Demand and GDP growth

III

Domestic private sector demand

Private consumption growth was strong in H1/2022 …
Seasonally adjusted household consumption spending grew by 4% quarter-on-quarter in Q2 (Chart III-1). Private consumption increased 13.5% between years, the strongest year-on-year growth rate in a single quarter since Q2/2005. These developments were well in line with the forecast in the August *Monetary Bulletin*, which provided for 14% growth.

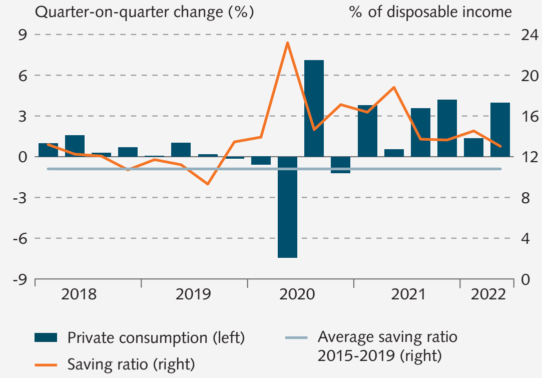
In the first half of the year, private consumption grew 11.4% year-on-year, reflecting households' generally strong position, which was driven by a significant increase in real disposable income and growing net household wealth. Households have also stepped up their purchases of various services, travel in particular, ever since the pandemic-related public health measures were lifted. This can be seen, for instance, in the surge in Icelanders' payment card turnover abroad (Chart III-2).

… but looks set to ease in H2
Leading indicators imply that household demand continued to grow in Q3. The outlook is for slower growth for the remainder of the year, however, as households have probably satisfied some of their pent-up desire to travel after pandemic-era restrictions were eased. Year-on-year growth in payment card turnover has tapered off (Chart III-3). Furthermore, new motor vehicle registrations (excluding car rental agencies) declined by 4½% year-on-year in July and August, after increasing steadily in the twelve months beforehand. The slowdown is probably due for the most part to market saturation following the surge in electric car purchases in H1/2022. Moreover, the most recent Gallup survey of major purchase plans indicates that households will

Chart III-1

Private consumption and household saving[1]

Q1/2018 - Q2/2022

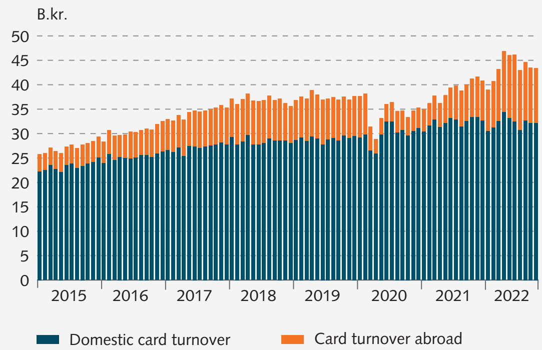


1. The saving ratio is calculated based on the Central Bank's disposable income estimates. Seasonally adjusted figures.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-2

Household payment card turnover[1]

January 2015 - October 2022



1. Debit and credit cards issued in Iceland. Domestic card turnover is deflated with the CPI excluding housing. Foreign turnover is deflated with the import-weighted exchange rate index. Seasonally adjusted figures.
Sources: Statistics Iceland, Central Bank of Iceland.

pull back on buying cars and travelling overseas in the near future.

The Gallup Consumer Confidence Index suggests, too, that consumers have grown more pessimistic (Chart III-3). This probably reflects not only the impact of higher inflation and declining real wages, but also tighter financial conditions in the wake of rapid interest rate hikes (see Chapter II).

The Central Bank's baseline forecast assumes that private consumption growth eased in Q3. It is estimated to have measured 5.7% year-on-year, which is broadly in line with the August forecast. The outlook for private consumption growth in 2022 as a whole is also largely unchanged since August. As was the case then, private consumption is forecast to grow by just over 7% for the second year in a row (Chart III-4).

Stronger private consumption projected for the next three years

According to preliminary figures published recently by Statistics Iceland, disposable income grew more strongly in 2021 and H1/2022 than previous estimates had indicated. The household saving ratio therefore declined less than was assumed in August and is still above its pre-pandemic average (Chart III-1).

Although households are more downbeat about the economic outlook, the higher saving ratio implies that households have more room for manoeuvre and can therefore maintain a higher level of spending than previously thought. As a result, the Bank has revised its year-2023 private consumption growth forecast upwards to 2.6% from the 2% assumed in August. As in August, private consumption is forecast to grow by nearly 3% in 2024 and then ease back to just over 2% in 2025. The household saving ratio therefore holds steady at around 10% of disposable income for the entire period, which is broadly in line with the pre-pandemic average.

Business investment grew strongly in H1 …

Business investment grew by 12.1% year-on-year in H1/2022, slightly outpacing the Bank's August forecast. General business investment (excluding ships, aircraft, and energy-intensive industry) grew by a fifth between years, but the contribution from investment in ships and aircraft was negative (Chart III-5).

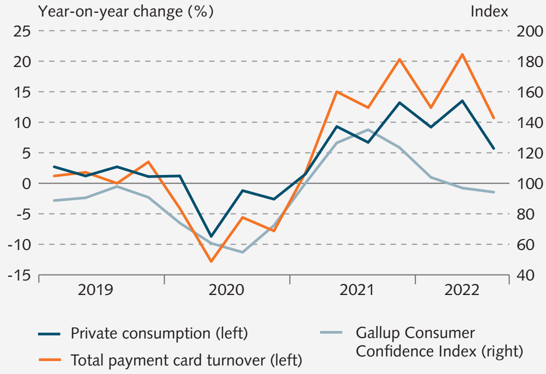
… and the outlook for 2022 as a whole has improved since August

Indicators imply that business investment remained strong in Q3. Imports of general investment goods were up nearly a third year-on-year at constant exchange

Chart III-3

Private consumption and its indicators[1]

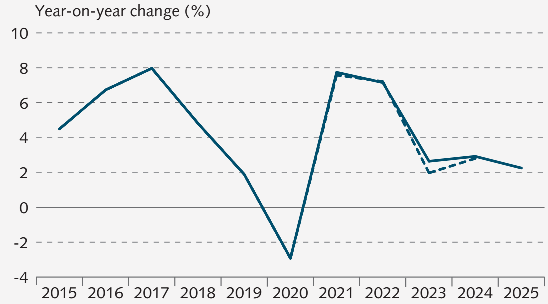
Q1/2019 - Q3/2022



1. Payment card turnover at constant prices. The Gallup Consumer Confidence Index is seasonally adjusted. Central Bank baseline forecast Q3/2022 for private consumption.
Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Chart III-4

Private consumption 2015-2025[1]

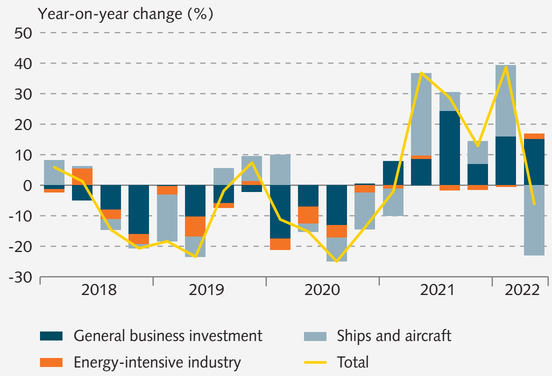


1. Central Bank baseline forecast 2022-2025. The broken line shows the forecast from MB 2022/3.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-5

Business investment and contribution of underlying components

Q1/2018 - Q2/2022



Sources: Statistics Iceland, Central Bank of Iceland.

rates, falling short of the growth rate from Q1 and Q2 (Chart III-6). The continuing increase in construction industry turnover and job growth in the sector since this summer also suggest stronger investment in building and construction.

This growth in investment activity is also in line with the results of the Central Bank's investment survey, carried out in September. According to that survey, firms plan to increase investment in 2022 by approximately 43% year-on-year in nominal terms (Chart III-7). This is a considerably larger increase in investment spending than was indicated by a corresponding survey taken in February and March. The survey results suggest that growth will extend to all sectors, although it will be strongest in tourism and transport.

The results of Gallup's August/September survey of Iceland's 400 largest firms imply as well that executives are optimistic about year-2022 investment, although they have scaled down their investment plans slightly since the March survey. About a third of executives expect to invest more this year than in 2021, while only half as many expect to invest less this year. The survey also indicates that executives in transport, transit, and tourism are the most optimistic about investment in 2022.

Indicators therefore imply that business investment will be stronger this year than was forecast in August. General business investment is estimated to have grown by just under 16% year-on-year in Q3 and, for 2022 as a whole, is projected to be 19% stronger than in 2021, instead of just over 15%, as was forecast in August. Total business investment is therefore revised upwards by 2 percentage points, to 14%. Part of this increase is due to positive base effects from an accounting adjustment in which business sector financial assets were recognised as public sector assets (for further discussion, see the section on public sector finances later in this chapter), although it also reflects indications that investment will be stronger in 2022 than was forecast in August. In addition to this, investment in energy-intensive industry is expected to grow more than was assumed in August.

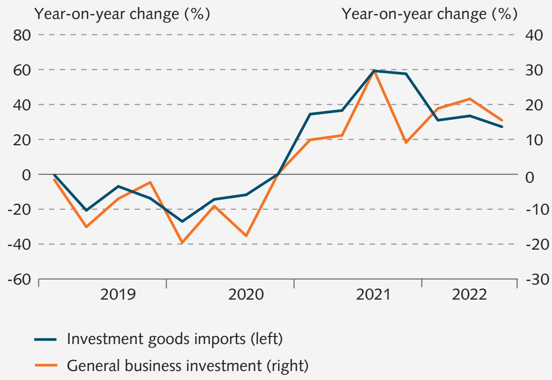
Residential investment set to contract in 2022 despite signs of increased construction activity

According to preliminary figures from Statistics Iceland, residential investment contracted by 7.2% year-on-year in H1/2022. Furthermore, the figures for 2021 and Q1/2022 were revised downwards. This weak investment activity came as a surprise, as it does not accord with other indicators of residential investment, leading to an overprediction of residential investment in the Bank's August forecast (Chart III-8). According to the corporate

Chart III-6

Investment goods imports and investment[1]

Q1/2019 – Q3/2022

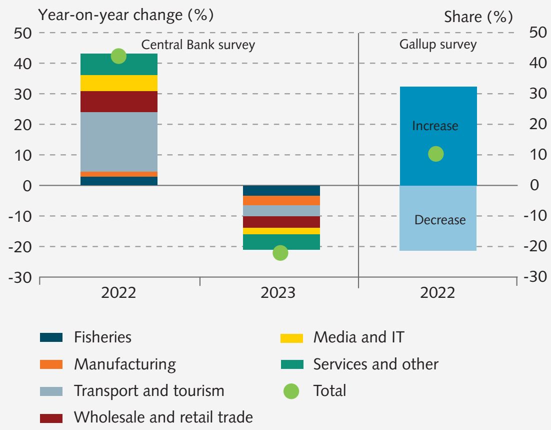


1. Imported investment goods and transport equipment for commercial use (excluding ships and aircraft). Business investment excluding energy-intensive industry and ships and aircraft. Figures for Q3 are estimated.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-7

Indicators of investment plans in 2022 and 2023[1]



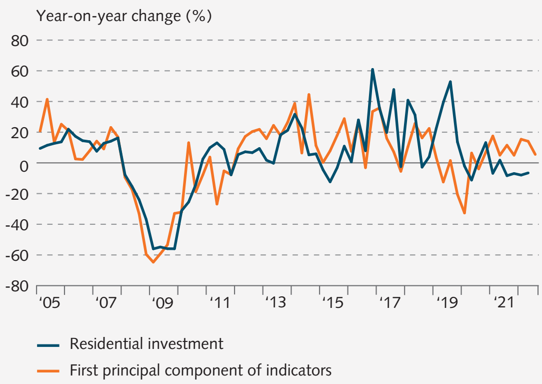
1. Central Bank survey of firms' investment plans (excluding investments in ships and aircraft). Gallup survey of Iceland's 400 largest firms' investment plans. The chart shows the share of firms intending to increase investment and the share intending to decrease it.

Sources: Gallup, Central Bank of Iceland.

Chart III-8

Indicators of residential investment[1]

Q1/2010 - Q3/2022



1. The first principal component of selected indicators of residential investment, which is scaled so that its mean value is 0 and the standard deviation is 1. The data used are: imports of building materials, cement sales excluding energy-intensive industry, and consumer sentiment towards expected real estate purchases.

Sources: Aalborg Portland Iceland, Gallup, Sementsverksmiðjan ehf., Statistics Iceland, Central Bank of Iceland.

survey taken by Gallup in September, executives in the construction sector report that their firms are operating at full capacity, and that they expect to invest more in 2022 than in 2021. A new survey conducted by the Housing and Construction Authority and the Federation of Icelandic Industries also suggests that the number of homes under construction in greater Reykjavík has risen marginally in comparison with a similar survey taken in the spring (Chart III-9). The survey results indicate as well that a larger number of homes will be completed this year and next year than was assumed this spring.

There are signs of ongoing growth in residential investment, but because of Statistics Iceland's figures on construction sector investment in H1, residential investment is now projected to contract by 1½% this year instead of growing by nearly 6%, as was forecast in August.[1]

Investment growth set to ease in 2022 but remain broadly unchanged over the forecast horizon as a whole

According to the baseline forecast, total investment will be 5.6% stronger this year than in 2021 (Chart III-10). This is a weaker growth rate than was forecast in August, owing largely to a poorer outlook for residential investment. On the other hand, the outlook is for stronger growth in business investment.

Year-2022 investment is driven mainly by stronger investment spending in the general business and energy-intensive sectors. Pulling in the other direction is a contraction in investment in ships and aircraft, which is due to base effects stemming from strong imports in 2021. Base effects from weaker investment in 2022 largely explain the outlook for stronger investment in 2023, whereas prospects for the forecast horizon as a whole are broadly unchanged since August. As in August, the investment-to-GDP ratio is expected to reach just over 23% by the end of the period. This is about 1 percentage point above the twenty-five-year average.

Public sector

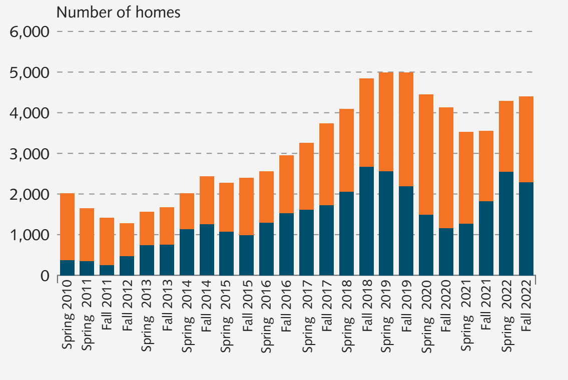
Modest growth in public sector demand over the forecast horizon

Compared to last year, public sector demand in H1/2022 eased somewhat as it grew by roughly 2% year-on-year. As in August, public consumption is forecast to grow by

1 As Statistics Iceland points out, the most recent national accounts estimates of residential investment are unusually uncertain, in view of the underlying baseline data, and the final result for the year could well be revised upwards once more complete data are received.

Chart III-9

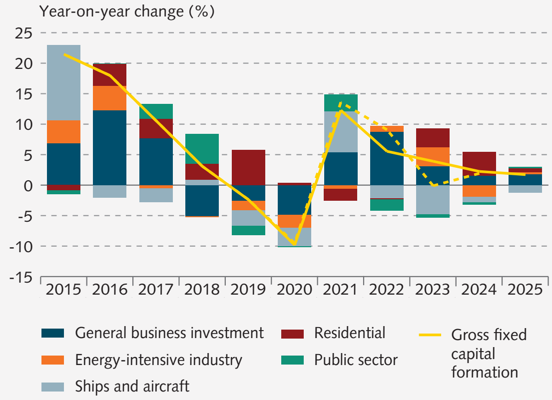
Residential housing under construction in the capital area[1]



1. According to residential construction surveys conducted each spring and fall.
Sources: Federation of Icelandic Industries, The Housing and Construction Authority.

Chart III-10

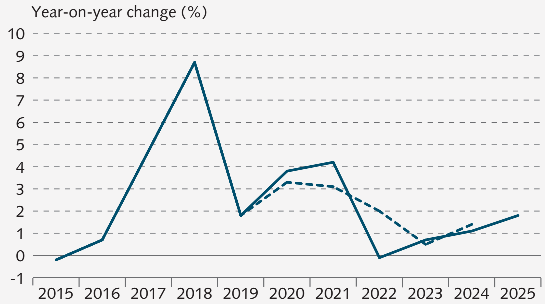
Gross fixed capital formation and contribution of main components 2015-2025[1]



1. General business investment excludes ships, aircraft, and energy-intensive industry. Central Bank baseline forecast 2022-2025. The broken line shows the forecast from MB 2022/3.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-11

Public sector final demand 2015-2025[1]



1. Public sector final demand in the national expenditure accounts is the sum of government consumption and public investment. Central Bank baseline forecast 2022-2025. Broken line shows forecast from MB 2022/3.
Sources: Statistics Iceland, Central Bank of Iceland.

1½% in 2022 as a whole, but now public investment is projected to contract by nearly 11% instead of growing by a full 4%, as was assumed in August. This is due largely to base effects from the transfer of real estate from Part B to Part A of the Reykjanesbær accounts. With this transfer, the assets fall under the public sector in the national accounts instead of being classified as business sector assets, and as a result, they are recognised as public investment in 2021, causing the aforementioned negative base effects in 2022. Furthermore, central government investment is projected to slow down more than was forecast in August.

Because of this measured contraction in year-2022 public investment, overall public sector demand will contract marginally in 2022 instead of growing by 2%, as in the August forecast (Chart III-11). The outlook is for growth to gain pace again in 2023 and average just over 1% per year as the forecast horizon progresses, which is broadly in line with the August forecast.

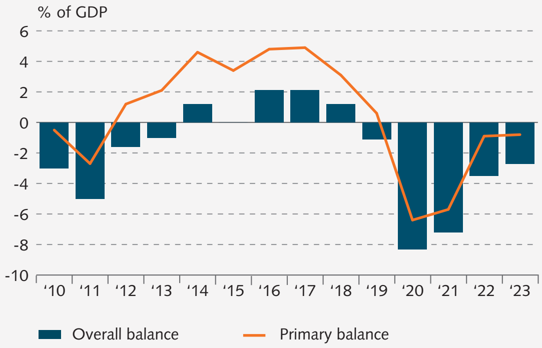
Turnaround in Treasury outcome due to economic rebound and expiry of pandemic response measures. Treasury operations generated sizeable deficits in the past two years, owing to the effects of the pandemic and associated mitigating measures. The combined deficit for the two years was 477 b.kr., or 7.7% of GDP for the period (Chart III-12). The deficit is projected to narrow significantly this year, to 3.5% of GDP (in terms of Treasury Part A). This reflects a marked improvement in the primary balance, albeit offset by a weaker interest balance, which is due to higher interest rates and the effects of inflation on inflation-indexed Treasury debt.[2] The projected deficit is smaller than was provided for in the Bank's last assessment of the fiscal stance, published in the May 2022 *Monetary Bulletin*. It is due mainly to a larger-than-expected increase in Treasury revenues, which in turn stems from stronger economic activity than was forecast in May.

The Treasury deficit is expected to keep shrinking in 2023. The change will be considerably smaller then than in 2022, however, but as before, the improvement in performance is due to stronger economic activity and the expiry of the Government's pandemic response measures. According to the new fiscal budget proposal, new measures on the revenues side will deliver increased revenues equivalent to 0.3% of GDP, but the expiry of temporary expenditures will be offset by scope for new and expanded projects (for further information, see Box

2 Adjustments have been made for the revenue revisions in the proposed budget supplement for 2022, reflecting new information on the levy and collection of certain taxes.

Chart III-12

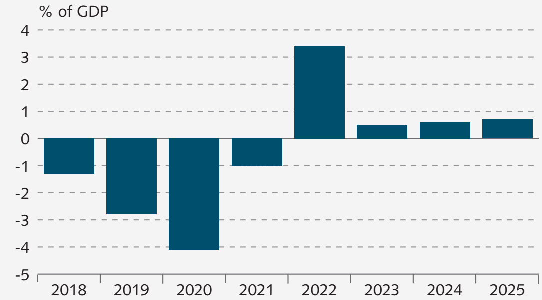
Treasury outcome 2010-2023[1]



1. Adjusted for irregular and one-off items. Central Bank baseline forecast 2022-2023.
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

Chart III-13

Change in central government cyclically adjusted primary balance 2018-2025[1]



1. Adjusted for irregular and one-off items. Central Bank baseline forecast 2022-2025.
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

3). The Treasury outcome is expected to be negative by 2.7% of GDP in 2023, and the deficit on the primary balance is projected at 0.8% of GDP. This is broadly in line with the provisions of the 2023 fiscal budget proposal.

Underlying Treasury performance to improve gradually in coming years

One manifestation of the past two years of broad-based Government support measures can be seen in the Treasury primary balance, which deteriorated by over 5% of GDP in cyclically adjusted terms. Most of the measures expired in late 2021, and this, coupled with robust GDP growth, has caused the Treasury's primary expenditures to decline as a share of GDP. For 2022, the cyclically adjusted Treasury outcome is expected to improve by 3.4% of GDP, representing a slightly tighter fiscal stance than was forecast in May (Chart III-13).

In 2023, the factors affecting the primary balance will be similar to those in play this year, although they will be considerably smaller in scope than in 2022. Treasury investment will be weaker than previously assumed, and measures on the revenues side in 2023 will generate more additional income than would otherwise have been forthcoming. The fiscal stance is therefore projected to tighten further, by ½% of GDP, which is less than was forecast this spring, owing in part to the base effects from this year's consolidation. Total fiscal easing for the period 2020-2023 – i.e., beginning with the onset of the pandemic – equals 1.2% of GDP, which is in line with the May forecast. Discretionary measures in 2022 and 2023 therefore do not fully offset the easing in the wake of the pandemic. The fiscal stance is set to tighten further in 2024-2025.

External trade and the current account balance

Robust export growth driven by a rebound in tourism …

Exports of goods and services grew by 4.4% quarter-on-quarter in Q2 (Chart III-14) and by 23.3% year-on-year in H1, slightly outpacing the Bank's August forecast. This more favourable outcome can be attributed in large part to services exports, which grew more than expected, or more than 73%, partly because of a revision of previous figures for Q1/2022.

This surge in services exports reflects the continuing recovery of tourism, which picked up strongly in Q2, driven by increased flight offerings to and from Iceland and a decline in COVID-19 case numbers following an earlier spike with the spread of the Omicron variant at the beginning of the year. Furthermore, the US authori-

Chart III-14

Exports of goods and services[1]

Q1/2010 - Q2/2022

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

ties stopped requiring COVID test results at the border, and the number of transit passengers therefore rose swiftly during the quarter. Domestic airlines' passenger transport revenues therefore surged in Q2, and total revenues from tourism rose to 94% of the 2019 level (at constant exchange rates). Spending per tourist was also well above the pre-pandemic average, and tourists generally stayed longer in the country.

Cargo transport continued to increase as well, and in addition, historical data were revised upwards. The year-on-year increase measured 27% in H1, albeit offset by a 9.4% contraction in other services exports. This was due primarily to a 69% contraction in exports relating to intellectual property leasing in the pharmaceuticals industry, plus a contraction of nearly a half in research and development services.

… which remained strong in Q3

Tourist numbers continued to rise alongside increased flight offerings in Q3. Broadly as was forecast in August, almost 654,000 foreign nationals departed via Keflavík Airport during the quarter, almost as many as in Q3/2019. Indicators of tourists' spending while in Iceland suggest that average spending declined marginally between Q2 and Q3 and moved closer to the pre-pandemic level. Part of the recent increase in spending stems from longer stays in Iceland than during the pre-pandemic period, as the number of overnight stays in Q3 was well above the total for the same period in 2018 and 2019 (Chart III-15). Furthermore, the nationality distribution remained different from that in the pre-pandemic period, with a larger number of European travellers offsetting the small number of visitors from Asia. The outlook is for domestic airlines' export revenues from passenger transport to be stronger in Q3 than was forecast in August, however. The passenger load factor was high, as were airfares, and revenues were considerably stronger than the rise in passenger numbers would indicate. Passenger transport still accounts for a smaller share of services exports than it did before the pandemic, however, as domestic airlines' activities remain smaller in scope than they were then. Moreover, revenues from cargo transit appear to have continued rising, and to a higher level than previously anticipated.

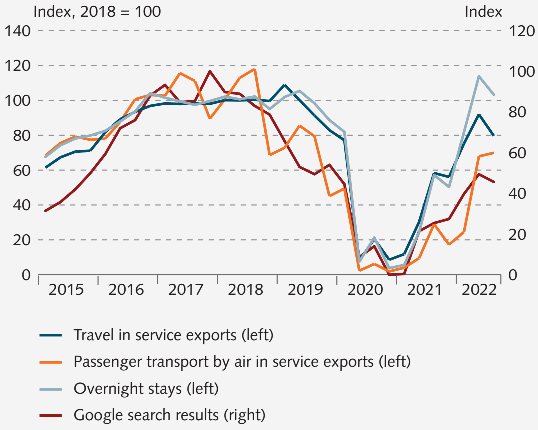
The outlook for tourism is broadly as in August

The global inflation and GDP growth outlook has continued to deteriorate since August, and uncertainty has mounted (see Chapter I). Nevertheless, the economic situation abroad does not appear as yet to have adversely affected tourist arrivals, tourists' spending while in

Chart III-15

Google searches and travel to Iceland[1]

Q1/2015-Q3/2022

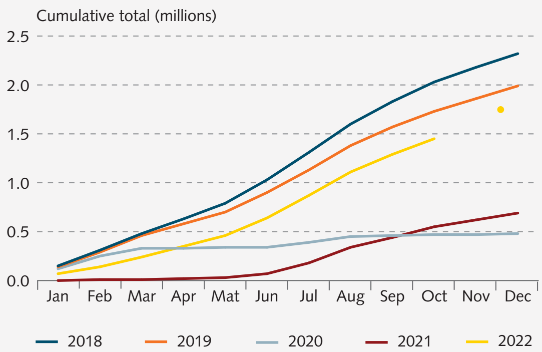


1. Travel and transport by air in service exports at constant prices, Central Bank baseline forecast Q3/2022. Overnight stays in all types of registered accommodation. Search results according to a principal component model combining the frequency of five different Google search strings relating to travel to Iceland. Seasonally adjusted figures.

Sources: Google Trends, Statistics Iceland, Central Bank of Iceland.

Chart III-16

Foreign nationals' departures via Keflavík Airport 2018-2022[1]



1. Cumulative total for each year. The dot indicates the 2022 total according to the Central Bank's baseline forecast.

Sources: Icelandic Tourist Board, Isavia, Central Bank of Iceland.

Iceland, or airline flight schedules for the coming winter. Flight offerings to and from Iceland are expected to keep increasing in 2023. Furthermore, the number of Google searches for flights to Iceland and accommodation in the country has been about the same in H2/2022 as it was in Q2/2022 (Chart III-15). Moreover, international airline bookings have continued to improve, according to data from the International Air Transport Association (IATA), although Q4 bookings within Europe declined somewhat.[3]

As in August, 1.7 million foreign tourists are expected to visit Iceland in 2022, followed by over 1.9 million in 2023 (Chart III-16). Visitor numbers are expected to keep rising over the forecast horizon, exceeding 2 million in 2024. These projections are highly uncertain, particularly as regards 2023, owing to the European energy crisis and its potential impact on Europeans' ability and willingness to travel. As is discussed in Box 1, the number of tourists could turn out lower and airlines' flight schedules could change if the energy crisis deepens still further. On the other hand, tourist numbers could rise faster than is currently projected if appetite for travel remains strong and the impact of reduced purchasing power proves weaker than expected.

In spite of an unchanged estimate of tourist arrivals, the outlook is for stronger growth in services exports this year, or 46% instead of the 41% forecast in August. This is due to stronger growth in services exports in H1 and the prospect of increased growth in transport and transit in H2. Because of base effects, the growth rate will be lower in 2023, or just over 8% instead of the 13% forecast in August.

Growth in goods exports weaker in H1, owing to revisions of previously published data …

Goods exports contracted by 0.1% quarter-on-quarter in Q2/2022 (Chart III-14) but grew by 0.4% in H1, whereas the August forecast assumed a growth rate of 1.8%. The difference is due in large part to a revision of previously published figures for H1/2021, although Q1/2022 figures were also adjusted downwards.

Marine product exports contracted by 2.3% year-on-year in H1, mainly because of a smaller quota for cod and a contraction in other demersal product exports. This was offset, however, by increased exports of capelin and herring. Aluminium exports increased 3% between years, and exports of silicon products grew as well, although they were offset by a contraction in aquacul-

3 See The International Air Transport Association, *Air Passenger Market Analysis*, September 2022.

ture exports, which was caused mainly by a viral infection affecting farmed fish in Q2.

… but the outlook for H2 and 2023 is broadly unchanged

The outlook for goods exports in H2 is broadly as depicted in the August forecast. Marine product exports are expected to grow modestly, owing to a historically large capelin quota offset by reduced exports of cod. However, exports of aluminium products grew strongly in Q3, and as a result, stronger growth is expected for 2022 as a whole. Growth in other goods exports is weaker, however, owing in particular to corrections of previously published figures for 2021 and H1/2022. As a result, total goods exports are forecast to grow by 1.2% this year instead of the 1.5% projected in August.

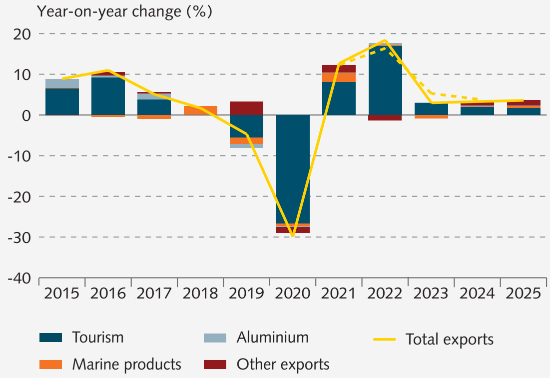
As was provided for in the August forecast, marine product exports are expected to contract in 2023, primarily because of a continued contraction in cod quotas. In addition to this, the outlook is for next year's capelin quota to be smaller than previously anticipated. As a result, marine product exports are now projected to contract by 3.9% in 2023, instead of the 2.7% assumed in August. Prospects for aluminium exports are largely unchanged, however, and a small increase is still expected next year. Yet the possibility of an energy shortage in Europe exacerbates uncertainty and could cut into demand for Icelandic aluminium products if manufacturing output in trading partner countries is reduced (see Box 1). Despite the poorer outlook for marine product exports in 2023, the forecast for goods exports as a whole is unchanged. A small contraction is expected, with stronger growth in other goods exports offsetting the bleaker outlook for the fishing sector.

Stronger growth in total exports forecast for 2022, but the outlook for the forecast horizon is broadly unchanged

Total exports are expected to grow by 18.4% this year, about 2 percentage points more than was assumed in August. The deviation from the August forecast stems from stronger growth in service exports, partially offset by a marginally poorer outlook for goods exports (Chart III-17). The outlook for the forecast period as a whole is broadly the same as in August, however. As was assumed then, total export volumes are projected to be more or less at the 2019 level by 2024.

Chart III-17

Exports and contribution of underlying components 2015-2025[1]



1. Because of chain-volume linking, the sum of components may not equal total exports. Tourism is the sum of "travel" and "passenger transport by air". Aluminium exports as defined in the national accounts. Central Bank baseline forecast 2022-2025. Broken line shows forecast MB 2022/3.

Sources: Statistics Iceland, Central Bank of Iceland.

Imports set to grow strongly this year but more modestly in 2023

Imports of goods and services grew by 17.6% year-on-year in Q2, and by 24.5% in H1, as was assumed in August (Chart III-18). Import growth had therefore risen above the 2018 peak in Q2. Goods imports grew by 7.7% in H1/2022, owing to strong growth in all key categories falling under "other goods imports". Imports of alumina, ships, and aircraft contracted between years, however. Leading indicators suggest that goods imports will remain strong in Q3, as was assumed in August, but because of revisions of previously published data, they are expected to grow by 6.6% in 2022 as a whole rather than the 6.9% forecast in August.

Services imports increased by 73.3% in H1, as was projected in August. The surge is due largely to increased spending by Icelanders travelling abroad, as overseas travel by Icelandic nationals in Q2 was back to the Q2/2019 level. Other subcomponents of services imports also grew markedly, with imports of other services up 39% year-on-year in H1/2022. Indicators imply that services imports grew in line with the August forecast in Q3, and for 2022 as a whole the outlook is for Icelanders' overseas travel to develop largely as was projected then. Total imports are expected to grow by 16.5% in 2022, which accords well with the August forecast. As was the case in August, import growth is expected to ease slightly in 2023 and average 3% per year throughout the forecast horizon.

Current account deficit expected throughout forecast horizon

Iceland recorded a current account deficit of 4.3% of GDP in Q2/2022, broadly as was forecast in August. Because Q1 figures were revised, however, the H1 deficit was smaller by nearly 15 b.kr., or 0.8% of GDP. Figures for previous years were revised as well, reflecting, among other things, that gross national saving is now estimated to be stronger than previously assumed. The current account deficit measured 1.6% of GDP in 2021 instead of the previously estimated 2.9%, and the year-2020 surplus was also a full 1 percentage point larger.

The composition of the current account has changed markedly since the primary income balance turned negative in Q4/2020. The turnaround is due primarily to stronger profits earned by foreign-owned Icelandic companies, mainly increased aluminium company profits, which stem from higher prices. The outlook is for the effects to taper off over the course of the year after the past few months' steep drop in global aluminium prices. Pulling in the same direction is the expecta-

Chart III-18

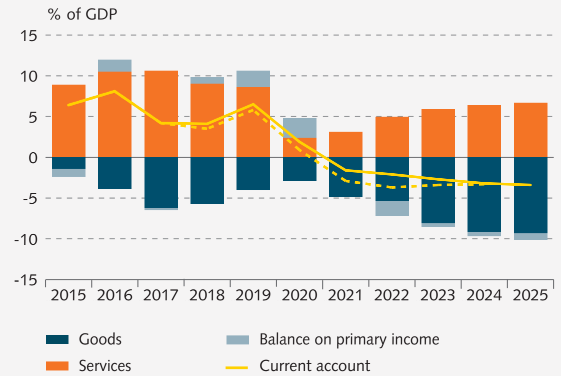
Imports of goods and services[1]

Q1/2010 - Q2/2022

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

Chart III-19

Current account balance 2015-2025[1]



1. Current account excluding the effects of the failed financial institutions in 2015. Balance on secondary income included in the balance on primary income. Central Bank baseline forecast 2022-2025. The broken line shows the forecast from MB 2022/3.
Sources: Statistics Iceland, Central Bank of Iceland.

tion of a larger surplus on services trade in H2 than was projected in August. Thus the outlook is for the current account to show a deficit of 2.1% of GDP this year, and not 3.7%, as in the August forecast (Chart III-19).

The deficit also looks set to be smaller next year despite a more pronounced deterioration in terms of trade than previously expected. This in turn is due to more favourable developments in primary income because of the aforementioned revision of historical data. The deficit for 2023 is projected at 2.7% of GDP, or 0.7 percentage points less than was forecast in August. As was assumed then, the deficit is expected to measure just over 3% per year in the latter half of the forecast horizon.

GDP growth

GDP above the pre-pandemic level

GDP grew by 3.9% quarter-on-quarter in Q2 and has therefore risen by nearly 17% from its Q2/2020 trough. It was 2% above the level from Q4/2019, just before the pandemic struck (Chart III-20). In nominal terms, however, it was nearly 15% above the end-2019 level by Q2/2022.

Year-on-year GDP growth was slightly weaker in H1 than was forecast in August …

GDP grew by 6.1% year-on-year in Q2, below the August forecast of 7.7%. Year-on-year GDP growth therefore softened relative to the previous quarter, when it had measured 7.6%, reflecting the contraction in investment and a negative contribution from inventories, which outweighed the surge in private consumption and the contribution from net trade (Chart III-21).

GDP growth averaged 6.8% in H1/2022, nearly 1 percentage point lower than had been assumed in the August forecast (Chart III-22). The increase in consumption and investment spending was well in line with the forecast, but the contribution from inventories turned out weaker, with the result that growth in domestic demand was 1 percentage point below the forecast.

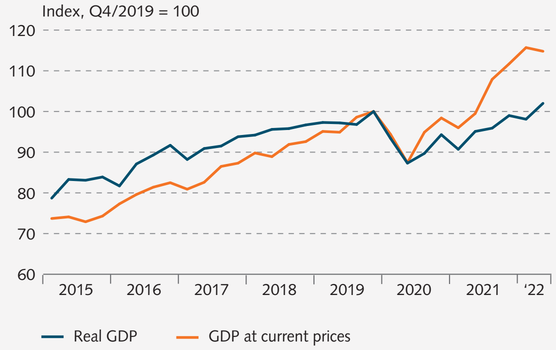
… but the GDP growth outlook is largely unchanged for the latter half of the forecast horizon

GDP is estimated to have increased by 5.2% year-on-year in Q3, and GDP growth for 2022 as a whole is projected at 5.6%, some 0.3 percentage points below the August forecast. This is due to the offsetting effects of a more favourable outlook for net trade, whose contribution to GDP growth is now expected to be positive for the first time since the pandemic, and weaker growth in

Chart III-20

Gross domestic product[1]

Q1/2015 - Q2/2022

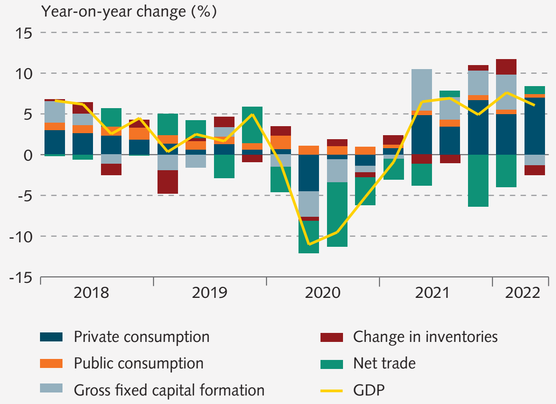


1. Real GDP is based on chain-volume measures. Seasonally adjusted figures.
Source: Statistics Iceland.

Chart III-21

GDP growth and contribution of underlying components[1]

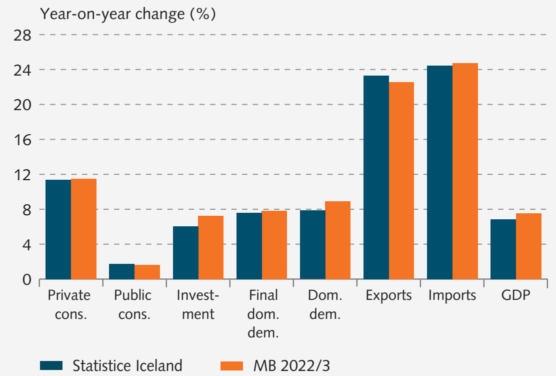
Q1/2018 - Q2/2022



1. Because of chain-volume linking, the sum of expenditure components may not equal GDP growth.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-22

National accounts for H1/2022



Sources: Statistics Iceland, Central Bank of Iceland.

domestic demand, which mainly reflects a bleaker outlook for residential investment.

Year-2023 GDP growth set to exceed the August forecast

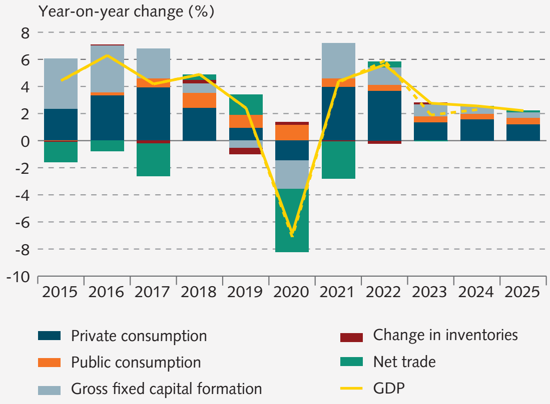
GDP growth is expected to ease in 2023, but at a slower rate than was forecast in August. This is due largely to more favourable prospects for private consumption, but also to base effects from more sluggish investment growth in 2022. Next year's GDP growth is estimated at 2.8%, nearly 1 percentage point above the August forecast (Chart III-23).

As in August, growth is expected to continue easing over the forecast horizon, averaging 2½% per year in 2024 and 2025.

The outlook is highly uncertain, and the output growth forecast could turn out overly optimistic if, for instance, the ongoing wage negotiations result in larger pay rises than are provided for in the baseline forecast, or if the European energy crisis deepens even further (see Box 1).

Chart III-23

GDP growth and contribution of underlying components 2015-2025[1]



1. Central Bank baseline forecast 2022-2025. The broken line shows the forecast from MB 2022/3.

Sources: Statistics Iceland, Central Bank of Iceland.