# Macroeconomic forecast 2020-2022

29 September 2020 | Íslandsbanki Research

## Strong recovery after a temporary deep shock

### Better times ahead if the virus loses steam

**GDP growth**

- The macroeconomic forecast assumes that a COVID vaccine will be in broad distribution before summer 2021
- GDP to contract 8.6% in 2020
- 3.1% growth in 2021
- 4.7% growth in 2022

### Strong export growth further ahead

**External trade**

- Goods and services exports shrink by 27.2% in 2020 but grow by 10.1% in 2021
- Imports contract by 16.3% in 2020
- Current account deficit 1.1% of GDP in 2020
- 0.4% current account surplus in 2021 and 1.4% surplus in 2022

### Inflation falls as the days grow longer

**Inflation**

- ISK depreciation showed in prices at the end of summer
- Inflation to average 2.7% in 2020 and 2021
- 1.9% inflation in 2022
- Greater credibility of monetary policy helps contain inflation expectations

### Chilly labour market ahead

**Labour market**

- Tourism recovery will determine largely how fast unemployment declines
- Unemployment to average 7.8% in 2020
- 7.6% in 2021
- 4.7% in 2022

### Interest rates may have bottomed out

**Interest rates**

- Policy rate down 3 percentage points YTD, to an all-time low
- Policy rate steady at 1% well into 2021, then rising gradually as economy recovers
- Long-term rates remain lower than in recent decades

### ISK appreciation likely as the economy picks up

**The ISK**

- 15% depreciation in 2020 is in line with previous depreciation episodes
- Strong action by the CBI supports the exchange rate
- Some appreciation likely as export sector begins to recover

## Executive summary

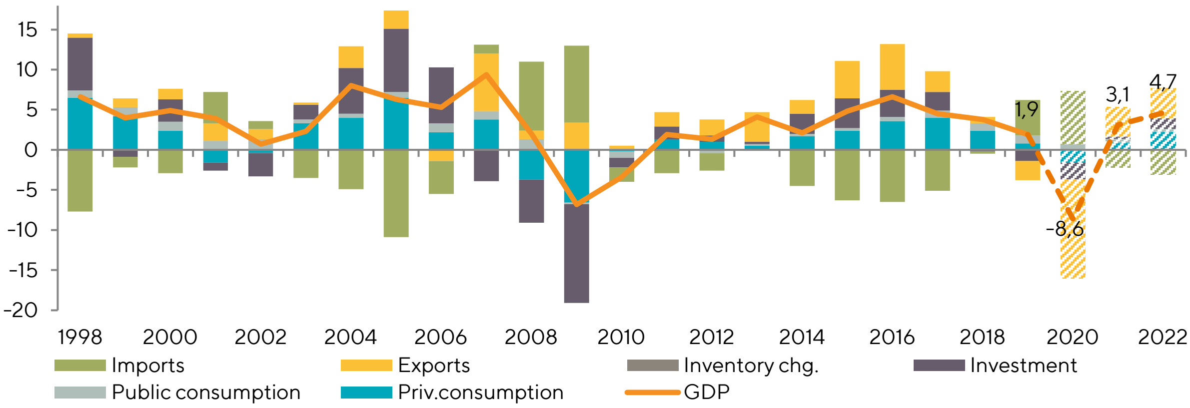
### Strong recovery after a temporary deep shock

In the six months or so since the COVID-19 pandemic began raging across the globe, the short-term economic outlook has been turned on its head. Fortunately, however, the first effects of the pandemic on the Icelandic economy appear to be somewhat milder than we projected in May. In that forecast, we projected that GDP would shrink by 9.2% this year, but now we expect a contraction of 8.6%.

About two-thirds of this year's contraction stems from a severe shock to external trade, while the other third is due to a contraction in domestic demand.

Private consumption and investment are set to contract sharply this year, albeit offset to a degree by public consumption and investment.

**GDP, YoY change and contribution of main subitems (%)**




Source: Statistics Iceland and ISB Research

In 2021, we expect a return to positive territory, with GDP growth measuring 3.1%, driven more or less equally by a rebound in external trade and growth in domestic demand. In our opinion, the economy should be on a fairly swift upward trajectory by 2022, with GDP measuring 4.7% and driven largely by demand growth. Exports will also gain ground, although imports will grow as well.

The pace of economic recovery depends on how quickly the pandemic recedes. This forecast assumes that a vaccine will be in distribution by Q2/2021, before the peak tourism season begins. If the pandemic proves more persistent through 2021, it could have a severe detrimental impact on Iceland's economic recovery.

Unlike the last crisis, Icelanders are far from being alone in facing strong economic headwinds. Actually, given how much the tourism sector contributes to export revenues and how important it is to the labour market, the blow to Iceland's economy is perhaps less devastating than could have been expected.

Most economies that depend on tourism as much as Iceland does were hit considerably harder when the pandemic struck.

That said, it appears that Iceland's crisis will be deeper and its recovery more sluggish than in other countries. According to OECD's recent global economic forecast, worldwide GDP is expected to contract by 4.5% this year and then grow by 5.0% in 2021. The forecast for the G20 countries provides for a 4.1% contraction this year and 5.7% growth next year.

It is worth noting, though, that the OECD does not specify countries that are similar to Iceland; i.e., small open economies with a large tourism sector and a floating currency

## .A temporary setback in external trade but foundations remain solid

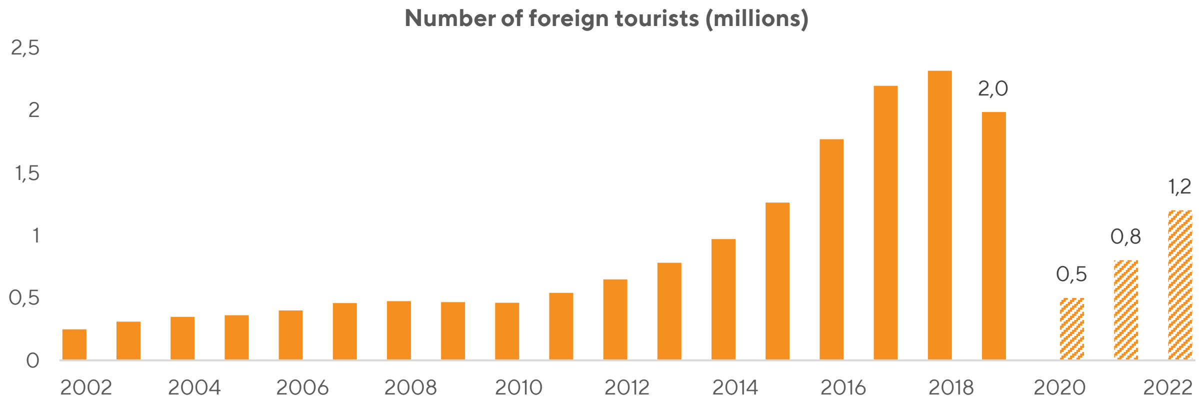
Nearly 2 million foreign tourists visited Iceland in 2019, making it the third-largest tourism year thus far, despite a 14% year-on-year decline.

In 2020 to date, 450,000 tourists have visited the country. But since August, when border restrictions were tightened, few tourists have come to Iceland, and we project the total for 2020 as a whole at less than 500,000, the lowest in a decade.

In recent years, tourism has generated over a third of Iceland's foreign exchange revenues. In 2019, revenues from foreign tourists totalled ISK 470bn, as compared with ISK 260bn from the fishing ISK 216bn from aluminium exports. Tourism industry revenues for 2020 are projected at around one-fourth of total foreign exchange revenues. Clearly, the current situation will deal a heavy blow to the broader economy.

We expect tourist arrivals to pick up to some degree in spring 2021. Even so, it will take time for tourists' appetite for travel to return to pre-pandemic levels, and conditions in the sector could become less favourable; for example, due to reduced competition in airfares and the increased focus on the environmental impact of air travel.

Our forecast assumes that roughly 800,000 tourists will visit Iceland in 2021, an increase of just over 70% YoY. For 2022, we forecast a 40% increase, to 1.1-1.2 million.




Source: Iceland Tourist Board and ISB Research

Despite heavy revenue losses in export sectors, the trade deficit has been modest as yet, totalling only ISK 1bn in H1/2020. One of the main reasons for this is that imports have contracted strongly, with reduced purchases of inputs for tourism, weak domestic demand, and the shift of consumption into the domestic economy.

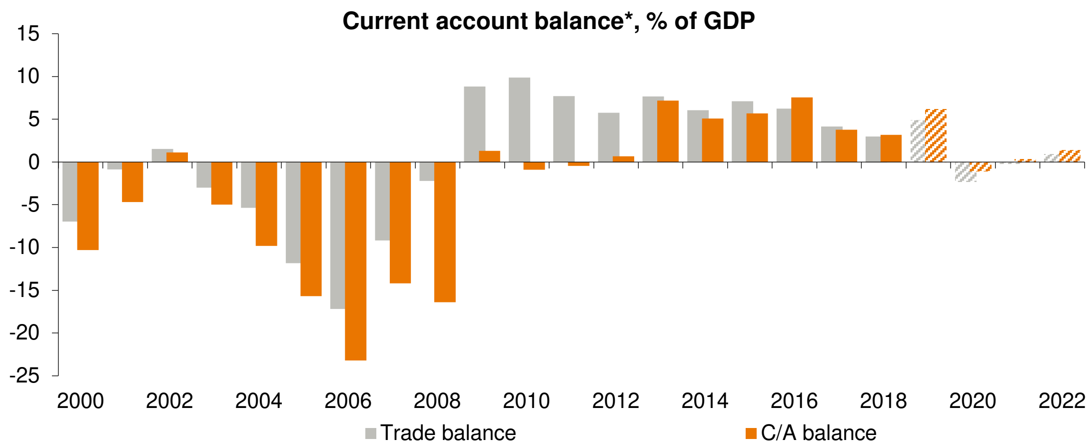
The outlook is for exports to contract by more than one-fourth in 2020. According to our forecast, imports will also contract, by about 16%. On the exports side, the contraction in tourism is by far the weightiest factor, while on the imports side, goods and services imports contract in roughly equal measure.

Our forecast assumes that exports will rebound in coming years, provided that tourism recovers satisfactorily. We project that exports grow by approximately 10% per year in 2021-2022. Growth will be driven largely by the recovery in tourism, although we also expect moderate growth in exports of marine and industrial products.

Growth in exports and domestic demand will call for increased goods and services imports. We expect imports to grow by 6% in 2021 and just over 8% in 2022. The contribution from net trade to output growth will therefore be positive in the latter half of the forecast horizon.

After the longest continuous current account surplus in the history of the Republic (2012-2019), the outlook is for a deficit this year.

According to our forecast, the balance on goods and services trade will probably be negative by just over 2% of GDP, as lost tourism revenues will outweigh the improvement in goods trade. On the other hand, it appears likely that the surplus on primary income will partly offset the trade deficit in the year's current account balance. We expect the current account to show a deficit amounting to 1.1% of GDP in 2020.




Source: Central bank of Iceland, Statistics Iceland and ISB Research * 2009-2015: C/A balance excl. old banks

As before, the outlook for the current account balance is quite good further ahead. A lower real exchange rate will promote a shift in demand into the domestic economy, and services revenues could grow strongly once the effects of the pandemic start to taper off. In addition, Iceland's international investment position (IIP) is quite robust; thus it is reasonably likely that the balance on primary and secondary income will make a positive contribution to the current account balance.

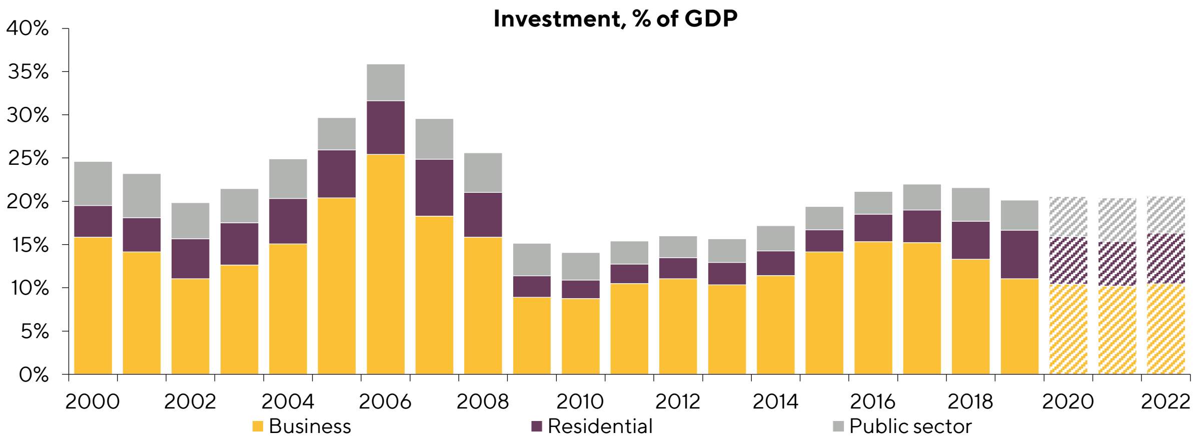
We forecast that the current account will show surpluses of 0.4% and 1.4% of GDP in 2021 and 2022, respectively. In our opinion, the current economic crisis will not reverse the improvements made in Iceland's external balance in the wake of the 2008-2009 crisis. Iceland's external assets net of liabilities totalled just over 28% of GDP in mid-2020 – a situation that could improve even more over time.

## Public sector investment to hold the fort until private investment recovers

Overall, investment sagged in 2019. Residential investment retained its momentum, however, although it was outweighed by the contraction in business investment and public investment. Total investment declined by 6.6% YoY in 2019.

The outlook is for a sizeable contraction in investment (10%) this year as well. The main factor in the downturn is a nearly 17% contraction in business investment, although we also expect residential investment to decline by almost 14% YoY. On the other hand, public investment is quite strong, owing to Government measures designed to mitigate the economic impact of the COVID-19 shock. We project growth in public investment at roughly 17% this year.

In 2021, public investment will account for the bulk of investment growth, which we project at 1.5% for the year. Residential and business investment will carry the day in 2022, however, contributing about equally to the 6.7% we forecast for the year.



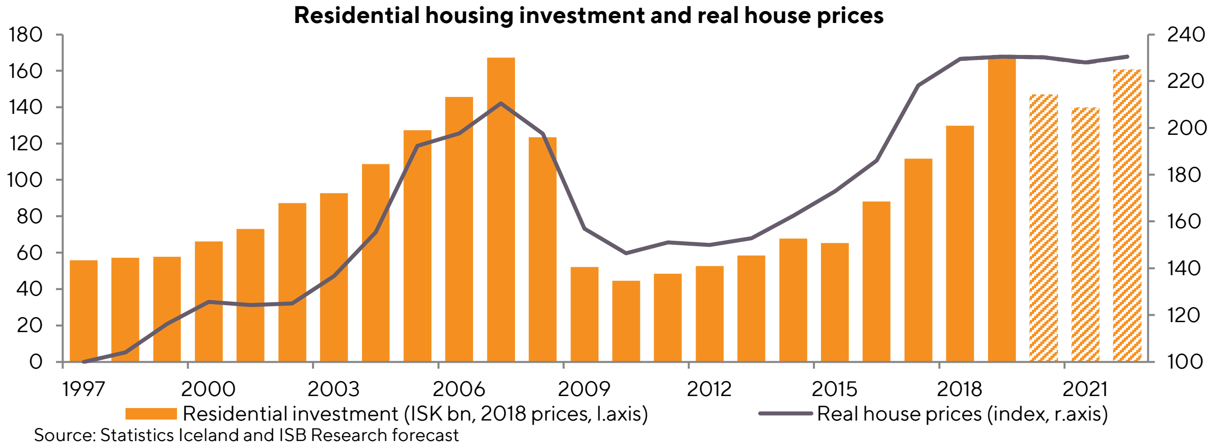
Source: Statistics Iceland and ISB Research forecast

The investment-to-GDP ratio will be just over one-fifth this year and will actually be relatively stable throughout the current downturn, unlike the situation following the 2008 financial crisis. Nevertheless, we expect the investment level to be lower in coming years than in recent decades, as it is difficult to see where there might be scope for development anywhere close that undertaken in the export sector since the mid-twentieth century.

The housing market has proven much more resilient than expected since the COVID shock struck. More favourable mortgage lending rates have made a palpable difference, as has most households' strong asset position.

The steep rise in prices seen in 2015-2018 has tapered off, however. In coming quarters, the market will be affected more strongly by rapidly rising unemployment, slower real wage growth, and a large supply of flats on the market. We expect real house prices to remain flat this year and then fall by 1% in 2021.

A strong decline in the number of new properties in the earliest stages of construction indicates a shrinking supply of new flats as the forecast horizon advances. This, together with declining unemployment and more rapid real wage growth, will tend to push house prices upwards over time. We forecast that real house prices will rise by 1.1% in 2022. If our forecast materialises, they will be back to the 2019 average by the end of the forecast horizon.



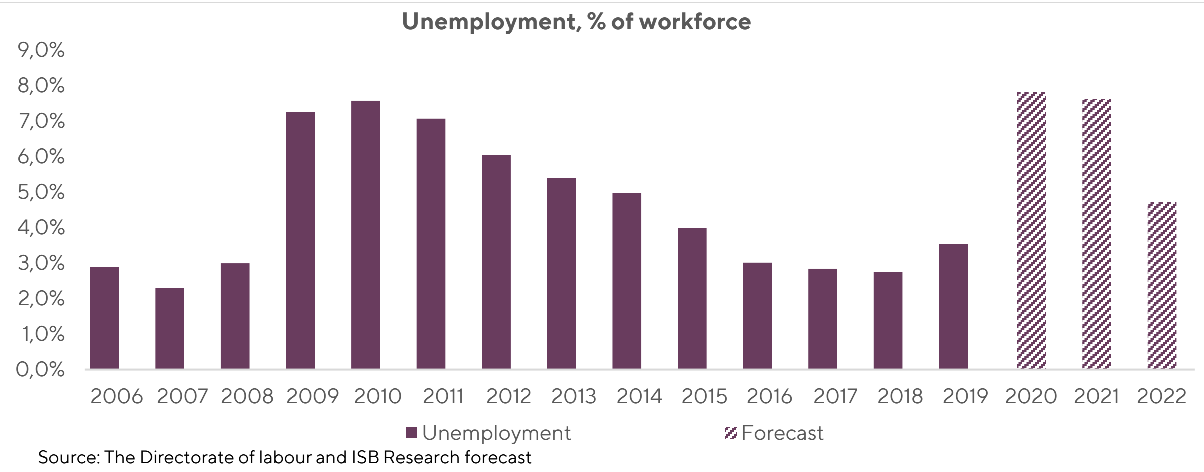

That said, given how resilient the housing market has been recently, the uncertainty in our forecast is concentrated on the upside, as house prices overall could rise somewhat faster than the general price level between now and end-2022.

## Chilly labour market ahead

Unemployment in Iceland has averaged 3% over the past four years, which is considered very low in international comparison. In March, however, the situation changed radically with the COVID-19 onslaught, which has sent the jobless rate soaring.

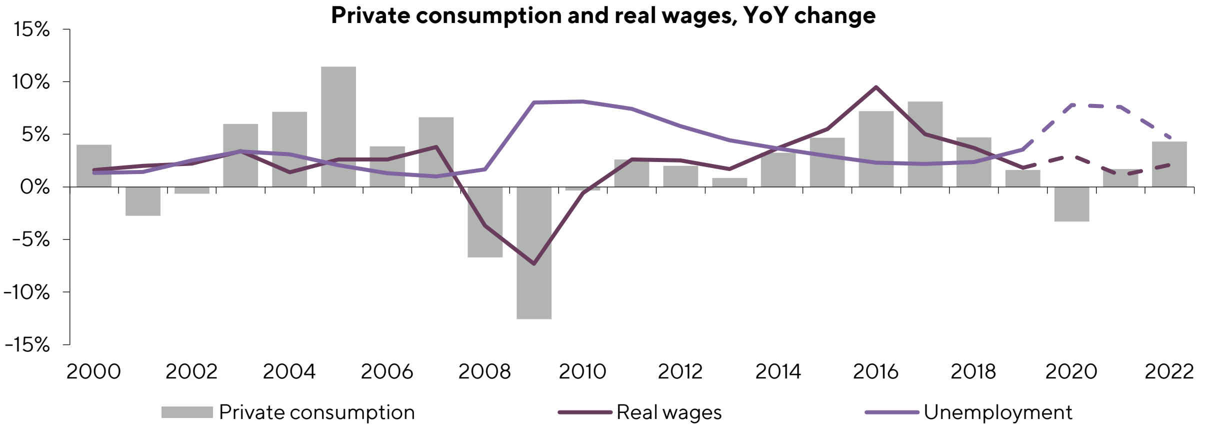
Because of the pandemic, it is plain that unemployment will be very high this year. As of end-August, more than 8,000 people, nearly 4% of the labour force, had lost their jobs in group layoffs.

Many firms have taken advantage of the Government's part-time unemployment benefits scheme, but participation in the programme peaked in April and has been on the decline since. About 0.9% of the labour market received part-time unemployment benefits in August, down from 10.3% in April.




We have revised our 2020 unemployment forecast downwards, partly because of a drop in the labour participation rate. Unemployment will continue to rise through the year-end but start to fall gradually thereafter. We forecast average unemployment in 2020 at 7.8%. The outlook for the coming two years is bleaker than in the May forecast, however. We expect unemployment to average 7.6% in 2021 and 4.7% in 2022.

The speed of the decline in the jobless rate will depend in large part on how strongly the labour-intensive tourism industry recovers. If next summer's peak season turns out similar to this year's or worse, unemployment will obviously be even more persistent.Consumption is generally sensitive to uncertainty, and some subcomponents of consumption are more likely to suffer than others. Those that are most likely to take a hit accounted for nearly 50% of all private consumption in 2019, including hotel and restaurant services and travel and transport.




Source: Statistics Iceland and ISB Research forecast

Travel restrictions and the ban on gatherings have already made a profound impact on private consumption, which contracted by 6.4% in Q2.

Furthermore, there are signs of a continued uphill battle ahead, as can be seen in key indicators such as the Consumer Confidence Index, payment card turnover, and the unemployment rate.

It was heartening, though, to see how briskly private consumption picked up when public health measures were relaxed in the spring. In addition, a larger share of consumption takes place within the domestic economy than before, which supports Icelandic sellers of goods and services.

The relationship between private consumption and the labour market is different now than in previous crises. The real wages of those still employed will be unaffected, but a larger share of the population will be out of work and will therefore lose substantial disposable income. The strong financial position of most households will also enable them to absorb income losses more easily and then step up their consumption when the economy picks up again.

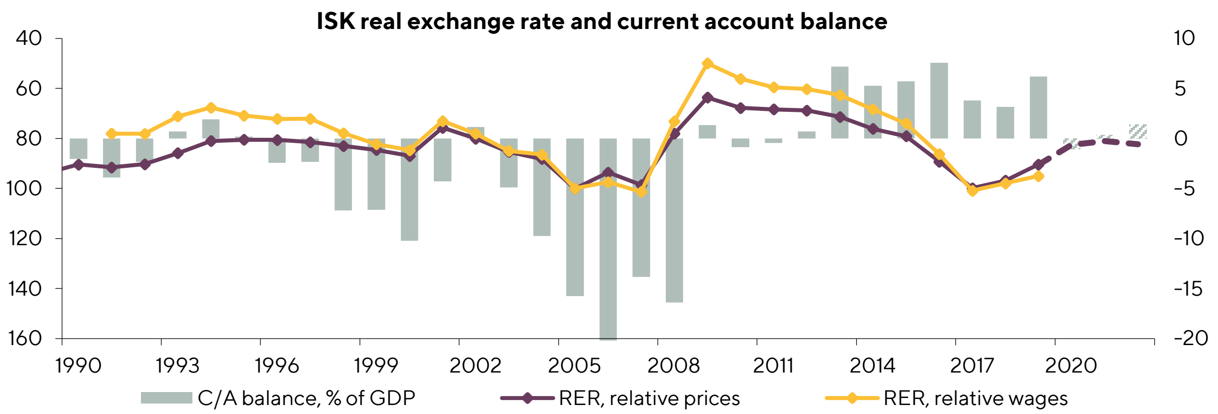
We expect private consumption to contract by 3.3% in 2020. For 2021, we project a growth rate of 1.6%, with consumption growth gaining momentum as unemployment falls and real wages rise. For 2022, we forecast real private consumption growth at 4.3%. ISK weakens, following the typical pattern in a contraction

## ISK appreciation likely as the economy picks up

The ISK has depreciated by about 15% against major currencies since the turn of the year. The depreciation took place primarily in March and April, although the exchange rate has been volatile since then.

The Central Bank (CBI) has intervened in the foreign exchange market to slow down the slide in the exchange rate and prevent short-term spiral formation. The CBI's sales year-to-date total approximately EUR 350m. At the beginning of the year, the CBI's international reserves amounted to about EUR 6bn.

Developments in 2020 to date appear to follow the same general pattern as the depreciation episodes in recent years. With the exception of 2008, when the foreign exchange market collapsed, the pattern appears to be that when the ISK depreciates, it finds a new temporary equilibrium roughly 10-17% below the previous level.




Source: Statistics Iceland and ISB Research forecast

The real exchange rate of the ISK has fallen by about one-fifth from its peak at the height of the tourism boom three years ago. As a result, Iceland is now much more competitive internationally than it was a few quarters ago. By this measure, Iceland is about as expensive a destination as it was in H1/2016.

Assuming that the shocks to the export sector are indeed temporary, and assuming that the external balance of the economy rests on stronger foundations than before, we expect the ISK to appreciate again over time. When and how much it appreciates is highly uncertain, however.

## Inflation to subside as interest rates remain low

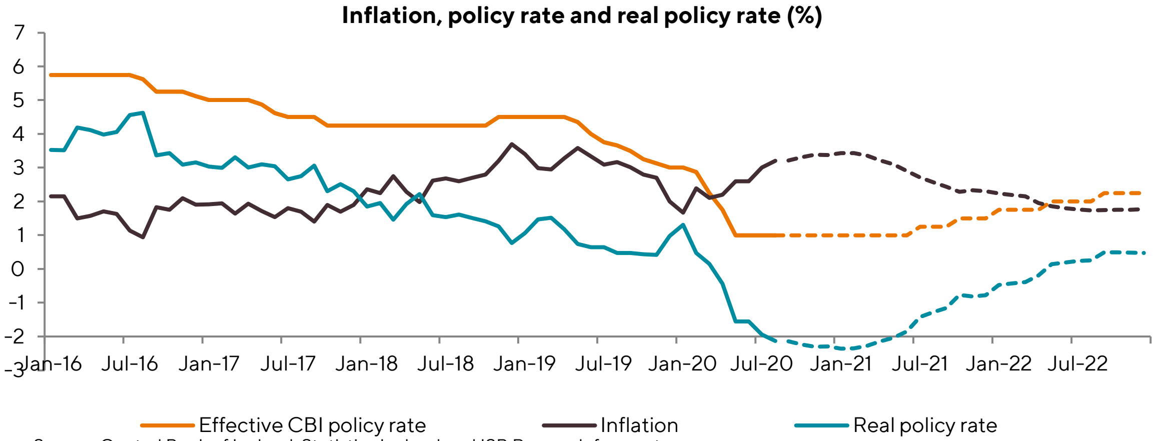
Inflation subsided in H2/2019 but has gained steam in response to the ISK depreciation earlier this year. It was 3.2% in August, the highest measurement since mid-2019.

Inflationary pressures have remained more modest than one might expect in view of the steep decline in the exchange rate and the concurrent rise in wages, particularly at the lower end of the pay scale. This offsets stiffening competition in the retail market, a growing slack in the economy and, thus far in 2020, lower petrol prices relative to 2019. It is of vital importance that the CBI's inflation target enjoys much more credibility than before, with the result that long-term inflation expectations have remained moderate.

The outlook is for inflation to remain above 3% until Q2/2021. There is some exchange rate pass-through from the ISK depreciation that has yet to emerge, and the wage increases taking effect at end-2020 will fuel inflationary pressures as well.

The outlook is for inflation to taper off over the course of 2021, however, owing mainly to a growing slack in the economy and a stable, and then modestly rising, exchange rate.

We project that inflation will average 2.7% this year and next, and then average 1.9% in 2022.



Source: Central Bank of Iceland, Statistics Iceland and ISB Research forecast

The CBI's policy rate has been lowered by 3.0 percentage points in 2020 to date. The key interest rate is now at an all-time low of 1.0%. Alongside these rate cuts, the CBI has eased liquidity requirements, lifted various restrictions on financial institutions, and declared itself willing to buy Treasury bonds in order to keep long-term interest rates in check.

In our opinion, the policy rate has hit bottom and will remain 1.0% until mid-2021. At that point, it will start to rise gradually as activity picks up and the slack in the economy narrows. Interest rates will nevertheless be low in historical context for the remainder of the forecast horizon.

Long-term nominal interest rates are currently about 2.7% and long-term real rates close to 0%. We expect average long-term rates to be lower this year than at any time since they were liberalised over 30 years ago. Both nominal and real rates will rise slightly in the latter half of the forecast horizon.

We forecast that long-term nominal rates will be around 3.2%, and real rates close to 0.7%, by the end of the forecast horizon. According to this, the long-term breakeven inflation rate will be around 2.5% as 2022 progresses. The breakeven rate is currently about 2.7%, which is well in line with the CBI's inflation target, after adjusting for the risk premium.

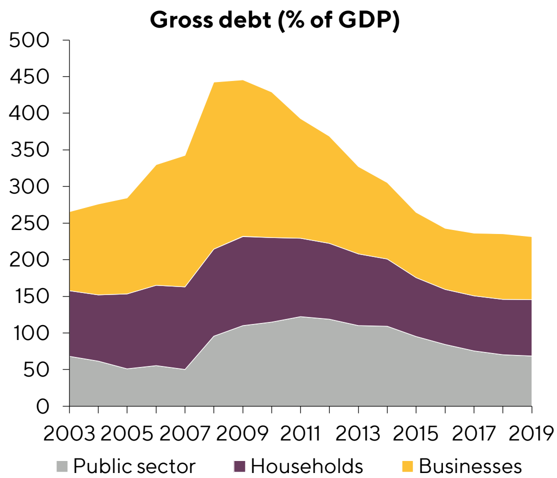
## Sound balance sheets a major strength

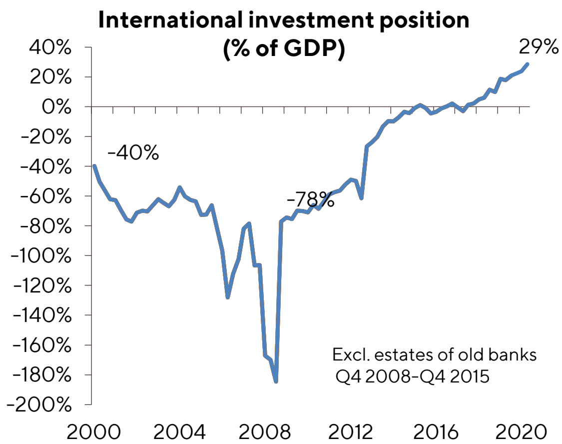
A generally sound pre-pandemic equity position in key sectors of the economy will prove an important source of support as Iceland weathers the current crisis and gains a foothold afterwards.

Substantial deleveraging by households, firms, and the public sector in the past decade has shored up financial resilience.

Most households' debt levels are modest, enabling them to face temporary income losses, and low interest rates lighten their debt service burden and give them additional financial flexibility.

Corporate deleveraging early in the decade and debt accumulation in line with GDP growth thereafter reduce the risk that headwinds in individual sectors and regions will cause spillovers ending with severe default and a system-wide wave of insolvencies.




By the same token, the reduction in public debt over the past decade provides the Government with the scope to undertake aggressive countercyclical measures in the form of public investment and other mitigating actions, as well as allowing automatic stabilisers to work without an undue increase in indebtedness. In this context, Iceland is much more favourably positioned than many other advanced economies.

Iceland's positive net IIP and moderate external debt, combined with the CBI's ample international reserves, greatly reduce the risk of capital flight and the associated negative effects on the exchange rate, inflation, and purchasing power.

## Macroeconomic forecast

| % | 2019 ISK m. | 2019 | Forecast 2020 | Forecast 2021 | Forecast 2022 |
|---|---|---|---|---|---|
| Private consumption | 1.506.682 | 1.3 | -3.3 | 1.7 | 4.3 |
| Public consumption | 721.930 | 4.2 | 3.0 | 1.8 | 1.5 |
| Fixed capital formation | 599.665 | -6.6 | -10.2 | 1.5 | 6.7 |
| thereof industrial investment | 330.457 | -18.1 | -16.9 | -0.2 | 8.7 |
| thereof residential housing | 167.159 | 31.3 | -13.7 | -3.4 | 19.4 |
| thereof public investment | 102.049 | -9.9 | 17.0 | 11.0 | -10.5 |
| Changes in inventories | -2.733 | 2.0 | 0.0 | 0.0 | 0.0 |
| Total national expenditure | 2.825.543 | -0.2 | -3.0 | 1.7 | 4.0 |
| Exports of goods and services | 1.344.017 | -4.9 | -27.2 | 10.1 | 9.7 |
| thereof exports of marine prod. | 224.393 | -6.4 | -7.0 | 4.0 | 2.4 |
| thereof aluminium production | 216.423 | -6.0 | -2.6 | 1.0 | 1.0 |
| thereof other goods exports | 211.857 | 24.6 | -9.0 | 4.0 | 4.0 |
| thereof service exports | 691.344 | -8.8 | -47.0 | 22.0 | 20.0 |
| Imports of goods and services | 1.203.943 | -10.2 | -16.3 | 6.0 | 8.1 |
| thereof goods imports | 751.632 | -8.3 | -10.8 | 3.7 | 7.3 |
| thereof service imports | 452.311 | -13.3 | -25.7 | 10.9 | 9.5 |
| **Gross domestic product** | **2.965.617** | **1.9** | **-8.6** | **3.1** | **4.7** |

| *% of GDP* | 2019 | Forecast 2020 | Forecast 2021 | Forecast 2022 |
|---|---|---|---|---|
| Investment | 20.1 | 20.6 | 20.4 | 20.6 |
| Current account balance | 6.2 | -1.1 | 0.4 | 1.4 |
| Trade balance | 4.9 | -2.3 | -0.2 | 1.0 |
| *Change in annual average (%)* | | | | |
| Consumption prices | 3.0 | 2.7 | 2.7 | 1.9 |
| Wages | 4.9 | 5.8 | 3.8 | 4.0 |
| Housing prices | 3.4 | 2.6 | 1.7 | 3.0 |
| Average FX exchange rate | 8.5 | 11.2 | 3.1 | -1.8 |
| Real ISK exchange rate | -7.4 | -10.5 | -1.5 | 2.1 |
| Purchasing power of wages | 1.8 | 3.0 | 1.1 | 2.1 |
| *Annual average (%)* | | | | |
| Unemployment (% of workforce) | 3.5 | 7.8 | 7.6 | 4.7 |
| ISK exchange rate index | 181.0 | 201.2 | 207.5 | 203.7 |
| Policy rate. Central Bank of Iceland | 3.9 | 1.5 | 1.2 | 2.0 |
| Long term interest rate (%) | 4.2 | 2.6 | 2.8 | 3.2 |
| Long term real interest rate (%) | 1.0 | 0.2 | 0.3 | 0.7 |

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