Appendix 2

Report to the Government on inflation below limits

According to data published by Statistics Iceland on 19 December 2014, twelve-month inflation in terms of the consumer price index (CPI) measured 0.8% during the month of December. Therefore, for the first time since the 2½% inflation target was adopted, inflation fell below the lower limit set forth in the joint declaration made by the Government and the Central Bank of Iceland on 27 March 2001, which defined the inflation target and limits for deviation. According to the declaration, the Central Bank must submit a report to the Government if inflation exceeds 4% or falls below 1%. These limits do not entail any other formal requirement vis-à-vis the Central Bank except to oblige the Bank to submit a report explaining the reasons for the deviation from the 2½% inflation target, estimating how long the deviation will endure and, as applicable, stating whether the Bank considers it necessary to take action in response to the deviation from the inflation target.

Recent developments in inflation

After peaking at 18.6% in January 2009, inflation gradually subsided to target by end-2010. In the wake of the spring 2011 wage settlements, which provided for wage increases well in excess of the level compatible with the inflation target, inflation began to increase again, rising to 6.5% in January 2012. It was brought under control with tight monetary policy, however, and fell back to target in early 2014. Since then, it has been at or below target, and by the end of the year it had fallen below the lower limit, to 0.8%.

The recent disinflation episode was even more pronounced in terms of the CPI excluding the housing component, according to which inflation measured 1% early in the year, then fell below 1% in September, and was slightly negative in November. In December, the CPI excluding housing had fallen 0.4% in the previous twelve months.

The decline in inflation has been rather broadly based, and underlying inflation has fallen markedly as well. Various measures of core inflation and statistical measures of inflation indicate that underlying inflation lay in the 0.4-1.4% range in December. The median value of these measures was 1%.

In the recent term, inflation has been driven primarily by domestic factors. Early on, it stemmed from increases in domestic goods and services prices. These increases have lost pace, however, and by this criterion domestic inflation measured 1.8% in December. In 2014, domestic inflation has therefore been driven primarily by the rise in the housing component. The twelve-month increase in the housing component measured 7.6% at the beginning of the year but had tapered off to 4.8% by December.

Global inflation has been very low in the recent past and has been on the decline over the course of the year. The sharp drop in

oil prices – some 50% since the summer – has been a major factor in the recent term. This steep decline has been reflected not only in domestic petrol prices; it has also affected the price of a wide range of goods and services, specifically to include transport and transit prices. At the same time, the króna has appreciated by around 2½% in trade-weighted terms in the past year, even though the Central Bank has leaned against the rise with substantial foreign currency purchases. As of 23 December, the Bank's net foreign currency purchases year-to-date totalled 112 b.kr., or 5½% of estimated year-2014 GDP. In nominal terms, prices of imported goods and services have declined markedly in the recent term. The twelve-month decline has accelerated in the latter half of the year, measuring 2.8% in December.

Short-term inflation expectations have fallen somewhat, in line with falling inflation. Corporate inflation expectations one year ahead recently measured 2.5%. After having hovered around 4% for some time, long-term inflation expectations have also approached the target – both survey-based rates and those determined by the spread between indexed and non-indexed bonds. Given that interest rate spreads reflect both a risk premium and market agents' expectations concerning inflation, it can be assumed that they suggest that long-term inflation expectations are now close to target.

Do recent economic developments change the assessment of the inflation outlook?

The Central Bank published its last inflation forecast in *Monetary Bulletin* 2014/4 on 5 November. According to that forecast, inflation was projected to fall from 2.1% in Q3/2014 to 1.7% in Q4, rise to 2% in Q1/2015, reach the target at mid-year, and remain close to target throughout the forecast horizon, which extended until year-end 2017.

Inflation declined markedly in November, however, and measured 1.3% in Q4, somewhat below the Bank's forecast. This decline will have a marked effect on twelve-month inflation in coming months and, combined with the steep drop in petrol prices, will cause inflation to be somewhat below the November forecast well into 2015.

The Bank will release a new inflation forecast in *Monetary Bulletin* 2015/1, which will be published on 4 February. That forecast will contain a more detailed assessment of the economic and inflation outlook and the key risks to the forecast.

The Monetary Policy Committee's response

The Central Bank's Monetary Policy Committee (MPC) has responded twice to the recent decline in inflation and long-term inflation expectations, lowering the Bank's interest rates by 0.25 percentage points in November and another 0.5 percentage points in December. The Bank's key rate is now 4.5%, down from 5.25% at the beginning of 2014.[1] As is stated in the MPC statement of 10 December, the Committee is of the view that the current interest rate level is close to the level consistent with full capacity utilisation and inflation at target. However, the Committee's statement also says that if inflation remains

1. The key rate is the interest rate that is the most important determinant of short-term market rates and therefore is the best measure of the monetary stance. At present, this is the seven-day term deposit rate.

below target and pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop. On the other hand, excessive pay increases and strong growth in demand could undermine the recently achieved price stability, however, and require that interest rates be raised again.

As is stated above, underlying inflation is low, and CPI inflation excluding the housing component is negative. In spite of this, a protracted deflation episode is unlikely. Nominal demand growth is still significant. Nominal GDP growth measured 3½% in the first three quarters of the year, and nominal wages as measured by the Statistics Iceland wage index grew 5½% over the same period. The margin of spare capacity in the economy has narrowed. It is expected to disappear soon and give way to a small positive output gap. As a result, conditions in Iceland differ markedly from those in many trading partner countries. In most of Iceland's trading partners, spare capacity still exists, nominal growth in demand and wages is negligible, and inflation expectations have fallen below target. This is why their nominal interest rates are considerably lower than in Iceland.

Protracted deflation can be a serious problem, particularly for indebted countries with weak economic growth. Thus there is as much reason to be on the watch against deflation as against inflation. This risk is less pronounced in Iceland than in other developed countries, however, and the negative side-effects of deflation are probably less pronounced as well, as Iceland is a small, open, and export-driven economy where it should be possible to impede deflation by forcing a currency depreciation by lowering interest rates or purchasing foreign currency. Furthermore, the widespread indexation of financial obligations in Iceland means that, in the absence of changes in income, real debt services does not increase during deflation episodes but declines. Unlike the situation in neighbouring countries, where interest rates are as low as can be achieved through conventional monetary policy instruments, the Central Bank's current interest rate level provides the Bank with the latitude to respond to deflation by lowering interest rates.

Prolonged deflation is undesirable for a number of reasons. Although such a situation is unlikely to develop in Iceland at this point, it is the role of monetary policy to direct inflation towards the target specified in the 2001 declaration. In this context, however, it is important to consider three factors that, at this stage, call for a cautious response. First of all, inflation is well below target at present mainly because of declining import prices, which in turn stem from price developments abroad and exchange rate stability at home. On the other hand, wage rises have been far larger than is consistent with the inflation target in the recent past. A turnaround in foreign inflation or in the exchange rate of the króna could cause domestic inflation to rise quickly. Second, inflation expectations have only recently fallen to target, and it has yet to be seen how firmly anchored they are at that level. Third, and certainly not least important, the current unrest in the labour market could trigger an abrupt rise in domestic inflation, irrespective of developments abroad. Therefore, the scope for a further reduction in Central Bank interest rates will remain unclear until the uncertainty in the labour market has subsided.