



# MONETARY BULLETIN

2013 • 1

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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 developments 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](http://www.sedlabanki.is/?PageID=179).

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Vol. 15 no. 1, 6 February 2013

ISSN 1607-6680, print

ISSN 1670-438X, online

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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.

# Statement of the Monetary Policy Committee

## 6 February 2013

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

Recent economic indicators suggest that output growth was weaker in 2012 than previously anticipated, and the outlook for 2013 is for more modest growth than was forecast in November. Total hours worked have also risen less than previously forecast. Although a slower rate of growth will ease inflationary pressures somewhat as the forecast horizon progresses, near-term inflation is projected to be higher than was forecast in November, owing to a weaker króna. The inflation outlook for the forecast horizon as a whole is therefore broadly unchanged since then.

In the recent term, poorer terms of trade have reduced the trade surplus at a time of extensive currency accumulation for foreign loan payments. The króna has depreciated as a result. There is considerable uncertainty about the persistence of these effects and therefore about near-term exchange rate developments. There is also the risk that self-fulfilling expectations of a depreciation will weaken the króna still further. In view of these conditions, the Central Bank has decided to suspend its programme of regular foreign currency purchases for the time being and support the króna through foreign exchange intervention.

The accommodative monetary stance has supported the economic recovery in the recent term. The rise in interest rates in the past year and a half and the decline in inflation have withdrawn a considerable amount of that accommodation. As spare capacity disappears from the economy, it is necessary that monetary policy slack should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments, which in turn will depend on exchange rate movements and wage-setting decisions in the near future.



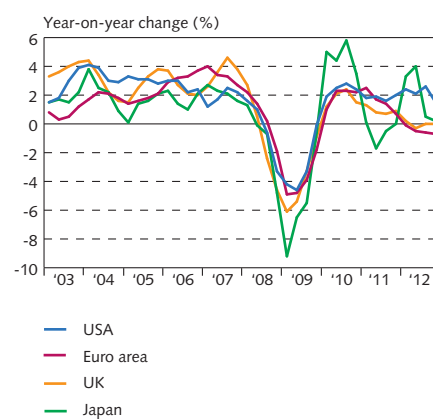
### Domestic recovery loses pace

Global economic activity slowed somewhat towards the end of the year, particularly in countries that rely on exports to the euro area, where exports contracted and consumer sentiment deteriorated. Iceland was among the countries affected, and the most recent indicators suggest that output growth in 2012 was somewhat weaker than anticipated. The updated forecast in this Monetary Bulletin therefore assumes that year-2012 output growth measured 2.2% instead of the 2.5% provided for in the Bank's November forecast. The outlook for 2013 has deteriorated as well, with output growth now projected at 2.1% instead of the nearly 3% in the November forecast. The poorer outlook for 2013 is due primarily to slower growth in energy-intensive investment, although slower growth in private consumption also plays a role. The current forecast assumes that a portion of energy-intensive investment will be shifted from 2013 to 2014-15, slightly improving the output growth outlook for the latter half of the forecast horizon. Output growth is now expected to average approximately 3¾% over those two years, instead of the 3½% assumed in November. Nonetheless, the GDP level is lower throughout the horizon than in the November forecast. Although unemployment has fallen broadly in line with the Central Bank's previous forecast, the increase in total hours worked has been somewhat slower than previously assumed. Because of weaker economic activity, total hours worked are expected to rise less and unemployment to fall more slowly than was projected in November. The inflation outlook has changed little, however, and relatively slow disinflation is still expected, owing to the more or less offsetting effects of the considerably weaker króna and a larger margin of spare capacity than was assumed in November. Although the probability of major shocks such as the dissolution of the euro area or an abrupt increase in fiscal consolidation in the US has declined considerably, the global economic situation is still highly uncertain. Conditions in Iceland's main export markets have deteriorated, particularly in Europe, and terms of trade are poorer than previously projected. As a result, export revenues have been lower, which has contributed to the recent weakness of the króna.

### Global economic affairs and external trade

- Over the course of 2012, output growth lost pace in Iceland's main trading partner countries, some of which experienced a contraction in mid-year. This applies in particular to countries that are heavily reliant on exporting to the euro area, whose exports have slowed markedly; furthermore, the problems facing the euro area have eroded the expectations of households and businesses in these countries, thereby cutting into domestic demand.
- Output growth had turned negative in the euro area at the beginning of 2012, and the contraction became more entrenched as the year progressed. Growth was negative by 0.6% in the third quarter, and preliminary figures indicate a 0.7% contraction in Q4. If those figures are borne out, the contraction for the year as a whole will measure 0.4% in the euro area.
- On the other hand, output growth gained pace in the US as 2012 progressed, measuring over 2½% in Q3. According to preliminary figures, however, it lost pace in Q4, measuring 1.5% for the quarter and 2.2% for the year as a whole.
- In Japan, output growth slowed markedly in the latter half of 2012, after a strong first half following the rebound from the

Chart 1  
International growth  
Real GDP growth Q1/2003 - Q4/2012

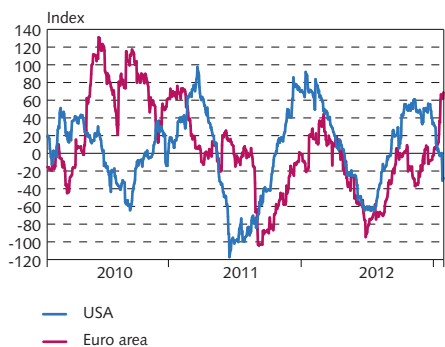


Sources: IMF, Macrobond.

1. The analysis appearing here is based in large part on the Bank's assessment of economic developments, published in November 2012 in *Monetary Bulletin* 2012/4, and on the updated forecast presented here. It is based on data available in early February.

Chart 2  
Economic surprise index<sup>1</sup>

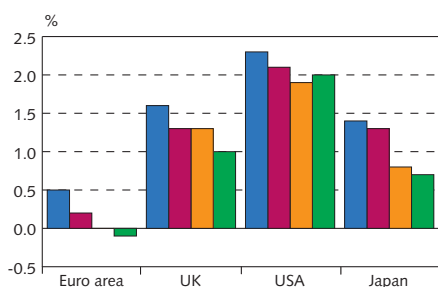
Daily data 1 January 2010 - 1 February 2013



1. When the index is below 0, the indicators are more negative than expected; when the index is above 0, the indicators are more positive than expected. The index does not imply that the indicators are positive or negative.

Source: Macrobond.

Chart 3  
GDP forecasts for 2013<sup>1</sup>

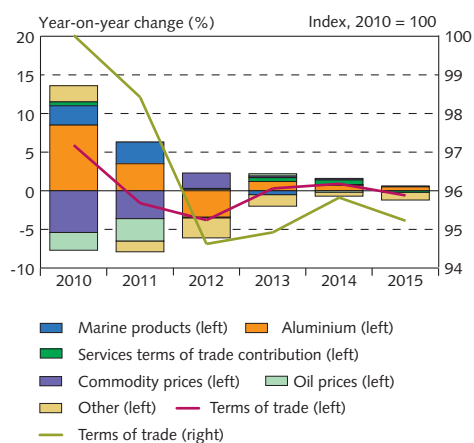


■ July 2012 forecast  
■ September 2012 forecast  
■ November 2012 forecast  
■ January 2013 forecast

1. Based on monthly forecasts from 250 forecasting agencies which are weighted together.

Source: Consensus Forecasts.

Chart 4  
Terms of trade and their main components 2010-2015<sup>1</sup>



1. Central Bank baseline forecast 2012 - 2015. 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.

earthquake that hit the country in March 2011. Preliminary figures imply output growth of only 0.2% in the fourth quarter. A similar tale can be told of the UK, where output growth was flat in the latter half of the year. For the year as a whole, growth is expected to be negative by 0.2%. Developments in the Nordic countries took the same tack, with output growth losing pace as the year progressed and a contraction taking hold in Denmark and Finland.

- In spite of weak growth and contractions in many economies, global financial market conditions have continued to improve. Confidence in official policy action to combat the euro area debt crisis has increased, although the future is still highly uncertain. Fears of tail risks such as the dissolution of the euro area or shocks related to US fiscal policy have abated, although the economic outlook is still highly uncertain.

- Year-2013 output growth forecasts have been adjusted downwards for most of Iceland's trading partners apart from Norway and China. The outlook for 2014 is similar, with all forecasts revised downwards except for China and Brazil. Consensus Forecasts now projects year-2013 output growth at 1.1% for Iceland's chief trading partners, as did the Organisation for Economic Co-operation and Development (OECD) in November and the International Monetary Fund (IMF) in its revised January forecast. The baseline forecast in this *Monetary Bulletin* also assumes 1.1% output growth in 2013 for Iceland's trading partners but has adjusted its year-2014 forecast downwards slightly, to 1.9%. The outlook for 2015 has worsened slightly as well, and the forecast is now for 2.7% growth instead of the 2.9% projected in November.

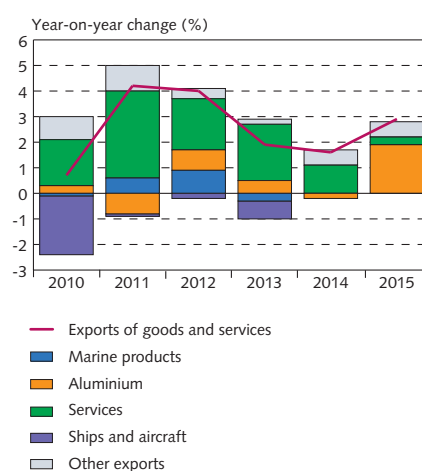
- The inflation outlook for Iceland's major trading partners, however, is broadly unchanged since November. Inflation has been on the wane in most places since the summer and autumn. In Sweden, inflation has fallen steadily since autumn 2011 and has given way to deflation for the second consecutive month. There is deflation as well in Japan, in keeping with the recent pattern. Inflation has risen marginally in Norway and the UK since the autumn.

- Most major central banks around the world have kept their policy rates unchanged since the publication of the November *Monetary Bulletin*, although some have reduced their rates. For example, rates have been cut by 0.25 percentage points in Sweden, Australia, and Turkey, and by 0.50 percentage points in Poland and Hungary.

- World trade contracted markedly in 2012, in tandem with waning output growth. Both the OECD and IMF have revised their world trade forecasts for 2012 and 2013 downwards, to approximately 3% in 2012, as opposed to the more than 4% assumed in the November *Monetary Bulletin*.

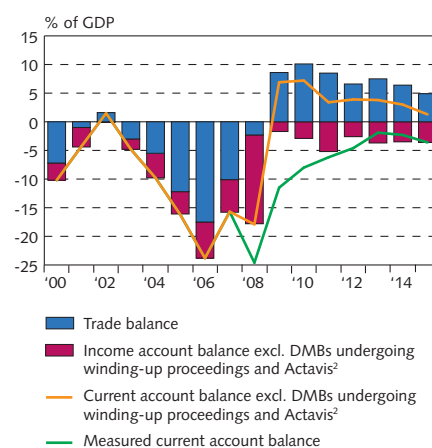
- Global commodity prices fell by 10% year-on-year in 2012, in line with the forecast in the last *Monetary Bulletin*. Prices rose slightly in Q4, however, after falling steeply in the first three quarters. In October, the IMF revised its July forecast for 2012 commodity prices sharply upwards and scaled down the estimated reduction for 2013. It revised its oil price projections still further this January and now assumes a considerably larger drop in 2013 than in its October forecast. The updated forecast in this *Monetary Bulletin* assumes that commodity prices will decrease marginally throughout the forecast horizon, but considerably less than was projected in November. Oil prices are assumed to fall by 3½% this year, which is broadly in line with the November forecast. On the other hand, they are expected to rise more in 2014 and 2015 than was forecast at that time.
- The price of Iceland's main exports will probably be somewhat lower this year than according to the forecast in the last *Monetary Bulletin*. Demersal fish prices are expected to fall considerably this year; however, pelagic fish products are expected to rise somewhat in price, so that the overall decline in marine product prices will measure about 1.8%, as opposed to the 2.1% increase assumed in the November forecast. The outlook for marine product prices in the coming two years is broadly unchanged since November, however.
- The price of aluminium in US dollars is expected to rise by just under 5% this year, as opposed to nearly 8% according to the last forecast. For the forecast horizon as a whole, the price increase is projected at 10% instead of the 15% in the November forecast.
- Terms of trade are expected to be somewhat weaker during the forecast horizon than in the November forecast. They are projected to improve marginally this year and by just under 1% in 2014, while the November forecast assumed an improvement of 1% in both years.
- The real exchange rate has fallen somewhat since the last *Monetary Bulletin*. It rose by an average of 0.8% between 2011 and 2012, due primarily to the nominal appreciation of the króna over the summer, although inflation was also higher in Iceland than in its main trading partners. The real exchange rate is still low in historical context and is expected to remain so throughout the forecast horizon.
- The most recent indicators imply that export growth will be much weaker in 2012 than was provided for in the last forecast, which assumed 4.6% growth, whereas the current estimate is just under 4%. The difference is due primarily to weaker-than-expected exports of marine products in the latter half of the year. Goods and services exports are expected to grow by some 1.8% this year, which is broadly in line with the November forecast. This reflects the offsetting impact of an improved outlook for services exports and a poorer outlook for exports of other goods. The out-

Chart 5  
Export development and its main components  
2010-2015<sup>1</sup>



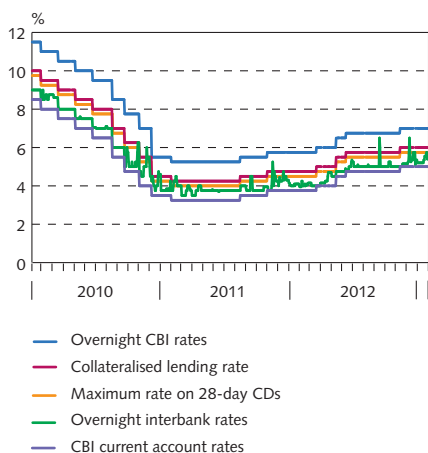
1. Central Bank baseline forecast 2012-2015.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6  
Current account balance 2000-2015<sup>1</sup>



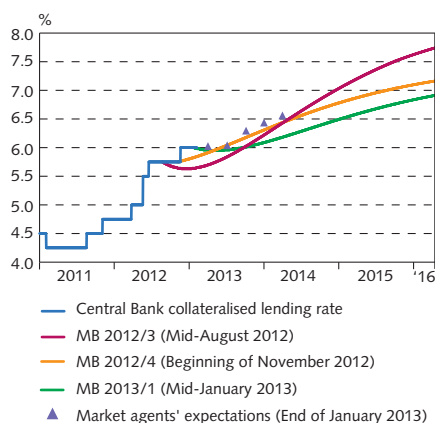
1. Net current transfers are included in the balance on income. Central Bank baseline forecast 2012 - 2015. 2. Excluding calculated income and expense of DMBs in winding-up proceedings but including the effects of the settlement of their estates, and excluding the effects of pharmaceutical company Actavis on the income account balance.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7  
Central Bank of Iceland interest rates and short-term market interest rates  
Daily data 1 January 2010 - 1 February 2013



Source: Central Bank of Iceland.

Chart 8  
Collateralised lending rate, forward market interest rates<sup>1</sup> and market agents' expectations concerning the collateralised lending rate<sup>2</sup>  
Daily data 1 January 2011 - 31 March 2016



1. Interbank interest rates and Treasury bonds were used to estimate the yield curve. Treasury bonds maturing in May 2013 and March 2014 are excluded 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 29 January - 1 February 2013.  
Source: Central Bank of Iceland.

look for the next two years has deteriorated somewhat, however, particularly 2015, when growth in aluminium exports is expected to slow down, owing to delays in energy-intensive investment projects.

- There was a rather sizeable surplus on goods and services trade in the first three quarters of 2012. The total surplus for the year is estimated at 6.6% of GDP, which is in line with the last forecast. As in the November forecast, the surplus is expected to increase this year, to about 7½% of GDP, and then decline to around 6½% in 2014 and just under 5% in 2015. This is a somewhat smaller surplus than was forecast in November and is due primarily to the outlook for slower export growth and poorer terms of trade.
- The deficit in the balance on income is now expected to be considerably smaller than was forecast in November, as reinvested earnings in Q3 were much larger than previously anticipated. The measured current account deficit for 2012 is therefore projected at 4.6%, far below the estimate in the last *Monetary Bulletin*. It is expected to be just under 2% in 2013 and to lie in the 2½-3½% range for the remainder of the forecast horizon, which is somewhat below the November projections. It is estimated that the current account balance will show a surplus of just under 4% if adjustments are made for the calculated net factor income of the deposit money banks (DMBs) in winding-up proceedings and the settlement of their estates, plus the calculated net factor income of pharmaceuticals company Actavis. This is a relatively larger surplus than in the last forecast. It is expected to diminish somewhat next year and average around 2% in 2014-15, which is broadly in line with the November forecast.

## Domestic financial markets

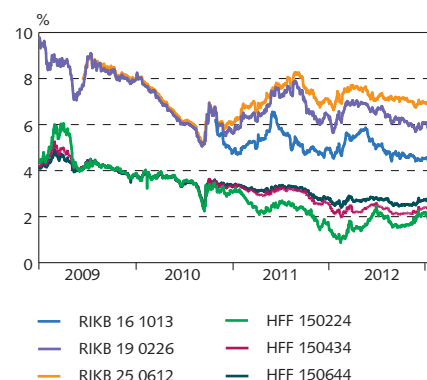
- The Central Bank of Iceland Monetary Policy Committee (MPC) raised the Bank's interest rates by 0.25 percentage points in November, when the last *Monetary Bulletin* was issued, but kept rates unchanged at its December meeting. Prior to the publication of this *Monetary Bulletin*, the current account rate was 5%, the maximum rate on 28-day certificates of deposit (CDs) was 5.75%, the seven-day collateralised lending rate was 6%, and the overnight lending rate was 7%.
- The Central Bank's real interest rate rose concurrent with the policy rate increase in November and is now 0.9%, according to the average of the various measures of inflation and inflation expectations. It is therefore about 0.2 percentage points higher than just before the November *Monetary Bulletin* was published, and about 1.8 percentage points higher than it was a year ago.
- Based on forward interest rates, the market appears to expect the MPC to keep Central Bank rates unchanged in 2013 and then raise them gradually in 2014. In comparison with the outlook in November, the Bank's rates will be lower throughout the



forecast horizon, based on the forward yield curve. Nonetheless, the Central Bank's survey among market participants, conducted in late January, indicates that market participants expect rates to rise by 0.25 percentage points this year. The difference is probably a result of measurement problems at the short end of the yield curve caused by the ineffectiveness of the interbank market, which introduce a measure of uncertainty into the indications of future policy rates provided by forward interest rates. Both the forward yield curve and survey results suggest that markets expect the collateralised lending rate to be 6.5% by year-end 2014.

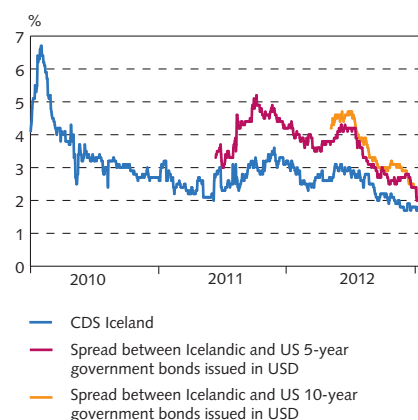
- Interbank market rates have inched upwards, in line with Central Bank rate increases, but have remained below the centre of the interest rate corridor, owing to abundant DMB liquidity. Nominal and indexed bond yields have fallen since November, however, in line with expectations of lower Central Bank rates in coming years. Bond yields fell further in the beginning of February following rumours of a pending change in regulation affecting investment opportunities of foreign bondholders locked in by the capital controls in domestic government bonds.
- Since the last *Monetary Bulletin*, the long-term interest rate spread against German government bonds has narrowed by 0.9 percentage points, to about 4%. The spread on short-term bonds has widened by 0.7 percentage points over the same period, however, and is now 4% as well.
- The CDS spread on five-year Treasury obligations is now 1.7 percentage points, the lowest since mid-2008. It has narrowed by 0.2 percentage points since the November *Monetary Bulletin* and by 1.2 percentage points from the same time a year ago. The premium on Treasury obligations as measured by the spread between five- and ten-year Icelandic Treasury bonds in US dollars and comparable bonds issued by the US Treasury has also narrowed since November, to roughly 2%. Other things being equal, the recent EFTA court judgment in the Icesave case should contribute to a continued reduction in the risk premium on domestic financial obligations and improve Iceland's sovereign credit ratings.
- Since the November *Monetary Bulletin*, the króna has depreciated by 2.2% in trade-weighted terms and by 4.7% against the euro, although it has appreciated by over 2% against the US dollar and the pound sterling. The recent development in the trade-weighted index (TWI) is probably due to a number of factors. For example, temporary factors related to financial institutions' year-end position weakened the króna at the end of the year, domestic firms and institutions have accumulated foreign currency in order to pay down foreign debt, and terms of trade have deteriorated.
- As in previous Central Bank forecasts, the current forecast is based on the technical assumption that the exchange rate will hold more or less steady at the current level throughout the forecast horizon. If this assumption is borne out, the TWI will be around

Chart 9  
Nominal and indexed bond yields  
Daily data 2 January 2009 - 1 February 2013



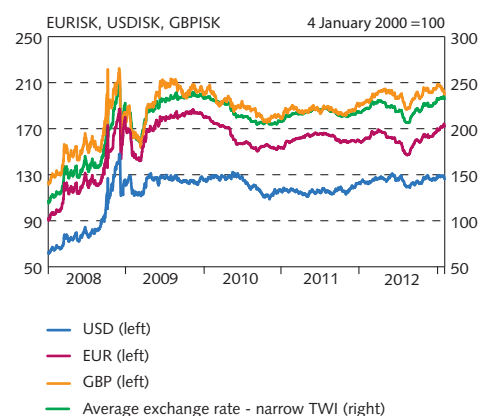
Source: Central Bank of Iceland.

Chart 10  
Risk premia on the Icelandic Treasury  
Daily data 1 January 2010 - 1 February 2013



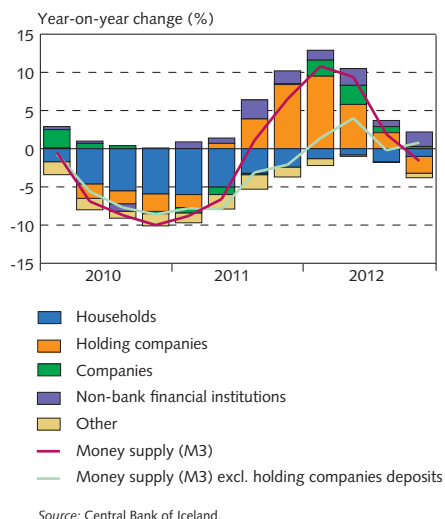
Sources: Bloomberg, Central Bank of Iceland.

Chart 11  
Exchange rate of the króna  
Daily data 3 January 2008 - 1 February 2013



Source: Central Bank of Iceland.

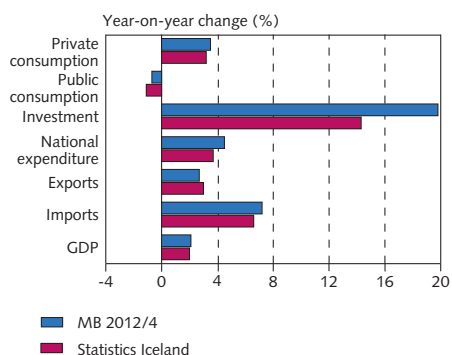
Chart 12  
Components of money supply  
Q1/2010 - Q4/2012



235 points for the majority of the horizon, about 4½% below the level assumed in the November forecast and a full 10% below the level in the August forecast, but close to the level assumed in the forecast published in the May 2012 *Monetary Bulletin*.

- Central Bank base money was up 14% year-on-year in Q4/2012. Over the same period, M3 contracted by 1.6%, while M1 and M2 contracted even more, in part due to transfers from general savings accounts and demand deposits to term deposits. The contraction is due primarily to a decline in holding company deposits, although it is offset somewhat by an increase in deposits of non-banking financial companies. The decline in the money supply need not indicate a downturn in economic activity, however. For instance, domestic agents have used some of their savings to pay down debt. Furthermore, it is likely that they have transferred some portion of their deposits to other investment options offering more attractive returns; for example, holdings in investment funds and corporate bonds have increased. In addition, the banks have sold companies and other assets that they acquired in the wake of the financial crisis.
- In terms of book value, the exchange rate- and inflation-adjusted credit base of households and firms other than holding companies decreased marginally in the first 11 months of 2012. The decline in the credit base is due primarily to exchange rate-linked loans, although indexed pension fund and Housing Financing Fund (HFF) loans have declined as well. The stock of nominal DMB loans has increased, however, reflecting in part the refinancing of older loans.
- Overall, private sector financial conditions have continued to improve. Asset prices have continued rising, and inflation has subsided. Private sector debt has decreased as well, in part due to court judgments on exchange rate-linked loans, although it remains high in international context. The domestic equity securities market has strengthened as well, which should help domestic firms to diversify their funding. On the other hand, the global and domestic economic outlook has deteriorated somewhat, and significant uncertainty remains.

Chart 13  
National accounts Q1 - Q3/2012  
and Central Bank estimate

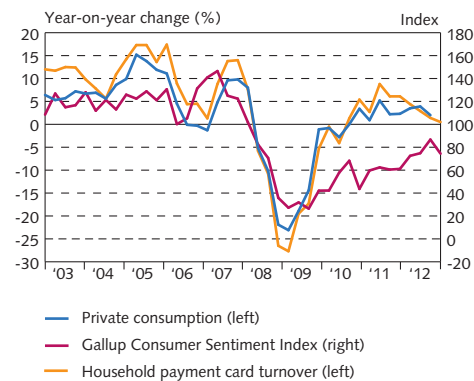


## The domestic real economy

- In December, Statistics Iceland published the national accounts for Q3/2012 and the revised accounts for the first half of the year. According to the national accounts figures, year-on-year output growth measured 2.1% during the third quarter and 2% for the first three quarters, as compared with the same period in 2011. In the first nine months of the year, growth was driven primarily by strong business investment, which grew by 20½%; exports, which were up 3% during the period; and private consumption, which grew 3.2%. Public consumption contracted by 1.1%, however, and, together with net trade, made a negative contribution to output growth.

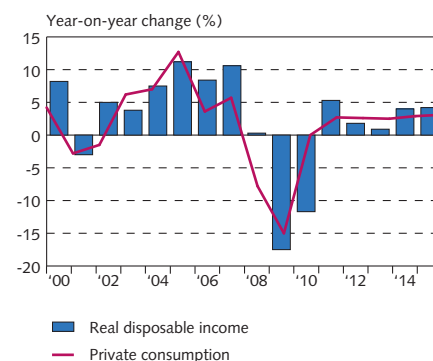
- Output growth was somewhat stronger in Q3 than the 1.7% forecast in the November *Monetary Bulletin*. Because output growth was adjusted downwards by ½ a percentage point in the revised national accounts, it was much closer to the November forecast of 2.1% for the first three quarters of the year.
- Seasonally adjusted private consumption contracted by 0.8% between the second and third quarters. This is well in line with the Bank's November forecast, which assumed a quarter-on-quarter contraction of 0.9%. On the other hand, H1/2012 private consumption was adjusted downwards in Statistics Iceland's revision of previous data; therefore, annual growth turned out 0.3 percentage points weaker in the first three quarters than was forecast in November.
- Leading indicators of developments in private consumption suggest a continuing slowdown in Q4, with year-on-year growth projected at 1.2%, somewhat less than in the November forecast. If this estimate is borne out, private consumption growth for the year as a whole will measure 2.6% instead of 3%, as in the November forecast. Some of the difference can be attributed to the above-mentioned revision of Statistics Iceland's H1 private consumption figures, but the bulk of it appears to stem from a more pronounced drop in household demand in the second half than was assumed in the November forecast. This is in line with slower employment growth than in the November forecast, but it reflects global developments as well, as private consumption growth is contracting rapidly in countries reliant on exports to the euro area. Economic activity has therefore tapered off faster than previously projected, and pessimism is on the rise, as can be seen in the downturn in the Capacent Gallup Consumer Sentiment Index late last year.
- The poorer economic outlook and high level of uncertainty are also considered to affect the near-term outlook for private consumption, although the extension of third-pillar pension savings withdrawals until the end of 2013 and the uptick in household sentiment in January have some counteracting effect. Private consumption growth is now projected at 2.5% instead of the 2.9% in the last forecast. It is also expected to grow more slowly in 2014-15, or by 3% instead of 3.3%, as in the November forecast. Private consumption as a share of GDP will therefore be just under 53% in 2015, considerably below the 30-year average of almost 58%.
- According to preliminary figures from Statistics Iceland, public consumption continued to contract in 2012. The wage component of public consumption has developed broadly in line with previous forecasts, while goods and services purchases are virtually unchanged in nominal terms. The November forecast provided for modest growth. The current forecast takes account of these developments, and it is now estimated that public consumption contracted by 1.1% in 2012, as opposed to the 0.6% provided for in the November forecast.

Chart 14  
Private consumption, consumer sentiment and payment card turnover  
Q1/2003 - Q4/2012<sup>1</sup>



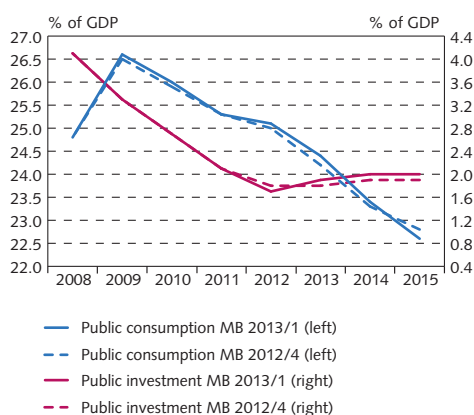
1. Figures for private consumption are only available until Q3/2012.  
Sources: Statistics Iceland, Centre for Retail Studies, Central Bank of Iceland.

Chart 15  
Private consumption and real disposable income 2000-2015<sup>1</sup>



1. Central Bank baseline forecast 2012-2015.  
Sources: Statistics Iceland, Central Bank of Iceland.

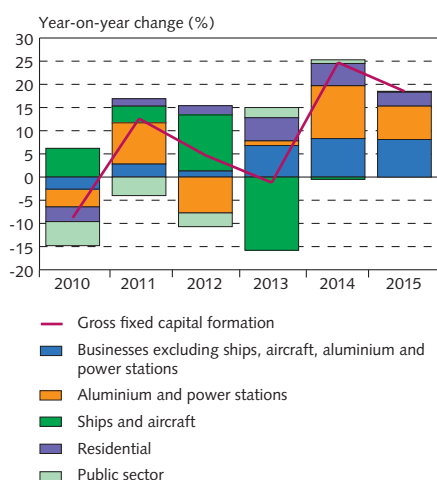
Chart 16  
Public final expenditure 2008-2015<sup>1</sup>



1. Central Bank baseline forecast 2012-2015.  
Sources: Statistics Iceland, Central Bank of Iceland.

- Preliminary figures from Statistics Iceland for the first three quarters of last year also indicate a larger contraction in public investment than in the previous forecast. This is due in part to the fact that central government investment is still somewhat below authorised levels. Public investment is now estimated to have contracted by nearly 20% last year and not 14%, as in the November forecast.
- In spring 2012, the Government issued its *Medium-Term Investment Strategy 2013-2015*. The investments described in the Strategy were to be financed with fishing fees, dividend payments and asset sales. The Bank's November forecast assumed the inclusion of the projects that were provided for in the original fiscal budget proposal. Between the first and second rounds of budget discussions, however, the Government presented a plan for increased investment, which was included in the fiscal budget. That increase is now included in the forecast. Public investment growth will therefore be somewhat stronger this year than was forecast in the last *Monetary Bulletin*. As in previous Central Bank forecasts, however, no investment related to new hospital construction is assumed, as this project is not included in the fiscal budget.
- The National Budget for 2013 was approved in December and is largely consistent with the original budget proposal as regards performance, although revenues and expenditures are higher by 9 b.kr. and 10 b.kr., respectively. According to the budget proposal, the overall balance will show a deficit of 3.7 b.kr., as opposed to 2.8 b.kr. in the original proposal, while the primary balance will be positive by 60 b.kr., which is virtually unchanged from the original proposal.
- Investment contracted by 5.3% year-on-year in Q3. This is a considerably weaker outcome than was assumed in November, when a year-on-year increase of almost 21% was projected. Owing to revisions of figures for the first half of the year, however, the difference is considerably less for the first three quarters combined. According to figures from Statistics Iceland, investment growth over that period measured about 14.3%, or some 5½ percentage points less than in the Bank's November forecast. For the first three quarters of 2012, all subcomponents of investment – business, public, and residential investment – were weaker than forecast. As a result, it is now assumed that total investment grew by approximately 5% last year instead of 9.2%, as in the November forecast. The difference stems primarily from weaker-than-expected investment in energy-intensive projects, although general business investment (excluding energy-intensive industry, ships, and aircraft) was also somewhat weaker than previously projected. Offsetting this, however, investment in ships and aircraft turned out somewhat stronger than was assumed in November.
- Because of the lower level of investment in energy-intensive industry, business investment is projected to be weaker in 2013 than previously forecast. This is mainly because the current

Chart 17  
Gross fixed capital formation and contribution of sub-components 2010-2015<sup>1</sup>

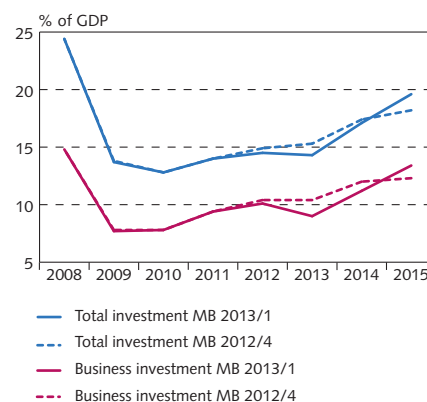


1. Central Bank baseline forecast 2012-2015.  
Sources: Statistics Iceland, Central Bank of Iceland.

forecast assumes that the construction of the first phase of the Helguvík aluminium smelter will begin after mid-2014, a year later than previously projected. The same applies to projects related to energy procurement. In addition, it is assumed that the ongoing project related to the expansion of the Straumsvík smelter will take longer than was assumed in the last forecast. Because of these foreseeable delays, energy-intensive investment will be about 8 b.kr. less in nominal terms during the forecast horizon, as a portion of the planned investment will take place in 2016, which lies beyond the current forecast horizon.

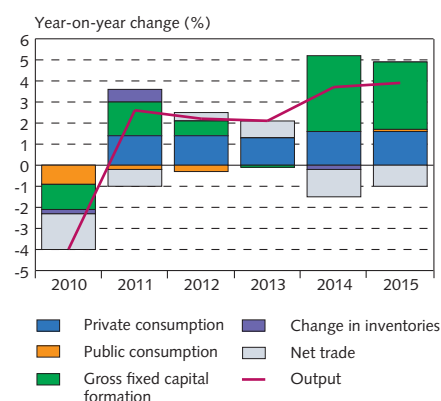
- Owing to the poorer outlook for the domestic economy, general business investment is now expected to grow somewhat slower in 2013 than in the November forecast, or by 20% instead of almost 27%. Slower growth in energy-intensive investment and a sharp decline in investment in ships and aircraft will cause a reduction of just over 11% in business investment this year, instead of the 2% increase provided for in the November forecast.
- In spite of stronger residential and public investment, total investment is now forecast to contract by 1% this year instead of growing by 5.3%, as in the last forecast, owing to the poorer outlook for business investment. In 2014-15, investment is forecast to grow by 19-25%. As compared with the Bank's last forecast, then, the outlook for total investment is weaker in the first half of the forecast horizon and stronger in the second half. This is due primarily to the shift in the path for energy-intensive investment, which is now more back-loaded than before. According to the current forecast, investment will amount to just under 20% of GDP in 2015, a somewhat higher share than was assumed in November.
- As is stated above, output growth measured 2.1% in Q3/2012. In line with slower growth in domestic demand, output growth is now estimated at 2.9% in Q4, about ½ a percentage point less than projected in November. If this forecast materialises, GDP growth for 2012 will measure 2.2%, which is 0.3 percentage points less than in the November forecast. Slower growth in exports and all subcomponents of domestic demand contribute to slower output growth, but the slowdown in investment and private consumption growth weigh most heavily. On the other hand, imports were weaker than was assumed in November, so that the contribution of net trade to output growth in 2012 was somewhat more positive than in the November forecast. Weaker domestic demand and reduced exports are in line with developments in other countries that depend on exporting to the euro area, where economic activity in the second half of 2012 has proven weaker than previously anticipated. Weaker exports and growing pessimism among households and businesses are important factors here.
- For 2013, output growth is also expected to be somewhat weaker than in the November forecast, or 2.1% instead of the previ-

Chart 18  
Investment as a share of GDP 2008-2015<sup>1</sup>



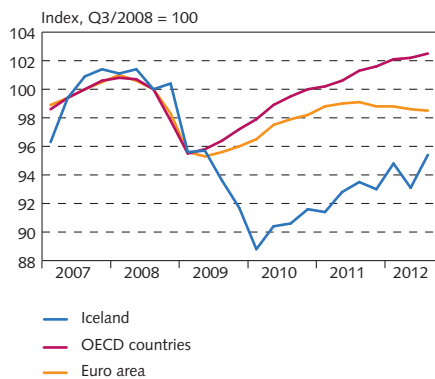
1. Central Bank baseline forecast 2012-2015.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 19  
GDP growth and contribution of sub-components 2010-2015<sup>1</sup>



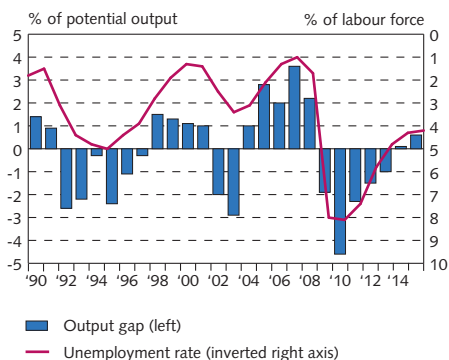
1. Central Bank baseline forecast 2012-2015.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 20  
GDP in Iceland and other developed economies<sup>1</sup>



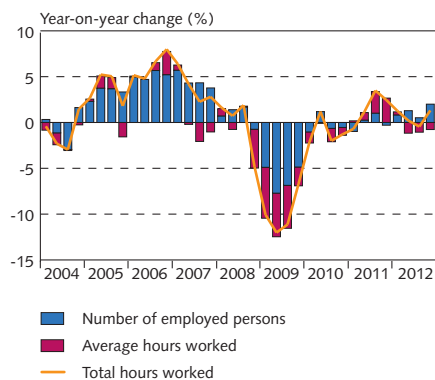
1. GDP data for Iceland are seasonally adjusted by the Central Bank of Iceland.  
Sources: OECD, Central Bank of Iceland.

Chart 21  
Output gap and unemployment 1990-2015<sup>1</sup>



1. Central Bank baseline forecast 2012-2015.  
Sources: Directorate of Labour, Statistics Iceland, Central Bank of Iceland.

Chart 22  
Changes in employment and hours worked  
Q1/2004 - Q4/2012



Source: Statistics Iceland.

ously assumed 2.9%. The downward adjustment is due mainly to slower growth in investment, particularly in the energy-intensive sector, although the slowdown in private consumption also plays a part. The stronger positive contribution from net trade has an offsetting effect, however.

- To counteract weaker output growth in 2012 and 2013, the current forecast assumes slightly stronger growth in the upcoming two years, or 3.7% in 2014 and 3.9% in 2015. The upward revision is due in large part to the aforementioned assumption that energy-intensive investment will be more back-loaded. Output growth for the upcoming two years is therefore driven quite strongly by investment, although private consumption is expected to grow as well. This will be offset by a negative contribution from net trade in both years, however.
- Because of the revision of output growth figures for 2012 and 2013, GDP is estimated to be about 1% less this year than according to the November forecast. Owing to more rapid output growth in the next two years, the gap will narrow as the forecast horizon progresses, although GDP will still be about 0.7% less at the end of the horizon than was forecast in November. It is currently about 5% below the pre-crisis peak, although it has grown by almost 8½% from the trough in H1/2010.
- In view of the fact that year-2012 output growth is now estimated to have been weaker than previously forecast, it is also assumed that the output slack has not diminished as much as was projected in November. The margin of spare capacity is now estimated at 2.3% of potential output in 2011 and 1.5% in 2012. It is expected to continue diminishing this year, measuring about 1% of potential output, although this is 0.4 percentage points more than was provided for in the last forecast. It is expected to disappear by the end of 2014, about half a year later than in the November forecast.
- According to the Statistics Iceland labour market survey, labour demand was somewhat weaker in Q4/2012 than in the November forecast, which provided for a 2.2% year-on-year increase in total hours worked instead of the actual 1.2%. As in the two previous quarters, the slower-than-expected growth was due to a drop in average hours worked. The number of employed persons continued to rise during the quarter, by roughly 2%, the strongest increase since Q4/2007. In 2012 as a whole, the number of employed persons rose by 1.1% year-on-year, and the employment rate rose by 0.8 percentage points. At the same time, total hours worked rose by 0.4%, while labour supply was virtually unchanged. The updated forecast assumes relatively slower growth in total hours worked than in the last forecast, or an average of 1% per year during the forecast horizon.
- Developments in unemployment as recorded by the Directorate of Labour (DoL) have been in line with the last Central Bank

forecast. Seasonally adjusted unemployment measured 5.5% in Q4/2012 and 5.8% for the year as a whole. Seasonally adjusted unemployment as measured by the Statistics Iceland labour market survey was also 5.5% in Q4, but it measured 6% for the year as a whole. It can be estimated that registered unemployment was, on average, 0.2 percentage points lower in 2012 because of labour market initiatives. In addition, registered unemployment will probably be somewhat lower this year than it would otherwise have been because the temporary provision extending entitlement to unemployment benefits from three years to four years expired at the end of 2012.<sup>2</sup> Registered unemployment is forecast to measure 4.8% in 2013 and fall to 4.2% by 2015, which is somewhat higher than the 3.7% provided for in the November forecast.

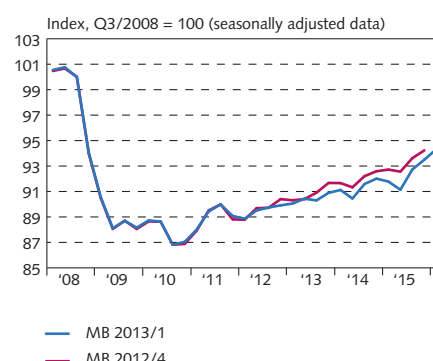
- Wages are expected to rise somewhat more in 2013 than in the November forecast, even though the wage settlement review in January did not trigger any additional pay increases. The upward revision is due primarily to greater wage drift at the end of 2012 than previously assumed, owing most likely to greater wage pressures in the export sector. It is also assumed that State employees' wages will rise more strongly in connection with the layoffs at Landspítali hospital. Because of the shortening of the contract period by two months, which was negotiated during the wage settlement review, it is now assumed that settlements will be reached earlier in 2014 and that the increase between annual averages will be larger that year, although it will be correspondingly smaller in 2015.
- Assumptions concerning other wage-related expenses have changed only slightly since the last forecast, as the payroll tax was reduced by 0.1 percentage point this year when the fiscal budget for 2013 was passed. The agreement reached in the labour market also entailed an increase of 0.1% in employer contributions to job training funds. The increase is to be implemented in stages from January 2014 to January 2015. Unit labour costs will therefore rise by 3-3½% per year during the forecast horizon, somewhat more than in the November forecast and more than is consistent with the Bank's 2½% inflation target.

## Inflation

- Inflation measured 4.3% in the fourth quarter of the year, 0.1 percentage points below the forecast in the November *Monetary Bulletin*. The rise in imported goods prices following the depreciation of the króna from August 2012 onwards had the greatest effect on the CPI in Q4, although it was offset by the drop in

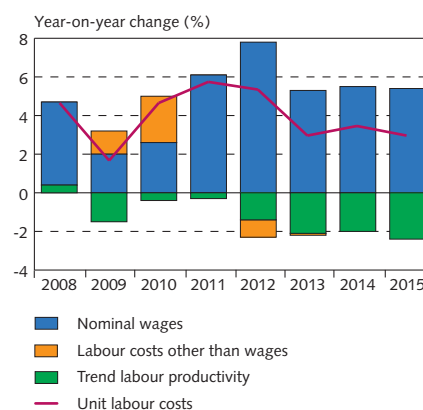
2. About 1,400 people exhausted their benefits at the end of 2012, and an estimated 3,700 will exhaust their benefits this year. The campaign called Effective Employment assumes that most will be offered employment-related labour market measures or employment-related job rehabilitation. Some people will continue to avail themselves of the DoL's employment agency services and will therefore be considered unemployed by the DoL.

Chart 23  
Total hours worked - comparison with MB 2012/4



Sources: Statistics Iceland, Central Bank of Iceland.

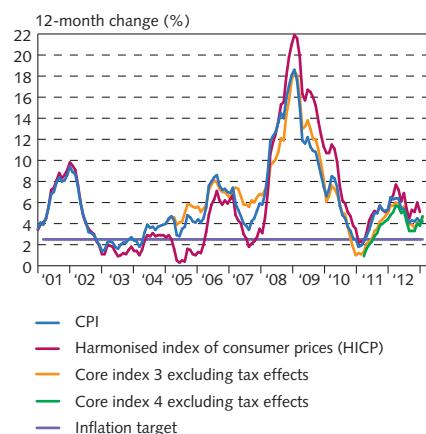
Chart 24  
Unit labour costs and contributions of underlying components 2008-2015<sup>1</sup>



1. Labour productivity growth is shown as a negative contribution to an increase in unit labour costs. Central Bank baseline forecast 2012-2015.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 25  
Various inflation measurements<sup>1</sup>  
January 2001 - January 2013

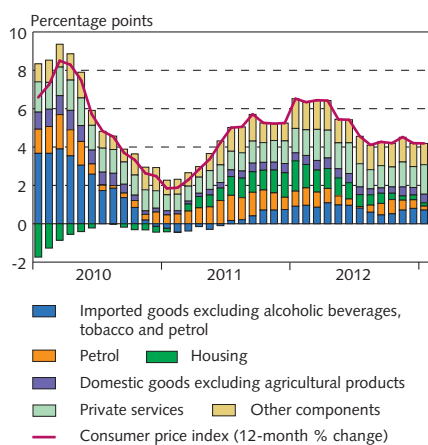


1. Core index 3 is the CPI excluding prices of agricultural products, petrol, public services and real mortgage interest expense. Core index 4 excludes the market price of housing as well.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 26  
Components of CPI inflation

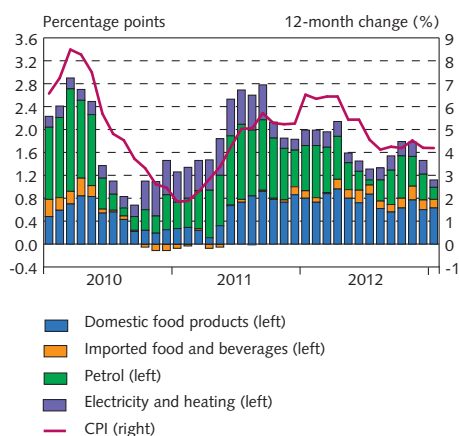
Contribution to inflation January 2010 - January 2013



Source: Statistics Iceland.

Chart 27  
Contribution of food, petrol and energy costs to annual inflation

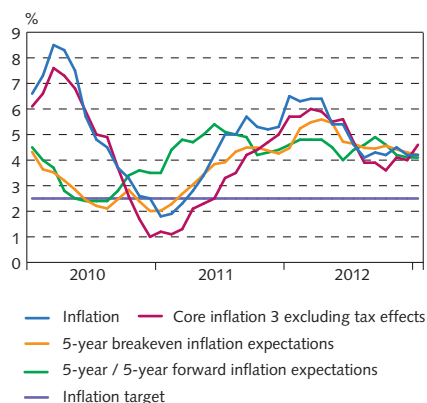
January 2010 - January 2013



Source: Statistics Iceland.

Chart 28  
Annual inflation, core inflation and long-term inflation expectations

January 2010 - January 2013



Sources: Statistics Iceland, Central Bank of Iceland.

petrol prices. Inflation averaged 5.2% in 2012, up from 4% in 2011.

- The CPI rose by 0.3% month-on-month in January, after remaining flat in December and rising by 0.3% in November. The increase in January is due primarily to the rise in the price of public services, new motor vehicles, and groceries, as well as the increase in tobacco taxes. Winter sales had a countervailing effect, however. The CPI excluding the effects of indirect taxes rose by 0.1% month-on-month.
- Twelve-month inflation measured 4.2% in January, which was unchanged from October (just before the publication of the last *Monetary Bulletin*) but down from the year-2012 peak of 6.5% in January 2012. Core index 3, which excludes the effects of taxes, volatile food items, petrol, public services, and real mortgage interest expense, fell by 0.2% in January. Underlying twelve-month inflation according to core index 3 measured 4.6%, up from 3.6% in October. Inflation has therefore risen in the past few months by this measure, although CPI inflation has remained broadly unchanged. In part, this is due to a difference in base effects, as there was an extremely large difference in the change in the CPI and core index 3 a year ago.<sup>3</sup>
- The breakeven inflation rate measured in terms of the spread between nominal and index-linked bonds has fallen since the last *Monetary Bulletin* was published. Both the five-year breakeven inflation rate and the five-year breakeven inflation rate five years ahead are just over 4%, having declined by roughly 0.3 percentage points since mid-November. By this measure, long-term inflation expectations appear to have subsided. They continue to fluctuate in the 4-4½% range, still above the Central Bank inflation target.
- According to the Capacent Gallup survey carried out in December, households' and businesses' inflation expectations have changed very little: households still project inflation at 5.5% one year ahead and 5% two years ahead, while businesses expect inflation to measure 4.5% one year ahead, which is a slight increase from the last survey. A similar result can be seen in the market inflation expectations survey conducted by the Central Bank at the end of January. According to the Bank's survey, market participants expect twelve-month inflation over the next year and on average over the next decade to measure roughly 4½%.
- The inflation outlook for the forecast horizon is broadly in line with the November forecast, with a weaker króna and more front-loaded wage increases counteracting relatively weaker economic activity than in the last forecast. Inflation is projected at 4% in Q1/2013, which is similar to the last forecast. Even though the

3. The CPI rose by 0.3% month-on-month in January 2012, whereas core index 3, excluding taxes, declined by 0.7%.



vast majority of indirect tax hikes in the budget proposal for 2013 were withdrawn, the recent weakening of the króna appears to have generated increased inflationary pressures. Inflation is forecast to average 3.8% this year, slightly more than was projected in November. It is expected to range between 3% and 4% through mid-2014 and then remain in line with the inflation target thereafter, in line with the last forecast.

- The króna has depreciated in trade-weighted terms in recent months, and is at its weakest point since the economic recovery began. As before, the exchange rate is the most prominent source of uncertainty. Other things being equal, if it continues to depreciate, inflation will be higher and taper off more slowly than is assumed in the baseline forecast, while inflation will give way more readily if the króna appreciates again. Inflation expectations have remained above the inflation target for some time. Uncertainty about the wage settlement review has abated for the short term, however, owing to the extension of the current contracts. It appears that the domestic recovery has lost some momentum in the recent past, however, easing inflationary pressures in the second half of 2012 and offsetting the effects of the króna depreciation. If the margin of spare capacity is larger than previously forecast in the near term, inflation will tend to be lower, but as has been the case for some time, the size and development of that spare capacity are highly uncertain.

Chart 29  
Inflation and inflation expectations of businesses, households and market agents one year ahead  
Q1/2003 - Q1/2013

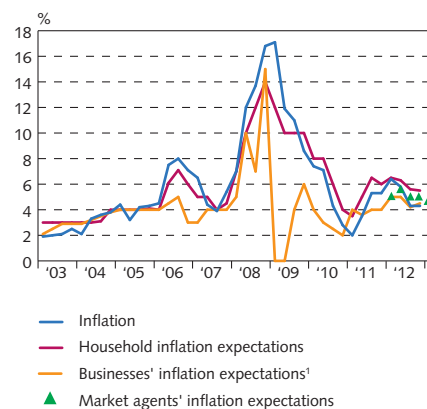


Chart 30  
Inflation with and without tax effects

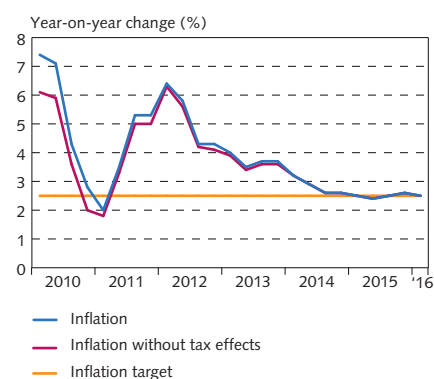
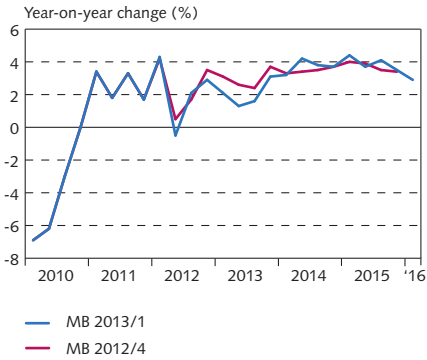
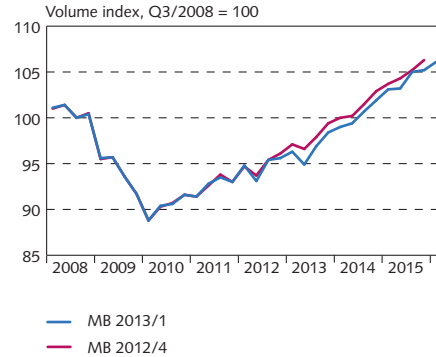


Chart 31  
Output growth - comparison with MB 2012/4



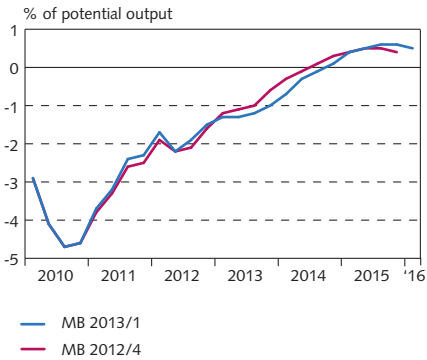
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 32  
Seasonally adjusted GDP - comparison with MB 2012/4<sup>1</sup>



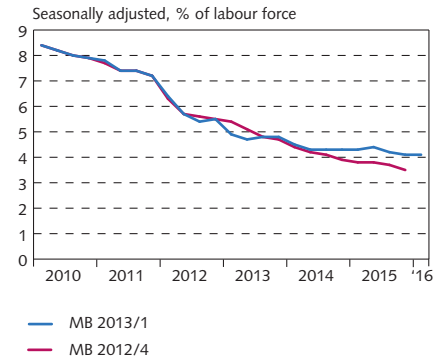
1. Seasonally adjusted data of the Central Bank.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 33  
Output gap - comparison with MB 2012/4



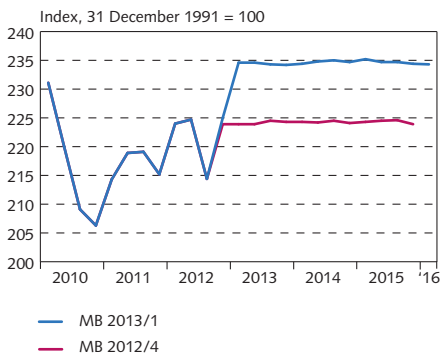
Source: Central Bank of Iceland.

Chart 34  
Unemployment - comparison with MB 2012/4



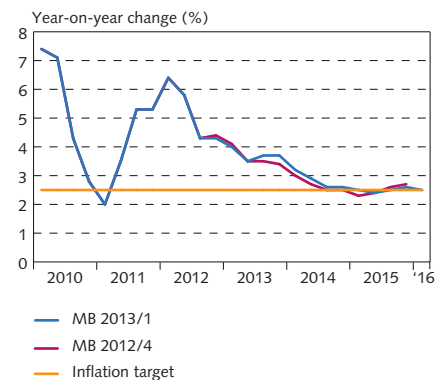
Sources: Directorate of Labour, Central Bank of Iceland.

Chart 35  
The ISK exchange rate against trade weighted index - comparison with MB 2012/4



Source: Central Bank of Iceland.

Chart 36  
Inflation - comparison with MB 2012/4



Sources: Statistics Iceland, Central Bank of Iceland.

## Appendix 1

## Baseline macroeconomic and inflation forecast 2013/1

Table 1 Macroeconomic forecast<sup>1</sup>

GDP and its main components	In b.kr. 2011	Change from prior year (%) unless otherwise specified				
		Forecast				
		2011	2012	2013	2014	2015
Private consumption	844.6	2.7 (2.7)	2.6 (3.0)	2.5 (2.9)	2.9 (3.3)	3.1 (3.3)
Public consumption	411.2	-0.9 (-0.9)	-1.1 (-0.6)	0.1 (0.2)	0.2 (0.2)	0.4 (0.4)
Gross fixed capital formation	227.0	12.8 (12.8)	4.9 (9.2)	-1.0 (5.3)	24.9 (18.3)	18.7 (8.2)
Business investment	152.9	25.1 (25.1)	8.6 (13.2)	-11.4 (2.0)	30.5 (20.1)	23.4 (6.4)
Residential investment	40.0	8.6 (8.6)	11.6 (12.4)	26.3 (17.5)	20.5 (18.7)	13.0 (16.2)
Public investment	34.1	-19.3 (-19.3)	-19.8 (-13.5)	19.0 (5.1)	5.8 (7.1)	1.8 (5.4)
National expenditure	1,487.5	3.8 (3.8)	2.0 (2.8)	1.3 (2.6)	5.4 (4.9)	5.3 (3.5)
Exports of goods and services	964.7	4.1 (4.1)	3.9 (4.6)	1.8 (1.7)	1.5 (1.5)	2.8 (4.6)
Imports of goods and services	825.8	6.8 (6.8)	3.7 (5.6)	0.5 (1.0)	4.2 (3.7)	5.2 (4.4)
Contribution of net trade to growth	-	-0.8 (-0.8)	0.4 (-0.1)	0.8 (0.5)	-1.3 (-1.0)	-1.0 (0.4)
Gross domestic product	1,626.3	2.6 (2.6)	2.2 (2.5)	2.1 (2.9)	3.7 (3.5)	3.9 (3.7)
<i>Other key figures</i>						
GDP at current prices (in b.kr.)		1,626 (1,626)	1,710 (1,724)	1,827 (1,849)	1,947 (1,975)	2,061 (2,089)
Trade account balance (% of GDP)		8.5 (8.5)	6.6 (6.5)	7.5 (7.3)	6.4 (6.6)	4.9 (6.3)
Current account balance (% of GDP)		-6.2 (-7.0)	-4.6 (-8.1)	-1.9 (-3.7)	-2.3 (-4.1)	-3.6 (-4.2)
Current account balance excl. DMBs undergoing winding-up proceedings(% of GDP) <sup>2</sup>		-0.3 (-0.9)	1.9 (-1.0)	1.8 (0.3)	1.1 (-0.5)	-0.5 (-0.9)
Current account balance excl. DMBs undergoing winding-up proceedings and Actavis (% of GDP) <sup>3</sup>		3.4 (2.8)	3.9 (2.4)	3.8 (3.5)	3.0 (2.6)	1.3 (2.0)
Terms of trade (change in average year-on-year)		-1.6 (-1.6)	-3.8 (-2.8)	0.3 (0.7)	0.9 (1.1)	-0.6 (-0.9)
Total gross fixed capital formation (% of GDP)		14.0 (14.0)	14.5 (14.9)	14.3 (15.3)	17.1 (17.4)	19.6 (18.2)
Business investment (% of GDP)		9.4 (9.4)	10.1 (10.4)	9.0 (10.4)	11.2 (12.0)	13.4 (12.3)
Output gap (% of potential output)		-2.3 (-2.5)	-1.5 (-1.6)	-1.0 (-0.6)	0.1 (0.3)	0.6 (0.4)
Unit labour costs (change in average year-on-year)		5.8 (5.7)	5.4 (5.0)	3.0 (2.4)	3.5 (2.7)	3.0 (3.4)
Real disposable income (change in average year-on-year)		5.3 (5.3)	1.8 (0.3)	0.9 (2.4)	4.0 (3.8)	4.2 (4.7)
Unemployment (% of labour force)		7.4 (7.4)	5.8 (5.8)	4.8 (5.0)	4.3 (4.2)	4.2 (3.7)
Average exchange rate - narrow TWI (31/12 1991 = 100)		216.9 (216.9)	222.0 (221.7)	234.4 (224.2)	234.7 (224.3)	234.8 (224.3)
Inflation (annual average, %)		4.0 (4.0)	5.2 (5.2)	3.8 (3.6)	2.8 (2.7)	2.5 (2.5)
Inflation excluding tax effects (annual average, %)		3.8 (3.8)	5.0 (5.1)	3.6 (3.4)	2.8 (2.7)	2.5 (2.5)

1. Figures in parentheses are from the forecast in *Monetary Bulletin* 2012/4. 2. Excluding the calculated income and expenses of DMBs in winding-up proceedings, but including the estimated effects of the settlement of their estates (% of GDP). 3. As in Footnote 2, but also adjusted for the effects of pharmaceuticals company Actavis on the balance on income (% of GDP).

Table 2 Quarterly inflation forecast (%)<sup>1</sup>

Quarter	Inflation (change year-on-year)	Underlying inflation (excl. tax effects) (change year-on-year)	Inflation (annualised quarter-on-quarter change)	
			Measured value	Forecasted value
2011:4	5.3 (5.3)	5.0 (5.0)	3.9 (3.9)	
2012:1	6.4 (6.4)	6.3 (6.3)	6.4 (6.4)	
2012:2	5.8 (5.8)	5.6 (5.6)	8.1 (8.1)	
2012:3	4.3 (4.3)	4.2 (4.2)	-1.0 (-1.0)	
2012:4	4.3 (4.4)	4.1 (4.3)	3.9 (4.5)	
2013:1	4.0 (4.1)	3.9 (3.9)	5.2 (5.0)	
2013:2	3.5 (3.5)	3.4 (3.2)	6.2 (5.5)	
2013:3	3.7 (3.5)	3.6 (3.2)	-0.3 (-1.0)	
2013:4	3.7 (3.4)	3.6 (3.1)	3.9 (4.0)	
2014:1	3.2 (3.0)	3.2 (3.0)	3.0 (3.5)	
2014:2	2.9 (2.7)	2.9 (2.7)	4.9 (4.5)	
2014:3	2.6 (2.5)	2.6 (2.5)	-1.2 (-1.8)	
2014:4	2.6 (2.5)	2.6 (2.5)	3.8 (3.9)	
2015:1	2.5 (2.3)	2.5 (2.3)	2.8 (2.9)	
2015:2	2.4 (2.4)	2.4 (2.4)	4.3 (4.9)	
2015:3	2.5 (2.6)	2.5 (2.6)	-0.8 (-1.0)	
2015:4	2.6 (2.7)	2.6 (2.7)	4.4 (4.3)	
2016:1	2.5	2.5	2.4	

1. Figures in parentheses are from the forecast in *Monetary Bulletin* 2012/4.