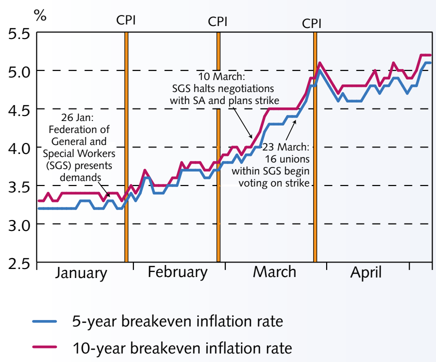
Box 2

Inflation expectations in the run-up to wage settlements: comparison with 2011

Chart 1

Breakeven inflation rates[1]

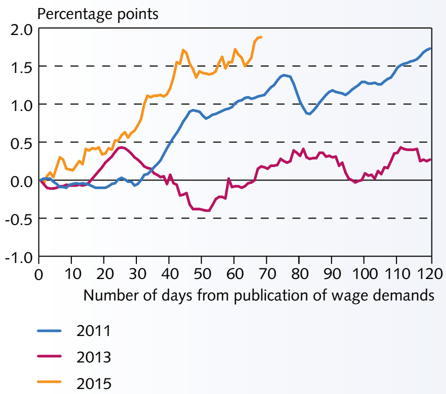
Daily data 2 January 2015 - 8 May 2015



1. Vertical lines indicate when the consumer price index was published. Forward breakeven inflation rate based on nominal and indexed yield curves. The breakeven rate indicates the expected annual inflation rate in five and ten years.
Source: Central Bank of Iceland.

Chart 2

Change in breakeven inflation rate from beginning of wage negotiations[1]



1. The breakeven inflation rate is based on the five-year breakeven rate in the bond market five years ahead; i.e., expectations concerning average inflation in 2020-2025. As of 6 December 2010 for the 2011 settlements, 4 November 2013 for the 2013 settlements, and 27 January 2015 for the 2015 negotiations.
Source: Central Bank of Iceland.

Inflation expectations were close to the Bank's inflation target by most measures at the end of 2014. However, there are signs that they have risen again recently, both in terms of the breakeven inflation rate in the bond market and in terms of market agents' and corporate executives' expectations. According to the survey carried out recently by the Central Bank, market agents' short-term inflation expectations have risen by almost 1 percentage point, to 3½%, and long-term expectations have risen by 0.2 percentage points, to 3.2%. Furthermore, the five- and ten-year breakeven inflation rates in the bond market have risen by almost 2 percentage points since the end of January, to just over 5% in early May.

It is likely that a large share of this increase in inflation expectations is due to concerns that the ongoing labour dispute will result in large pay increases, which would inevitably lead to a sizeable increase in inflation (see Section I). As Chart 1 indicates, news coverage of the labour market situation appears to have made a strong impact on the breakeven inflation rate, which is in line with market agents' responses to the Bank's May survey, where a majority of respondents considered the labour market situation to be the main cause of the rise in the breakeven rate during the year.

It is interesting to compare developments in the breakeven inflation rate with those during the run-up to the wage settlements in early 2011. The situation then was in some respects similar to that at the beginning of 2015: inflation was low, and wage negotiations were pending. However, the slack in the economy was more pronounced then, and unemployment was considerably higher. On the other hand, it could be assumed that inflation expectations are more firmly anchored to the inflation target now than they were then, as inflation has been low and stable for some time, whereas in spring 2011 it had been low only for a short period. The nominal pay increases being demanded now are considerably larger, however, and inflation expectations appear to have risen further and faster: the long-term breakeven rate has risen by almost 2 percentage points in three months, just over ½ a percentage point more than over a similar period in 2011 (Chart 2).

This is cause for major concern in view of the near-term inflation outlook. As yet, inflation is still relatively low, but the experience of 2011 should be a word to the wise. At the beginning of 2011, inflation was 1.8%, slightly above its current level, and had been close to the target for just a short period. By mid-2011 it had risen to 5%, and it peaked at 6.5% early in 2012. This differs markedly from developments in the wake of the end-2013 wage settlements, which provided for relatively modest pay increases. At that time, inflation expectations changed little (Chart 2), and inflation remained close to the target.