Macroeconomic forecast 2021-2024

Around 89% of Icelanders, 12 years and older, are now fully vaccinated against Covid-19. The rate of new infections is still rather high yet serious illness is rare. Developments in Iceland's main trading partner countries are similar, with vaccination rates a little lower than here. Despite a set-back to expectations of achieving herd immunity through vaccination caused by the delta variant, the economic outlook for 2021 has improved slightly. This year to date, foreign travellers to Iceland have increased rather less than we forecast in May. At the same time, average spending per tourist has been considerably higher. Development of export income from the travel sector has been more positive than we expected. Private consumption growth has also been more robust than we forecast in spring and unemployment levels have fallen more quickly. As a result, we expect 5.1% economic growth in 2021 following a 6.5% contraction in 2020. The outlook is for even more powerful growth in 2022, or around 5.5%, followed by more conservative growth in the latter part of the forecast period. Inflation has proved to be more persistent than indicated in May. This is primarily due to tension in the housing market, where price increases have been both higher and more persistent than we anticipated. We expect inflation to peak soon and to start to subside in early in 2022. The outlook is for a slow and steady decline in inflation as the year progresses and the international impact of the pandemic on such things as commodities prices and freight cost recedes. We do not expect inflation to hit the Central Bank's target until mid-2023. Robust economic growth and persistent inflation will press policy rate hikes in careful yet decisive steps over the next 1-2 years and we expect the CB's key interest rate to rise over 4% in the latter half of 2023.

Key points from the economic forecast:

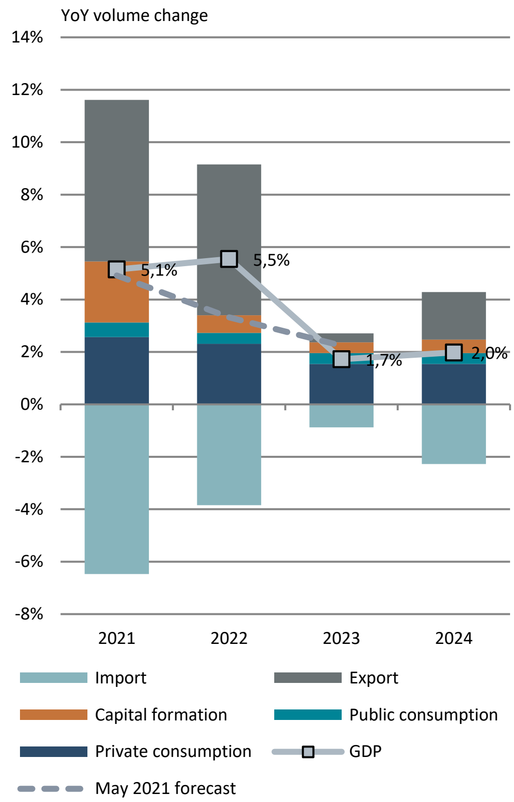
- It appears as if efforts to control the Covid-19 pandemic with extensive immunisation campaigns will soon come to fruition. The global economy is showing signs of robust recovery. Icelandic GDP grew by 3.5% in the first half of 2021 and we forecast 5.1% economic growth for the year as a whole. Export increases by just over 18%, private consumption by 5% and total capital formation by 10.8%.
- Continuous economic growth is expected over the 3-year forecast period; 5.5% in 2022, 1.7% in 2023 and 2% in 2024. GDP is expected to attain pre-pandemic levels towards the end of 2022.
- We expect the high increase in capelin fisheries in 2022 to contribute 1.7 percentage points to economic growth, all things remaining equal.
- Around 720,000 foreign travellers are expected to visit Iceland this year, 1.5 million next year, 1.8 million in 2023 and 2.1 million in 2024.
- We expect unemployment levels to continue falling throughout the forecast period and to be at 4.8% at the end of this year, to average 4.7% in 2022, fall to 4.1% in 2023 and 3.5% in 2024.
- We expect there to be a slight trade surplus this year, with a surplus of 2-4% of GDP in coming years.
- The outlook is for inflation to peak towards year-end 2021 and then to recede to 3% in Q4 of 2022. We expect inflation to hit target in Q3 of 2023 and to remain at and around target throughout the forecast period.
- The forecast assumes the policy rate to be raised incrementally going forward to Q3 of 2023, at which point it will be 4.25%. We further assume that the inflation target will be attained, with interest rates decreasing again to stand at 3.5% at the forecast horizon.
- The real estate market picked up sharply following rate cuts. We expect the housing price index to rise by 14% this year between annual averages and for the trend to slow considerably in coming years, to around 9% in 2022 and 4-5% in subsequent years.
- The National Treasury has assumed significant burdens in the recession. The budget for 2021 was passed with an ISK 326 billion deficit. Public consumption expenses grew by 3.1% in 2020 and we forecast a 2% increase this year and 1.5% increase in the following three years.

Robust economic recovery has begun

Economic impact of the pandemic begins to subside

Preliminary figures from Statistics Iceland show that GDP contracted by 0.2% in Q1 of this year as compared to a 6.5% contraction the previous year. There was a significant change on Q2, when GDP increased by 7.3% as compared with the same period the previous year, signalling the start of recovery. Preliminary figures indicate 3.5% economic growth in the first half of 2021. Expectations were high that successful immunisation in early 2021 would put an end to the pandemic quite quickly and, in May of this year, we forecasted robust economic growth in the latter part of 2021, driven by a strong increase in foreign travellers. Despite a set-back to expectations of achieving quick herd immunity through vaccination caused by the delta variant, the economic outlook for 2021 has improved slightly since May. While foreign visitors to Iceland have been fewer than we assumed in our May forecast, this is offset by significantly higher average spending by tourists than in a usual year. Development of export income from the travel sector has been more positive than we expected. Private consumption growth has also been more robust than we forecast in spring and unemployment levels have fallen more quickly. We now expect to see 5.1% growth this year, 0.2 pp up from our May forecast. The outlook is for even more robust growth next year, or by 5.5 %, which is just over 2 pp higher growth than we assumed in our previous forecast. The improved economic outlook for next year is based largely on expectations of capelin fisheries. We expect to see rather more modest growth in the latter part of the forecast period, or just under 2% on average.

Economic forecast



Source: Economic Research

Overview of macroeconomic forecast of Landsbankinn Economic Research.

	ISK bn	Volume change over previous year, %			
Domestic product and key components	2020	2021	2022	2023	2024
Gross domestic product	2,941	5.1 (4.9)	5.5 (3.3)	1.7 (2.2)	2.0
Private consumption	1,509	5.0 (3.8)	4.5 (3.5)	3.0 (3.0)	3.0
Public consumption	819	2.0 (2.0)	1.5 (1.5)	1.5 (1.5)	1.5
Capital formation	632	10.8 (5.5)	3.1 (2.1)	1.9 (4.8)	2.4
Industrial investment	352	14.3 (4.3)	6.2 (6.8)	1.2 (7.8)	3.0
Investment in residential housing	172	-2.0 (-4.0)	2.0 (-3.0)	5.0 (1.0)	2.5
Public sector investment	108	20.0 (25.0)	-5.0 (-5.0)	0.0 (0.0)	0.0
Total national expenditure	2,963	5.4 (3.7)	3.4 (2.7)	2.4 (3.0)	2.5
Export of goods and services	1,007	18.0 (15.3)	16.8 (14.6)	1.0 (8.5)	5.3
Import of goods and services	1,029	18.5 (11.5)	11.0 (13.0)	2.5 (10.5)	6.5
Policy rates and inflation		2021	2022	2023	2024
CB's key interest rate (7-day term deposits, year end, %)		1.75 (1.50)	3.25 (2.50)	4.25 (2.75)	3.50
Inflation (annual average, %)		4.4 (4.0)	3.5 (2.5)	2.7 (2.6)	2.6
EUR exchange rate (year end)		148 (145)	143 (140)	139 (140)	137
Real estate prices (annual average, %)		14 (11)	9 (5)	4 (3)	5
Labour market		2021	2022	2023	2024
Wage index (annual average, %)		7.9 (7.9)	6.8 (5.6)	5.8 (3.5)	4.6
Purchasing power (annual average, %)		3.4 (3.8)	3.2 (3.1)	3.0 (0.9)	1.9
Unemployment (annual average, %)		7.7 (8.8)	4.7 (5.5)	4.1 (4.6)	3.5
Trade balance		2021	2022	2023	2024
Number of foreign travellers (thousand individuals)		720 (800)	1,500 (1,500)	1,800 (2,000)	2,100
Goods and services balance (%GDP		0.1 (-0.2)	4.0 (0.3)	2.8 (-0.2)	1.9
Current account balance (%GDP)		0.6 (1.2)	4.1 (1.5)	2.9 (0.7)	2.1

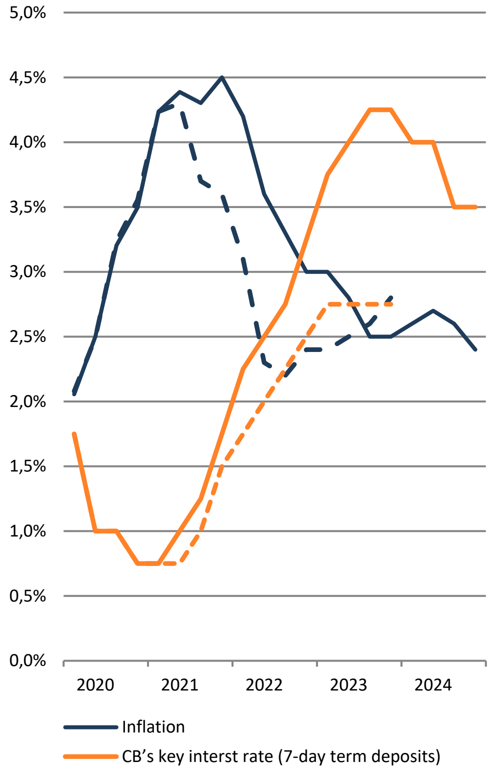
Numbers in brackets are from Economic Research's May forecast

No expectation of achieving inflation target until well into 2023

Inflation was 4.3% in September and has been above the upper limit of the inflation target throughout 2021. Inflation has proven much more persistent than expected, first and foremost due to significant price increases in the real estate market, which have been both higher and more long-lasting than we assumed. This great wave of price increases in the real estate market began in March and has up to and including September led to an 11% increase in housing prices, according to measurements by Statistics Iceland. Inflation less housing on the other hand has receded in the past few months, to 3.3% in September compared with 4.8% in March. We forecast that inflation will peak at 4.5% towards year end, at which point a slow but steady decrease phase will begin, supported by ISK appreciation, growing stability in the real estate market alongside policy rate hikes, and for inflation to reach the CB's target in Q3 of 2023. At that point, we expect inflation less housing to have fallen to 1.6%.

The CB began a rate-raising cycle in May 2021 with a 0.25 pp increase. The Monetary Policy Committee has since increased rates on its August and October meetings, by 0.25 pp each time. The policy rate is currently 1.5%, still historically very low for Iceland, and having regard for inflation, the real policy rate is negative by just under 3% and still having a stimulating effect on the economy. A robust economic recovery and persistent inflation will pressure further policy rate hikes in careful yet steady steps over the coming 1-2 years. The CB's key interest rate can be expected to have reached just over 4% in the latter half of 2023. The outlook is for conservative economic growth and near-target inflation in the latter part of the forecast period to create conditions to lower policy rates again towards the forecast horizon in 2024.

Inflation and policy rate forecast



Dotted line shows Economic Research's May 2021 forecast.
Source: Statistics Iceland, Central Bank of Iceland, Landsbankinn Economic Research

Travel sector recovery has begun and good capelin season expected next year

The outlook is for rather fewer foreign visitors to Iceland this year than we forecast in May. This is first and foremost because the pandemic has been more persistent than expected and border control has been more strenuous and long-standing than we assumed. In our previous forecast, we expected 800,000 foreign visitors to Iceland in 2021 - we have now revised this number down to 720,000. As we forecast in May, travellers' duration of stay and consumption has increased considerably in the wake of Covid-19 and compared with previous years. The effect is even stronger than we anticipated, as export income generated by this number of travellers now looks to equal that of 1.1 million travellers in a normal year. We expect this trend to recede significantly in the future, beginning already next year. We expect round 1.5 million travellers to Iceland in 2022, growing by 300,000 per year the following two years.

Following recent stock harvesting advice from the Marine Research Institute, we expect to see a considerable impact from the assumed 900 tonne capelin season next year. Should it come to fruition, we can expect up to 1.7 pp positive impact on economic growth, other things remaining equal.

All in all, we expect an export increase to the tune of around 18% in 2021, revised up from 15%, and for the growth to be driven primarily by the travel sector. We forecast just under 17% growth in export in 2022, with capelin export adding to the positive contribution of tourism. In the latter part of the forecast period, we assume a much slower increase based on the base effect from capelin fisheries and more conservative growth of the travel sector.

We expect a slight trade surplus this year and for it to be positive at 4.1% of GDP in 2022. In 2023, the outlook is for the trade surplus to be 3% of GDP and just over 2% in 2024.

Significant wage increases in the recession

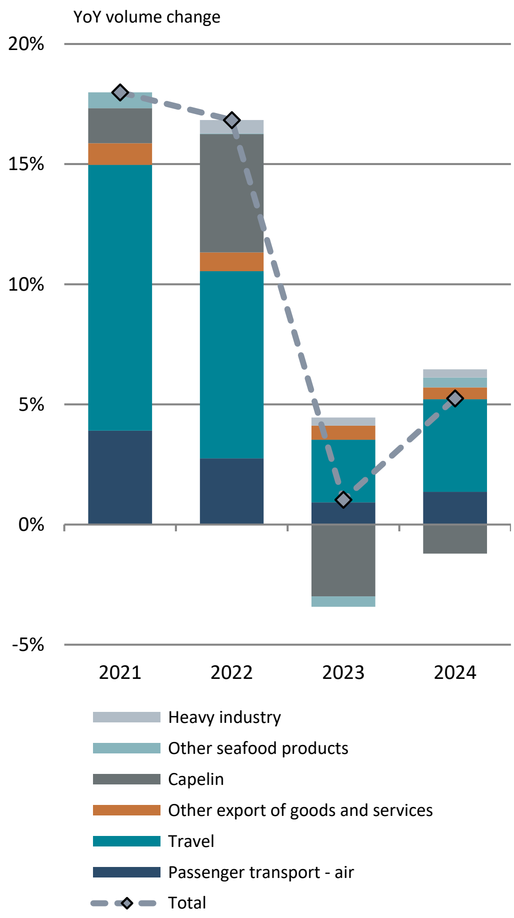
Despite an economic recession and sluggish labour market, there have been significant wage increases, considerably in excess of scheduled increases based on set amount raises provided for in collective bargaining agreements. The 12-month increase in the wage index was 7.9% in August, while prices had increased by 4.3% at the same time. The year-on-year increase in purchasing power was therefore considerable, or 3.5%. Total wages in the economy as a whole was just under 10% lower in real terms in the first half of 2021 than in the same period of 2019. The outlook is for continued considerable wage increases in the next two years, in light of, among other factors, the likelihood that collective bargaining agreement provisions for wage increases contingent on economic growth will be activated on 1 May of both 2022 and 2023, if our forecast holds.

Unemployment successfully reined in

Unemployment has decreased significantly since registered unemployment peaked at 11.6% in January of 2021. Unemployment was 5.0% in September, down by 6.6 pp since January. The hiring grants that have played an important part in reducing unemployment are set to expire soon. For future developments, it will be crucial to see if employment relationships established through such grants will continue or not. Total working hours have now increased five months running, a change from a decrease trend that began in early 2020, at around the time the pandemic hit.

We expect unemployment levels to continue falling throughout the forecast period and to be at 4.8% at

Export growth



Source: Statistics Iceland, Economic Research the end of this year, to average 4.7% in 2022, fall to 4.1% in 2021 and be 3.5% in 2024.

Icelanders indulging as Covid restrictions disappear

Private consumption increased by 4.7% YoY in the first half of the year and we expect to see continued robust growth in the latter part of 2021. Household savings have grown as consumption was delayed during the pandemic. Icelanders are likely to dip into those savings when the opportunity to travel abroad and purchase various services, unavailable during the past 18 months, again presents itself. Private consumption can be expected to increase this year as Icelanders look to be set to indulge. This trend is likely to be counteracted by interest rate increases which will reduce the impact of accumulated savings on consumption and lower disposable income through higher debt service on mortgages.

We forecast a 5% increase in private consumption this year, 4.5% next year and 3% in the two following years. If this forecast holds, consumption in 2021 will exceed pre-pandemic levels in 2019 by 2%.

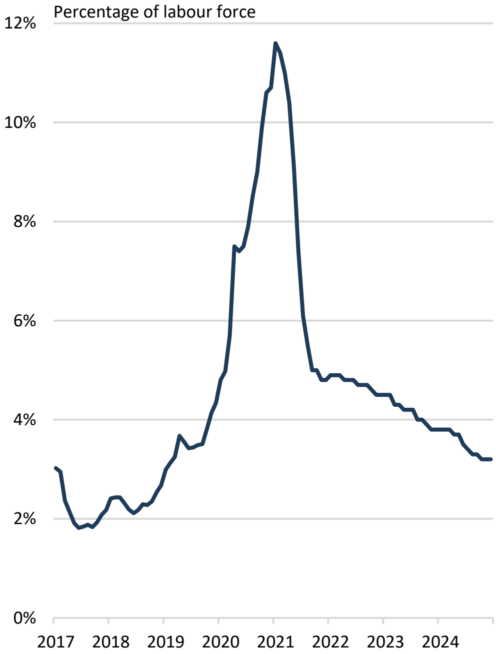
Increased business investment planned following contraction in past years

Business investment has picked up in the first half of the year following considerable contraction last year. We forecast an increase in business investment of just over 14% this year yet for business investment to remain slightly below 2019 levels, despite the increase. The forward outlook is positive as regards business investment. Market expectation surveys show high positivity among executives and that managers view current conditions among the most positive in a historical context. Interest rates are still historically low and company equity ratios are also strong in a historical comparison. We expect business investment to continue to grow throughout the forecast period, averaging 3.5% in the next three years.

Public consumption growth slows down while public investment finally picks up

Public consumption grew by 2.7% in the first part of the year compared to the same period the previous year. The change was 5.5% in 2020. The great

Registered unemployment



2021-2024 is Economic Research forecast
Source: Directorate of Labour, Landsbankinn Economic Research

pressure put on public consumption by the pandemic, especially on the National Treasury, seems to be receding. We expect public consumption growth to continue to slow in coming years and for the increase to measure 2% this year and 1.5% in 2022-2024.

The frequently heralded government investment scheme has been delayed in the past 18 months and public sector investment decreased by 10% in 2019, and 5% in 2020. Public sector investment increased by 14% in the first half of the year and the outlook is for considerable public investment this year, with various delayed projects finally being under way. Economic Research assumes that public investment will increase by 20% this year, decrease by 5% next year and remain unchanged in the latter part of the forecast period, in 2023 and 2024.

Treasury and municipality finances need to get back on track

Municipality finances have deteriorated a great deal between the first half of 2020 and the same period this year. Financial balance as a proportion of income has gone from a 9% to a 16% deficit between years. At the same time, the State deficit decreased from 30% to 25%. Total public finances were negative by 22-23% of income in the first half of both 2020 and 2021. It is clear that greatly increased wage cost has been a hard pill for the Treasury and municipalities to swallow, especially the municipalities.

Public debt has grown significantly alongside negative results and increased borrowing to 35% of GDP at year-end 2020. This year, total public debt according to the debt rule of the fiscal budget is expected to be around 44% of GDP, increasing alongside the public deficit to 49.5% of GDP at year-end 2022. The most recent fiscal budget assumes that debt will continue to increase in 2022-2025 to 54% of GDP in 2025.

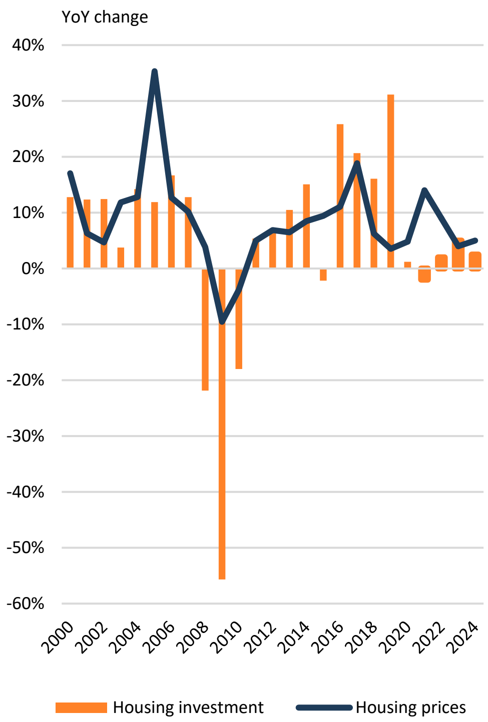
It will be interesting to see the new government's goals on how to regain alignment with statistical provisions of the Act on Public Finances and the resulting impact on public consumption and public investment.

Great housing price increases boost construction

Housing prices have grown extensively this year. We expect the growth trend to have peaked and to enter into a period of more conservative increases and lower 12-month changes. The increase in the housing price index for 2021 may amount to 14% YoY, overall, and we forecast a 9% increase next year and 4% increase between 2022 and 2023. The forecast is based on the assumption that interest rate hikes and other tools the CB may utilise to achieve a cooling of the market, alongside changed demand with a general increase in travel and daily life returning to pre-pandemic norms.

The housing price forecast is based on expected housing construction in coming years. There is currently a great increase in housing in the first stages of construction, especially in municipalities neighbouring the capital region and, provided these developments meet market demands, housing shortage is unlikely to occur. We forecast steady construction and development in coming years, as housing price increases have encouraged new projects and, even though housing investment may contract slightly this year, or by 2% according to our forecast, we expect to see 2% growth already next year and then 5% growth in 2023.

Housing investment and prices



Housing prices are nominal prices in the capital region.
2021-2024 is Economic Research forecast
Source: Statistics Iceland, Registers Iceland, Landsbankinn

The contents and form of this document were produced by employees of Landsbankinn Economic Research (hagfraedideild@landsbankinn.is) and are based on information available to the public when the analysis was compiled. Assessment of this information reflects the views of Economic Research's employees on the analysis date, which may change without notice.

Neither Landsbankinn hf. nor its personnel can be held responsible for transactions based on the information and opinions expressed here as the content is not provided as personal advice on individual transactions.

Attention should be drawn to the fact that Landsbankinn hf. may, at any time, have direct or indirect interests at stake either on its own behalf or through its subsidiaries or customers, for instance as an investor, creditor or service provider. Nonetheless, all analyses are prepared independently by Landsbankinn Economic Research and in accordance with the bank's rules on separation of activities accessible on the Landsbankinn website.