September 2022

Macroeconomic forecast:
Adjustment phase ahead

Adjustment phase

Summary

Waning output growth

GDP growth

- Growth driven increasingly by exports
- 7.3% growth in 2022
- 2.2% growth in 2023
- 2.4% growth in 2024

Current account: from deficit to surplus

External trade

- Growth of tourism weighs heavily in exports
- Exports to rise by 21.2% in 2022 and imports by 20%
- 1.5% current account deficit in 2022 flips to a surplus in 2023 and 2024
- Current account surplus 1% of GDP in 2023 and 2.4% in 2024

Inflation tapering off

Inflation

- Inflation estimated to have peaked at 9.9% in July but will remain above CBI target for the entire period
- Fairly rapid ease over the coming months
- Key uncertainties are wage agreements, house prices, and foreign prices
- Inflation to average 6.3% in 2023 and 3.9% in 2024

Labour shortage

Labour market

- Foreign workers could soon account for over 20% the Icelandic labour market
- Unemployment to average 3.8% in 2022
- 3.2% in 2023
- 3.6% in 2024

Policy rate nearing its peak

Interest rates

- Policy rate 6% by end-2022
- Gradual monetary easing from mid-2023 onwards
- Policy rate 4.5% near the end of the forecast horizon

ISK to strengthen in the coming term

The ISK

- The ISK will be about 6% stronger at the end of the forecast horizon than at end-August 2022
- More favourable external trade and inflows for securities investment contribute to the appreciation
- Pension funds set for substantial foreign investment

Weaker GDP growth in the cards after an impressive surge

Exports take over from demand as the main driver

After contracting nearly 7% in 2020, the Icelandic economy picked up strongly in 2021, recording 4.4% GDP growth. It was driven mainly by domestic demand and supported by the Government's economic policy response, an improving labour market, and a sound financial position among most households and businesses. Exports rebounded relatively strongly, albeit offset by brisk import growth.

We forecast GDP growth at 7.3% in 2022, Iceland's fastest growth rate in 15 years. Export growth is positioned to gain even more ground and take over as the mainstay of output growth in H2/2022. Investment growth will also be robust in H2, while private consumption growth will slow markedly after topping 11% in H1.

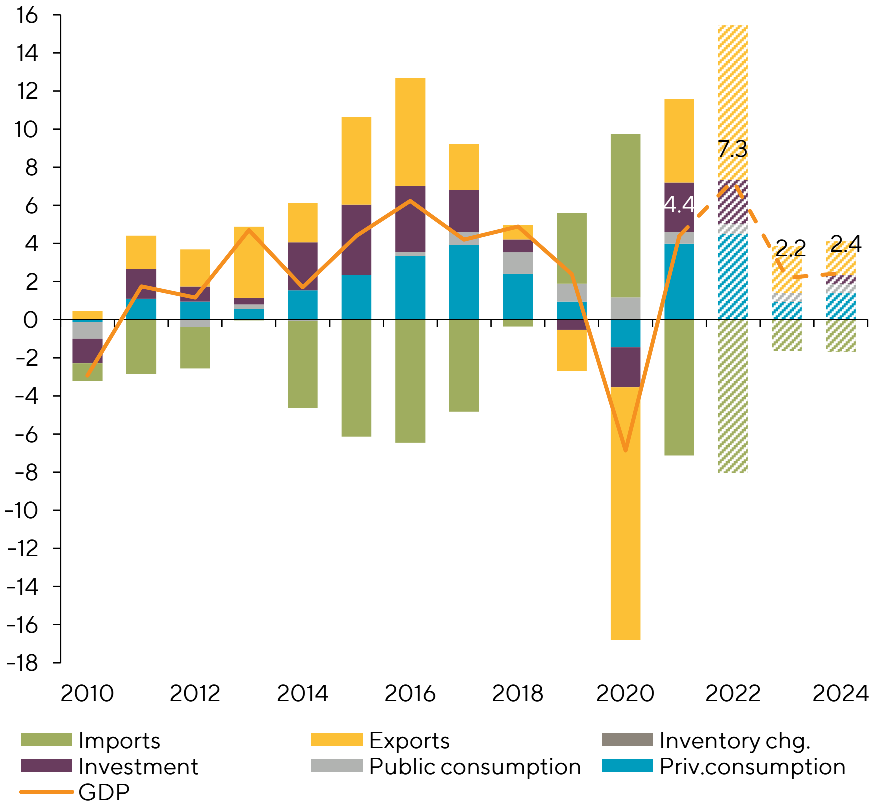
For 2023, we forecast GDP growth at 2.2%. It will be buoyed up largely by exports, as domestic demand growth will slow significantly year-on-year. For 2024, the final year of the forecast horizon, we project GDP growth at 2.4%. By then, export growth will have eased and consumption and investment will have started picking up again.

Near-term economic developments are highly uncertain. External uncertainties include the war in Ukraine, the effects of high inflation and rising interest rates on trading partner demand, and the ambiguous outlook for China, owing to its strict public health policy and vulnerable housing market.

In Iceland, developments will depend on the coming wage negotiations, the Central Bank's policy stance, and whether the housing market rebalances without a hard landing, to mention a few factors.

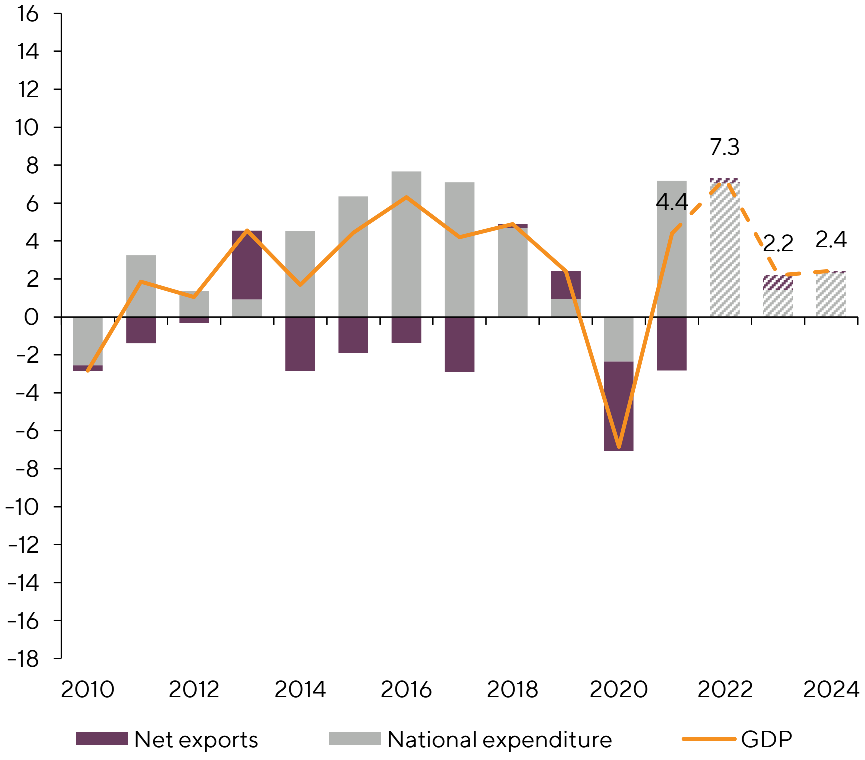
GDP and contribution of its subcomponents

Volume change from prior year (%)



GDP, domestic demand, and external trade

Volume change from prior year (%)



Sources: Statistics Iceland, ÍSB Research.

Tourism industry bouncing back after the pandemic

We expect 1.7 million tourists to visit Iceland in 2022, followed by 2 million in 2023

After two punishing years dominated by the pandemic, prospects for the tourism sector have improved rapidly.

Departure figures from Keflavík Airport show that just over 1.1 million tourists visited Iceland in the first eight months of 2022, the largest January-August total since 2019. Although travellers from Asia are far fewer now than before the pandemic, visitors from the US and Europe have made up the shortfall.

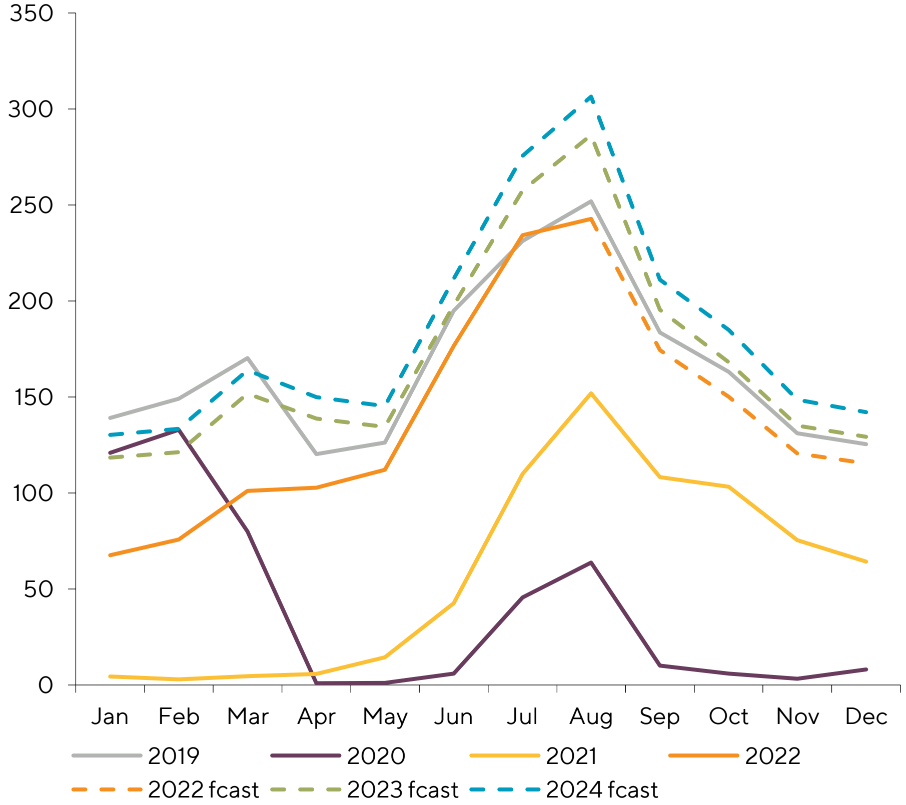
The outlook for coming quarters is quite good despite significant uncertainty about matters in the UK and mainland Europe. The status of bookings and the growing number of flights to and from Iceland suggest that tourist numbers in coming months could be on a par with the 2019 total.

We forecast 1.7 million tourist arrivals this year, about the same number as in 2016, if our forecast materialises. We expect tourist numbers to rise to 2 million in 2023 and 2.2 million in 2024. It is worth noting that this forecast is based on departures via Keflavík Airport, but a significant number of visitors will also travel through the airport in Akureyri or by cruise ship.

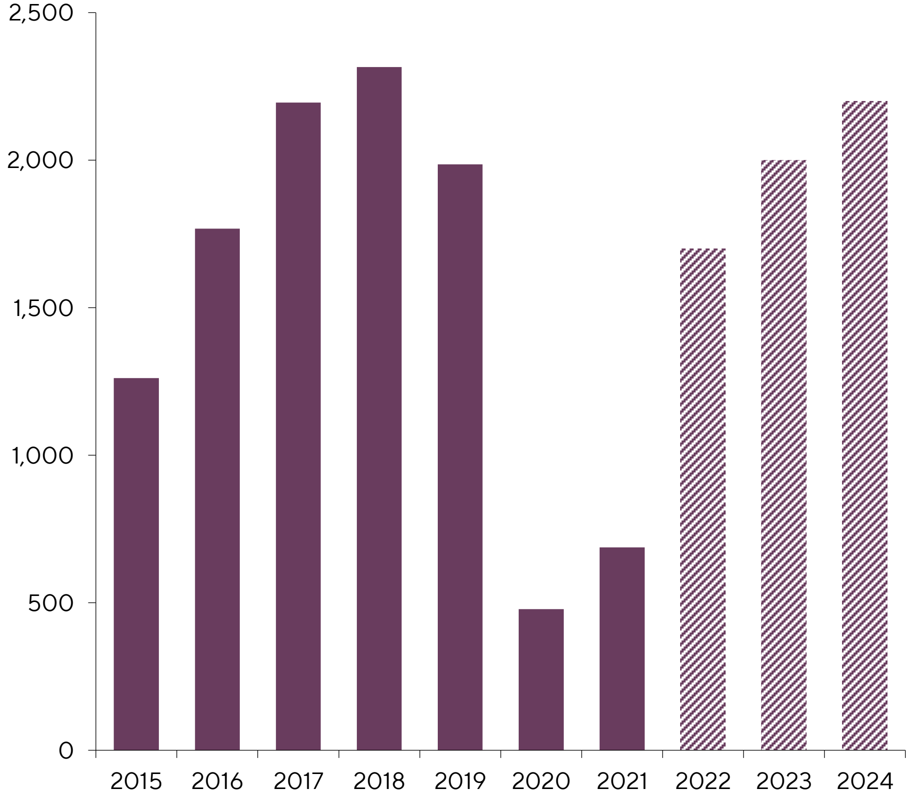
The slower increase later in the horizon is due in part to the ambiguous economic outlook on both sides of the Atlantic, as well as to the higher real exchange rate, which will make Iceland a costlier destination than it has been recently.

The total head count is not the only determinant of revenue generation, either: the length of each visitor's stay and the amount each spends on goods and services while in the country are also important factors. Fortunately, it appears that revenues per tourist are on the rise. Maintaining this trend is important for the sector in years to come.

Number of foreign tourists, by month
thousands



Number of foreign tourists, by year
thousands



Sources: Icelandic Tourist Board, ÍSB Research

Tourism the backbone of export growth, supported by other sectors

Pelagic fish, land-based aquaculture, and intellectual property are among other growth sectors, while import growth is set to lose pace

The return of tourism as Iceland's key export sector explains most of the 21% export growth we forecast for 2022. Exports of intellectual property and other services look set to grow markedly as well. Furthermore, the outlook is for modest growth in goods exports. This is due to booming exports of capelin, farmed fish, and silicon metals as well as a slight increase in exports of aluminium, offset by a contraction in exports of groundfish, particularly cod.

The continued rise in tourist numbers is the main driver of export growth in 2023 (forecast at nearly 6%) and 2024 (nearly 4%). Furthermore, we expect stronger exports of farmed fish, aluminium, and other industrial goods, plus increased revenues from intellectual property usage, to name but a few items.

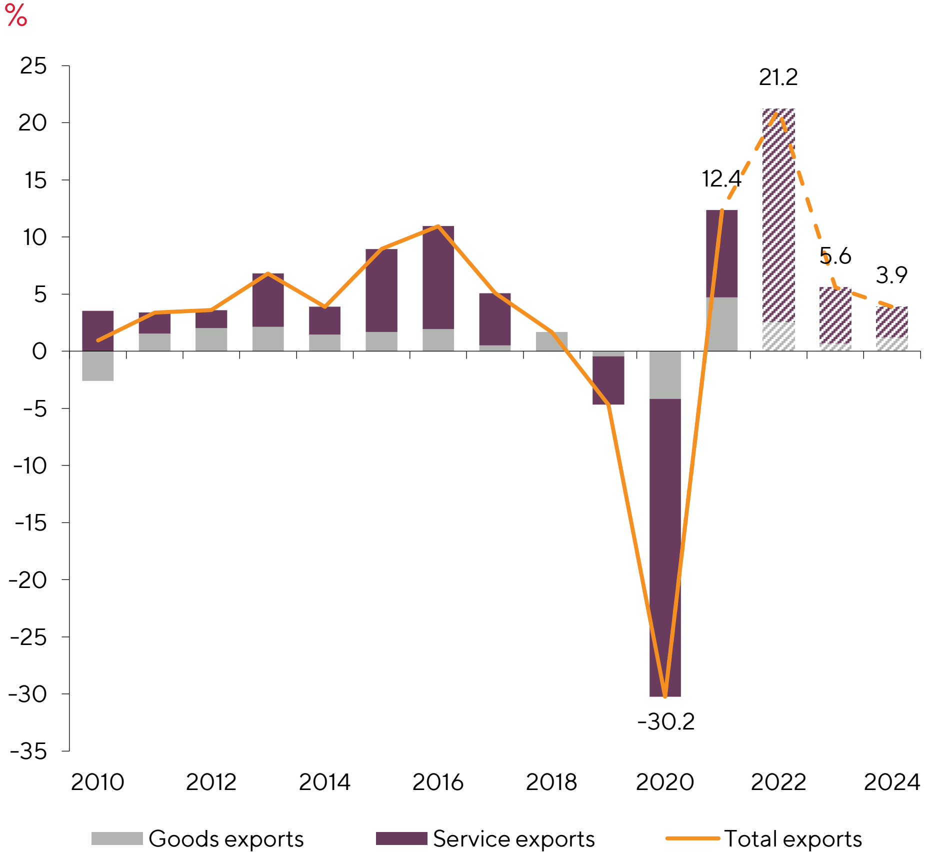
In all, imports grew by just over 20% in 2021, largely because of imported consumption and investment, but also because of a growing need for export-related inputs.

For the same reasons, the outlook is for imports to grow by over a fifth in 2022 as well. 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, particularly in H1.

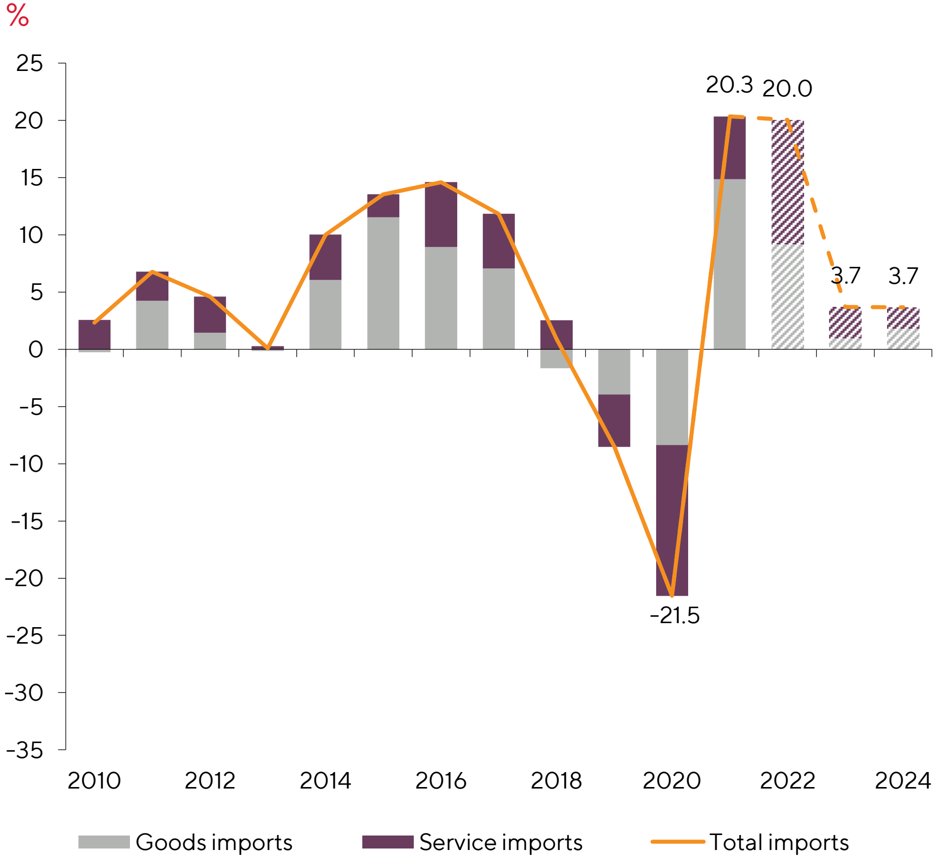
Import growth will then ease considerably over the next two years, according to our forecast, mostly because of weaker domestic demand, coupled with slower growth in the need for export-related inputs.

As exports overtake imports, the contribution from net trade, which has been negative for the past two years, will turn positive and remain so throughout the horizon.

Exports and contributions from subcomponents



Imports and contributions from subcomponents



Sources: Statistics Iceland, ÍSB Research.

Current account flips from deficit to surplus

Export growth and reduced demand growth push the current account back into positive territory

In 2021, the current account balance was negative by 1.6% of GDP, Iceland's first deficit since 2011, if calculated financial items relating to the failed banks are excluded. The 2021 deficit came to just over ISK 60bn. It breaks down into deficits of ISK 159bn on goods trade and ISK 35bn on secondary income, partially offset by surpluses of ISK 33bn on primary income and ISK 101bn on services trade.

Last year's deficit reflects the fact that domestic demand picked up faster than exports in the wake of the pandemic. Thus export growth did not fully offset imports, due to rapid growth in consumption and investment and a greater need for export-related inputs.

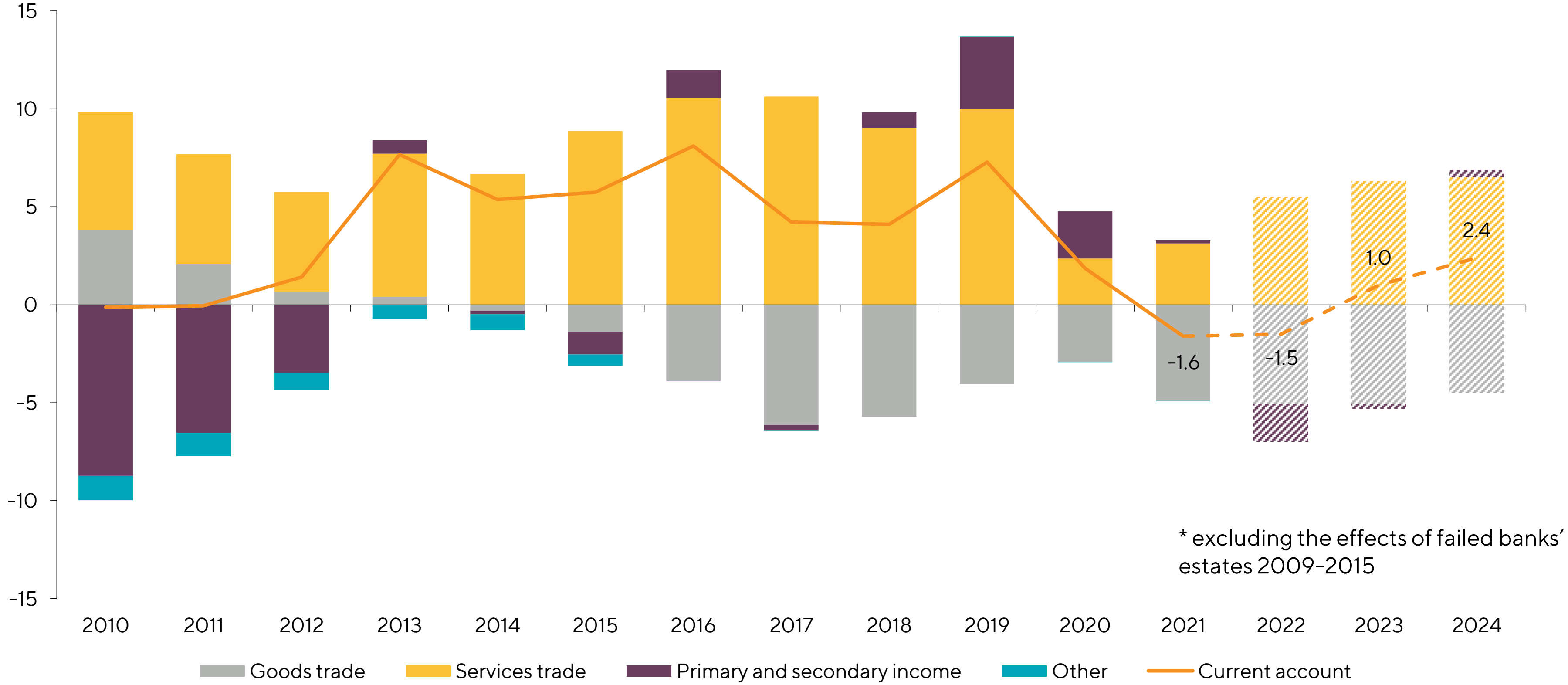
Developments in H1/2022 were similar, with a current account deficit of ISK 84bn. Vastly increased export revenues will probably offset growth in import-related expense in H2, as export growth gains pace in tandem with slower growth in domestic demand. It also helps that marine product prices have risen steeply and the price of imported goods such as fuel, metals, and food has eased after surging early this year.

The outlook is for a 1.5% current account deficit in 2022. In the latter half of the forecast horizon, the current account is forecast to show a surplus measuring 1.0% of GDP in 2023 and 2.4% of GDP in 2024. Whether the current account balance remains favourable thereafter will depend not least on the real exchange rate and terms of trade.

Iceland's net external assets currently equal nearly ¼ of GDP, providing crucial support for the ISK and the economy as a whole. The situation has deteriorated in 2022 to date, reflecting the plunge in foreign securities markets, but will hopefully right itself in the coming term.

The current account balance and its subcomponents

% of GDP*



* excluding the effects of failed banks' estates 2009-2015

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

Investment growth strong in 2022 but slower further ahead

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

After a two-year contraction, investment spiked in 2021, growing by over 12%, the fastest pace in five years.

Business investment and public investment grew markedly, while residential investment contracted by over 5%.

The investment-to-GDP ratio gained considerable momentum last year, reaching 22.7%, its highest in 13 years.

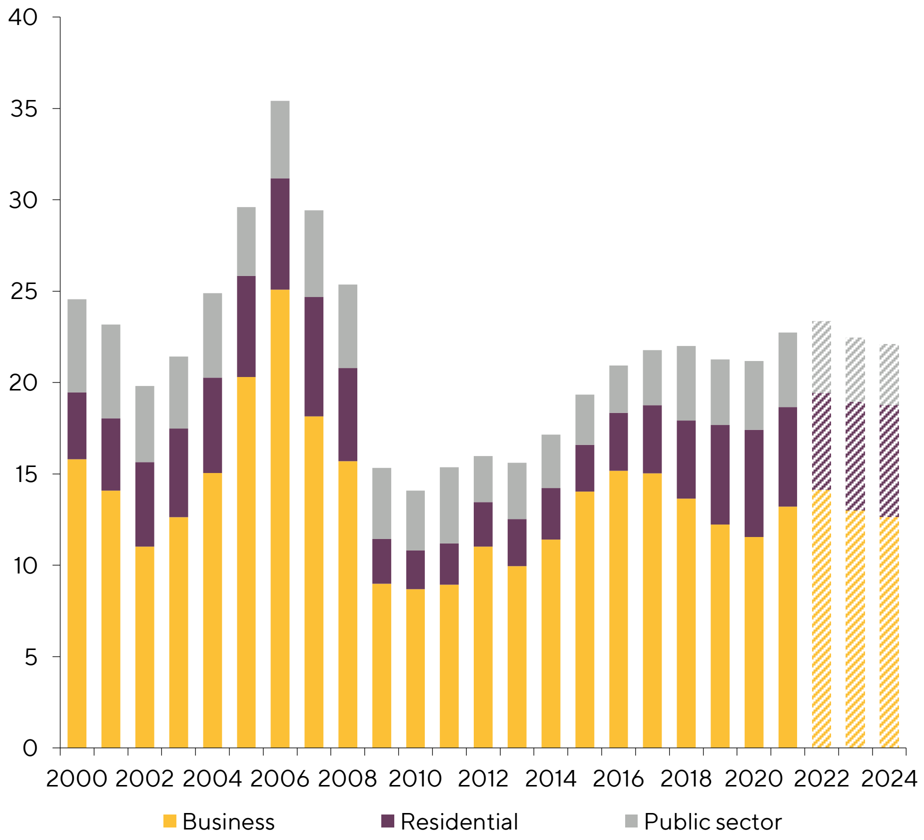
Business investment looks set to keep growing in 2022. It grew by 12% in H1, and indicators imply that the trend will continue through the year-end. Residential investment is also picking up after contracting in H1, and growth is expected to be positive for the year as a whole. Furthermore, the outlook is for continued moderate growth in public investment.

In 2023, residential investment is likely to be the sole driver of growth, as business investment looks set to contract because of rising interest rates and dwindling expectations about firms' operating environment. In addition, public investment has peaked and looks set to contract slightly next year.

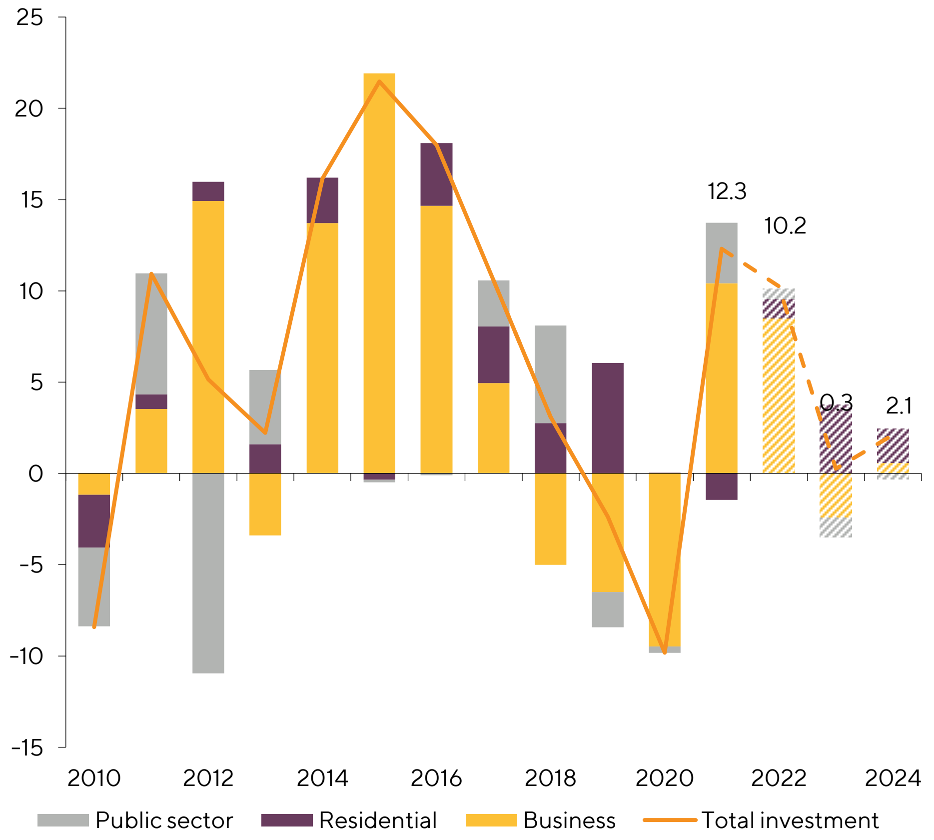
The final year of the forecast horizon will see moderate growth in private sector investment coupled with a marginal contraction in public investment.

We forecast that total investment will grow by just over 10% in 2022, remain virtually flat in 2023, and grow by just over 2% in 2024. The investment level in the economy will therefore fall gradually, even though total investment will be reasonably strong and the investment-to-GDP ratio acceptable.

Investment
% of GDP



Investment, real change, and contribution of subcomponents
%



Sources: Statistics Iceland, ÍSB Research.

Executives' expectations have declined

Higher financing costs and a more ambiguous outlook will probably cut into business investment over time

After a more than 30% contraction in 2018-2020, business investment picked up strongly in 2021.

Total business investment grew by over 19% year-on-year in 2021, and general investment excluding aircraft, ships, and energy-intensive industry grew by 15%.

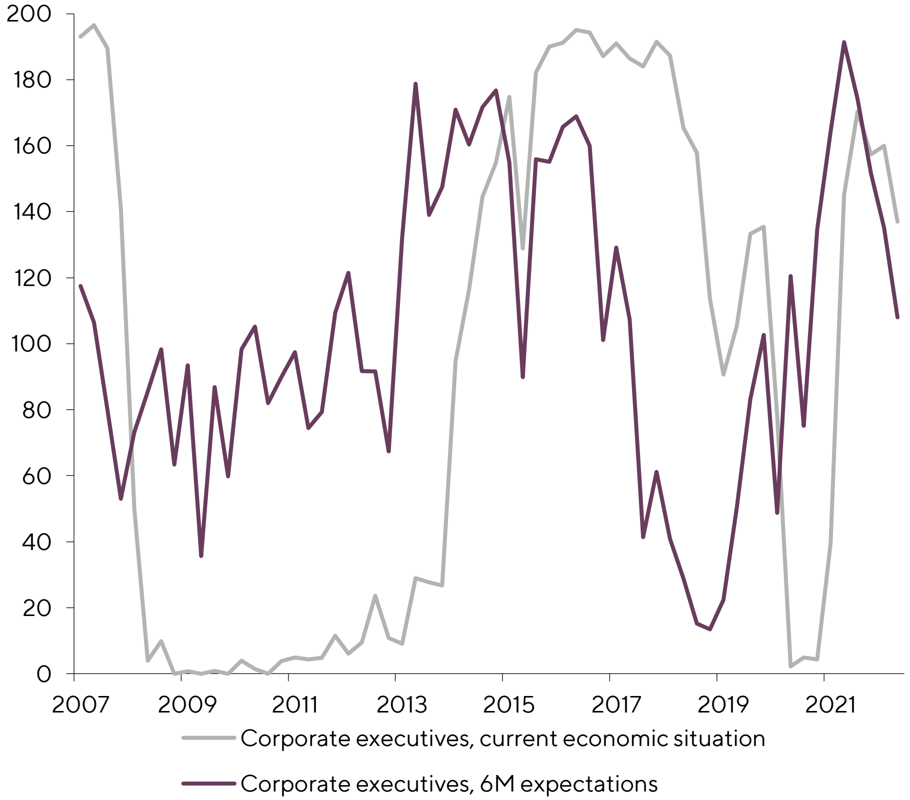
Among executives from Iceland's largest firms, expectations rose steeply in 2021 as the pandemic subsided, but have sagged once again in 2022, presumably because of the war in Ukraine, high inflation, and high interest rates in Iceland and abroad.

There seems to be a fairly strong correlation between corporate sentiment and subsequent developments in general 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 most recent measurements probably indicate weaker growth further ahead.

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

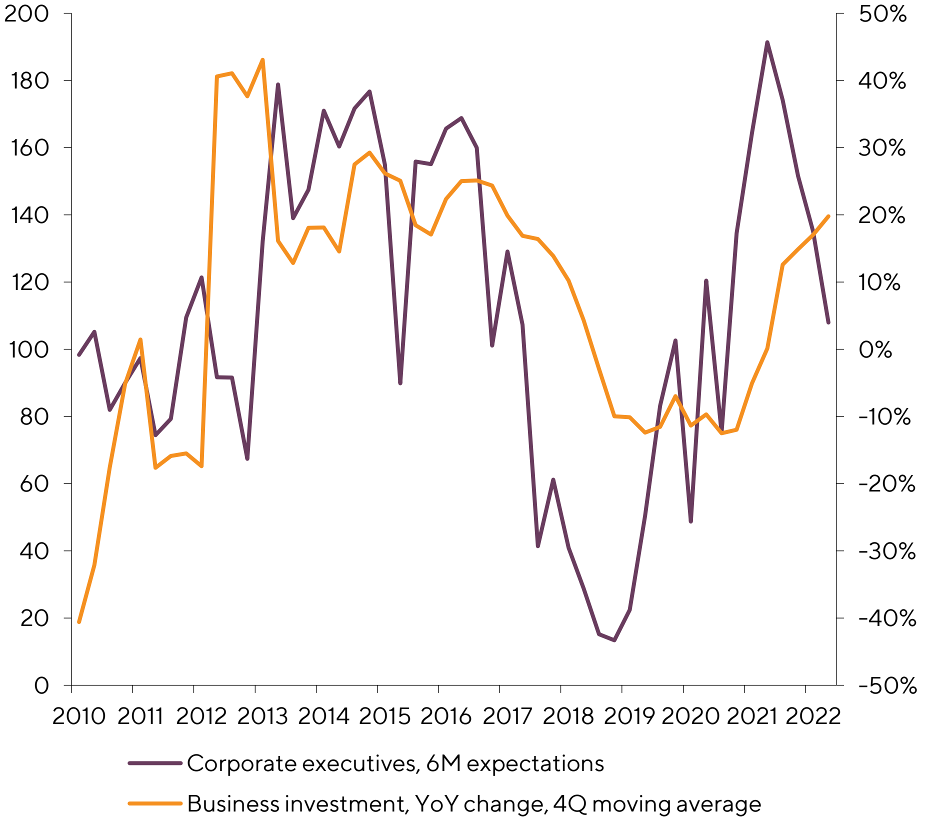
Expectations of executives from Iceland's 400 largest firms

Index



Executives' expectations and business investment

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



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

The housing market has begun to turn around

Central Bank measures appear to be achieving the intended result

The housing market has been buoyant in the recent term. Prices started rising when the pandemic struck in 2020. The pace accelerated a year later and has remained brisk ever since.

Twelve-month house price inflation nationwide now measures 25%, its highest since 2006. But the market has turned a corner, and the steep increases seen recently look set to come to an end.

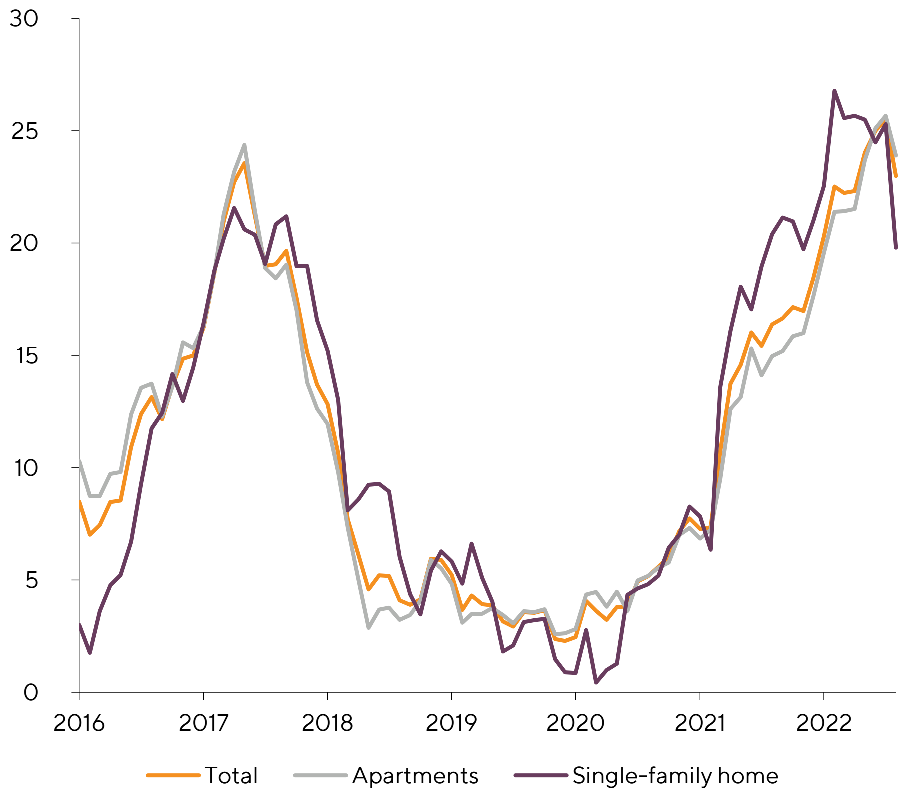
The first signs of cooling came in July, when prices rose much more slowly than in the months beforehand. When the house price index fell month-on-month in August, for the first time since November 2019, it was clear that a shift was underway.

There are various other signs of a calmer housing market as well, chief among them the number of flats for sale. According to the Housing and Construction Authority, about 1,000 homes were on the market in July, the largest number since the beginning of 2021.

Most properties on the market are older homes being re-sold, not new construction. This suggests that the market is slowing down not because of a larger supply of new homes but because of weaker demand. The primary reason for this, it would seem, is the Central Bank's policy actions. The CBI has raised interest rates aggressively and tightened borrower-based measures on new loans. Both of these are finally affecting the market. A large share of mortgage loans are non-indexed, which makes monetary policy transmission more efficient.

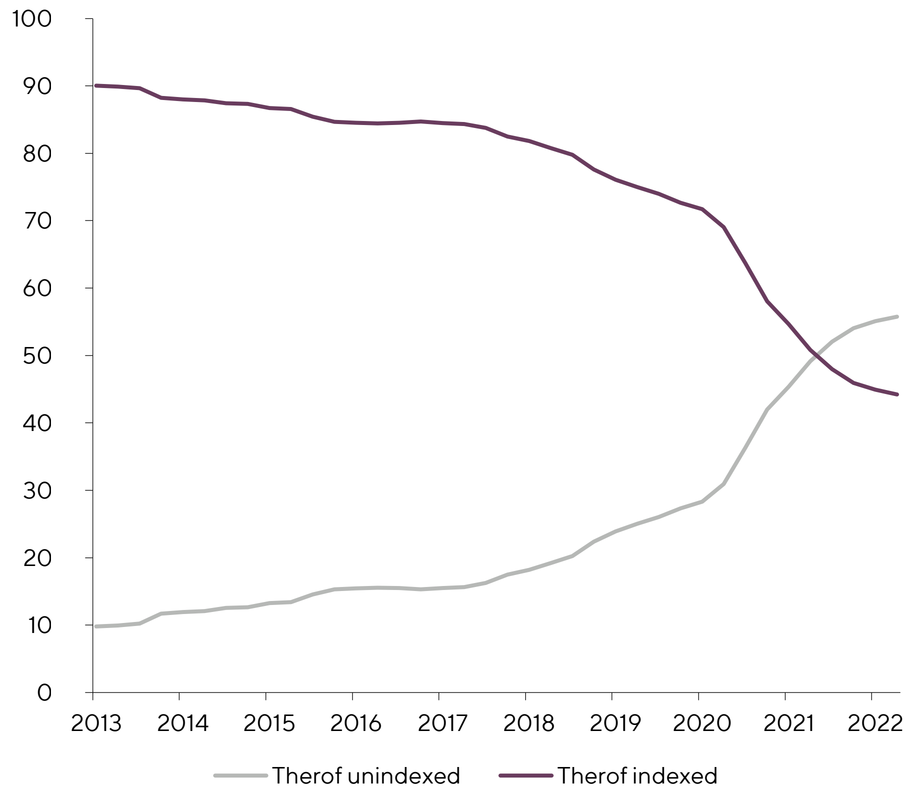
YoY rise in capital area house prices

%



Households' mortgage debt

%



Sources: Registers Iceland, Central Bank of Iceland.

Calmer housing market in 2023

House prices have eased much faster in other countries

The surge in house prices during the pandemic is not a uniquely Icelandic phenomenon: the same occurred in most neighbouring countries. In the OECD, for instance, real house prices rose nearly 9% in 2021, including more than 12% in the US.

Interestingly, housing markets appear to have cooled quite a bit faster abroad than in Iceland. The reasons for the price hikes are the same: governments introduced stimulative measures in the wake of the pandemic. But demand has clearly tapered off much faster abroad than it has here. Presumably, this is mainly because most other countries are not dealing with supply shortages as severe as those in Iceland, and demographic changes there are less likely to push demand upwards.

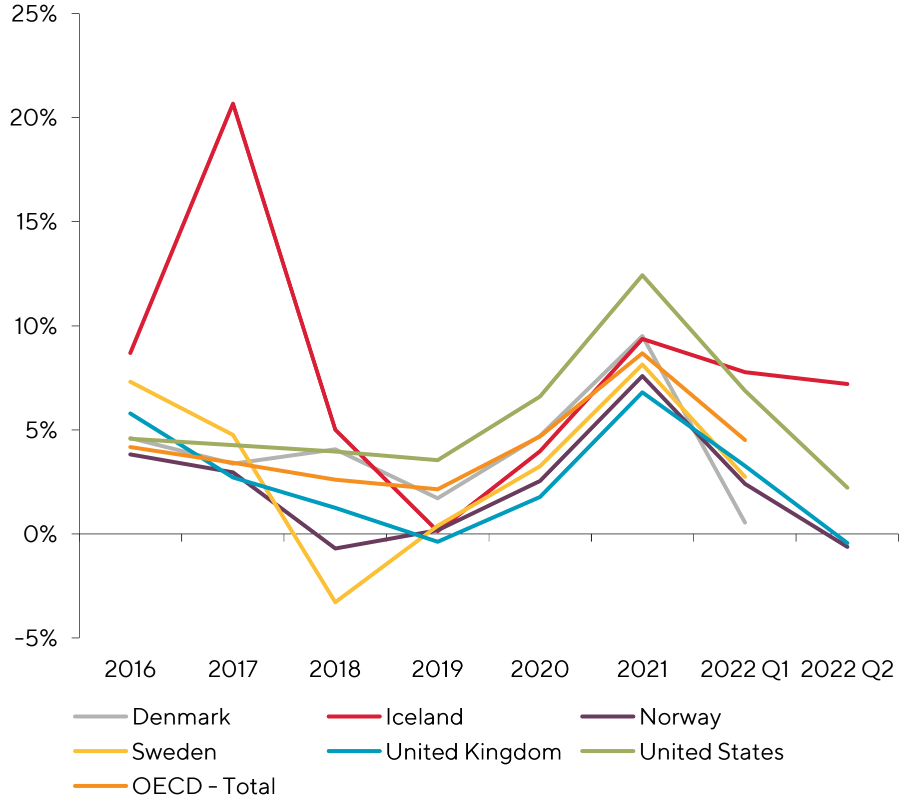
In Iceland, demand pressures are still strong, although they have started to ease. Even though supply has grown, it is still low in a historical context. The average time-to-sale is still very short, and many homes are selling above the asking price.

The supply of new properties must also pick up if the market is to achieve a better balance. According to the tally carried out by the Federation of Icelandic Industries and the Housing and Construction Authority, a large number of homes should be put on the market in late 2022 and 2023. Hopefully it will be enough to satisfy pent-up demand and demographic developments.

We expect house prices to cool quickly in coming months, and we hope the market will be reasonably balanced by early 2023. For this year, we project that real prices will rise by 11.6%, most of which has already materialised. We expect them to rise by 0.8% in 2023 and remain all but flat in 2024. Prices could fluctuate, and even fall in the short run, but according to our forecast, they will move in line with the general price level over the long term.

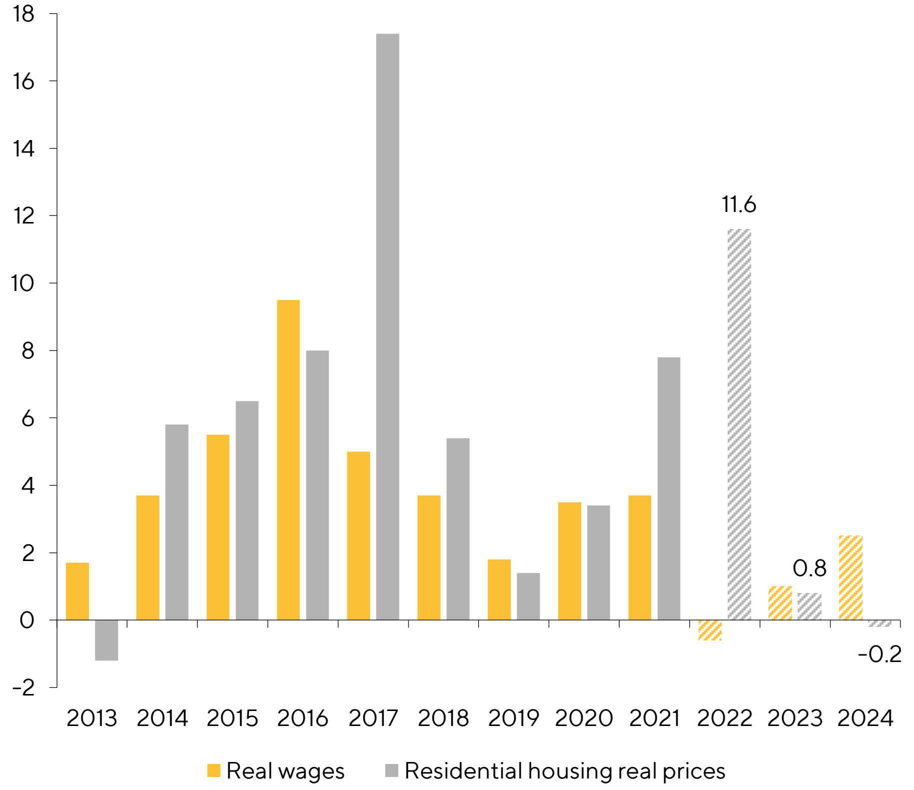
Real house prices, by country

% change



Real house prices and real wages

% change between years



Sources: Statistics Iceland, ÍSB Research.

Unemployment back to pre-pandemic level

Worker shortage at its second-highest ever

Unemployment has fallen very rapidly from its mid-pandemic peak. Registered unemployment measured 3.1% in August and is now roughly where it was before airline WOW Air folded in early 2019.

The labour market has rebalanced remarkably quickly, given the outlook at the onset of the pandemic. The rapid economic recovery has fostered strong job growth and caused the jobless rate to fall as rapidly as it indeed has. We forecast average unemployment in 2022 at 3.8%.

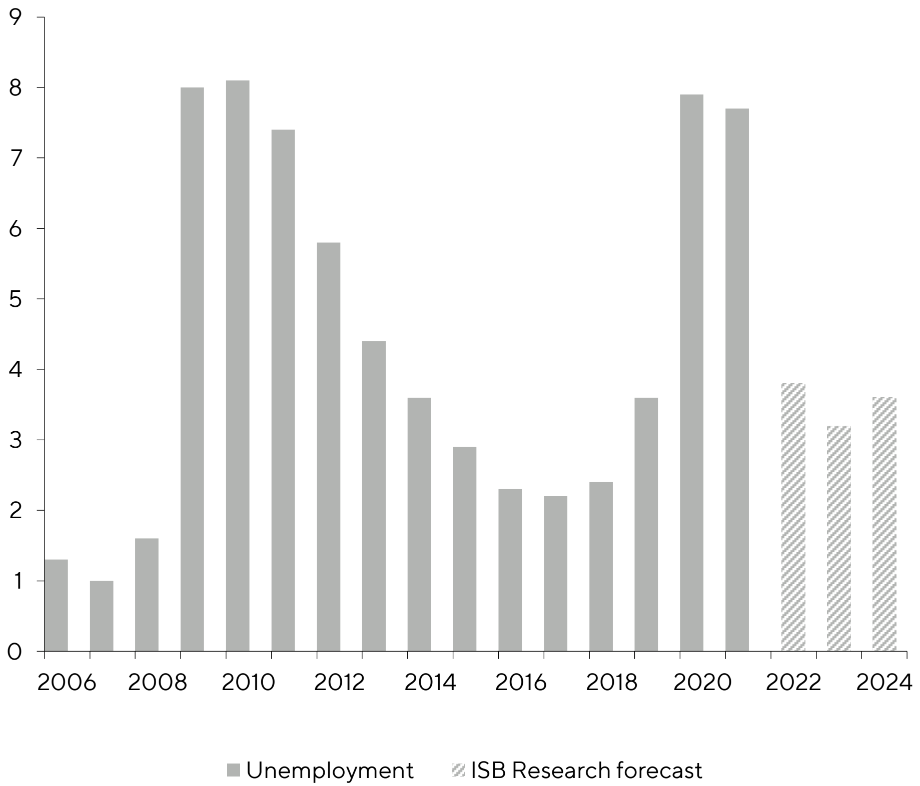
If anything, the labour market appears plagued by a shortage of workers, not a lack of jobs. According to the Gallup survey carried out among Iceland's 400 largest firms for the CBI and the Confederation of Icelandic Employers (SA), roughly 54% of company executives consider themselves short-staffed, particularly in sectors such as construction and tourism. Only once before – in 2007 – has this percentage been higher.

Job vacancies appear increasingly to be filled with foreign workers. In Q2, over 40,000 immigrants were in the domestic labour market, or about 20% of the entire workforce. This percentage has never been higher, and it can be expected to rise further in the near future, if the need for workers in key sectors is any indication.

Unemployment is already at its historical average, and we expect it to remain broadly at that level throughout the forecast horizon. We forecast average unemployment at 3.2% in 2023 and 3.6% in 2024.

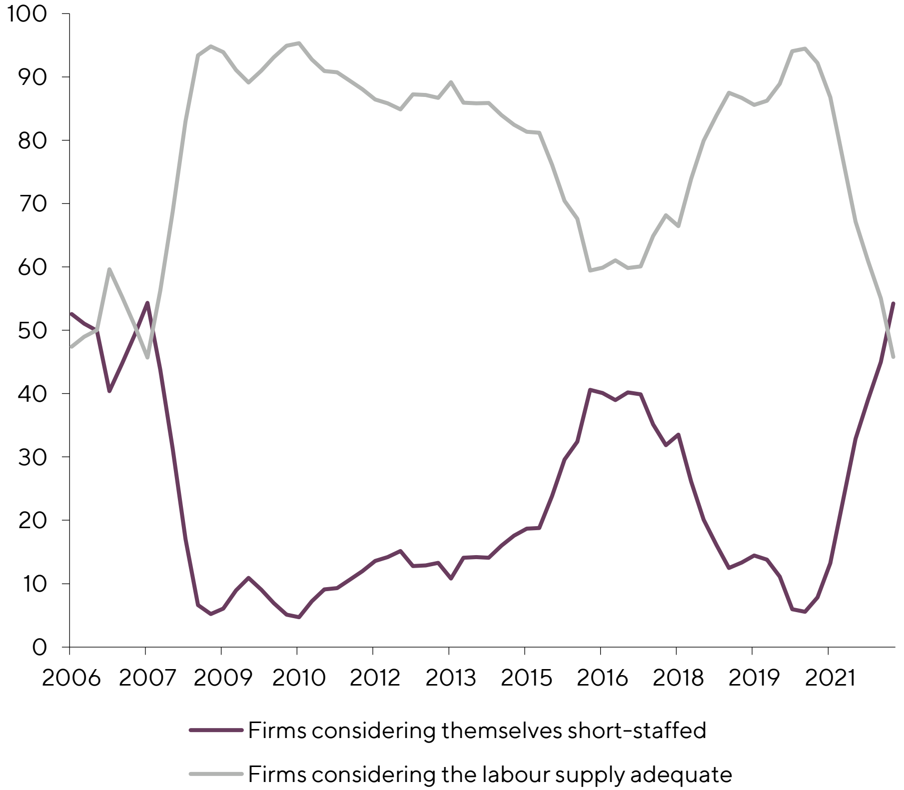
Unemployment as a share of the labour force

%



Labour supply according to corporate executives

%



Sources: Central Bank of Iceland, Directorate of Labour, ÍSB Research.

Private consumption growth eases after rising steeply

Erosion of real wages will cut a hefty slice out of private consumption growth in the near term

Private consumption has rebounded strongly after plummeting at the beginning of the pandemic. In 2021 it grew by 7.7% YoY in real terms and was above its 2019 level. In H1/2022, it grew by an even more rapid 11%, including 13.5% in Q2, the swiftest pace seen in 17 years.

Payment card turnover for July and August suggests robust growth in Q3 as well. As yet, there are no signs that erosion of real wages has affected private consumption growth.

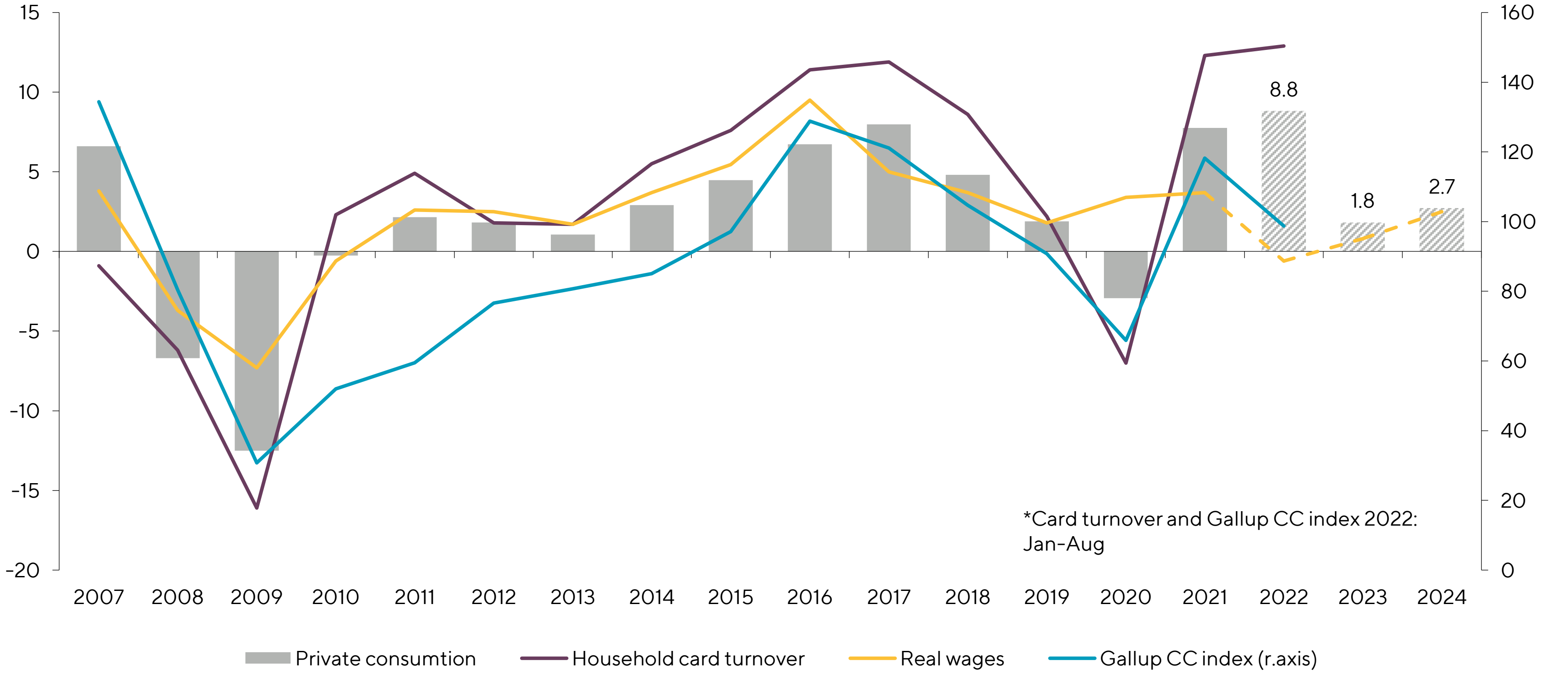
Real wages have indeed begun to deteriorate. In July, they fell YoY for the second month in a row, after a continuous growth spurt dating back to 2010. This trend is likely to continue in the near term – or at least until inflation truly loses steam. We forecast that real wages will deteriorate by 0.6% in 2022, but then grow by 1.0% in 2023 and 2.5% in 2024.

Given how strongly private consumption has grown in the recent term, a slowdown is inevitable, and we expect it to start as soon as Q4/2022. Households are more pessimistic than before and have begun scaling down their saving. Presumably, consumers have been enjoying their first post-COVID, restriction-free summer and will cut their consumption spending rather aggressively when the winter hits.

We project year-2022 private consumption growth at 8.8%. For next year, we expect a growth rate of 1.8%, as households will have depleted their savings to a large degree and real wage growth will be sluggish. For 2024, we project that private consumption will grow by 2.7% as inflation eases and real wage growth gains pace.

Private consumption and related indicators*

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



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

After appreciating by nearly 3% in 2021, the ISK continued to strengthen in trade-weighted terms over the first five months of 2022. From the beginning of January through end-May, it appreciated by an average of just over 7%. However, in June through August it depreciated by 5%.

Increased position-taking with the ISK via forward contracts probably played a role in the appreciation early in the year despite the hefty current account deficit. Consequently, part of the appreciation that would otherwise accompany FX inflows later this year has already materialised. Furthermore, investment-related FX outflows were sizeable. The CBI has greatly reduced its FX market intervention recently, although it takes action when temporary imbalances occur, particularly when they involve investment-related flows.

The near-term outlook for the current account has dimmed somewhat since we issued our May forecast. As a result, the tailwinds supporting the ISK will probably be weaker in the coming term than we had anticipated. Even so, a current account surplus is in the cards further ahead, with a wide interest rate differential, a strong external position, more favourable growth prospects than is widely envisioned abroad, and non-residents' securities holdings at a historical low.

On the other hand, the pension funds are likely to invest significant amounts abroad in the coming term. National saving in excess of investment will therefore be channeled to a large extent towards long-term investments in foreign assets.

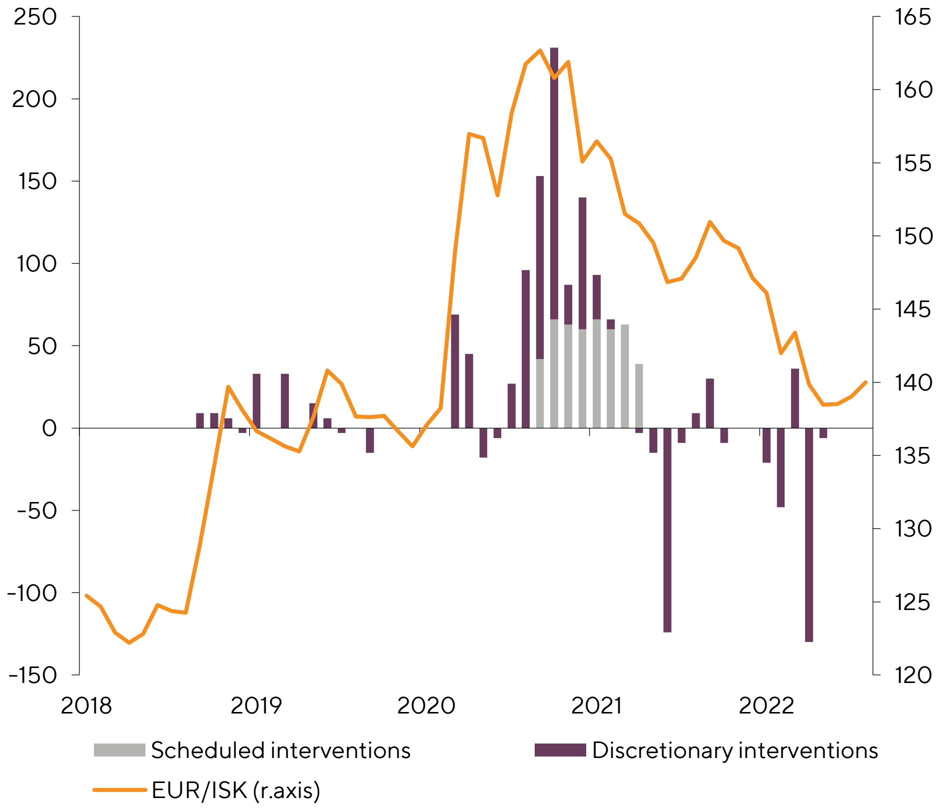
In general, the scope and timing of exchange rate movements is highly uncertain, but we forecast that the ISK will be some 6% stronger at the end of the forecast horizon than at end-August 2022. The real exchange rate in terms of relative consumer prices will then be broadly as in 2018-2019.

ISK set to strengthen further in the coming term

More favourable CA balance and inflows for securities purchases offset pension funds' foreign investments

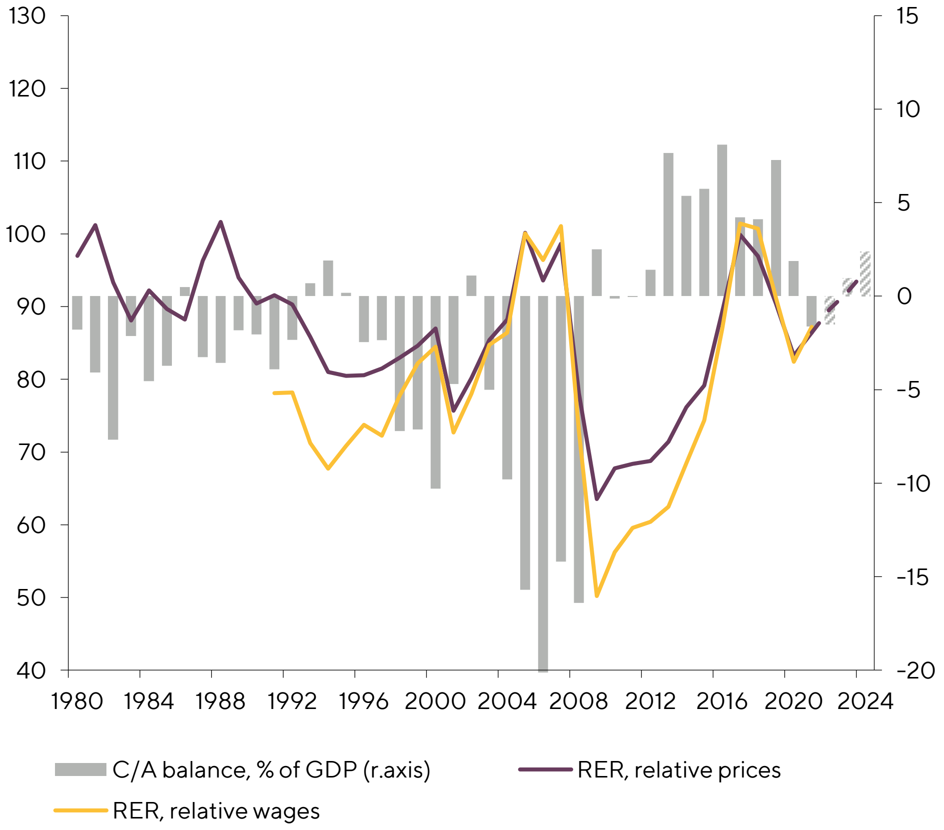
ISK exchange rate and CBI FX market intervention

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 peaked

Inflation set to subside rather quickly in the coming term

Inflation has risen sharply in the recent term. It peaked in July at 9.9%, its highest in nearly 13 years. We think it will not rise higher but rather start to taper off once again. Inflation eased to 9.7% in August and looks set to keep falling. We expect it to fall rather quickly in the near future.

The largest single driver of inflation at present is the housing component, as inflation excluding housing measured 7.1% in August. But even though housing is one of the main culprits, it is clear that there are others, chiefly to include services and imported goods.

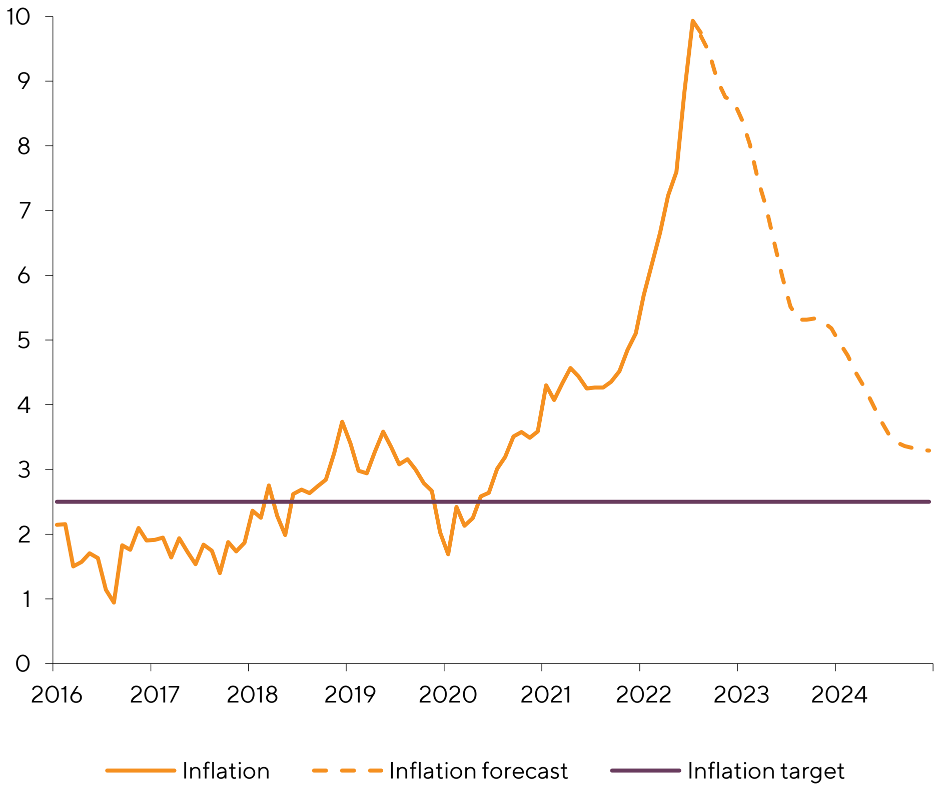
The main reasons inflation is likely to fall in the near future are that the housing market has started cooling rather quickly and imported inflation looks set to be somewhat lower, as commodity price hikes have lost momentum and global shipping costs are declining.

But even though inflation is apparently moving in the right direction, there is a long road ahead, and considerable ground to cover before it reaches the CBI's 2.5% target. We expect inflation to average 8.1% in 2022, 6.3% in 2023, and 3.9% in 2024. Thus it will not align with the target during the forecast horizon.

The main assumptions underlying our forecast are a calm housing market, a slowdown in imported inflation, and an ISK appreciation strong enough to contain import prices. A key uncertainty in our forecast is the upcoming round of wage negotiations. We project that wages will rise markedly, particularly in 2023.

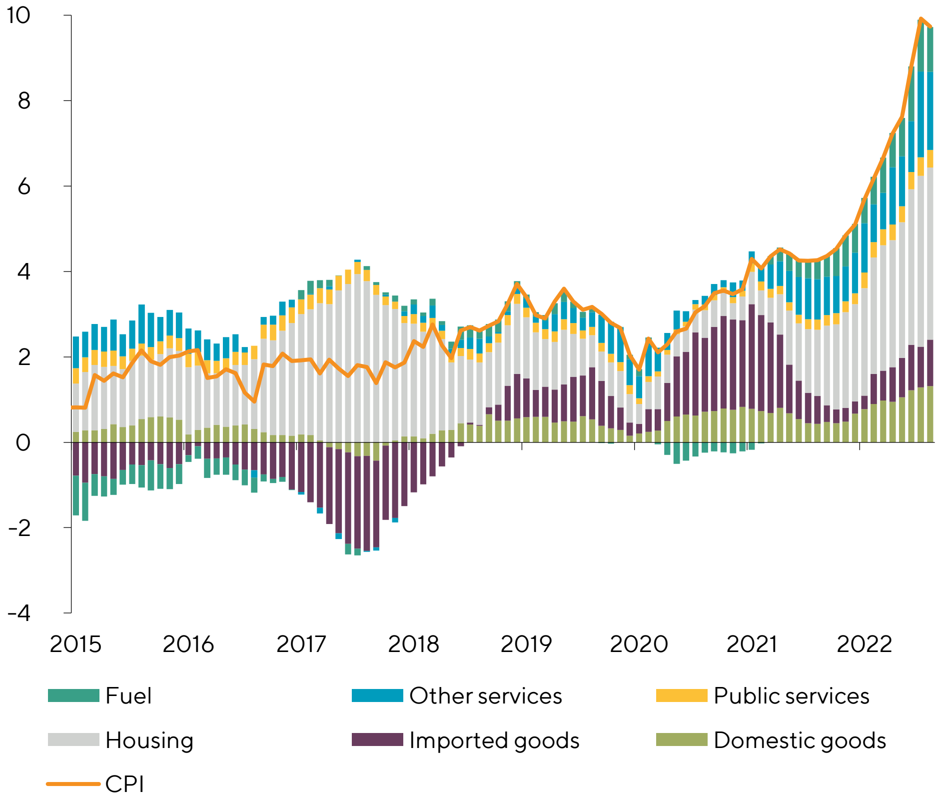
Inflation and the CBI inflation target

%



Inflation by type and source

%



Sources: Statistics Iceland, ÍSB Research.

Monetary tightening phase probably well advanced

Gradual easing further ahead; equilibrium rate in sight by the end of the horizon

The CBI began raising interest rates in spring 2021, in response to the worsening inflation outlook and improving economic outlook. The policy rate is now 5.5%, after being raised by 3.5 percentage points in 2022 to date.

The real policy rate is still low by all measures, however, and negative by some of them. The CBI has made it clear that further rate hikes can be expected in the near future, in order to rein inflation in, keep inflation expectations under wraps, and push the real policy rate above zero. Inflation and inflation expectations have eased since the CBI's last interest rate decision, however.

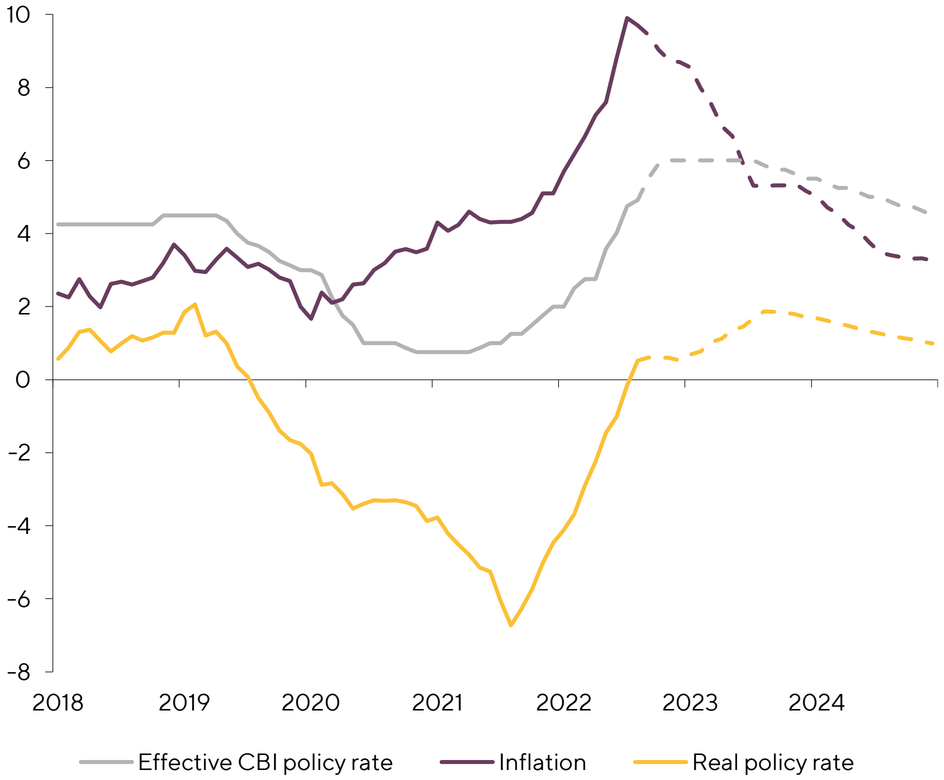
We forecast that the policy rate will be raised further in Q4/2022 and will end the year at around 6%. Assuming that inflation and demand pressures have indeed begun to ease, we expect the policy rate to remain unchanged until mid-2023 and then start to fall again in H2. Thereafter, we expect gradual 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 further policy rate hike has already been priced into long-term rates. The long-term base rate is currently close to 6%, but 1.6 - 1.8% in terms of the real rate. Long-term rates have risen markedly in 2022 to date, in the wake of policy rate hikes.

Assuming that the policy rate develops in line with our forecast, we think the rise in long-term rates has largely come to the fore. When the policy rate has peaked and an easing phase is in sight, we expect long-term rates to start inching downwards. By the end of the forecast horizon, we expect it to approach equilibrium, which we estimate at around 4.5% for nominal rates and somewhere near 1.3% for the real rate.

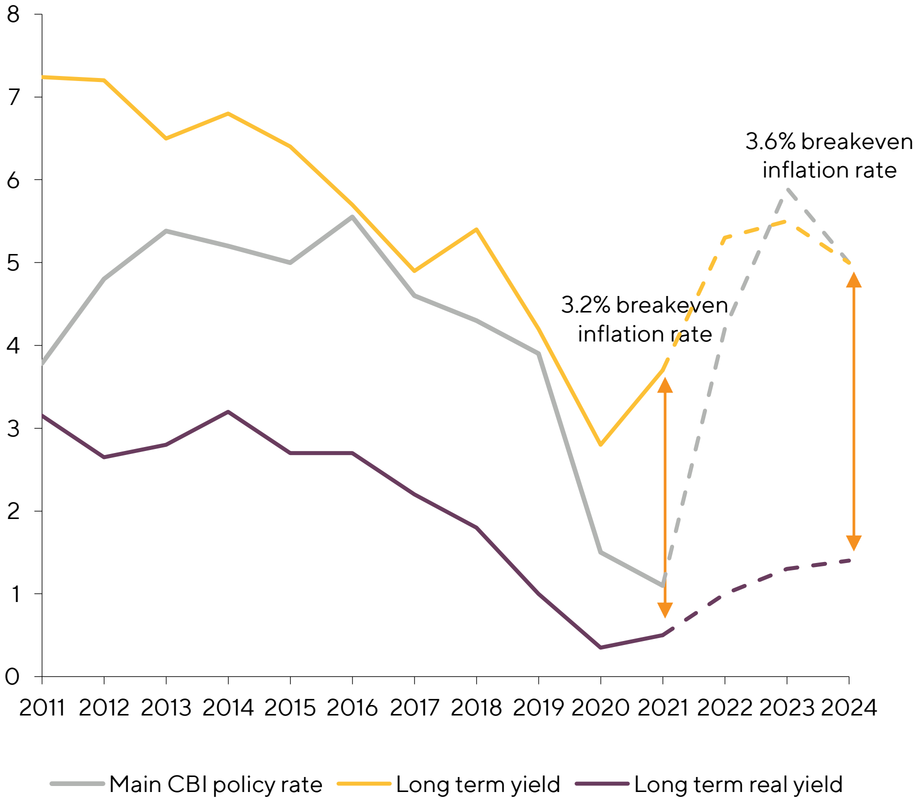
Policy rate and inflation

% Real policy rate in terms of average expected policy rate and inflation over the coming 12 months



Interest rates

%



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

Macroeconomic forecast summarised

GDP and its components

Volume change from prior year %	2021 in ISK m	2021	Forecast 2022	Forecast 2023	Forecast 2024
Private consumption	1,674,093	7.7	8.8	1.8	2.7
Public consumption	892,489	2.2	1.8	1.7	1.8
Investment	738,043	12.3	10.2	0.3	2.1
– business investment	429,398	19.1	14.6	-4.0	1.0
– residential investment	177,385	-5.2	4.5	16.5	7.0
– public investment	132,248	18.6	3.0	-6.5	-2.0
Changes in inventories	4,655	0.1	0.0	0.0	0.0
Domestic demand, total	3,309,281	7,1	7,1	1,4	2,3
Exports of goods and services	1,241,887	12.7	21.2	5.6	3.9
– marine product exports	292,502	9.3	8.9	1.7	3.8
– aluminium products	284,434	1.4	0.8	1.0	2.0
– other goods exports	190,551	5.5	2.0	1.0	2.0
– services exports	474,400	21.7	48.7	10.5	5.5
Imports of goods and services	1,299,947	26.4	20.0	3.7	3.7
– goods imports	926,996	28.9	12.9	1.5	2.8
– services imports	372,951	20.5	37.8	8.2	5.4
Gross domestic product	**3,251,222**	**4.4**	**7.3**	**2.2**	**2.4**

Macroeconomic forecast summarised

Other economic variables

% of GDP	2021	Forecast 2022	Forecast 2023	Forecast 2024
Investment	22.7	23.0	22.3	22.0
Current account balance	-1.6	-1.5	1.0	2.4
Trade balance	-1.8	0.4	1.2	2.0
Change between annual averages (%)				
Consumer prices	4.4	8.1	6.3	3.9
Wages and salaries	8.3	7.6	7.4	6.5
Real wages	3.7	-0.6	0.8	2.5
Real exchange rate in terms of relative consumer prices	4.8	3.7	2.7	3.1
% change over the year				
House prices	15.9	19.1	3.2	3.3
Annual average (%)				
Unemployment	7.7	3.8	3.2	3.6
Trade-weighted exchange rate index	196.1	188.6	185.1	180.6
CBI policy rate (7-day term deposits)	1.1	4.2	5.9	5.0
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

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