

3 Report to the Government on inflation above the deviation threshold

According to measurements published by Statistics Iceland on 26 January 2020, twelve-month inflation in terms of the consumer price index (CPI) was 4.3%. The Central Bank of Iceland's inflation target is 2½%, according to the declaration issued by the Government and the Central Bank on 27 March 2001, which also specifies a deviation band of 1½% from the target in either direction. Thus, inflation exceeded the 4% upper deviation threshold for the Central Bank's inflation target.

According to the March 2001 declaration, the Central Bank is to send a report to the Government if inflation rises above or falls below the deviation thresholds. The report is to explain the reasons for the deviation, how the Bank intends to respond, and how long the Bank anticipates that it will take to bring inflation back to the target. The report of the Bank shall be made public. The Bank last sent a report on inflation above the upper deviation threshold on 3 January 2014, and on 9 September 2016 it submitted a report when inflation fell below the lower threshold.¹

The January 2021 inflation measurement was slightly above the Bank's forecasts but nevertheless did not come entirely as a surprise. A key factor in this is highly unfavourable base effects, as the CPI fell much more between months in January 2020 than it did in January 2021. This year's winter sales were smaller in scope than those a year ago, perhaps due to some extent to stronger-than-expected domestic demand during the run-up to the Christmas holidays. In addition to the weaker seasonal sale effects, the price of housing, food, and petrol rose, pushing inflation upwards.

The inflation seen over the past twelve months is due in large part to the depreciation of the króna in 2020, and the CPI components that are most sensitive to exchange rate movements have risen the most. For instance, prices of imported goods excluding alcoholic beverages and tobacco had risen by 7.1% year-on-year in January. In Q4/2020, the króna depreciated by 12.5% year-on-year in trade-weighted terms, but the largest depreciation occurred in Q1. In recent months, the króna has appreciated again, and there are signs that the exchange rate pass-through from the depreciation of the króna to imported goods prices has weakened.

The inflationary effect of a lower exchange rate should therefore continue to diminish.

House prices have also risen in the recent term, or by 8.9% over the past twelve months. It is clear that economic policy actions by the Government and interest rate reductions by the Central Bank have stimulated demand in the real estate market. The housing component of the CPI has only risen by 3.6%, however, as rent has risen much less than house prices have, and lower real interest expense has pulled in the opposite direction. Domestic goods prices have risen as well, to some extent reflecting the resilience of domestic demand, which in turn is supported in part by sizeable wage increases, although rising prices of imported inputs also affect the price of domestic goods. Private services prices have not risen substantially in the past year, however, as various services – in the tourism sector, for instance – have suffered as a result of the pandemic and public health measures.

The outlook is for inflation to fall relatively quickly in coming months as the exchange rate pass-through effect from last year's depreciation subsides, especially if the króna remains stable or appreciates. High unemployment and a slack in output should also tend to reduce inflation. According to the Central Bank's most recent forecast, published on 3 February 2021, inflation will peak in Q1/2021 and then taper off relatively quickly over the course of the year, approaching the target by the year-end. According to this, inflation will only be above the 4% deviation threshold for a short time. Inflation expectations have remained relatively stable in the recent term, and long-term inflation expectations are at target by most measures, which is important.

As the Central Bank has stressed repeatedly, the economic outlook – including the inflation outlook – is unusually uncertain at present, owing largely to uncertainty about the COVID-19 pandemic and its impact on global economic activity.

Responses to a breach of the deviation threshold are under the auspices of the Monetary Policy Committee (MPC). The MPC statement of 3 February 2021 specifies that the Committee has decided to keep the Bank's interest rates unchanged and will apply the tools at its disposal to ensure that inflation eases back to the target within an acceptable time frame.

¹ In October 2016, the Bank sent the Minister a letter explaining that, because of an error in Statistics Iceland's measurements, inflation had actually not fallen below the 1% deviation threshold and there had been no need to send the report.