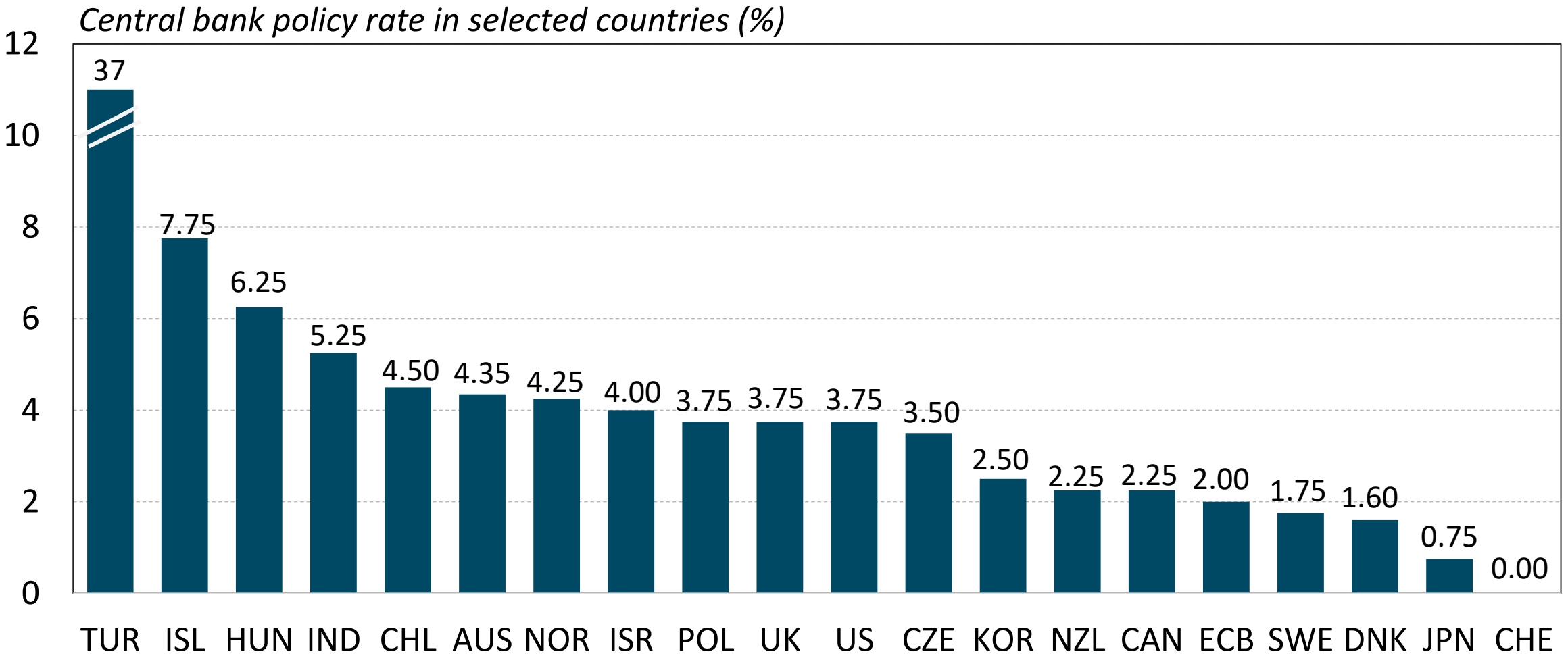
When expectations become de-anchored

Monetary Stability Through Pandemic, War, and Volatility



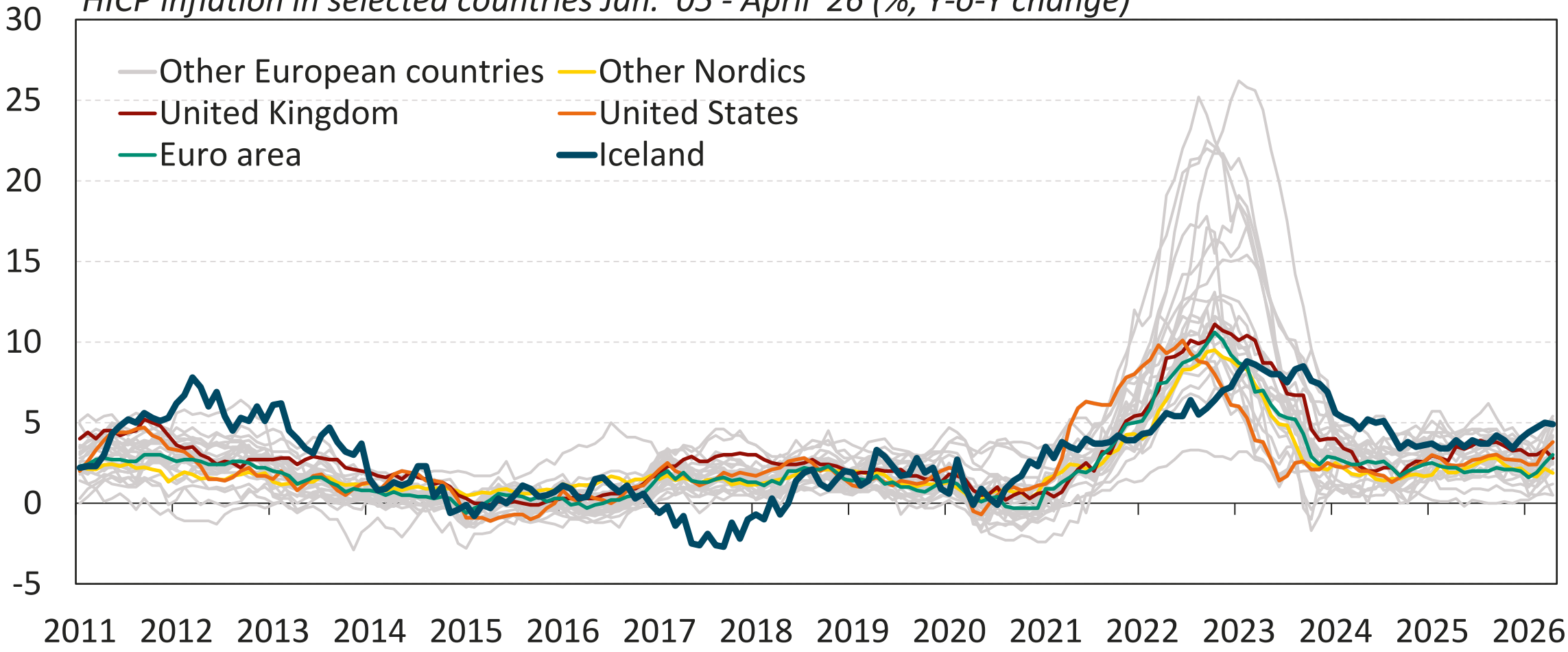
May
2026

Higher for Longer: Iceland has the second highest rate of OECD countries – after Turkey



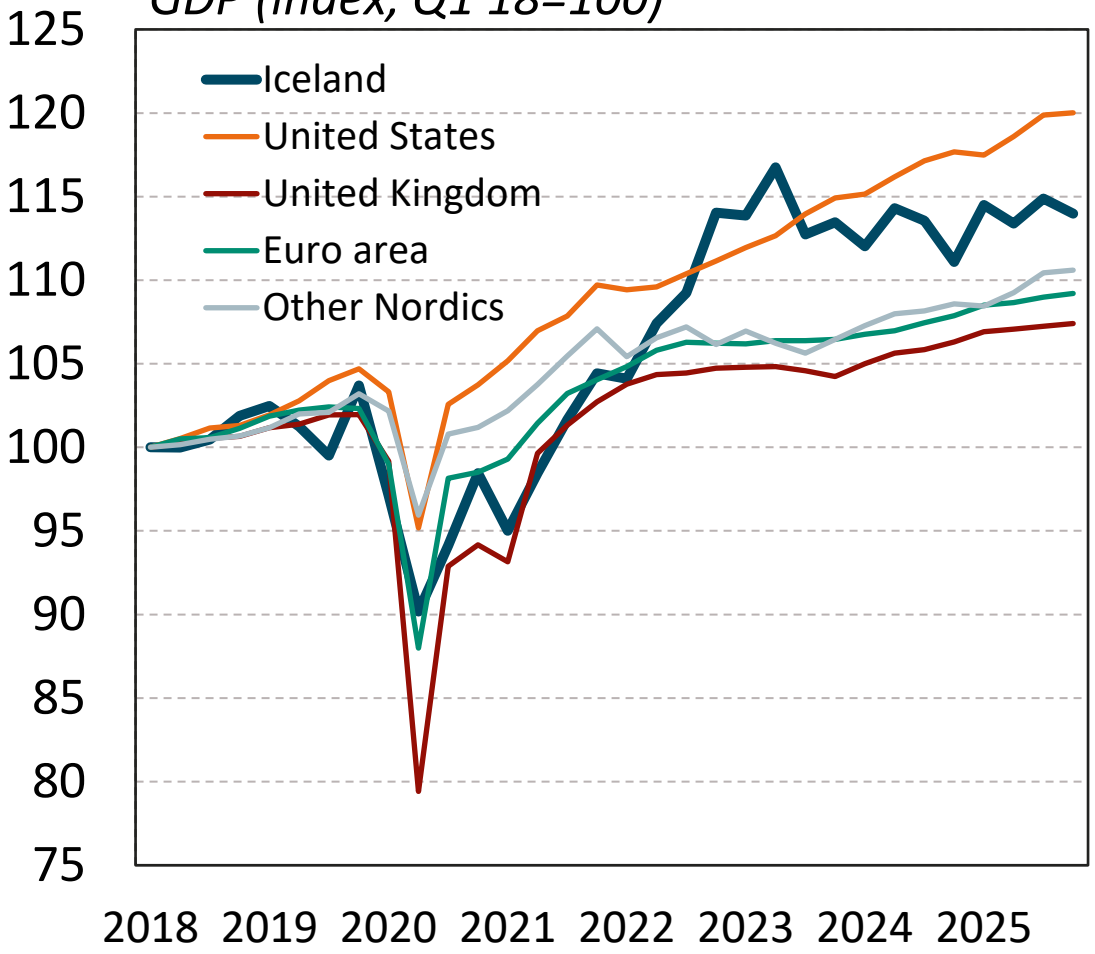
Inflation in Iceland peaked at a lower rate than in Europe – but has remained more persistent

HICP inflation in selected countries Jan. '05 - April '26 (%, Y-o-Y change)

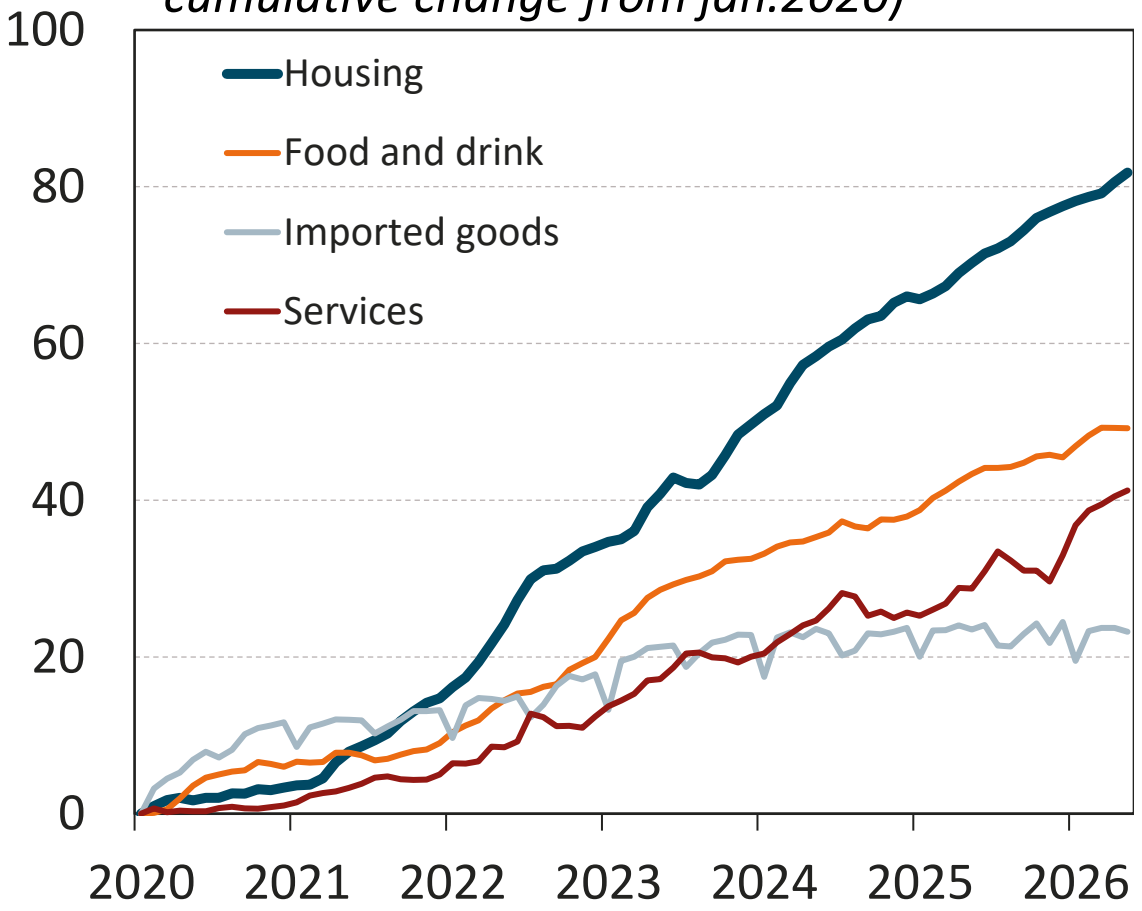


A rapid post-covid recovery and mounting domestic inflation pressures

GDP (index, Q1'18=100)

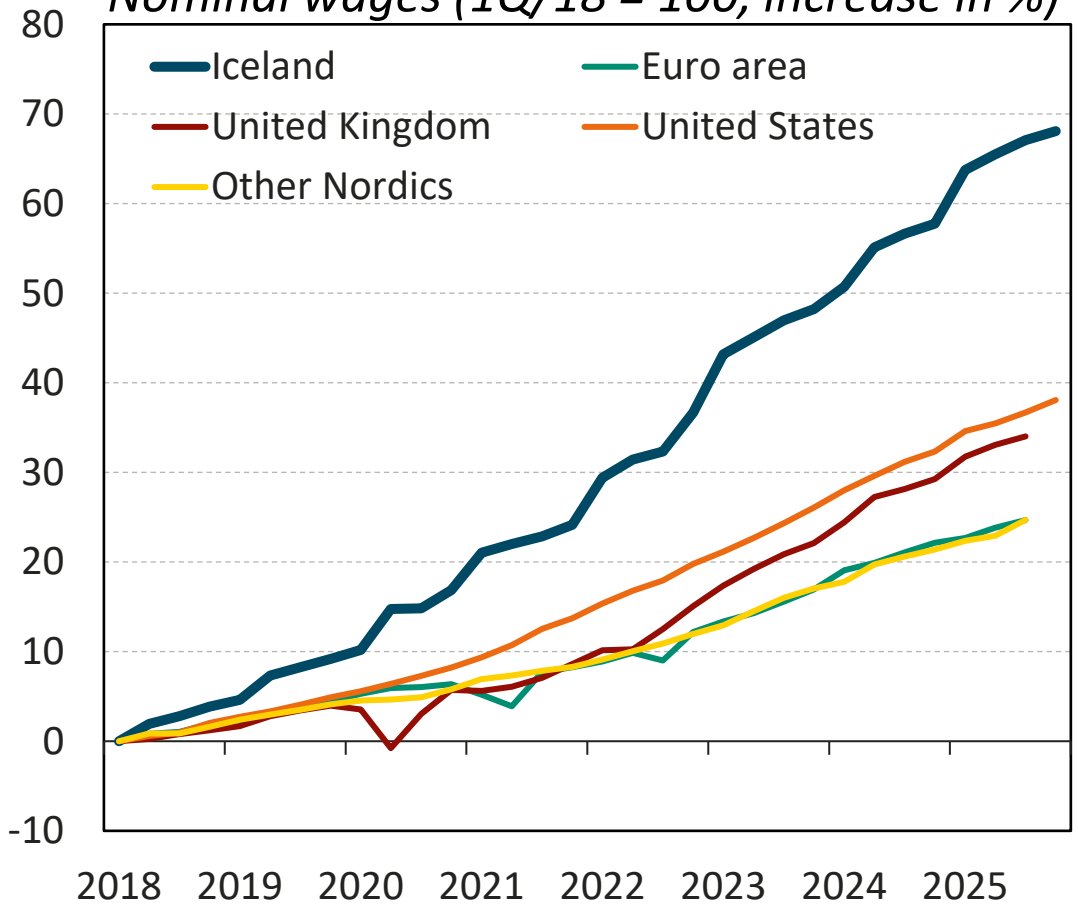


Domestic & imported inflation (% cumulative change from jan.2020)

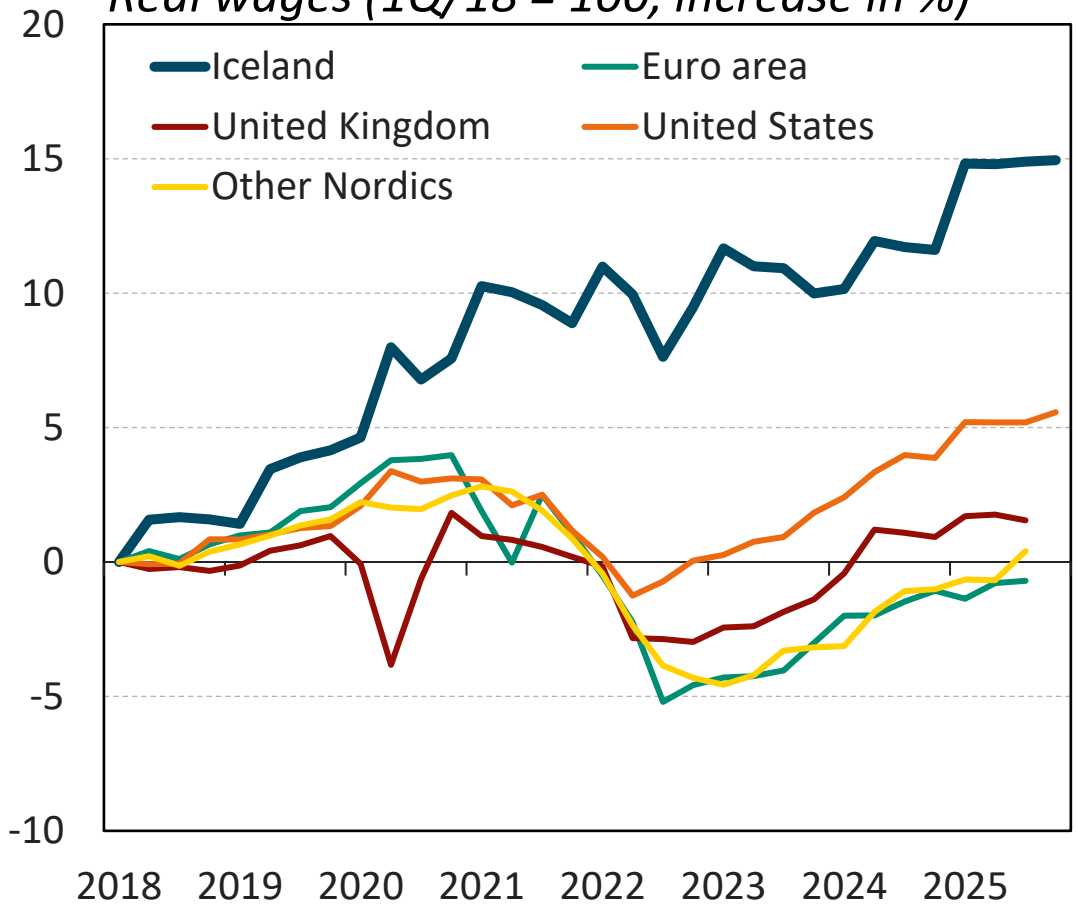


Strong nominal wage response to higher inflation from an overstretched labor market

Nominal wages (1Q/18 = 100, increase in %)

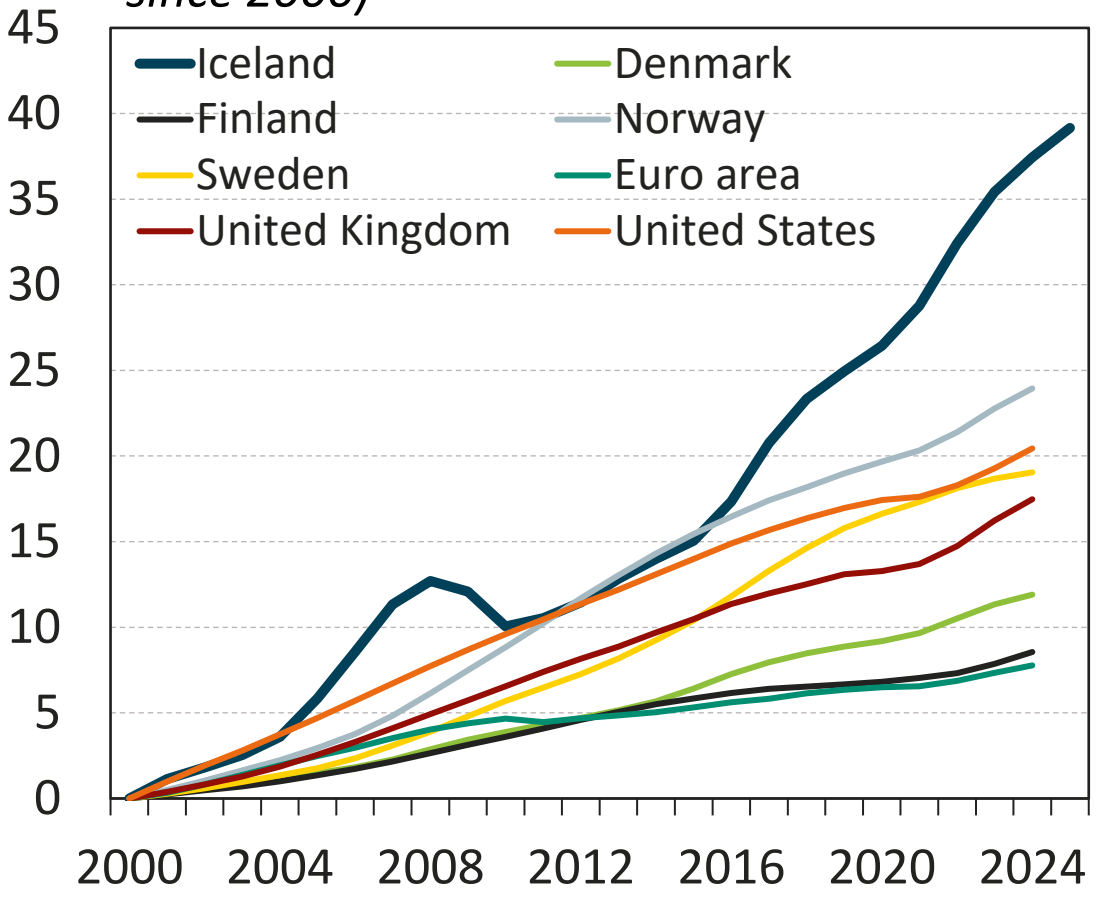


Real wages (1Q/18 = 100, increase in %)

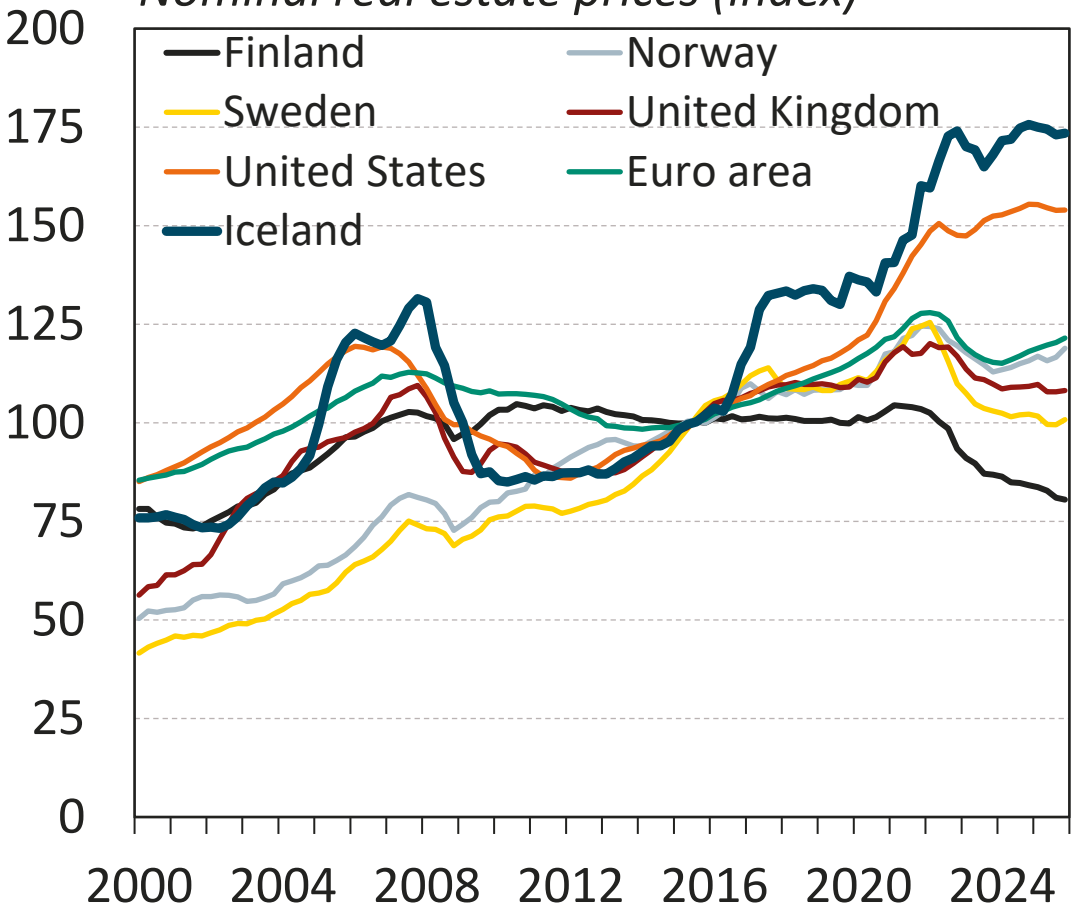


High population growth – almost 40% since 2000 and housing shortages led to a surge in real estate prices

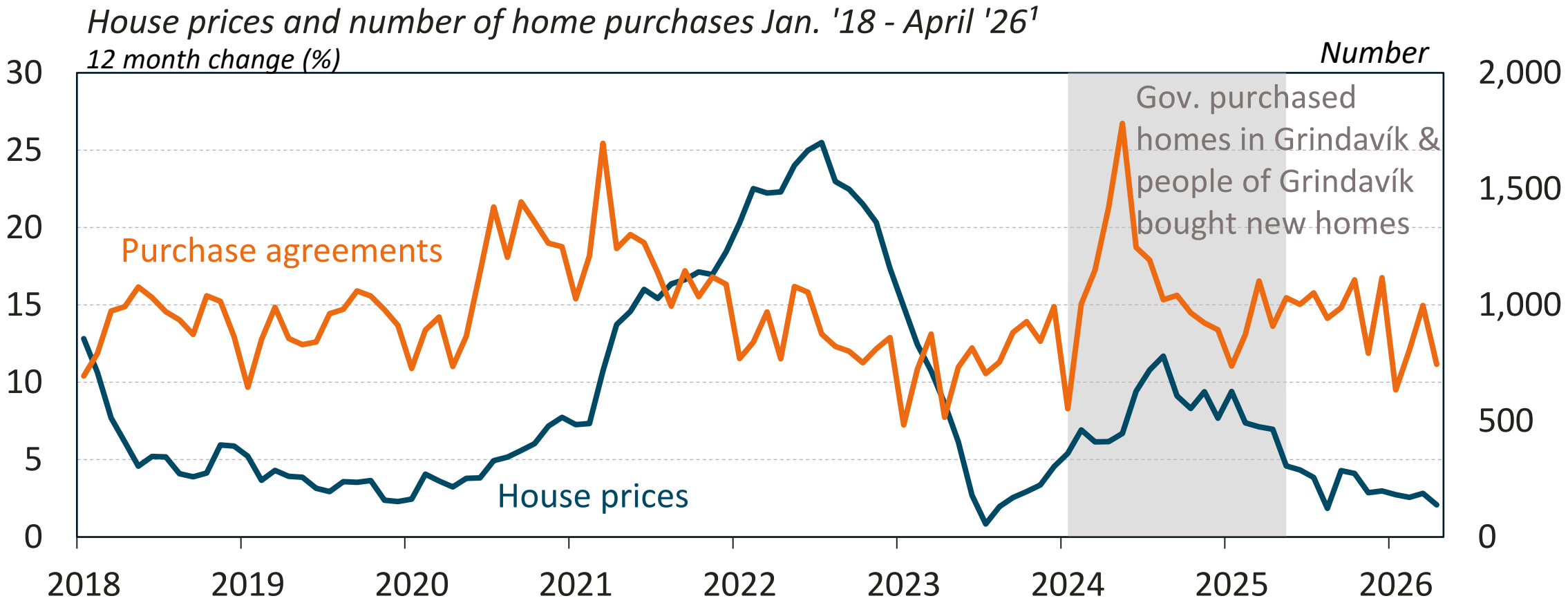
Population growth (% cumululative change since 2000)



Nominal real estate prices (index)



Volcano effect – 1% of population relocated after Government purchased their houses



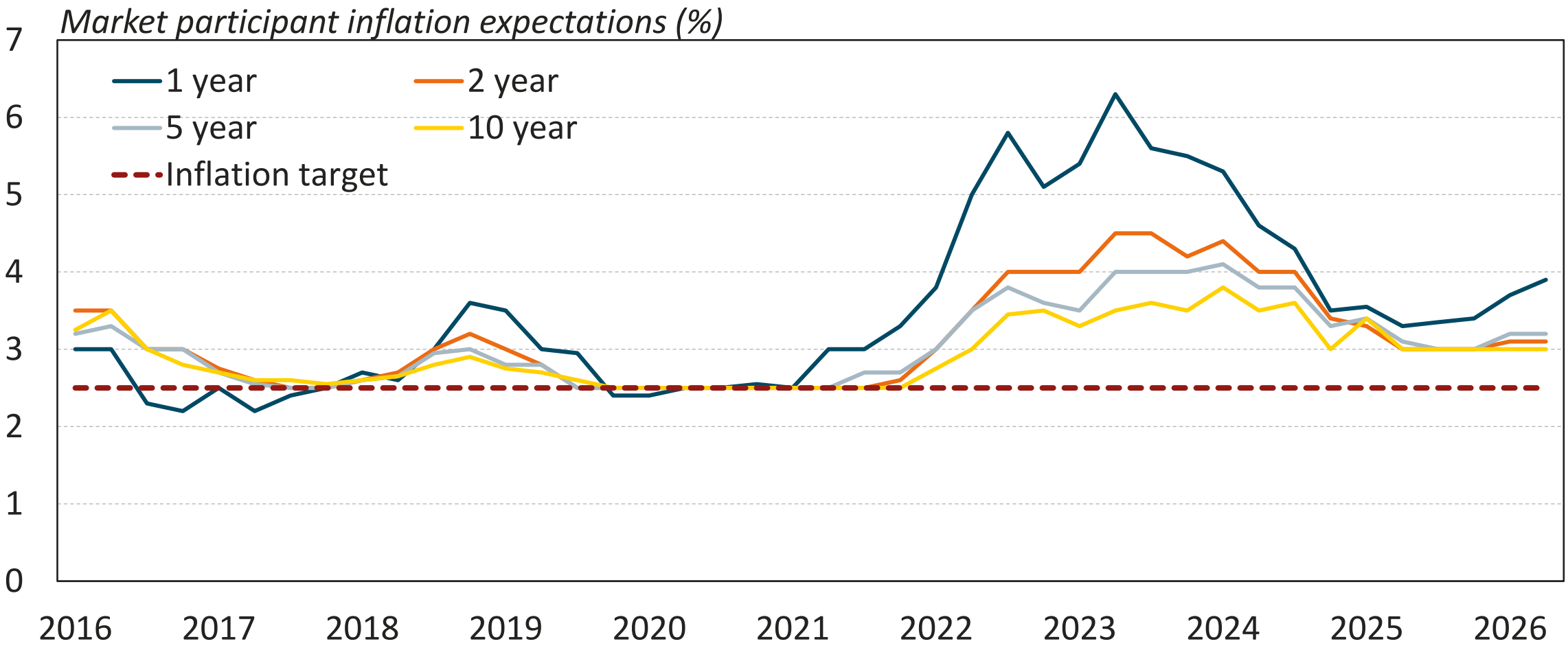
The de-anchoring of inflation expectations 2022-2023

Iceland faced multiple shocks:

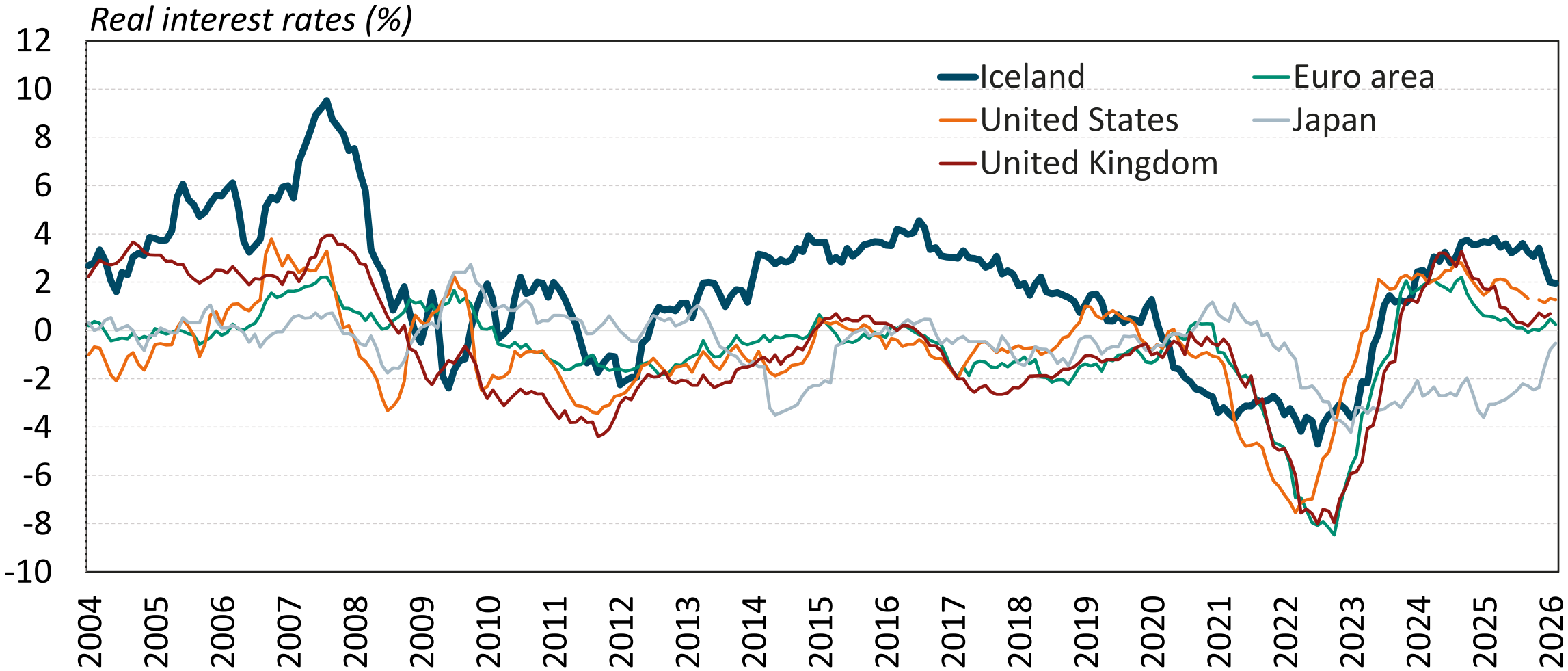
1. A sharp post-covid economic recovery – 9% GDP growth in 2022 creating a positive output gap
2. Heavy inflow of foreign labor and skyrocketing housing costs, resulted in persistent inflationary pressures
3. Foreign price shock – at the start of the war in Ukraine. Stirring unrest in the labor market, leading to a 10% nominal wage increase
4. A volcanic eruption displaced 1% of the population, who had to resettle elsewhere with a public compensation

This is the point where inflation expectations became de-anchored

Inflation expectations have yet to be re-anchored



Short-term real interest rate across countries



Policy response – anchoring expectations

- The Central Bank has since 2023 communicated an intermediate policy target of about 3-4% real interest rate
- The policy rate was raised to 9.25% and later lowered as inflation and inflation expectations began to decline
- However, since 2024, inflation has remained stuck around 4-5%, and the policy rate has stayed above 7%
- The economy has cooled and spare capacity begun to emerge
- Higher oil prices have renewed inflationary pressures and the Central Bank has implemented two 25 bp hikes since the start of the war in the Middle East

Lessons and reflection

- Iceland has faced many outsized supply shocks in the past 7 years and monetary policy has played a key role in stabilizing the economy supported by macroprudential measures
- The focus has been on maintaining stability in the balance of payments
- The goal and decision-making process of monetary policy are clear and concise, and lead to an inevitable collusion with other policies or lack thereof in other areas

Looking ahead

- One of the main challenges of our monetary policy is to assess the output gap and the neutral real rate of interest
- We may have underestimated the neutral real rate in the post-pandemic period (estimated 1-2%) but it is now estimated around 2½% for Iceland
- The only way forward is to bring both expectations and measured inflation to the 2,5% target by maintaining the actual real rate above the natural rate
- Possible EU membership & euro adoption Iceland may need other levers of public policy to maintain economic stability in face of supply shocks