V Inflation

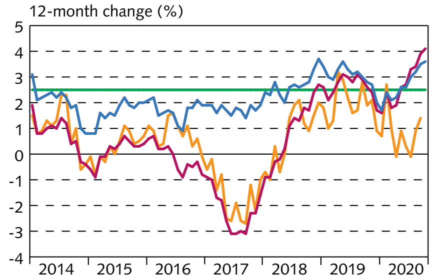
Recent developments in inflation

Inflation has risen in the recent term

Inflation measured 3.2% in Q3, slightly above the August forecast of 3%. In October it measured 3.6% and has therefore risen steeply since June, when it was close to the inflation target (Chart V-1). Inflation excluding housing was somewhat higher, at 4.1%. HICP inflation, however, was only 1.4% in September. The HICP also excludes owner-occupied housing costs, but low HICP inflation mainly reflects the fact that subcomponents capturing tourists' spending while in Iceland carry a proportionally heavier weight in the HICP than in the Icelandic CPI excluding housing. Because of the COVID-19 pandemic, the price of various services items such as airfares and accommodation has fallen year-on-year, and this weighs more heavily in the HICP.[1]

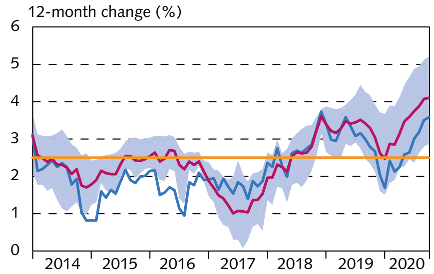
Underlying inflation in terms of the average of various measures was 4.1% in October, an increase of 0.4 percentage points since the last *Monetary Bulletin* (Chart V-2). This could indicate that underlying inflationary pressures are still growing. House prices have also risen recently, in response to interest rate cuts (see Chapter II). The contribution of the housing component of the CPI to twelve-month inflation measured 0.5 percentage points in October, similar to that in July, but the drop in real mortgage interest expense has partly offset the rise in house prices.[2]

Chart V-1
Various measures of inflation
January 2014 - October 2020



Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-2
Headline and underlying inflation[1]
January 2014 - October 2020



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

Indicators of inflationary pressures

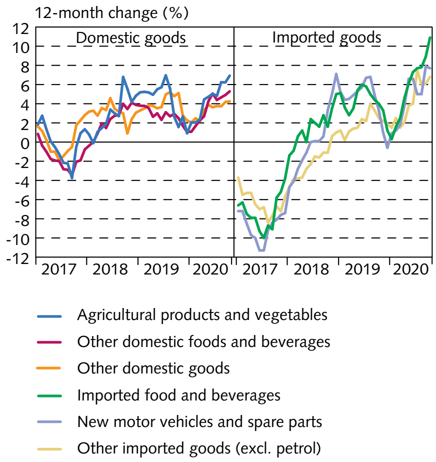
Depreciation of the króna has pushed inflation upwards

The króna has depreciated by 12% since the pandemic reached Iceland in late February (see Chapter II). All key subcomponents of imported goods have risen in price since then, apart from petrol, as global oil prices fell steeply in H1/2020 (Chart V-3). Price hikes on various imported goods such as furniture, housewares, and electronic equipment have weighed heaviest in the recent rise in the CPI. In fact, this subcomponent of the index has risen by 10% in the past twelve months. Domestic goods prices have risen as well, by 5.7% year-on-year in October, led by food prices and imported input prices.

As is discussed in Box 2, demand for various goods increased after public health measures were relaxed in the spring, which probably pushed prices upwards. Given that spending on travel, recreation, and cultural activities has been limited, individuals have to some extent shifted their consumption spending to other categories instead. This probably caused the CPI to underestimate inflation slightly in the recent term.

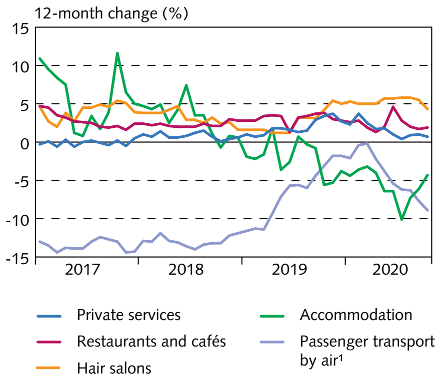
1. The composition of the HICP reflects consumption by everyone in Iceland, including tourists, while the CPI includes only Icelanders' domestic consumption spending. As a result, subcomponents such as airfares, accommodation, and restaurant services weigh heavier in the HICP than in the CPI.
2. Some measures of underlying inflation exclude the impact of lower real mortgage interest expense, but it is estimated that measured inflation was about 0.8 percentage points lower as a result.

Chart V-3
Domestic and imported goods prices
January 2017 - October 2020



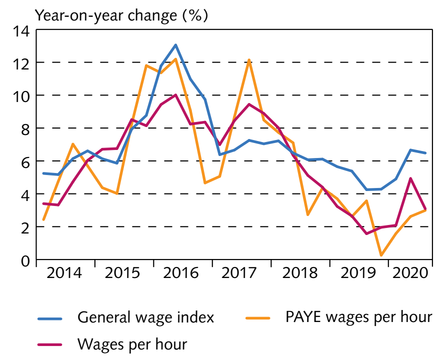
Source: Statistics Iceland.

Chart V-4
Private services and selected subcomponents of the CPI
January 2017 - October 2020



1. Twelve-month moving average.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-5
Wages[1]
Q1/2014 - Q3/2020



1. Wages per hour worked are based on annual figures for the wage portion of the "wages and related expenses" category from the production accounts, as a share of total hours worked according to the Statistics Iceland labour force survey, and are estimated for the year 2020. PAYE wages per hour are PAYE wages per total working hours from the LFS, with Q3/2020 based on July and August averages.
Sources: Statistics Iceland, Central Bank of Iceland.

Changed consumption patterns can also be seen in reduced spending on various types of services that are either unavailable because of public health measures or less in demand because consumers fear contagion. As a result, various private services prices have remained unchanged or fallen between years, as has previously been discussed. Overall, private services prices rose by only 0.7% year-on-year in October (Chart V-4).

Wage agreements hold, reducing uncertainty about medium-term wage developments

The general wage index rose in line with expectations in Q3, or by 0.5% between quarters and 6.5% year-on-year (Chart V-5). PAYE wages per hour rose less, however, or by 3% year-on-year, and have risen less in 2020 than was assumed in the Bank's August forecast. The outlook for wage developments in 2020 as a whole is broadly unchanged, however: wages per hour are expected to rise by an average of just under 3% this year and 3½% in 2021.

Uncertainty about medium-term wage developments eased when, after meeting with the Government early this autumn, the Confederation of Icelandic Employers abandoned plans to vote on terminating private sector wage agreements. At the same time, the Government announced new measures to support businesses, including a temporary 0.25 percentage point payroll tax reduction for 2021. Although the Government measures soften the blow firms would otherwise have sustained, it is clear that the negotiated wage rises taking effect at the beginning of 2021 will be challenging for many of them.

Inflation expectations

Long-term inflation expectations still close to target by most measures

According to recent surveys, households expect inflation to measure 4% in one year's time and businesses project it at 3%, while market agents assume that it will be at target (Chart V-6). Households therefore expect inflation to be higher a year from now than they indicated in the previous survey, whereas firms' and market agents' expectations have remained unchanged.

Long-term inflation expectations have been broadly unchanged in the recent term despite the depreciation of the króna. Among households, businesses, and market agents, they are unchanged from previous surveys and are at target, or close to it, by most measures. It is noteworthy that according to surveys, inflation expectations two or more years ahead are broadly the same as they were a year ago, or even lower. The five- and ten-year breakeven inflation rate in the bond market has averaged 2.6-2.7% in Q4 to date and is therefore also close to target, but somewhat higher than a year ago.[3]

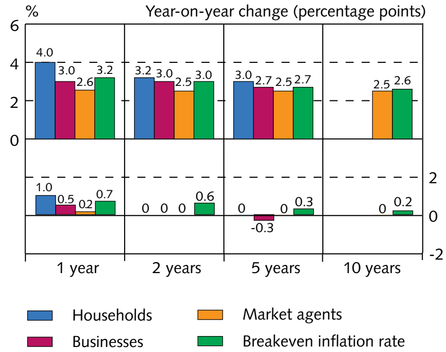
3. It should be noted that a part of recent fluctuation in the breakeven rate is due to technical factors relating to the calculation of indexed Treasury bond yields, as the bond maturing in 2021 was removed from market making. As a result, they are not solely due to changes in inflation expectations. Furthermore, the breakeven rate also includes an inflation risk premium and a liquidity risk premium.

Inflation higher over the forecast horizon than was projected in August

Q3 inflation was somewhat above the August forecast, owing to stronger exchange rate pass-through to imported goods prices and a smaller-than-expected slack in the economy. In addition, global commodity and food prices have risen in the recent term. As a result, the short-term inflation outlook has deteriorated, mainly due to a poorer initial position. Inflation is forecast to measure 3.7% in both Q4/2020 and Q1/2021, about 0.8 percentage points above the August forecast. Nevertheless, it is still assumed that once the effects of the currency depreciation have tapered off, the slack that has opened up in the economy will cause inflation to ease over the course of next year and align with the target in H2/2021. Owing to a continuing economic slack and low global inflation, domestic inflation will decline even further, falling slightly below the target in the latter half of the forecast horizon. It will not fall as much as was assumed in the August forecast, however, mainly because relative import prices are expected to rise more in 2020 and 2021 than was projected in August. The outlook is also for a somewhat smaller slack in output than was assumed in August, as potential output has been revised downwards (see Chapter IV).

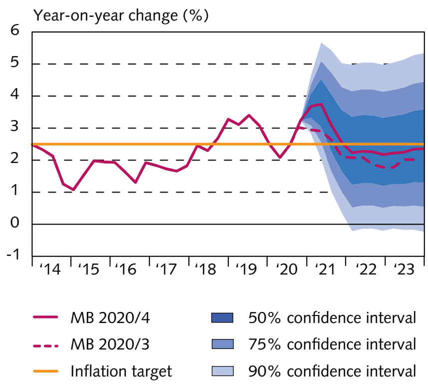
As is discussed in Box 1, the outlook for both the short and long term is highly uncertain. Short-term uncertainty centres mainly on the exchange rate and its effects on inflation, as well as the impact of the pandemic on output and consumption patterns. In the long term, the inflation outlook depends as much on the timing and strength of the economic recovery as it does on the long-term impact of the pandemic on potential output. The risk profile is considered to be similar to that in the Bank's most recent forecasts, and near-term inflation is more likely to be underestimated in the baseline forecast than overestimated. There is a roughly 50% probability that inflation will be within the 1¼-3⅓% range in one year and within a similar range by the end of the forecast horizon (Chart V-7).

Chart V-6
Inflation expectations[1]



1. The most recent Gallup surveys of corporate and household inflation expectations were carried out in September 2020. The most recent Central Bank survey of market agents' expectations is from the beginning of November 2020. Households and businesses are not asked about ten-year inflation expectations. The most recent value for breakeven inflation is the average in Q4/2020 to date. The lower part of the chart shows the year-on-year change.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-7
Inflation forecast and confidence intervals
Q1/2014 - Q4/2023



Sources: Statistics Iceland, Central Bank of Iceland.