Economic and monetary developments and prospects – updated forecast[1]

Inflation outlook improving short-term but compromised by growing output gap in the long run

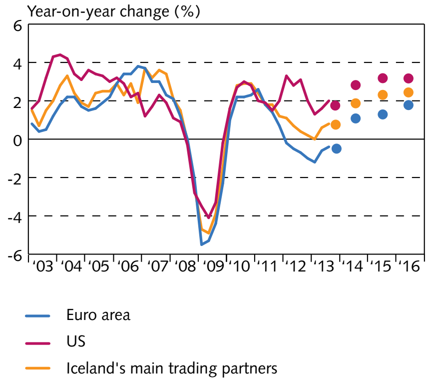
The global output growth outlook has improved since the publication of the November Monetary Bulletin*, although considerable uncertainty remains, particularly in relation to recent headwinds facing emerging economies. The outlook for Iceland's terms of trade has improved as well, but the outlook for exports has deteriorated, owing in particular to poorer prospects for capelin fishing this year. Last year's GDP growth appears to have been considerably stronger than previously anticipated, or 3% instead of the 2.3% in the November forecast, due to a much stronger contribution from net trade, while domestic demand developed in line with the forecast. The economic outlook is coloured strongly by the effects of the Government's household debt relief measures and other stimulative policy measures. As is described in Appendix 2, the debt relief package is expected to boost private consumption considerably in the near future. The increased demand will also emerge in increased imports, reducing national savings and cutting into the current account surplus. The GDP growth effect of the measures will be less pronounced than the effect on domestic demand. As in November, GDP growth for 2014 is estimated at 2.6%, reflecting the stimulative effects of the Government debt relief package and the offsetting outlook for weaker export growth, coupled with delays in energy-intensive industrial development projects. The GDP growth outlook for the next two years has improved considerably, with growth projected at 3.7% in 2015 and 3% in 2016. If the forecast materialises, output growth will average 3.1% per year over the forecast horizon, which is above the 30-year average and well above the average projection for Iceland's main trading partners. The domestic labour market has also recovered more strongly than previously forecast. On the strength of unexpectedly robust output growth, the slack in the economy will narrow more quickly than previously projected, and an output gap could develop early next year. Inflation is expected to be lower this year than according to the November forecast because of a stronger króna and smaller rises in unit labour costs than were anticipated then. If assumptions concerning developments in wages and the exchange rate are borne out, inflation will approach the inflation target this year. When the effects of the recent appreciation taper off and the output slack turns into an output gap, inflation could gain pace again and remain above the target for a time. According to the forecast, it will peak at about 3½% late in 2015 and then taper off in 2016, due to countervailing monetary tightening. If the forecast materialises, inflation will be somewhat above target at the end of the forecast horizon, although the target is well within the 50% confidence band of the forecast.*

Global economic affairs and external trade

- Since the publication of the November *Monetary Bulletin*, economic indicators for the euro area have developed broadly in line with market expectations. GDP grew slightly quarter-on-quarter for the second consecutive quarter, although output contracted year-on-year by 0.4%. The strength of the recovery varies from country to country, although early signs of recovery can also be discerned in Southern Europe. It also appears that recovery is gaining ground in the US and the UK, with both countries reporting GDP growth of nearly 1% quarter-on-quarter in Q3. Annual output growth is still relatively weak, however, at 1.8% in the US and 1.5% in the UK. In Japan, GDP grew 0.5% between quarters, bringing annual growth to 2.6%.

- On the whole, the global output growth outlook appears to have improved. In its January 2014 forecast, the International

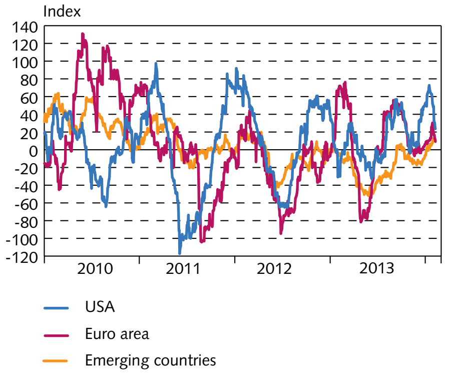
Chart 1
GDP growth in selected industrialised countries[1]



1. Points show forecast from Consensus Forecasts and Global Insight for 2013-2016.
Sources: Consensus Forecasts, Global Insight, Macrobond.

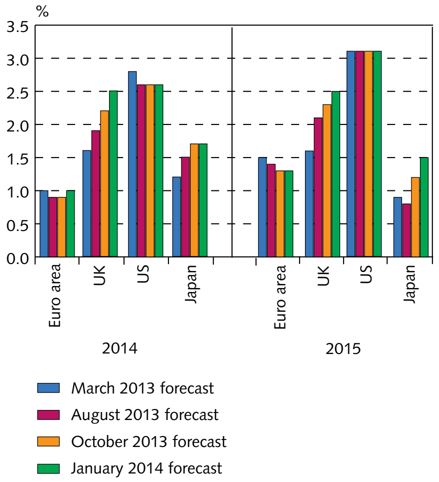
1. The analysis appearing here is based in large part on the Bank's assessment of economic developments, published in November 2013 in *Monetary Bulletin* 2010/4, and on the updated forecast presented here. It is based on data available in early February.

Chart 2
Economic surprise index[1]
Daily data 1 January 2010 - 7 February 2014



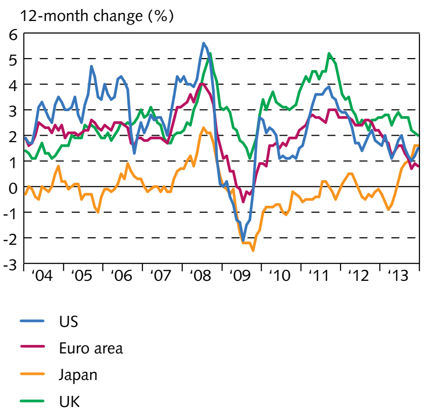
1.When the index is lower than 0, the indicators are more negative than expected; when the index is higher than 0, the indicators are more positive than expected. The index does not imply that the indicators are positive or negative.
Source: Macrobond.

Chart 3
GDP forecasts for 2014 and 2015[1]



1. Based on monthly forecasts from 250 forecasting agencies which are weighted together.
Sources: Consensus Forecasts, Global Insight.

Chart 4
Inflation in selected industrialised countries
January 2004 - December 2013



Source: Macrobond.

Monetary Fund (IMF) projects it at 3.7% in 2014 and 3.9% in 2015. The improvement since the Fund's October forecast is due primarily to a brighter outlook among industrialised countries. The GDP growth outlook for Iceland's main trading partners has improved as well, with 2% growth projected for this year instead of 1.8%, as in the November forecast. The outlook for 2015 has also improved slightly. GDP growth for the year is now projected at 2.3%, while the forecast for 2016 is unchanged since November, at 2.4%.

- The outlook is now for lower inflation in trading partner countries than was assumed in the last *Monetary Bulletin*. The greatest difference is in the euro area, where inflation measured only 0.7% in January. Inflation was also low in the US, measuring 1.5% in December, and in the UK it has tapered off relatively quickly and reached the Bank of England's 2% inflation target. In Japan, however, inflation has picked up rather rapidly after a prolonged deflation episode, climbing to a five-year high of 1.6% in December.

- In the euro area, the European Central Bank (ECB) lowered the policy rate by 0.25 percentage points, to 0.25%, shortly after the publication of the November *Monetary Bulletin*. The ECB also indicated that its balance sheet might be used for further monetary easing if necessary. The US Federal Reserve Bank has tapered off its bond purchase programme, however, in view of the improving economic outlook in the US. In addition, the Bank of England (BoE) decided to keep interest rates unchanged in February, although unemployment is approaching the level the BoE has defined as a reference for a possible rate increase.

- In the wake of the US Federal Reserve's decision to pull back on bond purchases, investors are setting their sights on emerging economies again, as they did last summer in response to early signs that the bank would begin pulling back its stimulus. Capital has fled emerging markets, with the associated pressure on currency exchange rates, increased inflationary pressures, and tighter financial conditions. Emerging countries with substantial foreign debt and current account deficits have felt the effects most keenly, as could be expected, and their central banks have responded with interest rate hikes and/or foreign exchange market intervention. Investors' concerns have also centred on the economic outlook in China, however, and the threat of declining GDP growth there, particularly due to potential financial instability associated with rapid lending growth in the shadow banking system.

- Even though GDP growth has gained momentum in industrialised countries and economic recovery has exceeded expectations in some economies, uncertainty about global GDP growth remains and unrest in the financial markets has increased again, particularly in connection with the situation in emerging countries. Share prices have risen steeply in industrialised countries in the past year, with stocks appreciating by over a third in the US and the euro area, while they fell by an average of 2% in emerging market countries. Share price volatility has increased again, in tandem with growing tension in the financial markets.

- Although the GDP growth outlook for Iceland's trading partners has improved slightly, trading partners' imports are expected to grow broadly in line with the November forecast, averaging 2½% per year in 2014-2016.

- Global commodity prices fell by 1% year-on-year in 2013, in line with the forecast in the last *Monetary Bulletin*. They are expected to fall by over 5% this year, as is assumed in the November forecast, with the decline driven by falling food prices. This is a slightly smaller decline than in the IMF's January forecast and notably smaller than in the Organisation for Economic Co-operation and Development's (OECD) November forecast. Oil prices are assumed to fall by 4½% this year, which is closely in line with the November forecast. They are expected to fall by 1-2% per year throughout the forecast horizon.

- The prospect of increased demand for fish products gives cause for greater optimism about marine product prices. Prices are now expected to rise by an average of 1% this year and next year instead of falling by 2% both years, as in the previous forecast. The outlook for developments in aluminium prices has worsened, however, with a decline of ½% expected this year, whereas an increase of over 3% was projected in November. The outlook for the coming two years is similar to the November forecast, however.

- Owing to the brighter outlook for marine product prices, terms of trade are now expected to deteriorate by just under ½% this year rather than nearly 1%, as in the November forecast. This will come in addition to the relatively positive developments from last year. As in November, terms of trade are assumed to deteriorate by an additional 2% in the next two years.

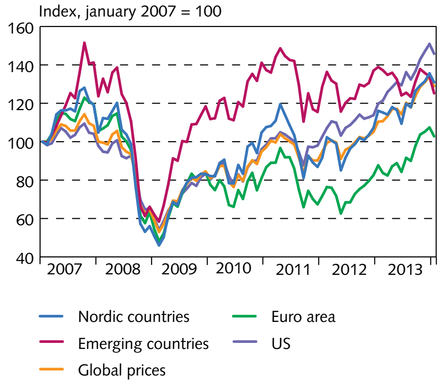
- The real exchange rate rose by nearly 10% year-on-year in December and by an average of 3.9% over 2013 as a whole, owing mainly to nominal appreciation of the króna at the beginning and end of the year, although higher inflation in Iceland than in trading partner countries is a factor as well. It remains low in historical context, however.

- Goods exports grew by nearly 3% last year, well in excess of the November forecast, owing to stronger-than-expected exports of marine products (driven by larger catches and improved utilisation) and aluminium. The outlook for goods exports in 2014 has worsened considerably, however, with a year-on-year contraction of almost 1% expected instead of a 2% increase. The deterioration is due to several factors, including the poorer outlook for capelin fishing and the proposed cutback in electricity to wholesale users, which will force aluminium manufacturers to scale down production in the first half of this year. Exports of marine

Chart 5

Equity prices in selected markets[1]

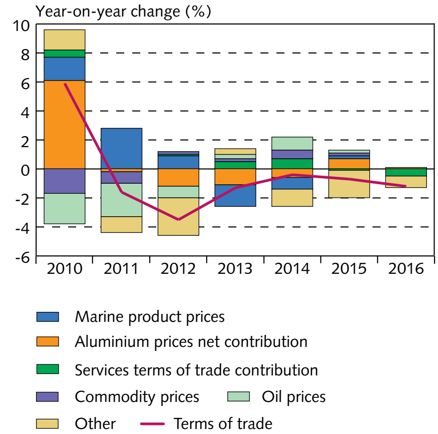
January 2007 - January 2014



1. Monthly averages.
Source: Macrobond.

Chart 6

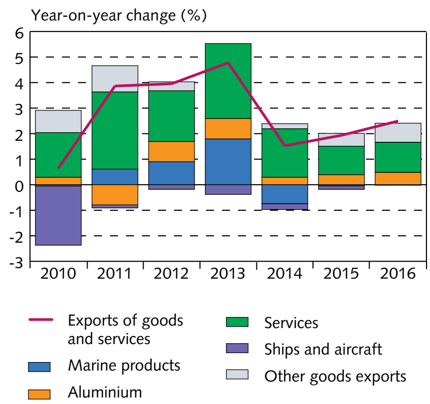
Terms of trade and their main components 2010-2016[1]



1. Central Bank baseline forecast 2013-2016. 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 7

Export development and its main components 2010-2016[1]



1. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

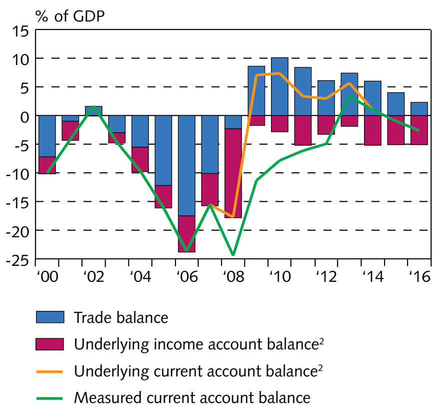
and aluminium products will therefore be weaker than previously forecast. For the next two years, however, the outlook for goods exports is considered marginally better.

- Services exports are projected to have grown by 4.7% last year, well above the 3.4% assumed in the November forecast. Even though they are expected to grow even more strongly this year, total exports are projected to grow by only 1.4% instead of the more than 2% provided for in the November forecast, owing to the weaker outlook for goods exports. Growth is expected to pick up again in the next two years, averaging 2% per year, in line with the November forecast.

- Last year's goods trade surplus was some 20 b.kr. larger than was assumed in the November forecast, due to the aforementioned surge in exports and to slightly weaker imports than previous estimates had indicated. The 2013 surplus on combined goods and services trade is now estimated at about 7½% of GDP, about 1½ percentage points more than according to the forecast in the last *Monetary Bulletin*. The surplus is estimated to narrow this year, to 6% of GDP, and contract still further in the next two years. It is projected at just over 2% of GDP in 2016. Even though last year's surplus was stronger than expected, the outlook is for a smaller surplus than was forecast in November, owing largely to the stimulative effect of the Government's debt relief measures (for further discussion, see Appendix 2).

- The underlying current account balance showed a record Q3/2013 surplus of 62.5 b.kr. For the year as a whole, it is expected to show a surplus of 94.1 b.kr., or 5.3% of GDP, which is 2 percentage points more than was forecast in November. In addition to more favourable developments in goods and services trade, there are signs that the underlying deficit in the balance on income was smaller than previously thought. Factor expense on non-residents' equity securities holdings was smaller and residents' interest income on foreign assets was larger, and the net effect of the settlement of bankruptcy estates on the balance on income is no longer included in the income account for last year, as the settlement did not take place. As in previous forecasts, the surplus is expected to shrink this year. It is estimated at just under 1% of GDP, which is slightly larger than was forecast in November. The surplus will turn into a 1% deficit in 2015, although this is 1 percentage point less negative than was projected in November. Because the surplus on goods and services trade is expected to narrow, the deficit is projected to be somewhat larger in 2016, or nearly 3% of GDP instead of more than 2% provided for in the November forecast.[2]

Chart 8
Current account balance 2000-2016[1]



1. Net current transfers are included in the balance on income. Central Bank baseline forecast 2013 - 2016. 2. Adjusted for calculated revenues and expenses of deposit money banks (DMBs) in winding-up proceedings and the effects of the settlement of their estates, and adjusted for the effects of the pharmaceuticals company Actavis until 2012.
Sources: Statistics Iceland, Central Bank of Iceland.

2. The forecast of the underlying balance on income account is based on the estimated division of the estates' assets among creditors. The revenues and expenses deriving from the assets were then added to the balance on income. Because of this, the balance on income will be more negative throughout the forecast horizon than it would have been otherwise.

Domestic financial markets

- The Central Bank of Iceland Monetary Policy Committee (MPC) decided to hold the Bank's interest rates unchanged at its November and December meetings. Prior to the publication of this *Monetary Bulletin*, the current account rate was 5%, the maximum rate on 28-day certificates of deposit (CDs) was 5.75%, the seven-day collateralised lending rate was 6%, and the overnight lending rate was 7%. The Bank's interest rates have been unchanged since November 2012.

- Demand for Central Bank liquidity facilities is limited due to abundant financial system liquidity; therefore, the simple average of the Bank's current account rate and the maximum rate on 28-day certificates of deposit (CD) is the closest approximation of the rate that determines money market interest rates. This rate is now 5.4%, whereas the overnight interbank rate is 5.25% and has developed broadly in line with Central Bank rates. Interest rates in Treasury bill auctions have also edged towards the Bank's interest rates and are now about 0.8 percentage points higher than they were a year ago; however, they remain almost a percentage point below the floor of the interest rate corridor.

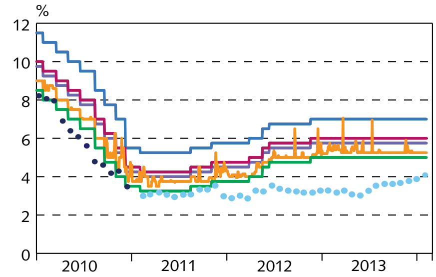
- Although the Bank's nominal interest rates have remained unchanged since November 2012, the monetary stance has tightened, and the Bank's real rate is now 2.2% in terms of current inflation and 1.8% in terms of various measures of inflation and inflation expectations, or 0.3-0.5 percentage points higher than when the November *Monetary Bulletin* was published.

- According to the Bank's market expectations survey, last carried out in early February, market agents expect Central Bank nominal rates to be lower in 2014 than they did prior to the issue of the November *Monetary Bulletin*. However, they expect higher real rates. The survey results indicate that they expect the Bank's collateralised lending rate to remain unchanged at 6% until the end of 2014, 0.5 percentage points lower than in the previous survey. On the other hand, they now appear to expect a 0.25-point rate increase in Q1/2015 and that the collateralised lending rate will be 6.5% two years from now. Forward interest rates indicate, however, that market agents expect the Bank's policy rate to rise by 0.5 percentage points this year, to 6.5%, which is 0.25 percentage points higher than they indicated at the beginning of November.[3]

- Yields on indexed and non-indexed bonds have risen since the November *Monetary Bulletin*, indexed yields by 0.2-0.8 percentage points and non-indexed yields by 0.3-1.0 percentage points. The rise in real rates reflects the aforementioned increase in the

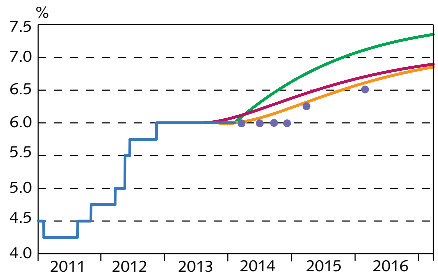
3. Measurement problems at the short end of the yield curve introduce a measure of uncertainty into the indications provided by the yield curve. Treasury bonds maturing in the next two years are not used, however, as their pricing is considered skewed by the effects of the capital controls.

Chart 9
Central Bank of Iceland interest rates and short-term market interest rates
Daily data 1 January 2010 - 7 February 2014



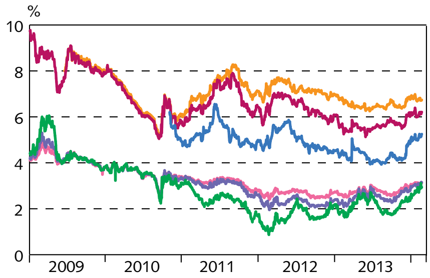
Source: Central Bank of Iceland.

Chart 10
Collateralised lending rate, forward market interest rates[1] and market agents' expectations concerning collateralised lending rate[2]
Daily data 1 January 2011 - 31 March 2017



1. Interbank interest rates and Treasury bonds were used to estimate the yield curve. Treasury bonds maturing within two years are excluded, however, because their pricing is assumed to be affected by the capital controls. 2. According to the median response in the Central Bank's market expectations survey for the period 3-5 February 2014.
Source: Central Bank of Iceland.

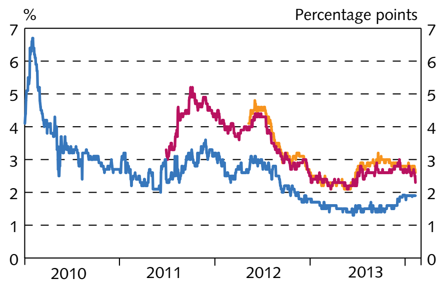
Chart 11
Nominal and indexed bond yields
Daily data 2 January 2009 - 7 February 2014



RIKB 16 1013
RIKB 19 0226
RIKB 25 0612
HFF 150224
HFF 150434
HFF 150644

Source: Central Bank of Iceland.

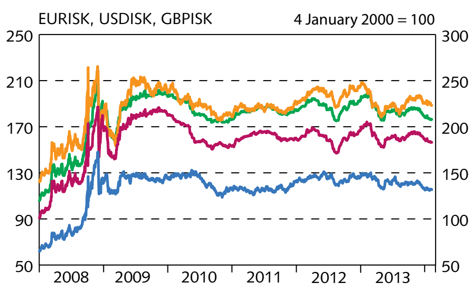
Chart 12
Risk premia on the Icelandic Treasury
Daily data 1 January 2010 - 7 February 2014



CDS Iceland (left)
Difference between Icelandic and US government bonds issued in USD maturing in 2016 (right)
Difference between Icelandic and US government bonds issued in USD maturing in 2022 (right)

Source: Bloomberg.

Chart 13
Exchange rate of the króna
Daily data 3 January 2008 - 7 February 2014



USD (left)
EUR (left)
GBP (left)
Average exchange rate - narrow TWI (right)

Source: Central Bank of Iceland.

Central Bank's real rate. There could also be further effects due to expectations of increased supply in the wake of the 16 December announcement of the planned sale of the Central Bank of Iceland Asset Holding Company's (ESÍ) indexed bonds in the amount of some 100 b.kr. over the next five years. It could also reflect uncertainty about the effects of the Government's household debt relief package on economic activity and the Treasury's debt position. Finally, it may reflect reduced demand among non-residents, who have scaled down their Treasury bond holdings in the recent term.

- In line with international developments, the risk premium on Icelandic Treasury obligations rose at mid-year, in the wake of global market unrest stemming from uncertainty about the future of the US Federal Reserve Bank's bond purchase programme. In terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, the risk premium has fallen since the November *Monetary Bulletin*, to just about 2½%, which is nonetheless higher than at the beginning of June. The CDS spread on five-year Treasury obligations has risen by about 0.3 percentage points since November, however, and now measures 1.9%. The decision by rating agency Standard & Poor's to change the outlook on Iceland's sovereign credit ratings from negative to stable in late January has not yet had any noticeable effect on developments in risk premia, which are higher by both criteria than they were a year ago.

- Towards the end of 2013, one of the three large commercial banks undertook its first foreign bond issue, making it the second Icelandic commercial bank since 2008 to seek foreign credit financing. Furthermore, two of the large commercial banks recently received credit ratings from international rating agencies, which should ease their access to international financial markets.

- Since the last *Monetary Bulletin*, the króna has appreciated by 5.4% in trade-weighted terms, 4.7% against the euro, and 5% against the US dollar. This is a radical departure from the steep depreciation a year ago. The króna is now 11.8% stronger in trade-weighted terms than at the same time last year. The trade surplus and the reduction in foreign loan payments by firms and municipalities have supported the exchange rate, although developments in terms of trade have pulled in the opposite direction.

- Exchange rate volatility has also diminished, in part due to action taken by the Central Bank. The Bank's net foreign exchange purchases in the interbank market totalled some 6.7 b.kr. in Q4/2013 and about 1 b.kr. for the year as a whole. Including payments on forward contracts, they totalled about 22.7 b.kr. The Bank has bought about 13.5 b.kr. in excess of sales so far this year.

- The króna was slightly weaker in Q4/2013 than was forecast in November, with the exchange rate index averaging just under 218 points. So far this year, however, the exchange rate index has averaged about 210. As before, the Bank's baseline forecast is based on the assumption that throughout the forecast horizon, the exchange rate of the króna will remain broadly stable at the level prevailing when the forecast was prepared. If this assumption is borne out, the exchange rate will be roughly 2½% higher than according to the November forecast.

- Residents' deposits in deposit money banks (DMB) increased by about 4.1% year-on-year in Q4/2013. The lion's share of the increase is due to deposits owned by holding companies, including the estates of the failed financial institutions. Over the same period, corporate deposits increased by 3.3% and household deposits by about 1%.

- M3 was up 4.1% year-on-year in Q4/2013. Narrower measures of the money supply also grew year-on-year, for the fourth month in a row, following an uninterrupted contraction extending back to July 2012. The year-on-year increase measured 2-3¾% in Q4. A portion of money supply growth is due to holding companies; if their deposits are excluded, M3 grew 1.3% between years in Q4. Over the same period, Central Bank base money has increased by 4.2%

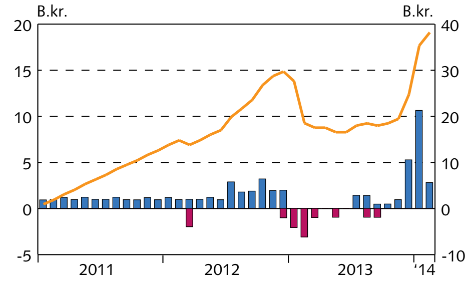
- In 2013, net new DMB lending (new loans net of prepayments) totalled 55 b.kr. in household loans and 84 b.kr. in non-holding company loans. Net new Housing Financing Fund (HFF) lending was negative by 4.4 b.kr. over the same period. The bulk of net new DMB lending to households and businesses has been non-indexed. The majority of new loans to households have been indexed, but prepayments of indexed loans are also higher. In spite of this growth in new credit, the inflation- and exchange rate-adjusted book value of the total loan stock continues to shrink. As before, the contraction is due for the most part to a smaller stock of exchange rate-linked DMB loans and indexed HFF loans.

- House prices rose by 6½% in 2013, while rent rose 10% and the number of registered purchase agreements was up 9½% year-on-year. The average time-to-sale for residential property was about five months in 2013, down from seven in 2012. Real house prices rose by 2½%, on average, between 2012 and 2013 and are now slightly higher than in autumn 2004, just before the major structural changes in the domestic mortgage market.

- Since the last *Monetary Bulletin* was published, the OMXI main list index has risen just under 10% and the OMXI6 by about 9%. The indices rose by nearly 28% and 19%, respectively, in 2013, and trading volume nearly trebled between years. The number of investment options available in the market continues to rise, and several companies are preparing for listing on the exchange in the next two years. Returns on sveral domestic mutual funds were considerably higher last year, at about 45%.

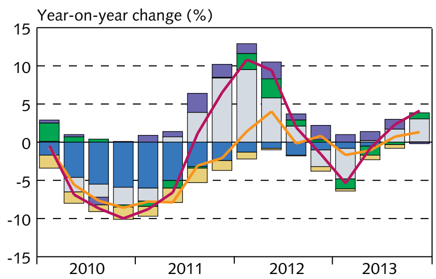
- Private sector financial conditions continue to move in the right direction. Households' and firms' net wealth has continued to rise

Chart 14
Central Bank transactions in foreign exchange market
January 2011 - February 2014[1]



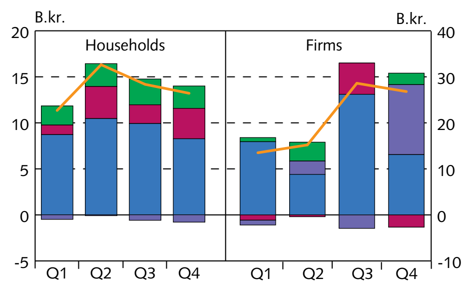
1. Based on data until 6 February.
Source: Central Bank of Iceland.

Chart 15
Components of money supply
Q1/2010 - Q4/2013



Source: Central Bank of Iceland.

Chart 16
Net new lending[1] from the three commercial banks to households and firms[2]
Q1/2013 - Q4/2013



1. New loans net of prepayments. 2. Excluding holding companies.
Source: Central Bank of Iceland.

in line with rising asset prices and declining debt levels, in part due to the recalculation of illegal exchange rate-linked loans, some of which are still pending. Households' financial situation will improve still further in coming years because of measures to lower household mortgage debt. The delinquency rate of households at the three large commercial banks and the HFF has also declined in recent months. The number of individuals on the default register has fallen as well, although default is still widespread in comparison with the beginning of the economic contraction. The number of firms on the default register has risen slightly in recent months, and some firms' financial situation appears fragile, as is discussed in the last *Monetary Bulletin*.

The domestic economy

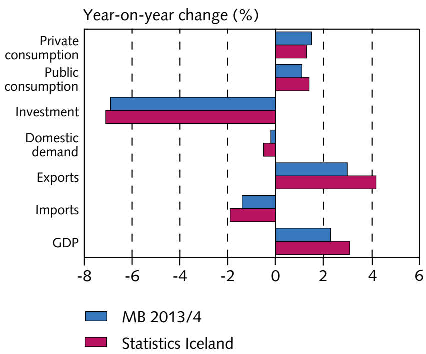
- In December, Statistics Iceland published the national accounts for Q3/2013 and the revised accounts for the first half of the year. According to the national accounts figures, year-on-year output growth measured 4.9% during the third quarter and 3.1% for the first three quarters, as compared with the same periods in 2012. Net trade was the main driver of growth during the first nine months of the year, with exports growing 4.2% and imports contracting by 1.9%. The contribution from domestic demand was negative, however, as it contracted by ½% year-on-year, owing to a steep contraction in investment in ships and aircraft, which was reflected in a contraction in investment of over 7%. Public and private consumption both grew by nearly 1½% during the period, however.

- In Q3/2013, output growth was considerably stronger than the 2.5% forecast in the November *Monetary Bulletin*. It outpaced the November forecast (which was 2.3%) for the first nine months of the year as well. The deviation is due primarily to stronger-than-expected exports, as well as to an unexpectedly large contraction in imports. Domestic demand developed in line with the Bank's forecast, although the contribution from net trade to output growth was substantially most positive than projected.

- Since the economic recovery took hold in Q2/2010, GDP has grown by nearly 11%, after having contracted by more than 12% from its pre-crisis peak.[4] This is a stronger recovery than in Iceland's main trading partner countries. Early on, the recovery was fuelled by growth in domestic demand, particularly private consumption and business investment, but in recent quarters, net trade has been the main driver.

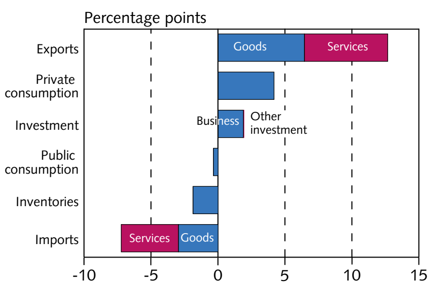
- Private consumption grew by 2.4% year-on-year in Q3/2013, which is well in line with the November forecast of 2.2% growth. In the first half of the year, it was weaker according to revised

Chart 17
National accounts for Q1-Q3/2013 and Central Bank estimate



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 18
Contribution of GDP components to economic recovery[1]



1. 2010 H1 - Q3/2103, seasonally adjusted.
Sources: Statistics Iceland, Central Bank of Iceland.

4. Based on seasonally adjusted figures from the Central Bank. See Box IV-1 in *Monetary Bulletin* 2012/4 for the reasons why the Bank uses its own method for seasonal adjustment of GDP.

figures from Statistics Iceland than according to earlier numbers. In the first three quarters of the year, growth measured 1.3%, as compared with the November forecast of 1.5%. Leading indicators suggest that private consumption growth in Q4 was broadly in line with that in the previous quarter. It is therefore assumed that year-on-year growth measured 2.5% during the quarter and 1.6% for the year as a whole.

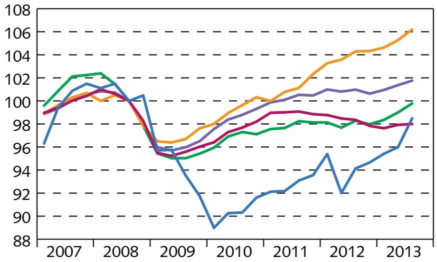
- The outlook for private consumption in 2014 and beyond is coloured by the Government's debt relief measures, which will foreseeably have some impact on households' economic position and spending decisions. Net household wealth will rise, and with increased collateral capacity, so will households' ability to take on additional debt to finance consumption. Households could also access their increased wealth by refinancing their current mortgages and use the proceeds to fund additional consumption, or they could also elect to spend other savings, owing to increased net housing wealth. The debt reduction will reduce households' debt service, thereby increasing the income available once they have paid their mortgages. On the other hand, the Government debt relief package provides for an increase in employees' third-pillar pension savings contribution, which will counteract the increase in disposable income, other things being equal. In addition, private consumption could surge temporarily in the near future, as many households may have chosen to postpone spending decisions until the announcement of the Government's debt relief plan.

- The debt relief measures are discussed in further detail in Appendix 2. As is stated there, private consumption can be expected to grow more rapidly in coming years as a result of the measures. The increase will crowd out investment to a degree, temporarily causing it to grow more slowly than it would otherwise. Imports will increase, and the current account balance will deteriorate. The GDP growth effect of the debt relief measures will therefore be less pronounced than the effect on domestic demand. As a result, GDP growth will be driven more by domestic demand, and gross national saving will be less than it would otherwise. A more pronounced output gap and a weaker króna will fuel inflationary pressures, although this will be offset by a tighter monetary stance, which will mitigate the stimulative and inflationary impact of the debt reduction plan. As is discussed in Appendix 2, the debt relief package is accompanied by a number of uncertainties. As a result, the ultimate impact of the measures comes with a wide confidence band. There is also some uncertainty about plans for a possible prohibition or restriction of household access to long indexed mortgages, and about the economic impact of such measures.

- In addition to the debt relief package that is supposed to take effect at mid-year, the authorisation for third-pillar pension savings withdrawals was extended and expanded at the beginning

Chart 19

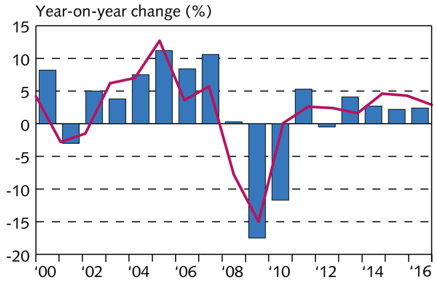
Post-crisis developments in GDP[1]



1. Seasonally adjusted data for Iceland are from the Central Bank of Iceland.
Sources: OECD, Central Bank of Iceland.

Chart 20

Private consumption and real disposable income 2000-2016[1]



1. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

of 2014. Private consumption growth in 2014 and the next few years will therefore be significantly stronger than was forecast in November. Private consumption is projected to grow by 4.6% this year and by an average of 3.9% over the forecast horizon, as opposed to 2½% according to the November forecast. If this forecast materialises, private consumption as a share of GDP will rise from 54% in 2013 to 56% in 2016.

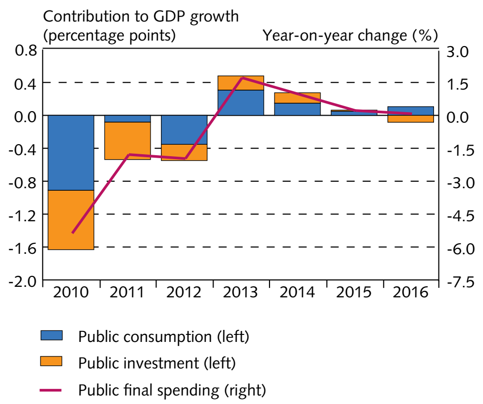
- According to preliminary figures from Statistics Iceland, growth in public consumption was weaker than was provided for in the last forecast. The deviation is due to the fact that the price increase in public consumption was underestimated in Q3. The forecast for 2013 as a whole is unchanged, however. The forecast for developments in public consumption throughout the forecast horizon is broadly unchanged.

- Preliminary figures from Statistics Iceland for the first three quarters of the year indicate weaker growth in public investment than in the previous forecast. Soon after taking office, the current Government announced its intention to scale down the previous Government's investment plans as laid down in the *Investment Strategy 2013-2015*. It is difficult to estimate how successful plans to discontinue development projects have been, but at present, the forecast for investment growth in 2013 is similar to the November forecast, which assumed that some of the projects had been stopped. According to the 2014 budgets passed recently by Iceland's largest municipalities, investment at the municipal level will be somewhat stronger than was assumed in November.

- According to the National Budget for 2014, approved in December, the overall and primary balances will be more positive than in the original budget proposal by 0.4 b.kr and 1.5 b.kr., respectively. Revenues and expenditures are estimated to be 25 b.kr. higher because of the debt relief package, which was added during the third round of Parliamentary discussion. According to the Budget, the overall surplus will be 0.9 b.kr. and the primary surplus will be 57.5 b.kr. A budget supplement for 2013 was passed as well. The deficit on Government operations was projected at 3.7 b.kr. according to the 2013 National Budget but is now estimated at 19.7 b.kr. The Ministry of Finance and Economic Affairs had previously estimated a deficit of up to 30 b.kr.

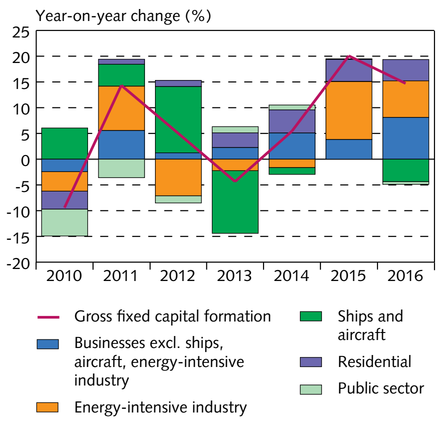
- Investment grew by 5.3% year-on-year in Q3, somewhat less than the 7% increase forecast in November. In the first nine months of the year, investment contracted by 7.1%, in line with the November forecast. Residential and public investment grew year-on-year during the period, but business investment contracted by more than 13%. The downturn in business investment is due largely to the sharp contraction in investment in ships and aircraft. Energy-intensive investment is weaker than previously anticipated, however, although general business investment is stronger.

Chart 21
Public consumption and investment 2010-2016[1]



1. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 22
Gross fixed capital formation and contribution of its main components 2010-2016[1]



1. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

- This forecast assumes that business investment contracted by nearly 12% year-on-year in 2013 and that total investment contracted by 4.3%, which is well in line with the November forecast. The contraction in business investment is more than 2 percentage points less than was expected in November, but this is offset by the fact that growth in residential and public investment is now estimated to have been weaker than in the November forecast.

- The outlook for 2014 is for weaker business investment than in the November forecast, owing mainly to the assumption of a delay of about a year in the Helguvík aluminium smelter project, which reduces this year's investment in the energy-intensive sector. On the other hand, general business investment is expected to grow by over 13%, as opposed to the 10% assumed in the November forecast, and estimates of investment in ships and aircraft have been revised upwards since November. These items will not outweigh the changes in energy-intensive investment, however, and business investment is therefore projected to grow by just under 1% this year instead of 5%, as was forecast in November.

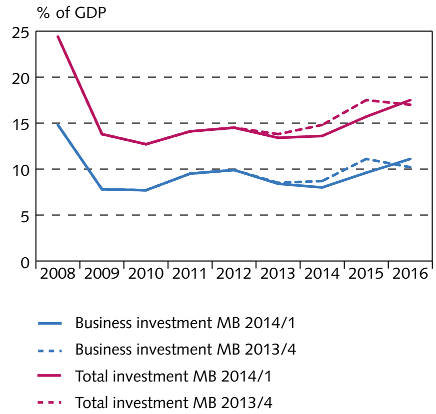
- In 2015 as well, the outlook is for considerably weaker business investment growth than was forecast in November, primarily because of weaker general business investment and a larger contraction in investment in ships and aircraft. On the other hand, energy-intensive investment will grow more, owing to the above-mentioned project postponement. If the forecast materialises, business investment will grow by about 25% in 2015 instead of 31%, as in the November forecast; however, it will grow more strongly in 2016 because the focus of energy-intensive investment will have shifted to that year.

- As is stated above, total investment is estimated to have contracted by 4.3% in 2013. It is expected to grow by 5½% this year, as opposed to the 9% assumed in the November forecast. Projections for residential investment are broadly unchanged since the last forecast. Over the forecast horizon, total investment is projected to grow by 13½%, on average, as opposed to 10%, as in the November forecast, and investment as a share of GDP will rise from 13½% in 2013 to 17½% in 2016, which is still about 2½ percentage points below the thirty-year average.

- As is stated above, GDP growth measured 4.9% year-on-year in Q3/2014 and 3.1% in the first three quarters of the year. GDP is assumed to have grown by 2.7% year-on-year in Q4, due to increased domestic demand and a stronger contribution from net trade. If this assumption is borne out, GDP growth measured 3% in 2013. According to the most recent figures from the International Monetary Fund (IMF), Iceland was the only country among the most developed countries to achieve a growth rate of 3% in 2013.

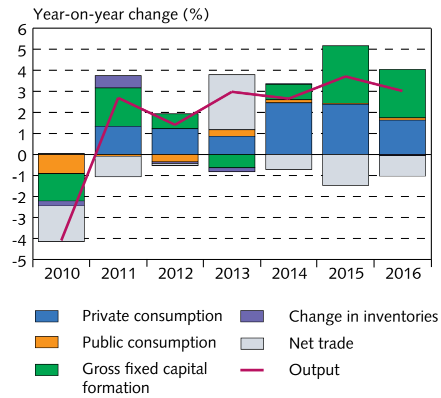
- As was forecast in November, GDP growth for 2014 is estimated at 2.6%. This reflects the offsetting effects of stronger growth in

Chart 23
Investment relative to GDP 2008-2016[1]



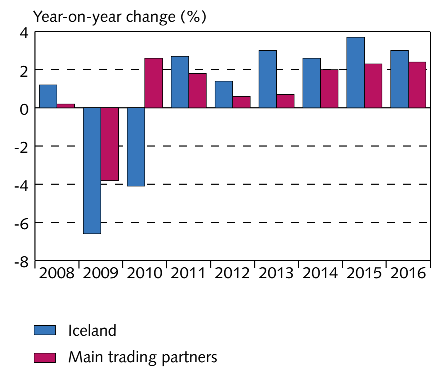
1. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 24
GDP growth and contribution of underlying components 2010-2016[1]



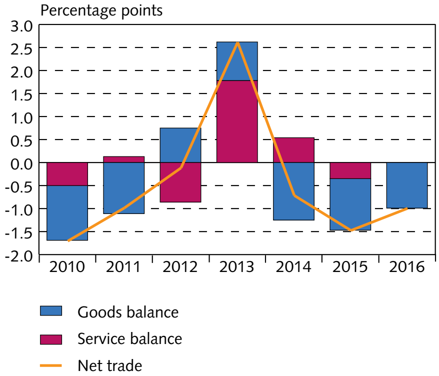
1. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 25
Output growth in Iceland and main trading partner countries 2008-2016[1]



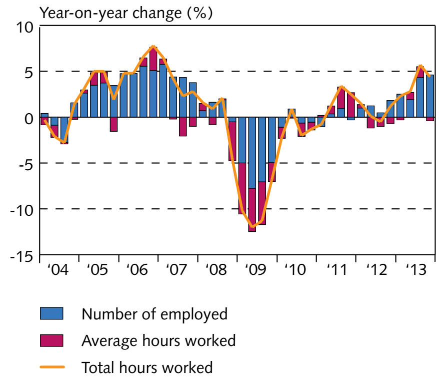
1. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 26
Contribution of net trade to GDP growth 2010-2016[1]



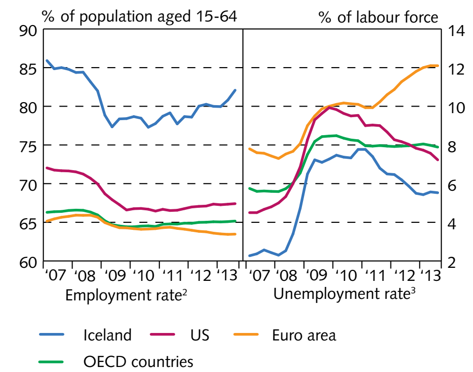
1. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 27
Changes in employment and hours worked
Q1/2004 - Q4/2013



Source: Statistics Iceland.

Chart 28
Employment rate and unemployment[1]
Q1/2007 - Q3/2013



1. Seasonally adjusted figures. 2. Number of employed persons as a share of the population aged 15-64. 3. Number of unemployed persons as a share of the labour force aged 15-64 (harmonised OECD measure).
Sources: OECD, Statistics Iceland, Central Bank of Iceland.

domestic demand, driven by private consumption growth, and weaker export growth, owing to a poorer outlook for capelin fishing and a downturn in aluminium exports. GDP growth in 2014 will be driven predominantly by domestic demand, with a much smaller contribution from net trade.

- In 2015, it is assumed that economic developments will be strongly coloured by the broad-based Government debt relief package, as it will be the first full year to see the impact of the measures. The same will be true when this forecast is compared with the November forecast: private consumption will be stronger and net trade will contribute less to output growth. On the whole, GDP growth is projected at 3.7% in 2015. It is estimated at 3% in 2016, due largely to the postponement of energy-intensive development projects until that year. If the forecast materialises, GDP growth will average 3.1% over the forecast horizon. This is above the thirty-year average and well above the average forecast for Iceland's trading partners.

- In view of the fact that year-2013 GDP growth is now estimated to have been somewhat stronger than previously forecast, it is also assumed that the output slack narrowed more than was assumed in November, to just under 1% instead of slightly more than 1%. As before, it is assumed that the slack will diminish further this year and virtually disappear by the year-end. An output gap is expected to develop gradually from 2015 onwards. The output gap will peak in 2016 at just under 1½% of potential output and then begin to taper off again, partly due to countervailing monetary tightening. Some output gap will still exist at the end of the forecast horizon, however. This is a substantial change from November, when the slack in the economy was not expected to disappear until late 2015. It should be noted, however, that estimates of potential output are highly uncertain.

- According to the Statistics Iceland labour market survey, labour demand was considerably stronger in Q4/2013 than in the November forecast, which provided for a 1% year-on-year increase in total hours worked instead of the actual 4.3%. As in recent quarters, the unexpectedly rapid increase is due to an increase in the number of employed persons (4.6%), while average hours declined by 0.4%. Although the increase in total hours worked for 2013 as a whole is due almost entirely to an increase in the number of employed persons (3.4%), average hours worked rose by 0.3%, after having contracted by 0.6% in 2012. Total hours worked therefore rose by 3.7% in 2013, the same percentage as in 2005 and 2007.

- All other measures of labour supply and demand pulled in the same direction in 2013. The employment rate rose by 1.4 percentage points year-on-year, the participation rate rose by 0.9 percentage points, and the number of persons outside the labour market fell by 3.3%.

- In Q4/2013, net migration was positive for the fifth quarter in a row. For the first time since the collapse of the banking system, the immigrants to Iceland therefore outnumbered emigrants for the year as a whole, with net migration for 2013 positive by 0.8% of the labour force. The net increase is due entirely to an increase in foreign immigrants, which supports other indicators of increased labour demand.

- The Capacent Gallup survey carried out in November and December among Iceland's 400 largest firms indicates that labour demand could grow more slowly in the first half of 2014 than in 2013. According to the survey, in November 2013 the number of executives interested in laying off staff was roughly equal to the number interested in recruiting, whereas the two surveys carried out in the first half of the year indicated that firms interested in recruiting outnumbered those wishing to downsize by about 10%.

- The updated forecast assumes that total hours worked will increase by just under 1%, as in the last forecast. The outlook for the upcoming two years is broadly unchanged as well, with growth projected to average 1% over the forecast horizon.

- Unemployment as registered by the Directorate of Labour (DoL) was somewhat lower in Q4/2013 than according to the Bank's last forecast. Seasonally adjusted unemployment as measured by the DoL was 4.1%, but it measured 5.3% according to the Statistics Iceland labour market survey.[5] Unemployment had fallen by 1.1 percentage point year-on-year according to the DoL, and by 0.2 percentage points according to the labour market survey. As could be expected, unemployment was therefore higher according to the labour market survey (5.4% in 2013) than the DoL (4.4%), as the survey includes those who have exhausted their unemployment benefits and the temporary provision extending benefits from three years to four was not extended last year.

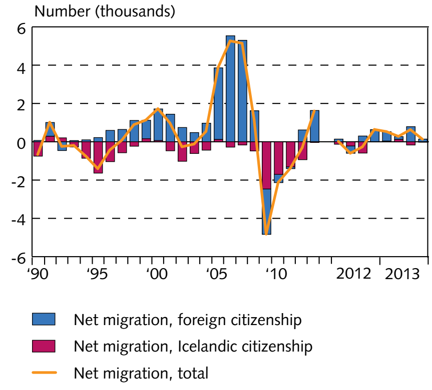
- It can be assumed that unemployment as registered by the DoL will continue to be somewhat lower than the survey-based rate in 2014. Registered unemployment is forecast to measure 3.7% in 2014 and fall to 3.5% by 2016, which is somewhat below the 4% provided for in the November forecast.

- Wages rose somewhat more in Q4/2013 than was assumed in the November forecast. The wage index rose by just under 1% quarter-on-quarter and 6% year-on-year during the quarter.

- The direct increase due to the private sector wage settlements signed just before Christmas is estimated at 3.2% (2.8% due to pay scale increases and 0.4% due to additional increases in the lowest wage categories). In addition, the negotiating parties

5. According to the labour market survey definition, workers who have been hired but have not yet started work are considered unemployed. Unemployment according to the labour market survey was 5%, excluding those who had been hired but had not started work.

Chart 29
Migration



Source: Statistics Iceland.

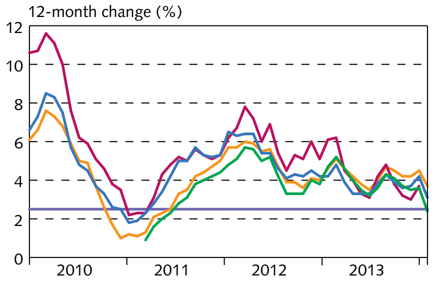
Chart 30
Different measures of unemployment
Q1/2003 - Q4/2013

Sources: Directorate of Labour, Statistics Iceland.

Chart 31
Unit labour costs and contributions of underlying components 2008-2016[1]

1. Labour productivity growth is shown as a negative contribution to an increase in unit labour costs. Central Bank baseline forecast 2013-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

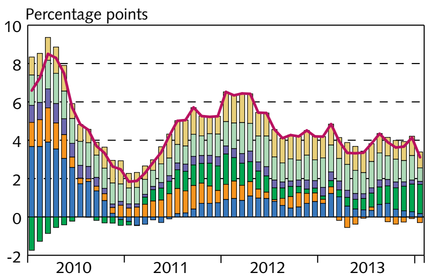
Chart 32
Various inflation measurements[1]
January 2010 - January 2014



- CPI
- Harmonised Index of Consumer Prices
- Core index 3 excluding tax effects
- Core index 4 excluding tax effects
- Inflation target

1. Core index 3 is the CPI excluding prices of agricultural products, petrol, public services and real mortgage interest expense. Core index 4 excludes the market price of housing as well.
Sources: Statistics Iceland, Central Bank of Iceland.

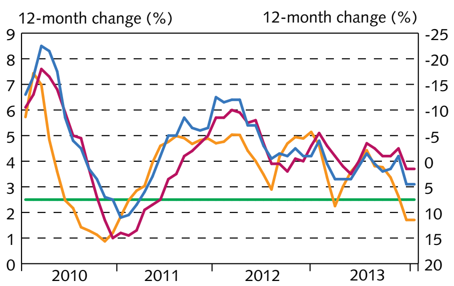
Chart 33
Components of CPI inflation
Contribution to inflation January 2010 - January 2014



- Imported goods excl. alcoholic bev., tobacco & petrol
- Petrol
- Housing
- Domestic goods excluding agricultural products
- Private services
- Other components
- Consumer price index (12-month % change)

Source: Statistics Iceland.

Chart 34
Inflation, core inflation and the exchange rate of the króna
January 2010 - January 2014



- CPI (left)
- Core index 3 excluding tax effects (left)
- Average exchange rate - narrow TWI (inverted right axis)
- Inflation target (left)

Sources: Statistics Iceland, Central Bank of Iceland.

assume that other wage changes in connection with the implementation of the agreements during the year will be small enough to keep the rise in the Statistics Iceland wage index below 4% during the period from December 2013 through December 2014. If this is borne out, wages will increase by roughly ½ a percentage point more. In view of the fact that negotiated pay increases have accounted for an average of 60% of changes in the wage index since 1990, this could be underestimated.

- Only half of the member organisations of the Icelandic Federation of Labour approved the wage settlements in the January vote. This forecast is based on the assumption that similar wage agreements will be reached with most of the groups that rejected the settlement and with public sector employees, whose contracts have expired or will do so in the near future. Furthermore, it is expected that wage drift will be somewhat more pronounced than the negotiating parties assume. Contractual wage increases will be somewhat smaller to than has been assumed in recent *Monetary Bulletin* forecasts, however. Next year's wage increases are expected to be similar this year's but will probably take effect earlier in the year. The year-on-year increase in average wages will therefore be slightly larger in 2015 than in 2014. In 2016, however, it is assumed that negotiated pay increases will be somewhat smaller than in 2014 and 2015, as it is assumed that a relatively front-loaded two-year contract will be negotiated in 2015.

- The assumptions concerning other wage costs have changed slightly from the last forecast, as the settlements included a 0.1% increase in the employer contribution to employees' education and training funds, which in most cases took effect at the same time as the wage agreement. Also assumed is a 0.2% increase in employees' wage costs at mid-year, as additional employees will decide to take advantage of third-pillar pension savings in connection with the Government's debt relief package (for further information, see Appendix 2).

- In addition to a slightly smaller increase in wages during the forecast horizon, the outlook is for more rapid productivity growth than was assumed in the last *Monetary Bulletin*. Unit labour costs will therefore rise by just under 4% this year. In the next two years, annual wage growth will be broadly in line with the Central Bank inflation target, or about ½-1 percentage points less than was forecast in November.

Inflation

- Inflation measured 3.8% in Q4/2013, in line with the November forecast. As before, most of the main drivers of inflation were of domestic origin – an increase in the housing component of the CPI and the price of private services – while the price of imported goods and fuel had an offsetting effect. Inflation averaged 3.9% for the year, down from 5.2% in 2012.

- The CPI fell by 0.72% month-on-month in January, after having risen for the two preceding months. The decline in January is due mainly to sales on clothing, footwear, and housewares, although last year's sales effects were stronger. Airfares and petrol prices declined, while health care, housing, heat, and electricity rose in price. The effects of indirect taxes pushed the CPI upwards by 0.08%, much less than previously anticipated. The CPI excluding tax effects therefore fell broadly in line with the overall index between months, or by 0.8%.

- Twelve-month inflation measured 3.1% in January, as opposed to 4.2% in December. Some base effects were present, as the CPI had risen by 0.3% in January 2013. About half of the January inflation figure is due to the housing component of the CPI, which has risen by 7.6% in the past twelve months. About a fifth of twelve-month inflation is due to increased private services prices, although imported inflation was limited, and the appreciation of the króna played a major role in the overall disinflation trend.

- Measures of underlying inflation have also subsided. For instance, core index 3 (which excludes volatile food items, petrol, public services, and real mortgage interest expense) without the effects of indirect taxes declined by 1% in January, and underlying annual inflation by that measure was 3.7%, down from 4.5% in December. Excluding the market price of housing as well (core index 4) gives an underlying inflation figure of only 2.4%. Other measures of underlying inflation also suggest that inflation has abated. The year-on-year change in the price of private services, which usually are good indicator of domestic inflationary pressures, were 3.3% in January, down from 6.1% in Desember. Statistical measures of underlying inflation also suggest that it lies in the 2½-3% range.

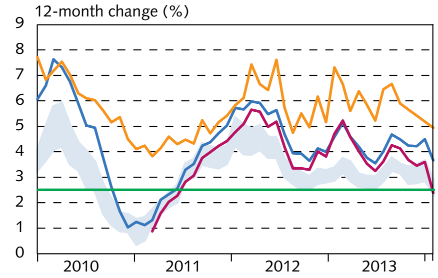
- Inflation expectations have subsided in the wake of the decline in inflation in January and increased expectations of modest wage increases this year. The two-year breakeven inflation rate has fallen by ¼ of a percentage point since November, while the five- and ten-year rate has fallen by just under 0.2 percentage points. The five-year breakeven inflation rate five years ahead has declined similarly. By all of these measures, inflation expectations now lie in the 3.3-3.7% range. Market agents' two-year inflation expectations have fallen slightly more, or by 0.5-0.7 percentage points, to 3.5%. Longer-term inflation expectations among market participants are unchanged since the last survey, however, averaging 4% over the next ten years. Households' and businesses' near-term inflation expectations are broadly unchanged, although this could reflect the fact that the last surveys were conducted before the wage settlements were finalised and before January inflation figures were published.

- Because of the steep rise in the CPI in February 2013, the outlook is for twelve-month inflation to fall still further in February and approach or align with the Bank's 2½% inflation target. Inflation

Chart 35

Various measures of underlying inflation and inflationary pressure

January 2010 - January 2014



Core index 3 excluding tax effects
Core index 4 excluding tax effects
Private services
Inflation target
Underlying inflation - difference between highest and lowest measurement[1]

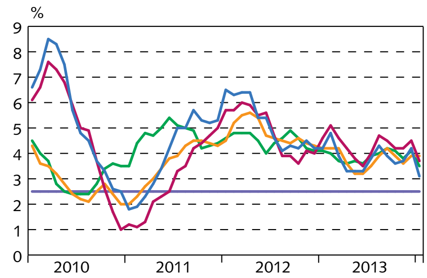
1. The trimmed mean is measured as underlying inflation where 5%, 10%, 15% and 20% of components with the largest price changes are excluded.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 36

Inflation, core inflation and long-term inflation expectations

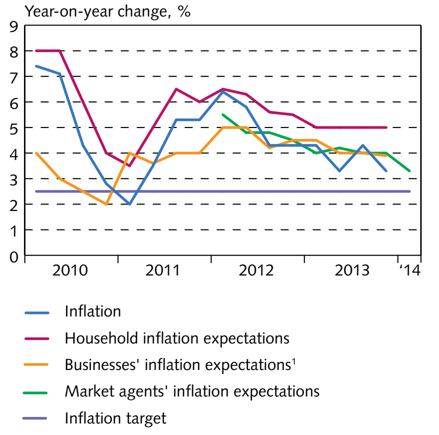
January 2010 - January 2014



Infaltion
Core inflation 3 excluding tax effects
5-year breakeven inflation expectations
5-year / 5-year forward inflation expectations
Inflation target

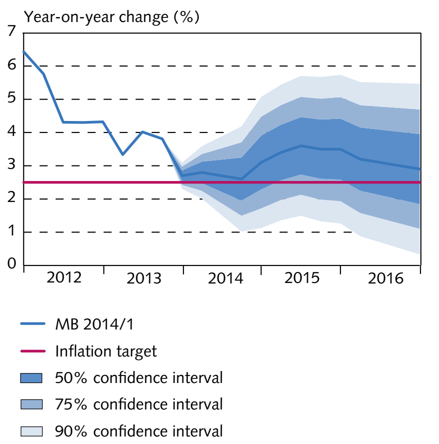
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 37
Inflation and inflation expectations
Q1/2010 - Q1/2014



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 38
Inflation forecast and confidence intervals



Sources: Statistics Iceland, Central Bank of Iceland.

is expected to fall to 2.7% in Q1/2014, roughly ½ a percentage point below the forecast in the November *Monetary Bulletin*. According to the forecast, inflation will remain at about that level for the remainder of the year, reflecting lower inflation at the beginning of the forecast horizon, a stronger króna, and smaller rises in unit labour costs than was forecast in November, all of which are offset by a smaller margin of spare capacity.

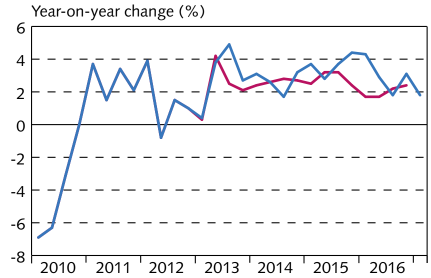
- According to the forecast, an output gap will begin to develop next year and continue to grow until the second half of 2016. If this materialises, the outlook is for inflation to pick up again early in 2015 and remain above 3% over the next two years, and then begin tapering off again towards the end of the forecast horizon, in part due to a tighter monetary stance. It will still be nearly ½ a percentage point above the target at the end of the forecast horizon, however, owing to the continued presence of an output gap fuelled by the Government's debt relief packages and increased economic activity in connection with energy-intensive development projects.

- The inflation outlook is highly uncertain, partly because of factors such as wage settlements, the exchange rate, and the impact of the debt relief package and other stimulative policy measures. There is also considerable uncertainty about potential output and about plans for energy-intensive development in the medium term. The uncertainty is exacerbated by the fact that inflation expectations remain somewhat above target, in spite of having fallen in the recent term. Chart 38 illustrates the probability distribution of the inflation forecast. The chart shows the range in which there is considered to be a 50%, 75%, and 90% probability that inflation will lie during the forecast horizon. According to the probability distribution, there is about a 50% likelihood that inflation will be between 2% and 3.3% in Q4/2014 and between 1.9% and 4% by the end of the forecast horizon. The uncertainties in the inflation forecast are broadly the same as in the November forecast, although the risk profile is roughly symmetric now, whereas it was tilted to the upside in November.

Chart 39

GDP growth – comparison with MB 2013/4

Year-on-year change (%)



MB 2014/1

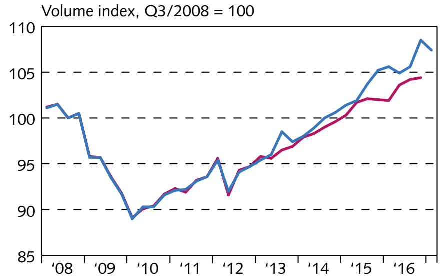
MB 2013/4

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 40

Seasonally adjusted GDP – comparison with MB 2013/4[1]

Volume index, Q3/2008 = 100



MB 2014/1

MB 2013/4

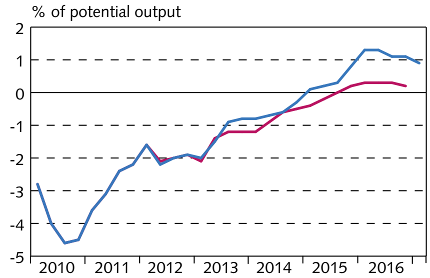
1. Seasonally adjusted Central Bank data.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 41

Output gap – comparison with MB 2013/4

% of potential output



MB 2014/1

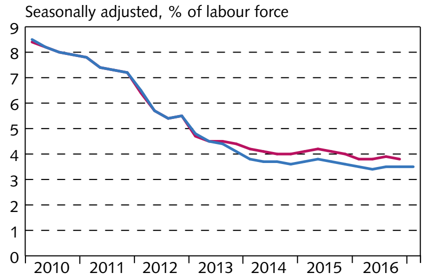
MB 2013/4

Source: Central Bank of Iceland.

Chart 42

Unemployment – comparison with MB 2013/4

Seasonally adjusted, % of labour force



MB 2014/1

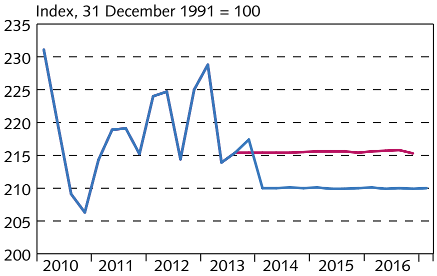
MB 2013/4

Sources: Directorate of Labour, Central Bank of Iceland.

Chart 43

Trade-weighted exchange rate index of the króna - comparison with MB 2013/4

Index, 31 December 1991 = 100



MB 2014/1

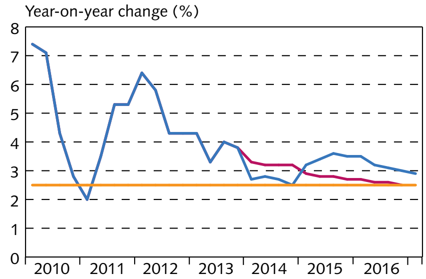
MB 2013/4

Source: Central Bank of Iceland.

Chart 44

Inflation – comparison with MB 2013/4

Year-on-year change (%)



MB 2014/1

MB 2013/4

Inflation target

Sources: Statistics Iceland, Central Bank of Iceland.