Inflation outlook improves with stronger króna

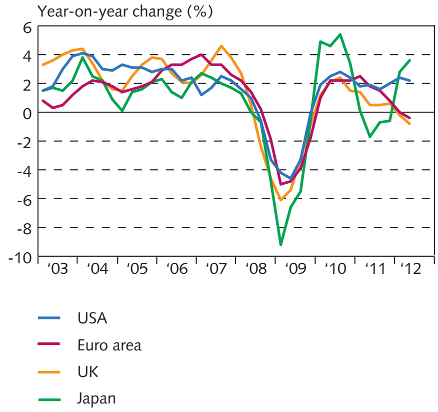
The króna has appreciated significantly since May, when the last Monetary Bulletin *was published. Positive exchange rate developments and lower petrol prices have kept inflation lower than was forecast at that time. In spite of the weaker global economic outlook, the domestic economy has been stronger than previously assumed, with GDP growth currently projected at just over 3%, about ½ a percentage point above the May forecast. The improved growth outlook is driven primarily by stronger export growth. For 2013, it is assumed that export growth will be correspondingly less and output growth therefore weaker than projected in May. The outlook for 2014 has improved, however, with GDP growth forecast at 3½% instead of just under 3%, as in the last forecast. The recovery of the domestic labour market has also been stronger than was forecast in May: unemployment has declined more rapidly, and the rise in total hours worked has been larger. Inflation is expected to continue to ease, falling to about 3% in the latter half of 2013 and converging with the Central Bank's inflation target by the end of 2014, which accords with the May forecast. As before, this is highly uncertain; inflation could subside faster or slower, depending on exchange rate developments. The strength and durability of the domestic economic recovery are uncertain as well, particularly in view of the troubled global outlook.*

Global economic affairs and external trade

- Output growth slowed down in Iceland's main trading partner countries towards the end of 2011 and continued to decline in the first half of 2012. Growth gained pace in some economies, however, such as the Nordic countries.
- Major economic indicators for the euro area and the US, released since the publication of the May *Monetary Bulletin*, have been generally worse than most analysts had predicted. Because of this, together with continued problems in the euro area and doubts about euro area governments' ability and willingness to solve their problems, growth forecasts for the region have been revised downwards for 2012 and 2013 since the last *Monetary Bulletin*.
- At the beginning of the year, output growth was flat in the euro area as a whole, and in Q2, GDP contracted by 0.2% from the previous quarter. In the UK, the contraction that commenced at the end of 2011 gained momentum in the first half of 2012. In the US, growth accelerated slightly in 2011 and early 2012, only to slow down once again in Q2. In Japan, the contraction that began after the early-2011 earthquake eased towards the end of the year, and growth was measured again in the first half of 2012.
- GDP growth forecasts for 2012 have been revised downwards for most of Iceland's major trading partners, apart from Japan. Consensus Forecasts now projects 0.7% growth in Iceland's main trading partner countries this year, which is in line with the International Monetary Fund (IMF) forecast of 0.8%. The Organisation for Economic Co-operation and Development

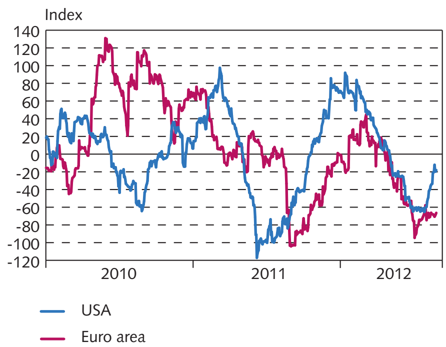
1. The analysis appearing here is based in large part on the Bank's assessment of economic developments, published in May 2012 in *Monetary Bulletin* 2012/2, and on the updated forecast presented here. It is based on data available as of mid-August.

Chart 1
International GDP growth
Real GDP growth Q1/2003 - Q2/2012



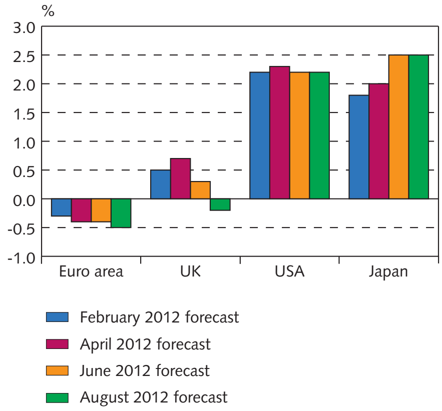
Source: Macrobond.

Chart 2
Economic surprise index[1]
Daily data 1 January 2010 - 17 August 2012



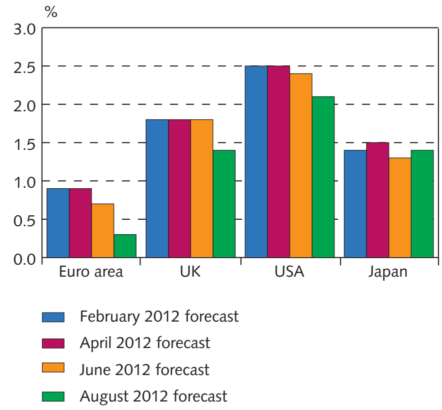
1. When the index is lower than 0, the indicators are more negative than expected; when the index is higher than 0, the indicators are more positive than expected. The index does not imply that the indicators are positive or negative.
Source: Macrobond.

Chart 3
GDP forecasts for 2012[1]



1. Based on monthly forecasts from 250 forecasting agencies.
Source: Consensus Forecasts.

Chart 4
GDP forecasts for 2013[1]



1. Based on monthly forecasts from 250 forecasting agencies.
Source: Consensus Forecasts.

(OECD) is somewhat more upbeat, forecasting 1.1% growth among Iceland's trading partners this year. The Central Bank's baseline forecast assumes 0.7% output growth among Iceland's main trading partners in 2012 and 1.4% in 2014, somewhat below the May forecast. The prospects for 2014 have worsened as well: output growth is now projected at 2.2% instead of the 2.5% assumed in May.

- The inflation outlook for Iceland's major trading partners is unchanged since May. Inflation peaked in the US, the UK, and the euro area last autumn and has tapered off steadily since. In the UK and the euro area, it is still marginally above the respective central banks' inflation targets.

- In early July, the policy rate in the euro area was lowered by 0.25 percentage points to the current 0.75%, the lowest ECB policy rate ever. The policy rate in Denmark has been lowered as well and has been below the ECB rate since November. In the other Nordic countries and in a number of emerging economies, including China and Brazil, policy rates have also been cut in recent months.

- In the latter half of 2011, growth in world trade began to slow down in line with declining output growth. That trend continued early in 2012. Both the OECD and the IMF have reduced their forecasts for global trade in 2012 and 2013 since the publication of the May *Monetary Bulletin*.

- Global commodity prices bottomed out towards the end of 2011 and then rose steeply in the first four months of 2012. Prices plunged again over the summer, only to recover fully in July. Commodity market analysts expect prices to rise until the latter part of this year and then fall in 2013. The average decline during the year is projected at 7% instead of the 8% in the May forecast, due in particular to a larger-than-expected increase in Q1. Oil prices, however, have been considerably lower year-to-date than was assumed in May. As a result, they are now expected to be broadly in line with last year's prices, on average, whereas in the last *Monetary Bulletin*, they were forecast to rise by 7% this year. The outlook for next year is for a 4½% decline, which is similar to the last forecast.

- The price of Iceland's principal exports has been revised downwards from the May forecast. The change is due primarily to substantially lower aluminium prices than projected in May, in addition to a marked slowdown in the rise in marine product prices. It is now assumed that aluminium prices will decline by about 15% this year instead of the 7½% in the May forecast. Marine product prices are projected to rise by only 2½% instead of the previously forecasted 3½%. The outlook for marine product prices in 2013 has deteriorated as well.

- The real exchange rate has risen somewhat in recent months, and in July it was almost 4% higher than in May. The main driver of the rise is the nominal appreciation of the króna, although inflation has also been higher in Iceland than in most major trading partners. The real exchange rate is still very low, in historical context, however.

- Terms of trade for goods and services are expected to be considerably poorer in 2012 than according to the May forecast, as the worsening outlook for export prices (particularly aluminium) outweighs the smaller rise in import prices. Terms of trade are expected to deteriorate by over 2% this year, whereas the previous forecast assumed no change. They are projected to remain more or less unchanged over the next two years, which is broadly in line with the last forecast.

- Goods and services exports are assumed to increase by 5.4% this year instead of the 3.8% in the last forecast. The main difference is in stronger marine exports, although exports of aluminium products and other industrial goods are expected to increase as well. Services exports are expected to be in line with the levels projected in May. Because of stronger export growth in 2012, correspondingly weaker growth is expected in 2013. The projection for 2014 is broadly in accordance with the May forecast.

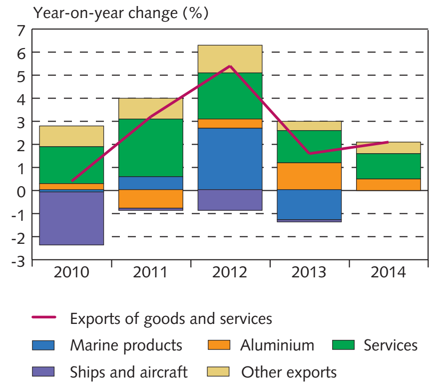
- The trade surplus was down sharply year-on-year in Q1/2012. The surplus on goods trade in Q2 was somewhat smaller than in Q2/2011. In spite of stronger export growth, it is now assumed that the trade surplus for the year will be about ½ a percentage point less than in the May forecast, or about 6½% of GDP instead of 7%. The surplus for the next two years is estimated at 4-5% of GDP, roughly 2 percentage points below the May forecast. This is due primarily to poorer terms of trade, but stronger import growth is also expected in both years.

- The 2012 deficit in the balance on income is expected to be somewhat larger than was forecast in May, owing to a larger-than-expected deficit in Q1. The headline current account deficit for the year is therefore estimated to be larger than according to the last *Monetary Bulletin* forecast. It is expected to measure 6.7% of GDP in 2012, which is similar to 2011, whereas a 5% deficit was forecast in May. Excluding the deposit money banks (DMBs) in winding-up proceedings, a 0.2% current account surplus is expected, which is in line with the May forecast. Excluding the pharmaceuticals company Actavis as well, the surplus is estimated at 3.5% for 2012 and 1-2% for the following two years, somewhat less than was projected in May.

Domestic financial markets

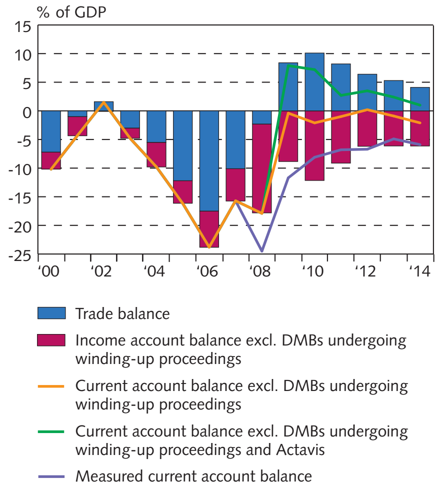
- The Central Bank of Iceland Monetary Policy Committee (MPC) raised the Bank's interest rates by 0.5 percentage points in May, when *Monetary Bulletin* was last issued, and by an additional 0.25 percentage points at its 13 June meeting. Prior to the publication of this *Monetary Bulletin*, the current account rate was

Chart 5
Export development and its main components 2010-2014[1]



1. Central Bank baseline forecast 2012-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6
Current account balance 2000-2014[1]

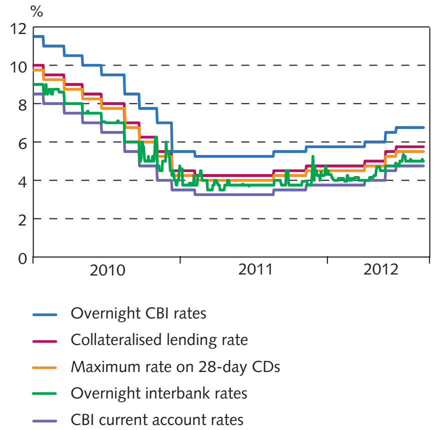


1. Net current transfers are included in the balance on income. Central Bank baseline forecast 2012-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7

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

Daily data 1 January 2010 - 17 August 2012

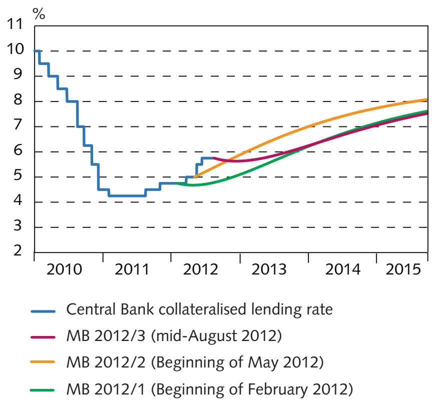


Source: Central Bank of Iceland.

Chart 8

Collateralised lending rate and forward market interest rates[1]

Daily data 1 January 2010 - 30 September 2015

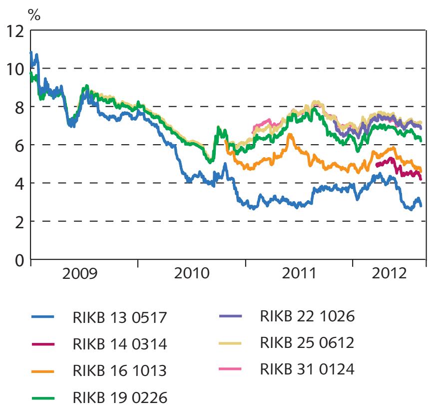


1. Interbank interest rates and Treasury bonds were used to estimate the yield curve.
Source: Central Bank of Iceland.

Chart 9

Yields on nominal Treasury bonds

Daily data 2 January 2009 - 17 August 2012



Source: Central Bank of Iceland.

4.75%, the maximum rate on 28-day certificates of deposit (CDs) was 5.5%, the seven-day collateralised lending rate was 5.75%, and the overnight lending rate was 6.75%.

- The Central Bank's real interest rate has risen concurrent with policy rate increases since May and is now 0.5%, according to the average of the various measures of inflation and inflation expectations. It is therefore about 1.7 percentage points higher than just before the May *Monetary Bulletin* was published, and 1.3 percentage points higher than a year ago. Monetary policy has therefore tightened since May, although the Bank's real rate is still very low.

- According to forward interest rates, the market appears to expect the MPC to keep Central Bank rates unchanged well into 2013. On the other hand, the Bank's market expectations survey indicates that market participants expect an additional 0.25-point increase in 2012. It is likely that measurement problems at the short end of the yield curve (owing to the inefficiency of the domestic interbank market) cause the yield curve to give unreliable indications of market expectations about the Central Bank's near-term interest rate decisions.

- Short-term interbank market interest rates have crept upwards, in line with rising Central Bank rates. Because of abundant liquidity, however, interbank rates are still below the centre of the interest rate corridor. Since the publication of the May issue of *Monetary Bulletin*, the yield on long nominal bonds has dropped by 0.3-1.0 percentage points. Yields on indexed bonds have remained unchanged or fallen slightly, however.

- Since the last *Monetary Bulletin* appeared, the long-term interest rate differential against German government bonds has declined by 0.7 percentage points, to about 5.1%. The spread on short-term bonds has declined by 0.5 percentage points over the same period.

- The CDS spread on the Republic of Iceland has fallen by 0.1 percentage points since the May *Monetary Bulletin*, to 2.8%. The risk premium on Treasury debt according to the interest rate differential between five-year Icelandic Treasury bonds in US dollars and a comparable bond issued by the US Treasury has narrowed by 0.6 percentage points, however, to roughly 3.3% as this *Monetary Bulletin* went to press. The spread on a comparable 10-year bond has narrowed similarly.

- In trade-weighted terms, the Icelandic króna has appreciated by 8.2% since the last *Monetary Bulletin*. It has appreciated by just over 10% against the euro and about 5.2% against the US dollar. The larger rise against the euro stems from the euro's decline against other currencies. Domestic firms and institutions have slowed the pace of their foreign loan repayments in the recent term, easing some of the pressure on the króna. It is also possible that the króna is being supported by the surge in foreign currency inflows from the summer tourist season and increased repatriation of exporters' foreign currency following the tightening of the Foreign Exchange Act last March.

- The króna traded at an average of 163 per euro in Q2, a full 2% above the exchange rate forecast in May. It has continued to strengthen in Q3 and looks set to average about 150 against the euro during the quarter. It is expected to remain around that level throughout the forecast horizon, some 11% above the level projected in May. The difference is somewhat smaller in trade-weighted terms. According to the current forecast, the trade-weighted exchange rate index is expected to stay close to 210 points for the remainder of the forecast horizon, about 8% above the May forecast.

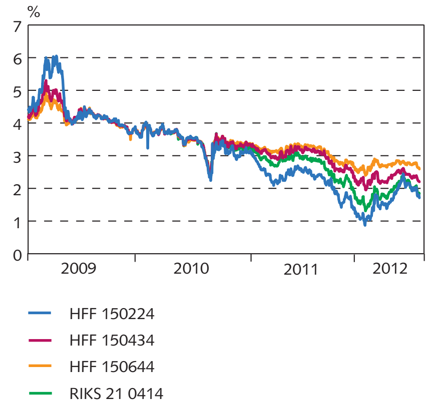
- The Central Bank's base money was 4% higher in Q2/2012 than in the same quarter in 2011. M1 grew by 1.7% over the same period, whereas M2 and M3 grew by nearly 6%. Growth in broad money over the past three quarters has been broadly in line with nominal GDP growth. As can be seen in Chart 12, holding companies' deposits account for the lion's share of the growth in money supply. That growth is due to the fact that, in Q3/2011, the commercial banking licences of the Glitnir Bank hf. and Kaupthing Bank hf. winding-up committees were revoked and the companies redefined as non-financial holding companies rather than financial institutions. As a result, their banking system deposits have become a part of DMBs' obligations vis-à-vis the public and are therefore part of the money supply.

- Household deposits contracted by 7% from June 2011, while deposits owned by firms other than holding companies rose by 7.4%. In part, the contraction in household deposits reflects the fact that real returns on them are negative, which has encouraged households to step up consumption of durables and semi-durables. Households have also used savings to invest in housing and moved their deposits to investment funds that offer higher real returns. Corporate deposits have increased primarily in the accounts of utility companies and marine product processing firms.

- The exchange rate- and inflation-adjusted credit base of households and firms other than holding companies has risen marginally year-to-date. Indexed lending grew somewhat in May and June. Clearly, a part of that increase is due to refinancing of existing loans, although some credit creation also took place. Overdraft loans to households have grown in the recent term, but this is due mostly to the merger of the credit card company kreditkort.is and Íslandsbanki; therefore, the rise does not fully represent an actual increase.

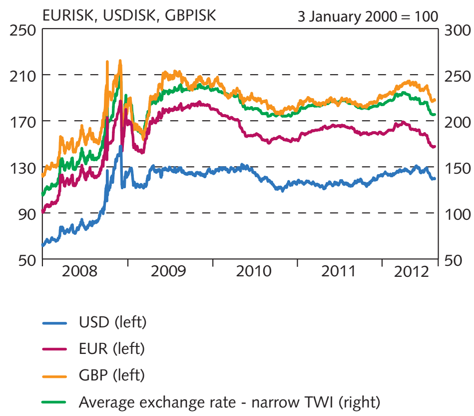
- Private sector financial conditions have continued to improve so far this year. Mortgage lending has increased, for instance, and indexed mortgage interest rates have fallen. Although nominal

Chart 10
Yields on indexed bonds
Daily data 2 January 2009 - 17 August 2012



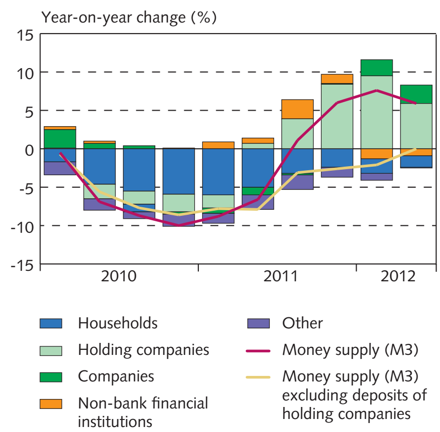
Source: Central Bank of Iceland.

Chart 11
Exchange rate of the króna
Daily data 3 January 2008 - 17 August 2012



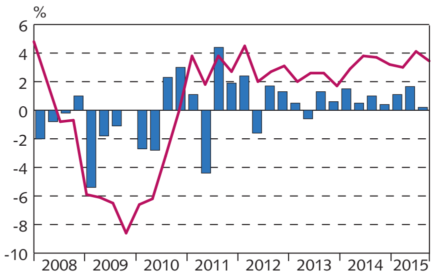
Source: Central Bank of Iceland.

Chart 12
Components of money supply
Q1/20010 - Q2/2012



Source: Central Bank of Iceland.

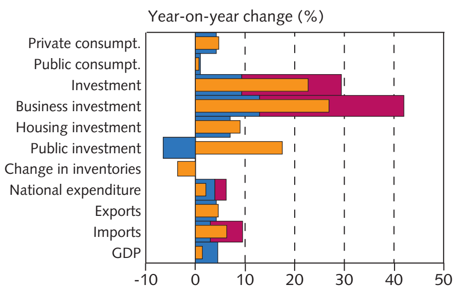
Chart 13
GDP growth
Q1/2008 - Q3/2015[1]



Change between quarters (seasonally adjusted)
Change from same quarter a year earlier

1. Central bank baseline forecast Q2/2012 - Q3/2015.
Sources: Statistics Iceland, Central Bank of Iceland.

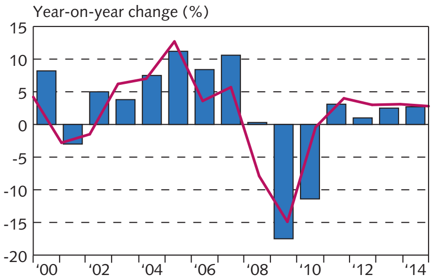
Chart 14
National accounts for Q1/2012
Year-on-year change (%) except change in inventories (share of GDP)



Preliminary Statistics Iceland figures
Expected revision due to aircraft imports
MB 2012/2 forecast

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 15
Private consumption and real disposable income 2000-2014[1]



Real disposable income
Private consumption

1. Central Bank baseline forecast 2012-2014. Central Bank estimate for real disposable income for 2011.
Sources: Statistics Iceland, Central Bank of Iceland.

mortgage lending rates have risen in line with increases in Central Bank interest rates, real rates remain low. At the same time, house prices have risen, debt has declined, and the domestic equity market has gained strength. Icelandic households and businesses remain heavily leveraged, however.

The domestic economy

- In June, Statistics Iceland published preliminary national accounts figures for Q1/2012. According to the preliminary figures, GDP growth was 4.5% year-on-year, while seasonally adjusted GDP growth measured 2.4% quarter-on-quarter. The figures also indicate that national expenditure rose by 3.9% year-on-year and that exports grew 4.2%, while imports were up 3%. The Statistics Iceland numbers indicate that the contribution of net trade to GDP growth was positive during the quarter.
- In September, when GDP figures for Q2 are published and Q1 figures revised, imports for the quarter will increase to match aircraft imports, which are entered in Statistics Iceland's external trade figures for January 2012 but did not appear in the national accounts at the time the preliminary figures are published. Presumably, a corresponding increase will show in investment for the quarter. This adjustment should not affect GDP growth, but the contribution from net trade will be less strongly positive because of increased imports, offsetting the stronger contribution from investment (see Chart 14).
- With this correction, the Central Bank estimates that business investment grew by 42% year-on-year in Q1 and by 23.3% between quarters (seasonally adjusted). This differs markedly from Statistics Iceland figures, which show business investment up by 12.9% year-on-year during the quarter but down by 18.1% between quarters (seasonally adjusted). This increases annual growth in total investment from 9.3% in Statistics Iceland numbers to 29.4%, and reduces the quarter-on-quarter contraction from 18.6% to 3.2%. National expenditure growth increases from 3.9% year-on-year in the Statistics Iceland figures to 6.2%.
- Year-on-year GDP growth for Q1 proved considerably stronger in Statistics Iceland figures (4.5%) than in the Bank's May forecast (1.4%). If account is taken of the aforementioned adjustments to investments and imports, the effect of inventory accumulation on GDP explains a large portion of the forecasting error. The May forecast assumed that changes in inventories would be considerably smaller than last year; however, Statistics Iceland figures show that they remained unchanged.
- Private consumption grew by 0.3% quarter-on-quarter in Q1 (seasonally adjusted) and by 4.2% year-on-year, about ½ a percentage point below the forecast in the last *Monetary Bulletin*. Private consumption has been one of the main drivers of the

economic recovery, as was expected, given that it contracted in excess of GDP in the wake of the banks' collapse. Temporary measures such as third-pillar pension savings withdrawals, additional mortgage interest subsidies, and write-downs of household loans have supported household demand in the recent term. There will probably be fewer such measures in coming quarters. It should be pointed out, though, that significant uncertainty remains concerning possible reimbursement of exchange rate-linked loans in the wake of the Supreme Court judgment from February 2012. Offsetting this, labour use has increased, real wages have risen, and financial conditions have improved. These factors are expected to stimulate household demand during the forecast horizon.

- The forecast estimates seasonally adjusted private consumption growth in Q2 at 0.3% quarter-on-quarter and 2.8% year-on-year. This is based on developments in a variety of indicators, including payment card turnover, consumer goods imports, and retail sales. According to the forecast, growth will measure about 3% for the year and remain at roughly that rate throughout the forecast horizon. This implies that private consumption will account for just under 54% of GDP by the end of the forecast horizon, somewhat below the 30-year average of 58%.

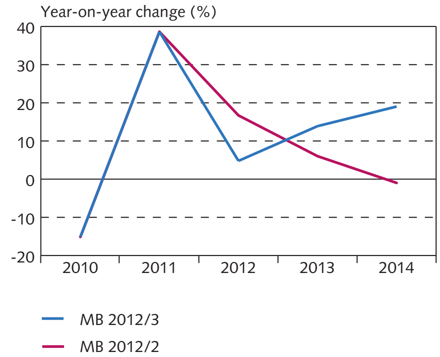
- Public consumption in Q1 was broadly in line with the forecast in the last *Monetary Bulletin*. The forecast for wage developments materialised, but public sector purchases of goods and services increased more than forecast and somewhat in excess of price increases. If this growth continues through the year, it is unlikely that the targeted reduction in public consumption volume will be achieved; however, because of the Government's declared austerity objectives, the forecast does not assume that the Q1 increase will continue throughout the year.

- The Treasury accounts for 2011 reveal that Government operations were within budgetary allocations if one-time write-offs due to the savings bank SpKef, the Icelandic Regional Development Institute, and the New Business Venture Fund are excluded. This is in line with the forecast in the last *Monetary Bulletin* concerning the results of conventional operations. On the other hand, it was forecast at that time that these write-offs would be recognised in 2012. In the forecast published in the November 2011 *Monetary Bulletin*, it was assumed that they would be recognised in 2011, even though no allowances had been made for them in that year's National Budget. As these write-offs did not appear in the first Statistics Iceland figures for 2011, they were transferred to 2012 when the last forecast was prepared, as they were considered unavoidable. In addition to the write-offs appearing in the Treasury accounts, the last forecast also provided for write-offs due to the Housing Financing Fund.

- Plans concerning investment in energy-intensive industries have changed since the last forecast. The current forecast provides for

Chart 16

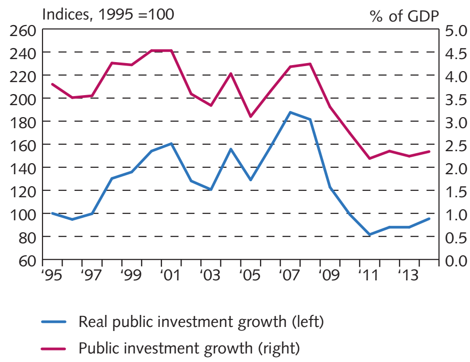
Investment in energy-intensive industries 2010-2014[1]



1. Central Bank baseline forecast 2012-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 17

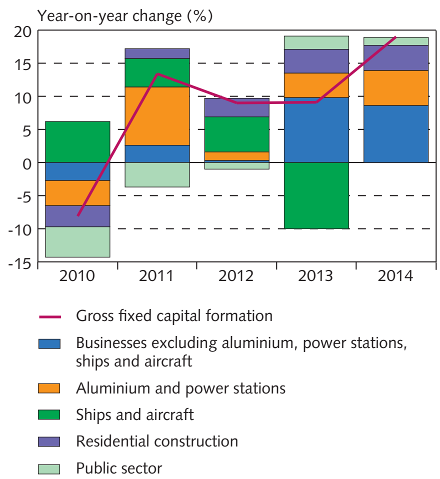
Public investment 1995-2014[1]



1. Central Bank baseline forecast 2012-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

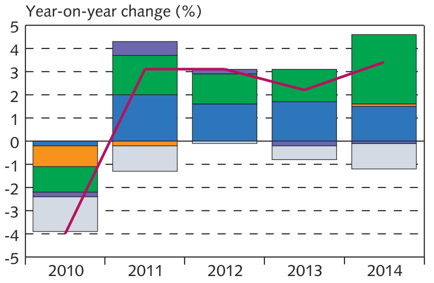
Chart 18

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



1. Central Bank baseline forecast 2012-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 19
Output growth and contribution of underlying components 2010-2014[1]



1. Central Bank baseline forecast 2012-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

stronger investment during the forecast horizon but assumes that it will be more back-loaded. The previous forecast assumed that energy-intensive investment would increase by almost 17% in real terms in 2012, whereas it is now estimated to rise by just under 5%. The increase will be larger in 2013 and 2014, both because of the smaller increase in 2012 and because the current forecast provides for nearly 11 b.kr. more investment in the sector (at constant 2012 prices) during the forecast horizon than was assumed in May.

- As in the May forecast, residential investment is estimated to grow by 16-19% during the forecast horizon. A number of large-scale projects are already underway in the greater Reykjavík area.

- This forecast assumes that public investment will be somewhat stronger than in the last forecast. In May, the Government announced plans to step up investment in 2013-2015. These plans are subject to funding, and the Government assumes that the projects will be financed through increased fishing fees, dividends from the banks in which the Government owns holdings, and profit on the sale of the banks. The increase in the fishing fee was passed into law in June, and it is assumed that the investment to be financed with that capital will materialise. On the other hand, the projects that depend on dividends and sales proceeds from the banks have been omitted or shifted back in time due to uncertainty about financing.

- Because of changes in planned energy-intensive investment during the forecast horizon, it is now assumed that the total increase in investment this year will be less than in the last forecast, or about 9% instead of 12.4%. The increase will be larger in the next two years, however: about 9% in 2012, as opposed to 6% in the May forecast, and 19% in 2014 instead of the previously projected 12%. In the forecast, it is estimated that business investment excluding ships, aircraft, and the energy-intensive sector will increase by just under 1% during the year, whereas the last forecast assumed no change year-on-year. Based on the forecast, it can be assumed that, as a share of GDP, business investment will have reached its 30-year average of 12½%. Total investment, on the other hand, will be 19% of GDP, slightly below the 30-year average of 21%.

- GDP is estimated to have grown by 2% year-on-year in Q2. If this projection materialises, annual GDP growth will measure 3.2% for the first half of the year, which is just under 1 percentage point more than was forecast in May. Output growth for the year as a whole is projected at 3.1%, or ½ a percentage more than in the May forecast. It is attributable primarily to growth in private consumption and business investment, which will contribute 1.6 and 1 percentage point, respectively. The contribution of net trade to GDP is expected to be zero this year, whereas the May forecast provided for a negative contribution of 0.8 percentage points. This turnaround in external trade explains the improved output growth outlook for the year. Offsetting this, output growth is expected to be somewhat weaker next year, or 2.2% instead of the 2.8% forecast in May. The downward adjustment is due largely to the negative base effect of strong export growth in 2012, which outweighs stronger growth in national expenditure. The growth outlook for 2014 has improved, however. Output growth is now estimated at 3.4% instead of the 2.7% assumed in May, due mainly to the previously mentioned increase in energy-intensive investment.

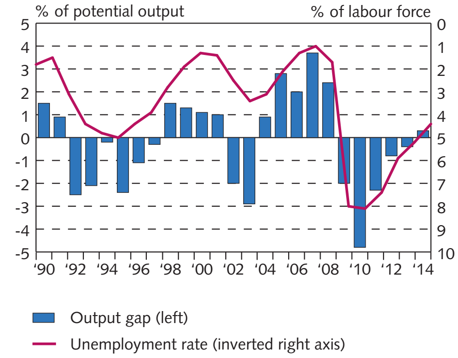
- The forecast assumes that the spare capacity developing after the banks' collapse was reduced considerably in 2011, to just under 1% of potential output, which is broadly in line with the May forecast. The slack is expected to shrink still further in 2012 and 2013 and then disappear early in 2014, which also accords with the May forecast.

- According to the Statistics Iceland labour market survey, labour demand was somewhat stronger in Q2 than in the Bank's May forecast. The last forecast projected a 0.4% year-on-year contraction in total hours worked, while the actual figure was virtually unchanged, as shorter working hours offset the 1.2% increase in the number of employed persons. The number of part-time workers rose after having declined steadily since Q4/2010. The increase was larger than that for full-time workers. The result was a 0.2% increase in total hours worked by the full-time employed and a 0.8% increase among part-time workers. The employment rate rose by nearly a percentage point, mainly due to an increase among the core age group. The labour participation rate was unchanged, however.

- Unchanged total hours worked and the rise in part-time workers is due entirely to the youngest age group and therefore does not indicate a general reversal in labour demand. Total hours worked increased by 0.6% among workers over age 25; however, this was offset by a decline in total hours worked among workers in the 16-24 age group. The youngest group also accounts for the rise in the number of part-time workers. It is therefore assumed that total hours worked will continue to grow relatively slowly throughout the forecast horizon, by an average of 1% per year, as was projected in the last forecast.

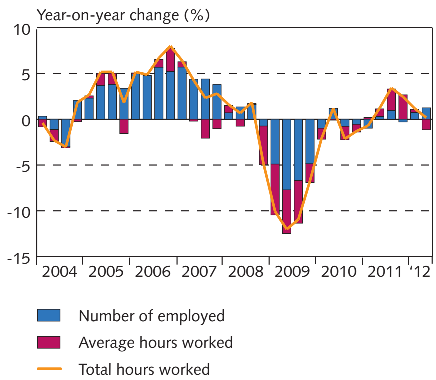
- Unemployment has declined faster than was assumed in the May forecast. According to Directorate of Labour (DoL) calculations, unemployment fell from 7.2% to 5.6% between Q1 and Q2, and from 6.4% to 5.7% adjusted for seasonality. The forecast estimated 6% unemployment during the quarter. The reduction in unemployment in the first half of the year is due in part to temporary projects sponsored by the DoL. Developments in the unemployment rate over the next year will depend on how many people become employed after the temporary projects are complete.

Chart 20
Output gap and unemployment 1990-2014[1]



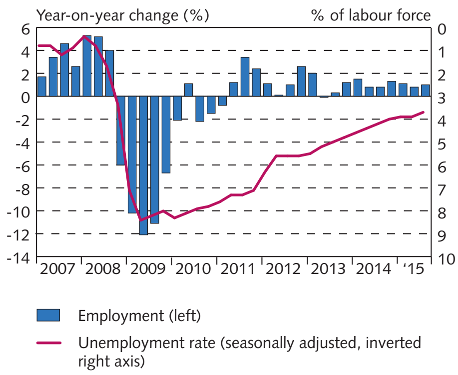
1. Central Bank baseline forecast 2012-2014.
Sources: Directorate of Labour, Statistics Iceland, Central Bank of Iceland.

Chart 21
Changes in employment and hours worked
Q1/2004 - Q2/2012



Source: Statistics Iceland.

Chart 22
Unemployment rate and employment growth
Q1/2007 - Q3/2015[1]

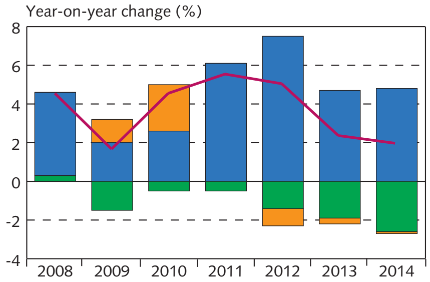


1. Central Bank baseline forecast Q3/2012 - Q3/2015.
Sources: Statistics Iceland, Directorate of Labour, Central Bank of Iceland.

Chart 23

Unit labour costs and contributions of underlying components 2008-2014[1]

Year-on-year change (%)



Nominal wages
Labour costs other than wages
Trend labour productivity
Unit labour costs

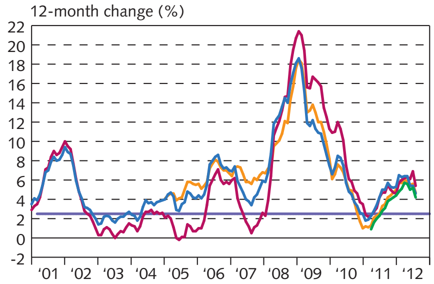
1. Labour productivity growth is shown as a negative contribution to an increase in unit labour costs. Central Bank baseline forecast 2012-2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 24

Various inflation measurements[1]

January 2001 - July 2012

12-month change (%)



CPI
Harmonised index of consumer prices
Core inflation 3 excluding tax effects
Core inflation 4 excluding tax effects
Inflation target

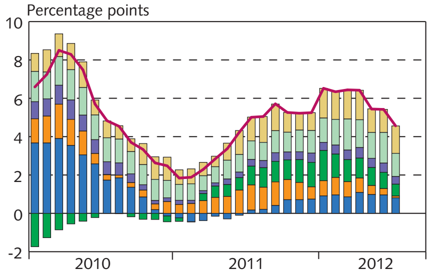
1. Core Index 3 is the CPI excluding prices of agricultural products, petrol, public services and the cost of real mortgage interest. Core Index 4 excludes the market price of housing as well.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 25

Components of CPI inflation

Contribution to inflation January 2010 - July 2012

Percentage points



Imported goods excl. alcoholic bev., tob. and petrol
Petrol
Housing
Domestic goods excluding agricultural products
Private services
Other components
Consumer price index (12-month % change)

Source: Statistics Iceland.

- The outlook for the unemployment rate has therefore improved since April, when the last forecast was in preparation. It is assumed that unemployment will measure 5.9% this year, 0.4 percentage points less than in the last forecast, and continue to decline over the course of 2013. Seasonally adjusted unemployment will have fallen to just under 5% by Q4/2013 and just under 4% by the end of the forecast horizon.

- Wages rose slightly more in Q2 than according to the May forecast. As in May, the forecast does not assume that the wage settlement review at the end of the year will trigger substantial additional pay increases. The outlook for wages has therefore changed little, and it is assumed that unit labour costs will develop broadly in line with the last forecast during the horizon. Unit labour costs are expected to rise by about 5% in 2012 and remain consistent with the Central Bank's inflation target from 2013 onwards.

Inflation

- Inflation has been somewhat lower than was forecast in May. It fell from 6.4% in Q1 to 5.8% in Q2/2012, or 0.3 percentage points less than in the May forecast. The components with the strongest upward effect on the CPI in Q2 were groceries and general services, while petrol prices had a downward effect and explain most of the forecasting error, together with the unexpected strength of the króna.

- The CPI fell by 0.7% month-on-month in July, after rising by 0.5% in June and remaining unchanged in May. The July decrease was due to summer sales and cuts in airfares and petrol prices, although it was offset to a degree by rising food prices. Twelve-month inflation measured 4.6% in July, down from 6.4% in April. The largest contributions to twelve-month inflation in July were from general services and groceries.

- Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and the cost of real mortgage interest) measured 5.9% in April but had dropped to 4.7% by July. Annual inflation according to the Harmonised Index of Consumer Prices (HICP), which excludes house prices, measured 5.4% in July, down from 7.2% in April. HICP inflation has therefore been somewhat higher than inflation according to the CPI excluding the housing component for some time, reflecting different weights assigned to individual components.[2]

- Inflation expectations based on the spread between indexed and nominal bond yields appear to have decreased since the May

2. The greatest difference is in the greater weight assigned to airfare and tourism-related service items, as the HICP reflects domestic consumption irrespective of the consumers' country of origin, whereas the Icelandic CPI reflects only Icelanders' domestic consumption patterns.

issue of *Monetary Bulletin*. By this criterion, inflation is expected to average just under 4½% over the next five years, a percentage point lower than in mid-May. Expectations over a longer horizon – five-year inflation five years ahead – are broadly unchanged since May and are also around 4½%.

- Household inflation expectations have declined marginally, according to the survey conducted by Capacent Gallup in May and June. One-year expectations measured 6.3%, which is 0.2 percentage points less than in the March survey. Households' inflation expectations two years ahead fell by about ½ a percentage point from the last survey, to the current 5½%. Corporate inflation expectations one year ahead were unchanged in the June survey, however, at 5%.

- Market participants' inflation expectations have declined since May, according to the Central Bank survey conducted just before this *Monetary Bulletin* went to press. According to the median response, market participants expect annual inflation to measure 4.8% one year ahead and 4½% two years ahead. They also expect inflation to average 4½% over the next ten years, which is around ½ a percentage point less than in the last survey. Based on the responses only from those who also participated in the May survey, they have decreased less. According to a principal component analysis of underlying developments in inflation expectations, inflation expectations measured 5.4% in Q2/2012, broadly unchanged from the previous quarter.

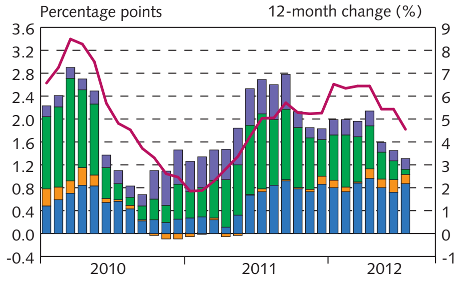
- The inflation outlook for 2012 and 2013 has improved somewhat since the publication of the last *Monetary Bulletin*. Average inflation for 2012 is projected at 5.4%, or 0.6 percentage points below the May forecast. The main reason for lower inflation is the strong appreciation of the króna and the steep decline in oil prices in recent months. The stronger króna also leads to more rapid disinflation in 2013 than was assumed in May, with inflation averaging 3.4% for the year.

- The exchange rate will be a key determinant of inflation developments. Other things being equal, inflation will be lower if the króna continues to strengthen; on the other hand, it will rise if the króna weakens. Wage developments may contribute to higher inflation following the contract review in January 2013. There is also uncertainty about house prices. The global economic outlook is still unstable, and increased unrest in foreign financial markets could jeopardise the economic recovery. The slack in the economy could prove larger and inflation correspondingly somewhat lower.

Chart 26

Contribution of food, petrol and energy costs to annual inflation

January 2010 - July 2012

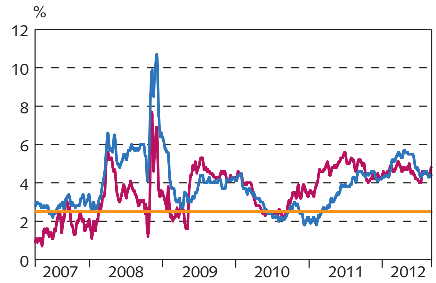


Source: Statistics Iceland.

Chart 27

Inflation expectations according to the spread between nominal and indexed forward interest rates[1]

Daily data, 2 April 2007 - 17 August 2012



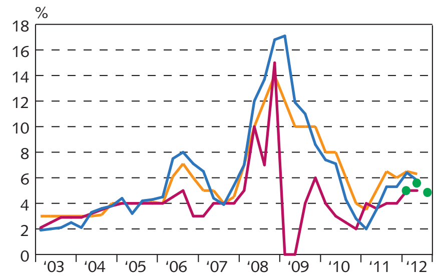
1. Breakeven inflation expectations are calculated from yield spreads between nominal and index-linked Government and Government-backed bonds (5-day moving averages).

Source: Central Bank of Iceland.

Chart 28

Inflation expectations of businesses, households and market agents one year ahead

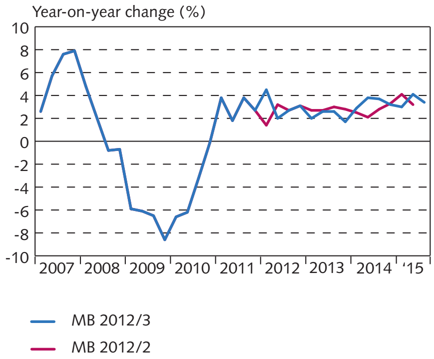
Q1/2003 - Q3/2012



1. Businesses' inflation expectations were measured on an irregular basis before Q3/2006 and are therefore interpolated until that time.

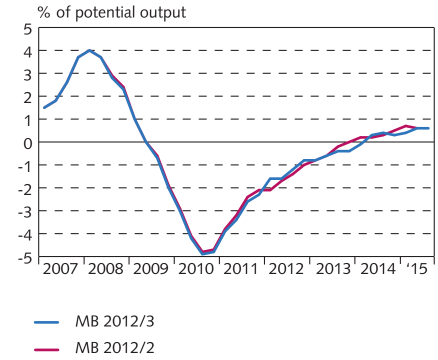
Sources: Capacent Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 29
Output growth - comparison with MB 2012/2



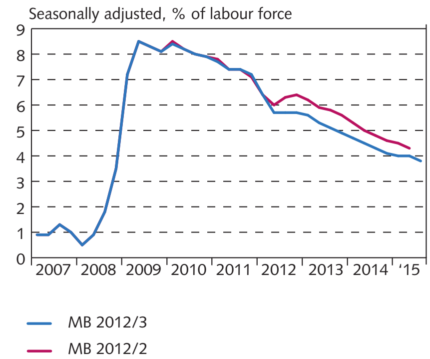
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 30
Output gap - comparison with MB 2012/2



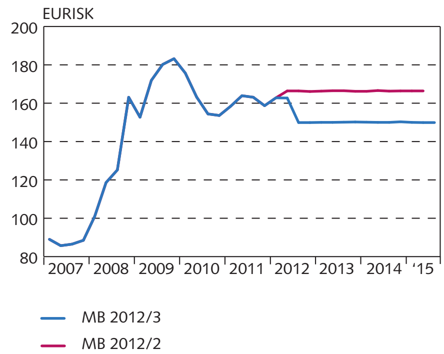
Source: Central Bank of Iceland.

Chart 31
Unemployment - comparison with MB 2012/2



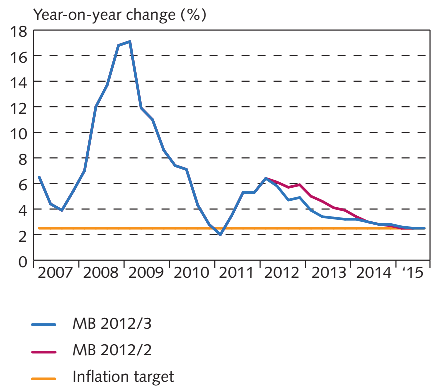
Sources: Directorate of Labour, Central Bank of Iceland.

Chart 32
The EURISK exchange rate -
comparison with MB 2012/2



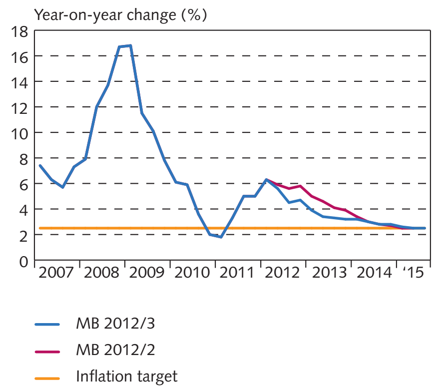
Source: Central Bank of Iceland.

Chart 33
Inflation - comparison with MB 2012/2



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 34
Inflation excluding tax effects -
comparison with MB 2012/2



Sources: Statistics Iceland, Central Bank of Iceland.