CENTRAL BANK OF ICELAND

SEÐLABANKI ÍSLANDS

MONETARY BULLETIN

2023 | 3

The objective of the Central Bank of Iceland's monetary policy is to contribute to general economic well-being in Iceland. The Central Bank does so by promoting price stability, which is one of its main objectives. In the joint declaration made by the Government of Iceland and Central Bank of Iceland on 27 March 2001, this is defined as aiming at an average rate of inflation, measured as the 12-month increase in the CPI, of as close to 2½% as possible.

Professional analysis and transparency are prerequisites for credible monetary policy. In publishing *Monetary Bulletin* four times a year, the Central Bank aims to fulfil these principles.

Monetary Bulletin includes a detailed analysis of economic developments and prospects, on which the Monetary Policy Committee's interest rate decisions are based. It also represents a vehicle for the Bank's accountability towards Government authorities and the public.

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Statement of the Monetary Policy Committee 23 August 2023

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.5 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 9.25%.

Inflation has eased recently, measuring 7.6% in July. The contribution of the housing component to inflation has diminished, global price hikes have subsided, and the króna has appreciated. Nevertheless, domestic price increases have proven persistent and remain widespread. Underlying inflation has therefore fallen more slowly than headline inflation, to 6.7% in July.

GDP growth measured 7% in Q1/2023, and unemployment has continued to fall. The labour market is therefore still very tight and strong demand pressures remain in the overall economy, although there are signs that economic activity has begun to slow down.

The long-term inflation outlook is broadly unchanged, even though the short-term outlook has improved since May. Furthermore, long-term inflation expectations are well above target, and the risk remains that inflation will become entrenched.

In light of this, it is necessary to tighten the monetary stance still further. It is particularly important to prevent a wage-price spiral. Indicators imply that the effects of recent interest rate hikes are coming more clearly to the fore, and near-term monetary policy will be determined by developments in economic activity, inflation, and inflation expectations.

Symbols:

*	Preliminary or estimated data.
0	Less than half of the unit used.
-	Nil.
...	Not available.
.	Not applicable.

Icelandic letters:

ð/Ð (pronounced like th in English this)
þ/Þ (pronounced like th in English think)
In this report, ð is transliterated as d and þ as th in personal names, for consistency with international references, but otherwise the Icelandic letters are retained.

Table of contents

Monetary Bulletin in a nutshell

GDP growth has eased in Iceland's main trading partner countries, albeit less than was assumed in the Bank's May forecast. Nevertheless, the outlook continues to be for weak output growth in 2023 and 2024 – about 1% per year. Falling energy prices have lowered headline inflation in advanced economies, but underlying inflation has proven far more persistent despite steep interest rate hikes implemented by major central banks.

In Iceland, GDP growth measured 7% in Q1/2023, owing mainly to strong growth in private consumption and exports, plus an increase in inventories during the quarter. Although GDP growth was above the 2022 average, it fell short of the May forecast. The Bank had expected private consumption growth to be even stronger, and investment – especially in residential construction and energy-intensive industry – proved far weaker than projected. Indicators imply that domestic demand growth softened still further in Q2/2023. Because of weaker growth in H1, GDP growth is now forecast at 3.5% for 2023 as a whole, well below the 4.8% forecast in May. The outlook for the next two years is broadly unchanged, however.

Total hours worked increased somewhat in Q2, and unemployment continued to fall, averaging 2.8% in Q2, its lowest since autumn 2017. Although job vacancies have declined in number recently, there are still clear signs that the labour market is quite tight. The baseline forecast assumes, however, that unemployment will gradually inch upwards to a level consistent with a balanced economy and price stability.

Inflation has eased recently. In July it fell to 7.6%, the same level as in May 2022. However, the disinflation in July is due in large part to strong base effects, as substantial price hikes a year earlier have now dropped out of the twelve-month measurement. Underlying inflation declined as well, but more slowly than headline inflation, and measured 6.7%. The impact of imported inflation has diminished, partly because of the recent appreciation of the króna, whereas domestic price rises have been more persistent. The general wage index rose by 10% year-on-year in Q2, and the price of groceries and private services has kept climbing. Furthermore, medium- and long-term inflation expectations are broadly unchanged, although inflation fell more than expected in July. Thus the long-term inflation outlook has changed little since May.

Although the supply side of the global economy appears largely to have normalised after the shocks of the past few years, there is still considerable uncertainty about the global economic outlook and about how costly it will be to re-establish price stability in major advanced economies. This applies to Iceland as well, as inflation expectations have apparently become less firmly anchored to the target. As a result, inflation could prove more persistent than is currently forecast, which would call for a stronger contraction in domestic economic activity to bring it under control again.

The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin* 2023/2 in May 2023, and on the updated forecast presented in this report. It is based on data available as of mid-August. The risk analysis in the updated forecast is based on the risk analysis in the May forecast.

Economic developments and updated forecast

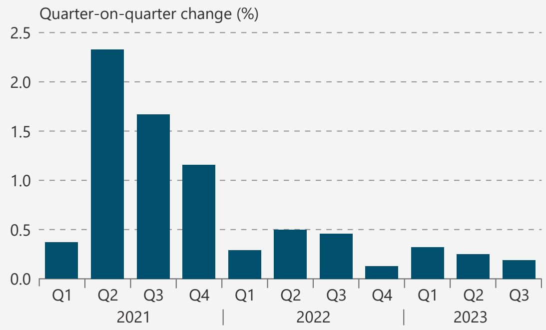
The global economy

GDP among Iceland's main trading partners grew by 0.3% quarter-on-quarter in Q1/2023, slightly outpacing the Bank's May forecast. In Q2, however, the trading partner growth rate was broadly in line with the forecast from May. Relative to expectations, economic activity in the US and the UK turned out more resilient, while the economic recovery in China slowed more and the quarter-on-quarter contraction in Sweden proved larger. In the eurozone, however, Q2 GDP growth was in line with the May forecast.

Chart 1

GDP growth in Iceland's main trading partners[1]

Q1/2021 - Q3/2023



1. Seasonally adjusted data. Central Bank baseline forecast Q2/2023 and Q3/2023.
Sources: Refinitiv Datastream, Central Bank of Iceland.

Leading indicators and international forecasts suggest that the outlook for H2/2023 GDP growth among Iceland's trading partners is in line with the Bank's May forecast. Trading partner GDP growth is still expected to taper off over the course of the year, falling to a level well below the average of recent decades. Now, however, it is also expected that economic activity will pick up more slowly in 2024 than was assumed in the last forecast.

Declining GDP growth among key trading partners and a weak GDP growth outlook are largely attributable to the effects of continued interest rate hikes, tighter financial conditions, and cost increases in the recent term, which have eroded real disposable income and cut into private sector demand. A favourable employment situation has mitigated this, however, supporting household income and bolstering economic activity. Furthermore, households in leading advanced economies still have pandemic-era savings that they can tap, and consumers' expectations about the economy have improved in the recent past.

Trading partner GDP growth is projected to average 1.1% in 2023, up slightly from the May forecast of 1%. For 2024, however, growth is expected to remain unchanged at 1.1% instead of rising to 1.3%. As in the May forecast, trading partner GDP growth is expected to average 2% in 2025. The global economic outlook remains highly uncertain, however.

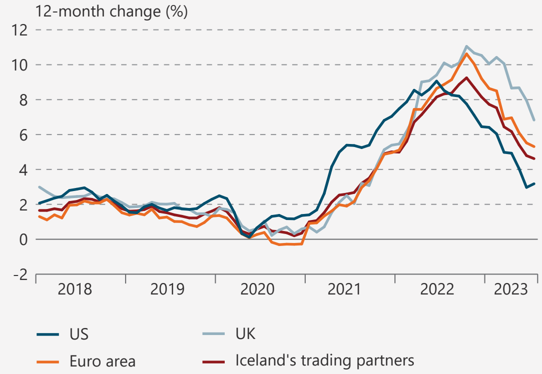
Global inflation

Inflation is still high in Iceland's main trading partner countries. It has eased in 2023 to date, however, owing mainly to the drop in energy prices following the spike in the wake of Russia's invasion of Ukraine in 2022. Twelve-month food price inflation has subsided as well, but from a very high level. The rise in goods prices has also lost pace in trading partner countries.

Chart 2

Global inflation

January 2018 - July 2023



Sources: Refinitiv Datastream, Central Bank of Iceland.

However, services price inflation has picked up even further, which is the main reason for the persistence of underlying inflationary pressures in trading partner countries. Developments in services prices have probably been affected for the most part by pent-up demand from the pandemic era, a tight labour market, and generous nominal pay rises.

Trading partner inflation averaged 5.5% in Q2, and the inflation outlook is broadly as in the May forecast. Average inflation among trading partners is expected to fall from 7.6% in 2022 to 5% in 2023. For 2024 it is forecast at 2.7%, but it is not expected to fall to 2% until H1/2025.

Global interest rates

Central banks in leading advanced economies have tightened their monetary stance even further this summer, in response to more resilient economic activity, a still-tight labour market, and still-persistent underlying inflation. The US Federal Reserve raised its key interest rate by 0.25 percentage points this summer, the European Central Bank (ECB) raised rates by a total of 0.5 percentage points, and the Bank of England by a total of 0.75 percentage points. The banks have given little forward guidance, however, and have announced that upcoming decisions would depend on economic developments in coming months, as the global economic outlook is highly uncertain at present.

Forward interest rates suggest that market agents are of the opinion that advanced economies' policy interest rates have peaked or will do so soon. On the other hand, market agents expect rates to be held higher over the forecast horizon than was assumed in May. This is reflected in developed countries' government bond yields, which have risen since May, particularly on short maturities.

Terms of trade

Terms of trade for goods and services deteriorated by 2.8% quarter-on-quarter in Q1/2023 but appear to have rebounded in Q2, in line with the decline in the price of imports, fuel in particular. Terms of trade are expected to deteriorate by 4.1% year-on-year in 2023 as a whole, or 1.4 percentage points less than was estimated in May. This improvement relative to the May forecast is due mainly to smaller price hikes on imported goods and more favourable developments in marine product prices, although it is offset by a larger decline in the price of aluminium and silicon products. Unfavourable base effects from last year's significant rise in aluminium prices continues to weigh heavily in year-on-year developments in terms of trade, which would improve by 0.7% this year if aluminium products were excluded. As in the Bank's May forecast, terms of trade are expected to hold broadly unchanged over the next two years; however, because they will deteriorate less this year, they will be more favourable over the forecast horizon as a whole than was assumed in May.

Domestic interest rates

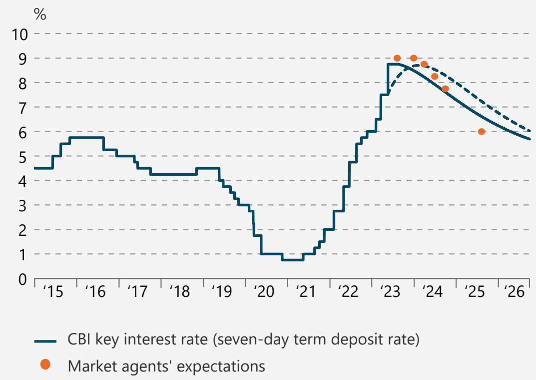
The Bank's key interest rate – the rate on seven-day term deposits – was increased by 1.25 percentage points in May and stood at 8.75% just before the publication of this *Monetary Bulletin*. At the May meeting, the MPC also increased deposit institutions' fixed reserve requirement from 1% to 2%. The Bank's real rate has risen as well and is now 2% in terms of the average real rate as calculated from various measures of inflation and one-year inflation expectations. According to the Bank's mid-August market expectations survey, respondents expect the key rate to rise to 9% in Q3 and then begin to fall in Q1/2024. Forward interest rates suggest, however, that the key rate has already peaked.

The yield on ten-year nominal Treasury bonds was 6.3% just before this *Monetary Bulletin* was published. It has held broadly unchanged since end-2022, apart from a temporary spike in February and March due to uncertainty about wage agreements and rapidly rising inflation. Until then, it had been on the rise since mid-2020. Yields on one- and two-year bonds declined this summer, however, in tandem with falling headline inflation, and the nominal yield curve is less downward-sloping as a result. The yield curve for inflation-indexed bonds has also inverted, as short indexed Treasury bond yields have risen more than long-term real interest rates in recent months.

Chart 3

Central Bank of Iceland key interest rate[1]

1 January 2015 - 30 September 2026



1. The Central Bank's key interest rate and Treasury bond yields were used to estimate the yield curve. The broken line shows forward market interest rates prior to MB 2023/2. Market agents' expectations from Central Bank's survey. Estimated from the median response on expectations concerning the collateralised lending rate. The survey was carried out during the period 8-10 August 2023.

Source: Central Bank of Iceland.

Exchange rate of the króna

The króna has appreciated by 6.6% in 2023 to date and is now roughly 10% stronger in trade-weighted terms than at its end-January trough. The last time it was this high was in October 2022. Seasonally adjusted tourism-related net payment card flows have continued to increase during the year. Furthermore, the short-term interest rate differential with abroad has widened rapidly in 2023 to date, and expectations of inflows into the foreign exchange market this autumn due to the recent foreign acquisition of an Icelandic biotechnology company have probably supported the exchange rate still further. Forward foreign currency sales have increased as well this summer, although they are still below the level seen in summer 2022. This is offset by a sizeable goods account deficit and foreign currency purchases by pension funds, which are larger in 2023 to date than at the same time in 2022.

Chart 4

Exchange rate of the króna[1]

2 January 2015 - 18 August 2023

1. Price of foreign currency in krónur. Narrow trade index.
Source: Central Bank of Iceland.

Thus far in Q3, the average exchange rate of the króna has been nearly 3% higher than was assumed in the Bank's May forecast. According to the current baseline forecast, it will fall marginally over the forecast horizon but remain above the level projected in May.

Money holdings and lending

Annual growth in M3 averaged about 8½% in H1/2023. Growth in household deposits has gained pace, whereas corporate deposit growth has eased.

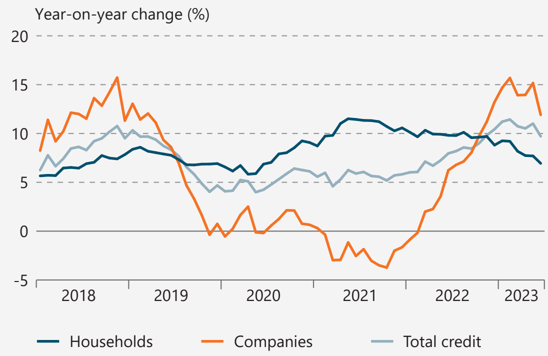
Year-on-year growth in credit system lending to households has lost steam, despite the rise in the nominal value of inflation-indexed mortgages due to rising inflation, as net new mortgage lending from the credit system has tapered off since H2/2022. It measured 7½% in Q2/2023, as compared with the 2022 average of nearly 10%. Demand for indexed loans has continued to pick up after a sharp increase in non-indexed interest rates, and since last November a majority of net new mortgage loans have been inflation-indexed. Furthermore, the pension funds have gained market share at the expense of the commercial banks.

Year-on-year growth in the corporate loan stock has slowed after rising strongly in 2022, and net new lending to businesses has tapered off slightly. According to the Central Bank's most recent lending survey, the commercial banks expect demand for corporate loans and the supply of credit to remain broadly unchanged over the next six months.

Chart 5

Credit system lending[1]

January 2018 - June 2023



1. Credit stock adjusted for reclassification and effect of Government debt relief measures. Excluding loans to deposit institutions, failed financial institutions, and the Government. Companies include non-financial companies and non-profit institutions serving households.
Source: Central Bank of Iceland.

Interest rates on non-indexed mortgages and rates on corporate loans have continued to rise in tandem with the increase in the Central Bank's key rate. Rates on households' and businesses' non-indexed deposits have also kept rising. The spread on new non-indexed mortgages relative to deposit rates is at its narrowest since Central Bank data collection began in 2015, while spreads on corporate loans have widened. Interest rates on indexed mortgages have remained more or less unchanged in recent months, however.

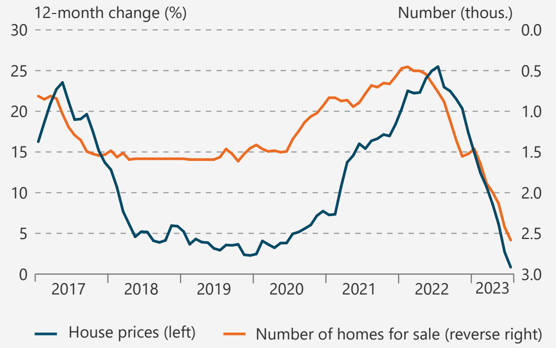
Asset prices

House price inflation has fallen rapidly, as higher interest rates and tighter borrowing requirements have clearly dampened demand for housing. Capital area house prices were up 0.8% year-on-year in July, the smallest yearly increase in over a decade. New loans taken for home purchases have declined somewhat in number year-to-date, housing market turnover has contracted virtually unabated since the beginning of 2021, and the share of first-time buyers has fallen over the same period. In addition, the supply of homes on the market in greater Reykjavík has increased nearly sixfold from its February 2022 trough, and the average time-to-sale has therefore grown markedly longer. On the other hand, wages have risen considerably year-to-date, and the population has grown steeply. The baseline forecast assumes that house price inflation will ease even further over the remainder of the year and that real house prices will decline throughout the forecast horizon.

Chart 6

Capital area house prices and number of homes for sale[1]

January 2017 - July 2023



1. Number of homes estimated from June 2018 - May 2019 by the Central Bank due to an error in data.

Sources: Morgunbladid Real Estate Website (mbl.is), Housing and Construction Authority, Central Bank of Iceland.

Share prices have fallen by 2% thus far in 2023, and private sector financial conditions are generally tighter than they were a year ago.

Private consumption

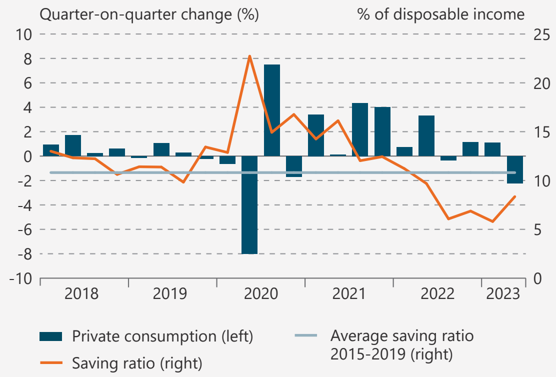
According to preliminary figures from Statistics Iceland, seasonally adjusted household consumption spending increased by 1.1% quarter-on-quarter in Q1/2023. Total payment card turnover was up strongly during the quarter, and the household saving rate declined at the same time, indicating the continued impact of inflation on households' financial situation. Private consumption grew 4.9% year-on-year, well below the Bank's May forecast of 6.8%, mainly because Icelanders' overseas spending was lower during the quarter than had been assumed in the forecast.

Indicators imply that household spending contracted in Q2, which would be the first year-on-year decline since year-end 2020. Private consumption therefore appears to be subsiding more rapidly than was expected in May. High inflation during the quarter and a tighter monetary policy stance were probably major factors in the shift. In addition, households appear to have grown more pessimistic, which may have prompted more precautionary saving and dampened appetite for spending, as can be seen in data

Chart 7

Private consumption and household saving[1]

Q1/2018 - Q2/2023



1. The saving ratio is calculated based on the Central Bank's disposable income estimates. Central Bank baseline forecast Q2/2023. Seasonally adjusted figures.

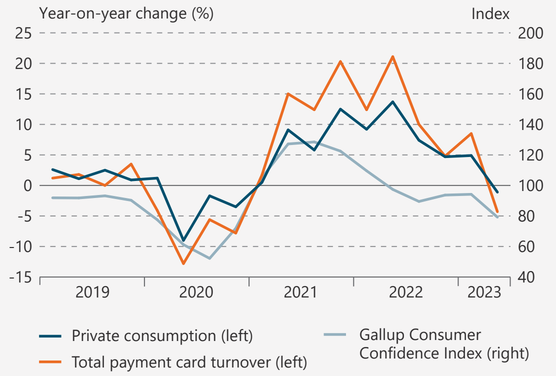
Sources: Statistics Iceland, Central Bank of Iceland.

on domestic payment card use. Furthermore, external trade data show that consumer goods imports declined during the quarter, after having increased substantially over the past two years. Households' payment card use abroad was buoyant, however, and new motor vehicle registrations were up marginally, although this offset the contraction in domestic card turnover only to a limited degree.

Chart 8

Private consumption and its indicators[1]

Q1/2019 - Q2/2023



1. Payment card turnover in constant prices. Central Bank baseline forecast Q2/2023 for private consumption.

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

The outlook for private consumption growth in H2/2023 is more or less unchanged since May. Modest growth is still expected, and private consumption is expected to increase by 1.6% over the year as a whole. This is 2 percentage points less than was forecast in May and largely reflects weaker growth in H1. In 2024, however, private consumption is projected to increase slightly more, owing to base effects from this year's weak growth. The outlook is also for slightly stronger growth in 2025.

Investment

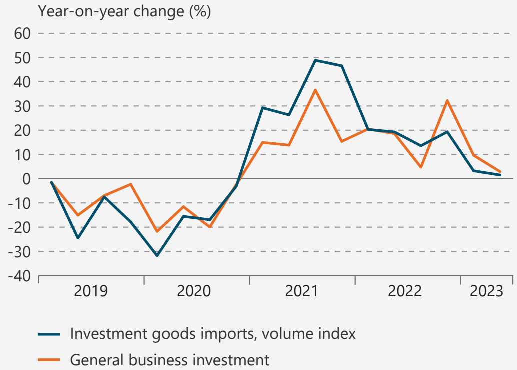
Investment was virtually unchanged year-on-year in Q1/2023, whereas the May forecast assumed a growth rate of 10.7%. The factor weighing heaviest is residential investment, which was much more sluggish than expected; however, business investment was markedly weaker as well, due to delays in planned investment in the energy-intensive sector. General business investment (excluding energy-intensive industry, ships, and aircraft) grew by 9.6% year-on-year, which was closer to the May forecast.

Imports of investment goods contracted still further in Q2, indicating that growth in general business investment continued to slow during the quarter. The outlook for 2023 as a whole is for a smaller increase than was projected in May, or about 4.1% instead of more than 7%. Weaker growth in residential investment is also expected for the year, partly because the Housing and Construction Authority now assumes that the number of newly built homes completed in 2023 and 2024 will be well below previous estimates. On the other hand, the contraction in public investment is now projected to be smaller than was forecast in May. As a result, total investment is expected to grow by 1.6% in 2023, as opposed to 5.7% according to the May forecast. The outlook for the coming two years is similar to the May forecast, however.

Chart 9

Investment goods imports and investment[1]

Q1/2019 - Q2/2023



1. Imported investment goods and transport equipment for commercial use (excluding ships and aircraft). General business investment excluding energy-intensive industry and ships and aircraft. Central Bank baseline forecast Q2/2023 for general business investment.

Sources: Statistics Iceland, Central Bank of Iceland.

Public sector finances

The public sector outcome in Q1/2023 was negative by 2.1% of GDP, as compared with a deficit of 2.3% in the same quarter of 2022. Since the Government's pandemic-related support measures ended, primary expenditure has been declining relative to GDP; however, the share of interest expense has risen, which explains why the deficit did not narrow more between years.

Public consumption grew in Q1 by 1.7% year-on-year, which is broadly on a par with the recent growth rate. Public investment grew by over 7% year-on-year, whereas in May it was forecast to contract this year. The increase is due largely to State investment activity, as spending due to the construction of the new Landspítali hospital is expected to increase substantially and distribution across individual quarters may differ from the typical pattern.

For 2023, the outlook is for public consumption and investment combined to grow by 1.4%, which is a slight increase relative to the May forecast, owing to the prospect of a smaller contraction in investment offset by weaker growth in public consumption. Over the next two years, public sector demand is projected to grow by 1½% per year, which is similar to the May forecast.

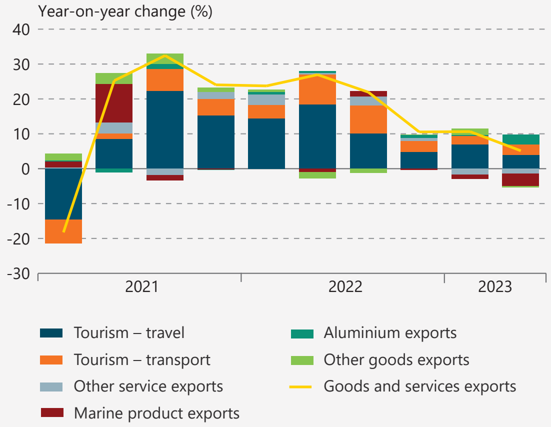
Exports of goods and services

Total exports grew by 10.8% between years in Q1, with the increase once again stemming mainly from strong growth in tourism. Goods exports were virtually unchanged year-on-year, however, and exports of

Chart 10

Exports and contribution of subcomponents[1]

Q1/2021 - Q2/2023



1. Because of chain-volume linking, the sum of components may not equal total exports. Aluminium exports as defined in the national accounts. Central Bank baseline forecast Q2/2023.

Sources: Statistics Iceland, Central Bank of Iceland.

other services were considerably weaker than anticipated.

Tourist arrivals grew still further in Q2, in tandem with increased flight offerings and high load factors, and were almost on a par with 2018. Over the first seven months of the year, 1.2 million tourists visited Iceland, about the same as in the May forecast. Average spending per tourist appears to have declined in foreign currency terms by 9% year-on-year in Q2, however.

The outlook for tourism is similar to that in the Bank's May forecast, and international demand for travel appears to be strong, although it seems to have started to ease in Europe. As was assumed in May, tourist numbers are expected to reach 2.2 million this year, whereas services exports look set to grow slightly less than anticipated, or by 11% instead of nearly 13% in the May forecast. This is due to the prospect of weaker exports of other services, coupled with a broadly unchanged forecast for tourism. The outlook for 2024 is also similar, with tourist arrivals projected to increase modestly between years.

The outlook for goods exports has deteriorated, however, as marine product exports in 2023 are likely to be weaker than previously forecast. A strong factor here is weaker-than-expected sales of capelin roe in 2023 to date, resulting in a marked contraction in marine product exports in Q2. Furthermore, exports of other goods have been somewhat weaker in H1 than was previously assumed. As a result, goods exports are projected to remain flat year-on-year in 2023 instead of growing by 1.4%, as was forecast in May. Total exports are expected to increase this year by 4.7%, or 1½ percentage points below the May forecast. The outlook for the next two years is largely unchanged, however, as growth in marine product exports is expected to be somewhat stronger in 2024 because of base effects.

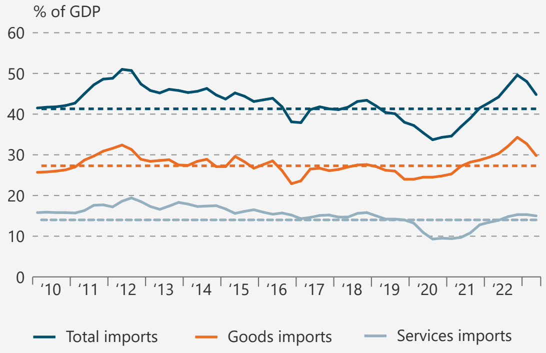
Imports of goods and services

Goods and services imports grew by 3.7% in Q1/2023, or 1 percentage point below the May forecast. Growth in goods imports slowed markedly, to just over 1% between years, excluding ships and aircraft. Contrary to expectations in May, goods imports appear to have contracted in Q2, reflecting a faster-than-anticipated reversal of domestic demand. Most key subcomponents of goods imports contracted between years, with the most pronounced decline in imports of investment goods. Icelanders' overseas travel has been largely in line with expectations, however, and the outlook for services imports is similar to the May forecast. Total imports are therefore projected to increase by 1.2% this year instead of 3.5%, while the outlook for 2024 and 2025 is broadly unchanged since May.

Chart 11

Imports of goods and services[1]

Q1/2010 - Q2/2023



1. Two-quarter moving average. Central Bank baseline forecast Q2/2023. Broken lines show average from 1998.

Sources: Statistics Iceland, Central Bank of Iceland.

Current account balance

The current account balance was negative by 1% of GDP, in Q1/2023. This deficit is only half the size of the deficit projected in May, as the primary income balance showed a sizeable surplus, whereas the May forecast had assumed a primary income deficit. The deviation is due for the most part to aluminium companies' operating results, which have fluctuated widely in the recent term. A profit was expected in both Q1 and 2023 as a whole, but preliminary figures show operating losses in Q1. The outlook for the full year has therefore changed, although aluminium companies are still expected to turn a profit in the latter half of the year.

For this year, the current account balance is expected to be negative by roughly 1% of GDP, which is nearly 2 percentage points less than the deficit projected in May. This is due to the combined effect of a narrower goods account deficit (owing to the prospect of reduced imports) and a smaller deterioration in terms of trade, together with the aforementioned improvement in the primary income balance. Year-2023 developments in primary income are quite uncertain, however, given the recent volatility in key subcomponents. The outlook is for the current account deficit to remain about the same throughout the forecast horizon.

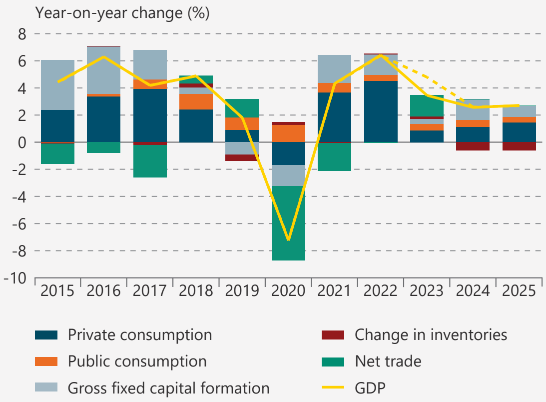
GDP growth

GDP grew by 7% year-on-year in Q1/2023. This is a slower growth rate than was forecast in May, mainly because domestic demand was more subdued than anticipated and the contribution from net trade was weaker.

Domestic demand appears to have been weaker in Q2 as well, which can be attributed to the contraction in private consumption and more sluggish investment growth. Year-on-year GDP growth is estimated at just under 4% for the quarter, well below the 7.5% assumed in the May forecast. GDP growth has therefore softened relative to previous quarters, reflecting a sharper easing of domestic demand growth than previously projected.

Chart 12

GDP growth and contribution of underlying components 2015-2025[1]



1. Central Bank baseline forecast 2023-2025. Broken line shows forecast from MB 2023/2.
Sources: Statistics Iceland, Central Bank of Iceland.

Because of the swifter decline in output growth in H1, the GDP growth forecast for the year has been revised downwards since May. Year-2023 growth is now estimated at 3.5%, which is close to the 2012-2019 average but 1.3 percentage points below the May forecast. Weaker growth in domestic demand is the main factor, although it is offset by more favourable net trade and a larger increase in inventories than was projected in May. For 2024 and 2025, GDP growth is estimated at 2½% per year, in line with the May forecast.

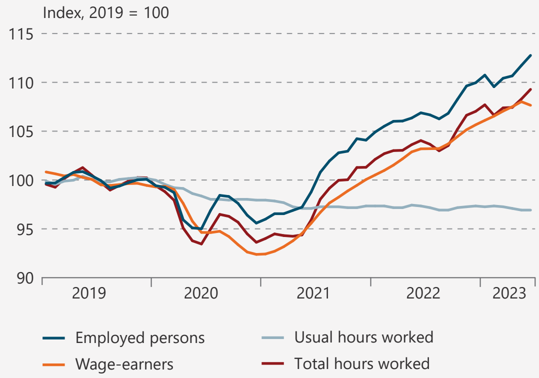
Employment and unemployment

According to the results of Statistics Iceland's labour force survey (LFS), the domestic labour market is still very strong. In Q2/2023, seasonally adjusted total hours worked increased by 1.8% quarter-on-quarter and 4.6% year-on-year, in line with the May forecast. Job growth was slightly stronger than was forecast in May, although average hours worked were shorter. The number of persons on the pay-as-you-earn (PAYE) register has developed similarly, but those figures show somewhat weaker job creation during the quarter.

Chart 13

Employment and hours worked[1]

January 2019 - June 2023



1. Wage-earners according to the Iceland Revenue and Customs' pay-as-you-earn (PAYE) register. Other figures are from the Statistics Iceland labour force survey (LFS). Persons aged 16-74 years old. Three-month moving average of seasonally adjusted figures.
Sources: Statistics Iceland, Central Bank of Iceland.

According to the LFS, seasonally adjusted unemployment fell by nearly 1 percentage point between quarters, to 2.8% in Q2, Iceland's lowest jobless rate since autumn 2017. Seasonally adjusted registered unemployment was very similar, at 3%.

Indicators imply that labour demand will lose some steam in the coming term. The results of Gallup's summer survey suggest that firms have scaled down their hiring plans, which are nevertheless above average. According to the Statistics Iceland survey, job vacancies declined markedly in number in Q2 and were about the same as in Q2/2019. The ratio of available jobs to unemployed persons, which gives a measure of labour market tension, declined as well, although it is still high, and above the pre-pandemic level.

The baseline forecast therefore continues to assume that growth in total hours will ease and that unemployment will rise from the current level. The LFS-based unemployment rate is projected to average 3.3% in 2023 and rise to 4.4% over the next two years.

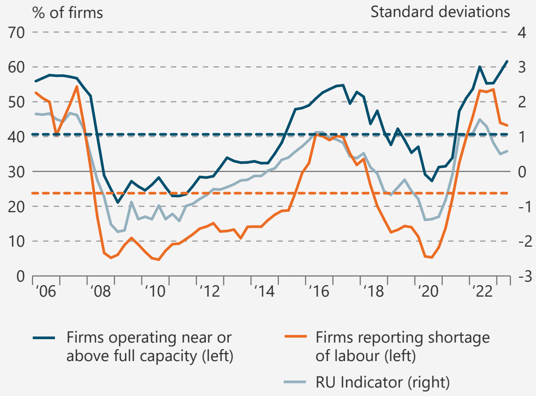
Resource utilisation

According to the seasonally adjusted results of Gallup's summer survey, 43% of corporate executives considered themselves understaffed. This is about the same as in the previous survey but a smaller share than was reported in summer 2022. The percentage of firms operating at full capacity rose to a new high, however, with 62% of respondents reporting that their companies would have difficulty meeting an unexpected increase in demand. The resource utilisation (RU) indicator, which combines various indicators of factor utilisation, has fallen somewhat from last summer's peak, suggesting that demand pressures in the economy could start to subside.

Chart 14

Capacity utilisation[1]

Q1/2006 - Q2/2023



1. Indicators of capacity utilisation are based on the Gallup Sentiment Survey conducted among Iceland's 400 largest companies. The resource utilisation indicator (RU indicator) is the first principal component of selected indicators of capacity utilisation; it is scaled so that its mean value is 0 and the standard deviation is 1. A more detailed description can be found in Box 3 in MB 2018/2. Seasonally adjusted figures. Broken lines show period averages.
Sources: Gallup, Central Bank of Iceland.

Indicators imply that consumption and investment spending grew more slowly in H1 than was assumed in the Bank's May forecast. Although the contribution from inventory changes and net trade pulled in the opposite direction, the outlook for 2023 is for weaker GDP growth and a narrower positive output gap than was projected then. According to the Bank's forecast, the output gap will be positive by 1½% of potential output this year instead of just over 2%, as was assumed in May. Demand pressures in the economy are expected to start abating this year and continue to ease over the next two years, until the output gap closes late in the forecast horizon.

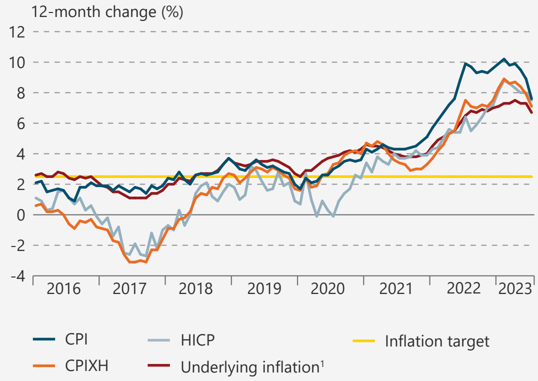
Inflation

Inflation averaged 9.4% in Q2/2023, as was forecast in May. The CPI rose by 0.03% month-on-month in July, and twelve-month inflation measured 7.6%. It has therefore fallen steeply in the recent term, partly because of strong base effects due to substantial price increases during the same period last year, which have now dropped out of twelve-month measurements. Inflation excluding housing declined as well, to 7.1% in July. Underlying inflation was 6.7% according to the average of various measures and has fallen by 0.8 percentage points from its April 2023 peak.

Chart 15

Various measures of inflation

January 2016 - July 2023



1. Underlying inflation shows the average of five different measures.
Sources: Statistics Iceland, Central Bank of Iceland.

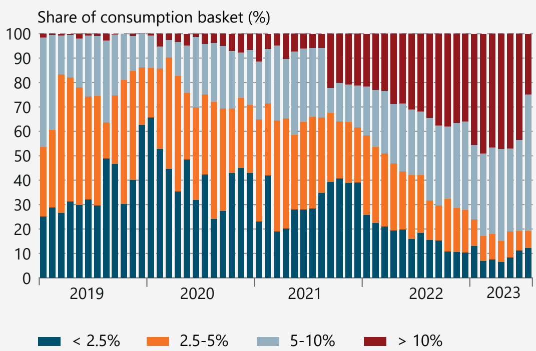
Although housing market activity subsided last winter, house prices rose somewhat in Q2/2023. In July, however, prices fell sharply month-on-month throughout the country. The contribution of housing to headline inflation has therefore grown smaller in the recent term. The effects of summer sales were about the same as in 2022 but remain more modest than they generally were before the pandemic. Petrol prices have fallen in recent months and are down 10% since July 2022.

The price of food and services has continued to rise, partly because of seasonal spikes in airfares, accommodation, and restaurant services. Private services prices have risen by 6.8% in the past twelve months, and domestic goods prices are up 11.5%. The price of groceries has risen by 12.2% year-on-year. As these figures show, inflationary pressures remain, although they subsided slightly in July. Nevertheless, over half of the consumption basket has risen by 5-10%

Chart 16

Price increases[1]

January 2019 - July 2023



1. The share of the CPI consumption basket categorised by annual increase.
Sources: Statistics Iceland, Central Bank of Iceland.

in the past year, and about a fourth has risen by more than 10%.

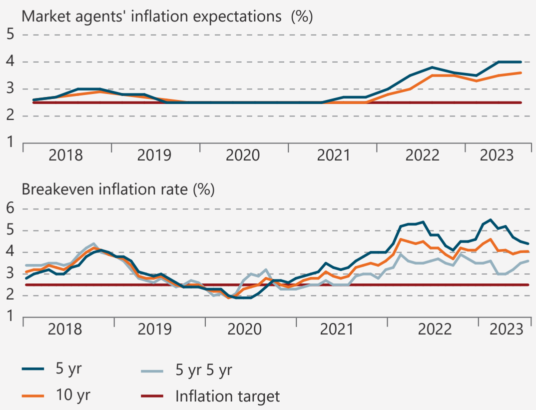
The general wage index increased by 3.1% quarter-on-quarter and 10% year-on-year in Q2, when the new wage agreements made by large labour federations with State and municipal authorities took effect. Although the wage agreements were more generous than was assumed in the May forecast, there are signs of offsetting effects stemming from changes in the composition of the labour market.

Overall, the outlook is for wage developments to be broadly in line with the May forecast whereas the productivity outlook has deteriorated. Unit labour costs are now expected to rise this year by 9.6%, nearly 1 percentage point more than was projected in May. If this forecast materialises, it will be the biggest rise in unit labour costs since 2006. For 2024 and 2025, the increase is projected to be smaller, averaging 5% per year.

According to Gallup's summer surveys, households' two-year inflation expectations rose to 7%, while their long-term inflation expectations were unchanged at 6%. On the other hand, businesses' long-term inflation expectations increased to an average of 5% over the next five years. According to the market expectations survey taken this August, respondents expect inflation to average 4% over the next five years, although their ten-year expectations inched upwards from the May survey, to 3.6%. Longer-horizon breakeven inflation rates in the bond market have also risen, with the five-year rate five years ahead measuring 3.6% in mid-August after having eased to 3% in May. The breakeven rate for a horizon of up to five years has eased somewhat, however.

Chart 17

Market long-term inflation expectations[1]



1. Median value of market agents' inflation expectations according to Central Bank survey (Q1/2018 - Q3/2023) and breakeven inflation rate in the bond market (monthly averages January 2018 - August 2023). Data through 18 August 2023.

Source: Central Bank of Iceland.

The inflation outlook

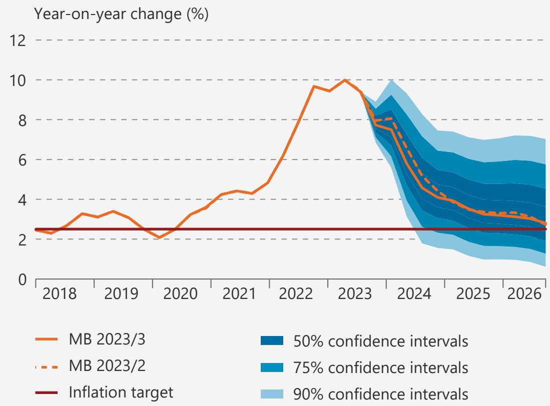
The outlook is for near-term inflation to be below the May forecast. It is expected to average 7.7% in Q3 and 7.5% in Q4, whereas the May forecast assumed that it would hover around 8% through the year-end.

The improved short-term outlook is due largely to the króna, which has appreciated more in the recent term than was previously forecast, and the prospect that economic activity will taper off more quickly than was forecast in May. In addition, house price inflation looks set to ease faster than previously projected. On the other hand, inflation is still expected to ease gradually, not falling below 4% until the end of 2024, as wage costs have surged in the recent past and inflation expectations are still far above the target. As a consequence, there is still the risk that inflation will turn out more persistent than is depicted in the baseline forecast, particularly in the long run. It is projected to fall below 3% in H1/2026 and align with the target at the end of the forecast horizon, conditional upon the interest rate path in the baseline forecast.

Chart 18

Inflation forecast and confidence intervals

Q1/2018 - Q3/2026



Sources: Statistics Iceland, Central Bank of Iceland.

Appendix

Forecast tables

Table 1 GDP and its main components[1]

	2021	2022	2023	2024	2025
Private consumption	7.0 (7.0)	8.6 (8.6)	1.6 (3.6)	2.2 (1.7)	2.8 (2.0)
Public consumption	2.4 (2.4)	1.6 (1.6)	1.9 (2.1)	2.0 (2.0)	1.6 (1.6)
Gross capital formation	9.8 (9.8)	6.9 (6.9)	1.6 (5.7)	6.5 (5.7)	3.4 (4.4)
Business investment	14.4 (14.4)	15.2 (15.2)	1.6 (6.9)	7.1 (3.8)	2.9 (2.8)
Residential investment	-5.2 (-5.2)	-6.3 (-6.3)	4.5 (11.1)	11.4 (15.5)	7.2 (10.1)
Public investment	18.9 (18.9)	-0.9 (-0.9)	-1.7 (-4.8)	-2.1 (-1.5)	-0.3 (0.8)
National expenditure	6.3 (6.3)	6.4 (6.4)	1.9 (3.5)	2.5 (2.6)	2.6 (2.5)
Exports of goods and services	14.7 (14.7)	20.6 (20.6)	4.7 (6.3)	4.0 (3.5)	3.1 (3.2)
Imports of goods and services	19.9 (19.9)	19.7 (19.7)	1.2 (3.5)	3.8 (3.7)	2.9 (2.7)
Gross domestic product (GDP)	4.3 (4.3)	6.4 (6.4)	3.5 (4.8)	2.6 (2.6)	2.7 (2.7)
GDP at current prices (ISK trillions)	3.24 (3.24)	3.77 (3.77)	4.16 (4.16)	4.48 (4.49)	4.76 (4.77)
Public sector demand[2]	4.4 (4.4)	1.3 (1.3)	1.4 (1.2)	1.5 (1.6)	1.4 (1.5)
Total investment (% of GDP)	22.2 (22.2)	22.4 (22.4)	22.8 (22.7)	23.5 (23.3)	23.7 (23.6)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2023/2).
2. Public sector demand in the expenditure accounts is the sum of public consumption and public investment.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 2 Global economy, external conditions, and exports[1]

	2021	2022	2023	2024	2025
Marine production for export	8.5 (8.5)	0.6 (0.6)	-5.3 (-1.6)	3.1 (1.9)	1.3 (1.0)
Aluminium production for export[2]	0.7 (0.7)	2.3 (2.3)	1.5 (1.0)	0.6 (0.5)	1.1 (1.1)
Goods exports, total	7.3 (7.3)	1.4 (1.4)	0.0 (1.4)	2.5 (2.1)	2.4 (1.9)
Services exports, total	28.5 (28.5)	53.8 (53.8)	11.0 (12.9)	5.6 (5.1)	3.7 (4.5)
Contribution of net trade to GDP growth (percentage points)	-2.0 (-2.0)	-0.1 (-0.1)	1.6 (1.3)	0.1 (-0.1)	0.1 (0.2)
Terms of trade for goods and services	3.8 (3.8)	3.0 (3.0)	-4.1 (-5.5)	0.1 (0.1)	-0.4 (-0.1)
Trade balance (% of GDP)	-2.0 (-2.0)	-0.7 (-0.7)	-1.1 (-2.1)	-0.9 (-2.1)	-1.0 (-1.9)
Current account balance (% of GDP)	-2.4 (-2.4)	-1.6 (-1.5)	-0.9 (-2.8)	-1.1 (-2.8)	-1.3 (-2.5)
Inflation in main trading partners[3]	2.8 (2.8)	7.6 (7.6)	5.0 (5.0)	2.7 (2.6)	2.1 (2.1)
GDP growth in main trading partners[3]	6.0 (5.8)	3.2 (3.4)	1.1 (1.0)	1.1 (1.3)	2.0 (2.0)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2023/2).
2. According to Statistics Iceland's external trade data.
3. Forecast based on Consensus Forecasts, IHS Markit, IMF, and OECD.

Sources: Consensus Forecasts, IHS Markit, International Monetary Fund, OECD, Refinitiv Datastream, Statistics Iceland, Central Bank of Iceland.

Table 3 Employment, wages, and factor utilisation[1]

	2021	2022	2023	2024	2025
Total hours worked[2]	2.7 (2.7)	6.7 (6.7)	4.3 (4.6)	1.0 (0.6)	1.9 (1.2)
Unemployment (% of labour force)[2]	6.0 (6.0)	3.8 (3.8)	3.3 (3.7)	4.4 (4.3)	4.4 (4.3)
GDP per hour worked[3]	1.6 (1.6)	-0.2 (-0.2)	-0.8 (0.2)	1.6 (1.9)	0.8 (1.5)
Unit labour costs[4]	4.3 (4.3)	8.2 (8.2)	9.6 (8.8)	5.3 (4.8)	4.5 (3.8)
Real disposable income[5]	3.1 (3.1)	2.5 (2.5)	0.8 (1.2)	2.8 (1.9)	3.9 (3.2)
Output gap (% of potential output)	-1.7 (-1.9)	2.4 (2.0)	1.5 (2.1)	0.5 (1.0)	-0.1 (0.4)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2023/2).
2. According to Statistics Iceland labour force survey (LFS).
3. Based on hours worked according to Statistics Iceland labour force survey (LFS).
4. Compensation of employees as a share of GDP, constant prices.
5. Ratio of disposable income to private consumption price index. Disposable income according to Central Bank estimate, based on Statistics Iceland's sector accounts.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 4 Exchange rate and inflation[1]

	2021	2022	2023	2024	2025
Trade-weighted exchange rate index[2]	2.5 (2.5)	3.1 (3.1)	-2.1 (-3.5)	0.4 (-0.5)	-0.7 (0.0)
Real exchange rate (relative consumer prices)	3.9 (3.9)	3.9 (3.9)	1.3 (0.1)	2.3 (1.7)	0.4 (1.2)
Inflation (consumer price index, CPI)	4.4 (4.4)	8.3 (8.3)	8.6 (8.8)	4.6 (5.0)	3.3 (3.4)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2023/2).
2. Average exchange rate in terms of narrow trade basket. Positive figures represent an increase in the exchange rate of the króna versus the average of other currencies.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 5 Quarterly inflation forecast (%)[1]

Quarter	Inflation (year-on-year change)	Inflation (annualised quarter -on-quarter change)
	Measured value	
2022:3	9.7 (9.7)	10.8 (10.8)
2022:4	9.4 (9.4)	5.0 (5.0)
2023:1	10.0 (10.0)	10.5 (10.5)
2023:2	9.4 (9.4)	11.4 (11.5)
	Forecasted value	
2023:3	7.7 (8.0)	4.2 (4.9)
2023:4	7.5 (8.1)	4.1 (5.5)
2024:1	5.8 (6.6)	3.7 (4.5)
2024:2	4.6 (5.2)	6.3 (5.9)
2024:3	4.1 (4.4)	2.3 (2.0)
2024:4	3.9 (3.9)	3.5 (3.5)
2025:1	3.5 (3.5)	2.1 (2.6)
2025:2	3.3 (3.4)	5.2 (5.5)
2025:3	3.2 (3.3)	2.1 (1.7)
2025:4	3.1 (3.3)	3.2 (3.3)
2026:1	3.0 (3.1)	1.7 (2.0)
2026:2	2.8 (2.7)	4.3 (3.8)
2026:3	2.6	1.3

1. Figures in parentheses are from the forecast in MB 2023/2.

Sources: Statistics Iceland, Central Bank of Iceland.

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MONETARY BULLETIN

2023 | 3