IV Demand and GDP growth

GDP growth looks set to ease in 2017, after rapid growth in the past two years. The contribution of two key drivers of growth in recent years – business investment and services exports – will moderate this year, but household demand will increase substantially. Services export growth has slowed down while imports have surged, and the contribution from net trade to output growth will therefore be negative. To some extent, the sharp rise in imports reflects the rapid growth in household income and favourable developments in household balance sheets in the recent term, but the reduction in import prices caused by the appreciation of the króna is also a factor. Households' strong position also has a major impact on demand for residential housing and residential investment, which will underpin the bulk of investment growth in the near future. The fiscal stance has eased somewhat this year – for the third year in a row – but the fiscal outlook is more uncertain than before.

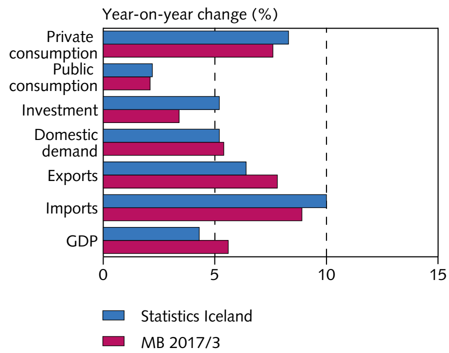
GDP growth and domestic private sector demand

GDP growth subsides faster than expected

GDP growth lost pace in H1/2017 after a strong 2016, according to preliminary figures from Statistics Iceland,[1] measuring 4.3%, down from 10.4% in H2/2016. As before, it was driven mainly by private consumption and services exports. The slowdown in GDP growth was due primarily to a decline in business investment growth and weaker growth in exports. Consumption and investment spending grew by a total of 6.1% year-on-year in H1/2017, but because of a negative contribution from inventory changes stemming largely from the effects of the fishermen's strike early in the year, growth in domestic demand was nearly 1 percentage point less, or 5.2%. In H1, export growth was characterised by weaker growth in tourism exports, the effects of the fishermen's strike, and less favourable developments in other services exports than had been expected. Imports grew well in excess of exports, and the contribution of net trade to GDP growth was therefore negative by nearly 1½ percentage points.

The forecast in the August *Monetary Bulletin* projected GDP growth for H1 at 5.6%, more than 1 percentage point above Statistics Iceland's current estimate (Chart IV-1). The deviation in the forecast is attributable mainly to the expectation of better utilisation of unused fishing quotas, which would have led to a more favourable contribution from inventory changes, and to weaker-than-expected exports of other services. This was offset somewhat by private consumption and business investment, which were stronger than previously forecast. Overall growth in domestic demand was well in line with the August forecast, however.

Chart IV-1
National accounts H1/2017

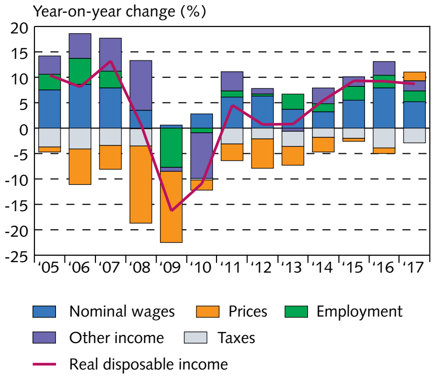


Sources: Statistics Iceland, Central Bank of Iceland.

1. The national accounts were also revised back to 1997 (see Box 4).

Chart IV-2

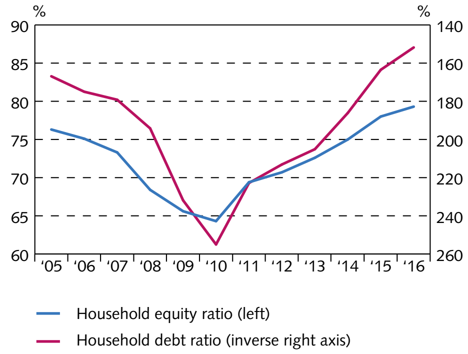
Real disposable income and its main components 2005-2017[1]



1. Central Bank baseline forecast 2017. The contribution of the main underlying components in annual changes in real disposable income is calculated based on each component's weight in disposable income. The combined contribution of underlying components does not add up to the total change due to rounding and incomplete income accounts for households from Statistics Iceland.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-3

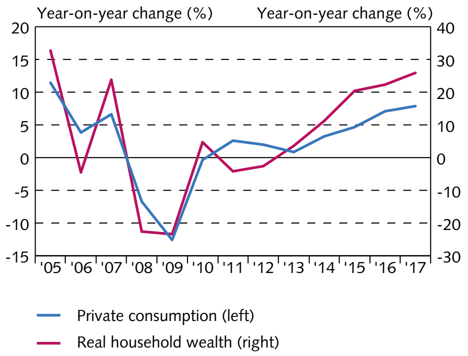
Household equity and debt ratio 2005-2016



Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-4

Private consumption and household net worth 2005-2017[1]



1. Central Bank baseline forecast 2017. Net wealth is the sum of households' housing and financial wealth (excluding pension rights), net of household debt (year-end figures).
Sources: Statistics Iceland, Central Bank of Iceland.

Households' disposable income has risen by a third since the economic recovery began

According to recent figures from Statistics Iceland, households' disposable income has increased markedly in the past few years. In real terms, it has risen by about a third from the post-crisis trough, and private consumption has grown by just over a fifth over the same period. Household saving has therefore increased, measuring 10.5% of disposable income in 2016. In real terms, disposable income grew by 9.2% last year, virtually the same as in 2015 (Chart IV-2). The surge is due to steep wage rises supported by strong job creation. Other income – for example, investment income – has grown as well, but weighs less heavily in the rise in disposable income than it did before the financial crisis. These same factors also explain this year's surge in real disposable income, although the year-on-year decline in consumer goods prices pulls in the same direction, with the private consumption deflator in H1/2017 falling 1.8% between years.

Households' equity position has strengthened markedly

Households' equity position has improved markedly in recent years, after deteriorating significantly in the wake of the financial crisis. In real terms, household equity grew by over a fifth in 2016 and has increased by more than 50% since bottoming out in 2010.[2] This rapid rise in net household wealth reflects the surge in house prices in recent years, as well as a considerable reduction in household debt and strong growth in disposable income (Chart IV-3). Owing to the continued steep increase in house prices this year, net wealth is expected to rise as much in real terms as it did in 2016.

Improved financial position and rising household income fuel private consumption growth

Private consumption increased 8.3% year-on-year in H1/2017, continuing the steady upward trend in private consumption growth since H2/2015. This trend is driven in large part by the above-described developments in households' income and net wealth (Chart IV-4). Private consumption has exceeded the Bank's last forecasts for 2017. The deviation is due in large part to a larger-than-projected increase in disposable income in 2016.

Leading indicators of developments in private consumption suggest that developments in Q3 were broadly similar to those in H1/2017. According to the August forecast, private consumption growth was expected to ease in H2, but in view of the most recent indicators and data on household income, the slowdown is now forecast to be less pronounced and private consumption projected to grow by 7.9% over the year as a whole (Chart IV-5). The ratio of private consumption to GDP will then rise from just over 49% last year to 51% this year, yet it remains well below its historical average. In spite of this robust rate of private consumption growth, household saving looks set to hold broadly unchanged at just over 10% of disposable income.

2. Based on Central Bank data, which differ from Statistics Iceland data in that the Bank calculates securities holdings in terms of market value whereas Statistics Iceland uses nominal value.

Business investment growth has slowed down

Business investment growth has slowed down after a strong three years. In H1/2017, the increase measured just over 1%, slightly more than was forecast in the August *Monetary Bulletin*. This modest growth rate is affected by a 4% contraction in investment in ships and aircraft, on the one hand, and in the energy-intensive sector, on the other. Other business investment grew by 4%, however, somewhat more than was indicated in the investment survey carried out by the Central Bank in May. The survey only covers roughly 100 of Iceland's largest firms, however, and the deviation could indicate relatively more investment spending by smaller firms than their larger counterparts. Even so, developments this year accord with the Bank's survey and other indications; i.e., that business investment growth has begun to ease after having measured about one-fifth annually in the past three years.

Firms expect broadly unchanged investment this year compared to 2016 but an increase in 2018 …

The Bank's most recent investment survey indicates, as the spring survey did, that firms generally expect investment spending to remain broadly unchanged year-on-year in 2017 (Table IV-1). There were several changes within specific sectors since the last survey, however. The most pronounced change was in tourism and transport, where investment is expected to grow by just over 4% year-on-year, as opposed to 18% in the spring survey. Furthermore, fishing companies expect less of a contraction than they did in the spring. According to this survey, investment will grow by the largest proportion in the financial and insurance sector, although significant growth is expected among manufacturing firms as well. Investment is expected to decline in other sectors.

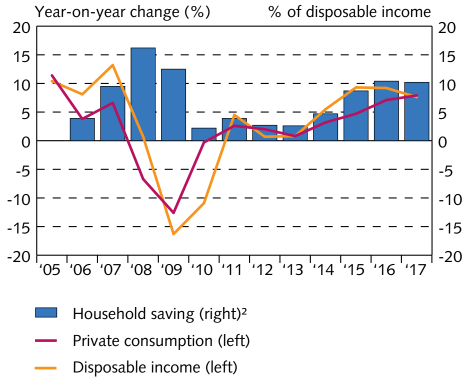
In the survey, participants are also asked about their investment plans for 2018, and their responses indicate that an increase is in the offing. The main difference is among companies in tourism and transport, where investment spending is projected to grow by 10% between 2017 and 2018. Fishing companies expect to continue reducing investment spending, whereas the largest proportional increase will

Table IV-1 Survey of corporate investment plans (excluding ships and aircraft)[1, 2]

Largest 101 firms Amounts in ISK billions	*2016*	*2017*	*2018*	*Change between 2016 and 2017 (%) (last survey)*	*Change between 2017 and 2018 (%) (last survey)*
Fisheries (17)	15.4	13.6	10.5	-11.7 (-42.9)	-22.9
Manufacturing (16)	4.6	5.1	7.9	9.3 (7.4)	56.8
Wholesale and retail sale (22)	8.0	7.2	6.5	-9.2 (-12.5)	-10.4
Transport and tourism (8)	44.0	45.8	50.6	4.1 (18.0)	10.3
Finance/Insurance (9)	3.7	5.3	6.3	42.3 (38.7)	18.1
Media and IT (7)	7.5	7.4	7.4	-2.1 (2.5)	0.1
Services and other (22)	18.1	15.8	15.4	-12.3 (-1.2)	-2.7
Total 101 (102)	101.4	100.3	104.5	-1.1 (1.8)	4.2

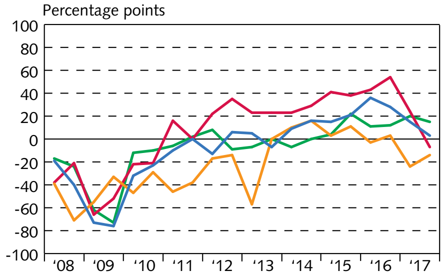
1. In parentheses are figures from the last survey, in which respondents from 102 firms were asked about investment plans for 2016-2017 (*Monetary Bulletin* 2017/2). A paired comparison between years is presented, but because the sample could change between surveys, this could affect the results. 2. Spare parts for ships and aircraft have been included.
Source: Central Bank of Iceland.

Chart IV-5
Private consumption, real disposable income, and household saving 2005-2017[1]



1. Central Bank baseline forecast 2017. 2. There is some uncertainty about Statistics Iceland's figures on households' actual income levels, as disposable income accounts are not based on consolidated income accounts and balance sheets. The saving ratio is calculated based on the Central Bank's disposable income estimates, as Statistics Iceland figures are rescaled to reflect households' estimated expenses over a long period.
Sources: Statistics Iceland, Central Bank of Iceland.

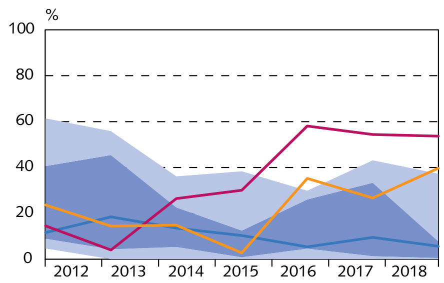
Chart IV-6
Investment: balance of opinion, by sector[1]



Average (excl. transport, transit, tourism, fisheries, and specialised services)
Transport, transit, and tourism
Fisheries
Misc. specialised services

1. Balance of opinion is the share who expect investment to increase between years less the share who expect it to decrease.
Source: Gallup.

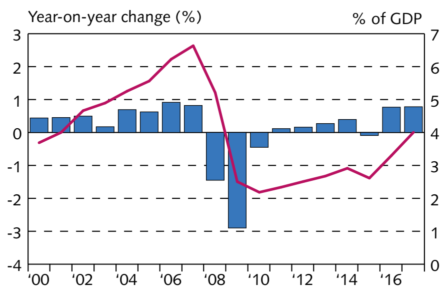
Chart IV-7
Credit-financed corporate investment 2012-2018[1]



Median
Tourism and transport
Fisheries
Interquartile range
Total range

1. Survey of corporate investment plans, excluding ships and aircraft. Median and ranges exclude transport, tourism, and fisheries.
Source: Central Bank of Iceland.

Chart IV-8
Residential investment 2000-2017[1]



Contribution to GDP growth (left)
Share of GDP (right)

1. Central Bank baseline forecast 2017.
Sources: Statistics Iceland, Central Bank of Iceland.

be among manufacturing firms. On the whole, the survey indicates that businesses' investment spending will increase by just over 4% year-on-year.

Similar results were obtained from the Gallup survey of the current situation and future plans, carried out among Iceland's largest 400 firms. According to the Gallup survey, the number of firms expecting investment to be stronger this year than in 2016 was roughly equal to the number expecting the reverse. The most pronounced change was among executives in the transport, transit, and tourism sector, where respondents expecting a downturn in investment outnumbered those expecting an increase (Chart IV-6). Among companies in specialised services, however, the Gallup results differed somewhat from the Central Bank survey results. According to Gallup, services firms planning to step up investment during the year considerably outnumbered those planning to scale it down.

…and they project that the share of credit-financed investment will be broadly unchanged in 2018

The investment survey indicates that firms expect to finance nearly 40% of their investment spending with credit this year. This is similar to the ratio in 2016, and survey participants expect it to remain roughly the same in 2018 as well. Credit financing now constitutes a considerably larger share of investment financing than in the period up to 2016, when the ratio lay in the 20-30% range. As before, the share is highest in the transport and tourism sector, although it increased signi-ficantly among firms in other services and among construction firms. In the fishing industry, credit financing has been less this year than was suggested in the last survey (Chart IV-7).

Business investment to grow modestly this year but contract in 2018

Business investment is expected to grow by just over 3% this year. The outlook is for relatively weak growth in the energy-intensive sector, and investment in ships and aircraft is expected to contract by a fifth. General business investment will increase by a full 8%, however. This is slightly below the August forecast, with stronger growth in 2017 to date offset by indications of reduced investment spending according to the Bank's investment survey. There are also signs of increased construction company investment in commercial property, which is not covered by the Bank's survey. For 2018, the outlook is for a nearly 7% contraction in business investment, owing to investment in the energy-intensive sector and ships and aircraft. General business investment will continue to grow, however, by nearly 10% year-on-year.

Surge in residential investment

Robust household demand and price developments in the real estate market have fuelled residential investment in the recent term. Residential investment grew by nearly 30% in 2016, and its contribution to the year's GDP was close to that during the pre-crisis construction boom. It continued growing in H1/2017, by nearly 29%, in line with the August forecast. The outlook for 2017 as a whole is therefore broadly unchanged. Residential investment is forecast to increase by nearly a fourth year-on-year, and its share in GDP is expected to rise to the 4% long-term average (Chart IV-8). It is expected to grow strongly in 2018 as well, or by more than 18% year-on-year, which is well in line with the August forecast.

Investment-to-GDP ratio expected to remain broadly constant over the forecast horizon

Total investment has grown significantly in the recent term. The average growth rate exceeds 19% per year over the past three years, with investment up by two-thirds since 2012, leading to a 5½ percentage point rise in the investment-to-GDP ratio over the same period. Total investment growth eased in H1/2017, although it was still over 5%. The outlook for 2017 as a whole is largely unchanged from the August forecast, with growth projected at nearly 9% (Chart IV-9). Investment is then expected to remain flat next year, and if the forecast materialises, the investment-to-GDP ratio will fall from almost 22% to roughly 21% in 2018 and remain broadly unchanged over the remainder of the forecast horizon.

GDP growth to ease in 2017 despite increased household demand

As is discussed above, GDP growth measured 4.3% in H1 and is expected to be considerably less in 2017 as a whole than in 2016. Last year, investment contributed over 4 percentage points to GDP growth, and the contribution from net trade was negative by less than 1 percentage point. Changes in these two components explain the lion's share of the reduction in GDP growth from last year's 7.4% to this year's projected 3.7%. The contribution from investment will be cut in half, and the contribution from net trade will be negative by more than 2 percentage points (Chart IV-10). The projected GDP growth rate is 1½ percentage points below the August forecast, primarily because the outlook is for a more pronounced slowdown in tourism growth and because this year's fishermen's strike appears likely to have a longer-lasting impact on marine product exports and fishing industry inventories than previously thought. On the other hand, private consumption is expected to grow more rapidly than previously anticipated. The GDP growth outlook for the next few years is broadly in line with the August forecast, however, with growth projected at 3.4% in 2018 and 2.5% from 2019 onwards.

Public sector

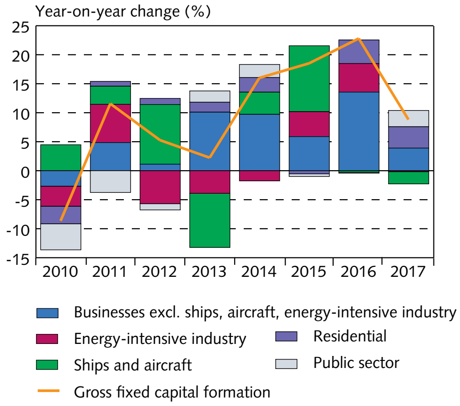
Public consumption growth expected to remain modest

In the first half of the year, public consumption grew by 2.2%, which is in line with the August forecast and slightly above the growth rate of the past few years. Growth is expected to ease in H2, measuring 1½% for the year as a whole. Central and local government consumption is expected to continue in this vein throughout the forecast horizon, although spending will grow faster at the local government level.

Public investment grew by 5.6% in H1, slightly less than projected. It is expected to pick up strongly in H2, owing to a historically

Chart IV-9

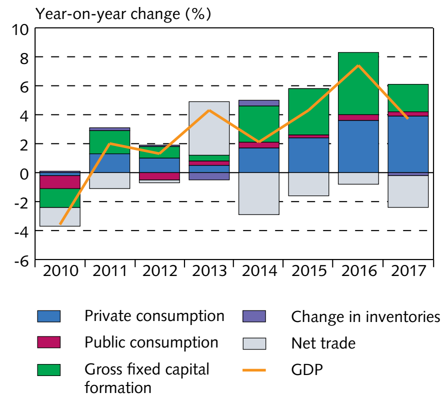
Gross fixed capital formation and contribution of main components 2010-2017[1]



1. Central Bank baseline forecast 2017.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-10

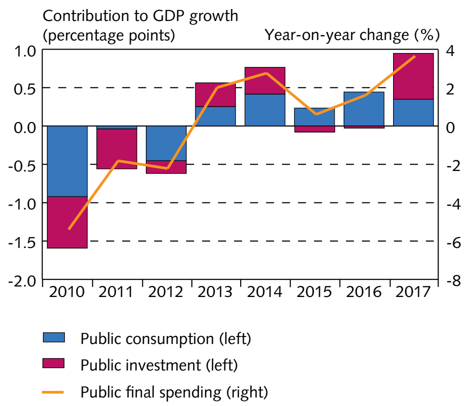
GDP growth and contribution of underlying components 2010-2017[1]



1. Central Bank baseline forecast 2017.
Sources: Statistics Iceland, Central Bank of Iceland.

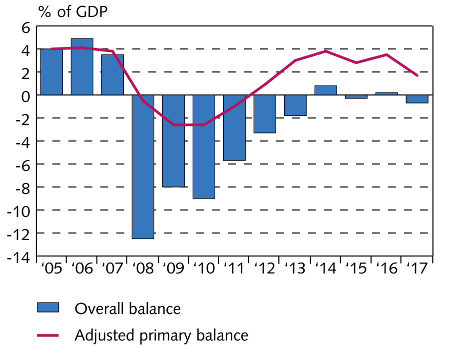
Chart IV-11

Public consumption and investment 2010-2017[1]



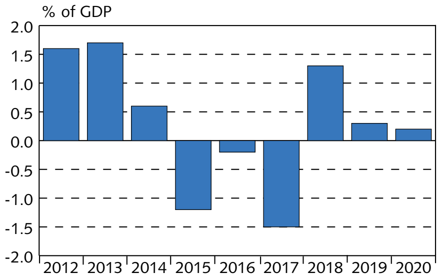
1. Central Bank baseline forecast 2017.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-12
Treasury balance 2005-2017[1]



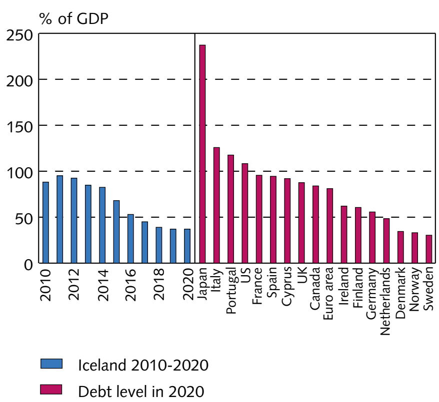
1. The primary balance is adjusted for one-off revenues and expenditures (e.g., stability contributions from the settlement of the failed financial institutions, accelerated write-downs of indexed mortgage loans, and dividend payments). In 2016 and 2017, the overall balance is adjusted for one-off items; i.e., the effects of the stability contributions, dividends in excess of the National Budget, and accelerated write-downs of indexed mortgage loans. Central Bank baseline forecast 2017.
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

Chart IV-13
Change in central government cyclically adjusted primary balance 2012-2020[1]



1. Central Bank baseline forecast 2017-2020. Primary balance is adjusted for one-off revenues and expenditures (e.g., dividends and accelerated write-downs of indexed mortgage loans).
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

Chart IV-14
General government gross debt



Sources: International Monetary Fund, Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

low investment level in H1 and to the floods in East Iceland, which necessitated increased investment in Q3. If these projections materialise, the growth rate for the year will be nearly 23%. Investment spending accounts for the vast majority of the nearly 4% growth in government final spending this year (Chart IV-11). Public investment measured 3.2% of GDP last year. It is expected to increase slightly this year and reach 3.4% by the end of the forecast horizon, about 0.7 percentage points below its twenty-five-year average.

Treasury outcome broadly unchanged from the previous estimate
The 2017 National Budget was approved with a 25 b.kr. surplus. Treasury spending has turned out 20 b.kr. more than previously expected; however, the dividends paid by the State-owned commercial banks have been increased to a total of 35 b.kr., more than 20 b.kr. over and above the Budget. The outcome for 2017 is therefore likely to be similar to that originally presented in the National Budget for the year (Chart IV-12)

Continued fiscal easing this year, followed by tightening in 2018
In assessing whether the fiscal stance is growing more or less accommodative, it is necessary to consider how the Treasury outcome is developing after adjusting for cyclical effects and excluding one-off items such as the aforementioned additional dividend payments (see Box 5). The fiscal stance has eased in the past two years, due to increased expenditures and reduced revenues. This easing is expected to continue this year and to measure about 1.5 of GDP (Chart IV-13). The total easing for all three years therefore equals 2.9% of GDP. In 2018, this will reverse in part, and the fiscal stance will tighten by 1.3% of GDP, and the current fiscal plan suggests that the fiscal stance will be broadly neutral in 2019 and 2020. This is broadly in line with the outlook described in *Monetary Bulletin* 2017/2, which is the last time the Bank made an assessment of the fiscal stance.

Increased uncertainty about general government debt
The assessment of developments in general government debt is based mainly on the outgoing Government's fiscal plan, which placed strong emphasis on rapid debt reduction. According to that plan, general government debt is to decline from 53% of GDP in 2016 to 37% of GDP by 2020 (Chart IV-14). But until the new Government issues a new medium-term fiscal plan, this will remain uncertain, as the reduction specified in the outgoing Government's plan exceeds that specified in the fiscal rule according to the Act on Public Finances, which states that debt shall not exceed 30% of GDP and, if it does, it shall be reduced by 5% of the excess amount each year until it reaches that limit.

External trade and the current account balance

Export growth slows more than previously forecast
After two years of 10% annual growth, export growth has eased this year. It measured 6.4% in H1, somewhat less than was forecast in the August *Monetary Bulletin*. Goods exports developed in line with that forecast, while growth in services was weaker, owing to a contraction

in other services exports (for example, film companies' exports and exports of other specialised services). Data from Statistics Iceland show that the past few years' swift growth in the travel component has lost pace, and spending per tourist was down year-on-year in H1 (Chart IV-15). The weaker growth in the travel component is in line with the Bank's August forecast, however.

The outlook is for services exports to grow more slowly in H2 than was assumed in August, owing mainly to items classified as "other services exports". The travel and transport components of services exports are broadly unchanged from the previous forecast, however, with the year-on-year growth rate projected to ease but remain robust. Goods exports are also expected to grow more slowly this year than previously estimated. This is due mainly to the persistent effects of the fishermen's strike, which had been expected to reverse in full within the year. It now appears that it will take longer to make up the production loss from the strike, and at the end of last season fisheries had some unused quotas that they have transferred to the current fishing year, which began in September 2017. At present, it is not assumed that these quotas will be fully used this year. As a result, the outlook for growth in goods export in 2017 – and for inventory changes as well – is poorer than in previous forecasts. Other goods exports will also grow considerably more slowly than previously forecast, primarily because of setbacks in production by silicon manufacturer United Silicon.

On the whole, exports look set to grow rather strongly this year, although the outlook is for a slower rate of growth than was forecast in August. Growth is now projected at just above 6%, or 2½ percentage points less than in the August forecast (Chart IV-16). Goods exports look set to grow at a slower rate next year, while growth in services exports will remain robust, as the country's two largest airlines plan to increase their passenger seat capacity by over a fourth. Growth in total exports is projected to measure about 4% and then ease over the remainder of the forecast horizon.

Robust import growth driven by strong domestic demand …

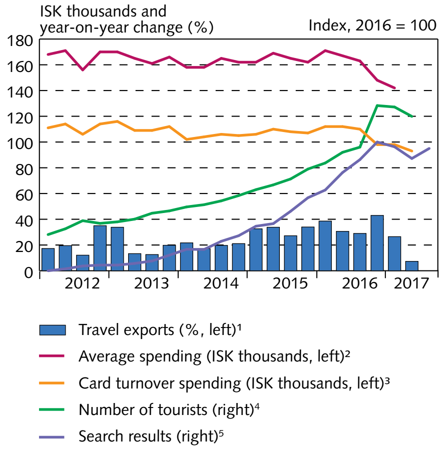
Rapid growth in domestic demand and the high exchange rate of the króna have supported import growth. In H1, imports were up by an unexpected 10% year-on-year, driven mainly by a nearly 19% increase in services imports, which have grown strongly in the recent term.

Growth in domestic demand is assumed to have peaked last year and is expected to subside gradually over the remainder of the forecast horizon. This is reflected in the forecast for imports, which are expected to increase by over 12% and then ease to slightly more than 5% in 2018. To some extent, the sharp slowdown in import growth is due to weaker imports of ships and aircraft next year. Imports excluding ships and aircraft will grow by more than 8% next year and 3-4% annually in the years thereafter.

… and a sizable negative contribution from net trade to GDP growth in 2017

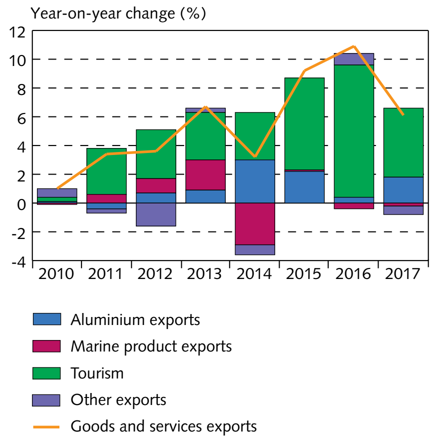
Since 2013, the contribution from net trade has been negative in spite of burgeoning export growth, as imports have grown even faster. In

Chart IV-15
Indicators of tourism sector activity
Q1/2012 - Q3/2017



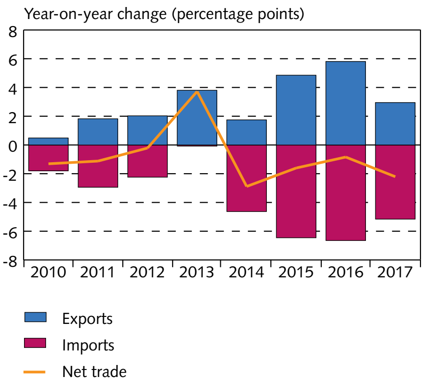
1. Year-on-year change of travel exports, at constant prices. 2. Seasonally adjusted average spending per tourist in Iceland, according to services export data. 3. Seasonally adjusted payment card turnover spending per tourist (excluding international airfares and public levies). 4. Seasonally adjusted passenger departures via Keflavík Airport. 5. A principal component model combining the frequency of five different Google search strings relating to travel to Iceland (seasonally adjusted).
Sources: Centre for Retail Studies, Google Trends, Isavia, Statistics Iceland, Central Bank of Iceland.

Chart IV-16
Exports and contribution of subcomponents 2010-2017[1]



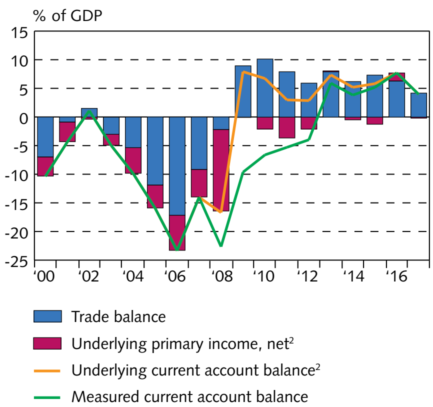
1. Aluminium exports as defined in the national accounts. Tourism is the sum of "travel" and "passenger transport by air". Central Bank baseline forecast 2017.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-17
Contribution of net trade to GDP growth 2010-2017[1]



1. Central Bank baseline forecast 2017.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-18
Current account balance 2000-2017[1]



1. Including secondary income. Central Bank baseline forecast 2017.
2. Excluding the effect of the failed financial institutions (2008-2015) and the pharmaceuticals company Actavis (2009-2012) on primary income. Also adjusted for the failed financial institutions' financial intermediation services indirectly measured (FISIM).
Sources: Statistics Iceland, Central Bank of Iceland.

H1, it was negative by 1½ percentage points, and for the year as a whole it is projected to be negative by 2.2 percentage points (Chart IV-17). This is a considerably more negative contribution than was assumed in the Bank's August forecast and is the main reason for downward revision in this year GDP growth forecast. The contribution from net trade will remain negative in the next few years, a development also more unfavourable than previously forecast.

Prospect of a smaller current account surplus than was forecast in August

The surplus on goods and services trade measured 1.7% in H1, slightly less than was forecast in August. At the same time in 2016, it measured 2.4% of GDP, and for the year as a whole it was 6.3%. This year's services account surplus is expected to be broadly equal to last year's, whereas the goods account is expected to show a sizeable deficit. The surplus as a whole will be 4.2% of GDP, nearly 2 percentage points less than was assumed in August. The change in outlook is due mainly to weaker export growth, supported by poorer terms of trade (see Chapter II). The surplus also looks set to contract somewhat faster later in the forecast horizon than was projected in August, primarily due to stronger import growth in 2018. It is forecast to measure 2.4% of GDP in 2020.

The current account balance was positive by 190 b.kr., or 7.8% of GDP, in 2016. Only once before has Iceland recorded a larger current account surplus – in 2009, when it measured 8% of GDP (Chart IV-18). In H1/2017, the primary income balance deteriorated year-on-year, although developments in Q2 were more favourable than expected because of one-off profits on a domestic company's foreign direct investment. Despite a better-than-expected outcome in H1, the forecast for this year's balance on primary income is unchanged since August. The surplus on primary income is expected to shrink next year even though interest premia on domestic firms' foreign financial obligations have fallen and external debt has declined still further. Updated primary income data show that the surplus on the wage item, which consists of Icelanders' wages abroad net of foreign nationals' wages in Iceland, has contracted more rapidly since 2015 than previously expected, owing to the appreciation of the króna and the increased number of foreign workers in Iceland. The outlook is for the current account surplus to measure 4% of GDP this year, down from 5.8% in the August forecast, and then narrow to just over 2% by 2020 (Chart IV-18). If the forecast materialises, national saving will fall from over 29% of GDP in 2016 to just under 26% this year and then continue declining over the forecast horizon, to 23½% of GDP by 2020.