



A Long Winter, a Slow Thaw

Economic Outlook 2026–2029

30 September 2026

Economic Outlook at a Glance

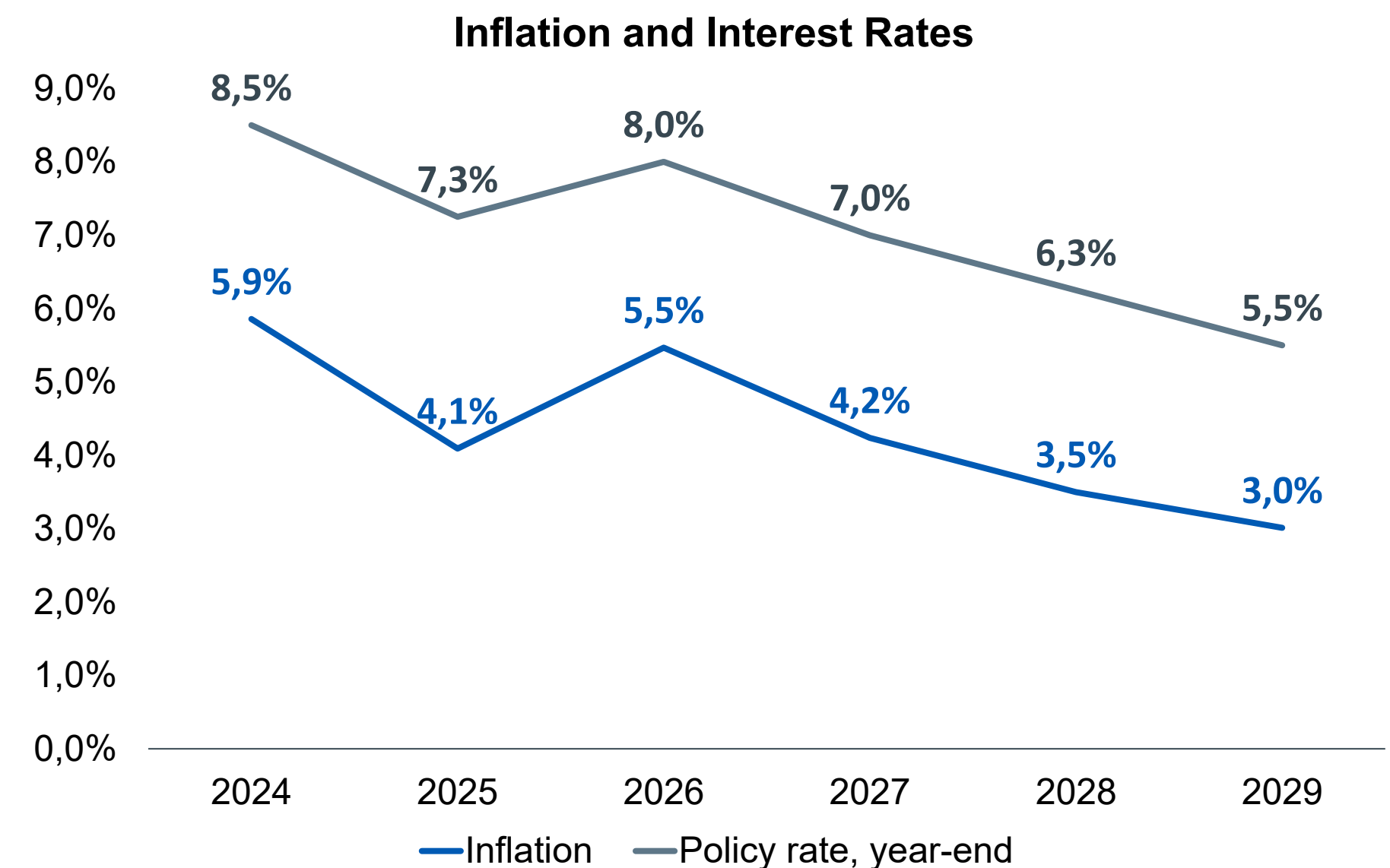
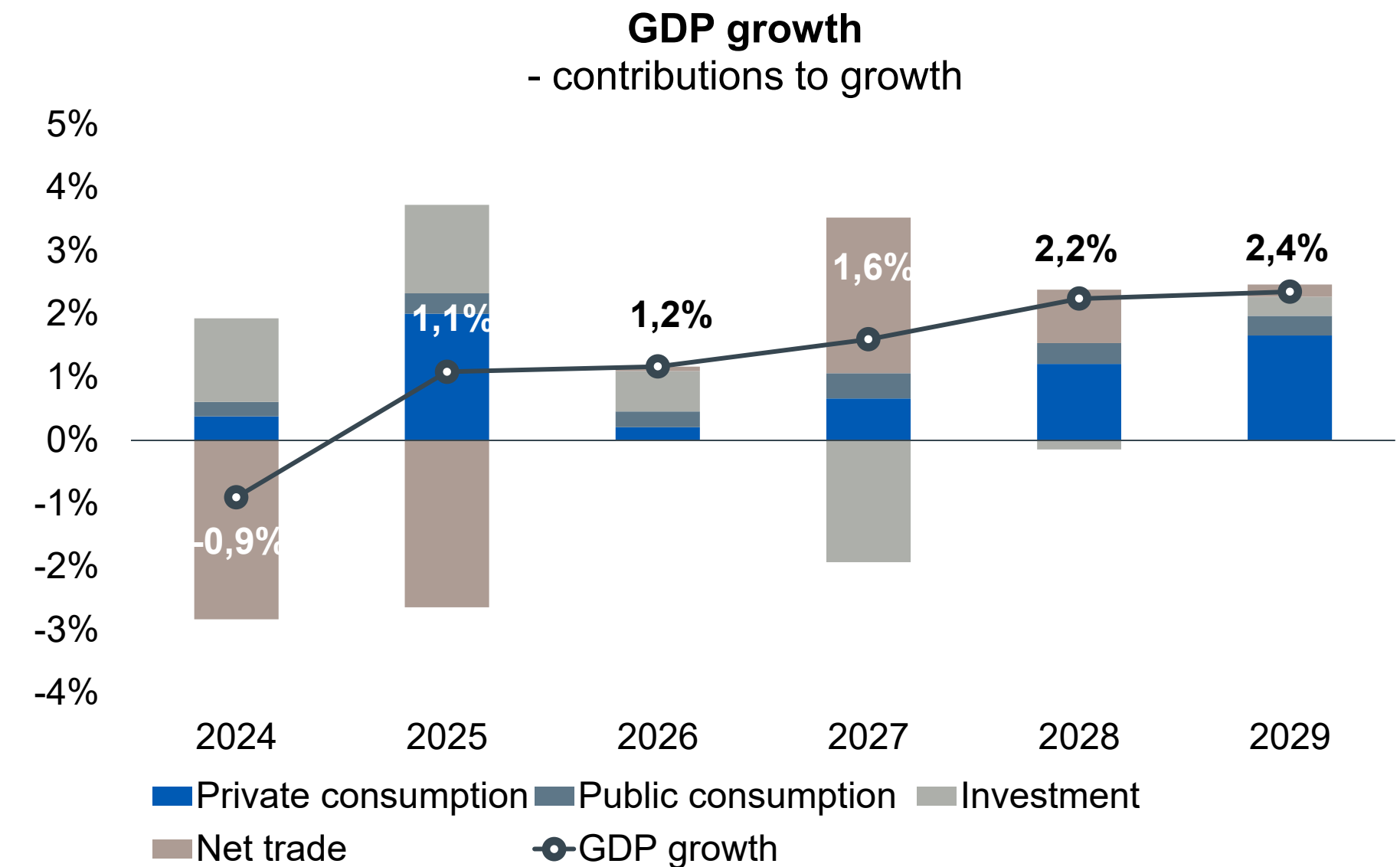
Arion Bank's new economic forecast assumes that winter will be long for the Icelandic economy and that the spring thaw will be late in coming. There is no end in sight to the war in the Middle East, with repercussions for energy markets, inflation and growth both in Iceland and abroad. Hopes of swift interest rate cuts have faded, and households and businesses have become more pessimistic. **These challenges are reflected in a lower growth forecast, higher interest rates and higher inflation.**

Inflation has proved harder to contain than previously expected. Persistent domestic inflationary pressures cannot be overlooked, but the main forces pushing inflation higher have been the war in the Middle East and increases in public levies. **We expect inflation to ease next year, partly thanks to base effects, averaging 4.2%.** The path to the inflation target remains difficult, however, delaying rate cuts until the middle of next year. **Our forecast puts the policy rate at 7% by the end of next year, a reduction of one percentage point.**

Although households carry little debt and their financial position is generally strong, high interest rates, a high cost of living and rising unemployment have dampened their expectations. Together, these factors are expected to **curb spending appetite and private consumption growth this winter and well into next year.** High interest rates and tighter credit conditions also shape the investment outlook, particularly **residential investment, which is expected to contract this year and more sharply next year.** We forecast continued weakness in the housing market and falling real house prices until mid-2028.

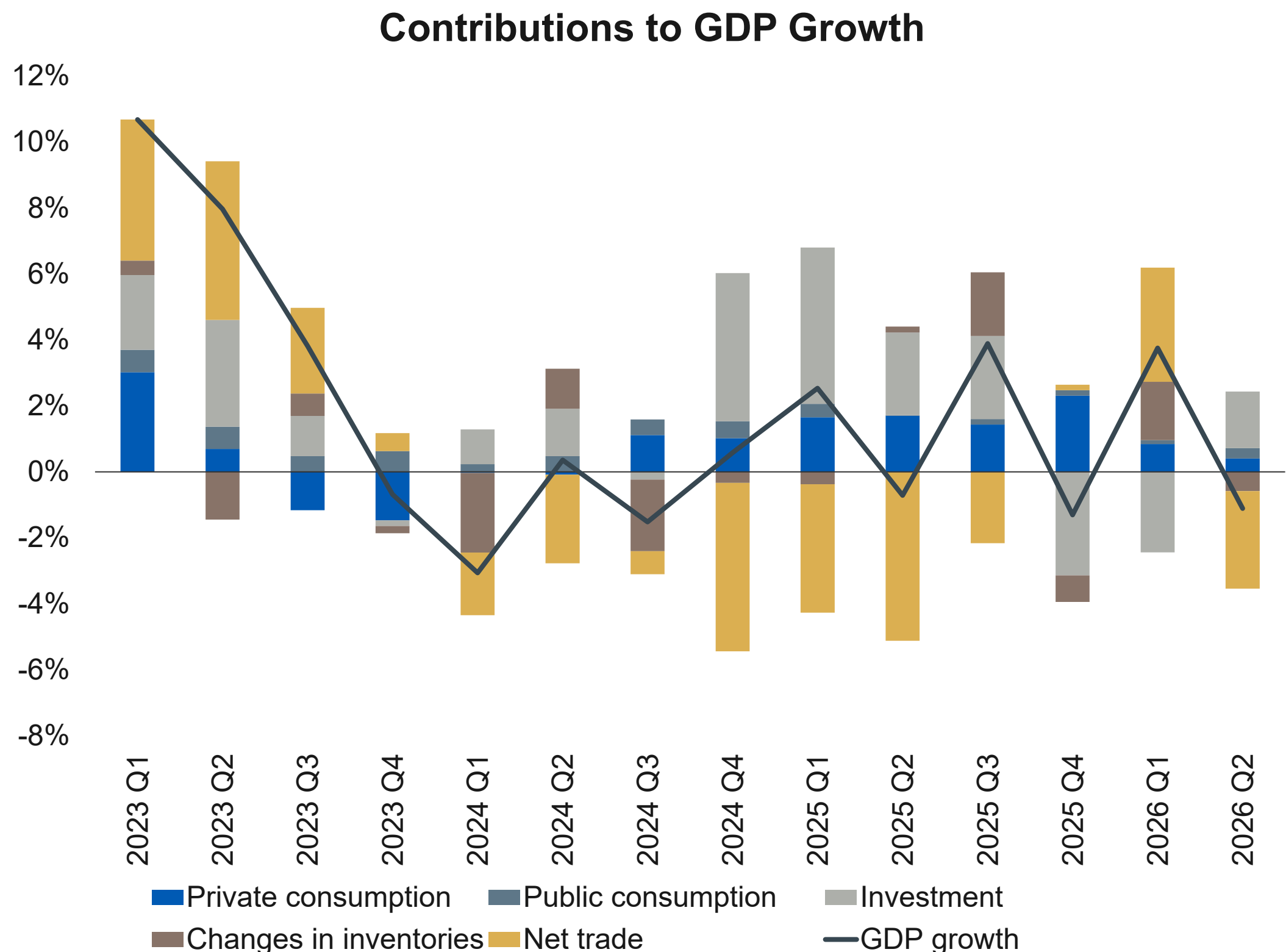
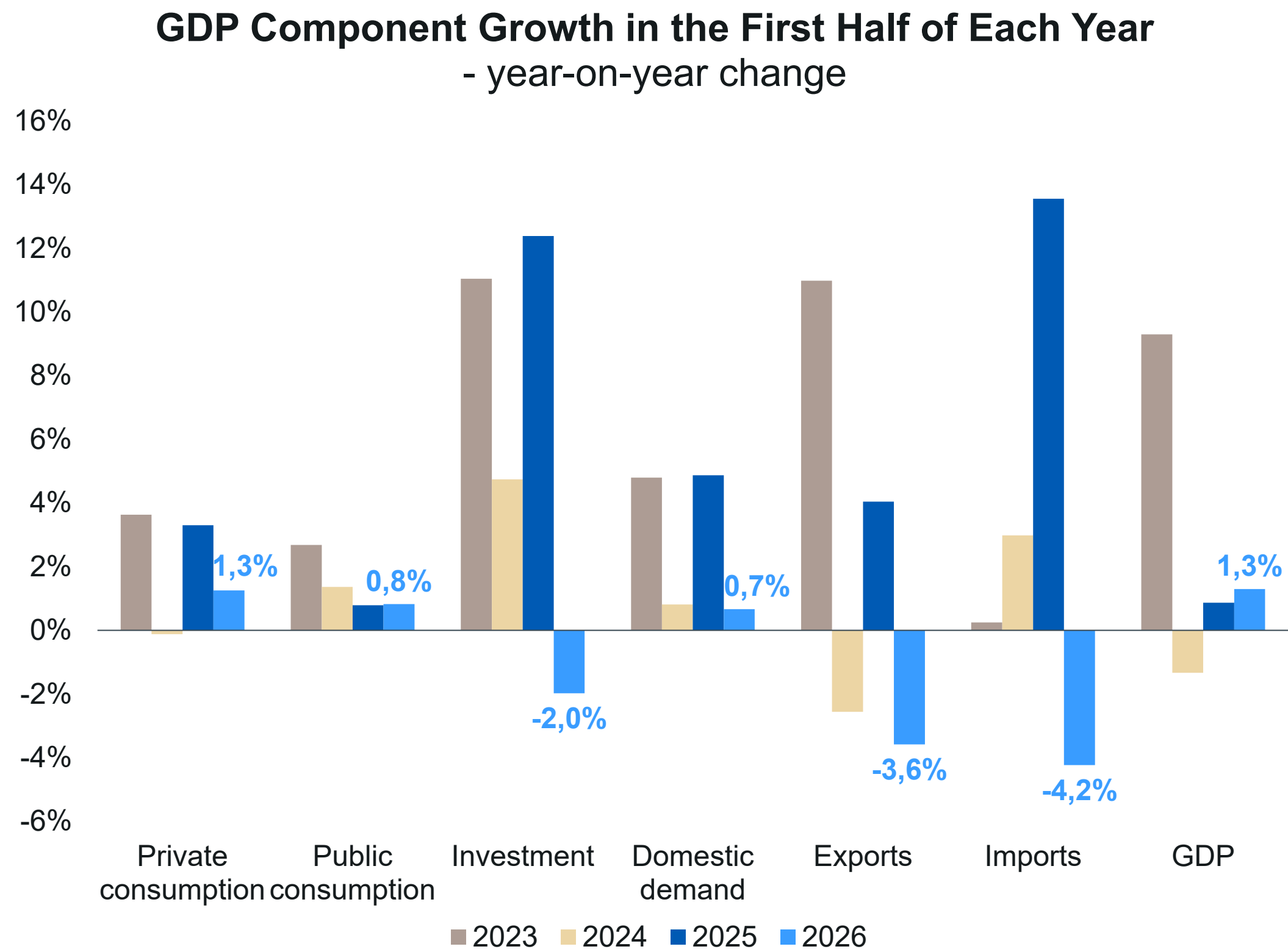
Data centres have driven fluctuations in the national accounts, with substantial imports of computer equipment this year while exports have contracted slightly. **All export components are expected to contribute to growth next year,** including tourism, fisheries, aluminium, aquaculture and data centres. Together with lower imports, this will give net trade a positive contribution to GDP growth. **The króna has been strong and is expected to remain so, despite the pressure this places on export industries.**

The outlook is more clouded than usual, with commodity prices moving rapidly, fragile international relations and tensions in the labour market. Whatever happens, we believe the economy rests on solid foundations and that spring will return, even if the thaw is slow to arrive.



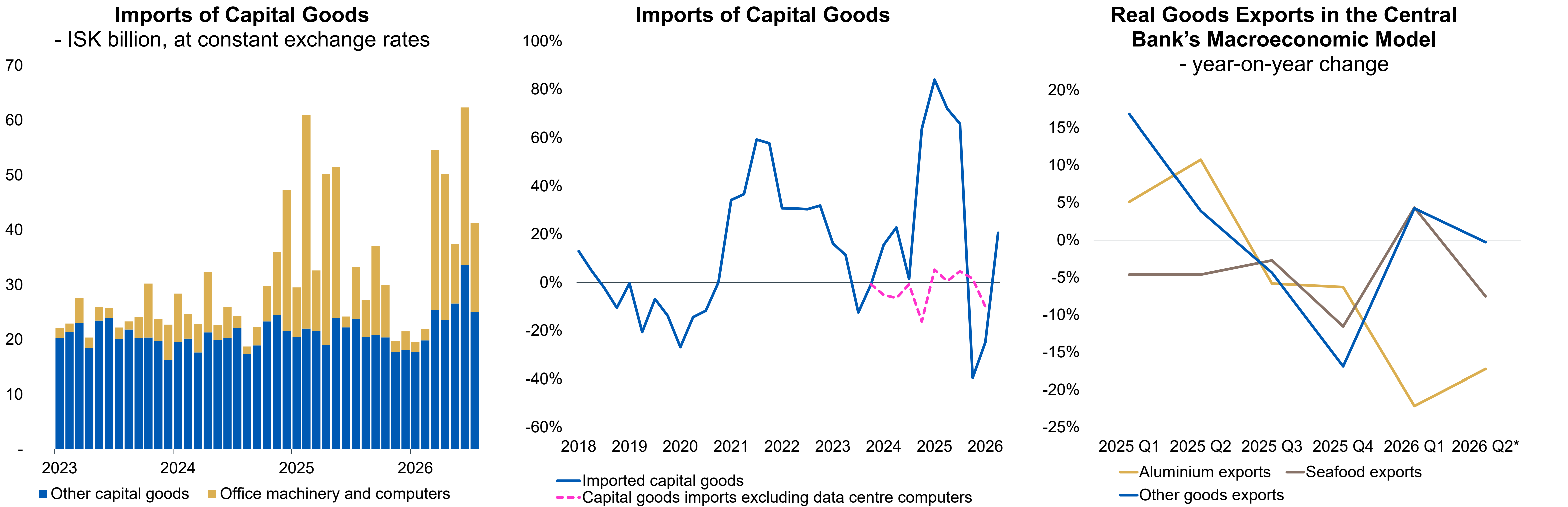
GDP Growth Has Followed the Swings in Net Trade

According to Statistics Iceland’s first estimate, GDP grew by 1.3% in the first six months of the year. Quarterly growth has fluctuated sharply, with alternating gains and setbacks. **Net trade has driven these swings**, while private consumption’s contribution to growth has diminished.



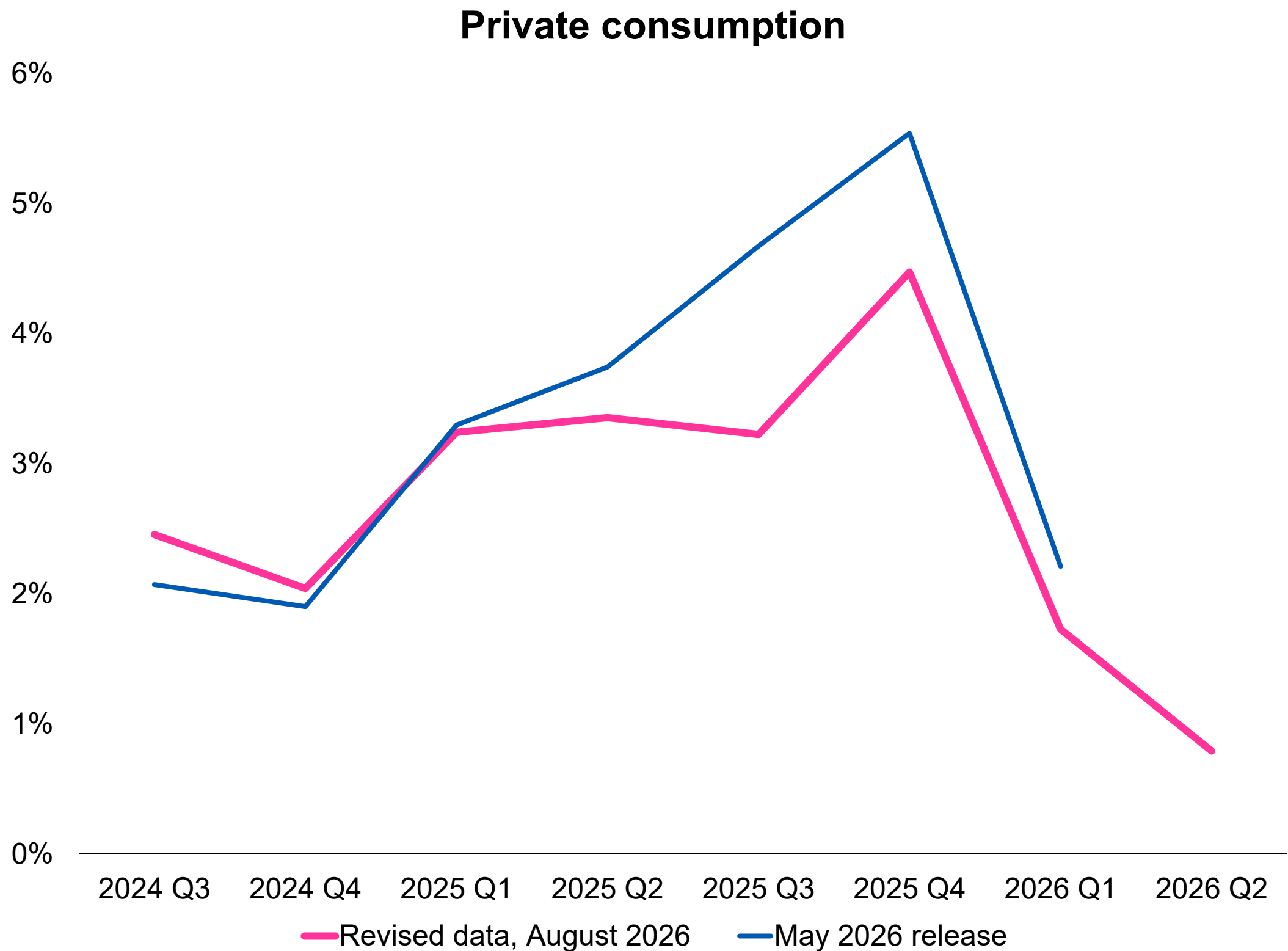
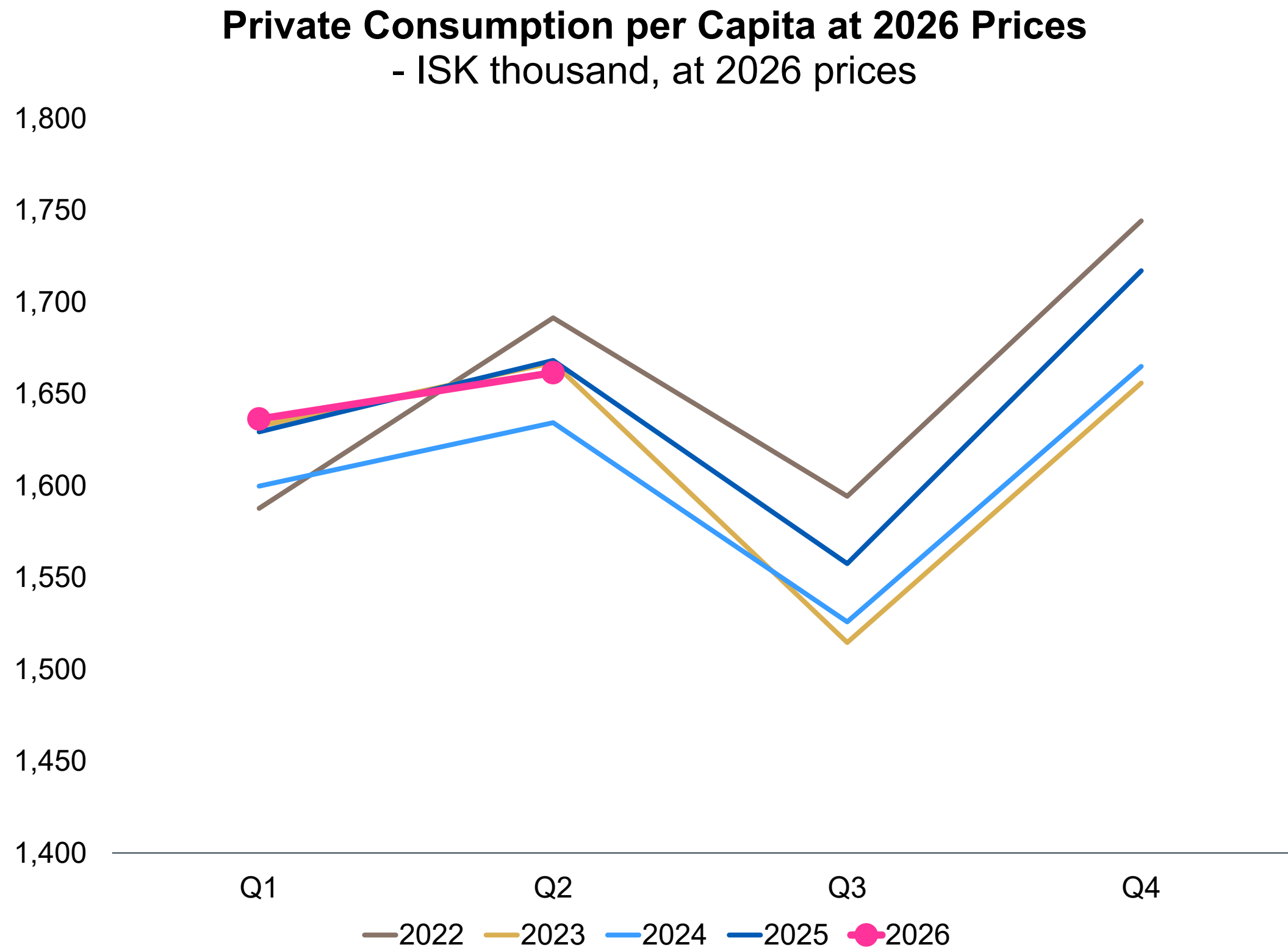
The Answers Lie in Goods Trade

The volatile contribution of net trade to GDP growth largely reflects **substantial imports of computers and related equipment for the development of data centres in Iceland**. In the first seven months of the year, these imports totalled ISK 115 billion, compared with ISK 170 billion in the whole of last year. Although imports explain much of net trade’s negative contribution to growth, exports have also played a part: aluminium exports have fallen significantly, as have seafood exports. Thanks to substantial price increases, the picture is considerably brighter for exports in nominal terms.



Consumption Revised: High Spending, but Less Than We Thought

Household consumption rose by 1.3% in the first half of the year, considerably less than most had expected. In analysts' defence, forecasts relied on earlier figures showing strong consumption growth. Statistics Iceland's latest revision lowered last year's private consumption growth from 4.3% to 3.6%. The change mainly reflects services transactions, with updated payment card data and actual data from small and medium-sized businesses leading to a downward revision. **Consumption remains high, but households have clearly become more cautious.**

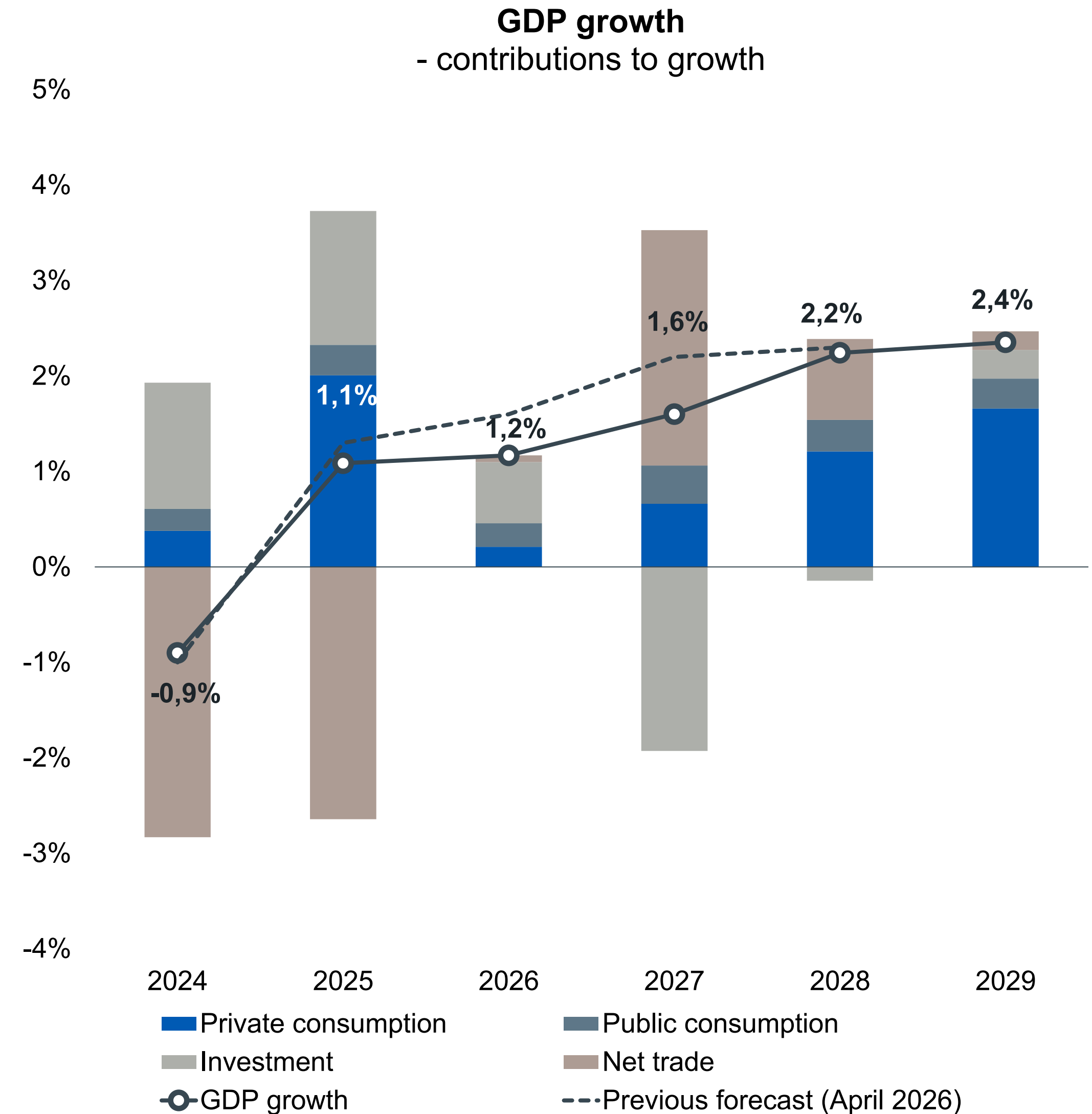


A Long Winter, a Slow Thaw

Many would agree that this has been a year of disappointed expectations. There is no end in sight to the war in the Middle East, hopes of interest rate cuts have faded, and the inflation and employment outlook has deteriorated. These challenges are reflected in **a lower growth forecast, particularly for next year.**

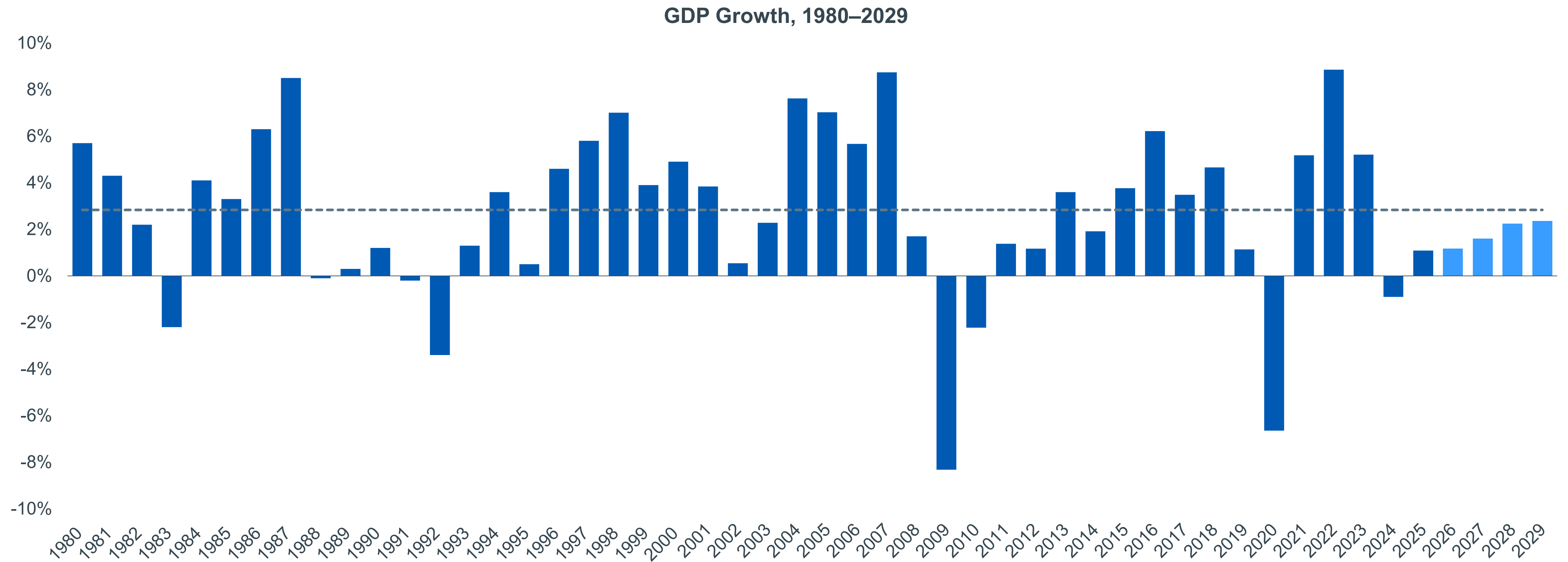
The main changes relate to private consumption and investment on the one hand, and foreign trade on the other. The inflation and interest rate environment has dented household confidence, while unemployment is rising and real house prices are falling. Together, these factors are expected to **curb spending appetite and private consumption growth this winter and well into next year.** High interest rates and tighter access to credit also shape the investment outlook, particularly **residential investment, which is expected to contract this year and more sharply next year.**

Export industries have meanwhile faced an uphill battle, with slightly fewer tourists, production disruptions in aluminium and smaller fishing quotas. The outlook is now beginning to brighten, however, and **exports are expected to return to growth next year.** Imports, by contrast, have risen this year, contrary to expectations, mostly due to data centres. **Imports are forecast to contract next year,** again largely due to data centres, giving foreign trade a positive contribution to growth. Data centre investment will still be substantial – just lower than this year.



Weak Growth in a Historical Context

We expect a long winter for the Icelandic economy and a slow thaw next year, with GDP growth of **1.2% this year** and **1.6% next year**. By comparison, average growth since the turn of the century is 2.8%.



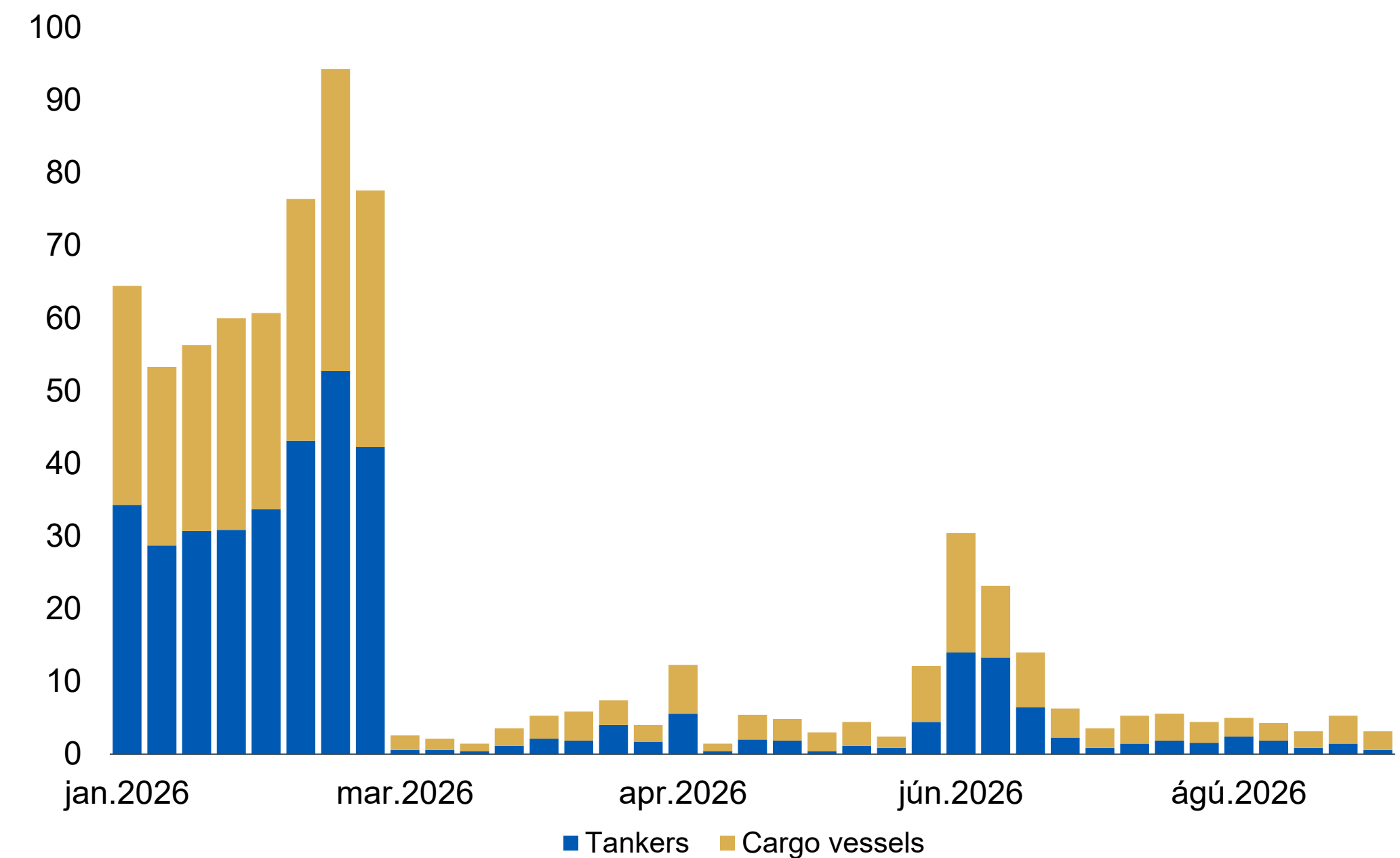
A Forecast in the Shadow of an Oil Crisis

Crude oil is now trading at USD 105 per barrel, 73% above its level at the start of the year. When conflict broke out in the Persian Gulf, some suggested oil could soon break through USD 200, but fortunately those predictions did not materialise. **The war's impact on oil prices has so far been smaller than feared.** Alternative routes for exporting oil from neighbouring countries have proved more effective, while China has significantly reduced its oil imports. Shipping through the Strait of Hormuz also appears to have been greater than official figures suggest.

Brent Crude Oil Futures Price
- USD per barrel

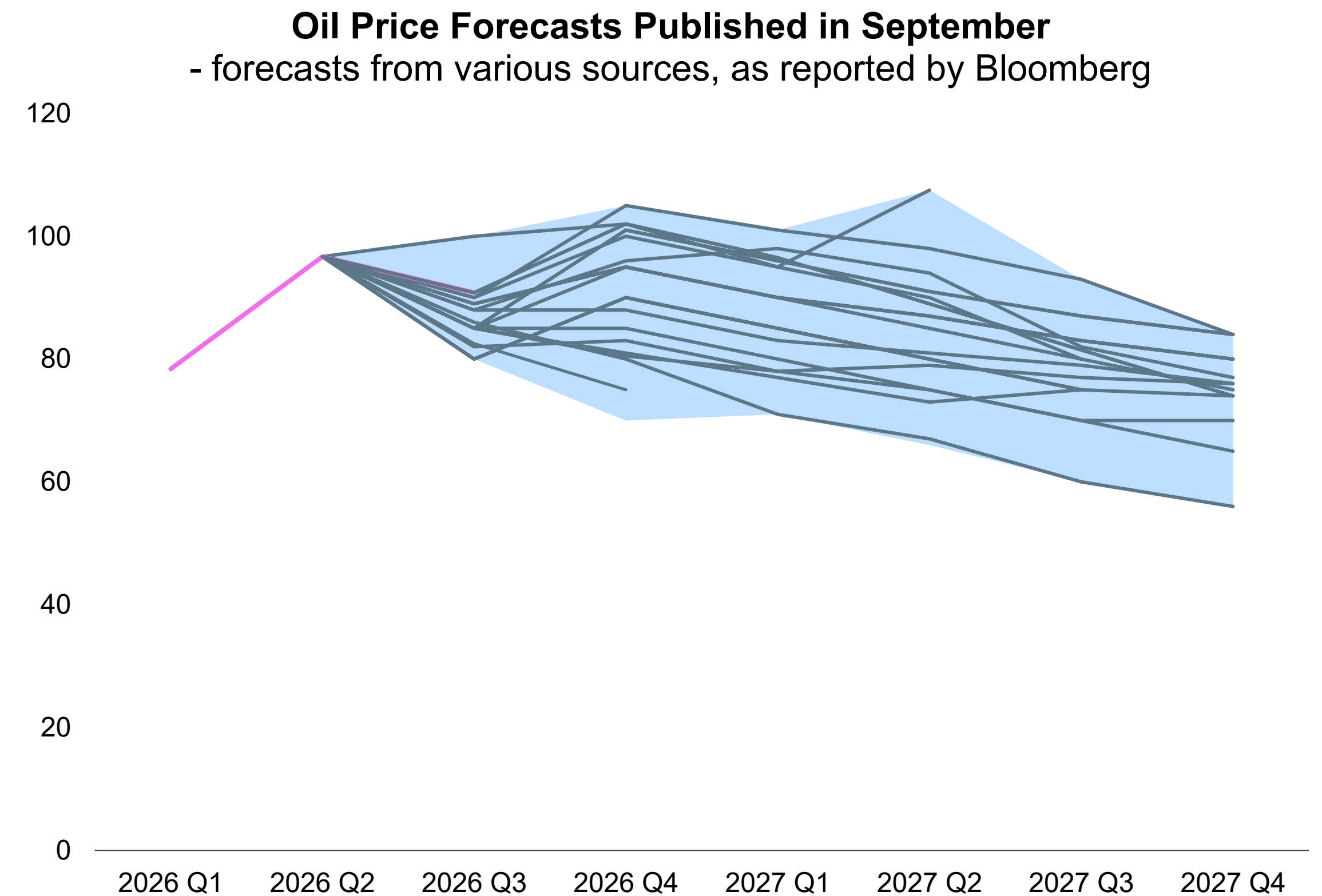
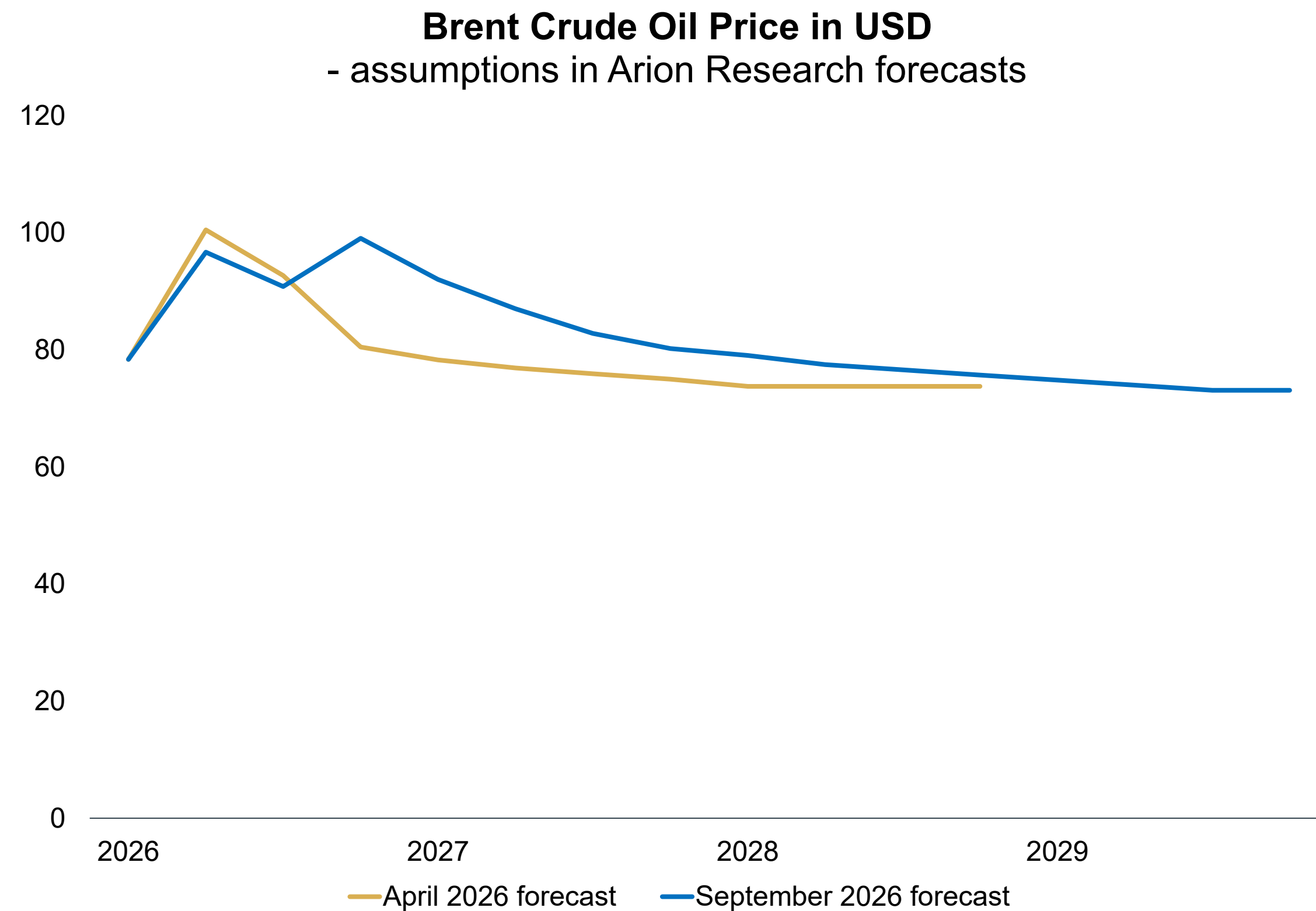


Recorded Vessel Transits through the Strait of Hormuz
- average number per day



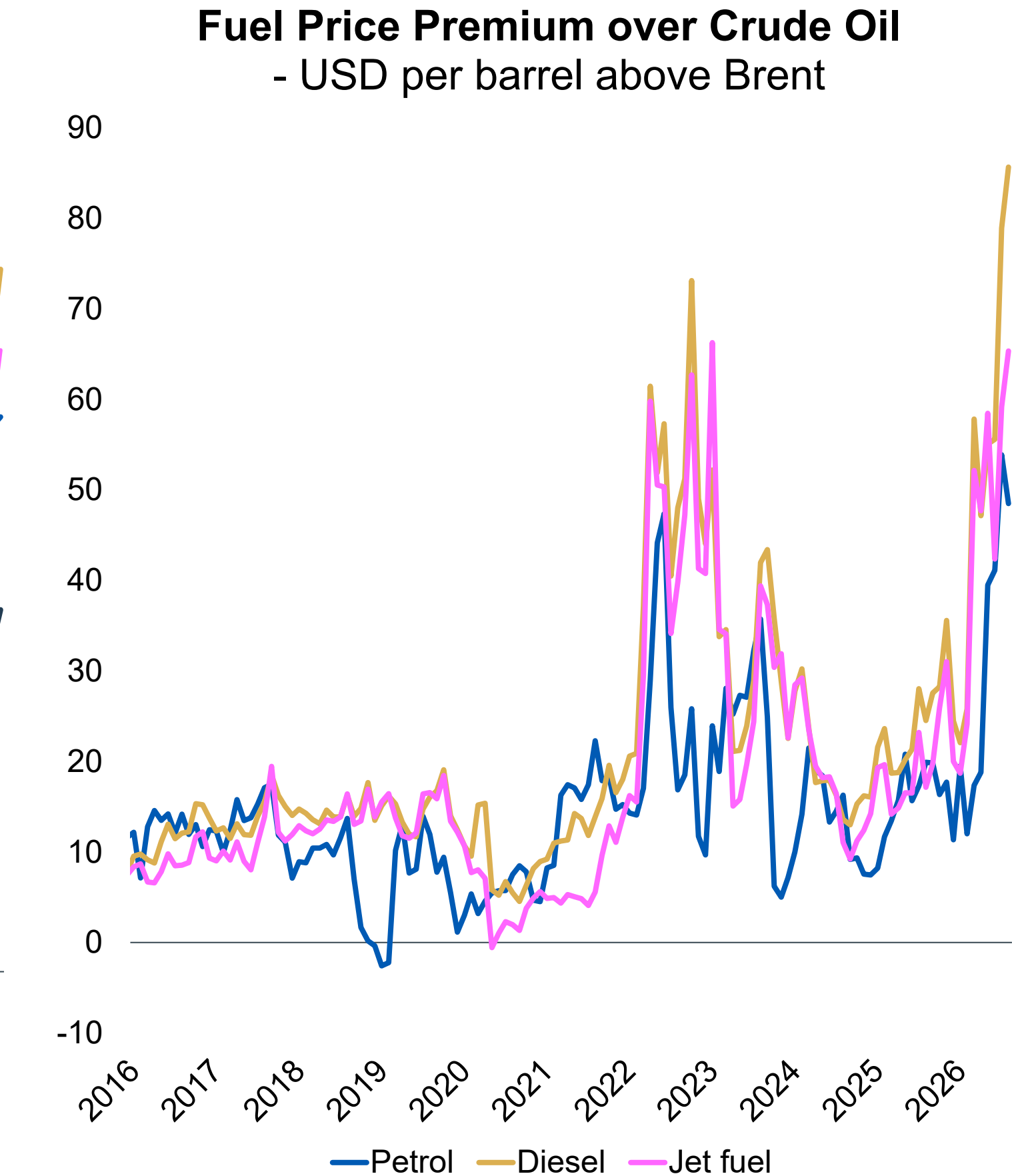
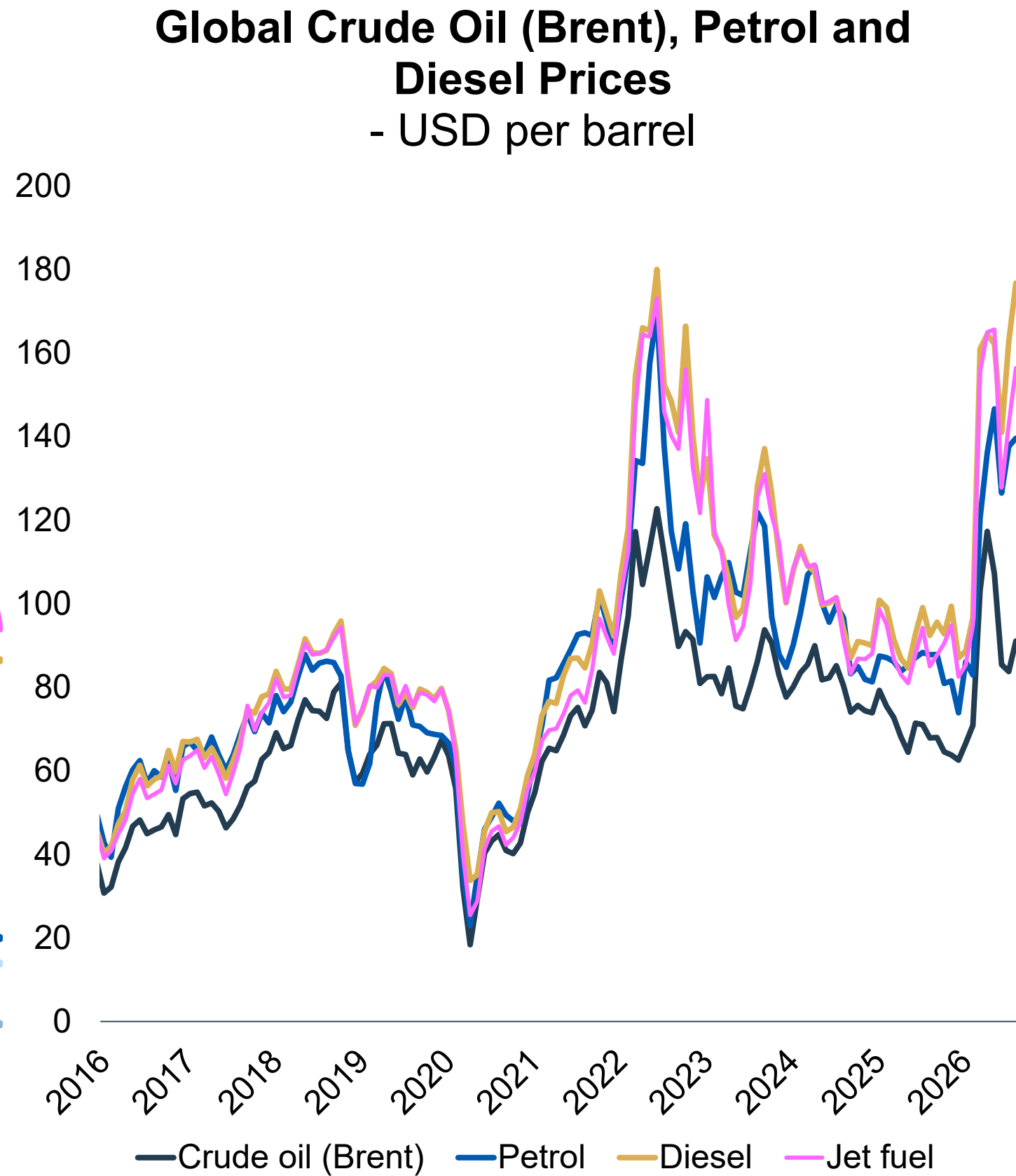
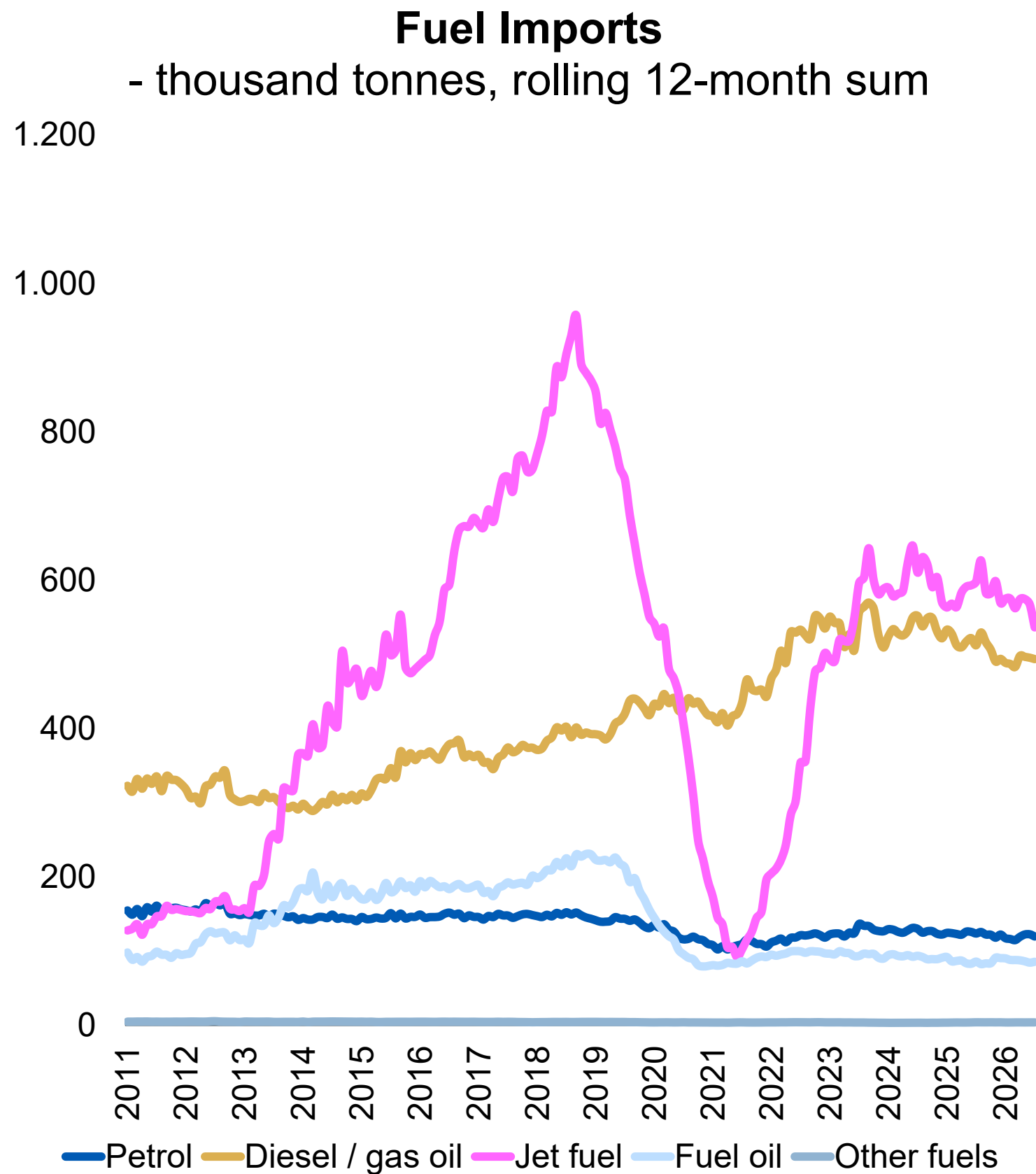
The Agony of Choice

A forecast such as this is based on an economic model and a complex interplay of various economic variables. Although the model forecasts many variables, some are so-called exogenous variables – variables on which the model has no influence. One such variable is the oil price. In the current situation, choosing an oil price path is no easy task, as forecasts are as diverse as they are numerous. **The path used here combines futures prices with forecasts and is, at best, an educated guess.**



Not All Oil Is Created Equal: Business Runs on Diesel

While households mostly drive petrol cars rather than diesel cars, the opposite is true for larger commercial vehicles such as trucks and heavy machinery. Ships also run on fuel closely related to diesel. **The price of diesel has risen more than the price of crude oil or petrol, and could also fall more slowly if and when crude prices decline.** Refining capacity has been shrinking, with attacks on Russian oil infrastructure contributing to this trend.



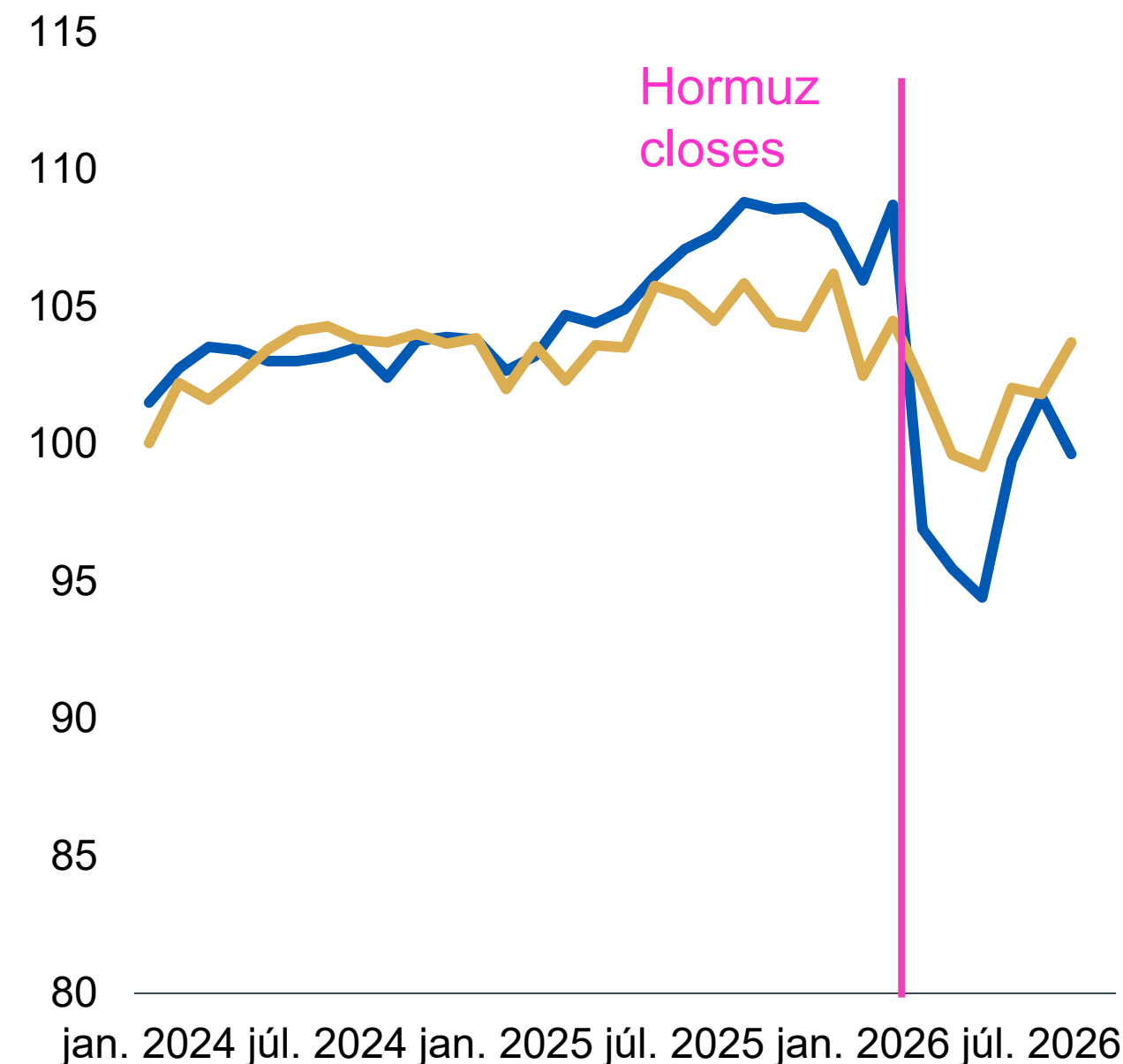
Global Oil Stocks Are Falling

When the Strait of Hormuz was effectively closed in February, oil supply fell sharply. The resulting price increases reduced demand, but between February and May consumption fell by 5.3 million barrels per day, compared with a supply reduction of 14.3 million barrels per day. Production has since recovered slightly, but the International Energy Agency (IEA) still estimates that supply will fall faster than demand this year.

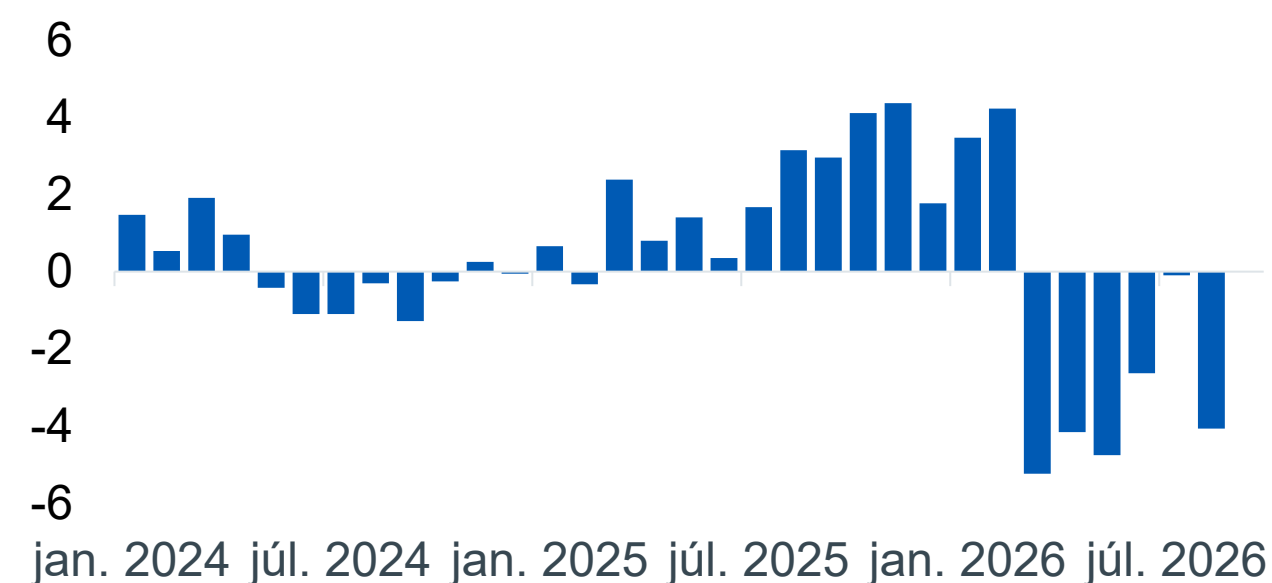
So far, **inventory drawdowns have played a key role in limiting price increases.** This is only a temporary solution, however, as many countries' emergency reserves are being depleted rapidly. If the conflicts in the Persian Gulf and Ukraine persist, oil prices are likely to remain high for some time and could rise further as the capacity to respond diminishes.

Most forecasts assume production will recover next year, but uncertainty has rarely been greater.

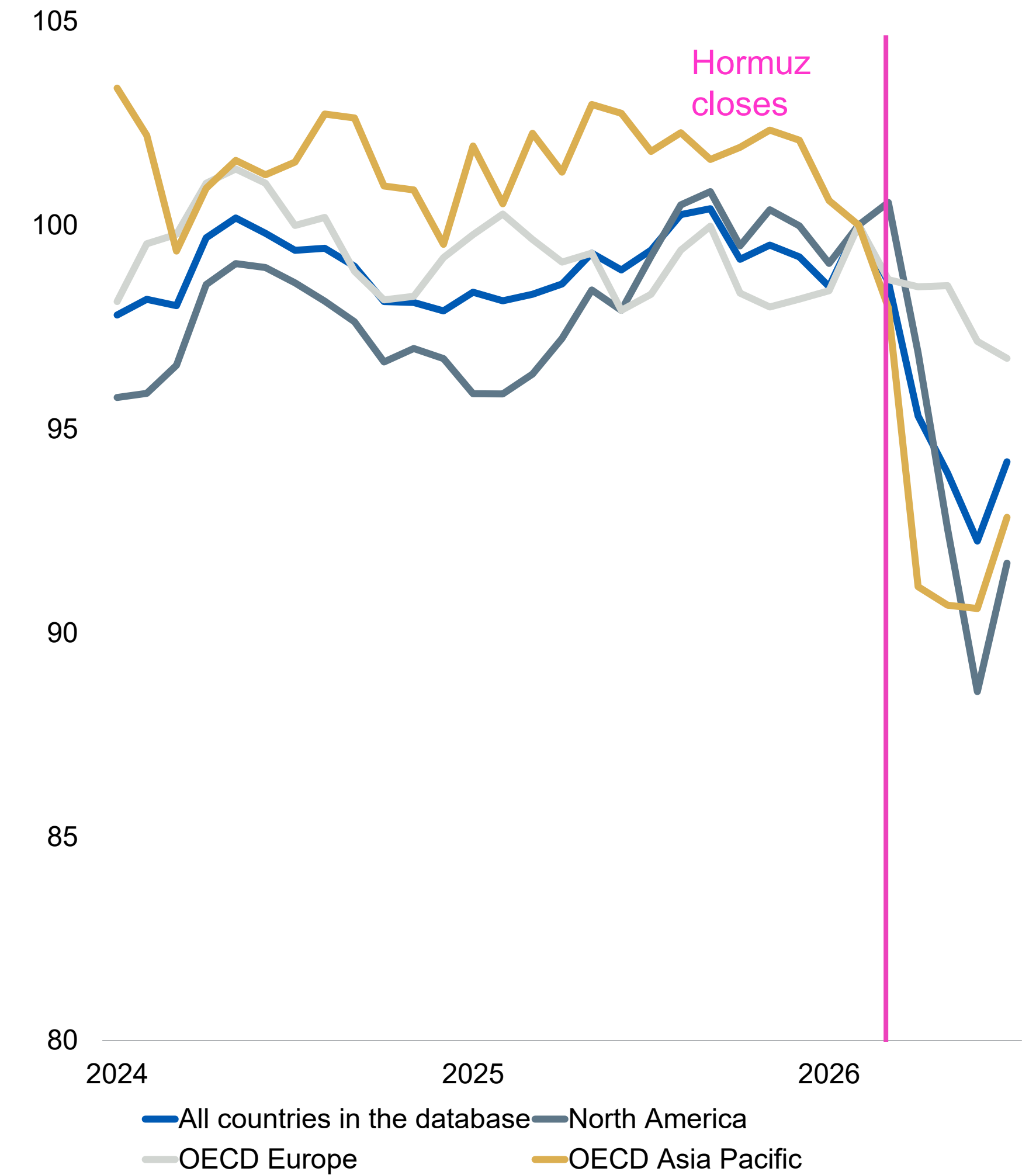
Global Production and Consumption*
- million barrels per day



Inventory Changes
- million barrels per day



International Oil Inventories**
- index (February 2026 = 100)



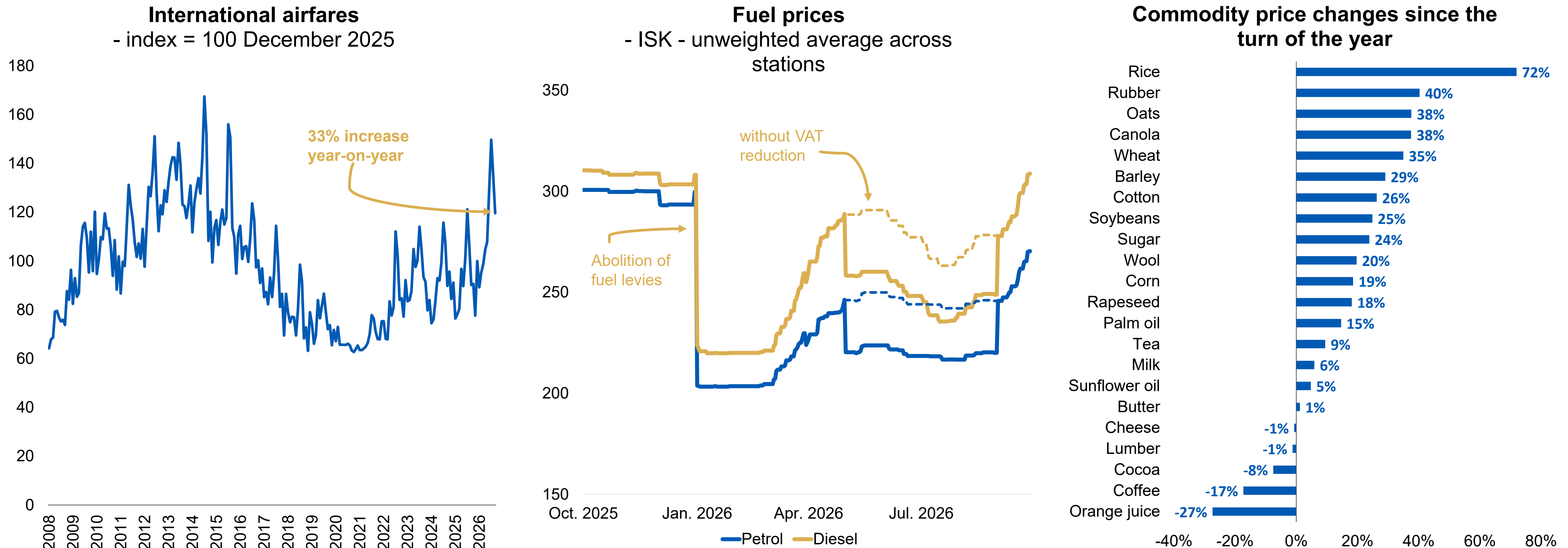
Sources: EIA, Short-Term Energy Outlook, September 2026, JODI-Oil World Database, Arion Research

11 *Liquid fuels. **Crude oil, NGLs and other primary oils. The JODI database covers most global oil inventories, but excludes China.



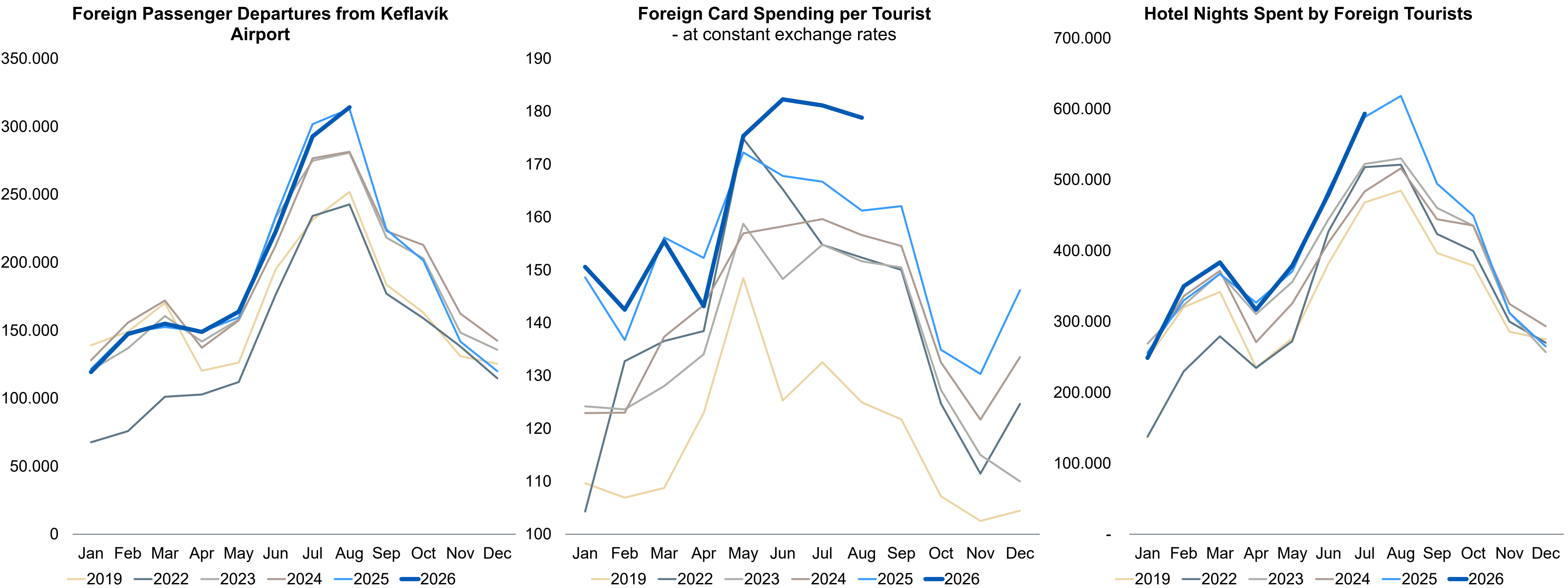
Visible Effects Here, There and Everywhere

So far, the effects of the oil crisis have mainly shown up in Statistics Iceland’s inflation measurements. **According to the CPI, the price of a litre of diesel has risen by 25% since the turn of the year, a litre of petrol by 18%, and international airfares by 33% year-on-year.** Should the conflict drag on, other commodity price increases and a deteriorating global inflation outlook can be expected to push up further components of the Icelandic consumption basket, such as food and beverages.



A Bountiful (Solar Eclipse) Summer Behind Us

The tourism sector faced an uphill battle last winter. Following Play’s bankruptcy, foreign tourist arrivals fell by 6% during the winter season (October–March). The sector’s revenues fared better than feared, however, as the length of stay and tourist spending largely held up. **Despite rising airfares and disruptions to air capacity, tourist arrivals recovered over the summer**, as did tourist card spending, which was unusually strong.



They Come If They Can

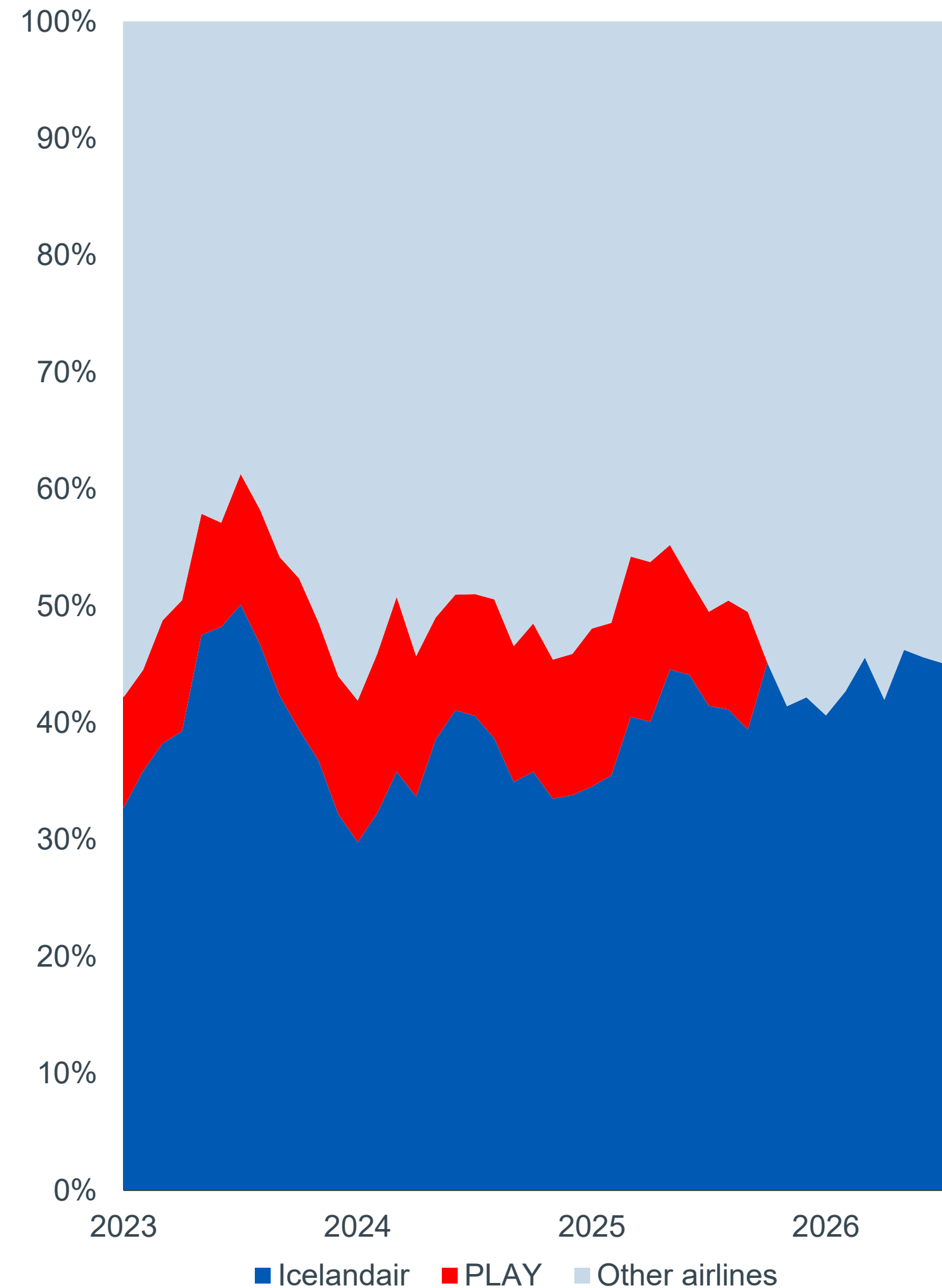
There is no question that Icelandair is the largest airline at Keflavík Airport. By our estimates, **the airline's jets carry close to half of all tourists visiting the country.** The company's operations and future plans therefore have a major bearing on the fortunes of tourism, the economy's largest export sector.

This spring, the airline responded to challenging operating conditions by raising prices across markets and slightly reducing capacity during the spring months. Even so, the number of passengers to Iceland continued to grow, which supports the theory that for small island states, air capacity matters most of all – more than exchange rates and price levels.

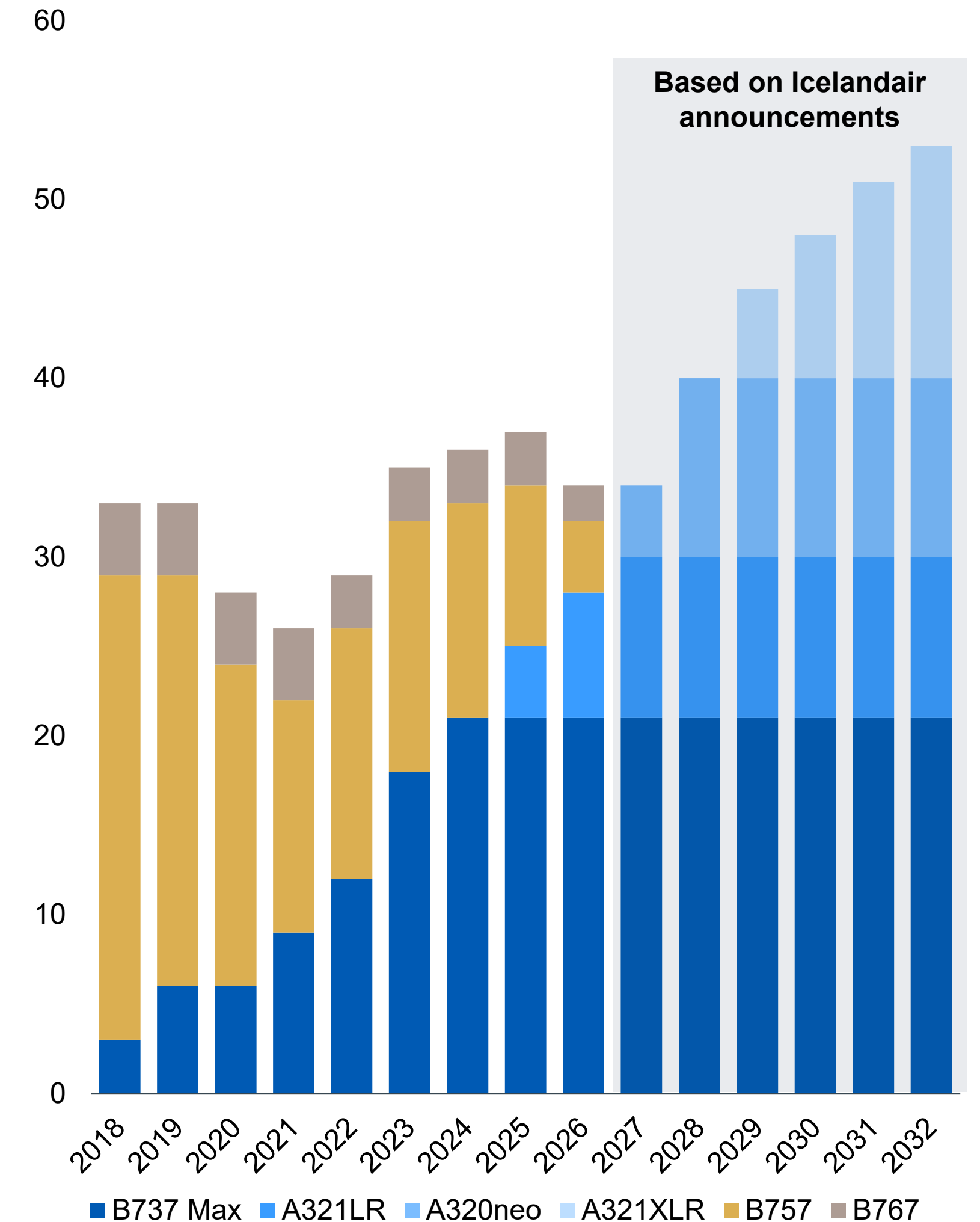
Air capacity to Iceland could increase significantly in the coming years if Icelandair's ambitious plans materialise.

High oil prices, a strong króna and challenging operating conditions could, however, throw a spanner in the works.

Icelandair's Share of Tourist Arrivals
- Arion Research estimates



Icelandair's International Fleet
- number of aircraft at year-end



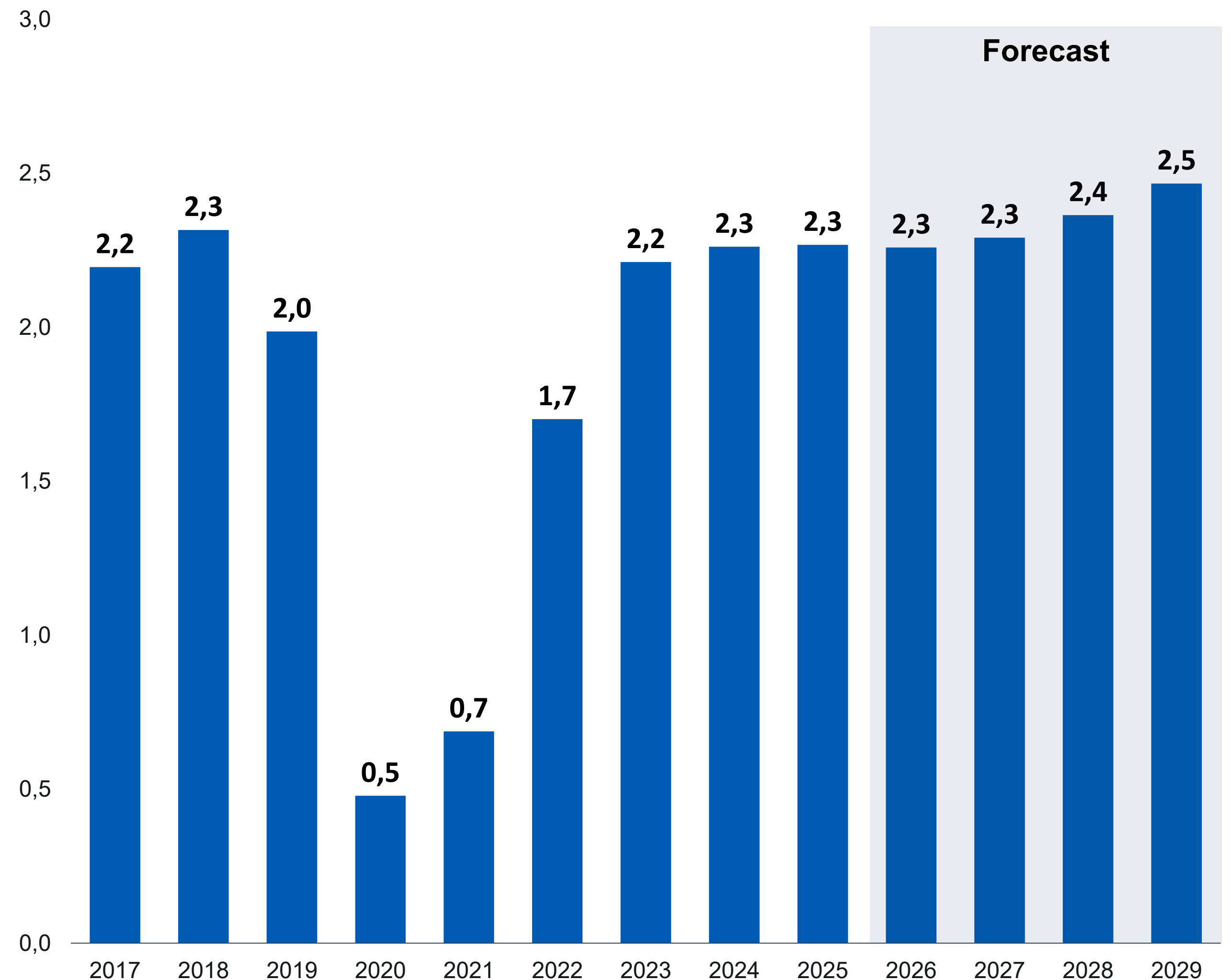
We Forecast a Slight Increase in Tourist Arrivals Next Year

Tourist arrivals have declined slightly so far this year. The contraction of around 1% is a considerably better outcome than we expected in the spring. Reduced air capacity does not appear to have done much harm, as each aircraft is carrying more tourists than before. **We expect this to continue, with the year ending in a contraction of just under 0.5%.**

The outlook for next year is similar, and **we forecast a similar number of tourists, with growth of just over 1%**, driven by foreign rather than domestic airlines, as Icelandair intends to focus on fleet renewal rather than growth. The reverse applies later in the forecast period, but as befits cautious economists, **we base the forecast on moderate assumptions rather than published plans, which nonetheless always serve as its starting point.**

Uncertainty is considerable at present, as **high jet fuel prices are squeezing airlines.** Many have cut capacity and raised fares, and some have sought creditor protection due to rising fuel costs. Outcomes could easily tilt either way as the war drags on.

Foreign Visitor Arrivals through Keflavík Airport
- annual totals, millions



Exports on the Mend

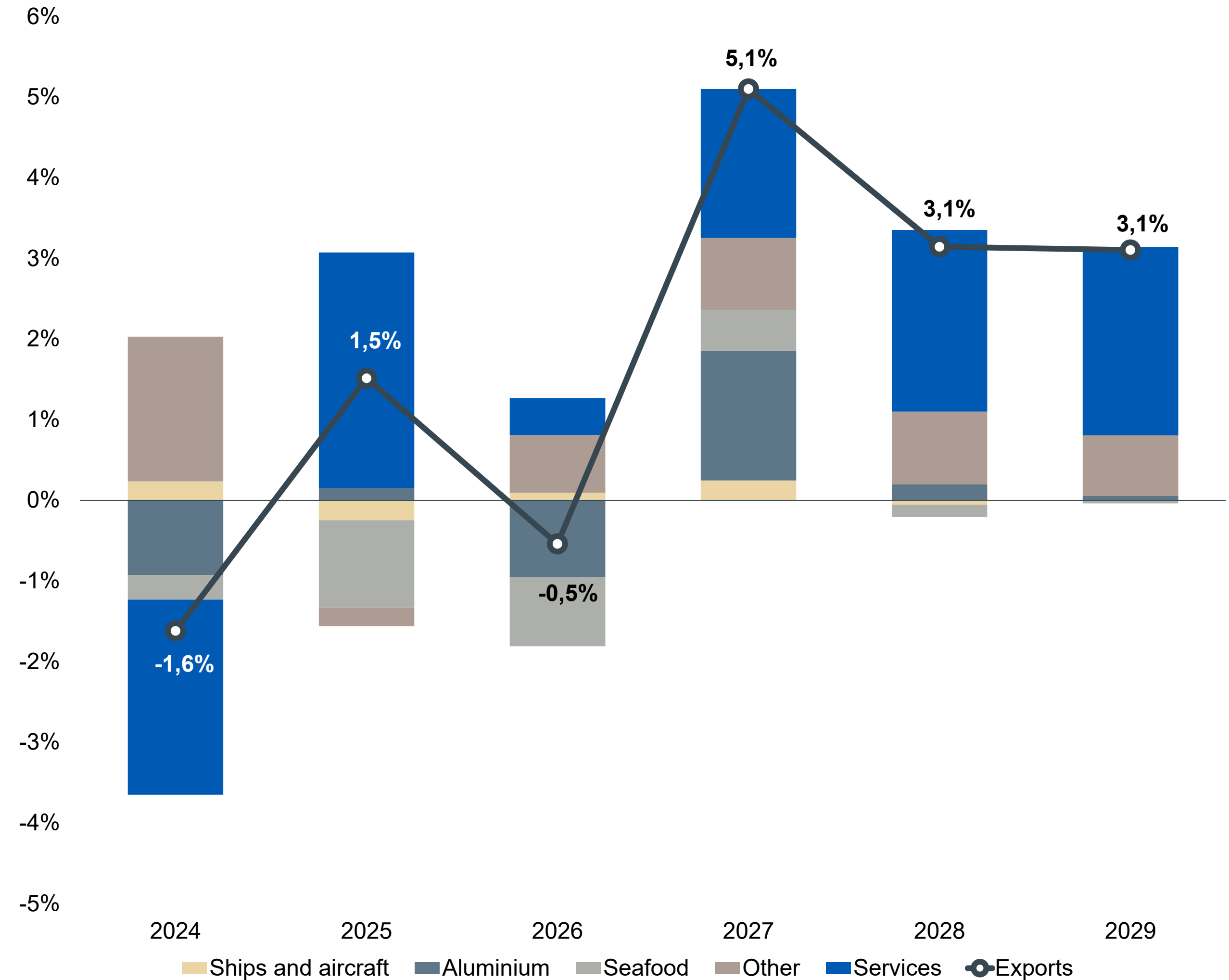
Despite massive growth in data centre services exports, the solar eclipse and expectations of a record year in aquaculture, we believe that **reduced production at Norðurál in the first half of the year and smaller fishing quotas will prevail, pulling exports into a 0.5% contraction.**

It is worth noting that **price increases for aluminium and seafood have offset the decline in volume** – and then some! Export values in ISK terms have therefore risen considerably in the first eight months of the year, by 8% for seafood and 5% for aluminium.

The outlook for next year is somewhat brighter, as all components of exports look set to pull in the same direction. The main drivers are full production capacity at the aluminium smelters, increased capelin exports, growth in salmon farming, and rising export revenues from data centres and other knowledge-based activities.

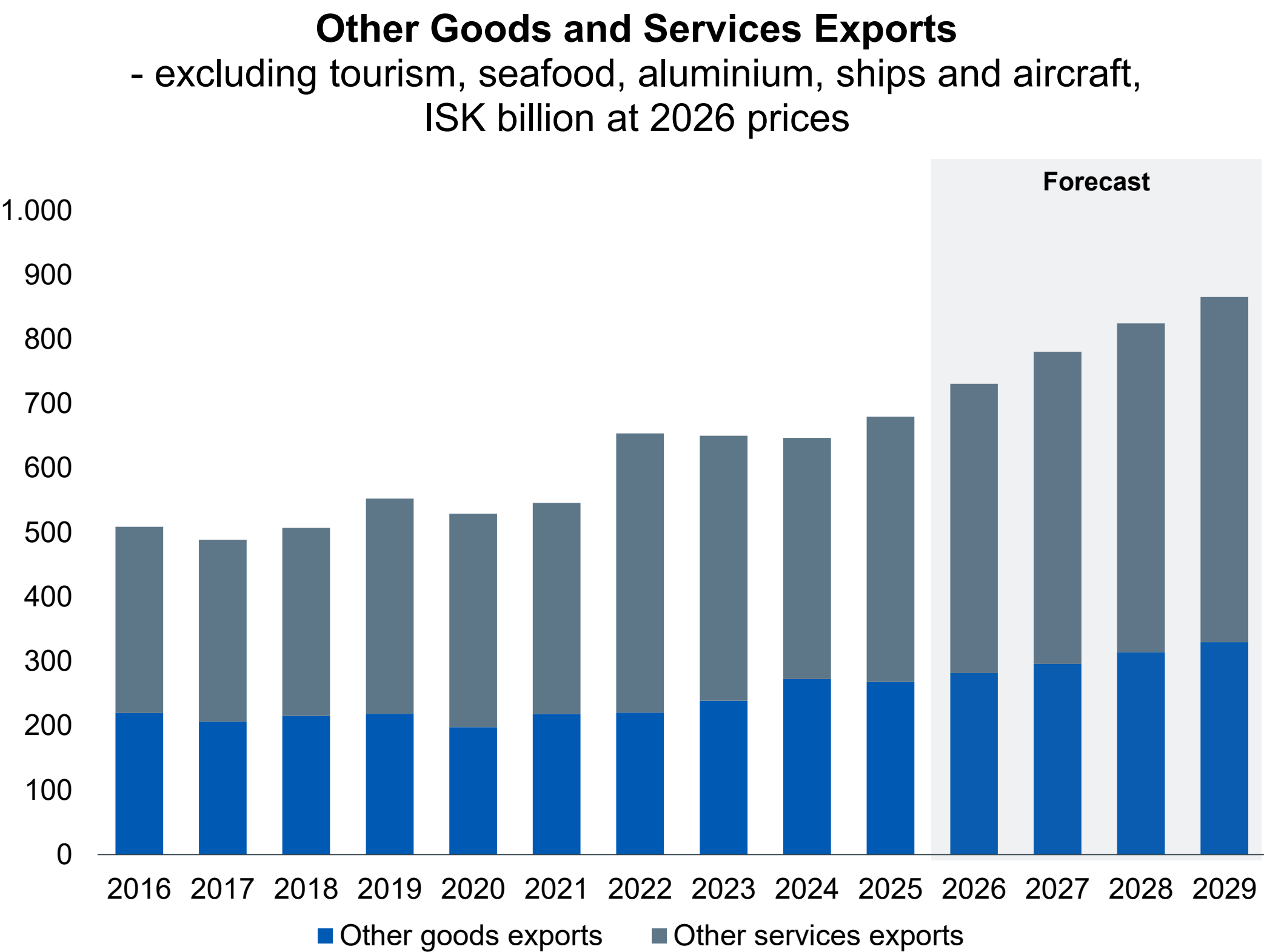
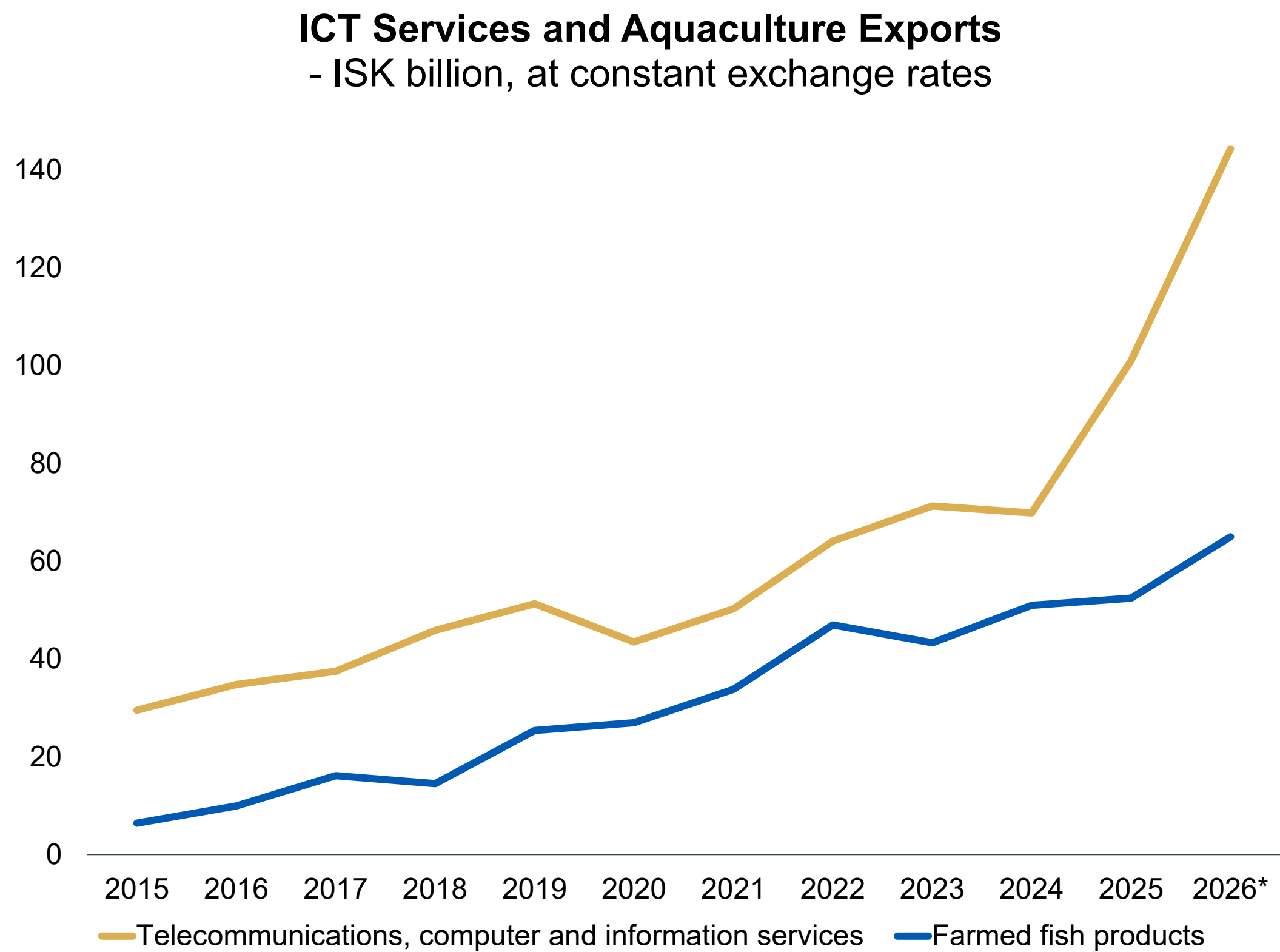
Uncertainty is, however, considerable, as a strong króna, deteriorating competitiveness and difficult operating conditions in a turbulent global environment are putting pressure on many exporters.

Exports
- contributions to growth



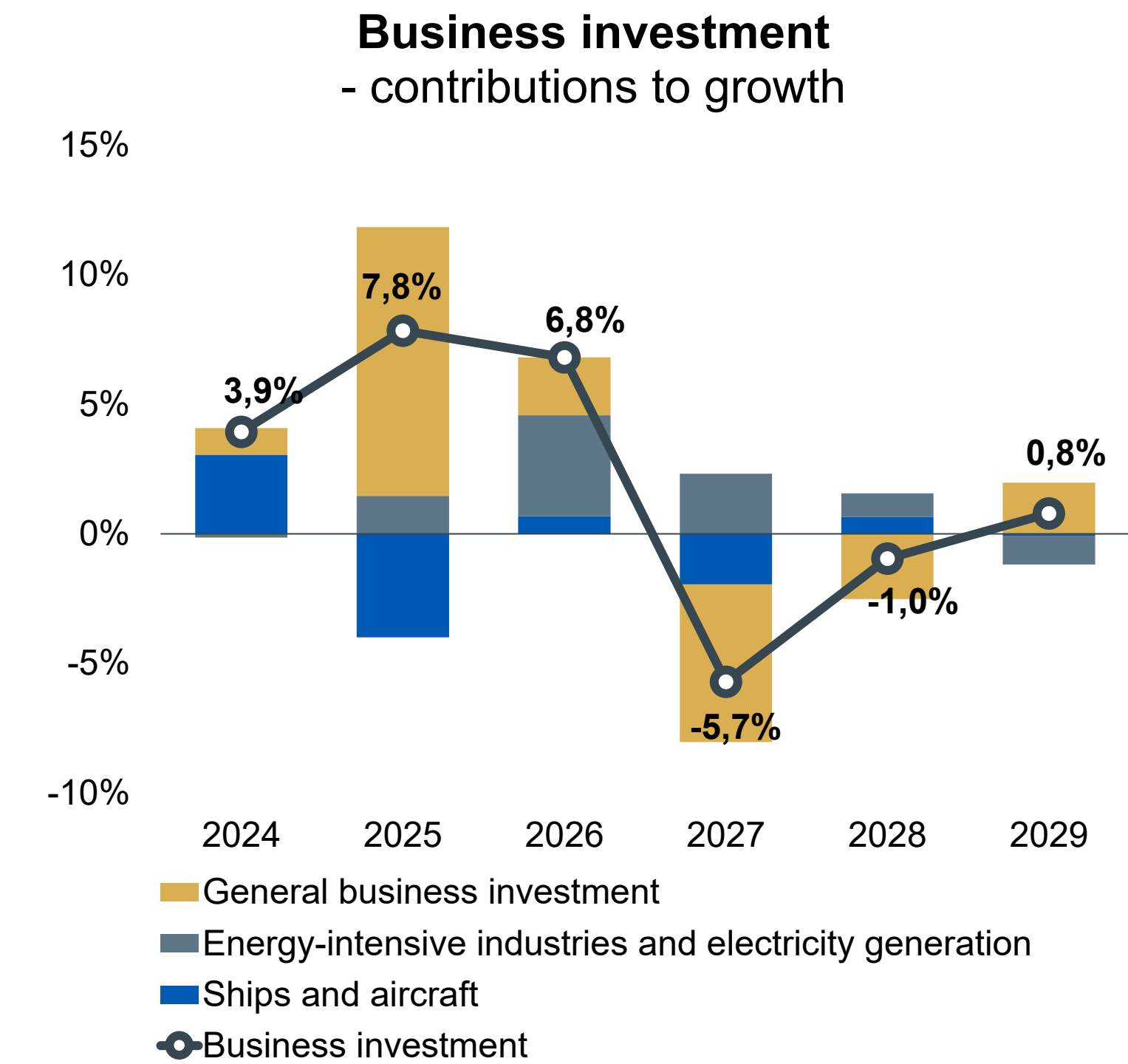
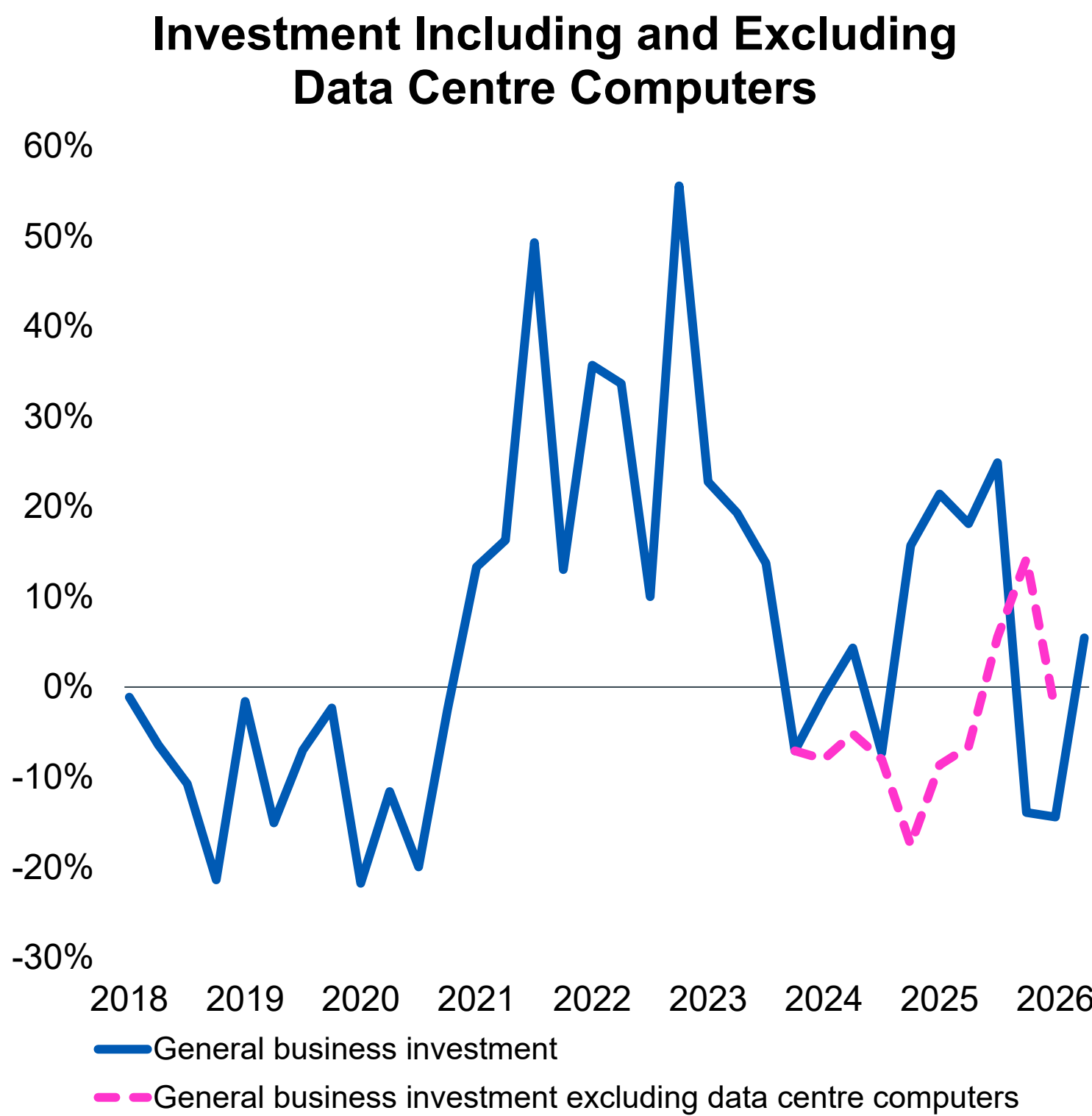
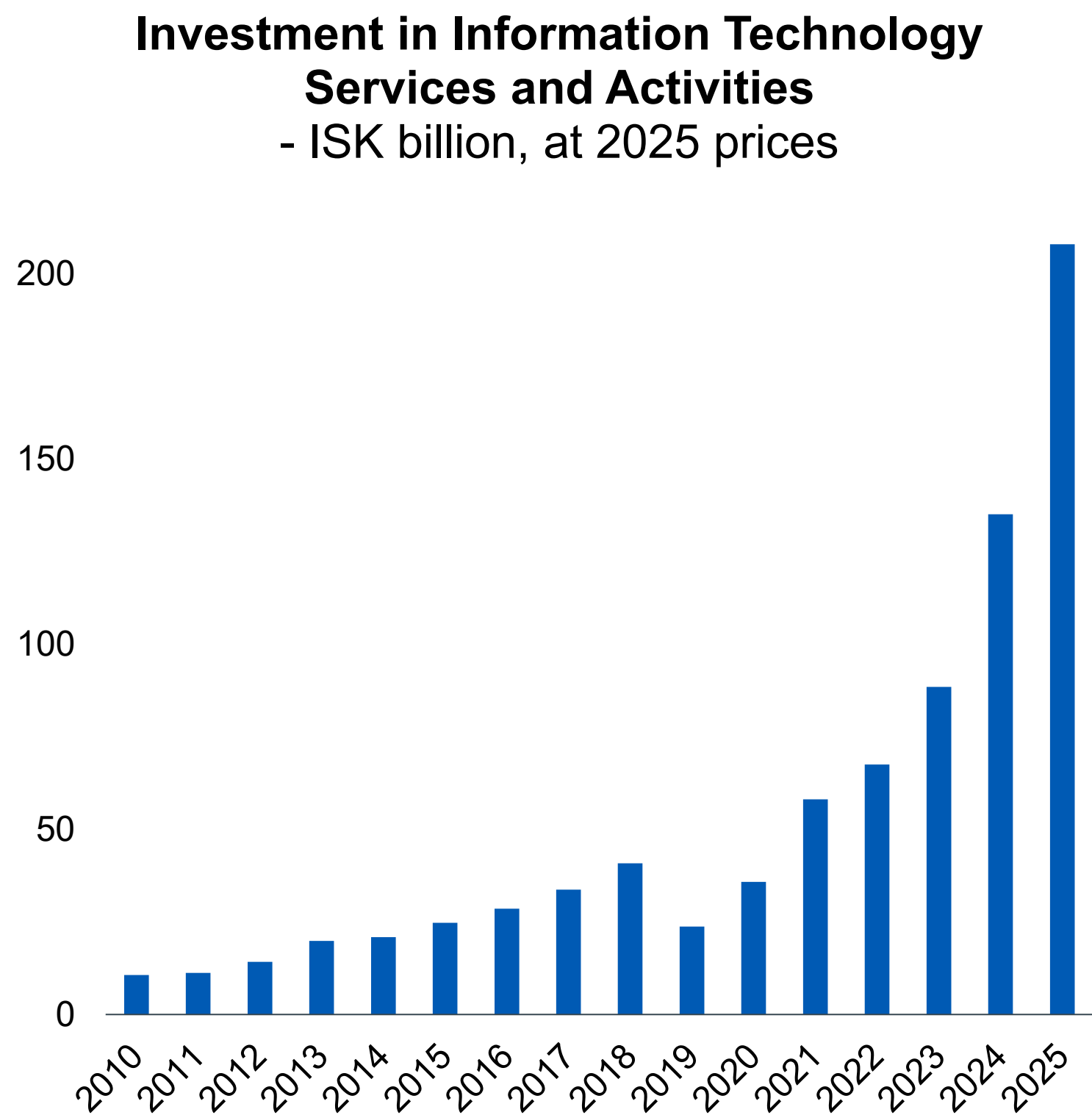
New Pillars of Exports Are Taking Root

After dominating imports for the past two years, data centres are now making a substantial mark on exports too. **Exports of telecommunications, computer and information services rose by 45% last year and by 73% in the first half of this year.** Substantial investment in recent years and growing demand for data centre services point to further export growth in the years ahead. Aquaculture is another source of growth, with a record year in prospect if current trends continue. Although marine aquaculture has room to expand, development appears to be shifting increasingly to land-based operations.



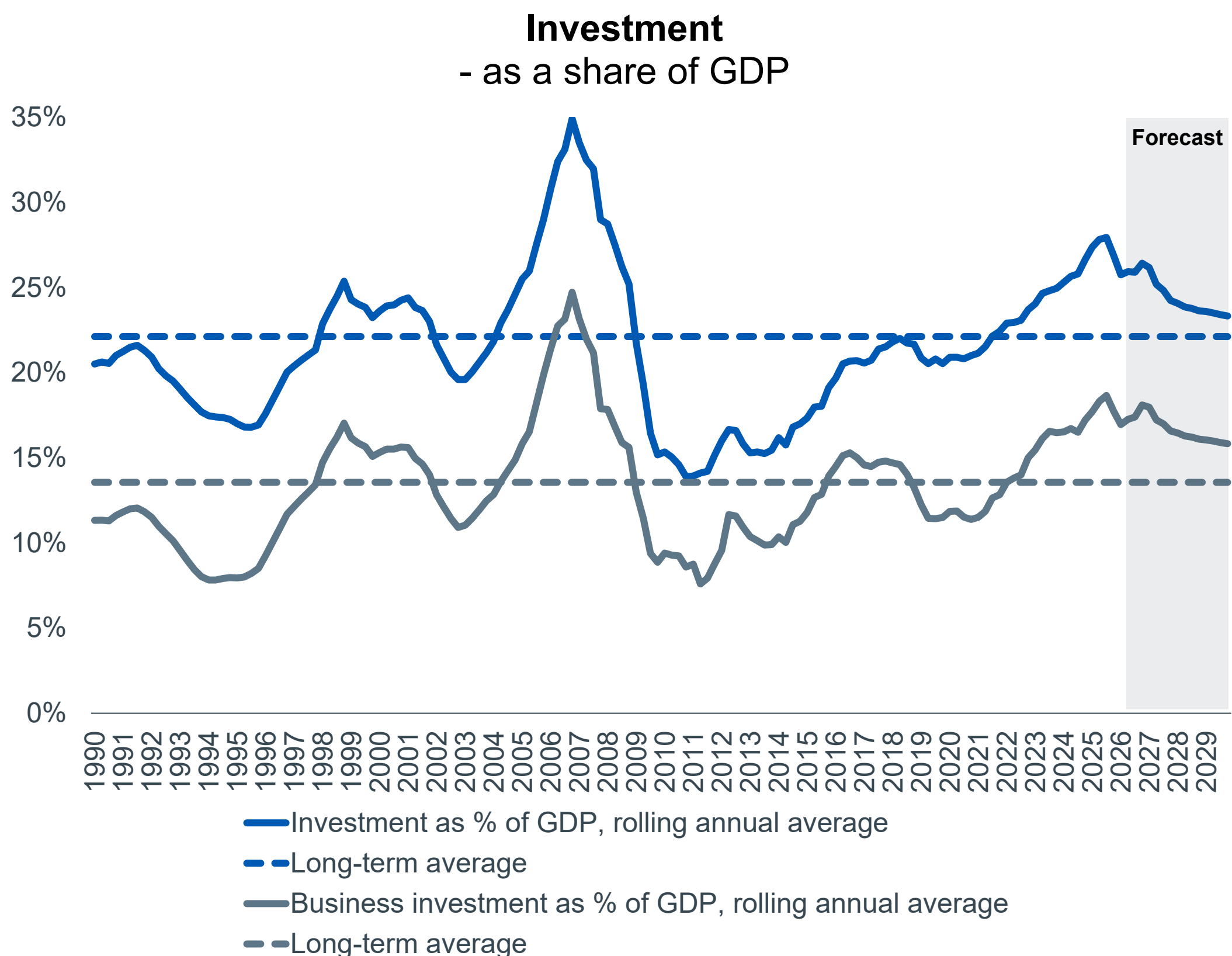
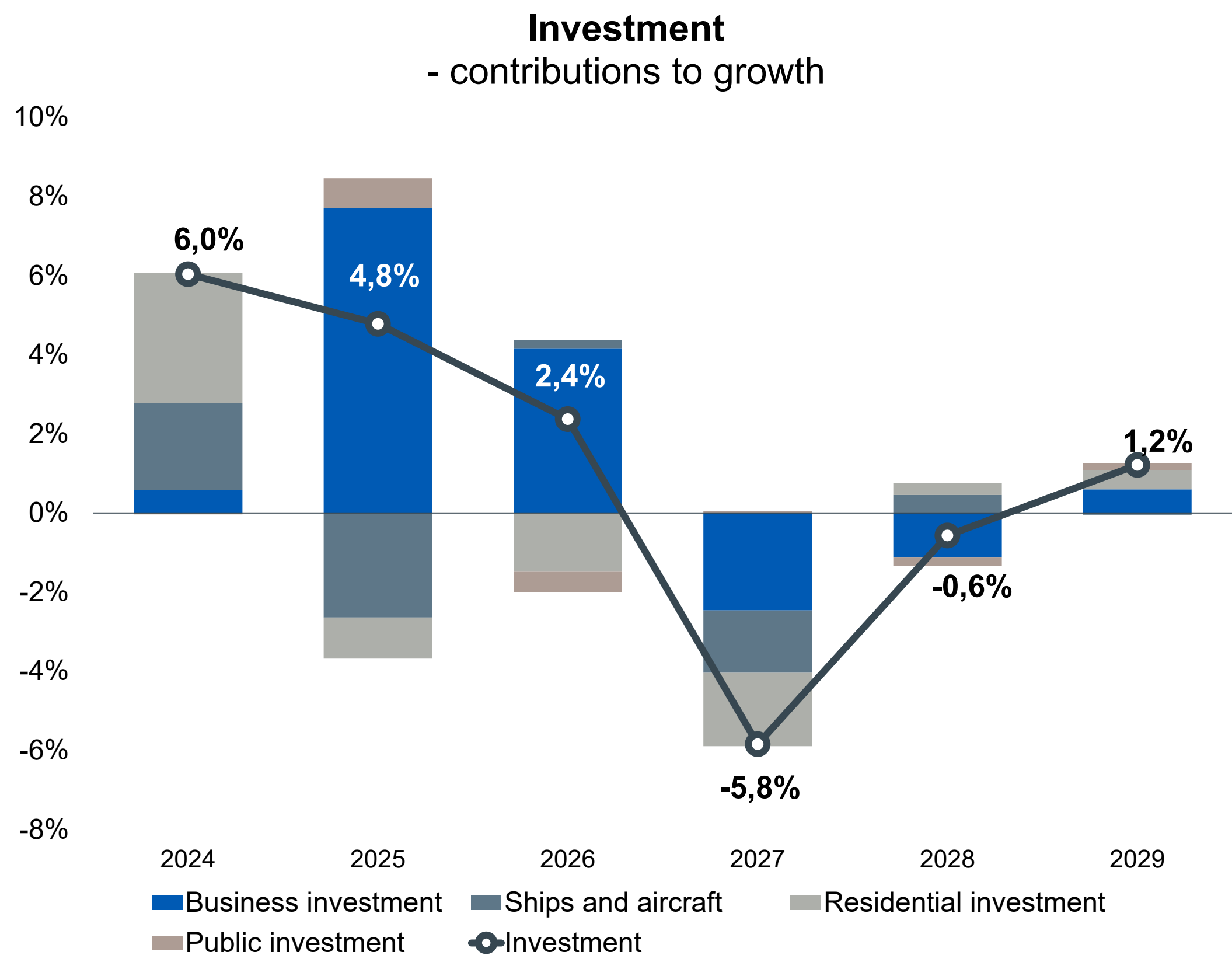
Data Centres Drive Business Investment

Substantial investment in data centres and related equipment has been a key driver of business investment over the past two years. Published plans point to investment totalling tens of billions of krónur over the next five years. **We nevertheless expect investment to peak this year and decline over the following two years, while remaining substantial.** Other general business investment is expected to contract next year in a challenging interest rate environment. The interest rate environment does not, however, appear to be deterring investment in heavy industry and power generation, as several large projects are in the pipeline.



Investment Contraction Spans (Almost) All Components

We expect investment to increase slightly this year and contract over the following two years. Although data centres play a major role in this forecast, other components also point to contraction next year. Residential investment is the largest of these, reflecting difficult conditions in the housing market. Investment has nevertheless increased substantially in recent years, by around 55% in real terms since 2020. Investment will therefore remain healthy and above its long-term average, despite contracting over the next two years.



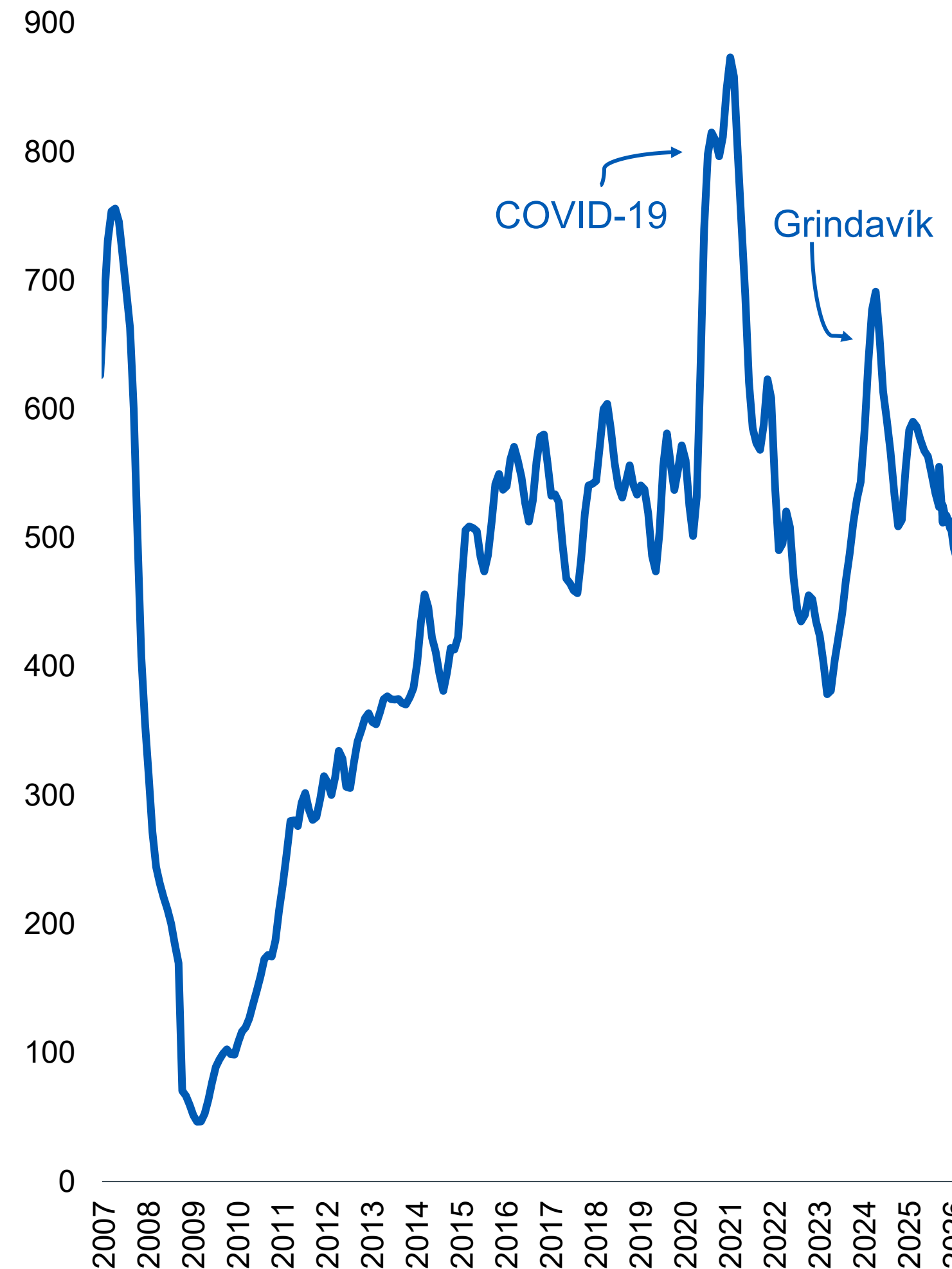
Real House Prices Still Too High Given Rates...

Home sales have slowed somewhat recently, and **the number of registered purchase agreements in the capital region has fallen fairly sharply** so far this year. House prices appear not yet to have adjusted fully to higher interest rates and other changes in credit markets, such as tighter access to inflation-indexed loans.

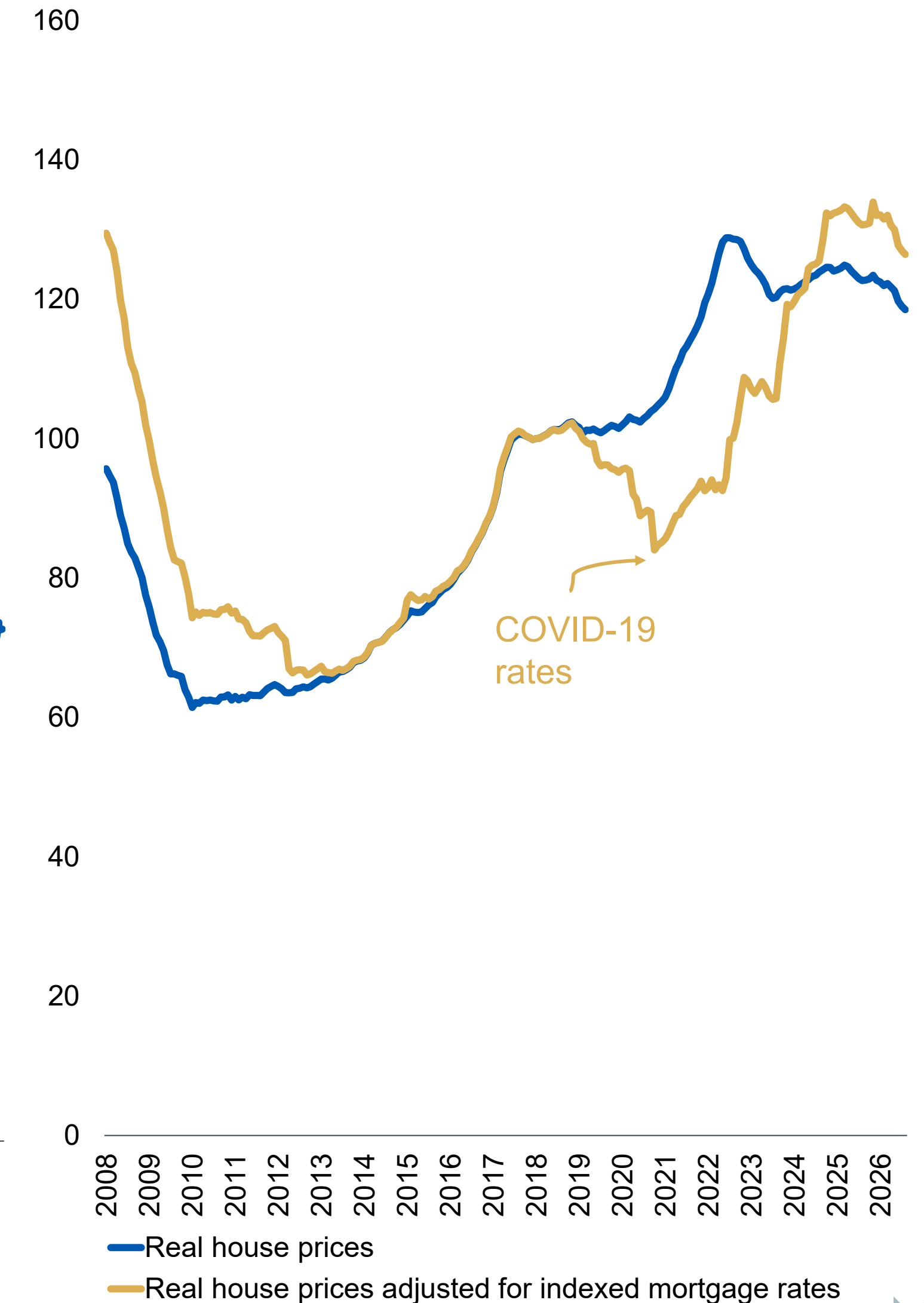
Higher interest rates require greater payment capacity to finance the same home purchase. Adjusting for this shows that **real house prices, adjusted for indexed mortgage rates, peaked in November 2025**, rather than July 2022.

It may be more than a coincidence that real prices on this measure began to fall at that point. Around the same time, the supply of indexed loans declined following the court ruling on interest rates. **The lowest mortgage payments available to buyers increased by more than interest rate rises alone would imply.** If other factors, such as loan maturity, were also accounted for, the payment burden required to finance a home purchase may not actually have fallen over the past twelve months.

Monthly Housing Purchase Agreements in the Capital Area
- seasonally adjusted trend

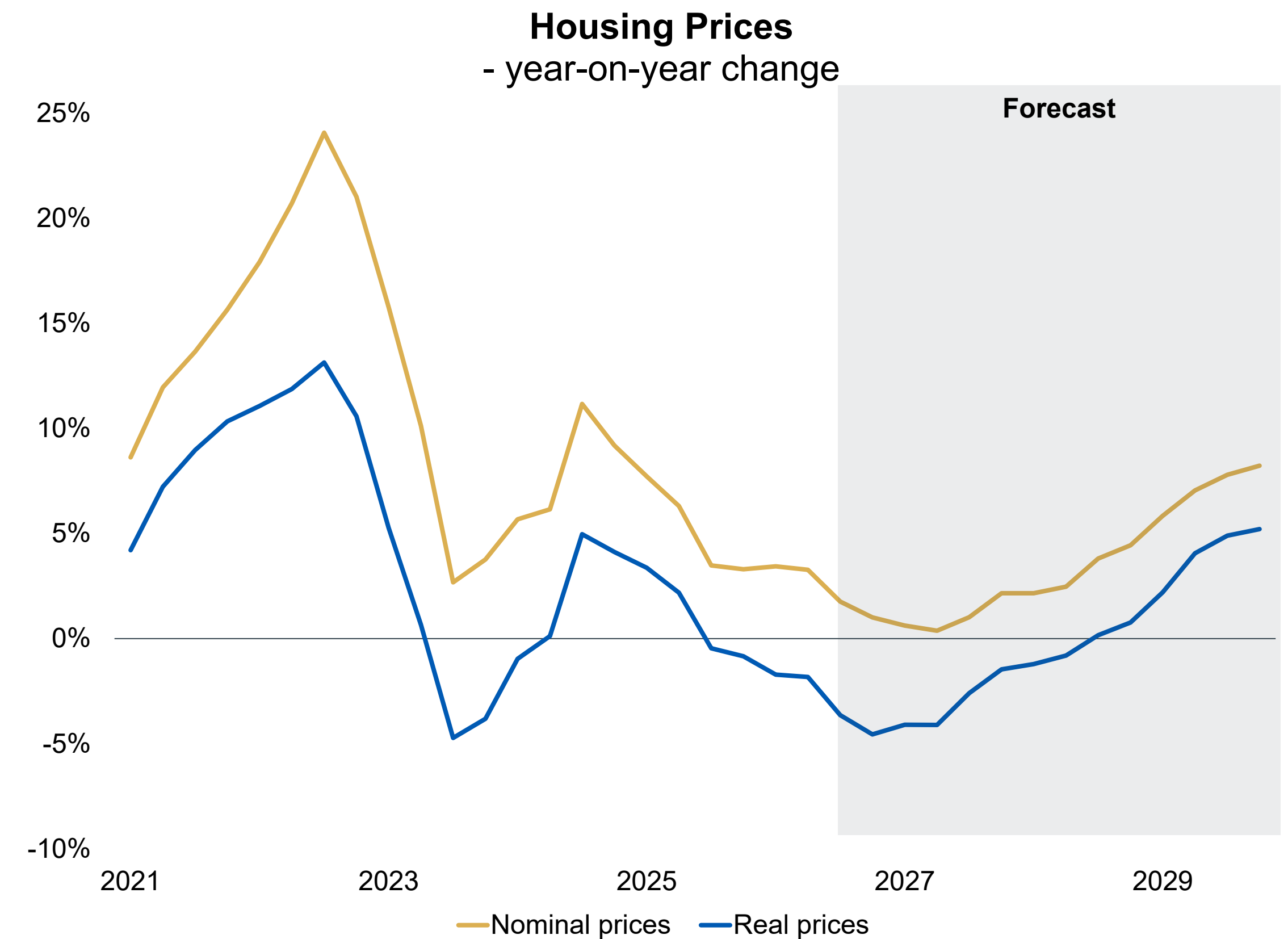
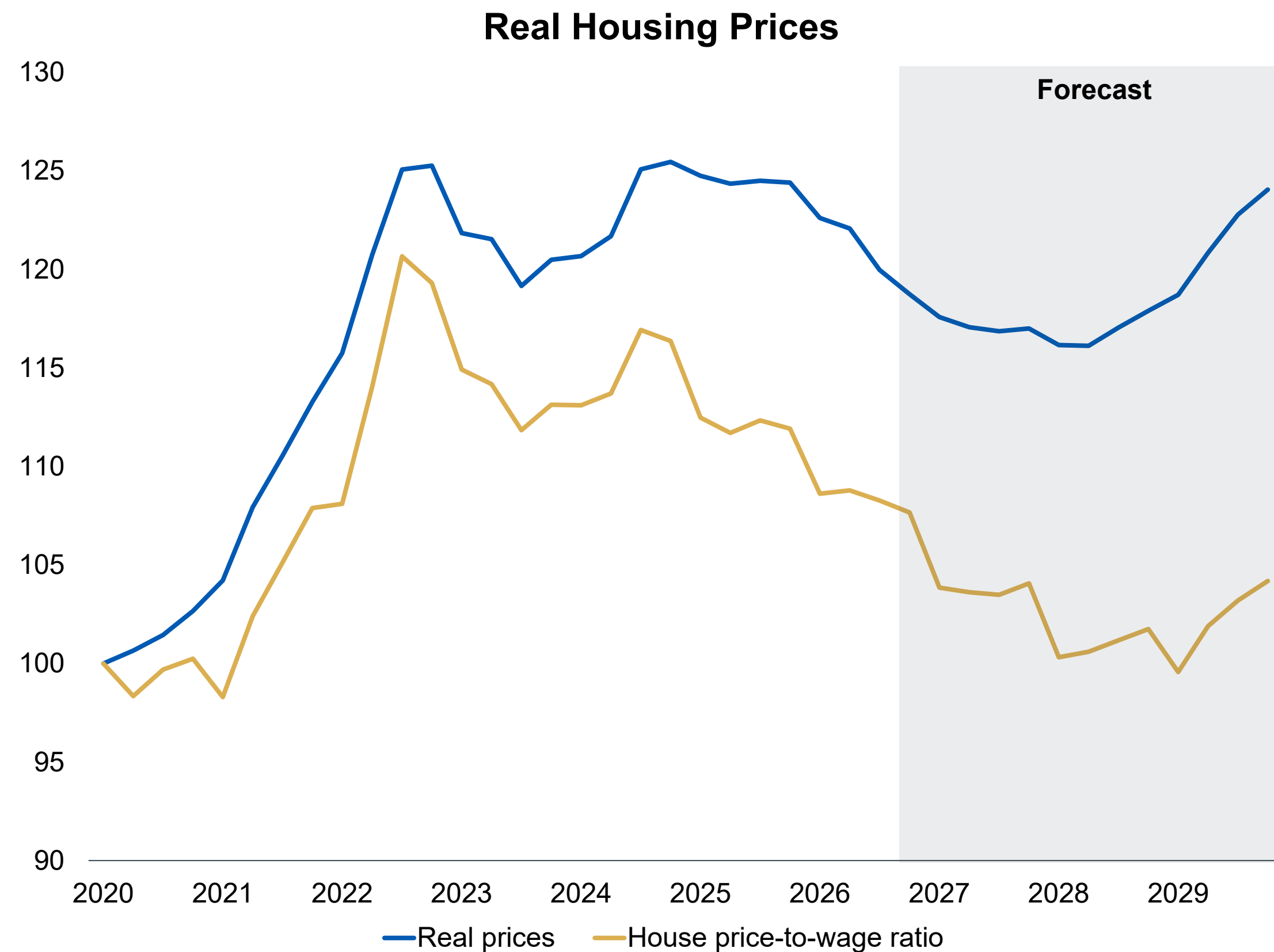


Real House Prices in the Capital Area
- index (January 2016 = 100)



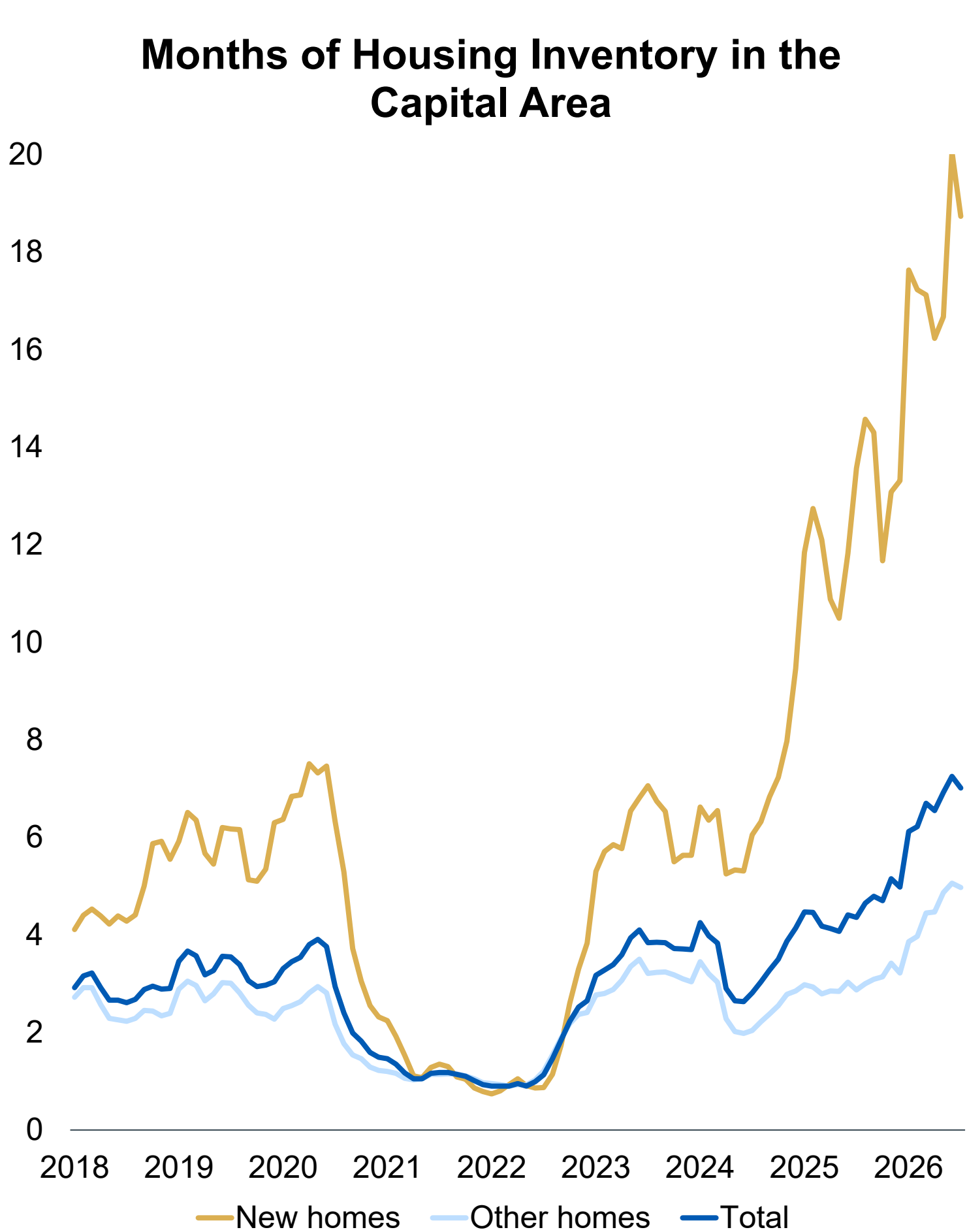
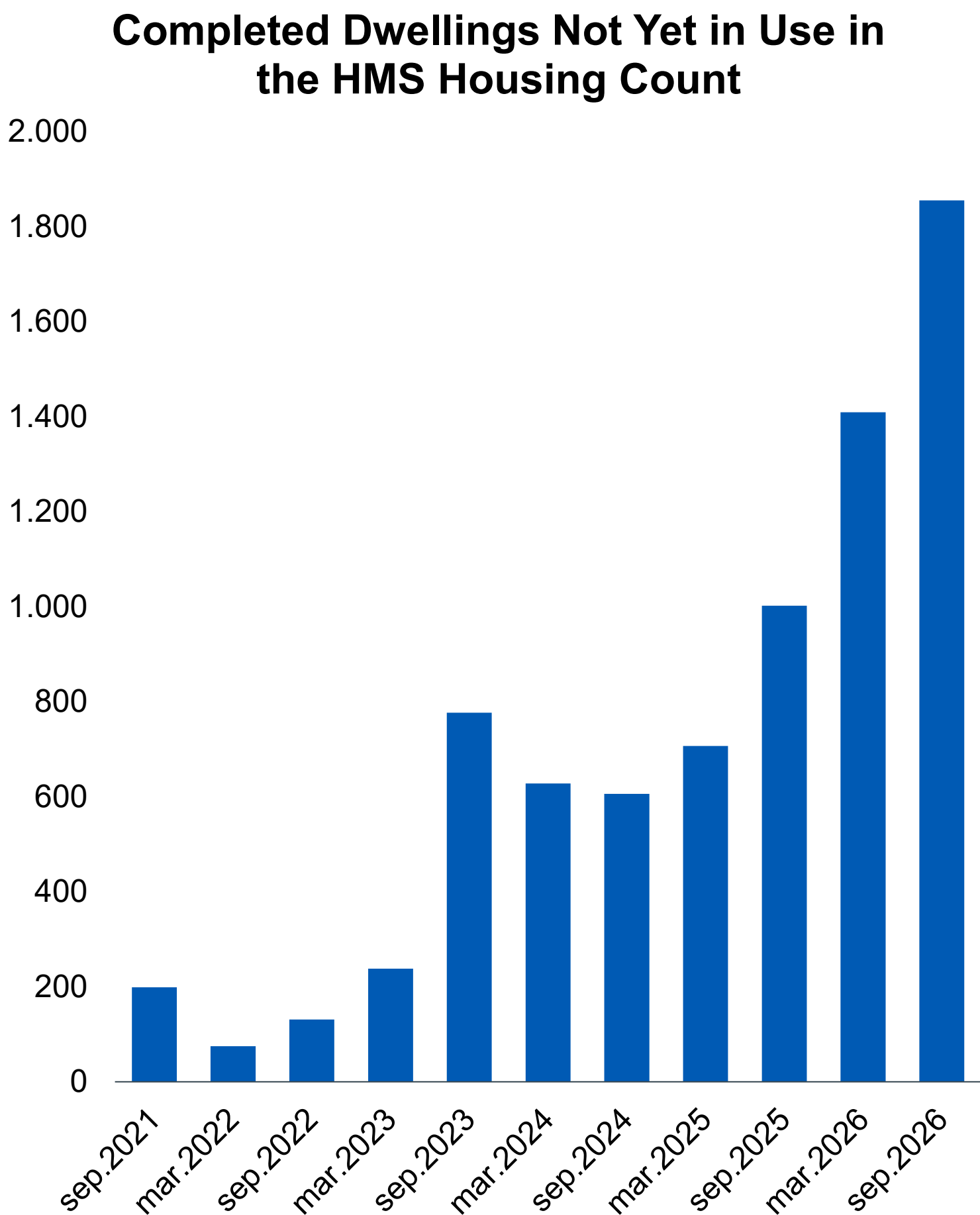
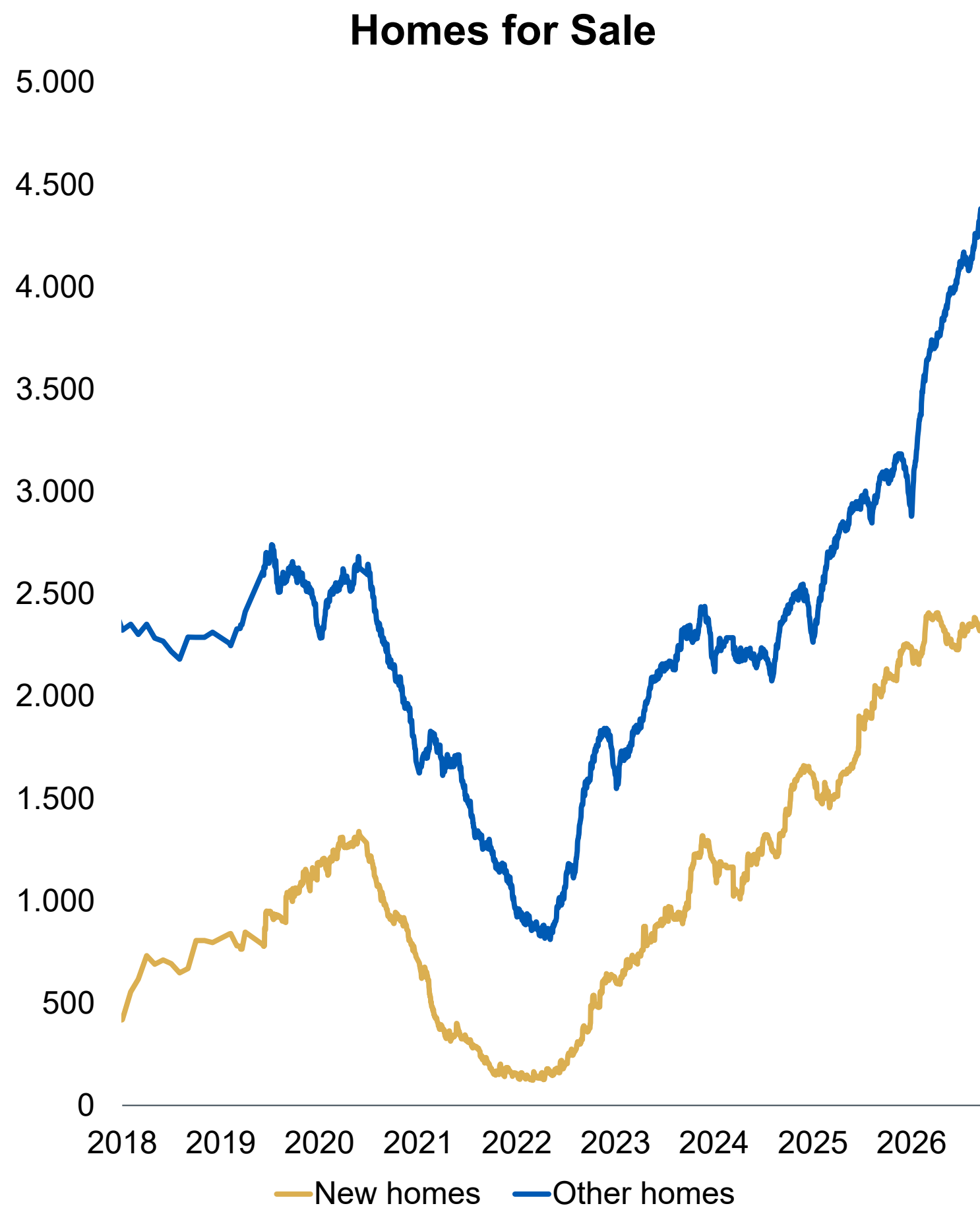
...and Are Likely to Fall Further

We forecast a **further decline of almost 5% in real housing prices by mid-2028**. If the forecast materialises, the house price-to-wage ratio will fall, reaching a level in 2028 around 14% below its peak. The adjustment in the housing market will therefore occur mainly as underlying variables, such as wages and consumer prices, rise faster than house prices. We expect real housing prices to recover as interest rates decline, residential construction slows and population growth becomes more balanced.



Slower Sales Are Driving Up Inventories

The stock of unsold new homes continues to pile up. Slow sales of new properties are putting pressure on the construction sector. **At the current sales pace, it would take almost 19 months to sell all the new homes currently on the market.**

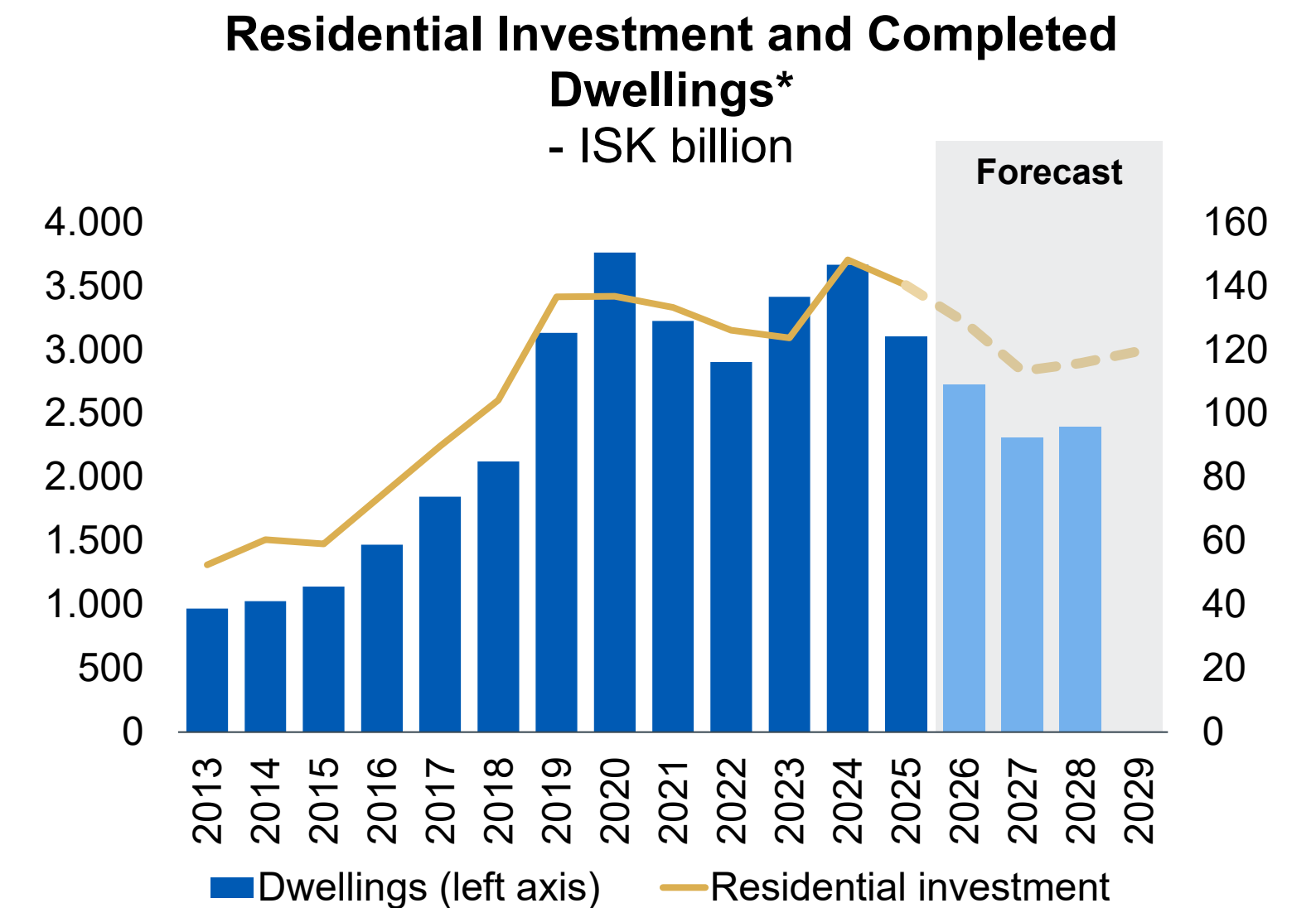
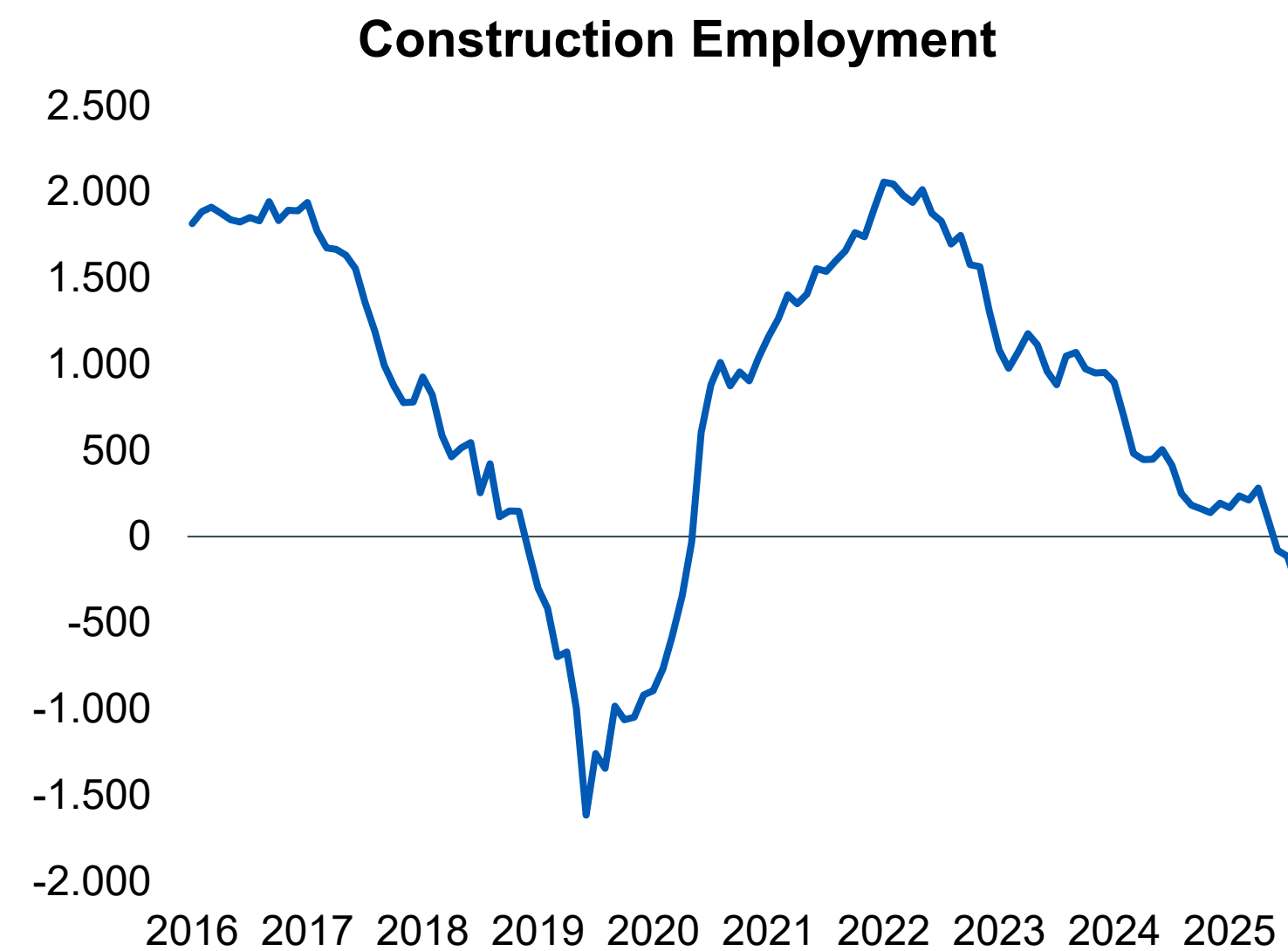
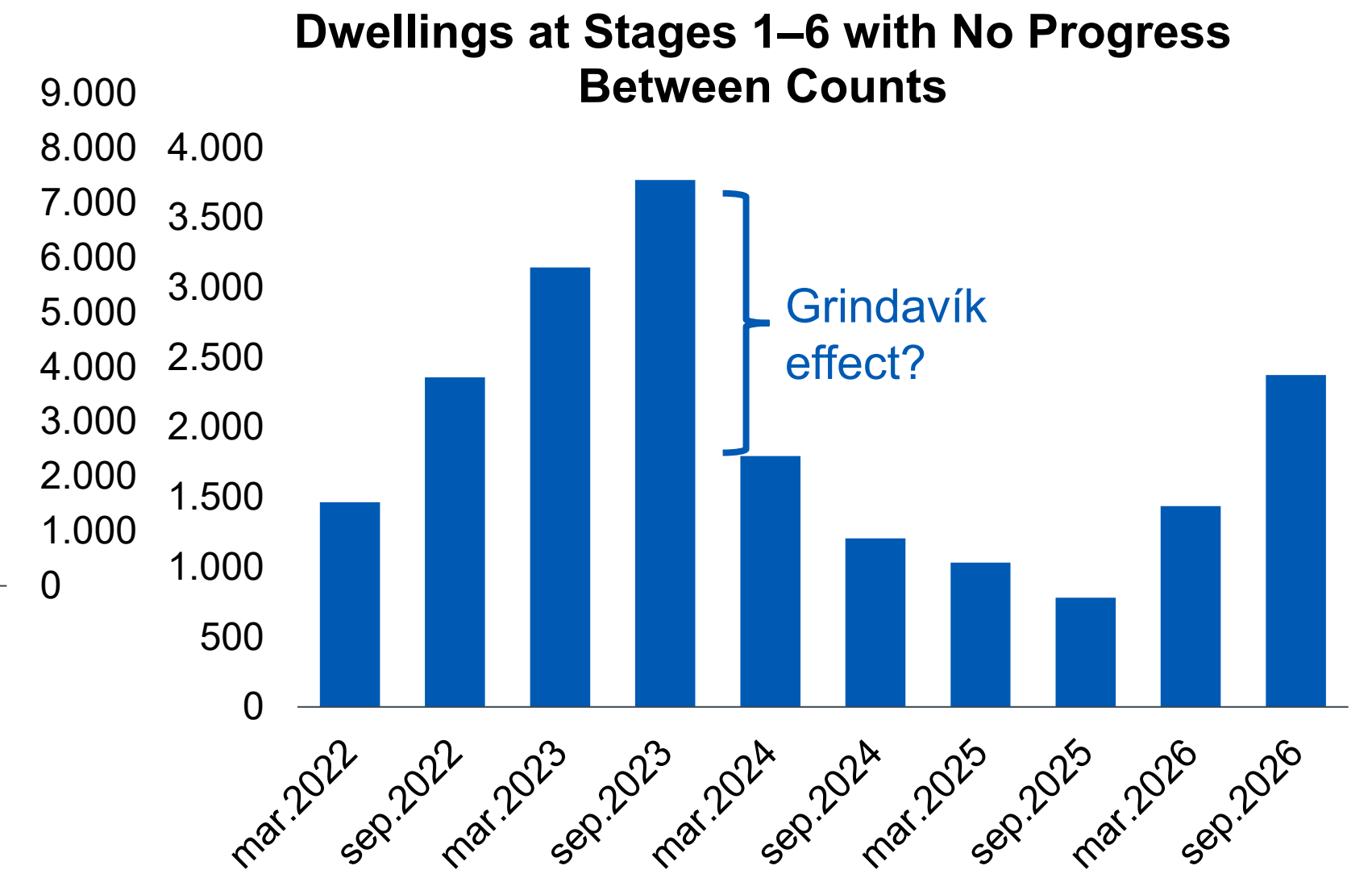
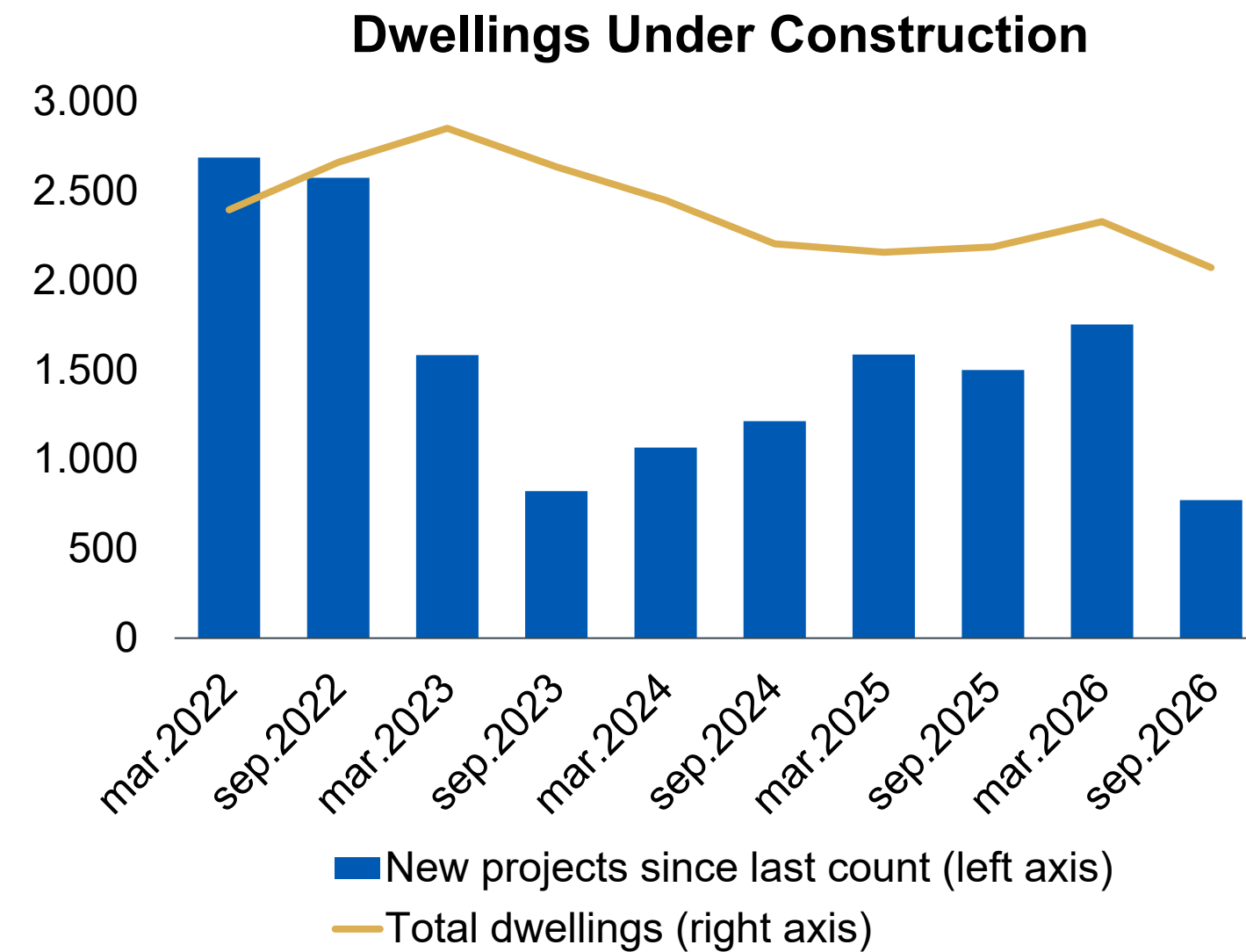


Little Sold, Little Built

High interest rates, long selling times and substantial equity tied up in unsold properties have led to a contraction in residential investment. Some developers struggle to finance further construction while holding large stocks of unsold homes, while others choose to hold back in the current environment.

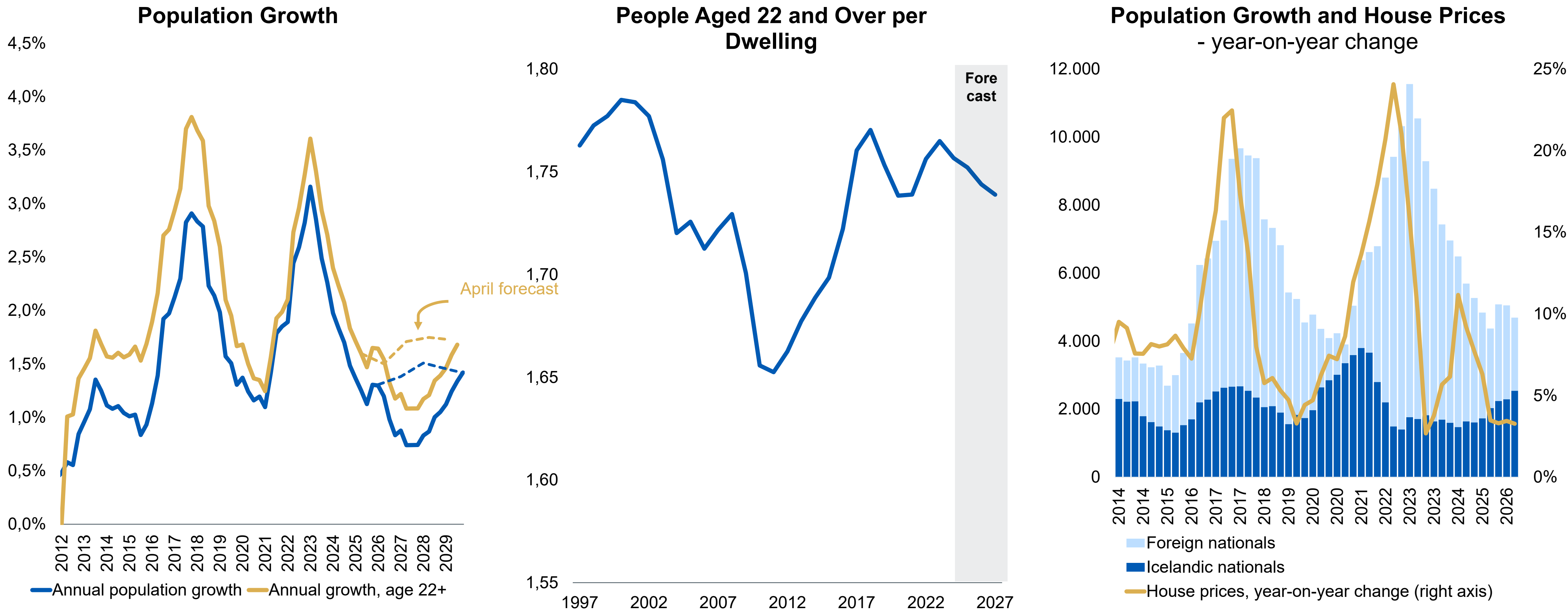
Following an unexpected increase in new projects in March, **HMS's September housing count paints a much darker picture**, more consistent with current market conditions. New projects fell substantially between counts, while the number of projects making no progress increased considerably. HMS has therefore sharply reduced its forecast of completed dwellings in the coming years. **We also expect a larger contraction in residential investment than previously forecast.**

Recent weakness in the housing market has put pressure on developers, prompting some to cut jobs and lower prices. **Construction employment fell year-on-year over the summer, a trend likely to continue into the winter.**



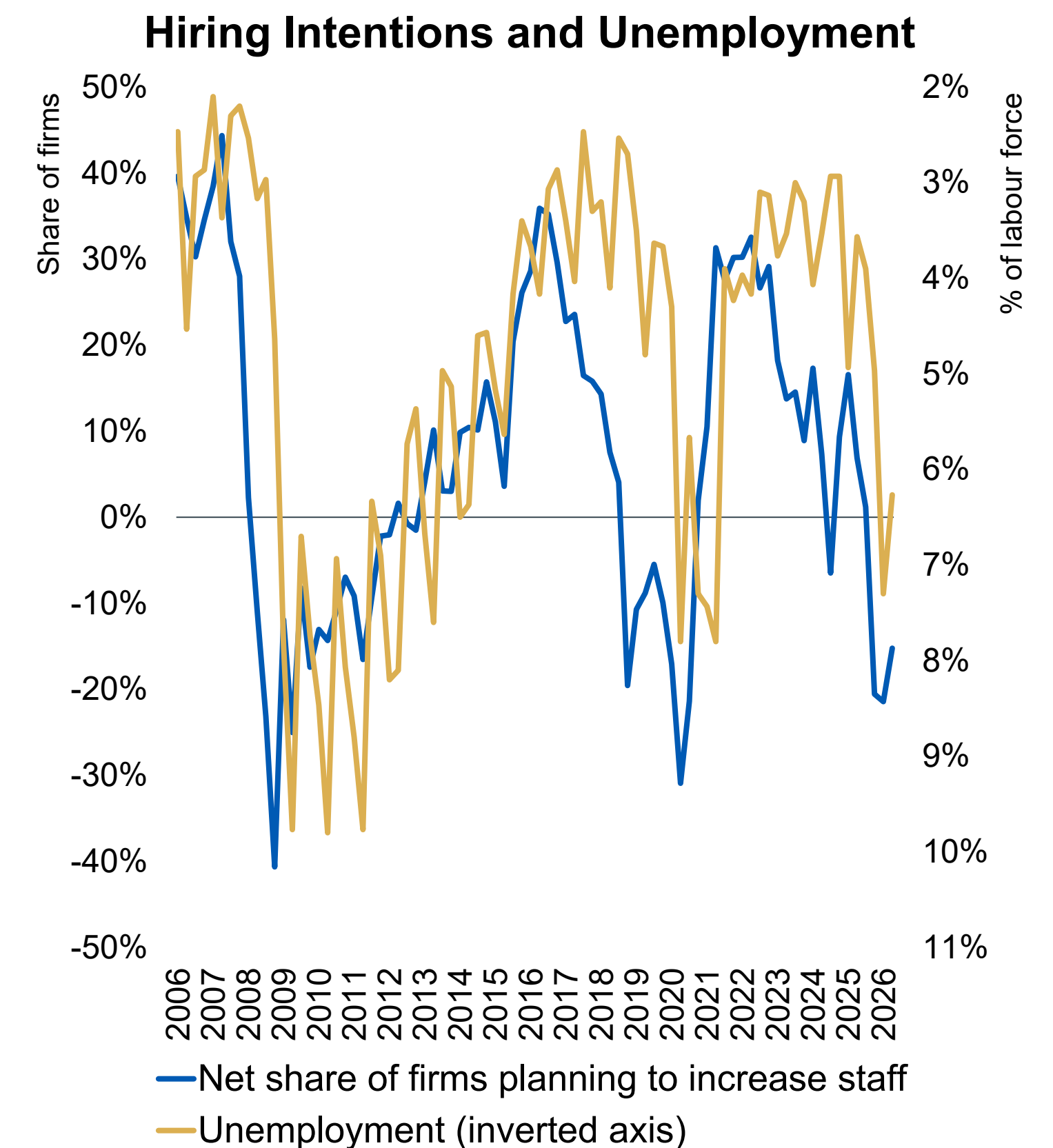
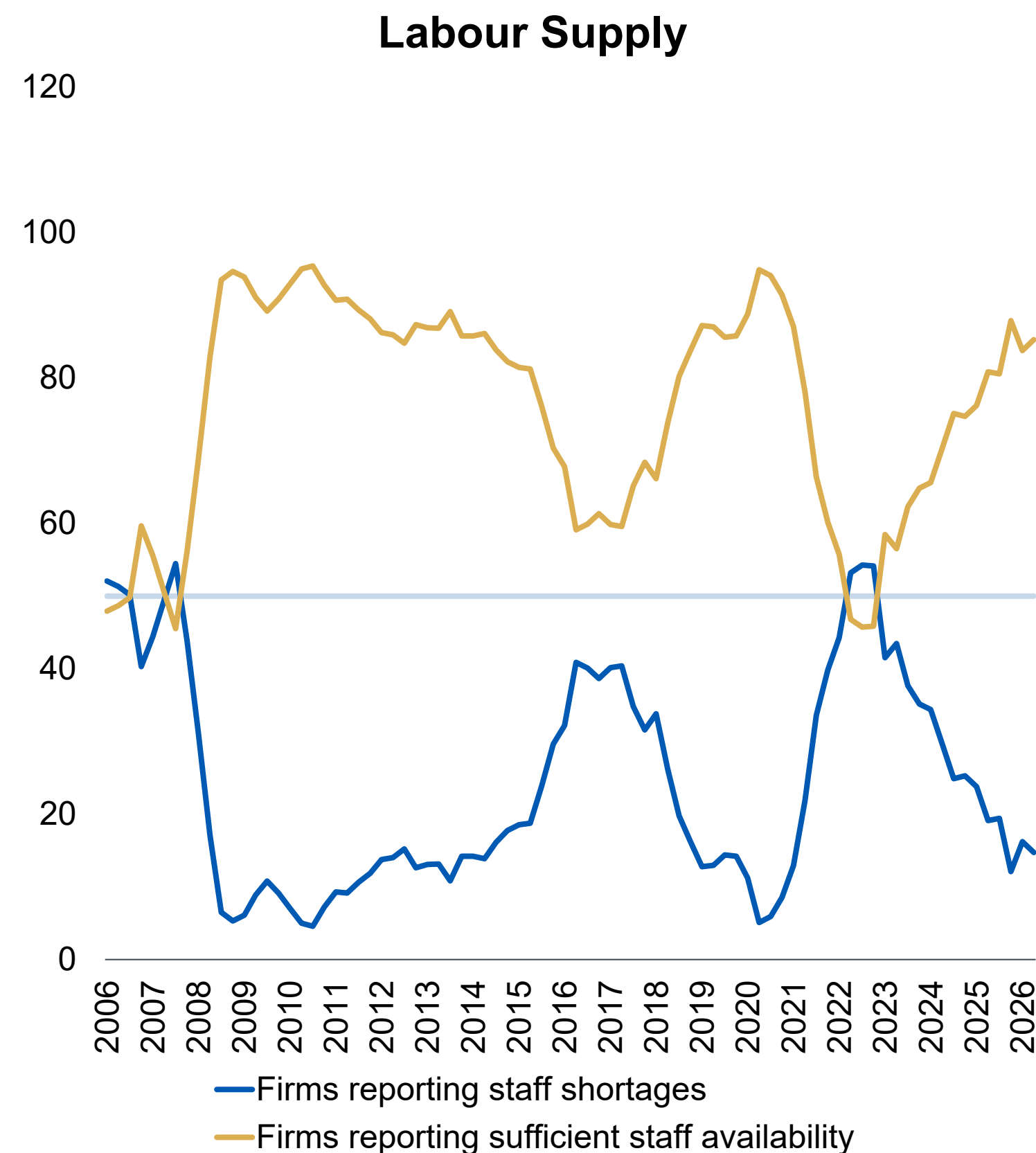
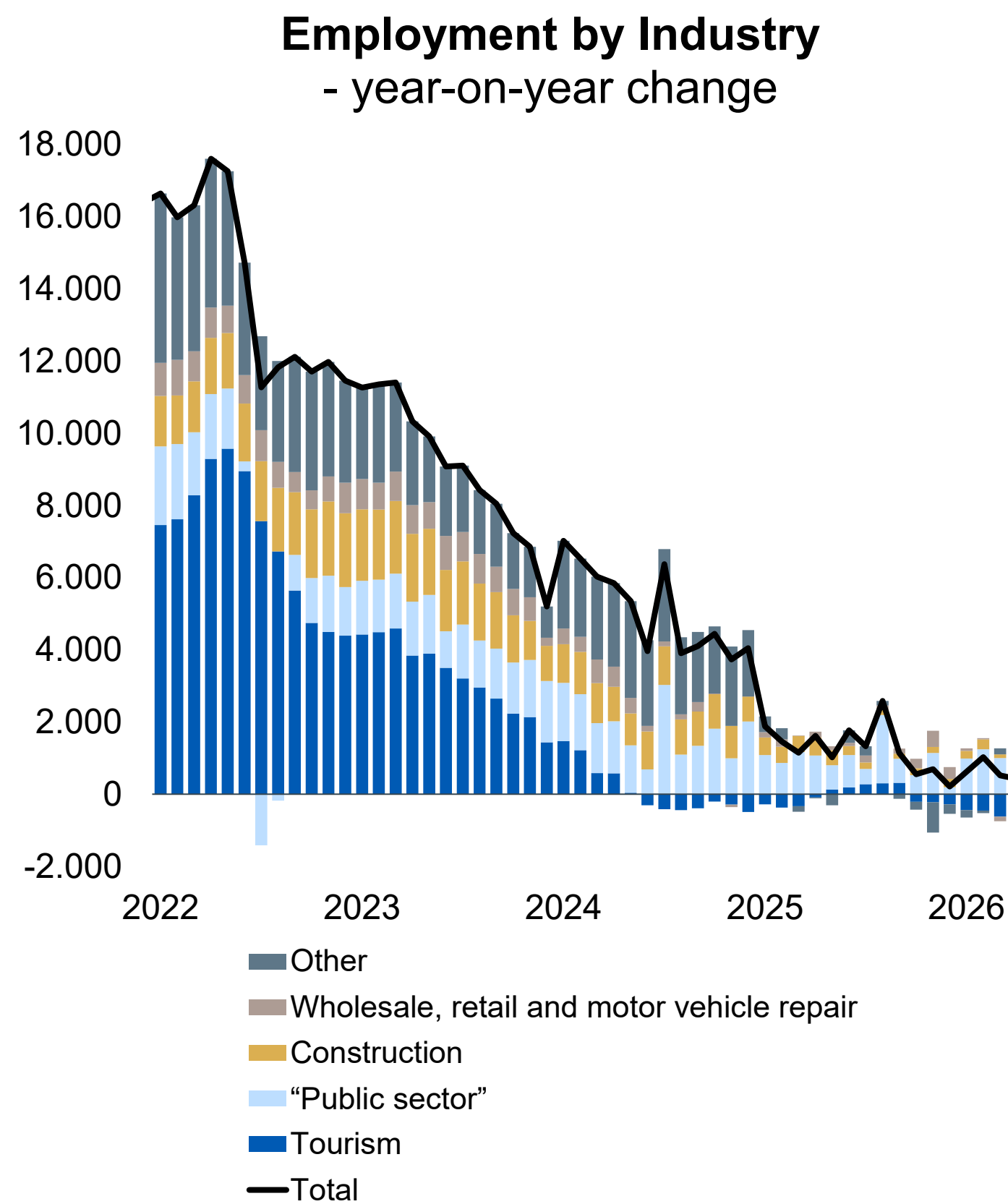
Labour Market Slack Reduces Labour Immigration

We now expect population growth over the forecast period to be somewhat slower than previously projected, mainly because of lower immigration by foreign nationals. This further eases demand pressures in the housing market and reduces the number of people per dwelling.



More People, Fewer Jobs*

The labour market shows clear signs of further cooling. Private sector employment has declined, particularly in tourism-related activities and construction. Although a substantial increase in public sector jobs has so far offset this decline, **job growth is not keeping pace with the working-age population**. Gallup’s business survey indicates that employment prospects have deteriorated and will weaken further, as more firms plan to reduce staff than increase it. Hiring intentions therefore suggest that unemployment will rise in the coming months.

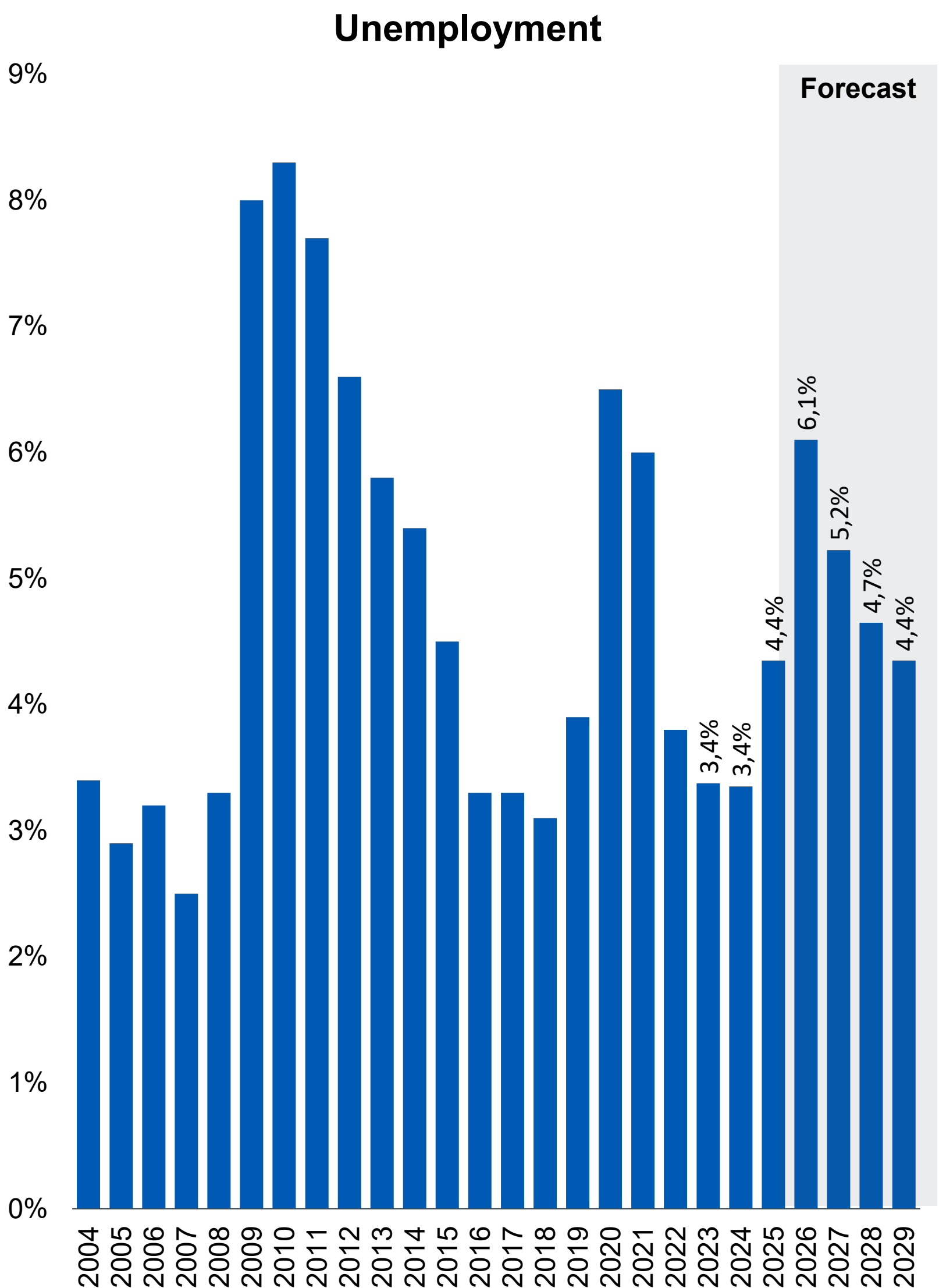
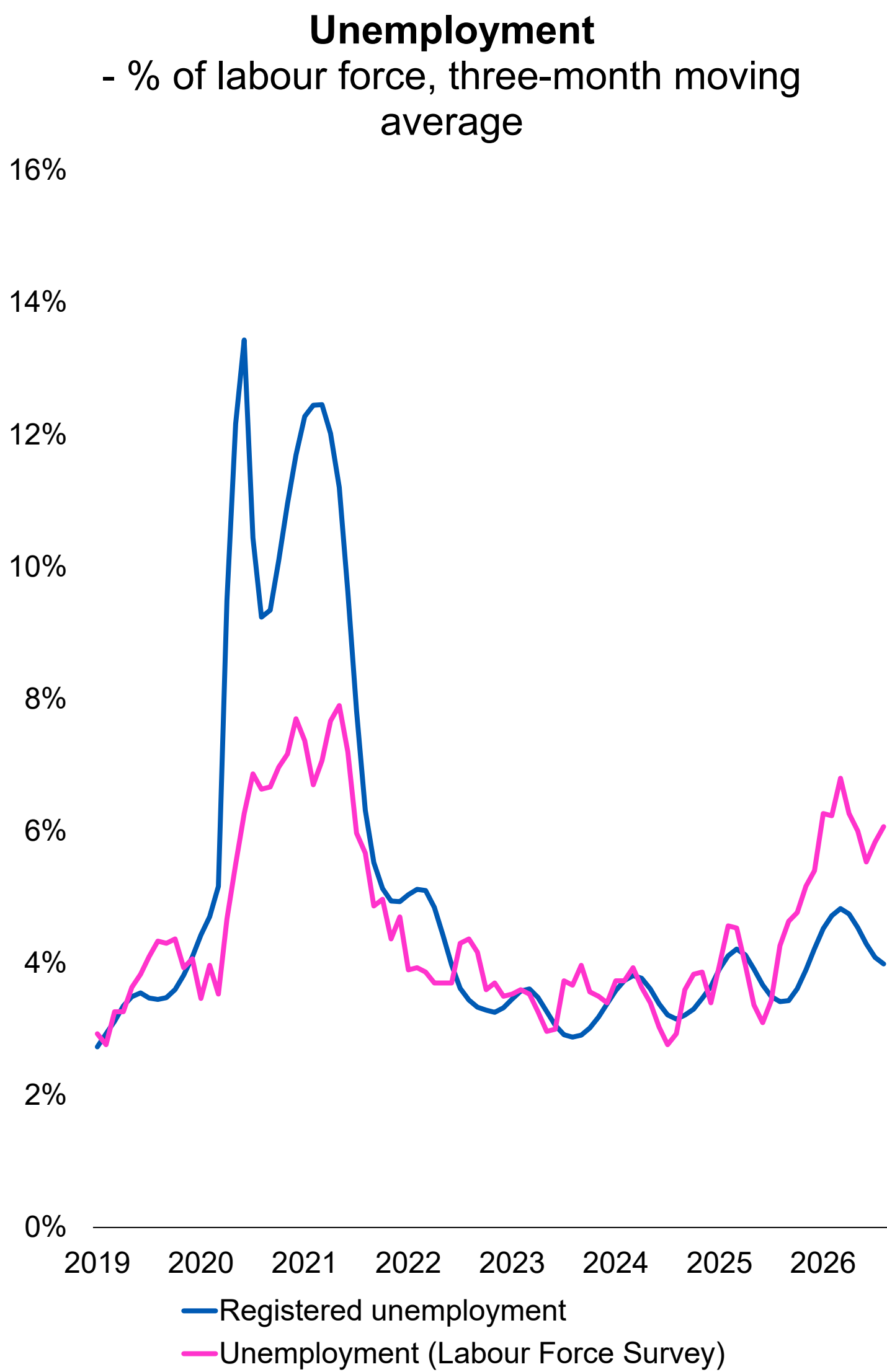


Measurement Matters: Unemployment Set to Rise, Despite a Lower Forecast

Unemployment has risen considerably according to Statistics Iceland’s Labour Force Survey – far more than Directorate of Labour figures suggest. **The growing gap between the two measures likely reflects Statistics Iceland’s methodology**, as it first emerged after improved contact information was introduced last November.

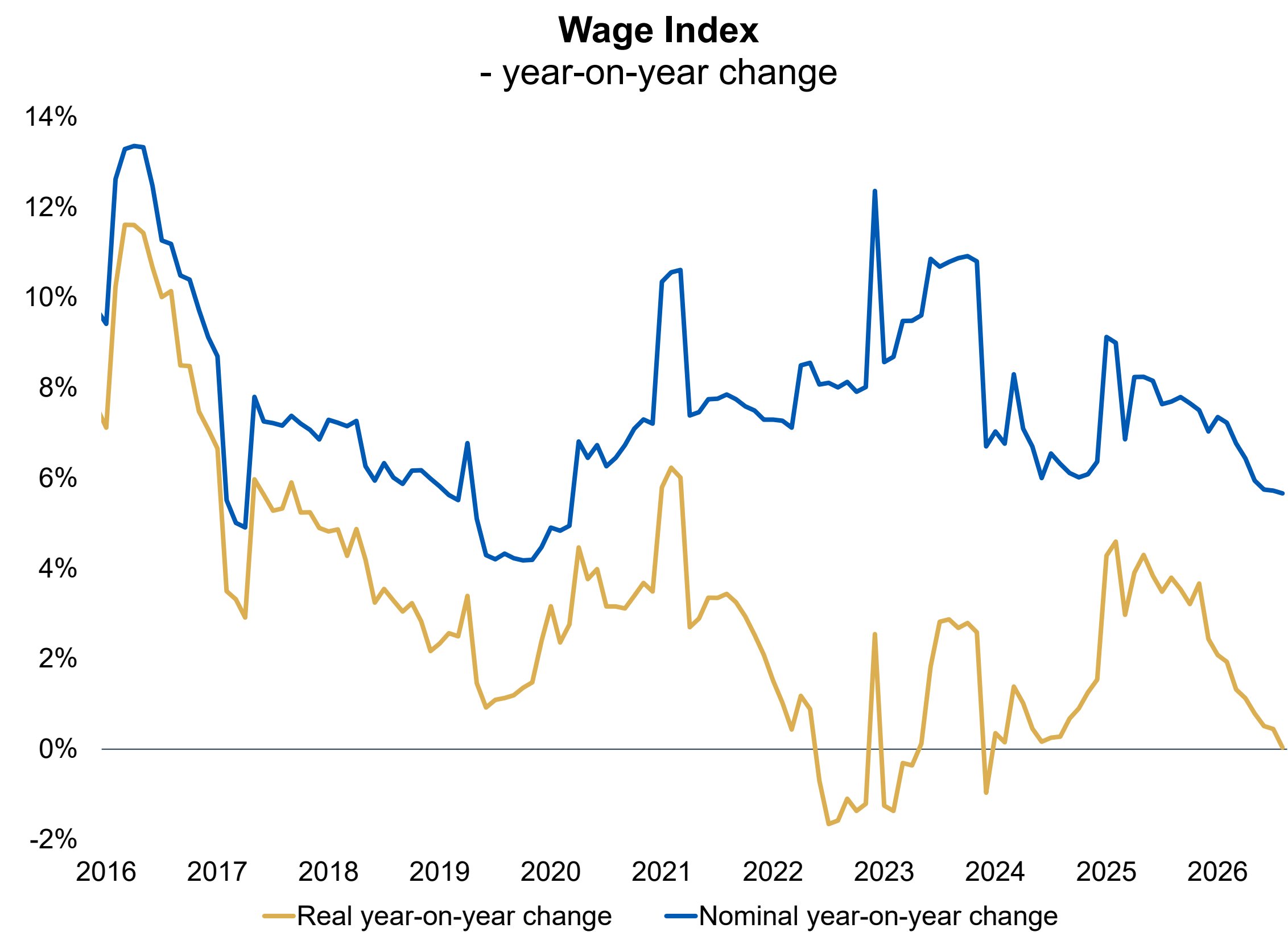
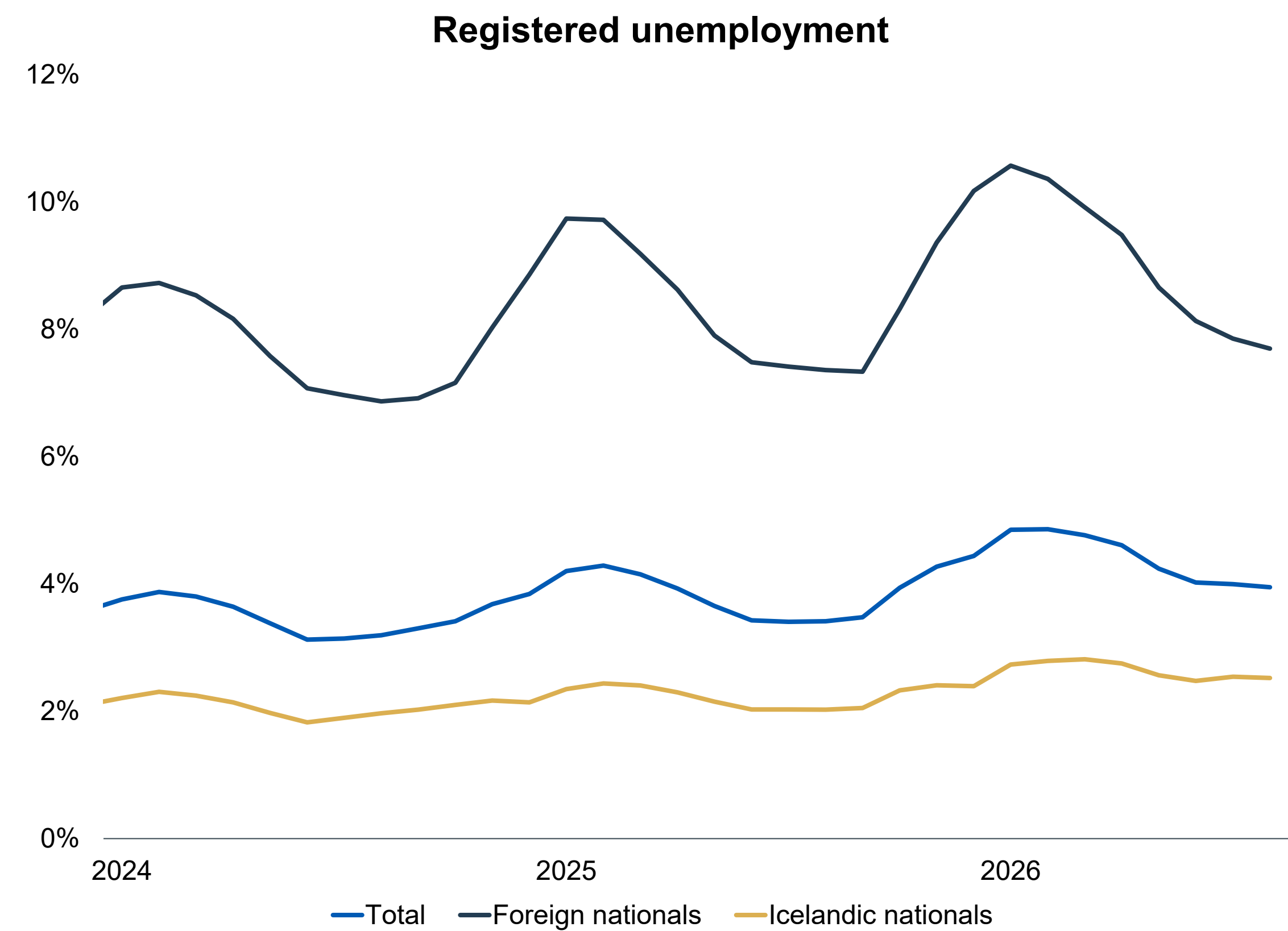
While we are almost certain that unemployment has in fact risen, **the increase in Statistics Iceland’s telephone survey may well be overstated – and with it our forecast for this year.** We expect the two measures to converge eventually, which is why our unemployment forecast peaks this year and eases next year.

In reality, we expect unemployment to keep edging up, peaking next year and staying relatively high throughout the forecast period, even as contact lists and technology distort measured unemployment this year – and skew the forecast.



The Labour Market Is Easing

Labour market slack has increased. Registered unemployment was 3.9% in August, compared with 3.4% a year earlier, and the Directorate of Labour expects it to continue rising until the middle of next year. **The increase is mainly driven by foreign nationals, among whom unemployment was 7.7% in August** compared with 2.5% among Icelanders. Differences in consumption behaviour between the two groups may explain why private consumption has not slowed more. **Increased slack has also dampened wage drift, and twelve-month growth in the wage index now measures 5.7%, the lowest since 2020.**

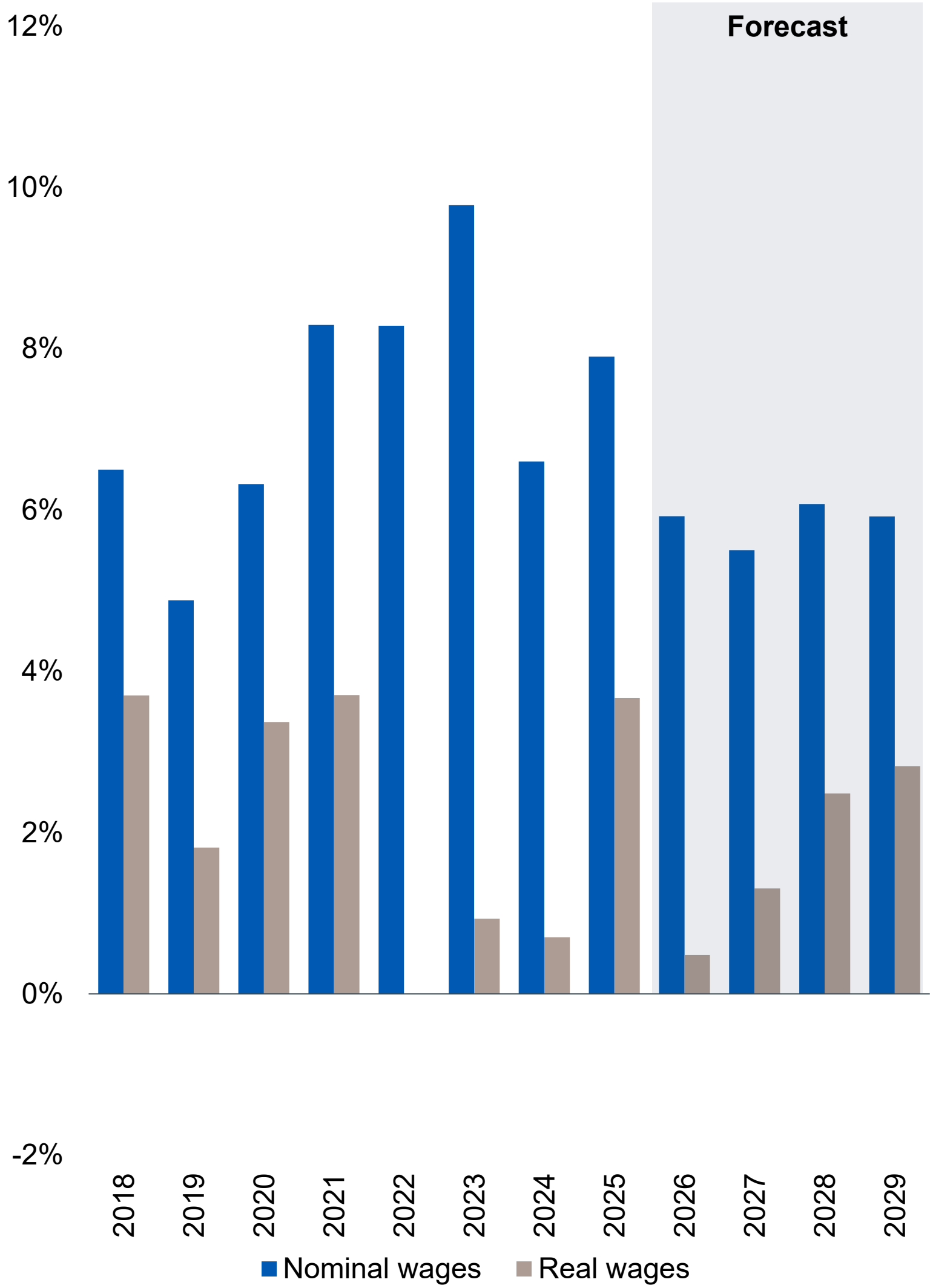


Moderate Wage Increases, Rising Real Wages

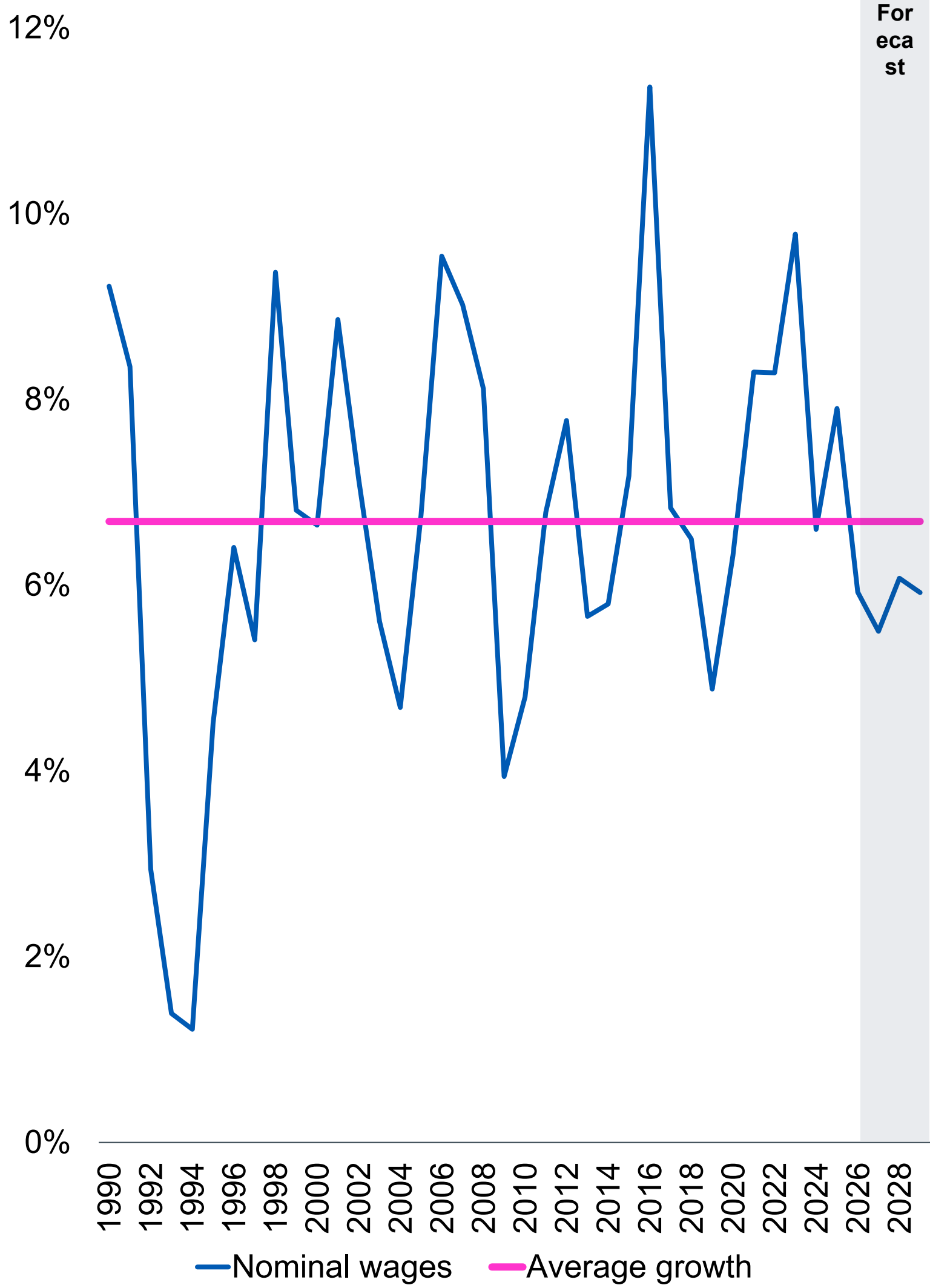
Some may consider our forecast too optimistic, given that Iceland’s wage bargaining framework has changed little. Even though a cooling labour market dampens wage drift and weakens unions’ bargaining position, it seems to take a concerted effort or an economic shock to reach moderate settlements. **As we do not forecast an economic shock, we expect broader consensus on bringing down interest rates and inflation.**

This applies both to the breached premises of current agreements and to next year’s new bargaining round in the general labour market. In other words, **we expect current agreements to remain largely untouched this autumn and realistic agreements in the next round**, with nominal wage increases of around 6% a year over the forecast period – somewhat below the average of recent decades. Real wages therefore rise faster as inflation subsides.

Nominal and Real Wages
- year-on-year change

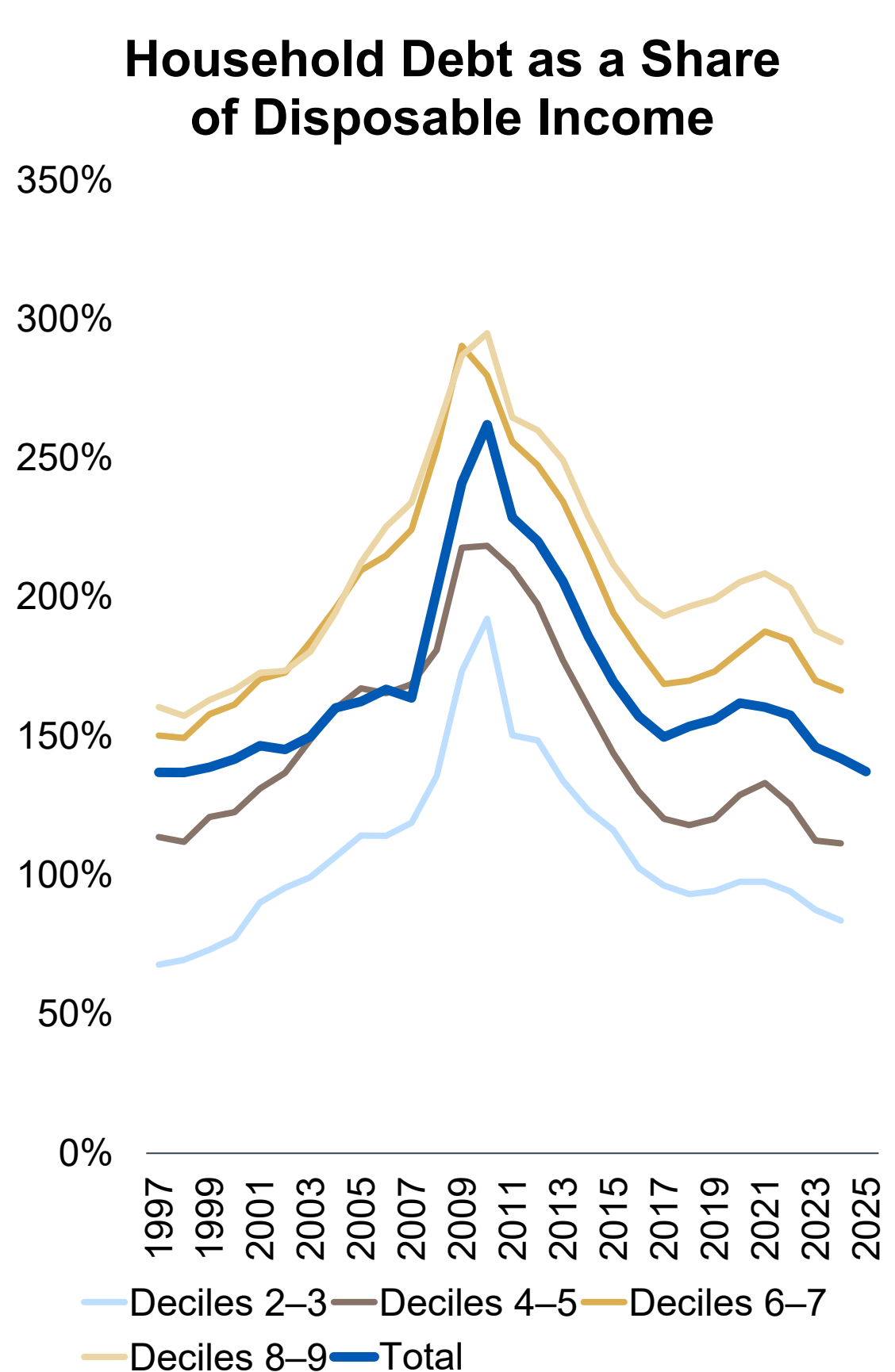
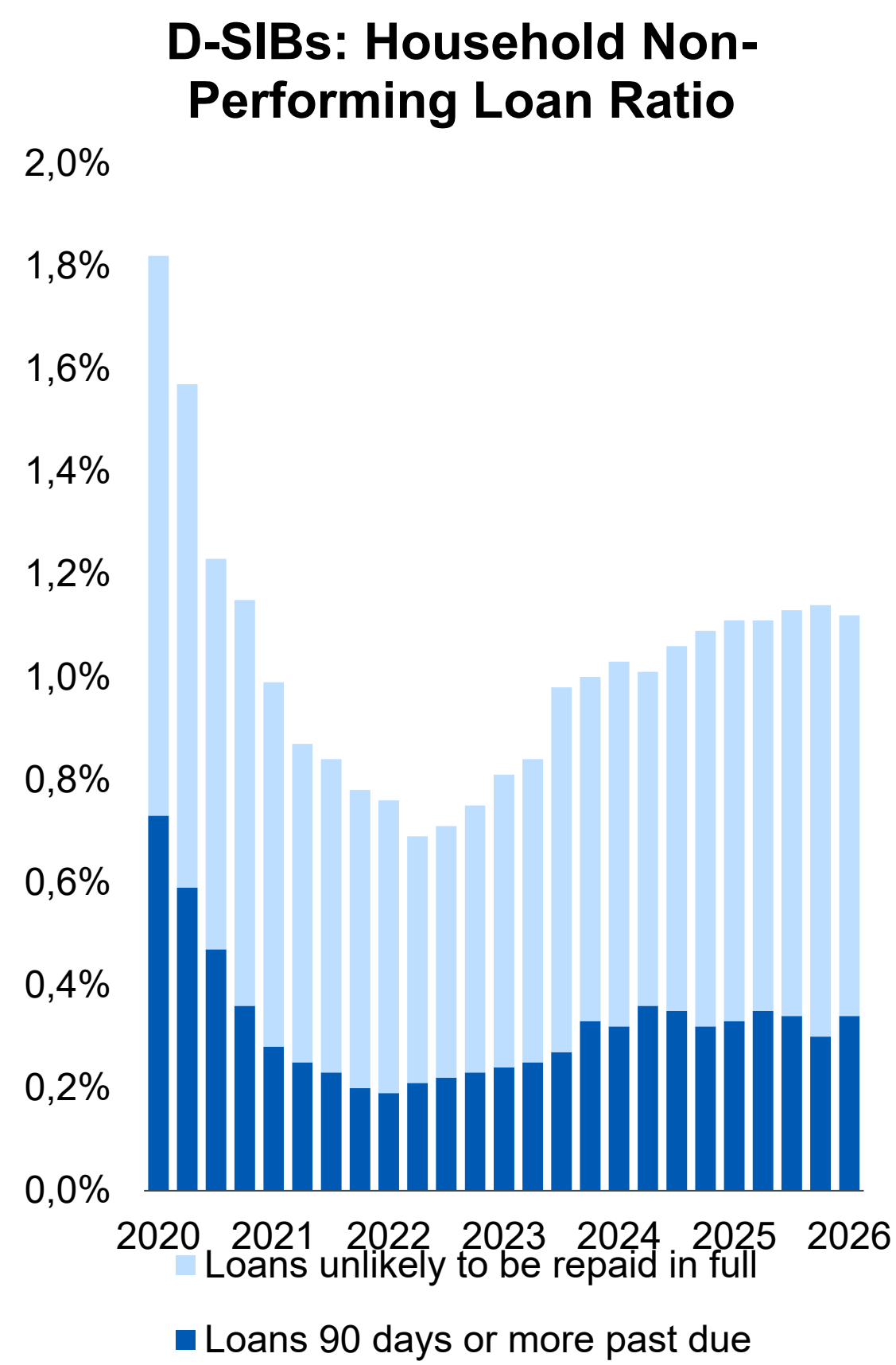
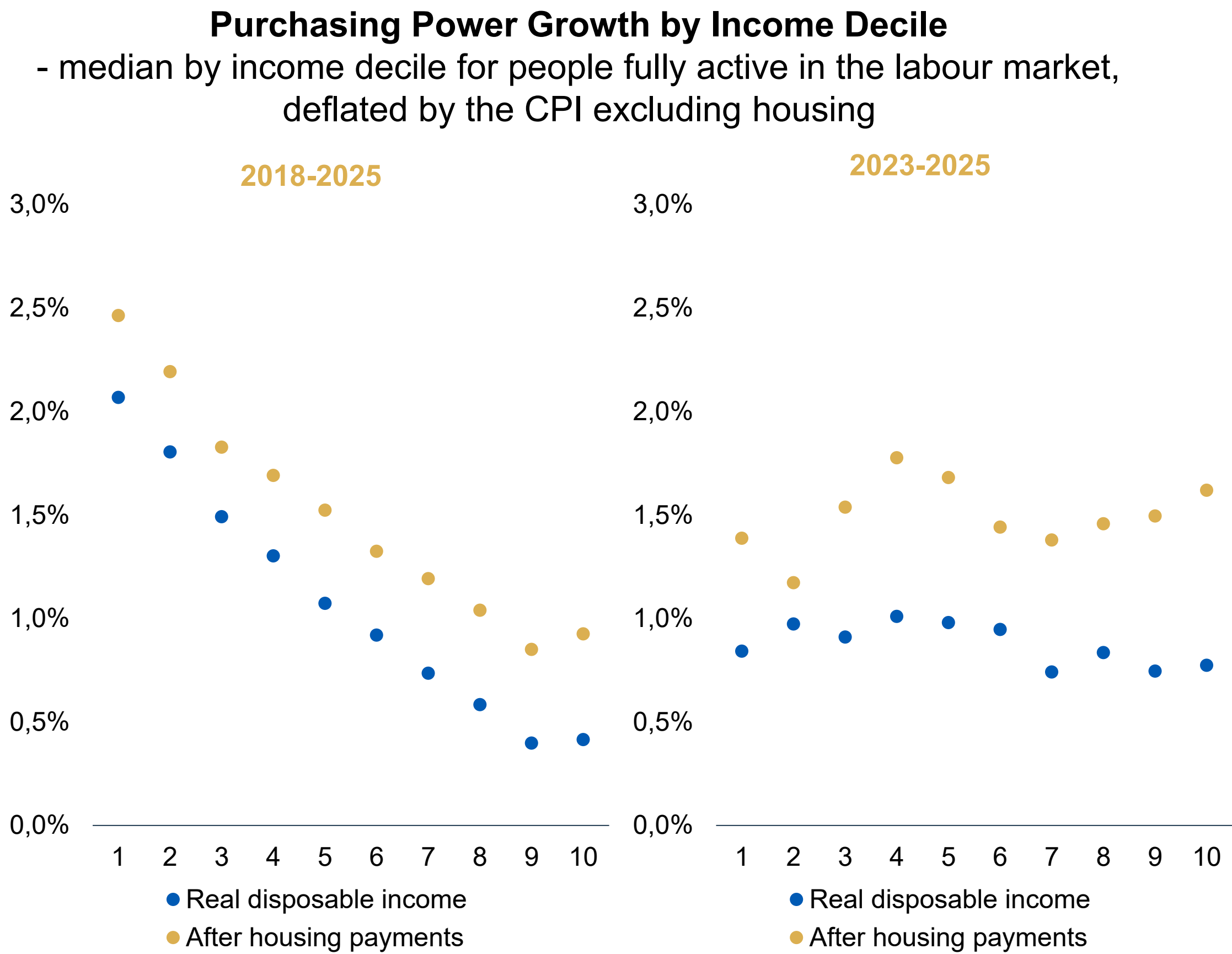


Wage Index
- year-on-year change



Household Finances Are Generally Strong...

Household purchasing power has grown considerably in recent years, particularly among lower-income households. Households generally carry little debt: their debt relative to disposable income has been falling and has not been lower since the end of the last century. Non-performing loan ratios are also historically low, at banks and other lenders alike. **Icelandic households are therefore generally resilient and well placed to weather temporary shocks.**



Sources: Central Bank of Iceland, Ministry of Finance and Economic Affairs, Arion Research



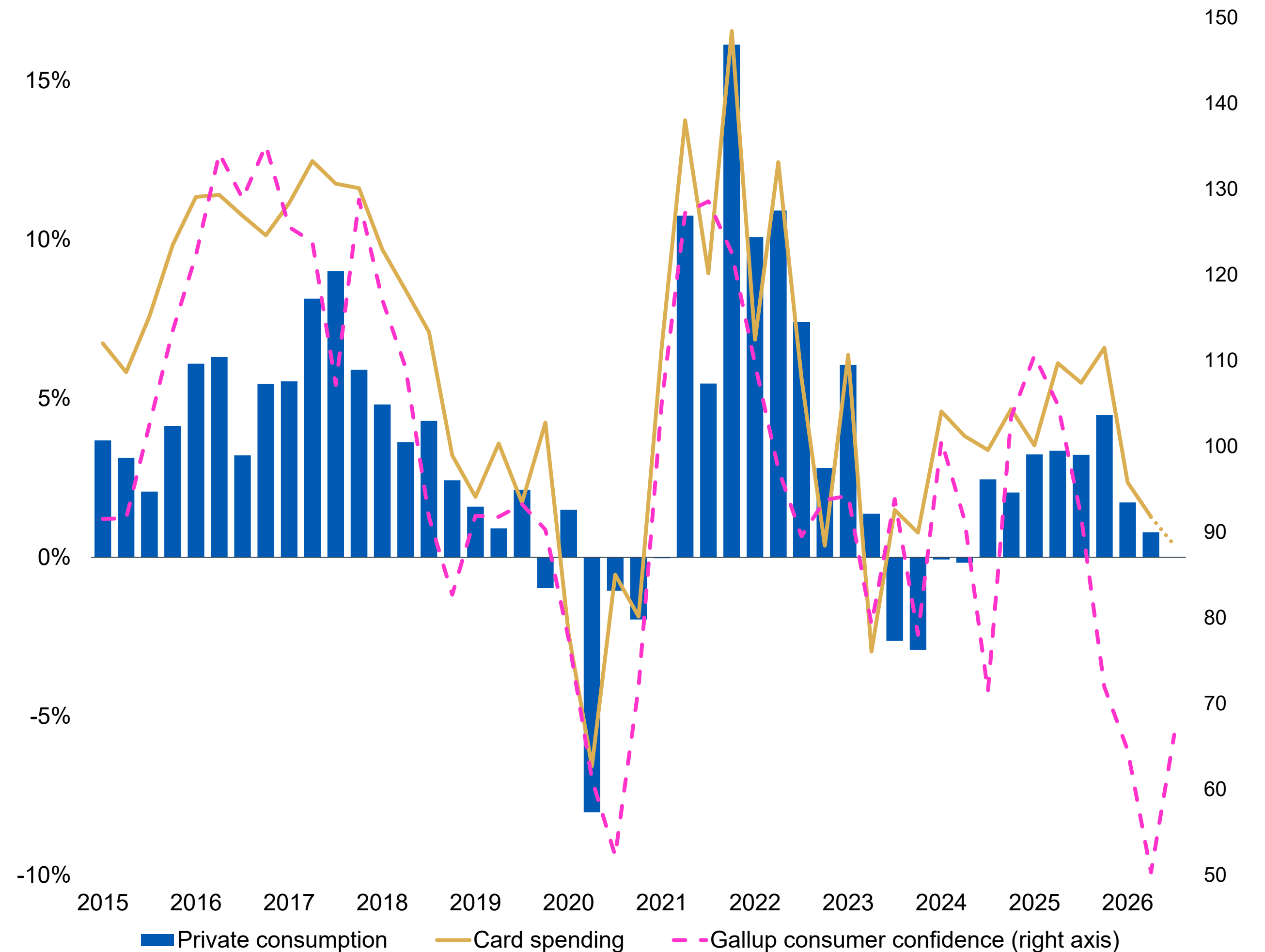
...but Greater Pessimism Is Curbing Spending Appetite

According to Gallup's consumer confidence index, **households were as pessimistic this summer as during the early months of the pandemic or the 2008 financial crisis.** The wet summer in southern Iceland may have played a part, but rising living costs and a weaker economic outlook are more likely to have been the main factors.

Subdued expectations, growing labour market slack and a difficult interest rate environment have dampened the willingness to consume. **Icelanders' total card turnover fell by 1% year-on-year in August, and domestic card turnover has declined in six of the first eight months of the year.** If current trends hold, card turnover – and with it private consumption – will likely grow little, if at all, in Q3 and soften in Q4.

Car purchases also appear to have slowed; they weigh heavily in consumption but rarely show up in card data.

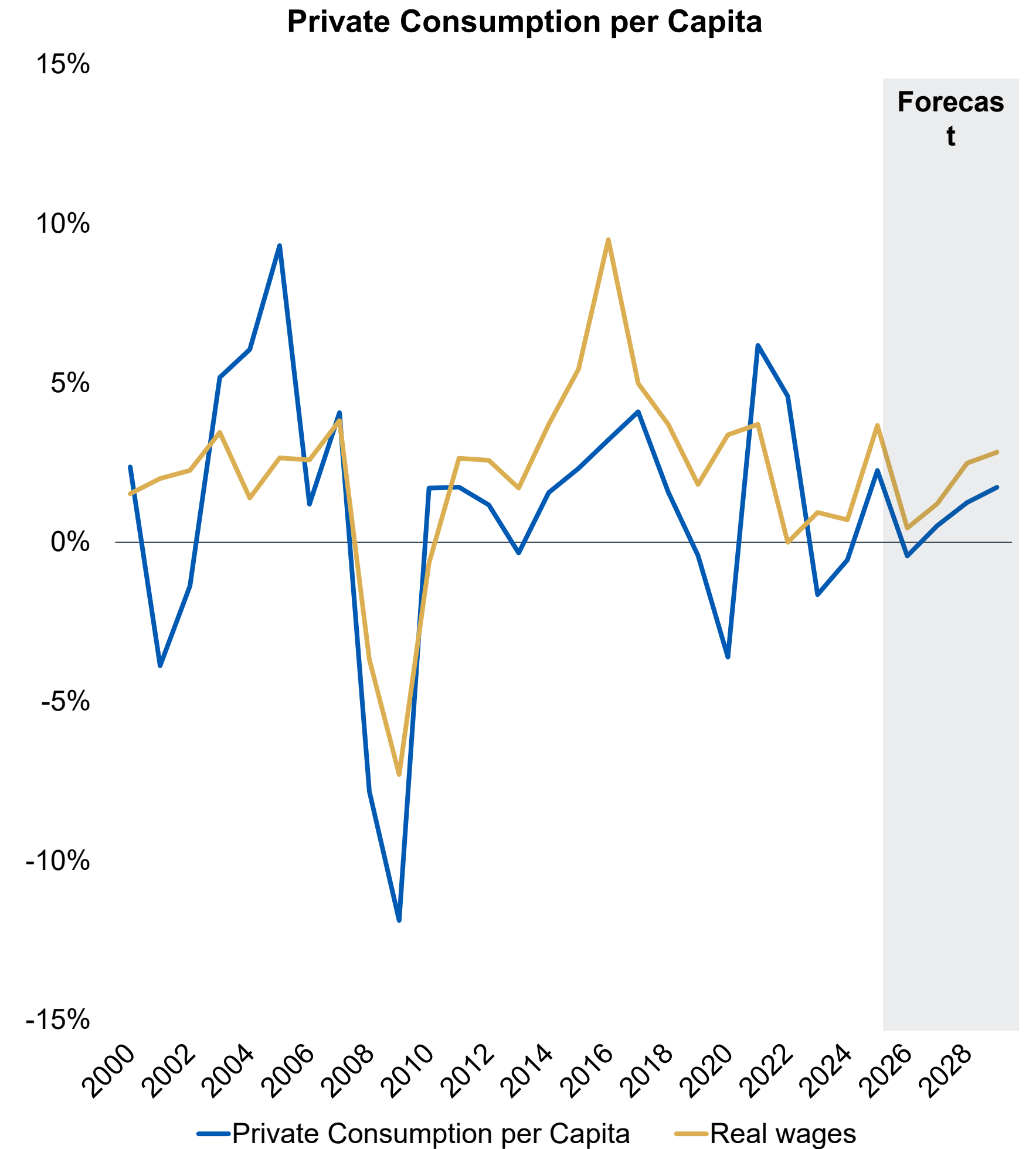
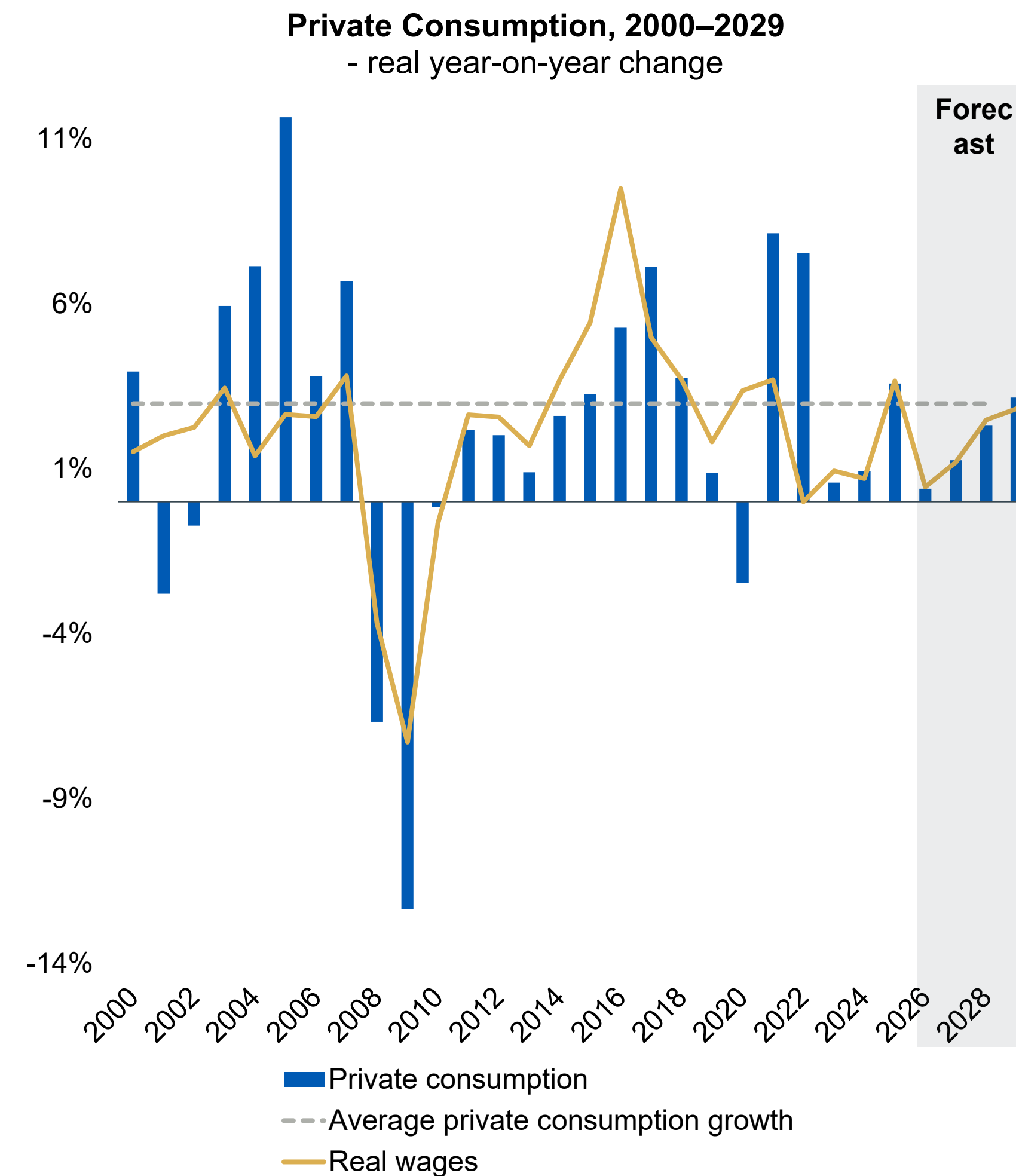
Card Spending and Private Consumption
- quarterly data, year-on-year change at constant exchange rates and prices



Although last year's private consumption was revised downwards, growth was nonetheless robust. **Slower growth this year partly reflects base effects**, as households rushed to buy cars last year ahead of changes in vehicle taxes. However, the growing pessimism that accompanies high inflation, high interest rates, rising unemployment and falling real house prices also matters, both for current developments and next year's outlook.

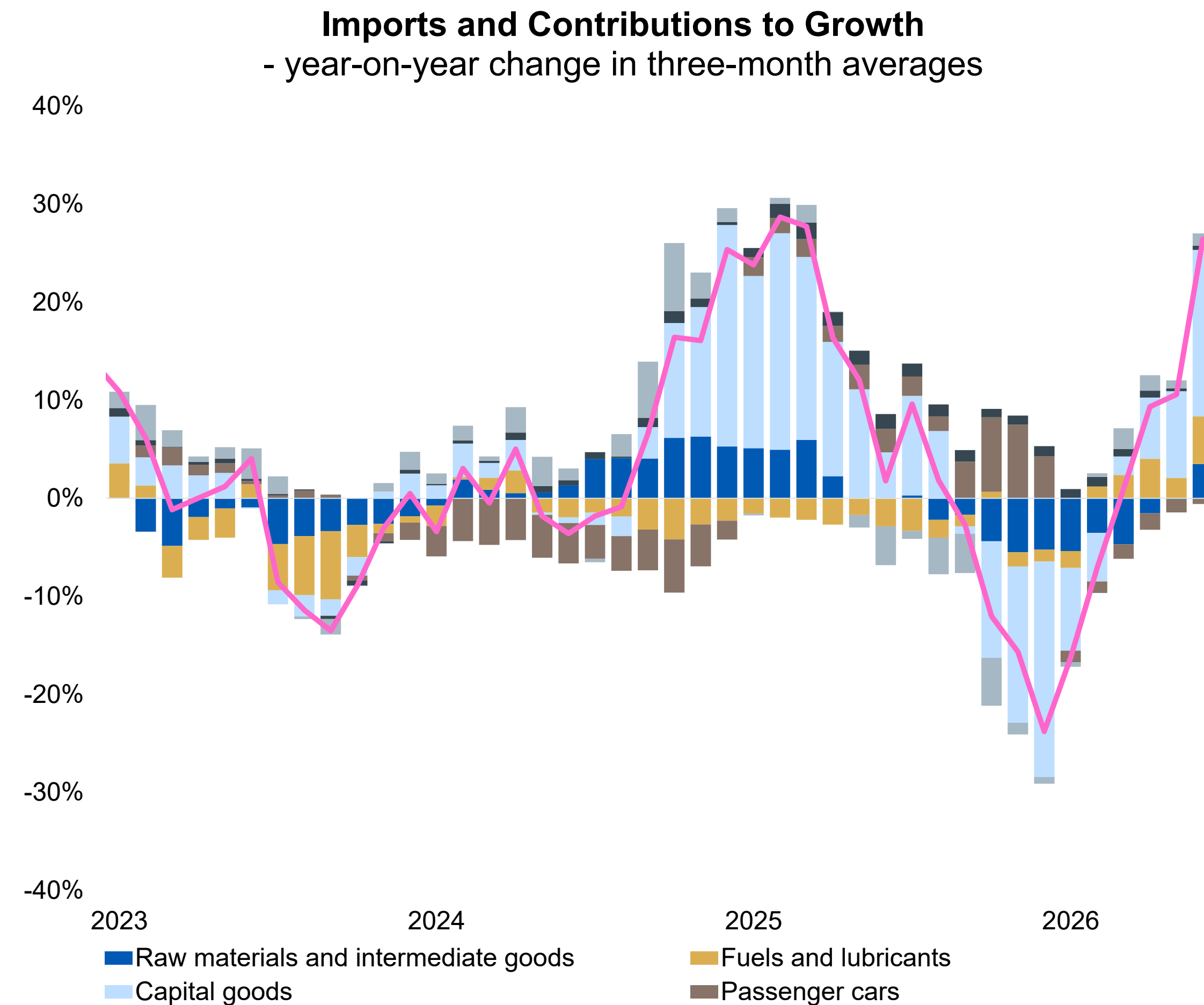
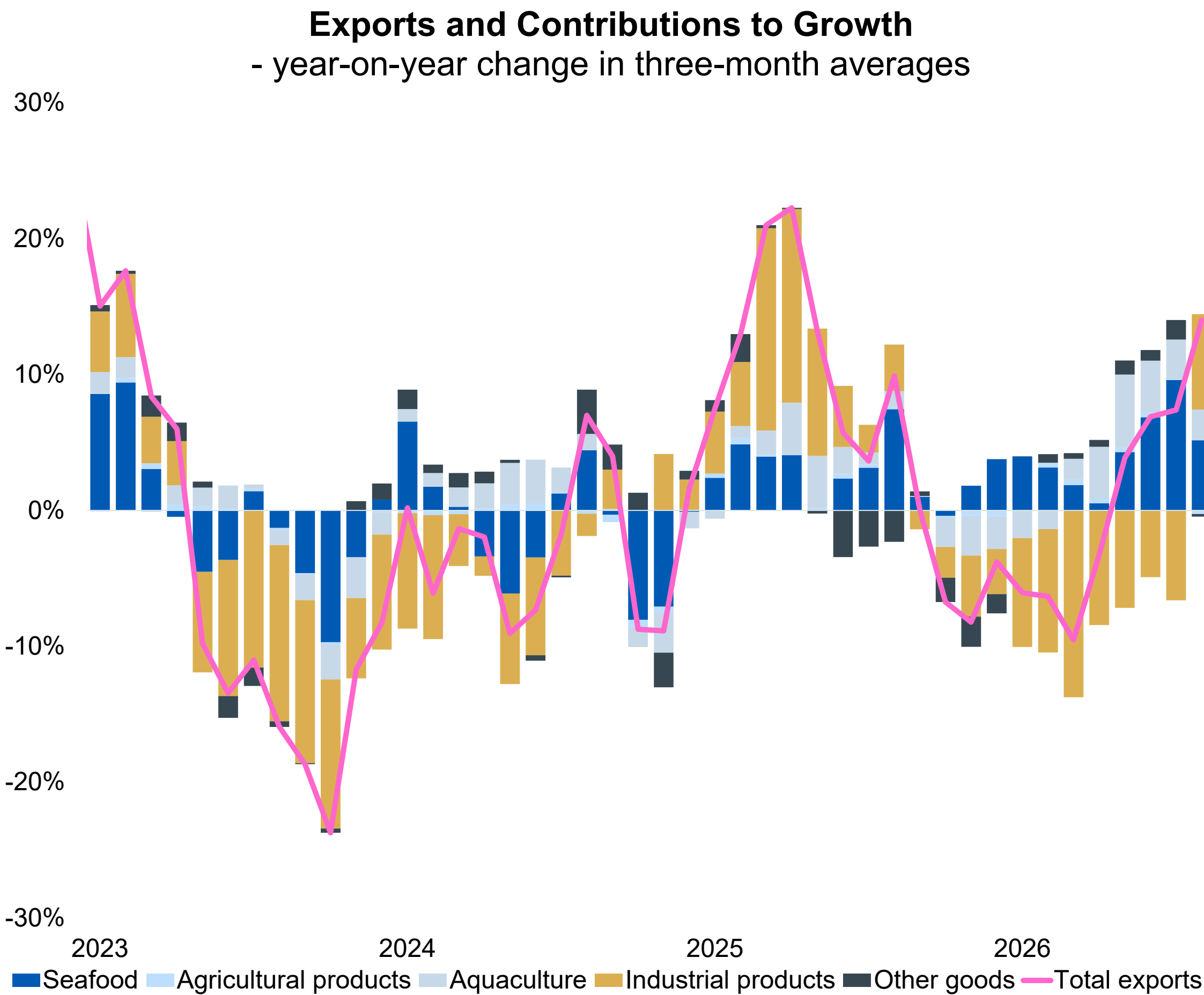
Our forecast shows **private consumption per capita declining this year and into next year, despite real wage growth**, before recovering as the forecast period progresses. Even so, consumption growth remains moderate by historical standards, particularly given households' strong finances. As so often before, private consumption could therefore surprise on the upside.

Cautious Households Hit the Brakes



Goods Trade Deficit Widening, Even as Households Hold Back

The goods trade deficit was small early in the year, mainly because of lower imports of computer equipment for data centres, lower vehicle imports and higher export prices, which offset reduced aluminium exports. **Now, however, the deficit is approaching levels similar to the same period last year** – a record year – mainly as imports of computer equipment have picked up again, but also due to higher oil prices.



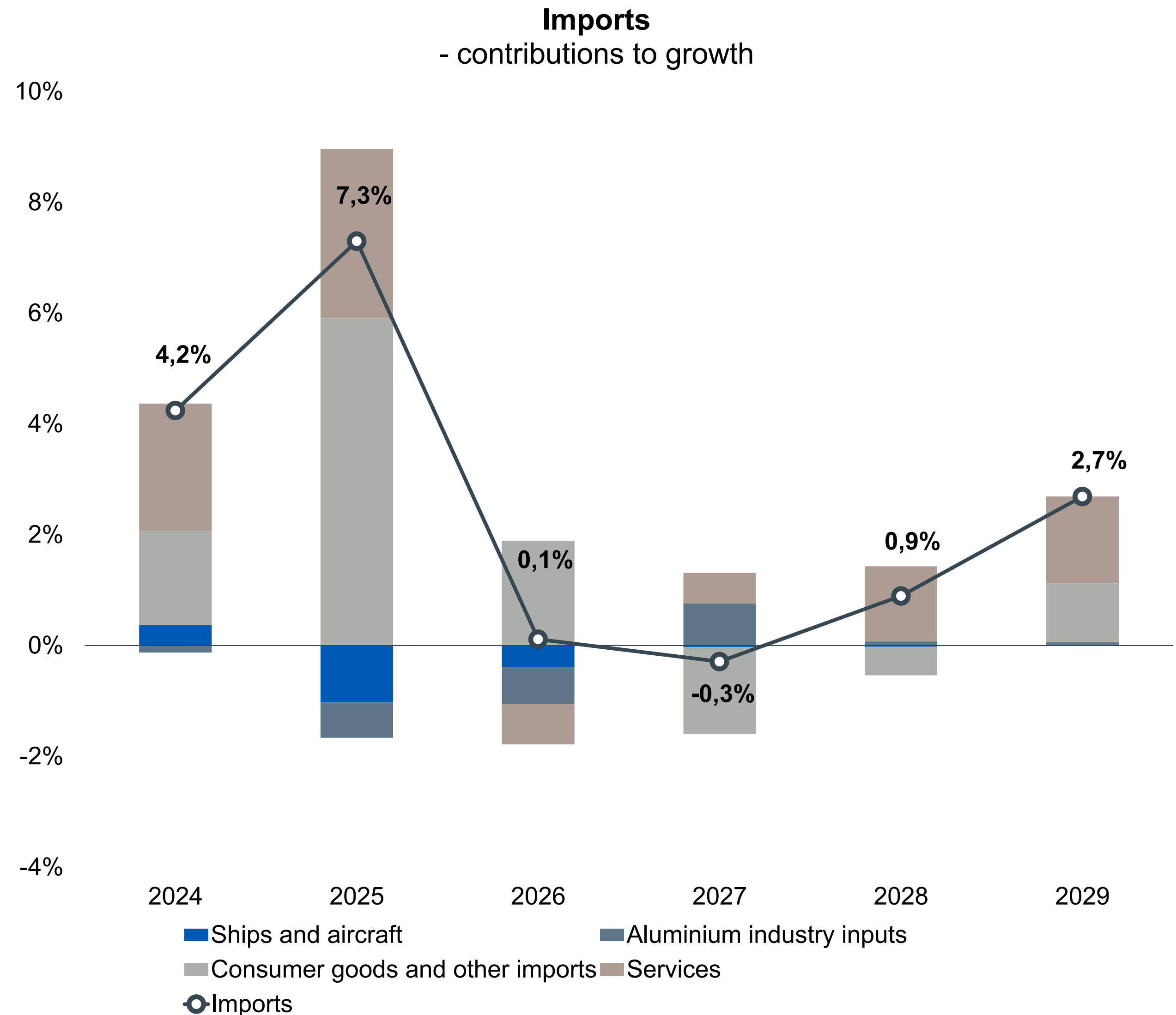
Data Centres Rock Imports

As discussed earlier, imports have been strong this year, contrary to analysts' expectations. Substantial investment in data centres has been the main surprise, boosting imports, while imports of aluminium industry inputs and services have declined.

The contraction in imports next year can primarily be explained by:

- The oft-mentioned **data centres**, as imports of data centre equipment look set to decline, although they will remain substantial.
- **A contraction in domestic demand**, reflecting investment, consumption and the nation's appetite for travel.

Later in the forecast period, however, private consumption is expected to gain momentum, and large investment projects under way and in the pipeline will shape import figures. Developments in tourism will also play a role, both through operating leases of aircraft and through the number of people in the country at any given time.

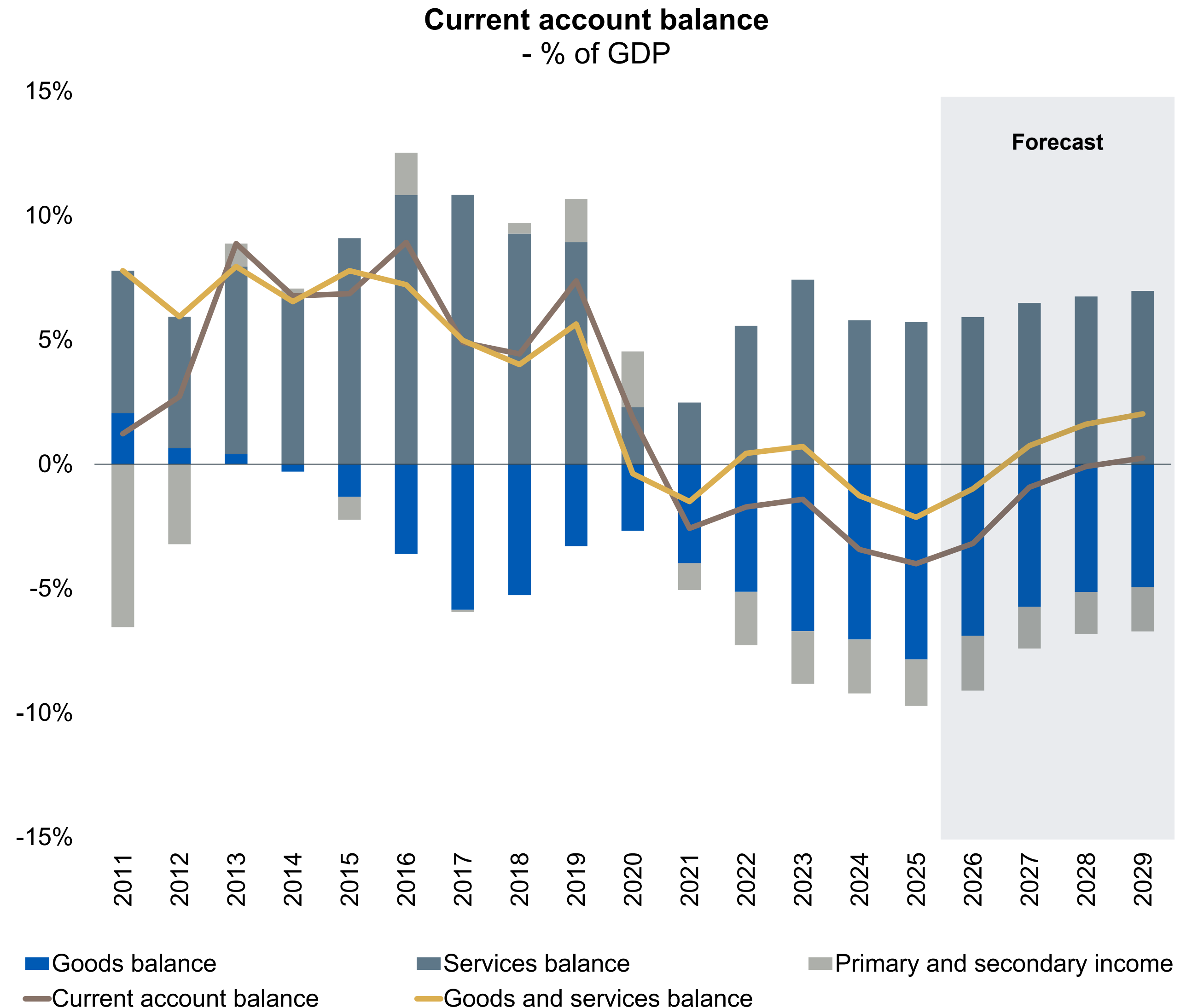


A Surplus in Sight

Data centre investment has clearly had a substantial impact on the current account through the goods trade deficit. Over the past three quarters, data centres have also begun to influence other components. As noted earlier, exports of telecommunications, computer and information services rose by 73% in the first half of the year.

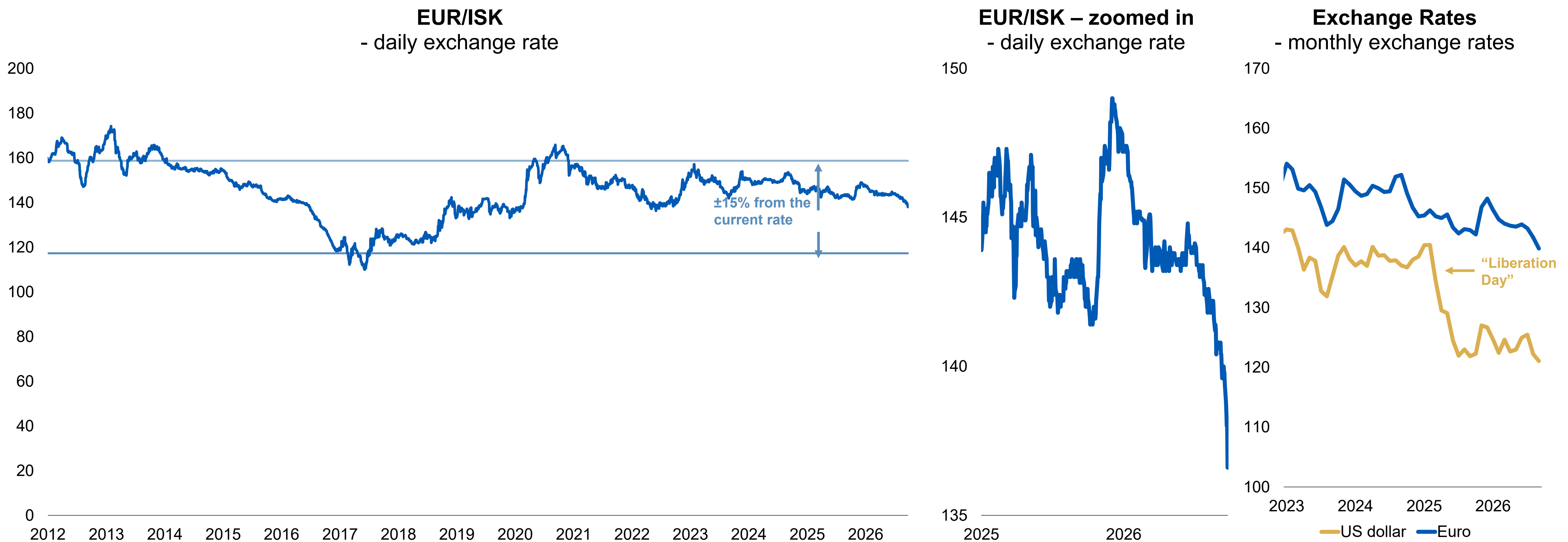
We expect the goods trade deficit to narrow slightly this year, driven by improved terms of trade rather than changes in trade volumes. **A surplus on goods and services is expected next year**, with exports growing, imports contracting and the terms of trade broadly unchanged. The current account will take another year to turn positive. The difference mainly lies in secondary income, including cross-border remittances.

All current account forecasts are, of course, highly sensitive to changes in the terms of trade, i.e. the ratio of export to import prices. **The forecast rests on fragile assumptions, for instance regarding oil and aluminium prices and seafood export prices**, which are currently changing rapidly. The forecast assumes the terms of trade will improve this year and then weaken slightly, but the range of uncertainty is unusually wide.



One of the World's Smallest Floating Currencies Is Remarkably Stable

This statement applies not only to the current year but to the entire past decade, during which the króna has fluctuated within a relatively narrow range against the euro. **If we zoom in, however, we see that the króna has strengthened by 7.3% against the euro this year, including 3.0% in September alone**, despite the Central Bank's increased regular foreign currency purchases. The September move does not necessarily reflect a sustainable exchange rate or underlying fundamentals, however, but rather temporary flows related to payment settlements.



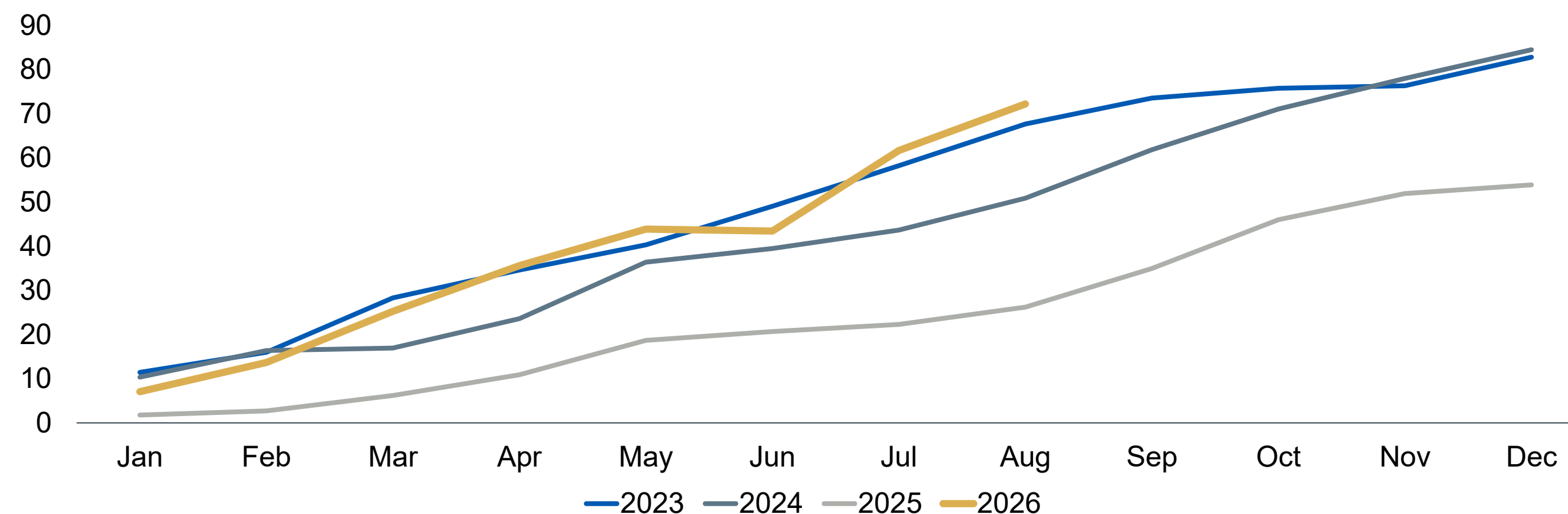
Real Exchange Rate Appreciation Despite Everything

The real exchange rate pays little heed to economists' views on how strong it is – **flows in the foreign exchange market simply trump conventional macroeconomic fundamentals in the short term**. The current account tells only part of the story and does not necessarily reflect FX flows, as data centres illustrate.

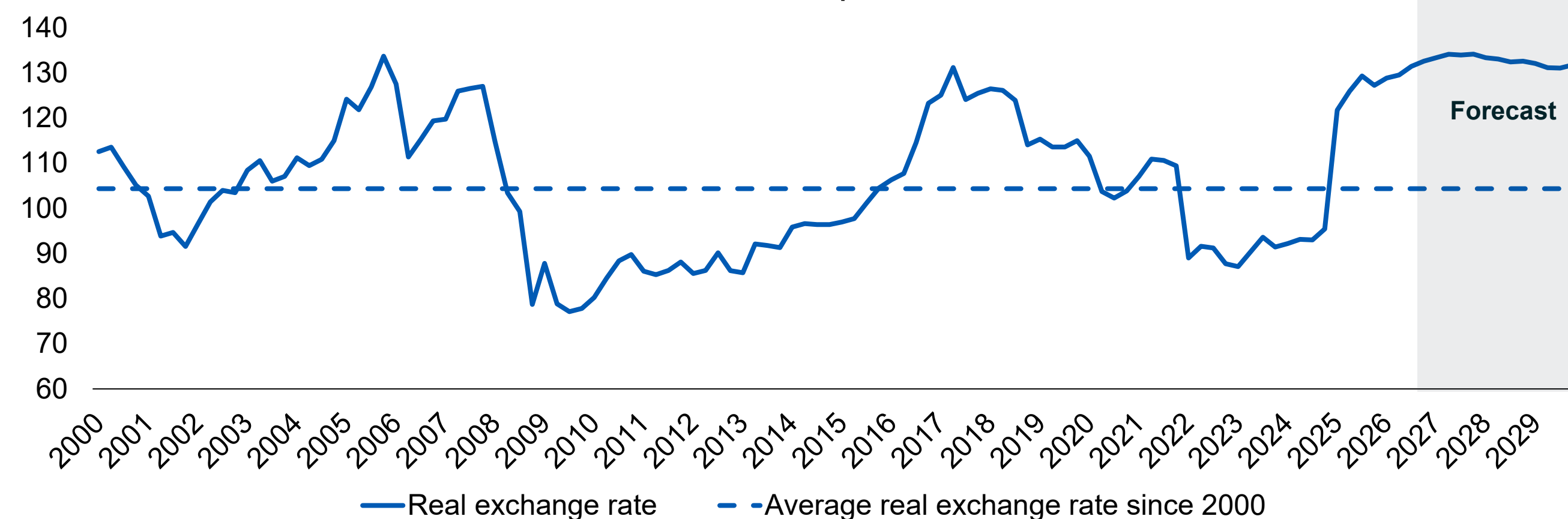
So far this year, high export prices have generated strong FX inflows, while foreign investors have added ISK 20 bn to their holdings of Icelandic bonds. Foreign investors' net outflows from Icelandic equities, sizeable FX purchases by the pension funds and the Central Bank's regular FX purchases have not been enough to weaken the real exchange rate.

We expect the real exchange rate, which the Central Bank estimates to be only slightly above equilibrium, to remain historically high throughout the forecast period, weighing on competitiveness. In the longer term, we believe gravity will assert itself in the FX market, as it always has in Iceland's economic history, and pull the real exchange rate down. Timing that move, however, is impossible.

Pension Funds' Cumulative Net Foreign Currency Purchases
- ISK billion



Real exchange rate
- relative prices

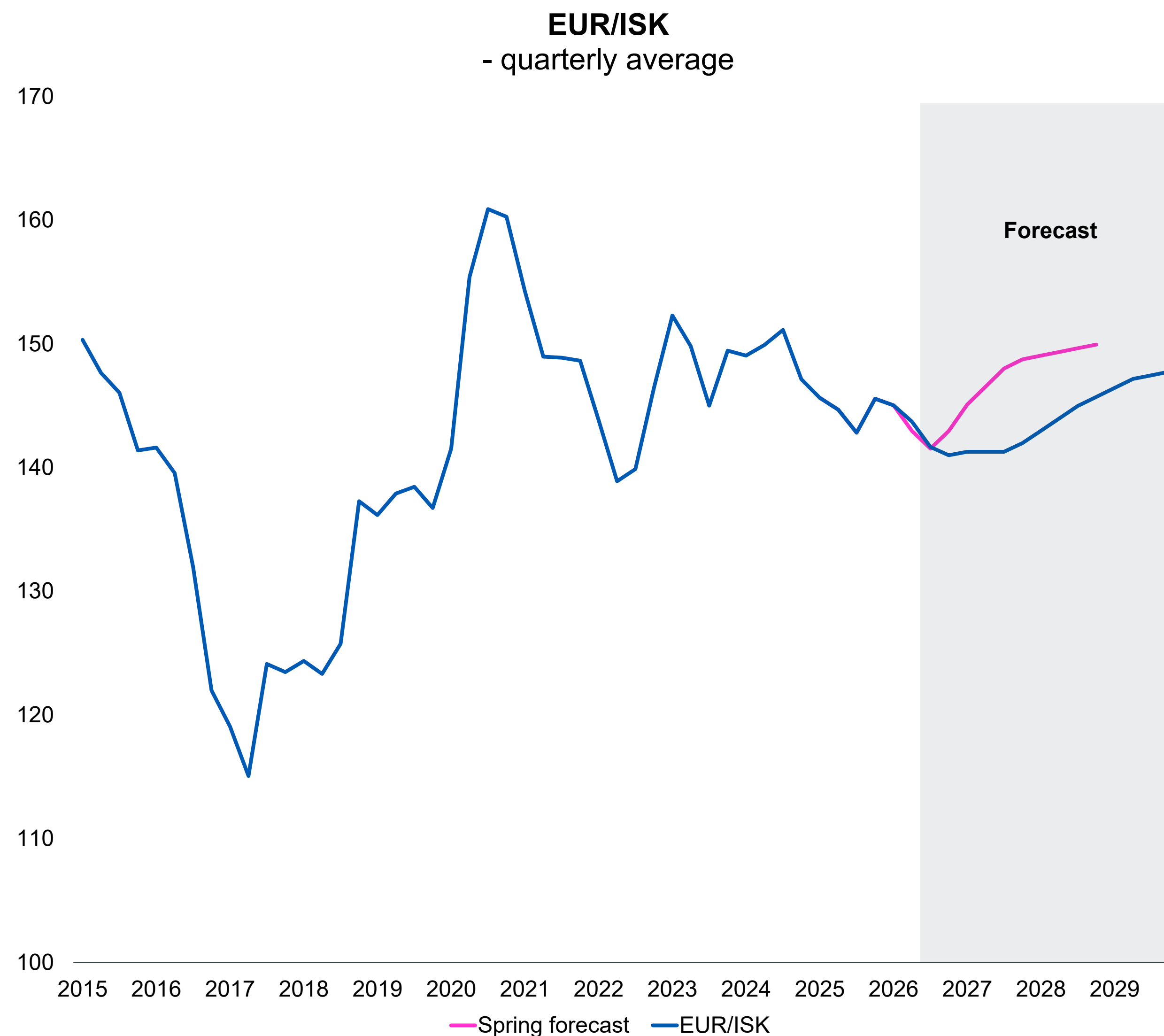


Like a Broken Record: We (Once Again) Forecast a Nominal Depreciation...

... but a smaller one than so often before. The króna has repeatedly caught us off guard, shrugging off last year's export shocks. Over the past three months, the króna has strengthened considerably, with the euro trading at ISK 137 at the time of writing. **Although we do not consider current levels sustainable, we do not expect a significant correction in the short term**, but rather expect the euro to hover just above ISK 140 until the middle of next year.

Most would probably agree that the króna is strong, perhaps excessively so when the real exchange rate is measured using relative labour costs. Throughout Iceland's economic history, it has **always been the nominal exchange rate that gives way, and we believe that will be the case this time as well** – but that the correction will be smaller in scale, as part of the economy's adjustment now appears to be taking place through the labour market.

Whether depreciation is gradual or abrupt, occurs this year or next, or materialises within the forecast period at all is impossible to predict, but the actual movements are likely to be larger and faster than the path shown here.



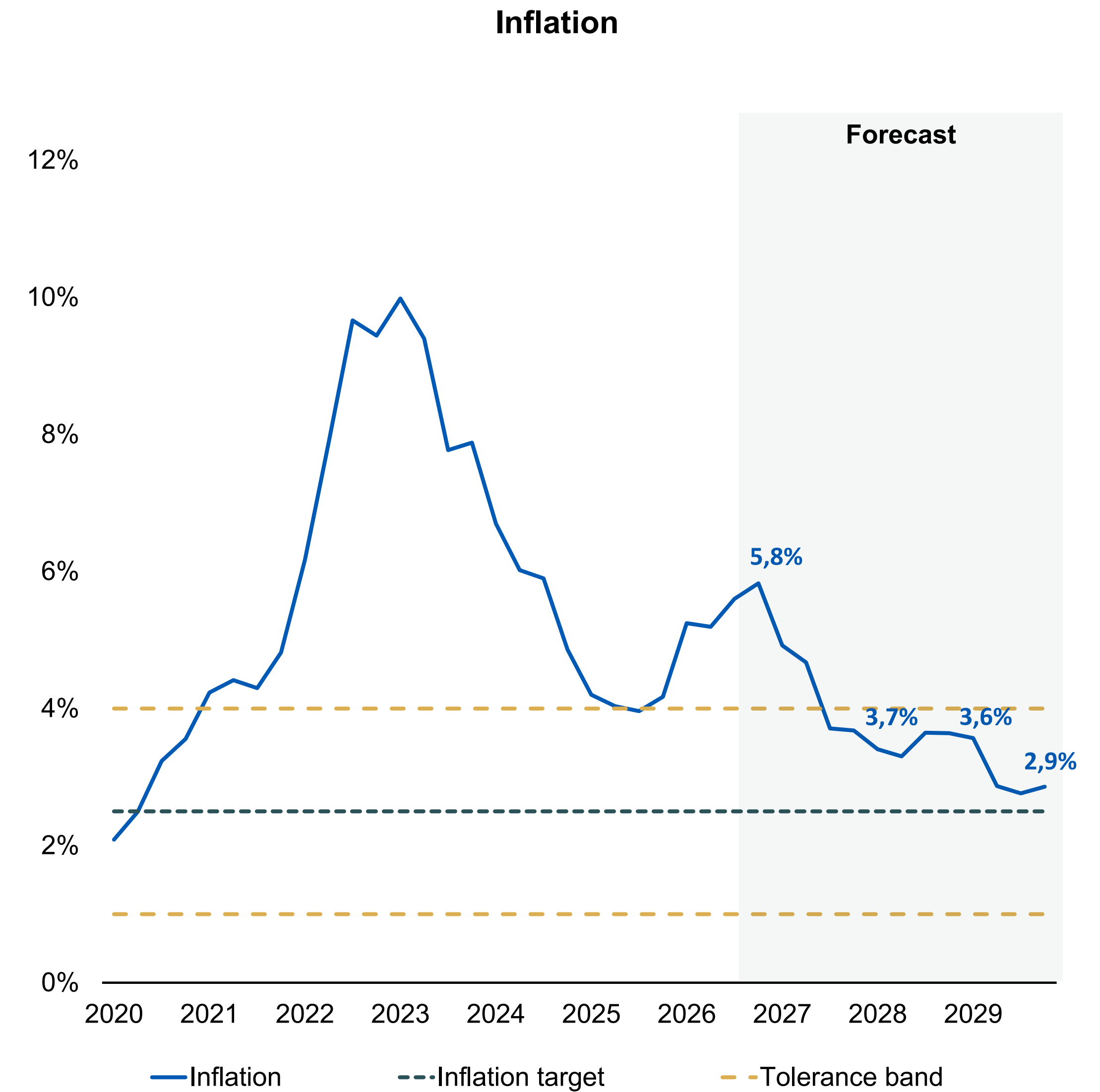
A Difficult Descent to Target

Inflation has proved harder to contain than previously expected. Persistent domestic inflationary pressures cannot be overlooked, but **the main forces pushing inflation higher have been the war in the Middle East and increases in public levies.**

Even as economic pressures ease and unemployment rises, **wage increases remain substantial and inconsistent with the Central Bank's inflation target.** The new methodology for imputed rent has also proved challenging for analysts, with the housing component currently out of step with a cooling housing market. We also forecast a weaker exchange rate, which inevitably feeds into this inflation forecast. **Nevertheless, we expect inflation to fall rapidly next year, partly because of base effects.**

Inflation forecasting is unusually difficult at present. The outlook depends on the interaction between oil prices and other cost increases, on one side, and rising unemployment and greater economic slack, on the other. Past experience leads us to view the risks as asymmetric: **the risk of underestimating inflation is greater than that of overestimating it.**

Inflation has been high for a long time, as have inflation expectations. Under these conditions, cost increases are more likely to feed through to prices, making the path to the inflation target even more difficult.



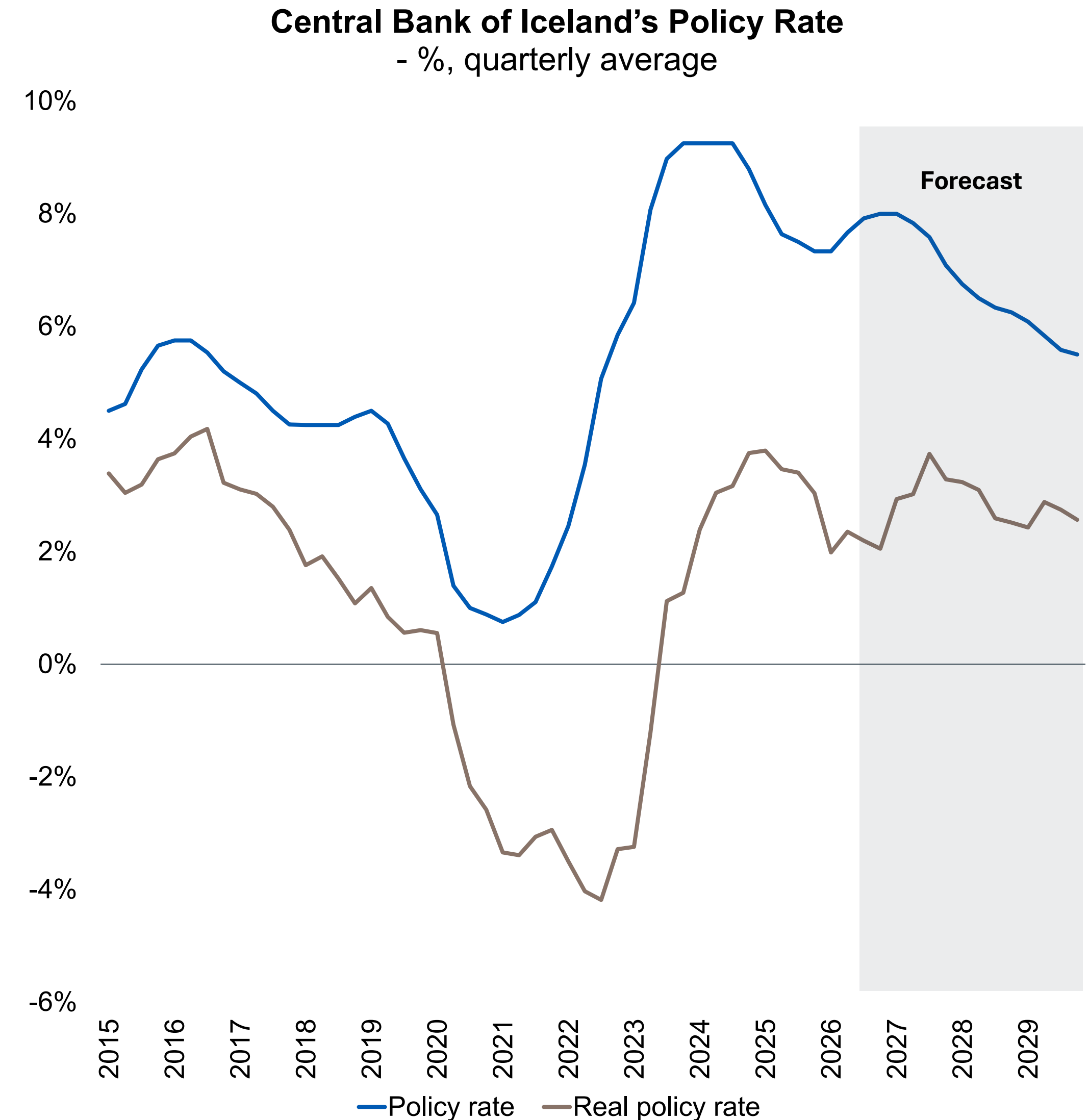
No Worse, but Slow to Improve

The Monetary Policy Committee of the Central Bank of Iceland has raised interest rates three times this year, by a total of 0.75 percentage points. The Bank's key interest rate therefore stands at 8%. Despite a deteriorating inflation outlook, the Committee struck a different and softer tone at its August meeting, with one member voting to keep rates unchanged.

The Committee faces the challenge of balancing a cooling economy on the one hand against persistent inflation and inflation expectations on the other, and of steering a middle course towards the inflation target without undue cost to the economy. This is a delicate task, as uncertainty is high and a cautious Committee prefers to err on the side of restraint.

Nonetheless, a certain turning point could be discerned at the last meeting, as the Committee's forward guidance had softened considerably. **Threats of further rate hikes were gone**, as the real rate stance is tight and there are growing signs that the real economy is weakening.

As things stand, we believe the Committee has reached the end of its tightening cycle and that interest rates will begin to fall as next year progresses, alongside more benign inflation developments. A possible revision of wage agreements and signs of second-round effects from oil price increases could, however, change the Committee's view in an instant, and even force further rate hikes. **Our baseline forecast, however, assumes that rates will be lowered to 7% next year.**



Is the Era of Cheap Funding Drawing to a Close?

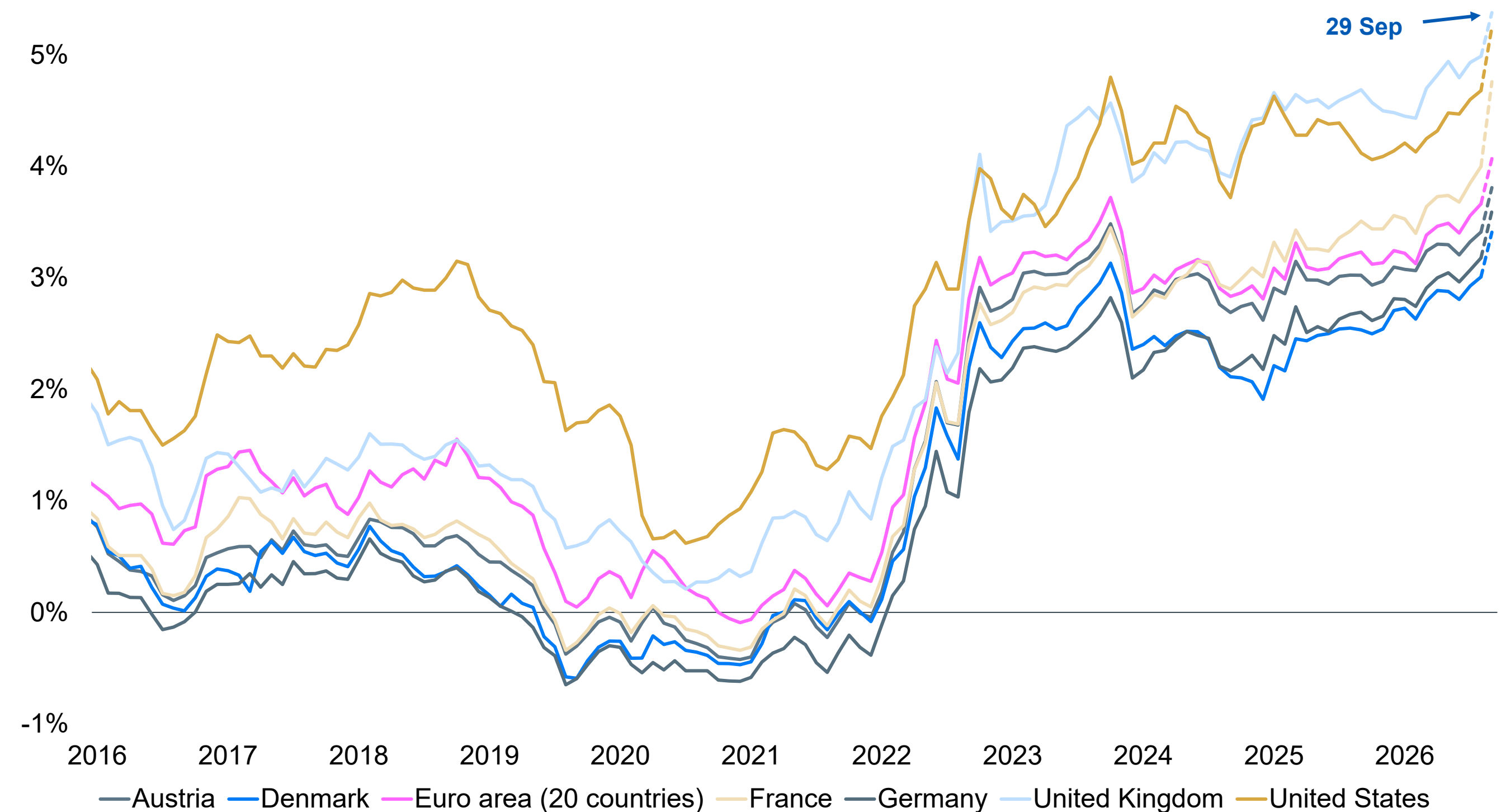
Public interest in bond markets is usually limited, but recently they have been edging into the spotlight.

Government bond yields have been rising in many of the world's most important markets. **For example, the yield on ten-year US Treasuries has risen above 5% for the first time since 2007.** The reasons for these increases are manifold, including:

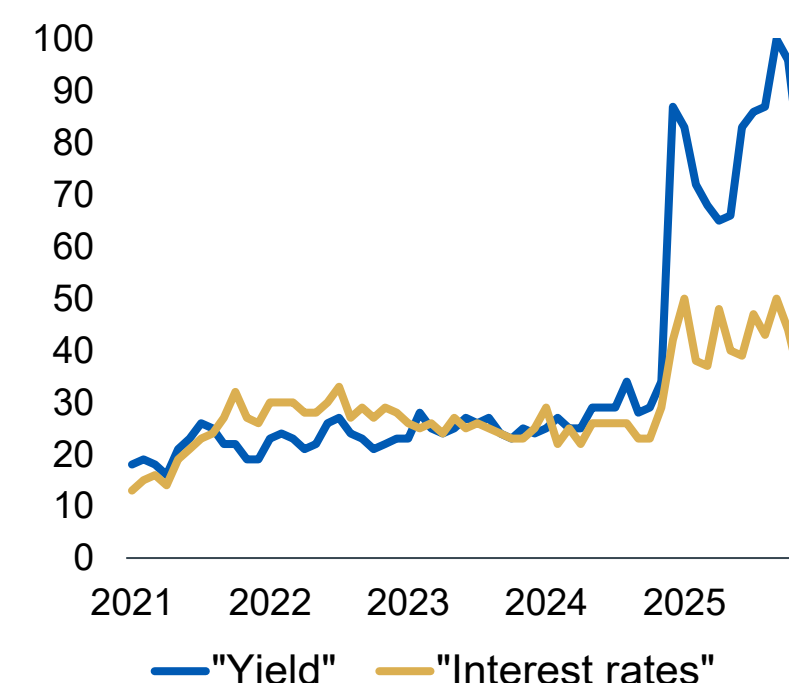
- Growing concerns about the debt levels and fiscal sustainability of various countries.
- Rising inflation expectations due to higher oil prices.
- Massive global investment in computer equipment and data centres, which is absorbing capital.
- Higher interest rates in Japan, which have reduced carry trades.

Higher yields can matter considerably, as they can significantly affect the terms available to businesses and the public. Although yields in Iceland have changed little, the banks partly fund themselves abroad, as do the Treasury and many larger companies.

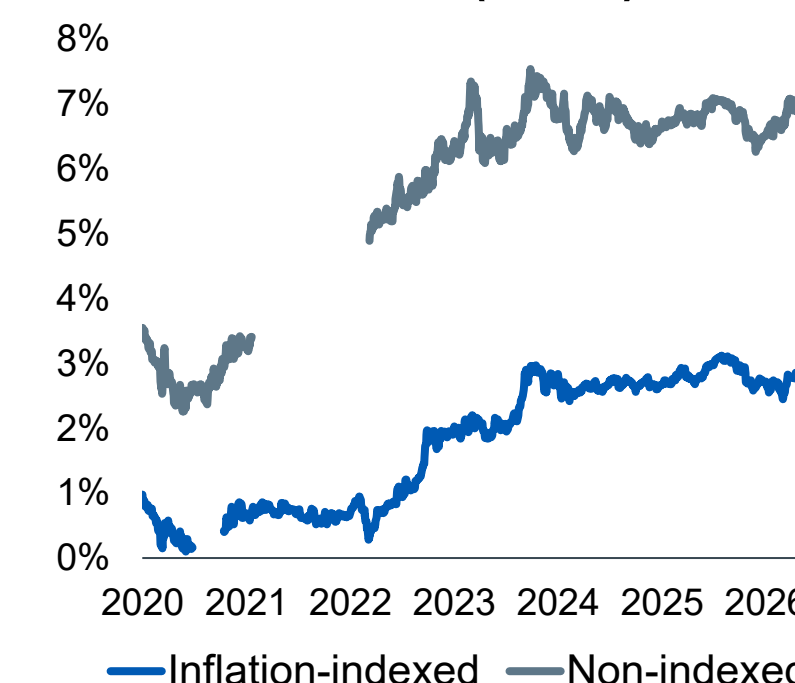
Ten-Year Government Bond Yields



Google Searches for Interest Rates and Yields



Ten-Year Par Yields in Iceland (FLVR)



Ten-Year US Treasury Yield (DGS10)



Key Economic Figures

GDP and components (previous Arion Research forecast in brackets)

<i>Change from previous year (%)</i>	2025	2026	2027	2028	2029
Private consumption	3.6 (4.3)	0.4 (1.2)	1.3 (1.9)	2.3 (2.6)	3.2
Public consumption	0.7 (1.2)	1.0 (1.4)	1.7 (1.7)	1.4 (1.5)	1.3
Investment	4.8 (4.0)	2.4 (-4.5)	-5.8 (0.4)	-0.6 (2.6)	1.2
<i>Business investment</i>	7.8 (7.5)	6.8 (-4.8)	-5.7 (-0.3)	-1.0 (2.9)	0.8
<i>Residential investment</i>	-5.4 (-5.9)	-8.2 (-4.0)	-12.0 (5.0)	2.2 (3.0)	3.3
<i>Public investment</i>	5.4 (2.3)	-2.8 (0.9)	0.5 (-1.9)	-1.4 (1.1)	1.3
Domestic demand*	3.6 (3.9)	1.3 (-0.1)	-0.4 (1.5)	1.3 (2.3)	2.2
Exports of goods and services	1.5 (1.0)	-0.5 (0.5)	5.1 (4.9)	3.1 (2.8)	3.1
Imports of goods and services	7.3 (7.2)	0.1 (-3.7)	-0.3 (3.0)	0.9 (2.9)	2.7
GDP	1.1 (1.3)	1.2 (1.6)	1.6 (2.2)	2.2 (2.3)	2.4

Other economic variables (previous forecast in brackets)

<i>Percentage of GDP (%)</i>	2025	2026	2027	2028	2029
Current account balance	-4.0 (-3.6)	-3.2 (-1.9)	-0.9 (-1.6)	-0.1 (-1.4)	0.2
Investment	26.9 (26.7)	26.4 (24.6)	24.3 (24.0)	23.7 (24.0)	23.4
<i>Change between annual averages (%)</i>					
Inflation	4.1 (4.1)	5.5 (5.0)	4.2 (3.7)	3.5 (3.0)	3.0
Wage index	7.9 (7.9)	5.9 (6.3)	5.5 (5.9)	6.1 (6.4)	5.9
Real wages	3.7 (3.7)	0.4 (1.2)	1.2 (2.1)	2.5 (3.3)	2.8
House prices	5.1 (5.1)	2.4 (2.4)	1.0 (2.7)	3.2 (5.4)	7.2
Real house prices	1.0 (1.0)	-2.9 (-2.5)	-3.1 (-1.0)	-0.3 (2.4)	4.1
Real exchange rate	6.4 (6.4)	3.6 (3.0)	2.5 (-1.4)	-0.8 (-0.8)	-1.0
<i>Annual average</i>					
Unemployment (%)	4.4 (4.4)	6.1 (5.0)	5.2 (4.7)	4.7 (4.6)	4.4
EUR/ISK	145 (145)	143 (144)	141 (148)	144 (150)	147
<i>Year-end</i>					
Central Bank's policy rate (%)	7.25 (7.25)	8.0 (8.0)	7.0 (6.5)	6.25 (5.75)	5.5

*Domestic demand is the sum of private consumption, public consumption, investment and changes in inventories.



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