

CENTRAL BANK OF ICELAND



2024 | 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.

Published by:

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Vol. 26 no. 1, 7 February 2024 ISSN 1670-438X, online

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Statement of the Monetary Policy Committee 7 February 2024

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 9.25%.

The effects of monetary policy are coming ever more clearly to the fore. The real rate has risen and inflation has fallen since the MPC's November meeting. Underlying inflation has eased as well. Indicators suggest that economic activity is subsiding faster than previously expected. According to the Central Bank's new forecast, the positive output gap is narrowing and will give way to a slack towards the end of the year. The inflation outlook has therefore improved.

Nevertheless, long-term inflation expectations are virtually unchanged and remain above target. Although labour market tightness has eased somewhat, pressures remain. As a consequence, inflation could remain persistent. Furthermore, there is uncertainty about the results of the ongoing wage negotiations and about possible fiscal measures relating to the wage negotiations and the seismic unrest in the Reykjanes area.

As before, near-term monetary policy formulation will be determined by developments in economic activity, inflation, and inflation expectations.

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.

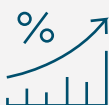
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Monetary Bulletin in a nutshell



GDP growth among key trading partner countries continued to soften over the course of 2023. Since November, the GDP growth outlook has deteriorated somewhat for most trading partners apart from the US, where growth has exceeded expectations. Global inflation has continued to ease, as has underlying inflation, albeit more slowly. The war in the Middle East could impede the decline in global inflation, partly because of the recent rise in shipping costs.



In Iceland, GDP growth measured 4.2% for the first three quarters of 2023, in line with the Bank's November forecast. The growth rate slowed markedly as Q3 advanced, measuring 1.1% for the quarter, somewhat less than was forecast in November. GDP growth is estimated to have picked up marginally in Q4 and is projected at 3.6% for 2023 as a whole, broadly in line with the November forecast. Domestic demand appears to have declined more rapidly, however, than was anticipated then, which is the main reason for the downward revision of this year's growth outlook. GDP growth for the year is now projected at 1.9%, as compared with the November forecast of 2.6%. The GDP growth outlook for the next two years is broadly unchanged overall, however.



Unemployment has inched upwards since mid-2023. Job growth has lost pace, and indicators imply that the positive output gap of the past two years is narrowing. The baseline forecast assumes that unemployment will keep rising this year and that a negative output gap will open up towards the year-end.



Inflation subsided in December, and even more so in January, when it measured 6.7%. Underlying inflation has also fallen but inflation expectations remain well above target. The inflation outlook has improved markedly, as growth in economic activity looks set to taper off more quickly than was projected in November. On the other hand, the outlook is for larger pay rises over the forecast horizon than was assumed then. Inflation is now projected to align with the target in H2/2026, more than half a year earlier than in the November forecast.



The global economic situation remains uncertain, not least because of the wars in Ukraine and the Middle East. Trading partner GDP growth has been muted, and it is unclear how solid the foundations for growth are. In Iceland as well, uncertainty has mounted in the wake of the volcanic eruptions on the Reykjanes peninsula. Actions taken by the Government in response to the situation could cause the economic outlook to differ from that provided for in the baseline forecast, but it is difficult to assess the impact of such measures before their scope and execution have been determined. The results of the ongoing wage negotiations and possible fiscal measures related to them could also cause the economic and inflation outlook to change relative to the baseline forecast. Another source of concern is still-high inflation expectations, which could make bringing inflation to target more difficult than is assumed in the baseline scenario.

The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin 2023/4* in November 2023, 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 0.1% quarter-on-quarter in Q3/2023, the same as in Q2 but somewhat below the Bank's November forecast. Trading partners' year-on-year GDP growth therefore continued to weaken and had fallen to 0.7% in Q3. Developments varied between countries, however. In the US, GDP growth has gained momentum, measuring 2.9% in Q3, while it shrank to 0.3% in the UK and 0% in the eurozone. GDP contracted by 0.3% in Denmark and 1.4% in Sweden.



Trading partners' average GDP growth is estimated to have been weak in Q4 as well and looks set to remain tepid in Q1/2024. It is expected to rebound later this year, however, in tandem with falling inflation and growth in real disposable income. Also, the employment situation remains favourable and many households in Europe still have some of the savings they accumulated during the pandemic and could tap into them if necessary.

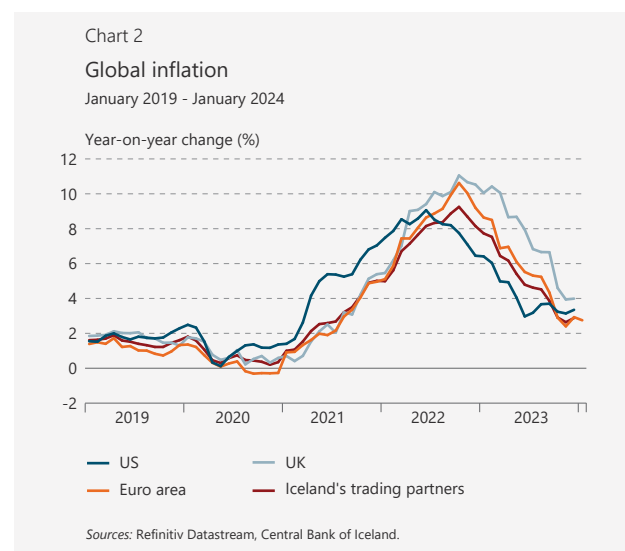
Even so, the GDP growth outlook for trading partners remains poor and the economic outlook highly uncertain, largely because of monetary tightening by central banks and the hefty cost increases and other shocks that have hit households and businesses in recent years. As before, economic developments will depend to a significant extent on how successfully these shocks are resolved and how inflation develops

in the coming term. The economic outlook will also depend on how the wars in Ukraine and the Middle East evolve and what impact they have. Indicators imply that supply chain disruptions have increased again and that shipping costs have risen because of repeated attacks on shipping vessels in the Red Sea. Furthermore, the fiscal situation in the US remains uncertain, as do economic prospects for China.

According to the Bank's baseline forecast, GDP growth among Iceland's main trading partners will measure 1% this year. This is 0.1 percentage points below the November forecast and far below the average of the past few decades. The change between forecasts is due in particular to the bleaker outlook for the eurozone, as well as the UK and Denmark. The GDP growth outlook for the US has improved, however. Trading partner GDP growth is expected to rise to 1.6% in 2025, which nevertheless is slightly below the November forecast.

Global inflation

Trading partner inflation has eased further in the recent past, to an average of 2.9% in December 2023. Lower inflation is driven to a large extent by falling energy prices, although a slower year-on-year rise in food and other goods prices contributes as well. Services price hikes have also eased, although they have been more persistent than price rises for other consumer items. Core inflation has therefore fallen more slowly than



headline inflation, to an average of 3.7% among trading partners in December 2023.

Trading partner inflation averaged 2.9% in Q4/2023, some 0.3 percentage points below the November forecast, and the inflation outlook has improved marginally. This is due in part to global energy prices, which fell more than projected in Q4. However, global oil prices started to pick up again in late January, in the wake of growing unrest in the Middle East. Nevertheless, futures prices indicate that they are still expected to be lower throughout the forecast horizon than was forecast in November. Trading partner inflation is expected to average 2.7% in 2024, or 0.2 percentage points below the November forecast. The outlook for 2025 and 2026 is broadly unchanged from the November forecast, however.

Global interest rates

Central banks in major advanced economies have held their policy interest rates unchanged since September, after raising them steeply during the period beforehand. Although they do not rule out further rate hikes, it is increasingly likely that interest rates have peaked, as inflation has fallen sharply and economic activity has slowed considerably in most countries. Nevertheless, monetary authorities have reiterated that interest rates will probably be kept high for a while longer in order to ensure that inflation keeps falling and realigns with the target within an acceptable time frame.

On the other hand, market agents appear convinced that interest rates in major advanced economies have already peaked, that central banks will start lowering them as soon as H1/2024, and that monetary easing will proceed more quickly than they previously thought. This can be seen, for instance, in advanced countries' government bond yields, which have fallen since November. At the same time, global equity prices have risen and premia on high-risk financial assets have fallen. As a result, financial conditions in major advanced economies have improved.

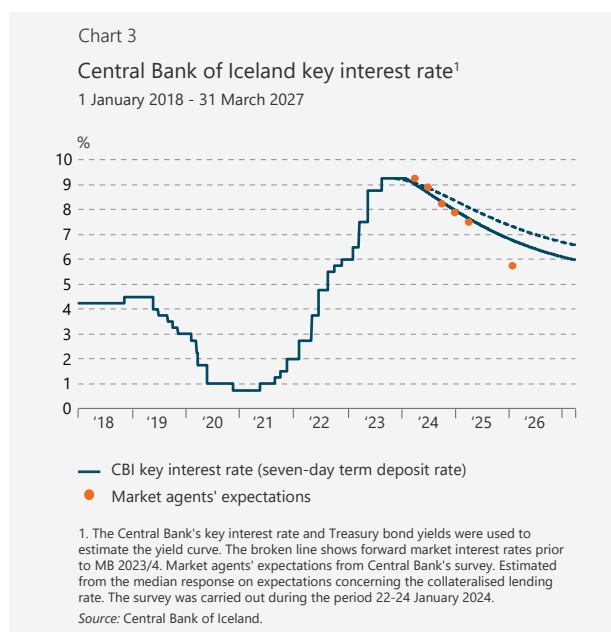
Terms of trade

Terms of trade for goods and services are estimated to have deteriorated by 5.5% in 2023, or 1 percentage point more than was expected in November. Marine export prices appear to have fallen more than expected in the final months of the year, and import prices seem to have risen more. As in November, terms of trade are expected to remain broadly flat over the forecast horizon.

Domestic interest rates

The Central Bank's Monetary Policy Committee (MPC) decided at its November meeting to hold the Bank's key rate (the rate on seven-day term deposits) unchanged at 9.25%, where it was just before the publication of this *Monetary Bulletin*. According to the Bank's January survey of market agents' expectations, respondents expect the key interest rate to have peaked and start falling in Q2/2024, reaching 5.75% in two years' time. Forward interest rates also suggest that market agents expect Central Bank rates to fall this year, in a similar way as is indicated in the survey. The Bank's real rate has risen markedly since mid-2023 and is now 3.3% in terms of the average real rate as calculated from various measures of inflation and one-year inflation expectations.

The yield on ten-year nominal Treasury bonds was 6.5% just before this *Monetary Bulletin* was published, or 0.6 percentage points lower than in November. It began to fall after the onset of seismic activity on the Reykjanes peninsula in mid-November, although global developments were probably a factor as well. It declined further after inflation fell by more than was expected in January. The yield on ten-year indexed Treasury bonds is broadly unchanged since November, however, and the breakeven inflation rate in the bond market has fallen as a result.

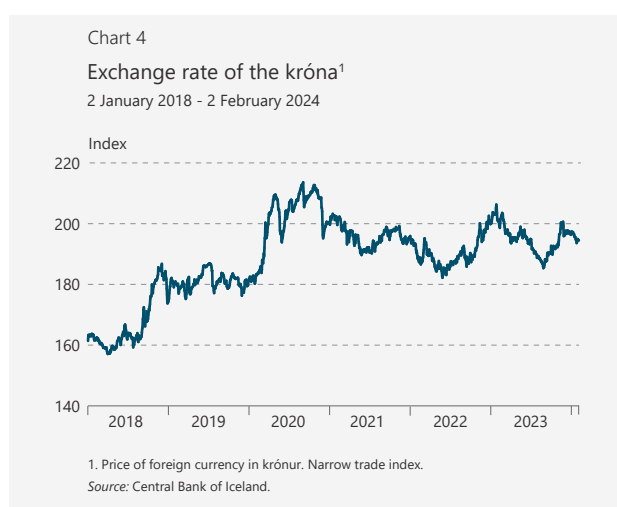


Exchange rate of the króna

The króna began to depreciate at the end of summer 2023 and weakened further in the wake of the seismic unrest on the Reykjanes peninsula in November. It rebounded relatively quickly, however, and has contin-

ued to appreciate in early 2024. It is now roughly 3% stronger, on average, against major trading partner currencies than it was at the time of the last *Monetary Bulletin*, and almost 3% stronger than in early February 2023.

Seasonally adjusted tourism-generated payment card flows increased substantially in 2023 and supported the króna until the final months of the year, when it decreased. The interest rate differential with abroad has been largely unchanged in the recent term, and foreign currency flows for new investment were weaker in 2023 than in 2022. Furthermore, the pension funds scaled down their currency purchases in H2/2023, and forward sales of foreign currency declined.



Although the average exchange rate has risen recently, it is close to 1% lower in Q1/2024 to date than the Bank projected in November. As in November, the current baseline forecast assumes that the currency will depreciate slightly over the forecast horizon.

Money holdings and lending

Year-on-year growth in M3 measured 8% in Q4/2023. Growth in household deposits accelerated in 2023 and has exceeded 15% year-on-year since August. In part, strong household deposit growth reflects the generous wage rises implemented recently, but over the course of 2023, private consumption started to ease and households' saving increased. Furthermore, new lending to households has grown concurrent with increased real estate market turnover. The vast majority of new loans have been inflation-indexed, while early retirement of non-indexed loans has increased.

Unlike household deposits, however, growth in corporate deposits has lost pace. Growth in corporate lending lost momentum as well in 2023, although there was an uptick in new lending late in the year,

particularly in inflation-indexed loans to real estate firms. This may indicate that real estate companies are shifting their financing more to the banks, as corporate bond issuance declined in 2023, after real interest rates started to rise.

Interest rates on non-indexed loans to households and businesses have increased in line with the Central Bank's key rate. Deposit rates have risen likewise. Interest premia on new non-indexed residential mortgages fell somewhat in 2023, while premia on corporate loans held relatively stable. Furthermore, indexed mortgage rates have started rising, as have other real rates.



Asset prices

In December 2023, house prices in greater Reykjavík were up 4.5% between years, whereas the smallest year-on-year increase, 0.8%, was in July. The number of net new mortgages has grown and turnover has risen again, after a contraction lasting nearly three years. In addition, real wages grew well into the year, the number of first-time buyers rose as 2023 progressed, and population growth remained strong. The supply of homes for sale in greater Reykjavík has shrunk in the past two months and is now broadly back to the pre-pandemic level. The average time-to-sale has lengthened at the same time to just over four months.

The Bank's baseline forecast assumes that house prices will rise more in early 2024 than was projected in November and then settle down as the year advances. Real house prices are expected to decline throughout the forecast horizon. This is highly uncertain, however, as the volcanic eruption on Reykjanes and the

Government's responses to it could cause prices to rise higher than is currently assumed.

The OMXI15 share price index has risen by one-fourth since the MPC's decision in November to hold interest rates unchanged. From the beginning of 2023 until then, however, the index had fallen by 16%. Households' and businesses' financial conditions tightened overall in 2023 and are at their tightest in three years, according to financial conditions indicators.



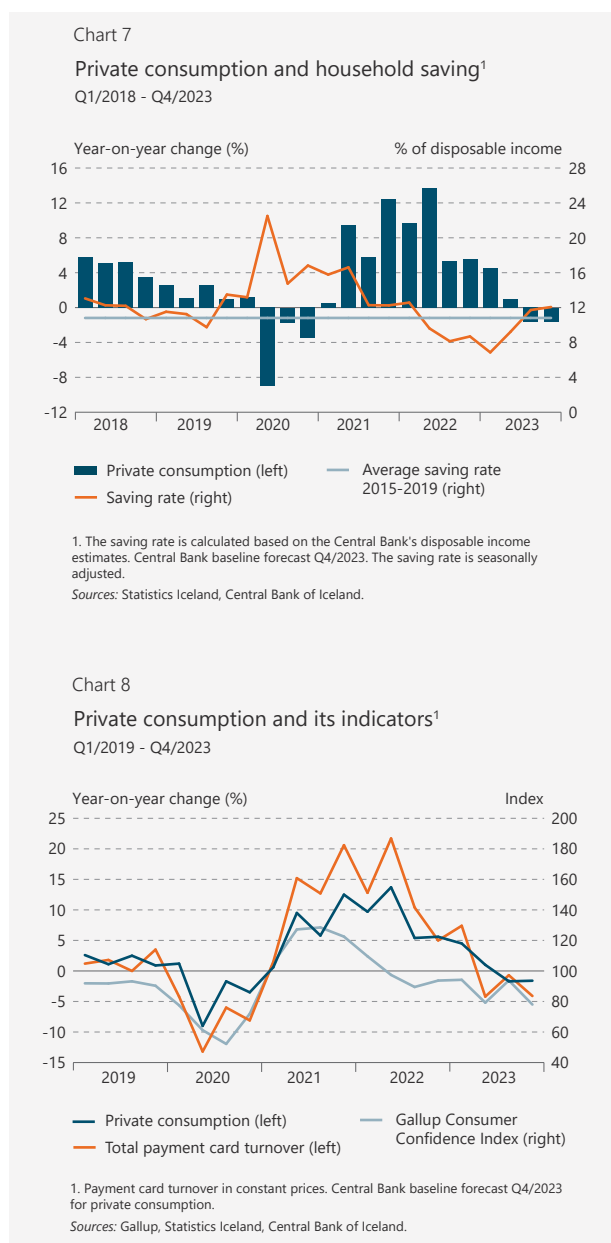
Private consumption

Seasonally adjusted household consumption spending contracted by 2.2% quarter-on-quarter in Q3/2023, largely in line with the Bank's November forecast, and the household saving rate has therefore increased again.

Private consumption shrank by 1.7% relative to Q3/2022. It was the first year-on-year contraction since Q4/2020. This is a significant deviation from the November forecast of 1% growth. The difference is smaller, however, for the first nine months of the year, when private consumption grew 1.3% year-on-year and the growth rate projected in November was 2%. The deviation is due mainly to households' payment card-based spending, which turned out weaker in Q2 and Q3 than had been indicated by preliminary figures.

There are signs that household spending contracted even further in Q4/2023. Preliminary payment card turnover figures, for instance, indicate that household demand has eased, and the quarter-on-quarter drop in the Gallup Consumer Confidence Index suggests increased pessimism.

The year-on-year contraction in private consumption in Q4/2023 is estimated to be similar to that in

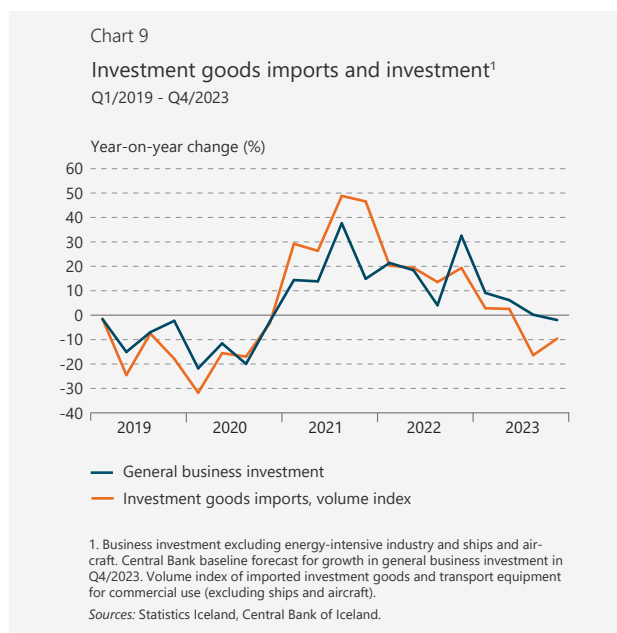


Q3. If the forecast materialises, growth will measure 0.5% for the year as a whole, as compared with the 1.8% growth projected in November. This would be the weakest full-year growth in private consumption since 2010, apart from 2020, the pandemic-induced outlier. Private consumption is also projected to grow more slowly in 2024 than was forecast in November, as economic activity looks set to decline more swiftly than was assumed then. In 2025 and 2026, however, private consumption is expected to grow more quickly, owing to stronger growth in real disposable income than was forecast in November.

Investment

Total investment contracted by 1.3% in the first three quarters of 2023, whereas the November forecast assumed a downturn of 1.7%. There were some devia-

tions in subcomponents of investment in Q3, however. Business investment was projected to contract but instead grew by 3.1%. It was offset, though, by weaker residential and public investment.



Imports of investment inputs contracted in H2/2023, and indicators imply that business investment contracted in Q4. As in November, total investment is estimated to have shrunk slightly year-on-year in 2023. The outlook for 2024 has deteriorated, however, and total investment is now projected to increase by 4.1%, 1 percentage point less than in the November forecast. This is due mostly to a somewhat poorer outlook for residential investment growth, which reflects in large part new estimates from the Housing and Construction Authority and the Federation of Icelandic Industries indicating a downturn in new construction in 2024 and a year-on-year reduction in the number of fully finished homes.

Public sector finances

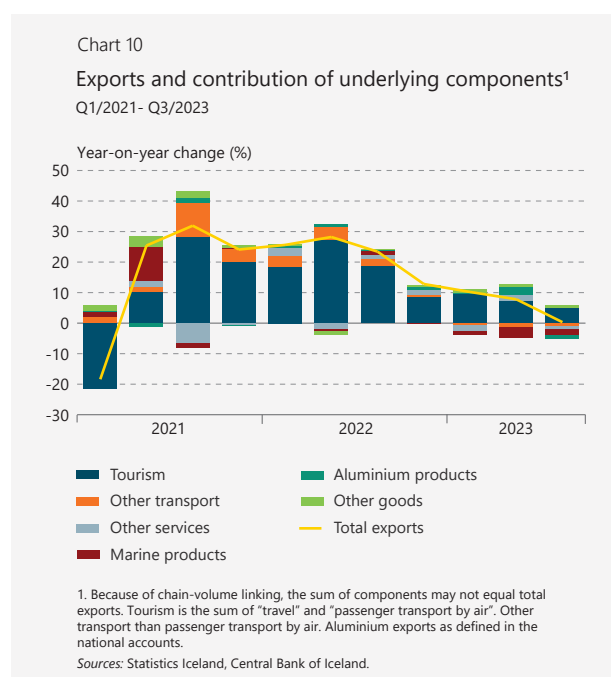
The 2024 National Budget was passed by Parliament with a deficit of 1.1% of GDP, but based on Government estimates for 2023, the Treasury outcome will improve marginally between years. The 2024 Budget estimates a Treasury primary surplus measuring 0.6% of GDP and a deficit on the interest balance measuring 1.7%, which accords well with the Bank's November forecast. However, the outlook is for the newly proposed measures in response to the Grindavik eruption to have a markedly negative impact on the Treasury outcome, even though the scope and execution of the measures are uncertain.

Public consumption and investment are estimated to have increased by a combined 1% in 2023. This reflects a 4.7% contraction in investment (due mainly to base effects from the Government's purchase of the new Landsbankinn headquarters in 2022) and a 1.9% increase in public consumption. The overall increase is slightly larger than was forecast in November, but public consumption is now estimated to have grown more strongly in 2023 than the forecast indicated. In 2024, public investment is projected to contract by an additional 0.5%, offset by 1.7% growth in public consumption. In the latter half of the forecast horizon, growth in public consumption and investment combined is expected to average just under 2% per year.

Exports of goods and services

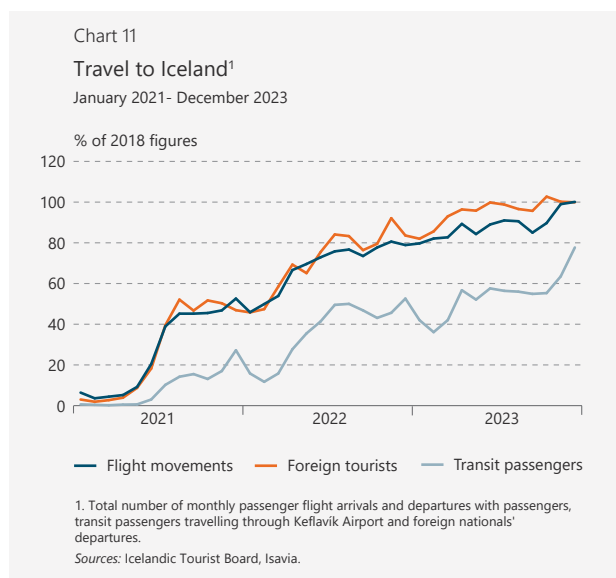
Growth in goods and services exports slowed significantly in Q3/2023, to 0.5% year-on-year, after having measured 9.1% in H1. Growth in tourism lost pace concurrent with a contraction in most other subcomponents of exports. Goods exports shrank by 3.7% year-on-year and other services exports by 5.5%.

Q4 began strongly in the tourism sector, however, with a record number of tourists visiting Iceland in October. Flight offerings to and from Iceland during the quarter were on a par with the same quarter of 2018. It was the first time since the fall of airline WOW Air that supply had reached this level. Seismic activity on Reykjanes peninsula and the associated media coverage affected the final two months of the year, however. The domestic airlines reported that sales of tickets to Iceland had declined relatively quickly, and



load factors were somewhat poorer than expected. In addition, transit passengers accounted for a larger share of total passenger numbers than before. Tourist numbers were similar to those in the same months of 2018, however, and in 2023 as a whole, 2.2 million tourists came to Iceland, as the Bank had forecast.

Services exports are estimated to have grown by 12.1% year-on-year in 2023, or 1.5 percentage points less than was forecast in November. This is due mostly to a contraction in other services exports in H2. As in November, goods exports are estimated to have contracted by 1.3% in 2023, while total exports are projected to have risen by 4.4%, some 0.7 percentage points less than forecast in November.



The outlook for tourism this year is in line with the November forecast, although there is still considerable uncertainty about the possibility of further volcanic activity in the Reykjanes area and its impact on demand for travel to Iceland. Flight offerings to and from Iceland are still expected to increase in 2024, and Google searches for flights to Iceland and accommodation in the country are broadly unchanged since November, although searches relating to seismic activity have also increased somewhat. On the other hand, indicators imply that hotel bookings for this year have weakened in the wake of recent media coverage, and it is uncertain whether the composition of the passenger group will change. Moreover, demand for international travel remains strong despite the poor global economic outlook.¹

1. See International Air Transport Association, *Air Passenger Market Analysis*, December 2023.

As in November, around 2.3 million tourists are expected to visit Iceland this year. Services exports are forecast to grow by 4% instead of the 4.9% projected in November, as the outlook is for a somewhat weaker Q1 in the tourism industry. This is compounded by relatively poorer outlook for goods exports in 2024, mainly due to cutbacks in energy sales to large manufacturers. Total exports are expected to grow by 2.7% this year, 1 percentage point less than was forecast in November. Growth could turn out stronger, however, if exports of pharmaceuticals increase more rapidly than is currently assumed or if the capelin fishing quota for the year is revised.

Imports of goods and services

Goods and services imports contracted by 3% between years in Q3/2023. It was the first year-on-year contraction in total imports in three years but consistent with slower growth in domestic demand. Goods imports contracted by 4.4% year-on-year during the quarter, while services imports were virtually unchanged. Services imports related to Icelanders' spending abroad contracted as well, and Icelanders' overseas travel continued to decline between years, although this was offset by growth in other services imports. Goods imports appear to have contracted much more in Q4 than was anticipated in November, in line with a sharper decline in the growth rate of domestic demand. Overseas travel among Icelanders also eased faster than the forecast provided for. As a result, total imports are estimated to have shrunk by 1.4% in 2023 as a whole, some 1 percentage point more than was forecast in November. The outlook is also for weaker growth in 2024.

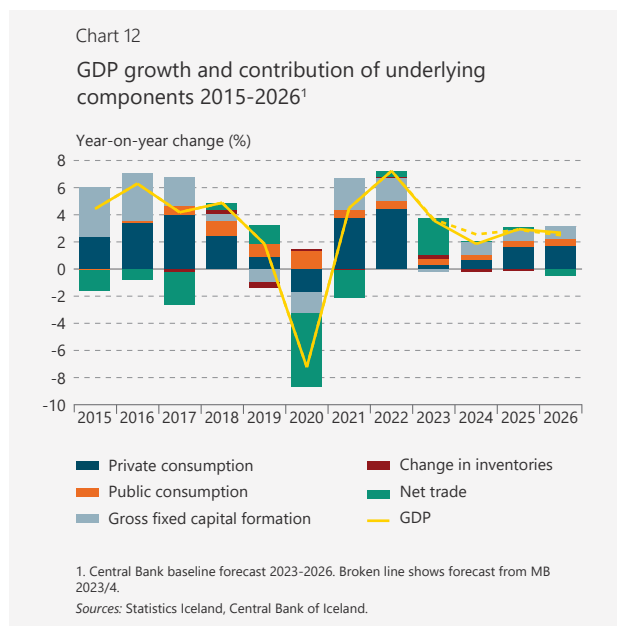
Current account balance

The current account surplus in Q3/2023 measured 5.7% of GDP, in line with the Bank's November forecast. It was the largest surplus since before the COVID-19 pandemic and was driven mainly by the strong summer tourist season. It was supported by a year-on-year turnaround in the primary income balance but offset by a continued large deficit on goods trade.

The current account is estimated to have been in balance in 2023 as a whole, which is ½ a percentage point weaker than was forecast in November. The deterioration is due to the revision of primary income in H1 and somewhat less favourable developments in Q4. The outlook is for the current account to remain in balance throughout 2025.

GDP growth

GDP grew by 1.1% year-on-year in Q3/2023, whereas the Bank's November forecast assumed a growth rate of 1.7%. Private consumption dropped off rapidly during the quarter, explaining most of the deviation. Over the first nine months of the year, GDP growth measured 4.2% between years, which accords well with the Bank's November forecast of 4.3% growth.



GDP growth in Q4/2023 is estimated to have picked up slightly between Q3 and Q4/2023, even though domestic demand continued to lose pace, reflecting favourable developments in net trade. GDP growth for the full year is projected at 3.6%, 0.1 percentage points below the November forecast and half of the growth rate in 2022.

In 2024, GDP growth is projected to soften further and measure 1.9%, well below the November forecast of 2.6%. Weaker growth in domestic demand – private consumption in particular – explains most of the revision of this year's GDP growth outlook. On the whole, though, prospects for 2025 and 2026 are in line with the November forecast.

Seismic activity on the Reykjanes peninsula

The seismic activity starting in mid-November on the Reykjanes peninsula has caused significant damage in Grindavík and environs and prompted the evacuation of the town's residents. Business operations in the town have halted, although some activities have been moved elsewhere.

The official property value of residential housing in Grindavík is just over 72 b.kr., while

commercial property is valued at 25 b.kr. and infrastructure another 7 b.kr. This gives a total of 105 b.kr., which is equivalent to just over 2% of GDP. The cost of rebuilding in the event that the entire community is declared a total loss need not be the same as the current market value of these assets, however, and it is difficult to estimate the financial impact of disruptions to commercial activities and residents' lives. By the same token, it is difficult to assess the economic effects of the disaster while it is still ongoing.

The Bank's baseline forecast does not assume any extraordinary impact beyond what has already come to light. If the disaster proves to have a stronger impact, a larger share of the community's housing stock could be lost, potentially pushing house prices upwards and affecting private consumption through a negative wealth effect. A portion of Iceland's capital stock could also be lost, thereby reducing potential output in the domestic economy. The effects of the disaster on inflation are therefore not clear. A preliminary estimate suggests, however, that the impact on GDP growth and inflation is relatively limited, although the immediate community is severely affected.

The disaster will also affect Government finances and debt levels, especially if the Government decides to buy all property in the area. Such measures could affect the domestic economy as well – particularly the housing market – although the impact will ultimately depend on how the Government orchestrates and finances such measures.

Employment and unemployment

According to the Statistics Iceland labour force survey (LFS), total hours worked rose by 4.5% year-on-year in Q4/2023. This is a larger increase than was provided for in the Bank's November forecast. Job creation measured 3.7% year-on-year, and the average work week grew longer by 0.7%. In seasonally adjusted terms, average weekly hours worked measured 38.3 during the quarter, which is their highest level in the past three years, although a full 2% below the pre-pandemic level. The increase in the working-age population continued to lose pace but was offset by stronger labour participation. LFS job numbers are probably overestimated, however, as the national population is overestimated because of underreported emigration. Statistics Iceland plans to publish revised figures later this year. Figures

from the pay-as-you-earn (PAYE) register suggest that job creation measured 3.1% year-on-year in Q4/2023, noticeably below the rate indicated by the LFS.

Seasonally adjusted unemployment according to the LFS measured 3.5% in Q4, about the same as in Q3. Seasonally adjusted registered unemployment likewise measured 3.5% in December. An increase can be detected in registered unemployment, which was 0.4 percentage points higher in December 2023 than at mid-year.



Although job growth has begun to slow down, the results of Gallup's winter survey indicate that job numbers will continue to rise in the coming term. Firms' recruiting plans are still marginally above historical average according to the survey, and Statistics Iceland's survey of job vacancies points in the same direction. The number of vacancies declined in Q4, both between quarters and between years, but was still higher than at the same time in 2019, just before the pandemic hit. The vacancy ratio declined quarter-on-quarter, although still indicating that the labour market remains tighter than just before the pandemic.

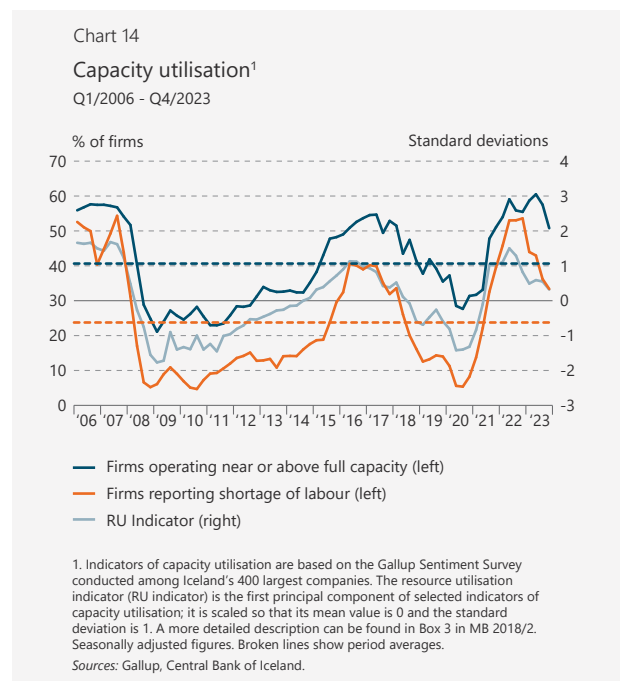
The baseline forecast assumes that labour market tightness will continue to ease, as will the rise in total hours worked over the forecast horizon. As in November, unemployment is expected to rise. It looks set to measure 4.8% in 2024 and then begin to fall again, to 3.8% at the end of the forecast horizon.

Resource utilisation

According to the seasonally adjusted results of Gallup's winter survey, one-third of executives consider themselves short-staffed, and just over half say their firms

are working at full capacity. Both ratios declined in the winter survey but are still high in historical terms. The resource utilisation (RU) indicator, which combines various indicators of factor utilisation, continued to fall during the quarter but still indicates the presence of demand pressures in the economy.

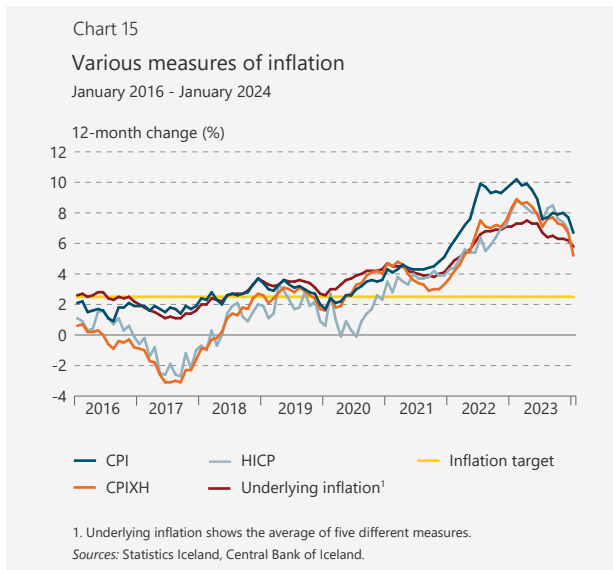
Domestic demand weakened over the course of 2023, and more rapidly than was assumed in the November forecast. The GDP growth outlook for 2024 has worsened as well. The output gap that opened up in 2022 therefore appears to be closing more quickly. It is estimated that a slack will develop in the economy late this year and peak in 2025 before tapering off in the final year of the forecast horizon.



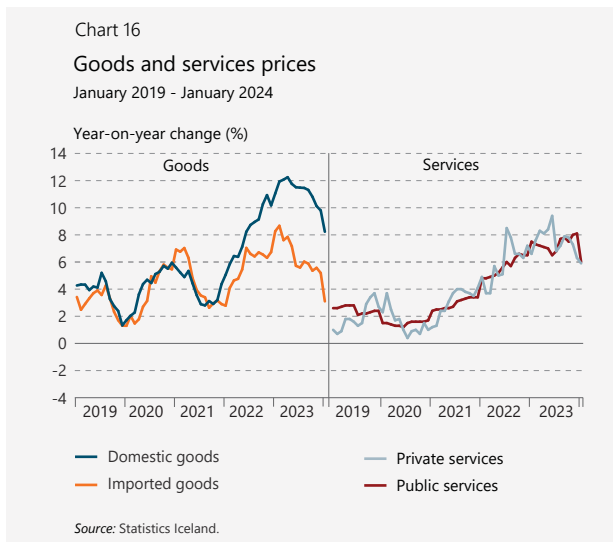
Inflation

Inflation averaged 7.9% in Q4/2023, as was forecast in the November *Monetary Bulletin*. It subsided in December and fell further in January, to 6.7%. Inflation excluding housing measured 5.2% and has fallen steadily since autumn 2023. Underlying inflation has continued to ease as well, to 5.8% according to the average of various measures, and has fallen by just under 2 percentage points since it peaked almost a year ago.

House price inflation was the main driver of the rise in the CPI in Q4/2023. The contribution of the housing component to headline inflation has therefore grown once again in the recent term. It now accounts for just under half of inflation. The cost of owner-occupied housing has increased by 12.7% in the past twelve months, driven to a large degree by the rise in real mortgage interest expense.



The year-on-year increase in both domestic and imported goods prices has markedly lost pace recently. Food price inflation eased somewhat towards the end of 2023, after having risen virtually uninterrupted for two years. Prices turned upwards again in January, however, owing largely to the decision by the agricultural product pricing committee to raise the price of dairy products. On the whole, domestic goods prices have risen by 8.2% in the past twelve months.

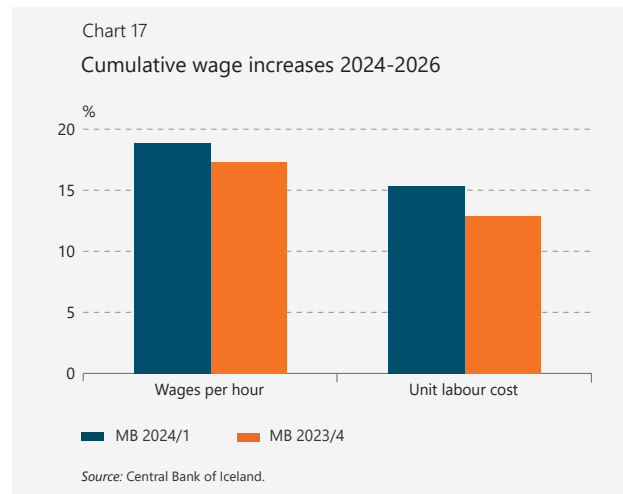


The recent winter sales were somewhat deeper than the average of the past few years. New motor vehicle prices rose in January, though, because of the cancellation of tax concessions on electric cars, although this is offset by subsidies from the Energy Fund. Overall, imported goods prices were up just over 3% year-on-year. The increase in private services prices has lost pace recently, easing to 5.9% between years, owing partly to a smaller-than-usual rise in airfares in

December. Public services prices rose in January, however, owing to various price list increases, and were 6% higher than in January 2023. There has been a change in CPI calculations, though, in that a portion of seasonal price list increases will appear in the February CPI measurement rather than in January; therefore, public services prices will continue to rise, all else being equal.

The general wage index rose by 9.4% year-on-year in Q4/2023. The total wage index rose less than the general wage index did in the first three quarters of 2023, however, indicating that the changed composition of either the labour market or wages themselves lowered average wage costs for the year.

The ongoing private sector wage negotiations were referred to the State Conciliation and Mediation Office in late January, and the outcome remains uncertain. The current status of the discussions suggests, however, that negotiated pay hikes over the next two years may well be larger than was assumed in the November forecast. Wages per hour are therefore projected to rise by an average of 6.5% this year and an average of 5½% per year in 2025 and 2026. As a result, they will rise by a total of nearly 19% over the forecast horizon, which is 1½ percentage points more than was assumed in November.



At the same time, the outlook is for labour productivity to have shrunk more in 2023 than previously thought, and prospects for 2024 have deteriorated even further. This is offset by a brighter outlook for the two years thereafter. The Bank's forecast therefore assumes that unit labour costs will rise by over 7% this year and an average of close to 4% per year in 2025 and 2026. The 2024 increase is over 2 percentage points more than was provided for in the last forecast, while prospects for the next two years are broadly unchanged.

This situation is highly uncertain, however, as contracts have yet to be finalised in both private and public sectors. If negotiations drag on or a work stoppage begins, wage costs could decline, at least temporarily. Furthermore, there is considerable uncertainty about wage drift and compositional effects during the forecast horizon, as well as about labour productivity, which was unusually volatile throughout the pandemic and until last year.

From wage agreements to the wage increases in Central Bank forecasts

Estimates of wage developments in the Bank's forecasts are based, among other things, on information from private and public sector contracting parties, assessments by Bank staff, and statistical models (a more detailed discussion of wage assumptions in the Bank's forecasts can be found in Box 4 in *Monetary Bulletin 2015/4*).

During wage contract preparation, the parties involved compile a wide range of wage data in order to estimate the cost of the contracts. This cost estimate typically lays the foundation for the estimation of wage developments during the forecast horizon, but once wage agreements have expired, other information must be used. Such information includes historical experience and an assessment of the situation in the domestic economy, but also – especially in the midst of a round of negotiations, as in the present case – information from contracting parties on the status of discussions and their likely outcome. Based on the current status of the negotiations, it is assumed that wage rises in 2024 will be broadly in line with the November forecast, while in 2025 and 2026 pay hikes will exceed the forecast.

Negotiated pay increases in strategic private sector wage agreements generally weigh heaviest in public discussion of wage developments, but additional factors must be considered during forecast preparation. For instance, an assessment must be made of whether other groups in the private sector and groups in the public sector will follow the path staked out by the agreements. The Bank's baseline forecast assumes that other groups in the labour market will adjust their contracts in a manner similar to that seen in the last round of negotiations. This assumption could underestimate the impact that still-pending contracts would have on wage developments, as leaders from some

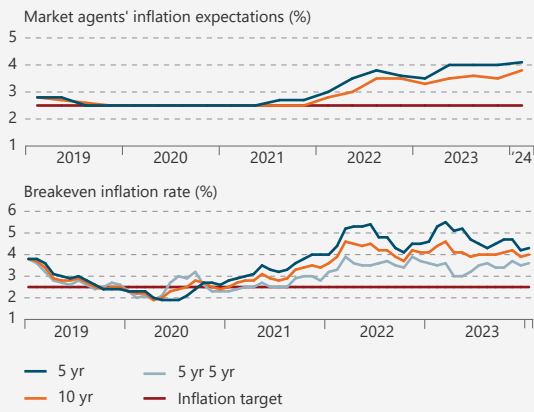
private and public sector unions and federations have implied that contracts based solely on unit-based pay rises (such as those currently being considered) would not be acceptable. Furthermore, wages could rise more than is provided for in the contracts if firms compete for workers because of demand pressures in the economy, or if there is no consensus on the wage distribution proposed in the contracts.

Pay rises in excess of contractual provisions are generally referred to as wage drift, which is typically captured by a rise in the general wage index over and above the estimated cost of the contracts. This could represent a large share of wage movements; for example, it is considered to explain about a third of the rise in the wage index between its 2022 and 2023 averages. Wage drift increased concurrent with the positive output gap that developed in the economy at the end of the pandemic, but the Bank's forecast assumes that this wage drift will taper off over time, in tandem with slower growth in economic activity.

Because the Bank's forecast is based on compensation of employees according to the production accounts, various composition effects can either offset or compound pay rises; however, these effects are not captured by the general wage index. Composition effects reflect, for instance, the surge in the foreign labour force and the boom in tourism, which have lowered average wage costs in recent years, as both of these groups generally receive below-average pay. The Bank's baseline forecast assumes that these compositional effects will be similar over the forecast horizon to those seen in the aftermath of the financial crisis.

According to the Bank's most recent survey, market agents' inflation expectations have risen since the November survey, and survey participants now expect inflation to measure 4.4% in two years' time. Households' and businesses' two-year inflation expectations were unchanged, however, according to surveys taken at the end of 2023. Corporate executives expect inflation to measure 5%, while households are even more pessimistic. On the other hand, households' and businesses' long-term inflation expectations rose again between surveys. Market agents' long-term expectations have risen since November as well: they now expect inflation to average 3.8% over the next ten years. The breakeven inflation rate in the bond market

Chart 18
Market long-term inflation expectations¹



1. Median value of market agents' inflation expectations according to Central Bank survey (Q1/2019 - Q1/2024) and breakeven inflation rate in the bond market (monthly averages January 2019 - January 2024).

Source: Central Bank of Iceland.

is lower than in November, however, and the five-year breakeven rate five years ahead was 3.6% at the beginning of February. It has hovered around 3½% since the start of 2023.

The inflation outlook

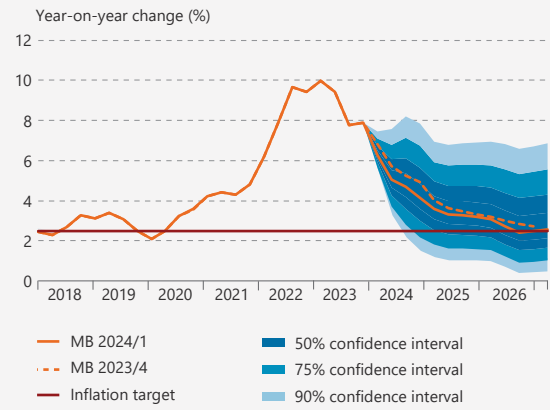
Inflationary pressures have eased overall in the recent term, and the inflation outlook has improved since November. Headline inflation is expected to continue falling, measuring 6.3% in Q1/2024 and 5% in Q2, which is 0.7 percentage points less than in the November forecast. Domestic demand has fallen more rapidly in the recent past than was forecast then, and a negative output gap is expected to open up at the end of this year. Global inflation has also fallen faster than was projected in November.

On the other hand, the outlook is for a larger increase in wage costs over the forecast horizon. There are still some inflationary pressures in the housing market, as activity has rebounded and house prices are on the rise, and inflation expectations are high by most measures.

Inflation is forecast to average 5% this year and fall below 4% in the beginning of 2025. The outlook for the next two years has also improved. Inflation is projected to average 3.3% next year, or 0.3 percentage points less than was forecast in November, and to realign with the target in H2/2026, conditional upon the interest rate path in the baseline forecast. This is somewhat earlier than was forecast in November. Statistics Iceland intends to change the method it uses to measure the housing component of the CPI, which could lead to a faster-than-expected decline in inflation later this year. On the other hand, there is still the risk that

inflation will be more persistent, as long-term inflation expectations have become less firmly anchored to the target.

Chart 19
Inflation forecast and confidence intervals
Q1/2018 - Q1/2027



Sources: Statistics Iceland, Central Bank of Iceland.

Appendix

Forecast tables

Table 1 GDP and its main components¹

	2022	2023	2024	2025	2026
Private consumption	8.5 (8.5)	0.5 (1.8)	1.2 (2.0)	3.1 (2.5)	3.2 (2.2)
Public consumption	2.2 (2.2)	1.9 (1.6)	1.7 (1.8)	1.7 (1.7)	2.0 (2.0)
Gross capital formation	7.6 (7.6)	-0.8 (-0.7)	4.1 (5.2)	3.8 (4.0)	4.5 (5.8)
Business investment	15.0 (15.0)	1.3 (-0.8)	5.2 (5.3)	4.6 (3.5)	5.6 (6.8)
Residential investment	-6.2 (-6.2)	-3.2 (2.2)	4.7 (11.4)	3.0 (7.4)	3.0 (5.9)
Public investment	3.3 (3.3)	-4.7 (-4.2)	-0.5 (-3.1)	1.8 (1.3)	2.2 (2.3)
National expenditure	6.6 (6.6)	0.8 (1.2)	1.7 (2.3)	2.7 (2.6)	3.1 (3.0)
Exports of goods and services	22.3 (22.3)	4.4 (5.1)	2.7 (3.7)	3.4 (3.3)	3.0 (2.9)
Imports of goods and services	19.9 (19.9)	-1.4 (-0.3)	2.4 (3.1)	2.9 (2.7)	4.1 (4.0)
Gross domestic product (GDP)	7.2 (7.2)	3.6 (3.7)	1.9 (2.6)	2.9 (2.9)	2.7 (2.5)
GDP at current prices (ISK trillions)	3.80 (3.80)	4.16 (4.19)	4.44 (4.52)	4.73 (4.83)	5.02 (5.12)
Public sector demand ²	2.4 (2.4)	1.0 (0.8)	1.4 (1.1)	1.7 (1.6)	2.0 (2.0)
Total investment (% of GDP)	22.3 (22.3)	21.9 (21.8)	21.7 (22.1)	21.8 (22.2)	22.1 (22.9)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2023/4).

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 exports¹

	2022	2023	2024	2025	2026
Marine production for export	1.0 (1.0)	-9.9 (-8.3)	2.2 (3.0)	1.3 (1.3)	2.2 (2.2)
Aluminium production for export ²	2.3 (2.3)	1.2 (1.7)	0.4 (0.6)	1.1 (1.1)	1.0 (1.0)
Goods exports, total	1.5 (1.5)	-1.3 (-1.3)	1.5 (2.6)	2.3 (2.4)	2.5 (2.4)
Services exports, total	58.3 (58.3)	12.1 (13.6)	4.0 (4.9)	4.4 (4.2)	3.5 (3.3)
Contribution of net trade to GDP growth (percentage points)	0.5 (0.5)	2.7 (2.5)	0.1 (0.3)	0.2 (0.3)	-0.5 (-0.5)
Terms of trade for goods and services	2.4 (2.4)	-5.5 (-4.4)	0.0 (0.0)	0.2 (0.0)	0.3 (0.3)
Trade balance (% of GDP)	-0.4 (-0.4)	-0.3 (0.0)	-0.2 (0.2)	0.1 (0.5)	-0.2 (0.2)
Current account balance (% of GDP)	-2.3 (-2.0)	0.0 (0.6)	-0.1 (0.7)	0.1 (0.7)	-0.5 (0.0)
Inflation in main trading partners ³	7.6 (7.6)	5.0 (5.1)	2.7 (2.9)	2.1 (2.1)	2.0 (1.9)
GDP growth in main trading partners ³	3.3 (3.3)	1.1 (1.1)	1.0 (1.1)	1.6 (1.8)	1.7 (1.9)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2023/4).

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 utilisation¹

	2022	2023	2024	2025	2026
Total hours worked ²	6.7 (6.7)	5.0 (4.4)	2.5 (0.5)	0.3 (1.7)	1.7 (1.9)
Unemployment (% of labour force) ²	3.8 (3.8)	3.4 (3.4)	4.8 (4.8)	4.6 (4.4)	3.8 (4.0)
GDP per hour worked ³	0.5 (0.5)	-1.3 (-0.7)	-0.6 (2.0)	2.7 (1.2)	1.0 (0.6)
Unit labour costs ⁴	7.6 (7.6)	8.6 (8.6)	7.2 (4.9)	3.0 (4.1)	4.5 (3.4)
Real disposable income ⁵	3.1 (3.1)	0.6 (1.4)	3.2 (1.7)	2.4 (2.9)	3.9 (2.7)
Output gap (% of potential output)	3.1 (2.8)	2.3 (2.0)	-0.3 (0.8)	-0.5 (0.4)	-0.1 (0.3)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2023/4).

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 inflation¹

	2022	2023	2024	2025	2026
Trade-weighted exchange rate index ²	3.1 (3.1)	-2.6 (-2.2)	-0.6 (-0.4)	-0.3 (-0.7)	-0.5 (-1.0)
Real exchange rate (relative consumer prices)	3.9 (3.9)	0.9 (1.3)	1.6 (2.2)	0.8 (0.8)	0.1 (0.0)
Inflation (consumer price index, CPI)	8.3 (8.3)	8.7 (8.7)	5.0 (5.7)	3.3 (3.6)	2.7 (2.9)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2023/4).

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 (%)¹

Quarter	Inflation (year-on-year change)	Inflation (annualised quarter -on-quarter change)
Measured value		
2023:1	10.0 (10.0)	10.5 (10.5)
2023:2	9.4 (9.4)	11.4 (11.4)
2023:3	7.8 (7.8)	4.4 (4.4)
2023:4	7.9 (7.9)	5.5 (5.5)
Forecasted value		
2024:1	6.3 (6.8)	4.0 (6.3)
2024:2	5.0 (5.7)	6.3 (6.8)
2024:3	4.7 (5.3)	3.0 (2.5)
2024:4	4.1 (4.9)	3.3 (4.1)
2025:1	3.6 (4.0)	1.8 (2.7)
2025:2	3.3 (3.6)	5.3 (5.1)
2025:3	3.3 (3.5)	2.7 (1.9)
2025:4	3.2 (3.3)	3.0 (3.6)
2026:1	3.1 (3.2)	1.3 (2.2)
2026:2	2.7 (3.0)	3.8 (4.4)
2026:3	2.4 (2.8)	1.5 (1.2)
2026:4	2.5 (2.7)	3.2 (3.0)
2027:1	2.5	1.6

1. Figures in parentheses are from the forecast in MB 2023/4.

Sources: Statistics Iceland, Central Bank of Iceland.

