Macroeconomic forecast 2019-2021

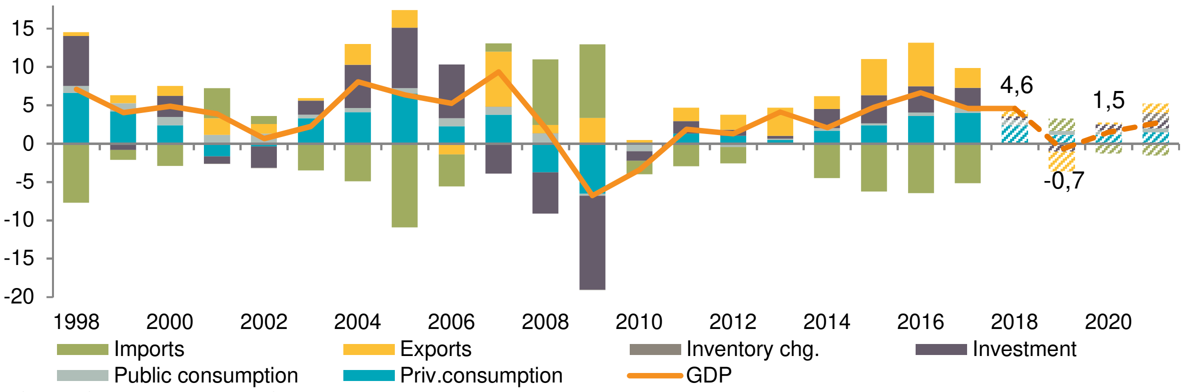
5 June 2019 | Íslandsbanki Research

Executive summary

The Icelandic economy has been buoyant for much of the current decade, with GDP growth averaging 4.5% per year in 2013-2018. The growth episode has been underpinned by the boom in tourism, supported by other favourable factors that have fuelled growth in private consumption and investment. Domestic demand gradually took over from exports as the main driver of growth as the period advanced.

Figures for Q1/2019 show clearly that the economy is cooling. GDP growth measured 1.7% for the quarter. WOW Air folded its tent at the end of Q1, and the March-April month-end therefore marks a clear turning point in the domestic economy.

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



Source: Statistics Iceland and ISB Research

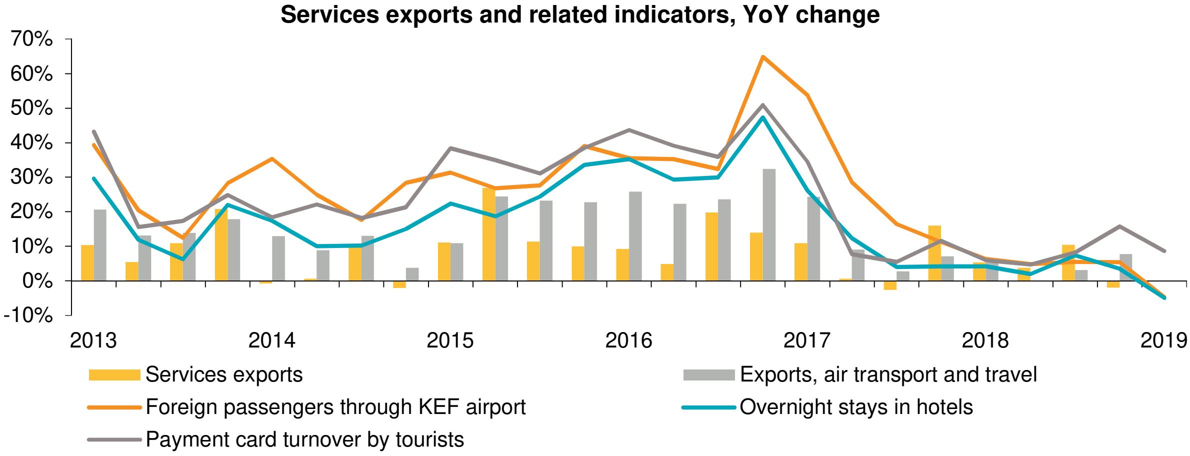
GDP looks set to contract by 0.7% in 2019 as a whole, making this year the first to see a contraction since 2010. An abrupt decline in exports is the main factor in this year's economic downturn, aided by a marked reduction in business investment. Private consumption growth will be sluggish as well. On the other hand, imports will probably contract significantly between years also.

For 2020, we expect relatively slow GDP growth of around 1.5%, driven by private consumption and investment in residential housing and infrastructure. We expect growth to pick up in 2021, measuring 2.7% for the year, as exports and business investment firm up again.

Developments in tourism a key determinant of the current account balance

After several boom years earlier in the decade, the tourism sector has begun to shrink. The number of visitors to Iceland fell by nearly 5% year-on-year in Q1/2019 and will probably fall still further as the year advances. Tourist arrivals were down by nearly a fifth YoY in April, following the collapse of WOW Air in late March. The outlook for the year as a whole is for a YoY decline in the number of visitors in the vicinity of 15%.

The main driver of the downturn is the reduction in flight offerings to and from the country. Compounding WOW's woes are the unexpectedly protracted difficulties faced by Icelandair in connection with its Boeing 737 Max jets. Moreover, a number of foreign airlines have announced reduced seat offerings for the coming autumn although there are also some news of airlines increasing seat offerings in coming quarters.



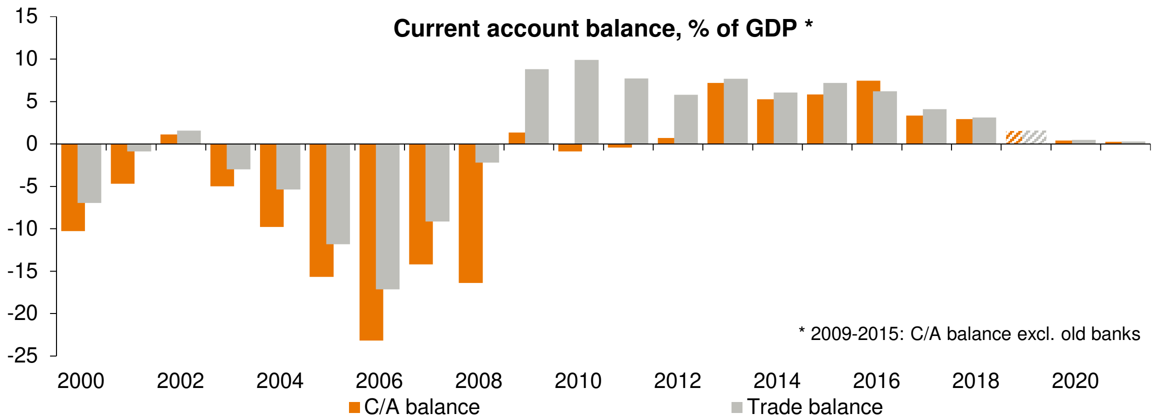
Source: Statistics Iceland, Iceland Tourist Board and Centre for Retail Studies

Developments thereafter are highly uncertain as well. That said, we assume that seat offerings will ultimately increase again, provided that demand for travel to Iceland remains robust, although flights to Iceland could continue to contract through this year and into 2020.

The outlook is for a significant contraction in both imports and exports in 2019. On the imports side, the contraction stems both from reduced imports of investment goods and operational inputs, as well as reduced expenses in connection with aircraft leasing and other services imports.

On the flip side, services exports will contract by around 10% this year, according to our forecast, while goods exports will hold virtually steady, with increased industrial goods exports and the sale of WOW Air's aircraft counterbalancing the contraction in marine product exports caused by the capelin catch failure in Q1.

The outlook is for both exports and imports to rebound to some extent in 2020. The recovery of exports will be weak early on, however, as we do not expect a large increase in tourist numbers. For 2021, though, we project a roughly 4% rise in tourist arrivals.



Source: The Central Bank of Iceland and ISB Research

The current account balance has been more favourable in recent years than at any time in the history of the Republic. This is even more remarkable in view of the generally robust GDP growth and relatively high real exchange rate of the past few years. This situation is likely to continue, with the interplay of these variables remaining more favourable than they were until the present decade.

The outlook for the current account balance has deteriorated from our January forecast, however. This is due mainly to a bleaker outlook for the services account balance, caused by headwinds in the tourism sector.

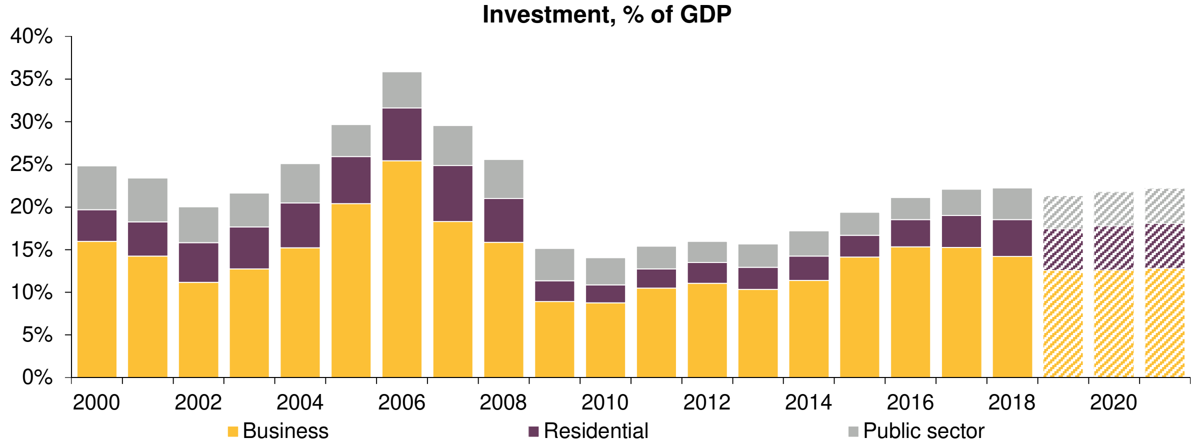
We forecast that the current account will show a surplus of 1.5% of GDP this year and then be broadly in balance in 2020 and 2021.

Iceland’s net international investment position will therefore remain positive, with external assets exceeding external liabilities by a full 1/5 of GDP as of end-March 2019. The positive NIIP is conducive to a higher equilibrium real exchange rate than would otherwise occur, as financial income from abroad should generally exceed financial expense.

Sharp contraction in business investment this year

Iceland’s investment level has risen steadily since the first half of this decade, driven largely by a surge in business investment. The investment-to-GDP ratio was 22% in 2018, after bottoming out at just over 14% in 2010.

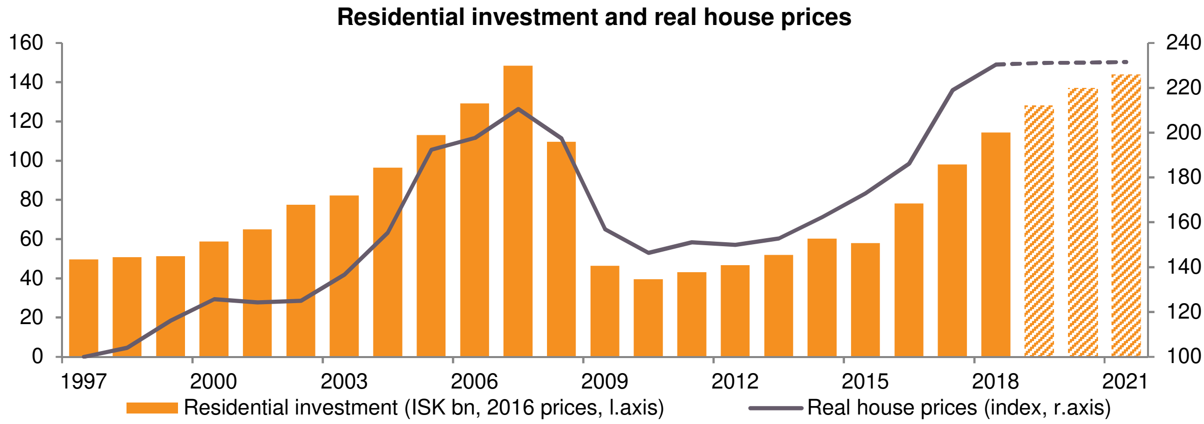
In recent years, though, the main source of growth has shifted to residential and public investment. In 2018, investment grew 2.1% YoY despite the contraction in business investment, owing to handsome growth in residential and public investment.



Source: Statistics Iceland and ISB Research

We expect investment as a whole to contract by just under 5% this year, due to a 12% contraction in business investment, which in turn results largely from reduced investment in transport equipment and hotels. Residential investment is expected to grow strongly this year, however. For the following two years, the outlook is for modest growth in all categories of investment, with total investment increasing by 3.6% in 2020 and 4.6% in 2021.

The investment-to-GDP ratio will be just over a fifth of GDP each year of the forecast horizon, however, and investment as a whole will be robust in spite of this year’s contraction in business investment.



Source: Statistics Iceland, Central bank of Iceland and ISB Research

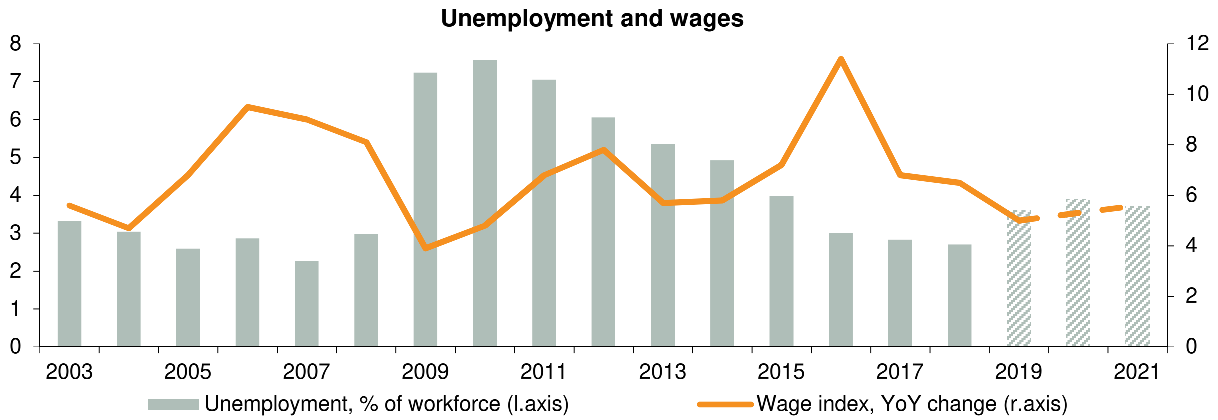
The past year's surge in residential investment is most welcome, as the real estate market was affected for a time by strong demand and housing shortages. In 2017, real house prices rose substantially in excess of real wages, whereas on average, these two variables tend to grow at comparable rates.

The supply of residential housing has increased steadily, and demand has eased considerably. As a result, the correlation between real house prices and real wages has been much healthier in the recent term. The outlook is for supply to keep increasing, which we expect to cut into real house price rises in the coming term.

Real house prices rose by just over 5% YoY in 2018. This year, however, we forecast that they will rise by only 0.3% in excess of the general price level, and in 2020 and 2021 we expect them to remain virtually flat.

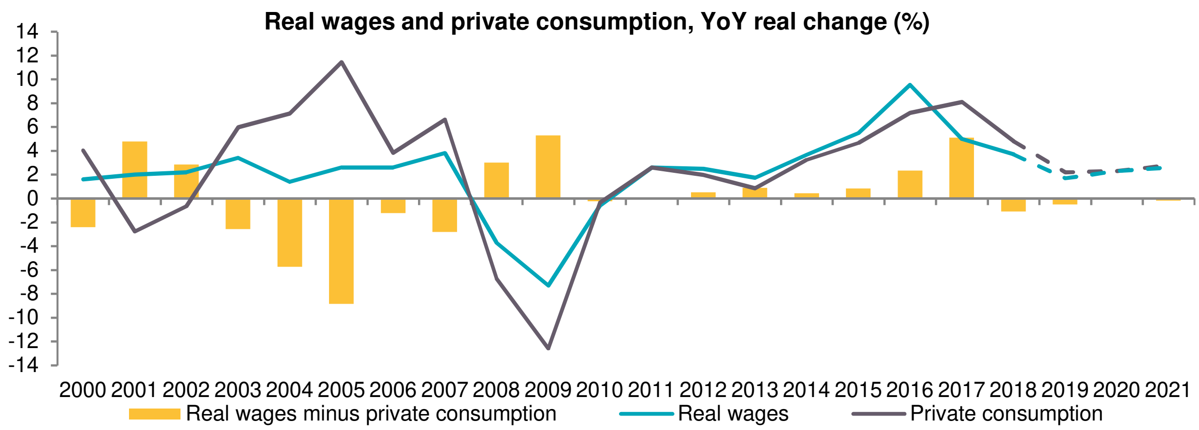
Private consumption growth tapers off

Developments in key indicators suggest that private consumption growth will subside incoming quarters. There are already signs that households are clutching their wallets tighter than before. Both real wage growth and payment card turnover growth have eased, and households' expectations are much more muted.



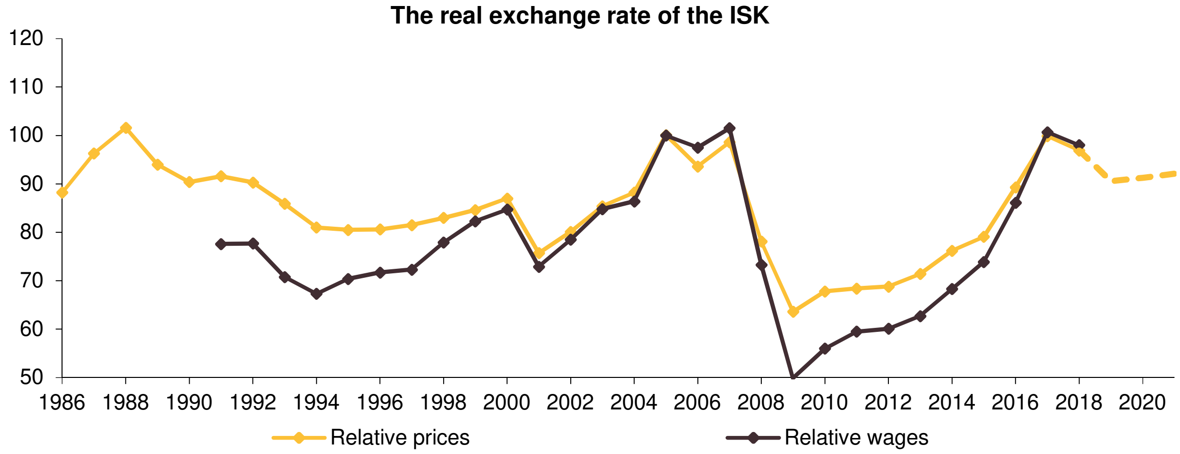
Source: Statistics Iceland and ISB Research

Furthermore, the labour market is clearly cooling. Unemployment shot upwards after WOW collapsed and looks set to keep rising in the coming term. We forecast that it will peak at around 4% in 2020. We also expect real wage growth to be considerably weaker than in the recent past.



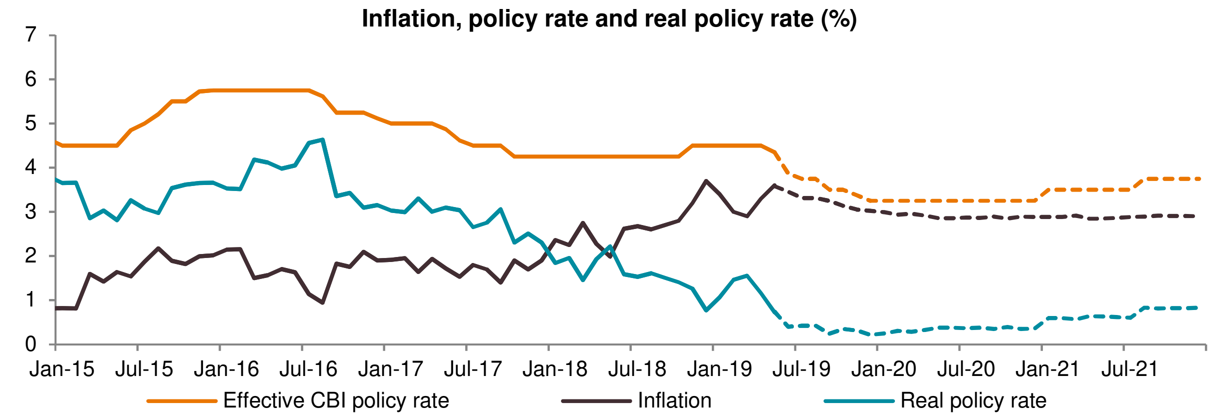
Source: Statistics Iceland and ISB Research forecast

The development of private consumption is a major factor in Iceland's GDP growth, as private consumption has accounted for more than half of GDP in recent years. After several buoyant years, it appears that a period of slower growth lies ahead. We forecast private consumption growth at 2.2% in 2019, 2.3% in 2020, and 2.8% in 2021.



Lower inflation and further policy rate cuts in the offing

After last year's depreciation, the ISK is now much closer to its equilibrium than it was in 2017-2018. We expect the exchange rate to hold broadly steady in coming years, provided that Iceland avoids running a large current account deficit and foreign investors remain keen to invest in the country.



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

In the wake of a spike caused by last year's ISK depreciation, the inflation outlook has brightened once again, and we think inflation has peaked. We expect it to average 3.2% in 2019 and 2.9% by the end of the forecast horizon. The darkening economic outlook and improved inflation outlook will result in further policy rate cuts later this year, following a 50bp rate cut in May. We forecast that the policy rate will have been lowered to 3.25% by the year-end and will remain low into 2021.

Macroeconomic forecast

Volume changes, %	2018 ISK m.	2018	Forecast 2019	Forecast 2020	Forecast 2021
Private consumption	1.422.183	4.8	2.2	2.3	2.8
Public consumption	660.529	3.3	2.4	2.3	2.2
Fixed capital formation	623.094	2.1	-4.8	3.6	4.6
thereof industrial investment	398.203	-5.4	-12.1	1.9	4.0
thereof residential housing	121.323	16.6	12.0	7.0	5.0
thereof public investment	103.568	21.2	3.5	5.0	6.0
Changes in inventories	10.726	1.0	0,0	0,0	0,0
Total national expenditure	2.716.531	4.1	0.2	2.6	3.0
Exports of goods and services	1.323.358	1.6	-5.4	0.4	2.7
thereof exports of marine products	239.741	11.8	-4.7	1.8	1.8
thereof aluminium production	230.132	-1.4	0.8	0.7	0.8
thereof other goods exports	144.807	10.9	6.4	-4.4	1.2
thereof service exports	708.679	0.1	-10.0	1.0	4.0
Imports of goods and services	1.236.841	0.1	-3.6	2.8	3.5
thereof goods imports	773.879	-4.0	-2.1	3.4	4.0
thereof service imports	462.962	7.3	-6.2	1.9	2.7
Gross domestic product	2.803.049	4.6	-0.7	1.5	2.7

% of GDP	2018	Forecast 2019	Forecast 2020	Forecast 2021
Investment	22.2	22.2	22.7	23.3
Current account balance	2.9	1.5	0.4	0.2
Trade balance	3.1	1.6	0.5	0.3
Change in annual average (%)				
Consumption prices	2.7	3.2	2.9	2.9
Wages	6.5	5.0	5.3	5.6
Housing prices	8.0	3.5	3.0	3.0
Average FX exchange rate	4.0	7.9	0.1	0.0
Real ISK exchange rate	-3.0	-6.6	0.8	0.9
Purchasing power of wages	3.7	1.7	2.3	2.6
Annual average (%)				
Unemployment (% of workforce)	3.0	3.6	3.9	3.7
ISK exchange rate index	166.7	179.8	180.0	180.0
Policy rate, Central Bank of Iceland	4.3	3.9	3.3	3.6
Long term interest rate (%)	5.4	4.5	4.1	4.3
Long term real interest rate (%)	1.8	1.0	1.1	1.3

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