30. ICELAND

Uncertainties persist amid a tentative recovery

Economic recovery has continued in the first half of 2011….

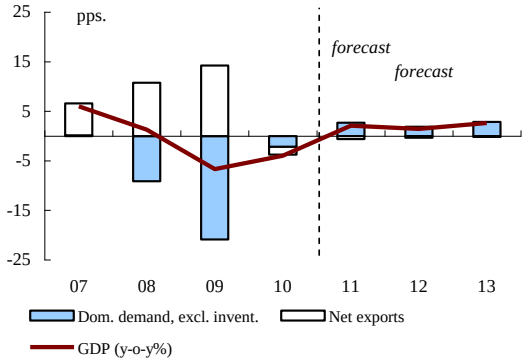
Following the collapse of its banking sector in October 2008, Iceland went into a long and deep recession. Real GDP declined by 6.7% in 2009 and by 4% in 2010, driven by a strong adjustment in domestic demand. The recession bottomed out in the second half of 2010 and the economy started to recover mildly, based on stronger private consumption and exports. In the first half of 2011, the recovery continued with real GDP growing at 2.5%. However, the pace of recovery is faltering and uncertainties continue to persist. Annual growth decelerated in the second quarter of 2011 compared to the first, as investment spending remained subdued. Export performance deteriorated while imports continued to grow markedly, while private consumption was buoyed by temporary measures.

High-frequency indicators for the third quarter present a mixed picture of the economic situation. Consumer confidence indicators dropped, the number of corporate insolvencies doubled in July on a year-on-year basis and most of Iceland's trading partners have revised downwards their economic forecasts. On the other hand, tourism has performed particularly well during the summer months and there were indications for a rise in private spending.

… with household spending being supported by temporary measures…

The outlook for domestic demand in 2011 has improved somewhat compared to the spring forecast due to stronger private consumption. However, this improvement is expected to be short-lived as private consumption in 2011 is largely driven by transitory factors. These include one-off pay increases related to wage settlements, extraordinary mortgage interest allowances, temporary withdrawals of savings from voluntary pension schemes, as well as one-off debt relief measures provided in the context of debt restructuring. While those factors provide temporary stimuli to private consumption, the three year wage agreement between social partners of May 2011 with relatively strong wage increases may have a more lasting positive impact on disposable incomes and on consumers' expectations. However, at the same time there are constraining factors as well. Consumer inflation has been on the rise recently, eating into households' real purchasing power. Many households will be left with a significant debt burden even after benefiting from various debt restructuring measures. The level of unemployment, although declining, is projected to stay far above pre-crisis levels. The 2012 budget contains further tax increases, reducing disposable incomes. Fiscal consolidation measures could lead to further cuts in benefits and transfers to households. Overall, this points to a deceleration of private consumption growth in 2012.

Graph II.30.1: **Iceland - GDP growth and contributions**



…while uncertainties persist with respect to firms' investment plans.

The corporate sector continues to suffer from financial problems and many firms still need to repair their balance sheets before being able to plan and finance new investment projects. A programme for debt restructuring of SMEs was set up in late 2010 to accelerate this process and create certainty among debtors and creditors. The scheme became fully operational in May 2011 and is supposed to assist a large number of firms in financial distress. Once corporate debt restructuring starts gaining pace, investment activity by SMEs is likely to unfold slowly. However, some investment related to the construction of the planned aluminium smelter at Helguvik is likely to be postponed beyond the forecast horizon, and investment in another energy company has been scaled down. Over the short term, a boost to investment is expected from the construction at the Straumsvik smelter. Moreover,

some private public partnership projects in transport and tourism are being elaborated, but their implementation is unlikely to start soon. In line with government's announcements, public investments are projected to decline again in 2011, before new projects will lead to some growth acceleration in 2012. Taking this into account, this forecast projects gross fixed capital formation to grow by around 7% in 2011 and around 9% in 2012.

A weaker global outlook limits prospects for stronger exports

Weaker than expected economic growth in Iceland's main trading partner countries has worsened the prospects for external demand and export growth. Moreover, growth in a large share of merchandise exports will continue to be subject to technical constraints (fishing quotas, capacity of aluminium smelters). Services exports are projected to benefit from stronger activity in the tourism industry.

In sum, the forecast projects a mild recovery in 2011, followed by a moderation of growth in 2012. Over the forecast horizon, domestic demand will be the main driver of growth whereas the contribution of net exports is likely to remain negative.

The inflation outlook has worsened…

After annual inflation fell below the Central Bank's official 2.5% inflation target in early 2011, it accelerated markedly to 5.7% in September as a result of rising oil, house and food prices and strong pass-through effects from unexpectedly high wage increases negotiated in the collective wage agreements of May. As those effects have worsened the inflation outlook, inflation expectations have risen markedly.

At the same time, a modest recovery of GDP growth and disposable incomes should not exert significant additional inflationary pressure over the medium term. The inflation outlook rests on the assumption of a continued exchange rate stabilisation, which has been a prime focus of monetary policy. As a result, annual average inflation is forecast to fall gradually over the forecast horizon.

…the trade balance will remain in surplus…

External deficits have shrunk markedly following the recession. The sharp contraction in domestic demand and depreciation of the exchange rate (around 50% during the crisis) contributed to a substantial improvement in the trade balance. The forecast projects a slight reduction in the trade surplus as of 2011, as a weaker outlook for Iceland's main trading partners limits external demand and export growth. The current-account balance is difficult to project, as net interest has appeared to be rather volatile. A large part of the net interest balance is accounted for by banks in winding-up proceedings. The forecast assumes that related accrued interest on the debt of those banks will be gradually reduced.

…but the labour market continues to struggle with relatively high, but falling, unemployment

The labour market remains weak, with unemployment close to historic highs. The unemployment rate rose from 7.8% in the first to 8.5% in the second quarter of 2011, only slightly lower than in the same period of 2010. The level of total employment fell by 1% y-o-y in the first quarter and rose marginally in the second quarter (0.3%).

The forecast projects that employment levels will respond to an increase in economic activity in 2011 and 2012 with some time lag. This will bring the unemployment rate down to below 7% by the end of the forecast period, still far above the average pre-crisis rate.

Public finance consolidation continues…

Following a marked deterioration of public finances in the wake of the crisis, the authorities took a series of fiscal consolidation measures with a view to reducing the fiscal deficit by around 3 pps. in 2010, from 10% of GDP in 2009. While the measures were successful in reining in spending and strengthening revenues, the revised general government deficit in 2010 remained at virtually the same level as in 2009 as a percentage of GDP, as the overall budget spending was affected by called guarantees for the Housing Financing Fund and the Agricultural Fund. The 2011 budget framework adopted in late 2010 initially foresaw new fiscal measures amounting to around 2.7% of GDP, with most of the adjustment on the expenditure side (2% of GDP). This changed the structure of fiscal adjustment

compared to 2009 and 2010, which was largely based on revenue measures. The first half of the year showed strong revenue performance and spending below projections. Total general government revenues increased by 3.9% and total spending by 0.9% y-o-y. The general government balance recorded a deficit of 2.5% of (annual) GDP, compared to a deficit of 3.1% in the first half of 2010.

…but fiscal policy has been relaxed somewhat in the course of 2011.

However, in the context of the three-year collective wage agreement adopted in spring, the government took additional spending commitments, comprising additional public investment as well as social protection, active labour market policy and education measures. As a result, expenditure adjustment measures in 2011 are expected to account for 1% of GDP instead of 2% as initially foreseen, and total spending is likely to exceed the initial level. Therefore, the budget balance for 2011 has been revised and a higher fiscal deficit is projected as compared to the spring forecast. A continuation of fiscal consolidation is, however, assumed for 2012 and 2013, leading to a gradual reduction of the fiscal deficit and allowing for a marginal decrease of the general government debt-to-GDP ratio below 90%.

Table II.30.1:

Main features of country forecast - ICELAND

	2010		Annual percentage change						
bn ISK	Curr. prices	% GDP	92-07	2008	2009	2010	2011	2012	2013
GDP	1537.1	100.0	3.6	1.3	-6.7	-4.0	**2.1**	**1.5**	**2.7**
Private consumption	787.7	51.2	3.8	-7.9	-14.9	-0.4	**3.8**	**1.5**	**2.0**
Public consumption	398.6	25.9	3.0	4.6	-1.7	-3.4	**-0.7**	**-0.3**	**0.0**
Gross fixed capital formation	199.9	13.0	6.4	-20.0	-51.1	-8.0	**6.8**	**8.9**	**13.4**
of which : equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	861.3	56.0	4.8	7.0	6.6	0.4	**1.8**	**2.1**	**3.0**
Imports (goods and services)	707.0	46.0	6.2	-18.4	-24.0	4.0	**3.4**	**3.3**	**3.9**
GNI (GDP deflator)	1219.4	79.3	3.5	-16.4	-4.3	-5.4	**4.5**	**3.5**	**3.7**
Contribution to GDP growth :	Domestic demand		4.5	-9.1	-20.9	-2.2	**2.7**	**1.9**	**2.9**
	Inventories		0.0	-0.3	-0.1	-	**-**	**0.0**	**0.0**
	Net exports		-0.8	10.8	14.2	-1.5	**-0.6**	**-0.4**	**-0.2**
Employment			1.6	0.8	-6.0	-0.3	**0.2**	**0.2**	**0.5**
Unemployment rate (a)			3.4	3.0	7.2	8.0	**7.6**	**7.3**	**6.7**
Compensation of employees/head			6.6	4.1	-3.0	3.7	**5.1**	**4.7**	**4.7**
Unit labour costs whole economy			4.6	3.6	-2.4	7.6	**3.2**	**3.5**	**2.4**
Real unit labour costs			0.6	-7.4	-9.8	0.7	**-0.5**	**0.0**	**-0.7**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			3.9	11.8	8.3	6.9	**3.7**	**3.4**	**3.1**
Harmonised index of consumer prices			-	12.8	16.3	7.5	**4.1**	**3.6**	**2.8**
Terms of trade of goods			-0.2	-6.3	-12.1	8.5	**-1.7**	**-0.3**	**-0.1**
Merchandise trade balance (c)			-2.3	-0.4	6.0	7.8	**5.8**	**5.0**	**4.5**
Current-account balance (c)			-6.2	-24.5	-11.7	-11.2	**-10.4**	**-9.6**	**-9.5**
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-	-	-	**-**	**-**	**-**
General government balance (c)			-	-13.5	-10.0	-10.1	**-5.7**	**-4.4**	**-3.1**
Cyclically-adjusted budget balance (c)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (c)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			-	70.3	87.9	92.9	**92.4**	**90.2**	**88.3**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.