May 2024

Macroeconomic forecast

Stability in the wheelhouse: Warm winds, cool seas?

Stability in the wheelhouse: Warm winds, cool seas?

Summary

GDP growth tepid in 2024 but set to gain pace further ahead

GDP growth

- Pace of growth to gain steam after the business cycle turns
- 0.9% GDP growth in 2024
- 2.3% growth in 2025
- 2.6% growth in 2026

Narrow current account surplus during the forecast horizon

External trade

- Tourism set to grow much more slowly than in recent years
- Exports to grow 0.4% in 2024 and imports by 1.4%
- 1.0% current account surplus in 2024
- Marginal CA surpluses in 2025 and 2026

Inflation to ease over time

Inflation

- Inflation has begun to subside after the recent spike
- Housing market holds firm; real prices to rise during the forecast horizon
- More stable import prices, a gradual ISK appreciation, and moderate wage agreements contribute to disinflation
- Inflation to average 5.9% in 2024, 3.6% in 2025, and 3.1% in 2026

Labour market pressures to recede slowly and steadily

Labour market

- Need for additional imported labour easing steadily
- Unemployment to average 3.9% in 2024, 4.1% in 2025, and 4.0% in 2026
- Recent wage agreements will cause real wages to stagnate in 2024 but deliver real wage growth later on
- Wages to rise 5.7% in 2024, 5.1% in 2025, and 4.7% in 2026

Policy rate to remain high in the coming term

Interest rates

- Monetary tightening phase at an end unless inflation stops falling
- Gradual monetary easing starting in autumn 2024
- Policy rate 8.75% at year-end 2024, 6.25% at year-end 2025, and 5.5% at the end of the forecast horizon
- Long-term interest rates will fall further ahead; 10-yr nominal rates to measure 5.7% and 10-yr real rates to measure 2.2% at the end of the forecast period

Modest ISK appreciation likely over the forecast horizon

The ISK

- Improved CA balance and investment-related FX inflows support the ISK
- Pension funds' foreign investment and other investment-related outflows will pull in the opposite direction
- The outlook is for the ISK to be 5% stronger at the end of the forecast horizon than at year-end 2023
- A high real exchange rate will cut into the CA surplus and could put downward pressure on the ISK further ahead

After a surge in 2021-2022, GDP growth reversed course in 2023, plunging from 8.9% year-on-year in Q1 to 0.6% in Q4. In H2, domestic demand contracted year-on-year as well, for the first time since the pandemic year 2020.

Exports shrank also in Q4, and an abrupt contraction in imports was the main reason for the marginal growth that did indeed occur during the quarter. In all, GDP growth measured 4.1% in 2023.

We project 0.9% growth in 2025. This is quite weak in historical context, and the year actually marks a turning point in the business cycle, although a year-on-year contraction is probably not in the cards. Intrayear developments will probably mirror those in 2023, in that growth will be sluggish initially, and consumption and investment will gain steam later in the year.

For 2025, we forecast GDP growth to measure 2.3%. More rapid growth in consumption and investment will be the main driver of year-on-year GDP growth, although goods exports will also pick up again.

The outlook is for 2.6% GDP growth in 2026, with growing domestic demand outweighing weaker export growth.

Stronger growth in investment and private consumption further ahead will stem not least from firms' greater capacity for investment with falling interest rates and robust real wage growth accompanying declining inflation.

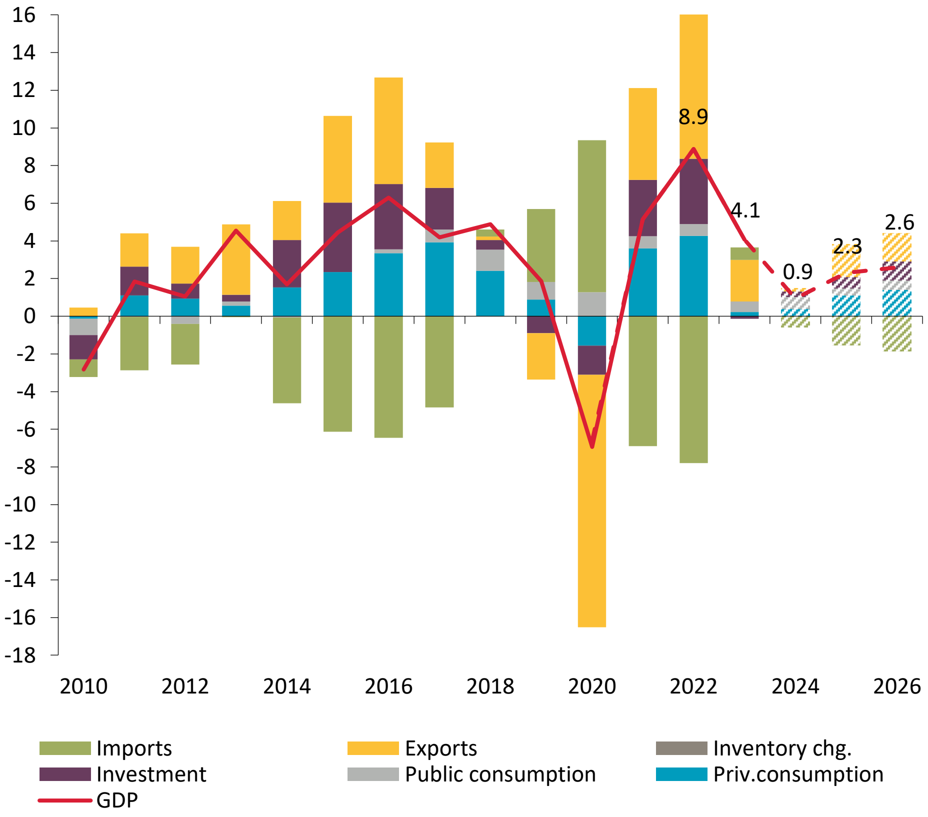
We now project considerably slower growth over the forecast horizon than we did in January. This is due not least to weaker growth in tourism and private consumption than we expected previously. This reflects, among other things, the effects of increased demand pressures in the economy in the recent term, as well as weaker real wage growth and higher interest rates than in the previous forecast.

GDP growth tepid in 2024 but set to regain momentum in coming years

Domestic demand to take over gradually from exports as the main driver of growth

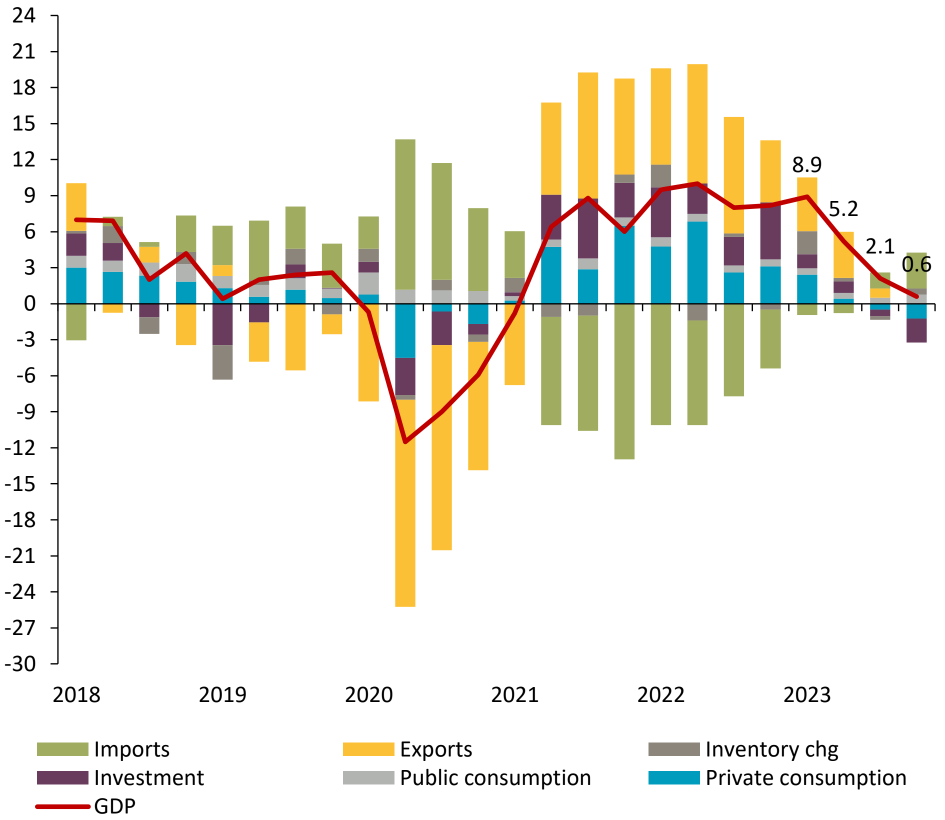
GDP and contribution of its subcomponents

Volume change from prior year (%)



GDP and its subcomponents, by quarter

Volume change from prior year (%)



Source: Statistics Iceland, ÍSB Research

The forecast is riddled with uncertainties, but these stand out

Global geopolitical unrest

Global tension and unrest are more pronounced than they have been for some time.

For instance, the war in Ukraine is still raging, armed combat in the Middle East has intensified, and there is considerable tension surrounding China's determination to annex Taiwan.

Any escalation of such conflicts could have a severe negative impact on international trade, price levels, and economic developments in Iceland and abroad.

Seismic activity on Reykjanes

Most likely, the seismic unrest and volcanic activity on the Reykjanes peninsula are far from over.

The risk remains that infrastructure and real estate could suffer substantial damage in more places than Grindavík alone.

This could disrupt energy supplies, for instance, and have an adverse effect on tourism and other commercial activities in Southwest Iceland in the coming term.

Residential property market

It appears that housing starts have tapered off sharply, and a survey taken among contractors indicates the same for coming quarters.

The risk is that the supply of new homes will decline significantly later in the forecast horizon, possibly pushing prices higher than is currently projected and slowing down disinflation and monetary easing.

Debt service

Despite the hefty rise in interest rates, data on arrears suggest that households and businesses are still able overall to manage their debt service.

That situation could change rapidly in coming quarters, however, not least among households, interest rates on the majority of non-indexed mortgages will be up for review by mid-2025.

The impact of higher interest rates on households and businesses could grow considerably stronger in a relatively short time, thereby dampening consumption and investment more than is currently projected.

Tourism comes of age

We forecast that just over 2.3 million tourists will visit Iceland in 2024, and nearly 2.5 million in 2026

After last year's surge in tourist arrivals, visitor numbers in 2024 to date have been somewhat lower than we expected at the turn of the year. In the first four months of 2024, almost 600,000 foreign nationals travelled to Iceland via Keflavík Airport, a YoY increase of 6%.

For 2024, growth in visitor numbers is expected to be the weakest in percentage terms since the beginning of the 2010s, apart from the years 2019 and 2020 when the numbers declined.

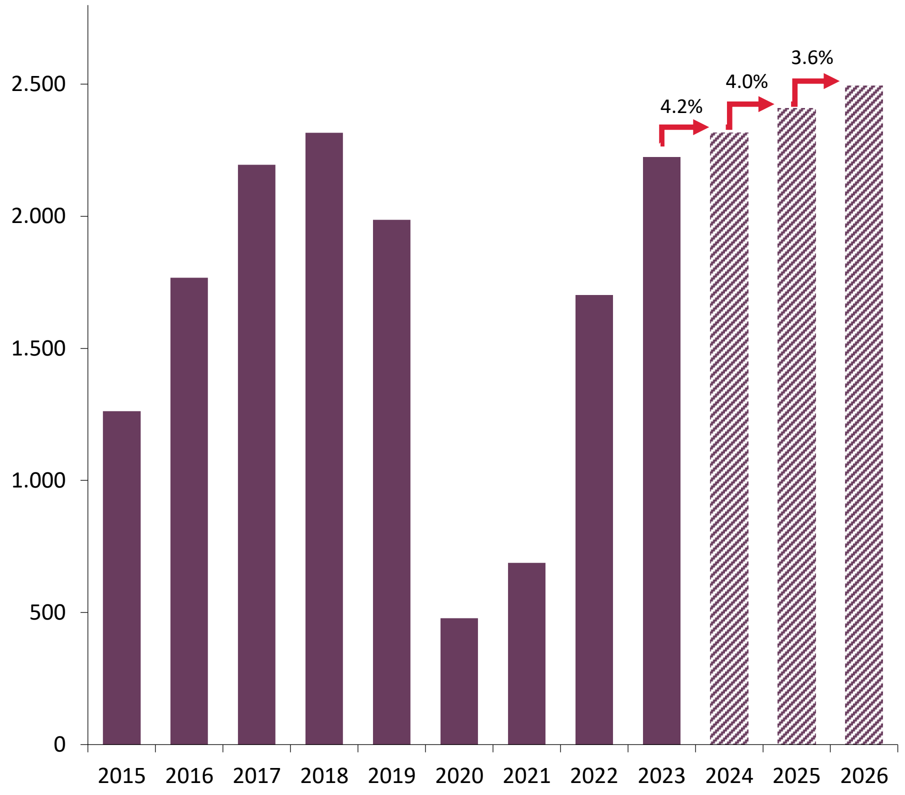
As we see it, there are three main reasons for this:

- Geothermal activity on the Reykjanes peninsula and the related media coverage of the situation there have dampened interest in travel to Iceland.
- The novelty of travelling to Iceland is apparently waning, and similar destinations such as the other Nordic countries are growing in popularity.
- Zest for travel has eased worldwide as would-be tourists have depleted their pandemic-era savings and satisfied their pent-up demand for travel from the COVID years.

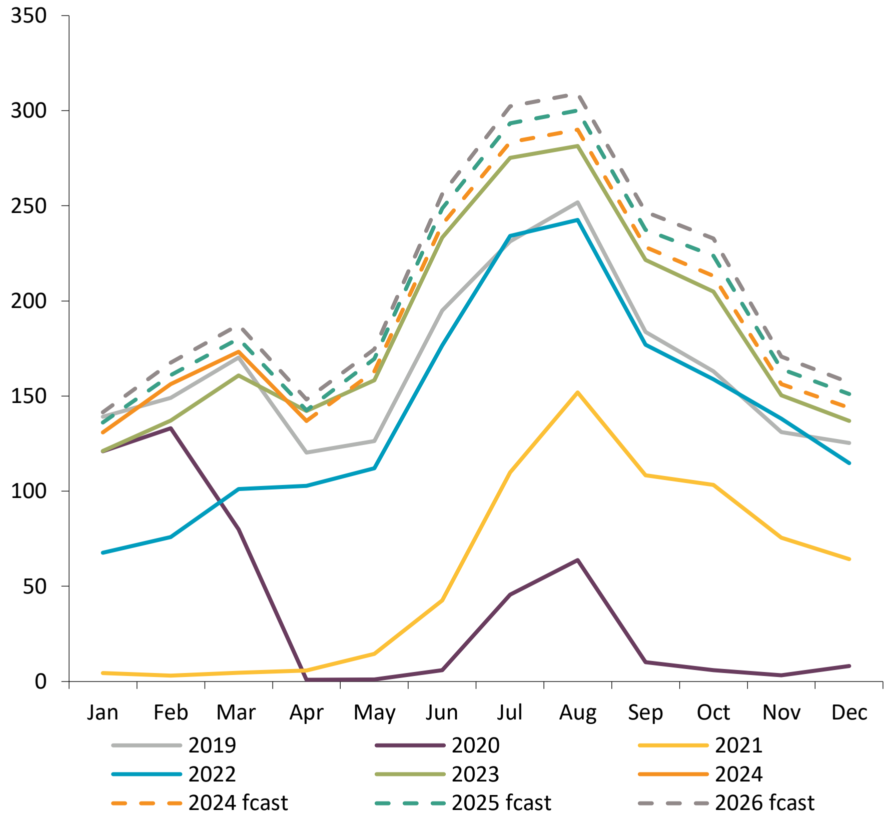
We think it increasingly likely that tourism is coming of age and taking its place alongside fishing and energy-intensive industry as a mature export sector where streamlining, growth in value added, and maintenance of competitive position are taking over from rapid growth and development as the main priorities of the sector.

As a result, we have revised our forecast from January and now expect tourism to grow quite a bit more slowly in the coming term than we did then. We now expect visitor numbers to grow by just over 4% this year and somewhat less in both 2025 and 2026. Based on this assumption, tourist arrivals will come to just over 2.3 million this year, 2.4 million in 2025, and a scant 2.5 million in 2026. This is broadly in line with recent forecasts of growth in tourism worldwide.

Number of foreign tourists, by year
Thousands



Number of foreign tourists, by month
Thousands



Sources: Icelandic Tourist Board, ÍSB Research

Although tourism will probably grow much more slowly than it did during its pre- and post-pandemic heyday, it will presumably account for a large share of growth in services exports – and total exports – in 2024. Furthermore, the outlook is for robust growth in exports of services based largely on Icelandic human capital, which are expected to gain steam steadily over the forecast horizon.

On the other hand, goods exports appear to be poised for a mild setback this year, partly because of cutbacks in electricity supply to aluminium smelters and the failure of the capelin catch.

In 2025 and 2026, however, we expect modest growth in exports of goods as well as services. On the goods side, the stage is set for increased farmed fish exports and moderate growth in groundfish catch quotas overall, and furthermore, energy rationing is expected to have less impact on aluminium exports.

On the whole, the outlook is for exports to grow by just under 0.4% in 2024, 4.0% in 2025, and 3.5% in 2026.

Imports slammed into reverse in 2023, contracting by 1.4% after two years of rapid growth. This is due not least to a turnaround in demand growth.

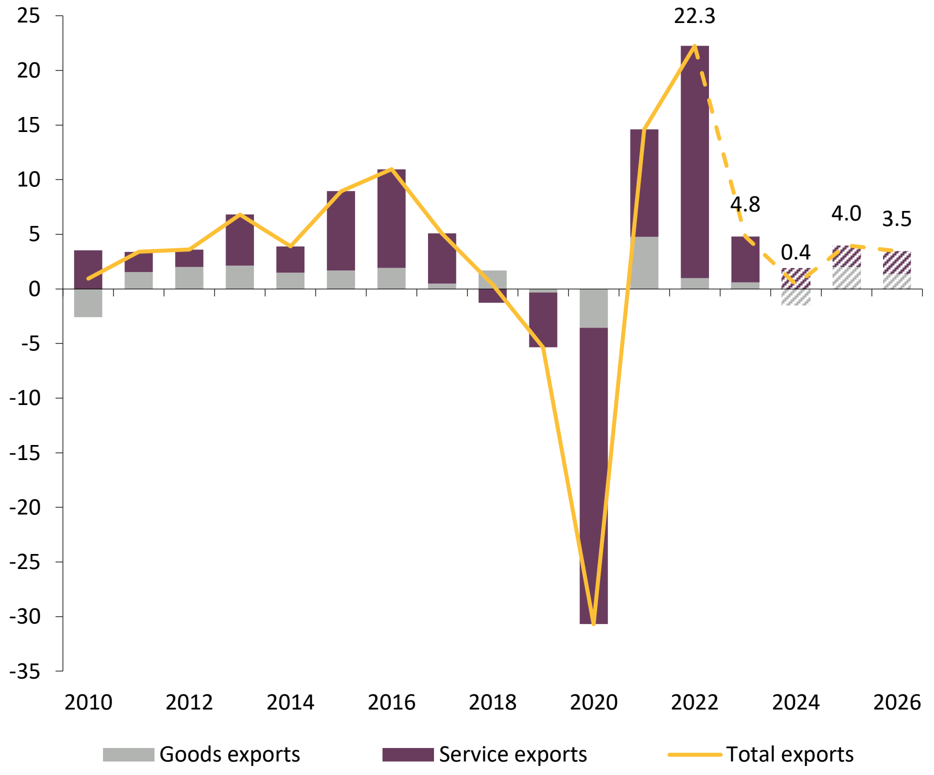
By the same token, the outlook is for weak import growth in early 2024, followed by a gradual acceleration further ahead. We project import growth at just over 1% this year, and then around 4% in both 2025 and 2026.

Modest export growth in the offing

External trade reflects the adjustment of the economy after a period of rapid growth in exports and demand

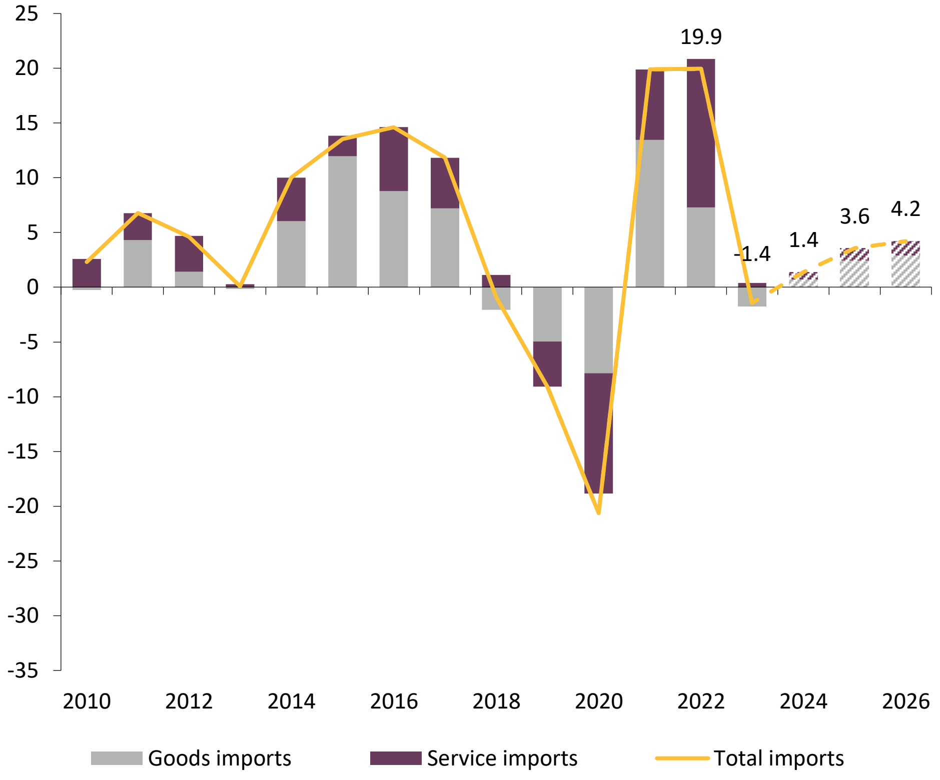
Exports, YoY change and contributions from subcomponents

%



Imports, YoY change, and contributions from subcomponents

%



Sources: Statistics Iceland, ÍSB Research

The pivot from rapid growth to a contraction is reflected in an improvement in the CA balance. After a two-year deficit in 2021-2022, the current account showed a surplus of 1% of GDP in 2023. The surpluses on services trade and the balance on income outweighed the deficits on goods trade and secondary income, however.

We forecast a moderate CA surplus each year from 2024 through 2026, with export growth overtaking import growth in coming quarters and a period of equilibrium thereafter. Terms of trade have also developed rather favourably in the recent past, and the outlook is for a slight improvement over the forecast horizon.

A rising real exchange rate could dampen prospects for external trade later in the period, however. If the ISK appreciates faster than we anticipate or if terms of trade worsen materially, the CA surplus could flip to a deficit around the mid- to late 2020s.

Iceland's net external assets totalled just under 38% of GDP at the end of 2023. This robust asset position is enormously important for the ISK and for the economy as a whole.

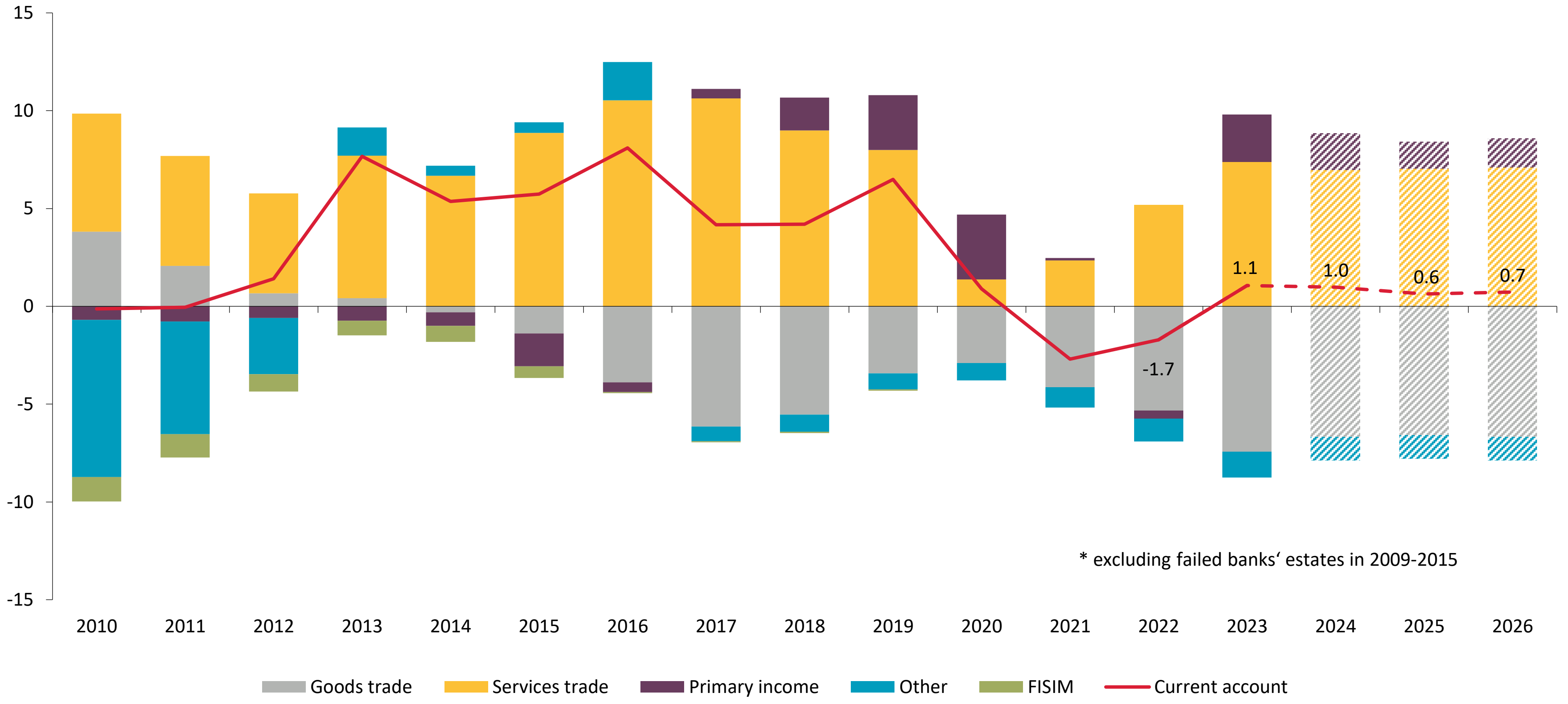
After deteriorating markedly early in the decade, the external position has firmed up again, partly due to rising asset prices in global markets. The outlook is for a moderate further improvement in tandem with a CA surplus and tailwinds in markets abroad.

External trade in the black once again

A better balance between exports and demand is reflected in a modest current account surplus

The current account balance and its subcomponents

% of GDP *



Sources: Central Bank of Iceland, Statistics Iceland, ÍSB Research

After skyrocketing in 2021-2022, investment softened marginally in 2023, contracting by a scant 1 percentage point in volume terms. This was due not least to rising interest rates, plus increased consolidation in investment spending after the hefty fiscal deficits of the pandemic era. The 6% contraction in public investment therefore outweighed the 1% increase in business investment, while residential investment was virtually flat over the same period.

The outlook is for marginal YoY growth in investment in 2024, reflecting the tug-of-war between modest growth in residential and business investment, on the one hand, and a contraction in public investment, on the other. Corporate expectations surveys and other indicators suggest that general business investment will pick up in 2024. The main driver of the overall trend is a surge in land-based aquaculture, which is set to hit its stride during the year.

In 2025 and 2026, the pace of investment is projected to increase steadily. The outlook is for a jump in corporate investment, and residential investment is likely to accelerate further ahead. In the latter case, however, indicators are ambiguous.

As regards business investment, hotel and guesthouse construction is likely to regain steam after a temporary lull because if it does not, there may be a shortage of accommodation later in the decade if tourist numbers develop as anticipated.

It also seems clear that underlying demand for housing will persist and will surface quickly once interest rates start to fall. Furthermore, there is a widespread and growing need for new investment in infrastructure.

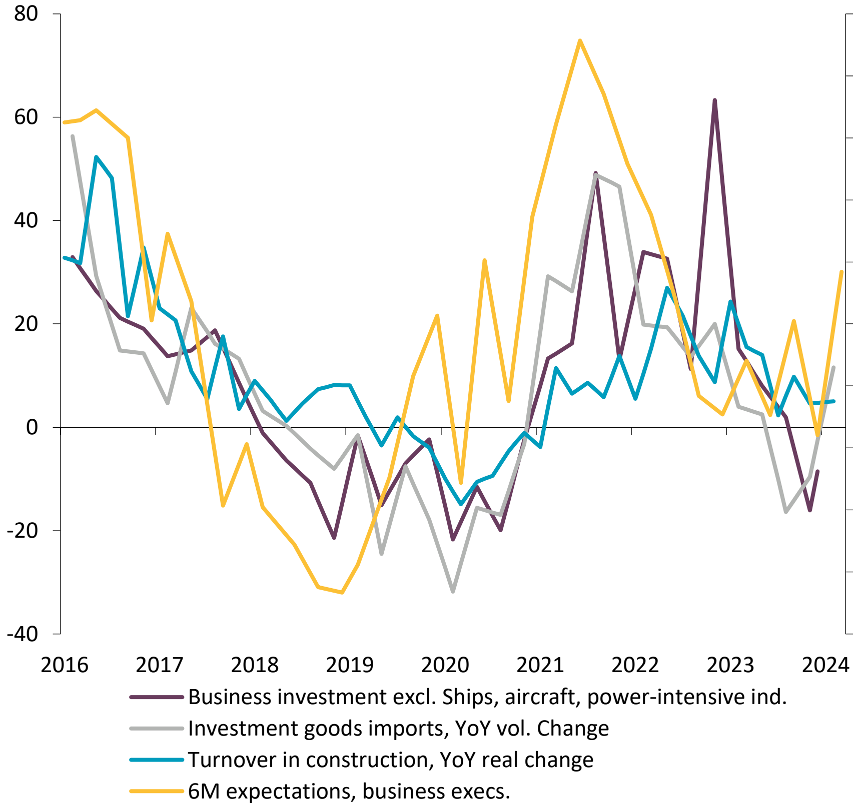
We expect total investment to grow by close to 3% in 2025 and just over 4% in 2026.

Investment on an upward path over the forecast horizon

Growing need for investment, falling interest rates, and greater optimism set to fuel investment growth

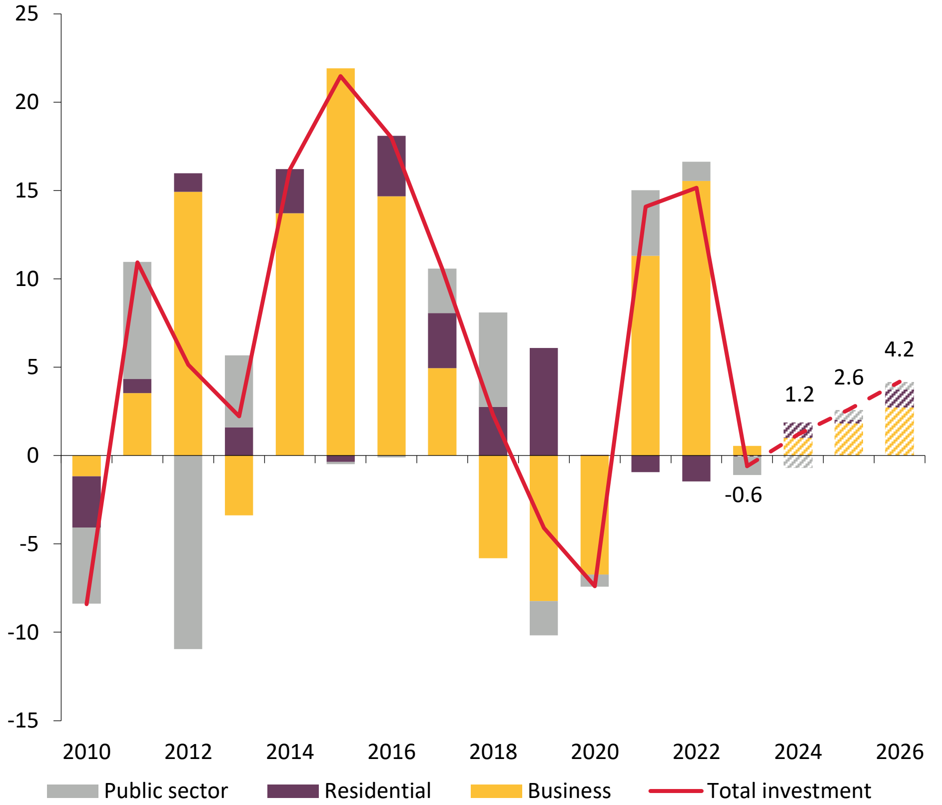
Business investment and related indicators

YoY change (%) and indices



Investment, real change and contribution of subcomponents

%



Sources: Central Bank of Iceland, Statistics Iceland, ÍSB Research.

House prices keep climbing

… but much more slowly than before

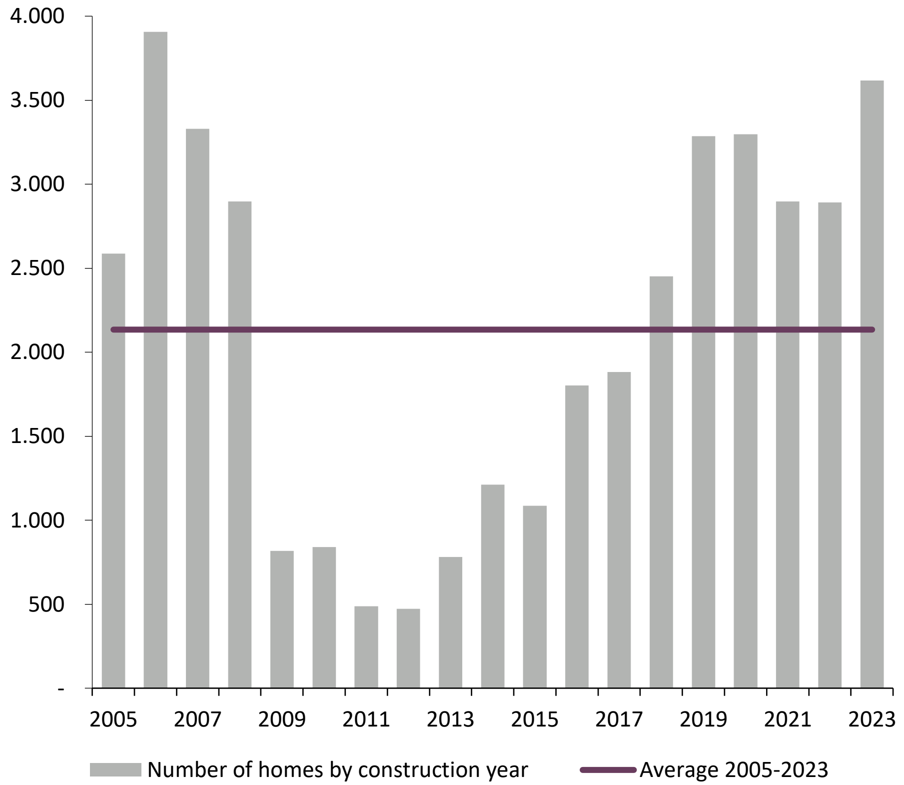
Property prices have risen markedly year-to-date, due both to the Government's buy-up of homes in Grindavík and to demand pressures from other sources. Around mid-2023, real estate market activity fell to a temporary low before picking up again in the wake of relaxed requirements for HMS equity loans. The earthquakes and volcanic eruptions in the Reykjanes area then accelerated the rise in home prices as former Grindavík residents entered the market. These effects were still palpable in early 2024, but we expect the "Grindavík effect" to subside over the next few months.

We forecast that prices will rise 5.8% this year, 5.1% in 2025, and 6.1% in 2026. In our opinion, the continued rise in house prices will be supported by three main factors: the ultimate impact of the Government's Grindavík home buy-up programme, population growth, and a change in mortgage loan composition. Borrowers have been shifting to indexed loans in ever greater measure, as maximum debt service ratios are subject to stringent requirements and non-indexed lending rates are at a historical high. It can be said that borrowers have accepted indexation once again – at least for the present – which may well explain some of the influx of new buyers into the market.

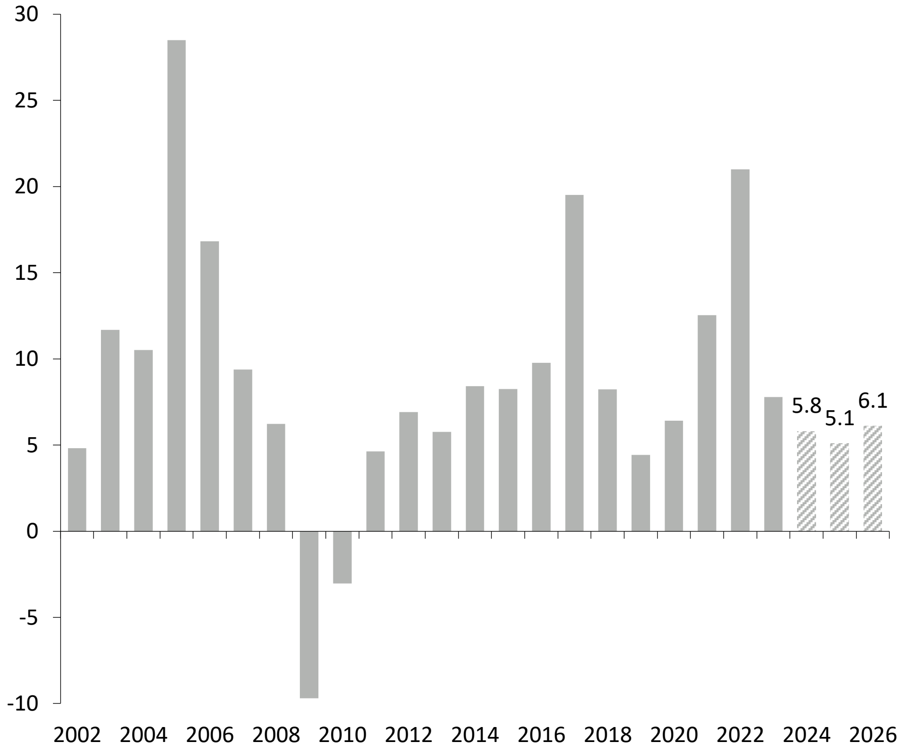
Concurrent with the monetary easing phase that we expect to begin in H2/2024, and with increased construction of new homes, we project that house price inflation will ease in 2025. In 2026, when interest rates and inflation start to approach previous levels, we expect stronger demand-driven price pressures to come to the fore again.

The number of homes under construction has fallen, as high interest rates have started to bite and the construction cost per dwelling has increased. Contractors want to finish projects already underway before starting new ones, and new construction should gain momentum again, as sales of new properties have been brisk in 2024. As a result, while we do not expect house prices to mushroom like they did a few years ago, we do anticipate a rise in real prices over the forecast horizon.

Number of homes, by construction year



Nominal house prices
% change between years



Sources: The Central Bank of Iceland, HMS, ÍSB Research

Private consumption shifts gears

Household consumption declines and saving rises

Private consumption shrank YoY in H2/2023, and most indicators imply that it did so again in Q1/2024. Payment card turnover within Iceland contracted in real terms over most of 2023 and in Q1/2024 as well. Private consumption grew by only 0.5% in 2023, the slowest growth rate Iceland has seen since the pandemic-era trough in 2020. Weak real wage growth, high interest rates, and inflation have therefore put a significant damper on private consumption. The Gallup Consumer Confidence Index shows fluctuations in household sentiment, but consumers are far more upbeat on the whole, and the most recent figures indicate greater optimism.

High interest rates discourage private consumption in two main ways. First, the direct cost of consumption rises through higher interest rates on, for example, payment card debt and residential mortgages; and second, the sacrifice cost of consumption is higher, as spending results in a loss of returns on savings.

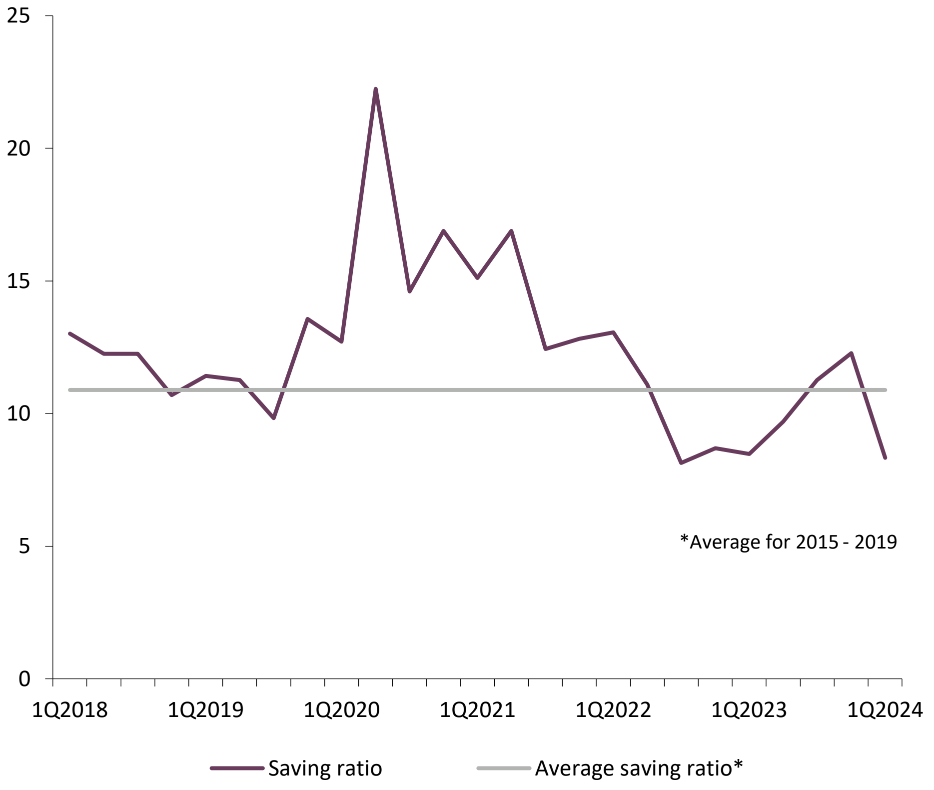
High policy rates have caused both of these to happen: households have stepped up their saving rate again after drawing down their COVID-era savings once the pandemic had passed, and the sacrifice cost of consumption has surged with higher real interest rates.

It can be said with certainty, then, that the policy rate has delivered the intended results in this area. With monetary easing, disinflation, and modest real wage growth in sight, we assume that private consumption will rebound in H2/2024 and that growth for the year will be positive, albeit modest. We then expect it to pick up more strongly in the two years to follow.

We project that private consumption will grow by 0.8% this year, 2.2% in 2025, and 2.8% in 2026, fuelled by rising real wages in tandem with falling inflation.

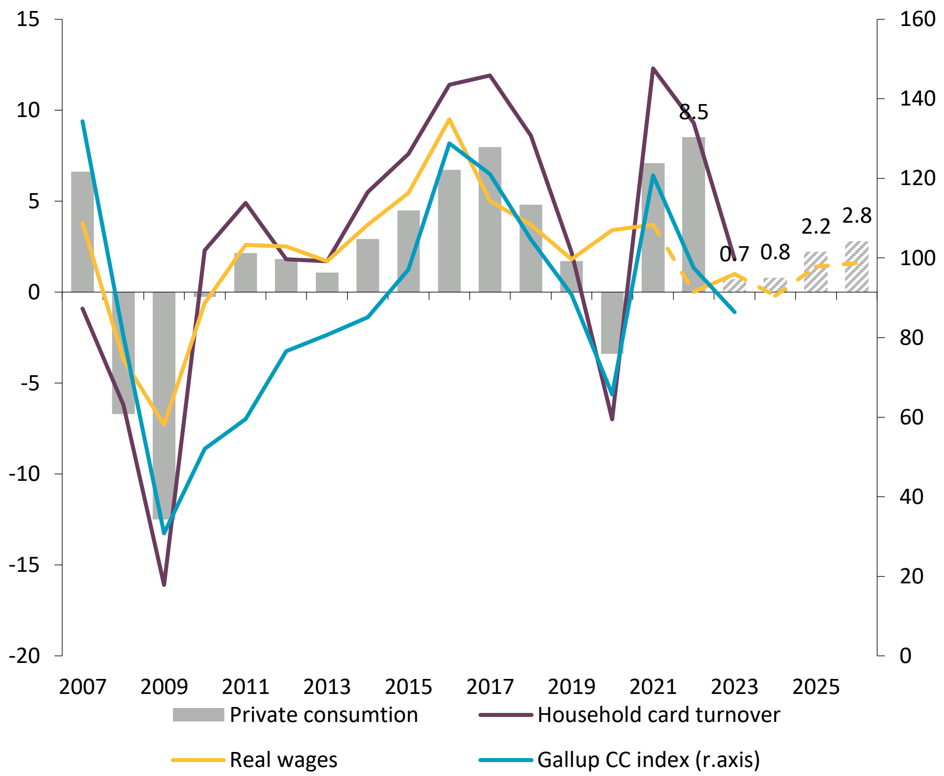
Household saving

% of disposable income



Private consumption and related indicators

% change between years (left) and index value (right)



Sources: Statistics Iceland, The Central Bank of Iceland, Gallup, ÍSB Research

Labour market tension to ease

Real wages set to grow during the forecast horizon

The Icelandic labour market is hardy and resilient, and we do not expect a significant rise in unemployment over the forecast horizon. The market has been quite tight in the recent term, and unemployment has fallen rapidly in the wake of the pandemic. A share of labour demand has been satisfied with foreign workers, who have been the driver of historically strong population growth. We expect that surge to abate and greater equilibrium to ensue.

Unemployment measured 3.2% in 2023, its lowest since 2018. Demand pressures remain, but they are subsiding in line with reduced domestic demand and high interest rates. Unemployment averaged 3.8% over the first four months of the year, as compared with 3.6% over the same period in 2023.

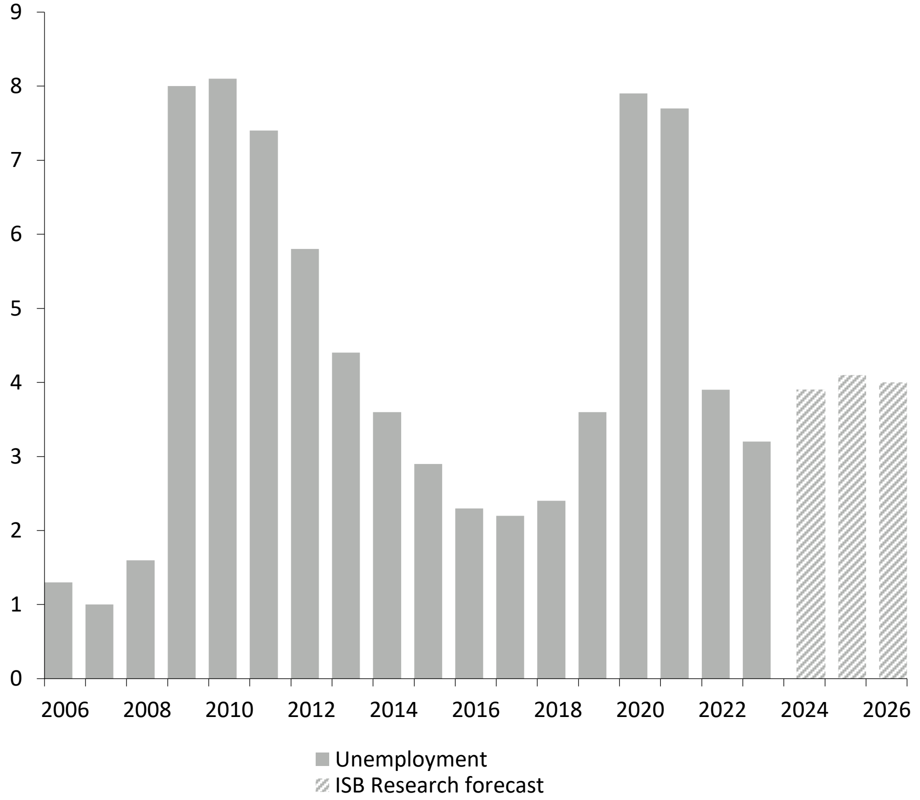
According to Gallup's spring survey among executives from Iceland's 400 largest companies, 30% of firms were planning to recruit, while 12% planned on reducing workforce. Diminishing tension in the labour market steadily reduces the need for additional imported labour.

We project average unemployment at 3.9% in 2024, 4.1% in 2025, and 4.0% in 2026. We also think the recent wage agreements will cause real wages to stagnate in 2024 and then grow in the years to follow.

The recent wage agreements have clearly eliminated a great deal of uncertainty, but even so, a significant segment of the labour market has yet to sign contracts, and demand pressures in the market could trigger wage drift during the forecast horizon.

We expect wages to rise on average by 5.7% this year, by 5.1% in 2025 and by 4.7% in 2026. Based on this forecast, real wages will remain flat in 2024 and then grow by 1.4% in 2025 and 1.6% in 2026.

Unemployment as a share of the labour force
%



Nominal and real wages
% change between years

Sources: The Central Bank of Iceland, Gallup, SA, ÍSB Research

The ISK exchange rate fluctuated markedly in 2023. It rose early in the year, then lost considerable ground until the autumn before rallying again towards the year-end. Intrayear exchange rate movements probably stem from trade-related flows, financial flows, and changes in ISK positions .

The ISK has been relatively stable in 2024 to date. The EURISK exchange rate, for instance, has remained between 148 and 151 from the turn of the year through mid-May. This stability reflects reasonably good equilibrium both in external trade (with the surplus on services offsetting the deficit on goods) and in flows within the financial account.

Near-term prospects for external trade are similar to those in our last forecast, with a modest CA surplus in each year of the forecast period. The surplus could come to an average of almost ISK 40bn per year in 2024-2026. Also, the outlook is for a fairly wide interest rate differential with abroad over the period. Iceland's external position is strong, and the stock of foreign-owned securities is low in historical and international context.

Offsetting potential FX inflows from the above-mentioned sources are the pension funds' continued foreign investments, which totalled ISK 83bn in 2023. Other domestic entities could also step up their foreign investment in the future, particularly if the ISK strengthens more than we expect.

Although considerable short-term volatility is likely, we expect the ISK to be approximately 5% stronger at the end of the forecast horizon than it was at the end of 2023. This translates to a price of ISK 143 per euro, a somewhat smaller appreciation than we had previously forecast.

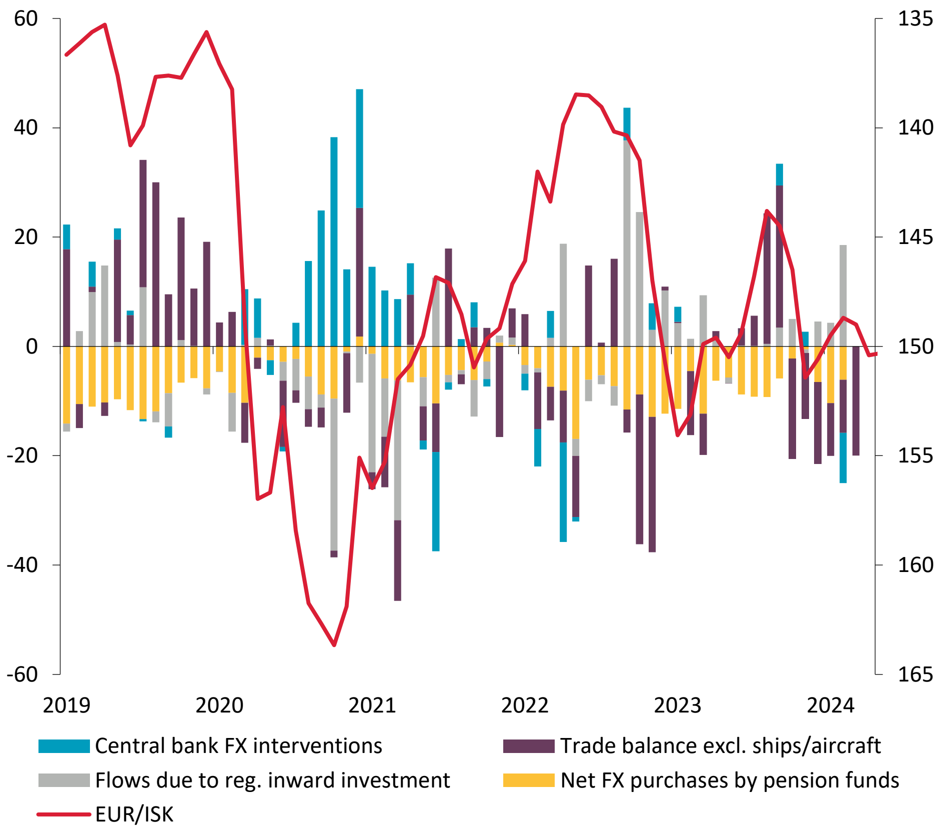
Such an appreciation, together with rapid wage growth and higher inflation than in trading partner countries, will push the real exchange rate close to its previous high towards the end of the forecast horizon. The probability of further strengthening will dwindle over time, and a depreciation later on will become more likely unless there is a change in these developments in wages and inflation.

Further ISK appreciation in the offing

Rising real exchange rate puts limits on the CA surplus over the forecast horizon, and the effects are reciprocal

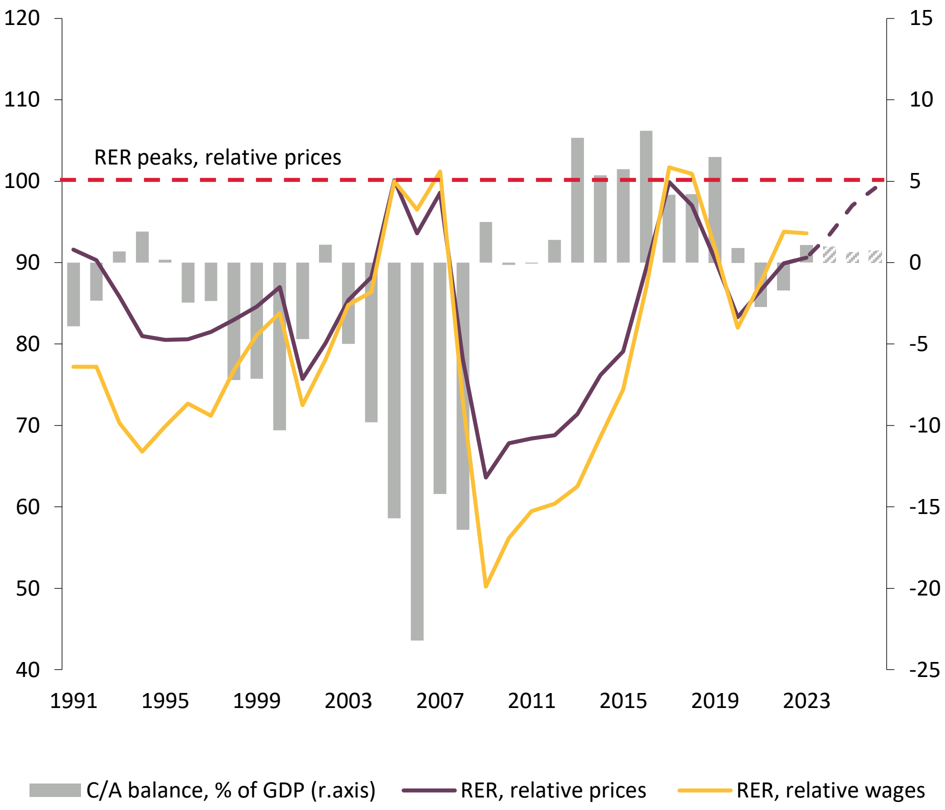
ISK exchange rate and selected determinants

ISK bn (left) and EURISK (right)



Real exchange rate and current account balance

Index and % of GDP



Sources: Central Bank of Iceland, ÍSB Research

Inflation has begun to subside after the recent spike. The resilience of the housing market has impeded disinflation more than was previously hoped. Headline inflation peaked at 10.2% in 2023 but has fallen since then, measuring 6.0% this April – still significantly above the Central Bank's (CBI) 2.5% inflation target.

The outlook is for continued disinflation in coming quarters, although inflation will be sticky in the months just ahead. If our forecast materialises, it will fall to 5.0% by the year-end. The main reason for more stubborn inflation has been rising house prices, due in part to the Government buy-up of homes in Grindavík, while other components have been relatively well-behaved on the whole. For instance, the ISK has been very stable year-to-date, and import prices have held steady, as have petrol prices.

The reason inflation has plunged as much as it did in H1/2024 is that large monthly increases from H2/2023 have dropped out of twelve-month measurements. Because the months dropping out of the headline inflation measurement in the near future are not "large" in the sense of capturing big price hikes, twelve-month inflation will be more inelastic in the coming term. We expect the housing market to remain resilient this year, and we project that real prices will rise over the forecast horizon.

We project that inflation will average 5.9% this year, 3.6% in 2025, and 3.1% in 2026. Stable prices abroad, a gradual ISK appreciation, and moderate wage agreements contribute perhaps the most to disinflation. According to our forecast, inflation will not realign with the CBI's 2.5% target but will be quite close to it in 2026.

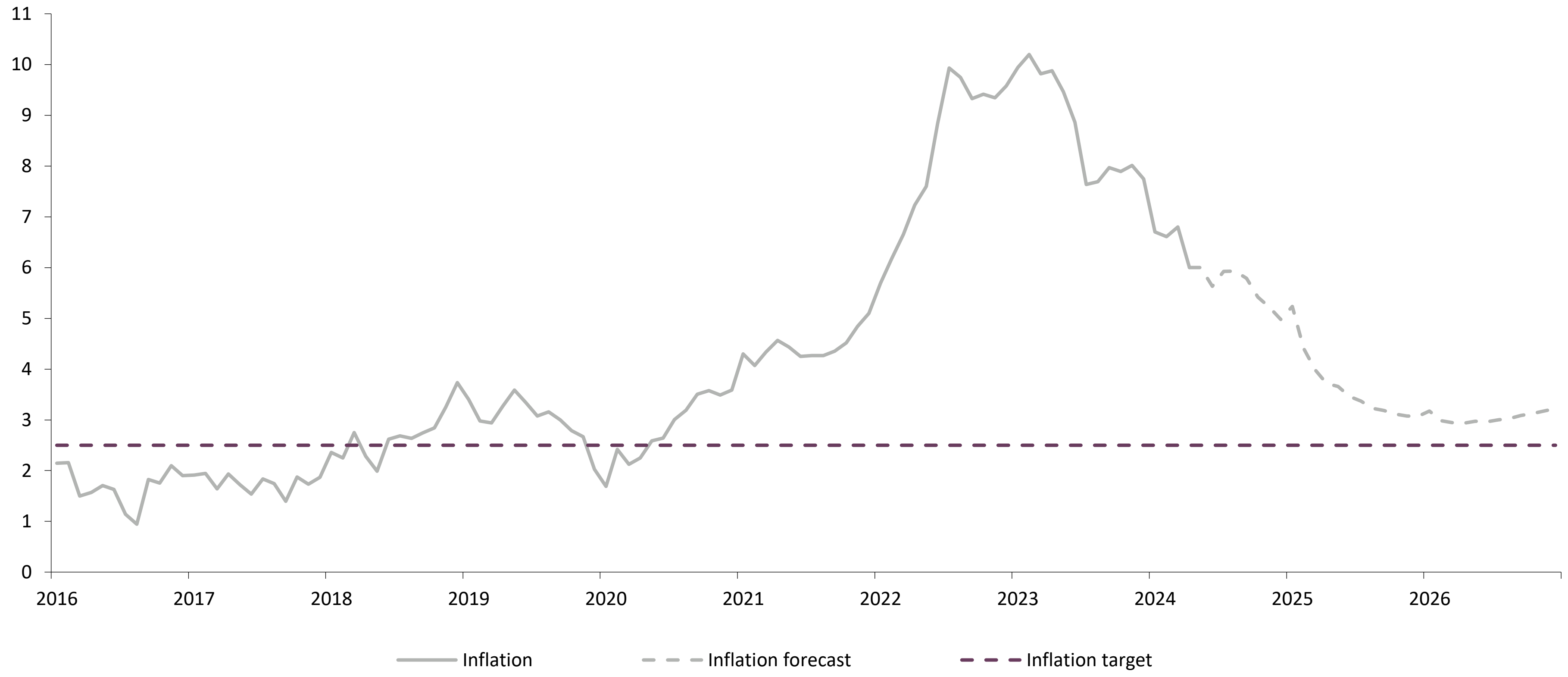
Key uncertainties in the forecast include the effects of the new methodology for imputed rent calculation, the extent of wage drift, and the impact of global geopolitical unrest. There is also the risk that the supply of new homes will decline significantly later in the forecast horizon, possibly pushing prices higher than is currently projected and slowing down disinflation and monetary easing.

Inflation declines but target-level inflation is still some way off

The Central Bank's inflation target remains elusive in the near-term but within reach by 2026

Inflation forecast

%



Sources: Statistics Iceland, ÍSB Research

How quickly will interest rates fall?

Declining inflation and a cooling economy pave the way for relatively slow monetary easing

The Central Bank's main policy interest rate has been unchanged at 9.25% since August 2023, following rate hikes totalling 8.5 percentage points since spring 2021. The real policy rate has risen markedly in recent quarters, however, reflecting the current tight monetary stance following a period of accommodative policy lasting until early 2023.

The outlook is for the next interest rate change to be a rate cut, as the CBI's Monetary Policy Committee (MPC) said in its May statement that the current real policy rate was probably sufficient to bring inflation back to target within an acceptable time frame. Further disinflation and a decline in inflation expectations should therefore give the MPC the scope for rate cuts in H2/2024.

If our economic and inflation forecasts materialise, the monetary easing phase could start when the MPC meets next, in late August. Nevertheless, it is possible that the MPC will wait until Q4, when two interest rate decision dates are on the calendar.

Although the Governor of the CBI signalled that interest rates could fall rather swiftly once the easing phase starts, we think the MPC is likelier to exercise caution at the outset. A robust investment level and underlying pressures in the housing market – plus the recent persistence of inflation – are all valid reasons to avoid easing the monetary stance too quickly.

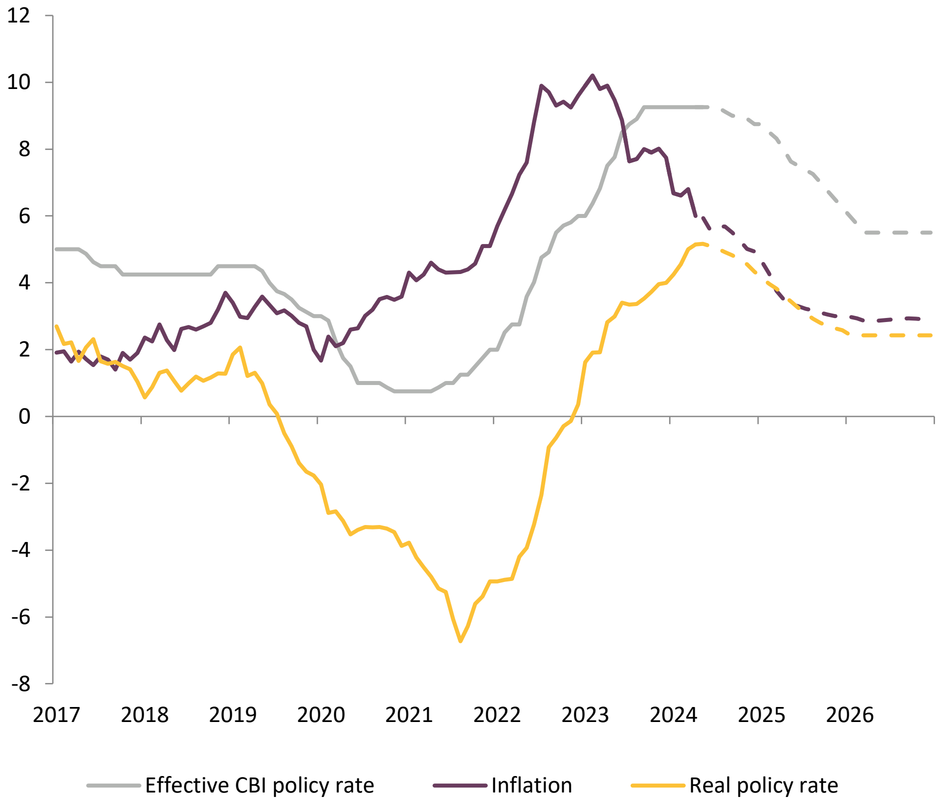
We project that the policy rate will be 8.75% at year-end 2024 and then fall to 6.25% by year-end 2025 and 5.5% towards the end of the forecast horizon, close to the equilibrium policy rate.

Presumably, long-term interest rates will fall gradually at the same time. Current nominal ten-year base rates are around 6.8%, and the corresponding real rate on indexed bonds is 2.6%.

We estimate that 10 year rates could fall to 5.7% and real rates to 2.2% over the forecast horizon. Accordingly, the long-term breakeven inflation rate would be 3.5%. It should be borne in mind, however, that long-term inflation expectations are probably lower than this, as the breakeven rate includes an uncertainty premium.

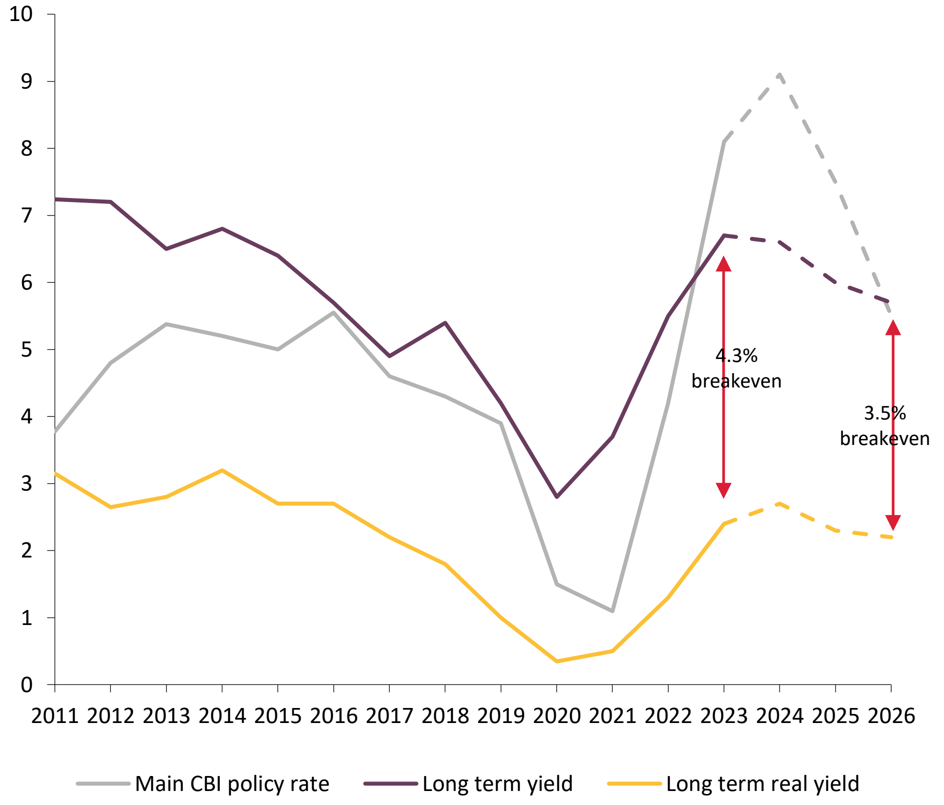
Policy rate and inflation

% real policy rate in terms of expected policy rate and inflation over the coming 12 months



Interest rates

% long-term nominal and real rates are average rates on long-term Treasury bonds



Sources: Kodiak, Central Bank of Iceland, Statistics Iceland, ÍSB Research

Macroeconomic forecast summarised

GDP and its components

Volume change from prior year %	2023 In ISK m	2023	Forecast 2024	Forecast 2025	Forecast 2026
Private consumption	2.139.207	0.5	0.8	2.2	2.8
Public consumption	1.098.402	2.2	2.5	1.5	2.0
Investment	1.014.018	-0.6	1.2	2.6	4.2
– business investment	655.588	0.9	1.6	3.0	4.5
– residential investment	195.501	-0.2	4.0	1.0	4.5
– public investment	162.929	-6.2	-4.0	3.0	2.4
Changes in inventories	29.603	0.0	0.0	0.0	0.0
Domestic demand. total	4.281.230	1.2	1.4	2.1	2.9
Exports of goods and services	1.855.717	4.8	0.4	4.0	3.5
– marine product exports	398.268	-2.2	-5.0	5.1	4.5
– aluminium product exports	323.723	1.4	-3.0	3.5	1.0
– other goods exports	222.256	-34.2	2.0	2.0	2.0
– services exports	911.471	9.8	4.1	4.0	4.2
Imports of goods and services	1.857.953	4.2	1.4	3.6	4.2
– goods imports	1.234.800	1.2	1.0	3.7	4.4
– services imports	623.153	1.2	2.0	3.2	3.8
Gross domestic product	**4.278.995**	**4.1**	**0.9**	**2.3**	**2.6**

Macroeconomic forecast summarised

Other economic variables

	2023	Forecast 2024	Forecast 2025	Forecast 2026
% of GDP				
Investment	23.7	23.5	23.2	23.4
Current account balance	1.0	1.0	0.6	0.7
Trade account balance	-0.1	0.3	0.5	0.4
Change between annual averages (%)				
Consumer prices	8.7	5.9	3.6	3.1
Wages and salaries	9.8	5.7	5.1	4.7
Real wages	1.0	-0.2	1.4	1.6
Real exchange rate (relative consumer prices)	0.7	3.2	3.8	2.2
House prices	7.8	5.8	5.1	6.1
Annual average (%)				
Unemployment	3.2	3.9	4.1	4.0
Trade-weighted exchange rate index	195.2	194.9	190.2	188.1
EUR/ISK	149.1	148.2	144.6	143.0
CBI policy rate (7-day term deposits)	8.1	9.1	7.5	5.5
Long-term nominal interest rates (10-yr nominal Treasury bonds)	6.8	6.6	6.0	5.7
Long-term real interest rates (10-yr indexed Treasury bonds)	2.3	2.7	2.3	2.2

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