Inflation

V

Recent developments in inflation

Headline inflation has been persistent …

Inflation has been consistently above 4% since the beginning of this year. In Q3 it measured 4.3%, marginally above the August forecast. House prices were the main driver of inflation during the quarter, as they were in Q2. Fuel prices also had some impact, as global oil prices are higher now than before the pandemic and at their highest since late 2014 (see Chapter I).

Headline inflation measured 4.5% in October, and housing and petrol prices continued to be the main drivers of the month-on-month rise in the CPI (Chart V-1). Inflation excluding housing measured 3% and has fallen markedly in recent months. The difference between headline inflation and inflation excluding housing is the largest in over three years. Inflation according to the HICP, which also excludes owner-occupied housing costs, was higher, however, measuring 3.8% in September, slightly above the August reading.

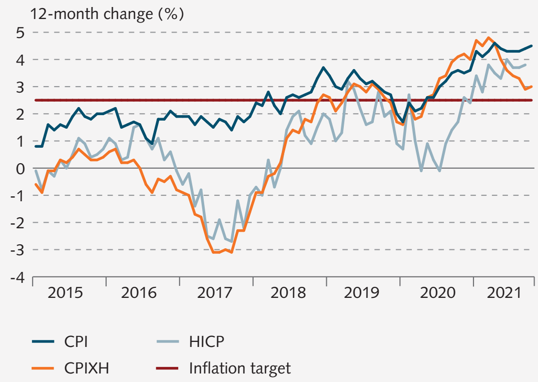
… but underlying inflation has eased since the last *Monetary Bulletin*

Underlying inflation has continued to fall. It measured 3.7% in October, according to the average of various measures (Chart V-2). According to all measures, inflationary pressures have eased in 2021 to date, but in other respects, they give divergent views of the situation. For example, underlying inflation is considerably lower in terms of the trimmed mean (which excludes subcomponents that show the most pronounced changes) and the weighted median (which is determined from the median price change of all CPI subcomponents). By both of these measures, underlying inflation was close to 3% in October. Since the pandemic struck, they have

Chart V-1

Various measures of inflation

January 2015 - October 2021

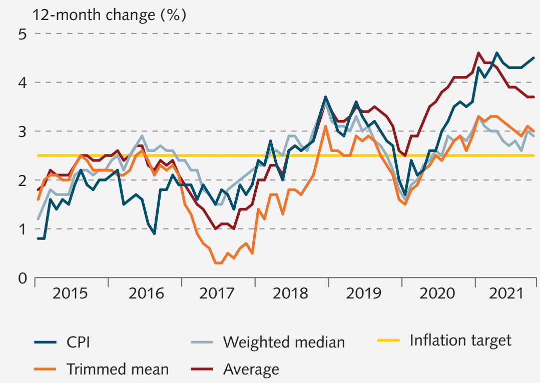


Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-2

Headline and underlying inflation[1]

January 2015 - October 2021



1. The calculation of the trimmed mean omits the subcomponents that change the most in any given month, while the weighted median is the median change of all CPI subcomponents. The average shows the average of five different measures of underlying inflation.

Sources: Statistics Iceland, Central Bank of Iceland.

indicated a smaller rise in underlying inflation than is suggested by conventional core indices (which always exclude the same subcomponents, such as petrol). This accords better with the significant slack that opened up in the economy at the height of the pandemic.

House prices have weighed heavily in inflation over the past year, and in October, nearly half of twelve-month inflation stemmed from the housing component of the CPI (Chart V-3). The cost of owner-occupied housing has risen by about 11.8% in the past twelve months, up from 8.5% in July. As is discussed in Chapter II, there are signs that house prices have risen more than can be attributed to developments in the macroeconomic fundamentals that generally determine long-term house price movements.

Indicators of inflationary pressures

Imported inflation has eased …

The króna depreciated markedly after the onset of the pandemic early in 2020. The impact of the depreciation on imported goods prices has tapered off in recent months, and imported inflation has subsided. As of October, imported goods prices had risen 2.9% over the previous twelve months. In particular, imported food price inflation has eased; indeed, prices have fallen by 2.3% year-on-year (Chart V-4). Furthermore, the twelve-month rise in the price of various imported goods – such as clothing, electronic equipment, and furniture – has lost pace in recent months, measuring 1.9% as of October.

… but the outlook is cloudy due to turbulence abroad …

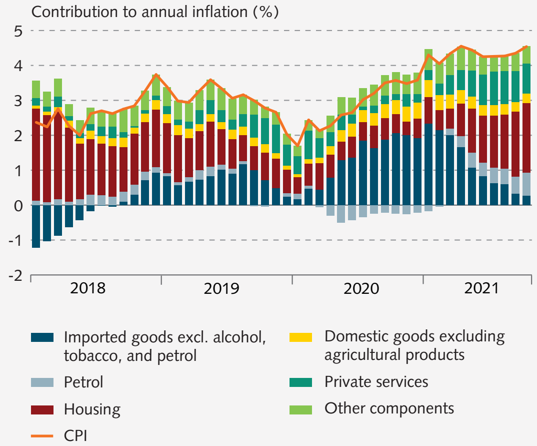
Global inflation has risen in recent months, in part due to steep rises in energy and commodity prices, increased demand following the relaxation of public health measures, and the impact of worldwide supply-chain bottlenecks (see Chapter I). The pandemic led to disruptions in production around the world and obstructed cross-border distribution of goods, which in turn caused a spike in shipping costs. The spread of the Delta variant of the virus then caused further disruption – for instance, in factories and harbours. Because of the spread of the variant, together with growing demand, it has taken longer to unwind these supply-chain disruptions. The problem has escalated still further in recent months because of peak activity during the run-up to the holiday season. The effects could therefore persist well into 2022.

The results of Gallup's autumn survey of corporate executives' expectations suggest the risk of continued

Chart V-3

Components of CPI inflation

January 2018 - October 2021

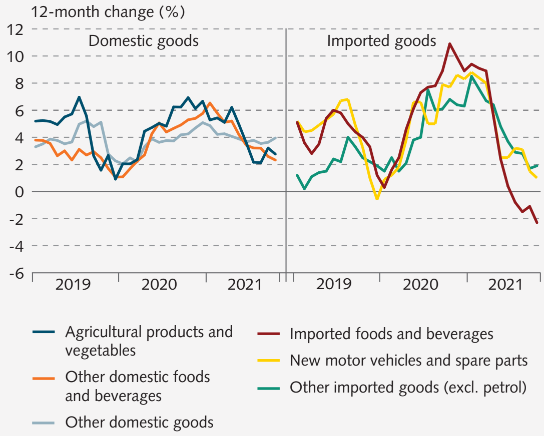


Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-4

Domestic and imported goods prices

January 2019 - October 2021



Source: Statistics Iceland.

increases in product prices. About 58% of executives expect to raise the price of their own goods and services in the next six months, and about 78% expect the price of intermediate inputs to rise. This is a substantial increase relative to the spring survey (Chart V-5). Furthermore, a larger number of survey participants cited input prices as the main driver of their own price increases in the coming term.

… and private services prices have begun to rise

Once a large share of Iceland's population had been vaccinated and public health measures eased, private services prices began to rise, and by October they were up 3.7% year-on-year. The subcomponents that have risen most in price are accommodation and maintenance services. Airfares have also risen in the past year (Chart V-6).

Wages up sharply in the recent term

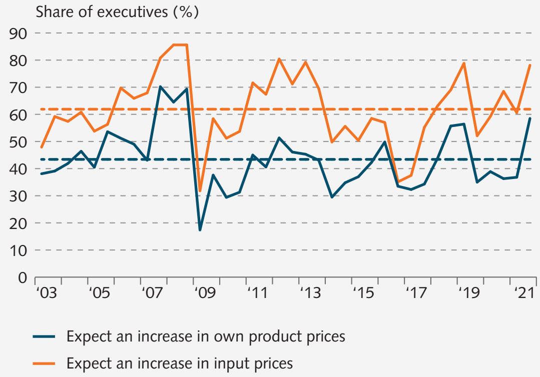
Historical figures for wages and related expenses were revised slightly in the national accounts published in August. The largest revisions were for 2018. The wage share – i.e., the ratio of wages and related expenses to gross factor income – is now estimated to have measured 61.3% in 2020, some 0.3 percentage points higher than in the previous national accounts figures and 1.7 percentage points above its twenty-year average.

The general wage index rose in line with expectations in Q3, or by 0.7% between quarters and 7.8% year-on-year (Chart V-7). In H1/2021, the total wage index was up 9.6% year-on-year, or 0.6 percentage points more than the general wage index. This indicates that the changed composition of wages or labour volume was conducive to higher wages per hour, and it is somewhat surprising that a similar trend could not be seen in 2020, when low-paying jobs declined markedly in number. The estimates of wages and labour volume in the national accounts suggest, however, that hourly labour compensation increased in 2020, owing to changes in sectoral composition. This made little impact on unit labour costs, however, as there was a comparable effect on labour productivity (see Chapter IV). According to the Bank's baseline forecast, unit labour costs are assumed to rise by just over 4% in 2021 and by an average of just under 6% per year throughout the forecast horizon. This is a larger increase than was assumed in the August forecast, mainly because it now appears that the contractual provision allowing for a so-called GDP growth supplement will indeed be triggered, which will cause even greater wage increases over the next two years.

Chart V-5

Corporate expectations of input and product prices 6 months ahead[1]

March 2003 - September 2021

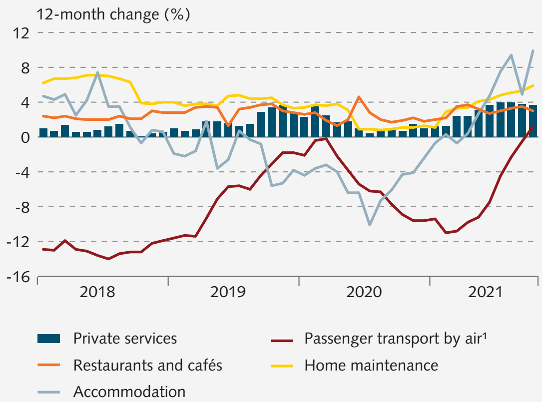


1. Broken lines show averages from 2003.
Sources: Gallup, Central Bank of Iceland.

Chart V-6

Private services and selected subcomponents of the CPI

January 2018 - October 2021

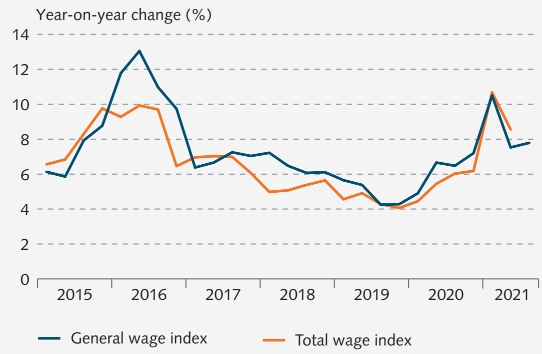


1. Twelve-month moving average.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-7

Wages

Q1/2015 - Q3/2021



Source: Statistics Iceland.

Inflation expectations

Developments in short-term inflation expectations have diverged in the recent term …

Developments in short-term inflation expectations have to some extent been affected by the fact that inflation has been more persistent than was anticipated. Market agents expect inflation to measure 3.3% one year ahead, which is higher than in the August survey, whereas they still expect it to be at target in two years' time (Chart V-8). According to Gallup's autumn survey, corporate executives expect inflation to average 3%, both one and two years ahead. Their one-year expectations were lower than in the summer survey. Thus they appear to expect inflation to start easing in the near future, even though the survey shows that a larger number of executives expect to raise their own product prices, as is mentioned above. Households, on the other hand, expect inflation to remain high, and their expectations two years ahead rose to 3.5% in the autumn survey.

… but long-term inflation expectations have risen by some measures

This autumn, there were signs that long-term inflation expectations had begun to ease after having risen temporarily early in the year. The breakeven inflation rate in the bond market has risen again in recent months, however. The five-year breakeven rate five years ahead was just over 3% in mid-November, as compared with 2.6% at the end of August (Chart V-9). Households' long-term inflation expectations had also risen according to the autumn survey, to 3.5%. Corporate executives, on the other hand, still expect inflation to measure 3% over the next five years. Furthermore, market agents' five- and ten-year expectations were unchanged since the August survey, and market participants still expect average inflation to be close to the target in the long run.

The inflation outlook

Inflation to ease more slowly than previously forecast

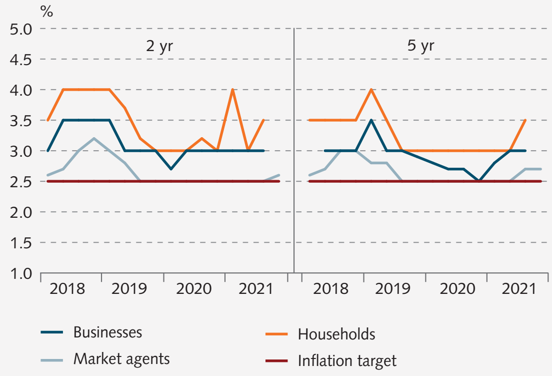
In Q3/2021, inflation was marginally above the August forecast, and the near-term outlook has deteriorated significantly. Inflation is forecast at 4.7% in Q4/2021 and 4.4% in Q1/2022, or 0.7 percentage points above the August forecast (Chart V-10). It therefore looks set to remain above 4% for longer than previously anticipated, and not to fall below 3% until Q4/2022.

The bleaker inflation outlook is due in particular to a poorer initial position and higher imported inflation than was assumed in August. Global inflation has

Chart V-8

Two- and five-year inflation expectations[1]

Q1/2018 - Q4/2021

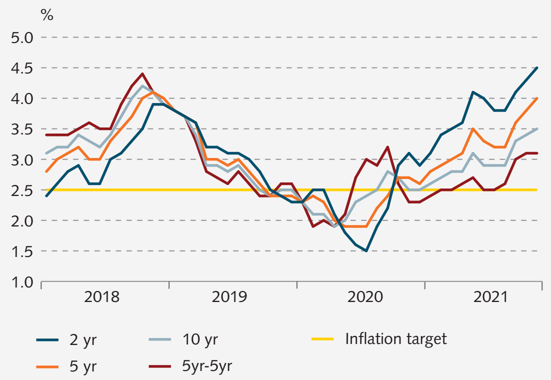


1. Gallup surveys of households' and businesses' inflation expectations and Cental Bank survey of market agents' inflation expectations. Median responses.
Sources: Gallup, Central Bank of Iceland.

Chart V-9

Breakeven inflation rate[1]

January 2018 - November 2021



1. Monthly averages.
Source: Central Bank of Iceland.

gained pace considerably, oil prices have risen more than previously expected, and the effects of supply-chain bottlenecks and disruptions in production appear likely to persist longer than previously assumed. Furthermore, in Iceland, a larger output gap is expected in the next two years, wages and house prices are projected to rise more than previously forecast, and the exchange rate of the króna is expected to be slightly lower over the forecast horizon than was projected in August. Moreover, because of the recent rise in long-term inflation expectations, it will take longer for the inflationary impact of cost increases to subside. According to the baseline forecast, inflation will be close to target by the end of 2022 and then rise slightly in the latter half of the forecast horizon, averaging 2.9% in 2023. It is expected to ease back towards the target thereafter.

Inflation risk still concentrated on the upside

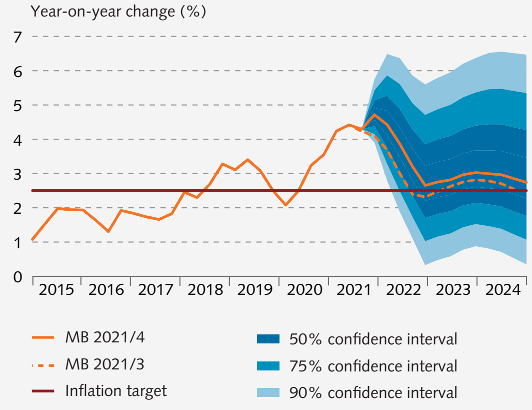
As is discussed in Box 1, the inflation outlook is highly uncertain at present. In the short run, it will be driven mainly by the exchange rate of the króna and house prices, but also by how quickly the supply-chain disruptions brought on by the pandemic can be unwound and by energy prices, which have risen steeply in the recent term. Further ahead, inflation will depend largely on inflation expectations – how they develop and whether they become unmoored from the target – given that inflation looks set to be relatively persistent.

The risk profile is considered tilted to the upside; i.e., near-term inflation is likelier to be underestimated in the baseline forecast than it is to be overestimated. The confidence interval is also wider than in August. There is a 50% probability that inflation will be in the 1¾-4% range in one year and in the 1¾%-4¼% range by the end of the forecast horizon (Chart V-10).

Chart V-10

Inflation forecast and confidence intervals

Q1/2015 - Q4/2024



Sources: Statistics Iceland, Central Bank of Iceland.