IV Demand and GDP growth

GDP growth measured just over 7% in 2016, well above trading partners' growth rates and Iceland's estimated long-term growth rate. As before, private sector demand is growing rapidly, in line with strong growth in income and employment. This development is based in sizeable positive shocks in the form of improved terms of trade and strong export growth, with further support from fiscal easing. In spite of strong demand growth, the trade surplus is large and national saving historically high. Household saving has continued to increase despite rapid growth in private consumption. The outlook is for GDP growth to be strong again this year, at over 6%, which is markedly above the February forecast, owing to the prospect of more robust export growth and more fiscal easing than was assumed then. As in the Bank's previous forecasts, GDP growth is projected to gradually approach its long-term trend rate as the forecast horizon progresses.

GDP growth and domestic private sector demand

2016 GDP growth outpaces the February forecast

GDP growth accelerated over the course of 2016, measuring 10.4% in H2, according to preliminary figures from Statistics Iceland. It measured 7.2% for the year as a whole and, as in the recent past, was driven mainly by domestic private sector demand plus a sizeable contribution from services exports (Chart IV-1). Added to this are the effects of fiscal easing in 2015-2016. Domestic demand growth measured 8.7% and was offset by a negative contribution from net trade in the amount of 0.8 percentage points, as import growth outweighed export growth. For the year as a whole, GDP growth was a full 1 percentage point above the forecast in the February *Monetary Bulletin*, and in Q4 it measured 11.3%, far more than was projected in February. This is due in part to a surge in residential investment, which was entered to that quarter in Statistics Iceland's figures, and more favourable developments in imports and exports than had been anticipated.

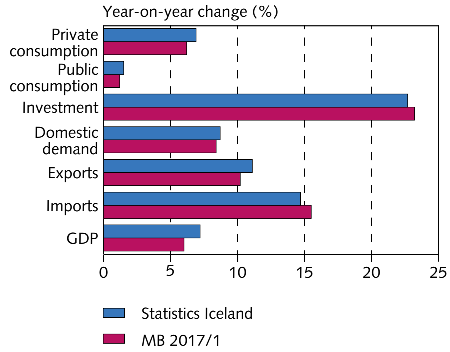
GDP growth in 2016 was the strongest since 2007 and well above the economy's long-term trend growth rate, which is assumed to be 2¾%. As of last year, GDP had increased by 22½% from the post-crisis trough in 2010, which is remarkable in international context, as Iceland's trading partners recorded growth rates of 1-3% in 2016 (Chart IV-2). Year-2016 growth rates like Iceland's can only be found in emerging market economies.

Effects of tourism clearly visible in production accounts

As in the previous year, the impact of the surge in tourism was clearly visible in the 2016 production accounts. Gross factor income rose by 7.6% in real terms in 2016, with nearly 3 percentage points of that growth from the tradable sector and the vast majority of that portion from tourism-dominated sectors (Chart IV-3). Construction also weighed heavily – likely owing to tourism-related development – as did residential investment. Domestic services sectors were important as well, reflecting both the rise in tourist visits to Iceland and a surge in

Chart IV-1

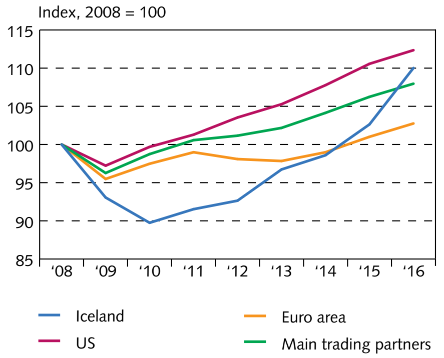
National accounts 2016



Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-2

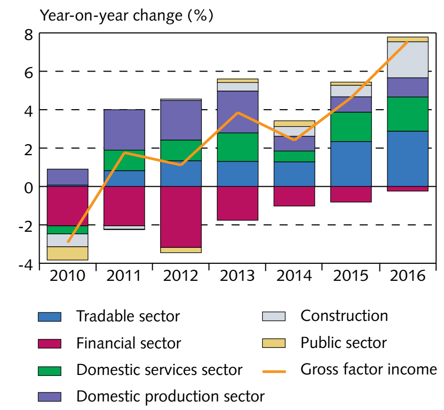
GDP in Iceland and its main trading partners 2008-2016



Sources: Macrobond, Statistics Iceland, Central Bank of Iceland.

Chart IV-3

Gross factor income and sectoral contributions 2010-2016[1]

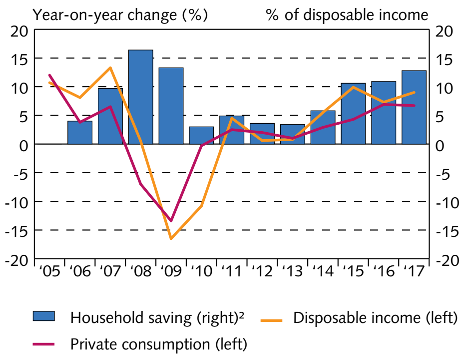


1. Gross factor income measures the income of all parties involved in production. It is equivalent to GDP adjusted for indirect taxes and subsidies. Included in the tradable sector are fisheries, fish product processing, manufacture of metals and pharmaceuticals, tourism, and 75% of electricity, gas, heat, and water utilities. Other sectors are considered non-tradable and are classified as construction, financial sector, services (excl. financial services), and production.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-4

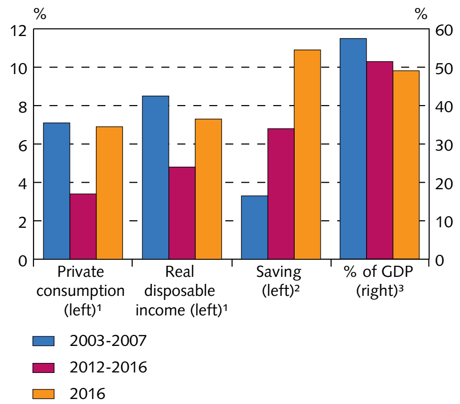
Private consumption, real disposable income, and household saving 2005-2017[1]



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-5

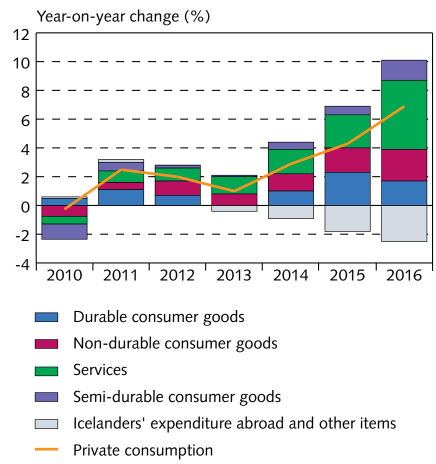
Private consumption during two five-year growth periods



1. Annual real growth in private consumption and disposable income. 2. Household saving relative to disposable income (see also the footnotes to Chart IV-4). 3. Private consumption at current prices relative to nominal GDP.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-6

Private consumption and its main components 2010-2016



Sources: Statistics Iceland, Central Bank of Iceland.

domestic demand. As in the past few years, the production accounts show growth in all sectors apart from financial services; therefore, year-2016 GDP growth appears to be relatively broad-based.

Household saving increases despite strong private consumption growth

Private consumption grew 6.9% in 2016, the fastest single-year growth rate since 2005. It was also above the February forecast, owing in part to Statistics Iceland's revision of previous figures but mainly to an unusually strong Q4, where private consumption growth was markedly above what leading indicators had implied.

Private consumption has grown by about a fifth since bottoming out in 2010, but its share in GDP has held broadly unchanged in recent years. The private consumption-to-GDP ratio is now below its pre-crisis level, as household saving has increased in the past few years, measuring just under 11% of disposable income in 2016 (Charts IV-4 and IV-5). During the current cyclical expansion of private consumption, the saving ratio has been about twice the 2003-2007 average. The current episode departs from previous cyclical expansions in Iceland, as households have increased their deposits and credit growth has been modest (see Chapter III) at a time of strong growth in private consumption.

An examination of the components of private consumption by expenditure shows that last year's increase is attributable to most categories (Chart IV-6). The chart also shows that even though Icelanders' spending abroad surged in 2016, it was outweighed by tourists' spending in Iceland.

Continued robust private consumption growth in 2017

Households' financial position has improved substantially since the cyclical trough after the financial crisis. Real wages have risen significantly, and unemployment is down. Real disposable income is estimated to have grown by 7.3% in 2016, more than twice the average increase in the past quarter-century. In addition, rising asset prices and reduced debt have improved households' financial situation. Real disposable income is expected to continue rising and households' net worth to increase further. Consumption growth is therefore expected to remain strong. Indicators of private consumption at the beginning of 2017 suggest that developments are similar to those last year; therefore, consumption is projected to grow by 6.7% this year, after which it will ease but remain robust.

Business investment above its long-term average in 2016 …

Business investment grew by nearly a fourth in 2016, to just over 15% of GDP. The business investment-to-GDP ratio has risen rapidly in recent years as construction has picked up, measuring about 2 percentage points above its long-term average in 2016. Investment in construction and equipment for construction-related groundwork dominated firms' investment expenditure during the year (Chart IV-7). General business investment accounted for the majority of the increase in business investment, although there was also a moderate increase in energy-intensive investment, while investment in ships and aircraft was broadly unchanged year-on-year.

… but expected to slow this year

The past few years' surge in investment is expected to ease this year. According to the forecast, business investment will increase by just over 4%, owing to offsetting effects from a contraction in investment in ships and aircraft and growth in general and energy-intensive investment. This projection is based not least on information concerning firms' investment plans (see below). General business investment is expected to continue growing in 2018, while investment in energy-intensive industry and ships and aircraft is projected to contract, resulting in a marginal decline in business investment as a whole.

Firms expect to step up investment modestly this year …

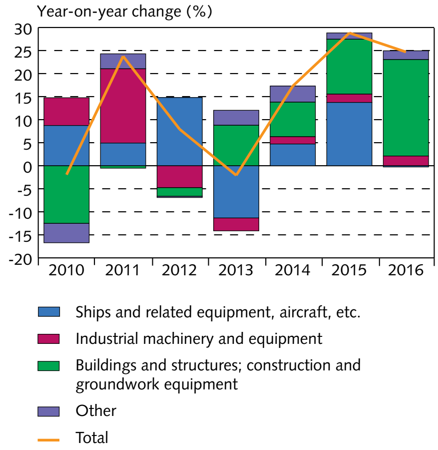
A survey of firms' investment plans, conducted earlier this spring, shows that respondents invested more in 2016 than was indicated in a comparable survey taken last autumn, although the year-on-year increase was somewhat less because of a revision of 2015 figures (Table IV-1). According to the survey, investment grew most in the fishing industry and in transport and tourism. This year, firms expect a modest increase in investment, whereas in the autumn survey they anticipated a contraction. The difference is due mainly to plans for increased investment in the transport and tourism sector, although a significant increase is also expected in the financial sector. In the fishing industry and in services and retail/wholesale trade, however, investment is expected to contract during the year.

Similar results were obtained from the Gallup survey of the current situation and future plans, conducted in March among executives from Iceland's 400 largest firms. According to the survey, fisheries planning to cut back on investment in 2017 outnumbered those planning increased investment by about a fourth. In transport, transit, and tourism, however, the opposite is true: firms planning to step up investment outnumber those planning cutbacks by one-fourth. Among manufacturing firms, those planning increased investment outnumber those planning reduced investment by about a third. In the retail and wholesale trade sector, an equal number of respondents were planning to increase investment and to reduce it.

… but the share of credit-financed investment rises in transport, tourism, and fishing, alongside reduced earnings

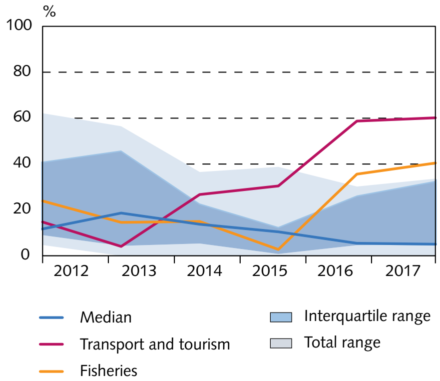
The Central Bank's investment survey includes questions about business investment financing. Notably, about 40% of investment was credit-financed in 2016, and respondents expect a similar percentage this year. This represents a marked increase from the Bank's previous surveys, where the share has ranged between 20% and 30%. The change is most pronounced among companies in transport and tourism, where investment spending has increased most rapidly in recent years, and in the fishing industry. Excluding these sectors, the share of investment that is credit-financed is broadly similar to that in previous surveys (Chart IV-8). Furthermore, the rise in credit financing is

Chart IV-7
Business investment and contribution by type 2010-2016



Sources: Statistics Iceland, Central Bank of Iceland.

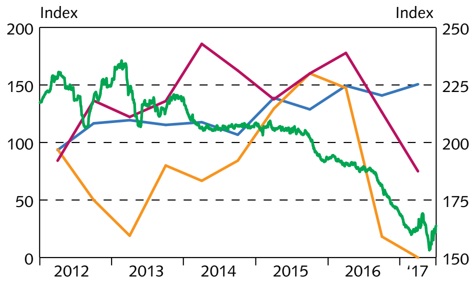
Chart IV-8
Credit-financed corporate investment 2012-2017[1]



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

probably due in part to reduced earnings as a result of the appreciation of the króna, as executives in these sectors say that the outlook has deteriorated as the exchange rate has risen (Chart IV-9). According to the Gallup survey from March, for example, the share of transport, transit, and tourism firms that reported reduced earnings in the past six months exceeded the share reporting increased earnings over the same period by 10 percentage points. Some 80% of fishing companies also said their earnings had declined. In other sectors, however, firms reporting increased earnings outnumbered those reporting a downturn.

Chart IV-9
Export sectors' EBITDA indices (last 6 months) and ISK exchange rate[1]
March 2012- March 2017



Average (excl. transport, tourism, and fisheries, left)
Transport and tourism (left)
Fisheries (left)
Average exchange rate - narrow TWI (right)

1. Daily data for trade-weighted exchange rate index; semiannual data for EBITDA indices.
Sources: Gallup, Central Bank of Iceland.

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

Largest 102 firms Amounts in ISK billions	*2015*	*2016*	*2017*	*Change between 2015 and 2016 (%) (last survey)*	*Change between 2016 and 2017 (%) (last survey)*
Fisheries (17)	12.2	15.4	8.8	26.0 (12.0)	-42.9 (-32.3)
Industry (17)	4.3	4.6	5.0	8.2 (11.6)	7.4 (10.8)
Wholesale and retail sale (23)	7.4	8.0	7.0	7.8 (22.0)	-12.5 (-9.4)
Transport and tourism (8)	33.9	42.5	50.1	25.4 (55.0)	18 (-6.0)
Finance/Insurance (9)	4.1	3.7	5.2	-9.3 (32.2)	38.7 (31.8)
Media and IT (7)	7.3	7.5	7.7	3.0 (-2.5)	2.5 (4.1)
Services and other (21)	16.4	17.1	16.9	4.3 (-8.5)	-1.2 (-5.3)
Total (102)	85.7	98.9	100.7	15.5 (19.1)	1.8 (-6.3)

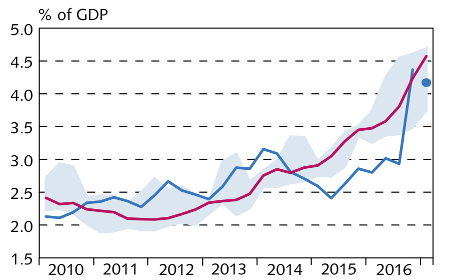
1. In parentheses are results from the last survey, in which respondents from 102 firms were asked about investment plans for 2016-2017 (*Monetary Bulletin* 2016/4). 2. Previously published figures on transport and tourism have changed because spare parts for aircraft are now included for all years, whereas they were previously classified separately. Spare parts for ships are now included as well.
Source: Central Bank of Iceland.

Residential investment finally on the rise

Rising real household incomes, population growth (including strong importation of foreign labour), and the surge in tourism have greatly increased demand for housing. Until recently, however, residential investment has been relatively weak. According to figures from Statistics Iceland, it grew by over 70% year-on-year in Q4, far outpacing the Bank's February forecast. To some extent, this strong uptick reflects the way in which residential investment data are submitted to and processed by Statistics Iceland rather than an actual surge taking place during the quarter.

However, this does not change the fact that residential investment has taken off, growing by about a third in 2016 as a whole, nearly double the rate provided for in the Bank's February forecast. Leading indicators imply that growth continued in Q1/2017 (Chart IV-10). Federation of Icelandic Industries figures from February indicate that, during the forecast horizon, construction will begin on over 8,000 flats and roughly 6,000 will be completed. As in the February forecast, residential investment is projected to continue growing apace, by one-fourth this year, followed by strong growth in 2018 and 2019. The ratio of residential investment to GDP will be just over 5% by the end of the forecast horizon, a full 1 percentage point above the long-term average.

Chart IV-10
Indicators of residential investment[1]
Q1/2010 - Q1/2017



Residential investment
MB 2017/2 baseline forecast
Median of indicators
Upper and lower limit of indicators of residential investment

1. The indicators are imports of building supplies, cement sales to buyers other than energy-intensive firms, and value-added tax turnover in the construction industry. In assessing the range, the variables are rescaled so that their average and standard deviation are the same as those for measured residential investment. The chart shows a two-quarter moving average of indicators. Seasonally adjusted data.
Sources: Aalborg Portland Iceland, Centre for Retail Studies, Sementsverksmiðjan ehf., Statistics Iceland, Central Bank of Iceland.

Investment-to-GDP ratio expected to fall marginally during the forecast horizon

Total investment grew by nearly one-fourth in 2016, but the growth rate is expected to slow this year because of reduced business investment. Growth is forecast at around 8½%, with the largest contributions from business investment excluding ships and aircraft and residential investment, as well as a modest increase in public investment (Chart IV-11). If the forecast materialises, the investment-to-GDP ratio will hold steady at about 21% this year before settling at 20% from 2018 onwards.

Prospect of continued strong GDP growth

GDP growth is assumed to have slowed down in Q1/2017, owing mainly to the negative impact of the fishermen's strike on export production, which was probably addressed with a partial depletion of export inventories. The impact of the strike is considered to be temporary, however, and growth is therefore projected to pick up strongly in Q2. GDP growth for 2017 as a whole is forecast at 6.3%, or 1 percentage point above the February forecast, as exports are now expected to grow faster than was projected then and the new National Budget entails more fiscal easing than previously anticipated (see below). As before, strong growth in exports and private consumption will be the main drivers of output growth (Chart IV-12). Output growth will also be somewhat stronger in 2018 than was projected in February, but as in that forecast, it is expected to ease gradually towards its long-term trend rate as the forecast horizon advances.

Public sector

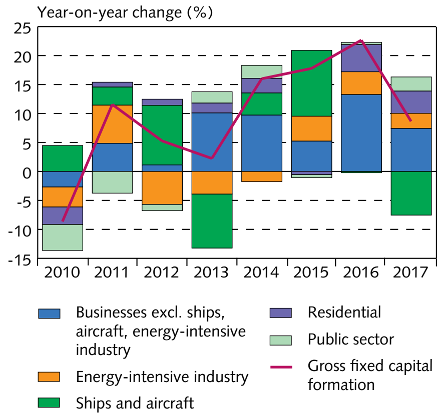
Outlook for growth in public consumption and investment broadly unchanged from February

According to preliminary figures from Statistics Iceland, public consumption grew by 1.5% last year, 0.5 percentage points more than in 2015. The central government's consumption expenditure rose to its post-crisis peak of 2.4% year-on-year, while municipal consumption contracted by nearly 1%. Central government wage costs rose by 9.4% in 2016 and municipal wages by 7%, even though the price of public consumption rose 1 percentage point more for local governments than for the central government. Cost control was therefore considerably more at the local government level than at the State level.

As in the February forecast, large wage increases are expected to impede real public consumption growth, which is now projected to remain broadly unchanged year-on-year. However, public investment is expected to increase between years, and public expenditure will therefore rise by nearly 3½% year-on-year (Chart IV-13). Public consumption growth will be broadly stable throughout the forecast horizon, while public investment will grow by just over 10% per year, which is below the 2004-2007 average of nearly 12%. The public investment-to-GDP ratio is expected to remain unchanged at slightly less than 3% until 2019 and then rise to 3¼% as the construction of the new Landspítali hospital gains momentum. The bulk of the hospital construction project will take place after the end of the current forecast horizon.

Chart IV-11

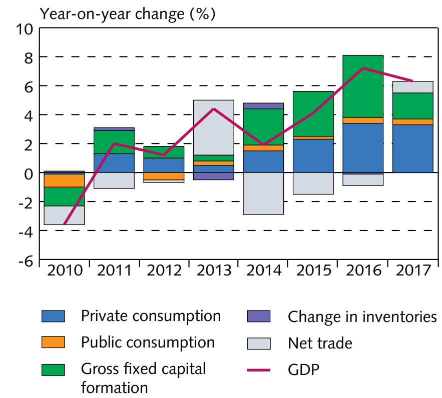
Gross fixed capital formation and contribution of main components 2010-2017[1]



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

Chart IV-12

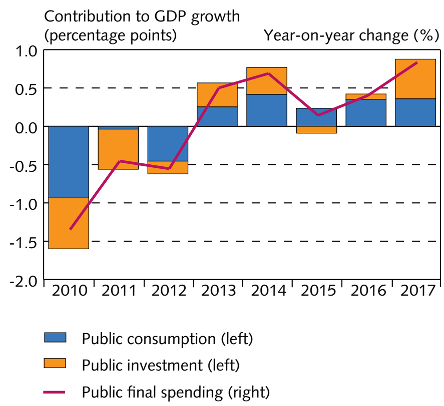
GDP growth and contribution of underlying components 2010-2017[1]



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

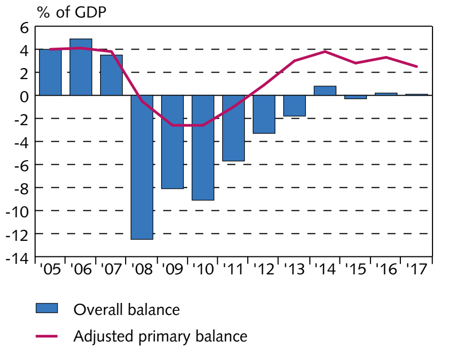
Chart IV-13

Public consumption and investment 2010-2017[1]



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

Chart IV-14
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, and accelerated write-downs of indexed mortgage loans). 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.

Treasury primary surplus to be smaller in 2017

According to preliminary figures from Statistics Iceland, general government operations generated a surplus of 17.2% of GDP in 2016. When the stability contributions and dividends in excess of budgetary allocations have been deducted, the underlying central government surplus is only 0.2% of GDP, which is still 0.6 percentage points more favourable than was assumed in the February *Monetary Bulletin*. The deviation is due for the most part to an overestimation of wage costs, as Statistics Iceland revised nominal wage expense downwards by 1.9% from its previous estimate when it calculated 2016 figures. In comparison, central government operations generated a deficit of 0.3% in 2015.

This year, it is assumed that the underlying surplus will be similar to that in 2016, or 0.1% of GDP. The Treasury primary surplus will contract, however. It is expected to equal 2.5% of GDP this year, as opposed to 3.3% in 2016, after adjusting for one-off effects (Chart IV-14).

New fiscal strategy and plan for 2018-2022

According to the Act on Public Finances, Parliamentary resolutions on a fiscal strategy and a fiscal plan for the next five years were presented before Parliament in January and again in late March. According to the fiscal strategy, the Treasury outcome will be positive by 1.5% of GDP in 2018 and the general government surplus will be 1.6%, therefore assuming a small surplus for local governments. For the remainder of the forecast horizon, the overall general government outcome is projected to deteriorate by 0.1% of GDP each year. The fiscal plan entails a virtually unchanged Treasury outcome from the previous plan, with the difference averaging 0.1% of GDP for the horizon of the plan. The forecast in *Monetary Bulletin* assumes that, during the forecast horizon, the Treasury outcome will be poorer by 0.4% of GDP per year than is provided for in the fiscal plan. The main reason for this lies in the treatment of fixed expenditures, wages, and goods and services purchases, as well as the effect of differing macroeconomic assumptions on the forecasts.[1]

The financial crisis called for tight control of public spending because of Iceland's difficult debt position. Even though the fiscal position has improved, a tight fiscal stance is still necessary because of the widening output gap. It could therefore be that the objective set forth in the fiscal plan – that the primary expenditure-to-GDP ratio will not rise during the period – is not conservative enough, as GDP growth over the period should provide scope for a significant increase in spending.

Significant fiscal easing three years in a row

This forecast assumes an improved fiscal outcome compared to the February forecast. For the most part, this is because it is no longer

1. Statistics Iceland and the Ministry of Finance and Economic Affairs publish the outcome using the so-called GFS standard. Their methods for presenting fixed assets, wages, and goods and services purchases differ, however. This report is based on Statistics Iceland's presentation.

assumed that the investment spending provided for in the transport strategy approved by Parliament just before the last elections will be implemented in full, as full funding is not laid down in the fiscal plan.

In other respects, the improved outlook can be attributed to stronger economic activity, as the forecast assumes a larger output gap during the forecast horizon than was projected in February (see Chapter V). Adjusting for the business cycle, the primary balance is expected to deteriorate year-on-year by 1.4% of GDP in 2017 (Chart IV-15). This easing, which is expected to show in both revenues and expenditures, comes in the wake of two years of easing amounting to 1.4% of GDP, making for a total of 2.8% in three years. This is more significant easing in 2017 than was forecast in February. The proposed increase in value-added tax (VAT) on tourism is expected to result in consolidation of about 0.7% of GDP in 2018, followed by easing in the amount of 0.2% of GDP in 2019, when the planned reduction of the general VAT rate takes effect.[2]

General government debt falls below fiscal rule criteria

The debt reduction provided for in the current Government's fiscal strategy is virtually identical to that laid down by the previous Government. It should be possible to achieve rapid deleveraging by using the expected fiscal surplus and the proceeds of planned asset sales. As a result, it is now estimated that Treasury debt will amount to 39% of GDP at the end of 2017. General government debt will total 45% of GDP at the same time, and 39% by the end of the forecast horizon, if current plans materialise (Chart IV-16).

External trade and the current account balance

Outlook for strong export growth for the third year in a row

Goods and services exports grew by 11.1% between years in 2016, driven mainly by a 19% year-on-year rise in services exports (Chart IV-17). This surge in services exports was the main reason exports grew by 1 percentage point more than the Bank had forecast in February. Services exports have grown by an average of almost 10% per year since 2011 and now exceed goods exports in value terms for the first time.

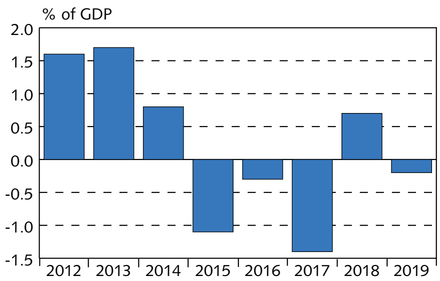
Indicators suggest that strong growth in services exports will continue this year and, if the forecast materialises, the growth rate will outpace the February forecast. Figures on foreign tourist arrivals show a 56% year-on-year increase in the first four months of 2017, compared to a 35% increase during the same period in 2016. The pace of the increase is expected to ease, however, to 22% for the year as a whole – about half that in 2016. The recent rise in the real exchange rate is likely a factor here, although the outlook is also for a slower increase in flight offerings from airlines, owing to capacity limitations at Keflavík Airport during peak times.

The outlook for this year's goods exports has also improved from the February forecast. Although marine product exports are expected

2. This is very close to the results of the Fiscal Council's calculations of the cyclically adjusted primary balance (taking one-off items into account), published in the Council's opinion on the 2018-2022 fiscal plan on 14 April 2017.

Chart IV-15

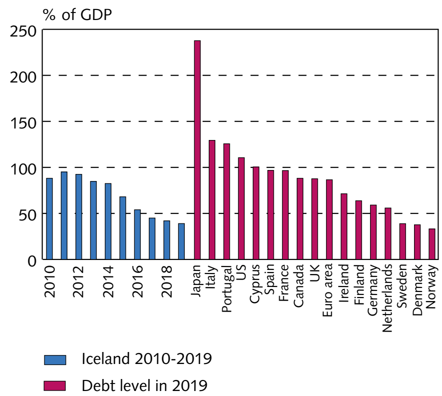
Change in central government cyclically adjusted primary balance 2012-2019[1]



1. Central Bank baseline forecast 2017-2019. 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, Central Bank of Iceland.

Chart IV-16

General government gross debt

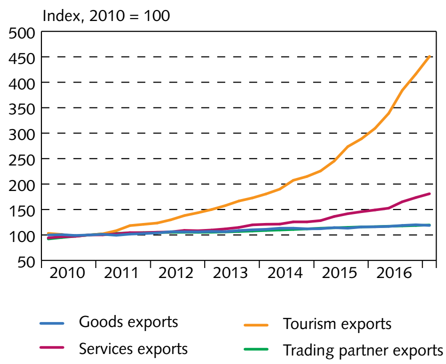


Sources: International Monetary Fund, Ministry of Finance and Economic Affairs, Central Bank of Iceland.

Chart IV-17

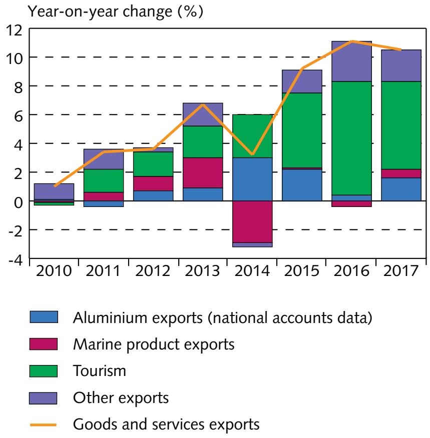
Goods and services exports and global demand[1]

Q1/2010 - Q1/2017



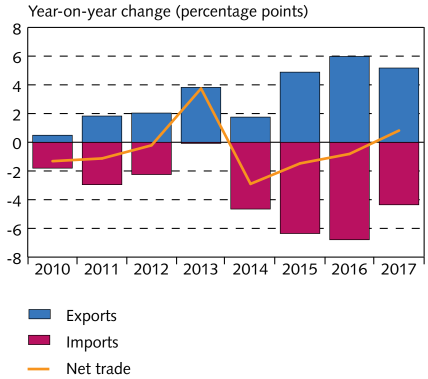
1. Four-quarter moving average. Export figures for Q1/2017 are from the baseline forecast in *Monetary Bulletin* 2017/2.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-18
Exports and contribution of subcomponents 2010-2017[1]



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

Chart IV-19
Contribution of net trade to GDP growth 2010-2017[1]



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

to have contracted markedly in Q1 because of the fishermen's strike, it is thought likely that this will primarily affect the distribution of export growth within the year and not marine exports for 2017 as a whole. The brighter outlook is due to a stronger capelin season than was forecast in February. Aluminium exports are also expected to be stronger than in 2016, and by a slightly larger margin than was projected in February, although the protracted production stoppage at the United Silicon plant could have some impact on the outcome. Overall, exports are projected to increase by 10.5% year-on-year, or 4.4 percentage points more than was forecast in February. If the forecast materialises, this will be the third year in a row with export growth over 9% (Chart IV-18). The outlook is also for services exports to grow more rapidly in 2018 than was forecast in February, but as was projected then, export growth is expected to slow somewhat in the coming two years, in line with a rising real exchange rate and relatively weak global economic growth.

Robust import growth driven by strong demand and a rising real exchange rate

Imports of goods and services grew by nearly 15% in 2016, the largest increase since 2005. The growth rate was almost 1 percentage point less than was forecast in February but almost twice domestic demand growth. Strong import growth is due not least to the large share of imports in private consumption last year – both goods and services purchases. Furthermore, export sectors such as tourism and international airline operations have grown swiftly, and their activities call for significant goods and services imports.

As with the forecast for exports, goods and services imports are expected to grow more than previously assumed, or about 10.2%, as opposed to just under 7.4% according to the February forecast. The main reason for the difference is the strength of services exports, which require substantial imports, as is mentioned above. Growth in domestic airlines' activities calls for the operation of additional leased aircraft during the year, and operating fees at foreign airports therefore increase. Furthermore, the real exchange rate has continued to rise, and the Icelandic Tourist Board's figures on Icelanders' departures via Keflavík Airport plus Gallup's survey of individuals' planned overseas travel suggest that services imports will continue to grow strongly this year.

Contribution of net trade to GDP growth positive for the first time since 2013

The contribution of net trade to GDP growth was negative by 0.8 in 2016, whereas the February forecast assumed a negative contribution of 1.7 percentage points (Chart IV-19). The difference is due to the combined effect of stronger export growth and weaker import growth than in the February forecast. In the past three years, the contribution from net trade has been negative in spite of hefty export growth, but it appears that there will be a turnaround this year. If the forecast is borne out, the contribution from net trade will be positive in 2017 – for the first time since 2013.

Trade surplus set to be larger than was forecast in February

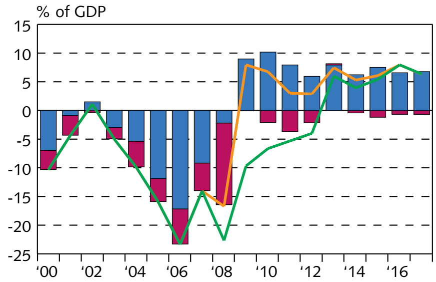
Last year's trade surplus amounted to 6.6% of GDP, more than was assumed in the February forecast. The main reason for the difference is stronger growth in services exports. Because of strong export growth and better terms of trade (see Chapter II), the surplus on combined goods and services trade is expected to measure roughly the same this year. It is then expected to taper off over the remainder of the forecast horizon.

The current account balance was positive by 194 b.kr., or 8% of GDP, in 2016. Only once before has Iceland recorded such a large current account surplus – in 2009, when it was also 8% of GDP (Chart IV-20). This is about 1½ percentage points more than was forecast in February, owing to much more favourable developments in primary income in addition to the increased trade surplus. The rise in primary income is due to improved returns on foreign direct investment (FDI), owing in part to the effects of large one-off profits on FDI assets held by the holding companies established on the basis of the failed banks' estates. A larger surplus on primary income is also assumed for this year, reflecting to some extent Iceland's improved external debt position and reduced interest rates on foreign financial obligations. However, the most important factor is stronger FDI returns, which have been positive for the past four years even though the net FDI position (adjusting for the effect of the failed banks' estates) has been negative. Therefore, the outlook for 2017 is for a larger current account surplus than was expected in February, or 6.4% of GDP instead of 4½%. The surplus is forecast to decline to 5½% in 2019.

National saving has increased markedly in recent years, measuring 29.3% of GDP in 2016, or 11 percentage points above its twenty-five year average (Chart IV-22). It has exceeded this level only once before: in 1965, when it measured just above 30% of GDP (see Box 1). According to the forecast, national saving will remain somewhat above the historical average throughout the forecast horizon.

Chart IV-20

Current account balance 2000-2017[1]

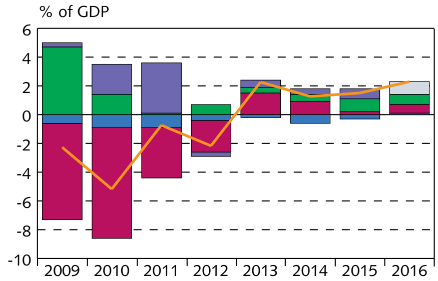


Trade balance
Underlying primary income, net[2]
Underlying current account balance[2]
Measured current account balance

1. Including secondary income. Central Bank baseline forecast 2017.
2. Excluding the effect of 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.

Chart IV-21

Net return on FDI 2009-2016[1]

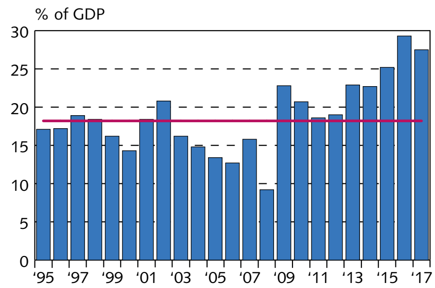


Power-intensive industry
Pharmaceuticals
Others
Failed financial institutions
Holding companies established from the failed financial institutions
Net return on FDI

1. Sum of net dividends, reinvested earnings, and interest on shareholder loans.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-22

National saving 1995-2017[1]



National saving
25-year average (1992-2016)

1. Underlying national saving in 2008-2015, based on the estimated underlying current account balance (adjusted for the effects of failed financial institutions 2008-2015 and pharmaceuticals company Actavis in 2009-2012). Central Bank baseline forecast 2017.
Sources: Statistics Iceland, Central Bank of Iceland.