CENTRAL BANK OF ICELAND

SEÐLABANKI ÍSLANDS

MONETARY BULLETIN

2025|1

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 5 February 2025

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower 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 8.0%. All Committee members voted in favour of the decision.

Inflation has continued to fall and was down to 4.6% in January. Underlying inflation has eased as well and is at its lowest in three years. The outlook is for continued disinflation in coming months.

Demand growth has subsided in line with a tight monetary stance, and the positive output gap in the economy is narrowing. Housing market activity has eased, and house price inflation has lost pace. There are signs that economic activity is stronger than preliminary national accounts figures imply, however, and wage costs continue to rise.

Although inflation has eased and inflation expectations have fallen, inflation pressures remain, which calls for a continued tight monetary stance and caution regarding decisions going forward. This is compounded by elevated global economic uncertainty.

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

The global GDP growth outlook is broadly unchanged since November, but developments differ from one country to another, with the US showing robust growth and the eurozone lagging behind. Trading partner GDP growth is expected to inch upwards relative to 2024, to an average of 1.7% this year. The global inflation outlook is also largely unchanged, and inflation is expected to keep falling. Central banks in major advanced economies have therefore continued to lower interest rates in line with the improved inflation outlook, but rates still remain well above pre-pandemic levels.

According to preliminary figures from Statistics Iceland, GDP shrank by 1% in the first three quarters of 2024. This is a larger contraction than was forecast in November, owing mainly to a more negative contribution from inventory changes and net trade. Year-on-year GDP growth is estimated to have turned positive again in Q4, but a contraction of 0.4% is projected for the year as a whole. In November, however, GDP was forecast to remain flat between years. Year-2025 output growth is also forecast to be slightly weaker than previously assumed, or 1.6%. The poorer outlook is due mainly to more muted growth in private consumption and a more negative contribution from net trade, although stronger investment will pull in the opposite direction. As in November, GDP growth is forecast to continue gaining pace in the coming two years.

Job numbers are rising in line with the historical average, and unemployment has inched upwards in the recent term. There are signs that labour supply and demand are better balanced than before. The baseline forecast assumes that unemployment will continue to rise to an average of 4.5% in 2025, concurrent with a slack developing in the economy around mid-year, somewhat earlier than previously estimated.

Inflation fell in Q4/2024 and averaged 4.9%, slightly above the forecast published in the November *Monetary Bulletin*. It continued to fall between months in January, to 4.6%. Underlying inflation has also declined, to 4.1% in January. Households' and businesses' inflation expectations have fallen, but market agents' long-term inflation expectations rose again in January as compared with the November survey. Inflation is expected to keep falling but to be slightly higher in coming quarters than in the November forecast. The outlook for the latter half of the forecast horizon is broadly as in November, however, and inflation is still projected to align with the target in mid-2026.

The global economic outlook is highly uncertain, owing largely to wars and geopolitical uncertainty. Concerns about growing trade protectionism have escalated, and the risk is that trading partner GDP growth will be weaker and inflation higher than previously forecast. Developments on this front will also affect the outlook for Iceland. The baseline forecast assumes that GDP contracted in 2024, and prospects for 2025 are slightly poorer than previously projected. Economic activity could be underestimated, though, if earlier figures on exports and investment are revised upwards. The pace of disinflation is uncertain as well.

The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin* 2024/4 in November 2024, and on the updated forecast presented here. It is based on data available at the end of January. The risk assessment in the updated forecast is based on the risk assessment in the November forecast.

Economic developments and updated forecast

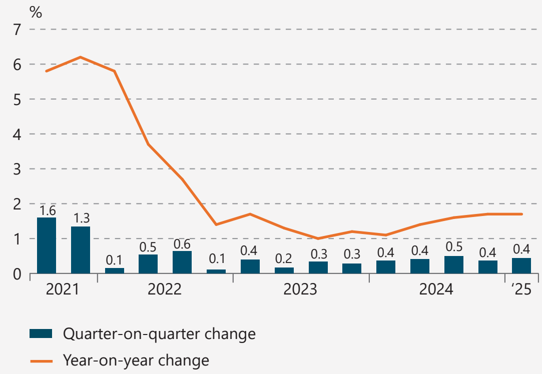
The global economy

Among Iceland's main trading partners, GDP grew by 0.5% quarter-on-quarter in Q3/2024, and by 1.6% year-on-year, as compared with an average of 1% at the beginning of 2024. This is also slightly stronger growth than in the Bank's November forecast. Nevertheless, developments differed from one country to another. In the US, output growth remained strong year-on-year, at 2.7% in Q3, and in Denmark it measured 3.1%. At the same time, growth measured just under 1% in the eurozone, the UK, and Norway, and only 0.7% in Sweden. In Germany, GDP shrank by 0.3% year-on-year during the quarter, contracting for the fifth consecutive quarter.

Chart 1

GDP growth in Iceland's main trading partners[1]

Q3/2021 - Q1/2025



1. Seasonally adjusted data. Central Bank baseline forecast Q4/2024 and Q1/2025.
Sources: LSEG Datastream, Central Bank of Iceland.

Developments in Q4 appear to have been well in line with the Bank's November forecast, and the global output growth outlook is broadly unchanged overall. GDP growth is still expected to inch upwards in 2025, buoyed by a favourable employment situation, real wage growth, falling interest rates, and rising asset prices.

Nevertheless, the economic outlook remains highly uncertain. As before, one of the determinants will be global inflation and how successfully it can be brought back to target. The effects of war also weigh heavily, although it appears that the war in the Middle East has passed a turning point. Furthermore, political uncertainty has increased in core eurozone countries, and concerns about fiscal policy are widespread. Added to this are elevated concerns about the effects of growing support for trade protectionism, including new tariffs on imports, which could trigger further geopolitical fragmentation, disrupt global supply chains, increase the cost of international trade, push import prices upwards, and dampen investment and economic activity. Moreover, there is considerable uncertainty about economic developments in China and the impact of fiscal support measures there.

According to the Bank's baseline forecast, GDP growth among Iceland's main trading partners will measure 1.7% this year, about the same as in the November forecast. GDP growth prospects have improved for the US, Denmark, and Norway, but have worsened for the eurozone. Trading partner GDP growth is also expected to measure 1.7% in 2026, as in the November forecast, but then ease to 1.6% in 2027.

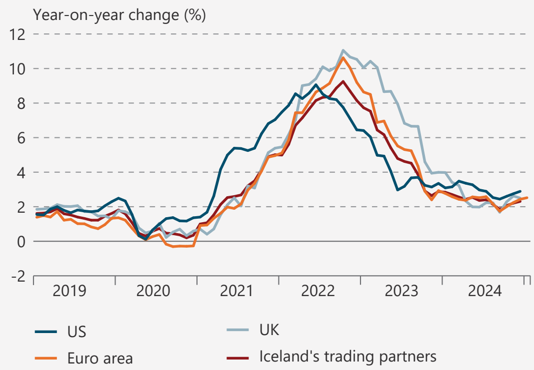
Global inflation

Trading partner inflation has tumbled from its peak roughly two years ago. It picked up again slightly in late 2024, however, to an average of 2.3% in December.

Chart 2

Global inflation

January 2019 - January 2025



Sources: LSEG Datastream, Central Bank of Iceland.

Although energy prices are still keeping global inflation in check, the year-on-year drop in prices has lost pace as base effects from previous increases have tapered off. At the same time, the twelve-month increase in food and goods prices has held relatively steady and services price inflation has been persistent. Core inflation in trading partner countries (i.e., excluding the direct effects of energy and food prices) has therefore remained flat at 2.6% over the past four months.

Trading partner inflation averaged 2.3% in Q4/2024, slightly below the November forecast. This is due mainly to lower inflation in the eurozone, offset by higher inflation in the US and the UK. Global oil and natural gas prices have risen more in the recent term than was projected in November, however, and the year-2025 inflation outlook for trading partners is therefore largely unchanged. Trading partner inflation is still expected to ease slowly in coming quarters, in tandem with declining services price inflation, and reach 2% in late 2025. The inflation outlook for the next two years is unchanged as well.

Global interest rates

Central banks in leading advanced economies have continued to lower interest rates as the inflation outlook improves and demand pressures subside in their economies. Nonetheless, interest rates are still well above pre-pandemic levels. The European Central Bank (ECB) lowered its key rate by 0.25 percentage points in December, and again in January, to 2.75%, from 4% at the beginning of last summer. The US Federal Reserve also lowered rates by 0.25 percentage points in December, to 4.25-4.5%, for a total rate cut of 1 percentage point since September. The Fed's forward guidance was more cautious than before, however, not least because of concerns about more persistent inflation and reduced concerns about a developing slack in the labour market. It was therefore unsurprising that the Fed held interest rates steady at its January meeting. The Bank of England (BoE) had lowered its policy rate in November but held it unchanged in December, as UK inflation has picked up again.

Forward interest rates in the market indicate that market agents expect continued rate cuts in leading advanced economies in 2025. Nevertheless, they expect rates in the US to fall less than was previously assumed. This is reflected in US government bond yields, which have risen still further since November. As of mid-January, US long-term yields were at their highest in over two years. Yields on other sovereign bonds have increased as well, particularly in the UK. Rising government bond yields are due in part to elevated uncertainty about public sector finances and inflation. Term premia have therefore risen considerably in many economies and, on long-term US government bonds, are at their highest since the aftermath of the financial crisis. Global share prices softened at the end of 2024 but then rebounded in January. Risk premia on high-risk financial assets in leading advanced economies have been broadly unchanged, however.

Terms of trade

Terms of trade for goods and services are estimated to have improved by 1.1% in 2024, as was forecast in November. The outlook for 2025 has deteriorated, though. Terms of trade are now projected to improve by 0.4% this year, or 1 percentage point less than in the November forecast. This is due primarily to larger hikes in import prices, which in turn stem from unfavourable developments in global oil and commodity prices and a more pronounced increase in the price of alumina. An improved outlook for the export price of aluminium and marine products pulls in the opposite direction. The outlook for 2026 and 2027 is largely unchanged, however.

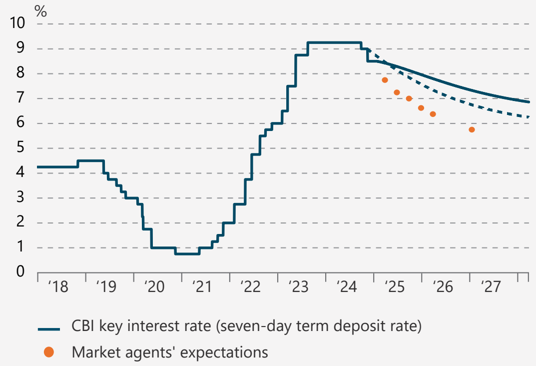
Domestic interest rates

At its November meeting, the Central Bank Monetary Policy Committee (MPC) decided to lower the Bank's key interest rate (the rate on seven-day term deposits) by 0.5 percentage points. The key rate was 8.5% just before this *Monetary Bulletin* and has been lowered by 0.75 percentage points since October. According to the Bank's January survey of market agents' expectations, respondents expect the key interest rate to continue falling, reaching 5.75% in two years' time. This is broadly the same as in the November survey. Forward interest rates also suggest that investors expect interest rates to decline, but somewhat more slowly than was assumed in November.

Chart 3

Central Bank of Iceland key interest rate[1]

1 January 2018 - 31 March 2028



1. Money market rates and Treasury bond yields were used to estimate the yield curve. The broken line shows forward market interest rates prior to MB 2024/4. Market agents' expectations from Central Bank's survey. Estimated from the median response on expectations concerning the collateralised lending rate. The survey was carried out during the period 20-22 January 2025.

Source: Central Bank of Iceland.

The Bank's real rate, based on the average real rate as calculated from various measures of inflation and one-year inflation expectations, is currently 4.5%. It has held broadly unchanged in the recent term, as the Bank's key rate has been lowered in tandem with falling inflation and inflation expectations.

Nominal Treasury bond yields started falling in August, reflecting greater investor optimism about disinflation and Central Bank interest rate cuts. Bond rates declined until December but have risen slightly since then, perhaps due in part to the aforementioned rise in global interest rates. Increased uncertainty about public finances following the change in Government could also have an impact. The yield on ten-year nominal Treasury bonds was 6.5% just before this *Monetary Bulletin* and has risen by 0.2 percentage points since November. The yield on ten-year indexed Treasury bonds was 2.5% at the same time and is largely unchanged since November. The long-term breakeven inflation rate in the bond market has therefore risen slightly.

Exchange rate of the króna

The króna began to appreciate in September, partly because of increased foreign inflows for investment in Treasury bonds. It strengthened even further in November. Developments towards the end of the year are probably affected by inflows relating to US company John Bean Technologies' takeover of Marel. The króna has depreciated slightly in 2025 to date, however, and is now 1% weaker in trade-weighted terms than in November, although it is nearly 1% stronger than it was a year ago. Foreign exchange market turnover has shrunk in the past two years, and the Central Bank last intervened in the market a year ago. This indicates that market participants' inflows and outflows are well balanced.

Chart 4

Exchange rate of the króna[1]

3 January 2022 - 31 January 2025

1. Price of foreign currency in krónur. Narrow trade index.
Source: Central Bank of Iceland.

In Q1 to date, the króna has been nearly 2% stronger than was assumed in the November forecast. The baseline forecast assumes a marginal appreciation in H1, followed by a gradual depreciation of just over 2% during the remainder of the forecast horizon. This would put the exchange rate at about the level projected in November.

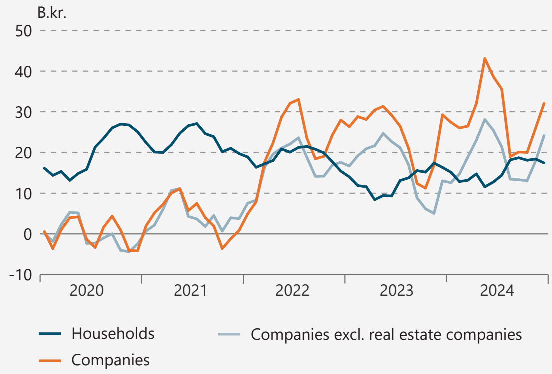
Money holdings and lending

Year-on-year growth in M3 measured just under 12% in December, slightly above the average for 2024 as a whole. Household deposits continue to account for the lion's share of growth, with an increase of just over 16% year-on-year in December. Household saving has largely taken the form of sight deposits, which delivered acceptable returns in 2024, and on the whole, households' interest income has increased markedly in the recent term. With interest rate cuts and falling inflation, it is not unlikely that households will be motivated to seek out higher-risk assets such as equities and funds. At the same time, growth in lending to households has slowed somewhat. New residential mortgages are still inflation-indexed for the most part, although the share of indexed loans in new lending has begun to shrink. Furthermore, early retirement of non-indexed loans has eased, as non-indexed lending rates declined in 2024. Inflation-indexed mortgage rates rose in 2024, however, and the commercial banks tightened their terms and conditions on those loans.

Chart 5

Net new lending[1]

January 2020 - December 2024



1. Net new lending consists of new lending net of prepayments and retirement of older loans. Lending from deposit institutions, pension funds, the Housing and Construction Authority, and the ÍL-fund. Three-month moving average.
Source: Central Bank of Iceland.

Year-on-year growth in credit system lending to companies lost pace late in 2024, measuring just under 11% at the year-end. Net new lending eased starting in mid-year but then picked up again towards the year-end. In recent months, new loans have been granted to a broader range of sectors, whereas in early 2024 it was concentrated mainly in loans to real estate firms. Companies have also been obtaining more financing through bond issuance in recent months. Corporate deposits increased by nearly 7% year-on-year in December. The growth rate eased relative to H1, in tandem with the slowdown in economic activity, but then picked up again towards the year-end.

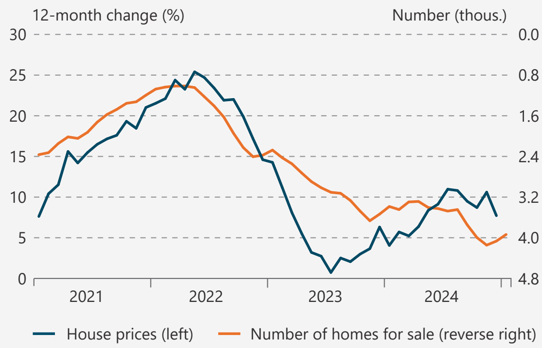
Asset prices

House prices rose briskly for much of 2024, but the pace slowed later in the year. House price inflation measured 7.7% in December, its lowest since April 2024. At the same time, real estate market activity tapered off decisively, particularly transactions relating to events in Grindavík, which peaked in April and May. The total number of purchase agreements was up 42% year-on-year, and the number of first-time buyers rose markedly. The number of homes for sale increased during the autumn, and in November there were more than 4,000 properties listed on the market. Market listings have fallen again in the past two months, however. Even so, the average time-to-sale has grown much longer since last spring. In December it measured 5.3 months, its longest since late 2017. Just over 15% of homes sell at a premium on the asking price, as compared with 19% in September 2024. As before, year-on-year house price inflation is projected to subside in 2025, albeit more slowly than was forecast in November.

Chart 6

House prices and number of homes for sale in the whole country

January 2021 - January 2025



Sources: Visir Real Estate Website (fasteignir.is), Housing and Construction Authority, Central Bank of Iceland.

Share prices started rising in the autumn, probably owing in part to greater optimism about interest rate cuts. The OMXI15 index has risen by 9% since November, and shares in most listed companies have increased in price over this period. Households' and businesses' financial conditions improved in 2024 but tightened slightly towards the end of the year.

Private consumption

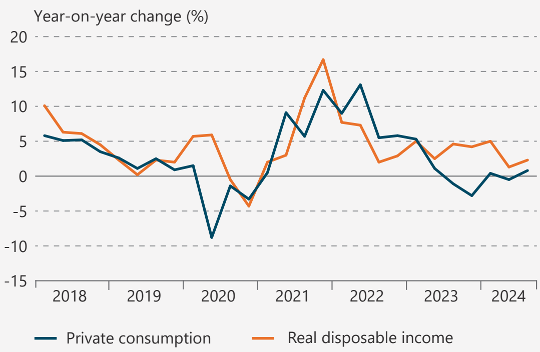
Private consumption grew by 0.8% year-on-year in Q3/2024, somewhat below the Bank's November forecast. More muted spending growth can be attributed in part to slower growth in real disposable income. Over the first three quarters of 2024, private consumption growth measured 0.2%, as was forecast in November. H1 figures were revised upwards, offsetting weaker-than-expected consumption in Q3.

As was projected in November, household spending appeared to pick up further in Q4. Preliminary payment card turnover figures suggest an uptick in household demand, as total card turnover grew by 6.1% year-on-year. Overseas turnover using Icelandic cards rose by 19% during the quarter, partly indicating brisk e-commerce activity, as online shopping with foreign merchants is classified as turnover abroad.

Chart 7

Private consumption and real disposable income[1]

Q1/2018 - Q3/2024



1. Statistics Iceland's estimate of disposable income is taken from the sectoral accounts. Both series are entered at constant prices and deflated with the private consumption price deflator.

Sources: Statistics Iceland, Central Bank of Iceland.

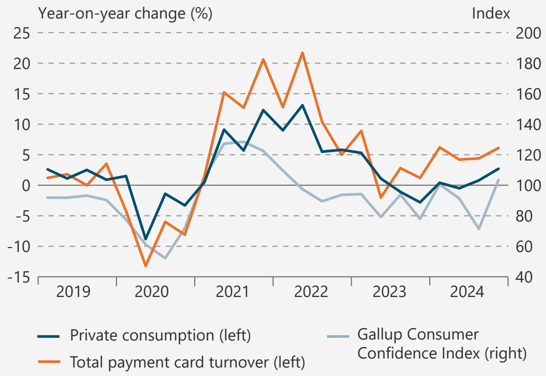
After falling early in 2024, the Gallup Consumer Confidence Index started to pick up late in the year, suggesting that consumers are growing more optimistic again. The index averaged just over 103 points in Q4, its highest since Q1/2022. Households' motor vehicle purchases continue to decline, however, explaining in part why private consumption has grown more slowly in the recent term than card turnover data imply.

Private consumption is estimated to have grown by 0.9% in 2024, as compared with the November forecast of 1% growth. As in November, growth is projected to gather pace this year, albeit more slowly than was assumed then. Private consumption growth is expected to measure 2.5% in 2025, whereas it was projected at 2.9% in November. The more subdued growth rate is due mainly to indications that real disposable income grew more slowly than expected in 2024. The outlook for private consumption growth in the latter half of the forecast horizon is more or less unchanged since November.

Chart 8

Private consumption and its indicators[1]

Q1/2019 - Q4/2024



1. Payment turnover in constant prices. Central Bank baseline forecast Q4/2024 for private consumption.

Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Investment

Investment grew by 3.8% in the first three quarters of 2024, while the November forecast assumed it would grow by 2.4%. The deviation stems mostly from stronger business investment in Q3, although residential investment was somewhat more robust as well.

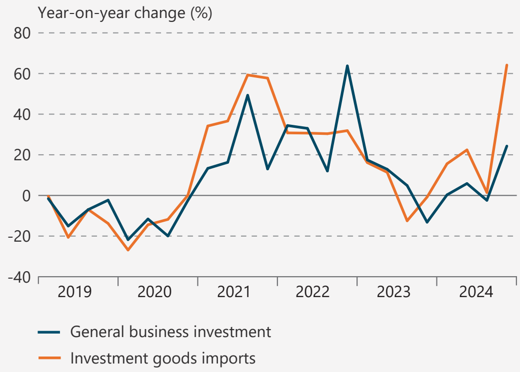
According to preliminary figures on goods trade from Statistics Iceland, investment goods imports grew by 64% year-on-year in Q4/2024 (goods and services imports are discussed more fully below). The surge can be attributed mainly to large-scale importation of computer equipment by companies operating data centres in Iceland. This investment activity is far stronger than could be discerned from the information available when the November forecast was prepared, and it therefore changes projections of investment activity in Q4/2024 and 2025. As a result, general business investment (i.e., excluding energy-intensive industry, ships, and aircraft) is now estimated to have grown by 24% in Q4 and by 6.8% in 2024 as a whole, instead of the November forecast of 2.6% for the full year.

The outlook is also for stronger growth this year: general business investment is now projected to increase by 6.2%, as compared with a 0.6% contraction forecast in November. Stronger investment in data centres is offset by slower growth in residential investment. Indicators imply that the number of new and newly registered homes will be broadly unchanged year-on-year in 2025, while fewer new projects will be started because of the large number of properties under construction. Total investment is projected to grow by 2.5% in 2025, or 2 percentage points more than in the November forecast. The investment-to-GDP ratio is expected to rise to 26%, its highest since 2007.[1]

Chart 9

Investment goods imports and investment[1]

Q1/2019 - Q4/2024



1. Business investment excluding energy-intensive industry and ships and aircraft. Central Bank baseline forecast for growth in general business investment in Q4/2024. Combined value of imported investment goods and transport equipment for commercial use (excluding ships and aircraft), deflated with the trade-weighted exchange rate index.

Sources: Statistics Iceland, Central Bank of Iceland.

Public sector finances

In December, the National Budget for 2025 was approved by Parliament with a deficit amounting to 1.3% of GDP. Based on updated estimates, the Treasury outcome will improve marginally between years, as the deficit on the interest balance is expected to shrink and the Treasury primary balance to remain unchanged. The 2025 Budget assumes a Treasury primary surplus measuring 0.4% of GDP and a 1.7% deficit on the interest balance. The estimated primary surplus is smaller than was projected in the November forecast, as the 2024 outcome as depicted in the Government's updated estimate was poorer than had been assumed in November. The change in primary balance between 2024 and 2025 is broadly as was projected in November, however.

Public consumption and investment are estimated to have increased by a combined 1.9% in 2024, reflecting a 2.8% contraction in investment and 2.7% growth

1. Development of the military defence site on Reykjanes peninsula has increased somewhat, but it is not yet clear how this investment will be treated in the national accounts. It could entail stronger investment than is assumed in the baseline forecast, as well as a revision of previous figures. Although this activity will probably be classified as public investment, it will have a negligible impact on the public sector outcome, as it is financed virtually in full by Iceland's NATO partners.

in public consumption. The increase is larger than was assumed in November, owing mainly to stronger public consumption spending. In 2025, public investment is projected to contract by 0.6%, offset by 2.1% 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, broadly as was forecast in November.

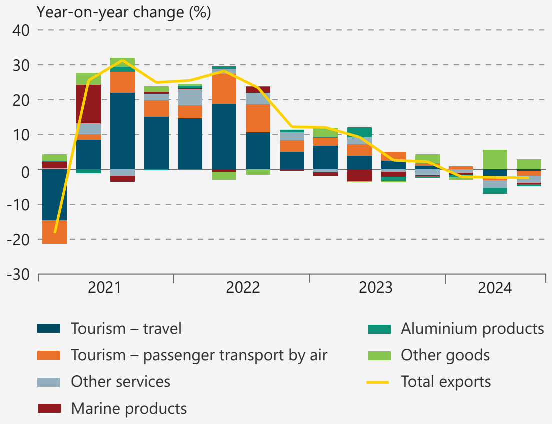
Exports of goods and services

Goods and services exports shrank by 2.2% year-on-year in Q3/2024, the third consecutive quarter to see a contraction of that size. Most subcomponents of exports contracted, apart from other goods exports (i.e. other than aluminium and marine products), which grew by 9% between years, owing largely to increased exports from the pharmaceuticals industry. The contraction in services exports measured 6%, somewhat more than was projected in November, and most subcomponents turned out weaker than expected.

Chart 10

Exports and contribution of subcomponents[1]

Q1/2021 - Q3/2024



1. Because of chain-volume linking, the sum of components may not equal total exports. Aluminium exports as defined in the national accounts.

Sources: Statistics Iceland, Central Bank of Iceland.

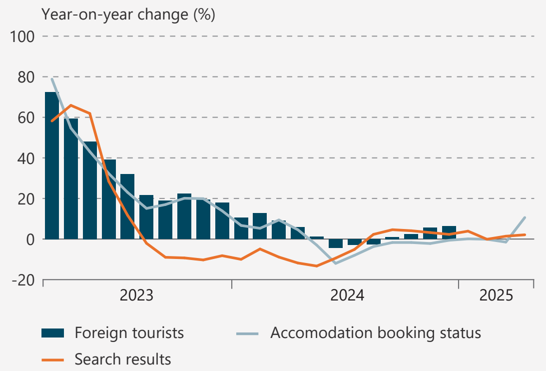
Indicators from the tourism industry suggest a strong Q4, however. Foreign nationals' arrivals in Iceland rose 6% between years, rising to the largest Q4 total on record.[2] Airlines' passenger load factors and hotels' occupancy rates improved year-on-year, and turnover with foreign-issued payment cards jumped nearly one-fifth. In part, though, the upturn is due to base effects, as the seismic activity on the Reykjanes area affected tourism in the same months of 2023.

2. The steep decline in Icelanders' overseas travel in November suggests that the share of foreign nationals among passengers travelling through Keflavík Airport may have been overestimated.

Chart 11

Travel to Iceland[1]

March 2023 - April 2025



1. Foreign nationals' monthly departures via Keflavík Airport throughout 2024. Search results based on a factor model combining the frequency of five different Google search strings relating to travel to Iceland, lagged by three months. Number of overnight stays booked through online travel agents according to data administered by Godo. Paired comparison for January - March 2025, according to the booking status as of 31 January 2025. Three-month moving average.

Sources: Godo, Google Trends, Icelandic Tourist Board, Isavia, Central Bank of Iceland.

In 2024 as a whole, nearly 2.3 million tourists visited Iceland, slightly more than was projected in November. Even so, services exports are now estimated to have contracted by 4.5% year-on-year in 2024, or 1.5 percentage points more than in the November forecast. The difference is due primarily to a larger contraction in other services exports in H2. On the other hand, goods exports are estimated to have grown by 1.5% year-on-year in 2024, slightly outpacing the November forecast. Total exports are therefore estimated to have contracted between years by 1.5%, or ½ a percentage point more than was forecast in November.

The outlook for tourism in 2025 is broadly as in the Bank's November forecast. Global demand for travel remains strong, and airline seat capacity on flights to and from Iceland is projected to remain largely unchanged. The share of transit passengers is expected to fall, however. Furthermore, Google searches for flights to Iceland and accommodation in the country are more or less unchanged, and the status of hotel bookings has improved marginally since November. Tourist numbers are still expected to be slightly higher this year than in 2024, or just over 2.3 million, and services exports are projected to grow by 2.4% year-on-year.

Prospects for goods exports are broadly the same, however, and as before, exports of pharmaceuticals and aquaculture products look set to continue growing. As a result, goods exports are projected to increase by 1.7% in 2025 and total exports by 2%, as was forecast in November. The outlook for 2026 and 2027 is similarly unchanged: tourist numbers are expected to rise modestly and other goods exports to grow somewhat.

Imports of goods and services

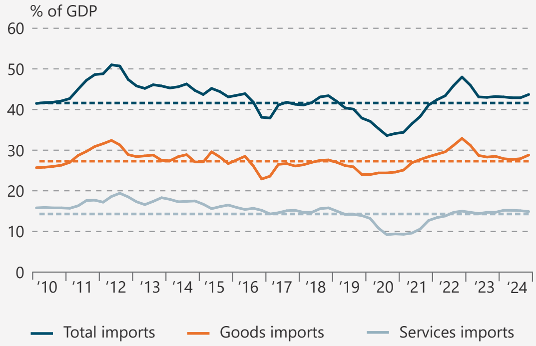
As was assumed in November, goods and services imports contracted by 0.7% year-on-year in Q3/2024. This is a marked change from the 2.4% growth seen in H1. Services imports continued to rise, particularly imports of financial services, whereas goods imports contracted by 1.8%.

On the other hand, goods imports appear to have grown considerably more in Q4 than was assumed in November, as imports of investment goods far outpaced estimates, reaching an all-time high for a single quarter. This was due to the aforementioned surge in data centre investment. Based on this new information, goods imports are now assumed to have increased by 3.9% in 2024 instead of the 1.1% forecast in November, and the ratio of imported goods values to GDP is projected to have risen again in Q4.

Chart 12

Imports of goods and services[1]

Q1/2010 - Q4/2024



1. Two-quarter moving average. Central Bank baseline forecast Q4/2024. Broken lines show average from 2000.

Sources: Statistics Iceland, Central Bank of Iceland.

Icelanders' overseas spending in Q4 also appears to have been stronger than projected, but in other respects the outlook for services imports is unchanged. Total imports are therefore estimated to have grown by 3.7% in 2024, some 2 percentage points above the November forecast. The outlook is also for stronger goods imports in 2025, owing to continued strong investment in data centres.

Current account balance

The current account showed a surplus of 3.8% of GDP in Q3/2024, about half as large as the surplus from the same quarter of 2023. The shrinking surplus is due mainly to a turnaround in the primary income balance. The Q3/2024 surplus also fell somewhat short of the November forecast. The deviation is due to a smaller surplus on services trade and more unfavourable developments in the primary income balance, which in turn stemmed from a stronger performance by foreign-owned aluminium and pharmaceuticals companies.

For 2024 as a whole, the current account is estimated to have shown a deficit of 2.3%, or a full 1.4 percentage points more than was assumed in November. The main driver of the deviation is a larger deficit on goods and services trade, owing to strong imports of investment goods in Q4. Unfavourable developments in the primary income balance pull in the same direction. These same factors will make an impact in 2025, as the forecast assumes a larger deficit on goods trade and primary income, owing to the prospect of a better performance by aluminium and pharmaceuticals companies.[3] The outlook for 2025 is for a deficit of 3%, which will then shrink again in the latter half of the forecast horizon, when the data centres' imports subside. By then, the balance on combined goods and services trade should be close to equilibrium.

GDP growth

Even though consumption and investment spending increased more in Q3 than was assumed in the November forecast, GDP growth proved markedly weaker. According to preliminary figures from Statistics Iceland, GDP contracted by 0.5% year-on-year, whereas the forecast had assumed 2.5% growth. The contribution of inventory changes to output growth turned out less favourable than expected, and this was compounded by the aforementioned contraction in exports. Over the first nine months of the year, GDP shrank by 1% between years, as compared with the 0.3% contraction forecast in November.

GDP growth in Q4 is estimated at 1.2%, marginally above the November forecast. If this projection is borne out, GDP will have contracted by 0.4% in 2024 as a whole, whereas in November it was assumed to remain unchanged year-on-year. Increased investment during the year is expected to have offset weaker external trade; therefore, the deviation is due to a more negative contribution from inventory changes than was assumed in November.

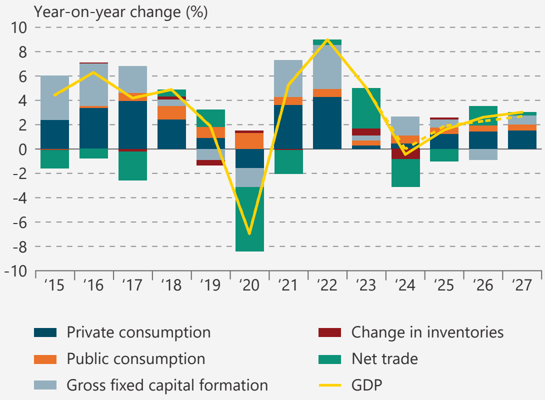
As in November, GDP growth is projected to pick up again this year and continue rising in 2026 and 2027. This year's recovery will be more gradual than previously forecast, however, as the prospect of a more negative contribution from net trade weighs heavier than the forecast of stronger growth in domestic

3. It should be borne in mind that because data centres' importation of investment goods does not require increased foreign currency flows, the larger current account deficit it causes does not put greater pressure on the exchange rate.

demand. GDP growth is projected at 1.6% in 2025, or 0.3 percentage points below the November forecast. It is expected to rebound to 2.6% in 2026 and 3% in 2027.

Chart 13

GDP growth and contribution of underlying components 2015-2027[1]



1. Central Bank baseline forecast 2024-2027. Broken line shows forecast from MB 2024/4.
Sources: Statistics Iceland, Central Bank of Iceland.

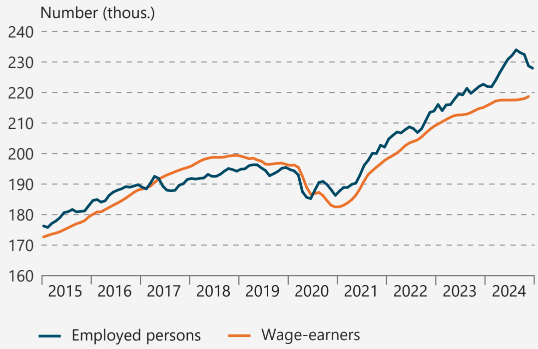
Employment and unemployment

In November 2024, the number of persons on the pay-as-you-earn (PAYE) register increased by 2% year-on-year, close to its historical average. As before, the Statistics Iceland labour force survey (LFS) is considered to overestimate job numbers and total hours worked, but according to the survey, the number of working persons rose far more in mid-2024 than the number on the PAYE register. The discrepancy between the two measures narrowed in Q4, however, when LFS-based labour participation rate declined again after a considerable increase in the first three quarters of the year.

Chart 14

Different measures of employment[1]

January 2015 - December 2024



1. Employed persons according to Statistics Iceland labour force survey and wage-earners according to the Iceland Revenue and Customs' pay-as-you-earn (PAYE) register. Persons aged 16-74 years old. Three-month moving average of seasonally adjusted figures.
Sources: Statistics Iceland, Central Bank of Iceland.

Seasonally adjusted registered unemployment has been creeping upwards for just over a year and a half. It measured 3.6% in December, as it had in the three months beforehand, after falling to a post-pandemic low of 3.1% in May 2023. Seasonally adjusted unemployment according to the LFS measured 3.2% in Q4/2024 but has been far more volatile in the recent past.

After a strong post-pandemic upswing, labour supply and demand appear more balanced than before. The seasonally adjusted results of Gallup's winter survey indicate that firms' recruitment plans are in line with the historical average, and Statistics Iceland's survey of job vacancies points in the same direction as regards both the number of vacancies and the ratio of job openings to unemployed persons.

The baseline forecast assumes that the gap that has developed between the LFS and other labour market indicators will continue to narrow. This means that job numbers and total hours worked will decline year-on-year in H2/2025 and H1/2026, owing to base effects from the overestimation in the survey a year earlier. The unemployment outlook is broadly unchanged since November: the jobless rate is projected to average 4.5% in 2025 and then start to subside.

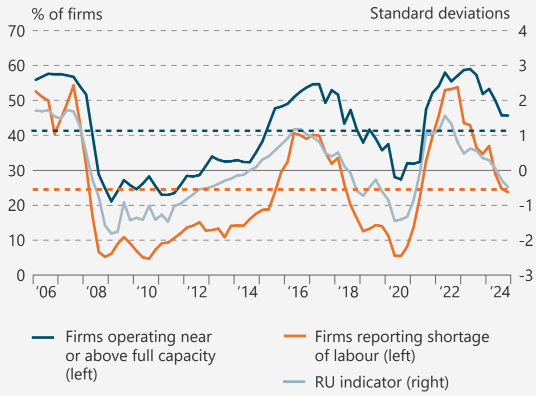
Resource utilisation

According to the seasonally adjusted results of Gallup's winter survey, 24% of corporate executives considered themselves short-staffed, which accords with the historical average. The share of firms operating at full capacity has been more resilient, however, as 46% of

Chart 15

Capacity utilisation[1]

Q1/2006 - Q4/2024



1. Indicators of capacity utilisation are based on the Gallup Sentiment Survey conducted among Iceland's 400 largest companies. The resource utilisation indicator (RU indicator) is the first principal component of selected indicators of capacity utilisation; it is scaled so that its mean value is 0 and the standard deviation is 1. A more detailed description can be found in Box 3 in MB 2018/2. Seasonally adjusted figures. Broken lines show period averages.
Sources: Gallup, Central Bank of Iceland.

executives still report difficulty responding to an unexpected increase in demand. The resource utilisation (RU) indicator, which combines various indicators of factor utilisation, is below its historical average for the second quarter in a row, indicating that a small negative output gap is developing in the economy. This slack is expected to open up early this year and measure just under 1% of capacity in 2025 as a whole, which represents a slightly larger slack than was forecast in November. As was the case then, the slack is expected to narrow as 2026 advances and close by the end of the forecast horizon.

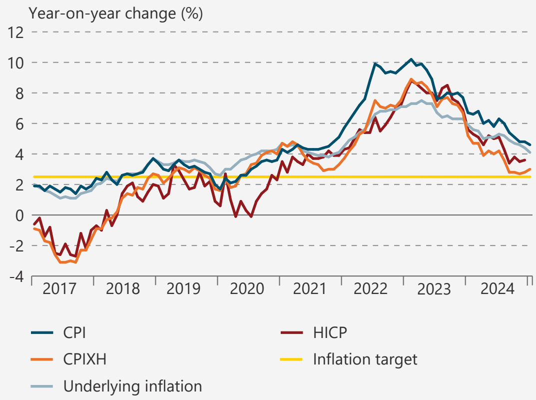
Inflation

Inflation subsided over the course of H2/2024. It averaged 4.9% in Q4, as compared with the November forecast of 4.8%. It declined month-on-month in January, to 4.6%. Inflation excluding housing rose, however, to 3%, after having held virtually unchanged since September. On the other hand, underlying inflation continued to fall, to 4.1% according to the average of various measures, or almost 2 percentage points less than at the same time a year ago.

Chart 16

Various measures of inflation

January 2017 - January 2025



Sources: Statistics Iceland, Central Bank of Iceland.

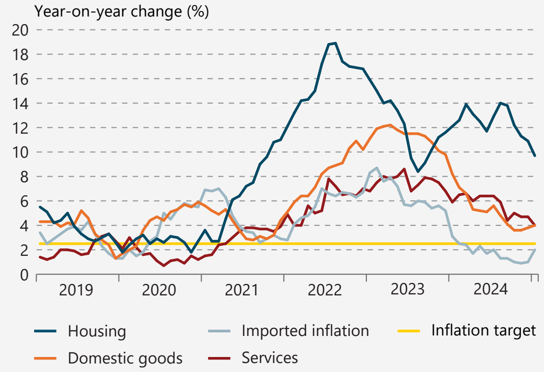
The housing component had the strongest effect on the CPI in Q4, as it has for quite some time. It still accounts for just under half of twelve-month inflation, and imputed rent has risen by 9.6% in the past twelve months. The contribution of the housing component to headline inflation has tapered off in the recent past, however, concurrent with declining real estate market activity.

As of January, domestic goods prices had risen by 4% over the previous twelve months, somewhat more than at the time of the November *Monetary Bulletin*. Imported goods inflation has also risen recently, to 2%. Although food price inflation lost steam in 2024, price hikes have been persistent, with food prices up by 4.2% year-on-year in January.

Chart 17

Domestic and imported inflation[1]

January 2019 - January 2025



1. Services are a weighted average of the private and public services components.
Sources: Statistics Iceland, Central Bank of Iceland.

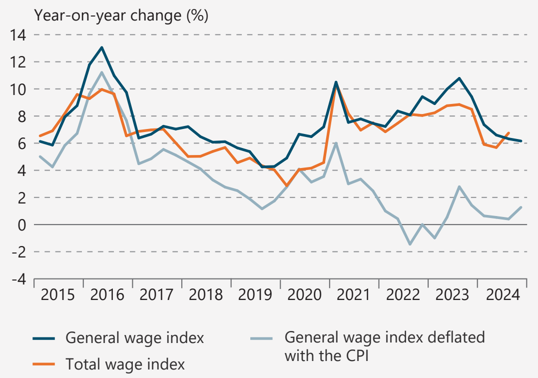
Public services prices rose in January, owing to various price list increases at the turn of the year, and were 5.7% higher than in the same month of 2024. Furthermore, unit levies on various goods such as fuel and alcoholic beverages were increased, and new fees were levied on a variety of nicotine products. Private services price inflation has also been persistent in the recent past, with a year-on-year rise of just over 3.4%. Services price inflation as a whole therefore measured 4% in January.

The twelve-month rise in the general wage index continued to taper off in Q4, when it measured 6.2%, but wage inflation as measured by the index is expected to pick up again at the beginning of 2025. Temporarily, the year-on-year increase in the index will

Chart 18

Wages

Q1/2015 - Q4/2024



Source: Statistics Iceland.

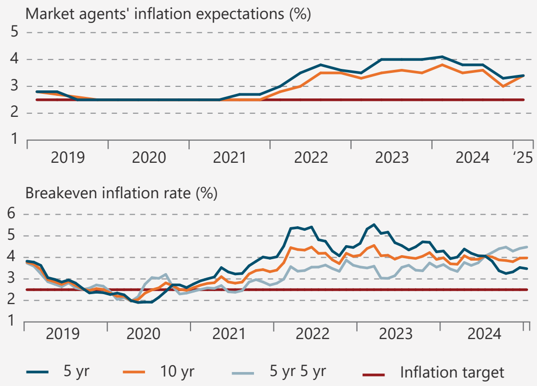
include two negotiated private sector wage rises, the former paid in March 2024 and the latter in January 2025. Furthermore, wage agreements between a sizeable group of public sector employees, on the one hand, and State and local authorities, on the other, were approved at the end of 2024.

The outlook is for unit labour costs to have risen by 7.3% year-on-year in 2024. Although wage cost increases have tapered off, reduced productivity pulls in the opposite direction. According to the Bank's baseline forecast, unit labour costs will rise by 5.2% in 2025 and 3½% per year in 2026 and 2027, owing to an improvement in productivity and the offsetting impact of continued generous nominal pay rises.

According to Gallup's winter survey, carried out at the end of 2024, households' and businesses' short- and long-term inflation expectations declined. Corporate executives expect 3.5% inflation, both two years from now and on average over the next five years, while households expect it to measure 4% over the same period.

Chart 19

Market long-term inflation expectations[1]



1. Median value of market agents' inflation expectations according to the Central Bank survey (Q1/2019 - Q1/2025) and breakeven inflation rate in the bond market (monthly averages January 2019 - January 2025).
Source: Central Bank of Iceland.

The most recent survey of market agents' inflation expectations, carried out in January, indicates that short-term expectations are unchanged, while long-term expectations have increased again. Market agents expect inflation to measure 3.4% or less, both two years from now and on average over the next ten years, whereas in November they expected inflation to be 3% over the next ten years. In addition, the breakeven inflation rate in the bond market has risen since November, with the ten-year rate measuring 4% at the end of January, up from 3.6% in mid-November.

The inflation outlook

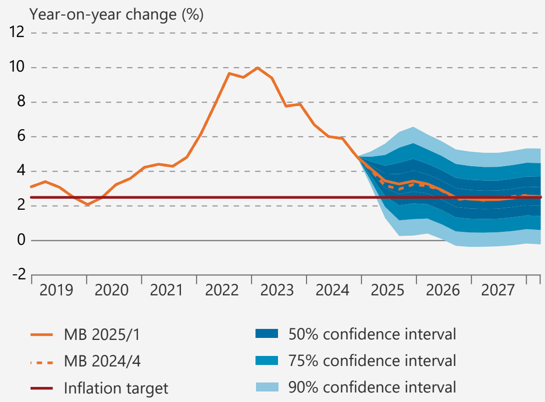
Overall inflationary pressures have eased, albeit slowly. Inflation is expected to measure 4.2% in Q1/2025 and 3.5% in Q2, slightly above the November forecast. As in November, inflation is expected to continue easing in Q3/2025 but to inch upwards in Q4 because of unfavourable base effects. Inflation is forecast to average 3.6% this year.

According to the baseline forecast, a slack in the economy will open up around mid-year, somewhat earlier than was projected in November. On the other hand, the outlook is for a larger rise in house prices this year, which could push the housing component of the CPI upwards because of the impact on rent prices. Added to this is the prospect of a somewhat larger increase in import prices.

On the whole, then, the inflation outlook is similar to that in November. Inflation is expected to subside to the target in mid-2026, conditional upon the interest rate path in the baseline forecast, and remain there for the rest of the forecast horizon. Cost increases in the recent past could cause inflation to be harder to uproot, however. It is clear that when inflation has been above target for a protracted period and inflation expectations have become less firmly anchored to the target, it can take a longer time to bring inflation under control. Inflation has indeed fallen slowly. On the other hand, it could fall more rapidly than in the forecast – for instance, if the slack in the labour market proves more pronounced than is currently assumed.

Chart 20

Inflation forecast and confidence intervals
Q1/2019 - Q1/2028



Sources: Statistics Iceland, Central Bank of Iceland.

Appendix

Forecast tables

Table 1 GDP and its main components[1]

	2023	2024	2025	2026	2027
Private consumption	0.5 (0.5)	0.9 (1.0)	2.5 (2.9)	2.9 (2.8)	3.1 (2.9)
Public consumption	1.8 (1.8)	2.7 (2.1)	2.1 (1.7)	1.8 (2.0)	1.8 (1.8)
Gross capital formation	1.7 (1.6)	6.4 (1.6)	2.5 (0.5)	-3.4 (1.6)	3.1 (2.6)
Business investment	3.8 (3.6)	8.4 (2.7)	2.4 (-1.9)	-6.8 (1.2)	3.5 (2.4)
Residential investment	-2.3 (-2.3)	7.7 (4.2)	5.4 (8.1)	4.6 (4.4)	2.3 (3.4)
Public investment	-1.2 (-1.2)	-2.8 (-5.5)	-0.6 (1.5)	1.2 (-0.6)	2.4 (2.5)
National expenditure	1.7 (1.6)	1.8 (1.1)	2.6 (2.0)	1.0 (2.2)	2.7 (2.6)
Exports of goods and services	6.3 (6.3)	-1.5 (-0.8)	2.0 (2.1)	3.1 (3.3)	3.4 (3.4)
Imports of goods and services	-1.1 (-1.1)	3.7 (1.7)	4.3 (2.3)	-0.7 (3.2)	2.6 (3.0)
Gross domestic product (GDP)	5.0 (5.0)	-0.4 (0.0)	1.6 (1.9)	2.6 (2.3)	3.0 (2.7)
GDP at current prices (ISK trillions)	4.32 (4.32)	4.56 (4.55)	4.84 (4.85)	5.12 (5.10)	5.43 (5.40)
Public sector demand[2]	1.3 (1.3)	1.9 (1.0)	1.7 (1.7)	1.7 (1.7)	1.9 (1.9)
Total investment (% of GDP)	24.2 (24.2)	25.8 (24.7)	26.0 (24.0)	24.4 (23.8)	24.4 (23.7)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/4).
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[1]

	2023	2024	2025	2026	2027
Marine production for export	-7.9 (-8.0)	-1.8 (-1.8)	0.2 (0.2)	1.3 (1.3)	1.5 (1.5)
Aluminium production for export[2]	1.2 (1.2)	-5.9 (-4.4)	2.3 (0.8)	1.1 (1.1)	1.5 (1.5)
Goods exports total	1.2 (1.3)	1.5 (1.3)	1.7 (1.8)	3.2 (3.3)	2.8 (2.9)
Services exports total	13.1 (13.1)	-4.5 (-3.0)	2.4 (2.5)	3.1 (3.3)	3.9 (3.9)
Contribution of net trade to GDP growth (percentage points)	3.4 (3.4)	-2.3 (-1.1)	-1.0 (-0.1)	1.6 (0.1)	0.3 (0.2)
Terms of trade for goods and services	-5.6 (-5.6)	1.1 (1.1)	0.4 (1.5)	0.3 (0.3)	0.2 (0.2)
Trade balance (% of GDP)	0.5 (0.5)	-1.3 (-0.1)	-2.1 (0.4)	-0.3 (0.6)	0.1 (0.8)
Current account balance (% of GDP)	1.1 (1.1)	-2.3 (-0.9)	-3.0 (0.0)	-1.2 (-0.1)	-0.9 (0.0)
Inflation in main trading partners[3]	5.0 (5.0)	2.5 (2.5)	2.2 (2.2)	2.1 (2.0)	2.0 (2.0)
GDP growth in main trading partners[3]	1.3 (1.3)	1.4 (1.4)	1.7 (1.6)	1.7 (1.7)	1.6 (1.7)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/4).
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, LSEG Datastream, OECD, Statistics Iceland, Central Bank of Iceland.

Table 3 Employment, wages, and factor utilisation[1]

	2023	2024	2025	2026	2027
Total hours worked[2]	5.0 (5.0)	4.5 (4.9)	-0.6 (-0.1)	0.6 (-0.6)	1.8 (1.8)
Unemployment (% of labour force)[2]	3.4 (3.4)	3.5 (3.6)	4.5 (4.4)	4.1 (4.3)	3.7 (3.7)
GDP per hour worked[3]	0.1 (0.1)	-4.7 (-4.7)	2.2 (2.0)	2.0 (2.9)	1.2 (0.9)
Unit labour costs[4]	6.8 (6.8)	7.3 (7.1)	5.2 (4.0)	3.6 (3.0)	3.3 (4.6)
Real disposable income[5]	4.0 (4.0)	2.2 (2.9)	1.6 (1.2)	2.5 (1.5)	3.6 (4.1)
Output gap (% of potential output)	5.1 (4.9)	0.9 (1.0)	-0.8 (-0.5)	-0.6 (-0.2)	0.1 (0.4)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/4).
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[1]

	2023	2024	2025	2026	2027
Trade-weighted exchange rate index[2]	-2.6 (-2.6)	0.0 (-0.3)	2.1 (0.9)	-0.2 (0.5)	-0.9 (-0.2)
Real exchange rate (relative consumer prices)	0.9 (0.9)	3.3 (3.0)	3.5 (2.1)	0.5 (1.2)	-0.5 (0.2)
Inflation (consumer price index, CPI)	8.7 (8.7)	5.9 (5.9)	3.6 (3.4)	2.8 (2.7)	2.4 (2.5)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/4).
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	
2024:1	6.7 (6.7)	5.7 (5.7)
2024:2	6.0 (6.0)	8.6 (8.6)
2024:3	5.9 (5.9)	3.9 (3.9)
2024:4	4.9 (4.8)	1.4 (1.4)
	Forecasted value	
2025:1	4.2 (4.1)	2.9 (2.7)
2025:2	3.5 (3.2)	5.7 (4.9)
2025:3	3.3 (3.0)	3.1 (3.0)
2025:4	3.4 (3.2)	2.0 (2.4)
2026:1	3.3 (3.2)	2.2 (2.3)
2026:2	2.9 (2.9)	4.3 (3.8)
2026:3	2.5 (2.4)	1.4 (0.9)
2026:4	2.4 (2.5)	1.7 (2.8)
2027:1	2.4 (2.3)	2.1 (1.8)
2027:2	2.4 (2.4)	4.3 (4.3)
2027:3	2.5 (2.5)	1.7 (1.3)
2027:4	2.6 (2.6)	2.2 (3.1)
2028:1	2.5	2.0

1. Figures in parentheses are from the forecast in MB 2024/4.

Sources: Statistics Iceland, Central Bank of Iceland.

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