13 April 2015

The Governor's introductory address at an open meeting of the Parliamentary Economic Affairs and Trade Committee on the work of the Monetary Policy Committee

The last meeting between representatives of the Monetary Policy Committee (MPC) and the Parliamentary Economic Affairs and Trade Committee took place on 17 November 2014. At that time, inflation had been below target for nine months, and inflation expectations were close to it by some measures. Inflation had yet to decline still further, falling below 1%, the lower deviation threshold of the inflation target, in December – for the first time since the target was adopted on 27 March 2001. Thereafter, long-term inflation expectations declined as well, and by the end of the year they had aligned with the target by most measures.

Because of the rapid drop in inflation and inflation expectations in the final months of 2014, the Bank's real rate rose well above the level the Monetary Policy Committee considered supported by economic fundamentals. As a result, the Committee lowered the Bank's interest rates by 0.25 percentage points in December, following a 0.25-point reduction in November.

It can be said that monetary policy brought inflation back to target last year. Actually, inflation would have fallen still further if the Bank had not bought substantial amounts of foreign currency during the year. To a large extent, however, the steep drop in inflation towards the end of 2014 stemmed directly from the decline in global petrol prices.

The MPC has pointed out that developments in petrol prices are beyond the scope of domestic monetary policy and that disinflation deriving from that source is temporary. In determining interest rates, it is therefore appropriate to look past this temporary decline, just as has been done when inflation has risen temporarily as a result of rising oil prices. If developments in oil prices begin to affect long-term inflation expectations, however, and spread to wage formation, leading to a prolonged period of below-target inflation, a monetary policy response is clearly called for. On the other hand, this is not the case in Iceland at present, as is indicated by developments in inflation expectations and the labour market.

The big picture is that the economic recovery is now well enough advanced that spare capacity is disappearing or has already done so. New national accounts figures show that GDP growth measured 1.9% last year, which is in line with the Bank's forecast from February. The new numbers also confirm the MPC's assessment that earlier figures on GDP growth for the first nine months of the year had been underestimated.

According to the Bank's forecast of 4 February, it is assumed that GDP growth will be considerably stronger this year, or over 4%, and remain strong for the following two years, particularly in view of the fact that we will have reached or perhaps even exceeded full capacity utilisation. The information available so far this year suggests that the forecast of strong GDP growth this year will materialise. The Bank will publish its new macroeconomic forecast on 13 May.

Inflation is below target at present, measuring 1.6%. According to the Bank's February forecast, it will remain below target into next year. This depends on the results of the wage negotiations currently underway, however. In this context, it should be noted that there are signs that inflation expectations have risen again in the first few months of this year and that long-term inflation expectations are now well above the target. This appears to be related to the unrest in the labour market.

The monetary stance is now broadly similar to what it was both in November, when we last met, and a year ago. The Bank's key interest rate is now 4.5%, and the real rate in terms of the average of various measures of inflation and inflation expectations is 2%. The Committee is of the opinion that the Bank's nominal rate is close to the level that is consistent with full capacity utilisation and inflation at target. Future developments in interest rates will depend to a significant degree on the results of the wage negotiations.

As I mentioned in my speech at the Bank's Annual General Meeting on 26 March, Iceland's macroeconomic equilibrium is good at present. But it is fragile, and in this context, we are facing three important risks: first, that lifting the capital controls could turn out badly, with negative implications for exchange rate stability, inflation, and financial system stability; second, that the global economic situation could turn against us; and third, that the interactions between labour market unrest and the turnaround from output slack to a positive output gap could undermine price stability and turn the current account surplus into a deficit. Presumably, we will discuss these risks and other factors here today.