Monetary Bulletin 2020/4[1]

The COVID-19 pandemic profoundly affected the global economy in H1/2020. GDP in Iceland's main trading partner countries contracted by more than 12% year-on-year in Q2, the largest single-quarter contraction on record. As the summer passed, the pandemic appeared to be receding, but it has surged in the recent term, forcing a re-tightening of public health measures. Thus the outlook is for a renewed contraction in trading partners' GDP in Q4, followed by a weaker recovery in H1/2021 than was forecast in the August *Monetary Bulletin*.

The resurgence of the pandemic has also caused Iceland's recovery to falter. After declining steeply in Q2, private consumption appears to have picked up markedly in Q3 but is projected to contract again in Q4. GDP contracted by 5.7% year-on-year in H1/2020 and is expected to remain virtually flat in H2. As a result, GDP is set to contract by 8.5% in 2020 as a whole, more than was forecast in August but broadly as was projected in May. The outlook for 2021 has deteriorated as well, as the forecast assumes that bringing the pandemic under control will take longer than was projected in the last forecast. Fewer tourists are expected to visit Iceland; therefore, exports will take longer to recover and will grow more slowly. As a consequence, GDP growth will measure only 2.3% in 2021, as compared with the August forecast of 3.4%. Unemployment will therefore rise higher and persist longer. Although robust GDP growth is forecast for 2022-2023, output is not expected to return to its 2019 level until 2023.

The outlook is highly uncertain, however, and near-term economic developments will depend to a large degree on how successful efforts to control the pandemic prove to be. The pandemic is expected to have largely subsided in Iceland by the end of 2020, and widespread inoculation is expected in Iceland and its main trading partners by mid-2021. If the pandemic proves more intractable, however, the economic recovery will be even more sluggish. The same is true if households are slower to tap the savings they have built up during the pandemic. Conversely, if efforts to control the disease are more successful, or if households use more of their savings, the economic recovery will be correspondingly stronger.

Inflation was at the Bank's 2.5% inflation target in Q2/2020. The króna depreciated after the pandemic spread to Iceland, however, and inflation has risen since then. It measured 3.2% in Q3 and had reached 3.6% by October. Short-term inflation expectations have risen recently, but medium- and long-term expectations do not appear to have become unmoored from the target. The outlook is for inflation to average 3.7% until early 2021, and then, once the effects of the depreciation of the króna disappear from measurements, it is expected to begin to ease relatively quickly, owing to the sizeable slack that has developed in the economy. This is a somewhat higher rate of inflation than was forecast in August, mainly due to stronger imported inflationary pressures.

1. The analysis presented in this *Monetary Bulletin* is based on data available in mid-November. Owing to the high level of uncertainty about the effects of the COVID-19 pandemic on the economic outlook, the forecast appendix shows fewer economic variables than usual.