Monetary Bulletin in a nutshell

A strong economic recovery took place among Iceland's main trading partners through much of 2021. However, a setback in the pandemic and continued repercussions of global supply-chain bottlenecks caused GDP growth to lose pace late in the year and slow down even further in 2022 to date. As a result, the outlook is for trading partners' GDP growth to be weaker this year than was forecast in the November *Monetary Bulletin*. Global inflation has also risen much more steeply than was forecast then.

In Iceland, GDP grew by 4.1% in the first three quarters of 2021, somewhat less than was forecast in November. Indicators suggest considerably stronger growth in domestic demand in Q4, however, and GDP growth for 2021 as a whole is therefore projected at 4.9%, 1 percentage point more than in the November forecast. On the other hand, the forecast for Q1/2022 has been revised downwards in response to the recent spike in COVID infections. GDP growth for 2022 as a whole is forecast at 4.8% instead of the 5.1% projected in November. The outlook for the next two years is broadly unchanged, however.

Job numbers continue to rise rapidly, and unemployment is approaching its pre-pandemic level. The outlook is for unemployment to keep falling, and towards the end of the forecast horizon it is expected to measure about 4%, close to its estimated equilibrium level. Leading indicators also imply that the slack in output has closed.

Inflation measured 5.7% in January, its highest in nearly a decade. It is driven mainly by surging house prices, plus sharply increasing global commodity prices and shipping costs. Domestic inflationary pressures have increased as well, reflecting in part the marked rise in wages and house prices. Inflation excluding housing has also increased, as has underlying inflation, which measured 4.4% in January. Long-term inflation expectations have risen as well. Inflation is expected to average 5.8% in Q1/2022, or 1.4 percentage points above the November forecast. It is assumed to remain above 5% for much of this year and not fall below 4% until early 2023, and it is not expected to fall below 3% until the latter half of the forecast horizon. The inflation outlook has therefore deteriorated markedly since November, owing mainly to a stronger domestic economic recovery and more persistent house price inflation. Furthermore, international price hikes have been larger than previously assumed.

The forecast assumes that there will not be a severe setback in the battle against the pandemic and that continuing progress will be made in unwinding the supply-chain disruptions that have pushed various commodity prices sharply higher. There is considerable uncertainty about this, however, and the risk of war in Europe and rapidly rising global inflation have further exacerbated this uncertainty. Moreover, the rise in inflation expectations could indicate that inflation will turn out even more persistent than is currently forecast.

The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin* 2021/4 in November 2021, and on the updated forecast presented here. It is based on data available in early February. The risk assessment in the updated forecast is based on the risk assessment in the November forecast.