



Growth in the shadow of inflation

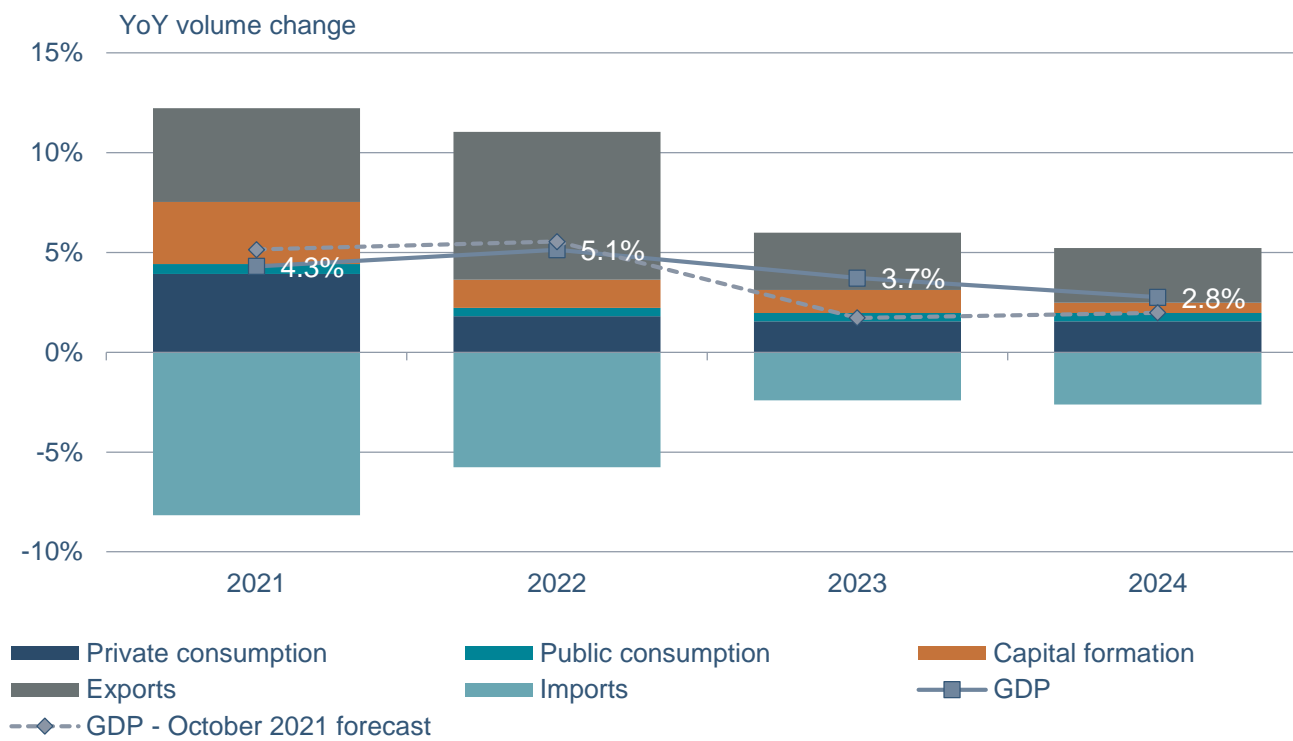
Economic Forecast for 2022-2024
Landsbankinn Economic Research
19 May 2022

Key points from the economic forecast:

- We expect GDP in Iceland to increase by 5.1% in 2022. Export increases by just over 19.4%, private consumption by 3.5% and total capital formation by 6.2%. Uninterrupted economic growth is expected over the coming two years; 3.7% in 2022 and 2.8% in 2024.
- Around 1.5 million tourists are expected in 2022, 2 million in 2023 and 2.4 million in 2024.
- Unemployment levels will recede as the year progresses and in coming years, with registered unemployment expected to average 4.5% this year, dropping to 4.2% next year and to 3.9% in 2024.
- The trade balance is expected to be positive at 0.7% of GDP on average in the forecast period.
- Inflation will peak in the third quarter of this year and remain above target to the forecast horizon. Inflation is estimated to average 7.4% this year, 5.8% next year and 4% in 2024.
- The forecast assumes a considerable increase in policy rates this year and for the policy rate to stand at 6% at year end. We may see the beginning of a rate-cut cycle next year and forecast a policy rate of 5.5% at year-end 2023; 4% at year-end 2024.
- Housing prices have surged. We assume that a sort of tolerance limit has now been reached and expect to see slower price growth moving forward. We forecast a 20% increase this year, between annual averages, 8% in 2023 and 4% in 2024.
- According to the fiscal budget, the State deficit will lessen during the forecast period. With this in mind, we forecast rather slow growth in public consumption, or 1.5% per annum, up to the forecast horizon.

Robust growth yet significant challenges

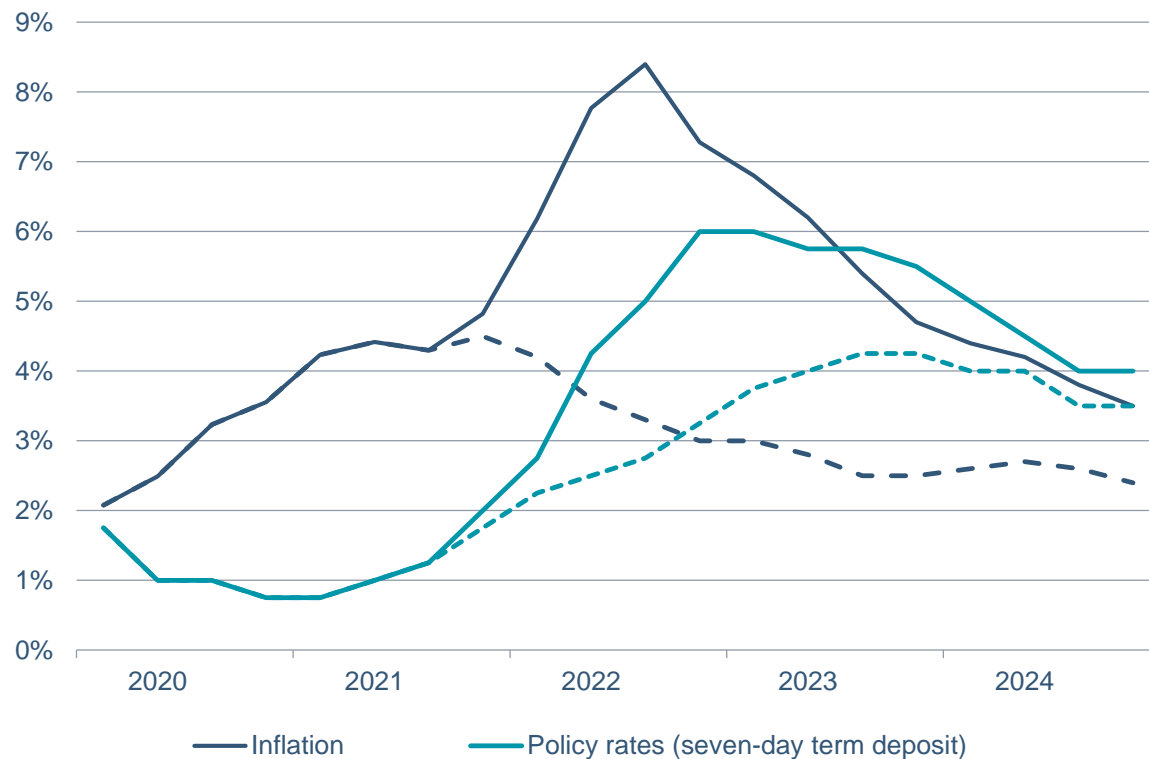
Economic growth



- The economic recovery that began in 2021 continues this year and we expect to see handsome growth this year and for the remainder of the forecast period. Yet growth phases such as these come with a set of challenges.
- An output gap has formed, businesses are experiencing labour shortage and the inflationary pressure is high. We expect policy rate hikes to achieve a cooling of the economy in the coming 1-2 years, though demand will remain strong and growth persist. Growth will be driven by an increase in export if our forecast for tourist arrivals holds.
- As before, this forecast is shrouded in a great deal of uncertainty. Domestic uncertainty is mainly caused by the labour market and inflation developments. Internationally, there is great uncertainty about the war in Europe and its impact on commodity prices, inflation and the purchasing power of travellers to Iceland.

Outlook for high and persistent inflation

Inflation and policy rates



- The inflation outlook, both domestically and internationally, has taken a sharp turn for the worse since we published our October forecast. Inflation in Iceland's main trading partner countries has not measured as high in 40 years. In Iceland, this is the highest inflation has been in 12 years, at which point in time the inflation spike caused by the financial crisis was petering out.
- Rising inflation is caused by considerable price increases internationally, first and foremost because of rising commodity prices fuelled by the war in Ukraine. Compounding the issue are domestic housing price increases, which have been higher and more persistent than most analysts expected. We expect domestic inflation to peak in the third quarter of this year, at 8.4%. Both inflation and inflation expectations, which have risen a great deal and are now considerably above target, will grow.
- The Central Bank will need to tighten its monetary stance and message considerably to pressure inflation expectations back toward target. We predict that the policy rate, currently at 3.75%, will reach 6% by the end of the year. The Monetary Policy Committee will shortly afterwards begin a slow but steady easing of restraint so that the policy rate stands at 4% at the forecast horizon.

Overview of Macro Economic Forecast

GDP and key components	ISK bn	Volume change from previous year (%)			
	2021	2021	2022	2023	2024
Gross domestic product	3.233	4.3 (5.1)	5.1 (5.5)	3.7 (1.7)	2.8 (2.0)
Private consumption	1.671	7.6 (5.0)	3.5 (4.5)	3.0 (3.0)	3.0 (3.0)
Public consumption	887	1.8 (2.0)	1.5 (1.5)	1.5 (1.5)	1.5 (1.5)
Capital formation	739	13.6 (10.8)	6.2 (3.1)	5.1 (1.9)	2.2 (2.4)
Business investment	429	23.1 (14.3)	5.0 (6.2)	5.4 (1.2)	3.0 (3.0)
Investment in residential housing	177	-4.4 (-2.0)	10.0 (2.0)	8.0 (5.0)	2.0 (2.5)
Public sector investment	132	12.4 (20.0)	5.0 (-5.0)	0.0 (0.0)	0.0 (0.0)
Total national expenditure	3.302	7.2 (5.4)	3.4 (3.4)	3.1 (2.4)	2.4 (2.5)
Exports of goods and services	1.233	12.3 (18.0)	19.4 (16.8)	7.5 (1.0)	7.2 (5.3)
Imports of goods and services	1.302	20.3 (18.5)	14.3 (11.0)	6.0 (2.5)	6.5 (6.5)
Prices, interest rates and exchange rates		2021	2022	2023	2024
Key interest rate (7 day term deposit, end of year,%)		2.00 (1.75)	6.00 (3.25)	5.50 (4.25)	4.00 (3.50)
Inflation (annual average,%)		4.4 (4.4)	7.4 (3.5)	5.8 (2.7)	4.0 (2.6)
EURISK exchange rate (end-of-year)		148 (148)	132 (143)	130 (139)	128 (137)
Real estate prices (change in annual average %)		14 (14)	20 (9)	8 (4)	4 (5)
Labour market		2021	2022	2023	2024
Wage index (change from previous year,%)		8.3 (7.9)	7.5 (6.8)	6.8 (5.8)	6.2 (4.6)
Purchasing power of wages (change from previous year,%)		3.7 (3.4)	0.1 (3.2)	0.9 (3.0)	2.2 (1.9)
Unemployment (% of labour force)		7.7 (7.7)	4.5 (4.7)	4.2 (4.1)	3.9 (3.5)
Trade balance		2021	2022	2023	2024
Number of foreign visitors (thousand)		688 (720)	1.500 (1.500)	2.000 (1.800)	2.400 (2.100)
Goods and services balance (%GDP)		-2.1 (0.1)	0.9 (4.0)	1.0 (2.8)	0.9 (1.9)
Trade balance (%GD)		-2.8 (0.6)	0.6 (4.1)	0.7 (2.9)	0.7 (2.1)

Numbers in brackets are from Economic Research's October 2021 forecast

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