MONETARY BULLETIN

2014•3

Contents

20 August 2014

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 27 March 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 February and August, an updated forecast is published together with an abbreviated report on economic and monetary deveolopments and prospects. The Monetary Policy Committee of the Central Bank bases its interest rate decisions on this analysis, among other things. 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.

Published by:
The Central Bank of Iceland, Kalkofnsvegur 1, 150 Reykjavík, Iceland
Tel: (+354) 569 9600, fax: (+354) 569 9605
E-mail: sedlabanki@sedlabanki.is
Website: www.sedlabanki.is

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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.

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.

Statement of the Monetary Policy Committee 20 August 2014

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged.

According to the Bank's updated forecast, published today, the outlook for the real economy over the next three years is broadly similar to that described in the May issue of *Monetary Bulletin*. However, the outlook is for slightly stronger growth in domestic demand this year and throughout the forecast horizon.

The inflation outlook has improved somewhat since May, and it now appears that inflation will remain close to target during the forecast horizon. A positive output gap is forecast to develop later than was assumed in the last forecast and will be less pronounced. Inflation expectations have changed little in the recent past, and long-term expectations are still above target.

The Bank's foreign exchange transactions in the past year have contributed to greater exchange rate stability. This year the Bank has bought significantly more foreign currency than it has sold, in both regular and *ad hoc* purchases. The Bank intends to continue its regular purchases in the current amount as long as conditions remain relatively unchanged. As before, the Bank will intervene in the foreign exchange market as needed to mitigate exchange rate volatility.

The slack in the monetary policy stance has probably disappeared, and it appears, based on the Bank's baseline forecast, that the current interest rate will suffice to keep inflation at target. Robust growth in domestic demand in the near term and growing tension in the labour market could generate increased inflationary pressures, however, and necessitate an increase in the Bank's nominal interest rates.

Inflation set to remain near target

Global output growth has been relatively weaker year-to-date than was forecast in the May issue of Monetary Bulletin *but, as in May, is expected to gain momentum over the next two years. The improvement in terms of trade is becoming more obvious, and the outlook for export prices has improved. The outlook for exports has improved as well, due mainly to growth in services exports this year. Preliminary figures from Statistics Iceland indicate that GDP was unchanged in Q1, in spite of more than 5% growth year-on-year in consumption and investment combined. This is considerably weaker GDP growth than was forecast in May, due primarily to one-off items that are not considered to reflect underlying developments in GDP growth. As a result, output growth is projected at 3.4% this year, slightly below the May forecast. It is expected to gain momentum next year, measuring 3.9%, owing to strong investment in the energy-intensive sector and to stimulative Government measures. As in May, GDP growth is expected to decline to just under 2.8% in 2016, when domestic demand growth eases. It will average 3.4% per year during the forecast horizon, compared to the average of 2.7% over the last thirty years and an average growth rate of 2.2% projected for Iceland's main trading partner countries over the forecast horizon. Furthermore, the labour market continues to recover. Total hours worked rose somewhat more in Q2 than was forecast in May. Inflation has been at target since early this year, and the inflation outlook has improved somewhat since May, primarily because the slack in the economy is now considered somewhat more pronounced. On the other hand, unit labour costs are projected to grow somewhat more rapidly, owing to slower productivity growth. As always, the inflation outlook is highly uncertain.*

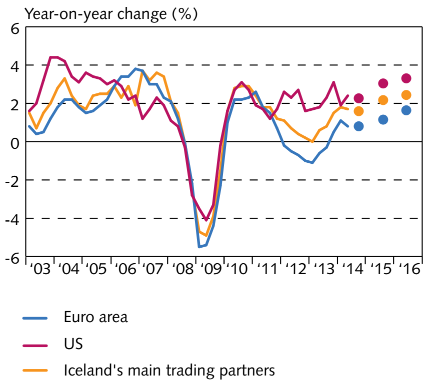
Global economic affairs and external trade

- GDP growth measured 1.8% among Iceland's main trading partners in Q1/2014. This is below expectations, due mainly to weaker-than-expected growth in the US. Growth gained pace slightly in the US in Q2, measuring 2.4% on an annualised basis, but was nonetheless below market projections from April. Preliminary figures for the euro area also indicate weaker-than-expected growth in Q2. GDP growth in Japan and the Nordic countries apart from Norway has also been below forecasts so far this year. In the UK, however, it has repeatedly outperformed forecasts, measuring 3.2% in Q2.

- The output growth outlook for 2014 has therefore deteriorated somewhat for the US and the euro area. According to projections from Consensus Forecasts, GDP growth for Iceland's main trading partners is forecast to average 1.9% this year, marginally below the May forecast. This forecast is also in line with projections from the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF), the latter of which estimates global output growth at 3.4% for this year, some 0.3 percentage points below its previous forecast. The baseline forecast assumes that trading partners' output growth will gain traction in the next two years, rising to 2½% by 2016.

- Global financial market conditions have continued to improve. Long-term interest rates have fallen still further in developed

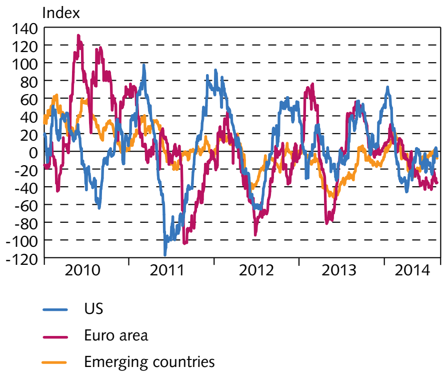
Chart 1
International growth[1]



1. Points show forecast from Consensus Forecasts for 2014-2016.
Sources: Consensus Forecasts, Global Insight, Macrobond.

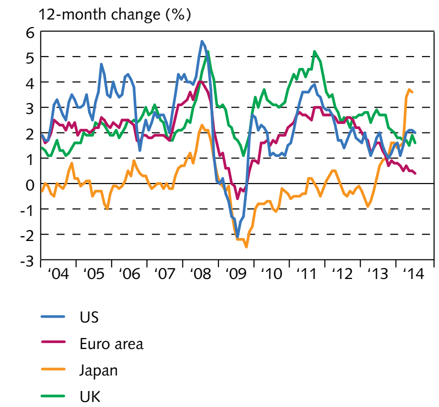
1. The analysis appearing here is based in large part on the Bank's assessment of economic developments, published in May 2014 in *Monetary Bulletin* 2014/2, and on the updated forecast presented in this report. It is based on data available as of mid-August.

Chart 2
Economic surprise index[1]
Daily data 1 January 2010 - 15 August 2014



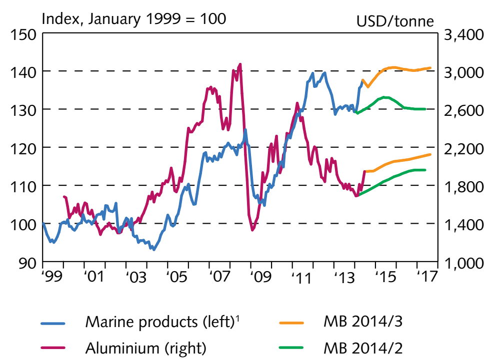
1. When the index is lower than 0, the indicators are more negative than expected; when the index is higher than 0, the indicators are more positive than expected. The index does not imply that the indicators are positive or negative.
Source: Macrobond.

Chart 3
Inflation in selected industrialised countries
January 2004 - July 2014



Source: Macrobond.

Chart 4
Prices of marine exports and aluminium
In foreign currency



1. Foreign currency prices of marine products are included by dividing marine product prices in Icelandic krónur by the export-weighted trade basket.
Sources: London Metal Exchange, Statistics Iceand, Central Bank of Iceland.

countries, and capital has sought out emerging markets once again. Risk premia on emerging market economies' debt have declined, asset prices in these countries have risen, and their currencies remained stable or even appreciated since May. Concerns about China's financial markets remain, however, and the political unrest in the Middle East and the Russia-Ukraine dispute has caused volatility in oil and stock prices.

- In the US, inflation has been close to 2%, somewhat above expectations, while in the UK it is 1.6%, slightly below the Bank of England's inflation target. In the euro area, inflation has been very low, however, falling to a nearly five-year low of 0.4% in July. Among Iceland's trading partners, it is projected to average 1.3% this year and then rise to 1.7% in 2015 and 2% in 2016.

- The policy interest rate in the euro area was cut by 0.1 percentage point in June, to 0.15%, the lowest rate since the establishment of the European Monetary Union. In addition, a new credit line to banking institutions was introduced, with the aim of providing small and medium-sized companies better access to credit, and the European Central Bank (ECB) is considering a bond purchase programme. Various other central banks, particularly in Eastern Europe and South America, have also cut interest rates since the publication of the May *Monetary Bulletin*, while rates have risen in some other countries, including New Zealand and Russia.

- Growth in world trade gained significant momentum in the latter half of 2013, in line with increased output growth. That trend continued early this year. Both the IMF and the OECD have revised their world trade forecasts for 2014 downwards, however, in response to weaker-than-expected global output growth, and the Central Bank's baseline forecast has been revised to reflect this. Demand among Iceland's main trading partners is projected to grow by 3.4% this year and by a similar amount in 2015 and 2016.

- The virtually constant three-year slide in global commodity prices was interrupted temporarily at the beginning of 2014, but as expected, the uptick proved transitory and subsided as the year advanced. The outlook is broadly unchanged since the May forecast, with commodity prices projected to continue falling over the next two years as supply exceeds demand. This is in line with the IMF forecast, although the OECD projects a slight increase in commodity prices next year. Oil prices have fallen less year-to-date than was projected in May, and it is now assumed that they will remain unchanged year-on-year in 2014, while the May forecast provided for a 3% decline. It is still assumed that they will decline throughout the forecast horizon, albeit more slowly than previously forecast.

- The outlook is for the price of Iceland's main export products to be somewhat higher during the forecast horizon than was assumed in May, as the price of marine products and aluminium have risen in recent months. According to the forecast, the foreign currency price of marine products will rise 4% per year in 2014 and 2015 and by a total of 8% over the forecast horizon, a full 6 percentage points more than was forecast in May. The outlook is uncertain, however, owing to the potential impact of the Russian trade embargo on many European countries. Aluminium prices rose somewhat more than expected in Q2, after declining over the previous four quarters, and the outlook for the forecast horizon has improved since May.

- After deteriorating steadily since 2010, terms of trade for goods and services appear to have started recovering in Q2, due primarily to rising export prices. The outlook is for a nearly 3% improvement in terms of trade over the forecast horizon as a whole. This is 2 percentage points more than was forecast in May.

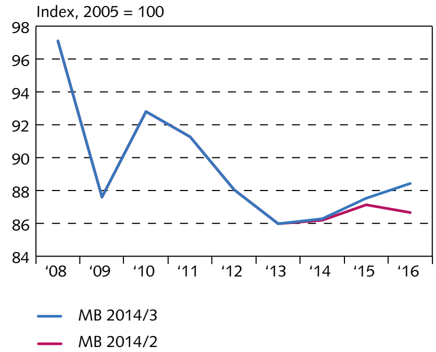
- In the first four months of the year, the real exchange rate rose markedly, reaching its highest value since August 2008. It has remained relatively stable since April, and over the first seven months of the year, it was nearly 8% higher than during the same period in 2013. Nonetheless, it remains 10% below the average over the past thirty years.

- Goods and services exports are assumed to increase by 4.3% this year instead of the 2.9% provided for in the last forecast. The key difference is the rise in services exports, with preliminary figures for Q1 indicating a growth rate of 17% and figures from the Icelandic Tourist Board showing that the number of foreign tourists in Iceland was up more than a fourth year-on-year in the first seven months of 2014. Services exports are projected to increase by 12½% this year, while goods exports are expected to contract by 1.2%. The main driver of the latter is a contraction in marine product exports of nearly 7%, somewhat more than was projected in May, owing to a smaller-than-expected increase in the cod quota for the upcoming fishing year. The outlook is for goods and services exports to grow over the next two years by an average of nearly 3% per year, somewhat more than was forecast in May.

- The surplus on goods and services trade was markedly smaller in Q1/2014 than in the same quarter of 2013. Due to strong imports of "other services" (which includes a variety of irregular items), the surplus on services trade was considerably smaller than anticipated. Furthermore, the surplus on goods trade was 9 b.kr., some 17 b.kr. less than in Q1/2013. A 13 b.kr. deficit in goods trade is estimated for the second quarter, due to a strong increase in consumer goods imports and a contraction in marine product exports. It is now assumed that the surplus on combined goods and services trade will total about 5% of GDP this year and about 4½% next year, and then contract to about 2½% of GDP in 2016. This is a slightly smaller surplus than was forecast in May.

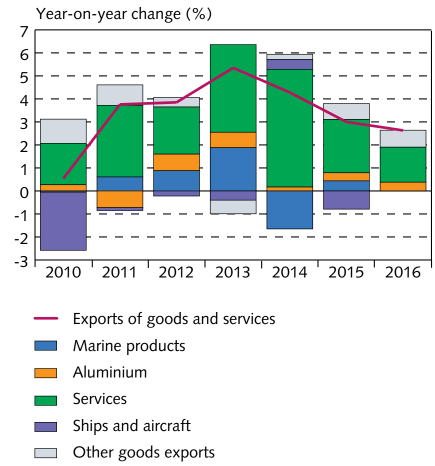
- The deficit in the underlying balance on income has been in line with expectations so far this year. The outlook is for it to be slightly

Chart 5
Terms of trade for goods and services – comparison with MB 2014/2



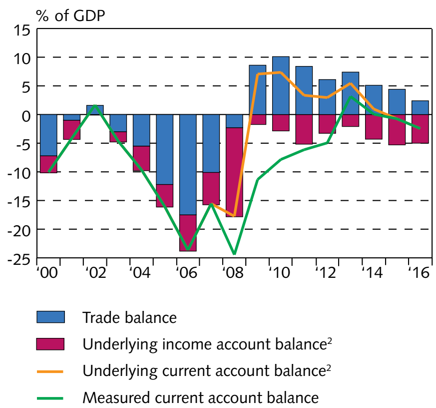
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6
Export development and its main components 2010-2016[1]



1. Central Bank baseline forecast 2014-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7
Current account balance 2000-2016[1]

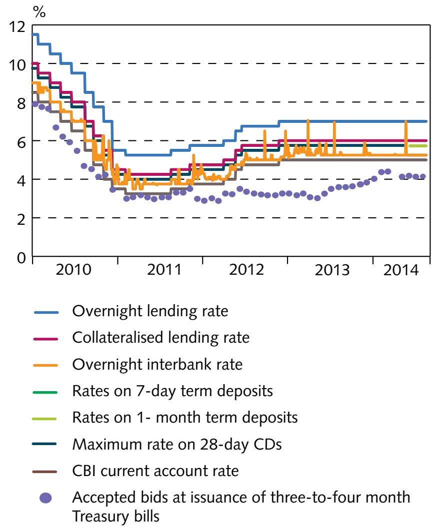


1. Net current transfers are included in the balance on income. Central Bank baseline forecast 2014-2016. 2. Adjusted for calculated revenues expenses of deposit money banks (DMBs) in winding-up proceedings and the effects of the settlement of their estates, and adjusted for the effects of the pharmaceuticals company Actavis until 2012.
Sources: Statistics Iceland, Central Bank of Iceland.

smaller this year than was forecast in May, as foreign short-term interest rates are lower and the exchange rate of the króna slightly higher; therefore, foreign debt service is correspondingly less. It is assumed there will be an underlying current account surplus of about 1% of GDP this year. However, as in the May forecast, a deficit is expected to develop beginning next year and amount to about 2½% of GDP in 2016.[2] This is a larger deficit than was projected in May.

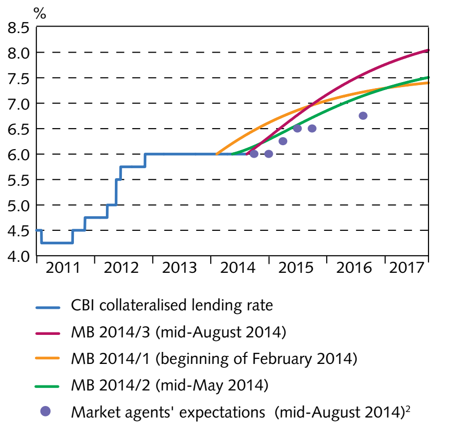
Domestic financial markets

Chart 8
Central Bank of Iceland interest rates and short-term market interest rates
Daily data 1 January 2010 - 15 August 2014



Source: Central Bank of Iceland.

Chart 9
Collateralised lending rate, forward market interest rates and market agents' expectations concerning collateralised lending rate[1]
Daily data 1 January 2011 - 30 September 2017



1. Interbank interest rates and Treasury bonds were used to estimate the yield curve. Treasury bonds maturing within two years are excluded, however, because their pricing is assumed to be affected by the capital controls. 2. According to the median response in the Central Bank's market expectations survey for the period 11-14 August 2014.
Source: Central Bank of Iceland.

- At its May and June meetings, the Central Bank of Iceland Monetary Policy Committee (MPC) decided to hold the Bank's interest rates unchanged. At its May meeting, the MPC also approved modifications to the Bank's monetary policy instruments, in part with the aim of enhancing the effectiveness and efficiency of the Bank's liquidity management and to lay the groundwork both for the planned sale of Central Bank of Iceland Holding Company (ESÍ) assets and for the liberalisation of the capital controls. A part of the modifications entailed discontinuing the issuance of 28-day certificates of deposit (CD) and offering two types of term deposits instead: one-week deposits, offered weekly and bearing fixed interest; and one-month deposits offered at the beginning of each month. For the latter deposits, financial institutions will submit bids specifying both amount and interest rate. Prior to the publication of this *Monetary Bulletin*, the Bank's current account rate was 5%, the rate on seven-day term deposits was 5.25%, the seven-day collateralised lending rate was 6%, and the overnight lending rate was 7%. The approved interest rate in auctions of one-month term deposits have been 5.75%.

- The above modifications to the Bank' monetary policy instruments have not changed the fact that financial system liquidity remains abundant, and interest rates on the Central Bank's deposit accounts are still the best approximation of the Central Bank rate that determines money market rates. The Bank's effective policy rate is calculated as the simple average of its current account rate and its term deposit rate (previously the maximum bid rate on 28-day CDs), which are unchanged since the May *Monetary Bulletin*. The overnight interbank lending rate has also remained unchanged since May, and interbank market turnover has been extremely limited.

- By the same token, the monetary stance is broadly unchanged since May. The Bank's effective real rate is now about 3% in terms of the current inflation level and just over 2% in terms of the average of various measures of inflation and inflation expec-

2. Adjusted for the calculated income and expenses of banks in winding-up proceedings, with the effects of the settlement of their estates added beginning with Q3/2014. The settlement of the estates is always assumed to occur in the quarter during which *Monetary Bulletin* is published. This does not indicate when the settlement will actually take place. For further information, see Section VII of *Monetary Bulletin* 2014/2.

tations. It is about 0.9-1.3 percentage points higher than it was a year ago.

- The Central Bank's market expectations survey, carried out in mid-August, still suggests that the market expects the Bank's seven-day collateralised lending rate to remain unchanged through this year. Respondents indicate that they expect rates to be raised by 0.25 percentage points, to 6.25%, in Q1/2015. On the other hand, they now appear to expect a further 0.25-point rate increase in Q2/2015, bringing the policy rate to 6.5%, and that it will be 6.75% in two years' time. This is 0.25 percentage points higher than was reported in a comparable survey conducted in mid-May. The findings also suggest that market participants expect a higher real rate than they did in the May survey. Forward rates give similar results. As in mid-May, the forward yield curve indicates that market agents expect the Bank's collateralised lending rate to rise to 6.25% this year and to have risen to 6.75% by mid-2015. This is 0.25 percentage points higher than the indication from the yield curve in mid-May.[3]

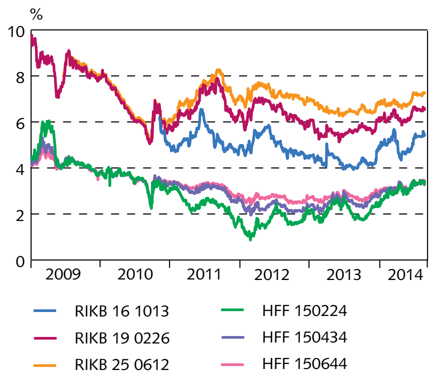
- Yields on indexed and non-indexed Housing Financing Fund (HFF) and Treasury bonds have risen by 0.3-0.7 percentage points since the May *Monetary Bulletin* was published, and by 0.8-1.5 percentage points in the past twelve months. In part, this could reflect the aforementioned rise in the Bank's real rate, as well as market expectations of a rate hike next year. The rise in long-term rates could also stem to some extent to the uncertainty about the future of the HFF, whose long-term credit rating was downgraded recently by Standard and Poor's (S&P).

- All three international rating agencies – S&P, Moody's and Fitch – have recently affirmed their ratings for the sovereign. S&P also changed the outlook from stable to positive, owing to strong output growth and improving public sector finances.

- In terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, the risk premium has fallen by nearly ½ a percentage point since the May *Monetary Bulletin*, to 1.4 percentage points for the bond maturing in 2016 and 1.9 percentage points for the bond maturing in 2022. The spreads have fallen to an all-time low in recent weeks. Similarly, the risk premium on the Treasury's most recent eurobond, which matures in 2020, is at 2.1 percentage points. The CDS spread on five-year Treasury obligations has narrowed as well, to 1.4%.

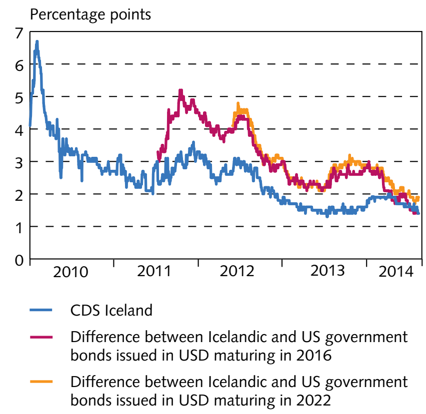
- The exchange rate of the króna has remained relatively stable since the May *Monetary Bulletin*. It has fallen slightly in trade-

Chart 10
Nominal and indexed bond yields
Daily data 2 January 2009 - 15 August 2014



Source: Central Bank of Iceland.

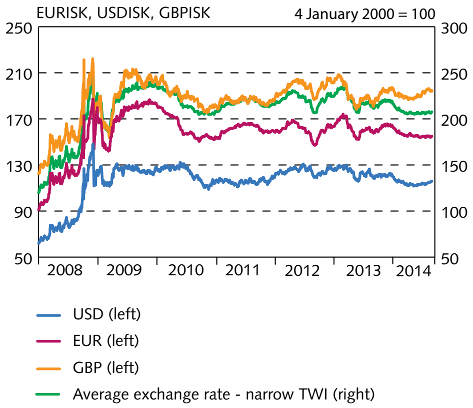
Chart 11
Risk premia on the Icelandic Treasury
Daily data 1 January 2010 - 15 August 2014



Source: Bloomberg.

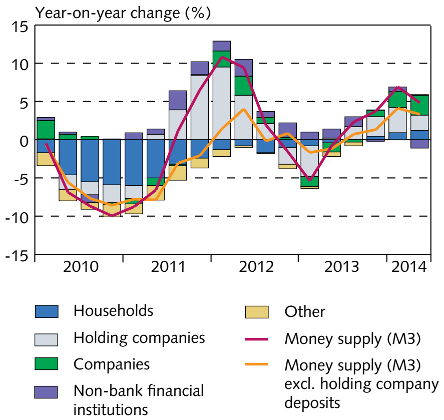
3. Measurement problems at the short end of the yield curve introduce a measure of uncertainty into the indications provided by the yield curve. Furthermore, Treasury bonds maturing in the next two years are excluded in the yield curve estimation, as their pricing is considered skewed by the effects of the capital controls. For further discussion, see Box III-1 in *Monetary Bulletin* 2013/4.

Chart 12
Exchange rate of the króna
Daily data 3 January 2008 - 15 August 2014



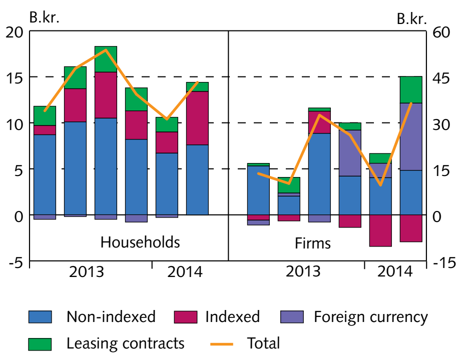
Source: Central Bank of Iceland.

Chart 13
Components of money supply
Q1/2010 - Q2/2014



Source: Central Bank of Iceland.

Chart 14
Net new lending[1] from the three commercial banks to households and firms[2]
Q1/2013 - Q2/2014



1. New loans net of prepayments. 2. Excluding holding companies.
Source: Central Bank of Iceland.

weighted terms and against the euro, and by 2-2½% against the US dollar and the pound sterling. Foreign exchange inflows from foreign tourists and smaller foreign loan payments by domestic firms and municipalities have supported the króna. On the other hand, the balance on goods has been unfavourable, and the Central Bank has bought significant amounts of foreign currency in the market in ad hoc purchases. In addition, the Bank resumed its regular foreign currency purchase programme in mid-June. The Bank's net foreign currency purchases in the interbank foreign exchange market have totalled 33 b.kr. since the publication of the May *Monetary Bulletin* and about 61 b.kr. year-to-date. This is more than over the preceding three years, including payments on forward contracts.

- In Q2, the trade-weighted exchange rate index stood at just over 206 points, slightly higher than was provided for in the May forecast. As before, the Bank's baseline forecast is based on the assumption that throughout the forecast horizon, the exchange rate of the króna will remain broadly stable at the level prevailing when the forecast was prepared. If this materialises, the index will measure just over 206 points throughout the forecast horizon, which is similar to the May forecast.

- Money holdings have continued to grow year-on-year, although the pace eased in Q1 in comparison with the preceding quarter. M3 was up 4.8% year-on-year in Q2/2014, and narrower measures of money holdings were up 4½-7½%. Growth in holding company deposits has slowed down, and M3 growth has been driven primarily by other firms' deposits during the quarter. Central Bank base money grew by about 7.1% over the same period.

- The price- and exchange rate-adjusted stock of loans from deposit money banks (DMB), pension funds, and the HFF to households and firms grew by 0.3% in Q2, after contracting uninterrupted since Q4/2010. There was a marked increase in net new lending to firms, which rose by 36.3 b.kr. in Q2 and 46 b.kr. in the first half of the year. This is about twice the increase seen at this time last year. New lending to households increased less in Q2 than at the same time in 2013, however. Net new household loans totalled 14.4 b.kr., about 9.3% less than in Q2/2013. The increase in lending to households is still due primarily to non-indexed loans, although the share of indexed loans has been on the rise in recent months. For example, indexed loans constituted the majority of net new household mortgages for the first time in Q2.

- House prices rose sharply early in the year, but in May and June they declined somewhat between months. In H1, however, the increase measured 9.1% year-on-year. At the same time, the number of registered house purchase agreements rose by 10½%, and rent rose by over 8%. Share prices have also begun to rise again, after a steep decline early in the year. Since May, the OMXI Main List index has risen by 4.3%. The OMXI8 has risen somewhat less, however. The difference is due to the strong increase in the price of orthopaedics company Össur's shares during the period, as Össur is not part of the OMXI8 but weighs rather heavily in the Main List index. Asset prices have therefore risen more or less across the board this year, and private sector financial conditions have improved.

The domestic economy

- Statistics Iceland published the Q1/2014 national accounts in June. According to those figures, GDP contracted by 0.1% year-on-year, after growing by 3.8% in the last quarter of 2013. GDP growth also was far weaker in Q1 than the 4.1% provided for in the May forecast. In spite of this weak first quarter, domestic demand grew by 2.1% year-on-year – and by 5.2% excluding the negative contribution from inventory changes, which is due primarily to a negative impact from marine product inventories. Weak GDP growth in the first quarter is therefore due primarily to the negative contribution from inventory changes and net trade, the latter of which is attributable to strong growth in services imports during the quarter. In other respects, economic activity developed broadly in line with the May forecast.

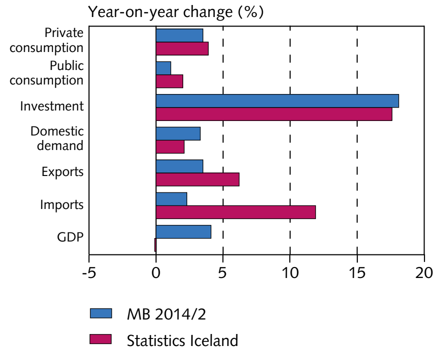
- It is considered likely that the effects of the inventory changes will even out within the year and that the changes in services imports are a one-off occurrence. Furthermore, it is possible that some of the leasing costs recognised as services imports in the Q1 accounts could generate increased tourism-related services exports later in the year. As a result, developments in these items probably have less of an impact on the GDP growth outlook for the year as a whole than might appear at first glance.

- Private consumption grew by 3.9% year-on-year in Q1 whereas the Bank's May forecast had provided for 3.5% growth. Leading indicators of developments in private consumption suggest that growth was somewhat stronger in Q2 than in Q1 – and also stronger than was forecast in May. As before, it can be expected that developments in 2014 will reflect the impact of the Government's debt relief measures to some extent. There is some uncertainty about how the impact of the measures on private consumption will surface, in terms of both scope and timing. According to the forecast under discussion here, private consumption growth will be somewhat stronger in H1 than was projected in May, indicating that the effects of the debt relief package have begun to emerge earlier but that their scope is broadly in line with expectations.[4]

- The outlook for developments in private consumption is broadly similar to that in the May forecast. As was the case then, growth is expected to remain strong in the second half of this year and in 2015 as well. During the forecast horizon, private consump-

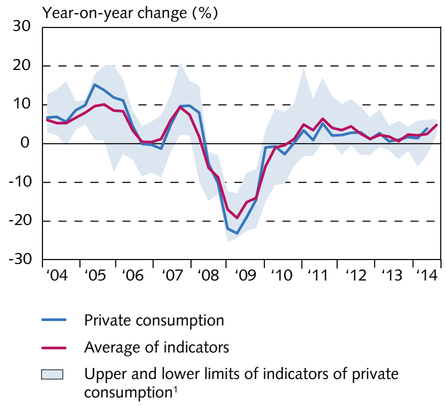
4. For further discussion and an analysis of the debt relief measures, see Appendix 2 in *Monetary Bulletin* 2014/1.

Chart 15
National accounts for Q1/2014 and Central Bank estimate



Sources: Statistics Iceland, Central Bank of Iceland.

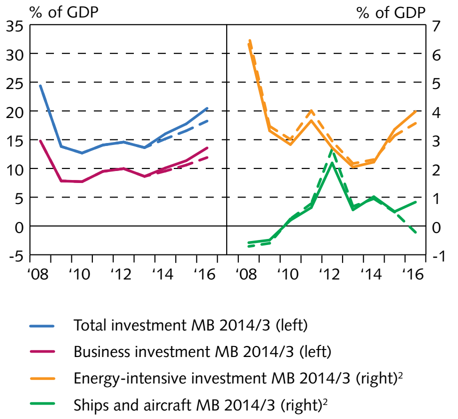
Chart 16
Indicators of private consumption
Q1/2004 - Q2/2014



1. Indicators are payment card turnover, groceries turnover, share prices, housing prices, consumer goods imports, new motor vehicle registrations, wages, and unemployment. The indicators are rescaled so that they have the same average and standard deviation as private consumption.
Sources: Centre for Retail Studies, Statistics Iceland, Central Bank of Iceland.

Chart 17

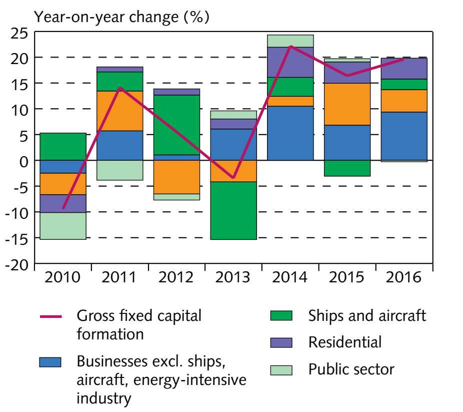
Investment as a share of GDP 2008-2016[1]



1. Broken lines show the forecast from MB 2014/2. 2. Change in historical figures is due to different price bases between the two forecasts.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 18

Gross fixed capital formation and contribution of its main components 2010-2016[1]



1. Central Bank baseline forecast 2014-2016. Components may not sum to total due to chain-linking.
Sources: Statistics Iceland, Central Bank of Iceland.

tion growth will be supported by improved household equity, real wage growth, and the impact of the debt relief package. Growth in private consumption is forecast at 4½% in 2014 and 2015 but is expected to ease to 2.9% in 2016.

- According to the overview of Treasury finances for the first six months of the year, spending on five of six functions was within budgetary limits. Only one function has been over budget: healthcare, with an overrun of 4.2%. Spending on all functions combined exceeded the budget by 160 m.kr., or 0.1%. Nominal growth in public consumption in Q1 was well in line with the Bank's May forecast. In volume terms, growth was somewhat stronger than forecast, however, as public consumption prices rose less than expected. For this year, public consumption is expected to grow by just over 1% in volume terms, which is slightly more than was forecast in May. As in the May forecast, growth is projected at 1% per year in 2015 and 2016.

- Investment grew by 17.6% year-on-year in Q1, which is slightly below the May forecast. All of the main components of investment grew markedly during the period, both between quarters and between years. The main contributor to business investment growth was investment excluding ships, aircraft, and the energy-intensive sector. Growth in this category measured 22.6% year-on-year. There was also a marked increase in residential investment during the quarter, with demand for new housing growing markedly in the recent term. Overall, residential investment has grown by more than 53% from its post-crisis trough. In spite of this steep increase, it totalled only 3% of GDP during the quarter, well below the thirty-year average of 4½%.

- The Bank's most recent forecasts have assumed that construction would begin on the first stage of the Norðurál aluminium smelter at Helguvík and on a silicon plant as well. The current forecast does not assume that Norðurál will undertake further investment at Helguvík during the forecast horizon but assumes instead that two additional silicon plants will be built. This change alone somewhat reduces the scope of energy-intensive investment during the forecast horizon, but due to the planned increase in maintenance-related investment and increased energy procurement activity, energy-intensive investment for the period as a whole increases in comparison with the May forecast.

- Business investment was up 15% year-on-year in Q1 and, as in May, is expected to continue growing strongly. Growth is projected at just under one-fourth, as opposed to a fifth according to the May forecast. Stronger growth in Q1 also gives rise to the expectation that public investment and residential investment will be stronger than was forecast in May. As a result, total investment is projected to grow by more than 22% year-on-year, as opposed to 19% in the May forecast. Next year is expected to develop in a similar manner, albeit with a growth rate of about 16½%. In

2016, however, in a departure from the May forecast the pace is expected to pick up again, with growth approaching 20%. The main reason for the deviation is the change in assumptions concerning energy-intensive investment during the horizon. If this forecast materialises, investment will amount to just over 20% of GDP, which is close to the thirty-year average, by 2016.

- Even though GDP remained flat in Q1 according to Statistics Iceland figures and was well below the Bank's May forecast, it is not considered necessary to make major changes to the output growth forecast for the year as a whole, as the deviation is probably due to an error in the estimated distribution of output growth within the year. Growth is expected to be relatively strong for the remainder of the year. For 2014 as a whole, GDP growth is projected at 3.4%, which is 0.3 percentage points below the May forecast but similar to year-2013 growth.

- As in the May forecast, it is assumed that GDP growth will gain even more momentum in 2015, measuring 3.9%, driven by both strong private consumption growth and investment in the energy-intensive sector. The pace of GDP growth will slow in 2016 but remain strong, at 2.8%.

- As before, near-term GDP growth will be driven by domestic demand – primarily private consumption and private investment – and exports. Domestic demand is expected to grow by some 5½% per year during the forecast horizon, and exports are forecast to grow by just over 3% per year, on average, in 2014 and the following two years. However, imports are projected to grow as well, albeit somewhat less next year than this year. According to the forecast, the contribution from net trade will therefore improve between years but will remain negative throughout the forecast horizon.

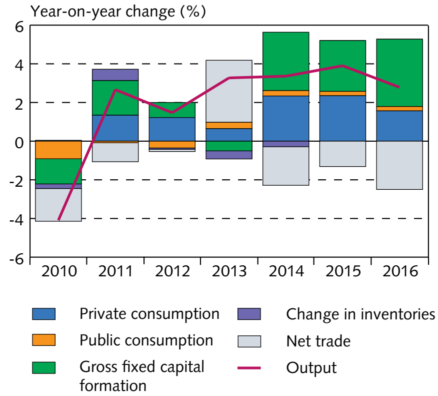
- If the forecast materialises, GDP growth during the forecast horizon will average 3.4% per year, which is well above Iceland's thirty-year average of 2.7% and far in excess of the 2.2% average projected for Iceland's trading partners during the same horizon.

- The margin of spare capacity that emerged following the financial crisis narrowed last year. It is estimated to have equalled about 1% of potential output in 2013, which is somewhat more than was forecast in May. It is also estimated to disappear somewhat more slowly than previously estimated and is expected to close in early 2015 rather than in mid-2014, as in the May forecast.

- According to the Statistics Iceland labour market survey, labour demand was somewhat stronger in Q2 than in the Bank's last forecast, which provided for a 1.5% year-on-year increase in total hours worked, instead of the actual 2.6%. The increase is broadly similar to that in the preceding quarter and is due largely to an increase in the number of employed persons, although average hours worked also rose by 0.7%.

Chart 19

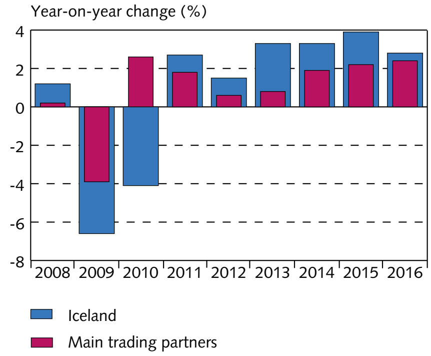
GDP growth and contribution of underlying components 2010-2016[1]



1. Central Bank baseline forecast 2014-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 20

GDP growth in Iceland and its main trading partners 2008-2016[1]

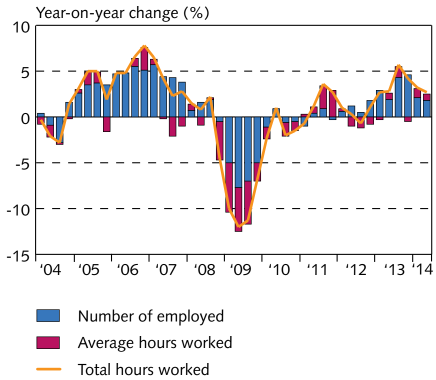


1. Central Bank baseline forecast 2014-2016.
Sources: Macrobond, Statistics Iceland, Central Bank of Iceland.

Chart 21

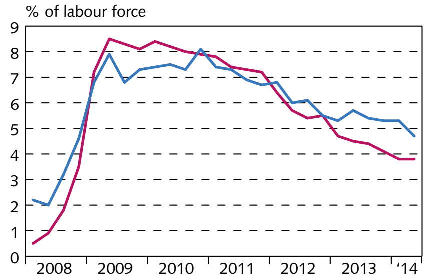
Changes in employment and hours worked

Q1/2004 - Q2/2014



Source: Statistics Iceland.

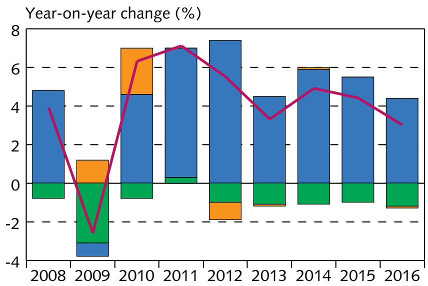
Chart 22
Seasonally adjusted unemployment
Q1/2008 - Q2/2014



Unemployment, labour market survey
Unemployment, Directorate of Labour

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

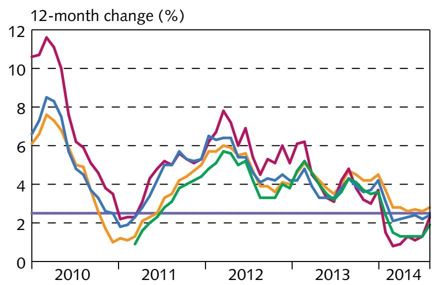
Chart 23
Unit labour costs and contributions of underlying components 2008-2016[1]



Nominal wages
Labour costs other than wages
Trend labour productivity
Unit labour costs

1. Labour productivity growth is shown as a negative contribution to an increase in unit labour costs. Central Bank baseline forecast 2014-2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 24
Various inflation measurements[1]
January 2010 - July 2014



CPI
Harmonised index of consumer prices
Core index 3 excl. tax effects
Core index 4 excl. tax effects
Inflation target

1. Core index 3 is the CPI excluding prices of agricultural products, petrol, public services and real mortgage interest expense. Core index 4 excludes the market price of housing as well.
Sources: Statistics Iceland, Central Bank of Iceland.

- In Q2/2014, net migration was positive for the seventh quarter in a row. The increase is slow, however, at 0.1% of the labour force, and is due almost entirely to an increase in foreign immigrants, which supports other indicators of increased labour demand.

- The Capacent Gallup survey carried out in May and June among Iceland's 400 largest firms indicates that labour demand could grow more rapidly in the latter half of the year. According to the survey, about 10% more firms were considering adding on staff than were planning redundancies. This is similar to the findings from the survey taken in March. In spite of a sharp increase in labour demand, which can be seen in the rise in the employment rate over the past two years, the share of firms that consider themselves understaffed has not risen.

- The updated forecast therefore assumes that total hours worked will increase by about 2.5% this year, which is slightly more than in the last forecast. The outlook for the upcoming two years has improved since May, with growth projected to average 1.8% over the forecast horizon.

- As in the May forecast, seasonally adjusted unemployment as registered by the Directorate of Labour (DoL) was broadly unchanged quarter-on-quarter in Q2/2014. Unemployment as measured by the labour market survey fell by 0.6 percentage points between quarters, however. The survey-based rate is probably a more accurate measure of unemployment than the DoL rate, as it includes those who have exhausted their entitlement to unemployment benefits. In Q2, unemployment declined by 0.7-0.9 percentage points year-on-year on both measures. Adjusted for seasonality, it measured 3.8% according to the DoL and 4.7% according to the labour market survey.

- It can be assumed that unemployment as registered by the DoL will continue to be somewhat lower than the survey-based rate in 2014. Registered unemployment is projected at 3.7% this year and is expected to fall to 3.4% in 2016, which is broadly in line with the May forecast.

- According to the Statistics Iceland wage index, wage increases have been somewhat larger than was assumed in the last forecast. The wage index rose 5.2% year-on-year in the first half of the year. Since the first wage agreements were made in December, it has risen by over 4%, which is the increase assumed by the contracting parties for the entire year (December 2013 to December 2014).

- The pay increases provided for in some of the wage settlements made since the May forecast was prepared have been larger than that forecast assumed. Contractual pay increases will therefore be larger than previously forecast this year. On the other hand, increases are expected to be broadly similar throughout the forecast horizon, as it is still assumed that a relatively front-loaded three-year contract will be negotiated early next year.

The assumptions concerning other wage costs are unchanged from the May forecast, but the outlook is for somewhat weaker productivity growth during the forecast horizon, owing to more rapid growth in hours worked than was assumed in the forecast. Unit labour costs are projected to rise by 4.9% instead of the 4% in the last forecast, with growth averaging 4.1% per year over the forecast horizon, just over 1 percentage point more than was forecast in May. As a result, inflationary pressures from the labour market are likely to be stronger over the forecast horizon than was forecast in May.

Inflation

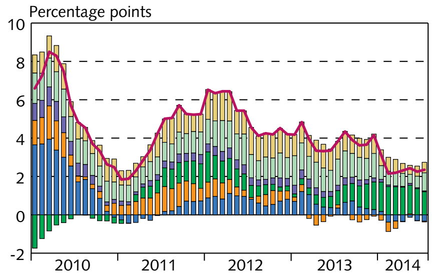
- Inflation measured 2.3% in Q2/2014, about 0.1 percentage points below the May forecast. As before, domestic factors were the main drivers of inflation during the quarter, particularly housing and private services prices. Reductions in imported goods prices offset these factors, however, apart from petrol, which had a slight upward effect on the CPI.

- The CPI fell by 0.17% month-on-month in July, after rising by 0.4% in June and remaining virtually unchanged in May. The drop in July, due to summer sales, was offset somewhat by hikes in international airfares. Sales effects were similar to those from last year but somewhat weaker than during winter sales in January. Twelve-month inflation measured 2.4% in July and was virtually unchanged since just before the last *Monetary Bulletin* was published. About half of twelve-month inflation is due to the housing component, and about 40% stems from increased private services prices. In essence, then, it is due almost entirely to domestic factors. Pulling in the opposite direction were imported goods prices (apart from alcoholic beverages and tobacco), which have fallen by 1.2% in the past twelve months, while the króna has appreciated by 3.8%.

- Twelve-month inflation in terms of various measures of underlying inflation has risen very slightly since the last *Monetary Bulletin*. Core index 3 (which excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense) declined by 0.3% in July, and underlying annual inflation by that measure was 2.8%, as opposed to 2.6% in April. Excluding the market price of housing as well (core index 4) gives an underlying inflation figure of only 1.9% in July, up from 1.3% in April. The increase was due to base effects from the sharp drop in core index 4 in July 2013. Statistical measures of underlying inflation suggest that it lay in the 1-1½% range in July.

- Measures of short-term inflation expectations have changed little since the last *Monetary Bulletin* was published. Households continue to expect inflation to measure 4% in one year's time, and firms project it at 3%. Market agents' expectations and indicators from the breakeven inflation rate in the bond market have also

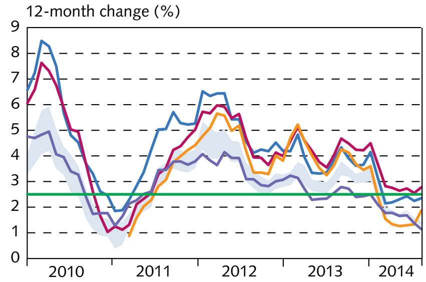
Chart 25
Components of CPI inflation
Contribution to inflation January 2010 - July 2014



Imp. goods excl. alcoholic beverages, tob. and petrol
Petrol
Housing
Domestic goods excluding agricultural products
Private services
Other components
Consumer price index (12-month % change)

Source: Statistics Iceland.

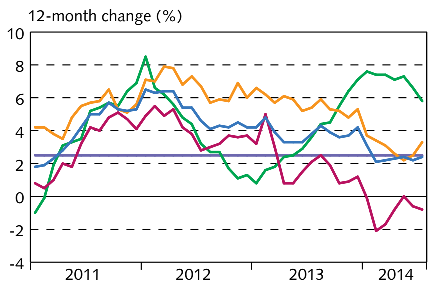
Chart 26
Various measures of underlying inflation
January 2010 - July 2014



CPI
Core index 3 excluding tax effects
Core index 4 excluding tax effects
Inflation target
Weighted median[1]
Trimmed mean - difference between highest and lowest measurement[2]

1. A measure of underlying inflation based on the price change of the weighted median of the CPI components. 2. The trimmed mean is measured as underlying inflation excluding 10%, 15%, 20% and 25% of components with the largest price changes.
Sources: Statistics Iceland, Central Bank of Iceland.

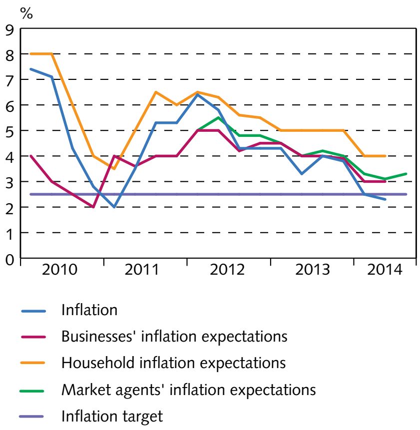
Chart 27
Traded and non-traded inflation[1]
January 2011 - July 2014



CPI
Imported prices (35%)
Domestic prices excluding housing (44%)
Housing (21%)
Inflation target

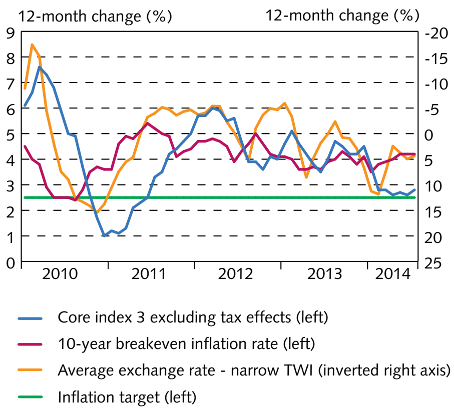
1. Imported inflation is estimated using the price of imported food and beverages, new motor vehicles and spare parts, petrol, and other imported goods. Domestic inflation is estimated using the price of domestic goods and the price of private and public services. The figures in parentheses show the current weight of these items in the CPI.
Sources: Statistics Iceland, Central Bank of Iceland.

Mynd 28
Inflation expectations of businesses, households and market agents one year ahead and inflation
Q1/2010 - Q3/2014



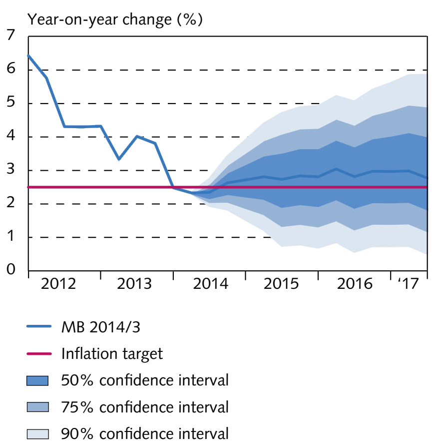
Sources: Capacent Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 29
Core inflation, the exchange rate of the króna and long-term inflation expectations
January 2010 - July 2014



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 30
Inflation forecast and confidence intervals



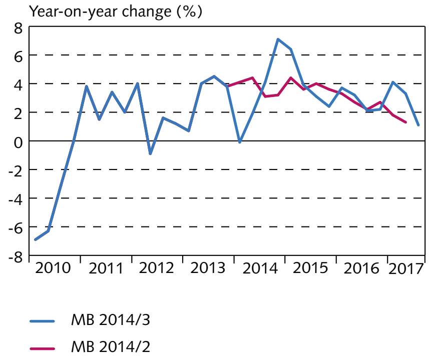
Sources: Statistics Iceland, Central Bank of Iceland.

changed very little. According to these criteria, inflation expectations two years ahead are around 3½%. Indications of long-term inflation expectations are broadly unchanged as well, at about 4%, both five and ten years ahead.

- The short-term inflation outlook is similar to that in May. For Q3/2014, inflation is estimated at 2.3%, or 0.2 percentage points less than was forecast in May, and for Q4 it is projected at 2.6%, which is similar to the last forecast. According to the forecast, inflation will average 2.4% this year. Next year it is expected to rise modestly as spare capacity disappears from the economy, averaging about 2.8%, and in 2016 it is projected at 2.9%, slightly below the May forecast. Implied in this forecast is the assumption that the margin of spare capacity in the economy is greater than previously estimated and the assessment that this outweighs the prospect of larger rises in unit labour costs. According to the forecast, inflation will peak at 3% in the latter half of the forecast horizon and then begin to subside to target in mid-2017.

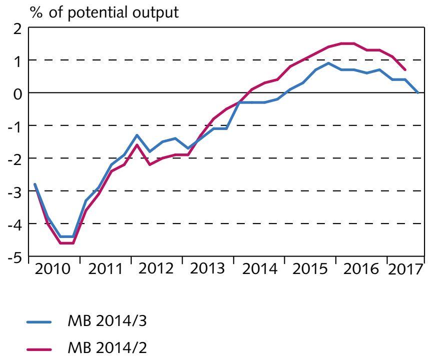
- As before, developments in wage costs and the exchange rate are the most prominent uncertainties in the outlook for inflation over the forecast horizon. Uncertainty about the exchange rate weighs especially heavily in view of the uncertainty about the liberalisation of the capital controls and the settlement of the failed banks' estates. Long-term inflation expectations have been above the Bank's inflation target for some time, and there is still the risk that underlying inflationary pressures are underestimated, particularly if these expectations are reflected in excessive wage demands in upcoming wage negotiations, price list increases, and firms' pricing decisions. House prices have risen somewhat year-to-date, and inflation could prove higher over the forecast horizon if the real estate market livens up still further. Other sources of considerable uncertainty are the impact of the Government's debt relief package and medium-term plans for energy-intensive development. Conversely, inflation could undershoot the forecast if domestic demand or global output growth prove to be overestimated and if global inflation rises less than assumed. Chart 30 illustrates the probability distribution of the inflation forecast. The shaded areas show the confidence intervals in the baseline forecast. According to the probability distribution, there is considered to be a 50%, 75%, and 90% probability that inflation will lie within the relevant ranges during the forecast horizon (the methodology is described in Appendix 3 in *Monetary Bulletin* 2005/1). According to this assessment, the risk profile is tilted to the upside; however, this is highly uncertain as well. There is a roughly 50% probability that inflation will be in the 2-3½% range in one year and in the 2-4% range by the end of the forecast horizon. This is similar to the analysis of uncertainties in the May forecast.

Chart 31
GDP growth – comparison with MB 2014/2



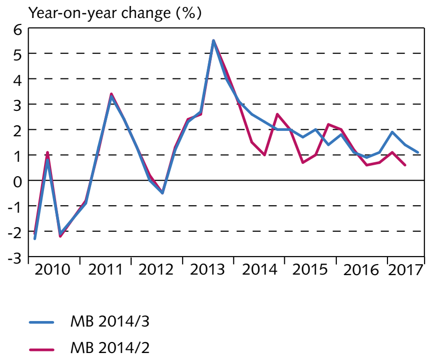
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 32
Output gap – comparison with MB 2014/2



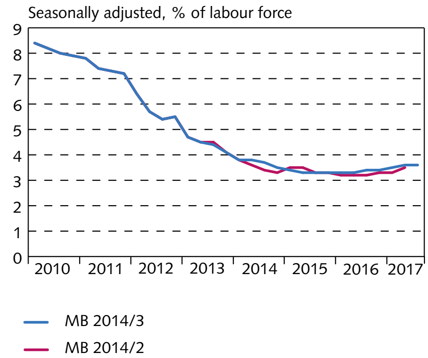
Source: Central Bank of Iceland.

Chart 33
Total hours worked – comparison with MB 2014/2



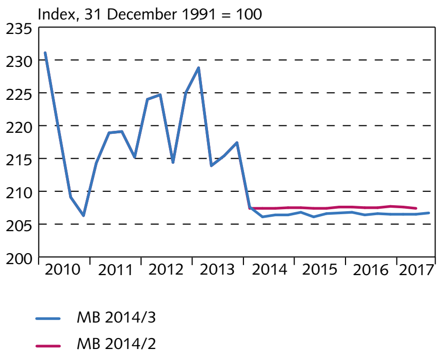
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 34
Registered unemployment – comparison with MB 2014/2



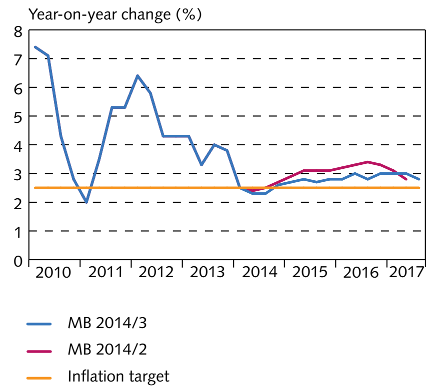
Sources: Directorate of Labour, Central Bank of Iceland.

Chart 35
Trade-weighted exchange rate index of the króna - comparison with MB 2014/2



Source: Central Bank of Iceland.

Chart 36
Inflation – comparison with MB 2014/2



Sources: Statistics Iceland, Central Bank of Iceland.

Appendix 1

Baseline macroeconomic and inflation forecast 2014/3

Table 1 Macroeconomic forecast[1]

GDP and its main components	B.kr. 2013	2013	Forecast 2014	Forecast 2015	Forecast 2016
		Volume change on previous year (%) unless otherwise stated			
Private consumption	957.4	1.2 (1.2)	4.4 (4.4)	4.3 (4.3)	2.9 (2.9)
Public consumption	455.1	1.3 (1.3)	1.1 (0.9)	0.9 (0.8)	0.9 (0.8)
Gross fixed capital formation	243.3	-3.4 (-3.4)	22.2 (19.0)	16.4 (15.6)	19.6 (13.2)
Business investment	154.0	-10.2 (-10.2)	23.0 (20.0)	18.6 (17.9)	24.6 (15.3)
Residential investment	50.8	10.8 (10.8)	27.9 (23.9)	18.8 (17.7)	18.0 (16.4)
Public investment	38.5	11.7 (11.7)	15.1 (9.6)	4.2 (1.5)	-2.0 (-4.1)
National expenditure	1,654.2	0.1 (0.1)	5.8 (5.6)	5.5 (5.2)	5.5 (4.2)
Exports of goods and services	1,027.6	5.3 (5.3)	4.3 (2.9)	3.0 (3.0)	2.6 (2.2)
Imports of goods and services	895.6	-0.1 (-0.1)	8.9 (6.4)	5.9 (5.5)	7.8 (5.0)
Contribution of net trade to growth	-	3.2 (3.2)	-2.0 (-1.5)	-1.3 (-1.0)	-2.5 (-1.3)
Gross domestic product	1,786.2	3.3 (3.3)	3.4 (3.7)	3.9 (3.9)	2.8 (2.7)
Other key figures					
GDP at current prices (in b.kr.)		1,786 (1,786)	1,878 (1,885)	2,025 (2,025)	2,145 (2,140)
Trade account balance (% of GDP)		7.4 (7.4)	5.1 (5.5)	4.4 (4.8)	2.4 (3.1)
Current account balance (% of GDP)		3.9 (3.9)	-0.1 (0.2)	-0.9 (-0.6)	-2.6 (-2.2)
Underlying current account balance (% of GDP)[2]		6.2 (6.2)	0.8 (0.7)	-0.9 (-0.6)	-2.6 (-2.2)
Terms of trade (change in average year-on-year)		-2.4 (-2.4)	0.3 (0.2)	1.5 (1.1)	1.0 (-0.5)
Total gross fixed capital formation (% of GDP)		13.6 (13.6)	16.0 (15.2)	17.8 (16.6)	20.4 (18.2)
Business investment (% of GDP)		8.6 (8.6)	10.1 (9.5)	11.4 (10.6)	13.6 (11.9)
Output gap (% of potential output)		-1.1 (-0.5)	-0.2 (0.4)	0.9 (1.4)	0.7 (1.3)
Unit labour costs (change in average year-on-year)[3]		3.3 (3.2)	4.9 (3.9)	4.4 (3.3)	3.0 (2.5)
Real disposable income (change in average year-on-year)		4.5 (4.3)	4.9 (4.0)	3.0 (2.4)	3.0 (2.3)
Unemployment (% of labour force)		4.4 (4.4)	3.7 (3.5)	3.3 (3.4)	3.4 (3.2)
Average exchange rate - narrow TWI (31/12 1991 = 100)		218.9 (218.9)	206.6 (207.4)	206.6 (207.5)	206.6 (207.6)
Inflation (annual average, %)		3.9 (3.9)	2.4 (2.5)	2.8 (3.1)	2.9 (3.3)
Inflation excluding tax effects (annual average, %)		3.7 (3.7)	2.4 (2.4)	2.8 (3.1)	2.9 (3.3)

1. Figures in parentheses from forecast in *Monetary Bulletin* 2014/2. 2. Adjusted for the calculated income and expenses of banks in winding-up proceedings and the effects of the settlement of their estates. 3. Based on underlying productivity.

Table 2 Quarterly inflation forecast (%)[1]

Quarter	*Inflation (change year-on-year)*	*Underlying inflation (excl. tax effects) (change year-on-year)*	*Inflation (annualised quarter-on-quarter change)*
		Measured value	
2013:2	3.3 (3.3)	3.2 (3.2)	4.1 (4.1)
2013:3	4.0 (4.0)	3.9 (3.9)	1.7 (1.7)
2013:4	3.8 (3.8)	3.7 (3.7)	3.1 (3.1)
2014:1	2.5 (2.5)	2.4 (2.4)	1.1 (1.1)
2014:2	2.3 (2.4)	2.3 (2.3)	3.5 (3.9)
		Forecasted value	
2014:3	2.3 (2.5)	2.3 (2.4)	1.7 (1.9)
2014:4	2.6 (2.7)	2.6 (2.6)	4.2 (3.8)
2015:1	2.7 (2.9)	2.8 (3.0)	1.5 (2.3)
2015:2	2.8 (3.1)	2.8 (3.1)	3.9 (4.6)
2015:3	2.7 (3.1)	2.7 (3.1)	1.4 (1.9)
2015:4	2.8 (3.1)	2.8 (3.1)	4.6 (3.6)
2016:1	2.8 (3.2)	2.8 (3.2)	1.4 (2.7)
2016:2	3.0 (3.3)	3.0 (3.3)	4.8 (5.1)
2016:3	2.8 (3.4)	2.8 (3.4)	0.5 (2.2)
2016:4	3.0 (3.3)	3.0 (3.3)	5.3 (3.0)
2017:1	3.0 (3.1)	3.0 (3.1)	1.3 (2.1)
2017:2	3.0 (2.8)	3.0 (2.8)	4.9 (4.1)
2017:3	2.8	2.8	-0.3

1. Figures in parentheses are from the forecast in *Monetary Bulletin* 2014/2.