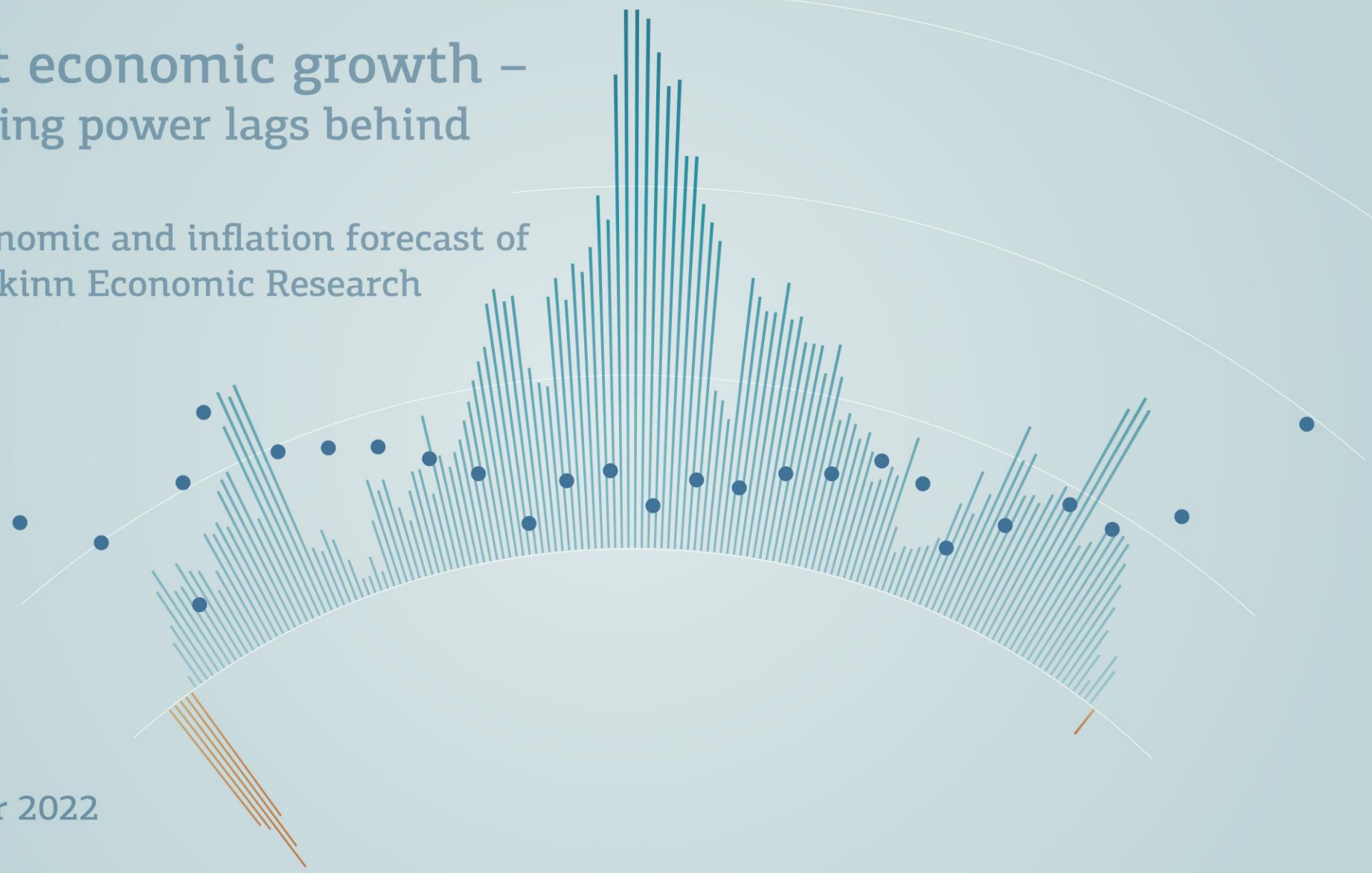




Robust economic growth – purchasing power lags behind

Macroeconomic and inflation forecast of
Landsbankinn Economic Research



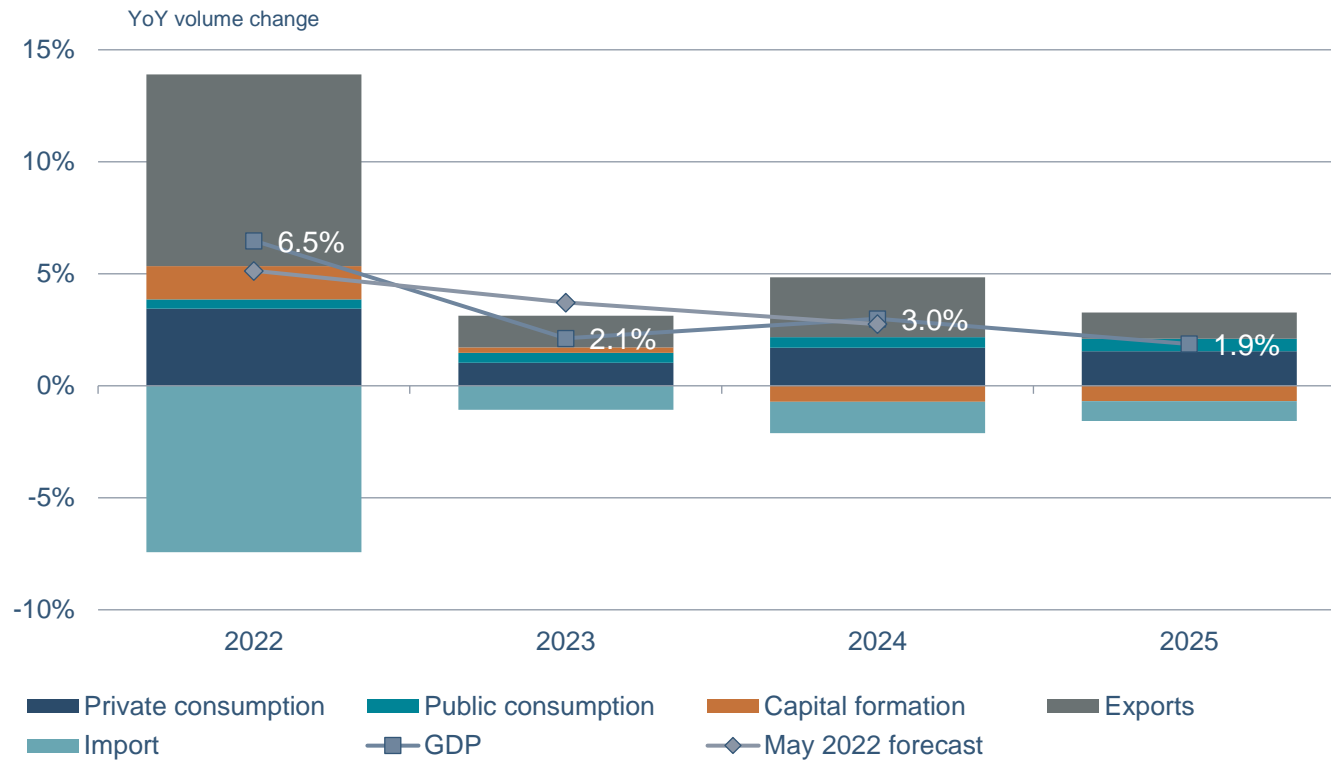
19 October 2022

Highlights

- We expect domestic product to increase by 6.5% this year and 2.1% next year. Economic growth this year will be driven by a 22.4% increase in export, 6.7% growth in private consumption and 6.6% increase in fixed capital formation. Next year, we expect to see growth slowing down to 2.1%, to be 3.0% in 2024 and 1.9% in 2025.
- We assume that 1.7 million travellers will visit Iceland this year, an increase from our May forecast. Conversely, we forecast 1.9 million tourists next year, a reduction from our May forecast. We expect to see 2.3 million tourists in 2024 and 2.5 million in 2025.
- The trade balance will be negative this year by 2.2% of GDP, if our forecast holds. As the forecast period progresses, the trade balance will transition from a deficit to a surplus which we expect to peak in 2025, at 1.9% of GDP.
- We are of the opinion that the Icelandic króna (ISK) will appreciate a little next year and more significantly in 2024, once a trade surplus forms. This appreciation phase will continue in 2025.
- One of the main uncertainties in our forecast concerns the labour market which is heading into negotiations for collective bargaining agreements. The labour market has been strong, the wage drift significant and businesses have experienced a labour shortage. We expect a 7.6% wage increase this year and 7.1% next year, more or less in line with developments in recent years.
- Inflation has in our opinion peaked and will average 6.5% next year, considerably down from the 8.1% inflation we forecast for this year. We do not expect inflation to fall down to the inflation target of the Central Bank of Iceland (CBI) in the forecast period.
- We assume that the CBI's rate hike cycle has come to an end and expect no further policy rate increases. The current interest level will be maintained for the next year or so and the rate-cutting process will not begin until the third quarter of next year, according to our forecast.
- Housing price increases are finally cooling down and we expect to see a maintenance of the current status quo in the coming months. In general, housing prices will increase by around 5% next year, which is lower than the average change since the turn of the century and quite a departure from the 22% price rise of this year, if our forecast holds.
- The aim is to reduce the Treasury deficit during the forecast period and even faster than initially planned. The fiscal budget nevertheless assumes ongoing deficit on both national and municipality levels up to the year 2027.

Lower GDP growth ahead

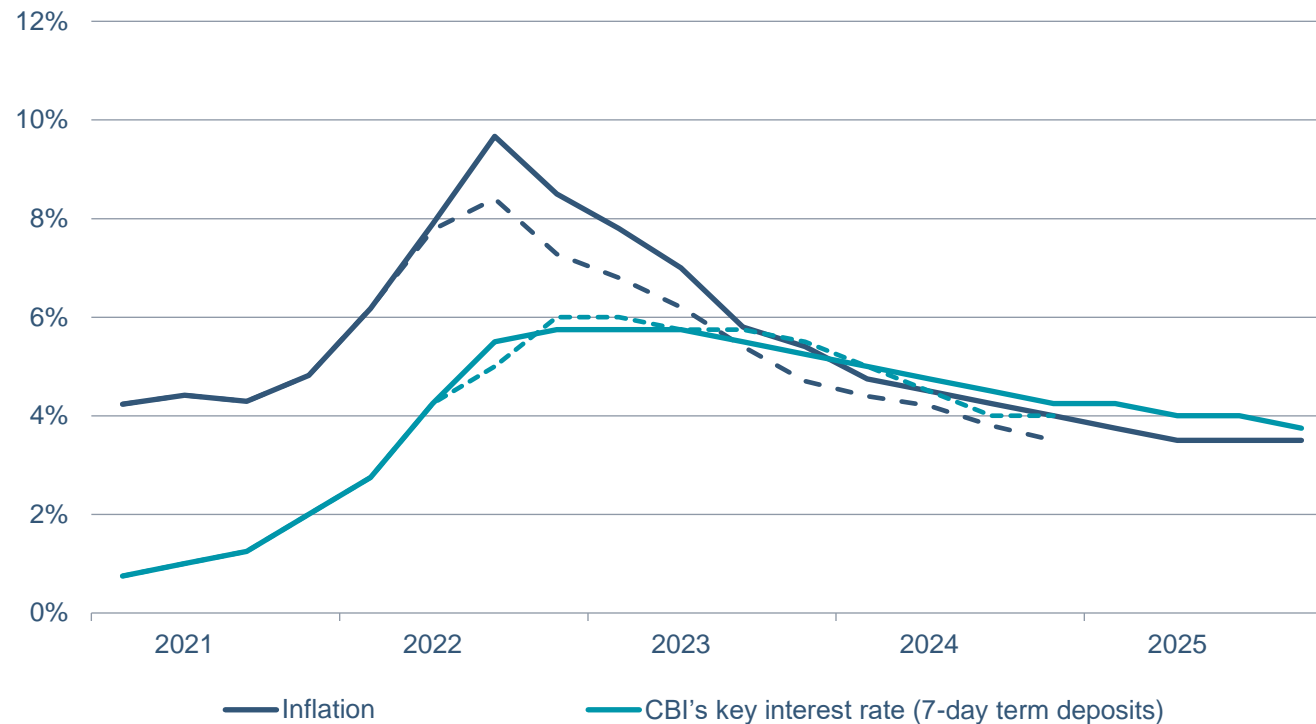
Economic forecast and weight of components



- We forecast 6.5% economic growth in Iceland this year, the greatest since 2007. Robust growth in export sectors coupled with strong domestic demand has driven handsome GDP growth in the past year. We expect to see more growth this year than what we forecast in May, mainly because we have upped our forecast for tourist numbers from the May forecast.
- On the other hand, we forecast less growth in the latter years of the forecast period. There are several indications that economic expansion has slowed, mainly influenced by inflation, interest rate hikes and dwindling purchasing power.

Expect inflation to recede slowly

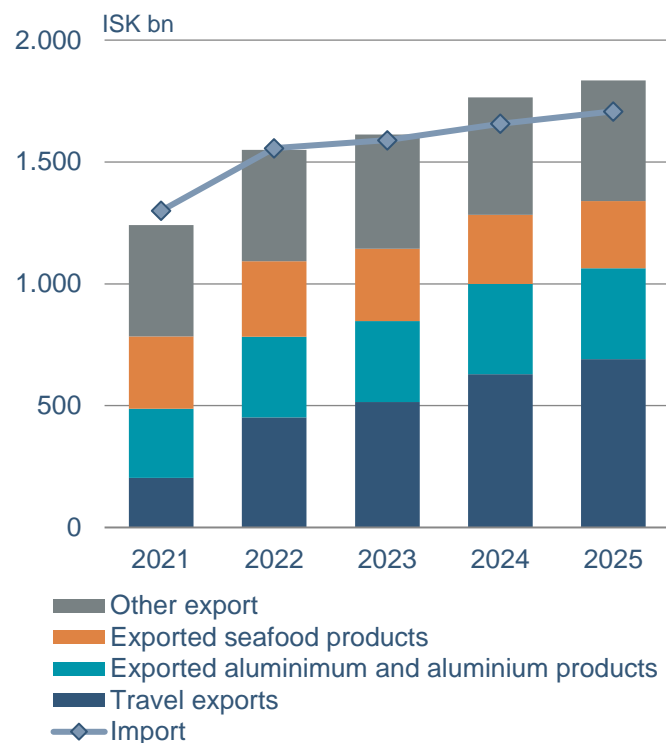
Inflation and policy rate forecast



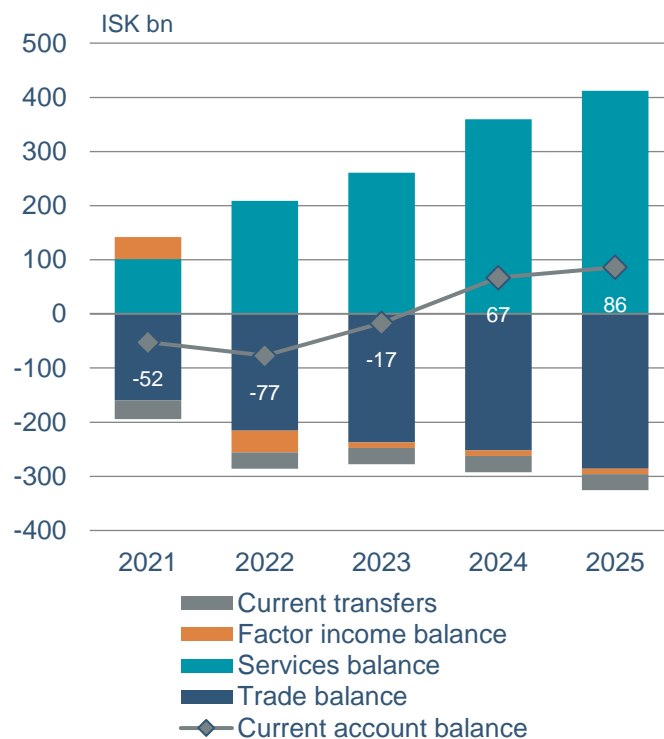
- While we consider that inflation has peaked, it has by no means been laid to rest and we are looking at a trajectory of slow decline. We do not expect that the CBI's inflation target (2.5%) will be reached during the forecast period yet do expect inflation to fall under the upper tolerance limit (4%) in 2025 at the earliest. The main challenge for the CBI will be to lower inflation expectations.
- In May, we expected the policy rate to top at 6% towards the end of the year. The Monetary Policy Committee (MPC) raised the policy rate to 5.75% now in October with a strong indication that it saw no reason for further rate hikes. We are now of the opinion that the policy rate has peaked and will be maintained at current levels until the third quarter of next year when a slow rate-cutting programme will begin in line with inflation receding back towards target.

Trade surplus up to the forecast horizon

Export and import



Current account balance



- Continuous surplus of trade in goods and services from 2009 turned to a deficit in 2020 with the pandemic. We expect to see a continuation of that development this year, with import outweighing export. We then expect a turnaround next year with an ISK 23 bn surplus on trade in goods and services yet for the overall current account balance to remain negative, because of the negative impact of current transfers and factor income.
- All combined, we expect an ISK 77 bn current account deficit this year. Improvement will begin in 2023, with a surplus on trade in goods and services yet still a ISK 17 bn current account deficit. With growth of the travel sector in coming years, the deficit will turn to an ISK 67 bn surplus by 2024 and ISK 86 bn by 2025.

Key figures from Landsbankinn Economic Research's macroeconomic forecast

Domestic product and key components	ISK bn	Volume change from previous year (%)			
		2022	2023	2024	2025
Gross domestic product	ISK 3,251	6.5 (5.1)	2.1 (3.7)	3.0 (2.8)	1.9
Private consumption	1,674	6.7 (3.5)	2.0 (3.0)	3.3 (3.0)	3.0
Public consumption	892	1.5 (1.5)	1.6 (1.5)	1.7 (1.5)	2.0
Capital formation	738	6.6 (6.2)	1.1 (5.1)	-3.2 (2.2)	-3.1
Investment in industry	422	9.4 (5.0)	2.3 (5.4)	-4.4 (3.0)	-3.7
Investment in residential housing	176	1.0 (10.0)	4.5 (8.0)	0.5 (2.0)	-1.5
Public sector investment	140	5.0 (5.0)	-7.0 (0.0)	-4.0 (0.0)	-3.0
Total national expenditure	3,309	5.3 (3.4)	1.7 (3.1)	1.4 (2.4)	1.4
Export of goods and services	1,242	22.4 (19.4)	3.7 (7.5)	7.0 (7.2)	3.1
Import of goods and services	1,300	18.6 (14.3)	2.7 (6.0)	3.5 (6.5)	2.2
Policy rate and inflation		2022	2023	2024	2025
CBI's key interest rate, 7-day term deposits, year end, %		5.75 (6.00)	5.25 (5.50)	4.25 (4.00)	3.75
Inflation, annual average, %		8.1 (7.4)	6.5 (5.8)	4.4 (4.0)	3.5
EUR exchange rate, year end		139 (132)	138 (130)	132 (128)	130
Real estate prices, annual average, %		22 (20)	5 (8)	4 (4)	5
Labour market		2022	2023	2024	2025
Wage index, annual average, %		7.6 (7.5)	7.1 (6.8)	6.4 (6.2)	5.0
Purchasing power of wages, annual average, %		-0.4 (0.1)	0.5 (0.9)	1.9 (2.2)	1.3
Unemployment, annual average, %		3.8 (4.5)	3.2 (4.2)	3.3 (3.9)	3.4
Current account balance		2022	2023	2024	2025
Number of foreign travellers, thousand individuals		1,700 (1,500)	1,900 (2,000)	2,300 (2,400)	2,500
Goods and services balance, %GDP		-0.2 (0.9)	0.6 (1.0)	2.5 (0.9)	2.8
Current account balance, %GDP		-2.2 (0.6)	-0.4 (0.7)	1.6 (0.7)	1.9

Numbers in brackets are from Economic Research's May 2022 forecast

Disclaimer

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