Macroeconomic forecast 2018-2020

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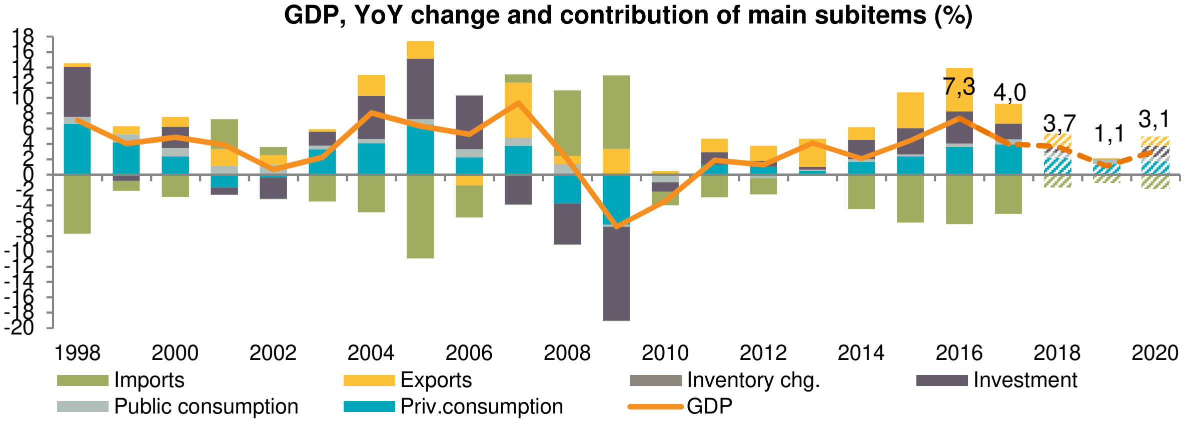
Executive summary

The current business cycle has proven more resilient than many expected. GDP growth averaged 4.4% per year in 2013-2017. The surge in tourism has played a major role in this, as have a number of other factors that have supported private consumption growth and investment.

Figures for the first nine months of 2018 show a continuation of this trend. Output growth measured 5.0% over the period, owing in particular to swift private consumption growth and a favourable contribution from net trade. Yet there are a number of signs of a marked slowdown in Q4, and we therefore project output growth for 2018 as a whole at 3.7%.

GDP, YoY change and contribution of main subitems (%)



Source: Statistics Iceland and ISB Research

The outlook is for much weaker growth in 2019. The drivers of the recent growth spurt will all be on sabbatical this year. Private consumption growth will be slow and services export growth muted, and business investment will contract year-on-year, according to our forecast, which provides for GDP growth of 1.1% in 2019.

The outlook is for growth to pick up again in 2020, soaring to 3.1%, buoyed up by livelier private consumption growth, a resumption of growth in business investment, and continued growth in other investment and in goods and services exports.

CA surplus through the end of the decade

The tourism industry is still growing, although the pace has eased considerably from the 2015-2016 peak, when growth in tourist arrivals measured 39% year-on-year.

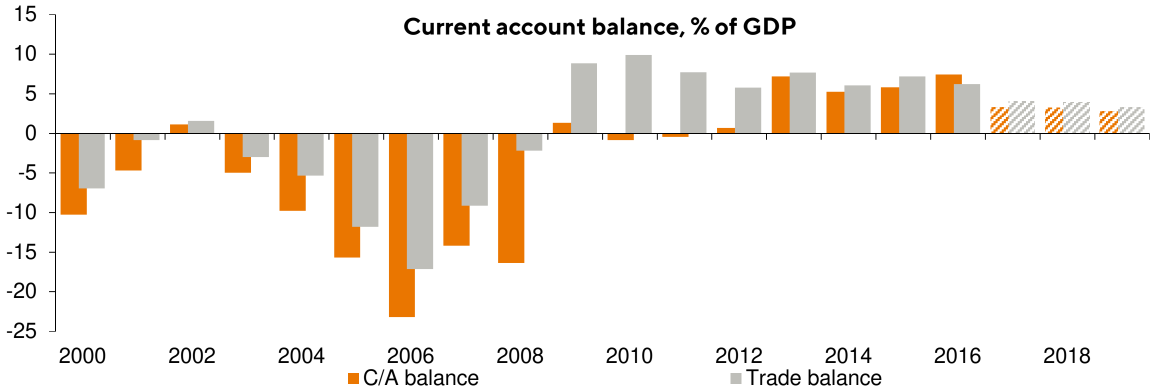
Last year was the first without an appreciation of the ISK since the tourism boom started. The ISK began to weaken last autumn, after appreciating for several years. As a result, Iceland is now a bit less expensive a destination than it was in mid-2018. The tourism sector shows signs of maturing, with increased emphasis on streamlining and mergers taking over from rapid growth and supply-side increases among many providers.

In our opinion, the sector is moving towards greater equilibrium, and this year will be a testing ground for its newfound maturity. We expect tourism to keep growing in the coming term, albeit quite a bit more slowly than it has to date.

We also expect growth in both imports and exports to be weaker in the next two years than it has been for most of the decade. We project export growth at 0.3% and import growth at 2.4% this year, followed by 2.5% and 4.4%, respectively, in 2020. The contribution from net trade will therefore be slightly negative in the coming term.

Services exports — tourism in particular — will continue to be the mainstay of export growth, in our opinion. For imports, however, the reverse applies, as goods imports will weigh heaviest, particularly once domestic demand kicks in again.

Iceland's current account balance has never been this favourable in the history of the Republic. The current decade stands out, featuring a persistent current account surplus paired with strong GDP growth and a rising real exchange rate. This situation is highly likely to continue, with these variables remaining more favourable they have been in recent decades.



Source: The Central Bank of Iceland and ISB Research

* 2009-2015: C/A balance excl. old banks

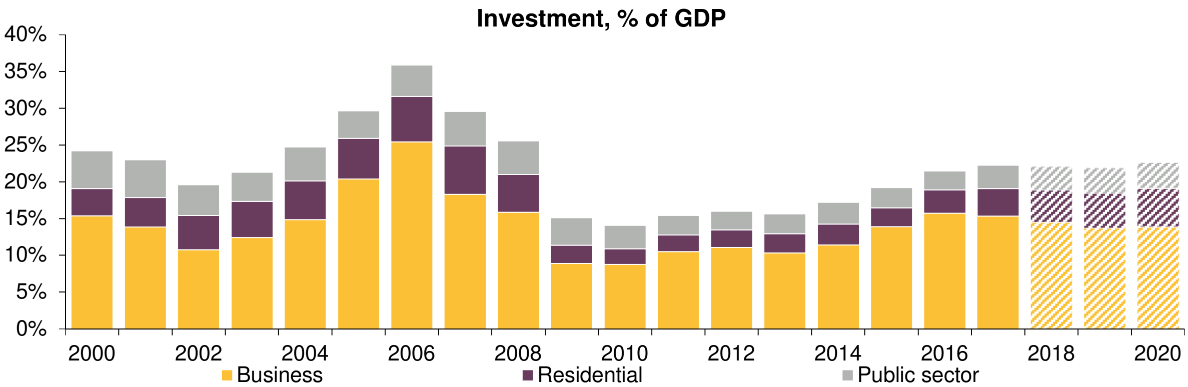
The outlook for the current account balance has improved somewhat since our September forecast. This is due in part to weaker-than-expected import growth in 2018, plus a continued improvement in Iceland's net international investment position (NIIP). If our forecast materialises, 2020 will be the ninth year in a row with a current account surplus.

The outlook is for the 2018 CA surplus to measure 3.2% of GDP. We forecast the surplus at 2.8% of GDP this year and 2.0% of GDP in 2020.

Iceland's NIIP will therefore continue to improve through the end of the decade, all else being equal. As of end-September 2018, external assets exceeded external liabilities by over 13% of GDP.

Surge in residential investment

Iceland's investment level rose substantially around the middle of the decade, after a period of limited investment in 2009-2013. This surge was driven to a large degree by business investment. The investment-to-GDP ratio was 22% in 2017, after bottoming out at just over 14% in 2010.



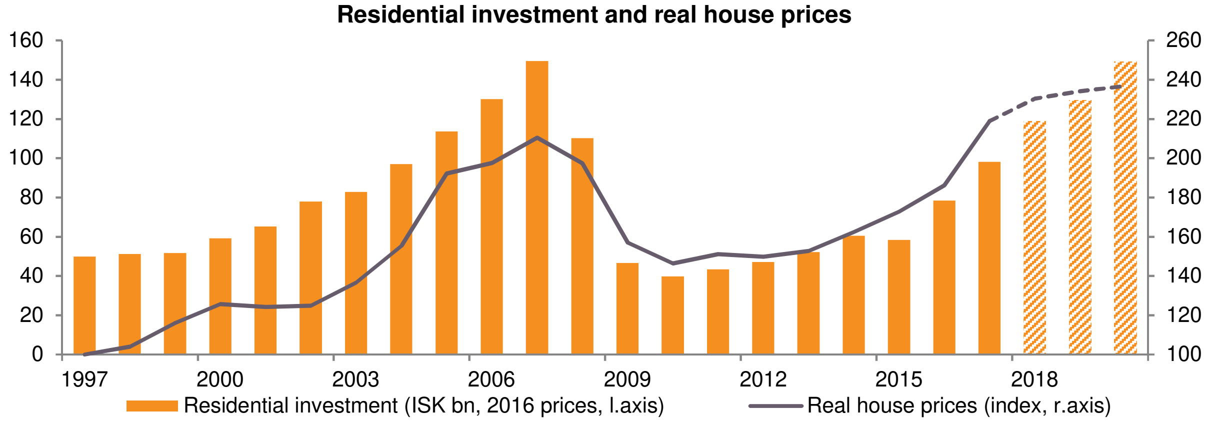
Source: Statistics Iceland and ISB Research

In the past few years, however, the main source of growth has shifted to residential and public investment. We estimate 2018 investment growth at 3.4% year-on-year in spite of the contraction in business investment, which was outweighed by the surge in residential investment.

Thereafter, we expect investment to contract slightly in 2019, as a continued contraction in business investment will offset growth in other types of investment. In 2020, however, all categories of investment will increase, delivering 6.7% growth in total investment that year.

The investment level will be just over a fifth of GDP in each year of the spread, and investment as a whole will therefore be robust in spite of the downturn in business investment.

The past year's handsome growth in residential investment is highly welcome, as the real estate market was affected for a time by strong demand and housing shortages. In 2017, real house prices rose substantially in excess of real wages, whereas on average, these two variables tend to grow at comparable rates.



Source: Statistics Iceland, Central bank of Iceland and ISB Research

House prices and real wages have developed much more in line with one another in the recent term, as the housing supply has increased steadily and demand has eased. The outlook is for a continued increase in the supply of new flats.

House prices rose by an average of 5.2% year-on-year in real terms in 2018. For this year, we forecast a 1.6% rise in real house prices, followed by 1.2% in 2020.

Weaker real wage growth, reduced population growth, and a continued increase in new housing construction will be the main drivers of this slowdown in house price inflation. It can be said that this reflects a calmer and better balanced housing market than we have seen in the past several years.

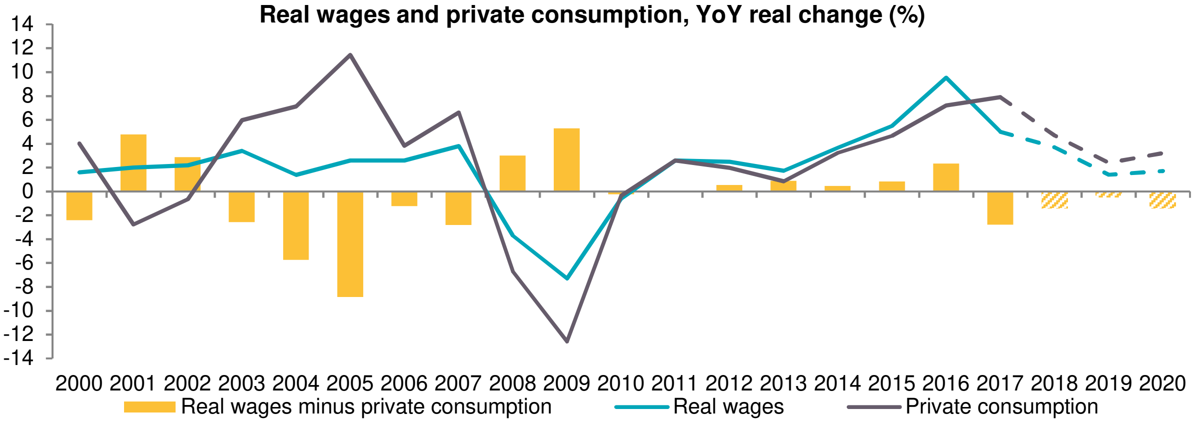
Household consumption growth eases

Private consumption has grown rapidly in recent years, fuelled by swift growth in real wages and population, a favourable employment situation, and overall optimism among consumers. In the recent past, however, private consumption growth has levelled off.

Developments in key indicators suggest a further slowdown ahead. The Gallup Consumer Confidence Index is at its lowest in five years, real wage growth has stalled, and payment card turnover in Q4/2018 was half that in Q1.

In our opinion, this is a clear sign that private consumption growth will turn out weak in Q4/2018, after measuring 5.4% for the first three quarters of the year.

The Icelandic labour market has been lively in recent years, with rapid wage rises and steadily declining unemployment. The tension in the labour market peaked in 2016-2017. In 2016, the wage index rose by 9.1%, and in 2017 unemployment bottomed out at 2.8%.



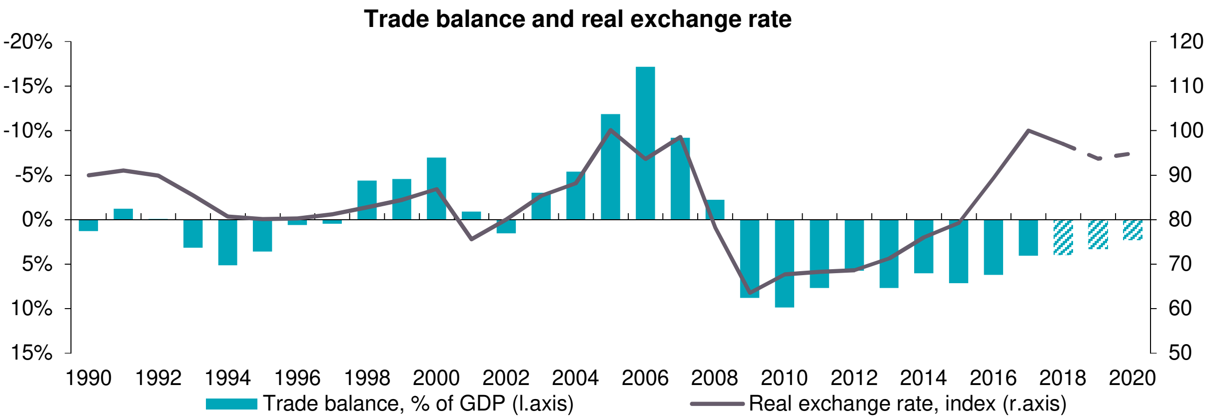
Source: Statistics Iceland and ISB Research forecast

The next few months will be a period of marked uncertainty in the labour market because of the wage agreements that expired at year-end 2018. Unemployment has inched upwards, and we expect it to continue rising marginally over the next few years. We also expect real wage growth to ease from the recent pace.

As a consequence, the outlook is for weaker private consumption further ahead, with private consumption growth estimated at 4.4% in 2018, followed by 2.7% in 2019 and 3.4% in 2020. This is below the recent pace, but new payment card turnover figures, the Consumer Confidence Index, and consumer goods imports support our projections.

ISK rests on stronger foundations

The ISK depreciated by nearly 7% in the last four months of 2018, after a twelve-month period of relative stability. In our opinion, this depreciation was a positive development, conducive to reducing the risk of growing external imbalances in the short term.



Source: Central Bank of Iceland and ISB Research forecast

We think there are various reasons to believe the real exchange rate will stay relatively high, however. The net asset position in the economy is at its best in decades, and the Central Bank (CBI) has large international reserves at its disposal if temporary capital flight should threaten to derail the exchange rate. If our forecast materialises, the current account will show a healthy surplus through the end of the decade.

In most senses, the economy stands on solid ground, and prospects for long-term growth are good. Foreign investors' interest in Iceland should therefore suffice to counterbalance the outflows from pension funds' foreign investments that are not financed through the current account surplus. All of this should keep the real exchange rate relatively high throughout the decade.

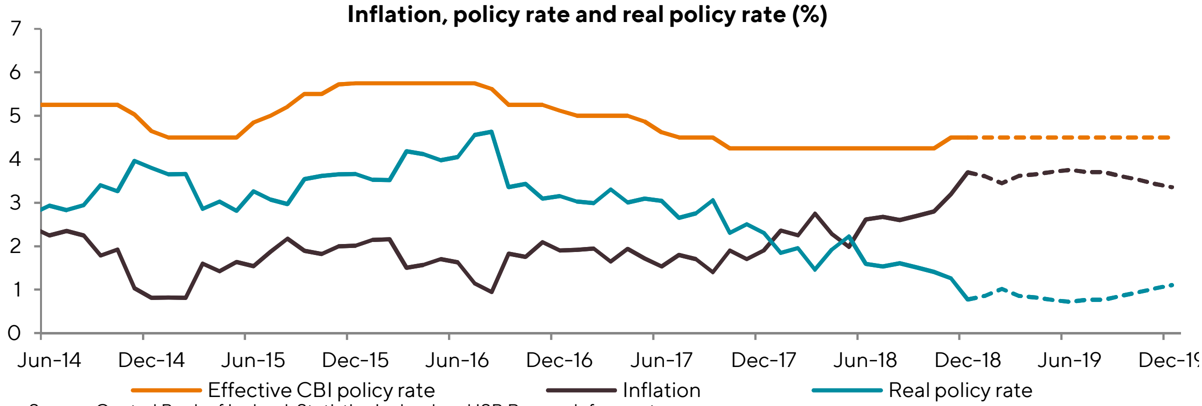
Inflation relatively high in the coming term

Inflation has moved steadily closer to the upper tolerance limit of the CBI's inflation target in the recent term. It measured 3.7% in 2018, its highest in five years. The composition of inflation has changed: inflationary pressures from house prices have eased, and a larger share of the CPI increase stems from imported goods, whose prices are pushed upwards by the weakening of the ISK.

The outlook is for inflation to remain relatively high in 2019, peaking in Q3 at 3.8% and then tapering off steadily. We expect it to measure 3.6% at the end of 2019 and to average 3.2% in 2020.

Our forecast is based on the assumption that wages and house prices will rise rather modestly and the ISK will remain relatively stable. The upcoming wage settlements are one of the principal uncertainties in the forecast. If wages rise more than we have projected, inflationary pressures could be stronger further ahead.

Inflation, policy rate and real policy rate (%)



Source: Central Bank of Iceland, Statistics Iceland and ISB Research forecast

The CBI's key interest rate was raised by 0.25% last November, after having been held unchanged for a year. The worsening inflation outlook and rising inflation expectations were the main reasons for the November rate hike. The bank's key rate is now 4.5%.

The real policy rate will remain low in the near future, as long as inflation stays broadly at the current level. Weaker growth in domestic demand and more stable inflation outlook and expectations should call for a low real rate, however, all else being equal. When inflation starts to subside again, it will go hand-in-hand with a need for a relatively higher real rate as GDP growth gains momentum.

Long-term interest rates in Iceland have fallen steadily in recent years. Long-term nominal rates are now around 5.4%, whereas long-term real rates as determined by Treasury bonds are roughly 1.5%.

We expect long-term nominal rates to fall again during the forecast horizon, whereas real rates will rise. We forecast that long-term nominal rates will be around 4.9% and real rates close to 1.7% by the end of the forecast horizon. As a result, the long-term breakeven inflation rate will decline over time.

Macroeconomic forecast

Volume changes (%)	2017 ISK m	2017	Est. 2018	Forecast 2019	Forecast 2020
Private consumption	1,315,669	7.9	4.4	2.7	3.4
Public consumption	613,559	3.7	3.1	2.6	2.4
Fixed capital formation	579,655	9.0	3.4	0.1	6.7
thereof industrial investment	400,821	4.8	-2.0	-4.3	4.2
thereof residential housing	98,031	18.4	21.3	9.0	15.0
thereof public investment	80,803	23.0	8.2	8.0	5.0
Changes in inventories	754	0.0	0.0	0.0	0.0
Total national expenditure	2,509,637	7.0	3.8	2.1	3.9
Exports of goods and services	1,206,292	5.5	3.6	0.3	2.5
thereof exports of marine products	197,251	-3.8	10.1	-3.1	0.4
thereof aluminium production	202,893	4.4	-1.5	0.8	0.8
thereof other goods exports	127,197	1.3	2.7	1.6	0.9
thereof service exports	675,783	8.8	3.8	1.0	4.0
Imports of goods and services	1,099,482	12.5	3.8	2.4	4.4
Gross domestic product	**2,616,447**	**4.0**	**3.7**	**1.1**	**3.1**
% of GDP					
Investment		22.2	22.8	23.1	23.8
Current account balance		3.3	3.2	2.8	2.0
Trade balance		4.1	3.9	3.3	2.2
Change in annual average (%)					
Consumption price		1.8	2.7	3.6	3.2
Wages		6.9	6.5	5.6	5.2
Housing prices		19.4	8.0	5.3	4.4
Average foreign currency exchange rate		-10.9	4.0	5.1	-0.1
Real ISK exchange rate		10.7	-3.0	-3.4	1.3
Purchasing power of wages		5.0	3.7	1.9	1.9
Annual average					
Unemployment (% of workforce)		2.8	3.0	3.2	3.4
ISK exchange rate index		160.3	166.7	175.2	175.0
Policy rate of the CBI (%)		4.6	4.3	4.5	4.5
Long term real interest rate (%)		2.2	1.8	1.5	1.7
Long term interest rate (%)		4.9	5.4	5.2	4.9

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