



Icelandic Economic Update

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Iceland's GDP beats expectations in 2009

– We forecast a 2% contraction in 2010

- We expect private consumption to contract less than originally estimated in 2010. We now forecast a 2.5% drop in 2010 compared with nearly 5% in our previous forecast. In 2009 GDP decreased by 6.5%, although it is a record contraction it was less than expected. The economy is expected to recover more slowly owing to high unemployment rate and the weakness of the ISK, a three-year downturn in consumption is expected to end this year (see page 2).

External trade forecast

- Goods and services surplus at 12,5% of GDP in 2010

- We forecast a substantial goods and services surplus in 2010. Iceland's turnaround in trade has already come along way and it will not take much for the surplus to reach the level of our forecast (see page 6).

Calendar

Date	Title	Period
18 March 2010	Wage index	Year 2009
19 March 2010	Auction Treasury Notes	
23 March 2010	Analytical accounts of the banking sector	February 2010
24 March 2010	Consumer price index	March 2010
25 March 2010	Earnings in the private sector	
30 March 2010	New registrations and insolvencies of companies	February 2010
30 March 2010	Producer price index	February 2010
31 March 2010	External trade in goods	Jan-Feb 2010
31 March 2010	External trade of goods	Year 2009
9 April 2010	Economic indicators	April 2010
9 April 2010	Auction Treasury Notes	
12 April 2010	Analytical accounts of the Central Bank and international liquid reserves	March 2010
13 April 2010	Auction Treasury Bills	
15 April 2010	Unemployment figures	March 2010

Iceland's GDP beats expectations in 2009

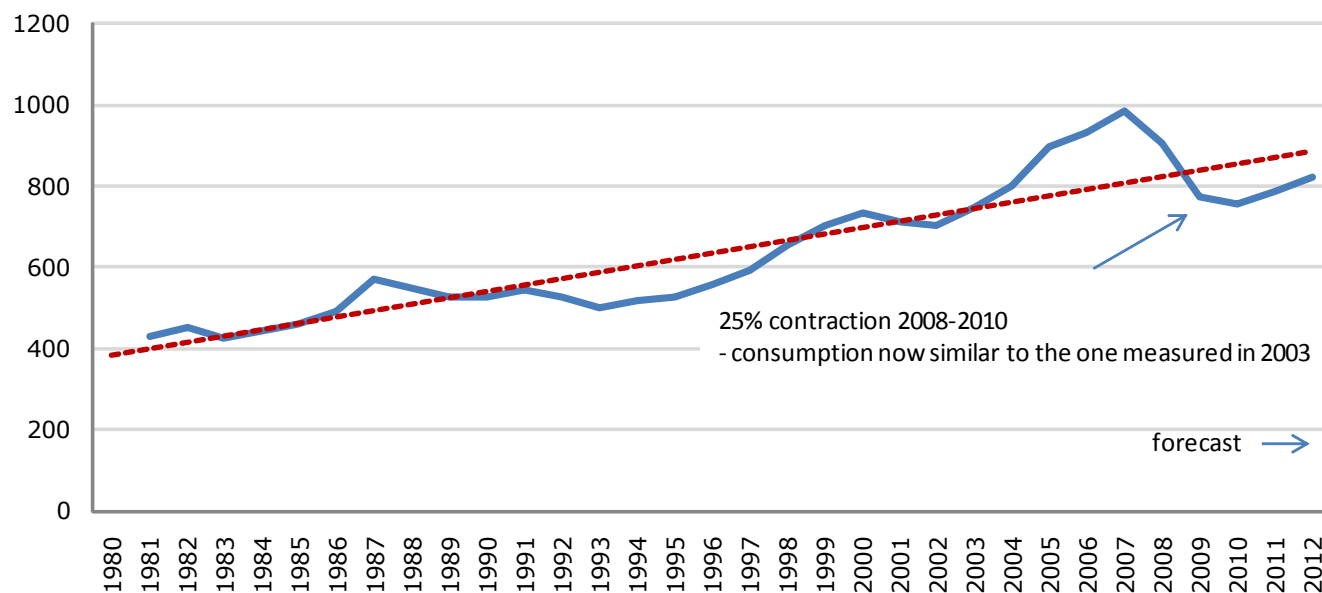
– We forecast a 2% contraction in 2010

The recently reported 6,5% contraction in GDP was smaller than previously estimated (see discussion below). Arion Research forecasts economic growth to be negative by around 2% in 2010 and the contraction period will come to an end in 2010. However the uncertainty has increased in recent weeks due to the fact that the Icesave dispute is still unsolved. This could have the effect of weaker recovery – that is larger contraction in 2010, further delay in investment and higher unemployment.

The latest figures reveal that consumption has checked its decline between years after a substantial slump. Spending is likely to fall at the beginning of the year as higher tax rates on income and goods hit household disposable income. We now project a 2.5% drop in 2010 in private consumption compared with nearly 5% in our previous forecast. Note that this forecast projects a decline in real terms, consumption will remain virtually unchanged measured in nominal terms between 2009 and 2010.

If our forecast proves accurate private consumption will decrease by 25% in real terms in the period 2008-2010. Last year the consumption level was similar to the level measured in 2003 and it is expected to be at the same level this year as well. The three-year downturn in consumption is expected to end this year. Nevertheless, we only expect a modest recovery in private consumption, or grow about 4% in annual terms, in the next couple of years given that unemployment will remain high in 2011-2012 and the exchange rate will continue to weak.

Private Consumption (in fixed prices of 2009) - in ISK billion



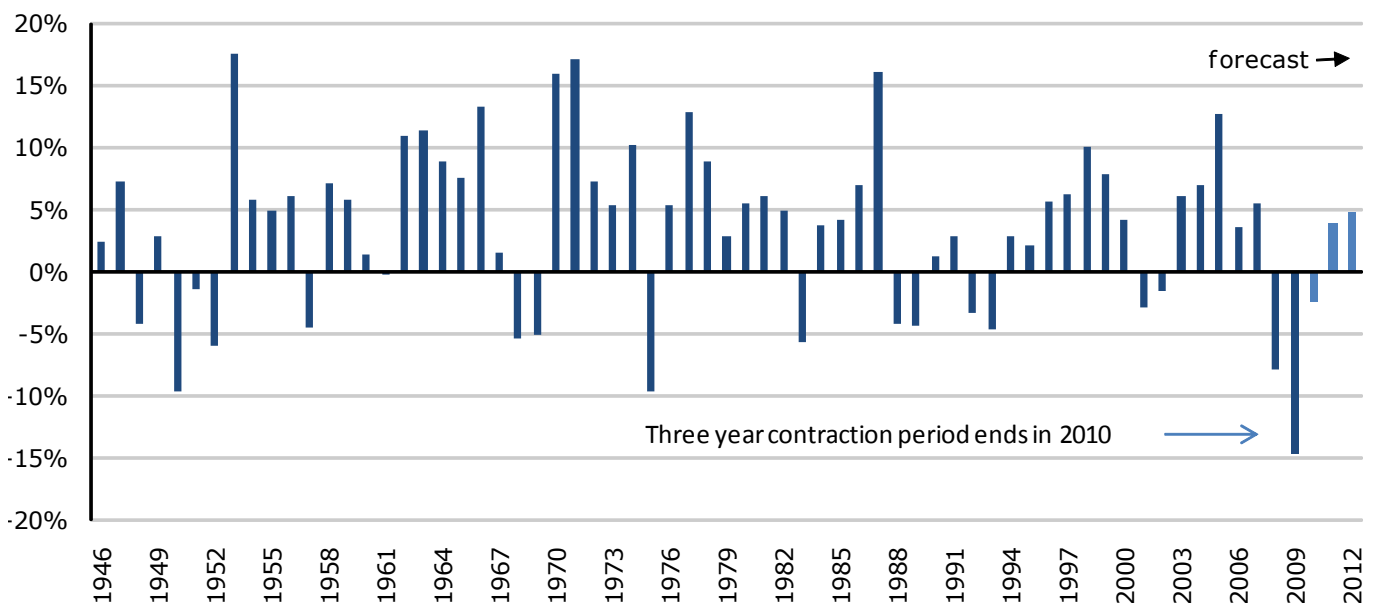
Source: Statistics Iceland & Arion Research

Key factors

The main factors curbing private consumption are:

- Tax increases – taxes on both income and goods were raised at the beginning of the year and weigh heavily on household disposable income.
- Negative purchasing power – Salary increases are likely to be moderate this year both in the private and public sectors.
- High interest rates – The Central Bank of Iceland has promised a tight monetary stance particularly at a time when there is uncertainty over loans from the IMF and the Nordic countries.
- Unemployment will remain high – unemployment currently measures 9.3% and our forecast assumes that it will remain high throughout the year.
- Changed consumption patterns – an increasing tendency for households to save rather than spend will become apparent this year and over the next few years.
- Low expectations and insecurity – There is a degree of pessimism and uncertainty in the outlook of households, undermining consumers' eagerness to spend and thus reducing consumption.

Private Consumption (real changes from previous year)



Source: Statistics Iceland & Arion Research

Main uncertainties:

Positive factors:

- Sharper drop in unemployment – unemployment measured 9.3% in February and we expect it to similar level during the year, peaking at 9.4%. If unemployment recedes more quickly, the economy might stage a more rapid recovery.
- Rise in salaries – We are unlikely to see any significant wage drift this year. A more rapid recovery of the labour market could fuel consumption.

Negative factors:

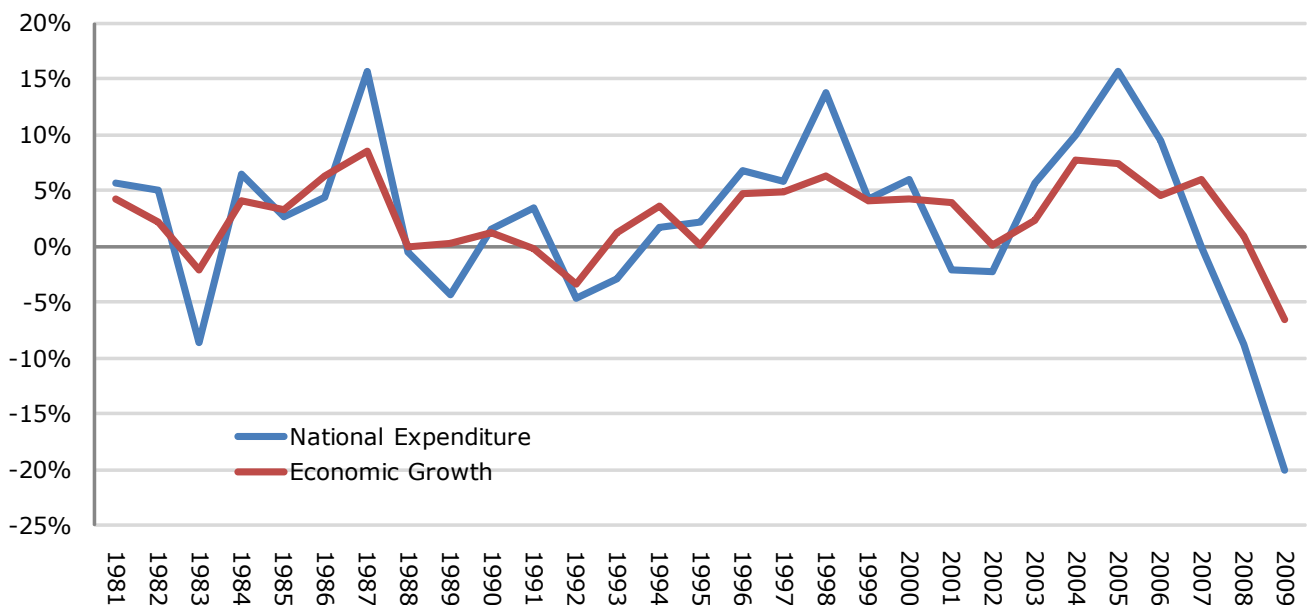
- Continuing uncertainty – If the Icesave dispute is not resolved soon, there is a risk that economic regeneration in Iceland will be further delayed. If our forecast is to prove accurate, it is crucial that all uncertainty is eliminated as soon as possible.
- Higher unemployment – Should unemployment be higher than in our forecast then consumption will be also be lower than projected.

A glimpse of the latest GDP figures

GDP decreased by 6.5% in real terms in 2009 from previous year, which is slightly below our forecast of 7.5% and significantly better than what the Central Bank and IMF forecast first after the financial crisis hit. The difference is explained by a less pronounced contraction in private consumption and a better trade balance.

Despite the fact that the drop in GDP is one of the biggest on record, it was less than expected considering the drop in national expenditure (see graph below). Since the currency collapse in late 2008, consumers have increasingly turned to domestically produced goods at the expense of imported goods, which has had a positive effect on the trade balance and therefore output.

GDP Growth and National Expenditure (real changes)

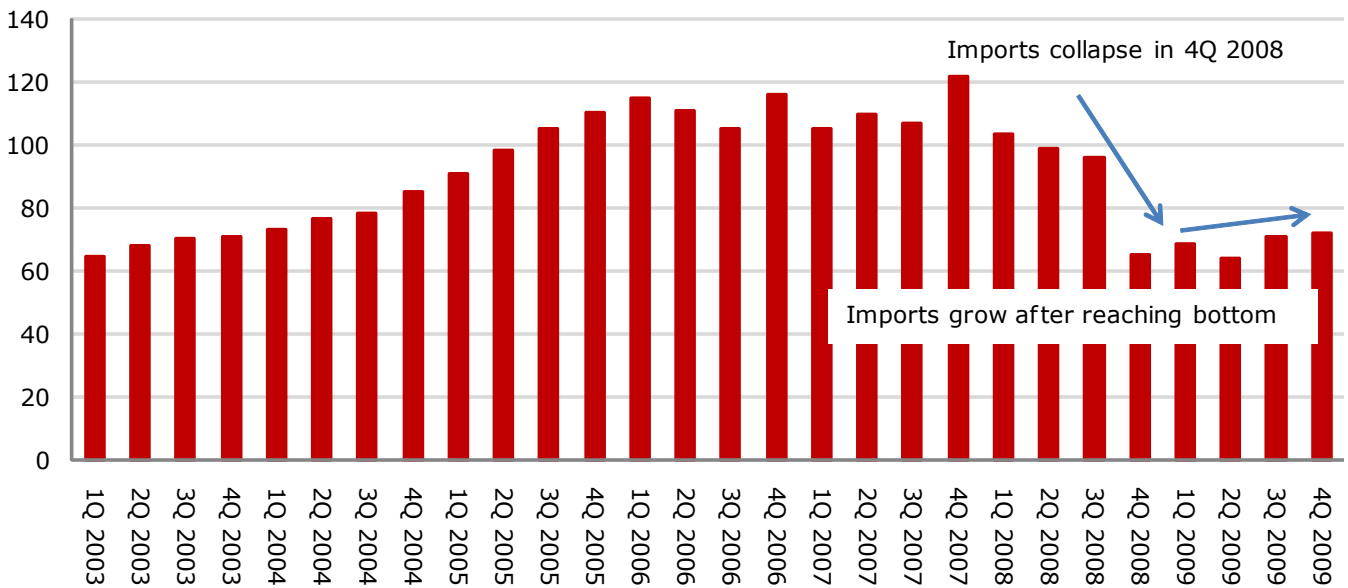


Source: Statistics Iceland

Key points:

- Effect of the crash in imports fades out – despite the fact that imports are growing this year, there was a massive decline between 2008 and 2009. The positive impact of this was reflected in the trade balance and output growth in the first quarters of 2009. We expect no change or a small drop in imports in 2010.
- Growth in exports – at the same time as imports were plunging, exports grew by 6.2%, exceeding our forecasts.

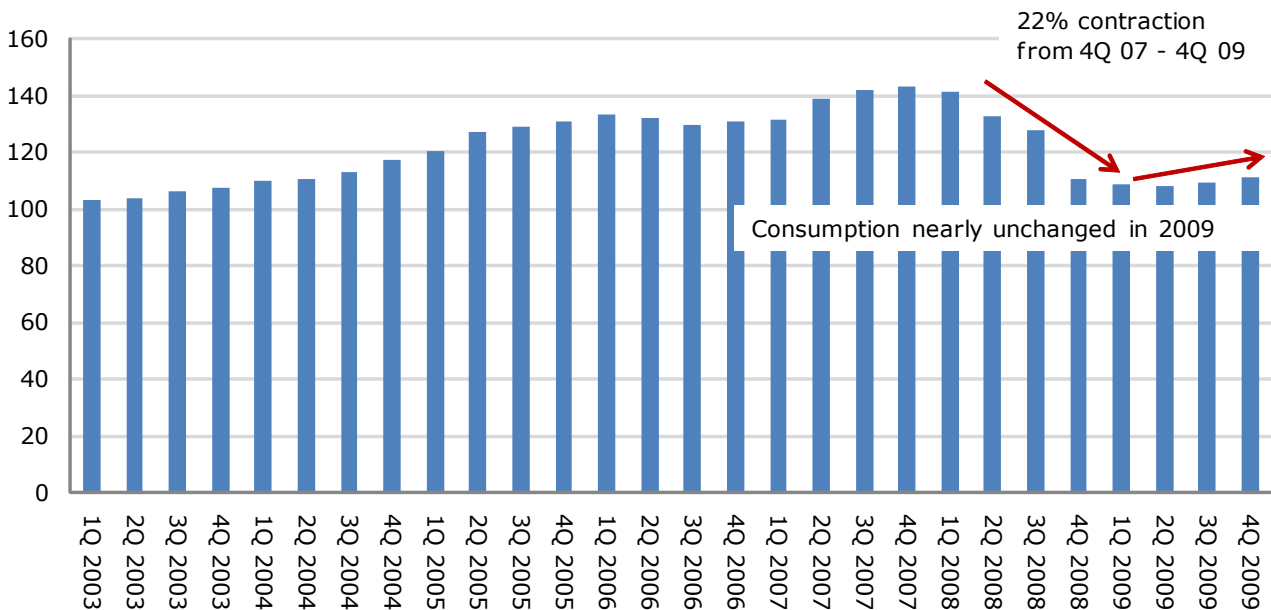
Imports (in fixed prices of year 2000 and seasonally adjusted)
- in ISK billion



Source: Statistics Iceland

- Drop in private consumption comes to halt – the main component of GDP, private consumption, remained unchanged in Q4 2009 from Q4 2008 which suggests that the massive slump in consumption triggered by the banking collapse is coming to an end. Seasonally adjusted consumption grew by 1.4% between quarters. We believe that household consumption has reached a low and is likely to remain at similar level this year.

Private Consumption (in fixed prices of year 2000)
- in ISK billion



Source: Statistics Iceland

- Investments went up between quarters but down sharply between years - despite the fact that investments grew between quarters (seasonally adjusted) these figures should not be interpreted too literally since investments fluctuate sharply from one quarter to the next.

Investments have plunged 50% between years and are at an all-time low of 14% of GDP, compared to a peak of 34% at the height of the economic cycle.

External trade forecast

- Goods and services surplus at 12,5% of GDP in 2010

Arion Research forecasts a goods and services surplus of EUR 1.15 billion in Iceland for 2010 (12,5% of GDP). While some people might consider this figure to be pretty high – it is the equivalent of EUR 95 million a month or 12.5% of GDP – Iceland has in fact already come a long way:

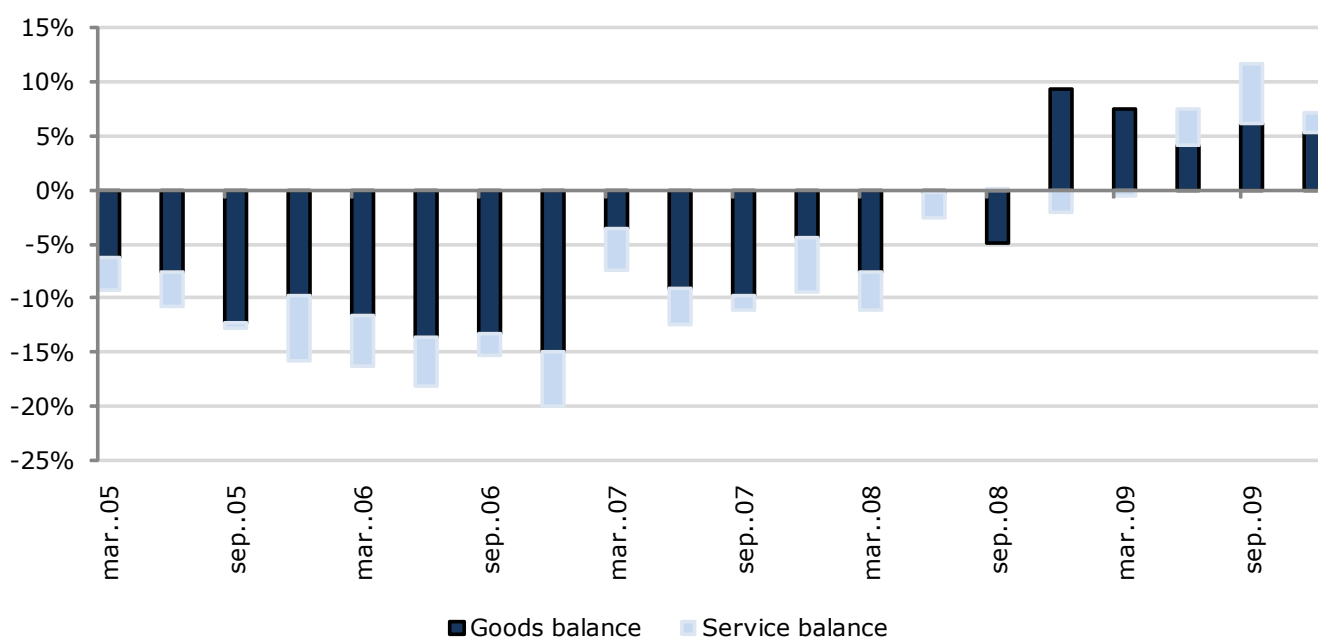
- The goods and services surplus averaged EUR 46 million a month in 2009, or 8.5% of GDP (according to new figures from Statistics Iceland, see table below).
- The surplus really took off in the second half of the year, when the goods and services surplus was EUR 71 million a month or 9.5% of GDP.
- Today's figures from Statistics Iceland reveal that foreign trade netted a surplus of EUR 57 million during the first two months of the year.

It therefore would not take much for our forecast to turn out to be correct. Let's look at it in more detail.

Goods and services balance 2009			Goods and services balance for latter half 2009		
	EUR million	% GDP		EUR million	% of GDP
Goods and services balance 2009	730	8.4%	Goods and services balance 2H 2009	425	9.4%
Goods balance	500	5.8%	Goods balance	260	5.7%
Services balance	230	2.6%	Services balance	165	3.7%

Source: Central Bank of Iceland

Foreign trade (as % of GDP)

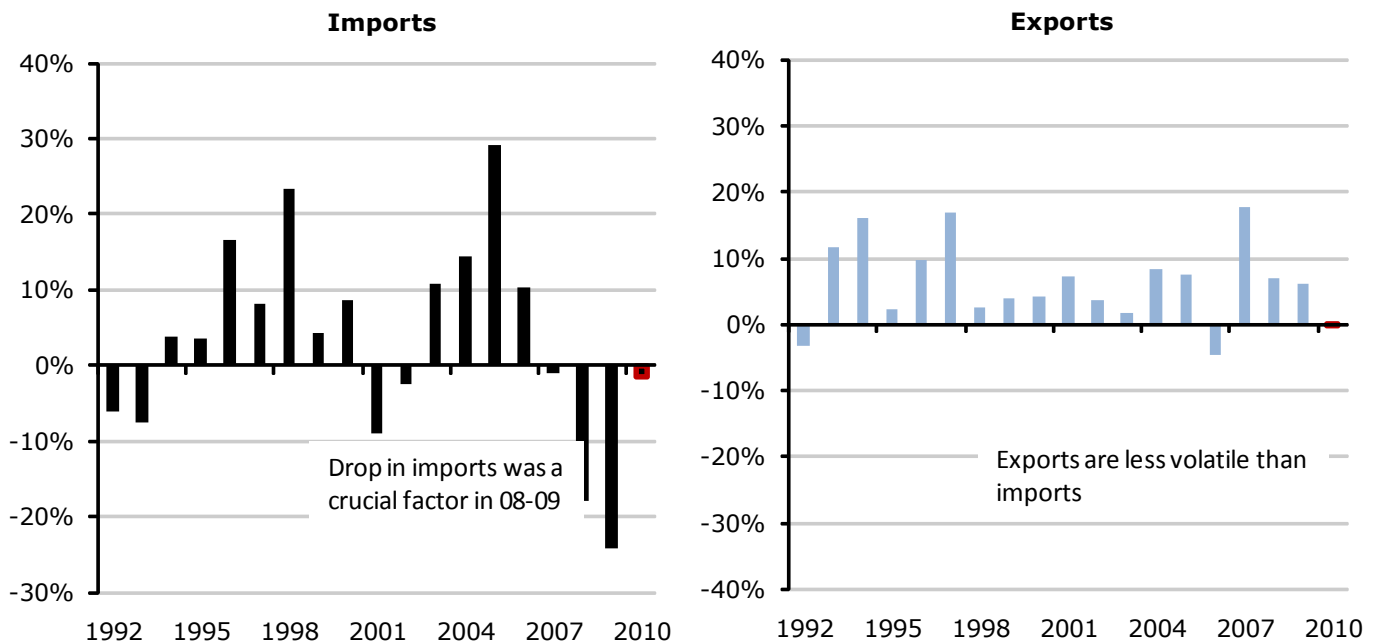


Source: Central Bank of Iceland

Drop in imports has made the difference

The reason that the balance of trade has been transformed from a massive deficit into a surplus in a very short space of time is the collapse of imports. Imports plummeted in real terms in 2008 and 2009 while the real value of exports increased.

Imports and exports of goods and services (real changes between years)

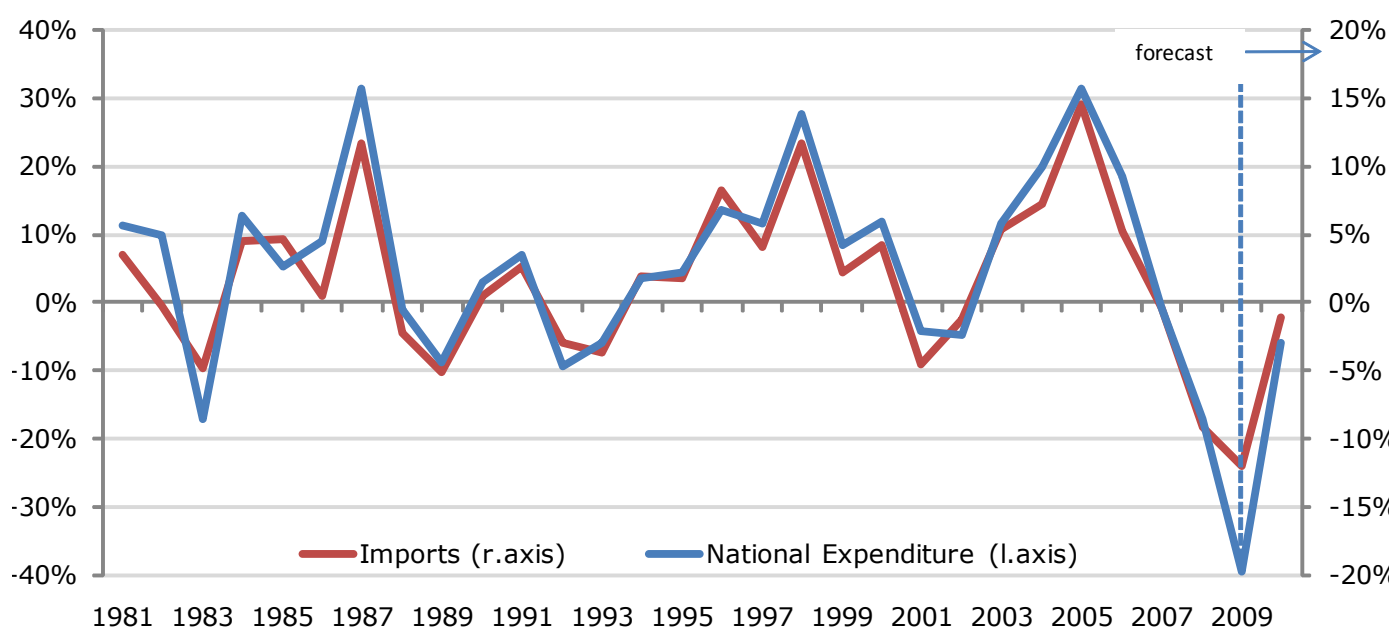


Source: Central Bank of Iceland

External trade positive while economy is sluggish

Iceland had a respectable trade surplus in 2009. This surplus is likely to remain intact in the near term since imports - so closely linked to economic activity - are hardly set to increase in the immediate future. If we measure economic activity in terms of national expenditure we can see a close relationship with imports (see diagram below). We forecast that national expenditure and imports will both show a slight decrease in 2010. Another important factor is the sharp increase in export prices between years, with aluminum prices, for example, up 25% from last year.

Imports follows national expenditure (real changes between 1981-2009, forecast for 2010)



Source: Central Bank of Iceland

How big will the current account surplus be?

If we assume that the goods and service surplus will be 12.5% of GDP, the trade balance simply depends on the size of the balance of income.

- If the balance of income remains at 2009 levels (i.e. 5.4% excluding the old banks) it would result in a 7% trade surplus.
- The actual surplus will probably turn out to be less though. There is likely to be a larger income deficit in 2010 as a result of borrowing to shore up the foreign reserve. Interest expenses related to the expansion of the foreign reserve could increase the income deficit by 1% of GDP, thus lowering the current account.
- Furthermore, accrued interest relating to Icesave will also add to the income deficit after 2010 (there is likely to be a grace period on interest until then) although the end effect will probably be less pronounced than originally thought. Initially it was believed that the interest on Icesave would add 2-3% of GDP a year to the income deficit. According to the proposals which have been made in the Icesave dispute, the figure should be closer to half a percent of GDP a year.

The bottom line is that Iceland's trade surplus could possibly approach 5% of GDP in 2010 (EUR 500 million) provided that the ISK remains stable. If the forecast proves accurate, it will be a clear show of strength from an otherwise troubled currency zone.

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