



MONETARY BULLETIN

2019 • 1

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6 February 2019

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 made by the Government of Iceland and Central Bank of Iceland on 27 March 2001, this is defined as aiming at an average rate of inflation, measured as the twelve-month increase in the CPI, of as close to 2½% as possible.

Professional analysis and transparency are prerequisites for credible monetary policy. In publishing *Monetary Bulletin* four times a year, the Central Bank aims to fulfil these principles.

Monetary Bulletin includes a detailed analysis of economic developments and prospects, on which the Monetary Policy Committee's interest rate decisions are based. It also represents a vehicle for the Bank's accountability towards Government authorities and the public.

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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.

Statement of the Monetary Policy Committee

6 February 2019

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The Bank's key interest rate – the rate on seven-day term deposits – will therefore remain 4.5%.

According to the Bank's new macroeconomic forecast, published in the February *Monetary Bulletin*, GDP growth will slow markedly this year, to 1.8%. This is about 1 percentage point less than the Bank projected in November, and if this forecast materialises, it will be Iceland's weakest output growth since 2012. The slowdown in growth is due in particular to a contraction in tourism. Therefore, the outlook is for the positive output gap to narrow faster than previously assumed.

Inflation rose over the course of 2018, measuring 3.7% in December. Weighing heaviest was the rise in import prices, a result of the depreciation of the króna in the autumn. Although inflation eased to 3.4% in January and the króna has appreciated since the MPC's December meeting, the outlook is for inflation to pick up this year and remain above the target until H2/2020.

Market agents' inflation expectations and the breakeven inflation rate in the bond market have fallen since the December meeting. The monetary stance as measured by the Central Bank's real rate has therefore tightened again.

The near-term monetary stance will depend on the interaction between a narrower output gap, wage-setting decisions, and developments in inflation and inflation expectations.

The MPC reiterates that it has both the will and the tools necessary to keep inflation and inflation expectations at target over the long term. This could call for a tighter monetary stance in coming months. Other decisions, particularly those relating to the labour market and fiscal policy, will be important in determining whether that will be the case and will affect the sacrifice cost in terms of lower employment.

Monetary Bulletin 2019/1¹

The outlook for global output growth has deteriorated once again, and trading partner countries' output growth is now expected to be slightly weaker than was forecast in the November *Monetary Bulletin*. Uncertainty has increased as well, and international asset prices have softened. Terms of trade deteriorated more in 2018 than was assumed in November, even though the steep rise in oil prices early in the year reversed towards the year-end. The króna started to appreciate again at the end of last year after a sharp depreciation last autumn, but that appreciation has mostly reversed. Investors appear to be pessimistic about both the economic outlook and the outcome of the wage negotiations currently underway, and domestic short-term real interest rates have fallen.

GDP growth slowed markedly over the course of last year, measuring 2.6% in Q3 but averaging 6.3% in H1. Growth is estimated at 4.3% for the year as a whole, slightly below the November forecast. The outlook is for an even further slowdown in 2019, to only 1.8%, Iceland's weakest output growth rate since 2012 and a steep decline from the November forecast. There are signs that growth in tourism has slowed markedly and that services exports will contract this year, for the first time since 2008. Weaker export growth and the prospect of somewhat slower growth in domestic demand therefore pull in the same direction. As in November, GDP growth for the next two years is expected to be close to 2¾% per year.

Job growth has slowed and firms' recruitment plans indicate that job numbers may fall in H1/2019. There are therefore signs of reduced strain on domestic resources, and the output gap is now expected to have more or less closed in late 2020, earlier than previously forecast.

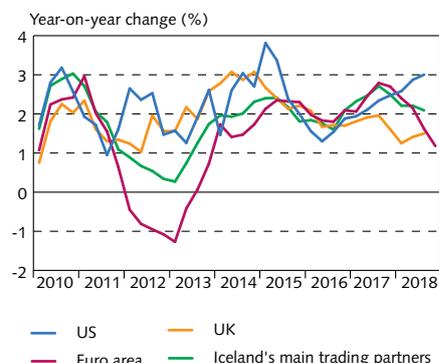
Although the growth rate of output has eased, inflation has risen somewhat in the recent term, measuring 3.4% in January, as opposed to 2.4% a year earlier. The impact of the depreciation of the króna last autumn has added to domestic inflationary pressures stemming from the persistent output gap. Underlying inflation has risen similarly. Long-term inflation expectations have fallen since November, however, although they remain above the target. The outlook is for inflation to keep rising to a peak of 3.8% in Q3 and remain at or above 3% through mid-2020 before falling back to the target again towards the end of that year. As a result, inflation looks set to be higher in 2019 and 2020 than was forecast in November, due primarily to a lower exchange rate than was assumed then, albeit offset by a narrower output gap and lower oil prices.

1. The analysis appearing here is based on the Bank's assessment of economic developments, published in November 2018 in *Monetary Bulletin* 2018/4, and on the updated forecast presented in this report. It is based on data available in early February. The risk assessment of the updated forecast is based on the one in the previous forecast.

The global economy and terms of trade

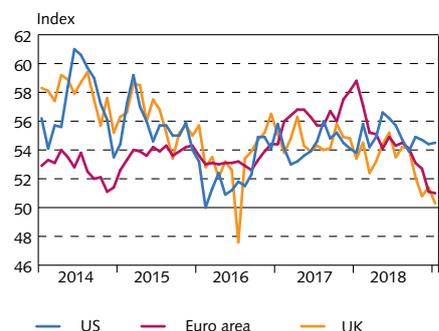
- GDP growth among Iceland's main trading partners measured 2.1% in Q3/2018, below the Bank's November forecast. It turned out weaker than forecast in most trading partner countries and measured only 1.6% in the euro area. This sluggish growth rate partly reflects temporary production problems in the motor vehicle industry, although domestic demand growth also lost pace in some eurozone countries. Furthermore, preliminary data suggest that GDP growth in the region slid even further in Q4, to 1.2%, the weakest seen in five years. In the UK, the slow pace of GDP growth continued in Q3 from previous quarters, whereas in the US growth increased still further, to 3%.
- Leading indicators suggest that the global output growth outlook has worsened relative to the Bank's November forecast. This is particularly the case for the euro area, where key indicators have turned out below expectations, pessimism among households and businesses has risen further, and the composite purchasing managers' index (PMI) has lost additional ground. The GDP growth outlook for the US has also deteriorated slightly, owing to mounting concerns about the trade dispute with China and the effects of the recent partial government shutdown, both of which appear to have begun weighing on sentiment among US households and businesses. For the UK, however, the GDP growth outlook is broadly unchanged in spite of increased uncertainty about how Britain's exit from the EU will play out.
- GDP growth among Iceland's main trading partners is projected to measure 1.9% this year, 0.2 percentage points below the November forecast. This is due mainly to the poorer outlook for the eurozone, but also for the US, Norway, and Sweden. The outlook is for slightly weaker output growth in the next two years as well. The forecast for trading partner imports has also been revised downwards, in line with a poorer output growth outlook and gloomier international forecasts.
- Trading partner inflation rose in 2018, to 2.2% in Q3, following the large increase in oil prices. The rise in oil prices reversed in Q4, however, and inflation has generally eased once again. Headline inflation among Iceland's trading partners is forecast to average 1.8% in 2019, 0.1 percentage points less than was forecast in November, and is expected to be slightly lower in the next two years as well.
- The US Federal Reserve raised its policy rate by 0.25 percentage points in December, to 2.25-2.5%, in line with market expectations. Interest rates were also raised by 0.25 percentage points in Sweden, the first rate hike since July 2011, although the policy rate is still negative by 0.25%. The European Central Bank has kept its key interest rate unchanged but discontinued its net monthly bond purchases at the end of December. Continued

Chart 1
Global GDP growth
Q1/2010 - Q4/2018



Sources: Thomson Reuters, Central Bank of Iceland.

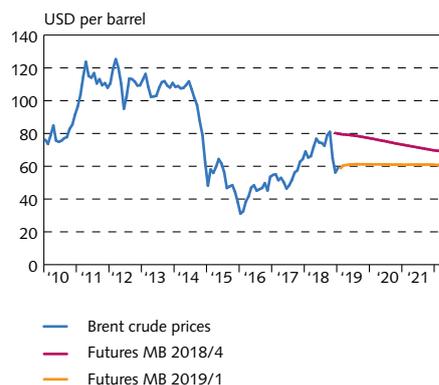
Chart 2
Composite PMI¹
January 2014 - January 2019



1. Markit composite purchasing managers' index. The index is published monthly and is seasonally adjusted. An index value above 50 indicates month-on-month growth, and a value below 50 indicates a contraction.

Source: Thomson Reuters.

Chart 3
Global oil prices
January 2010 - March 2022



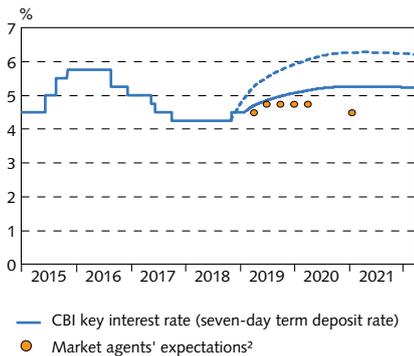
Sources: Thomson Reuters, Central Bank of Iceland.

Chart 4
Terms of trade and real exchange rate¹
Q1/2010 - Q4/2018



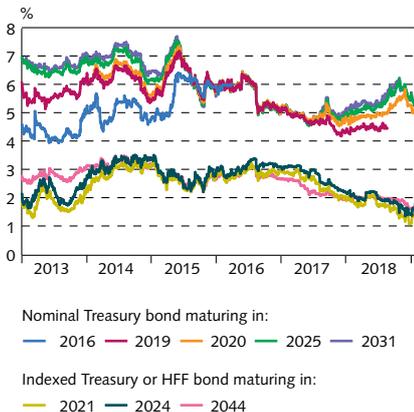
1. Real exchange rate in terms of relative prices. Q4/2018 terms of trade based on Central Bank baseline forecast.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5
Central Bank of Iceland key interest rate and expected developments¹
1 January 2015 - 31 March 2022



1. The Central Bank's key interest rate and Treasury bond yields were used to estimate the yield curve. Broken lines show forward market interest rates prior to MB 2018/4. 2. Estimated from the median response in the Central Bank's survey of market agents' expectations concerning the collateralised lending rate. The survey was carried out during the period 21-23 January 2019.
Source: Central Bank of Iceland.

Chart 6
Nominal and indexed bond yields
2 January 2013 - 1 February 2019



Source: Central Bank of Iceland.

turbulence in global financial markets and increased uncertainty about the global growth outlook have given rise to greater uncertainty about leading central banks' next move.

- Global oil prices have fallen even further since November, erasing the entire rise from the first three quarters of 2018. Increased production is the main driver of the decline, although the bleaker global economic outlook is a factor as well. Futures prices suggest that oil prices will remain just above 60 US dollars per barrel over the forecast horizon, considerably below the November forecast. The price of aluminium and other commodities has also fallen recently, while marine product prices have risen and look set to climb further, both this year and throughout the forecast horizon, due to strong demand and limited supply.
- In spite of the steep drop in oil prices in Q4, terms of trade are estimated to have deteriorated more in 2018 than was forecast in November, owing mainly to a larger-than-expected rise in other import prices. They are expected to improve more in 2019 and the two years following, however, and the outlook for terms of trade over most of the forecast horizon is therefore very similar to that in November.
- The real exchange rate in terms of relative consumer prices held relatively stable early in 2018 but fell markedly during the autumn, following the nominal depreciation of the króna, with the 2018 average down some 3% from 2017. As in November, it is expected to rise slightly over the forecast horizon but still be about 4% below the November forecast by the end of the period.

Monetary policy and domestic financial markets

- The Central Bank Monetary Policy Committee (MPC) decided in November to raise the Bank's key interest rate from 4.25% to 4.5% but kept it unchanged in December. The Bank's real rate is marginally higher than in November, at 0.9% in terms of the average of various measures of inflation and one-year inflation expectations, but down by 0.3 percentage points, to 1.1%, in terms of twelve-month inflation.
- The reduction of the special reserve ratio on capital inflows from 40% to 20% at the beginning of November appears to have had limited impact. In early December, it was announced that a bill of legislation that allows for greater flexibility in the implementation of the special reserve requirement would soon be presented before Parliament.
- According to the Central Bank's January survey, market agents expect the Bank's key rate to be raised to 4.75% in Q2/2019, remain there into 2020, and then begin to fall again. This is slightly below their expectations according to the previous survey. The forward yield curve has also declined since the last *Monetary Bulletin*.

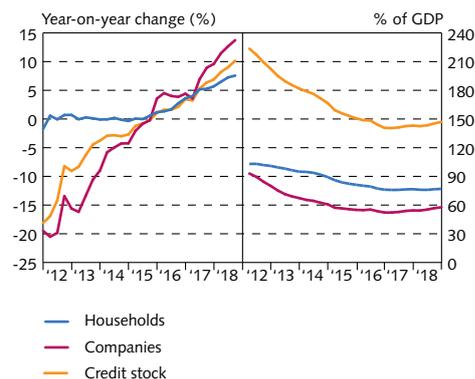
- Yields on the longest nominal Treasury bonds are currently 5.2% and have fallen by about 0.8 percentage points since just before the November *Monetary Bulletin*. Yields on bonds of shorter duration have fallen less, however, and the slope of the yield curve has therefore flattened slightly. At the same time, yields on the longest indexed Treasury and Housing Financing Fund (HFF) bonds measure 1.7% and have declined by 0.2 percentage points.
- The nominal interest rate differential with key trading partners has narrowed in the past two years but has been largely unchanged since November. The real interest rate differential has continued to narrow, however, owing to the decline in the domestic real rate and the rise in real rates abroad. At the same time, risk premia on Treasury foreign obligations have changed very little.
- Net capital outflows excluding Central Bank reserves increased in Q3/2018, to nearly 86 b.kr. Since November, capital inflows for new investment have also slowed and outflows have increased. In Q4, net capital flows for new investment were therefore negative for the first time.
- The exchange rate of the króna began to fall in September 2018, following news of WOW Air's financing difficulties and growing concerns about the economic outlook and the coming wage negotiations. Around the turn of the year, the króna appreciated again, but that gain reversed for the most part at the start of the new year. Investors remain pessimistic about the economic outlook and wage negotiations, and the decline in short-term real interest rates may have had an effect. The trade-weighted exchange rate index now measures about 181 points, broadly the same as at the time of the November *Monetary Bulletin* but about 10% lower than it was a year ago.
- The Central Bank stepped up its intervention in the foreign exchange market in H2/2018. The Bank's objective in intervening is to mitigate excessive short-term exchange rate volatility, but the intervention also reflects the Bank's view that the króna is below its equilibrium rate at a time when inflation is above target. Since the November *Monetary Bulletin*, the Bank has bought foreign currency in the interbank market in the amount of 0.4 b.kr. and sold it in the amount of 5.3 b.kr., or 10% of total foreign exchange market turnover during the period.
- The outlook is for the króna to be weaker in Q1/2019 than was forecast in November. The baseline forecast is based on the assumption that the exchange rate will rise slightly through 2019 and into 2020, and then remain unchanged for the rest of the forecast horizon. This assumes that the króna will be just under 5% weaker over the forecast horizon than was assumed in the November forecast.
- M3 grew by 9% in Q4/2018, the strongest growth rate since the economic recovery began in 2010. As before, growth in M3 stemmed primarily from increased household deposits, although financial and commercial sector deposits have grown as well.

Chart 7
Exchange rate of the króna¹
2 January 2014 - 1 February 2019



1. Price of foreign currency in terms of the króna.
Source: Central Bank of Iceland.

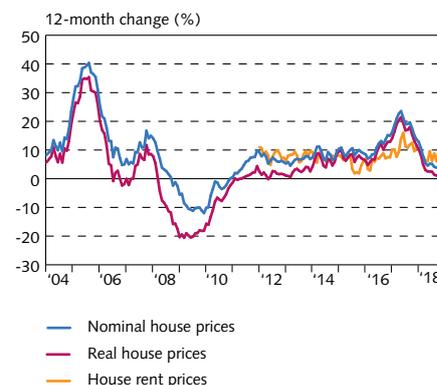
Chart 8
Credit system lending to resident borrowers¹
Q1/2012 - Q4/2018



1. Credit stock adjusted for reclassification and effect of Government debt relief measures. Only loans to pension fund members are included with pension funds. 2. Excluding loans to deposit institutions, failed financial institutions and the Treasury. Q4/2018 figures are Central Bank estimates.

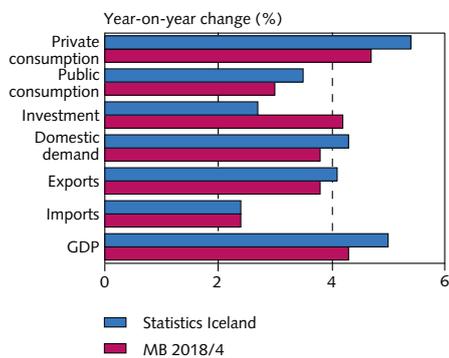
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 9
Capital area house and rent prices
January 2004 - December 2018



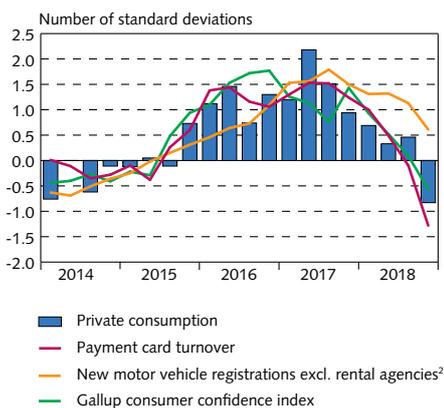
Sources: Statistics Iceland, Registers Iceland.

Chart 10
National accounts for Q1-Q3/2018



Sources: Statistics Iceland, Central Bank of Iceland.

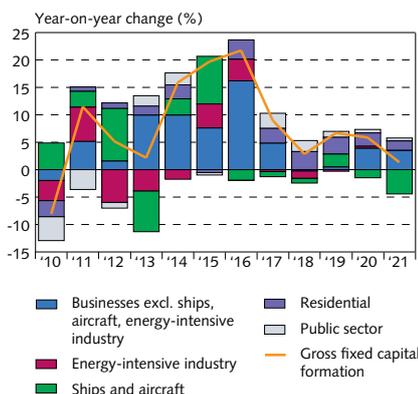
Chart 11
Private consumption and its indicators¹
Q1/2014 - Q4/2018



1. The data are scaled so that their average from 2011 is 0 and the standard deviation is 1. Private consumption and payment card turnover are annual changes, while new motor vehicle registrations and the Gallup Consumer Confidence Index are seasonally adjusted time series. 2. New motor vehicle registrations net of car rental agencies' applications for new registrations in each quarter. The value for Q4/2018 is the average of the values for October and November. Central Bank baseline forecast Q4/2018 for private consumption.

Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 12
Gross fixed capital formation and contribution of main components 2010-2021¹



1. Central Bank baseline forecast 2018-2021.
Sources: Statistics Iceland, Central Bank of Iceland.

- Credit system lending is estimated to have grown by just over 10% year-on-year in Q4/2018, but the credit stock has held broadly unchanged relative to GDP since 2016. Lending to households grew by 7.6% in Q4 and is still gaining pace. Year-on-year growth in corporate lending was stronger, at 13.7%, but because a portion of the loans are in foreign currencies, part of the increase in the credit stock can be attributed to the depreciation of the króna in H2.
- Capital area house prices rose by 5.9% year-on-year in December, and the twelve-month rise in prices has therefore picked up again, after retreating from its May 2017 peak. In real terms, however, the rise was much smaller, or 2.1%. The twelve-month rise in house prices is still less than the increase in rent, however, which measured 7.8% in December. The number of purchase agreements rose 8.4% year-on-year in 2018 but by 20% for new construction. The number of transactions finalised at a premium over asking prices also rose between years, and new home prices rose considerably more than the price of older properties.
- The OMX18 Main List index has risen by 4.8% in 2019 to date and by about 1.2% since the last *Monetary Bulletin*. Equity market turnover contracted by 22% year-on-year in 2018.
- Private sector debt grew by 3.1% quarter-on-quarter in Q3/2018, as well as rising slightly relative to GDP. Even though non-performing loan ratios have continued to fall, corporate insolvencies increased year-on-year in the first eleven months of 2018 and are now at about the level seen in 2016.
- In general, the commercial banks' non-indexed deposit and lending rates have risen in line with the Central Bank's rate hike in November. Pension funds' fixed non-indexed rates have risen by a similar amount, whereas their variable non-indexed rates have risen more strongly.

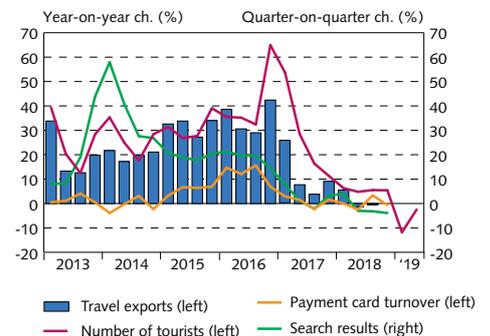
Demand and GDP growth

- According to preliminary figures from Statistics Iceland, GDP growth measured 2.6% in Q3/2018, down from 6.3% in H1. It therefore measured 5% in the first three quarters of the year, as domestic demand grew by 4.3% and the contribution from net trade was positive by 0.9 percentage points. GDP growth was 0.6 percentage points above the November forecast. Final domestic demand developed in line with the forecast, with stronger-than-expected growth in consumption spending and weaker residential investment pulling in opposite directions. The contribution from net trade was also in line with the forecast, whereas the increase in inventories was larger than projected.
- Private consumption grew by 5.3% in Q3/2018, about the same as in H1 but above the November forecast. Despite newly published figures from Statistics Iceland suggesting stronger-than-expected growth in real disposable income in recent years, leading indicators imply a slowdown in private consumption growth in

Q4. For 2018 as a whole, the growth rate is estimated at 4.5%, in line with the November forecast. It is forecast to ease further this year, to 4%, and to average 3% over the next two years.

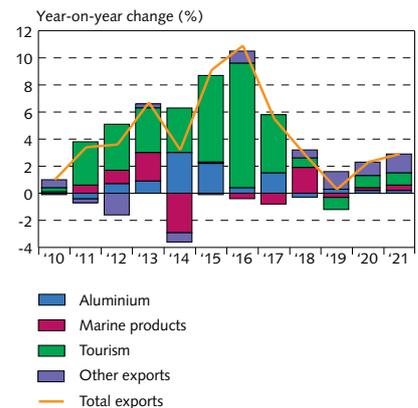
- In the first three quarters of 2018, investment grew by 2.7%, some 1.6 percentage points below the November forecast. Growth in business and public investment somewhat outpaced the forecast, while residential investment growth turned out slower. As a consequence, total investment in 2018 is estimated to have grown rather less than forecast, or by just under 3%. This year, investment is projected to grow by 6.7%, somewhat below the November forecast, but the outlook for the next two years is broadly unchanged.
- The National Budget for 2019 was passed with a surplus of 1% of GDP. This is 0.1 percentage points more than was assumed in the November forecast, which was based on the 2019 fiscal budget proposal presented last September and the fiscal plan approved by Parliament last spring. Treasury revenues have increased significantly during the economic upswing, and a large share of these cyclical revenues have been allocated to increased spending. Primary expenditure is up nearly 9% in comparison with the 2018 National Budget, but the rise in primary income is smaller, at just under 7%.
- Public consumption grew by 3% year-on-year in the first three quarters of 2018, and public investment grew 6%. Government spending is estimated to have increased by 4.9% in 2018, about the same as in the prior year but more than was forecast in November. Even so, the outlook for the forecast horizon is largely unchanged, although the composition of spending growth has somewhat changed from the November forecast, owing to changes in the treatment of research and development expenditure.
- Although growth in goods exports slowed in the first three quarters of 2018, total export growth slightly outpaced the November forecast. This is due in particular to intellectual property exports in the pharmaceuticals industry, which had been expected to take place in Q4. In spite of this, the estimate for 2018 export growth has been revised downwards by 1 percentage point, mainly because growth in tourism in H1 appears to have been weaker than previous Statistics Iceland figures had indicated. Furthermore, growth in goods exports appears to have turned out weaker than was forecast in November, owing to weaker growth in aluminium exports, albeit offset by stronger-than-expected marine product exports.
- The outlook for this year's export growth has also deteriorated. The main factor is the bleaker outlook for tourism, stemming from a contraction in airline services, with available seats to and from Iceland set to decrease markedly as a result of WOW Air's having downsized its fleet of aircraft. The uncertainty about the airline's financing in recent months may also have had a detrimental impact on demand for travel to Iceland, although this is offset

Chart 13
Indicators of tourism sector activity¹
Q1/2013 - Q2/2019



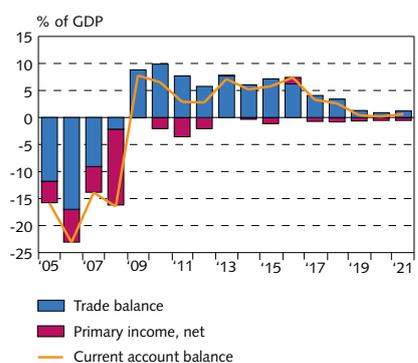
1. Travel exports at constant prices and payment card turnover per tourist in Iceland (excl. transport and public levies) in foreign currency (in terms of the trade weighted exchange rate index). Number of tourists is the number of passenger departures via Keflavik Airport. Isavia forecast for 2019. Search results according to a principal component model combining the frequency of five different Google search strings relating to travel to Iceland (seasonally adjusted, two-quarter moving average). Sources: Centre for Retail Studies, Google Trends, Icelandic Tourist Board, Isavia, Statistics Iceland, Central Bank of Iceland.

Chart 14
Exports and contribution of subcomponents
2010-2021¹



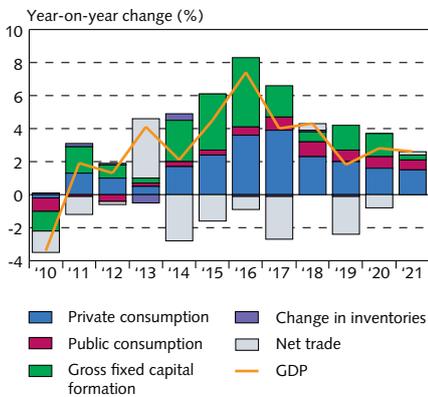
1. Aluminium exports as defined in the national accounts. Tourism is the sum of "travel" and "passenger transport by air". Central Bank baseline forecast 2018-2021. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 15
Current account balance 2005-2021¹



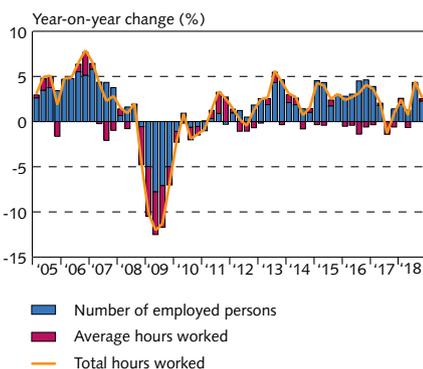
1. Including secondary income. Current account balance excludes the effect of the failed financial institutions (2008-2015) and the pharmaceuticals company Actavis (2009-2012) on primary income. Also adjusted for the failed financial institutions' financial intermediation services indirectly measured (FISIM). Central Bank baseline forecast 2018-2021. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 16
GDP growth and contribution of underlying components 2010-2021¹



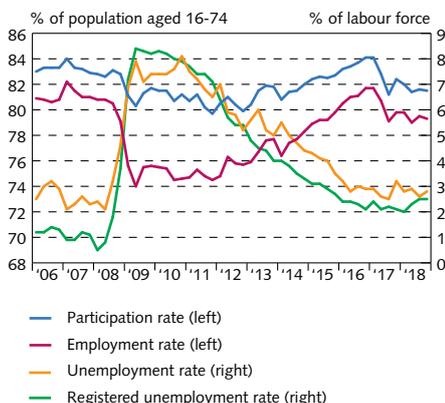
1. Central Bank baseline forecast 2018-2021.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 17
Employment and hours worked¹
Q1/2005 - Q4/2018



1. Quarterly averages of monthly figures.
Source: Statistics Iceland.

Chart 18
Unemployment, employment,
and labour participation¹
Q1/2006 - Q4/2018



1. Seasonally adjusted figures. Registered unemployment rate is seasonally adjusted by the Central Bank.
Sources: Directorate of labour, Statistics Iceland, Central Bank of Iceland.

by the lower exchange rate of the króna. The effect on domestic tourism will probably taper off over time as Icelandair and various foreign carriers increase their flight offerings to compensate. For example, Isavia, which manages Keflavík Airport, assumes a 12% year-on-year drop in tourist arrivals in the first four months of 2019, but a 2.4% decline for the year as a whole. Other indicators, such as online searches for Iceland-bound flights and hotels in Iceland, support this. Offsetting the contraction in services exports is the prospect of stronger growth in goods exports. This is due mainly to the prospect of a smaller contraction in marine product exports and an increase in aluminium exports. Goods and services exports combined are forecast to remain virtually unchanged year-on-year instead of growing by 2.3%, as was projected in November, although the outlook for the next two years is broadly unchanged.

- As was expected in November, imports of goods and services grew by 2.4% in the first three quarters of 2018. Growth in Q4 appears to have been much weaker, though, due to a decline in goods imports. As a result, the estimated growth rate for 2018 as a whole is a full 1 percentage point below the November forecast. Year-2018 import growth excluding ships and aircraft is projected at just under 3%, and the outlook is for a similar growth rate in 2019. As in the November forecast, growth is expected to pick up in the next two years.
- Last year's surplus on goods and services trade is estimated at 3.4% of GDP, slightly below the November forecast, owing in particular to poorer terms of trade. This year, the trade surplus will narrow more quickly than had been forecast, due mainly to the prospect of weaker growth in services exports. It is expected to measure 1.3% of GDP in 2019 and then remain broadly unchanged in the two years thereafter. The current account surplus will develop similarly, shrinking from 2.7% of GDP in 2018 to 0.5% this year and remaining close to that level for the rest of the forecast horizon.
- GDP growth is estimated at 2.4% in Q4/2018 and 4.3% in 2018 as a whole. This is above the 2017 growth rate but slightly below the November forecast. The outlook for 2019 has changed much more, however. GDP growth is now forecast to measure only 1.8% this year, as opposed to the 2.7% projected in November. The main contributor is the sudden turnaround in tourism, followed by a minor downward revision in domestic demand. If this forecast materialises, this year's GDP growth rate will be the slowest since 2012, and well below the 2012-2018 average of nearly 4½%. GDP growth is projected at 2¾% per year in the next two years, well in line with the November forecast.

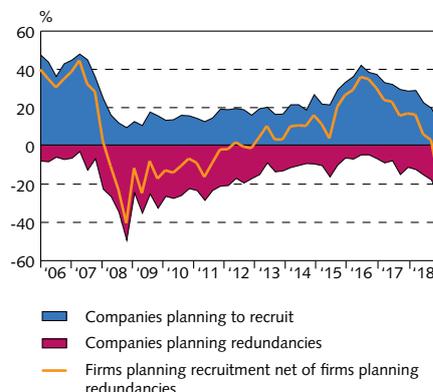
Labour market and factor utilisation

- According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 2.5% year-on-year in Q4/2018, somewhat more than was forecast in November. Job creation

measured 2.3% year-on-year, and the average work week grew slightly longer. Growth in the number of employed persons according to pay-as-you-earn (PAYE) data has continued to ease, after measuring 2.3% year-on-year in Q3/2018.

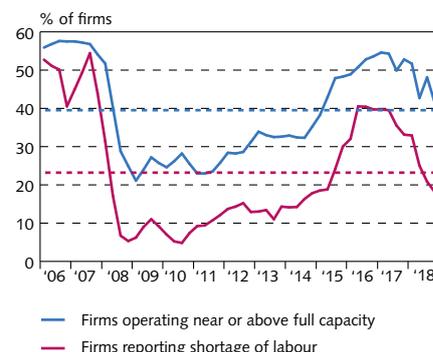
- The labour participation rate fell by nearly 1 percentage point year-on-year in Q4/2018, but the decline in the employment rate was smaller. Seasonally adjusted unemployment measured 2.8% in Q4, slightly more than in Q3 but 0.4 percentage points less than in Q4/2017. Registered unemployment rose by 0.5 percentage points year-on-year in Q4, however. Foreign nationals accounted for about 2/3 of the increase. Because the LFS response ratio among foreign nationals working in Iceland has been on the decline, it could be that the survey fails to capture the turnaround observed in registered unemployment.
- Iceland's foreign labour force is still growing strongly, although labour importation has eased. Net migration of foreign nationals aged 20-59 was positive by 0.4% of the population in Q4/2018, less than in Q3. For the year as a whole, however, the foreign labour force grew by 3.1% of the population, the second-largest calendar-year increase ever measured. Active employees working for temporary employment agencies and foreign services companies accounted for about 0.8-0.9% of the labour force in the first eleven months of 2018 but only 0.7% in December.
- According to Gallup's winter survey among Iceland's 400 largest firms, job numbers could fall in H1/2019. About 12% of respondents were planning to recruit staff, while 30% were planning to downsize, a negative balance of 18 percentage points. This is a large shift from the autumn survey, when the same balance of opinion was slightly positive, and an even greater change from the winter 2017 survey, when it was positive by 17 percentage points. Sentiment among executives is at its most pessimistic since the financial crisis. The balance of opinion was negative in nearly all sectors, particularly among executives in industry and manufacturing.
- According to the Gallup survey, 18% of executives consider themselves short-staffed. This percentage has therefore continued to fall and is now slightly below its historical average. The shortage of workers in the construction industry has shrunk in the last two surveys, with 11% of construction executives now considering themselves understaffed. The number of firms reporting difficulty responding to unexpected demand has also declined, both between surveys and between years. After adjusting for seasonality, 41% of respondents — close to the historical average — consider their firms to be operating at or above full capacity. The RU indicator, which combines a number of indicators of resource utilisation, continued to fall in Q4, at about the same pace as in the two quarters beforehand.
- Total hours worked are expected to increase this year by 1.4%, which is 0.7 percentage points below the November forecast. The outlook is for a similar rise in the next two years. Unemployment

Chart 19
Companies planning to change staffing levels within 6 months¹
Q1/2006 - Q4/2018



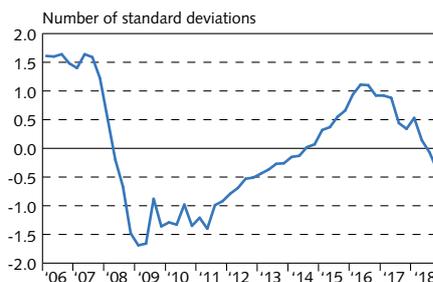
1. Seasonally adjusted figures.
Sources: Gallup, Central Bank of Iceland.

Chart 20
Capacity utilisation¹
Q1/2006 - Q4/2018



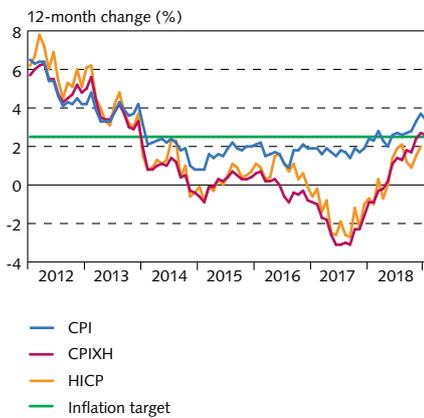
1. Indicators of factor utilisation are from the Gallup Sentiment Survey conducted among Iceland's 400 largest companies. Seasonally adjusted figures. Broken lines show period averages.
Sources: Gallup, Central Bank of Iceland.

Chart 21
RU indicator¹
Q1/2006 - Q4/2018



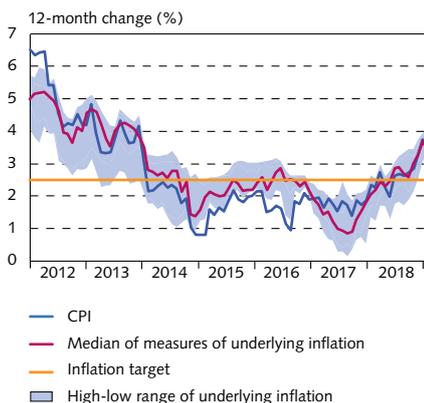
1. The resource utilisation indicator (RU indicator) is the first principal component of selected indicators of factor utilisation; it is scaled so that its mean value is 0 and the standard deviation is 1. A more detailed description can be found in Box 3 in MB 2018/2.
Source: Central Bank of Iceland.

Chart 22
Various measures of inflation
January 2012 - January 2019



Sources: Statistics Iceland, Central Bank of Iceland.

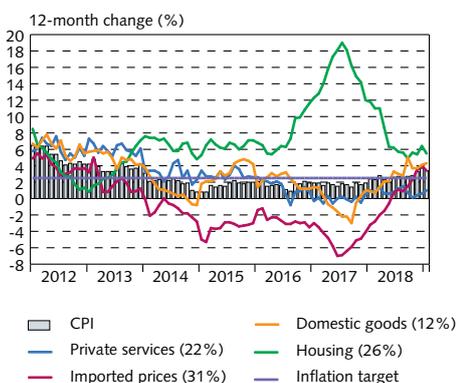
Chart 23
Headline and underlying inflation¹
January 2012 - January 2019



1. Underlying inflation measured using a core index (which excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense) and statistical measures (weighted median, trimmed mean, a dynamic factor model, and a common component of the CPI).

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 24
Imported and domestic inflation¹
January 2012 - January 2019



1. Imported inflation is estimated using imported food and beverages and the price of new motor vehicles and spare parts, petrol, and other imported goods. The figures in parentheses show the current weight of these items in the CPI.

Sources: Statistics Iceland, Central Bank of Iceland.

is likely to be higher this year and throughout the forecast horizon than was forecast in November. It is expected to rise from last year's average of 2.7% to 3.1% this year, and to 3½% by the end of the forecast horizon. In line with developments in the RU indicator and the prospect of weaker GDP growth this year, the output gap is expected to have virtually closed in late 2020, sooner than previously projected.

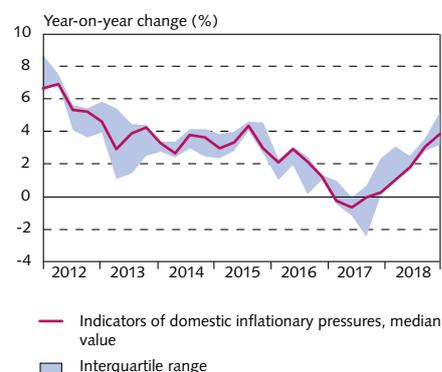
Inflation

- Inflation has risen in recent months, measuring 3.3% in Q4/2018, marginally above the November forecast of 3.2%. Rising imported goods prices following the depreciation of the króna had the greatest impact during the quarter, higher new motor vehicle prices in particular, although owner-occupied housing costs rose as well. Fuel prices declined during the quarter — one of the few components of the CPI to do so — after global oil prices began to fall again in early October. Inflation measured 2.7% in 2018, after four years below the target.
- The CPI fell by 0.41% month-on-month in January. Twelve-month inflation measured 3.4%, an increase of 1 percentage point between years. Winter sales weighed heavily on the January measurement, together with a drop in new motor vehicle prices, offset by a seasonal increase in public services prices. Twelve-month inflation excluding housing measured 2.6% in January and has risen faster than CPI inflation in the recent term. The difference between inflation including and excluding housing is at its narrowest since autumn 2013. Inflation according to the HICP (which also excludes owner-occupied housing costs) measured lower, however, at 2% in December.
- Underlying inflation measured the same as headline inflation in January, or 3.4% according to the median of various measures. It has therefore risen by 1.4 percentage points between years.
- House price inflation slowed markedly last autumn but has since picked up again, with the twelve-month rise in the housing component of the CPI reaching 5.5% in January. The contribution of the housing component to headline inflation has declined significantly in the recent term. In January, nearly half of twelve-month inflation was due to housing.
- Imported goods prices have risen markedly since the November *Monetary Bulletin*, following the roughly 10% depreciation of the króna in the past year. In January, the price of imported goods in the CPI had risen by 3.4% in the previous twelve months, as opposed to 2.3% in October. Higher imported input prices have also shown in rising producer prices of goods sold domestically, which were up 5.2% year-on-year in Q4, the largest increase since summer 2012.
- The wage index rose by 0.9% between quarters in Q4/2018, and by 6.1% year-on-year, in line with the November forecast. Unit labour costs are estimated to have risen slightly more in 2018 than

previously assumed, as productivity growth is estimated to have been weaker than projected. Wage negotiations are currently underway, and the outcome is still unknown. The assumptions in the forecast concerning near-term wage developments have therefore changed little since November. However, the revision of the GDP growth outlook entails the prospect of somewhat weaker productivity growth, and therefore a larger rise in unit labour costs this year than was forecast in November. The increase is projected at just under 6%, about the same as in 2018, but is expected to align with the inflation target by the end of the forecast horizon.

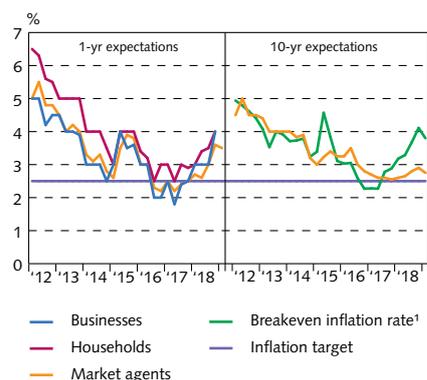
- According to Gallup's winter surveys, households' and businesses' one-year inflation expectations have risen to 4%, which is 0.5-1 percentage point higher than in the autumn surveys. The Central Bank's most recent survey indicates, however, that market agents' one- and two-year inflation expectations have eased since the October survey. Market agents now expect inflation to measure 3.5% one year ahead and 3% two years ahead, which nevertheless is 0.4-0.8 percentage points higher than a year ago.
- Market agents' long-term inflation expectations also fell between surveys, to an average of about 2.8% over the next five and ten years, a 0.2-point decline from the previous survey but a corresponding increase from the survey a year earlier. The long-term breakeven inflation rate in the bond market, which reflects inflation expectations in the market plus a risk premium, has fallen by 0.3 percentage points since Q4/2018 and has averaged 3.8% in Q1/2019 to date. It is still 0.6 percentage points higher than it was a year ago, however. According to Gallup's winter surveys, however, households' and executives' long-term inflation expectations were unchanged between surveys, at 3-3.5%.
- The outlook for 2019 and 2020 is for inflation to exceed the November forecast, due to a weaker króna than was assumed in November. During the forecast horizon, the lower exchange rate and the prospect of both a smaller output gap and lower oil prices will pull against one another. Inflation is projected to measure 3.4% in Q1 and then peak at 3.8% in Q3, 0.4 percentage points above the last forecast. The outlook is for it to remain at or above 3% through mid-2020, then subside gradually as the effects of the lower exchange rate taper off, and close in on the target by the end of 2020.
- The inflation outlook is subject to numerous uncertainties, and changes in important assumptions about domestic and global economic developments could cause inflation to diverge from the path presented here. As is the custom with the Bank's updated forecasts, the risk assessment of the baseline scenario is unchanged from the previous forecast. The probability distribution of inflation is therefore unchanged from November, which implies that there is a 50% probability that inflation will be in the 2-4¼% range in one year and in the 1¼-4% range by the end of the forecast horizon.

Chart 25
Domestic inflationary pressures¹
Q1/2012 - Q4/2018



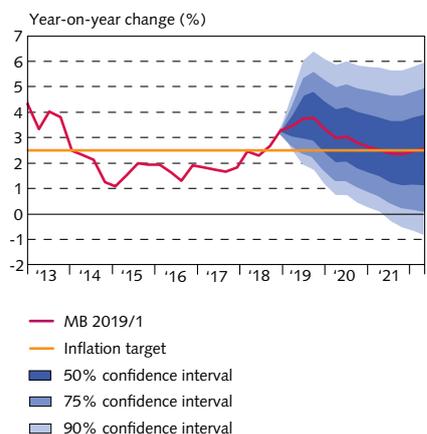
1. The shaded area includes five indicators of domestic inflationary pressures. The indicators are unit labour costs (moving average), the GDP price deflator, prices of private services and domestic goods, and producer prices of goods sold domestically. Central Bank baseline forecast Q4/2018 for the GDP price deflator and for unit labour costs. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 26
Inflation expectations
Q1/2012 - Q1/2019



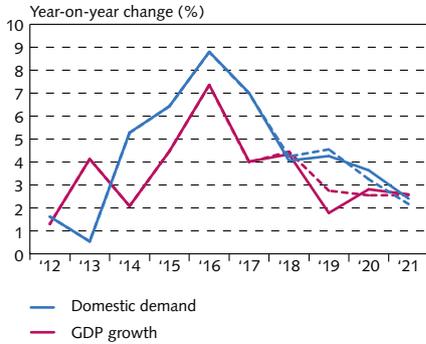
1. The Q1/2019 figure is the average for the quarter to date. Sources: Gallup, Central Bank of Iceland.

Chart 27
Inflation forecast and confidence intervals
Q1/2013 - Q1/2022



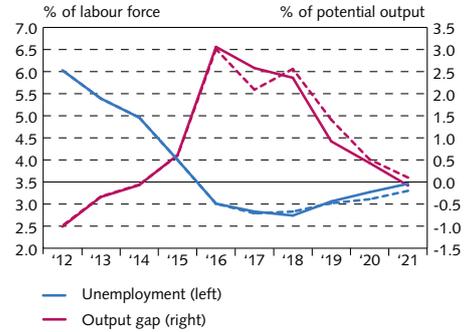
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 28
Domestic demand and GDP growth 2012-2021¹



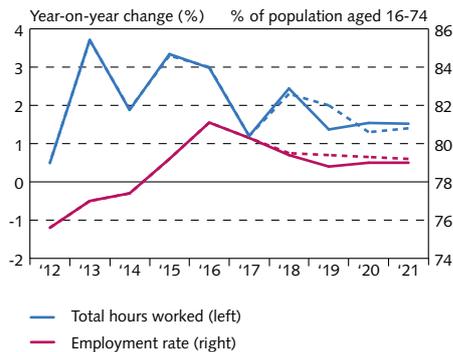
1. Central Bank baseline forecast 2018-2021. Broken lines show forecast from MB 2018/4.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 29
Unemployment and output gap 2012-2021¹



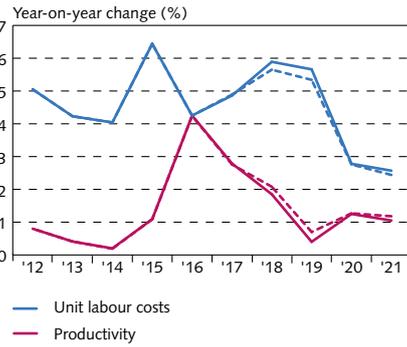
1. Central Bank baseline forecast 2018-2021. Broken lines show forecast from MB 2018/4.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 30
Total hours worked and employment rate 2012-2021¹



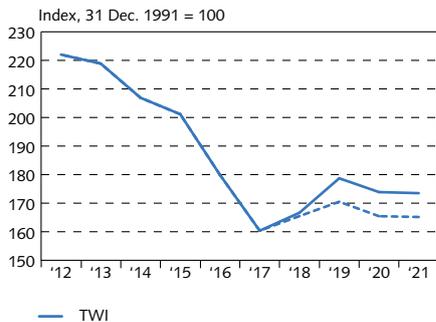
1. Central Bank baseline forecast 2018-2021. Broken lines show forecast from MB 2018/4.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 31
Unit labour costs and productivity 2012-2021¹



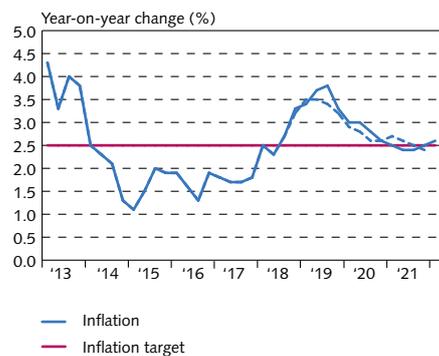
1. Productivity measured as the ratio of GDP to total hours worked. Central Bank baseline forecast 2018-2021. Broken lines show forecast from MB 2018/4.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 32
Exchange rate 2012-2021¹



1. Narrow trade basket. Central Bank baseline forecast 2018-2021. Broken lines show forecast from MB 2018/4.
Source: Central Bank of Iceland.

Chart 33
Inflation¹
Q1/2013 - Q1/2022



1. Central Bank baseline forecast Q1/2019 - Q1/2022. Broken lines show forecast from MB 2018/4.
Sources: Statistics Iceland, Central Bank of Iceland.

Appendix 1

Forecast tables

Table 1 GDP and its main components¹

	2017	2018	2019	2020	2021
Private consumption	7.9 (7.9)	4.5 (4.6)	4.0 (3.9)	3.1 (2.8)	2.9 (2.5)
Public consumption	3.7 (3.1)	3.6 (2.9)	3.0 (2.0)	2.9 (2.1)	2.5 (2.5)
Gross capital formation	9.0 (9.5)	2.9 (5.0)	6.7 (8.5)	5.9 (5.3)	1.4 (1.0)
Business investment	4.8 (4.8)	-3.5 (-3.0)	4.0 (2.7)	4.4 (4.6)	-1.5 (-2.9)
Residential investment	18.4 (18.4)	19.5 (31.4)	15.2 (15.8)	11.2 (10.2)	7.7 (9.2)
Public investment	23.0 (26.9)	14.4 (12.4)	7.0 (22.4)	4.1 (1.3)	3.5 (2.8)
Domestic demand	7.0 (7.0)	4.1 (4.2)	4.3 (4.6)	3.6 (3.2)	2.4 (2.2)
Exports of goods and services	5.5 (5.5)	2.8 (3.9)	0.3 (2.3)	2.3 (2.3)	2.9 (2.9)
Imports of goods and services	12.5 (12.5)	2.0 (3.3)	5.6 (6.2)	4.0 (3.8)	2.5 (2.0)
Gross domestic product (GDP)	4.0 (4.0)	4.3 (4.4)	1.8 (2.7)	2.8 (2.5)	2.6 (2.6)
GDP at current prices (ISK billions)	2,616 (2,615)	2,805 (2,818)	2,969 (2,993)	3,152 (3,150)	3,325 (3,318)
GDP at current prices (growth rate)	4.5 (4.5)	7.2 (7.8)	5.9 (6.2)	6.1 (5.2)	5.5 (5.3)
Total investment (% of GDP)	22.2 (22.3)	22.4 (22.9)	23.6 (24.2)	24.2 (24.5)	23.8 (23.9)
Business investment (% of GDP)	15.3 (15.3)	14.4 (14.4)	14.8 (14.4)	15.0 (14.4)	14.3 (13.5)
Gross national saving (% of GDP) ²	25.5 (25.6)	25.3 (25.7)	24.1 (25.2)	24.4 (25.2)	24.5 (25.3)
Contribution of net trade to GDP growth (percentage points)	-2.6 (-2.6)	0.4 (0.4)	-2.3 (-1.6)	-0.8 (-0.6)	0.2 (0.4)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2018/4). 2. The sum of investment, inventory changes, and the current account balance.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 2 Global economy, external conditions, and exports¹

	2017	2018	2019	2020	2021
Marine production for export	-3.9 (-3.9)	11.3 (10.2)	-1.5 (-3.5)	1.0 (1.0)	2.0 (2.0)
Aluminium production for export ²	4.5 (4.5)	-1.5 (0.0)	1.5 (0.0)	1.0 (1.0)	1.0 (1.0)
Foreign currency prices of marine products	-0.8 (-0.8)	5.0 (5.0)	4.5 (3.0)	3.5 (2.0)	3.5 (2.0)
Aluminium prices in USD ³	20.3 (20.3)	13.9 (15.9)	-6.7 (-0.6)	3.9 (1.7)	3.1 (2.3)
Fuel prices in USD ⁴	24.1 (24.1)	30.6 (37.6)	-13.6 (5.3)	0.1 (-4.4)	-0.7 (-5.0)
Terms of trade for goods and services	1.7 (1.7)	-2.6 (-1.9)	0.5 (-0.1)	0.9 (0.6)	0.5 (0.3)
Inflation in main trading partners ⁵	1.7 (1.7)	1.9 (2.0)	1.8 (1.9)	1.8 (1.9)	1.8 (1.9)
GDP growth in main trading partners ⁵	2.5 (2.4)	2.1 (2.2)	1.9 (2.1)	1.7 (1.8)	1.7 (1.8)
Main trading partners' imports ⁵	3.9 (4.0)	3.3 (3.9)	3.8 (4.2)	3.6 (3.6)	3.3 (3.4)
Policy rates in main trading partners (%) ⁶	0.2 (0.2)	0.5 (0.5)	0.6 (0.6)	0.6 (0.7)	0.7 (0.9)

1. Year-on-year changes (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2018/4). 2. According to Statistics Iceland's external trade data. 3. Forecast based on aluminium futures and analysts' forecasts. 4. Based on average price of Brent crude oil futures during the period 21-25 January 2019. 5. Forecast based on Consensus Forecasts, Global Insight, IMF and OECD. 6. Forecast based on main trading partners' forward policy rates.

Sources: Bloomberg, Consensus Forecasts, Global Insight, IMF, New York Mercantile Exchange, OECD, Statistics Iceland, Thomson Reuters, Central Bank of Iceland.

Table 3 Current account balance and its subcomponents¹

	2017	2018	2019	2020	2021
Trade balance	4.1 (4.1)	3.4 (3.6)	1.3 (1.8)	0.9 (1.4)	1.2 (1.9)
Balance on primary income ²	-0.7 (-0.7)	-0.7 (-0.8)	-0.8 (-0.8)	-0.6 (-0.6)	-0.6 (-0.5)
Current account balance	3.3 (3.3)	2.7 (2.8)	0.5 (1.0)	0.2 (0.7)	0.7 (1.3)

1. % of GDP (figures in parentheses are from the forecast in MB 2018/4). 2. The sum of primary and secondary income.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 4 Labour market and factor utilisation¹

	2017	2018	2019	2020	2021
Unemployment (% of labour force)	2.8 (2.8)	2.7 (2.8)	3.1 (3.0)	3.3 (3.1)	3.5 (3.3)
Employment rate (% of population aged 16-74)	80.3 (80.3)	79.4 (79.5)	78.8 (79.4)	79.0 (79.2)	79.0 (79.2)
Total hours worked	1.2 (1.2)	2.4 (2.3)	1.4 (2.0)	1.5 (1.3)	1.5 (1.4)
Labour productivity ²	2.8 (2.8)	1.9 (2.1)	0.4 (0.7)	1.3 (1.3)	1.0 (1.2)
Unit labour costs ³	4.9 (4.9)	5.9 (5.6)	5.7 (5.3)	2.8 (2.8)	2.6 (2.4)
Wage share (% of gross factor income)	63.1 (63.1)	65.0 (64.7)	66.1 (65.9)	65.8 (66.0)	65.6 (65.8)
Real disposable income	11.5 (7.7)	4.5 (6.5)	4.5 (5.1)	2.1 (2.0)	2.3 (2.1)
Output gap (% of potential output)	2.6 (2.1)	2.4 (2.6)	0.9 (1.4)	0.4 (0.5)	-0.1 (0.1)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2018/4). 2. GDP per total hours worked. 3. Wage costs divided by productivity.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 5 Exchange rate and inflation¹

	2017	2018	2019	2020	2021
Trade-weighted exchange rate index ²	160.3 (160.3)	166.7 (165.5)	178.7 (170.5)	173.9 (165.4)	173.5 (165.2)
Real exchange rate (relative consumer prices) ³	99.8 (99.8)	96.9 (97.5)	91.8 (95.9)	95.4 (99.6)	96.1 (100.4)
Real exchange rate (relative unit labour costs) ³	99.8 (99.6)	99.8 (100.2)	96.5 (100.5)	99.8 (104.0)	100.2 (104.1)
Inflation (consumer price index, CPI)	1.8 (1.8)	2.7 (2.7)	3.6 (3.4)	2.9 (2.7)	2.4 (2.5)
Inflation (CPI excluding effects of indirect taxes)	1.5 (1.5)	2.6 (2.6)	3.5 (3.3)	2.8 (2.6)	2.4 (2.5)

1. Year-on-year (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2018/4). 2. Narrow trade-weighted basket (index, 31 December 1991 = 100). The index has been recalculated so that on 2 January 2009 it was assigned a value equivalent to that of the now-discontinued Exchange Rate Index. 3. Average 2005 = 100.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 6 Quarterly inflation forecast (%)¹

Quarter	Inflation (year-on-year change)	Inflation excluding effects of indirect taxes (year-on-year change)	
		Measured value	Inflation (annualised quarter-on-quarter change)
2018:1	2.5 (2.5)	2.4 (2.4)	2.5 (2.5)
2018:2	2.3 (2.3)	2.2 (2.2)	3.1 (3.1)
2018:3	2.7 (2.7)	2.6 (2.6)	2.6 (2.6)
2018:4	3.3 (3.2)	3.2 (3.1)	4.9 (4.6)
<i>Forecasted value</i>			
2019:1	3.4 (3.5)	3.4 (3.4)	3.2 (3.6)
2019:2	3.7 (3.5)	3.7 (3.4)	4.3 (3.2)
2019:3	3.8 (3.4)	3.7 (3.3)	2.7 (2.3)
2019:4	3.3 (3.2)	3.2 (3.1)	3.2 (3.7)
2020:1	3.0 (2.9)	2.9 (2.8)	1.8 (2.5)
2020:2	3.0 (2.8)	3.0 (2.7)	4.4 (2.6)
2020:3	2.8 (2.6)	2.7 (2.5)	1.7 (1.6)
2020:4	2.6 (2.6)	2.6 (2.5)	2.6 (3.5)
2021:1	2.5 (2.7)	2.4 (2.6)	1.3 (2.9)
2021:2	2.4 (2.6)	2.3 (2.5)	3.9 (2.4)
2021:3	2.4 (2.5)	2.3 (2.4)	1.7 (1.3)
2021:4	2.5 (2.4)	2.4 (2.3)	3.0 (2.9)
2022:1	2.6	2.6	1.7

1. Figures in parentheses are from the forecast in MB 2018/4.

Sources: Statistics Iceland, Central Bank of Iceland.