

# Economy seeking a balance

Landsbankinn Economic Research  
Macroeconomic forecast

17 October 2023



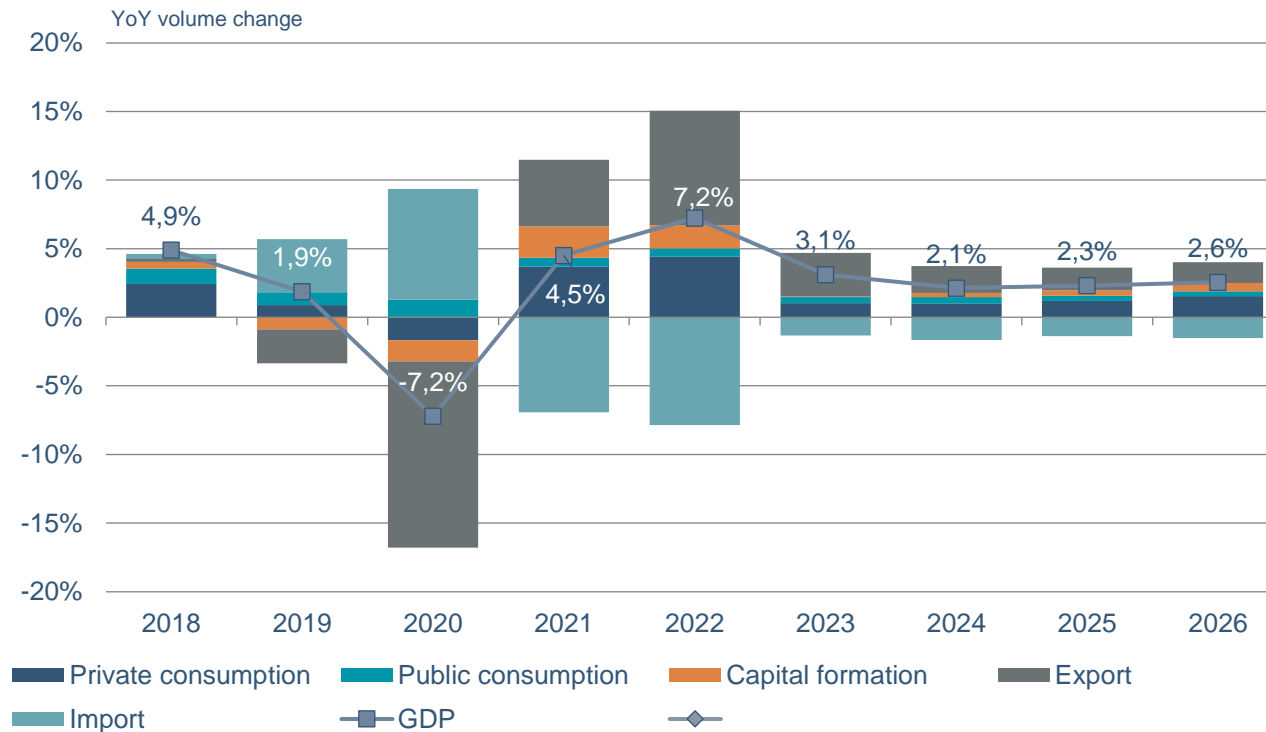
# Highlights

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- Economic growth will be 3.1% in 2023 and 2.1% in 2024, according to the forecast. It will pick up slowly in the following years, be 2.3% in 2025 and 2.6% in 2026.
- Inflation will recede slowly, still averaging 5.3% in 2024 and 4.3% in 2025. We do not anticipate that inflation will reach the Central Bank's target during the forecast period.
- Policy rates have peaked for now, so the forecast, yet we won't see rate cuts until the second quarter of next year. We expect the policy rate to stand at 4.75% at the forecast horizon.
- The outlook is for appreciation of the Icelandic króna (ISK) during the forecast period, with the euro costing ISK 144 at year-end 2023 and ISK 138 at the end of 2026.
- We expect private consumption to increase considerably less this year and over the coming years as compared to 2022, or by 2.0% this year and 1.9% next year. Private consumption will then increase slowly alongside lower interest rates and increasing purchasing power.
- Unemployment edges slowly upwards as economic activity declines. We forecast 3.2% unemployment this year, 3.9% next year, 4.4% in 2025 and 4.1% in 2026.
- The purchasing power of wages increases but slightly this year, by 0.6%, and a little more in the coming years, between two and three percent each year.
- According to our forecast, the housing price index will on average be 5.0% higher this year than in 2022, 2.0% higher in 2024 than this year. Activity on the market will slowly pick up again when interest rates start to decline and we expect housing prices to increase by 6.1% in 2025 and 7.4% in 2026.
- Residential housing investment continues to contract, by 5% this year and 3% next year before picking up again in 2025 and moving forward.
- We expect slow growth in business investment, or 3% this year and 3.4% in 2024.
- Export will grow by 6.8% compared to 2022, driven by increased tourist arrivals in Iceland in early 2023, and grows by 4.2% in 2024. Import increases much less this year than in 2022, by 2.8% and 3.5% in 2024.
- We expect tourist visits to Iceland to amount to 2.2 million this year. This number will increase but slightly in the coming years, to 2.3 million in 2024, 2.4 million in 2025 and 2.5 million in 2026.
- We anticipate a slight trade surplus for all years of the forecast period following the deficit of previous years and expect to see an increased surplus from trade in services and increased deficit from trade in goods.

# Significant growth slow-down in 2023 and quiet period ahead

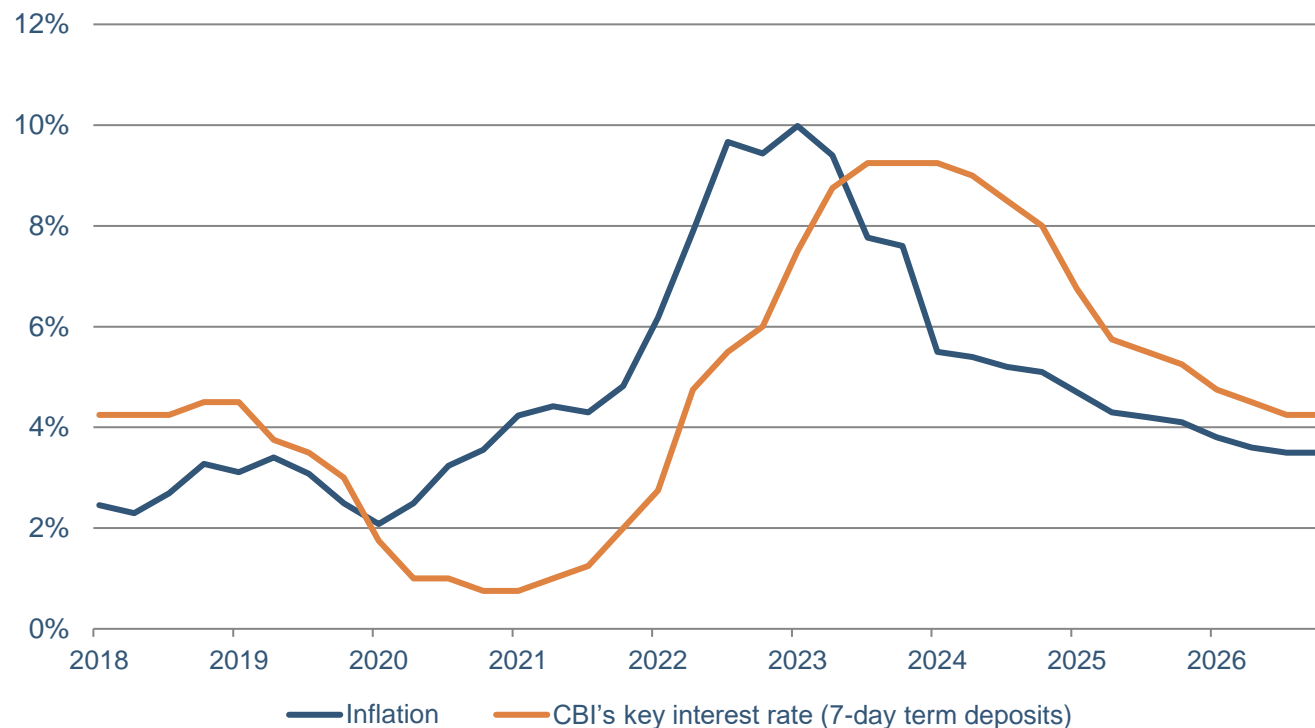
## Economic forecast



- Following two years of robust economic growth, driven by a sharp turnaround in the travel sector and private consumption post pandemic, we now forecast a significant cooling.
- Growth measured 5.8% in the first half of the year, according to preliminary figures from Statistics Iceland. We expect to see much slower growth in the second half of the year and forecast net 3.1% growth in 2023.
- We also expect the domestic economy to continue ticking over at a leisurely pace in 2024, when the effect of a tighter monetary policy and fiscal restraint will become more wide-spread. Economic growth will be 2.1% in 2024 and 2.3% in 2025.
- Our growth forecast for this year is nearly unchanged from our April forecast, down by only 0.1 percentage points. We forecast slightly less growth in private consumption and a contraction in residential housing investment, offset by our forecast for increased business investment and decreased import.
- Alongside a dramatic increase in immigration to Iceland, per capita growth has fallen short of measured economic growth in the past quarters and we consider this trend likely to continue.

# Inflation will not hit target during the forecast period

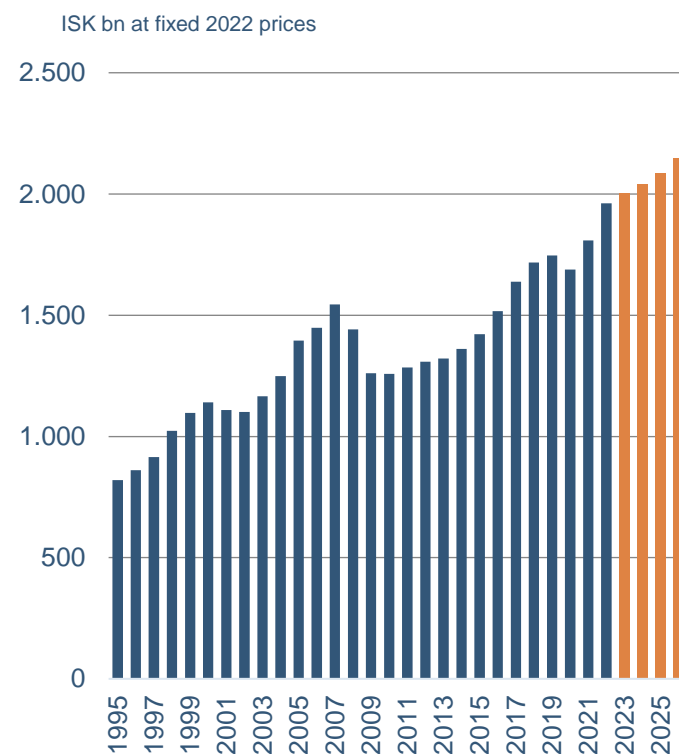
## Inflation and policy rate forecast



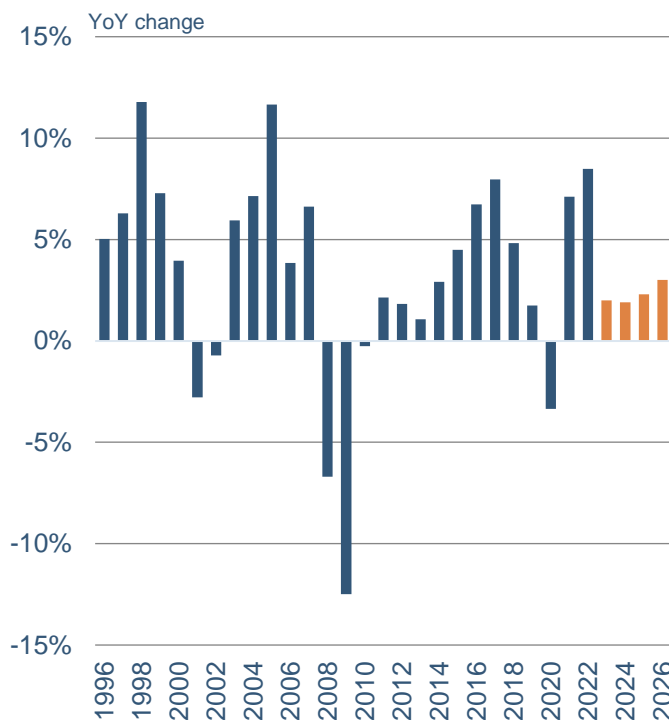
- We expect the effect of interest rate hikes to manifest more clearly in the coming months, for economic tension to recede and put downward pressure on inflation.
- Despite this forecast, we do not expect inflation to fall back to the CBI's target of 2.5% during the forecast period. We expect inflation to measure 3.5% in the fourth quarter of 2026.
- Following fourteen consecutive policy rate hikes, from 0.75% to 9.25%, the Monetary Policy Committee (MPC) decided to hold the policy rate unchanged in early October.
- Our forecast does not anticipate further rate hikes in the near future. We do expect this interest rate level to be maintained until the second quarter of 2024, or past the period of heaviest collective bargaining. At that point, a slow rate-cutting cycle will commence.

# Less robust domestic demand

## Private consumption



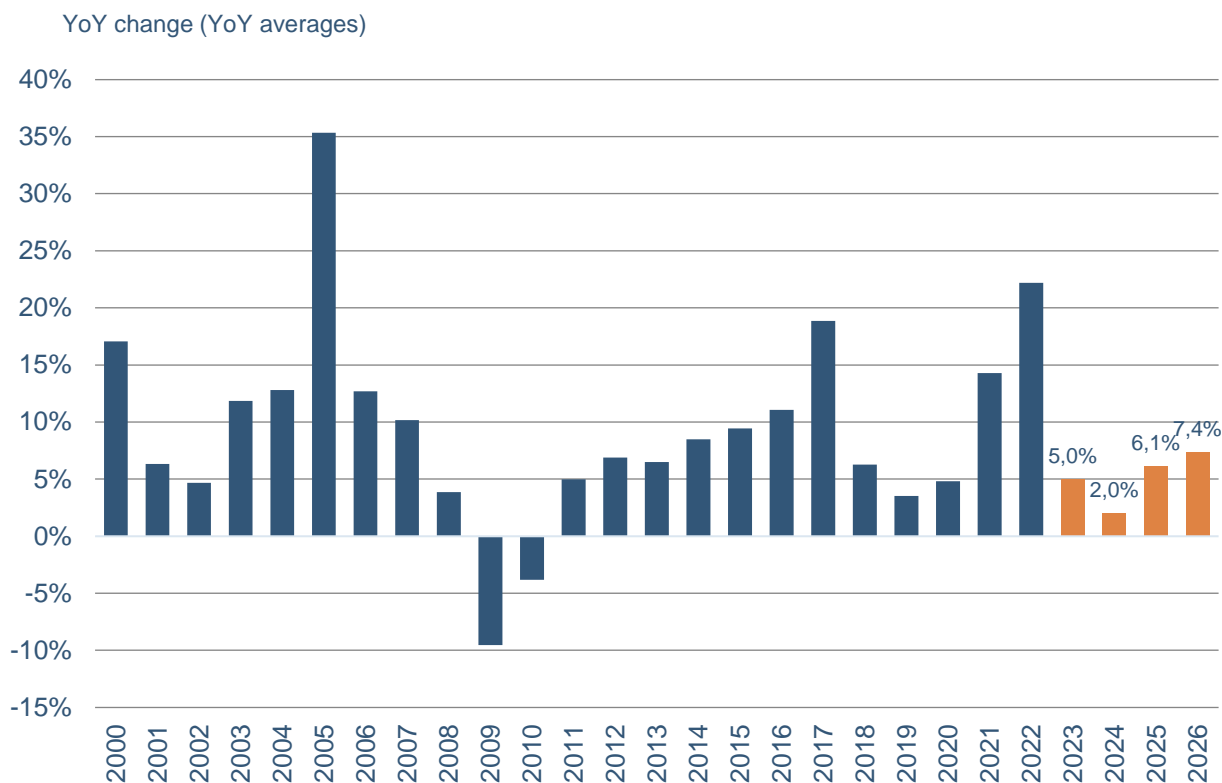
## Private consumption - development and forecast



- Tighter monetary restraint has reduced the vigour of domestic demand in the past months, with private consumption increasing by a mere half percent between years in the second quarter.
- Private consumption was much more robust in the first quarter of the year and increased by 4.6% between years, fueled by wage hikes. Higher interest rates finally appear to have made an impact in the second quarter though other factors also contribute to this development, such as the slower rise of purchasing power around mid-year and the more limited ability of households to utilise funds amassed during the pandemic.
- We expect persistent inflation and high interest rate levels to continue to put a damper on private consumption but for rising purchasing power in the latter half of this year and wage increases moving into 2024 to rekindle consumption again in the first half of that year.
- We forecast 2.0% growth in private consumption this year, 1.9% next year and 2.3% in 2025. In 2026, we expect private consumption to increase more alongside falling interest rates, or by 3.0%.

# Housing prices will pick up when interest rates fall

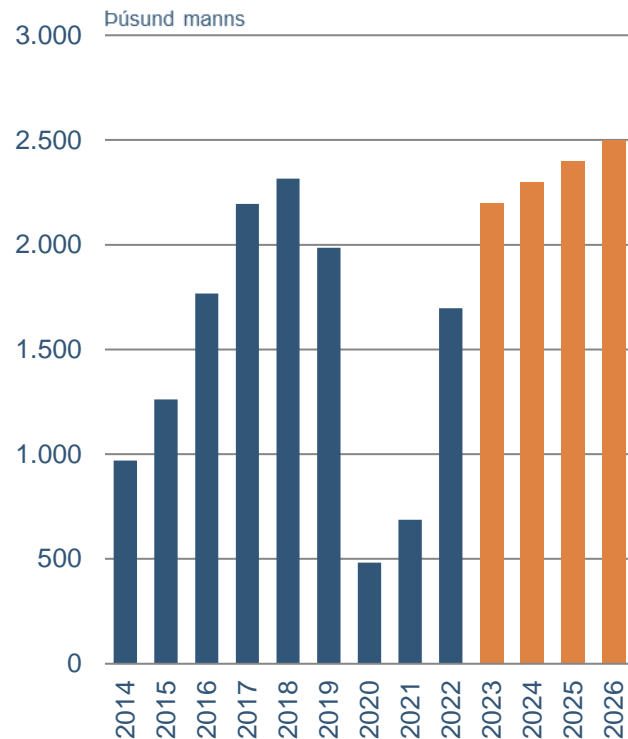
## Housing prices - developments and forecast



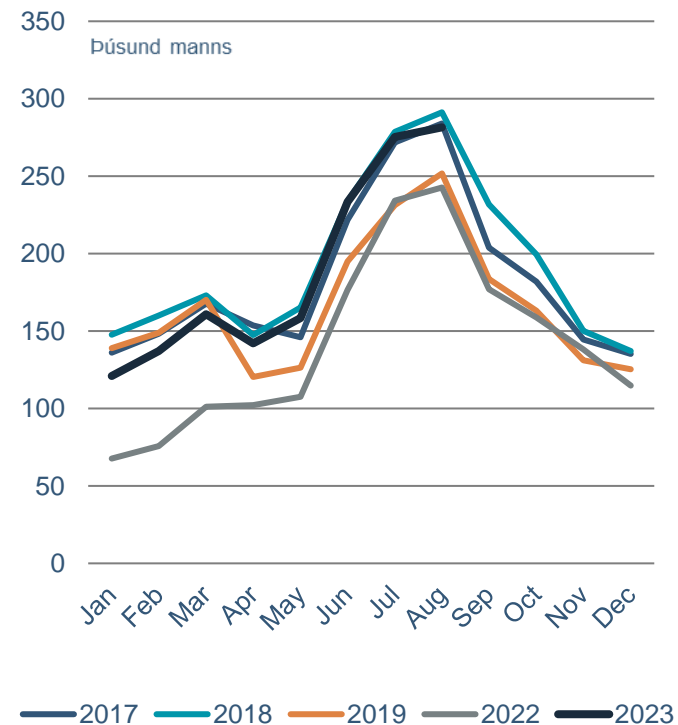
- The residential housing market reflects the impact of higher interest rates most rapidly and clearly, with price developments changing completely in just over one year. Tighter conditions imposed on borrowers have contributed to the slow-down and made it especially difficult for new buyers to enter the market.
- The 12-month increase in the housing price index reached 25.5% in July 2022 and was 2.0% in August of this year. Over the past 25 months, signed purchase contracts in the capital region have been fewer than in the same month the previous year, time to sell has lengthened and apartments more commonly sell under asking price.
- Increased demand for housing caused by rapid population growth maintains the pressure on housing prices, reflected in a 9.4% increase in rental prices in the capital region in the past 12 months. In addition, equity loans (Ice. *hlutdeildarlán*) introduced by the domestic authorities have boosted demand.
- Despite these factors, we do not expect housing price increases to pick up any real steam until there are clear signs of interest rate cuts. We expect the housing price index to increase by 5.0% on average between years this year, 2.0% in 2024, 6.1% in 2025 and by 7.4% in 2026.

# Travel sector leads export growth

## Tourist numbers and forecast



## Tourist numbers by month



- We forecast 2.2 million tourist arrivals in Iceland through Keflavík International Airport in 2023. If our forecast proves accurate, arrivals in 2023 will equal 2017 figures, the runner up year for most tourist arrivals.
- In our previous forecast, we expected to see 2.1 million visitors in 2023. It is now clear from the numbers year-to-date that arrivals will exceed that forecast.
- Moving forward, we expect a more conservative increase in tourist numbers, with the enlargement of Keflavík International Airport affording the opportunity to increase seat supply on flights to Iceland. This growth will come nowhere near that of this year and in 2022 as the travel industry now appears to have fully attained - or actually surpassed - its former strength following the contraction caused by Covid. The travel industry may be limited by its infrastructure, such as accommodation space, in coming years and economic developments in neighbouring countries may also play a part.
- We forecast 2.3 million tourists in 2024, 2.4 million in 2025 and 2.5 million in 2026.



# Forecast ISK appreciation

## EURISK exchange rate



- The outlook is for appreciation of the Icelandic *króna* (ISK) during the forecast period.
- Following a trade deficit in the past two years, the outlook is for a surplus this year and to the forecast horizon. The travel sector has regained its footing after the pandemic and, alongside subsiding tension in the economy in line with our forecast, import should increase at a slower pace.
- A considerable domestic-foreign interest differential can be expected in the next few years, contributing to ISK appreciation. It will be more expensive for domestic parties to own currency and, with a growing interest spread, domestic bonds will become more attractive to foreign parties.
- The spread premium on foreign currency bond issuance by domestic banks has fallen significantly in the past few months, following an increase in 2022 and again following the failure of banks in the USA and Switzerland. It has now attained near pre-pandemic levels.
- As is usual, some intra-year and even intra-month exchange rate fluctuations are to be expected throughout the forecast period. The timing of such fluctuations cannot be gauged.



# Overview of Landsbankinn Economic Research's macroeconomic forecast

<b>Domestic product and key components</b>	ISK bn	Volume change from previous year (%)				
	2022	2022	2023	2024	2025	2026
Gross domestic product	3,797	7.2 (6.4)	3.1 (3.2)	2.1 (2.7)	2.3 (2.3)	2.6
Private consumption	1,962	8.5 (8.6)	2.0 (2.4)	1.9 (2.7)	2.3 (2.5)	3.0
Public consumption	994	2.2 (1.6)	1.7 (1.6)	1.9 (1.7)	1.4 (1.7)	1.3
Capital formation	846	7.6 (6.9)	0.2 (2.3)	1.3 (3.2)	1.8 (1.4)	2.7
Investment in industry	507	15.0 (15.2)	3.0 (2.5)	3.4 (2.6)	1.6 (1.4)	1.8
Investment in residential housing	184	-6.2 (-6.3)	-5.0 (5.9)	-3.0 (5.1)	3.0 (1.0)	6.0
Public sector investment	156	3.3 (-0.9)	-3.0 (-3.0)	-1.0 (3.0)	1.0 (2.0)	2.0
Total national expenditure	3,812	6.6 (6.4)	1.3 (1.9)	1.8 (2.6)	1.9 (2.1)	2.5
Export of goods and services	1,769	22.3 (20.6)	6.8 (8.4)	4.2 (4.7)	3.6 (4.3)	3.3
Import of goods and services	1,784	19.9 (19.7)	2.8 (5.6)	3.5 (4.4)	2.9 (3.8)	3.2
<b>Policy rate and inflation</b>		2022	2023	2024	2025	2026
CBI's key interest rate, 7D term deposits, year end, %		6.00 (6.00)	9.25 (8.50)	8.00 (6.50)	5.25 (5.00)	4.25
Inflation, annual average, %		8.3 (8.3)	8.7 (8.4)	5.3 (6.2)	4.3 (4.7)	3.6
EUR exchange rate, year end		152 (152)	145 (146)	142 (143)	138 (140)	138
Real estate prices, annual average, %		22.2 (22.2)	5.0 (4.8)	2.0 (1.0)	6.1 (2.9)	7.4
<b>Labour market</b>		2022	2023	2024	2025	2026
Wage index, annual average, %		8.3 (8.3)	9.4 (8.7)	7.9 (7.8)	7.0 (5.8)	6.1
Purchasing power of wages, annual average, %		0.0 (0.0)	0.6 (0.2)	2.4 (1.5)	2.6 (1.0)	2.4
Unemployment, annual average, %		3.9 (3.9)	3.2 (3.6)	3.9 (3.6)	4.4 (3.6)	4.1
<b>Current account balance</b>		2022	2023	2024	2025	2026
Number of foreign travellers, thousand individuals		1,695 (1,695)	2,200 (2,100)	2,300 (2,300)	2,400 (2,500)	2,500
Goods and services balance, %GDP		-0.4 (-0.7)	1.3 (0.2)	0.3 (0.2)	0.3 (0.3)	0.4
Current account balance, %GDP		-2.0 (-1.5)	1.2 (-0.5)	0.2 (-0.5)	0.2 (-0.5)	0.3

Numbers in brackets are from Economic Research's April 2023 forecast

# Disclaimer

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