

Monetary Bulletin in a nutshell



Global economic activity rebounded strongly in Q3/2020, after COVID-19 infection rates began to fall, but then softened again in Q4, when case numbers started to rise once more. Despite a weakening outlook for Q1/2021, a robust recovery is expected among Iceland's main trading partners as the year progresses and widespread vaccination is achieved.



In Iceland, GDP grew more strongly in Q3/2020 than had been forecast in the November *Monetary Bulletin*. Nevertheless, it was still 10.4% lower than in Q3/2019. Statistics Iceland's revision of GDP growth figures for H1/2020 resulted in a larger year-on-year contraction than had been assumed in November. Indicators imply that GDP continued to grow in Q4 and that it contracted by 7.7% in 2020 as a whole, as opposed to the 8.5% contraction forecast in November. The outlook for 2021 has also improved somewhat, with a poorer outlook for exports offset by more favourable prospects for domestic demand. GDP growth is forecast to measure 2.5% in 2021 as a whole and then rise to 5.1% in 2022 before easing back to 4.1% in 2023.



Job numbers have fallen steeply since the pandemic struck. Registered unemployment excluding persons on the partial unemployment programme measured nearly 11% in December, up by 6.4 percentage points year-on-year. According to the baseline forecast, unemployment will begin to ease in mid-2021 but will be above pre-pandemic levels throughout the forecast horizon. The slack in output that opened up in the wake of the pandemic peaked in H2/2020 and is not expected to close until very late in the forecast horizon.



Inflation rose in H2/2020 and averaged 3.6% in Q4. It rose further in January, to 4.3%, partly because of unfavourable base effects from the prior year. This is the first time since December 2013 that inflation has breached the upper deviation threshold of the inflation target. In spite of this, it appears that the exchange rate pass-through from the depreciation of the króna has begun to ease and that inflation will decline rapidly in the near future, as there is a sizeable slack in the economy. Furthermore, inflation expectations have remained relatively stable. Inflation is expected to ease back to the inflation target in Q4/2021 and fall briefly below it in 2022.



To a large extent, economic developments will depend on how successful efforts to control the pandemic prove to be, both in Iceland and elsewhere. Vaccinations began in late 2020 and, as in the Bank's November forecast, it is assumed that a majority of the population in Iceland and trading partner countries will be vaccinated by mid-year. The forecast also assumes that the current public health restrictions at the border will remain in effect broadly unchanged until then. All of these assumptions are highly uncertain, however, as the pandemic has been spreading strongly in many areas and new mutations have appeared. Furthermore, vaccine distribution has been erratic in some places, and there is some uncertainty about participation levels among the general public. As a result, the economic outlook as presented in the baseline forecast could prove to be overly optimistic. On the other hand, the recovery could be swifter and stronger if efforts to control the pandemic are more successful.

The analysis appearing here is based on the Bank's assessment of economic developments, published in November 2020 in *Monetary Bulletin* 2020/4, and on the updated forecast presented here. It is based on data available at the end of January. The risk assessment in the updated forecast is based on the risk assessment in the November forecast. 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.