Inflation

V

Recent developments in inflation

Inflation above the upper deviation threshold of the inflation target in Q1/2021 …

Inflation measured 4.2% in Q1/2021, whereas the Bank's February forecast had assumed it would be 3.9%. The main drivers of inflation during the quarter were rising prices of petrol, private services, and residential housing (Chart V-1). Domestic petrol prices began increasing in late 2020, after global oil prices started to rise. Private services prices have also inched upwards recently, most likely due to wage hikes and an increase in domestic demand following the relaxation of public health measures early in Q1.

… and has risen since the February *Monetary Bulletin*

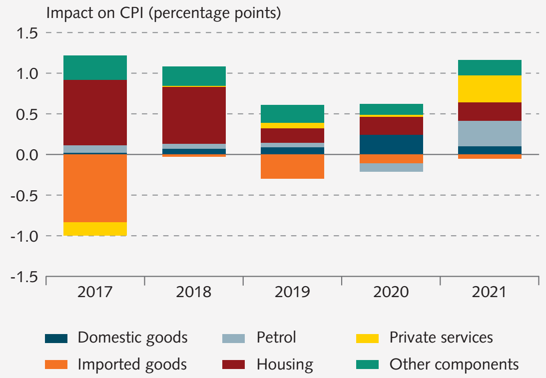
Headline inflation has continued to rise in the recent term, reaching 4.6% in April (Chart V-2), its highest level since February 2013. A large share of the past few months' spike in inflation is due to rising house prices, as inflation excluding housing slowed to 4.6% in April, after having exceeded the headline rate since June 2020. Inflation according to the HICP, which also excludes owner-occupied housing costs, was lower, however, measuring 3.8% in March.[1]

Underlying inflation according to the average of various measures was 4.3% in April and, unlike headline inflation, has slowed in recent months (Chart V-3). It is still high, however, indicating the presence of relatively

1 As is discussed in *Monetary Bulletin* 2020/4, the main difference between the CPI excluding housing (CPIXH) and the HICP is that the weight of various tourism-related subcomponents is greater in the HICP than in the CPIXH. The price of most of these subcomponents has risen only slightly or has fallen in the past year.

Chart V-1

Impact of CPI components in Q1[1]

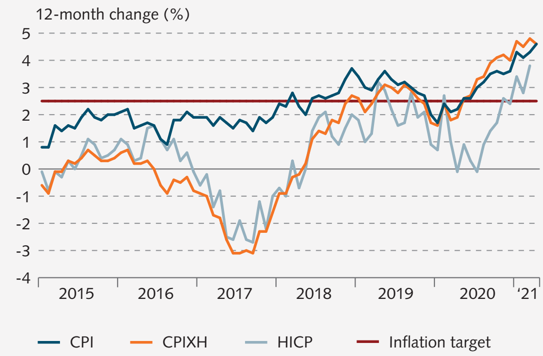


1. The combined impact of subcomponents equals the sum of monthly changes in the CPI in Q1.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-2

Various measures of inflation

January 2015 - April 2021



Sources: Statistics Iceland, Central Bank of Iceland.

widespread inflationary pressures. Almost half of twelve-month inflation is due to higher imported goods prices, but the contribution from various subcomponents that weigh heavily in the CPI – such as services and domestic goods – has grown stronger as well. The housing market has been buoyant, and house prices have surged (see Chapter II). The cost of owner-occupied housing rose 4.8% year-on-year in April, with lower real mortgage interest expense offsetting the rise in house prices.[2]

Indicators of inflationary pressures

The recent appreciation of the króna has eased inflationary pressures …

As is mentioned above, last year's depreciation of the króna had a strong impact on imported goods prices. The exchange rate pass-through had eased by early 2021, however, and the króna has appreciated by just over 2% year-to-date. The foreign exchange market has been relatively well balanced over the same period. Imported inflation has therefore eased in recent months, apart from the surge in petrol prices since the end of 2020 (see Chapter I). Imported food and beverage prices have risen by 5.6% in the past twelve months, and the price of miscellaneous imported goods such as clothing, electronic equipment, and furniture is up 6.4% (Chart V-4). Petrol prices, however, are 10% higher than they were a year ago.

… but transport costs and global commodity prices are up sharply

The pandemic has led to steep hikes in transport costs and the price of various inputs, owing to disruptions in production, value chains, and domestic and cross-border distribution channels (see also Box 2 in *Monetary Bulletin* 2020/4). Added to this was the temporary halt in transport by sea via the Suez Canal following the blockage of the canal in late March. These supply-side disruptions have had a strong impact. The cost of cross-border container shipping, for instance, is three times the 2019 average, and the price of various commodities, including food, has risen as well (see Chart V-5 and Chapter I).[3] Furthermore, many companies' low inventory levels in the wake of the pandemic could amplify these cost effects even further. It will probably take some

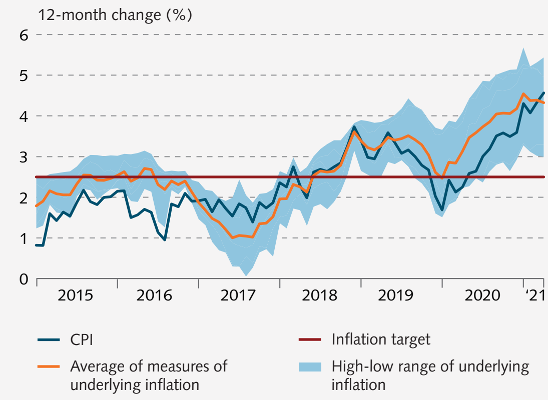
2 Headline twelve-month inflation is lower by an estimated 0.9 percentage points because of lower real mortgage interest expense.

3 Soon after the pandemic struck in early 2020, it was expected that global food and commodity prices would fall markedly. The analysis in *Monetary Bulletin* 2020/2, published in May, was based in part on the World Bank forecast, which assumed that global food and beverage prices would decline by just over 1% in 2020. In fact, they rose by more than 6%.

Chart V-3

Headline and underlying inflation[1]

January 2015 - April 2021



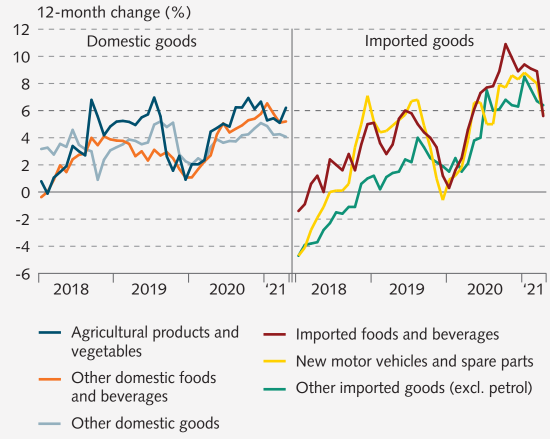
1. Underlying inflation measured using a core index (which excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense) and statistical measures (weighted median, trimmed mean, a dynamic factor model, and a common component of the CPI).

Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-4

Domestic and imported goods prices

January 2018 - April 2021

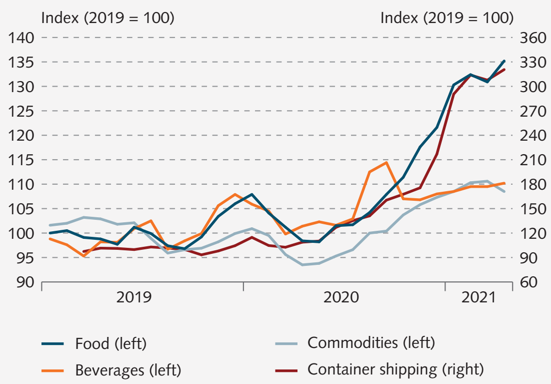


Source: Statistics Iceland.

Chart V-5

Global shipping and commodity prices[1]

January 2019 – April 2021



1. Food includes various comestible oils, various meal and grains, meat, and fruit. Beverages include cocoa, coffee, and tea. Commodities include timber, cotton, rubber, and tobacco. Container shipping based on the Freightos Global Container Index.

Sources: Freightos Limited, World Bank.

time to unwind the supply disruptions, and their aftereffects could persist well into this year. As a result, it could take longer for inflationary pressures to subside.

On the other hand, indications from Gallup's spring survey of corporate expectations, carried out in February and March 2021, suggest that executives do not think inflationary pressures have risen significantly since last autumn. About 58% of survey respondents expect to keep the price of their own goods and services unchanged in the next six months, and 37% expect to raise them. This is virtually the same as in the autumn survey (Chart V-6). Furthermore, the share of respondents expecting their input prices to rise fell between surveys.

If these supply disruptions persist, however, and if transport prices continue to rise, there is the risk of second-round effects – for instance, on services prices. There have been widespread disruptions in services activities due to broad public health measures, particularly in contact-intensive sectors. Now, with further relaxation of public health measures on the horizon as the vaccination roll-out proceeds, the increase in demand could trigger further price hikes for private services, which had risen by 2.4% year-on-year in April (Chart V-7).

Wages have risen steeply

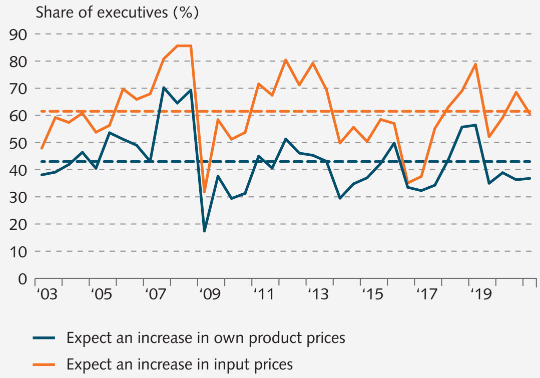
Housing is not the only non-traded good that has risen in price since the pandemic hit Iceland. Wages have risen markedly as well. The general wage index rose by 6.3% year-on-year in 2020, and the total wage index by nearly as much, or 5.6%. The smaller increase in the total wage index reflects both the impact of changes in the composition of the labour force and various payments not captured by the general wage index. With these sizeable pay hikes, the share of wages in factor income rose last year, unlike what happened following the financial crisis just over a decade ago.

The general wage index rose by 4.3% quarter-on-quarter in Q1/2021, as was assumed in the Bank's February forecast, bringing the twelve-month rise in the index to 10.5% (Chart V-8). This large increase is due mainly to the fact that two negotiated pay rises have taken effect in the twelve-month period in question – in April 2020 and January 2021 – and moreover, base effects from the delayed public sector contracts in 2020 can still be felt. It can therefore be expected that the twelve-month rise in the index will ease again in Q2 and the quarters to follow. Unit labour costs are estimated to have risen by over 5% in 2020 but are expected to rise less strongly this year and in 2022-2023, or an average of 3½% per year.

Chart V-6

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

March 2003 - March 2021

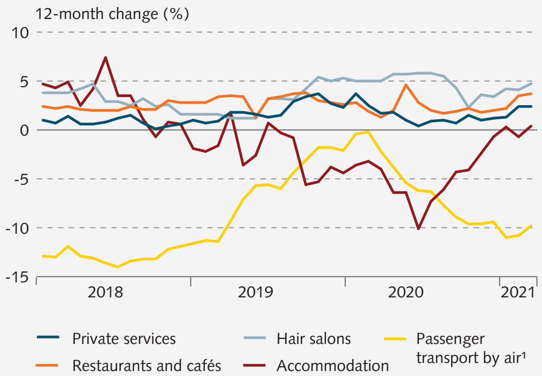


1. Broken lines show averages from 2003.
Sources: Gallup, Central Bank of Iceland.

Chart V-7

Private services and selected subcomponents of the CPI

January 2018 - April 2021

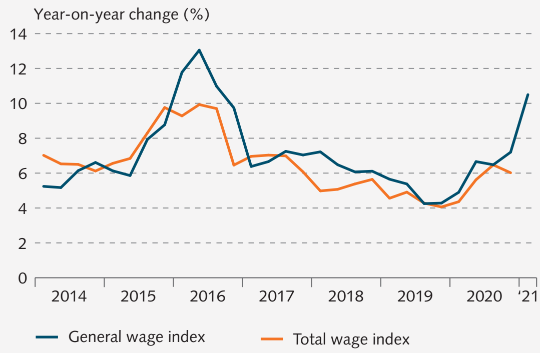


1. Twelve-month moving average.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-8

Wages

Q1/2014 - Q1/2021



Source: Statistics Iceland.

Inflation expectations

Short-term inflation expectations have risen by several measures …

Short-term inflation expectations have increased by several measures since the last surveys were taken, as inflation has been persistently high in the recent term. Market agents expect inflation to measure 3% in one year's time, whereas in the previous survey they assumed it would be at the Bank's 2.5% target. Their inflation expectations two years ahead are still at target. According to Gallup's spring survey, households expect inflation to measure 4% in one year, as in the previous survey; however, their expectations two years ahead have risen by 1 percentage point, to 4%. Corporate executives expect inflation to measure 3% in both one and two years, which is unchanged between surveys but somewhat higher than a year ago (Chart V-9).

… and there are also signs that long-term inflation expectations have inched upwards

Market agents' five- and ten-year inflation expectations are still at target, where they have been continuously since H2/2019. According to Gallup's spring surveys, households continue to expect inflation to average 3% over the next five years, while corporate executives' long-term inflation expectations have risen since the previous survey and measure 2.8%, as they did a year ago. The five- and ten-year breakeven inflation rate in the bond market has also risen in recent months, and the ten-year rate has averaged 2.9% in Q2/2021 to date, compared with just over 2% in Q2/2020.[4] Long-term inflation expectations have therefore risen by several measures, which could indicate that the anchor to the inflation target has weakened in the recent past.

The inflation outlook

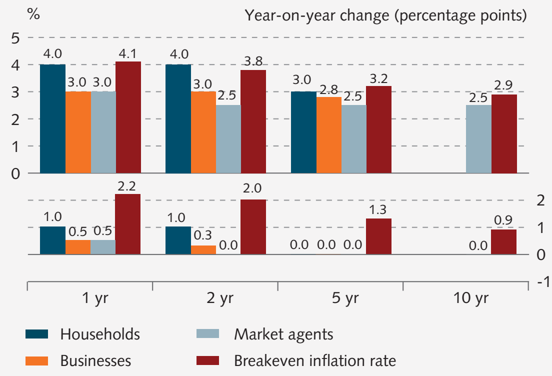
Inflation to taper off considerably slower than previously forecast

In Q1/2021, inflation was above the Bank's February forecast, partly because the slack in the economy was smaller than expected and oil and commodity prices rose more than was assumed in the forecast. Furthermore, the inflationary effects of various supply-side disruptions were underestimated, as is discussed above. In spite of this, inflation is expected to begin declining in the near

4 It can be assumed that about one-third of the year-on-year increase in the one- to five-year breakeven rate is due to technical factors relating to the removal of a bond maturing in 2021 from market making and thus from the calculation of the real zero coupon curve. Furthermore, the breakeven rate also includes an inflation risk premium and a liquidity risk premium. For further information, see Chapter II.

Chart V-9

Inflation expectations[1]



1. The most recent Gallup surveys of corporate and household inflation expectations were carried out in February/March 2021. The most recent Central Bank survey of market agents' expectations is from the beginning of May 2021. Households and businesses are not asked about ten-year inflation expectations. The most recent value for breakeven inflation is the average in Q2/2021 to date. The lower part of the chart shows the year-on-year change.

Sources: Gallup, Central Bank of Iceland.

future. It is forecast to measure 4.4% in Q2 and fall to 3.8% by Q4 (Chart V-10). Inflation will therefore be markedly more persistent than previously forecast, as the February forecast assumed that it would align with the target by the year-end. Now it is not expected to do so until mid-2022. This is due mainly to higher imported inflation, although the króna is now expected to be stronger than previously projected. Furthermore, in the latter half of the forecast horizon, the outlook is for inflation to be higher than was assumed in February, as a positive output gap is now expected to open up earlier than was forecast then. According to the forecast, inflation will be at target, on average, over the latter half of the forecast horizon.

Inflation risk concentrated on the upside

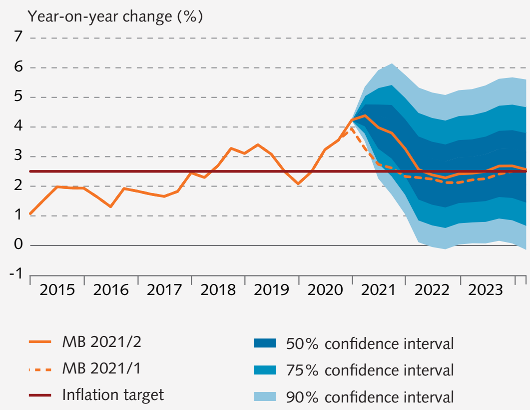
Inflation has systematically exceeded forecasts since the pandemic struck, as the slack in the economy has been smaller than anticipated and the exchange rate pass-through from the depreciation of the króna to imported goods prices has been stronger than expected. Cost increases due to pandemic-related disruptions in manufacturing were also underestimated, as is discussed above, and global oil prices have repeatedly risen more than projected (Chart V-11).

As is discussed in Box 1, the inflation outlook for both short and long term is highly uncertain. Uncertainty about the short term centres mainly on how the exchange rate develops and how long supply-side disruptions continue to affect value chains and goods transport. In the long term, the inflation outlook depends as much on the strength of the economic recovery as it does on the long-term impact of the pandemic on potential output. The risk profile is considered to be similar to that in the Bank's most recent forecasts, and tilted to the upside; i.e., near-term inflation is likelier to be underestimated in the baseline forecast than it is to be overestimated. There is a roughly 50% probability that inflation will be in the 1½-3¾% range in one year and in a similar range at the end of the forecast horizon (Chart V-10).

Chart V-10

Inflation forecast and confidence intervals

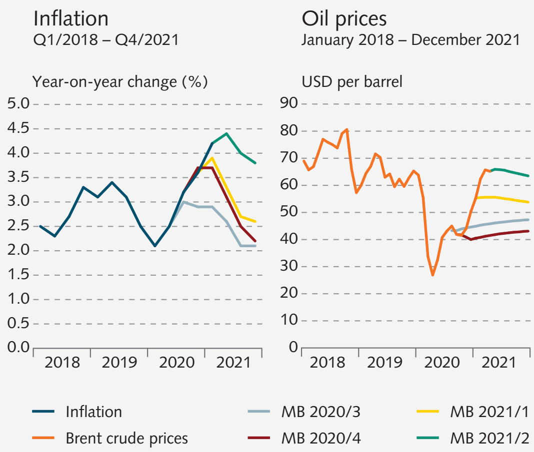
Q1/2015 - Q2/2024



Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-11

Forecasts of inflation and oil prices in the wake of the pandemic



Sources: Refinitiv, Statistics Iceland, Central Bank of Iceland.