Icelandic Economic Update

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Arion banki

Signs of a recovery: GDP numbers improving

- GDP during the third quarter contracted by 1.6% compared with the same period last year. This is far less than the 7-7.5% decrease recorded in the first two quarters of 2010. Private consumption is beginning to increase again after having been in decline for nine consecutive quarters. Investments, however, have still not reached their lowest level and continued to decrease between years. Arion Research believes that the new GDP figures are showing signs of economic recovery.

Annual rate of inflation one percent next year

- The appreciation of the Icelandic króna (ISK) and the difficult economic climate are likely to play a larger role than usual in forthcoming inflation measurements. We consider it likely that the annual rate of inflation will have dropped to just over 1% in only three months' time and will stay at this level next year.

Calendar

Date	Title	Period
13 December 2010	Auction Treasury Bills	
13 December 2010	Unemployment figures	November 2010
17 December 2010	Auction Treasury Bonds	
22 December 2010	Consumer Price Index	December 2010

Signs of a recovery: GDP numbers improving

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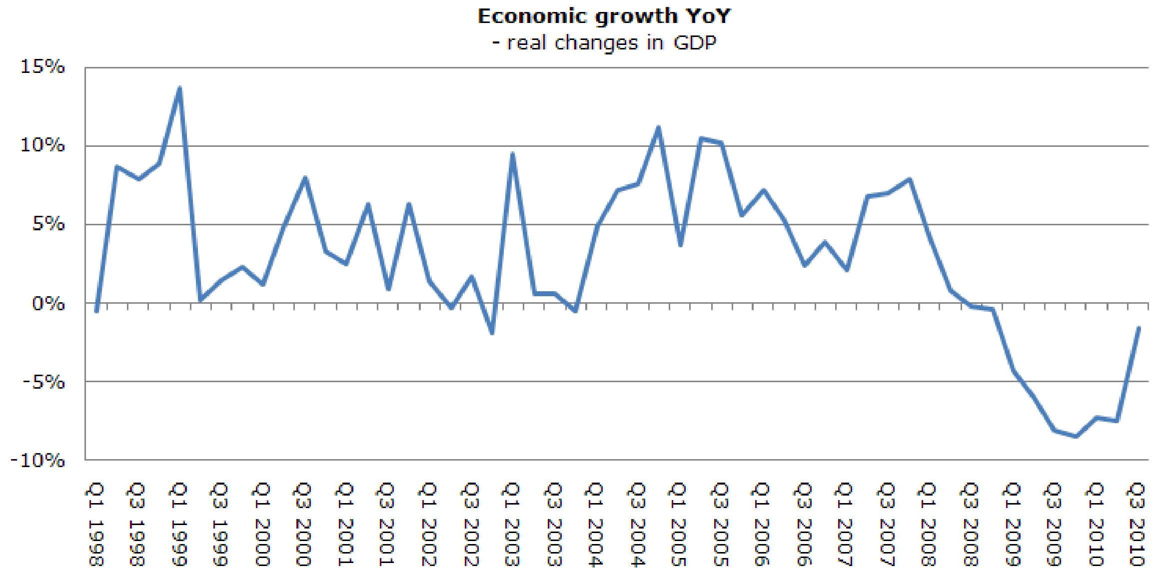
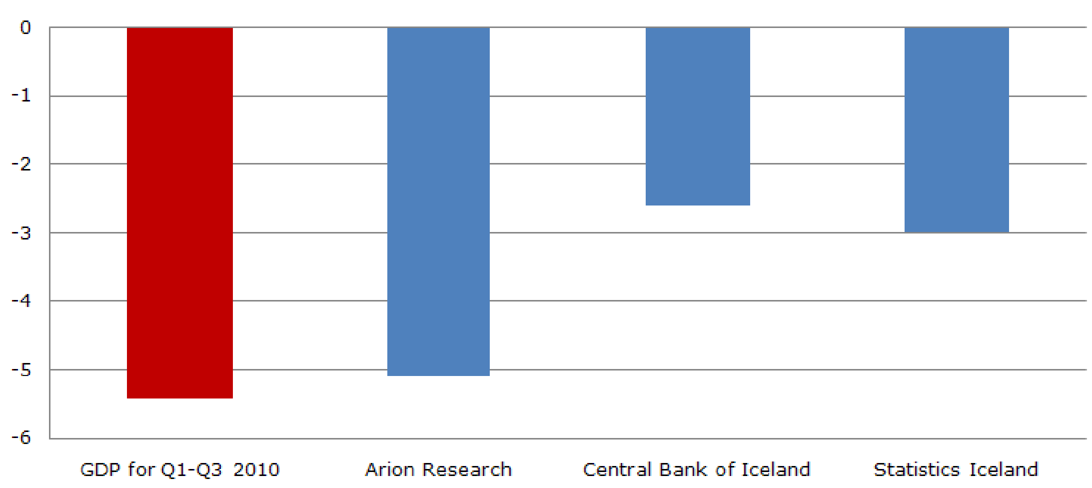
Economic growth YoY - real changes in GDP



Source: Statistics Iceland

The economic growth rate so far this year is in line with our forecasts, which projected that the output gap would peak in the first half of the year while signs of a recovery would be seen in the second half. Statistics Iceland appears to have underestimated investments during the first half of the year (now corrected) and therefore we have probably overestimated the contraction this year as a result. However, the figures for the first three quarters of 2010 probably fall short of the expectations of the Central Bank of Iceland and Statistics Iceland, whose new economic forecast projected a 2.5-3% decrease this year, while GDP has in fact decreased by 5.5% during the first nine months of the year. If their forecast is to prove accurate, GDP needs to increase by 5-6% in the final quarter of 2010, which is unlikely given the state of the economy.

Economic growth forecast and real figure for the first three quarters (%) - changes in GDP between years

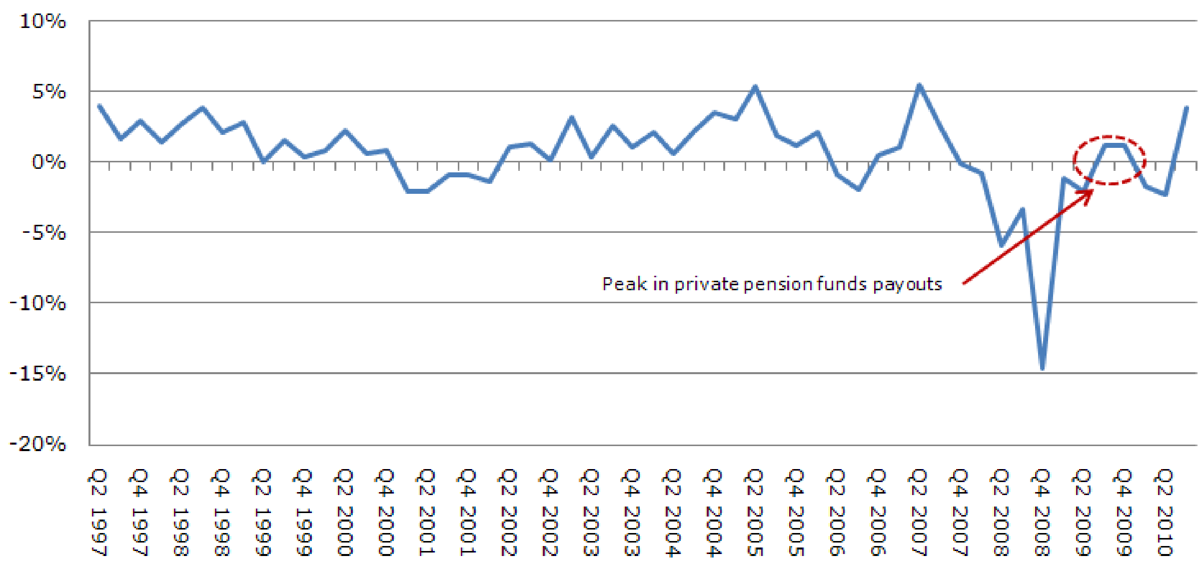


Source: Statistics Iceland, Central Bank of Iceland & Arion Research

Private consumption increasing

Private consumption appears to be staging a slight recovery following one long slump all the way back to the beginning of 2008, a total drop of 24%. The freezing of foreign currency car loans following a ruling by the Supreme Court this summer may have had some effect here. There are several signs in the economy that private consumption has reached its lowest point. However, we do not expect the recovery to be particularly robust as purchasing power will not significantly improve, unemployment remains high and expectations are still very subdued. The economic collapse in Iceland may also have altered household consumption patterns and we may now be seeing a greater inclination to save. Arion Research has previously pointed out the clear link between rising private consumption and the peak in private pension payouts at the beginning of the year, showing that households were using savings to fuel consumption. The government budget provides for a further ISK 10-11 billion to be paid out in private pension savings in 2011 and we might therefore see an upswing in private consumption next year. However, this extra provision in next year's budget is less than the total payout in 2010 (an estimated ISK 16 billion) and it is unclear how many people are able or are willing to use their savings to further fuel consumption.

Private consumption - real changes between quarters, seasonally adjusted



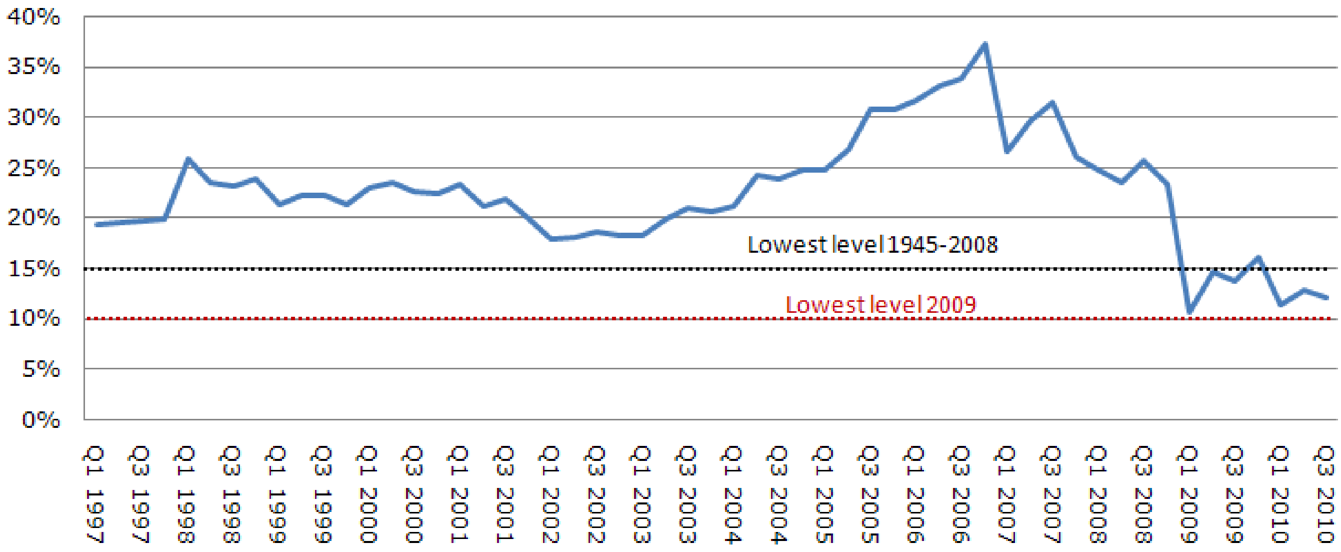
Source: Statistics Iceland

Investments continue to decrease

Investments are at an absolute minimum in Iceland, just over 10% of GDP. In comparison investment never dipped below 15% of GDP from the period of 1945-2008. Arion Research does not expect a proper recovery in investments in the medium term as major construction projects, such as Helguvík, are on hold. Many companies are being restructured and therefore need some time before they can embark on new investments. All uncertainty over the economic outlook and the government's tax policy is also bound to undermine companies' incentive to invest. Many investors have clearly preferred to seek safe investing in government bonds rather than putting money into private companies.

And while business sector investment is struggling, there is little prospect of any public sector investment over the next few years. Statistics Iceland's recent economic forecast (on which the fiscal budget is based) does expect decrease in any public sector investment in the coming years.

Investment - as % of GDP



Source: Statistics Iceland

Negative external trade

Although the real exchange rate is at a historical low, external trade is slowing down economic growth. The main reason is that exports are at a virtual standstill and imports increasing between years. The current capital controls do hamper this development to some extent as the exchange rate is largely determined by the current account balance; in other words if imports increase, export income will not be sufficient to support this development. Therefore the ISK will depreciate, resulting in fewer exports (as a result of falling private consumption). There are still restrictions on the growth of private consumption, particularly if the export sector cannot continue to grow. After all, private consumption is generally very sensitive to the exchange rate of the ISK.

Annual rate of inflation one percent next year

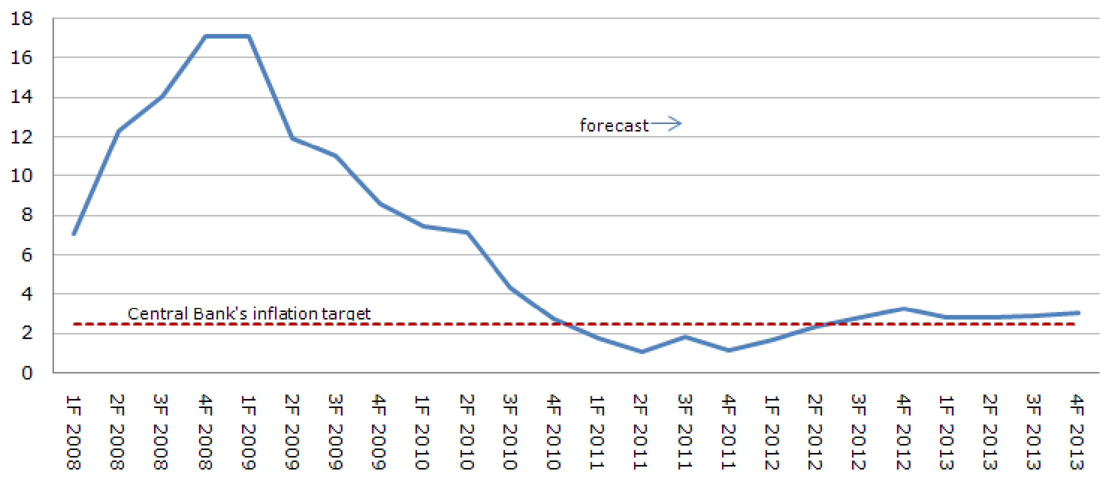
The appreciation of the Icelandic króna (ISK) and the difficult economic climate are likely to play a larger role than usual in forthcoming inflation measurements. We consider it likely that the annual rate of inflation will have dropped to just over 1% in only three months' time and will stay at this level next year.

Main assumptions:

- There will continue to be slack in the economy and household purchasing power will remain low. In the current climate, there is likely to be minimal or even zero demand pressure in the economy, and this situation does not appear to change next year.
- Salary increases will be moderate and unemployment will remain high. There is therefore little risk of cost inflation as a result of rising salaries.
- ISK remains stable. We assume that the current capital controls will remain in place and that any easing of restrictions will be very gradual. Therefore there is little to suggest that the exchange rate will change significantly in the medium term.
- Increases in taxes and public service fees Tax increases are expected to be slightly lower next year and the overall effect is estimated to be 0.25% in 2010 and 0.1% in 2011 (according to the Central Bank of Iceland's estimate in the latest Monetary Bulletin). The local authorities are also expected to raise their public service fees, the effects of which will largely be felt in the first quarter of 2011.
- Price of housing will have no effect next year. Since the economic collapse in Iceland the price of housing has depressed inflation by more than 2%, while prices have risen by more than 13%. The decrease in the price of housing is probably being underestimated at the moment as each measurement is based on limited data. We are therefore very cautious in our forecast on the housing price component of the CPI and we believe it will have a very limited impact on inflation next year. It could easily be argued that this assumption is slightly optimistic, particularly if people start buying property again. A higher turnover is likely to be reflected in a drop in housing prices.

As the diagram shows, we expect inflation to remain below the Central Bank's inflation targets until mid-2012. In the second half of 2012, inflation will start to increase again as the economy starts to recover, expectations improve, unemployment drops and purchasing power grows.

Inflation forecast (%) - changes between years



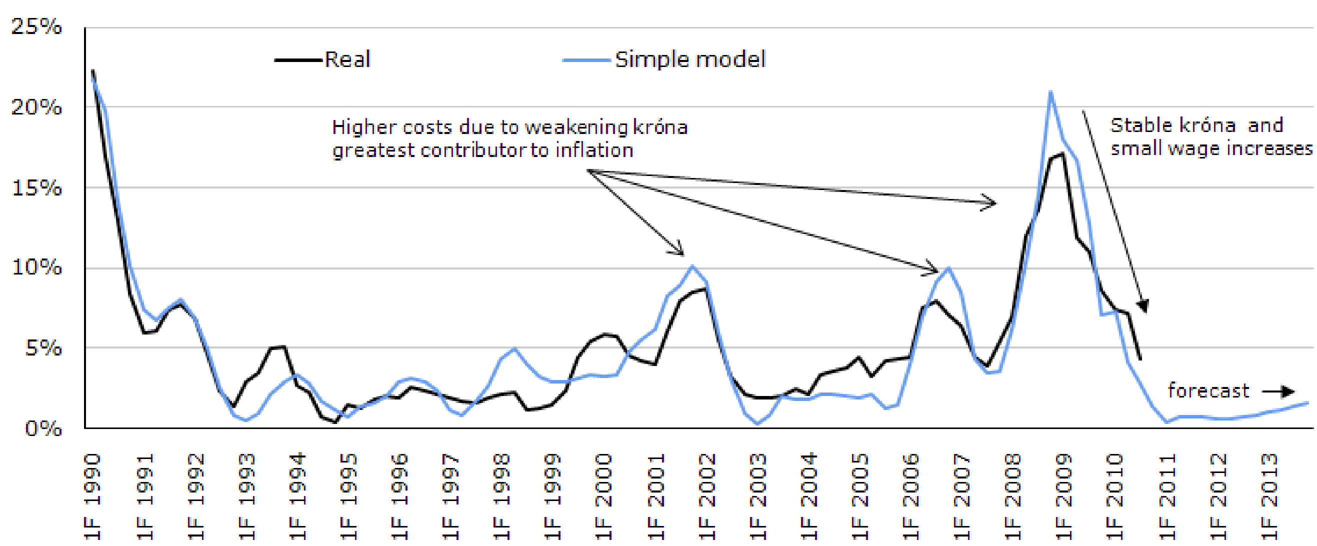
Source: Statistics Iceland & Arion Research

Salaries and the exchange rate as a cause of inflation

Cost items such as changes in the exchange rate and salaries have generally been key reasons behind inflation in recent years. These factors are unlikely to be drivers behind inflation over the next few years. Union wage agreements are likely to be moderate as companies are in no position to foot large wage increases with demand in the economy so low. Union agreements are however subject to great uncertainty as usual. If the pressure to increase salaries is greater than we assume here, then there is a risk that such pressure could spill over into prices. We expect the ISK to remain stable throughout the forecast period, meaning that we do not assume any costs relating to the depreciation of the ISK.

It is interesting to examine the cost effect in greater detail by looking at a simple cost model where inflation is determined by its own lag and changes in the exchange rate and salaries. The diagram shows that on average there is little difference between forecast values and real values – i.e. cost items can explain things quite clearly compared with real figures (i.e. inflation itself). It is therefore interesting to note that if only cost items, salary and exchange rate, were included in the equation, the model would forecast virtually zero inflation over the next two years.

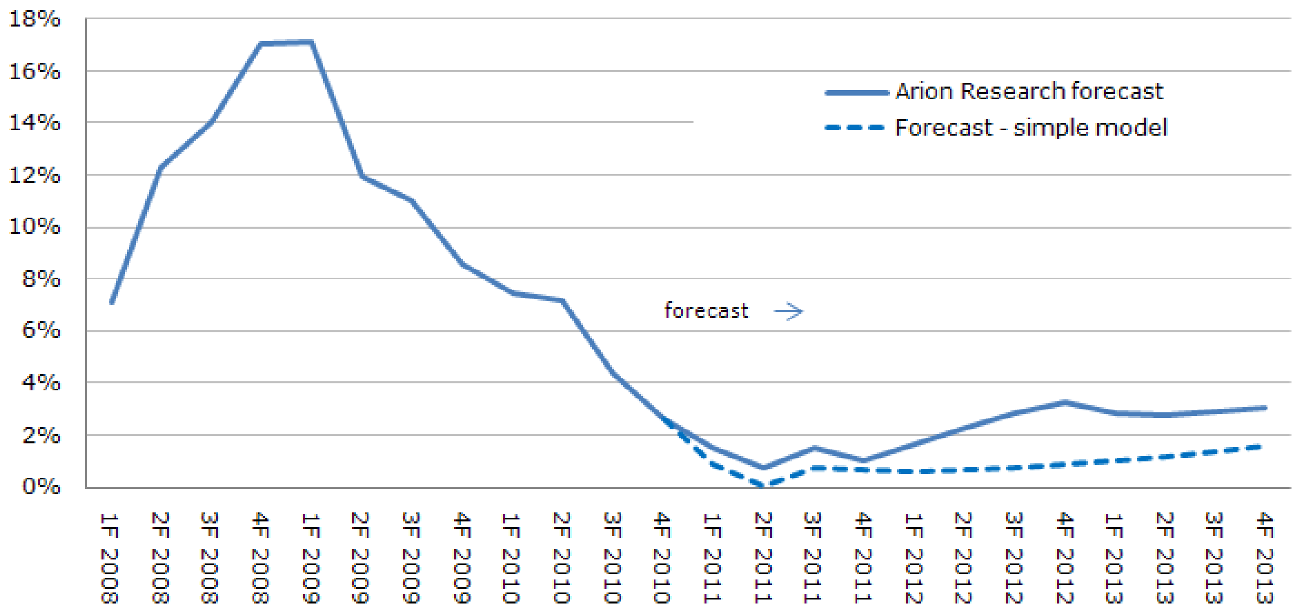
Inflation and a simple model - 12 month inflation



Source: Statistics Iceland & Arion Research estimates

So why are we forecasting any inflation? In our baseline forecast we assume that fuel and food prices will increase in the medium term as a result of rising global commodity prices. Our simple model above does not take into account these cost effects (i.e. global oil and commodity prices). Instead inflation is only measured with respect to salaries and the exchange rate. However, should the price of commodities drop in the near term inflation may well measure zero or deflation might even be measured at some point.

Inflation forecast - changes between years



Source: Arion Research

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