



25 April 2016

## 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

Representatives of the Central Bank Monetary Policy Committee (MPC) last attended a meeting of the Parliamentary Economic Affairs and Trade Committee on 11 November 2015.

Since that time, there have been few major developments in interest rates and inflation, as the Central Bank's interest rates have been unchanged, the króna has been relatively stable, and inflation has fluctuated between 1.5% and 2.2%.

Inflation has been at or below target for just over two years. This is the longest such episode since inflation targeting was adopted fifteen years ago, and it has occurred in spite of recent wage increases, which have been far above the level consistent with medium-term price stability. Offsetting the wage increases are deflation in global goods markets and the appreciation of the króna, which measures about 8½% year-on-year. Near-term developments in inflation will depend to a large degree on how the tug-of-war between domestic inflationary pressures and global and exchange rate developments plays out. Oil prices have actually risen from a historical low recently, and most forecasts assume that they will keep rising and that other commodity prices will stop falling soon. At that point, the effects of pay rises and growing tension in the domestic economy could show more strongly in inflation figures; however, the extent and timing of this rise in inflation are uncertain. The recent tightening of the monetary stance has also helped to offset it.

The króna is about 2% stronger than when we met in this forum in November. It would have appreciated much more, however, if the Central Bank had not bought large amounts of foreign currency. During the first quarter of 2016, the Bank's net foreign currency purchases totalled 97 b.kr., as opposed to 34 b.kr. in the first quarter of 2015. Because of these recent currency purchases, the Central Bank's foreign exchange reserves have grown and the proportion financed domestically has risen.

The scope of foreign currency purchases is one of the issues facing monetary policy conduct at present. The equilibrium exchange rate of the króna has risen in the recent term, owing to improvements in terms of trade, reduced domestic debt following the settlement of the failed

banks' estates, and the growth of tourism. If intervention in the foreign exchange market prevents a rise in the nominal exchange rate following a rise in the equilibrium exchange rate, the ultimate result will be increased inflation. At present, several factors weigh against this. First of all, the auction of offshore krónur and the liberalisation of capital controls on Icelandic residents lie ahead. These call for strong foreign exchange reserves. Second, there are restrictions on capital outflows but not on inflows, which have grown considerably. Third, it is uncertain how durable the improvement in terms of trade and the growth of tourism will prove to be. Given all of these factors, the foreign currency purchases must be deemed appropriate. This situation shows, however, how important it is to be able to take decisive steps towards lifting controls on Icelandic residents as soon as possible.

At our last meeting, we discussed the disruptions in monetary policy transmission that are caused by increased carry trade. That situation is largely unchanged, but capital flow management tools are now being developed in order to restrict carry trade when needed. In spite of this, monetary policy transmission along the interest rate channel has been partially effective, as banks' non-indexed interest rates have broadly reflected changes in Central Bank rates.

The Central Bank's key interest rate is currently 5.75%. It is perhaps somewhat higher than would be needed if the economy were in balance, with inflation at target and neither a positive nor a negative output gap. This is not inappropriate, however, because forecasts suggest that inflation could rise somewhat above target in the coming term and a positive output gap has already developed in the domestic economy. Furthermore, the tighter monetary stance in the past year is one of the reasons inflation has remained below target, and furthermore, a positive real rate encouraged increased private sector saving, which has contributed to the current account surplus. But it is understandable that opinions about the monetary stance at any given time should differ, as statistics concerning the recent past contain measurement errors and the future is uncertain.

Included with the documents distributed to you prior to this meeting are some recent speeches in which I discuss the monetary policy framework that is currently being developed but must be finalised and formalised before capital controls on Icelandic residents are fully lifted. Because our time today is limited, I cannot expand on that topic now, but we are ready and willing to answer questions about it and to discuss anything related to monetary policy with you.