The Economy ticking along nicely: 2.4% economic growth in first half of 2012

- Gross domestic product grew in real terms by 2.4% during the first half of 2012 compared with the same period last year. This falls just short of the Central Bank of Iceland's forecast as a result of the lower than expected contribution of foreign trade. However, growth in domestic demand (private consumption + public consumption + investment) exceeded expectations. Statistics Iceland has revised its GDP figures for 2011 from 3.1% to 2.6%.

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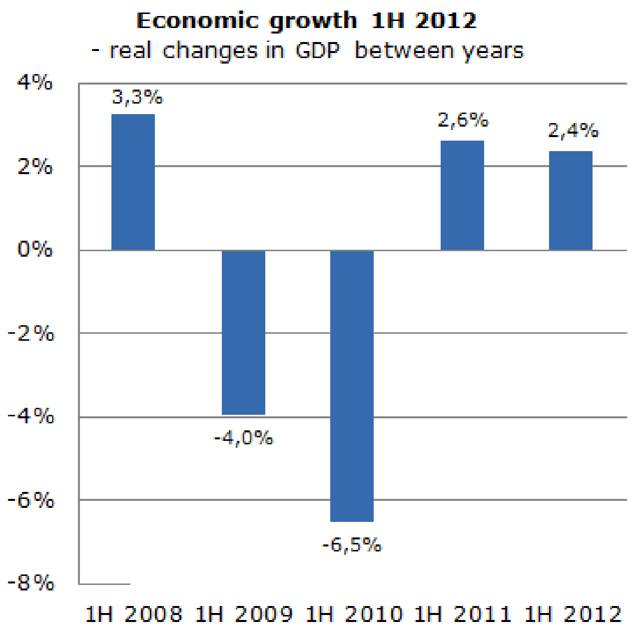
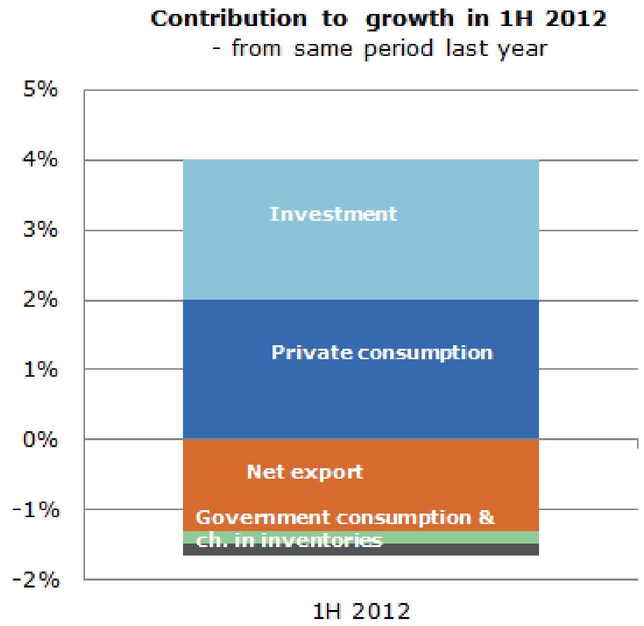
GDP during the first half the year was driven by private consumption and investment, each contributing 2% to economic growth. Foreign trade on the other hand had a negative effect on economic growth, meaning that imports of goods and services grew at a greater rate than exports in the first six months of the year. Since changes in inventory have an unusually large impact on GDP figures in the first two quarters (inflating economic growth in the first quarter and having the opposite effect in the second quarter), it is better to look at the combined total of the first two quarters in order to gain a clearer picture of the situation.

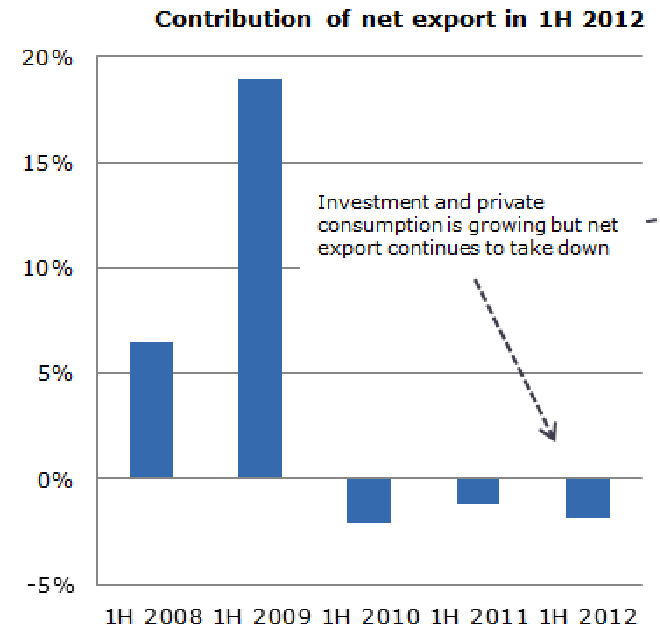


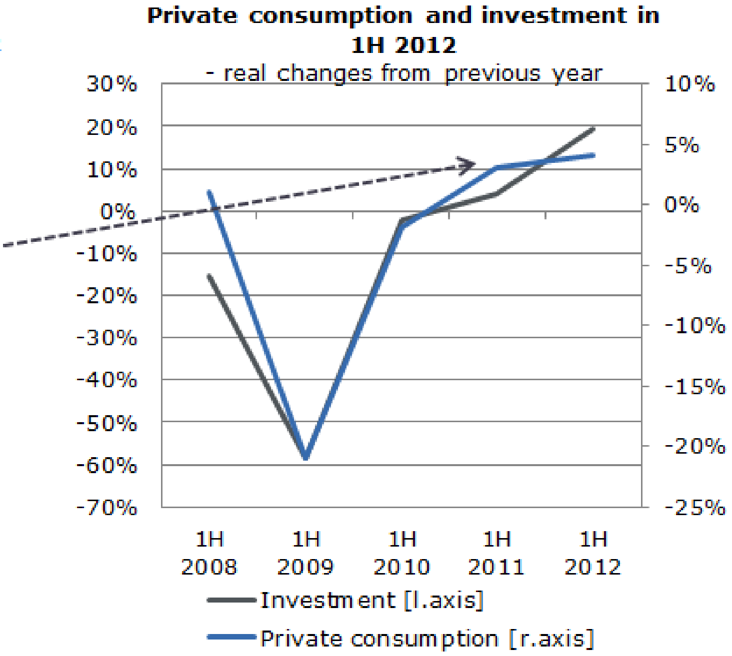


Source: Statistics Iceland

Ticking along nicely

Overall the economy performed similarly in the first half of 2012 to what it did in 2011. As was the case last year, private consumption and investment were the main drivers in the economy, while economic growth remained similar between years. Foreign trade had a negative impact on economic growth, as it did last year, which could be a cause for concern if growth is largely driven by rising private consumption. When economic activity is picking up it is normal for imports to increase. However there are indications that Icelandic consumers are spending proportionately more abroad, which is not a positive development.

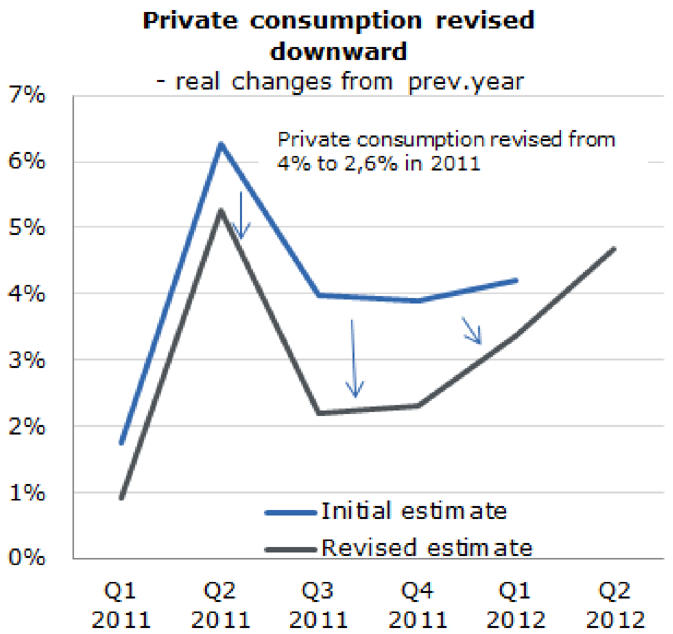


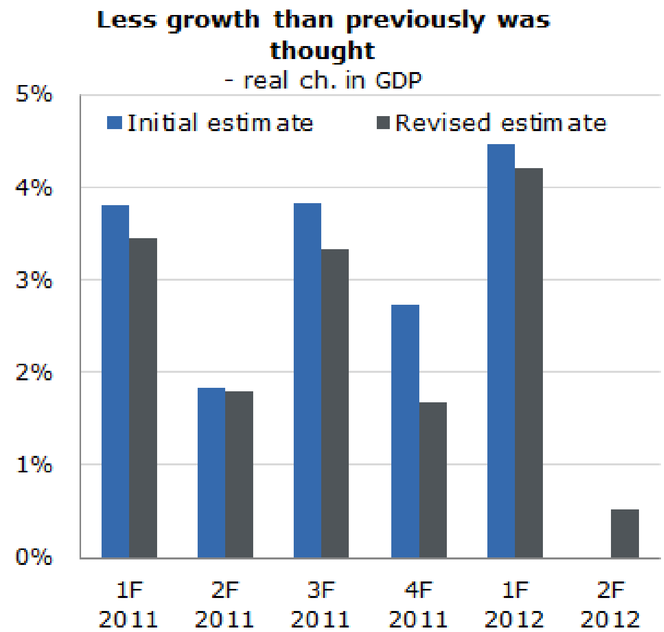


Source: Statistics Iceland

Economic growth in 2011 was not 3.1% but 2.6%

The revised GDP figures for 2011 show 2.6% economic growth instead of 3.1% as was previously estimated. The downward revision is due to less private consumption than was previously thought. This change affects the economic forecasts of analysts, including the Central Bank of Iceland, as it is clear that GDP was lower in ISK in 2011 than originally estimated. This revision came as somewhat of a surprise, since estimates of investment figures have been more prone to change as time passes than consumption figures. Therefore we think it likely that the Central Bank's macroeconomic model will predict lower economic growth in the next issue of the Monetary Bulletin (unless changes occur in other criteria of the model).

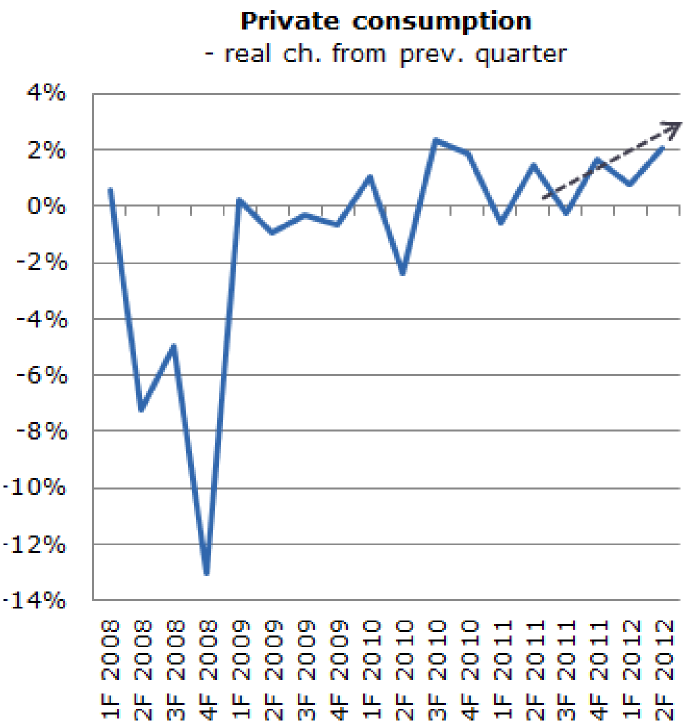


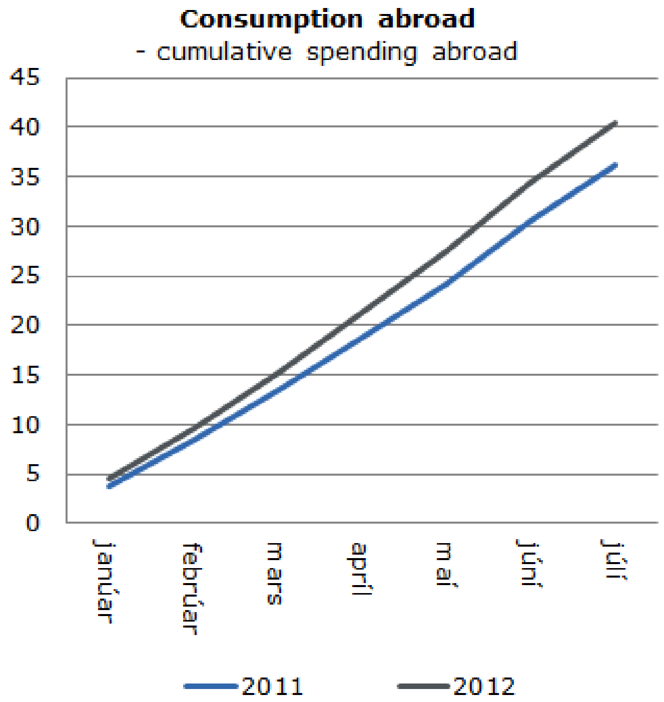


Source: Statistics Iceland

Private consumption continues to grow

Household consumption was up 4% in the first half of 2012 compared with the same period last year. Overall it appears that private consumption is ticking along nicely and has been growing the last couple of quarters. It is important to consider where this growth is coming from. Figures for the first seven months of 2012 indicate a strong increase in the use of Icelandic payment cards used abroad. This is consistent with the rather discouraging foreign trade figures for the first half of 2012.

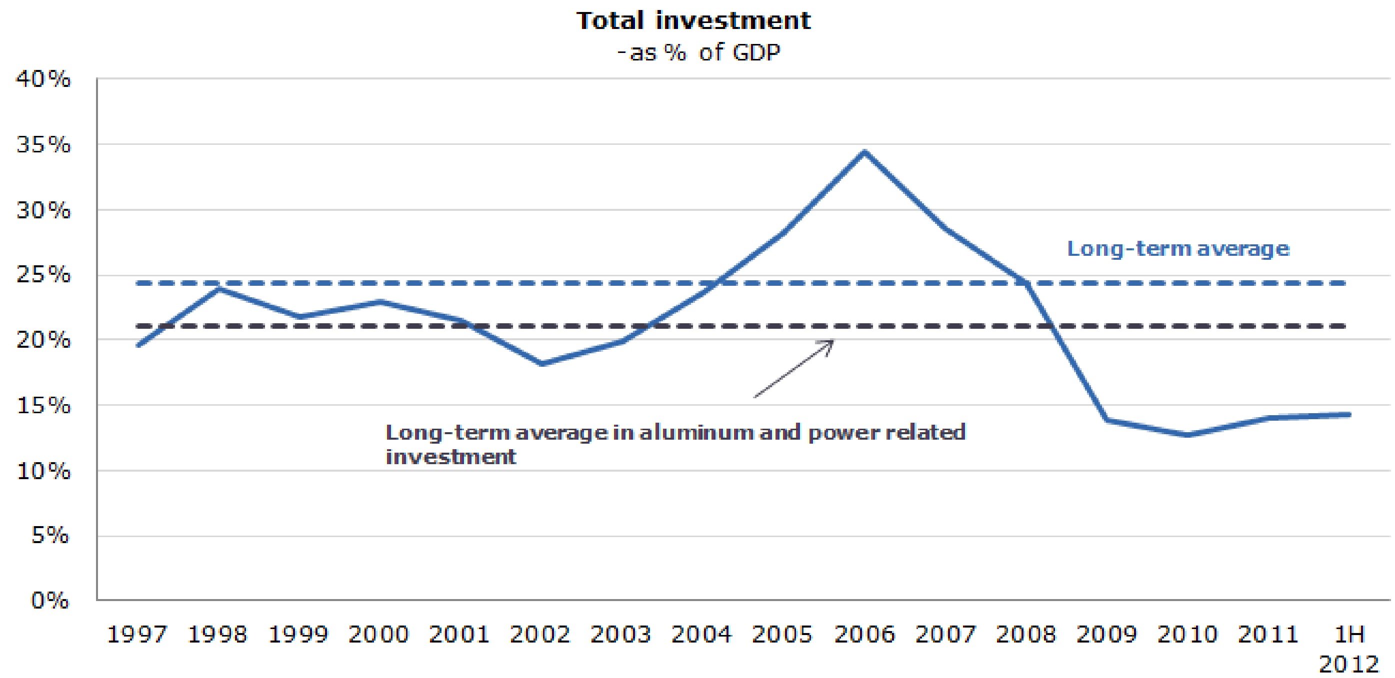




Source: Statistics Iceland

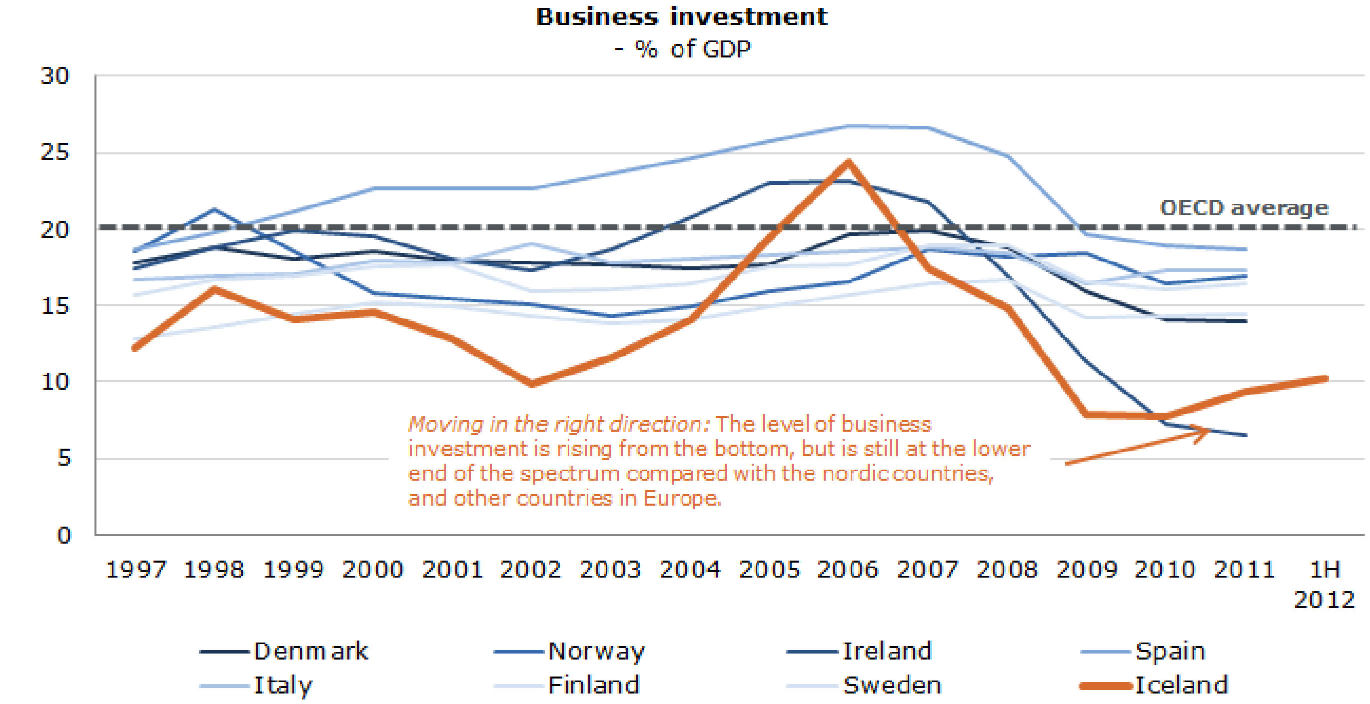
Investment at absolute minimum

Investment grew by 19% during the first half of 2012 compared with the same period last year. This is a slightly more robust growth than in 2011 when investment grew by 13% over the whole year. Although investment is on the right track, it should be remembered that the investment level is at an absolute minimum as a percentage of GDP. Investment currently measures around 14%, while the long-term average is around 24% of GDP, and 21% when adjusted for investments in the aluminium and energy sectors.



Source: Statistics Iceland

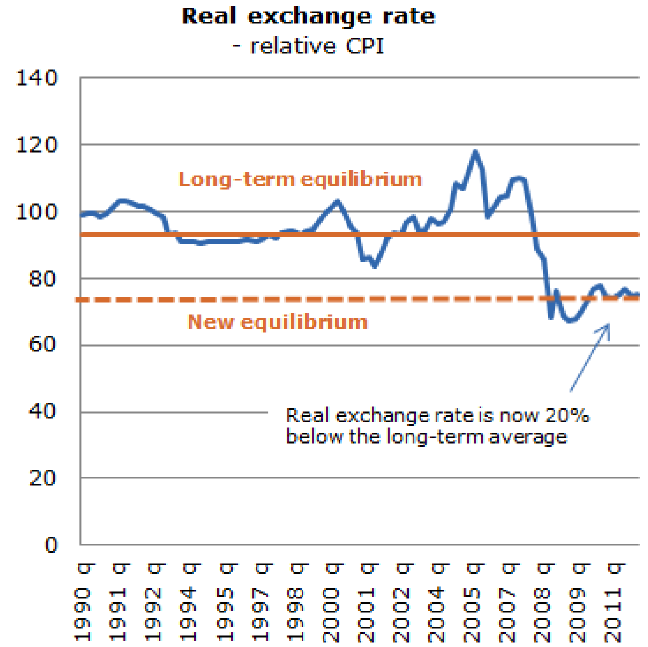
Business investment (representing 70% of total investment in Iceland) is still well below the long-term average (14% of GDP) and is historically very low compared with other comparable countries. During the last quarter of a century investment among OECD countries has been around 20% of GDP. Although total investment in Iceland has been growing the last six quarters (based on year-on-year change) there is still a long way to go before investment reaches previous levels.

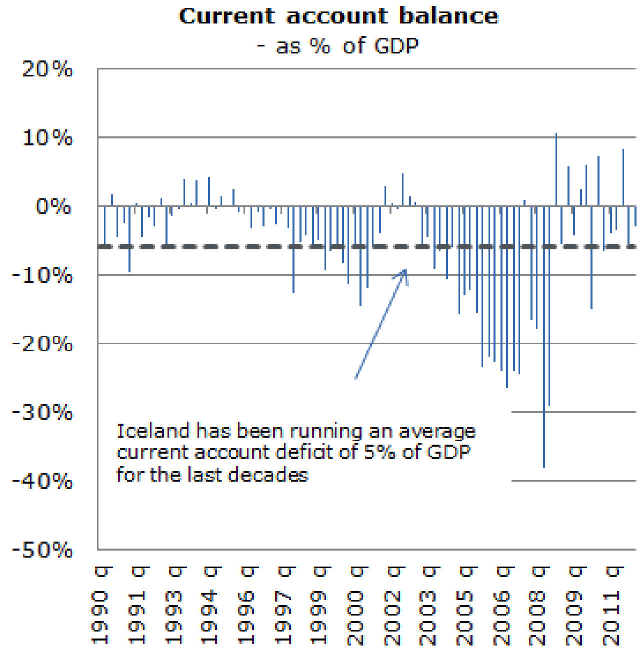


Source: Statistics Iceland

Contribution made by foreign trade

Foreign trade has had a negative impact on economic growth. Exports are subject to certain volume restrictions as the vast majority of exports are related to fisheries and aluminium. At the same time imports are recovering, with imports outgrowing exports in over the last two years. In our view there are signs that the ISK is too strong and developments in foreign trade give us no reason to change that view. We believe it is important that the real exchange rate of the ISK will remain low in the coming years in order to prevent Iceland from running a current account deficit similar to what we were used to in the last couple of decades.





Source: Central Bank of Iceland

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