Trip notes

We visited Reykjavik at the beginning of March, we came back positively impressed. I have travelled to Iceland since 2006 when I first started following the macro developments of Iceland for Dresdner Kleinwort. I have thus followed closely the country and its banking sector during the bull times, the bust, the capital controls and the recent years of a renewed growth profile.

My recent visit strengthened my positive assessment that had emerged in the data since 2022. Iceland has strongly corrected the imbalances that had led to the 2008 bust and has made a leap forward in terms of diversification of growth model, while still showing the signs of a country that is emerging from a crisis and therefore still pays too much of a premium due to a lack of foreign trust and low foreign participation.

The ideal European candidate to show the power of human capital in the age of digitalisation. The strongest fundamental factor that makes Iceland stand out today in my view is that it is the European country that best embraces the benefits of strong human capital and the digital transformation. Digital technology is allowing a productivity upside to leverage a highly educated and very entrepreneurial country. The first unicorn company in Iceland was Kerecis, acquired by Coloplast for USD1.3bn last summer. More are likely to emerge going forward.

Foreign positioning in local equities and local bonds is just beginning to normalise Iceland introduced capital controls in 2008 when the banking sector had to be rescued and began to lift restrictions in 2015 completing the process in 2021. This means that Iceland can be seen as in its "early stages" of full recovery for financial markets post the last crisis and we should expect that given high bond yields and gradually improving liquidity and stock listings in the local stock market, foreign positioning will rise with time.

Very high population growth makes Iceland in a different trajectory to any EU country Iceland has a small population:387 thousands as of 2023, but rising at an accelerating pace: up by 3% last year and up on average by 1.8% a year in the last decade thanks to higher fertility than in the EU and immigration.

The economy is modestly decelerating, but plenty of business action will keep growth positive and well above the eurozone average. The local expectation is that real GDP will decelerate just under 2% this year and a mild rise in the unemployment rate will contribute to lower inflation and lower interest rates. We found that local's forecasts align with our assessment, though we see plausible outperformance in terms of real GDP growth.

Raffaella Tenconi

London 13th March 2024

The growth model of Iceland: how it has evolved over time

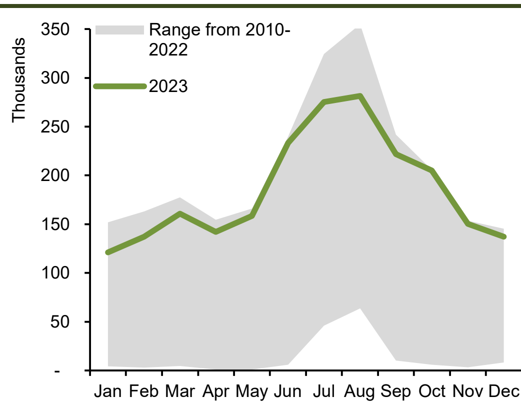
To understand Iceland, it is important to understand the evolution of its growth model, which contrary to other developed economies is capable of quite radical shifts within a decade.

Back in 2006 when I started travelling to Iceland regularly, the growth model of Iceland had recently been pivoting. Iceland in the 1970s was a very closed economy, hugely dependent on fishing where it had a clear competitive advantage, but was also bearing the costs of what was then a inhospitable land with little agriculture. In 1994, Iceland entered EFTA which allowed for a reduction of trade tariffs. Over time, technology was beginning to allow for some agricultural expansion, but by and large in the 2000s Iceland was still importing a huge variety of goods as a necessity.

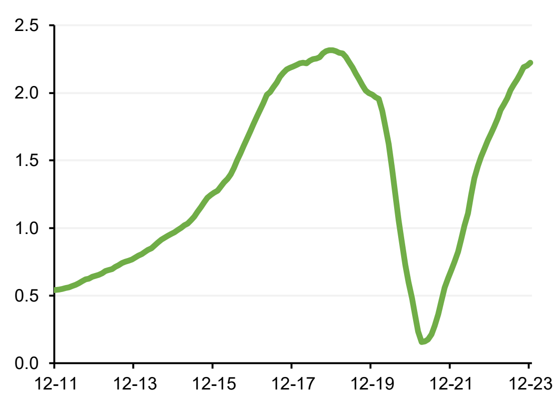
In early 2000, aluminium smelters began to operate in Iceland, supported by cheap energy prices. As a result, by 2006, Iceland was a highly open economy, exporting primarily two commodities with fairly inelastic production capacity (fish and aluminium both exhibited quite high volatility in price and less flexibility in production) with a banking sector that was in full expansion mode.

Three critical elements were responsible for the 2008 bust: banks were allowed to growth too much relative to the GDP of the country and what macro prudential rules dictate today (Iceland was not alone in this, but had the biggest imbalance between banks and GDP), the growth model of the country was too concentrated and, as it happens in countries that experience a first credit bubble, the institutional set up was not equipped to match the changes that were taking place.

Visitors arrivals via Keflavik airport



Visitors arrivals mn persons, 12m rolling

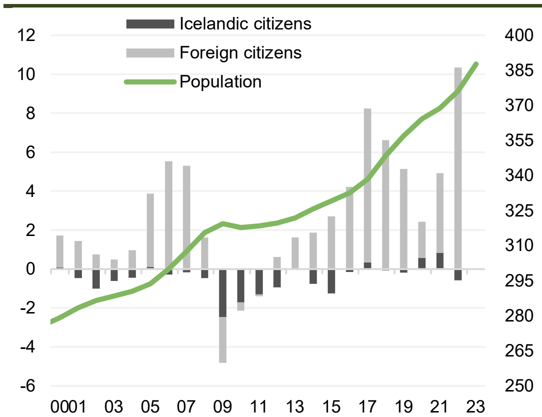


Source: Sedlabanki, ADA Economics

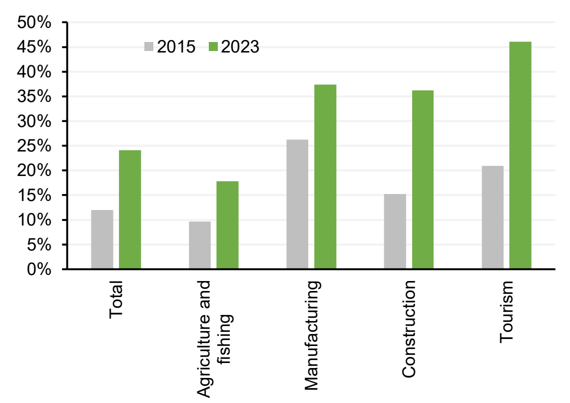
Fast forward to today: as a by product of the 2008 crisis, Iceland developed a big tourism industry which has high positive multipliers for GDP and is an industry that is price sensitive: thus exports adjust to fluctuations in the currency in a way that aluminium and fishing cannot, which anchors the current account better than before. Secondly, institutions and society learned from the gaps in 2008 and, together with a more complex European regulatory system, the balance sheets of Iceland today – public and private – are robust. Thirdly, thanks to the high education level, a highly democratic set up that supports creative endeavour, and the digital technology revolution that every country is experiencing these days, Iceland is developing new business opportunities that have better odds of becoming globally relevant in a way that was not there before.

Examples of the areas where Icelandic entrepreneurs are operating, which are aligned with global trends: healthcare research, carbon capture, sustainable fishing production, exploration of Nordic resources, women financial empowerment and sustainable tourism.

Population changes



Share of foreign workers in employment



Source: Sedlabanki, ADA Economics in association with WOOD Research

Balance sheets and monetary transmission channel

The current account stood at 1 % of GDP in 2023, reflecting an almost perfect balance between a trade deficit of 6.8% of GDP and a services surplus of 6.7% of GDP. The income balance, which is the third pillar of the current account, swings from mild deficit to mild surplus depending on remittances and occasional large foreign transactions. The current account last year improved relative to a deficit of 1.7% of GDP in 2022 and a deficit of 2.7% of GDP in 2021.

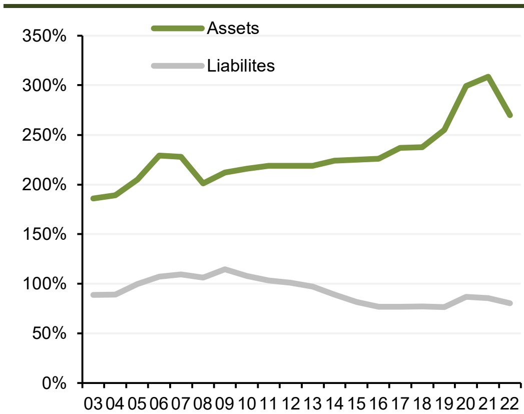
The international investment position of Iceland is currently in a positive balance of 37.7% of GDP as of 2023. The international investment position is a fairly obscure, but effective, indicator to see if a country has been accumulating debt or assets over time. To give you a sense of how other developed countries look today: the US IIP is currently in a deficit of 65.8% of GDP as of Q3 2023, Germany has a surplus of 68% of GDP surplus, France holds a deficit of 28.1% of GDP, Spain a deficit of 53% of GDP and Italy holds a surplus of 6.1% of GDP. IIP is particularly important for Iceland because it is a robust signal that there is no serious excessive leverage in the country at the moment.

The central bank of Iceland is Sedlabanki. The monetary policy is decided by a majority vote in a five members Council, which aims to target inflation on average as close as possible to 2.5% on a 12m moving average basis. The main policy rate is currently at 9.25%, within a corridor with the upper bound at 11% for the overnight CBI rate and a lower bound of 9.00% for the current account rate.

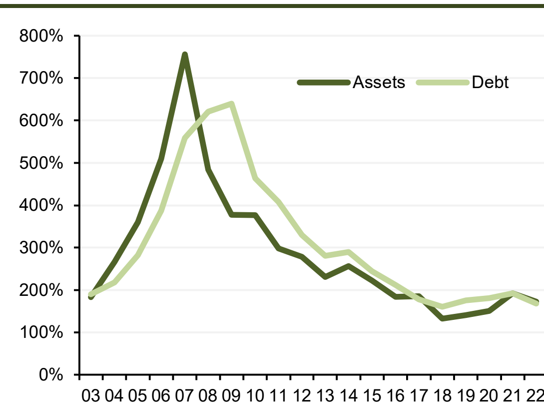
Icelandic inflation is historically more volatile and higher than in the eurozone or the US. This is partly a by product of the small size and high growth, but it also reflects the construction of the basket: inflation includes the real estate market, similarly to the US CPI but very different from the eurozone index or the UK CPI index (the old HICP index instead included housing inflation).

In the 1970s, Iceland began using lending rates in real terms and until the previous business cycle, most people borrowed in real terms, the state issued often in CPI linked bonds and wage contracts were highly regulated and followed inflation. Today real interest rate borrowing continues to exist and at the moment it is slightly accelerating in demand. However, society overall appears to me to be moving away from it, which in my view is a desirable change and also a catalyst for more sustainable growth. Wage bargaining remains an important feature of Iceland, but the latest round of agreements concluded in March showed significant restrain: average increases of 3.25% in 2024 (with a higher 5.9% for low incomes) and 3.5% in the subsequent two years, while inflation still stand today at 6.6%yoy. Compared with Germany, which is the only other country in Europe that continue to have a highly regulated labour market, it appears to me that redundancies are not difficult in Iceland: companies can and do adjust their labour force as needed, while in Germany redundancies are very long and expensive, which is currently a constraint on the competitiveness of the economy.

Households balance sheets % GDP



NFCs balance sheets % GDP



Source: Sedlabanki, ADA Economics

The latest projections published by Sedlabanki in February 2024 forecast real GDP growth at 1.9% in 2024, down from 3.6% in 2023 (this is a preliminary estimate) and at 2.9% in 2025. Inflation is forecast to ease from 6.6%yoy in February to an average of 4.1% in Q4 this year and 3.2% in Q4 2025.

Iceland macro projections

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, avg	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			

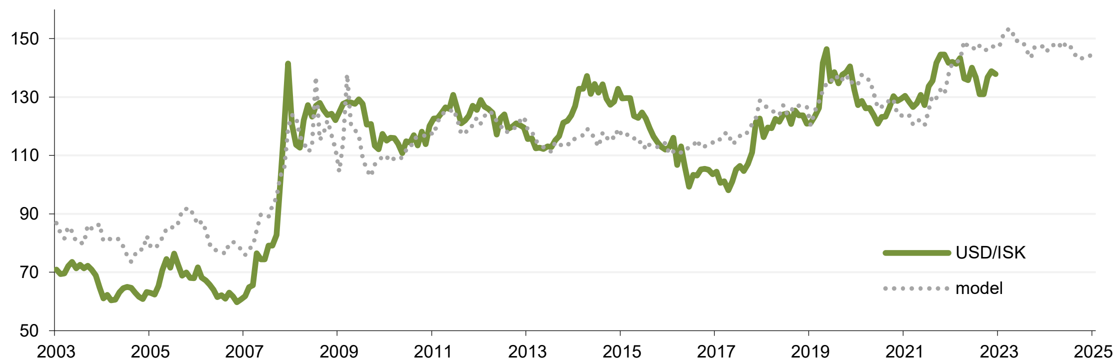
Source: This is a reprint of our projections released on the 11th of January 2024. Note that the BoP data was just released for 2023 and shows a 1% of GDP surplus last year

ISK is outperforming our fair value model

We have created a fair value model for the ISK akin to what we use for the other countries we monitor: it it is a model built to represent the macro picture and therefore does not predict the changes in market sentiment. The model is so far correctly indicating a sideways direction for the currency, but spot is proving stronger than its fair value: currently at ISK 135 to the USD, while fair value is at ISK148/ USD. Fair value estimates are not meant to be used always as a trading forecast. In this case, as we observe growing foreign participation in the local bond market and the tourism season is beginning, the currency should be stronger than its fair value. Fair value in this case is guidance on whether there is a fundamental misalignment between the strength of the economy and the currency.

According to the data released by the Ministry of Finance, foreign bond ownership of local bonds stands at 9.8% of total issuance as of February. Positioning in non indexed bonds has risen to 14% of nominal bonds as of February, up from 10.2% three months ago and 8.8% a year ago (you can find the full release here https://www.lanamal.is/asset/13536/market-information_march-2024.pdf). Accessibility of local bonds at the moment is a little impaired for foreigners, but there is a gradual normalisation process in place.

USD-ISK outlook based on a macro fair value model



Source: Sedlabanki, ADA Economics This is a reprint of the chart released on the 11th of January 2024

Catalysts that are interesting to monitor going forward

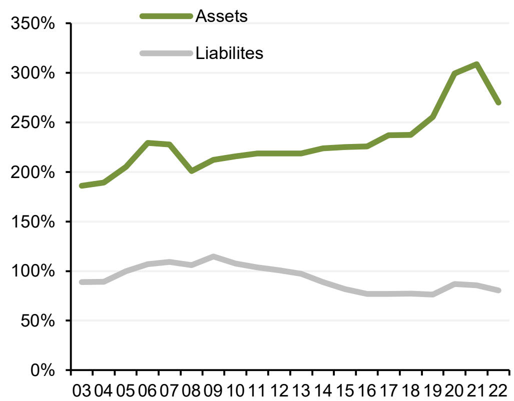
These are the things that we see as interesting stories unfolding in the background that should contribute to local growth and financial asset repricing up as a trend going forward.

1) The state has not completed the process of divestment from the banking sector, one more bank Landsbankinn is likely to be sold in the next year

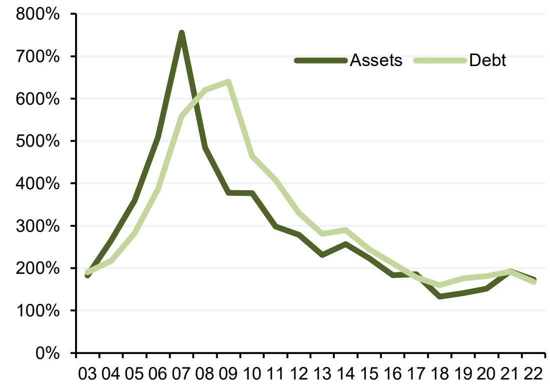
2) Iceland is currently in the secondary emerging market status for FTSE and frontier for MSCI where liquidity and the number of large stocks are key constrains. We understand that this process will meaningfully ameliorate in the next two to three years. Up to 10 companies have mentioned the intention to IPO in the future, which is likely to broaden the local equity market beyond what it was even it its best years during the previous cycle.

3) A new trade agreement was signed with India and 4 EFTA countries and Iceland is among the participating countries in the deal, together with Switzerland, Norway and Liechtenstein. This block of countries completed the trade negotiations with India before the EU, which is also soon due to announce a new trade deal. Iceland

Households balance sheets % GDP

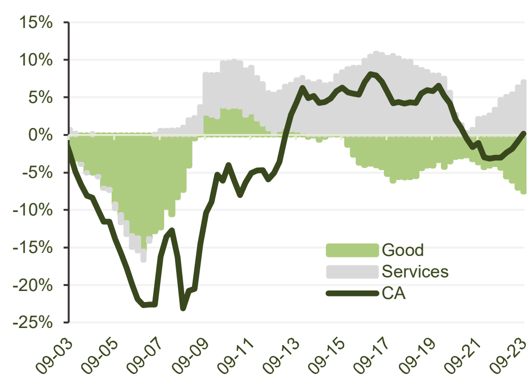


NFCs balance sheets % GDP

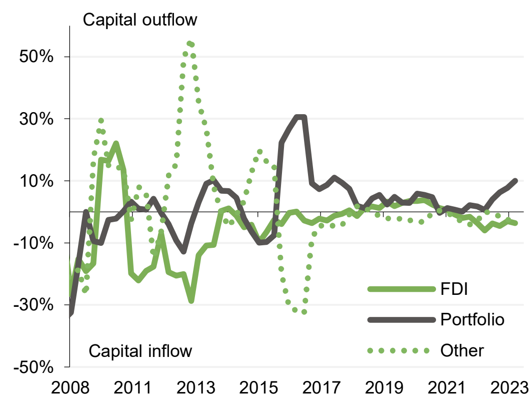


Source: Sedlabanki, ADA Economics in association with WOOD Research

Current account, 12mrs GDP



Financial account, 12mr GDP



Source: Sedlabanki, ADA Economics in association with WOOD Research

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