



# MONETARY BULLETIN

2011 • 1

## Contents

- 3 *Statement of the Monetary Policy Committee*
- 5 *Economic and monetary developments  
and prospects – updated forecast*  
Weak recovery underway

*Appendix 1: Baseline macroeconomic and inflation forecast 2011/1*

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 its main objective. In the joint declaration by the Government of Iceland and the Central Bank of Iceland on March 27, 2001, it is explained that the Central Bank's aim shall be that annual inflation, measured as the twelve-month increase in the CPI, remains as close to 2½% as possible.

Professional analysis and transparency are important prerequisites for credible monetary policy. In publishing *Monetary Bulletin*, the Central Bank attempts to fulfil these principles. Twice a year, in early May and early November, *Monetary Bulletin* includes an in-depth analysis of economic and monetary developments and prospects. In January and August, an updated forecast is published together with an abbreviated report on economic and monetary developments and prospects. The Monetary Policy Committee of the Central Bank bases its interest rate decisions on this analysis, among other things. The publication of *Monetary Bulletin* also represents a vehicle for the Bank's accountability towards government authorities and the public.

The framework of monetary policy and its implementation and instruments are described further on the Central Bank's website: [www.sedlabanki.is/?PageID=179](http://www.sedlabanki.is/?PageID=179).

**Published by:**

The Central Bank of Iceland, Kalkofnsvegur 1, 150 Reykjavík, Iceland

Tel: (+354) 569 9600, fax: (+354) 569 9605

E-mail: [sedlabanki@sedlabanki.is](mailto:sedlabanki@sedlabanki.is)

Website: [www.sedlabanki.is](http://www.sedlabanki.is)

**Editorial Board and staff:**

Thórarinn G. Pétursson, chairman

Sturla Pálsson

Tómas Örn Kristinsson

Tryggvi Pálsson

Rannveig Sigurdardóttir

Helga Gudmundsdóttir

Vol. 13 no. 1, 2 February 2011

ISSN 1607-6680, print

ISSN 1670-438X, online

Material may be reproduced from the *Monetary Bulletin*, but an acknowledgement of source is kindly requested.

**Icelandic letters:**

ð/Ð (pronounced like th in English this)

þ/Þ (pronounced like th in English think)

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

**Symbols:**

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

# Statement of the Monetary Policy Committee

## 2 February 2011

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.25 percentage points. The deposit rate (current account rate) is lowered to 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) to 4.0%, the seven-day collateralised lending rate to 4.25% and the overnight lending rate to 5.25%.

Inflation continued to subside in December and January. The CPI rose 1.8% year-on-year in January, or 1.6% excluding consumption tax effects, significantly below the inflation target of 2½%. One-off factors added to the seasonal drop in January. Favourable exchange rate developments over the past year, declining inflation expectations, and the slack in the economy continue to contribute to low and stable inflation.

According to the forecast published in *Monetary Bulletin* today, economic recovery will be somewhat stronger this year than was forecast in November. Output is forecast to grow by 2.8% in 2011 and by just over 3% in 2012 and 2013. Inflation has been slightly lower than was implied in the November forecast, due mainly to a one-off change in public services charges; however, according to the Bank's forecast, it is expected to remain somewhat below the target until close to the end of the forecast period.

While economic fundamentals and the capital controls continue to support the króna, the exchange rate has depreciated by 4½% in trade-weighted terms since the MPC's December meeting. It is too early to determine to what degree this development has been driven by temporary factors. Moreover, the Central Bank's sizeable purchases of foreign exchange in December 2010, with the aim of reducing the banks' foreign exchange imbalances and bolstering the Bank's non-borrowed reserves, may have had some short-term effect.

With the prospect that inflation will remain near target and with interest rates at a historically low level, the direction of future policy moves becomes more uncertain. In addition, the prospect of removing the capital controls creates uncertainty about short-term room for manoeuvre. The MPC stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.



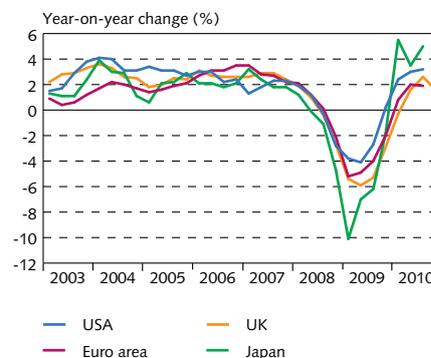
## Weak recovery underway

Terms of trade have improved somewhat more than was forecast in the November issue of Monetary Bulletin, and robust export growth looks set to take hold. As a result, external trade will contribute more to GDP growth than previously projected. Yet in spite of more advantageous terms of trade and stronger net trade, the króna is expected to be somewhat weaker than according to the November forecast. It appears as though investment in the first three quarters of 2010 was somewhat stronger than Statistics Iceland's preliminary figures indicate. Last year's contraction in GDP is therefore estimated to have been somewhat smaller than implied by Statistics Iceland figures. The current forecast assumes a 2.7% contraction in GDP in 2010, which is broadly in line with the November projection. The outlook is for domestic demand to continue to firm up in 2010, with GDP growth measuring about 2.8%, somewhat more than was forecast in November. The current forecast also assumes somewhat stronger output growth in the next two years, or just over 3% each year. The labour market survey for Q4/2010 implies that labour market developments accord with the Bank's previous forecast. The employment rate appears likely to begin rising again in the first half of 2011, with unemployment declining gradually as the year passes. Inflation has developed broadly in line with the Central Bank's November forecast, and the inflation outlook is more or less unchanged from November. As before, the forecast is subject to marked uncertainty and the recovery remains fragile.

## The global economy and international trade

- As 2010 progressed and the effects of stimulative policy action petered out, global output growth and trade declined as well, in line with most forecasts.
- Iceland's main trading partners experienced this as well. Output growth slowed markedly in the euro area in Q3. As before, Germany led the region in GDP growth, while other countries' performance varied greatly. Growth declined also in the UK but rose in the US and Japan. The first indications for Q4 suggest increased GDP growth in the US but lower growth in the euro area, the UK, and Japan.
- Growth is expected to slow down somewhat year-on-year in Iceland's main trading partner countries this year and remain close to the levels seen in the latter half of 2010. Both the OECD and the IMF forecast 1.9% growth for the year, which is broadly in line with the projections in the last *Monetary Bulletin*. Projections from Consensus Forecasts point in the same direction.
- The inflation outlook in Iceland's main trading partner countries has changed marginally since early November 2010. In December, inflation rose to 2.2% in the euro area, the region's highest rate in two years. Inflation is now slightly above the reference limits set by the European Central Bank (ECB), although underlying inflation is considerably lower. Inflation rose even more in the UK in December and has been above the Bank of England's inflation target for some time. In the US, it rose somewhat in December

Chart 1  
International growth  
Real GDP growth Q1/2003 - Q4/2010



Source: Macrobond.

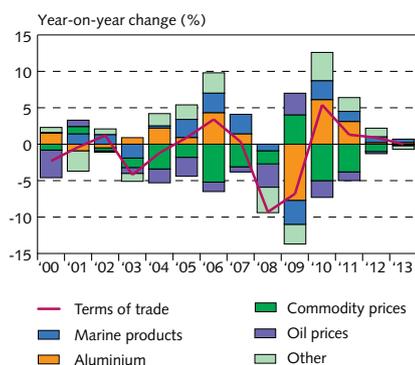
Chart 2  
World trade



1. Imports of goods and services in Iceland's main trading partners.  
2. Arithmetic average of merchandise import and export volumes in OECD countries and the largest non-OECD countries.  
Sources: OECD, Central Bank of Iceland.

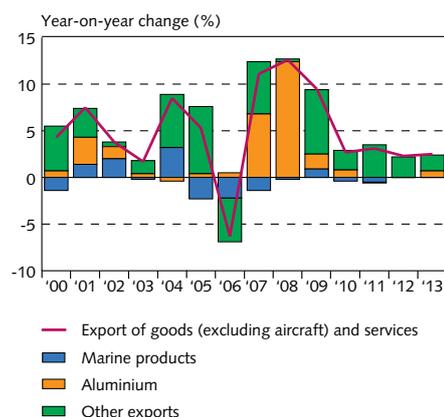
1. The analysis appearing here is based in large part on the Bank's assessment of economic developments, published in November 2010 in *Monetary Bulletin* 2010/4, and on the updated forecast presented here. It is based on data available at the end of January.

Chart 3  
Terms of trade and its main components 2000-2013<sup>1</sup>



1. Central Bank baseline forecast 2010 - 2013. The contribution of the main sub-indices to year-on-year changes in terms of trade is determined by weighting the annual change in the sub-index concerned together with its weight in the import or export of goods and services. The item "other" is a residual.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4  
Export development (excl. aircraft) and its main components 2000-2013<sup>1</sup>



1. Central Bank baseline forecast 2010-2013.  
Sources: Statistics Iceland, Central Bank of Iceland.

but remains low. The recent upsurge in inflation is due in large part to rising global fuel and commodity prices.

- Central banks in most industrial countries have maintained unchanged policy rates in recent months. A few emerging countries have cut their interest rates, however, including South Africa and Turkey. Fewer countries are cutting interest rates, and in many areas rate hikes have begun: for example, the central banks of Brazil, Sweden, India, Hungary, and Poland have recently raised their rates.
- Global trade rallied after a steep contraction in 2008 and 2009 and then subsided again in the latter half of 2010. Nonetheless, both the OECD and the IMF project robust growth in global trade in the coming two years. In its updated forecast, the Central Bank assumes that imports rose by just under 8% in 2010 in Iceland's major trading partner countries and that it will rise by another 5% in 2011, somewhat more than in the last forecast.
- Commodity prices continued to rise towards the end of 2010, and the increase proved larger than in the November forecast. Increased demand from emerging Asian countries and poor harvests fuelled last year's price increases. As a result, commodity prices in the revised forecast are somewhat higher throughout the forecast horizon than in November.
- Aluminium prices are expected to be some 14% higher in 2011 than in 2010, whereas the November forecast assumed a 7% increase. Crude oil prices have also risen considerably in the recent term, as have other commodity prices. Crude oil is now expected to appreciate by 15% in 2010, whereas in November it was expected to rise in price by just over 5%. On the other hand, the forecast for marine product prices is broadly unchanged from November.
- Terms of trade improved somewhat more in 2010 than according to the November forecast. Improvement is expected to continue in 2011, driven by rising aluminium and marine product prices, which should outpace the increase in commodity and fuel imports. The outlook for the upcoming two years is similar to that in November.
- The real exchange rate fell slightly in December, after having risen steadily since September 2009. The real exchange rate is still extremely low in historical context, about 19% lower than the average for the past 30 years.
- It is assumed that goods and services exports in 2010 were unchanged year-on-year, whereas the last forecast projected a 0.4% increase. The slight downward adjustment is due mainly to a sharper contraction in marine exports than was previously anticipated. The outlook for exports has improved for this year, due

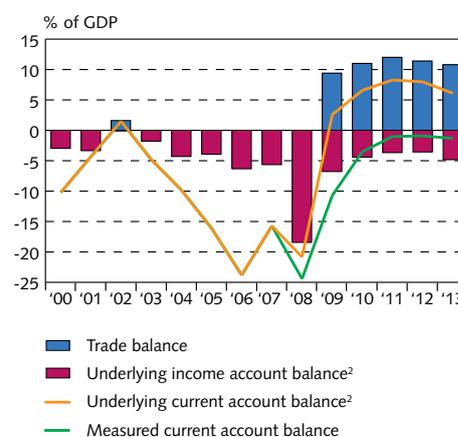
mainly to the prospect of a smaller contraction in marine exports than previously expected. Exports are also projected to increase more over the next two years than according to the November forecast.

- The first three quarters of 2010 saw a sizeable surplus on goods and services trade. The surplus for the year is estimated at 11% of GDP, somewhat more than was forecast in November. On the other hand, the deficit in the balance on income was larger than projected in November, mostly due to the revision of first-half figures because of a reduction in the value of foreign assets held by deposit money banks (DMBs) in winding-up proceedings. In addition, the estimated accrued interest payments due to the new Icesave agreement will weigh more heavily in 2010 than in the Bank's earlier forecasts, as interest payments will begin earlier than previously assumed. As a result, the headline current account deficit will rise slightly from the November projection, or from 3% of GDP to 3.5%. The current account surplus excluding the DMBs in winding-up proceedings, however, is much larger than was estimated in November, at about 6½% of GDP instead of the 3% in the last forecast, as the above-mentioned revaluation of these DMBs' foreign assets does not affect this measure of the current account balance.
- The headline current account deficit is projected to diminish significantly this year and average around 1% of GDP throughout the forecast horizon. This is due chiefly to the fact that the trade surplus will probably be larger during the period than previous forecasts indicated, or about 12% of GDP instead of just over 9%, as in the November forecast. The outlook for the current account balance excluding the DMBs in winding-up proceedings has improved still further, to about 6-8% of GDP, some 5-7 percentage points more than was projected in November. Apart from improved external trade, the explanation lies in more advantageous interest rate terms and a more front-loaded repayment profile in the new Icesave contract than in the figures assumed in the November forecast.

## Domestic financial markets

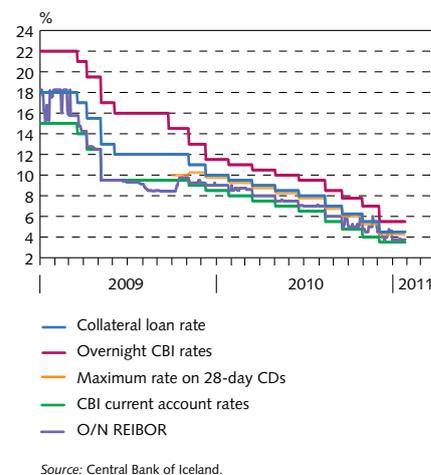
- The Central Bank has lowered interest rates twice since November: first, upon the issue of the November *Monetary Bulletin*, and then, on the December interest rate decision date. The Bank's deposit rates have declined from 4.75% to 3.5%, and maximum rates on 28-day certificates of deposit (CDs) have dropped from 6% to 4.25%. At the same time, 7-day collateralised lending rates have dropped from 6.25% to 4.5% and overnight loan rates from 7.75% to 5.5%.
- At its December meeting, the Monetary Policy Committee decided to narrow the Bank's interest rate corridor by 1 percent-

Chart 5  
Current account balance 2000 - 2013<sup>1</sup>



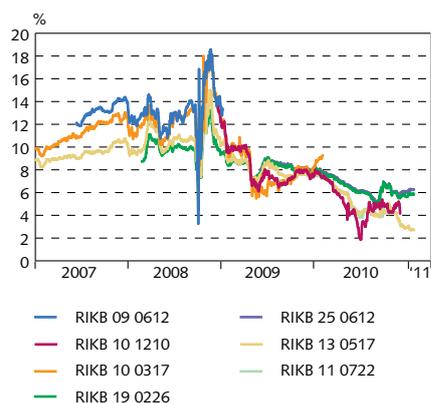
1. Net current transfer is included in the balance of income.  
Central Bank baseline forecast 2010 - 2013.  
2. Without accrued interest due to deposit institutions undergoing winding-up proceedings.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6  
Central Bank of Iceland interest rates and short-term market interest rates  
Daily data 1 January 2009 - 28 January 2011



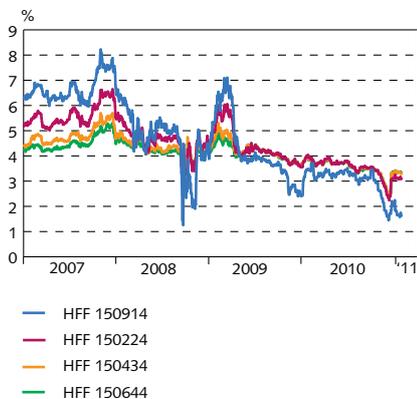
Source: Central Bank of Iceland.

Chart 7  
Long-term nominal Treasury bond yields  
Daily data 3 January 2007 - 28 January 2011



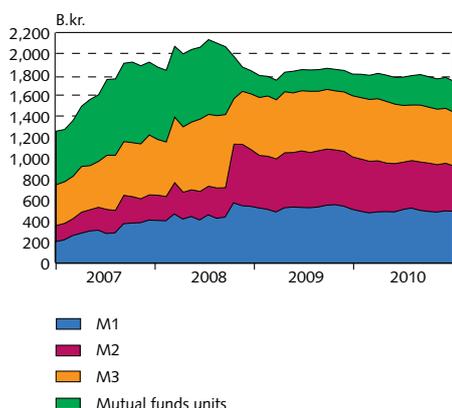
Source: Central Bank of Iceland.

Chart 8  
Yields on indexed HFF bonds  
Daily data 3 January 2007 - 28 January 2011



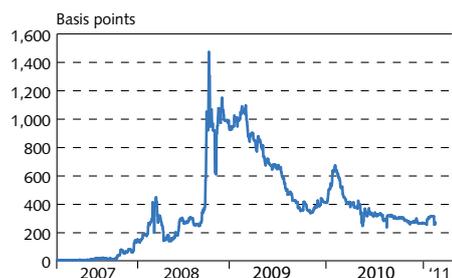
Source: Central Bank of Iceland.

Chart 9  
Money holdings  
January 2007 - December 2010<sup>1</sup>



<sup>1</sup> Data from October 2008 are preliminary.  
Source: Central Bank of Iceland.

Chart 10  
CDS Iceland  
Daily data 29 March 2007 - 28 January 2011



Source: Bloomberg.

age point, from 3 points to 2. The centre of the corridor therefore declined by 1 percentage point, while monetary restraint, which is measured by the average of the interest rates on the deposit side of the Bank's market operations, fell by slightly less, or 0.75 points.

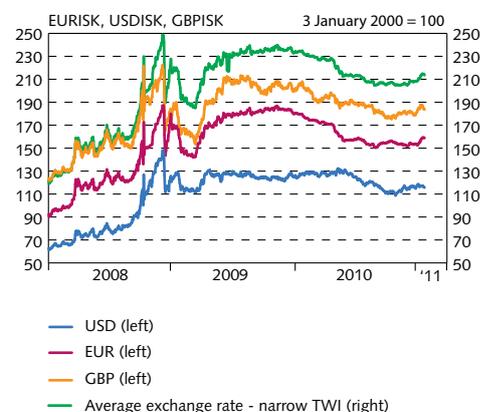
- The objectives of narrowing the interest rate corridor are to move overnight rates closer to the centre of the corridor and to reduce fluctuations in market rates. This, in turn, tends to reduce volatility in monetary restraint as reflected in market rates. Reducing the spread between the Bank's deposit and lending rates also reduces possible fluctuations in restraint when the main impact of Central Bank interest rates on short-term market financing moves between the deposit and lending sides of the Bank's market operations.
- In terms of the current inflation rate the Central Bank's real interest rate is broadly unchanged since the last *Monetary Bulletin* was published, at roughly 2%. The real rate has declined by other criteria, however, except for household inflation expectations, which have fallen even faster than the Bank's interest rates. By other measures, the decline ranges from ¼-1½ percentage points. The real rate has fallen by roughly ¼ percentage point on average and currently averages about 2%.
- Financial institutions' deposits with the Central Bank have increased since the fall, domestic currency deposits in particular. Balance sheets for the Icelandic banking system for October 2008 - December 2010 have been published since the last *Monetary Bulletin* appeared. The figures suggest that growth in new lending is virtually nonexistent. Similar developments can be seen in developments in the money stock. By end-November, broad money (M3) had declined by approximately 10% year-on-year. A large share of the contraction emerges in lower balances on money market deposit accounts, while there has been a sizeable increase in issuance of mutual fund shares. The contraction in M3 should be interpreted in light of the fact that there may be substitutability between deposits and other investment options.
- Short-term interbank rates have declined by 1-1½ percentage points since the November issue of *Monetary Bulletin* and yields on short nominal Treasury securities by almost 2 percentage points, in line with cuts in Central Bank interest rates. Yields on longer nominal Treasury bonds have fallen by as much as ½ percentage point since November. The decline in yields on indexed Housing Financing Fund (HFF) bonds was almost 0.2 percentage points.
- Interbank market trading in krónur totalled 110.5 b.kr. in November and December 2010. Trading was concentrated in overnight transactions, although longer-term loans were also

granted – for the first time since September 2008. On two occasions in November, and once in December, loans were granted for one week.

- The CDS spread on the Republic of Iceland now stands at about 2.7 percentage points, similar to early November levels. At the same time, the spread vis-à-vis German Treasury bonds declined by 1½ percentage points, to 3.3% for three-month bonds and 2.7% for ten-year bonds. Therefore, based on the CDS spread, the short- and long-term risk-adjusted interest rate differentials are close to zero.
- At year-end 2010, the króna was nearly 12% higher in trade-weighted terms, and nearly 17% higher against the euro, than at the beginning of the year. On the other hand, the króna has depreciated so far this year, trading at just under 159 against the euro prior to the publication of this *Monetary Bulletin*, a drop of just over 2½% since early November. According to the forecast, the króna will remain more or less at current levels until year-end, some 3% weaker on average than was projected in November. The trade surplus and improved terms of trade should support the exchange rate. On the other hand, it should be borne in mind that when removal of the capital controls begins, which is likely to occur during the forecast horizon, short-term pressure on the króna could develop. Uncertainty about this short-term effect gives cause for caution in projecting exchange rate developments, even though it is also possible that lifting the controls could cause the króna to rise or to fall only briefly and then recover, so that the impact of the depreciation will be minimal.
- In August 2010, the Central Bank began regular weekly purchases of foreign currency in order to bolster its non-borrowed foreign exchange reserves. To date, the Bank has purchased approximately 30 b.kr., or 193.5 million euros, in the market. Towards the end of 2010, the Bank purchased foreign currency for 24.6 b.kr. (160 million euros) from domestic financial institutions, as well as negotiating forward contracts amounting to 47.9 b.kr. (312 million euros). Taken together, these transactions will expand the Central Bank's foreign exchange reserves by about 72.5 b.kr. (472 million euros) by year-end 2015.
- The real estate market showed signs of recovering in 2010. Total turnover rose by 16% year-on-year, although it remains very low in historical context. At the same time, the slide in housing prices has slowed down markedly. Real house prices in the greater Reykjavík area have fallen by nearly 35% since peaking in October 2007, and nominal prices have fallen by 14.3% from their high point in January 2008. The updated forecast assumes that house prices will bottom out in the latter half of 2011 and then begin a slow recovery.

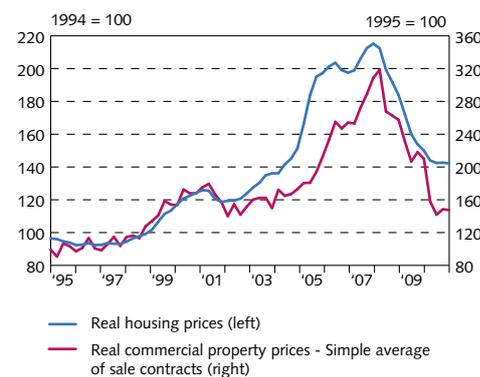
Chart 11  
Exchange rate of the króna

Daily data 3 January 2008 - 28 January 2011



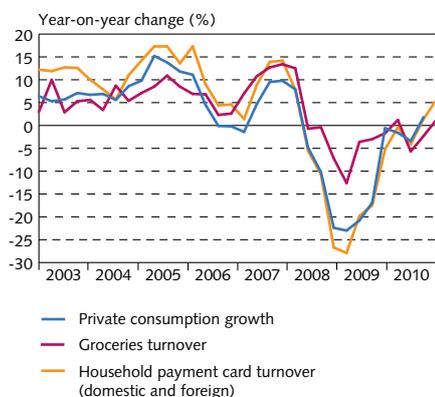
Source: Central Bank of Iceland.

Chart 12  
House prices in greater Reykjavík  
Q1/1995 - Q4/2010



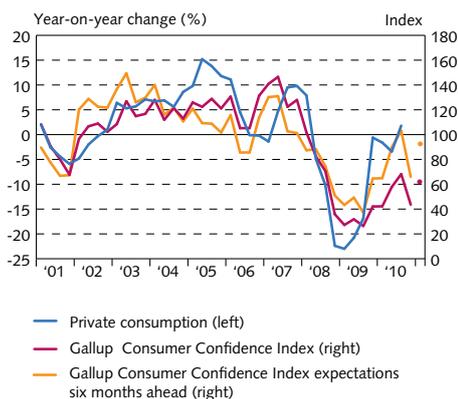
Sources: Registers Iceland, Central Bank of Iceland.

Chart 13  
Private consumption, groceries and payment card turnover<sup>1</sup>  
Q1/2003 - Q4/2010



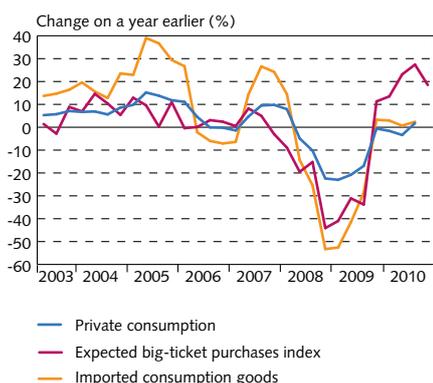
1. Private consumption data extend only to Q3/2010.  
Sources: Federation of Trade and Services, Statistics Iceland, Central Bank of Iceland.

Chart 14  
Private consumption and consumer confidence  
Q1/2001 - Q1/2011<sup>1</sup>



1. Three-month average of Gallup Consumer Confidence index. Value for Q1/2011 is for January. Private consumption data extend only to Q3/2010.  
Sources: Capacent Gallup, Statistics Iceland.

Chart 15  
Private consumption, expected big-ticket purchases and imported consumer goods<sup>1</sup>  
Q2/2003 - Q4/2010



1. Private consumption data extend only to Q3/2010.  
Sources: Capacent Gallup, Statistics Iceland.

## Domestic economy and inflation

- On 7 December 2010, Statistics Iceland published its first estimates of GDP growth in Q3/2010, together with revised estimates for the first two quarters of the year. According to these estimates, GDP fell by 1.6% year-on-year in Q3 and was about 5.5% lower year-on-year in the first three quarters. This is a somewhat stronger contraction than the Central Bank had projected in November, due primarily to developments in investment. Statistics Iceland's figures on investment in Q2 were revised upwards, in line with the Central Bank's assumptions in its November forecast; however, Q1 figures were revised downwards. In addition, Statistics Iceland's preliminary numbers suggest that investment in Q3 was considerably weaker than according to the Bank's November forecast. The Central Bank forecast for private consumption in Q3 was borne out, but in view of a revision of figures for the first half of the year, the contraction in private and public consumption in the first three quarters of 2010 is now estimated to have been larger than the Bank projected in November. On the other hand, net trade in the first three quarters of 2010 was somewhat more robust than the Bank had forecast.

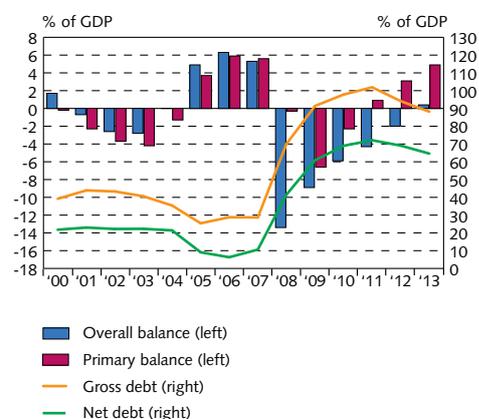
- According to Statistics Iceland's preliminary figures, private consumption rose 1.8% year-on-year in Q3, the first annual increase since Q1/2008. In Q3, seasonally adjusted private consumption rose by about 3.8% quarter-on-quarter, after having contracted for two quarters in a row. Leading indicators suggest continuing private consumption growth in Q4. Seasonally adjusted payment card and groceries turnover rose between Q3 and Q4, as did planned big-ticket purchases, according to the Capacent Gallup survey. Seasonally adjusted consumer goods imports also rose markedly quarter-on-quarter in Q3, after having contracted in the first half of 2010. Seasonally adjusted private consumption is forecast to increase by 1.2% between Q3 and Q4, and by 2% year-on-year. This is a significant change from the November forecast, which assumed a contraction of 0.7%. If the forecast materialises, private consumption will have contracted by 0.3% in 2010.

- Since November, household debt relief measures have been clarified, both with the passage of legislation following court judgments on the illegality of linking loans to currency exchange rates and through coordinated measures by the Government and the financial institutions. These measures will benefit some households directly, through reimbursement of overpaid loan instalments, which has already begun, and by dramatically reducing the uncertainty about household debt. This uncertainty has probably prompted households to curtail their spending. The debt relief measures, together with the authorisation to withdraw third-pillar pension savings, have supported private consumption in the recent term and are considered likely to continue doing so. In general, though, they are broadly in line with the Bank's earlier

forecasts and do not call for major revisions in the Bank's assessment of the medium-term outlook for private consumption.

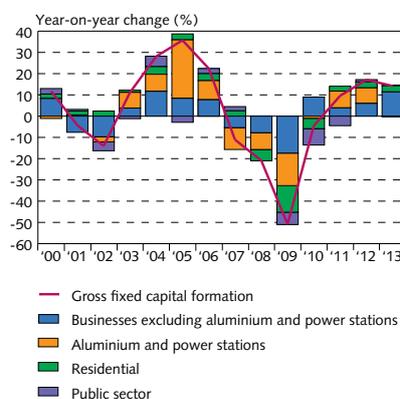
- Private consumption is expected to grow by about 3% annually, both this year and in 2012, somewhat outpacing the growth in real disposable income and thus eroding household savings until 2013, when savings will begin to pick up again. Even though private consumption is projected to grow significantly, as a share of GDP it will only amount to approximately 50% during the forecast horizon, which is very low in historical context.
- The National Budget was approved in December, with a few changes from the budget proposal used as a basis for the November forecast. The biggest change is that wage reductions were cut down by about 2.8 b.kr. On the other hand, cutbacks in budgetary allocations for initial expense items were increased by 3.3 b.kr. The Treasury deficit is estimated at 37.3 b.kr. for 2011, some 1 b.kr. larger than the original budget proposal allowed for. The primary balance is correspondingly less favourable. It is still assumed that there will be a primary surplus amounting to just under 1% of GDP, in line with the Government-IMF programme.
- Statistics Iceland's first estimates of public consumption for the first two quarters of 2010 seemed to indicate a slackening of restraint in comparison with previous plans. This was taken into consideration in the Central Bank's November forecast of public consumption growth. In Statistics Iceland's revised figures, published in December, public consumption expenditures were much lower, however, and in accordance with the expectations in the Bank's August forecast. The outlook for public consumption has therefore been changed in the revised forecast; in line with new figures, it is assumed to remain relatively constant in nominal terms throughout the forecast horizon. Volume changes in public consumption are similar to those set forth in the August forecast. Although the Bank's forecasts of volume changes in public consumption have fluctuated recently, the fluctuations stem mainly from revisions to the price deflator and do not signal a changed assessment of Budget implementation.
- New investment in heavy industry and associated power generation contracted by 4.5% in 2010 but is expected to increase by nearly 36% in real terms in 2011. Alcoa's planned carbon anode manufacturing plant will increase investment, while maintenance projects are expected to decline. On the whole, the outlook for investment in heavy industry has changed little in krónur terms since the last forecast.
- According to preliminary figures from Statistics Iceland, business investment rose 15.4% year-on-year during the first three quarters of 2010; however, in the Central Bank's assessment, recent indicators, including information on imports of investment goods,

Chart 16  
Public sector finances 2000 - 2013<sup>1</sup>



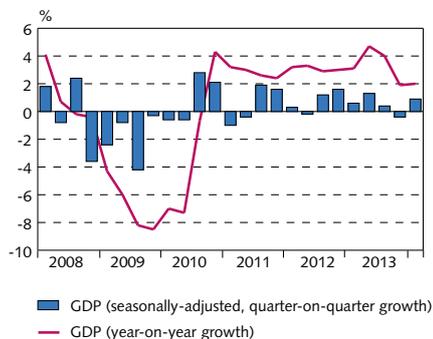
1. Central Bank baseline forecast 2010 - 2013.  
Sources: Ministry of Finance, Statistics Iceland, Central Bank of Iceland.

Chart 17  
Gross fixed capital formation and contributions of its main components 2000 - 2013<sup>1</sup>



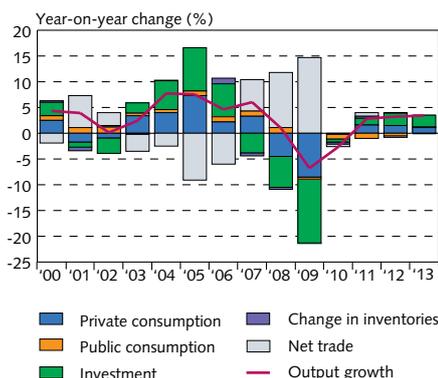
1. Central Bank baseline forecast 2010-2013.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 18  
Gross domestic product  
Q1/2008 - Q1/2014<sup>1</sup>



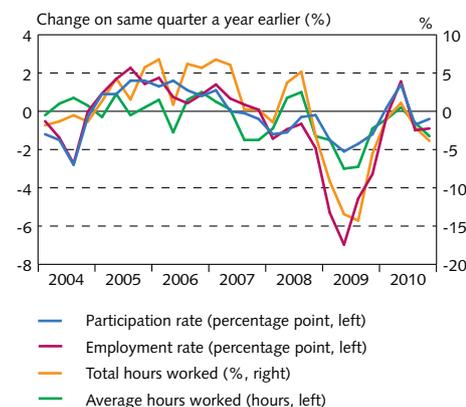
1. Central bank baseline forecast Q4/2010-Q1/2014.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 19  
Output growth and contribution of underlying components 2000-2013<sup>1</sup>



1. Central Bank baseline forecast 2010 - 2013.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 20  
Changes in labour market  
Q1/2004 - Q4/2010



Source: Statistics Iceland.

suggest that growth was somewhat stronger than the Statistics Iceland figures imply, or 23%. It is assumed that business investment for 2010 as a whole rose by 14.4% year-on-year, whereas the last *Monetary Bulletin* assumed slightly less robust growth. Nonetheless, the contraction in total investment is estimated to have been rather sharper than in the November forecast, or 4.5% instead of 3.7%.

- Total investment is forecast to increase by nearly 10% in 2011, rather more than was projected in November, due mainly to strong business investment. Some residential investment is expected as well, however. This projection assumes that developers will attempt to complete unfinished residential housing projects. A large number of homes remain partially built, and the completion of such projects raises measured investment figures. Growth in residential investment is nonetheless expected to be less than was forecast in November. Public investment is expected to contract more than previously estimated; however, the two-year outlook for total investment is broadly unchanged.
- Based on the Central Bank's estimate of investment rather than the preliminary data from Statistics Iceland, GDP contracted by 5.1% year-on-year in the first three quarters of 2010, compared to the 5.5% implied by Statistics Iceland's preliminary figures. Therefore, according to the Bank's estimates, seasonally adjusted GDP increased by 2.8% quarter-on-quarter in Q3/2010, after a continuous decline lasting more than two years. Seasonally adjusted quarterly growth is also indicated in Statistics Iceland's figures, and appears independent of the method used to adjust for seasonal fluctuations. This supports the reliability of the assessment, as quarterly GDP data have been quite volatile in the recent term, complicating the estimate of seasonal fluctuations. According to the forecast, seasonally adjusted GDP continued to rise in Q4, with growth measuring 2.1% between quarters. If these projections prove correct, the contraction for the year as a whole was 2.7%, close to the November forecast.
- The forecast assumes a temporary setback in seasonally adjusted quarterly growth in the first half of 2011. A revival is expected in the latter half of the year, however, with GDP growth forecast at 2.8% for 2011 as a whole, somewhat more than was projected in November. GDP growth is projected at just over 3% per year for the next two years, also slightly more than the November forecast indicated.
- In line with previous Central Bank forecasts, the output slack is considered to have peaked in mid-2010, then diminish gradually over the forecast horizon and disappear by the latter half of 2013. As before, however, it should be borne in mind that estimates of spare capacity are subject to significant uncertainty, especially in the wake of the financial crisis.

- The Statistics Iceland labour market survey shows that labour demand contracted year-on-year by all criteria in Q4/2010. Total hours worked declined by 3.9% between years, due both to a reduction in the number of employed persons and to a shorter work week. On the other hand, the survey shows that both labour participation and the employment rate rose in the youngest age group, in what is perhaps the first indication of a turnaround in labour demand.
- Figures on net migration reveal that persons leaving Iceland outnumbered those moving to the country by over 2,000 in 2010, or about 1% of the labour force. Net outflow, which increased in the wake of the financial crisis, has slowed down, but the comparable figure for 2009 totalled 4,800.
- Q4 unemployment as registered by the Directorate of Labour rose marginally quarter-on-quarter, to 7.7%, in line with the Bank's November forecast. Measured unemployment was 8.1% in 2010, as opposed to 8% in 2009. Although 2010 unemployment measurements were similar to those in 2009, the actual jobless rate was higher because changes in entitlement to unemployment benefits and changes in the methods for calculation of unemployment reduce 2010 unemployment figures by ½-1 percentage point in comparison with the previous year. Figures from the Statistics Iceland labour market survey show that unemployment increased in 2010.
- Indicators of developments in unemployment over the next few months suggest that the unemployment rate has yet to rise. For example, Capacent Gallup's December survey among Iceland's 400 largest firms implies that companies planning to lay off staff in the next six months outnumber those interested in recruiting. The survey also indicates that more companies planned redundancies in December than in September, and that fewer were planning to recruit. The greatest change in staffing plans was among companies in the fisheries sector: some one-third were considering downsizing in December, as opposed to only 14% in September. A recent survey conducted by the Confederation of Icelandic Employers (SA) among its member organisations accords with this, indicating that companies intend to reduce staffing by 1,000 in the next six months. This corresponds to an increase in unemployment amounting to just over ½ percentage point.
- According to the recent agreement reached by SA, financial institutions, and the Government, a review of the financial position of small and medium-sized companies should be complete before June 2011. It is hoped that these measures will expedite the resolution of these firms' debt problems. While corporate debt restructuring will probably result in a temporary spike in unemployment, it is likely to improve the employment outlook over the longer term.

Chart 21  
Employment  
Q1/2007 - Q1/2014<sup>1</sup>

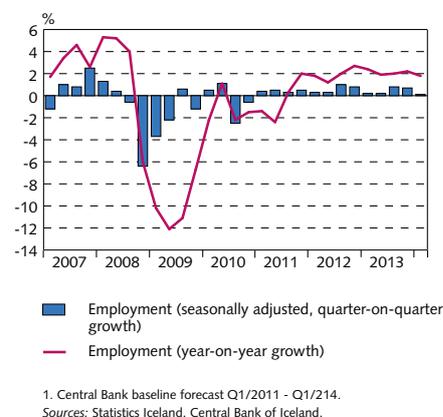


Chart 22  
Companies planning to change staffing levels during the next 6 months

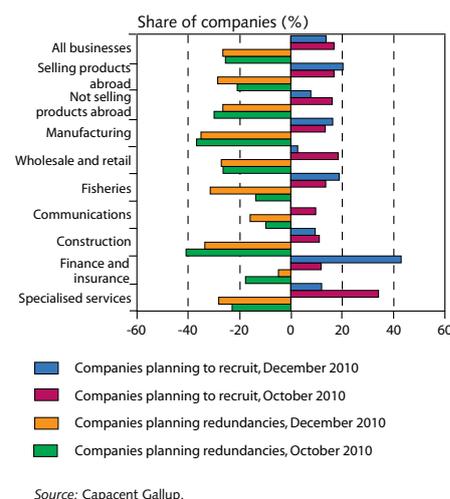


Chart 23  
Unit labour costs and contributions of underlying components 2000-2013<sup>1</sup>

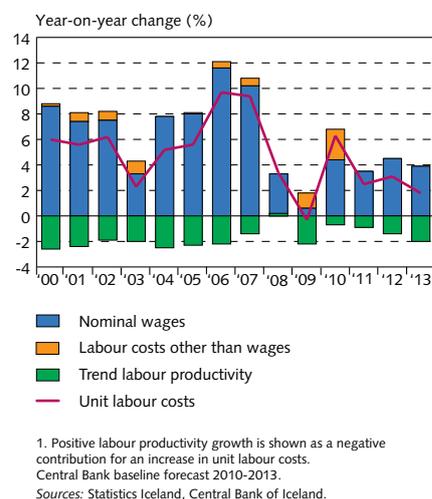
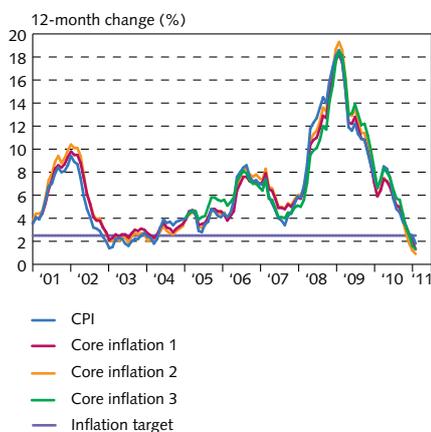
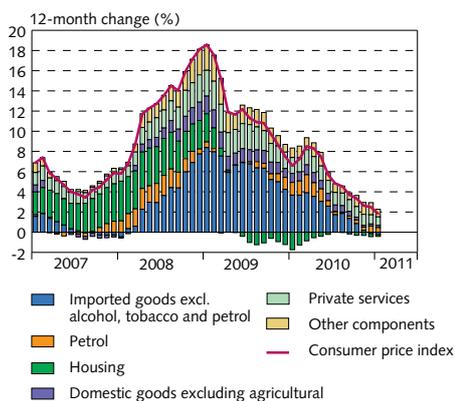


Chart 24  
Inflation  
January 2001 - January 2011<sup>1</sup>



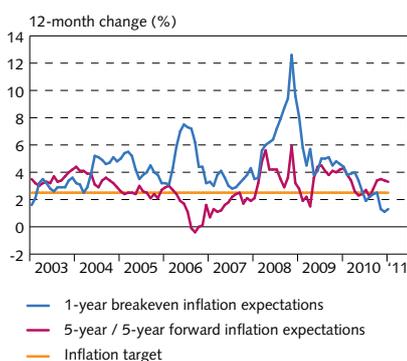
1. The core indices measure underlying inflation, with Core Index 1 excluding prices of agricultural products and petrol, and Core Index 2 excluding prices of public services as well. Core Index 3 also excludes the effect of changes in mortgage rates.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 25  
Components of CPI inflation  
Contribution to inflation in past 12 months Jan. 2007 - Jan. 2011



Source: Statistics Iceland.

Chart 26  
Inflation expectations according to the difference between nominal and indexed interest rates<sup>1</sup>  
Monthly data January 2007 - January 2011



1. Breakeven inflation expectations are calculated from yield spreads between nominal and index-linked Government and Government-backed bonds.  
Source: Central Bank of Iceland.

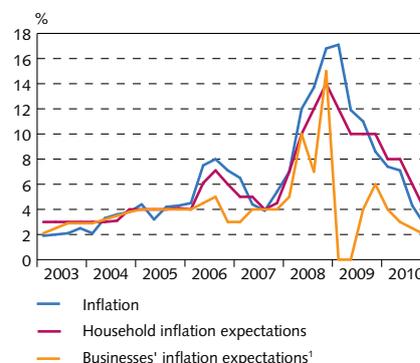
- According to the updated forecast, the unemployment outlook for coming years is broadly unchanged from November. It is assumed that unemployment will rise in the first half of the year, peaking at about 8½% in Q1, and then taper off gradually as the economy rallies, falling to about 3% by year-end 2013.
- The Statistics Iceland labour market survey suggests that the employment rate (the ratio of employed persons to the population aged 16-64) declined by 2½ percentage points between Q3 and Q4/2010. Seasonally adjusted employment is projected to increase quarter-on-quarter in Q1/2011. A slow but steady recovery of employment is expected for the remainder of the forecast horizon, with the employment rate measuring about 2½ percentage points higher at the end of the horizon than in 2010.
- No new indicators of increased wage pressures have emerged, although wages rose slightly more in Q4/2010 than was assumed in the last forecast. As the November forecast indicated, relatively modest wage rises are expected to result from the wage negotiations currently underway. The outlook for unit labour costs is also similar to that forecast in November.
- The Central Bank's inflation target was reached towards the end of 2010, after inflation had exceeded target levels since April 2004. Inflation averaged 5.4% in 2010, as opposed to 12% in 2009. Measured inflation was 2.8% in Q4/2010, which is consistent with the November forecast.
- The consumer price index (CPI) fell by 0.9% in January, after having risen by 0.33% in December and remaining almost unchanged in November. In January, twelve-month inflation measured 1.8%. On the other hand, the CPI excluding indirect tax effects fell by 1.1%, as the impact of the increase in alcohol, tobacco, oil, and carbon taxes is excluded. By that criterion, twelve-month inflation measured 1.6%. The main factors influencing price levels in January were winter sales, which reduced the CPI by 0.9 percentage points, and the change in CPI treatment of broadcasting fees, which reduced the index by 0.4 percentage points.<sup>2</sup> This was counteracted by seasonal increases in public service prices and in the price of food, beverages, and petrol.
- The breakeven inflation rate in the bond market gives an indication of developments in inflation expectations, as well as reflecting an inflation risk premium, which is difficult to assess. Fluctuations in risk premia and bond market volatility unrelated to inflation expectations can also complicate the interpretation of short-term changes in the breakeven inflation rate. The breakeven inflation rate indicates that inflation expectations one year ahead

2. Because of changes in the arrangements for collection of broadcasting fees, Statistics Iceland now views the fees as a direct tax instead of a service charge; therefore, broadcasting fees are no longer included in calculations of the CPI.

amount to about 1%, somewhat less than when the November issue of *Monetary Bulletin* was published. For the longer term (the five-year breakeven rate five years ahead, which measures expectations of average inflation in 2016-2021), however, the breakeven inflation rate stands at about 3½%, which is close to the November figure. Risk premia may well explain a part of the difference, in which case long term inflation expectations are somewhat below 3½%.

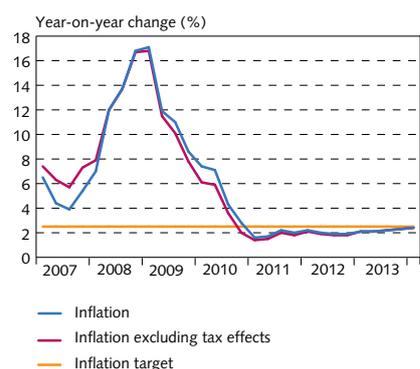
- According to the median response to Capacent Gallup's quarterly survey of corporate inflation expectations, last conducted in December, executives expected 2% inflation twelve months ahead, or about ½ percentage point less than in the September survey. Household inflation expectations have also continued to subside. Capacent Gallup's December survey of household inflation expectations indicated 4% inflation twelve months ahead, which is 2 percentage points lower than in the September survey. On the other hand, household expectations of twelve-month inflation two years ahead are unchanged at 5%. Therefore, household inflation expectations are still above the Central Bank inflation target. It should be noted, though, that both household inflation expectations and the breakeven inflation rate in the bond market appear to be strongly affected by past inflation.
- The outlook is for Q1/2011 inflation to be somewhat lower than according to the November forecast, due in particular to the changes in Statistics Iceland's treatment of broadcasting fees in its calculation of the CPI and due to stronger sales effects than previously anticipated. Inflation excluding tax effects is projected at 1.4% for Q1/2011, as opposed to 2.2% according to the last forecast. In addition, headline inflation is expected to measure 1.6% in Q1, down from 2.5% in the November forecast. Inflation is forecast to remain below target in 2011 and bottom out in the first half of the year. If the forecast materialises, inflation will average 1.9% this year, as was forecast in November.
- The exclusion of broadcasting fees from the CPI lowers both twelve-month headline inflation and underlying inflation (excluding indirect tax effects) by 0.4 percentage points. In assessing underlying inflation and the inflation outlook and in formulating monetary policy, it is therefore appropriate to ignore these tax effects.
- Uncertainty about developments in inflation in the near term is largely due to uncertainty about the exchange rate of the króna. It is also possible that wage rises in the upcoming wage agreements will be larger than the forecast assumes, resulting in higher inflation than is currently expected. However, the strength of the economic recovery is also uncertain. If the domestic economy proves less resilient than is envisaged here, inflation could be lower. An uncertain inflation outlook also reflects uncertainty about devel-

Chart 27  
Inflation expectations of businesses and households one year ahead and current inflation



1. Businesses' inflation expectations were measured on an irregular basis before Q3/2006 so until then measurements are interpolated.  
Sources: Capacent Gallup, Statistics Iceland, Central Bank of Iceland.

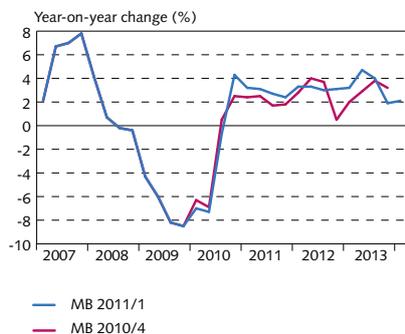
Chart 28  
Inflation including and excluding tax effects¹



1. Central Bank baseline forecast Q1/2011 - Q1/2014.  
Sources: Statistics Iceland, Central Bank of Iceland.

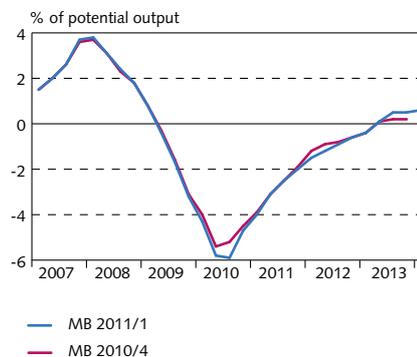
opments in the residential housing market. The decline in house prices has proven less pronounced than the Bank had forecast, owing in part to the capital controls, which have supported domestic asset prices in the wake of the crisis. The global inflation outlook is also uncertain: commodity prices are unstable, and major currencies could change rapidly.

Chart 29  
Output growth - comparison with MB 2010/4



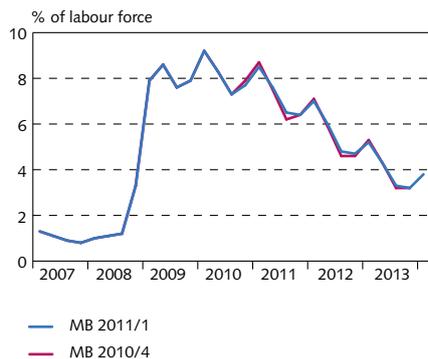
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 30  
Output gap - comparison with MB 2010/4



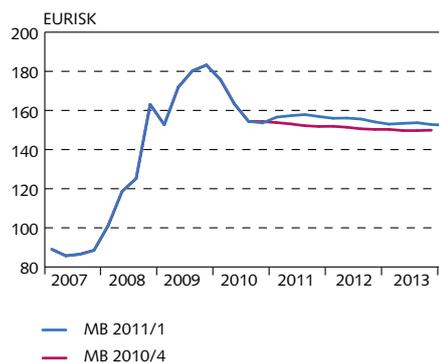
Source: Central Bank of Iceland.

Chart 31  
Unemployment - comparison with MB 2010/4



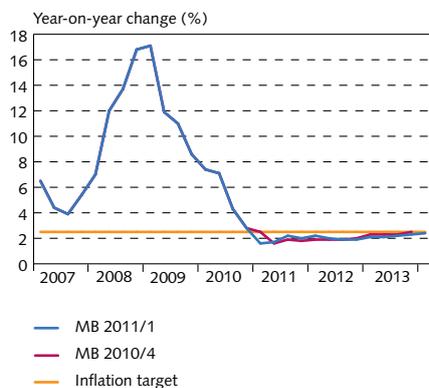
Sources: Directorate of Labour, Central Bank of Iceland.

Chart 32  
The ISK exchange rate against the euro - comparison with MB 2010/4



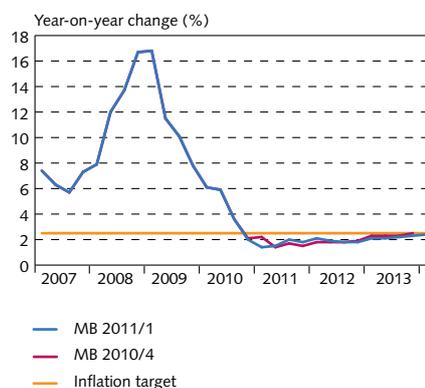
Source: Central Bank of Iceland.

Chart 33  
Inflation - comparison with MB 2010/4



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 34  
Inflation excluding tax effects - comparison with MB 2010/4



Sources: Statistics Iceland, Central Bank of Iceland.

## Appendix 1

### Baseline macroeconomic and inflation forecast 2011/1

Table 1 Macroeconomic forecast<sup>1</sup>

	In b.kr.	Change from prior year (%) unless otherwise specified				
		2009	2010	2011	2012	2013
<i>GDP and its principal subcomponents</i>						
Private consumption	765.4	-16.0 (-16.0)	-0.3 (-0.3)	3.1 (3.6)	2.9 (2.3)	2.2 (2.2)
Public consumption	396.9	-1.7 (-1.7)	-3.5 (-1.7)	-4.1 (-2.4)	-2.2 (-2.4)	0.5 (2.0)
Gross capital formation	207.9	-50.9 (-50.9)	-4.5 (-3.7)	9.6 (8.3)	17.1 (22.0)	14.2 (12.2)
Business investment	115.8	-55.0 (-55.0)	14.4 (13.6)	17.8 (10.8)	18.4 (26.3)	15.2 (12.0)
Residential investment	40.1	-55.7 (-55.7)	-25.2 (-22.1)	14.7 (24.2)	17.5 (20.4)	18.1 (15.9)
Public investment	52.1	-31.6 (-31.6)	-30.9 (-28.2)	-24.8 (-13.5)	9.1 (4.5)	2.0 (8.0)
National expenditure	1,369.1	-20.9 (-20.9)	-2.4 (-1.6)	2.4 (2.8)	4.0 (4.2)	4.0 (4.0)
Exports of goods and services	794.8	7.4 (7.4)	0.0 (0.4)	2.5 (0.8)	2.2 (2.0)	2.4 (2.0)
Imports of goods and services	663.2	-24.1 (-24.1)	1.1 (2.9)	1.6 (1.8)	3.6 (4.8)	3.2 (3.9)
Gross domestic product	1,500.8	-6.8 (-6.8)	-2.7 (-2.6)	2.8 (2.1)	3.2 (2.7)	3.4 (3.0)

#### Other key figures

GDP at the price level of each year (in b.kr.)	1,501 (1,501)	1,563 (1,561)	1,639 (1,617)	1,730 (1,706)	1,820 (1,791)
Trade account balance (% of GDP)	8.8 (8.8)	11.0 (9.5)	12.0 (9.3)	11.5 (8.9)	10.9 (7.8)
Current account balance (% of GDP)	-11.3 (-2.2)	-3.5 (-3.0)	-1.0 (-3.7)	-0.9 (-4.1)	-1.3 (-4.5)
Underlying current account balance (% of GDP) <sup>2</sup>	3.0 (4.3)	6.6 (2.8)	8.3 (2.5)	8.0 (1.3)	6.1 (-0.7)
Output gap (% of potential output)	-3.2 (-3.1)	-4.7 (-4.5)	-2.0 (-1.9)	-0.6 (-0.6)	0.5 (0.2)
Unit labour costs (change in average year-on-year)	-0.3 (-0.3)	6.3 (6.5)	2.5 (3.2)	3.1 (3.2)	1.8 (1.9)
Real disposable income (change in average year-on-year)	-17.7 (-17.7)	-7.7 (-9.2)	0.4 (0.6)	1.5 (3.2)	2.1 (2.3)
Unemployment (% of labour force)	8.0 (8.0)	8.1 (8.2)	7.3 (7.2)	5.6 (5.5)	4.0 (4.0)
EURISK exchange rate	172.0 (172.0)	161.7 (161.9)	157.2 (152.8)	155.5 (151.1)	153.2 (149.9)

1. Figures in parentheses from forecast in *Monetary Bulletin* 2010/4 2. Current account balance excluding unpaid accrued interest due to credit institutions in winding-up proceedings.

Table 2 Inflation forecast (%)<sup>3</sup>

Quarter	Inflation (change year-on-year)	Underlying inflation (excluding tax effects) (change year-on-year)	Inflation (annualised quarter-on- quarter change)	
			Measured value	Forecasted value
2009:4	8.6 (8.6)	7.8 (7.8)	10.4 (10.4)	
2010:1	7.4 (7.4)	6.1 (6.1)	4.9 (4.9)	
2010:2	7.1 (7.1)	5.9 (5.9)	4.7 (4.7)	
2010:3	4.3 (4.3)	3.6 (3.6)	-2.3 (-2.3)	
2010:4	2.8 (2.8)	2.0 (2.1)	4.0 (4.2)	
2011:1	1.6 (2.5)	1.4 (2.2)	0.0 (3.4)	
2011:2	1.7 (1.6)	1.5 (1.4)	5.2 (1.3)	
2011:3	2.2 (1.9)	2.0 (1.7)	-0.1 (-1.2)	
2011:4	2.0 (1.8)	1.8 (1.5)	3.0 (3.8)	
2012:1	2.2 (1.9)	2.1 (1.8)	0.8 (3.7)	
2012:2	2.0 (1.9)	1.9 (1.8)	4.4 (1.3)	
2012:3	1.9 (1.9)	1.8 (1.8)	-0.4 (-1.2)	
2012:4	1.9 (2.0)	1.8 (1.9)	3.0 (4.5)	
2013:1	2.1 (2.3)	2.1 (2.3)	1.5 (4.8)	
2013:2	2.1 (2.3)	2.1 (2.3)	4.5 (1.1)	
2013:3	2.2 (2.3)	2.2 (2.3)	0.0 (-1.1)	
2013:4	2.3 (2.5)	2.3 (2.5)	3.4 (5.4)	
2014:1	2.4	2.4	1.7	
<i>Annual average</i>	<i>Inflation</i>	<i>Underlying inflation (excluding tax effects)</i>		
2010	5.4 (5.4)	4.4 (4.4)		
2011	1.9 (1.9)	1.6 (1.7)		
2012	2.0 (1.9)	1.9 (1.8)		
2013	2.2 (2.3)	2.2 (2.3)		

3. Figures in parentheses from forecast in *Monetary Bulletin* 2010/4.