Már Guðmundsson: The work of the Monetary Policy Committee

Opening remarks by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at an open meeting of the Parliamentary Economic Affairs and Trade Committee on the work of the Monetary Policy Committee, Reykjavik, 17 November 2014.

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The last meeting between representatives of the Monetary Policy Committee (MPC) and the Parliamentary Economic Affairs and Trade Committee took place on 5 March 2014.

At that time, inflation had recently fallen below target, while short- and long-term inflation expectations were still above it. By now, inflation has been below target for nine months and is expected to be at target well into 2015, at least. The main difference in the situation now versus that in March is that inflation expectations have fallen back towards the target and, by some measures, are quite close to it, particularly short-term expectations.

The big picture is that the economic recovery is now well enough advanced that spare capacity is disappearing. There still appears to be a sizeable current account surplus, although it has diminished since last year. The surplus covers net capital outflows and significantly more, as the Central Bank has bought foreign currency on the market for the equivalent of 95 b.kr., or 5% of GDP.

According to the Bank's forecast from early November, GDP growth is projected to measure just under 3% this year and then rise to about 3½% in 2015 before easing back to 3% in 2016. This level of growth is expected to exceed the growth potential output, giving rise to a positive output gap, particularly in 2015. Other things being equal, this will contribute to higher inflation.

GDP growth in 2014–2016 will be driven by domestic demand, both private consumption and investment, and the contribution from net trade will be negative for the entire period. As a consequence, the sizeable current account surplus we have seen in 2013 and 2014 will shrink rapidly next year and give way to a small deficit by 2016. This is cause for concern in and of itself, and we hope that this forecast will not materialise, as Iceland needs to maintain a current account surplus in the next several years as it focuses on putting its external debt onto a more solid footing and building up FX-reserves that are not financed with foreign loans. Economic policy and economic incentives would then have to centre on improving the outlook for the current account balance.

According to the forecast, which extends until end-2017, inflation will be at target for the entire forecast horizon, apart for the last quarter of 2015 and the first quarter of 2016. It will average 2.6% for the three-year period from 2014 through 2017, which is well in line with the 2½% inflation target.

But the current equilibrium is fragile, the future is highly uncertain, and there are important known risks ranging from the global economy to the liberalisation of Iceland's capital controls. We will doubtless discuss some of these at this meeting.

On 5 November, the Monetary Policy Committee (MPC) announced its decision to lower the Bank's interest rates by 0.25 percentage points. This was done in view of the rise in the Bank's real rate caused by the past few months' decline in inflation and inflation expectations, which has been more pronounced than previously anticipated. The rise in the real rate was greater than is warranted by the business cycle position and the near-term outlook. In other respects, for the rationale behind the decision, I refer you to the MPC statement and the speech I gave at the Iceland Chamber of Commerce's monetary policy meeting the following day. Naturally, we are also ready and willing to answer your questions about both this decision and the interest rate outlook.

Finally, I would like to mention that the MPC has been examining its monetary policy instruments in the recent term and, although certain changes have been made, this review is still underway. According to the statement from its March meeting, the aim of this review is primarily to ensure that monetary policy instruments are optimally suited to the achievement of monetary policy objectives, given that it is also desirable that monetary policy implementation be as effective, comprehensible, and economical as possible in terms of the Central Bank's balance sheet. We are ready and willing to answer any questions that you have on this topic.