

Economic Outlook 2020-2023:

Every storm runs out of rain



Summary

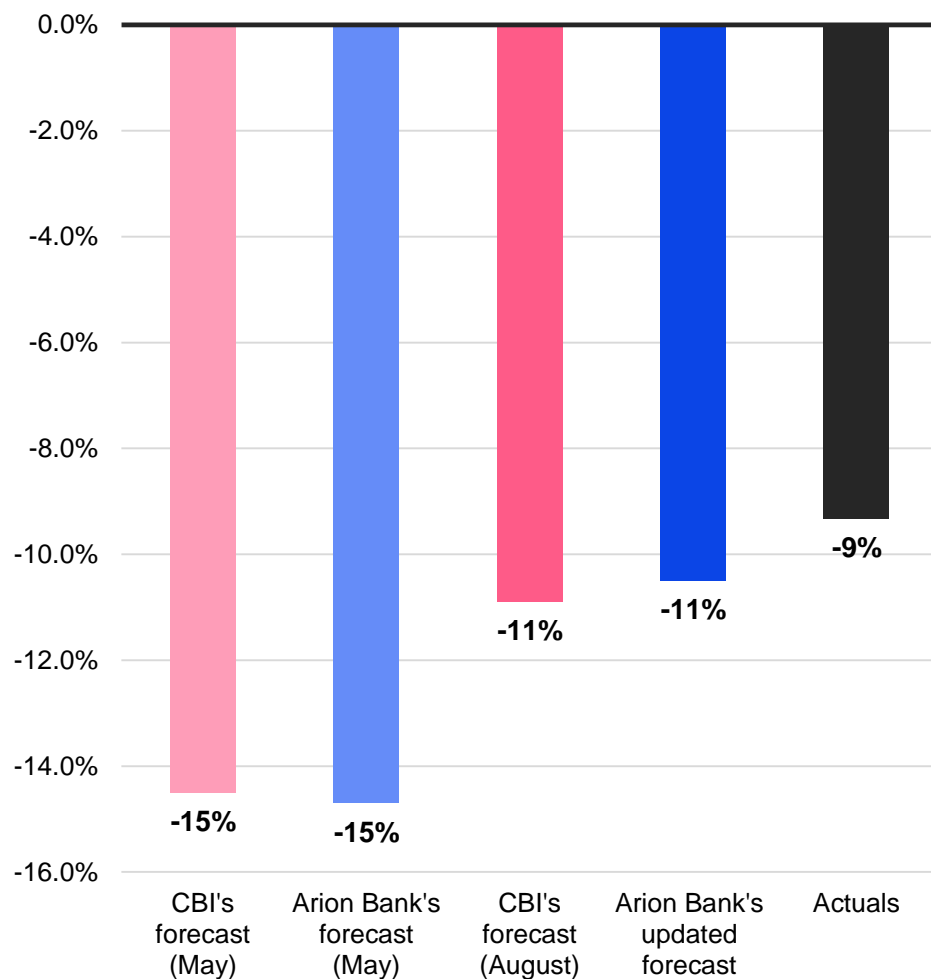
- **Arion Bank forecasts a 7.5% drop in GDP in 2020.** The economic outlook for this winter has deteriorated over the last few weeks and **the contraction seems set to extend into the first quarter of next year.** The economic recovery will therefore begin slowly **but gather momentum in 2022 and 2023.**
- **Arion Bank's tourist arrival forecast assumes that the winter season is as good as gone** and that the total number of tourists in **2021 will be approximately 800,000.** Although Iceland's main export sectors are facing an uphill struggle, **other exports have flourished.**
- The bleaker economic outlook for the coming winter is reflected in the unemployment forecast. **Unemployment is expected to continue to rise and will average 8.3% next year.** It looks like companies are going to have to take on a **5-6% nominal wage increase a year to the end of the forecast period.**
- **Arion Bank forecasts a 4.2% drop in private consumption this year.** Although unemployment is higher now than during the financial crisis, **it appears that private consumption will contract less as most people who keep their jobs are set to receive a real wage increase.** Higher property prices and lower interest rates also serve to buoy private consumption.
- The forecast assumes that the drop in trips abroad by Icelanders is similar to the decrease in tourist arrivals to Iceland. This assumption is reflected in the massive decline in imports this year. **As a result of this, and other factors, the current account surplus is expected to prevail this year and next but will decrease substantially.**
- **The composition of the current account surplus provides the Icelandic króna (ISK) with little support, however.** The flow on the foreign exchange market hasn't supported the ISK, **even though the Central Bank is actively intervening.** Other buyers of ISK appear to be lacking **and it is therefore likely that there will continue to be depreciation pressure on the ISK.** The flow could turn around quickly however when **the economic outlook becomes brighter.**
- **Housing prices are expected to continue to rise but the rate of increase will slow over the course of next year.**
- Rising housing prices and a weaker ISK will **nudge inflation above the upper tolerance limits (4%) but only temporarily as inflation is expected to drop below inflation target in 2022.** Therefore the spike in inflation **doesn't call for interest rate changes.** Interest rates could increase in mid-2022, however, as the output gap decreases.
- **Business investment is expected to shrink** this year despite historically low interest rates. Financing costs have risen despite the cut in policy interest rates and the promise of quantitative easing. This could slow down the upturn in investment.
- **This economic forecast assumes that the impact of COVID-19 on the global economy will start to diminish significantly in the second half of next year.** If this happens sooner or later than assumed, the forecast will shift accordingly.



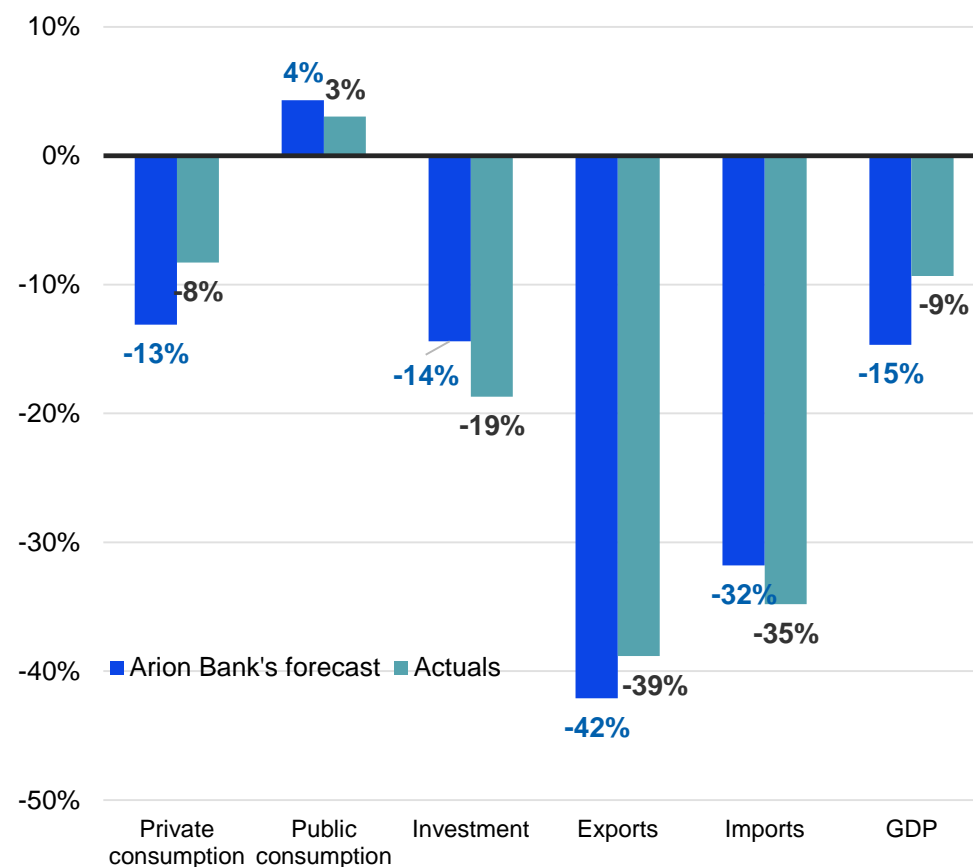
9.3% contraction in Q2: ugly beautiful

In the middle of the COVID-19 storm this spring analysts were nervous about the economic figures for the second quarter, when social distancing measures were at their strictest, the tourism industry paralyzed, and unemployment was at a historic high. As it turned out, analysts were overly pessimistic and the contraction in Q2 was significantly lower than initial forecasts, something mainly attributable to the fact that private consumption surpassed all expectations.

GDP contraction in Q2 – forecast and actuals

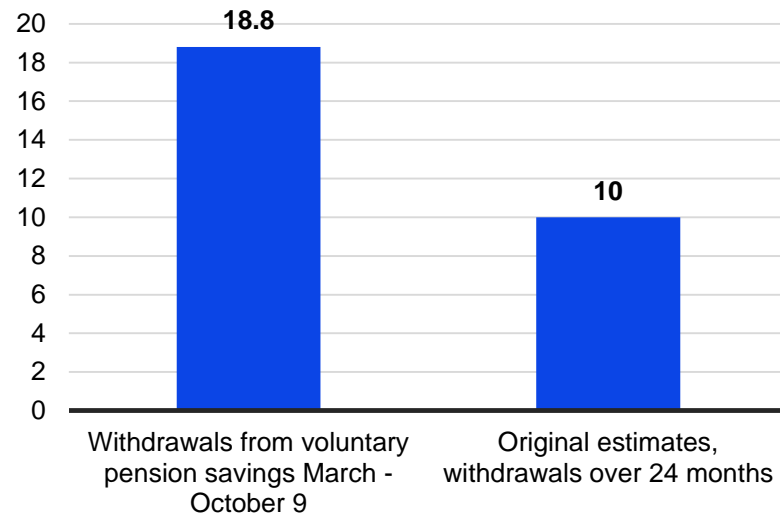


GDP and subcomponents in Q2 2020

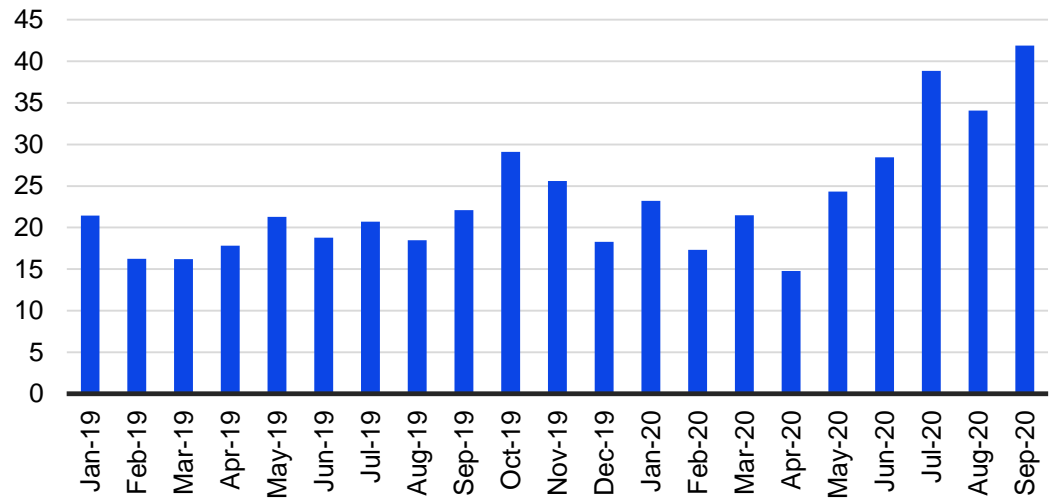


Four factors that have buoyed domestic demand (and most will continue to do so)

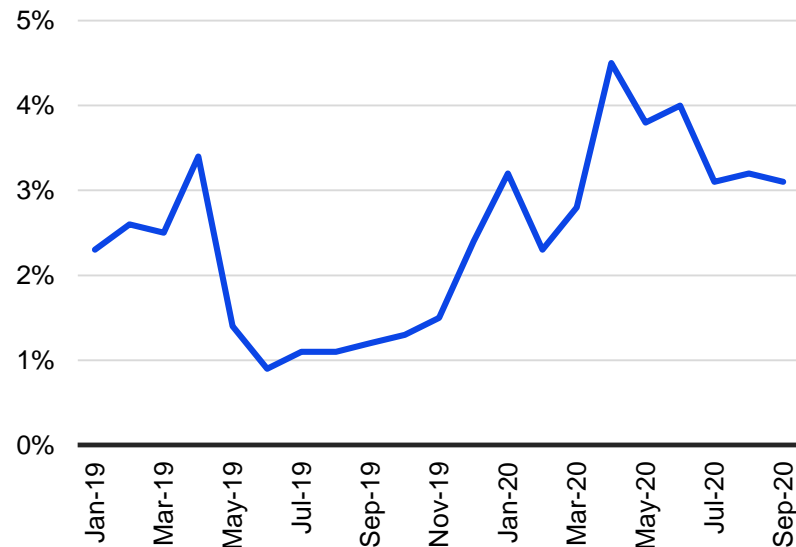
Withdrawals from voluntary pension savings – bn. ISK



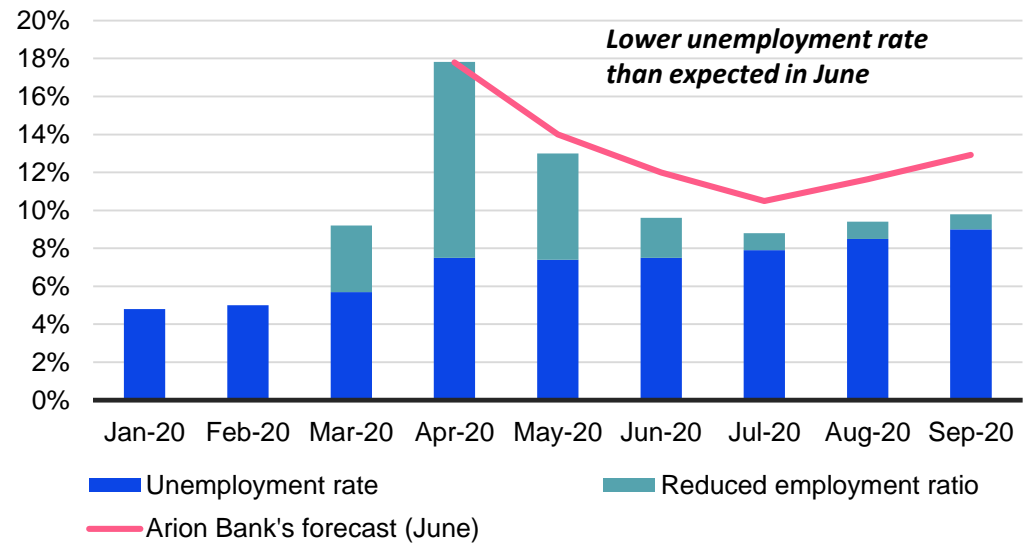
Banking system's and pension fund's net new lending to households – bn. ISK at nominal value, less prepayments and excess payments



Real wages – YoY %-change



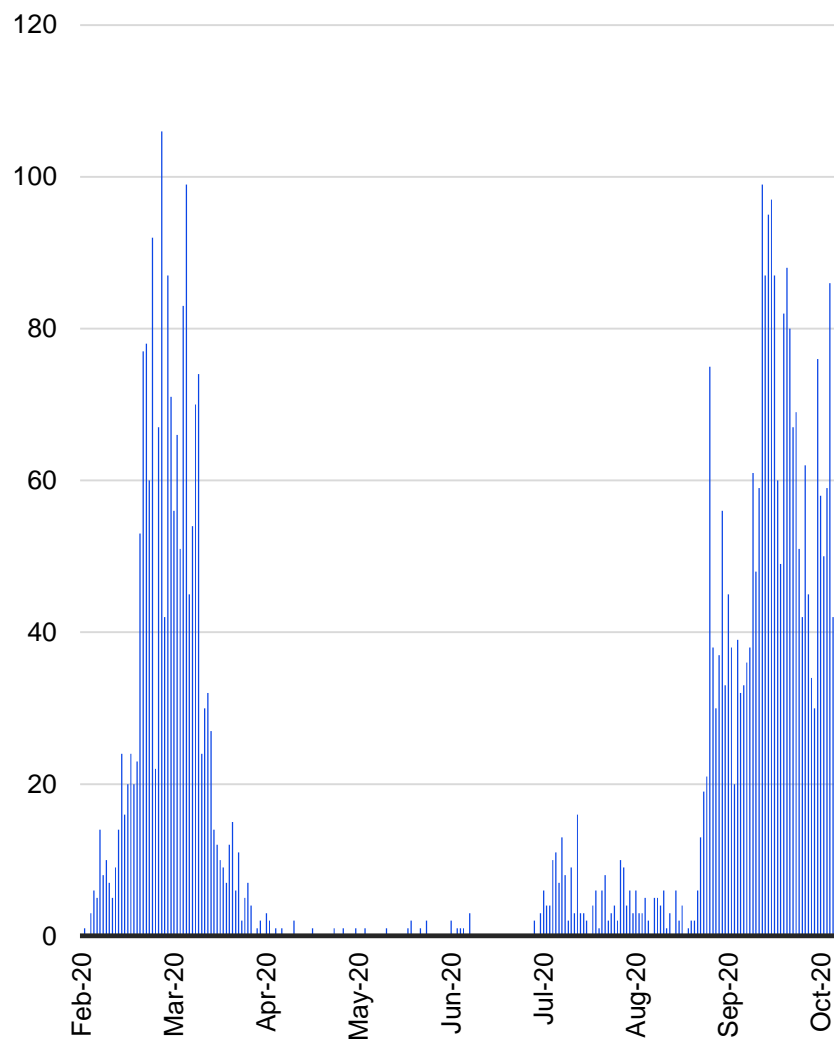
Unemployment rate



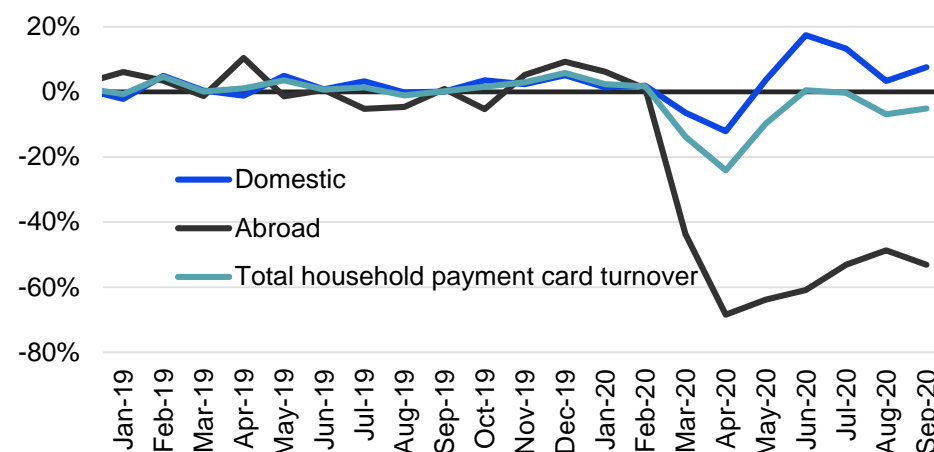
Summer turned out fine, but the outlook has deteriorated

The third wave of the pandemic has led to strict social distancing measures. Household expectations clearly reflect the situation, plunging each time social distancing measures have been tightened – in April, August, and October. Household payment card turnover and domestic consumption are particularly sensitive to social distancing measures and the figures for October will undoubtedly reflect this.

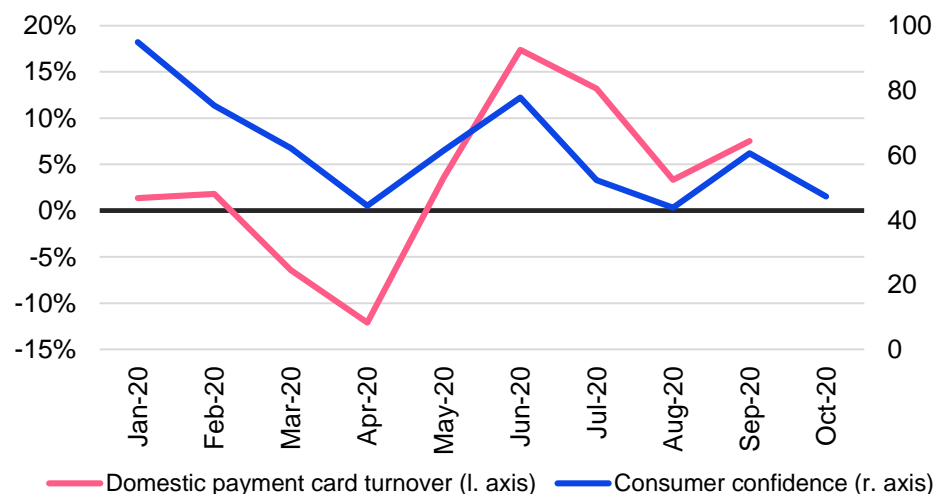
Number of domestic infections - total



Payment card turnover – YoY %-change, real changes



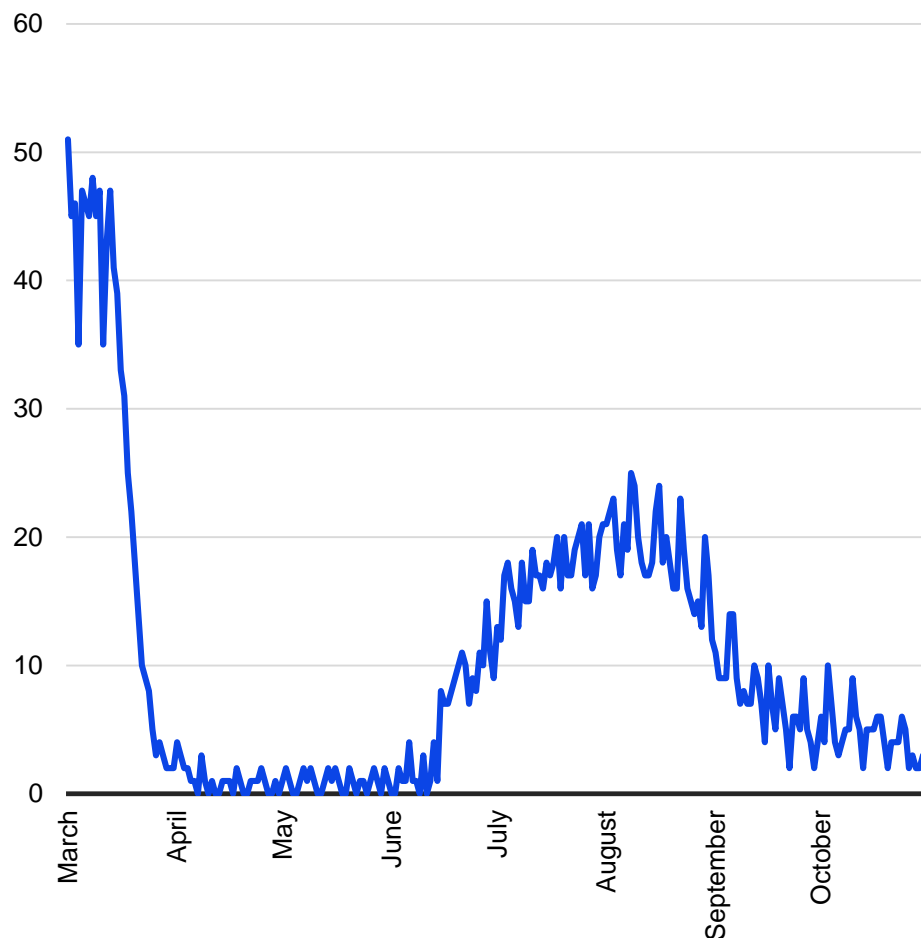
Consumer confidence and domestic payment card turnover



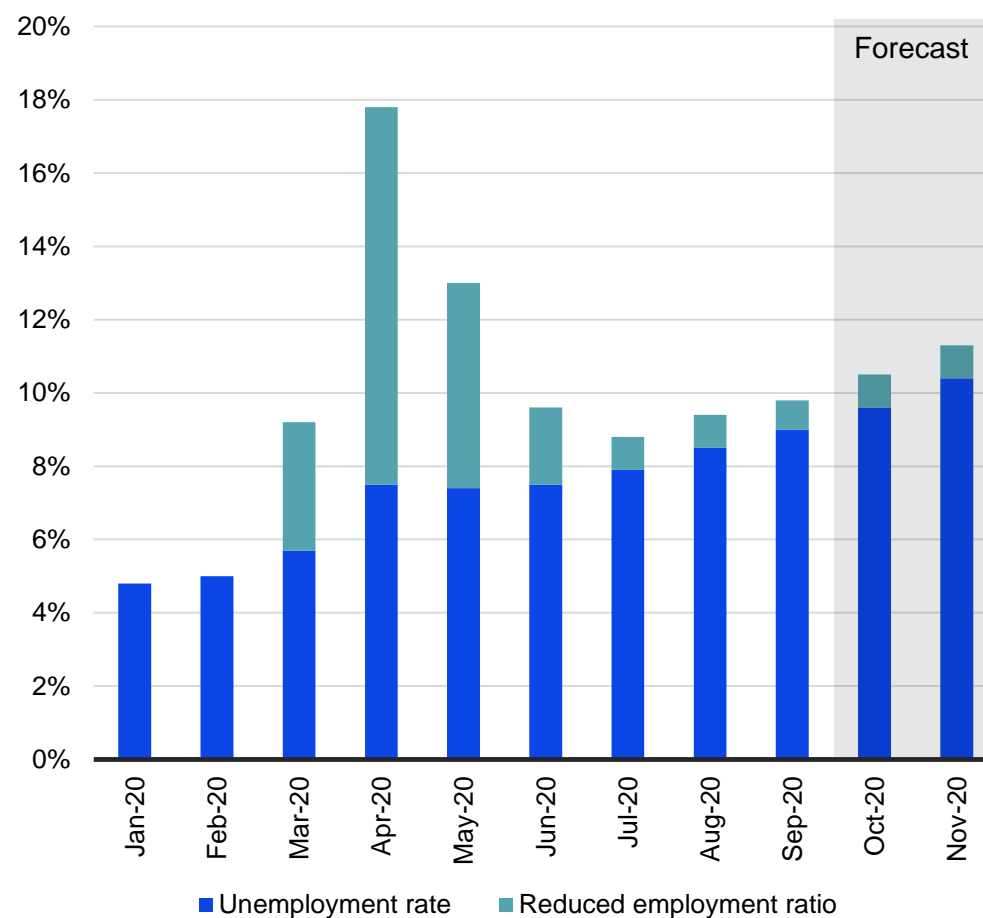
Icy winter ahead?

It's clear we must learn to live with the virus and the restrictions it places on us, at least in the immediate future. High frequency data and the short-term outlook for the tourism industry and labour market have deteriorated rapidly in the last few months. There is little to suggest the situation will improve in the coming months.

Departures from KEF airport – adjusted for cancelled flights



The composition of registered unemployment – Directorate of Labour's forecast



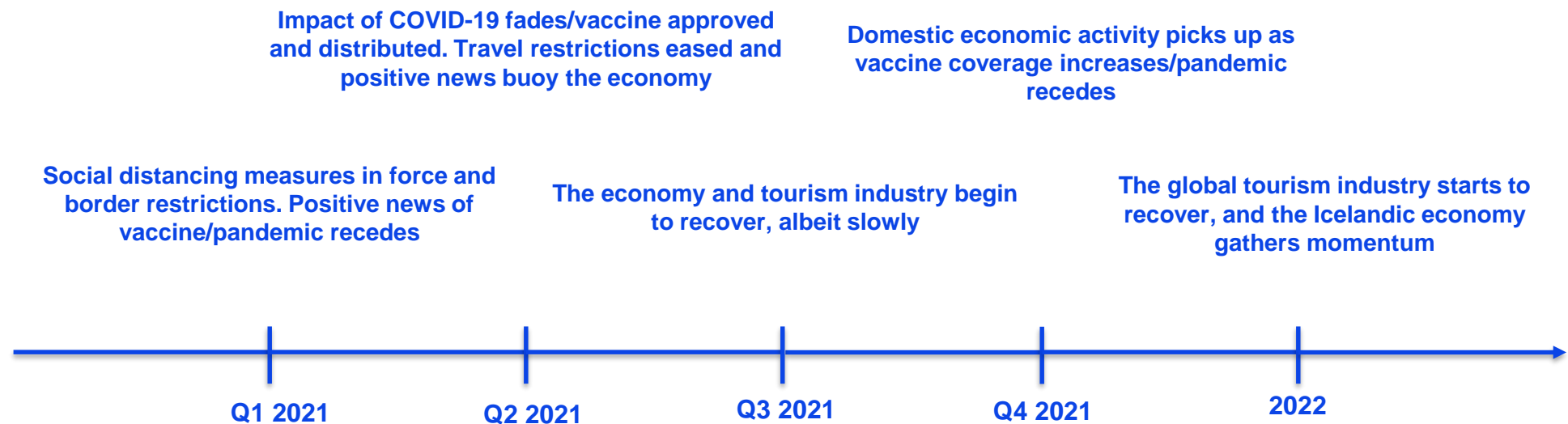
When will the vaccine be ready?

This is the question on everyone's lips, not least economists' lips, since the path of the pandemic is critical to how the economic situation pans out.

From the IMF's World Economic Outlook:

“The baseline projection assumes that social distancing will continue into 2021 but will subsequently fade over time as vaccine coverage expands and therapies improve. Local transmission is assumed to be brought to low levels everywhere by the end of 2022.”

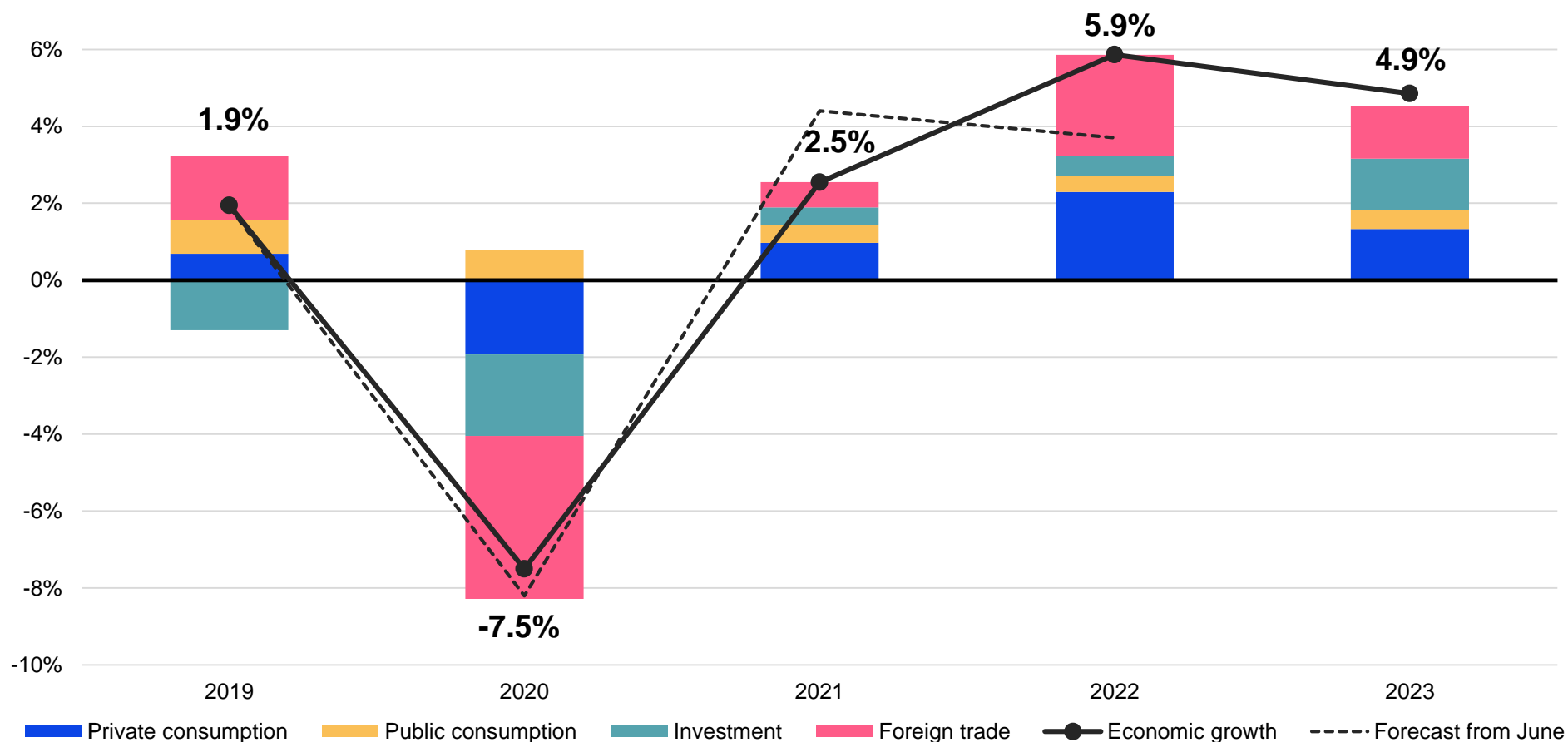
The forecast's assumptions on the impact of COVID-19 on the global economy in the medium term



A cold winter is followed by a cool summer

It appears that the economic contraction this year will be slightly smaller than previously thought, mainly due to more robust private consumption over the summer. Nevertheless all sub-components of GDP are pulling in the same direction, apart from the public sector which is offsetting the contraction through public spending and investment. The economic outlook for this winter has deteriorated in recent weeks and the economy seems set to recover slowly next year before rebounding more strongly in 2022.

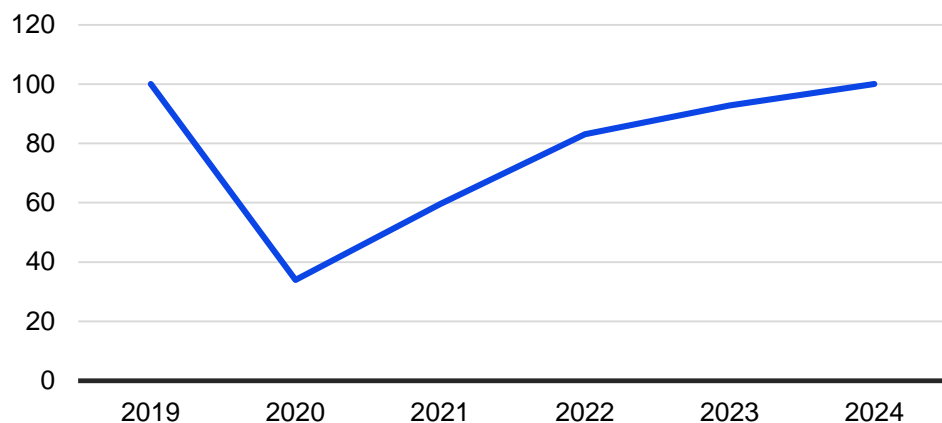
Economic growth – growth contributions of GDP components



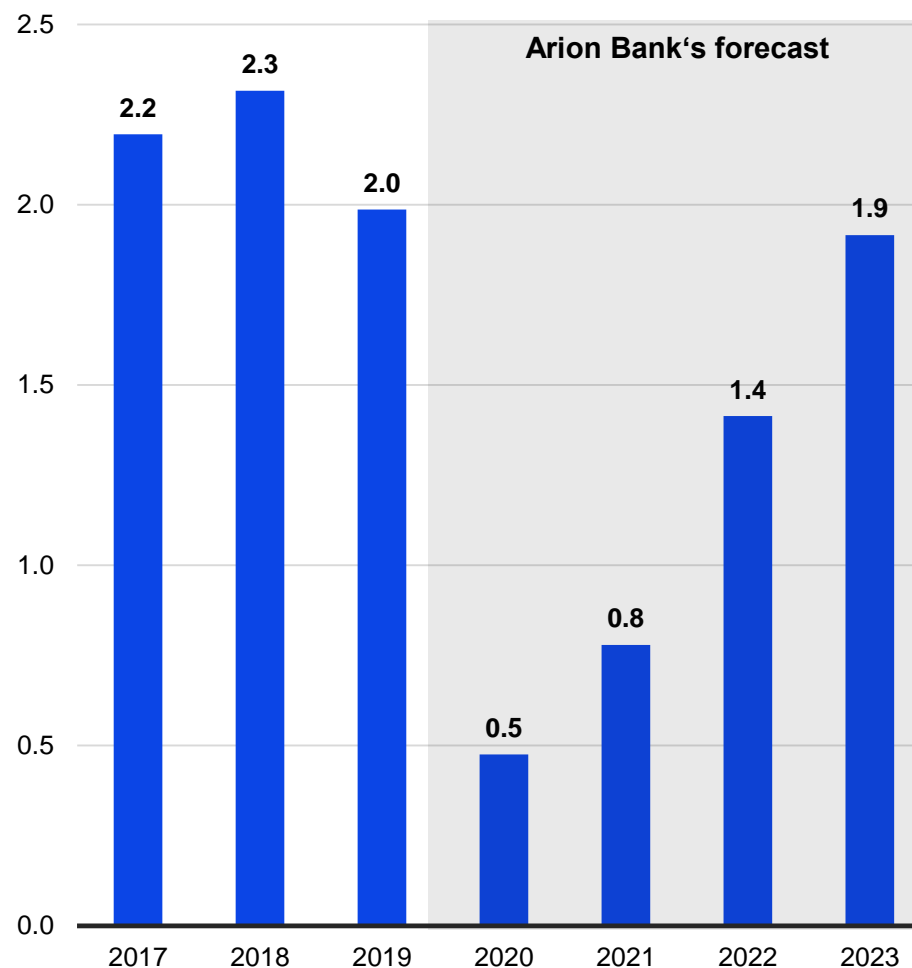
Number of tourists, a key variable in the economic forecast

It would be more accurate to call the tourist arrival forecast an educated guess given the available data. Arion Bank's forecast utilizes estimates from Icelandair, IATA's global passenger forecast, and the economic outlook in Iceland's main trading partners. Approx. 800,000 foreign tourists are expected to visit the country next year, the majority in the second half of the year.

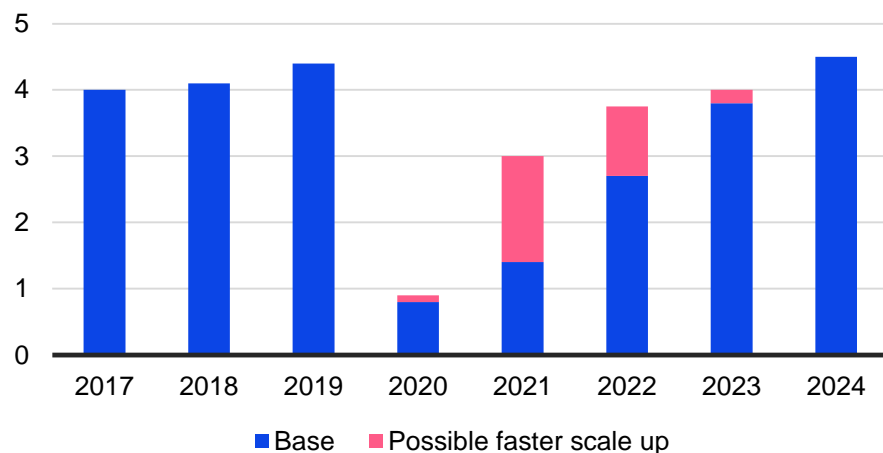
IATA's global passenger forecast – RPKs, index = 100 in 2019



Tourist arrivals via KEF airport - millions



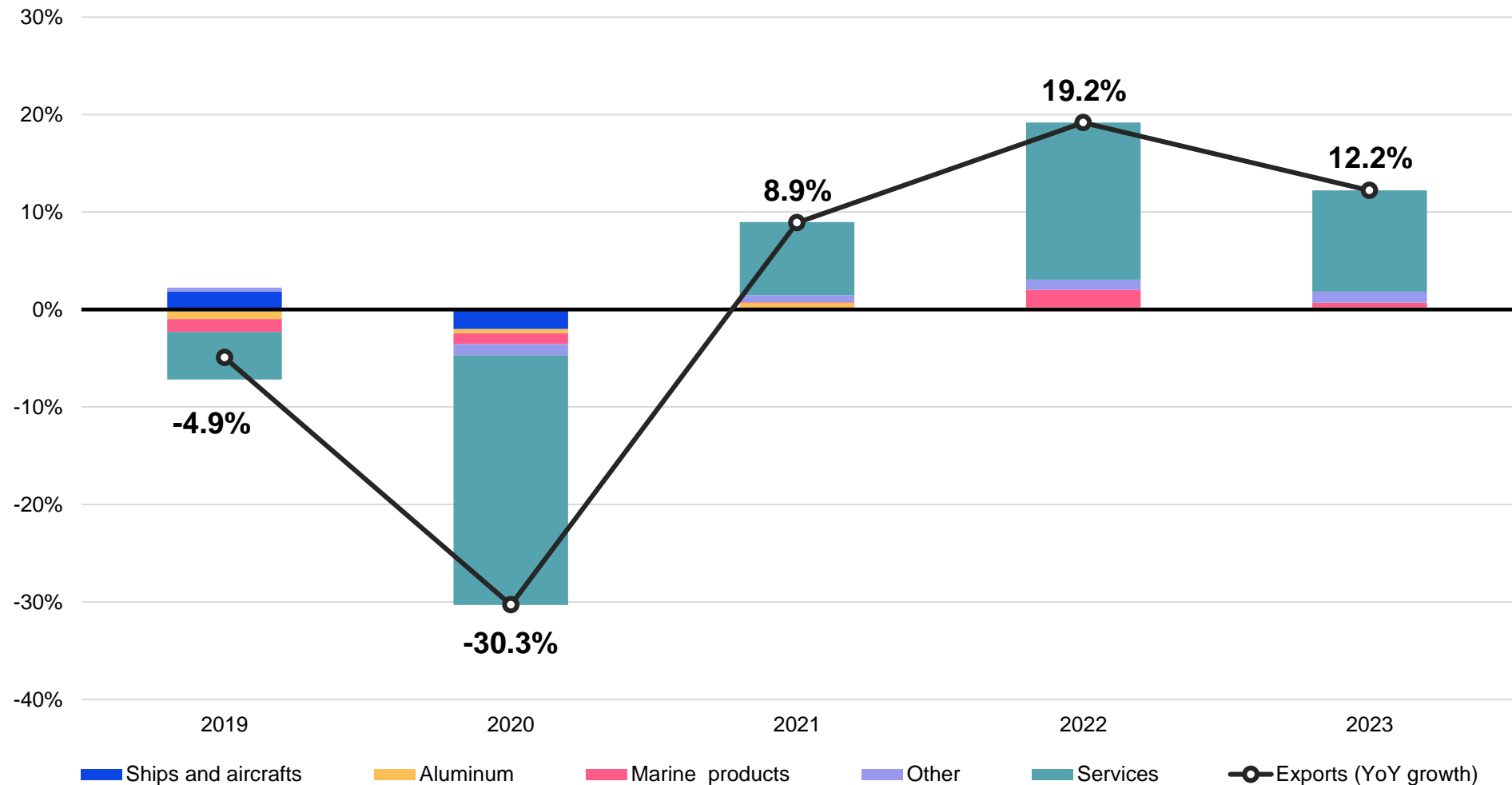
Icelandair's passenger numbers – millions, Icelandair's scenarios



Export sectors edge out of the storm next year

All of Iceland's largest export sectors will contract this year, although the tourism sector will suffer the most. The recovery appears to get off to a slow start, particularly in the seafood industry.

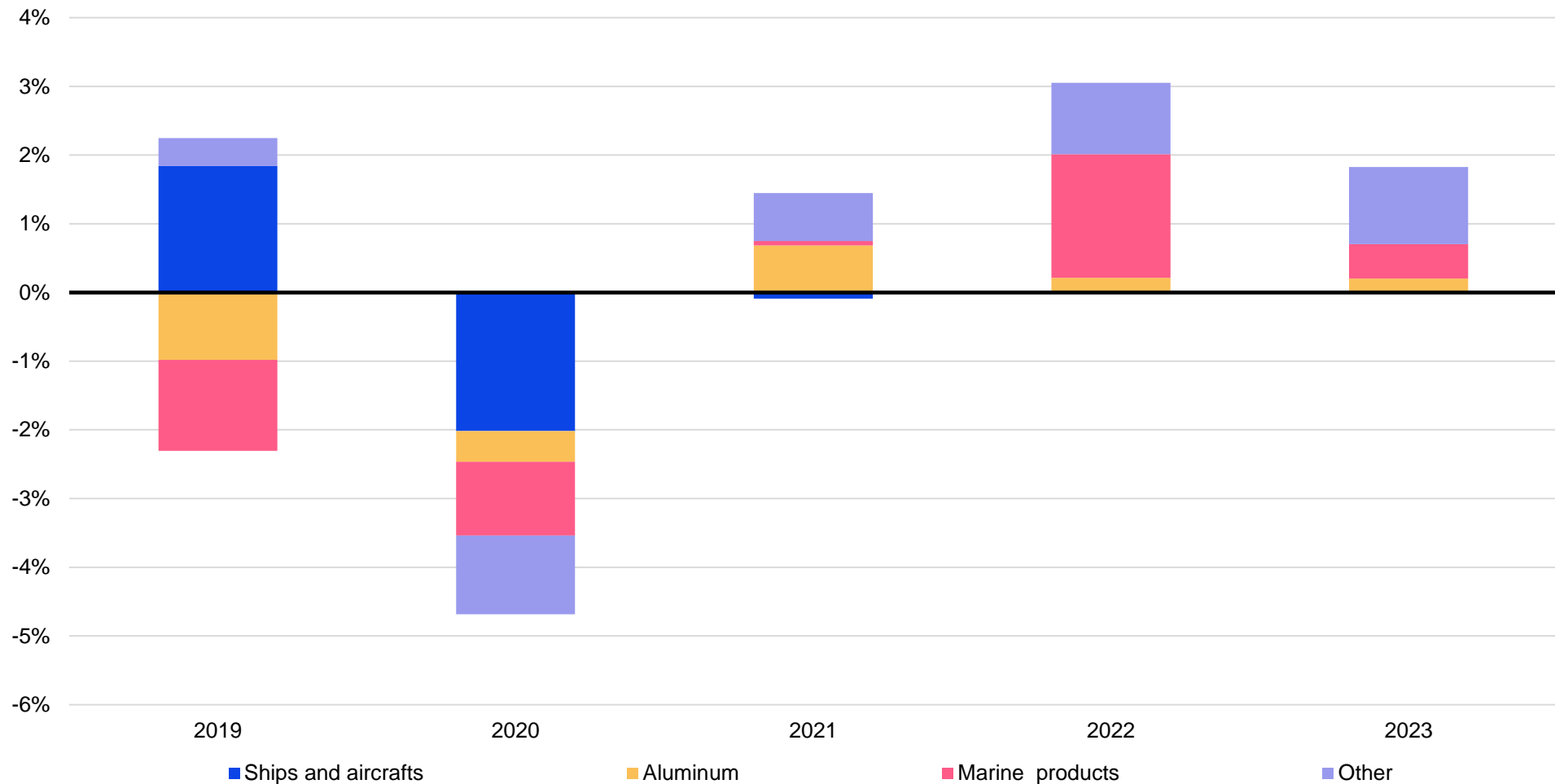
Exports – contribution of components



Tourism is not our only export sector

The tourism sector will be the driving force behind exports growth over the next few years, understandably as it took a huge hit this year. As a result the graph on the previous slide is dominated by service exports. However, if we look beyond service exports, it's clear that many sectors are flourishing in the shadow of the travel sector. For example, we expect the seafood sector to grow in 2022, but most notable is the increase in other goods exports, often referred to as the “trash pile” but which should really be called the treasure chest.

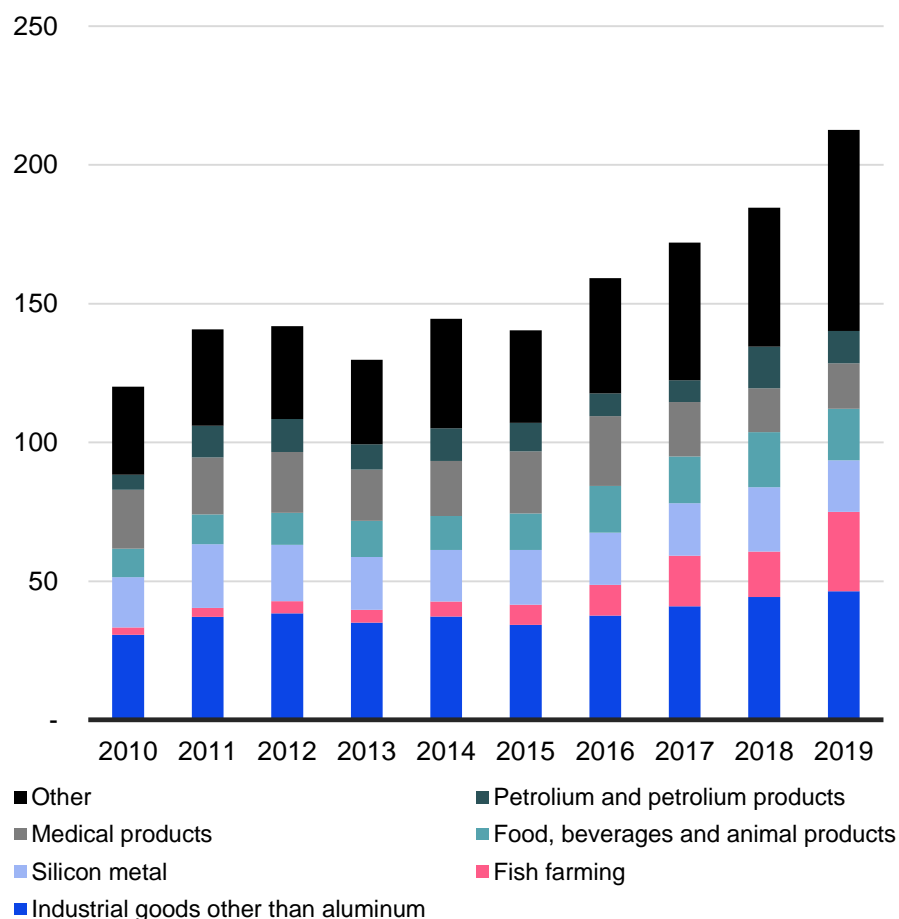
Exports excluding services – contribution to total export growth



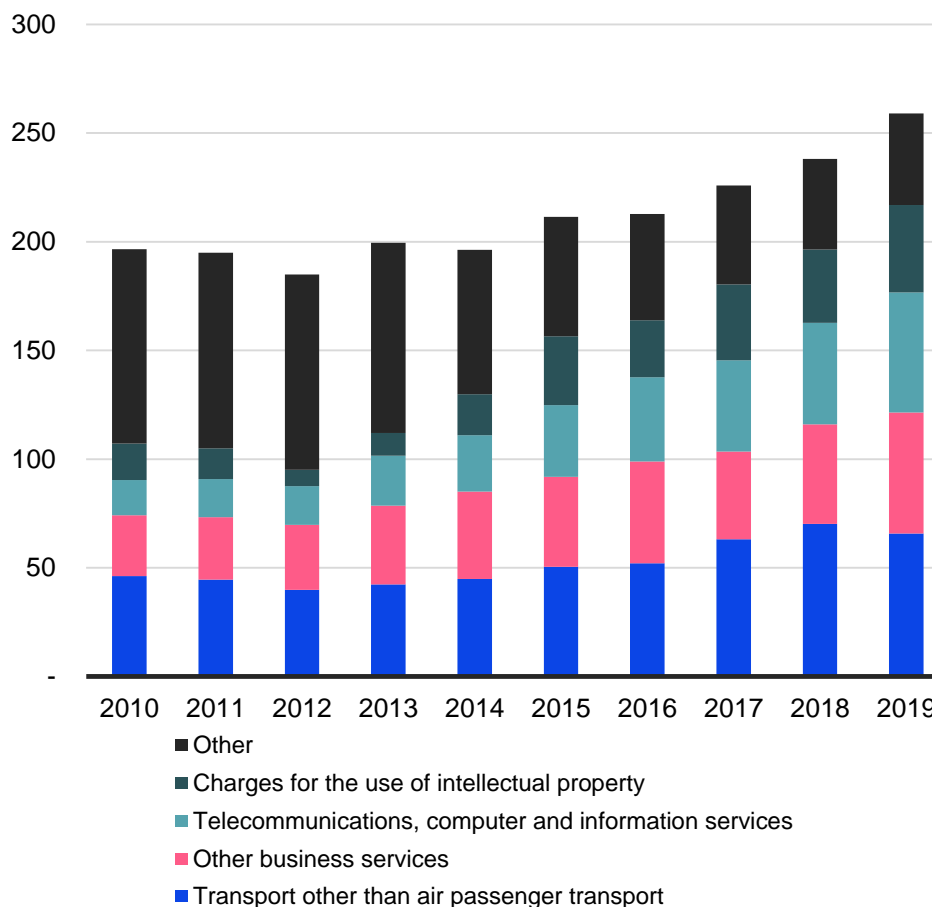
What's hidden in the treasure chest?

All sorts! Other goods exports include industrial goods other than aluminum, fish farming, silicon and agricultural produce. Highly ambitious plans are afoot in fish farming and pharmaceuticals, and continued growth in these sectors can be expected in the next few years. As for other service exports, there are three sub-components which dominate, but it must be remembered that service exports are not subdivided to the same extent as goods exports and it can therefore be difficult to trace growth back to individual sectors.

Other goods exports – bn. ISK at constant exchange rate, excluding marine products and aluminum



Other service exports – bn. ISK at constant exchange rate, excluding tourism

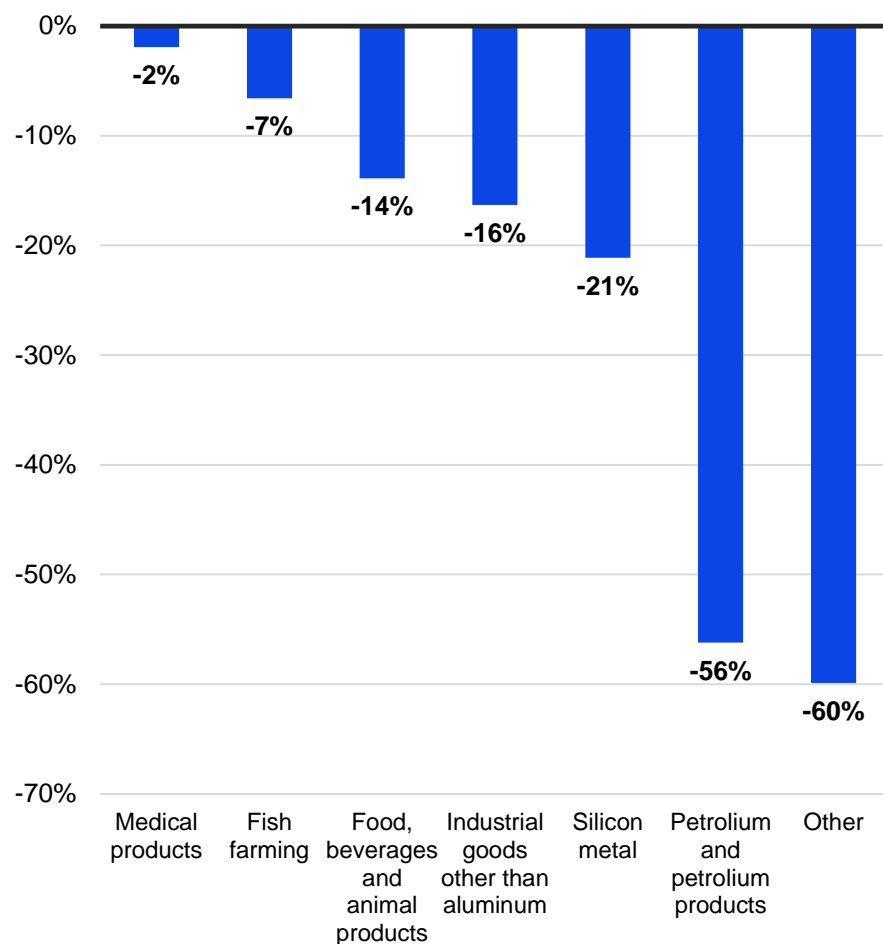


The treasure chest shrinks - temporarily

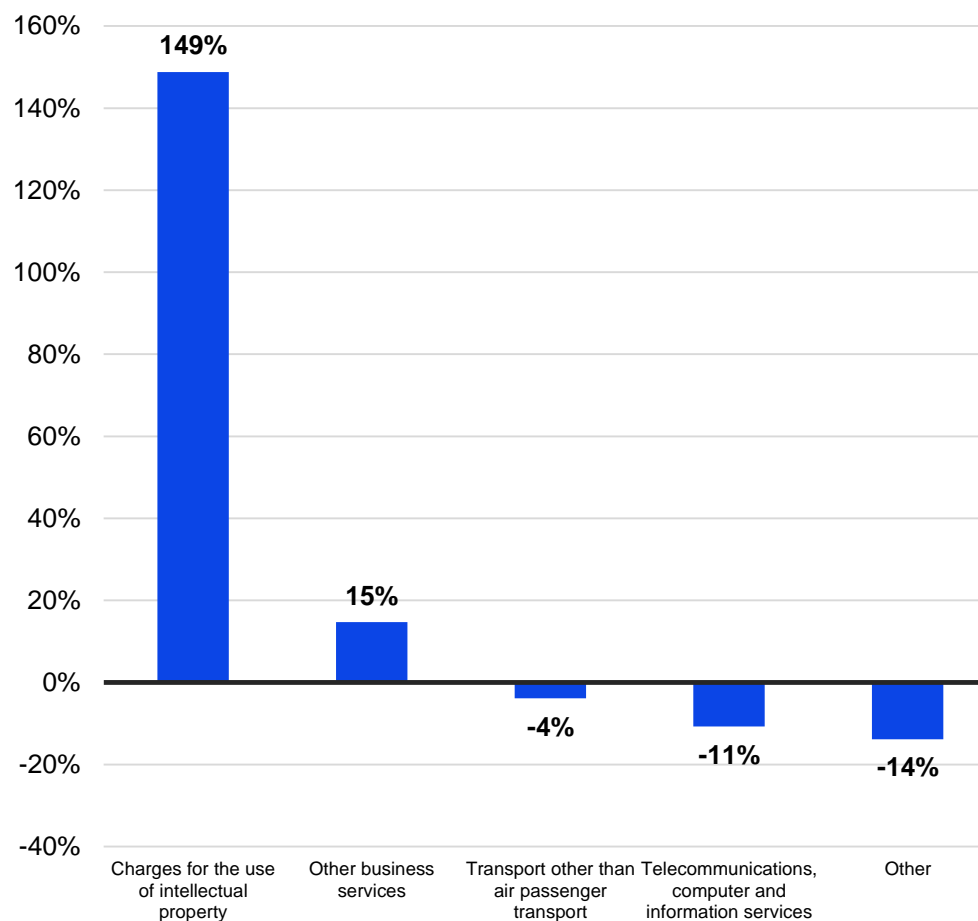
COVID-19 has been detrimental to other goods exports, but the impact has varied greatly between industries. Keep in mind that the figures are adjusted for the exchange rate of ISK. If this were not done, several sub-components would go from negative change to a positive one.

Furthermore the sale of WOW air aircrafts at the beginning of last year skews comparisons between years. Other service exports have withstood the storm somewhat better, increasing by 4% in the first half of the year, at constant exchange rate.

Other goods exports in the first eight months of 2020 – constant exchange rate, YoY %-change



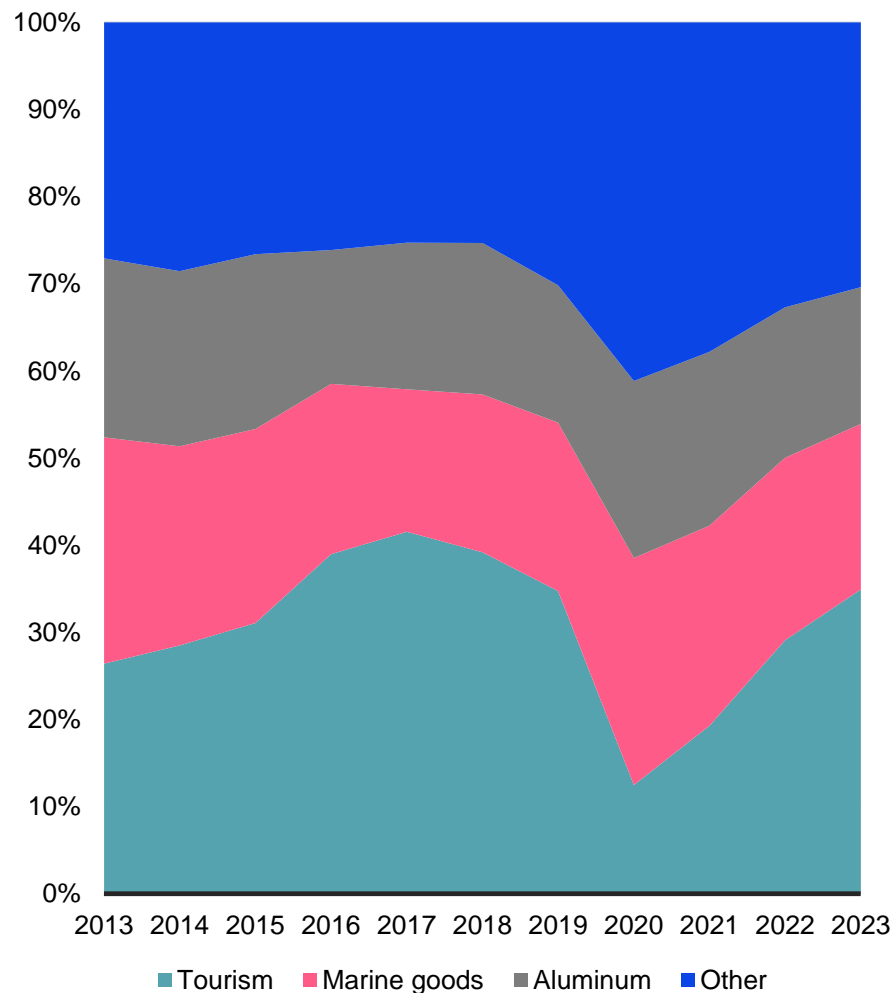
Other service exports in the first half of 2020 – constant exchange rate, YoY %-change



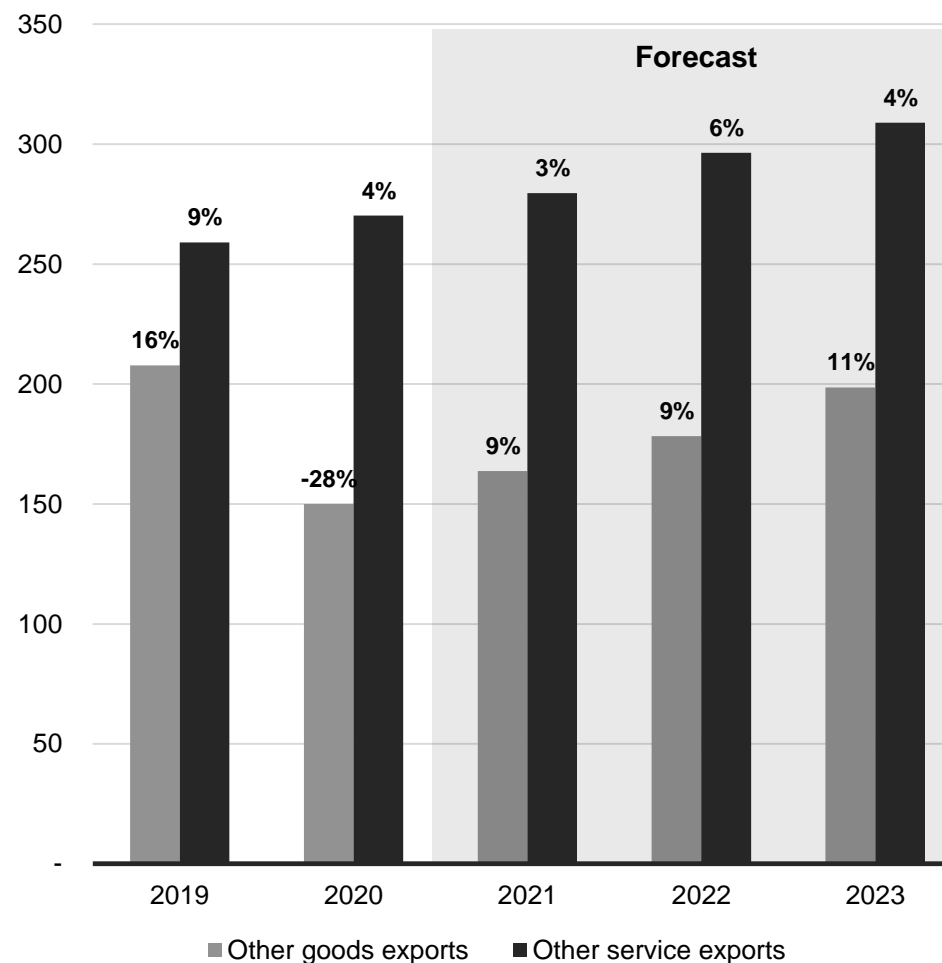
One third of exports are “other exports”

Even if the tourism sector recovers, and three aluminum smelters operate in Iceland through the forecast horizon and the capelin reappears, it is other exports, i.e. both other goods and services exports, that weather this storm and come out stronger on the other side. It is vital for a small economy such as Iceland to nurture other exports – to create more diverse means of generating foreign currency.

Share in total exports – nominal value



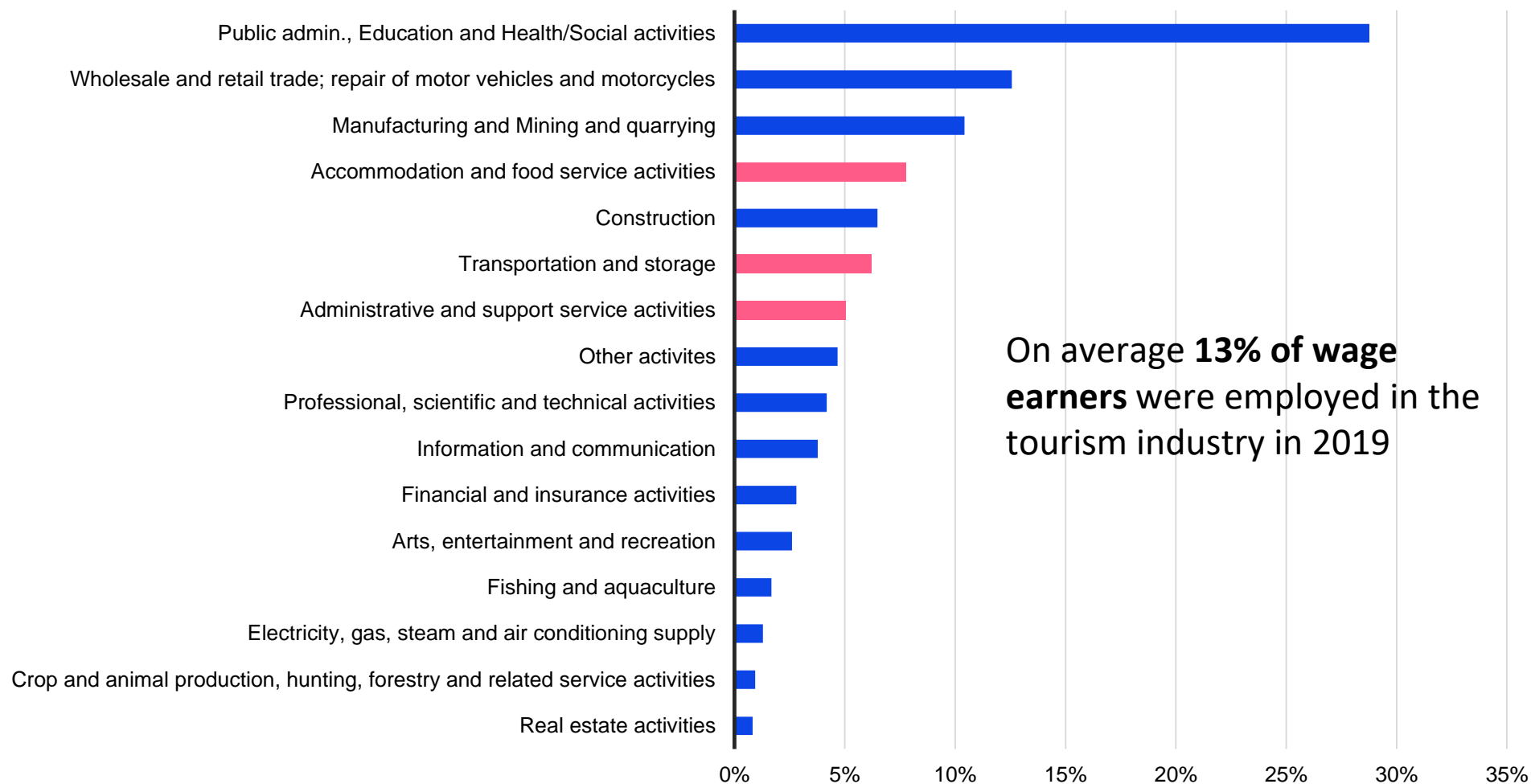
Exports excluding tourism, marine products and aluminum – bn. ISK, constant exchange rate



Tourism sector nevertheless remains in the limelight

Naturally, as it has been the largest export sector in recent years and is one of the mainstays of the economy. From 2010 until 2018 the sector created around 17,000 new jobs. The direct link between the sector and unemployment figures is therefore clear, although rising unemployment is not restricted to this sector.

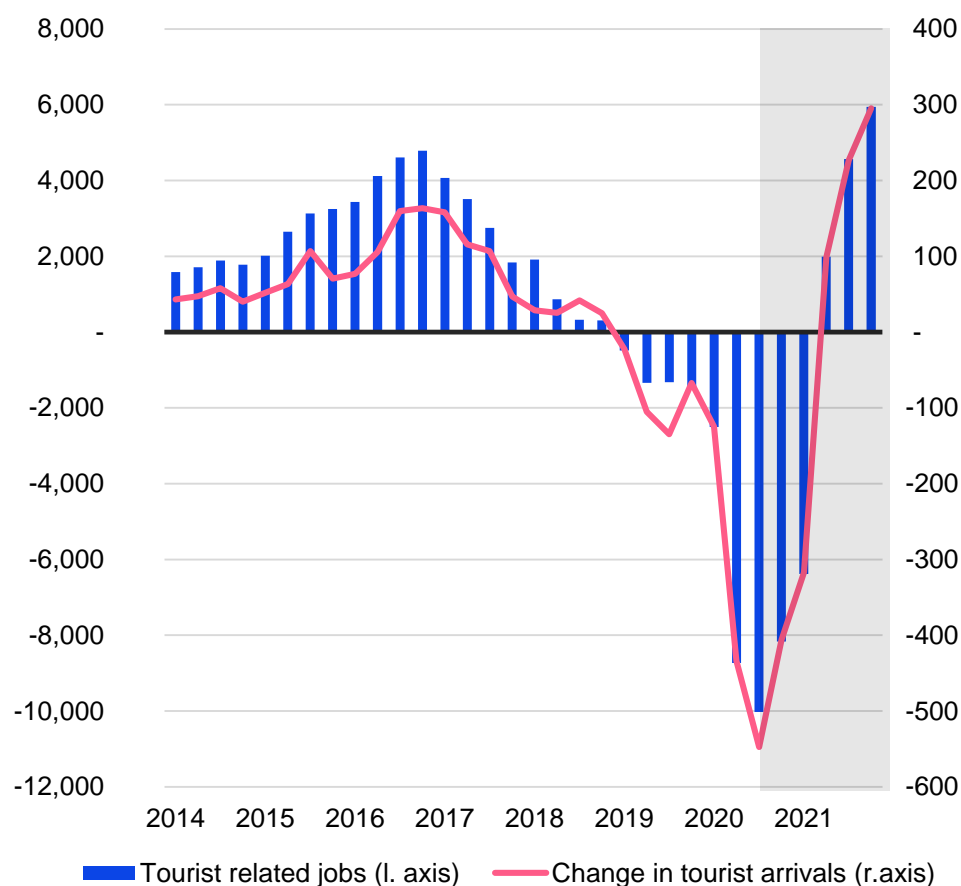
Register based employment by economic activity - % of total



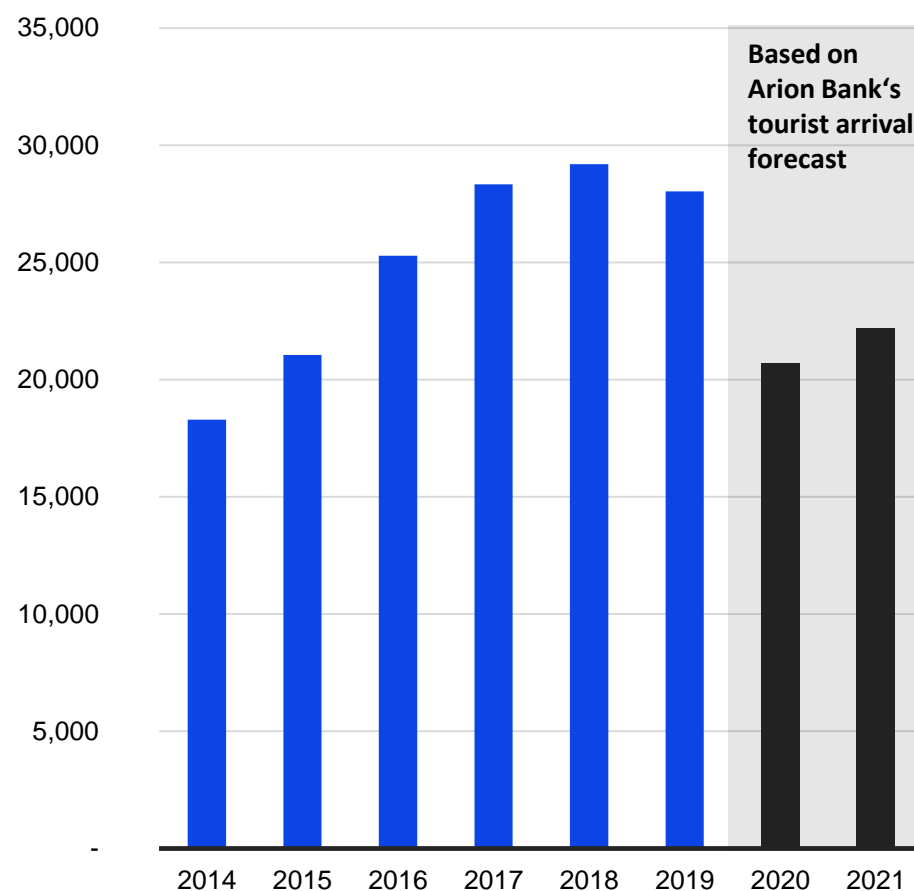
Collapse in number of jobs in tourism sector

The number of jobs in the tourism sector decreased by 11,000 between years last August. According to Arion Bank's tourism forecast and given the relationship between the increase/decrease in the number of tourists and related jobs, it is expected that the number of jobs in the sector will decrease from 28,000 on average in 2019 to 20,000 on average in 2020. Despite hopes of a recovery next year it will start off slowly, as will job increases. It cannot be assumed that the new jobs will be like the ones lost. It will depend on economic competitiveness and the focuses within the industry. A huge restructuring in the sector seems inevitable.

Change in tourist arrivals and the number of tourist related jobs
– based on Arion Bank's tourist arrivals forecast



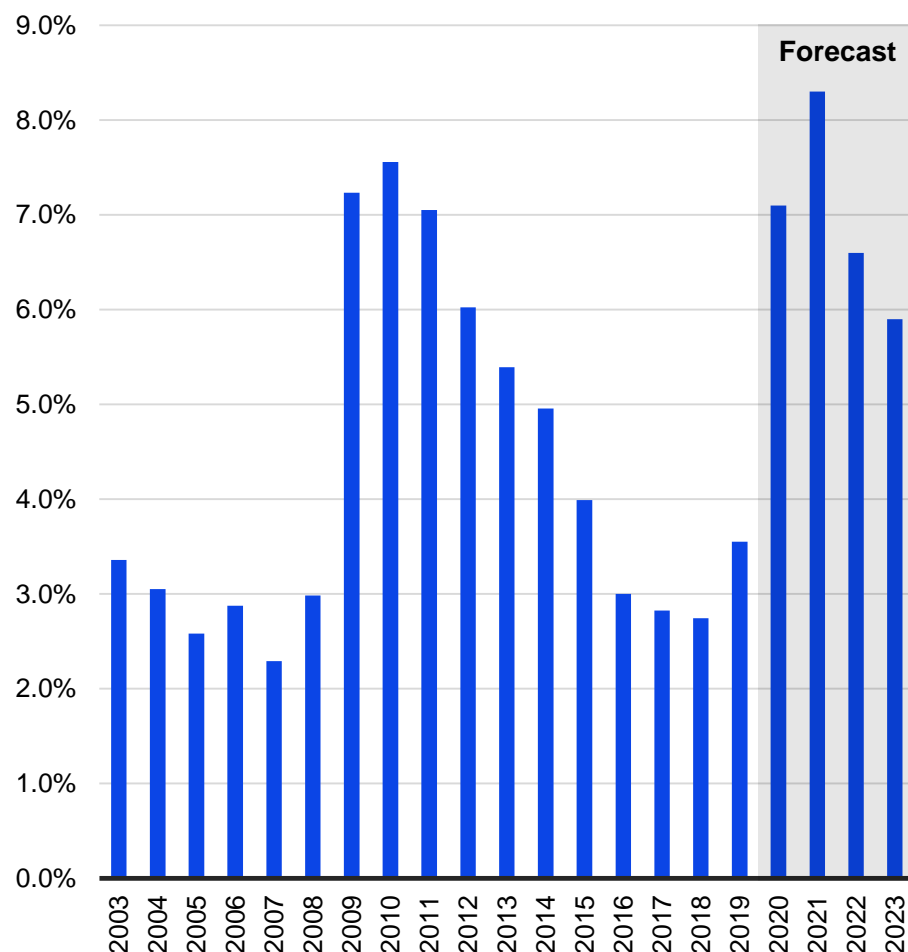
Total number of employees in tourist related jobs



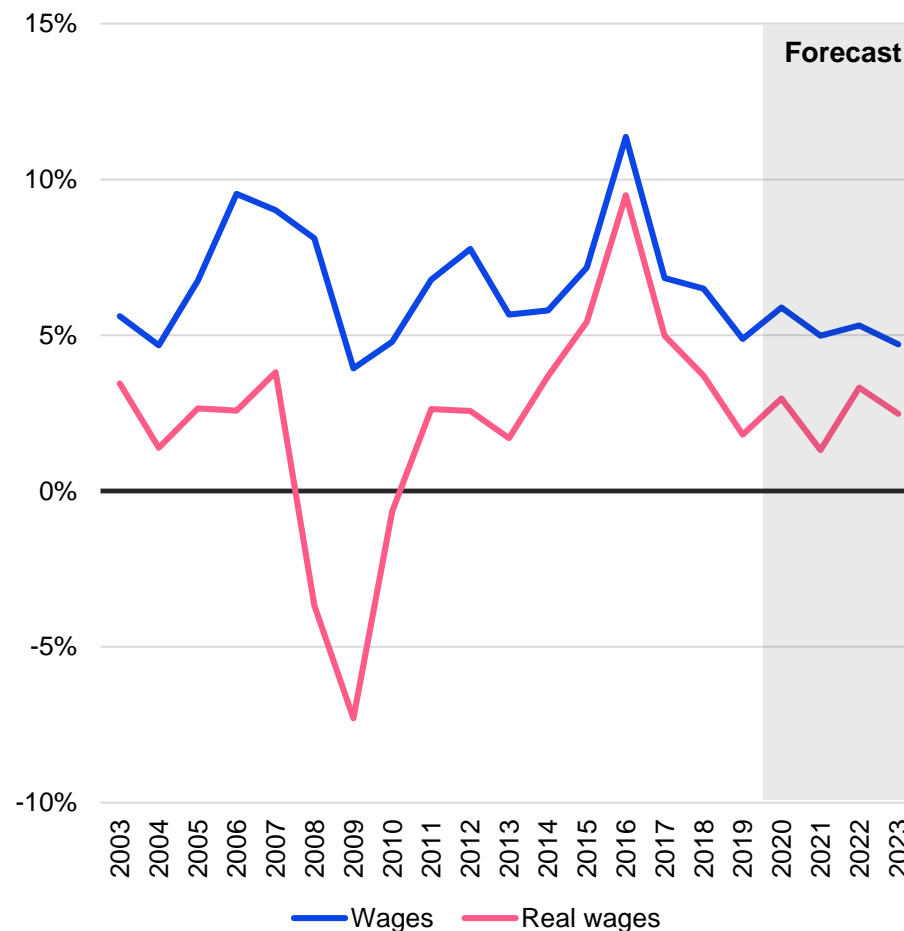
Difficult times ahead in a divided labour market

Although the spike in unemployment predicted this spring has not materialized in the autumn, it does not mean that the risk has evaporated. On the contrary it appears that unemployment will continue to increase as the tourist industry has written off the winter. The declining economic outlook for this coming winter is reflected in the unemployment forecast, with higher unemployment on average next year than this year. At the same time as unemployment reaches unprecedented heights, the purchasing power of salaries, measured by real wages, is increasing. This is an uncharted territory in Iceland as in the past efforts have been made to maintain high employment levels at the expense of price and exchange rate stability. Now, the adjustment appears to be via the labour market, which means higher unemployment than otherwise.

Unemployment rate – Labor Force Survey



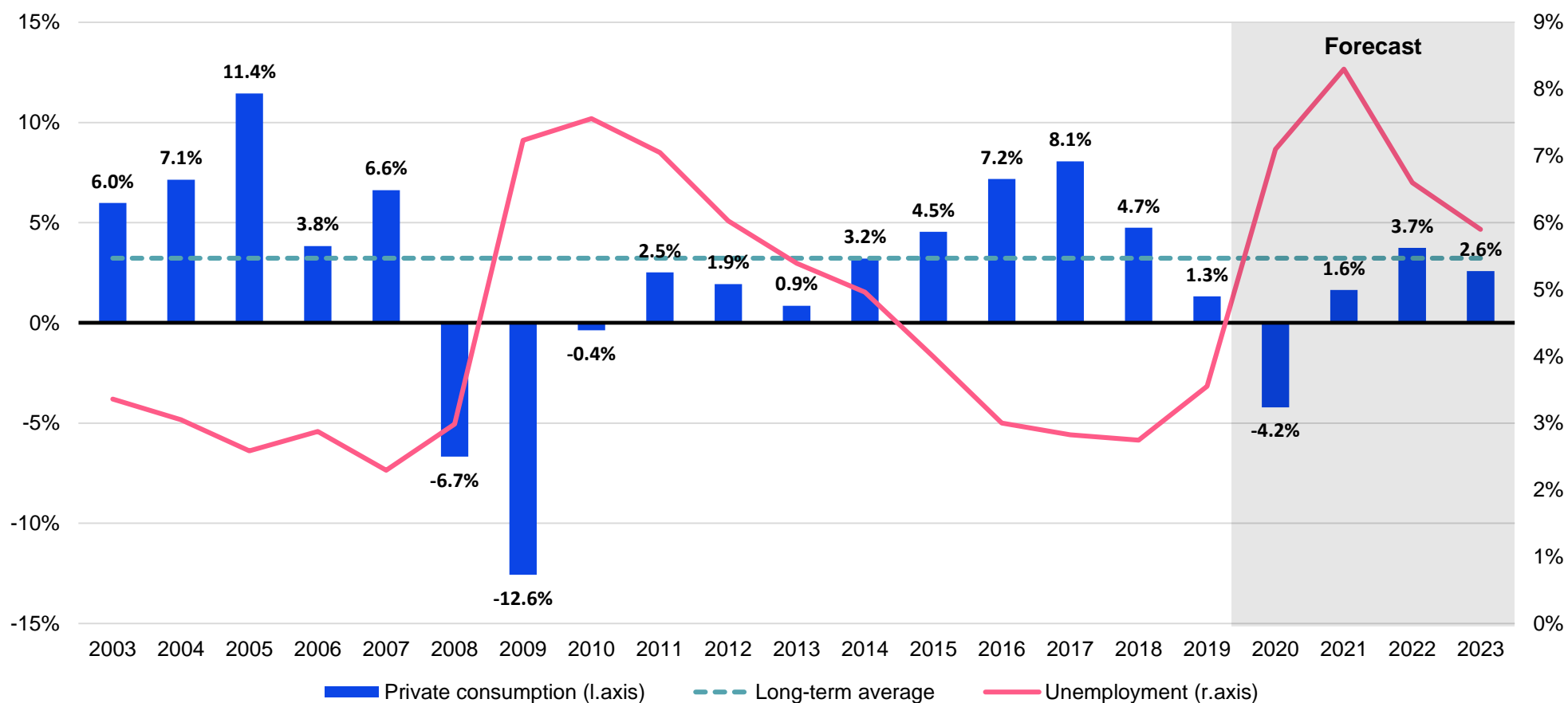
Wages and real wages – YoY %-change



Higher unemployment but a smaller drop in private consumption

Even though unemployment will probably be higher now than in the financial crisis, private consumption seems set to decrease less since real wages of a large part of the labour market are increasing. Added to this comes rapid asset growth on the residential property market and lower debt servicing costs. This differs from earlier downturns, when nearly everyone suffered a loss of disposable income as a result of a weaker exchange rate and inflation. Nevertheless high unemployment, an uncertain economic outlook and travel restrictions do impose some limits on private consumption and might undermine its growth next year. Consequently, private consumption is not expected to regain previous levels until mid-2022.

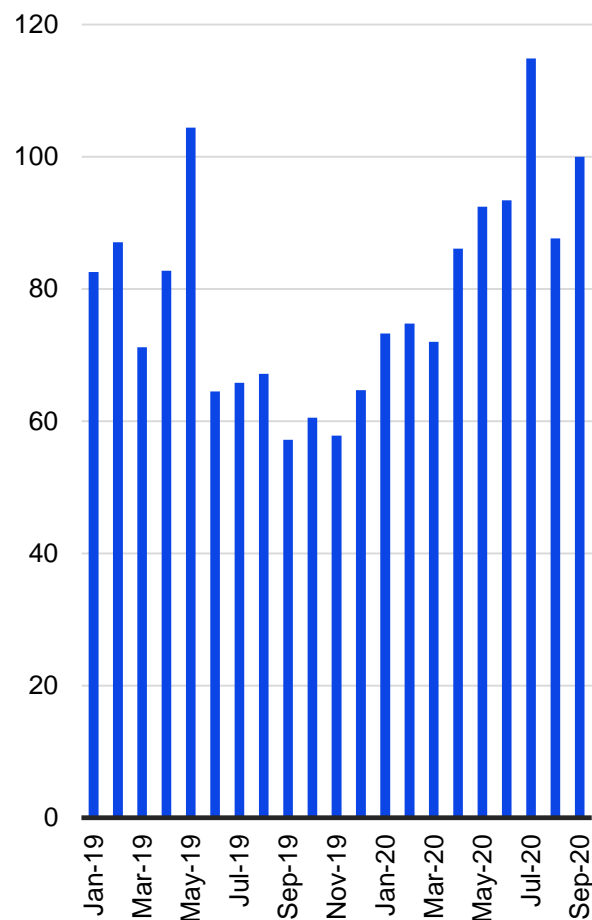
Private consumption – YoY %-change



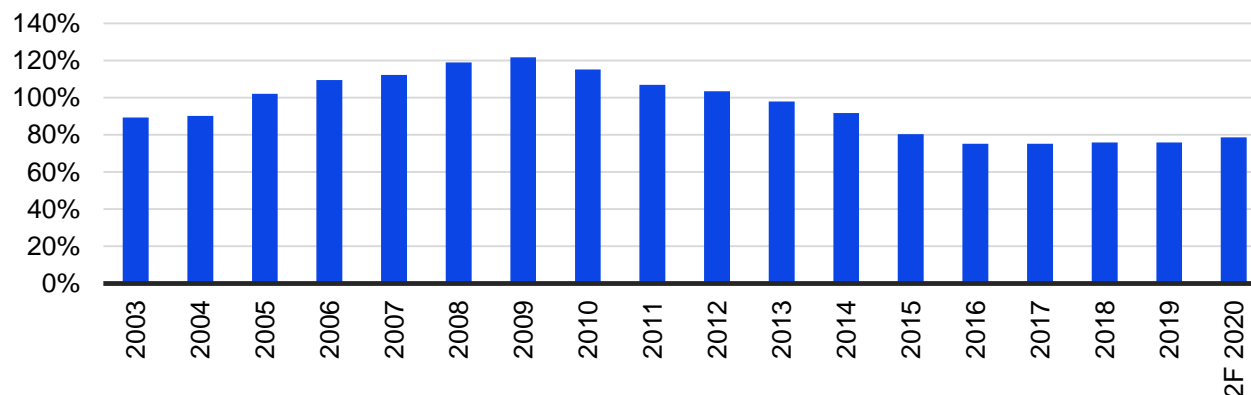
Private consumption might bounce back quicker

Household deposits in the banking system have increased by ISK 66 billion so far this year. The increase might partly be attributed to salary increases, shifting consumption patterns, an uncertain economic outlook, and to a more accommodative monetary stance this spring which resulted in increased loans, mainly to households, and more money in circulation. Increased deposits and more liquidity in the financial system, lower LTV ratios, real wage increases, and low interest rates counterbalance the frigid labour market and could lay the foundations for strong private consumption.

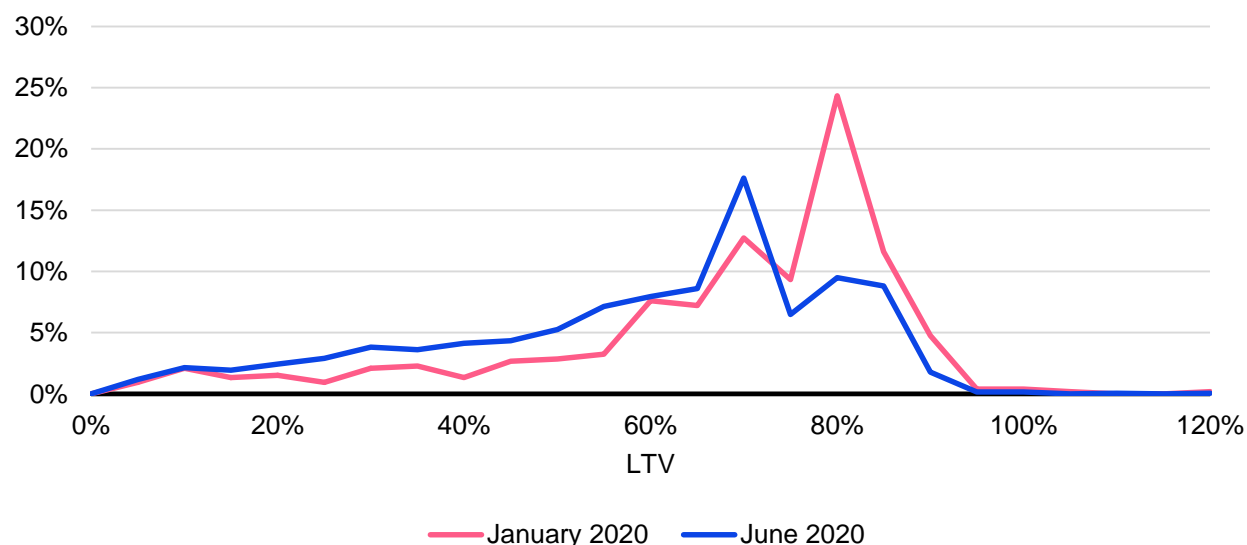
Household deposits – change between years, bn. ISK



Household debt - % of GDP



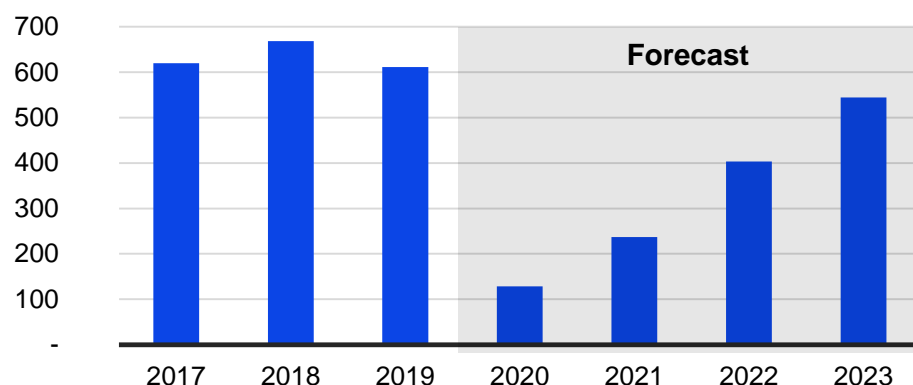
LTV distribution of D-SIBs' * new mortgage loans to consumers



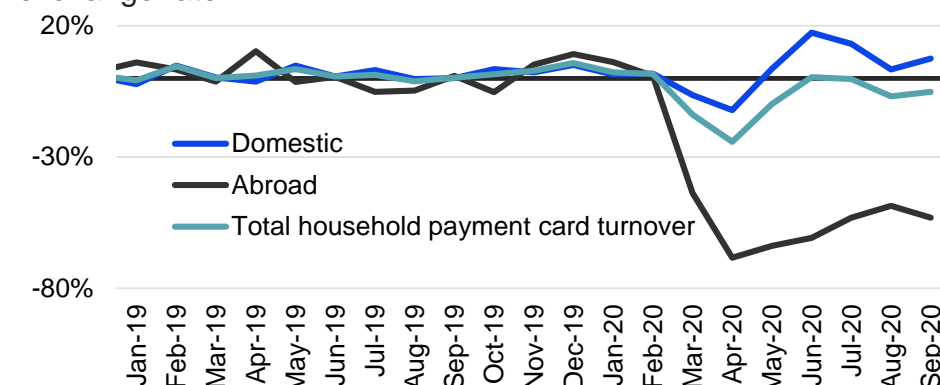
Travel restrictions have an impact on both private consumption and imports

Private consumption comprises of domestic and foreign consumption, with the latter representing 12% of private consumption last year. It's therefore obvious that travel restrictions and fewer trips abroad have a major impact on private consumption, a fact clearly underlined by payment card turnover figures. The effect is more wide-reaching however, as overseas trips by Icelanders accounted for 18% of total imports last year. Just the decline in trips abroad has a huge effect on imports. On the other hand domestic consumption has increased as it's no longer easy to dash abroad on a shopping spree. So far this year, only one sub-component of goods imports has increased YoY – consumer goods.

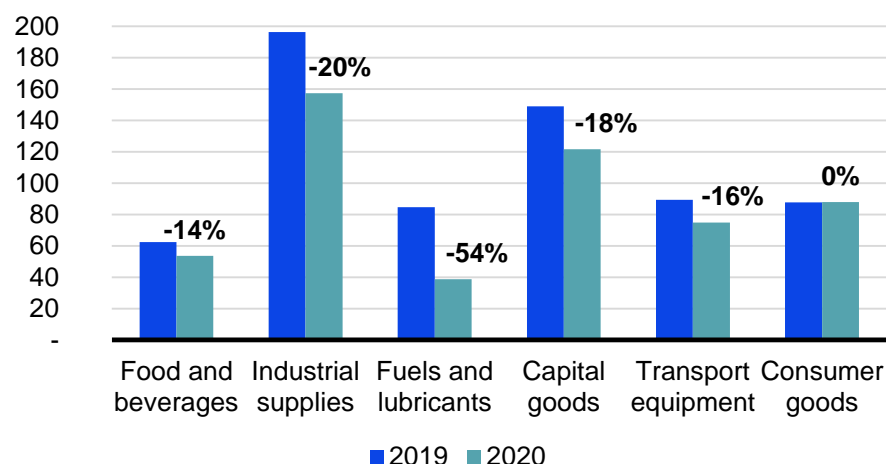
Icelanders departures via KEF airport – YoY %-change



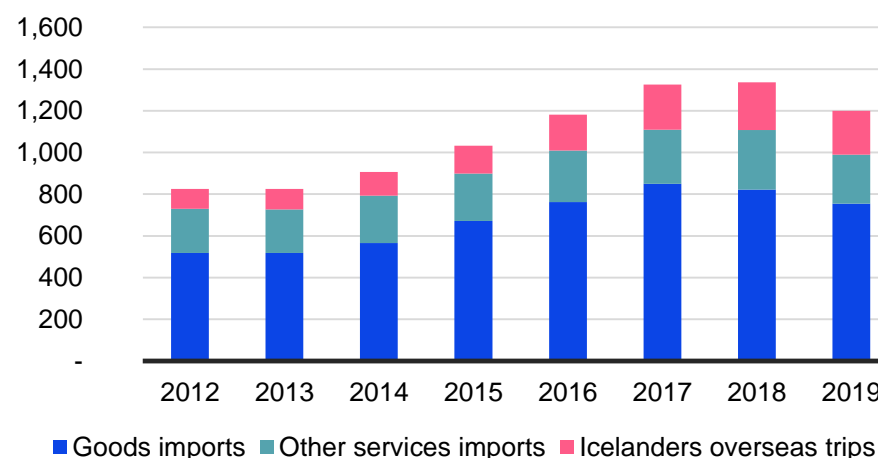
Payment card turnover – YoY %-change, constant prices and exchange rate



Imported goods January – September – bn. ISK at constant exchange rate



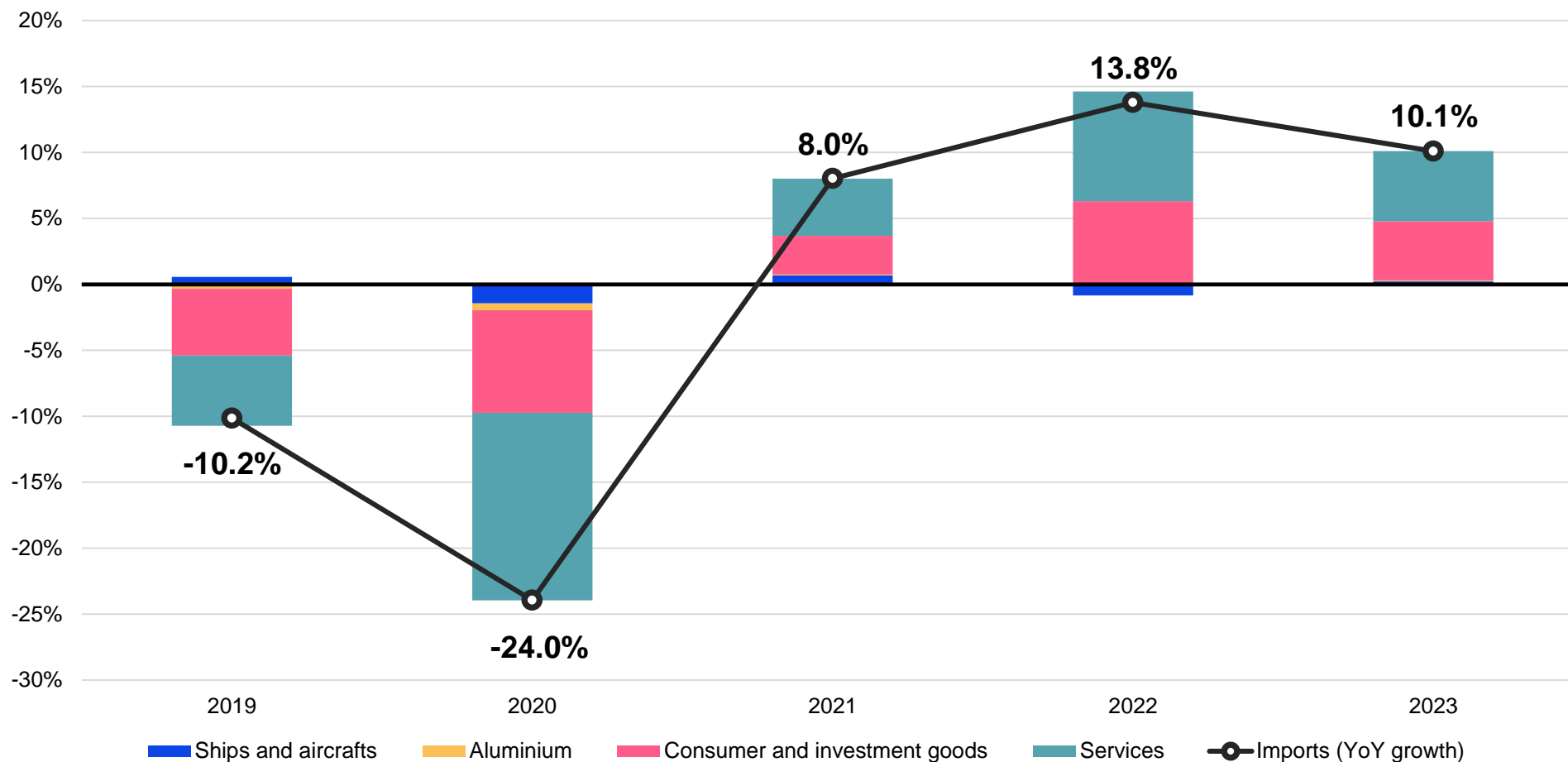
Composition of imports – bn. ISK at 2019 prices



Travel restrictions, investment and production behind drop in imports

The forecast assumes a 24% drop in imports this year, primarily due to a contraction in imported services, i.e. due to the fall in the number of overseas trips by Icelanders. Reduced economic activity and the difficulties faced by many companies largely account for decline in goods imports. Imports are expected to grow next year as domestic demand recovers.

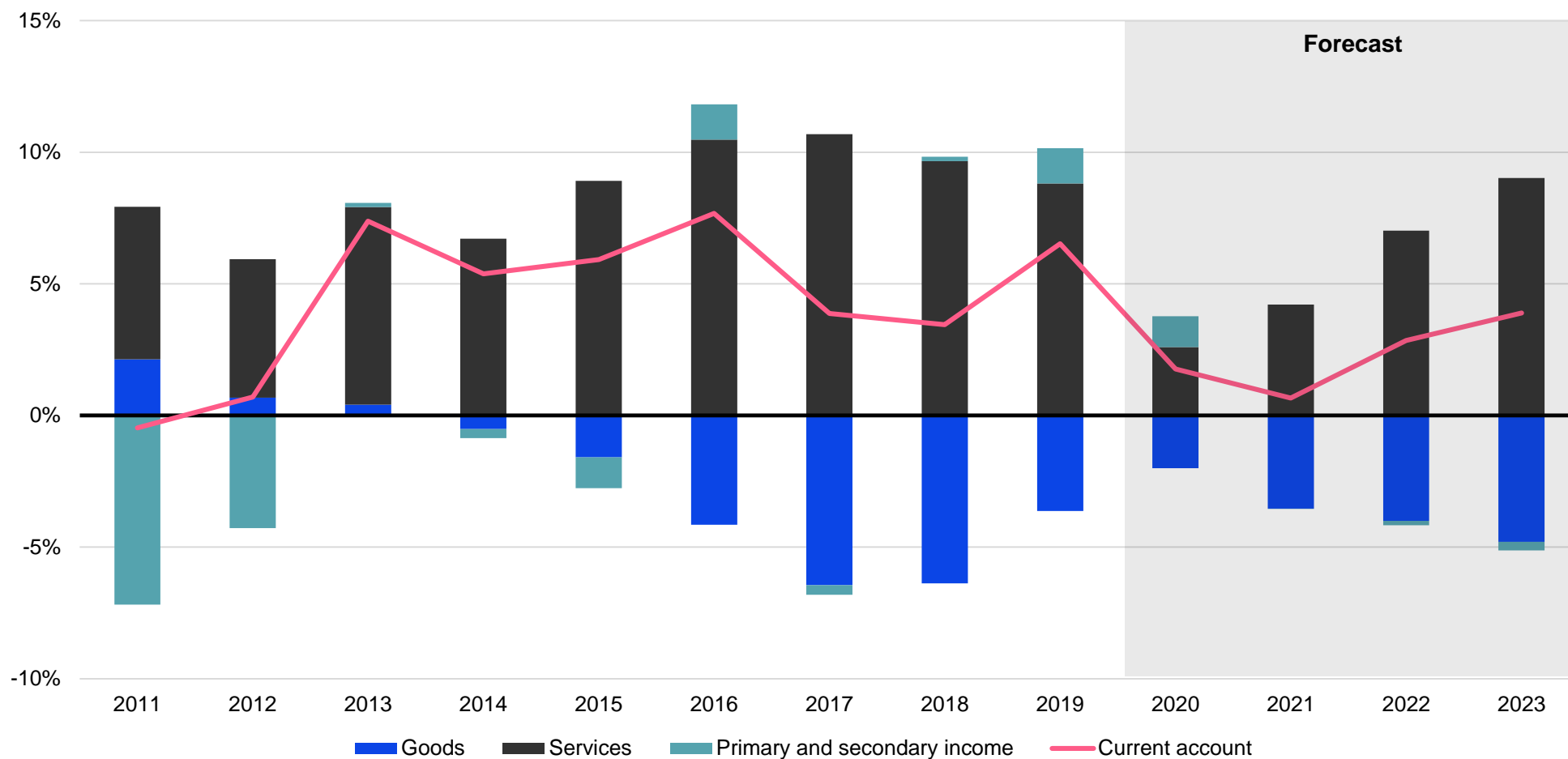
Imports – contribution of components



The most surprising result: Current account surplus remains

The main reason behind the current account surplus is the massive drop in imports which counterbalances the slump in exports. Exports have nevertheless decreased more than imports, reflected by the shrinking current account surplus YoY. According to Arion Bank's forecast the current account surplus will decrease from ISK 180 billion to ISK 50 billion. Most of the surplus can be attributed to surplus on primary income. Excluding primary income, the surplus is substantially smaller.

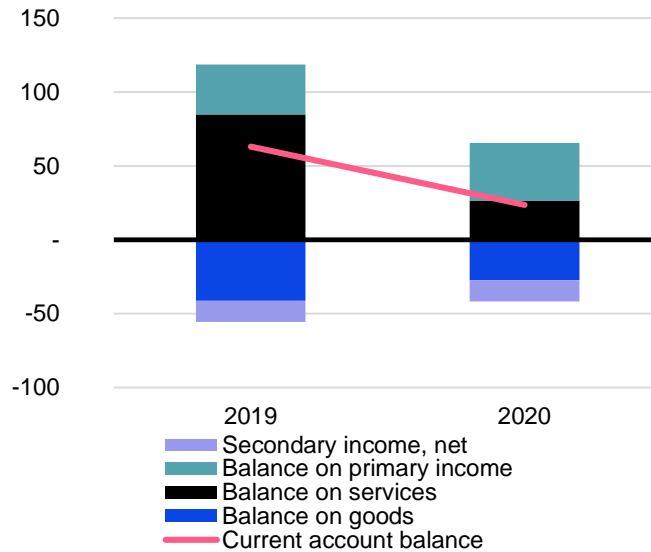
Current account - % of GDP



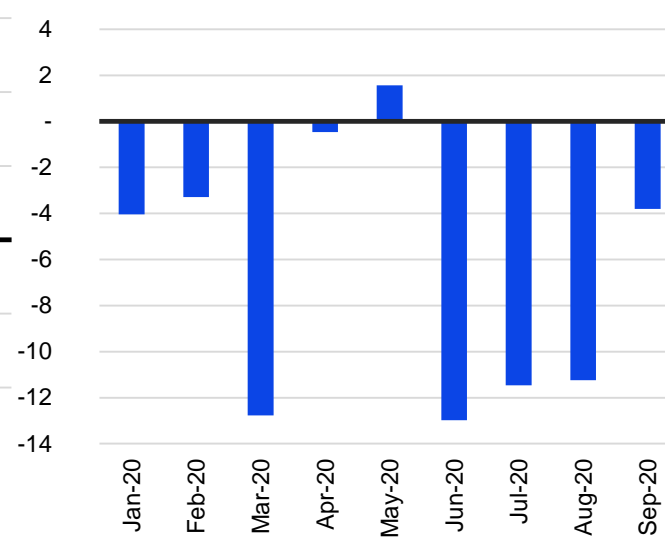
What's going on?

How come there is a current account surplus this year? There are several reasons for this: current account surplus in 1H of 2020 was ISK 24 billion, goods deficit in Q3 was ISK 26.5 billion while payment card turnover figures in Q3 indicate tourism surplus of ISK 20 billion, there will (probably) still be a primary income surplus and the forecast assumes a positive balance on services excluding tourism in Q4 due to exports of intellectual property.

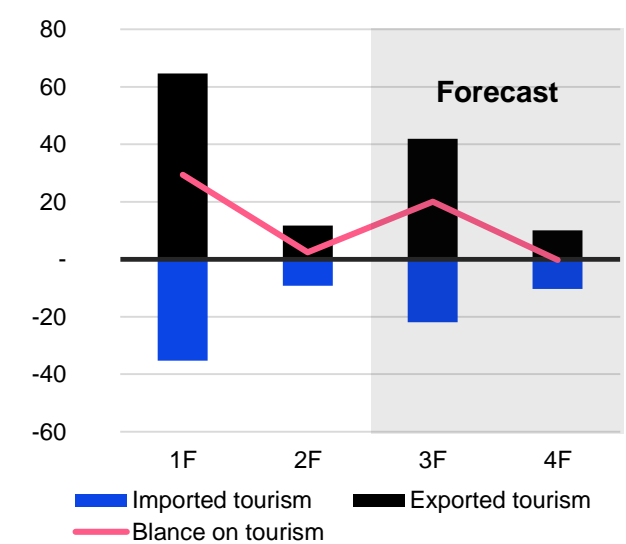
Current account balance in 1H – bn. ISK, floating exchange rate



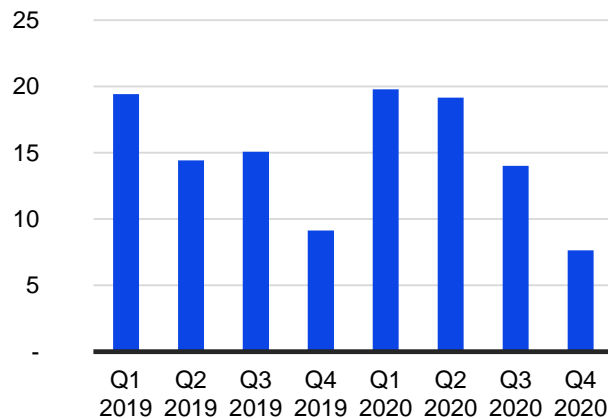
Balance on goods – bn. ISK, floating exchange rate



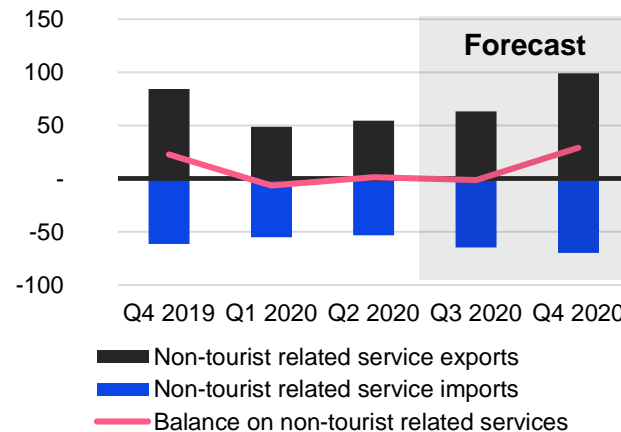
Balance on tourism in 2020 – bn. ISK, floating exchange rate



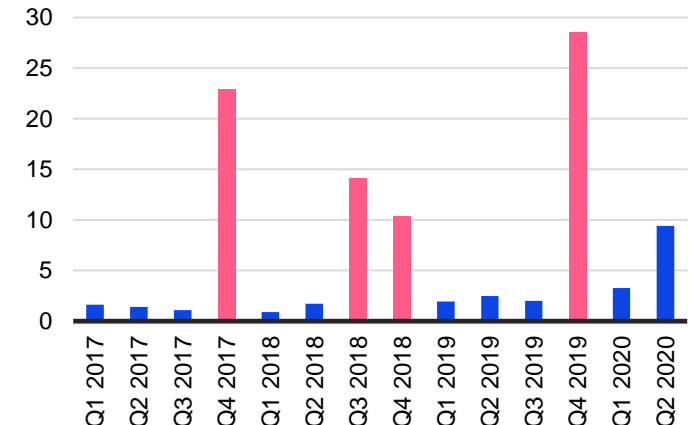
Balance on primary income – bn. ISK, floating exchange rate



Balance on non-tourist related services – bn. ISK, floating exchange rate



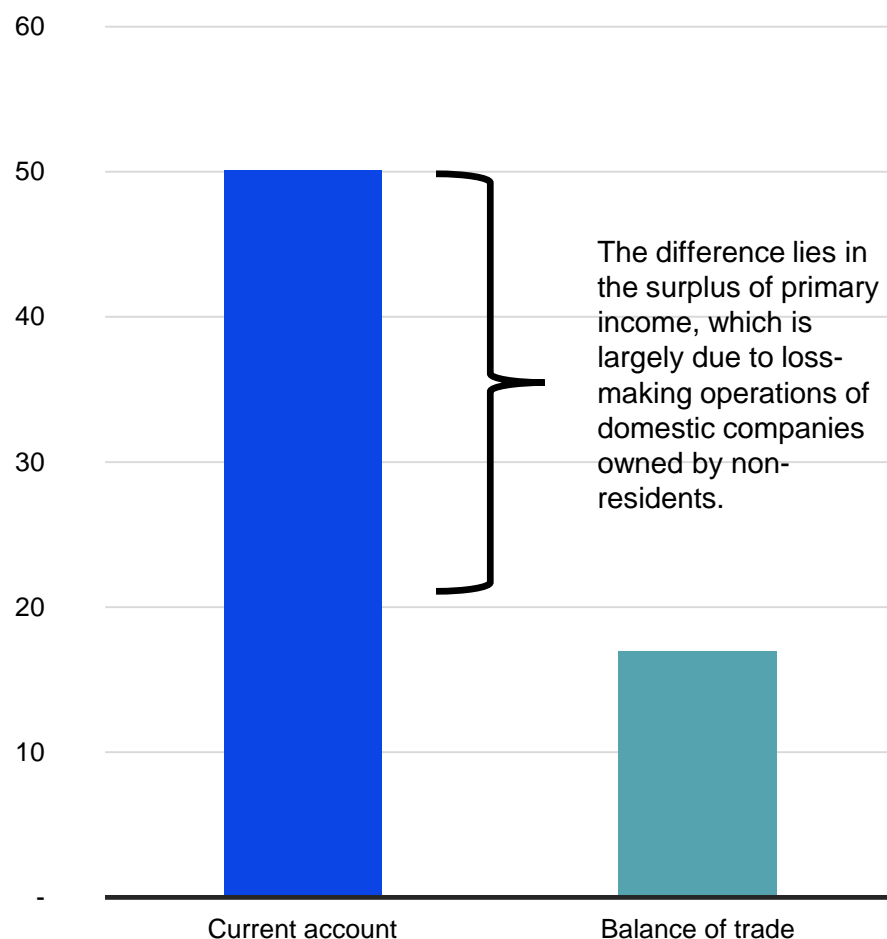
Exports of services: Charges for the use of intellectual property bn. ISK at floating exchange rate



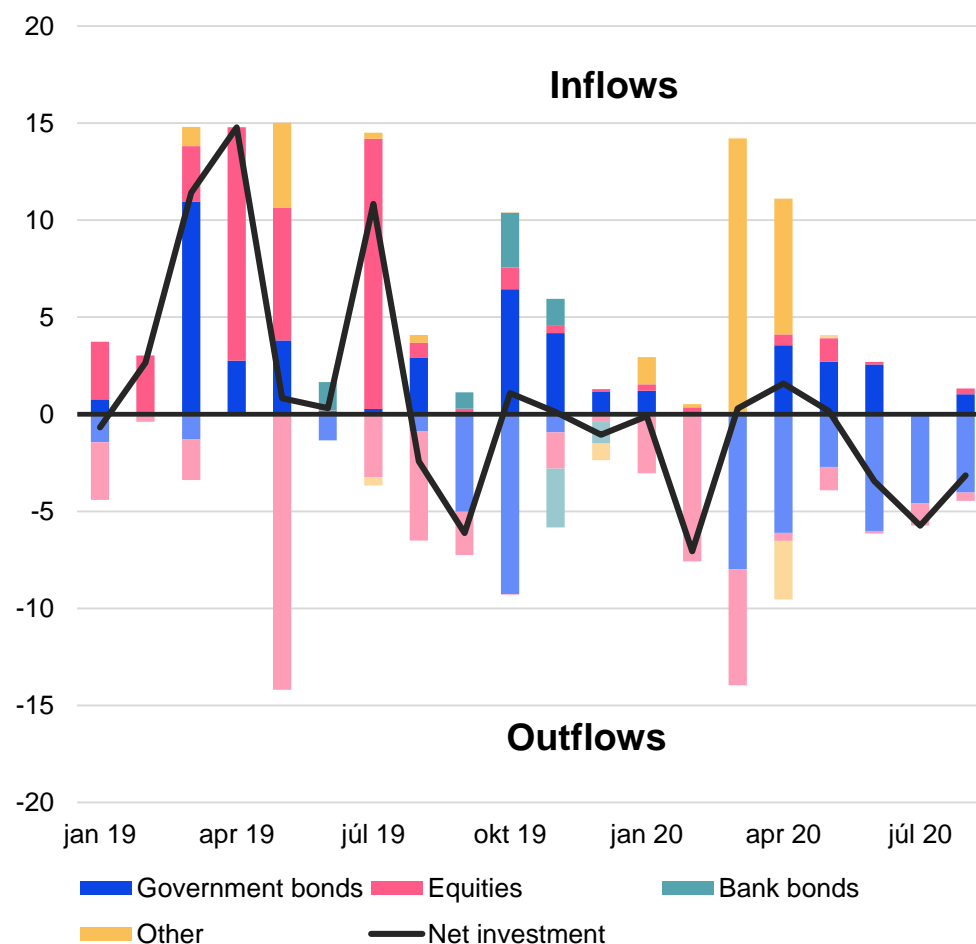
Current account surplus ≠ appreciation of ISK

The Icelandic FX market is shallow, inefficient and still subject to restrictions as FX derivatives are not permitted except for hedging purposes. The exchange rate of the ISK is thus determined by the flow on the market, and a current account surplus, particularly a surplus largely generated by loss-making operations of domestic companies, does not necessarily correspond to inflow. At the moment the flow is not helping the ISK, foreign investors want to exit the ISK environment, the pension funds want to increase foreign investment and the current account provides little support.

Current account and balance of trade in 2020 – bn. ISK, floating exchange rate, Arion Bank's forecast for 2H



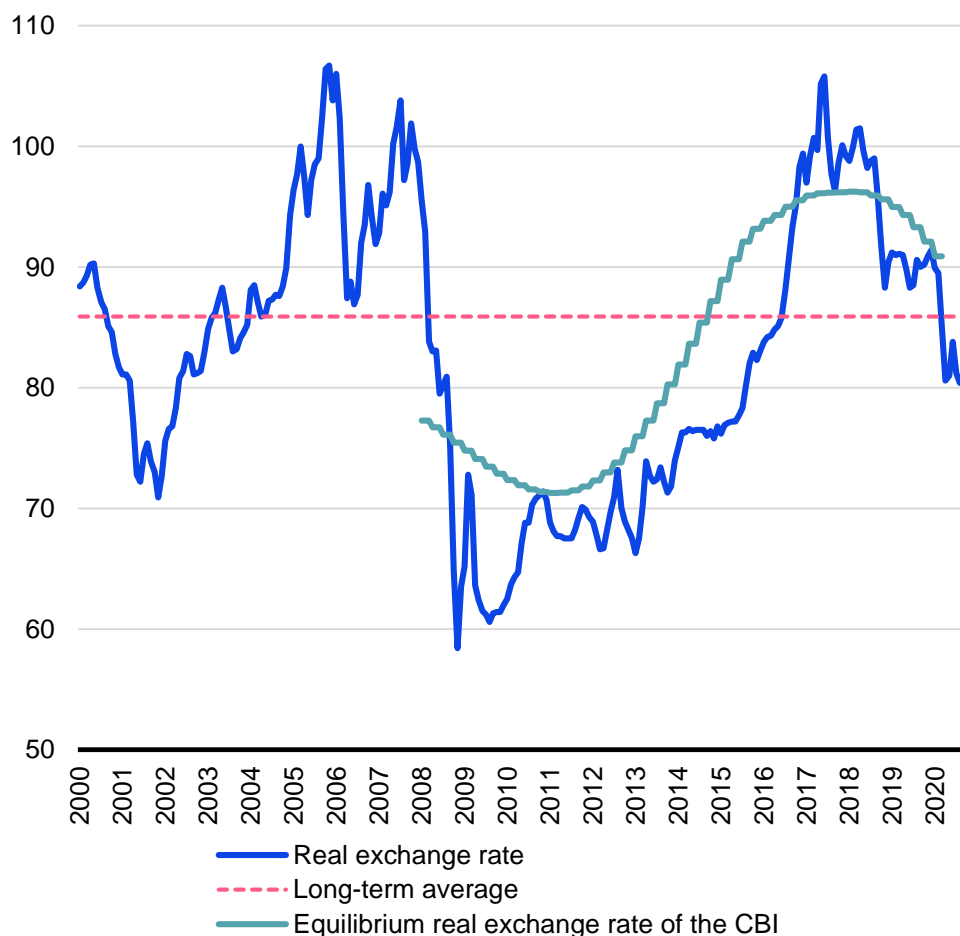
Registered new investment – bn. ISK, inflows in dark colors, outflows in light colors



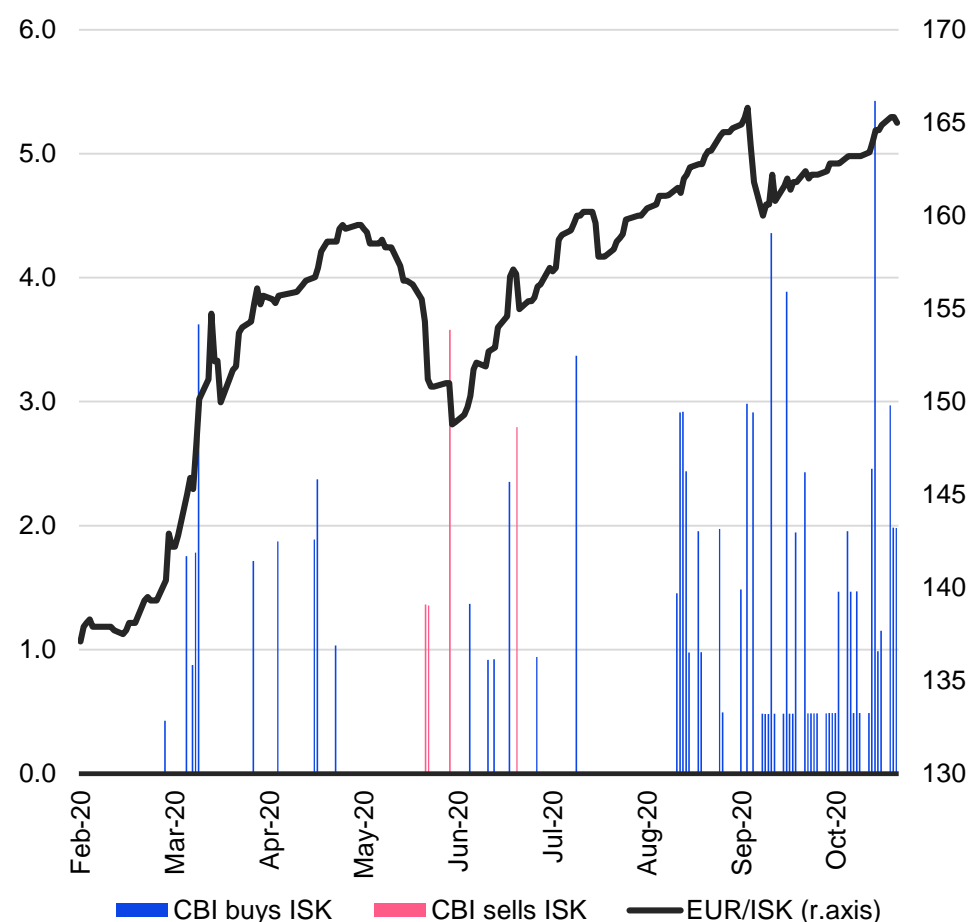
ISK is in the “good hands” of the Central Bank

According to the Central Bank's estimates the ISK is too weak, although this opinion seems to have mellowed in the last few weeks to “fairly well balanced”. As a result the Central Bank has been active on the FX market in recent weeks and launched a program of regular foreign currency sales on 14 September. However, there seems to be a lack of other buyers of the ISK. Although the Central Bank has the means to support the ISK, with ISK 700 billion in net currency reserves, it would have to be more aggressive and less predictable in its interventions in order to turn the exchange rate around, at least in the short term.

Real exchange rate of the ISK – relative prices, 2005=100



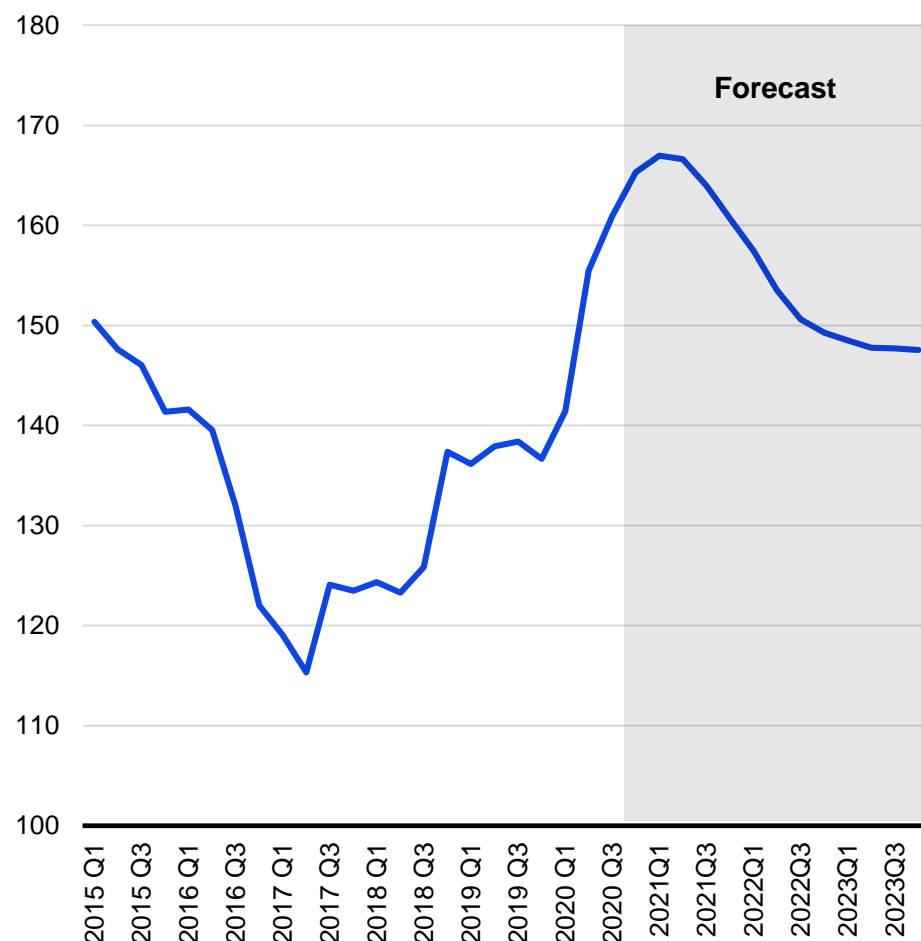
EUR/ISK and the CBI's intervention in the FX market – bn. ISK



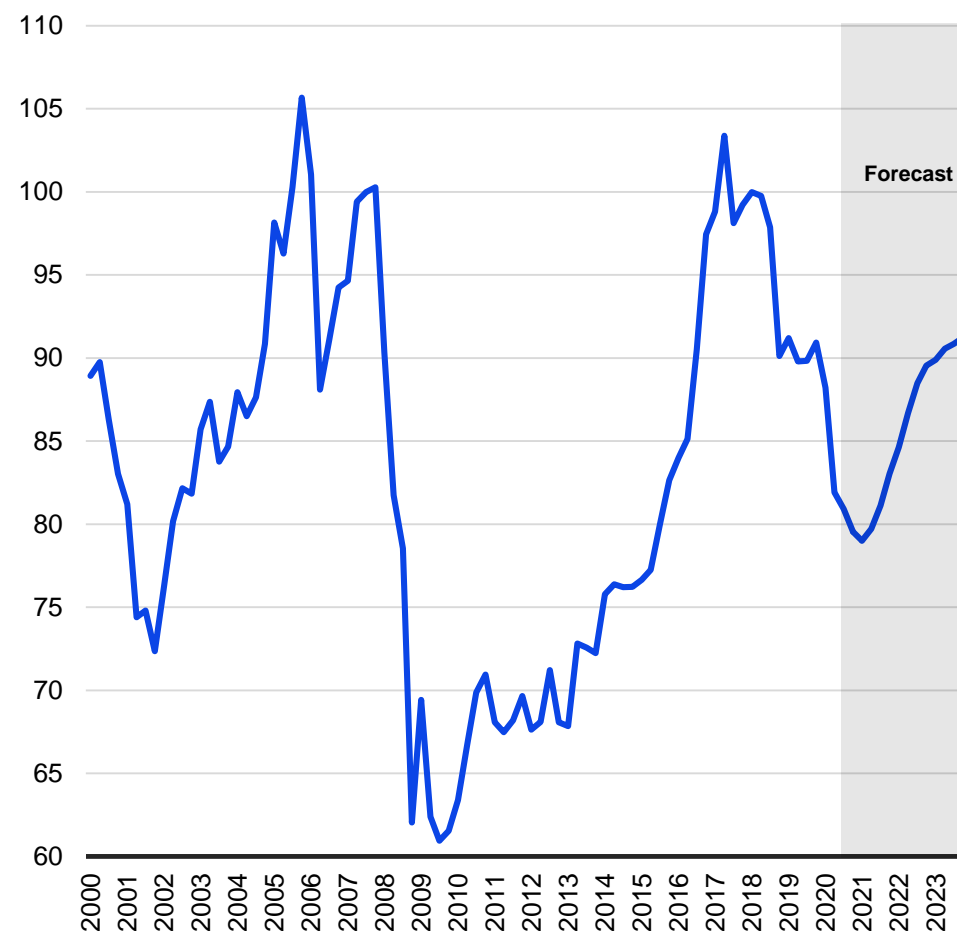
We forecast continued depreciation pressure until mid-2021

The ISK has not depreciated inordinately compared with other equally (or more) tourist-dependent economies which have similar currency regimes. The general economic outlook, particularly the outlook for the tourism sector, indicate that we are facing a long and difficult winter, including on the FX market. In the short term the flow seems unlikely to buoy the ISK and the Central Bank will have a full-time job supporting the exchange rate. However, once positive news begins to filter through and the tourism sector begins to bounce back, the flow might be quick to turn round – as will the exchange rate.

EUR/ISK – quarterly average



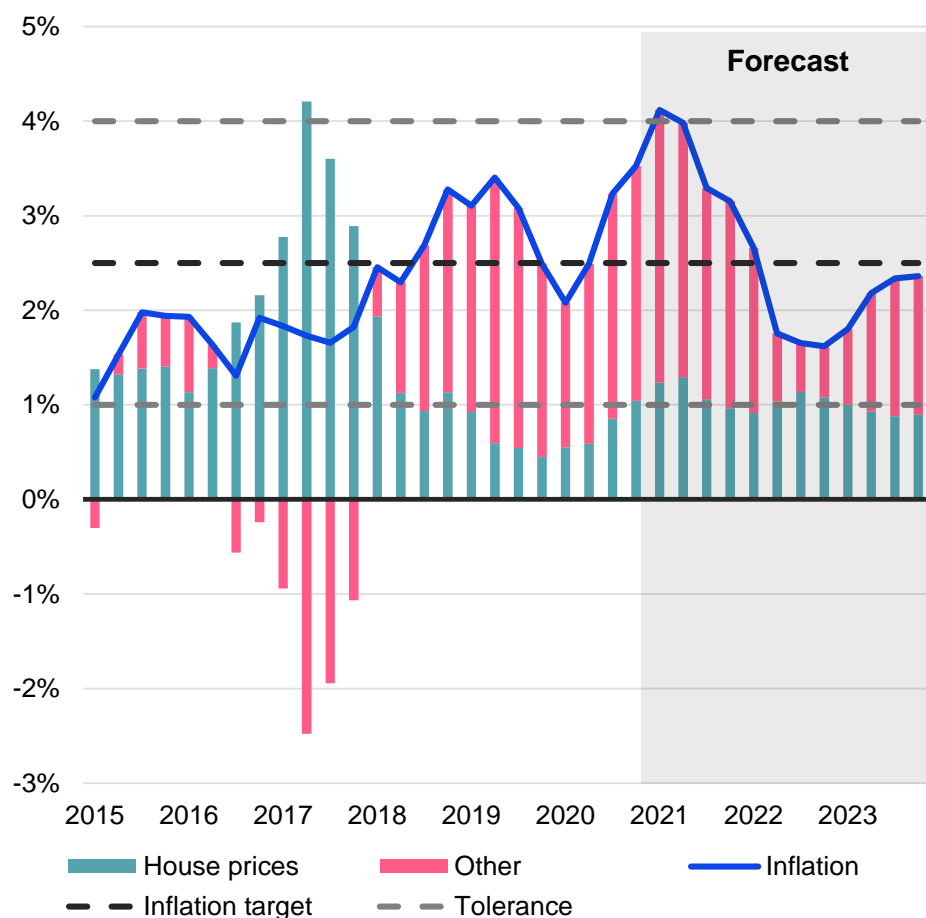
Real exchange rate of the ISK – relative prices



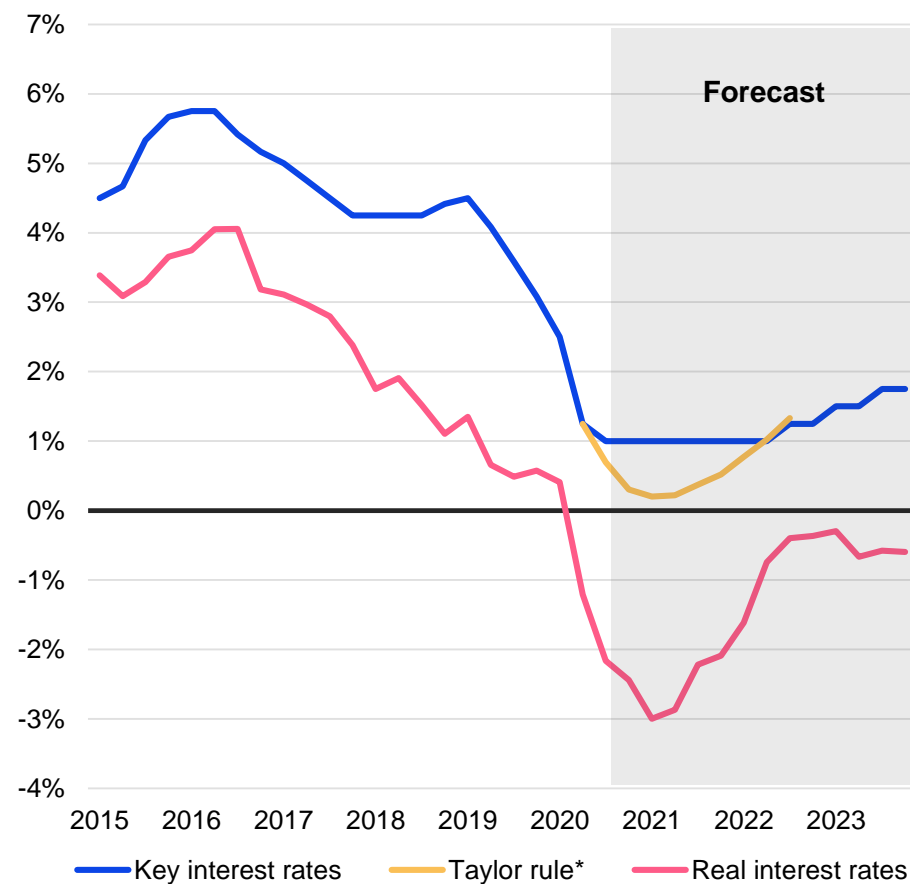
Interest rates remain unchanged through the inflation spike

Depreciation pressure on the ISK and rising property prices counterbalance the slack in the economy and the low inflation in Iceland's main trading partners. However, inflation will be quick to subside if, and when, the ISK appreciates, and is likely to stay below the Central Bank's inflation target in the second half of the forecast period. Even if inflation temporarily creeps above the upper limits (4%), inflation expectations have remained firmly anchored. The monetary policy committee should therefore be able to support the economy through these tough times by keeping interest rates low.

Inflation – contribution of underlying components



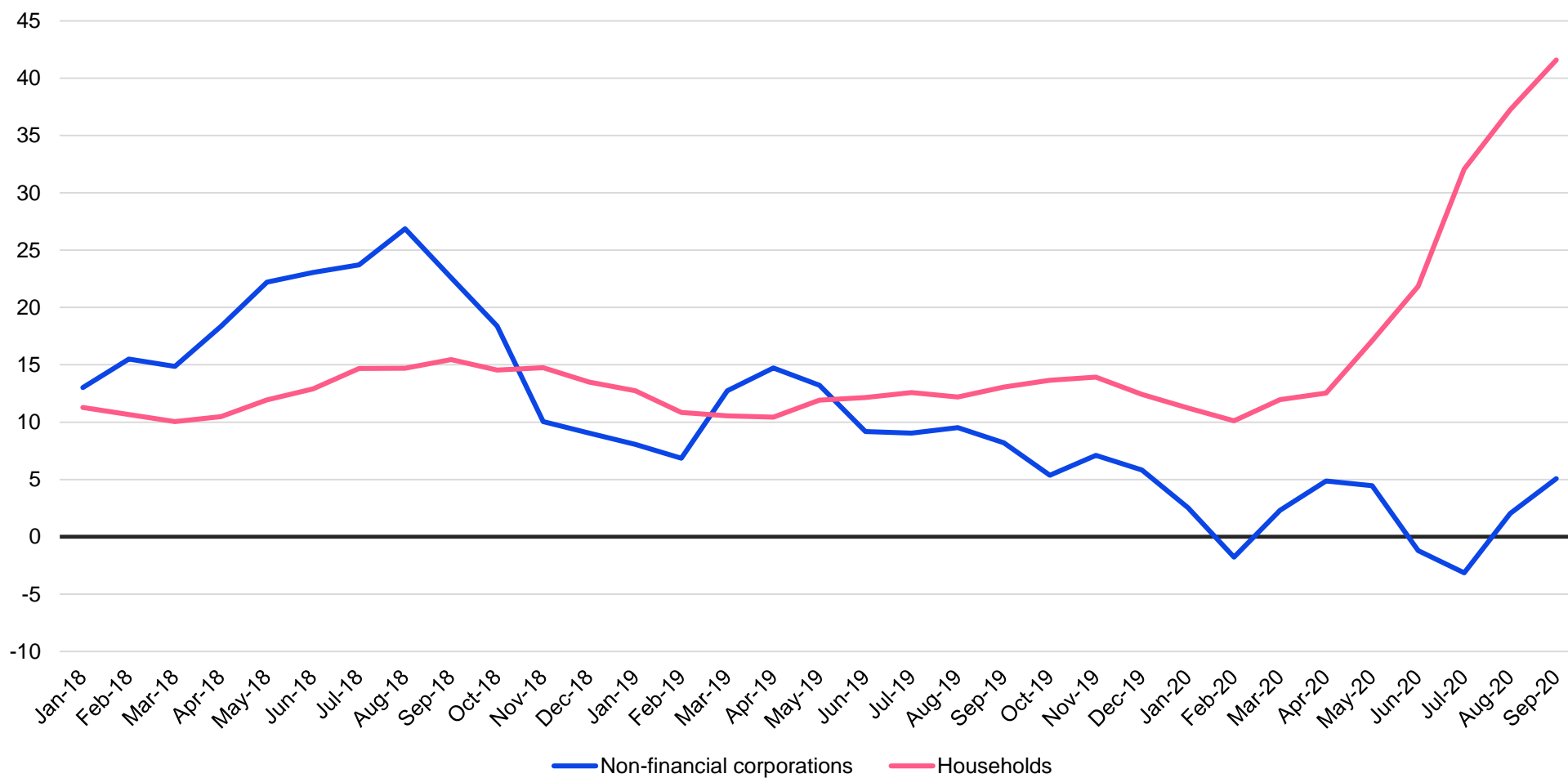
CBI's key interest rates – based on Arion Bank's inflation forecast



Who has benefited from the cut in key interest rates?

In short, households

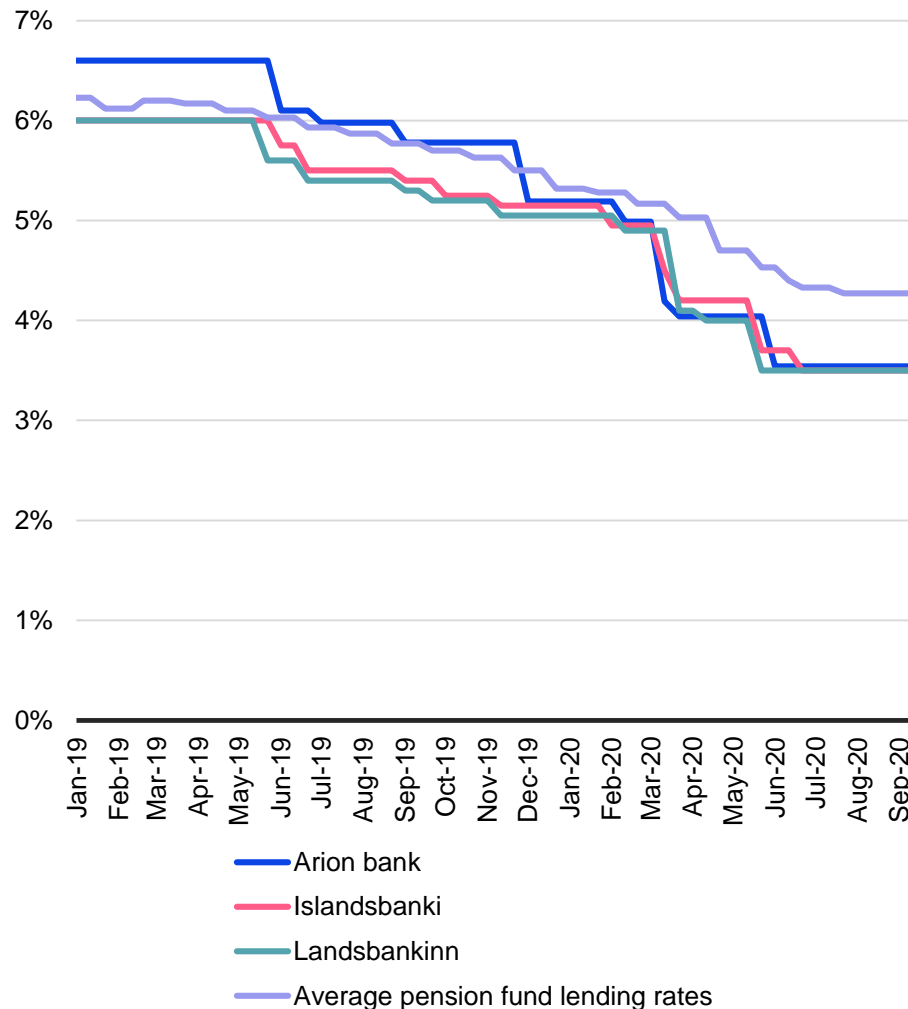
Deposit lending corporations' new credit less repayments – 3-month MA, bn. ISK



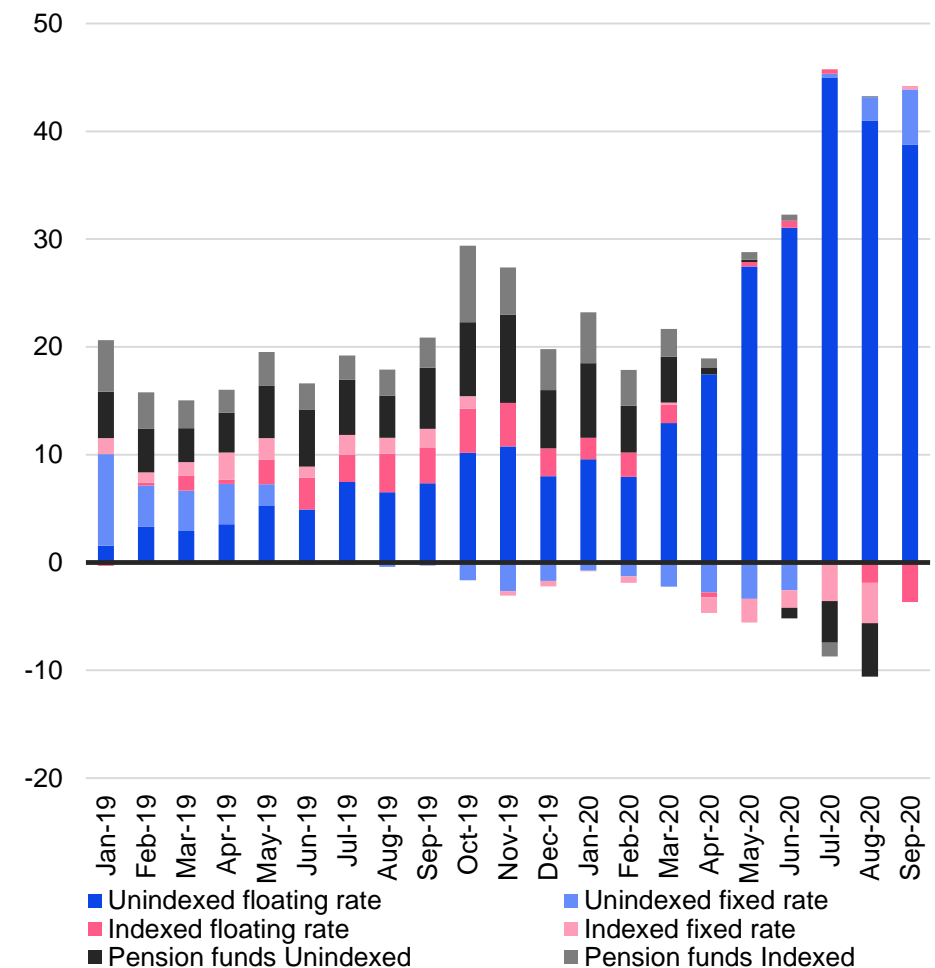
Interest rate cuts animate the property market

The Central Bank's rate cuts and reduction in the countercyclical capital buffer on banks have benefited households as mortgage rates have dropped sharply this year. Non-indexed floating rate loans are the most popular choice among consumers, unsurprisingly as debt servicing costs have decreased by over 30% in less than two years. Lower debt burdens on mortgages have made refinancing more popular, enabled people to buy larger properties and allowed many to get on to the first rung of the property ladder.

Interest rates on nominal housing loans



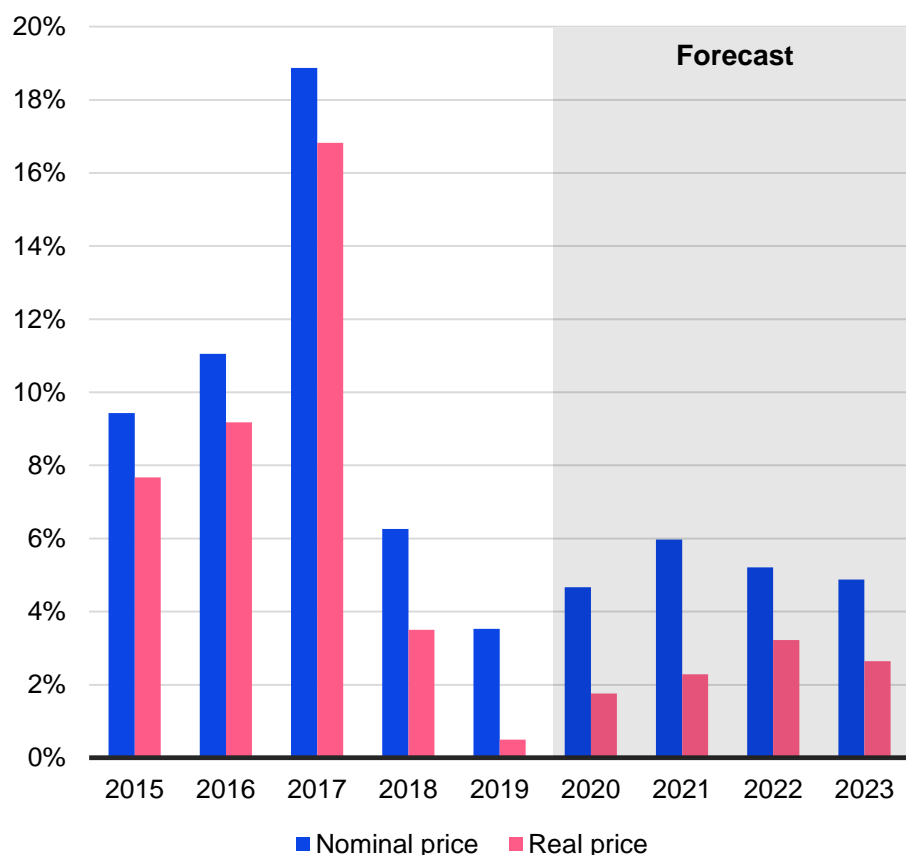
Net new lending to households – banking system and pension funds



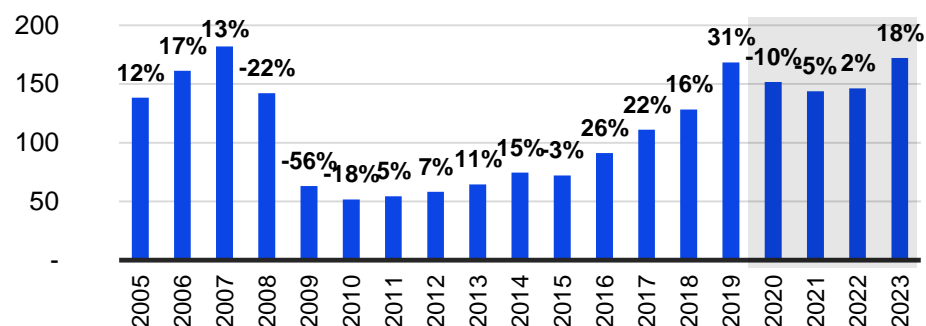
Housing prices expected to continue to rise

Despite high unemployment, economic slack and rising numbers of new properties, housing price increases have gathered steam. This increase has been helped by lower interest rates and the divided labor market. Low interest rates may have also made property a more popular investment choice. Prices appear likely to continue to rise but the rate of increase will slow over the course of next year. Price increases will probably buoy housing investment, although there will be a contraction at first. Rising long-term interest rates on the bond market in recent weeks will be reflected in higher mortgage rates, all other things being equal, the first signs of which have already materialized. Rising long-term interest rates are a significant risk factor on the housing market which could temporarily halt price increases and hamper investment.

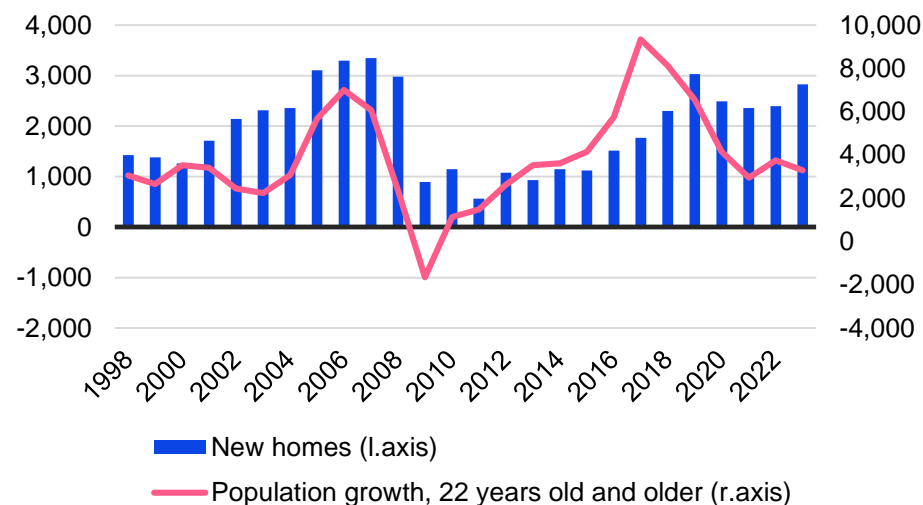
House prices – YoY %-growth between annual averages



Housing investment – bn. ISK at 2020 prices



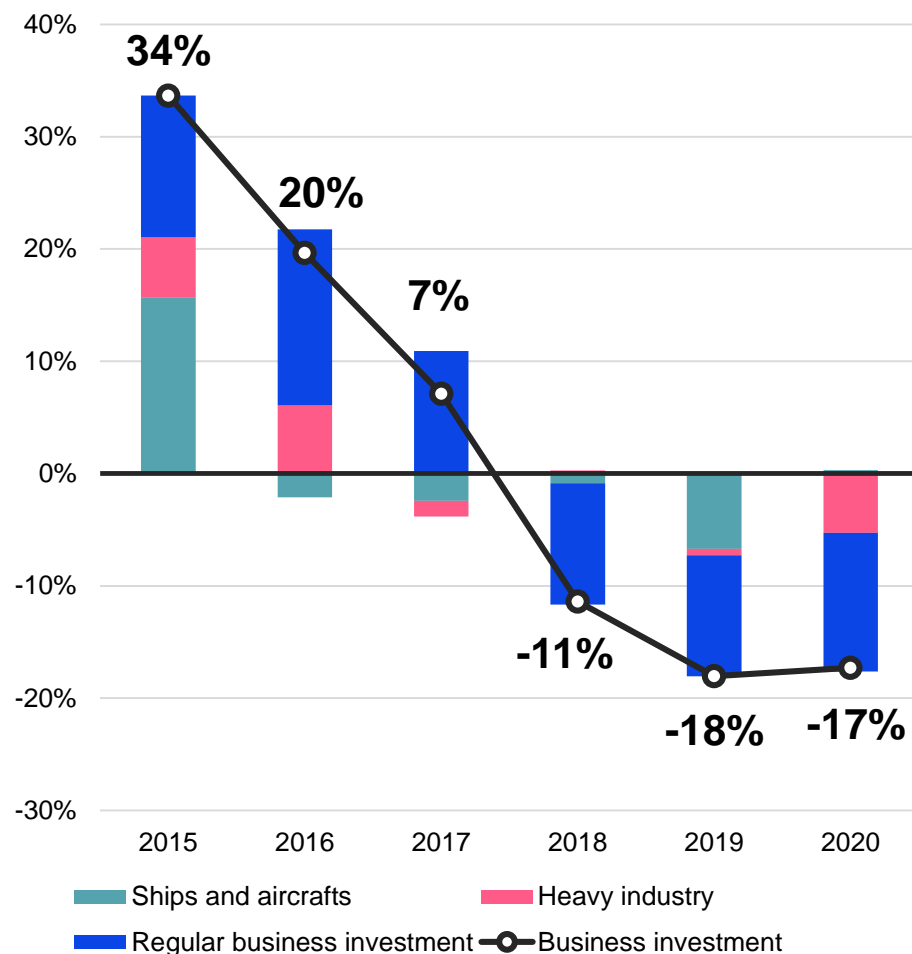
Number of new homes and population growth



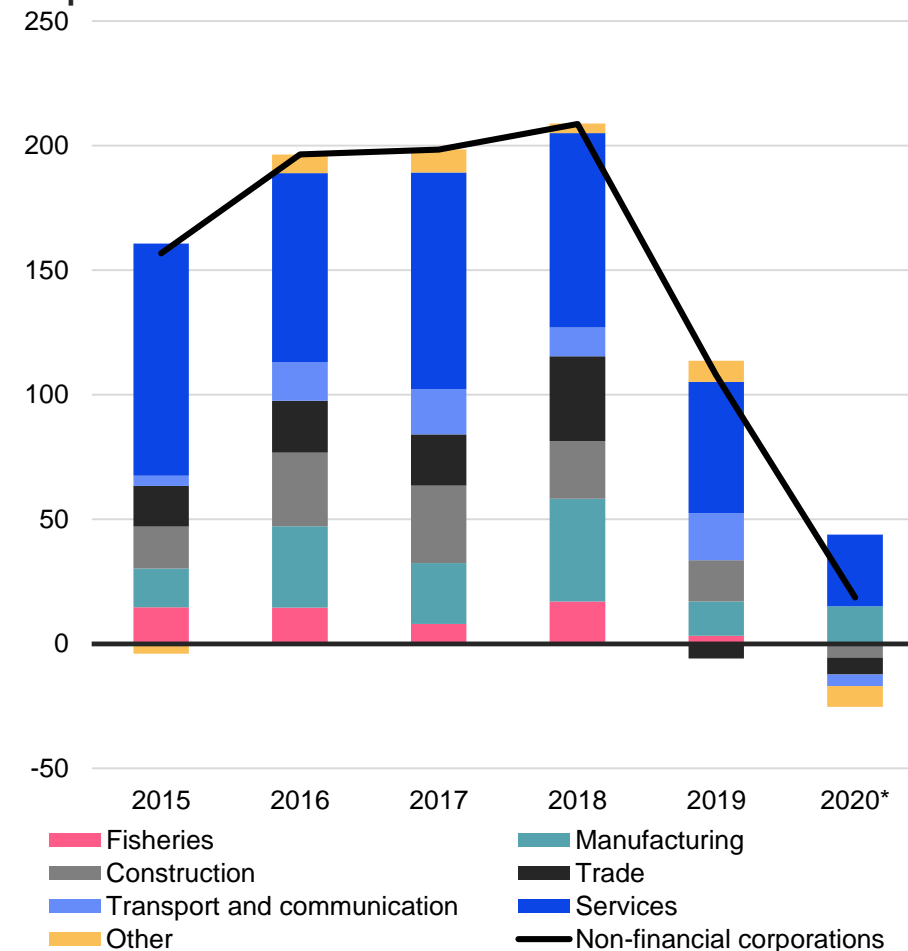
Lower interest rates have had no visible impact on business investment

Business investment is set to decrease for the third year in a row. This is primarily due to regular business investment, a serious development given that it involves companies which a large portion of the population work for, companies which play a significant part in creating the foundations for future revenue generation. There are signs that things are improving on corporate funding markets. Domestic long-term savings are gradually finding their way into domestic value creation.

Business investment – contributions of components



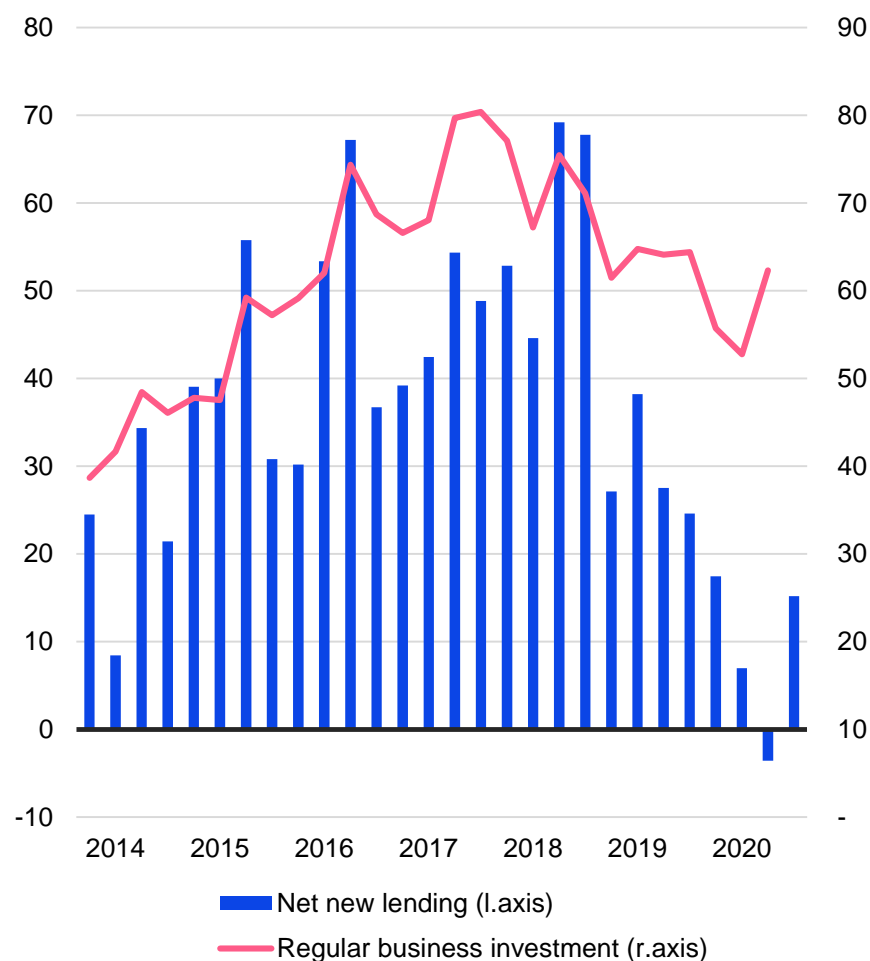
Banking system's net new lending to non-financial corporations – bn. ISK



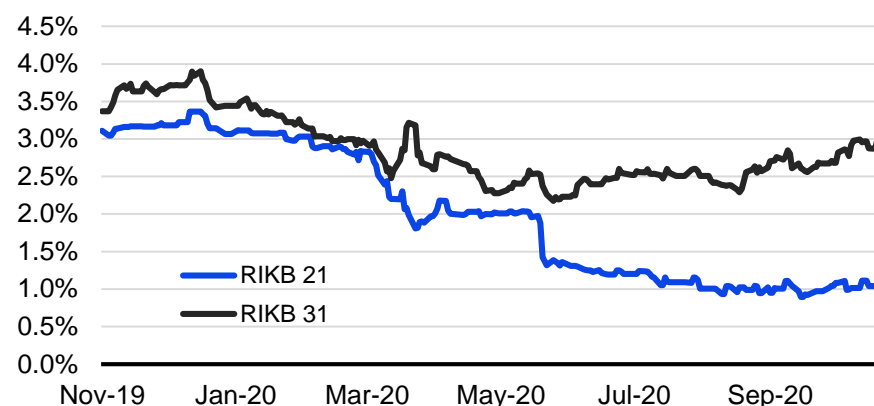
Recovery held back by higher interest rates?

Loans to companies recovered slightly over the summer, giving hope that business investment is finding its feet again. However, there is a danger that these hopes could be dashed by the third wave of COVID-19 and rising long-term interest rates. In March, the Central Bank followed upon its policy interest rate cuts by announcing it was launching a QE program. By doing so it wanted to ensure that low policy rates would benefit companies and households. The rise in long-term rates is contrary to these aims and could reduce investment, particularly by businesses.

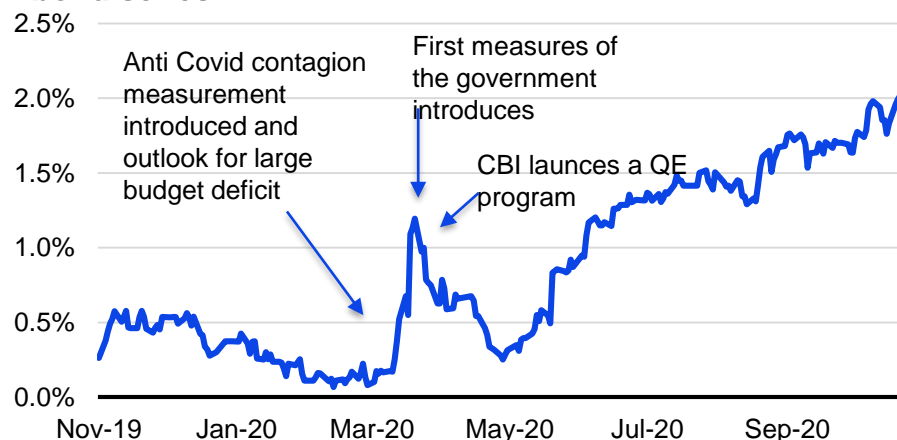
The banking system's loans to corporates and regular business investment – bn. ISK at nominal prices



Yield of longest and shortest T-bond series



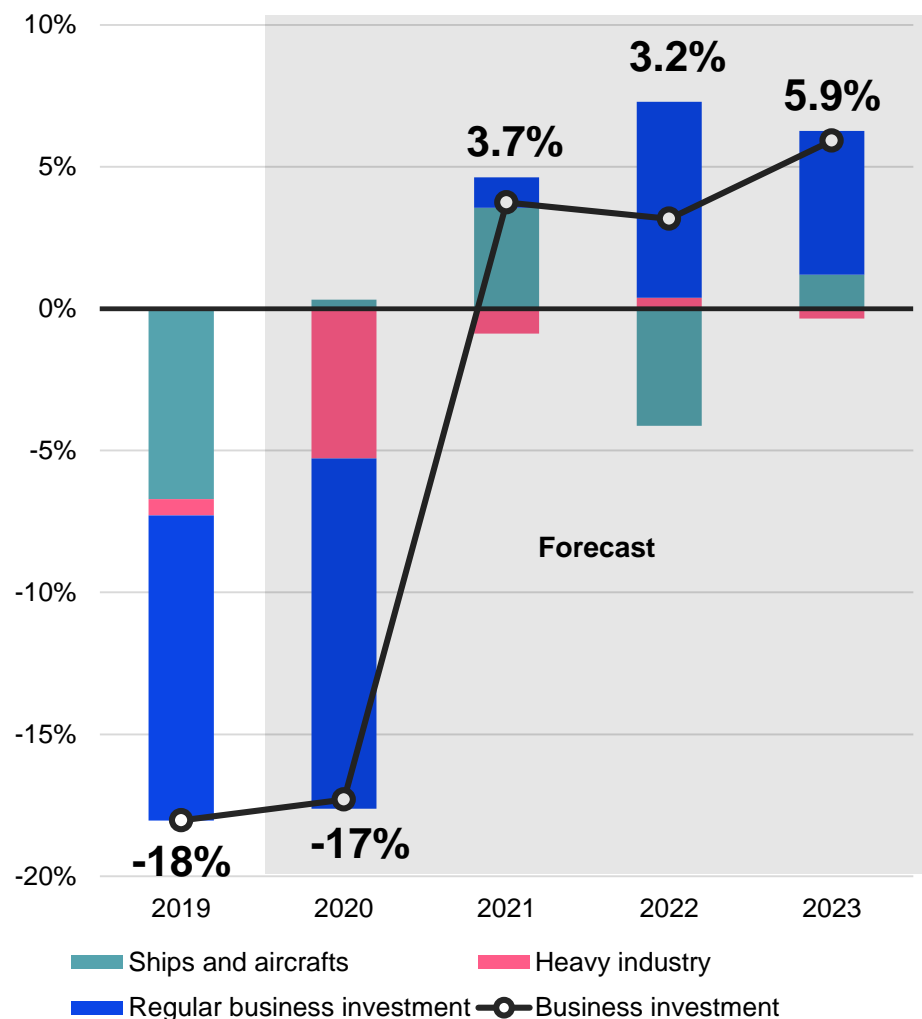
The difference between yields on the longest and shortest T-bond series



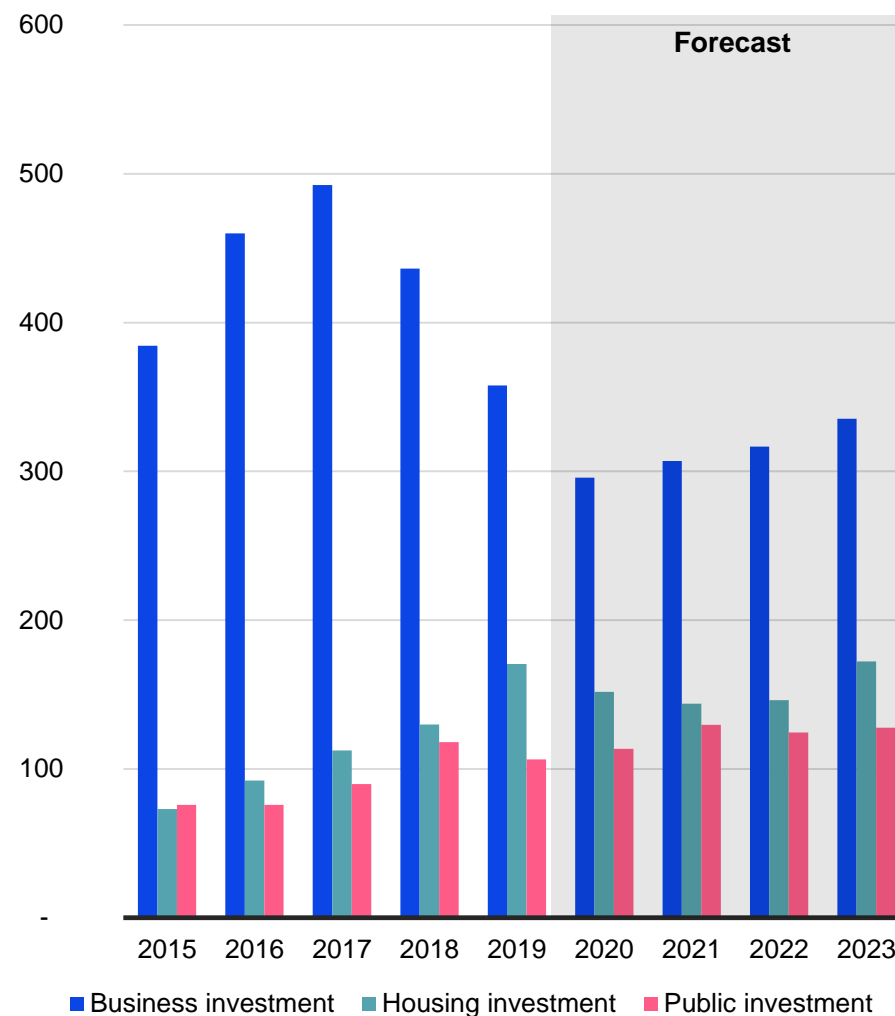
Business investment will hopefully start to recover next year

The recovery is off to a slow start, with regular business investment only expected to grow by 1.2% next year. Even if the government ramps up investment, it won't change the big picture since business investment is bigger than public investment and housing investment combined.

Business investment – contributions of components

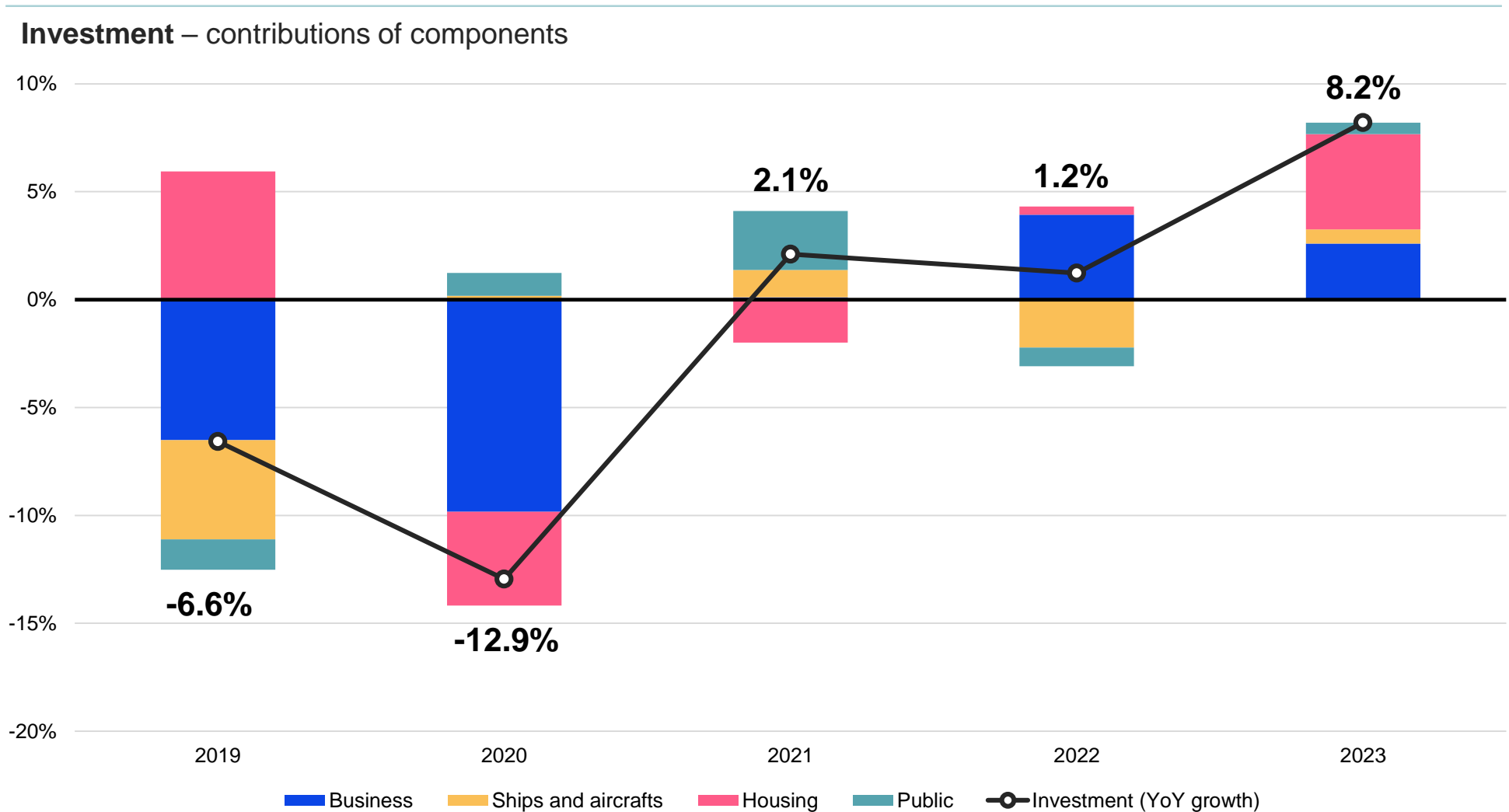


Investment – bn. ISK at 2020 prices



Investment gets off to slow start

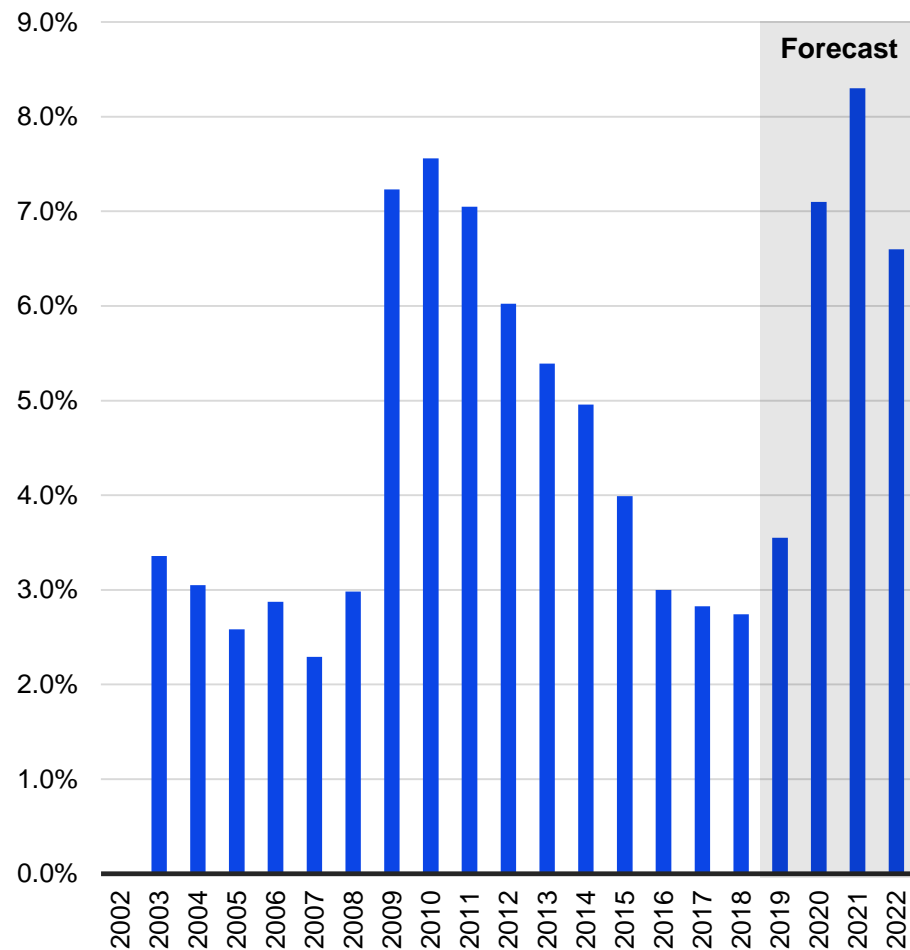
Business investment is the main driver behind the investment contraction this year, followed by housing investment. Despite noble aims and grand statements, public investment has fallen short of expectations, a development which has an impact on total growth over the year. Growth is expected to be significantly greater next year, and public investment is expected to be responsible for most of the investment growth.



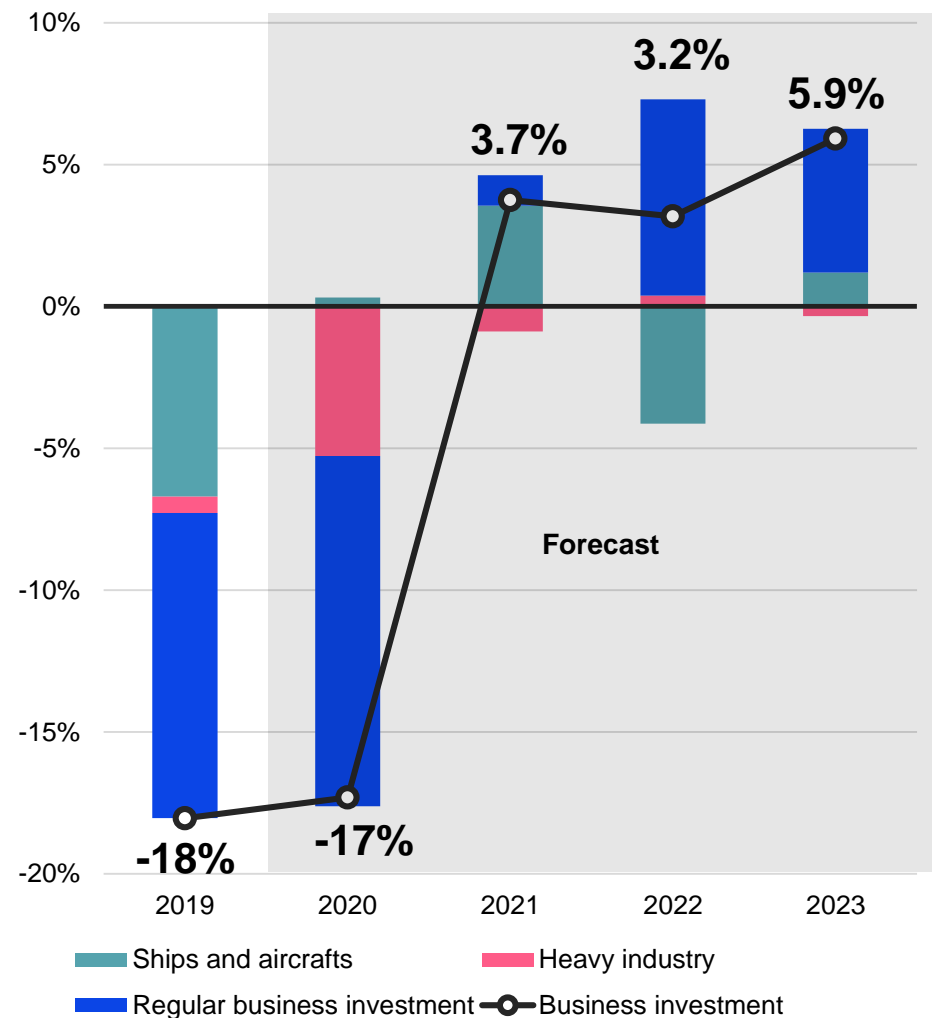
The major challenges

The main challenge we face at present is the high unemployment rate and the bleak outlook on the labour market. The challenge is not restricted to the tourism sector and there is a danger that companies across many sectors will be forced to cut back, even go out of business as the situation becomes more prolonged. In the long term it's vital to nurture investment. Business investment is the mainstay of value creation in the economy, and in order to ensure diverse sources of revenue, e.g. exports, the investment environment needs to be as efficient as possible.

Unemployment rate



Business investment – contributions of components



Main economic indicators

GDP components

<i>Change from previous year (%)</i>	2019	2020	2021	2022	2023
Private consumption	1.3	-4.2	1.6	3.7	2.6
Public consumption	4.2	2.6	1.5	1.8	2.2
Investment	-6.6	-12.9	2.1	1.2	8.2
<i>Business investment</i>	-18.0	-17.3	3.7	3.2	5.9
<i>Housing investment</i>	31.2	-10.9	-5.2	1.6	17.9
<i>Public investment</i>	-9.8	6.7	14.2	-4.0	2.6
Domestic demand	-0.2	-3.9	1.7	2.7	3.7
Exports of goods and services	-4.9	-30.3	8.9	19.2	12.2
Imports of goods and services	-10.2	-24	8.0	13.8	10.1
Gross domestic product (GDP)	1.9	-7.5	2.5	5.9	4.9



Main economic indicators

<i>Proportion of GDP (%)</i>	2019	2020	2021	2022	2023
Current account	6.2	1.8	0.7	3.0	4.2
Investment	20.1	19.7	20.4	19.9	20.6
<i>Change from previous years (%)</i>					
Inflation	3.0	2.8	3.6	1.9	2.2
Nominal wages	4.9	5.9	5.0	5.3	4.7
Real wages	1.8	3.0	1.3	3.3	2.5
Housing prices	3.5	4.7	6.0	5.2	4.9
Real housing prices	0.5	1.8	2.3	3.2	2.6
Real exchange rate	-6.7	-8.6	-2.3	8.2	3.8
<i>Annual averages</i>					
Unemployment (%)	3.6	7.1	8.3	6.6	5.9
EUR/ISK	137	156	165	153	144



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