Our assessment of the Icelandic economy 2024/2025

Economic growth is moderating, but in European context Iceland is among the most resilient countries. We expect GDP growth to slow down from an estimated 3.5% in 2023E to below below-trend pace of 2.3% in 2024E.: Iceland's participation in the InvestEU program is positive, which should help sustain potential growth in between 2.5%-3% in the medium term via enhanced R&D efforts, better innovation, and support for all-important micro-SMEs.

Disinflation is a slow process ahead: We expect inflation to average 5.8% and 4.0% in 2024E and 2025E, above Sedlabanki's November forecast. High housing and wage growth kept headline inflation flat around 8%yoy in the 2H23. Bringing inflation back to the 2.5% target will be a long and arduous process that will require a protracted period of restrictive rates.

The central bank will stay hawkish in coming months, cutting towards the end of the year At the November meeting, the MPC resumed its hawkish bias, stating that another rate increase was due, if not for the uncertainty caused by the seismic activity in Reykjanes peninsula. The situation is still fluid, and the developments so far are not concerningly growth negative. If this remains the case, then the odds are alive for a February/March rate hike and a peak rate of up to 10.50% is still plausible, in our view. In any case, we do not expect a softer tone until the May meeting and the potential upside from the housing market will coerce the MPC to maintain a restrictive forward-looking real rate of 4% by the year-end. Looking ahead, we expect the policy rate down to 7.50% by the end of this year.

The current account is back to balance and the excesses of the 2008 crises have been addressed. The current account has returned a mild surplus in 3Q23E for the first time since 2020, on a 12M rolling basis, but remains far from the pre-pandemic norm of 5%-6% of GDP. Rising business investment needs and higher vehicle imports will prevent a return of such high surpluses in the near term.

Fiscal consolidation to support disinflation momentum: fiscal shortfall has credibly been reigned in with the deficit narrowing from 8.5% of GDP in 2021 to a targeted 1.3% of GDP in 2023 and 1.1% of GDP in 2024. The deficit is predominately financed domestically via pension funds with a massive balance sheet of 176% of GDP assets, holding nearly 41% of the debt stock. This is followed by other financial institutions and mutual and investment funds holding 16% of the debt stock, each. Despite being rated A-grade by the three main credit agencies, non-resident positioning in treasury's debt stock is at a meagre 7%, while that for private equity is 7% of GDP.

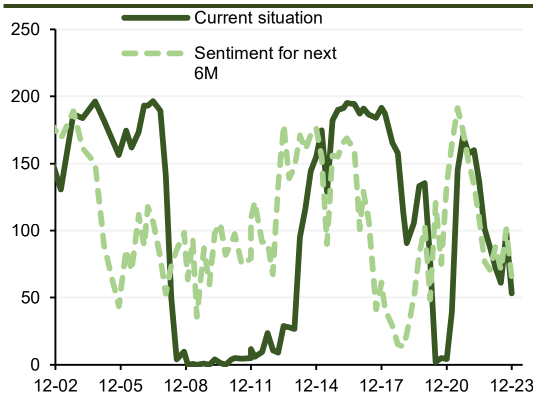
Adnan Asif

London 11th of January 2024

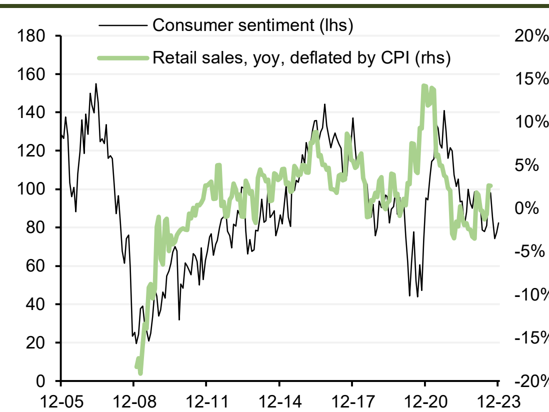
The economy: decelerating, but overall a soft landing

Incoming data for 4Q suggests that economic activity likely ended 2023 on a softer note, following the slowdown to 1.7%yoy in 3Q23E and 3.3%yoy in 2Q23E, in seasonally adjusted terms. Both survey-based and high-frequency data imply deterioration in domestic private spending. In terms of the former, business sentiment as of 4Q has receded to its lowest since 2013 (bar Covid), while consumer sentiment remains anaemic with waning demand for major purchases, despite the positive real wage growth (2%+ yoy). For the latter, domestic debit/credit spending deflated by inflation contracted in 4Q, in annual terms, while household deposits with banks increased at a brisk pace (16.5% yoy in November) implying weaker spending appetite. At the same time, bank lending to households more than halved to 4.1%yoy in November.

Business sentiment



Consumer sentiment



Source: Gallup via Sedlabanki, ADA Economics in association with WOOD Research

On the other hand, the labour market has stayed resilient in the face of the slowdown and a sharp monetary tightening cycle, with the unemployment rate contained at 3.9% as of December. However, there are increasing signs that cooling is taking place, with softening in employment growth and vacancies, and a reduction in the proportion of firms flagging labour shortage amidst the influx of migrants. More importantly, business insolvencies have also risen to the highest level since 2012, on a 12M rolling basis, with numbers specifically accentuated in sectors such as construction, accommodation and food, communication, and education. The total categories that have seen a surge last year constitute around 47% of the total employment.

Given these developments, we expect some loosening of the labour market this year. Moreover, analysis from Sedlabanki suggests that corporate profits may not have enough leeway to retain employment in the face of a sharp slowdown. The analysis finds that post-pandemic inflation surge was driven mainly by excess demand and less so by markups, as contribution of unit profits to inflation was broadly in line with the historic norm (excluding metal production and energy firms). This in turn supports the view that firms may not be able to hoard labour for long in the face of slowdown and especially in the presence of highly inflexible and unionised labour contracts.

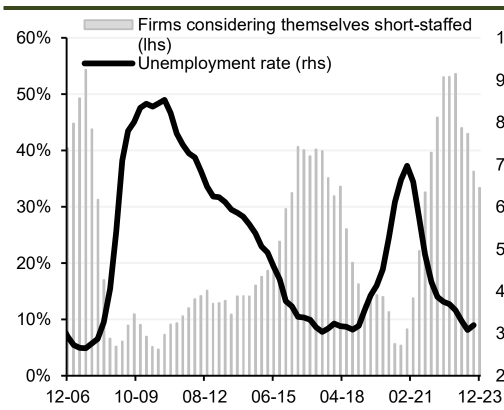
Having said that, we do not expect a meaningful rise in the unemployment rate as the backdrop for private spending is not so grim in the presence of positive real wage growth and resilient household balance sheets. Icelandic households have had less exposure to wealth erosion from inflation owing to their lower holdings of cash and deposits (30% of GDP as of 2022), as compared to that of the eurozone (75% of GDP as of 2022) where private spending remains subdued. In a broader context, pension funds' assets have become more diversified over the years, with 37% of total invested in foreign assets in 2023, vs. 21% in 2016-17, which should offer longer-term resilience.

Iceland

yoy % unless stated otherwise	2021	2022	ADA 2023E	ADA 2024E	Consensus 2023E	Cons. 2024E	Cons. 2025E
Real GDP	4.5	7.2	3.5	2.3	2.8	2.4	2.7
CPI	4.4	8.3	8.8	5.8	8.7	5.3	3.6
Unemployment rate, sa, % eop	4.2	3.6	3.2	4.5			
Current account % GDP	-3.0	-2.3	0.2	1.2	0.9	0.5	0.3
FDI % GDP (-ve = capital inflow)	-2.0	-3.8	-3.5	-3.5			
General gov budget balance % GDP	-8.5	-4.1	-2.7	-1.5	-4.9	-5.4	-3.8
General government debt % GDP	75.4	68.9	61.2	55.0			
Policy rate (7-day term deposit), % eop	2.00	6.00	9.25	7.50			
USD-ISK fair value, avg	126.50	135.40	137.20	148.50			

Source: Bloomberg, CEIC, IMF, ADA Economics in association with WOOD Research

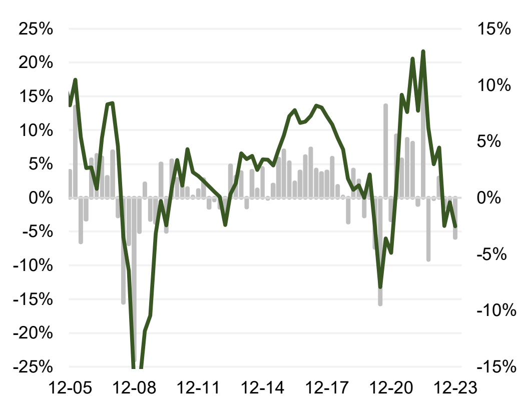
Unemployment rate and labour shortage



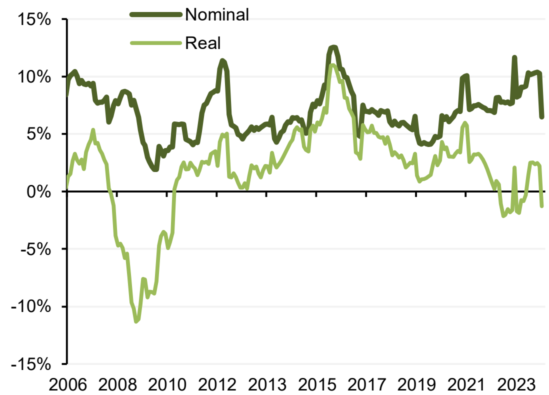
Active job postings

Source: CEIC, Sedlabanki, ADA Economics in association with WOOD Research

Deflated total household credit/debit card turnover*



Wage growth, yoy



*Source: Sedlabanki, ADA Economics in association with WOOD Research * Card issued in Iceland.*

Therefore, we think an unemployment rate of 5.0% will be the upper limit to which job losses could reach, above the level of 3.9% registered in 2023. A major downside risk stems from tourism if disruptions from seismic activity are prolonged, and/or major central banks including the Fed, ECB and BoE delay the start of the easing cycle to 2H24E or cut less than expected by the consensus. We expect growth to slow down below trend at 2.3% this year, from an estimated 3.5% in 2023E. Our projections are below Sedlabanki's November forecast of 3.7% for 2023E and 2.6% for 2025E.

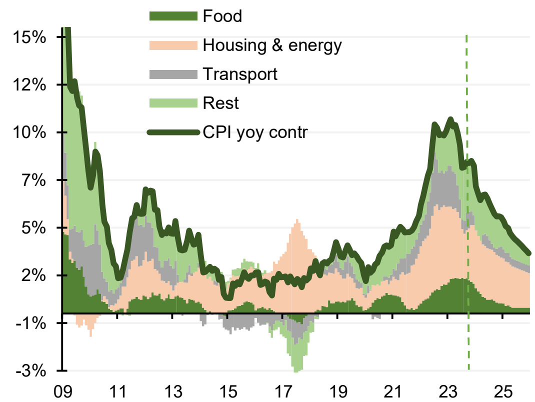
Inflation is on a moderation trajectory, but will not return to target any time soon.

Headline inflation eased to 6.7%yoy in January, having remained flat around 7.8%yoy in the second half. More than a third of the pricing pressures in December stemmed from the housing component comprising of rents (10.8%yoy or 3.0pp contribution), and one-fifth from each, food and private services. The path of inflation for this year will be determined by the magnitude of wage agreements and the dynamics of house prices, influencing headline inflation through rents. Regarding the former, the news flow on negotiations have been relatively favourable, with the labour market appearing loose compared to the time of negotiations last year. On the other hand, house prices have picked up to 4.7%yoy in January from the low point of 2%yoy in August and present the key upside risk to the inflation outlook.

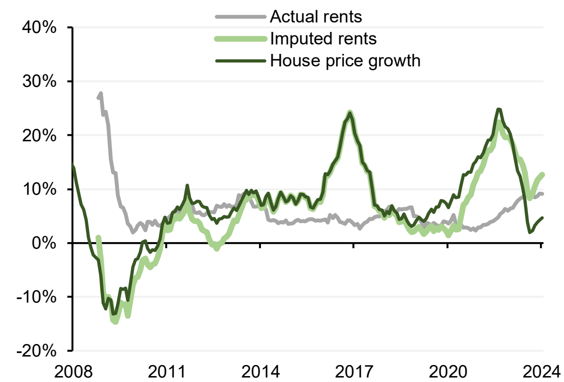
Housing demand remains supported by the availability of indexed loan mortgages priced well below the policy rate, the strong labour market, and the rising population. Nevertheless, the rising house price will be met with tighter borrower-based measures from the central bank, in our view.

Starting from January, price increases have been communicated for public and administrative services. These include higher taxes on alcohol, tobacco, fuel and a new tax on owners of electric vehicles. Charges for refuse collection have been raised, while bus fares in the capital have been raised by 11%. In terms of our forecast, we do not see inflation declining to the 2.5% target next year and expect it to end this year around 5.0%yoy (5.8% aop) and end-2025E at 3.5%yoy (4.0% aop). Our forecasts are higher as compared to Sedlabanki's November aop forecast of 5.7%yoy in 2024E and 3.6%yoy in 2025E.

Our inflation forecast



Housing inflation indicators



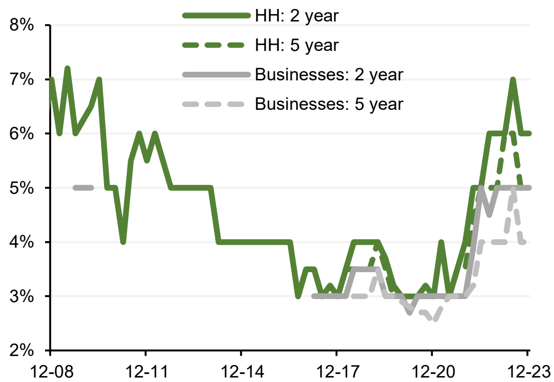
Source: Sedlabanki, ADA Economics in association with WOOD Research

Expect high interest rates to remain in place, though falling on a nominal basis by the end of 2024

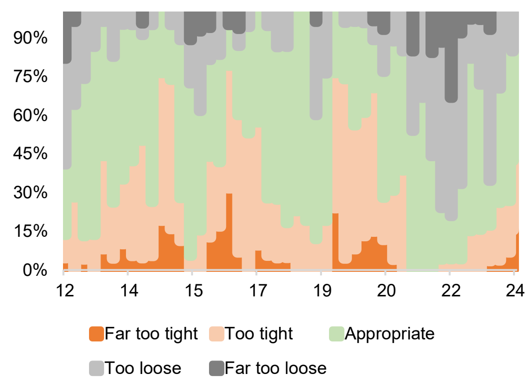
At its November meeting, the MPC held the policy rate unchanged at 9.25% but maintained a hawkish tone, mentioning that the Council would have hiked rates if not for the uncertainty caused by the seismic activity on the Reykjanes peninsula.

Sticky inflation expectations amongst businesses and households and renewed pickup in housing activity are concerning for the MPC. The seismic activity situation is dynamic, and additional eruptions are anticipated according to the Icelandic Met Office. However, the impact so far is not pro-inflationary as it could have been potentially more significant in case of crippling damage to critical infrastructure, affecting energy prices and raising fiscal spending.
The impact from earthquakes has neither been growth negative so far, and if this remains the case until February/March then we see a fair chance of further hikes up to 10.50%, as we previously anticipated. Conversely, prolonged disruption to tourism could put an end to the tightening cycle, but we see the risks biased in favour of additional tightening. In comparison, an increasing proportion of market participants find the current monetary stance as either appropriate (27%) or restrictive (21%), as per Sedlabanki's 1Q24 survey. For our base case, we expect the policy rate to be cut down to 7.50% by the end of this year, and to 6.00% by the end of 2025E.

Inflation expectations of households and businesses



Market expectations on the monetary stance

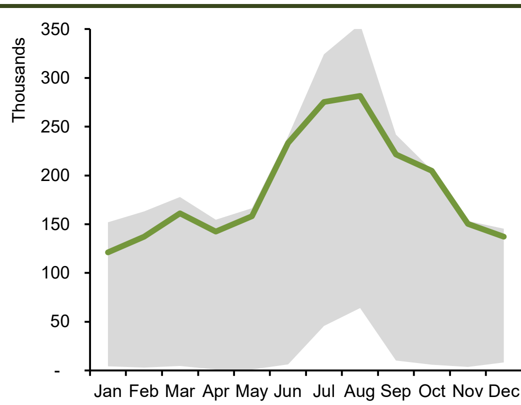


Source: Sedlabanki, ADA Economics in association with WOOD Research

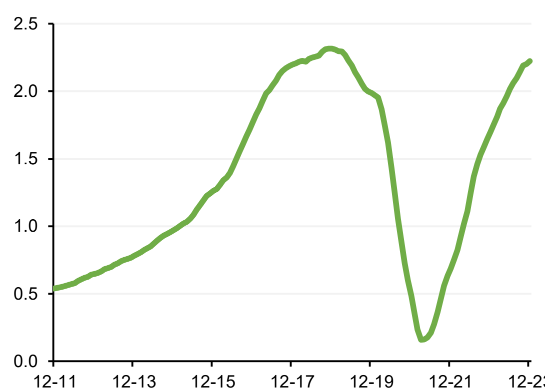
Improving current account will support the ISK

The current account has emerged back into surplus as of 3Q23 (0.2% of GDP), on a 12M rolling basis, recovering from a low of -3.2% of GDP in early 2022. Despite this, the surplus remains well below the average of 5.6% of GDP recorded before the pandemic (2014-2019) and is being restrained by the worsening of the goods deficit, led by imports of machinery and transport equipment. A large part of the deterioration has been countered by rapidly recovering services balance (aided by tourism recovery), having increased to 7.1% of GDP, on a 12M rolling basis, but below the peak of 11% of GDP recorded before the pandemic. Tourism ended the year on a strong note despite the earthquakes and volcanic eruptions in November/December as visitor arrivals via Keflavik Airport rose to 2.2mn in December, on a 12M rolling basis, which is 4% below the peak reached at the end of 2018. Press statements from the budget airline Play suggest a pickup in the initial days of January.

Visitors arrivals via Keflavik airport



Visitors arrivals mn persons, 12m rolling



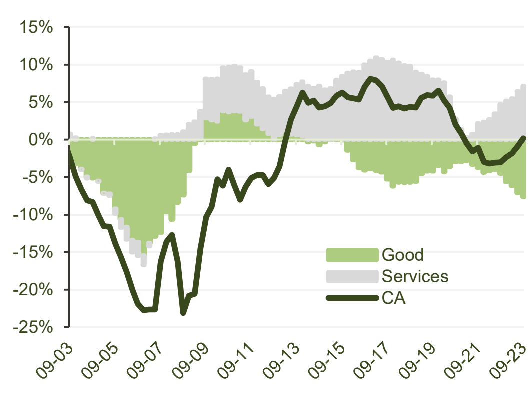
Source: Sedlabanki, ADA Economics in association with WOOD Research

On the funding side, FDI inflows have strengthened during the year and hovered around 3.7% of GDP, for the first time since 2016, on a 12M rolling basis. To the contrary, portfolio outflows have intensified to 10% of GDP as of 3Q23 and mainly represent the foreign asset accumulation by pension funds in line with the gradual increase in the statutory cap that allows for FX assets and is scheduled to rise to 65% of total assets in 2036 from roughly 50% in 2024. The magnitude of outflows should not be problematic since the flows are destined to reverse as payment of pension benefits becomes due.

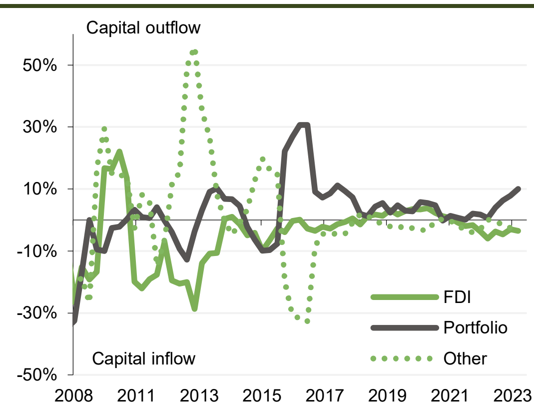
Official reserves with the Sedlabanki have dropped from 2021, but still stood ample in terms of import cover. Reserves stood at USD 5.7bn as of December, down from USD 7.3bn in 2021. On the other hand, imports cover expressed in terms of the past 12M of goods and services imports stood at 4.9 months as of November, above the international convention of 3 months. However, this was lower than the historical norm of 7-8 months seen before the pandemic.

Our USD/ISK suggests a mild weakening in the fair value this year to an average of 148.5 and 145.7 in 2025E.

Current account, 12mrs GDP

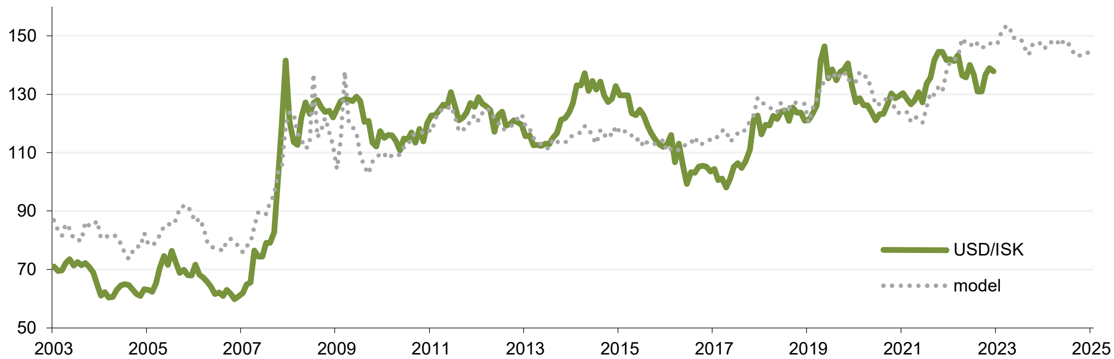


Financial account, 12mr GDP



Source: Sedlabanki, ADA Economics in association with WOOD Research

USD-ISK outlook based on a macro fair value model



Source: Sedlabanki, ADA Economics in association with WOOD Research

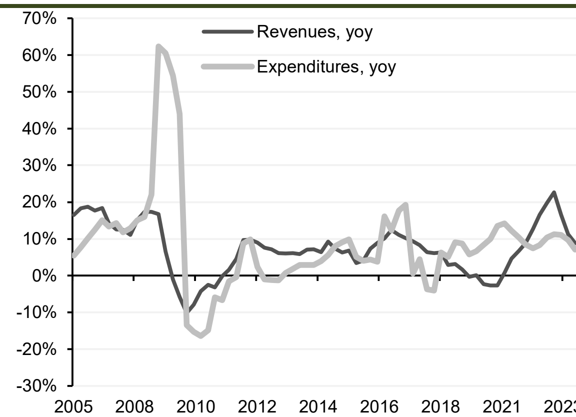
Fiscal consolidation supportive of the disinflationary process

The general government deficit narrowed to 3.7% of GDP in 3Q23, on a 12M rolling basis, from 4.2% of GDP in 2Q and the low of 9.2% of GDP back in 1Q21. The improvement was driven by a greater increase in revenues (8.8%yoy in 3Q23) over that of spending (7%yoy), on a 12M rolling basis. For 2024E, the government is aiming for consolidation to 1.1% of GDP (ISK 51bn) from 1.3% of GDP expected for this year, which should support the disinflation process. Much of the consolidation is sought from a reduction in spending (-1.3pp or 30.8% of GDP vs. 31.1% of GDP estimate for 2023), followed with higher revenues (+0.7pp or 29.8% of GDP). Despite the spending curbs, allocation for healthcare, education, R&D and for development of rental apartments have been increased, which is a positive for medium-term potential GDP.

Funding of the mild deficit will not be problematic and in any case, the treasury's cash in hand, held with the Sedlanbanki is more than the deficit: at ISK 82bn as of December, more than the planned deficit of ISK 51bn. Additionally, against the EUR 1.8bn FX debt due in the next years, the treasury is holding around EUR 1.3bn of FX deposits, which are also part of Sedlanbanki's FX reserves. With that said, diversification of the government's debt is skewed heavily inwards, with only meagre 7% of the stock being held by foreign investors.

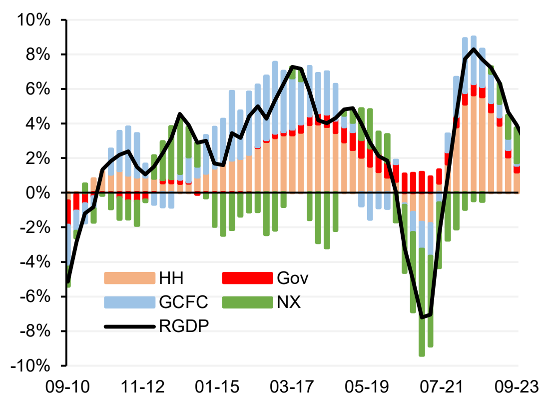
Budget deficit % GDP

Revenues and spending (12mr yoy)

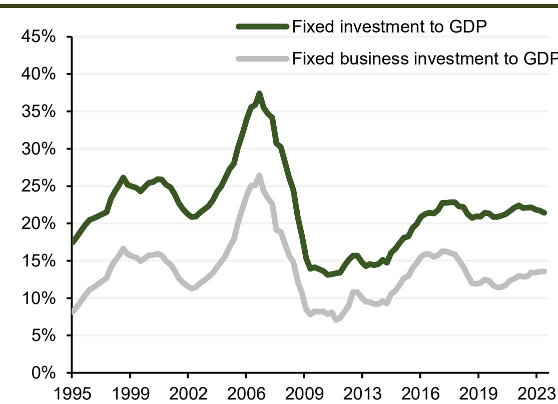


Source: Sedlabanki, ADA Economics in association with WOOD Research

GDP breakdown

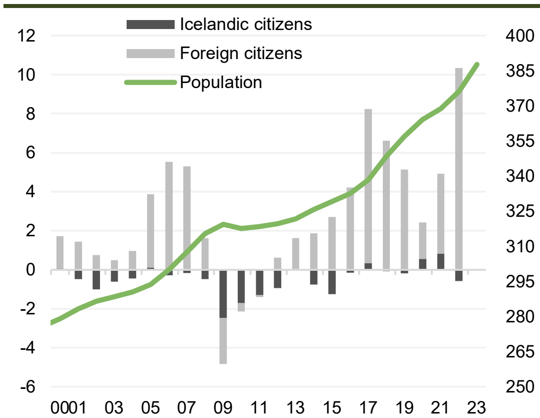


Investment rate

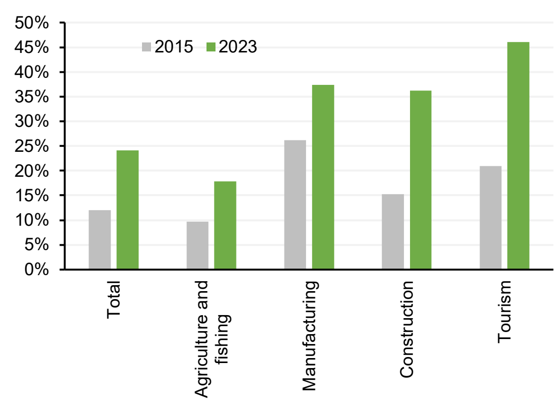


Source: Sedlabanki, ADA Economics in association with WOOD Research

Population changes

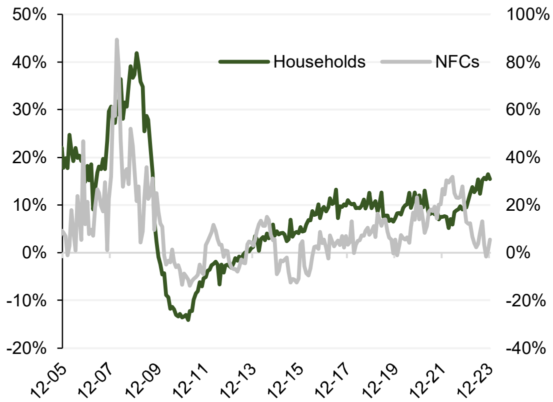


Share of foreign workers in employment

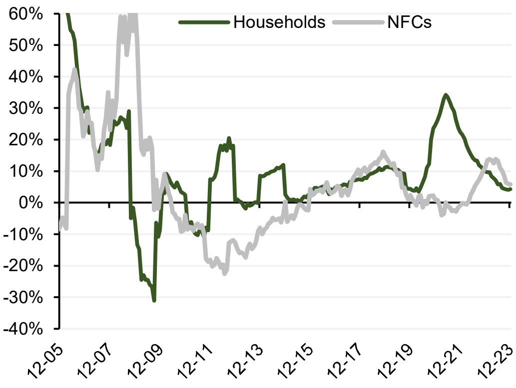


Source: Sedlabanki, ADA Economics in association with WOOD Research

Deposits, yoy growth

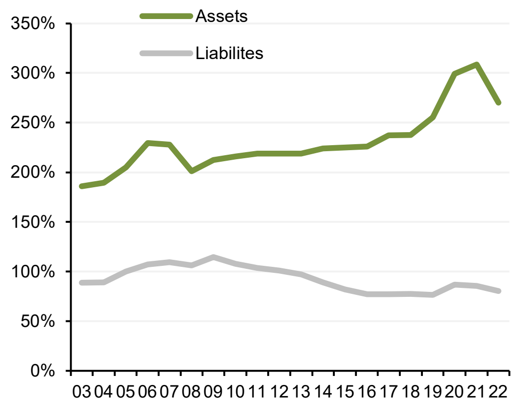


Loans yoy growth

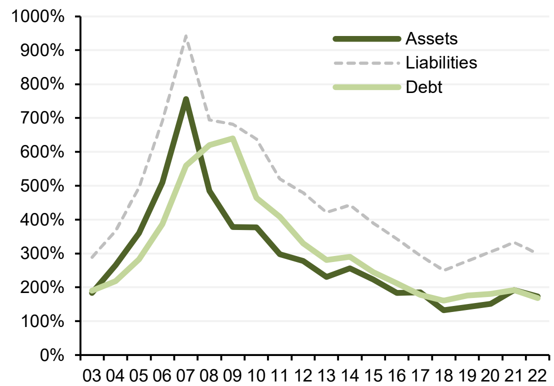


Source: Sedlabanki, ADA Economics in association with WOOD Research

Households balance sheets % GDP

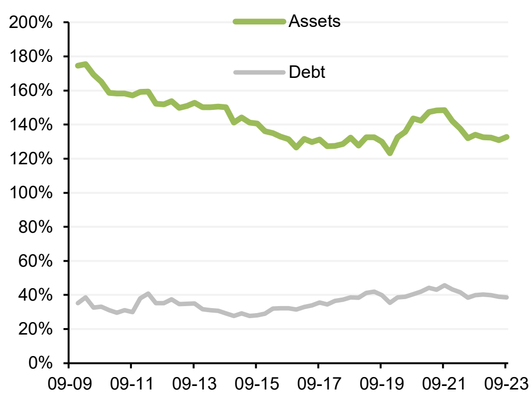


NFCs balance sheets % GDP

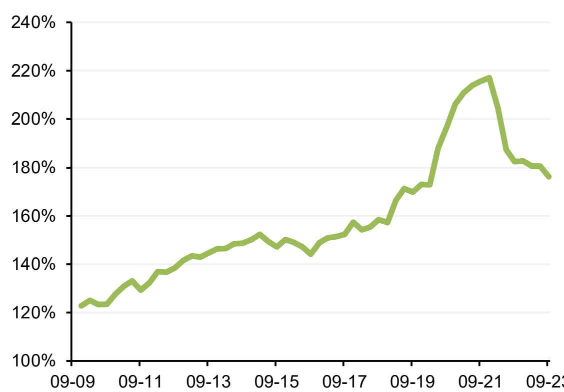


Source: Sedlabanki, ADA Economics in association with WOOD Research

Banks balance sheet % GDP



Pension funds balance sheet % of GDP



Source: Sedlabanki, ADA Economics in association with WOOD Research

Disclaimer

This report may provide information, commentary on and the discussion of issues relating to the state of the economy and the capital markets. All opinions, projections and estimates constitute the judgment of the author as of the date of the report and are subject to change without notice. ADA is under no obligation to update this report and readers should therefore assume that ADA will not update any fact, circumstance or opinion contained in this report.

The content of this report is provided for discussion purposes only. Any forward-looking statements or forecasts included in the content are based on assumptions derived from historical results and trends. Actual results may vary from any such statements or forecasts. No reliance should be placed on any such statements or forecasts when making any investment decision, and no investment decisions should be made based on the content of this report.

This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and particular needs of any specific person. Under no circumstances does any information represent a recommendation to buy or sell securities or any other asset, or otherwise constitute investment advice. Investors should seek financial advice regarding the appropriateness of investing in specific securities or financial instruments and implementing the investment strategies discussed or recommended in this report.

This report should not be regarded by recipients as a substitute for the exercise of their own judgment and readers are encouraged to seek independent, third-party research on any companies discussed or affected by this report.

Securities and other financial instruments discussed in this report are not insured and are not deposits or other obligations of any insured depository institution. Investments in general and, derivatives, in particular, involve numerous risks, including, among others, market risk, counter-party default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell, and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that the price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report. Investors in such securities and instruments effectively assume currency risk.

Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Individuals identified as economists in this report do not function as research analysts. Under U.S. law, reports prepared by them are not research reports under applicable U.S. rules and regulations.

In accordance with rules established by the U.K. Financial Services Authority, macroeconomic analysis is NOT considered investment research.

Materials prepared by ADA research personnel are based on public information. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of ADA.

Our contact details

Our office address is:

16 Berkeley street, London W1J 8DZ

United Kingdom Registration number: 9707197

You can reach us also in the following way:

For sales: Sabrina.Freeman@adaeconomics.com

By phone: +44 (0)203 3907 4216