

CENTRAL BANK OF ICELAND



2023 | 1

# MONETARY BULLETIN

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 one of its main objectives. 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 12-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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# Statement of the Monetary Policy Committee 8 February 2023

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.5 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 6.5%.

Headline inflation gained pace in January, reaching 9.9%, while underlying inflation remained flat at 7%. Although the housing market has begun to cool and global inflation has eased slightly, inflationary pressures are still pronounced and price increases widespread.

The inflation outlook has worsened since the MPC's last meeting, and although inflation has most likely peaked, bringing it back to target will take longer than previously anticipated. The deterioration in the outlook stems in particular from the recently finalised private sector wage agreements, which entail considerably larger pay rises than previously assumed. Furthermore, the króna has depreciated, and the outlook is for a larger positive output gap during the forecast horizon. Added to this is the prospect of a more accommodative fiscal stance than was provided for in the Bank's November forecast, even though the fiscal deficit will narrow this year. Long-term inflation expectations are still well above target, and the Bank's real rate has declined since the MPC's last meeting.

According to the Bank's new macroeconomic forecast, year-2022 GDP growth measured 7.1%, far above the November forecast and, if the forecast materialises, the strongest GDP growth rate since 2007. GDP growth is set to weaken in 2023 but the labour market is expected to remain tight, however.

The MPC considers it likely that the monetary stance will have to be tightened even further in coming term so as to ensure that inflation eases back to target within an acceptable time frame.

**Symbols:**

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

**Icelandic letters:**

ð/Ð (pronounced like th in English this)

þ/Þ (pronounced like th in English think)

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

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# Monetary Bulletin in a nutshell



Although pessimism about the global economy has receded, the GDP growth outlook for advanced economies remains poor. GDP in trading partner countries is expected to be only 0.6% this year, far below the average in recent decades. Global inflation is still high, although it has subsided from its 2022 peak. Bringing inflation back to target is expected to take some time, as underlying inflation remains high as well.



In Iceland, GDP growth measured 7.4% over the first nine months of 2022, outpacing the Bank's November forecast. To a large degree, the deviation reflects Statistics Iceland's upward revision of H1 GDP growth from 6.8% to 7.5%. Although leading indicators suggest that GDP growth eased in Q4, the growth rate for 2022 as a whole has been revised upwards from 5.6% to 7.1% – the fastest calendar-year growth rate since 2007, if the forecast materialises. GDP growth is still expected to lose pace in 2023. It is estimated at 2.6%, slightly below the November forecast. The outlook for the forecast horizon as a whole has also deteriorated marginally.



Total hours worked increased strongly in Q4/2022, after declining in Q3. The labour participation rate rose as well, and unemployment fell marginally. Other indicators from the labour market suggest a continued labour shortage, but newly finalised wage agreements could cut into growth in labour demand. Unemployment is expected to inch upwards and capacity utilisation to ease during the forecast horizon.



Inflation continued to rise in January, measuring 9.9%. Excluding housing, it measured 8.3%, its highest since May 2010. Underlying inflation measured 7%, however, as in December. Long-term inflation expectations are broadly unchanged and remain well above the inflation target. The recently concluded private sector wage agreements entail considerably larger pay rises than had been assumed in the Bank's November forecast. Furthermore, the króna is weaker than was projected in November. The inflation outlook has therefore deteriorated once again. Inflation is projected to average 9.5% in Q1/2023, which is 1 percentage point above the November forecast but in line with the August forecast. It is still considered to have peaked but is now expected to ease considerably more slowly than was forecast in November: it is assumed to exceed 5% throughout this year, remain above 4% until H2/2024, and only fall below 3% a year after that.



As before, the economic outlook is highly uncertain. The global economic situation will depend in large part on developments in the war in Ukraine, which unavoidably affects Iceland as well. Added to this is pronounced uncertainty about developments in the wake of the newly landed wage agreements, which provide for hefty pay rises at a time of little or no productivity growth, worsening terms of trade, a weakening currency, and a weaker anchoring of inflation expectations. Under such conditions, it is possible that the falling exchange rate and rising wages will push inflation higher than it has been in the past decade. Moreover, not all wage agreements have been finalised, and wage inflation could therefore turn out higher than is currently anticipated. Similarly, if the wage agreements expiring a year from now are renewed on terms similar to those recently negotiated, wages could rise by more in the latter half of the forecast horizon than is provided for in the baseline forecast.

The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin* 2022/4 in November 2022, and on the updated forecast presented here. It is based on data available in early February. The risk assessment in the updated forecast is based on the risk assessment in the November forecast.

# Economic developments and updated forecast

## The global economy

Among Iceland's main trading partners, GDP grew by 0.5% quarter-on-quarter in Q3/2022, the same as in Q2 but above the Bank's November forecast. Growth appears to have slowed markedly in Q4, and the outlook is for a small contraction in Q1/2023.



The GDP growth outlook for trading partner countries continues to be poor for the year as a whole, owing largely to the effects of high inflation and worsening financial conditions on private sector demand. In Europe, high energy prices and uncertainty about energy supplies for the winter have a dampening effect on economic activity, and in China, the near-term outlook has deteriorated in tandem with the surge in COVID-19 cases over the past few months. In spite of the COVID outbreak, the Chinese authorities have eased public health measures, setting the stage for a sharp increase in economic activity when case numbers subside again. The COVID outbreak in China has caused a resumption of manufacturing bottlenecks, but strain on global supply chains is less pronounced now than in the past two years, and shipping costs are approaching their pre-pandemic level.

The employment situation in trading partner countries remains favourable, however, and many households still have savings accumulated during the pandemic and could tap them if necessary. Moreover, fiscal measures have cushioned against the impact of

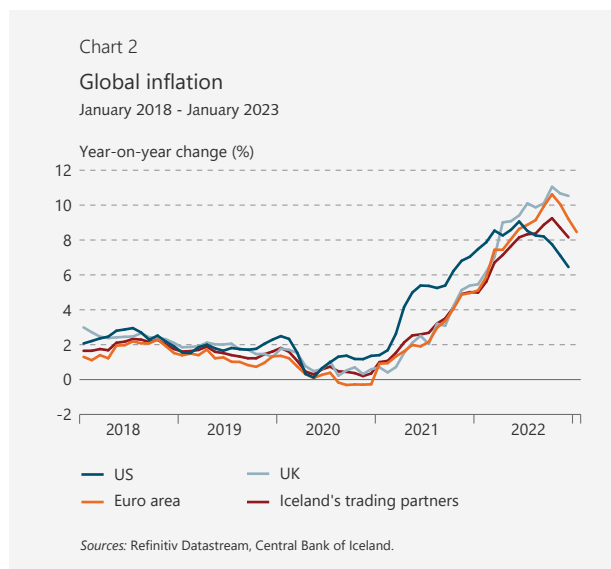
rising living costs on domestic demand. Uncertainty about wintertime energy supplies in Europe has abated as well, and energy prices have subsided due to unusually mild weather, increased energy saving, sizeable inventories, and increased importation of natural gas from suppliers other than Russia. There is still a risk of natural gas shortages in Europe, however, particularly in winter 2023-2024.

As a result, the global economic outlook remains highly uncertain, and as before, developments will depend to a large degree on how the war in Ukraine evolves. Economic developments will also depend on inflation and the effects of worldwide cost-of-living increases on economic activity.

According to the Bank's baseline forecast, GDP growth among Iceland's main trading partners will measure 0.6% this year. This is in line with the Bank's November forecast but only about half of the growth rate projected in August. Trading partner GDP growth is expected to rise to 1.4% in 2024, about 0.2 percentage points below the November forecast.

## Global inflation

Trading partner inflation has risen steeply since mid-2021. Although it is still high, it appears to have peaked, and in most trading partner countries, particularly the US, it has already begun to ease in line with the fall in energy prices.



Underlying inflation has risen still further in the majority of trading partner countries, however, and food prices continue to climb. This is the main reason the inflation outlook is largely unchanged relative to the November forecast. Pulling in the other direction, however, are oil and natural gas prices, which have fallen more than was projected in November.

Trading partner inflation is expected to average 5.1% in 2023, or 0.1 percentage points above the November forecast. For 2024 it is forecast at 2.3%, which is also slightly above the last forecast. If the current forecast materialises, average trading partner inflation will have fallen to just over 3% by late 2023 and to 2% by H2/2024.

## Global interest rates

In spite of the poor GDP growth outlook, central banks in major advanced economies have tightened their monetary stance in order to ensure that inflation eases back to target within an acceptable time frame. They have slowed the pace of interest rate hikes recently, however, after last year's historically large and rapid increases.

In line with leading central banks' forward guidance, market agents expect continued policy rate increases in the next few months, as inflation is high and labour markets tight. Yields on long-term US Treasury bonds have tapered off since the November *Monetary Bulletin*, however, although yields have risen in other major advanced economies.

## Terms of trade

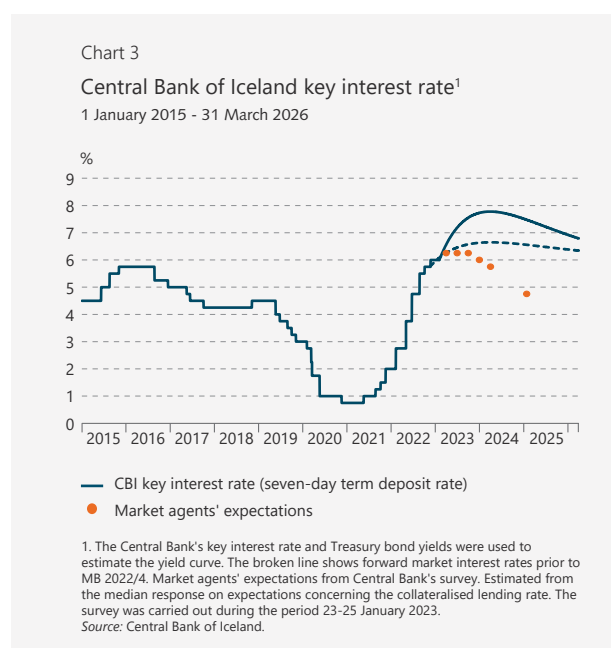
Terms of trade for goods and services are estimated to have improved by 1.4% in 2022, compared to 2.3% in the November forecast. The deviation from the forecast is due to a larger-than-expected increase in import prices. Prospects for 2023 are largely unchanged, with terms of trade projected to deteriorate by 4%, owing to lower marine and aluminium product prices and a continued increase in the price of imported goods. Terms of trade are expected to deteriorate further in 2024-2025.

## Domestic interest rates

The Central Bank Monetary Policy Committee (MPC) decided to raise interest rates at all of its meetings in 2022, bringing the Bank's key rate from 2% at the beginning of the year to 6% by the year-end. The

Bank's real rate started to rise in H2/2022 and is now -0.7%, based on the average real rate as calculated from various measures of inflation and one-year inflation expectations. According to the Bank's January market expectations survey, respondents expect interest rates to rise slightly higher and then begin to fall in late 2023. Forward interest rates suggest, however, that rates are expected to rise further and that they will not start to ease until next year.

The yield on ten-year nominal Treasury bonds was 6.4% just before this *Monetary Bulletin* was published, after rising steadily since mid-2020. A large share of the increase in long-term nominal rates is due to a higher breakeven inflation rate, which has nevertheless declined since H1/2022, after inflation-indexed rates began to rise. Last year's rapid rise in short-term rates caused the nominal yield curve to invert, and two-year yields are now higher than ten-year yields.



## Exchange rate of the króna

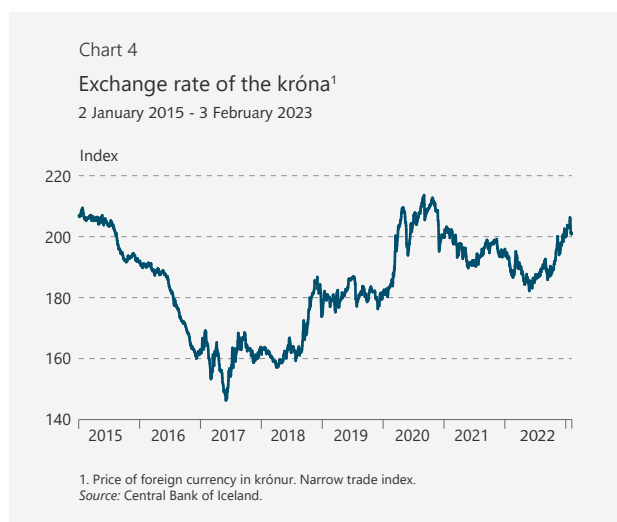
The exchange rate of the króna has fallen by 3% in trade-weighted terms since the November *Monetary Bulletin* and is now 6% lower than it was a year ago. This is the lowest average exchange rate since February 2021.

The past few months' depreciation of the króna probably reflects the deficit on goods trade and Icelanders' more frequent overseas travel. Furthermore, the short-term interest rate differential with abroad has narrowed with last year's rapid rise in global interest rates. The pension funds' foreign currency purchases and declining forward FX sales have also put downward



pressure on the króna, although it has been offset by currency transactions related to inward foreign direct investment and inflows into the domestic equity securities market.

The average exchange rate has been just over 5% lower in Q1/2023 to date than the Bank projected in November. According to the baseline forecast, the króna will strengthen slightly during the latter half of the forecast horizon, although at the end of the period it will still be more than 4% weaker than was assumed in November.

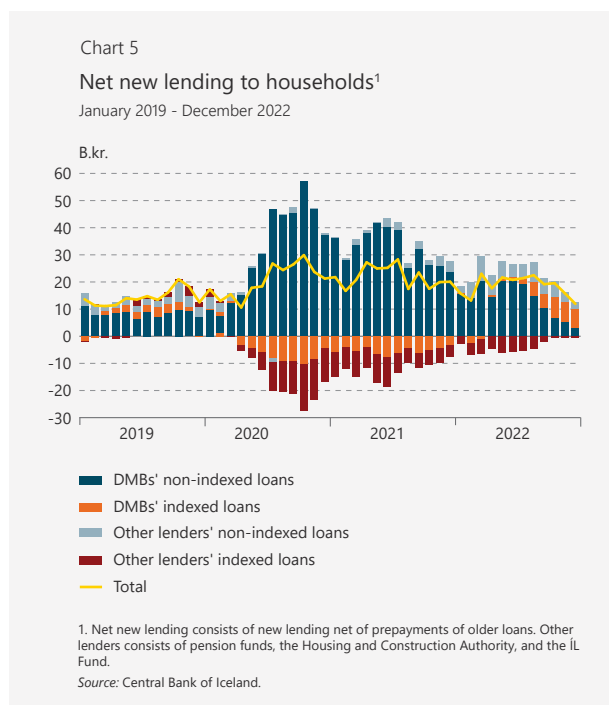


## Money holdings and lending

Year-on-year growth in M3 eased slightly over the course of 2022 and averaged 9½% in H2. Growth in corporate deposits gained pace in tandem with increased economic activity during the year, while growth in household deposits remained broadly unchanged.

Credit system lending to the corporate sector has picked up noticeably, with year-on-year growth measuring just over 11% in Q4/2022. Lending to nearly all sectors increased, although growth is strongest in lending to construction and services companies. Lending to households remained virtually flat at around 10% year-on-year throughout 2022. Towards the end of the year, new lending tapered off in tandem with reduced real estate market activity, and the year-on-year growth rate is therefore likely to ease in the coming term. The pension funds' share of year-on-year growth has increased while the banks' share has decreased, and demand for inflation-indexed loans has grown in response to the surge in non-indexed lending rates.

Interest rates on non-indexed mortgages and rates on corporate loans have continued to rise in tandem with the increase in the Central Bank's key rate.



## Asset prices

In December 2022, house prices in greater Reykjavík were up 17.4% year-on-year, a full 8 percentage points less than the peak increase in July. Higher interest rates and tighter borrower-based measures appear to have begun to tamp down on demand for housing, as new lending has diminished, housing market turnover is down, and the share of first-time buyers has fallen. Furthermore, the supply of properties in the capital area has more than trebled since bottoming out in February 2022, and the average time-to-sale has grown longer. The baseline forecast therefore assumes that year-on-year house price inflation will fall swiftly in the

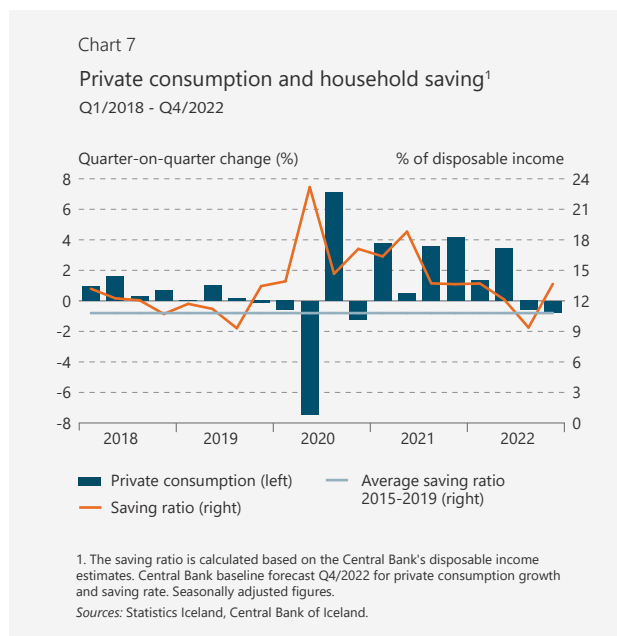


coming term and that real house prices will decline throughout the forecast horizon.

The OMXI10 share price index fell by over a fourth year-on-year in 2022. Although share prices have risen somewhat in 2023 to date, the index is still roughly 3% lower than at the time of the November *Monetary Bulletin*.

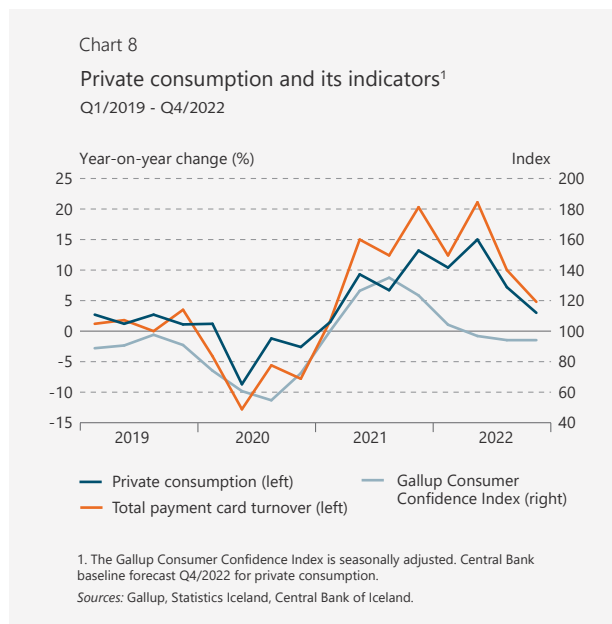
## Private consumption

Seasonally adjusted household consumption spending contracted by 0.6% quarter-on-quarter in Q3/2022. At the same time, households cut back on saving, reflecting the growing impact of inflation and tighter financial conditions on household finances. Private consumption grew 7.2% between years, whereas the Bank's November forecast assumed a growth rate of 5.7%. The difference is smaller, however, for the first nine months of the year, when private consumption grew 10.9% year-on-year and the forecasted growth rate was 9.5%. The deviation from the forecast is due largely to the fact that households' consumption spending turned out stronger in H1 than had been indicated by previously published figures from Statistics Iceland.



Household spending remained strong in Q4, although indicators suggest that year-on-year private consumption growth lost pace during the quarter. Owing to more robust growth in the first nine months of the year plus indications of stronger growth in real disposable income in 2022 as a whole, private consumption is now estimated to have increased consider-

ably more than was forecast in November. Households' large-scale payment card use overseas in Q4 points in the same direction. Households' consumption spending is projected to have increased by 8.7% in 2022 as a whole instead of the 7.1% assumed in the Bank's November forecast.



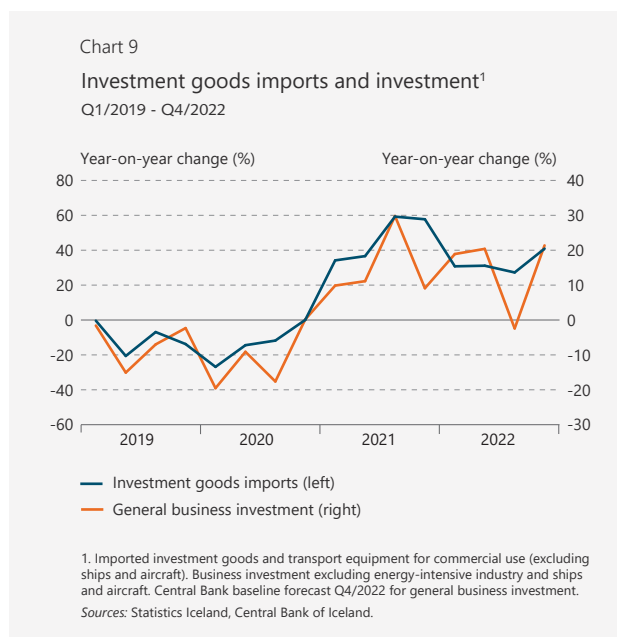
Households have grown more pessimistic as inflation and debt service burdens have increased. Because of this, combined with negative base effects from strong private consumption growth for much of 2022, year-on-year growth in private consumption will continue to lose momentum. Pulling in the opposite direction are indications of a more favourable employment situation than was assumed in November. Private consumption is projected to grow by 2.5% this year, marginally below the November forecast. The outlook is also for slightly slower growth in household consumption in the next two years.

## Investment

In the first three quarters of 2022, investment grew by 5.2% year-on-year, about 1 percentage point less than in the November forecast. Business investment turned out weaker than previously assumed, while public investment was stronger.

General business investment (i.e., excluding energy-intensive industry, ships, and aircraft) contracted by 2.4% between years in Q3, whereas the November forecast assumed an increase of 15.5%. The difference is due in part to the State's purchase of the newly constructed north building at Austurbakki from

Landsbankinn, which was previously assumed to take place in Q4. The State's purchase entails a transfer of 6 b.kr. from the business sector to the public sector, but it has no impact on total investment.



Imports of investment goods continued apace in Q4, and general business investment is estimated to have grown by over a fifth year-on-year during the quarter and by 14% in 2022 as a whole. This is below the November forecast but more in line with the average of previous years. Total investment is therefore projected to have grown by 3.8% in 2022, nearly 2 percentage points below the November forecast. The outlook is for more rapid growth in investment throughout the forecast horizon, however, which mainly reflects increased investment activity in the energy-intensive sector.

## Public sector finances

The National Budget for 2023 was approved by Parliament with a deficit of 3% of GDP. If the assumptions in the Budget are borne out, the fiscal deficit will shrink in 2023, even though the deficit in the Budget as passed is larger by 0.7 percentage points of GDP than that in the fiscal budget proposal presented in September 2022. By the same token, the primary deficit in the Budget is larger than that in the budget proposal, which entails a more accommodative fiscal stance than was provided for in the Bank's November forecast.

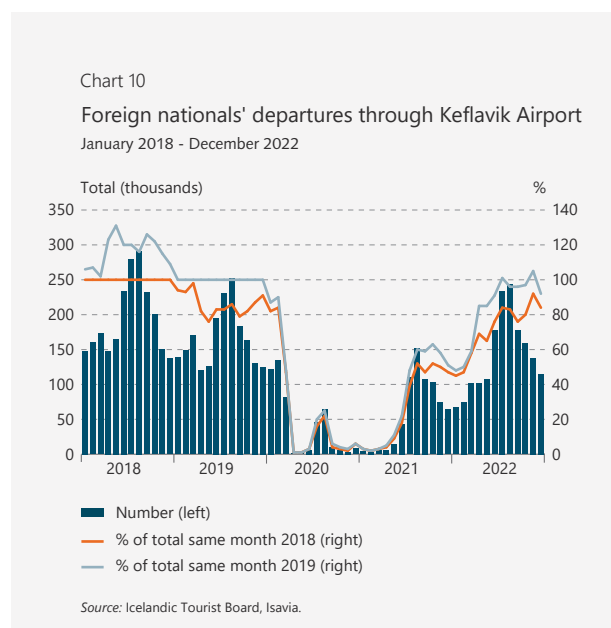
Public sector demand is estimated to have increased by 0.8% in 2022, whereas the November forecast assumed that it would remain flat between years. In large part, this reflects increased public invest-

ment during the year. According to the Budget, the outlook is for stronger public consumption growth and weaker investment growth than was forecast in November. Public sector demand will therefore grow by 0.8% in 2023, about the same as in the November forecast. As was assumed then, public sector demand is projected to grow by just under 2% per year in the latter half of the forecast horizon.

## Exports of goods and services

Total exports grew by 22.9% year-on-year in Q3/2022, largely because of the continued recovery of tourism. Tourist numbers grew rapidly alongside increased flight offerings during the quarter. In H2, tourist arrivals were on a par with H2/2019 but a scant one-fifth below the total for H2/2018. Tourist arrivals in 2022 as a whole totalled 1.7 million, as was forecast in November. On the other hand, indicators imply that pharmaceuticals companies' intellectual property revenues for Q4 were well in excess of estimates. As a consequence, services exports are projected to have grown by 56% in 2022 as a whole, well above the November forecast of 46%. Goods exports developed in line with the previous forecast, however. Total exports are estimated to have grown by 22.6% in 2022, or 4.2 percentage points more than was forecast in November.

The outlook for tourism in 2023 has improved since November, owing to the prospect of a greater supply of flights than was previously anticipated. Demand for travel appears to be buoyant despite the strong contraction in purchasing power in trading partner countries, and Google searches for flights to

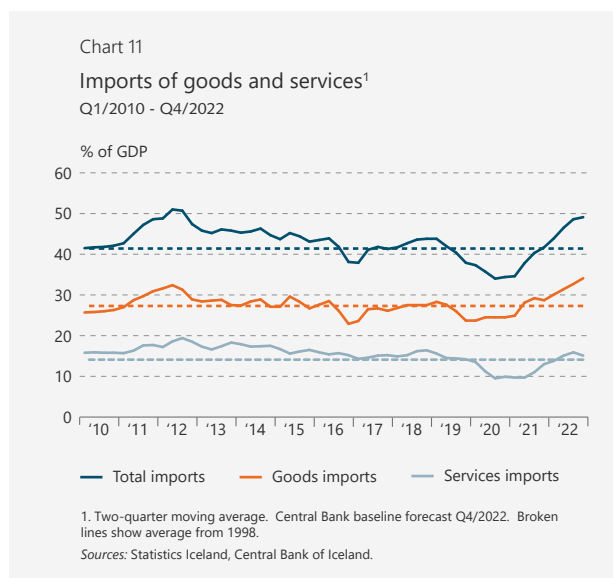


Iceland and accommodation in the country seem to have increased at the beginning of the year. Over 2 million tourists are projected to visit Iceland in 2023, and a record number of cruise ships are expected. As before, these estimates are quite uncertain, owing to the poor global economic outlook; however, with the recent relaxation of public health measures in China, the number of Chinese visitors could grow rapidly in the coming term. Offsetting the brighter prospects for tourism are negative base effects from last year's jump in intellectual property leasing.

A small contraction in goods exports is still expected as a result of reduced catch quotas in the fishing industry. Total exports are projected to increase by nearly 3%, broadly as was assumed in November. The outlook for 2024 and 2025 is also largely unchanged: tourist numbers are projected to increase modestly between years, in line with global tourism forecasts, and other goods exports are expected to grow somewhat.

## Imports of goods and services

Goods and services imports increased by 18% in Q3, over 1 percentage point more than was forecast in November. The outlook for Q4 has changed markedly, however, and imports are now projected to have grown by 18.4% in 2022 as a whole instead of the previously forecast 16.5%. Services imports have apparently developed in line with the November forecast, while goods imports were far stronger, particularly imports of investment goods and fuels. Goods imports have surged in the recent term, and in H2/2022, their value relative to GDP was at its highest since 2006.

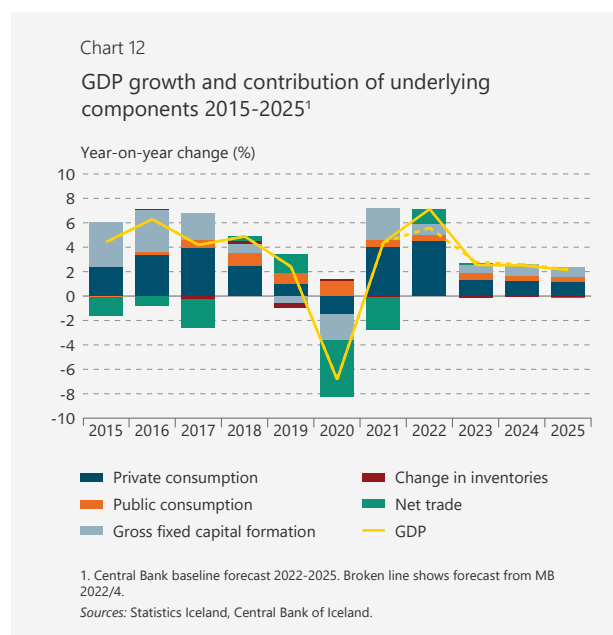


## Current account balance

In Q3/2022, the current account balance was positive by 2.3% of GDP. This is a slightly smaller surplus than was projected in November, owing to a larger deficit on the primary income balance, which in turn was due mainly to stronger-than-expected aluminium company profits. For 2022 as a whole, the current account is estimated to have shown a deficit of 1.6% of GDP, or 0.5 percentage points smaller than was forecast in November. This reflects a larger surplus on services trade – due to intellectual property revenues – and a larger deficit on goods trade. The same pattern will hold this year, with a larger surplus on services trade because of the improved outlook for tourism and a larger deficit on goods trade than was previously envisioned. The current account deficit for the year as a whole is projected at 2.4%, broadly as was forecast in November. As in November, the deficit is expected to widen throughout the forecast horizon.

## GDP growth

GDP growth measured 7.3% year-on-year in Q3/2022. For the first nine months of the year it measured 7.4%, some 1.2 percentage points above the Bank's November forecast. To a large degree, the deviation reflects Statistics Iceland's upward revision of H1 GDP growth from 6.8% to 7.5%.



It appears that domestic demand growth in Q4 outpaced the forecast as well, largely because of stronger-than-expected private consumption and a more positive contribution from net trade. Year-on-

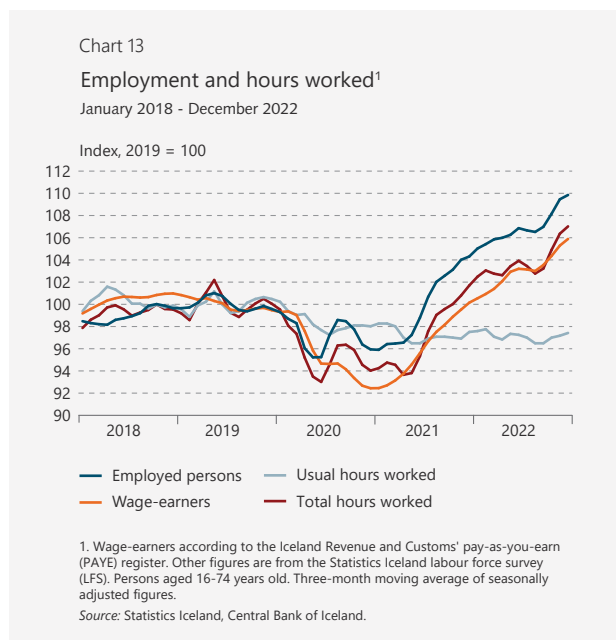
year GDP growth is estimated at 6.3% for Q4, well above the November forecast of 4%. Because of stronger private consumption and more favourable net trade, GDP growth for 2022 as a whole is projected at 7.1%, or 1.5 percentage points above the previous forecast. This would be the fastest calendar-year growth rate since 2007.

As was assumed in November, growth is expected to ease in 2023. For the year as a whole, it is projected at 2.6%, or 0.2 percentage points less than was forecast in November. The outlook for the forecast horizon as a whole has deteriorated, mainly because of the prospect of weaker private consumption growth and less favourable net trade, which will be offset in part by investment, particularly in the energy-intensive sector.

## Employment and unemployment

According to the Statistics Iceland labour force survey (LFS), seasonally adjusted total hours worked grew by 3.7% quarter-on-quarter and 5.9% year-on-year in Q4/2022. This is a far larger increase than was provided for in the Bank's November forecast, which assumed that total hours would decline marginally after a contraction in Q3. Developments in Q4 can be attributed to job growth, which in turn is due to increasing population growth and a steep rise in labour participation. Data from the pay-as-you-earn (PAYE) register indicate a similar increase in job numbers.

The LFS indicates that seasonally adjusted unemployment measured 3.7% in Q4, a slight decline relative to Q3, whereas registered unemployment was even lower, at 3.4%.

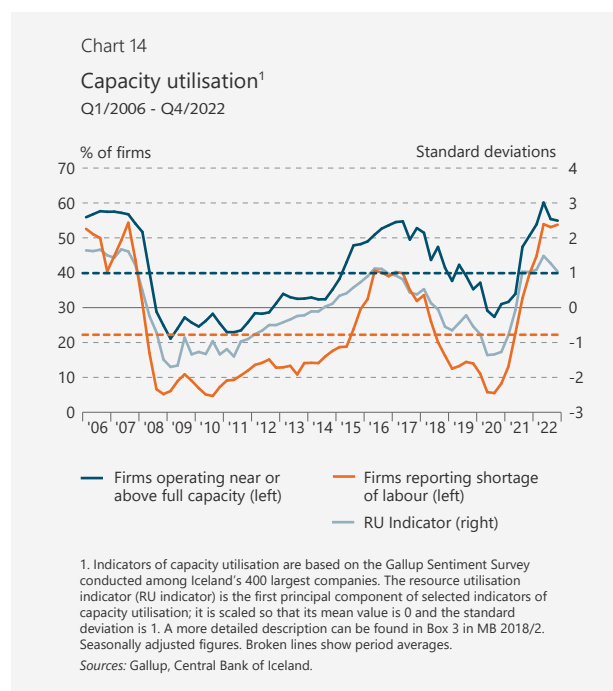


The results of Gallup's winter survey suggest that firms' interest in recruiting workers remains strong. For the most part, however, the survey was carried out before the first private sector wage agreements were renewed, and the significant cost increases entailed in those contracts could cut into demand for labour in the near future. The baseline forecast therefore assumes that total hours worked will ease more quickly over the forecast horizon and that unemployment will rise more than was projected in November. Unemployment according to the LFS is expected to measure 4% in 2023 and rise to 4.6% by the end of the forecast horizon. Registered unemployment is expected to follow a similar pattern.

## Resource utilisation

According to the seasonally adjusted results of Gallup's winter survey, 54% of corporate executives – still a historical high – considered themselves short-staffed. A comparable share of respondents reported that their firms would have difficulty responding to an unexpected increase in demand. The resource utilisation (RU) indicator, which combines various indicators of factor utilisation, declined for the second quarter in a row, yet it still indicates significant demand pressures in the economy.

Statistics Iceland's revised national accounts figures imply that the output gap was wider in 2022 than previously estimated. According to the Bank's forecast, demand pressures will be greater throughout the



forecast horizon than was assumed in the November forecast. The output gap is expected to narrow as the forecast horizon advances, however. It is projected to measure 1½% of potential output in 2023 but to have almost closed by the end of the period.

## Inflation

Inflation averaged 9.4% in Q4/2022, as was forecast in the November *Monetary Bulletin*. The CPI rose by 0.85% month-on-month in January, and twelve-month inflation increased to 9.9%, thereby realigning with its July 2022 peak. This was the largest month-on-month rise in the January CPI since 2002. Inflation excluding housing rose as well, to 8.3%, its highest since May 2010. Underlying inflation was unchanged between December and January, however, at 7% in terms of the average of various measures.

House prices were still the main driver of inflation in Q4, although the pace of price increases has eased in the recent term. The rise in food prices continues unabated, however, measuring 10.8% year-on-year in January. Higher prices in trading partner countries and the recent depreciation of the króna have pushed imported goods prices sharply upwards, and the cost of inputs has risen as well. Domestic goods prices have also risen, by just over 11% between years.

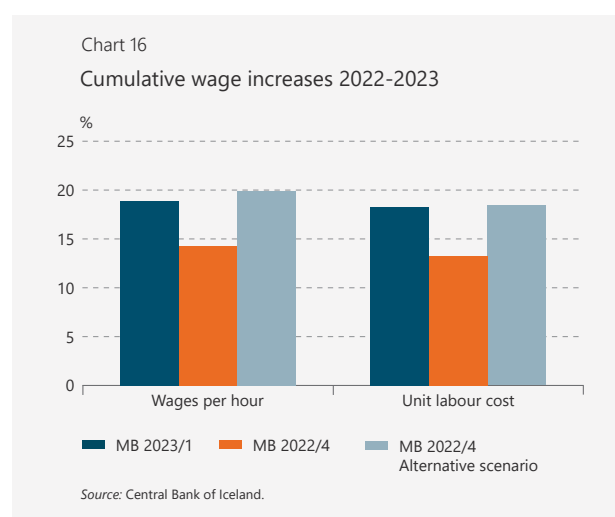
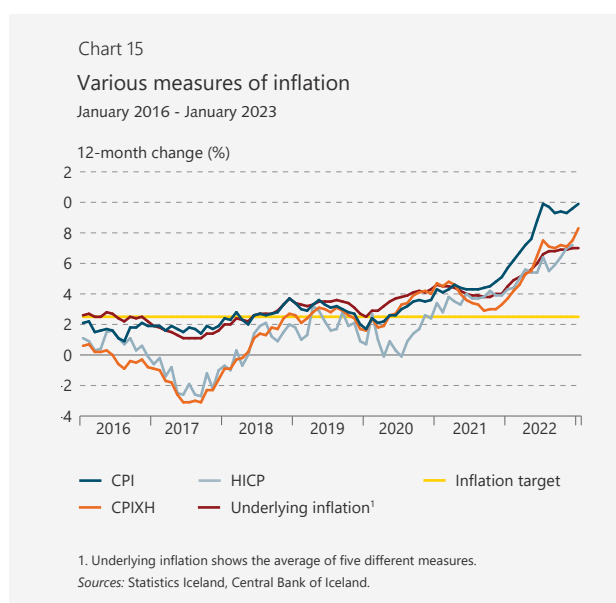
Furthermore, large price list increases and hikes in public levies took effect in January, and public services prices were 7.5% higher than a year earlier. Winter sales were deeper this year than last year, however, offsetting the price hikes to a degree. The year-on-year rise in private services prices has maintained a steady pace in recent months, measuring 6.6% in January. Inflation

is therefore quite widespread, as there are still strong demand pressures in the economy, and it appears that many firms are passing cost increases through to prices to a greater degree than before.

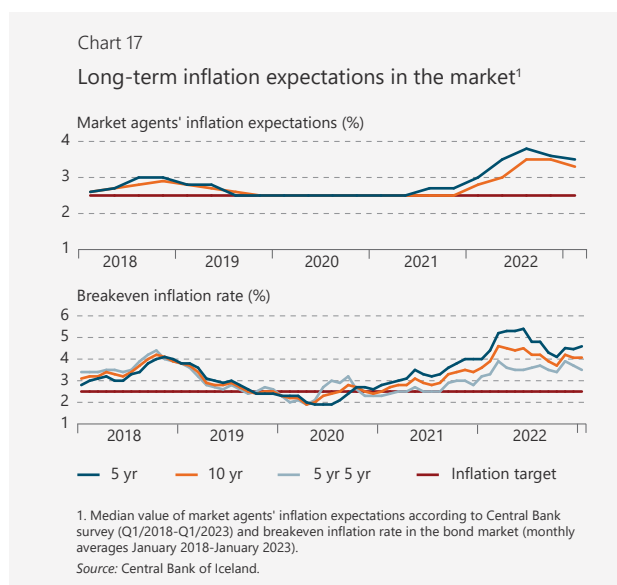
The general wage index rose by 9.4% year-on-year in Q4/2022. Wage agreements affecting some 80% of private sector workers were renewed in December, supplanting the previous contracts. The new agreements were retroactive to 1 November 2022 and remain in effect through end-January 2024. The main provisions include a 33,000 kr. general pay rise, plus an increase of 35,000-52,000 kr. in wage scales for lower wages but a 6.75% increase for higher wages, subject to a maximum pay rise of 66,000 kr. In addition, wages will rise as a result of further changes to wage tables, and the GDP growth supplement has been brought forward and will be paid out simultaneously.

These wage agreements are both costlier and more front-loaded than was assumed in the Bank's last baseline forecast, and the outcome is similar to that in the alternative scenario published in the November *Monetary Bulletin* providing for larger pay rises. In the last baseline forecast, wages per hour were estimated to have increased by 7.8% between annual averages in 2022 and were projected to rise another 6% in 2023, for a total of 14.3% over the two years combined. They are now estimated to have risen by 8.6% in 2022, followed by 9.4% this year, or 18.8% over the same two-year period.

This is uncertain, however, as negotiations with a number of employee groups are still outstanding. The current baseline forecast assumes that the remaining wage agreements will be similar to those recently finalised. Furthermore, because of the significant shortage of labour, there is the risk of further wage drift in the implementation of wage agreements.



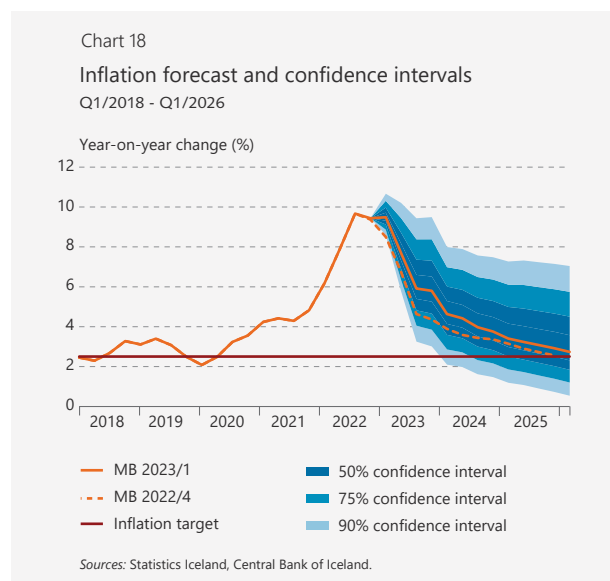
In view of these large pay rises, wage developments in the latter half of the forecast horizon have also been revised upwards. The outlook is for a 9% increase in unit labour costs in 2023 and a total increase of just over 18% in 2022 and 2023 combined, or 5 percentage points more than was assumed in November. If this projection materialises, this year's rise in unit labour costs will be the largest in a single year since 2006.



Recent surveys show that inflation expectations are broadly unchanged between surveys by most measures and are well above the Bank's inflation target. According to the Bank's market expectations survey, respondents still expect inflation to measure 4% in two years' time. Corporate executives and households are more pessimistic, however, and expect inflation to fall even more slowly. Executives still expect it to average 4% over the next five years, whereas households expect it to average 5% over the same period. Market agents are more upbeat about the long-term outlook, however. They expect inflation to average 3.5% in the next five years and 3.3% in the next ten years. Their expectations have fallen marginally between surveys, as has the breakeven inflation rate in the bond market. The five-year breakeven rate five years ahead was 3.6% at the beginning of February, down from an average of 3.9% in November.

## The inflation outlook

Even though inflation was in line with the November forecast in Q4, it looks set to be higher and more persistent in 2023 and 2024 than was projected in November. It is expected to measure 9.5% in Q1/2023 and 7.7% in Q2. In particular, the bleaker outlook reflects the far greater increase in wage inflation, as well as the fact that the króna has depreciated more in the recent past than was assumed in November. Added to this is the prospect of a wider output gap for much of the forecast horizon. In the short run, though, the housing market has started to cool and global inflation has fallen slightly faster in the recent term than was previously expected. On the other hand, there is the risk that inflation will turn out more persistent in Iceland than in neighbouring countries, where it has been driven more by spiking energy prices, which are now receding. Furthermore, long-term inflation expectations in Iceland appear to be less firmly anchored to the target than before.



According to the baseline forecast, inflation will therefore fall more slowly than was projected in November. It is forecast to average 4.2% in 2024 and not fall below 3% until H2/2025, conditional upon the interest rate path in the baseline forecast.

# Appendix

## Forecast tables

Table 1 GDP and its main components<sup>1</sup>

	2021	2022	2023	2024	2025
Private consumption	7.7 (7.7)	8.7 (7.1)	2.5 (2.6)	2.3 (2.9)	2.1 (2.3)
Public consumption	2.2 (2.2)	1.9 (1.6)	2.2 (1.6)	1.7 (1.7)	1.8 (1.8)
Gross capital formation	12.3 (12.3)	3.8 (5.6)	3.0 (3.9)	4.2 (2.3)	3.2 (1.7)
Business investment	19.1 (19.1)	9.3 (14.0)	2.5 (3.0)	-0.6 (-2.4)	4.6 (1.5)
Residential investment	-5.2 (-5.2)	-1.9 (-1.6)	13.2 (13.2)	16.3 (16.5)	1.7 (2.4)
Public investment	18.7 (18.7)	-6.0 (-10.8)	-8.8 (-5.4)	2.5 (-3.3)	1.0 (1.4)
National expenditure	7.1 (7.1)	5.8 (5.1)	2.4 (2.8)	2.5 (2.5)	2.3 (2.0)
Exports of goods and services	12.7 (12.7)	22.6 (18.4)	2.9 (3.0)	3.7 (3.3)	3.1 (3.6)
Imports of goods and services	20.3 (20.3)	18.4 (16.5)	2.6 (3.1)	3.6 (3.0)	3.3 (3.1)
Gross domestic product (GDP)	4.4 (4.4)	7.1 (5.6)	2.6 (2.8)	2.5 (2.6)	2.1 (2.2)
GDP at current prices (ISK trillions)	3.25 (3.25)	3.76 (3.71)	4.07 (3.96)	4.33 (4.20)	4.57 (4.43)
Public sector demand <sup>2</sup>	4.2 (4.2)	0.8 (-0.1)	0.8 (0.7)	1.8 (1.1)	1.7 (1.8)
Total investment (% of GDP)	22.7 (22.7)	22.3 (22.7)	22.7 (23.3)	23.2 (23.4)	23.3 (23.2)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2022/4).

2. Public sector demand in the expenditure accounts is the sum of public consumption and public investment.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 2 Global economy, external conditions, and exports<sup>1</sup>

	2021	2022	2023	2024	2025
Marine production for export	8.5 (8.5)	0.6 (1.4)	-3.1 (-3.9)	1.1 (1.1)	2.3 (2.3)
Aluminium production for export <sup>2</sup>	0.7 (0.7)	2.3 (1.8)	0.4 (0.4)	0.8 (0.8)	1.1 (1.1)
Goods exports, total	7.3 (7.3)	1.8 (1.2)	-0.4 (-0.7)	2.0 (1.8)	2.7 (2.5)
Services exports, total	21.7 (21.7)	56.1 (46.3)	7.0 (8.0)	5.3 (4.8)	3.5 (4.8)
Contribution of net trade to GDP growth (percentage points)	-2.7 (-2.7)	1.3 (0.5)	0.2 (0.0)	-0.1 (0.1)	-0.2 (0.1)
Terms of trade for goods and services	3.6 (3.6)	1.4 (2.3)	-4.0 (-4.1)	-1.1 (-1.2)	-0.3 (-0.3)
Trade balance (% of GDP)	-1.8 (-1.8)	0.1 (-0.3)	-1.7 (-2.3)	-2.3 (-2.7)	-2.4 (-2.6)
Current account balance (% of GDP)	-1.7 (-1.6)	-1.6 (-2.1)	-2.4 (-2.7)	-3.1 (-3.2)	-3.5 (-3.4)
Inflation in main trading partners <sup>3</sup>	2.8 (2.8)	7.6 (7.7)	5.1 (5.0)	2.3 (2.2)	2.0 (2.1)
GDP growth in main trading partners <sup>3</sup>	5.8 (5.7)	3.3 (3.1)	0.6 (0.6)	1.4 (1.6)	2.1 (2.0)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2022/4).

2. According to Statistics Iceland's external trade data.

3. Forecast based on Consensus Forecasts, IHS Markit, IMF, and OECD.

Sources: Consensus Forecasts, IHS Markit, International Monetary Fund, OECD, Refinitiv Datastream, Statistics Iceland, Central Bank of Iceland.



Table 3 Employment, wages, and factor utilisation<sup>1</sup>

	2021	2022	2023	2024	2025
Total hours worked <sup>2</sup>	2.7 (2.7)	6.7 (5.2)	2.2 (2.1)	0.6 (1.7)	1.3 (0.9)
Unemployment (% of labour force) <sup>2</sup>	6.0 (6.0)	3.8 (3.8)	4.0 (3.8)	4.4 (4.0)	4.6 (4.3)
GDP per hour worked <sup>3</sup>	1.7 (1.7)	0.4 (0.4)	0.4 (0.6)	1.9 (0.8)	0.9 (1.4)
Unit labour costs <sup>4</sup>	4.7 (4.7)	8.4 (7.5)	9.0 (5.4)	5.1 (5.2)	4.4 (3.6)
Real disposable income <sup>5</sup>	5.7 (5.7)	4.9 (3.0)	1.0 (-0.5)	2.3 (2.9)	2.9 (3.0)
Output gap (% of potential output)	-1.3 (-1.2)	2.4 (1.1)	1.6 (1.1)	1.3 (0.5)	0.4 (0.3)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2022/4).

2. According to Statistics Iceland labour force survey (LFS).

3. Based on hours worked according to Statistics Iceland labour force survey (LFS).

4. Compensation of employees as a share of GDP, constant prices.

5. Ratio of disposable income to private consumption price index. Disposable income according to Central Bank estimate, based on Statistics Iceland's sector accounts.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 4 Exchange rate and inflation<sup>1</sup>

	2021	2022	2023	2024	2025
Trade-weighted exchange rate index <sup>2</sup>	2.5 (2.5)	3.1 (3.7)	-6.1 (-1.2)	-0.1 (0.0)	1.2 (0.0)
Real exchange rate (relative consumer prices)	3.9 (3.9)	3.9 (4.2)	-4.3 (-0.3)	1.7 (1.3)	2.4 (0.7)
Inflation (consumer price index, CPI)	4.4 (4.4)	8.3 (8.3)	7.2 (6.0)	4.2 (3.6)	3.2 (2.8)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2022/4).

2. Average exchange rate in terms of narrow trade basket. Positive figures represent an increase in the exchange rate of the króna versus the average of other currencies.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 5 Quarterly inflation forecast (%)<sup>1</sup>

Quarter	Inflation (year-on-year change)	Inflation (annualised quarter -on-quarter change)
Measured value		
2022:1	6.2 (6.2)	8.3 (8.3)
2022:2	7.9 (7.9)	13.7 (13.7)
2022:3	9.7 (9.7)	10.8 (10.8)
2022:4	9.4 (9.4)	5.0 (4.8)
Forecasted value		
2023:1	9.5 (8.5)	8.5 (4.9)
2023:2	7.7 (6.7)	6.4 (6.5)
2023:3	5.9 (4.6)	3.7 (2.3)
2023:4	5.8 (4.4)	4.6 (3.7)
2024:1	4.6 (3.9)	3.8 (3.0)
2024:2	4.4 (3.6)	5.6 (5.3)
2024:3	4.0 (3.4)	1.9 (1.7)
2024:4	3.8 (3.4)	3.7 (3.4)
2025:1	3.4 (3.1)	2.4 (2.1)
2025:2	3.2 (2.9)	4.9 (4.3)
2025:3	3.1 (2.7)	1.3 (1.0)
2025:4	2.9 (2.6)	3.1 (2.8)
2026:1	2.7	1.7

1. Figures in parentheses are from the forecast in MB 2022/4.

Sources: Statistics Iceland, Central Bank of Iceland.

