Macroeconomic forecast 2019-2021

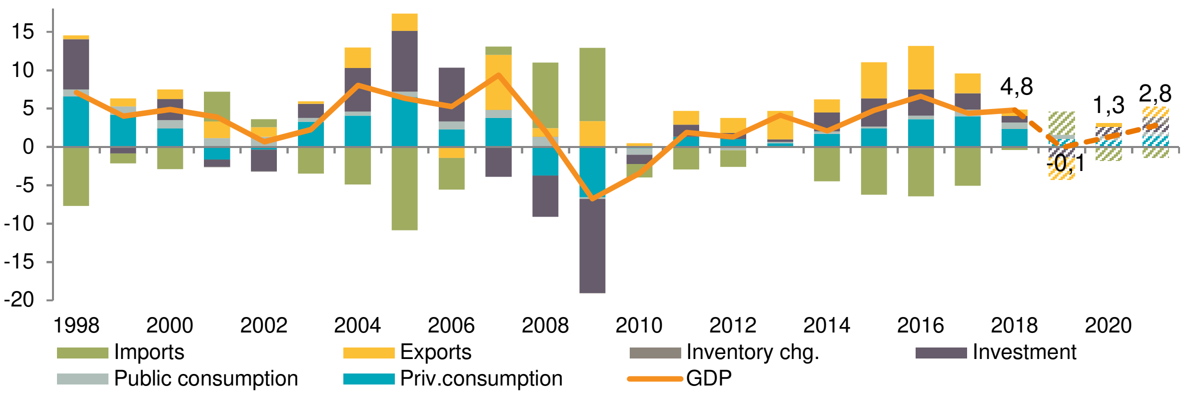
25 September 2019 | Íslandsbanki Research

Executive summary

Strong GDP growth has been a salient feature of the Icelandic economy in recent years. From 2013 through 2018, output growth averaged 4.5% per year, more than double the OECD average. One of the main drivers of growth was the surge in tourism, coupled with a number of favourable factors that have bolstered the position of households, businesses, and the government. As the period advanced, domestic demand gradually took over from exports as the main driver of growth.

Figures for H1/2019 indicate clearly that the economy is cooling, however. GDP growth measured 0.9% during the half. Domestic demand contracted by 2.4%, however, albeit offset by an unusually favourable contribution from net trade.

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



Source: Statistics Iceland and ISB Research

The outlook is for GDP to contract by 0.1% in 2019. Actually, it is perhaps more accurate to say growth will be flat, as this figure is well within the margin for error of zero growth. A sharp contraction in business investment and services exports counterbalances consumption growth and a strong contraction in imports.

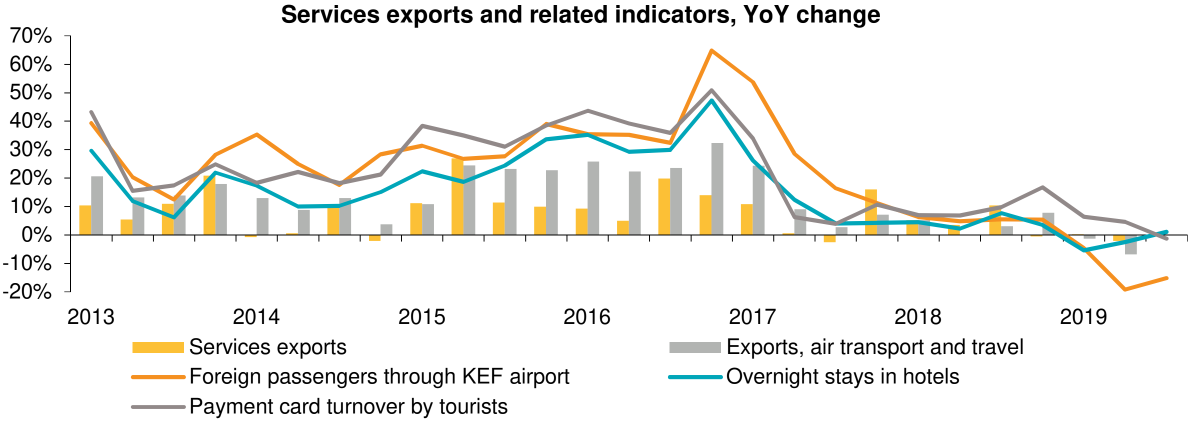
For 2020, we expect relatively slow growth of about 1.3%, driven by modest growth in domestic demand. We expect the economy to pick up to about 2.8% in 2021, as private consumption and exports regain momentum.

Developments in tourism a key determinant of the current account balance

The tourism sector has suffered a reversal after a boom lasting until 2018. In the first eight months of 2019, tourist arrivals were down 13% year-on-year. Tourist numbers had already begun to fall in Q1/2019, however, and the decline accelerated after WOW Air went out of business.

A key driver of the downturn is the reduction in airline seat offerings to and from the country. WOW's troubles were compounded by Icelandair's difficulties with its Boeing 737 Max jets, which have dragged on much longer than was previously hoped. In addition, various foreign carriers have announced reduced seat capacity for the coming winter, although some are planning to step it up again later on.

Spending per tourist is up, however, somewhat mitigating the impact of reduced visitor numbers. The average length of stay has increased, and payment card turnover figures suggest a steep rise in turnover per tourist in ISK terms.



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

How quickly the tourism industry recovers will depend in large part on seat offerings in the coming term. In our opinion, the outlook is not for a large increase in 2020, although we expect a growth rate of about 4% per year thereafter. This is in line with projected growth in tourism worldwide.

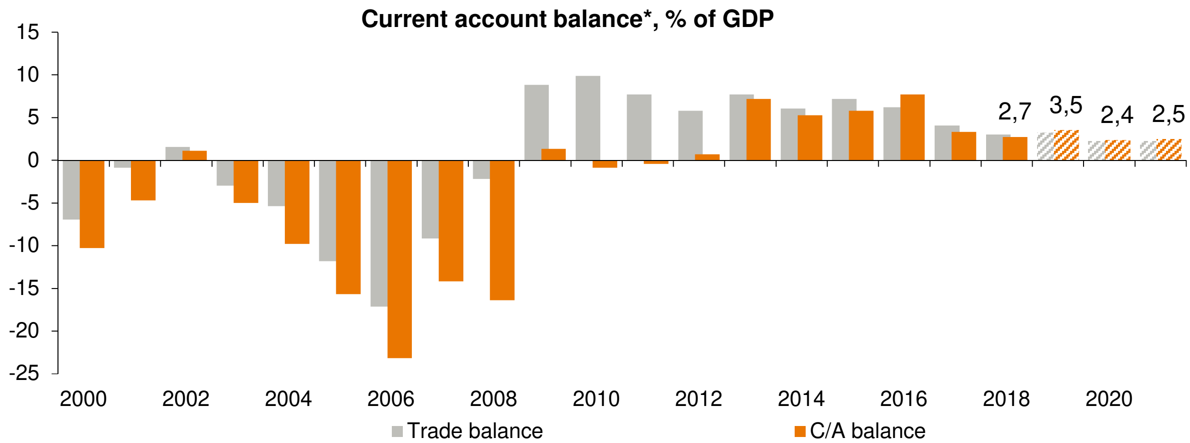
The surplus on goods and services trade was sizeable in H1, in spite of reduced tourist numbers and the failure of the capelin catch. It totalled over ISK 42bn, as compared with ISK 8bn in H1/2018. To a large extent, the surge was due to one-off items like the sale of WOW Air's aircraft and a contraction in pharmaceuticals companies' services imports.

However, for 2019 as a whole, the outlook is for a marked contraction in both import and export volumes. On the imports side, the contraction is due to reduced importation of investment and consumer goods, as well as a reduction in aircraft leasing expenses and other services imports.

On the exports side, our forecast indicates that services exports will contract by nearly 10%, mostly because of the decline in tourist arrivals. Goods imports look set to decline by 1.5%, partly because of the capelin catch failure and interruptions in production at the Rio Tinto aluminium smelter.

The outlook is for both exports and imports to rebound in 2020. The recovery of exports will be weaker in 2020 but will gain momentum in 2021. Imports, on the other hand, will grow more evenly over the forecast horizon after this year's contraction.

The contribution of net trade to GDP growth will therefore be positive this year, significantly negative next year, and more or less neutral in 2021.



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

* 2009-2015: C/A balance excl. old banks

The most recent upward cycle stands out in the context of Iceland's economic history in that the current account has persistently been in surplus in the past several years, despite strong GDP growth and a high real exchange rate. This situation is highly likely to continue, with these variables remaining more favourable than they were until the present decade.

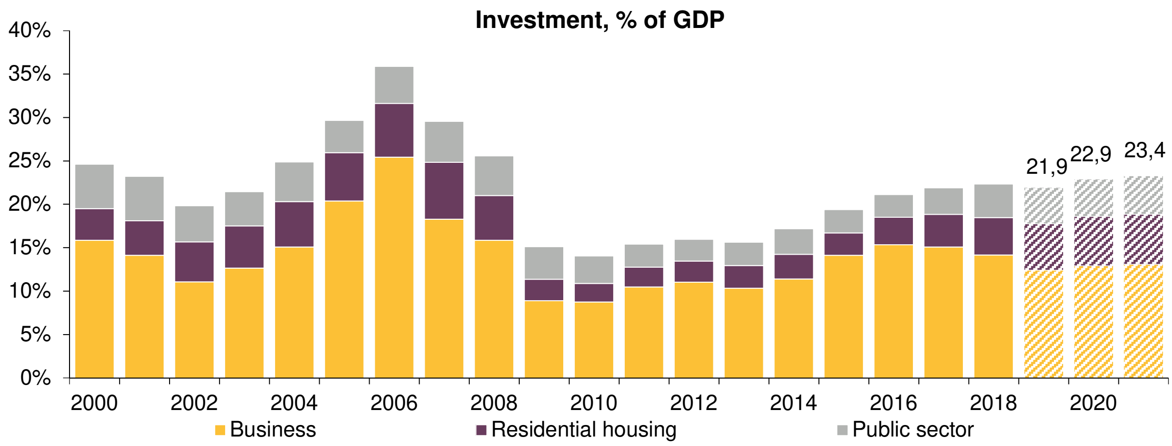
The outlook for the current account balance has improved somewhat from our June forecast, owing in part to the aforementioned contraction in services imports, as well as to improved terms of trade and a stronger external position.

We project the 2019 current account surplus at approximately ISK 100bn, or 3.5% of GDP, followed by surpluses of around 2.5% of GDP in 2020 and 2021.

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

Sharp contraction in business investment this year

Iceland's investment level has risen steadily in the past five years, fuelled mainly by strong growth in business investment. Total investment equalled just over 22% of GDP in 2018, slightly above the 20% benchmark for advanced economies.



Source: Statistics Iceland and ISB Research forecast

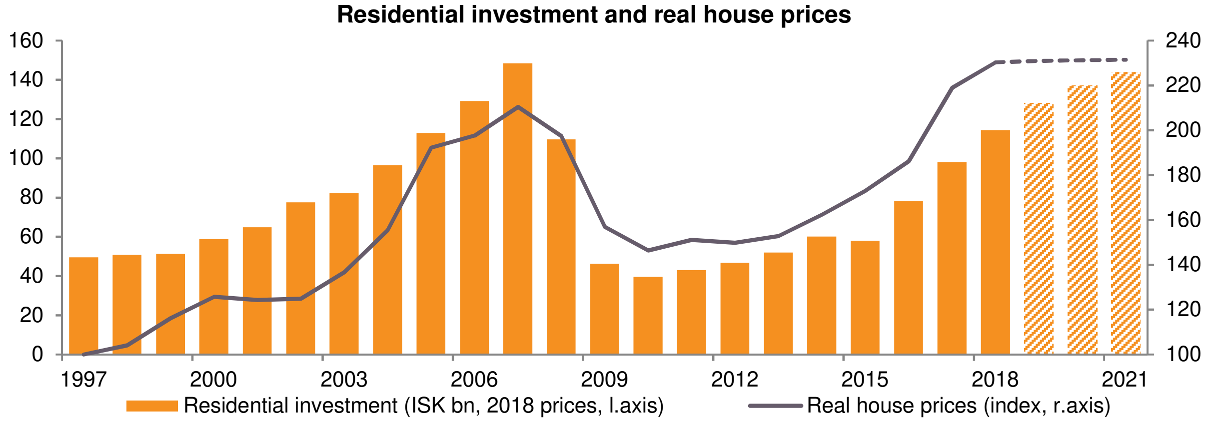
In the past two years, however, the main source of growth has shifted to residential investment and public investment. In 2018, investment grew by just under 4% YoY despite the contraction in business investment, owing to handsome growth in residential and public investment.

We expect investment as a whole to contract by 6-7% this year, due to a sizeable contraction in business investment, which in turn results largely from reduced investment in transport equipment and hotels. On the other hand, residential investment is expected to grow strongly this year. For the two years thereafter, the outlook is for modest growth in all categories of investment, with total investment increasing by nearly 6% in 2020 and 4.5% 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 respectable in historical terms despite this year's contraction in business investment.

Real house prices and real wages are two economic variables that have tracked one another quite reliably over time. In 2017, however, the rise in real house prices exceeded the rise in real wages many times over, as the real estate market was affected by a housing shortage and strong demand.

The surge in residential investment is therefore most welcome, and the correlation between real house prices and real wages has normalised once again. Residential investment grew by 16.2% in 2018, and the outlook is for a growing supply of new flats during the forecast horizon. We expect residential investment to grow by 17.5% this year, 7.5% in 2020, and 5% in 2021.



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

Real house prices rose by 5.2% YoY in 2018. We expect them to remain flat this year and then rise marginally thereafter: by 0.2% in excess of the price level in 2020 and 0.5% in 2021.

The main factors supporting our opinion are the increase in supply, the slowdown in real wage growth, higher unemployment, and weaker population growth. In many ways, these developments are a welcome turn of events, as the housing market is now calming down after several turbulent years.

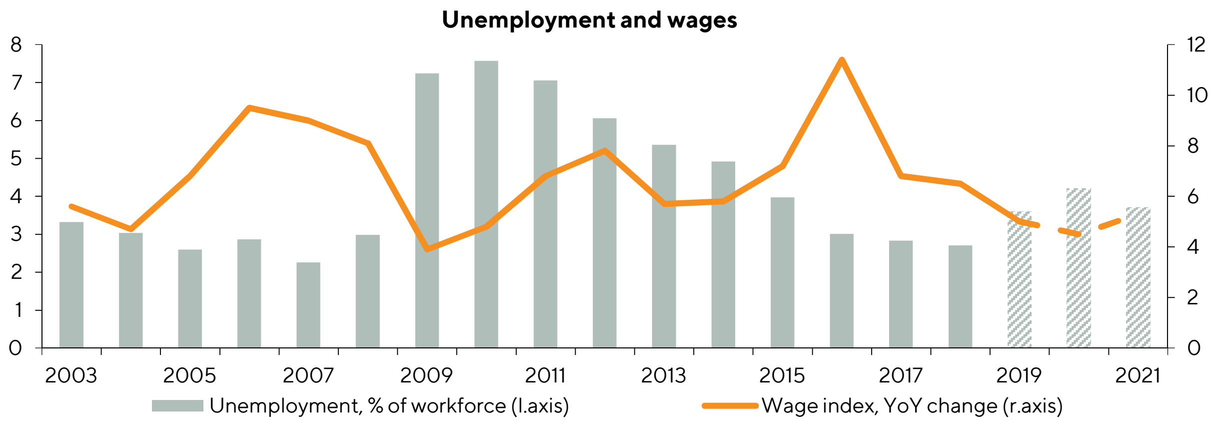
Private consumption growth tapers off

Private consumption has grown apace in the past several years, peaking at 9.8% in Q2/2017. The main drivers of the surge are strong real wage growth, low unemployment, robust population growth, and generally upbeat consumer sentiment. Unlike the previous upswing, household debt has been modest and saving considerable.

Private consumption growth has eased in the recent term. In Q2/2019, it measured 2.2%, the slowest in five years.

Developments in key indicators suggest a further slowdown ahead. Payment card turnover figures indicate that households are clutching their wallets tighter than before, as real wage growth has slowed, unemployment has risen, and consumer confidence has grown more muted.

Indicators imply that private consumption growth will be weak in coming quarters.

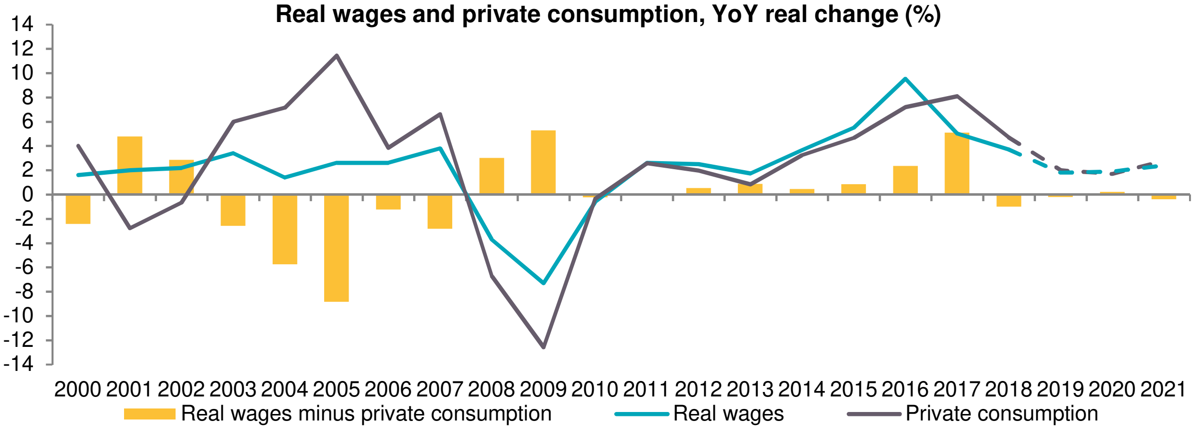


Source: Statistics Iceland and ISB Research

The labour market has been buoyant in recent years, with unemployment falling steadily and wages rising swiftly. Tension in the labour market peaked in 2016-2018. In 2016, the wage index rose 11.4%, and in 2018 unemployment bottomed out at 2.7%.

By now, however, the tension in the market has already begun to ease. Unemployment has been rising, partly due to insolvencies at WOW Air and other firms, and looks set to keep climbing in the near future.

Even though the signing of the so-called standard of living agreement was positive overall, there is still some uncertainty in the labour market, as public sector wage agreements are still pending. We expect unemployment to peak next year at 4.2% and then fall to 3.7% in 2021. In addition, we expect real wage growth to fall to 2% next year and inch upwards to 2.4% in 2021.

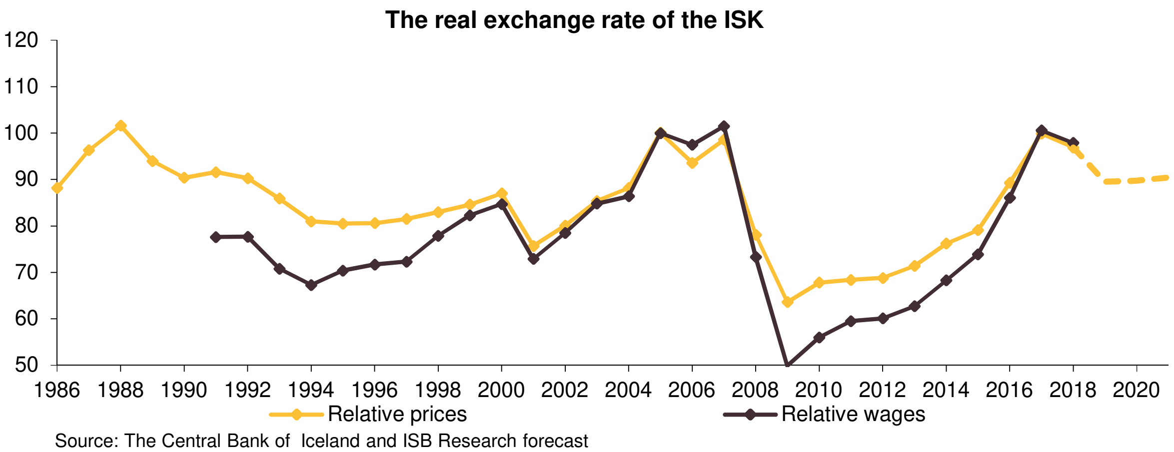


Source: Statistics Iceland and ISB Research forecast

Developments in private consumption are a major factor in Iceland's GDP growth, accounting for about half of GDP in recent years. We think weaker private consumption growth lies ahead; in fact, households' positive position is the main reason we anticipate positive growth at all in the early part of the forecast horizon. We project private consumption growth at 2.0% in 2019, 1.7% in 2020, and 2.8% in 2021.

Lower inflation and further policy rate cuts in the offing

The ISK depreciated by 9% in H2/2018, concurrent with the deterioration in the outlook for Iceland's key export sectors. In 2019 to date, however, it has held steady within a relatively narrow band. The real exchange rate is now closer to equilibrium than it was in 2017-2018. It is relatively high compared with recent decades, however, particularly in terms of relative unit labour costs.



Source: The Central Bank of Iceland and ISB Research forecast

We expect it to remain high in historical context. The net asset position of the economy is at its most favourable in the history of the Republic. In mid-2019, external assets exceeded external liabilities by a full one-fifth of GDP. The Central Bank (CBI) has large international reserves at its disposal if temporary capital flight should threaten to derail the exchange rate. Furthermore, there is a strong likelihood of a continued current account surplus in the coming term.

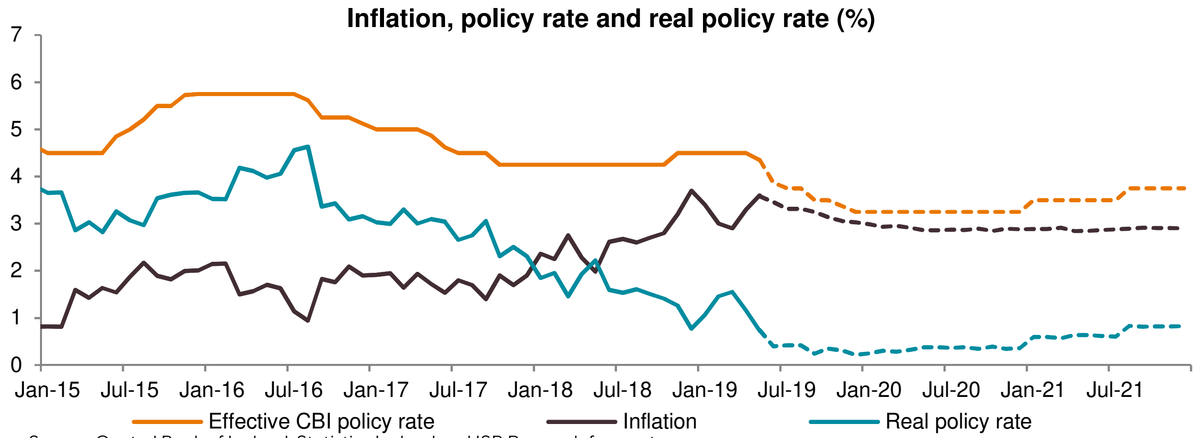
In most senses, the pillars of the economy are sound, and the outlook is for healthy medium-term growth. As a result, foreign investors' interest in Iceland should suffice to offset outflows that stem from pension funds' foreign investments and are not financed with the current account surplus.

On the other hand, the steep wage and price increases in Iceland relative to neighbouring countries will put greater downward pressure on the nominal exchange rate, as these increases lead to a corresponding rise in the real exchange rate, all else being equal.

Inflation has begun to taper off again, after a relatively short-lived spike last winter. In 2018, it measured 3.7%, the highest in five years. It has averaged 3.1% in 2019 to date and 3.2% in August.

The composition of inflation has changed markedly. The upward pressure from house prices has eased and imported goods account for much of the current inflationary pressures, owing in turn to the aforementioned ISK depreciation.

We think inflation has peaked for the present and is on the decline. We expect it to measure 2.4% at the end of 2019 and then average 2.6% and 2.8%, respectively, in 2020 and 2021. According to this, the CBI's inflation target will be in sight not only at end-2019 but for the remainder of the forecast horizon.



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

If our forecast materialises, it will be easier for the CBI to mitigate the business cycle with appropriate interest rate adjustments. The main uncertainties in our forecast are the possibility of an ISK depreciation this coming winter, and the wage demands in still-pending labour market negotiations. On the other hand, developments in house prices could lead to lower inflation.

Thus far in 2019, the CBI has lowered its policy rate by 1 percentage point, citing the poorer economic outlook, the improving inflation outlook, and declining inflation expectations.

The CBI's key rate — i.e., the rate on seven-day deposits — is now 3.5%, its lowest since the inflation target was adopted in spring 2001.

We think interest rates will fall still further, and we expect at least one more rate cut before the end of this year. Thereafter, we expect the policy rate to remain steady at 3.25% through 2020 and then begin rising again in 2021 as the economic outlook improves. The uncertainty in this forecast is concentrated on the downside, in that short-term interest rates could fall further.

Long-term nominal interest rates are currently about 3.6% and long-term real rates 0.8%. For 2020, we expect nominal long-term rates to be below the average in 2019 to date. We then expect both nominal and real rates to rise marginally in the latter half of the forecast horizon.

We forecast that long-term nominal rates will be around 4.2%, and real rates close to 1.2%, by the end of the forecast horizon. According to this, the long-term breakeven inflation rate will be around 3.0% in 2021. It is now roughly 2.8%, after a marked decline since the turn of the year.

The economic adjustment will inevitably be painful for many, after the long growth phase and the severe setbacks suffered by Iceland's largest export sector earlier this year. That said, Iceland is now in an entirely different – and stronger – position than before and is better able to withstand economic headwinds than it has been in decades. There are several important differences: the economic position of households, businesses, and the public sector is much healthier than before, and Iceland's favourable international investment position enhances confidence and reduces the risk of capital flight.

Macroeconomic forecast

, %	2018 ISK m.	2018	Forecast 2019	Forecast 2020	Forecast 2021
Private consumption	1.421.835	4,7	2,0	1,7	2,8
Public consumption	666.999	3,5	2,4	2,3	2,2
Fixed capital formation	628.415	4,0	-6,5	5,7	4,5
thereof industrial investment	398.105	-4,1	-16,5	5,5	4,0
thereof residential housing	121.323	16,2	17,5	7,5	5,0
thereof public investment	108.988	28,3	3,5	3,8	5,2
Changes in inventories	10.726	1,0	0,0	0,0	0,0
Total national expenditure	2.727.975	4,6	-0,3	2,7	3,0
Exports of goods and services	1.324.447	1,7	-6,0	1,1	2,9
thereof exports of marine prod.	239.741	11,8	-2,8	1,1	2,0
thereof aluminium production	230.132	-1,4	-4,5	3,5	2,0
thereof other goods exports	144.219	10,4	5,3	-4,3	2,8
thereof service exports	710.356	0,4	-9,9	1,5	3,5
Imports of goods and services	1.240.417	0,8	-6,8	4,3	3,3
thereof goods imports	776.922	-3,2	-5,8	4,3	3,8
thereof service imports	463.495	7,9	-8,6	4,4	2,5
Gross domestic product	2.812.006	4,8	-0,1	1,3	2,8

% of GDP	2018	Forecast 2019	Forecast 2020	Forecast 2021
Investment	22,3	21,9	22,9	23,4
Current account balance	2,8	3,5	2,4	2,5
Trade balance	3,0	3,2	2,2	2,2
Change in annual average (%)				
Consumption prices	2,7	3,1	2,6	2,8
Wages	6,5	5,0	4,5	5,3
Housing prices	8,0	3,1	2,8	3,3
Average FX exchange rate	4,0	8,8	0,3	0,0
Real ISK exchange rate	-3,0	-7,6	0,3	0,8
Purchasing power of wages	3,7	1,8	1,9	2,4
Annual average (%)				
Unemployment (% of workforce)	2,7	3,6	4,2	3,7
ISK exchange rate index	166,7	181,4	182,0	182,0
Policy rate, Central Bank of Iceland	4,3	3,9	3,3	3,7
Long term interest rate (%)	5,4	4,1	3,9	4,2
Long term real interest rate (%)	1,8	1,0	0,9	1,2

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