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.