

Report to the Government on inflation below the lower deviation limit

According to data published by Statistics Iceland on 26 August 2016, twelve-month inflation in terms of the consumer price index (CPI) was 0.9% in August. Measured inflation was therefore below 1%, the lower limit for the inflation target. According to the joint declaration issued by the Government and the Central Bank of Iceland on 27 March 2001, the Bank is to send a report to the Government if inflation deviates by more than 1½ percentage points from the target. 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 it.

Recent developments in inflation

At the end of 2014, inflation fell below the lower deviation limit of the inflation target for the first time since the target was adopted. The deviation was not long-lived, however, as inflation had moved back within the deviation band only three months later. Since then, and until recently, inflation has measured between 1½% and just over 2%; that is, below the target but within the deviation band. Inflation has now fallen for three months in a row, alongside the appreciation of the króna and low global inflation.

In terms of the CPI excluding the housing component, inflation has been much lower, or -0.9%, and has been below 1% ever since the beginning of 2015. It appears that underlying inflation has also been on the decline. Most measures that the Bank takes account of suggest that it ranged between 1.3% and 2.1% in August, about the same level as at year-end 2014, when measured inflation last fell below the lower limit. Underlying inflation then rose, as did measured inflation.

In the recent term, rising house prices have been the main driver of twelve-month inflation, and the year-on-year rise in the housing component of the CPI measured 7.3% in August. The contribution of

domestic goods to twelve-month inflation has also increased. For example, domestic goods prices rose by 2.4% year-on-year in August. These domestic inflationary pressures have been offset by the appreciation of the króna, falling oil prices, and low global inflation. Prices of imported goods fell by 3.1% year-on-year in krónur terms in August, including a 9.7% drop in petrol prices. Other commodity prices have fallen as well. In Q2/2016, prices of non-oil commodities fell by nearly 12% year-on-year in krónur terms.

Furthermore, as is described in *Monetary Bulletin* 2016/3, published on 24 August, inflation expectations have been gradually declining and appear to be more firmly anchored to the target than before. For instance, at the beginning of 2012, market agents appeared to expect inflation to measure 4½% over the next ten years, but by the beginning of 2015 their ten-year expectations had subsided to 3%. Following the wage settlements that spring, inflation expectations rose temporarily but had fallen back to 3% by August 2016. The breakeven inflation rate in the bond market has developed similarly; it was 5% at the beginning of 2012 but had fallen to just over 3% by early 2015. It rose again as the year progressed, peaking at about 4.8% around the time the new wage settlements were concluded. Since then, it has fallen once again and had aligned with the target by early September.

The inflation outlook

The Central Bank published its last inflation forecast in *Monetary Bulletin* 2016/3. According to that forecast, inflation will average 1.2% in Q3/2016 and then rise to 2.2% in the fourth quarter of the year. The August inflation measurement, which was published a few days afterwards, is well in line with the Bank's most recent forecast. According to that forecast, inflation is quite likely to rise above the lower deviation limit soon, perhaps as early as next month.

As is described in *Monetary Bulletin* 2016/3, it appears that the strong improvement in terms of trade in recent years, low global inflation, the appreciation of the króna, and a tight monetary stance have largely contained the cost effects of the large wage increases negotiated in the recent past. However, if the króna does not appreciate further, its effects will gradually taper off as the forecast horizon progresses. According to the baseline forecast in *Monetary Bulletin*, inflation will be just over 3% by mid-2017 and will peak at 3.8% in the first half of 2018. It will then

begin to ease again and is expected to fall below 3% during the first half of 2019. It is appropriate to emphasise that uncertainty about near-term exchange rate developments is greater than it has been in recent years because of the planned liberalisation of capital controls.

The Bank will release a new inflation forecast in *Monetary Bulletin* 2016/4, to be published on 16 November. That forecast will contain a detailed assessment of the economic and inflation outlook and the key risks to the forecast.

Monetary policy response

On 24 August, the Central Bank of Iceland Monetary Policy Committee (MPC) announced its decision to lower the Bank's key interest rate by 0.5 percentage points, from 5.75% to 5.25%. As is noted in the MPC statement, the Committee considers the inflation outlook to have improved even though demand pressures have begun to develop in the domestic economy. In view of favourable developments in inflation, an improved inflation outlook, and signs that long-term inflation expectations are more firmly anchored than before, the Committee is of the view that it can keep inflation at target over the medium term with lower interest rates than it had previously thought possible.

That notwithstanding, the Committee considers it necessary, as before, to maintain a relatively tight monetary stance so as to ensure price stability over the longer term. GDP growth is strong, and considerably above its long-term trend level. The output slack is considered to have disappeared in 2015, and a positive output gap has developed and is expected to continue growing until next year. Unemployment is now low in historical and international context, and a labour shortage has begun to emerge. Wage increases have been considerable, and well in excess of productivity growth. Unit labour costs have therefore risen sharply, and more than is consistent with 2½% inflation over the medium term. Nominal demand has also grown rapidly, and nominal GDP grew by more than 10% in 2015 and nearly 7% in H1/2016. Although the decline in inflation expectations gives hope of a firmer anchor, it has yet to emerge how susceptible long-term inflation expectations will be to temporary fluctuations in the exchange rate and inflation.

In this respect, conditions in Iceland are quite different from those in most other advanced economies, even though inflation rates are similar

at present. Iceland's main trading partners have seen GDP growth levels well below expectations, and a pronounced slack still remains in most of them. And in many instances, wages have risen only modestly for a long time, which has been a drag on demand growth, among other things. These conditions, together with the current global deflationary pressures, have caused inflation to remain persistently below target in many trading partner countries. As a result, many central banks are concerned that inflation expectations will fall still further and will be below inflation targets for a protracted period. In Iceland, however, the economic recovery has been much more robust than in trading partner countries, wage costs have risen much more, the slack in output has disappeared and a positive output gap opened up, and inflation expectations have been above target until recently. All of this is reflected in higher interest rates in Iceland than in many neighbouring countries.

Nevertheless, in view of the improving inflation outlook and declining inflation expectations, the MPC considered it timely to lower the Bank's nominal interest rates in August, as the Bank's real rate had risen more than the Committee had assumed in June. Near-term developments in inflation and inflation expectations are highly uncertain, and large steps in the capital account liberalisation process lie ahead. As a result, it is not possible to make statements about the Committee's next steps.

The MPC's next interest rate decision will be published on 5 October 2016.