CENTRAL BANK OF ICELAND

MONETARY BULLETIN

2024 | 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.

Published by:
The Central Bank of Iceland, Kalkofnsvegur 1, 101 Reykjavík, Iceland
(+354) 569 9600, sedlabanki@sedlabanki.is, www.sedlabanki.is

Vol. 26 no. 3, 21 August 2024 ISSN 1670-438X, online
This is a translation of a document originally written in Icelandic. In case of discrepancy or difference in interpretation, the Icelandic original prevails. Both versions are available at www.cb.is.

Statement of the Monetary Policy Committee 21 August 2024

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The Bank's key interest rate – the rate on seven-day term deposits – will therefore remain 9.25%.

Inflation has risen marginally since the MPC's last meeting, after having eased earlier this year. Underlying inflation remains high and price increases are widespread, even though the contribution of the housing component is still significant. Furthermore, inflation expectations are broadly unchanged and have remained above target.

Domestic demand has eased in the past year, in line with a tighter monetary stance. Some demand pressures remain in the domestic economy, however, and they have subsided very little since the MPC's May meeting. It therefore appears that it will take some time to achieve an acceptable rate of disinflation.

The MPC is of the view that the current monetary stance is sufficient to bring inflation back to target, but persistent inflation and strong domestic demand call for caution. As before, monetary policy formulation 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 6

Economic developments and updated forecast 7

Appendix

Forecast tables 18

Monetary Bulletin in a nutshell

The global GDP growth outlook is broadly unchanged relative to the Bank's May forecast. GDP growth in major trading partner countries is projected to average 1.3% this year and then inch up to just above 1½% in the two years thereafter. Uncertainty about the global economic outlook has increased, however. Global inflation has continued to subside thus far in 2024, and more central banks in advanced economies have begun to lower interest rates. As in May, inflation is expected to keep easing in major advanced economies and return to target in H2/2025.

Output growth in Iceland slowed markedly over the course of 2023, and in Q1/2024 it shrank by 4% year-on-year, close to the May forecast of a 3.7% contraction. The negative impact of reduced inventory accumulation due to the failed capelin catch early this year was a major factor, as domestic demand excluding inventory changes grew by 0.9% year-on-year during the quarter, outpacing the 0.6% growth rate projected in May. GDP is estimated to have grown by 2% between years in Q2, and GDP growth for the year as a whole is forecast at only 0.5%, compared to the 1.1% forecast from May. The deviation is due primarily to a poorer outlook for tourism. The output growth outlook for 2025 and 2026 has also deteriorated slightly since May.

Job growth has slowed since H1/2023. Unemployment is broadly unchanged, however, owing to the offsetting effect of a rising labour participation rate. Unemployment remains low, although indicators imply that labour market tightness is easing. The positive output gap is expected to keep narrowing and flip to a modest slack around mid-2025, largely as was forecast in May.

Inflation tapered off in H1/2024, averaging 6% in Q2, in line with the May forecast. It was nearly 2 percentage points below the Q4/2023 average. A spike in July pushed it back up to 6.3%, however. Inflation excluding housing rose as well, to 4.2%, and underlying inflation increased to 5.3%. The uptick in inflation therefore appears to be relatively broad-based, and as yet there are few signs of a decline in inflation expectations. The inflation outlook is largely unchanged since May, however. Because of a poorer initial position, inflation is expected to slightly exceed the May forecast through H1/2025, but from then onwards it is projected to ease in line with the May forecast and realign with the target in H2/2026.

The global economic situation remains uncertain, not least because of the wars in Ukraine and the Middle East. Trading partner GDP growth has been muted, and it is unclear how solid the foundations for growth are. In Iceland, activity in the tourism industry has slowed, and the GDP growth outlook could prove overly optimistic if the sector loses more ground. On the other hand, GDP growth could turn out to be underestimated, given households' significant accumulated savings, which they could choose to draw down more quickly than is assumed in the forecast. There is also considerable uncertainty about developments in inflation over the forecast horizon, not least because inflation expectations are less firmly anchored, which could cause inflation to be more persistent than is currently anticipated. This is compounded by uncertainty about how measured inflation will be affected by the forthcoming changes to taxes on motor vehicle use, which are set to take effect at the turn of the year.

The analysis appearing here is based on the Bank's assessment of economic developments since the publication of *Monetary Bulletin* 2024/2 in May 2024, 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

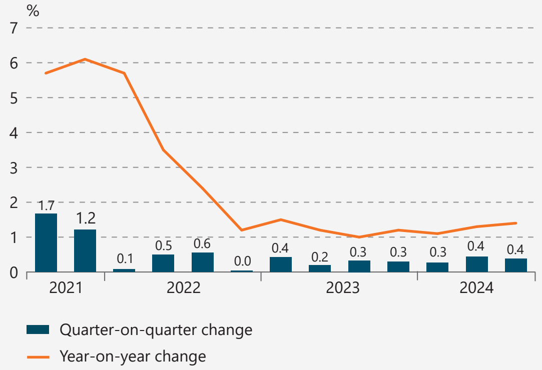
The global economy

As was assumed in May, GDP among Iceland's main trading partners grew by 0.3% quarter-on-quarter in Q1/2024. In the UK and the euro area, however, growth was stronger than expected, while in the US it subsided more quickly. Trading partner growth is now estimated to have been just over 0.4% quarter-on-quarter in Q2, slightly outpacing the May forecast. In the US, output growth unexpectedly picked up again during the quarter, and in the UK it was also stronger than previously projected. In the eurozone, however, Q2 GDP growth was in line with the May forecast. Leading indicators and international forecasts suggest, though, that the outlook for trading partner GDP growth in H2/2024 is consistent with the forecast from May.

Chart 1

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

Q3/2021 - Q3/2024



1. Seasonally adjusted data. Central Bank baseline forecast Q2/2024 and Q3/2024.
Sources: Refinitiv Datastream, Central Bank of Iceland.

Uncertainty about the global economic outlook has mounted, however, particularly in view of recent labour market data for the US, which indicate that economic activity in the world's largest economy could subside more quickly than generally expected. In China, too, economic activity has proven less resilient than previously forecast, and there is continued uncertainty about developments in the wars in Ukraine and the Middle East and their impact on the global economy. Uncertainty about the global inflation outlook remains, although it has receded, and economic developments will continue to depend in large part on how successfully central banks can bring inflation back to target.

According to the Bank's baseline forecast, GDP growth among Iceland's main trading partners will average 1.3% this year. This is 0.1 percentage points above the May forecast but well below the average of the past few decades. As in May, trading partner GDP growth is projected to rise to 1.6% in 2025 and 1.7% in 2026.

Global inflation

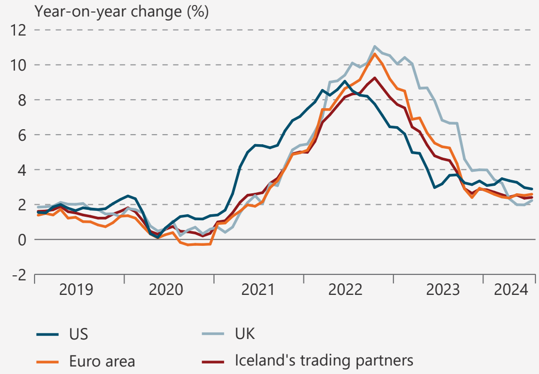
Average inflation among Iceland's main trading partners fell to 2.5% in Q2/2024, as was projected in May. It was higher than expected in the UK, eurozone, and US, but lower in the other Nordic countries. Twelve-month rises in the price of goods and foodstuffs have lost pace still further contributing to continued disinflation. A smaller year-on-year decline in energy prices has pulled in the opposite direction, however. Services price inflation has held broadly unchanged recently but is still high, averaging just over 4% in trading partner countries. More persistent services price inflation is one of the main reasons the inflation outlook for these countries has deteriorated slightly relative to the May forecast. Natural gas prices in Europe have risen as well in the recent term, owing to developments in the Russo-Ukrainian war, but this is offset by a larger decline in global oil prices than was projected in May.

Inflation in trading partner countries is expected to average 2.6% this year and 2.2% in 2025, which is

Chart 2

Global inflation[1]

January 2019 - July 2024



1. Central Bank estimate for trading partners in July 2024.
Sources: Refinitiv Datastream, Central Bank of Iceland.

0.1 percentage points above the Bank's last forecast. It is still projected to fall to an average of 2% by 2026.

Global interest rates

Central banks from a greater number of advanced economies have started lowering interest rates again, as inflation has fallen steeply, inflation uncertainty has subsided, and labour market tensions have eased. Even so, policy rates in many advanced economies are still far higher than they have been in a decade or more. The European Central Bank (ECB) and the Bank of England (BoE) took the lead this summer and cut their rates by 0.25 percentage points. They issued no pledges about upcoming moves, however, as underlying inflation remains high and wages have risen markedly in the recent term. The US Federal Reserve has kept rates unchanged at 5.25-5.5%, however. It has signalled a possible rate cut this coming September, though, and increased economic and labour market uncertainty in the US has made such a move more likely. Unlike central banks in other advanced economies, the Bank of Japan raised its policy rate again this past summer, to 0.25%.

Forward interest rates in the market suggest that market agents expect central bank rates in advanced economies to be lowered more in the coming term than was indicated in May. This can be seen in these countries' long-term bond rates, which have fallen recently. Global equity prices have fallen, however, and risk premia on riskier assets have risen in tandem with increased uncertainty about the global economic outlook.

Terms of trade

Terms of trade for goods and services are expected to hold virtually unchanged this year, as was forecast in May. Prospects for aluminium export prices have improved, however, owing to a larger-than-anticipated rise in Q2. More favourable developments in other exported goods prices pull in the same direction. On the other hand, the outlook for marine product export prices has deteriorated. The outlook for terms of trade in the next two years is also broadly unchanged, and a slight improvement is still expected over the forecast horizon.

Domestic interest rates

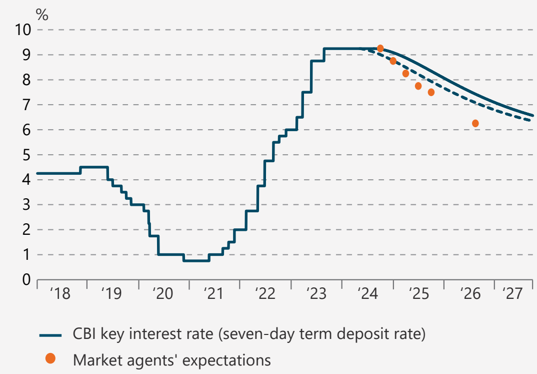
The Central Bank's Monetary Policy Committee (MPC) decided at its May meeting to hold the Bank's key rate (the rate on seven-day term deposits) unchanged at 9.25%, where it was just before the publication of this *Monetary Bulletin*. The key rate has been unchanged since August 2023. According to the Bank's August market expectations survey, respondents expect the key rate to begin falling in Q4/2024 and measure 6.25% in two years' time. This is a slightly higher policy rate than survey participants expected in H1/2024. Forward interest rates also suggest that investors expect rates to ease more slowly than they expected last spring.

The Central Bank's real rate has risen marginally since H1/2024. Based on the average real rate as calculated from various measures of inflation and one-year inflation expectations, the real rate is currently 4.2%.

Chart 3

Central Bank of Iceland key interest rate[1]

1 January 2018 - 30 September 2027



1. Money market rates and Treasury bond yields were used to estimate the yield curve. The broken line shows forward market interest rates prior to MB 2024/2. 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 12-14 August 2024.

Source: Central Bank of Iceland.

The yield on ten-year nominal Treasury bonds was 6.7% just before the publication of this *Monetary Bulletin,* an increase of 0.1 percentage points since May. Yields began rising in mid-June, following the publication of the rent price index, which showed a significant rise between months. They climbed even further after Government Debt Management announced in June that Treasury bond issuance in 2024 would be increased by 30 b.kr. relative to the previous issuance calendar. In the beginning of August, however, yields started falling in line with global developments, probably reflecting expectations of more rapid interest rate cuts in the US.

In mid-July, the Icelandic Government announced plans to replace oil and petrol taxes with a per-kilometre charge for all motor vehicles. The announcement caused a marked increase in the yield on the shortest inflation-indexed Treasury bond but made little impact on other yields. The short-term breakeven inflation rate therefore declined markedly, while the ten-year breakeven rate held broadly steady, causing the five-year breakeven rate five years ahead to increase. It is not clear to what extent this increase is due to higher inflation expectations, but it can be attributed to sparse and limited trading in short-term Treasury bonds in an extremely shallow market. The breakeven inflation rate then rose even further in response to unfavourable inflation measurements in late July.

Exchange rate of the króna

The króna held broadly stable for much of this year but then depreciated in August. In trade-weighted terms, it is 1.4% weaker than it was in May, and around 5.8% weaker than in August 2023.

Tourism-related payment card flows and the pension funds' foreign currency purchases have declined year-to-date in comparison with 2023. Furthermore, foreign currency flows related to new investments and forward foreign currency sales have eased after increasing early this year. Foreign exchange market turnover has also fallen, which could indicate that external trade, on the one hand, and inward and outward currency flows, on the other, have been well balanced recently.

Chart 4

Exchange rate of the króna[1]

2 January 2022 - 16 August 2024

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

Developments in the exchange rate in Q3 to date are well in line with the Bank's May forecast. As was the case in May, the current baseline forecast assumes that the króna will remain rather stable over the forecast horizon.

Money holdings and lending

Year-on-year growth in M3 has gathered pace in 2024, measuring 12% in Q2. Most of the increase is due to household deposits, which have been growing by more than 15% for nearly a year. This reflects, among other things, hefty pay rises in recent years and an increase in households' interest income, as deposit interest rates have risen broadly in line with the Central Bank's key rate. Furthermore, it is likely that developments since this spring have been shaped by the Government's purchase of residential property in Grindavík through the real estate company Þórkatla.

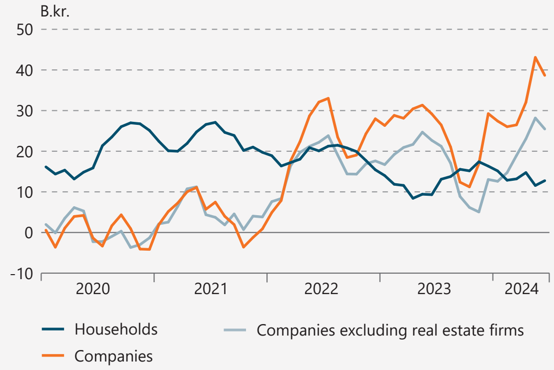
Growth in lending to households has measured around 6% since mid-2023, as real estate market turnover remains strong and home prices have risen somewhat. As before, most new loans are inflation-indexed. Early retirement of non-indexed loans has increased this year, a trend that in all likelihood has been affected by the Government's purchase of property in Grindavík. Fixed rates on non-indexed mortgages have fallen marginally in 2024, while inflation-indexed mortgage rates have risen, as have other real rates.

Corporate deposits have increased this year, although not at the same rate as household deposits. Growth in lending to companies has accelerated as well over the course of 2024, after having softened markedly in 2023. Strong turnover in the construction market has sustained lending growth, as the majority of the increase since mid-2023 has been in loans to companies in the real estate and construction sectors. The Government's buy-up of Grindavík properties has had some impact, as the company Þórkatla, which administers the purchases, is classified as a real estate firm. For the most part, new loans to companies have been inflation-indexed, although foreign-denominated lending has increased in the past few months. There has been little change in non-indexed interest rates offered to companies, but interest rates on new inflation-indexed corporate loans have risen since 2023.

Chart 5

Net new lending[1]

January 2020 - June 2024



1. Net new lending consists of new lending net of prepayments and retirement of older loans. Lending from deposit institutions, pension funds, the Housing and Construction Authority, and the IL Fund. Three-month moving averages.
Source: Central Bank of Iceland.

Asset prices

House price inflation measured 9.1% year-on-year nationwide in June 2024, as compared with a low of 0.7% in July 2023. Real estate market activity in 2024 has been affected strongly by housing demand from Grindavík residents and Þórkatla's buy-up of property in the town following the seismic unrest on the Reykjanes peninsula. The number of purchase agreements made in H1/2024 was 72% higher than in H1/2023.

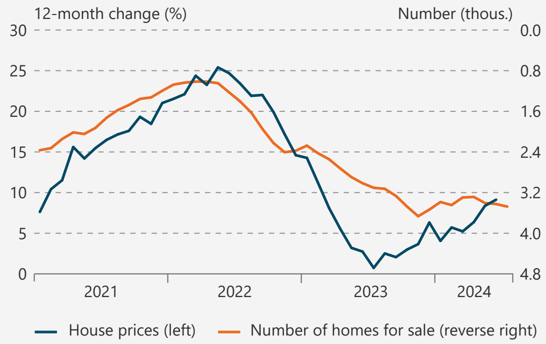
Housing supply has increased somewhat in the past three months, however. In July, an average of 3,500 homes were listed for sale nationwide, and the average time-to-sale was broadly the same as in March, after having fallen in April and May. The share of homes selling at a premium on the asking price is still somewhat greater than at the beginning of the year.

The baseline forecast assumes that twelve-month house price inflation will peak in Q3/2024 and then start to ease, and that overall it will be similar to the May forecast.

Chart 6

House prices and number of homes for sale in the whole country

January 2021 - July 2024



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

The OMXI15 index on the Nasdaq Iceland stock exchange was quite stable this summer until mid-August when it rose and is 4% higher than in May. Households' and businesses' financial conditions tightened steadily from mid-2022 onwards, alongside rising interest rates, but have generally improved thus far in 2024. At present, they are neither unusually tight nor unusually accommodative in historical context.

Private consumption

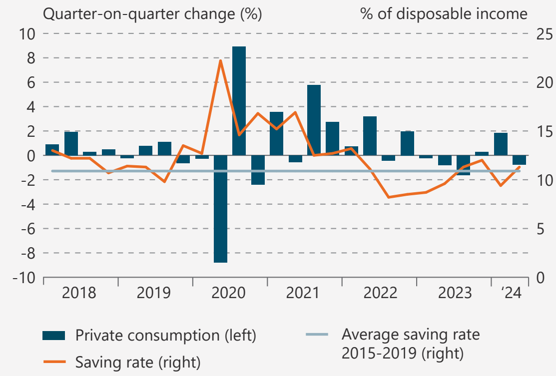
According to preliminary figures from Statistics Iceland, seasonally adjusted household consumption spending increased by 1.8% between quarters in Q1/2024, noticeably more than the 1.3% assumed in the Bank's May forecast. Private consumption grew by 0.2% between years, whereas in May it had been forecast to keep contracting as it did in H2/2023. Developments in private consumption in Q1/2024 are more closely aligned with recently revised payment card turnover data, which show stronger growth in household spending during the quarter than was indicated by the previous figures. The new card turnover data also suggest continued private consumption growth in Q2. A more detailed discussion of the potential impact of these new figures on historical national accounts data can be found later in this report.

Other indicators do not give such unequivocal signs of how private consumption developed in Q2, however. For instance, household pessimism increased between Q1 and Q2, and new motor vehicle registrations (excluding car rental agencies) contracted by 43%

Chart 7

Private consumption and household saving[1]

Q1/2018 - Q2/2024

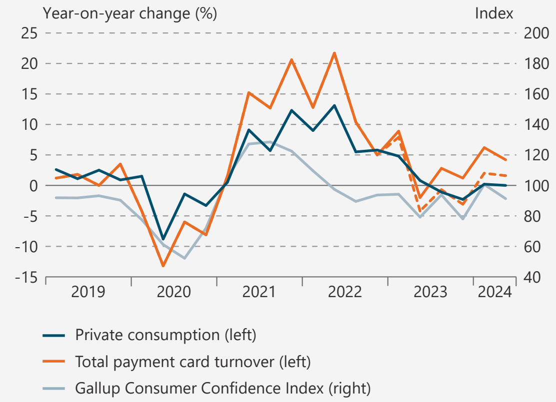


1. The saving rate is calculated based on the Central Bank's disposable income estimates. Central Bank baseline forecast Q2/2024. Seasonally adjusted figures.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 8

Private consumption and its indicators[1]

Q1/2019 - Q2/2024



1. Payment turnover in constant prices. The broken line shows card turnover before revision. Central Bank baseline forecast Q2/2024 for private consumption.
Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

over the first six months of the year. The Bank's baseline forecast therefore assumes that private consumption was flat year-on-year during the quarter, which is roughly in line with the May forecast. As a result, the household saving rate is estimated to have risen back to a level close to that seen at the end of 2023.

The outlook for 2024 is considered similar to the May forecast. Private consumption is expected to grow by 1% this year, as opposed to the 0.7% growth rate projected in May. The change primarily reflects stronger growth in Q1/2024. Over the next two years, growth is expected to be slightly weaker, as real disposable income is projected to rise a bit more slowly than was forecast in May.

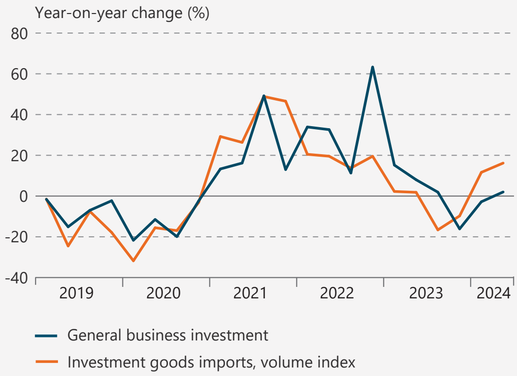
Investment

Investment grew by 2.4% year-on-year in Q1, slightly less than was projected in May. Subcomponents of investment diverged somewhat, however: residential and public investment turned out stronger than forecast, while business investment was weaker. This downturn was due primarily to a nearly 3% contraction in general business investment (excluding ships, aircraft, and energy-intensive industry), whereas 7% growth was forecast in May. That forecast reflected an increase of over 11% in the volume of investment goods imports during the quarter.

Chart 9

Investment goods imports and investment[1]

Q1/2019 - Q2/2024



1. Business investment excluding energy-intensive industry and ships and aircraft. Central Bank baseline forecast for growth in general business investment in Q2/2024. Volume index of imported investment goods and transport equipment for commercial use (excluding ships and aircraft).

Sources: Statistics Iceland, Central Bank of Iceland.

In line with continued strong investment goods imports in Q2, it is assumed that general business investment will grow again between years after the preceding two-quarter contraction; however, the outlook is for weaker growth over the year as a whole than was predicted in May, or 1.7% instead of the projected 5%. Furthermore, residential investment is forecast to grow more strongly this year, reflecting the results of Gallup's business survey, which indicates increasing strain on capacity in the construction industry, as well as indicators of greater activity and an increase in the number of new development projects. Public investment is still expected to shrink this year, or by 4%, some 2 percentage points smaller than the contraction forecast in May. As a result, total investment is now assumed to grow by just under 2% this year, marginally less than was provided for in the May forecast. The outlook for the next two years is broadly unchanged, however.

Public sector finances

The public sector outcome was positive by just under 1 b.kr. in Q1/2024. As a share of GDP, this represents a year-on-year improvement of 2.3 percentage points. The primary balance was positive by 2.6% of GDP during the quarter, albeit offset by a negative interest balance.

Public consumption grew by 1.2% year-on-year in Q1, a somewhat slower growth rate than in 2023 as a whole. The main difference lay in central government consumption expenditure, which increased far more slowly than in the quarters immediately beforehand. Furthermore, public investment contracted by 5.8% between years, somewhat less than was projected in May. The deviation here is attributable mainly to the prospect of a shift, relative to the May forecast, in the distribution of investment expenditures within the year, rather than to an increase in the scope of investment.

The outlook is for public consumption and investment combined to increase by 0.8% in 2024, slightly less than was forecast in May. The main difference lies in weaker growth in public consumption. For the next two years, the combined increase is projected at 1.5% and 2%, respectively, which is unchanged from the May forecast.

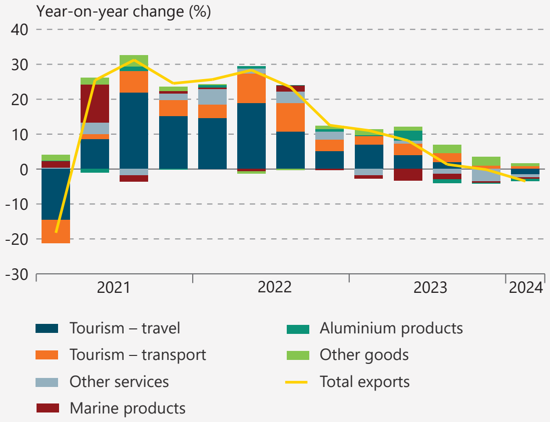
Exports of goods and services

Exports of goods and services contracted by 3.3% year-on-year in Q1, after having held virtually unchanged in H2/2023. For the first time since the COVID-19 pandemic, most subcomponents of exports contracted, and by more than was forecast in May. Nevertheless, the difference is due in part to a shortage of data on tourist spending in Iceland in the recent term (for further detail, see the discussion below on new payment card data and their potential impact on historical national accounts data).

Chart 10

Exports and contribution of subcomponents[1]

Q1/2021 - Q1/2024



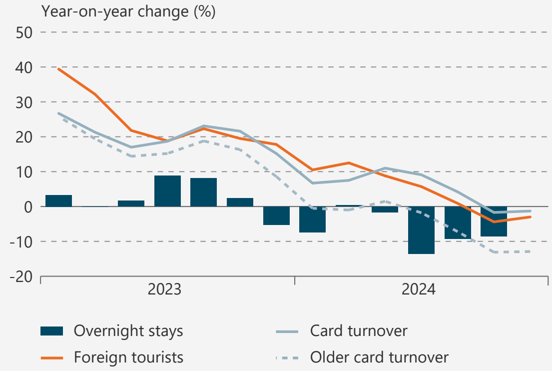
1. Because of chain-volume linking, the sum of components may not equal total exports. Aluminium exports as defined in the national accounts.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 11

Indicators of tourism sector activity[1]

June 2023 - July 2024



1. Foreign tourists' overnight stays in hotels. Payment card turnover based on monthly turnover with foreign payment cards in Iceland at constant exchange rates. Foreign nationals' monthly departures via Keflavík Airport. Three-month moving average for tourist and turnover numbers.

Sources: Icelandic Tourist Board, Isavia, Statistics Iceland, Central Bank of Iceland.

Tourism activity subsided in Q2/2024, and visitor arrivals fell by 5% year-on-year despite an increase in flight offerings. On the other hand, the number of transit passengers continued to rise significantly. Overnight stays declined in number more than tourist arrivals did, or by 10% year-on-year, and it appears that visitors are staying in Iceland for a shorter period of time. In spite of shorter stays, new and revised payment card turnover data imply that in foreign currency terms, average spending per tourist had increased year-on-year during the quarter, whereas previous figures had suggested a substantial drop in average spending. Over the first seven months of the year, 1.2 million tourists visited Iceland, roughly on a par with the same period in 2023 but slightly below the May forecast. The outlook for H2 has also worsened, and it appears that flight offerings to Iceland will decline in Q4. Furthermore, the status of hotel bookings appears poorer than at the same time in 2023, although Google searches for flights to Iceland and accommodation in the country are broadly unchanged.[1]

As a result, about 2.2 million tourist arrivals are expected in 2024, slightly fewer than was forecast in May, and services exports are projected to shrink by 1.1% year-on-year instead of growing by 1.7%, as in the May forecast. The difference is due primarily to slower growth in services exports in Q2 and a bleaker outlook for the tourism sector.

Prospects for goods exports are slightly better than in May, however, owing largely to one-off effects due to exports of ships in Q2. Goods exports are estimated to grow by 3.2% this year, almost 1 percentage point more than was assumed in May, due to the offsetting effects of reduced exports of aluminium and marine products and an improved outlook for other goods exports. Total exports are therefore expected to grow by 1.1% this year, about 1 percentage point below the May forecast. The outlook for 2025 has deteriorated as well, but as before, tourist numbers are expected to rise modestly and other goods exports to grow somewhat.

1. According to data from hospitality software firm Godo on the booking status of accommodation nationwide.

New payment card data and a possible revision to the national accounts

Data on turnover from foreign payment card use in Iceland, as well as domestic card use in Iceland and abroad, have been revised sharply upwards since the publication of the May *Monetary Bulletin*. The revision is due to improvements in data collection by foreign acquirers and domestic payment card issuers. It covers the period stretching back to January 2023, and all else being equal, the new data on foreign card use in Iceland and domestic card use abroad should result in changes to historical national accounts figures on developments in both private consumption and services trade, which will be published at the end of this month. The revision of turnover with domestic cards in Iceland will probably have limited impact on historical data, however, as those figures are not used directly in Statistics Iceland's estimates of Icelandic households' domestic consumption spending.

As was discussed in the May *Monetary Bulletin*, foreign tourists' spending had not developed in line with their numbers in the recent past, and it therefore appeared as though average spending per tourist had declined sharply. However, the revised figures suggest that at constant exchange rates, average spending per tourist over the first seven months of this broadly unchanged or higher than the previous year. Furthermore, it looks as though H2/2023 was somewhat stronger than previously thought. New card turnover figures should therefore lead to an upward revision of Statistics Iceland's data on services exports in 2023 and Q1/2024, all else being equal. Based on the revision of Icelanders' card turnover abroad, services imports will probably be revised upwards as well.

The revision of card turnover data will probably affect historical figures on developments in private consumption also, but the effect on estimates of Icelanders' private consumption spending will presumably be in both directions, upwards and downwards. Foreign tourists' spending in Iceland is used to estimate their share in total turnover within the country, and the revision could result in a downward adjustment of private consumption data. On the other hand, the revision of Icelanders' spending abroad should tend to push private consumption estimates upwards. The magnitude of the adjustment of private consumption is therefore unclear.

On the whole, then, it is uncertain what impact the new payment card data will have on Statistics Iceland's estimates of GDP growth in 2023 and Q1/2024. Because the revision of foreign card use in Iceland causes an increase in services exports and an offsetting decrease in private consumption, and the revision of Icelanders' card use abroad causes an increase in private consumption and an offsetting increase in services imports, it is possible that the overall impact on GDP growth will be relatively limited, even if the effect on developments in some expenditure subcomponents of GDP proves significant.

Imports of goods and services

Goods and services imports grew by 1.6% year-on-year in Q1, after having contracted by 6% in Q4/2023. This is a stronger growth rate than was assumed in the May forecast, mainly because of stronger services imports, which grew by 6.6% between years. Increased imports of financial services underpin a large share of services import growth, supported by a rise in Icelanders' spending while travelling overseas. Goods imports shrank year-on-year by 0.9% in Q1, however, owing in particular to a contraction in imports of alumina.

Goods imports appear to have increased again in Q2, as was forecast in May, and the outlook for growth in services imports is also virtually unchanged. As a result, total imports are expected to grow by 2.4% in 2024 as a whole, or 0.4 percentage points more than in the May forecast, owing primarily to a strong Q1. Growth looks set to be marginally weaker in 2025 and 2026, however.

Current account balance

The Q1/2024 current account deficit totalled 35.9 b.kr., or 3.5% of GDP, some 0.2 percentage points more than was forecast in May. It was considerably larger than the Q1/2023 deficit of 14.6 b.kr., mainly because of a larger deficit on goods and services trade.

The current account is now expected to show a deficit of 0.6% of GDP for 2024 as a whole, whereas in May it was projected to be in balance. The difference is due in large part to a poorer outlook for tourism, although the primary income balance is also expected to show a smaller surplus, as it is assumed that higher aluminium prices improve aluminium companies' operating performance. The outlook for the next two years has deteriorated as well, but the deficit looks set to narrow in 2025 and measure ¼% of GDP at the end of the forecast horizon.

GDP growth

GDP shrank by 4% year-on-year in Q1/2024. This is well in line with the May forecast of a 3.7% contraction during the quarter. The contraction is due primarily to inventory changes, which had a negative impact on GDP growth in the amount of 3.5 percentage points. This stemmed largely from the capelin catch failure and the fact that, unlike in Q1/2023, no capelin inventories were accumulated in Q1 of this year. Excluding inventory changes, domestic demand grew by 0.9% between years, slightly more than was forecast in May.

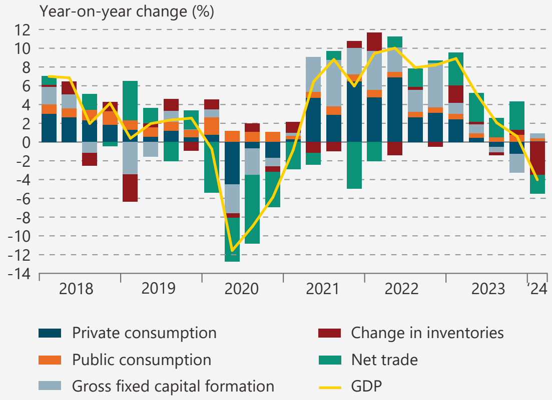
The negative impact of inventory changes on GDP growth partly reversed in Q2, and GDP is now estimated to have started growing again between years. It is projected to have grown by 2% year-on-year, somewhat less than was forecast in May. The outlook for the year as a whole has deteriorated as well. Year-

2024 growth is now projected at 0.5%, which is 0.6 percentage points below the May forecast. This is due mainly to the poorer outlook for exports, particularly the prospect of weaker growth in services exports. The output growth outlook for 2025 and 2026 has also deteriorated slightly.

Chart 12

GDP growth and contribution of components[1]

Q1/2018 - Q1/2024

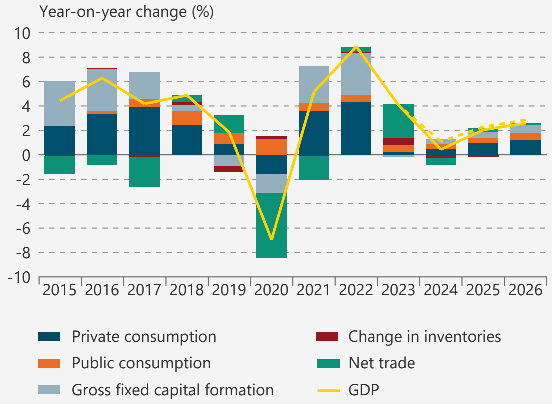


1. Because of chain-volume linking, the sum of expenditure components may not equal GDP growth.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 13

GDP growth and contribution of underlying components 2015-2026[1]



1. Central Bank baseline forecast 2024-2026. Broken line shows forecast from MB 2024/2.

Sources: Statistics Iceland, Central Bank of Iceland.

Employment and unemployment

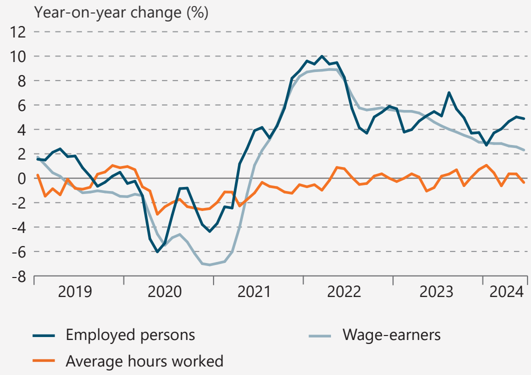
According to the Statistics Iceland labour force survey (LFS), total hours worked rose by 4.5% year-on-year in Q2/2024. Of that amount, job growth measured 4.9%, while the average work week grew shorter by 0.3%. The increase in job numbers and total hours worked was somewhat greater than was assumed in May, but the survey probably gives an overly optimistic view of the labour market situation. For instance, the year-on-year increase in the number of wage-earners on the pay-as-you-earn (PAYE) register was only half as large as the increase in job numbers according to the LFS during the quarter, or 2.3%, and job creation has been losing pace by this measure almost continuously since spring 2023.

Seasonally adjusted LFS results show that the labour participation rate also increased considerably in Q2 and drew close to its historical peak. At the same time, unemployment fell by nearly 1 percentage point between quarters, to 3.1% in Q2, whereas the Bank's May forecast assumed that unemployment would continue to rise. At the same time, seasonally adjusted registered unemployment measured 3.5% and was up slightly between quarters. Registered unemployment is therefore still inching upwards, indicating that pressures in the labour market are gradually easing.

Chart 14

Employment and hours worked[1]

January 2019 - June 2024



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.

Sources: Statistics Iceland, Central Bank of Iceland.

Gallup's summer survey indicates that job numbers will continue to grow in the coming term. The survey taken this spring suggested an increase in planned recruitment among the companies surveyed, but that rise appears to have reversed this summer. The results now indicate that labour demand will be close to its historical average in H2/2024. Statistics Iceland's corporate survey of job vacancies tells a similar tale. The seasonally adjusted number of vacancies declined in Q1 and as a result, the vacancy ratio was broadly similar to its 2019 level.

The Bank's baseline forecast assumes that the discrepancy that has developed between the LFS and other labour market indicators will recede in the latter half of the year. The rise in total hours worked is expected to lose pace this year, and a marginal downturn is expected in 2025. Unemployment is projected to rise in H2/2024 and average 4.1% for the year as a whole. According to the forecast, it will peak at 5% in 2025 but then taper off again in the final year of the forecast horizon.

Resource utilisation

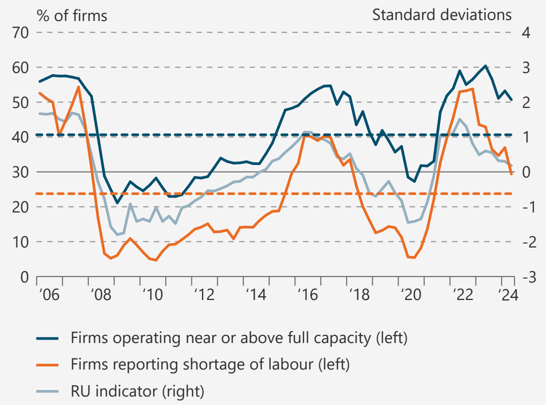
According to the seasonally adjusted results of Gallup's summer survey, just under 30% of executives considered their firms short-staffed, fewer than in the previous survey. Nonetheless, a full half of respondents still reported that their companies were operating at full capacity. The resource utilisation (RU) indicator, which combines various indicators of factor utilisation, continued to fall during the quarter.

The outlook is for GDP growth to be weaker in 2024 than was forecast in May, and for demand pressures in the economy to subside more quickly than was projected then. As in May, a slack in the economy is expected to open up as 2025 advances, and remnants of it will still be in evidence towards the end of the forecast horizon.

Chart 15

Capacity utilisation[1]

Q1/2006 - Q2/2024



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.

Inflation

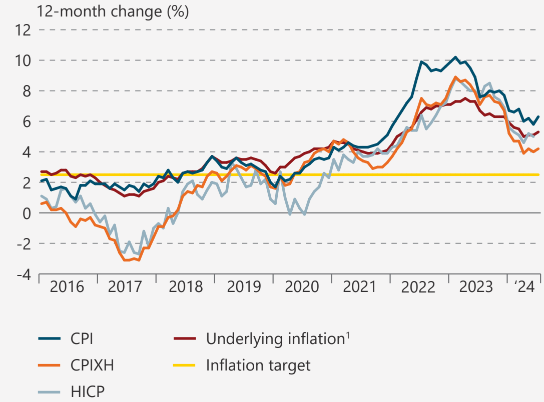
Inflation averaged 6% in Q2/2024, in line with the May forecast, and declined by 0.7 percentage points between quarters. A spike in July pushed it back up to 6.3%, however. Inflation excluding housing rose as well, to 4.2%. Underlying inflation was 5.3%, according to the average of various measures, and had risen marginally since June, but it was down 1½ percentage points year-on-year.

In June, Statistics Iceland changed its methodology for calculating imputed rent, adopting the rental equivalence method instead. Imputed rent has risen by 13.6% in the past twelve months, and the housing component still accounts for nearly half of twelve-month inflation. As a result of this methodology change, real mortgage interest expense is no longer included in the calculation of owner-occupied housing costs. Furthermore, the change will probably dampen volatility in the housing component of the CPI.

Chart 16

Various measures of inflation

January 2016 - July 2024



1. Underlying inflation shows the average of five different measures. From June 2024, Core Index 2 is used since Core Index 3 is no longer published.

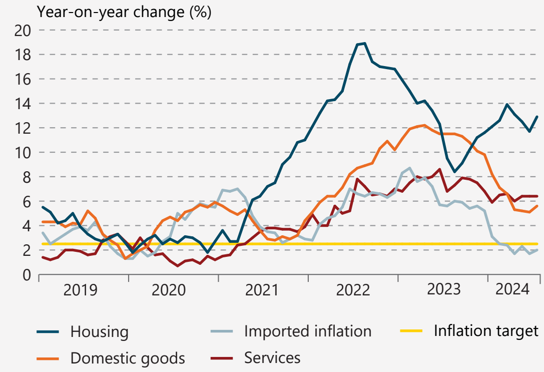
Sources: Statistics Iceland, Central Bank of Iceland.

Food and beverage prices, which have been rising unabated in the recent term, surged in July. The twelve-month rise in both domestic and imported foods had lost momentum in recent months but has now gathered pace again. On the whole, domestic goods prices have risen by 5.6% in the past twelve months and the price of groceries by 5.4%. Services price inflation has

Chart 17

Domestic and imported inflation[1]

January 2019 - July 2024



1. Services are a weighted average of the private and public services components.

Sources: Statistics Iceland, Central Bank of Iceland.

been persistent as well, holding fairly steady at 6½% in 2024 to date. The price of private services was up 5.7% year-on-year, as airfares and the price of various travel-related services rose in July.

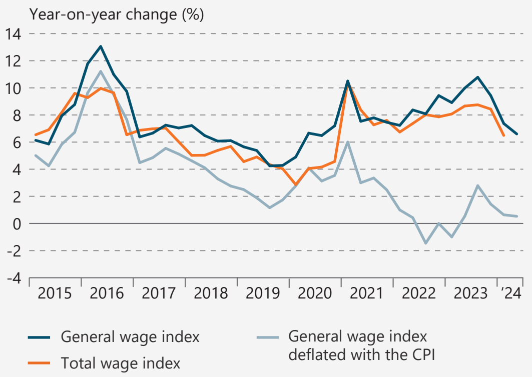
The general wage index rose 6.6% between years in Q2, and the year-on-year increase in the total wage index was similar in Q1. In June and July, labour unions within the Icelandic Federation of Labour (ASÍ), the Federation of State and Municipal Employees (BSRB), and the Association of Academics (BHM) signed wage agreements with the state and local governments. The Bank's forecast assumes that the labour market contracts still outstanding will be finalised this autumn and will be consistent with those already concluded.

Figures on wages subject to withholding tax, or PAYE wages, suggest that wages and related expenses will rise less in 2024 than previously estimated. It is now assumed that wages per hour will rise by 4.5% this year, somewhat less than was forecast in May, but that annual increases in 2025 and 2026 will average just under 6%. The outlook for developments in unit labour costs is broadly unchanged, however, as the productivity outlook for the period deteriorates accordingly.

Chart 18

Wages

Q1/2015 - Q2/2024

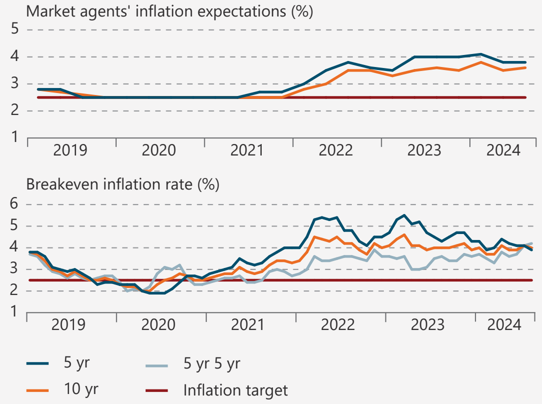


Source: Statistics Iceland.

According to the Bank's most recent survey, market agents' inflation expectations were largely unchanged relative to the April survey. Respondents expect inflation to measure 4% two years from now, as corporate executives do. Households' inflation expectations were unchanged between surveys as well, at 5%. Similarly, market agents' long-term inflation expectations were broadly unchanged, both between surveys and between years, at an average of 3.6% over the next ten years, slightly higher than in April. Corporate executives still expect inflation to average 4% in the next five years, but households are more pessimistic. The five-year breakeven inflation rate five years ahead has risen since May, to 4.2% as of mid-August. As is discussed above, some of that increase is due to sparse and limited trading in short-term inflation-indexed Treasury bonds. As a result, it is not clear that the rise reflects an increase in long-term inflation expectations.

Chart 19

Market long-term inflation expectations[1]



1. Median value of market agents' inflation expectations according to the Central Bank survey (Q1/2019 - Q3/2024) and breakeven inflation rate in the bond market (monthly averages January 2019 - August 2024). Data through 16 August 2024.
Source: Central Bank of Iceland.

The inflation outlook

Inflation has proven persistent, and it appears that some inflationary pressures still remain. Headline inflation is forecast to measure 6.3% in Q3 and then fall to 5.8% in Q4. This is above the May forecast, owing to a poorer initial position, as the inflation outlook has actually changed little since May. The positive output gap is estimated to be slightly smaller and is expected to close and a slack to open next year, as was previously expected. In addition, the outlook is for wage costs to rise less in 2024 and 2025 than was previously assumed. On the other hand, inflation expectations are broadly unchanged and are poorly anchored to the target.

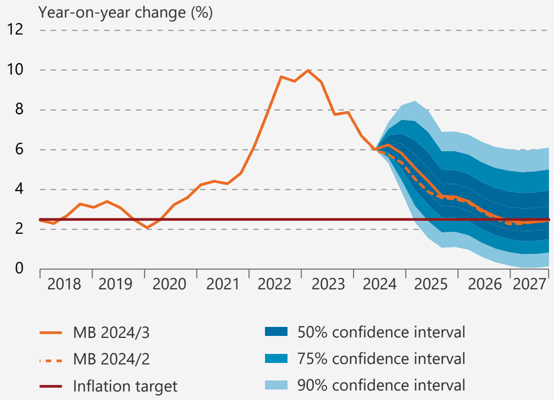
At the beginning of 2025, the Government plans to introduce a per-kilometre charge for all motor vehicles but increase the carbon tax and cancel the tax on oil and petrol. It is still unclear how this will be formulated and how Statistics Iceland will treat the change in its CPI measurements. It seems most logical that a comprehensive per-kilometre charge will cause an increase in public levies in the index, which would offset the downward effect on petrol prices, ultimately resulting in little change in the CPI. As a consequence, the baseline forecast does not take particular account of these plans. Nevertheless, a per-kilometre charge for electric cars and plug-in hybrids was introduced in January 2024 and did not affect the CPI at that time. It is therefore possible that this will continue when the charge is levied on all vehicles, causing the CPI to fall at the beginning of 2025. In that case, the Bank's forecast would overestimate measured year-2025 inflation by that amount. There would be no change in underlying inflationary pressures, however.

As before, the Bank's forecast assumes that inflation will ease slowly in 2025, falling to 3.6% by the end of the year. The slow pace of disinflation is due mainly to the length of time it has taken to unwind the positive output gap that developed early in 2022. Furthermore, the risk is that when inflation has been above target for an extended period of time and expectations are poorly anchored, inflation will fall more slowly than it would otherwise. As in the forecasts from February and May 2024, it is expected to return to the target in H2/2026, conditional upon the interest rate path in the baseline forecast.

Chart 20

Inflation forecast and confidence intervals

Q1/2018 - Q3/2027



Sources: Statistics Iceland, Central Bank of Iceland.

Appendix

Forecast tables

Table 1 GDP and its main components[1]

	2022	2023	2024	2025	2026
Private consumption	8.3 (8.3)	0.5 (0.5)	1.0 (0.7)	1.8 (2.1)	2.4 (2.7)
Public consumption	2.3 (2.3)	2.2 (2.2)	1.5 (2.0)	1.7 (1.8)	2.0 (2.0)
Gross capital formation	15.1 (15.1)	-0.6 (-0.6)	1.8 (2.3)	1.9 (1.4)	2.9 (3.2)
Business investment	27.0 (27.0)	0.9 (0.9)	2.0 (3.9)	0.9 (0.7)	2.8 (3.2)
Residential investment	-6.2 (-6.2)	-0.3 (-0.3)	5.8 (3.5)	6.6 (5.1)	4.1 (4.3)
Public investment	5.8 (5.8)	-6.1 (-6.1)	-3.8 (-5.8)	-0.2 (-0.3)	1.8 (1.8)
National expenditure	8.2 (8.2)	1.2 (1.2)	1.0 (1.1)	1.6 (1.7)	2.4 (2.6)
Exports of goods and services	22.3 (22.3)	4.8 (4.8)	1.1 (2.1)	3.1 (3.8)	3.3 (3.8)
Imports of goods and services	20.0 (20.0)	-1.4 (-1.4)	2.4 (2.0)	2.2 (2.4)	3.0 (3.3)
Gross domestic product (GDP)	8.9 (8.9)	4.1 (4.1)	0.5 (1.1)	2.0 (2.3)	2.6 (2.9)
GDP at current prices (ISK trillions)	3.88 (3.88)	4.28 (4.28)	4.52 (4.55)	4.81 (4.84)	5.11 (5.16)
Public sector demand[2]	2.8 (2.8)	1.0 (1.0)	0.8 (1.0)	1.5 (1.5)	2.0 (2.0)
Total investment (% of GDP)	24.0 (24.0)	23.7 (23.7)	24.1 (23.3)	23.9 (22.9)	23.9 (22.9)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/2).
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]

	2022	2023	2024	2025	2026
Marine production for export	1.4 (1.3)	-8.0 (-7.9)	0.3 (1.0)	0.5 (1.5)	1.3 (2.1)
Aluminium production for export[2]	2.3 (2.3)	1.2 (1.2)	-0.8 (0.5)	1.6 (1.1)	0.5 (1.0)
Goods exports total	1.5 (1.5)	1.1 (1.1)	3.2 (2.5)	2.0 (2.7)	3.3 (3.7)
Services exports total	58.3 (58.3)	9.8 (9.8)	-1.1 (1.7)	4.3 (4.9)	3.4 (4.0)
Contribution of net trade to GDP growth (percentage points)	0.5 (0.5)	2.9 (2.9)	-0.6 (0.1)	0.4 (0.6)	0.2 (0.3)
Terms of trade for goods and services	2.5 (2.5)	-5.7 (-5.7)	0.1 (0.1)	0.3 (0.4)	0.3 (0.6)
Trade balance (% of GDP)	-0.2 (-0.2)	-0.1 (-0.1)	-0.6 (0.0)	0.0 (0.8)	0.2 (1.2)
Current account balance (% of GDP)	-1.7 (-1.7)	0.9 (1.0)	-0.6 (0.2)	-0.3 (0.8)	-0.3 (1.1)
Inflation in main trading partners[3]	7.6 (7.6)	5.0 (5.0)	2.6 (2.5)	2.2 (2.1)	2.0 (2.0)
GDP growth in main trading partners[3]	3.1 (3.3)	1.2 (1.2)	1.3 (1.2)	1.6 (1.6)	1.7 (1.7)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/2).
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]

	2022	2023	2024	2025	2026
Total hours worked[2]	6.7 (6.7)	5.0 (5.0)	2.2 (2.0)	-0.4 (0.7)	1.6 (1.3)
Unemployment (% of labour force)[2]	3.8 (3.8)	3.4 (3.4)	4.1 (4.8)	5.0 (4.9)	4.2 (4.2)
GDP per hour worked[3]	2.0 (2.0)	-0.9 (-0.9)	-1.7 (-0.9)	2.5 (1.6)	1.0 (1.6)
Unit labour costs[4]	7.3 (7.3)	7.8 (7.8)	6.3 (6.5)	3.4 (3.9)	4.6 (4.0)
Real disposable income[5]	3.5 (3.5)	0.6 (0.6)	1.3 (0.6)	0.9 (1.8)	3.9 (3.8)
Output gap (% of potential output)	4.1 (4.0)	4.0 (3.8)	0.4 (0.6)	-0.7 (-0.5)	-0.5 (0.0)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/2).
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]

	2022	2023	2024	2025	2026
Trade-weighted exchange rate index[2]	3.1 (3.1)	-2.6 (-2.6)	-0.2 (-0.5)	-0.3 (-0.2)	-0.5 (-0.1)
Real exchange rate (relative consumer prices)	3.9 (3.9)	0.9 (0.9)	3.3 (2.8)	1.6 (1.6)	0.4 (0.7)
Inflation (consumer price index, CPI)	8.3 (8.3)	8.7 (8.7)	6.2 (5.9)	4.2 (3.9)	2.9 (2.8)

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/2).
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	
2023:3	7.8 (7.8)	4.4 (4.4)
2023:4	7.9 (7.9)	5.5 (5.5)
2024:1	6.7 (6.7)	5.7 (5.7)
2024:2	6.0 (6.0)	8.6 (8.4)
	Forecasted value	
2024:3	6.3 (5.8)	5.3 (3.5)
2024:4	5.8 (5.3)	3.8 (3.9)
2025:1	5.1 (4.5)	2.8 (2.5)
2025:2	4.4 (3.9)	5.8 (5.8)
2025:3	3.7 (3.6)	2.3 (2.3)
2025:4	3.6 (3.5)	3.6 (3.7)
2026:1	3.4 (3.3)	1.9 (1.7)
2026:2	3.0 (2.9)	4.0 (3.9)
2026:3	2.6 (2.5)	1.0 (0.9)
2026:4	2.4 (2.3)	2.8 (2.6)
2027:1	2.3 (2.3)	1.5 (1.8)
2027:2	2.4 (2.4)	4.2 (4.2)
2027:3	2.5	1.3

1. Figures in parentheses are from the forecast in MB 2024/2.

Sources: Statistics Iceland, Central Bank of Iceland.

MONETARY BULLETIN

2024 | 3