Growth despite high interest rates

Landsbankinn Economic Research Macroeconomic forecast 2024-2026

29 April 2024

Highlights

We predict 0.9% economic growth this year. Private consumption grows but little and capital formation remains more or less unchanged, with high interest levels suppressing growth. Going forward, we forecast 2.2% growth in 2025 and 2.6% in 2026.

Inflation will remain persistent in the next few months and measure on average 6% this year, if our forecast holds, before dwindling to 4.4% next year and 3.5% in 2026. Interest rates will be kept high in an attempt to control inflation and we do not expect to see the first rate cut until the fourth quarter of this year.

We anticipate continued growth in the travel sector, yet slower. We expect 2.3 million tourists to visit Iceland this year, around the same figure as in the record year 2018.

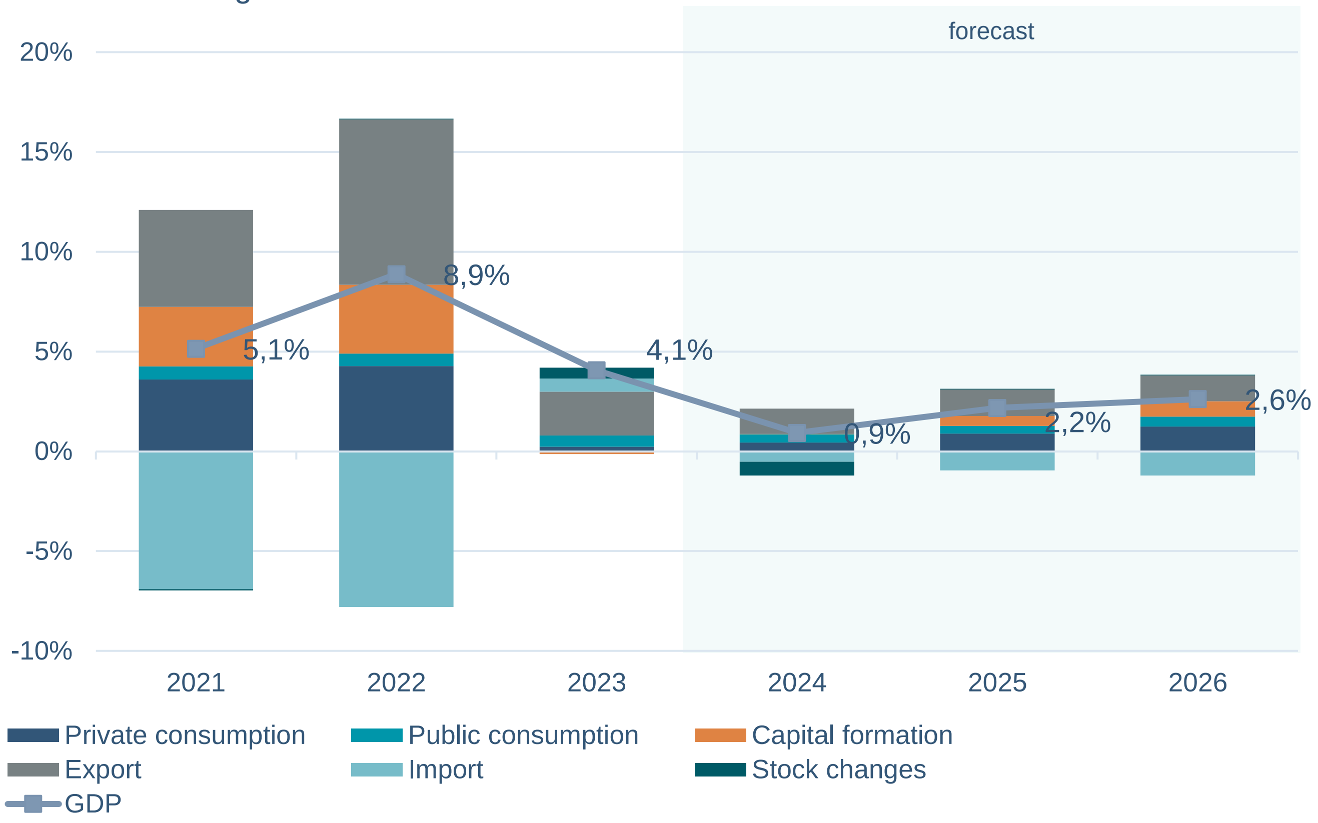
Pressure from demand appears notable on the residential housing market despite high interest rate. We expect housing prices to measure on average 7% higher this year than in 2023. We forecast a 9% increase next year and close to 8% in 2026.

As before, there are various uncertainties in the forecast, most notably represented by international war efforts that may impact several of our trading partners. In addition, the seismic and volcanic activity on the Reykjanes peninsula is on-going and could pose a threat to local infrastructure and tourism in the area.

High interest rate levels detract from growth

Economic growth and weight of components

YoY volume change



Following robust economic growth in the past years, the Icelandic economy has now reached a turning point. We forecast limited growth this year, or a mere 0.9%. We expect that the Monetary Policy Committee of the Central Bank of Iceland will maintain a high policy rate in an attempt to control inflation. This will have a cooling effect on the economy, which nonetheless proves resilient and grows between years.

Growth is as before driven by exports which we expect to increase by 2.9% this year. Domestic demand cools quite significantly and we forecast only 0.9% growth in private consumption while capital formation remains more or less stable between years.

Going forward, the outlook is more promising. Interest rates will fall slowly but steadily next year and in 2026, with economic growth coming in at 2.2% in 2025 and 2.6% in 2026, if our forecast holds.

2024-2026 is Economic Research's forecast
Source: Statistics Iceland, Landsbankinn Economic Research

Overview of Landsbankinn Economic Research's macroeconomic forecast

Domestic product and key components	ISK bn 2023	Volume change from previous year (%) 2023	2024	2025	2026
Gross domestic product	**4,279**	**4.1**	**0.9**	**2.2**	**2.6**
Private consumption	2,139	0.5	0.9	1.8	2.5
Public consumption	1,098	2.2	1.6	1.5	1.9
Capital formation	1,014	-0.6	0.1	2.0	3.3
Investment in industry	656	0.9	0.7	2.0	2.8
Investment in residential housing	196	-0.3	-1.0	3.0	6.0
Public sector investment	163	-6.1	-1.0	1.0	2.0
Total national expenditure	4,281	1.2	0.2	1.8	2.5
Export of goods and services	1,856	4.8	2.9	3.1	3.0
Import of goods and services	1,858	-1.4	1.2	2.2	2.8

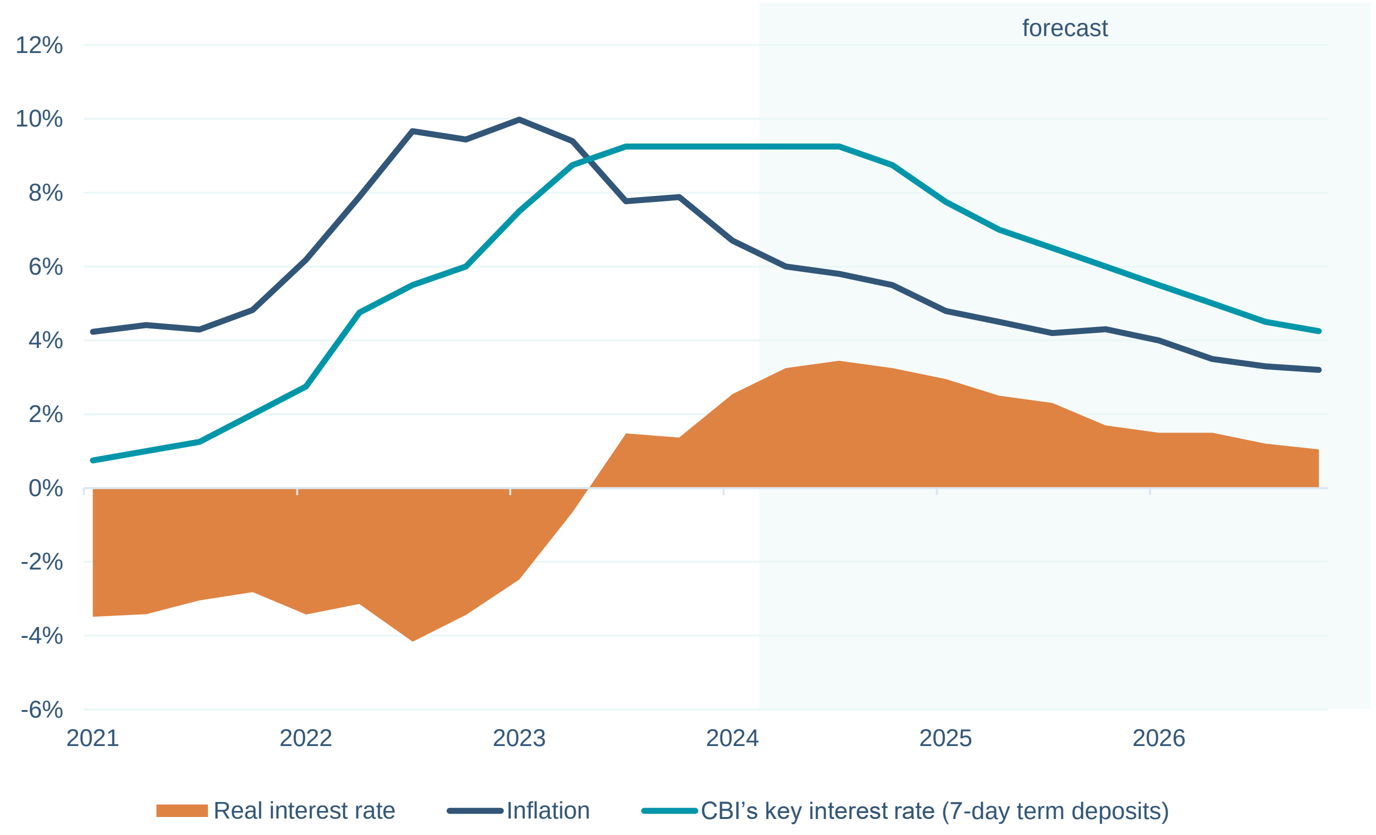
Policy rate and inflation	2023	2024	2025	2026
CBI’s key interest rate, 7-day term deposits, year-end, %	9.25	8.75	6.00	4.25
Inflation, annual average, %	8.7	6.0	4.4	3.5
EUR exchange rate, year end	150.5	148.0	146.0	145.0
Real estate prices, annual average, %	5.1	7.0	8.8	7.7

Labour market	2023	2024	2025	2026
Wage index, annual average, %	9.8	6.6	6.1	5.5
Purchasing power of wages, annual average, %	0.9	0.6	1.6	2.0
Unemployment, annual average, %	3.3	4.0	4.2	3.9

Current account balance	2023	2024	2025	2026
Number of foreign travellers, thousand individuals	2,224	2,300	2,400	2,500
Goods and services balance, %GDP	-0.1	0.8	0.5	0.6
Current account balance, %GDP	1.0	0.6	0.3	0.3

Forecast unchanged policy rate until October

Inflation, policy rate and the real policy rate



The orange area shows the real policy rate compared to past inflation. 2024-2026 is Economic Research's forecast.
Source: Statistics Iceland, Landsbankinn Economic Research

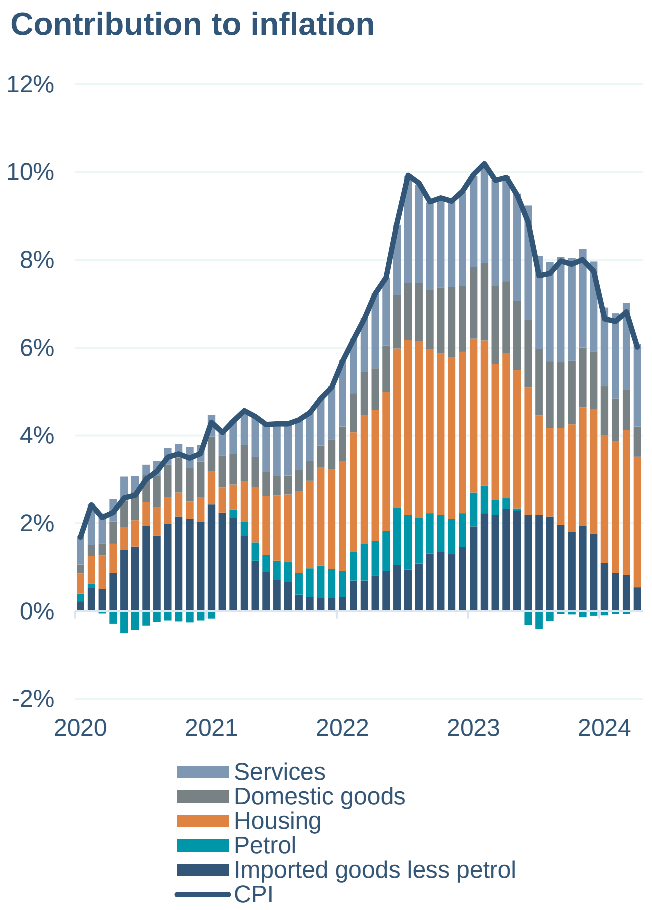
Despite some decline in inflation in recent months, the Monetary Policy Committee (MPC) has maintained unchanged policy rates since August 2023. At the MPC's meeting now in March, it was discussed that the rate-cutting cycle should begin at "a credible point in time" and not before there were "clear indications" of receding inflation.

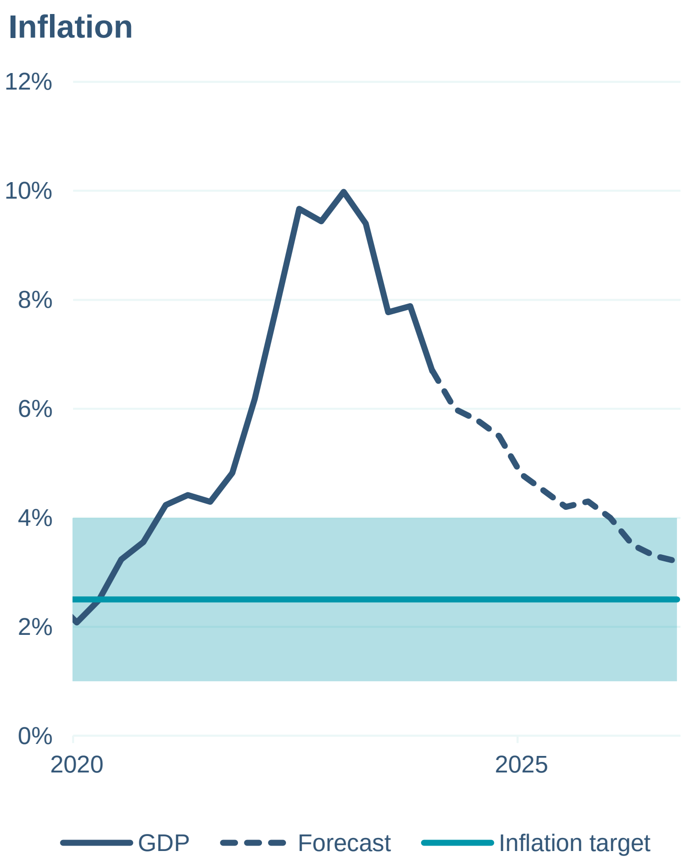
We do not expect rate cuts until the fourth quarter of this year, at which point the policy rate will have been unchanged at 9.25% for over a year. Anticipating a fairly steady rate-cutting cycle places the policy rate at 4.25% at the forecast horizon, that is at year-end 2026.

According to the forecast, the real policy rate will peak at 3.5% in the third quarter of this year when inflation has receded without any rate cuts having been introduced. The real rate will then start to decrease alongside falling interest rate levels to stand at around 1 percentage point at the end of the forecast period.

The MPC announced an increase in the reserve requirement, from 2% to 3%, in early April. Generally speaking, raising the reserve requirement can enhance monetary policy restraint yet now the MPC considers that the effect will be limited due to the banks' healthy liquidity position.

Inflation remains persistent





Inflation peaked at 10.2% at the beginning of 2023 and has receded slowly in the past few months, to measure 6.0% in April. Inflation has not least been driven by rising real estate prices, but also rising prices of services and various goods, both domestic and imported.

We expect inflation to remain stable at around 6% over the summer months. We then expect it to average 5.5% in the fourth quarter of this year, at around which time the rate-cutting cycle will commence.

According to the forecast, inflation will continue to recede and will fall to the upper tolerance limit of the CBI's inflation target, 4%, in the beginning of 2026. Inflationary pressure will continue to decrease slowly in 2026 and we forecast 3.2% inflation at the forecast horizon.

For this forecast to eventuate, demand must cool down, fiscal policy must be credible and wage increases conservative.

Dotted line on image to the right is Economic Research's forecast.
Source: Statistics Iceland, Landsbankinn Economic Research

Forecast slow ISK appreciation

Currency rate development

EUR/ISK

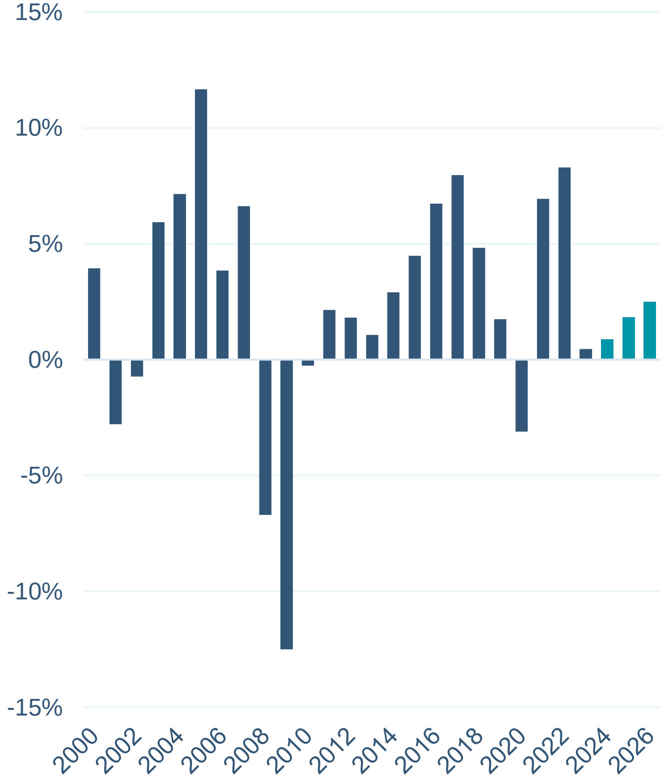
We forecast slow ISK appreciation throughout the period. The outlook for foreign trade is fair and we anticipate a slight trade surplus. The domestic-foreign interest rate differential will likely remain considerable, which supports the ISK exchange rate. It is of note in this regard that international parties are starting to show increased interest in Treasury notes. The market is in general positively inclined towards the ISK, as evidenced by FX forward contracts.

This appreciation may already be priced in, and hence we forecast a limited appreciation. As is usual, some intra-year and intra-month exchangerate fluctuations are to be expected throughout the forecast period.

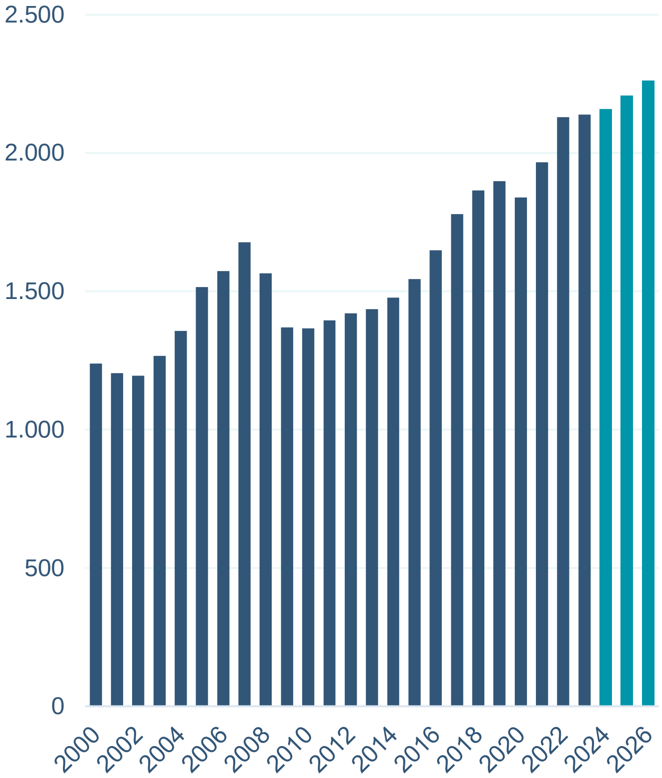
Solid line is historical data, last date April 24, 2024. Dotted line is Economic Research's forecast, year-end values.
Source: Central Bank of Iceland, Landsbankinn Economic Research

Private consumption grows but little in coming years

Development of private consumption
YoY change



Annual private consumption
ISK bn at 2023 fixed prices



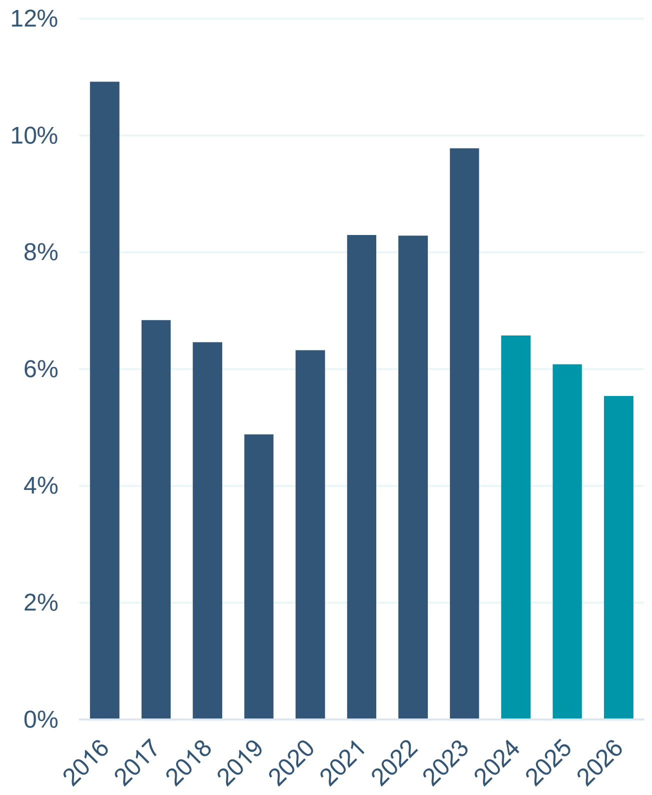
We forecast moderate growth in private consumption this year, with the high interest rate levels restraining consumption much as in the latter part of 2023. Once interest rate cuts begin, which we except to start towards the end of this year, private consumption is likely to grow more while remaining conservative by historic measure. We predict that private consumption will grow by 0.9% this year, 1.8% in 2025 and finally by 2.5% in 2026.

The outlook is for continued labour market tension to attract international workers to Iceland, resulting in population growth, though likely less growth than in previous years. Population growth ensures an overall increase in private consumption despite a contraction in private consumption per capita. In 2023, private consumption grew by 0.5% while private consumption per capita contracted by 2%.

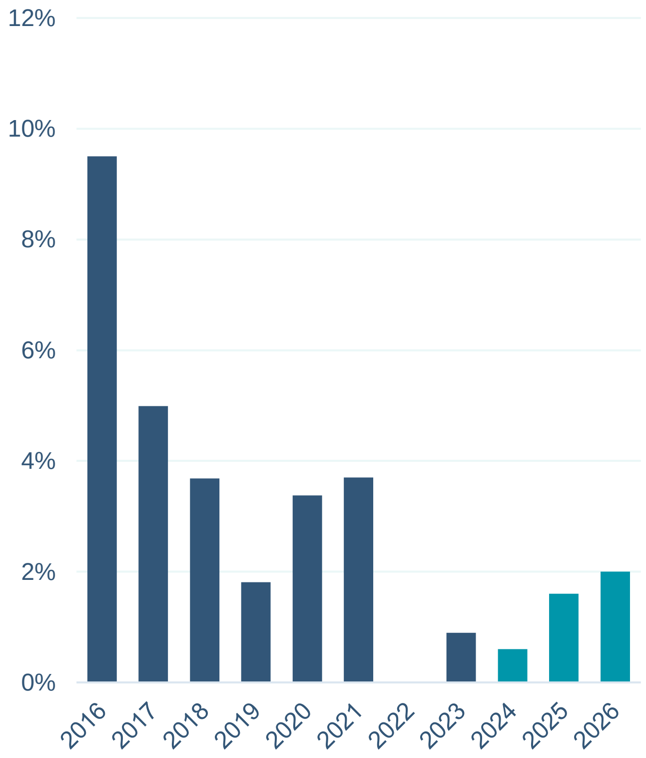
2024-2026 is Economic Research's forecast
Source: Statistics Iceland, Landsbankinn Economic Research

More moderate wage increases than in previous years

Wage development and forecast
YoY change to wage index



Purchasing power of wages and forecast
Real change YoY



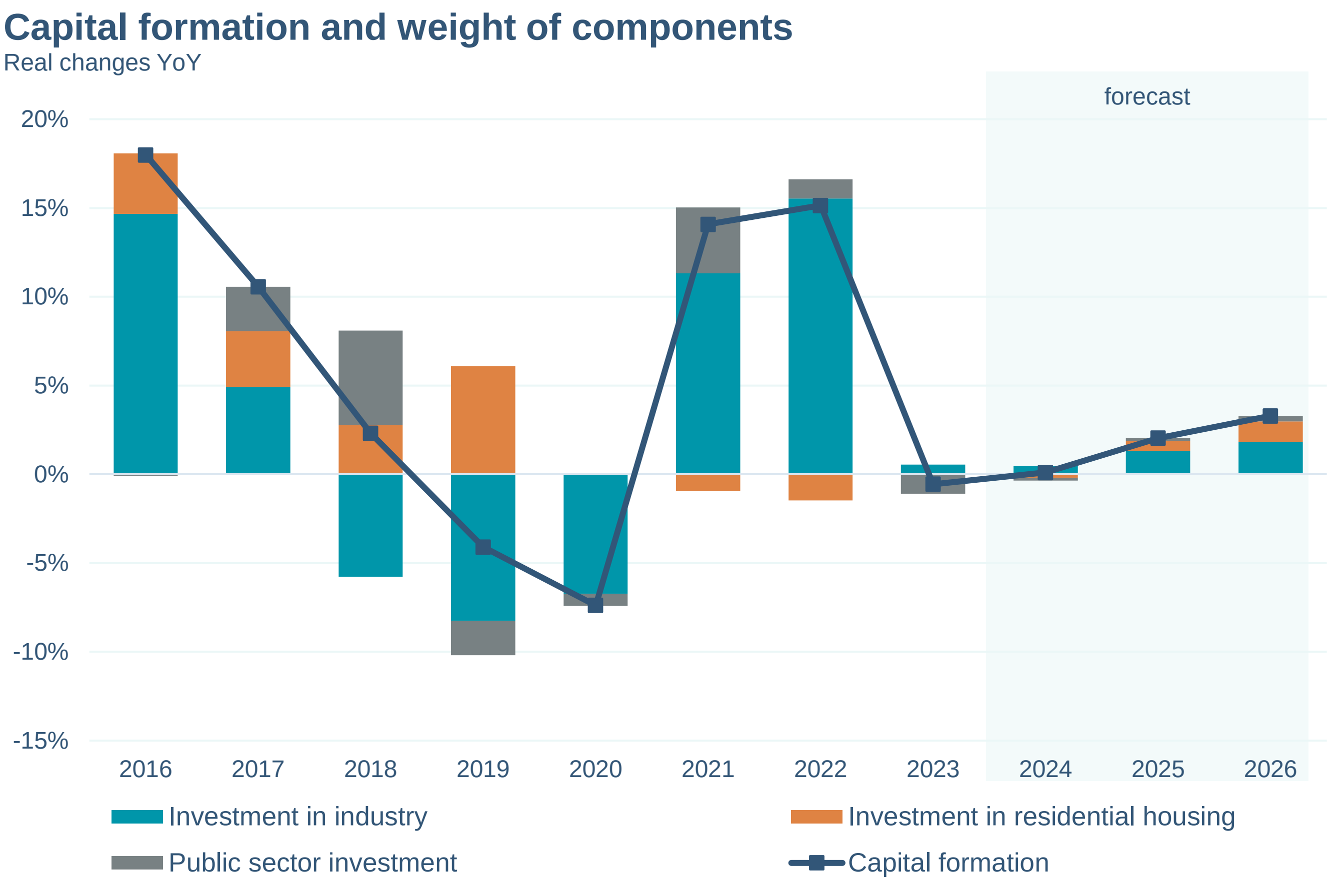
New collective bargaining agreements for a large part of the labour market provide for fairly moderate wage increases. Other agreements are likely to follow suite. We forecast rather lower wage increases in coming years than in the previous three years. Wage drift will remain a factor to some extent while tension continues to characterise the labour market.

The wage index has risen by 7.5% annually on average in the past decade. We expect increases to remain shy of the average in coming years, around 6.6% this year, 6.1% in 2024 and at around 5.5% in 2026.

Based on our inflation forecast, purchasing power will increase by 0.6% this year, 1.6% in 2025 and 2% in 2026.

2024-2026 is Economic Research's forecast
Source: Statistics Iceland, Landsbankinn Economic Research

Moderate growth of capital formation in coming years



Capital formation increased significantly in 2021 and 2022 in a lower interest rate environment. It was primarily driven by increased investment in industry. In 2023, investment contracted slightly as a result of less investment in residential housing and less public sector investment.

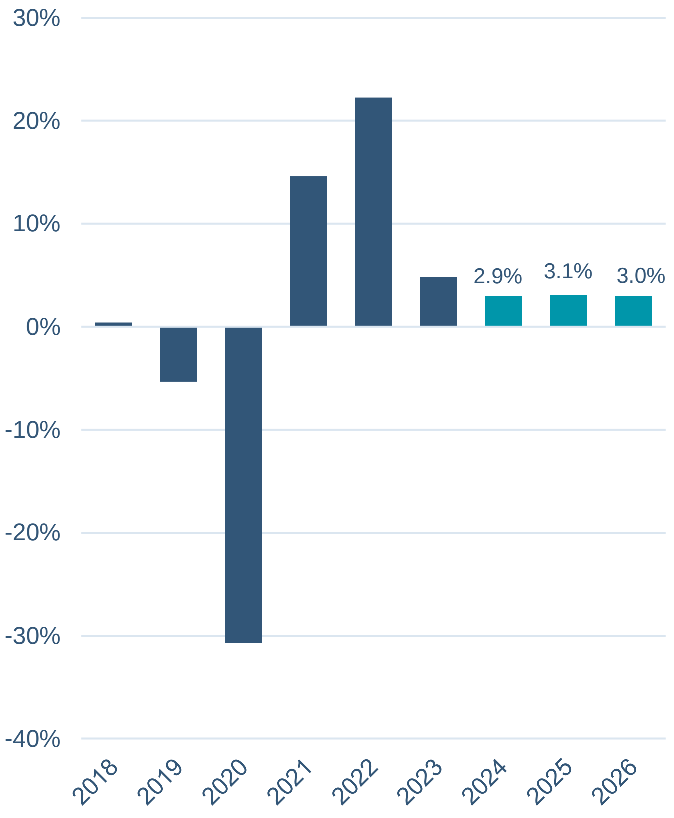
We assume that the on-going high interest rate levels will continue to deter capital formation this year and that it will grow by only 0.1%. We anticipate more activity in the next two years across all components of capital formation alongside lower interest rates.

Of note are also individual factors, such as power plant projects, that should fuel business investment, the construction of a new National-University Hospital (LSH) that calls for increased public investment, and rising housing prices that should encourage increased construction.

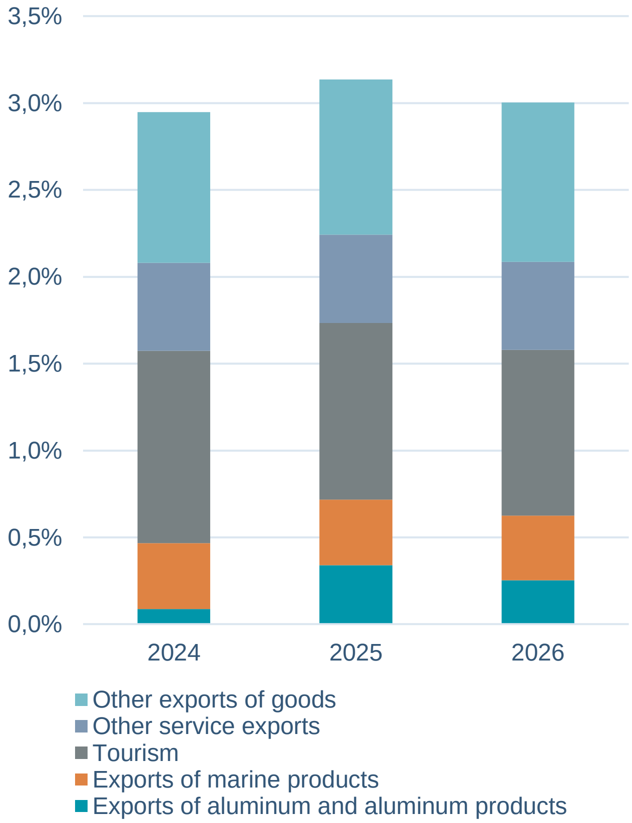
2024-2026 is Economic Research's forecast
Source: Statistics Iceland, Landsbankinn Economic Research

Forecast 2.9% export growth this year

Export
YoY change at 2023 fixed prices



Export forecast
Contribution of components



Export will be up by 2.9% this year if our forecast holds, export of goods up by 2.6% and export of services by 3.3%.

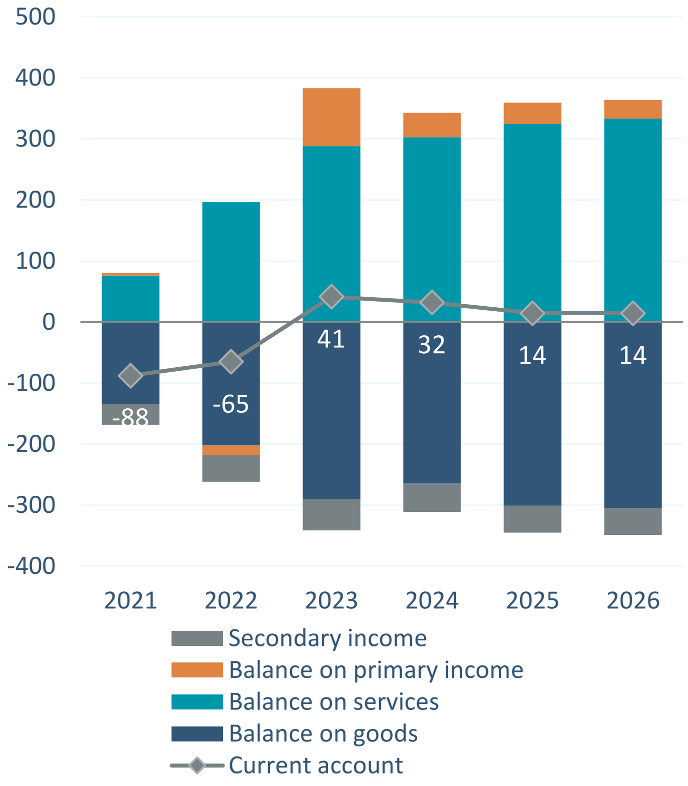
Growth in the travel sector will be more moderate this year than in the past two years. On the other hand, export of marine products will grow between years following a considerable contraction in 2023. The increase between years is mainly because of higher catch quotas for demersal fish that counteracts the capelin catch failure. We expect aluminium export to increase less this year than in recent years, not least due to the reduction in energy allocation to large users in early 2024.

Other export, i.e. other than the travel sector, aluminium and fisheries, has increased handsomely in recent years; a trend we expect to continue going forward. The outlook is for significant growth in the export of pharmaceuticals and medical equipment, which doubled between years last year. Export of farmed fish is also likely to increase.

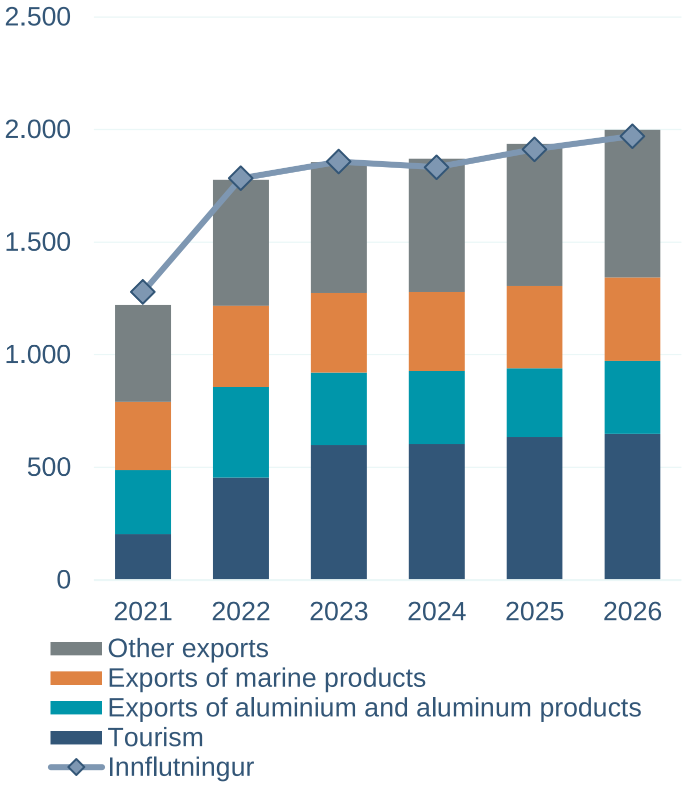
2024-2026 is Economic Research's forecast
Source: Statistics Iceland, Landsbankinn Economic Research

Small surplus in foreign trade

Current account balance
ISK bn



Goods and services balance
ISK bn



In 2023, the current account balance showed a slight surplus despite a slight deficit on the goods and service balance due to a surplus on primary income, traceable to worse performance by aluminium companies that was again caused by lower aluminium prices.

We forecast a small surplus on goods and services trade in coming years as services outweigh the deficit on goods. We expect a lower surplus on primary income going forward than last year but a similar deficit on secondary income.

In total, we forecast a slight trade surplus throughout the forecast period.

2024-2026 is Economic Research's forecast
Source: Statistics Iceland, Landsbankinn Economic Research

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