



MONETARY BULLETIN

2013 • 3

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The objective of the Central Bank of Iceland's monetary policy is to contribute to general economic well-being in Iceland. The Central Bank does so by promoting price stability, which is its main objective. In the joint declaration by the Government of Iceland and the Central Bank of Iceland on 27 March 2001, it is explained that the Central Bank's aim shall be that annual inflation, measured as the twelve-month increase in the CPI, remains as close to 2½% as possible.

Professional analysis and transparency are important prerequisites for credible monetary policy. In publishing *Monetary Bulletin*, the Central Bank attempts to fulfil these principles. Twice a year, in early May and early November, *Monetary Bulletin* includes an in-depth analysis of economic and monetary developments and prospects. In February and August, an updated forecast is published together with an abbreviated report on economic and monetary developments and prospects. The Monetary Policy Committee of the Central Bank bases its interest rate decisions on this analysis, among other things. The publication of *Monetary Bulletin* also represents a vehicle for the Bank's accountability towards government authorities and the public.

The framework of monetary policy and its implementation and instruments are described further on the Central Bank's website: www.sedlabanki.is/?PageID=179.

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Vol. 15 no. 3, 21 August 2013

ISSN 1607-6680, print

ISSN 1670-438X, online

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Icelandic letters:

ð/Ð (pronounced like th in English this)

þ/Þ (pronounced like th in English think)

In *Monetary Bulletin*, ð is transliterated as d and þ as th in personal names, for consistency with international references, but otherwise the Icelandic letters are retained.

Symbols:

- * Preliminary or estimated data.
- 0 Less than half of the unit used.
- Nil.
- ... Not available.
- . Not applicable.

Statement of the Monetary Policy Committee

21 August 2013

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged.

According to the updated forecast published in *Monetary Bulletin* today, output growth will measure just under 2% in 2013, which is broadly in line with the Bank's May forecast. The outlook for output growth over the next two years has deteriorated, however, with growth projected at just under 3% per year instead of slightly more than 3%, owing primarily to less investment in the energy-intensive sector in the near term. The recovery of the labour market has been more robust than was forecast in May and is expected to continue on that path.

According to the current forecast, inflation will rise slightly in the latter half of the year and then begin subsiding towards the target early in 2014. If wage increases are consistent with the inflation target, inflation will fall more quickly and interest rates will be lower than would otherwise be necessary, other things being equal.

The Central Bank's foreign exchange market strategy, introduced in May, has contributed to reduced exchange rate fluctuations, and the króna has remained relatively stable since the MPC's last meeting. As yet, however, this development has not led to lower inflation expectations.

Monetary policy must always take account of fiscal policy and other factors that affect aggregate demand. There is some uncertainty about the path public sector finances will take in coming years, but that should diminish with the presentation of the fiscal budget proposal in early October. It is critical that Treasury finances be brought into balance as soon as possible so that the monetary and fiscal policy mix contributes to external balance of the economy, fosters overall economic stability, and delivers inflation close to target, at the lowest possible cost.

The accommodative monetary stance has supported the economic recovery in the recent term. It is still the case that as spare capacity disappears from the economy, it is necessary that slack in monetary policy should disappear as well. The degree to which such normalisation takes place through changes in nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements.

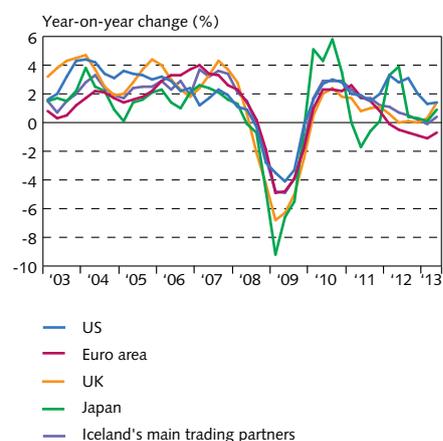
Recent labour market recovery stronger than expected, but outlook for weaker GDP growth than in the May forecast

Global output growth has been relatively weaker year-to-date than was forecast in the May issue of Monetary Bulletin. However, the most recent indicators suggest a gradual recovery, in line with the May forecast, while the outlook for the upcoming two years is for weaker output growth than previously expected among Iceland's main trading partners. In line with weaker growth in economic activity, the outlook for growth in world trade and developments in Iceland's terms of trade has deteriorated. In Q1, output growth in Iceland proved somewhat weaker than was assumed in May, primarily because of more unfavourable inventory changes than previously expected. Despite this, the recovery from the GDP trough remains somewhat stronger than the average among Iceland's main trading partners. The outlook for 2013 is similar to the Bank's May forecast, with output growth projected at almost 2%. However, the output growth outlook for the upcoming two years has deteriorated, from just over 3% per year to just below 3%. One of the main reasons for the poorer output growth outlook is that investment related to the expansion of the Straumsvík aluminium smelter will not take place. As a result, the investment level will be lower next year than was provided for in the May forecast, and export growth will be weaker in 2015. The recovery of the domestic labour market has been much more robust than was projected in May, however. The number of employed persons has continued to grow, average hours worked have begun to rise again, and total hours worked increased somewhat more than was forecast in May. Seasonally adjusted unemployment continued to decline as well, and it appears as though the majority of those who leave the unemployment register find jobs. The labour market recovery is expected to continue, although the jobless rate will decline only slightly from the current level. A larger increase in total hours worked concurrent with the prospect of weaker output growth implies that productivity growth will be slower in coming years than was previously assumed. As a result, the near-term inflation forecast has deteriorated since May. Inflation is projected to rise somewhat in the latter half of the year and then taper off again in the first half of 2014, and align with the inflation target in the second half of 2015, somewhat later than according to the May forecast. As before, there is some uncertainty about the exchange rate and inflation outlook and the strength and durability of the domestic economic recovery, particularly in view of the uncertain global situation.

Global economic affairs and external trade

- In Iceland's main trading partner countries, GDP growth was weaker in Q1 than was projected in May but appeared to turn around in Q2. The contraction in the euro area appears to be over, according to the most recent preliminary figures, with GDP growing quarter-on-quarter in Q2 after a contraction lasting eighteen months. In the UK, GDP growth was marginal in Q1 and then jumped to 1.4% year-on-year in Q2. Q2 growth in the US also measured 1.4%, while Japan recorded somewhat weaker growth of about 1%.
- The outlook is for GDP growth to continue firming up in leading industrialised countries as the year progresses, and the most recent indicators for the euro area and the US, released since the publication of the May *Monetary Bulletin*, have been more favourable than generally expected. In spite of the improved outlook, however, the outlook for 2013 as a whole in the euro area

Chart 1
GDP growth in Iceland's main trading partners and selected industrialised countries
Real GDP growth Q1/2003 - Q2/2013

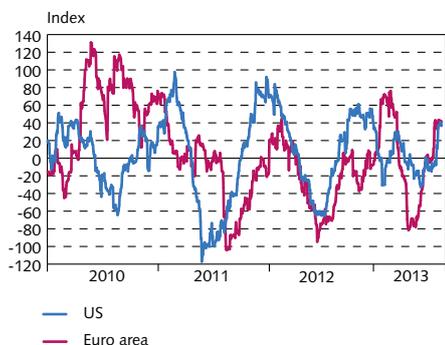


Sources: Macrobond, Central Bank of Iceland.

1. The analysis appearing here is based in large part on the Bank's assessment of economic developments, published in May 2013 in *Monetary Bulletin* 2013/2, and on the updated forecast presented in this report. It is based on data available as of mid-August.

Chart 2
Economic surprise index¹

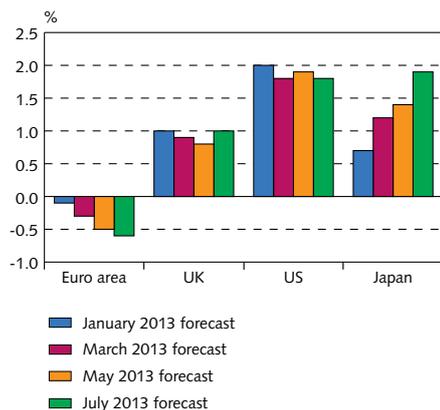
Daily data 1 January 2010 - 16 August 2013



1. When the index is lower than 0, the indicators are more negative than expected; when the index is higher than 0, the indicators are more positive than expected. The index does not imply that the indicators are positive or negative.

Source: Macrobond.

Chart 3
GDP forecasts for the year 2013¹



1. Based on monthly forecasts from 250 forecasting agencies which are weighted together.

Source: Consensus Forecasts.

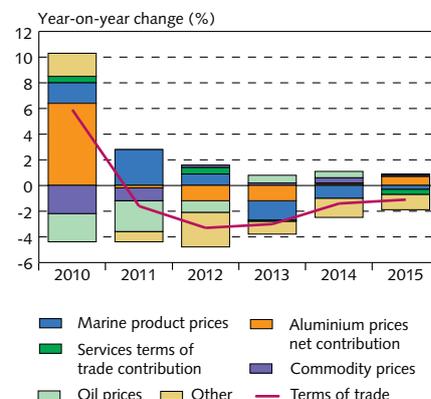
and the US has worsened slightly since May, owing to weaker GDP growth figures for the first half of the year.

- Consensus Forecasts now projects 0.8% GDP growth among Iceland's main trading partners this year, which is in line with the forecast from the International Monetary Fund (IMF), whereas the Organisation for Economic Co-operation and Development's (OECD) forecast is rather more pessimistic, at 0.6%. The baseline forecast assumes that Iceland's trading partners will record GDP growth of 0.8% this year and 1.8% next year, slightly below the May forecast. The outlook for 2015 has deteriorated somewhat more, however, to an estimated 2.2% GDP growth instead of the 2.6% projected in May.
- In spite of the prospect of stronger global GDP growth in the latter half of the year, conditions in the international financial markets have worsened. Concerns about the markets in China and a slowdown in emerging economies have caused interest rates and risk premia to rise again, and financial market instability has escalated somewhat.
- The inflation outlook for Iceland's trading partners has improved somewhat since the last *Monetary Bulletin*. In the US, the UK, and the euro area, inflation bottomed out in April but has inched upwards since then. Even though it tapered off in the UK in April, it has remained above the Bank of England's (BoE) inflation target. Inflation has remained below target in the US and the eurozone, however.
- In May, the policy rate in the euro area was lowered by 0.25 percentage points to the current 0.5%, the lowest in the history of the monetary union. The European Central Bank (ECB) has followed the example of various other central banks and has begun to provide more information on future policy moves in order to ease the monetary stance still further. The ECB has stated that monetary policy will continue to support economic recovery as long as necessary, and that interest rates will be held unchanged for a relatively protracted period. The BoE has taken similar steps.² The Danish central bank's rates were lowered in the wake of the ECB policy rate reduction and are still below euro area rates. A large number of other central banks, particularly in Eastern Europe and Asia, have also cut their rates since the last *Monetary Bulletin* was published, some of them more than once. At the same time, the central banks in Brazil and Indonesia have raised rates twice.
- Growth in world trade lost pace in the latter half of 2012, in line with declining output growth. That trend continued early this year. Both the IMF and the OECD have revised their world trade forecasts for 2013 and 2014 downwards, and the Central Bank's baseline forecast has been revised to reflect this.

2. Both the US Federal Reserve Bank and the Bank of England have issued a numerical unemployment reference rate that triggers a review of monetary policy.

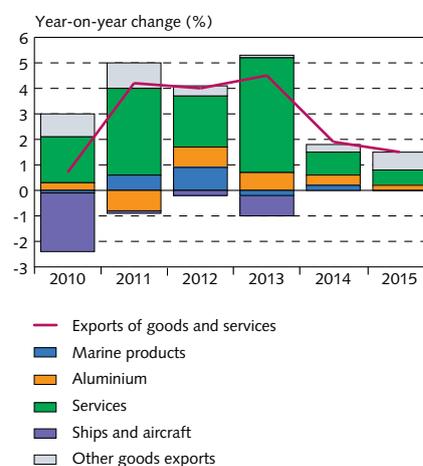
- Global commodity prices have continued to fall since the last *Monetary Bulletin*. The IMF assumes that prices will continue to fall and expects the pace of the decline to quicken next year. The baseline forecast now assumes a 1% decline this year, instead of the 1½% in the May forecast, primarily because the price drop in Q2 was smaller than previously projected. Oil prices have fallen slightly more than was anticipated in May, however. As a result, they are now expected to average about 4½% lower this year than in 2012, whereas in the last *Monetary Bulletin* they were forecast to fall by 3% this year. The outlook for 2014 is for oil prices to fall by just over 4%, about ½ a percentage point more than in the last forecast.
- The price of Iceland's principal export products is expected to be somewhat lower than in the May forecast, mainly because aluminium prices are considerably lower, and marine product prices have fallen more, than was assumed then. Aluminium prices are expected to fall by just over 7% this year instead of remaining unchanged on average year-on-year, as was forecast in May, and marine product prices are projected to fall by 4% instead of the previously forecast 2%. The forecast for aluminium and marine product prices in 2014 is broadly unchanged since May.
- Terms of trade for goods and services are expected to be poorer this year than according to the May forecast, as the weaker outlook for export prices outweighs the larger decline in import prices. Terms of trade are expected to deteriorate by 3% this year and not 2%, as was projected in May. They are expected to continue to worsen over the next two years as well, which is in line with the last forecast.
- The real exchange rate rose somewhat in the early months of the year but then fell again in May and June, in tandem with the nominal depreciation of the króna. It then rose slightly in July, however, because of the rise in the nominal exchange rate and higher inflation than in trading partner countries. The real exchange rate is now about 5% above last year's average but remains low in historical context.
- Goods and services exports are assumed to increase by 4.4% this year instead of the 2.9% in the last forecast. The main difference is in services exports, although aluminium product exports are expected to grow and marine product exports are expected to contract less than previously assumed. The outlook for 2014 has improved somewhat as well, owing to the prospect of increased aluminium and marine product exports, whereas the last forecast provided for a 1% contraction in aluminium exports and no change in marine product exports.
- The surplus on goods and services trade was somewhat larger in Q1 than in the same quarter a year ago, as the services account showed a surplus for the first time ever in Q1. In Q2, however, there was a deficit on goods trade for the first time since Q4/2008.

Chart 4
Terms of trade and their main components 2010-2015¹



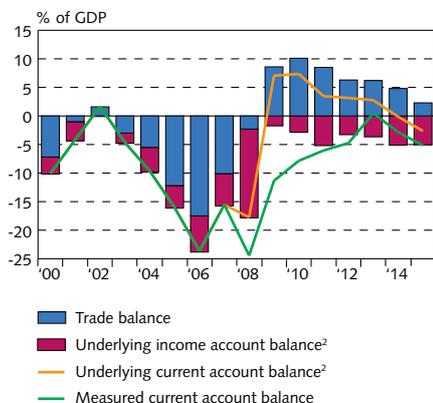
1. Central Bank baseline forecast 2013-2015. The contribution of the main sub-indices to year-on-year changes in terms of trade is determined by weighting the annual change in the sub-index concerned together with its weight in the import or export of goods and services. The item "other" is a residual.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5
Export development and its main components 2010-2015¹



1. Central Bank baseline forecast 2013-2015.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6
Current account balance 2000-2015¹

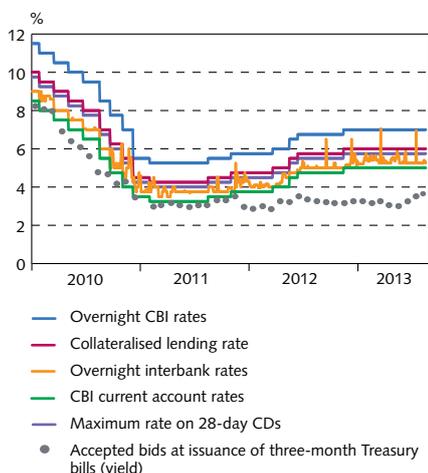


1. Net current transfers are included in the balance on income. Central Bank baseline forecast 2013-2015. 2. Adjusted for calculated revenues and expenses of deposit money banks (DMBs) in winding-up proceedings and the effects of the settlement of their estates, and adjusted for the effects of the pharmaceuticals company Actavis until 2012.
Sources: Statistics Iceland, Central Bank of Iceland.

In spite of stronger export growth, it is now assumed that the trade surplus for the year will be ½ a percentage point smaller than in the May forecast, or about 6.2% of GDP. It is expected to shrink to just under 5% of GDP in 2014 and just over 2% in 2015. This is about a percentage point less than was forecast in May and is due primarily to weaker growth in aluminium exports, which in turn is due to the smaller-than-expected increase in production capacity at the Straumsvík aluminium smelter.

- The deficit in the balance on income for this year is expected to be somewhat smaller than was forecast in May, owing to a smaller-than-expected deficit in Q1. The main reason for the change is the diminished importance of accrued interest due to the old banks. The year-2013 current account balance as calculated according to official standards is forecast to be positive by 0.3%, whereas the forecast in the last *Monetary Bulletin* provided for a 1.5% deficit. On the other hand, the deficit in the underlying balance on income is expected to be larger than in the May forecast and the underlying current account surplus correspondingly smaller. The main reason for the adjustment is that, as of the beginning of 2013, the effects of pharmaceuticals company Actavis are no longer set aside in the assessment of the underlying current account balance. The underlying current account balance is now projected to be positive by 2.7%, as opposed to 4.1% in the May forecast. A deficit is expected to development as early as 2014, a year earlier than was forecast in May. The difference stems primarily from the fact that Actavis is no longer omitted from the assessment of the underlying balance, as was mentioned above.³ The outlook is also for a larger deficit in 2015. It should be borne in mind that current account forecasts are subject to great uncertainty and relatively small changes in terms of trade and international interest rates can lead to large adjustments in forecasts of the current account.

Chart 7
Central Bank of Iceland interest rates
and short-term market interest rates
Daily data 1 January 2010 - 16 August 2013



Source: Central Bank of Iceland.

Domestic financial markets

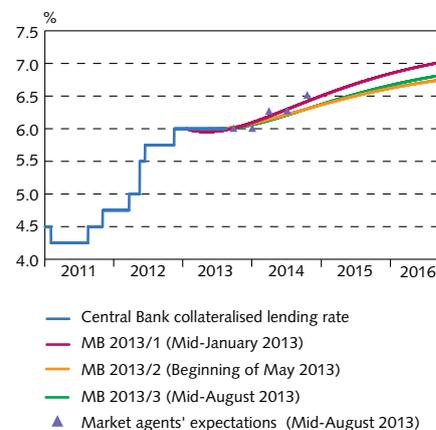
- At its May and June meetings, the Central Bank of Iceland Monetary Policy Committee (MPC) decided to hold the Bank's interest rates unchanged. Prior to the publication of this *Monetary Bulletin*, the current account rate was 5%, the maximum rate on 28-day certificates of deposit (CDs) was 5.75%, the seven-day collateralised lending rate was 6%, and the overnight lending rate was 7%.
 - The monetary stance has eased slightly since the last *Monetary Bulletin* was published. The Bank's effective real rate is now about 1.5% in terms of the current inflation level and 1.3% in terms of
3. In the recent term, the Central Bank has ignored the effects of pharmaceuticals company Actavis in its assessment of the underlying balance on income. At the end of 2012, Actavis was sold to an American pharmaceuticals firm, and its assets and liabilities were then restructured. This diminished Actavis' impact on Iceland's international investment position (IIP) and thereby its effect on the balance on income; therefore, there is no longer any reason to omit the company when assessing either the IIP or the balance on income, even though some effects on the net position still remain.

the average of various measures of inflation and inflation expectations. It is therefore about 0.2 percentage points lower than just before the *May Monetary Bulletin* was published, and about 0.9 percentage points higher than in August 2012.

- According to forward interest rates, the market appears to expect the MPC to keep Central Bank rates unchanged in 2013 and then raise them gradually in the first half of 2014.⁴ The Central Bank's market expectations survey, carried out in mid-August, also suggests that the market expects rates to remain unchanged through this year. Respondents indicate that they expect rates to be raised by 0.25 percentage points in Q1/2013 and by a further 0.25 percentage points in Q3/2013, to 6.5%.
- Overnight interest rates in the interbank market have developed in line with Central Bank rates but remain below the centre of the interest rate corridor, owing to abundant deposit money bank (DMB) liquidity. In Treasury bill auctions, however, interest rates on Treasury bills have been somewhat below the interest rate corridor, although they have been on the rise since the last *Monetary Bulletin*.
- Yields on indexed bonds have been on the decline this summer. Since the publication of the last *Monetary Bulletin*, they have fallen by 0.2-0.7 percentage points, mostly at the short end of the yield curve. Demand for indexed bonds has remained strong, and supply has shrunk. Inflation expectations appear to have risen anew, and the risk premium on Housing Financing Fund (HFF) bonds has fallen again.
- Since the May issue of *Monetary Bulletin* appeared, yields have fallen on short nominal Treasury bonds as well, while yields on longer nominal bonds have risen slightly. Since the Treasury bond maturity in May, non-residents have added to their holdings in other short Treasury bonds, probably contributing to the decline in yields.
- The CDS spread on five-year Treasury obligations is 1.6 percentage points, slightly higher than when the last *Monetary Bulletin* was published. The risk premium on Treasury obligations as measured by the spread between the Treasury's five-year US dollar bonds and comparable bonds issued by the US Treasury rose in the first half of July but has tapered off since then. At present, it is close to the level seen at the time the *May Monetary Bulletin* was published, and about 1.5 percentage points lower than in August 2012. The risk premium on comparable 10-year bonds has risen by 0.7 percentage points since May but is still about 0.9 percentage points lower than in August 2012. The recent decision by rating agency Standard & Poor's to change the outlook on Iceland's sovereign credit rating to negative has not yet had any obvious effect on the risk premium on Icelandic financial obligations.

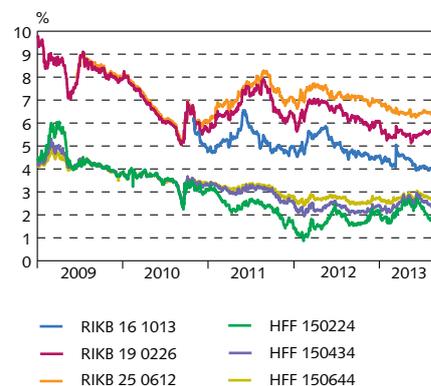
4. Measurement problems at the short end of the yield curve (caused by the ineffectiveness of the interbank market) introduce a measure of uncertainty into the indications provided by the yield curve.

Chart 8
Collateralised lending rate, forward market interest rates¹ and market agents' expectations concerning collateralised lending rate²
Daily data 1 January 2011 - 30 September 2016



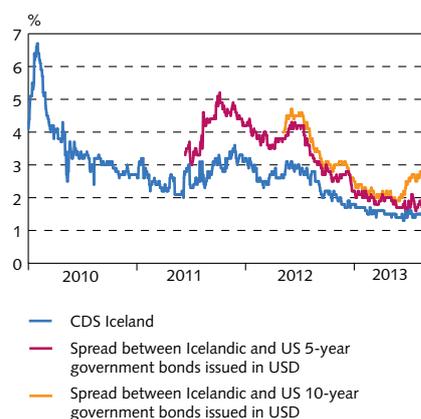
1. Interbank interest rates and Treasury bonds were used to estimate the yield curve. Treasury bonds maturing within two years are, however, excluded. 2. According to the median response in the Central Bank's market expectations survey for the period 12-15 August, 2013. Source: Central Bank of Iceland.

Chart 9
Nominal and indexed bond yields
Daily data 2 January 2009 - 16 August 2013



Source: Central Bank of Iceland.

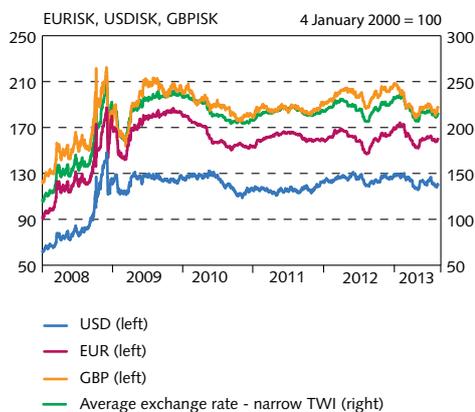
Chart 10
Risk premia on the Icelandic Treasury
Daily data 1 January 2010 - 16 August 2013



Sources: Bloomberg, Macrobond.

Chart 11
Exchange rate of the króna

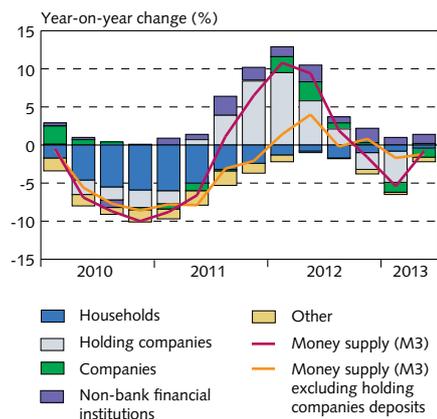
Daily data 3 January 2008 - 16 August 2013



Source: Central Bank of Iceland.

Chart 12
Components of money supply

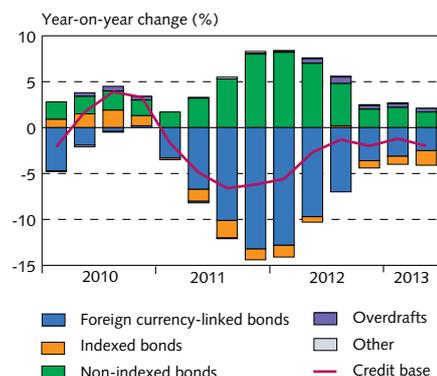
Q1/2010 - Q2/2013



Source: Central Bank of Iceland.

Chart 13
Contribution to growth in lending¹ to households and firms by DMBs, pension funds, and the Housing Financing Fund²

Q1/2010 - Q2/2013



1. Adjusted for estimated effects of price level and exchange rate movements on CPI-indexed and exchange rate-linked loans. Loans of DMBs are assessed at book value. 2. Excluding holding companies.

Source: Central Bank of Iceland.

- Since the *May Monetary Bulletin*, the króna has appreciated by 0.9% in trade-weighted terms. The appreciation is somewhat less than over the same period last year. Furthermore, since May the króna has appreciated by 2.9% against the US dollar but depreciated by 0.7% against the euro. Tourist arrivals in Iceland have increased in number this year; however, the balance on goods trade was negative in Q2, for the first time since the banks failed. The Central Bank also bought foreign currency during the summer months in line, with the foreign exchange intervention strategy announced in May.
- The trade-weighted exchange rate index (TWI) measured 213.9 points in Q2, some ¾ stronger than was projected in the May issue of *Monetary Bulletin*. As in previous Central Bank forecasts, the current forecast is based on the technical assumption that the exchange rate will hold more or less steady at the current level throughout the forecast horizon. If that assumption is borne out, the TWI will be around 215 points for most of the forecast horizon, as was projected in May.
- Total DMB deposits held by residents contracted by 0.9% year-on-year in Q2. In the past year, deposits owned by holding companies and mutual and investment funds have increased, while deposits held by pension funds, firms, and households have contracted.
- Central Bank base money was up 0.9% year-on-year in Q2. Over the same period, M3 contracted by 0.8% but then began to grow year-on-year in June, after a continuous decline dating from the second half of 2012. Narrower measures of the money supply contracted as well, with both M1 and M2 shrinking by nearly 7% year-on-year in Q2.
- The total stock of loans granted by DMBs, pension funds, and the HFF to households and non-holding company firms continued to contract. In Q2, the book value of the exchange rate- and inflation-adjusted credit base shrank by 0.5% between quarters and about 2% year-on-year. The total amount of new mortgage loans from DMBs, the HFF, and pension funds was just over 32 b.kr. in the first six months of the year, slightly less than for the same period in 2012. The total amount of new mortgage lending from the HFF has continued to decline, while the amount of new pension fund loans has increased.
- In the first six months of the year, house prices rose nearly 6% year-on-year, housing market turnover increased, and the average time-to-sale declined slightly. Real house prices rose by about 2% over the same period and are now at the level prevailing in autumn 2004, when the banks entered the mortgage lending market.
- Since the *May Monetary Bulletin* was published, the OMXI main list index has risen by 3.2% and the OMXI6 by 3.9%. Turnover in the first seven months of the year was more than three times last

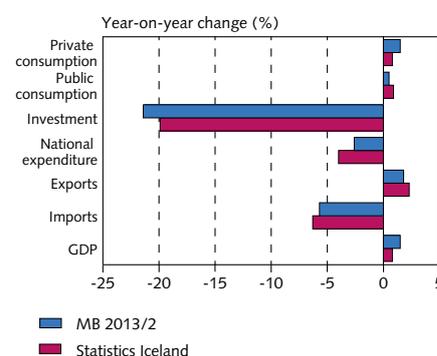
year's seven-month total. Two new firms have been listed on the exchange this year, and others have announced plans for listing in coming months.

- Overall, private sector financial conditions have continued to improve, in part due to rising asset prices. The banks' supply of nominal mortgage loans is now more diverse, and terms have improved since the commercial banks began issuing covered bonds. General lending by the HFF has continued to contract, and the Fund's default ratio for household loans has continued to fall. Firms' post-crisis financial restructuring has continued. Some firms that underwent restructuring received three-year bridge loans on favourable terms, and in some cases their financial capacity may be put to the test when they need to refinance those loans.

The domestic real economy

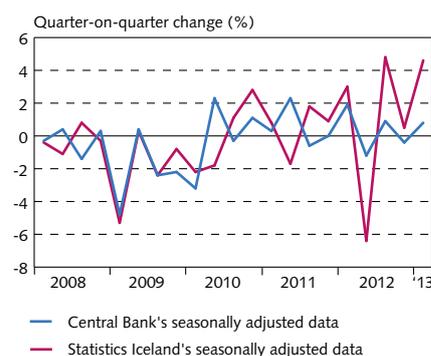
- Statistics Iceland published the Q1/2013 national accounts in June. According to those figures, year-on-year output growth measured 0.8% for the quarter, whereas seasonally adjusted quarter-on-quarter growth measured 4.6%, owing to a surge in inventory changes between quarters. The Central Bank's seasonally adjusted figures indicate much less growth between quarters, or 0.8%, but as is discussed in Box IV-1 in *Monetary Bulletin* 2012/4, Statistics Iceland's seasonally adjusted GDP figures fluctuate much more widely than the Bank's figures do.
- Underlying this GDP growth of just under 1% during the quarter was growth of slightly less than 1% in private and public consumption, in addition to a positive contribution from net trade, with exports growing by 2.3% and imports contracting by 6.3%. Offsetting this, however, total investment contracted by nearly a fifth between years, owing largely to a contraction in business investment, which reflects strong base effects from large-scale investments in ships and aircraft in Q1/2012.
- In comparison with the forecast in the *May Monetary Bulletin*, year-on-year GDP growth for the quarter was somewhat weaker than projected, largely due to a larger-than-expected contraction in inventory changes. Private consumption was weaker than forecast, while public consumption growth was stronger and the contraction in investment less pronounced than previously anticipated. On the whole, consumption and total investment developed in line with the forecast, contracting by 2.7% during the quarter. The contribution from net trade was more positive than in the forecast, as exports grew more strongly and imports contracted less than projected. Consequently, the weaker-than-forecast output growth is due primarily to inventory changes, as is discussed above.
- Seasonally adjusted private consumption contracted by 1.1% between quarters in Q1 but grew by 0.8% year-on-year. This is

Chart 14
National accounts Q1/2013
and Central Bank estimate



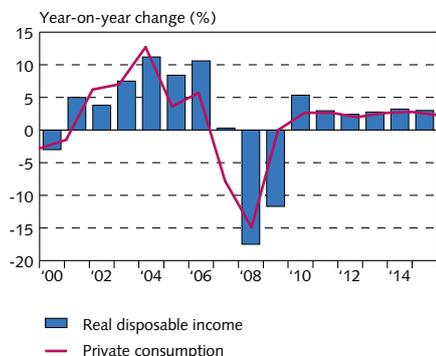
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 15
Quarterly changes of GDP - seasonally
adjusted data of the Central Bank and
Statistics Iceland



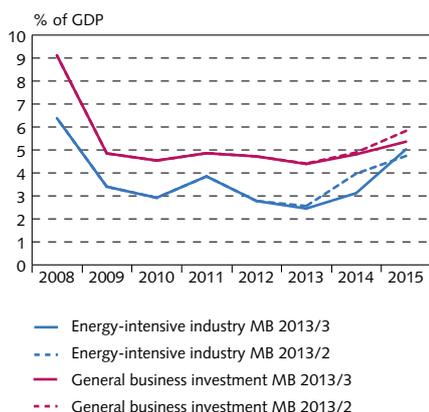
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 16
Private consumption and real disposable income 2000-2015¹



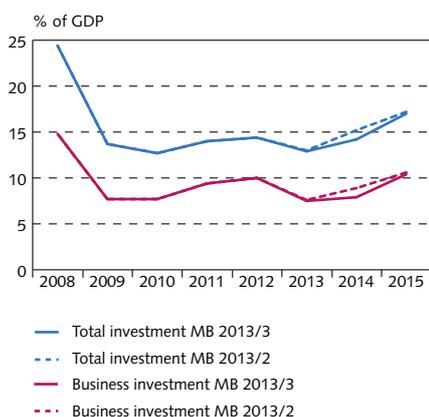
1. Central Bank baseline forecast 2013-2015. Central Bank estimate for real disposable income for 2012.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 17
Investment in energy-intensive industry and general business investment¹ 2008-2015²



1. Business investment, excluding energy-intensive industry, ships and aircraft. 2. Central Bank baseline forecast 2013-2015.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 18
Investment 2008-2015¹



1. Central Bank baseline forecast 2013-2015.
Sources: Statistics Iceland, Central Bank of Iceland.

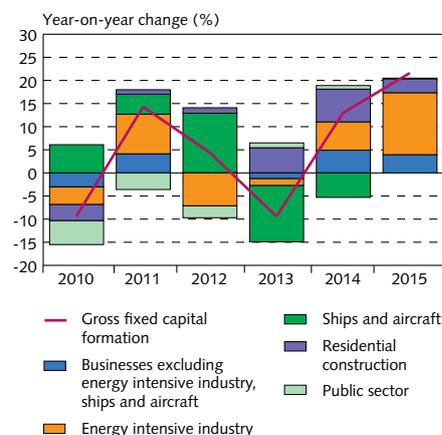
a somewhat weaker outcome than in the Bank's May forecast, which provided for 1.5% growth between years. Leading indicators of developments in private consumption in Q2 suggest that annual growth was modest, although it outpaced the first quarter. The forecast assumes just under 2% growth year-on-year during the quarter, which translates to 1.3% for the first half of the year, other things being equal. This growth reflects relatively slow growth in real wages, the heavy debt service burden faced by many households, and general uncertainty about the economic outlook, among other things. It is still unknown how the new Government intends to implement the household debt relief measures it promised this spring, and that uncertainty probably discourages households from undertaking large-scale consumption expenditures.

- The forecast assumes that real disposable income will rise by an average of just under 3% during the forecast horizon and that net household wealth will rise over the period, due in part to rising house prices and continued reduction of debt. These factors also support household demand, and private consumption is estimated to grow by an average of 2¾% year-on-year in 2014-2015, somewhat slower than was forecast in May. If the forecast materialises, the share of private consumption in GDP will be just over 52%, about 5 percentage points below the 30-year average, at the end of the forecast horizon.
- In 2011 and 2012, the Government's wage costs exceeded budgetary allocations. Government institutions responded by keeping purchases of goods and services virtually unchanged in nominal terms. The Central Bank's last forecast assumed that wage costs would also exceed the assumptions in the 2013 fiscal budget and that goods and services purchases would remain broadly unchanged in nominal terms, as in the two preceding years. The first figures from Statistics Iceland on public consumption growth in Q1/2013 indicate, however, that the premises concerning goods and services purchases will not hold; therefore, this item is now forecast to grow by 1.2% this year and not 0.5%, as in the May forecast. The outlook is also for relatively stronger public consumption growth in the upcoming two years.
- Investment shrank over the course of 2012, and in Q1/2013 it contracted by 4.1% between quarters and nearly 20% between years. Business investment contracted by 5.8% quarter-on-quarter and almost 27% year-on-year in Q1, which largely explains the developments during the quarter. The year-on-year contraction is somewhat smaller than the more than 31% forecast in May.
- Among subcomponents of business investment, investment other than ships, aircraft, and energy-intensive industry grew by over 31% year-on-year, outpacing the forecast by about 2 percentage points. Energy-intensive investment contracted by over 3 percentage points more than projected, however, or 25.4%. Investment

in ships and aircraft was almost 11 percentage points less than forecast, contracting by nearly 76%. Business investment excluding ships and aircraft grew by almost 7%. This figure gives a much clearer view of the contribution of business investment to output growth, as imports related to investments in ships and aircraft are deducted from GDP.

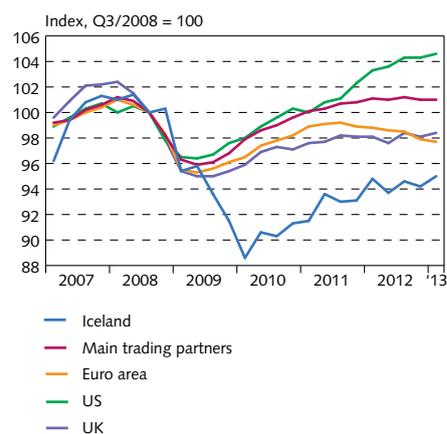
- The forecast assumes that investment related to the energy-intensive sector will contract by almost 8% this year and not 5.3%, as in the last forecast. A more pronounced change from the previous forecast is foreseeable for 2014, as investments related to the expansion of the Straumsvík aluminium smelter will be smaller than previously estimated. It is assumed, however, that energy-intensive investment will grow significantly in the next two years, from 2½% to 5% of GDP by 2015, when the effects of the planned construction at Helgúvík increase markedly. As always, though, these projects are subject to some uncertainty.
- The current forecast is broadly in line with the previous one as regards other business investment. Business investment is forecast to contract by nearly 22% this year, slightly less than was projected in May. It is expected to turn around in the next two years, however, and grow by nearly 10% in 2014 and almost a third in 2015. As in the May forecast, it is assumed that business investment as a share of GDP will measure just over 10% in 2015, whereas the 30-year average is 12%.
- Residential investment is expected to develop broadly in line with the forecast in the last *Monetary Bulletin* throughout the forecast horizon. The forecast is based on Federation of Icelandic Industries estimates of new construction in 2013 and 2014. Figures on cement sales outside the energy-intensive sector in the first half of the year are in line with the Federation's estimates, as it is likely that a large share of the cement sold recently will be used to build new homes. The forecast assumes residential investment will grow by just over a fifth year-on-year, on average, in 2013 and the following two years.
- Public investment projects outlined in the previous Government's investment strategy for 2013-2015 were provided for in the 2013 fiscal budget, and it was assumed that the projects included would be financed with fishing fees, dividends, and asset sales. The new Government has now decided, however, to reduce the fishing fees and has announced plans to abandon some investment projects and postpone or spread out others. As a result, the forecast for public investment has been revised downwards.
- On the whole, it is assumed that investment will contract by about 9½% this year, due mostly to the contraction in investment in ships and aircraft. The main factor offsetting that contraction will be residential investment. For 2014, investment is forecast to grow by 13%, driven by energy-intensive investment, residential investment, and investment apart from ships and aircraft and

Chart 19
Gross fixed capital formation and contributions of its main components 2010-2015¹



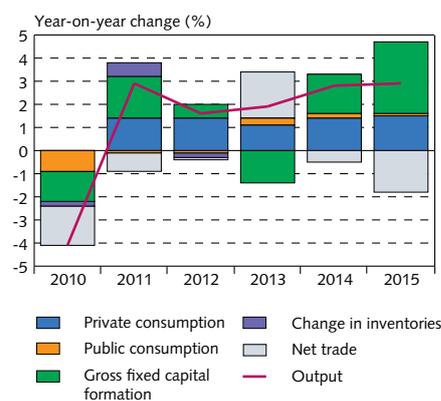
1. Central Bank baseline forecast 2013-2015.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 20
Post-crisis developments in GDP¹



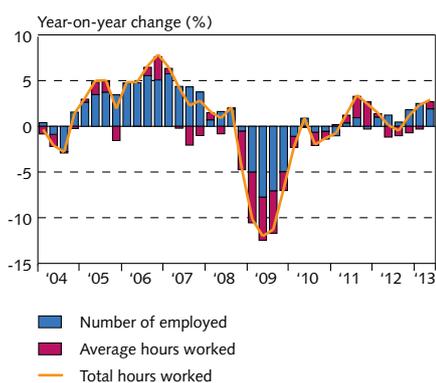
1. GDP data for Iceland are seasonally adjusted by the Central Bank of Iceland.
Sources: OECD, Central Bank of Iceland.

Chart 21
Output growth and contribution of underlying components 2010-2015¹



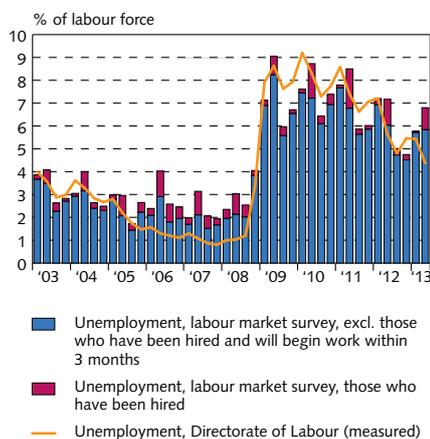
1. Central Bank baseline forecast 2013-2015.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 22
Changes in employment and hours worked
Q1/2004 - Q2/2013



Source: Statistics Iceland.

Chart 23
Different measures of unemployment
Q1/2003 - Q2/2013



Sources: Statistics Iceland, Directorate of Labour.

the energy-intensive sector. Further growth is forecast for 2015, driven by a surge in energy-intensive investment and a significant contribution from residential and other business investment. If this forecast materialises, investment will measure almost 17% of GDP in 2015, slightly less than was forecast in May and a full 3 percentage points below the 30-year average.

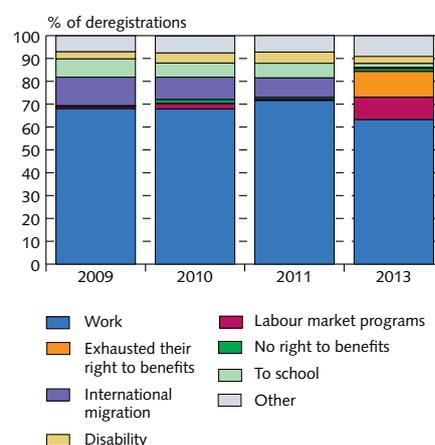
- As is stated above, GDP growth measured 0.8% in Q1 after losing pace slightly from the prior year, as it did in other industrialised countries. GDP had grown by 7.3% from its Q1/2010 trough, which is somewhat more than the average among Iceland's main trading partners. Iceland's recovery is slightly weaker than that in the US but much stronger than in the UK and the euro area.
- It is assumed that GDP contracted by about 1% year-on-year in Q2. This implies that it was virtually unchanged year-on-year in the first half, as compared with 1.8% growth in the latter half of 2012. According to the forecast, GDP growth will pick up in the latter half of the year and measure 1.9% for 2013 as a whole, whereas the May forecast provided for 1.8% for the year.
- For the next two years, it is forecast that GDP will grow in line with increased domestic demand, to just under 3% per year, which is somewhat less than in the May forecast. One of the main reasons for the poorer output growth outlook is the above-mentioned change in the Straumsvík aluminium smelter investment project, which reduces both investment in 2014 and export growth in 2015.
- If the forecast is borne out, year-2015 GDP will be about ½% below the level forecast in May. As before, the largest contribution to output growth will be from private consumption and business investment, which are by far the largest contributors to GDP growth for the period. The contribution from net trade will be negative by 0.5-1.8 percentage points during the period.
- The margin of spare capacity that developed in the wake of the financial crisis is estimated at about 1½% of potential output in 2012 and just under 1% this year. As in the May forecast, it is assumed that this slack will disappear early in 2015.
- Labour market indicators imply stronger growth in economic activity than preliminary statistics do. According to the Statistics Iceland labour market survey, labour demand was significantly stronger in Q2 than in the Bank's May forecast, which provided for a 0.7% year-on-year increase in total hours worked, far less than the actual 2.7%. This is the second quarter in a row to see a much larger rise in total hours worked than was assumed in the Bank's forecast, as previous projections had been revised downwards in view of weak output growth figures. According to this forecast, growth in total hours worked will slow down in the latter half of the year, and growth for the year will measure about 2% instead of the 1% projected in May. The outlook for the coming

two years is more or less unchanged from the May forecast, however.

- Average hours worked grew by 0.8% in Q2, after having contracted steadily for four quarters, and the number of employed persons continued to rise. The increase in the number of employed, which measured 1.9% for the quarter, on the heels of a 2.7% rise in Q1. Total hours worked rose by 3.2% among the full-time employed and fell by 0.9% among part-time workers. As in the past year, both the labour participation rate and the employment rate rose, and the number of persons outside the labour market declined.
- According to Capacent Gallup's May survey of the country's 400 largest firms, labour demand is generally on the rise. For the first time since June 2007, the number of firms across all sectors that are interested in recruiting in the next six months exceeds the number considering redundancies. As in the March survey, the change was greatest among construction companies. In May, about half of firms in the sector were interested in recruiting and about 57% considered themselves understaffed.
- The net migration rate was positive in Q2, for the third quarter in a row. Unlike the previous two quarters, however, when the lion's share of the population increase came from foreign nationals, Icelandic nationals account for nearly a half of the rise.
- Unemployment as measured by the Directorate of Labour (DoL) was 4.4% in Q2 and 4.6% adjusted for seasonality. This is broadly in line with the Bank's May forecast, which provided for 4.4% unemployment during the quarter. Unemployment according to the Statistics Iceland labour market survey was somewhat higher, however, or 6.8%. Excluding those who had become employed, it measured 5.8%, and when adjusted for seasonality it measured 5.5%.
- Seasonally adjusted unemployment has therefore declined by 1.3 percentage points in the past year, according to the DoL, and by 0.4 percentage points according to the Statistics Iceland survey. As expected, the survey-based unemployment rate declined less than the DoL rate because the temporary provision extending entitlement to unemployment benefits from three years to four years expired at the end of 2012.
- DoL figures show that 63% of those who dropped off the unemployment register in the first half of the year had become employed. This is a somewhat lower percentage than in 2009-2011, when it was just under 70%.⁵ A far greater number take advantage of labour market measures now, or 10% instead of the previous average of 1%. Emigration played a negligible part in declining unemployment this year, or 0.4%, as opposed to the 2009-2011 average of around 10%. The percentage of those who

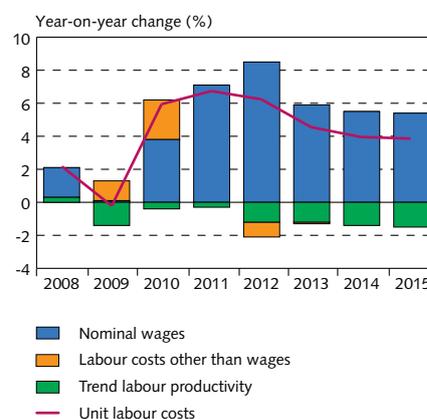
5. Figures from 2009-2011 are for the first quarter. No data are available for 2012.

Chart 24
Reasons for deregistrations of claimants¹



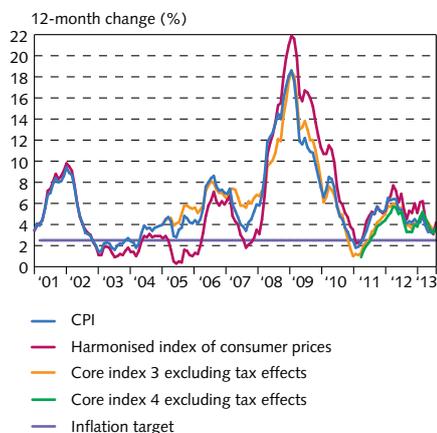
1. Reasons for deregistrations grouped under "other" include mainly pension, vacation and parental leave. The data covers the first quarter of 2009-2011 and the first half of 2013. Data for 2012 is not available.
Source: Directorate of Labour.

Chart 25
Unit labour costs and contributions of underlying components 2008-2015¹



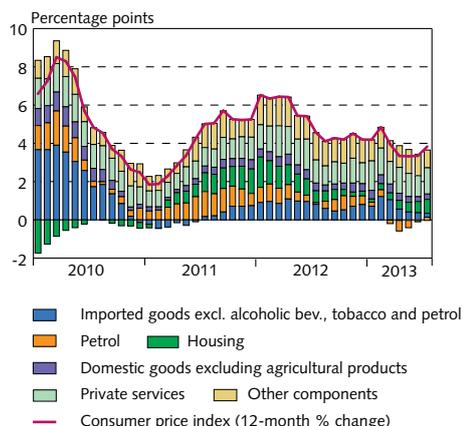
1. Labour productivity growth is shown as a negative contribution to an increase in unit labour costs. Central Bank baseline forecast 2013-2015.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 26
Various inflation measurements¹
January 2001 - July 2013



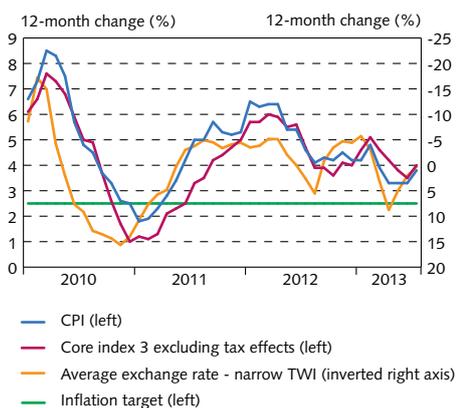
1. Core index 3 is the CPI excluding prices of agricultural products, petrol, public services and real mortgage interest expense. Core index 4 excludes the market price of housing as well.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 27
Components of CPI inflation
Contribution to inflation January 2010 - July 2013



Source: Statistics Iceland.

Chart 28
Inflation, core inflation and the exchange rate of the króna
January 2010 - July 2013



Sources: Statistics Iceland, Central Bank of Iceland.

leave the unemployment register because they are unable to work is broadly in line with the 2009-2011 average, however, or 3-4%.

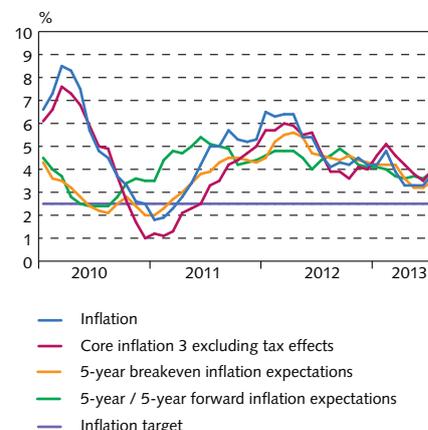
- Registered unemployment is forecast to measure 4.8% in 2013 and decline to 4.3% by 2015, which is similar to the 4.1% provided for in the May forecast.
- Wage developments were in line with the May forecast in Q2. The wage index rose by just under 2% quarter-on-quarter and 5.6% year-on-year. Wage developments have differed from sector to sector over the current wage settlement period. Wages have risen by 16% from Q1/2011 to Q1/2013 according to the Statistics Iceland wage index. Wages in the financial and transport sectors have risen more markedly, while wages in manufacturing, retail and private sector services in general have risen in line with the overall index. Wages in construction and public services have risen by a smaller margin, however.
- The assumptions concerning wage developments have changed little since the last forecast. Productivity growth is expected to be somewhat weaker during the forecast horizon than according to the last *Monetary Bulletin*; therefore, unit labour costs are projected to rise more strongly than in the May forecast, or just over 4.2% per year on average, which is somewhat above what is consistent with the Central Bank's inflation target.

Inflation

- Inflation measured 3.3% in Q2/2013, about 0.1 percentage points below the May forecast. The subcomponents that had the strongest upward impact on the CPI were private services and owner-occupied housing, although they were offset by declining petrol and imported goods prices.
- The CPI fell by 0.3% month-on-month in July, after rising by 0.5% in June and remaining unchanged in May. The decline in July, due largely to sales effects, was offset by owner-occupied housing costs and petrol prices. The cost of owner-occupied housing has risen in the past four months, mostly because of rising market prices. House prices have risen by 5.8% in the past year, the largest twelve-month rise since September 2012, although it is restricted to the greater Reykjavík area.
- Twelve-month inflation measured 3.8% in July, up from 3.3% just before the last *Monetary Bulletin* was published. Some base effects could be discerned in July, however, due to the marked drop in the CPI in July 2012. Core index 3, which excludes the effects of taxes, volatile food items, petrol, public services, and real mortgage interest expense, fell by 0.5% in July from the previous month. Underlying twelve-month inflation according to core index 3 measured 4%, up from 3.5% in June. It had fallen from 4.2% in April, however, and is therefore broadly the same as when the last *Monetary Bulletin* was published.

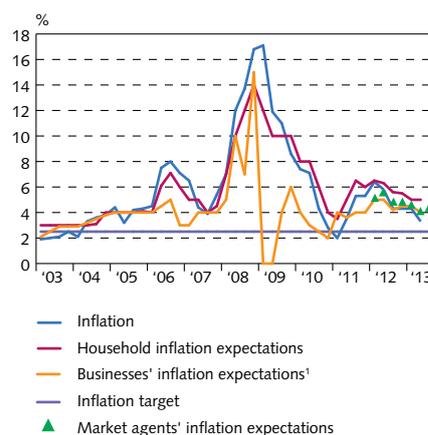
- The breakeven inflation rate measured in terms of the spread between nominal and index-linked bonds has risen since the last *Monetary Bulletin*. The five-year breakeven inflation rate is 3.8% and has risen by 0.6 percentage points since mid-May. The five-year rate five years ahead is just under 4% and has risen by 0.3 percentage points. By this criterion, long-term inflation expectations seem to have risen since May and are still significantly above the Bank's inflation target.
- According to the Capacent Gallup survey carried out in May, households still expect 5% inflation both one and two years ahead, while firms expect 4% inflation in one year, which is a slight drop since the February survey. According to the survey conducted by the Central Bank in mid-August, market agents expect inflation to measure 4.2% one year ahead and 4½% two years ahead, both up from 4% in May. Their long-term inflation expectations remain slightly above 4% and have not changed materially since the May survey.
- It is assumed that inflation in Q3/2013 will be somewhat higher than was forecast in May, or 4% instead of 3.7%, primarily because the CPI declined less than expected between months in July. Furthermore, inflation is projected at just over 4% in Q4/2013, as opposed to 3.7% in the last forecast. It is expected to taper off again early next year and approach the inflation target in the latter half of 2015. Inflation will therefore be somewhat more persistent than in the May forecast, primarily because productivity growth is forecast to be weaker than previously assumed and the rise in unit labour costs correspondingly larger during the forecast horizon. In addition, long-term inflation expectations have risen in the recent term. Inflation is forecast to average about 4% this year and 3% in the next two years.
- As has been discussed previously, inflation expectations have persistently been above the Bank's inflation target. That alone could keep inflation high or slow down disinflation if these expectations are reflected in the demands made in the upcoming wage negotiations and firms' price setting decisions. The exchange rate of the króna has been relatively stable recently, in the wake of Central Bank measures to smooth out exchange rate fluctuations and affect inflation expectations. Somewhat weaker economic activity than was forecast in May should also help to contain inflationary pressures, although the degree to which the spare capacity in the economy will keep inflation in check is always uncertain.
- Chart 31 illustrates the uncertainties in the baseline forecast and the probability distribution of inflation developments. The chart shows the range in which there is considered to be a 50%, 75%, and 90% probability that inflation will lie during the forecast horizon. According to the probability distribution, there is a roughly 50% likelihood that inflation will be between just under 2½% and just under 4% a year from now.

Chart 29
Annual inflation, core inflation and long-term inflation expectations
January 2010 - July 2013



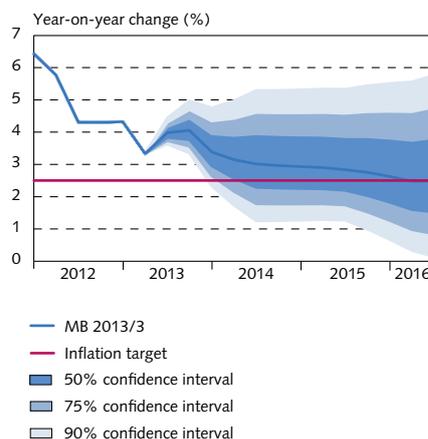
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 30
Inflation and inflation expectations
Q1/2003 - Q3/2013



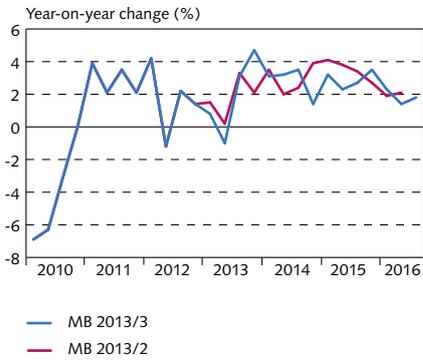
1. Businesses' inflation expectations were measured on an irregular basis before Q3/2006, so until then measurements are interpolated.
Sources: Capacent Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 31
Inflation forecast and confidence intervals



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 32
Output growth - comparison with MB 2013/2



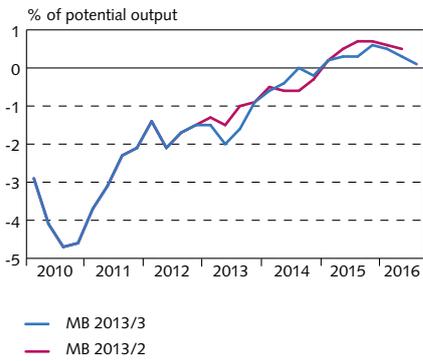
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 33
Seasonally adjusted GDP - comparison with MB 2013/2¹



1. Seasonally adjusted data of the Central Bank.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 34
Output gap - comparison with MB 2013/2



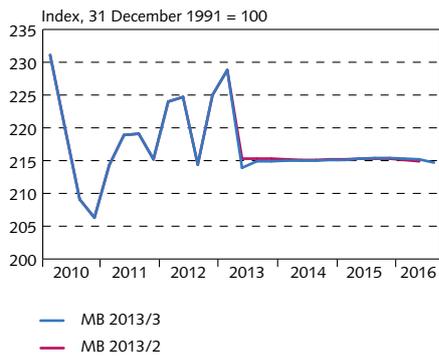
Source: Central Bank of Iceland.

Chart 35
Unemployment - comparison with MB 2013/2



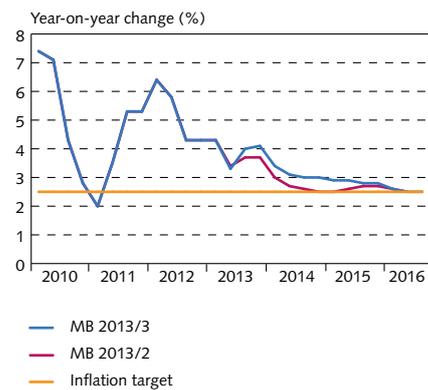
Sources: Directorate of Labour, Central Bank of Iceland.

Chart 36
The ISK exchange rate against trade weighted index - comparison with MB 2013/2



Source: Central Bank of Iceland.

Chart 37
Inflation - comparison with MB 2013/2



Sources: Statistics Iceland, Central Bank of Iceland.

Appendix 1

Baseline macroeconomic and inflation forecast 2013/3

Table 1 Macroeconomic forecast¹

GDP and its main components	B.kr.	Volume change on previous year (%) unless otherwise stated			
		2012	Forecast		
			2012	2013	2014
Private consumption	915.9	2.7 (2.7)	2.0 (2.2)	2.6 (2.9)	2.8 (3.0)
Public consumption	435.8	-0.2 (-0.2)	1.2 (0.5)	0.6 (0.3)	0.5 (0.3)
Gross fixed capital formation	245.8	4.4 (4.4)	-9.4 (-9.2)	13.0 (20.9)	21.6 (17.0)
Business investment	169.9	8.6 (8.6)	-21.6 (-23.0)	9.8 (22.5)	30.9 (22.5)
Residential investment	45.3	6.9 (6.9)	29.2 (29.7)	26.3 (25.6)	10.0 (11.6)
Public investment	30.6	-17.0 (-17.0)	8.5 (17.7)	5.4 (7.5)	1.4 (1.4)
National expenditure	1,600.4	1.9 (1.9)	0.0 (0.0)	3.5 (4.7)	5.0 (4.5)
Exports of goods and services	1,011.0	3.9 (3.9)	4.4 (2.9)	1.8 (1.2)	1.4 (3.3)
Imports of goods and services	903.2	4.8 (4.8)	1.2 (-0.2)	3.0 (4.1)	5.1 (5.2)
Contribution of net trade to growth	-	-0.1 (-0.1)	2.0 (1.8)	-0.5 (-1.4)	-1.8 (-0.8)
Gross domestic product	1,708.2	1.6 (1.6)	1.9 (1.8)	2.8 (3.0)	2.9 (3.5)
<i>Other key figures</i>					
GDP at current prices (in b.kr.)		1,708 (1,708)	1,763 (1,778)	1,855 (1,877)	1,952 (1,996)
Trade account balance (% of GDP)		6.3 (6.3)	6.2 (6.7)	4.8 (4.6)	2.3 (3.3)
Current account balance (% of GDP)		-4.9 (-4.9)	0.3 (-1.5)	-3.0 (-4.5)	-5.3 (-5.5)
Underlying current account balance (% of GDP)		3.0 (3.1)	2.6 (4.1)	-0.3 (0.7)	-2.8 (-0.7)
Terms of trade (change in average year-on-year)		-3.3 (-3.3)	-3.0 (-2.1)	-1.4 (-0.8)	-1.1 (-0.6)
Total gross fixed capital formation (% of GDP)		14.4 (14.4)	12.9 (13.0)	14.2 (15.2)	16.9 (17.2)
Business investment (% of GDP)		9.9 (9.9)	7.5 (7.5)	7.9 (8.9)	10.3 (10.5)
Output gap (% of potential output)		-1.5 (-1.5)	-0.9 (-0.9)	-0.2 (-0.3)	0.6 (0.7)
Unit labour costs (change in average year-on-year) ²		6.3 (6.3)	4.6 (3.9)	4.0 (3.8)	3.9 (3.9)
Real disposable income (change in average year-on-year)		3.0 (3.0)	2.4 (1.3)	2.8 (3.7)	3.2 (3.7)
Unemployment (% of labour force)		5.8 (5.8)	4.8 (4.6)	4.4 (4.2)	4.3 (4.1)
Average exchange rate - narrow TWI (31/12 1991 = 100)		222.0 (222.0)	218.1 (218.7)	215.0 (215.2)	215.3 (215.3)
Inflation (annual average, %)		5.2 (5.2)	3.9 (3.8)	3.1 (2.7)	2.9 (2.6)
Inflation excluding tax effects (annual average, %)		5.0 (5.0)	3.8 (3.6)	3.1 (2.7)	2.9 (2.6)

1. Figures in parentheses are from the forecast in *Monetary Bulletin* 2013/2. 2. Adjusted for calculated revenues and expenses of deposit money banks (DMBs) in winding-up proceedings and the effects of the settlement of their estates. In 2012 adjustment is also made for the effects of the pharmaceuticals company Actavis. 3. Based on underlying productivity.

Table 2 Quarterly inflation forecast (%)¹

Quarter	Inflation (change year-on-year)	Underlying inflation (excl. tax effects) (change year-on-year)	Inflation (annualised quarter-on-quarter change)	
			Measured value	Forecasted value
2012:2	5.8 (5.8)	5.6 (5.6)	8.1 (8.1)	
2012:3	4.3 (4.3)	4.2 (4.2)	-1.0 (-1.0)	
2012:4	4.3 (4.3)	4.1 (4.1)	3.9 (3.9)	
2013:1	4.3 (4.3)	4.2 (4.2)	6.5 (6.5)	
2013:2	3.3 (3.4)	3.2 (3.3)	4.1 (4.5)	
2013:3	4.0 (3.7)	3.8 (3.6)	1.5 (0.1)	
2013:4	4.1 (3.7)	3.9 (3.6)	4.2 (3.8)	
2014:1	3.4 (3.0)	3.4 (3.0)	3.7 (3.8)	
2014:2	3.1 (2.7)	3.1 (2.7)	3.2 (3.1)	
2014:3	3.0 (2.6)	3.0 (2.6)	1.0 (-0.1)	
2014:4	3.0 (2.5)	3.0 (2.5)	4.0 (3.4)	
2015:1	2.9 (2.5)	2.9 (2.5)	3.6 (3.8)	
2015:2	2.9 (2.6)	2.9 (2.6)	3.0 (3.2)	
2015:3	2.8 (2.7)	2.8 (2.7)	0.7 (0.6)	
2015:4	2.8 (2.7)	2.8 (2.7)	3.7 (3.0)	
2016:1	2.6 (2.6)	2.6 (2.6)	3.1 (3.7)	
2016:2	2.5 (2.5)	2.5 (2.5)	2.4 (2.8)	
2016:3	2.5	2.5	0.7	

1. Figures in parentheses are from the forecast in *Monetary Bulletin* 2013/2.