Monetary Bulletin in a nutshell

Although global GDP growth somewhat outpaced forecasts in H1/2022, indicators imply that it softened more than projected in H2. The outlook for 2023 has deteriorated as well. The energy crisis that struck Europe in the wake of Russia's invasion of Ukraine continues to deepen, and global inflation has surged. Households' cost of living and firms' operating costs have therefore risen sharply and financial conditions have worsened. For Iceland's main trading partners, GDP growth prospects have therefore deteriorated still further, with year-2023 growth set to be the weakest since 2009, apart from the pandemic-related contraction in 2020.

Preliminary national accounts data suggest that GDP growth in Iceland measured 6.8% in H1, somewhat below the Bank's August forecast. GDP growth for 2022 as a whole is estimated at 5.6%, or 0.3 percentage points less than previously forecast. The outlook for 2023 has improved, however, and growth is now projected at 2.8%, up from the August forecast of 1.9%. This is due largely to the prospect of more rapid growth in domestic demand, which in turn is due in part to revised disposable income data indicating that households are better able to support their expenses than was previously assumed. As in August, GDP growth is expected to average 2½% per year in the latter half of the forecast horizon.

Job numbers are still rising year-on-year, although the pace has eased in recent months, and quarterly job growth was actually negative in Q3. The labour participation rate fell as well, and unemployment as measured by the Statistics Iceland labour force survey rose quarter-on-quarter. Other indicators from the labour market point in the same direction, although unemployment is still low, significant labour shortages remain, and job openings are numerous. As a result, there is still considerable strain on resources.

Headline inflation measured 9.4% in October after ticking upwards month-on-month, but has fallen by 0.5 percentage points from its July 2022 peak. Underlying inflation is high as well, and inflation has grown ever more widespread, with a majority of CPI subcomponents up sharply in price in the past year. Inflation has risen less than was feared in August, however, reflecting a more rapid shift in the housing market and larger-than-expected declines in petrol prices and airfares this autumn. The short-term inflation outlook has therefore improved, although prospects further ahead are broadly unchanged. Inflation is now expected to measure 9.4% in Q4 and then gradually start easing at roughly the pace forecast in August.

The economic situation is highly uncertain. The war in Ukraine has upended global commodity markets and thrown trade relationships and supply chains into disarray. It has caused an energy crisis in Europe, with no end yet in sight. A severe energy shortage could ensue, requiring widespread energy rationing and causing major economic hardship on the Continent. If this happens, GDP growth in Iceland will probably be weaker and inflation higher than in the Bank's baseline forecast. The inflation outlook could also prove overly optimistic if the current wage negotiations lead to larger pay rises than are assumed in the baseline. This would also exacerbate the risk of a wage-price spiral, as indicators imply that inflation expectations are less firmly anchored to the target than before.

The analysis presented in this *Monetary Bulletin* is based on data available in mid-November.