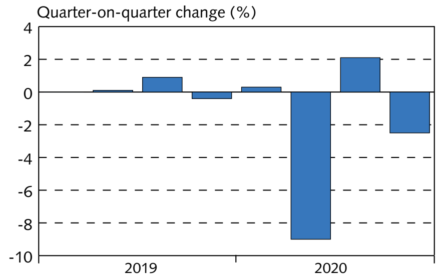
III Demand and GDP growth

Domestic private sector demand

Private consumption contracted strongly in Q2 …

Broad-based public health measures aimed at curbing the spread of COVID-19 in March and April had a strong impact on households' willingness and opportunity to spend. Private consumption declined by 9% quarter-on-quarter in Q2, the largest single-quarter contraction since Q4/2008 (Chart III-1). It contracted by 8.3% from Q2/2019, slightly less than had been forecast in the August *Monetary Bulletin*.

Chart III-1
Quarterly growth in private consumption[1]
Q1/2019 - Q4/2020

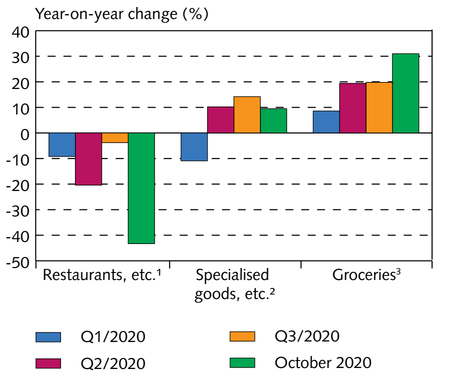


1. Seasonally adjusted data. Central Bank baseline forecast for Q3 and Q4/2020.
Sources: Statistics Iceland, Central Bank of Iceland.

… but rebounded in Q3 …

Private consumption appeared to recover strongly at the end of Q2 and into the summer, when the pandemic had receded and public health measures were relaxed (Chart 2 in Appendix 1). Traffic increased markedly from the level seen in March and April. The same pattern could be seen in households' domestic payment card use for purchases of groceries and specialty goods, as well as miscellaneous services requiring close physical proximity to others (Chart III-2). Private consumption is estimated to have increased by just over 2% between Q2 and Q3, somewhat more than was forecast in August (Chart III-1).

Chart III-2
Payment card turnover by main categories



1. Restaurants, accommodation, transport, package tours, duty-free shopping, culture and recreation, and personal care and services.
2. Electronics, household appliances, furniture, clothing, and other specialised retail goods and services. 3. Grocery stores and supermarkets.
Source: Centre for Retail Studies.

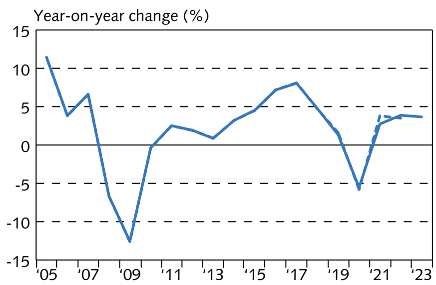
… only to sag again in Q4

The resurgence of the pandemic in late September prompted a further tightening of public health measures and a renewed contraction in economic activity. As Chart 2 in Appendix 1 indicates, traffic declined in the greater Reykjavík area, and payment card turnover lost pace, particularly to include spending on activities requiring close physical proximity to other people (see also Chart III-2). Because of this setback in the battle with the pandemic, private consumption is now expected to contract once again in Q4 (Chart III-1). If this forecast materialises, the contraction for the year as a whole will measure 5.5%. Even so, this is a smaller contraction than was forecast in August, owing to stronger-than-projected private consumption in H1 (Chart III-3).

Private consumption forecast to rebound in 2021 – depending on developments in the pandemic

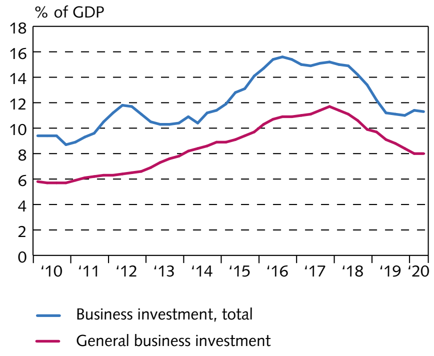
Near-term developments in household demand depend in large part on how successful efforts to contain the pandemic prove to be, as public health measures restrict the supply of various services and affect households' income and expectations. The current baseline forecast assumes that the battle with the pandemic will take longer than was projected in August, as the situation deteriorated again this fall. It is now assumed that the worst of the pandemic will be over in Iceland by the end of this year, although continued isolated outbreaks cannot be ruled out. It is also assumed that a vaccine will be available early in 2021 and mass-produced thereafter, and that much of the population in Iceland and its key trading partners will have been inoculated by

Chart III-3
Private consumption 2005-2023[1]



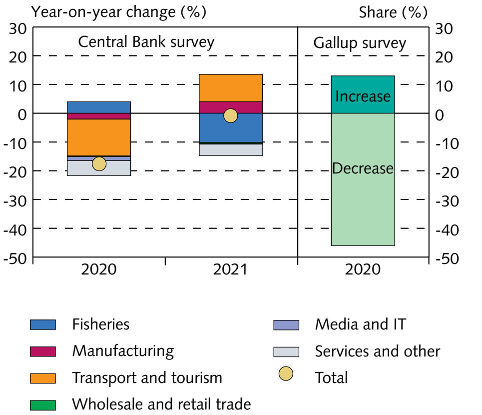
1. Central Bank baseline forecast 2020-2023. Broken line shows forecast from MB 2020/3.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-4
Business investment[1]
Q1/2010 - Q2/2020



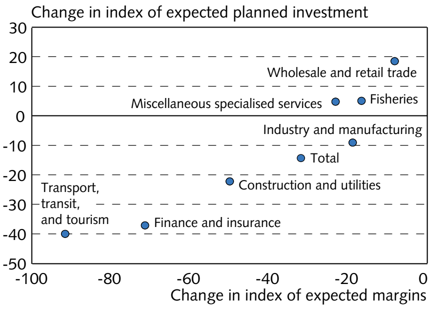
1. Four-quarter moving average. General business investment excludes ships, aircraft, and energy-intensive industry.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-5
Indicators of investment plans[1]



1. Central Bank survey of 96 firms' investment plans (excluding investments in hotels, ships, and aircraft). Gallup survey of Iceland's 400 largest companies' investment plans. The chart shows the share of firms intending to increase investment and the share intending to decrease it.
Sources: Gallup, Central Bank of Iceland.

Chart III-6
Business executives' expectations concerning margins and investment expense[1]



1. Change between surveys carried out in March and September 2020. Respondents were asked about their expectations concerning their margins in the next six months and whether their 2020 investment spending would be greater than or less than in 2019.
Source: Gallup.

mid-year. Widespread inoculation and improvements in treatment will reduce the need for social distancing over the course of the year and make it possible for daily life to normalise gradually.

Until then, it is assumed that households will use a portion of the savings they accumulated earlier this year to finance consumption spending. A majority of households have a strong asset and debt position, and lower interest rates have eased their expense burden. Government measures to protect jobs and household incomes are also important, and many households have taken advantage of the authorisation to withdraw third-pillar pension savings to cover current expenses. These measures have partially offset income losses stemming from declining employment levels.

The Bank's baseline forecast assumes that private consumption will rise again in Q1/2021 and grow by nearly 3% in 2021 as a whole. It is expected to continue rising over the forecast horizon and grow by just under 4% per year in 2022-2023. Box 1 examines alternative scenarios that provide for differing levels of success in the battle with the pandemic. It also shows alternative scenarios based on different assumptions concerning how quickly households tap the savings they have accumulated recently.

Business investment contracted in H1/2020 …

Business investment contracted in H1/2020 by 4.7% year-on-year, less than was forecast in August. The contraction in Q2 measured nearly 18% year-on-year but was offset in part by positive base effects from the previous quarter, due to the sale of aircraft from WOW Air's fleet in Q1/2019. The contraction in general business investment in H1 (i.e., investment excluding energy-intensive industry, ships, and aircraft) was even larger, or nearly 18% between years, and investment in energy-intensive industry shrank by around 30%. The business investment-to-GDP ratio has therefore fallen rapidly in the recent term and is now below its twenty-five-year average (Chart III-4).

… and firms expect to cut investment spending this year

The results of the Central Bank survey of businesses' investment plans suggest that their investment spending will be nearly 18% less this year than in 2019 (Chart III-5). Businesses are therefore considerably more pessimistic about their investment plans than in a comparable survey taken in March, which presumably did not reflect the full impact of the pandemic on investment decisions. Over half of the firms surveyed estimate that they will invest less this year than in 2019, and those that have been hit hardest by reduced tourist numbers have scaled their plans down the most. These results are in line with Gallup's September survey among Iceland's 400 largest firms, where 46% of respondents expect to invest less this year than last (Chart III-5). According to that survey, only 13% of executives expect to invest more this year than in 2019. The balance of opinion has not been as negative since September 2009. According to Gallup, executives' expectations concerning demand and margins in the next six months, which correlate relatively strongly with investment plans, have deteriorated since the spring (Chart III-6).

Business investment set to contract more in 2020 than previously projected

In addition to these survey results, it appears that hotel construction activity will decline more in 2020 and 2021 than was assumed in the Bank's last forecast. The same is true of commercial property construction in 2020. General business investment is expected to contract by a full 22% this year, in addition to the downturn in energy-intensive industry, where investment is set to contract by one-fourth. If the Bank's forecast materialises, business investment will decline by nearly a fifth between 2019 and 2020, a full 6 percentage points more than previously forecast.

Residential investment to contract strongly this year

A new tally taken by the Federation of Icelandic Industries in September indicates that the number of flats under construction has fallen considerably, and the Bank's baseline forecast assumes that residential investment will contract by nearly a fifth in 2020. This is due partly to a reduced number of housing starts, which in turn stems partly from increased difficulty in financing new projects and from a limited supply of lots. Added to this is uncertainty relating to the pandemic, although it is offset to a degree by the Government support measures from the spring and the decision to extend value-added tax reimbursements on new construction through the end of 2021.

Total investment to contract markedly in 2020 and turn around slowly in 2021

Total investment is assumed to contract by 15½% this year, somewhat more than was forecast in August (Chart III-7). The Bank's survey of businesses' year-2021 investment plans suggests that firms will hold back on investment spending until the pandemic has started to recede (Chart III-5). The baseline forecast therefore assumes that business investment will virtually stand still next year, while total investment will increase by just over 3% year-on-year and then by 6% per year, on average, in 2022-2023.

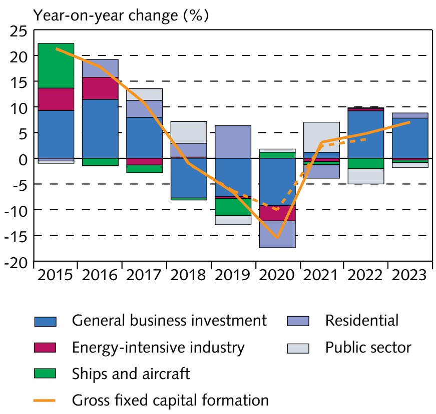
Public sector

Public consumption and investment stimulated with special measures

Public sector demand is expected to increase by 3.9% this year, a slower rate than was assumed in the Bank's August forecast. The weightiest factor here is Government investment, which turned out a fifth lower in H1/2020 than in a typical season. Public consumption spending was stronger, however, and looks set to increase by nearly 4% in 2020 as a whole, owing to discretionary measures to mitigate the impact of the pandemic. The Bank's baseline forecast assumes that a portion of the Government investment initiative planned for this year will be shifted to 2021. As a result, public sector demand will grow somewhat more in 2021 than was forecast in August, or just over 4%. For the forecast horizon as a whole, the outlook is therefore broadly unchanged from the August forecast.

Chart III-7

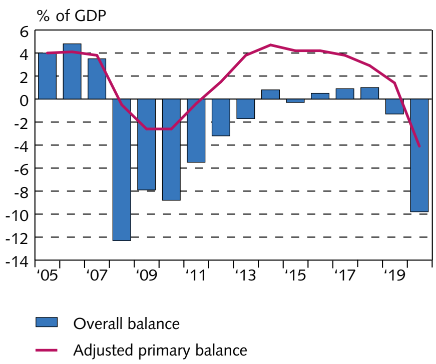
Gross fixed capital formation and contribution of main components 2015-2023[1]



1. General business investment excludes ships, aircraft, and energy-intensive industry. Central Bank baseline forecast 2020-2023. Broken line shows forecast from MB 2020/3.
Sources: Statistics Iceland, Central Bank of Iceland.

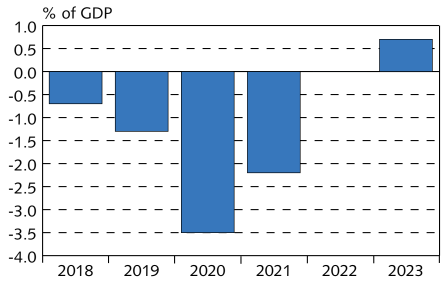
Chart III-8

Treasury outcome 2005-2020[1]



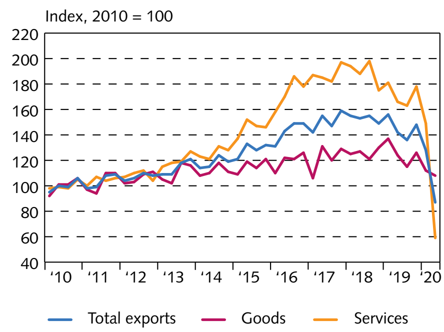
1. The primary balance is adjusted for one-off items. For 2016 through 2020, both the overall balance and the primary balance are adjusted for stability contributions, accelerated write-downs of indexed mortgage loans, a special payment to LSR A-division, dividends in excess of the National Budget, and other discretionary measures. Central Bank baseline forecast 2020.
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

Chart III-9
Change in central government cyclically adjusted primary balance 2018-2023[1]



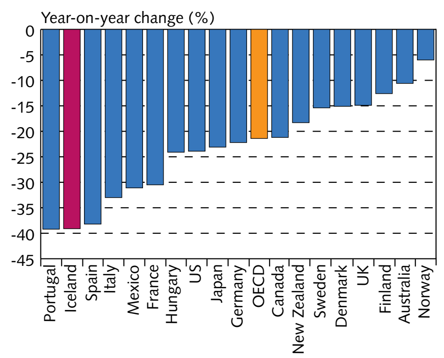
1. The primary balance is adjusted for one-off items. Central Bank baseline forecast 2020-2023.
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

Chart III-10
Exports of goods and services[1]
Q1/2010 - Q2/2020



1. Seasonally adjusted volume indices.
Source: Statistics Iceland.

Chart III-11
Q2 exports in selected OECD countries[1]



1. Seasonally adjusted volume indices for exports of goods and services.
Sources: OECD, Central Bank of Iceland.

Large Treasury deficit expected in coming years

The abrupt economic turnaround will severely affect the Treasury outcome in 2020 and throughout the forecast horizon, due both to automatic fiscal stabilisers and to the discretionary measures taken by the Government to mitigate the economic repercussions of the pandemic (for further discussion, see Box 3). The Bank's baseline forecast assumes that the deficit on the overall balance will increase from 1.3% of GDP in 2019 to 9.8% in 2020. By the same token, the primary balance will reverse to a deficit of 4% of GDP, overtaking the post-financial crisis peak in 2009, as the Treasury loss at that time showed more in the capital account (Chart III-8).

Fiscal easing counteracts the economic contraction

It is assumed that the cyclically adjusted primary balance will deteriorate by 3.5% of GDP this year (Chart III-9). The easing of the fiscal stance this year reflects the discretionary pandemic response measures introduced in the spring and autumn, which entail both spending increases and relinquished tax revenues. Further fiscal easing of more than 2% of GDP is expected next year. However, the Government's fiscal plan assumes that unspecified consolidation measures will be introduced in 2023-2025 in order to halt the rise in the debt-to-GDP ratio.

External trade and the current account balance

Exports contract strongly in Q2

Goods and services exports contracted by 38.8% year-on-year in Q2/2020, the largest single-quarter contraction on record. The virtual halt in international air travel to and from Iceland resulted in a 91% year-on-year contraction in tourism-related exports. Services exports shrank by over 64%, to the level last seen in 2003 (Chart III-10). The contraction in goods exports in the wake of the pandemic was much smaller, or 12.9%, with an 11.7% decline in marine product exports playing a major role.

The fall in exports in Q2 was nearly twice the OECD average (Chart III-11). A similar contraction in exports could be seen only in Portugal and Spain, both of which rely heavily on tourism.

Indicators point to a slight improvement in Q3/2020. The year-on-year contraction in tourism eased (Chart 2 in Appendix 1), and a further increase is expected in other services exports (i.e., pharmaceuticals companies' intellectual property exports, high-tech research, and services from various computer and software firms). The contraction in exports of marine product and other goods appears to have eased as well, and aluminium exports have flipped from a contraction to an increase between years.

The outlook for goods exports has deteriorated

The outlook for goods exports in 2020 has worsened somewhat since August. A contraction of nearly 10% is now expected, or 5.5% if exports of ships and aircraft are excluded. As in August, marine products exports are projected to contract by 8% year-on-year, while aluminium exports are forecast to contract more than was assumed in

August. The outlook for 2021 has deteriorated as well, mostly because the Marine Research Institute measurements indicated that the capelin stock was too small to issue an initial quota. The Bank's forecast therefore assumes that marine product exports will increase by 2.5% in 2021, less than half the increase projected in August. However, marine exports are expected to grow more strongly in 2022 and, coupled with increased exports of pharmaceuticals and farmed fish, are projected to contribute to robust growth in goods exports for that year.

Surging COVID-19 case numbers have exacerbated uncertainty about tourism, and the outlook for 2021 has worsened

Developments in tourism in H2 are set to be less favourable than was assumed in August. Domestic airlines scaled down their operations more rapidly and foreign tourists' payment card turnover declined more steeply when infection rates started to rise in Iceland and trading partner countries (Charts 1 and 2 in Appendix 1). The outlook for tourism is highly uncertain and depends in part on when intercontinental travel restrictions are lifted, particularly on travel between Europe and North America. Before the pandemic struck, about a fifth of all tourists who visited Iceland came from the US. Travel is not projected to resume in earnest until Q2/2021, when tourism is expected to start recovering as the pandemic subsides and international travel restrictions are eased. Just over 750,000 tourists are projected to visit Iceland next year, well below the August forecast of over 1 million. It is assumed that capacity in the tourism sector will be largely preserved and that the recovery could be a swift one when overseas travel resumes. Tourist numbers in 2022 are projected at about 1.5 million. Services exports are forecast to increase by a fourth in 2021, after contracting by half this year. For 2022, growth is expected to be even stronger, or 45%.

2020 set to see record contraction in exports

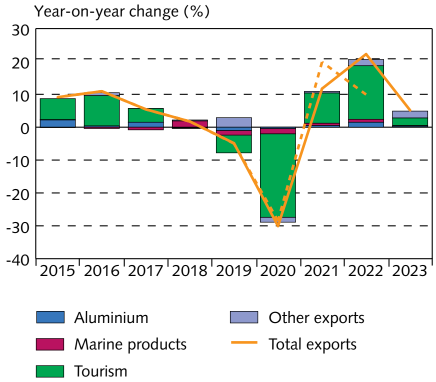
Goods and services exports are expected to contract by 30% this year, which would be 2 percentage points more than was forecast in August and the largest decline in exports in the history of Icelandic national accounts data (Chart III-12). With a weaker recovery in the tourism sector, exports of goods and services are now expected to grow by 12% in 2021 instead of nearly 20%, as was forecast in August. The growth rate in 2022 should be considerably stronger, however. If the forecast materialises, the combined volume of goods and services exports will return to the 2019 level by the end of the forecast horizon in 2023. Services exports will still be slightly below the 2019 level, however.

Imports to contract strongly this year and recover more slowly in 2021

Goods and services imports contracted by nearly 35% year-on-year in Q2/2020, with goods imports down 25.7% and services imports by more than half. Icelanders' spending while travelling abroad plunged 85%, and the contraction in goods imports by one-fourth stemmed largely from categories such as fuel and transport equipment. The decline in imports of consumer products and investment goods was

Chart III-12

Exports and contribution of subcomponents 2015-2023[1]



1. Because of chain-volume linking, the sum of components may not equal total exports. Aluminium exports as defined in the national accounts. Tourism is the sum of "travel" and "passenger transport by air". Central Bank baseline forecast 2020-2023. Broken line shows forecast from MB 2020/3.
Sources: Statistics Iceland, Central Bank of Iceland.

smaller, at around 10%. The contraction appears to have eased in Q3, owing mainly to an uptick in household purchases of imported consumer goods during the summer. Combined goods and services imports are projected to shrink by nearly one-fourth this year, which is broadly consistent with the August forecast. Year-2021 imports are expected to be weaker than previously forecast, however. A key factor in this is the expectation that the pandemic will subside more slowly than was projected in August, cutting into overseas travel and imported goods purchases.

Current account shows a surplus in H1 despite a record contraction in exports …

The current account balance was positive by 1.7% of GDP in H1/2020. This is a smaller surplus than in H1/2019 but roughly equal to or larger than in the two years beforehand. The composition of the surplus has changed, however. For the first time since 2008, the balance on goods and services trade was negative. The services account surplus shrank markedly, although it was partially offset by a smaller goods account deficit. On the other hand, the balance on primary income showed the largest half-year surplus on record, owing to historically low domestic interest rates, favourable terms on foreign loans, and Iceland's positive external position.

… and the surplus looks set to hold throughout the forecast horizon

The trade balance is expected to return to positive territory in H2, resulting in a surplus of nearly 1% of GDP for 2020 as a whole. This is a significantly smaller surplus than was forecast in August, owing to the bleaker outlook for export growth and the prospect of less favourable terms of trade. Pulling in the other direction is the larger surplus on primary income in H1, which stems in part from record returns on foreign direct investment. The current account surplus for 2020 will therefore be larger this year than was forecast in August, at about 2½% of GDP (Chart III-13).

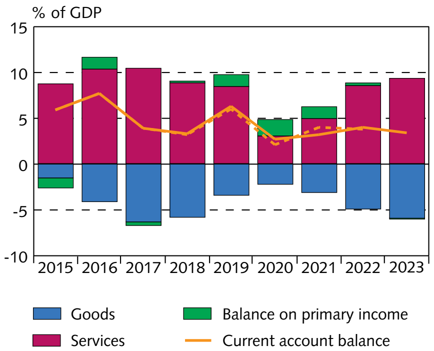
The surplus is projected to increase somewhat in 2021, although it will be smaller than previously projected, or 3% of GDP instead of the nearly 4% forecast in August. This is due primarily to the prospect of more sluggish growth in tourism in 2021 and a weaker improvement in terms of trade. If the forecast materialises, the current account surplus will widen again in 2022, as tourism gains steam. It is projected to measure nearly 4% of GDP, as was forecast in August.

GDP growth

H1 contraction smaller than was forecast in August

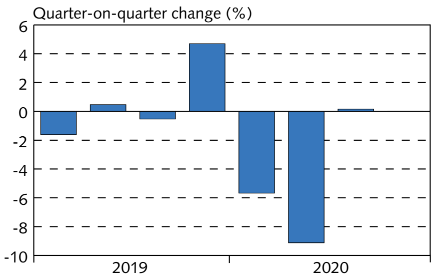
Negative export shocks had already caused economic activity to falter at the beginning of this year (see Box 4). This was compounded by base effects from last year's intellectual property exports, much of which showed in Statistics Iceland figures for Q4/2019, significantly boosting GDP for the period and contributing to a 5.7% quarter-on-quarter contraction in GDP in Q1/2020 (Chart III-14). Furthermore, the effects of the COVID-19 pandemic, which could already be felt by

Chart III-13
Current account balance 2015-2023[1]



1. Balance on secondary income included in the balance on primary income. Central Bank baseline forecast 2020-2023. Broken line shows forecast from MB 2020/3.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-14
Quarterly GDP growth[1]
Q1/2019 - Q4/2020



1. Seasonally adjusted data. Central Bank baseline forecast for Q3 and Q4/2020.
Sources: Statistics Iceland, Central Bank of Iceland.

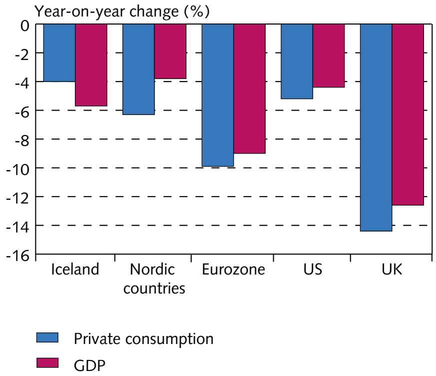
the end of Q1, came fully to the fore in Q2, when GDP contracted by 9.1% quarter-on-quarter, similar to the contraction in Q1/2009.

GDP shrank year-on-year by 9.3% in Q2/2020, less than was forecast in August but still the largest Iceland has ever recorded in a single quarter. Domestic demand contracted by over 7% year-on-year, with net trade shaving an additional 2.2 percentage points from output growth. On the whole, the contribution from net trade was in line with the Bank's forecast, but as is discussed above, domestic demand contracted less than projected.

GDP contracted more in Iceland than in the other Nordic countries in H1, but private consumption contracted less

GDP contracted by 5.7% in H1/2020, more than the average in the other Nordic countries and in the US, although less than in the euro-zone and the UK (Chart III-15). Private consumption contracted less in Iceland than in the comparison countries, however. This reflects the magnitude of the export shock in Iceland (Chart III-11), but it also shows that Iceland managed to control the pandemic more effectively in the spring and summer and thereby avoid the harsh lockdown measures imposed widely in Europe (see Chapter I and Chart 1 in Appendix 1).

Chart III-15
Comparison of private consumption and GDP in H1/2020[1]



1. Figures for the Nordic countries are a simple average of Denmark, Finland, Norway, and Sweden. Norwegian GDP growth figures are for the Norwegian mainland economy.
Sources: Statistics Iceland, Central Bank of Iceland.

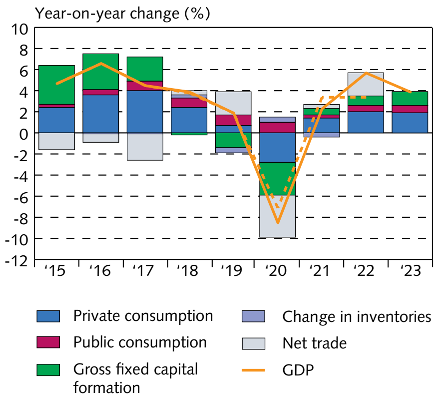
Pandemic to have a stronger-than-expected impact in H2

The contraction in H1/2020 was smaller than was assumed in August, but the outlook for H2 has worsened, not least because of the recent resurgence of the pandemic. Tightened public health restrictions have caused a reduction in various business activities in Iceland, and the impact on tourism is stronger than previously anticipated. As a result, GDP is projected to remain virtually flat in H2/2020 (Chart III-14), and the year-on-year contraction is expected to deepen to about 11% in H2.[1] This is a departure from the projection from August, when the year-on-year contraction was assumed to ease between Q3 and Q4. If this forecast materialises, the contraction for 2020 as a whole will measure 8.5%, which is 1.4 percentage points more than was projected in August but broadly in line with the forecast in the May *Monetary Bulletin*. The poorer outlook for exports weighs heaviest in this assessment, although it is compounded by the stronger contraction in business investment.

The GDP growth outlook for 2021 has deteriorated as well

The slower decline in the pandemic and the poorer outlook for tourism also weigh heavily in the deterioration of the GDP growth outlook for 2021. GDP is not expected to grow year-on-year until H2/2021, a quarter later than in the August forecast. GDP growth for the year as a whole is projected at only 2.3%, some 1.1 percentage points less than previously forecast (Chart III-16). On the other hand, GDP growth is expected to be stronger in the latter half of the forecast horizon, when domestic demand and external trade will both make a positive contri-

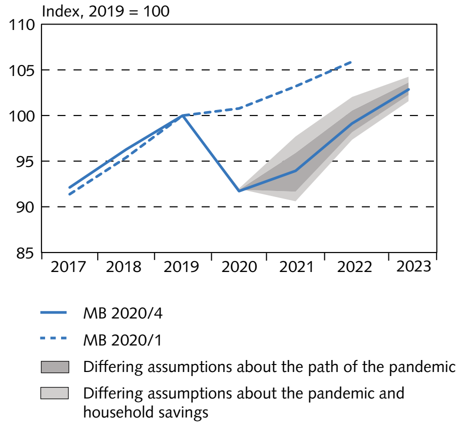
Chart III-16
GDP growth and contribution of underlying components 2015-2023[1]



1. Central Bank baseline forecast 2020-2023. Broken line shows forecast from MB 2020/3.
Sources: Statistics Iceland, Central Bank of Iceland.

1. It should be noted that seasonally adjusted quarterly GDP data for Iceland often fluctuate widely; therefore, it can be difficult to separate out regular seasonal patterns. This is even more problematic in the current circumstances, when economic data are unusually volatile.

Chart III-17
GDP 2017-2023[1]



1. GDP according to Central Bank baseline forecast 2020-2023 and different alternative scenarios in Box 1.
Sources: Statistics Iceland, Central Bank of Iceland.

bution to growth. Output growth is forecast to measure 5.7% in 2022 and then ease to 3.9% in 2023.

Restoring the pre-pandemic output level will be a lengthy process

If the forecast materialises, GDP will not return to its 2019 level until 2023, but nevertheless, it will remain nearly 6% below the pre-pandemic forecast from February 2020 (Chart III-17). The outlook is highly uncertain, though, and it is possible that the baseline forecast is overly optimistic. As is discussed in the alternative scenarios in Box 1, the economic recovery will be weaker if it proves more difficult to control the pandemic. The same is true if households are slower to tap the savings they have built up during the pandemic. In that case, GDP could contract further next year, which would put it more than 6% below the February 2020 forecast by 2023. By the same token, GDP growth could pick up more strongly than is assumed in the baseline forecast if efforts to control the pandemic bear fruit and households spend more of their savings. In that case, output growth could exceed 5% in 2021 and, by 2023, GDP could be about 4% below the February forecast.