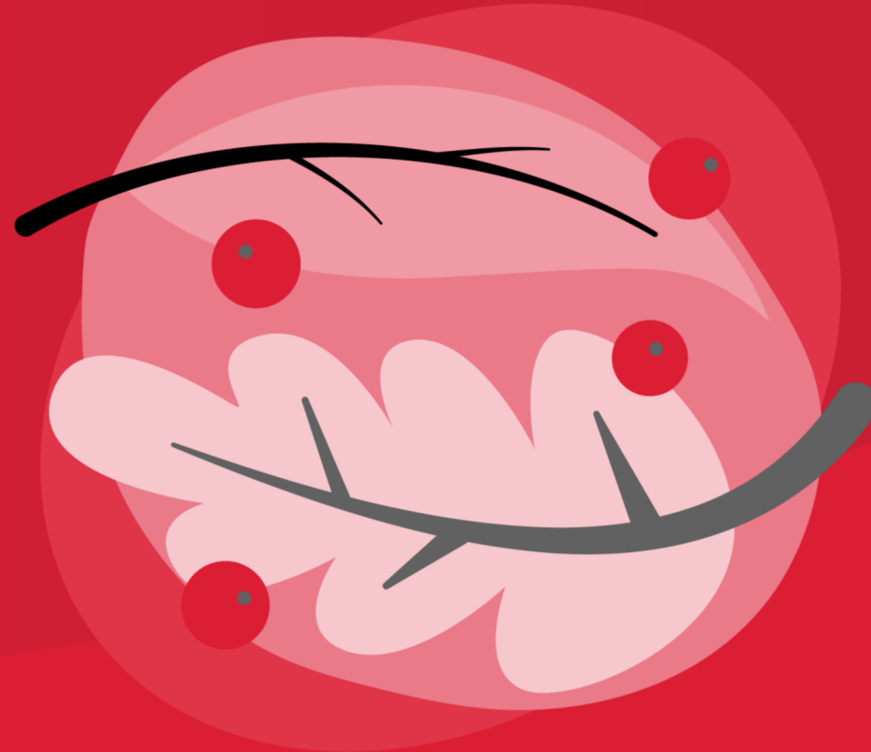
September 2024

Autumn takes hold in the economy

Macroeconomic forecast 2024-2026

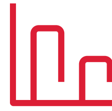


Autumn takes hold in the economy

Summary

Negligible output growth in 2024, with better times ahead

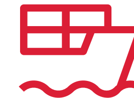
GDP growth



- Unfavourable external trade offsets modest growth in demand this year
- Demand better aligned with growth potential in coming years
- 0.3% GDP growth in 2024
- 1.2% GDP growth in 2025
- 2.5% GDP growth in 2026

Temporary current account deficit set to rebalance

External trade



- Growth in tourism flat in 2024 and modest thereafter
- Marginal contraction in fish and aluminium exports in 2024
- Exports contract by 0.9% in 2024, while imports grow 2.4%
- Current account deficit 1.1% of GDP
- CA in balance in 2025 and 2026

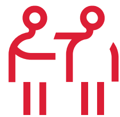
Inflation eases as the economy cools

Inflation

- Inflation has begun to subside after the recent spike
- Housing market holds its ground; real prices to rise during the forecast horizon
- Price stability abroad, reduced demand pressures, and modest wage agreements foster disinflation
- Inflation to average 6.0% in 2024, 3.7% in 2025, and 3.0% in 2026

Labour market tightness continues to ease

Labour market



- Reduced need for further imported labour
- Unemployment to average 3.7% in 2024, 4.1% in 2025, and 3.8% in 2026
- Recent wage agreements will lead to flat real wages in 2024 but deliver real wage growth in coming years
- Wages to rise 5.7% in 2024, 5.1% in 2025, and 4.7% in 2026

Easing to start this winter, but rates remain high

Interest rates

- Persistent inflation and a resilient economy delay rate cuts
- Gradual easing could begin in Q4/2024
- Policy rate 9.0% at end-2024, 7.5% at end-2025, and 5.5% at the end of the forecast horizon
- Long-term interest rates fall over time
- 10-yr nominal rates to measure 5.8% and 10-yr real rates to measure 2.2% at the end of the period.

Modest ISK appreciation likely over the forecast horizon

The ISK

- Improvements in CA balance and investment-related FX inflows support the ISK further ahead
- Pension funds' foreign investment and other investment-related outflows will pull in the opposite direction
- ISK set to be 2% stronger at the end of the horizon than in August 2024
- High real exchange rate will cut into CA surplus and could put downward pressure on the ISK later on

After a surge in 2021-2022, GDP growth lost steam over the course of 2023, plunging from 9.1% in Q1 to 1.5% in Q4. In H2, domestic demand contracted year-on-year as well, for the first time since the pandemic year 2020.

GDP contracted nearly 2% in H1/2024. The failed capelin catch was a major factor, but there were headwinds in other exports, and private consumption shrank.

For 2024, we project 0.3% growth, the weakest GDP growth rate since the financial crisis of 2009-2010, apart from the pandemic year 2020. The year 2024 marks the end of a business cycle, even though a full-year contraction is not likely. This is also a far weaker growth rate than we forecast in May. The deviation stems from a poorer outlook for exports, stronger imports, and the effects of high real interest rates on demand in H2.

For 2025, we forecast GDP growth at 1.2%. Private consumption and exports will gain steam, but investment looks set to be virtually flat YoY.

For 2026, the outlook is for 2.5% GDP growth, with investment set to rebound and private consumption and exports to pick up further.

Stronger growth in investment and private consumption further ahead will stem from not least from firms' greater capacity for investment, with falling interest rates and faster real wage growth alongside lower inflation.

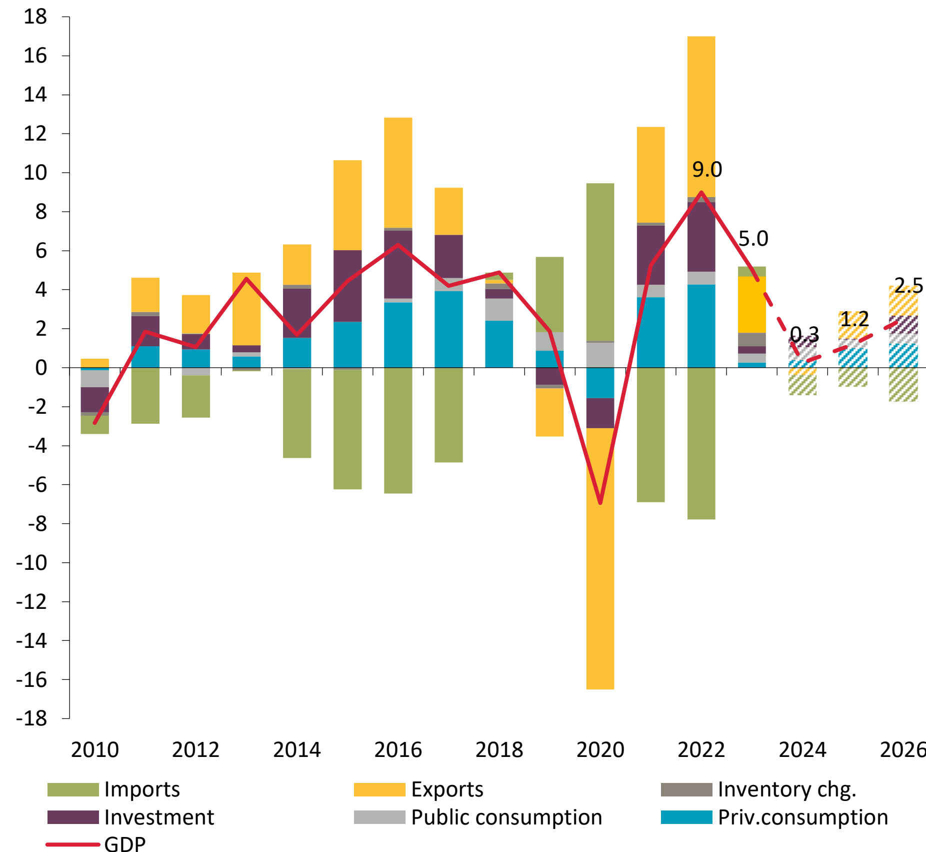
We now project considerably slower growth over the forecast horizon than we did in May, driven by slower growth in tourism, relatively weak growth in marine product exports, and the long-term impact of a high real interest rate. On the other hand, growth in recent years now measures higher than previous figures indicated. Therefore, slower growth in this forecast does not necessarily mean significantly more slack later on.

Negligible output growth in 2024, with steady improvement ahead

Growth prospects have dimmed due to weaker export growth and the effects of chronically high interest rates

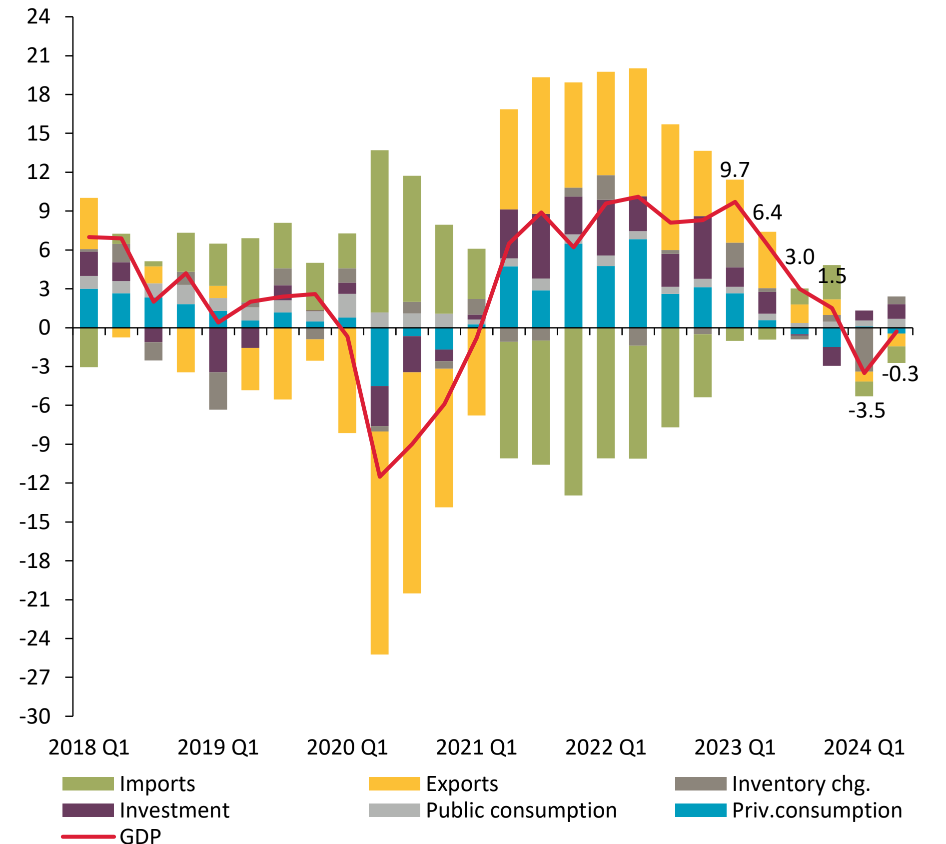
GDP and contribution of its subcomponents

Volume change from prior year (%)



GDP and its subcomponents, by quarter

Volume change from prior year (%)



Source: Statistics Iceland, ÍSB Research

Growth in tourism flat in 2024

Tourist numbers to be broadly unchanged YoY in 2024 and rise slowly in the years to follow

After surging in 2023 and early 2024, tourist arrivals slackened off in Q2/2024. Foreign nationals' departures via Keflavík Airport declined by 5% YoY in Q2.

The peak season more or less righted the ship, however, and visitor numbers in July and August were marginally higher than in the same months of 2023.

The outlook is for just over 2.2 million tourist arrivals via Keflavík Airport this year, about the same as in 2023. Added to this are passengers using other airports, cruise ships, and the Smyril Line ferry.

As we see it, there are three main reasons for the changed pattern in tourism.

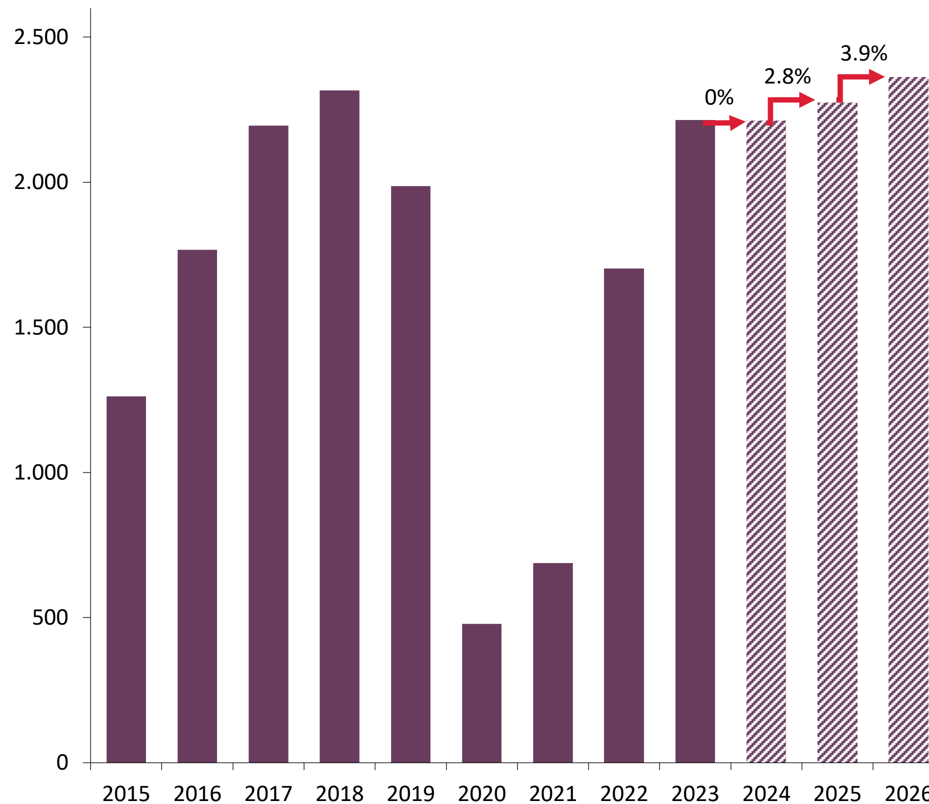
- Geothermal activity on the Reykjanes peninsula and the related media coverage of the situation there have dampened interest in travel to Iceland.
- The sprouting of interest in trips to Iceland is apparently waning, and similar destinations such as the other Nordic countries are growing in popularity.
- A rising real exchange rate has eroded the sector's competitive position recently.

Prospects for the coming term are somewhat ambiguous. Airline seat capacity this winter looks set to be reduced relative to last year. However, there is rather keen interest in trips to Iceland next spring and summer, and the outlook for global tourism is generally acceptable.

We forecast that tourist numbers will be virtually unchanged between 2023 and 2024 and then grow modestly in 2025 and 2026. That would put tourist arrivals at just over 2.2 million this year, nearly 2.3 million in 2025, and a scant 2.4 million in 2026. This is broadly in line with recent forecasts of growth in tourism worldwide.

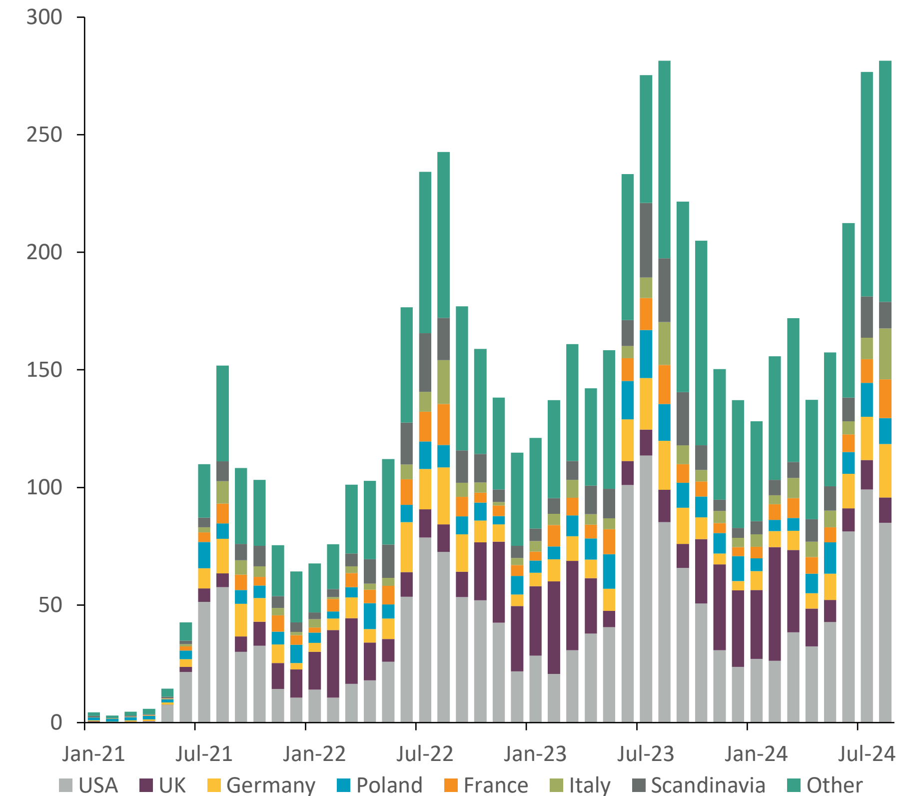
Number of foreign tourists, by year

Thousands



Number of foreign tourists, by month

Thousands



Source: Iceland Tourist Board, ÍSB Research

Setback in external trade, but a return to balance is ahead

2024 saw headwinds in goods and services exports, but conditions for growth will firm up again

Services exports shrank 6% in real terms in H1/2024. In addition to a contraction in tourism revenues, export revenues from intellectual property and miscellaneous specialised services declined YoY. Although the outlook for H2 is more favourable, services exports are expected to contract slightly in 2024 as a whole.

Key goods exports are also expected to suffer a setback this year, partly because of cutbacks in electricity supply to aluminium smelters, the failed capelin catch, and a rather weak mackerel catch. Growth is expected in aquaculture exports and other smaller export sectors, however.

In 2025 and 2026, we expect modest growth in exports of goods as well as services. On the goods side, we expect increased farmed fish exports, modest growth in groundfish quotas overall, and stronger pelagic fish catches. Also, energy cutbacks should have less impact on aluminium exports, and exports of pharmaceuticals and high-tech goods are expected to grow.

Growth in tourism should be supplemented by increased export revenues from specialized services and knowledge-intensive services.

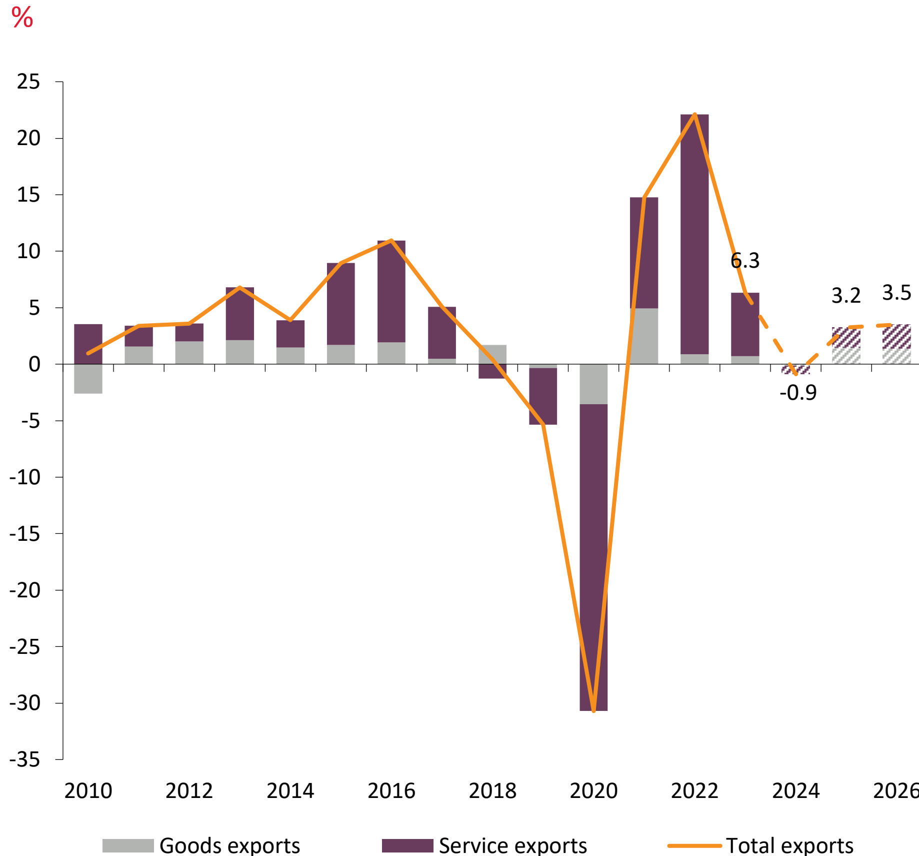
Overall, the outlook is for exports to contract by 0.9% in 2024, then grow by 3.2% in 2025 and 3.5% in 2026.

Imports slammed into reverse in 2023, contracting by 1.1% after two years of rapid growth. This is due in fair measure to a turnaround in demand growth.

Imports have picked up again, however, growing by nearly 3% in H1/2024. We project import growth at just over 2% in 2024 and 2025, and then nearly 4% in 2026. More rapid import growth further ahead is linked not least to stronger demand growth in the economy.

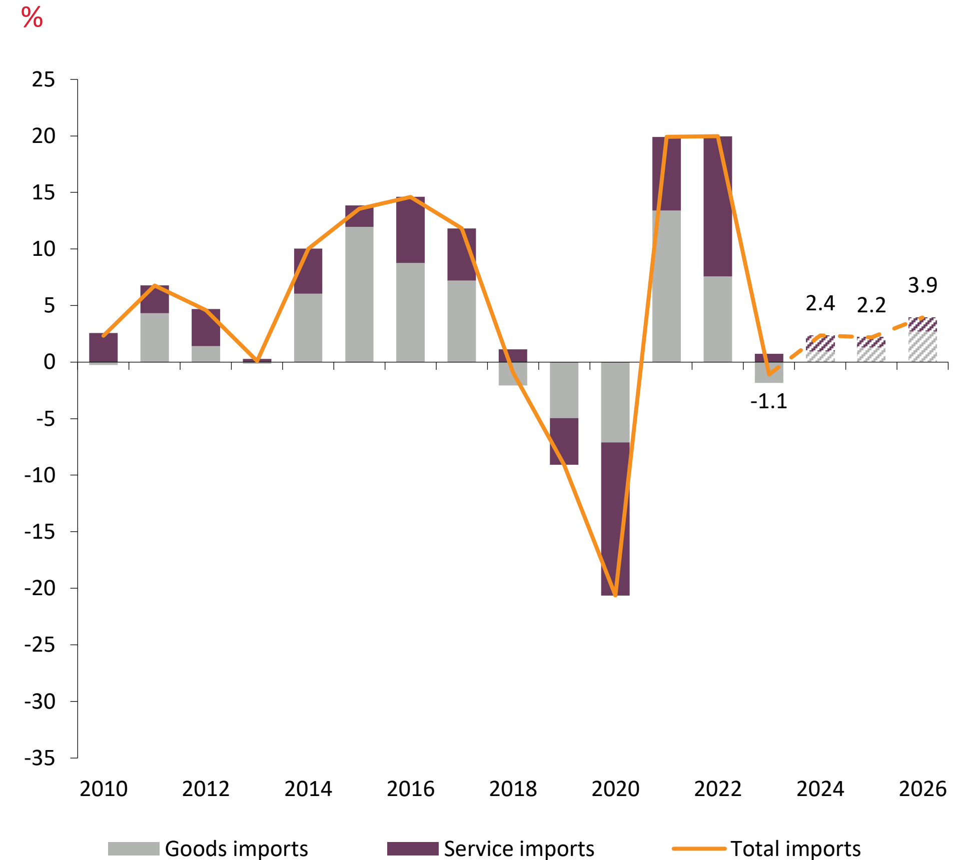
Exports, YoY change and contributions from subcomponents

%



Imports, YoY change, and contributions from subcomponents

%



Source: Statistics Iceland, ÍSB Research

Current account flips from surplus to temporary deficit

A setback in exports and buoyant imports cause a CA deficit this year, but a balanced CA is in sight

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

In H1/2024, the CA balance deteriorated again, with a deficit of ISK 78bn, as compared with a deficit on ISK 9bn in H1/2023. A smaller surplus on services trade was a major driver, plus a larger goods account deficit and a weaker balance on income.

Although the peak tourist season will doubtless bolster the current account in H2, the outlook is for a CA deficit of just over 1% of GDP in 2024 as a whole. In all likelihood, though, export growth will deliver a balanced current account in 2025 and 2026. Developments in terms of trade could make a real difference here. We expect export prices to improve a bit more than imported goods and services prices in the coming term.

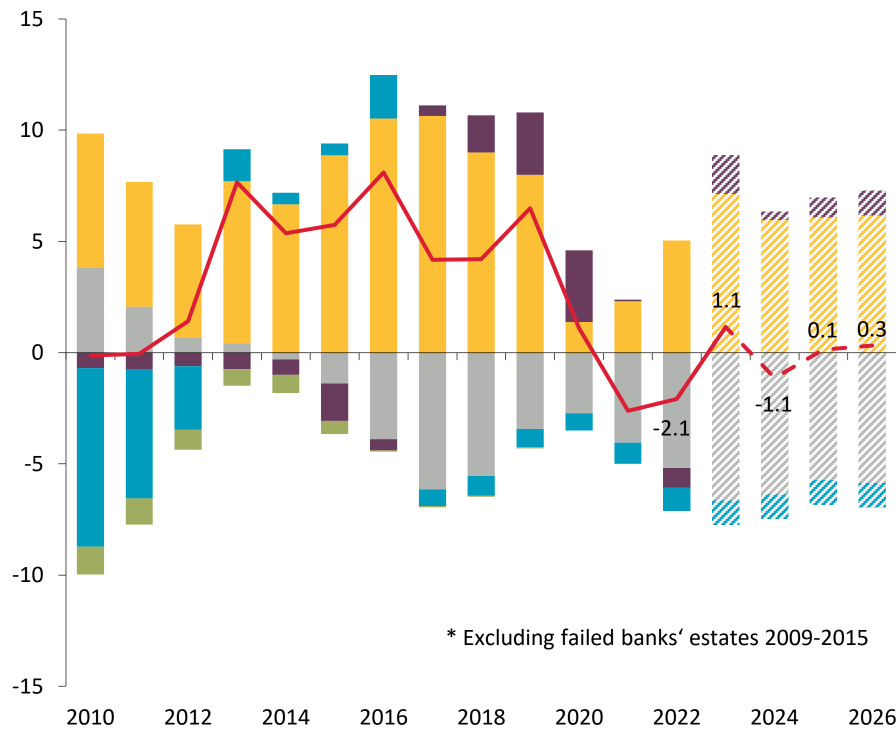
If the ISK appreciates more than we anticipate or if terms of trade worsen materially, the CA surplus could flip to a deficit around the mid- to late 2020s.

Iceland's net external assets totalled just under 39% of GDP in mid-2024. This robust asset position is enormously important for the ISK and the economy as a whole.

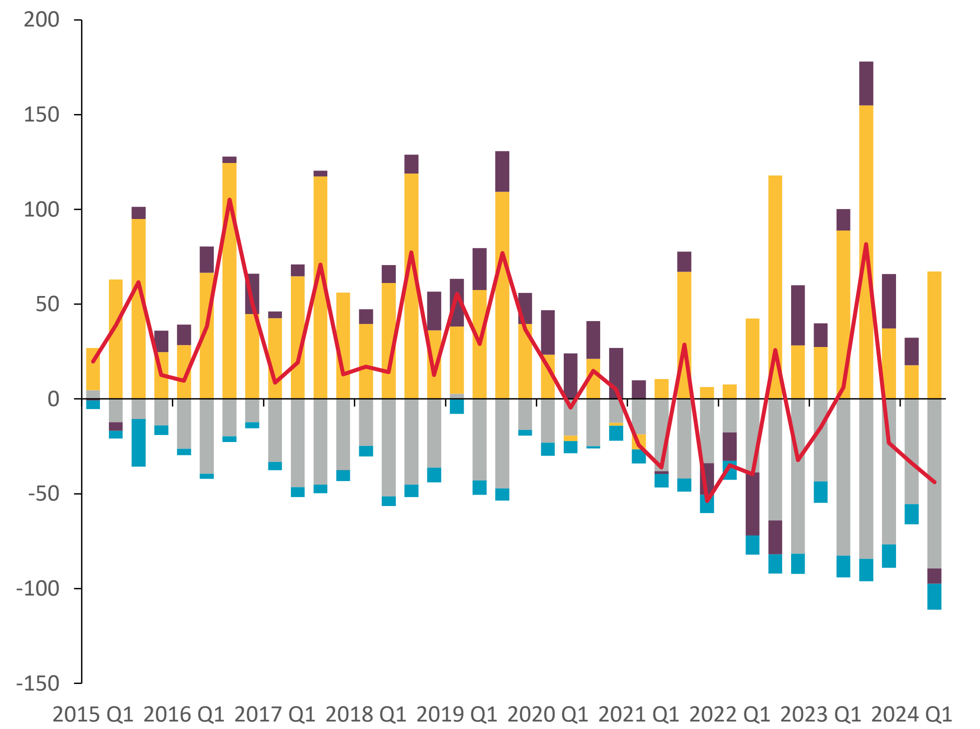
After deteriorating markedly early in the decade, the external position has firmed up again, partly due to price hikes in foreign equity markets.

The outlook is for the external position to remain strong, but whether it improves in coming years will depend on developments in foreign asset markets and in the CA balance.

The current account balance and its subcomponents
% of GDP *



The current account balance and its subcomponents by quarter
ISK bn



Source: The Central Bank of Iceland, Statistics Iceland, ÍSB Research

After a period of relative stability lasting through mid-2024, the ISK softened in Q3. Presumably, this is because the CA balance deteriorated YoY in H1, due mainly to setbacks in tourism and goods exports. Changed expectations about external trade have also been reflected in less position-taking with the ISK in recent months.

Near-term prospects for external trade are slightly poorer than in our last forecast. The outlook is for a CA deficit this year and a balanced current account in 2025 and 2026, whereas in May we projected a modest surplus in 2024 as well as the two years afterwards.

Even so, several factors should be rather positive for the ISK. The outlook is for a sizeable interest rate differential with abroad in the coming term. Furthermore, Iceland's external position is still strong, and the stock of foreign-owned securities is modest in historical and international context.

Potential FX inflows from the above-mentioned sources are offset by continued foreign investment by the pension funds, which bought currency for ISK 37bn in the first five months of 2024. Other domestic entities could also step up foreign investment in the future, particularly if the ISK strengthens more than we expect.

As usual, short-term ISK volatility can be expected. In our view, though, the big picture is that the ISK will probably hold rather stable, with the possibility of a modest appreciation as the CA balance improves. Our forecast assumes that it will be roughly 2% stronger at the end of the forecast horizon than in August 2024. This translates to a price of ISK 148 per euro, which is somewhat weaker than in our previous forecast.

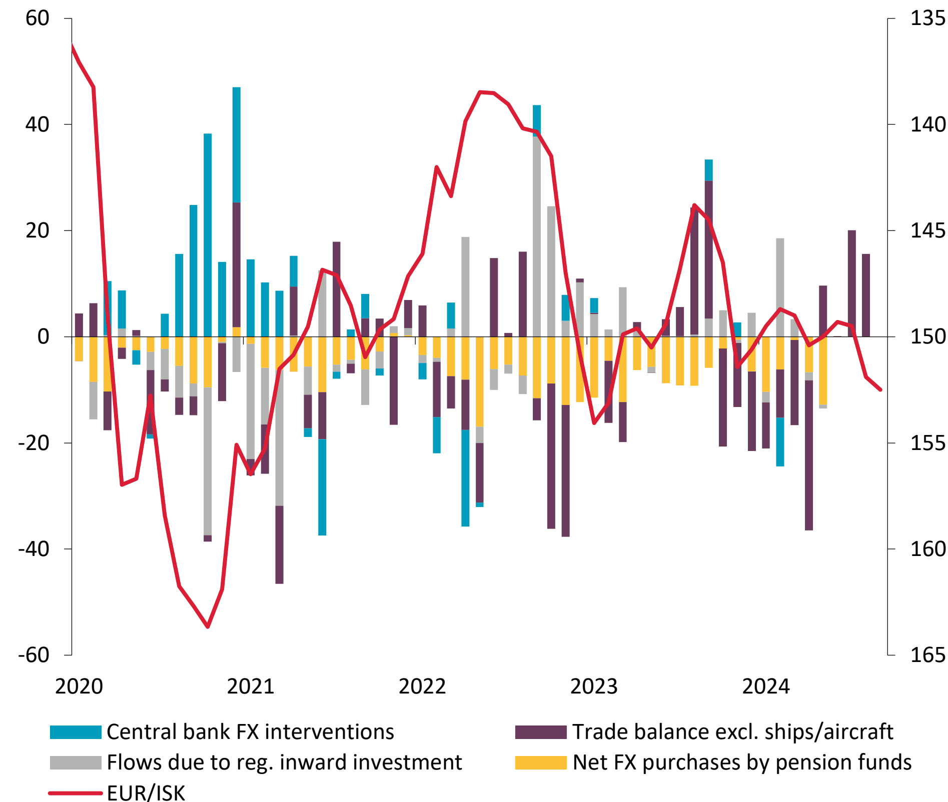
While the nominal exchange rate will rise only slightly in our forecast, robust wage growth and higher inflation than in trading partner countries will cause the real exchange rate to rise, although probably not to its previous high. Thus Iceland's competitive position should remain slightly more favourable than in 2017-2018 and during the 2005-2007 boom. In all likelihood, though, the real exchange rate will ultimately rebalance as it has done before, with a nominal depreciation of the ISK, if the differential between domestic and foreign inflation and wage growth persists.

ISK set to appreciate marginally during the forecast horizon

The real exchange rate is close to equilibrium in terms of the external balance of the economy

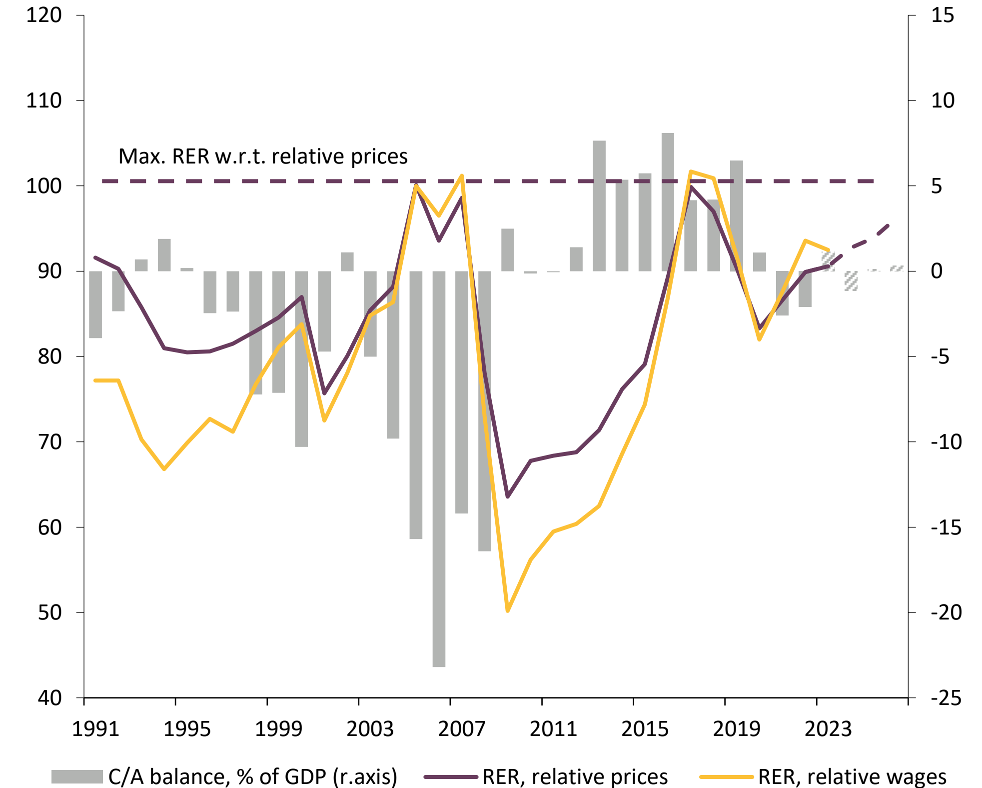
ISK exchange rate and selected determinants

ISK bn (left) and EURISK (right)



Real exchange rate and current account balance

Index and % of GDP



Source: The Central Bank of Iceland, Statistics Iceland, ÍSB Research

After two strong years in 2021-2022, investment growth slowed substantially in 2023, owing largely to rising interest rates, plus increased consolidation in public investment spending after the hefty fiscal deficits of the pandemic era. Total investment grew by just under 2% in 2023.

The pace accelerated in H1/2024, however. Growth overall measured 4% YoY during the half, with business and residential investment up by 5% and nearly 7%, respectively, more than offsetting the nearly 5% contraction in public investment.

The outlook is for stronger investment growth this year than in 2023. Surveys of corporate executives' expectations and other indicators suggest that general business investment will pick up in the near future. A key driver of the increase is a surge in development relating to land-based aquaculture. Residential investment also looks set to remain strong.

Business investment is expected to grow by 2.6% and residential investment by 6.0% this year, while public investment is projected to shrink by 3.5% YoY. Total investment will therefore increase by 2.3% in 2024.

In 2025, however, the outlook is for a slight contraction in business investment, while residential and public investment are expected to increase marginally. A high real interest rate is a key factor in this, and over time, weak growth in exports will be reflected in a reduced need for investment.

On the other hand, business investment will probably rebound as interest rates fall and exports grow later in the forecast horizon.

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.

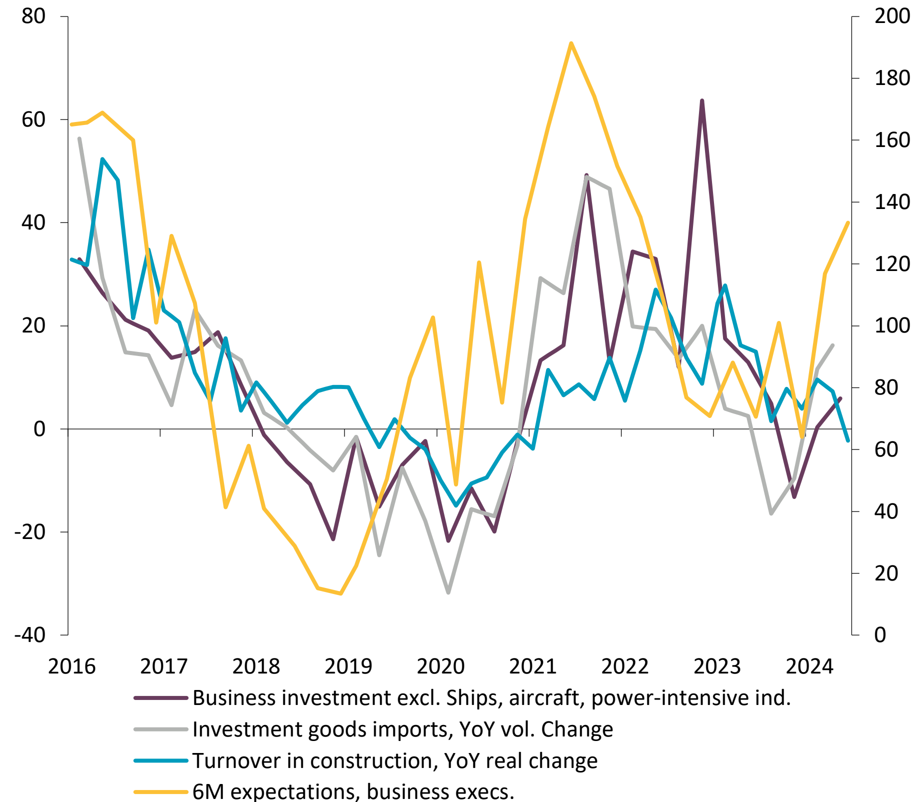
We project that on the whole, investment will be virtually unchanged YoY in 2025 and then grow by just under 4% in 2026.

Robust investment over the forecast horizon

High interest rates and a more ambiguous outlook for exports will impede investment temporarily, but growth will pick up again later

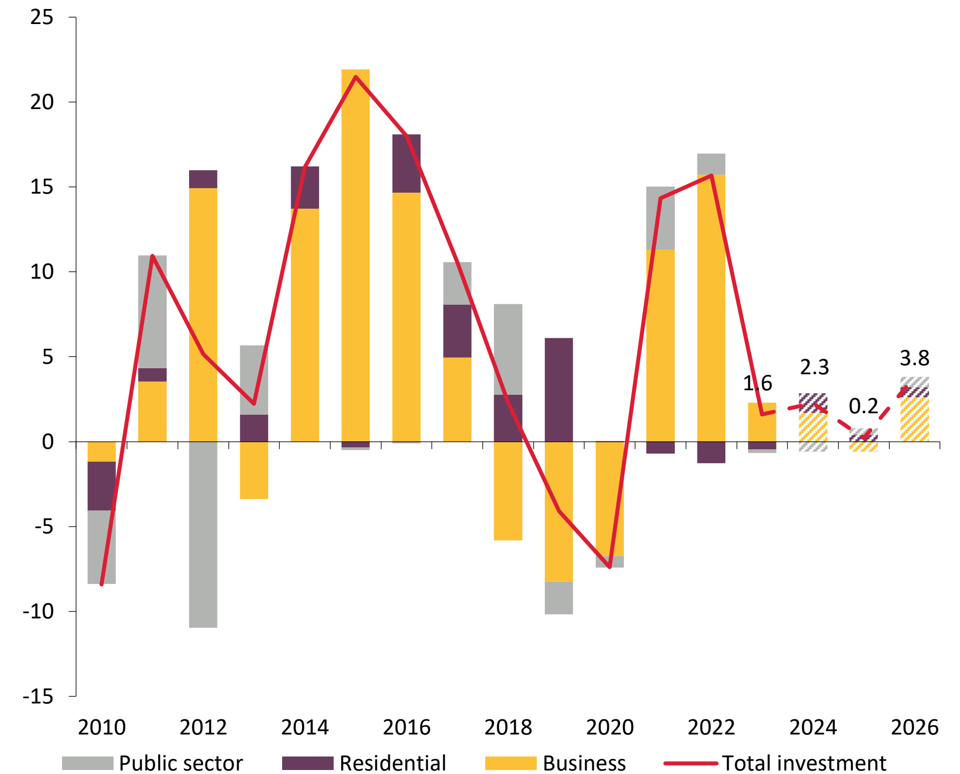
Business investment and related indicators

YoY change (%) and indices



Investment, real change and contribution of subcomponents

%



Source: The Central Bank of Iceland, Statistics Iceland, ÍSB Research

Housing market still running hot

Grindavík Effect stronger than anticipated

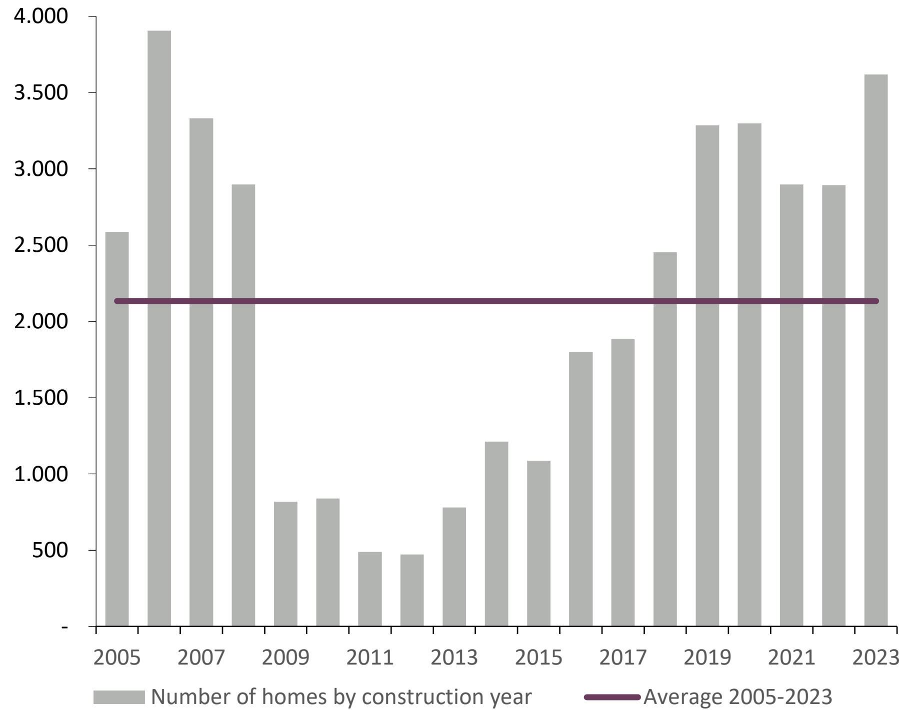
This year's house price inflation shows clear signs of the so-called Grindavík Effect. The State's buy-up of Grindavík properties has freed up capital and greased wheels that were starting to rust, thereby enabling the market to move faster despite high interest rates and strict borrower-based measures. Nonetheless, we expect a slowdown in Q4 and an even slower pace by 2026, when supply increases and the tug-of-war between supply and demand settles down.

Even though price hikes will lose pace, they will still be considerable, albeit not as hefty as during the peak two years ago. As a result, with declining inflation, real prices will rise markedly over the forecast horizon. We forecast that prices will rise 10.7% this year, 7% in 2025, and 6.1% in 2026. For this year, one factor is the expectation that the Grindavík Effect will stretch into 2025 to a degree. Alongside falling inflation and interest rates, a larger housing supply will foster a better balance between supply and demand.

The changed composition of mortgage loans has affected housing market developments and the impact of monetary policy. Many borrowers opted for fixed interest rates when rates were historically low, with rates locked in for three or five years. The large proportion of mortgages bearing fixed interest rates clearly blunted the effect of monetary tightening. The same can be said of the effects of shifts between loan forms once fixed-rate clauses expire. A rising share of indexed loans in the outstanding mortgage stock dilutes the effect of monetary policy and can maintain higher house price inflation, thereby sustaining higher real interest rates for a longer period of time.

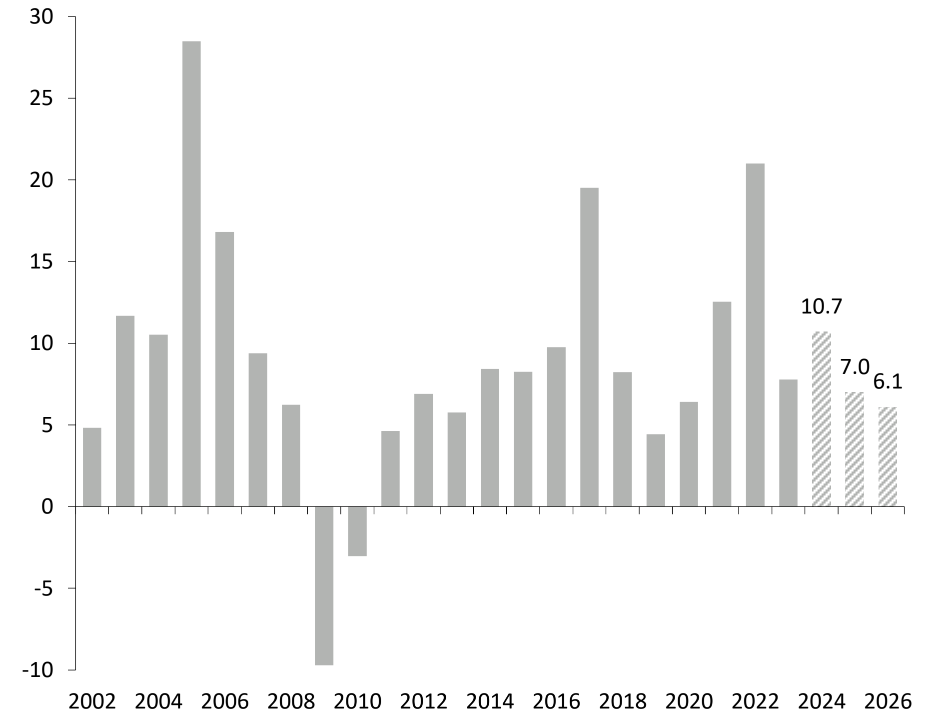
The policy rate has a twofold effect on the real estate market: it curbs demand and impedes supply as well, by raising financing costs. The impact of interest rate hikes further ahead will depend on how the race between supply and demand develops. Supply is more inelastic than demand, which could push prices higher until supply starts to catch up later in the forecast horizon.

Number of homes, by construction year



Nominal house prices

% change between years



Source: The Central Bank of Iceland, HMS and ISB Research

Private consumption growth eases but is still resilient

Private consumption expected to grow weakly in the near term but gain steam later in the forecast horizon

Private consumption ticked upwards unexpectedly in Q1/2024, after shrinking in the last two quarters of 2023. However, the recent revision of payment card turnover data puts this into clearer context, as previous figures strongly indicated a contraction. Q2 saw a contraction of 0.9%, however. According to Statistics Iceland (SI), the strongest downturn was in the purchase of consumer durables such as cars, although services consumption shrank as well.

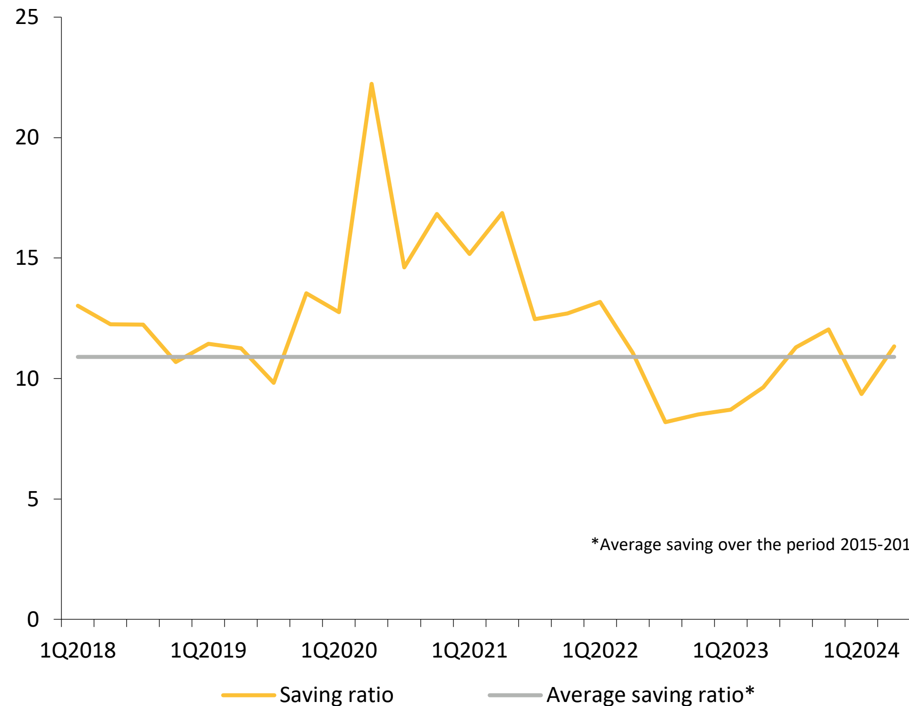
We expect households to remain cautious about buying durables in coming quarters, as high real interest rates push financing costs and sacrifice costs upwards. In 2025 and 2026, however, consumption of durables will pick up again as interest rates and inflation decline, making financing cheaper and freeing up savings for use in consumption spending.

Growth in payment card turnover has been modest YTD, and much weaker than a few quarters ago. Even so, turnover figures do not indicate that households are tightening their belts at the moment, though, despite high interest rates, weak real wage growth, and sagging economic expectations. Although it is worth noting the recent population growth spurt in this context, card turnover seems to be growing slightly faster than the population.

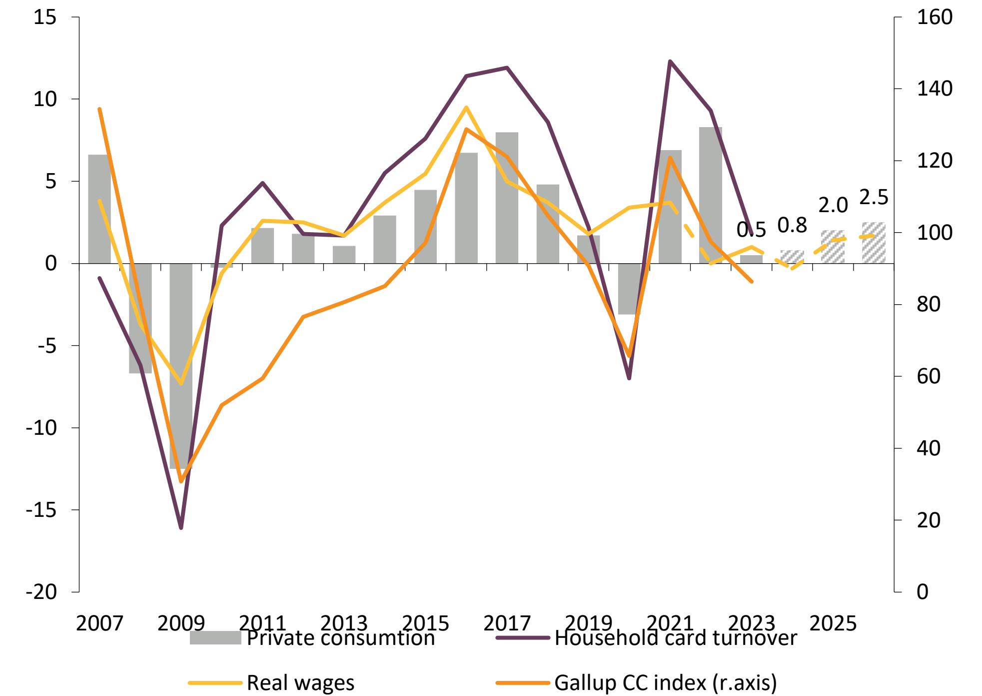
High real interest rates on savings have prompted households to put more money aside, as can be seen in the recent increase in the saving rate. Households' interest income has therefore risen steeply, helping to offset rising interest expense. This has supported private consumption; for instance, households' interest income exceeded their interest expense in H2/2023. With moderate wage growth alongside falling inflation, real wages are expected to hold their ground this year and then rise modestly in 2025 and 2026. This will help sustain private consumption growth over the forecast horizon.

We project that private consumption will grow by 0.8% this year, 2% in 2025, and 2.5% in 2026. We expect it to grow in the coming two quarters, owing in part to base effects from the strong contraction in H2/2023.

Household saving
% of disposable income



Private consumption and related indicators
% change between years (left) and index value (right)



Source: The Central Bank of Iceland, Statistics Iceland, ÍSB Research

Labour market shows signs of rebalancing

Real wages set to grow over the forecast horizon

The Icelandic labour market has been tight and the participation rate high during the post-pandemic period. The tight market has been accompanied by strong population growth, as demand has been met partly with imported labour. Even though export growth has softened this year, labour demand has remained robust, although it shows signs of easing.

In the first eight months of 2024, unemployment averaged 3.5%, as compared with 3.2% over the same period in 2023. The number of persons unemployed for 6-12 months was up by a third YoY, according to the Directorate of Labour (DoL).

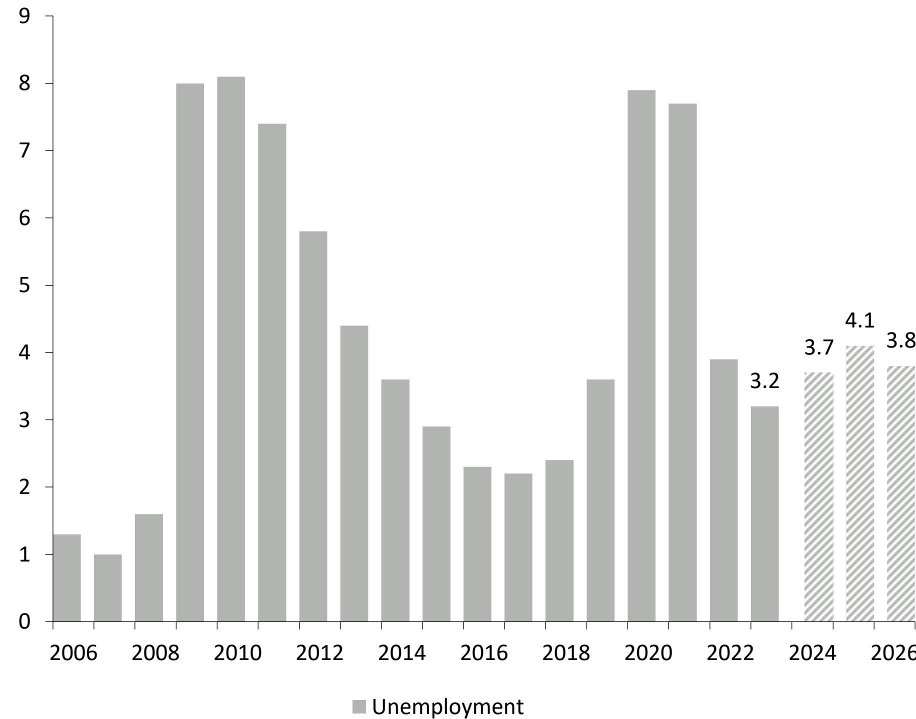
Recent surveys indicate signs of a cooling labour market. This spring, 22% of executives surveyed by Gallup planned to recruit staff, down from 30% in Q1, and in June, 14% planned to downsize, up from 13% earlier in the year. The share of firms reporting staffing shortages fell from 54% in early winter 2022 to 29% this spring, its lowest in three years.

We expect unemployment to measure 3.7% this year and 4.1% in 2025, and then fall to 3.8% in 2026. This suggests only a slight rise in the jobless rate, as the Icelandic labour market is very flexible in international context. With reduced tension in the market, the likelihood of wage drift has eased, although it is not necessarily non-existent. We forecast that wages will rise by 5.7% this year, 5.1% in 2025, and 4.7% in 2026.

If our forecast materialises, real wages will shrink slightly this year but then grow by 1.4% and 1.7%, respectively, in 2025 and 2026. The finalisation of wage agreements for most of the labour market has dramatically reduced uncertainty about developments in nominal and real wages in coming years.

Unemployment as a share of the labour force

%



Nominal and real wages

% change between years

Source: Directorate of Labour, Statistics Iceland, ÍSB Research

Colder weather brings cooling inflation

Inflation will not reach target during the forecast horizon but will fall below the upper tolerance limit in Q2/2025

Inflation has fallen steeply from its H1/2023 peak of over 10%. It averaged 6.7% in Q1/2024 and 6.0% in Q2, falling to a recent low of 5.8% in June. We forecast that it will remain flat quarter-on-quarter at an average of 6.0% in Q3 and then measure 5.1% at the end of 2024.

One of the main uncertainties about inflation in 2024 has been SI's new method for calculating owner-occupied housing costs. Despite widespread concerns, including our own, the new method has not yet pushed inflation upwards. Actually, inflation would be about 1 percentage point higher if the old method were still in use. Housing costs have been the main driver of inflation this year and are likely to remain so.

We project that inflation will average 6.0% this year, 3.7% in 2025, and 3.0% in 2026. The decline in inflation is based partly on price stability abroad, moderate wage agreements, limited wage drift, and a stable ISK. As before, the key uncertainties are the housing market and the new imputed rent calculation method, which could cause upward pressures to be sticker for longer. Another uncertainty is the impact of the ongoing conflict in the Middle East on commodity prices and shipping routes. Furthermore, there is still some uncertainty about the ISK later in the forecast horizon.

The main short-term uncertainty is the change in motor vehicle taxes set to take effect at the year-end, as it could strongly affect inflation measurements in 2025. It could push inflation sharply downwards in January, but actual developments will depend on how the change is structured.

According to our forecast, inflation will not return to target during the forecast horizon; however, it will fall below the upper tolerance limit in Q2/2025 and approach the target in the latter half of the period.

Inflation and inflation forecast

%

Inflation — Inflation forecast — Inflation target

Source: Statistics Iceland, ÍSB Research

Monetary easing to start before the year-end?

Falling inflation and a cooling economy should create the conditions for a policy rate cut this winter

After aggressive monetary tightening starting in spring 2021, the CBI's policy rate has been held at 9.25% since August 2023. The real policy rate has surged in recent quarters, however, reflecting a tight monetary stance at present.

Expectations of a rate cut in Q3 evaporated, though, after a summer of stubborn inflation and strong economic activity.

Although the Monetary Policy Committee (MPC) took a fairly stern tone at its August interest rate decision, several factors have supported monetary policy since. Inflation is down and the near-term outlook has improved somewhat. The breakeven inflation rate has fallen markedly since the August decision date, although long-term inflation expectations remain high by most measures.

If our economic and inflation forecasts materialise, the easing phase could start on 20 November, the last rate-setting date of the year. But the margin for error is slim, and unless everything more or less lines up, rate cuts will be delayed until next year.

Although the CBI Governor signalled that interest rates could fall rather swiftly once easing starts, we think it likelier – and wiser – for the MPC to exercise caution at the outset. A robust investment level and underlying housing market pressures, plus the persistent inflation we have seen recently, are all valid reasons to avoid unwinding the monetary stance too quickly.

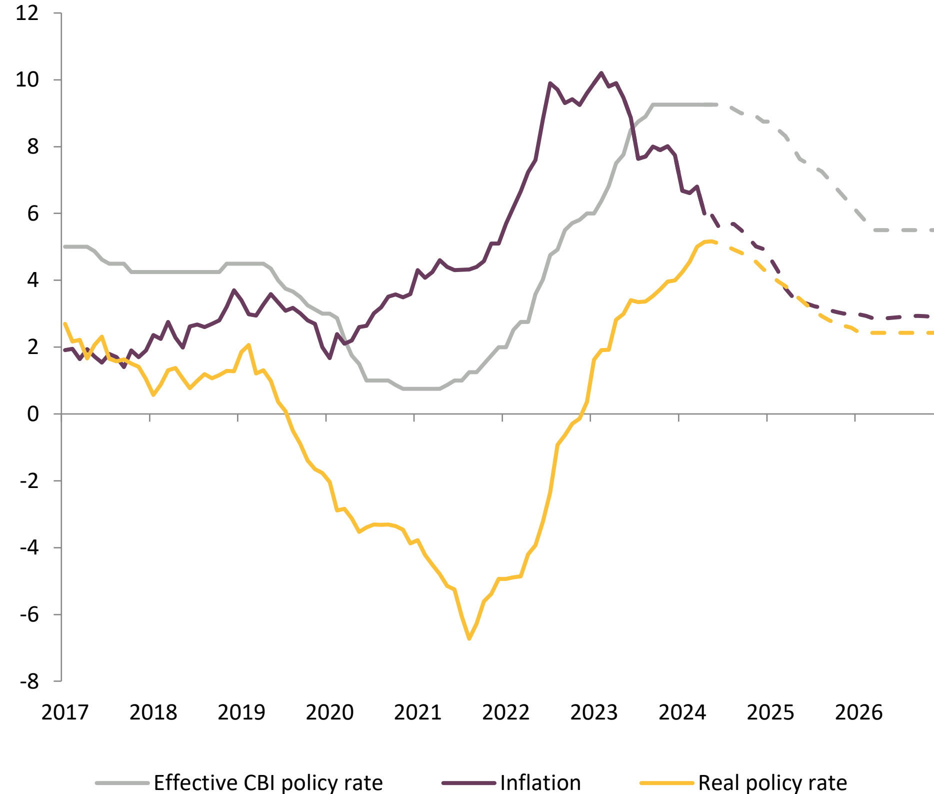
We project that the policy rate will fall to 8.25% by mid-2025, 7.5% at end-2025, and 5.5% near the end of the forecast horizon. We think this last figure is close to the current equilibrium rate.

Long-term interest rates are high at present. Based on Treasury yield curves, nominal ten-year base rates are now around 6.8%, and the corresponding real rate on indexed bonds is close to 2.7%.

We think long-term nominal rates could fall to 5.8% and real rates to 2.2% over the forecast horizon. Accordingly, the long-term breakeven rate would be 3.6%, down from the current 4.0%. Long-term inflation expectations are probably lower than this, though, as the breakeven rate includes an uncertainty premium.

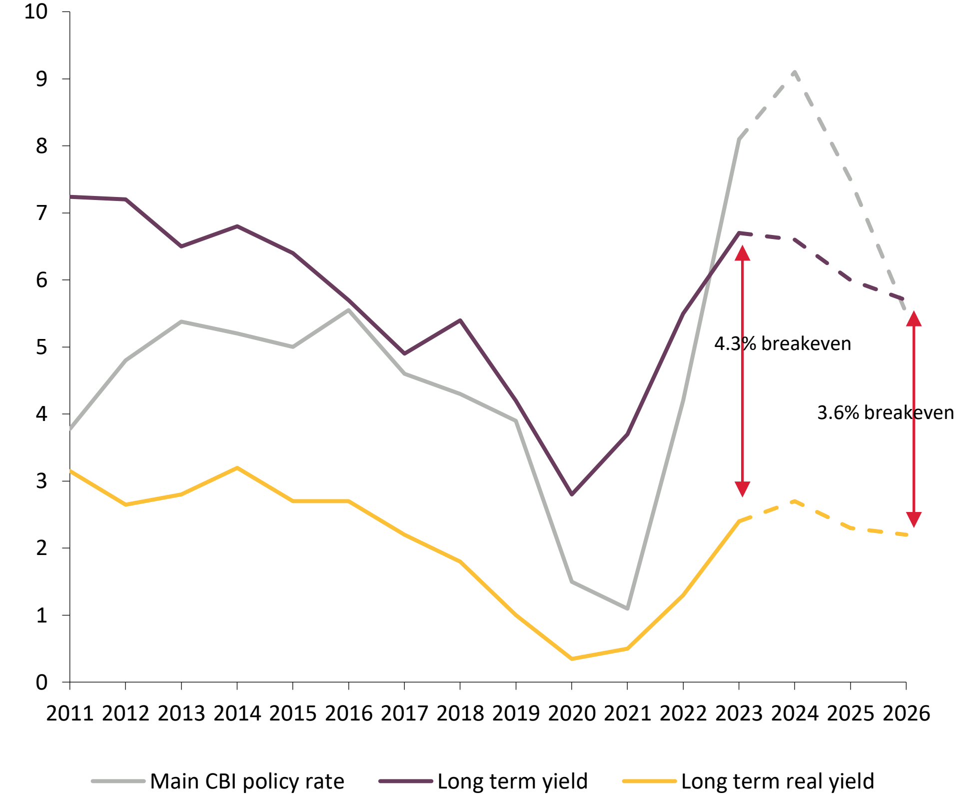
Policy rate and inflation

% 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 10 year treasury yields



Source: Kodiak, The Central Bank of Iceland, Statistics Iceland, ÍSB Research

Macroeconomic forecast summarised

GDP and its subcomponents

Volume changes from prior year %	2023 In ISK m	2023	Forecast 2024	Forecast 2025	Forecast 2026
Private consumption	2,140,722	0.5	0.8	2.0	2.5
Public consumption	1,084,584	1.8	2.7	1.7	2.0
Investment	1,044,879	1.6	2.3	0.2	3.8
– business investment	676,427	3.6	2.6	-0.9	4.0
– residential investment	195,561	-2.3	6.0	2.0	3.0
– public investment	172,892	-1.2	-3.5	2.5	4.0
Changes in inventories	29,603	0.0	0.0	0.0	0.0
Domestic demand. total	4,299,789	1.6	1.7	0.8	2.7
Exports of goods and services	1,885,878	6.3	-0.9	3.2	3.5
– marine product exports	352,797	-2.2	-1.2	3.4	4.5
– aluminium product exports	323,726	1.4	-1.5	3.0	1.5
– other goods exports	262,530	-33.3	6.0	2.0	2.0
– services exports	938,828	13.1	-1.5	3.5	4.2
Imports of goods and services	1,864,588	-1.1	2.4	2.2	3.9
– goods imports	1,234,341	-2.7	1.5	2.0	4.2
– services imports	630,247	2.3	4.1	2.5	3.5
Gross domestic product	**4,332,309**	**5.0**	**0.3**	**1.2**	**2.5**

Macroeconomic forecast summarised

Other economic variables

As % of GDP	2023	Forecast 2024	Forecast 2025	Forecast 2026
Investment	24.2	24.4	24.1	24.2
Current account balance	1.1	-1.1	0.1	0.3
Trade account balance	0.5	-0.4	0.4	0.3
Change between annual averages (%)				
Consumer prices	8.7	6.0	3.7	3.0
Wages and salaries	9.8	5.7	5.1	4.7
Real wages	1.0	-0.3	1.4	1.7
Real exchange rate (relative consumer prices)	0.7	2.4	1.2	2.5
House prices	7.8	10.7	7.0	6.1
Annual average (%)				
Unemployment	3.2	3.7	4.1	3.8
Trade-weighted exchange rate index	195.2	197.0	197.3	194.3
EUR/ISK	149.1	150.6	150.5	148.2
CBI policy rate (7-day term deposits)	8.1	9.2	8.2	6.4
Long-term nominal interest rates (10-yr nominal Treasury bonds)	6.8	6.8	6.3	5.8
Long-term real interest rates (10-yr indexed Treasury bonds)	2.3	2.7	2.3	2.2

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