

# Monetary Bulletin 2020/2<sup>1</sup>

The global economic outlook seemed to be improving at the beginning of the year but darkened suddenly when the COVID-19 pandemic began to spread within and between countries. Governmental authorities the world over have taken aggressive action in a bid to curb the spread of the disease. Entire regions have been locked down, public gatherings banned, domestic and international travel restricted, and borders closed. These pandemic response measures have caused enormous disruption to the world economy, giving rise to the deepest global peacetime contraction since the Great Depression in the 1930s.

The current crisis is also unique in that it has brought some economic activities to a virtual standstill and profoundly affected the lifestyles of much of the world's population, owing to the curfews and other similar restrictions that have been in place for several weeks. Uncertainty about when economic activity will start to normalise is therefore unusually pronounced, and the future will depend not least on how the pandemic is finally quelled.

In Iceland, as in other countries, the economic outlook has changed radically. Instead of the nearly 1% GDP growth forecast in the February *Monetary Bulletin*, the Bank now expects a contraction of 8% this year, Iceland's steepest single-year contraction in a century. A major factor in this is the prospect of a more than 80% year-on-year decline in tourist visits in 2020. Exports as a whole will therefore contract by nearly one-third, the largest single-year contraction in the history of Iceland's national accounts. Unemployment is set to peak at about 12% in Q3/2020. It is forecast to average almost 9% in 2020 as a whole, which would be the highest unemployment rate ever measured and markedly above its level after the financial crisis a decade ago.

According to the baseline forecast, economic activity will gradually normalise in H2/2020, but tourist visits are not expected to resume to any significant degree until 2021. Because of this year's contraction and the resulting output slack, the outlook is for robust GDP growth in 2021, provided that efforts to subdue the pandemic are successful and the lockdown can be lifted.

Even though the outlook is for robust output growth in 2021 and 2022, the pandemic is set to cause long-lasting damage to the domestic economy. If the forecast materialises, output in 2022 will be about 6% below what was forecast in February, which corresponds to roughly 180 b.kr. The final outcome is highly uncertain, however.

With the recent depreciation of the króna, inflation is expected to be higher in coming months than was forecast in February, although it is still expected to be at or below the Bank's inflation target. Offsetting the lower exchange rate are the plunge in global oil prices and an overall decline in global food and commodity prices, although shortages and various types of production problems have pushed some goods prices upwards. As 2020 progresses, however, the impact of the sizeable slack that has opened up in the economy will carry the day, and inflation is therefore expected to be below 2% in the latter half of the forecast horizon.

1. The analysis presented in this *Monetary Bulletin* is based on data available in mid-May. The COVID-19 pandemic has affected the activities of the Central Bank of Iceland, just as it has affected other firms and institutions. As a consequence, the May 2020 issue of *Monetary Bulletin* is being published in a different and more condensed format than usual. Owing to the high level of uncertainty about the effects of the pandemic on the economic outlook, the forecast appendix also shows fewer economic variables than usual.