

## IV Demand and GDP growth

Revised figures show that 2017 GDP growth was stronger than previous figures had indicated and growth for H1/2018 was faster than had been forecast in the August *Monetary Bulletin*. Although the pace of GDP growth is expected to slow in H2, the outlook is for stronger growth in 2018 as a whole. The composition of GDP growth is changing as well. Private sector demand is growing slower than before, whereas public sector demand growth has been more resilient. In addition, the outlook is for a positive contribution of net trade to output growth for the first time in five years. In part, this is because demand has shifted increasingly towards domestic production.

### GDP growth and domestic private sector demand

#### GDP growth exceeded expectations in H1/2018

According to revised figures from Statistics Iceland, GDP growth measured 4% in 2017, about 0.4 percentage points more than previous figures had suggested. Growth slowed from 2016 onwards but gained pace again in H1/2018. Figures from Statistics Iceland indicate that GDP growth measured 7.2% in Q2/2018 and 6.4% in H1 as a whole. Growth in domestic demand eased from the 2017 level, but the contribution from net trade was much more favourable, owing to a sizeable contraction in import growth and a smaller contraction in export growth.<sup>1</sup>

The forecast in the August *Monetary Bulletin* assumed that GDP growth would increase in H1, but less than Statistics Iceland figures indicate. On the whole, consumption and investment increased in line with the Bank's forecast, reflecting offsetting effects of weaker private consumption versus stronger business investment, while the contribution of net trade was more favourable than had been anticipated (Chart IV-1). In addition, the contribution from inventory changes was greater than had been forecast in August, although it is expected to even out in H2, resulting in a broadly neutral contribution for the year as a whole.

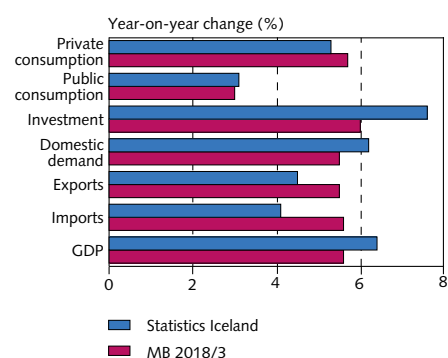
#### Private consumption growth weaker than expected ...

Private consumption grew by 5.3% in H1/2018, somewhat less than in the previous two years but still a full 2 percentage points above its long-term annual average. This is slightly below the August forecast of 5.7% growth for the half.

#### ... and set to continue easing

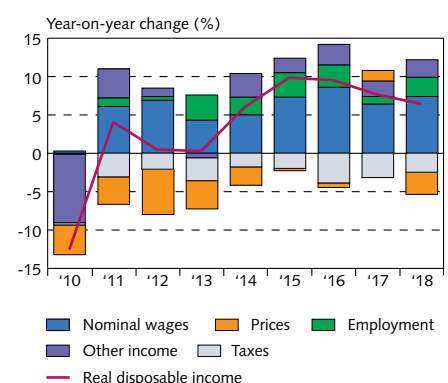
Real disposable income is estimated to have risen by 7.7% in 2017, concurrent with strong job growth and rising wages (Chart IV-2).<sup>2</sup> Dis-

Chart IV-1  
National accounts H1/2018



Sources: Statistics Iceland, Central Bank of Iceland.

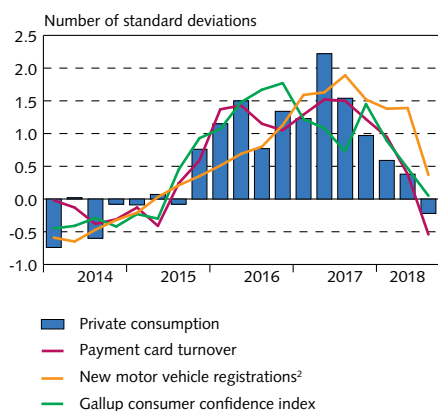
Chart IV-2  
Real disposable income and its main components 2010-2018<sup>1</sup>



1. The contribution of the main underlying components to annual changes in real disposable income is calculated based on each component's weight in disposable income. The combined contribution of underlying components does not add up to the total change due to rounding and incomplete income accounts for households from Statistics Iceland. Central Bank baseline forecast 2017-2018.  
Sources: Statistics Iceland, Central Bank of Iceland.

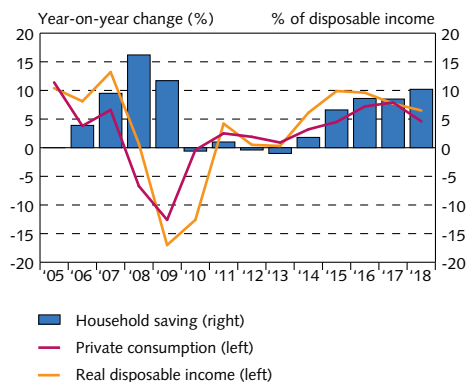
1. This year marks a decade since the financial crisis struck in autumn 2008. In view of this, Box 2 presents an assessment of the post-crisis output loss.
2. Statistics Iceland's figures on households' disposable income for the prior year are usually available by the time the fourth issue of *Monetary Bulletin* is published; however, because of delays in publishing the Government accounts, these figures are not available at present.

Chart IV-3  
Private consumption and its indicators<sup>1</sup>  
Q1/2014 - Q3/2018



1. The data are scaled so that their average from 2011 is 0 and the standard deviation is 1. Private consumption and payment card turnover are annual changes, while new motor vehicle registrations and the Gallup Consumer Confidence Index are seasonally adjusted time series.  
2. New motor vehicle registrations net of car rental agencies' applications for new registrations in each quarter.  
Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Chart IV-4  
Private consumption, disposable income,  
and saving 2005-2018<sup>1</sup>



1. 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. Central Bank baseline forecast 2018.  
Sources: Statistics Iceland, Central Bank of Iceland.

posable income growth is assumed to ease this year but remain robust, at 6.5%. Households' assessment of their own employment position and the general economic outlook appears to have deteriorated in the recent past, however, and there are signs of a change in sentiment, as can be seen in weaker payment card turnover and a year-on-year reduction in new motor vehicle registrations (Chart IV-3). It is possible that the market is saturated after the past several years' surge in new car registrations and household purchases of consumer durables. Private consumption growth is expected to ease still more in H2, and the growth rate for 2018 as a whole is projected at 4.6%, or 1 percentage point below the August forecast. This implies that household saving is set to increase further (Chart IV-4).

### Investment growth outpaces forecasts ...

Investment grew by 7.6% year-on-year in H1/2018, outpacing the Bank's August forecast. Growth in business investment was considerably stronger than had been projected, but on the other hand, growth in residential and public investment was weaker. Business investment grew by 5.6% in H1, contrary to the Bank's August forecast of a contraction. The main difference was in general business investment — i.e., investment excluding energy-intensive industry and ships and aircraft — which turned out stronger than projected. Investment in ships and aircraft increased somewhat in H1, and it appears that energy-intensive investment for the year as a whole will be more front-loaded than the Bank had assumed in August.

### ... but businesses plan less investment this year than they did in the spring

The results of the Bank's survey of corporate investment plans, carried out this autumn, suggest that the investment plans covered by the survey will be smaller in scope than in 2017 (Table IV-1). The greatest differences are in transport and tourism and in retail and wholesale trade. In comparison with the Bank's spring survey, the results suggest that on the whole, firms are planning less investment this year, although this is due in particular to changes in plans by a few large companies in these two sectors. The survey results are interesting,

Table IV-1 Survey of corporate investment plans (excluding ships and aircraft)<sup>1</sup>

Largest 99 (102) firms Amounts in ISK billions	2017	2018	2019	Change between	Change
				2017 and 2018 (%)	between 2018 and 2019 (%)
Fisheries (15)	14.4	12.8	14.3	-10.8 (-14.3)	11.4
Manufacturing (16)	8.5	6.6	5.5	-23.0 (-19.5)	-17.0
Wholesale and retail trade (21)	8.6	7.5	8.9	-12.9 (13.5)	19.5
Transport and tourism (8)	28.7	18.1	20.4	-36.7 (3.9)	12.3
Finance/Insurance (9)	3.5	5.4	6.0	54.4 (28.2)	9.9
Media and IT (6)	7.6	7.8	7.6	3.1 (-2.0)	-3.3
Services and other (24)	19.0	14.3	16.1	-24.9 (-25.5)	13.2
Total 99 (102)	90.3	72.6	78.8	-19.6 (-4.8)	8.6

1. In parentheses are figures from the last survey, in which respondents from 102 firms were asked about investment plans for 2017-2018 (*Monetary Bulletin* 2018/2). A paired comparison between years is presented, but because the sample could change between surveys, this could affect the results.

Source: Central Bank of Iceland.

given that general business investment was stronger than forecast in H1/2018. It should be borne in mind, though, that the survey does not include hotel construction, where activity has been brisk this year.

Gallup's survey of the position and future prospects of Iceland's 400 largest firms, carried out in September, gives a similar view of businesses' investment plans. As compared with Gallup's February survey, there was an increase in both the number of respondents planning to step up investment and the number planning to scale it down. The increase in the latter group was larger, and for the first time since September 2013, the number of executives who expect to cut back on investment exceeded the number planning an increase. According to the Gallup survey, companies that have scaled down investment plans since the last survey are primarily in the transport, transit, and tourism sector and in miscellaneous specialised services, which is in line with the Bank's survey (Chart IV-5). Companies in construction are more pessimistic than in the last survey as regards developments in domestic demand for their products in the next six months, indicating that the past few years' surge in building and construction investment will begin to ease (Chart IV-6).

### Share of credit-financed business investment declines in 2018

The Bank's investment survey reveals that about 30% of this year's investment will be credit-financed, about 8½ percentage points less than in 2017, with tourism and transport companies and contracting firms reducing their share of credit financing the most. In comparison with the Bank's spring survey, the share of planned credit financing has fallen by about 5 percentage points. The survey suggests that the share of credit financing will pick up again in 2019, to 38%, about the same level as in 2016-2017, with much of the increase from fisheries and contracting firms.

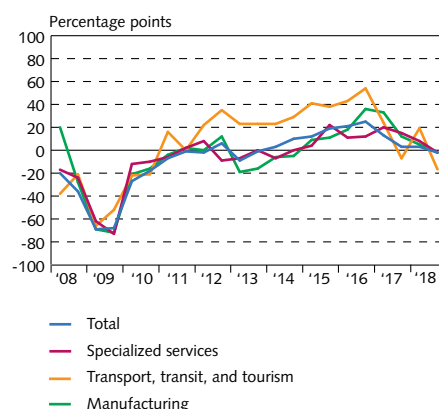
### Business investment set to decline in 2018

Based on the investment survey and other indicators of business investment and investment plans, it is assumed that business investment will contract by 3% in 2018 as a whole. The forecast assumes that growth in general business investment will slow markedly and that other types of business investment will also contract in H2, in line with leading indicators (Chart IV-7). Energy-intensive investment and investment in ships and aircraft appear likely to be weaker this year than in 2017; however, this will be offset in part by a 2% increase in general business investment. According to the forecast, general business investment will turn out somewhat stronger than the investment survey implies. In this context, it should be borne in mind that the survey does not include small businesses and that the largest changes in the survey stem from a few large companies' changes in plans. Weaker growth in general business investment in H2 is more in line with other indicators, such as the Gallup corporate sentiment survey.

### Signs of increased growth in residential investment

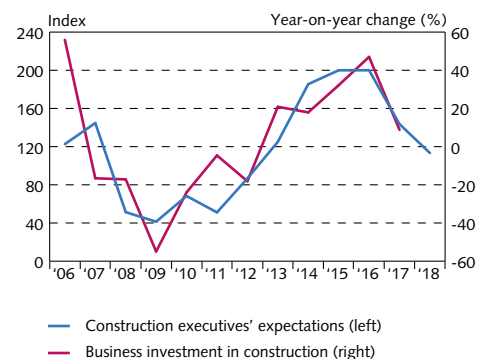
Residential investment grew by just over 24% in H1/2018 and has been one of the mainstays of investment growth in the recent term,

Chart IV-5  
Investment: balance of opinion, by sector<sup>1</sup>  
Q1/2008 - Q3/2018



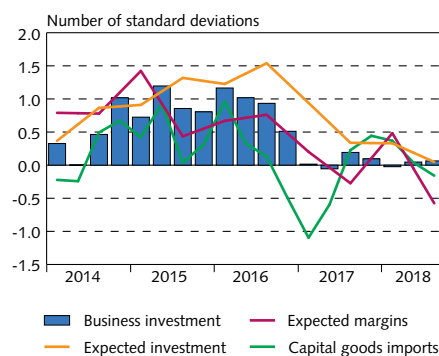
1. Balance of opinion is the share who expect investment to increase between years less the share who expect it to decrease.  
Source: Gallup.

Chart IV-6  
Expectations within construction sectors and developments in construction 2006-2018<sup>1</sup>



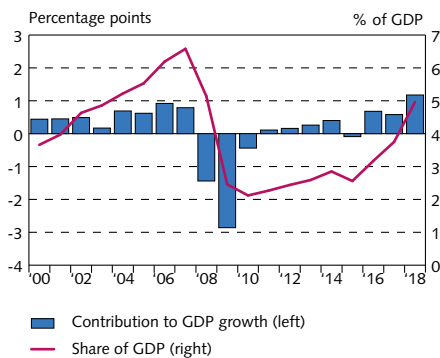
1. Expectations of executives in the construction and utilities sectors on developments in domestic demand for their firms' goods and/or services in the next six months. The index takes a value between 0 and 200, with a value of 100 indicating parity between those expecting an increase and those expecting a decrease.  
Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Chart IV-7  
Business investment and its indicators<sup>1</sup>  
Q1/2014 - Q3/2018



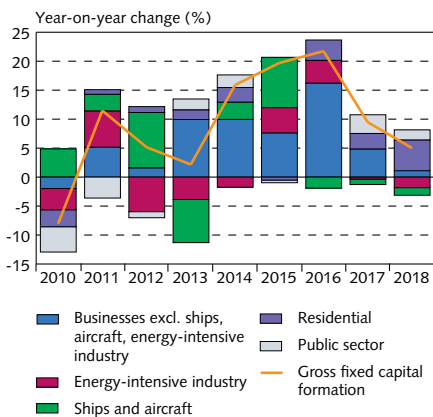
1. The data are scaled so that their average from 2006 is 0 and the standard deviation is 1. Two-quarter moving average for annual change in business investment and imports of investment goods. Figures on expected margins (EBITDA) and investment taken from measurements of expectations six months ahead of executives from Iceland's 400 largest companies. Central Bank baseline forecast Q3/2018 for business investment.  
Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Chart IV-8  
Residential investment 2000-2018<sup>1</sup>



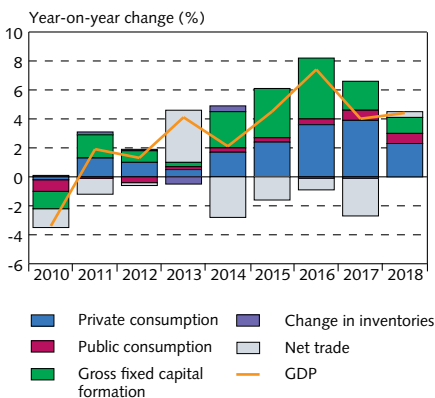
1. Central Bank baseline forecast 2018.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-9  
Gross fixed capital formation and contribution of main components 2010-2018<sup>1</sup>



1. Central Bank baseline forecast 2018.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-10  
GDP growth and contribution of underlying components 2010-2018<sup>1</sup>



1. Central Bank baseline forecast 2018.  
Sources: Statistics Iceland, Central Bank of Iceland.

driven by growing household real earnings and rising house prices. The increase in H1 was smaller than had been projected in August, however. In spite of this, residential investment is forecast to grow by nearly a third in 2018 as a whole, as was assumed in August. This is based in part on a recent count taken by the Federation of Icelandic Industries of flats under construction, which indicates that the number of fully finished properties will increase strongly this year. If the forecast materialises, the contribution of residential investment to year-2018 GDP growth will rise above its pre-crisis peak (Chart IV-8).

### Investment growth to ease this year

After a few strong years, investment growth slowed markedly in H1/2018, owing in particular to weaker growth in business investment. For 2018 as a whole, investment spending is expected to increase by a total of 5%, roughly half of last year's growth rate. Growth in general business investment is weakening apace, and in the energy-intensive industry and in ships and aircraft, investment spending is contracting. This is offset by robust growth in residential and public investment (Chart IV-9). If the forecast materialises, the investment-to-GDP ratio will be close to 23% this year, some 1½ percentage points above its long-term average.

### GDP growth to pick up in 2018 despite weaker domestic demand

In H1/2018, GDP growth was considerably stronger than previously forecast, as is discussed above. The outlook is for a slowdown in H2, however, and the baseline forecast assumes that growth for 2018 as a whole will measure 4.4%. This is 0.4 percentage points more than in 2017, in spite of reduced growth in domestic demand and exports. Demand appears to have shifted increasingly to domestic production, as can be seen in a contraction in goods imports in H1 and signs of a continued contraction in Q3. The outlook is for the contribution of net trade to output growth to be positive by 0.4 percentage points in 2018, after having been markedly negative in recent years (Chart IV-10). This is also a change from the Bank's August forecast. The outlook is for GDP growth to be 0.8 percentage points above the August forecast, even though domestic demand growth will be 0.5 percentage points weaker. The GDP growth outlook for coming years is broadly unchanged, however; as before, output growth is expected to ease towards its long-term trend rate of 2.7%.

### Public sector

#### Public consumption growth expected to remain robust

Public consumption grew by 3.1% in H1/2018, about the same as in 2017 and in line with the forecast in the August *Monetary Bulletin*. Developments in H2 are projected to be broadly the same as in H1, with growth for the year as a whole measuring 2.9%. The forecast assumes that growth in central and local government consumption will be similar. On the other hand, public investment was considerably less than previously estimated, due in part to the lag between increased budgetary allocations and project implementation. The forecast therefore assumes that public investment will expand faster in H2, as budg-

etary allocations are used for development, and that the increase for 2018 as a whole will measure just over 12%. Public consumption and investment combined are expected to grow by 4% this year, and their contribution to GDP growth is about 1 percentage point, somewhat less than in 2017 (Chart IV-11).

### Treasury outcome improves slightly from the previous estimate

The Treasury outcome for this year is set to be well in line with the assumptions in the National Budget, which was passed with a surplus of 33 b.kr. There are several changes in composition of revenues and expenditures, however. For example, regular primary income will be 7 b.kr. less than was provided for in the Budget, whereas dividends paid by the State-owned commercial banks will be increased by just over 6.5 b.kr., to 37.7 b.kr. Expenditures other than interest expense will be greater than was assumed in the Budget, and interest expense will be lower, and the overall impact on the Treasury outcome will be negative by 0.1% of GDP. This year's outcome will therefore be slightly better than last year's. It is assumed that there will be an underlying surplus of 0.8% of GDP, whereas the surplus on the underlying primary balance will be 2.4% of GDP (Chart IV-12).

### Fiscal stance to tighten marginally in 2018 but set to ease slightly again in the following two years

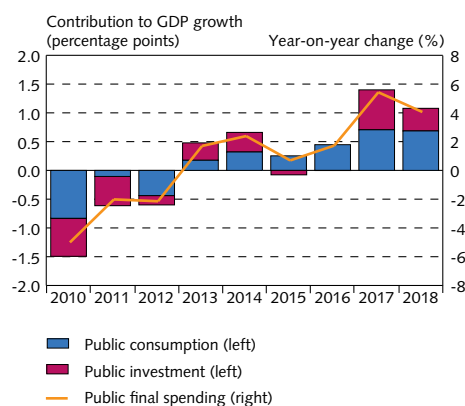
In terms of the cyclically adjusted primary balance, the fiscal stance has eased considerably in the past three years. However, if the Bank's forecast materialises, that will change this year, and the stance will tighten slightly (Chart IV-13) although less than was estimated this when the Bank last assessed the fiscal stance. Based on the fiscal budget proposal for 2019, however, the fiscal stance can be expected to ease again during the year, albeit less than was assumed last spring (for further discussion of the budget proposal, see Box 3). According to current estimates, the stance is also set to ease slightly in 2020, although this will reverse in part in 2021. Over the period as a whole, the outlook for the fiscal stance is broadly unchanged since the spring, however. General government debt will therefore continue to decline broadly as has been assumed in the past.

## External trade and the current account balance

### Export growth in H1 weaker than assumed in August

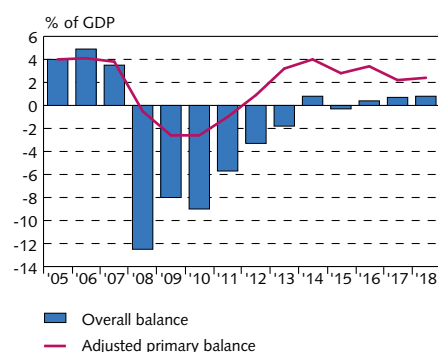
Exports of goods and services grew by 4.5% year-on-year in H1/2018. Goods exports grew by over 6%, owing mainly to marine product exports, which reflects in large part the contraction early in 2017 resulting from the fishermen's strike. Services exports grew by just over 3%, somewhat less than in recent years, due largely to slower growth in tourism. Growth in total exports in H1 was 1 percentage point weaker than was assumed in August, owing in large part to Statistics Iceland's revision of previously published export figures, which show that export volumes were higher in 2017 than previously thought. Goods and services export volumes in H1/2018 were therefore well in line with the Bank's August forecast. The composition of services exports was slightly different than projected, however. The transport and transit

Chart IV-11  
Public consumption and investment 2010-2018<sup>1</sup>



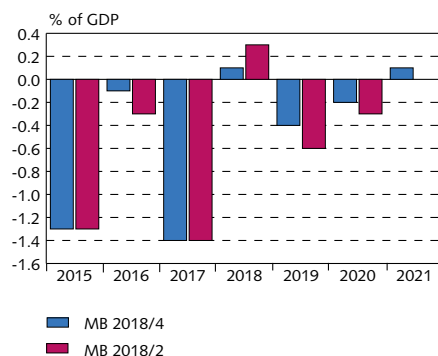
1. Central Bank baseline forecast 2018.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-12  
Treasury balance 2005-2018<sup>1</sup>



1. The primary balance is adjusted for one-off items. In 2016 to 2018, both the overall and primary balance is adjusted for stability contributions, accelerated write-downs of indexed mortgage loans, special payment to LSR A-division and dividends in excess of the National Budget. Central Bank baseline forecast 2018.  
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

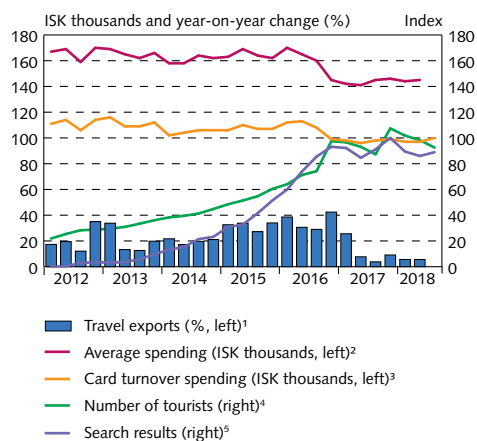
Chart IV-13  
Change in central government cyclically adjusted primary balance 2015-2021<sup>1</sup>



1. Primary balance is adjusted for one-off items (stability contributions, accelerated write-downs of indexed mortgage loans, special payment to LSR A-division and dividends in excess of the National Budget). Central Bank baseline forecast 2018-2021.  
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.



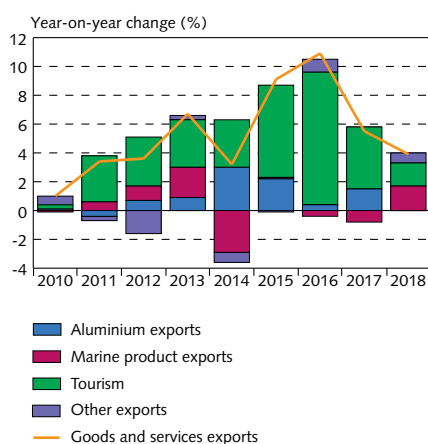
Chart IV-14  
Indicators of tourism sector activity  
Q1/2012 - Q3/2018



1. Year-on-year change of travel exports, at constant prices. 2. Seasonally adjusted average spending per tourist in Iceland, according to services export data. 3. Seasonally adjusted payment card turnover spending per tourist (excluding international airfares and public levies). 4. Seasonally adjusted passenger departures via Keflavik Airport. 5. A principal component model combining the frequency of five different Google search strings relating to travel to Iceland (seasonally adjusted).

Sources: Centre for Retail Studies, Google Trends, Icelandic Tourist Board, Isavia, Statistics Iceland, Central Bank of Iceland.

Chart IV-15  
Exports and contribution of subcomponents  
2010-2018<sup>1</sup>



1. Aluminium exports as defined in the national accounts. Tourism is the sum of "travel" and "passenger transport by air". Central Bank baseline forecast 2018.

Sources: Statistics Iceland, Central Bank of Iceland.

component contracted unexpectedly year-on-year in H1, for the first time since 2008. On the other hand, both the travel component and other services exports grew more than anticipated.

### Outlook for weaker growth in services exports in 2018 ...

Growth in services exports has lost pace in the recent term, after a surge in the past few years, particularly in tourism. There are signs that growth will continue this year, but at a more moderate pace than was forecast in August. The reduced growth rate is due in particular to base effects stemming from the aforementioned revision of last year's figures. It is also assumed that growth in tourism will ease as a result of a contraction in the transport component of services exports. In spite of this, the tourism industry looks set to keep growing apace. The number of foreign tourists visiting Iceland was up year-on-year by 3.3% this summer and by 5.5% in the first nine months of 2018. The increase is considerably smaller than in recent years but more than industry analysts had expected. Other indicators also imply that tourism will continue growing this year. For instance, the number of people who used search engines to search for hotels in and flights to Iceland was about the same in Q3 as in the first half of this year (Chart IV-14). In addition, average spending per tourist increased slightly year-on-year in krónur terms in H1, and foreign nationals' payment card withdrawals in Iceland suggest as well that turnover per tourist was up slightly between years in Q2 and Q3. Spending per tourist is still somewhat less than in 2012-2015, however. The number of hotel bed-nights booked by foreign nationals has also increased between years. On the whole, then, the outlook is for growth in services exports to be broadly unchanged between H1 and H2, measuring 3.6% for the full year.

### ... but stronger growth in goods exports

Goods exports are forecast to grow by 4.2% this year, a full 1 percentage point more than in the August forecast, even though the increase in H1 was smaller than was projected then. The greatest difference was the prospect of more than 10% growth in marine product exports, which would be the strongest seen in decades and nearly 3 percentage points stronger than was forecast in August. The upward revision since August is due mainly to increased fish catches in Q3, but also to an increased demersal fish quota in the current fishing year, which began on 1 September. The outlook is therefore for goods and services exports to grow by 3.9% in 2018 as a whole, which is broadly in line with the August forecast (Chart IV-15).

### Import growth has eased after several strong years

The outlook is for import growth to ease faster in 2018 than previously projected, after several years of robust growth. The slowdown is due in particular to weaker growth in domestic demand, but by the same token, demand appears to be shifting increasingly towards domestic production. Imports of goods and services grew by 4.1% year-on-year in H1, some 1½ percentage points less than was assumed in the August forecast. The main factor here was a 1% contraction in goods imports, which in turn was due to a year-on-year contraction in im-

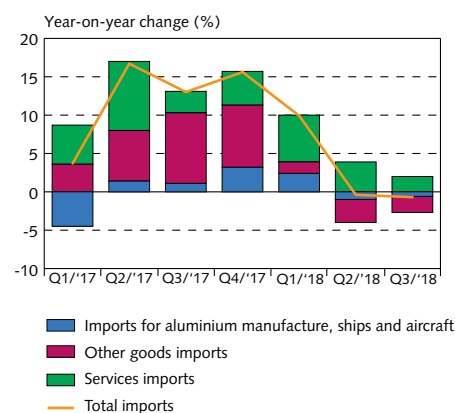
ports of passenger cars, other consumer durables, and commodities and operational inputs. Growth in imports of most goods has eased, apart from fuels and lubricants, which have increased between years. Preliminary external trade figures from Statistics Iceland also suggest that goods imports contracted still further year-on-year in Q3 (Chart IV-16). Counteracting the contraction in goods imports, services imports were somewhat stronger in H1 than was anticipated in August, and appear set to grow swiftly in 2018 as a whole. For instance, travel agency figures indicate a continued year-on-year increase in Icelandic nationals' departures via Keflavik Airport. For this reason, the Bank's forecast of 2018 goods and services imports has been revised significantly since August. Growth is now forecast at only 3.3%, as opposed to 6% in August. If the forecast materialises, the contribution of net trade to output growth will be positive by 0.4 percentage points instead of being negative by just under 1 percentage point, as was assumed in August. This would be the first positive contribution from net trade in five years.

### Surplus on goods and services trade set to grow in 2018

The surplus on combined goods and services trade measured 1% of GDP in H1/2018, slightly less than was forecast in August and less than in H1/2017, when it measured 1.9% of GDP. The trade surplus for 2018 as a whole is now estimated at 3.6% of GDP, 1.2 percentage points more than was forecast in August. A smaller goods account deficit, owing to reduced imports, is the main reason for the changed outlook, although it is offset in part by a smaller surplus on services trade.

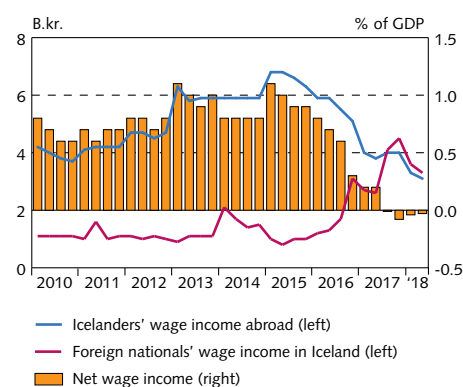
2018 will be the tenth consecutive year with a sizeable current account surplus. The surplus has been shrinking, however, in the recent term. In H1/2018, it measured 0.4% of GDP, down from 1.6% for the same period in 2017 and 3.8% in H1/2016. In addition to the shrinking surplus on goods and services trade, the balance on primary and secondary income reversed last year from a surplus to a deficit. Income from foreign direct investment (FDI) has contracted more than FDI expense. Furthermore, Icelanders' foreign wage income has contracted in recent years, at the same time that foreign nationals' wage income in Iceland has increased due to the appreciation of the króna and the rise in the number of foreign workers (Chart IV-17). The primary and secondary income balance is also expected to be negative this year, but to a lesser degree than was forecast in August. The current account surplus is still expected to shrink, although more favourable goods trade will offset it. The surplus is projected at 2.8% of GDP this year, as opposed to the 1.3% forecast in August (Chart IV-18). If the forecast materialises, gross national saving will measure 25½% of GDP in 2018, as in 2017.

Chart IV-16  
Imports and contribution of subcomponents<sup>1</sup>  
Q1/2017 - Q3/2018



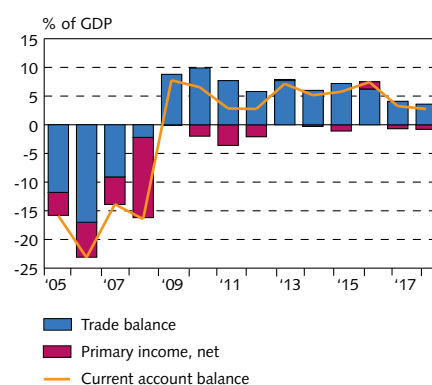
1. Aluminium imports according to national accounts definition. Central Bank baseline forecast Q3/2018.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-17  
Net wage income  
Q1/2010 - Q2/2018



Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-18  
Current account balance 2005-2018<sup>1</sup>



1. Including secondary income. Current account 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). Central Bank baseline forecast 2018.  
Sources: Statistics Iceland, Central Bank of Iceland.