Monetary Bulletin in a nutshell

The GDP growth outlook for Iceland's main trading partners is broadly unchanged since February. In the US, growth continues to exceed expectations, but growth remains weak in large parts of Europe. Trading partner GDP growth is projected to average 1.2% this year and then inch up to just above 1½% in the two years thereafter. Trading partner inflation tumbled in 2023 but has fallen more slowly in 2024. As in February, it is forecast to measure 2.5% in 2024 and ease to 2% by late 2025.

In Iceland, GDP growth measured 4.1% in 2023, on the heels of 8.9% growth in 2022, the country's strongest output growth rate in over half a century. This is considerably stronger growth than previous estimates from Statistics Iceland had suggested. Statistics Iceland's revision of GDP growth figures for the first three quarters of 2023 is also the main reason growth for the year exceeded the Bank's February forecast. Economic activity began to subside as 2023 advanced, however, and GDP is projected to have contracted in Q1/2024. The contraction appears to have been larger than was forecast in February, and the outlook for the year as a whole has worsened. Year-2024 GDP growth is now projected at 1.1%, as compared with the February forecast of 1.9%. The deviation is due primarily to a bleaker outlook for domestic demand growth. As in the previous forecast, GDP growth is expected to gain pace in 2025. It is projected to average 2½% over the next two years.

Unemployment has inched upwards since mid-2023, and job growth has slowed. A positive output gap remains, however, and is estimated to be larger than previously thought because of Statistics Iceland's revisions of historical data. As before, however, the output gap is expected to narrow over the forecast horizon and a small slack to open up in 2025, a year later than previously projected.

Inflation measured 6% in April, its lowest since January 2022, before commodity prices spiked in the wake of Russia's invasion of Ukraine. Underlying inflation has also continued to fall and was down to 5% in April. Survey-based measures of inflation expectations have also declined. In Q1, inflation exceeded the February forecast, and the inflation outlook for most of the forecast horizon has deteriorated. This applies especially to 2024, owing to a poorer initial position combined with a larger and more persistent output gap, albeit offset by the prospect of a slower rise in wage costs. Inflation is now forecast to be above 5% through this year and not fall back to the target until H2/2026.

The global economic situation remains uncertain, not least because of the wars in Ukraine and the Middle East. In Iceland as well, uncertainty has mounted in the wake of the volcanic eruption on the Reykjanes peninsula. On the other hand, uncertainty about wage developments has subsided with the signing of private sector wage agreements. The risk remains, though, that weakly anchored inflation expectations will cause inflation to be more persistent than is currently assumed. On top of this is uncertainty about how the change in the calculation of the housing component in the CPI, which Statistics Iceland has announced, will affect near-term measured inflation.

The analysis presented in this *Monetary Bulletin* is based on data available in early May.