Growing risk of overheating in the domestic economy

The global economic outlook has deteriorated once again, and uncertainty has mounted since the forecast in the August Monetary Bulletin*. The outlook for exports is broadly unchanged, however, owing to offsetting effects from the prospect of continued strong growth in services exports and diminishing growth in other exports. Revised figures from Statistics Iceland imply strong GDP growth in H1/2015 and 5.6% year-on-year growth in Q2, the highest single-quarter growth rate since the beginning of 2008. GDP growth for 2015 as a whole is projected at 4.6%, almost ½ a percentage point more than was forecast in August. As in the Bank's previous forecasts, GDP growth is assumed to ease in 2016, although the outlook for the forecast horizon as a whole has improved. GDP growth in 2015 and ever since the economic recovery began in mid-2010 has been reflected to a significant degree in strong job creation, with unemployment declining sharply in spite of a sizeable increase in labour participation. Productivity has therefore been virtually flat in the past five years and productivity growth will, according to the forecast, remain below both its historical average and the level seen in previous recoveries. Inflation was somewhat lower in Q3 than had been forecast in August, and because of a stronger initial position, a higher exchange rate, and lower commodity and oil prices, the near-term inflation outlook improves from the previous forecast. On the other hand, there is the prospect of greater domestic inflationary pressures, as can be seen in a more pronounced positive output gap and larger rises in unit labour costs. The inflation outlook for the latter half of the forecast horizon is therefore considered broadly unchanged since August, although uncertainty has risen.*

I Economic outlook and key uncertainties

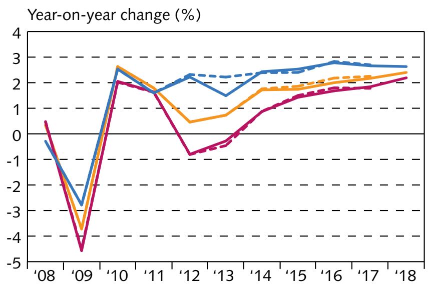
Central Bank baseline forecast[1]

Global economic outlook deteriorates again …

The International Monetary Fund's (IMF) most recent forecast provides for 3.1% global output growth this year, or 0.3 percentage points less than in 2014 and 0.2 percentage points below the Fund's summer forecast. The outlook has worsened for both developed and emerging countries – especially the latter – and if the forecast materialises, this will be the fifth consecutive year to see a year-on-year decline in emerging countries' GDP growth. The outlook has worsened in particular for commodity- and oil-exporting countries, which have lost revenues because of declining oil and commodity prices, and for countries with substantial US dollar-denominated debt, which have suffered from the appreciation of the dollar.

GDP growth among Iceland's main trading partners measured 1.9% in the first half of the year, slightly more than was forecast in the August *Monetary Bulletin*. The outlook for the year as a whole is slightly weaker than was forecast in August, however (Chart I-1). Trading partners' GDP growth is expected to be broadly unchanged year-on-year, at 1.7%, rising to 2% in 2016 and averaging 2¼% in 2017-2018. The GDP growth outlook for the forecast horizon as a whole has therefore deteriorated since August, and uncertainty about the global economy has increased again. Further discussion of the global economy can be found in Chapter II, and uncertainties in the global outlook are discussed later in this chapter.

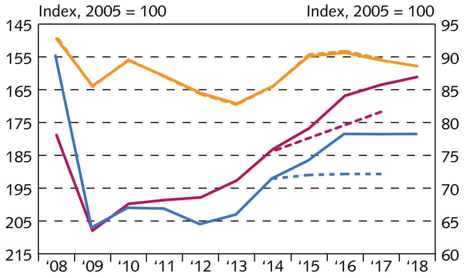
Chart I-1
Global output growth 2008-2018[1]



1. Central Bank baseline forecast 2015-2018. Broken lines show forecast from MB 2015/3.
Sources: Macrobond, OECD, Statistics Iceland, Central Bank of Iceland.

1. The analysis presented in this *Monetary Bulletin* is based on data available in early November.

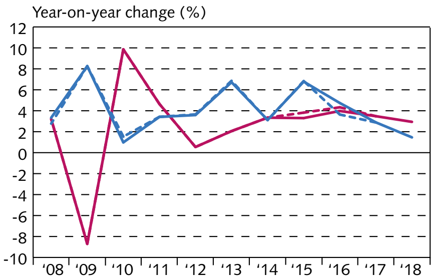
Chart I-2
Exchange rate and terms of trade 2008-2018[1]



TWI, MB 2015/4 (inverted left axis)
Real exchange rate, MB 2015/4 (right)
Terms of trade, MB 2015/4 (right)

1. Central Bank baseline forecast 2015-2018. Broken lines show forecast from MB 2015/3.
Sources: Statistics Iceland, Central Bank of Iceland.

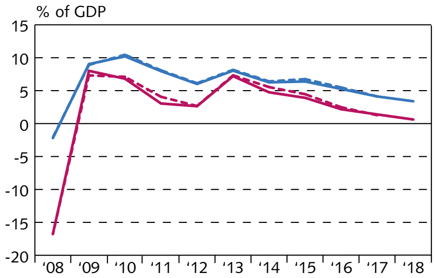
Chart I-3
Exports of goods and services 2008-2018[1]



Goods and services exports, MB 2015/4
Trading partners' imports, MB 2015/4

1. Central Bank baseline forecast 2015-2018. Broken lines show forecast from MB 2015/3.
Sources: Macrobond, Statistics Iceland, Central Bank of Iceland.

Chart I-4
Current account balance 2008-2018[1]



Trade account balance, MB 2015/4
Underlying current account balance, MB 2015/4

1. Central Bank baseline forecast 2015-2018. Broken lines show forecast from MB 2015/3.
Sources: Statistics Iceland, Central Bank of Iceland.

... with export growth likely to weaken in coming years

In spite of significant foreign currency purchases by the Central Bank, the exchange rate of the króna has risen by almost 4½% in trade-weighted terms since the August *Monetary Bulletin*. As in the Bank's previous forecasts, it is assumed that the trade-weighted index (TWI) will remain broadly unchanged for the remainder of the forecast horizon; therefore, the current forecast is based on a higher exchange rate than the August forecast (Chart I-2). The real exchange rate has also risen with the nominal appreciation of the króna and increases in domestic costs in excess of the trading partner average. According to the forecast, the real exchange rate will continue to rise throughout the forecast horizon and will be some 3% above its thirty-year average by 2018; however, it will still be nearly 18% below its pre-crisis high.

Terms of trade improved by about 10½% year-on-year in the first half of 2015, following a 3% improvement in 2014. This strong improvement is due primarily to the decline in global oil and commodity prices and the rise in marine product prices. The recovery is projected to slow down in the second half, and terms of trade are expected to improve by just over 5% this year, about ½ a percentage point less than was forecast in August. The outlook for coming years is unchanged since August, however, although uncertainty has grown in tandem with increased uncertainty globally.

Services exports grew considerably more in H1 than was assumed in the August forecast, owing mainly to the burgeoning tourism sector and to substantial and unforeseen one-off revenues from patent applications. Although these one-time revenues probably do not reflect developments over the year as a whole, the outlook for 2015 is nonetheless for strong growth in services exports. Offsetting this, however, are weaker marine product exports, owing to reduced mackerel catches, the Russian import ban, and weak sales to Nigeria. Growth in goods and services exports is therefore estimated at 6.8% this year, as in the August forecast (Chart I-3). According to the forecast, export growth will slow down somewhat over the next three years, in line with the rising real exchange rate (see the discussion of the effects of exchange rate movements on external trade in Box 2). Goods exports are expected to be weaker next year than was projected in August, as the rise in the real exchange rate is larger and trading partner demand weaker than was forecast then. This is offset by the improved outlook for tourism, however.

As in the Bank's previous forecasts, it is assumed that the trade surplus will diminish somewhat in coming years, mainly due to strong imports, although this will be offset by the improvement in terms of trade that began last year and looks set to continue into 2016. The surplus on goods and services trade is forecast to shrink from 6½% of GDP in 2015 to about 3½% by 2018 (Chart I-4). The underlying current account surplus will narrow accordingly, from 4% of GDP this year to ½% by 2018. Further discussion of the real exchange rate and terms of trade can be found in Chapter II, and the external balance is discussed in Chapter IV.

Strong domestic demand growth in 2014 and even more expected this year

According to preliminary figures from Statistics Iceland, private consumption grew by about 4.4% year-on-year in the first half of 2015, owing to a number of factors: a significant rise in real disposable income stemming from large wage increases, increased employment, and relatively low inflation, and improvements in household equity stemming from rising asset prices and reduced debt. The outlook is for this to continue and to be augmented by proposed tax cuts, which will stimulate household demand still further. Private consumption is projected to grow by 4.6% this year, somewhat more than was forecast in August, and by about 4% per year over the next three years. Although this is a significant growth rate, it is well below growth in real disposable income; therefore, household saving is forecast to increase over the forecast horizon.

Investment also grew markedly in the first half of the year. Total investment was up 21% year-on-year, including a 38% rise in business investment. These figures are affected somewhat by strong investment in ships and aircraft, but even if these items are excluded, there is a considerable amount of investment activity, and the Bank's recent investment survey indicates that it is likely to continue. Total investment is projected to grow by nearly 21% this year and another 11½% in 2016, and the investment-to-GDP ratio is expected to rise from last year's 16.7% to nearly 20% by 2018.

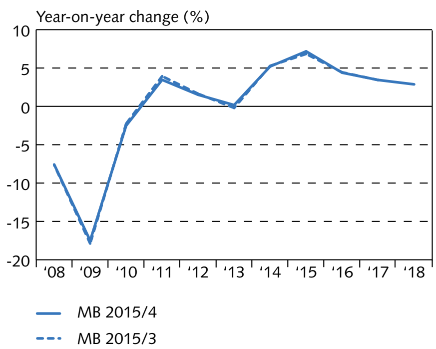
On the whole, domestic demand is forecast to grow by 7.2% this year, after a growth rate of 5% in 2014 (Chart I-5). As was forecast in August, the pace of growth will ease somewhat in coming years but will remain robust. Further discussion of private and public sector demand can be found in Chapter IV.

GDP growth robust in 2015 but projected to taper off gradually

According to preliminary figures from Statistics Iceland, GDP growth measured 5.6% in Q2, the strongest single-quarter measurement since the beginning of 2008. Statistics Iceland also revised previously published figures and now estimates Q1 GDP growth at 4.8% instead of the previous 2.9%. H1 GDP growth is now estimated at 5.2%, well above the 3% projected in the Bank's August forecast. Statistics Iceland's current assessment is much closer to the Bank's May forecast of 4.8%, which was prepared before the first preliminary figures for Q1 were available. Although strong GDP growth in the first half reflects in part the above-mentioned one-off effects from services exports, the outlook for the year as a whole has been revised upwards since the August forecast, with 2015 GDP growth now forecast at 4.6%. This is 0.4 percentage points above the August forecast but in line with the forecast from May. The improved outlook reflects both strong growth in domestic demand and a slightly more positive contribution from net trade.

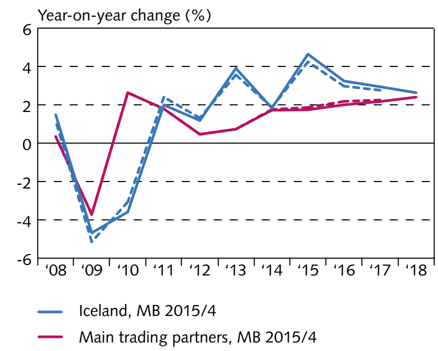
As in the August forecast, GDP growth is assumed to ease in coming years, although it is still expected to remain above its long-term average for the majority of the forecast horizon. It is projected at 3.2% in 2016, 3% in 2017, and 2½% in 2018. To some extent,

Chart I-5
Domestic demand 2008-2018[1]



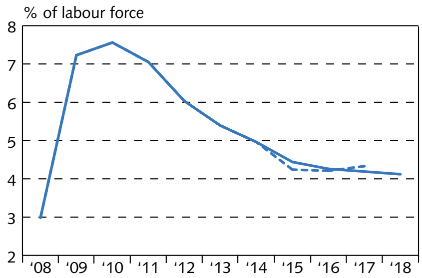
1. Central Bank baseline forecast 2015-2018.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-6
GDP growth in Iceland and trading partners 2008-2018[1]



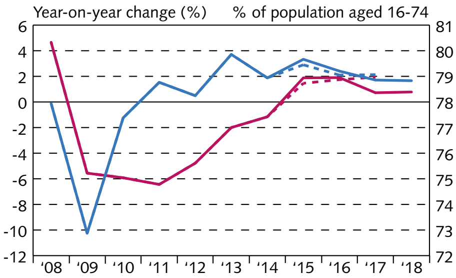
1. Central Bank baseline forecast 2015-2018. Broken lines show forecast from MB 2015/3.
Sources: Macrobond, Statistics Iceland, Central Bank of Iceland.

Chart I-7
Unemployment 2008-2018[1]



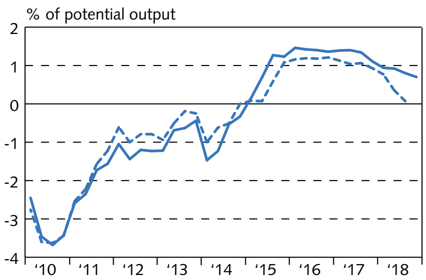
1. Central Bank baseline forecast 2015-2018.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-8
Total hours worked and employment rate 2008-2018[1]



1. Central Bank baseline forecast 2015-2018. Broken lines show forecast from MB 2015/3.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-9
Output gap[1]
Q1/2010 - Q4/2018



1. Central Bank baseline forecast Q3/2015-Q4/2018.
Source: Central Bank of Iceland.

this year's strong output growth reflects the unusually rapid rise in tourism, but it also bears witness to the temporary stimulative impact of large wage increases and Government policy actions, such as household debt relief measures, which fuel private consumption. As the forecast horizon progresses, the effects of these will taper off, and dwindling export growth and sluggish productivity growth will weigh more heavily. Further discussion of developments in GDP growth can be found in Chapter IV.

Job creation continues, but low productivity growth gives cause for concern

Seasonally adjusted unemployment measured 4% in Q3/2015, having declined by ½ a percentage point year-on-year and more than 4 percentage points from its post-crisis high. Declining unemployment is due to job creation; however, the participation rate has also risen markedly. The seasonally adjusted labour participation rate is now 3 percentage points above the post-crisis trough from Q4/2011 and is closing in on its peak from early 2007. The employment rate has risen as well and was up 1½ percentage points year-on-year in Q3. Other indicators from the labour market point in the same direction.

As in the Bank's previous forecasts, the recovery of the labour market is projected to continue, with declining unemployment and an increase in the number of jobs and total hours worked. The recovery is forecast to be somewhat weaker than was assumed in August, however, due to the expectation of larger rises in unit labour costs. Unemployment will fall from its 4.4% average for this year to about 4% in 2018 (Chart I-7), and total hours worked will increase, on average, by just over 2% per year (Chart I-8). The employment rate will therefore taper off slightly from the current high.

Productivity has been virtually flat for five years in a row but is expected to pick up a bit this year, growing about 1¼%, as in the August forecast (see Chart I-10 below). Productivity is expected to grow by approximately 1% per year over the forecast horizon, broadly in line with the average of the past ten years but somewhat below both the long-term average and the growth rate seen in previous recoveries. Further discussion of the labour market can be found in Chapter IV.

Outlook for a wider positive output gap than previously forecast

In line with Statistics Iceland's revision of historical GDP growth figures, the slack in the economy between 2011 and 2014 is now considered to have been just under ½ a percentage point per year larger than previous figures indicated. As in August, however, the spare capacity is considered to have disappeared early this year, and owing to stronger GDP growth both in 2015 and over the forecast horizon as a whole, the outlook is for a somewhat wider positive output gap than was previously projected. It is forecast to peak at 1½% of potential output early in 2016 and to remain at about that level until mid-2017 before narrowing once again (Chart I-9). According to the forecast, a slight positive gap will nonetheless remain at the end of the forecast horizon, owing to robust economic activity during the period.

As always, the assessment of the output gap is highly uncertain. A discussion of the main uncertainties in the assessment is below, and a discussion of factor utilisation can be found in Chapter IV.

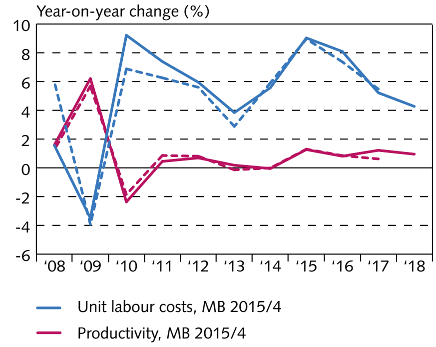
Inflation outlook improved for the near term but unchanged further ahead

Inflation measured 1.8% in October and only 0.3% excluding the housing component of the CPI. By that measure and according to various measures of underlying inflation, it has risen slightly since the beginning of the year. The same is true of most measures of inflation expectations, although it is unusually difficult to interpret developments in measures of inflation expectations in the bond market because of capital inflows that have suppressed the long end of the yield curve (see Chapter III and Box 1).

Inflation averaged 2% in the third quarter of the year, 0.4 percentage points below the forecast in the August *Monetary Bulletin*. The deviation is due primarily to a stronger króna and steeper declines in global oil and commodity prices than in the August forecast. Furthermore, the inflationary effects of the recent wage settlements appear to be more modest than was assumed then, probably due in part to the appreciation of the króna and the improvement in terms of trade in recent months. It is still too early to determine the ultimate effect of the large pay increases provided for in the wage settlements, however, and it is likely that the arbitration panel ruling in August will entail larger pay hikes during the forecast horizon than was assumed in the August forecast. Although offset by somewhat more rapid productivity growth in the latter half of the forecast horizon, unit labour costs are still projected to rise steeply, or by 9% this year and 8% in 2016. If the forecast materialises, the increase in 2015 and the ensuing three years will average 6.7% per year, far in excess of the level compatible with medium-term price stability (Chart I-10).

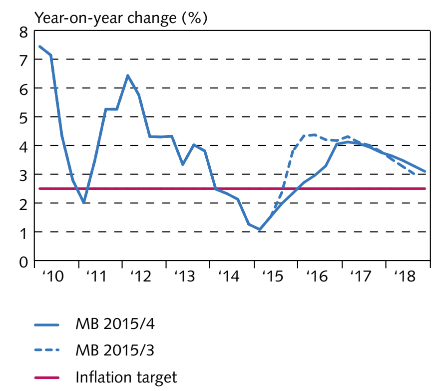
The near-term inflation forecast has improved markedly from the August forecast, although significant and growing domestic inflationary pressures remain and could take hold once the effects of a stronger króna and lower import prices begin to taper off. In Q4/2015, inflation is projected to be at 2.3%, 1½ percentage points less than was forecast in August (Chart I-11). According to the forecast, it will continue to inch upwards, albeit somewhat more slowly than was forecast in August. As was projected then, it is expected to be at or above 4% from the end of 2016 into H2/2017 and then begin to taper off again. In comparison with the August forecast, inflation will therefore be 1-1½ percentage points lower until the second half of 2016, owing primarily to a better initial position, a stronger króna, and lower oil and commodity prices. Offsetting this is the prospect of stronger domestic inflationary pressures, as is reflected in a wider output gap and larger increases in unit labour costs. The inflation outlook is highly uncertain at present, however. The uncertainties in the inflation forecast are discussed below, and developments in global prices and domestic inflation and inflation expectations are discussed in Chapters II and V.

Chart I-10
Unit labour costs and productivity 2008-2018[1]



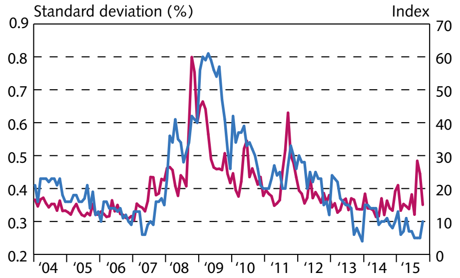
1. Productivity measured as the ratio of GDP to total hours worked. Central Bank baseline forecast 2015-2018. Broken lines show forecast from MB 2015/3.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-11
Inflation[1]
Q1/2010 - Q4/2018



1. Central Bank baseline forecast Q4/2015-Q4/2018.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-12
Dispersion of output growth forecasts and implied stock price volatility
January 2004 - October 2015



Dispersion of output growth forecasts (left)[1]
VIX index (right)[2]

1. Weighted average of standard deviation in output growth forecasts compiled by Consensus Forecasts for the G7 (weighted with PPP-adjusted GDP). 2. Chicago Board Options Exchange S&P 500 Implied Volatility Index (VIX).
Sources: Consensus Forecasts, Macrobond.

Key uncertainties

The baseline forecast reflects an assessment of the most likely economic developments over the next three years. It is based on forecasts and assumptions concerning developments in the external environment of the Icelandic economy, as well as assessments of the effectiveness of specific markets and on the transmission of monetary policy to the real economy. All of these factors are subject to uncertainty. The following is a discussion of several important uncertainties in the forecast.

Growing uncertainty about the global economy

Uncertainty about the global economy appears to have risen again, primarily concerning the outlook in emerging market economies, including China and oil- and commodity-exporting countries (Chart I-12). The appreciation of the US dollar has tested balance sheets in many such countries, particularly in those where financial imbalances have accumulated in recent years, and has exacerbated the situation resulting from falling oil and commodity prices. By the same token, expectations of a policy rate hike in the US have significantly reduced capital flows to these countries and have increased the risk of a setback in an already fragile economic recovery, particularly if interest rate hikes go hand-in-hand with further appreciation of the dollar. Some geopolitical uncertainty remains, and while it has probably subsided on the whole over the past year, the heavy streams of refugees from the bottom of the Mediterranean have created new points of friction. Further ahead, difficulties in bringing inflation up to target and unfavourable age demographics in many advanced economies could indicate that the global GDP growth outlook is too optimistic. Global GDP growth could also turn out stronger than the baseline forecast indicates if, for instance, the decline in oil and commodity prices affects demand in industrialised countries more than is currently assumed or if the European Central Bank's (ECB) recent stimulative measures prove more effective than has been suggested. As before, with respect to the global economic outlook, the risk in the baseline forecast is tilted to the downside.

Exchange rate developments uncertain

As before, the baseline forecast assumes that the exchange rate of the króna will remain stable throughout the forecast horizon. There is some uncertainty about this, however. The króna could weaken, for example, if terms of trade deteriorate. Strong increases in domestic wage costs following the recent wage settlements will also lead to a rise in the real exchange rate, thereby creating growing downward pressure on the nominal exchange rate, particularly in the longer term.

On the other hand, the exchange rate could rise from the level assumed in the baseline forecast. The recent appreciation of the króna stems in part from more favourable economic developments in Iceland than in neighbouring countries, and the possibility that this will continue cannot be excluded. The króna could also appreciate if there is an increase in inflows of capital in search of better returns or if

Iceland's terms of trade improve more than is assumed in the baseline forecast.

Uncertainty could increase temporarily upon settlement of the failed banks' estates

The settlement of the failed banks' estates lies ahead, in connection with liberalisation of the capital controls. The forecast assumes that settlement will take place through, among other things, the payment of a stability contribution, which could affect domestic balance sheets during the settlement process.[2] The objective is to use market operations so as to prevent settlement from affecting the liquidity supply or the money stock so it would not cause the monetary stance to diverge from the Monetary Policy Committee's (MPC) objectives. The transformations could prove so pronounced, however, that attempts to counteract them will not be entirely successful. There is therefore the risk that settlement will cause a temporary disturbance in liquidity and the monetary stance, which could exacerbate uncertainty for a time, although this risk is less than it would be if the settlement were to take place through the stability tax.

Difficulties in monetary policy transmission

Until recently, changes in Central Bank interest rates have been transmitted more or less smoothly along the yield curve and to the interest rates offered to households and businesses. Now, however, it appears that the transmission of monetary policy to other interest rates has been weakened. Domestic long-term bond interest rates have fallen considerably in the recent term (Chart I-13), and although the effects of this can be seen only to a limited extent in households' and businesses' interest rate terms, it is not unlikely that this drop in long-term rates will gradually spread to the terms offered to households and businesses. As is discussed in Chapter III and Box 1, this reduction in long-term rates is linked to increased capital inflows, which have lowered term premia in the bond market. This development is not unique to Iceland, and there are numerous examples of similar trends elsewhere, even in large economies like the US. This does not change the fact that it makes it more difficult for monetary policy to affect domestic interest rates to the intended degree. Under such conditions, market interest rates and rates offered to borrowers could decline during an attempt at monetary tightening. The monetary policy transmission mechanism therefore shifts from domestic interest rates to the exchange rate, which is unfortunate, as the exchange rate channel of monetary policy is less reliable. In view of this, the MPC has been examining ways to use other policy instruments in addition to interest rates.

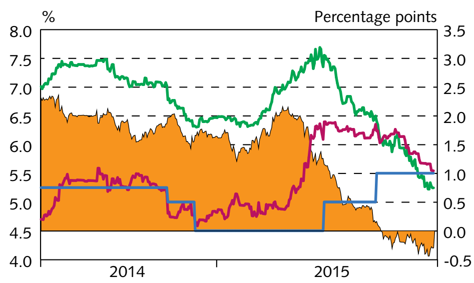
Increased uncertainty about the monetary and fiscal policy mix

According to the baseline forecast, the new fiscal budget proposal represents an easing of fiscal policy of about 1½% of GDP in 2015

Chart I-13

Key Central Bank rate and nominal Treasury bond yields

Daily data 21 May 2014 - 30 October 2015

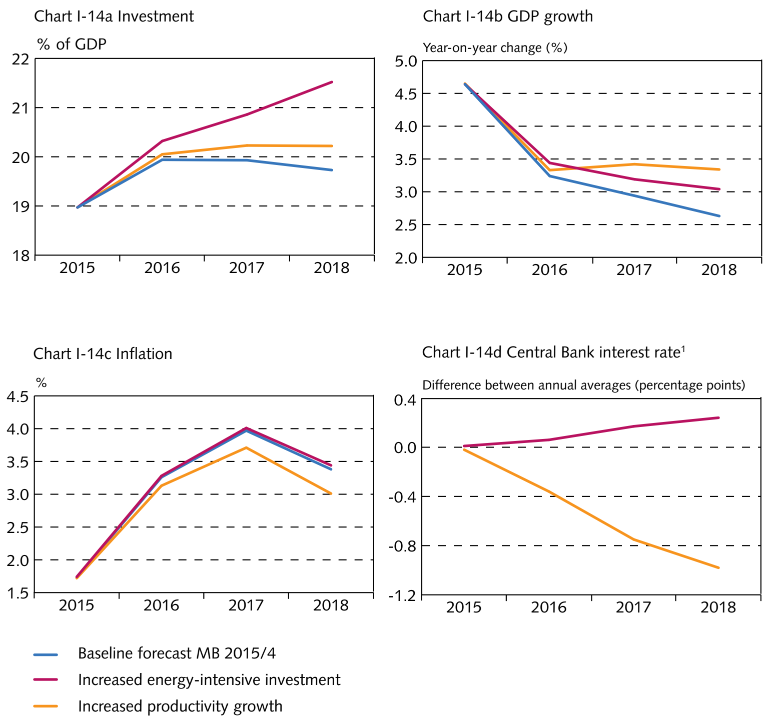


Source: Central Bank of Iceland.

2. See, for instance, Thorvardur Tjörvi Ólafsson (2015), "Economic analysis of capital account liberalisation in Iceland". Central Bank of Iceland *Special Publication* (forthcoming).

and 2016 (see Chapter IV and Box 3). This easing not only calls for a tighter monetary stance but also increases the risk of negative side effects of a suboptimal policy mix. The budget proposal and the medium-term fiscal plan are based on expenditure assumptions that in some cases appear fragile; for instance, as regards public employees' pay increases and estimated expenditures for operations and infrastructure investments. Therefore, there is the risk that the operating surplus will be smaller than is assumed unless further consolidation is achieved elsewhere. On the other hand, the revenue assumptions could underestimate cyclical revenues in view of increased strength in the economy. If this materialises, it is important to avoid relinquishing these revenues with further tax cuts unless countervailing measures on the expenditures side are imposed to offset them. This applies in particular to potential revenues reverting to the authorities upon the settlement of the failed banks' estates. It is vital that those revenues not be allocated so as to exacerbate the expansion of the economy, either through increased spending or through tax cuts. Such a scenario would require an even tighter monetary stance and create an even less optimal monetary and fiscal policy mix.

Chart I-14
Alternative scenarios



1. Deviation from baseline forecast.
Source: Central Bank of Iceland.

Energy-intensive investment could prove stronger than in the baseline forecast

According to the baseline forecast, investment in the energy-intensive sector will increase markedly in coming years, in part due to the construction of three silicon plants. There are also plans to build a fourth silicon plant of roughly the same size as the other three combined. If these plans come to fruition, investment in the energy-intensive sector could prove to be even stronger during the forecast horizon than is assumed in the baseline forecast. Chart I-14 shows the potential impact of building the fourth silicon plant, with construction estimated to begin in mid-2016 and production to start in 2019. As the chart shows, investment would grow somewhat more strongly than in the baseline forecast, and the investment-to-GDP ratio could turn out nearly 2 percentage points higher by 2018 than is assumed in the baseline scenario. GDP growth could be ¼ of a percentage point stronger in the next two years and almost ½ a percentage point more in 2018. Increased economic activity fuels domestic inflationary pressures, but this is offset by the appreciation of the króna, partly because of increased inflows of foreign capital in connection with the project but also because domestic interest rates will be higher than they would otherwise, and Central Bank rates will be about ¼ of a percentage point higher in 2018.

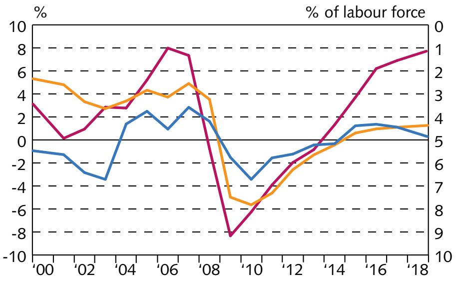
Increased productivity growth could offset large wage rises

According to figures from Statistics Iceland, labour productivity has been broadly unchanged for the past five years and has grown by less than 1% per year, on average, since the financial crisis struck in autumn 2008. This is considerably below productivity growth in previous recoveries and far below the thirty-year average. According to the baseline forecast, productivity growth will remain around 1% per year throughout the forecast horizon. Such weak productivity growth over such a long period of time is cause for concern, although similar developments can be seen among most other developed countries (the possible reasons for this are discussed in Chapter IV of *Monetary Bulletin* 2015/2), as productivity growth is one of the fundamentals that determine an economy's long-term potential output and one of the most important determinants of how rapidly an economy can grow without increased inflationary pressures. If productivity growth returns to its historical average beginning in 2016, potential output will increase accordingly and inflationary pressures will be reduced. Interest rates could therefore be lower than would otherwise be required, further supporting domestic demand and GDP growth. As can be seen in Chart I-14, the ratio of investment to GDP will be as much as 1 percentage point higher in 2018 than in the baseline forecast, and GDP growth will be just over ½ a percentage point more per year from 2017 onwards. Inflation will also be about ½ a percentage point less than in the baseline forecast, and Central Bank interest rates will be about 1 percentage point lower by 2018.

The impact of wage negotiations on demand and inflation possibly underestimated

The recently concluded private sector wage agreements have dramatically increased domestic inflationary pressures. Following the arbitration panel ruling on pay rises for university-educated public employees, labour market unrest has escalated yet again, and it is likely that the ruling will lead to even larger pay rises early next year, owing to the review clauses in the private sector contracts. The baseline

Chart I-15
Output gap, unemployment, and wage share 2000-2018[1]



1. Central Bank baseline forecast 2015-2018.
Sources: Statistics Iceland, Central Bank of Iceland.

forecast takes account of these factors, but there is still considerable uncertainty about the ultimate effect of the original wage agreements and the turmoil caused by the arbitration panel ruling (see also Box 4). Inflation has certainly risen more slowly than the Bank had previously assumed, both in its analysis last spring of the impact of wage settlements (see Chapter I in *Monetary Bulletin* 2015/2) and in its August forecast. But only a short time has passed, and as yet there are no clear signs that firms are absorbing the cost increases with additional streamlining, at least not if recent developments in employment and recruitment plans are reliable indicators. At all events, the rapid rise in the wage share indicates the risk that the baseline forecast represents an underestimation of the economic imbalances that could result from these wage settlements and that demand growth will turn out even stronger and economic imbalances will develop more rapidly than in the baseline scenario (Chart I-15).

Therefore, the uncertainties discussed in Chapter I of *Monetary Bulletin* 2015/2 still apply. Fiscal targets could be jeopardised, for instance, which could increase risk premia on domestic financial assets, raising domestic borrowers' financing costs and possibly undermining the capital account liberalisation strategy. This uncertainty and the poorer competitive position that accompanies steep rises in domestic costs (see Box 2) could also put additional pressure on the exchange rate of the króna, which increases the risk that the impact of wage rises on inflation is underestimated in the baseline forecast.

Increased uncertainty about the inflation outlook, with risk concentrated on the upside

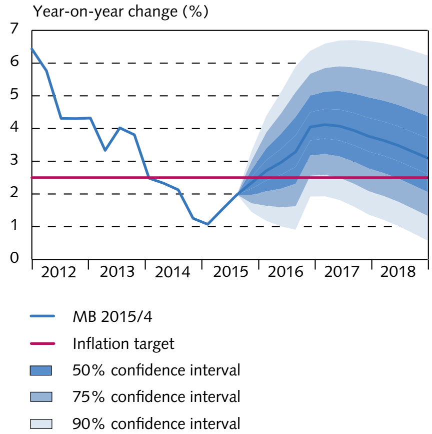
The uncertainties described above show clearly that the inflation outlook for the next three years could easily deviate from the scenario presented in the baseline forecast. Inflationary pressures could be underestimated, which (other things being equal) would call for higher interest rates than are implied in the baseline forecast in order to keep inflation at target if, for instance, firms pass the cost increases from the recent wage settlements through to price levels to a greater extent than is assumed in the baseline scenario or if the impact on private consumption of the strong temporary rise in real disposable income is underestimated.[3] Inflation could also prove more persistent than is forecast if these hefty pay increases de-anchor inflation expectations still further. The same applies if the króna proves weaker over the forecast horizon than is assumed in the baseline forecast or if the tension in the economy is more pronounced; for instance, if activity in the energy-intensive sector is greater than forecast, or if there is more slack in fiscal policy. The recent weakening of the monetary policy transmission mechanism could also make it more difficult for monetary policy to contain domestic demand, which could lead to higher inflation than is forecast, other things being equal. On the other hand, inflation could prove lower than is forecast if the global economic outlook worsens or global oil and commodity prices fall still

3. The baseline forecast is based on the assumption that monetary policy will be applied so as to ensure that inflation remains close to target throughout the business cycle.

further. The króna could also turn out stronger than is assumed in the baseline forecast, and firms could respond to the steep rise in wage costs by cutting their own profit margins or with increased streamlining. Productivity growth could also prove stronger than in the baseline forecast, which would counteract to a greater degree the inflationary pressures from the labour market.

Chart I-16 illustrates the above-mentioned uncertainties in the inflation forecast by showing the inflation outlook according to the baseline forecast together with the confidence intervals for the forecast; i.e., the range in which there is considered to be a 50%-90% probability that inflation will lie over the next three years (the methodology is described in Appendix 3 in *Monetary Bulletin* 2005/1). Uncertainty about the inflation outlook is considered to have grown since August, in part due to increased tension in the labour market and greater uncertainty about the global economy. As in August, the risk to the inflation forecast is tilted to the upside throughout the forecast horizon. There is a roughly 50% probability that inflation will be in the 3¼-5% range in one year and in the 2-4½% range by the end of the forecast horizon.

Chart I-16
Inflation forecast and confidence intervals
Q1/2012 - Q4/2018



Sources: Statistics Iceland, Central Bank of Iceland.