19 September 2019

Governor’s introductory remarks at an open meeting of the Parliamentary Economic Affairs and Trade Committee on the work of the Monetary Policy Committee

I am appearing before you today for the first time as Governor of the Central Bank, to discuss the Monetary Policy Committee’s report to Parliament. Here with me is Committee member Gylfi Zoëga.

You have received a copy of the MPC’s report on its work in H1/2019, together with other materials. Among those materials are the newest issue of *Monetary Bulletin*, with the most recent update of the Bank’s macroeconomic and inflation forecasts; the Monetary Policy Committee’s last statement; and the minutes from its last meeting, which were published on 11 September.

Seven months have passed since representatives of the Central Bank Monetary Policy Committee (MPC) last attended a meeting of the Parliamentary Economic Affairs and Trade Committee. The exchange rate of the króna is broadly the same as it was then, and inflation has eased slightly, from 3.4% to 3.2%. Over this period, the GDP growth outlook for 2019 and 2020 has deteriorated, and the Bank’s key interest rate has been lowered from 4.5% to 3.5%.

The Icelandic economy is entering a downward cycle after eight years of uninterrupted growth. Since 2010, when GDP fell to its post-crisis trough, it has grown by over a third. The economy has been relatively stable over the past few years. The contraction expected this year is relatively mild: the Bank forecasts it at 0.2% of GDP, followed by positive growth next year. In line with these developments, the Bank has embarked on a monetary easing phase, lowering interest rates in August for the third time this year.

The króna has been relatively stable in the recent term, even though the economy has slowed and Iceland’s leading export sector – tourism – has suffered setbacks. Historically, the króna has usually weakened in response to a downturn. The balance of payments has become disrupted, with an unsustainable current account deficit and other imbalances in the economy. The situation today is quite different: we have a current account surplus and a positive international investment position, and external trade rests on a relatively strong foundation. In addition, the Central Bank has ample international reserves that it can use to ensure stability if the need arises.

A look at long-term developments shows that interest rates in Iceland have been on the decline in recent decades. This is true not only of short-term rates, which often receive the most attention, but also of long-term rates, which are of pivotal importance for the real economy.

Long-term real rates in the bond market have fallen markedly in the past two years, particularly in 2019 to date, and are now at a historical low. In a longer context, real rates have been trending downwards since the beginning of the 1990s; therefore, we have seen interest rates in Iceland move closer to those in other countries.

Yet among Western countries, it is considered a privilege to have positive nominal interest rates that can be used to stimulate the economy, just as we have done this year. Many of our neighbouring economies have negative nominal rates, which have created a floor for further rate cuts.

Looking ahead, the current monetary easing phase could continue, as was suggested in the MPC’s most recent statement – if inflation and inflation expectations continue to fall, or if the GDP growth outlook deteriorates from the Bank’s most recent forecast. There is some uncertainty about how the tourism industry will withstand both the cost increases and the shocks to international air travel that it has suffered.

On the whole, monetary policy has been successful in recent years. It would be very good news if the contraction turned out no deeper than is currently forecast, given the rapid growth of the past several years. It is also important that prices in Iceland have been broadly stable over the past six years. This stability bears witness to the success of monetary policy and gives cause for hope that it will be possible to keep inflation at target in the future.