Macroeconomic forecast 2020-2022

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Highlights

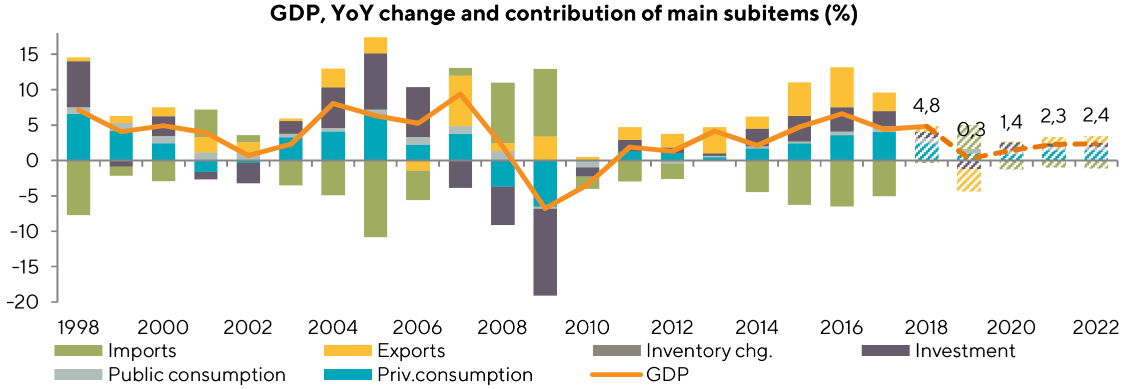
- Contraction not in the offing, but adjustment will take time.
  GDP growth 1.4% in 2020, 2.3% in 2021, and 2.4% in 2022.
- Exports to regain strength gradually.
  Export growth 0.4% in 2020 and 2.0% in 2021.
- Current account to remain in surplus.
  CA surplus 2.8% of GDP in 2020 and 2.5% of GDP in 2021.
- Inflation modest in the near term.
  Inflation 2.2% in 2020 and 2.6% in 2021.
- Steady growth in purchasing power despite moderate wage hikes.
  Real wage growth 2.2% in 2020 and 2.1% in 2021.
- Unemployment relatively high in the near term.
  Jobless rate 4.4% in 2020 and 3.8% in 2021.

Executive summary

No recession in Iceland ... fortunately

It is safe to say that the past decade has been bountiful for the Icelandic economy. After the severe shocks in the late 2000s, living standards are back to pre-crash levels or above them. The main driver of the upsurge is Iceland's third resource – its uniqueness and clean wilderness – which, coupled with its fishing waters and renewable energy resources, provide the bulk of the country's export revenues. In addition, efforts to resolve legacy issues from the financial crisis have been successful, and economic policy has been favourable.

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



Source: Statistics Iceland and ISB Research

Available data for the first three quarters of 2019 indicate a clear turnaround, however, after the setback in tourism at the beginning of the year. GDP growth measured 0.2% during the period. Domestic demand contracted by 0.9%, however, albeit offset by a favourable contribution from net trade.

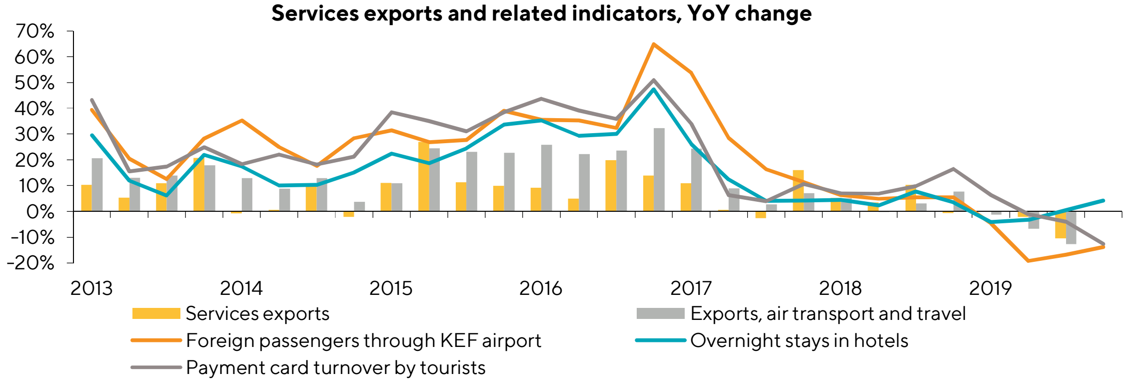
Output growth is estimated at 0.3% for 2019 as a whole. A sharp contraction in business investment and services exports counterbalances consumption growth and a strong contraction in imports.

For 2020, we expect relatively slow growth of about 1.4%, driven by modest growth in domestic demand. We expect the economy to gain steam in 2021 and 2022, with growth measuring 2.3% and 2.4%, respectively, as private consumption and exports regain momentum.

The tourism sector comes of age

Setbacks in the tourism industry early in 2019 led to a contraction in export revenues within the sector and narrowed the services account surplus. Even so, tourism generates the equivalent of nearly four in every ten krónur of foreign exchange revenues. Furthermore, the sector is the main reason the current account is expected to continue showing a sizeable surplus.

Services exports and related indicators, YoY change



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

Revenues from foreign tourists totalled ISK 382bn in the first nine months of 2019, a contraction of just over 8% year-on-year in ISK terms. Over the same period, the fishing industry generated revenues of ISK 192bn and aluminium exports ISK 161bn.

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

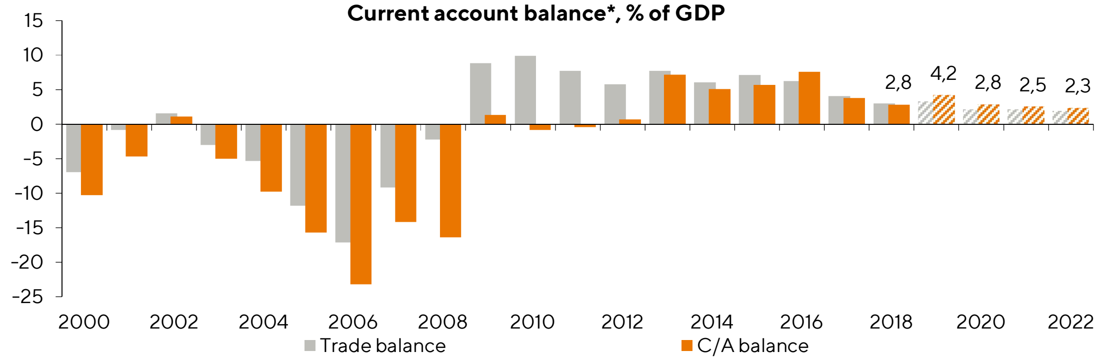
According to Isavia's recent forecast, visitor numbers will be broadly unchanged in 2020. In our opinion, the tourism sector has reached a turning point, with streamlining and maximisation of value per tourist taking over from rapid growth due to steeply rising visitor numbers.

Our forecast indicates an increase in tourist arrivals of approximately 3% per year in 2021 and 2022, in line with forecasted developments in global tourism.

Continued current account surplus expected

The balance on combined goods and services trade showed a sizeable surplus in 2019, in spite of reduced tourist numbers and the failure of the capelin catch. The deficit on goods trade totalled ISK 109bn, but the outlook is for a surplus on services trade in the amount of just over ISK 200bn for the year.

Current account balance*, % of GDP



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

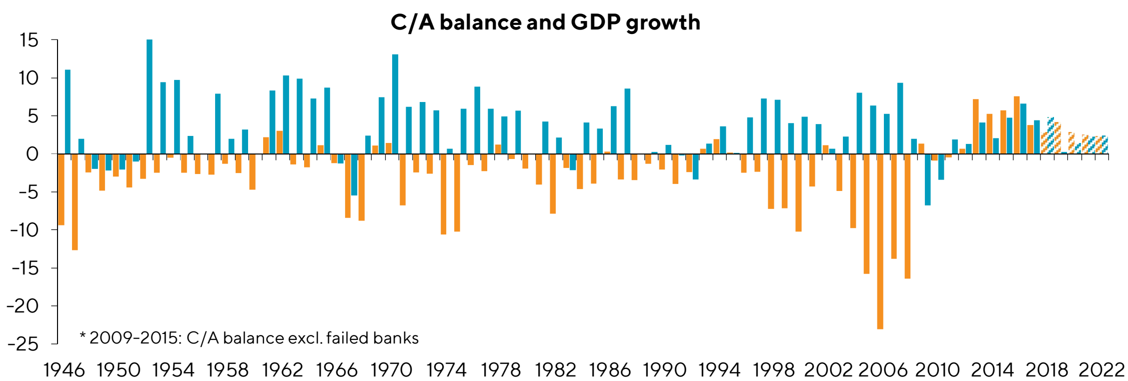
* 2009-2015: C/A balance excl. old banks

Actually, last year's goods account deficit was the smallest since 2015. The main reason for this is the sharp contraction in imports, although exports did develop more favourably than had been anticipated. By the same token, the contraction in services exports was smaller and the contraction in imports larger than expected.

However, these favourable developments in 2019 will be reflected in relatively unfavourable internal developments in imports and exports in 2020. The outlook is for very weak export growth and considerably stronger growth in imports, particularly goods imports.

Exports appear set to pick up next year, fuelled by moderate growth in the tourism and fishing industries. On the other hand, we expect a slowdown in import growth.

As a result, the contribution of net trade to GDP growth will be markedly negative this year and more or less neutral in 2021 and 2022.



Source: The Central Bank of Iceland

Since the founding of the Republic, Iceland's current account has featured all but constant deficits followed by accumulation of foreign debt. The past decade has seen a radical shift, however, with an uninterrupted current account surplus since 2012 despite spates of unrest in the domestic economy.

In spite of severe blows to export sectors in 2019, the current account surplus for that year is likely to be relatively large. We estimate the 2019 surplus at about ISK 120bn (4.2% of GDP).

We project that the current account surplus will measure 2.8% in 2020 and then narrow to 2.3% by the end of the forecast horizon. If our projections materialise, 2022 will see Iceland's 11th consecutive current account surplus.

The net international investment position (NIIP) is therefore expected to continue improving, as external assets exceeded external liabilities by nearly a fourth of GDP at the end of September 2019.

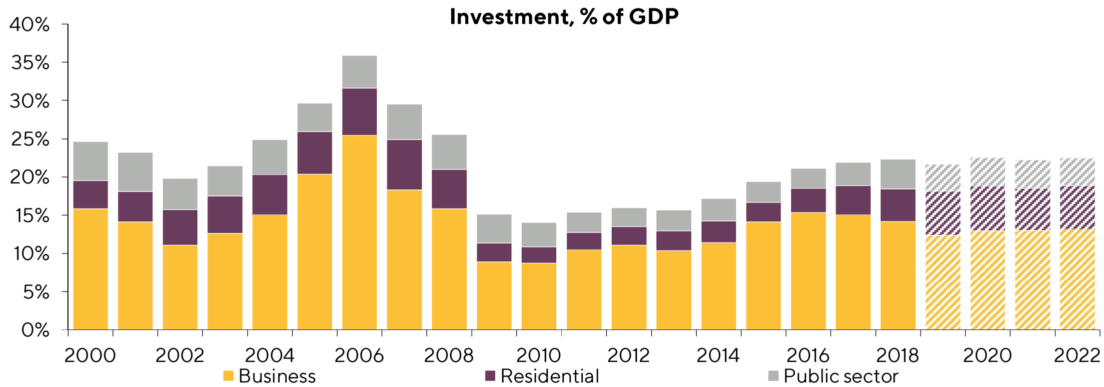
The positive NIIP is conducive to a higher equilibrium real exchange rate than would otherwise occur, as financial income from abroad should exceed financial expense.

Is investment rebalancing after lean times?

Investment lost pace in 2019, after a five-year period of uninterrupted growth. Residential investment retained its momentum, however, although it was probably outweighed by the contraction in business investment and public investment. We estimate that total investment shrank by 5.6% YoY in 2019.

The outlook is for a rebound in 2020, with total investment growth measuring just over 5%, due mainly to 6% growth in business investment after a two-year contraction. We also expect an upturn in public investment this year, offset by a significant slowdown in residential investment.

In 2021 and 2022, business investment will continue to be the main driver of investment growth. On the other hand, we expect a contraction in residential investment in 2021, followed by a contraction in public investment in 2022. In all, we forecast investment growth at 2.2% in 2021 and 2.5% in 2022.

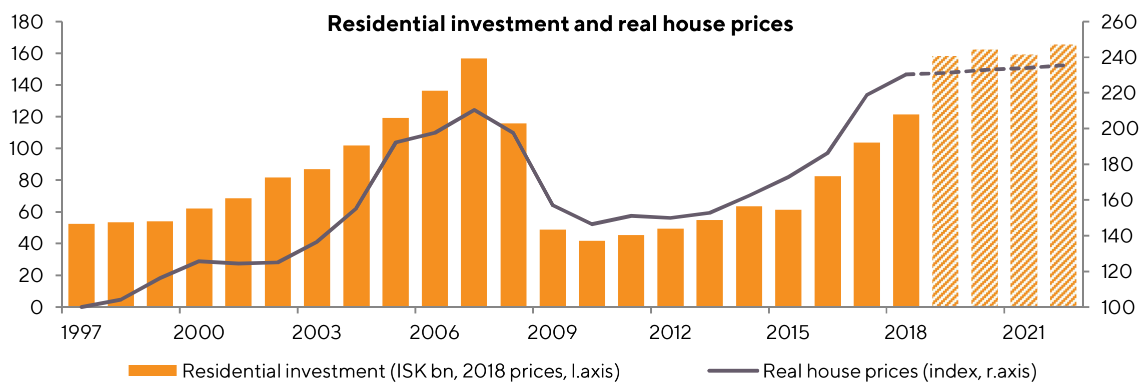


Source: Statistics Iceland and ISB Research forecast

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, even though it will be below the level we have been accustomed to seeing in recent decades. In our opinion, this is partly because it is hard to imagine that any particular sector will offer profitable investment opportunities to the same extent that export sectors have in the past few decades.

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.

Since then, however, the surge in residential investment coupled with declining demand has eased pressures in the market, and the correlation between real house prices and real wages has normalised once again. Residential investment grew by more than 30% in 2019, and the outlook is for a growing supply of new flats during the forecast horizon. We expect growth to measure 2.5% this year, followed by a 2.0% contraction in 2021 and a rebound to 4.0% growth in 2022.



Source: Statistics Iceland and ISB Research forecast

Real house prices rose by 0.4% YoY in 2019, the smallest real increase since 2012. We project that they will rise by 0.6% per year, on average, in 2020-2022.

The main factors supporting our opinion are the increase in supply, the slowdown in real wage growth, higher unemployment, and weaker population growth. Favourable mortgage lending terms and Government measures to support buyers continue to buoy up prices, however. It can be said that these developments in the housing market are in many ways welcome. The market has calmed down after several turbulent years.

Have households begun to dampen cyclical pressures?

Private consumption has been strong in recent years, bolstered by rapidly rising real wages, low unemployment, robust population growth, and a general sense of optimism. Unlike the previous upswing, household debt has remained modest and saving considerable.

Private consumption growth has eased in the recent term. It bottomed out at 1.6% in Q2/2019 but then picked up in the second half of the year.

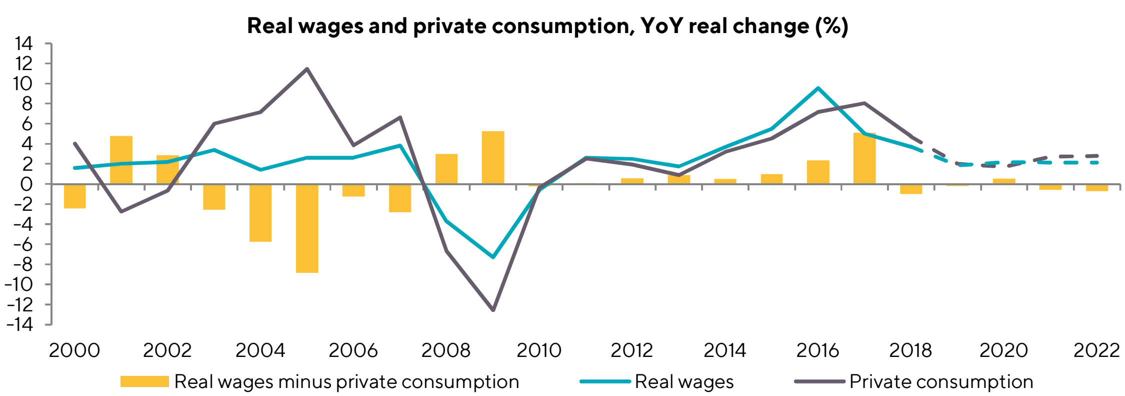
Consumption is now directed increasingly at domestic goods and services, as can be seen in real growth in domestic payment card turnover, which has far outpaced card turnover abroad. This is positive in that it mitigates the impact of weaker private consumption growth on sectors that sell goods and services in Iceland.

The outlook is for households to dampen cyclical swings in coming quarters, in a departure from the usual pattern. It appears that an increasing number of Icelandic households are opting for prudence and long-term thinking in their consumption spending.

Source: Statistics Iceland and ISB Research

Around the middle of the last decade, the labour market was characterised by considerable tension. Unemployment fell steeply, and wages rose quickly. 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%.

Last year, however, there was an abrupt turnaround. Unemployment rose by about a percentage point of the labour force, and wage rises were the most modest since 2010. WOW Air's collapse and the contraction in tourism are important factors in this about-face, together with streamlining in the banking system and elsewhere.



Source: Statistics Iceland and ISB Research forecast

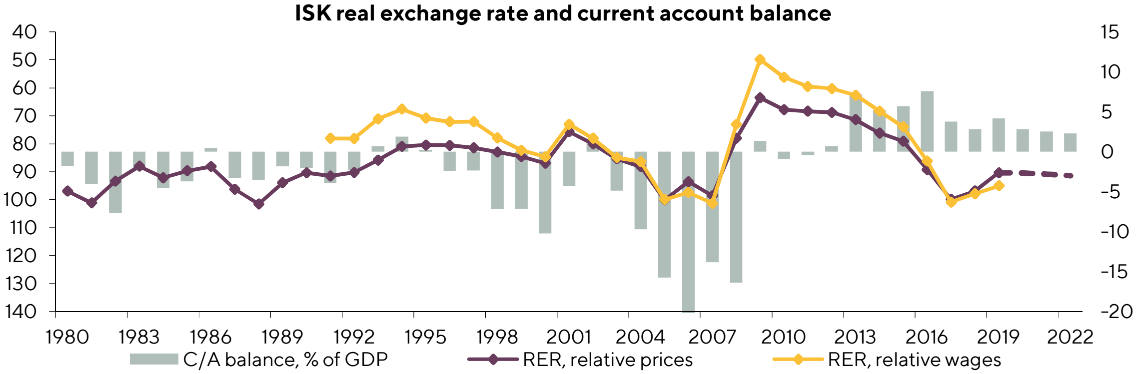
Even though the signing of the so-called standard of living agreement was positive overall, there is still some uncertainty in the labour market, as public sector wage agreements are still pending. We expect unemployment to peak next year at 4.4% and then fall to 3.0% in 2022. We also expect real wage growth to measure about 2.0% per year through 2022.

Private consumption is an important factor in Iceland's GDP growth, accounting for about half of GDP in recent years. We foresee a period of slower private consumption growth ahead, although households' strong position will help greatly in this regard. We expect the growth rate to measure 1.7% in 2021 and rise to 2.8% by the end of the forecast horizon.

ISK relatively well balanced

After depreciating by 9% in H2/2018, the ISK was more stable by various measures in 2019 than in any single year since it was floated at the turn of the century. Economic headwinds had relatively little impact on the exchange rate last year. From the beginning of 2019 through end-January 2020, the ISK has fluctuated within a band of roughly 6% centred on an index value of 180 in terms of the Central Bank's (CBI) trade-weighted exchange rate index (TWI).

ISK real exchange rate and current account balance



Source: Statistics Iceland and ISB Research forecast

It appears that the real exchange rate is currently within the range that is consistent with an internally and externally balanced economy. Furthermore, major players in the market are convinced that this is the case and that this equilibrium will prevail for a while to come.

As a consequence, we consider the uncertainty about near-term exchange rate developments to be broadly symmetric. It is quite likely that the ISK exchange rate will remain around the level seen in the past year, provided that there are no dramatic and unexpected changes in major underlying factors.

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 will lead to a corresponding rise in the real exchange rate, all else being equal, and this will erode Iceland's competitive position and cut into external trade.

Inflation under wraps and a policy rate cut in the pipeline

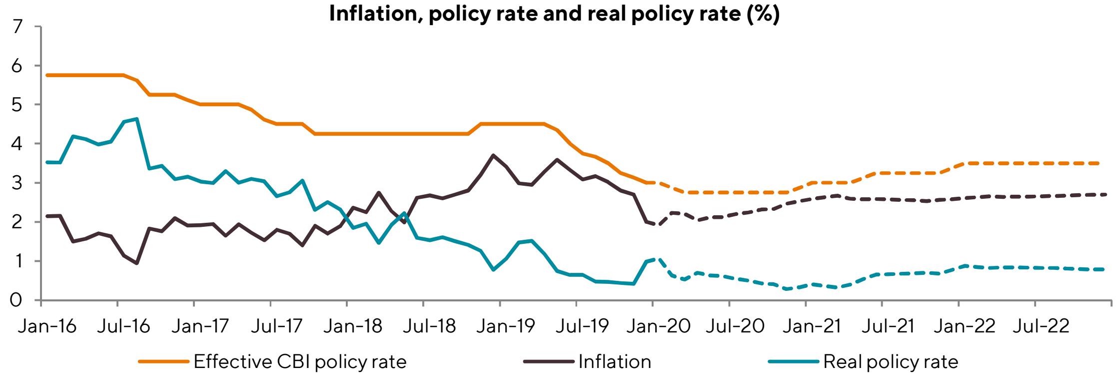
After a short-lived spike following the ISK depreciation in autumn 2018, inflation fell markedly in 2019. By the end of 2019, it measured 2.0%, its lowest in two years.

This disinflation episode is due primarily to the slowdown in house price inflation, dwindling exchange rate pass-through from the 2018 ISK depreciation to imported goods prices, and reduced price pressures from domestic goods. The composition of inflationary pressures has changed radically from before the last inflation spike, which was catalysed in large part by house prices but held in check by exchange rate pass-through in the opposite direction, with the appreciation of the ISK keeping import prices under control.

The outlook is for modest inflation during the forecast horizon. We expect inflation to remain below the CBI's target this year, averaging 2.2%, before rising to an average of 2.6% in 2021 and 2.7% in 2022.

The main assumptions underlying our forecast are a relatively stable exchange rate, moderate wage hikes, and a well-balanced housing market featuring price increases in line with the general price level.

Inflation, policy rate and real policy rate (%)



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

In 2019, the CBI's policy rate was lowered by a total of 1.5 percentage points as the inflation outlook improved and the economy cooled. The real policy rate fell much less, however.

The CBI's key interest rate – i.e., the rate on seven-day deposits – is now 3.0%, 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 middle of this year. Thereafter, we expect the policy rate to remain steady at 2.75% 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 and remain low for a longer period.

Long-term nominal interest rates are currently about 3.2% and long-term real rates 0.7%. We expect average long-term nominal 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 4.1%, 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 2.9% as 2022 progresses. It is currently about 2.5%, after falling steeply last year.

Economic foundations have been buttressed

Fortunately, a number of the pillars of the Icelandic economy are quite robust at present:

Substantial deleveraging by households, firms, and the public sector in the past decade has shored up financial resilience. This reduces the risk that temporary headwinds will trigger serious default and insolvency in the private sector, and it enhances the Government's countercyclical capacity.

The financial system has been transformed and is now characterised by prudence and effective supervision. This, plus moderate private sector debt, reduces the likelihood of financial crises and procyclical aftereffects from lending activity.

Iceland's positive NIIP and moderate external debt, combined with the CBI's ample international reserves, greatly reduce the risk of capital flight accompanied by adverse effects on the exchange rate, inflation, and purchasing power.

The Icelandic job market is unusually flexible in international comparison, labour participation is high, and unemployment is lower than in most advanced economies.

Unlike many neighbouring countries, we have been fortunate enough to amass large pension funds. This reduces the risk that an aging population will turn out to be a drag on the public sector and an undue burden on future taxpayers.

Macroeconomic forecast

%	2018 ISK m.	2018	Forecast 2019	Forecast 2020	Forecast 2021	Forecast 2022
Private consumption	1.421.835	4,7	2,0	1,7	2,7	2.8
Public consumption	666.999	3,5	2.6	2.3	2.2	2.0
Fixed capital formation	628.415	4,0	-5.6	5.2	2.2	2.5
thereof industrial investment	398.105	-4,1	-14.9	6.1	3.5	3.5
thereof residential housing	121.323	16,2	30.4	2.5	-2.0	4.0
thereof public investment	108.988	28,3	-11.9	6.5	4.5	-3.0
Changes in inventories	10.726	1,0	0,0	0,0	0,0	0.0
Total national expenditure	2.727,975	4,6	0.0	2.6	2.5	2.5
Exports of goods and services	1.324.447	1,7	-6,6	0.4	2.0	2.2
thereof exports of marine prod.	239.741	11,8	-3.5	1.0	1.9	1.7
thereof aluminium production	230.132	-1,4	-3.8	4.0	0.5	0.5
thereof other goods exports	144.219	10,4	11.0	-6.0	2.0	2.0
thereof service exports	710.356	0,4	-12.1	0.5	2.5	3.0
Imports of goods and services	1.240.417	0,8	-7.6	3.2	2.4	2.6
thereof goods imports	776.922	-3,2	-6.5	3.8	2.7	2.8
thereof service imports	463.495	7,9	-9,6	2.1	1.9	2.1
Gross domestic product	2.812.006	**4,8**	**0.3**	**1.4**	**2.3**	**2.4**

% of GDP	2018	Forecast 2019	Forecast 2020	Forecast 2021	Forecast 2022
Investment	22.3	21.6	22.4	22.3	22.3
Current account balance	2.8	4.2	2.8	2.5	2.3
Trade balance	3.0	3.2	2.1	2.1	1.9
Change in annual average (%)					
Consumption prices	2,7	3.0	2.2	2.6	2.7
Wages	6.5	4.9	4.4	4.8	4.9
Housing prices	8.0	3.4	2.9	3.0	3.4
Average FX exchange rate	4.0	8.6	0.0	0.0	0.0
Real ISK exchange rate	-3.0	-7.5	0.2	0.5	0.6
Purchasing power of wages	3.7	1.8	2.2	2.1	2.1
Annual average (%)					
Unemployment (% of workforce)	2.7	3.7	4.4	3.8	3.0
ISK exchange rate index	166.7	181.0	181.0	181.0	181.0
Policy rate, Central Bank of Iceland	4.3	3.9	2.8	3.3	3.5
Long term interest rate (%)	5.4	4.2	3.4	3.8	4.1
Long term real interest rate (%)	1.8	1.0	0.9	1.1	1.2

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