

Iceland

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IN A NUTSHELL

- Economic growth slowed to 4.1% from 8.9%. Unemployment remained stable at 4%.
- Inflation remained persistent at 7.9% despite monetary tightening.
- House prices fell in real terms by 3% but rose in nominal terms by 4.5%.

MACROECONOMIC OVERVIEW

The economy fared better post COVID than most policy makers anticipated. GDP numbers have been revised substantially upwards due to a new census at the beginning of 2024. Growth in 2023 was 4.1% (from 8.9% in 2022) driven by the rebound of tourism, favourable terms of trade in 2022 and productivity was substantially higher than previously anticipated. The economy has rebounded and surpassed GDP per capita for 2019. This has brought new challenges for monetary and fiscal policies.

The labour market has been strong post COVID, unemployment has been stable around 4%. Participation in the Icelandic labour market is among the highest in European countries at 80.5% (75.1% on average in the EU).

Inflation in 2023 was 7.7%, y-o-y according to the CPI in December, i.e. higher and more persistent than anticipated. The tight monetary policy that the Central Bank of Iceland has maintained has put a strain on the economy in the last quarter, when the economy grew only by 0.6%. Latest unrevised numbers for the Q124 suggest a contraction of 4%, although this is principally due to inventory change.

LOOKING AHEAD

According to the economic forecast of the Central Bank of Iceland, the principal export growth factors will be the innovation sector, which includes pharmaceutical produce, IT, gaming etc. In addition, major investments are taking place in the aquaculture industry, mainly outside the capital region, and are expected to continue to revive the housing markets in deprived areas. This is a fundamental change, the economy has historically been driven by three export sectors: fisheries, energy intensive industries and tourism. The power sector is expected to install more green energy mainly due to Iceland's international climate obligations. Investment in housing is expected to continue due to population growth and demographic change.

The consensus among forecasters (CBI & IMF) is that the economy will grow around 1.1 to 1.7% in 2024. The economy is expected to rebound towards a sustainable growth of 2.4% in 2025.

Volcanic activity on the Reykjanes peninsula led to the evacuation of the town of Grindavík, with around 1200 housing units and close to 1% of the population of Iceland. The Grindavík population will relocate either to housing in the nearby municipalities or to the Reykjavík Capital Region (see box). This will put a substantial strain on public finances and pressure on housing markets, particularly in the neighbouring municipalities.

HOUSING MARKETS

The housing market was close to overheating in 2022. Sharp policy measures by the Central Bank of Iceland - lowering maximum loan-to-value ratios and raising further the capital ratios of the banks - contributed to a real decrease in house prices in 2023. In addition, the bank raised its policy rate to 9.25% in September 2023 in several steps from 6% in December 2022. Other factors countered these actions, including high number of first-time buyers, immigration and supply constraints in the construction of new housing. High household saving rates also contributed to activity in the market despite rising mortgage rates. Debt ratios of Icelandic households remained relatively low compared to other Nordic countries.

According to preliminary numbers from Statistics Iceland, housing investment increased by 15.7% in Q1 2024 (y-o-y). This is expected to ease supply constraints by 2025. Total investment in residential housing was ISK 195 bn in 2023 a decrease by 2% from 2022 in real terms.

The numbers of housing starts have been revised and the data is now benchmarked with March each year. According to HMS – The Housing & Construction Authority – housing starts from 2022 to 2023 were 4,158 units, but between 2023 to 2024 were only 1,887.

Housing completions in 2023 were 3,977 units compared to 2,869 in 2022.

Lack of housing supply is putting strain on first-time buyers, migrants and quasi-first-time buyers from Grindavík. Housing supply is likely to increase when financial conditions ease. The government's help-to-buy programme contributed to increased demand towards end of year 2023.

Owner occupancy has been historically high in Iceland. It is estimated to be around 75% according to the 2021 census.

Housing prices decreased by 3% in real terms in 2023. The increase was 4.5% in nominal terms. Rental prices in the capital region increased by 8.2% in nominal terms.

The Government's current estimate is that the cost to the Treasury because of the evacuation of Grindavík Municipality will be around ISK 100 bn or around EUR 660 mn. The funds will be used to acquire residential property in the area, as stated above, as well as to support small and medium sized businesses affected by the volcanic activity.

MORTGAGE MARKETS

OA large number of mortgages which have rates fixed for 5 years, will have their rates reset in 2024/H1 2025. This would increase debt service burden for the affected households as mortgage rates have risen considerably since the rates were fixed. This might induce switching to indexed linked mortgages that have lower debt burden in the beginning in comparison to variable rate mortgages. The Central Bank of Iceland estimates that around ISK 245 bn of non-indexed fixed-rate loans will be subject to interest rate reviews in 2024 and ISK 175 bn in the first half of 2025. It is expected that households will either partially or fully

HOW VOLCANIC ERUPTION HAS AFFECTED THE HOUSING MARKET – THE CASE OF GRINDAVÍK

Earthquakes in part of the Reykjanes Peninsula in 2023 formed fissures in the landscape. The town of Grindavík a small town about 60 km from Reykjavík and 30 km from the Keflavík International Airport, was one of the casualties of those earthquakes. In November 2023 a state of emergency was declared, and the town was evacuated. This was due to cracks and a newly formed subsidence valley. A series of volcanic eruptions in the area have been ongoing since. On January 24, 2024, a lava stream from a volcanic eruption entered part of the town. The town accounted for around 1% of the national population at the beginning of 2024 according to official data. The town was one of the largest fishing towns in Iceland with relatively high income per capita. Subsequently, after a period of consideration, the government, in cooperation with the inhabitants and local authorities, decided to offer residential homeowners to buy their houses at 95% of official insurance valuation. This was done through government owned real estate company Þórkatla which was founded for this purpose by special legislation. This has a precedent in Icelandic history when similar, although not the same, measures were implemented following a volcanic eruption in Vestmannaeyjar islands in 1973. Under the current program the homeowners in Grindavík hold an option to buy their property back within the next three years. The total number of housing units in Grindavík were about 1200. The Grindavík residents are categorized as quasi-first-time buyers. This adds to the pressure on the housing market in neighbouring areas, including Reykjavík and other towns on the Reykjanes peninsula. The market is already constrained due to demand from first-time buyers as well as migrant workers, either buying or renting. This will support a further rise in house prices in the area in the medium term, despite tight monetary policy.

The last known volcanic eruption in the area, previously to the episode which started at the end of 2023, was between 1210-1240.

refinance with indexed-linked mortgages. The variety of mortgage products has increased substantially over the past few years. The type of mortgage chosen by the public changes due to sentiments, e.g. inflation expectations.

Outstanding residential mortgages were ISK 2,576 bn by year-end an increase of 7% from 2022. As a percentage of GDP, outstanding mortgages for households were 60.2%, a decrease of 1.8 pps from 2022. In general, the demand for credit has decreased due to high interest rates and borrower-based measures.

Lack of housing supply is putting strain on first-time buyers, migrants and quasi-first-time buyers from Grindavík. Housing supply is likely to increase when financial conditions ease. The government's help-to-buy programme contributed to increased demand towards end of year 2023.

The Central Bank of Iceland has in place borrower-based measures rules. Among them are loan-to-value (LTV) ratios and debt service-to-income (DSTI) ratios at the time when the loan is issued i.e. rules no. 217/2024. Other financial stability rules apply to capital requirements of financial institutions. Most changes took effect in 2022.

The objective of this strategy was to cool the housing market that contributed

to inflation.

Nominal mortgage rates increased further in 2023 after a steep rise in 2022. Average variable mortgage rates were 3.7% on average in 2021 to 5.8% in 2022 and soared to 9.5% on average in 2023. Indexed mortgage rates increased on average from 2.27% in 2022 to 3.3%.

The average loan to value ratio for new mortgages in 2022 was 53.4%, a decrease of 5.7 pps. Numbers for 2023 were not available by mid-year 2024.

At year-end 52% of mortgages were indexed linked of these 24.8% was subject to variable rates. The share of non-indexed mortgages was at the same time 48%. Around 21.7% was subject to variable rates. In the beginning of 2024 household demand for indexed linked mortgages increased. Indexed linked mortgage rates are usually annuities and therefore have payments fixed in real terms throughout.

Households in arrears on mortgage payments is historically low or around 1%, increasing slightly in 2023 from 2022.

The state and the local authorities continued to provide financial support (i. stofnstyrkir) for the construction and purchase of affordable rental apartments, with the objective of lowering rental prices in the general market.

According to the European Banking Authority, the exposure of banks to real estate activities was 23.5% and construction 15.4% respectively as percentage of total of exposures to non-financial corporations in December 2023.

MORTGAGE FUNDING

Covered bond issuance has returned and is developing in Iceland. In 2024 the three systemically important banks became full members of the European Mortgage Federation-European Covered Bond Council. This might point to further increase in covered bond issuance.

In 2023 the Domestic systemically important banks issued 90 bn in króna denominated covered bonds. According to the Financial Stability report of the Central Bank of Iceland the stock of outstanding covered bonds denominated in ISK totalled 554 bn at year-end 2023. Around ISK 83 bn of covered bonds matured in 2023.

Other funding sources come mostly from deposits and from direct lending from pension funds. The principal buyers of covered bonds are pension funds and insurance companies.

GREEN FUNDING

The financial sector has continued to develop green funding products and giving customers better terms for green defined investment projects. The most common financing has been for green vehicles like cars fuelled by electricity, hydrogen and methane.

Icelandic housing is heated nearly entirely with geothermal energy or electricity generated in a sustainable way, e.g. hydro dams. Nearly all housing is well insulated and with double glazed windows.

The Icelandic banks have actively been seeking green financing, e.g. by issuing green bonds denominated in euros and ISK. The Nordic Investment Bank has especially been active in green financing of the Icelandic banks.

Construction companies and HMS are more aware of the carbon footprint of the industry and have already taken steps to reduce emission. In addition, it is more common that new housing units are certified as green, e.g. by the Nordic Swan Ecolabel, which is one of the world's toughest environmental certifications.

	ICELAND 2022	ICELAND 2023	EU 27 2023
MACROECONOMIC VARIABLES			
Real GDP growth (%) (1)	8.9	4.1	0.4
Unemployment Rate (LSF), annual average (%) (1)	3.8	3.5	6.1
HICP inflation (%) (1)	5.7	8.0	6.4
HOUSING MARKET			
Owner occupation rate (%) (1)	n/a	n/a	69.2
Gross Fixed Investment in Housing (annual change) (1)	-6.2	-0.3	-3.1
Building Permits (2015=100) (2)	n/a	n/a	94.0
House Price Index - country (2015=100) (2)	214.8	231.6	170.2*
House Price Index - capital (2015=100) (2)	212.5	224.8	165.1*
Nominal house price growth (%) (2)	21.0	7.8	3*
MORTGAGE MARKET			
Outstanding Residential Loans (mn EUR) (2)	15,889	17,114	6,782,375
Outstanding Residential Loans per capita over Total Population (EUR) (2)	42,231	44,136	15,114
Outstanding Residential Loans to disposable income ratio (%) (1) (2)	n/a	n/a	71.3
Gross residential lending, annual growth (%) (2)	n/a	n/a	-26.6
Typical mortgage rate, annual average (%) (2)	2.3	3.3	4.7

* Please note that this value is a simple average of the available values in 2023.

Sources:

(1) Eurostat.

(2) European Mortgage Federation - Hypostat 2024, Statistical Tables.

ICELAND FACT TABLE

Which entities can issue mortgage loans in your country?	Deposit taking corporations (banks) and Pension Funds, the Housing and Construction Authority.
What is the market share of new mortgage issuances between these entities?	In the year 2022 the market share of deposit taking banks was 95% and the pensions fund's share was 4% the remaining 1% was lent by the government's housing authority and building authority (HMS).
Which entities hold what proportion of outstanding mortgage loans in your country?	At year-end 2022 the deposit taking banks held 67% of the total outstanding mortgages to households, the pension funds 18% and IL – Fund (in winding-up, precursor to the HMS) 15%.
What is the typical LTV ratio on residential mortgage loans in your country?	About 55% on new mortgages and about 65% for first time buyers. The maximum LTV at year-end 2022 was 80%, but up to 85% for first time buyers (limit to price). This limit was lowered on 15 June 2022 from 85% to 80% and 90% to 85% respectively.
How is the distinction made between loans for residential and non-residential purposes in your country?	A residential mortgage is a loan to an individual which is backed by real estate or is made for the purpose of buying a residential asset. The Central Bank currently makes a distinction between those loans in its accounts. Banks and pension funds require a pledge in the underlying property for a new mortgage.
What is/are the most common mortgage product(s) in your country?	Mortgage for 25 to 40 years with 3 to 5 year reset period on interest rates (29.4% of outstanding mortgages at end of 2022, about 45% of new mortgages in 2021). Mortgages with fixed payments are more common than with fixed installments. The relative popularity of indexed vs. non-indexed mortgages varies depending on the level of interest and inflation. Most mortgages have flexible rates with reset periods up to five years.
What is the typical/average maturity for a mortgage in your country?	25 to 40 years.
What is/are the most common ways to fund mortgage lending in your country?	Covered bonds and deposits in the case of banks. Members funding in terms of pension funds.
What is the level of costs associated with house purchase in your country (taxes and other transaction costs)?	Stamp duty – 0.8% of the official property valuation (fasteignamat) for individuals and 1.6% for rental companies/legal entities.
What is the level (if any) of government subsidies for house purchases in your country?	The government has introduced a help to buy programme and pays interest expense benefits to low income households. First time buyers pay half of the stamp duty.