Statement of the Monetary Policy Committee 17 August 2011

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.25 percentage points. The current account rate will therefore be 3.5%, the maximum rate on 28-day certificates of deposit (CDs) 4.25%, the seven-day collateralised lending rate 4.50%, and the overnight lending rate 5.5%.

The interest rate increase is in accordance with recent MPC statements and reflects the fact that the inflation outlook for the coming two years has deteriorated still further since the Committee's last meeting. Furthermore, newly released data and the updated Central Bank forecast, published in *Monetary Bulletin* today, indicate that domestic demand and employment will grow more strongly in 2011 than was assumed in the last forecast.

The unrest in global financial markets and weaker-than-expected output growth in major industrial countries could in the coming period weigh against the recent strength of domestic demand and have a negative impact on the Icelandic economy over the medium term. The size of this effect is extremely difficult to estimate at this moment, however. In view of the growing momentum in the domestic economy, as is described in the Bank's updated forecast, the risk that a modest interest rate hike at the current juncture will derail the economic recovery is low, as the past few months' steep decline in short-term real interest rates is only reversed to a small degree.

Inflation has risen sharply in the past five months. Headline inflation measured 5% in July, and underlying inflation – defined as CPI inflation excluding the effects of consumption taxes, volatile food items, petrol, public services, and interest expense – was 3.3%, up from 1.2% in January. Higher inflation is due in part to a weak króna and rising house and oil prices. Contractual wage rises will raise inflation still further in the near future, in spite of the recent modest appreciation of the króna. Based on the current exchange rate, the outlook is for inflation to rise well into next year and not return to the inflation target until the latter half of 2013.

Developments in recent months have increased the risk that higher inflation expectations and a weak currency will cause inflation to become entrenched, particularly once economic recovery gains pace. In the worst-case scenario, the expectation of higher inflation, a negative real interest rate, and a narrow risk-adjusted interest rate differential with major trading partners could further undermine the króna and cause a spiral of rising inflation and falling exchange rate, although the amount of spare capacity in the economy should mitigate such a development to some extent.

In order to reduce the risk of such a turn of events, it is necessary to act now to contain inflation and reduce potential pressure on the króna. This may call for further interest rate hikes. As always, however, monetary policy decisions will depend on recent developments and prospects.

The MPC stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.