Fair outlook yet anything may happen

Forecast by Landsbankinn
Economic Research 9 April 2025

Main conclusions

We forecast 1.4% economic growth this year, 2.1% in 2026 and 2.3% in 2027. This growth will be fairly broadly based, originating both in domestic consumption and investment, and also deriving from increased exports.

If our forecast holds, inflation will recede fairly slowly in the coming months and we expect an additional 0.75 pp policy rate cut this year. Inflation will stand at 3% at year-end 2027 and the real policy rate at 2%.

We expect good export growth, provided there are no major setbacks. The main growth will be in pharmaceuticals, medical equipment and farmed fish.

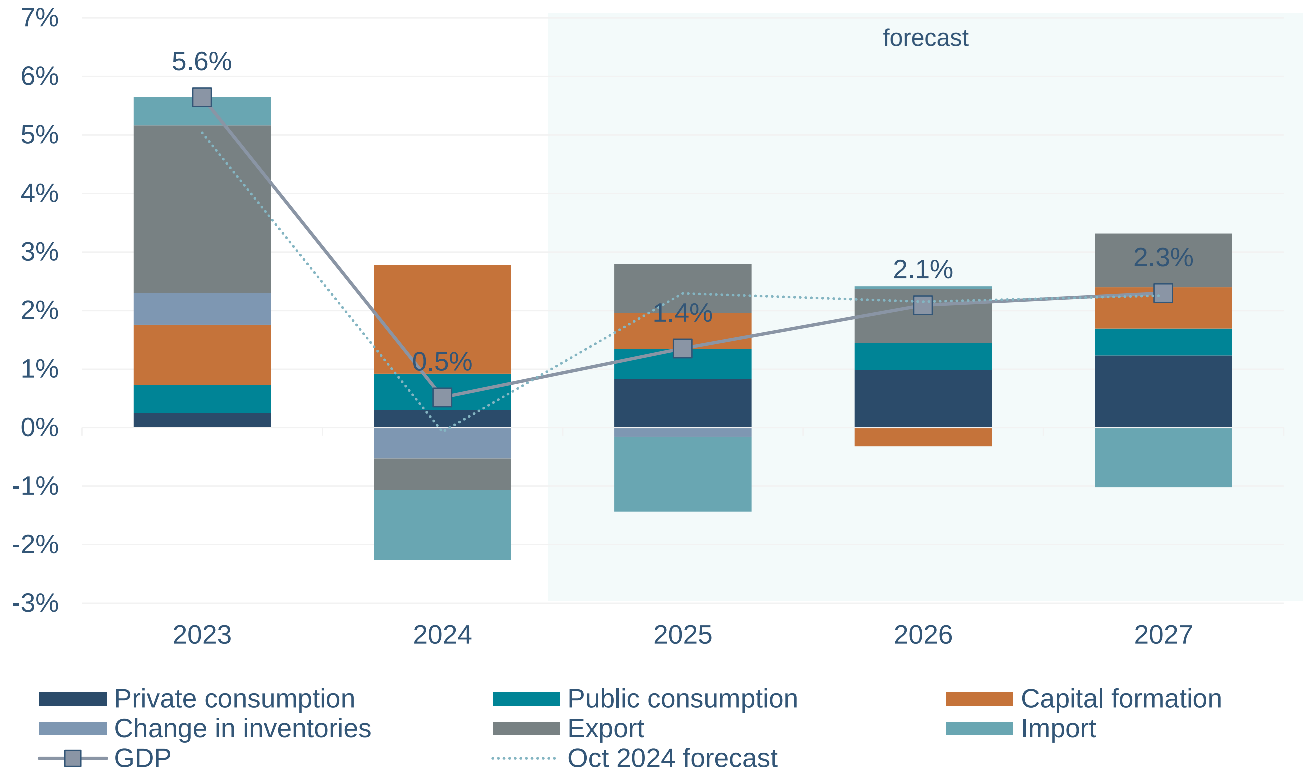
The residential housing market has cooled and investment in new housing has been high lately. We forecast much more moderate price increases than in previous years, around 5-6% per annum in the coming years.

The United States has imposed the most extensive import tariffs since the early 20th century and the effects on Iceland's economy are still unclear. If a global trade war escalates, negative impacts on economic growth can be expected, but the effects on inflation are, in our view. more uncertain.

Economic growth increases to the forecast horizon

Economic growth and contribution of underlying components

YoY volume change



The economy has cooled down following a robust period of growth in the years after the pandemic and we now anticipate a slow start. Last fall, we predicted a slight contraction in 2024 and around 2% growth in the following years. The temperature of the economy turned out to be higher than we thought, and instead of a contraction. growth measured 0.5% last year. The growth was driven in large part by increased investment, both in industry and residential construction.

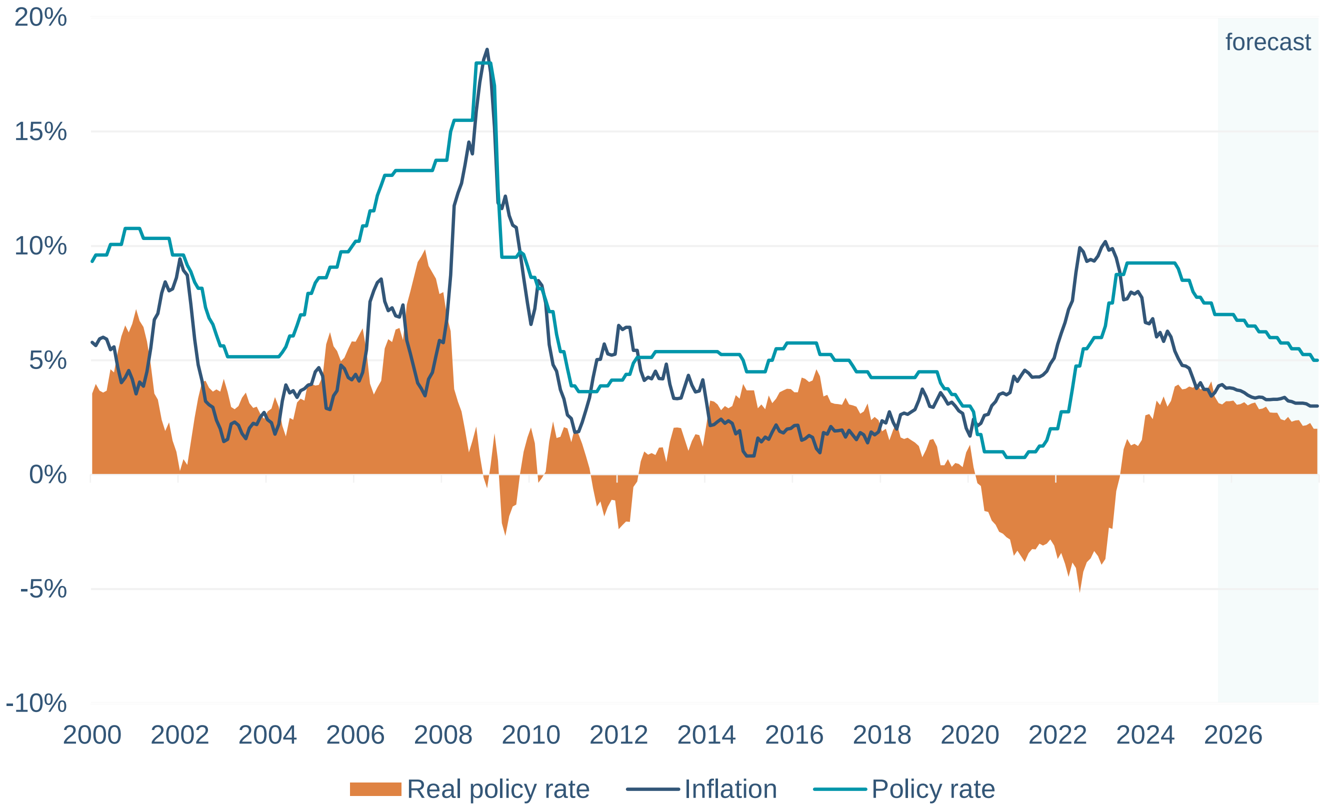
We forecast steady growth in the domestic economy throughout the period. We assume that capital formation will increase less in the coming years as compared to 2024, while private consumption gathers momentum as the forecast period progresses and exports will be substantial.

There are certainly some clouds on the horizon in the global economy and the domestic economy is highly dependent on foreign trade not experiencing major disruptions.

2025-2027 is Economic Research's forecast.
Source: Statistics Iceland and Landsbankinn Economic Research.

Sticky inflation and tight restraint

Inflation, policy rate and the real policy rate



We expect the rapid disinflation in recent months to turn sticky at around 4% in the coming months. Inflation expectations have not declined as hoped and the Monetary Policy Committee has been clear in its stance that as long as expectations remain unchanged, real interest rates must be kept high, close to current values.

With that in mind, we expect fairly tight restraint in the coming months and forecast that the policy rate will be 7% at year-end. It is likely that the monetary stance will ease later in the forecast period, but we expect real interest rates to be around 2% by the end of the period.

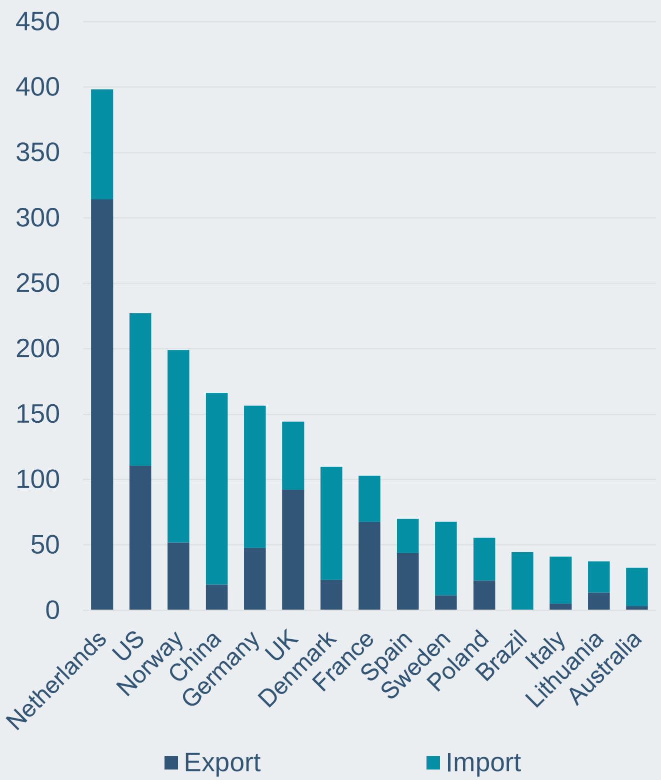
It is not easy to say what the real policy rate level should be under normal conditions, as the economy has experienced various shocks in recent years which have caused sharp changes to the real policy rate. Our forecast assumes a fairly stable yet slowly dwindling real policy rate level.

Real policy rate compared to past inflation.
Source: Statistics Iceland and Landsbankinn Economic Research.

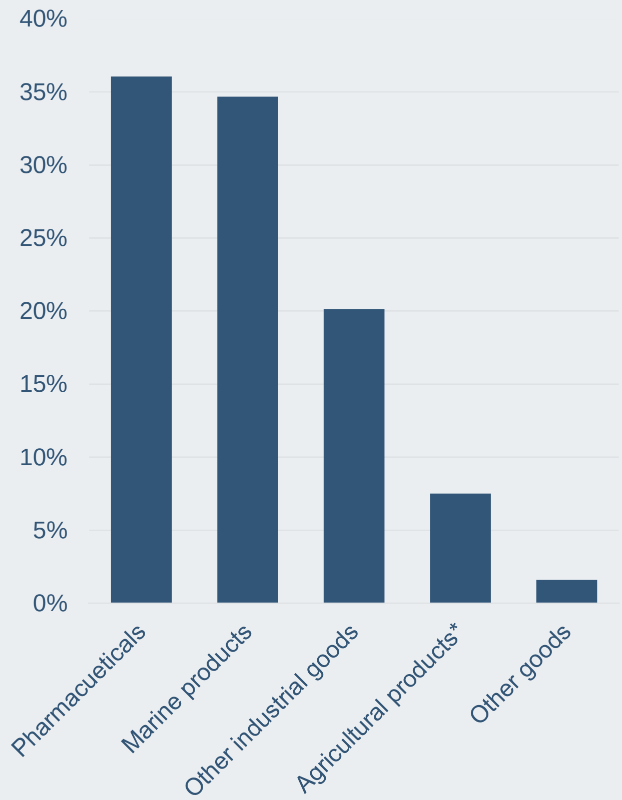
Iceland has much at stake

Trade in goods in 2024

ISKbn



Breakdown of Iceland's goods exports to the US in 2024



The United States is one of Iceland's largest trading partners, and the main components of Iceland's exports to the US are pharmaceuticals, medical products and seafood. Last week, the President of the United States announced wide-reaching import tariffs, which took effect this past Saturday. The tariffs vary greatly between countries with tariffs on Iceland being in the lowest bracket, 10%. It also appears that pharmaceuticals will be exempt from the tariffs.

In light of recent events, the economic forecast is presented with the disclaimer that it remains to be seen how other countries will respond. At this point, it is still impossible to predict the overall impact of these events on Iceland.

Iceland is a small, open economy that relies heavily on foreign trade. Even if the Icelandic economy is not directly affected to a significant degree by the newly announced US tariffs, various indirect effects could leave their mark on the Icelandic economy, especially if a policy of protectionism becomes widespread.

*Including farmed fish.

Source: Statistics Iceland and Landsbankinn Economic Research.

Worse growth prospects and uncertain impact on inflation

Economic growth

We believe that the announced US import tariffs could result in lower economic growth than currently forecast, and possibly even a contraction. Iceland is heavily dependent on international trade and relies greatly on unhindered access to foreign markets.

If a global trade war escalates - especially if our export sectors face restricted access not only in the US but in other countries as well - there is a risk that activity in export sectors will decline, and with it, the overall economy. This does not only apply to goods exports as the effects could also be felt through a significant reduction in tourist arrivals. Tariffs in the US and elsewhere would, all else being equal, reduce purchasing power and potentially dampen travel plans abroad.

The economic contraction would initially show through reduced exports, which would quickly affect domestic demand and nearly all components of GDP growth. Uncertainty alone, coupled with fears of the impact of a trade war, could also hold back investment and by extension the strength of the economy.

It should be noted that while tariffs on Icelandic exports to the US remain lower than those on exports from various other countries, the competitive position of certain Icelandic export sectors in the US market could actually improve.

Inflation /

Forces that may fuel inflation

Restrictions on international trade may raise global market prices on various goods, leading to increased imported inflation in Iceland. Imported inflation could spread and push up prices on domestic goods as well, for example through more expensive resources and higher inflation expectations. If Iceland's export sectors are subjected to significant tariffs in various countries, the ISK is likely to weaken, which would further fuel imported inflation. Similar effects could arise if the number of tourists to Iceland drops significantly due to reduced purchasing power and less interest in travel in our trading partner countries.

Forces that may reduce inflation

Import tariffs in the US and possibly elsewhere could reduce demand for goods and services that Iceland exports, thereby weakening the domestic export sectors. This would reduce overall economic activity, potentially increase unemployment and lead to decreased purchasing power and economic expansion. A decline in US demand for exports from other countries could also result in a shift in trade flows. A temporary oversupply of goods outside the US would lower prices, for example in Europe, and Iceland could end up importing cheaper goods than before.

Overview of Landsbankinn Economic Research's forecast

	ISKbn	Volume change from previous year (%)			
Domestic product and key components	2024	2024	2025	2026	2027
Gross domestic product	4,616	0.5	1.4	2.1	2.3
Private consumption	2,267	0.6	1.7	2.0	2.5
Public consumption	1,176	2.5	2.0	1.8	1.8
Capital formation	1,219	7.5	2.3	-1.2	2.7
Investment in industry	798	6.7	5.4	-4.0	2.3
Investment in residential housing	242	18.0	-5.0	2.0	4.0
Public sector investment	179	-1.4	-1.5	8.0	3.0
Total national expenditure	4,669	2.3	1.8	1.1	2.4
Export of goods and services	1,920	-1.2	2.0	2.2	2.2
Import of goods and services	1,973	2.7	3.0	-0.1	2.4

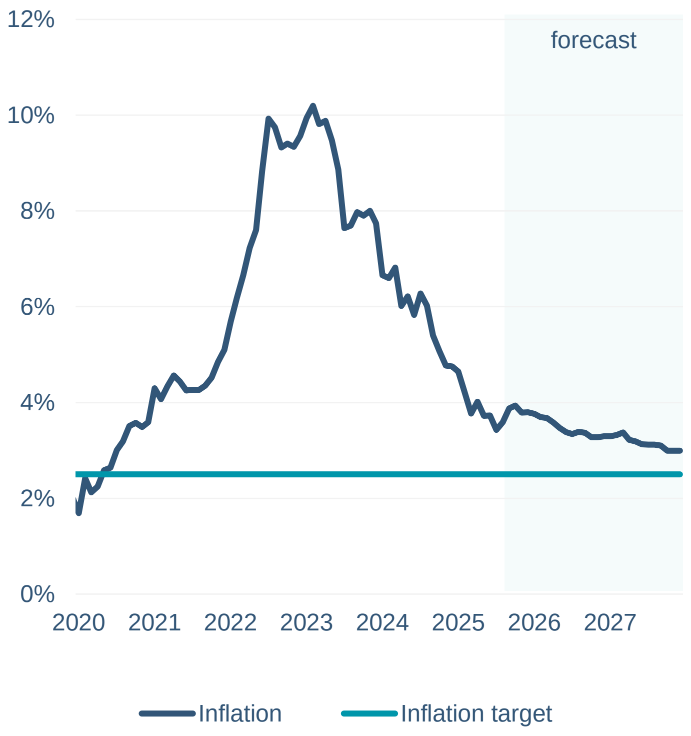
Policy rate and inflation	2024	2025	2026	2027
CBI’s key interest rate (7-day term deposits. year end. %)	8.50	7.00	6.00	5.00
Inflation. annual average. %	5.9	3.9	3.5	3.2
EUR exchange rate. year end	143.9	144	146	148
Residential housing prices. annual average. %	8.1	5.9	4.8	6.4

Labour market	2024	2025	2026	2027
Wage index. annual average. %	6.6	6.0	5.5	5.6
Purchasing power of wages. annual average. %	0.7	2.1	1.9	2.4
Unemployment. annual average. %	3.5	3.8	3.7	3.5

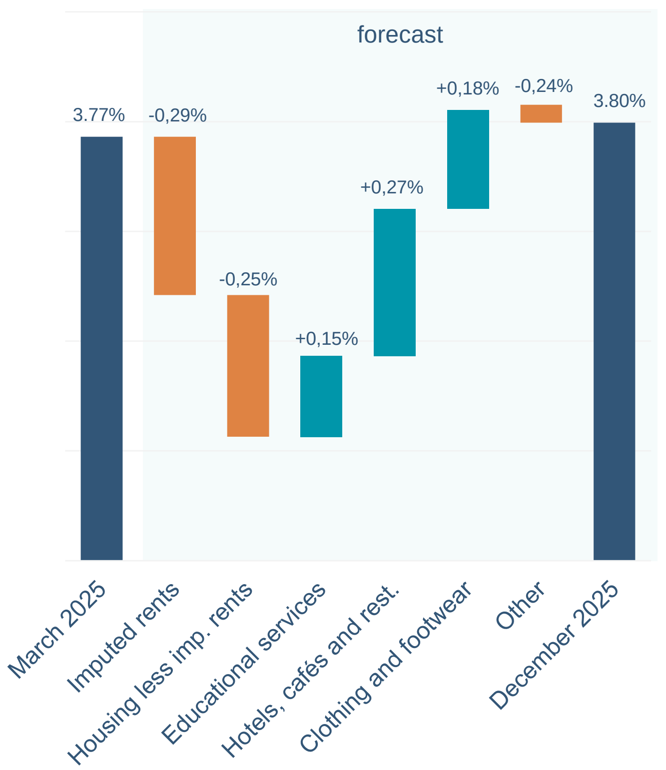
Trade balance	2024	2025	2026	2027
Number of foreign travellers. thousand individuals	2,261	2,230	2,265	2,300
Goods and services balance. %GDP	-1.1	-0.3	0.7	0.6
Current account balance. %GDP	-2.5	-1.4	-0.4	-0.6

Forecast unchanged inflation at year-end 2025

Inflation



Forecast for the remainder of the year



Inflation measured 3.8% in March, down from a peak of 10.2% in February 2023. Inflation has receded rapidly, but we believe a turning point has been reached. In recent months, large monthly increases have dropped out of the 12-month measurements, aiding the disinflation process. This will no longer be the case in the coming months. which could make the final stretch more challenging.

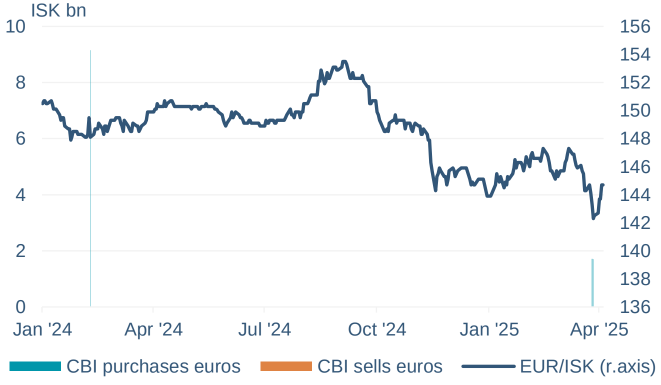
We project that inflation will remain around current levels at year-end, at 3.8%. Housing has been one of the main drivers of inflation, and its contribution is expected to continue declining. On the other hand, one-off changes that contributed to disinflation last year will drop out of the annual inflation base in the fall, likely causing inflation to rise again. These one-offs include the elimination of tuition fees at several universities and the introduction of free school meals in primary schools. In addition, we expect clothing and footwear prices to rise this year, partly because prices are still below pre-sale levels from the beginning of the year.

Inflation will likely continue to ease over the next two years, but we do not expect it to reach the target within the forecast horizon. We forecast inflation at 3.0% at the end of 2027.

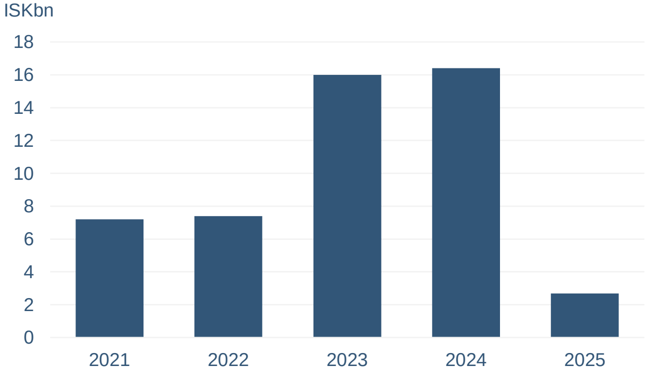
April 2025 to December 2027 is Economic Research's forecast.
Source: Statistics Iceland and Landsbankinn Economic Research.

ISK depreciates in the latter half of the forecast period

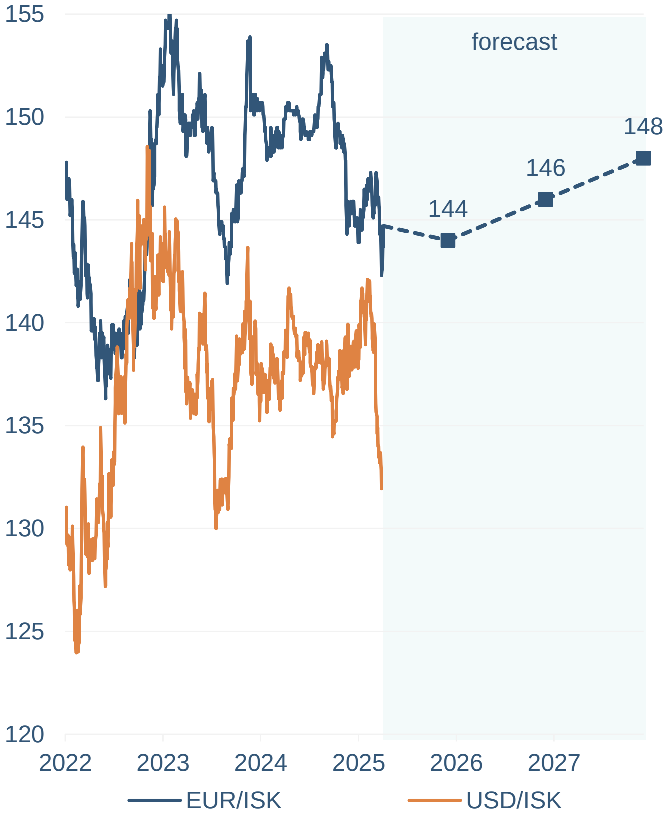
CBI's market involvement



Net FX purchases by pension funds Jan-Feb



Exchange rates



Despite a trade deficit last year, the ISK appreciated. It was a relatively calm year in the interbank foreign exchange market, with minimal turnover and volatility.

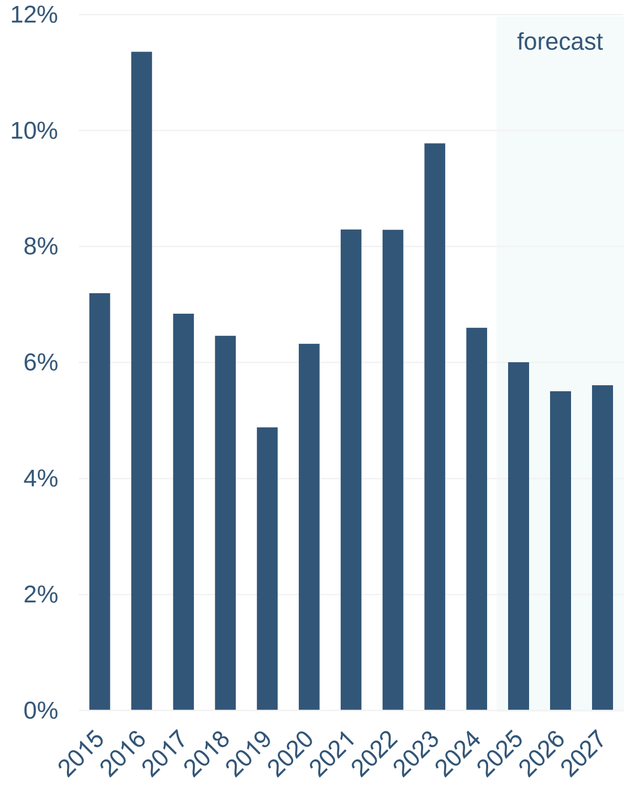
Year to date, the pension funds having significantly reduced their foreign currency purchases, as they received currency through JBT's acquisition of Marel and expect further inflows related to the resolution of ÍL-sjóður. The ISK strengthened in March and the Central Bank of Iceland intervened at the end of the month, presumably to prevent excessive exchange rate fluctuations. The appreciation in March was then reversed at the beginning of April.

We expect the ISK to be roughly at the same level at the end of the year as it is now. Greater exchange rate volatility can be expected this year compared to last year, as the pension funds are not as responsive to foreign currency inflows as before. We project that the ISK will weaken in 2026 and 2027, mainly due to a continued current account deficit.

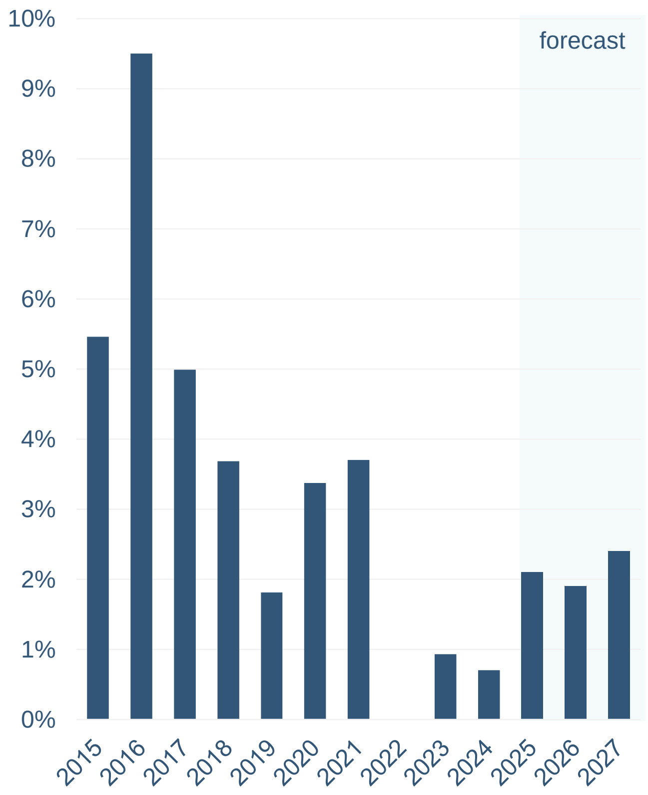
The end of 2025. 2026 and 2027 is Economic Research's forecast.
Source: Central Bank of Iceland and Landsbankinn Economic Research.

Long-term agreements reduce uncertainty

Wage index
YoY change to wage index



Purchasing power of wages
YoY change



After several volatile years in the labour market, uncertainty seems to have diminished with the conclusion of long-term collective agreements covering the vast majority of the workforce. The agreements stipulate different wage increases for various groups, which makes it challenging to predict the exact development of the wage index. For example, teachers' agreements earlier this year drew particular attention due to wage increases that exceeded those of most other groups. In the short term, the teachers' agreements could contribute to wage drift and, in the longer term, they may affect labour market stability and potentially erode trust in the next bargaining rounds.

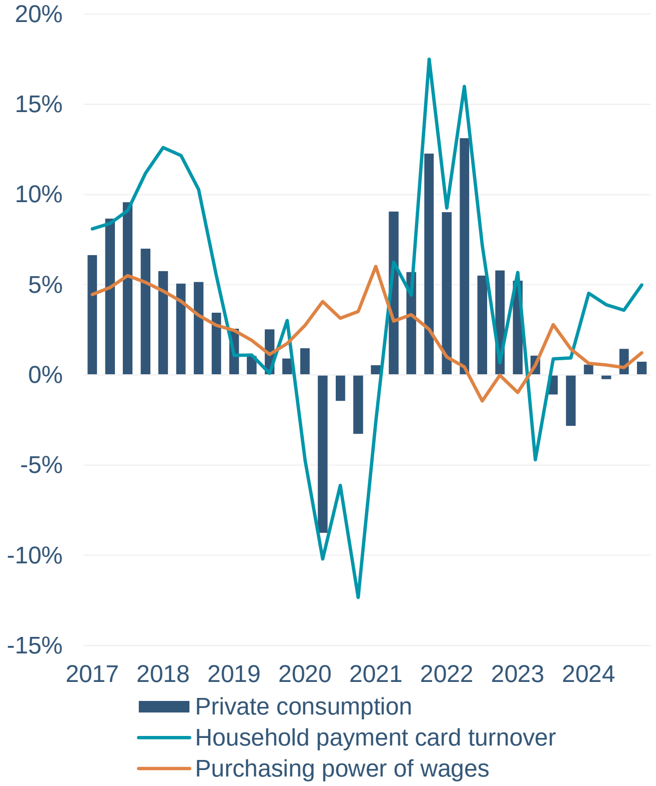
Since the turn of the century, the wage index has increased by just over 7% per year on average. We expect increases to remain shy of the average in coming years, around 6.0% this year, 5.5% in 2026 and 5.6% in 2027.

Purchasing power has increased only marginally over the past three years, but with inflation easing, we expect it growth to gradually resume. On average, purchasing power has grown by 2.1% per year since 2000, which is roughly the rate we project over the next few years.

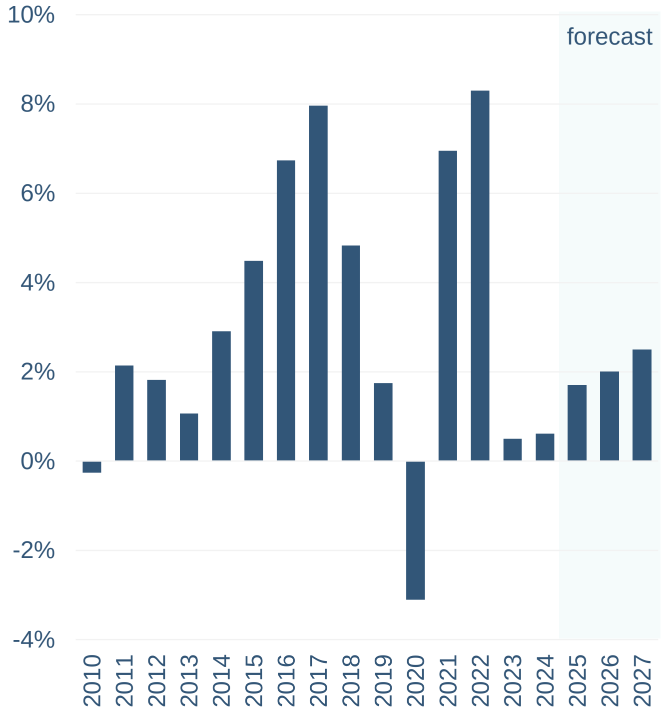
2025-2027 is Economic Research's forecast.
Source: Statistics Iceland and Landsbankinn Economic Research.

Private consumption increases as the forecast period progresses

Private consumption, payment card turnover and wages
YoY change, quarterly data



Development of private consumption
YoY change



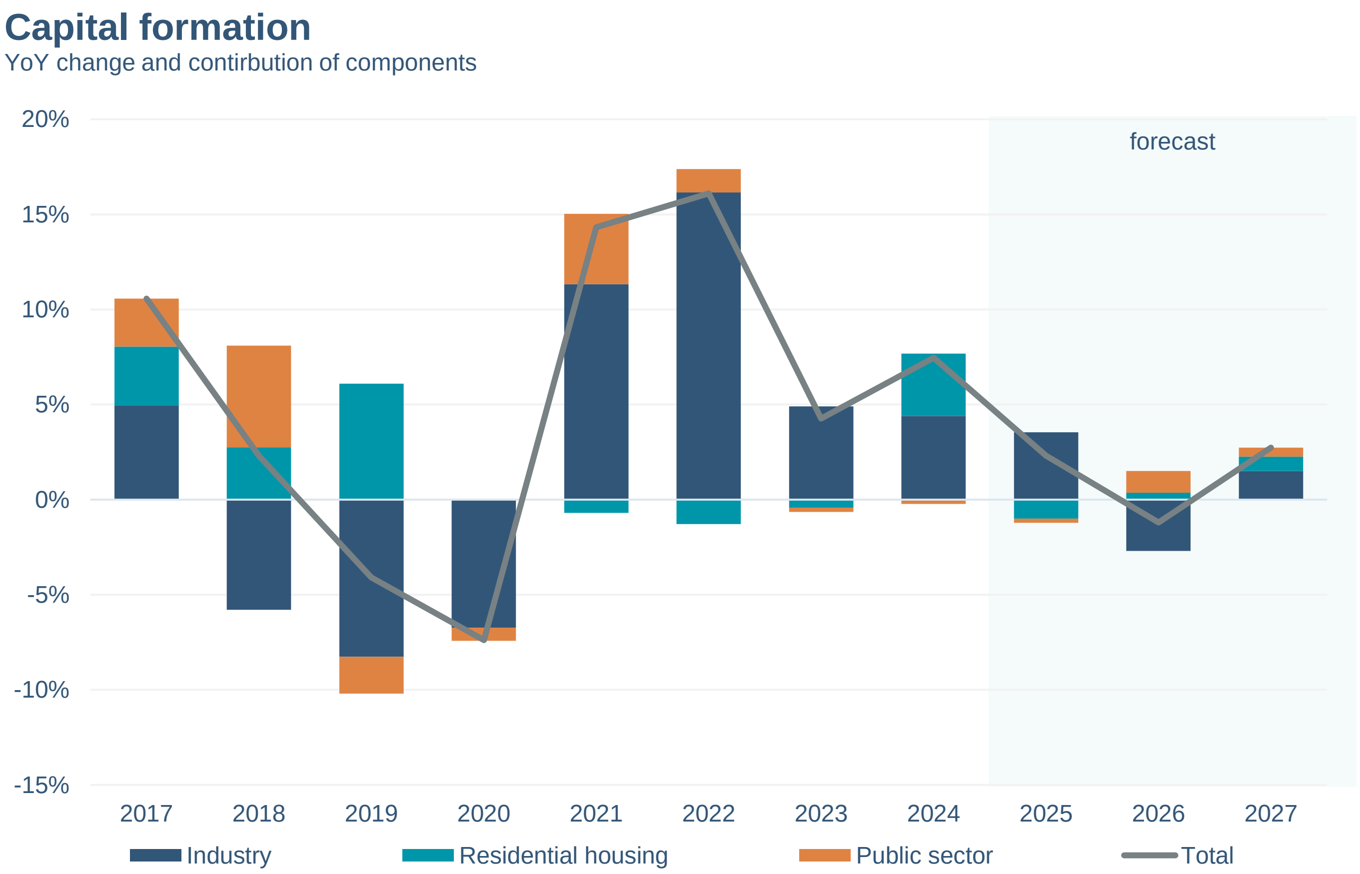
Private consumption grew minimally in 2024, by 0.6%, considerably less than payment card turnover. Lower car sales are a possible factor here as they are included in private consumption yet seldom appear in payment card data.

We assume that accumulated savings and increasing payment card turnover indicate that private consumption may grow faster in coming years. We forecast a 1.7% increase in private consumption this year, 2% in 2026 and 2.5% in 2027. Wage increases and higher purchasing power also support consumption, in addition to which, interest rate cuts should over time increase leeway for consumption.

Private consumption has grown by 2.5% annually since the turn of the century and, taking the historic view, private consumption will be fairly conservative in the coming years.

2025-2027 is Economic Research's forecast.
Source: Statistics Iceland and Landsbankinn Economic Research.

Slow growth of capital formation



Capital formation will show moderate growth this year, in contrast to high growth in 2024, both investment in residential housing and industry. Investment can basically be expected to maintain its momentum alongside improving funding terms. Large investment projects also impact overall development.

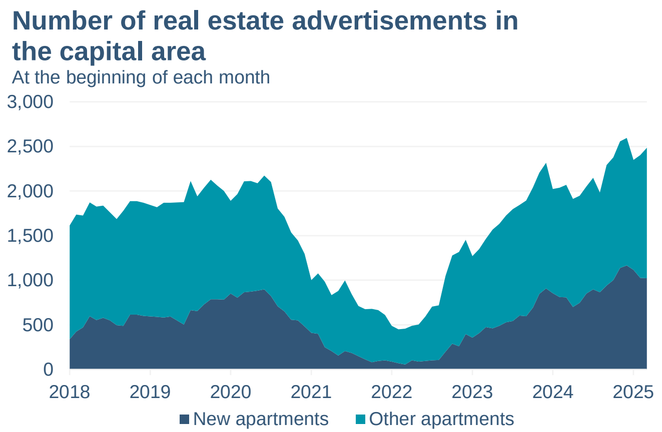
Firstly, investment in residential housing grew considerably in 2024 - far beyond forecasts - and we consider it unlikely that it will continue to increase at the same rate in the near future.

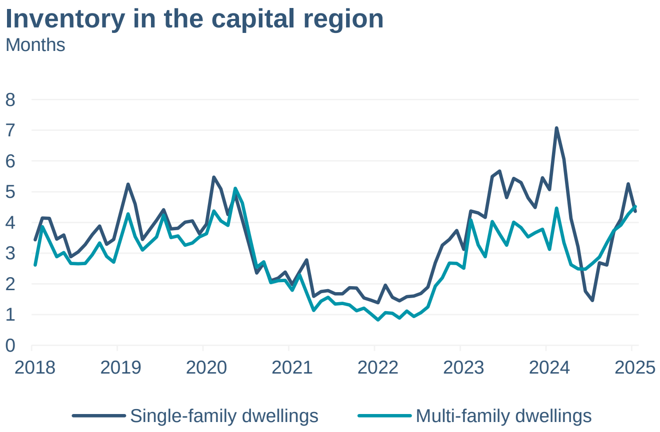
Business investment also grew somewhat in 2024, especially in the final quarter of the year in connection with investment in data centres. There was also considerable growth in investment in seafaring vessels in 2024.

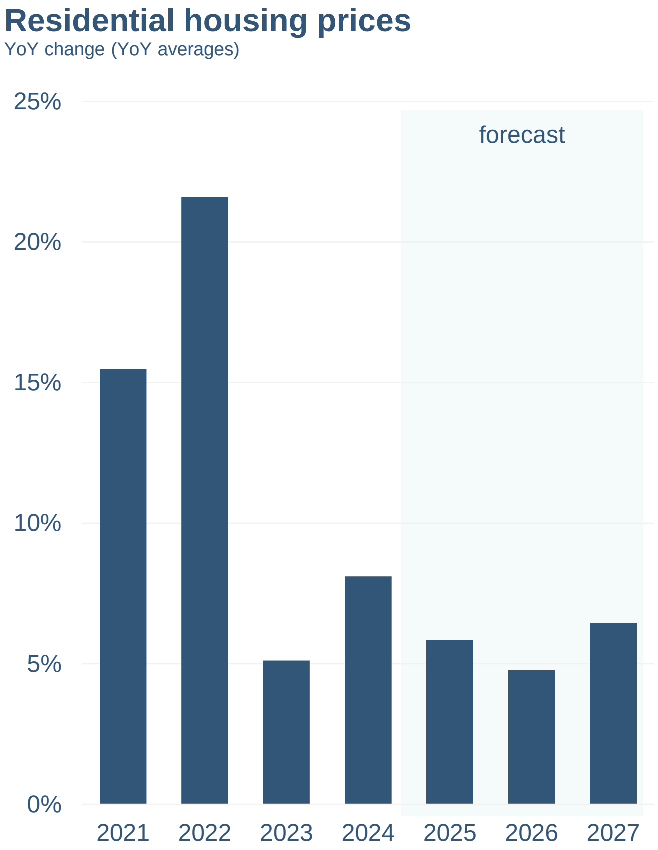
We expect public sector investment to contract slightly this year and then to increase in 2026, by 8%, not least due to planned investment in road maintenance and other traffic and transport projects.

2025-2027 is Economic Research's forecast.
Source: Statistics Iceland and Landsbankinn Economic Research.

More relaxed price development in the residential housing market







We expect a considerable slowdown in house price increases in the near term. The number of residential properties for sale has risen rapidly recently and average time on the market has increased. This indicates increased slack in the housing market and, as a result, more moderate price increases can be expected. The sharp increase in residential investment last year, along with continued high investment this year, will help curb price growth.

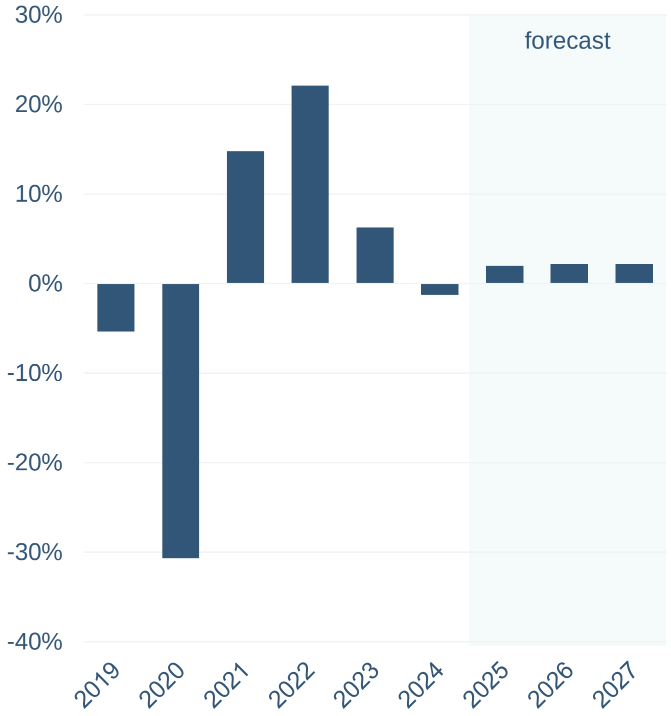
In addition, a high real interest rate environment over the coming quarters is likely to have a cooling effect on demand, even if nominal interest rates begin to fall. We forecast relatively moderate price increases over the next few years: 5.9% this year, 4.8% in 2026 and 6.4% in 2027. By comparison, house prices have grown by an average of 13% annually since 2021.

Many fixed-rate mortgages are due for interest rate review this year, which could lead to higher monthly payments for borrowers, a factor we believe may dampen price growth. In addition, strict lending requirements remain in place, which also act to limit upward pressure on prices.

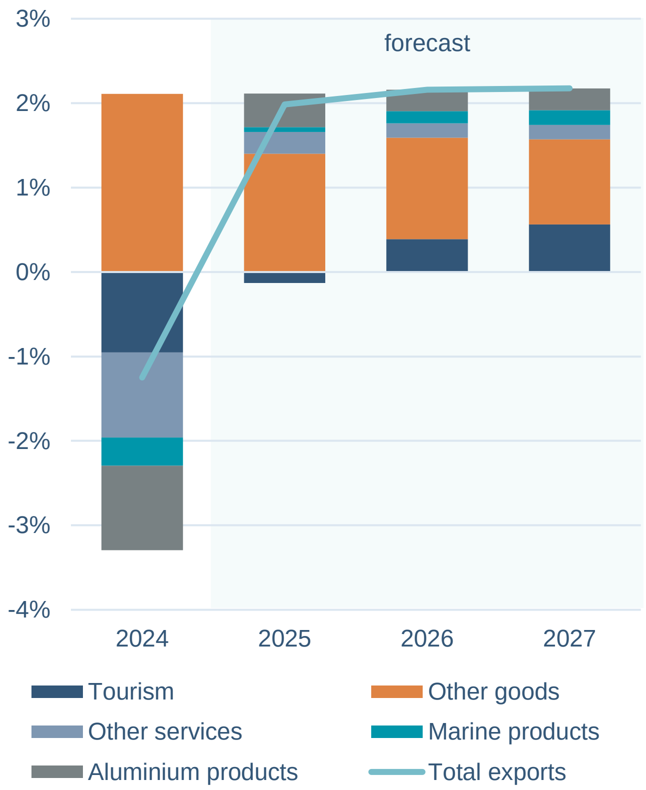
2025-2027 is Economic Research's forecast.
Source: The Housing and Construction Authority and Landsbankinn Economic Research.

Forecast 2.0% export growth this year

Exports
YoY volume change



Export forecast
Contribution of components



The export outlook for the year is fundamentally favorable. Reservoir levels give no reason to believe that aluminium companies will face reduced electricity delivery, at least not in the first half of the year. The impact of seismic and volcanic activity on the Reykjanes Peninsula on tourism is diminishing and continued growth is expected in fish farming and pharmaceutical production.

That being said, the newly announced US import tariffs could affect export sectors in the coming years, especially if they trigger protectionism internationally.

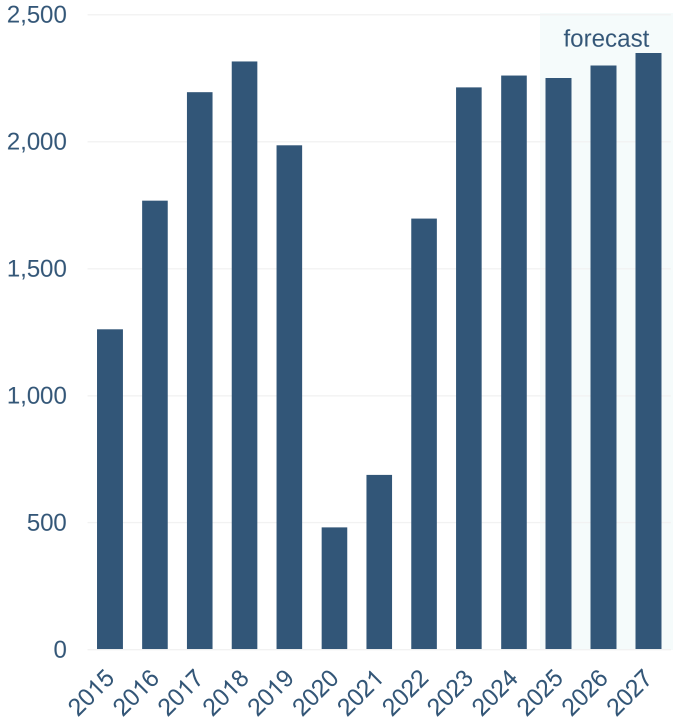
It should be noted that, as it stands, tariffs on Icelandic exports to the US are lower than for most other countries and, in addition, pharmaceuticals appear to be exempt. This could improve the competitive position of Icelandic exports to the US compared to exports from other countries, even if overall US demand for imported goods is expected to decline.

According to the forecast, there will be growth in aluminium exports, pharmaceuticals, medical products and farmed fish this year. Exports of marine products are expected to remain roughly unchanged, but we anticipate a contraction in tourism this year due to a drop in arrivals from the US.

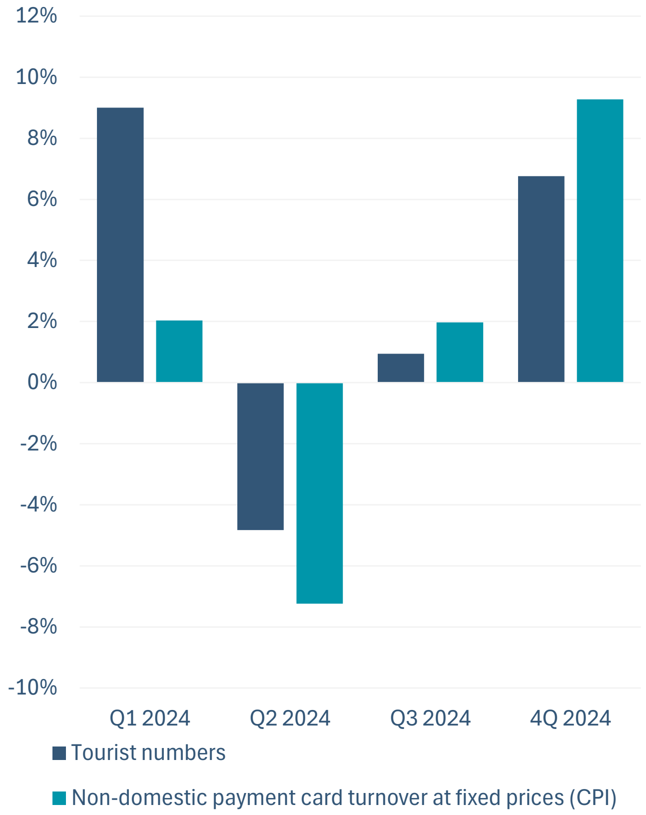
2025-2027 is Economic Research's forecast.
Source: Statistics Iceland and Landsbankinn Economic Research.

Expect slight decline in tourist arrivals from the US

Tourist numbers and forecast
Thousand individuals



Change from previous year



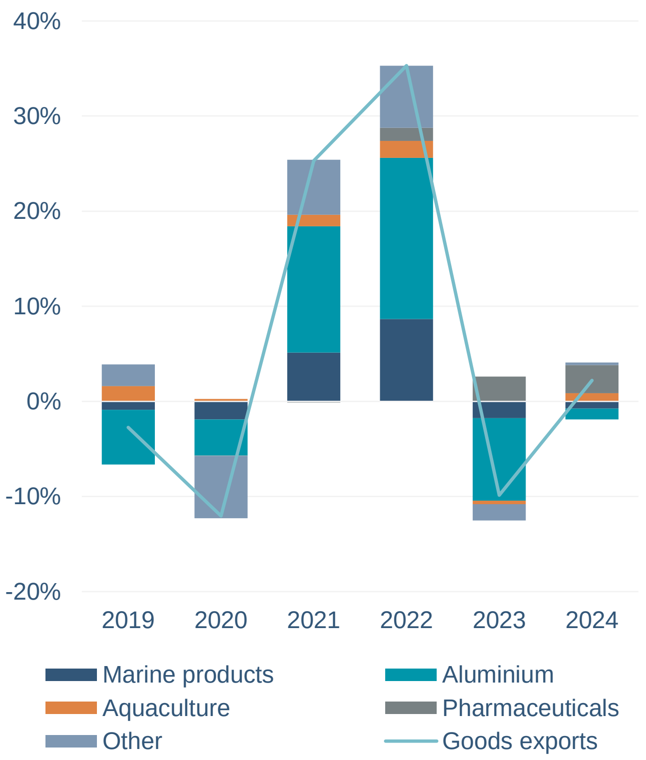
We expect a slight contraction in the travel sector this year, by 0.4%. We expect tariffs to cause less travel from the US, not least due to reduced purchasing power, and for this to result in slightly fewer visits to Iceland. US nationals are by far the largest tourist groups to visit Iceland, accounting for around 30% of tourists in 2024.

In the first half of 2024, the tourism sector was affected by seismic and volcanic activity. These effects were most noticeable in a decline in overnight stays and lower payment card turnover by tourists, despite the number of visitors increasing slightly. The impact of the eruptions appears to have faded in the second half of 2024 and figures from the first months of this year suggest that the number of tourists has decreased, while card turnover has increased between years this year to date. This indicates that travellers are staying longer.

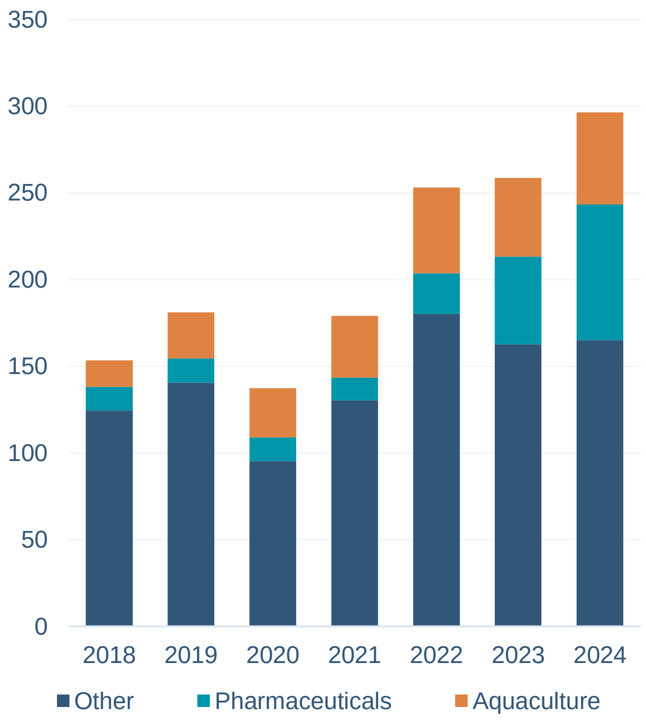
2025-2027 is Economic Research's forecast.
Source: Icelandic Tourist Board. Statistics Iceland and Landsbankinn Economic Research.

Continued positive developments in pharmaceuticals, medical products and farmed fish

Goods exports and weight of components
YoY change at fixed prices



Other goods exports



Goods exports grew in 2024, thanks largely to a significant increase of the export of pharmaceuticals and aquaculture products. Export of goods categorised as “other goods”, i.e. other than marine products and aluminium, grew by over 15% last year.

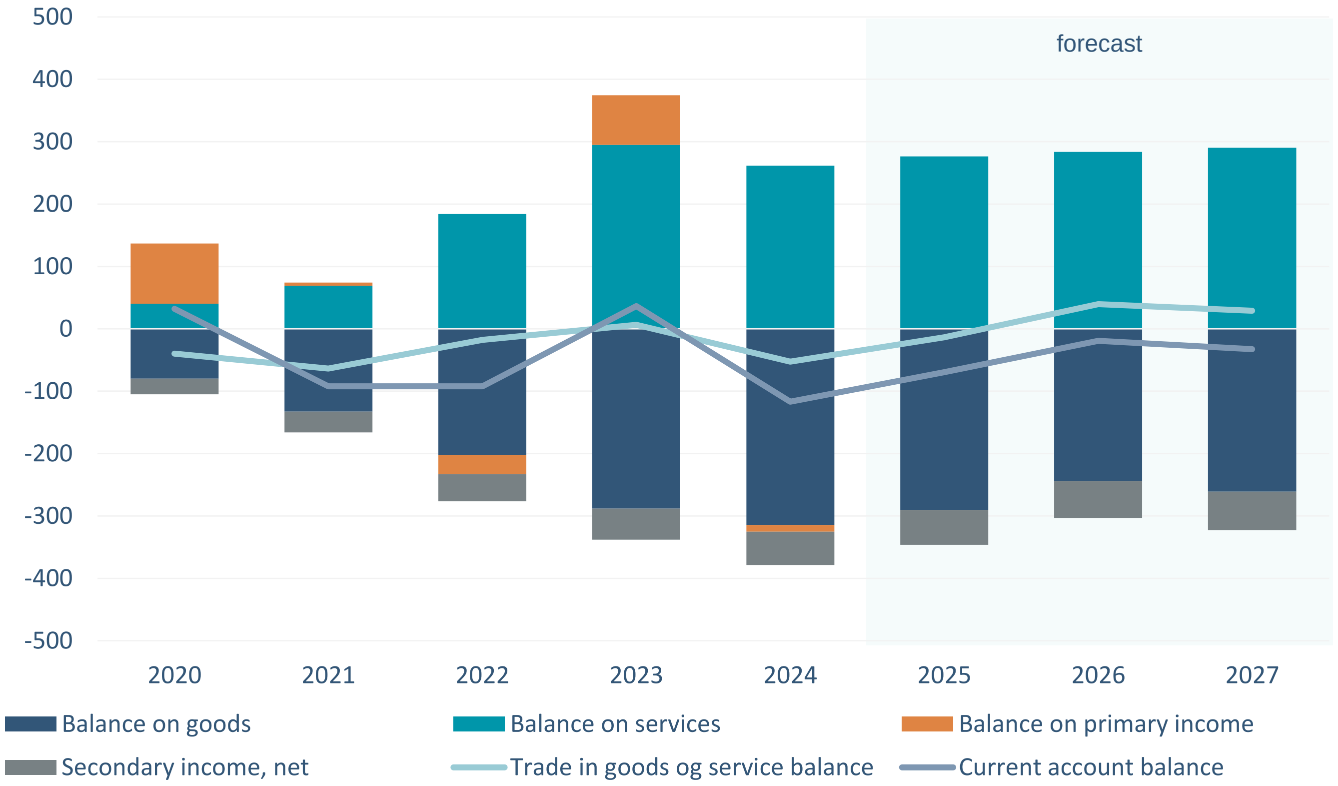
We expect continued growth in the export of pharmaceuticals and aquaculture products, and for these products to drive the growth in goods exports in coming years. In the forecast, we expect other goods exports to grow by a total of just under 9% this year.

Around half of Icelandic export of pharmaceuticals and medical equipment is to the US. So far, the US has not imposed tariffs on pharmaceuticals; if this changes, and significant tariffs are imposed on international trade in pharmaceuticals, the outlook may worsen.

Source: Statistics Iceland. Central Bank of Iceland and Landsbankinn Economic Research.

Current account deficit throughout the forecast period

Current account
ISKbn



There was a significant current account deficit last year following a surplus in 2023. The turnaround between years is due to such factors as growing revenue in foreign-owned pharmaceutical companies, which is deducted from factor income.

This year, we expect exports to increase less than imports in real terms. We expect terms of trade to improve year-over-year, which should be enough to reduce the deficit in the goods and services. We expect the current account deficit to decrease, while primary and secondary income change little between years.

In the coming years, we project that exports will grow faster than imports, resulting in a surplus in the goods and services balance. There will continue to be a deficit in the and secondary income and the overall current account is expected to remain in deficit throughout the forecast period.

2025-2027 is Economic Research's forecast.
Source: Central bank of Iceland and Landsbankinn Economic Research.

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