May 2022

Macroeconomic forecast: Higher and higher?

Higher and higher?

Summary

Exports to fuel GDP growth

GDP growth

- Exports take over from domestic demand as the main driver of growth
- 5.0% growth in 2022
- 2.7% growth in 2023
- 2.6% growth in 2024

Rapid recovery of tourism drives export growth

External trade

- 1.5-1.6 million tourists expected in 2022
- Exports to rise by 20% in 2022 and imports by 16.5%
- Current account set to be in balance in 2022
- Current account surplus around 2% of GDP in 2023 and 2024

Persistent inflation in the near term

Inflation

- Inflation to peak at 8.4% in late summer and remain above the CBI target for the entire period
- Key uncertainties are wage agreements, house prices, and import prices
- Inflation to average 7.6% in 2022
- Inflation 5.9% in 2023 and 3.9% 2024

Unemployment on the wane

Labour market

- Unemployment falls further, and a labour shortage could develop
- Unemployment to average 4.4% in 2022
- 3.7% unemployment in 2023
- 3.6% unemployment in 2024

Hefty interest rate hikes in the offing

Interest rates

- Policy rate above 5% by end-2022
- Gradual monetary easing from mid-2023 onwards
- Interest rates around 4.5% at the end of the forecast horizon

Further ISK appreciation a possibility

The ISK

- The ISK will be about 5% stronger at the end of the forecast horizon than at the end of April 2022.
- Increased foreign investment by pension funds and CBI foreign currency purchases cut into current account surplus and improved IIP

Export-driven GDP growth following robust growth in demand

GDP growth rapid in 2022 but slower in coming years

After a 7.1% contraction in 2020, the Icelandic economy recovered strongly in 2021, with GDP growth measuring 4.3%. Growth was driven mainly by domestic demand, supported by the authorities' economic policy response, an improving labour market, and a sound financial position among most households and businesses. Exports also picked up strongly, albeit outpaced by import growth.

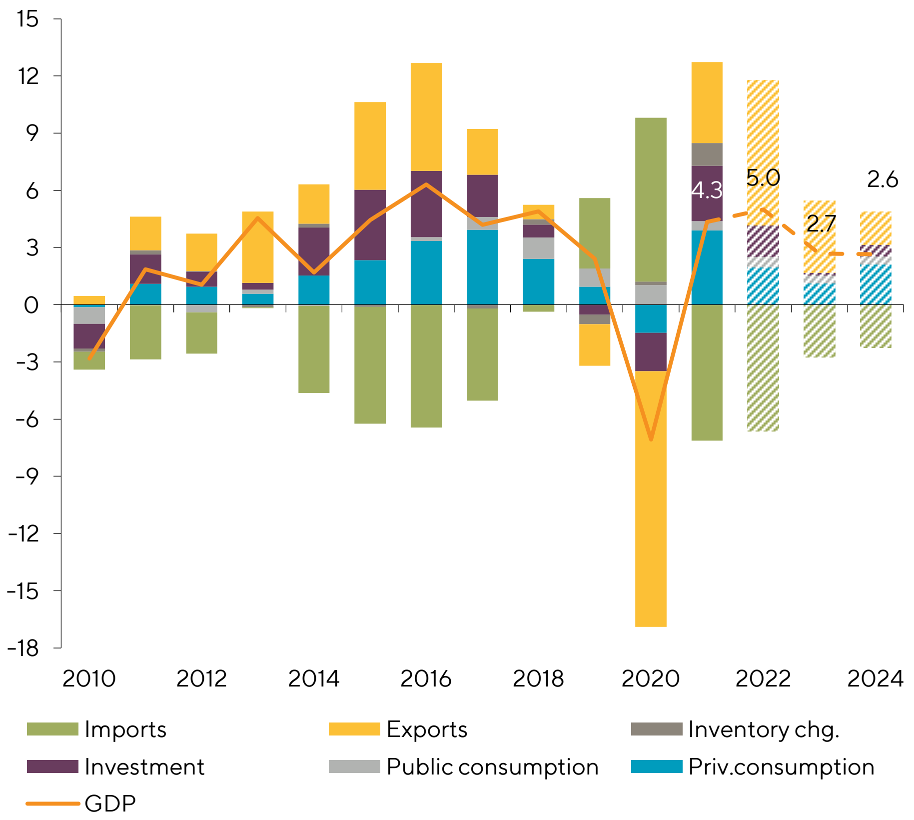
We forecast GDP growth at 5.0% in 2022, the fastest growth rate since 2016. Exports take over from domestic demand as the main catalyst of growth, with a rapid recovery of tourism and an increase in other exports. Growing consumption and investment also fuel GDP growth in 2022.

For 2023, we forecast that GDP growth will measure 2.7%, with exports once again the main driver, although growth in exports as well as domestic demand will ease year-on-year. 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 supply constraints will slow the pace of growth.

Economic uncertainties centre on developments in the Ukraine war and the COVID-19 endgame. If either or both of these put severe pressure on the global economy in the coming term, it could weaken the Icelandic economy further ahead. Based on the current outlook, though, we think it likeliest that these effects will taper off in coming quarters. The Appendix contains alternative scenarios illustrating developments markedly worse/better than are assumed in the baseline forecast.

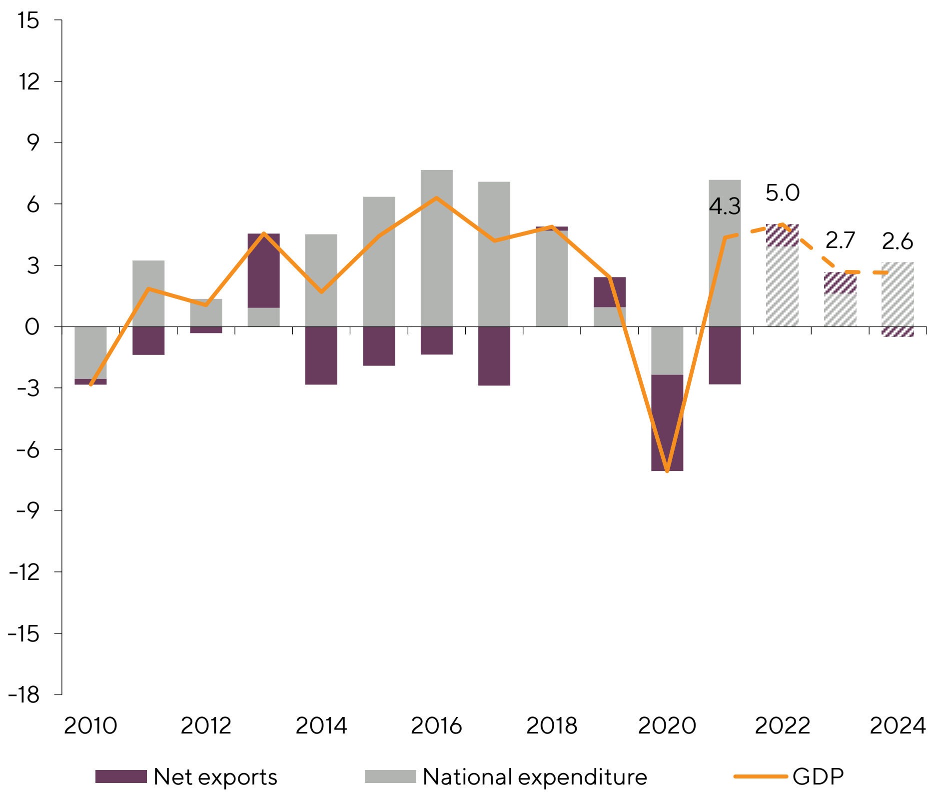
GDP and contribution of its subcomponents

Volume change from prior year (%)



GDP, domestic demand, and external trade

Volume change from prior year (%)



Sources: Statistics Iceland, ÍSB Research.

Tourism recovering swiftly from a two-year drought

We forecast that 1.5-1.6 million tourists will visit Iceland in 2022

After a turbulent two-year period featuring brief gusts of growth interspersed with pandemic-induced doldrums in tourism, the sector appears poised for a swift recovery.

Departure figures from Keflavík Airport show that just over 340,000 tourists visited Iceland in the first four months of 2022, the largest total for this period since Jan-Apr 2019. British tourists have been particularly prominent in this resurgence and have been an important part of winter tourism in Iceland since well before the pandemic.

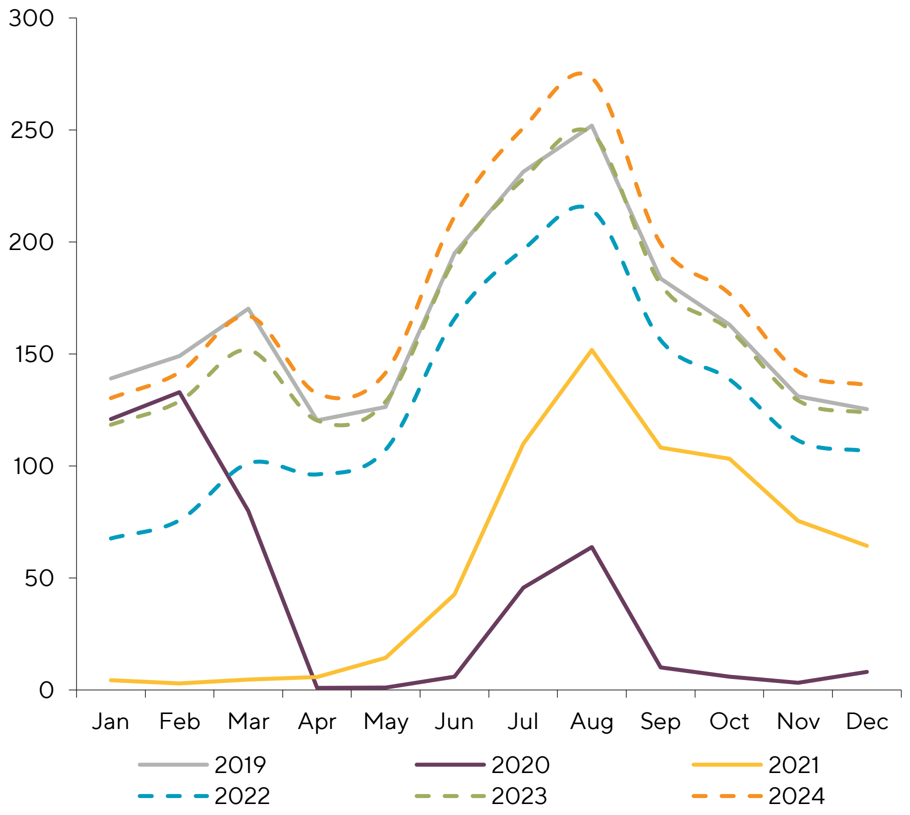
Tourism operators are upbeat about the coming summer and autumn. The status of bookings and the growing number of flights to and from Iceland suggest that this year's tourist numbers could come to 80-90% of the 2019 total.

We expect 1.5-1.6 million tourists this year, about the same number as in the mid-2010s, if our forecast materialises. We expect tourist numbers to rise to 1.9 million in 2023 and 2.1 million in 2024.

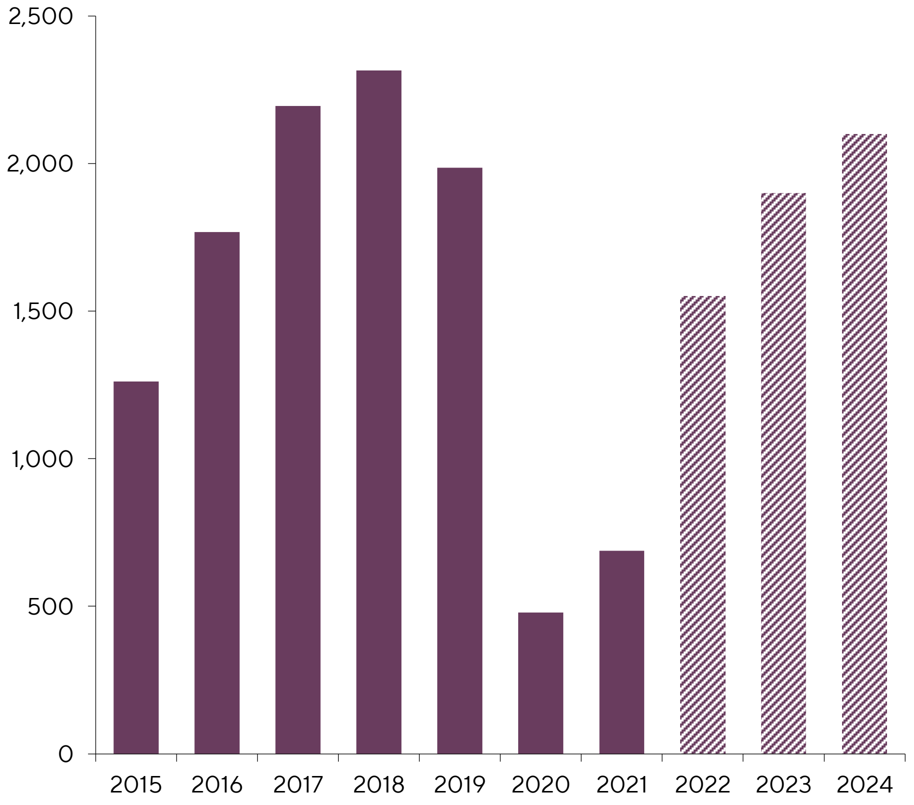
The slowdown in growth further ahead is due in part to a higher real exchange rate, which will make Iceland more expensive in comparison with other destinations, and the prospect of weaker growth in global demand.

Even though visitors were far fewer in 2021 than before the pandemic, they supported revenue generation by staying longer and spending more in Iceland than they did previously. It is of vital importance that this trend should continue, and we think it quite likely that average revenues per tourist will be somewhat higher than in the past decade.

Number of foreign tourists, by month
thousands



Number of foreign tourists, by year
thousands



Sources: Icelandic Tourist Board, ÍSB Research

Tourism to weigh heaviest in near-term export growth

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

The rapid recovery of tourism explains a large share of the 20% export growth we forecast for 2022. Added to this is growth in exports of intellectual property and other services, plus modest growth in goods exports, with booming capelin, farmed fish, and silicon metals exports and a slight increase in exports of aluminium, offset by a contraction in exports of groundfish, particularly cod.

In 2023 and 2024, increased tourist arrivals will deliver the lion's share of export growth, which is projected at nearly 9% and 4%, respectively. Furthermore, the outlook is for stronger exports of farmed fish, aluminium and other industrial goods, and increasingly, intellectual property usage.

In all, imports grew by just over 20% during the year, reflecting increased imported consumption and investment, but also growing imports of export-related inputs.

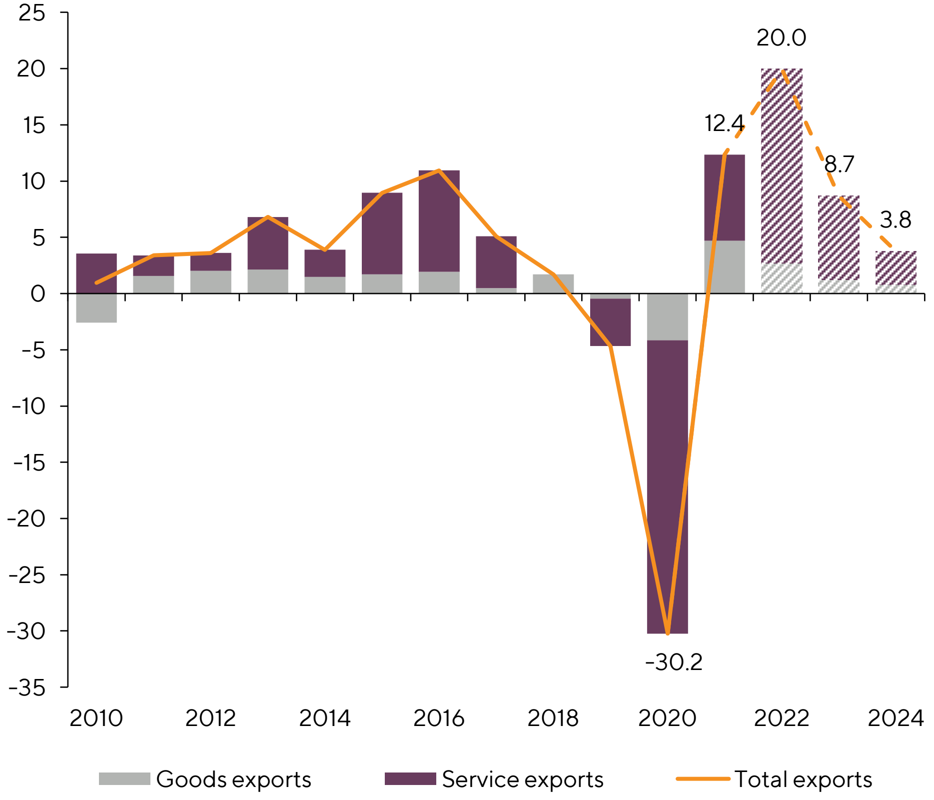
For the same reasons, the outlook is for imports to grow by more than 16% in 2022. Both the surge in tourism and the increase in other exports call for more imported inputs, and growing domestic demand causes an increase in imports of consumer and investment goods.

According to our forecast, import growth will ease in 2023 and slow still further in 2024, owing to reduced need for inputs in tourism and other import sectors and to weaker growth in domestic demand.

The contribution from net trade will be positive this year as well as in 2023 but negative in 2024.

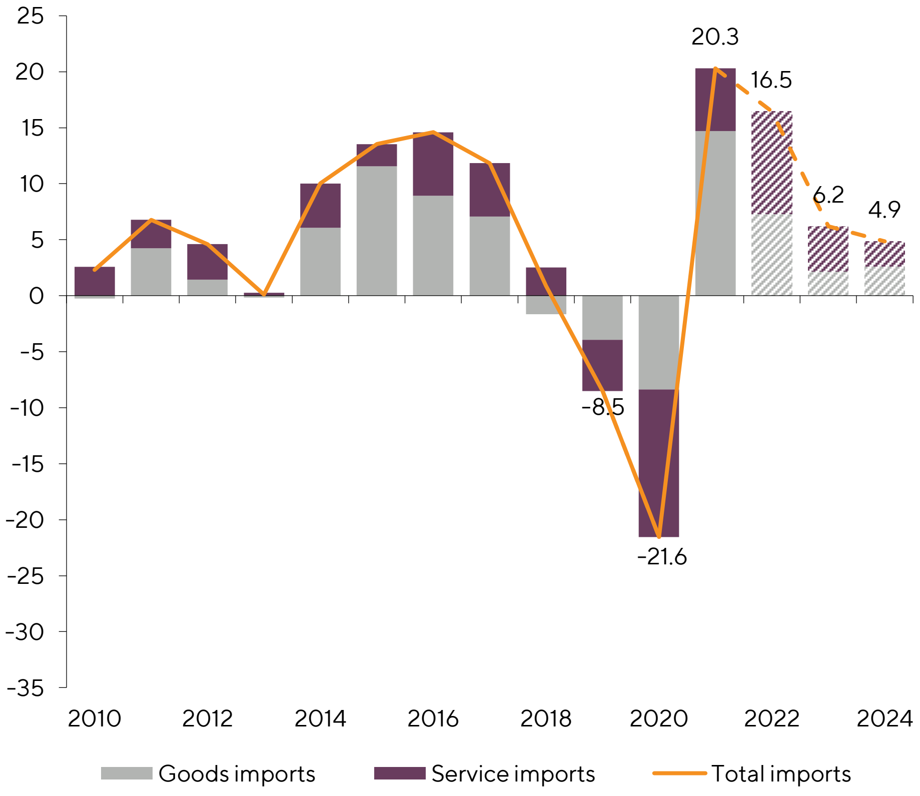
Exports and contributions from subcomponents

%



Imports and contributions from subcomponents

%



Sources: Statistics Iceland, ÍSB Research.

Current account balance set to improve over the forecast horizon

Increased share of exports in GDP growth spurs a recovery of external trade in coming quarters

Iceland ran a current account deficit in 2021, after a nine-year spate of surpluses. The deficit came to just over ISK 90bn, or 2.8% of GDP. It breaks down into a deficit of ISK 164bn on goods trade and a deficit of ISK 33bn on secondary income, partially offset by a primary income surplus of ISK 12bn and a services account surplus of ISK 95bn.

Last year's deficit reflects the fact that domestic demand picked up sooner than exports in the wake of the pandemic. Export growth therefore did not compensate fully for imports, owing to growth in consumption, investment, and the need for export-related inputs.

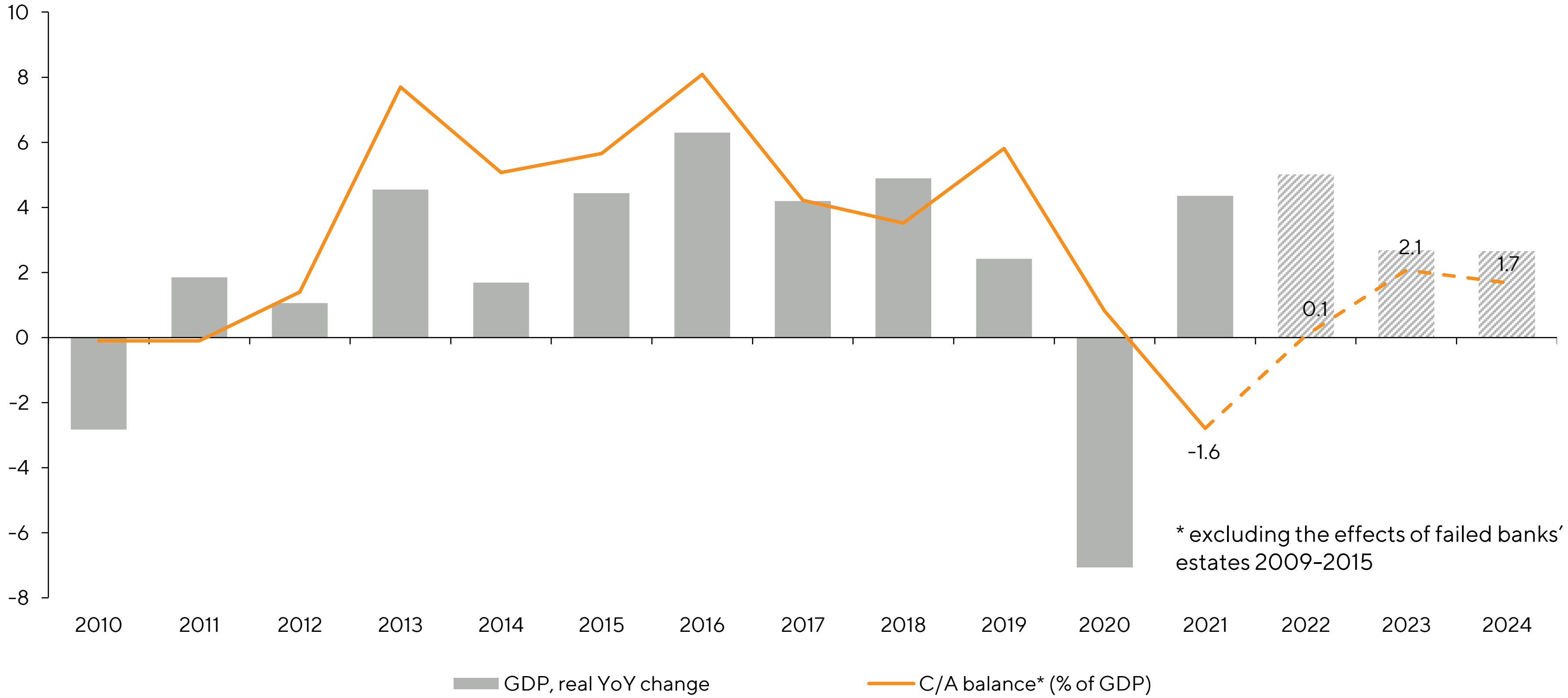
For 2022, though, the outlook is for the current account to be in balance. Vastly increased export revenues will offset growth in import-related expense over the course of the year, as export growth gains pace in tandem with slower growth in domestic demand. It helps that the price of Iceland's leading exported goods – aluminium and marine products – has risen steeply in the recent term, offsetting higher foreign prices of fuel, commodities, food, and other imported goods.

In the latter half of the forecast horizon, we expect a current account surplus of around 2% of GDP in both 2023 and 2024. This is supported by increased imports and an improvement in terms of trade, whereas a higher real exchange rate will offset it further ahead.

Iceland's net external assets currently total just over 4/10 of GDP. This could improve even further during the forecast horizon, although the outlook for external trade is more ambiguous than we had previously assumed and we now project a smaller current account surplus in than in previous forecasts.

Current account balance and GDP growth

% of GDP and %



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

Investment growth loses pace after a growth spurt

Residential investment to take over from business investment as the driver of growth

After a two-year contraction, investment spiked in 2021, with growth measuring just under 14% overall, its fastest pace in five years.

Business investment growth was extremely strong, and public investment grew handsomely as well, while residential investment shrank by over 4%.

The investment-to-GDP ratio therefore rose by leaps and bounds, reaching 22.9%, its highest in 13 years.

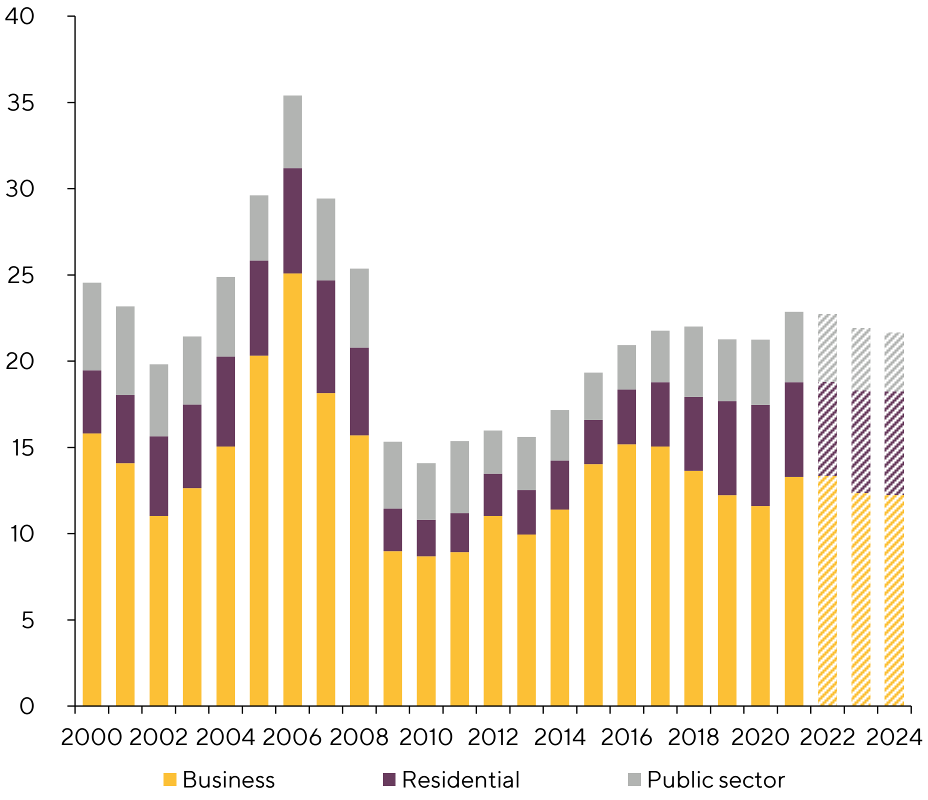
According to surveys, import data, and other indicators, the outlook is for relatively robust growth in business investment in 2022. Residential investment will also pick up again after contracting in 2021. Properties in early stages of construction have increased markedly in number, according to the Federation of Icelandic Industries' tally, and demand for new homes is strong.

In 2023, residential investment will be the sole driver of growth, as business investment looks set to contract because of rising interest rates and bleaker expectations about firms' operating environment. The final year of the forecast horizon will see moderate growth in private sector investment coupled with a contraction in public investment.

We forecast that total investment will grow by over 7% in 2022, less than 1% in 2023, and nearly 3% in 2024. The investment-to-GDP ratio will therefore taper off gradually, although investment will be relatively strong in historical context.

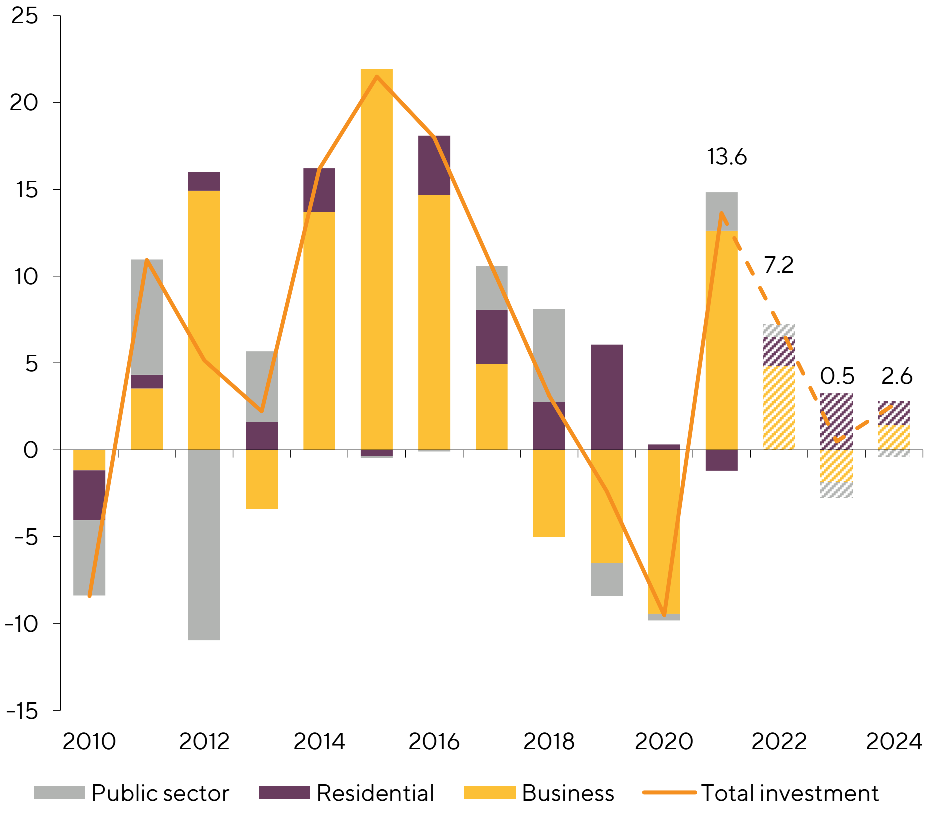
Investment

% of GDP



Investment, real change, and contribution of subcomponents

%



Sources: Statistics Iceland, ÍSB Research.

Corporate expectations have sagged again

The ambiguous outlook for firms' operating environment could cut into planned investment over time

After contracting by 30% in 2018-2020, business investment made a sudden but welcome turnaround in 2021.

During the year, total business investment grew by over 23% year-on-year. General investment excluding aircraft, ships, and energy-intensive industry grew by nearly a fifth.

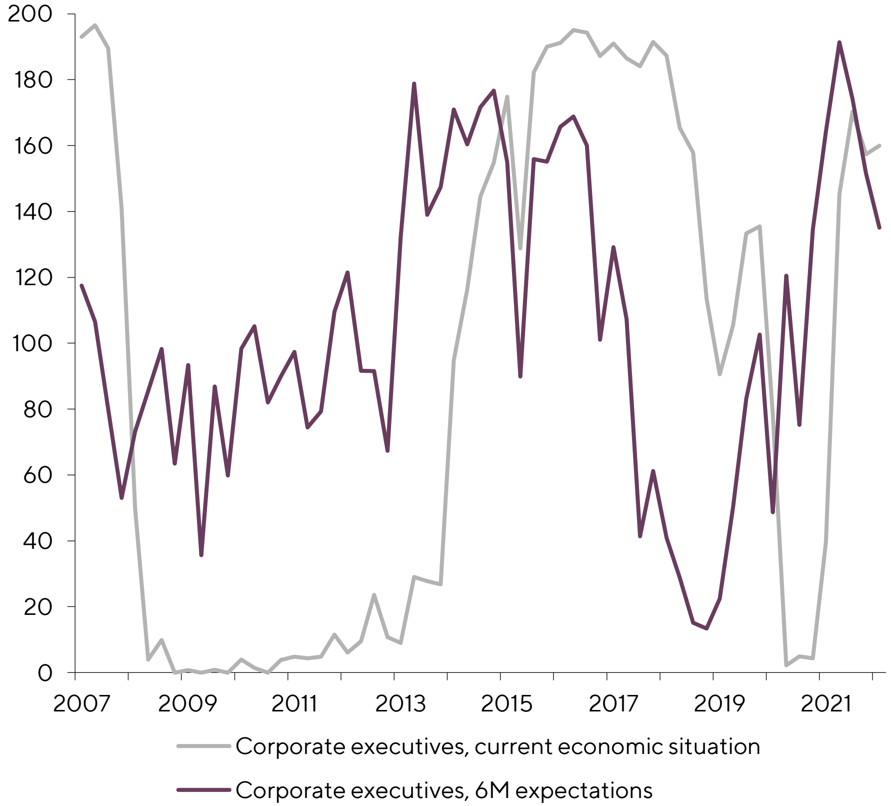
Corporate executives' expectations about near-term economic conditions rose swiftly after plunging at the end of the 2010s, reaching a historical high in mid-2021. The assessment of the current situation followed suit: a sizeable majority considered conditions positive in Q1/2022, although the Ukraine war dampened expectations again, according to the Gallup survey conducted for the CBI and the Confederation of Icelandic Employers.

There seems to be a fairly strong correlation between corporate sentiment and subsequent growth (positive or negative) in business investment. Widespread optimism about economic developments and prospects is therefore a good sign of a high investment level in coming quarters, but by the same token, dwindling optimism in the last measurements may indicate weaker growth further ahead.

Gallup's measurements of corporate expectations therefore support our opinion that business investment will grow markedly in the near future and then lose pace later in the forecast horizon.

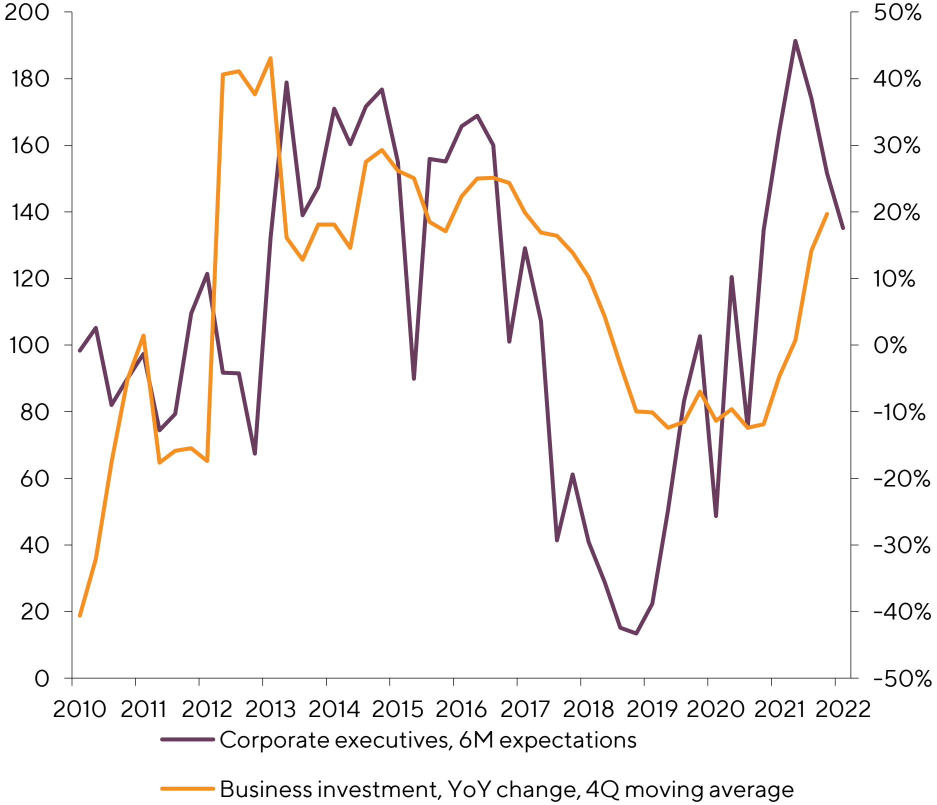
Expectations of executives from Iceland's 400 largest firms

Index



Executives' expectations and business investment

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



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

Continued strong demand pressures in the housing market

The record number of new properties put on the market in recent years has not satisfied demand

Before the COVID-19 pandemic struck, the housing market had rebalanced after the surge in prices in 2016 and 2017. At the beginning of the pandemic, prices rose in line with real wages, but in 2021 real house prices shot up more than 10%, far outpacing real incomes.

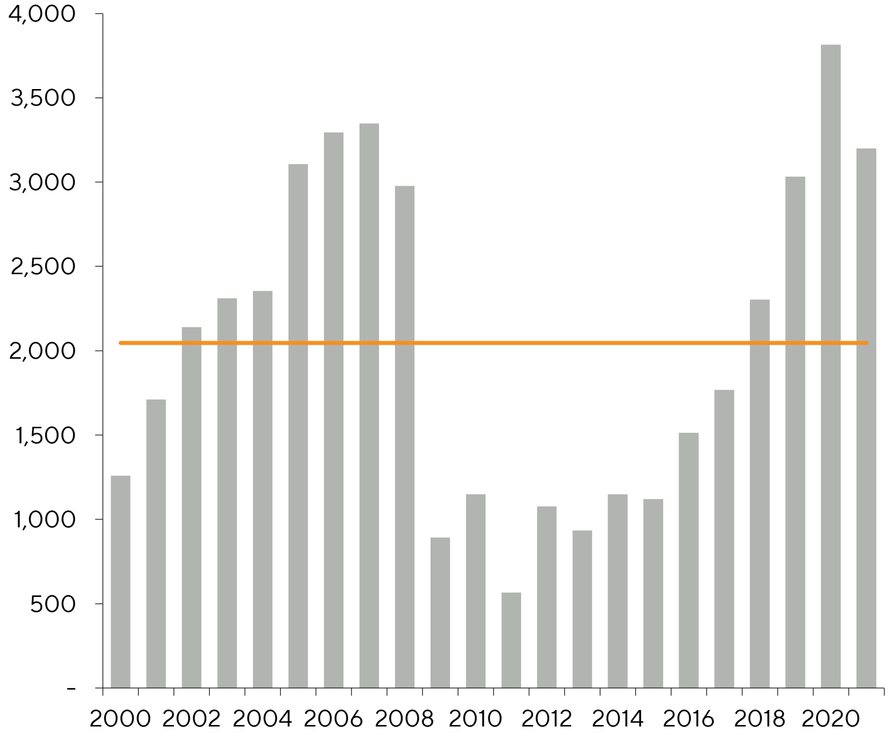
A favourable lending environment and households' sound financial position were the main reasons demand grew as fast as it did. This is not a uniquely Icelandic phenomenon, though, as most neighbouring countries saw house prices soar during the pandemic.

Clearly, not enough homes have been built to satisfy the brisk demand currently in evidence, but it takes time to respond to changes in expected demand and build new properties. Even though supply has not kept pace with demand, a large number of properties have been built in the past two years, according to data from SI. A record 3,800 new homes were put on the market in 2020, followed by 3,200 in 2021 – a slowdown between years but still above the recent average.

Clearly, the housing market suffers from severe supply-demand mismatches at present. Actually, it can be said that the market has been emptied of available homes: the number of advertised flats has fallen by nearly 70% since the onset of the pandemic and is now at an all-time low.

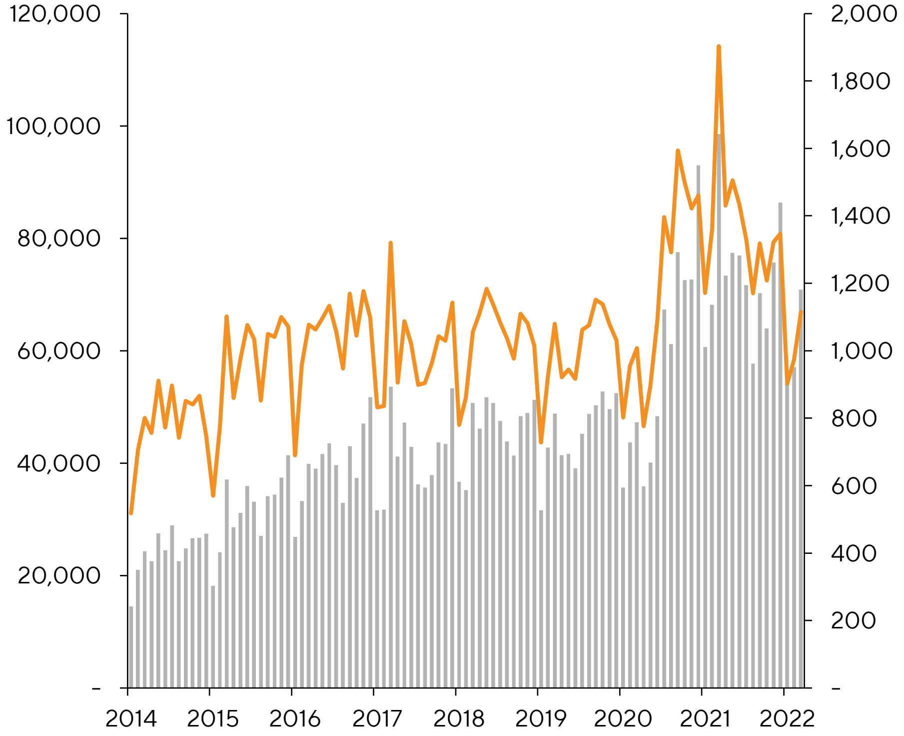
There are no signs of declining demand as yet: the average time-to-sale is at a historical low, and a large share of homes sell at a premium on the asking price.

Number of new properties nationwide



Capital area housing market activity

Turnover in ISKbn



Sources: Registers Iceland, Statistics Iceland, ÍSB Research.

House price inflation set to ease later in 2022

We expect prices to keep rising until supply increases

House prices are now very high in historical terms and have deviated sharply from fundamentals. This gives cause for genuine concern, and the CBI has adopted measures designed to contain price hikes and ensure that borrowers do not become overleveraged; i.e., raising the key interest rate and tightening rules capping loan-to-value (LTV) ratios and debt service-to-income (DSTI) ratios on new mortgages.

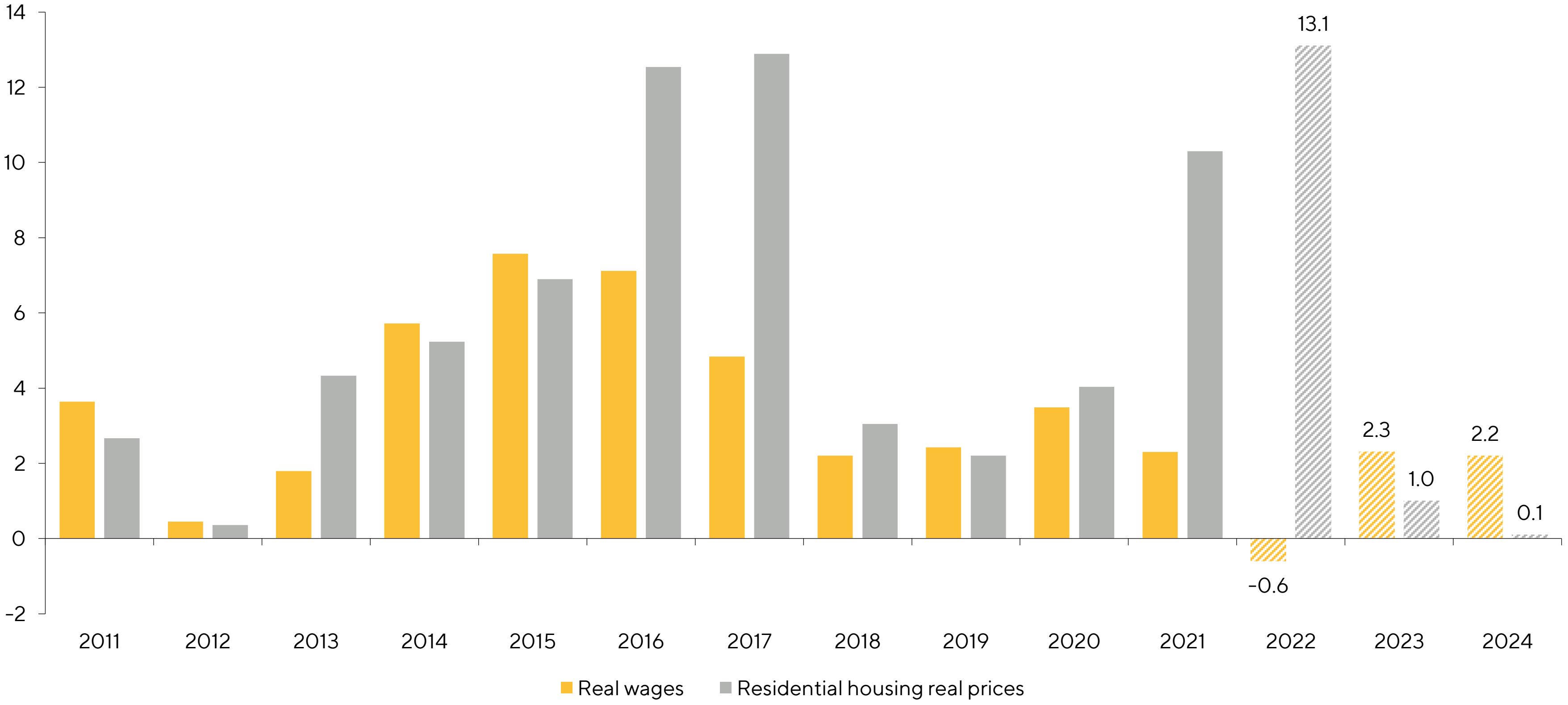
Thus far, these measures have not had the intended effect on the housing market, and we are convinced that increased supply will also be needed to materially affect house prices.

According to a recent tally carried out by the Federation of Icelandic Industries and the Housing and Construction Authority, over 7,000 new homes are under construction nationwide, some 5,000 of them in greater Reykjavík. It is hoped that a considerable number of these new properties will be put on the market later this year, and that this will be enough to satisfy pent-up demand plus demographic developments.

Nominal house prices have already risen by 8% in the first four months of 2022. We believe the conditions are in place for a continued increase in coming months, but with larger supply and declining demand we expect house price inflation to ease as the year progresses.

We forecast that real house prices will rise by 13% this year and 1% in 2023. There is a precedent for an abrupt slowdown in house price inflation following a surge – most recently in 2018, after the housing boom in the two years beforehand. For 2024, we project that real house prices will remain flat and that the market will have rebalanced by then.

Real house prices and real wages
% change over the year



Sources: Statistics Iceland, ÍSB Research.

Unemployment continues to fall

A growing labour shortage will probably be one of the greatest challenges

Unemployment has fallen swiftly after peaking in January 2021. Registered unemployment averaged 5.1% in Q1/2022 and looks set to fall even further in coming months.

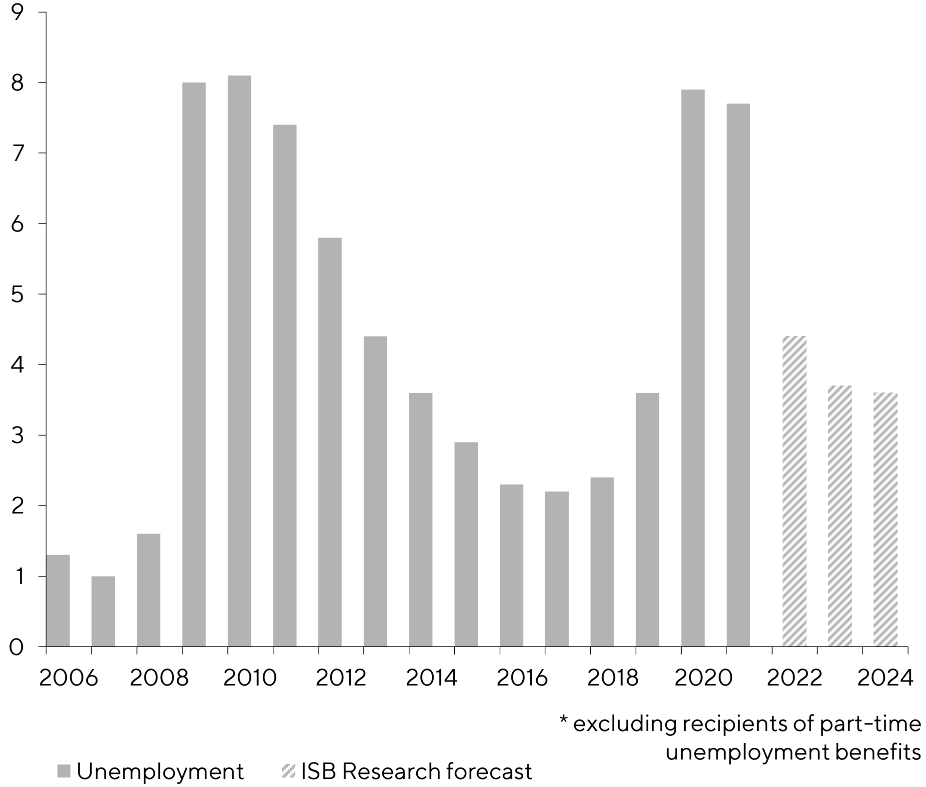
Most of the Government's pandemic support measures have expired by now, but unemployment has kept falling nevertheless. The rapid economic recovery in 2021 has fostered job growth, causing the jobless rate to fall as rapidly as it indeed has. We forecast average unemployment in 2022 at 4.4%.

According to the Gallup survey carried out among Iceland's 400 largest firms for the CBI and the Confederation of Icelandic Employers, roughly 40% of company executives consider themselves short-staffed, most of them in construction and tourism. Job numbers are now higher than before the pandemic, although the composition of jobs has changed somewhat. At present, tourism and related sectors employ 20% fewer workers than before the pandemic; thus it will clearly be a challenge for these companies to recruit staff in the coming term. Foreign nationals have been prominent among employees in these sectors, and it appears that labour immigration will continue as the economy recovers.

We expect unemployment to keep falling over the forecast horizon, and in fact, our forecast is broadly unchanged since January. Labour demand has been strong in the recent past, and the outlook is for a growing shortage of workers. We expect unemployment to average 3.7% in 2023 and 3.6% in 2024, which will bring it back to the 2019 level.

Unemployment as a share of the labour force*

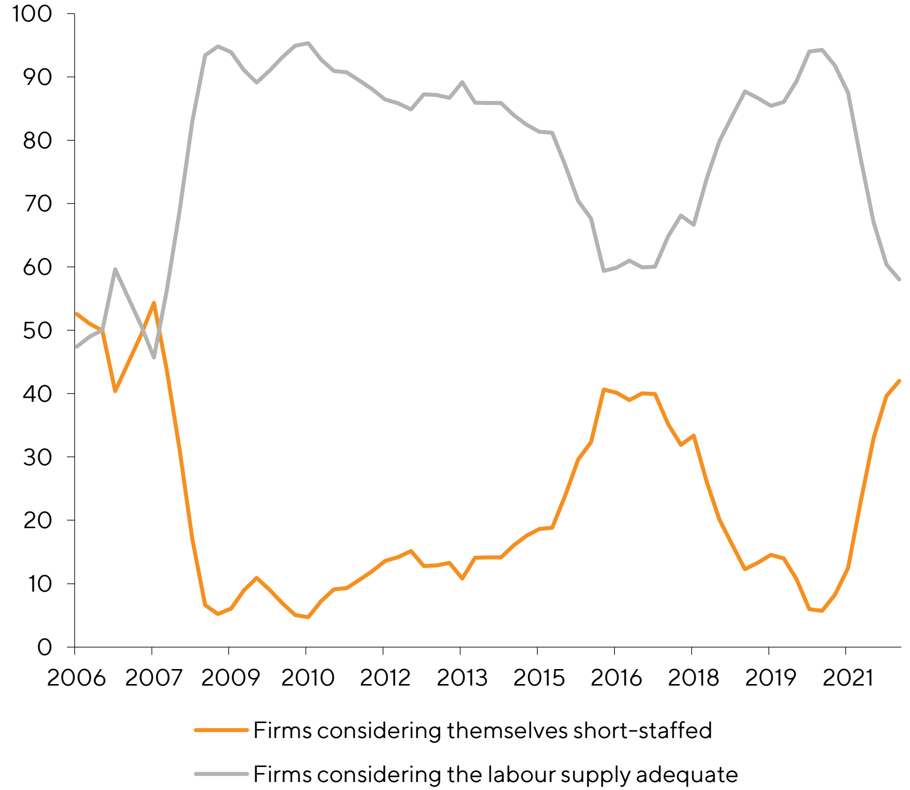
%



* excluding recipients of part-time unemployment benefits

Labour supply according to corporate executives

%



Sources: Central Bank of Iceland, ÍSB Research.

Inflation erodes household purchasing power

Private consumption growth will be weaker as a result

Private consumption rallied last year, after contracting by 3% in 2020. It grew by 7.6% YoY in 2021 and, in real terms, was 4.4% more than in 2019. It can be said, then, that Icelanders have more than recovered their pre-pandemic consumption level.

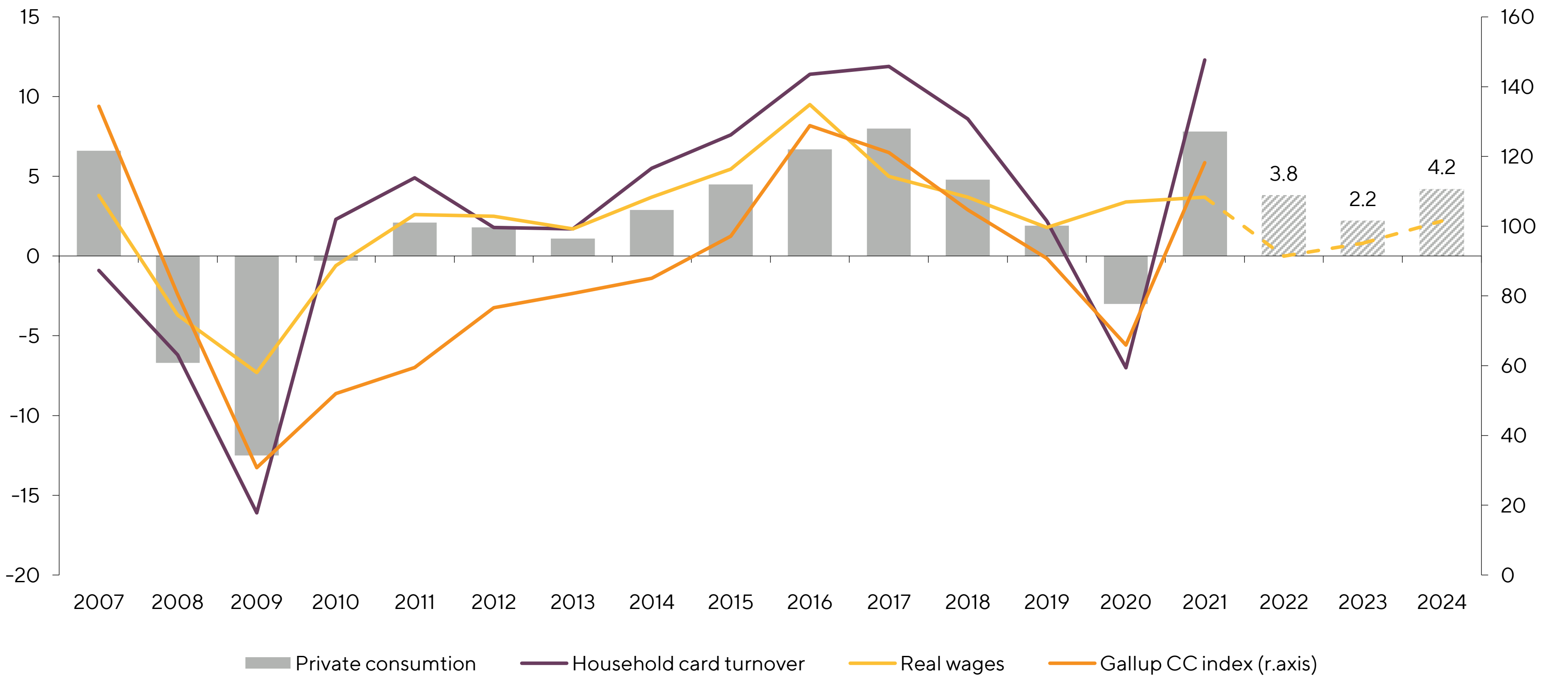
There are signs that private consumption grew briskly in Q1/2022. Payment card turnover was up markedly, borne by turnover abroad, and new motor vehicle sales were at their strongest since 2018.

The outlook has now changed, however, and private consumption growth looks set to lose momentum as the year advances. Households are not as optimistic as before, and inflation will very probably erode their purchasing power in the coming term. Real wages actually rose throughout the pandemic, but the current high inflation looks set to change things. We expect real wages to hold steady this year and then grow slowly for the remaining two years of the forecast horizon.

Households are well positioned, though, and have accumulated significant savings, which will come in handy and will probably help sustain private consumption growth for the rest of this year. We forecast private consumption growth at 4% in 2022 and 2% in 2023, as households will have drawn down their savings by then. For 2024, we project that private consumption growth will measure just over 4%, in tandem with declining inflation.

Private consumption and related indicators

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



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

ISK likely to appreciate further

CA surplus and inflows for securities purchases offset pension funds' foreign investments

The ISK appreciated by nearly 3% in 2021, mostly 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.

In 2022 through end-April, the ISK appreciated by over 5%, on average, against major currencies. Increased position-taking with the ISK via forward contracts probably played an important role in the appreciation. Consequently, part of the appreciation that would otherwise accompany FX inflows later this year has already materialised. As in previous years, the CBI intervened in the market to mitigate short-term volatility, with net FX purchases totalling just over EUR 160m in the first four months of 2022.

We expect the ISK to strengthen still further over time. A surplus on the current account is on the horizon further ahead, interest rates are on the rise, Iceland's IIP is strong, the growth outlook is reasonably good, and non-residents' securities holdings are relatively limited in historical terms.

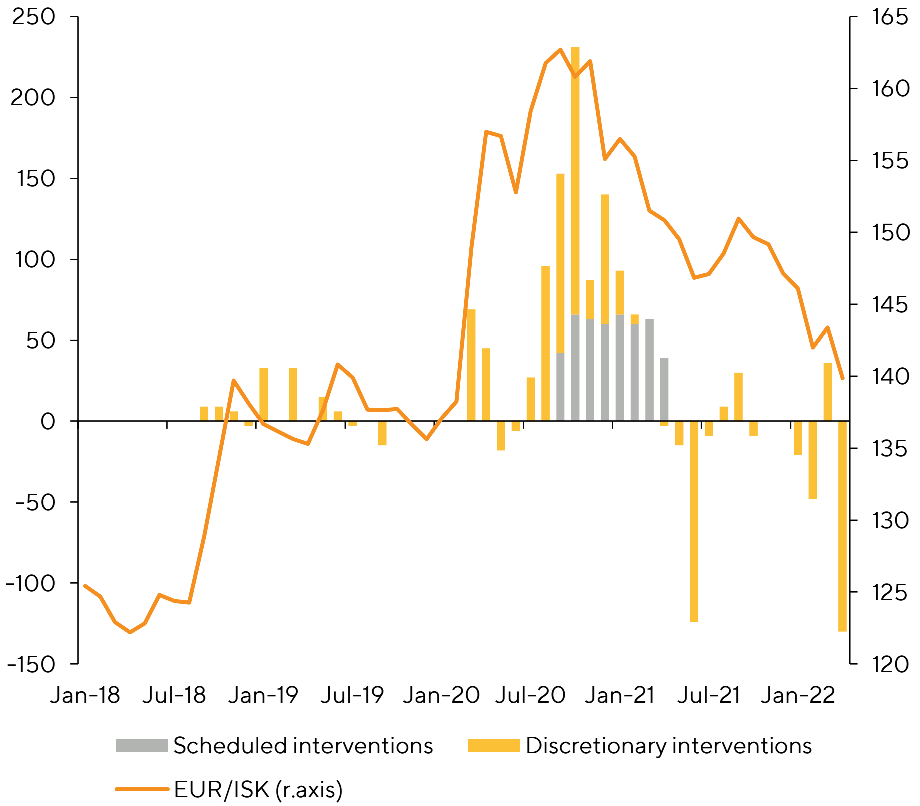
On the other hand, the pension funds are likely to invest heavily abroad in the coming term, and it is possible that the CBI will add to its FX reserves if the ISK strengthens quickly over any given period.

It is impossible to pinpoint how the appreciation will materialise, but our forecast assumes that the ISK will be about 5% stronger at the end of the forecast horizon than at the end of April 2022.

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

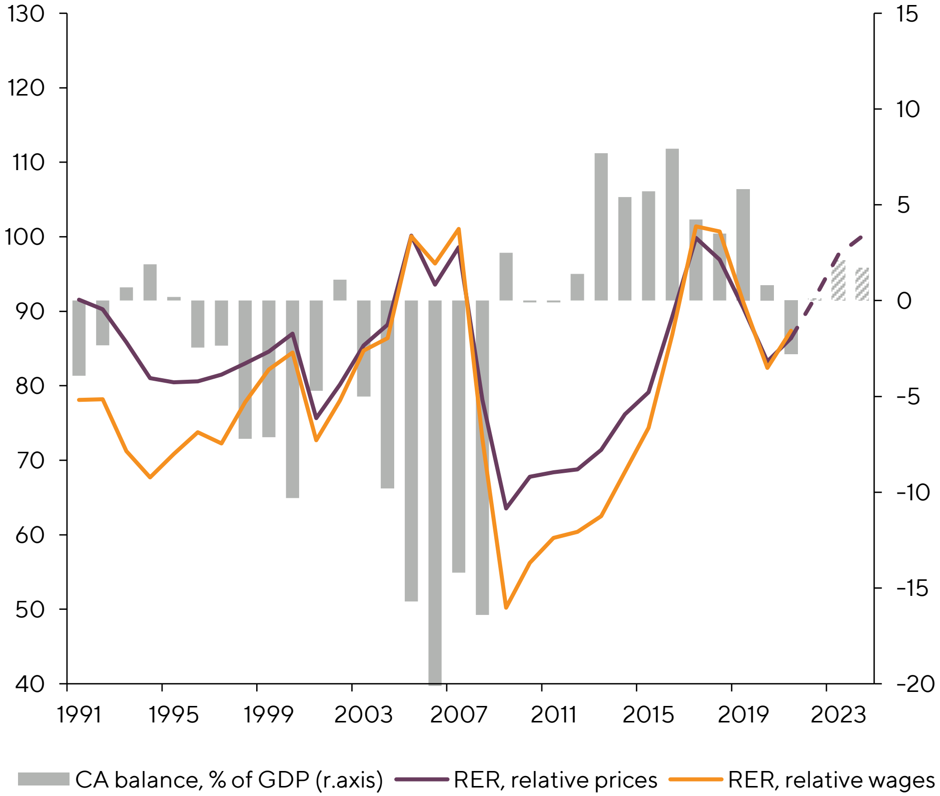
ISK exchange rate and CBI FX market intervention

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 yet to peak

Inflation is unlikely to fall in earnest before mid-2023

Inflation started rising in mid-2020, soon after the pandemic struck, and hit a twelve-year high of 7.2% in April this year.

Most (if not all) analysts in Iceland and abroad have underforecast inflation recently, and it is clear that inflation is far more persistent than previously assumed. It has proven difficult to forecast about pandemic-related supply chain issues, and the war in Ukraine, which took most observers by surprise, has pushed many commodity prices sharply upwards.

The composition of inflation has changed quite a bit recently. Although the housing component is the main driver at present, the contribution from imported goods has grown markedly. The contribution from domestic goods has also grown in the recent term, mainly as a result of imported inflation, which raises the price of foreign inputs used for domestic manufacturing.

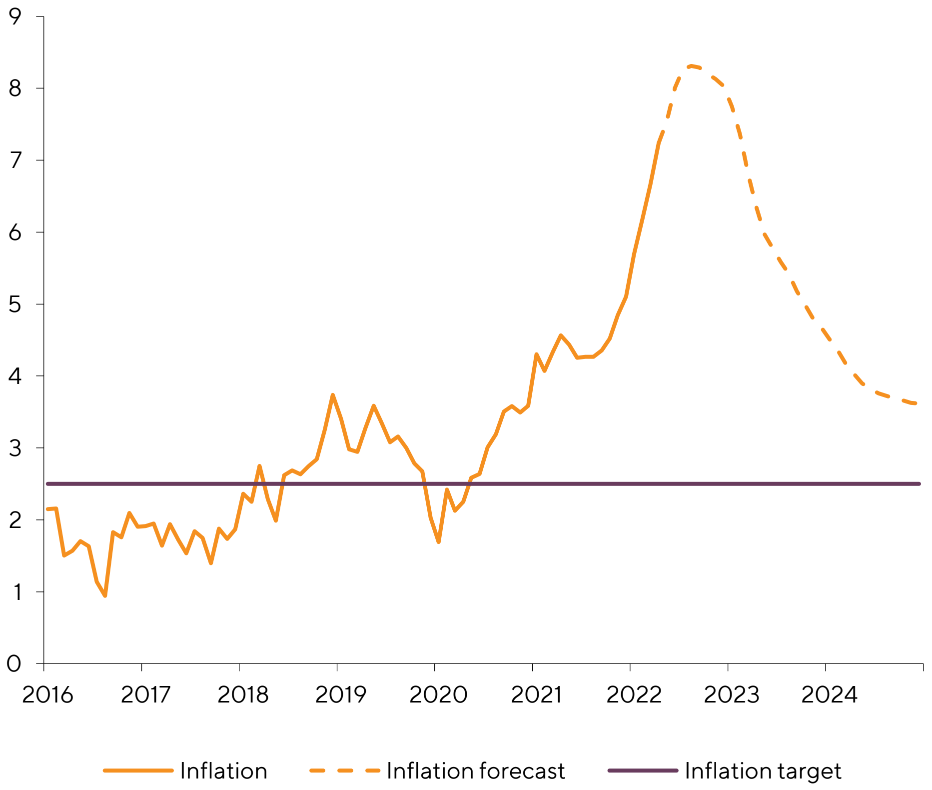
At present, the main catalysts of inflation are rising house prices and increased imported inflation. These items do not look set to decline in price in coming months, and we therefore assume that inflation will keep rising, peaking at 8.4% in late summer.

We do not expect a decisive drop in inflation before mid-2023. We forecast inflation at 7.6% in 2022, 5.9% in 2023, and 3.9% in 2024. If these projections materialise, inflation will remain above the CBI's target for the entire forecast horizon.

It is extremely important for developments in inflation – and one of the key assumptions underlying our long-term forecast – that house price inflation should begin to ease later this year. If they do, the slower rise in house prices will eventually offset imported inflation. Another important assumption behind our forecast is that the wage negotiations set for late this year do not

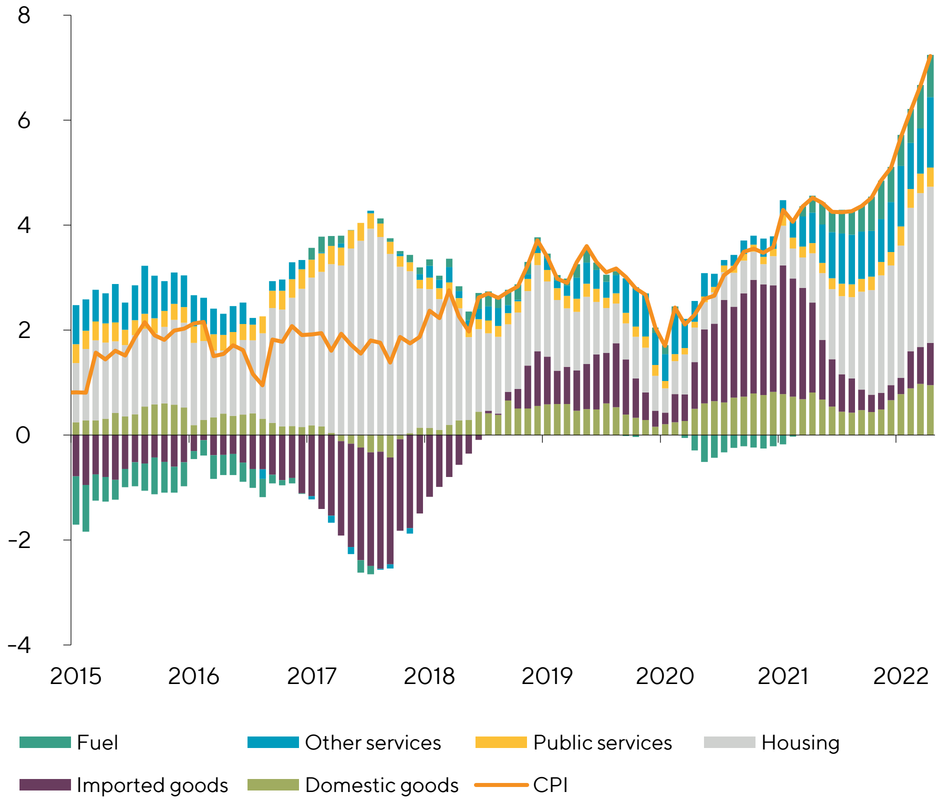
Inflation and the CBI inflation target

%



Inflation by type and source

%



Sources: Statistics Iceland, ÍSB Research.

Policy rate to rise rapidly in 2022

Gradual easing further ahead; equilibrium rate in sight by the end of the 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 3.75%, after being raised by 3 percentage points in the past year.

The real policy rate is still negative by all measures, however. Based on recent CBI statements and actions, steep rate hikes can be expected in the near future, so as to rein inflation in, keep inflation expectations under wraps, and push the real policy rate above zero.

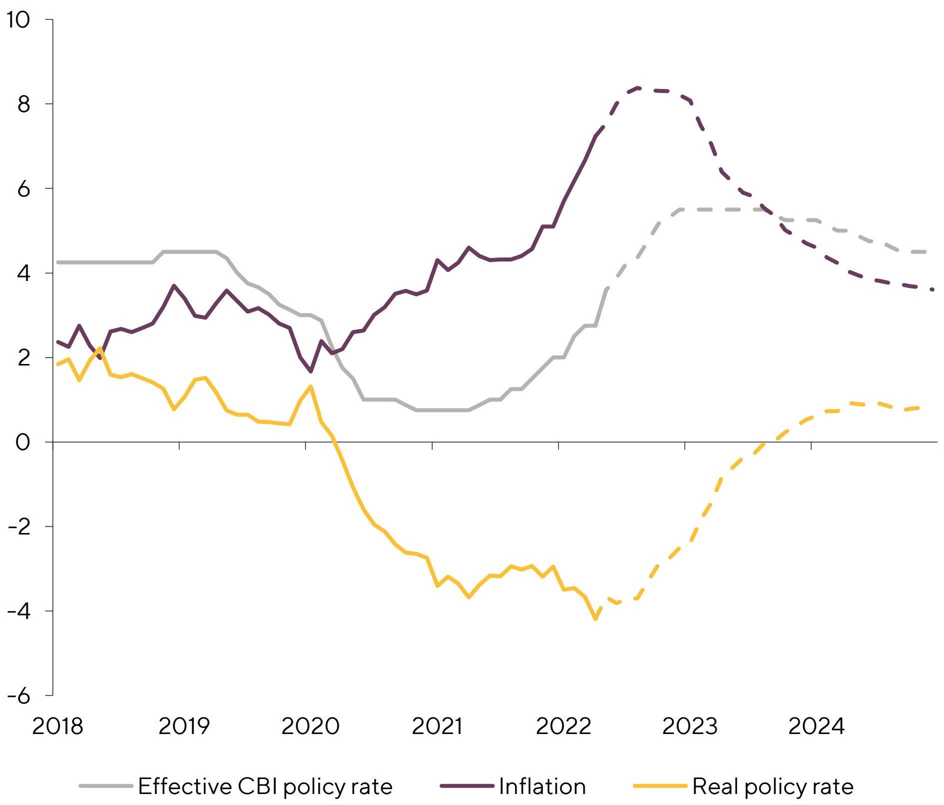
We forecast that the policy rate will continue to rise swiftly, peaking at 5-6% by end-2022. Provided that inflation and demand pressures have begun to ease, we expect the policy rate to remain unchanged well into next year and then start to fall again in H2/2023. Thereafter, we expect gradual easing towards the equilibrium real rate, which is probably 1-1.5%. The nominal policy rate could therefore be around 4.5% at the end of the forecast horizon, although the situation is highly uncertain further ahead.

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 5.3%, and real rates are around 1.0%. Long-term nominal rates have risen sharply in 2022 to date, but real rates are roughly where they were at the beginning of the year, fluctuations notwithstanding.

If the policy rate develops in line with our forecast, we think long-term rates will rise somewhat in coming quarters. Interest rates will then fall slowly and steadily, and we expect long-term rates to approach equilibrium, which we estimate at around 4.5% for nominal rates and somewhere near 1.3% for the real rate.

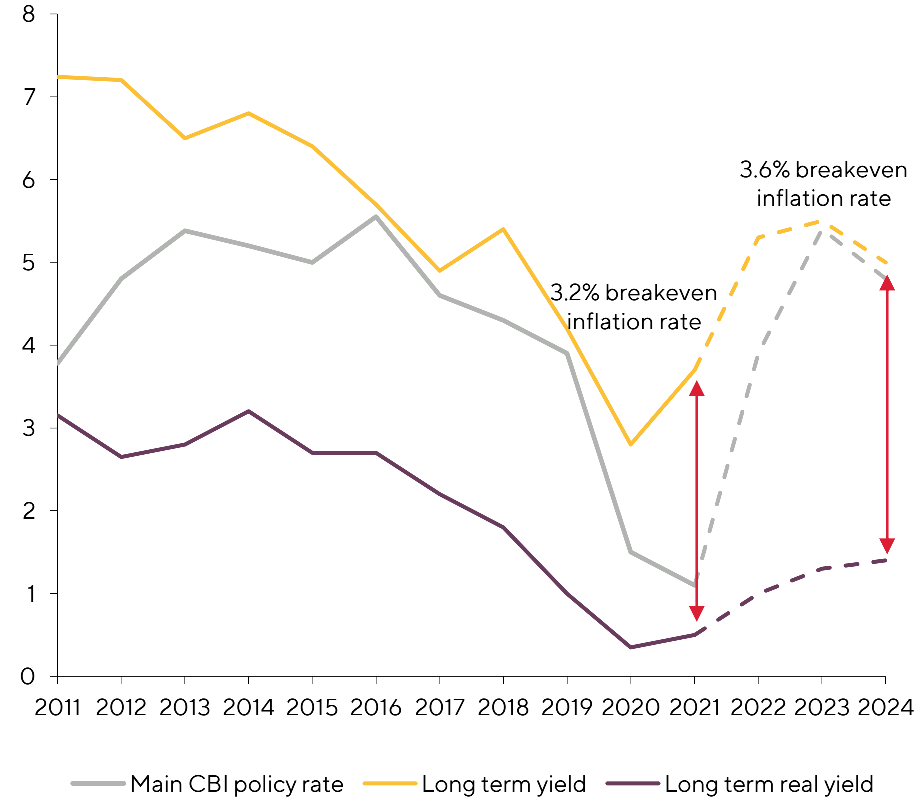
Policy rate and inflation

%



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 2021 in ISK m	2021	Forecast 2022	Forecast 2023	Forecast 2024
Private consumption	1,671,451	7.6	3.8	2.2	4.2
Public consumption	886,683	1.7	2.0	1.6	1.6
Investment	739,031	13.6	7.2	0.5	2.6
– business investment	429,398	23.1	8.3	-3.2	2.6
– residential investment	177,385	-4.4	7.0	13.5	5.0
– public investment	132,248	12.4	4.0	-5.0	-2.5
Changes in inventories	4,655	0.1	0.0	0.0	0.0
Domestic demand, total	3,301,821	7.2	3.9	1.6	3.1
Exports of goods and services	1,232,685	12.4	20.0	8.7	3.8
– marine product exports	292,502	9.3	7.4	3.2	1.8
– aluminium products	284,434	1.4	2.0	1.5	1.0
– other goods exports	187,020	5.5	3.0	2.0	2.0
– services exports	468,730	20.3	45.4	16.1	6.0
Imports of goods and services	1,301,505	20.3	16.5	6.2	4.9
– goods imports	927,608	21.0	10.2	3.2	4.0
– services imports	373,897	18.6	31.9	12.4	6.6
Gross domestic product	**3,233,001**	**4.3**	**5.0**	**2.7**	**2.6**

Macroeconomic forecast summarised

Other economic variables

% of GDP	2021	Forecast 2022	Forecast 2023	Forecast 2024
Investment	22.9	22.8	21.8	21.6
Current account balance	-2.8	0.1	2.1	1.7
Trade balance	-2.1	0.0	2.0	1.6
% change over the year				
Consumer prices	5.1	8.0	4.7	3.6
Wages and salaries	7.5	7.4	7.1	5.9
House prices	15.9	22.2	5.7	3.7
Real wages	2.3	-0.6	2.3	2.2
Change between annual averages (%)				
Real exchange rate in terms of relative consumer prices	4.6	6.2	6.3	2.5
Annual average (%)				
Unemployment	7.7	4.4	3.7	3.6
Trade-weighted exchange rate index	196.1	187.3	181.4	180.0
CBI policy rate (7-day term deposits)	1.1	3.9	5.4	4.8
Long-term nominal rate (RIKB 31)	3.7	5.3	5.5	5.0
Long-term real rate (RIKS 30)	0.5	1.0	1.3	1.4

Appendix

Economic scenarios for 2022-2024

Methodology for scenario preparation

The economic outlook for Iceland, like the global outlook, has fluctuated widely since we issued our macroeconomic forecast in January. In particular, developments in the COVID-19 pandemic and Russia's invasion of Ukraine have changed the outlook in the interim. Furthermore, there is considerable uncertainty about the results of private sector wage negotiations later this year. Domestic economic developments in the coming term will be affected in no small part by whether or not wage settlements entail a smooth landing featuring wage rises in line with moderate inflation. Circumstances at the time the wage negotiations begin in earnest will also depend not least on the aforementioned two factors.

Because of this, we decided to supplement our baseline forecast, which we consider likely to represent a balance between optimism and pessimism about developments further ahead, with two alternative scenarios:

An optimistic scenario, which we consider to have a roughly 10% probability of materialising or being exceeded

A pessimistic scenario, which we consider to have a roughly 10% probability of materialising or being exceeded

The two alternative scenarios reflect developments that we consider realistic but much less likely to materialise than those in the baseline scenario.

This is a subjective assessment and not a statistical one, and it should be borne in mind that the interactions among the factors involved – pandemic, war, and wage settlements – could develop differently than is described here; for instance, some could develop more favourably, while others more closely resemble the pessimistic scenario.

It should be noted that the scenarios, particularly the pessimistic one, are not conceived as stress scenarios. It is possible to sketch out an even more unfavourable path than is done here, but by the same token, such a scenario is less likely to materialise. The scenarios are intended to create a framework around the developments that we consider most likely to occur during the year. In broad terms, we consider there to be an 80% probability that actual events will be neither worse than the pessimistic scenario nor more favourable than the optimistic scenario.

Optimistic scenario

Key assumptions

COVID-19

- The pandemic continues to taper off worldwide, and its impact on global manufacturing and supply chains, as well as on economic activity in Asia and elsewhere, subsides in coming months.

The war in Ukraine

- Peace returns to Ukraine in Q2/2022. Economic activity and manufacturing in Ukraine gradually normalises in coming quarters, and sanctions on Russia and Belarus are lifted in stages over the next few years.

Wage agreements

- Private sector negotiations result in wage agreements consistent with the CBI's inflation target plus productivity growth in coming years. Public sector agreements reached thereafter produce similar results.

Commodity prices

- Global supply chain bottlenecks are resolved relatively quickly. The price of fuel, metals, food, and other goods therefore falls significantly once again.

Tourism

- The improved economic outlook and reduced global uncertainty lead to a rapid rise in appetite for travel to Iceland. Tourist numbers therefore increase faster than in the baseline.

Residential property market

- Lower input prices, modest wage inflation, and lower financing costs lead to a rapid increase in housing supply, and the market rebalances sooner in spite of strong demand.

Pessimistic scenario

Key assumptions

COVID-19

- A new variant of the virus spreads widely in Q3/2022, causing a resurgence in the pandemic around the world and affecting transcontinental supply chains and shipping.

The war in Ukraine

- The war resulting from Russia's invasion of Ukraine drags on, with a strong and persistent impact on the volume and price of goods such as fossil fuels, metals, fertiliser, and various foods.

Wage agreements

- Private sector wage negotiations are contentious and result in sizeable wage rises after heated disputes. The contracts set the tone for commensurate pay rises in the public sector.

Commodity prices

- Global supply shortages grow worse over the remainder of the year. The price of fossil fuels, metals, food, and other commodities rises further.

Tourism

- The protracted war in Ukraine and the persistent pandemic cause a setback in global appetite for travel. Tourist numbers increase far more slowly than in the baseline.

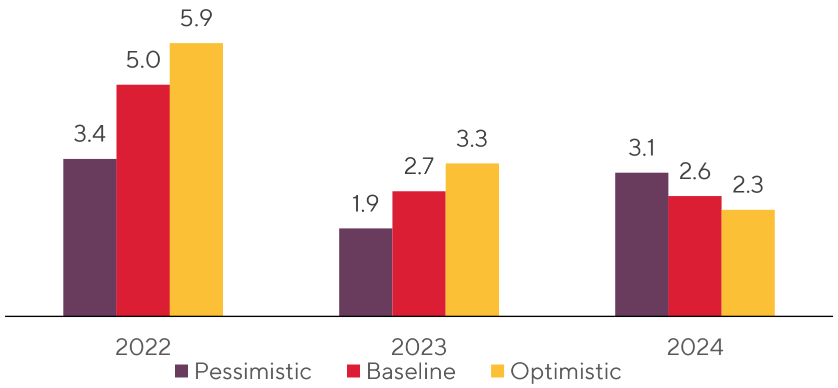
Residential property market

- The bleaker economic outlook and higher policy rate have a dampening effect on demand.
  The impact on housing supply is much stronger, however, owing to higher prices of construction inputs and higher financing and wage costs faced by contractors.

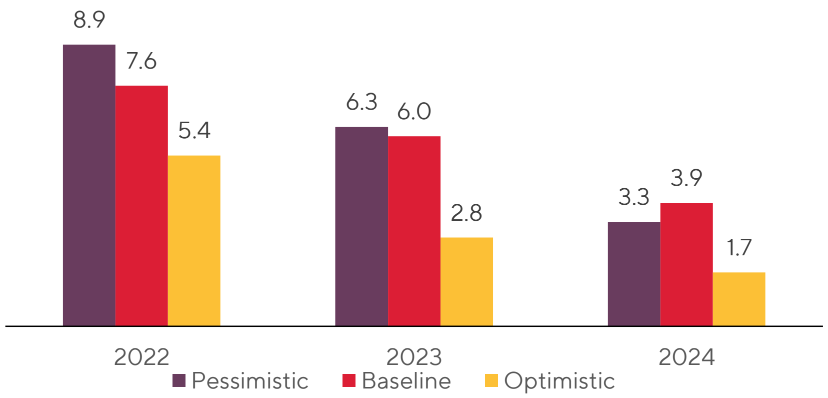
Comparison of key variables

Baseline forecast and scenarios

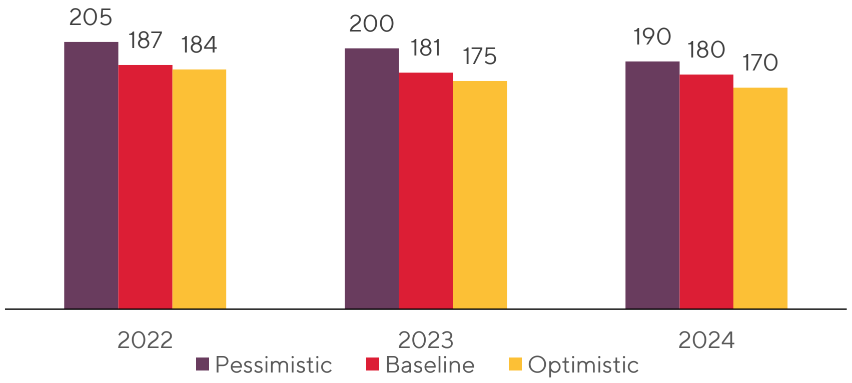
GDP growth, %



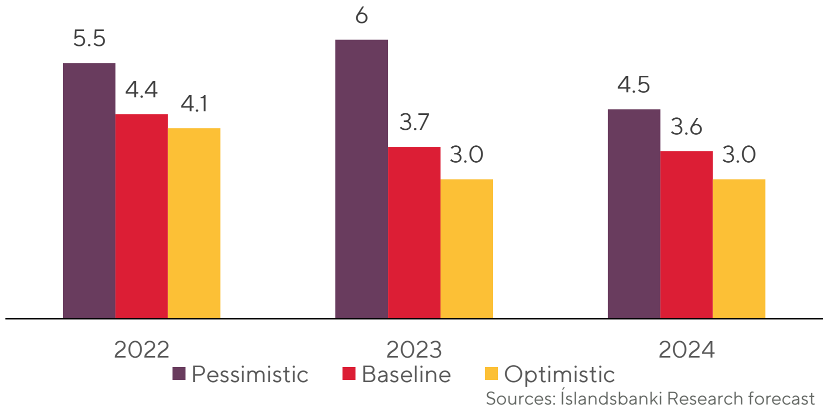
Inflation, %



Trade-weighted exchange rate index



Unemployment, % of labour force



Sources: Íslandsbanki Research forecast

Optimistic scenario

Key economic variables

	2021	2022	2023	2024
Number of tourists, thousands	688	1,700	2,100	2,300
Services exports, % change	20.3	59	17	5
Trade-weighted exchange rate index	196	184	175	170
Inflation, %	4.4	5.4	2.8	1.7
Unemployment, % of labour force	7.7	7.5	5.5	4.5
% change between years				
Private consumption	7.6	4.2	3.0	3.0
Public consumption	1.7	2.0	1.6	1.6
Investment	23.1	9	2.0	2.5
Domestic demand	7.2	4.5	2.9	2.5
Exports	12.4	25	9.5	3.3
Imports	20.3	20.5	8.3	3.9
Gross domestic product	4.3	5.9	3.3	2.3

Pessimistic scenario

Key economic variables

	2021	2022	2023	2024
Number of tourists, thousands	688	1,150	1,500	1,700
Services exports, % change	20.3	21	17	12
Trade-weighted exchange rate index	196	205	200	190
Inflation, %	4.4	8.9	6.3	3.3
Unemployment, % of labour force	7.7	5.5	6.0	4.5
% change between years				
Private consumption	7.6	2.5	1.0	4.0
Public consumption	1.7	2.0	1.6	1.6
Investment	23.1	7.5	-10.0	6.0
Domestic demand	7.2	3.1	-0.1	3.8
Exports	12.4	10.3	8.8	5.4
Imports	20.3	9.3	3.7	7.0
Gross domestic product	4.3	3.4	1.9	3.1

Legal disclaimer

This report is compiled by Islandsbanki Research of Islandsbanki hf.

The information in this report originates in domestic and international information and news networks that are deemed reliable. along with public information. and Islandsbanki Research's own processing and estimates at each time. The information has not been independently verified by Islandsbanki which therefore does not guarantee that the information is comprehensive and accurate. The views of the authors can change without notice and Islandsbanki holds no obligation to update. modify or amend this publication if assumptions change.

This publication is only published for informational purposes and shall therefore not be viewed as recommendation/advice to make or not make a particular investment or an offer to buy. sell or subscribe to specific financial instruments. Islandsbanki and its employees are not responsible for transactions that may be carried out based on information put forth in the report. Before making an investment decision. recipients are urged to seek expert advice and get well acquainted with the investments market and different investment alternatives. There are always financial risks related to investment activities. including risk due to international investments and fluctuations in the exchange rate of currencies. Investors' investment objectives and financial position vary. Past performance does not indicate nor guarantee future performance of an investment

The research report and other information received from Islandsbanki are meant for private use only. The materials may not be copied. quote or distributed. in part or in whole. without written permission from Islandsbanki.

This report is a short compilation and should not be considered to contain all available information on the subject it discusses.

Supervisory body: The Financial Supervisory Authority of Iceland (www.fme.is).

UNITED STATES

This report or copies of it must not be distributed in the United States or to recipients who are citizens of the United States against restrictions stated in the United States legislation. Distributing the report in the United States might be seen as a breach of these laws.

CANADA

The information provided in this publication is not intended to be distributed or circulated in any manner in Canada and therefore should not be construed as any kind of financial recommendation or advice provided within the meaning of Canadian securities laws.

OTHER COUNTRIES

Laws and regulations of other countries may also restrict the distribution of this report.

Further information regarding material from Islandsbanki Research can be accessed on the following website: http://www.islandsbanki.is.

Publisher

Íslandsbanki Research

greining@islandsbanki.is

Publication date: 18 May 2022