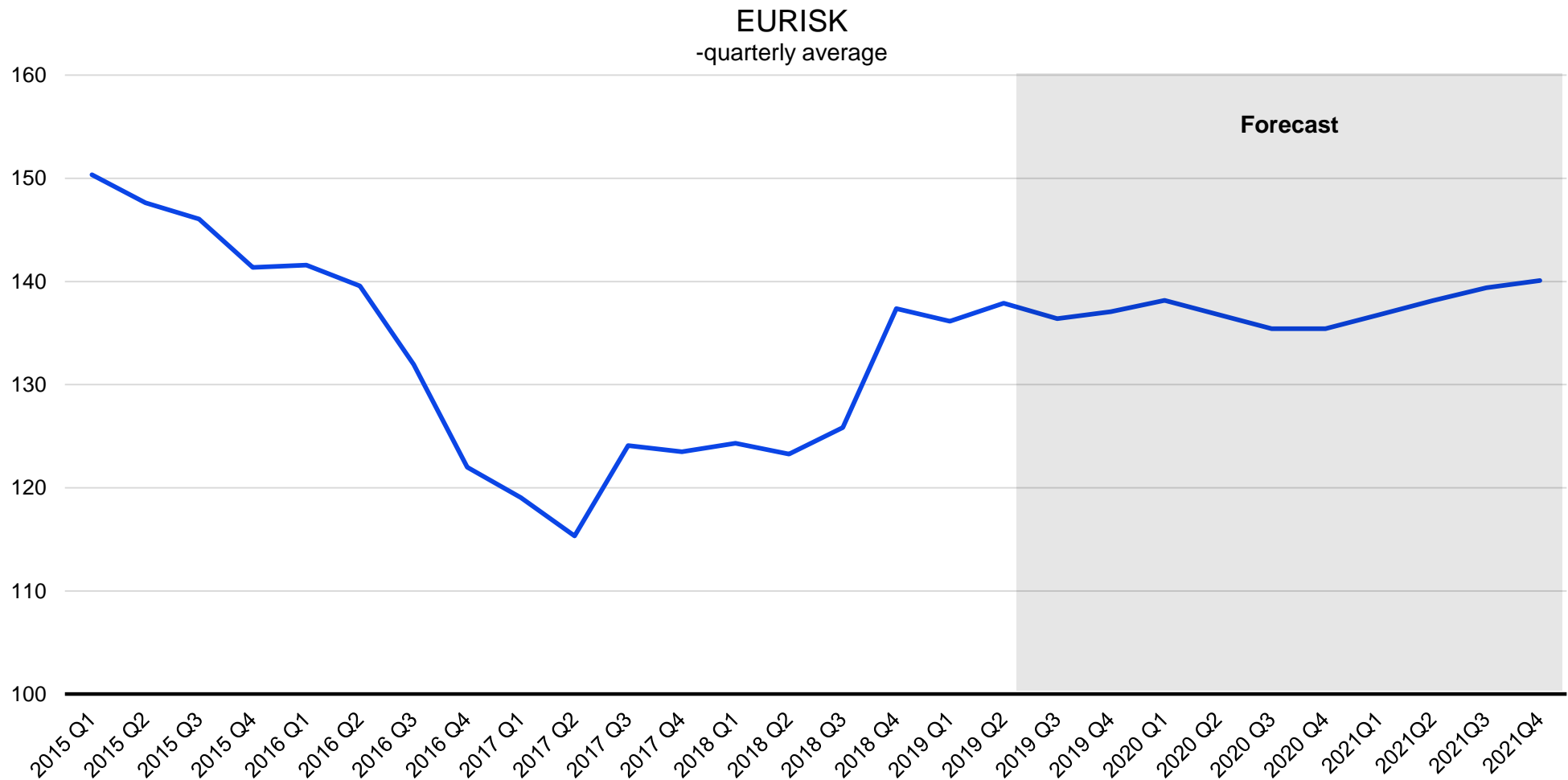


Sources: CBI, Arion Research. * This is the most uncertain component, as it includes many items which are unclear whether cause direct currency movements or not.



Fairly stable króna

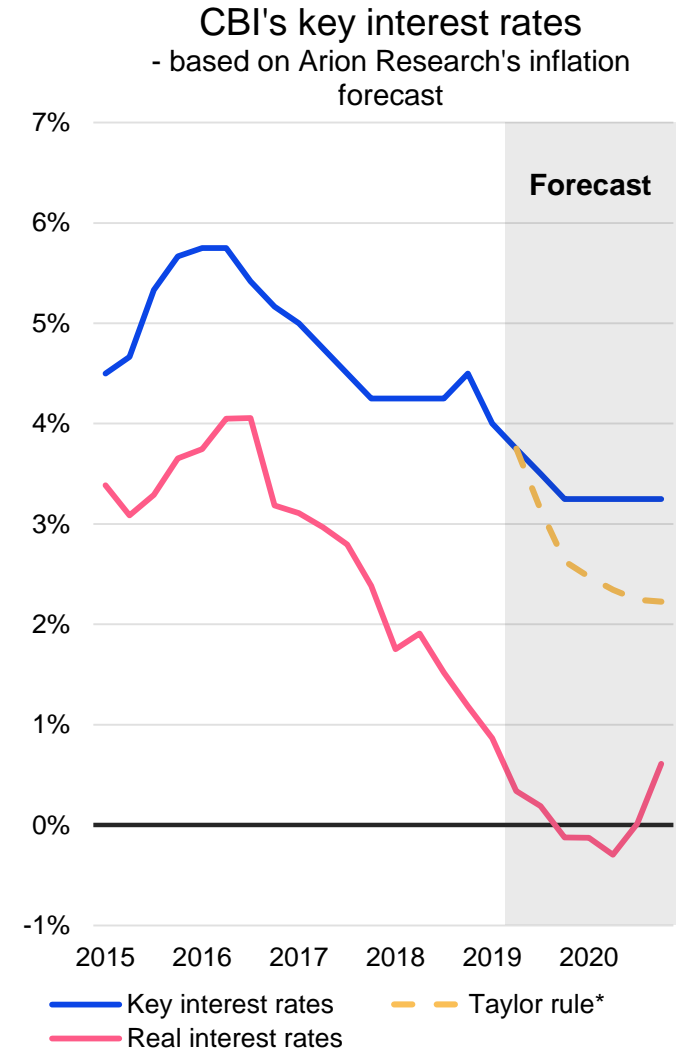
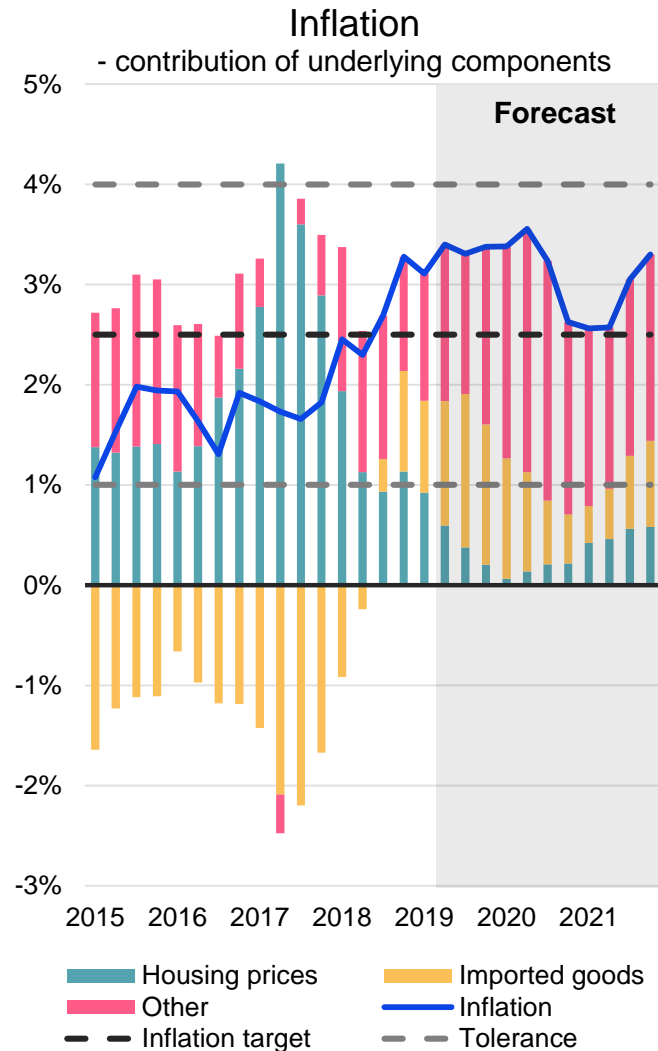
We assume that the króna will fluctuate within a narrow range throughout the year, as the economic contraction has largely been priced into the exchange rate. It may well be that economic turnaround will rekindle foreign investor's interest in domestic assets, especially if foreign interest rates continue to drop. In the long run however, we expect a nominal exchange rate depreciation, reflecting higher wages and inflation compared to the country's main trading partners.



Low inflation and further rate cuts

Inflation is forecast to stay above the CBI's inflation target, but remain well within the tolerance limit.

- Despite wage increases and a depreciation of the ISK, inflation has remained low in historical context. There are several indications that firms are having a harder time than before pushing cost increase into prices.
- Because of this development, firms are forced to rely more heavily on cost-cutting measures, such as layoffs.
- The composition of inflation has undergone considerable changes in the past months, with housing prices giving way to imported goods. We expect this trend to continue in the near term, with the importance of housing prices decreasing.
- The CBI has cut interest rates by 75 bps this year. If inflation expectations remain anchored we expect further rate cuts this fall and winter.



Main economic indicators

GDP components

<i>Change from previous year(%)</i>	2017	2018	2019	2020	2021
Private consumption	8.1	4.8	1.3	2.1	3.6
Public consumption	3.6	3.3	2.1	2.3	2.1
Investment	11.6	2.1	-3.0	0.5	1.4
<i>Business investment</i>	7.7	-5.4	-10.9	2.8	-0.7
<i>Housing investment</i>	20.7	16.7	26.0	-3.8	4.9
<i>Public investment</i>	23.3	21.2	1.4	2.9	4.4
Domestic demand	7.6	4.1	-0.2	1.9	2.7
Exports of goods and services	5.4	1.6	-7.0	3.2	3.0
Imports of goods and services	12.5	0.1	-5.5	5.3	3.7
Gross domestic product (GDP)	4.6	4.6	-0.9	1.0	2.5



Main economic indicators

<i>Relative to GDP (%)</i>	2017	2018	2019	2020	2021
Current account	3.8	3.1	1.2	0.7	1.0
Investment	22.1	22.2	22.2	21.8	21.5
<i>Change from previous year (%)</i>					
Inflation	1.8	2.7	3.3	3.2	2.9
Nominal wages	6.8	6.5	5.3	6.0	5.1
Real wages	5.0	3.7	1.9	2.7	2.2
Housing prices	18.9	6.3	2.9	1.0	2.8
Real housing prices	16.8	3.5	-0.4	-2.2	-0.1
Real exchange rate	11.9	-3.0	-6.1	1.7	-0.6
<i>Annual averages</i>					
Unemployment (%)	2.8	2.7	4.0	4.5	4.1
EUR/ISK	121	128	137	136	139



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