

6 January 2014
1401006

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Re: Report to the Government on inflation in excess of tolerance limits

Twelve-month CPI inflation was 4.2% in December, according to measurements published by Statistics Iceland on 20 December 2013. Inflation therefore exceeded 4%, the upper tolerance limit for the inflation target. According to the joint declaration on the inflation target, issued by the Government of Iceland and the Central Bank on 27 March 2001, this obliges the Bank to submit a report to the Government. Previous reports submitted by the Bank on like occasions give a further explanation of the Bank's understanding of this obligation (see, for example, the last report, dated 12 September 2013, and the aforementioned declaration of 2001).

At its last two meetings, the Monetary Policy Committee has taken account of the Bank's November 2013 forecast, which indicated that inflation could rise temporarily above 4%. The recently concluded wage settlements and the appreciation of the króna in the past several weeks enhance the likelihood that inflation will subside quickly in the early months of 2014, as the Bank projected in November. Therefore, there is no reason at this time for a more detailed report than is included in this letter. This letter will be published on the Central Bank of Iceland website tomorrow, Tuesday 7 January 2014.

The increased inflation in December is due mainly to rising housing costs. Excluding the housing component, the CPI has risen by 3.3% in the past twelve months. However, service prices have risen well in excess of other prices, although this is offset by the fact that imported goods prices have risen by only 1.2% (or 0.6% excluding alcohol and tobacco) over the same period.

In Q4/2013, inflation measured 3.8%, as provided for in the Bank's November forecast, published in *Monetary Bulletin* 2013/4. According to that forecast, it will subside to 3.3% as early as Q1/2014. The króna has appreciated since the November forecast was prepared and was 2½% stronger by end-2013 than was assumed in the forecast. Furthermore, the newly finalised wage settlements imply that unit labour costs could rise somewhat less in 2014 than in the Bank's forecast, although this depends on

successfully containing wage drift. On the other hand, household debt relief measures could stimulate inflation, but these effects will emerge over a longer period of time and will hardly have a noticeable effect in the next few months. On the whole, it is therefore highly likely that inflation will decline rapidly in the near term and that the current period of inflation in excess of tolerance limits will be very short.

According to the Bank's November forecast, inflation will subside only gradually towards the target after the rapid initial decline. The Bank's next inflation forecast, to be published on 12 February, will analyse the extent to which wage settlements, recent exchange rate developments, debt relief measures, and other factors change this outlook.

The Monetary Policy Committee's statement from December states as follows: "A stronger economic recovery and the above-mentioned Government measures will require more rapid monetary tightening than previously expected, other things being equal. The degree to which such tightening takes place through changes in nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements."

The December CPI measurement does not change this, for the reasons specified above. When the next Monetary Policy Committee statement is published on 12 February, the effects of recent exchange rate developments, wage settlements, and debt relief measures on monetary policy will be further clarified.

Respectfully yours,
Central Bank of Iceland

Már Guðmundsson
Governor

cc:
Prime Minister