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

Continued recovery despite weaker global outlook

The global economic outlook continues to deteriorate. But international forecasts still assume the contraction in the euro area will be relatively short-lived. Terms of trade were somewhat poorer in 2011 than was previously forecast and will be poorer this year as well. Exports appear a bit stronger, however. The GDP growth outlook is broadly unchanged from the Bank's November forecast. Output growth appears to have measured 3% in 2011; it is estimated at 2½% per year in 2012-2014. The forecast assumes that the labour market will continue to recover, as was projected in November. Inflation is still expected to peak in Q1/2012 and then begin to subside, reaching the inflation target early in 2014. As before, the economic outlook is affected by uncertainty in the global situation.

Global economic affairs and external trade

- Output growth slowed down in Iceland's main trading partner countries as 2011 progressed, and the optimism that reigned in the first half of the year – the hope that the worst was over – dissipated. Continuing uncertainty about the sovereign debt crisis in the euro area, the risk that the crisis will spread, and slower output growth around the world have prompted analysts to slash growth forecasts for 2012.

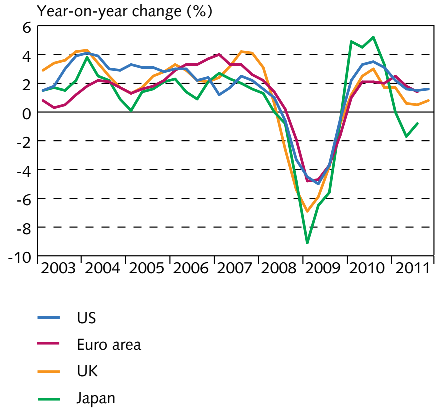
- GDP growth slowed significantly in most euro area countries in Q3/2011. The vast majority of euro area countries have seen their CDS spreads skyrocket in the past year, and the region is generally considered to be in a mild recession. Growth also lost considerable momentum in the UK and the US in Q3. In Japan, however, the contraction eased somewhat, once the effects of last year's earthquake tapered off. The first indications of developments in Q4 suggest that GDP growth was stronger in the US and the UK but slowed down in the euro area.

- Forecasts for 2012 have been revised downwards for most of Iceland's trading partners, apart from the US and Japan. The OECD forecasts 0.8% GDP growth for Iceland's major trading partners, while Consensus Forecasts and the International Monetary Fund (IMF) project ½% growth, which is far below the assumptions in the last *Monetary Bulletin*.

- The inflation outlook in Iceland's main trading partner countries has changed little since early November 2011. Inflation appears to have peaked in most of them last autumn, and it has been subsiding since, partly due to falling commodity prices. In the UK and the euro area, however, it is still somewhat above target levels.

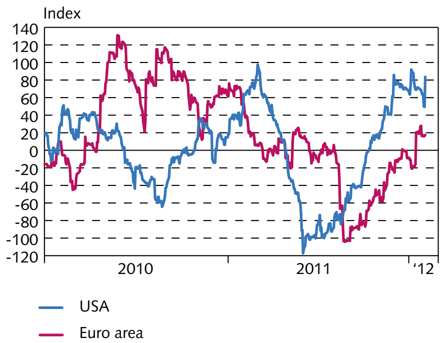
- The European Central Bank (ECB) has cut euro area policy rates twice since the last *Monetary Bulletin*, reversing the rate increases

Chart 1
International GDP growth
Real GDP growth Q1/2003 - Q4/2011



Source: Macrobond.

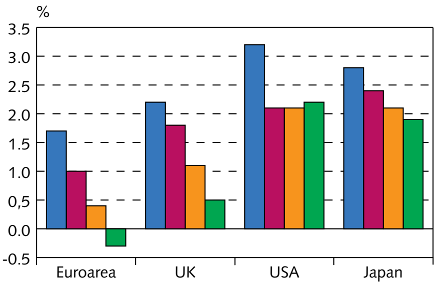
Chart 2
Economic surprise index[1]
Daily data 1 January 2010 - 3 February 2012



1. When the index is lower than 0, the indicators are more negative than expected, and 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.

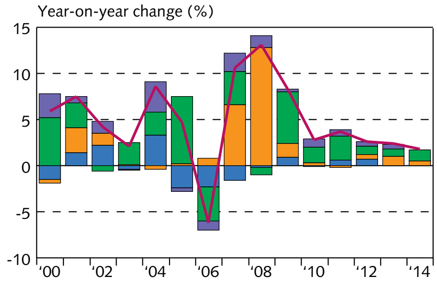
1. The analysis appearing here is based in large part on the Bank's assessment of economic developments, published in November 2011 in *Monetary Bulletin* 2011/4, and on the updated forecast presented here. It is based on data available in early February 2012.

Chart 3
GDP forecasts for 2012



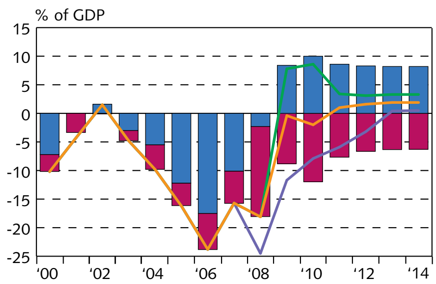
Source: Consensus Forecasts.

Chart 4
Export development (excl. ships and aircraft) and its main components 2000-2014[1]



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

Chart 5
Current account balance 2000-2014[1]



1. Net current transfer is included in the balance on income. Central Bank baseline forecast 2011-2014.
Source: Statistics Iceland, Central Bank of Iceland.

implemented earlier last year. The Danish central bank followed with large rate reductions, bringing Denmark's policy rate below that in the euro area for the first time. Rates have also been lowered elsewhere in recent months; for example, in the other Nordic countries and a number of emerging economies.

- World trade began to slow considerably in the second half of 2011. Both the OECD and the IMF have reduced their forecasts for global trade in 2012 and 2013. In its updated forecast, the Central Bank assumes that imports rose by just under 4.8% in major trading partner countries in 2011 and will rise by another 2.9% in 2012, somewhat less than in the last forecast.

- Commodity prices continued to fall towards the end of 2011 but appear to have bottomed out in mid-December. The total decline in Q4 was somewhat larger than in the Central Bank's November forecast. In spite of a slight rise since the beginning of 2012, it is now assumed that commodity prices will be slightly lower this year than according to the last *Monetary Bulletin*. Crude oil prices are expected to fall less markedly during the year, however.

- The price of Iceland's principal exports will probably be somewhat lower this year than according to the forecast in the last *Monetary Bulletin*. Aluminium prices are projected to be about 7% lower on average than in 2011, whereas the November forecast assumed an increase of almost 2%. Marine product prices in foreign currency are expected to continue rising, but the increase is projected at 4% instead of the 6% in the last *Monetary Bulletin*.

- Terms of trade for goods and services were somewhat poorer in 2011 than was forecast in November, due primarily to larger-than-expected increases in import prices in Q3 and the decline in aluminium prices in Q4. The outlook for 2012 has deteriorated as well, although some improvement is still expected as a result of rising marine product prices and declines in oil and commodity prices. The outlook for the upcoming two years is broadly unchanged from November.

- Exports of goods and services grew by an estimated 3.3% year-on-year in 2011, whereas the November forecast indicated an increase of 2.5%. This upward revision is due mainly to a larger increase in services exports than preliminary figures indicated, particularly in Q2. The outlook for 2012 has improved as well, mostly due to stronger marine product exports.

- The first three quarters of 2011 saw a significant surplus on goods and services trade. The surplus for the year as a whole is estimated at 8½% of GDP, less than in the November forecast, owing primarily to poorer terms of trade in the latter half of the year and increased imports in Q4. The deficit in the balance on income is expected to be somewhat less for the year than was forecast in November, however, due to increased reinvestment abroad by deposit money banks (DMBs) in winding-up proceedings. The current account deficit for 2011 is therefore reduced considerably, from the 8.2% of GDP assumed in the November forecast to just under 6% in the current forecast, while the current account surplus excluding the DMBs in winding-up proceedings remained close to the level assumed in the November forecast, or 0.4% of GDP. The current account surplus excluding the DMBs in winding-up proceedings is projected at 1½-2% of GDP per year in 2012 and the following two years, slightly below the November forecast.

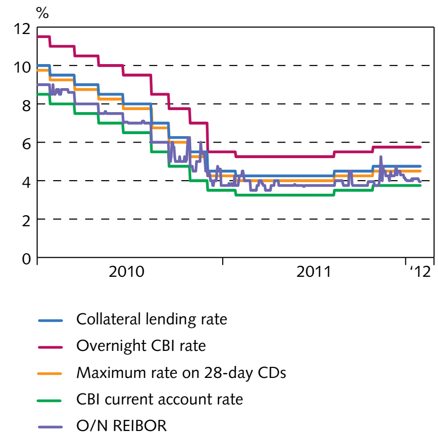
Domestic financial markets

- The Central Bank of Iceland Monetary Policy Committee (MPC) raised the Bank's interest rates by 0.25 percentage points at the beginning of November, when the last *Monetary Bulletin* was issued, but held rates unchanged in December. Prior to the publication of this *Monetary Bulletin*, the current account rate was 3.75%, the maximum rate on 28-day certificates of deposit (CDs) was 4.5%, the seven-day collateralised lending rate was 4.75%, and the overnight lending rate was 5.75%. The Bank's real interest rate, however, has declined since November, to -0.8% in terms of the average of various measures of inflation and inflation expectations.
- Forward interest rates suggest that the market expects the Central Bank to keep rates unchanged until the autumn, when a 0.25 percentage point increase seems to be priced into the yield curve. According to forward rates, the collateral lending rate will be 5% by year-end 2012 and 6.5% by the end of 2013.
- Short-term interbank market rates have fluctuated between 3.75% and 5.25% since the publication of the November *Monetary Bulletin*. Nominal long-term yields have declined by 0.2-0.3 percentage points, while long-term indexed rates have fallen by 0.4-1.0 percentage points.
- Base money has grown slightly since the last *Monetary Bulletin*, and M3 is up 10.7% from its trough in May 2011. The increase in M3 in the latter half of 2011 is due in large part to the fact that deposits held by companies previously classified as financial companies but now restructured as non-financial holding companies are now included in the money supply data. In December, year-on-year growth in M3 measured 8.6%, yet this remains below nominal GDP growth, which is estimated at just over 10% year-on-year in Q4.
- Since the publication of the November *Monetary Bulletin*, the long-term interest rate differential against German government bonds has remained virtually unchanged at 4.7%, while the short-term spread has widened by 0.3 percentage points and measured 4.2% just before the publication of this issue.
- The risk premium on Icelandic Treasury liabilities has declined by roughly ½ a percentage point since the November *Monetary*

Chart 6

Central Bank of Iceland interest rates and short-term market interest rates

Daily data 1 January 2010 - 3 February 2012

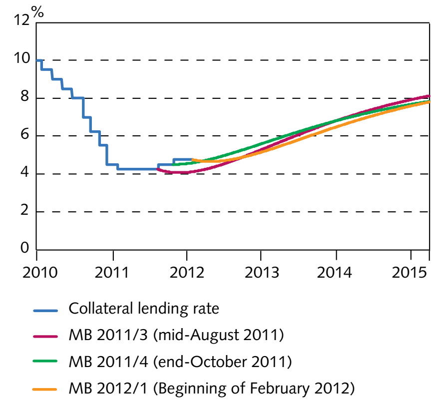


Source: Central Bank of Iceland.

Chart 7

Collateral lending rate and forward market interest rates[1]

Daily data 1 January 2010 - 31 March 2015

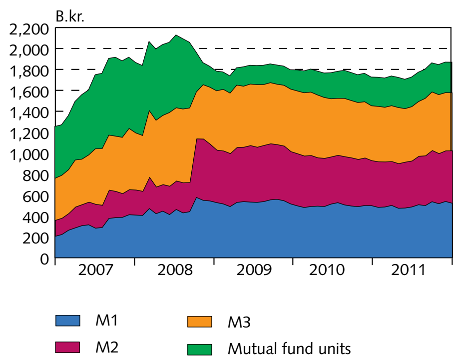


1. Interbank interest rates and Treasury bond rates were used to estimate the yield curve. Treasury notes maturing in 2012 and 2013 are excluded beacause their pricing is assumed to be affected by the capital controls.
Source: Central Bank of Iceland.

Chart 8

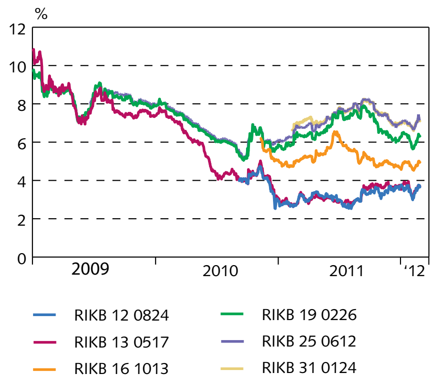
Money supply

January 2007 - December 2011



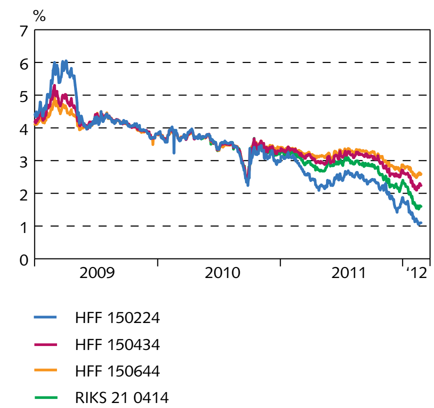
Source: Central Bank of Iceland.

Chart 9
Yields on nominal bonds
Daily data 2 January 2009 - 3 February 2012



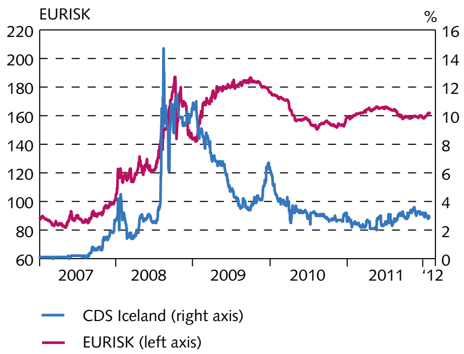
Source: Central Bank of Iceland.

Chart 10
Yields on indexed bonds
Daily data 2 January 2009 - 3 February 2012



Source: Central Bank of Iceland.

Chart 11
ISK exchange rate and risk premia
28 March 2007 - 3 February 2012



Sources: Bloomberg, Central Bank of Iceland.

Bulletin, in terms of both the CDS spread and the interest rate differential between five-year Icelandic Treasury bonds in US dollars and comparable bonds issued by the US Treasury. The CDS spread is now about 2.8 percentage points, whereas the interest rate differential is around a percentage point higher.

- The Icelandic króna has depreciated by just over 2% against the euro and by a full 6.3% against the US dollar since the November *Monetary Bulletin*. In trade-weighted terms, the depreciation measures 3.9%. The steep decline against the US dollar is probably due to a general weakening of various currencies against the dollar, which is prompted by increased global market unrest in connection with the banking and sovereign debt crisis in the euro area. Seasonal factors and poorer terms of trade are also likely to have played a role in the weakness of the króna against other currencies. In addition, there are indications that the recent weakness of the króna can be attributed in part to large repayments of foreign loans by firms and, to some extent, local governments.

- Prior to the publication of this *Monetary Bulletin*, the exchange rate was just under 162 krónur against the euro, somewhat below the level forecast in the November issue. According to the updated forecast, it is assumed, similar as in November, that the króna will remain relatively stable at 160 krónur per euro throughout the forecast horizon.

- Financial conditions of the private sector continued to improve through 2011. For example, mortgage lending has increased and loan terms have improved. At the same time, house prices have risen, with the year-on-year increase measuring almost 10% in December (4% in real terms). Private sector debt has also declined considerably. Indicators of increased domestic equity market activity should also contribute to greater diversity in domestic corporate financing.

The domestic economy

- In December, Statistics Iceland published the national accounts for Q3/2011 and the revised accounts for the first half of the year. According to preliminary figures from Statistics Iceland, seasonally adjusted GDP growth measured 4.7% quarter-on-quarter in Q3, and year-on-year growth was 4.8%. Growth during the year was driven by a 2.6% rise in national expenditure and a 5.4% increase in exports, offset by a 2% year-on-year growth in imports.[2]

- GDP growth in the first three quarters of 2011 measured 3.7% year-on-year and was driven primarily by growth in private consumption, which rose by 4.4% during the period. Public con-

2. As has been reported in previous issues of *Monetary Bulletin*, the Central Bank's estimate of investment in 2010 is about 7 b.kr. more than the Statistics Iceland estimate. As a result, the Bank assumes that GDP growth in Q3 measured 4.4% year-on-year and that national expenditure grew by 2.1%. The discussion below is based on the Central Bank's estimates of investment in 2010.

sumption contracted by 0.1%, however, while investment rose by 2.6%. The contribution from net exports was positive by 0.2% of GDP. Exports grew by 3.2% and imports by 3.6%, in tandem with the improvement in domestic demand.

- GDP growth in Q3 was well in line with the Central Bank's November forecast of 4.9% annual growth. For the first three quarters of the year, however, growth was somewhat stronger than in the November forecast, at 3.7% instead of the projected 3.2%.

- Seasonally adjusted private consumption rose by 1.1% quarter-on-quarter in Q3, up from the 0.6% forecast in November. The deviation in the forecast was greater in terms of year-on-year figures, reflecting to a large degree the revision of Q1 and Q2 numbers in the national accounts published in December. According to the revised figures, consumption growth in the first half of the year was considerably stronger than previously estimated – and actually, closer to the forecast in the August *Monetary Bulletin*.

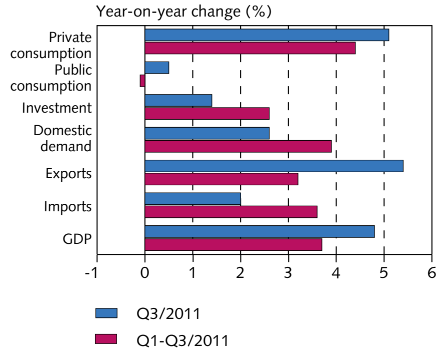
- Private consumption has been one of the main drivers of the recovery in recent quarters. This is expected to continue, although growth is likely to be slower than in 2011, as the effects of temporary stimulative policy measures begin to taper off. Over the next quarters, private consumption will be driven more by higher employment levels, rising purchasing power, and growing net worth of households, reflecting reduction of debt, rising asset prices, and falling real interest rates.

- The forecast estimates seasonally adjusted private consumption growth in Q4 at almost 2% quarter-on-quarter and 5% year-on-year. These estimates are based on developments in a variety of leading indicators, including payment card turnover, consumer goods imports, and retail sales. Private consumption is now assumed to have grown by 4.5% in 2011, markedly more than according to the November forecast. Growth is projected to average 2½% per year during the forecast horizon. But the consumption share in GDP will remain low in historical context.

- Statistics Iceland's first estimates of public consumption for the first two quarters of 2011 seemed to indicate a considerable slackening of fiscal restraint in comparison with previous plans. The Bank's November forecast did not take these indicators fully into account. According to Statistics Iceland's revised figures from December, public consumption expenditures were much lower, and in line with the expectations in the November forecast. The Bank's updated forecast for public consumption is therefore very similar to that in November.

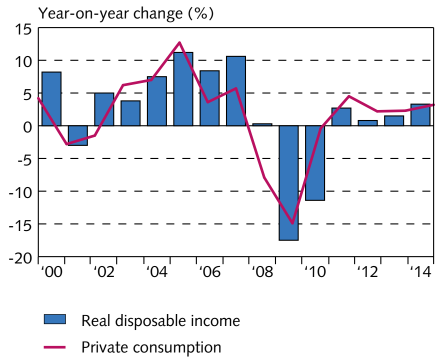
- The National Budget was approved in December, with a few changes from the budget proposal used as a basis for the November forecast. The overall balance according to the final Budget was 3 b.kr. lower than in the original budget proposal. The main difference was that wage costs were not as tightly controlled

Chart 12
National accounts for first 3 quarters of 2011



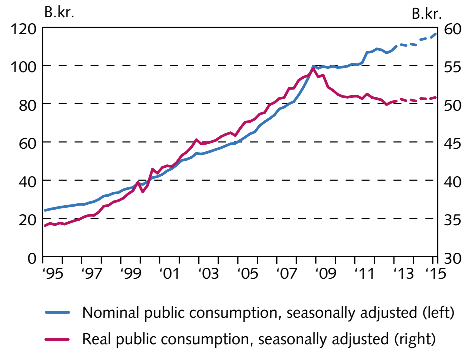
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 13
Private consumption and real disposable income 2000-2014[1]



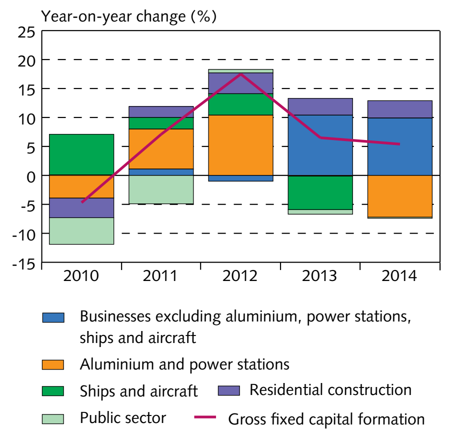
1. Central Bank baseline forecast 2011-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 14
Nominal and real public consumption growth
Q1/1995 - Q1/2015[1]



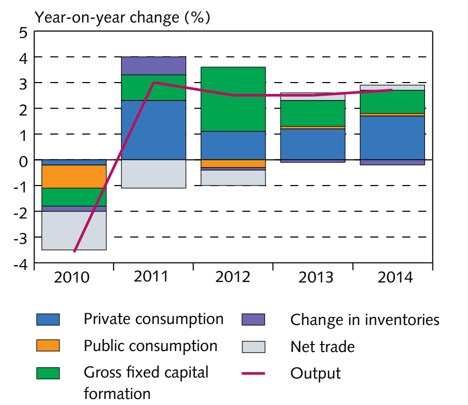
1. Central Bank baseline forecast Q4/2011 - Q1/2015.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 15
Gross fixed capital formation and contributions of its main components 2010-2014[1]



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

Chart 16
Output growth and contribution of underlying components 2010-2014[1]



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

as in the proposal, leading to a deviation of 2.1 b.kr. It is assumed that wage costs will be 2.5% higher in 2012 than in 2011. Given the public sector pay increases already negotiated, it will clearly be necessary to cut back on hours worked if this assumption is to hold. The Treasury deficit for 2012 is estimated at 20.7 b.kr. It is assumed that the primary balance will equal 2% of GDP, or 35.9 b.kr., instead of the 39.6 b.kr. provided for in the budget proposal. The estimated primary balance is nonetheless in line with the revised economic programme devised by the Icelandic authorities and the IMF.

- Investment contracted by 1.6% year-on-year in Q3/2011, according to the Central Bank's estimate of investment in 2010. This is somewhat less than was forecast in the November *Monetary Bulletin*, reflecting a steep decline in public investment amounting to 28% year-on-year. Business investment was up 6.5%, however, and residential investment by 9.2%. Business investment is therefore on the rise, albeit from a low level following the large contraction in the wake of the financial crisis. The recent growth spurt is probably due to the need for renewal of fixed capital and the pick-up in domestic and foreign demand.

- Plans for energy-intensive investment projects have changed very little since November, although some projects have been delayed somewhat. As a result, energy-intensive investment will be less in 2012 but somewhat greater in 2013. Investment in ships and aircraft is expected to increase markedly this year, however. It is now assumed that other business investment was weaker in 2011 than in the November forecast, but in 2012 investment growth is expected to remain unchanged in real terms from the November projections. On the whole, it is estimated that business investment increased by 16% in 2011 and will grow by just over 19% in 2012, somewhat more than according to the last forecast. The outlook is also for more robust growth in investment next year, but for 2014 it is expected to be weaker than was forecast in November.

- According to the forecast, total investment grew by about 7% in 2011. It is projected to grow by nearly 18% in 2012 and by 5½-6½% per year in the coming two years. The rise is attributable in large part to the above-mentioned increase in business investment, although residential investment is expected to grow by 15-20% per year during the forecast horizon. Public investment is still projected to continue declining, but the contraction in the latter part of the forecast period will be smaller than was forecast in November, partly because public investments related to last year's wage settlements have been launched more slowly than originally planned. In spite of healthy growth during the forecast horizon, the investment share in GDP will remain below its historical average, reaching 17% of GDP by the end of the horizon.[3]

3. From 1980 investment as a share of GDP has been 21% on average.

- The updated forecast assumes that year-on-year GDP growth measured just shy of 2% in Q4/2011, which is somewhat weaker than was assumed in the November forecast. Seasonally adjusted GDP is estimated to have contracted by 0.4% from the previous quarter in Q4, which is very similar to what was assumed in November. This implies that GDP growth measured 3% in 2011 as a whole, which is almost identical to the November forecast.

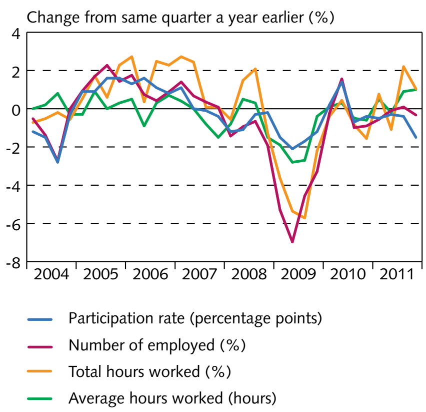
- Growth is projected at 2.5% for 2012, due primarily to increased investment. The contribution from private consumption is measurable as well, although it will be more limited than in 2011. The contribution from net exports is expected to be negative by 0.6 percentage points of GDP this year, which is similar to the November forecast. GDP growth is also forecast at 2.5% in 2013 and 2.7% in 2014. As before, investment and private consumption are expected to be the main drivers of growth. The contribution from net trade is expected to improve slightly and be positive in the next two years, with only marginal changes between years. The GDP growth outlook for 2012-2014 is therefore very similar to that in the November forecast.

- The output slack is assumed to have diminished sharply in 2011, to 2% of potential output. It is expected to decline still further in 2012 and 2013 in spite of modest GDP growth, and disappear in 2014, well in line with the November forecast. Estimating the margin of spare capacity in the economy is unusually difficult at the current juncture due to the large adjustments in the economy following the financial crisis.

- Labour demand continued to grow year-on-year in Q4, as it did in the second and third quarters, according to the Statistics Iceland labour market survey. The recovery has slowed down somewhat, however, in line with the Central Bank's November forecast. Total hours worked increased by 2.4% year-on-year, even though the number of persons working declined marginally, as average hours worked rose by one hour per week. Employment measured in man-years therefore rose by 1.5% between years, which accords with the November forecast. The number of persons employed full-time is also still on the rise, while the number of part-time workers is declining. It is assumed that employment will continue to grow relatively slowly throughout the forecast horizon, by an average of 1% per year, as was projected in November.

- Labour supply declined by over 3,000 persons year-on-year in Q4/2011, however, reducing the labour participation rate by 1.5 percentage points, to the lowest level since quarterly labour market surveys began in the year 2003. The participation rate measured 80.4% in 2011 after falling 0.7 percentage points from 2010, or by almost 1,000 persons. The number of persons outside the labour market rose by almost 3,000 at the same time. The increase in those not in the labour market is due mostly to a rise in the number of students and disability pensioners.

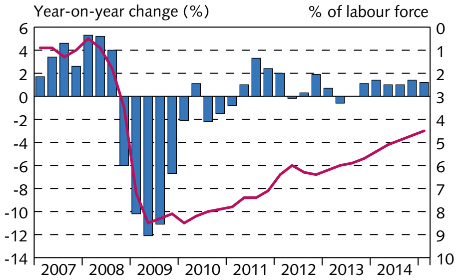
Chart 17
Changes in labour force
Q1/2004 - Q4/2011



Source: Statistics Iceland.

Chart 18

Unemployment rate and employment growth Q1/2007 - Q1/2015[1]



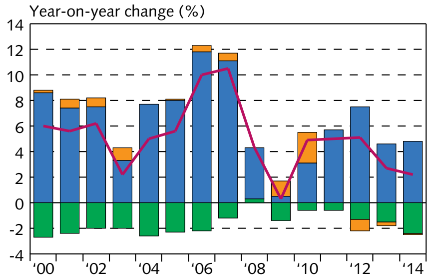
Employment (left)

Unemployment rate (seasonally adjusted, reversed right axis)

1. Central Bank baseline forecast Q1/2012 - Q1/2015.
Sources: Statistics Iceland, Directorate of Labour, Central Bank of Iceland.

Chart 19

Unit labour costs and contributions of underlying components 2000 - 2014[1]



Nominal wages

Labour costs other than wages

Trend labour productivity

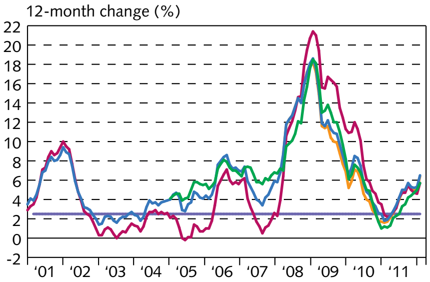
Unit labour costs

1. Labour productivity growth is shown as a negative contribution to an increase in unit labour costs. Central Bank baseline forecast 2011-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 20

Various inflation measurements

January 2001 - January 2012



CPI

CPI excluding housing

CPI excluding tax effects

Core inflation 3 excluding tax effects

Inflation target

Sources: Statistics Iceland, Central Bank of Iceland.

- Unemployment has developed in line with the Central Bank's last forecast, both in Q4/2011 (7.1%) and in 2011 as a whole (7.4%). Unemployment fell by 0.7 percentage points between years. The results of Capacent Gallup's December survey among Iceland's 400 largest firms indicate that companies expecting to lay off staff in the next six months outnumber those wishing to recruit by 7.5 percentage points, half the percentage in the October survey. The unemployment outlook is more or less unchanged from the November forecast. Unemployment is expected to measure 6.3% this year and is projected to have fallen to 4½% by the end of the forecast horizon.

- Last year's wage increases were broadly in line with the November forecast, although they were smaller in the last months of the year, as planned wage increases appear to have emerged later than previously assumed. As a result, the outlook for wages has changed little, and the assumptions concerning the proposed payroll tax cut in 2012 and 2013 are unchanged. Unit labour costs are expected to develop broadly in line with the last forecast, rising by just over 5% this year and by an average of 2½% per year in 2013 and 2014.

Inflation

- Inflation measured 5.3% in Q4/2011, or 0.3 percentage points less than in the November forecast, and was unchanged between the third and fourth quarters. The CPI components whose prices rose most sharply were housing and private services. Inflation averaged 4% in 2011, as opposed to 5.4% in 2010.

- The CPI rose by 0.28% month-on-month in January, after rising by 0.36% in December and remaining unchanged in November. The uptick in January was caused mainly by increases in public services price lists and in food and petrol prices, which were offset by price reductions due to winter sales. Twelve-month inflation measured 6.5%, up from 5.3% in December.

- On the other hand, the CPI excluding indirect tax effects rose by 0.13% month-on-month in January, as the impact of the increase in alcohol, tobacco, and fuel taxes is excluded. By that criterion, twelve-month inflation measured 6.4%. Strong base effects cause headline inflation to rise more than it would otherwise in January, as the Icelandic National Broadcasting Service broadcasting fee, which was excluded from the CPI one year ago, has lowered the index by 0.4 percentage points until now.

- Core index 3, excluding tax effects, volatile items, public services, and real interest expense, declined by 0.8% month-on-month in January. Annual core inflation 3 measured 5.7% in January, up from 5% in December and 4.4% when *Monetary Bulletin* was last published.

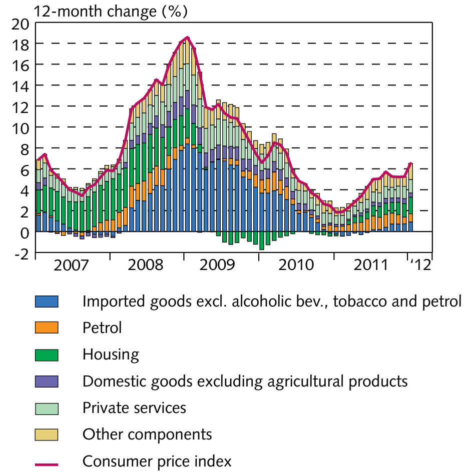
- The breakeven inflation rate in the bond market may suggest that inflation expectations in the market have risen slightly since the November *Monetary Bulletin* was issued. Five-year break-even inflation averaged just under 5%, both for 2012-2017 and for 2017-2022, as opposed to about 4½% at the beginning of November 2011. Inflation expectations are likely to be somewhat lower, as breakeven rates include an inflation risk premium to compensate for uncertain inflation developments. Expectations about the medium-term supply of bonds in the market make an impact as well.

- Household inflation expectations have declined somewhat, according to the survey conducted by Capacent Gallup in December. One-year expectations measured 6%, which is ½ a percentage point less than in the September survey. Households' inflation expectations two years ahead fell by the same amount since the last survey, to the current 5.5%. On the other hand, corporate inflation expectations one year ahead remained unchanged at 4% in December.

- The inflation outlook is broadly similar to that in November, when the last *Monetary Bulletin* was issued. Inflation looks set to measure just over 6% in Q1/2012, which accords with the last forecast. It is then expected to taper off over the course of the year, averaging 4.6% for 2012 as a whole, some 0.5 percentage points higher than in the November forecast. Inflation excluding indirect tax effects is forecast at 4.4% in 2012. Slower disinflation this year is due in part to the delayed emergence of inflationary pressures expected at the end of 2011, which is due in part to later-than-expected implementation of wage increases. It is also assumed that the króna will be somewhat weaker than in the November forecast. Inflation is projected to align with the inflation target early in 2014, somewhat later than was forecast in November, partly because of the assumption of a weaker króna during the forecast horizon. Inflation should fall to target earlier, however, if the recent depreciation of the króna proves to be temporary.

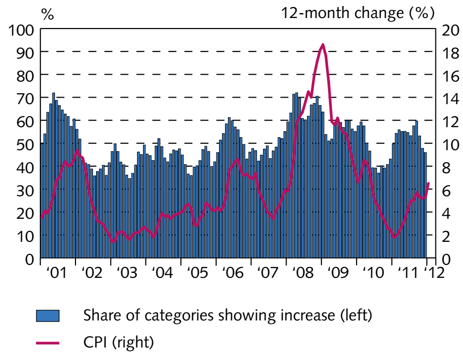
- The pace of disinflation therefore remains uncertain and will be strongly influenced by exchange rate developments. The baseline forecast assumes that the króna will remain low throughout the forecast horizon. Capital inflows could emerge as soon as the current deleveraging of external debt subsides and domestic financial and non-financial sectors' access to foreign credit normalises. Improvements of the capital account could therefore add to an underlying current account surplus in supporting the króna. The removal of the capital controls could lead to a temporary offsetting depreciation of the króna, however. But it is far from clear that the capital account liberalisation will lead to a weakening of the króna, and even if the króna came under pressure the inflationary impact will depend on the duration of that depreciation. Factors other than capital flows and exchange rate developments will also affect the pace of disinflation. After last year's upsurge, there is the risk that inflation and inflation expectations will

Chart 21
Components of CPI inflation
Contribution to inflation January 2007 - January 2012



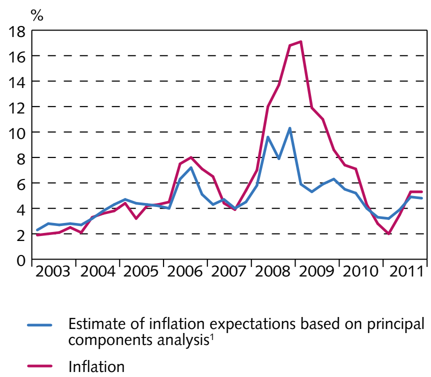
Source: Statistics Iceland.

Chart 22
Distribution of price increases in the CPI[1]
January 2001 - January 2012



1. The percentage of goods categories that increase in price is a 3-month centred average.
Source: Statistics Iceland.

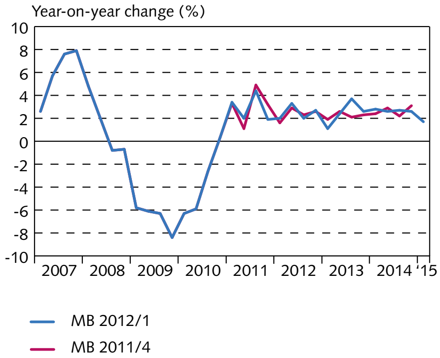
Chart 23
Inflation expectations and inflation
Q1/2003 - Q4/2011



1. Principal components analysis measures the common trend of a number of measures of inflation expectations.
Sources: Capacent Gallup, Statistics Iceland, Central Bank of Iceland.

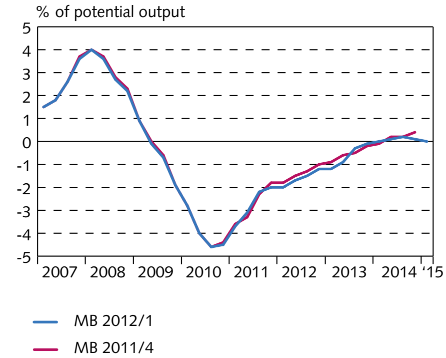
become entrenched. It is also difficult to say how much spare capacity there is in the economy and how effectively it will contain inflationary pressures. If house prices continue to rise rapidly, they will also slow down disinflation. Furthermore, there is the risk that the steep rise in oil prices year-to-date will have second-round effects on companies' input prices and other expense items. Moreover, the strong and swift increase in core inflation in the past year indicates that inflation could prove chronic. On the other hand, the global growth outlook is relatively poor, which could mean that inflation will be lower than it might otherwise.

Chart 24
Output growth - comparison with MB 2011/4



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 25
Output gap - comparison with MB 2011/4

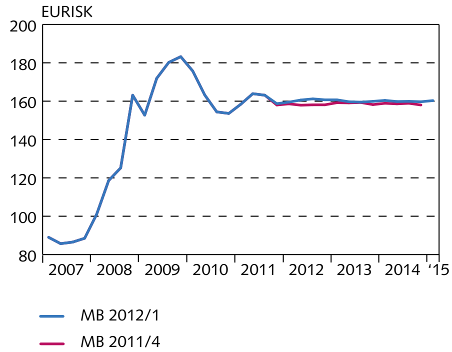


Source: Central Bank of Iceland.

Chart 26
Unemployment - comparison with MB 2011/4

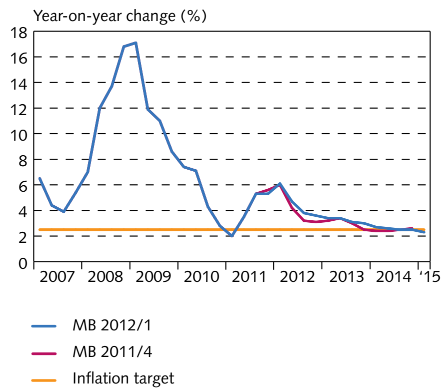
Sources: Directorate of Labour, Central Bank of Iceland.

Chart 27
EURISK exchange rate - comparison with MB 2011/4



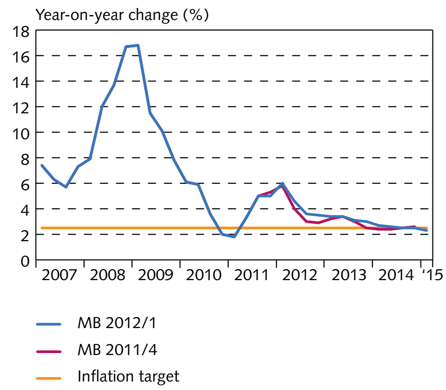
Source: Central Bank of Iceland.

Chart 28
Inflation - comparison with MB 2011/4



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 29
Inflation excluding tax effects - comparison with MB 2011/4



Sources: Statistics Iceland, Central Bank of Iceland.

Appendix 1

Baseline macroeconomic and inflation forecast 2012/1

Table 1 Macroeconomic forecast[1]

	In b.kr.	Change from prior year (%) unless otherwise specified				
			Forecast			
GDP and its principal subcomponents	*2010*	*2010*	*2011*	*2012*	*2013*	*2014*
Private consumption	787.7	-0.4 (-0.4)	4.5 (2.9)	2.2 (3.1)	2.3 (3.2)	3.2 (2.8)
Public consumption	398.6	-3.4 (-3.4)	-0.1 (-0.2)	-1.2 (-1.2)	0.3 (0.4)	0.2 (0.3)
Gross fixed capital formation	206.9	-4.7 (-4.7)	7.1 (6.7)	17.5 (16.5)	6.5 (4.4)	5.4 (11.1)
Business investment	129.4	5.5 (5.5)	16.0 (13.2)	19.3 (16.5)	6.5 (4.4)	3.9 (13.5)
Residential investment	35.5	-17.6 (-17.6)	11.0 (13.8)	19.9 (21.6)	15.9 (14.6)	15.4 (15.1)
Public investment	42.0	-19.3 (-19.3)	-24.0 (-19.8)	4.0 (9.5)	-6.1 (-8.8)	-1.8 (-8.5)
National expenditure	1,389.9	-2.2 (-2.2)	4.4 (3.9)	3.4 (3.2)	2.4 (2.3)	2.7 (3.4)
Exports of goods and services	861.3	0.4 (0.4)	3.3 (2.5)	1.8 (1.3)	2.4 (1.6)	1.8 (2.1)
Imports of goods and services	707.0	4.0 (4.0)	6.3 (4.0)	3.4 (2.8)	2.2 (1.6)	1.6 (3.5)
Contribution of net trade to GDP growth	-	-1.5 (-1.5)	-1.1 (-0.4)	-0.6 (-0.5)	0.3 (0.2)	0.2 (-0.4)
Gross domestic product	1,544.1	-3.6 (-3.6)	3.0 (3.1)	2.5 (2.3)	2.5 (2.3)	2.7 (2.6)
Other key figures						
GDP at the price level of each year (in b.kr.)		1,544 (1,544)	1,656 (1,674)	1,788 (1,822)	1,883 (1,918)	1,981 (2,009)
Trade account balance (% of GDP)		10.0 (10.0)	8.6 (10.0)	8.3 (10.9)	8.2 (10.8)	8.2 (10.0)
Current account balance (% of GDP)		-7.9 (-11.1)	-5.9 (-8.2)	-3.2 (-1.5)	0.5 (1.1)	0.5 (-0.2)
Current account balance excluding unpaid accrued interest due to DMBs in winding-up proceedings (% of GDP)		-2.0 (-2.4)	0.4 (0.5)	1.6 (3.3)	1.9 (2.6)	1.9 (1.2)
Total gross capital formation ((% of GDP)		13.4 (13.4)	14.0 (13.7)	16.0 (15.0)	16.5 (15.3)	17.0 (16.6)
Business investment (% of GDP)		8.4 (8.4)	9.5 (9.0)	11.1 (9.8)	11.4 (10.0)	11.6 (11.1)
Output gap (% of potential output)		-4.5 (-4.4)	-2.0 (-1.8)	-1.2 (-1.0)	-0.1 (-0.2)	0.1 (0.4)
Unit labour costs (change in average year-on-year)		4.9 (4.9)	5.0 (5.4)	5.1 (4.6)	2.7 (2.7)	2.2 (2.9)
Real disposable income (change in average year-on-year)		-11.4 (-11.4)	2.7 (2.2)	0.8 (0.9)	1.5 (0.5)	3.3 (4.8)
Unemployment (% of labour force)		8.1 (8.1)	7.4 (7.4)	6.3 (6.2)	6.0 (5.8)	5.0 (4.9)
EURISK exchange rate		161.7 (161.7)	161.0 (160.8)	160.5 (158.2)	159.9 (158.9)	159.9 (158.6)
Inflation (average for the year, %)		5.4 (5.4)	4.0 (4.1)	4.6 (4.1)	3.2 (3.0)	2.6 (2.5)
Inflation excluding tax effects (average for the year, %)		4.4 (4.4)	3.8 (3.9)	4.4 (3.9)	3.2 (3.0)	2.6 (2.5)

1. Figures in parentheses from forecast in *Monetary Bulletin* 2011/4

Table 2 Quarterly inflation forecast (%)[1]

Quarter	*Inflation (change year-on-year)*	*Underlying inflation (excl. tax effects) (change year-on-year)*	*Inflation (annualised quarter-on-quarter change)*
		Measured value	
2010:4	2.8 (2.8)	2.0 (2.0)	4.0 (4.0)
2011:1	2.0 (2.0)	1.8 (1.8)	1.8 (1.8)
2011:2	3.5 (3.5)	3.3 (3.3)	10.9 (10.9)
2011:3	5.3 (5.3)	5.0 (5.0)	4.6 (4.6)
2011:4	5.3 (5.6)	5.0 (5.3)	3.9 (5.2)
		Forecasted value	
2012:1	6.1 (6.0)	6.0 (5.8)	5.2 (3.4)
2012:2	4.7 (4.2)	4.6 (4.0)	5.2 (3.4)
2012:3	3.8 (3.2)	3.6 (3.0)	0.9 (0.7)
2012:4	3.6 (3.1)	3.5 (2.9)	3.3 (4.9)
2013:1	3.4 (3.2)	3.4 (3.2)	4.0 (3.7)
2013:2	3.4 (3.4)	3.4 (3.4)	5.5 (4.5)
2013:3	3.1 (3.0)	3.1 (3.0)	-0.5 (-0.9)
2013:4	3.0 (2.5)	3.0 (2.5)	3.1 (2.8)
2014:1	2.7 (2.4)	2.7 (2.4)	3.0 (3.2)
2014:2	2.6 (2.4)	2.6 (2.4)	4.9 (4.6)
2014:3	2.5 (2.5)	2.5 (2.5)	-0.9 (-0.7)
2014:4	2.5 (2.6)	2.5 (2.6)	2.9 (3.3)
2015:1	2.3	2.3	2.5

1. Figures in parentheses from forecast in *Monetary Bulletin* 2011/4.