28 May 2026
Reykjavik

When Expectations Become De-Anchored: Monetary Stability Through Pandemic, War and Volatility

Governor Ásgeir Jónsson

Reykjavik Economic Conference

29 May 2026

I would like to speak about what is perhaps every central banker's greatest nightmare, which is when inflation expectations become de-anchored.

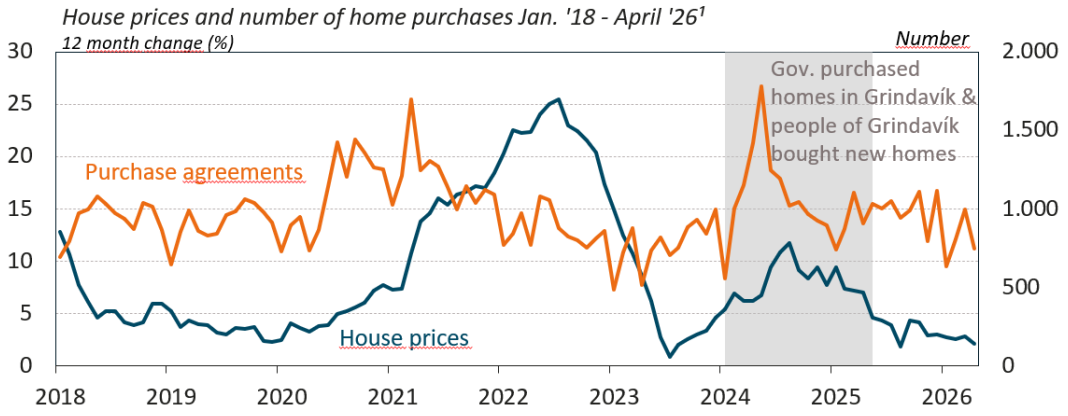
Let me begin with where we stand today. The Central Bank of Iceland's policy rate is currently 7.75%, the second-highest policy rate in Europe after Turkey. We have raised rates twice since the outbreak of the conflict in the Middle East, reflecting renewed inflationary pressures and a more uncertain external environment. At first glance, Iceland's inflation experience may appear somewhat unusual. During the global inflation surge earlier this decade, inflation in Iceland peaked at a lower level than in many other European countries. This largely reflected our unique energy structure. Nearly 90% of Icelandic households rely on geothermal heating and domestically produced carbon-free electricity. Our domestic energy production shielded the economy from much of the energy-price shock that affected the rest of Europe.

Our challenge, however, is that inflation has been very persistent. The roots of that persistence are primarily domestic. Iceland experienced one of the sharpest recoveries among advanced economies following the pandemic. During the Covid pandemic, tourism – our largest export sector – came to a near standstill almost overnight. Parts of the fisheries sector were also severely affected as restaurants and hotels across Europe closed. The recovery was remarkably swift, however. Real GDP grew by approximately 20% in just three years, making Iceland one of the first advanced economies to fully recover the output losses caused by the pandemic. This highlights the flexibility and resilience of the Icelandic economy, but it also created significant demand pressures. Inflationary pressures have increasingly originated from domestic sources, particularly the housing sector, services and other domestic factors, while imported inflation has been relatively stable in recent years.

I also draw your attention to our labour market. For many years, Iceland has operated with exceptionally strong and growing labour demand. The tourism sector is labour intensive, as are sectors such as construction. Nominal wage increases have been much greater than in most

other advanced economies. Indeed, unlike many other European countries, real household purchasing power did not decline in Iceland in the post-pandemic inflation wave. In fact, the purchasing power of disposable income increased by 25% in real terms over the past five years, and currently we have the highest hourly wage cost in Europe. While this reflects strong economic performance and rising living standards, it has also generated persistent inflationary pressures. A fast-growing economy is desirable, but growth that consistently exceeds productive capacity ultimately becomes inflationary.

A long-standing excess demand for labour has also been the key driver of influx of foreign workers. Iceland's population has increased by almost 40% over the past 25 years. Our birth rate used to be high in a European comparison, but it has declined as of late. The population increase is mainly explained by the immigration of foreign nationals that currently account for 20% of our labour force. This development has played an essential role in supporting economic expansion, but at the same time, rapid population growth has intensified demand in the housing market and strained societal infrastructure. Housing supply has struggled to keep pace, resulting in persistent increases in both house prices and rents. Housing therefore became one of the most important drivers of underlying inflation.



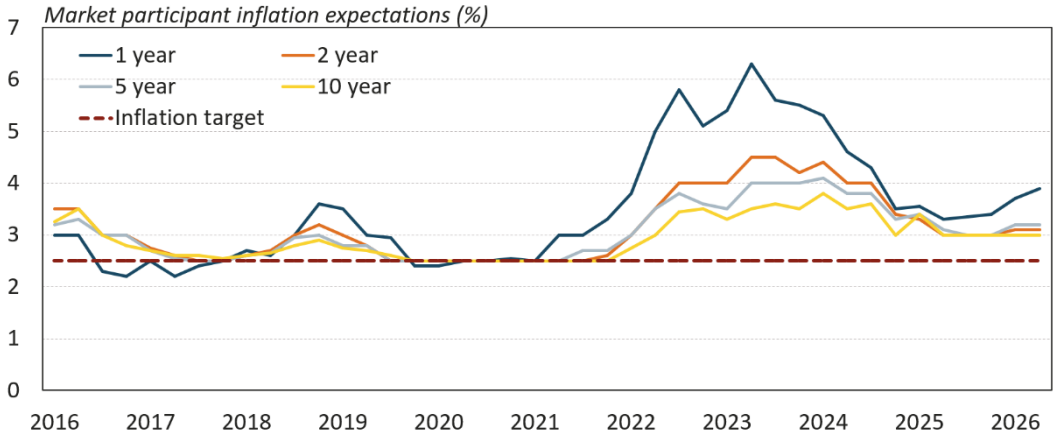
Source: Housing and Construction Authority

On top of that, beginning in late 2023, there was a series of volcanic eruptions on the Reykjanes Peninsula. Roughly 1% of the country's population had to evacuate their homes. The Government responded by purchasing residential properties in the affected area and compensating residents.

From a macroeconomic perspective, this represented both a pure positive fiscal shock and a housing demand shock. The figure above illustrates that the housing market had been cooling following a period of monetary tightening and tighter borrower-based measures. However, the relocation of displaced households created an additional demand impulse in an already constrained housing market. What initially

appeared to be a localized geological event quickly evolved into a significant macroeconomic wave of new demand. The "volcano-effect" reversed part of the adjustment underway and contributed to renewed housing inflation in 2023.

By 2022 and 2023, Iceland had therefore been hit by multiple overlapping shocks: a rapid post-pandemic recovery, strong wage growth, population expansion, housing shortages, external price shocks and volcanic disruption. This is the point where inflation expectations became de-anchored. This may have stemmed both from the fact that we were too late in hiking the policy rate after the pandemic, even though we were the first central bank to do so and believed that we were raising rates sharply at the time. In hindsight, the cumulative impact of these shocks was just too large for monetary policy to cope within a reasonable time frame.



Source: Central Bank of Iceland

Once expectations become de-anchored, every central banker's nightmare becomes reality. Monetary policy instantly loosens its grip. The immediate consequence is that as inflation expectations rise, real interest rates decline. This is precisely what occurred in Iceland. Despite substantial policy tightening, expected inflation increased even faster. Real borrowing costs therefore fell, supporting renewed credit growth and domestic demand at precisely the time when monetary conditions needed to become more restrictive.

In response, the Central Bank adopted a clearer communication framework centred on real interest rates. Since 2022, we have consistently communicated an intermediate objective of maintaining the real policy rate in the range of approximately 3–4%. Given Iceland's higher neutral real rate than in most European countries and the country's structural characteristics, this level was broadly consistent with the Taylor Rule, as Emi Nakamura showed earlier in the first paper discussed at this conference, where the Central Bank of Iceland was shown to be one of the few central banks in the world to follow the Taylor Rule.

This approach was particularly important because Iceland has a large market for inflation-indexed financial instruments. When inflation expectations rise, real rates in indexed markets can decline sharply. Clear communication regarding the intended path of real interest rates therefore became an essential part of the policy transmission mechanism. To achieve this intermediate target the policy rate peaked at 9.25% in August 2023 and from then on inflation expectations gradually began to decline, which then in turn gave room for nominal rate cuts while maintaining the targeted real policy rate. Inflation also moderated. However, the last mile to the 2,5% target has proven slower than we initially expected, and inflation expectations have remained stuck around 3–4%.

The broader lesson is that Iceland has faced an extraordinary sequence of shocks over the past decade, as already mentioned. In his talk yesterday Deputy Governor Þórarinn G. Pétursson showed the tourist boom which started after the eruption of Eyjafjallajökull in 2010, where annual tourist arrivals increased from roughly 300 to 400 thousand tourists to about 2.5 million in just a few years. That was another shock in addition to the global financial crisis, the pandemic, the volcanic eruptions and now geopolitical energy shocks.

These experiences have highlighted one of the central challenges facing modern monetary policy – one that representatives of the Federal Reserve also discussed at this conference – namely estimating potential output, productivity growth and the neutral rate of interest. In Iceland, structural changes and repeated shocks have complicated these estimates.

The volcanic eruptions on the Reykjanes Peninsula provide a good example. In retrospect, what we feared might become a major negative supply shock through a collapse of the tourist industry turned out to be something quite different. The fiscal response was expansionary, reconstruction activity supported demand, and the eruptions themselves became a tourist attraction. As is often the case, reality turned out to be more complicated than our initial forecasts.

Looking ahead, our task remains clear. Inflation expectations must be fully re-anchored and measured inflation must return to the 2.5% target. Achieving that objective requires maintaining a sufficiently restrictive real policy stance, with real interest rates in the range of 3–4%, for as long as necessary.

The economy has cooled. The output gap has narrowed. Unemployment has risen modestly. As always, the final stage of disinflation is the most challenging because the costs become more visible while the benefits are less immediate.

At the same time, Iceland is once again debating its long-term monetary framework, including potential European Union membership and

eventual euro adoption. Whatever path is chosen, one lesson is unmistakable: small open economies exposed to frequent supply shocks require robust stabilization mechanisms. If monetary independence were reduced, alternative policy instruments – whether fiscal, macroprudential or structural – would need to assume a much greater role.

For many years, Iceland has placed a substantial burden on monetary policy and the exchange rate as shock absorbers. The experience of recent years reminds us both of the value of those tools and of their limitations.

Thank you