



Alþýðusamband Íslands

Revised Economic Forecast 2011–2013

Icelandic Confederation of Labour (ASÍ)
March 2011

Downturn has bottomed out, slow growth ahead

According to all indications, a turnaround is taking place in the Icelandic economy, with slow recovery expected in coming years. While the labour market situation will continue to be difficult, it will improve as the economy picks up. Temporary government actions assist households and their position improves somewhat, although it will remain constrained. Inflation will be moderate, hovering around the Central Bank's 2.5% inflation target or in the range of 2.2-3.0% during the forecast period.

ASÍ predicts that after two years of contraction, GDP growth will be positive by around 2.5% this year. Slow growth will continue in 2012 and 2013 with an annual GDP increase of just over 2%.

ASÍ'S MACROECONOMIC PROGNOSIS MARCH 2011

Volume change on previous year (%)	In b. ISK		Prognosis		
	2010	2010	2011	2012	2013
Private consumption	782.6	-0.2	2.0	2.3	2.0
Public consumption	399.0	-3.2	-4.8	-2.2	-0.3
Gross fixed capital formation	198.9	-8.1	17.0	14.1	10.3
<i>Business sector investment</i>	122.6	0.9	34.1	18.6	9.8
<i>Residential construction</i>	35.5	-17.0	0.0	8.0	20.0
<i>Public sector investment</i>	40.8	-22.4	-22.6	-3.7	2.0
National expenditure	1,377.1	-2.5	2.5	3.1	2.9
Export of goods and services	869.3	1.1	1.8	2.4	2.3
Import of goods and services	706.9	3.9	1.6	4.5	3.5
GDP	1,539.5	-3.5	2.5	2.1	2.3
Inflation ¹		5.4	2.2	3.0	2.7
Unemployment, ²		8.1	7.4	6.1	5.2
Exchange rate, trade-weighted index ³		217	203	199	195
Current account balance, % of GDP		1.7	8.6	7.8	7.6

¹ Changes between annual averages

² Registered unemployment, as a % of total est. labour force, annual average

³ Annual average

The forecast assumes that fiscal balance will be achieved in 2013; that construction will proceed on improvements to the Straumsvík aluminium smelter and related power projects; and the construction of a silicon plant in Helguvík. Work on the Helguvík aluminium smelter or power projects connected to it is not anticipated during the forecast period. The forecast assumes that stability will continue on the labour market and collective bargaining agreements will be concluded for a three-year period. Furthermore, it assumes that the Icesave dispute with the UK and the Netherlands will be resolved and confidence in the Icelandic economy will increase thereafter, resulting in easier access to foreign credit.

Household situation improves

In coming quarters, the situation of Icelandic households should improve, although it will remain constrained. Temporary measures by the government to assist highly indebted households, repayment of amounts overpaid on exchange-rate-indexed loans and withdrawal of private pension savings all help household budgets. This is offset by increases in public levies, a difficult labour market situation and high debts. High uncertainty will also restrain private consumption.

Household purchasing power will grow during the current year as the impact of temporary assistance for highly indebted households is felt. However, there will be limited change in purchasing power in the following two years as the effect of these measures ebbs. Household consumption will slowly grow once more in tandem with increased purchasing power and an improving labour market situation. ASÍ expects household consumption to grow by 2.0% this year, by 2.3% in 2012 and by 2.0% in 2013.

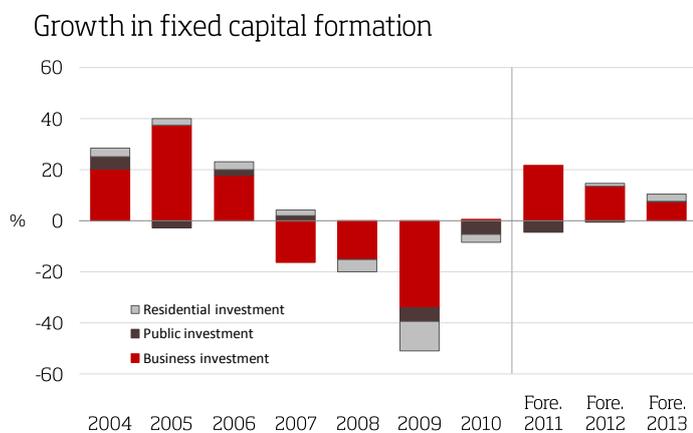
Local and central governments practice strict fiscal restraint

Both the state and municipalities are struggling to balance their budgets following the economic collapse, as their income sources have shrunk while expenditures have increased. The financial situation of the state and municipalities is slowly improving, however, and their deficits decreased substantially last year.

According to the economic recovery program agreed by the government and IMF, the primary balance should already be positive this year and a surplus will be achieved on the total balance in 2013. To achieve this objective, the state and the municipalities have to adapt their finances to reduced incomes and therefore years of cutbacks await. ASÍ forecasts a drop in public consumption of 4.8% this year, of an additional 2.2% next year and of 0.3% in 2013.

Turnaround in investment

This year will witness a turnaround in investment, with total investment expected to increase by over 17%. Investment is forecast to increase by 14% next year and by 10% in 2013. Investment growth will result from increased industrial investment, which will rise by 1/3 during the current year, by almost 1/5 next year and by 10% in 2013. The major share of industrial investment is due to construction at the Straumsvík smelter, a silicon plant in Helguvík and related power projects.



Uncertainty in operations and difficult financing will obstruct the growth of other industrial investment. In addition, many enterprises have unused production capacity due to the drop in domestic demand and therefore have little need for further investment in coming quarters.

Cutbacks in public works

Continued restraint is expected in public investment, but should decrease as the forecast period progresses. Public investment will drop by over 1/5 this year, following on the heels of a similar drop last year. Next year projects by local authorities and the state are expected to decrease by close to 4%, then it begin to increase once more in 2013, when the rise will be around 2%.

Employment situation improves slowly

In February unemployment was 8.6%, or equivalent to around 13,800 persons out of work. The outlook is for little change in unemployment in March, but a gradual improvement in the situation during the latter half of the year.

The employment situation is expected to improve gradually in coming years in tandem with economic recovery, with unemployment averaging 7.4% this year, 6.1% next year and 5.2% in 2013.

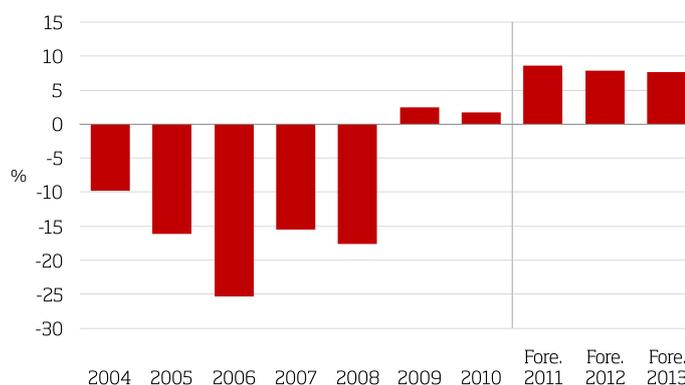
Imports on the rise

As economic activity picks up, imports can be expected to increase once more after contracting strongly in recent years. The increase is expected to be slow this year, then accelerate somewhat next year when private consumption and investment increase, currency controls are relaxed and the ISK exchange rate strengthens. ASÍ forecasts that imports will increase this year by 1.6%, by 4.5% in 2012 and by 3.5% in 2013 when construction at the Straumsvík plant and the silicon plant in Helguvík concludes.

Increased exports

A weak ISK and low real exchange rate boost the export sector and improve its competitiveness vis-à-vis foreign competitors. Despite this, exports have not increased as might be expected. The scope of many export companies to increase their production is now fully utilized, and high indebtedness and difficult access to credit limit the growth possibilities of many of them, therefore hindering traditional export sectors from taking full advantage of the favourable competitive position.

Current account



Exports grew by 1.1% last year; goods exports decreased by 2% while exports of services grew by 6.5%. A contraction in goods exports can be explained for the most part by fluctuations in the sale abroad of irregular export items, such as aircraft, which weigh heavily in the statistics. If these items are excluded total, exports increased by just over 3%. ASÍ's forecast assumes that exports will increase by 1.8% this year. Next year production will commence following the improvements to the Straumsvík plant, with an estimated increase in exports of 2.4%. In 2013 the silicon plant in Helguvík will come into operation and the forecast anticipates an increase in exports of 2.3% that year.

Large current account surplus

Exports of goods and services have been growing while imports have fallen sharply, resulting in a large surplus in the external trade balance. Despite some growth in imports once more, a continuing large current account surplus is expected throughout the forecast period, if the impact of interest payments on debts of companies being wound up is excluded. As the forecast period progresses, the surplus will decline as imports increase, but will remain considerable.

ISK continues weak

A strong current account surplus should generally result in a high inflow of currency and ISK appreciation. High instalments on national debt, however, will mean that a large portion of this currency will exit the country once more and curb exchange rate strengthening.

The forecast assumes that the ISK will appreciate by 10% during the forecast period but remain weak. Now as before, exchange rate developments are shrouded in considerable uncertainty, making predictions difficult. The ISK can be expected to weaken temporarily when the Central Bank begins to relax currency controls. No schedule for removing currency controls has yet been announced, but is expected to be presented by the end of March.

Inflation rises but will stay close to target

The outlook for price level developments has worsened. The impact of rising global oil and grain prices is already becoming visible and will increase as the year progresses. ISK strengthening will offset this to some extent, but currently the outlook is for inflation of 2.2-3.0% during the forecast period. A temporary inflation spike can be expected after the Central Bank begins to relax currency controls around the middle of this year.

ASÍ forecasts inflation will average 2.2% this year, 3.0% next year and 2.7% in 2013.

