Box 1

Alternative scenarios and uncertainties

The baseline forecast reflects the most likely economic developments over the forecast horizon. The outlook is highly uncertain, however, and could alter in response to changes in key underlying assumptions. For example, the fact that some key uncertainties specified in the Bank's last forecast have materialised has led to changes in the assumptions underlying the current forecast. Early this year, for instance, the vaccine roll-out proceeded more slowly than had been expected. On the other hand, household saving has declined more quickly than previously projected, and domestic demand has therefore proved more resilient. Furthermore, the Government has announced even more fiscal stimulus measures. The impact of the pandemic on global value chains has also proven stronger than previously forecast, and global oil and commodity prices have risen more.

As before, global and domestic economic developments will depend to a large degree on how successful efforts to control the COVID-19 pandemic prove to be and how quickly vaccination programmes can be implemented. It is difficult to predict how long this will take. There are other uncertainties as well, however, and this Box discusses several of them. It also presents alternative scenarios based on different assumptions about the progress made in the battle against the pandemic.

Alternative scenarios: How quickly will the pandemic subside?

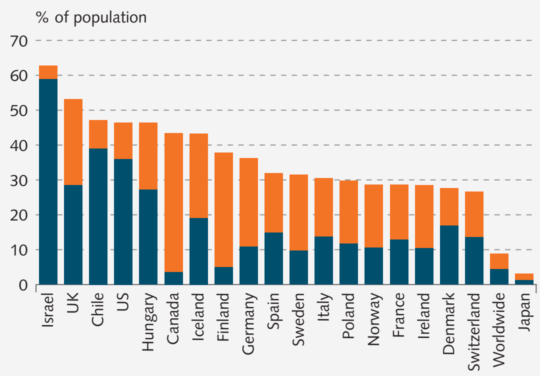
Pandemic- and vaccine-related assumptions in the baseline forecast

Iceland's vaccine roll-out began in late 2020, and as of this writing, about 43% of the population have received at least one dose. This is somewhat higher than the trading partner average but below the rates in the countries that are furthest along in their vaccination programmes (Chart 1).

Early this year, Iceland's vaccination programme proceeded somewhat more slowly than was expected in February. Furthermore, since the end of March, public health measures have been broader than was assumed in February, but on the other hand, they appear to affect domestic economic activity less than they did earlier in the pandemic (see Chapter III). Based on Government estimates, though, the outlook is for the vaccination rate to be back on schedule during Q2; therefore, the vaccine roll-out assumptions in the baseline forecast are broadly unchanged for the remainder of

Chart 1

COVID-19 vaccination rates[1]



1. Figures as of 14 May 2021.
Source: Our World in Data.

this year. It is assumed that all individuals in priority groups will have received at least one dose of the vaccine by mid-June and almost everyone by Q3. As in February, it is assumed that on average, vaccination programmes in trading partner countries will proceed at roughly the same pace as in Iceland, although there will be significant differences from one country to another. The public health measures currently in place at the border – with testing and quarantine – are assumed to continue until this autumn, with exemptions based on the status of the pandemic in tourists' country of origin. This is unchanged from the February forecast, but because of the steep rise in infection rates in some of Iceland's main trading partner countries, tourism is now expected to bounce back more slowly than was projected then (see Chapter III). It is assumed that public health measures within Iceland will be scaled back gradually but not lifted in full until later this year. Nor is it impossible that localised closures will be needed well into this year and that some public health measures will remain in place at the border through the year-end.

All of these factors are subject to considerable uncertainty. As a result, the assumptions about the progress of the vaccine roll-out may be overly optimistic. Furthermore, new variants of the virus have been identified, and others may surface as well, especially if it takes a long time to vaccinate the global population. Nor is it assured that the currently available vaccines will be effective against all of the variants. As a consequence, the possibility of a setback in the battle with the virus cannot be ruled out, and it could prove necessary to implement stringent lockdown measures once again, plunging the global economy back into recession. On the other hand, the assumptions in the baseline forecast could be overly pessimistic. It could be that vaccination programmes will proceed more quickly than is assumed here, and that public health measures can be unwound sooner, particularly as regards international travel. The two alternative scenarios below describe the potential impact of such scenarios on the domestic economy.

The economic recovery could be delayed if vaccination proceeds more slowly

In this alternative scenario, it is assumed that the pandemic will prove more difficult to control than in the baseline forecast; for example, if vaccines are not manufactured fast enough to halt further spread of the disease and new variants of it. In that case, it will be necessary to impose more stringent public health measures and keep them in place longer. Pessimism about the economic outlook will gain ground again, causing the general public to spend less and start building up precautionary savings once more. Increased uncertainty will also make firms less likely to hire workers and embark on new investment projects. Furthermore, credit spreads on firms' domestic financing will rise higher than in the baseline forecast. The domestic economic recovery that began in late 2020 will stall again. This is compounded by a setback in the global recovery and more stringent restrictions on international travel. Domestic tourism will be hit hardest, as it is assumed that pandemic-related border restrictions will be extended. As a result, tourist arrivals will not increase to any marked degree before the end of Q3/2021, and they will rise more slowly well into 2022. In this scenario, the summer 2021 recovery assumed in the baseline forecast will not occur. Tourist numbers will hardly rise at all year-on-year in 2021, and in 2022 they will increase more slowly than is assumed in the baseline. Services exports therefore grow by just over 8% this year, as opposed to 22% in the baseline forecast, and because of the weaker recovery in trading partner countries, the outlook for goods exports will deteriorate as well. Combined goods and services exports will grow by 5 percentage points less than in the baseline forecast this year but will be similar to the baseline in the two years to follow (Chart 2a).[1]

Chart 2
Alternative scenarios

Source: Central Bank of Iceland.

1 Based on a recent assessment by the International Monetary Fund of various levels of success against the pandemic and their differing impact on the global economy. See *World Economic Outlook*, Chapter 1, April 2021.

The poorer outlook for exports amplifies still further the adverse effects of the pandemic on domestic employment, incomes, and demand. Added to this is increased pessimism among households, which causes household saving to remain higher than in the baseline by 1 percentage point of disposable income until well into 2022 (see also Box 1 in *Monetary Bulletin* 2020/4). Credit spreads on corporate financing remain as much as 1 percentage point higher than in the baseline forecast over the same period.

The persistence of the pandemic causes more widespread company failures, more people exit the labour market, unemployment falls more slowly, and productivity growth is more sluggish. The scarring of potential output is therefore deeper (see Boxes 3 and 4).

Although domestic economic policy measures pull in the opposite direction, the alternative scenario assumes that the economic outlook will deteriorate relative to the current forecast.[2] Private consumption grows by 2½ percentage points less in 2021 and ½ a percentage point less in 2022 (Chart 2b). GDP growth is weaker by 1½ percentage points this year and ½ a percentage point next year (Chart 2c). As a result, GDP will be 1½% below the baseline forecast level in 2023 and will return to its 2019 level roughly a year later than is currently assumed (Chart 3).

Because of poorer external conditions and lower interest rates, the króna is weaker than in the baseline forecast. Year-2021 inflation is broadly in line with the baseline, however, owing to the offsetting effects of a larger slack in the economy versus a lower exchange rate, as is reflected in higher unemployment and slower wage rises, among other things. Over the course of 2022, the impact of greater spare capacity will weigh heavier, and inflation will be lower than in the baseline forecast (Chart 2d).

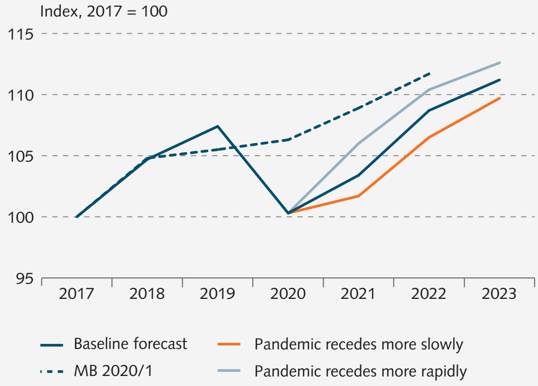
The economic recovery could turn out stronger if the pandemic subsides faster

In the latter alternative scenario, it is assumed that the production and distribution of vaccines will proceed more quickly than in the baseline forecast, resulting in greater success in controlling the pandemic. This scenario assumes that widespread vaccination will be achieved quickly throughout the developed world and that public health measures will be relaxed relatively rapidly. Reduced fear of the pandemic will boost the general public's appetite for various activi-

2 It is assumed that monetary policy will respond with lower interest rates than in the baseline, in line with the monetary policy rule in the Bank's macroeconomic model, and that automatic fiscal stabilisers will be allowed to work unimpeded. Conversely, the economic policy stance is correspondingly tighter in the more optimistic alternative scenario.

Chart 3

GDP according to various scenarios[1]



1. GDP according to the Central Bank baseline forecast for 2021-2023 and various assumptions concerning the COVID-19 pandemic

Sources: Statistics Iceland, Central Bank of Iceland.

ties, including travel. Demand will therefore grow quickly in services sectors, and tourism will recover sooner than in the baseline forecast. With increased optimism, households will tap deeper into their savings, and the household saving ratio will be lower than in the baseline by about 1 percentage point of disposable income starting in H2/2021. Credit spreads on corporate financing remain as much as 1 percentage point lower over the same period. As a result, domestic demand rebounds more rapidly, compounded by a speedier recovery in trading partner countries. It is assumed that a total of 1 million tourists visit Iceland in 2021, services exports more than double during the year, and total exports grow by 11 percentage points more than in the baseline forecast (Chart 2a).

The turnaround in private consumption will therefore be considerably stronger than in the baseline. It will increase by over 2 percentage points more this year, and slightly more in 2022 (Chart 2b). GDP growth will therefore be 2.7 percentage points stronger in 2021 than is currently forecast, or just under 6%, whereas in 2022 it will be weaker than in the baseline because of base effects from this year's strong export growth (Chart 2c). A more rapid turnaround in the domestic economy also means that supply-side disruptions and long-term damage to the domestic economy will be less pronounced. GDP will return to its 2019 level somewhat earlier than in the baseline forecast and will be about 1½% higher than the baseline level in 2023 (Chart 3).

The swifter economic turnaround and more rapid interest rate hikes to ensure that inflation remains at target over the medium term will support the króna, offsetting the impact of the faster elimination of spare capacity relative to the baseline scenario. As 2022 progresses, increased domestic demand and more rapid pay rises will push inflation slightly above the currently forecasted level (Chart 2d).

Other uncertainties

A number of other factors could change the economic outlook …

The medium-term economic outlook is subject to a number of other uncertainties. Uncertainty lies not only in how long the pandemic persists and how it affects demand and GDP growth in 2021 and 2022, but also in its potential impact on the long-term GDP growth and employment outlook (see Boxes 3 and 4). Changes in fiscal policy following the upcoming Parliamentary elections could also affect the economic outlook. The same applies in the event of sudden changes in financial conditions; i.e., if uncertainty increases even more, prompting investors to reassess risk and reprice financial products. Moreover, the global economic outlook is highly uncertain, and it is not known whether and how quickly world trade will recover from the damage done by trade disputes in recent years. In addition, the recovery of GDP growth in the coming term will depend on the pace at which households tap the savings they have accumulated recently (for further discussion, see Box 1 in *Monetary Bulletin* 2020/4). The GDP growth outlook will also depend on the extent to which households' and businesses' increased willingness to spend is directed at domestic production rather than imported goods and services. Furthermore, the pandemic could accelerate shifts already underway in areas such as e-commerce and telework, leading to structural changes in demand for certain types of residential and commercial real estate, with broad-based impact on relative prices.

... and affect inflation during the forecast horizon

According to the baseline forecast, the slack in the economy will cause inflation to ease over the course of this year and align with the target around mid-2022. But because of the pandemic, there is considerable uncertainty about inflation, both in the next few months and further ahead.

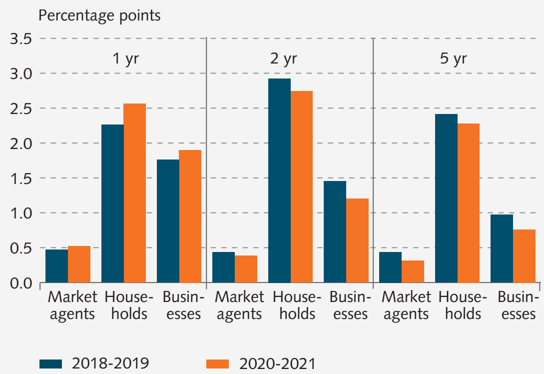
For example, the pandemic has made it unusually difficult to estimate potential output and the amount of spare capacity that is considered to exist. Estimating underlying inflationary pressures is also challenging, as the pandemic has affected different sectors to differing degrees, thereby bringing about significant changes in relative prices (see Box 2 in *Monetary Bulletin* 2020/4).

The pandemic has also caused widespread disruptions in production, thrown global value chains into disarray, and impeded domestic and cross-border distribution of goods. Manufacturing and transport costs have therefore risen steeply in the recent term, and far more than was previously forecast (see Chapter V). There is considerable uncertainty about how these factors will develop in the coming term, as the recent situation is unprecedented. As a result, the possibility cannot be excluded that continued supply-side woes will cause input prices to rise higher, making inflation more persistent than is assumed in the baseline forecast. This increased uncertainty about the short-term inflation outlook shows clearly in inflation expectations surveys. As Chart 4 indicates, the dispersion of one-year inflation expectations has increased since the pandemic struck Iceland, particularly among households, but also among businesses and market agents. The dispersion of medium- and long-term expectations has continued to decline, however.

Developments in inflation over the forecast horizon will also be affected by the exchange rate of the króna. According to the baseline forecast, the average exchange

Chart 4

Dispersion of inflation expectations[1]



1. Standard deviation in market agents', households', and businesses' responses on inflation expectations 1, 2, and 5 years ahead. Data for 2021 are from Q1 for households and businesses and from Q2 for market agents.

Sources: Gallup, Central Bank of Iceland.

rate will hold broadly steady at the current level throughout the forecast horizon. However, inflation could taper off faster if the króna appreciates further, both by reducing imported inflation and by directing a larger share of domestic spending abroad, thereby easing strains on domestic factors of production. On the other hand, if the króna depreciates again, inflation would decline more slowly than is currently forecast, all else being equal.

The baseline forecast also assumes that inflation expectations will remain anchored to the target, even though inflation has been above target in the recent term. If they become unmoored, however, the inflationary impact of temporary cost increases could become more firmly entrenched than is currently forecast. The inflationary effects of last year's depreciation could also turn out stronger and taper off more slowly.

The path of the pandemic and the sustainability of the recent turnaround in demand will also weigh heavily in inflation developments over the forecast horizon. If the pandemic persists longer than is assumed in the baseline forecast and a setback occurs in the economic recovery, inflation could decline faster and to a lower level than in the forecast. On the other hand, the slack in the economy could be overestimated if the negative impact of the pandemic on potential output is greater than is currently assumed; therefore, underlying inflationary pressures could actually be stronger than is estimated at present. The same applies if the economic recovery proves stronger, exacerbating demand pressures on domestic prices. This will also be the case if housing market activity continues to grow at the current pace.

Consequently, the inflation outlook is unusually uncertain at present, and although inflation has been more persistent recently than was forecast in February and various uncertainties have therefore materialised, the risk profile is still considered to be tilted to the upside. ■