GDP contracts by 8.3%

- Gross domestic product contracted by 8.3% during the second quarter compared with the same period last year according to preliminary data. Private consumption appears to heading for a second dip judging by recent figures from Statistics Iceland. There was a significant new slump in investments after a period of growth in the first quarter of the year; investments do tend to fluctuate, however. GDP shrank by 7.3% during the first half of 2010 compared with the same period last year. These economic figures strengthen our conviction that the Central Bank will cut interest rates by 100 basis points at its next meeting on 22 September.

Calendar

Date	Title	Period
10 September 2010	Auction Treasury Bonds	
13 September 2010	Auction Treasury Bills	
13 September 2010	Unemployment figures	August 2010
24 September 2010	Auction Treasury Bonds	
22 September 2010	CBI's interest rate decision	
28 September 2010	Consumer Price Index	September 2010

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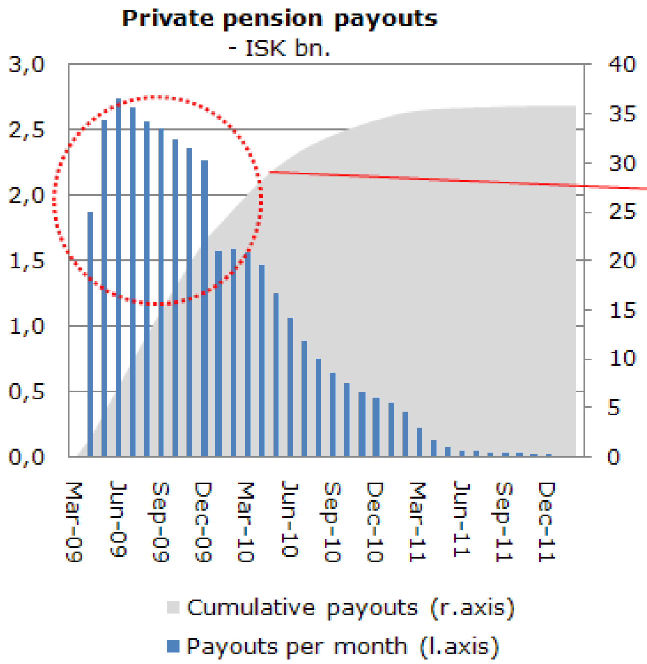
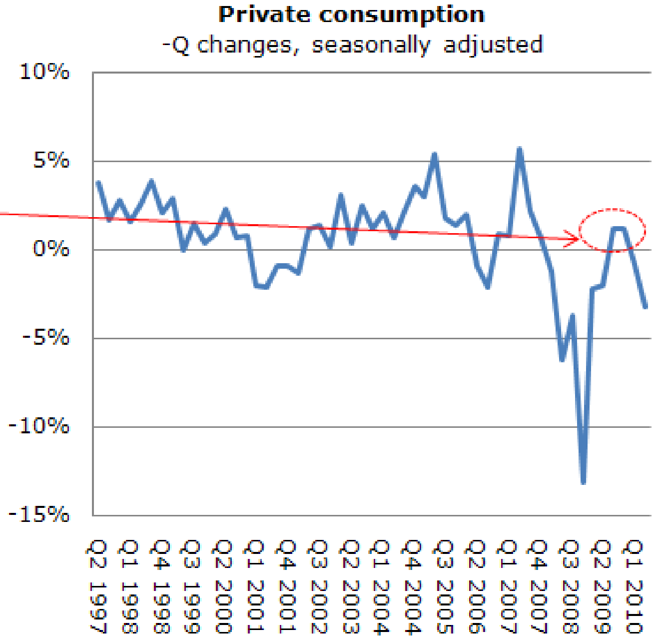
The Central Bank of Iceland recently published an economic growth forecast which indicates that economic growth has fallen short of expectations so far this year. The forecast assumes a 1.9% contraction in 2010 which means that during the second half of the year GDP needs to grow by 3.5% to match the bank's forecast.

Is the government's budget realistic? The Ministry of Finance uses the economic forecast published by Statistics Iceland as a reference when drawing up the budget. The economic forecast published by Statistics Iceland (published in June) for 2010 is, like the Central Bank's forecast, rather optimistic for this year and predicts a contraction of 2.9%. If the assumptions used in the 2010 budget are wrong, then there is a risk that the fiscal balance for the whole year will be below expectations, which might necessitate higher taxes or further cutbacks next year.

Slump in private consumption. Private consumption fell by 2% year-on-year in Q2 2010, compared with zero growth in the first quarter. The government's short-term measures (paying out private pensions, freezing loans, adjusting payments on loans) have now come to an end but they did appear to have some effect in stimulating consumption. As payouts of private pensions have peaked and other measures have come to an end, it's only natural that consumption should tail off again. However, we do not expect private consumption to drop as sharply as it did in 2008-2009 as consumption is already at rock bottom and conditions would have to deteriorate sharply for consumption to decline further. It is still unclear what effect the Supreme Court judgment on currency-linked lending will have on household consumption. It is likely that consumption will increase in the short-term, and this pattern might emerge as early as the second half of this year.

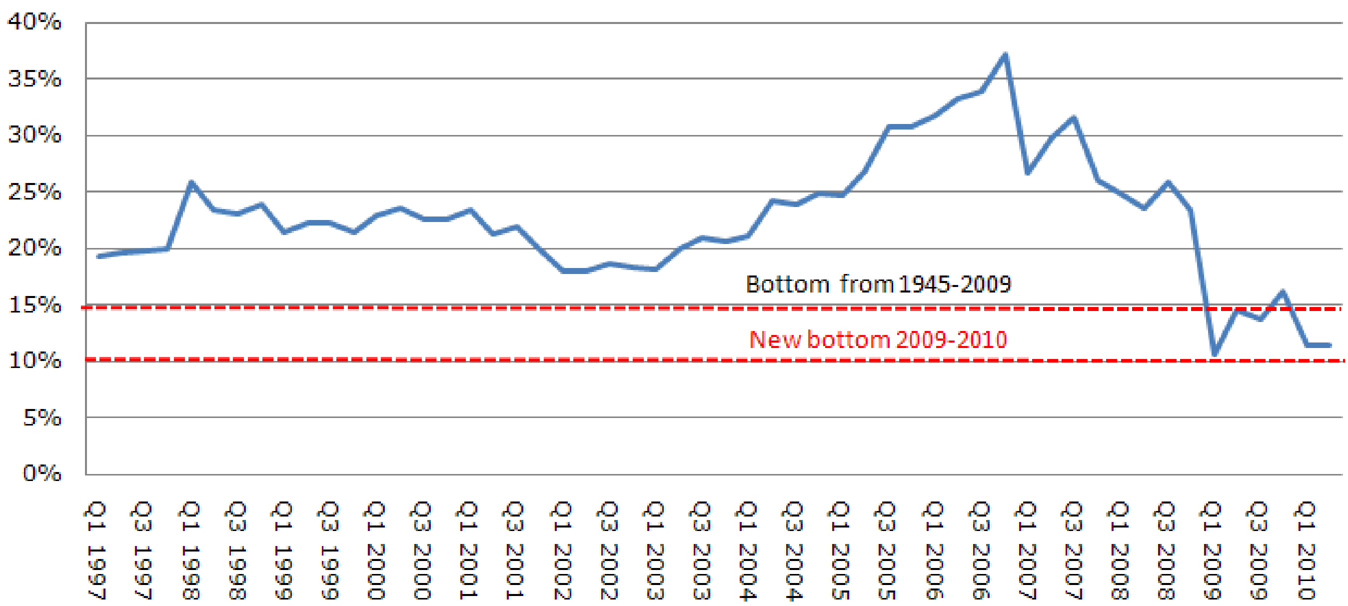




Source: Statistics Iceland

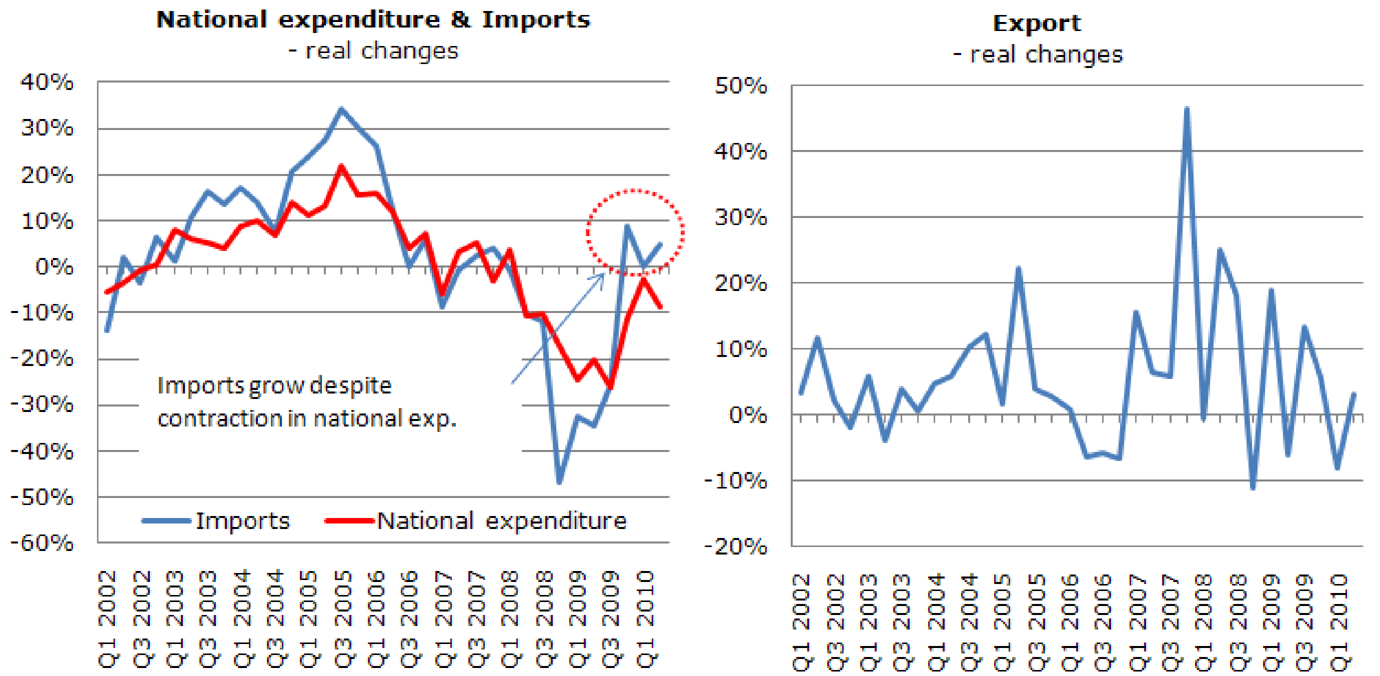
Investments remain low key. In the current environment it is perhaps not surprising that investments remain at a low level. Investments as a percentage of GDP are now close to 10%, which is far below the previous minimum of 15% from 1946 to 2008. There is very little activity in the way of aluminium and hydropower projects. Many sectors have had a difficult time as domestic demand is at a low. Many companies have been restructuring their businesses, there is great uncertainty concerning the government's tax policy and corporate debt, while there is a certain crowding-out effect associated with the treasury deficit since investors look for safe investments rather than riskier private schemes. There has been a total collapse in public investments since the government and local authorities have had to cut back heavily on spending.

Investments (% of GDP)



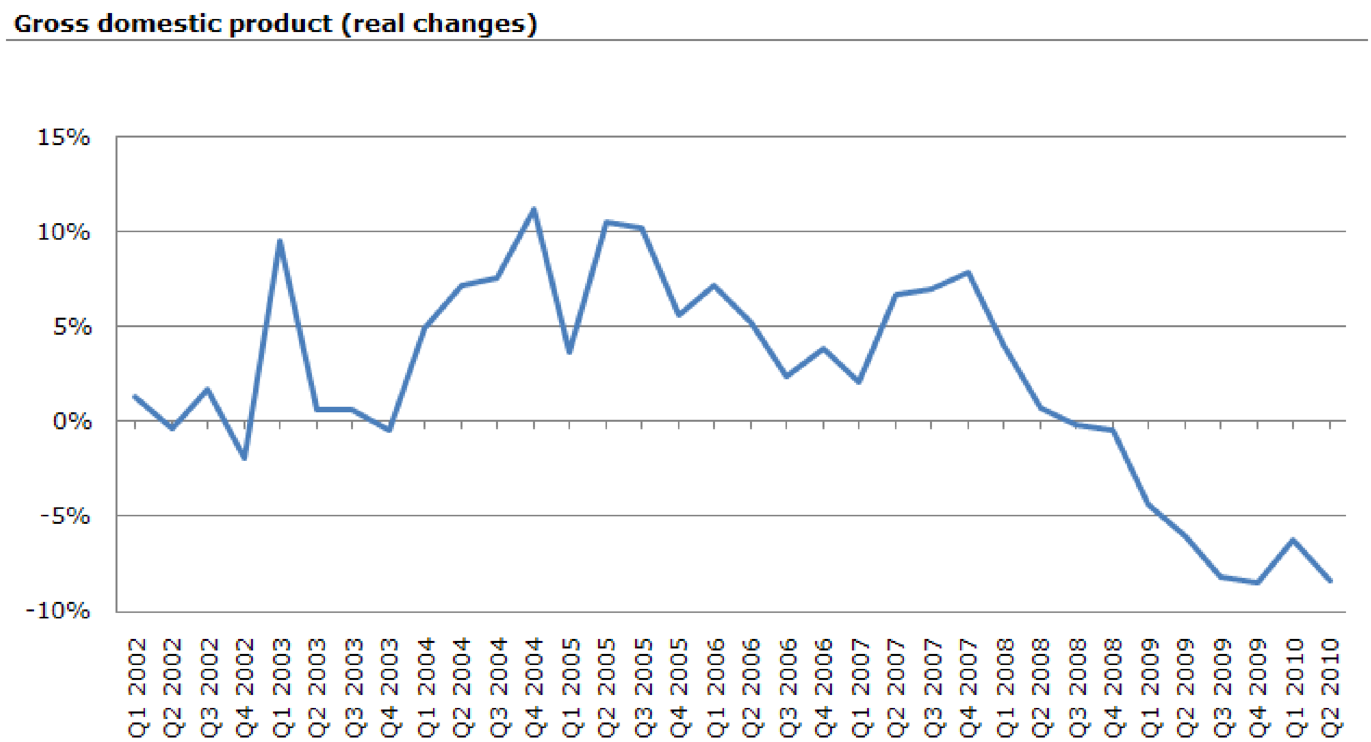
Source: Statistics Iceland

External trade contributes nothing. External trade contributed nothing to economic growth this time around. Exports of goods and services grew by 3% while imports rose 5% - the overall effect on economic growth is zero. It is interesting to note that imports increased at the same time as national expenditure (private consumption and investment) is down 9% between years. The main reason is the growth in imported services (imports of goods are virtually unchanged).



Source: Statistics Iceland

Have we reached the bottom? Given the latest economic figures, it is too early to say whether we have reached the bottom as national expenditure and GDP are still contracting. Since the economic collapse in the fourth quarter of 2008, GDP has shrunk by 14%.



Source: Statistics Iceland

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