



# Strong economic recovery starts next fall

*Landsbankinn Economic Research forecasts an 8.5% contraction in domestic product in 2020 as a result of Covid-19. There is still a great deal of uncertainty about the economic outlook. It now appears that the pandemic will remain an active factor longer than we anticipated in our macroeconomic and inflation forecast in May. At this point, we do not expect the economy to begin its recovery until next fall, at the earliest. Economic growth will nevertheless be positive by 3.4% in 2021. We expect to see robust growth in 2022 and 2023, or 5% each year, alongside a speedy recovery of the travel industry.*

### **Main conclusions:**

- The outlook is for an 8.5% contraction in GDP in 2020 as a result of the Covid-19 pandemic. Export contracts by 30%, private consumption by 5.5%, and total capital formation by over 10%. On the other hand, public consumption and public investment increase significantly and import decreases by 22%.
- The contraction period will be relatively short-lived, yet recovery will be slow to begin with. Economic Research forecasts 3.4% growth in 2021 and 5% annual growth in 2022 and 2023.
- Around 500,000 tourists are expected to visit Iceland this year, 650,000 next year, 1.3 million in 2022 and 1.9 million in 2023.
- Unemployment levels have risen considerably and will average 7.8% this year and rise to 8.4% in 2021 before dwindling down to 5.8% in 2022 and 4.8% in 2023.
- Despite the drop in export activity, there will be a slight current account surplus this year (+0.1% of GDP), a minor deficit next year (-0.3% of GDP) followed by a growing surplus in 2022 (+1.4% of GDP) and 2023 (+3.4% of GDP).
- Inflation will remain slightly above target until the latter half of 2021 because of ISK depreciation 2020. Inflation will average 3.1% next year, 2.7% in 2022 and 2.6% in 2023.
- The policy rate will be unchanged at 1% throughout 2021, rise to 1.75% in 2022 and stand at 3.5% at year-end 2023.
- The real estate market picked up sharply in spring following rate cuts. We assume that real estate prices will increase by 4.5% this year and 4% per annum on average during the forecast period. This increase is not significant in historic terms, yet nevertheless noteworthy in light of the fact that the economy is going through a deep downturn.
- The National Treasury has taken on significant obligations and outlays in response to Covid-19. It is clear that revenues have fallen, and expenses increased above and beyond any expectations or former guidelines, and the accumulated deficit of 2020 and 2021 is expected to approximate ISK 600 billion. Accordingly, national debt will increase significantly, rising from 28% of GDP at year-end 2019 to 48% in 2021.



The impact of the Covid-19 pandemic is primarily felt in three ways: through direct disease prevention measures which limit economic activity, such as border closings and limitations on various industries and businesses that decrease productivity; through lower demand caused by rising unemployment and falling disposable income; and, finally, through altered behaviour among the public caused by fear of infection and possible loss of employment. These factors affect purchasing behaviour and the general public's will to save.

### ***Economic downturn of almost global proportions***

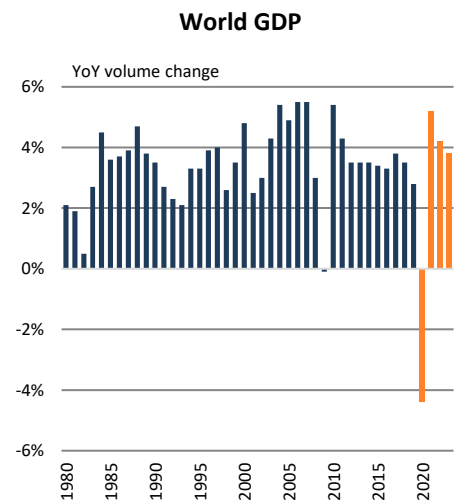
The International Monetary Fund (IMF) expects world production to contract by 4.4% this year and to grow again by just over 5.2% in 2021. Developments are extremely uncertain, and the IMF assumes that the contraction may be up to 0.75 pp higher this year and economic growth in 2021 around 3 pp lower, if there is a setback in the fight to contain the virus and develop vaccines.

### ***Record contraction in GDP in the second quarter of the year***

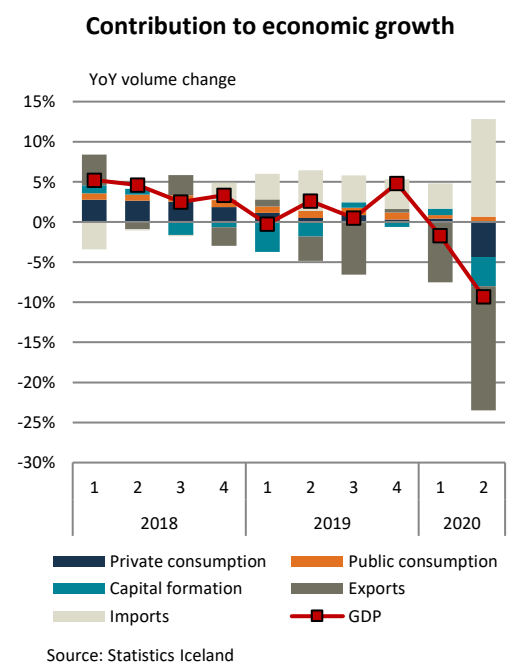
Preliminary figures in national accounts for the first half of the year confirm that the Icelandic economy has already suffered a considerable blow as a result of the pandemic. Private consumption in the second quarter contracted by 8.3%, import by 38.8% and GDP by 9.3%. Unemployment has undergone a rapid increase and had reached 9% in September. The Treasury deficit is significant. At the beginning of summer, it appeared that the spread of the virus had been successfully slowed down in Iceland and many other countries. Consumption and economic activity picked up for a time, though the rise in the infection rate in the latter half of the summer and fall is likely to again put a damper on the economy, both domestically and abroad.

### ***When will the pandemic end?***

The economic impact of the pandemic, both in Iceland and on the world economy, is likely to continue to be significant until herd immunity is achieved, i.e. when a large enough percentage of the population has become immune to stop the spread of the virus. Most agree that achieving herd immunity in the near future is dependent on the development of a



2020-2023 IMF forecast.  
Source: IMF World Economic Outlook September 2020

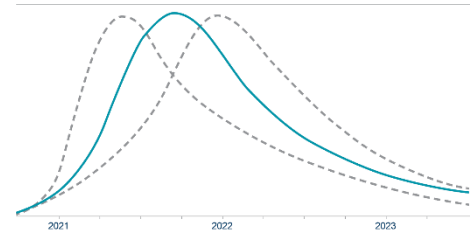


Source: Statistics Iceland



vaccine. Here there are several uncertainty factors. Firstly, how long it will take to develop and market a vaccine; secondly, how impactful such a vaccine will be (in duration and effectiveness); and, thirdly, how willing the public will be to receive immunisation.

Management consulting company McKinsey recently published its forecast for likely achievement of herd immunity in the US. Developments are expected to be similar in other developed countries. Three scenarios describe the various assumptions about vaccination. The most likely scenario holds that herd immunity will be achieved in the third quarter of next year. This scenario, the blue curve in the middle of the image on the right, assumes that one or more vaccines will be approved at the turn of the year. Production and distribution of the vaccine is expected to take six months and public willingness to be immunised is assumed to be high. The optimistic scenario assumes that an effective vaccine will be ready earlier, and that production and distribution will be swift. The pessimistic scenario (far right curve) assumes that the first vaccines will not be very effective and/or have considerable side effects which will reduce public willingness to be immunised. Should this scenario eventuate, herd immunity is not expected until the second half of 2022.

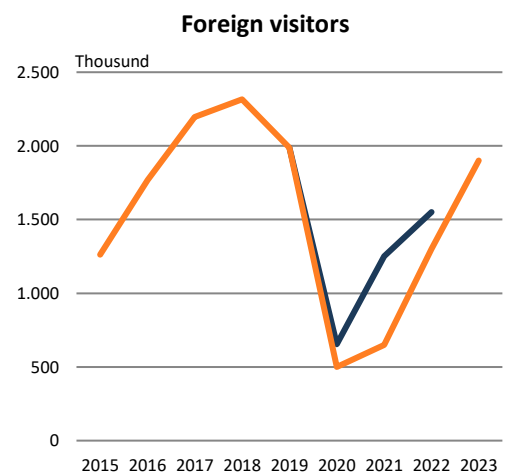


Three scenarios describing the various assumptions about vaccination.  
Source: McKinsey.

The macroeconomic forecast of Economic Research assumes that the pandemic will follow the most likely scenario in broad strokes, i.e. that general herd immunity will be achieved in Iceland and in main trading partner countries in the third quarter of 2021. The third wave of the pandemic is expected to mostly recede before year-end 2020 and economic activity to return to more or less normal, in line with developments in June and July this summer. On the other hand, strict disease prevention measures are expected to remain in place at the border until the end of summer, which will prevent any great influx in travellers to Iceland until next fall.

***Outlook for 8,5% contraction this year and conservative recovery next year***

Economic growth prospects for 2020 have not changed much since our May forecast despite various components of domestic product developing rather differently from what we expected then. We expect economic growth to be negative by 8.5% this year, constituting the sharpest economic contraction in one year in the history of the Icelandic Republic. We



— May 2020 forecast — October 2020 forecast  
Source: Icelandic Tourist Board, Landsbankinn Economic Research



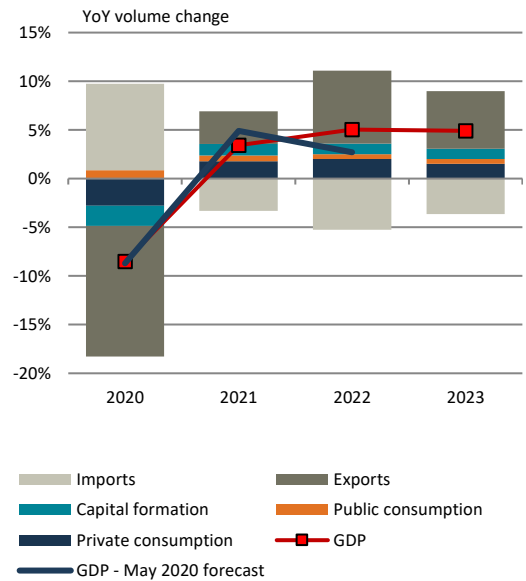
expect the contraction period to be relatively short-lived and for the economy to make a robust recovery next fall alongside successful measures to contain the spread of the virus. Next year, we expect GDP to grow by 3.4% and for growth to be driven primarily by increased export, private consumption and investment. In 2022 and 2023, GDP growth can be expected to pick up alongside a recovery of the travel industry and increased traveller arrivals in Iceland. In 2022, we expect tourist numbers to double between years and 17% growth in total export. The dwindling effect of Covid-19 will lead to a resurgence of tourism world-wide in 2023 and we expect arrivals of foreign travellers in Iceland to attain 2019 levels. The recovery of the travel industry alongside conservative growth in domestic demand will lead to 5% annual economic growth both years.

Despite a sharp turnaround towards the latter part of the forecast period, we do not expect GDP to attain previous 2019 levels until yearly 2023. The blow to the labour market will be hard. We expect unemployment to average 7.8% this year and rise to 8.4% next year before dwindling to 5.8% in 2022 and 4.8% in 2023. Despite the drop in export activity, there will be a slight current account surplus of +0.1% this year, a minor deficit of -0.3% next year, followed by a growing surplus of 1.4% in 2022 and 3.4% in 2023.

### ***ISK depreciation has pressured inflation up and reduced the likelihood of further rate cuts***

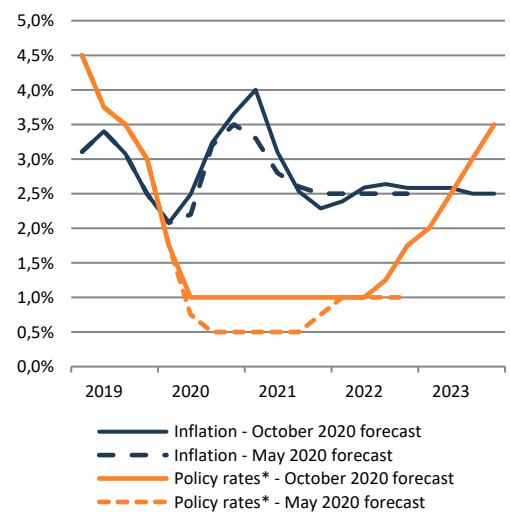
Inflation has increased somewhat since January this year, when it measured 1.7%, and was 3.5% in September. This is the highest inflation has measured since May 2019, when it was 3.6%. Increased inflation since January is primarily driven by exchange rate influences. We expect inflation to rise to 4% at the beginning of next year due to depreciation of the ISK and to average 3.1% in 2021. For inflation to recede next year, the ISK exchange rate must remain fairly stable. If this eventuates, the outlook is for inflation to fall rapidly considering base effects from the previous year and that a large part of current inflation is manifested in rising prices of imported goods. Despite a considerable negative output gap in the economy, cost pressure can be expected to grow on the back of contractual wage increases. As a result, inflation can be expected to remain slightly above

### **Contribution to economic growth**



Source: Landsbankinn Economic Research

### **Inflation and policy rate forecast**



\*7 day term deposit, end of quarter

Source: Statistics Iceland, CBI, Landsbankinn Economic



target in the latter part of the forecast period, or at around 2.6% on average.

If inflation were closer to target, there would be good grounds for further policy rate cuts. However, while inflation remains above target, the policy rate is unlikely to be lowered further. A short-term hike of the policy rate is also unlikely, as the negative output gap is currently wide, reflected amongst other things in high unemployment. We expect that the Monetary Policy Committee of the Central Bank of Iceland will hold the policy rate unchanged this year and next.

The negative output gap is expected to decrease moving toward the forecast horizon, a series of interest rate hikes to begin in the second half of 2022 and real policy rates to again be positive by mid-year 2023.

#### Key points from the macroeconomic forecast of Landsbankinn Economic Research

GDP and key components	ISK bn	Volume change from previous year (%)			2023
	2019	2020	2021	2022	
<b>Gross domestic product</b>	<b>2,970</b>	<b>-8.5 (-8.7)</b>	<b>3.4 (4.9)</b>	<b>5.0 (2.7)</b>	<b>4.9</b>
Private consumption	1,502	-5.5 (-7.0)	3.5 (1.5)	4.0 (2.0)	3.0
Public consumption	727	3.5 (7.0)	2.5 (3.0)	2.0 (2.0)	2.0
Capital formation	598	-10.3 (-17.7)	5.9 (4.7)	5.3 (6.7)	5.3
Business investment	328	-16.9 (-36.0)	5.7 (9.0)	7.1 (10.0)	7.8
Investment in residential housing	166	-16.0 (-10.0)	2.5 (-5.0)	2.0 (0.0)	5.0
Public sector investment	103	20.0 (29.0)	10.0 (9.0)	5.0 (8.0)	0.0
Total national expenditure	2824	-4.1 (-5.6)	3.7 (2.5)	3.7 (2.9)	3.2
Exports of goods and services	1,346	-29.6 (-27.5)	7.4 (17.3)	16.6 (7.2)	13.1
Imports of goods and services	1,200	-22.0 (-22.6)	8.2 (11.0)	13.0 (8.2)	9.0
<b>Verðlag og vextir</b>		2020	2021	2022	2022
Key interest rate (7 day term deposit, end of year,%)		1.00 (0.50)	1.00 (0.75)	1.75 (1.00)	3.50
Inflation (annual average,%)		2.9 (2.7)	3.1 (2.8)	2.7 (2.5)	2.6
EURISK exchange rate (end-of-year)		162 (160)	162 (155)	158 (150)	155
Real estate prices (change in annual average %)		4.5 (2.0)	4.0 (3.0)	4.0 (3.0)	4.0
<b>Vinnumarkaður</b>		2020	2021	2022	2022
Purchasing power of wages (change from previous year,%)		2.8 (2.7)	3.0 (2.0)	2.3 (1.1)	1.3
Unemployment (% of labour force)		7.8 (9.1)	8.4 (7.0)	5.8 (6.0)	4.8
<b>Trade balance ISK bn (%GDP)</b>	2019	2020	2021	2022	2022
Number of foreign visitors	1,987	500 (654)	650 (1,250)	1300 (1,550)	1,900
Goods and services balance		-1.0 (0.1)	-1.0 (1.7)	0.8 (1.9)	2.9
Trade balance		0.1 (0.5)	-0.3 (2.1)	1.4 (2.2)	3.4

Numbers in brackets are from Economic Research's May 2020 forecast

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.