22 February 2017

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, 22 February 2017

Representatives of the Central Bank Monetary Policy Committee (MPC) last attended a meeting of the Parliamentary Economic Affairs and Trade Committee on 29 August 2016.

On the whole, the economic and monetary situation was favourable at that time. The domestic economy was at or above full employment. The outlook was for strong GDP growth in both 2016 and 2017. There were concerns that this could lead to overheating of the economy, which could cause inflation to rise above the target. These concerns were exacerbated by wage increases well in excess of the inflation target plus productivity growth. There were also concerns about an overshooting of the exchange rate in the near term, during the prelude to capital account liberalisation. As a result, the Central Bank was buying foreign currency so as to reduce the likelihood of such a development. The Bank's aim was also to build up the foreign exchange reserves to the desired size before large steps towards liberalisation were taken. In spite of this, inflation had been below target for nearly three years, the inflation outlook had improved, and inflation expectations had subsided to the inflation target by virtually all measures. It was clear that monetary policy was achieving unprecedented success.

The big picture facing us now is broadly unchanged, except that developments have been more favourable than was anticipated at that time. GDP growth in 2016 and 2017 will be stronger, the current account surplus larger, and unemployment lower. The inflation outlook has improved, and inflation expectations are more firmly anchored to the target than before. Inflation is projected to be just below target this year and then peak at 3% in Q2/2019, whereas the Bank's August forecast assumed that it would peak at just under 4% in Q2/2018.

A number of factors have contributed to this outcome. Productivity growth is stronger than was forecast in August, and partly because of this, the rise in unit labour costs is smaller. Terms of trade have improved more than was assumed in August. The tourism industry has been more robust than previously projected. Because of this, the exchange rate of the króna is currently almost 10% stronger than it was when we met with the Committee in August, in spite of sizeable foreign currency purchases by the Central Bank in the interbank market.

When we met with the Economic Affairs and Trade Committee in August, the Monetary Policy Committee had recently lowered the Bank's interest rates by 0.5 percentage points, and the MPC statement was neutral as regarded upcoming interest rate decisions. The MPC then lowered the Bank's interest rates by 0.25 percentage points in December.

The Bank's key interest rate – the rate on seven-day term deposits – is currently 5%. This is a much lower Central Bank interest rate, on average, than Iceland has seen since the mid-1980s, when market-determined interest rates began to make their mark. Of course, this stemmed to an extent from the fact that inflation and inflation expectations were higher than they are now, but it was also because real interest rates were higher.

Many indicators imply that the Central Bank's equilibrium real interest rate has fallen since before the financial crisis. In the recent past, the MPC has discussed how much it may have fallen, but this is highly uncertain. The decline would have to be quite large, however, if a real rate of 2½%—as we have currently, according to inflation expectations—were to be considered abnormally high, particularly given the significant demand pressures that have developed in the economy.

The question of the interest rate level is related to one of monetary policy's main challenges at present. The challenge I refer to is that foreign interest rates are at a historical low at a time when there is a growing output gap in the Icelandic economy. This makes it more difficult than it would otherwise be to maintain the domestic interest rate needed to achieve a balance between demand and supply of domestic factors of production and to keep inflation at target over the medium term. Capital flow management measures and capital controls make this easier, but the capital controls will soon be gone, and it was not intended that the capital flow management measure should be in prolonged use. To an extent, these conditions are temporary, however. There are increasing signs that trading partners' interest rates will rise in the coming term, and the pressures in the domestic economy will ultimately subside in response to economic policy or market adjustment.