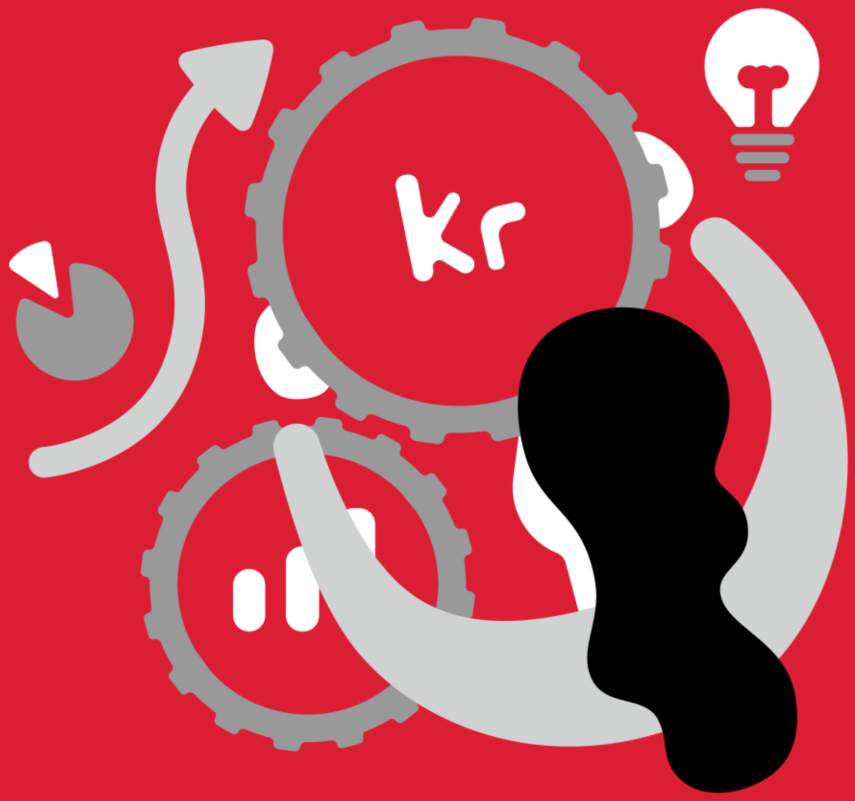
January 2022

Macroeconomic forecast:
Growth on the horizon



Growth on the horizon

Summary

Export-driven economic recovery

GDP growth

- Exports to fuel GDP growth in the coming term
- 4.7% growth in 2022
- 3.2% growth in 2023
- 2.6% growth in 2024

Tourism the main driver of export growth

External trade

- 1.1-1.2 million tourists expected in 2022
- Exports to rise by 19% in 2022 and imports by 15%
- Current account surplus 1.8% of GDP in 2022
- Current account surplus over 3% of GDP in 2023 and 2024

Inflation to ease gradually in 2022

Inflation

- Inflation set to remain above 4% CBI tolerance limit for most of the year 2022
- Key uncertainties are tourism, wage agreements, house prices, and foreign prices
- Inflation 3.2% over the year 2022
- Inflation 2.4% in 2023 and 2.7% 2024

Unemployment seeks new equilibrium

Labour market

- Unemployment has fallen rapidly with the economic rebound and is expected to ease further
- Set to average 4.5% in 2022
- 3.7% unemployment in 2023
- 3.6% unemployment in 2024

Monetary tightening to continue

Interest rates

- Policy rate 3.25% by end-2022
- Tightening to lose pace thereafter; policy rate to reach 4% at the beginning of 2024
- Equilibrium long-term yields in sight in the latter half of the forecast horizon

Exports to drive further ISK appreciation

The ISK

- ISK set to be 8-9% above end-2021 level at the end of the forecast horizon
- If so, the real exchange rate will be similar to that in 2018
- CBI foreign currency purchases and increased foreign investment by pension funds cut into current account surplus and improved IIP

After a deep contraction in 2020, the economic recovery took hold in 2021. Domestic demand gained considerable traction, supported by the Government's economic policy response, an improving labour market, and a sound financial position among most households and businesses. Despite a modest current account deficit, exports also rebounded strongly.

Year-2021 GDP growth is estimated at 4.1%. Growth was driven equally by consumption, investment, and exports but was offset by strong import growth.

We forecast GDP growth at 4.7% in 2022, the fastest growth rate since 2018. The surge is due mostly to robust growth in exports, mainly tourism and fishing. Private consumption also fuels GDP growth in 2022, while the share of investment will ease markedly relative to 2021.

For 2023, we project 3.2% growth, driven by exports and domestic demand in roughly equal measure. For 2024, the final year of the forecast horizon, we project GDP growth at 2.6%. By then, export growth will have started to ease significantly, and tighter economic policy and capacity constraints will slow the pace of growth.

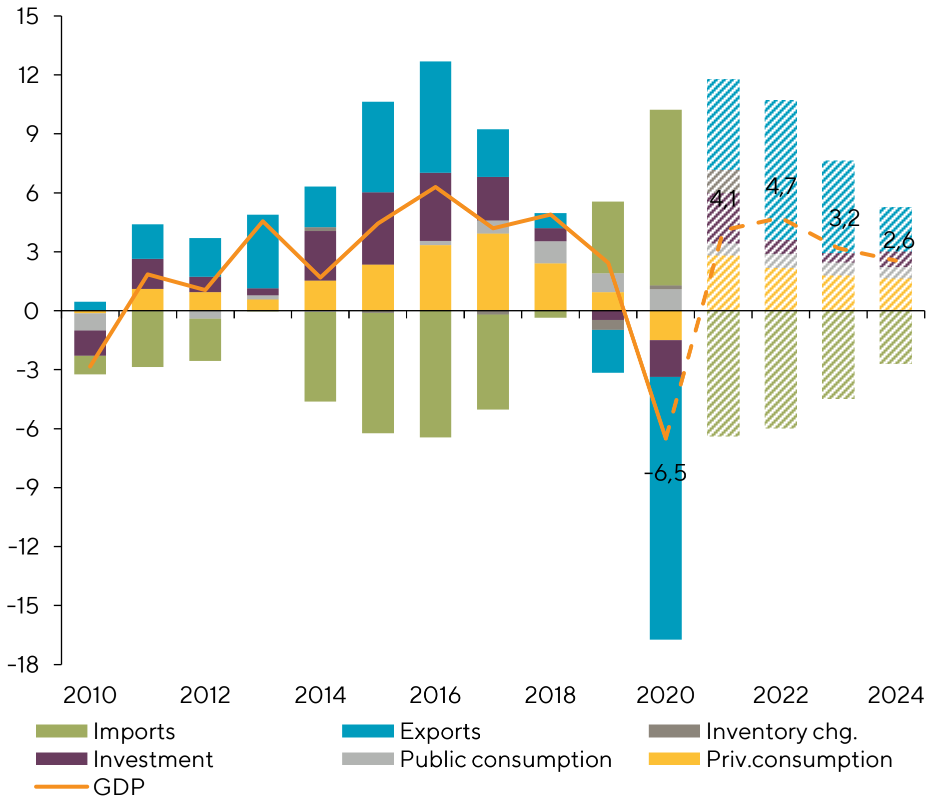
Uncertainty about the path of the pandemic in the coming term remains substantial. In our view, though, the past few quarters have shown the economy's resilience against fluctuations in infection rates and public health measures. In the worst-case scenario, a more persistent pandemic would delay the growth phase but probably not disturb it to any marked degree in the medium term.

Exports replace domestic demand as the key catalyst of growth

Strong GDP growth following a milder-than-feared pandemic-related contraction

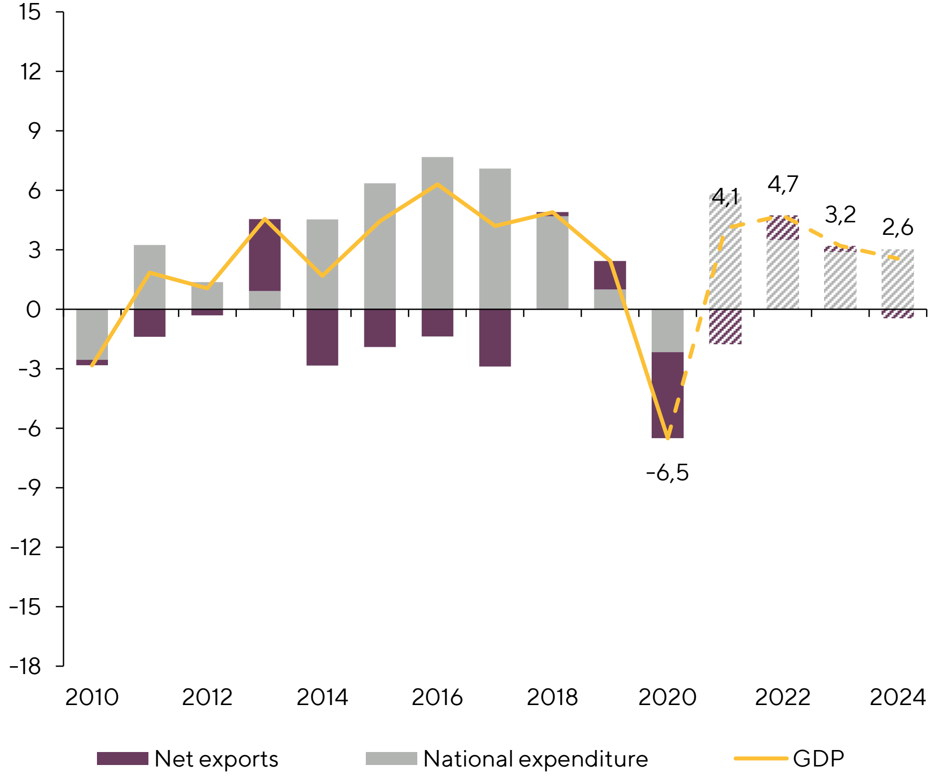
GDP and contribution of its subcomponents

Volume change from prior year (%)



GDP, domestic demand, and external trade

Volume change from prior year (%)



Sources: Statistics Iceland, ÍSB Research.

Tourism re-arms itself

We forecast that 1.1-1.2 million tourists will visit Iceland in 2022

Nearly 700,000 tourists visited Iceland in 2021, an increase of nearly 45% relative to 2020 but still only a third of the 2019 total. The vast majority – 470,000 – came in July-October.

The short-term outlook for tourism has undeniably worsened with the rise of the Omicron variant in Iceland and elsewhere. Even so, we believe appetite for travel is keen and that people have begun to travel despite the virus. In this light, many view Iceland as a desirable destination, as it is possible to travel here without close proximity to other people.

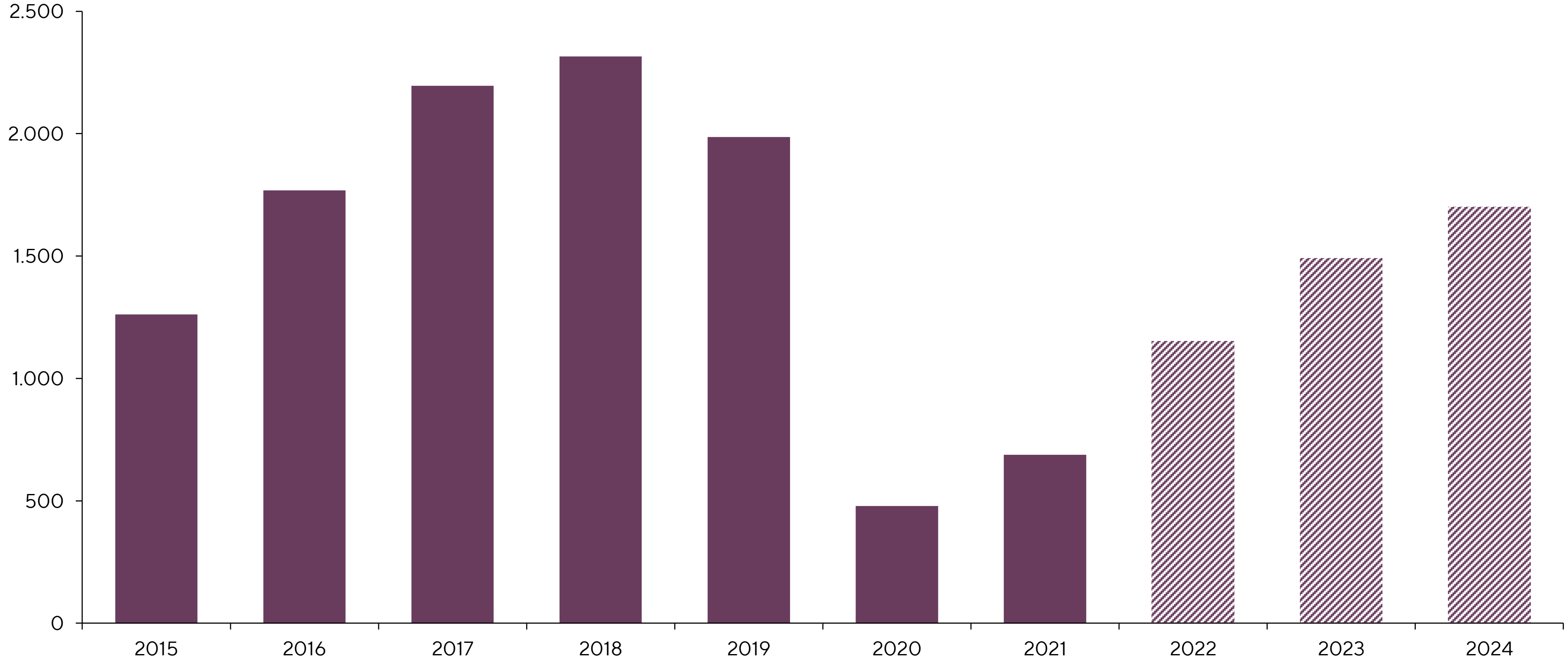
We expect 1.1-1.2 million tourists this year. If our forecast materialises, the total will be close to that in 2015, albeit more than 40% less than in 2019. We expect tourist numbers to rise to 1.5 million in 2023 and 1.7 million in 2024.

Tourist flows are vitally important for economic developments in the coming term. Uncertainty about new variants of the virus and the duration of the pandemic remains pronounced, of course. Widespread vaccination among populations likely to travel to Iceland, and less severe illness caused by the Omicron variant warrant cautious optimism, however.

Even though the pandemic has upended tourism in the past two years, it was undeniably helpful that those who visited Iceland in 2021 generally stayed longer and spent more than pre-pandemic travellers did. If this favourable trend continues, the future for tourism looks bright in spite of this temporary setback.

Number of foreign tourists, by year

thousands



Sources: Icelandic Tourist Board, ÍSB Research

Tourism among the main drivers of surging export growth

Capelin, farmed fish, and intellectual property are among other growth sectors, although import growth pulls in the opposite direction

Tourism, plus exports of intellectual property and other services, is the main driver of the 19% export growth we forecast for this year. Added to this is modest growth in goods exports, with booming capelin, farmed fish, and silicon metals exports offset by a contraction in exports of aluminium and groundfish, particularly cod.

Increased tourist arrivals will deliver the lion's share of the forecasted 11% export growth in 2023 and scant 5% growth in 2024. Furthermore, the outlook is for stronger exports of farmed fish, aluminium and other industrial goods, and increasingly, intellectual property usage as well.

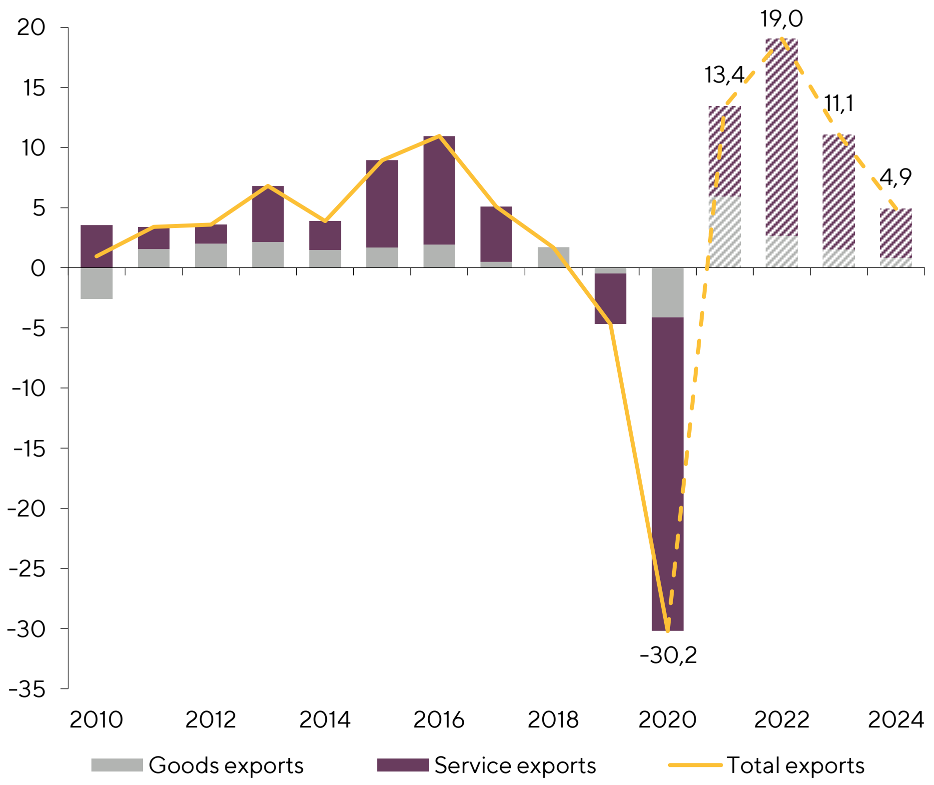
2021 was characterised by strong import growth, reflecting increased imported consumption and investment, but also growing imports of export-related inputs. In all, imports grew by over 18% during the year.

By the same token, the outlook is for imports to grow by more than 15% in 2022. Rapid growth in tourism plus moderate growth in other exports calls for more inputs, and growing domestic demand requires more imports.

According to our forecast, imports will grow far more slowly in 2023, and slower still in 2024, not least because the need for inputs in tourism and other export sectors will grow more slowly further ahead, and growth in domestic demand will ease.

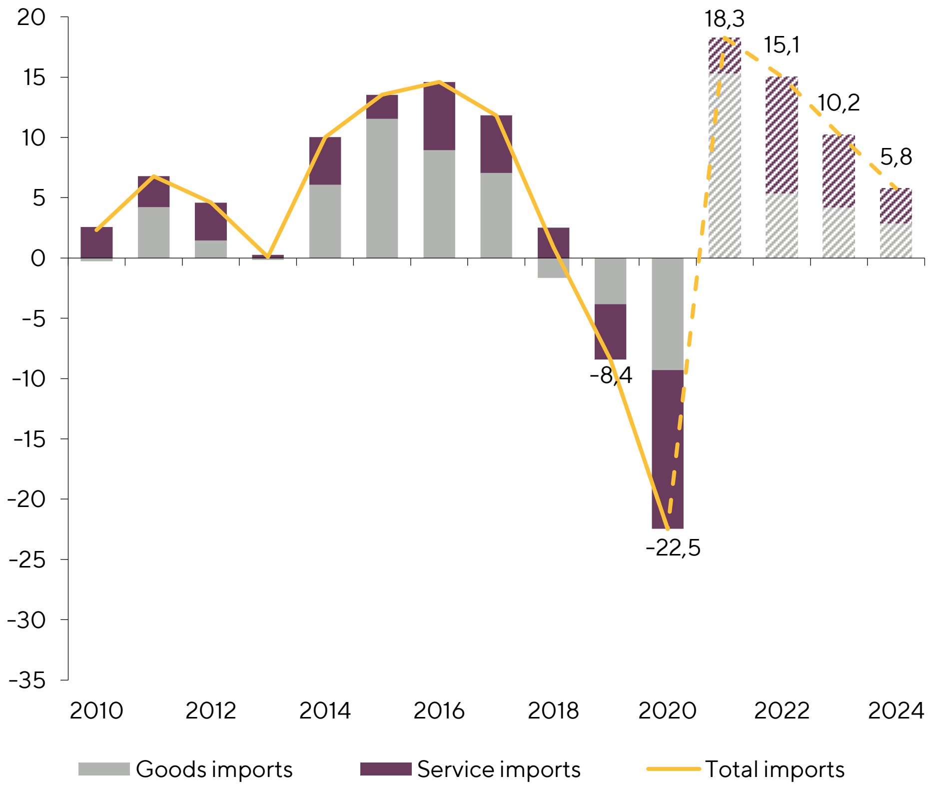
Exports and contributions from subcomponents

%



Imports and contributions from subcomponents

%



Sources: Statistics Iceland, ÍSB Research.

Current account surplus in the offing after a temporary deficit

The brief deficit is due to domestic demand, which has been a few steps ahead of the recovery of exports

After a nine-year spate of current account surpluses, 2021 saw a deficit. The deficit on goods and services trade probably totalled around ISK 65bn and was only partially offset by a surplus on the income account. We estimate the 2021 deficit at 1.6% of GDP.

The simplest explanation of the deficit is that domestic demand recovered from the 2020 contraction before exports did. Export growth therefore did not compensate fully for imports due to growth in consumption, investment, and the need for export-related inputs.

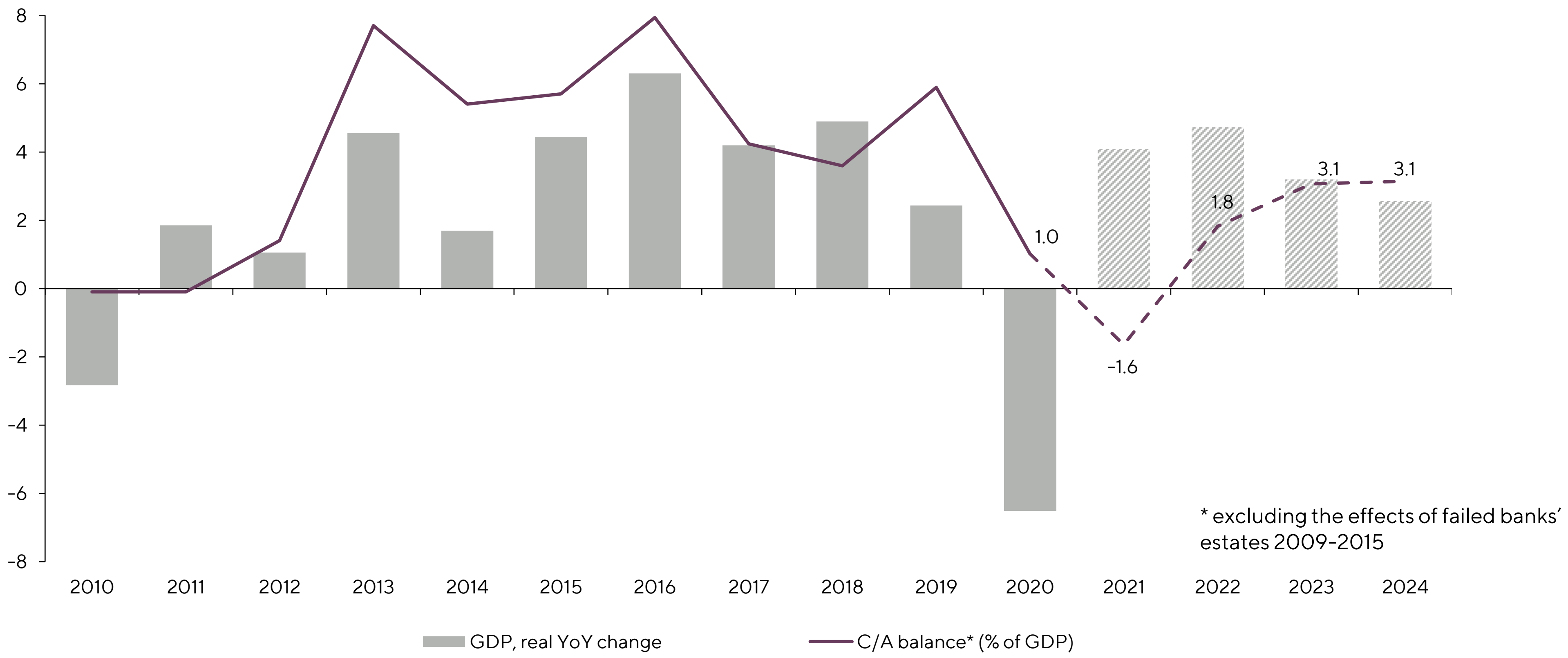
In our opinion, however, the deficit will prove transitory. Vastly increased export revenues will quickly offset growth in import-related expense, as export growth gains pace in tandem with slower growth in domestic demand. It helps that the price of various exported goods – aluminium and certain groundfish species – has risen markedly in the recent term, although some imported goods prices have risen as well.

We forecast that the current account surplus will measure 1.8% of GDP in 2022 and just over 3% in both 2023 and 2024.

In our opinion, Iceland's external trade position has improved permanently. The country's net external assets are currently equivalent to over 4/10 of GDP – a situation that could improve further over the forecast horizon.

Current account balance and GDP growth

% of GDP and %



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

After a two-year contraction, investment spiked in 2021. We estimate that on the whole, investment increased by just under 12% in 2021, the fastest growth rate in five years.

It was fuelled in particular by strong growth in business and public investment, whereas residential investment contracted.

Changed methodology in Statistics Iceland's (SI) treatment of aircraft leasing explains some of the nearly 20% growth in business investment in 2021. General business investment also increased markedly, however. We estimate that public investment grew by just over 14% in 2021, as the Government's pandemic-related investment initiative finally kicked into high gear as the year progressed.

For 2022, the outlook is for residential investment to finally rebound after last year's contraction. Flats in early stages of construction have increased markedly in number, according to the Federation of Icelandic Industries' tally, and demand for new homes is strong. Furthermore, public investment will gain momentum this year, although business investment looks set to contract slightly.

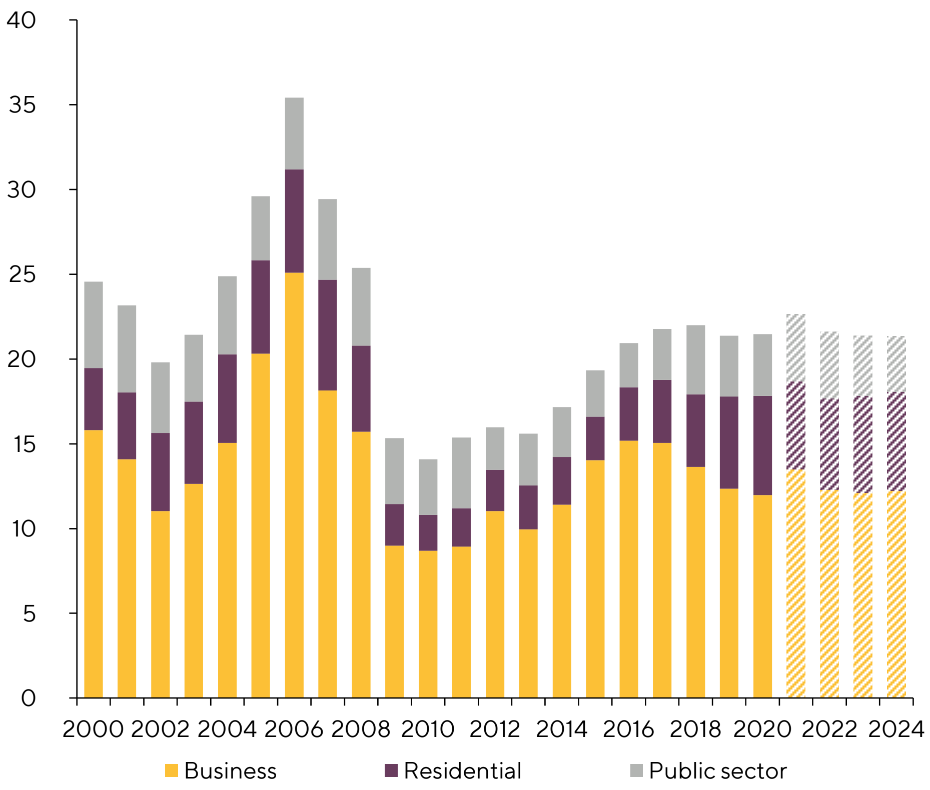
In 2023, however, household and business investment will be the main driver of growth, and public investment will contract year-on-year.

We forecast that total investment will grow by 3.1% in 2022, 2% in 2023, and 3.5% in 2024. The investment level in the economy will therefore be relatively stable, and rather high in historical context.

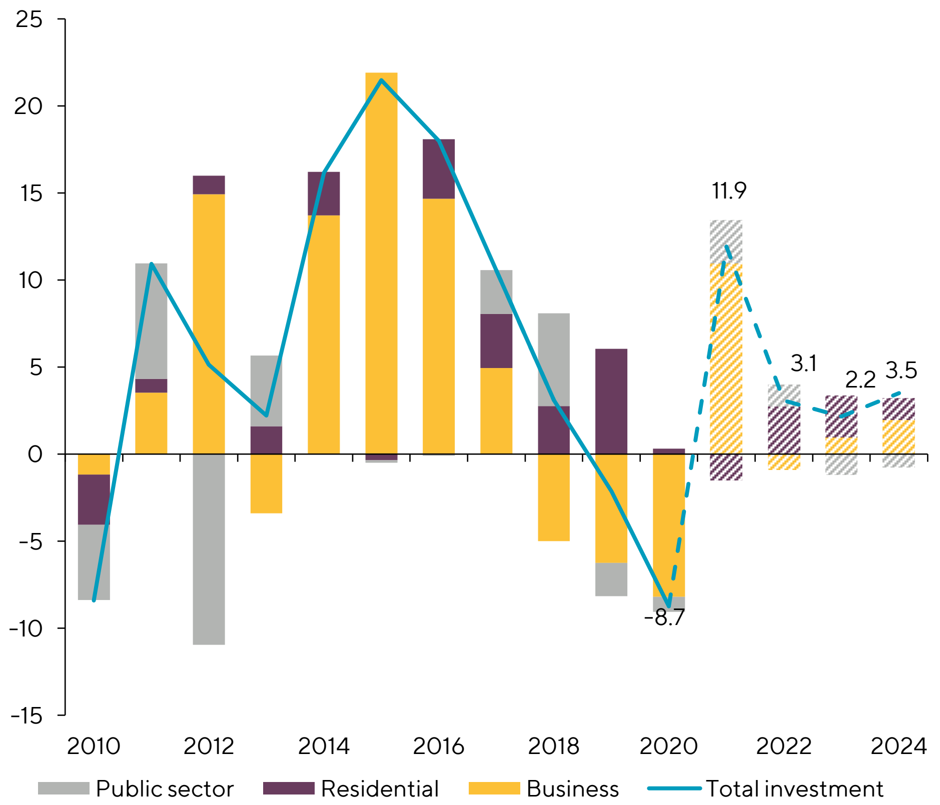
Modest investment growth after a spike in 2021

Residential investment to gain steam, while public investment will contract further ahead

Investment
% of GDP



Investment, real change, and contribution of subcomponents
%



Sources: Statistics Iceland, ÍSB Research.

Increased optimism goes hand-in-hand with growth in demand

Dwindling uncertainty and relatively favourable financing conditions fuel business investment

After contracting by 28% over the past three years, business investment turned around in 2021.

Available figures show that total business investment grew by nearly one-fourth in the first nine months of the year. General investment excluding aircraft, ships, and energy-intensive industry grew by more than a fifth.

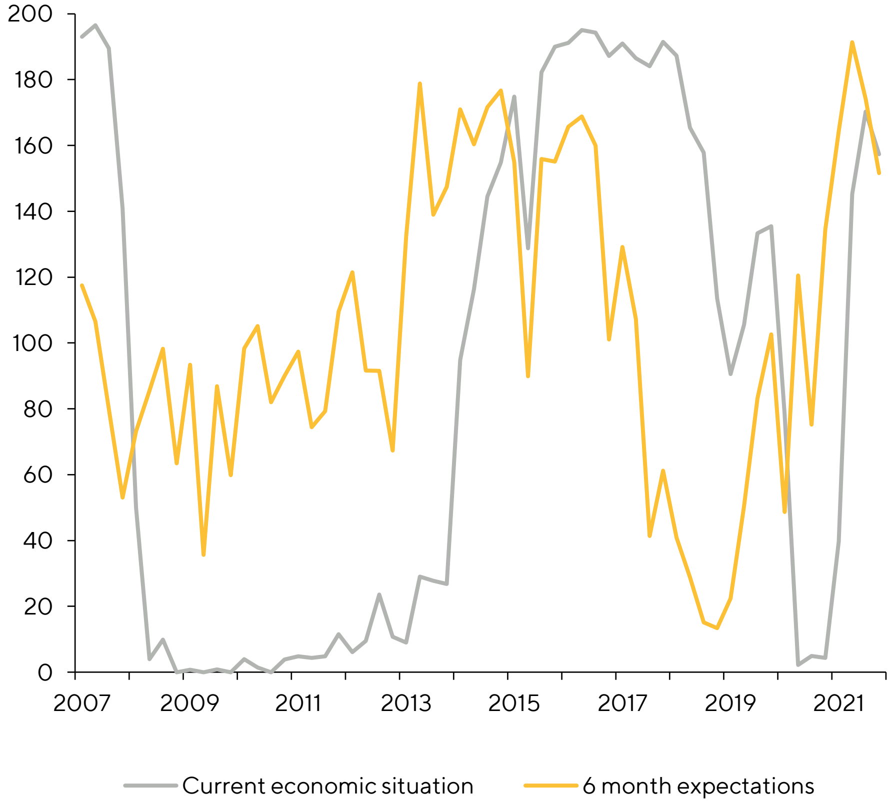
Executives' expectations concerning near-term economic conditions have improved markedly in recent quarters, hitting an all-time high in mid-2021. The assessment of the current situation has shifted accordingly. According to a Gallup survey conducted for the CBI and the Confederation of Icelandic industries, a hefty majority of executives considered conditions favourable in Q4 2021 despite the persistence of the pandemic.

There is a fairly strong correlation between corporate sentiment and growth (positive or negative) in business investment. Widespread optimism about economic developments and prospects is a good sign of a high investment level in coming quarters.

Added to this, most firms are financially sound, and relatively favourable financing conditions should facilitate investment as pandemic-related uncertainty subsides.

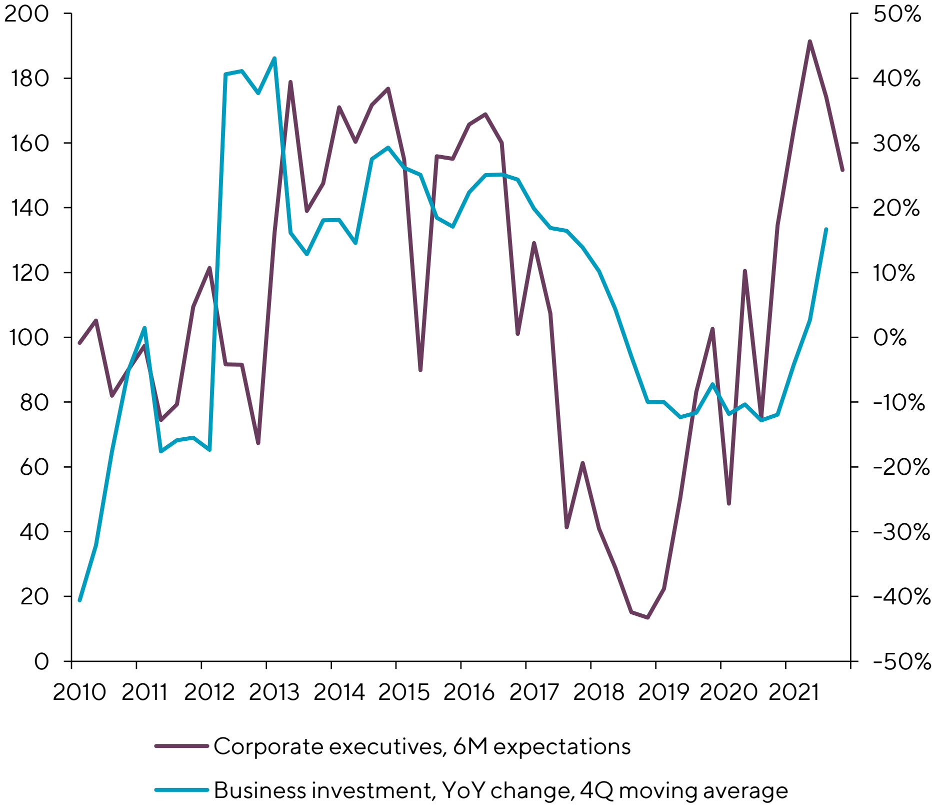
Expectations of executives from Iceland's 400 largest firms

Index



Executives' expectations and business investment

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



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

When will house price inflation ease?

CBI takes action to contain house prices

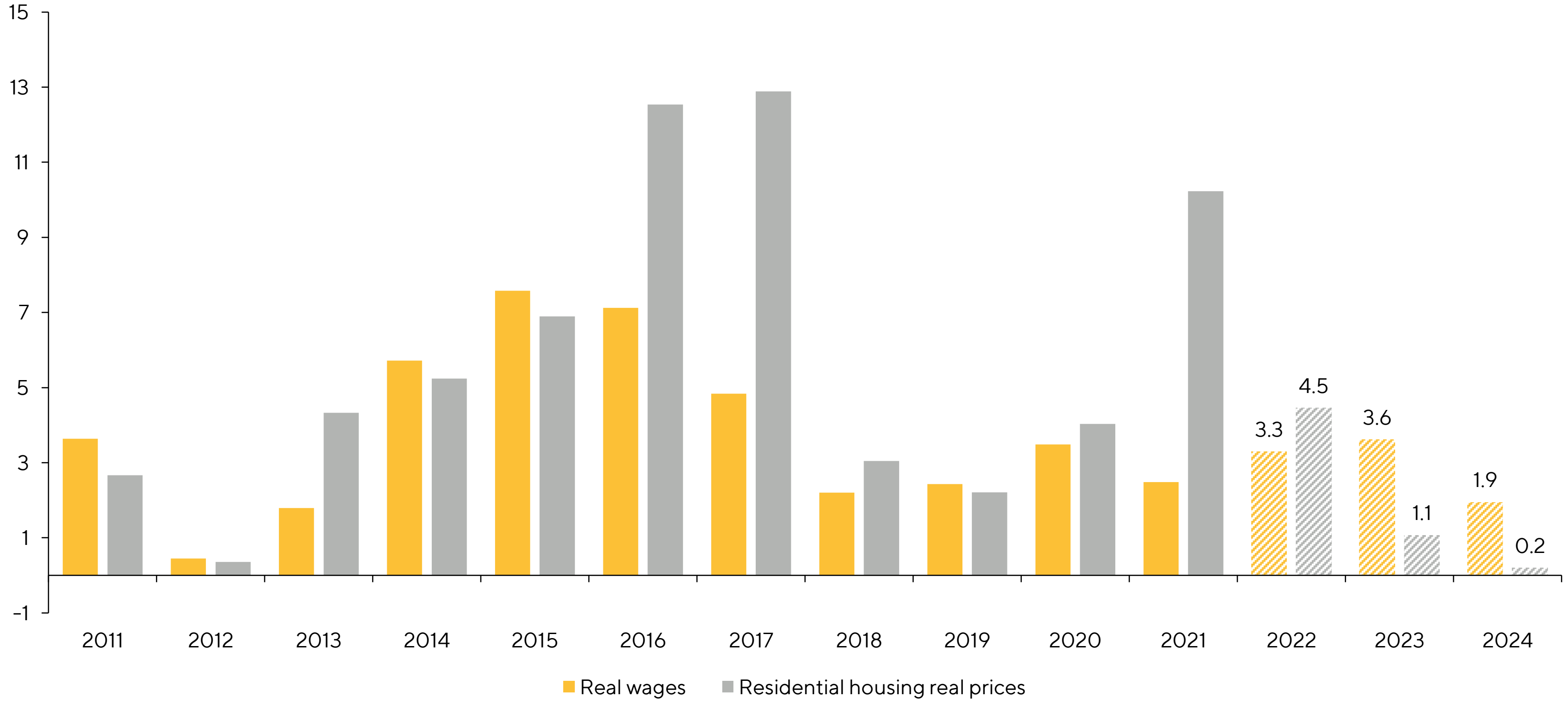
Demand for housing was strong throughout 2021. Prices rose nearly 16% in nominal terms, or just over 10% in real terms. Even though real wages also grew markedly in 2021, real house prices rose much faster.

Favourable interest rates and households' strong asset position are the main reasons demand for housing is as strong as it is. Even though a record number of new flats were put on the market in 2020, it is quite clear that supply has not kept pace with demand. Residential investment declined in 2021, contracting by 7.5% in the first nine months, although this is considerably less than previously expected.

Supply takes a while to catch up with rising demand in the housing market, as it generally takes around two years to build new flats. It is hoped that supply will increase this year. This accords with the Federation of Icelandic Industries tally from September 2021, which showed a sizeable increase in the number of capital area flats in early stages of construction.

House price inflation well above rises in wages and the general price level is not sustainable in the long run. The CBI has taken action to contain house prices. It has raised the policy rate, as well as tightening rules on maximum loan-to-value and debt service-to-income ratios. These measures will have an increasing impact on the housing market in the coming term.

Real house prices and real wages
% change over the year



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

Housing demand still strong

We think house prices will calm down this year as interest rates rise and supply grows

Single-family home prices in the capital area rose by 18% in 2021, while house prices in regional Iceland rose 16.5% and condominium prices in the capital area by 15%.

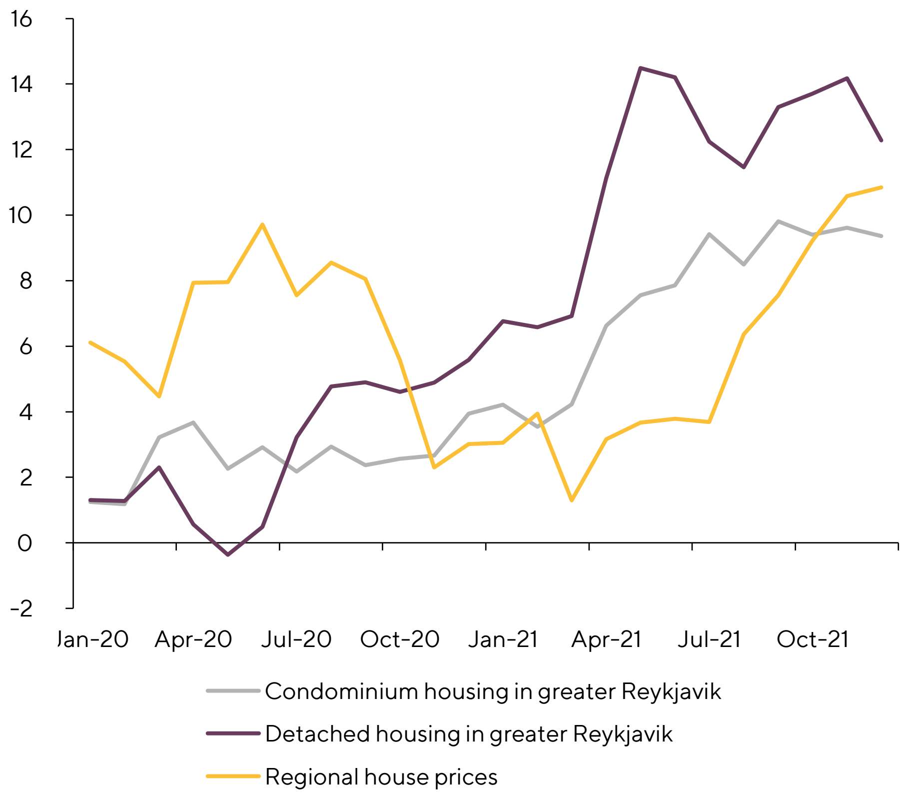
Since mid-2020, detached home prices in the capital area have risen fastest. Presumably, this stems in large part from the boom in pandemic-related remote working, which has fuelled a shift towards larger homes. House prices in regional Iceland and condominium prices in greater Reykjavík started to rise faster over the course of 2021, and the price differential between locations and home types has narrowed.

Housing market activity was unusually brisk in 2021, but in recent months the market has cooled in terms of both turnover and the number of registered purchase agreements. Presumably, this is due to limited supply, as various indicators suggest that demand remains very strong. Flats are selling quickly, and many of them are still selling at a premium on the asking price.

As we see it, conditions are in place for house prices to keep rising but for the pace to ease with policy rate hikes and increased supply later in the year. We forecast that nominal house prices will rise by just under 8% in 2022, 3.5% in 2023, and 2.9% in 2024, whereupon the market will have rebalanced.

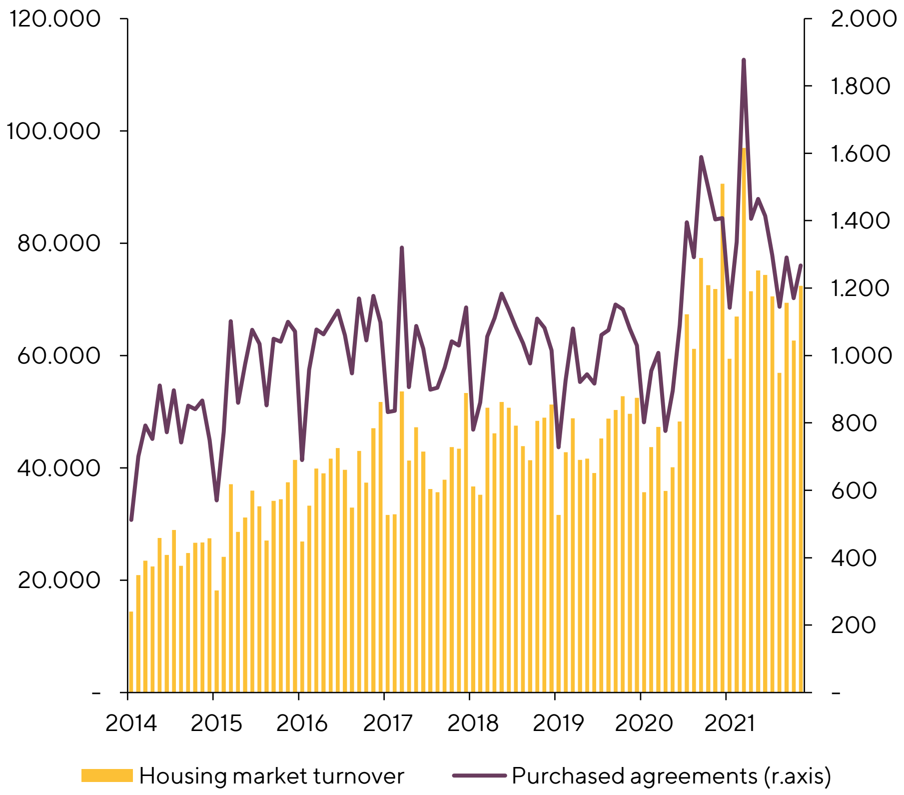
Real change in house prices, by country

% change, annualised



Capital area housing market activity

Turnover in ISKbn



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

Unemployment converging to a new equilibrium

The relatively swift economic recovery has caused a rapid decline in unemployment

Unemployment fell rapidly in 2021. At the start of the year it was very high, at 11.6% of the labour force, excluding employees receiving part-time unemployment benefits, but by the year-end it had fallen to 4.9%. The jobless rate was cut by more than half over the course of 2021 and averaged 7.7% for the year as a whole.

The authorities introduced various labour market initiatives in the wake of the pandemic, and without them unemployment would probably have been a bit higher. Most of these measures have now expired, but even so, we expect unemployment to keep falling this year.

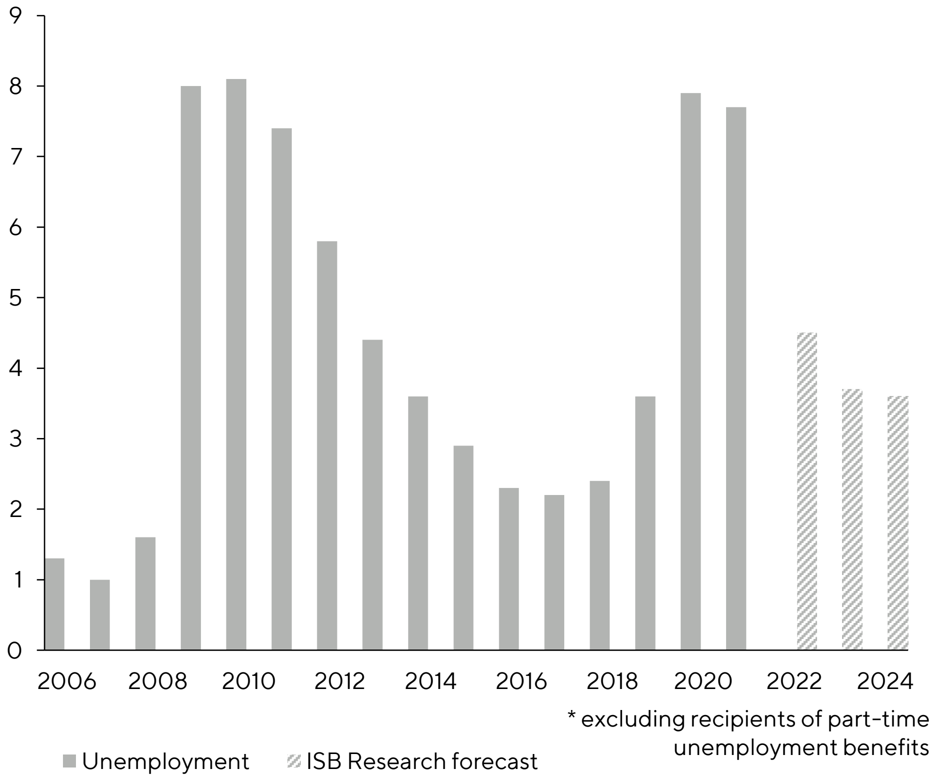
The relatively swift economic recovery in 2021 has fostered job growth, causing unemployment to fall rapidly. We expect the decline to continue in 2022, albeit more slowly. We forecast average year-2022 unemployment at 4.5%.

According to a recent Gallup survey carried out for the CBI and the Confederation of Icelandic Employers, nearly 40% of company executives consider themselves short-staffed. Construction and tourism companies in particular envision adding on staff in the next six months. As foreign workers have been prominent in these sectors, labour importation is likely to increase markedly this year.

We forecast that unemployment will fall to a new equilibrium in the coming term, averaging 3.7% in 2023 and 3.6% in 2024. This is roughly the level seen in 2019.

Unemployment as a share of the labour force*

%



* excluding recipients of part-time unemployment benefits

Labour supply according to corporate executives

%

Sources: Directorate of Labour, ÍSB Research.

Private consumption growth exceeded expectations in 2021

Indicators suggest further growth over the forecast horizon

Private consumption contracted by 3% YoY in 2020. But domestic demand gained strongly in 2021. In the first nine months of the year, private consumption grew 5.4%, and many indicators imply a similar growth rate for 2021 as a whole. It therefore appears not only that last year's contraction reversed but that private consumption has grown markedly relative to 2019.

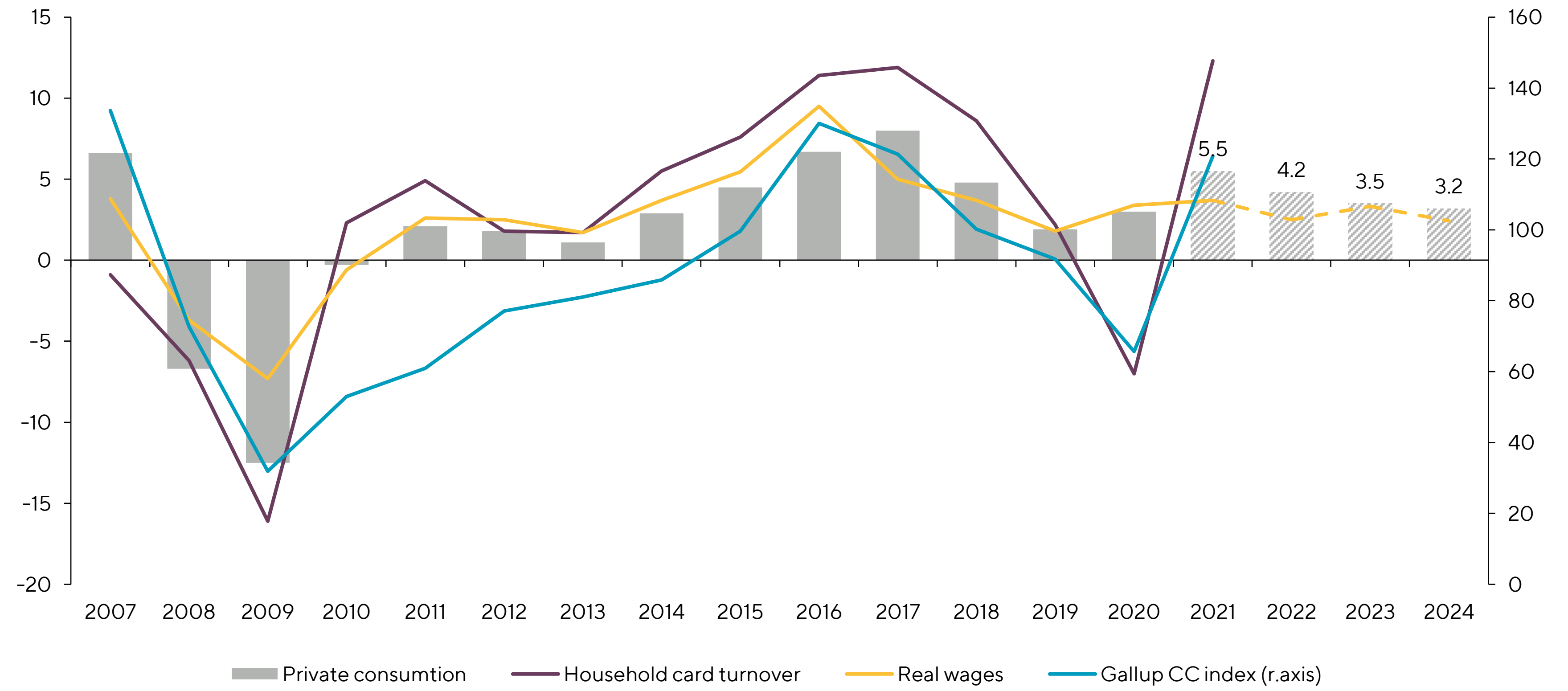
Indicators that give reliable signs of developments in private consumption all suggest that growth is in the offing. For instance, card turnover has been rising swiftly in the past year, particularly to include turnover abroad. The Consumer Confidence Index is high, and unemployment has fallen rapidly.

Furthermore, real wages grew by an average of 3.7% in 2021, despite high inflation. We forecast that real wages will keep rising over the forecast horizon, by 2.5% in 2022, 3.3% in 2023, and 2.4% in 2024. Our forecast rests, among other things, on the assumption that the wage settlements slated for later this year will be relatively moderate.

Private consumption is an important factor in Iceland's GDP growth. As we see it, appetite for consumption remains strong, and growth will continue over the forecast horizon, although the peace will ease gradually. We forecast private consumption growth at 4.2% in 2022, 3.5% in 2023, and 3.2% in 2024.

Private consumption and related indicators

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



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

ISK set to appreciate further with growth in export revenues

The ISK has been stable recently, and the CBI has suspended intervention

The ISK weakened markedly at the beginning of the pandemic, and the CBI traded heavily in the FX market to mitigate volatility, but in recent quarters the market has grown considerably more balanced.

The ISK appreciated by nearly 3% in 2021, with all of the strengthening occurring in H1, while in H2 it fluctuated within a relatively narrow range. The CBI steadily scaled down its FX market intervention over the course of the year, and in Q4/2021 it hardly traded in the market at all.

We expect the ISK to strengthen again, although the appreciation may well be delayed somewhat in the months to come. A surplus on the current account is in the offing, interest rates are on the rise, Iceland's IIP is strong, the growth outlook is good, and non-residents' securities holdings are relatively limited in historical terms.

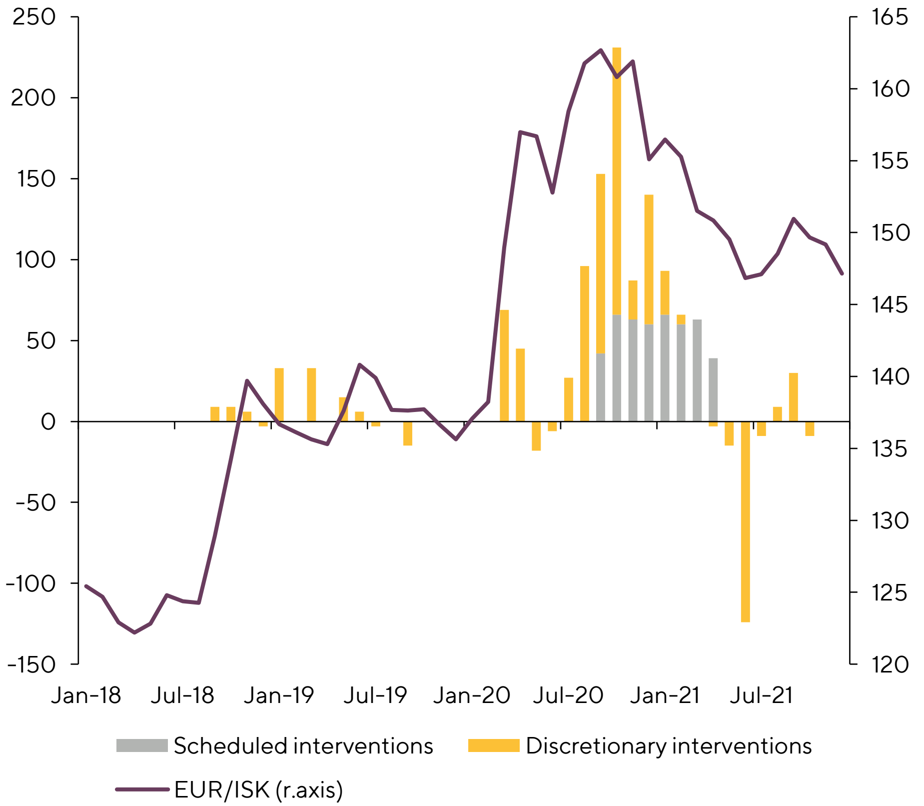
On the other hand, the pension funds are likely to step up their foreign investment in the coming term, and it is possible that the CBI will add to its FX reserves again if the ISK strengthens quickly over any given period.

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 8-9% stronger by the end of the forecast horizon than it was at the beginning of 2022.

The real exchange rate in terms of relative consumer prices will then be similar to that in 2018.

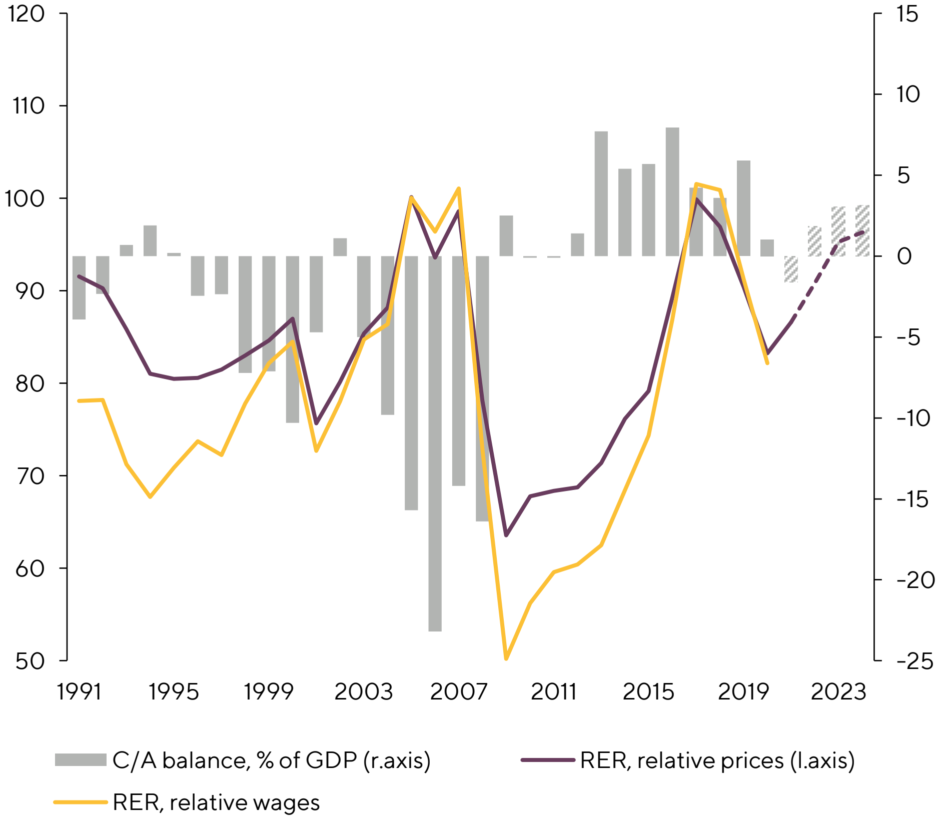
ISK exchange rate and CBI FX market intervention

EUR m (left) and EURISK (right)



Real exchange rate and current account balance

Index and % of GDP



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

Inflation has risen steadily since mid-2020, and since the beginning of 2021 it has been above 4%, the upper tolerance limit of the CBI's inflation target. 2021 was Iceland's biggest inflation year since 2012, with prices rising by an average of 4.4%. Inflation peaked at 5.1% in December.

Inflation proved much more persistent last year than forecasts had generally assumed. Strong domestic demand, which (among other things) pushed house prices upwards, played a major role. Furthermore, foreign prices have risen markedly and shipping costs have soared because of pandemic-induced supply-chain bottlenecks abroad.

Stubborn inflation is far from a uniquely Icelandic problem. Prices have been rising in most Western countries during the pandemic. In the OECD, for instance, inflation averaged 5.8% in November 2021. Most countries are therefore battling the same problem in the wake of the pandemic.

The outlook is for inflation to ease steadily in 2022, both in Iceland and abroad. According to our forecast, it will still be somewhat above the 4% tolerance limit for much of the year, averaging 4.3% in 2022 as a whole. It will align with the CBI's 2.5% target in H1/2023, according to our forecast. We expect inflation to average 2.5% in 2023 and 2.7% in 2024.

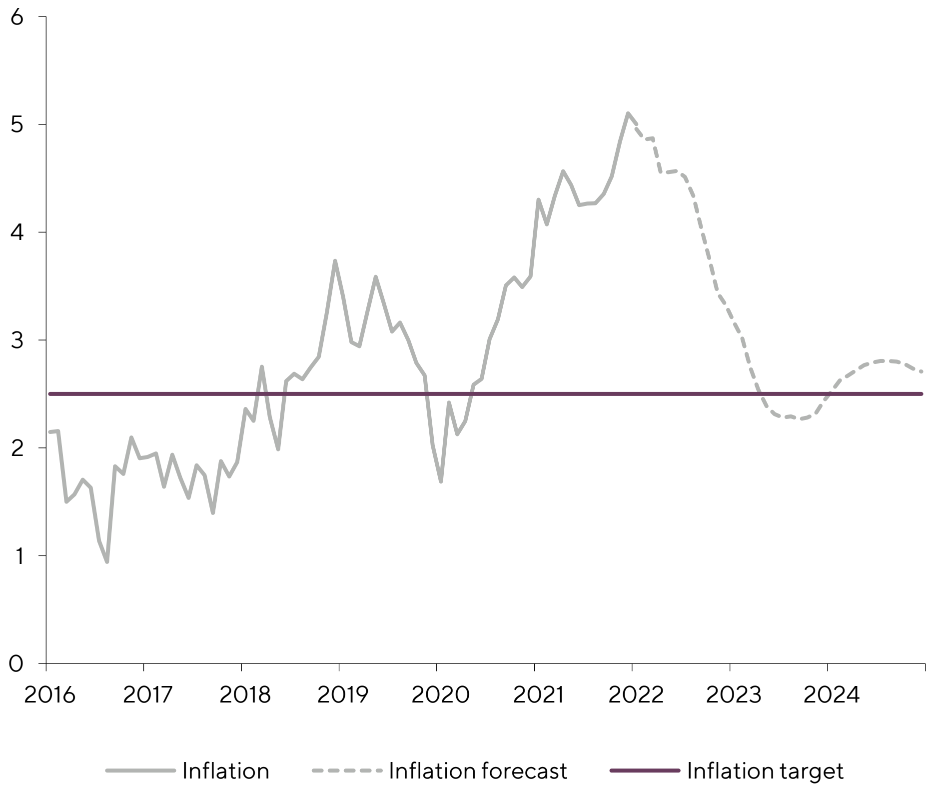
One of the main assumptions underlying our forecast is that the ISK will appreciate in coming quarters, once tourists start visiting the country in greater numbers. In addition, we assume that house price inflation will ease, and we do not expect overly large pay rises to result from the upcoming wage negotiations. Furthermore, we expect the supply-chain problems abroad to be resolved this year.

Inflation to ease steadily over the year

Inflation likely to reach the target in H1/2023

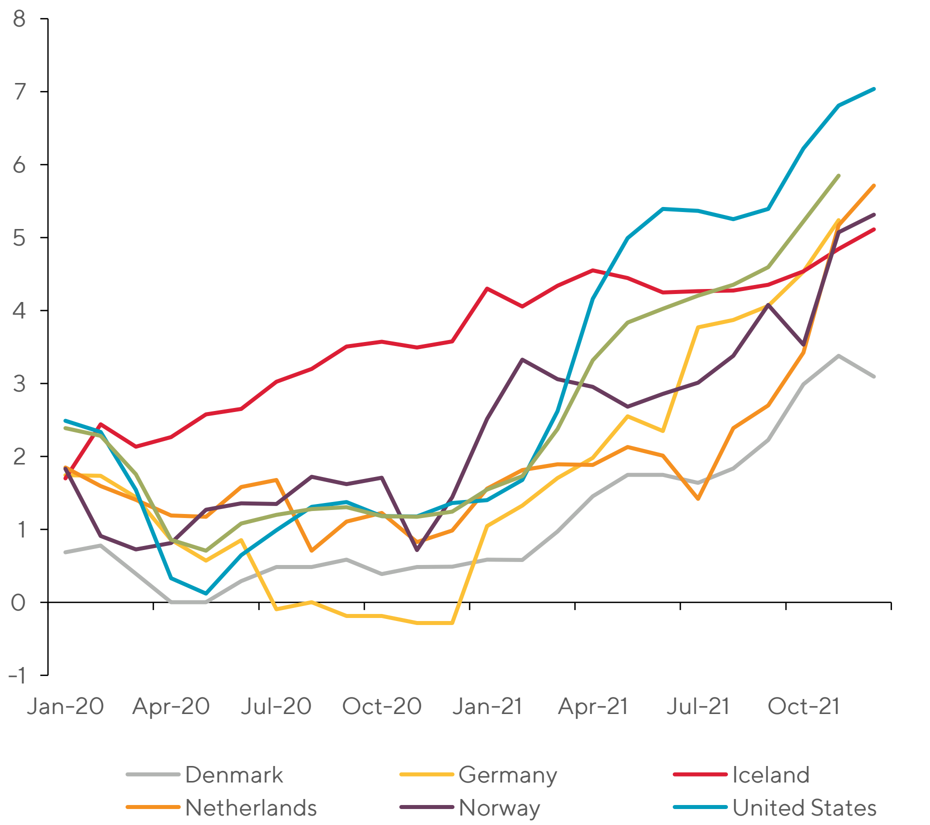
Inflation and the CBI inflation target

%



Headline inflation, by country

%



Sources: OECD, Statistics Iceland, ÍSB Research.

Policy rate to keep rising in the next two years

Equilibrium rate in sight in the latter half of the forecast horizon

Persistent inflation, a deteriorating short-term inflation outlook, and the economic recovery prompted the CBI to embark on a monetary tightening phase in May 2021. The policy rate is now 2.0%, after being raised by 1.25 percentage points last year.

However, long-term inflation expectations are still reasonably well in line with the target. Monetary policy appears to have a stronger impact on households and businesses than before, and the outlook is for declining inflation and slower demand growth further out the forecast horizon. The CBI therefore has less need to resort to steep rate hikes in order to have the desired effect on the economy and the medium-term inflation outlook.

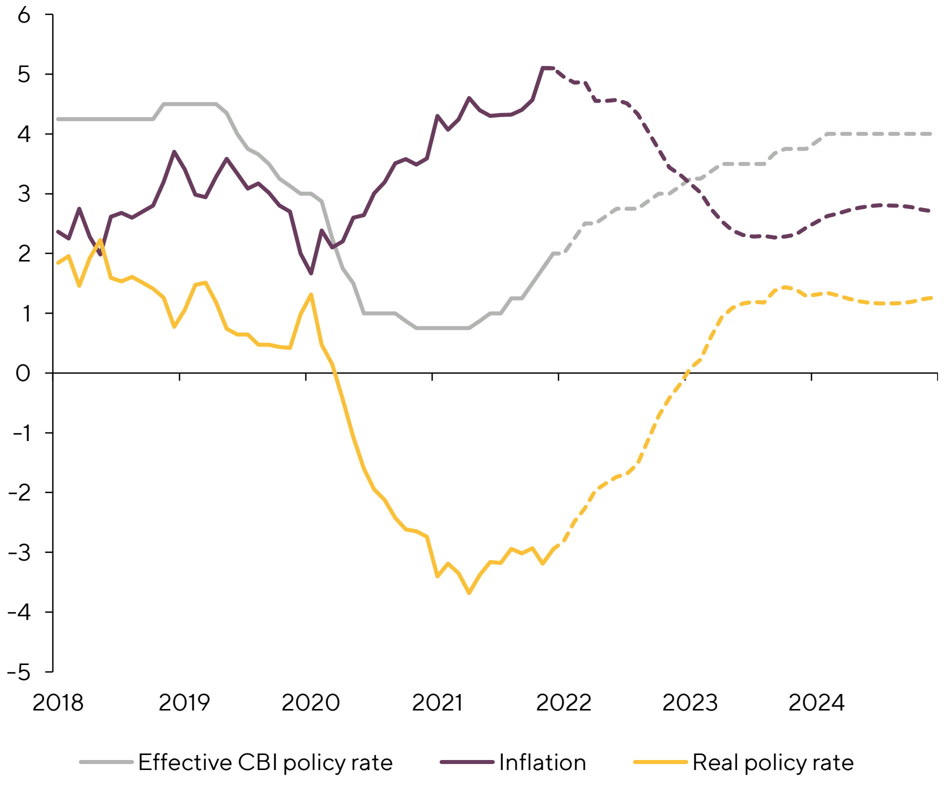
As a result, we forecast that the policy rate will keep rising, reaching 3.25% this year. We expect a somewhat slower increase thereafter. We project that by the beginning of 2024, the policy rate will be up to 4.0%, which we believe is close to its equilibrium level.

Yield curves in the market suggest that a sizeable policy rate hike has already been priced into long-term rates. Long-term base rates are now 4.3%, and real rates are around 0.7%. Long-term nominal interest rates have risen steeply in the past year, yet real rates are broadly unchanged despite some fluctuation.

Assuming that the policy rate does not rise much above 4% during the forecast horizon, we expect the rise in long-term rates to be modest. Towards the end of the horizon, we expect long-term rates to approach equilibrium, which we estimate at around 4.5% for nominal rates and somewhere near 1.2% for the real rate.

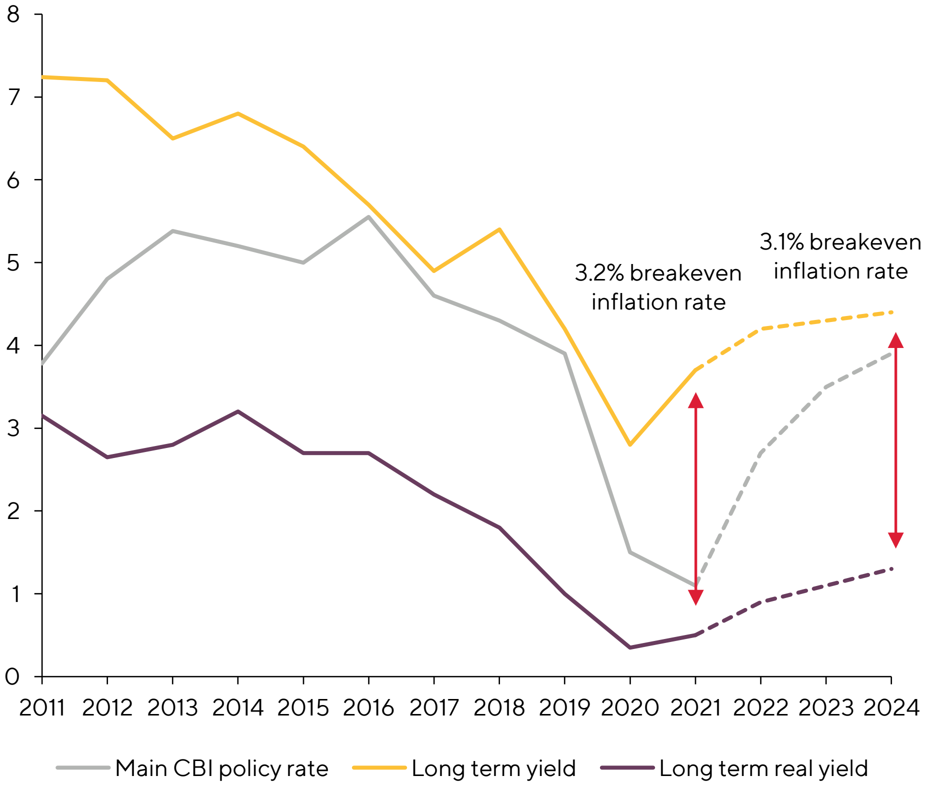
Policy rate and inflation

%



Interest rates

%



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

Macroeconomic forecast summarised

GDP and its components

Volume change from prior year %	The year 2020 in ISK m	2020	Estimate 2021	Forecast 2022	Forecast 2023	Forecast 2024
Private consumption	1,509,028	-3.0	5.5	4.2	3.5	3.2
Public consumption	818,915	4.5	2.1	2.6	2.4	2.2
Gross capital formation	631,591	-8.7	11.9	3.1	2.2	3.5
– business investment	352,066	-14.2	19.7	-1.5	1.7	3.5
– residential investment	171,935	1.2	-5.5	12.0	9.5	4.6
– public investment	107,590	-5.2	14.4	7.0	-6.5	-4.5
Changes in inventories	3,166	0.1				
Domestic demand, total	2,962,700	-2.2	5.8	3.5	2.9	3.0
Exports of goods and services	1,006,999	-30.2	13.4	19.0	11.1	4.9
– marine product exports	269,917	-4.9	10.0	9.8	2.8	2.0
– aluminium products	207,674	-1.0	2.0	-2.0	4.0	1.0
– other goods exports	150,532	-16.9	19.0	3.0	2.0	2.0
– services exports	378,877	-50.5	19.9	41.2	20.2	8.0
Imports of goods and services	1,028,601	-22.5	18.3	15.1	10.2	5.8
– goods imports	718,805	-14.5	21.9	7.4	6.2	4.5
– services imports	309,796	-36.7	9.8	34.7	18.5	8.2
Gross domestic product	**2,941,099**	**-6.5**	**4.1**	**4.7**	**3.2**	**2.6**

Macroeconomic forecast summarised

Other economic variables

			Forecast	Forecast	Forecast
% of GDP	2020	2021	2022	2023	2024
Gross capital formation	21.5	22.6	21.8	21.2	21.3
Current account balance	0.9	-1.6	1.8	3.1	3.1
Trade balance	-0.7	-2.0	1.8	3.0	3.1
% change over the year					
Consumer prices	3.6	5.1	3.2	2.4	2.7
Wages and salaries	7.2	7.6	6.6	6.1	4.7
House prices	7.8	15.9	7.8	3.5	2.9
Real wages	3.5	3.7	2.5	3.5	2.4
Change between annual averages (%)					
Real exchange rate, relative consumer prices	-10.1	5.8	4.9	4.9	1.1
Annual average (%)					
Unemployment	7.9	7.7	4.5	3.7	3.6
Trade-weighted exchange rate index	201.0	196.1	189.5	180.6	180.0
CBI policy rate (7-day term deposits)	1.5	1.1	2.7	3.5	3.9
Long-term nominal rate (RIKB 31)	2.8	3.7	4.2	4.3	4.4
Long-term real rate (RIKS 30)	0.4	0.5	0.9	1.1	1.3

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