



MONETARY BULLETIN

2010 • 3

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Appendix 1: Baseline macroeconomic and inflation forecast 2010/3

The objective of the Central Bank of Iceland's monetary policy is to contribute to general economic well-being in Iceland. The Central Bank does so by promoting price stability, which is its main objective. In the joint declaration by the Government of Iceland and the Central Bank of Iceland on March 27, 2001, it is explained that the Central Bank's aim shall be that annual inflation, measured as the twelve-month increase in the CPI, remains as close to 2½% as possible.

Professional analysis and transparency are important prerequisites for credible monetary policy. In publishing *Monetary Bulletin*, the Central Bank attempts to fulfil these principles. Twice a year, in early May and early November, *Monetary Bulletin* includes an in-depth analysis of economic and monetary developments and prospects. In January and August, an updated forecast is published together with an abbreviated report on economic and monetary developments and prospects. The Monetary Policy Committee of the Central Bank bases its interest rate decisions to a great extent on this analysis. The publication of *Monetary Bulletin* also represents a vehicle for the Bank's accountability towards government authorities and the public.

The framework of monetary policy and its implementation and instruments are described further on the Central Bank's website: www.sedlabanki.is/?PageID=179.

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Icelandic letters:

ð/Ð (pronounced like th in English this)

þ/Þ (pronounced like th in English think)

In *Monetary Bulletin*, ð is transliterated as d and þ as th in personal names, for consistency with international references, but otherwise the Icelandic letters are retained.

Symbols:

- * Preliminary or estimated data.
- 0 Less than half of the unit used.
- Nil.
- ... Not available.
- . Not applicable.

Central Bank lowers interest rates

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by one percentage point. The deposit rate (current account rate) will be 5.5%, and the maximum bid rate for 28-day certificates of deposit (CDs) will be 6.75%. The seven-day collateralised lending rate will be 7.0% and the overnight lending rate 8.5%.

Inflation has declined markedly in recent months. Twelve-month inflation fell from 7.5% in May to 4.8% in July, or 4% excluding consumption tax effects. This is more rapid disinflation than in the Central Bank's May forecast, due in large part to a stronger-than-expected exchange rate. According to the updated inflation forecast, which appears in today's *Monetary Bulletin*, inflation excluding tax effects will reach the Bank's inflation target by year-end and will fall somewhat below target early in 2011. Inflation expectations have also declined sharply in the recent term.

In trade-weighted terms, the króna has appreciated by over 2½% since the MPC's last meeting, held in June, and by over 2% against the euro, without any foreign exchange market intervention by the Central Bank. Over this same period, the CDS spread on sovereign debt has remained broadly unchanged. The capital controls, developments in terms of trade and the current account balance, and the interest rate differential with major currencies all continue to support the exchange rate.

Lower inflation, lower inflation expectations, a stronger króna, and the prospect of more rapid disinflation than previously expected provide the scope for a larger interest rate reduction than has generally been the case in the past year. Declining inflation and inflation expectations have caused real Central Bank interest rates to rise since the last interest rate decision date. Although recovery appears to be underway, it is still weak at present, and the outlook is for an output slack to remain for the next few years.

Given the inflation outlook, the Central Bank's interest rates are still rather high, and there are grounds for continuing to lower them; however, it is not yet clear to what extent the recent disinflation episode reflects short-term factors. Moreover, it should be borne in mind that, when capital account liberalisation begins, the risk-weighted interest rate differential between Iceland and abroad must provide sufficient support to the króna. However, there is still some uncertainty about when it will be possible to begin lifting the capital controls. Consequently, it is difficult to state what this entails for interest rate policy over the next few months.

When the Third Review of the Government-IMF economic programme is complete, the preconditions for capital account liberalisation will be in place as regards the foreign exchange reserves and macroeconomic stability. However, there is still considerable uncertainty

about the strength of the financial system in the wake of the recent Supreme Court judgments. As a result, it is necessary to review the existing capital account liberalisation strategy in view of changed circumstances and the delays that have already occurred.

As was stated in the last MPC statement, it is important to replace the Central Bank's borrowed foreign exchange reserves with non-borrowed reserves in the medium term. The appreciation of the króna and the decline in risk premia on Icelandic financial obligations provide now the scope for modest foreign currency purchases for this purpose. Such purchases will begin on 31 August, and the quantity will be decided with the aim of minimising the impact on the króna.

As before, the Committee considers that the premises for continued monetary easing should be in place, provided that the króna remains stable or appreciates and inflation subsides as forecast. The MPC stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.

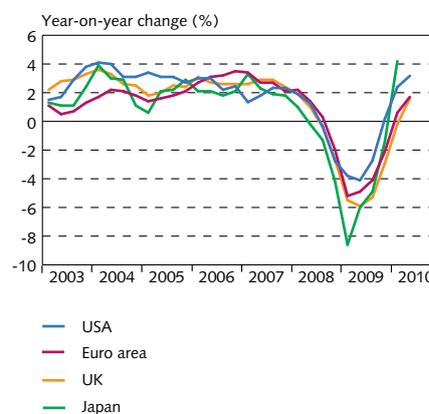
Some indicators suggest recovery has begun

There are some indications that the recession has already hit bottom. If recovery has begun or is about to begin, it comes somewhat earlier than the Central Bank assumed in its May forecast, published in the last Monetary Bulletin. The increase in investment goods imports in the first half of the year gives reason to assume that business investment has been stronger than previously projected, in spite of further delays in energy-intensive industrial development projects. The forecast presented here assumes that stronger business investment in 2010 will more than offset weaker private consumption. Labour market indicators in particular support the view that the recovery is stronger and comes earlier than previously forecast, while other indicators, such as turnover data, give cause for caution. The Bank's updated forecast therefore assumes that this year's contraction in GDP will be somewhat smaller than was projected in May. The Icelandic króna has appreciated over the summer and has been stronger than indicated in the May forecast. As a result, inflation has abated more rapidly than expected. Disinflation is assumed to continue, and inflation is expected to reach the Central Bank inflation target in mid-2011, while inflation excluding consumption tax effects is expected to reach the target by the end of 2010, somewhat sooner than was forecast in May.

The global economy and international trade

- Output grew in Iceland's main trading partner countries in Q1/2010. It turned out weaker than expected in the United States and Japan and was limited in the United Kingdom as well, although growth in the UK gained momentum in Q2, rising to a four-year high. Growth in Q2 also turned out strong in the euro area after a weak first quarter, partly due to inclement weather at the start of the year.
- The growth outlook for the latter half of the year is generally quite uncertain. There is the risk that growth will slow down again, as a number of stimulative policy measures are being wound down or have already been completed, particularly in the US. However, the most recent forecasts from the IMF and Consensus Forecasts are very similar to their forecasts from the time the last *Monetary Bulletin* was published. As a result, the assumptions on global economic development are unchanged in this forecast.
- The inflation outlook in Iceland's main trading partner countries is broadly unchanged from May. In general, inflation seems to have stopped rising, and in many economies it is declining. In the UK, inflation seems to have peaked in April and has subsided since then. Similar developments have been seen in the US, while in the euro area inflation has remained more or less unchanged.
- Policy interest rates have remained unchanged in major industrial countries in recent months; however, Canada, first among the G7 countries, raised its rates twice this summer. Interest rates have also been raised in many other parts of the world, primarily in Asia but also in New Zealand and elsewhere.

Chart 1
International growth
Real GDP growth Q1/2003 - Q2/2010



Source: Reuters EcoWin.

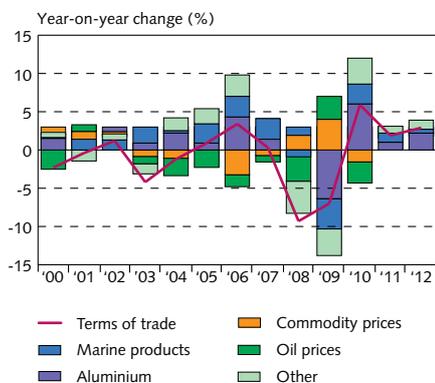
Chart 2
World trade



1. Imports of goods and services in Iceland's main trading partners.
2. Arithmetic average of merchandise import and export volumes in OECD countries and the largest non-OECD countries.
Sources: OECD, Central Bank of Iceland.

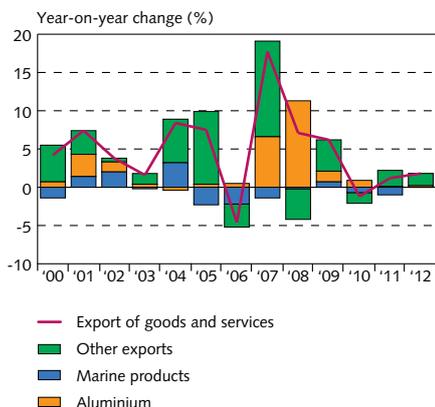
1. The analysis appearing here is based in large part on the Bank's assessment of economic developments, published in May 2010 in *Monetary Bulletin* 2010/2, and on the updated forecast presented here. It is based on data available on 13 August.

Chart 3
Terms of trade and its main components
2000-2012¹



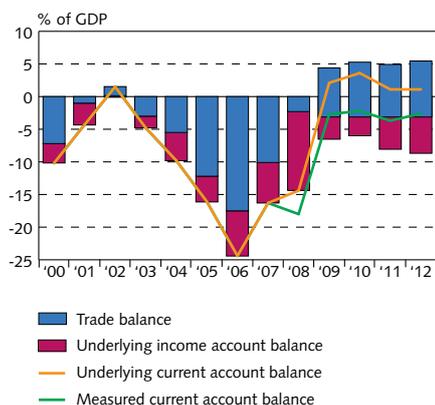
1. Central Bank baseline forecast 2010-2012. The contribution of the main sub-indices to year-on-year changes in terms of trade is determined by weighting the annual change in the sub-index concerned together with its weight in the import or export of goods and services. The item "other" is a residual.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4
Export development and its main components
2000-2012¹



1. Central Bank baseline forecast 2010-2012.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5
Current account balance 2000-2012¹



1. Net current transfer is included in the balance of income. Central Bank baseline forecast 2010-2012.
Sources: Statistics Iceland, Central Bank of Iceland.

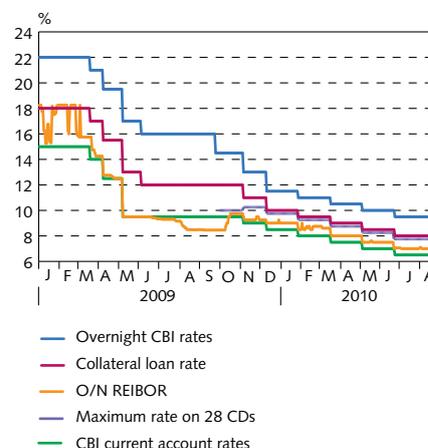
- According to the most recent forecasts from the OECD and the IMF, the global trade outlook has continued to improve. The first half of 2010 is estimated to have been even stronger than expected. The updated Central Bank forecast assumes that imports among Iceland's main trading partners will grow by 7.5% this year, while the May forecast projected a rise of just under 4%.
- Commodity prices have risen markedly in the latter half of the summer, and much more than previously forecast. Food prices have skyrocketed, due in particular to widespread crop failures. As a result, the updated forecast assumes that commodity prices will be considerably higher than in the May forecast.
- Marine product prices for 2010 are expected to rise about 10% year-on-year. This is a somewhat larger increase than was forecast in May, as prices have surged in recent months. The forecast for aluminium and crude oil prices is virtually unchanged, however, and assumes price increases of just under 28% and 29%, respectively. The outlook is for crude oil prices to rise by another 7% in 2011, a slightly larger increase than was assumed in the May forecast.
- Terms of trade are assumed to be broadly unchanged from the last forecast. They are expected to improve by just under 6% this year, after deteriorating markedly, in 2009. Higher commodity prices than previously forecast will erode terms of trade in 2010, but this is counteracted by the rise in marine product prices. Terms of trade look set to continue improving over the coming two years, as was forecast in May.
- The real exchange rate has continued to rise, with the increase measuring nearly 11% so far in 2010. Nonetheless, it remains 22% below the average over the past 30 years.
- Exports of goods and services are expected to shrink by just over 1% this year, while the May forecast assumed an increase of 0.4%. The downturn is attributable in large part to a stronger contraction in marine product export production than previously expected, lower aircraft export values, and a larger contraction in service exports. The 2011 forecast for goods and services exports is broadly unchanged, with smaller marine product exports (despite an increased cod quota) offset by larger exports of industrial goods and services. The outlook for 2012 has deteriorated somewhat, however, due to delays in aluminium and power sector development.
- The trade surplus for Q1/2010 was considerably larger than in the first quarter of 2009. The merchandise trade surplus continued to grow in Q2, and many indicators suggest that the trend will continue. The forecast assumes that the trade surplus will amount to 9.6% of GDP in 2010, a slight downward adjustment from the previous forecast. It assumes as well that the deficit in

the balance on income will be larger than previously projected, as revised figures for 2009 revealed a wider deficit than previous figures suggested. This will affect the expected deficit for 2010. The measured current account deficit for 2010 is therefore somewhat larger than was projected in the last *Monetary Bulletin*. The underlying current account surplus for 2010 – that is, the current account balance less accrued interest due to credit institutions in winding-up proceedings – will be slightly smaller, however, than in the last forecast. It is assumed that the measured current account deficit will rise again temporarily in 2011, and that the underlying surplus will narrow, in line with the May forecast.

Domestic financial markets

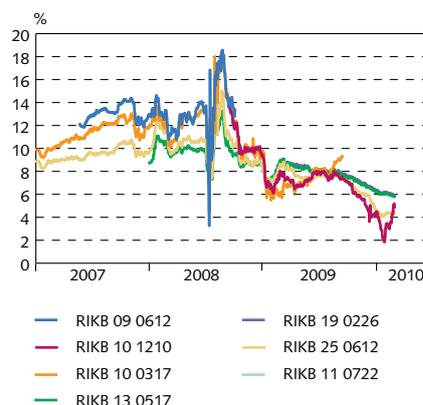
- Central Bank of Iceland interest rates were lowered by 0.5 percentage points on two occasions: at the publication of the last *Monetary Bulletin* in May, and again in June. The current account rate was prior to the publication of the current *Monetary Bulletin* 6.5%, the maximum rate on 28-day certificates of deposit (CDs) 7.75%, and the collateral lending rate 8%.
- Despite this decline in the Bank's nominal interest rates, short-term real interest rates have risen, as inflation and inflation expectations have fallen even more rapidly. In this sense, monetary policy restraint has increased.
- However, the risk-adjusted short-term interest rate differential with abroad has narrowed, as domestic short-term interest rates have fallen more than the risk premium on Icelandic financial assets. Thus monetary policy has eased slightly vis-à-vis abroad.
- Since the last *Monetary Bulletin* appeared, figures have been published on the balance sheet of the banking system as of end-May. In general, these figures have provided information on developments in bank lending. Current figures are affected by the restructuring of the banking system, however, and most of the larger changes in bank lending can be attributed to this restructuring. Even though these data should be interpreted with caution, they do indicate that credit growth is limited or non-existent. In many respects, this trend can be seen more clearly in money supply figures, with M3 contracting by nearly 5% from year-end 2009 to end-May 2010.
- Yields on nominal Treasury bonds currently range between 4% and 6%, with the yield curve shifting downward, more or less in line with Central Bank interest rate reductions. Yields on indexed housing bonds have also declined since May, although the decrease is somewhat less, between 0.2 and 0.6 percentage points, with yields currently around 3-3½%.
- The CDS spread on sovereign debt has subsided since May, but a reversal in the last few days prior to the publication of this report

Chart 6
Central Bank of Iceland interest rates and short-term market interest rates
Daily data 1 January 2009 - 13 August 2010



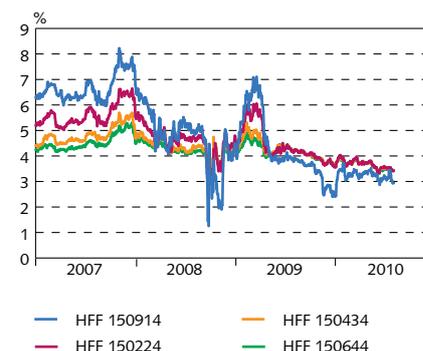
Source: Central Bank of Iceland.

Chart 7
Long-term nominal Treasury bond yields
Daily data 3 January 2007 - 13 August 2010



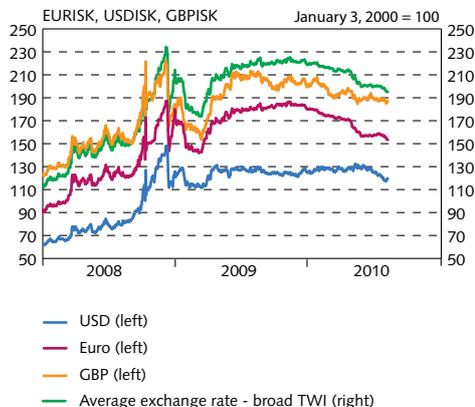
Source: Central Bank of Iceland.

Chart 8
Yields on indexed HFF bonds
Daily data 3 January 2007 - 13 August 2010



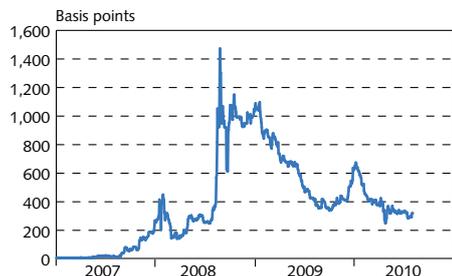
Source: Central Bank of Iceland.

Chart 9
Exchange rate of the króna
Daily data January 3, 2008 - 13 August, 2010



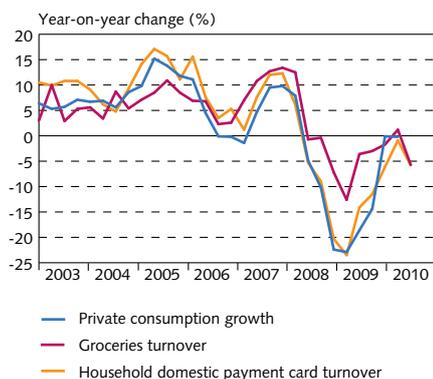
Source: Central Bank of Iceland.

Chart 10
CDS Iceland
Daily data 29 March 2007 - 13 August 2010



Source: Bloomberg.

Chart 11
Private consumption, groceries
and payment card turnover
Q1/2003 - Q2/2010



Sources: Federation of Trade and Services, Statistics Iceland, Central Bank of Iceland.

has brought it back up to nearly 3.2 percentage points. CDS spreads on the European countries hit most severely by the financial crisis have also risen in the period immediately preceding this publication, after declining over a period of several weeks. Thus it can be assumed that recent movements in Iceland's CDS spread largely reflect these global developments.

- The underlying trade surplus, improved terms of trade, and the declining CDS spread have supported the recent appreciation of the króna. Since the publication of the May issue of *Monetary Bulletin*, the króna has strengthened by nearly 8% against the US dollar and about 9% against the euro, without any Central Bank intervention. In trade-weighted terms, the appreciation measures about 8%. According to the updated forecast, the exchange rate will remain near current levels throughout the forecast horizon, just over 7% stronger against the euro than was forecast in May.
- The drop in real estate prices has lost momentum in recent months. Real house prices in the greater Reykjavík area have fallen by over 34% since peaking in October 2007, and nominal prices have fallen by 14.2% from their peak in January 2008. Activity in the real estate market has picked up somewhat from a year ago. Accumulated turnover in July was about 21% higher than in July 2009, although turnover remains very low in a historical context. The updated forecast assumes that real house prices will continue to fall in the months to come, although the decline is expected to be somewhat less pronounced than according to the forecast in the May *Monetary Bulletin*. This is due in part to stronger real disposable income and lower unemployment than in the previous forecast.

Domestic economy and inflation

- National accounts data for Q1/2010 suggest that the domestic economy was somewhat more resilient in Q1 than was assumed in the last *Monetary Bulletin*. Domestic demand contracted by about 2% year-on-year, whereas a contraction of 5.2% had been projected. This marked difference is due primarily to a considerably smaller contraction in public consumption than was assumed in May. The divergence in public consumption is due in large part to a considerably smaller rise in the public consumption price deflator than was projected, as the nominal value of public consumption was well in line with the forecast. The preliminary figures on private consumption and investment for Q1/2010 were consistent with the Bank's forecast. The negative contribution from external trade resulted in a GDP contraction of 6.9%, nearly 5 percentage points larger than the contraction in national expenditure. According to the May forecast, GDP was expected to contract by about one percentage point less in Q1, as that forecast assumed a rather smaller contraction in exports. Furthermore, changes in inventories, attributable to inventory accumulation in the fisheries sector, were unusually pronounced.

- After a steep contraction in 2009, private consumption shrank marginally year-on-year in Q1, according to the preliminary figures from Statistics Iceland. Seasonally adjusted private consumption contracted by 0.6% quarter-on-quarter, after having grown for the two preceding quarters. This was in line with the Bank's May forecast, which assumed a 0.7% contraction between quarters.
- Q1/2010 was the eighth consecutive quarter with a year-on-year contraction in private consumption. The updated forecast assumes that this trend will continue in Q2 and that private consumption will fall by 1.5%. This is consistent with high-frequency indicators of private consumption developments, although they are not unambiguous. For example, indicators such as payment card turnover and retail sales indices suggest that private consumption has continued to shrink in the second quarter; however, consumer goods imports have been growing year-on-year, and consumer expectations appear to have improved over the summer. Among other things, planned big-ticket purchases have increased, which could indicate more robust private consumption than the forecast assumes. In view of all this, private consumption growth is expected to measure about 0.5% in 2010, instead of the 1.1% forecast in May. The forecast for the next two years, however, is broadly similar to the May forecast.
- The Treasury's tax revenues turned out 1.4% below expectations for the first six months of the year. The deviation is due primarily to lower returns from turnover taxes, which could have implications for next year's budget preparation, as the Government-IMF economic programme stipulates that a positive primary balance must be achieved in 2011. On the expenditure side, national accounts for Q1/2010 reveal that fiscal consolidation is more or less in line with the economic programme. A radical change has occurred in expenditure trends, as nominal public consumption expenditures have remained stable at about 100 b.kr. for five quarters in a row. In broad terms, the updated forecast assumes that developments in public sector finances will be similar to those in the May forecast. Public consumption will contract by about 2½-3½% per year during the forecast horizon, and public expenditure will contract until 2012. It is assumed that public sector finances will be largely in line with the May forecast, and in line with the economic programme.
- Proposed aluminium and power sector investment is still shrouded in uncertainty. In the forecast presented here, it is assumed that the Helguvík project allowed for in the May forecast will be postponed for the most part until 2011. Projects previously expected in 2011 and 2012 have also been shifted back by approximately one year. Moreover, it is clear that energy sector investment will be somewhat less this year. In combination, these factors suggest that energy-intensive investment will be similar to 2009 in

Chart 12
Private consumption and consumer confidence
Q1/2001 - Q2/2010

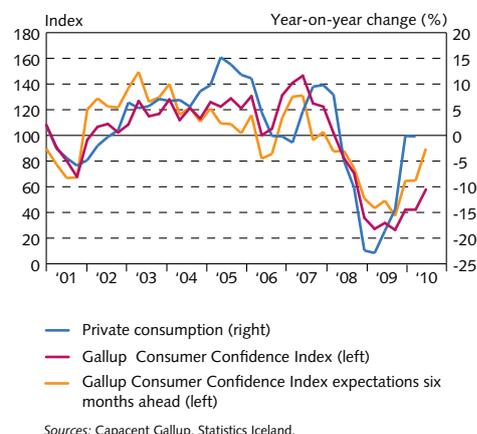


Chart 13
Business investment as a percentage of GDP¹

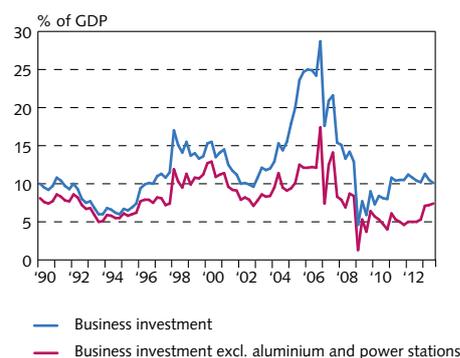


Chart 14
Gross fixed capital formation and contribution of underlying components 2000-2012¹

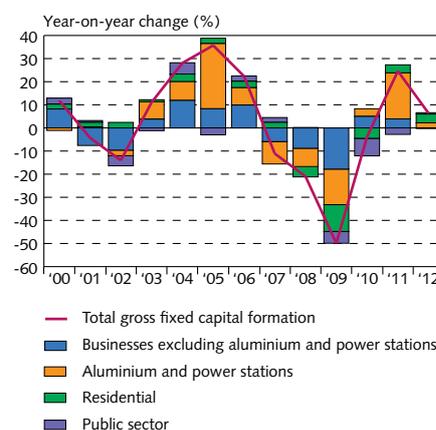
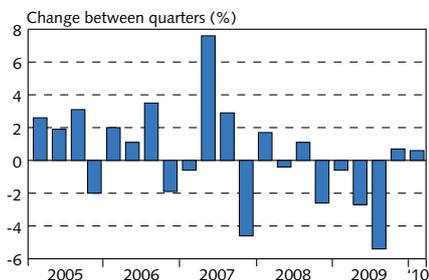
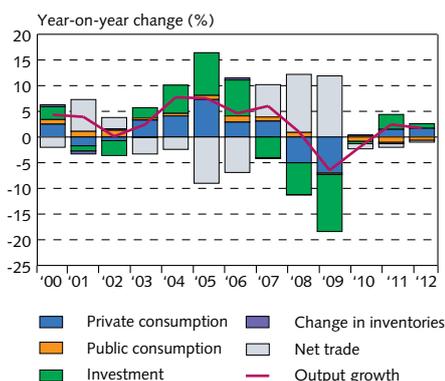


Chart 15
Quarterly seasonally adjusted output growth



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 16
Output growth and contribution of underlying components 2000-2012¹



1. Central Bank baseline forecast 2010-2012.
Sources: Statistics Iceland, Central Bank of Iceland.

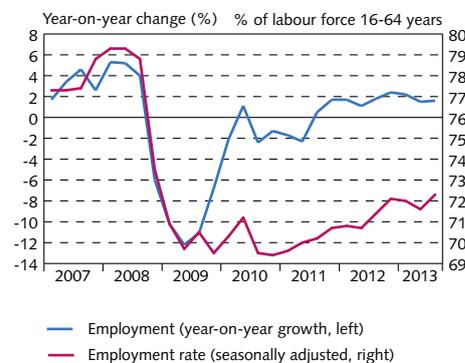
nominal terms and about 15% greater in volume terms, instead of the 45% rise assumed in the May forecast. This change implies a larger increase in 2011 and a somewhat smaller one in 2012. Increases in exports of energy-intensive industrial products will be delayed correspondingly.

- Indicators imply that general business investment has begun recovering after falling to a historical low as a share of GDP. Imports of investment goods increased significantly in Q2/2010 after contracting without interruption since 2006. Investment goods imports grew by 15% year-on-year in the first half of 2010, while the May forecast had assumed a constant level this year. The assumption in the May forecast was consistent with indicators from the Capacent Gallup survey carried out in March 2010 among Iceland's 400 largest companies. The updated forecast assumes that general business investment will grow by about 15% in 2010, while the last forecast suggested a rise of only 8.4%. The outlook for general business investment in 2011, however, is similar to that in the May forecast, and business investment as a share of GDP is expected to have risen to its long-term average level by the end of the forecast horizon.
- Because of stronger business investment and a smaller contraction in residential investment and public investment, gross capital formation is estimated to shrink by just under 4% this year, whereas the May forecast assumed a contraction of over 10%. The outlook for general investment in 2011 is broadly unchanged from the May forecast, while stronger growth is projected for 2012, with a greater share of energy-intensive investment shifting to that year.
- Statistics Iceland's assessment of seasonal fluctuations in GDP indicates that seasonally adjusted GDP began growing between quarters in Q4/2009 and continued growing in the first quarter of 2010. This suggests that recovery is already underway, somewhat earlier than was forecast in May. It should be noted, however, that the seasonal pattern of GDP in Iceland is subject to great uncertainty because of unusually irregular quarterly changes in GDP. This uncertainty is perhaps even greater at present because of the extreme changes that accompany turning points in the business cycle.
- As has been stated previously, GDP contracted by 6.9% year-on-year in Q1/2010. The updated forecast assumes that the contraction will diminish gradually as the year progresses and that, in the third quarter, GDP will return to year-on-year growth for the first time since Q2/2008. In spite of this, however, it is assumed that average annual GDP will contract year-on-year, in line with earlier forecasts. A contraction of 1.9% is expected in 2010, roughly half a percentage point less than in the May forecast. The improved outlook is attributable in large part to a smaller contraction in

investment than previously assumed, in spite of further delays in energy-intensive industrial investment. The contraction in domestic demand is estimated to be about one percentage point less than was forecast in May, and because of the negative contribution from external trade, the contraction in GDP will be greater than it would otherwise have been.

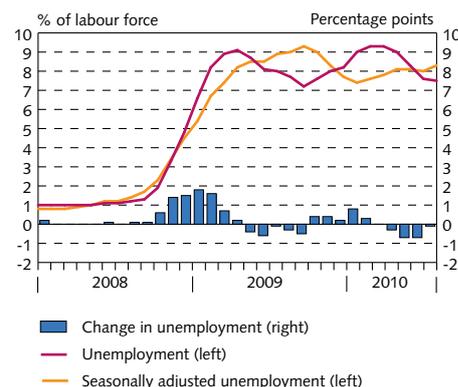
- The GDP growth outlook for the next two years has deteriorated slightly since May. Output is now expected to grow by 2.4% in 2011, instead of the 3.4% forecast in May, and to grow by 1.7% in 2012, as compared to 1.9% according to the May forecast. These changes are due largely to less growth in domestic demand in 2011 and weaker exports in 2012, the latter of which is due to delays in industrial investment projects.
- The outlook is for a slightly smaller output slack early in the forecast horizon than was projected in May or 4% instead of 4½% in 2010. As was forecast in May, the slack will narrow gradually and will almost disappear by the end of the forecast period. It should be noted, though, that estimates of the output gap are subject to significant uncertainty, especially in the wake of the financial crisis.
- The labour market survey conducted by Statistics Iceland in the second quarter of 2010 indicates that the labour market has already begun to recover. This turnaround comes somewhat earlier than was projected in the May forecast, which assumed that employment would not begin to grow until mid-2011. Demand for labour increased by all measures in Q2/2010, for the first time since 2007. Employed persons as a share of the population aged 16-74 rose by 1.6 percentage points year-on-year, and total hours worked rose by 1.1% due to an increase in hours worked and the number of persons at work. The increase was most prominent in the oldest and youngest age groups, whereas the core age group (25-54 years) saw a decrease.
- Survey results are always subject to some sampling uncertainty, and because of the large contribution of the oldest age group to the overall increase, it seems likely that the survey overestimates the growth in the labour force in Q2/2010. The forecast presented here assumes that this increase is not an indicator of developments in upcoming quarters and that labour demand will not increase year-on-year until mid-2011. The employment rate (employed persons as a share of the population aged 16-64) will be about 70% in 2010, just over half a percentage point higher than was forecast in May.
- Unemployment as registered by the Directorate of Labour declined by just under one percentage point quarter-on-quarter in Q2/2010, to measure 8.3%. Unemployment is probably as high as it was at the same time a year ago, however, because changes

Chart 17
Employment and employment rates¹



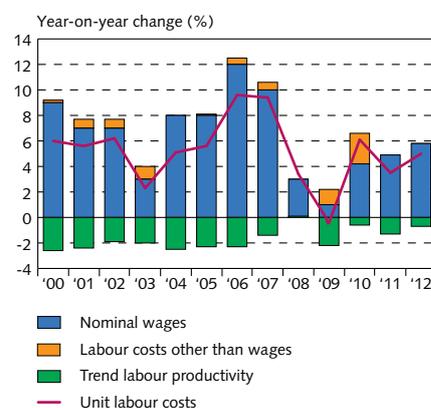
1. Central Bank baseline forecast Q2/2010 - Q3/2013.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 18
Unemployment



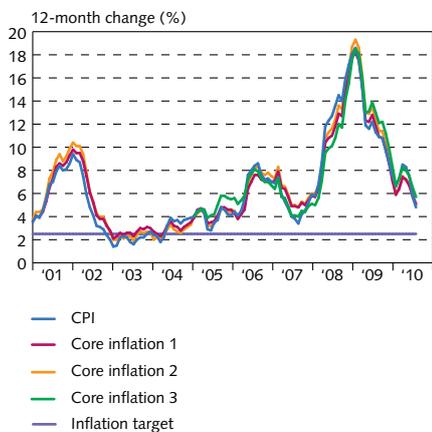
Sources: Directorate of Labour, Central Bank of Iceland.

Chart 19
Unit labour costs and contributions of underlying components 2000-2012¹



1. Positive labour productivity growth is shown as a negative contribution for an increase in unit labour costs. Central Bank baseline forecast 2010-2012.

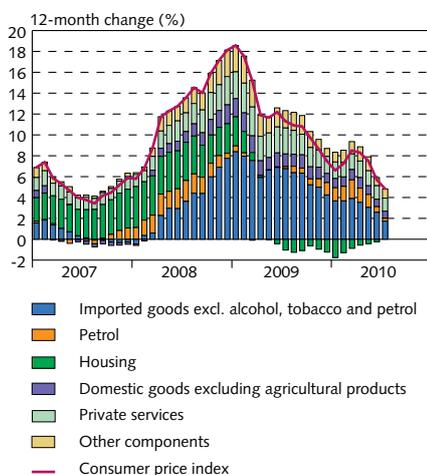
Chart 20
Inflation January 2001 - July 2010¹



1. The core indices measure underlying inflation, with Core Index 1 excluding prices of agricultural products and petrol, and Core Index 2 excluding prices of public services as well. Core Index 3 also excludes the effect of changes in mortgage rates.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 21
Components of CPI inflation
Contribution to 12 months inflation January 2007 - July 2010



Source: Statistics Iceland.

in the methodology used to calculate unemployment and changes in entitlement to unemployment benefits have caused unemployment to measure ½-1 percentage point lower this year than it would have otherwise.

- In Q2, measured unemployment was about 1½ percentage point lower than in the Bank's May forecast. Unemployment has been overestimated during the past year, as it has been assumed that the financial restructuring of the corporate sector would proceed more quickly than has actually been the case. After adjusting for the aforementioned changes in methodology, however, the difference is smaller.
- Indicators of developments in unemployment over the next few months diverge. According to information from the financial system, the restructuring of the largest companies is largely complete. Household sentiment about the labour market situation has turned more upbeat since the spring, according to the Gallup Consumer Sentiment Index; however, the Capacent Gallup poll carried out in June among Iceland's 400 largest firms indicates that the labour market has yet to soften somewhat. According to the Capacent Gallup survey, more firms expected to shed labour in June than in a comparable survey conducted in March, while the number of firms planning to add on staff remained unchanged.
- The current forecast assumes that unemployment will rise slightly in the coming fall and winter, peaking at 9% in Q1/2011 before gradually tapering off as the economy recovers and falling to about 6% in 2012. Thus unemployment is expected to be about one percentage point lower throughout the forecast horizon than was assumed in the May forecast.
- Wages have developed in line with the last forecast. No new indicators of increased wage pressures have emerged, nor is it expected that there will be much pressure to correct real wages during the next round of wage negotiations. The larger-than-expected growth in the labour force than assumed in May implies that productivity will be somewhat lower this year than was previously assumed. As a result, unit labour costs will increase by about 6% this year, one percentage point more than was forecast in May. Developments over the next two years, however, are expected to be in line with the May forecast.
- The consumer price index (CPI) fell by 0.66% in July, following a 0.33% decline in June. Twelve-month inflation has therefore abated quickly since the publication of the last *Monetary Bulletin*, measuring 4.8% in July. Inflation excluding indirect tax effects measured 4%. In April, headline inflation measured 8.3%, and inflation excluding indirect taxes measured 6.9%; thus inflation by both measures has declined by approximately three percentage points since the May issue of *Monetary Bulletin*. Some base

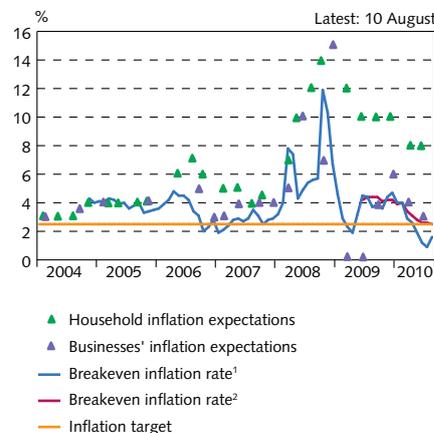
effects were apparent due to the sharp rise in the CPI in Q2/2009. Seasonally adjusted annualised three-month inflation measured -2.3% in July, down from 6.8% in April.

- Inflation was 7.1% in the second quarter of 2010, while the May forecast assumed 7.4%. The difference is due primarily to the fact that the króna appreciated more than was forecast in May. In addition, global oil prices rose slightly less in Q2 than previously expected. On the other hand, house prices proved stronger than was forecast in May.
- Inflation expectations as measured by breakeven rates have fallen since the last *Monetary Bulletin*, with three-year inflation expectations measuring 1½%, while ten-year inflation expectations are about 2½%. Inflation expectations in the bond market have therefore fallen by approximately ½-1 percentage point since May. According to the median response to Capacent Gallup's quarterly survey of corporate inflation expectations, last conducted in June, executives expected 3% inflation twelve months ahead, or about one percentage point less than in the March survey. In Capacent Gallup's June survey among households, inflation expectations were unchanged since April, at 8% according to the median response. On the other hand, household expectations of twelve-month inflation two years ahead had risen to 7% in June, as opposed to 6.5% in the last survey. Household inflation expectations therefore remain very high even though the inflation outlook has improved; however, household inflation expectations tend to reflect past inflation to greater extent than other measures of inflation expectations.
- The outlook is for inflation to subside more rapidly this year than was assumed in the May issue of *Monetary Bulletin*. This is attributable to a considerably stronger exchange rate and lower inflation expectations, among other factors. In addition, summer sales effects proved stronger than in recent years, and it is uncertain whether these effects will reverse in full when new goods are purchased at a stronger exchange rate. Headline inflation is projected to reach the Central Bank's inflation target in the second quarter of 2011, while inflation excluding consumption tax effects is expected to reach the target at year-end 2010, somewhat earlier than in the May forecast. If this forecast materialises, inflation will be about half a percentage point lower this year than in the May forecast, or 5.7%, down from 12% in 2009.
- There is some uncertainty about the short-term inflation outlook, not least because of recent steep increases in global oil and commodity prices, wheat in particular. The outlook is for food prices to rise sharply in coming months. There is considerable uncertainty about how strong the inflationary effects will be, and how quickly they surface. A possible offsetting factor would be a stronger króna than is allowed for in the forecast.

Chart 22

Inflation expectations

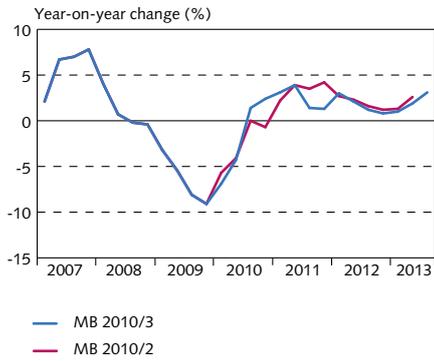
Breakeven inflation rate in the bond market at month-end and inflation expectations according to surveys



1. Spread between RIKB 13 0517 and HFF 150914. 2. Spread between RIKB 25 0612 and HFF 150434.

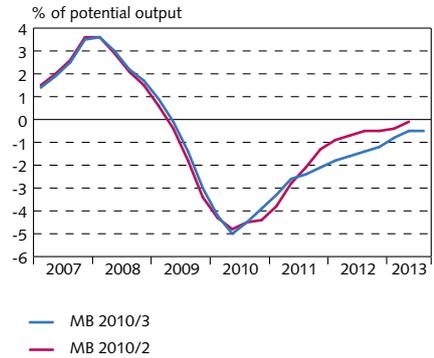
Sources: Capacent Gallup, Central Bank of Iceland.

Chart 23
Output growth - comparison with MB 2010/2



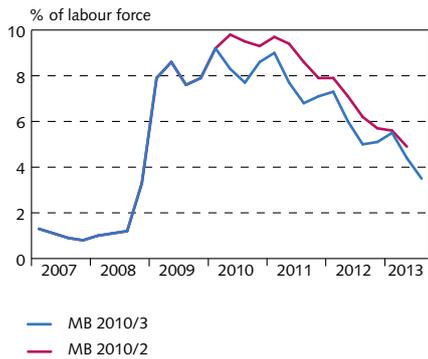
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 24
Output gap - comparison with MB 2010/2



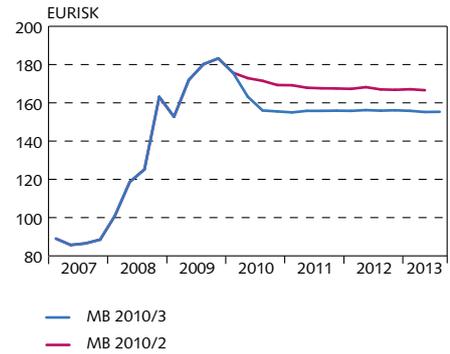
Source: Central Bank of Iceland.

Chart 25
Unemployment - comparison with MB 2010/2



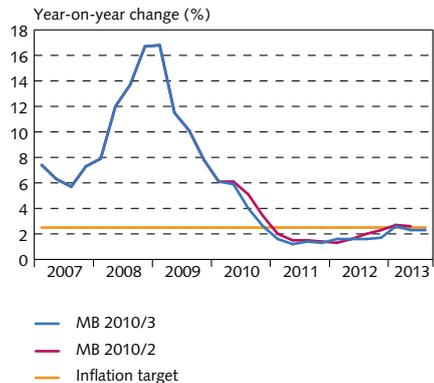
Sources: Directorate of Labour, Central Bank of Iceland.

Chart 26
The ISK exchange rate against the euro - comparison with MB 2010/2



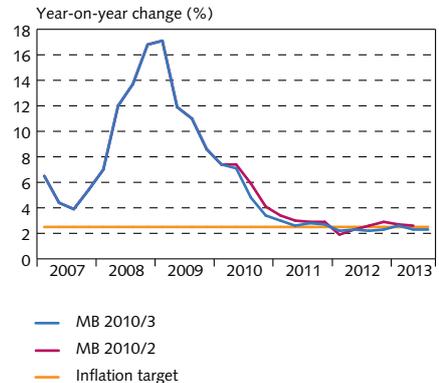
Source: Central Bank of Iceland.

Chart 27
Inflation excluding tax effects - comparison with MB 2010/2



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 28
Inflation - comparison with MB 2010/2



Sources: Statistics Iceland, Central Bank of Iceland.

Appendix 1

Baseline macroeconomic and inflation forecast 2010/3

Table 1 Macroeconomic forecast¹

	In b.kr.	Change from prior year (%) unless otherwise specified			
		2009	2010	Forecast	
				2011	2012
<i>GDP and its main components</i>					
GDP	1,500.2	-6.5 (-6.5)	-1.9 (-2.6)	2.4 (3.4)	1.7 (1.9)
Private consumption	774.6	-14.6 (-14.6)	0.5 (1.1)	3.3 (3.1)	3.5 (4.1)
Public consumption	391.6	-3.0 (-3.0)	-3.2 (-3.0)	-3.8 (-3.5)	-2.4 (-2.4)
Gross capital formation	211.8	-49.9 (-49.9)	-3.8 (-10.2)	24.6 (24.8)	6.3 (3.5)
Business investment	117.7	-54.2 (-54.2)	15.1 (8.4)	35.6 (37.0)	2.8 (-0.3)
Residential investment	40.1	-55.7 (-55.7)	-24.3 (-35.1)	23.9 (21.0)	26.0 (24.4)
Public investment	54.0	-28.9 (-28.9)	-29.9 (-32.4)	-15.2 (-15.5)	4.5 (4.4)
National expenditure	1,379.8	-20.1 (-20.1)	-0.7 (-1.9)	3.7 (4.5)	2.5 (2.4)
Exports of goods and services	784.1	6.2 (6.2)	-1.2 (0.4)	1.2 (1.0)	1.8 (2.6)
Imports of goods and services	663.7	-24.0 (-24.0)	1.3 (2.5)	3.7 (2.7)	3.5 (3.8)
<i>Other key aggregates</i>					
GDP at current prices	1,500 (1,500)	1,599 (1,616)	1,701 (1,742)	1,806 (1,828)	
Trade account balance (% of GDP)		8.0 (8.0)	9.6 (9.8)	9.2 (9.7)	9.8 (9.6)
Current account balance (% of GDP)		-3.8 (-3.3)	-2.2 (-0.6)	-3.7 (-2.0)	-2.6 (-2.0)
Underlying current account balance (% of GDP) ²		2.1 (3.0)	3.6 (5.0)	1.1 (2.4)	1.1 (1.6)
Output gap (% of potential output)		-3.0 (-3.4)	-3.9 (-4.4)	-2.1 (-1.3)	-1.2 (-0.5)
Unit labour costs (change in average year-on-year)		-0.4 (-0.6)	6.1 (5.2)	3.5 (3.7)	5.0 (4.6)
Real disposable income (change in average year-on-year)		-20.3 (-18.0)	-6.4 (-9.8)	-0.2 (0.3)	3.0 (3.0)
Unemployment (% of labour force)		8.0 (8.0)	8.5 (9.5)	7.7 (8.9)	5.9 (6.7)
EURISK exchange rate		172.0 (172.0)	162.6 (172.3)	155.6 (168.1)	156.0 (167.3)

1. Figures in parentheses are from the forecast in *Monetary Bulletin* 2010/2. 2. Current account without accrued interests due to deposit institutions' undergoing winding-up proceedings.

Table 2 Inflation forecast (%)³

Quarter	Inflation (change year-on-year)	Inflation excluding tax effects (change year-on-year)	Inflation (annualised quarter-on-quarter change)
2009:1	17.1 (17.1)	16.8 (16.8)	9.6 (9.6)
2009:2	11.9 (11.9)	11.5 (11.5)	5.9 (5.9)
2009:3	11.0 (11.0)	10.1 (10.1)	8.6 (8.6)
2009:4	8.6 (8.6)	7.8 (7.8)	10.4 (10.4)
2010:1	7.4 (7.4)	6.1 (6.1)	4.9 (4.9)
2010:2	7.1 (7.4)	5.9 (6.1)	4.7 (5.7)
Forecasted value			
2010:3	4.8 (5.9)	4.0 (5.1)	-0.6 (2.8)
2010:4	3.4 (4.1)	2.6 (3.4)	4.8 (3.2)
2011:1	3.0 (3.4)	1.6 (2.0)	3.2 (2.1)
2011:2	2.6 (3.0)	1.2 (1.5)	3.1 (3.7)
2011:3	2.8 (2.9)	1.4 (1.5)	0.1 (2.6)
2011:4	2.7 (2.9)	1.3 (1.4)	4.6 (3.1)
2012:1	2.2 (1.9)	1.6 (1.3)	1.2 (-1.7)
2012:2	2.3 (2.3)	1.6 (1.6)	3.2 (5.3)
2012:3	2.2 (2.6)	1.6 (2.0)	-0.3 (4.1)
2012:4	2.3 (2.9)	1.7 (2.3)	5.1 (4.2)
2013:1	2.6 (2.7)	2.6 (2.7)	2.3 (-2.6)
2013:2	2.3 (2.6)	2.3 (2.6)	2.2 (4.6)
2013:3	2.3	2.3	-0.3
<i>Annual average</i>			
2009	12.0 (12.0)	11.4 (11.4)	
2010	5.7 (6.2)	4.6 (5.1)	
2011	2.8 (3.0)	1.4 (1.6)	
2012	2.2 (2.4)	1.6 (1.8)	

3. Figures in parentheses are from the forecast in *Monetary Bulletin* 2010/2.