

# Will the equation add up?

Economic update in March 2021



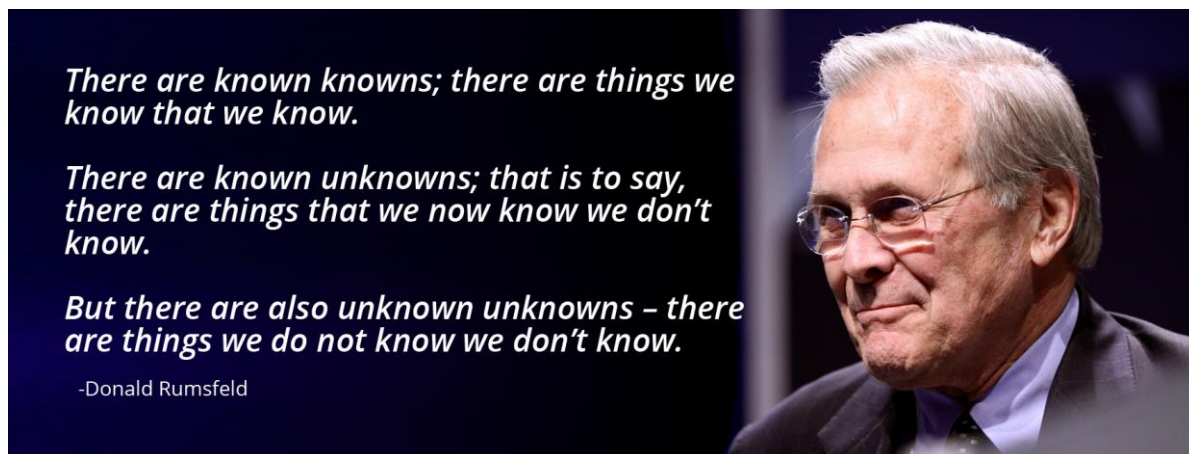
ICELAND CHAMBER  
OF COMMERCE

EST. 1917



# Uncertainty, uncertainty and yet again uncertainty

The clumsy defence minister who knew and unknew about knowns and unknowns



... Donald received the Gobbledygook award for the novel quote in 2002



Víðir Reynisson, State police civil protection head, 2021:  
*„Four features of knowledge in crisis management:*

- *What you don't know that you know*
- *What you don't know that you don't know*
- *What you know that you don't know*
- *What you know that you know*



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## How little did we know?

What do we know that we know?

What do we think?

And then what?

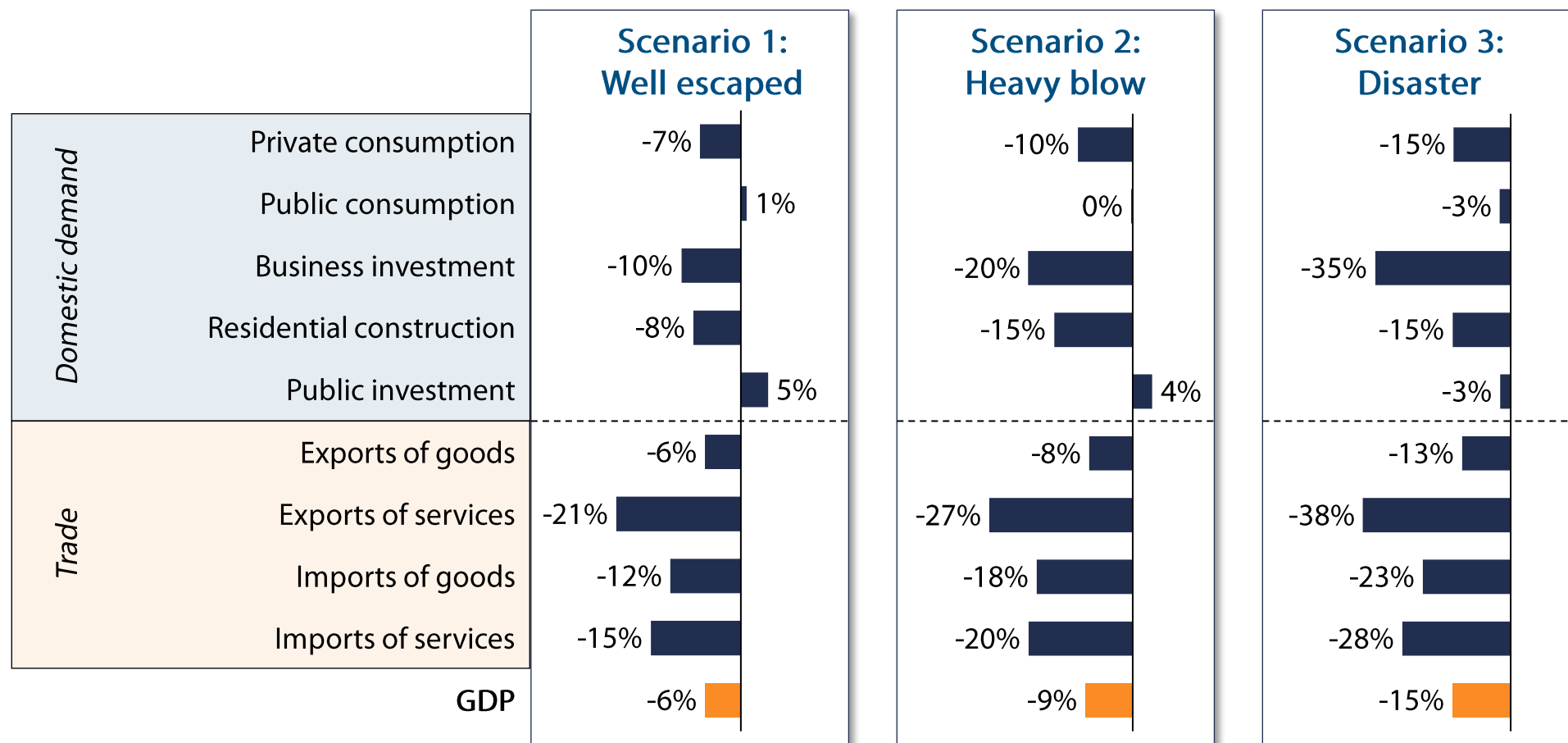
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# How little did we know?

## Scenario analysis from March 2020

### Scenario analysis: GDP and its components 2020 YoY change

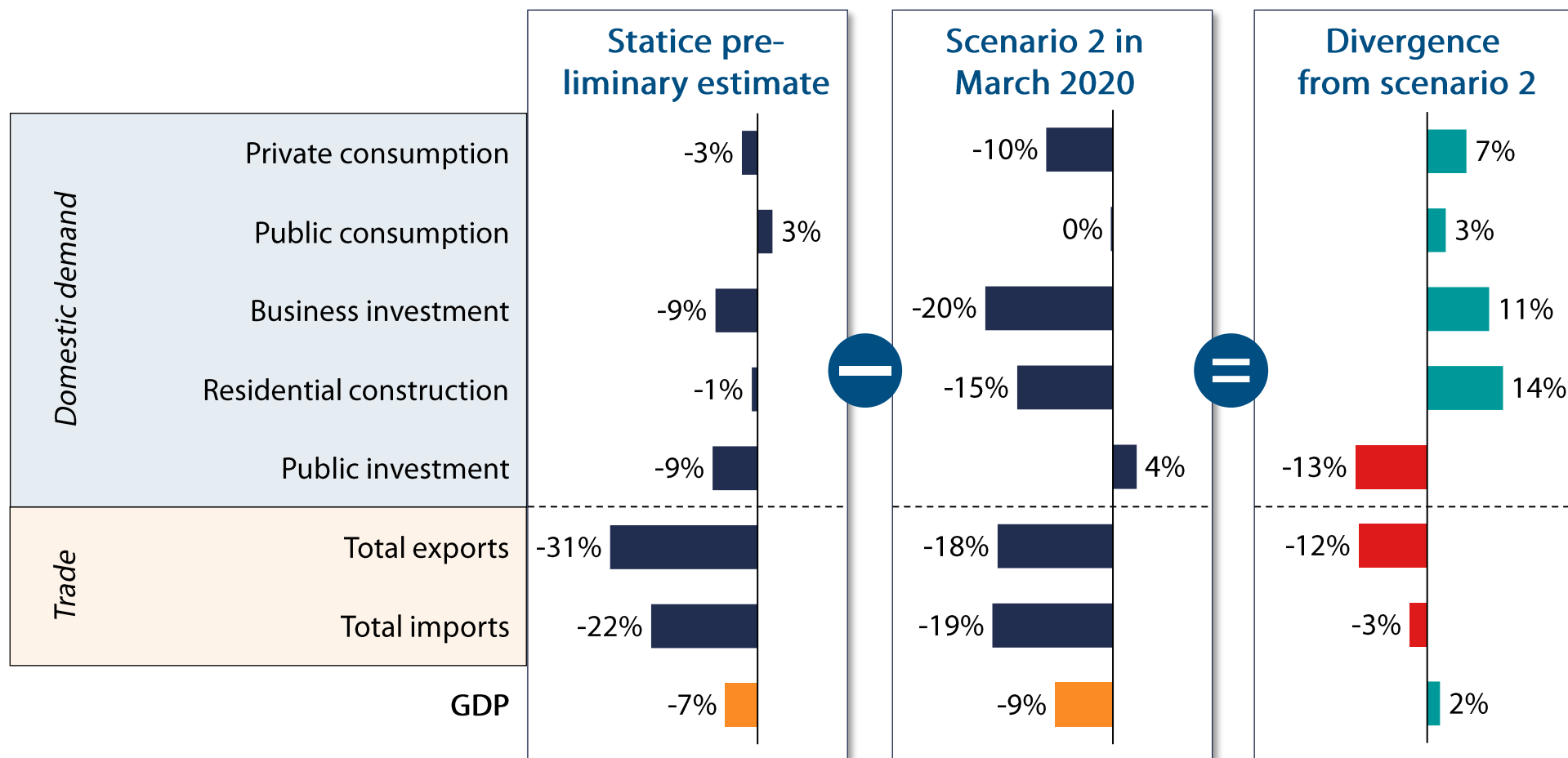


# The economy escaped relatively well due to domestic demand...

... despite a larger hit on tourism than initially thought

## GDP and its components

YoY change



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How little did we know?

**What do we know that we know?**

What do we think?

And then what?

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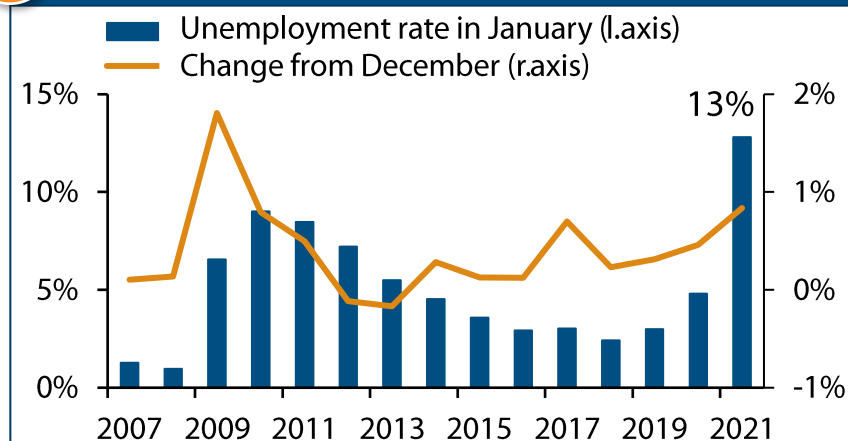


# We are somewhat wiser today

The light at the end of the tunnel is in sight but uncertainty persists

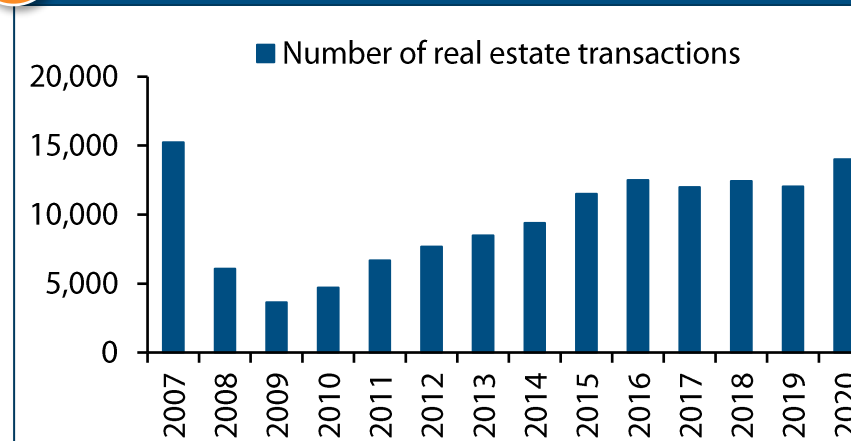
1

## Registered unemployment not diminishing



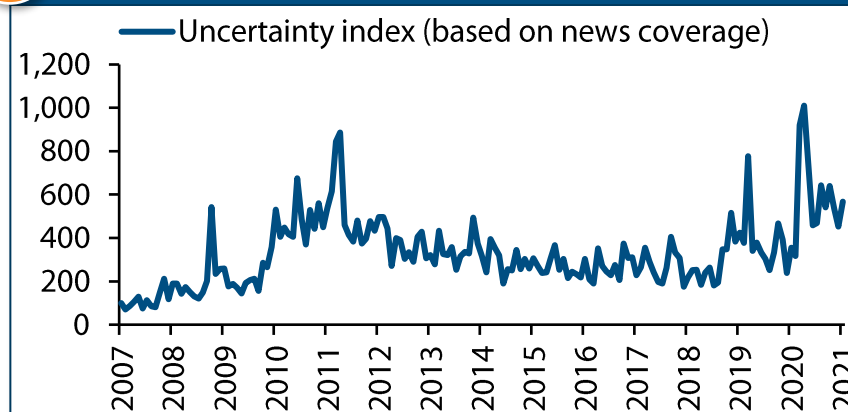
2

## No crisis in the residential sector



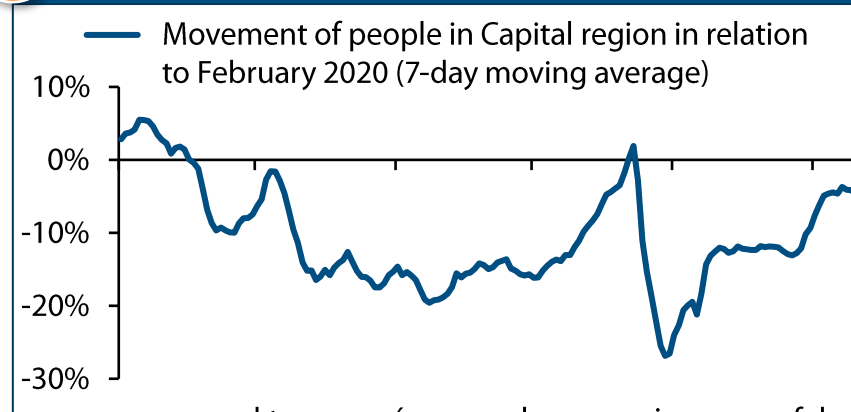
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## Level of uncertainty still elevated



4

## People are back in motion



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And then what?

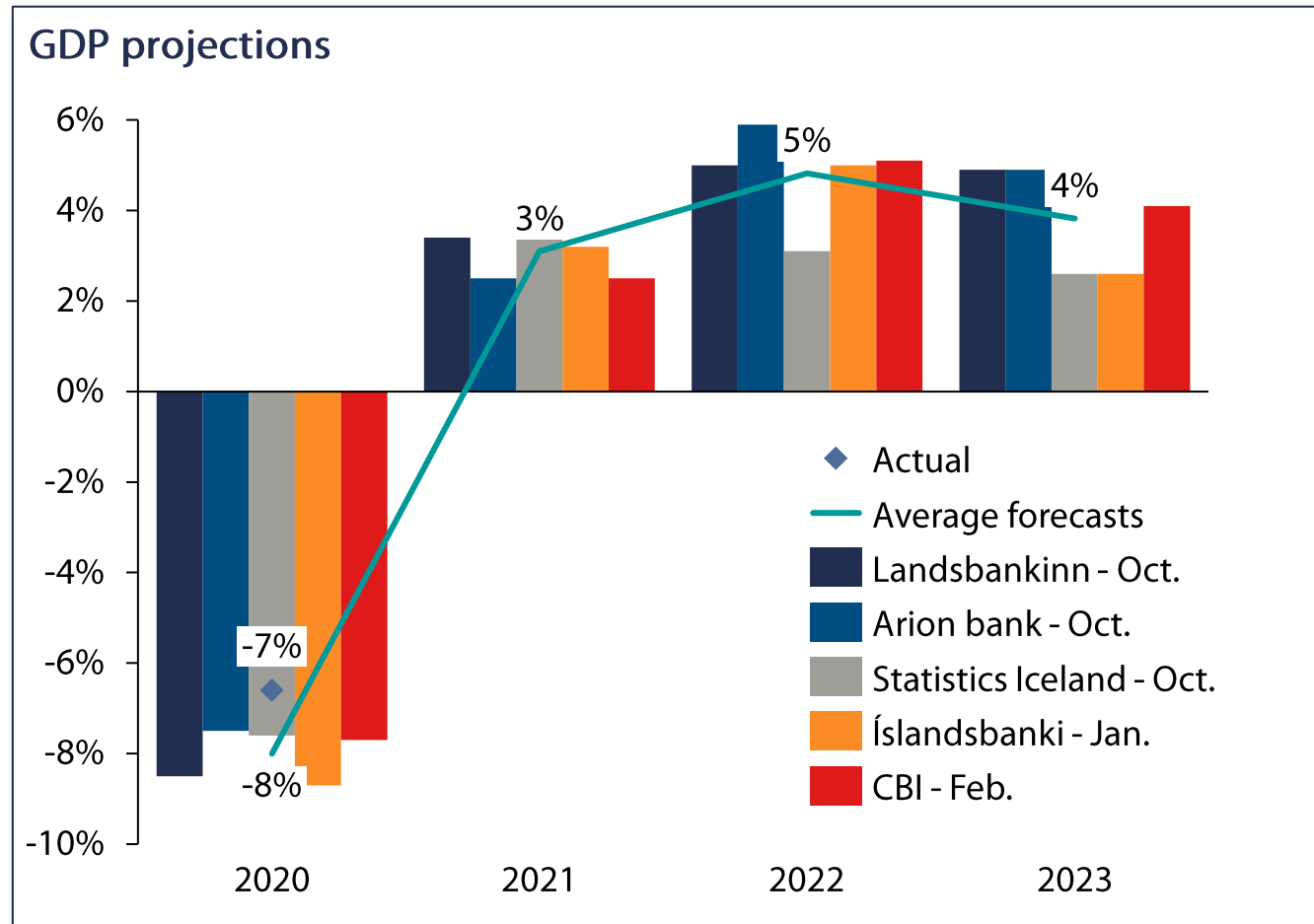
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# GDP projections are favourable – all things considered

The timeline of tourism recovery is the main uncertainty

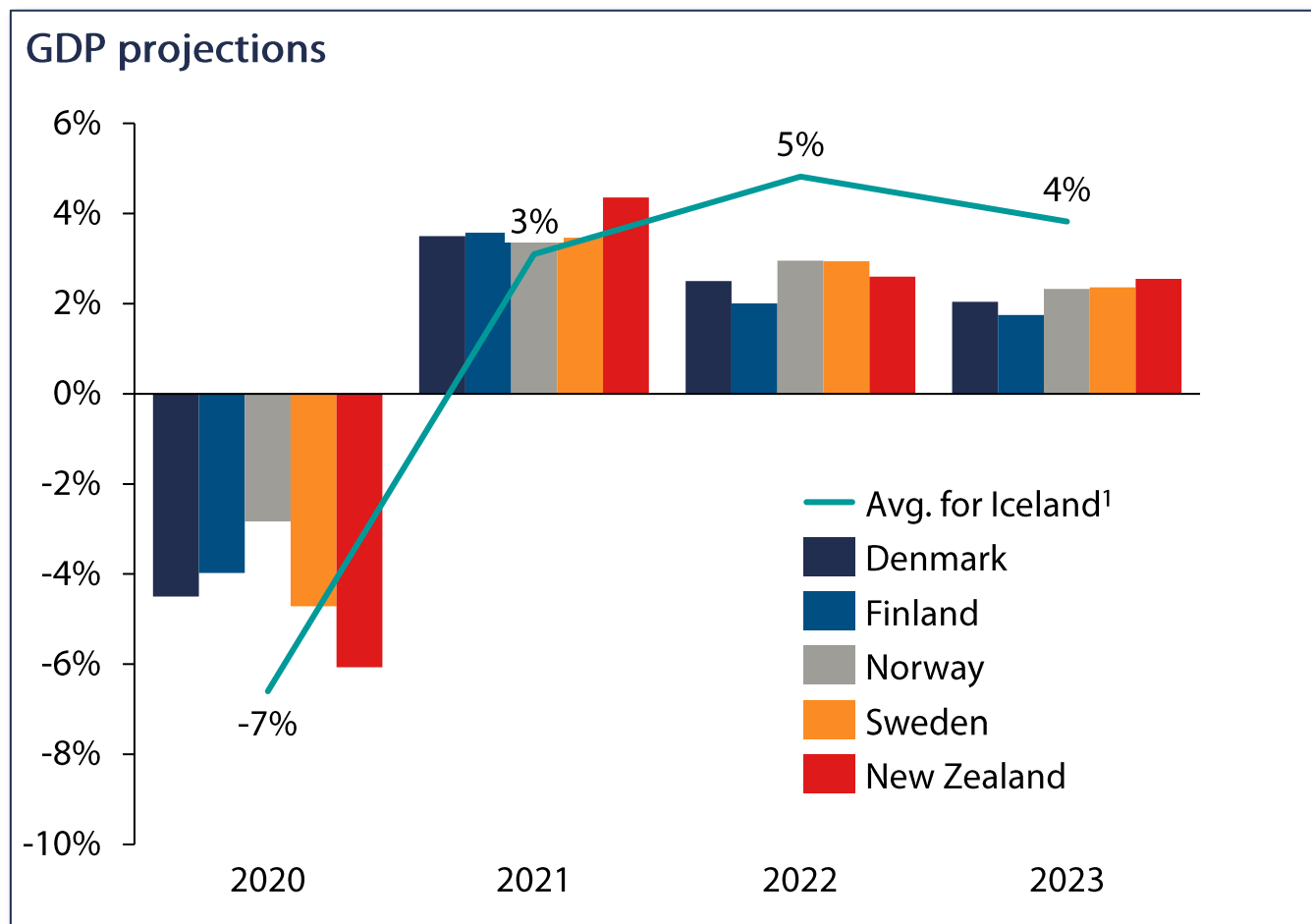


- Forecasts have remained unaltered for a few months
- Production back to 2019 levels in late 2022 or early 2023
- Tourism rebounding this summer
- Statistics Iceland, as usual, with the most moderate projection



# Narrower economic cycles in other countries

Smaller down- and upturns



1. The weight of tourism makes Iceland stand out
  - A more severe blow, but greater room for growth
2. Having control of the epidemic is crucial
  - New Zealand: 2,2% GDP contraction in the first 9 months of 2020



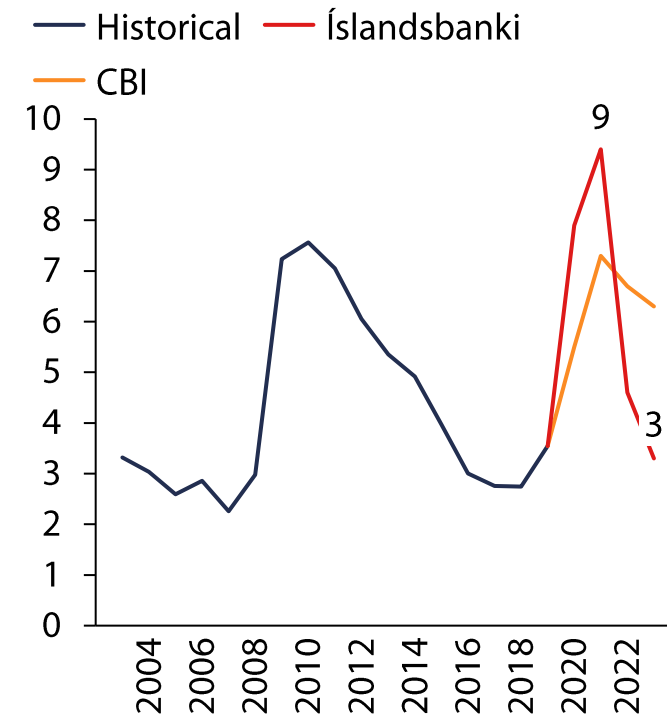
# Scrutinizing projections sheds light on the uncertainty

Different view on key elements but consensus on inflation

1

## Unemployment rate

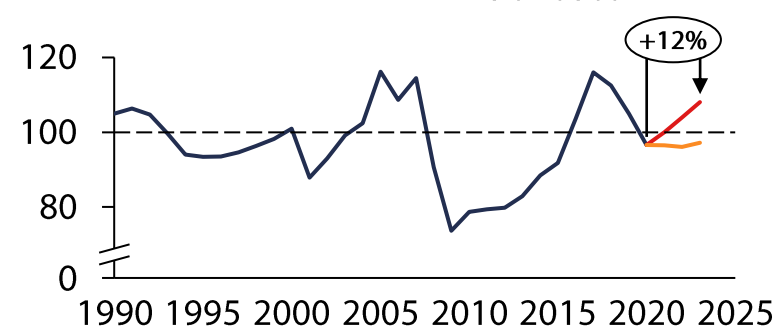
%, labour market survey



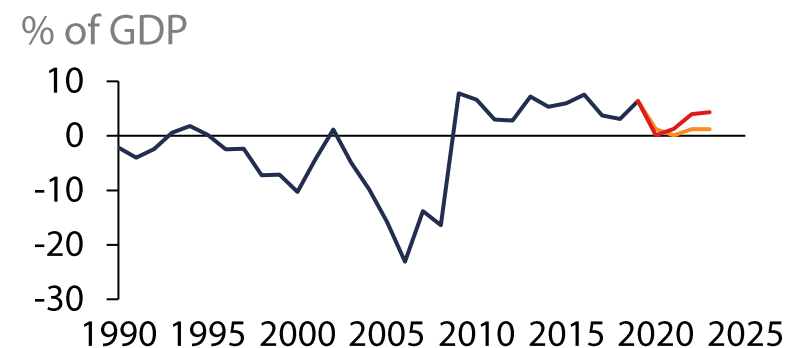
How chronic will unemployment be?

2

## Real exchange rate



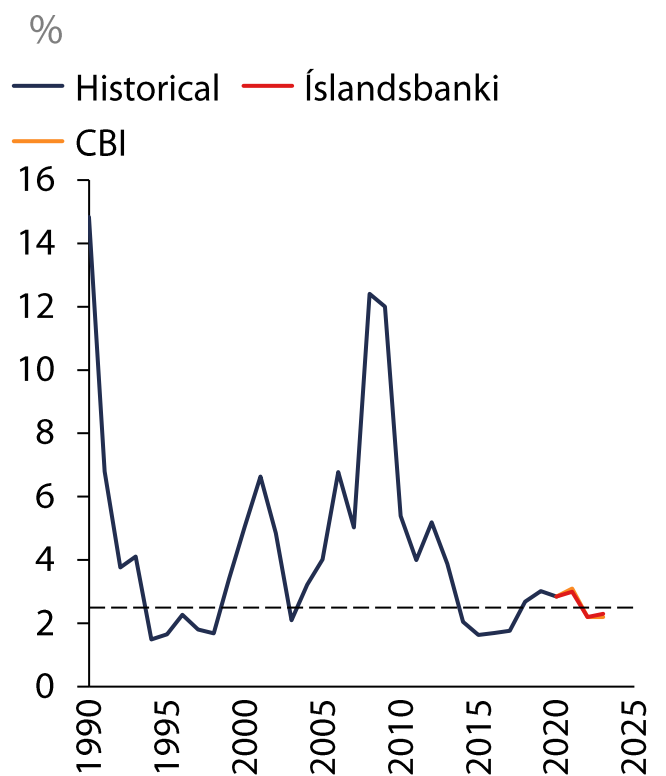
## Current account



Is the króna too weak?

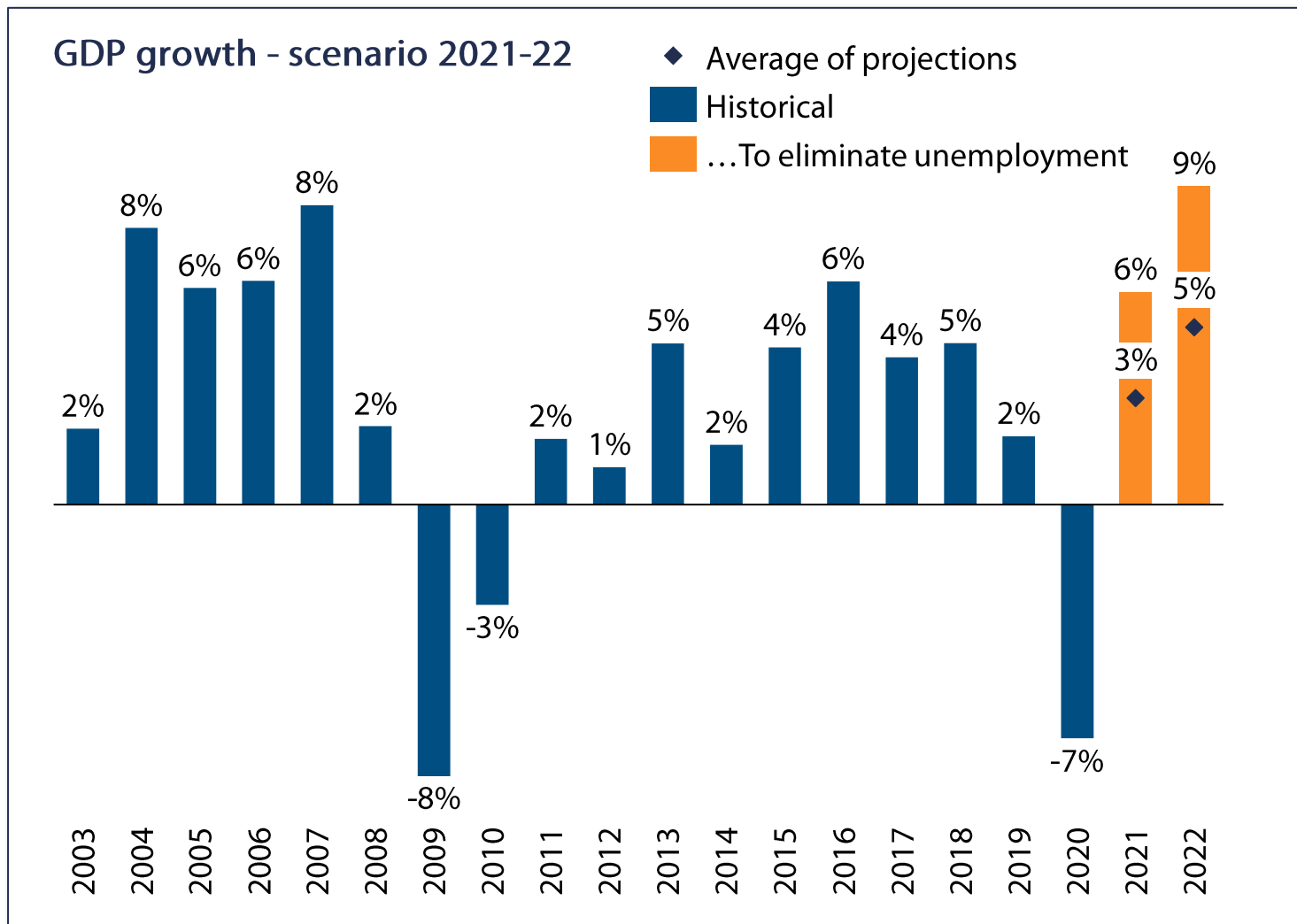
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## Inflation



Has herd immunity against inflation been reached?

# How much GDP growth is required to eliminate unemployment in two years?



## Assuming...

1. Unemployment starts decreasing in late 2021 and reaches 3.5% in late 2022
2. Labour force participation recuperates lost ground
3. Productivity-trend restores in 2022
4. Shortening of average working hours is retracted halfway
5. Population grows according to Statistics Iceland's forecast

**17.000 jobs (+9%)**

**700 jobs per month**





# Did the CBI overestimate the strength of the króna?

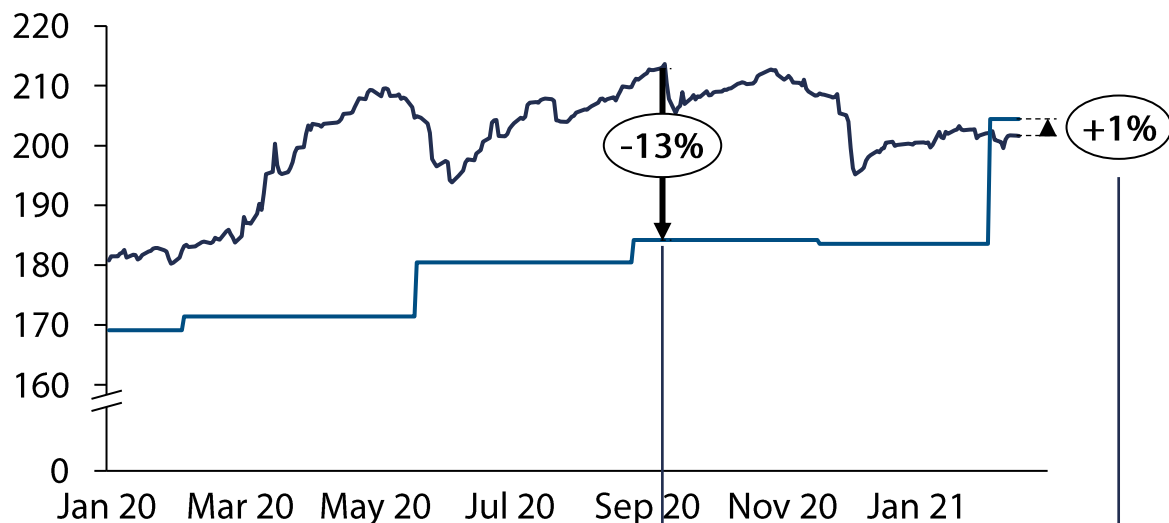
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Based on its own model: Yes

## ISK exchange rate

Index – higher number=weaker ISK

- Exchange rate index
- Exchange rate conforming to the latest estimate of the equilibrium rate<sup>1</sup>



Ásgeir Jónsson, CBI Governor

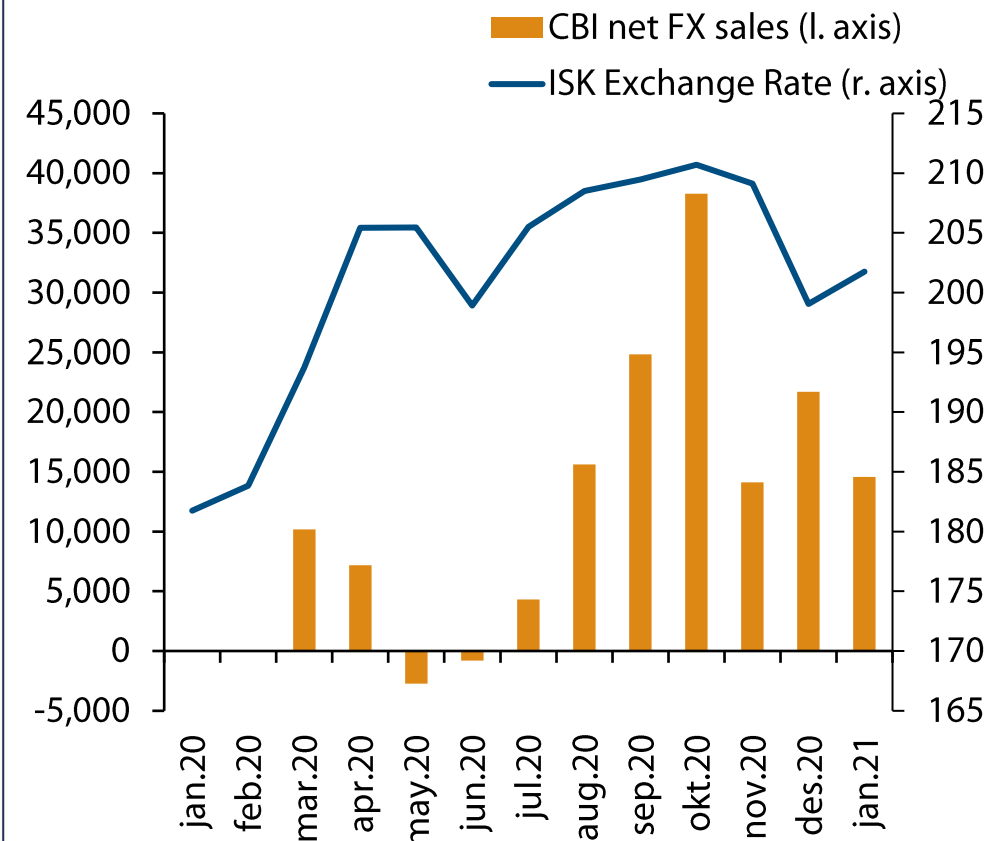


**September 10:** „CBI governor says the exchange rate is really low“

**February 16:** New estimate of the real equilibrium exchange rate: ISK is too strong

## ISK exchange rate and FX interventions by the CBI

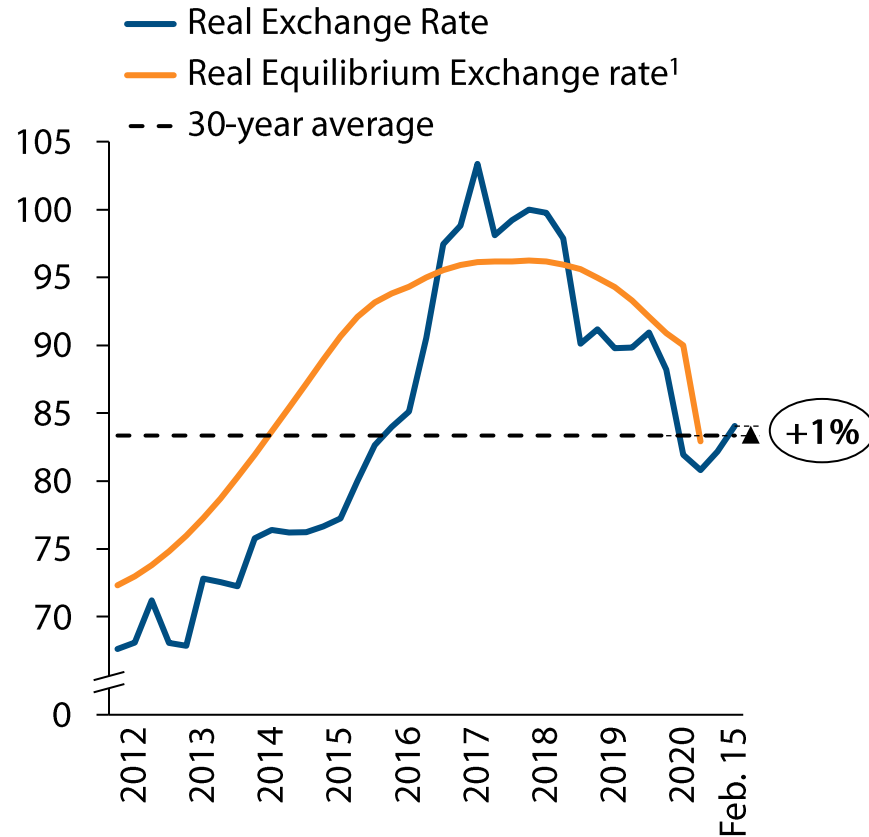
M.ISK and Index<sup>1</sup>



# Reduced current account projections indicate a weaker ISK ... and/or government financing the deficit abroad?

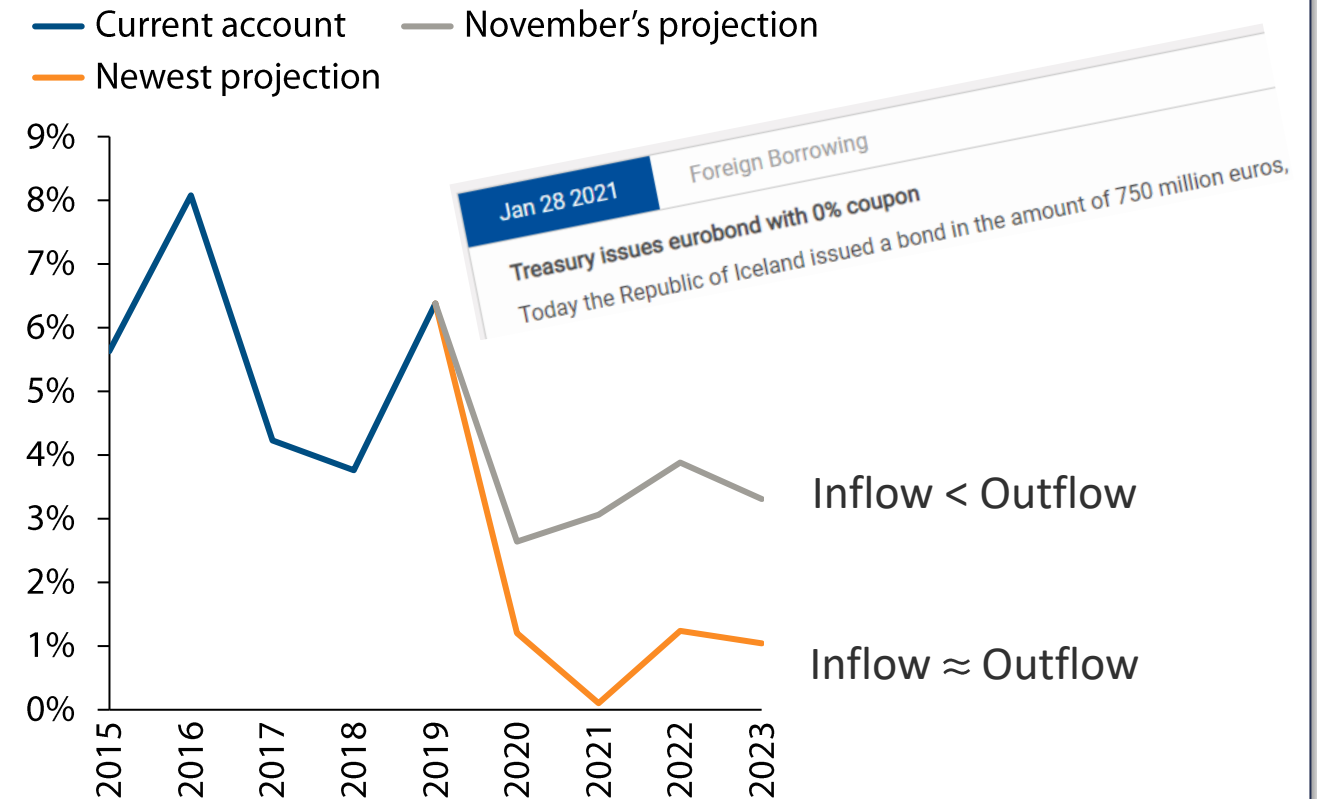
## Real Exchange Rate

Index (2005 = 100)



## Current account = Net capital flows from Iceland

% of GDP



# Has herd immunity against inflation been reached?

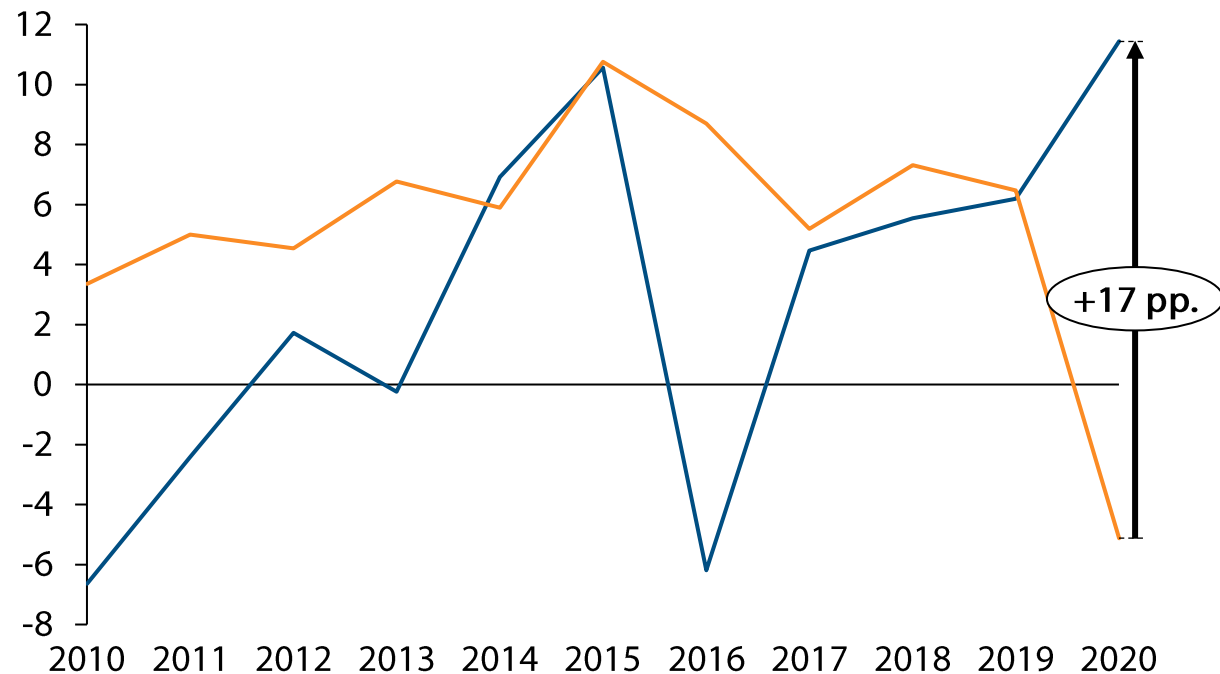
Abroad, inflation prospects are rising

3

## Money supply and value creation

% change, Iceland

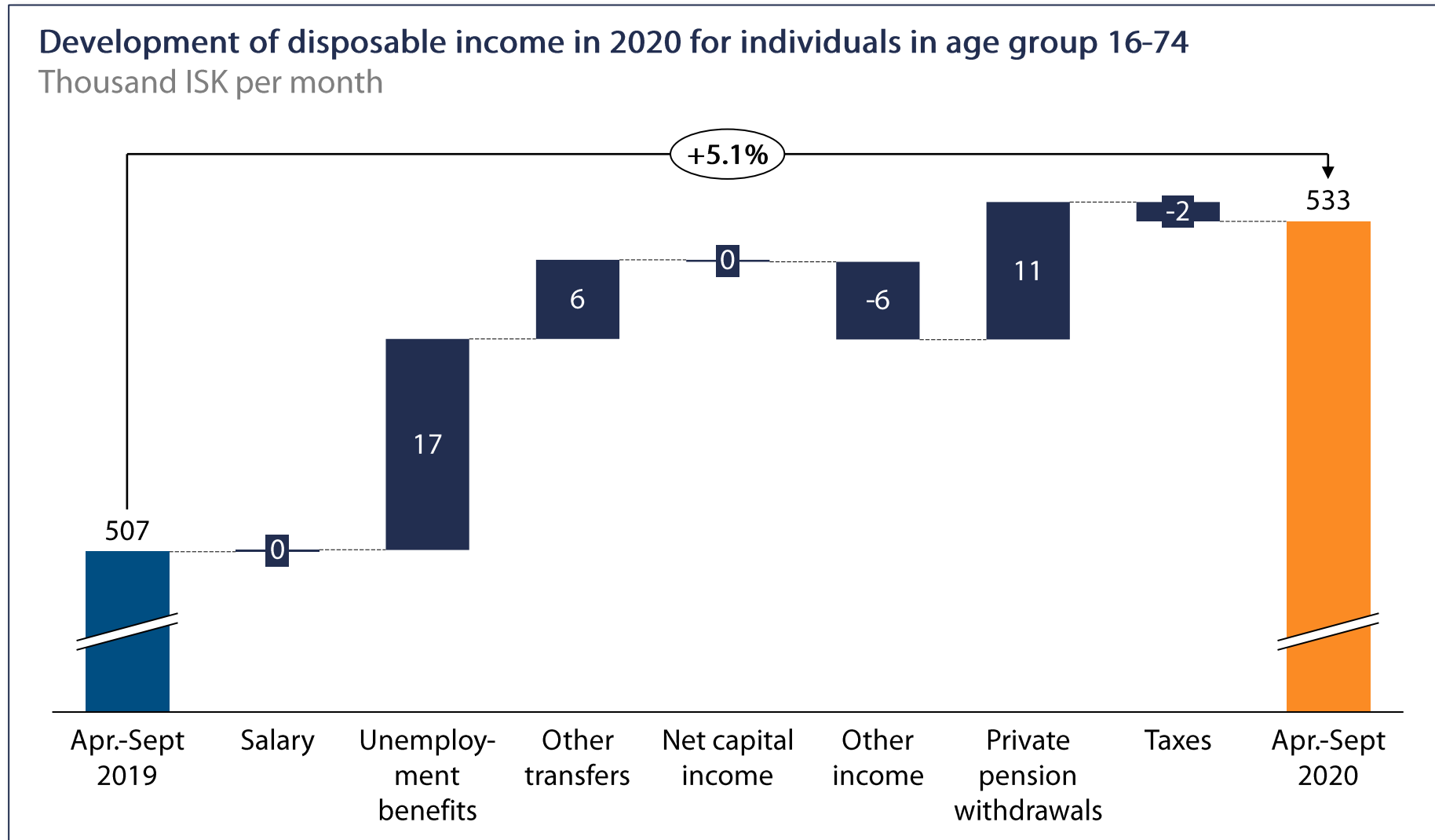
— Money supply (M3)  
— GDP (nominal)



# Spending power rises during a steep recession

Wage hikes and government measures outweigh other effects

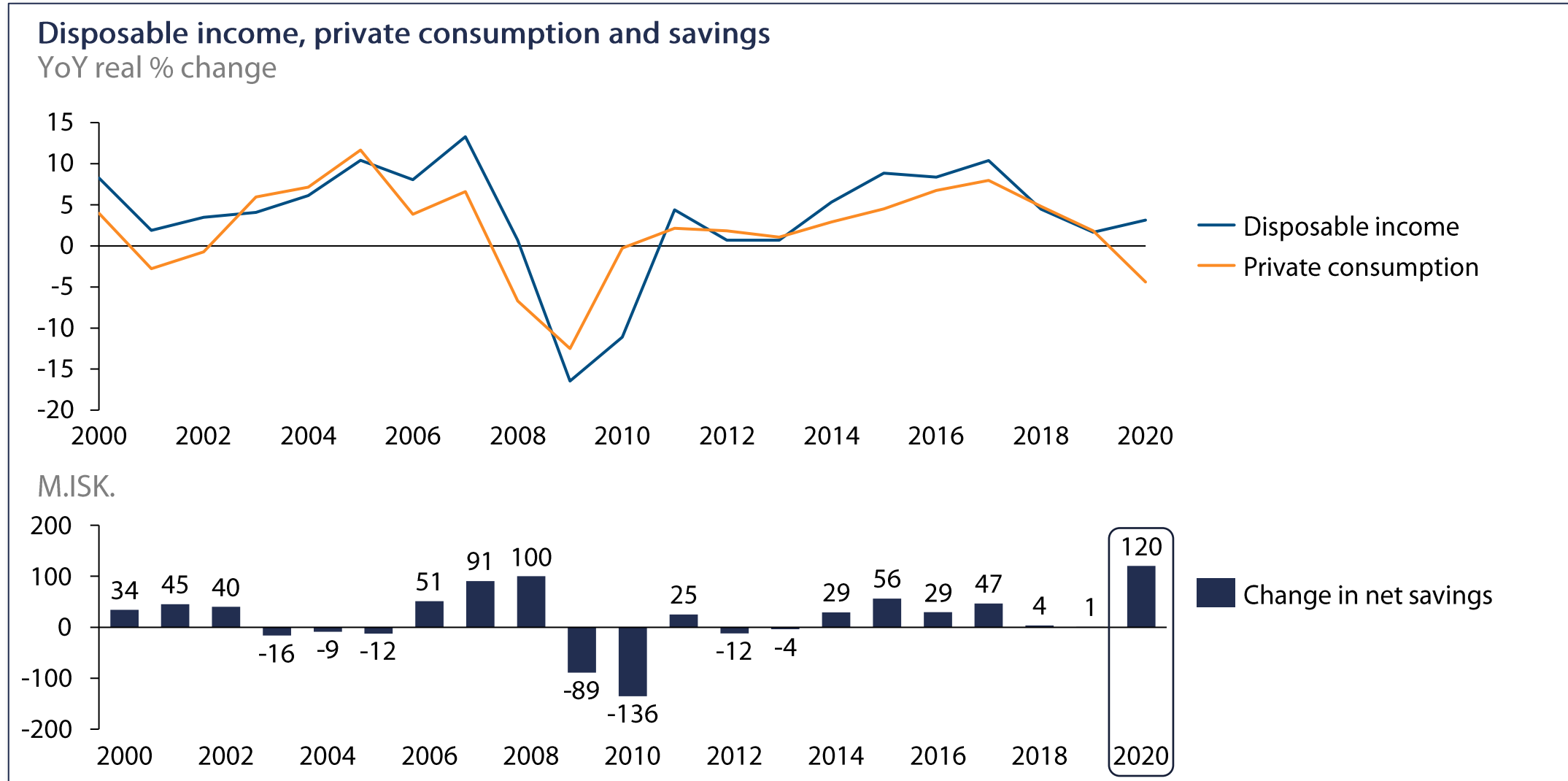
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# Meanwhile, private consumption is in a downturn

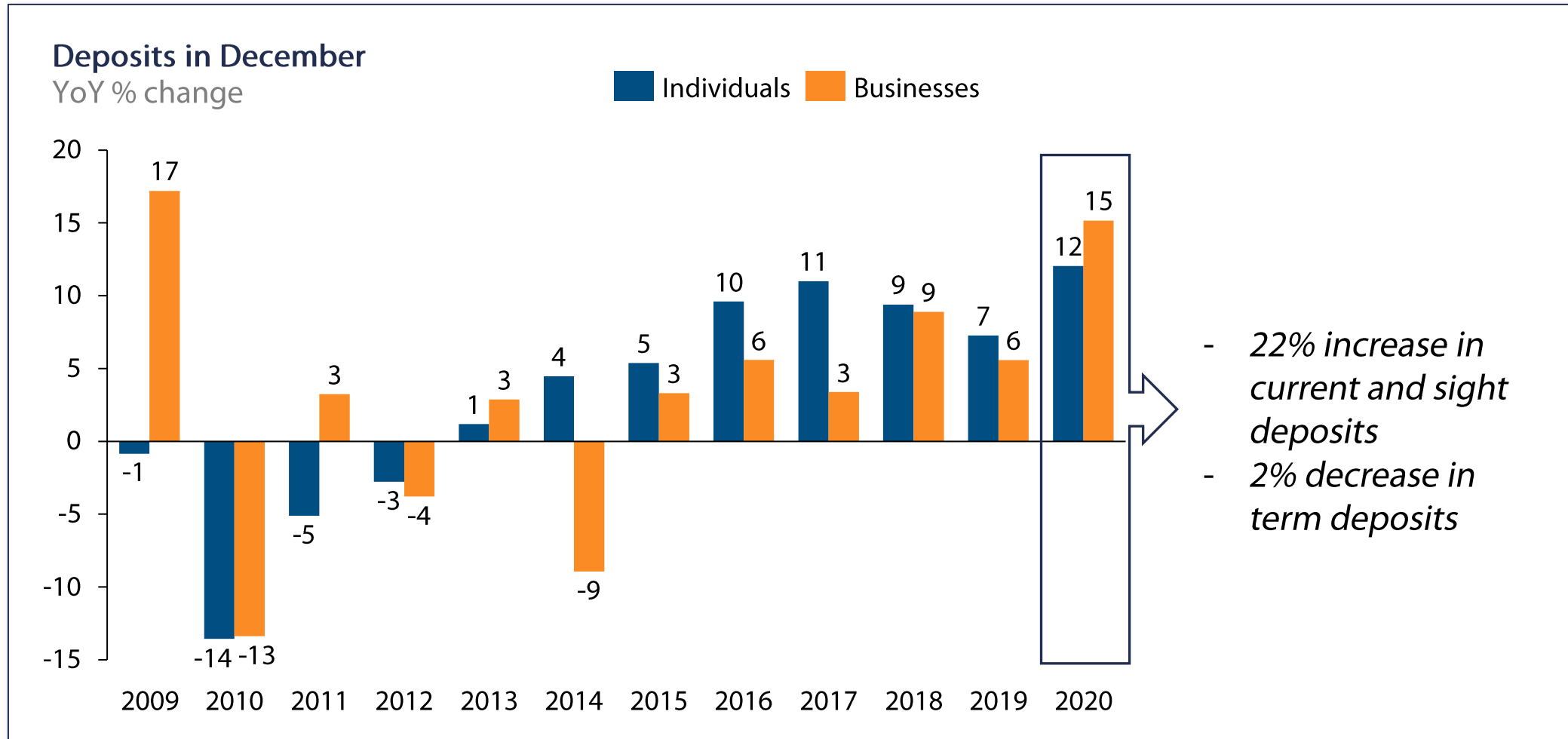
## Which has led to increased savings



# What if a bulk of savings starts flowing into the economy?

3

Will it increase inflationary pressures?



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What do we think?

**And then what?**

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# Heavy-weight factors are still uncertain

What do we know that we don't know?

## Prospect could improve if...

- Trading partners get hold of the virus faster
- Investment rebounds
- Tourism kicks off with great force
- Other exports industries heal swiftly
- Cumulative savings supports private consumption without creating instability

## Prospect could deteriorate if...

- The pandemic will be prolonged
- Investment remains subdued
- Tourism does not kick off this summer
- Sluggish growth in other exports industries
- Slack public finances, increased money supply, and etc., spark inflation



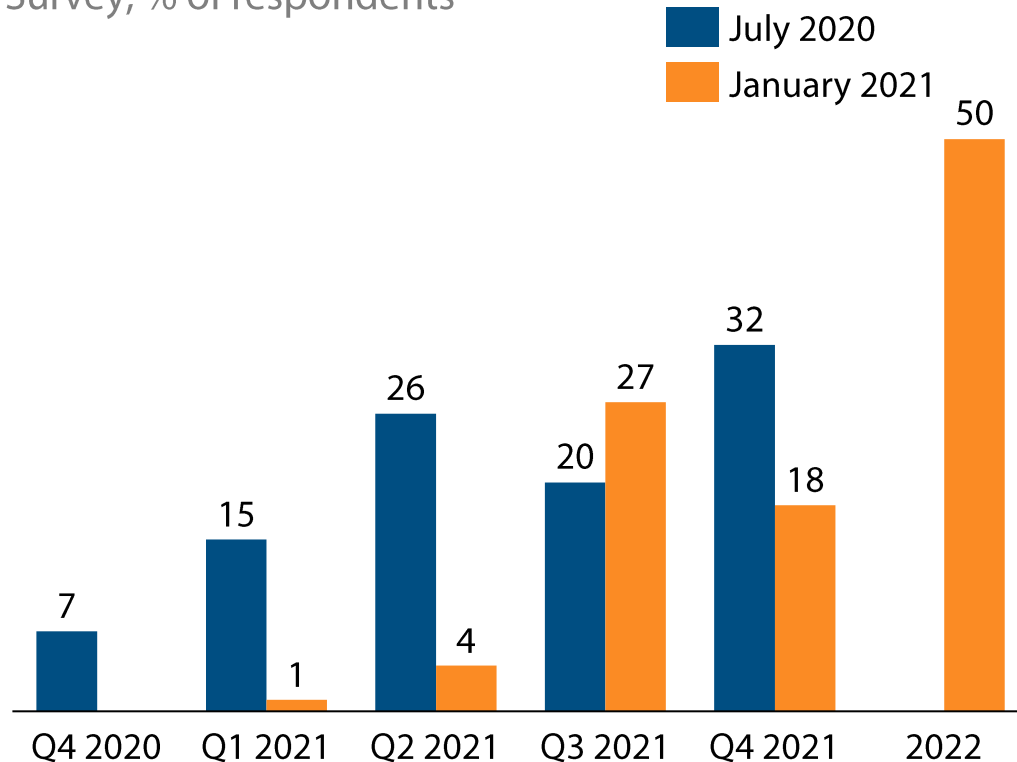


# It all hinges on the recovery of tourism

The one sure thing that can quickly terminate unemployment

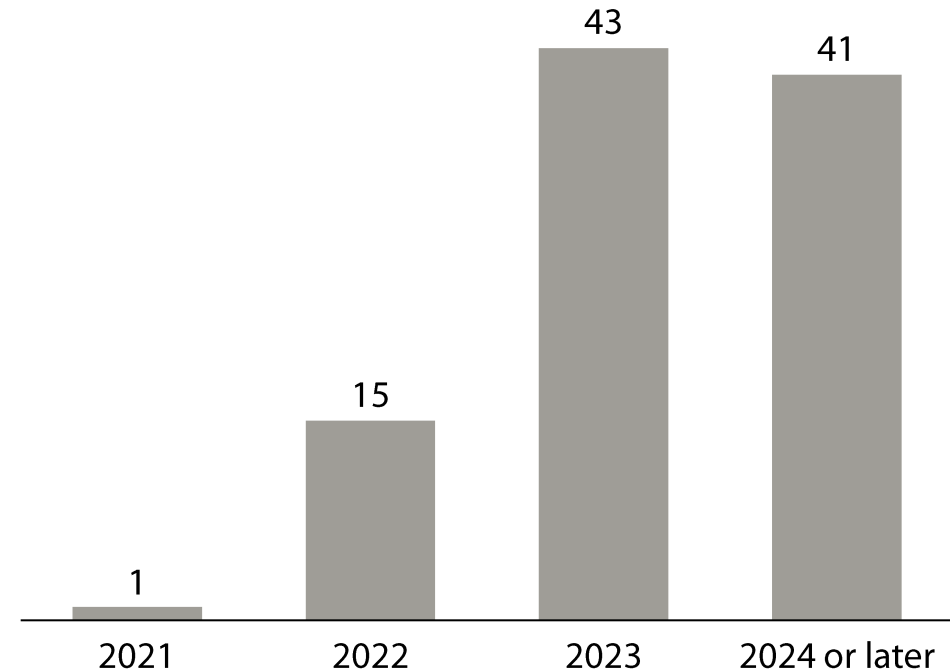
## When will tourism recover world-wide?

Survey, % of respondents



## When will tourism reach 2019 levels in your country?

Survey, % of respondents

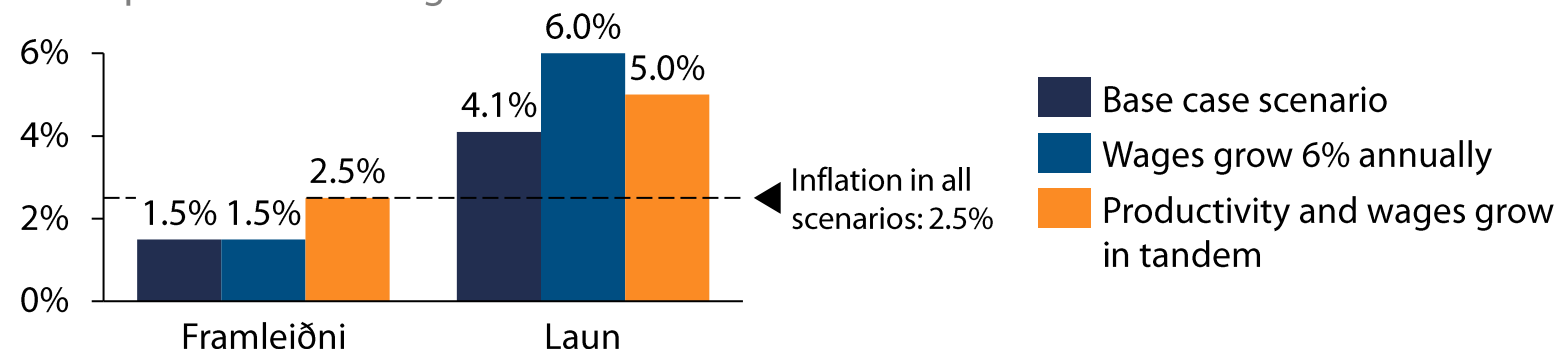


# Gazing at the future: Is the Icelandic model sustainable?

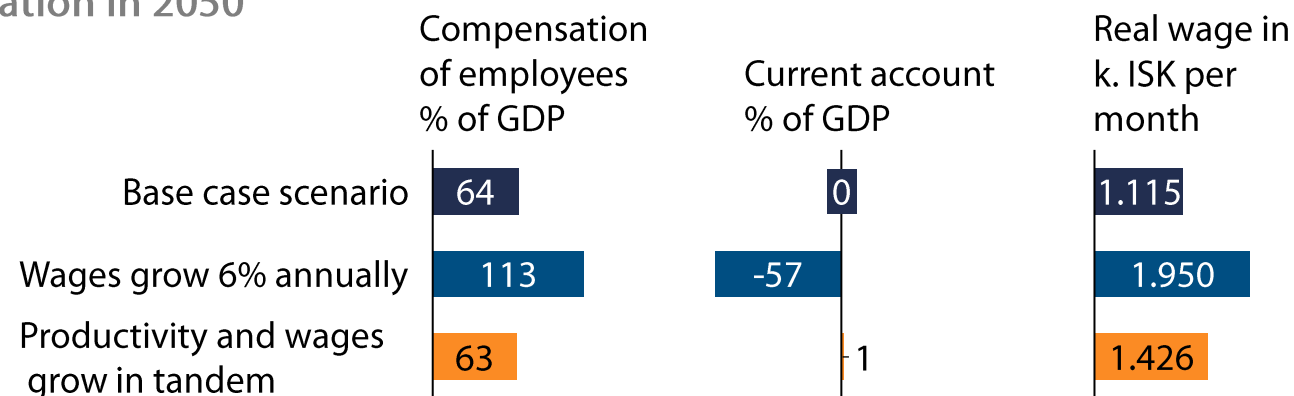
## Here's looking at you, labour market

### Scenario analysis of long-run economic performance

Prerequisites YoY changes

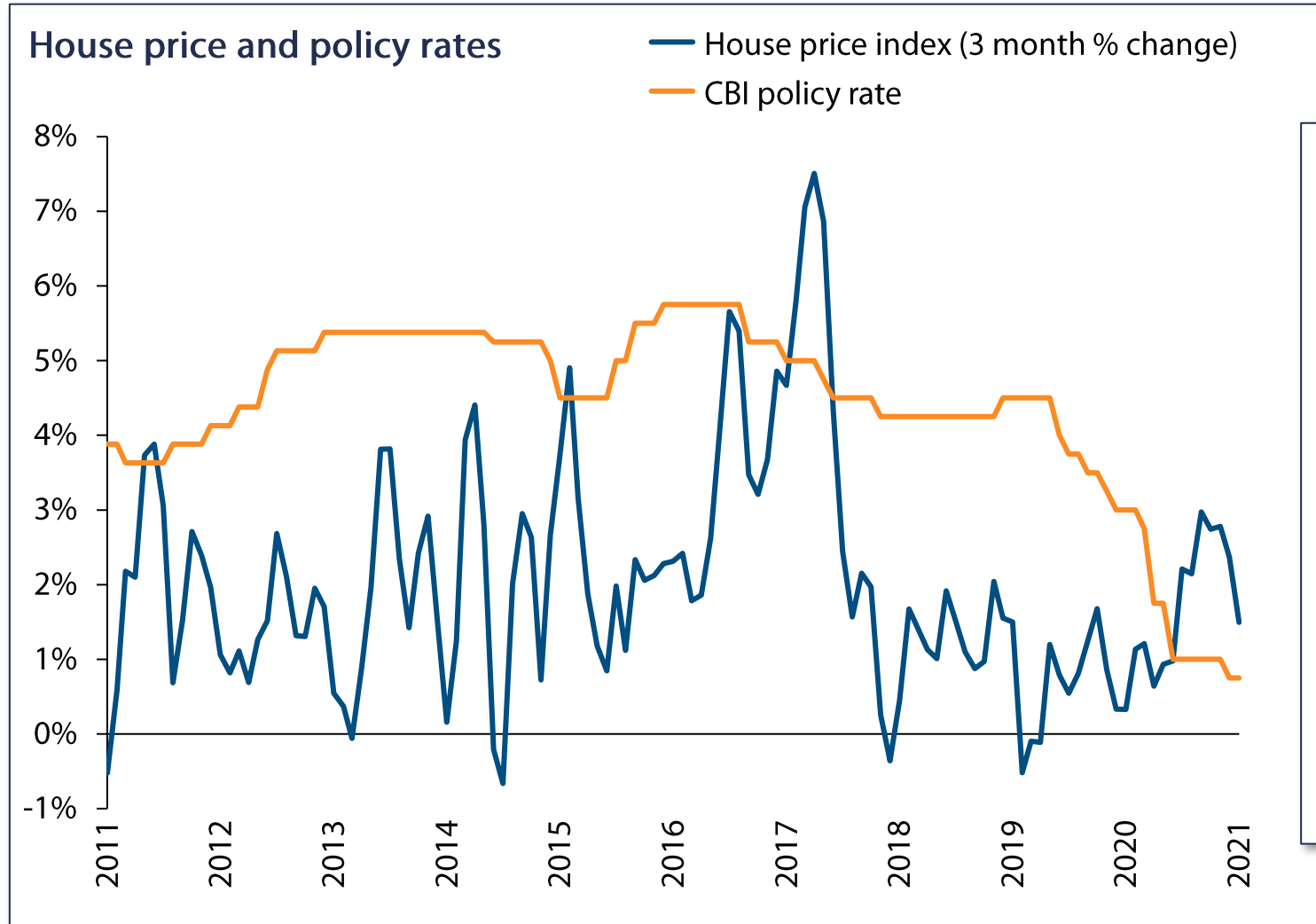


### The situation in 2050



# Extra: What will happen in the residential housing market?

Declining debt service costs helped record activity in 2020



- Turnover in the residential market reached historical heights in 2020 while prices rose 8% in the Capital Region. Similar story as in many countries during the pandemic.
- A swift decrease in policy rates and the increase in savings have boosted the housing market.
- The effect of price increases on down payments are so far dwarfed by the effect of declining interest rates.

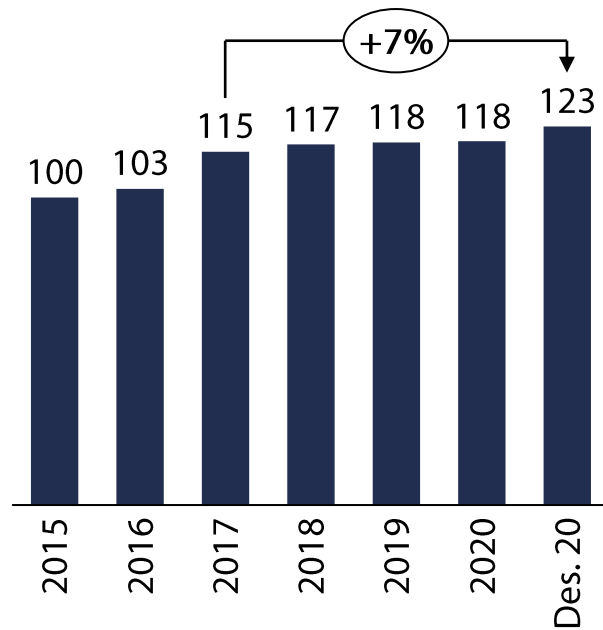


# Extra: What will happen in the residential market?

Prices should continue to rise until higher down payments outstrip the attraction of low interest rate. When? Hard to say

## Price-to-income

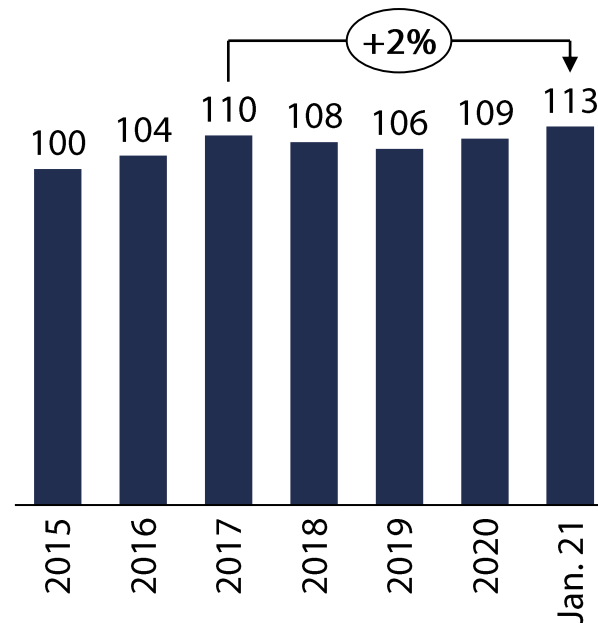
Index, 2015=100 (disposable income)



Price has outgrown disposable income...

## Price-to-rent

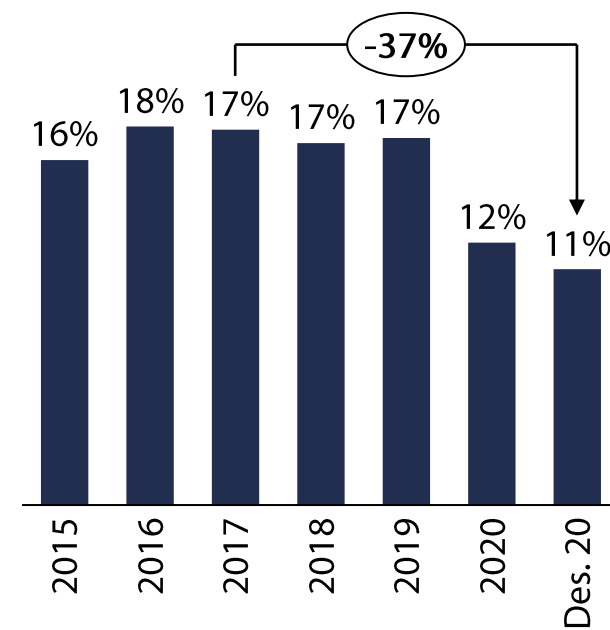
Index, 2015=100



...and rental prices...

## Debt service cost

% of disposable income<sup>1</sup>



... but interest rates have dramatically reduced debt burden

