

# Inflation



## Recent developments in inflation

### Inflation is at its highest since 2010 ...

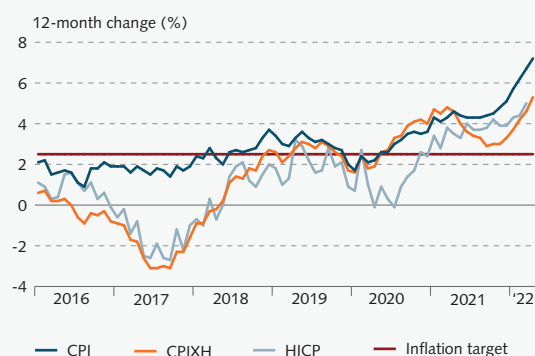
Inflation has risen steeply in the recent past, measuring 6.2% in Q1/2022, as compared with the February forecast of 5.8%. House prices have continued to surge, and the rise in the housing component of the CPI was the main driver of inflation during the quarter, as it was in 2021. Higher imported goods prices contributed nearly as much to inflation, however, owing in particular to increased petrol, furniture, and housewares prices. In March, domestic petrol prices had risen by nearly a fourth year-on-year, driven by the steep increase in the global market following Russia's invasion of Ukraine (see Chapter I and Box 2).

Headline inflation measured 7.2% in April, up from 5.7% in January (Chart V-1). Just over a third of the month's increase in the CPI was due to the rising cost of owner-occupied housing. Inflation excluding housing has also risen rapidly, measuring 5.3% in April. Inflation according to the HICP, which also excludes owner-occupied housing costs, has developed similarly, measuring 5% in March.

### ... and underlying inflation has risen as well in the recent term

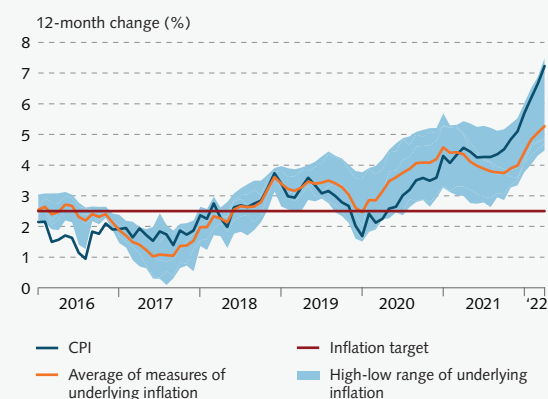
Underlying inflation in terms of the average of various measures was 5.3% in April, as compared with 4.4% in January (Chart V-2). There are signs that inflationary pressures are more widespread than they were in 2021. All measures of underlying inflation have risen in the recent term, but the dispersion among them has also increased, suggesting greater uncertainty. At the same time, the share of subcomponents that rise in price on a monthly basis is well above its historical average (Chart V-3).

Chart V-1  
Various measures of inflation  
January 2016 - April 2022



Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-2  
Headline and underlying inflation<sup>1</sup>  
January 2016 - April 2022



1. Underlying inflation measured using a core index (which excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense) and statistical measures (weighted median, trimmed mean, a dynamic factor model, and a common component of the CPI).

Sources: Statistics Iceland, Central Bank of Iceland.

Furthermore, the composition of inflation has changed in 2022 to date. Although a large share of headline inflation was still attributable to the housing component in April, the contribution from imported goods – petrol and other imports – increased as well. Moreover, the contribution of price increases in domestic goods and private services had grown since the beginning of the year (Chart V-4).

## Indicators of inflationary pressures

### Rising house prices still the main driver of inflation ...

As is discussed in Chapter II, house prices have increased rapidly since the beginning of 2021 and have been the main driver of higher inflation. Developments in the housing market are therefore one manifestation of stronger domestic inflationary pressures. Owner-occupied housing costs were up 17.2% year-on-year in April.

### ... but global inflation has taken off ...

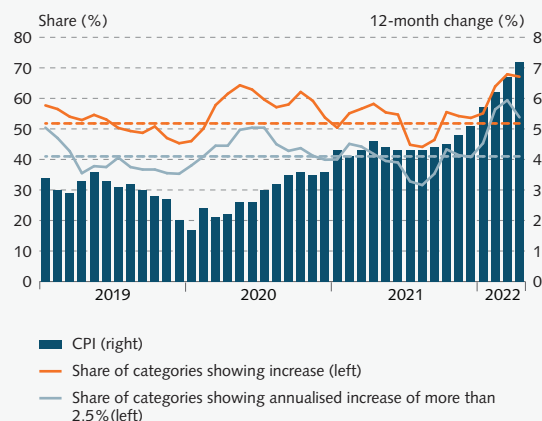
Imported inflation eased in 2021, but the outlook has deteriorated once again in view of global developments. The impact of global supply-chain disruptions caused by the pandemic can still be felt, and shipping costs are high, although they have fallen since the autumn. The rapid spread of the Omicron variant of the virus has set matters back in many markets, although the disruptions have apparently been less severe compared to previous waves of the pandemic, as governments and businesses have to some extent tried to adapt to circumstances. The supply-chain problem has been amplified by the invasion of Ukraine, however, and oil and commodity prices have risen even further (see Box 2). Furthermore, the recent surge in COVID case numbers in China and the subsequent tightening of public health measures there, have contributed to a further setback in attempts to resolve the bottlenecks.

As a result, trading partner inflation has soared as well in the recent term. In many eurozone countries, it is now roughly on a par with inflation in Iceland, whereas in the US it is noticeably higher (Chart V-5). If the effects of the large rise in food and energy costs are excluded, however, US inflation is similar to that in Iceland, whereas in the euro area it is considerably lower (see also Chapter I).

### ... and imported inflation is therefore on the rise

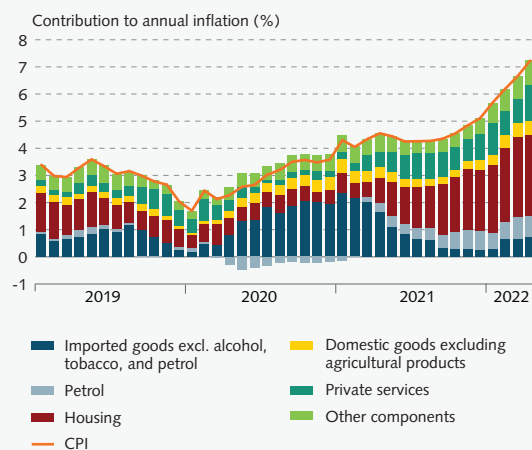
These factors have pushed imported inflation upwards in recent months, with the price of imported goods rising from 2.9% year-on-year at the end of 2021 to 4.8% by April. Higher commodity prices and higher global infla-

Chart V-3  
Distribution of price increases in the CPI<sup>1</sup>  
January 2019 - April 2022



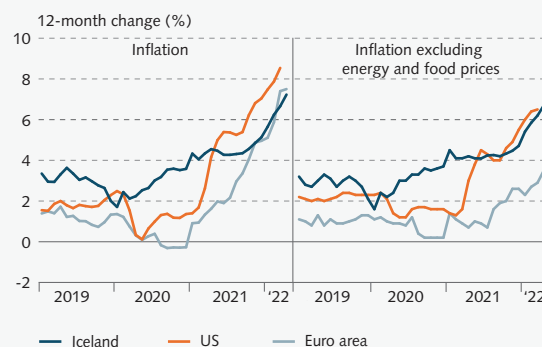
1. The share of goods categories that rise in price is a 3-month moving average. Broken lines show averages for the period January 2008 - April 2022.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-4  
Components of CPI inflation  
January 2019 - April 2022



Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-5  
Inflation in Iceland and in international comparison  
January 2019 - April 2022



Sources: Refinitiv Datastream, Statistics Iceland.

tion also affect domestic goods prices, owing to rising input prices. Domestic goods have risen in price by 6.4% between years. Offsetting these developments is a slightly more than 5% appreciation of the króna in 2022 to date.

Although imported inflation has gained pace, the effects of supply-chain disruptions and higher global inflation have passed through to domestic prices more slowly than previously expected. In this respect, the effects appear to differ from those seen in early 2020, when the króna depreciated after the pandemic spread to Iceland and imported inflation spiked abruptly (Charts V-6 and V-7). To an extent, this may reflect differences in the impact higher import prices have on firms' pricing decisions, which could vary depending on whether they attribute the price hikes to the depreciation of the króna or to higher foreign goods prices. The depreciation of the króna affects the full range of imported goods, whereas supply-chain bottlenecks and global price hikes tend to affect only selected goods. Furthermore, it can take time for higher shipping costs to pass through to prices, and if firms believe the global price increases are temporary, they may well be more reluctant to pass them on to their own prices.<sup>1</sup>

### Services prices continue to rise

Private services prices rose over the course of 2021, but the pace of the increase eased in Q1. Airfares rose sharply in April, however, as oil prices had risen and willingness to travel increased substantially in the recent term. The price of private services rose by 5.7% year-on-year in April, a larger annual increase than at the end of 2021.

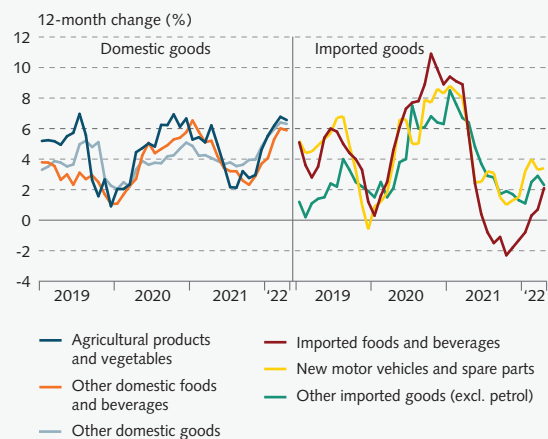
### Corporate executives expect further price hikes

The results of Gallup's spring survey of corporate expectations indicate significant risk that stronger cost pressures will continue to pass through to prices. About 70% of executives expect to raise the price of their own goods and services in the next six months, and about 90% expect the price of intermediate inputs to rise. This is a substantial increase since the autumn survey. Because part of the survey was carried out after the invasion of Ukraine began, the results are not entirely unexpected. Firms' expectations probably also reflect the recent surge in wage costs, however.

### Wages have risen considerably

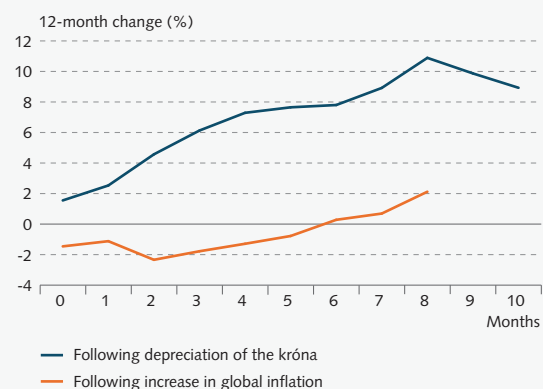
The general wage index and the total wage index have more or less kept pace with one another recently, both

Chart V-6  
Domestic and imported goods prices  
January 2019 - April 2022



Source: Statistics Iceland.

Chart V-7  
Increase in imported food and beverage prices during selected periods<sup>1</sup>



1. Annual increase in price of imported food and beverages in the CPI following the depreciation of the króna after the onset of COVID-19 (initial measurement February 2020) and following the rapid increase in global inflation (initial measurement August 2021).

Source: Statistics Iceland.

<sup>1</sup> See, for example, Carrière-Swallow *et al.* (2022), "Shipping costs and inflation", International Monetary Fund, *IMF Working Paper* no. 2022/061.

indices rising by an average of 8.3% in 2021 (Chart V-8). The general wage index rose by 7.2% year-on-year in Q1, and since March 2019, before the current private sector wage agreements took effect, it has increased by 24.3%. Because GDP per capita grew by just over 2.5% year-on-year in 2021, according to Statistics Iceland's estimate, the provision in the wage agreements known as the GDP growth supplement will be activated, and wages will rise even further this year. The outlook is for the GDP growth supplement to be triggered again in 2023 (for further discussion, see Box 1). According to the baseline forecast, unit labour costs will increase this year by 7½%, the biggest single-year jump since 2011. They are projected to rise by about 5% per year, on average, in 2023 and 2024. Wage developments are highly uncertain, however, as private sector contracts are set to expire towards the end of the year.

## Inflation expectations

### Short-term inflation expectations have risen ...

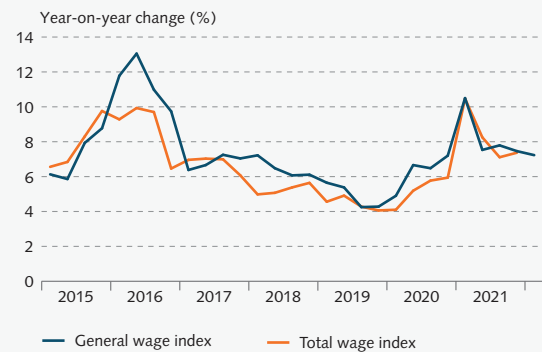
Short-term inflation expectations have soared recently, as they generally reflect developments in measured inflation. Market agents expect inflation to measure 5% a year from now and 3.5% after two years. This is roughly 0.5 percentage points above their response in the January survey (Chart V-9). The results of Gallup's spring surveys suggest that corporate executives expect inflation to measure just under 4% in two years' time, nearly 1 percentage point higher than in the winter survey. Households generally expect higher inflation than businesses do, and their two-year expectations also rose by around 1 percentage point, to 5%. By most of these measures, short-term inflation expectations are at their highest in a decade or more.

### ... and there is greater risk that expectations have become de-anchored from the target

Long-term inflation expectations have also risen in recent months. Market agents expect inflation to average 3.5% in the next five years and 3% in the next ten, the highest survey responses since 2016. As Chart V-10 shows, both short- and long-term expectations among market agents have inched upwards, although far more in the short term than further ahead.<sup>2</sup> The dispersion of their responses has also increased since the last survey, indicating greater uncertainty about the long-term outlook. Corporate executives' and households'

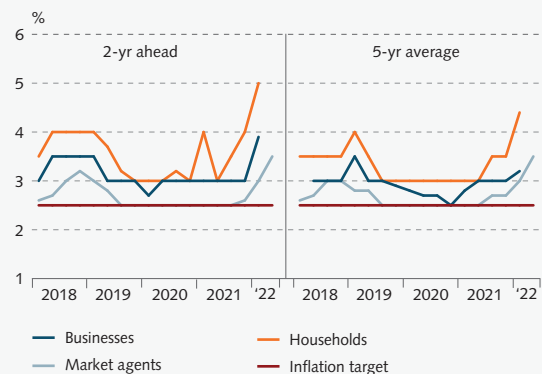
2 It should be borne in mind that the January survey of market expectations was conducted before Statistics Iceland published the CPI for that month.

Chart V-8  
Wages  
Q1/2015 - Q1/2022



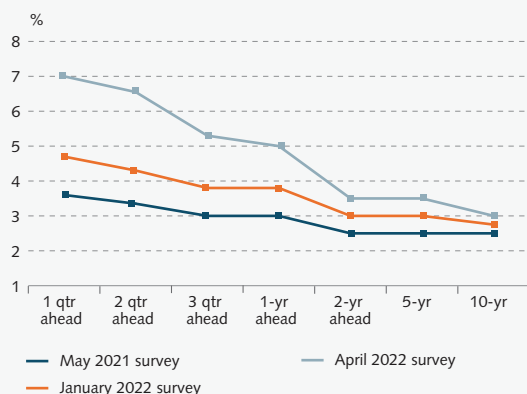
Source: Statistics Iceland.

Chart V-9  
Two- and five-year inflation expectations<sup>1</sup>  
Q1/2018 - Q2/2022



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

Chart V-10  
Market agents' inflation expectations during selected periods



Source: Central Bank of Iceland.

expectations concerning inflation five years ahead have risen as well, to 3.2% and 4.4%, respectively.

In addition, the breakeven inflation rate in the bond market has risen since February (Chart V-11). The ten-year breakeven rate was 4.4% at the end of April, after rising by approximately 0.7 percentage points since the beginning of February. The five-year breakeven rate five years ahead, which generally gives a more reliable indication of long-term inflation expectations and how firmly anchored they are, rose less, to 3.4%. It should be borne in mind, however, that to a degree, the rise in the breakeven rate probably reflects a rise in the inflation risk premium due to growing uncertainty about inflation. Furthermore, some of the rise in the breakeven rate is likely due to technical issues in the bond market, such as a shortage of indexed bonds (see Chapter II). Even so, there is a risk that inflation expectations have become less firmly anchored to the target, given that all measures of inflation expectations have risen in the recent past.

## The inflation outlook

### The inflation outlook has deteriorated still further ...

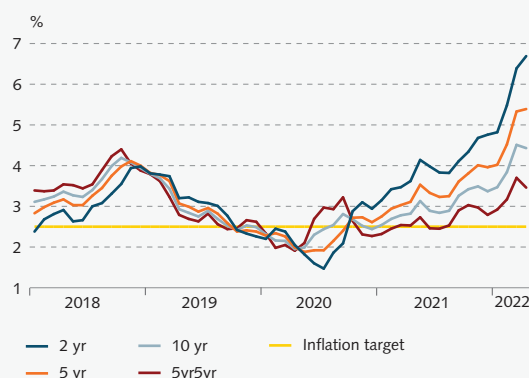
In Q1, inflation was above the February forecast, particularly because of larger-than-projected rises in the price of housing and fuel. The near-term outlook has deteriorated markedly because of elevated global inflation and higher commodity prices following the invasion of Ukraine. There are also continuing global supply-chain problems, which have grown worse with the onset of the war. Moreover, house prices are expected to rise more in the coming term than was previously anticipated. Inflation is forecast at 7.5% in Q2 and 8.1% in Q3, some 2.8 percentage points above the February forecast. It is then expected to begin easing again once house price inflation loses momentum and the effects of higher imported inflation taper off.

Further ahead, the inflation outlook is also bleaker, owing to higher imported inflation and higher long-term inflation expectations, which cause it to take longer than it would otherwise to bring inflation under control. Inflation is not expected to fall below 4% until late 2023. It is projected to average 2.9% in 2024 and be close to the target in mid-2025.

### ... and uncertainty has grown

As is discussed in Box 1, uncertainty about the inflation outlook has grown substantially. It is particularly uncertain how global inflation and commodity prices will develop in the near term and how long the impact lasts, in light of the war in Eastern Europe, as well as how

Chart V-11  
Breakeven inflation rate<sup>1</sup>  
January 2018 - April 2022



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

long it takes to unwind the global supply-chain gridlock. Given how long inflation has been above target, and because inflation expectations have begun rising, there is also a growing risk that inflation expectations have become unmoored from the target. Added to this are the forthcoming wage settlements, which will strongly affect inflation over the forecast horizon. Steep pay rises in the recent term and further tightening of the labour market during the run-up to the negotiations will exacerbate the risk of a wage-price spiral, which could cause inflation to become entrenched and make it more costly to bring it back to target.

The risk profile is still 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, and uncertainty has increased. There is a 50% probability that inflation will be in the 4¼–6½% range in one year and in the 1¾–4½% range by the end of the forecast horizon (Chart V-12).

