22 February 2018

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

Today marks exactly one year since members of the Central Bank's Monetary Policy Committee last came before the Parliamentary Economic Affairs and Trade Committee.

A number of things have changed since then. In trading partner countries, the economic outlook has improved and inflation and interest rates are rising, which makes the conduct of monetary policy easier in Iceland. GDP growth has eased in Iceland and demand pressures have subsided, although they remain significant. Inflation is now at target after hovering below it for several years. Inflation expectations have been at target by most measures. The increased short-term exchange rate volatility following large steps taken towards full capital account liberalisation early in 2017 has receded. The Bank's key interest rate has been lowered by 0.75 percentage points.

The slowdown in GDP growth reflects weaker export growth, as the tourism boom could not be expected to continue at the pace seen in the recent past. Furthermore, terms of trade are not expected to improve much in the near future. This means that the effects of the positive shocks that enabled us to grow rapidly and simultaneously keep inflation low are tapering off. The appreciation of the króna played a major role in the economy's adjustment to these shocks, while foreign exchange market intervention and the special reserve requirement on capital inflows were used to prevent overshooting. Now, however, a substantial additional rise in the real exchange rate would entail risks.

Interest rates in Iceland are currently low in historical context, particularly in view of the business cycle position. With one very short-lived exception, indexed Treasury bond rates are at an all-time low, as are indexed mortgage lending rates. Apart from a short period early in this decade, when Iceland was at an entirely different point in the business cycle than it is now, the Central Bank's interest rates are at their lowest since the early 1990s, when they became an important monetary policy instrument. In the absence of an outright slack in the economy, we must therefore be realistic about whether we can expect further rate

cuts. In the coming term, Central Bank rates will reflect economic developments, which could be in either direction.

Monetary policy has delivered good results in the recent term, and the overall economic situation is relatively favourable. Furthermore, according to current forecasts, GDP growth will continue and there will be a soft landing. But the outlook is uncertain and various risks could materialise. It is important in this connection that the level of interest rates and large foreign exchange reserves imply that there is considerable scope to respond to adverse developments. The more firmly long-term inflation expectations are anchored to the target, the greater that scope will be. One of the main tasks of monetary policy, of course, is to strive to anchor inflation expectations at the target. If other decisions that affect domestic cost levels and demand pull in another direction, the resulting tug-of-war could call forth a further rise in the real exchange rate and could adversely affect employment.