

Icelandic Federation of Labour
Macroeconomic Forecast 2008-2010
Summary (May 2008)

“Economic conditions have changed dramatically and uncertainty has seldom been as pronounced as now,” says in a newly published macroeconomic forecast published by the Economic Department of the Icelandic Federation of Labour (ASÍ). “The global financial crises which set in last summer, has been more serious and its impact more widespread than first expected. Taking also into account the current macroeconomic imbalances in the Icelandic system, weak Krona, runaway inflation, high interest rates and a large current account deficit, the unavoidable adjustment process is bound to be harsh.”

According to the forecast the Icelandic economy is standing at crossroads. After a period of sustained high growth rates it will actually shrink for the next two consecutive years. Even though it is still humming along it could grind to a halt later in the year. In the course of a sharp devaluation of the Krona and a simultaneous pick up of inflationary speed households have already cut down on private consumption and business sector investment and residential construction can be expected to contract markedly this year. In a way this represents an adjustment process that is well known in Iceland. What is unusual, however, is that the underlying imbalances seem not to clear out in the near future.

This forecast assumes that work will commence on construction of a new aluminium smelter in Helguvík later this year. It also assumes that the global financial crises will ease somewhat during the course of the year; if not this forecast could be seriously compromised. Wage developments are shrouded in considerable uncertainty. Due to high inflation the prerequisite clauses of newly signed collective bargaining agreement in the private sector will almost certainly not hold, meaning an obligation to negotiate a response which may consist in agreements being renewed or terminated as of 1 March 2009. Meanwhile in the public sector old collective agreements have expired without new ones having been negotiated. In the forecast it is assumed that the social partners will work out a plan which contains interaction between wage increases and inflation.

Tight monetary policy with high interest rates will prevail for the remainder of the forecast period. As regards the Krona it is very difficult to predict its exchange rate developments in the coming quarters as it will to a considerable degree be affected by economic developments in other “high interest rate countries” and risk aversion amongst international investors. In the forecast it is assumed that investors have taken up a more critical approach than before and that their believe in the Icelandic economy is somewhat dented. Furthermore, as interest rates start to go up again in other economies investors’ appetite for investments in Iceland might subside. All said the Krona will be relatively weak.

The economic department predicts a GDP growth of 2,4% this year, followed by a contraction of 1,7% next year and of 0,2% in 2010.



Main conclusions

- After a period of sustained high growth rates the economy will actually shrink in 2009 and 2010. This does not mean, however, that the underlying imbalances will clear. Rather, a new equilibrium might emerge with a weak Krona and high inflation and interest rates.
- Diminishing purchasing power, growing debt service burden and restricted access to credit will restrain household consumption, not only this year but probably also for the following two years.
- Business sector investment will drop markedly this year and residential construction will drop next year. Public investment, however, will increase, especially this year.
- A corollary of the fall in private consumption and investment is a contraction of imports. Exports, on the other hand, will grow, mainly due to increased production of aluminium. The current account deficit is thus set to diminish, although it will persist at substantially high level throughout the period.
- The situation on the labour market will take a turn for the worse and unemployment is expected to rise sharply this autumn. Creation of new jobs has stagnated somewhat and announcements of layoffs have been on the increase. As yet there are no clear indications that foreign workers will leave the country as the economic situation deteriorates.
- Due to high inflation the prerequisite clauses of newly signed collective bargaining agreements in the private sector will almost certainly not hold, meaning an obligation to negotiate a response which may consist in agreements being renewed or terminated as of 1 March 2009.
- Inflation reached 12% in April. The odds are that it will increase further before it subsides by the end of the year. Even so it will remain high throughout the forecast period.
- Notwithstanding tight monetary policy in recent years the Central Bank's policy rate is first now starting to bite. This is not a surprise given the worsening access to alternative finance in international markets. The policy rate can be expected to remain at a high level.
- As regards the Krona it is very difficult to predict its exchange rate developments in the coming quarters as it will, to a considerable degree, be affected by economic developments in other "high interest rate countries" and risk aversion amongst international investors. Here it is assumed that it will be relatively weak throughout the forecast period.

ASÍ'S MACROECONOMIC FORECAST MAY 2008

Volume change on previous year (%)	2006	<i>Prelim.</i> 2007	2008	<i>Forecast</i> 2009	2010
Private consumption	4,4	4,2	-2,1	-4,0	-3,6
Public consumption	3,9	3,3	3,5	3,3	4,3
Gross fixed capital formation	20,4	-14,8	-2,6	-8,0	-1,9
<i>Business sector investment</i>	21,1	-25,4	-12,7	-9,4	-3,0
<i>Residential construction</i>	16,5	13,2	0,0	-12,0	-10,0
<i>Public sector investment</i>	22,7	4,3	41,6	1,2	9,8
National expenditure	9,3	-2,3	-0,8	-3,4	-1,4
Export of goods and services	-5,0	18,1	4,3	2,3	2,2
Import of goods and services	10,2	-1,4	-5,2	-2,4	-0,9
GDP	4,4	3,8	2,4	-1,7	-0,2
Inflation ¹	6,8	5,0	11,1	7,0	5,5
Unemployment ²	1,5	1,0	1,5	2,2	3,6
CB policy rate ³	11,7	13,4	15,5	12,6	13,2
Foreign exchange rate index ⁴	121,5	118,1	143	148	156
Current account balance, % of GDP	-25,4	-15,6	-13,5	-10,5	-8,7

¹ Changes between annual averages

² Registered unemployment, s.a. % of total estim. labour force, annual average

³ Annual average

⁴ Annual average