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# 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 13 April of this year.

Since then, the monetary policy landscape has changed markedly, as large segments of the labour market have negotiated wage increases well in excess of the level consistent with the inflation target over the medium term. At the same time, the economic slack that has characterised the domestic economy since the financial crisis has turned around into a positive output gap. Inflation expectations rose sharply in the spring, during the run-up to wage settlements. They have subsided since then, in part because developments abroad and the appreciation of the króna have contained the rise in domestic inflation in recent months. By many measures, however, expectations are still above the inflation target.

According to the Central Bank forecast published earlier this month, inflation will rise in the near future, as the effects of lower oil prices and low global inflation diminish. Inflation will overtake the target in mid-2016, peaking at just over 4% in 2017. It will return to target in 2018. Underlying this forecast is the assumption that monetary policy will respond to increased tension and higher inflation by tightening the monetary stance so as to keep inflation close to target over the medium term.

The MPC has considered it unavoidable to respond to these developments by raising the Bank's interest rates three times since its representatives last met with the Parliamentary Economic Affairs and Trade Committee. The rate increases over this period total 1.25 percentage points: the Committee reversed the 0.75-point reduction from late in 2014, and the Bank's interest rates are now 0.5 percentage points higher than they were just over a year ago. Allowing for the fact that various measures of inflation and inflation expectations give differing results, and although the breakeven inflation rate in the bond market has been distorted by capital inflows, it appears that the

Central Bank's real rate is broadly similar to the real rate from a year ago. The difference is that currently there are demand pressures in the economy and inflation is likely to increase.

The speech I gave at the monetary policy meeting of the Chamber of Commerce on 5 November has been distributed to Economic Affairs and Trade Committee members in advance of this meeting, together with other materials. In that speech, I point out that monetary policy is at a crossroads in many senses, which makes implementation unusually complicated. These crossroads entail several things: the turnaround from negative to positive output gap; the aforementioned developments in the labour market; the interplay between domestic inflationary pressures and global deflationary tendencies, which exacerbates the uncertainty about the near-term inflation outlook; and recent positive developments concerning the resolution of the balance of payments problem and the prospect of capital account liberalisation, which have contributed to strong capital inflows into the domestic Treasury bond market.

Until the MPC's last interest rate increase, this last factor had led long-term Treasury bond interest rates to move in the direction opposite to what the recent rate increases and the messages from the MPC should have warranted. There was limited contagion to other parts of the financial market, however, and nominal commercial bank rates had risen in line with Central Bank rates. Nonetheless, this was a foretaste of what could happen as capital account liberalisation reaches the final stages: the transmission of monetary policy through the interest rate channel could weaken severely and shift increasingly to the exchange rate channel. For this reason, we are now developing tools that could enhance the effectiveness of monetary policy via the interest rate channel when needed.

Since the Bank raised interest rates by 0.25 percentage points earlier this month, however, this development has reversed. Rates at the long end of the bond market have risen well in excess of the interest rate hike, actually, and the yield curve is no longer downward-sloping. It appears that this development reflects two underlying factors: residents have reassessed the situation, and inflows from non-residents have halted. The effect on the banks' interest rates will come clear soon, as the banks usually announce changes in interest rates every ten days.

Both the monetary policy challenges that I have just mentioned and other topics will doubtless give rise to an interesting discussion at our meeting today, and I look forward to hearing Committee members' questions.