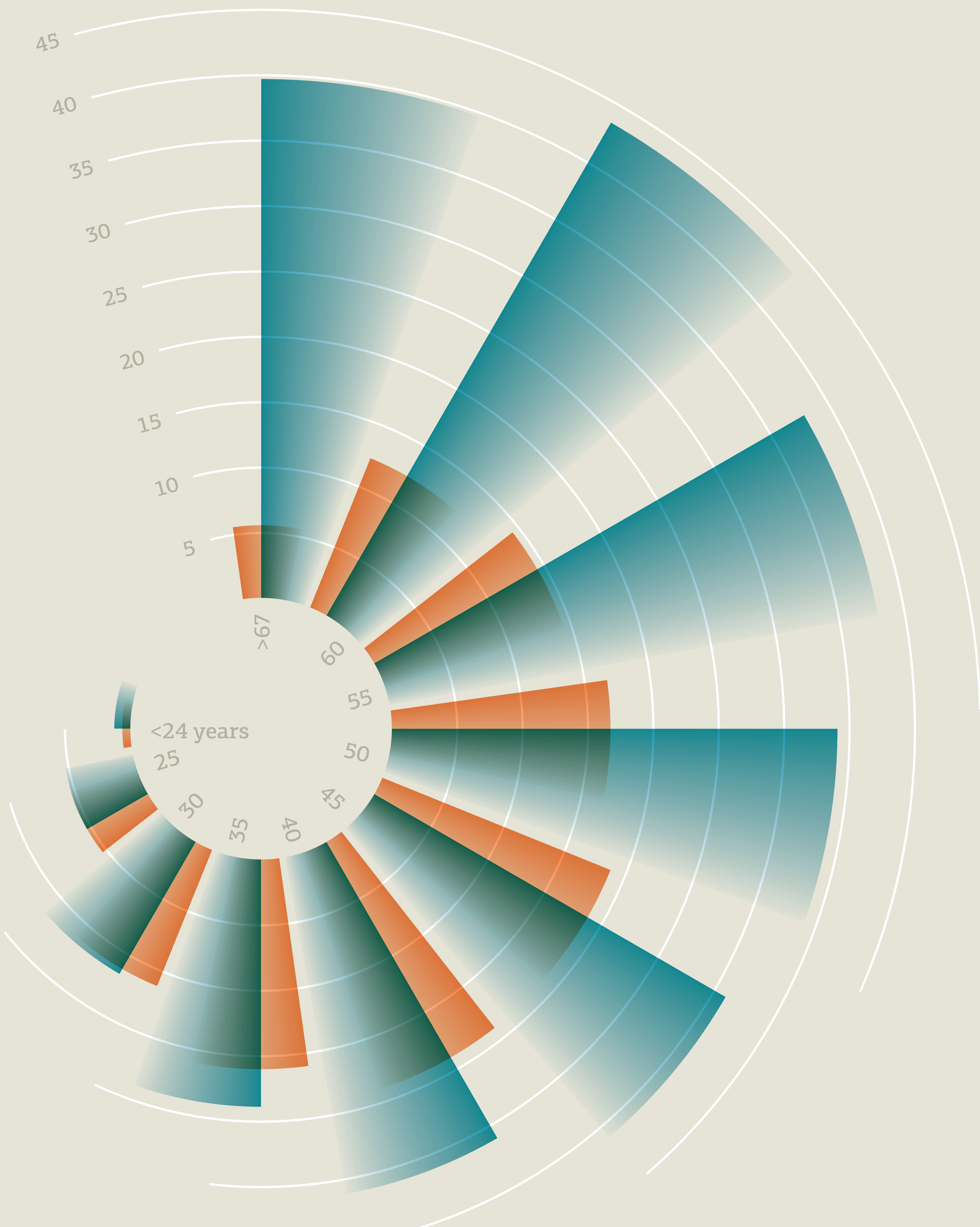
Þjóðhagur

5th edition

Economic Forecast for 2015-2018

November 2015



Assets and liabilities of individuals
in ISK million by age group 2014
Source: Statistics Iceland, Landsbankinn Economic Research

Þjóðhagur

Economic Forecast for 2015-2018

Contents

Foreword

This is the fifth edition of Þjóðhagur, the annual review of Landsbankinn Economic Research. Þjóðhagur discusses developments and the outlook in the economy, Economic Research's macroeconomic and inflation forecast for the coming three years, as well as the department's older forecasts and those of other entities.

Economic conditions have for the most part been very favourable in the past two years.

Inflation has remained under the Central Bank's inflation target, purchasing power and disposable income has increased considerably and household and corporate debt decreased.

Landsbankinn Economic Research expects continued economic growth during the forecast period. According to the forecast, economic growth will be at 4.5% this year and over the next two years, dipping down to 3.7% in 2018. Inflation will remain close to the Central Bank's target until mid-2016, when strong economic growth and the resulting positive output gap, along with significant wage increases over the next few years, is likely to interrupt the current price stability. Inflation is expected to increase significantly next year, to spike at around 5% in 2017 and then trend downwards to the inflation target towards the end of the forecast period. Average inflation is expected to be around 3.3% during the period 2015 - 2018.

1. Introduction and overview

Economic conditions are in most respects very good. Unemployment levels are low, household purchasing power is growing and debt decreasing. The Icelandic króna (ISK) has appreciated and inflation remains low.

It appears that an end is in sight regarding settlement of the bankrupt estates of the fallen banks. It appears that the conclusion will allow authorities to lift capital controls and reduce national debt significantly. All indications are that the country's net foreign debt will drop to a historic low following settlement of the fallen banks' estates.

Economic recovery remains strong for the fifth consecutive year and it looks like economic growth will be considerably higher throughout the forecast period than it has been the past four years. Growing pains will accompany this strong economic growth, with newly concluded collective bargaining agreements a clear indication that the negative output gap created during the recession years has been closed. While it appears inevitable that inflation will increase somewhat in coming years, prudent management of monetary and public finance policy should allow for its containment at the upper tolerance limit of the inflation target, once growth peaks. This will require that both sides of industry reach a sensible conclusion regarding the format of future collective bargaining negotiations to secure both benefits and economic stability for employers.

Private consumption is growing

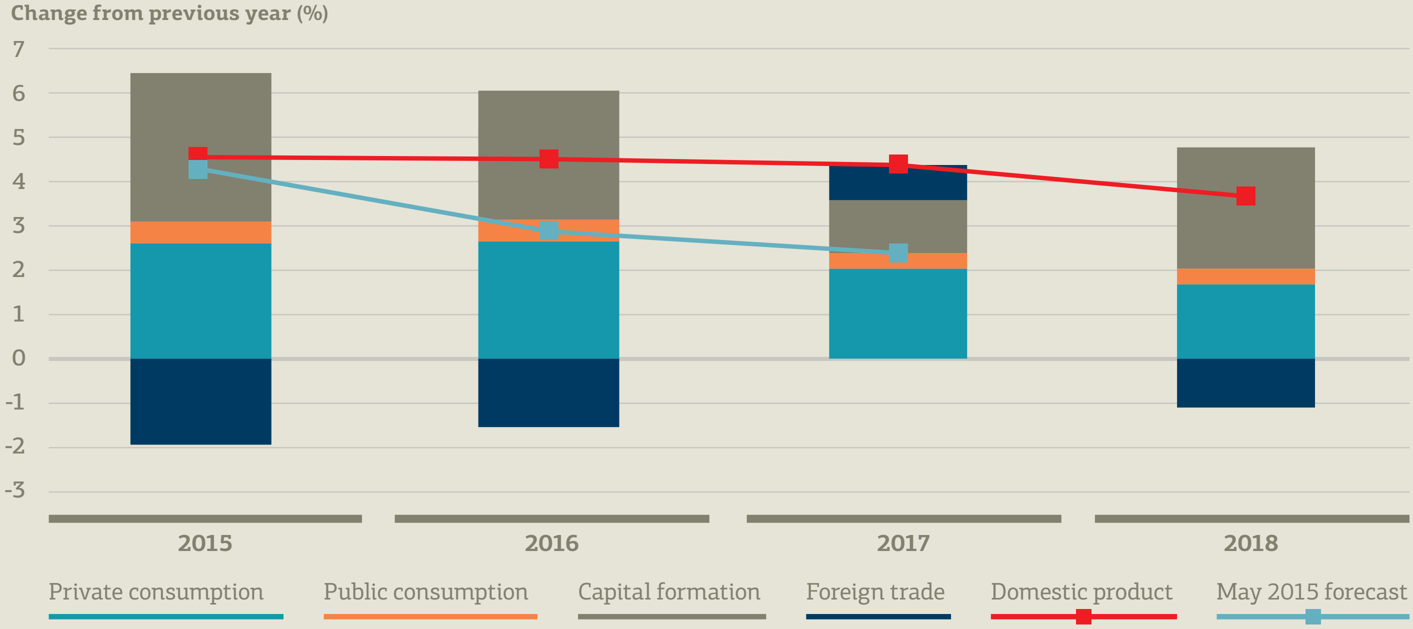
Private consumption accounts for around half of GDP and is as such an important factor in economic growth prospects. It is safe to say that an unusual number of the factors, that influence the development of private consumption, are currently favourable. The employment situation is good, wages and disposable income have increased and the asset and debt balance of households improved.

Private consumption increased by 4.4% during the first six months of the year as compared to the same period last year. We expect a continued increase in the second half of 2015 and for the total increase in private consumption this year to amount to 4.9%. This is a considerable change from recent years. If the forecast proves correct, the increase in private consumption in 2015 will be the highest since 2007, when it grew by 6.7% between years. The outlook is for even greater growth in 2016, or 5%. The increase will level out after that. We expect a 3.8% increase in private consumption in 2017 and 3.2% towards the end of the forecast period in 2018.

Despite a greater and more drawn-out contraction in private consumption in the recent recession as compared to previous downturn periods, private consumption has picked up much slower than after previous recessions. Five years have passed since economic recovery began and private consumption has increased by 2.6% on average per annum. In previous growth periods since 1980, private consumption increased by just under 7% per annum on average. Economic Research's macroeconomic forecast expects the average annual growth of private consumption during the period 2015-2018 to be 4.5%. Should private consumption growth trend towards what we have seen following previous recessions, economic growth will have been substantially underestimated in the macroeconomic forecast of Economic Research.

Economic growth and weight of components

Source: Landsbankinn Economic Research



Strong labour market

Unemployment has decreased sharply. In September, 12M unemployment was 3.1%, according to figures from the Directorate of Labour on registered unemployment. Labour demand has increased greatly in line with growing demand in the economy. It is clear that economic developments will lead to growing demand for labour in coming years which will need to be met to some degree with the import of foreign labour. Unemployment can be expected to decrease further, albeit slower than hitherto. Economic Research expects registered unemployment to have fallen down to 2.7% by the end of the forecast period in 2018.

Wages have increased significantly

Wage development and the development of purchasing power was very favourable to employers last year. Steady wages in Iceland were on average 8.2% higher in September of 2015 than in the same month of 2014. The increase in purchasing power averaged 6.2% for the same period. The purchasing power of wages is currently at a historic high. We expect the purchasing power of wages to continue to increase over the forecast period, by 5% in 2016 and by over 2% in 2017 and 2018.

Real estate prices soaring

Housing prices in the capital region increased by 8.5% last year. Price developments have followed a similar pattern this year, with the 12M increase in housing prices reaching 9.3% in September. Most signs indicate that housing prices will continue to increase. Supply of new housing does not appear to be keeping up with demand. There is increased competition in the housing mortgage market and supply of credit has become more plentiful. Purchasing power looks set to continue to increase, household debt has improved considerably and rising real estate prices have provided increased scope for mortgage. These factors will all contribute to rising real estate prices in the near future. Economic Research expects real estate prices to rise by 9.5% this year and by 8% per annum over the next three years.

Investment increases considerably during the forecast period

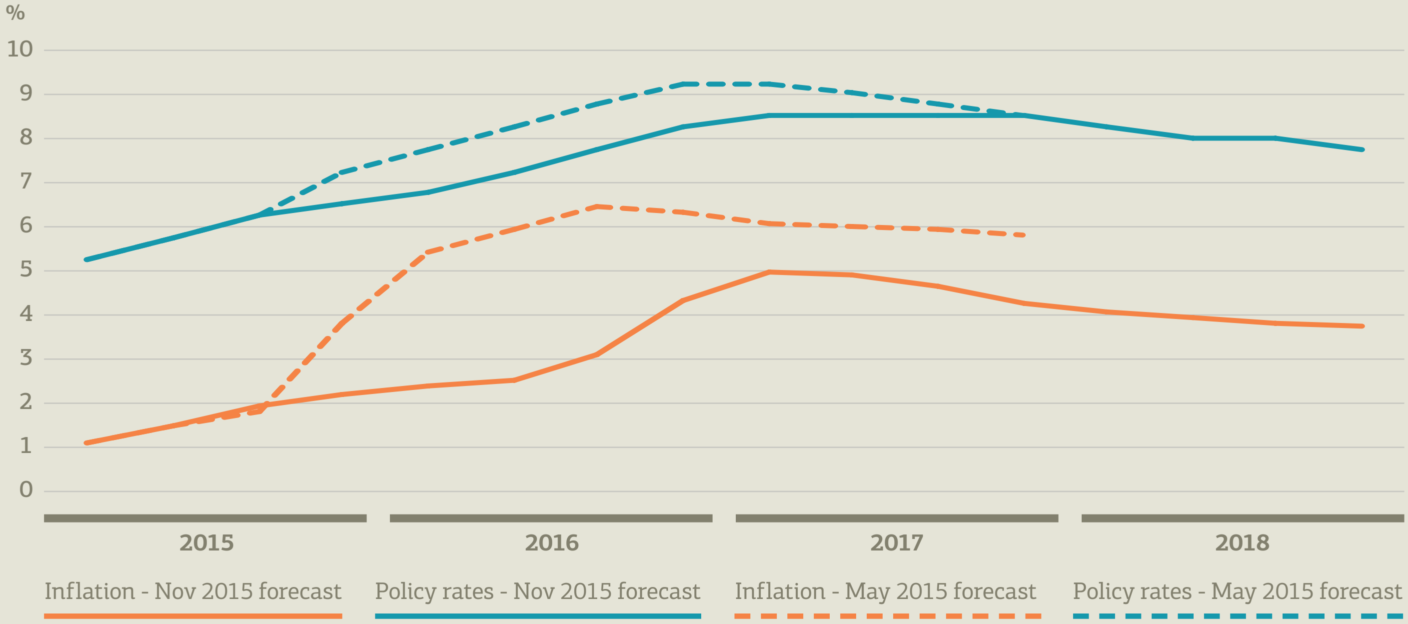
Total capital formation in the economy is expected to increase considerably this year and next. Investment will increase by over 20% this year and by 15% next year. After that, growth will slow to 6% in 2017 but pick up again at 12% in 2018.

This is due to mostly to stronger industry investment in coming years, with housing investment contributing a significant share over the next three years.

Industry investment appears set to increase considerably during the forecast period, not least this year. It will continue strong in 2016 and in 2018. While investment in housing is not expected to

Inflation and policy rate forecast

Source: Statistics Iceland, Central Bank of Iceland, Landsbankinn Economic Research



increase much this year, it is expected to grow by 15% on average in 2016-2018. Despite the improving balance of the National Treasury, obvious signs of economic heating leave little room for increased public sector investment in coming years. The difficult financial position of municipalities suggests that their investments will not increase much. We expect annual public sector investment to increase by just over 4% during the forecast period.

Inflation close to target until mid-2016

The inflation outlook for the next months is fair. At the beginning of 2016, tolls on clothing and footwear will be abolished. This could have a -0.5 percentage point impact on the Consumer Price Index. Significant changes will also occur when figures for February and March 2015 fall out of the 12M inflation calculation as the CPI rose sharply between these two months. We expect inflation to remain in general close to the Central Bank's target until mid-2016.

Economic Research does however continue to expect inflation to increase significantly over the next couple of years. We now expect the inflation surge to occur somewhat later than forecast in May and also for the spike to be less pronounced. During the forecast period until the end of 2018 we expect average inflation to spike at just under 5% (quarterly average) during the first half of 2017. We expect inflation to fall back below the upper tolerance limit of the target around the middle of the forecast period yet remain well above the 2.5% inflation target.

Policy rates will increase significantly

The Monetary Policy Committee (MPC) of the Central Bank of Iceland (CBI) has increased policy rates by 1.25 percentage points this year. Based on the inflation outlook in May, we expected the MPC to raise the CBI's rates by a total of two percentage points this year.

We assume that the CBI will raise policy rates considerably as 2016 progresses in response to the worsening inflation outlook. Economic Research's inflation and macroeconomic forecast expects policy rates to reach 8.5% in early 2017 and to fall again in 2018.

Increased export carried by expansion in the travel industry

Increased export is expected to be carried by expansion in the travel industry, as in recent years. Total exports are expected to increase by just under 8% this year and by around 6% per annum over the next two years, or by 4% in 2018.

Cod exports are expected to increase while pelagics will remain similar to that of last year. The forecast for export from heavy industry has changed in that the proposed Thorsil silicon plant at Helguvík is now included in our forecast.

Overview of Landsbankinn Economic Research's macroeconomic forecast.

	ISK bn	Volume change over previous year,%			
GDP and key components	**2014**	**2015**	**2016**	**2017**	**2018**
Gross Domestic Product	1,989	4.5 (4.3)	4.5 (2.9)	4.4 (2.4)	3.7
Private consumption	1,046	4.9 (4.5)	5.0 (3.5)	3.8 (2.0)	3.2
Public consumption	484	2.0 (2.0)	2.0 (1.5)	1.5 (1.5)	1.5
Capital formation	332	20.3 (21.6)	14.9 (9.6)	6.1 (-0.3)	12.3
Industrial investment	212	30.0 (27.2)	17.2 (8.7)	3.1 (-4.5)	15.1
Investment in residential housing	59	2.5 (18.0)	18.0 (18.0)	18.0 (10.0)	10.0
Public sector investment	61	3.5 (3.5)	4.0 (4.0)	5.0 (5.0)	5.0
Total national expenditure	1,865	5.3 (6.9)	6.0 (4.1)	3.6 (1.5)	4.4
Exports of goods and services	1,067	7.9 (6.8)	5.9 (4.5)	5.7 (3.2)	3.8
Imports of goods and services	942	13.0 (12.3)	9.4 (7.1)	4.5 (1.5)	6.1

Policy rates and inflation	**2015**	**2016**	**2017**	**2018**
Policy rate (year-end, %)	6.50 (7.25)	8.25 (9.25)	8.50 (8.50)	7.75
Inflation (annual average, %)	1.7 (2.0)	3.1 (6.0)	4.7 (5.5)	3.9
EUR exchange rate (annual average)	147 (148)	141 (148)	139 (148)	138
Real estate prices (change in annual average, %)	9.5 (10.0)	8.0 (8.0)	8.0 (8.0)	8.0

	Annual average			
Labour market	**2015**	**2016**	**2017**	**2018**
Purchasing power of wages (change from previous year	5.1 (5.8)	5.3 (0.9)	2.1 (0.0)	2.3
Unemployment (% of labour force)	2.9 (3.5)	2.8 (3.9)	2.7 (3.9)	2.7

	% of GDP			
Trade balance	**2015**	**2016**	**2017**	**2018**
Goods and services balance	6.9 (6.4)	5.8 (5.5)	6.5 (6.5)	5.3
Trade balance	3.3 (2.2)	2.7 (1.2)	3.8 (2.5)	2.5

Numbers in brackets are from Economic Research's May 2015 forecast

Overall, developments in export volume are most strongly influenced by our forecast for the continued growth of tourism. Foreign travellers are expected to increase by 26% in 2015 and by 24% next year, with the growth slowing considerably as the forecast period progresses.

Public finances heading in the right direction

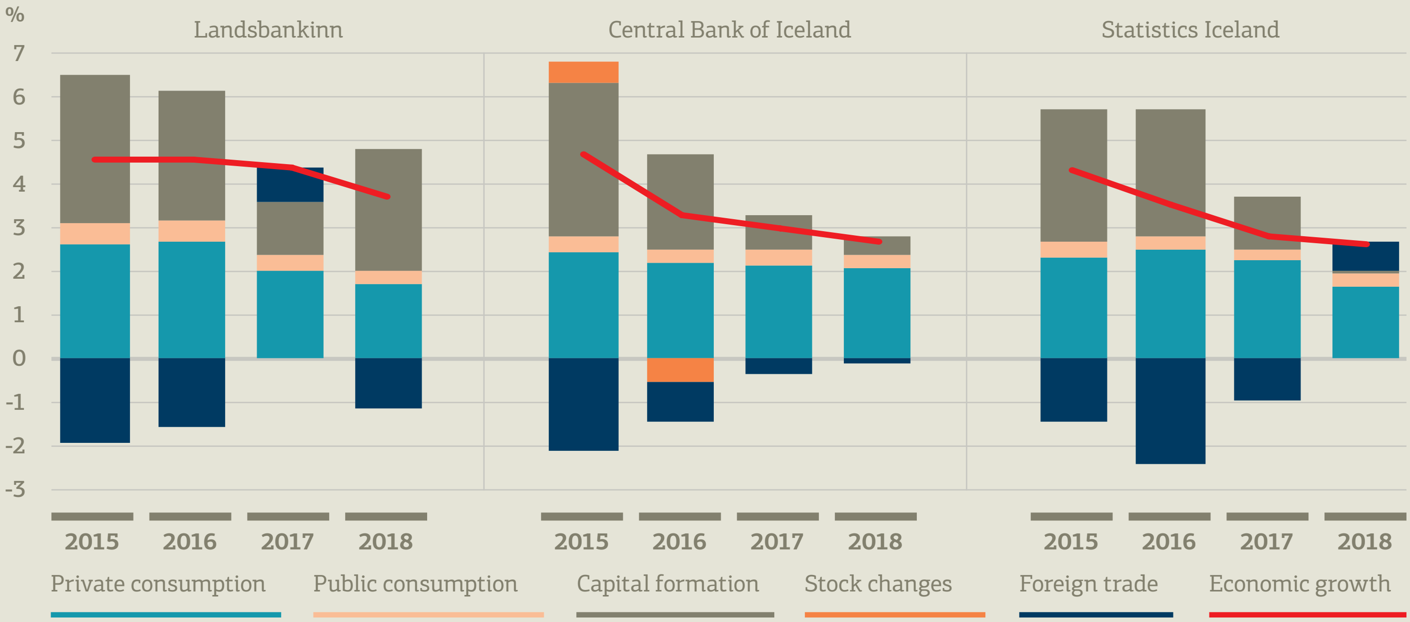
The financial position of municipalities remains difficult, with little surplus due, among other things, to increased wage costs.

The balance of the National Treasury has, on the other hand, improved steadily in recent years. A proposal for increased budgetary allocations for 2015 has now been submitted. The proposal assumes an ISK 20 bn surplus this year, or substantially more than the ISK 3.5 bn anticipated in the budget. The budget proposal for 2016 presents a fairly focused schedule to pay off government debt. While no direct mention is made of the impact of plans to lift capital controls in the proposed budget, statements from government officials indicate that much of the leeway created by the settlement of the bankruptcy estates of the fallen banks will be used to pay off government debt.

Economic Research forecasts a 2% increase in public consumption in 2015, another 2% increase in 2016 and 1.5% in 2017 and 2018. As domestic product is expected to increase considerably in excess of public consumption, the latter will weight 22% in domestic product towards the end of the period, much less than in previous years.

Economic growth forecast and weight of componentsSource:

Central Bank of Iceland, Statistics Iceland. Landsbankinn Economic Research



Domestic financial markets

The outlook for the Icelandic financial market in 2016 is generally good, in line with the positive outlook for the entire economy. Equity markets will be supported by economic growth.

Uncertainty linked to the lifting of capital controls, such as regarding the amount of capital outflow and inflow, the application of new control measures and a lower supply of Treasury notes will influence developments in the bond market.

ISK likely to appreciate

If our forecast for a continued trade surplus during the period proves correct we deem it more likely than not that the ISK will appreciate rather than devalue once capital controls are lifted, all things remaining equal. Accordingly, the macroeconomic forecast of Economic Research expects the average EUR/ISK exchange rate to be around 6% higher in 2018 than in 2015.

Growth prospects in main trading countries deteriorate slightly

Economic growth prospects in Iceland's main trading countries have changed somewhat this year. Expectations of economic growth in the eurozone are currently for 1.5% growth as compared to 1.1% in a survey carried out towards the end of 2014. While expectations for economic growth in the UK and USA decreased this year, considerably more growth is expected in these countries than in the eurozone.

Terms of trade improve

Bloomberg's commodity index was on average 23% lower in the first 10 months of 2015 than in 2014. World oil prices have dropped by 41% and aluminium prices by 10%. Declining world commodity prices have not had a noticeable impact on the price of marine products. To the contrary, the marine product purchase price index has remained higher this year than in 2014. We expect national trade terms to improve overall by 5% this year, to remain fairly steady next year and to deteriorate somewhat in the latter half of the forecast period.

Public forecasts concur

Economic Research's forecast is for 4.3% average economic growth during the period, rather more than the 3.3% average growth forecast by the CBI and Statistics Iceland. The forecasts are similar in most other respects, including the expected composition of economic growth in coming years, i.e. that it will be driven by growth in domestic demand; private consumption, investment and public consumption. The forecast by Economic Research differs from the others in that it assumes that foreign trade will have a considerable influence on economic growth in 2017. Statistics Iceland does expect foreign trade to contribute positively in 2018.

2. Inflation to increase around mid-2016

Economic Research expects inflation to increase substantially in coming quarters. According to our new forecast, however, the inflation surge will occur considerably later than we expected in May and will also be more moderate.

During our forecast period, which extends until year-end 2018, we expect inflation to peak at close to 5% (quarterly average) in the first half of 2017. It should drop again below the upper tolerance limit of the CBI's inflation target by the end of the forecast period but remain well over the 2.5% target.

Change in inflation outlook basically due to two main factors

Firstly, wage increases this spring have not impacted price levels to the extent which should have been expected. The 12M increase in domestic services was 2.7% in October, for instance, very close to the CBI's inflation target. One might have expected the cost of services to be among the most sensitive to wage increases and therefore to the effects of recently concluded collective bargaining agreements. This suggests that enterprises have possibly had more leeway to absorb wage increases than was anticipated in May.

Secondly, the ISK has strengthened somewhat this year, while our May forecast assumed an unchanged exchange rate during the forecast period. The Central Bank of Iceland has acquired most of the surplus currency inflow on the market, totalling ISK billion in the first 10 months of this year. In spite of this the ISK has strengthened during this period.

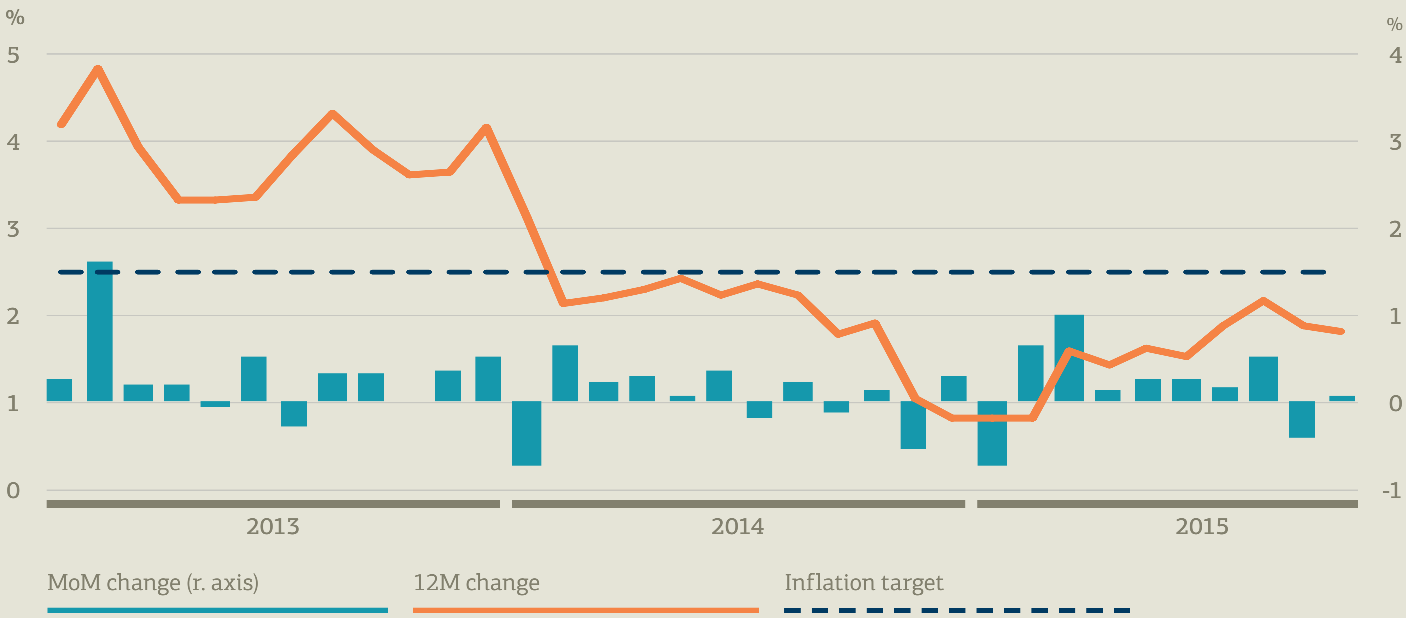
Economic Research's forecast predicts a continuing trade surplus throughout the forecast period, although it will decrease as time progresses. At the same time, the CBI is expected to cut back substantially its FX purchases once a currency auction to address the so-called offshore ISK problem concludes early next year. We consider it unlikely that the CBI will completely abandon the exchange rate mechanism as a route for the transmission of its monetary policy, with major interventions in the market, as this would directly contravene the bank's inflation targeting. ISK strengthening lowers the prices of imported goods and services, directing part of the rise in domestic demand out of the country, in addition to which large-scale FX purchases by the CBI boost the money supply and thereby domestic demand. Economic Research's inflation forecast therefore expects a slight ISK appreciation during the forecast period.

Inflation below target for 21 months

October inflation was 1.8%, which is considerably below the CBI's 2.5% target. Inflation first fell below the target in February 2014 and has remained below target for a continuous period of 21 months. Never before has inflation remained so low over such an extended period

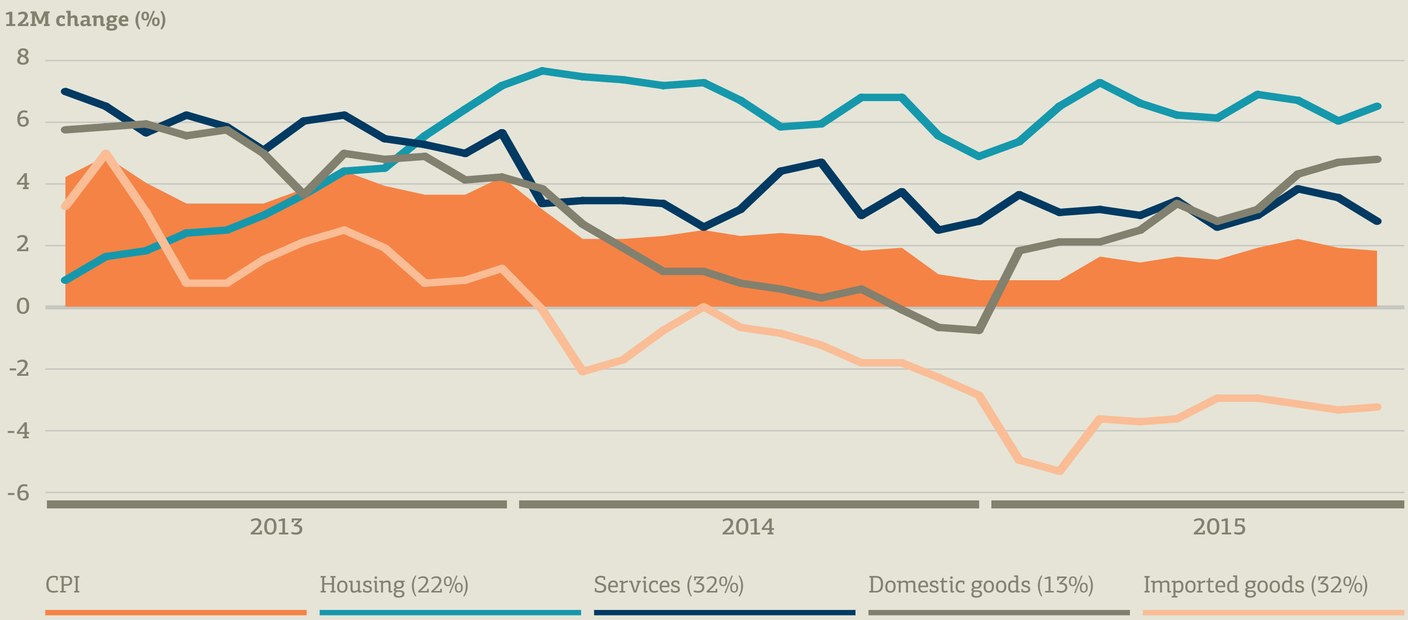
Inflation
CPI change

Source: Statistics Iceland



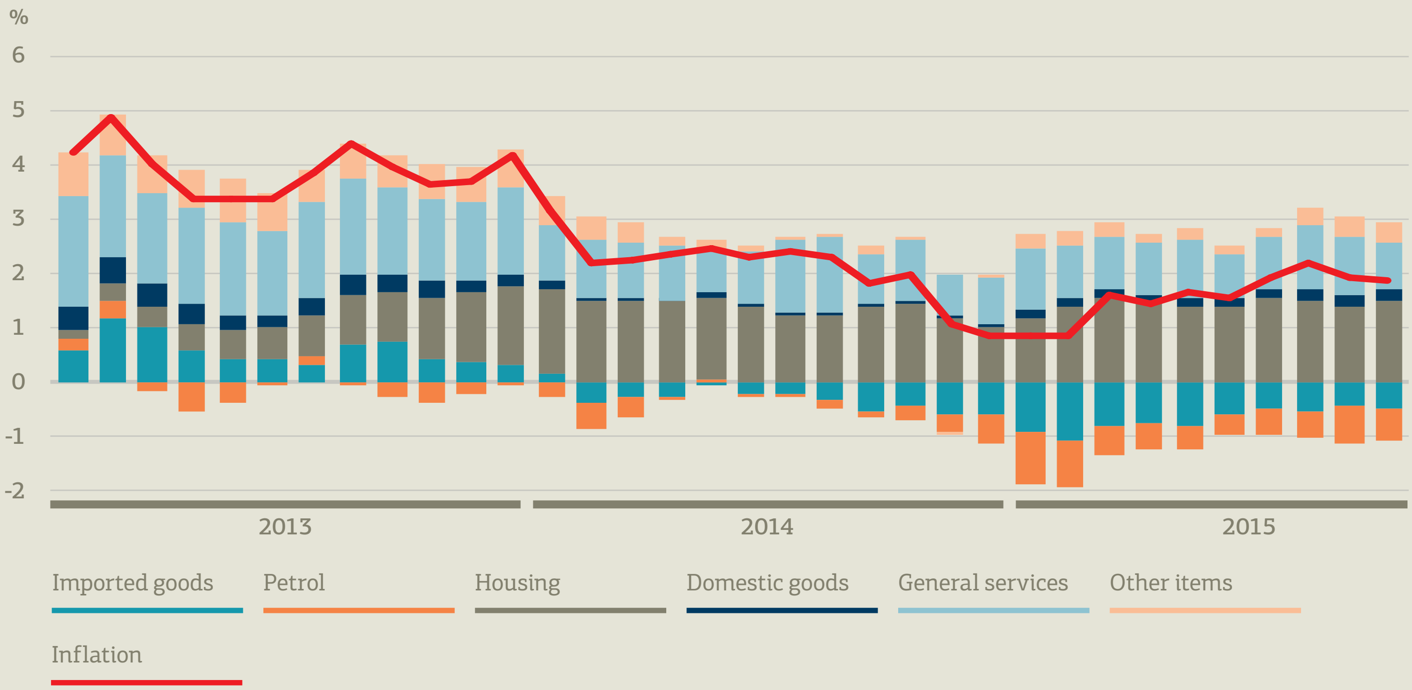
Imported and domestic inflation

Source: Statistics Iceland



Contribution of components

Source: Statistics Iceland



since inflation targeting was adopted shortly after the beginning of this century.

The total housing cost, which comprises around 22% of the CPI, has been the primary force driving inflation for the past two years. The 12M increase in the housing component of the CPI has been around 6% since the beginning of 2014. Domestic services, which account for around 32% of the index, have also risen fairly steadily by an average of 3.3% annually. Goods imports (13% of the CPI) have decreased fairly continuously since the beginning of 2014, as the result of both a stronger ISK and falling import prices.

Historical data shows that price trends for domestic goods and services generally follow a fairly similar path. During the first part of this period the paths of these two components diverged somewhat, with deflation in domestic goods prices. This year they converged again, with the 12M increase in domestic goods in October slightly higher than that of domestic services.

Inflation expectations point in different directions

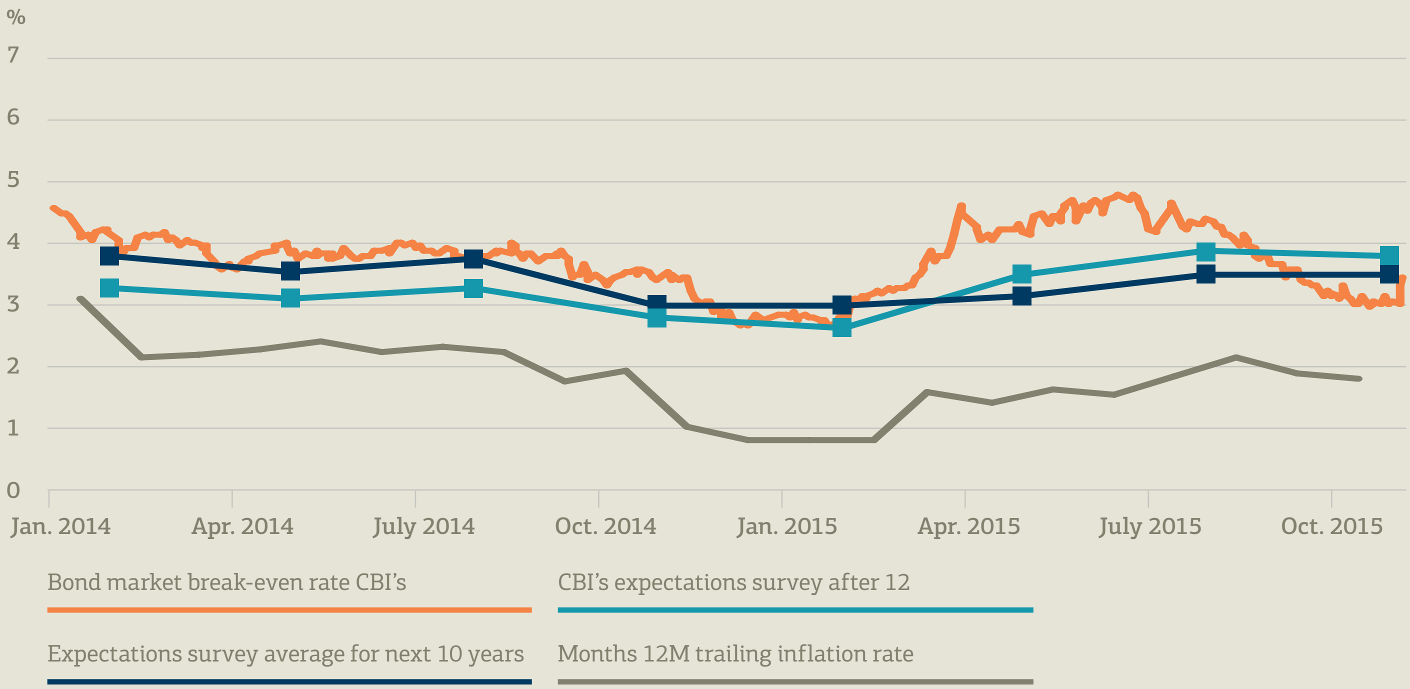
In an efficient market the bond market break-even rate should serve as a good indicator of investors' inflation expectations.

At the beginning of this year the difference between yields on inflation-indexed and non-indexed bonds with a term of about five years was less than three percentage points, and the break-even rate was headed for the inflation target. After it became clear where collective bargaining agreements would end up the premium rose once more, peaking at close to 5% in mid-summer. Foreign investors have poured into the bond market in recent months, lowering the premium, since they are primarily interested in non-indexed bonds. The break-even rate is currently around 3%. Due to this attitude of foreign investors it would be incautious to assume that the premium reflects the inflation expectations of all investors.

The increase in inflation expectations immediately prior to the wage agreements was also visible in a survey of the inflation expectation of market actors. In the February survey analysts' median response on inflation expectations in 12 months' time was 2.6%, while the median response on average inflation over the next five years was 3%. During the year inflation expectations in 12 months' time rose fairly

Inflation expectations

The bond market break-even rate is calculated as the difference between RIKB22 and RIKS21 notes. Most recent date 6 Nov. 2015. Source: Statistics Iceland, Central Bank of Iceland, Kodiak pro



rapidly, to 3.8% in the survey taken at the end of October. On the other hand, expectations for average inflation over the next five years were considerably lower, at 3.5% in the October survey. This outcome in the survey, indicating that market actors expect higher inflation in the coming 12 months than on average for the next five years, fits well with our forecast that an inflation surge can be expected, i.e. that inflation will increase in the next 1-2 years then subside once more.

Inflation still close to target ...

The inflation outlook for the coming months is fairly good. At year-end import duties on clothing and footwear will cease. Given the weighting of these goods in the CPI the removal of duties could lower the index by as much as 0.5 percentage points if the decrease is passed on completely to consumers.

Significant changes will also occur when figures for February and March 2015 fall out of the 12M inflation calculation as the CPI rose sharply MoM in these two months. We expect inflation to remain in general close to the Central Bank's target until mid-2016.

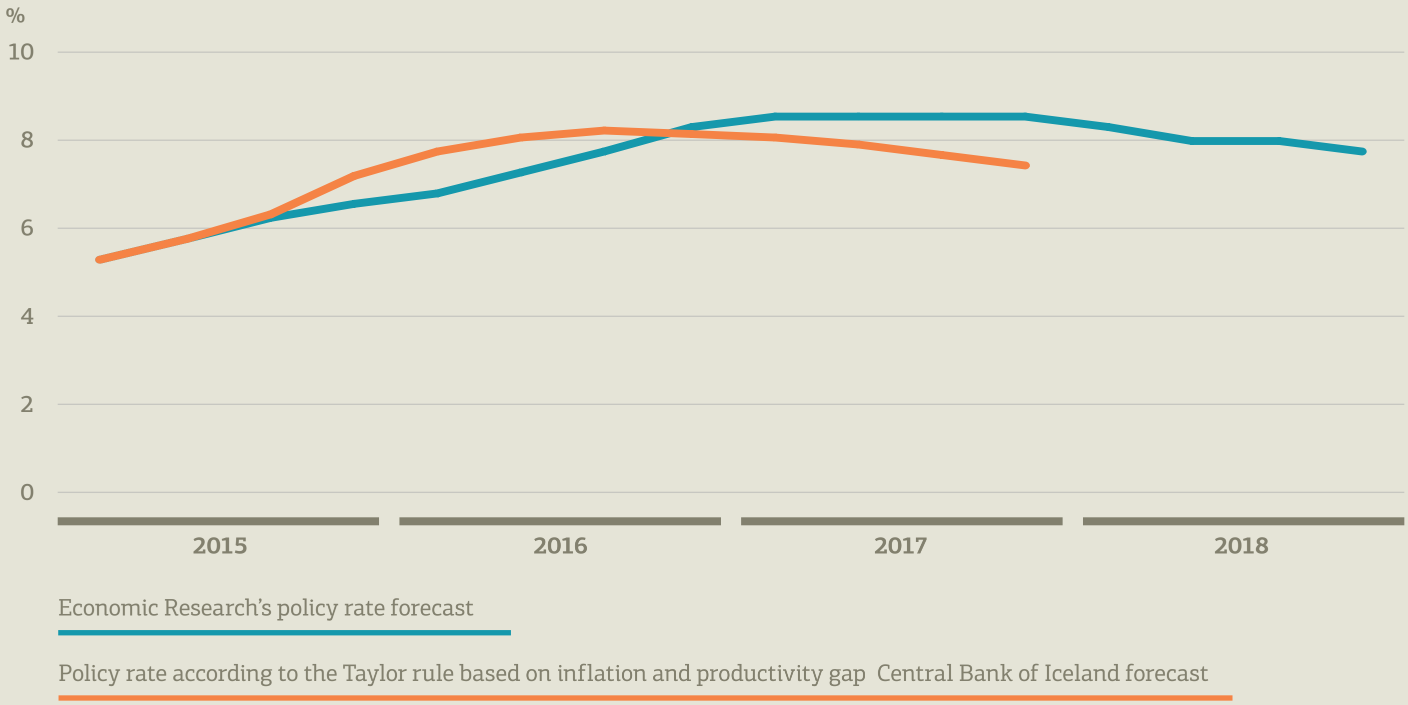
... although wage increases next year will increase pressure on price levels

The second round of contractual wage increase is due in Q2 of 2016. The recent agreement of the SALEK group could mitigate the inflationary impact of these wage rises, especially if an agreement is reached for part of the increases to be in the form of equalising pension rights. This should dampen the demand impact of increases, even though the cost to wage payers will be the same.

We regard it as appropriate for the state to respond to higher wage costs by lowering the social security contribution, which would reduce the cost impact of wage increases on price levels. The social security contribution was raised to cover the cost of higher unemployment benefits following the economic contraction. Unemployment has fallen sharply, however, in recent years and is now at a level similar to that of the years prior to the collapse, making it natural that the social security contribution levied reflect decreasing unemployment.

Policy rate

Source: Central Bank of Iceland, Landsbankinn Economic Research



There is little possibility of avoiding an eventual increase in inflation as a result of the substantial wage increases which were negotiated for the next three years. Although our forecast assumes that oil and other commodity prices will remain low, and the ISK appreciate slightly in coming quarters, this will not suffice to offset the effects of wage rises. We expect inflation to rise fairly sharply in the latter half of 2016 and to approach 5% in 2017.

We assume that the CBI's policy rate will rise rather steadily until around mid-2017, by which time its effect will be felt strongly. Assuming that the CBI manages to restrain the rise in long-term inflation expectations, inflation appears likely to subside once more towards target level by the end of the forecast period. Having regard to all of this, we expect that inflation will average around 3.6% during the entire forecast period, i.e. to the end of 2018.

CBI policy rate on an upward trend

At its meeting in early June the Monetary Policy Committee (MPC) decided on a policy rate hike of 0.5 percentage points and added another hike of the same size in August. At the beginning of November the rate was raised by another 0.25 percentage points. Our May forecast assumed that the MPC would raise the bank's rate by a total of 2 percentage points during the year. However, we now expect the MPC to keep rates unchanged at its next meeting at the beginning of December, which would make the policy rate 6.5% at year-end rather than 7.25% as forecast in May. The change is explained by considerably lower inflation this year than we anticipated.

The CBI does not include an interest rate curve in its macroeconomic forecast. The model on which the bank bases its inflation forecast assumes that short-term interest rates will follow the Taylor rule, making it possible to estimate the rate curve at least approximately based on the bank's inflation and productivity gap forecast.

3. Private consumption is growing

Private consumption accounts for half of GDP making it a key factor in economic growth prospects. It is safe to say that an unusual number of factors influencing growth in private consumption are optimally favourable at the moment. These include employment, increases in wages and disposable income, and the improved household asset and debt position.

From its nadir during the last downturn in 2010 private consumption has been increasing steadily by a total of 9.2% to year-end 2014. Growth stalled in 2013 at a mere 0.8% YoY, but this could be explained, among other things, by uncertainty as to the government's fulfilment of promises to reduce households' indexed housing mortgages, together with the decreasing impact of one-off boosts to household income such as withdrawals of private pension savings. Private consumption rose on average by 2.5% in the other years.

Preliminary figures from Statistics Iceland indicate that the growth in private consumption has been rising in recent months, as it grew by 4.4% in the first half of this year over the same period the previous year.

Strong growth in public consumption is expected to continue in the latter half of this year, with the increase for 2015 as a whole around 4.9%. This is a considerable change from recent years. If the forecast proves correct, the increase in private consumption in 2015 will be the highest since 2007, when it grew by 6.7% between years. The outlook is for even greater growth of 5% next year, after which it is expected to slow. We expect a 3.8% increase in private consumption in 2017 and 3.2% towards the end of the forecast period in 2018.

Key aspects of the development of private consumption include the rising purchasing power of wages, increased household mortgaging capacity as a result of de-leveraging and rising real estate prices, falling unemployment, ISK appreciation and changes to customs duties and import levies.

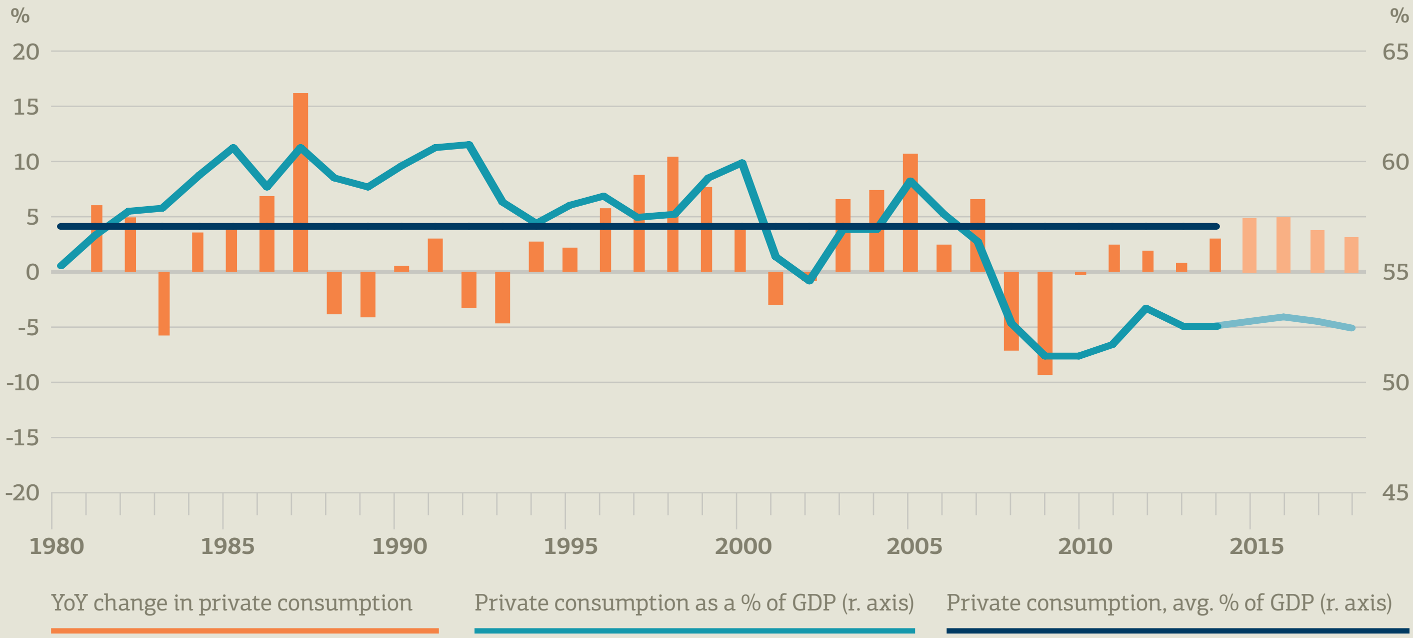
At the same time we predict strong GDP growth, and as a result private consumption relative to GDP will not change greatly. Private consumption is expected to comprise 53% of GDP at the end of the forecast period, which is considerably lower than in other developed countries with similar per capita GDP. Furthermore, private consumption will remain a lower proportion of GDP than it has been on average during the past 30 years.

Payment card turnover suggests private consumption is gaining strength

Changes in private consumption and card turnover have been historically closely correlated, as payments cards are by far the most common method of payment used by households. This makes card turnover generally a good

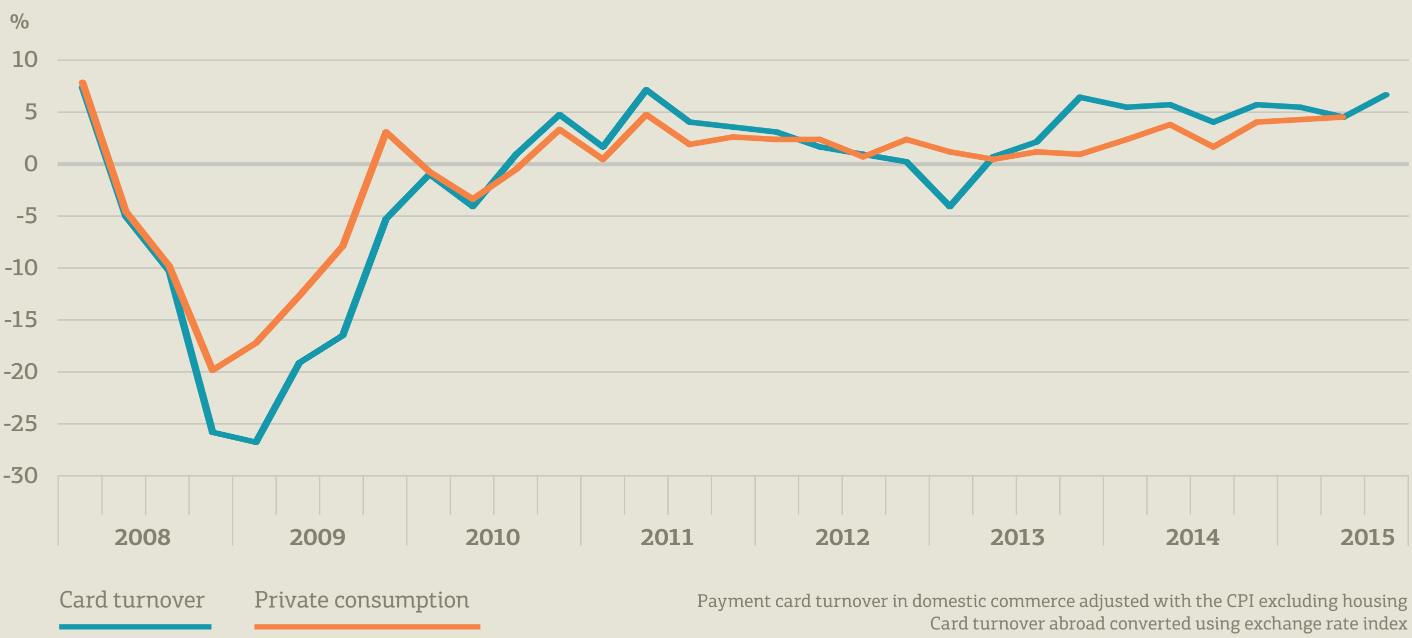
Development of private consumption

Figures for 2015-2018 are from Economic Research's forecast.
Sources: Statistics Iceland, Landsbankinn Economic Research



Increased private consumption and payment card turnover

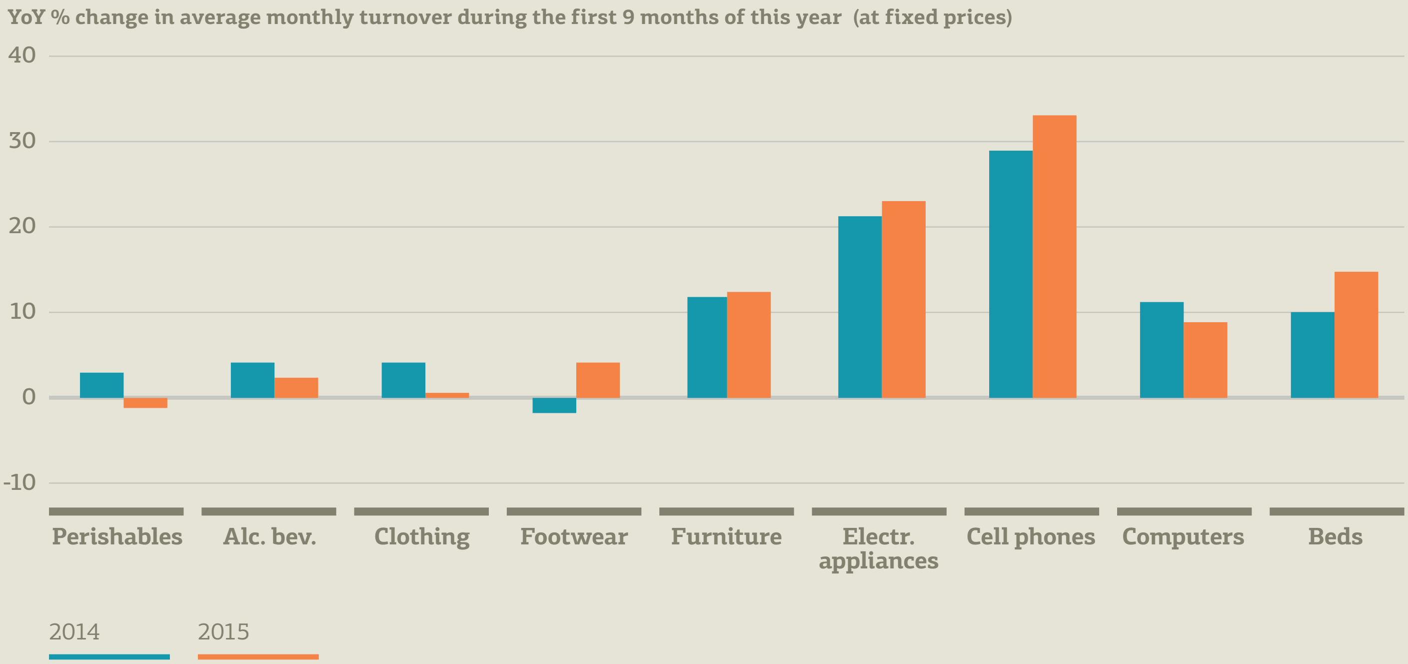
Heimild: Seðlabanki Íslands, Hagstofa Íslands, Hagfræðideild Landsbankans



Payment card turnover in domestic commerce adjusted with the CPI excluding housing
Card turnover abroad converted using exchange rate index

Retail Trade Indices

Source: Centre for Retail Studies
Landsbankinn Economic Research



indicator of the development of private consumption.

The trend in card turnover YtD indicates that private consumption has risen by at least 5% in real terms during the first half of this year, with a slight acceleration in growth in Q3. During the first nine months of this year domestic card turnover in Icelandic outlets rose by around 3.9% in real terms over the same period last year. Use of domestic cards abroad, however, grew considerably more, rising by 18.2%[1] over the same period, When used as a measure of private consumption, the figures include consumption of domestic parties both in Iceland and abroad. The nine-month card turnover this year both in Iceland and abroad shows an increase of 5.6% YoY. Based on average consumption using payment cards during the past 12 months the YoY increase was around 5.2% in September in real terms.

Retail trade more lively

The Retail Trade Indices published by the Centre for Retail Studies show a sizeable increase in most categories of consumer durables, while turnover in perishables has dropped by around 0.9% YoY in real terms. The increase is greatest in sales of electric appliances, which increased by 23.5% YoY in the first 9 months of this year. There appears to be no end to the growth in sales of electric appliances, as during the same period last year the YoY increase was 21%. Furniture sales rose by 12.6% in real terms in Q1-Q3 of 2015, while the increase was smaller in sales of footwear (4.4%) and clothing (0.8%). The budget bill currently before the Icelandic parliament Althingi provides for the elimination of customs duties on clothing and footwear at the beginning of next year, which could result in a decrease of as much as 13% in the price of such goods to consumers. Retail clothing and footwear sales can therefore be expected to pick up as next year progresses.

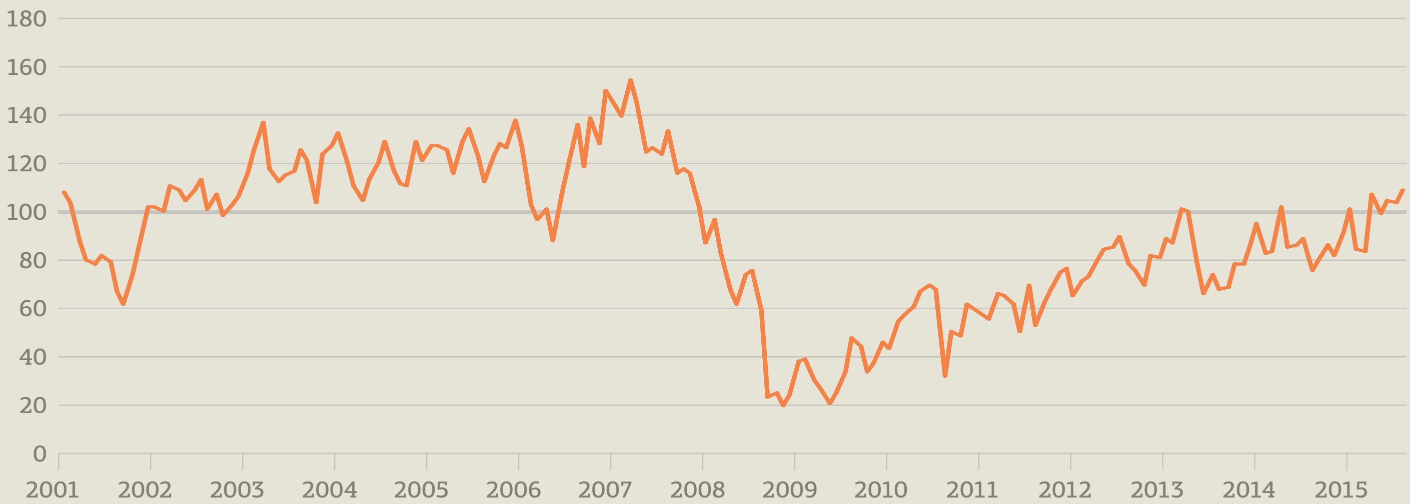
Renewal of the automobile fleet underway

As of the end of October 12,399 new passenger vehicles had been registered since the beginning of this year, an increase of over 42% YoY for the same period; total

[1] Card turnover of domestic parties abroad includes both purchases by Icelanders travelling abroad and internet and mail transactions by domestic parties with parties abroad.

Gallup's Consumer

Values above 100 indicate more respondents are optimistic than pessimistic.
Source: Gallup, Datamarket



new registrations in 2014 were 9,498. For this year as a whole car rental vehicles are expected to comprise half of all new registrations, and end up on the general market just over a year later. By comparison, around 2,000 new vehicles were registered in 2009 when imports reached their lowest level.

Icelanders decide things are looking up – optimists finally outnumber the pessimists

Households' expectations are a major factor deciding their consumption. As might be expected, people are generally less likely to undertake investments or large purchases of consumer goods when uncertainty prevails. In line with improvements in both the household and national economy Gallup's Consumer Confidence Index (CCI) has inched upwards in recent quarters, although with considerable fluctuations. In October this year it was 108.9, and still a good distance from its peak of 154.9 in May 2007. Nonetheless a majority of Icelanders are optimistic regarding the situation and outlook in the economy and the labour market.

The increased consumer optimism is also visible in the index for proposed major purchases. This suggests that consumers are rapidly loosening the purse strings and that more of them are considering purchases of motor vehicles and travel abroad now than a year ago.

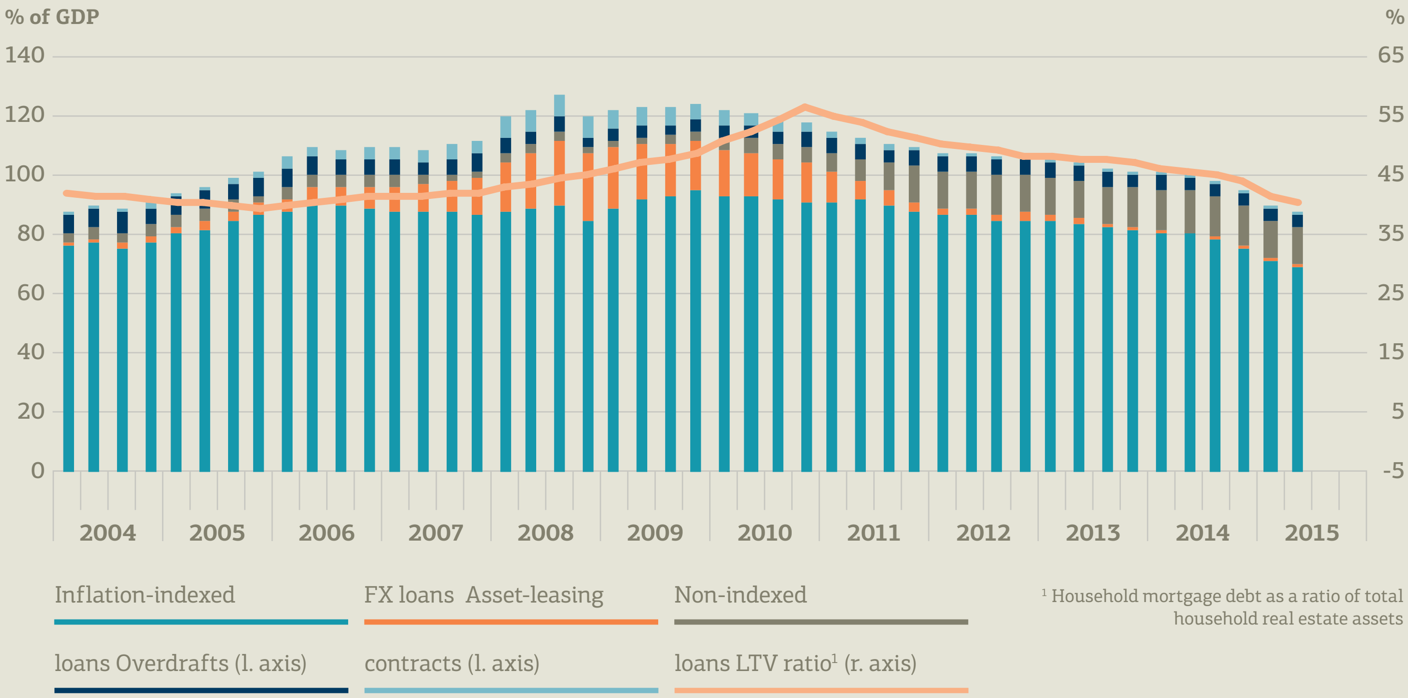
Planned cuts to taxes and customs duties encourage private consumption during the forecast period

According to the 2016 Budget and Medium-term Budget Plan for 2016-2019, import duties on clothing and footwear currently averaging around 15% will be abolished as of year-end. The change should lower the CPI by around 0.5 percentage points if it is passed on fully to consumers. At the beginning of 2017 duties on other dry goods ranging from 7.5 to 15% will be eliminated with a similar impact on the CPI.

Changes are also proposed to personal income tax which should reduce the household tax burden by around ISK 5.5 billion. These tax cuts should benefit in particular middle-income earners, with monthly incomes ranging from ISK 300,000 to 850,000, while for other income groups the tax burden will be unchanged. Altogether, the changes could boost individuals' disposable income by around ISK 12,000 per month for those benefiting the most.

Household debt as a ratio of GDP

Source: Central Bank of Iceland



[1] Household mortgage debt as a ratio of total household real estate assets

The elimination of customs duties is expected to reduce Treasury revenues by around ISK 2.5 billion and other things remaining equal this could possible increase households' disposable income by the same amount.

This is offset by an expansion of tax liability which is to deliver around ISK 1 billion in increased revenue to the Treasury.

If these proposed cuts to taxes and customs duties are implemented they could positively affect private consumption. Households can choose to dispose of their increased income either in consumption or savings. If the increase in disposable income is permanent, as can be expected in this case, there is generally a greater probability that individuals will use a greater portion of their income increase for consumption than for savings. Lower income groups are also more likely to use a greater portion of the income increase to increase consumption than the highest income groups. Furthermore, if the increase in income comes at the same time as consumer confidence is high or growing, it is also more likely that a greater portion will be devoted to consumption than to savings.

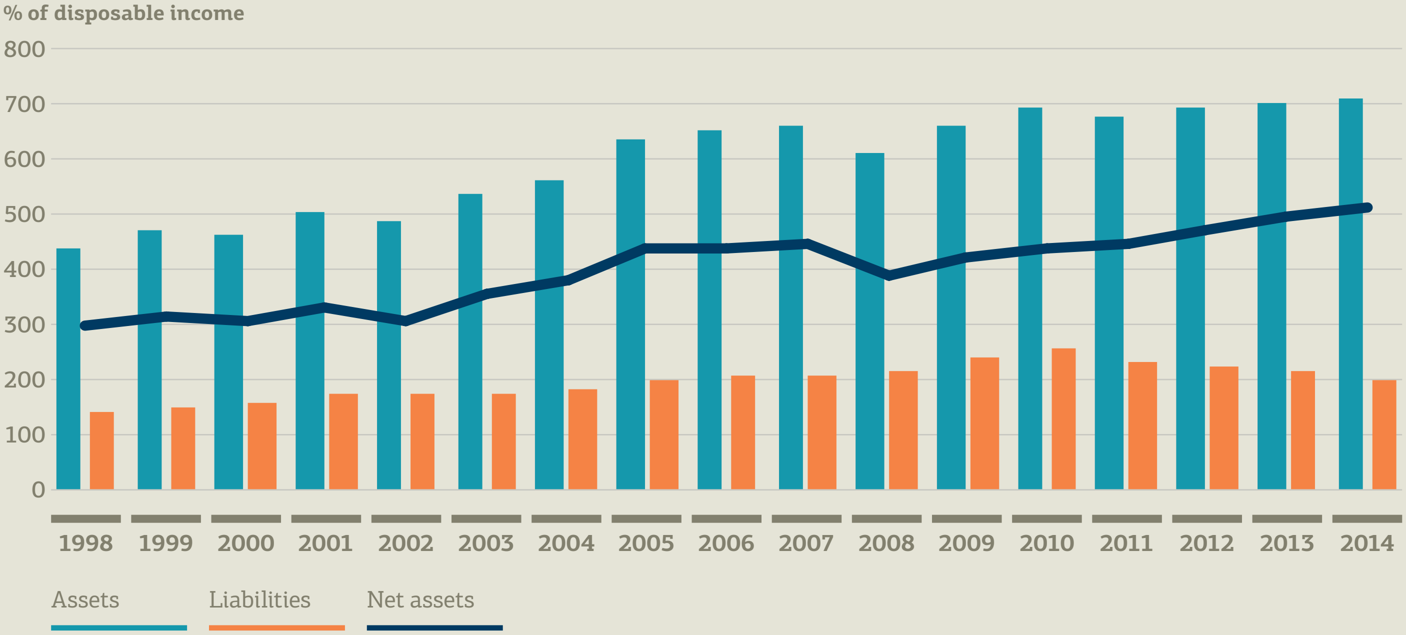
The ratio of household debt to GDP has not been lower since the beginning of this century

Around the middle of this year household debt was equivalent to around 88% of GDP, compared to around 100% at the same time last year. Aggregate household debt decreased by around 4.6% in real terms during those twelve months. The Central Bank estimates that household debt has fallen by around ISK 60 billion, both as a result of direct write-downs and the use of private pension savings to reduce their debts. Even if these actions had not been implemented, the Central Bank estimates that household debt would have decreased by 9 percentage points of GDP instead of 12 percentage points when these actions are included.[2] Part of the authorities' write-downs has not yet appeared (in deb-

[2] Fjármálastöðugleiki 2015:2, Seðlabanki Íslands.

Household assets and liabilities

Pension assets are based on benefits paid net of 30% income tax.
Source: Central Bank of Iceland



tors' tax returns) in addition to which households are expected to avail themselves of tax-exempt personal pension savings to reduce their housing mortgage principal until mid-2017. Other things remaining equal, the outlook is therefore for a continuing decrease in household debt during the forecast period.

Household debt as a ratio of disposable income is estimated to have been around 184% at mid-2015. This ratio reached a peak in 2010 at around 256% of disposable income. The debt burden has therefore decreased on average by the equivalent of 9 months' disposable income in just under 5 years. However, the debt burden varies by age-group, with young people's situation, for example, still difficult although it is improving. The ratio of debt to disposable income in the 35-40-year age group was 263% at year-end 2014, but was 369% at year-end 2010. Due to rising housing prices, lower debt and higher incomes as of the end of last year the average equity position in all age groups was positive. In 2010 the average equity position in the 30-35-year age group was negative by ISK 1.7 million whereas at year-end last year it was positive by around ISK 0.8 million.

Substantial improvement in net asset position

The ratio of households' net assets to their income has never been higher than at year-end 2014. Net household assets are estimated to have been equivalent to around five times their disposable income at year-end compared to around 380% at year-end 2008 and around 300% at year-end 1997. While major increases in real estate prices account for much of this change household debt has also decreased.

Households' improved asset position provides scope for increased indebtedness, e.g. to finance purchases of consumer durables.

Unemployment continues to fall

Unemployment has fallen rapidly, whether measured by registered unemployment as reflected in the figures of the Directorate of Labour or the outcome of Statistics Iceland's surveys. In September the average 12M unemployment rate was 3.1% according to the figures of the Directorate of Labour for registered unemployment and 4.3% as measured by Statistics Iceland's survey. Labour demand has increased greatly in line with growing demand in the economy. Unemployment among males and younger people has decreased the most in recent months according to Statistics Iceland's survey.

Another positive sign according to the results of a Gallup survey conducted in August and September among the country's 400 largest companies was that more companies wished to increase the number of their employees than before. Job seekers declined in number by 1,500 YoY and the number of long-term unemployed has also decreased. Around mid-2015 the number of persons who had been unemployed for more than a year declined by over 500. They were then 13% of job seekers whereas in 2011 their proportion had peaked at 26%.

Large increase in number of jobs

Jobs have increased greatly, as Statistics Iceland reports that between September 2014 and September 2015 the number of employed persons rose by 5,600. The total number of hours worked has risen by 3.5% from the beginning of this year, with an increase in both the number of persons working and longer working hours.

It is evident that the trend in the economy will create increasing demand for labour in coming years, which has already been partially met with increased imports of foreign workers. This will continue.

Various large investment projects calling for increased labour are in the pipeline and an increase in number of tourists will create more jobs.

Men fare better than women

Since the spring of 2012 more women have been registered as unemployed than men, although Statistics Iceland's figures have generally indicated higher unemployment among men than among women. The gender difference has been falling, according to Statistics Iceland's figures, although there are considerable fluctuations from one month to the next. At the beginning of this year the 12M average unemployment rate among men fell below the corresponding figure for women and the situation has been unchanged since them. Unemployment among women therefore is higher than among men as reported both by the Directorate of Labour and Statistics Iceland.

Development more rapid in the capital area

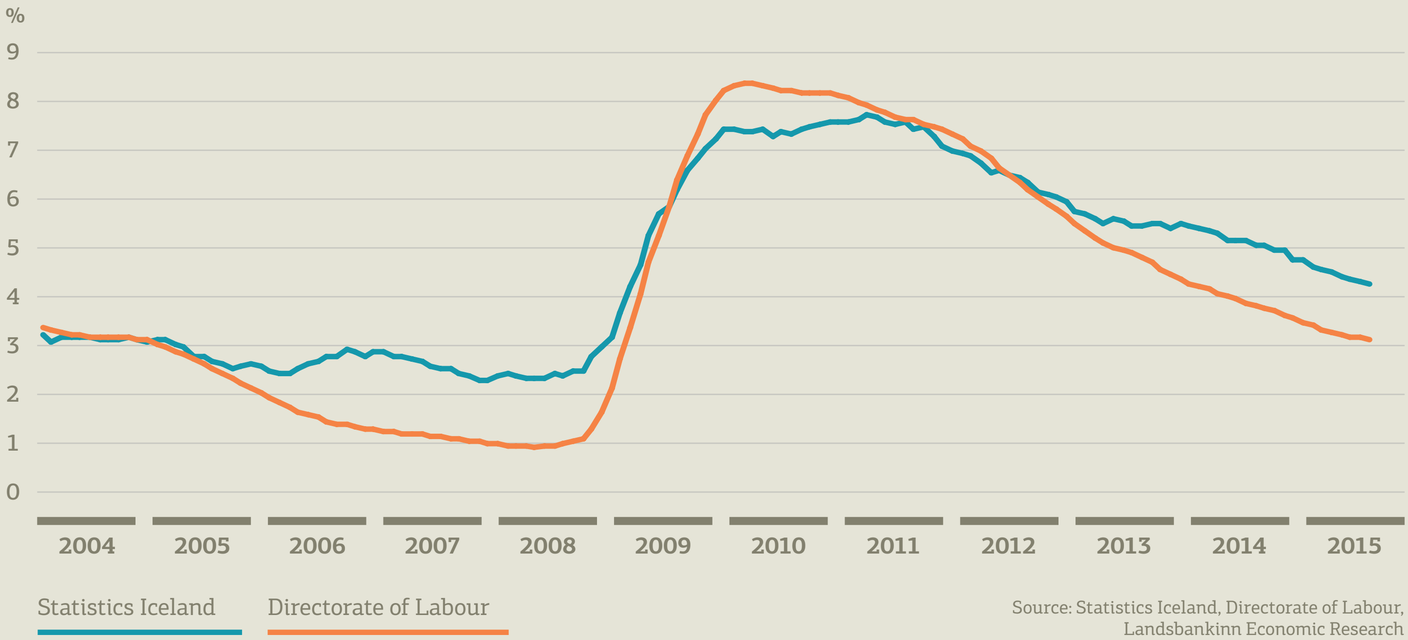
Registered unemployment among males has fallen more than among females. This is especially true of males in the capital region, as unemployment among males has fallen by around 5.5 percentage points since the beginning of 2012 as measured by the 12M average. Unemployment among males outside the capital area has decreased by around 3.3 percentage points at the same time. Figures for female unemployment present a similar picture. Unemployment among females in the capital region has fallen by around 3.8 percentage points during this period and by around 2.9 percentage points among females outside the capital area.

Unemployment has long been higher in the Suðurnes area than elsewhere in Iceland. This unique situation has become less pronounced in recent months, as unemployment in the Suðurnes area does not differ greatly now from that of the capital region. Strong growth in the travel industry and an increase in the number of jobs in connection with the Keflavík airport no doubt explains part of this positive trend in the Suðurnes area.

For university graduates the situation has become relatively worse

From January 2010 until August 2015 the number of registered unemployed has fallen by a total of 71%. Unemployed persons with compulsory school education only have decreased in number by 76% and those with a certified trade by 85%, whereas unemployed university graduates have decreased in number by only 45%. The number of university graduates has increased and it

Unemployment figures of Statistics Iceland and the Directorate of Labour



Source: Statistics Iceland, Directorate of Labour, Landsbankinn Economic Research

appears either more difficult to create jobs for them than for others or that many jobs for university graduates have simply disappeared.

Low productivity growth

Labour productivity has not risen in recent quarters and it seems that productivity has grown relatively little since the financial crisis. Growth was, however, greater in the first half of this year than the equivalent of the increase in total working hours and by this measure therefore labour productivity is greater.

The situation in Iceland, in fact, differs little from that in other developed countries. Key factors here are, for instance, high uncertainty concerning the economic situation and outlook and corporate indebtedness, which has resulted in low investment; in Iceland industrial investment has generally been low.

Unused production capacity has decreased steadily in recent years and years of slack in the economy have probably come to an end. This year GDP growth can be expected to outstrip the productive capacity in the economy, thereby increasing the output gap.

In September this year average unemployment in the past 12 months was 3.1% according to the figures of the Directorate of Labour and averaged 3.6% in 2014. In recent quarters unemployment has fallen fairly rapidly. It can be expected to fall still further, but not as rapidly as before. Economic Research forecasts registered unemployment of 2.9% for 2015, 2.8% for 2016, and 2.7% in 2017 and 2018.

Wages have increased greatly

Wages have increased greatly

The development of wages and purchasing power was generally very favourable to employees last year. Basic wages in Iceland were on average 8.2% higher in September of 2015 than in the same month of 2014. During this period purchasing power grew on average by around 6.2%, increasing steadily until January 2015 after which it weakened and did not reach its former peak level until June this year; since that time it has increased strongly. Purchasing power of wages is now at its highest ever. Purchasing power as measured by the wage index peaked in August 2007, regained that level in November 2014 and has risen since then.

Private sector lags behind

The 12M increase in the wage index from Q2 2014 to the same quarter of 2015 was 5.7%. In the private sector the increase was 4.8% and 7.8% for public sector employees. Among the latter, wages of state employees rose by 5.1% and those of municipal employees by 11.0%. The wages of these groups followed a similar path since the beginning of 2011 until Q2 2015. For instance, the difference between wage increases in the private and public sectors during this period is only 1.6%, which hardy supports the constantly repeated claim that certain groups have fallen far behind others and should be entitled to a correction to their wages. While such a difference does sometimes arise, it is generally soon evened out and currently the difference is not great.

Almost all collective bargaining this year has focused on a comparison by various groups with other groups in the labour market. Such actions can easily result in wage increases which fuel inflation but do not manage to increase purchasing power significantly. In this connection mention could be made of criticism from OECD regarding the Icelandic labour market and collective bargaining model this summer. OECD urged that greater emphasis be placed on the economic reality rather than focusing on wages of other groups in preparing negotiation objectives.

Collective bargaining agreements of 2015

Collective bargaining agreements negotiated by the Confederation of Icelandic Employers with private sector workers' organisations provide for wage rises of around 20% until year-end 2018. An arbitration board Ruling in the dispute between the Union of University Graduates (BHM) and the Icelandic Nurses' Association and the state granted considerably higher wage increases, suggested to be 25-30%. Based on the arbitration board's Ruling, three state sector unions demanded 30% increases during the period of their agreements, which were concluded along these lines. At the beginning of September the state also reached agreements with the Federation of General and Special Workers in Iceland and the Flóabandalag regional alliance on wage increases of almost 30%.

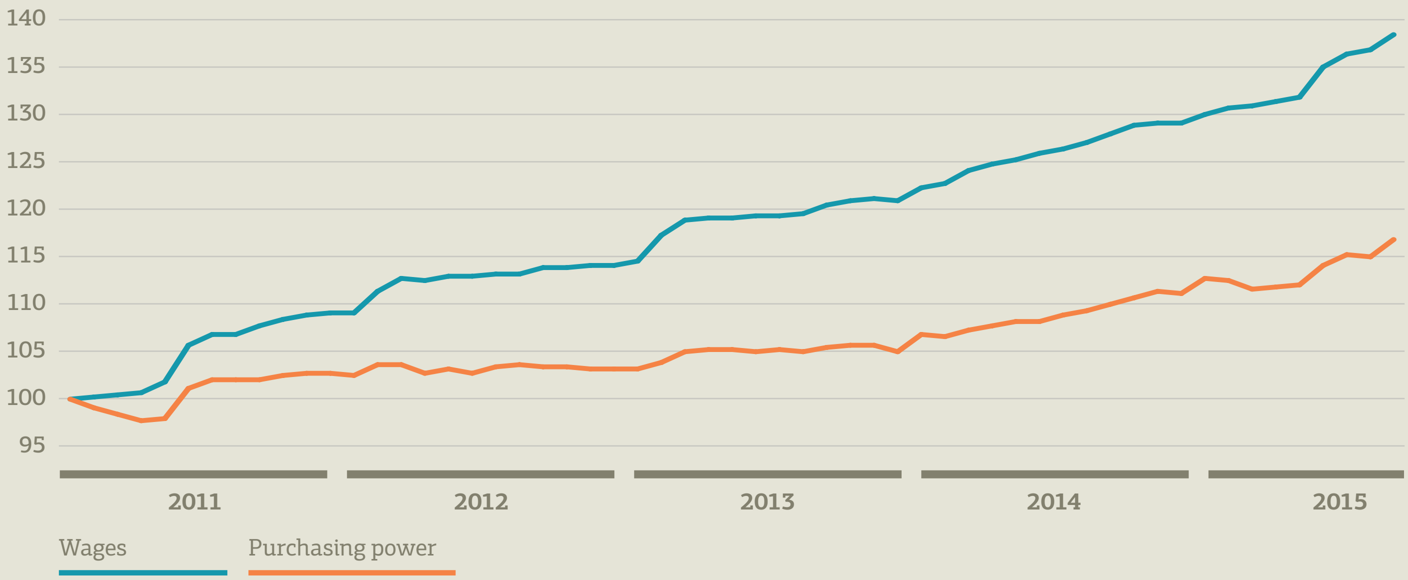
The SALEK agreement

A new direction of sorts was taken at the end of October, when an agreement was reached by the so-called SALEK group. SALEK is an acronym for a collaborative committee on wage data and economic premises for collective bargaining agreements made up of leading labour market actors. The agreement deals with both a future model for concluding collective bargaining agreements in Iceland and also with how the problem currently affecting them, the so-called leapfrog phenomenon, can be dealt with. The agreement provides for a co-ordinated wage policy which is to apply for the next three years. This policy is to be based on a joint cost index, which is set at 100 as of November 2013 and may not exceed 132 by year-end 2018, i.e. the cost of wage increases for all groups will not exceed 32% during this period. It is stated specifically that the cost of evening out pension rights shall be included when the increases are calculated. Furthermore, public emplo-

Wages and purchasing power

Source: Statistics Iceland, Landsbankinn Economic Research

Index January 2011 = 100}



yees are to be ensured the same wage drift as occurs in the private sector.

At first glance it might appear that part of the pu-blic employees have already reached this 32% limit. The private sector appears to have received wage inc-reases of around 20% and the same applies possibly to some public servants. By a rough estimate therefore there is yet considerable scope remaining in the private sector to reach the limit. The methodology will likely be that the Icelandic Confederation of Labour (ASÍ) and the Confederation of Icelandic Employers (SA) will start by finding a sol-ution which will be adapted by others. Modifi-cations to collective bargaining agree-ments must be completed no later than 1 February 2016 and submitted to members for a vote. The intention is to have provisions on termination of agreements cancelled in the following years, allowing the contracts to continue in force for their entire term, which would mean peace on the labour market until year-end 2018. The outcome will be that by year-end 2018 wage costs of all groups will have risen by 32% since year-end 2013, although exactly how this will be implemented is not known.

It is not unlikely that equalising with the public sector will to some extent involve pension entitlements to make these more equal between private and public sector wage earners. Making the pension entitlements of these groups more equal, e.g. by increasing private sector pension contributions from 12% to 15.5%, has long been an objective. Higher employers' contributions to pension funds would then be included as private sector wage increases, but would not be measured by the wage index and thereby not contribute to economic expansion, although the cost impact on employers would be the same.

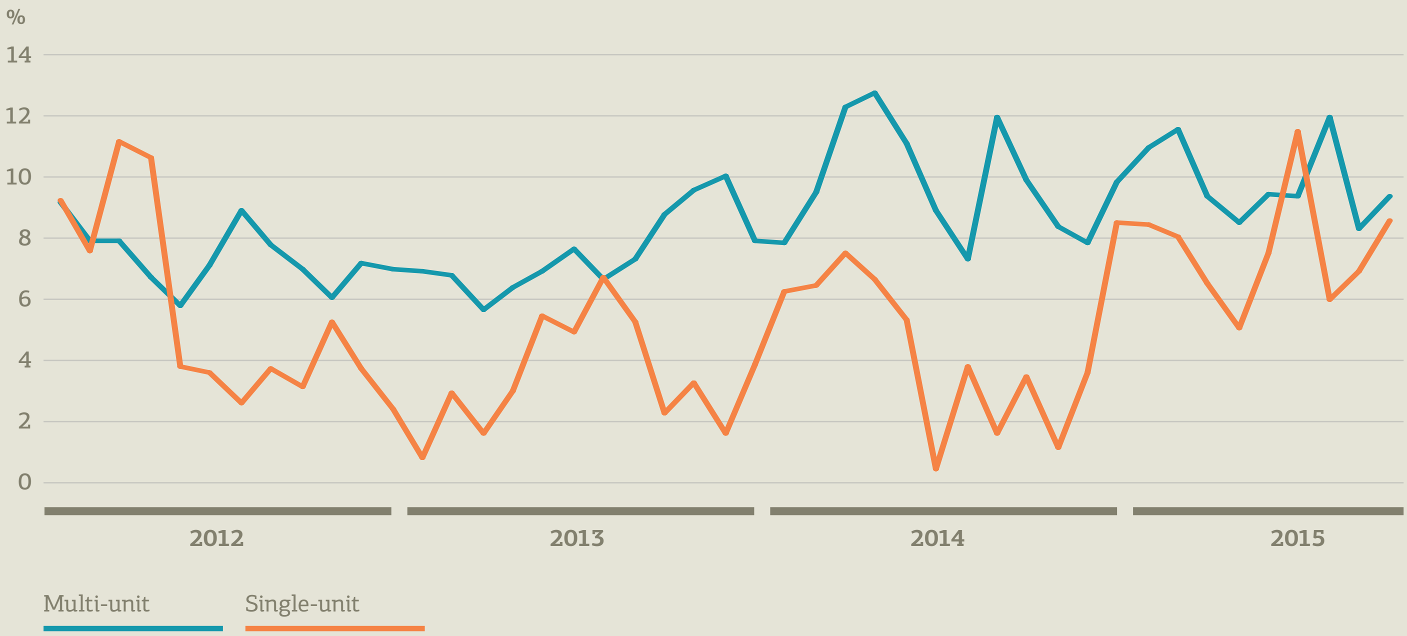
It is also evident that discussions will commence with public authorities on mitigating measures in an attempt to ensure that inflation will not increase in parallel with this agreement. Here the obvious demand of employers is a decrease in the social security contribution to its former level, on the grounds that unemployment has decreased greatly. A cut in the social security contribution is a likely move by the government to mitigate the inflationary impact of major wage increases. Another possible move would be tax increases, to dampen demand, but such options are unlikely to be among those considered by the current government.

Wage developments highly uncertain

A major test of the SALEK agreement is upcoming at the end of this year, when it will be decided whether current collective bargaining agreements can be extended until year-end 2018 and their termination provisions in 2017 and 2018 cancelled. It will also be very significant for the development of the wage index whether compensation to workers takes the form of higher wages, improved pension entitlements or some other route. The probable outcome will be that at year-end 2018 employers' wage costs will have risen on average by around 32% since year-end 2013 with the actual wage increase of various groups varying. While opinions vary regarding this agreement the transfer of power and negotiating mandate from smaller units to larger ones is probably a prerequisite for achieving changes of this sort. Disagreement over the SALEK agreement has already resulted in a labour tribunal action being brought against individual members contending that the agreement is contrary to the labour code.

12M increase in residential housing prices

Source: National Registry, Landsbankinn Economic Research



Real estate prices still climbing

Real estate prices in the capital region increased by 8.5% between 2013 and 2014. The trend has continued this year and in September the 12M increase in housing prices was 9.3%.

Increase in single-unit home prices greater than in previous years

The 12M increase in prices for multi-unit dwellings was 9.4% in September and 8.6% for single family dwellings, in both cases quite a significant rise. Multi-unit dwellings have risen in price fairly steadily since 2011, while the price increase for single family dwellings has been lower and more erratic. A glance at developments in recent years shows that the 12M price increase for multi-unit dwellings has been over 8% for a long period. It is also evident that the rise in price of single-unit dwellings has been considerably higher this year than in 2012-2014.

Price rises appear likely to continue

Most signs indicate that housing prices will continue to increase. It appears evident, for example, that the supply of housing, especially new housing, does not satisfy the demand for it and such market conditions drive prices up. There have also been signs of increased competition in the housing mortgage market. Pension funds are making their presence felt in this market.

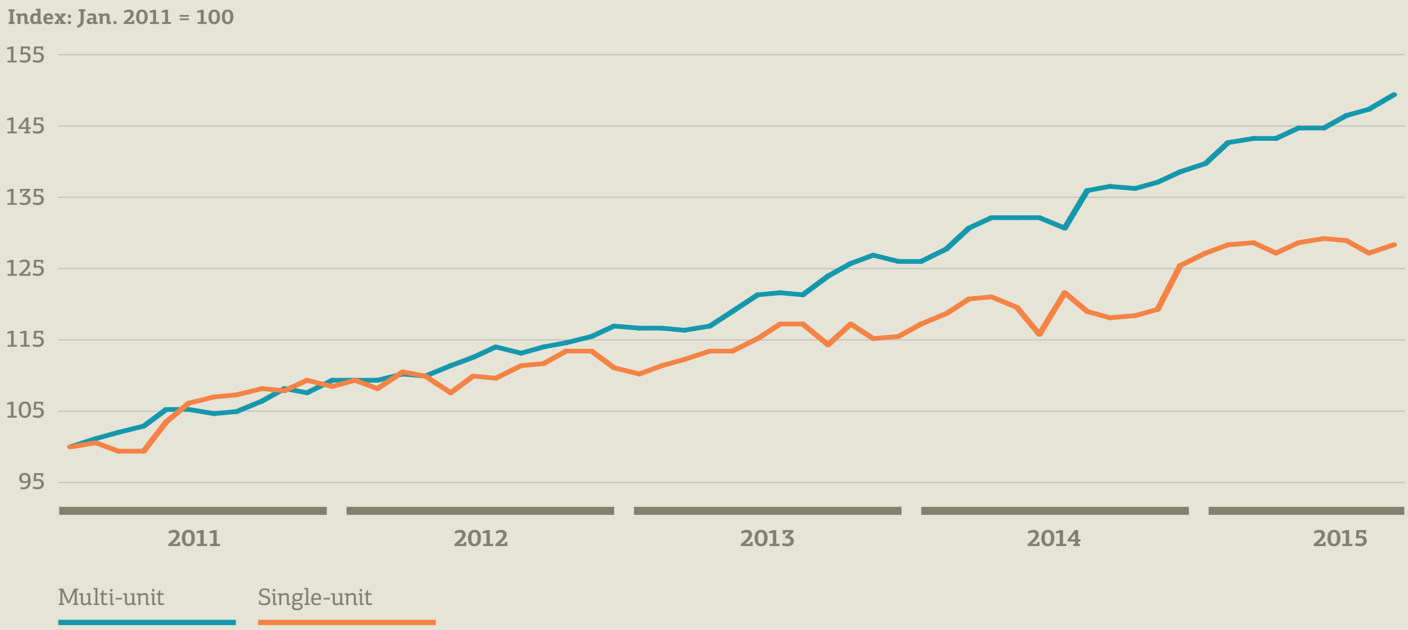
They have lowered their mortgage rates in line with bond market yields and offer rates lower than the commercial banks, as well as offering non-indexed mortgages also. Pension funds have raised their LTV ratios and lowered up-front fees for new mortgages.

Some response has already been seen from the commercial banks, suggesting possible increased mortgage market competition. All of which facilitates access to financing and in turn encourages price increases. In addition to this, factors such as lower funding costs and lower taxes on financial undertakings could increase the banks' scope for lowering housing mortgage rates.

Following major wage increases recently the development of purchasing power is still favourable.

Nominal real estate prices in the capital region

Source: National Registry,
Landsbankinn Economic Research



Household finances have greatly improved recently, debt has decreased, their equity position has improved and mortgage ratios are lower than they have been for a long time. This means households should be capable of increasing their debts in the upswing ahead. All of these factors point in the direction of continuing housing price increases.

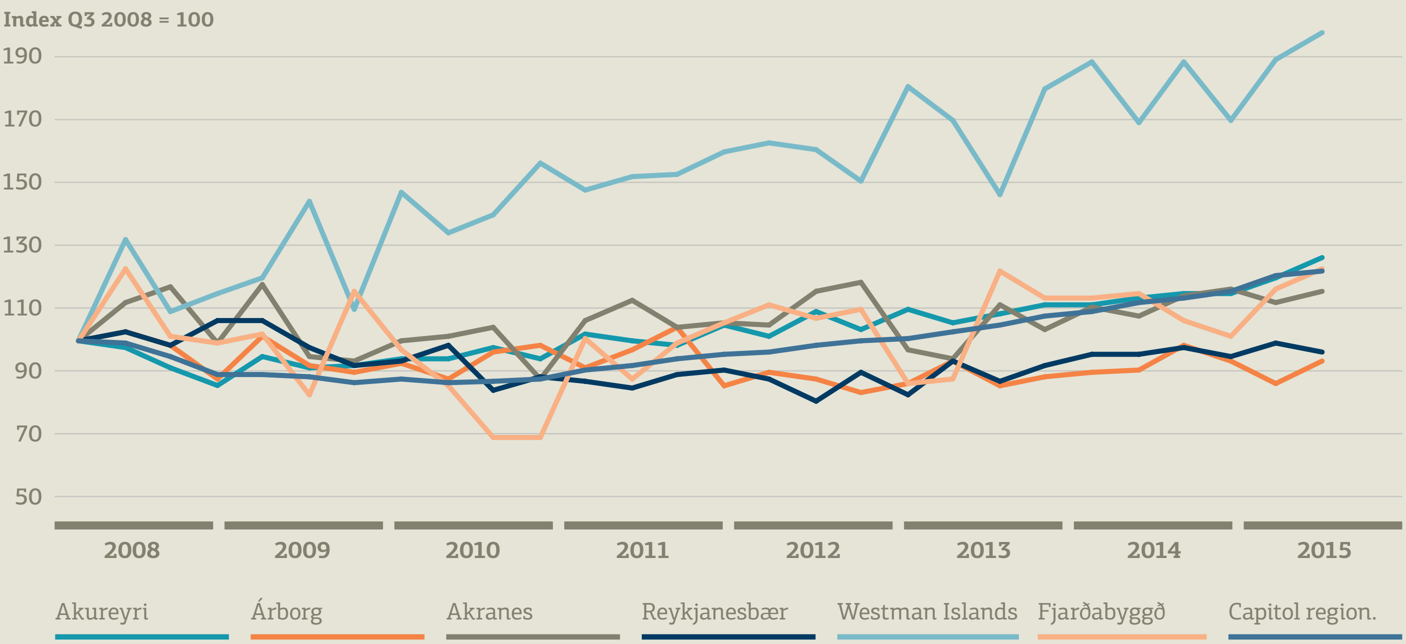
Other factors could be mentioned in this connection, e.g. the need for continuing import of labour in coming quarters, which will require additional housing, and if the increase in foreign travellers continues at the same pace the renting of accommodations to tourists will reduce the supply of housing still further.

Same price trends in larger towns

A glance at the development of real estate prices in large towns outside the capital region from Q3 of 2008 to Q2 this year shows that developments vary. The situation in the Westman Islands is in a class by itself, as prices have doubled during this period. Prices have fallen in Árborg and Reykjanesbær but remained fairly stable in recent quarters. In other municipalities, i.e. in the capital region, in Akureyri, Fjarðabyggð and Akranes,

Housing price developments

Source: National Registry, Landsbankinn Economic Research



prices have risen at a similar pace. These figures show clearly that developments in the capital region are by and large comparable to what has been happening elsewhere.

Real estate turnover still growing

Strikes at District Commissioners' registry offices have made it difficult to track monthly developments in the real estate market this year.

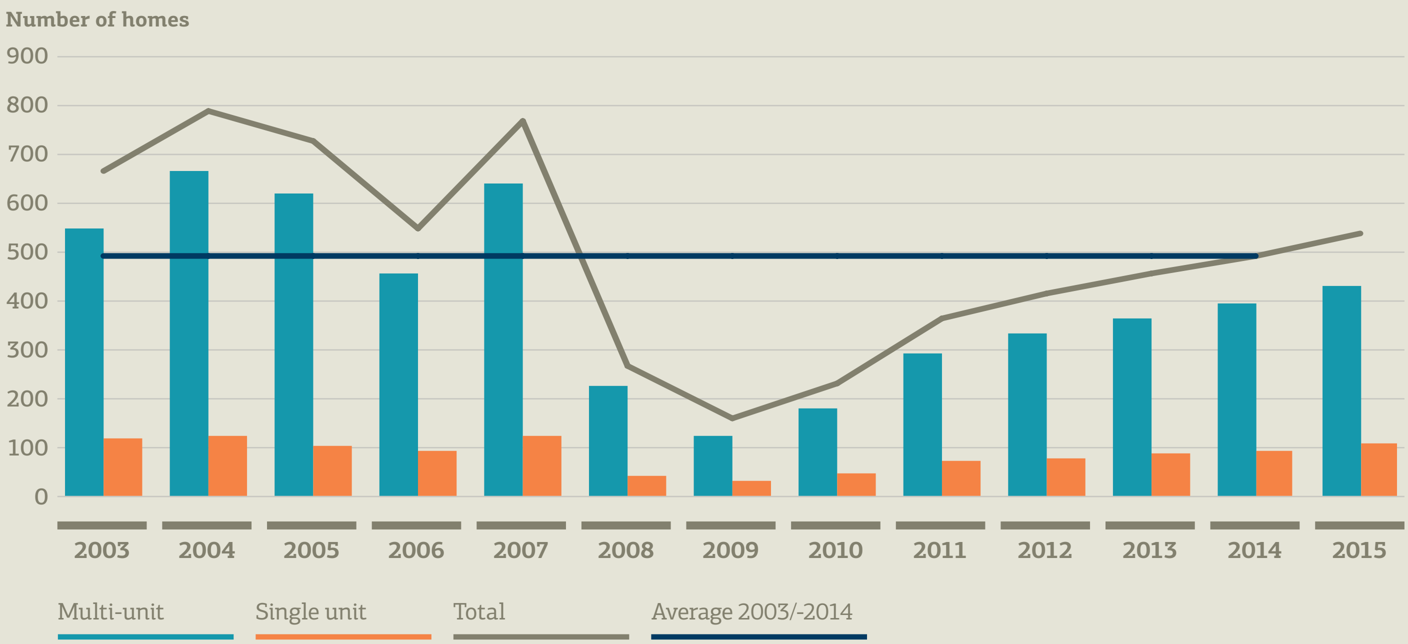
The average number of transactions over a longer period shows that during the first 9 months of this year the average number of monthly transactions was well over that of the past 11 years. Real estate market turnover is therefore still increasing and as long as a greater supply of new housing is not added this situation points towards a further increase.

Rents have not risen in line with purchase prices

Although rents and purchase prices for multi-unit housing have been closely correlated for the past 4 years, in recent months it would appear that rent increases have slowed. In September, for instance, the 6M increase in the purchase

Avg. no of real estate transactions per month in the capital region

Source: National Registry, Landsbankinn Economic Research



price of multi-unit dwelling rose by 4.3%, while rents dropped by 1%.

The rental market has traditionally been less stable and less mature in Iceland than in neighbouring countries, as the emphasis has been on owner occupancy. In spite of widespread discussion of the necessity of improving the rental housing situation the authorities have done little to encourage such changes, as improvements would be very costly.

The nature of the rental market has changed in recent quarters with enterprises to an increase-ing extent buying up housing for rental and thereby adding to the pressure on the traditional home buyers' market.

Short-term rentals to tourists have also increased substantially, squeezing the traditional rental market.

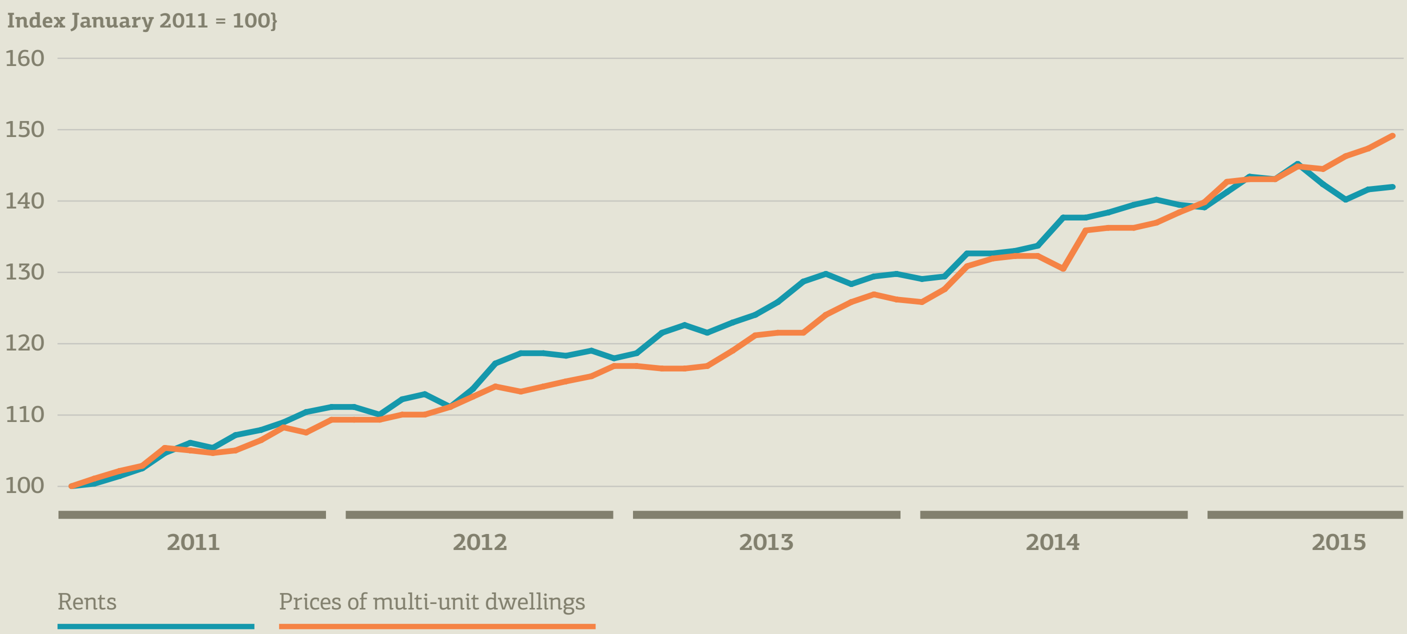
Plans for construction of more rental housing

In May this year the government issued a declaration on housing affairs in collaboration with the social partners and local authorities.

The declaration is aimed at the construction of 2,300 social housing rental units

Housing rents and purchase prices

Source: National Registry, Landsbankinn Economic Research



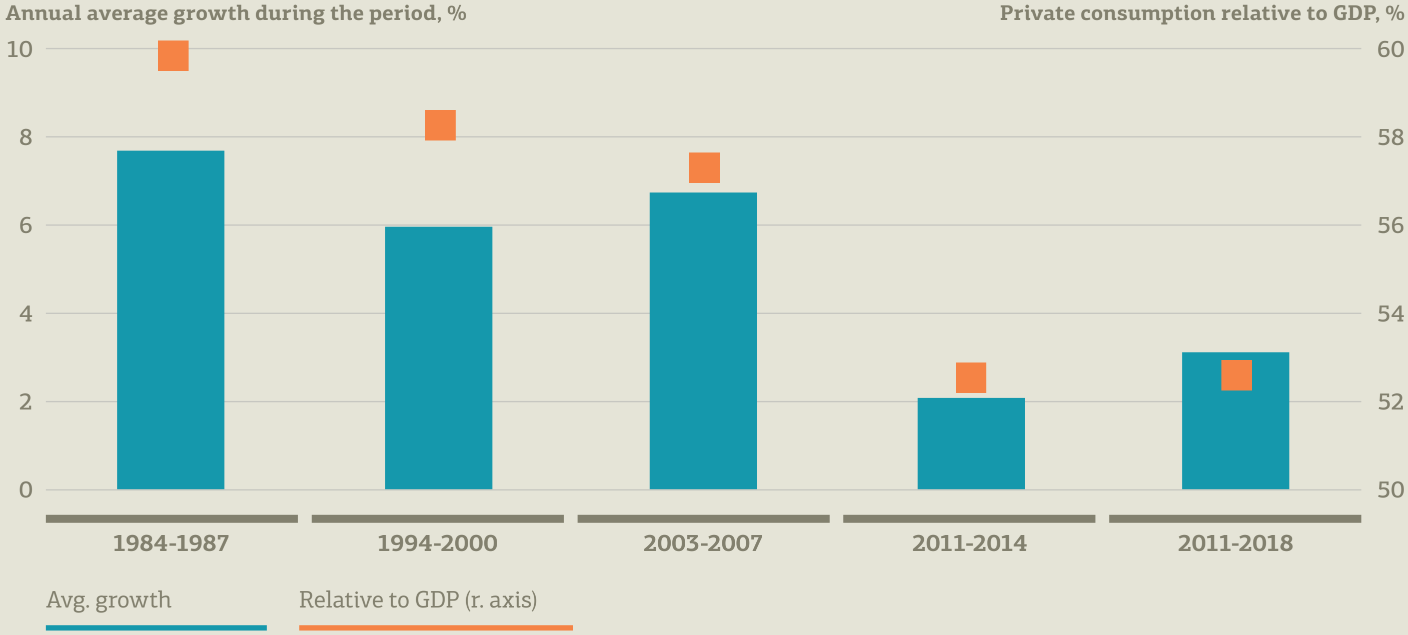
over the next four years, i.e. from 2016-2019, however, at a maximum rate of 600 units per year. This is a high volume if compared for example with the number of units purchased by enterprises from individuals for rental and also compared with construction activity in recent years. It appears evident that these plans will be delayed somewhat, e.g. the construction of all the units planned for the next two years in the declaration will hardly be completed.

Housing prices the primary inflation fodder

Persistent housing price rises have strongly amplified inflation in Iceland for some time. During the past 18 months the housing component has explained the lion's share of inflation. Other domestic prices have admittedly also boosted inflation in recent months as the pace in the economy has accelerated strongly. Growth has risen as have private consumption and the purchasing power of disposable income. Real estate prices have kept pace with other economic indicators, making it highly likely that the long-term increase in real estate prices will continue in coming months and quarters. Economic Research expects real estate prices to rise by 9.5% this year and by 8% per annum over the next three years.

Private consumption grows during an economic upswing

Source: Statistics Iceland, Landsbankinn Economic Research



Growth of private consumption slower now than following previous downturns

Although the drop in private consumption during the contraction period which ended recently was both deeper and more lasting than in previous downturns, it has picked up at a considerably slower rate in this instance than previously. Almost five years have passed since economic recovery began and private consumption has increased by 2.6% on average per annum. In previous growth periods since 1980, private consumption increased by just under 7% per annum on average. The present upswing has witnessed a more moderate rise in private consumption by comparison. This can conceivably be explained by the fact that household debt was higher than generally was the case before and this debt had a tighter grip on purse strings.

Economic Research's forecast anticipates an increase in private consumption of approximately 5% this year and next year, of close to 4% in 2017 and just over 3% in 2018.

Over the past 35 years private consumption has averaged around 57% of GDP, although fluctuating considerably. It peaked at around 61% in the 1980s and 1990s and fell to a low of 51% in 2009 and 2010. In 2014 it was 52.5%. Economic Research's forecast expects significant growth in private consumption in coming years, averaging 4.5% during the period 2015-2018. Over this same period we expect a strong increase in fixed capital formation resulting accordingly in high GDP growth as well during this period, of around 4.3% annually. We therefore do not expect private consumption to increase significantly relative to GDP in coming years. However, should private consumption growth trend towards what we have seen following recent recessions, our GDP growth forecast will have been substantially underestimated.

4. Investment is on the rise

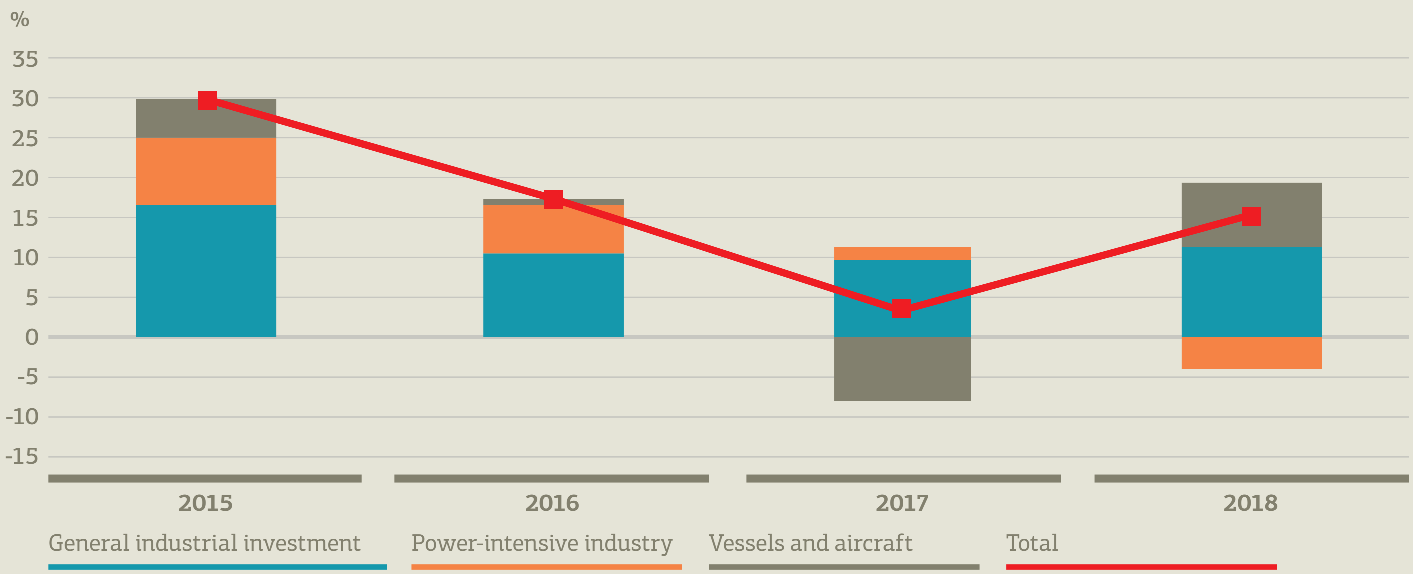
The outlook is for strong growth in industrial investment during the forecast period, not least this year. It will continue strong in 2016 and in 2018. Housing investment is not expected to increase much this year, but to grow by 15% on average annually in 2016-2018.

Despite the Treasury's improved situation, clear signs of overheating leave scant scope for increasing public investment in coming years. Nor does the difficult fiscal situation of local authorities give much cause to expect their investment will increase substantially. On the whole we expect annual public sector investment to increase on average by just over 4% during the forecast period.

Total capital formation in the economy is expected to increase considerably this year and next, by over 20% this year and around 15%

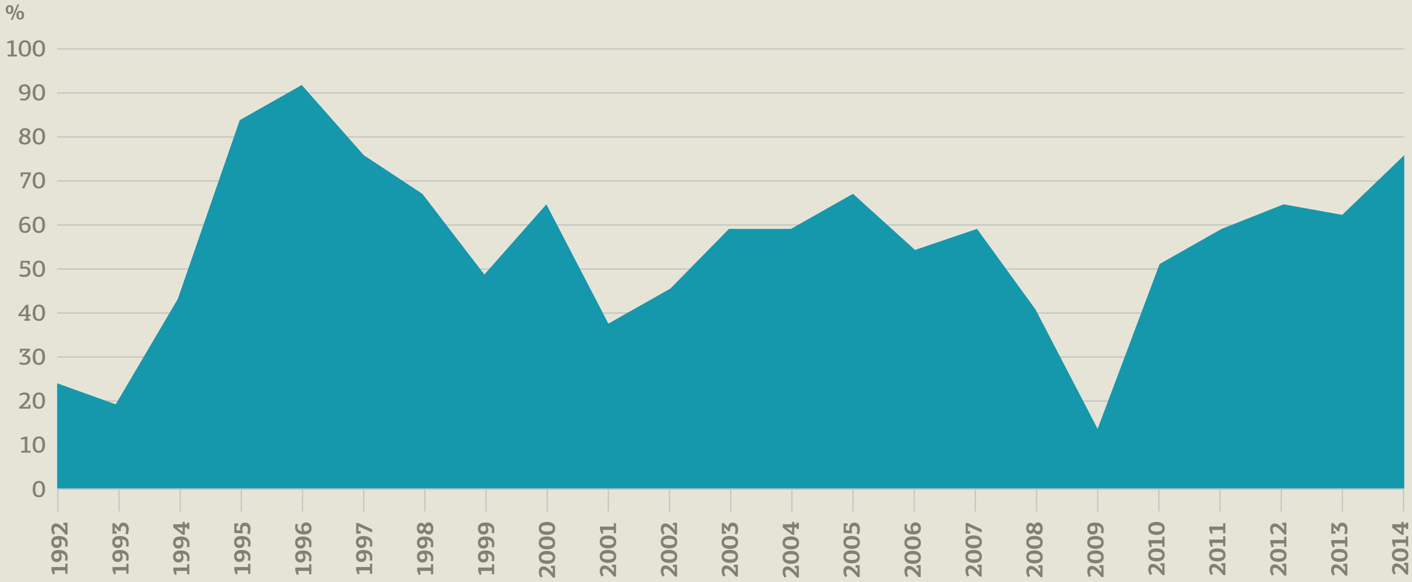
Growth of industrial investment and sub-categories

Source: Landsbankinn Economic Research



Broader increase in investment than previously

Source: Statistics Iceland



Relative share of 37 leading business sectors tracked by Statistics Iceland increasing investment YoY

next year. Growth will then slow in 2017, to 6%, and pick up once more in 2018 to over 12%. This is due mostly to stronger industrial investment in coming years, together with a significant housing investment contribution over the next three years.

Strong increase in investment in first half of 2015

According to preliminary figures from Statistics Iceland, investment in the economy grew by around 21% YoY in the first half of this year, entirely due to industrial investment as both housing investment and public investment contracted during this period. Industrial investment, however, surged by 38%, with investment in vessels and aircraft as the leading factor. If vessels and aircraft are excluded, industrial investment grew by 13.7% and total investment by 6.1%.

Substantial growth in industrial investment expected

Economic Research forecasts an increase of 30% in industrial investment in 2015, primarily as a result of increases in general industrial investment. Growth of around 17% is expected next year and of 3% in 2017. The lower growth anticipated in 2017 is mainly due to the tapering off of investment once renewal of fishing vessels is accomplished. Growth is expected to pick up again strongly once more to around 15% in 2018, partly as the result of major investments in aircraft by Icelandair in 2018.

Industrial investment more broadly based than often before

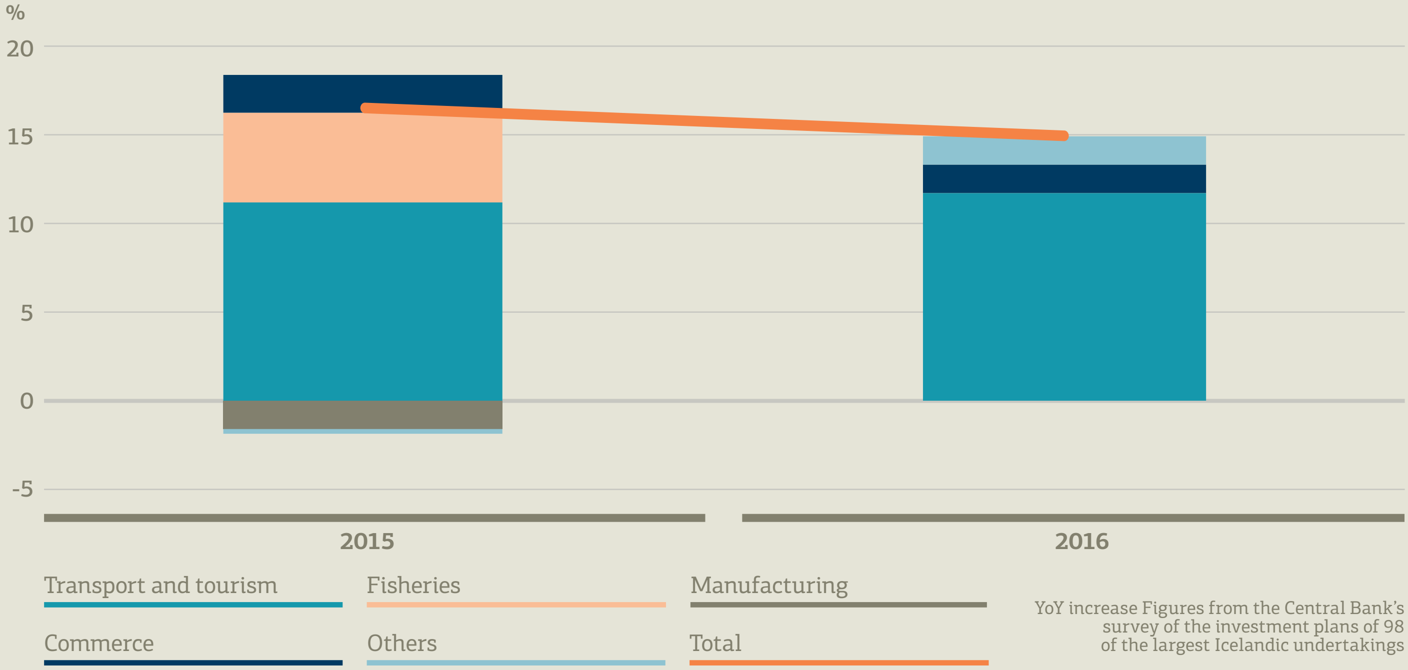
The growth in industrial investment in the first half of 2015 has not been as strong since the first half of 2006 and it is even longer since the increase was as broadly distributed. Statistics Iceland divides industrial investment into 37 industrial sectors and in the past year investment increased in 28 or 76% of these sectors. Not since 1996 has this proportion been as high. Strong industrial investment growth is due in part to the very limited investment in the years following the banking collapse. A pent-up need for investment has now apparently been released. This is actually a repeat of the events which followed the economic downturn of the early 1990s.

Surveys indicate further growth in industrial investment

The Central Bank's survey of corporate investment plans suggests sizeable growth this year, as 98 of the country's largest enterprises expect to make investments totalling around ISK 66 billion, or some 17% more than these companies undertook last year. Next year they expect to increase their investment by 15%. Both this year and next year undertakings in transport and travel services plan on increasing their investment the most,

Growth of industrial investment and individual sector investment

Source: Central Bank of Iceland



YoY increase Figures from the Central Bank's survey of the investment plans of 98 of the largest Icelandic undertakings

by around 46% this year and 38% next year. Figures on imports of investment goods plus vessels and aircraft during the first 8 months of this year support the conclusions of the survey, as these imports rose by 16.5% YoY.

Sizeable increase in corporate lending

Since industrial investment is partly funded by credit, increasing industrial investment is accompanied by credit growth. During the first 8 months of this year new corporate lending[3], net of repayments, amounted to ISK 117 billion compared to ISK 59 billion over the same period last year, almost doubling YoY. The increase results from increased lending to various sectors, but most conspicuously to service sectors. New lending to companies in services during the above-mentioned period totalled ISK 64 billion compared to ISK 9.1 during the same period last year. A large portion of this credit is probably extended to companies in travel services which have grown very rapidly in recent years. Part of the lending to the service sector is to real estate companies. Operation of hotel real estate and other hotel operations are often administered through separate companies. A sizeable portion of lending to real estate companies therefore is likely to be made to companies for hotel construction.

Lending growth suggests stronger investment growth in first half of 2015

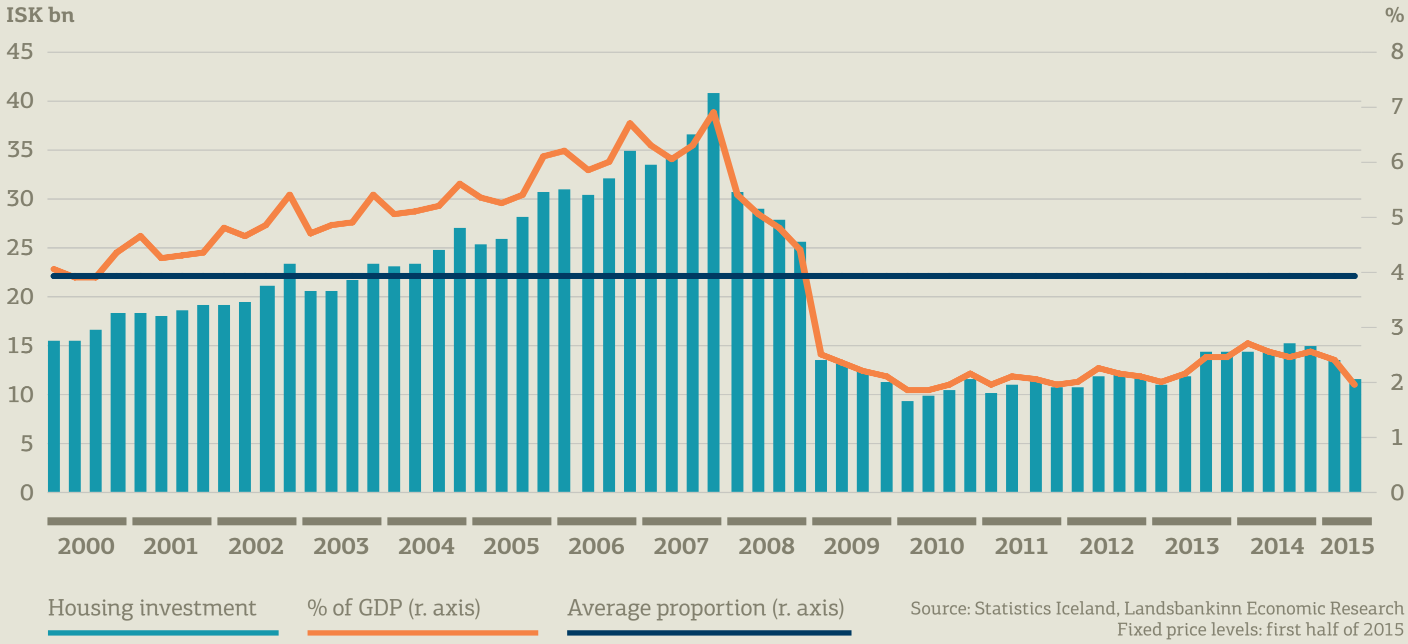
Based on an analysis of corporate lending we consider it likely that investment growth in the first half of this year may be underestimated to some extent. This would accord with the situation in recent years, where the first preliminary figures from Statistics Iceland tend to underestimate the level of investment. Last year total industrial investment amounted to ISK 212 billion. New lending net of paybacks during the same period was ISK 96 billion. New lending YtD amounts to ISK 117 billion and the figure for industrial investment is ISK 136 billion. We estimate that, based on net new lending during the first 8 months of this year, the total figure for this year will be around ISK 149 billion. That would be around ISK 53 billion higher than last year and ISK 66 billion more than in 2013.

Thorsil adds to investment in power-intensive industry

Agreements were recently concluded between Thorsil and Landsvirkjun for sale of

[3] Um er að ræða atvinnugreinaflokkana landbúnað, fiskveiðar, iðnað, byggingastarfsemi og mannvirkjagerð, verslun o.fl., samgöngur og flutningar og þjónustu.

Housing investment at fixed prices and relative to GDP



Source: Statistics Iceland, Landsbankinn Economic Research
Fixed price levels: first half of 2015

electricity to Thorsil's silicon plant in Helguvík. Economic Research's recent forecasts followed the principle that investment in power-intensive industry would not be included in the forecast until electricity for its operations was secured. For this reason the forecast for power-intensive industry investment includes the PCC silicon plant at Bakki and United Silicon, as previously, and with the addition of Thorsil now. A fourth silicon project is that of Silicor Materials at Grundartangi. There an agreement has been reached between Silicor Materials and ON Power, a subsidiary of Reykjavík Energy, for the purchase of 40 mW of electric power. As the project requires a considerably greater amount of electricity, however, around 85 mW, sufficient power has not been secured and the project is not included in our forecast.

ISK 25 billion of investment in aircraft 2018

Substantial investment is in the pipeline in the travel industry in coming years. Around two years ago Icelandair signed an agreement to purchase 16 passenger jets from Boeing, with options to purchase an additional 8. The total value of the 16 aircrafts according to Boeing's list price is around USD 1,6 billion. Assuming common discounts on the list price in aircraft purchases of this magnitude, we estimate that the total investment will amount to around ISK 100 billion. As the planes are to be delivered in 2018-2021, their impact will be felt near the end of the forecast period. Four of the aircraft are expected to arrive in Iceland in 2018, with a value of around ISK 25 billion.

Major investment in hotel accommodations planned

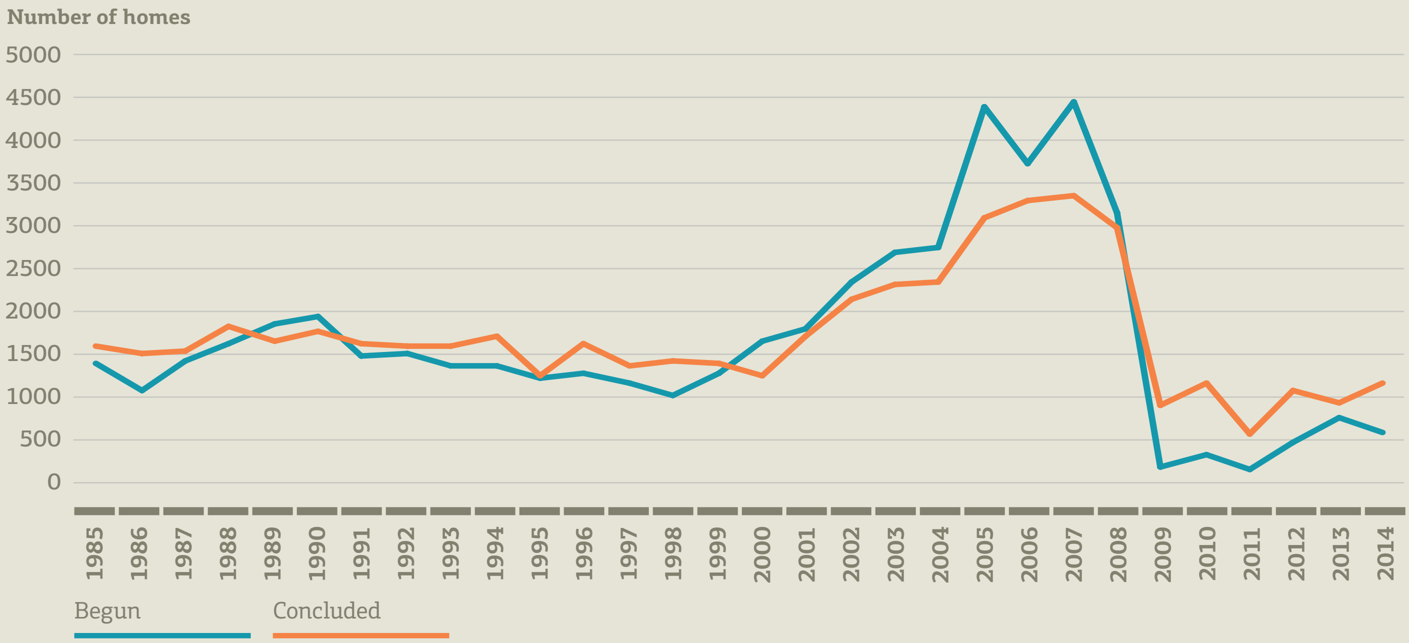
In another capital intensive sector of the travel industry, hotel operations, large investments are also in preparation. Leading among them is a 250-room hotel to be built on the lot beside the Harpa Concert Hall and Convention Centre, at an estimated cost of around ISK 16 billion, which is to open in 2018. Other major hotel investments are planned for the forecast period on the Landsími site and Hlíðarendi, as well as the Fosshótel on Höfðatorg square which will open this year. The other hotels are to open in the final year of the forecast period, 2018. The greatest share of all hotel investment will be in 2017 and 2018, around ISK 11.5 each of those years. In 2015-2018 total hotel investment will amount to an estimated ISK 38 billion.

Proposed investment by Isavia of ISK 70-90 billion

By far the largest share of foreign visitors arrive in Iceland at the Leifur Eiríksson airport in Keflavík and the

Housing construction - all Iceland

Source: Statistics Iceland



forecast growth in tourist traffic makes it urgent to enlarge the airport. Isavia, the airport operator, intends to enlarge the facility substantially, with investments of ISK 70-90 billion in 2017-2020. The forecast assumes that around ISK 8 billion of that amount will be in 2017 and ISK 20 billion in 2018.

Housing investment not in accord with public discussion

In 2014 housing investment was equivalent to 3% of GDP, whereas from the beginning of this century until 2008 it ranged from 4 to 6% annually. The proportion dropped to less than 2% in 2010 and again in Q2 of 2015. In the past three years housing investment averaged around 2.7% of GDP, which is far below the average of 4.1% during the period 2000-2014.

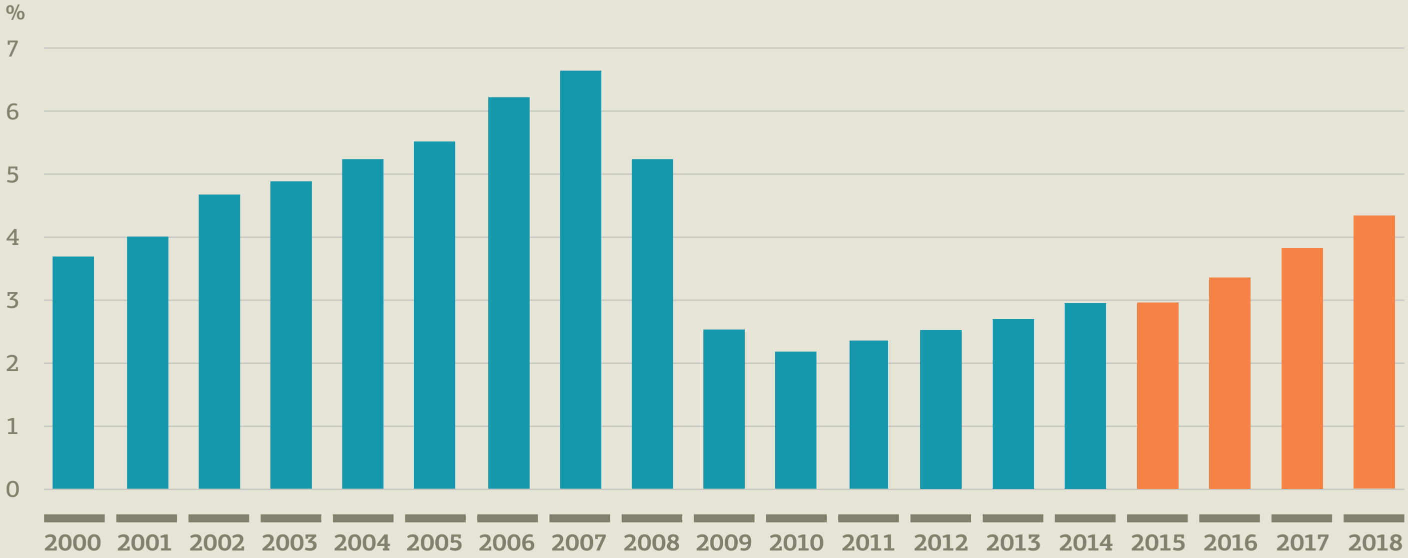
In the first half of 2015 housing investment declined YoY by 13.3% according to Statistics Iceland's preliminary figures. This contraction in housing investment is rather at odds with public discussion on these activities and the possibility cannot be excluded that they will change upon closer examination. Until the end of 2007 housing investment grew steadily to ISK 40 billion in Q4 that year at 2015 price levels. Housing investment then collapsed to a low of around ISK 9 billion at the beginning of 2010 before increasing once more to ISK 12-15 billion quarterly until year-end 2014. Since that time it has dropped again, however, amounting to only just over ISK 12 billion in Q2 this year.

Housing construction statistics tell a similar tale

Figures on the number of dwellings under construction point in the same direction. The construction industry collapsed in 2008 and has yet to fully recover. In 2014 construction of only 580 homes began in the entire country, according to figures from Statistics Iceland, and construction of around 1,150 homes was completed. From 1985 to 2014 home construc-tion starts were on an average 1,700 annually, and a similar number were completed. Home construction starts in 2014 therefore were only around 35% of the yearly average over the last 30 years. Statistics from the Federation of Icelandic Industries on homes under construction in the capital area paint a similar picture, e.g. number of homes under construction decreased in number from the tally of October 2014 to that of March 2015 after having increased up until that time. The tally in October 2015, however, showed that the number of homes under construction had increased slightly, while

Housing investment as a proportion of GDP

Source: Statistics Iceland, Landsbankinn Economic Research
The last 4 years are Economic Research's forecast



home construction starts decreased somewhat. These figures support conjectures that construction activity is slowing. Statistics on the sale of cement for building other than power-intensive industry also indicate that activity in construction is less than it has been in recent quarters. Sales of cement rose greatly in 2013 and 2014, but have been considerably lower since mid-2014.

Is construction still too costly?

The link between the construction cost and selling price of housing was skewed considerably by the financial collapse. Housing prices fell while construction cost rose greatly, especially due to ISK depreciation, with the result that construction came almost to a standstill. A better balance was regained between these two figures in the years after 2011, and especially from mid-2013 onwards, when purchase prices rose considerably more than construction cost. Following the collective bargaining agreements last spring the Construction Cost Index rose sharply and construction cost can be expected to have risen in parallel to this, although the correlation between the index and the real cost of construction is not perfect. The increase in real estate prices, however, is steep and continuous, which should encourage investment in housing in coming years.

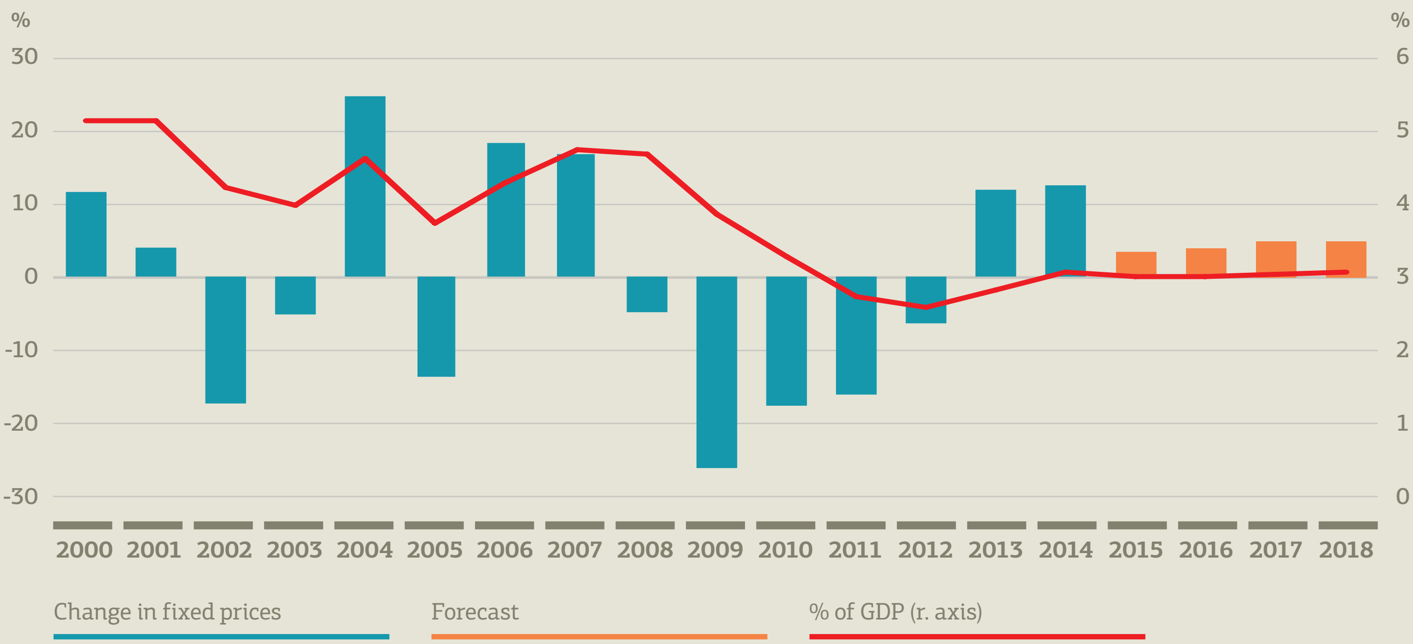
It appears that there are still considerable incentives to build larger and more expensive homes, despite extensive public debate and promises by leaders that changes are needed. Discussion of the housing market situation has been widespread. The national government, for instance, issued a statement in connection with the collective bargaining agreements in May promising to make major effort towards increasing rental housing, with the objective of building 2,300 rental units over the next four years. It appears evident that these plans will be delayed somewhat.

Sizeable increase in housing investment in coming years

Despite Statistics Iceland's figures on a decline in housing investment YoY in the first half of 2015, Economic Research predicts that housing investment will increase by 2.5% in 2015 as a whole, then by 18% in 2016 and 2017 and 10% in 2018. If this forecast proves correct, housing investment will comprise 4% of GDP in 2018, which is similar to the average of the past 15 years.

Public investment 2000-2018

Source: Statistics Iceland, Landsbankinn Economic Research



Limited scope for increased public investment in coming years

Public investment increased by 12.8% last year according to Statistics Iceland and was 3.1% of GDP, or half a percentage point less than the average of the past decade. Then in the first half of this year there was a decline of 0.8% in public investment. The 2016 Budget discusses near-term Treasury investment extensively, stating that the intention is to maintain a level of investment similar to that provided for in the 2015 budget, or approximately 1.2% GDP. According to this there could be scope for new investment in 2017, replacing those projects which conclude during the period. Government plans provide, among other things, for the construction of a patient hotel on the site of the National University Hospital to be completed together with final design of the new NUH treatment centre. To some extent low public investment is part of government policy to restrain expansion, as it can sometimes be easier to slow the pace of public works, or not begin them, than to cut back on normal expenditures.

In recent years a considerable need for investment has developed in various areas, for instance, due to lack of maintenance. It is clear that the fiscal situation will improve considerably next year in part as a result of stability contributions from the estates of the failed banks. In addition, national elections will take place in 2017, and experience teaches that investment is not unlikely to increase in next year's budget.

Given the municipalities' situation, they are not expected to increase their investment in coming quarters. Economic Research sees no reason to alter its previous forecast for 2015-2018 and expects public investment to increase by 3.5% this year, 4% next year and 5% in 2017 and 2018. Public investment will amount to 3.1% of GDP in 2018, or similar to that of 2014.


EIMSKIP

5. Tourism continues as the driving force in exports

Export growth in the first half of 2015 was 9% over the same period of 2014. This is very strong growth, and one would have to go back 7 years in time to find a first half-year with higher export growth. The trend was primarily driven by increased exports of services, for the most part attributable to travel industry growth.

As tourism has expanded very substantially in recent years its contribution to export value has risen year after year. At the same time the export value of cod and capelin products has risen, together with exports of services other than travel services.

Increased exports driven by expansion in the travel industry

Expansion in the travel industry is expected to continue to fuel growth in exports. The forecast for exports from power-intensive industry has changed in that now the Thorsil silicon plant in Helguvík is included. The cod stock is still expected to grow and the next capelin season to be similar to the last one. Exports of services other than travel services have risen considerably and are expected to continue to increase in coming years. Export growth of 7.9% is forecast for this year, of around 5.8% in the following two years and then to drop to 3.8% in 2018. The overall trend is dominated by forecasts of increasing tourist numbers.

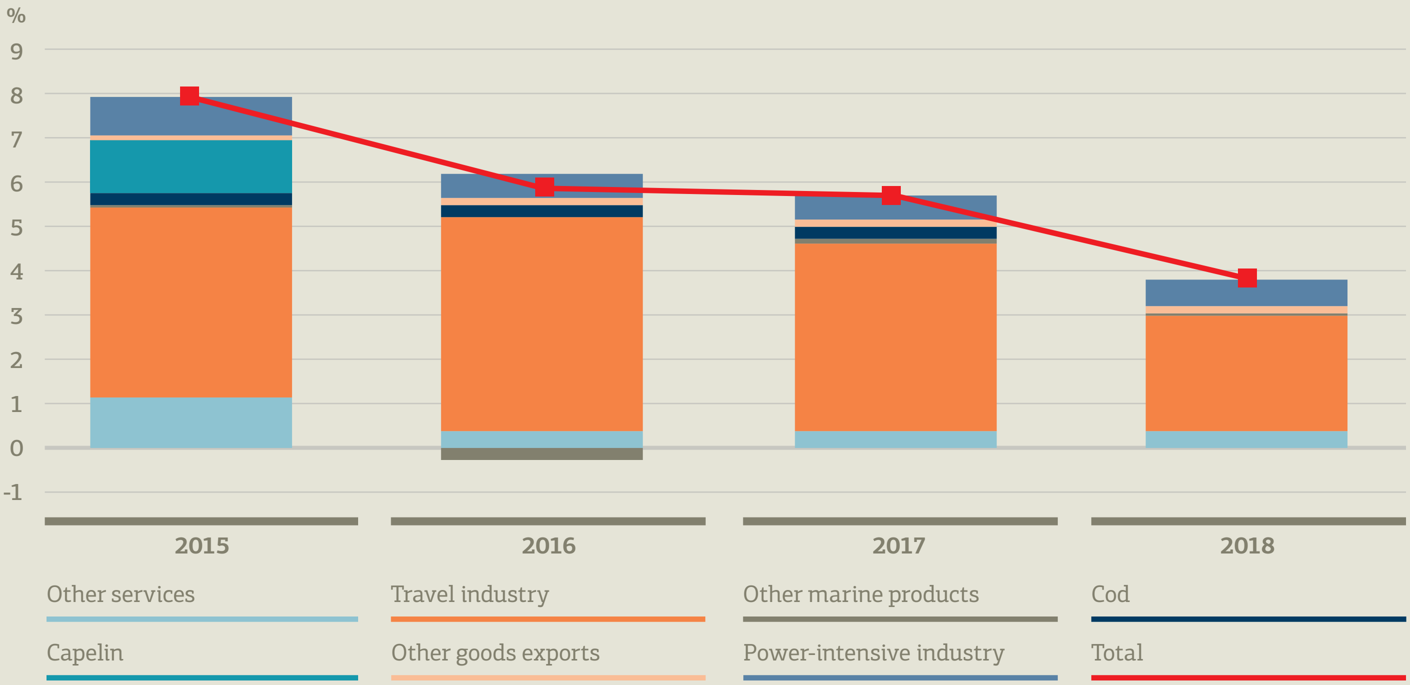
A large increase in the number of travellers expected next year

Our forecast on the factors driving export growth has changed little in recent years. Now as before the travel industry will be the driving force. The number of foreign visitors is forecast to increase by 26% this year. During the first 10 months of the year over a million travellers entered Iceland through the Keflavík airport, an increase of 29.8% YoY. This is in fact the greatest YoY increase of the current upward trend which began in 2011. Next year an increase of 24% is expected in the number of travellers, based on Isavia's forecast. In recent years Economic Research's forecast has predicted that this growth will slow as the forecast period progresses, dropping to 18% in 2017 and to 10% in 2018, which would be just over the historical average increase.

Exports of travel services from Iceland are of two types, firstly, consumption of foreign travellers in the country and, secondly, the income of Icelandic airlines from passenger traffic whether they actually enter the country or not.

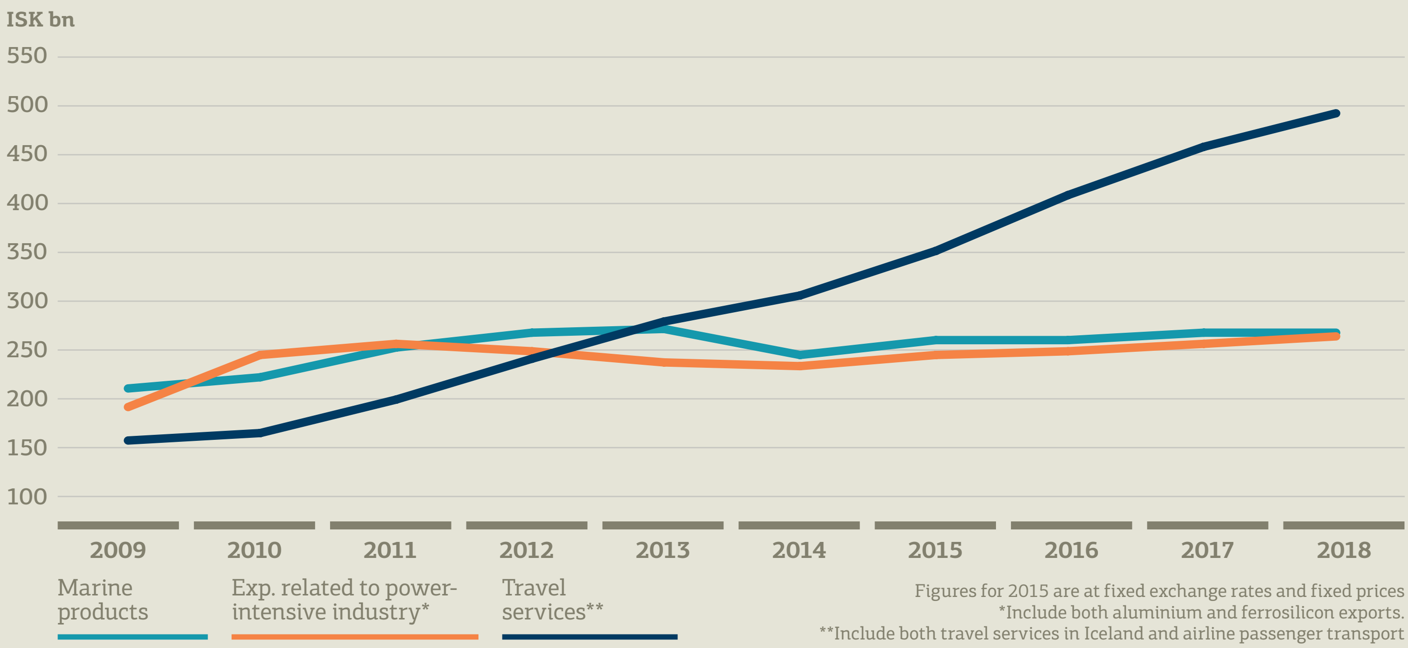
Growth of exports and sub-categories

Source: Landsbankinn Economic Research



Three export pillars

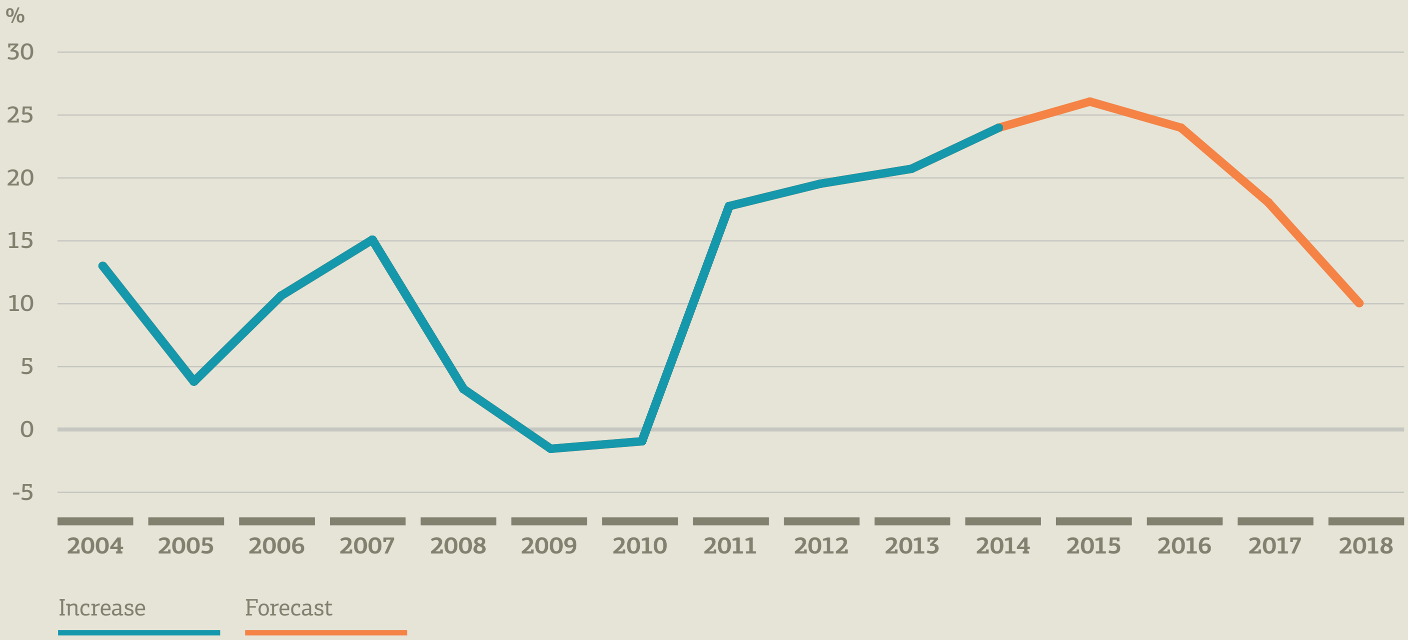
The last 4 years are Economic Research's forecast Statistics Iceland, Landsbankinn Economic Research



Figures for 2015 are at fixed exchange rates and fixed prices
*Include both aluminium and ferrosilicon exports.
**Include both travel services in Iceland and airline passenger transport

Increase in foreign travellers

Source: Icelandic Tourist Board, Landsbankinn Economic Research



Passenger traffic, which has in recent years comprised around half of the travel industry's foreign currency earnings, has risen more slowly than consumption by foreign travellers in Iceland and this trend is expected to continue.

Share of travel services almost equal to that of power-intensive industry and fisheries combined

If this forecast proves correct, the share of the three pillars in total exports will change considerably. Travel services, which contributed around 28% to exports in 2014, will increase its share to 36% in 2018. Marine products and power-intensive industry exports each accounted for around 22% of total exports in 2014 but the share of each of these sectors will drop below 20% at the end of the forecast period. The combined contribution of these three pillars to total exports will rise from 72% in 2014 to 75% in 2018.

Various factors point to a continued increase in tourist numbers

Various factors support forecasts for a continued rise in the number of travellers to Iceland, including forecast GDP growth of 2-2.5% in coming years[4] in the countries where these travellers originate. Low fuel prices will also encourage a further increase in numbers, as fuel costs are among airlines' largest expenditure items.

Three silicon plants likely to be built in the near term

Investment in power-intensive industry planned for the forecast period will result in increased exports. Our forecast assumes the development of three silicon plants: the PCC plant at Bakki, near Húsavík, in northeast Iceland, together with United Silicon and Thorsil, both of which will be located in Helguvík, near Keflavík. The last-mentioned recently secured a supply of electricity for its production and is therefore included in our forecast. Total production of these three plants is estimated at 110 thousand tonnes annually, which would double exports of silicon products from those of 2014. In addition, work has been underway at the Norðurál aluminium smelter on Grundartangi to expand its production capacity from 300 to 350 thousand tonnes annually.

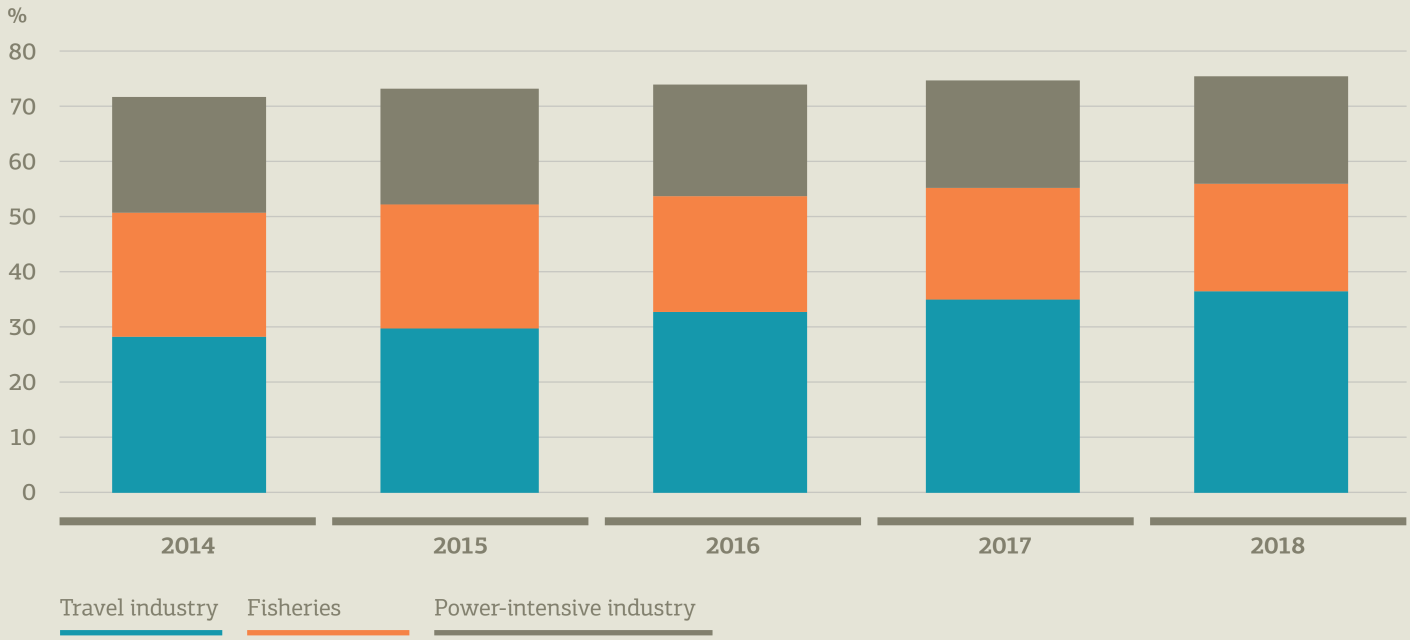
Strong import growth in first half of 2015

It is quite some time since imports have grown this rapidly: the YoY increase in the

[4] The growth forecast for each country is weighted with its share in the total number of travellers to Iceland last year, based on IMF forecasts.

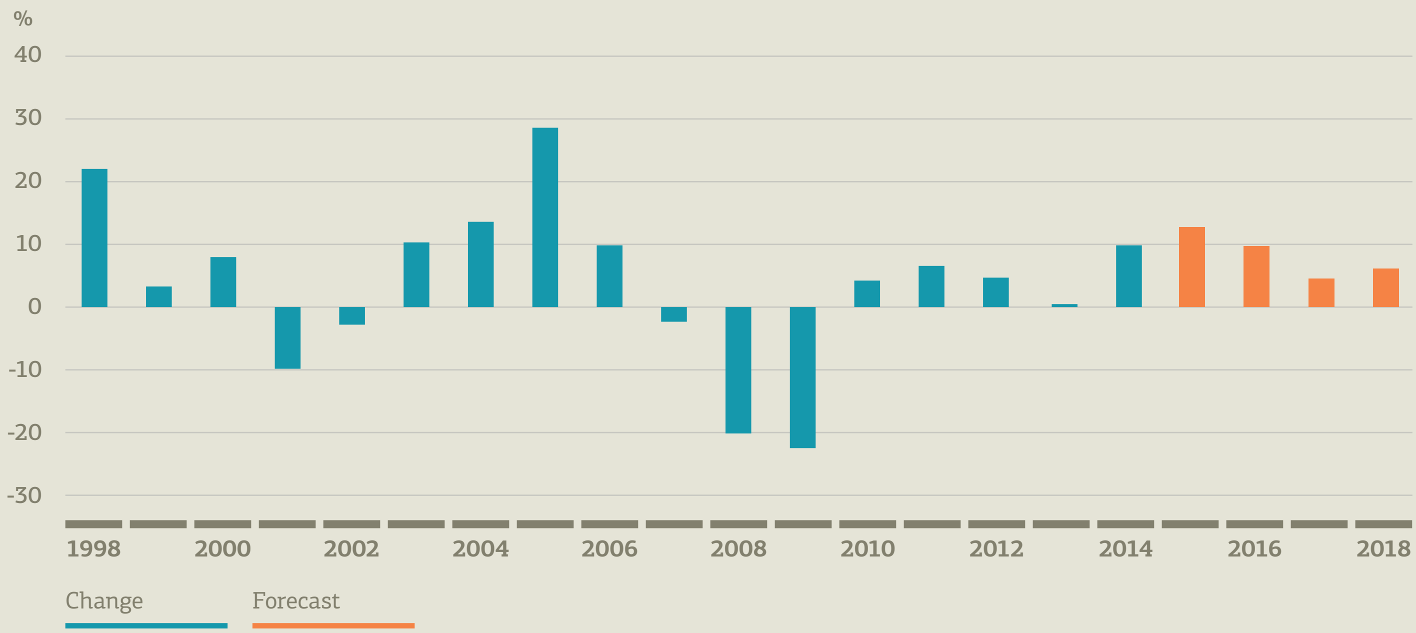
Share of each pillar in total exports

At fixed exchange rates and fixed prices
Source: Statistics Iceland, Landsbankinn Economic Research



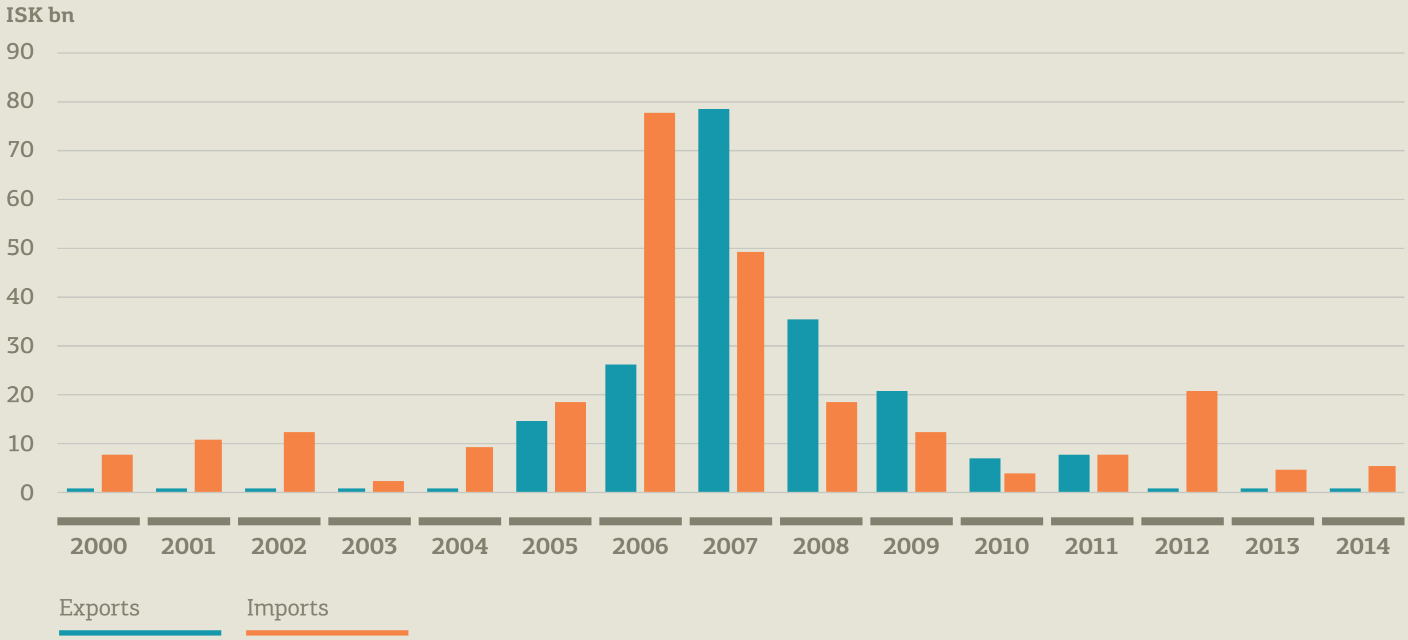
Changes in imports

Source: Statistics Iceland,
Landsbankinn Economic Research



Import and export of aircraft

At fixed exchange rates in 2014 Source: Statistics Iceland



first half of 2015 was 13.6%, an increase the like of which has not been seen since 2006. The increase in goods imports was considerably more than the rise in imports of services and accounts for by far the greatest share of overall import growth in the first half of this year. Almost 90% of the total increase in imports was due to higher imports of goods.

Aircraft imports figure strongly in import statistics

Imports are generally a good indication of changes in domestic demand, especially private consumption and industrial investment. A glance at individual sub-categories shows that major increases in aircraft imports account for a substantial portion of the rise in total imports. Aircraft imports increased YoY by ISK 14 billion in the first half of this year. By comparison, total imports of goods rose by ISK 56 billion, with aircraft accounting for around one-third of the increase. In addition, imports of vessels comprised around 13% of the increase in goods imports. Aircraft imports have often comprised a striking proportion of total imports without this having any lasting effects. Aircraft were apparently often imported and registered in Iceland prior to the financial collapse only to be exported a year later, and thus not part of permanent investment. In 2012-2014 imports of aircraft amounted to over ISK 30 billion while exports were only ISK 1.4 billion. The aircraft imported this year are likely to make their home here permanently, as the investment was made by the airline WOW air. Substantial aircraft imports are anticipated near the end of the forecast period, as in 2018-2021 Icelandair plans to invest in new planes for around ISK 100 billion.

Imports will continue to rise

Imports are expected to increase by 13% in 2015 as a whole, which would be the strongest increase in imports since 2005. The forecast for imports is actually a derived figure, determined primarily by YoY changes in private consumption and industrial investment. Import growth will also be strong next year, at 9.4%, then drop to 4.5%, mostly due to little increase in industrial investment that year. Imports are expected to grow once more at the end of the forecast period, by 6.1%, due for the most part to a sizeable increase in industrial investment that year.

6. State finances on the right track, but local authorities still struggling

Public consumption grew by 1.8% last year and by 1% in the first half of 2015. Public consumption comprised almost one-quarter of GDP last year, a proportion which has remained fairly stable since 2009. Local authorities are still struggling to meet expenses and their operating surpluses have shrunk, in part due to higher expenditures and wage costs.

Unlike most local authorities, the Treasury's situation has improved steadily in recent years. In fact the positive balance in national accounts for the past two years is due to a large extent to one-off and irregular items, although there are nonetheless many signs of positive developments. The anticipated stability contributions of the failed banks will make a major difference in this connection.

Treasury finances indicate rapid expenditure growth

The Treasury's cash flow statements for the first 8 months of this year are now available and provide information on the fiscal situation based on revenues collected and expenditures paid. The current balance for the period was positive by around ISK 462 million. Revenues rose by ISK 24.4 billion YoY while expenditures increased by around ISK 37.3 billion. Treasury revenues during the first 8 months of this year totalled ISK 430 billion, an increase of around 6%, while expenditures amounted to ISK 429 billion, a rise of 9.5%. Expenditures have therefore risen considerably more than revenues during the first 8 months of this year. Despite the difference between revenues and expenditures during the period, the rise in expenditure was similar to what had been expected. This could indicate that discipline in expenditures could be greater, and that the significant share of one-off and irregular income encouraged higher expenditures. These figures reflect only cash flows and not the operating outcome for 2015.

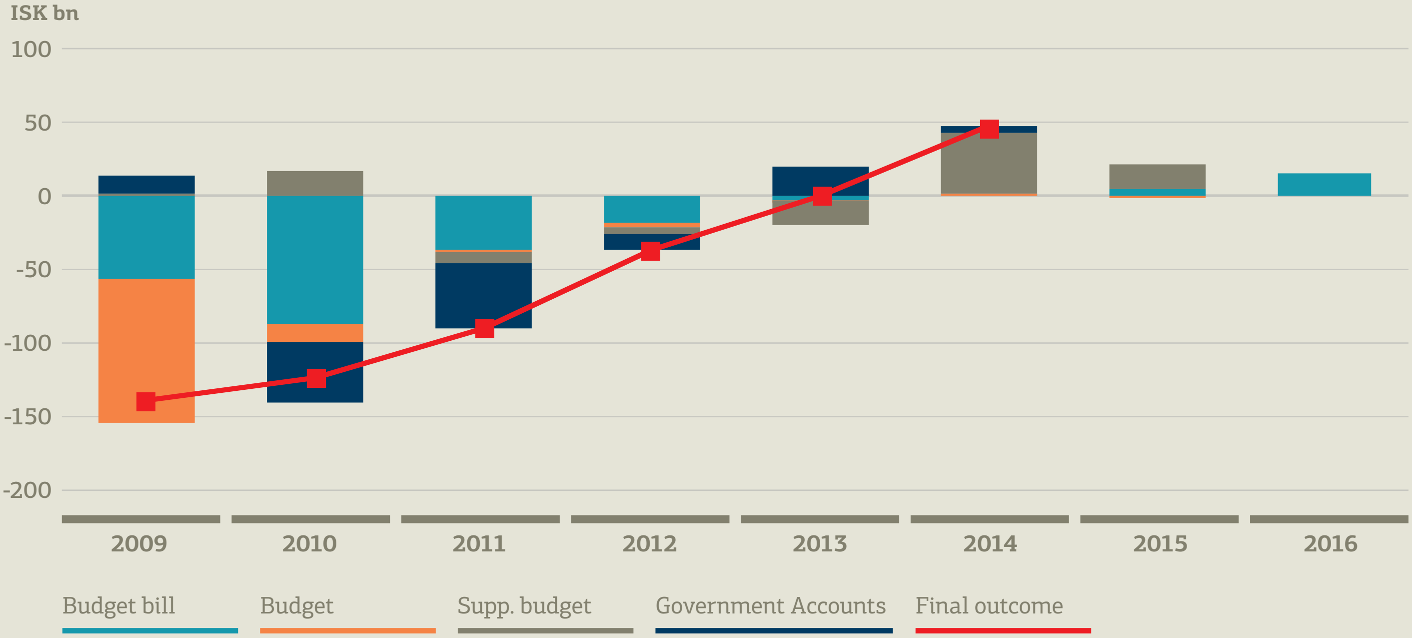
Supplementary budget for 2015

The supplementary budget for 2015 has now been submitted to the Althingi. It provides for a surplus on state operations this year of over ISK 20 billion, while the original budget estimate was a surplus of ISK 3.5 billion. With regard to income, the most significant deviation is dividends of ISK 15 billion more than anticipated paid to the Treasury from its corporate holdings, especially Landsbankinn, which paid dividends totalling ISK 23.5 billion this year. The improvement in the Treasury's perfor-mance from budget estimates is ISK 17 billion, of which higher dividends account for around ISK 15 billion.

Expenditures will increase by close to ISK 10 billion from budget allocations. The largest items include an increased allocation of ISK 3 billion to Icelandic Road Administration for snow removal, of over ISK 2 billion to Icelandic Health Insurance and of ISK 850 million to a tourist site development fund.

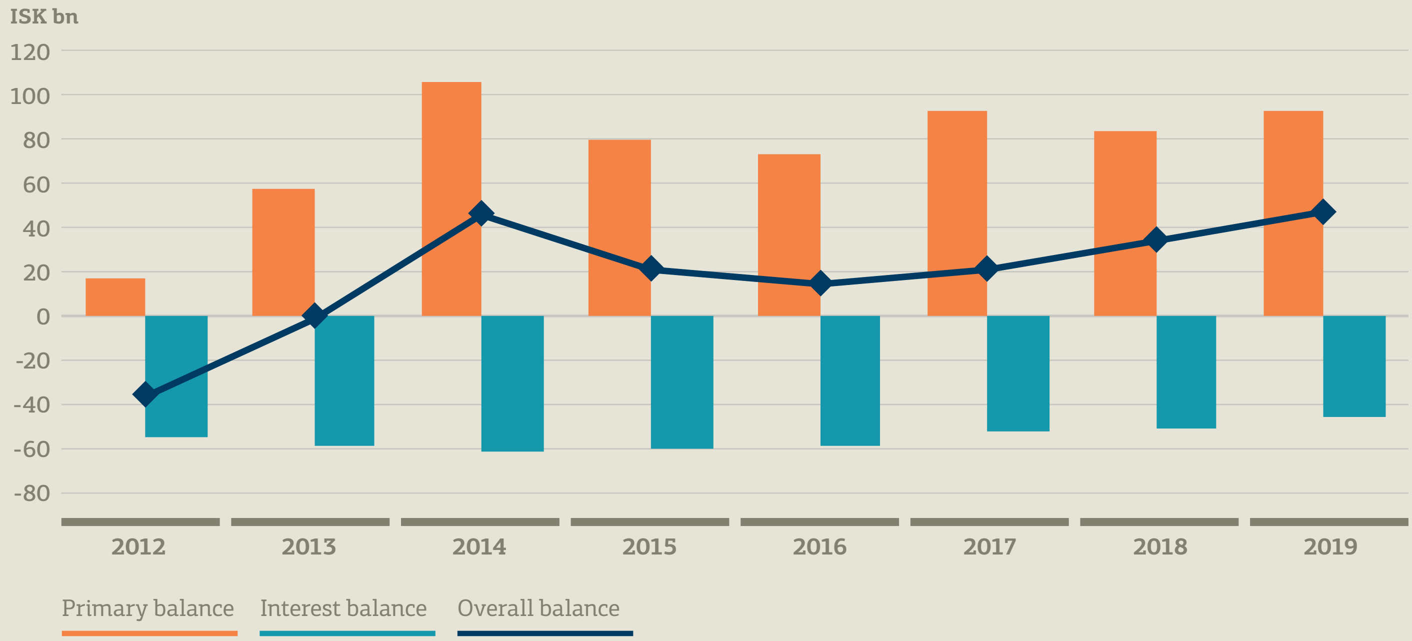
State current balance

Source: Financial Management Agency, Ministry of Finance and Economic Affairs, Landsbankinn Economic Research



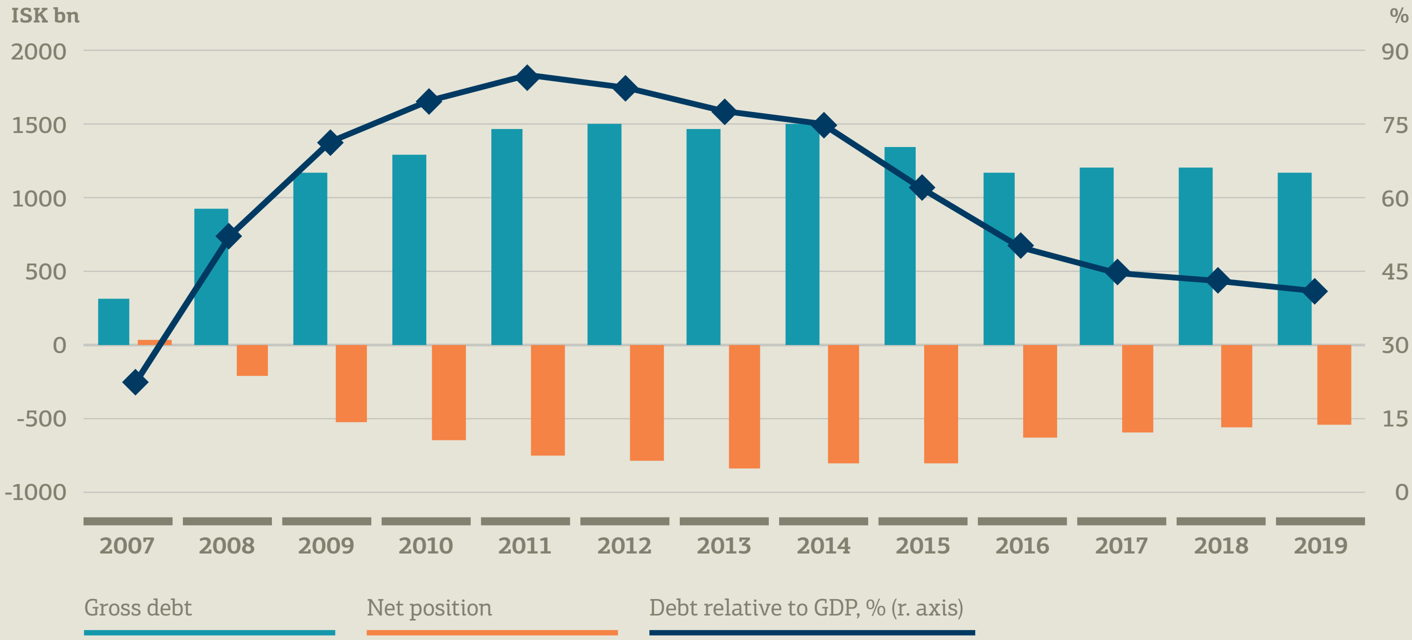
Forecast outcome of Treasury operations

Source: 2016 Budget bill



Treasury debt

Source: 2016 Budget bill



The Treasury's interest balance is expected to improve by around ISK 5 billion, or 0.2% of GDP, mainly as a result of savings of ISK 5.7 billion on interest expenses, as interest rates were lower than anticipated during the year.

Budget bill provides for a surplus

The 2016 Budget bill provides for a surplus of ISK 15.3 billion. The point of departure was more moderate restraint in the growth of primary Treasury expenditures than in recent years, but higher than expected wage increases are likely to affect these intentions and result in higher expenditures. According to the bill priority is to be given to funds earmarked for social security, healthcare and education. No demands will be made, e.g. for cutbacks in social security and unemploy-ment insurance, as has been the case in recent years.

Personal income tax is to be lowered in two steps. The latter step will reduce the number of tax rates from three to two. Customs duties on clothing and footwear are to be abolished at year-end 2015. Other duties on consumer goods, apart from foodstuffs, are to be eliminated on 1 January 2017.

In recent years the government has introduced a variety of tax cuts while at the same time exercising spending restraint. Higher revenues, in particular resulting from one-off and irregular items, explain part of the subsequent relaxation of fiscal restraint. A statement by the Central Bank's Monetary Policy Committee (MPC) accompanying its rate decision at the beginning of November, for instance, pointed out specifically that some loosening of fiscal discipline was evident in the Budget bill, after cyclical effects were considered.

Factors of uncertainty

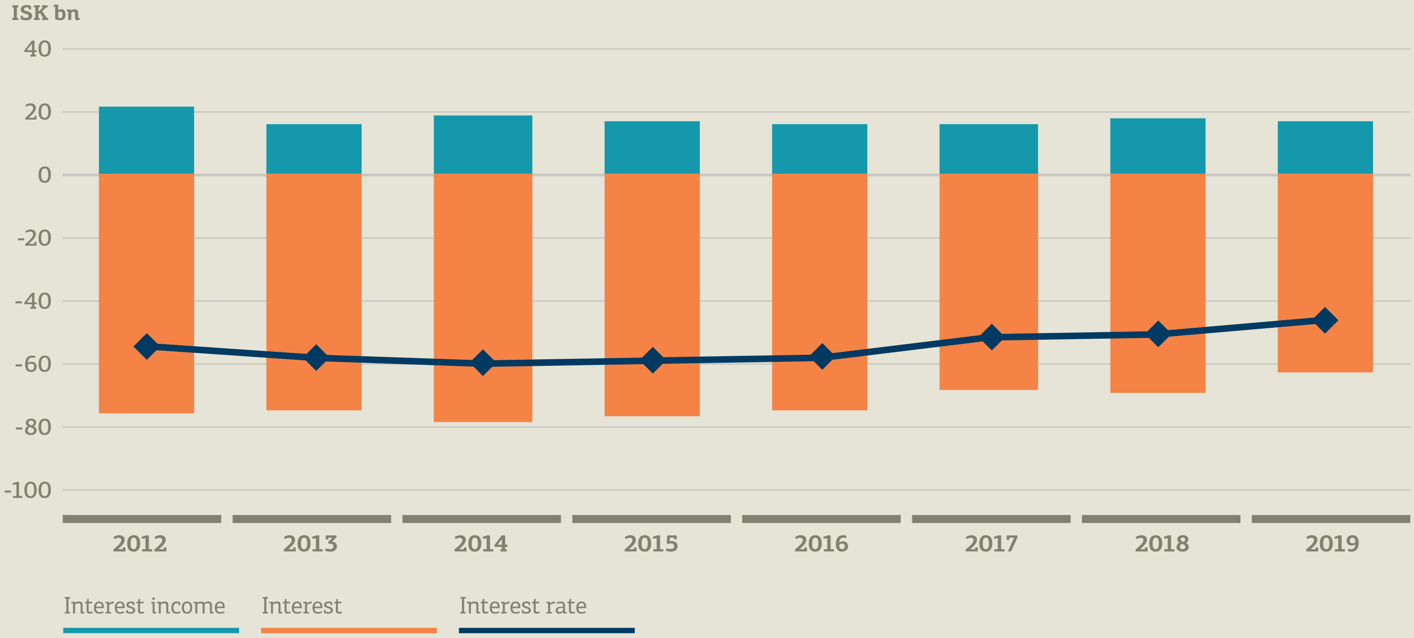
The principal risk factors in government finances are unfunded pension obligations of the Treasury, which amounted to ISK 435.6 billion at year-end 2014. If no action is taken, public pension coffers will be empty by 2030. Recently the Minister of Finance Bjarni Benediktsson stated that the intention was to begin contributions to the pension fund in 2017, but no such plans are visible, however, in budget or supplementary budget bills. Another factor is the situation of the Housing Financing Fund (HFF), as outstanding government guarantees of its obligations amount to over ISK 900 billion and the Treasury has already expensed a contribution to the Fund of some ISK 50 billion.

Treasury debt decreasing

Discussion of Treasury debt in the 2015 Budget debate emphasised that debt relative to GDP would decrease, although it was pointed out that the reduction would not

Treasury interest balance

Source: 2016 Budget bill



necessary be great in nominal terms. These plans have clearly changed, as there have been various reports of debt repayments, e.g. when the Treasury repurchased its own bonds amounting to USD 400 million face value this summer and paybacks of loans from the IMF.

The Budget bill for 2016 presents a fairly focused schedule for Treasury debt repayment. No specific provision is made for the effects of plans for capital account liberalisation apart from the fact that the Treasury is to repay a bond of the Central Bank in the first half of 2016. This payment will be equivalent to around 6% of GDP. The bill also expects another special debt repayment to be made following the sale of 30% in Landsbankinn currently owned by the state.

Treasury situation brightens following contributions from the estates of the failed banks

According to statements from various authorities the intention is to use the assets acquired by the Treasury to a large extent to reduce debt, possibly in addition to that described above. As a result it is estimated that the Treasury's gross debts will be equivalent to around 45% of GDP at year-end 2018 and total public sector debt to 53%. This is a major reversal of the situation in recent years.

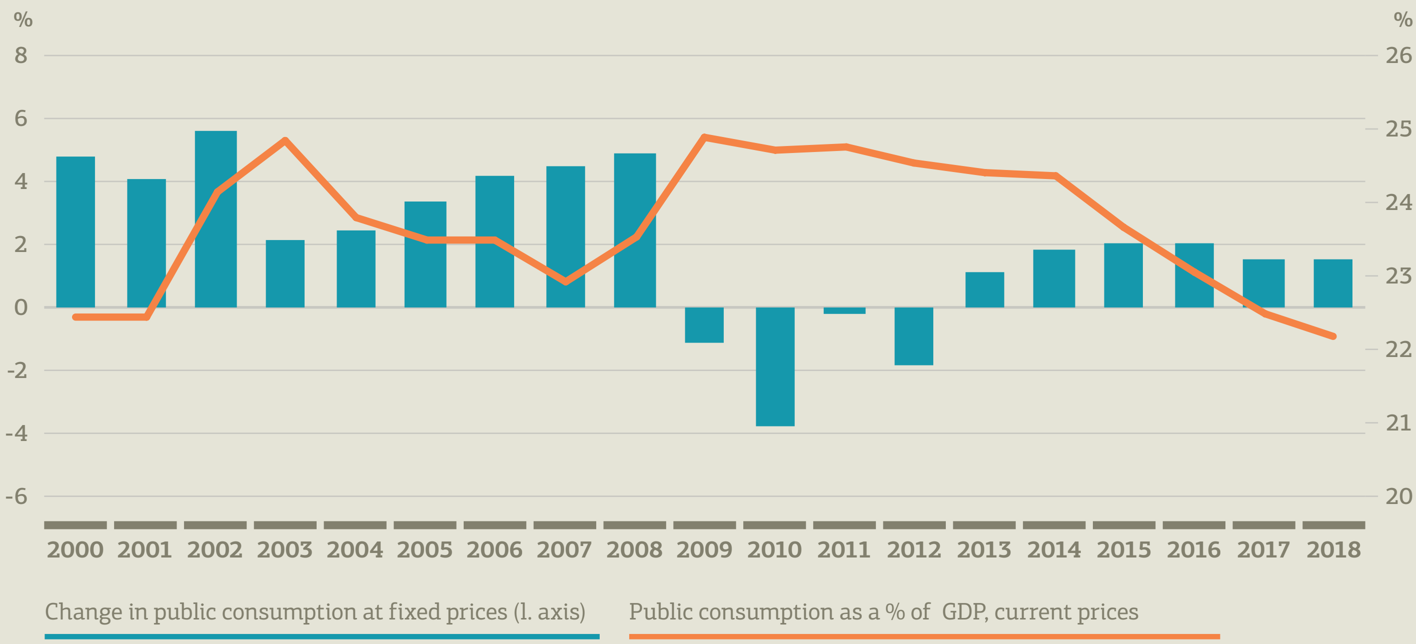
Treasury interest expenses

Total Treasury debt at year-end 2014 according to Government Accounts was ISK 1,485 billion. To this unsettled obligations of the Treasury of ISK 430 billion to Section B of the Pension Fund for State Employees must be added. If this obligation is included, total debt amounts to ISK 1,915 billion or around 96% of GDP for the year. Of this debt, ISK 1,500 billion was denominated in ISK and the equivalent of ISK 415 billion in foreign currencies.

The Treasury's interest payments on this debt have been considerable. Interest expense paid by the Treasury during the first 8 months of this year amounted to around ISK 55.3 billion, or around 13% of total Treasury expenditures and in recent years the Treasury's capital costs have been equivalent to 4% or more of GDP. These high debts which accumulated in the wake of the financial collapse are therefore a heavy burden on the Treasury, but the outlook is considerably brighter in this respect. Reducing this debt will lower the Treasury's interest expense considerably. It has been stated, for instance, that a debt reduction of ISK 640 billion could lower the Treasury's interest expense by some ISK 35 billion annually.

Public consumption 2000-2018

The last 4 years are Economic Research's forecast
Source: Statistics Iceland, Landsbankinn Economic Research



Expenditure for public consumption will increase

Public consumption can be expected to increase somewhat more than it has done in recent quarters, in line with higher GDP growth and expanding economic activity. Various factors suggest development will be in this direction, e.g. statements by the government on various actions, such as in housing affairs, in connection with recently concluded collective bargaining agreements.

Actions of this sort generally boost state expenditures and reduce tax revenues, thereby resulting in less fiscal discipline. It is also evident that the Treasury's wage expenditure will be greater than anticipated. Reception of refugees will also mean additional expense, to take one example. Unfortunately, history shows that governments have had great difficulty in reining in Treasury expenditures in an upswing, with the result that more often than not they aggravate cyclicality rather than countering it, as would be most advantageous. Currently circumstances are all favourable to the Treasury. As in most previous instances, however, there is a risk that a positive Treasury situation may lead to increased government expenditure and thereby add to overheating in the economy.

Economic Research forecasts a 2% increase in public consumption in 2015, another 2% increase in 2016 and 1.5% in 2017 and 2018. These figures assume that GDP will increase more than public consumption. Public consumption is estimated to be around 22% of GDP at the end of the forecast period, which is considerably lower than it has been in recent years.

7. Domestic financial markets

The outlook for the Icelandic financial market in 2016 is generally good, in line with the positive outlook for the economy as a whole. The equity market will be buoyed up by good GDP growth. Uncertainty regarding the removal of capital controls, for instance, concerning the magnitude of capital outflows and inflows and how new management tools will be applied, together with a lower supply of Treasury notes will strongly influence bond market developments.

The greatest factor of financial market uncertainty in the coming year is capital account liberalisation. Despite the fact that in the long term it is positive, and necessary, to relax controls, an incautious step in this direction could cause disturbance and capital flight, resulting in a short-term market downturn. If it is successfully accomplished the impact on enterprises in Iceland should be positive as a result of their improved creditworthiness, lower interest rates and improved access to capital. We expect the first steps will be cautious and they should not result in upsetting financial markets, especially in light of the fact that the interest rate differential between Iceland and main trading partner countries is very substantial at the moment.

Equity prices have risen sharply YtD

The OMX Iceland selected shares index (OMXI8ISK) has risen by 41% during the first 10 months of this year, to 1846 points as of the end of October. Average monthly turnover in the first 10 months of this year was ISK 32 billion, compared to ISK 23 billion over the same period last year.

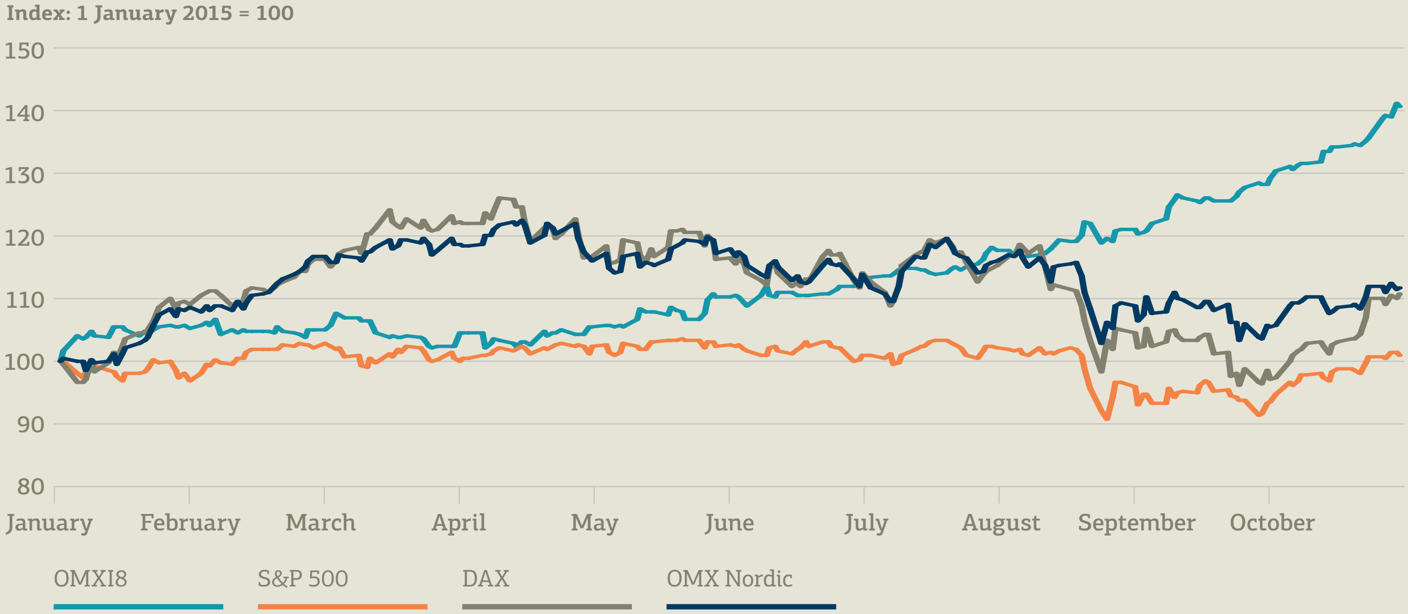
At year-end 2014 there were high expectations that equities would rise strongly in 2015. During the early months of the year, however, the selected shares index increased little, and remained almost unchanged until the beginning of April. This was followed by a lengthy upward trend until November, with the index rising by around 34% in five months. One of the explanations for the increase this summer was that listed companies had presented good results during this period and that bond market yields were declining. The government announced its action plan for capital account liberalisation in June, which had a positive effect on expectations and encouraged increases on the market.

Market prices for Icelandic companies similar to those abroad relative to profits

One common method of assessing equity market prices is to check the companies' price/earnings (P/E) ratios. In the US these ratios are generally between 10 and 20, with the longer-term average around 15.5..A high P/E ratio suggests that equities may be overpriced and similarly

Equity indices in 2015

Source: Bloomberg, Landsbankinn Economic Research



a low ratio can indicate they may be underpriced.[5]

The average P/E ratio on the Icelandic market has been around 16 this year comp-ared to 18 in the US equity market (S&P 500) and 18.2 on the Ger-man equity market (DAX). Since the beginning of 2013 the P/E ratio of Icelandic companies has tracked foreign markets fairly clo-sely and kept within similar limits, i.e. between 15 and 20. At the end of Septem-ber this ratio was 16.8 in Iceland. The close correlation with foreign markets should not come as a surprise consi-dering the fact that a large portion of listed companies on the Icelandic equity market keep their accounts and publish their results in foreign currencies.

Three new companies listed

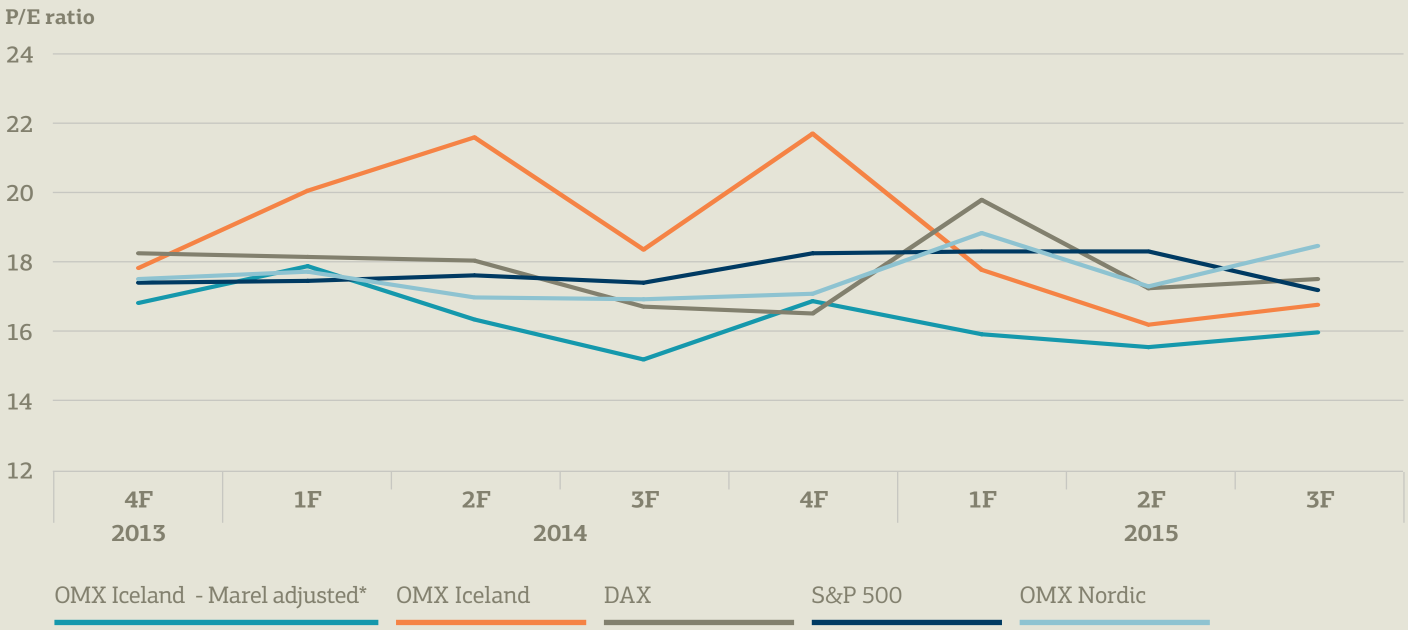
In April this year the real estate companies Eik and Reitir were listed on OMX Iceland and in October they were joined by the telecom company Síminn. Through IPOs 14% of the share capital of Eik, 13% of that of Reitir and 21% of that of Síminn were sold in con-nection with their listing. The companies' offerings were all over-sub-scribed, that of Síminn five times, of Reitir four times and of Eik 2 1/2 times over. At the beginning of November the market value of Síminn was around 14% over the com-pany's offer price, that of Eik 16% higher and of Reitir 33% higher (compared to offer book A prices for the company). The total amount of shares sold in the three companies was ISK 16.4 billion.

While there is little def-inite news regarding new listings in the coming year, it has been suggested that Skeljungur, an oil Company, could be listed, in addition to which the intention is to sell 30% in Lands-bankinn currently owned by the state. The future of Arion Bank and Íslandsbanki is also uncertain; in all likeli-hood the state will take over all of Glitnir's holding in Íslandsbanki next year. It is not clear how sale of the state's holdings in the banks will be arranged or whether they will be publicly listed. Insurance companies are included under financial undertakings and three of them are listed on OMX Icel-and. Their total market cap is equivalent to around 10% of total market cap of Main List companies on OMX Iceland. On markets abroad the weighting of financial undertakings is considerably greater. Financial under-takings account for over 30% of he S&P 500 and the share of financial under-takings on OMX Stockholm is over 20%. The listing of at

[5] Many aspects are involved here, however, such as the interest rate level in the country and the sector breakdown of companies in the index.

P/E ratios

*Key figures for Marel adjusted for one-off items.
Source: Bloomberg, Landsbankinn Economic Research



least one of the large commercial banks would probably strengthen the equity market in Iceland. Due to its small size the listing of one large commercial bank would be sufficient to raise the share of financial undertakings in the equity market to a level similar to that of leading comparison countries. However, if all the large banks were listed publicly it is evident that financial undertakings would account for over 40% of the OMX Iceland equity market.

Major bond market increases

The market value of inflation-indexed bonds rose by 13.7% and that of non-indexed bonds by 8.5% during the first 10 months of this year, according to GAMMA's bond indices. Average monthly turnover in the first 9 months of 2015 was ISK 160 billion, compared to ISK 116 billion in 2014. Turnover in non-indexed and indexed bonds was 77% and 23% respectively of total turnover. Turnover in HFF and Housing Authority bonds comprised 9% and that of indexed Treasury bonds 11%. The total outstanding stock of market, i.e. listed, bonds was ISK 2,352 billion as of the end of September. By comparison total equity market cap was around ISK 873 billion at the same time. The largest portion of listed bonds were Treasuries (38%) and HFF bonds (32%).

Foreign investors increased their holdings in Treasuries this autumn. From the end of May to the end of October they acquired an additional ISK 41 billion in these assets, mostly long maturities. This had the effect of lowering yields and thereby raising prices. As foreign investors appear primarily to have been interested in longer-term securities, the rate curve has gone from upward-sloping to slightly downward-sloping.

Turnover explosion on the FX market

There was a veritable explosion in FX market turnover this summer which peaked at ISK 80 billion in August compared with an average monthly turnover of around ISK 20 billion prior to that. Turnover fell again in September and October, as the peak tourist period ended. Total FX market turnover during the first 10 months this year was 80% higher YoY.

The trade-weighted index (TWI) remained very stable since the beginning of 2014, in spite of normal fluctuations in the rates of individual currencies against the ISK, until around mid-July. Then the ISK began to appreciate slightly against currencies of main trading partner countries. This strenghtening occurred despite large-scale FX purchases by the Central Bank of Iceland. The ISK is discussed in more detail in Chapter 8.

8. External conditions and the national economy

Some changes have occurred to the outlook for GDP growth in Iceland's main trading partner countries. Bloomberg's survey of market expectations at the end of October indicated that growth of around 1.5% is expected in the Eurozone this year, compared to 1.1% in last year's survey.[6]

Expectations for GDP growth in the UK and US were lower this year, but considerably more growth is still expected in these countries than in the Eurozone. The decline in growth outlook in the US is in part the result of anticipated base rate hikes, as US interest rates have been very low since 2009.

Decline in global market prices for oil and aluminium but rising prices for marine products

It is no exaggeration to say that changes in commodity prices have been very sizeable this year. Bloomberg's commodity index was on average 23% lower YoY in the first 10 months of 2015. Global oil prices have dropped by 41% and aluminium prices by 10%. The global oil price took a sharp downturn near the end of 2014, when it became clear that OPEC states would not respond to low oil prices by cutting production. This summer growth expectations for China declined. In recent years China has been a very significant market for commodities. Its share of total imports of metal and metal ore, for instance, has risen from around 2% in the 1980s to one-third at the beginning of this year.

Declining global commodity prices do not appear to have noticeably impacted prices for marine products. On the contrary, the marine product price index has on average been higher this year than in 2014. We expect Iceland's overall terms of trade to improve by around 5% this year, remain fairly stable next year, then deteriorate slightly during the latter half of the forecast period, as demand for commodities rises with increasing growth in the global economy.

Compositions make a positive impact on the net IIP

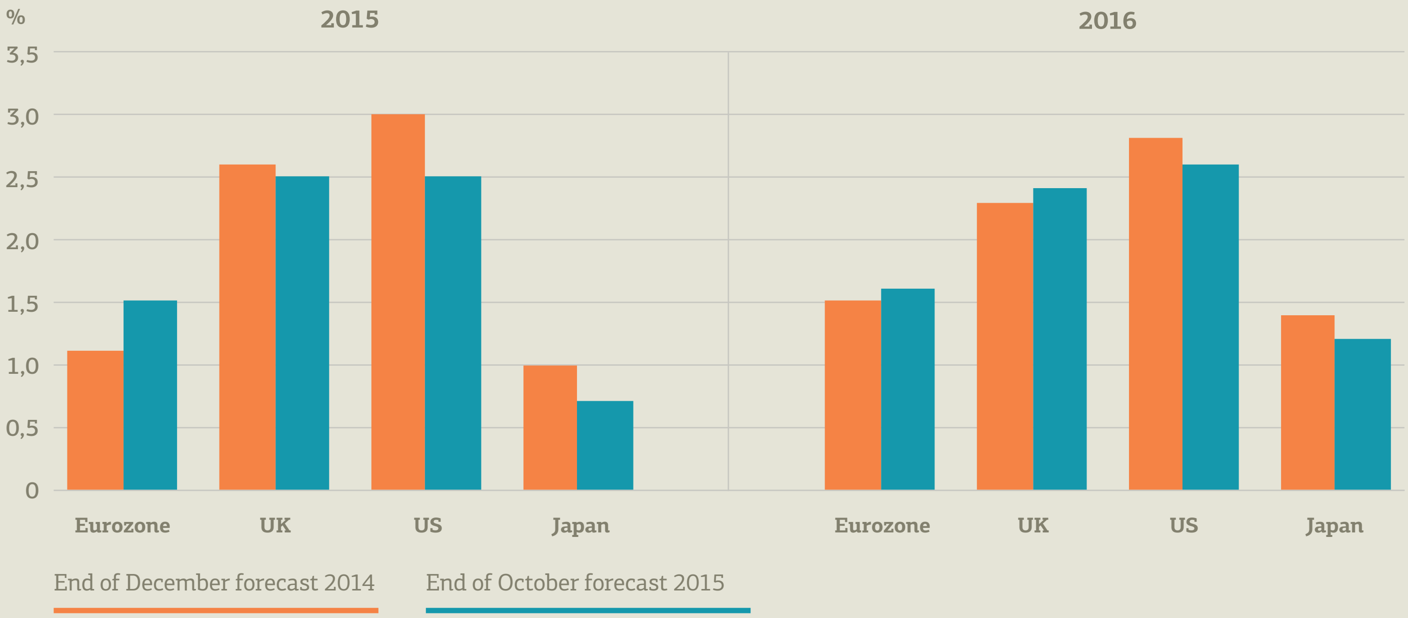
In early June this year the government announced a plan for liberalisation of the capital account and the Winding-up Boards of the former banks submitted composition proposals. Glitnir's Winding-up Board would later alter its proposal. The Central Bank delivered a report at the end of October, stating that the bank was of the opinion that the existing draft proposals, together with anticipated mitigating measures, would neither result in instability in exchange rate and monetary affairs nor upset financial stability. There would therefore appear to be little to prevent the compositions from being implemented.

While the proposals are technically rather complex, roughly speaking the estates turn over the lion's share of their ISK assets, totalling some ISK 379 billion, to the state in the form of a

[6] Based on the median response.

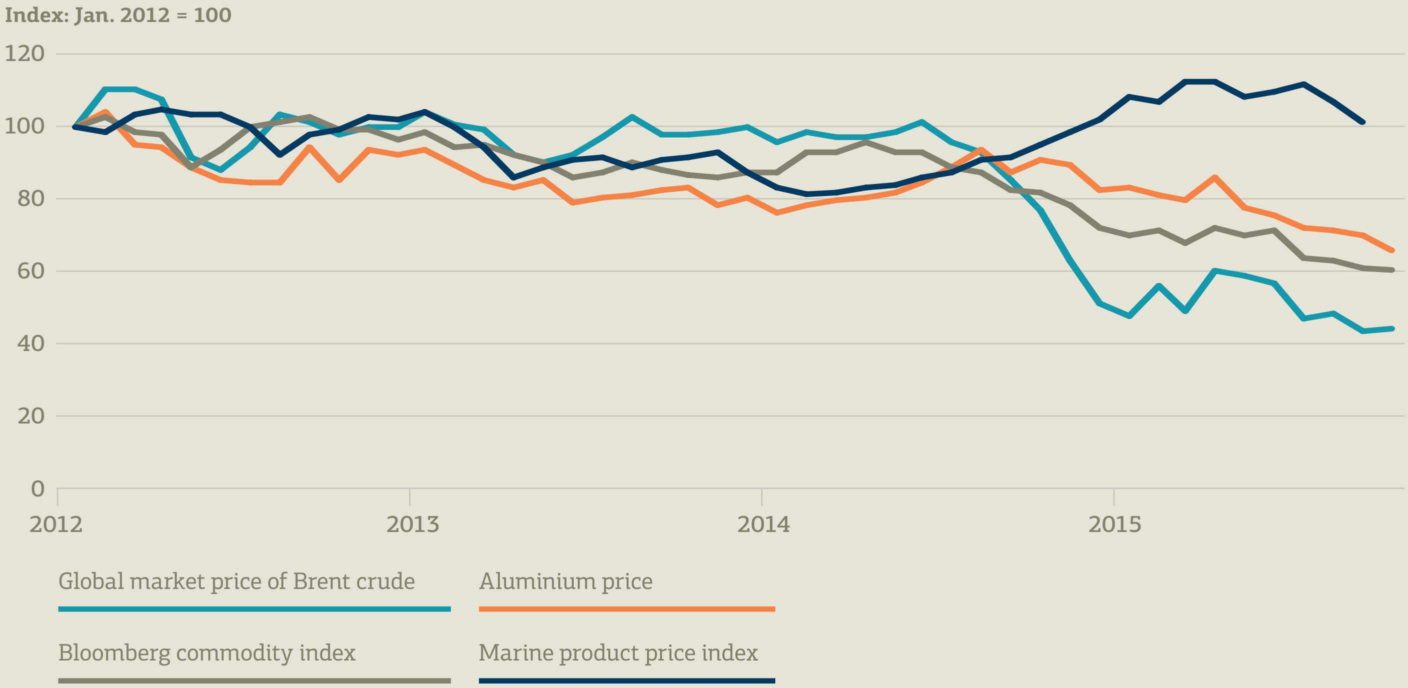
Forecast GDP growth

Median forecast of market actors on Bloomberg.
Source: Bloomberg



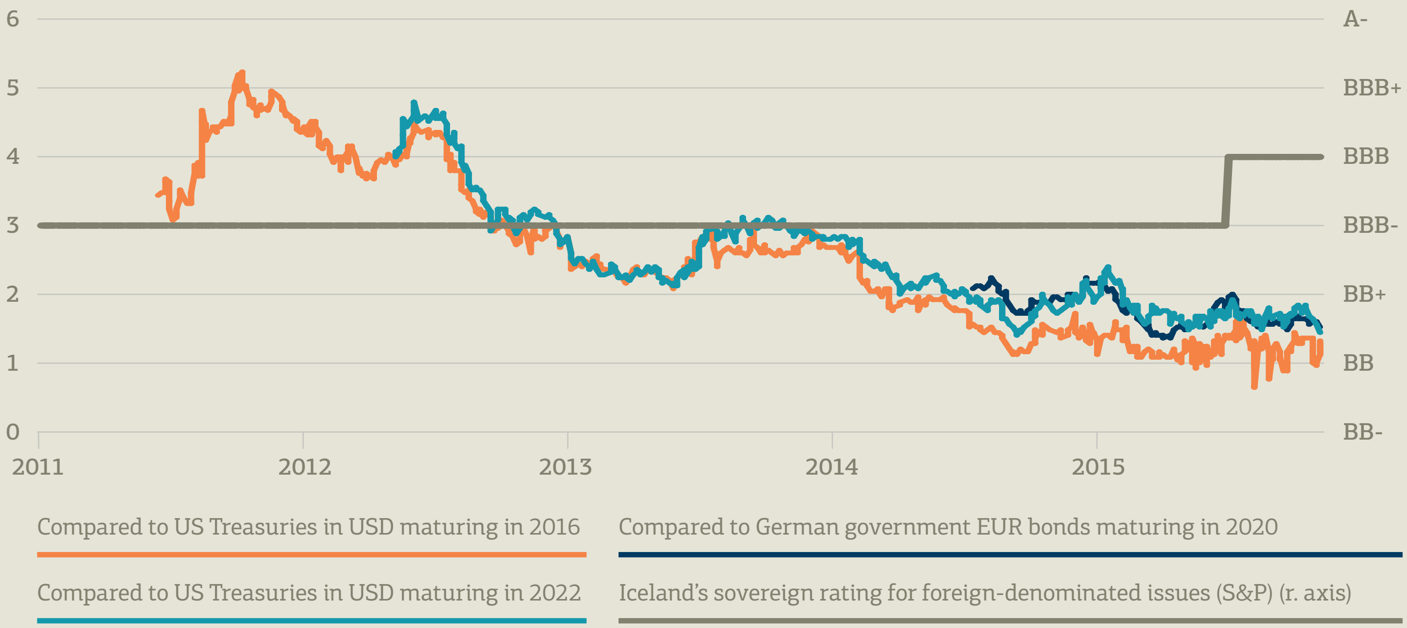
Commodity prices

All prices in USD Source: Bloomberg Statistics Iceland, Central Bank of Iceland



Premium on Icelandic government securities denominated in foreign currencies

Most recent figures from 5 Nov. 2015
Source: Bloomberg



stability contribution and refinance credit extended by the Central Bank and the state to the new commercial banks. In return, the insolvent estates will be granted exemptions to distribute their foreign assets to creditors and convert their remaining ISK assets to foreign currency.

The Central Bank of Iceland, through its subsidiary holding company ESÍ ehf., holds very substantial claims on the estates of the failed banks. FX recoveries by ESÍ from the settlements of the estates, together with the refinancing of the new banks, will offset the outflows resulting from conversion of ISK assets to foreign currency. The Central Bank estimates that the overall impact on currency reserves will be positive by over ISK 40 billion.

Our forecast assumes that the compositions will be imple-mented in accordance with the existing proposals. The impact will be felt particularly through the current account, in part due to lower interest and dividends affecting the balance of payments once the settlements of the old banks are complete.

Treasury's interest terms abroad continue to improve

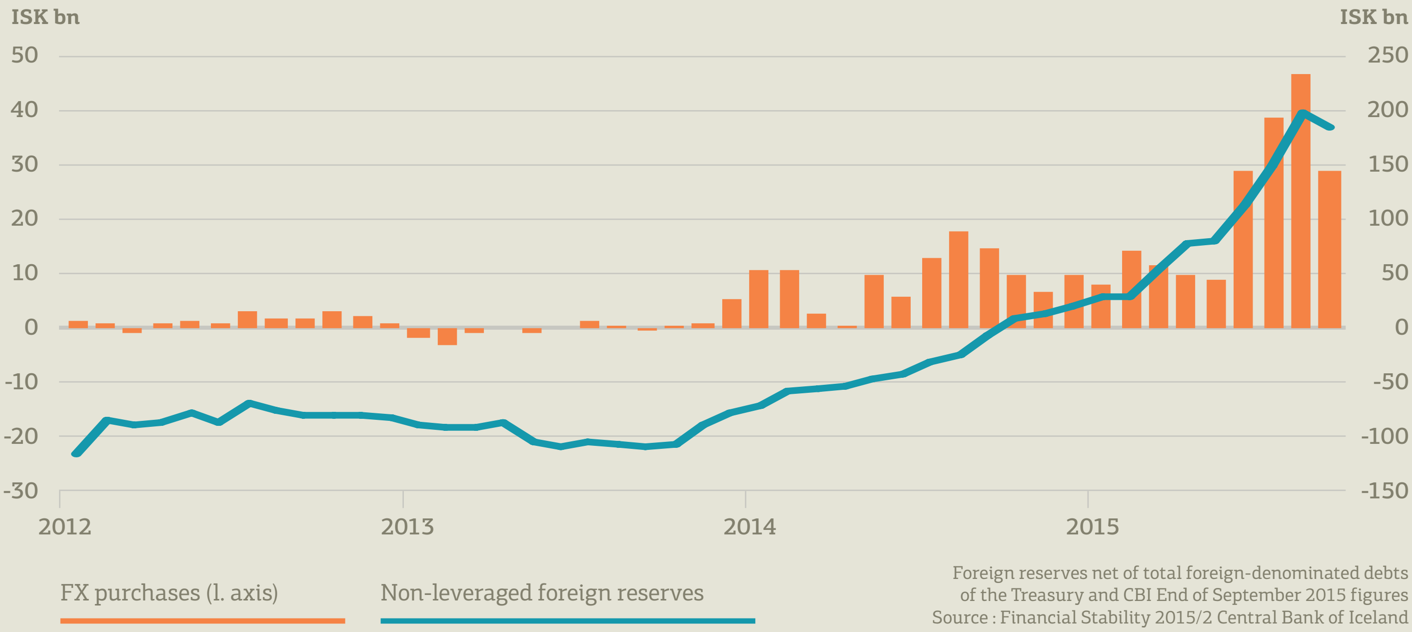
In June this year Moody's upgraded Iceland's sovereign rating for foreign currency debt one notch. S&P and Fitch then each followed suit in July. Currently Iceland's sovereign rating from S&P is one notch above Russia and one below Italy. The prime factor prompting the rating upgrade from the agencies at this point in time was their view that the action plan for capital account liberalisation was realistic.

Earlier this year the Treasury prepaid a loan from Poland taken out in 2009 in connection with the economic recovery programme agreed by the authorities and the IMF following the financial collapse. This autumn the Treasury paid off the loan from the IMF taken on the same occasion. In so doing the Treasury has paid off all loans taken in connection with the recovery programme and is now exclusively reliant on market funding. In addition to the above prepayments, this year the Treasury has also bought back part of its USD notes issue maturing in 2016.

Increased confidence in the Icelandic economy is reflected in lower yields on foreign-denominated Treasury bonds

Shortly after the Treasury first issued its first market bonds abroad since 2008 in June of 2011 the yields on these bonds on the secondary market were around 5 percentage points higher than on US Treasuries of the same maturity. Since then this premium has fallen and the premiums on the three foreign-denominated marke-

FX purchases by the Central Bank of Iceland and non-leveraged foreign reserves



Foreign reserves net of total foreign-denominated debts of the Treasury and CBI End of September 2015 figures
Source : Financial Stability 2015/2 Central Bank of Iceland

table securities issues by the Treasury since 2008 are now between 1.3 and 1.5 percentage points over US and German Treasuries of the same maturity.

CBI builds up its non-leveraged foreign reserves

In 2014 the surplus on goods and services trade was ISK 125 billion (6.3% of GDP). Economic Research's forecast predicts a surplus of ISK 145 billion (6.9% of GDP) this year. The Central Bank of Iceland has purchased FX on a large scale this year with net purchases in the first 10 months of this year amounting to around ISK 218 billion, somewhat above our forecast surplus on trade in goods and services for the year as a whole. This is in addition to net FX purchases of ISK 111 billion last year.

Despite the fact that its stated objective in intervening in the FX market was originally to smooth out short-term ISK exchange rate fluctuations, rather than to accumulate non-leveraged foreign reserves the bank has managed to accumulate fairly impressive reserves.[7] The Central Bank's foreign reserves currently amount to around ISK 185 billion more than the foreign-denominated debt of the Treasury and the bank. It should be pointed out, however, that part of these reserves will be used for foreign currency auctions in connection with capital account liberalisation in which the Central Bank will act as counterparty.

Commercial banks seek funding on markets abroad

After S&P upgraded Iceland's sovereign rating it also upgraded the ratings of Arion Bank, Íslandsbanki and Landsbankinn. All three now have a BBB- rating, and Landsbankinn's rating has a positive outlook.

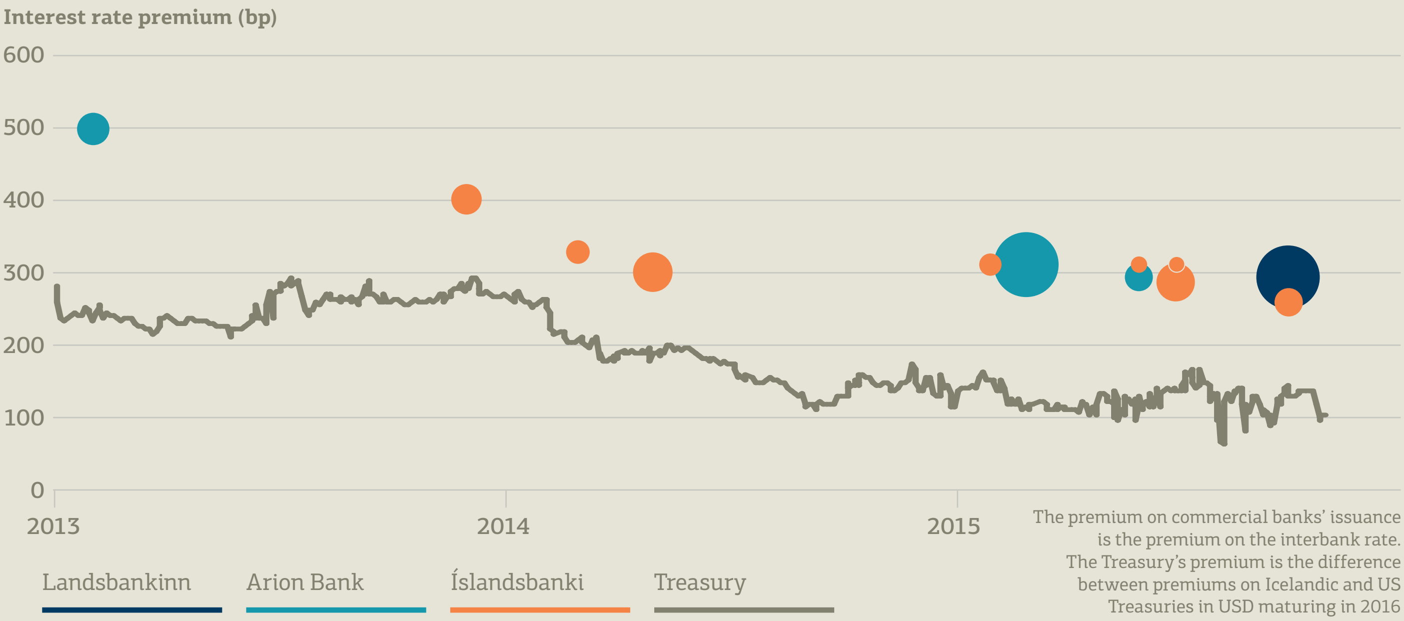
All three commercial banks this year issued bonds abroad, amounting in total to some ISK 130 billion. The terms ranged from 2.6-3.1 percentage points over interbank rates in the currency of the respective issues, which were in EUR, NOK and SEK.

Landsbankinn's EUR 300 bond issue in October was its first issuance abroad since the financial collapse. The bank will use the proceeds of the issue to prepay secured bonds in foreign currencies owed to LBI (the estate of the former Landsbanki Íslands) maturing in October 2016 and part of the bonds maturing in October 2018.

[7] This refers to non-leveraged foreign currency holdings.

Commercial banks' foreign-denominated bond issues

Circle size relative to size of issue
Source: Bloomberg



The premium on commercial banks' issuance is the premium on the interbank rate. The Treasury's premium is the difference between premiums on Icelandic and US Treasuries in USD maturing in 2016

Carry trade commences once more

During the first nine months of this year total investment by non-residents in Iceland amounted to around ISK 54 billion, of which ISK 40 billion were in Treasuries. This is a major increase over last year, when net new investment totalled around ISK 7 billion. This increase in interest shown by foreign investors in Icelandic Treasuries can be attributed primarily to the large interest rate differential between Icelandic and foreign Treasuries, as interest rates in the Eurozone and the US are currently very low.

The influx of foreign investors in the carry trade began shortly after the plan for capital account liberalisation was announced. The development appears to have caught the Central Bank unawares, as so-called macro-prudential tools intended to manage such flows are still not ready. The Central Bank has indicated, however, that these instruments are in preparation and can be expected to be ready when controls are lifted.

Positive current account balance throughout the forecast period

According to Economic Research's forecast, the balance of trade in goods and services will show a surplus for the entire forecast period ranging from 5.3-6.8% of GDP. The factor income balance, however, will be negative throughout the forecast period, making the current account balance overall considerably lower than merely the balance on trade in goods and services. Nonetheless the current account balance is expected to be positive for the entire forecast period by the equivalent of 3% of GDP on average. If this forecast proves correct the period from 2012 to 2018 will probably be the longest period in Iceland's economic history with a positive underlying current account balance.

ISK likely to appreciate

The minutes of the Central Bank's Monetary Policy Committee from September reveal that committee members agreed that the objective of the bank's FX purchases was not to prevent ISK appreciation which was based on developments in the core economy, but rather to build up foreign reserves in preparation for capital account liberalisation which were not financed by foreign borrowing and to moderate exchange rate fluctuations, e.g. resulting from temporary in- or outflows. If the committee follows this strategy, the Central Bank can be expected to substantially reduce its FX purchases early next year when auctions in connection with the elimination of so-called offshore ISK have concluded. If Economic Research's forecast proves correct, and the surplus on trade in goods and services remains very sizeable during the forecast period, we expect the ISK will more likely than not strengthen following the lifting of controls. Accordingly, Economic Research's macroeconomic forecast expects an average EUR/ISK exchange rate around 6% higher in 2018 than in 2015.

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