Þjóðhagur

Hagfræðideild Landsbankans
30. október 2019

Introduction and overview

This is the ninth edition of *Þjóðhagur*, the annual review of Landsbankinn Economic Research. *Þjóðhagur* focuses on current economic developments and the outlook. It features Economic Research's macroeconomic and inflation forecast, provides a comparison with the previous forecast as well as forecasts from other main public entities.

Economic growth will be negative by 0.4% this year

Economic conditions in Iceland have in most respects been extremely favourable in recent years. Inflation held steady under the Central Bank's (CBI) 2.5% target since February 2014 and until the mid-2018, and economic growth has been continuous since 2011. The purchasing power of wages has never been higher, unemployment levels have risen slightly yet are still low by international standards, and household and corporate debt is at an historic low. The National Treasury is strong and the net foreign debt position has never been as favourable.

A changing point has now been reached in the economic cycle. Landsbankinn Economic Research expects economic growth to slow considerably in coming years following the robust growth period of recent years. According to our forecast, domestic product will contract slightly this year and economic growth will be negative by 0.4%. Next year, we expect moderate growth of 2%, stepping up slightly in 2021 and 2022.

The inflation outlook has improved this year to date and we now expect inflation to remain at or around target throughout the forecast period, as economic growth is expected to harmonise with the long-term trend growth rate of the economy.

Moderate economic growth in coming years

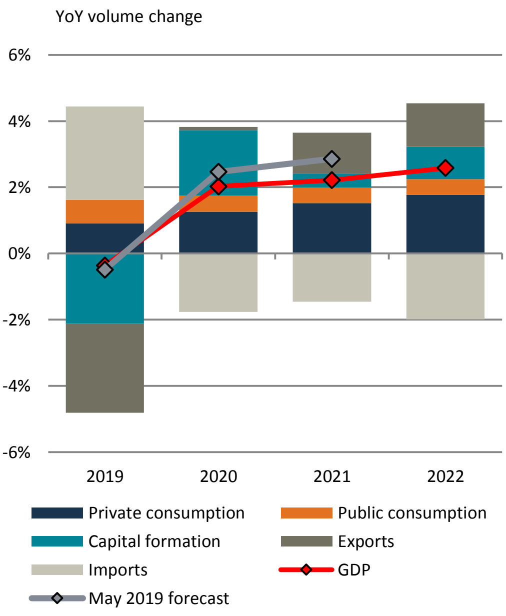
The outlook is for a moderate economic upswing in coming years, supported by low yet sustainable growth in private consumption, increased public investment, rising export and a turnaround in business investment going forward. The forecast also reflects considerable uncertainty about global economic developments in the next 1-2 years, already materialising in the slower growth of international trade and manufacturing. Further escalation of these developments, beyond current expectations, may have a considerable negative impact on Iceland, i.e. on the travel industry, fisheries and seafood, and heavy industry. Conversely, a positive change in global trade would have a more positive impact on the domestic economy than assumed in the forecast.

The inflation outlook has improved in recent months and inflation expectations are now roughly in line with the Central Bank of Iceland's (CBI) target. The ISK exchange rate has proven more stable at the end of the economic cycle than has generally been the case historically, and newly concluded collective bargaining agreements afford predictability and stability in the labour market in coming years.

Successful growth period behind us

The Icelandic economy has grown substantially in the past eight years. Economic growth has been considerably in excess of the domestic economy's long-term growth capacity, averaging 3.8% per annum. Even so, inflation has been low in the past five years, remaining at the CBI's target, with the exception of slight inflation spikes in the past 1-2 years. In 2019, we have reached a turning point in this relatively long and successful growth period as the outlook is for subtle contraction in domestic product this year. According to the International Monetary fund's (IMF) newest World Economic Outlook report, a slowdown is expected in 90% of the world's economies this year. The contraction in Iceland is as such a part of the current cooling of the global economy.

Contribution to economic growth



Landsbankinn Economic Research forecast
Source: Landsbankinn Economic Research

In Iceland, the end of growth phases has historically been followed by difficult transition periods due to an imbalance that builds up in the preceding upswing. This time is an exception. Breaking with tradition, households and companies are currently generally well placed in terms of assets and liabilities. The purchasing power of wages has never been as high. The National Treasury is very strong and municipalities have generally grown stronger in recent years. In addition, the CBI has amassed a very handsome non-leveraged FX reserve, a significant departure from history. The continuing foreign trade surplus supports the ISK exchange rate.

Despite the considerable depreciation of the ISK leading up to and following shocks to the travel industry and fisheries and seafood, inflation only rose slightly above the CBI's target and inflation expectations are now in line with target inflation, by most measures.

Slight contraction this year

We expect to see negative growth of around 0.4% this year, driven by a significant contraction in export and business investment. A moderate increase in private consumption and considerable growth in public consumption will counterbalance the effect. Housing investment will grow powerfully between years and public sector investment will show some growth, alongside a significant contraction in import.

In coming years, we will see moderate economic growth supported by fairly wide foundations. Initially, the economic pick-up will be driven by increased capital formation, private and public consumption, with a turnaround in export in the latter half of the forecast period providing an even stronger basis for growth.

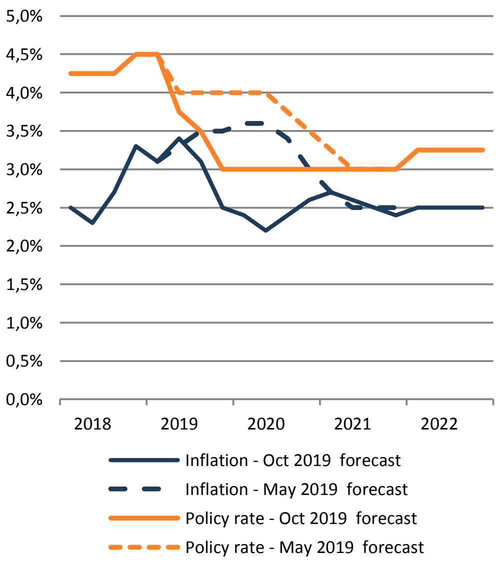
All in all, annual economic growth as of next year will be around 2.3% per annum throughout the forecast period which ends in 2022. In comparison, the IMF forecasts 1.7% average growth in developed countries next year.

Improved inflation outlook

The inflation outlook has improved somewhat since we published our updated macroeconomic and inflation forecast for the period in May. We now expect inflation to fall below the CBI's target towards year-end and for it to remain more or less at target throughout the forecast period.

The main driver of the improved inflation outlook is the change from a considerable positive output gap

Inflation and policy rate forecast



*7 day term deposit, end of quarter
Source: Statistics Iceland, CBI, Landsbankinn Economic Research

in previous years to a negative output gap in the coming 1-2 years. Long-term agreements in the labour market providing for moderate wage increases throughout the contract period, a fairly stable ISK exchange rate despite shocks to exports, combined with increased balance in the housing market all provide important support for price stability in coming years. In addition, inflation expectations have decreased in the past quarters and are now more or less in line with the CBI's target.

Uncertainty in the inflation forecast includes considerations about the travel industry, especially uncertainty as regards flight connections to and from Iceland in the next 1-2 years. Economic set-backs in Iceland's main trading partner countries, such as a no-deal Brexit and a widening rift in the trade dispute between the US and China, could significantly impact demand in the travel industry and the export of aluminium and seafood products.

Policy rate decrease and increased public expenditure in response to economic contraction

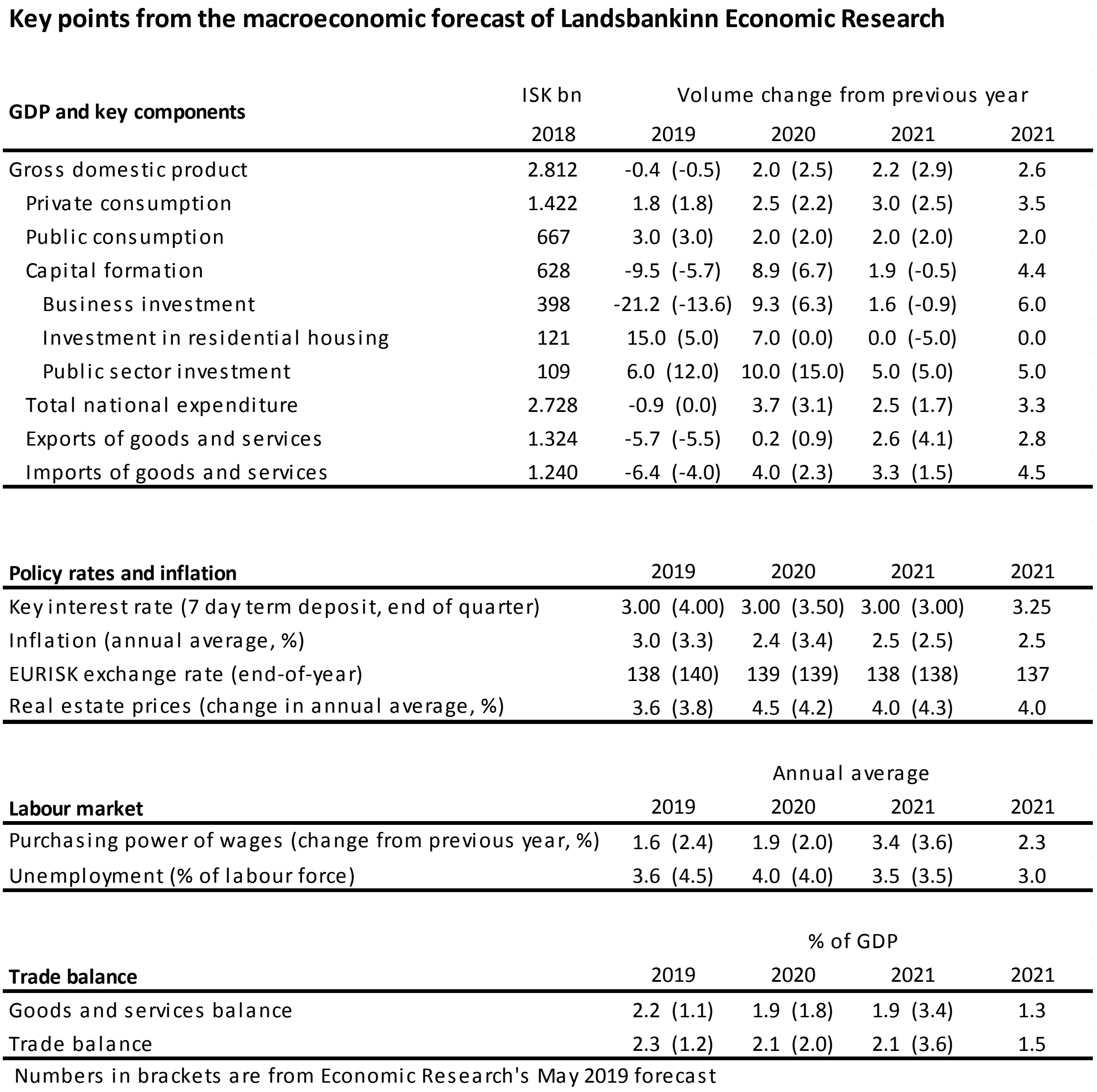
The Monetary Policy Committee (MPC) of the CBI has responded to falling inflation and inflation expectations alongside indications of increased economic slack by lowering policy rates. Since May, the MPC has lowered the CBI's key rate four times by a total of 1.25 percentage points, from 4.5% to 3.25%. As a result, historical inflation currently puts real policy rates at just 0.25%. The CBI's key rates are at a historic low, previously dipping to 3.6% in 2011.

There are two scheduled rate decisions meetings left this year, in November and December. We deem it likely that the MPC will lower the CBI's rates by 0.25 percentage points at one of these meetings and that the CBI's key rate, i.e. the seven-day term deposit rate, will as a result be 3.0%. After that, we expect a rather lengthy period of unchanged policy rates. If our forecast for increased economic growth and lower unemployment for 2021 eventuates, some loosening of the monetary policy will become timely with an increase of policy rates to 3.25% in early 2022.

High uncertainty in the forecast

Economic forecasts are always subject to a high degree of uncertainty about numerous domestic and foreign factors. Uncertainty in the current forecast is high, not least as regards the growth outlook. This includes uncertainty about developments in the travel industry in coming years and economic developments in main trading partner countries. It is also unclear to what extent the government will be able to utilise the window of opportunity now opening to launch public investments that have been on hold in recent years due to the high economic tension.

Finally, a number of foreign factors, outside of the influence of the Icelandic economy, such as uncertainty about oil prices and other commodities prices, could have a considerable influence on both the inflation and economic outlook in Iceland.



Key points from the macroeconomic forecast of Landsbankinn Economic Research

GDP and key components	ISK bn	Volume change from previous year			
	2018	2019	2020	2021	2021
Gross domestic product	2.812	-0.4 (-0.5)	2.0 (2.5)	2.2 (2.9)	2.6
Private consumption	1.422	1.8 (1.8)	2.5 (2.2)	3.0 (2.5)	3.5
Public consumption	667	3.0 (3.0)	2.0 (2.0)	2.0 (2.0)	2.0
Capital formation	628	-9.5 (-5.7)	8.9 (6.7)	1.9 (-0.5)	4.4
Business investment	398	-21.2 (-13.6)	9.3 (6.3)	1.6 (-0.9)	6.0
Investment in residential housing	121	15.0 (5.0)	7.0 (0.0)	0.0 (-5.0)	0.0
Public sector investment	109	6.0 (12.0)	10.0 (15.0)	5.0 (5.0)	5.0
Total national expenditure	2.728	-0.9 (0.0)	3.7 (3.1)	2.5 (1.7)	3.3
Exports of goods and services	1.324	-5.7 (-5.5)	0.2 (0.9)	2.6 (4.1)	2.8
Imports of goods and services	1.240	-6.4 (-4.0)	4.0 (2.3)	3.3 (1.5)	4.5

Policy rates and inflation	2019	2020	2021	2021
Key interest rate (7 day term deposit, end of quarter)	3.00 (4.00)	3.00 (3.50)	3.00 (3.00)	3.25
Inflation (annual average, %)	3.0 (3.3)	2.4 (3.4)	2.5 (2.5)	2.5
EURISK exchange rate (end-of-year)	138 (140)	139 (139)	138 (138)	137
Real estate prices (change in annual average, %)	3.6 (3.8)	4.5 (4.2)	4.0 (4.3)	4.0

	Annual average			
Labour market	2019	2020	2021	2021
Purchasing power of wages (change from previous year, %)	1.6 (2.4)	1.9 (2.0)	3.4 (3.6)	2.3
Unemployment (% of labour force)	3.6 (4.5)	4.0 (4.0)	3.5 (3.5)	3.0

	% of GDP			
Trade balance	2019	2020	2021	2021
Goods and services balance	2.2 (1.1)	1.9 (1.8)	1.9 (3.4)	1.3
Trade balance	2.3 (1.2)	2.1 (2.0)	2.1 (3.6)	1.5

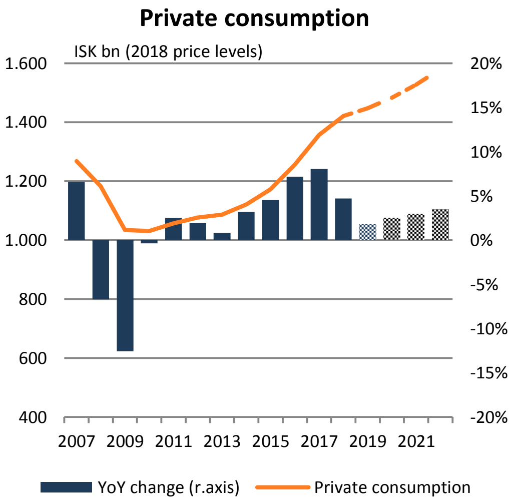
Numbers in brackets are from Economic Research's May 2019 forecast

Less private consumption yet growth on the horizon

Private consumption growth has slowed down considerably since 2017 alongside a more leisurely rise in the purchasing power of wages. We expect continued moderate growth this year and next, with rather more powerful growth in the latter half of the forecast period.

Private consumption increased by 2.3% YoY in Q1 of this year and 2.2% in Q2, and growth had not been lower since Q1 2014. Obviously there has been a considerable slowdown in private consumption which now is developing more in sync with the purchasing power of wages. The purchasing power of wages grew by 2.5% YoY in Q1 and by 1.9% in Q2. Ever since the beginning of 2017, private consumption growth has outstripped any increase in purchasing power.

Our forecast assumes 1.8% growth in private consumption this year. The growth rhythm is expected to increase steadily in coming years, to 2.5% in 2020, 3.0% in 2021 and 3.5% in 2022.



2019-2022 is the forecast of Landsbankinn Economic Research
Source*:* Statistics Iceland, Landsbankinn Economic Research

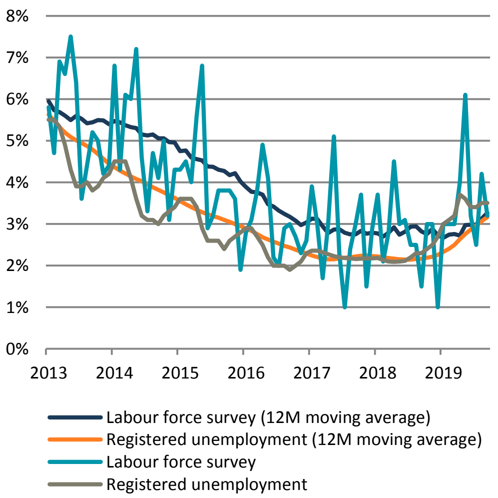
Higher unemployment

Registered unemployment as measured by the Directorate of Labour is now considerably higher than a year ago. In September of 2018, unemployment measured 2.3% and had risen to 3.5% at the end of September this year. This is a 1.2 percentage point increase in one year.

A look at the 12-month average shows that the participation rate contracted by 0.3 percentage points from September 2018 to September 2019. A sharp contraction in the participation rate may indicate hidden unemployment whereby marginal groups in the labour market choose to drop out instead of expending time and effort on a difficult job search.

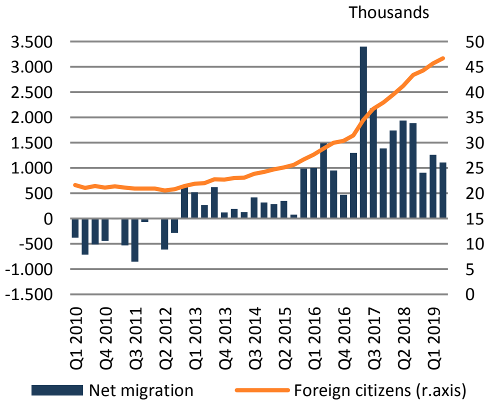
The net increase in foreign nationals was still on the rise in Q2 this year, indicating that the current economic contraction has not affected workforce participation by foreign individuals, at least not yet.

Unemployment rate



Source: Directorate of Labour, Statistics Iceland.

Net external migration and foreign nationals



Source: Statistics Iceland

Wages continue to rise, though at reduced speed

According to figures from Statistics Iceland, the wage index increased by 4.3% between Q3 2018 and Q3 2019, the lowest YoY change since early 2010.

Despite lower wage increases, the purchasing power of wages has remained stable in recent months. Purchasing power was 1.2% higher in September of this year than September 2018. Since the beginning of 2015, the purchasing power of the wage index has grown by over 26.2%, or by 6% per annum, which is significant growth.

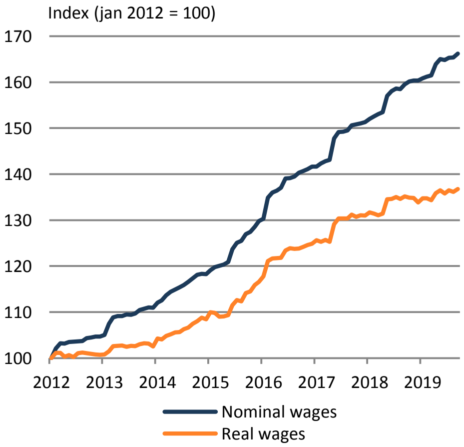
The effects of direct wage increases provided for in the agreement can be supposed to average 3-4% annually. So far, there is little indication of any wage drift caused by the agreements.

Should public sector employees conclude collective bargaining agreements similar to those signed by the private sector as regards general wage increases, Economic Research expects the wage index to rise by 4.7% this year, 4.2% in 2020, 6% in 2021 and 4.9% in 2022.

Wage index

Source: Statistics Iceland

Nominal and real wages



Source: Statistics Iceland

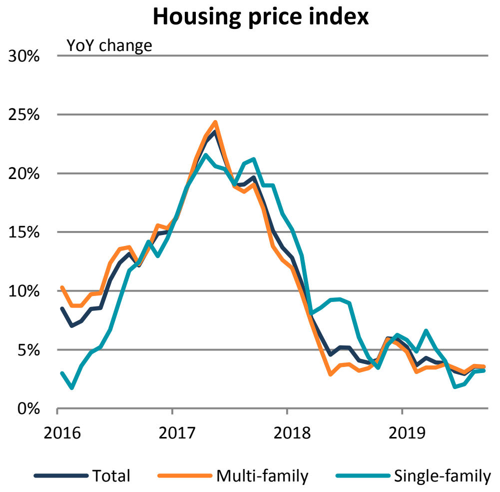
Moderate housing price increases

In September 2019, the housing price index in the capital area rose by 0.6% MoM. There are indications that the housing market is heating up somewhat following a period of low activity in spring and summer. Annualised increases in real prices have been between 0-1% since May and we predict continued moderate increases.

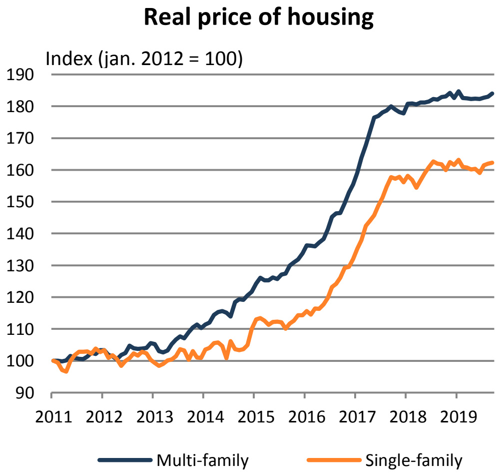
Over a 12-month period, the price for multi-family dwellings has risen by 3.6% and single-family dwellings by 3.2%. The weighted annual increase in housing prices currently amounts to 3.5%, which is a slight increase, historically speaking. 12-Month increases have lain between 3-5% this year to date as compared to 4-13% last year and 14-24% in 2017, when the increases peaked.

Conditions are generally favourable for housing purchase at this time. There is a good supply of housing, mortgage rates are as low as they get and housing price increases have been relatively low compared with the rise in purchasing power in the past 6-18 months.

Bearing all this in mind, Economic Research expects the real price of housing to increase by around 1% annually in the next years. We expect to see an annual increase of around 4% in housing prices on average in the next three years. Housing price increases will as such be moderate, historically speaking, and driven mainly by more favourable loan terms and higher purchasing capacity as disposable income increases following changes to the taxation system and the implementation of measures to facilitate housing purchases.



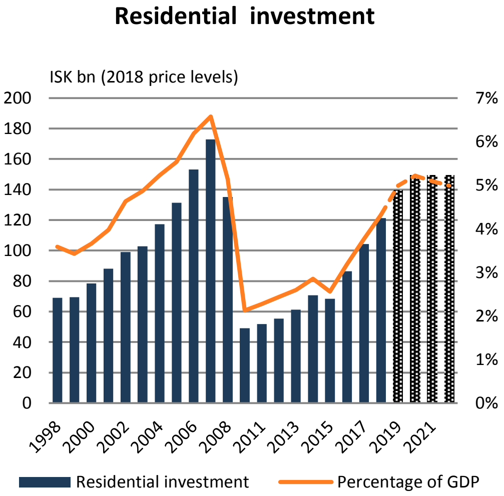
Source: Registers Iceland



Source: Registers Iceland, Statistics Iceland

Capital formation contracts severely this year

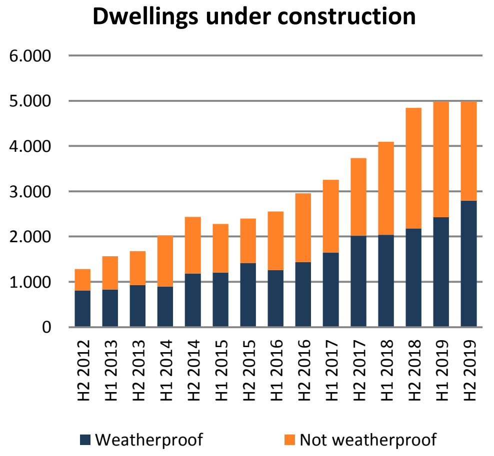
As is most often the case during boom periods, investment in the economy has increased significantly in the past years. Investment is the most volatile item in the national accounts, growing proportionally fast in growth periods and contracting as fast again during downswings. In H2 of 2018, capital formation contracted by 3% as compared to the same period in 2017, representing the first contraction in capital formation since H1 of 2013. The contraction became more pronounced in H1 of this year, or 13.8%. The contraction in H1 of this year and H2 of 2018 can in both cases be traced to contracting business investment, as there was an increase in both public investment and housing investment during these periods. Business investment contracted by 15.7% in H2 of 2018 and by 30.3% in H1 of this year, the most significant contraction of business investment since H2 of 2009.



2019-2022 is the forecast of Landsbankinn Economic Research
Source: Statistics Iceland, Landsbankinn Economic Research

Considerable building volume of residential housing in coming years

Figures from Statistics Iceland show that the construction of 2,300 apartments was completed in Iceland in 2018, an increase of just over 500 as compared to the previous year. According to counting undertaken by the Federation of Icelandic Industries (SI), construction of residential housing is increasing this year as compared to 2018, yet growth is slowing down. Nevertheless, around 200 more apartments were found to be in various stages of construction in September of this year than in September of 2019. All together, we predict that housing investment will increase by 15% this year and 7% next year. Little change is expected between years in 2021 and 2022. This means that the increase in housing investment that has characterised recent years will slow. There is considerable activity surrounding construction plans in relation to public declarations made during collective bargaining agreements which could impact events if they come to fruition.



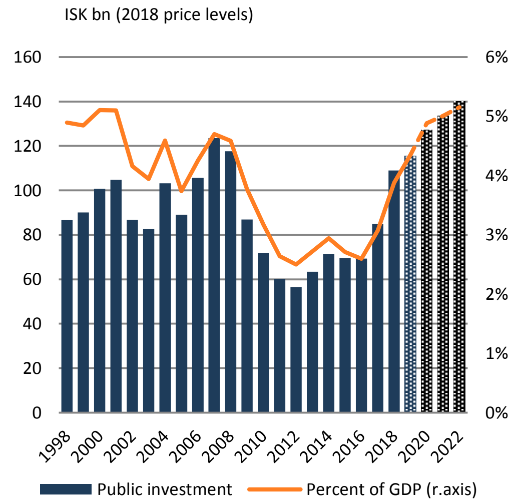
Capital area
Source: Federation of Icelandic Industies

Public investment

Public investment increased by 21.2% in real terms last year and by 23.3% in 2017, constituting a considerable increase. According to the fiscal policy, public investment will be considerable and equally distributed in coming years.

Our forecast expects public investment to continue to increase quite strongly in coming years, by 6% in 2019, 10% in 2020 and 5% in 2021 and 2022. Public investment will change considerably more than domestic product during the period so that the weight of public investment in GDP will continue to increase.

Public investment



2019-2022 is the forecast of Landsbankinn Economic Research
Source: Statistics Iceland, Landsbankinn Economic Research

Business investment

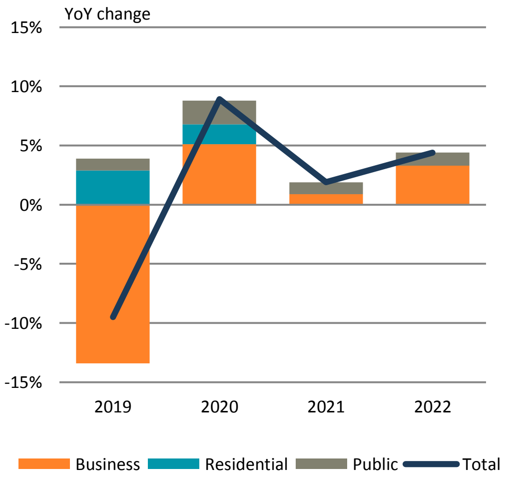
We forecast a 21.2% contraction in business investment this year. If the forecast proves correct, this will be the largest contraction since 2009. The total contraction is mostly due to a contraction in general business investment and investment in ships and aircraft, with the former weighing more heavily. The contraction in investment in ships and aircraft can largely be traced to the sale by WOW air of four passenger jets to Air Canada in early 2019, which is deducted from investment in ships and aircraft.

We expect capital formation to grow by 9.3% next year, driven by an increase in investment in fishing vessels. We expect to see growth in both 2021 and 2022, rather more the latter year. We predict a 1.6% increase in 2021 to be driven by growth in general business investment with a negative impact from both heavy industry, and ships and aircraft. In 2022, we expect general business investment, which is business investment less energy-intensive industry, ships and aircraft, to increase by 7%; total business investment will grow by 6%.

Total capital formation contracts this year, increases in coming years

We forecast a 9.5% contraction in capital formation in the economy this year. If that forecast proves correct, this will be the most significant contraction in capital formation since 2009. Contraction this year is driven solely by contraction in business investment since we forecast a considerable growth in both public investment and housing investment. Next year, we see a renewed increase in capital formation. In 2020, we expect an 8.9% increase and

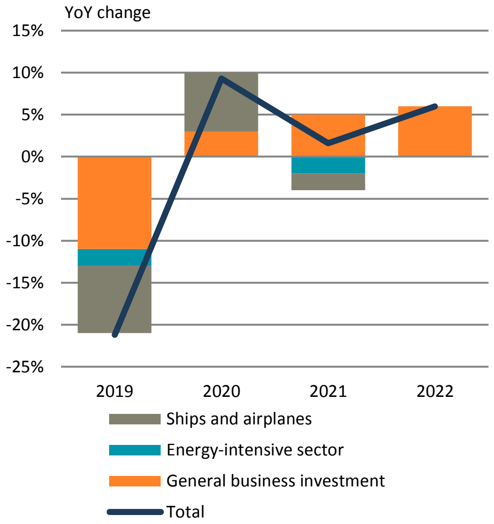
Capital formation and contribution of main components



Landsbankinn Economic Research forcast
Source: Landsbankinn Economic Research

growth in all individual components of capital formation; business investment, public investment and housing investment. In the following two years, we expect rather slow growth in capital formation driven by increased business investment. Public investment will also contribute.

Business investment and sub-categories



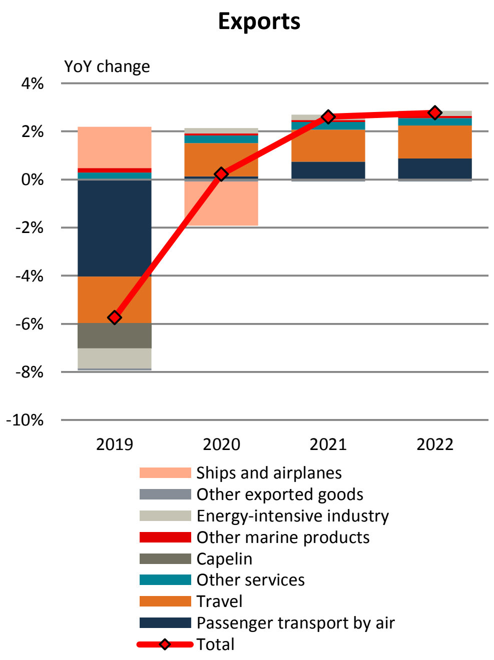
Landsbankinn Economic Research forecast
Source: Landsbankinn Economic Research

Export shrinks this year

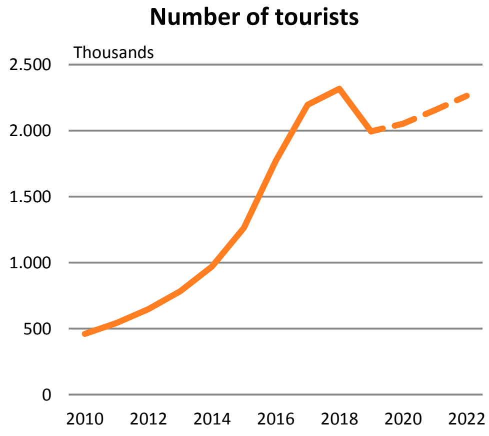
Export increased by 1.7% last year, the lowest growth figure since 2010. In a departure from previous years, last year's growth was driven by goods export which increased by 3.5% while service export increased by a mere 0.1%.

In H1 of 2019, total export contracted by 2.8% between years. This contraction is caused solely by a contraction in service export with goods export contributing an increase. The contraction in service export is in turn primarily caused by a contraction in the travel industry.

Our export forecast for this year has changed but little since May. A 5.7% contraction in export is expected this year, due mainly to the bankruptcy of WOW air and a slowdown in the travel industry. This is a somewhat sharper contraction than we expected in May, when we forecast 5.5% contraction. Export growth of 0.2% is expected in 2020, driven by growth in the travel industry. Slow growth next year is partly caused by the base effect of an unusual and high-volume aircraft export this year. In 2021 and 2022, we expect to see continued moderate export growth, again driven by growth in the travel industry.



Landsbankinn Economic Research forecast
Source: Landsbankinn Economic Research



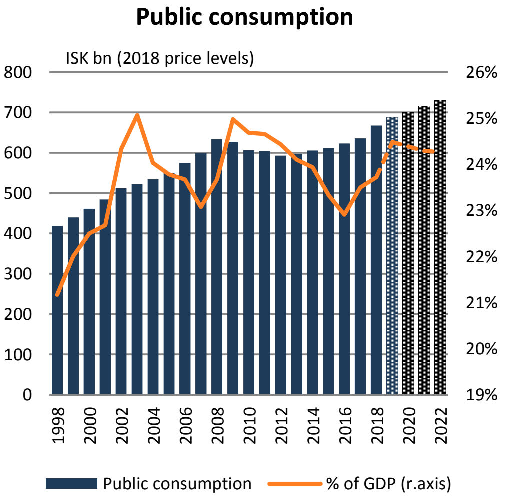
2019-2022 is the forecast of Landsbankinn Economic Research

Public consumption increases in coming years

Public consumption has increased greatly in recent years. It grew by 3.3% in real terms in 2018 and 3.6% in 2017.

The fiscal budget bill for 2020 proposes a 10% increase in Treasury expenditure (nominal value) as compared to the previous year, which is well in excess of price level developments and GDP growth.

We consider it likely that public consumption will increase rather more slowly going forward than in previous years. We expect 3% growth this year and 2% growth in 2020 to 2022. The ratio of public consumption in GDP will increase considerably this year and remain fairly steady in 2020 and 2022.



2019-2022 is the forecast of Landsbankinn Economic Research

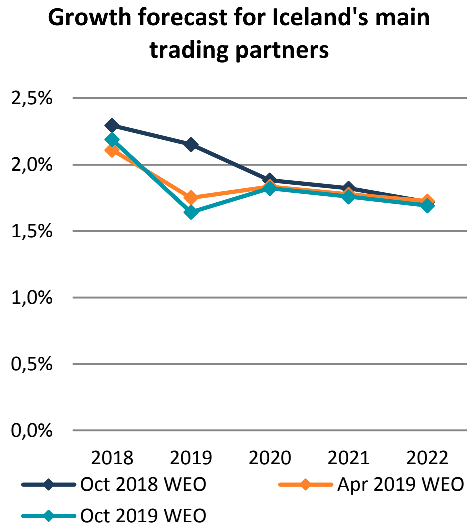
Growth prospects in main trading countries have deteriorated

The IMF publishes its World Economic Outlook report biannually, in April and October. In October, the IMF forecast 3% growth in the global economy for 2019, downgrading its previous forecast by 0.3 percentage points. If this forecast holds, this will be the lowest global economic growth since the international financial crisis in 2008 and 2009.

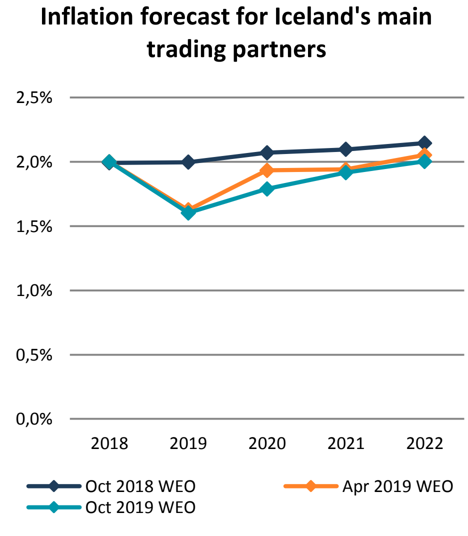
The IMF deems economic growth on a global scale to have slowed somewhat in the last three quarters of 2018 and that growth has been slack this year to date. Increased tension in international trade is reflected in escalating sanctions between the US and China. Conversely, looser monetary policy in the US, for example, which country has also introduced tax cuts, has counteracted the trend somewhat.

The IMF lowered its growth forecast for 2019 for Iceland's main trading partner countries from 1.8% in April to 1.6% in October, with the October forecast last year being 2.2%. On the other hand, the IMF has changed its forecast for 2020 but little and expects 1.8% economic growth that year.

The IMF did not alter its inflation forecast for Iceland's main trading partner countries between April and October and still expects 1.6% inflation this year. The inflation forecast for 2020 was downgraded somewhat, from 1.8% to 1.9% in April, and 2.1% in October of last year.



Trade-weighted growth in Iceland's main trading partners
Source: IMF WEO, Landsbankinn Economics Reasearch

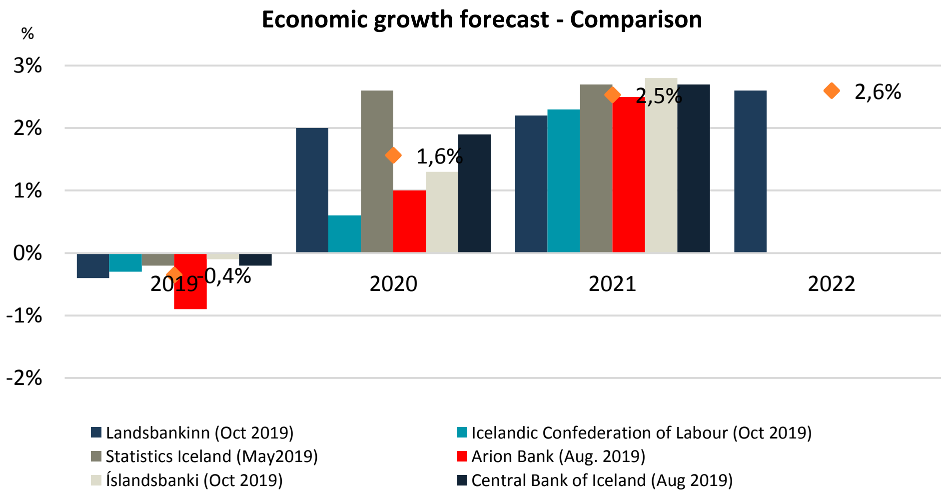


Trade-weighted inflation in Iceland's main trading partners
Source: IMF WEO, Landsbankinn Economics Reasearch

Forecasts agree on contraction this year and a turnaround in coming years

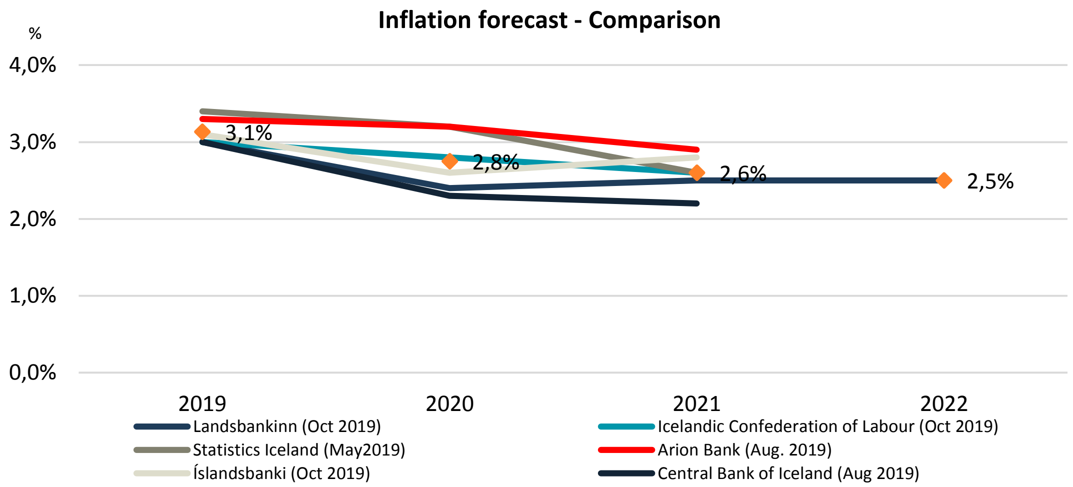
In the past months, at least six domestic parties have published economic forecasts. All forecasts expect a slight contraction in the economy this year. They also agree on a turnaround as early as next year and positive growth, albeit to a varying degree.

- The forecast of Landsbankinn Economic Research is for a 0.4% contraction this year and for 2.3% average growth in the next three years.
- The CBI's August forecast is also for slight contraction this year, or by 0.2%, and for average economic growth of 2.3% the next two years.
- The May forecast of Statistics Iceland predicts a 0.2% contraction this year, just as the CBI, and 2.7% average growth in the coming two years.
- In August, Arion Bank Research forecast a contraction of 0.9% this year, 1.0% growth next year and 2.5% growth in 2021.
- In September, Íslandsbanki forecast a 0.1% contraction this year, 0.6% growth next year and 2.8% in 2021.
- The Icelandic Confederation of Labour issued its economic forecast in mid-October. It is for a 0.3% contraction this year, 0.6% growth next year and 2.3% growth in 2021.



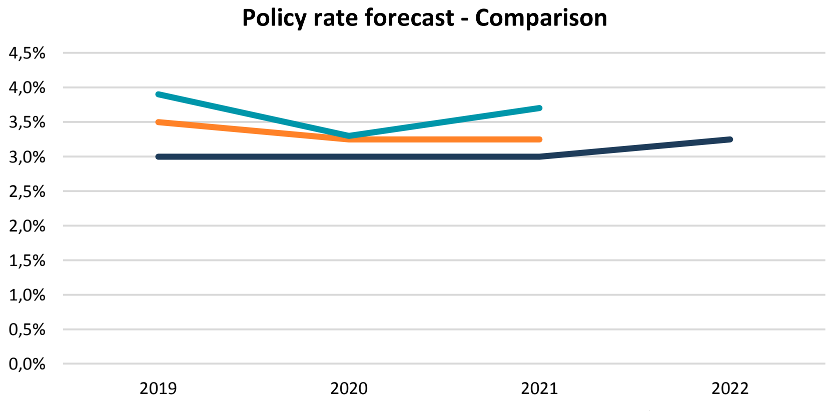
Source: Landsbankinn, Íslandsbanki, Arion Bank, Statistics Iceland, Central Bank of Iceland, Icelandic Confederation of Labour

The inflation forecasts of Landsbankinn and the CBI agree in that they expect inflation to have fallen below the CBI's target next year and for it to remain there throughout the forecast period. The other forecasts expect inflation to hover just above target throughout the forecast period.



Source: Landsbankinn, Íslandsbanki, Arion Bank, Statistics Iceland, Central Bank of Iceland, Icelandic Confederation of Labour

The CBI, Statistics Iceland and ASÍ do not make their policy rate forecasts public like the commercial banks. In August, Arion Bank forecast that the CBI's key interest rate would be 3.5% at year-end, be stepped down to 3.25% in 2020 and remain unchanged throughout 2021. Íslandsbanki expects policy rates to average 3.3% next year, rising to 3.7% in 2021. We forecast that policy rates will be lowered to 3.0% before the end of this year to remain unchanged until early 2022, when they will be hiked up to 3.25%.



Landsbankinn and Arion Bank forecast at end-of-year, Íslandsbanki forecast annual average

Source: Landsbankinn, Íslandsbankinn, Arion banki.