

## Monetary Bulletin 2020/3<sup>1</sup>

The COVID-19 pandemic and governmental measures to curb the spread of the disease have had a profound impact on the global economy. In Q2/2020, GDP among Iceland's main trading partners is estimated to have contracted by nearly 13%, more than in any single quarter since quarterly measurements were introduced. Indicators imply that global economic activity picked up as the quarter progressed, but the outlook for H2/2020 has deteriorated since the May *Monetary Bulletin* because of the resurgence of the pandemic in many parts of the world.

Domestic economic activity had begun to slow before the pandemic reached Iceland, contracting by just over 1% year-on-year in Q1/2020. The effects of the pandemic started to show towards the end of that quarter and intensified in April. On the other hand, there are signs that domestic demand gained momentum in May and June, when the pandemic eased and public health measures were relaxed. Nevertheless, the outlook is for a nearly 11% year-on-year contraction in GDP in Q2. This is a smaller contraction than was forecast in May, mainly because household consumption spending did not suffer as much as was feared at that time. Although the outlook for H2 is rather poorer than was forecast in May, GDP is expected to contract by 7.1% in 2020 as a whole, instead of the previously projected 8%.

Because economic developments in H1 were more favourable than expected, unemployment has not risen as much as was feared in May, although the Government's part-time unemployment benefits scheme, a lower labour participation rate, and an increase in part-time jobs all played a role in keeping the jobless rate lower than it would have been otherwise. Even so, unemployment is expected to keep rising, peaking at around 10% towards the year-end. As in May, robust GDP growth is projected for 2021, as the economy will be rising from a deep trough and production factors are therefore underutilised. Nevertheless, GDP is not expected to return to the end-2019 level until late in 2023. But the outlook remains extremely uncertain, and developments will depend not least on the success of efforts to quell the pandemic. The Bank's forecast assumes that there will not be a major resurgence of the illness, although the possibility of recurring small-scale outbreaks cannot be ruled out.

Inflation measured 2.5% in Q2 but had risen to 3% by July, probably in large part because the króna is now about 14% weaker than it was a year ago. In spite of the inflation spurt, medium- and long-term inflation expectations have held broadly unchanged. The outlook is for inflation to average about 3% over the remainder of 2020. However, because of the significant slack in the economy and low global inflation, it will taper off in 2021 and is projected to average 2% in the latter half of the forecast horizon. For the first half of the forecast period, this is a higher inflation rate than was projected in May, as inflation is higher at the outset and the slack in the economy is smaller now than previously expected.

1. The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin* 2020/2 in May 2020, and on the updated forecast presented in this report. It is based on data available as of mid-August. The risk analysis in the updated forecast is based on the risk analysis in the May forecast. As was the case in May, owing to the high level of uncertainty about the effects of the COVID-19 pandemic on the economic outlook, the forecast appendix shows fewer economic variables than usual.