Monetary Bulletin in a nutshell

Although pessimism about the global economy has receded, the GDP growth outlook for advanced economies remains poor. GDP in trading partner countries is expected to be only 0.6% this year, far below the average in recent decades. Global inflation is still high, although it has subsided from its 2022 peak. Bringing inflation back to target is expected to take some time, as underlying inflation remains high as well.

In Iceland, GDP growth measured 7.4% over the first nine months of 2022, outpacing the Bank's November forecast. To a large degree, the deviation reflects Statistics Iceland's upward revision of H1 GDP growth from 6.8% to 7.5%. Although leading indicators suggest that GDP growth eased in Q4, the growth rate for 2022 as a whole has been revised upwards from 5.6% to 7.1% – the fastest calendar-year growth rate since 2007, if the forecast materialises. GDP growth is still expected to lose pace in 2023. It is estimated at 2.6%, slightly below the November forecast. The outlook for the forecast horizon as a whole has also deteriorated marginally.

Total hours worked increased strongly in Q4/2022, after declining in Q3. The labour participation rate rose as well, and unemployment fell marginally. Other indicators from the labour market suggest a continued labour shortage, but newly finalised wage agreements could cut into growth in labour demand. Unemployment is expected to inch upwards and capacity utilisation to ease during the forecast horizon.

Inflation continued to rise in January, measuring 9.9%. Excluding housing, it measured 8.3%, its highest since May 2010. Underlying inflation measured 7%, however, as in December. Long-term inflation expectations are broadly unchanged and remain well above the inflation target. The recently concluded private sector wage agreements entail considerably larger pay rises than had been assumed in the Bank's November forecast. Furthermore, the króna is weaker than was projected in November. The inflation outlook has therefore deteriorated once again. Inflation is projected to average 9.5% in Q1/2023, which is 1 percentage point above the November forecast but in line with the August forecast. It is still considered to have peaked but is now expected to ease considerably more slowly than was forecast in November: it is assumed to exceed 5% throughout this year, remain above 4% until H2/2024, and only fall below 3% a year after that.

As before, the economic outlook is highly uncertain. The global economic situation will depend in large part on developments in the war in Ukraine, which unavoidably affects Iceland as well. Added to this is pronounced uncertainty about developments in the wake of the newly landed wage agreements, which provide for hefty pay rises at a time of little or no productivity growth, worsening terms of trade, a weakening currency, and a weaker anchoring of inflation expectations. Under such conditions, it is possible that the falling exchange rate and rising wages will push inflation higher than it has been in the past decade. Moreover, not all wage agreements have been finalised, and wage inflation could therefore turn out higher than is currently anticipated. Similarly, if the wage agreements expiring a year from now are renewed on terms similar to those recently negotiated, wages could rise by more in the latter half of the forecast horizon than is provided for in the baseline forecast.

The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin* 2022/4 in November 2022, and on the updated forecast presented here. It is based on data available in early February. The risk assessment in the updated forecast is based on the risk assessment in the November forecast.