Macroeconomic forecast 2021-2023

Highlights

Economic recovery to begin alongside rising tourist numbers

GDP growth

- For the most part, GDP growth for the year is thanks to growth in tourism and modest increases in consumption and investment
- 2.7% growth in 2021
- 4.9% growth in 2022
- 2.9% growth in 2023

Strong export growth after a historically deep contraction

External trade

- If forecasts of 700,000 tourist arrivals materialise, this will equal a 40% year-on-year increase
- Exports to rise by 11.7% in 2021 and imports by 9.8%
- Current account balance to be positive by 0.9% of GDP
- Current account surplus around 4% of GDP or more in 2022 and 2023

Inflation to start falling later in the forecast horizon

Inflation

- Inflation looks set to remain above the CBI's 4% tolerance limit for a while and then start to decline
- ISK appreciation to chip away at inflation
- Inflation to average 4.1% in 2021
- Inflation 2.6% in 2022 and 2.4% 2023

Unemployment more persistent than previously hoped

Labour market

- The recovery of tourism will be the main determinant of how fast unemployment declines
- Unemployment to average 8.8% in 2021
- 5.3% in 2022
- 3.6% in 2023

A gradual monetary tightening phase has begun

Interest rates

- The first post-pandemic policy rate hike came in May, owing to waning uncertainty and high inflation
- Interest rates to rise gradually, averaging 1.8% in 2022 and 2.8% in 2023
- Long-term rates have already risen markedly and are not expected to climb much further during the forecast horizon

ISK likely to strengthen with rising tourist numbers

The ISK

- The ISK has already strengthened, and further appreciation will probably accompany rising tourist numbers and other FX inflows
- ISK appreciation estimated at 3.2% in 2021, 4.7% in 2022, and 1.3% in 2023
- CBI to continue mitigating short-term volatility and start shoring up its reserves again if the ISK appreciates significantly

Economic recovery to take root this year and blossom in 2022

GDP growth to gain pace in H2/2021; robust growth expected in 2022

Even though many hoped a year ago that 2021 would be the "year after COVID," the pandemic has made its mark on H1. But the endgame could be in sight, as the vaccination roll-out is moving ahead at a brisk pace in many parts of the world.

Fortunately, Iceland has been able to tackle the challenge more effectively than many feared. The pandemic itself has not been as catastrophic in Iceland as it has been in many other countries, and Icelandic authorities, business community and households have handled an exceedingly complex situation remarkably well.

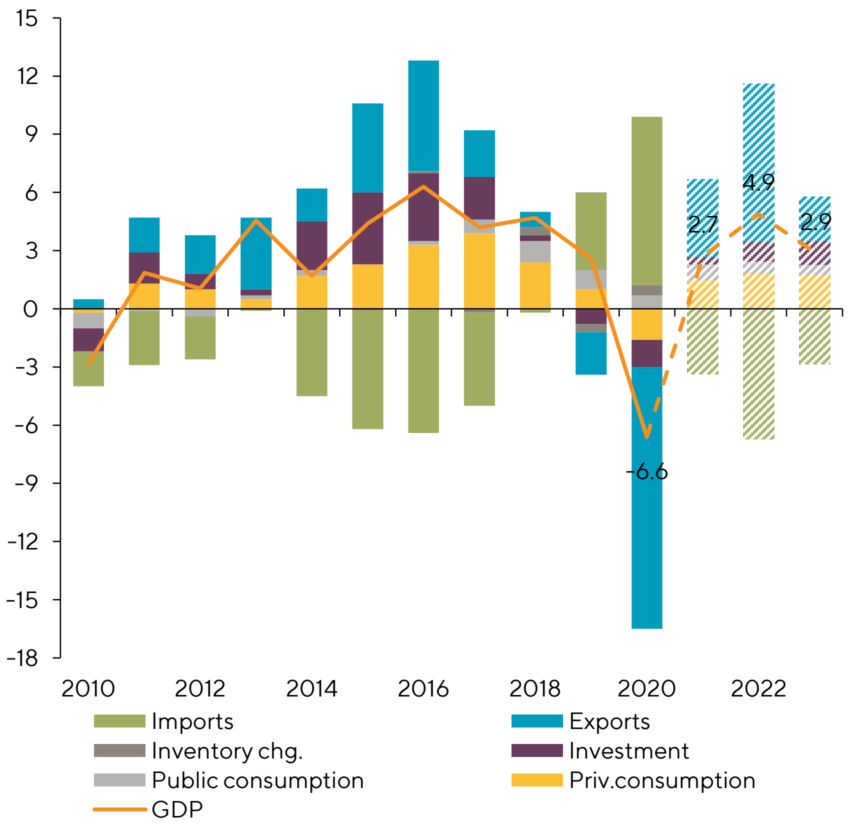
The Icelandic economy shrank by 6.6% in real terms in 2020. Given the body blow dealt to the country's largest export sector, we consider this a defensive victory. The main drivers of this relatively good performance were domestic demand, which largely held its ground, and the abrupt contraction in imports, which did much to counteract the contraction in exports over the period.

We project that GDP growth will measure 2.7% in 2021, owing mainly to a recovery of exports and modest growth in investment and consumption. This forecast represents a downward revision of GDP growth relative to the January forecast, mainly because the 2020 contraction turned out smaller than we had expected.

In 2022, we project growth at 4.9%, as we expect both exports and domestic demand to rebound even more strongly. In the final year of the forecast horizon, 2023, we forecast 2.9% growth, as the impact of COVID-19 will be tapering off and the economy will have somewhat rebalanced.

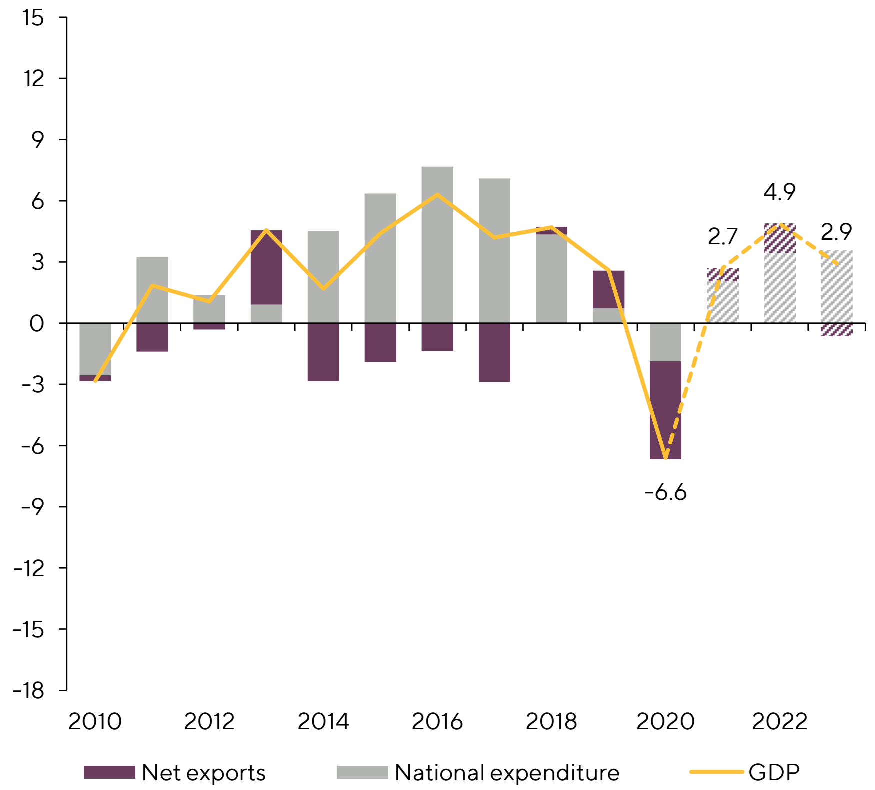
GDP and contribution of its subcomponents

Volume change from prior year (%)



GDP, domestic demand, and external trade

Volume change from prior year (%)



Sources: Statistics Iceland, ÍSB Research.

Uptick in tourist arrivals is starting

We forecast 700,000 tourist visits this year

There is no doubt that an upswing in tourist arrivals in the coming term will be the main determinant of how quickly the economy rights itself. Although tourist numbers for 2021 remain uncertain, this uncertainty is declining alongside rising vaccination rates in Iceland and abroad and relaxation of restrictions at national borders.

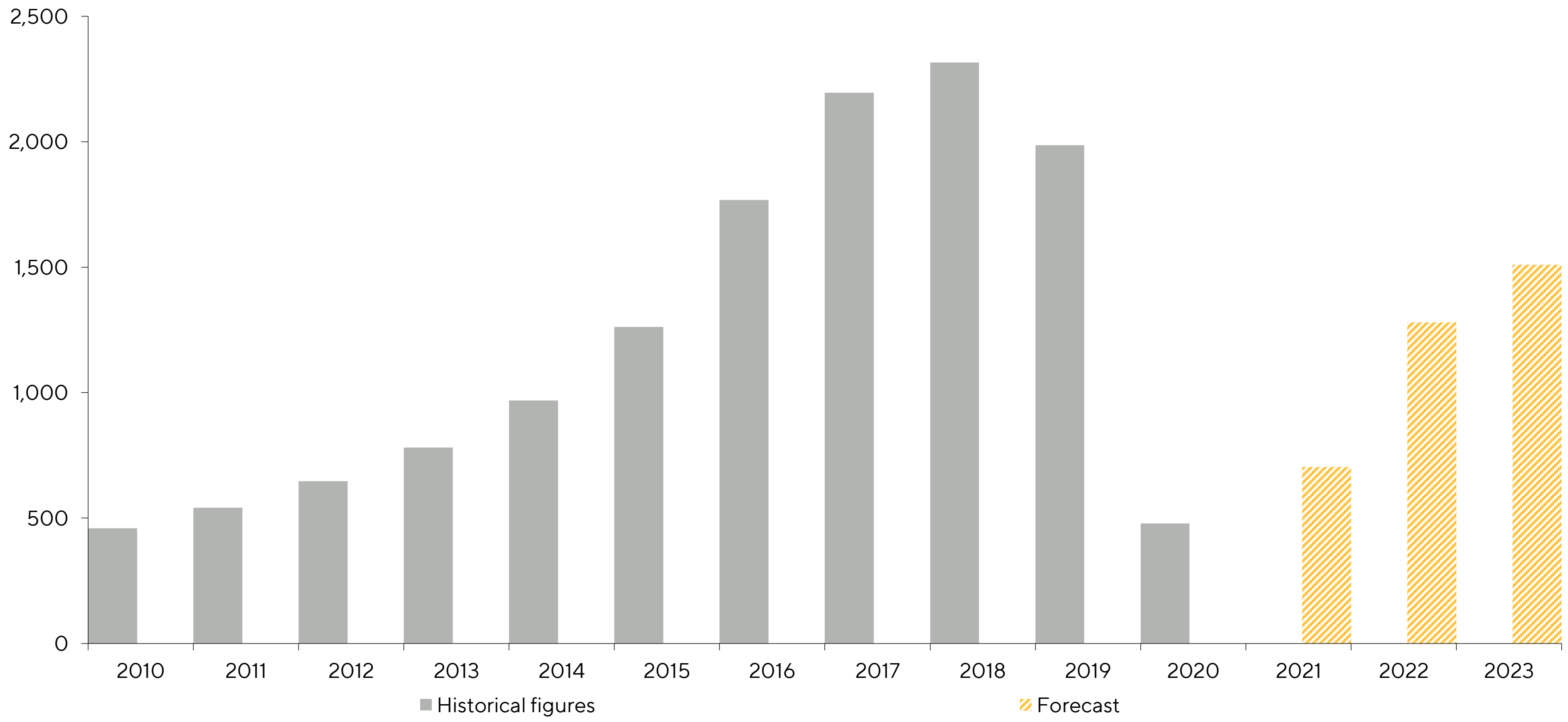
Iceland is viewed by many as a desirable destination during the pandemic, as infection rates have been curtailed and visitors can travel inside the country without overly close contact with other people. It can also be said that the volcanic eruption in Geldingadalur has been a silver lining in cloudy times, making Iceland an even more attractive travel destination.

We expect tourism to rebound this year, with 700,000 foreign nationals visiting the country. If our forecast materialises, this year's total would be about one-third of the 2019 figure. We expect tourist numbers to nearly double in 2022, to about 1.3 million, and a more moderate rise to 1.5 million in 2023.

This forecast of tourist arrivals is unchanged from our January forecast, as it appears that the more upbeat outlook for H2/2021 will offset the unexpectedly weak total for H1.

Number of foreign tourists, by year

Thousands



Sources: Icelandic Tourist Board, ÍSB Research

Tourism to weigh heaviest in export growth

... but imports will follow

Although we expect it to take some time for tourism to regain its previous momentum, this year's rise in visitor numbers explains the majority of the one-fourth increase in services exports that we expect in 2021. Added to this is modest growth in goods exports, particularly to include farmed fish, aluminium, and silicon metal.

There are already signs that the fishing industry is generating more export revenues this year than in 2020. One major factor in the uptick is the capelin that was caught and processed in the first four months of the year. On the whole, the outlook is for nearly 12% export growth in 2021.

A surge in tourist arrivals will deliver the lion's share of the forecasted 22% export growth in 2022 and just over 5% growth in 2023.

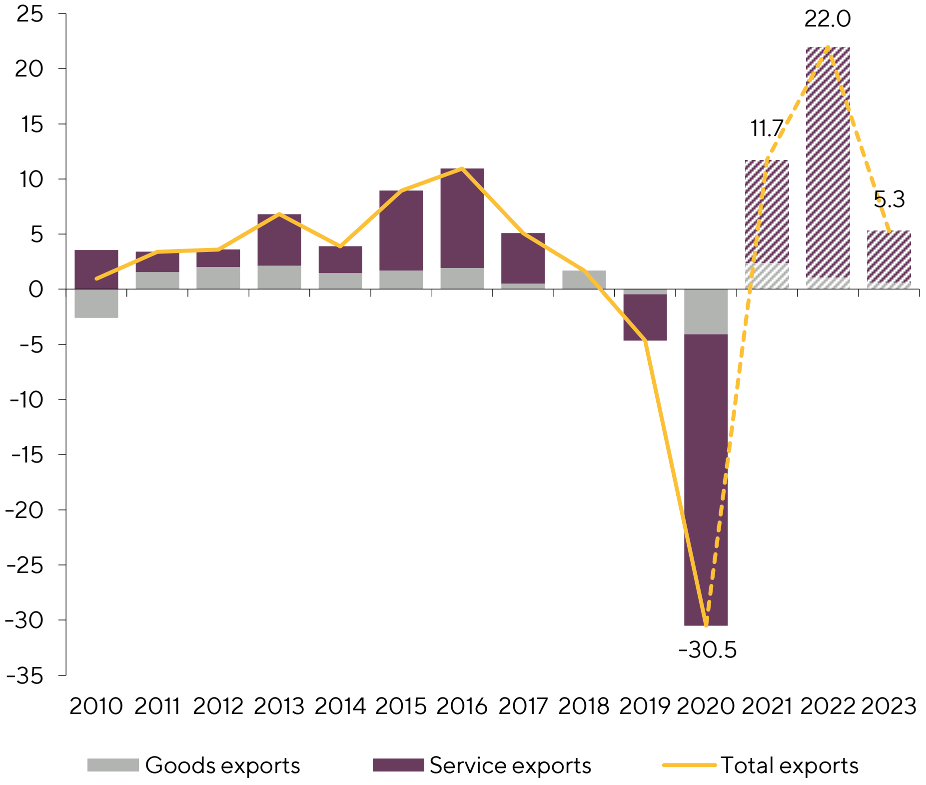
Imports have developed broadly in line with exports in the recent term, and the contraction in imports greatly mitigated the tourism-generated blow to the current account balance.

By the same token, the outlook is for imports to grow by nearly 10% this year, owing to a growing need for tourism-related inputs and an increase in Icelanders' consumption spending abroad.

Imports will then grow even faster in 2022, according to our forecast, as we expect more rapid growth in exports, private consumption, and investment. Thereafter, import growth will ease, largely because the need for tourism-related inputs will grow more slowly further out the horizon.

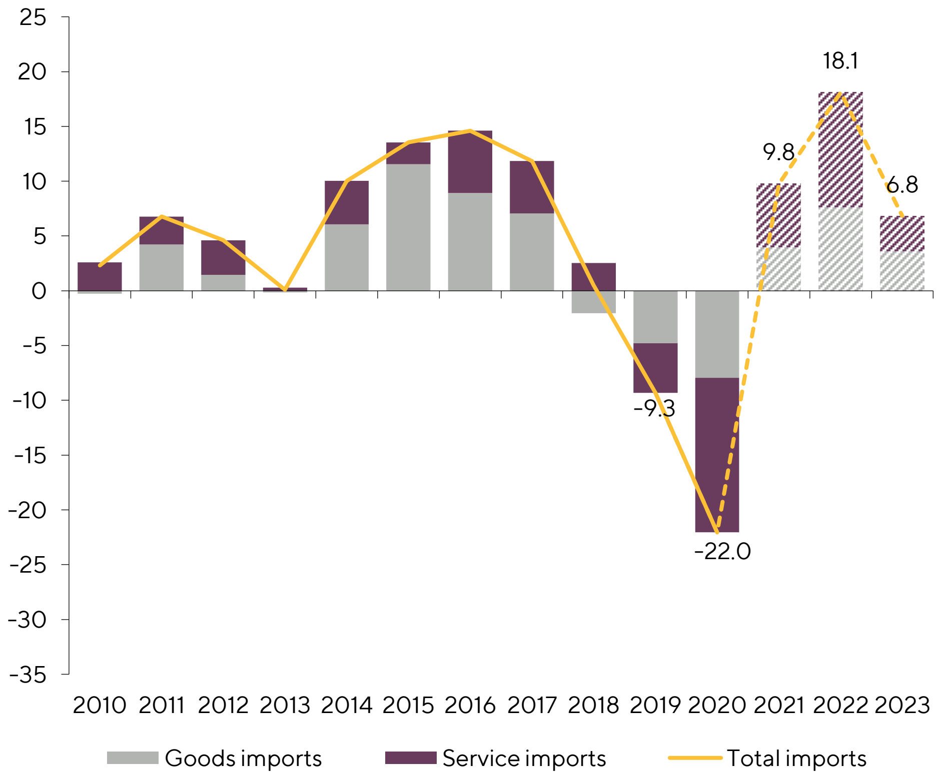
Exports and contributions from subcomponents

%



Imports and contributions from subcomponents

%



Sources: Statistics Iceland, ÍSB Research.

Current account surplus to increase again in coming years

The recovery of tourism will support both the current account surplus and GDP growth in coming years

The fact that the pasting taken last year by Iceland's exports did not bring on a current account deficit is an indication of a radically improved external balance. Offsetting the plunge in exports was a steep decline in imports. There was a small trade deficit, but it was outweighed by a handsome surplus on primary income.

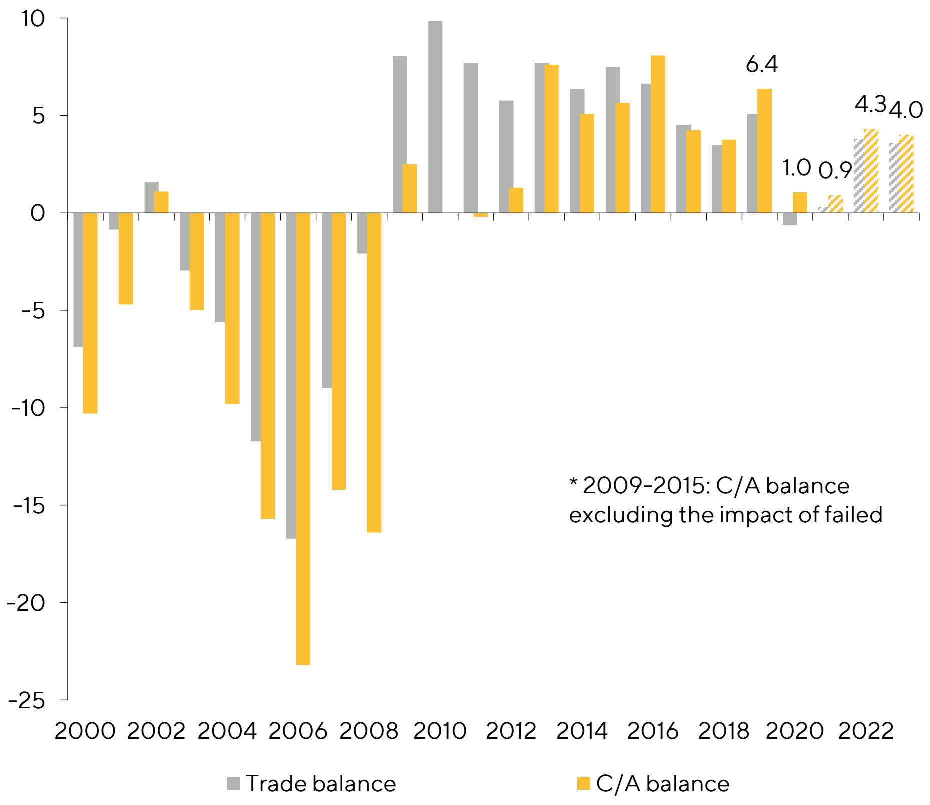
The current account balance was positive by 1% of GDP in 2020, the ninth consecutive surplus year. The outlook is for a continued surplus throughout the forecast horizon.

We forecast that the CA surplus will measure 0.9% of GDP, or roughly ISK 30bn, this year. With the improvement in the services account balance caused by the revivification of the tourism industry, the surplus will widen once again. We forecast the CA surplus at 4.3% of GDP in 2022 and 4.0% in 2023.

In our opinion, Iceland's external trade position has improved permanently. The country's net external assets are currently equivalent to over a third of GDP and could improve further over the forecast horizon.

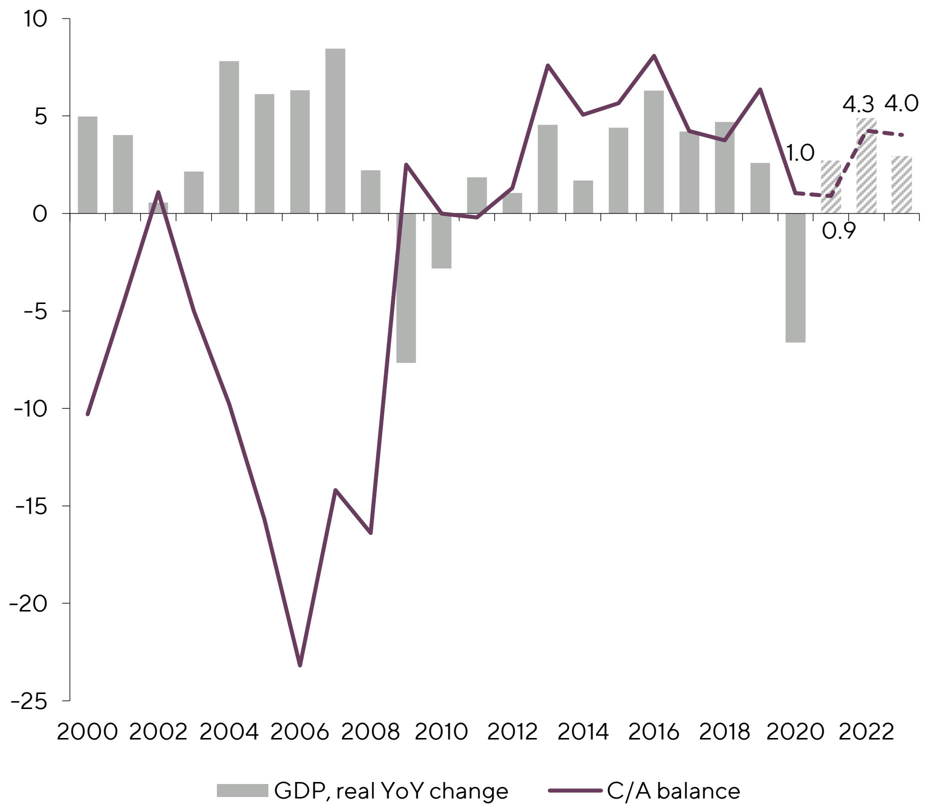
Current account balance

% of GDP*



Current account balance and GDP growth

% of GDP and %



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

Public sector to lead investment growth in 2021

Private sector to take the lead thereafter

Investment has sagged for two years running, after a period of relatively robust growth early in the 2010s. Between 2018 and 2020, it contracted by a total of over 10%.

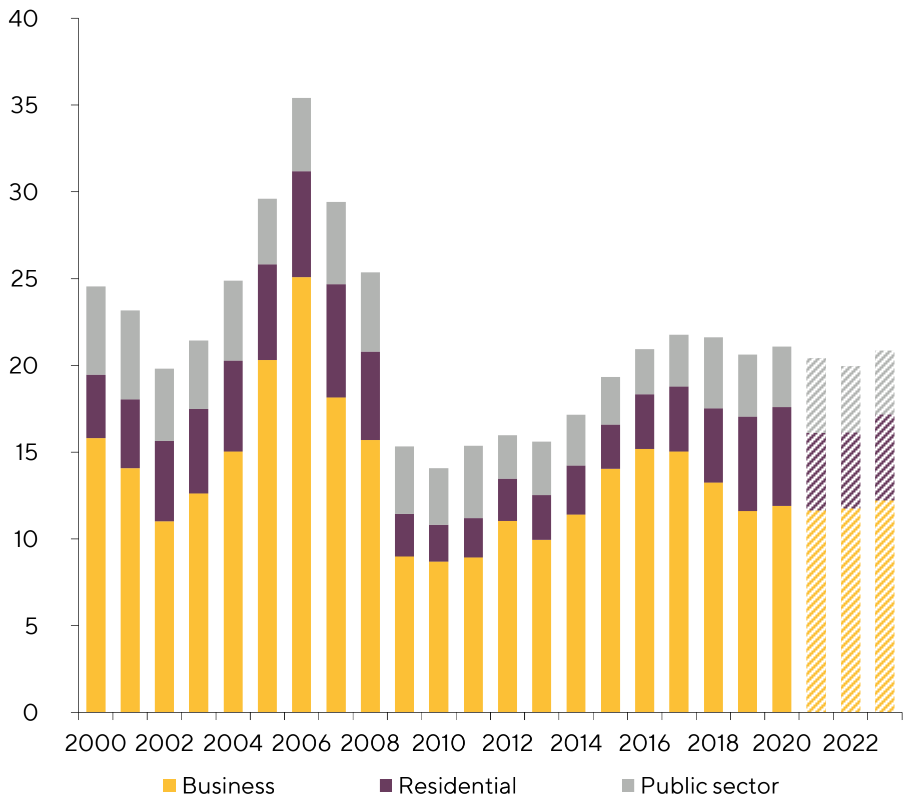
The investment-to-GDP ratio has not suffered much, however, unlike the post-financial crisis situation. Last year's 6.8% contraction in investment was in line with the overall decline in GDP growth.

For 2021, the public sector will lead the way, after a two-year contraction in total investment. We expect public investment to grow by 30% this year, as the Government's COVID-related investment initiative is set to peak.

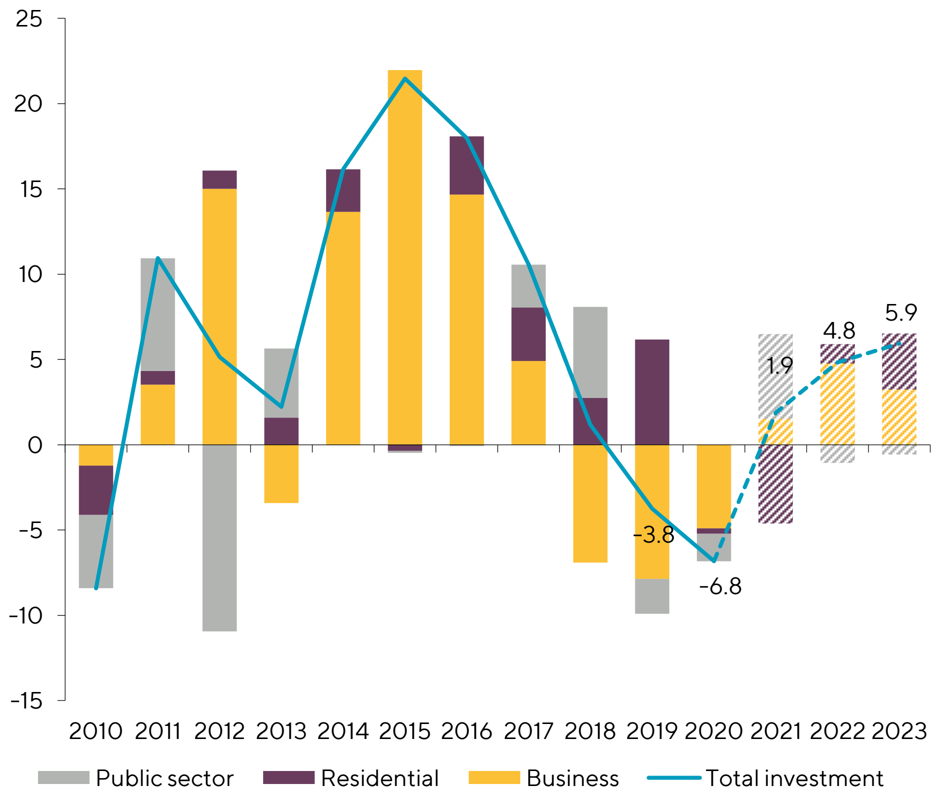
In 2022 and 2023, however, private sector investment will be in the driver's seat.

We forecast that total investment will grow by nearly 2% this year, nearly 5% in 2022, and nearly 6% in 2023. The investment-to-GDP ratio will remain relatively stable, however, at around 20%.

Investment
% of GDP



Investment, real change, and contribution of subcomponents
%



Sources: Statistics Iceland, ÍSB Research.

Rising corporate expectations signal investment growth to come

Reduced uncertainty and favourable financing conditions should put an end to the contraction in business investment

The slump in business investment over the past three years (excluding hotels and other tourism-related investment) gives cause for some concern. In all, business investment has contracted by 28% in the past three years.

Luckily, there are signs that the situation will turnaround this year and that business investment will grow each year of the forecast horizon.

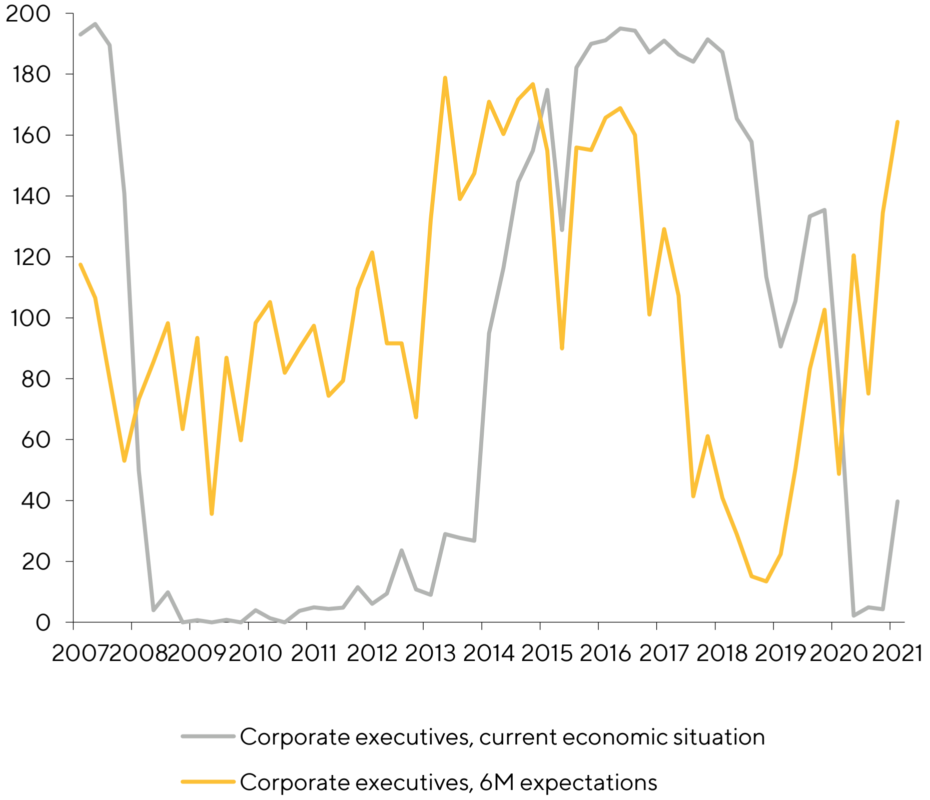
Executives' expectations concerning near-term economic conditions have risen markedly in recent quarters. In March, a majority of representatives from Iceland's 400 largest firms expected that the situation would be better in six months' time, according to the Gallup survey conducted on behalf of the CBI and the Confederation of Icelandic Employers.

This is the best survey result by this metric in four years. There is a fairly strong correlation between upbeat corporate sentiment and growth in business investment.

Added to this, most firms are financially sound, and favourable financing conditions should help pave the way for investment once pandemic-related uncertainty subsides.

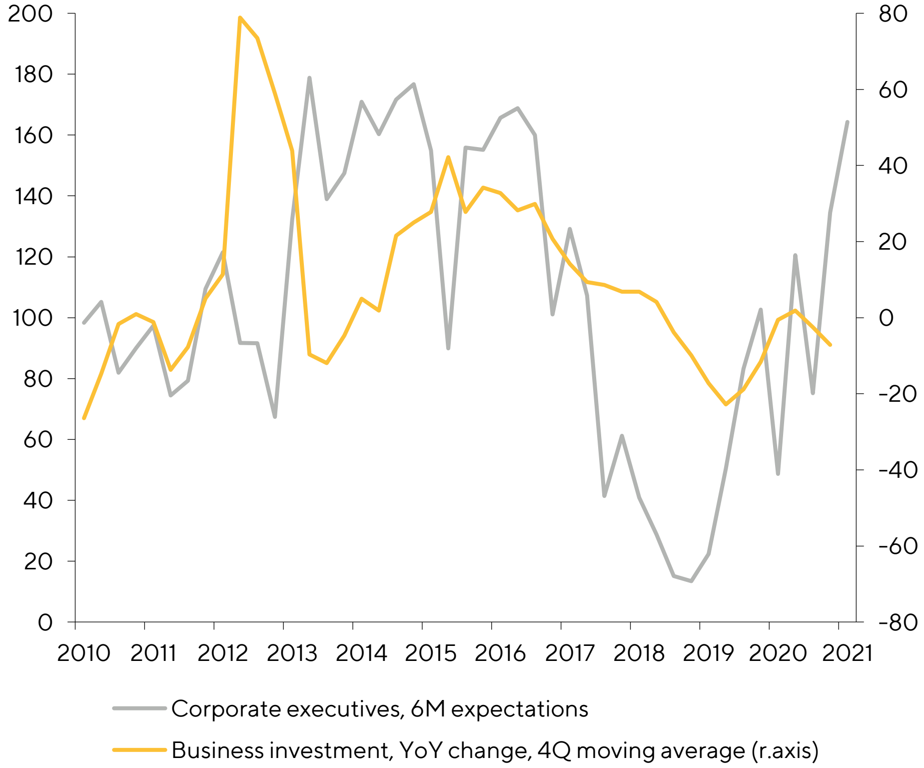
Expectations of executives from Iceland's 400 largest firms

Index



Executives' expectations and business investment

Index value (left) and % change year-on-year (right)



Sources: Statistics Iceland, ÍSB Research.

Demand pressures in the housing market

Rising real wages, strong household financial position, and favourable borrowing terms fuel demand

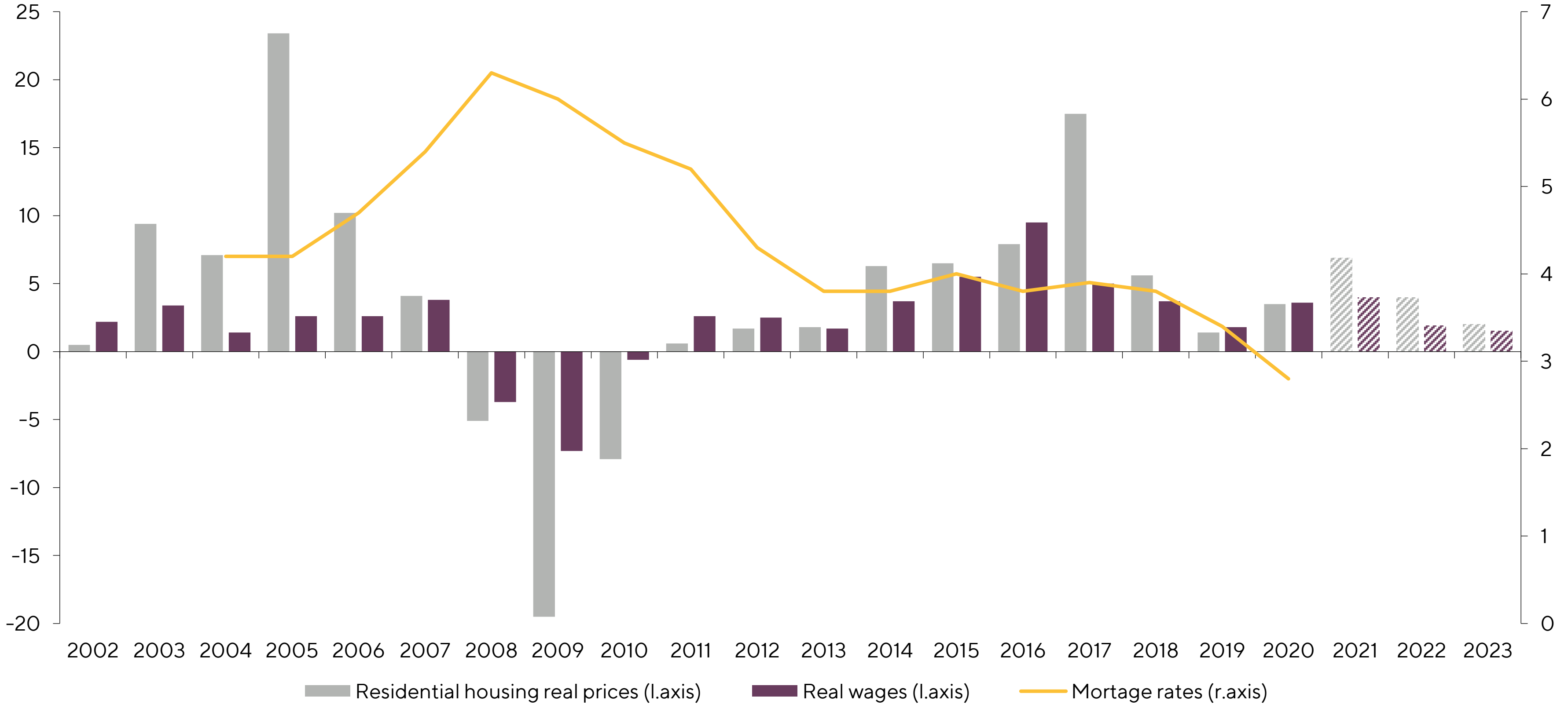
The sector that has been the big surprise since the Corona Crisis struck is the housing market. House prices have risen markedly in the past year, and turnover remained lively.

Demand is brisk at present, mainly because of rising real wages, households' strong financial position, and favourable borrowing terms. Clearly, the decline in the policy interest rate has made a major impact, lowering debt service on many mortgages and boosting homebuyers' purchasing power.

The supply of new properties has been limited and does not appear likely to rise in the near future. According to the Federation of Icelandic Industries' tally, the number of flats under construction plunged when the pandemic hit, and supply of new homes appears set to remain limited in the coming term. It can be said that demand pressures reign in the market at present.

Real house prices, real wages, and indexed mortgage rates

% change year-on-year (left), average (right)



Sources: Registers Iceland, Statistics Iceland, ÍSB Research.

House prices also rising abroad

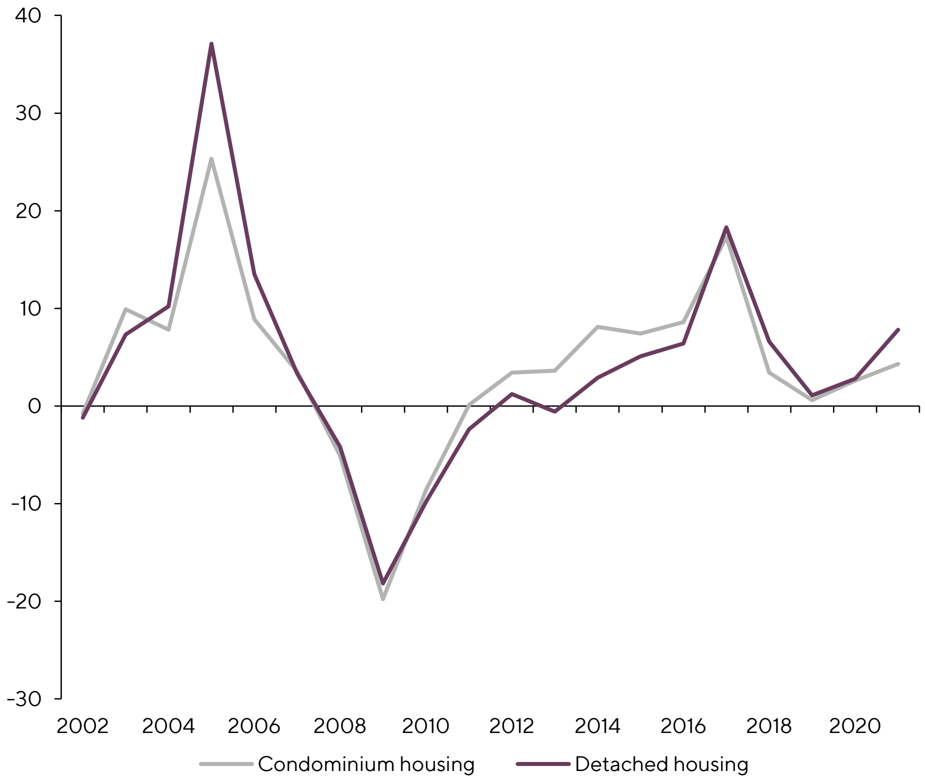
Detached housing rising the most

Since the pandemic struck, detached housing prices have risen considerably more than condominium prices. In the first four months of 2021, detached housing prices in greater Reykjavík have risen by 7.8% in real terms, while condominium prices are up 4.3%. Demand for detached housing appears to be gaining steam, and apparently, buyers are taking advantage of favourable lending rates and "trading up". This could be partly due to the pandemic, with remote working and more time spent at home triggering a push for larger homes.

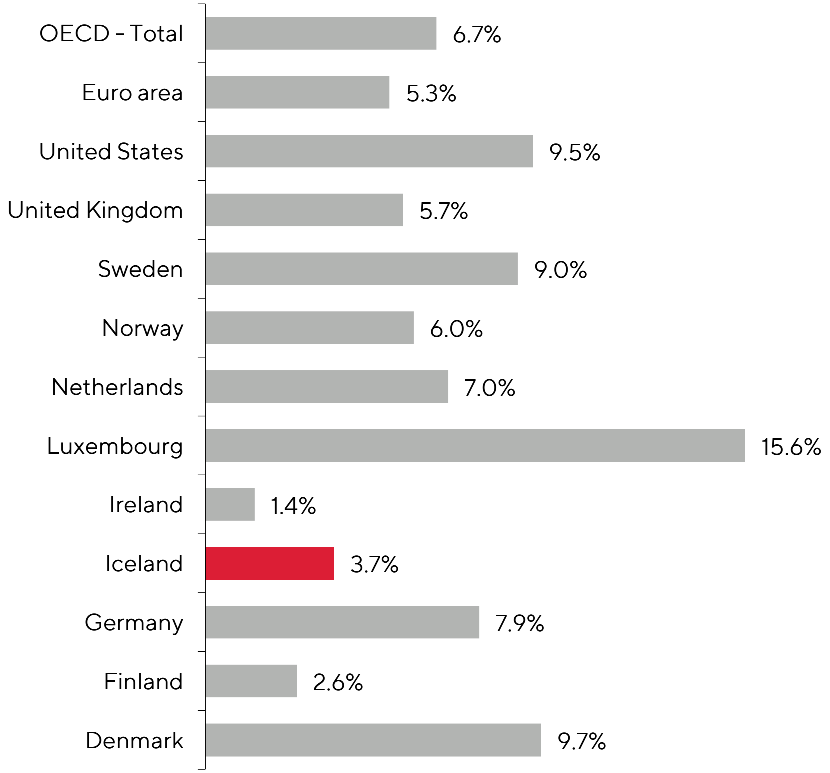
Iceland is not the only country with strong house price inflation during COVID; the same trend can be seen in comparison countries. Between Q4/2019 and Q4/2020, real house prices rose 3.7% in Iceland, well below the OECD average increase of 6.7%.

We think conditions are in place for house price inflation over and above the general price level, especially in 2021. We forecast that prices will rise 11.3% this year and 6.7% in 2022. The market will settle down when supply catches up, with prices rising 4.4% in 2023.

Real change in house prices in greater Reykjavík
% change, annualised



Real change in house prices, by country
% change, Q4/2019-Q4/2020



Sources: OECD, Statistics Iceland, ÍSB Research.

Unemployment more persistent than previously hoped

Equilibrium unemployment will probably be higher further ahead

Unemployment has risen rapidly since mid-2020, as 15% of jobs in the labour market were directly related to tourism.

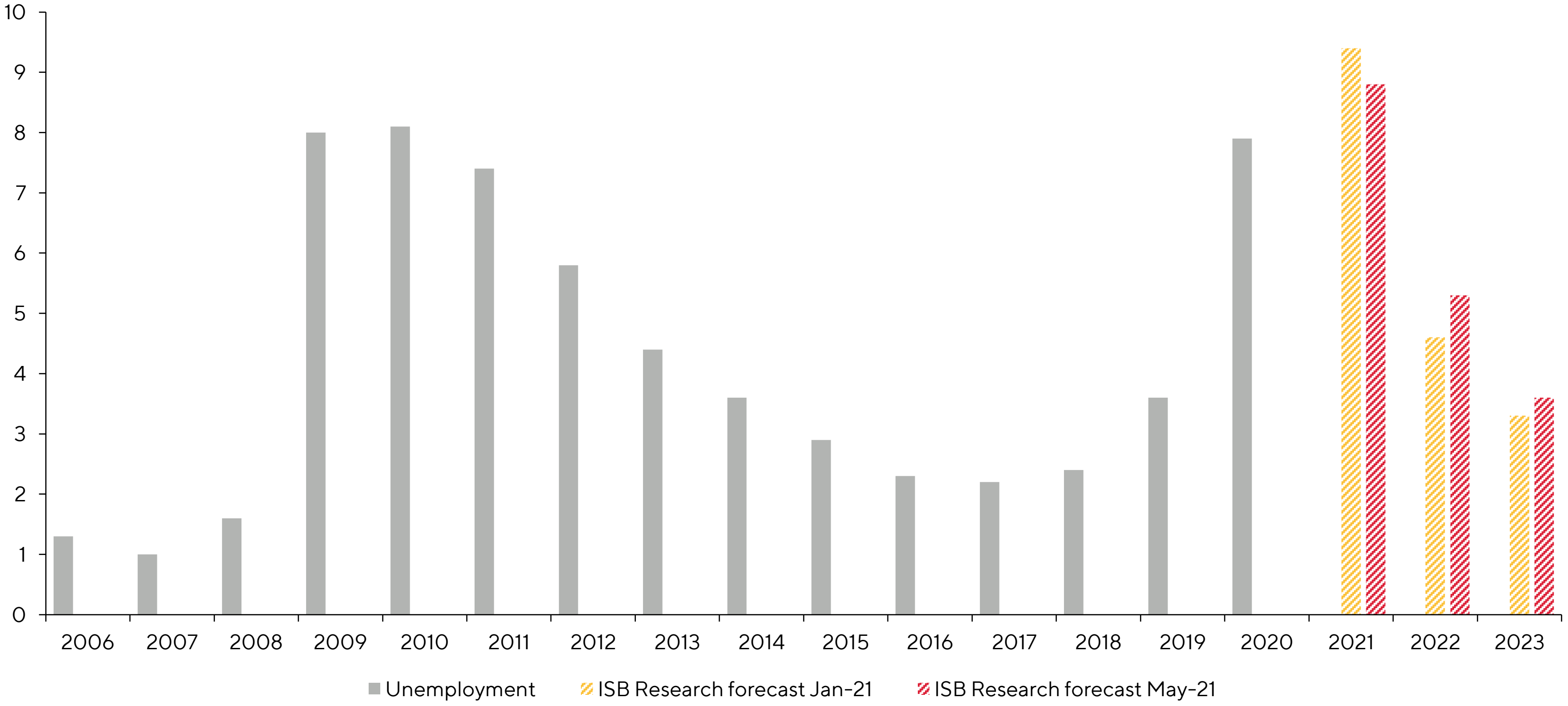
It peaked at 11.3% in Q1/2021 and would probably have been much higher without government measures. We expect the jobless rate to taper off rather quickly this year, as tourism regains momentum.

However, we expect it to remain relatively high in the coming term, as it will take time for tourism and other hard-hit sectors to recover fully. Furthermore, with rapidly rising wage costs, unemployment will likely be more persistent than previously hoped, probably pushing equilibrium unemployment above its historical average.

Until now, Iceland has had one of the lowest jobless rates in the Western world. We expect unemployment to average 8.8% in 2021 and 5.3% in 2022. In 2023, we assume it will fall back to the pre-pandemic level of 3.6%, last seen in 2019.

Unemployment as a share of the labour force

%



Sources: Directorate of Labour, ÍSB Research.

Robust real wage growth supports private consumption

Private consumption growing steadily once again

Developments in private consumption have been interesting in the past year. In 2020, it shrank by 3.3%, owing mainly to a contraction in spending abroad and on services hit hardest by public health measures. Consumption within Iceland largely held its own.

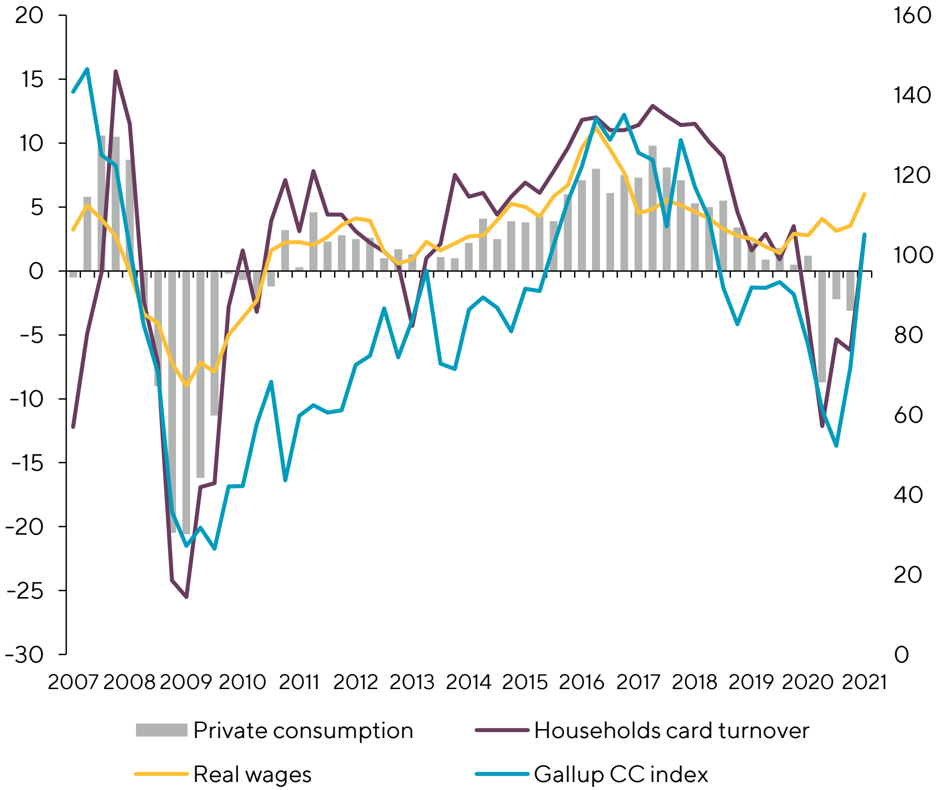
Real wages rose 6% YoY in Q1/2021, due mainly to contractual pay hikes at the turn of the year, plus the shortening of the work week, which affects measurements.

This is the first time in Iceland's modern economic history that real wages have risen alongside sky-high unemployment and a strong contraction in GDP. As a result, most who have kept their jobs are well positioned financially and have considerable consumption capacity, as can be seen in strong payment card turnover figures in recent quarters.

Furthermore, most households' asset position is sound, and the past year's interest rate cuts have supported their appetite for spending. We forecast that private consumption will grow again this year, measuring 2.9%. We expect it to grow by 3.5% in 2022 and 3.4% in 2023.

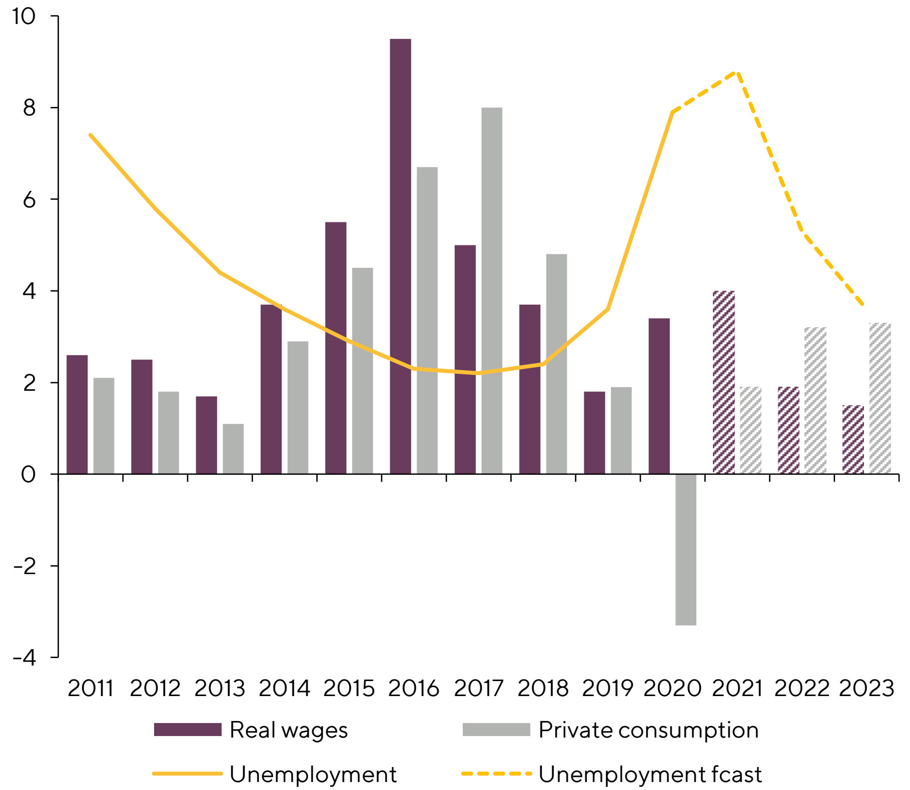
Private consumption and related indicators

% change year-on-year (left) and index value (right)



Private consumption, purchasing power and unemployment

%



Sources: Statistics Iceland, ÍSB Research.

ISK appreciation to gain steam in the coming term

The CBI has mitigated exchange rate volatility in the past decade

The ISK was 10% weaker at year-end 2020 than it was a year earlier. But it depreciated less than could have been expected given the collapse of tourism revenues. A weighty factor here was the CBI's use of EUR 830m from its reserves to mitigate short-term volatility and offset pressures due to non-residents' sales of domestic securities.

But the CBI had deep pockets after having accumulated hefty reserves in the mid-2010s: the reserves equalled nearly 30% of GDP as of end-2020. Actually, the CBI has done much to ease the exchange rate volatility that would otherwise have accompanied both the upswing of the early 2010s and the downturn in the past year or so.

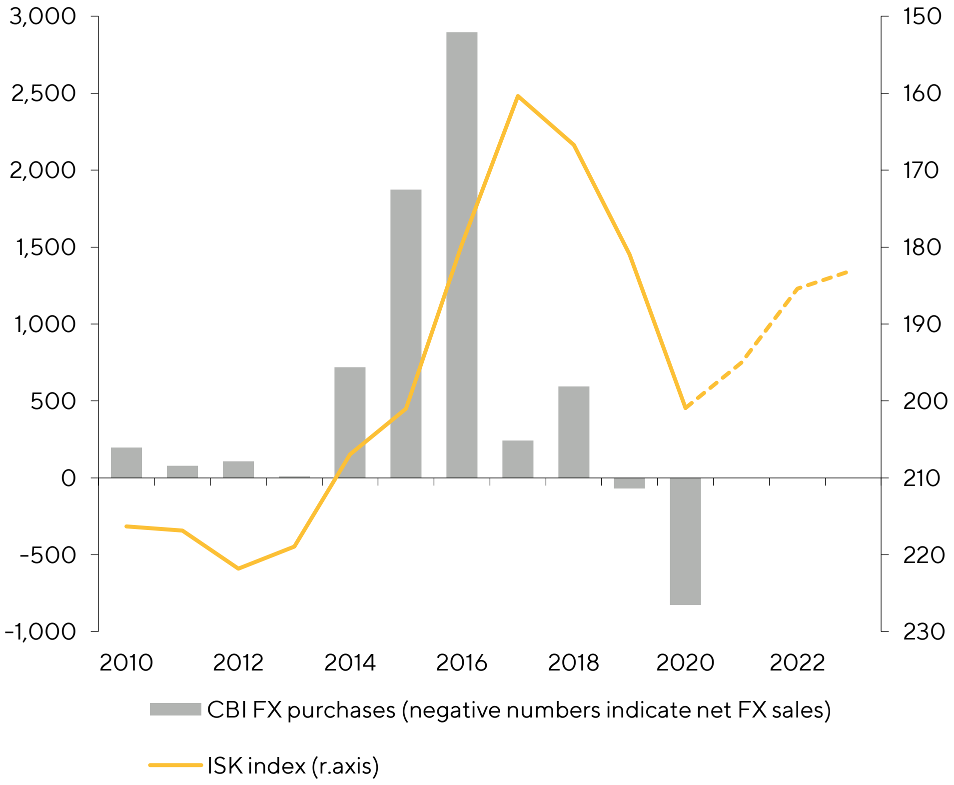
The ISK has appreciated somewhat in 2021 to date. We think it likely that it will appreciate even more once tourist numbers start to rise again and FX inflows with them.

Iceland's interest rates are higher than in most neighbouring countries, its international investment position is strong, its growth potential solid, and foreign investors' securities holdings at a minimum.

Factors offsetting this include the pension funds' foreign investments and possible CBI purchases of reserve assets. It is impossible to predict how rapid such an appreciation will be or when it will occur, but the forecast assumes that the ISK exchange rate will be nearly 10% above its 2020 average by the end of the forecast horizon.

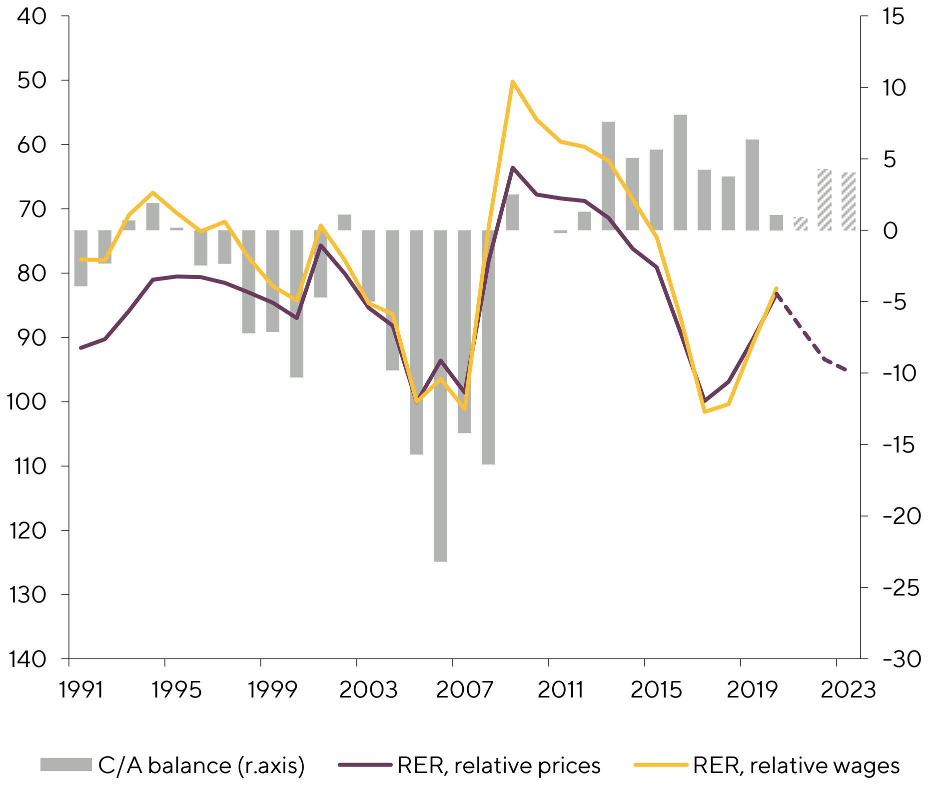
ISK exchange rate and CBI FX market intervention

EUR m (left) and exchange rate index (right)



Real exchange rate and current account balance

Index and share of GDP (%)



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

Inflation has peaked and is set to taper off

We expect inflation to align with the CBI's 2.5% inflation target around mid-2022.

The depreciation of the ISK made its mark on inflation last year, when the Corona Crisis struck. Inflation rose steadily, to 3.6% by the year-end.

Despite the ISK appreciation this year, inflation has proven more persistent than we expected, rising to an eight-year high of 4.6% in April. It was therefore well above the tolerance limits of the CBI's inflation target, and we expect it to average 4.1% this year.

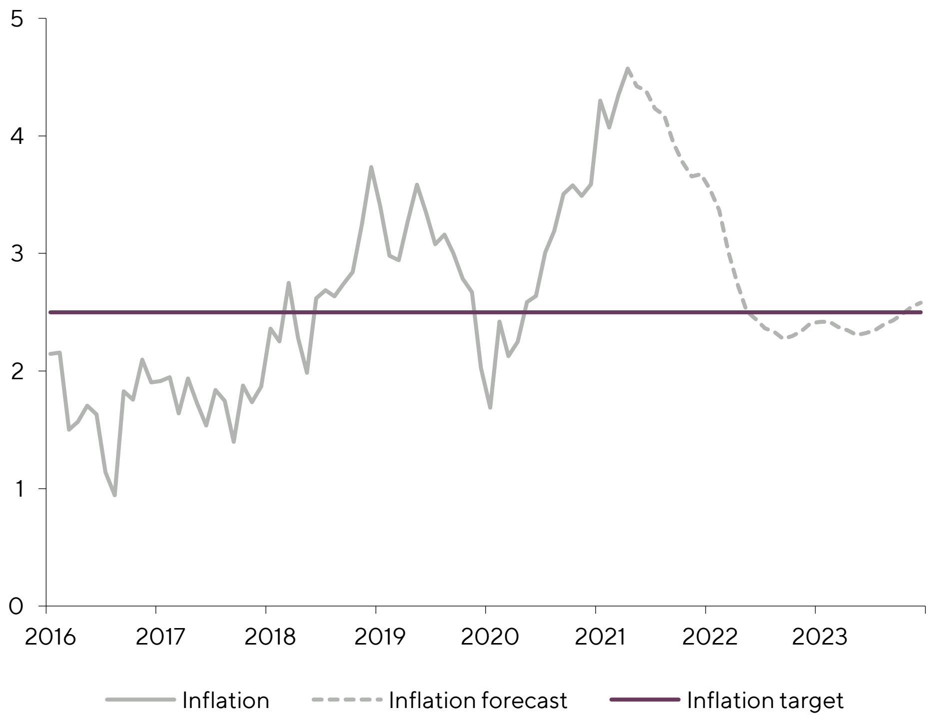
Inflationary pressures are not limited to the housing market, even though house prices have risen steeply in the recent past. Higher import prices are responsible for about 40% of inflation in April, while house price inflation accounts for 20% and domestic goods prices about 18%. Inflation therefore stems from a variety of factors at present.

We are of the view that inflation has peaked and will start to ease gradually in the near future, as the ISK appreciates. According to our forecast, it should be close to target around the middle of next year. We expect inflation to average 2.6% in 2022 and 2.4% in 2023.

The main assumptions underlying the forecast are that the ISK will strengthen with increased tourist arrivals and that house price inflation and pay rises will not be excessive. Furthermore, pandemic-related price increases abroad could cause inflation to be more persistent than is depicted here.

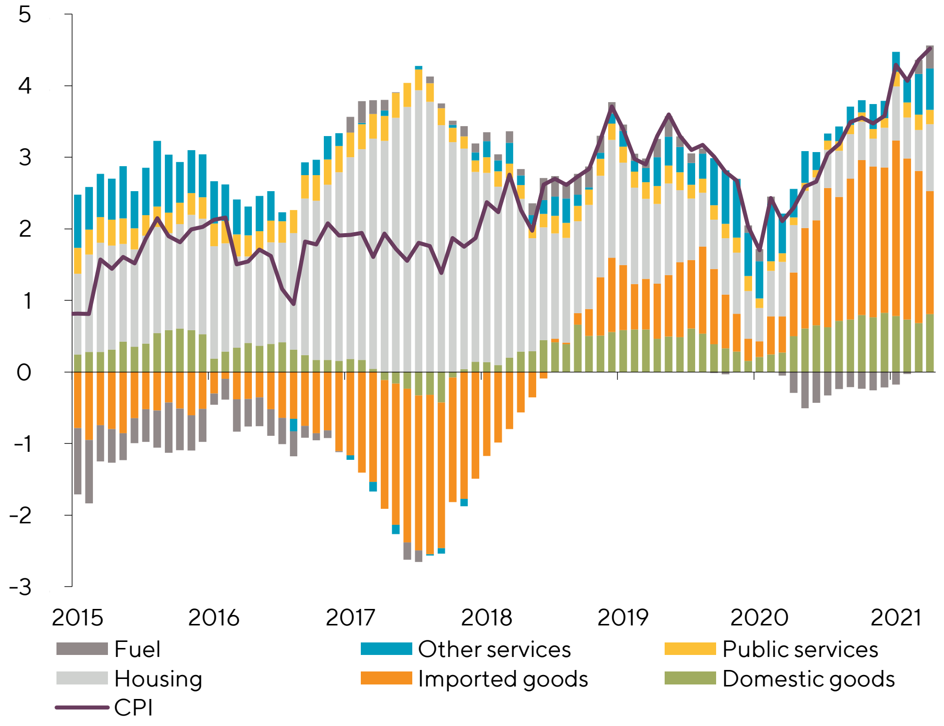
Inflation and the CBI inflation target

%



CPI, by nature and origin

%



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

Policy rate to rise gradually

Modest rise in long-term interest rates ahead

A bleaker short-term inflation outlook and reduced uncertainty about the economic recovery prompted the CBI to raise interest rates in May. The policy rate is now 1.0%, where it was from May-November 2020.

Fortunately, long-term inflation expectations are still well in line with the target. In addition, there are numerous signs that monetary policy efficacy is much greater than before and that the CBI will have less need to raise interest rates to have the desired impact on the economy and the medium-term inflation outlook.

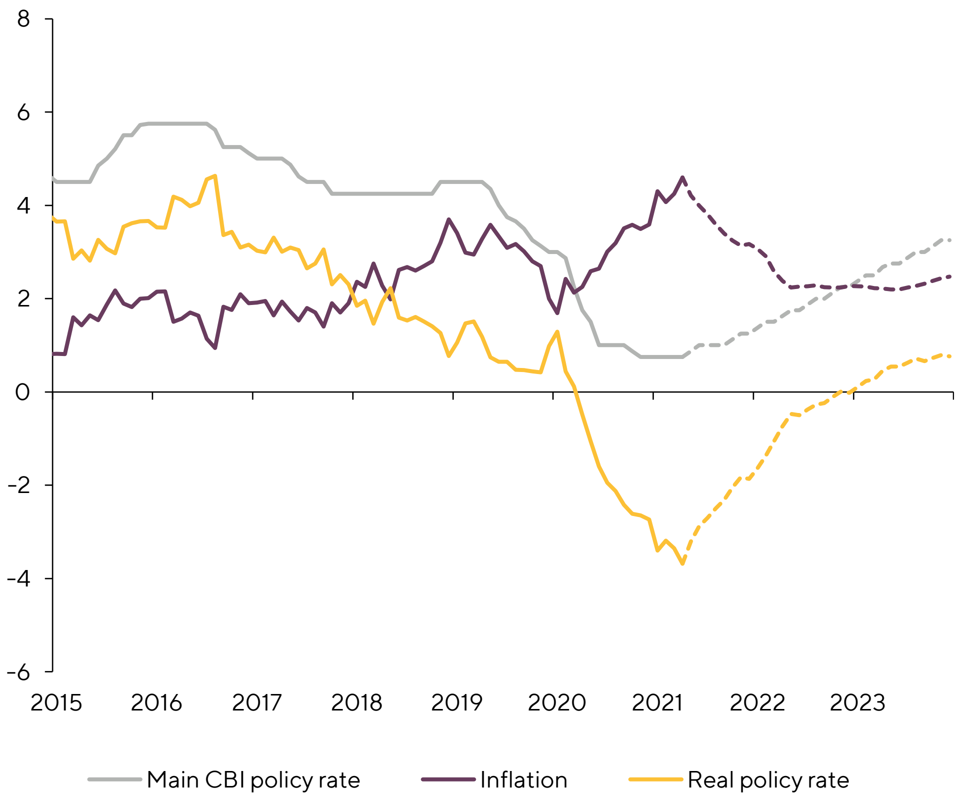
As a result, we forecast that the policy rate will be 1.25% by end-2021. We expect a gradual tightening phase thereafter. We project that the policy rate will be 3.25% by the end of the forecast horizon.

Although the policy rate is historically low, long-term rates have risen markedly after bottoming out in mid-2020. Long-term base rates are now just under 4%, and real rates are around 0.6%. The long-term base rate fell below 2.5% last year, and the real rate fell below zero.

Therefore, a hefty rise in short-term rates has already been priced into long-term rates, and it is not clear that they will rise much further, even though the policy rate rises in the near future. Over time, real rates will probably rise again, but we expect nominal rates to remain below 4% and real rates to not exceed 1% for the entire forecast horizon.

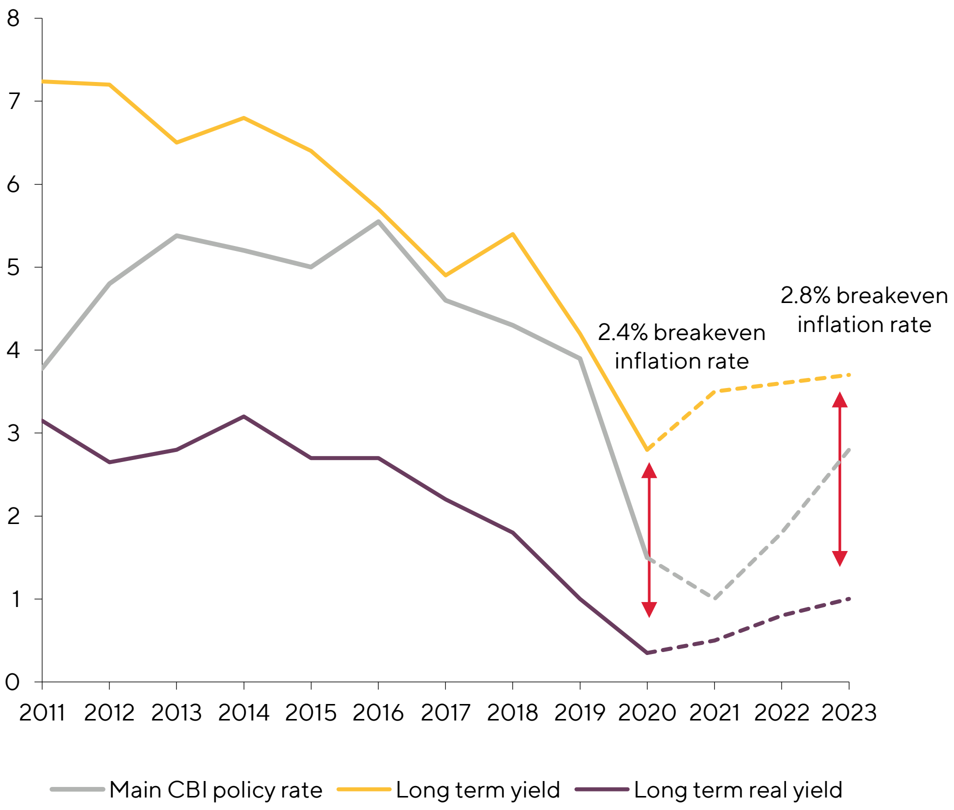
Inflation and policy rate

%



Interest rates

%



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

Macroeconomic forecast summarised

GDP and its components

Volume change from prior year (%)	The year 2020 in ISK m	2019	2020	Forecast 2021	Forecast 2022	Forecast 2023
Private consumption	1,512,162	1.9	-3.3	2.9	3.5	3.4
Public consumption	808,804	3.9	3.1	2.9	2.3	2.0
Gross capital formation	619,787	-3.8	-6.8	1.9	4.8	5.9
– business investment	350,177	-12.8	-8.7	2.7	8.4	5.5
– residential investment	167,160	31.2	-1.2	-17.1	5.0	14.9
– public investment	102,451	-10.8	-9,3	30.0	-5,0	-3.0
Changes in inventories	17,380	0.0	0.0	0.0	0.0	0.0
Domestic demand, total	2,958.134	0.7	-1.9	2.1	3.4	3.6
Exports of goods and services	1,002,774	-4.6	-25,8	11,7	22.0	5.3
– marine product exports	269,917	-6.4	-4.9	2.4	1.8	1.2
– aluminium products	207,674	-6.0	-1.0	4.0	1.0	1.0
– other goods exports	150,919	21.1	-16,7	6.0	3.0	2.0
– services exports	374,264	-7,9	-46.3	25.0	50.0	9.0
Imports of goods and services	1,020,270	-9,3	-14,8	9.8	18.1	6.8
– goods imports	718,805	-7.6	-5.3	5.7	11.2	5.7
– services imports	301,465	-12,3	-31,1	19.5	32.7	8.8
Gross domestic product	**2,940,638**	**2.6**	**-6.6**	**2.7**	**4.9**	**2.9**

Macroeconomic forecast summarised

Other economic variables

			Forecast	Forecast	Forecast
% of GDP	2019	2020	2021	2022	2023
Gross capital formation	20.6	21.1	20.4	19.9	20.4
Current account balance	6.4	1.0	0.9	4.3	4.0
Trade balance	5.1	-0.6	0.3	3.8	3.6
Change between yearly averages (%)					
Consumer prices	3.0	2.8	4.1	2.6	2.4
Wages and salaries	4.9	6.4	8.3	4.6	3.9
House prices	4.4	6.4	11.3	6.7	4.4
Average exchange rate	8.5	11.1	-3.2	-4.7	-1.3
Real exchange rate in terms of relative consumer prices	-7.4	-10.1	6.3	5.6	2.0
Real wages	1.8	3.5	4.0	1.9	1.5
Annual average (%)					
Unemployment	3.6	7.9	8.8	5.3	3.6
Trade-weighted exchange rate index	181.0	201.0	194.6	185.4	183.0
CBI policy rate (7-day term deposits)	3.9	1.5	1.0	1.8	2.8
Long-term nominal rate (RIKB 31)	4.2	2.8	3.5	3.6	3.7
Long-term real rate (RIKS 30)	1.0	0.4	0.5	0.8	1.0

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