CENTRAL BANK OF ICELAND

SEÐLABANKI ÍSLANDS

MONETARY BULLETIN

2024|4

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.

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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 20 November 2024

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.5 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 8.5%.

Inflation has eased recently, measuring 5.1% in October. The decline in inflation has been broad-based, and underlying inflation has fallen as well. Furthermore, inflation expectations have declined overall, and the real rate has therefore risen.

The effects of a tight monetary stance can still be seen in economic activity, and growth in domestic demand has lost pace. Unemployment continues to inch upwards, and the outlook is for demand pressures in the economy to ease, albeit more slowly than previously assumed.

Persistent inflation and inflation expectations above target call for caution, however. As a result, it is still necessary to maintain an appropriately tight monetary stance in order to bring inflation back to target within an acceptable time frame.

As before, near-term 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.

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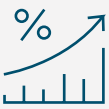
Monetary Bulletin in a nutshell

Trading partner GDP growth has developed in line with the August forecast, and the outlook is broadly unchanged. GDP growth in trading partner countries is expected to inch upwards from 1.4% in 2024 to 1.7% by 2026. As before, robust output growth in the US weighs heavily, while the outlook for the eurozone remains relatively poor. Global inflation has continued to ease. It averaged 2.2% in Q3/2024, but as in the August forecast, it is projected to fall to 2% late in 2025.



In Iceland, GDP rose again between Q1 and Q2, but because of a sizeable Q1 contraction stemming from the negative effects of inventory changes due to the failed capelin catch, GDP was still down by 1.9% year-on-year in H1. This represents a significant reversal, as GDP growth measured 5% in 2023 and 9% in 2022. GDP is projected to be flat year-on-year in 2024, as compared with the August forecast of 0.5% growth. The poorer outlook is due primarily to the H1 contraction, which turned out larger than previously expected. As in August, GDP growth is projected to rebound to nearly 2% in 2025 and then average 2½% per year in the latter half of the forecast horizon. As was assumed in August, output growth during the forecast horizon will be driven largely by domestic demand – private consumption in particular.

According to pay-as-you-earn tax data, job numbers have fallen and unemployment continues to inch upwards. Thus the positive output gap continues to narrow, even though it is now wider than previously estimated because of Statistics Iceland's revision of 2023 GDP growth figures. The output gap is projected to close and a slack to open up in late 2025, slightly later than previously forecast.

Inflation measured 5.1% in October, after falling by nearly 1 percentage point since August and close to 3 percentage points since October 2023. Inflation excluding housing has fallen still further, and underlying inflation has continued to ease. Similarly, inflation expectations have fallen by most measures. In Q3, inflation was somewhat below the August forecast, and because of a more favourable initial position, the inflation outlook through 2025 has improved. This is supported by a slightly stronger króna but offset by a larger positive output gap. Therefore, the inflation outlook for the latter half of the forecast horizon is broadly as in August. Inflation is projected to fall below 3% in H1/2026 and return to target by the middle of that year.

The risk of a hard landing in the US has receded, but the global economic outlook remains quite uncertain, owing chiefly to concerns about the protracted war in Ukraine and escalation of the war in the Middle East. Global commodity prices could therefore rise more than is currently forecast, and imported inflationary pressures in Iceland could prove stronger. Furthermore, because inflation expectations are less firmly anchored, the effects of higher commodity prices and recent pay rises in Iceland could be underestimated in the Bank's forecast. Developments in domestic economic activity will also affect the inflation outlook. For instance, inflation could prove more persistent than is currently forecast if households draw down their recently accumulated savings more quickly. It could fall more rapidly, though, if tourism sector activity subsides more than currently expected.

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

The global economy and terms of trade

I

The global economy

Global GDP growth picked up in Q2 ...

GDP growth among Iceland's main trading partners averaged 0.4% quarter-on-quarter in Q2/2024 (Chart I-1). This is up marginally from the quarters beforehand but in line with the Bank's August forecast. Year-on-year GDP growth measured 1.4% in Q2 and gained pace between quarters, although it is still markedly below the average of recent decades.

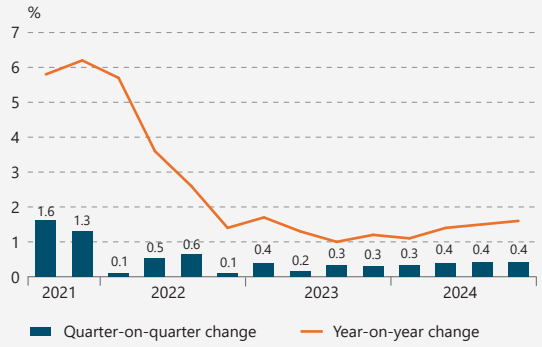
... but growth rates in the US and Europe still diverge widely ...

Although trading partner GDP growth picked up in Q2, it still varies greatly from one country to another (Chart I-2). It regained momentum in the US and remained close to 3% year-on-year for the fifth consecutive quarter, which is well above the US economy's estimated long-term potential. In Denmark as well, GDP grew markedly during the quarter, although the increase is due mainly to activities in the country's pharmaceuticals industry, which has become very large relative to the economy as a whole. The turnaround in the UK continued in Q2 after a weak 2023, but year-on-year GDP growth remained sluggish, at 0.7%. The euro area also showed weak growth in Q2, or 0.6% year-on-year. The economic contraction in Germany continued to weigh heavily, although growth was stronger in other core eurozone economies, Spain in particular. Output growth remained tepid in Norway and Sweden in Q2, and sagged more than generally expected in China.

Chart I-1

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

Q3/2021 - Q4/2024

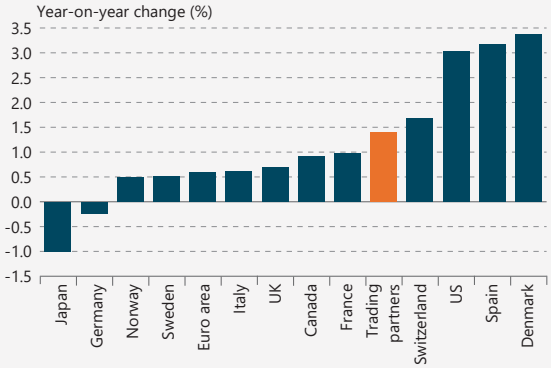


1. Seasonally adjusted data. Central Bank baseline forecast Q3/2024 and Q4/2024.

Sources: LSEG Datastream, Central Bank of Iceland.

Chart I-2

GDP growth among Iceland's main trading partners Q2/2024[1]



1. Seasonally adjusted data. Figures for Norway exclude the production and shipping of oil and gas.

Sources: LSEG Datastream, Central Bank of Iceland.

… owing primarily to differences in domestic demand

As before, the differences stem largely from domestic demand, which has diverged from one trading partner country to another. This is particularly applicable to private consumption, which has been strong in the US, whereas households' consumption spending in Europe has either grown weakly or even contracted (Chart I-3). Divergences in real wage growth are a key factor in this, as wages lost much more ground in Europe in the wake of the Ukraine war (Chart I-4). Furthermore, the war and the associated uncertainty about energy supplies in Europe have presumably caused European households and businesses to be more cautious about spending and investment decisions. Asset price gains have also been larger in the US and domestic fiscal support measures more expansive. Households in the US have therefore continued to spend a larger share of their disposable income than is the case in Europe, where households are still saving more than they did before the pandemic (Chart I-5). As is discussed in the May 2024 issue of *Monetary Bulletin*, interest rate hikes may have had a stronger and more rapid effect on households' disposable income in Europe than in the US, owing to differences in mortgage lending arrangements.

Concerns about the US economic outlook have abated …

The past summer's figures from the US labour market were highly disappointing, fuelling concerns that the economy could lose steam more rapidly than previously thought. These concerns have subsided, however, with strong job creation in September, more favourable unemployment data during the autumn, and other positive economic indicators. The GDP growth outlook for the world's largest economy has therefore improved since August, owing largely to continued real wage growth and more favourable financial conditions. Labour market tightness has eased in the US, however, as it has in other leading advanced economies, and manufacturing has softened. As a result, US output growth is still expected to ease in coming quarters.

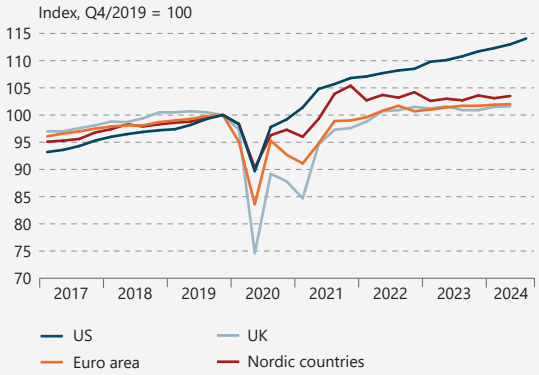
… but prospects for GDP growth in the euro area have deteriorated

Leading indicators also imply that the GDP growth outlook for the UK has improved since August. PMI indices have mostly held their ground, and retail sales figures suggest that household demand in the UK has finally begun to pick up, in tandem with rising real wages (Charts I-6 and I-7).

Chart I-3

Private consumption among main trading partners[1]

Q1/2017 - Q3/2024



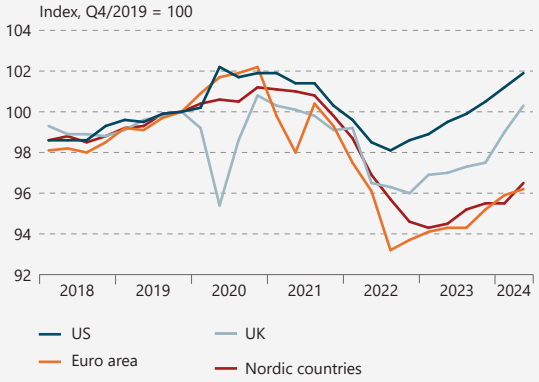
1. Seasonally adjusted data. "Nordic countries" is the simple average for Denmark, Norway, and Sweden.

Source: OECD.

Chart I-4

Real wages in main trading partner economies[1]

Q1/2018 - Q2/2024



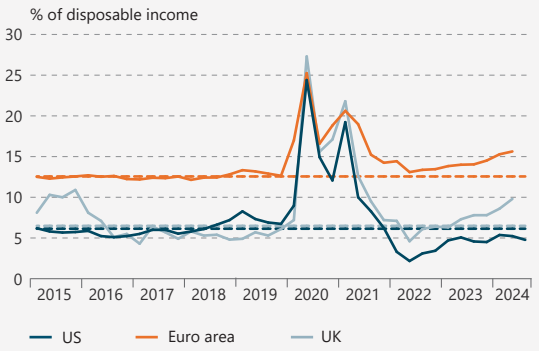
1. Seasonally and calendar-adjusted hourly earnings in manufacturing. "Nordic countries" is the simple average for Denmark, Norway, and Sweden.

Source: OECD.

Chart I-5

Household saving[1]

Q1/2015 - Q3/2024



1. Broken lines show 2015-2019 averages.

Source: LSEG Datastream.

Retail sales in the eurozone have also picked up recently in tandem with increased household purchasing power. PMI indices have, however, tapered off and manufacturing has been weak, especially in the motor vehicle industry. Similarly, surveys suggest that labour demand has weakened still further. Output growth prospects for the euro area have therefore deteriorated.

Trading partner GDP growth still expected to increase gradually over the forecast horizon

Trading partner GDP is estimated to have grown by an average of 0.4% quarter-on-quarter and 1.5% year-on-year in Q3/2024 (Chart I-1), or 0.1 percentage points above the Bank's August forecast. The slight upward revision is due mainly to stronger growth in the US, fuelled by continued growth in private consumption. Trading partners' GDP growth is also expected to be slightly stronger in Q4, measuring about 1.4% for 2024 as a whole instead of the 1.3% forecast in August (Chart I-8).

The GDP growth outlook is broadly unchanged since August, however, and GDP is projected to measure just over 1½% during the next two years. In 2025, growth is expected to be stronger in the US, UK, and Denmark, but weaker in the euro area and Norway. The outlook for China is more or less unchanged since August, with weaker growth in Q2 and Q3/2024 offset by increased fiscal support from the Chinese government. Recent hikes in tariffs on goods imported from China to the EU and the US will probably have a negative impact on the Chinese economy, on top of the problems relating to the real estate market and sluggish private consumption.

The global GDP growth outlook is broadly unchanged …

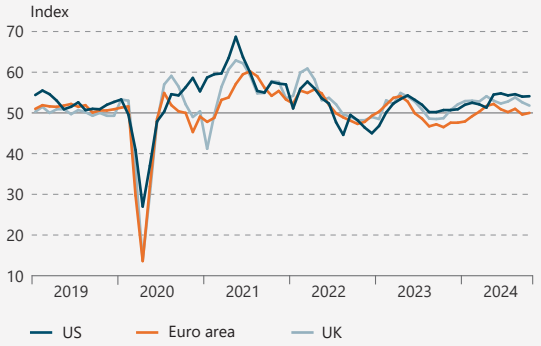
The Central Bank's baseline forecast for GDP growth in Iceland's trading partner countries accords well with the International Monetary Fund's (IMF) new global forecast. The IMF projects that global GDP growth will decrease from 3.3% in 2023 to 3.2% in 2024, the same as in its forecasts from April and July. In 2025, the growth rate is also expected to measure 3.2%. In the IMF's opinion, prospects for GDP growth in 2024 and 2025 have improved for the US but worsened for other advanced economies, especially Germany and Japan.

The Fund still assumes that world trade will rebound this year and gain further momentum in 2025, after having slowed markedly in 2023. The growth rate is still expected to fall short of the average of recent

Chart I-6

PMI for manufacturing and services[1]

January 2019 - October 2024



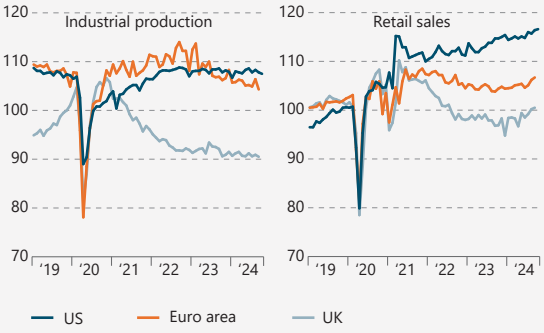
1. S&P Global purchasing managers' index for services and manufacturing (Composite Output Purchasing Managers' Index). The index is published monthly and is seasonally adjusted. An index value above 50 indicates month-on-month growth in output, and a value below 50 indicates a contraction.

Source: LSEG Datastream.

Chart I-7

Industrial production and retail sales[1]

January 2019 - October 2024

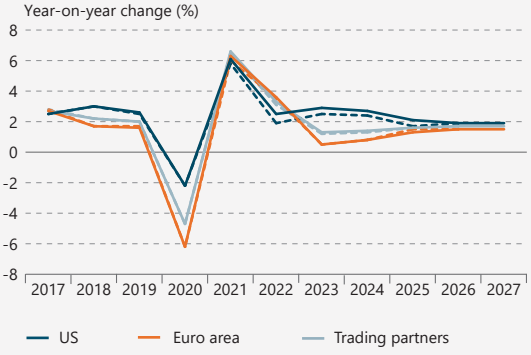


1. Seasonally adjusted volume indices (2020 = 100).

Source: LSEG Datastream.

Chart I-8

GDP growth among Iceland's main trading partners 2017-2027[1]



1. Trade-weighted average for main trading partners. Central Bank baseline forecast 2024-2027. Broken lines show forecast from MB 2024/3.

Sources: LSEG Datastream, Central Bank of Iceland.

decades, however, in line with weaker global GDP growth and an increase in protectionist policies. The IMF also assumes that import and export growth in advanced economies will be weaker than in its previous forecast.

… but the economic outlook remains highly uncertain

Although concerns about the US economic outlook have receded and prospects for global output growth are largely unchanged, there are still significant uncertainties, chief among them global inflation and how successfully it can be brought back to target and held there. Economic developments will also depend on how well households and businesses weather the shocks and cost increases of recent years. The impact of recent years' interest rate hikes on consumption and investment decisions could be underestimated, for instance, and GDP growth could turn out weaker than is currently assumed. Reductions in central bank interest rates and expectations of additional rate cuts could offset this, however, and contribute to stronger output growth than is currently forecast. Moreover, further vulnerabilities in the global financial system could come to the fore; for instance, if the inflation outlook deteriorates and central banks are forced to hold interest rates higher than is currently envisioned, and for a longer period of time.

The global economic outlook also depends in large part on developments in and repercussions of the wars in the Middle East and Ukraine, including their impact on world trade, commodity prices, and inflation. Furthermore, geopolitical fragmentation and the increased protectionism seen in recent years could escalate further, disrupting global supply chains, pushing the cost of international trade higher, and negatively affecting global economic activity. Moreover, there is considerable uncertainty about the fiscal outlook in many economies. Many emerging and developing economies are still poorly positioned because of high debt levels and interest rates. In addition, there is lingering uncertainty about economic developments in China and the impact of fiscal support measures there.

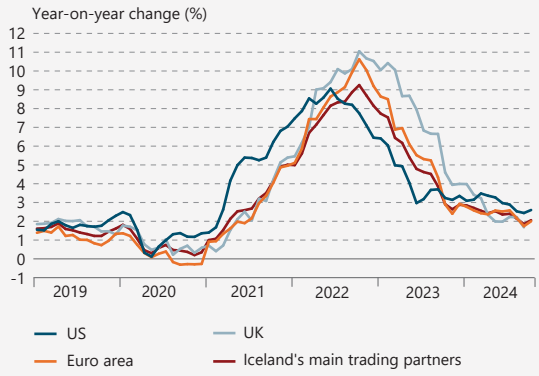
Trading partner inflation has continued to fall …

In trading partner countries, inflation has fallen still further this autumn, to an average of 1.9% in September, although it is projected to have risen back to 2.1% in October (Chart I-9). The year-on-year decline in energy prices still plays a role in impeding inflation, owing both to base effects from previous increases and to

Chart I-9

Global inflation[1]

January 2019 - October 2024



1. Central Bank estimate for trading partners in October 2024.

Sources: LSEG Datastream, Central Bank of Iceland.

the recent drop in energy prices. The surge in energy prices in 2021-2022 was one of the main reasons inflation rose as high as it did (Chart I-10). The steep year-on-year rise in food prices in the wake of the war in Ukraine has also subsided, and food price inflation has held steady at around 2% in the recent term. The contribution of goods prices to twelve-month inflation among trading partners has also declined and has been negligible in the recent past.

It is likely that fewer disruptions in manufacturing, more favourable developments in commodity prices, and falling energy prices are holding back rises in manufacturing costs and therefore contributing to lower goods and food prices than would otherwise be seen. Lower producer prices in China also play an important role in these developments. Furthermore, the post-pandemic shift in households' consumption from goods to services probably continues to impede goods price inflation. This year's rise in shipping costs, partly because of war in the Middle East, has presumably pulled in the opposite direction, contributing to larger price hikes.

... although services price inflation remains high ...

Although services price inflation has lost momentum in trading partner countries, it is still high and is the main reason headline inflation has been as high as it has been in the recent term (Chart I-11). This is probably due in large part to hefty rises in nominal wages and costs, together with tight labour markets and pent-up demand for services since the pandemic. Core inflation in trading partner countries (i.e., excluding the direct effects of energy and food prices) remains higher than headline inflation and is generally above target in the countries concerned.

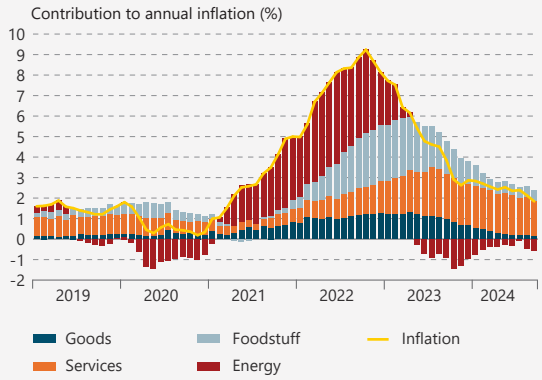
... and the inflation outlook for trading partners is broadly unchanged

Trading partner inflation averaged 2.2% in Q3/2024, or 0.3 percentage points below the Bank's August forecast, driven primarily by lower inflation in the US and the Nordic countries, although inflation was higher than projected in the UK. Owing to a better initial position, 2024 inflation is forecast to be lower, on average, in trading partner countries, or 2.5% instead of the 2.6% forecast in August. The inflation outlook for 2025 and 2026 is more or less unchanged, however. Average trading partner inflation is still expected to pick up again in Q4/2024 as base effects from previous energy price hikes taper off, and it is not expected to return to 2% until late 2025.

Chart I-10

Inflation among main trading partners and contribution of main components[1]

January 2019 - September 2024



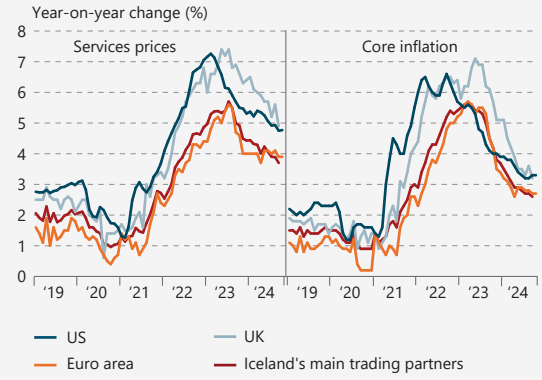
1. Trade-weighted average for main trading partners. The weight of each cost item is estimated using its weight in the euro area consumption basket.

Sources: LSEG Datastream, Central Bank of Iceland.

Chart I-11

Global services prices and core inflation[1]

January 2019 - October 2024



1. Excluding energy and food.

Sources: LSEG Datastream, Central Bank of Iceland.

Central banks in most advanced economies have lowered interest rates …

Central banks in almost all of the world's advanced economies have lowered their policy rates recently, in light of declining inflation and reduced uncertainty about the inflation outlook (Chart I-12). In some countries, policy rate cuts also reflect a weak economy, poorer prospects for GDP growth, and elevated uncertainty about the employment outlook. The European Central Bank (ECB), for instance, has lowered rates three times since this summer, for a total of 0.75 percentage points, and the Bank of England (BoE) has cut rates twice. The US Federal Reserve Bank lowered interest rates by 0.5 percentage points in September, its first rate cut in more than four years, and followed with a reduction of 0.25 percentage points in November. Furthermore, the central banks in Sweden, Switzerland, and Canada have lowered rates even further in the recent term, while Norges Bank has held its policy rate unchanged.

In spite of recent reductions, both nominal and real interest rates in leading advanced economies are still higher than they have been for some time (Chart I-13). Central banks in these countries remain cautious and have been largely reticent about their next moves, as underlying inflationary pressures are still fairly strong, which can be seen, for instance, in persistent services price inflation and large pay rises in the recent past.

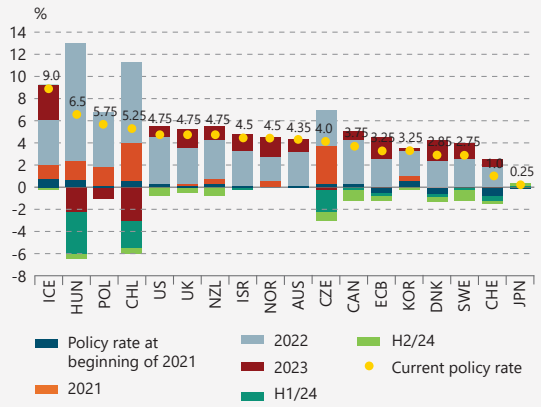
… and markets expect further rate cuts in the coming term

According to forward interest rates and surveys among market participants, central banks in major advanced economies are expected to continue lowering their policy rates in the weeks and months ahead (Chart I-14). Nevertheless, market participants do not expect rate cuts to be quite as large in the US as they projected in August and September. Presumably, this partly reflects regained optimism about the labour market and the output growth outlook, as is discussed above. Expectations about the policy rate in the UK have developed in a broadly similar manner.

These expectations are reflected in government bond yields in the countries concerned, which have risen again after declining in late summer and early autumn (Chart I-15). The rise in yields in leading advanced economies is probably also due in part to higher inflation expectations, greater uncertainty about the outlook for inflation and interest rates, and increased concerns about fiscal policy. This is reflected

Chart I-12

Central bank policy rates in OECD countries and changes since the beginning of 2021[1]



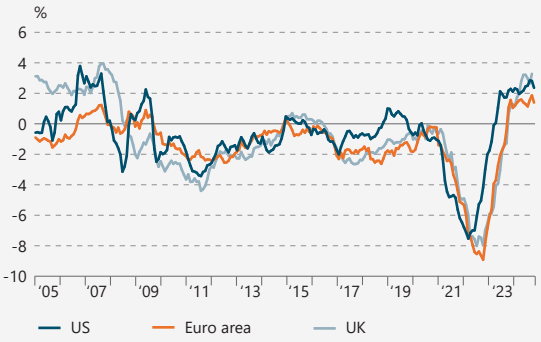
1. The US interest rate is the upper bound of the US Federal Reserve Bank's interest rate corridor, and the rate for euro area countries is the European Central Bank's deposit facility rate.

Source: LSEG Datastream.

Chart I-13

Central bank real rates[1]

January 2005 - October 2024



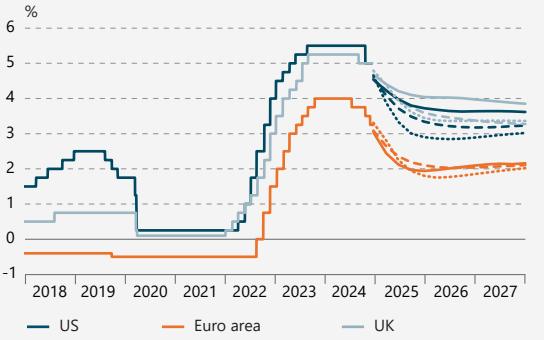
1. Monthly averages. Real rates according to central bank policy rates and the 12-month rise in the consumer price index. The US interest rate is the upper bound of the US Federal Reserve Bank's interest rate corridor, and the rate for the euro area are the European Central Bank's deposit facility rate.

Source: LSEG Datastream.

Chart I-14

Central bank policy rates[1]

January 2018 - December 2027



1. Daily data 1 January 2018 through 15 November 2024, and quarterly data Q4/2024 through Q4/2027. The US interest rate is the upper bound of the US Federal Reserve Bank's interest rate corridor, and the rate for euro area countries is the European Central Bank's deposit facility rate. Forward rates are based on overnight index swaps (OIS). Solid lines are based on forward rates as of early November 2024, dotted lines as of end-September 2024, and broken lines as of mid-August 2024.

Sources: Bloomberg, LSEG Datastream.

in a rise in breakeven inflation rates and term premia on their government bonds. However, share prices in advanced economies have firmed up again after falling in August, mainly in the US, and price volatility has diminished, although it is still greater than it was earlier in the year (Chart I-16). Share prices have also risen steeply in China, owing to the aforementioned fiscal support measures. Furthermore, premia on higher-risk financial assets in leading advanced economies and emerging economies have fallen. Financial conditions therefore appear to have improved somewhat since August.

Export prices and terms of trade

Marine product prices projected to fall less in 2024 ...

Foreign currency prices of Icelandic marine product exports started to soften early in 2023, in response to a downturn in demand in foreign markets (Chart I-17). They continued to decline in H1/2024, when they were down by 1.8% year-on-year. They began to rebound in Q3, however, rising more between quarters than was forecast in August. The increase is due in part to new EU tariffs and tighter US embargoes on Russian marine products imported from China, which took effect early this year. Marine product export prices are now expected to fall by 0.3% year-on-year in 2024, as compared with the 1% drop forecast in August. The outlook for the latter half of the forecast horizon is broadly unchanged, however, and marine product prices are still expected to rise further, owing mainly to the prospect of a weaker global cod supply due to reduced catch quotas in the Barents Sea.

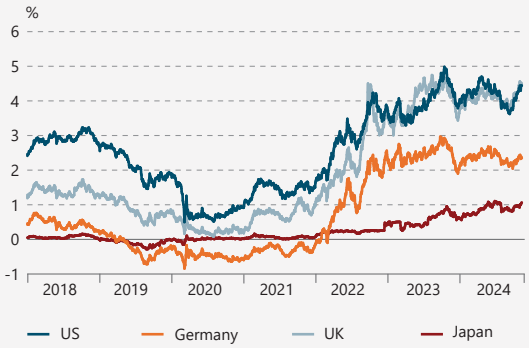
... while aluminium prices are projected to rise more than was forecast in August

Global aluminium prices have fluctuated widely in the recent term. They fell virtually unimpeded from mid-2022 until Q4/2023, after having peaked in the wake of Russia's invasion of Ukraine (Chart I-17). Global prices held broadly stable in Q1/2024 but then rose abruptly in April, after the UK and the US imposed embargoes on new metals imports from Russia. The increase reversed to a degree in Q3, partly because of reduced demand from China, which in turn was due to continuing problems in the country's real estate market, and from Europe, owing to weak manufacturing, particularly in the motor vehicle industry. Nevertheless, global prices were still an average of 8% higher in Q3 than in Q1.

Chart I-15

10-year government bond yields

1 January 2018 - 15 November 2024

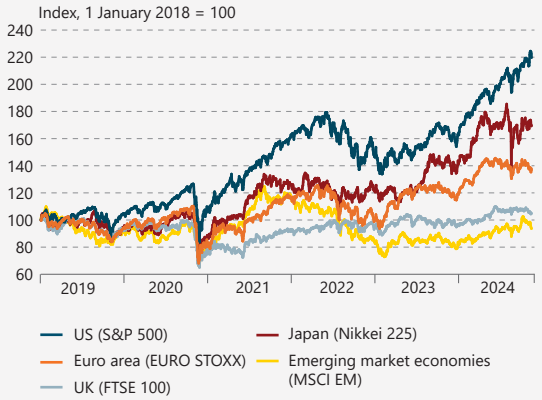


Source: LSEG Datastream.

Chart I-16

Global share prices

1 January 2018 - 15 November 2024

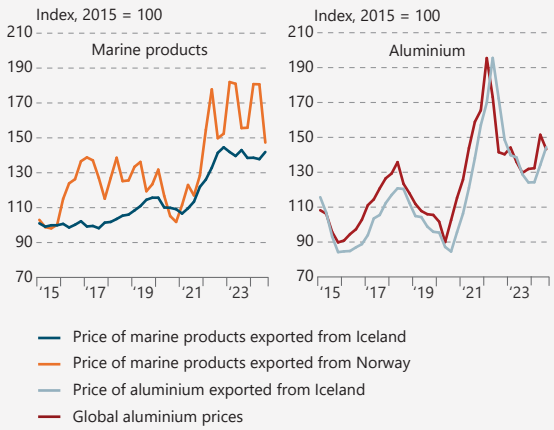


Source: LSEG Datastream.

Chart I-17

Export prices[1]

Q1/2015 - Q3/2024



1. Export prices of marine products at constant exchange rates. The price index for Norway is seasonally adjusted. Global aluminium prices and prices of aluminium exports from Iceland in USD.

Sources: Central Bank of Norway, Statistics Iceland, Statistics Norway, World Bank, Central Bank of Iceland.

The price of aluminium exported from Iceland has moved more or less in line with global prices in the recent term. It fell by around one-fourth in 2023, held steady in Q1/2024, and then rose considerably in Q2. In H1 as a whole, however, it was still down by an average of 7% year-on-year. Even though global market prices have fallen, it appears that the price of aluminium exports rose more in Q3 than was forecast in August. As a result, the price of Icelandic aluminium exports is projected to be an average of 1.4% higher in 2024 than in 2023, or 1 percentage point above the August forecast. Furthermore, futures prices suggest that aluminium prices will rise more in 2025 and 2026 than was assumed in the last forecast.

Oil prices have fallen since the summer …

Global oil prices started sliding in mid-summer and fell even more in September (Chart I-18), driven largely by elevated concerns about global demand, particularly because of weak economic activity in China. Market agents' confidence that the OPEC+ countries will stick to their previous plans and reverse production cutbacks again towards the end of 2024 has probably pulled in the same direction, as the group had previously postponed these plans. Their considerable scope to boost production, continuing output increases from other oil-producing countries, and the prospect of slower growth in demand have therefore enhanced the likelihood of a significant oversupply in the coming term, with the associated impact on prices. Increased unrest due to the war in the Middle East has pulled in the opposite direction, however. Although the war has made limited impact on oil exports from the region thus far, there are concerns that this will change, particularly because of the possibility that Israel will attack important oil infrastructure in Iran. Cutbacks in US production in the Gulf of Mexico, owing to unusually inclement weather this autumn, have also pushed oil prices higher.

The average price of Brent crude was just over 75 US dollars per barrel in October, which is 15% lower than in October 2023 and 5% below the Bank's August forecast. Oil futures suggest that prices will ease to around 70 dollars per barrel during the forecast horizon and remain below the level assumed in the Bank's last forecast (Chart I-19).

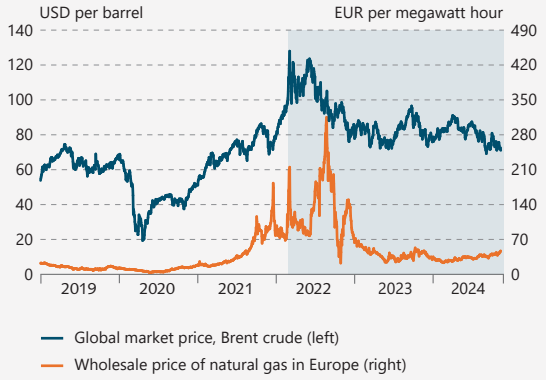
… but European natural gas prices have risen

The price of natural gas in Europe has risen in 2024 to date, although it remains well below the peak following Russia's invasion of Ukraine in 2022 (Chart I-18). This

Chart I-18

Oil and natural gas prices[1]

1 January 2019 - 15 November 2024



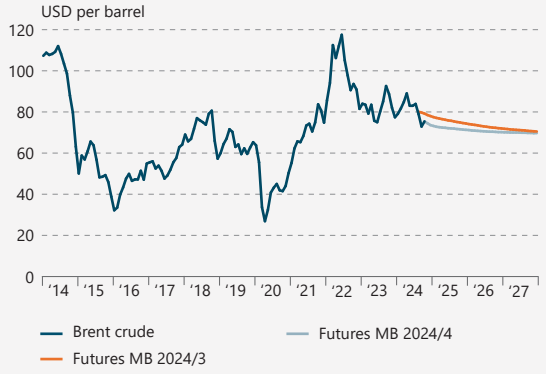
1. The shaded area shows the period following the onset of war in Ukraine.

Source: LSEG Datastream.

Chart I-19

Global oil prices

January 2014 - December 2027

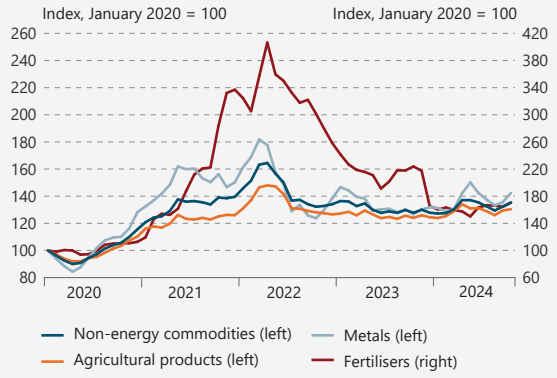


Sources: LSEG, Central Bank of Iceland.

Chart I-20

Global commodity prices[1]

January 2020 – October 2024



1. Agricultural products are classified as food (62%), beverages (13%), and raw materials (25%).

Source: World Bank.

year's rise is attributable to stronger energy demand during the summer, which in turn was due to unusually warm weather and elevated concerns about the possibility that shipments of the natural gas still being imported from Russia to Europe will be discontinued. Weak economic growth in Europe and strong inventories pulled in the opposite direction, however, and price hikes were smaller as a result.

Other commodity prices declined in Q3

After rising in Q2, the average price of key non-energy commodities started to fall again during the summer (I-20). The decline measured about 3½% quarter-on-quarter in Q3, as was forecast in August, but prices were still a full 2% higher than in Q3/2023. Metals prices fell the most between quarters, in line with declining demand from China and Europe. Agricultural product prices dropped as well, but as was discussed in *Monetary Bulletin* 2024/2, year-on-year price changes vary greatly from one food category to another (Chart I-21). Fertiliser prices rose between Q2 and Q3, however, but were still down by approximately one-fourth relative to the same period in 2023.

The outlook is for average non-energy commodity prices to be just over 1% higher this year than in 2023. This is broadly in line with the Bank's August forecast. The outlook for commodity prices over the next two years is also similar to the August forecast.

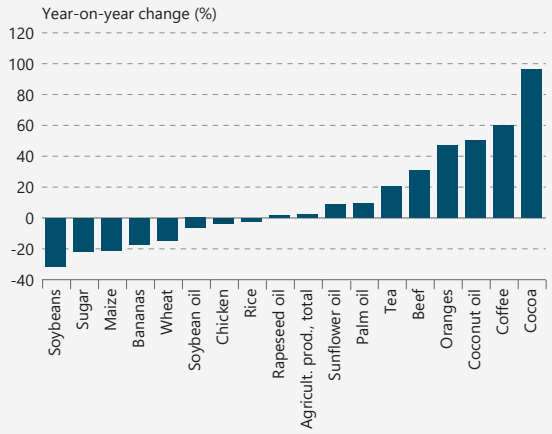
Terms of trade set to improve more than was anticipated in August

Terms of trade for goods and services deteriorated by 5.6% year-on-year in 2023, or 0.5% excluding the effects of aluminium and alumina prices. Aluminium prices have had less impact on terms of trade in 2024, as fluctuations have diminished. In H1/2024, terms of trade deteriorated by 0.6% overall, slightly less than was projected in August. Excluding the effects of aluminium and alumina prices, however, they improved marginally, or by 0.2% (Chart I-22). Price indices of key goods exports fell year-on-year in H1, particularly for marine products, ferrosilicon, and farmed fish, while the price of services exports increased. The price of other goods imports was unchanged between years, however.

The outlook for terms of trade has improved since August. They are now expected to improve by 1.1%, whereas in August they were projected to remain broadly flat (Chart I-23). The change is due mainly to a smaller rise in import prices in H2/2024 and to more favourable developments in aluminium and marine

Chart I-21

Agricultural product prices Q3/2024

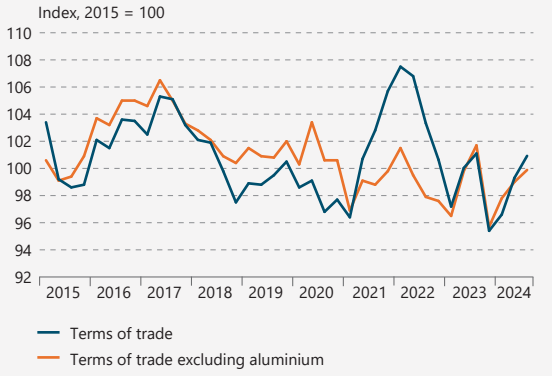


Source: World Bank.

Chart I-22

Terms of trade with and without aluminium prices[1]

Q1/2015 - Q3/2024



1.Terms of trade for goods and services excluding the impact of aluminium prices on export prices and excluding the impact of alumina prices on import prices. Central Bank baseline forecast Q3/2024.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-23

Terms of trade for goods and services 2015-2027[1]

1. Central Bank baseline forecast 2024-2027. The broken line shows the forecast from MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

product prices. Excluding the impact of aluminium and alumina prices, terms of trade are projected to improve by 0.9% this year. They are expected to improve still further next year and the outlook for the remainder of the forecast horizon has improved since August.

Monetary policy and domestic financial markets

II

Monetary policy and market interest rates

Key interest rate lowered for the first time in four years

At its October meeting, the Central Bank of Iceland's Monetary Policy Committee (MPC) decided to lower the Bank's interest rates by 0.25 percentage points. Therefore, the Bank's key interest rate – the rate on seven-day term deposits – was 9% prior to the publication of this *Monetary Bulletin* (Chart II-1). The October rate cut marked the first change in the Bank's policy rate in over a year, and the first reduction since November 2020, when the key rate was lowered to 0.75%.

The real policy rate has continued to rise, however (Chart II-2). The Bank's real rate in terms of the average of various measures of inflation and one-year inflation expectations is now 4.4% and has risen by 1.5 percentage points in 2024 to date. Despite the reduction in the key rate in October, the Bank's real rate is 0.2 percentage points higher than at the time of the August *Monetary Bulletin*, as inflation has eased and short-term inflation expectations have fallen by most measures. A similar trend can be seen in other advanced economies (see Chapter I).

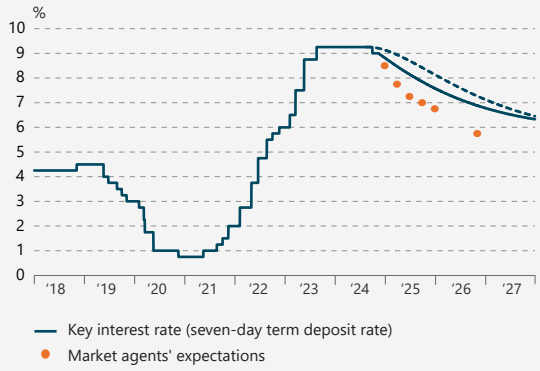
The baseline forecast assumes that the key rate will develop in line with the monetary policy rule in the Bank's macroeconomic model, which ensures that forecasted inflation will be broadly at target over the medium term.[1] Rates on bills with a maturity longer

1. According to the monetary policy rule in the model, the key interest rate is determined in part by developments in the Bank's neutral real rate, which is the real rate that would be required, all else being equal, to keep inflation at target and ensure full factor utilisation. The neutral real rate is considered to have risen again in the recent term, after falling in the wake of the financial crisis (see Box 1 in *Monetary Bulletin* 2019/4), and is now estimated at 2¼%. This assessment is highly uncertain, however.

Chart II-1

Central Bank of Iceland key interest rate[1]

1 January 2018 - 31 December 2027



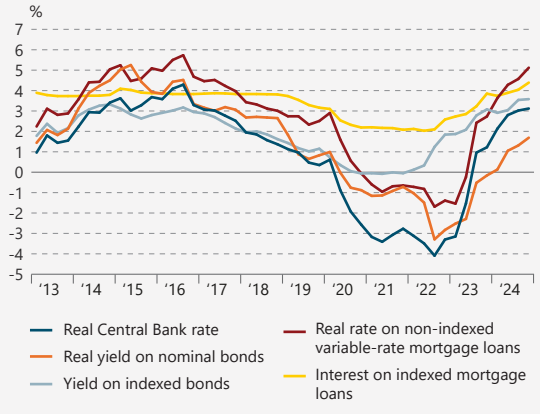
1. Money market rates and Treasury bond yields are used to estimate the yield curve. Broken line shows forward market interest rates prior to MB 2024/3. Market agents' expectations from Central Bank survey. Estimated from the median response on expectations concerning the collateralised lending rate. Survey carried out 4-6 November 2024.

Source: Central Bank of Iceland.

Chart II-2

Real Central Bank interest rate and real rates in the market[1]

Q1/2013 - Q4/2024



1. Q4/2024 data through 15 November 2024. Bond yields are five-year rates based on the zero-coupon yield curve, estimated with the Nelson-Siegel method. Interest on mortgage loans is a simple average of the lowest lending rates from the three largest commercial banks. Real interest rates based on 12-month inflation.

Sources: Statistics Iceland, Central Bank of Iceland.

than seven days fell more than the key rate in October, suggesting that investors expect further rate cuts in the coming term. Forward interest rates have therefore fallen, indicating that market agents expect the Bank's rates to fall faster than was anticipated in August. This is also in line with the Bank's November survey, according to which market participants expect the key rate to fall by an additional 0.5 percentage points in Q4/2024, continue easing in 2025, and measure 5.75% in two years' time (Chart II-1).

Long-term nominal interest rates have fallen since August ...

Yields on long-term nominal Treasury bonds rose somewhat over the summer, driven by investor concerns that inflation would be more persistent than previously thought; furthermore, it was announced at the end of June that Treasury bond issuance would be increased during the year. Yields started to fall in August, however, owing partly to expectations of more rapid interest rate cuts in trading partner countries, but since then, inflation in Iceland has also fallen more than expected. Investors therefore expect interest rates to fall more rapidly than before, and inflows due to non-residents' investments in Treasury bonds also increased during the autumn, which tends to push bond yields downwards.

The yield on ten-year nominal Treasury bonds was 6.2% just before this *Monetary Bulletin* and has fallen by 0.5 percentage points since August (Chart II-3). Since the October policy rate cut, short-term interest rates have fallen more than long-term yields, and the nominal yield curve is therefore less downward-sloping: the spread between ten- and two-year nominal yields is now 1.5 percentage points, after having hovered around 2 percentage points since year-end 2023.

... but long-term inflation-indexed rates are broadly unchanged

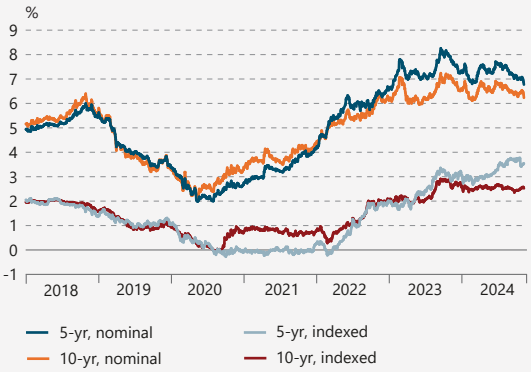
Although long-term nominal interest rates have fallen recently, longer inflation-indexed rates have held more or less flat. The yield on ten-year indexed bonds is broadly unchanged since August, at 2.5% just before this *Monetary Bulletin*.

Yields on shorter indexed bonds have fluctuated somewhat in the recent term, however. They rose steeply this summer, when the Government announced plans to replace oil and petrol taxes with a per-kilometre charge on all motor vehicles. The rise in yields reflected expectations that the change would lead to a marked drop in the CPI at the beginning of 2025.

Chart II-3

Government-guaranteed bond yields[1]

2 January 2018 - 15 November 2024



1. Based on the zero-coupon yield curve, estimated with the Nelson-Siegel method, using money market interest rates and Government-guaranteed bonds.

Source: Central Bank of Iceland.

The spike largely reversed in October, however, when Statistics Iceland announced that the per-kilometre charge would offset the decline in the oil and petrol taxes in CPI measurements. This made it clear that the change would have little impact on measured inflation, which is in line with the assumptions in the Bank's August forecast. However, in mid-November it was decided that a per-kilometre charge would not replace oil and petrol taxes at the start of 2025.

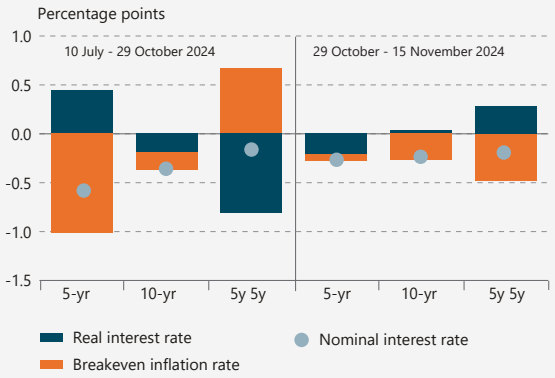
Significant changes in the short-term breakeven rate

Fluctuations in short-term inflation-indexed interest rates have caused major changes in the short-term breakeven inflation rate. The short-term breakeven rate plummeted following the Government's announcement this summer but then rebounded in part after Statistics Iceland explained how it would handle the per-kilometre charge. Nevertheless, it remains lower than before the Government's announcement in July, as inflation has fallen faster than market agents expected and the inflation outlook has therefore improved.

The ten-year breakeven rate has held broadly unchanged this year, however, but has declined slightly in the past weeks. Because of this, the five-year breakeven rate five years ahead, which reflects the latter half of the ten-year breakeven rate curve, increased starting in July but has tapered off again (Chart II-4). These fluctuations probably do not reflect changes in investors' long-term inflation expectations. It is more likely that they are due to investors' position-taking in the bond market in connection with uncertainty about Statistics Iceland's handling of the per-kilometre charge in the CPI.

Chart II-4

Breakdown of change in nominal bond interest rates[1]



1. Change in nominal Treasury bond yields (based on the zero-coupon yield curve estimated using the Nelson-Siegel method) and contribution of corresponding changes in inflation-indexed bond yields and the breakeven inflation rate.
Source: Central Bank of Iceland.

Chart II-5

Exchange rate of the króna[1]

4 January 2021 - 15 November 2024

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

Exchange rate of the króna

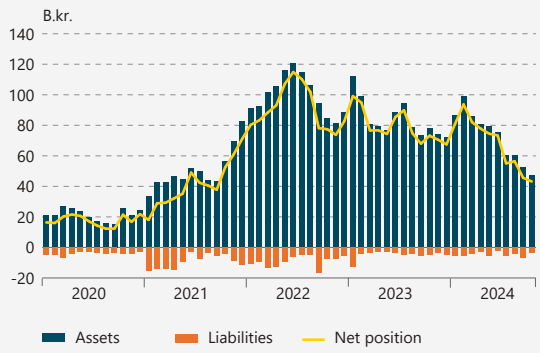
The króna has appreciated this autumn

After holding relatively stable early in 2024, the króna began to weaken in August (Chart II-5). By that time, investors had closed out a portion of their forward positions, as growth in tourism had slowed in Q2 and pessimism about tourism-generated export revenues had started to set in (Chart II-6). At the beginning of September, however, the króna began to appreciate again and rose even further in mid-November. The rise is due partly to the aforementioned inflows into domestic Treasury bonds, as interest rates are considerably higher in Iceland than in trading partner countries and Iceland's sovereign credit rating was upgraded in September. In addition to this, activity in tourism bounced back in Q3 and the pension funds have

Chart II-6

Commercial banks' FX forwards[1]

January 2020 - October 2024



1. Forward foreign exchange contracts involving the króna against foreign currency.
Source: Central Bank of Iceland.

bought less foreign currency year-to-date than over the same period in 2023. Expectations of payments to the pension funds due to the takeover of Marel by US company John Bean Technologies (JBT) may also be a factor, as Icelandic pension funds own a combined stake of over 40% in the company. Furthermore, by mid-year, most of the pension funds were approaching the internal target ratios of foreign assets to total assets provided for in their investment strategies. On the other hand, forward position-taking with the króna has continued to subside, perhaps indicating that investors expect a depreciation.

Just before this *Monetary Bulletin*, the króna was 3.7% stronger in trade-weighted terms than in August, and about 4.7% stronger than in November 2023. In 2024 to date, the Central Bank has intervened in the foreign exchange market once, buying foreign currency for 9.2 b.kr. in February, in a bid to counter the impact of strong foreign inflows into the bond market on price formation in the foreign exchange market. Foreign exchange market turnover has declined relative to the past two years, suggesting that currency flows are well balanced among market participants, and that they have less need to go to the market.

Króna set to be slightly stronger over the forecast horizon than was assumed in August

The trade-weighted exchange rate index (TWI) stood at 197 points in Q3/2024, and the króna was therefore about 1% weaker, on average, than was forecast in the August *Monetary Bulletin*. The average exchange rate has risen in Q4 to date, and the baseline forecast assumes that it will rise further over the forecast horizon. It is expected to be just over 2% higher at the end of the period than was assumed in August (Chart II-7).

Chart II-7

Exchange rate of the króna 2015-2027[1]

1. Price of foreign currency in krónur. Narrow trade index. Central Bank baseline forecast 2024-2027. Broken line shows forecast from MB 2024/3.

Source: Central Bank of Iceland.

Money holdings and lending

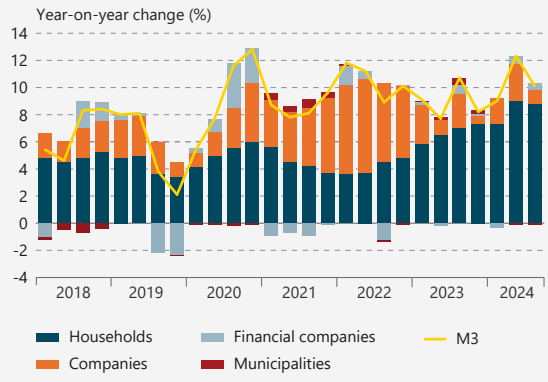
Household deposits continue to grow

Growth in M3 measured 10% year-on-year in Q3 but eased between quarters (Chart II-8). Household deposits continued to surge, however, growing by an average of 17% year-on-year in 2024 to date. Among other things, this reflects the past few years' sizeable pay rises alongside a slowdown in private consumption growth, and households have continued to build up their savings (see Chapters III and V). Growth in deposits varies by societal group, but unlike in the US, for instance, households in Iceland have not used their savings to finance consumption spending to any marked degree. Furthermore, deposit interest rates

Chart II-8

Money holdings[1]

Q1/2018 - Q3/2024



1. M3 is adjusted for deposits of failed financial institutions. Companies include non-financial companies and non-profit institutions serving households.

Source: Central Bank of Iceland.

rose steeply, in tandem with the Bank's key rate, making it likely that households have allocated a larger share of their savings to deposit accounts in the recent term instead of opting for riskier investments.

Corporate deposits grew by only a scant 3% year-on-year in Q3, however, and the growth rate has slowed since H1, in line with weakening activity in the domestic economy. Other likely factors in this trend include substantial cost hikes in the recent term and a reduction in new corporate borrowing.

Growth in lending to households has been stable in the past year ...

Growth in credit system lending measured 8.1% in September and has picked up since H1/2024 (Chart II-9). Year-on-year growth in credit system lending to households was about 6% in September and has held a relatively steady pace since August 2023. Net new household lending has averaged 15 b.kr. per month since then, as housing market turnover has been brisk this year (Chart II-10). A portion of housing market activity since the spring stemmed from the Government buy-up of homes in Grindavík and residents' subsequent relocation to other communities. Most of these purchases were complete by the end of summer, however.

The majority of new household loans have been inflation-indexed, and early retirement of non-indexed loans has continued. According to the Central Bank's lending survey from early October, the commercial banks had detected little change in demand for mortgages in the preceding three months, and a downturn in demand for car loans. The banks expect a slight increase in demand for mortgages over the next six months, however.

... while corporate lending has gathered pace

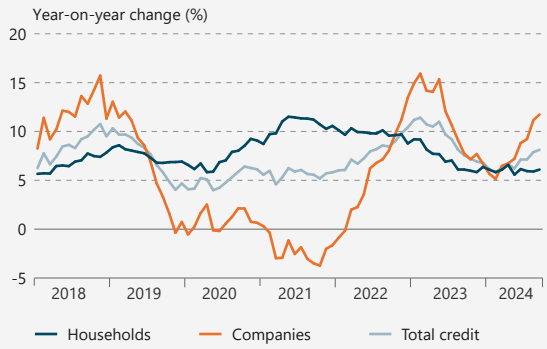
Year-on-year growth in credit system lending to companies has gained momentum thus far in 2024, rising from 5% in February to nearly 12% in September. At the beginning of the year, growth was driven almost entirely by lending to real estate and construction firms, but lending to companies in the services and fishing sectors has picked up as well. Net new lending to companies has eased since this spring, however, perhaps indicating that growth in the credit stock will soon lose pace (Chart II-11). Even so, the lending survey shows that the commercial banks expect a modest increase in demand for corporate loans in the coming six months.

Around mid-2023, inflation-indexed lending to companies started to increase somewhat, and by the

Chart II-9

Credit system lending[1]

January 2018 - September 2024



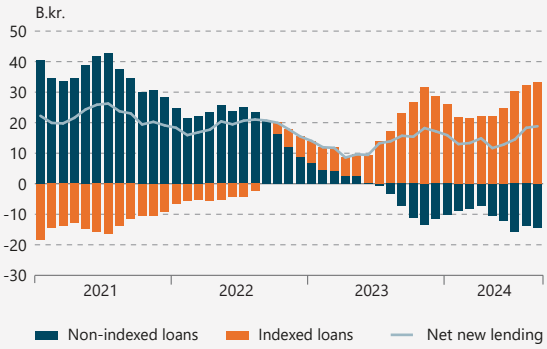
1. Credit stock adjusted for reclassification and effect of Government debt relief measures. Excluding loans to deposit institutions, failed financial institutions, and the Government. Companies include non-financial companies and non-profit institutions serving households.

Source: Central Bank of Iceland.

Chart II-10

Net new lending to households[1]

January 2021 - September 2024



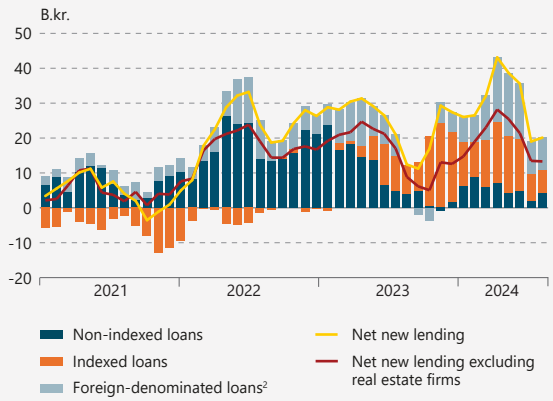
1. Net new lending consists of new lending net of prepayments and retirement of older loans. Lending from deposit institutions, pension funds, the Housing and Construction Authority, and the ÍL Fund. Three-month moving averages.

Source: Central Bank of Iceland.

Chart II-11

Net new corporate lending[1]

January 2021 - September 2024



1. Net new lending consists of new lending net of prepayments and retirement of older loans. Lending from deposit institutions, and the ÍL Fund. Three-month moving averages. 2. This also includes leasing contracts, but their amounts are small.

Source: Central Bank of Iceland.

beginning of 2024 a majority of net new corporate loans were indexed. Over the course of the year, foreign-denominated lending increased as well. In recent months, companies have increasingly sought out financing from commercial banks rather than from the bond market or institutional investment funds.

Asset prices

Residential purchase agreements have surged in number this year ...

House prices rose nationwide in autumn 2023, alongside a surge in market turnover. The rise in prices continued in H1/2024, peaking in July at 11% year-on-year. Developments in 2024 to date have been affected rather strongly by increased activity stemming from the earthquakes and volcanic eruptions in the Reykjanes area starting in late 2023.

The number of purchase agreements finalised nationwide rose by 59% year-on-year in the first nine months of 2024 (Chart II-12). In all, just over 900 purchase agreements have been registered year-to-date in connection with real estate firm Þórkatla's purchase of properties in Grindavík, as have another 700 agreements for home purchases by Grindavík residents in connection with the Þórkatla buy-up.[2] Apart from these, the number of purchase agreements is up by one-third year-on-year. Real estate market activity has therefore picked up in 2024, particularly first-time purchases, owing in part to strong demand for equity loans from the Housing and Construction Authority (HMS) early in the year. Significant accumulated household savings and increased parental assistance have also enabled a larger number of first-time buyers to enter the housing market.

... but house price inflation has begun to ease

Twelve-month house price inflation receded in August and eased further to 9.5% in September (Chart II-13). Reduced price pressures are probably due in large part to the fact that nearly all of the direct impact of the seismic activity in the Grindavík area has already come to the fore, after peaking in April and May (Chart II-12). Furthermore, the effects of a tighter monetary stance have likely begun to show in greater measure.

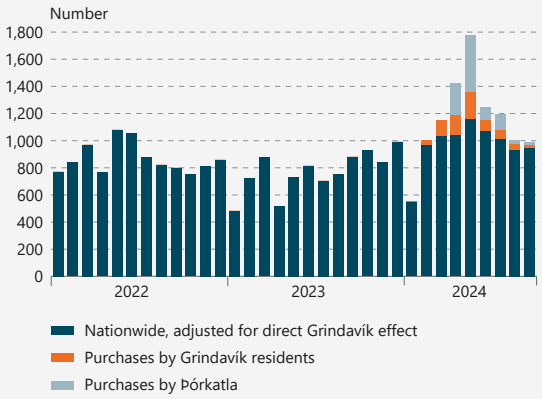
The supply of housing for sale nationwide has grown in the past six months, especially in September and October. About 4,000 homes are listed for sale,

2. Furthermore, at the beginning of the year, rental company Bríet bought 70 homes intended as rentals for Grindavík residents.

Chart II-12

Number of home purchase agreements nationwide[1]

January 2022 - September 2024



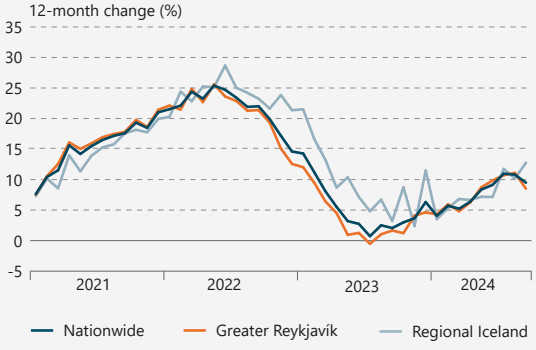
1. Figures on Grindavík residents' purchases are based on registered purchases by individuals registered as owners of property in Grindavík at year-end 2023.

Source: Housing and Construction Authority.

Chart II-13

House prices nationwide[1]

January 2022 - September 2024



1. The house price index is quality-adjusted using the official property valuation and is based on purchase agreements concluded in the previous month.

Source: Housing and Construction Authority.

which is roughly on a par with the peak from May 2020, early in the pandemic (Chart II-14). The share of newly built homes on the market has also risen to a new high, or 38%, as contractors have given priority to finishing projects already underway (see Chapter III). Nevertheless, the increase may also stem from the mid-year lull in allocation of HMS equity loans, which are granted only for the purchase of newly built property. The average time-to-sale has increased, to 3.9 months as of September – roughly the same as in September 2023 but about two months longer than in spring 2024, when it was shortest.

Recent figures from Statistics Iceland for Q3/2024 suggest as well that population growth has slowed after peaking in Q1/2023. Moreover, new figures for September suggest that real wage growth has eased in recent months and is now broadly flat year-on-year (see Chapters IV and V). Nevertheless, real house prices are still 3.9% higher than they were a year ago.

Rent price inflation has eased as well

Rent prices in greater Reykjavík subsided month-on-month in August and September, although they remain 10.5% higher than in September 2023. The recent surge in rent is probably due to stronger demand for rental housing, which in turn stems both from a substantial increase in housing benefits in connection with this year's wage agreements and from the strong influx of foreign workers and tourists in the past three years. Nonetheless, there are signs that the twelve-month rise in rent will continue to taper off in response to the slower increase in tourist numbers and foreign workers in the recent term. Furthermore, there is uncertainty about how amendments to the Rent Act, which entered into force in September, will affect the rental housing supply, as the amendments make increased requirements of landlords and put restrictions on rent increases.

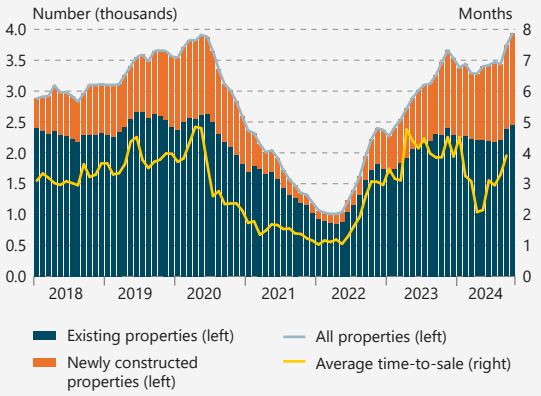
The ratio of house prices to wages has risen

The ratio of house prices to rent prices has been on the decline in the past two years; however, the ratio of house prices to wages has risen, doubtless owing in large part to Grindavík residents' relocation. The share of homes selling at above the asking price is up from a year ago and now measures about one-fifth (Chart II-15). For newly built homes, however, the share of properties selling at a premium on the asking price has been somewhat smaller, however, as a large number of newly built properties are on the market (see Chapter III).

Chart II-14

Number of residential properties for sale and average time-to-sale nationwide

January 2018 - October 2024

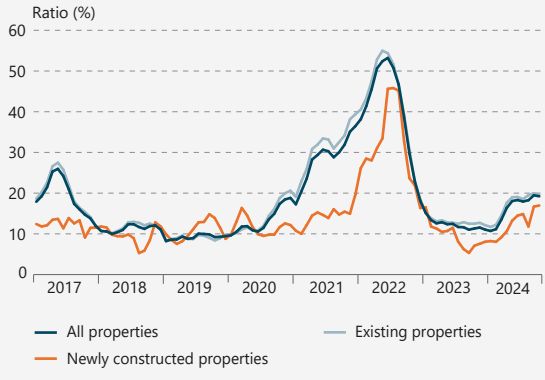


Sources: Fasteignir.is, Housing and Construction Authority, Central Bank of Iceland.

Chart II-15

Properties sold at a premium on the asking price nationwide[1]

January 2017 - October 2024



1. Properties sold at a premium on the asking price as a percentage of sold properties. Three-month moving average.

Sources: Housing and Construction Authority, Central Bank of Iceland.

House price inflation set to exceed the August forecast in 2024 and 2025

The Bank's baseline forecast assumes that house prices will rise by a total of nearly 17% in 2024 and the three years to follow. For 2024, a larger increase is expected than in August, as the year-on-year rise in Q3 outpaced the August forecast; however, this probably reflects an underestimation of the impact of the situation in Grindavík. Prices are also forecast to rise more strongly in 2025, but as in August, the year-on-year increase is still assumed to have peaked already and real prices are expected to fall marginally in the next two years. Nevertheless, there are significant uncertainties concerning both the resilience of demand and projections about new residential construction.

Turnaround in the equity market

The OMXI15 index has risen by 10.3% since the turn of the year. After a steady slide starting in February, it began to rise again in mid-September. It has appreciated by 15.6% since the last *Monetary Bulletin*, showing share price increases for a majority of listed companies. Presumably, part of the rise is due to a change in investors' expectations about interest rate cuts. Stock market turnover totalled just over 800 b.kr. in the first ten months of 2024, an increase of a third year-on-year. Since the last *Monetary Bulletin*, turnover has been strongest in Arion Bank shares, owing partly to share buybacks. JBT's aforementioned takeover bid for Marel has probably contributed to the rise in the index and fuelled growth in market turnover.

Financial conditions

Households' borrowing requirements have tightened

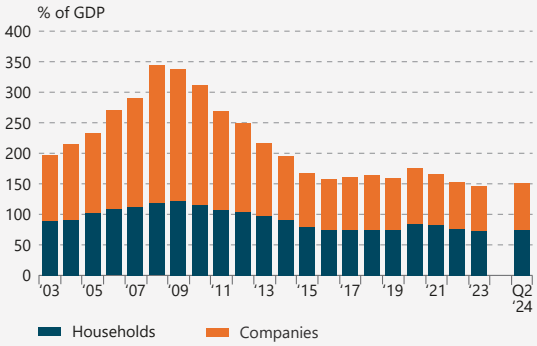
On the whole, households' financial position remains strong. Their equity is ample, and the ratios of debt to both GDP and disposable income are historically low and broadly unchanged (Chart II-16).

The commercial banks began lowering fixed interest rates on non-indexed mortgage loans early this year, presumably because they expected policy rate cuts in the near future (Chart II-17). In October, variable rates on non-indexed mortgages declined in line with the reduction in the Central Bank's key rate, but they remain considerably higher than fixed rates because they had previously been raised more. Deposit rates have also been falling.

However, inflation-indexed mortgage rates have risen recently, as have other real rates. They rose still

Chart II-16

Household and non-financial corporate debt 2003-2024[1]



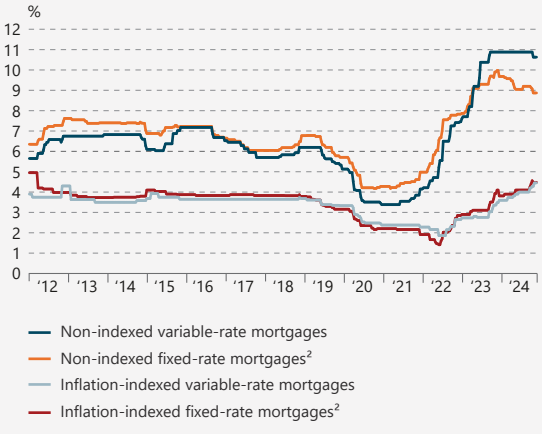
1. Debt owed to financial undertakings and market bonds issued. Excluding financial institutions (which includes holding companies). Q2/2024 GDP is the sum of the previous four quarters.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart II-17

Commercial banks' mortgage lending rates[1]

1 January 2012 - 11 November 2024



1. Simple average of the lowest mortgage rates from Arion Bank, Íslandsbanki, and Landsbankinn. 2. Rates are fixed for 3-5 years.

Source: Central Bank of Iceland.

further in September and are at their highest since 2012. In addition, the large commercial banks decided to tighten borrowing requirements, but in varying ways; for instance, by shortening maximum maturities on inflation-indexed loans from 40 years to 25, lowering the maximum loan-to-value (LTV) ratio on base loans, and offering indexed annuity loans only to first-time buyers. This tightening exacerbates the effect of higher indexed interest rates on the debt service burden for new loans.

Households' interest expense continues to rise, but interest income is rising even more

Household deposits have grown markedly in the past two years, as is noted above. Because deposit rates rose more or less in line with the Central Bank's key rate, households' interest income has increased significantly. At the same time, their interest expense has risen in accordance with the increase in lending rates, but more slowly than interest income has (Chart II-18). This is partly because a portion of household loans bear fixed interest for a short period of time, and partly because households have increasingly sought out inflation-indexed loans in the recent past. This could change in the near future, however, when a large share of non-indexed fixed-rate mortgages come due for an interest rate reset. The loans in question were taken at rates much lower than those offered today, and debt service on them can be expected to increase, along with households' interest expense.

Household arrears are below their pre-pandemic level, even though interest expense is higher. The number of individuals on the CreditInfo default register has held broadly unchanged in the past two years, but arrears to the commercial banks are up slightly, and there are signs of an increase in other arrears, although they remain limited in historical context.

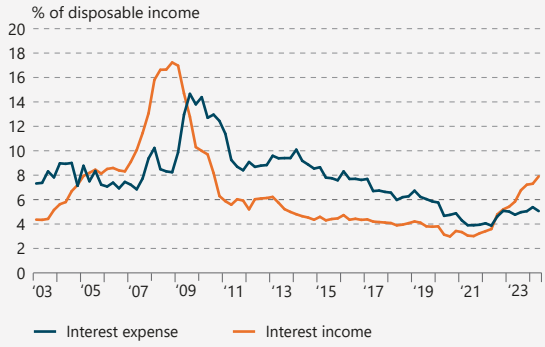
Marginal increase in corporate debt

The ratio of corporate debt to GDP has risen slightly in 2024, as GDP growth has eased concurrent with the above-mentioned increase in lending to companies (Chart II-16). The debt level is still historically low, however. The non-indexed lending and deposit rates offered to companies have been broadly unchanged in the past year, and competition for corporate deposits appears to have grown stronger in the past few months. Interest rates on new inflation-indexed corporate loans have risen, however, as have other real rates. They have increased by 1.5 percentage points since mid-2023, when firms began seeking out indexed loans in greater measure.

Chart II-18

Households' interest expense and interest income

Q1/2003 - Q2/2024



Source: Statistics Iceland.

Corporate arrears are up slightly this year. Although developments differ from one sector to another, arrears have increased the most in the hospitality sector. The number of companies on the CreditInfo default register has fallen this year, however, and as with households, corporate arrears remain below the pre-pandemic level. The number of insolvencies declined year-on-year in the first nine months of 2024, but company failures were unusually numerous in 2023, probably stemming in part from the expiry of pandemic-era support measures. The number of insolvencies in 2024 to date has been broadly equal to or lower than before the pandemic in most segments of the economy. Exceptions include construction, and tourism-related sectors, where company failures have been higher. Furthermore, the number of new company registrations over the first nine months of the year has been similar to that seen since 2021, which is well above the pre-pandemic level.

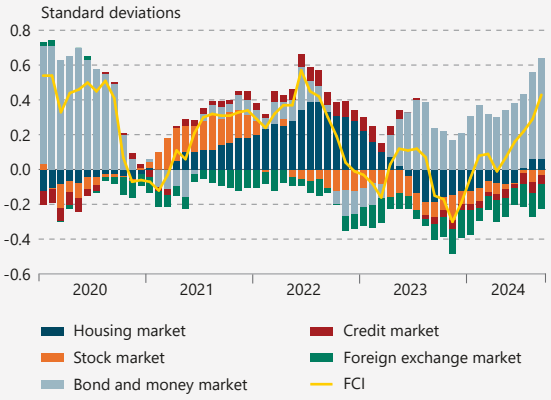
Private sector financial conditions continue to improve

Households' and businesses' financial conditions have improved overall year-to-date, although they are not especially favourable in historical context (Chart II-19). The improvement is due largely to the expectation of a decline in real interest rates in the coming term, which can be seen in a steeper downward-sloping indexed yield curve starting in mid-summer. This reversed in part towards the end of October, however, when it was made clear that the per-kilometre charge on motor vehicle use would have little impact on measured inflation. Higher house prices, a narrower long-term interest rate differential with abroad, and the recent appreciation of the króna have also contributed to more favourable financial conditions. The recent tightening of households' borrowing requirements, discussed above, is not included directly in the measurement of financial conditions unless it leads to a downturn in credit growth. Developments in financial conditions in Iceland are similar to those seen in other advanced economies (see Chapter I).

Chart II-19

Financial conditions[1]

January 2020 - September 2024



1. Financial conditions as measured using the financial conditions index (FCI); i.e., the first three principal components of selected indicators of financial conditions, scaled so that the mean is 0 and the standard deviation is 1. A lower index value indicates a deterioration in financial conditions. The estimation period is 2002-2024. A more detailed description can be found in a Box in *Financial Stability* 2023/1.

Source: Central Bank of Iceland.

Demand and GDP growth

III

Domestic private sector demand

Private consumption contracted slightly in H1/2024 ...

Private consumption growth has lost considerable steam in the recent term. According to preliminary figures from Statistics Iceland, it measured only 0.2% year-on-year in Q1/2024, and in Q2 it was negative by 0.9%. In H1 as a whole it contracted by 0.3% year-on-year, as compared with the Bank's August forecast of 0.1% growth for the period.

Private consumption growth has therefore lost pace more rapidly than previously anticipated, showing a significant reversal since early 2023, when it grew by over 5% between years. Among other things, this reversal reflects the impact of a tighter monetary stance and weaker growth in households' real disposable income (Chart III-1). It is also reflected in more sluggish growth in households' payment card turnover and an increase in consumer pessimism (Chart III-2).

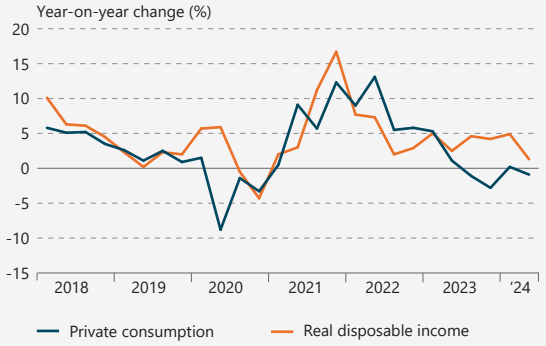
... but indicators imply that it picked up again in Q3

It appears that private consumption started to bounce back in Q3, however. Payment card turnover rose 4.4% year-on-year during the quarter, about the same as in late 2022. The increase in turnover is due mainly to card use abroad, which was up 13% between years, while card use in Iceland grew only 0.6%. Furthermore, households' motor vehicle purchases shrank by 34% year-on-year in Q3, although this was a smaller contraction than in the two quarters beforehand. In spite of the uptick in card turnover, the Gallup Consumer Confidence Index continued to decline in Q3, fall-

Chart III-1

Private consumption and real disposable income[1]

Q1/2018 - Q2/2024



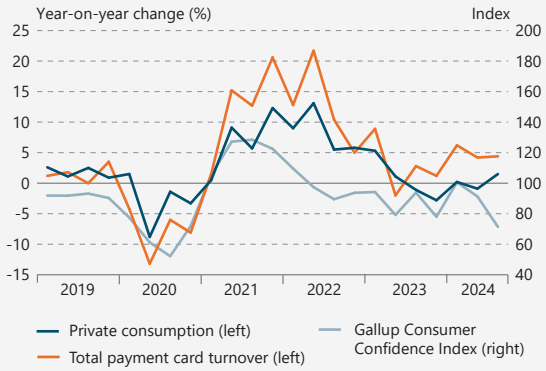
1. Statistics Iceland's estimate of disposable income is taken from the sectoral accounts. It is entered at constant prices and deflated with the private consumption price deflator.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-2

Private consumption and its indicators[1]

Q1/2019 - Q3/2024



1. Payment card turnover at constant prices. Central Bank baseline forecast Q3/2024 for private consumption.

Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

ing to its lowest since H2/2020. Even though it rose again in October, it remains below 100 points. Private consumption is now estimated to have grown by 1.5% year-on-year in Q3, as compared with the August forecast of 1.9%.

Forecast of 2025 private consumption growth revised upwards since August, owing to faster income growth

Revised household disposable income figures published recently by Statistics Iceland indicate that real disposable income grew far more in 2022-2023, and 2024 to date than was previously estimated. The household saving rate is therefore above previous estimates, and households' net wealth has continued to grow (Chart III-3).

Because of this revision of households' financial position, it is now assumed that private consumption will grow more strongly in Q4 than was projected in August, offsetting the weaker growth seen year-to-date. The forecast for 2024 as a whole is therefore unchanged: as in August, private consumption is projected to grow by 1% between years. If this forecast is borne out, private consumption per capita will contract year-on-year for the second year running.

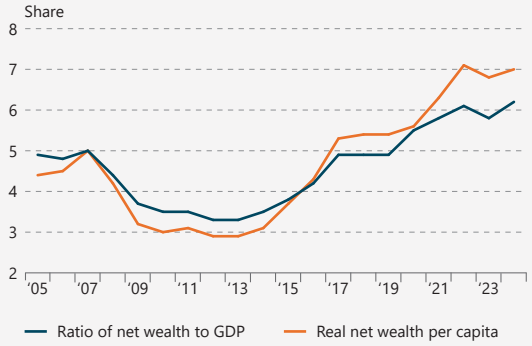
Although many residential mortgages are up for interest rate review soon, households' overall financial position is good. Private consumption growth is forecast to measure 2.9% in 2025, a full 1 percentage point above the August forecast. The outlook for the latter half of the forecast horizon is broadly unchanged, however (Chart III-4).

Business investment grew more strongly in H1 than was forecast in August ...

Business investment grew by just over 5% between years in H1/2024, somewhat more than was forecast in August (Chart III-5). Growth was led by general business investment (excluding energy-intensive industry, ships, and aircraft), although investment in ships and aircraft also grew more than expected. The deviation is affected to a degree by Statistics Iceland's upward revision of investment figures for Q1. In H1 as a whole, the growth rate turned out far closer to the Bank's May forecast, which was prepared before Statistics Iceland's preliminary estimate for Q1 was available. Figures for 2023 were revised as well, as Statistics Iceland's preliminary numbers tend to underestimate investment spending (see Boxes 1 and 5).

Chart III-3

Net household wealth 2005-2024[1]

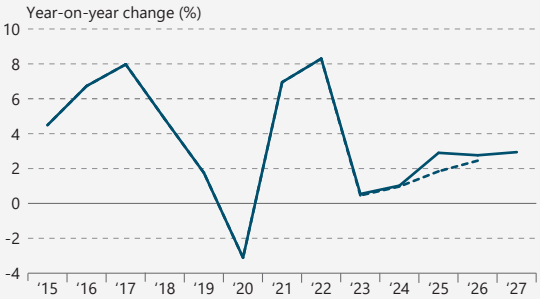


1. Net household wealth comprises net financial assets and housing wealth. The chart shows annual averages and the Central Bank forecast for 2024.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-4

Private consumption 2015-2027[1]



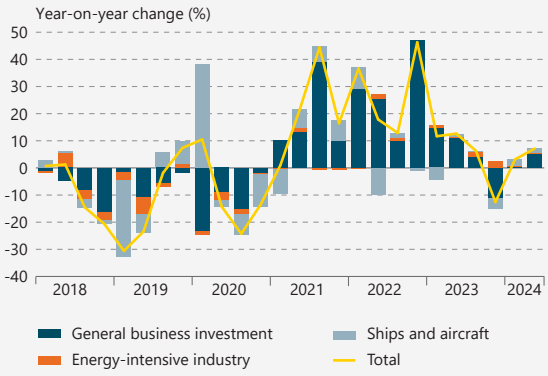
1. Central Bank baseline forecast 2024-2027. Broken line shows forecast from MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-5

Business investment and contribution of subcomponents[1]

Q1/2018 - Q2/2024



1. General business investment excludes ships, aircraft, and energy-intensive industry. Because of chain-volume linking, the sum of subcomponents may not equal total business investment.

Sources: Statistics Iceland, Central Bank of Iceland.

… but there are signs of more sluggish growth in H2

The results of the Central Bank's September investment survey imply that firms plan to increase their investment spending this year by 7.5% in nominal terms. This represents a bleaker outlook than in the March survey, which indicated that respondents planned to scale up investment spending by nearly a fifth. As in the Bank's previous surveys, investment in aquaculture (classified with the fishing industry) and data centres (classified with media and IT) weighs heavily in the overall increase, as business investment would contract somewhat in 2024 if these subsectors were excluded (Chart III-6).

Gallup's survey of Iceland's 400 largest firms, carried out in August and September, gave similar results – again, if the above-mentioned investment in aquaculture and data centres is excluded. According to the Gallup survey, firms plan to spend less on investment in 2024 than in 2023. The number of respondents expecting to scale down investment has increased since the spring survey and has now overtaken the number planning an increase. The outlook is either poorer or unchanged between surveys in all sectors apart from fishing and finance and insurance.

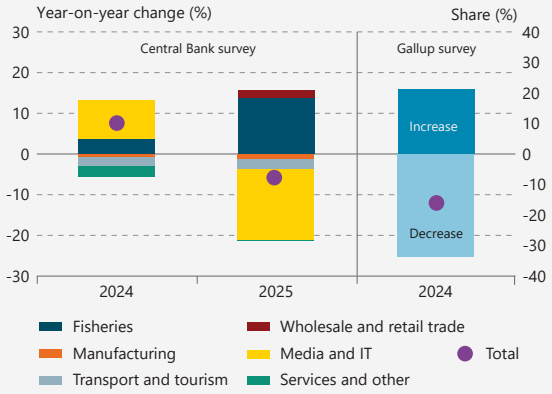
High-frequency indicators also suggest that growth in business investment tapered off again in Q3. For instance, imports of investment goods sagged during the quarter, after surging in H1 (Chart III-7). Furthermore, figures on employment in the construction industry imply weak growth in turnover in Q3. General business investment is estimated to have grown by 1.5% during the quarter, only half the rate forecast in August. Growth for 2024 as a whole is set to measure nearly 1 percentage point higher than in the last forecast, or 2.6%, owing mainly to stronger growth in H1.

Residential investment growth weaker in H1 than was projected in August

According to preliminary figures from Statistics Iceland, residential investment grew by 6.6% year-on-year in H1/2024, far below the August forecast of 13.3% growth. Statistics Iceland revised its Q1 figures downwards due to weaker-than-expected home renovation and maintenance activity. The increase in Q1 was in line with short-term indicators from the construction industry, while in Q2 it was less robust than indicators had suggested (Chart III-8).

Chart III-6

Indicators of investment plans in 2024-2025[1]



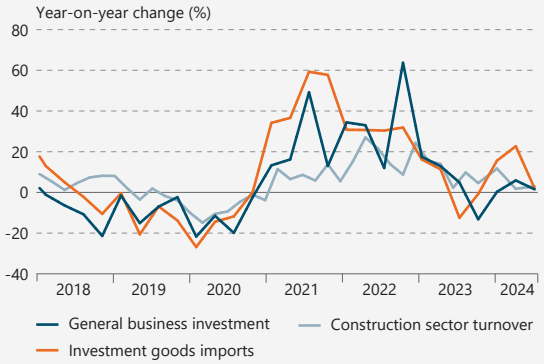
1. Central Bank survey of firms' investment plans (excluding investments in ships and aircraft). Gallup survey of Iceland's 400 largest firms' investment plans. The chart shows the share of firms intending to increase investment and the share intending to decrease it.

Sources: Gallup, Central Bank of Iceland.

Chart III-7

General business investment and indicators[1]

Q1/2018 - Q3/2024



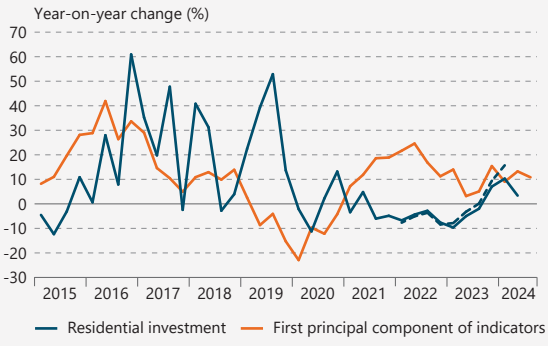
1. General business investment excludes ships, aircraft, and energy-intensive industry. Central Bank baseline forecast for growth in general business investment in Q3/2024. Combined value of imported investment goods and transport equipment for commercial use (excluding ships and aircraft), deflated with the trade-weighted exchange rate index. Aggregate construction sector turnover. The data are published by two-month value-added tax periods and deflated with the building cost index.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-8

Residential investment and indicators[1]

Q1/2015 - Q3/2024



1. The first principal component of selected indicators of residential investment; it is scaled so that its mean value is 0 and the standard deviation is 1. The data used are: cement sales excluding heavy industry, consumer sentiment towards expected purchases of real estate property, employment in construction, imports of building materials, sentiment of construction companies towards expected investment activity, and value-added tax turnover in the construction industry. Seasonally adjusted data. The dotted line shows residential investment according to Statistics Iceland's national accounts in May 2024.

Sources: Aalborg Portland Iceland, Gallup, Sementsverksmiðjan ehf., Statistics Iceland, Central Bank of Iceland.

Highly strained construction sector prioritised finishing ongoing projects in early 2024 …

According to the Housing and Construction Authority (HMS) property registry, about 7,800 homes were under construction nationwide in November, the largest number since 2006 (Chart III-9). Tallies conducted by the HMS during the year indicate that construction firms have given greater priority to finishing projects already underway, but newly built properties have accounted for a growing share of homes for sale thus far in 2024.

According to Gallup's autumn survey, just over half of construction company executives consider themselves short-staffed, and about three out of four said they would have difficulty responding to an unexpected increase in demand (see also Chapter IV). Furthermore, executives planning to recruit outnumbered those planning to downsize. As a result, there is still considerable strain in the sector, although the situation has eased since the summer.

As in the Bank's last forecast, the number of homes completed this year is expected to be on a par with the 2023 total. The HMS' projection for 2024 is also unchanged relative to its estimate from April, while for 2025, the number of new properties is expected to be slightly higher relative to the April tally.

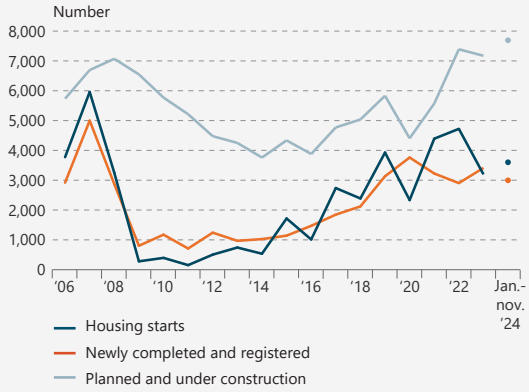
… but housing starts are on the rise again

The number of housing starts declined markedly between years in 2023, and new projects increased only slowly in H1/2024. Activity appears to have picked up again in recent months, however. The HMS tally shows that new construction projects increased by 48% year-on-year in September, after having contracted in the tallies beforehand. As a result, it appears that the number of housing starts will be up slightly this year relative to the August forecast, and higher than in 2023, according to data from the HMS property register (Chart III-9).

Residential investment is now expected to grow by 4.2% in 2024, which is somewhat below the August forecast. This is due in large part to more sluggish growth in H1, as key short-term indicators of construction industry activity suggest that growth has lost pace over the course of the year (Chart III-9). The outlook for 2025 and 2026 is more favourable, however, reflecting in large part the increased number of new projects started in 2024 and a stronger rise in house prices following the seismic activity on the Reykjanes peninsula than was forecast in August (see Chapter II). If the forecast materialises, the ratio of residential investment to GDP

Chart III-9

Status of residential construction nationwide 2006-2024[1]



1. Newly completed and registered properties include homes that are newly finished, those that have been converted into residential property, and those that were previously unregistered. Data for 2024 are based on the status between 1 January and 15 November 2024.

Sources: Housing and Construction Authority, Central Bank of Iceland.

will be just over 5% at the end of the forecast horizon, or 1 percentage point above its twenty-five-year average.

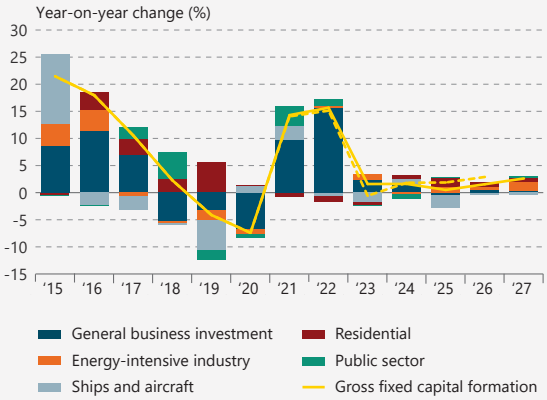
Investment growth in line with expectations in 2024 but expected to slow in the years ahead

The Bank's baseline forecast assumes that total investment will grow by 1.6% this year, which is broadly in line with the August forecast (Chart III-10). Prospects for 2025 have worsened somewhat, however, owing mainly to a bleaker outlook for business investment: general business investment is now projected to contract by 0.6%, whereas in August it was forecast to grow by just over 2% during the year. The revision can be attributed primarily to reduced need for investment spending after the surge in recent years, as Statistics Iceland has revised general business investment figures for 2023 upwards by 0.4% of GDP. This reduced need also explains the outlook for weaker investment growth in the latter half of the forecast horizon, although it will be offset in part by stronger investment in the energy and energy-intensive industry sectors.

After the strong growth of recent years, the investment-to-GDP ratio had risen to 24.2% in 2023, a full 2 percentage points above its twenty-five year average. According to the Bank's baseline forecast, the ratio will rise slightly more in 2024 but then start to fall gradually, although it will still be nearly 2 percentage points above the historical average at the end of the forecast horizon.

Chart III-10

Gross fixed capital formation and contribution of main components 2015-2027[1]



1. General business investment excludes ships, aircraft, and energy-intensive industry. Because of chain-volume linking, the sum of components may not equal total gross fixed capital formation. Central Bank baseline forecast 2024-2027. Broken line shows forecast from MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

Public sector

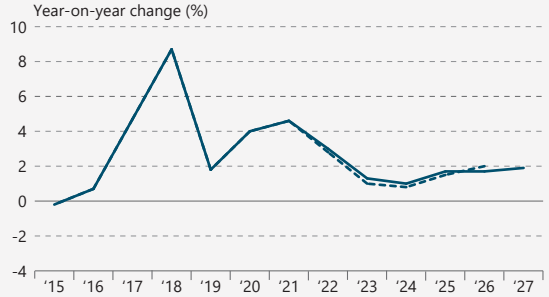
Growth in public sector demand eases

Public consumption grew by 2.3% in H1/2024, whereas public investment shrank by 4.6%. Public sector demand therefore increased by 1.4% year-on-year, about the same as in 2023. Nonetheless, the growth rate was slightly stronger than was forecast in August, owing mainly to the revision of the Q1 national accounts, which entailed a marked increase in public consumption and investment.

Public sector demand is expected to grow more slowly in H2 and to increase by around 1% in 2024 as a whole. Public investment is projected to contract by 5.5% year-on-year and public consumption to grow by 2.1%. According to the baseline forecast, the outlook is for somewhat stronger growth in public sector demand than was envisioned in August (Chart III-11). For the next few years, public consumption is projected to grow by an average of 1.8% per year and public investment by an average of just over 1%. This implies that

Chart III-11

Public sector final demand 2015-2027[1]



1. Public sector final demand in the national expenditure accounts is the sum of government consumption and public investment. Central Bank baseline forecast 2024-2027. Broken line shows forecast from MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

growth in public sector demand will average 1.7% per year over the next three years.

Treasury outcome expected to be broadly unchanged in 2024

After a decisive turnaround in 2022, the Treasury outcome continued to improve in 2023, supported by strong economic activity. After adjusting for irregular items, the outcome for the year was negative by 1.5% of GDP, however, while the primary balance was positive by 0.4% of GDP. It was Iceland's first primary surplus since 2019 (Chart III-12).[1]

In H1/2024, the Treasury outcome was affected strongly by the Government buy-up of properties in Grindavík through the real estate firm Þórkatla. In Statistics Iceland's accounts, the purchases are recognised as transfer outlays in the amount of 57 b.kr. The fiscal deficit for H1/2024 is therefore considerably larger than in the periods beforehand, at roughly 65 b.kr., or 3% of GDP for the period. Excluding these effects, the H1 outcome was negative by 8 b.kr., or 0.4% of GDP, whereas the Treasury primary balance for H1 was positive by nearly 37 b.kr., or 1.7% of GDP. For 2024 as a whole, the primary balance excluding irregular items is projected to improve year-on-year, to 1.6% of GDP. Growth in the Treasury's tax revenue is expected to lose pace, however, owing to the marked slowdown in GDP growth during the year. Nevertheless, the primary balance is set to improve between years because of an increase in dividend payments to the Treasury and slower growth in primary expenditure. The overall Treasury balance will remain negative, showing a deficit of 1% of GDP, as the improvement in the primary balance will be offset by a larger deficit in the interest balance relative to 2023.

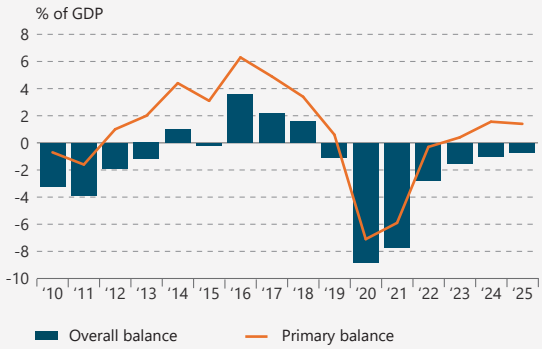
Fiscal deficit to narrow in 2025

The Treasury outcome is projected to improve further in 2025, to a deficit of 0.7% of GDP. This is due to the impact of a larger slack in the economy, on the one hand, and fiscal measures provided for in the 2025 budget proposal, on the other. As a result, the primary balance will be broadly unchanged year-on-year, but the deficit on the interest balance is expected to narrow during the year.

The Government has introduced a number of spending consolidation measures to improve the out-

Chart III-12

Treasury outcome 2010-2025[1]



1. Adjusted for irregular and one-off items, including the impact of the Government buy-up of properties in Grindavik. Central Bank baseline forecast 2024-2025.

Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

1. This refers to the Treasury Part A outcome based on data from Statistics Iceland and adjusted for irregular and one-off items according to information from the Ministry of Finance and Economic Affairs. If no adjustment is made for these items, the deficit for 2023 was 1.2% of GDP.

come, as well as proposing a range of tax system changes although the changes in taxation of motor vehicle use and petrol, planned for next year, will be postponed.

The changes in the tax system are estimated to boost Treasury revenues by 0.3% of GDP in 2025 (see also Box 4).

The fiscal stance will tighten markedly in 2024, but less so in coming years

As is noted above, the Treasury primary balance is estimated to improve this year, if irregular items such as the Government buy-up of homes in Grindavík are excluded. At the same time, the positive output gap is expected to narrow considerably (see Chapter IV). Owing to the interaction of these factors, the fiscal stance will tighten year-on-year by just over 2% of GDP (Chart III-13).

In 2025, the stance is expected to tighten further, by 0.8% of GDP, due more or less equally to measures on the revenues and expenditures sides. In 2026-2027, limited changes in the cyclically adjusted Treasury outcome are projected and the fiscal stance therefore to be virtually unchanged.

External trade and the current account balance

Services exports weakened significantly in Q2 …

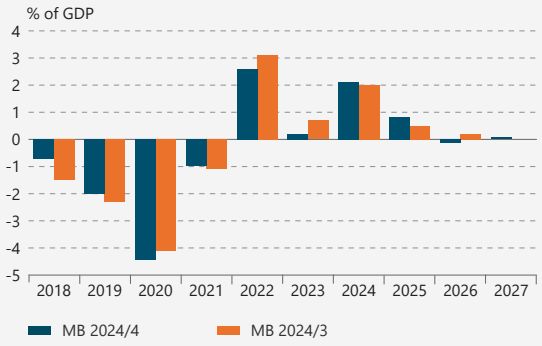
Goods and services exports shrank by 2.1% in H1/2024, whereas the August forecast assumed a contraction of 0.4%. The downturn is attributable largely to a more than 10% contraction in services exports in Q2, albeit offset by strong growth in exports of goods other than aluminium and marine products (Chart III-14). It was the first year-on-year decline in services exports since the beginning of 2021. The value of tourism-related exports shrank during the quarter by 5% year-on-year at constant exchange rates, in tandem with the decline in visitor numbers. In the same vein, exports of services apart from transport and travel were considerably weaker than was forecast in August, contracting by 13% between years despite robust growth in R&D services relating to pharmaceuticals exports.

… but the revision of historical data calls the reliability of preliminary figures into question

The larger-than-anticipated contraction in H1 is also due to base effects from stronger exports in the previous year. Concurrent with the publication of Q2 data, previously released figures on services exports

Chart III-13

Change in central government cyclically adjusted primary balance 2018-2027[1]



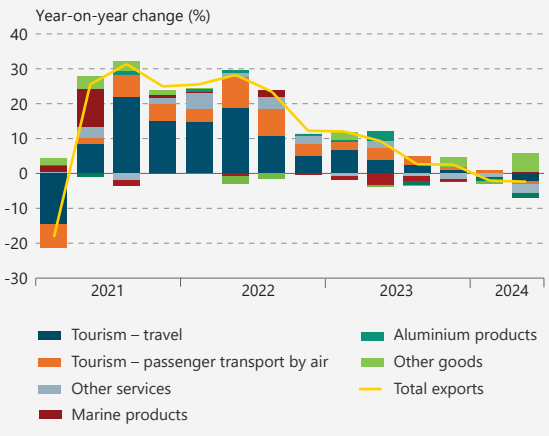
1. Adjusted for irregular and one-off items, including the impact of the Government buy-up of properties in Grindavík. Central Bank baseline forecast 2024-2027.

Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

Chart III-14

Exports and contribution of subcomponents[1]

Q1/2021-Q2/2024



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.

were revised upwards for Q1/2024 and all of 2023. According to these revised numbers, services exports grew by 13.1% in 2023 and not 9.8%. Although the revision stems partly from a change in the travel sub-component of services exports in response to new payment card turnover data, it is due primarily to other services exports. New figures indicate that the value of other services exports was 19 b.kr. more in 2023 than was previously estimated, which translates to 4% year-on-year growth instead of a contraction of a similar rate. The main differences were in revisions of other business services and in telecommunications, computer, and information services.[2] In view of this, the steep contraction in services exports in Q2 gives rise to questions about whether they are still underestimated in the newly published preliminary figures.

Tourist numbers picked up again slightly in Q3 …

After contracting between years in Q2, tourist arrivals were slightly higher year-on-year in Q3, and over the first ten months of 2024 they were up 1.4% relative to the same period in 2023 (Chart III-15). Foreign nationals' overnight hotel stays continued to decline year-on-year in July, but developments diverged by region in the latter half of the quarter. Overnight stays increased in the capital area but fell in many other parts of the country.[3] To some extent, the shift could reflect changed tourist demographics, as the number of visitors from China has increased in line with global trends, while the number of tourists from the US has fallen. Nevertheless, average spending per tourist in foreign currency terms appears to have increased slightly compared to the same period in 2023. Domestic airlines' export revenues from passenger transport continued to shrink year-on-year despite higher passenger numbers, while the share of transit passengers continued to rise. Furthermore, turnover figures from value-added tax returns imply that other services exports grew again in July and August.

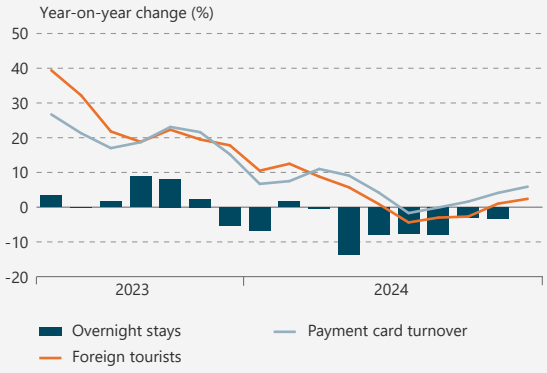
… but prospects for airline seat capacity in 2025 have worsened and other services exports are more uncertain

Global air traffic has continued to increase, albeit at a slower pace since it returned to the pre-pandemic level. Although there are signs that consumers are likelier to

Chart III-15

Indicators of tourism sector activity[1]

June 2023 - October 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.

2. The revision is due to new information from small and medium-sized companies whose data on services trade are collected only once a year by Statistics Iceland.
3. Given the rapid increase in Icelanders' overnight stays recently, particularly in certain regions, it is possible that the ratio of foreign tourists' stays of total overnight stays is underestimated.

seek out low-cost destinations, travel to most European countries has continued to grow (Chart III-16).[4]

The outlook for Iceland's tourism sector has deteriorated somewhat, however. Flight availability to and from Iceland in 2025 looks set to deteriorate relative to the August forecast, as the airline Play has announced a change in its business model, with fewer planes flying to and from Iceland and reduced flight offerings to the US. This reduction in capacity will probably have relatively less impact on the number of foreigners visiting Iceland, however, as the airline's share of transit passenger numbers will decline as a result of the change. Other indicators are ambiguous, however: the status of hotel bookings for the next several months still appears slightly weaker year-on-year, although visitors have tended in the recent past to book accommodation at shorter notice than before (Chart III-17). Furthermore, there has been an uptick recently in Google searches for travel to Iceland and accommodation in the country.

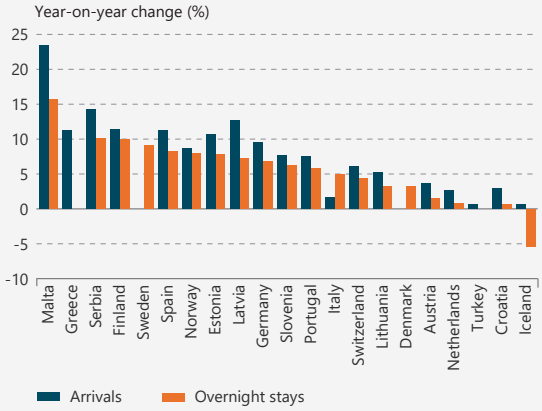
Prospects for tourism in 2024 are broadly unchanged: as previously forecast, just over 2.2 million visitors are expected, with tourism contributing slightly negatively to the outlook for exports in 2024. Nonetheless, because of a larger-than-anticipated contraction in other services in Q2, plus base effects from stronger growth in 2023, the outlook is for services exports to shrink by 3% and not 1.1%, as was forecast in August. In view of the revision of 2023 data, published figures for H1/2024 could be underestimated, as is noted above. Owing to the changed outlook for airline seat capacity, tourist numbers are expected to rise more slowly in 2025, to a total of just under 2.3 million for the year as a whole. Services exports are projected to grow by 2.5%, as compared with the increase of more than 4% in the August forecast. As before, the situation is highly uncertain, as the outlook is for a change in the composition of supply in 2025, with reduced emphasis on transit passengers. An alternative scenario in Box 1 explores the impact of even weaker developments in tourism than are depicted in the baseline forecast.

Strong goods exports in Q2, after a contraction in Q1 …

Goods exports grew by 5.7% year-on-year in Q2/2024, after contracting in Q1. Although part of the increase is due to one-off effects from exports of ships, other goods exports grew strongly as well. Exports of goods other than aluminium, marine products, and ships and

Chart III-16

Tourist arrivals and overnight stays 2024[1]



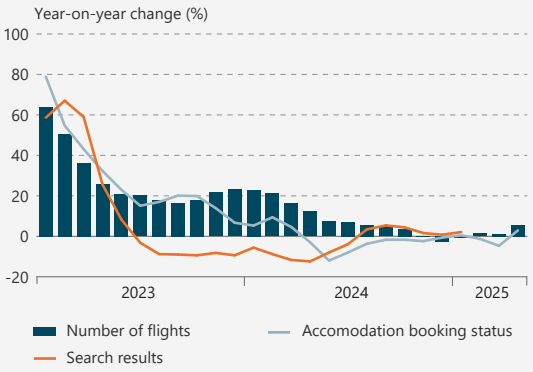
1. Available data for 2024 vary by destination.

Sources: European Travel Commission, TourMIS.

Chart III-17

Travel to Iceland[1]

March 2023- April 2025



1.Total number of monthly passenger flight arrivals and departures, November 2024 - April 2025 according to Isavia's flight schedule as of October 2024. Search results based on a factor model combining the frequency of five different Google search strings relating to travel to Iceland, lagged by three months. Number of overnight stays booked through online travel agents according to data administered by Godo. Paired comparison for November 2024 - April 2025, according to the booking status as of 18 November 2024. Three-month moving average.

Sources: Godo, Google Trends, Isavia, Central Bank of Iceland.

4. See The International Air Transport Association, *Air Passenger Market Analysis*, September 2024, and European Travel Commission, *European Tourism – Trends & Prospects (Q3/2024)*, November 2024.

aircraft grew by 29% year-on-year in Q2, and by 15% year-on-year in H1. Growth in other goods exports was broad-based, with a sizeable jump in exports of aquaculture products, other manufactured goods, and pharmaceuticals and medical equipment. Marine product exports grew 1.4% between years in Q2, owing to stronger exports of demersal products. Landsvirkjun's cutbacks in electricity supplies to large-scale users affected aluminium manufacturing in H1, however, and exports of aluminium products shrank by 9.6% year-on-year in Q2.

... but the outlook for H2 has deteriorated

Prospects for goods exports in 2024 have worsened since August. Marine product exports are projected to be weaker than previously assumed, owing to reduced exports of mackerel, as catches fell short of the issued quota. As a result, marine product exports are expected to contract by 1.8% this year instead of increasing slightly, as in the August forecast. The outlook for aluminium exports has also deteriorated since August. Exports in Q3 appear to have been weaker than projected, and demand for aluminium from Iceland has been tepid, especially due to weak car manufacturing in Europe. The outlook for Q4 has worsened as well, owing to Landsvirkjun's cutback in the supply of energy to large-scale users in the southwest part of the country. Exports of aluminium are therefore projected to contract by 4.4% this year, somewhat more than was forecast in August. Prospects for other goods exports are broadly unchanged since August, with strong growth projected in H2, particularly in exports of pharmaceuticals. Because of the bleaker outlook for exports of aluminium and marine products, goods exports as a whole are projected to grow by 1.3% this year, whereas in August they were forecast to grow by just over 3%.

The outlook for aluminium and marine product exports in 2025 is likewise weaker. The poorer outlook for the fishing industry is due to Iceland not having been allocated a quota for Barents Sea cod; however, quotas for mackerel and blue whiting are also expected to be smaller, based on the recommendation of the International Council on the Exploration of the Sea (ICES). Furthermore, for the second year in a row, no capelin quota was issued, which is in line with the August forecast. Moreover, Landsvirkjun's energy cutbacks, which were set to remain in place through May 2025, are expected to affect planned aluminium manufacture for the year. Total goods exports are therefore projected to grow by 1.8% in 2025, slightly less than was forecast in August.

Total exports set to contract marginally in 2024 and grow more slowly in 2025

Total exports are expected to contract by 0.8% this year, as compared with the August forecast of just over 1% growth (Chart III-18). The outlook is both for a larger contraction in other services exports and for weaker growth in goods exports, owing to poorer prospects for exports of marine and aluminium products. The outlook for 2025 has deteriorated as well. Total export growth is forecast at 2.1% instead of just over 3%, driven in large part by the bleaker outlook for tourism and for aluminium and marine product exports. Exports of pharmaceuticals and aquaculture products are still expected to grow during the forecast horizon.

Imports picked up again in H1

Imports of goods and services grew by 2.9% year-on-year in Q2, in line with the August forecast (Chart III-19). The increase is due in large part to imports of ships, although other goods imports grew as well, after contracting markedly in H2/2023. On the other hand, there are signs that Q3/2024 was weaker than expected, as investment goods imports declined more quarter-on-quarter than previously anticipated, although they have fluctuated in the recent term. Goods imports are projected to grow by 1.1% instead of the 2.5% forecast in August, and the ratio of total imports to GDP is expected to continue moving towards its historical average (Chart III-20).

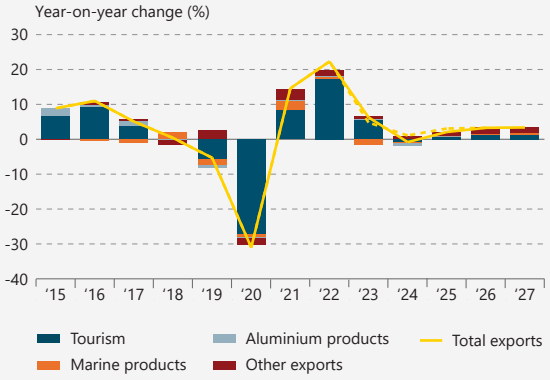
Services imports were virtually flat year-on-year in Q2, as was assumed in August, owing to continued strong growth in imports of financial services and an offsetting contraction in most other subcomponents. However, services imports were revised upwards for Q1/2024 and 2023 as a whole, in part due to new figures on Icelanders' payment card use abroad. Financial services imports are expected to continue growing strongly in H2, but the outlook is unchanged in other respects. Owing to the increase in financial services imports and the revision of Q1 figures, services imports are forecast to grow by 3% in 2024 as a whole, slightly outpacing the August forecast. Because growth in goods imports looks set to be weaker, however, total imports are now forecast to grow by 1.7%, as compared with 2.4% in the August forecast. The outlook for the next few years is more or less unchanged, though.

Current account deficit set to be slightly larger this year than was forecast in August

The current account deficit measured 3.6% in H1/2024, far more than the 1.9% deficit projected in August.

Chart III-18

Exports and contribution of underlying components 2015-2027[1]



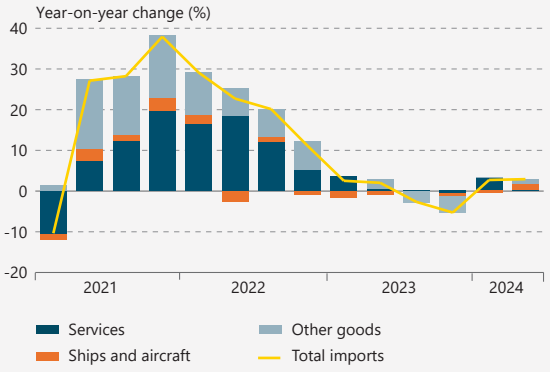
1. Because of chain-volume linking, the sum of components may not equal total exports. Tourism is the sum of "travel" and "passenger transport by air". Aluminium exports as defined in the national accounts. Central Bank baseline forecast 2024-2027. Broken line shows forecast MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-19

Imports and contribution of underlying components[1]

Q1/2021 - Q2/2024



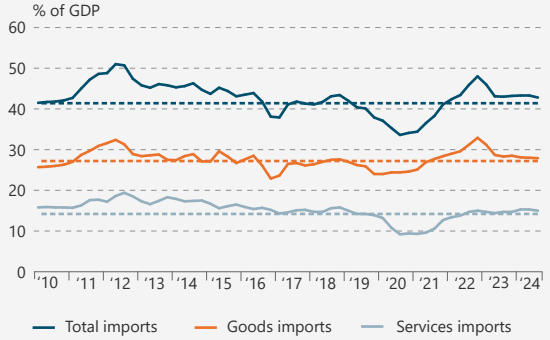
1. Because of chain-volume linking, the sum of components may not equal total imports.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-20

Imports of goods and services[1]

Q1/2010 - Q3/2024



1. Two-quarter moving average. Central Bank baseline forecast Q3/2024. Broken lines show average from 1999.

Sources: Statistics Iceland, Central Bank of Iceland.

The difference is due both to the above-mentioned contraction in other services exports in Q2 and to a less favourable primary income balance than previously expected, the latter due in turn to a sharp reversal in pharmaceuticals companies' contribution to primary income (Chart III-21). The impact of increased revenues from pharmaceuticals sales on the primary income balance came to the fore earlier and was stronger than had been assumed in the forecast.

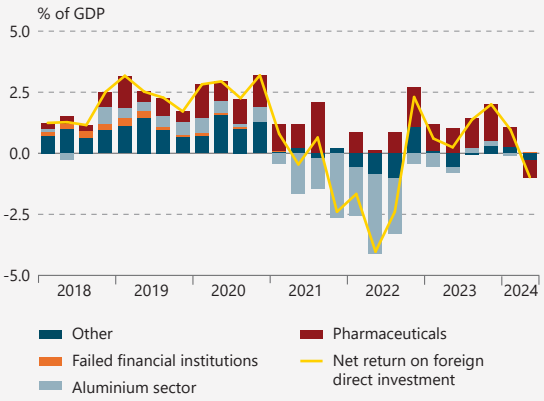
The current account was also revised back to 2021. Because foreign-owned domestic firms (excluding aluminium and pharmaceuticals companies) generated stronger returns, the primary income balance is now estimated to be less favourable than before, offsetting the aforementioned upward revision of the balance on services. The current account deficit for 2022 as a whole turned out 0.4 percentage points larger than previously estimated, or 2.1%. Conversely, the 2023 surplus was 0.2 percentage points larger, or 1.1% (Chart III-22).

The outlook for the current account in 2024 has deteriorated slightly since August, owing mainly to a weaker primary income balance, which in turn is due to the aforementioned contribution from pharmaceuticals companies. On the other hand, the trade deficit is expected to be smaller, due partly to the revision of the balance on services for 2023, but also to more favourable developments in terms of trade, offsetting a poorer outlook for exports (see Chapter I). Increased optimism about terms of trade also explains why the current account balance is projected to develop more favourably over the forecast horizon in spite of the poorer outlook for exports.

Chart III-21

Net return on foreign direct investment

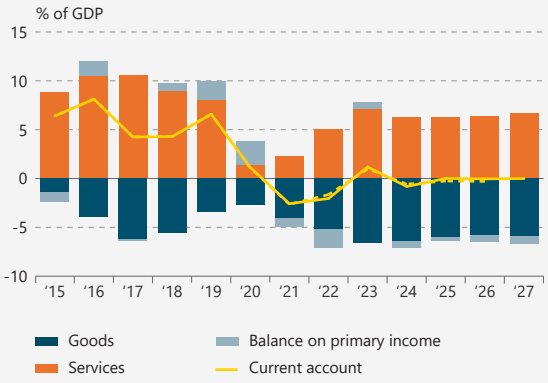
Q1/2018 - Q2/2024



Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-22

Current account balance 2015-2027[1]



1. Current account excluding the effects of the failed financial institutions in 2015. Balance on secondary income included in the balance on primary income. Central Bank baseline forecast 2024-2027. Broken line shows forecast from MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

GDP growth

H1 output growth fell short of the August forecast …

GDP growth started to lose pace over the course of 2023, and in Q1/2024 there was a sizeable contraction, owing to a negative contribution from inventory changes, which stemmed in turn from the failed capelin catch and the resulting lack of accumulated capelin inventories during the quarter. Seasonally adjusted GDP contracted by 1% quarter-on-quarter and 3.5% year-on-year. This is a slightly smaller contraction than was indicated by Statistics Iceland's previous figures, however.

Because these effects of inventories came to the fore mostly in Q1, GDP was expected to grow again in Q2 – which it did, by a seasonally adjusted 1.7%

between quarters, although it shrank by 0.3% year-on-year (Chart III-23). This is a slower growth rate than had been forecast in August, mainly because of the negative contribution from net trade discussed earlier in this chapter. Nevertheless, developments in domestic demand were largely in line with the August forecast: domestic spending grew by 2% between years, slightly less than was projected then.

Concurrent with the publication of preliminary figures for Q2/2024, Statistics Iceland released its revision of year-2023 GDP growth, which is now estimated at 5% instead of 4.1%. The increase stems in part from the previously discussed revisions of services exports and investment.

In H1/2024, GDP shrank by 1.9% year-on-year (Chart III-24), well in excess of the 1% contraction forecast in August. The contraction is affected to a degree by the above-mentioned negative contribution from inventory changes, plus the negative contribution from net trade, which primarily reflects the 2.1% contraction in exports. Domestic demand was flat in H1, although it grew by 1.4% if the effects of inventory changes are excluded. Developments in domestic spending were therefore in line with the forecast, whereas the contribution from net trade turned out weaker. However, this could be affected by the possible underestimation of export revenues during the period, discussed earlier in this chapter, and therefore, developments could ultimately turn out better aligned with the August forecast.

… and looks set to be slightly weaker in 2024 as a whole

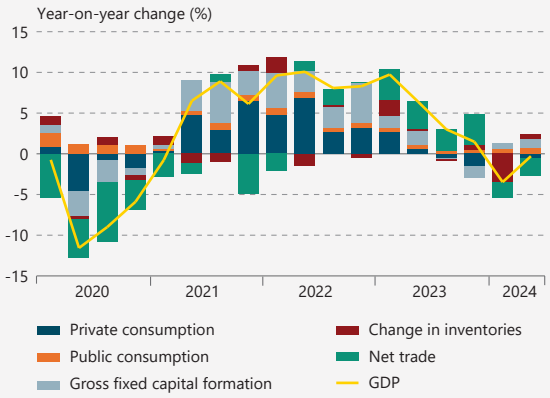
GDP is estimated to have grown by 2.5% year-on-year in Q3/2024, broadly in line with the August forecast. Alongside weaker growth in domestic demand, imports sagged during the quarter, resulting in a stronger contribution of net trade to output growth than was assumed in that forecast.

According to the new baseline forecast, GDP is expected to remain flat year-on-year in 2024, whereas in August it was projected to grow by 0.5% (Chart III-25). This is due primarily to the bleaker outlook for external trade. There are a few changes in subcomponents of domestic demand, as is noted above, but on the whole, the outlook for domestic demand is broadly unchanged. It is now expected to grow by 1.1% year-on-year, as compared with 1% growth provided in the August forecast.

Chart III-23

GDP growth and contribution of components[1]

Q1/2020 - Q2/2024

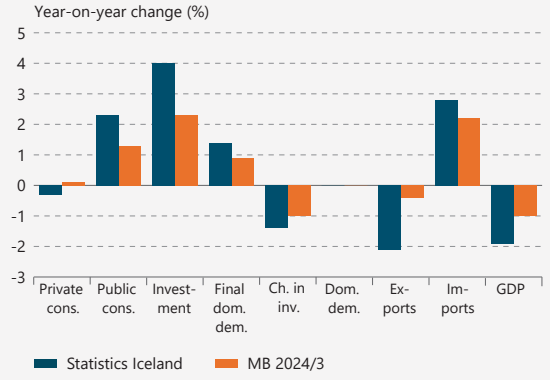


1. Because of chain-volume linking, the sum of components may not equal GDP growth.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-24

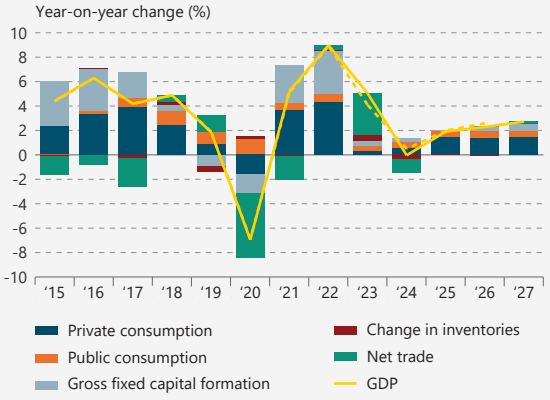
National accounts H1/2024



Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-25

GDP growth and contribution of underlying components 2015-2027[1]



1. Central Bank baseline forecast 2024-2027. Broken line shows forecast from MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

As in August, GDP growth is expected to regain pace in 2025

As in the August forecast, GDP growth is expected to pick up again in 2025. It is forecast to measure 1.9% for the year as a whole, which is well in line with August forecast. As was assumed then, GDP growth is projected to gain momentum in the latter half of the forecast horizon, measuring an average of 2½% per year. As before, output growth during the forecast horizon will be driven largely by domestic demand – private consumption in particular. The outlook is highly uncertain, however. The forecast could turn out overly pessimistic if households choose to spend a larger share of the savings they have accumulated in recent years. On the other hand, it could prove too optimistic if tourist numbers over the next few years are lower than is assumed in the baseline forecast (see Box 1).

Labour market and factor utilisation

IV

Labour market

Job numbers declined slightly in Q3

According to data from the pay-as-you-earn (PAYE) register, the number of employed persons rose 1.8% between years in Q3/2024. The year-on-year increase was therefore close to its historical average, but the pace has slowed virtually unabated since the peak in spring 2022. Over a three-month period, however, job numbers have fallen marginally since June, and in September the three-month decline in jobs measured 0.5% in annualised terms (Chart IV-1).

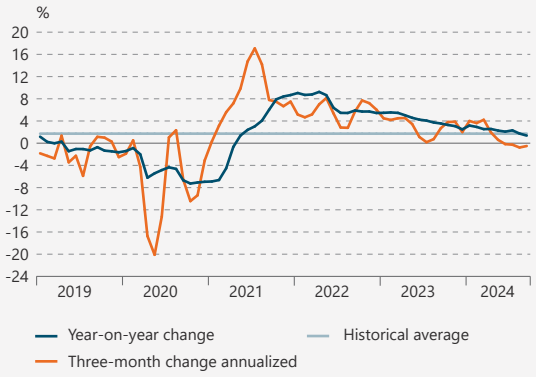
The decline is most pronounced in tourism, where numbers started to slide in March 2024 and nearly 800 jobs had been lost by September. Well over a hundred jobs have disappeared in the information and communication sector, and about the same number have been shed in wholesale and retail trade. This is interesting in view of how modest job creation has been in tourism and trade relative to the pre-pandemic period. Compared with the 2019 average, job numbers are up 3.2% in tourism and 6.4% in wholesale and retail trade. At the same time, however, job growth in the labour market as a whole measured just over 10% (Chart IV-2). The construction sector shows more resilience against weaker economic activity, with job numbers up nearly one-fourth relative to the pre-COVID period. Even so, there are no clear signs of job losses as yet, although the growth rate has slowed markedly. Among other things, this reflects strong demand for housing, a tight real estate market, and the industry's crowding-out effect on other sectors.

Figures on employment from the national accounts for H1/2024 point in the same direction, with a year-on-year slowdown in job creation and

Chart IV-1

Employment[1]

January 2019 - September 2024



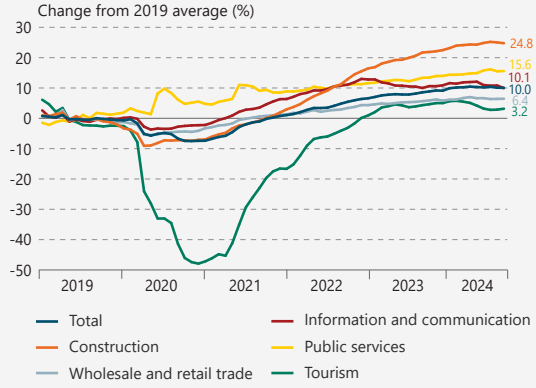
1. Wage-earners of ages 16-74 according to the Iceland Revenue and Customs' pay-as-you-earn (PAYE) register. 3-month change on an annual basis is based on seasonally adjusted figures. Historical average is based on the period 2006-2023 and is 1.7%.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-2

Number of wage-earners in selected sectors[1]

January 2019 - September 2024



1. Wage-earners aged 16-74 according to the Iceland Revenue and Customs pay-as-you-earn (PAYE) register. Figures are seasonally adjusted by the Central Bank. Public services includes NACE rev. 2 categories O-Q (public administration, education, and health and social services). Tourism reflects Statistics Iceland's classification of tourism-related industries.

Sources: Statistics Iceland, Central Bank of Iceland.

total hours worked. However, the results of Statistics Iceland's labour force survey (LFS) are still affected by problems relating to declining response ratios and difficulties in estimating recent population developments, which apparently lead to a significant overestimation of job numbers and total hours worked.

Unemployment inching upwards

Seasonally adjusted unemployment was unchanged month-on-month in October, at 3.6% (Chart IV-3). It has therefore risen by 0.4 percentage points from its post-pandemic trough in May 2023, which equates to an increase of 1,700 persons on the unemployment register. But the increase during the intervening period has been gradual or close to 0.1 percentage points per quarter. About 0.6% of the labour force has been out of work for longer than a year, according to figures from the Directorate of Labour (DoL). This percentage has been unchanged since mid-2023 and similar to that seen before the pandemic. Unemployment according to the LFS measured 3.5% in Q3 and is back on a par with registered unemployment, after having fallen somewhat in the months beforehand.

For the first time in nearly four years, more firms want to downsize than to hire workers

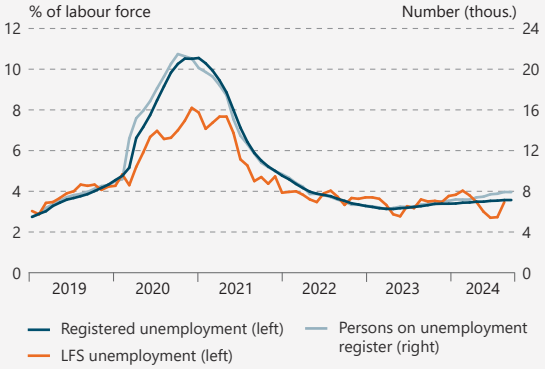
According to the seasonally adjusted results of Gallup's autumn survey among Iceland's 400 largest firms, respondents have scaled down their staff recruitment plans still further. The balance of opinion – the difference between firms planning to recruit and those planning to downsize – was negative by 1 percentage point in the survey, after having been positive by 9 percentage points in the summer survey. It is also about 10 percentage points below its historical average and was last negative at the end of 2020 (Chart IV-4). Only in the construction sector is the share of firms planning to add workers still above its historical average, although it has fallen considerably since the summer. In all other sectors, the share of companies planning to hire is below the historical average, and the outlook is for job numbers to fall in sectors other than construction and miscellaneous specialised services.

Seasonally adjusted results of Statistics Iceland's corporate survey indicates that there were just under 6000 job vacancies in Q2. These are fewer job openings than in Q1 and roughly half of the number seen at the peak in mid-year 2022. Similarly, the vacancy-unemployment ratio measured 0.8 and has also almost declined by half in the last two years (Chart IV-5).

Chart IV-3

Unemployment[1]

January 2019 - October 2024



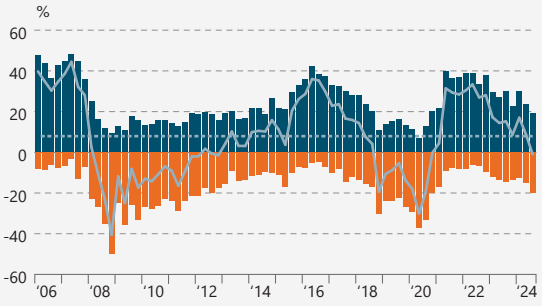
1. Figures for registered unemployment and number of persons on unemployment register are seasonally adjusted by the Central Bank. Unemployment according to the Statistics Iceland Labour Force Survey (LFS) is a three-month moving average of seasonally adjusted figures.

Sources: Directorate of Labour, Statistics Iceland, Central Bank of Iceland.

Chart IV-4

Firms' recruitment plans[1]

Q1/2006-Q3/2024



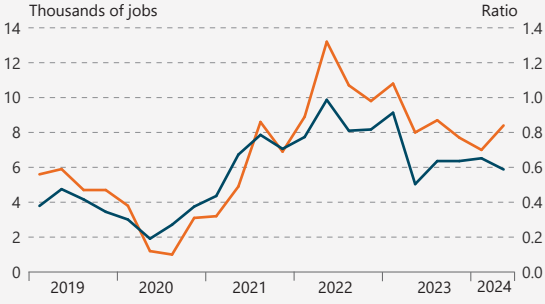
1. Share of firms planning redundancies shown with a negative sign. Broken line shows period average. Seasonally adjusted figures.

Sources: Gallup, Central Bank of Iceland.

Chart IV-5

Job vacancies[1]

Q1/2019 - Q2/2024



1. Job vacancies according to Statistics Iceland's company survey and number of unemployed persons according to the Statistics Iceland labour force survey. Figures are seasonally adjusted by the Central Bank, however, the adjustment is subject to considerable uncertainty due to limited time series length.

Sources: Statistics Iceland, Central Bank of Iceland.

Population growth continues to slow

Iceland's population grew by 1.7% year-on-year in Q3. The growth rate has slowed since mid-2023, as the number of immigrants has slowed and more foreign nationals are leaving the country (Chart IV-6). This is due in part to a reduced influx of refugees. Over the first ten months of 2024, just under 1,700 applications for political asylum were submitted, less than half the number filed during the same period in 2023.

Labour market tightness is easing, and a slack is expected to emerge in 2025

Indicators suggest either that there is still some tightness in the labour market or that it has already disappeared. Labour demand looks set to keep easing in the coming term, and a slack is therefore expected to open up. The Bank's baseline forecast assumes that total hours worked according to the LFS will rise by 5% between annual averages in 2024, as they did in 2023, and then decline marginally in 2025 and 2026 before starting to pick up again. Due to the overestimation of total hours in the LFS, the forecast is highly uncertain, as it does not take into account possible revisions of historical figures.

LFS-based unemployment is projected to measure 3.6% this year and increase to 4.4% in 2025, when a slack will develop in the labour market and remain through 2026. This is a lower unemployment rate than in the August forecast, as the positive output gap is projected to be wider than previously thought (see below). Compounding this, there are signs that the overestimation of labour participation in the LFS is considerably larger than previously assumed. Unemployment is still expected to taper off from 2026 onwards and fall below 4% in the final year of the forecast horizon (Chart IV-7).

Indicators of factor utilisation

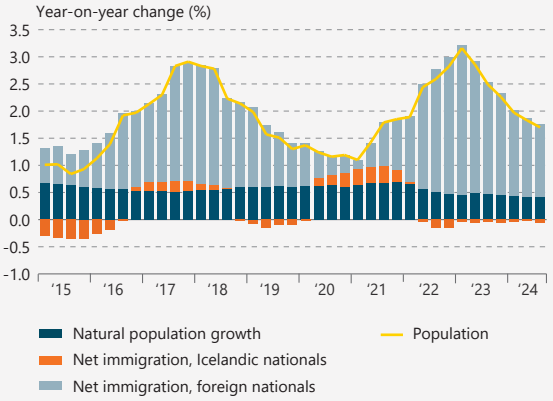
Labour productivity fell markedly in H1/2024

In terms of GDP per hour worked according to employment data from the national accounts, labour productivity has declined since Q1/2023. Measurements of working hours were strongly affected by differences in the timing of the Easter holidays in 2023 and 2024, however, and it is therefore useful to examine semi-annual developments. In H1/2024, labour productivity was 3.7% lower by this measure than during the same period of 2023. This is a somewhat larger contraction than occurred in H2/2020, during the pandemic (Chart IV-8). Data suggest that the trend is due to reduced

Chart IV-6

Population

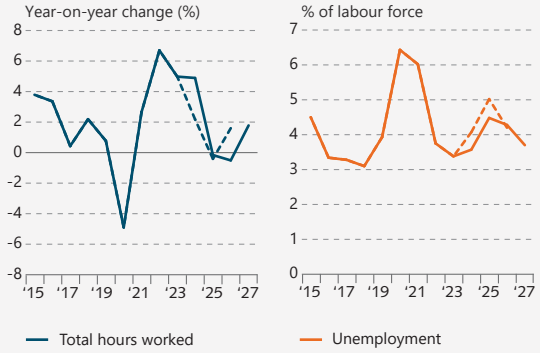
Q1/2015-Q3/2024



Source: Statistics Iceland.

Chart IV-7

Total hours worked and unemployment 2015-2027[1]



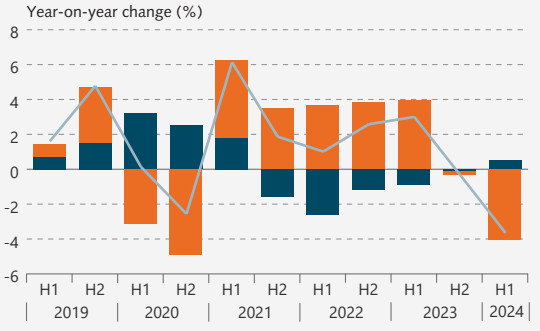
1. Total hours worked and unemployment according to the Statistics Iceland labour force survey (LFS). Central Bank baseline forecast 2024-2027. Broken lines show forecast from MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-8

Labour productivity[1]

H1/2019 - H1/2024



1. Labour productivity is GDP volume divided by total hours according to national accounting standards. The calculation uses the capital stock from the Bank's QMM model and a fixed 60% labour share.

Sources: Statistics Iceland, Central Bank of Iceland.

total factor productivity, but events largely unconnected to the business cycle could be a contributing factor. These include the failed capelin catch and the seismic activity on the Reykjanes peninsula. The prospect of stronger GDP growth in H2 could turn the situation around somewhat, however. Furthermore, there has been an increasing contribution from the capital stock per hour worked, which could continue alongside the slowdown in the domestic labour market.

The Bank's forecast of productivity is based on total hours worked according to the LFS, which, as is noted above, overstates job numbers. As a result, developments in productivity based on the LFS sketch out a bleaker picture. By that measure, GDP per hour worked contracts by 4.7% between annual averages in 2024, but in 2025 it turns around, and the outlook is for productivity to grow by an annual average of 2% over the next three years.

Capacity pressures in 2023 greater than previously assumed and outlook for a smaller slack to open up

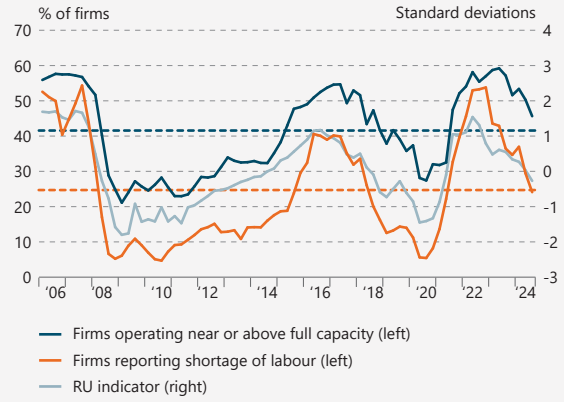
According to the seasonally adjusted results of Gallup's autumn survey, about a fourth of executives considered themselves short-staffed. This is close to the historical average and 5 percentage points lower than in the last survey, but roughly half of the H2/2022 peak. The share of respondents reporting that their firms would have difficulty responding to an unexpected increase in demand declined as well, although it is still above its historical average. The resource utilisation (RU) indicator, which combines various indicators of factor utilisation, therefore continued to fall. It dipped below its historical average for the first time since mid-2021, indicating that the positive output gap is closing and a slack is opening up (Chart IV-9).

The Gallup survey indicates that there are still considerable capacity constraints in the construction and utilities sectors (Chart IV-10). About 84% of companies in these sectors would have difficulty responding to an unexpected increase in demand, and over half report difficulties recruiting. In both cases, the ratios are well above their historical averages. Although the ratios have fallen since the last survey, the construction sector still appears to be operating at close to full capacity. On the other hand, it looks as though a slack has developed in retail and wholesale trade; transport, shipping, and tourism; and finance and insurance. The recent rise in the real exchange rate may have weakened the domestic tourism industry's competitive position (see Box 1) and shifted demand out of the

Chart IV-9

Capacity utilisation[1]

Q1/2006 - Q3/2024



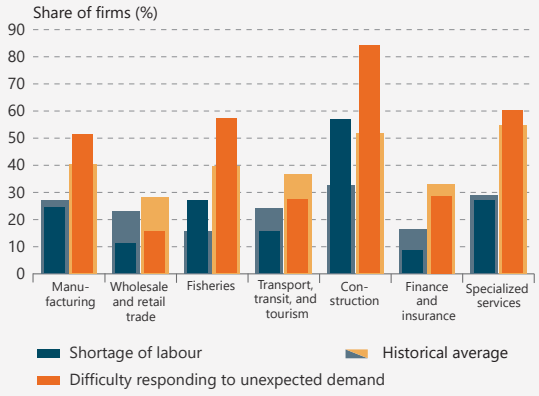
1. Indicators of capacity utilisation are based on the Gallup Sentiment Survey conducted among Iceland's 400 largest companies. The resource utilisation indicator (RU indicator) is the first principal component of selected indicators of capacity utilisation; it is scaled so that its mean value is 0 and 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.

Chart IV-10

Capacity utilisation by sector[1]

Gallup survey, autumn 2024



1. Historical average from 2006 onwards. Seasonally adjusted figures.

Sources: Gallup, Central Bank of Iceland.

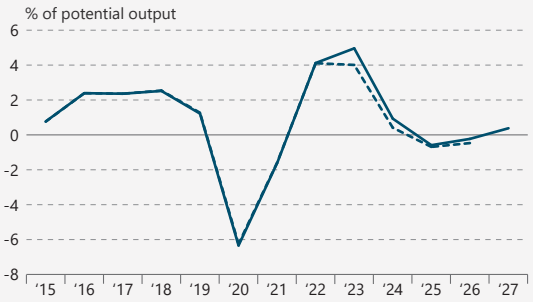
local economy. Furthermore, domestic trade is slowing, but this may be due in part to technological advances in the sector; for instance, an increase in self-service options could curb demand for labour and bolster capacity at the same time.

Statistics Iceland's most recent national accounts figures imply that the output gap was wider in 2023 and H1/2024 than previously estimated. This is due largely to the revision of both investment and the contribution from net trade in 2023, although the revision of potential output in 2024 because of the overestimation of total hours worked in the LFS pulls in the same direction.

The output gap is estimated to be positive by 1% of capacity in 2024 instead of the ½% forecast in August. It is then expected to be negative by ½% in 2025, which is a smaller slack than was previously projected. The slack is expected to narrow more quickly in the latter half of the forecast horizon, and a small positive output gap is set to open up near the end of the period (Chart IV-11). As before, this assessment is highly uncertain. Further discussion of the uncertainties in the forecast, together with alternative scenarios, can be found in Box 1.

Chart IV-11

Output gap 2015-2027[1]



1. Central Bank baseline forecast 2024-2027. Broken line shows forecast from MB 2024/3.

Source: Central Bank of Iceland.

Inflation

V

Recent developments in inflation

Inflation fell in Q3 ...

Inflation has been above the Bank's inflation target for more than four years. It averaged 5.9% in Q3, which is 0.4 percentage points below the forecast in the last *Monetary Bulletin* but in line with the Bank's May forecast. Higher owner-occupied housing costs affected the CPI most strongly during the quarter, and housing market activity remained brisk, owing partly to the impact of the seismic activity in Grindavík. On the other hand, the price of private services declined, driven mainly by lower airfares and the provision of free meals in primary schools, which was a one-off measure introduced by the Government in connection with wage agreements earlier this year.

... and is at a three-year low ...

The CPI rose by 0.28% month-on-month in October, and twelve-month inflation measured 5.1% (Chart V-1). Headline inflation therefore fell by 0.3 percentage points month-on-month and is at its lowest since year-end 2021. The October measurement was affected most strongly by higher food prices and airfares.

Inflation excluding the housing component has fallen more than headline inflation in the recent term, measuring 2.8% in October as well as September. HICP inflation has developed similarly, measuring 3.4% in September.

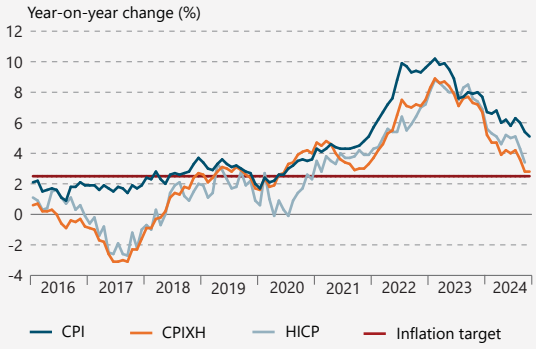
... and underlying inflation has eased as well

Underlying inflation measured 4.7% in October, according to the average of various measures. It has fallen by 0.6 percentage points since July and 1.6 percentage

Chart V-1

Various measures of inflation

January 2016 - October 2024

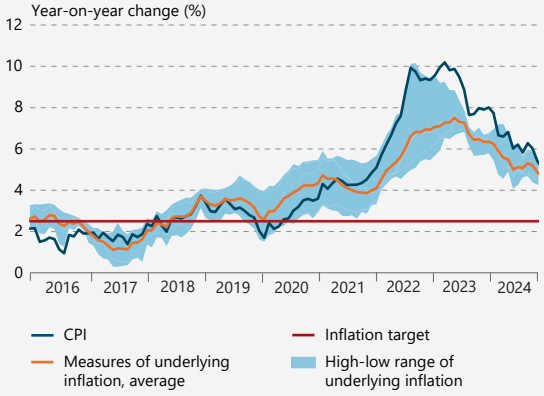


Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-2

Headline and underlying inflation[1]

January 2016 - October 2024



1. Underlying inflation measured using a core index (which excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense) and statistical measures (weighted median, trimmed mean, a dynamic factor model, and a common component of the CPI).

Sources: Statistics Iceland, Central Bank of Iceland.

points since October 2023 (Chart V-2). It appears that both the scope and the frequency of price hikes have continued to subside in line with the drop in inflation, and a larger share of the consumption basket has risen by less than 5% (Chart V-3).

House prices have been one of the main drivers of inflation in recent years. The housing component still accounts for more than half of inflation, even though its contribution to the headline rate has declined (Chart V-4). In June, Statistics Iceland changed its methodology for calculating imputed rent, adopting the rental equivalence approach (see Box 3), which entails estimating the amount households would have to pay for their property if they were in the rental market. As is discussed in Chapter II, the market price of housing has risen markedly since the change was implemented, but unlike with the previous approach, the increase has not directly affected the CPI. Furthermore, real mortgage interest expense is no longer included in the calculations, which makes monetary policy easier to conduct. The impact of higher owner-occupied housing costs has therefore been less pronounced under the new method than it would have been under the previous one. On the other hand, movements in rent prices now have a direct impact on measured inflation.

The composition of inflation has therefore changed somewhat in the recent term. In addition, the contribution of domestic goods and services, as well as imported goods, has been declining. Apart from the housing component, however, services prices account for the largest share of inflation.

Indicators of inflationary pressures

Domestic inflation has eased, but services price inflation remains high ...

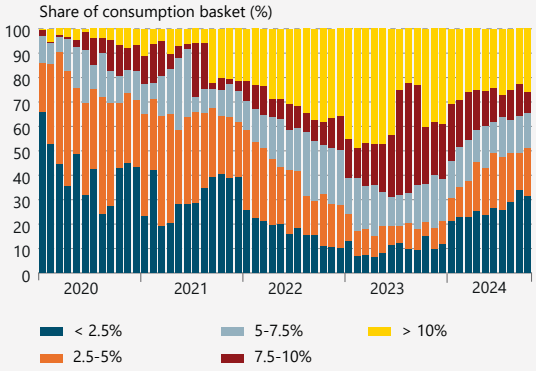
Growth in economic activity has continued to subside, and based on the forecast there was only marginal year-on-year growth in private consumption over the first three quarters of the year (see Chapter III). Furthermore, there are signs that housing market activity is cooling. In October, domestic goods prices had risen 3.6% in the previous twelve months, and the pace of the year-on-year increase had slowed considerably (Chart V-5). The twelve-month rise in food and other goods prices has tapered off since July, although part of the slowdown is probably due to the entry of a new competitor in the grocery store market.

Private services prices have risen by 4.4% in the past twelve months, and the pace of the increase has subsided in the recent term. To a large extent, the slow-

Chart V-3

Extent of price increases[1]

January 2020 - October 2024

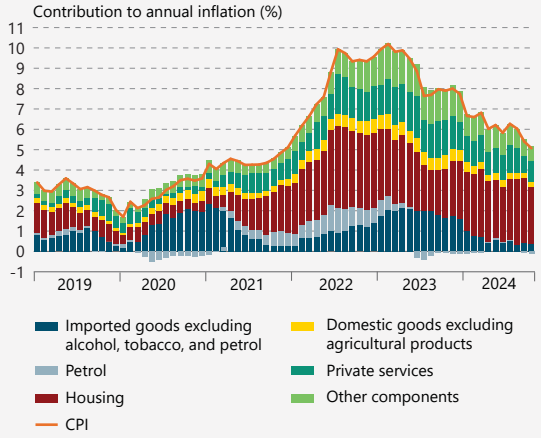


1. The share of the CPI consumption basket categorised by annual increase.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-4

Components of CPI inflation

January 2019 - October 2024

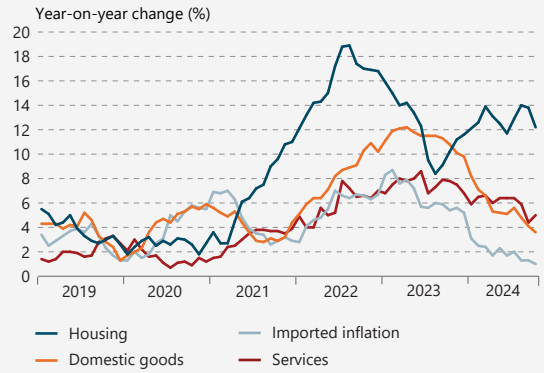


Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-5

Domestic and imported inflation[1]

January 2019 - October 2024



1. Services are a weighted average of the private and public services components.
Sources: Statistics Iceland, Central Bank of Iceland.

down is due to the introduction of free school meals, which had a significant downward impact on the CPI. The year-on-year rise in public services prices measured 6.6% in October, but the Government's decision to cancel a portion of fees for university education also lowered the price of public services this autumn. Services prices were up by an average of 5% year-on-year in October; therefore, services price inflation is still high.

... and imported food prices have risen persistently

On the whole, imported inflation has continued to ease, and the year-on-year increase in imported goods prices was down to 1% in October. However, price hikes on imported foods and beverages have been persistent recently, although the twelve-month increase has eased slightly, to 5.1%. The price of new motor vehicles and other imported goods has risen only marginally in the recent term, though.

As is discussed in Chapter I, global inflation has continued to fall. Domestic petrol prices have declined in recent months, in the wake of lower global oil prices, and other commodity prices have fallen as well. As Chart V-6 shows, the contribution of energy prices to inflation in trading partner countries increased markedly at the start of the post-pandemic recovery, and even more so after Russia invaded Ukraine. Developments in Iceland followed a different pattern: The contribution of energy prices to domestic inflation has been negligible in recent years, as fluctuations in energy prices have less impact on the cost of home heating in Iceland. As a result, the diminishing effects of energy price hikes account for a sizeable share of the decline in global inflation. In Iceland, the past few years' strong inflationary pressures stem from other sources, and inflation has therefore been more persistent.

Unit labour costs have risen far more than is consistent with price stability

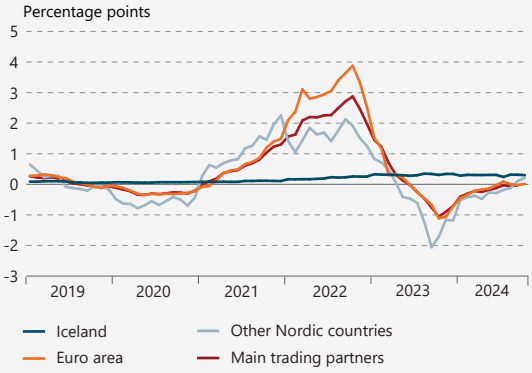
According to the national accounts published in September 2024, the wage share – i.e., the ratio of labour compensation to GDP – was revised slightly from 2018 onwards. It is now estimated to have been 60% in 2023, which is in line with its twenty-year average.

The general wage index rose by 0.9% between quarters in Q3, and by 6.3% year-on-year. This is in line with the Bank's August forecast, although that forecast assumed that new public sector wage agreements would be finalised more quickly. According to the labour cost index, labour costs per hour rose by nearly 5% year-on-year in H1/2024. This increase is nearly 2 percentage points smaller than that depicted

Chart V-6

Contribution of energy prices to inflation[1]

January 2019 - October 2024



1. The contribution to twelve-month inflation of electricity, gas, and other energy sources in the housing component of the CPI. Trade-weighted average for main trading partners. The other Nordic countries are represented by a simple average for Denmark, Norway, and Sweden.

Sources: OECD, LSEG Datastream, Central Bank of Iceland.

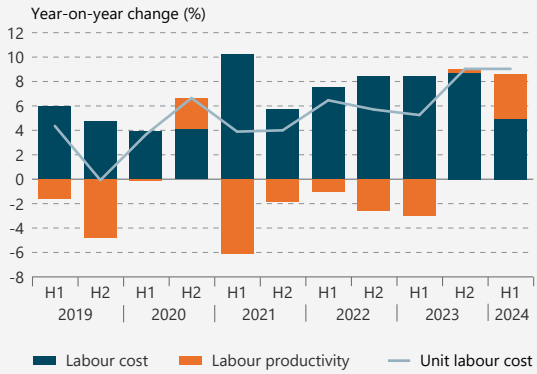
by the general wage index for the same period, and smaller than the measured rise in labour costs over the past three years. At the same time, Statistics Iceland's figures indicate that labour productivity has declined. It is estimated to have fallen by 3.7% year-on-year in H1/2024 (see also Chapter IV). Thus there are signs that the year-on-year increase in unit labour costs is largely unchanged, measuring about 9% in H1/2024, as it did in H2/2023 (Chart V-7).

The baseline forecast assumes that the rise in unit labour costs will slow down in H2, resulting in an increase of 7.1% for the year as a whole. Furthermore, this pattern is expected to continue as inflation falls and labour productivity recovers. Unit labour costs are expected to rise by an average of 4% per annum over the next three years. Labour costs will therefore continue to rise more than is consistent with price stability. The forecast assumes that the wage policy outlined at the beginning of the current round of wage negotiations will remain in effect throughout the forecast horizon. Uncertainty about this assumption has grown, however, in view of the situation that has arisen in negotiations with teachers and doctors.

Chart V-7

Indicators of unit labour cost[1]

H1/2019 - H1/2024



1. Hourly labour costs according to the Statistics Iceland labour cost index. Labour productivity is GDP divided by total hours worked according to national accounts standards. Unit labour costs are derived as the ratio of these indicators. Labour productivity growth is shown as a negative contribution to an increase in unit labour costs. Sectoral coverage is not fully matched, as hourly labour costs cover sectors B-S according to the NACE REV. 2 classification system, whereas labour productivity figures cover all sectors.

Sources: Statistics Iceland, Central Bank of Iceland.

Inflation expectations

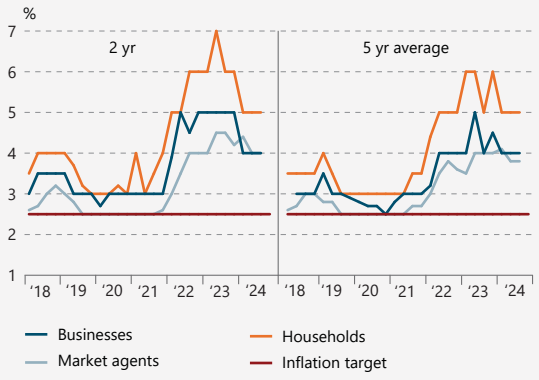
Market agents' inflation expectations have fallen …
Inflation has declined more rapidly than market agents expected in August. Their short-term inflation expectations have therefore subsided, according to a recent survey, and respondents now expect inflation to measure about 3.5% both one and two years ahead (Chart V-8). Market agents' long-term inflation expectations have also fallen, and they expect inflation to average 3.3% over the next five years and 3% over the next ten, which is ½ a percentage point less than they expected in August.

… but households' and businesses' expectations are broadly unchanged …
According to Gallup's autumn survey, however, households' and business executives' two-year expectations were unchanged: executives expect inflation to measure 4% in two years' time, and households expect it to measure 5%. Their long-term inflation expectations were also unchanged between surveys: businesses expect inflation to measure 4% over the next five years, and households expect it to be 5%. Since inflation has fallen markedly in the recent past, it should be borne in mind that these surveys were conducted last September.

Chart V-8

Two- and five-year inflation expectations[1]

Q1/2018 - Q4/2024



1. Gallup surveys of households' and businesses' inflation expectations and Central Bank survey of market agents' inflation expectations. Median responses.

Sources: Gallup, Central Bank of Iceland.

… and breakeven rates have fluctuated widely in the recent term

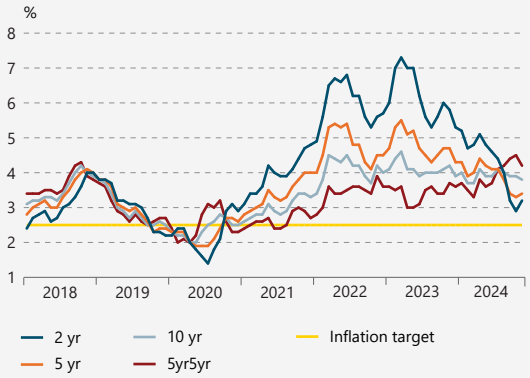
The short-term breakeven inflation rate in the bond market has fluctuated in the recent term, owing to uncertainty about how Statistics Iceland would classify the proposed change in taxation of motor vehicle use. Under the new system, fuel taxes would be cancelled and a per-kilometre charge introduced instead (see Chapter II). The breakeven rate fell this summer, driven by expectations that the CPI would decline steeply because of the change. It rose again in late October, however, when Statistics Iceland announced that the per-kilometre charge would be included in the index and would offset the cancelled fuel tax, as was assumed in the Bank's August forecast. The two-year breakeven rate was just under 3% in mid-November and had fallen by 1 percentage point since August (Chart V-9).

The long-term breakeven inflation rate in the bond market has also eased in the recent past. The ten-year breakeven rate was 3.6% as of mid-November. Because the short-term breakeven rate dropped steeply while the ten-year rate held largely unchanged, the five-year rate five years ahead rose markedly during the autumn. As is discussed in Chapter II, it is unlikely that this indicates a rise in long-term inflation expectations; instead, it probably reflects the impact of investors' position-taking in short-term bonds. After Statistics Iceland issued the above-mentioned announcement, the five-year breakeven rate five years ahead declined again, to 4.1% as of mid-November. However, in mid-November it was decided that the per-kilometre charge would not replace oil and petrol taxes in January 2025.

Chart V-9

Breakeven inflation rate[1]

January 2018 - November 2024



1. Monthly averages. Data through 15 November 2024.

Source: Central Bank of Iceland.

The inflation outlook

The short-term inflation outlook has improved …

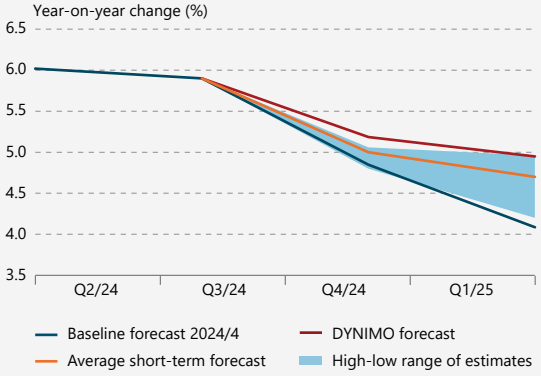
Inflation turned out 0.4 percentage points lower in Q3 than was forecast in August. The deviation is due both to the stronger-than-expected impact of the Government's above-mentioned one-off measures and to weaker overall inflationary pressures. Inflation is projected at 4.8% in Q4, or 1 percentage point below the August forecast. It looks set to keep falling, to 4.1% in Q1/2025. The inflation outlook for coming quarters has therefore improved. There is some uncertainty about the near-term outlook, however, and the Bank's other forecasting models indicate that inflation could turn out higher than in the baseline forecast (Chart V-10).

Economic activity is expected to continue easing and a slack to open up in late 2025. Inflation will be

Chart V-10

Short-term inflation forecast[1]

Q2/2024 - Q1/2025



1. A comparison of the baseline forecast, the DYNIMO forecast, and the average of five statistically estimated inflation models used by the Bank for short-term inflation forecasts.

Sources: Statistics Iceland, Central Bank of Iceland.

down to 3.2% towards the end of the year, which is somewhat below the August forecast, reflecting an improved outlook for the exchange rate of the króna and weaker imported inflationary pressures than were projected then.

... but the long-term inflation outlook is largely as it was in August ...

As is discussed in Chapter IV, the positive output gap appears to have been wider in 2023 and is expected to close more slowly than was forecast in August. The slack that will develop in the next two years will also be marginally smaller than was projected at that time. The inflation outlook for the latter half of the forecast horizon is therefore largely unchanged since August. Inflation is expected to fall below 3% in H1/2026, somewhat earlier than was assumed in August, and return to target around mid-year, as in the August forecast. Inflation will then remain close to target for the rest of the period, conditional upon the interest rate path in the baseline forecast.

... and inflation risk is broadly symmetric

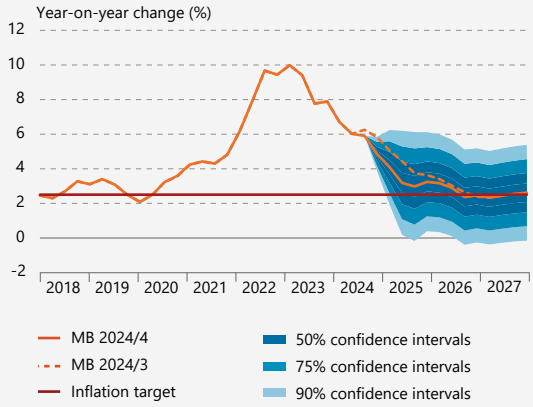
As is discussed in Box 1, the inflation outlook is highly uncertain at present. The global economic situation is fragile because of escalating war and trade protectionism. As a result, import prices could rise more than is currently assumed. Uncertainty about the still-pending wage agreements has increased as well, and it is uncertain whether their outcome will affect contracts already finalised. The output gap could be underestimated, and the impact of recent cost increases could prove stronger than is assumed. If wage drift increases over the forecast horizon, inflationary pressures from the labour market could grow stronger as well. On the other hand, the slack in the economy could turn out wider over the forecast horizon than is currently envisioned, and the effects of the rise in real interest rates could be underestimated. If so, inflation could fall more rapidly.

In view of all of this, the risks to the inflation outlook are considered broadly balanced. There is a 50% probability that inflation will be in the 2-4½% range in one year and in the 1¼-3½% range in two years' time (Chart V-11).

Chart V-11

Inflation forecast and confidence intervals

Q1/2018 - Q4/2027



Sources: Statistics Iceland, Central Bank of Iceland.

Box 1

Alternative scenarios and uncertainties

The Central Bank's baseline forecast reflects the likeliest economic developments over the forecast horizon. The economic outlook is uncertain, however, and could change in response to changes in key assumptions underlying the forecast.

Recent growth in economic activity could be underestimated, for instance, in view of Statistics Iceland's repeated underestimation of business investment growth in the past few years. GDP growth in 2023 and in 2024 to date could therefore be stronger than is currently assumed, and the positive output gap could be larger and underlying inflationary pressures more pronounced as a result. The potential impact of an upward revision of recent investment figures is covered in an alternative scenario.

Economic developments will also depend on prospects for tourism during the forecast horizon. The baseline forecast assumes that tourist arrivals will continue to increase in coming years. That forecast could prove overly optimistic, however, if interest in visiting Iceland wanes – for example, in view of the recent rise in the real exchange rate. The potential impact of this on the economic outlook is described in another alternative scenario.

This Box closes with a discussion of several other uncertainties that could affect the outlook for domestic GDP growth and inflation over the forecast horizon.

Alternative scenario: Business investment stronger in 2023 and 2024 than is currently assumed

Statistics Iceland's estimates of business investment have regularly been revised upwards

According to Statistics Iceland's first figures on year-2023 business investment, published in February 2024, investment spending growth was estimated at 0.9% year-on-year. When the national accounts were revised in May, however, growth in business investment was revised upwards by 3%, to 3.6% between years. The revision for 2022 was even larger: according to the first estimate, business investment grew by 15.2% during the year, but now Statistics Iceland projects the growth rate at 27.4%, which represents an upward revision of 63.5 b.kr. at constant prices, or 16.6% above the original estimate. As is discussed in Box 2 in *Monetary Bulletin* 2024/2, the revision strongly affected

Statistics Iceland's estimate of GDP growth for the year, which was originally 7.2% but is now 9%.

Although this revision of investment figures for 2022 was unusually large, it is not a one-off situation (see also Box 5). As can be seen in Chart 1, Statistics Iceland's initial estimates of business investment have been revised upwards for seven of the past ten years. On average, the increase relative to the original estimate of investment spending measures 4.5%, which corresponds to just under 15 b.kr. at constant prices, or 0.6% of average GDP for the period. As Chart 1 shows, the revision also tends to follow the business cycle: investment figures are usually revised upwards during an upswing, while they are more often revised downwards during a downturn. The exception is 2018, when the investment level was lowered with the third revision, carried out in early 2020. After that, however, investment was gradually revised upwards, although the current estimate is still below the original one.

Statistics Iceland's final estimates of business investment are based on information from corporate tax returns. This information becomes available with a time lag, however, and the first estimates are therefore based on other data, such as value-added tax revenue and investment goods imports, as well as corporate surveys. As a result, Statistics Iceland's underestimations partly reflect a lack of reliable information from the business sector. Furthermore, the problem seems to have grown worse in recent years, with increased activity in new sectors such as aquaculture and data centres. In these instances, it appears that Statistics Iceland has not been able to scale up its data collection to accord with the rapid growth in the sectors.

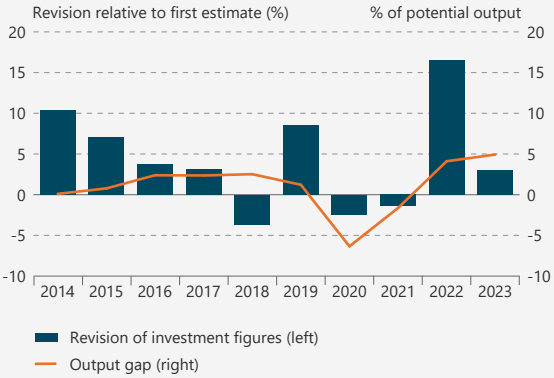
The output gap could be underestimated if investment turns out stronger than initial estimates suggested

In assessing economic developments and prospects and preparing its baseline forecast, the Bank relies on historical national accounts data from Statistics Iceland and a number of other indicators. However, the situation described above could suggest that the current assessment of recent developments in investment spending is an underestimation and that spending will be revised upwards in the future. This could affect the Bank's assessment of economic activity and the output gap, and therefore of underlying inflationary pressures.

The Bank's QMM model is used to assess the potential impact of such revisions on economic developments. It is assumed that general business investment (i.e., excluding investment in energy-intensive industry, ships, and aircraft) was about 5% more in 2023 than is currently estimated and

Chart 1

Statistics Iceland's revisions of business investment data 2014-2023[1]

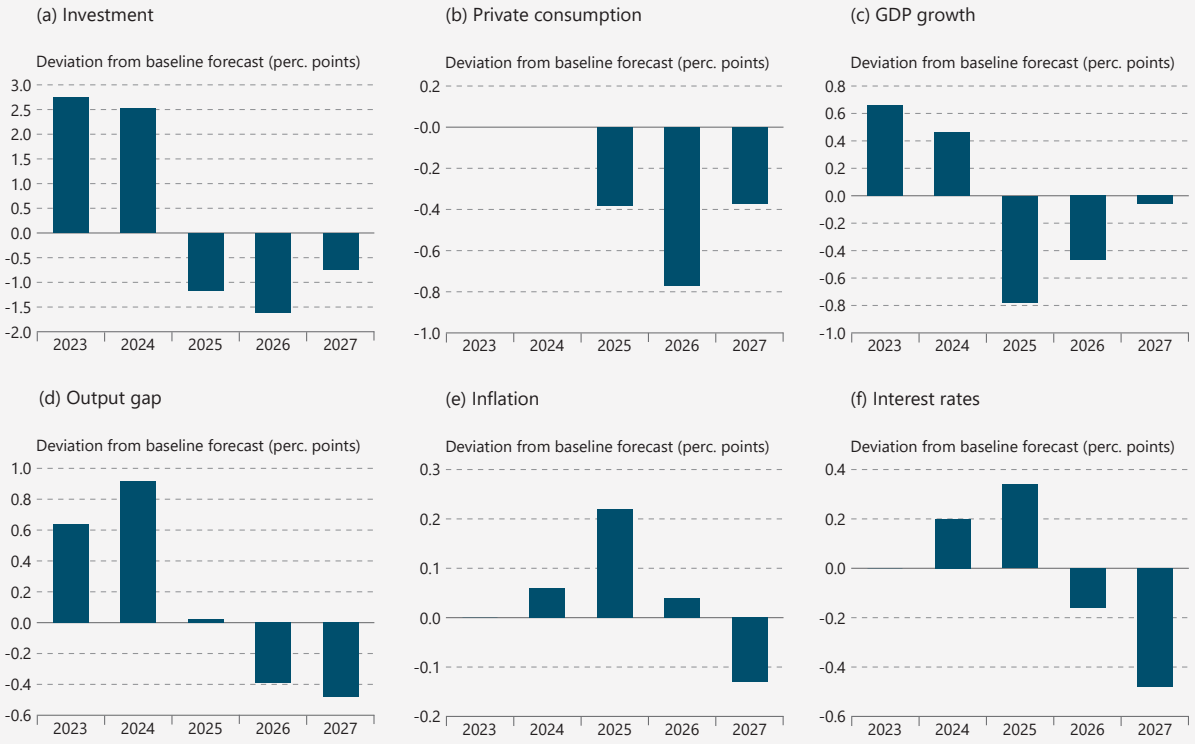


1. Changes in Statistics Iceland's annual business investment figures, from first estimate to most recent.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2

Alternative scenario: Business investment stronger than currently forecast



Source: Central Bank of Iceland.

that Statistics Iceland will make a corresponding revision for H1/2024. As a result, total business investment is estimated to have grown by about 4 percentage points more in 2023 than Statistics Iceland's current figures indicate, and a similar revision of H1/2024 figures is assumed.

As Chart 2a shows, this entails an increase in total year-2023 investment by nearly 3 percentage points over and above the current estimate. Because the alternative scenario does not assume that other expenditure items in the national accounts will be revised, this entails an increase in year-2023 GDP growth of 0.7 percentage points, from 5% to 5.7% (Chart 2c). The alternative scenario assumes a similar revision of H1/2024 growth in investment spending, causing total investment for 2024 as a whole to increase by 2.5 percentage points relative to the baseline forecast. As a result, GDP growth for the year will be 0.5 percentage points stronger, measuring 0.5% instead of remaining flat as in the baseline.

Although increased investment expands the capital stock, therefore increasing potential output, this revision of recent GDP growth results in a larger positive output gap than is assumed in the baseline forecast: In the alternative scenario, the 2023 output gap is ½ a percentage point larger than in the current baseline forecast, and the output gap for 2024 is nearly 1 percentage point larger (Chart 2d).

A potential revision of historical investment data would therefore reveal greater strain on domestic resources. Inflation would thus be somewhat higher into 2025 (Chart 2e). In that instance, a tighter monetary stance would be needed to ensure that inflation continues to subside to target. Based on the monetary policy rule in the model, the Central Bank's key interest rate is about 0.2-0.3 percentage points above the baseline forecast in 2024 and 2025 (Chart 2f). Investment and private consumption therefore grow more slowly than in the baseline for the remainder of the forecast horizon (Charts 2a and 2b), and GDP growth is an average of ½ a percentage point below the baseline over the next three years (Chart 2c).

Alternative scenario: Tourist numbers are lower than in the baseline forecast

Tourist visits to Iceland have surged in the past decade despite a significant rise in the real exchange rate

The number of tourists visiting Iceland has soared in the past decade. In 2018, over 2.3 million tourists came to the country, an increase of nearly 250% relative to 2012, even though the real exchange rate rose by 41% over the same period (Chart 3). At the same time, tourist numbers worldwide rose by only 33%.

The collapse of airline WOW Air in spring 2019 marked a setback in tourist visits to Iceland. Nevertheless, between 2012 and the onset of the pandemic in 2020, the number of visitors to Iceland rose far in excess of the global increase, even though the real exchange rate of the króna soared at the same time.

This trend is most likely due to a change in foreign tourists' travel habits, reflected in vastly increased interest in Iceland as a destination. This can be seen in Chart 4, which gives a stylised example of supply and demand in the domestic tourism market. The demand curve (*D*) is a typical downward-sloping curve that illustrates how interest in travelling to Iceland declines as the cost of visiting the country increases; i.e., with rises in the real exchange rate (which depicts relative prices in Iceland and abroad, measured in the same currency). The supply curve (*S*), on the other hand, is upward-sloping; i.e., as the real exchange rate rises, it becomes more profitable to sell trips to Iceland, which boosts supply in the domestic tourism industry. Before interest in visiting Iceland grows, the tourism market is in equilibrium at point A. When interest in travelling to Iceland picks up, the demand curve shifts to the right until a new equilibrium emerges at point B, at which time tourist numbers have increased and the real exchange rate has risen.

Chart 3

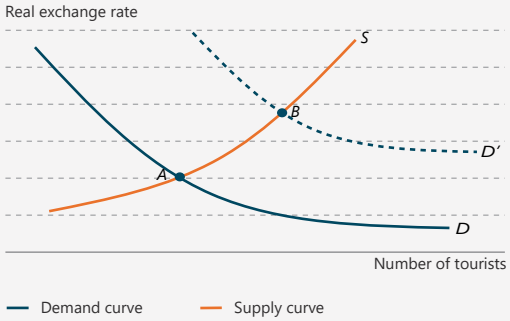
Real exchange rate and tourist numbers 2012-2019[1]

1. International tourist arrivals in Iceland and worldwide.

Sources: Icelandic Tourist Board, UN World Tourism Organization (UNTWO), Central Bank of Iceland.

Chart 4

Travel to Iceland: supply and demand[1]



1. The chart gives a stylised example of supply and demand for travel to Iceland, showing how increased interest in visiting Iceland led to a higher real exchange rate concurrent with a rise in tourist numbers.

Source: Central Bank of Iceland.

The GDP growth outlook could prove overly optimistic if this increased interest in visiting Iceland reverses

What would happen if this change were to reverse in part – for instance, because the novelty of travelling to Iceland has diminished? Presumably, the demand curve would shift back to some extent and a new equilibrium would emerge, with a lower real exchange rate and fewer tourist arrivals.

The Bank's baseline forecast assumes that tourist numbers will increase by just over 1% year-on-year in 2024, around 2% in 2025, and by 3½% per year for the remainder of the forecast horizon. This is somewhat below the projected global rise, as tourist visits to Iceland have increased more over the past three years, reflecting the Icelandic tourism industry's comparatively rapid post-pandemic recovery. Towards the end of the forecast horizon, however, the rise in tourist arrivals is broadly in line with the International Air Transport Association's (IATA) forecasted increase in the number of passengers flying to Europe.[1]

As can be seen in Chart 5, this implies that services exports grow over the forecast horizon and align with the 2017 peak by the end of the period. Due to Iceland's more rapid post-pandemic recovery, its share in global tourism increased in 2022-2023. According to the baseline forecast, however, it will decline again during the forecast horizon, returning to its 2019 level by the end of the period.

The alternative scenario assumes, however, that Iceland's market share will continue to fall from 2025 onwards and will be close to its 2015-2016 average at the end of the horizon. Under this scenario, tourist numbers decline by about 1% in 2025 and then by 1½% per year in the latter half of the forecast horizon, and services exports remain broadly flat at their 2024 level. Chart 6 summarises the effects of these developments on the domestic economy, using the Bank's QMM model. As Chart 6a indicates, growth in total exports is about 1 percentage point weaker in 2025 than is assumed in the baseline, largely because services export growth slows by nearly 2 percentage points. Exports lose even more ground after 2026 and, by 2027, are a full 4% below the baseline forecast.

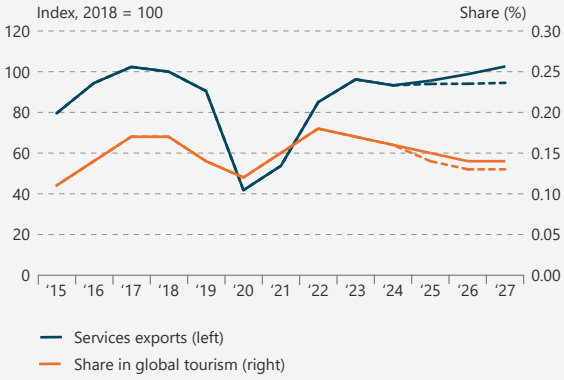
As is discussed above, declining demand for travel to Iceland also causes the real exchange rate to fall to nearly 2% below the baseline forecast by the end of the horizon (Chart 6b). The external balance of the economy deteriorates as well, with the current account balance deteriorating by 1½% of GDP by the end of the forecast period (Chart 6c).

With reduced activity in the tourism industry, the output growth outlook worsens relative to the baseline

1. See IATA (2024), "Deep change", *Global Outlook for Air Transport*, June 2024.

Chart 5

Services exports and tourist numbers in the baseline forecast and an alternative scenario[1]

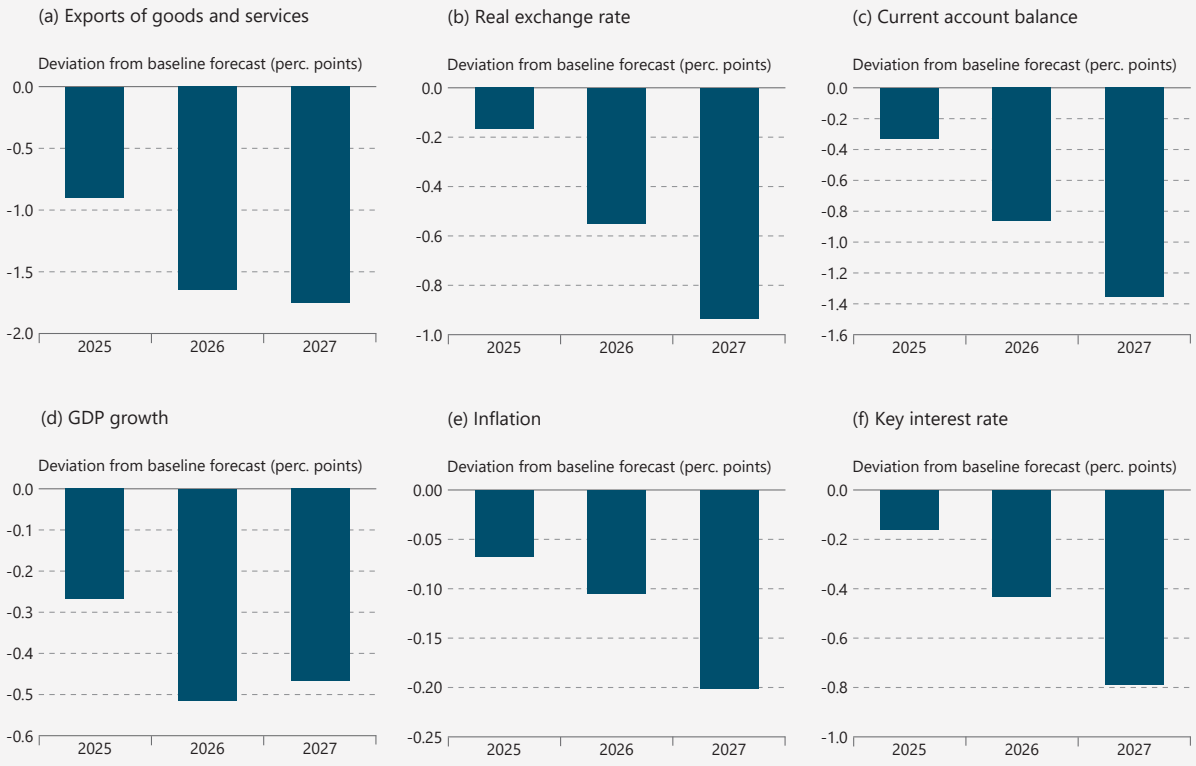


1. The share in global tourism is measured as the ratio of tourist arrivals in Iceland to tourist arrivals worldwide. Central Bank baseline forecast 2024-2027 for services exports and tourist arrivals (broken lines show alternative scenario). The projected number of tourists worldwide is based on the International Air Transport Association's (IATA) forecast of the number of global air passengers.

Sources: Icelandic Tourist Board, International Air Transport Association (IATA), Statistics Iceland, UN World Tourism Organization (UNTWO), Central Bank of Iceland.

Chart 6

Alternative scenario: Tourist numbers are lower than in the baseline forecast



Source: Central Bank of Iceland.

forecast. GDP growth is weaker than in the baseline example by 0.3 percentage points in 2025 and 0.5 percentage points per year in 2026-2027 (Chart 6d). As a result, GDP is 1¼% lower than in the baseline at the end of the forecast horizon. Unemployment is higher as well, albeit offset by reduced labour importation.

More sluggish growth in economic activity also reduces domestic inflationary pressures, although this is offset by a weaker króna. In the alternative scenario, inflation is lower by 0.1-0.2 percentage points per year throughout the forecast horizon (Chart 6e). According to the monetary policy rule in the model, the Central Bank's key interest rate is lower for the entire forecast horizon, and by the end of the period it is nearly 1 percentage point lower than in the baseline forecast (Chart 6f).

Other uncertainties

The inflation outlook is uncertain …

As before, the global economic outlook is highly uncertain. The war in Ukraine has been ongoing for nearly three years. The war in the Middle East has escalated, and the risk of further spread to neighbouring countries is growing. Free

trade is under greater pressure, and signs of increasing fragmentation and bloc formation in cross-border trade can be seen. Commodity and food prices could increase more than is assumed in the baseline forecast, and supply-side disruptions, rising shipping costs, and greater cross-border trade barriers could cause import prices to rise higher than is currently projected. Added to this is uncertainty about commodity and food prices because of more frequent harvest failures due to extreme weather episodes. Domestic inflationary pressures could therefore be underestimated, although they would be offset by weaker economic activity in trading partner countries.

These inflationary pressures could also prove more persistent if the domestic economy proves more robust than is currently assumed. As has been discussed previously in *Monetary Bulletin*, households accumulated significant savings during the pandemic and have only drawn down a portion of them (see, for instance, Box 2 in *Monetary Bulletin* 2024/2). As a result, private consumption growth could turn out stronger than is currently envisioned, and the positive output gap could prove more persistent. The same applies if fiscal policy is more accommodative than current estimates provide for. Furthermore, ongoing labour market disputes could result in stronger wage pressures than the forecast indicates.

Domestic inflationary pressures could also turn out more persistent than is currently forecast if the pass-through of large recent cost increases – either imported cost hikes or steep wage rises – are underestimated. The risk of this is greater because inflation expectations are less firmly anchored to the target (see, for instance, Box 1 in *Monetary Bulletin* 2023/4). Poorly anchored inflation expectations could also undermine the króna and impede the transmission of monetary policy to the real economy, thereby making it harder to stabilise the economy. Moreover, the recent national accounts may underestimate firms' investment spending, and as is noted above, underlying pressures in the economy could therefore be stronger than is currently assumed.

On the other hand, domestic economic activity could weaken more, and inflation could fall faster, than is currently forecast. For instance, the impact of the past few months' surge in real interest rates probably has yet to emerge in full. It is possible that this is underestimated in the baseline forecast, particularly because a large number of mortgage loans taken at lower interest rates are soon due for interest rate resets. Furthermore, the outlook for tourism as presented in the baseline forecast could be overly optimistic, as is discussed above.

… but the inflation risk profile is broadly symmetric

For some time, the risk profile in the Bank's inflation forecasts has been tilted to the upside. These concerns have receded recently, however, and risks to the inflation outlook are now considered symmetric. Nevertheless, considerable uncertainty remains.

Box 2

Economic recovery in the shadow of recent shocks

A number of economic shocks have rattled the global economy in the 2020s to date. Chief among them is the COVID-19 pandemic, which spread all over the globe in early 2020 and is the most severe economic shock to strike the world economy since the end of World War II. In the nearly five years that have passed since the onset of the pandemic, other shocks have followed, including the wars in Ukraine and the Middle East and growing fragmentation of global trade. Furthermore, central banks' battle to control surging inflation has taken its toll.

This Box explores the extent to which the Icelandic economy has recovered from the post-pandemic contraction. Relative to the Central Bank's early-2020 forecast, issued just before the pandemic hit, it can be said that by 2023 the economy had returned to its pre-COVID trend. Developments in Iceland differ from those in other countries, where the impact of the past few years' shocks can still be felt.

Economic activity has rebounded in full after the COVID-era contraction in 2020 ...

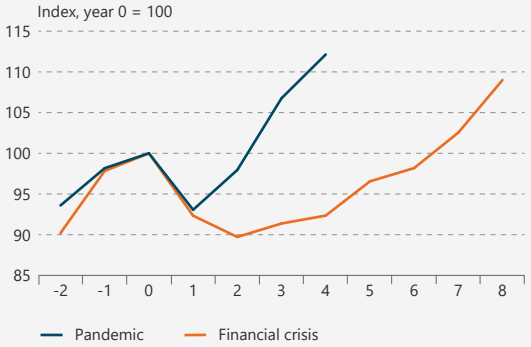
The COVID-19 pandemic had a profound impact on economic activity in Iceland, as it did all over the world. Domestic GDP shrank by 6.9% in 2020. It was the largest single-year contraction since 2009, when GDP plunged 7.7% in the wake of the financial crisis. These two years therefore resemble one another in terms of the size of the initial contraction, but the economy rebounded from the pandemic much earlier than from the financial crisis. Economic activity started to recover as soon as 2021. A year later, GDP had returned to its pre-COVID level, and despite further shocks to the global economy, it was 12% higher by 2023 than in 2019 (Chart 1).

On the other hand, the post-financial crisis turnaround proceeded much more slowly, and GDP continued to shrink in 2010. It contracted by a combined total of 10.3% in 2009-2010 and did not return to its pre-crisis level until 2015, six years later.[1] In part, the sluggish post-crisis recovery reflects the nature of severe financial crises (see, for instance, Einarsson *et al.,* 2015); however, more flexible

1. It should be noted that yearly averages partially camouflage the depth of these crises. According to seasonally adjusted quarterly data GDP contracted by 14.9% from the pre-crisis peak to the post-crisis trough, and by 12.2% from peak to trough at the time of the pandemic.

Chart 1

Comparison of GDP following two deep economic crises[1]



1. GDP during COVID-19 and the financial crisis. Year 0 is the year before GDP began contracting. In the former case, Year 0 is 2019, and in the latter it is 2008.

Sources: Statistics Iceland, Central Bank of Iceland.

countercyclical economic policy – which made it possible to provide support during the pandemic – is likely to have played an important role as well, by preventing an even larger contraction and supporting the recovery. A major factor in this was the flexibility of monetary policy to cut interest rates aggressively, which was not possible in the wake of the financial crisis.[2]

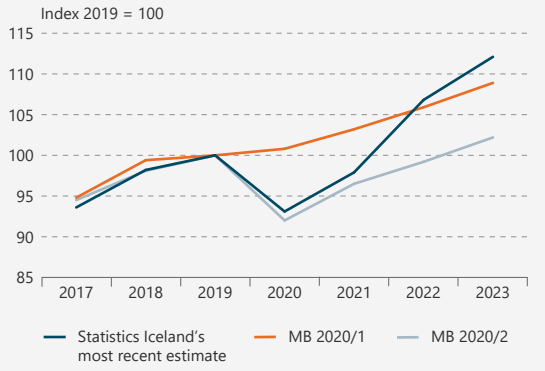
... and has reached the level projected before the pandemic struck

The fact that economic activity has returned to the pre-pandemic level does not tell the whole story, though, as it can be assumed that if the pandemic had not occurred, activity would have kept increasing from its 2019 level. In order to estimate the impact of recent shocks on the economy, it is therefore more useful to compare actual developments to pre-shock projections.

Chart 2 shows such a comparison. The comparison uses the trend path projected in *Monetary Bulletin* 2020/1, which was prepared in February 2020, just before the pandemic reached Iceland. That forecast assumed that economic activity would pick up gradually in 2019 and 2020 and that GDP growth would then inch upwards to 2½% from 2021 onwards, which corresponds roughly to its long-term potential. The outlook changed dramatically with the onset of the pandemic, however. This can be seen clearly in the change in the Bank's forecasts between February and May 2020; i.e., soon after the pandemic hit Iceland. The projected contraction provided for in the May forecast materialised for the most part, as did the turnaround in 2021.[3] Economic activity in 2022 was significantly underestimated, though, partly because there was little known at the time about the scope and duration of fiscal measures introduced in response to the pandemic. These measures were intended to protect household incomes, but because disease prevention measures put such severe limits on consumption options, households accumulated sizeable savings, which supported a strong recovery once the restrictions were eased (see, for instance, Box 2 in *Monetary Bulletin* 2023/4). In 2022, GDP growth measured 9%, the strongest seen in Iceland since 1971 (see Box 2 in *Monetary Bulletin* 2024/2). Therefore, in 2023 it was 2.9% above the Bank's February 2020 forecast. This brisk recovery then gave

Chart 2

GDP in 2017-2023 and comparison with forecasts from just before and after the onset of the pandemic[1]



1. The chart shows Statistics Iceland's most recent estimate of GDP and a comparison with the forecasts in MB 2020/1 and 2020/2, just before and after the pandemic reached Iceland.

Sources: Statistics Iceland, Central Bank of Iceland.

2. See, for example, Pétursson (2023). A discussion of how post-crisis monetary policy reforms enhanced the credibility of monetary policy and better enabled it to smooth out cyclical fluctuations can be found, for instance, in Pétursson (2019).
3. The accuracy of the May forecast for 2020 and 2021 is particularly interesting because at the time it was prepared, Statistics Iceland's national accounts data extended only through Q4/2019.

rise to persistent inflationary pressures that are still being unwound.

As Chart 3 indicates, domestic demand grew more strongly than had been forecast before the pandemic, especially investment, which in 2023 was a full 15% above the February 2020 forecast. The recovery of domestic demand is also reflected in imports, which by 2023 had returned to the pre-pandemic level. The same can be said of developments in the labour market. Exports, however, have not reached the level seen before the pandemic.

Business investment has grown strongly in recent years, albeit offset by a downturn in residential investment

As can be seen in Chart 4, most components of investment have grown much more than was forecast before the pandemic, business investment in particular. This is due in large part to companies in the land-based aquaculture, hotel, and data centre sectors, which have invested heavily in buildings and a wide range of machinery and equipment (see Box 2 in *Monetary Bulletin* 2024/2). The only component of investment that appears not to have reached its pre-pandemic level is residential investment. According to national accounts data from Statistics Iceland, residential investment was broadly flat year-on-year in 2020 and then contracted by a combined total of over 10% in 2021-2023, although indicators from the housing market paint a somewhat different picture.

The steep post-pandemic contraction in tourism explains the underperformance of exports

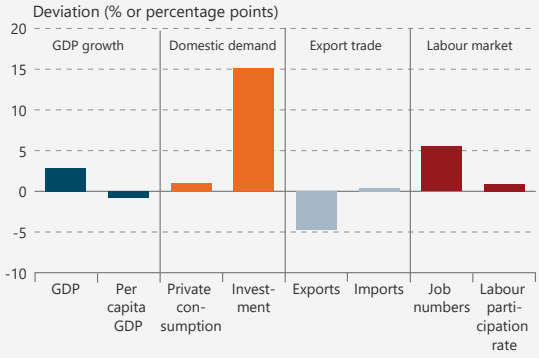
The pandemic had a major impact on tourism in Iceland, as it did elsewhere. Services exports shrank by nearly 54% year-on-year in 2020, and in 2023 they were still more than 6% below the pre-pandemic trend (Chart 5). Goods exports also contracted in the wake of the pandemic, but much less than services exports did. In spite of increased fragmentation of global trade in recent years, by 2023 Iceland's goods exports had more or less returned to the level forecast before the pandemic. Exports of marine and aluminium products still have some ground to cover before they pull even with the pre-pandemic forecast, but this is offset by strong growth in other exports.

Pandemic-induced labour market scarring appears to have been overestimated

As Chart 6 illustrates, job creation has been far stronger in recent years than was assumed during the run-up to the pandemic. This surge in job numbers is reflected in growth

Chart 3

Economic situation in 2023 and comparison with the Bank's pre-COVID forecast[1]

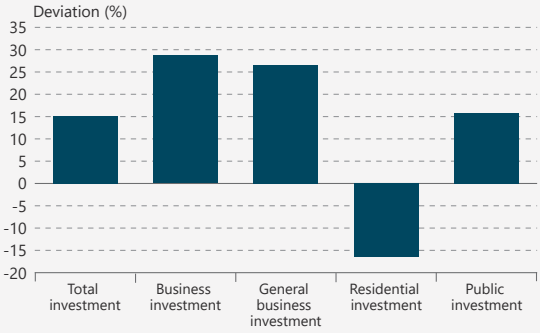


1. Comparison of *Monetary Bulletin* 2020/1 forecast for 2023 and the most recent estimate for that year. Adjusted for Statistics Iceland's revision of data for the pre-pandemic period. Per capita GDP is expressed in terms of GDP per employed individual (aged 16-74).

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4

Investment in 2023 compared with the Bank's pre-COVID forecast[1]

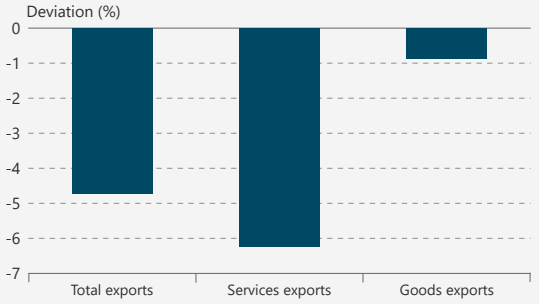


1. Comparison of *Monetary Bulletin* 2020/1 forecast of year-2023 investment and the most recent estimate for that year. Adjusted for Statistics Iceland's revision of data for the pre-pandemic period. General business investment is business investment excluding energy-intensive industry and ships and aircraft.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5

Exports in 2023 compared with the Bank's pre-COVID forecast[1]



1. Comparison of *Monetary Bulletin* 2020/1 forecast of year-2023 exports and the most recent estimate for that year. Adjusted for Statistics Iceland's revision of data for the pre-pandemic period.

Sources: Statistics Iceland, Central Bank of Iceland.

in the working-age population, which in 2023 was nearly 4% larger than the Bank forecast just before the pandemic struck. The employment rate had therefore risen above the pre-pandemic forecast by 2023. Even though the year-2023 labour participation rate also exceeded that forecast, unemployment was 0.5 percentage points below the pre-COVID projection. As a result, labour market scarring, which was discussed widely in Iceland and abroad, appears to have been overestimated somewhat, although other shocks, positive and negative, have hit the economy since then, complicating the picture.

Although GDP had already exceeded its pre-pandemic trend, GDP per employed person was still slightly below the level forecast in February 2020 (Chart 3). This reflects the surge in population during the period. It can also be seen in labour productivity, which by 2023 was broadly back to the pre-COVID projection (Chart 6). The shortfall in the 2023 GDP prediction therefore mainly reflects an underprediction of population growth over the period.

Chart 6

Labour market in 2023 compared with the Bank's pre-COVID forecast[1]

1. Comparison of *Monetary Bulletin* 2020/1 labour market forecast for 2023 and the most recent estimate for that year. Adjusted for Statistics Iceland's revision of data for the pre-pandemic period.

Sources: Statistics Iceland, Central Bank of Iceland.

Iceland has recovered more strongly overall than other countries

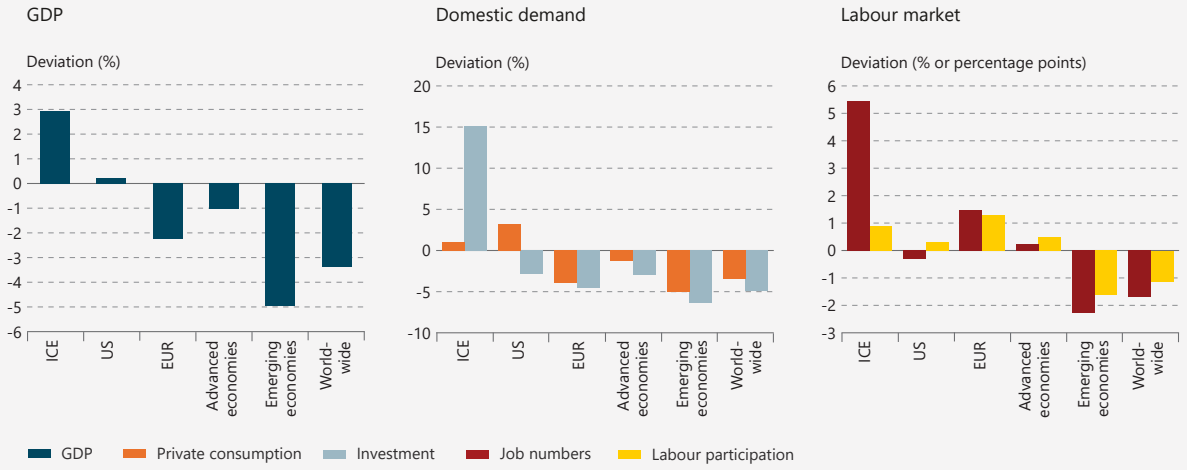
On the whole, Iceland has recouped the output losses following the pandemic in 2020 and the global economic challenges of recent years. As Chart 7 indicates, the domestic economy has withstood these shocks more successfully than other economies (see International Monetary Fund, 2023). In 2023, global GDP was still a full 3% below its pre-pandemic trend. Among other advanced economies, the recovery has been strongest in the US, where, by 2023, GDP had realigned with the trend path projected before COVID struck. On the other hand, output in the eurozone was still just over 2% below the level forecast before the pandemic, as the war in Ukraine caused terms of trade to deteriorate far more in mainland Europe than in other regions. The shocks of recent years have had an even stronger impact on emerging market economies, where year-2023 GDP was still around 5% lower than was forecast just prior to the pandemic.

As in the US, private consumption in Iceland had already overtaken the pre-pandemic forecast by 2023.[4] This is probably due in large part to fiscal support measures that protected jobs and incomes. Another factor, though, is that Iceland's economic contraction was driven far more by a negative export shock than was the case in other OECD countries, while domestic demand in Iceland was more

4. As in other countries, the surge in demand for various types of services and recreation was an important factor (see Chapter III in *Monetary Bulletin* 2024/2).

Chart 7

Global economic situation in 2023 and comparison with pre-COVID forecasts[1]



1. Comparison of forecasts for 2023 (MB 2020/1 for Iceland and WEO January 2020 for other countries) and the most recent estimates for that year. Icelandic data are adjusted for Statistics Iceland's revision of data for the pre-pandemic period. ICE is Iceland, US is the United States, and EUR is the eurozone.

Sources: International Monetary Fund, (*World Economic Outlook*, Chapter 1, October 2023), Statistics Iceland, Central Bank of Iceland.

resilient (see Box 2 in *Monetary Bulletin* 2021/2). The recovery in the eurozone is weaker, but this is probably because Russia's invasion of Ukraine affected disposable income more strongly in mainland Europe than in Iceland and the US. As before, emerging countries have more ground to cover than advanced economies do before private consumption realigns with its previous trend path, as vaccination against COVID-19 was not as widespread in emerging countries, delaying the resumption of economic activity. Furthermore, advanced economies were able to provide far more extensive fiscal support, and remote work was more feasible there than in poorer countries.

Unlike other countries, Iceland has seen investment grow well in excess of pre-pandemic forecasts. In advanced economies, the investment level was still 3% below pre-COVID forecasts, and globally it was still 5% below the trend path assumed at the beginning of 2020. One factor that could be important is that corporate debt grew markedly in many other economies, which probably impeded global investment spending, whereas in Iceland, companies' debt levels did not rise to the same degree. Elevated uncertainty and higher interest rates probably made a difference as well, although the impact of these is not as visible in Iceland.

As can be seen in Chart 7, job growth has been much stronger in Iceland than in other countries. In the US, year-2023 job numbers were still marginally below its pre-pandemic trend, while in the eurozone they were more than 1% higher. To some extent, this reflects more widespread use of labour market-related measures in which, as

in Iceland, companies were helped to retain workers, while such programmes were less extensive in the US. In general, the labour participation rate has returned to its previous trend path in advanced economies, while job numbers and participation rates are still lagging in emerging economies, as safety nets in the latter countries are generally weaker and the economic crisis was deeper.

Summary

Almost five years after suffering the most severe shock since the end of World War II, the global economy is still grappling with the repercussions. In part, this reflects the prolonged impact of the COVID-19 pandemic, but added to that are the effects of Russia's invasion of Ukraine, the war in the Middle East, increased fragmentation in international politics and trade, and the effects of tighter monetary policy as central banks all over the world have attempted to bring inflation under control. Developments in Iceland have stood somewhat apart, however, and by 2023, domestic output had already exceeded the level forecast before the pandemic.

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Box 3

Change in methodology for calculating the housing component of the CPI

Statistics Iceland calculates the consumer price index (CPI), which is intended as a measure of changes in the price of Icelandic households' consumption spending. A portion of this consumption spending reflects the purchase of housing services; i.e., the consumption flow associated with living in a home. For those living in rented property, rent reflects the price of these housing services. For homeowners, however, the price of corresponding housing services must be estimated. There are various methods of calculating owner-occupied housing costs, also referred to as imputed rent. Until recently, Statistics Iceland used the simple user cost method, but in June 2024 it adopted a new rental equivalence method, which entails using data from rental leases to compute the equivalent of rent for owner-occupied properties. This Box discusses these alternative approaches and the effect the change in methodology could potentially have on the CPI and measured inflation.

Different approaches for calculating imputed rent

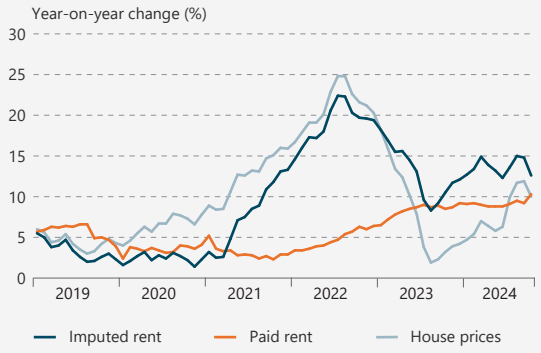
Several approaches have been used to estimate the cost of owner-occupied housing in the CPI, and the method best suited to any given country will depend on the quality of the data and the characteristics of the housing market concerned. In Iceland, the objective is to estimate the value of the service represented by residing in owner-occupied housing, in accordance with the method used to measure the private consumption price level and in line with international national accounts standards (Gudnason, 2004). Spending on housing generally represents a large share of households' total expenses, no matter whether they are renters or homeowners. Given how important it is that the CPI should reflect households' total consumption spending as accurately as possible, it is generally agreed that the cost of housing services should be included with the expenses measured by the index. Paid rent is also part of the index and reflects actual spending on rent. It includes rental leases that are subsidised by municipalities. Chart 1 gives a comparison of these measures of rent and house prices.

For a long period of time, Statistics Iceland used the *simple user cost method* to calculate owner-occupied housing costs. That method was based on extrapolating the official property valuation each month, using a price index of sold property that is based on a three-month moving average of changes in house prices. After adjusting for

Chart 1

Housing costs[1]

January 2019 - October 2024



1. Statistics Iceland began using a new method for imputed rent calculation in June 2024. Nationwide house price data.

Source: Statistics Iceland.

the assumed rate of depreciation of the property and a required rate of return, this generated the homeowner's so-called yearly payment, which was used to estimate imputed rent. As a result, movements in house prices affected the CPI through the imputed rent subcomponent. The official property valuation was deflated with the required rate of return, reflecting assumptions concerning real mortgage interest, which was also included in the calculation of user costs. The disadvantage of this method was that changes in the Central Bank's key interest rate directly affected the housing component of the CPI through indexed mortgage interest, thereby complicating monetary policy conduct.[1]

At the beginning of 2024, Statistics Iceland announced plans to change its method for imputed rent calculation and adopt the *rental equivalence method*, which entails estimating the amount households would have to pay for their property if they were in the rental market. This method had not been used before in Iceland because the rental market was proportionally small and insufficient data were available. However, Statistics Iceland has recently created a database containing over 20,000 currently valid rental agreements in cooperation with the Housing and Construction Authority (HMS), and it uses the data to calculate rental equivalence for the imputed rent subcomponent of the CPI (Statistics Iceland, 2024). According to Statistics Iceland, 20-25% of households in Iceland are in the rental market. Although the market is relatively small in international context, Statistics Iceland argues that the data it provides are reliable enough for use in calculating rental equivalence for the estimation of imputed rent. Nevertheless, it is still uncertain how complete a picture the data give on, for example, rent for detached housing and for housing in regional Iceland.

The third method that has been used to estimate owner-occupied housing costs is called the *net acquisition method*, according to which price changes are measured based on the price of new homes. When this method is used, changes in the weights in the price index can become larger and more closely linked to the business cycle, as the number of new homes built each year depends on the overall macroeconomic situation.

Furthermore, some countries have used the so-called *payment method*, which centres on estimating changes in housing costs; i.e., mortgage payments, operation and maintenance, property taxes, and insurance. A potential

1. Until 2005, a five-year moving average of real interest rates was used, but from 2005 onwards, a shorter reference period of twelve months was applied, which exacerbated the problem, as the Central Bank warned at that time (see, for instance, Chapter IX in *Monetary Bulletin* 2005/2).

advantage of this method is that it derives from households' actual housing expense. The drawback, however, is that it no longer measures the price of private consumption, but instead measures the homeowner's investment expense.

Most countries use the rental equivalence method

The method used to estimate imputed rent differs from one country to another. Most use the rental equivalence method, including Denmark, Germany, Norway, the US, and Japan. Sweden and Canada have used the simple user cost method, as was done in Iceland until this past June. However, it can be argued that the method used in Canada is actually closer to the payment method, which takes depreciation into account and is therefore not a pure payment method. The net acquisition method is used in Australia, New Zealand, the Czech Republic, and Finland, and the European Central Bank (ECB) has proposed that it be used to estimate price changes in owner-occupied housing in the harmonised index of consumer prices (HICP) (Statistics Iceland, 2024).

Statistics Iceland, like other European countries, also calculates the HICP, so as to facilitate comparisons of inflation from one country to another. However, as Eiglsperger *et al.* (2024) point out, it has long been considered a drawback of the HICP that owner-occupied housing costs are not included. In a recent review of the ECB's monetary policy framework, emphasis has been placed on addressing this shortcoming (European Central Bank, 2021). At present, only paid rent is included in the HICP. Given that housing and rental markets differ greatly from one member country to another, and because rental markets vary in size, they are reflected in differing ways in the index. The ECB therefore prepared a guidance proposal for the European Commission and the EU statistical bureau Eurostat, recommending that the HICP contain imputed rent based on the net acquisition method. It appears that implementing these changes will take some time, however.

The advantages and potential disadvantages of using the rental equivalence method

A benefit of the rental equivalence method for calculating imputed rent is that theoretically it directly estimates the variable in question; i.e., the cost of the services provided by housing. Furthermore, Eiglsperger *et al.* (2024) posit that the rental equivalence method produces less volatile inflation measurements than methods based on movements in house prices do. Another advantage over the previous simple user cost method is that the rental equivalence method does not include mortgage interest expense.

On the other hand, the rental equivalence method is dependent on the size and depth of the rental market and the quality of the underlying data on rent (Riksbanken, 2021). According to Statistics Iceland (2024), about 23% of households in Iceland were in the rental market in 2021, which is a relatively small share in terms of acceptable data coverage. Furthermore, the share of detached homes in the rental market is smaller than the share of condominiums, and the rental market is smaller in regional Iceland than in greater Reykjavík. Measured inflation could also prove stickier, as a relatively large share of residential leases are price-indexed. Nevertheless, paid and imputed rent based on the user cost method have moved together reasonably well over longer periods of time, and it can therefore be assumed that various measures of owner-occupied housing costs should continue to correlate well.

Imputed rent has risen less strongly in recent months

Only a short time has passed since the rental equivalence method was adopted in Iceland, so it is too soon to draw sweeping conclusions about the long-term impact of the change on measured inflation. It can be seen, however, that imputed rent has risen less in recent months than it would have under the simple user cost method. The monthly effect of the rise in imputed rent on the CPI has ranged between 0.02 and 0.17 percentage points since the new method was introduced (Chart 2). In terms of seasonally adjusted data from Statistics Iceland on house prices nationwide, prices have risen by just over 4.8% since May 2024. Rent prices have risen by 2.7% over the same period, according to data from HMS. Based on developments in the market price of housing since June 2024 and the average rise in real mortgage interest expense in H1/2024, inflation would have measured almost 6% in October if Statistics Iceland had not switched methods, instead of the actual measurement of 5.1%. It therefore appears that using the rental equivalence method has at least mitigated the impact of steep house price inflation on the CPI in the recent term.

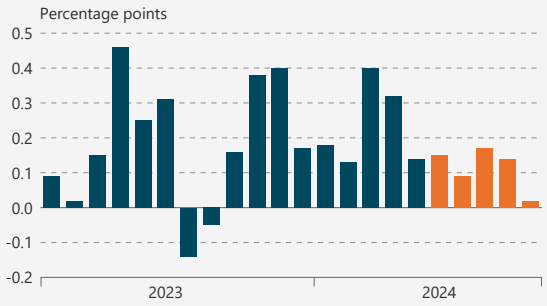
Summary

Statistics Iceland has changed its method for calculating the housing component of the CPI and has adopted the so-called rental equivalence method, which entails using residential leases currently in effect to estimate the rent that homeowners would have to pay if they were renting their home. On the other hand, Iceland's rental market is small in international context, and its efficacy as a basis for measuring rental equivalence is therefore a subject for debate, particularly as regards detached housing and prop-

Chart 2

Monthly impact of imputed rent on the CPI

January 2023 - October 2024



Source: Statistics Iceland.

erty in regional Iceland. There is no single "correct" method of calculating the cost of owner-occupied housing or the service it provides to the homeowner, however, and the selection of a suitable method depends on circumstances in the country concerned.

Since Statistics Iceland changed its method in June 2024, imputed rent has continued to increase, but its impact on the CPI has been less pronounced than it would have been under the previous method. At first glance, the rental equivalence method appears to mitigate volatility in the housing component of the CPI, and abrupt changes in house prices do not affect measured inflation as rapidly. Furthermore, changes in real mortgage interest expense no longer have a direct impact on the CPI, which should facilitate monetary policy conduct, all else being equal. On the other hand, real estate market activity will continue to affect measured inflation through developments in rent prices.

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Box 4

Fiscal budget proposal for 2025

The fiscal budget proposal for 2025 was introduced before Parliament in September. According to the proposal as originally presented, Treasury revenues will total 1,448.5 b.kr. in 2025, while total expenditures will equal 1,489.4 b.kr. The Treasury Part A1 outcome will therefore be negative by just under 41 b.kr., or 0.8% of GDP. The Treasury primary balance is expected to show a surplus of 36.4 b.kr. in 2025, whereas the interest balance will again show a sizeable deficit, which is estimated at 77.4 b.kr.

In comparison with the year-2024 National Budget, the overall deficit according to the fiscal budget proposal for 2025 is smaller by 10.3 b.kr. This year's fiscal deficit looks set to total around 6 b.kr. more than was provided for in the National Budget, owing to a larger deficit on the interest balance. Compared with an updated estimate for 2024, the Treasury outcome will improve by 16.4 b.kr. in 2025, according to the budget proposal (Table 1).[1]

Table 1 Summary of fiscal outcome: 2024 Budget and 2025 budget proposal

National accounts basis	Budget 2024	Estimate 2024	Budget proposal 2025	Change from previous year's budget	Budget 2024	Estimate 2024	Budget proposal 2025	Change from previous year's budget
Primary income	1,315.1	1,332.3	1,409.2	94.1	29.1	29.1	28.8	-0.3
Primary expenditures	1,290.2	1,300.0	1,372.8	82.6	28.5	28.4	28.1	-0.5
Primary balance	24.9	32.3	36.4	11.5	0.6	0.7	0.7	0.2
Interest income	41.4	41.2	39.3	-2.1	0.9	0.9	0.8	-0.1
Interest expense	117.6	130.6	116.6	-0.9	2.6	2.9	2.4	-0.2
Interest balance	-76.2	-89.4	-77.4	-1.2	-1.7	-2.0	-1.6	0.1
Total revenues	1,356.5	1,373.5	1,448.5	92.0	30.0	30.0	29.6	-0.4
Total expenditures	1,407.7	1,430.6	1,489.4	81.7	31.1	31.3	30.5	-0.7
Overall balance	-51.2	-57.2	-41.0	10.3	-1.1	-1.2	-0.8	0.3

Source: Fiscal budget proposal 2025.

The macroeconomic assumptions in the budget proposal are based on Statistics Iceland's June 2024 forecast. Table 2 shows Statistics Iceland's forecast and the estimates in the budget proposal in comparison with the Central Bank forecast from May 2024 (*Monetary Bulletin* 2024/2). There is little difference between the forecasts, although the Bank expects somewhat weaker output growth and higher unemployment in 2025. In comparison with the Bank's new baseline forecast, the budget proposal assumes higher GDP growth and inflation but lower unemployment.

1. Real estate company Þórkatla is a Part A3 Government institution; therefore, the cost of its buy-up of property in Grindavík does not affect the estimated Treasury Part A1 outcome for 2024.

Table 2 Macroeconomic assumptions in the 2025 fiscal budget proposal[1]

	Statistics Iceland forecast (%)	MB 2024/2 (%)
Private consumption	2.4	2.1
Public consumption	0.9	1.8
Investment	3.0	1.4
Exports	4.2	3.8
Imports	2.9	2.4
Gross domestic product	2.6	2.3
Consumer price index	3.9	3.9
Unemployment	4.2	4.9
Trade-weighted exchange rate index	0.0	0.2
Wages	5.4	5.6

1. The table shows year-on-year changes except for unemployment, which is expressed as a share of the labour force.

Sources: Fiscal budget proposal 2025, Statistics Iceland, Central Bank of Iceland.

Price, wage, and exchange rate assumptions underlying the 2025 fiscal budget proposal

- Wage assumptions: The average rise in public sector wage scales in 2025 is assumed to be just over 4%. Because of this, plus the revision of wage assumptions for the prior year, next year's expenditures will increase by 29.8 b.kr.
- Price assumptions: The general rise in operating expenditures is based on Statistics Iceland's inflation forecast. Inflation is expected to measure 3.9% in 2025, and expenditures for the year are projected to increase by 12.2 b.kr. as a result.
- Exchange rate assumptions: The exchange rate is projected to equal the average from June 2024. The exchange rate index is now 1.9% higher than was assumed in the 2024 National Budget. These changes are estimated to cause expenditures to rise by 1 b.kr.
- Unemployment and social security benefits: Benefits are expected to rise by 4.3%, reflecting the price level forecast for 2025, and the difference between the new year-2024 inflation forecast and the forecast underlying the 2024 National Budget will cause benefits to increase as well. The resulting rise in expenditures is estimated at 11.4 b.kr.

Table 3 Changes in wages, benefits, prices, and exchange rate in 2025

Accrual basis	Effect on expenditures, b.kr.
Effect of wage increases	29.8
Unemployment and social security benefits	11.4
General price level assumptions	12.2
Exchange rate assumptions	1.0
Changes in wages, benefits, prices, and exchange, total	54.4

Source: Fiscal budget proposal 2025.

In all, changes in wages, benefits, prices, and exchange rates in the 2025 budget proposal total 54.4 b.kr. (see Table 3).

Expenditure sources in the fiscal budget proposal

The year-on-year increase in budgetary framework appropriations over and above inflation totals 26.8 b.kr., according to the proposal. This reflects greater scope for spending due to new and expanded projects and growth in committed expenditures, on the one hand, versus fiscal consolidation and the expiry of temporary expenditures, on the other. Increased costs due to committed expenditures result from economic and structural factors. New and expanded projects include pension system changes, costs due to measures introduced in connection with wage agreements, expenditures relating to transportation affairs, an increase in the tax-free threshold for retirement income, and increased support for Ukraine. Among the temporary measures set to expire are investment projects that have been completed and allocations due to the seismic activity in Grindavík. Finally, an estimated 28.7 b.kr. will be saved via general and targeted consolidation measures.

Table 4 Changes in framework expenditures, by reason

Expenditure sources	Changes from previous budgetary appropriations (b.kr.)
Increased scope for expenditure in budget proposal	61.2
Committed expenditures	6.5
Expiry of temporary measures	-12.2
Consolidation measures	-28.7
Wage and price updates	51.2
Total	78

Source: Fiscal budget proposal 2025.

Changes on the revenues side

Changes in the tax system are estimated to deliver an additional 20.8 b.kr. in revenues in 2025. The main difference is due to taxation of fuels and motor vehicle use, as

Table 5 Impact of tax changes on Treasury revenues in 2025 (b.kr.)

Accrual basis	Revenues, b.kr.
Changes to the tax system	
Income tax on legal entities increases from 20% to 21%	6.7
Revised taxation of motor vehicles and fuels	8.0
Changes in tourism fees	1.9
Fishing fees	2.0
Aquaculture fees	0.3
Changed rules on estimated self-employment income	0.5
Increase in unit levies by 2.5%	1.4
Total	20.8

Source: Fiscal budget proposal 2025.

well as the temporary increase in corporate income tax for the 2024 operational year. In addition, various smaller changes will deliver about a fourth of next year's increase in revenues (Table 4).

Revision of year-2024 estimated outcome

There is a small change in updated estimated outcome for 2024 in comparison with the National Budget for the year. The estimate indicates a 57.2 b.kr. deficit on Treasury operations in 2024, about 6 b.kr. more than was provided for in the Budget. The primary surplus is larger in the estimate than in the Budget, however, or 32.2 b.kr. instead of 24.9 b.kr. Offsetting this, the deficit on the interest balance is now expected to be larger than was provided for in the Budget, or 89.4 b.kr. instead of 76.2 b.kr.

2025 Treasury outcome set to improve marginally between years but will be slightly poorer than in the fiscal strategy plan

As is noted above, the Treasury outcome will be negative by 41 b.kr., or 0.8% of GDP, in 2025. The deficit will therefore narrow year-on-year relative to GDP. The primary balance is projected to be positive by 0.7% of GDP in 2025, as in 2024, and the deficit on the interest balance will shrink from 1.2% to 0.8% of GDP (Chart 1).

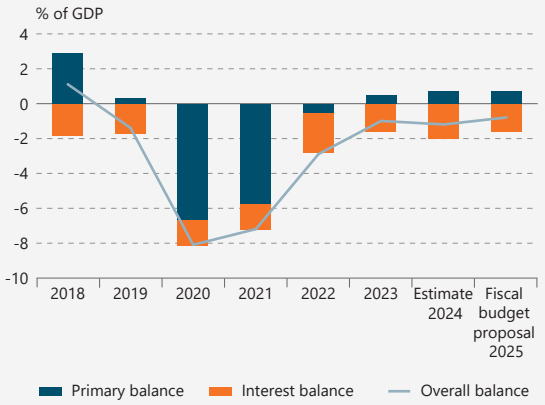
The outcome according to the fiscal budget proposal is somewhat poorer than was estimated in this summer's fiscal strategy plan, which assumed that the 2025 deficit would be just under 25 b.kr., or 0.5% of GDP. According to the budget proposal, the primary surplus will be smaller than in the fiscal strategy plan by about 4 b.kr., or 0.1% of GDP, whereas the deficit on the interest account is projected to be 0.2 percentage points larger. Chapter III contains a more detailed discussion of the cyclically adjusted Treasury outcome, which estimates the fiscal stance at any given time.

Treasury debt-to-GDP ratio to fall in 2025

Treasury debt according to the debt rule in the Act on Public Finances increased from 21.8% of GDP in 2019 to a peak of 33.2% in 2021.[2] It then declined to 31.5% in 2023 but is expected to increase again in 2024, to 32.1% of GDP. It is projected to fall once more in 2025, by 31.4%, or 0.4 percentage points more than was provided for in the last fiscal strategy plan (Chart 2).

Chart 1

Treasury outcome 2018-2025[1]

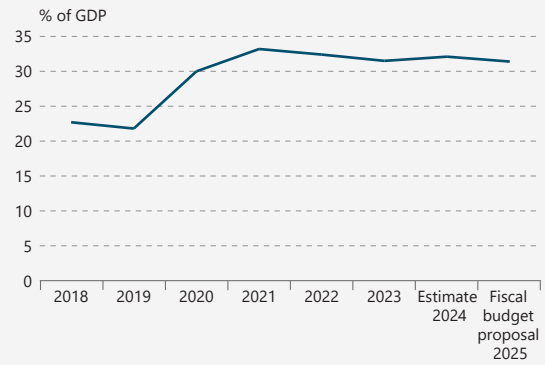


1. Part A1 Treasury balance.

Sources: Fiscal budget proposal for 2025, Fiscal strategy plan 2025-2029.

Chart 2

Treasury debt 2018-2025[1]



1. Part A1 Treasury debt according to the debt rule; i.e., total debt net of pension obligations, accounts payable, cash balances, and bank deposits.

Sources: Fiscal budget proposal 2025, Ministry of Finance and Economic Affairs.

2. This assumes that total public sector debt net of pension obligations and accounts payable, and net of cash balances and bank deposits, will be less than 30% of GDP.

Year-2025 deficit estimated to be larger after second round of Parliamentary discussions

The discussion above is based on the 2025 fiscal budget proposal as originally introduced before Parliament. Budget proposals are typically modified during Parliamentary handling, and macroeconomic assumptions are updated before the second round of discussions. This may call for revised estimates of revenues, and therefore of the projected outcome. The updated revenue estimate, which takes account of new tax changes, reduced revenues by 23.8 b.kr. relative to the original budget proposal. In part, this change is due to the deferral of the proposed cancellation of oil and fuel taxes and simultaneous implementation of the per-kilometer charge on all vehicles. On the other hand, expenditures were revised downwards by 6.2 b.kr., as a decrease of 9.7 b.kr in primary expenditure is partly offset by an increase of 3.5 b.kr. in expected interest payments. As a consequence, the outlook is for the fiscal deficit to total 58.6 b.kr., or 1.2% of GDP, which is 17.6 b.kr. larger than in the original budget proposal.

Box 5

The Central Bank´s macroeconomic forecast 2023

As in previous years, the November issue of *Monetary Bulletin* includes a summary of the Bank's macroeconomic forecasts and forecasting record over the previous calendar year. This helps the Bank to shed light on the main causes of forecasting errors, so that it can learn from them and use them to improve its models and forecast preparation.

Although uncertainty eased significantly, forecasting challenges remained

In 2022, the effects of the COVID-19 pandemic and the Government's mitigating measures were still in evidence, but a strong recovery started as soon as the pandemic was over and gained steam over the course of 2023. Inflation rose concurrent with the recovery, reaching its highest level since aftermath of the financial crisis, owing to strong demand pressures in the economy. Interest rates were therefore increased several times as 2023 advanced.

Predicting the surge in GDP growth that took place during the year proved difficult, and the positive output gap was underestimated as a result. The turnaround in tourism was more rapid than expected, and the labour market was tight during the period. Volcanic activity resumed on the Reykjanes peninsula towards the end of the year, threatening the near-lying community and dampening tourists' interest in visiting Iceland. This was compounded by Statistics Iceland's large revisions of previously published figures.

GDP growth forecasts were overly pessimistic

When the May 2022 issue of *Monetary Bulletin* was published, the COVID-19 pandemic was receding and global travel gradually recovering. But war had broken out in Ukraine in late February 2022, and the potential impact on the global economy was highly uncertain. It was expected that the war could slow down global demand growth, cause shortages of manufacturing inputs, and push commodity prices higher, with adverse effects on many advanced economies. As a result, the GDP growth outlook, both in Iceland and worldwide, was considered poorer than before. The year-2023 GDP forecast for Iceland was therefore revised downwards relative to the previous forecast, but because the year-2022 estimate was revised downwards even more, GDP growth was expected to be slightly stronger in 2023.

Over the course of 2022, inflation rose and the labour market grew tighter during the run-up to wage negotia-

tions. However, worsening financial conditions were offset by the strong position of most households, coupled with robust growth in disposable income. Domestic demand appeared stronger in 2022 than previously projected, and a positive output gap had begun to emerge. Therefore, in H2/2022, GDP growth for 2023 was still projected at just under 2-3% and was expected to be driven mainly by private consumption growth (Chart 1).

From then until the May 2023 *Monetary Bulletin*, signs of growing demand pressures in the economy grew stronger, bolstered by a more positive outlook for both domestic demand and external trade. Once Statistics Iceland's GDP estimate for Q1/2023 became available, however, it was clear that the May forecast had been overly optimistic about growth in private consumption and investment. Furthermore, there were signs that the slowdown in domestic demand growth in Q2 would be more rapid than previously forecast, although it was somewhat offset by a swifter recovery in the tourism sector. The Bank's GDP forecasts from H2/2023 and February 2024 (the last forecast published before the release of Statistics Iceland's first estimates) all assumed a GDP growth rate of 3½% for the year, but the projected composition of GDP growth changed: there were growing signs of a strong recovery of external trade, but on the other hand, domestic demand was clearly softening more rapidly than had been envisioned early in the year.

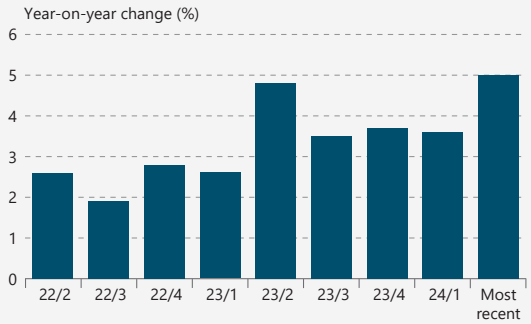
According to Statistics Iceland's first estimate, year-2023 GDP growth was 4.1%, which is in line with the Bank's baseline forecasts from H2/2023 and February 2024. Since then, however, Statistics Iceland has revised GDP growth upwards to 5%, which is somewhat above the Bank's forecasts except for its May 2023 forecast of 4.8% GDP growth for the year. The deviation from the Bank's forecasts primarily reflects an underestimation of the contribution from net trade, while the contribution from domestic demand was far closer to projections made later in the year.

Tourism recovered more rapidly than was initially forecast

By the time of the May 2022 *Monetary Bulletin*, the pandemic-era restrictions had been eased considerably, but there was uncertainty about the effects of the Ukraine war on travel. The global inflation and GDP growth outlook had begun to darken, and it was feared that higher oil prices would cause airfares to rise. As autumn 2022 progressed, optimism about the recovery of tourism took hold again, as both the pandemic and the related disease-prevention measures had developed more favourably than previously

Chart 1

GDP growth forecasts for 2023[1]



1. Forecasts of year-2023 GDP growth as published in MB 2022/2-2022/4 and 2023/1-2023/4, together with the most recent estimate from Statistics Iceland. The chart also shows the forecast from MB 2024/1, the Bank's last forecast before Statistics Iceland published its first estimate of year-2023 GDP growth.

Sources: Statistics Iceland, Central Bank of Iceland.

forecast. In addition, a volcanic eruption began in Meradalir on the Reykjanes peninsula in late summer, apparently piquing travellers' interest in coming to Iceland. Soon it was clear that tourist numbers would move close to pre-pandemic levels in 2023. In the May 2023 *Monetary Bulletin*, it was forecast that nearly 2.2 million tourists would visit Iceland. That forecast was well in line with the actual outcome (Chart 2).

In autumn 2023, uncertainty mounted again because of volcanic activity in the Reykjanes area. The final two months of the year were dominated by news reports about the evacuation of the town of Grindavik and the possibility that the eruption could threaten important infrastructure, which cut into demand for travel to Iceland. Even so, the Bank's last forecast of year-2023 tourist numbers, published in the November *Monetary Bulletin*, was well in line with the Icelandic Tourist Board's most recent tallies.

Deviations in the Bank's export forecasts are affected by revisions and changes in Statistics Iceland's methodology

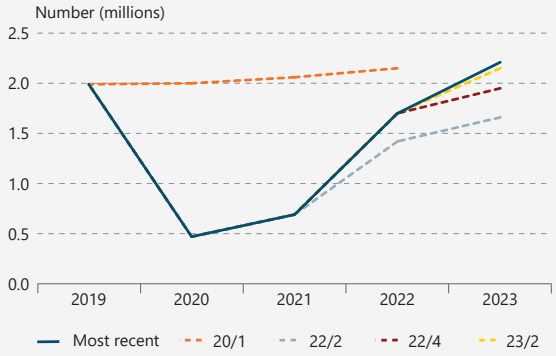
The Bank's export growth forecasts were well in line with Statistics Iceland's most recent estimate, but they deviated from that path for a while (Chart 3). Before the November 2022 *Monetary Bulletin*, Statistics Iceland revised its H1/2022 services exports data upwards, concurrent with a significant improvement in the outlook for H2. Prospects for year-2023 exports were unchanged, but because of base effects, year-on-year growth was forecast at 3% instead of the previous 5.3%.

When the national accounts were released in late February 2023, Statistics Iceland stopped including trade in intellectual property with its external trade figures, and with that change, year-2022 export volumes were revised downwards. Base effects caused an upward revision in the Bank's May forecast of year-2023 export growth. In addition, a projected contraction in the year's export revenues from intellectual property was omitted. Goods export price indices were revised at the same time, strongly affecting the interpretation of historical data.

In autumn 2023, it was clear that sales of capelin roe were below expectations. As a result, the Bank assumed in its August forecast that goods exports would remain flat between years instead of increasing. The outlook for goods exports deteriorated again in the November forecast because of problems in silicon product manufacturing due to maintenance of Elkem's largest arc furnace, and because farmed fish escaped from cages in Patreksfjörður fjord. This was offset by an improved outlook for services exports.

Chart 2

Forecasts of tourist arrivals in Iceland[1]

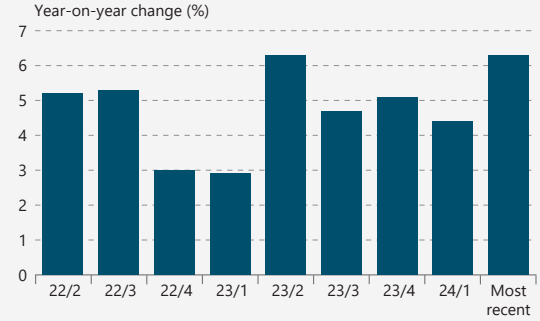


1. The forecast from *Monetary Bulletin* 2020/1, the Bank's last forecast before the COVID-19 pandemic, did not include projections of passenger numbers in 2021 and 2022. Instead, a specified growth rate in the travel component of services exports was assumed: 3.2% in 2021 and 4% in 2022. That forecast is used here to estimate tourist numbers. Broken lines indicate forecasts, while the solid line indicates actual figures.

Sources: Icelandic Tourist Board, Central Bank of Iceland.

Chart 3

Forecasts of exports in 2023[1]



1. Forecasts of year-2023 growth in goods and services exports as published in MB 2022/2-2022/4 and 2023/1-2023/4, together with the most recent estimate from Statistics Iceland. The chart also shows the forecast from MB 2024/1, the Bank's last forecast before Statistics Iceland published its first estimate of year-2023 export growth.

Sources: Statistics Iceland, Central Bank of Iceland.

According to *Monetary Bulletin* 2024/1, which contained the Bank's last export growth forecast for 2023, exports were projected to grow by 4.4% year-on-year. This was well in line with Statistics Iceland's preliminary estimate of 4.8% growth for the year, published in February 2023. Since then, Statistics Iceland has revised the growth rate upwards to 6.3%. The main reason for the increase is that services exports by small and medium-sized companies had been substantially underestimated in previous figures, as these companies were not included in the services trade survey conducted by Statistics Iceland before the publication of the national accounts in February.

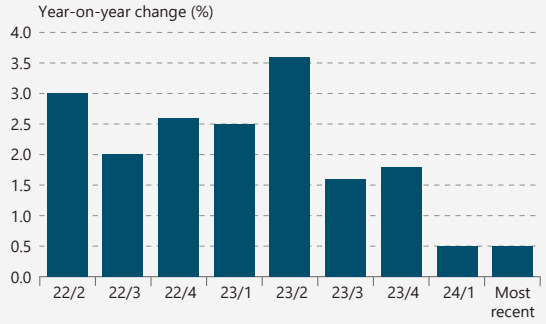
Private consumption forecasts proved overly optimistic, and the household saving rate rose once again

At the beginning of 2022, there were a number of signs of stronger household demand in the wake of the pandemic. New motor vehicle registrations surged, household sentiment was extremely high, and there was robust growth in payment card turnover. In *Monetary Bulletin* 2022/2, the Bank forecast that in spite of this, private consumption would grow by only 3% per year in 2022 and 2023, as it was thought that the newly begun war in Ukraine could dampen appetite for consumption. As 2022 advanced, it came to light that private consumption was growing far more rapidly, supported by households' strong position, robust disposable income growth, and sizeable accumulated savings. This strong position in 2022 also affected the revision of forecasts for 2023, and by May of that year, the 2023 private consumption forecast had been increased to 3.6% (Chart 4).

At the end of May 2023, however, when Statistics Iceland published its first private consumption growth estimate for Q1/2023, it became clear that consumption during the quarter had been significantly overestimated in the Bank's forecast. When indicators for Q2 began to appear, it became even clearer that higher inflation, a tighter monetary stance, and greater pessimism had begun to make their mark. In the Bank's August 2023 forecast, its estimate of private consumption growth was therefore much lower than before, or 1.6%. Even so, the Bank's forecast still turned out overly optimistic. Statistics Iceland's preliminary figures published in November showed that private consumption had contracted year-on-year in Q3 instead of growing marginally, as in the forecast. In view of this, the forecast in *Monetary Bulletin* 2024/1 assumed that private consumption would contract between years in Q4 as well, and that growth for the entire year would measure a far weaker 0.5%, which is in line with Statistics Iceland's current estimate for the 2023 growth rate.

Chart 4

Forecasts of private consumption for 2023[1]



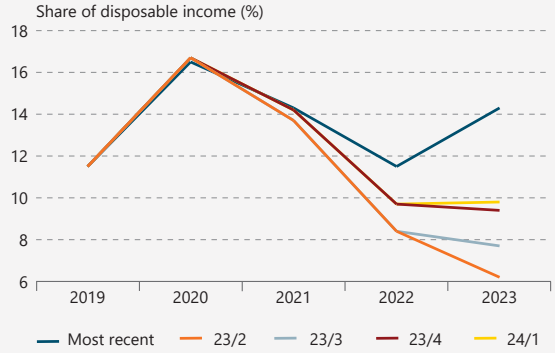
1. Forecasts of year-2023 growth in private consumption as published in MB 2022/2-2022/4 and 2023/1-2023/4, together with the most recent estimate from Statistics Iceland. The chart also shows the forecast from MB 2024/1, the Bank's last forecast before Statistics Iceland published its first estimate of year-2023 private consumption growth.

Sources: Statistics Iceland, Central Bank of Iceland.

As has been discussed in earlier issues of *Monetary Bulletin*, there has been considerable uncertainty about how households would allocate the excess savings they had built up in the wake of the pandemic (see, for instance, Box 2 in *Monetary Bulletin* 2024/2). It was thought that the saving rate would fall from its 2020 peak and either realign with its pre-pandemic average or even fall below it again. What actually happened, though, was that the saving rate started once again to rise steeply in 2023, reflecting that year's slow growth in private consumption despite the surge in real disposable income (Chart 5).

Chart 5

Forecasts of the household saving rate 2019-2023[1]



1. Forecasts of the ratio of savings to disposable income as published in MB 2023/2-2023/4 and 2024/1, together with the most recent estimate from Statistics Iceland.

Sources: Statistics Iceland, Central Bank of Iceland.

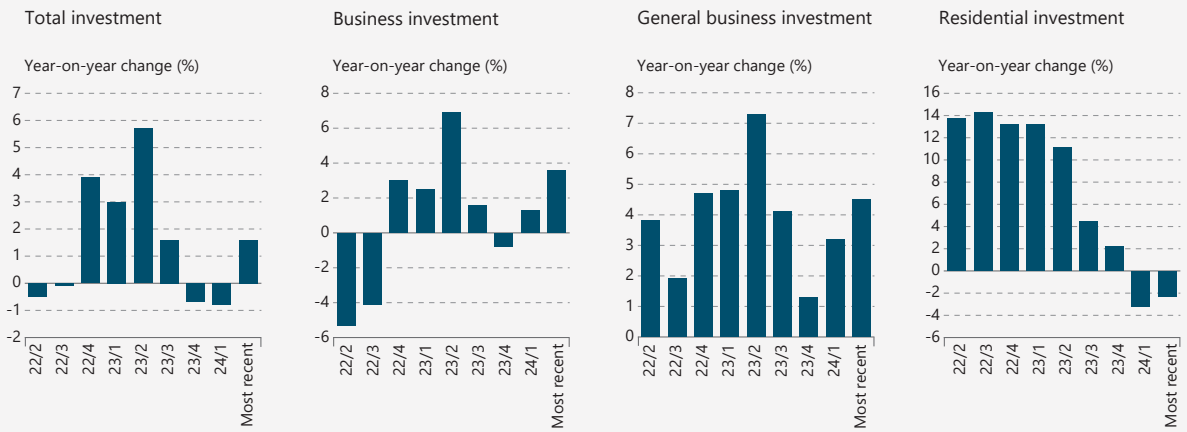
Business investment was significantly underestimated …

Forecasts of developments in business investment in 2023 ranged from a 5.3% contraction (in *Monetary Bulletin* 2022/2) to 6.9% growth (in *Monetary Bulletin* 2023/2) (Chart 6). The Bank's forecasts flipped from contraction to growth in November 2022. Although the Bank's investment survey suggested a contraction of more than 20% in planned investment and a contraction across all sectors in 2023, strong activity in the construction industry indicated that gross capital formation was growing apace. Added to this were plans for increased investment in the energy-intensive sector in 2023.

In *Monetary Bulletin* 2023/2, the projection of year-on-year growth in business investment was revised steeply upwards relative to the previous forecast. For the most part, the change was due to the revision of Statistics Iceland's historical data, as the treatment of aircraft leases in the national accounts had been changed, causing measured investment in ships and aircraft to be weaker in 2022. In

Chart 6

Forecasts of investment for 2023[1]



1. Forecasts of year-2023 growth in investment as published in MB 2022/2-2022/4 and 2023/1-2023/4, together with the most recent estimate from Statistics Iceland. The chart also shows the forecast from MB 2024/1, the Bank's last forecast before Statistics Iceland published its first estimate of year-2023 investment growth.

Sources: Statistics Iceland, Central Bank of Iceland.

the forecasts immediately following, the outlook for 2023 deteriorated again, owing to reports of delayed investment in energy-intensive sectors and indications of a slowdown in general business investment growth. Growth in construction industry turnover slowed markedly as the year progressed, and imports of general investment inputs contracted abruptly. In *Monetary Bulletin* 2024/1, the Bank projected that total business investment had grown modestly in 2023, or by 1.3%, which was close to Statistics Iceland's preliminary estimate from February 2024. Since then, Statistics Iceland has revised its estimate to 3.6%.

... as Statistics Iceland's preliminary figures implied far weaker investment activity

The Bank's forecasts of business investment in 2023 turned out well below both Statistics Iceland's preliminary estimate from February 2024 and its revised figures from August. In Statistics Iceland's most recent estimate, the value of business investment is nearly a fifth above the average of the Bank's last eight forecasts, which were prepared before the release of Statistics Iceland's first estimate. Although there are various reasons for the poor results of business investment forecasts, the main explanation lies in Statistics Iceland's large-scale revisions. As can be seen in Chart 7, Statistics Iceland's most recent estimate of business investment was over 15% higher, on average than its first preliminary figures for 2022, and almost 17% higher for 2023 (see also Box 1).

The biggest revision was in general business investment (excluding energy-intensive industry, ships, and aircraft). Statistics Iceland's preliminary figures are based on general indicators of investment activity, such as construction sector turnover and investment goods imports. These earlier figures are revised once corporate tax return data are available and published in the February national accounts, just over twelve months after the end of the accounting year concerned. When data from year-2022 corporate tax returns were available in February 2024, they showed that investment activity had been much stronger. This revision significantly affected extrapolated preliminary figures for 2023 (Chart 8).

Residential investment was overforecast

Early on, the Bank projected that residential investment would be stronger in 2023 than it proved to be, and that it would grow substantially between years, or by 13-14% (Chart 6). In 2022, measured residential investment turned out increasingly weaker than could be discerned from data and surveys. Statistics Iceland's figures therefore proved to

Chart 7

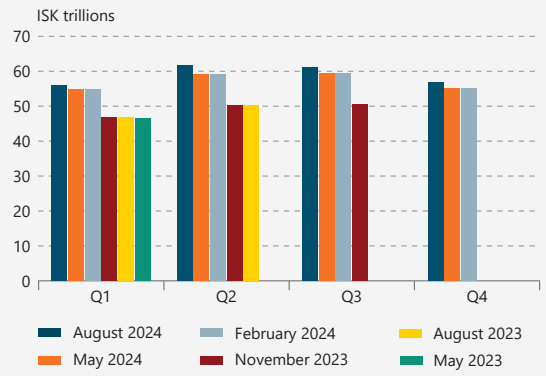
Revisions of business investment[1]

1. The percentage difference between Statistics Iceland's first estimate for each quarter and the most recent estimate. Statistics Iceland's most recent estimate is from the August 2024 national accounts. Statistics Iceland's first estimate of quarterly business investment is published two months after the end of the reference period.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 8

Business investment 2023[1]



1. The chart shows various Statistics Iceland estimates of year-2023 business investment, at 2005 prices, from the first publication of Q1/2023 data in May 2023 until the most recent publication in August 2024.

Source: Statistics Iceland.

be out of line with the Housing and Construction Authority's (HMS) tallies of homes under construction, as well as with other short-term indicators such as construction sector turnover and imports and sales of building materials. For a while, it was thought that residential investment was in fact stronger than Statistics Iceland's preliminary figures indicated, and that the shortfall would disappear as figures were updated. Nevertheless, the forecast of residential investment was revised downwards with each publication during the year.

When *Monetary Bulletin* was issued in May 2023, the residential investment growth forecast was adjusted downwards to 11%, but the contraction in 2022 turned out larger than expected. In spite of this, the HMS property register showed a record number of homes under construction nationwide by the end of the year. Furthermore, Gallup's survey indicated that most construction companies were operating at full capacity and wanted to hire workers. According to Statistics Iceland's preliminary figures on residential investment in Q1/2023, which were available by the time of the August *Monetary Bulletin*, investment was far weaker than had been forecast. On top of this, the HMS estimated that the number of homes finished during the year would be considerably lower. As a result, residential investment for the year as a whole was forecast to be even weaker, or 4.5%. But this forecast, too, would prove overly optimistic.

At the time of the November 2023 *Monetary Bulletin,* residential investment had contracted eight quarters in a row. Short-term indicators continued to point towards growth, however, and in mid-November, the number of properties under construction nationwide was the highest in the history of the property register. For this reason, residential investment was expected to rebound in H2. By the time of *Monetary Bulletin* 2024/1, however, it was clear that residential investment had continued to contract in Q3, and the forecast provided for a 3.2% contraction for the year as a whole. In Statistics Iceland's most recent estimate, residential investment in Q4 was the same as the Bank had forecast in February, but the revision of historical figures showed stronger investment in 2022 and 2023, and the contraction for the year therefore turned out smaller, at 2.3%.

Forecasts for public consumption growth were relatively accurate, but public investment was underpredicted

The weight of public consumption and investment in GDP grew markedly in the wake of the pandemic. This reversed in part in 2022, when the Government's mitigating measures expired. As a result, it was assumed that growth in

public sector demand would be weaker in 2023 than in the years beforehand.

The Bank's forecasts of the contribution of public consumption to GDP growth changed very little over time and were well in line with Statistics Iceland's most recent estimate (Chart 9). Forecasts of the contribution from public investment were less accurate, however. A contraction was expected from the outset, but in the end it turned out smaller than projected. On the whole, the Bank's forecasts of the public sector contribution to GDP growth in 2023 were close to Statistics Iceland's most recent estimate, or 1.3%, which was slightly above the forecast in *Monetary Bulletin* 2024/1.

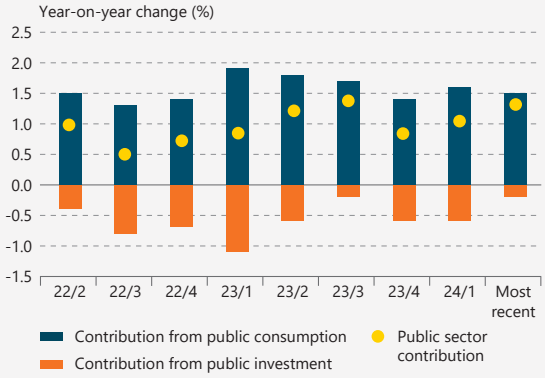
Inflation rose far more than was initially forecast …

In the February 2022 *Monetary Bulletin*, inflation was forecast to peak in Q1/2022 and average 3.4% in 2023. In May 2022, the 2023 forecast was revised upwards to 5% (Chart 10), as the inflation outlook changed radically after Russia invaded Ukraine (see Box 6 in *Monetary Bulletin* 2023/4). Furthermore, the strength of the post-pandemic recovery was substantially underestimated, as is discussed above. This elevated level of economic activity resulted, among other things, in rising house prices and wages and the associated increase in domestic inflationary pressures.

Inflation surged in Q2/2022, and as a result, the forecast in *Monetary Bulletin* 2022/3 assumed that it would be even higher and more persistent. Housing market activity eased temporarily in autumn 2022, however, causing inflation to subside. Inflation dipped briefly in Q3, affecting the forecast in *Monetary Bulletin* 2022/4, which assumed that inflation would be lower in 2023.

Chart 9

Forecasts of public sector demand for 2023[1]

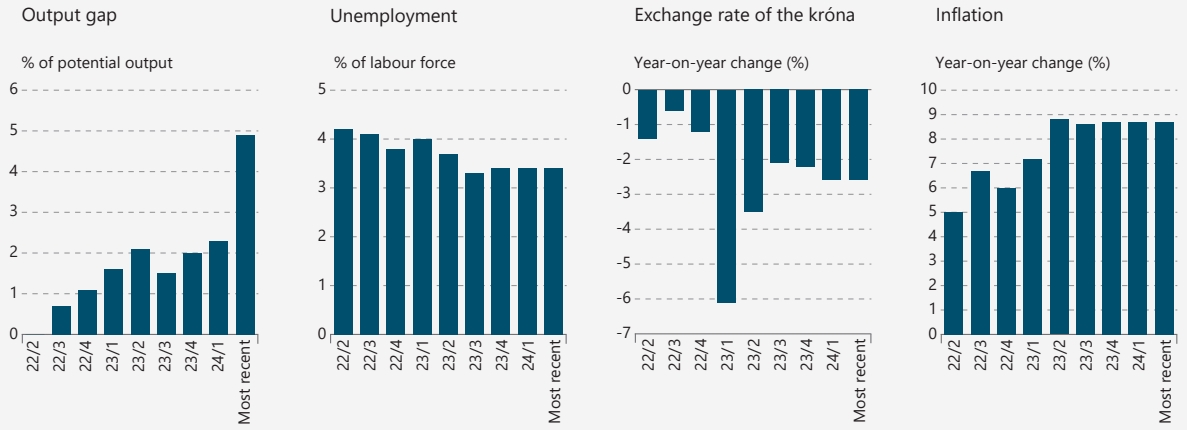


1. Forecasts of year-2023 growth in public sector demand as published in MB 2022/2-2022/4 and 2023/1-2023/4, together with the most recent estimate from Statistics Iceland. The chart also shows the forecast from MB 2024/1, the Bank's last forecast before Statistics Iceland published its first estimate of year-2023 public sector demand.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 10

Forecasts of drivers of year-2023 inflation[1]



1. Forecasts of developments in selected macroeconomic variables in 2023, as published in MB 2022/2-2024/1, together with the final outcome for the year. The chart shows unemployment according to the Statistics Iceland labour force survey.

Sources: Statistics Iceland, Central Bank of Iceland.

… and strong capacity pressures in the economy kept inflation persistently high in 2023

Inflation started to rise again towards the end of 2022. By the time of *Monetary Bulletin* 2023/2, it was plain that the positive output gap was far wider than previously estimated, and the forecast of average inflation for the year was adjusted upwards to 8.8%. The new wage agreements were costlier and more front-loaded than previously expected, and there was a shortage of labour, which exacerbated the risk of wage drift. Strong economic activity, rapid population growth (Chart 11), and a robust rise in disposable income caused the inflation outlook to deteriorate at a time when inflation in trading partner countries was falling due to lower energy prices. This buoyant domestic demand made it easier for firms to pass cost increases through to prices, and long-term inflation expectations had become more weakly anchored to the target. Furthermore, unemployment turned out lower than previously forecast, compounding wage pressures.

Ultimately, the positive output gap was far larger in 2023 than was originally estimated (Chart 10). As has already been noted, GDP growth for the year was also stronger than previously assumed. Moreover, in February 2024, Statistics Iceland made a large revision of year-2022 GDP, from the previous 7.2% to the current estimate of 9% (see Box 2 in *Monetary Bulletin* 2024/2). Underlying inflationary pressures therefore turned out stronger than previously thought. In the end, average inflation for the year was 8.7%, in line with the May 2023 forecast.

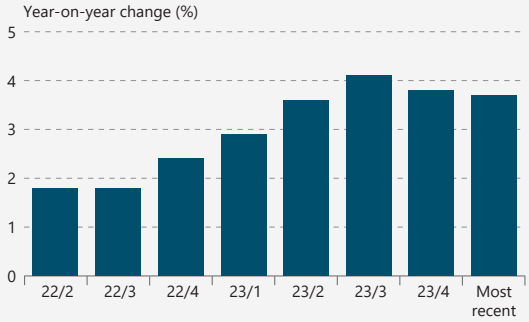
Summary

Although the enormous uncertainty prevailing during the pandemic had receded, the errors in the Bank's forecasts for 2023 proved unusually large, partly because significant errors in Statistics Iceland's preliminary figures led to bigger revisions of historical figures than in previous years, which complicated the forecasting process (Chart 12).

Economic activity was therefore underestimated, and demand pressures in the economy were stronger than previous estimates had indicated. High and persistent inflation ultimately caused inflation expectations to become more weakly anchored to the target. Underlying inflationary pressures therefore proved stronger than projected, with the result that inflation for the year was underforecast early on.

Chart 11

Forecasts of the year-2023 working-age population[1]



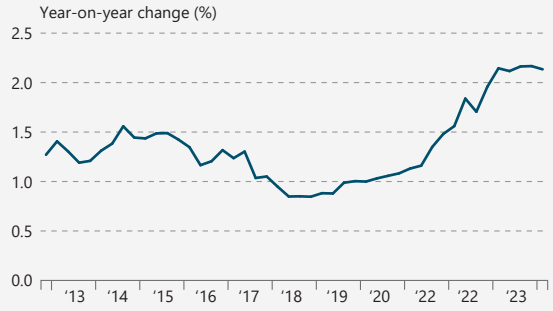
1. Forecasts of growth in the working-age population in 2023, as published in MB 2022/2-2022/4 and 2023/1-2023/4, together with the final outcome for the year.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 12

Revisions of GDP growth figures[1]

Q4/2012 – Q1/2024



1. The difference between Statistics Iceland's first GDP growth estimate for each quarter and the most recent estimate. Statistics Iceland's first estimate is published just under two months after the end of the reference period. The most recent estimate is from August 2024. Three-year moving average of absolute differences.

Sources: Statistics Iceland, Central Bank of Iceland.

Appendix

Forecast tables

Table 1 GDP and its main components[1]

	2023	2024	2025	2025	2027
Private consumption	0.5 (0.5)	1.0 (1.0)	2.9 (1.8)	2.8 (2.4)	2.9
Public consumption	1.8 (2.2)	2.1 (1.5)	1.7 (1.7)	2.0 (2.0)	1.8
Gross capital formation	1.6 (-0.6)	1.6 (1.8)	0.5 (1.9)	1.6 (2.9)	2.6
Business investment	3.6 (0.9)	2.7 (2.0)	-1.9 (0.9)	1.2 (2.8)	2.4
Residential investment	-2.3 (-0.3)	4.2 (5.8)	8.1 (6.6)	4.4 (4.1)	3.4
Public investment	-1.2 (-6.1)	-5.5 (-3.8)	1.5 (-0.2)	-0.6 (1.8)	2.5
National expenditure	1.6 (1.2)	1.1 (1.0)	2.0 (1.6)	2.2 (2.4)	2.6
Exports of goods and services	6.3 (4.8)	-0.8 (1.1)	2.1 (3.1)	3.3 (3.3)	3.4
Imports of goods and services	-1.1 (-1.4)	1.7 (2.4)	2.3 (2.2)	3.2 (3.0)	3.0
Gross domestic product (GDP)	5.0 (4.1)	0.0 (0.5)	1.9 (2.0)	2.3 (2.6)	2.7
GDP at current prices (ISK trillions)	4.32 (4.28)	4.55 (4.52)	4.85 (4.81)	5.10 (5.11)	5.40
Public sector demand[2]	1.3 (1.0)	1.0 (0.8)	1.7 (1.5)	1.7 (2.0)	1.9
Total investment (% of GDP)	24.2 (23.7)	24.7 (24.1)	24.0 (23.9)	23.8 (23.9)	23.7

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/3).
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]

	2023	2024	2025	2026	2027
Marine production for export	-8.0 (-8.0)	-1.8 (0.3)	0.2 (0.5)	1.3 (1.3)	1.5
Aluminium production for export[2]	1.2 (1.2)	-4.4 (-0.8)	0.8 (1.6)	1.1 (0.5)	1.5
Goods exports total	1.3 (1.1)	1.3 (3.2)	1.8 (2.0)	3.3 (3.3)	2.9
Services exports total	13.1 (9.8)	-3.0 (-1.1)	2.5 (4.3)	3.3 (3.4)	3.9
Contribution of net trade to GDP growth (percentage points)	3.4 (2.9)	-1.1 (-0.6)	-0.1 (0.4)	0.1 (0.2)	0.2
Terms of trade for goods and services	-5.6 (-5.7)	1.1 (0.1)	1.5 (0.3)	0.3 (0.3)	0.2
Trade balance (% of GDP)	0.5 (-0.1)	-0.1 (-0.6)	0.4 (0.0)	0.6 (0.2)	0.8
Current account balance (% of GDP)	1.1 (0.9)	-0.9 (-0.6)	0.0 (-0.3)	-0.1 (-0.3)	0.0
Inflation in main trading partners[3]	5.0 (5.0)	2.5 (2.6)	2.2 (2.2)	2.0 (2.0)	2.0
GDP growth in main trading partners[3]	1.3 (1.2)	1.4 (1.3)	1.6 (1.6)	1.7 (1.7)	1.7

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/3).
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, LSEG Datastream, OECD, Statistics Iceland, Central Bank of Iceland.

Table 3 Employment, wages, and factor utilisation[1]

	2023	2024	2025	2026	2027
Total hours worked[2]	5.0 (5.0)	4.9 (2.2)	-0.1 (-0.4)	-0.6 (1.6)	1.8
Unemployment (% of labour force)[2]	3.4 (3.4)	3.6 (4.1)	4.4 (5.0)	4.3 (4.2)	3.7
GDP per hour worked[3]	0.1 (-0.9)	-4.7 (-1.7)	2.0 (2.5)	2.9 (1.0)	0.9
Unit labour costs[4]	6.8 (7.8)	7.1 (6.3)	4.0 (3.4)	3.0 (4.6)	4.6
Real disposable income[5]	4.0 (0.6)	2.9 (1.3)	1.2 (0.9)	1.5 (3.9)	4.1
Output gap (% of potential output)	4.9 (4.0)	1.0 (0.4)	-0.5 (-0.7)	-0.2 (-0.5)	0.4

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/3).
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]

	2023	2024	2025	2026	2027
Trade-weighted exchange rate index[2]	-2.6 (-2.6)	-0.3 (-0.2)	0.9 (-0.3)	0.5 (-0.5)	-0.2
Real exchange rate (relative consumer prices)	0.9 (0.9)	3.0 (3.3)	2.1 (1.6)	1.2 (0.4)	0.2
Inflation (consumer price index, CPI)	8.7 (8.7)	5.9 (6.2)	3.4 (4.2)	2.7 (2.9)	2.5

1. Year-on-year change (%) unless otherwise specified (figures in parentheses are from the forecast in MB 2024/3).
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	
2023:4	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 (8.6)
2024:3	5.9 (6.3)	3.9 (5.3)
	Forecasted value	
2024:4	4.8 (5.8)	1.4 (3.8)
2025:1	4.1 (5.1)	2.7 (2.8)
2025:2	3.2 (4.4)	4.9 (5.8)
2025:3	3.0 (3.7)	3.0 (2.3)
2025:4	3.2 (3.6)	2.4 (3.6)
2026:1	3.2 (3.4)	2.3 (1.9)
2026:2	2.9 (3.0)	3.8 (4.0)
2026:3	2.4 (2.6)	0.9 (1.0)
2026:4	2.5 (2.4)	2.8 (2.8)
2027:1	2.3 (2.3)	1.8 (1.5)
2027:2	2.4 (2.4)	4.3 (4.2)
2027:3	2.5 (2.5)	1.3 (1.3)
2027:4	2.6	3.1

1. Figures in parentheses are from the forecast in MB 2024/3.

Sources: Statistics Iceland, Central Bank of Iceland.

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