Monetary Bulletin in a nutshell

Global GDP growth rebounded strongly in Q2/2021, as vaccination rollouts proceeded and public health restrictions were eased. The outlook for Q3 is weaker than was assumed in the May *Monetary Bulletin*, however, owing in part to the rapid spread of the Delta variant of the COVID-19 virus. Nevertheless, the growth outlook for the year as a whole is brighter than was forecast in May. At the same time, a strong recovery of domestic demand and persistent supply-side disruptions caused by the pandemic have pushed commodity prices and shipping costs sharply upwards. As a result, global headline inflation has risen swiftly in recent months.

In Iceland, GDP contracted more in Q1/2021 than was assumed in the May forecast. Growth appeared robust in Q2, however, reflecting declining infection rates, relaxation of public health measures, and rising tourist numbers. Although COVID case numbers rose again over the course of the summer, the outlook is for a continued economic recovery in H2/2021. GDP growth is projected at 4% for the year as a whole, some 0.9 percentage points above the May forecast. It is expected to hold close to that pace in 2022 and then ease back towards long-term trend growth in 2023.

Job numbers are rising quickly, and labour participation is back to the pre-pandemic rate. Job vacancies have increased markedly in number, and more firms indicate that they are short-staffed. Unemployment has fallen faster than was forecast in May and currently measures just over 6%, in terms of both the Statistics Iceland labour force survey (LFS) and the registered unemployment rate. It is expected to continue declining and reach the pre-pandemic rate by the end of the forecast horizon, which is well below the May forecast. The slack in the economy will therefore narrow more quickly than was projected then.

Although the exchange rate pass-through from last year's depreciation of the króna has weakened significantly, inflation has remained above 4% since the turn of the year, measuring 4.4% in Q2. The recovery of domestic demand is a major factor here, although the surge in shipping costs and global oil and commodity prices plays a part as well. Inflation eased to 4.3% in July and appears to have peaked in the spring. This pattern can be seen more clearly in the CPI excluding housing or in the underlying inflation rate, which had fallen to 3.8% by July. Measured inflation is expected to hover above 4% for the remainder of the year and therefore ease more slowly than was forecast in May. According to the Bank's forecast, it will align with the target in Q3/2022, slightly later than previously anticipated.

As before, both domestic and global economic developments will depend in large part on how successful efforts to control the pandemic prove to be. Although a large percentage of Iceland's population has been fully vaccinated, the current vaccines' effectiveness against the Delta variant and its potential successors remains uncertain. The Bank's baseline forecast assumes that the current set of public health measures will remain in place for a while but will have relatively little impact on domestic economic activity. This assessment could change, however, if there is a setback in the response to the pandemic and restrictions must be tightened once again, or if individuals refrain increasingly from their usual activities due to fear of contagion.

The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin* 2021/2 in May 2021, and on the updated forecast presented in this report. It is based on data available as of mid-August. The risk analysis in the updated forecast is based on the risk analysis in the May forecast.