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Report to the Government on inflation in excess of tolerance limits

According to measurements published by Statistics Iceland on 27 June 2011, twelve-month inflation in terms of the consumer price index (CPI) measured 4.2% in June. This is a deviation of more than 1½ percentage points from the inflation target. The limits for the deviation of inflation from target have thus been breached after inflation fell below them in September 2010, therefore necessitating this report.

Main reasons for rising inflation

In spite of a marked slack in the economy in the wake of the financial crisis and economic contraction, inflation has risen again after declining virtually unimpeded since January 2009, when it peaked at 18.6%. In terms of the CPI, inflation bottomed out at 1.8% in January 2011. It remained relatively stable until March but then began rising rapidly, measuring 2.8% in April, 3.4% in May, and the aforementioned 4.2% in June.

The main reasons for this sudden turnaround are well known and not restricted to Iceland. The principal cause is the steep rise in global commodity and oil prices in the recent term. Over the past twelve months, global oil and commodity prices have increased by almost half, causing inflation to rise rapidly in many countries; for example, to 3.6% in the US, 2.7% in the euro area, and about 4.5% in the UK.

The effects have been felt in Iceland as well. For example, petrol prices have climbed by over one-fifth in the past twelve months, according to Statistics Iceland, while food prices have risen by about 4½% over the same period.

In addition, the exchange rate of the króna has fallen by nearly 4% in trade-weighted terms, and almost 5% against the euro, in the past year. Since the beginning of 2011, the króna has depreciated by 7% against the euro and by 5½% in trade-weighted terms. As a result, imported goods and services have become more expensive. The króna depreciation is likely to have an effect for some time.

In addition to the impact of higher global oil and commodity prices and import prices in general, inflation has been affected by increased prices of public services and other goods and services whose prices are dependent on official decisions. These include Reykjavík Energy's (Orkuveita Reykjavíkur) heat and electricity price hikes and price increases in various public services, such as pre-school tuition, daycare, bus fares, and waste collection. The price of public services has therefore risen by about 8.4% in the past twelve months.

In part, the recent increase in inflation is attributable as well to consumption tax increases, which raise price levels and therefore inflation until the effects disappear from twelve-month inflation figures. In Statistics Iceland's estimation, consumption tax hikes added 1-1½ percentage points to annual inflation during the period from mid-2009 through year-end 2010. Since then, those effects have dissipated, but inflation excluding direct consumption tax effects is still about 0.2 percentage points less than CPI inflation.[1]

It is difficult to estimate exactly where inflation would lie if these price increases had not occurred, but it would probably have been considerably lower. Of the 2.4 percentage point rise in annual inflation from its trough in January through June, 0.7 percentage points are due to petrol price hikes, 0.4 percentage points to increased domestic food prices, and 0.2 percentage points to price increases of public services. In total, these three factors account for more than half of the increase in twelve-month inflation since the beginning of the year. This is reflected in developments in underlying inflation, which excludes these factors and others. In June, underlying inflation measured 2.5%, up from 1.2% in January, and was therefore considerably lower than CPI inflation, in addition to having risen less steeply.[2]

Another important factor in the recent rise in inflation is the increase in the housing component of the CPI. The contribution of the housing component to the increase in twelve-month inflation from January measured 0.8 percentage points in June. In part, the increase stems from various cost items related to housing operation and maintenance, but the bulk of it is due to rising market prices. Housing market turnover has increased in the recent term after the post-crisis slump,

[1] The Central Bank‘s current forecasts assume that consumption taxes will increase again in the beginning of 2012, based on the approved National Budget, which will also raise headline inflation, even though it is assumed that the effects will be less than in January 2011. In addition, Statistics Iceland changed its method for treating broadcasting fees, which led inflation to measure 0.4 percentage points less than it otherwise would have. Therefore, 0.4 percentage points will also add to headline inflation in January 2012, when these effects disappear from annual figures.

2 According to Core Inflation 3 without tax effects, which excludes prices of volatile items such as petrol and various food products, public services and mortgage payments.

and house prices have risen by an average of 3.8% over the past twelve months.

Although the recent inflation episode is attributable for the most part to the abovementioned factors, it is to some degree general in nature. The price of private services, for example, has risen by 4.3% in the past twelve months. Primarily, this development in inflation reflects increases in imported and domestic inputs, although the impact of contractual wage rises on the price level has yet to emerge. Inflation expectations have also risen by most measures. The breakeven inflation rate in the bond market has risen somewhat since the beginning of the year, and a recent survey indicates increased household inflation expectations as well. On the other hand, corporate inflation expectations have declined. By all measures, however, inflation expectations appear to be higher than is consistent with the inflation target.

Do these developments change the estimated inflation outlook?

In the Central Bank's last forecast, published in the April issue of *Monetary Bulletin*, it was assumed that inflation would peak at 3.3% in Q3 and then begin to subside again, reaching the target in the latter half of 2012. The inflation outlook had deteriorated from the Bank's February forecast. The April forecast for 2011 and the first half of 2012 allowed for a rise in inflation of 1 percentage point above and beyond the February forecast for that period. The main reasons for the deterioration in the inflation outlook were the aforementioned increases in oil and commodity prices, the weaker exchange rate, the stronger housing market, mounting inflation expectations, and the prospect of larger and more front-loaded wage rises than previously assumed.

The April forecast also stressed that the inflation outlook was extremely uncertain with the risk of short-term inflation being underforecast. It can be said that this concern has materialised. Oil and commodity prices have risen more than projected, the króna has been rather weaker, and the wage rises in the recent settlements have been larger. Overall, significant risk factors have contributed to making the inflation outlook worse than according to the April forecast.

Inflation measured 3.5% in Q2, as opposed to the 2.7% in the Bank's April forecast. It appears likely to continue rising in the next few months, as the effects of the recent increases in global commodity prices and the depreciation of the króna have yet to emerge. In addition, further price increases are expected as a result of the recent wage agreements. Based on current information, there is a material risk that inflation will exceed 5% in Q4/2011.

Oil and commodity price hikes and increases in public levies and services cannot drive inflation by themselves, however, unless they prove continuous. The current slack in the economy and the weakness of the recovery, which is reflected partly in high unemployment and limited growth in lending and money supply, should therefore ensure that inflation returns to the target when the effects of these increases have subsided. Based on the current outlook and the premises for developments in these factors, it is therefore likely that inflation will begin to abate once again as 2012 progresses and be close to target in the first half of 2013.

There is considerable uncertainty about these assumptions, however, and consequently about the pace at which inflation will subside. The increases in oil and commodity prices could prove more persistent, and the exchange rate outlook is uncertain, as is often the case. There is also some uncertainty about the magnitude of the slack in the economy and to what extent it weighs against further wage and price increases. Moreover, there is a certain risk that the recent spurt of inflation, although it stems from transitory factors, could develop into lasting inflation to some degree. Inflation could therefore become somewhat more entrenched than current forecasts indicate.

In August 2011, the Central Bank will publish its updated inflation forecast, which will include a more in-depth discussion of the inflation outlook and the main uncertainties in the forecast.

The response of monetary policy

As is described above, the Central Bank has broadly considered the main reasons for the rise in inflation being either transitory factors or factors outside the scope of monetary policy. A majority of Monetary Policy Committee members have been largely in agreement with this assessment by the Bank. In view of the weak domestic economy, the Committee has maintained unchanged interest rates at its last two rate-setting meetings, in spite of mounting inflation and rising inflation expectations.

However, the Committee has become increasingly concerned about the inflation outlook, and some members have already considered it necessary to begin tightening monetary policy. At the Committee's April meeting, one member was in favour of raising interest rates, and at the June meeting it was decided to amend the MPC's communication concerning upcoming decisions so as to imply that interest rates would be more likely to rise than to fall in the near future. The probability that it will be necessary to raise interest rates in the near future in order to ensure that inflation and inflation expectations are close to target in the medium term has therefore increased.

The Monetary Policy Committee’s next interest rate announcement is scheduled for 17 August 2011.