29 August 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 25 April 2016.

Since then, a number of developments related to monetary policy have taken place.

First of all, in June, a special reserve requirement was imposed on foreign capital inflows into the bond market and into deposits. As a result, these inflows have virtually halted, and the disturbances in monetary policy transmission associated with them have all but disappeared.

Second, inflation has continued to decline and has been below the Bank's May forecast, which, like its recent predecessors, was based on the technical assumption that the exchange rate of the króna would remain unchanged throughout the forecast horizon. However, between May and the time of last week's interest rate decision, the exchange rate of the króna had risen by 6½%. According to the newly published consumer price index for August, inflation now measures 0.9% and is therefore below the lower deviation threshold of the inflation target. Accordingly, the Central Bank will soon send the Government a report, as is mandated by law. In addition, growth in M3 and total credit has been very modest in the recent term.

Third, inflation expectations have continued to move towards the inflation target, and just before last week's interest rate decision, both short- and long-term expectations were at or very near the target by most measures.

Fourth, the Central Bank's interest rates were lowered by 0.5 percentage points last week. That decision was taken with reference to the developments I have just described, the resulting increase in the Bank's real rate, and the assessment of economic developments and prospects prepared before the Monetary Policy Committee's (MPC) meeting and published in *Monetary Bulletin* last week. In this context, a key factor is the MPC's assessment that it appears that it will be possible to keep inflation at target over the medium term with a lower Central Bank interest rate than was previously considered necessary. How much lower is uncertain, of course, and will become clear in the coming term. Furthermore, both the likelihood of growing demand pressures in the economy and the plans for large steps towards capital account liberalisation in coming months call for caution in upcoming interest rate decisions. The next interest rate decisions will therefore be determined by economic developments and the success of the liberalisation process.

This is very good news, of course. We are on the brink of making more lasting progress with the inflation target than at any time since it was introduced. Monetary policy enjoys more credibility than before, as target-level inflation expectations show. In this context, it was satisfying to see that long-term expectations fell still further after last week's interest rate decision. Both five- and nine-year spreads between nominal and indexed bonds fell by 0.3 percentage points on Wednesday and Thursday, to 2.4% and 2.6%, respectively. Because bond market spreads include both inflation expectations and a risk premium, it is likely that long-term inflation expectations in the market are well in line with the inflation target following the interest rate reduction.

But winning this battle is no guarantee that we have won the war. According to the inflation forecast published by the Central Bank last week, the outlook is for inflation to be below target into 2017 if the exchange rate remains unchanged, and then rise, temporarily overtaking the target when import prices stop falling and the effects of the appreciation of the króna subside. It is our task, however, to try to see to it that this forecast does not materialise and that inflation expectations remain anchored to the target in spite of fluctuations in inflation and the exchange rate in the future.

Favourable external conditions appearing in, for instance, a significant improvement in terms of trade, a burgeoning stream of tourists, and low global inflation certainly play a large role in the positive developments I have just mentioned. On the other hand, inflation has been below target for nearly three years. This low-inflation period is too long to be explained without reference to the effects of monetary policy. For more than two years, a looser monetary stance would doubtless have resulted in higher inflation. An analysis of the drivers of inflation in the recent term supports this conclusion. Furthermore, the recent appreciation of the króna is not independent of monetary policy. Monetary policy therefore plays a role in this positive outcome, and probably a much larger one than many observers realise. Higher interest rates have, among other things, made domestic demand lower than it would otherwise have been and have been conducive to channelling a portion of the sharp rise in disposable income towards saving. As a result, the current account surplus and foreign currency inflows are stronger, which supports the appreciation of the króna. Furthermore, relatively high interest rates and credible MPC statements to the effect that all necessary steps will be taken to keep inflation at target have led firms to be more hesitant to pass wage hikes through to prices.

I will close here, and I look forward to interesting discussions today on a variety of issues relating to monetary policy.