

Economic forecast 2024-2027

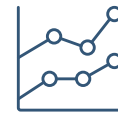


The Economy Catches its Breath

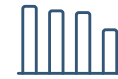
Landsbankinn Economic Research, October 15, 2024



Highlights



Our forecast is for a 0.1% contraction in the economy in 2024. Setbacks earlier this year led to minimal growth in exports between years and high interest rate levels limit private consumption. We forecast over 2% growth in coming years.



Inflation recedes during the forecast period, averaging 4% next year, 3.7% in 2026 and 3.3% in 2027, if our forecast holds. While we expect to see almost continuous rate cuts to the forecast horizon, these cuts will take place in small steps.



Volcanic activity on the Reykjanes peninsula affected the travel sector this year. We expect a slight contraction in the sector this year and steady growth in the years to come. Diversity characterises export growth in the coming years.



There has been relatively high activity in the residential housing market recently and we expect a 9% increase in prices this year and again next year. Prices will increase rather less in 2026 and 2027, influenced for example by growing investment in residential housing.

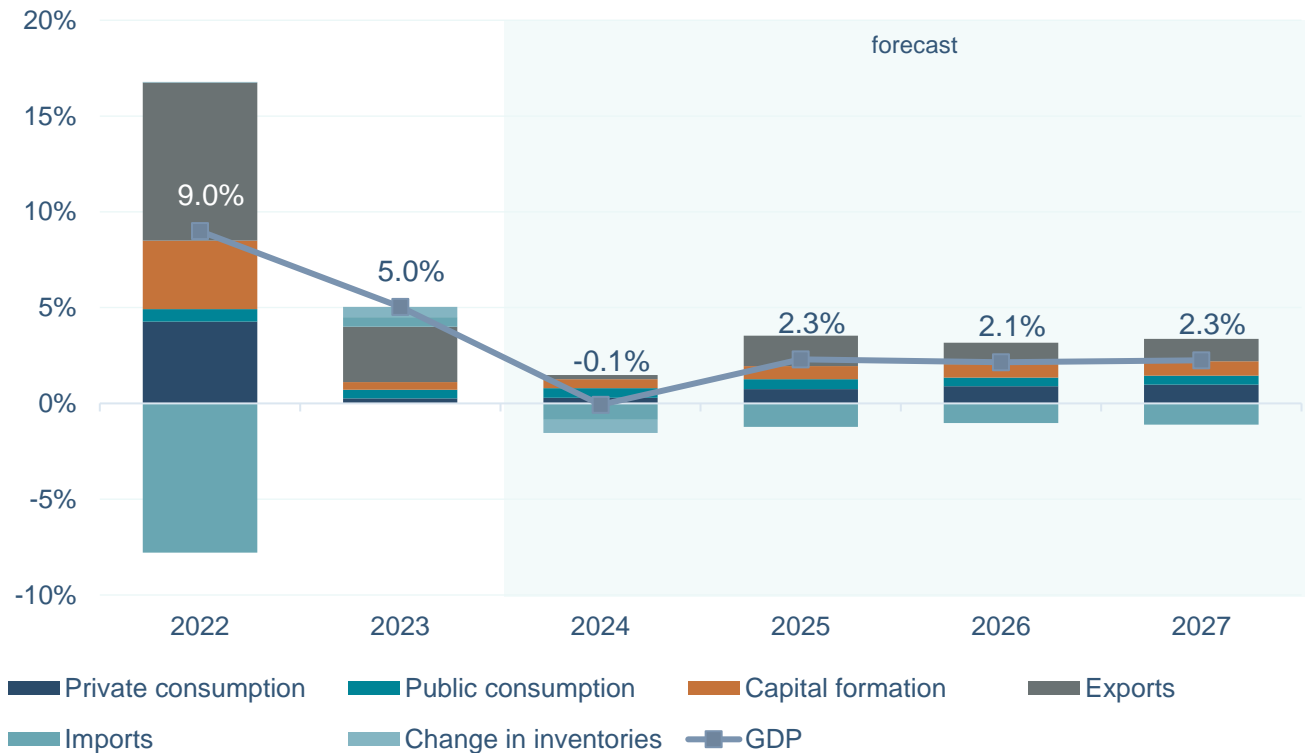


Tension in the labour market has eased recently and we forecast a slight increase in unemployment, especially early in the period. Increased slack in the labour market aids in the cooling of the economy and creates opportunities for further rate cuts.

Slight contraction this year

Economic growth and contribution of underlying components

YoY volume change

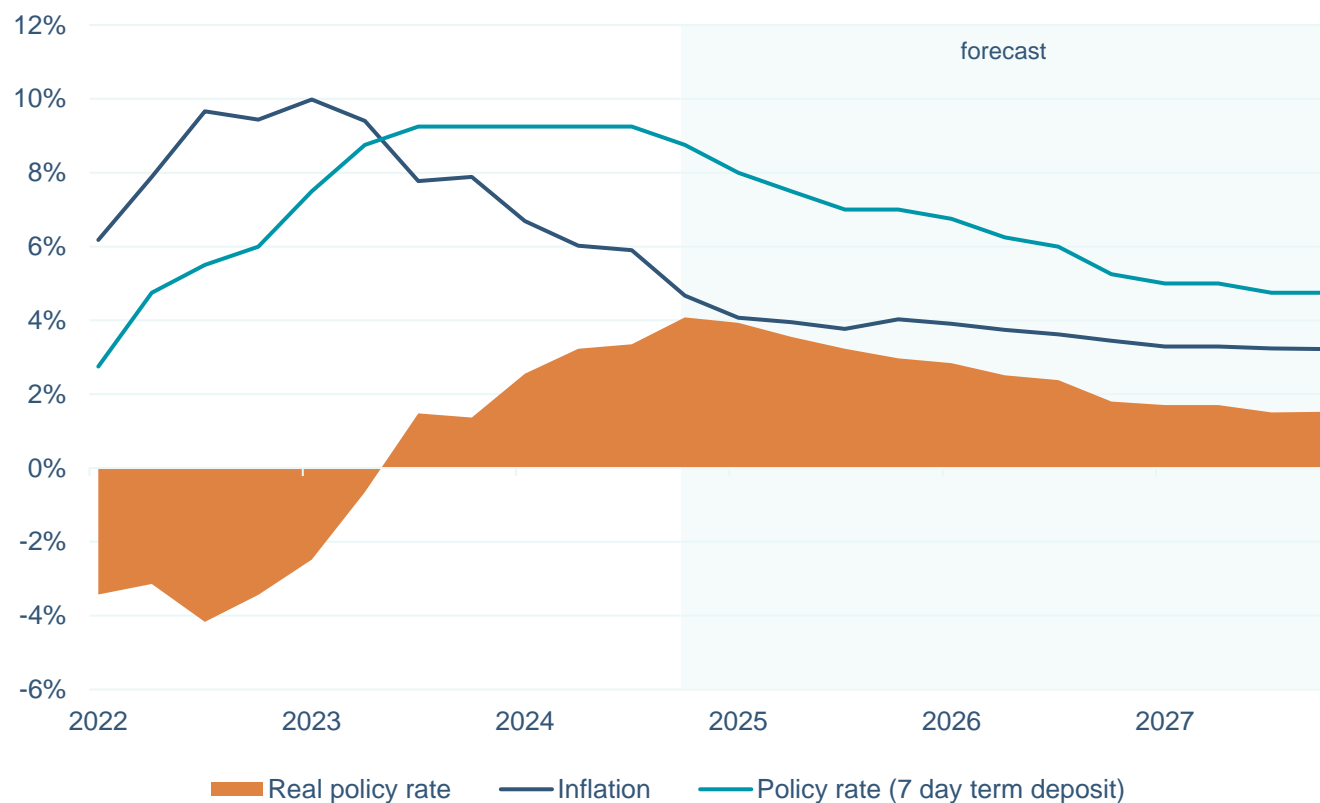


Landsbankinn Economic Research forecasts a near status quo in the economy between years this year and a 0.1% contraction in GDP. A setback in exports affected the first half of the year, with capelin catch failure and slower growth in the travel sector causing a contraction compounded by the cooling impact of high interest rates on demand, which nevertheless remains strong.

This is a considerable change from previous years, when annual economic growth has measured 5-9%, though accompanied by high and persistent inflation. We now expect a different and calmer tempo. Tension in the economy has eased, allowing for a breather - inflation recedes considerably, interest rates decrease, and the economy gets off to a nice and easy start with 2% annual growth in the coming years.

Rate cuts continue alongside receding inflation

Inflation, policy rate and the real policy rate



In early October, the Central Bank of Iceland (CBI) lowered its key interest rate by 0.25 percentage points (pp) after more than a year of unchanged rates at 9.25%. We expect that the Monetary Policy Committee will continue to take cautious steps and to gradually lower rates over the coming years. We anticipate a further 0.25 pp cut in November, meaning that the policy rate will be 8.75% at year end. We forecast a policy rate of 7.0% at year-end 2025, 5.25% at year-end 2026 and 4.75% at the end of 2027, alongside a slowing of the rate-cutting cycle.

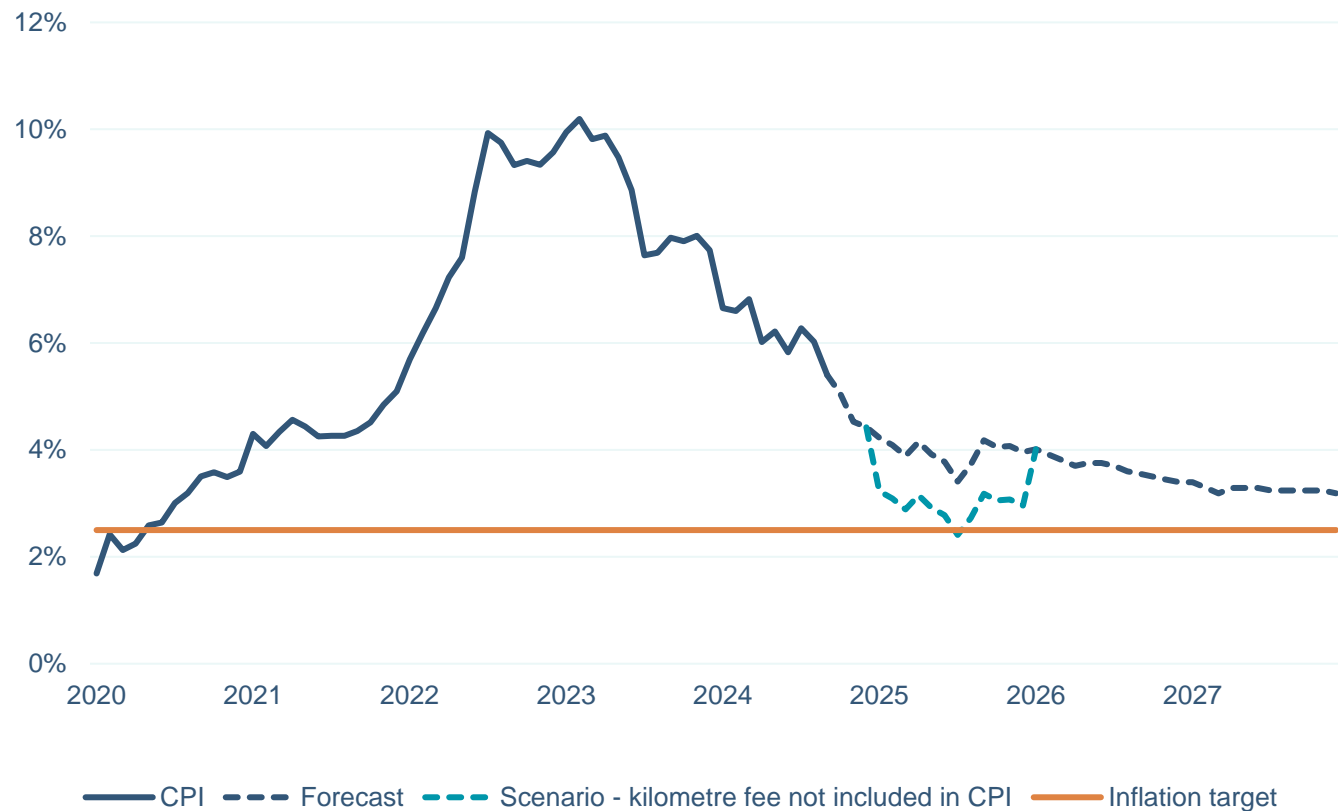
According to our forecast, the real policy rate based on past inflation will peak at 4.1% at the end of this years, after a considerable reduction in inflation and a 0.50 pp policy rate cut. The real policy rate will then start to dwindle alongside falling interest rate levels to stand at around 1.5% at the end of the forecast period.

Overview of Landsbankinn Economic Research's forecast

Domestic product and key components	ISKbn	Volume change from previous year (%)				
	2023	2023	2024	2025	2026	2027
Gross domestic product	4,321	5.0	-0.1	2.3	2.1	2.3
Private consumption	2,141	0.5	0.6	1.5	1.8	2.0
Public consumption	1,085	1.8	2.0	2.0	1.8	1.8
Capital formation	1,045	1.6	1.9	2.8	2.8	3.0
Investment in industry	676	3.6	2.5	2.8	3.0	3.0
Investment in residential housing	196	-2.3	5.0	3.0	3.0	4.0
Public sector investment	173	-1.2	-4.0	2.5	2.0	2.0
Total national expenditure	4,300	1.6	0.6	1.9	2.1	2.2
Export of goods and services	1,886	6.3	0.5	3.6	2.5	2.6
Import of goods and services	1,865	-1.1	2.0	2.8	2.3	2.5
Policy rate and inflation		2023	2024	2025	2026	2027
CBI's key interest rate (7-day term deposits, year end, %)		9.25	8.75	7.00	5.25	4.75
Inflation, annual average, %		8.7	5.8	4.0	3.7	3.3
EUR exchange rate, year end		150.5	149	148	147	146
Real estate prices, annual average, %		5.1	8.9	9.2	8.1	7.4
Labour market		2023	2024	2025	2026	2027
Wage index, annual average, %		9.8	6.6	6.1	5.5	5.7
Purchasing power of wages, annual average, %		0.9	0.7	2.1	1.8	2.3
Unemployment, annual average, %		3.3	3.6	3.5	3.4	3.3
Current account balance		2023	2024	2025	2026	2027
Number of foreign travellers, thousand individuals		2,224	2,200	2,300	2,350	2,400
Trade balance, %GDP		0.5%	0.8%	0.8%	0.4%	0.7%
Current account balance, %GDP		1.1%	-0.3%	-0.8%	-1.0%	-0.9%

Win in the battle against inflation within sight

Inflation, development and forecast



Inflation has receded considerably from its peak at 10.2% in early 2023. It currently measures 5.4% and we expect it to fall to 4.4% by the end of the year. We forecast continuous tapering off of inflation throughout the forecast period, even though we may see some temporary setbacks.

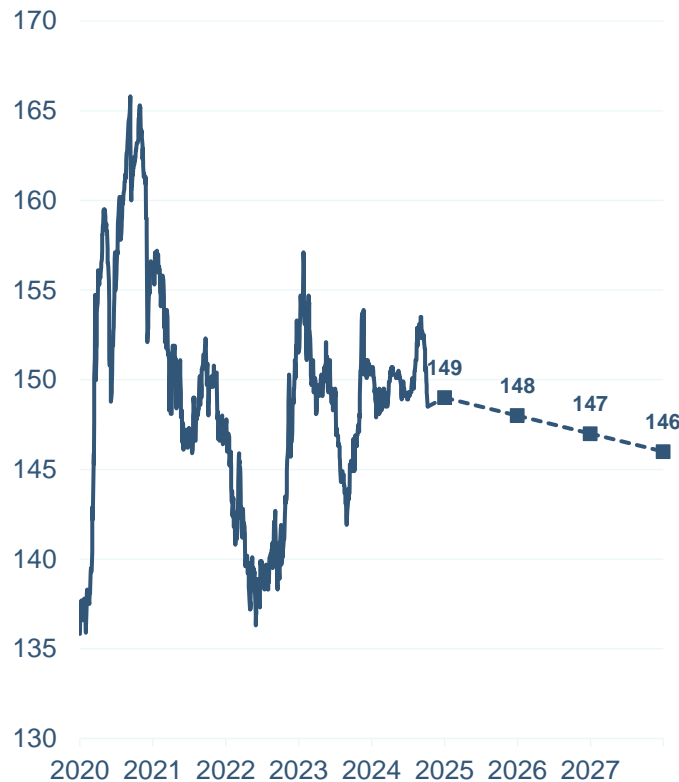
We expect inflation to hover slightly above the upper tolerance interval of the inflation target in the first quarter of 2025, at 4.1%, to then decrease throughout that year until the fourth quarter, when it rises slightly again. The end-of-year increase is caused by the decrease in the CPI in August and September of this year, as the impact of one-off items drops from the annualised CPI in those months.

The Government's plans are creating some uncertainty at this point in time, as the intention is to introduce a kilometre fee for all vehicles at the turn of the year, irrespective of energy source, and to in effect lower the price of gasoline with the revocation of levies. It has not yet been announced whether the kilometre fee will be included in Statistics Iceland's price measurements. If the fee is not included in measurements, inflation can be expected to fall by 1% in general next year. In our forecast, we assume that the fee will be included in measurements but also include a scenario that shows the trajectory of inflation excluding the fee.

Forecast slight ISK appreciation

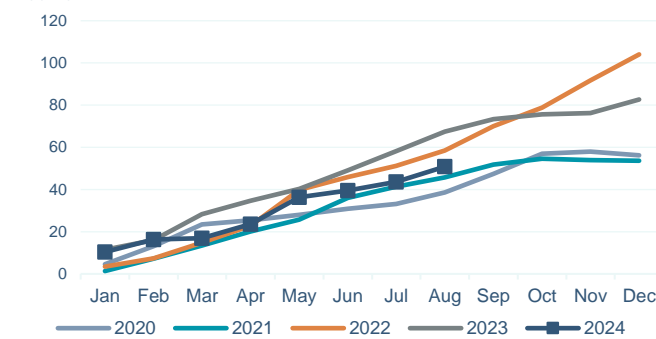
Currency rate development

Price of the euro



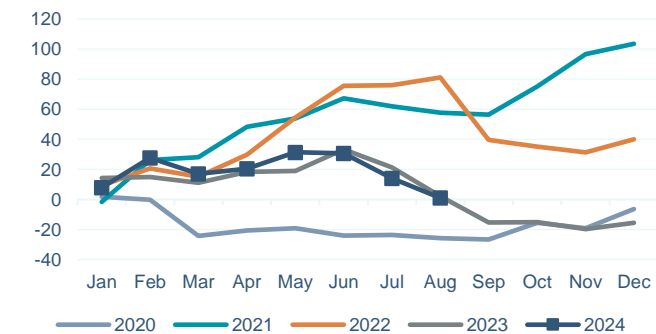
Pension funds' foreign currency purchases

Aggregated, ISK bn



Net forward FX position of the commercial banks

YTD, ISK bn



Until August, the ISK/EUR exchange rate had been fairly stable at around ISK 150 since November 2023. In August, the ISK depreciated somewhat; a weakening that has now reversed. We forecast that the exchange rate will remain close to current levels at year end, with the price of the euro at ISK 149. Looking further ahead, we anticipate slight appreciation of the ISK for the remainder of the forecast period.

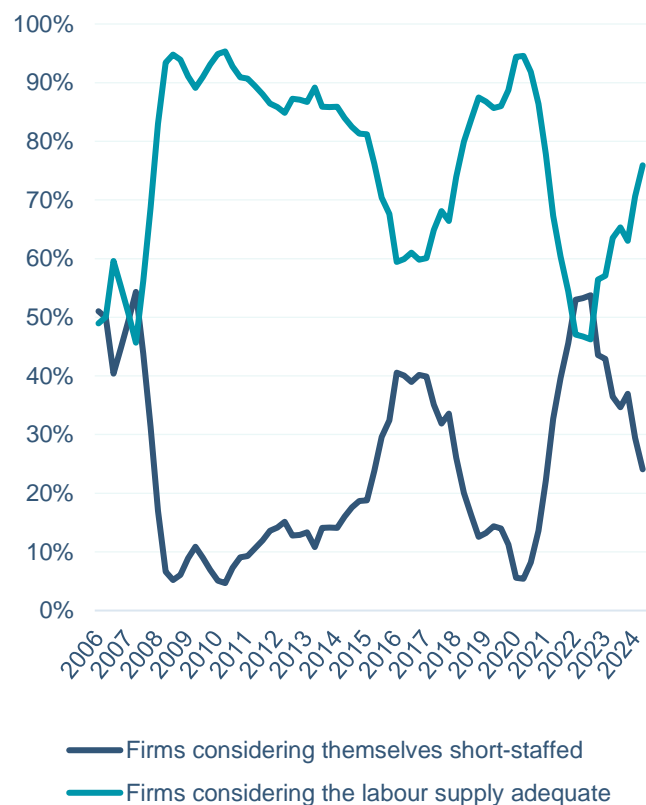
Various factors may have either a strengthening or weakening impact on the ISK, which is likely to fluctuate somewhat during the forecast period. There are indications that capital inflow to Iceland will increase in the near future, which could lead to ISK appreciation. That being said, international uncertainty, including from escalating international war efforts, may trigger a flight to major currencies away from minors.

We expect a slight but persistent current account deficit throughout the forecast period, which again may weaken the ISK. It should be noted that a trade imbalance is not always accompanied by matching currency flows.

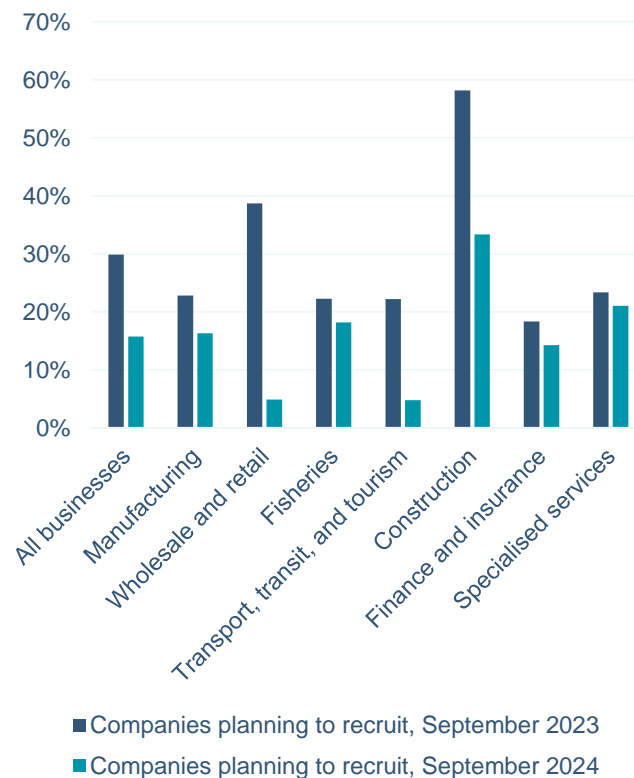
Solid line shows historical data, latest values from 11 October 2024. Dotted line is Economic Research's forecast, end-of-year values. Source: Central Bank of Iceland, Landsbankinn Economic Research

Labour market tension appears to be easing fast

Demand for labour



Companies planning to change staffing levels



There are various signs of easing tension in the labour market. A growing number of corporate managers, currently 76% according to the CBI's recent survey, consider the supply of labour adequate. This number was 46% in the latter part of 2022.

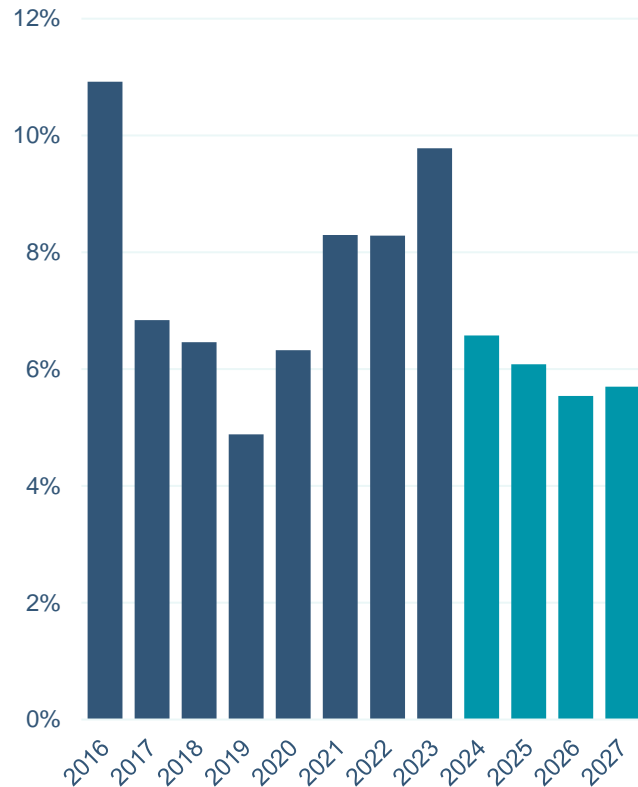
The same survey shows that companies in the majority of sectors are less likely than before to consider hiring in the next six months. Demand for labour in retail has plummeted between years, as well as in construction & utilities, and tourism.

Increased slack in the labour market helps reduce tension in the economy and creates opportunity to lower rates. More slack could lead to a gradual increase in unemployment, weakening the bargaining power of workers. This reduces the likelihood of wage drift which dampens demand pressure in the economy.

Purchasing power of wages continues on an upward trend

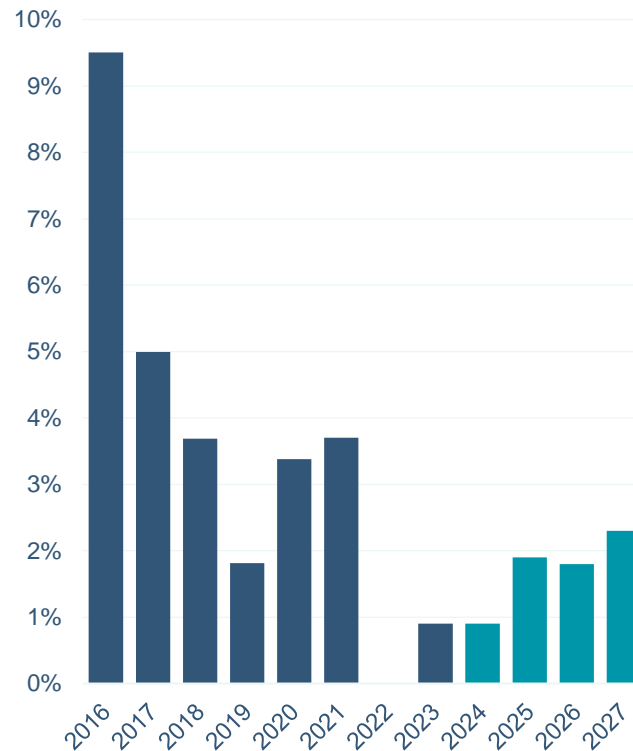
Wage development and forecast

YoY change



Purchasing power of wages and forecast

YoY change



Four-year collective bargaining agreements were recently concluded for a large part of the labour market, providing for a more moderate wage increase than the previous year's agreement. The wage drift seems to have slowed, leading to the assumption that wages will rise considerably less in coming years than in the past three years.

The wage index has risen by 7.5% per annum 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 2025, 5.5% in 2026 and at around 5.7% in 2027.

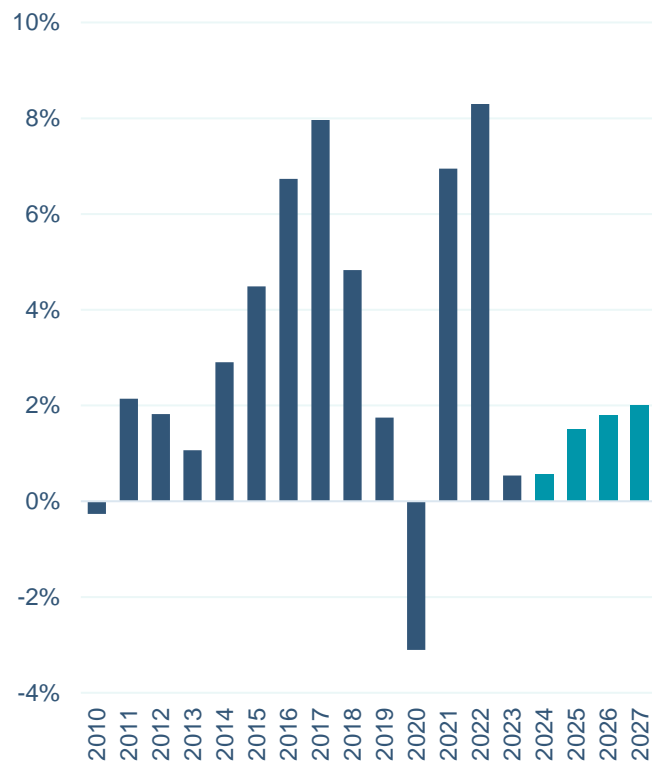
With dwindling inflation, the outlook is for growing purchasing power despite slower wage increases. We expect purchasing power to increase but little this year, or by only 0.7%. It will pick up in the following years, growing by 2.1% next year, 1.8% in 2026 and 2.3% in 2027.

The long-term collective agreements are premised on inflation being below 4.95% in August 2025; any higher triggers a revision clause. This premise and the agreements will hold, according to our inflation forecast.

Private consumption growth slows down

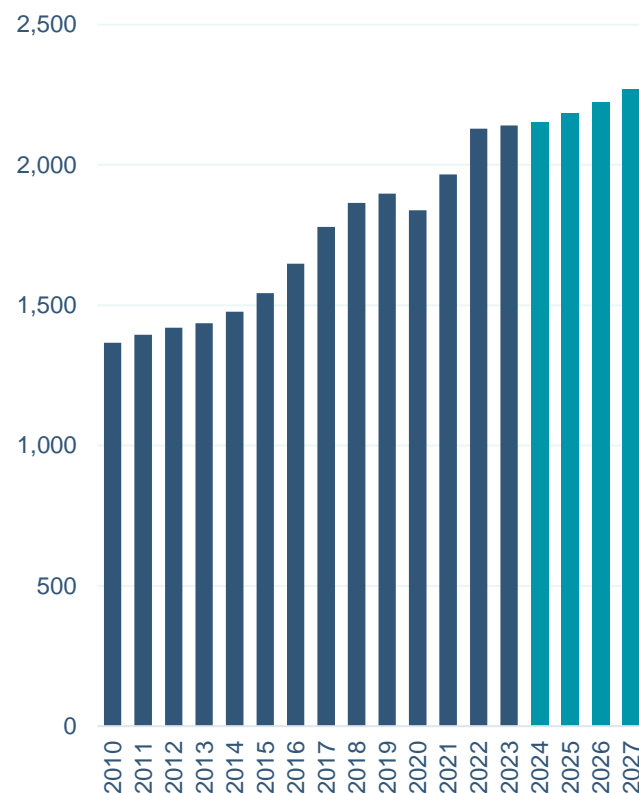
Development of private consumption

YoY change



Annual private consumption

ISK bn at 2023 fixed prices



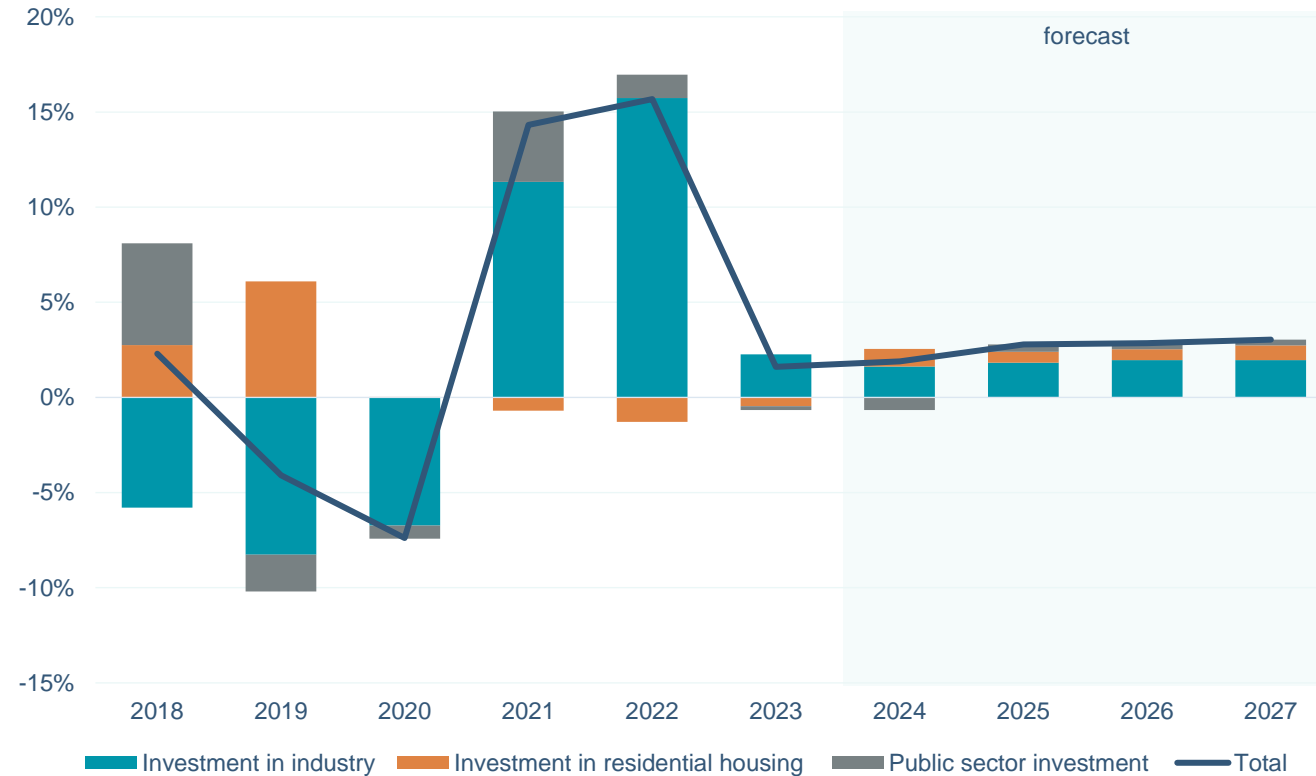
We forecast moderate growth in private consumption this year, or 0.6%, slightly above last year's growth, when private consumption grew by 0.5%. We expect high interest rates to deter consumption, despite this growth. This scenario could easily lead to a reduction in private consumption per capita, like last year.

In the latter years of the forecast period, we anticipate 1.5-2% annual growth in private consumption as accumulated household savings prop up consumption in a rate-cutting environment. This is limited growth, historically speaking, in line with our forecast for positive real interest rates throughout the forecast period, which will encourage saving rather than consumption.

Capital formation trends slowly upward to the forecast horizon

Capital formation and contribution of components

YoY change

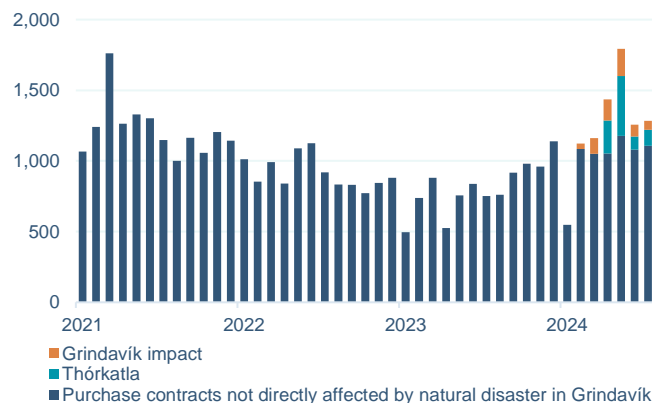


Capital formation increased by 1.6% last year and we expect to see similar growth this year, or 1.9%. We then forecast steady growth of just under 3% in the next years. This year, growth will be most pronounced in residential housing investment, or 5%, but moving forward, we expect growing activity in public sector investment along with the largest component of capital formation, industry investment, which we expect to show gradual growth throughout the whole period.

Tighter restraint in the past few years has slowed the growth of capital formation significantly. While the rate-cutting cycle has begun, and the outlook is for easing restraint as the forecast period progresses, capital formation will pick up, but slowly. Population growth and the impact of natural disaster in Grindavík call for a gradual increase of investment in residential housing, the construction of the new National-University Hospital is still under way, and plans for investment in aquaculture and power plant schemes will fuel industrial investment.

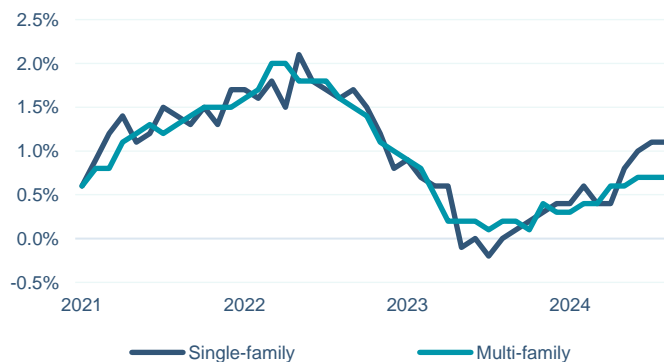
Continued growth in residential housing prices

Sold apartments per month



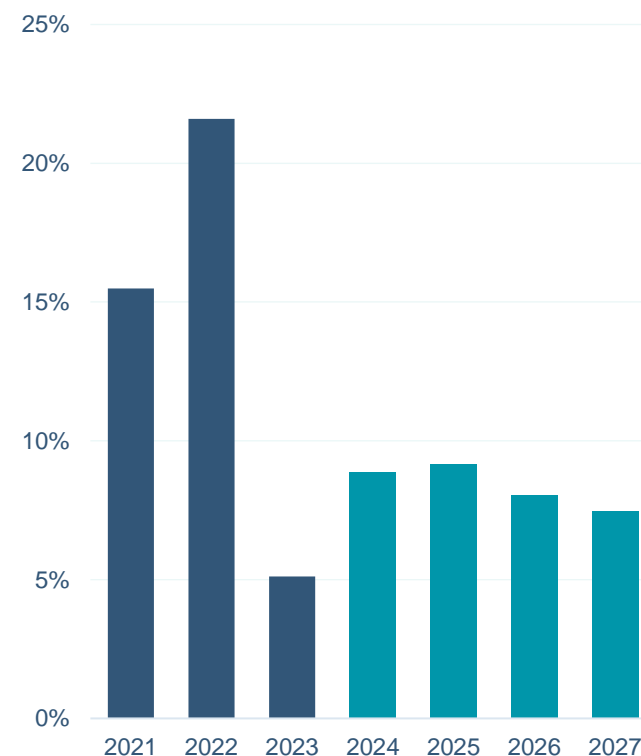
Housing prices in the capital region

MoM change, 12 month running average



Housing prices - developments and forecast

YoY change



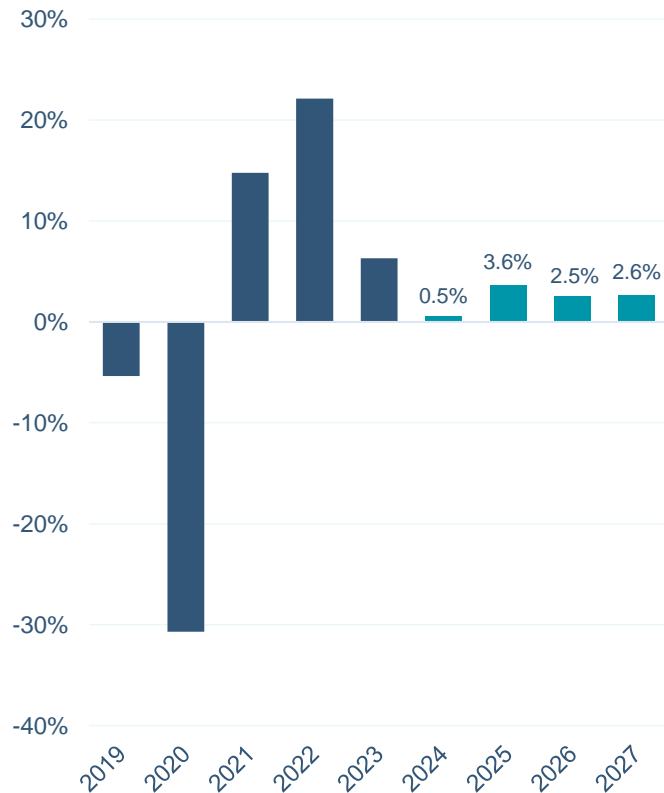
There has been considerable activity in the residential housing market lately, despite high interest rates. Prices have been driven upwards by such factors as the State's acquisition of residential housing in Grindavík through real estate company Thórkatla and the inhabitants of Grindavík entering the housing market elsewhere. In addition, expectations of rate cuts in the near future may have encouraged real estate purchases at the same time that an influx in inflation-indexed loans has lightened debt service burdens. Price increases in recent years have hastened asset formation and widened the mortgage margin for many.

We expect fairly steady investment in residential housing in the forecast period and for increased supply to meet increased demand, caused by such factors as lower interest rates. The outlook is for continued price increases yet as a rule more moderate than in the past few years. We forecast an 8.9% increase in prices this year, 9.2% next year and then a 7-8% price increase in the last years of the forecast period. The slightly higher year-over-year increase next year compared to this year is mainly caused by price hikes that have already eventuated. In general, we expect to see much lower increases between months next year compared to this year.

Forecast only 0.5% export growth this year

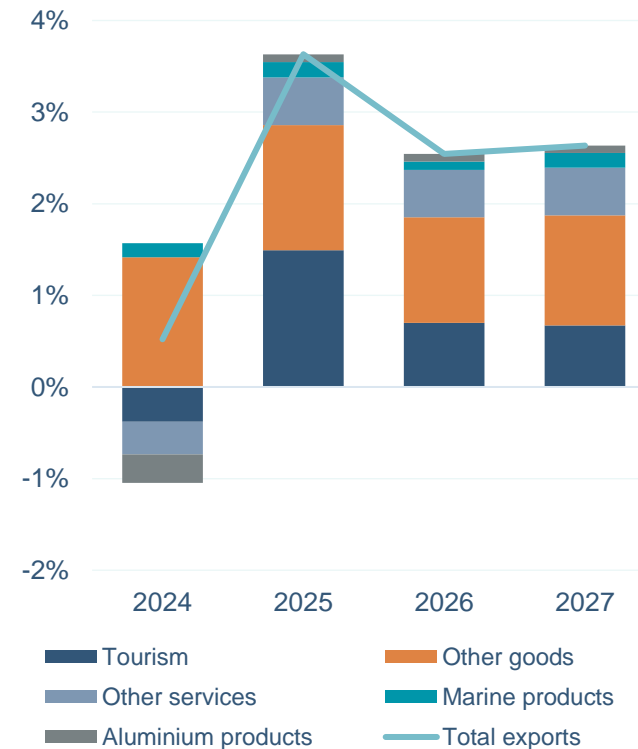
Exports

YoY change



Exports and contribution of subcomponents

YoY change



We forecast a mere 0.5% growth in export this year.

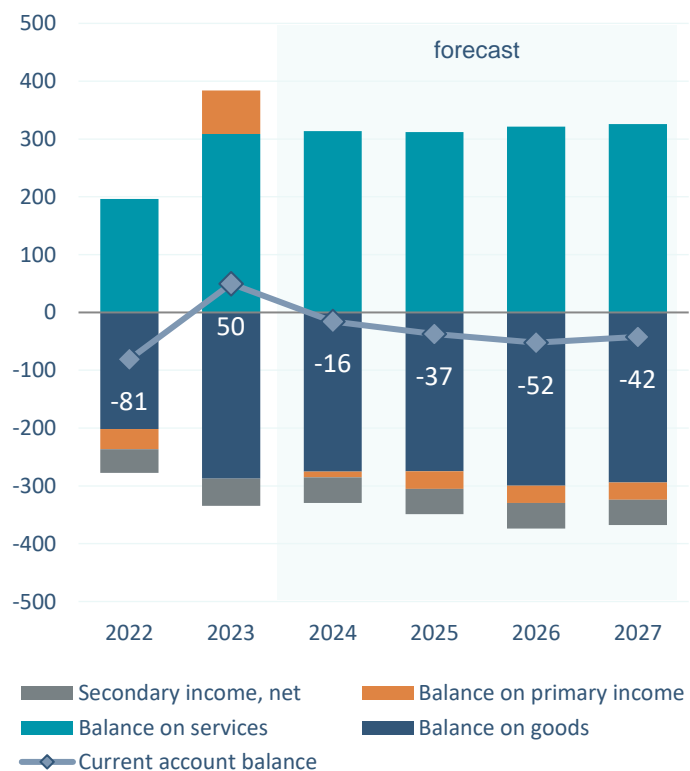
Service export contracts by 1.5%, offset by an increase of 2.5% in goods export. The outlook for this year is affected by a contraction in the travel sector in the second quarter, capelin catch failure and a contraction in aluminium export, influenced by cuts in electricity provision.

We expect to see continued growth in “other goods exports”, i.e. other than aluminium and marine products, and for this category to drive the majority of growth we forecast this year. Export of pharmaceuticals has increased significantly this year, as has export of farmed fish.

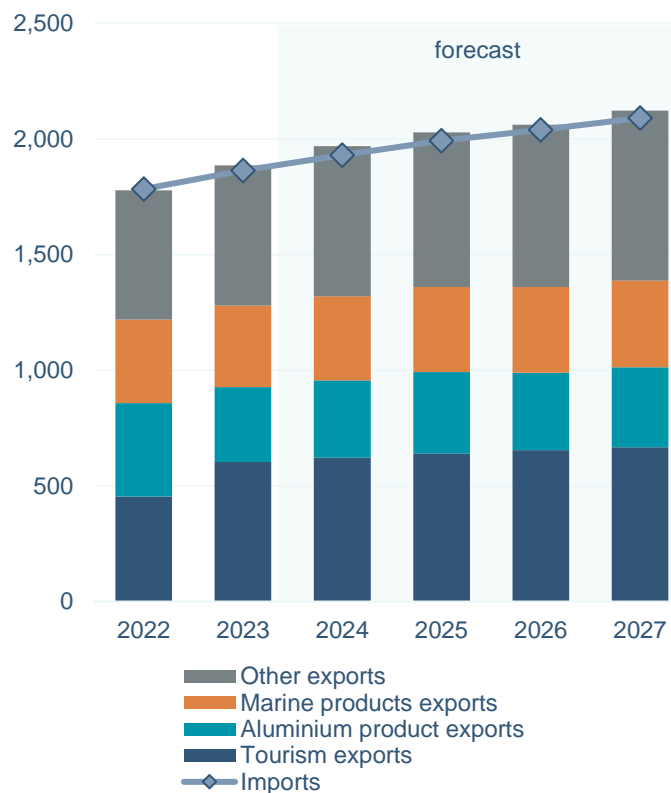
Next year, we forecast a 3.6% growth in total export based on growth in all export sectors. We forecast similar growth in the last two years of the forecast period, or 2.5% and 2.6%.

Persistent trade deficit to the forecast horizon

Current account balance
ISK bn



Exports and imports
ISK bn



In the first half of the year, the trade deficit was ISK 77 billion. We expect a rather lower deficit for the year as a whole, or ISK 16 billion, due to a surplus created in the third quarter, high season for the travel sector.

We expect to see a surplus on the trade in goods and services, influenced by more favourable trading terms, yet a deficit on the trade balance as a whole because of a deficit in factor income caused by improved results from the aluminium smelters.

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