



Setback of the century

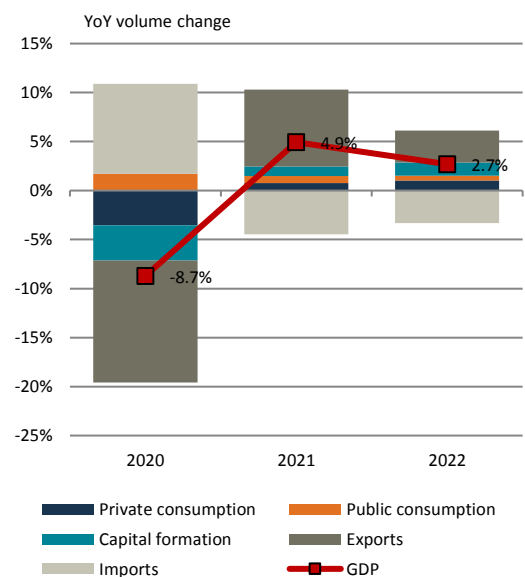
Landsbankinn Economic Research's macroeconomic and inflation forecast, published twice a year, is entitled "setback of the century". As the title indicates, the economic contraction Iceland and the entire world economy are now about to experience is the most significant in living memory. The crisis hit without preamble and is otherwise unique in that it is largely caused by direct administrative decisions taken to impede the spread of the dangerous and highly infectious virus currently harrying the world. Authorities around the globe have intentionally dampened activity in their economies by imposing extensive restrictions on freedom of travel, employment and social activity.

Heading towards 9% contraction in GDP

Economic growth was 1.9% in 2019, according to preliminary figures from Statistics Iceland. This growth outstrips our forecast from October of last year by a considerable margin - we forecast a 0.5% contraction in GDP. At that time, we expected growth to be 2% this year. Clearly, this will not come to pass. Due to the Covid-19 pandemic, the outlook for the global economy has taken a drastic downturn and world production looks to contract significantly between years.

No figures have yet been published from the domestic national accounts for this year, yet several indicators show that the Icelandic economy has already suffered a crushing blow as a result of the pandemic. Initial, reliable data to indicate as much were monthly figures about tourist arrivals, overnight stays in hotels, Icelandair's passenger numbers and payment card figures for travellers. The figures are conclusive - they show an almost complete halt in Iceland's main export industry since wide-reaching travel bans were imposed around mid-March. Shortly afterwards, various restrictions were imposed on other sectors, cultural events and schools to counteract the spread of the virus domestically. While uncertainty about the future is great, all indicators show that export, private consumption and investment will contract severely and that economic growth will be significantly negative this year following a rather long period of economic growth in recent years.

Contribution to economic growth



Source: Landsbankinn Economic Research



Key points from the macroeconomic forecast of Landsbankinn Economic Research

GDP and key components	ISK bn	Volume change from previous year (%)		
	2018	2020	2021	2022
Gross domestic product	2,966	-8.7	4.9	2.7
Private consumption	1,507	-7.0	1.5	2.0
Public consumption	722	7.0	3.0	2.0
Capital formation	600	-17.7	4.7	6.7
Business investment	330	-36.0	9.0	10.0
Investment in residential housing	167	-10.0	-5.0	0.0
Public sector investment	102	29.0	9.0	8.0
Total national expenditure	2,826	-5.6	2.5	2.9
Exports of goods and services	1,344	-27.5	17.3	7.2
Imports of goods and services	1,204	-22.6	11.0	8.2
Verðlag og vextir		2020	2021	2022
Key interest rate (7 day term deposit, end of year,%)		0.5	0.8	1.0
Inflation (annual average,%)		2.7	2.8	2.5
EURISK exchange rate (end-of-year)		160	155	150
Real estate prices (change in annual average %)		2.0	3.0	3.0
Vinnumarkaður		2020	2021	2022
Purchasing power of wages (change from previous year,%)		2.7	2.0	1.1
Unemployment (% of labour force)		9.1%	7.0%	6.0%
Trade balance ISK bn (%GDP)	2019	2020	2021	2022
Goods and services balance	140 (4.7)	3 (0.1)	52 (1.7)	60 (1.9)
Trade balance	172 (5.8)	13 (0.5)	62 (2.1)	70 (2.2)

Our baseline scenario assumes that the Icelandic authorities will ease restrictions incrementally around mid-year, as will our main trading partners. Part of postponed consumption, accumulated during the restriction period, will take place once restrictions are lifted. Consumption of various services not purchased while restrictions on gatherings held sway will most likely only be carried forward to a limited degree. Businesses will gradually begin rehiring and considering investment opportunities. Policy rate cuts and various stimulus measures are effective in this regard. That being said, uncertainty about the spread of the virus will prevent the economy from regaining its former strength in the latter half of the year. The travel industry segment that is focused on non-Icelandic tourists will take even longer to regain its footing and we do not expect tourist arrivals in Iceland to attain 2019 levels in the next three years.

Instead of moderate growth this year, as we forecast last fall, we now expect an 8.7% contraction in GDP in Iceland. If our forecast proves correct, this will be the most severe contraction in GDP since the foundation of the Icelandic Republic. We expect the contraction period to be short-lived and for the economy to pick up with just under 5% growth already next year, supported by a turnaround in export, especially tourism, which sees a vast contraction this year. Despite a rather sharp about-turn, we do not expect



domestic product to reach 2019 levels until late 2022. The blow to the labour market will be hard. We expect unemployment to measure over 9% on average this year and to gradually dwindle to 6% in 2022.

A weaker ISK pushes inflation temporarily over target

12M inflation was 2.2% in April compared to an average of 3.1% 2019, just over the Central Bank's inflation target. ISK depreciation against main trading currencies leading up to and in the wake of the bankruptcy of WOW air was the main reason inflation passed target last year.

Economic developments in the past few months and the outlook for the coming 1-2 years indicate the formation of a considerable negative output gap, both as regards increased unemployment and underused infrastructure and production equipment, mostly in the travel industry. The outlook is also for limited housing price increases and consequently no great increase in household housing cost. Oil prices have dropped significantly and the outlook is for continued low prices in the coming 1-2 years. It appears that inflation in our main trading partner countries will be high on nil this year and only rise slightly towards targets in the next years. Underlying inflation pressure is therefore low, disregarding the considerable depreciation of the ISK in recent months. During the first four months of the year, the ISK has weakened by 15% against the EUR and 17% against the USD. In our opinion, businesses will only be able to absorb the ISK depreciation to a limited degree and it will inevitably impact price levels in coming months, pushing inflation temporarily over the Central Bank's target. We do not expect the ISK to weaken from current values to any degree. Provided public and corporate trust in the ability and intention of the Central Bank to defend its inflation target prevails, as is reflected in inflation expectations, the inflation surge is likely to be low and short-lived. We expect inflation to peak at 3.5% in the fourth quarter of this year and that it will have receded back to target at mid-2021.

This time around, world economies are all in the same boat

The International Monetary Fund (IMF) expects world production to contract by 3.5% this year and to grow again by just over 5% in 2021. Developments are



extremely uncertain and the IMF assumes that the contraction may be as severe as 6% this year and another 2% next year, if there is a setback in the fight to contain the virus. In Iceland's main trading partner countries, GDP is expected to contract by between 2% and 8% in 2020.

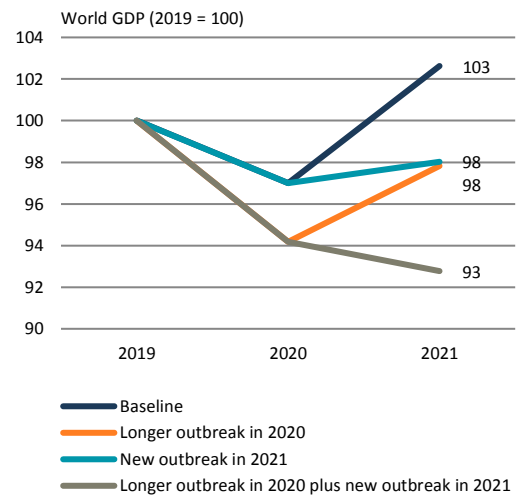
The outlook is for low inflation in most countries in 2020 due to a fall in demand for products and services, and a sharp decrease in oil prices, as well as other commodity prices. Once demand rekindles in the course of 2021 and the effect of lower oil prices dwindle, inflation can be expected to rise again towards the targets of developed countries. Low policy rates in many countries, alongside stimulus action in public finances, are drivers of inflation pressure. This is counteracted by a negative output gap which can be assumed to be considerable in many countries, reflected among other things in higher unemployment going forward compared to previous years.

Action to limit the economic impact of the pandemic

Government authorities throughout the world have introduced extensive measures to reduce the negative ramifications to economies that local and international action to counteract the spread of the virus have had. Policy rates were already very low in many countries, prior to the pandemic, yet where possible, central banks have lowered rates as far down as zero. The central banks of the US, the Eurozone and England, and other countries, have also initiated action of an unprecedented magnitude to increase money supply in circulation. Most governments have greatly increased public spending in reaction to the direct and indirect impact of the pandemic. The same is true in Iceland. The Monetary Policy Committee of the Central Bank of Iceland (MPC) cut policy rates by 1.25 percentage points in Q1 and the CBI's key interest rate is now 1.75%. There is still considerable leeway to reduce monetary policy restraint. We expect that the MPC will take advantage of this already at its next meeting and that policy rates will be set down by one percentage point. The baseline scenario assumes that policy rates will reach a low of 0.5% in Q3 to be raised in slow increments as of Q4 2021.

Fiscal restraint has also been relaxed considerably in Iceland and various stimulus measures have been introduced. Clearly, monetary and fiscal policies must

World economic outlook



Source: IMF World Economic Outlook, April 2020



be closely attuned in the next 1-2 years to aid the domestic economy through the enormous shock it has suffered with as little damage as possible.

Considerable risk of a setback

The high degree of risk in these unprecedented times cannot be overstated, both relating to development of the pandemic and its economic ramifications. Our baseline scenario assumes that economic recovery will begin in the latter part of the year as the pandemic subsides without any significant setbacks in the fight against the virus. This is by no means a certainty. In light of the prevailing high degree of uncertainty, we have developed two scenarios beside our main forecast. The more pessimistic scenario assumes negative developments; a recurrence of the virus after the first wave has passed. As a result, economic growth is slower to pick up and is considerably weaker next year compared to the baseline scenario. Our other, optimistic scenario, assumes a more rapid economic recovery world-wide and stronger demand from our main trading partners. This scenario assumes that an effective treatment and/or vaccine against Covid-19 is developed faster than now appears likely.

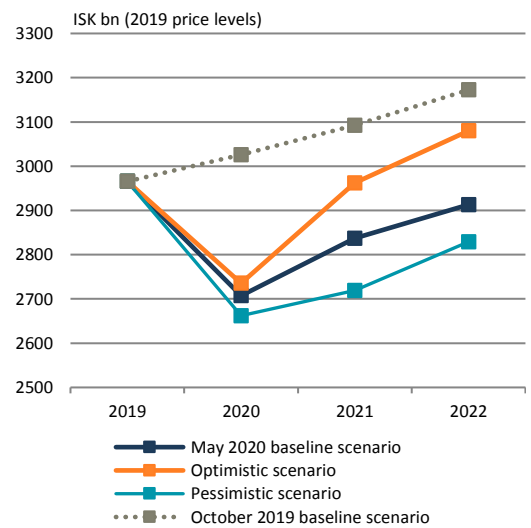
In the optimistic scenario, contraction will be rather less than in the baseline this year, or just under 8% instead of 9%. The main difference is that economic recovery will be more robust next year, or 9%, driven by quicker growth in export, private consumption and investment. If this scenario eventuates, 2019 GDP levels will be reached already at year-end 2021 and recovery will be V-shaped. The more pessimistic scenario results in an L-shaped recession. It assumes over 10% contraction this year and only 2% growth next year. At the forecast horizon in 2022, GDP is still 5% lower than in 2019 and unemployment is 7%.

All in all, we consider uncertainty in the forecast to be on the downside, with 40% probability of developments being in line with the pessimistic scenario, assigning 10% probability to the optimistic scenario.

Other uncertainty factors

There is uncertainty about other factors than the Covid-19 pandemic. The trade war between the US and China can best be described as on hold at the moment. At the end of 2019, there was some hope for resolution of the conflict or at least that it would cease

GDP forecasts -before and after Covid 19



Source: Statistics Iceland, Landsbankinn Economic Research



to escalate. In light of statements by US government officials about China's supposed responsibility for the seriousness of the pandemic, the conflict may rekindle once the pandemic recedes, not least if Donald Trump will be re-elected as president. If this is the case, economic recovery will be even slower than currently expected. Arrangement of international trade once Britain exits the EU is also uncertain. It is likely that the transition period will be extended due to the pandemic, if no agreement is reached by the end of the year.

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