12 September 2013

Report to the Government on inflation in excess of tolerance limits

According to the Act on the Central Bank of Iceland, no. 36/2001, the principal objective of monetary policy is to promote price stability. In the joint declaration issued by the Government of Iceland and the Central Bank of Iceland on 27 March 2001, an inflation target was set for the Bank; that is, the Bank shall aim at a rate of inflation, measured as the twelve-month increase in the consumer price index (CPI), of as close to 2½% as possible. According to the declaration, if inflation deviates more than 1½ percentage points from the target, the Central Bank is obliged to send the Government a report stating what it considers the main reasons for the deviation, how it intends to respond, and how long the Bank anticipates that it will take to bring inflation back to target. This report is to be made public. It is appropriate to reiterate that the above-mentioned tolerance limits do not represent a formal requirement that the Bank take any other action. The Bank's objective is to keep inflation as close to 2½% as possible, on average, and not merely within the tolerance limits.

According to measurements published by Statistics Iceland on 28 August 2013, twelve-month inflation according to the CPI measured 4.3% in August. This is more than 1½ percentage points above the inflation target. The tolerance limits for the inflation target have thus been breached again after inflation fell below the upper limit in March 2013, therefore triggering this report.

Recent developments in inflation

Inflation fell to its post-crisis trough early in 2011. It then began to rise slightly as the year progressed, first due to rising oil prices and the depreciation of the króna, and later, primarily due to sizeable pay increases in the wake of the spring 2011 wage settlements. After it peaked at 6.4% in April 2012, inflation began to taper off again, falling to 3.3% by June 2013. It then began to rise once more, reaching 4.3% by August. The rise in August was attributable in some measure to adverse base effects; that is, the decline in the CPI a year earlier, which can be attributed to the strong appreciation of the króna during the summer.

Two factors have weighed heavily in recent inflation developments. First of all, domestic services prices have increased markedly in the past year; private services rose by 6.7% year-on-year in August, and public services rose by 5%. These two items combined account for almost a third of the CPI. Another important contributor to inflation is the rise in the housing component of the CPI, due partly to increases in various cost items related to operation and maintenance and partly to rising market prices.

Recent inflation appears to be rooted primarily in domestic rather than imported costs. For instance, the twelve-month rise in the price of imported goods excluding alcoholic beverages and tobacco measured only 2% in August. In addition, price increases appear to be rather broad-based. This is also reflected in measures of underlying inflation, which have also risen somewhat since June. Inflation according to core index 3 excluding tax effects measured 4.7%, as opposed to 3.5% in June. Underlying inflation according to core index 4 excluding tax effects has risen as well, from 3.2% in June to 4.2% in August.[1]

Inflation expectations are also around 4% and above. They have developed broadly in line with observed inflation and have risen by most measures since the spring.

Do these developments change the Bank's assessment of the inflation outlook?

According to the Central Bank's last inflation forecast, published in *Monetary Bulletin* 2013/3 on 21 August, inflation was projected to rise from 3.3% in Q2/2013 to 4% in Q3 and 4.1% in Q4. Subsequently, it was forecast to subside, falling to approximately 3% in Q4/2014, approaching the 2½% inflation target in the latter half of 2015, and reaching it early in 2016.

The spurt of inflation in late summer was thus foreseen to a large degree and in line with the Bank's forecast, although the increase is larger than anticipated. At this juncture, there is no reason to change the assessment of the inflation outlook as presented in the Bank's forecast in *Monetary Bulletin* 2013/3.

The Bank will release a new inflation forecast in *Monetary Bulletin* 2013/4, which will be published on 6 November.

[1] Core index 3 excluding tax effects excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense. Core index 4 excluding tax effects also excludes the effects of changes in the market value of housing.

Monetary policy responses

Because the breach of the tolerance limits was foreseen, for the most part, it is reflected in the Monetary Policy Committee's (MPC) last interest rate decision and, in and of itself, does not require special monetary policy responses.

According to the Bank's August forecast, inflation will start to taper off at the beginning of 2014 but will subside gradually and will not reach the inflation target until early in 2016. This very slow pace of disinflation is hardly acceptable; therefore, it is essential to take steps to speed the process up.

To a large extent, this slow pace stems from the fact that the forecast takes account of past experience and assumes that the pay increases following the upcoming wage settlements will be relatively large. Unit labour costs will therefore rise by about 4½% this year and by 4% per year in 2014 and 2015. Other things being equal, this is considerably above the level that is consistent with the 2½% inflation target. According to the forecast, these sizeable wage increases will counterbalance the relatively stable exchange rate and the continued slack in the economy. This development could call for further increases in the Bank's interest rates in the near term, and in any case, interest rates will be higher than they would be if wage increases prove consistent with the inflation target. It is therefore inevitable that, if wage increases are larger than is assumed in the forecast, the MPC will need to respond by raising interest rates.

On the other hand, if pay increases in the upcoming wage settlements are more modest than is assumed in the forecast, inflation will fall more rapidly, other things being equal. Interest rates would then be lower and domestic demand, labour use, and output growth would be stronger than is provided for in the Bank's forecast. To illustrate the advantages of such a development for the Bank's inflation target, if wage increases are in line with both the inflation target and estimated productivity growth in 2014 and 2015, inflation will, other things being equal, return to target in late 2014 or early 2015, a year earlier than is assumed in the baseline forecast. It is vital to take steps to ensure this outcome.

The Bank's principal tool for controlling inflation is its interest rates for transactions with deposit money banks (DMBs). In general, the outlook for inflation persistently above target calls for higher interest rates, with the aim of dampening economic activity and reducing inflationary pressures. In assessing the current situation, it should be borne in mind that the Central Bank has already raised its interest rates significantly since they bottomed out, and the effects of those rate hikes have hardly materialised in full yet.

Another important channel for monetary policy transmission is its influence on the exchange rate of the króna, which also affects wage and price developments. Other things being equal, higher interest rates tend to appreciate the króna, at least temporarily, but because of the capital controls, using the interest rate channel to affect the exchange rate is less effective than it would otherwise be. Both of these channels for monetary policy transmission are highly uncertain. As a result, interest rate decisions and possible foreign exchange market intervention are always a matter of judgement, despite decisions being based on all the relevant information and the best models available for assessing the economic outlook.

In the MPC's view, there has been some spare capacity in the economy since the financial collapse of autumn 2008; that is, capacity has not been utilised to a degree that would stimulate inflation. Therefore, there has been some scope to keep the Bank's real rate temporarily lower than is necessary when capacity is more or less fully utilised. In this way, monetary policy has supported the economic recovery. On the other hand, the MPC has repeatedly emphasised that, as spare capacity disappears from the economy, it is necessary that the slack in monetary policy should disappear as well. The Bank has therefore raised its nominal interest rates by 1.75 percentage points from their historical low in 2011, in order to respond to the inflation outlook and move the real rate closer to its neutral level, i.e. the level that is consistent with low, stable inflation when capacity is close to full utilisation.

Under certain circumstances, interbank foreign exchange market transactions undertaken by a central bank with the aim of mitigating exchange rate volatility can prove to be an important monetary policy instrument, particularly in a small, open economy where exchange rate movements have a strong, rapid effect on the domestic price level. For some time, the Central Bank has announced in its publications that it would step up its foreign exchange market activity with the aim of smoothing out fluctuations in the exchange rate. Under the present circumstances, where inflation expectations have been volatile and insufficiently anchored to the inflation target, it can be expected that wide exchange rate fluctuations could cause inflation expectations to be more volatile than they would otherwise be. In that instance, the inflation target would be harder to attain.

Last May, the Central Bank increased its foreign exchange market activity, with the aim of smoothing out exchange rate fluctuations and thereby contributing to more rapid disinflation than would occur otherwise. The premise for this decision was that foreign exchange imbalances in financial institutions' balance sheets had been reduced considerably and the exchange rate of the króna had for some time been close to the level that, other things being equal, could be considered sufficient to bring inflation back to target in the near future.

During the period since the Central Bank increased its market activity, the daily fluctuation in the exchange rate has been reduced by about half in comparison with a period of equal length prior to the Bank's decision, and fluctuations over a longer period have diminished as well. The MPC hopes that, over time, a more stable exchange rate will provide a better anchor for inflation expectations, thereby contributing to more modest wage settlements and lower inflation. While it is too early to draw conclusions about its success, the intervention policy will remain in place in coming months.

In this context, it is appropriate to emphasise that increased foreign exchange market activity by the Central Bank does not entail a declaration of an exchange rate peg, as Iceland's fundamental exchange rate policy may not be changed in this way without ministerial approval. As was stated when the Bank's intervention policy was announced in May, the policy may be reviewed as decisive steps are taken towards removing the capital controls, as it would be imprudent to use borrowed foreign reserves to reduce the risk of those wishing to convert króna-denominated assets to foreign currency at that time. The exchange rate uncertainty attached to this and the uncertainty about the debt service burden of foreign loans inevitably work against the reduction of inflation expectations to a degree. Successful measures to reduce this uncertainty could therefore contribute to lower inflation expectations.

In addition to the effect of foreign debt service and capital account liberalisation on the exchange rate, two other uncertainty factors will determine the level of Central Bank interest rates required to bring inflation back to target. First, the results of the upcoming wage negotiations will have a strong impact on the speed at which inflation converges to the target, because of the direct effect on firms' wage costs and the indirect effect on the exchange rate. Second, fiscal policy will have a significant impact in the long run, as sufficiently tight fiscal policy can lighten the burden on interest rate policy.

The Monetary Policy Committee's next interest rate decision will be announced on 2 October.