Monetary policy statement by the Board of Governors of the Central Bank of Iceland

Policy rate left unchanged

The Board of Governors of the Central Bank of Iceland has decided to leave the Bank's policy interest rate unchanged at 13.3%.[1] Inflation has declined more slowly than the Central Bank forecast at the end of March 2007, even though the króna has been stronger than expected. Headline inflation is currently 4%, but underlying inflation is estimated at 6%. The inflation outlook until 2008 has deteriorated since the March forecast and the inflation target will probably be attained later than assumed then even if the policy rate is left unchanged for longer. The current forecast indicates that it will not be possible to lower the policy rate until the first half of 2008, if reasonable prospects are to be created for moving close to the target that year and fully attaining it early in 2009. As before, the policy rate path in the baseline forecast does not represent a statement or commitment on the part of the Board of Governors. However, it does provide an important indicator of the policy rate needed, other things being equal, if the target is to be attained within the forecast horizon.

Two broad considerations underlie the decision by the Board of Governors to leave the policy rate unchanged in the face of a poorer inflation outlook. First, the policy rate is already high and has had a growing impact on both nominal and indexed bond yields. The monetary policy statement and the policy rate path published in *Monetary Bulletin* in March therefore seem to have had the intended effect. Since March, the króna has also appreciated by more than was forecast. At its present level, the policy interest rate exerts considerable constraint on inflationary pressures. Nonetheless, the economy has been unexpectedly vigorous this year. Although the national accounts for Q1/2007 suggest that domestic demand has eased, most other indicators – the labour, housing and equity markets, confidence and business sentiment indices, lending, retail turnover, payment card turnover and underlying inflation – point in the opposite direction. Growth is robust on all these fronts and in some cases increasing. Thus the tight stance will have to be maintained for longer than was previously assumed.

Alternative scenarios and the risk profile for the forecast also show higher probability that inflation will exceed the forecast than fall below it. As before, the exchange rate of the króna is the greatest potential risk. Strong domestic demand has prevented the appreciation of the króna in recent months from being reflected in a lower rate of inflation. The real exchange rate of the króna is very high

1. From now on, the Central Bank's policy rate is presented as a nominal discounted rate, instead of annual yield; a 13.3% nominal rate corresponds to the 14.25% annual yield quoted hitherto for the Bank's regular collateral loan facilities. The change of presentation was announced in Central Bank of Iceland press releases No. 9/2007 on May 16 and No. 12/2007 on June 18, 2007.

again, increasing the probability of an eventual depreciation. This risk is reflected in the baseline forecast and its risk profile. Households are now eagerly borrowing in low-yielding currencies. There is a danger that they underestimate the inherent risk. In Q1/2007 the current account deficit was much smaller than had been forecast, but after adjustment for irregular items it is still far from sustainable. In recent months the króna has appreciated in pace with other high-yielding currencies, a sign of its sensitivity to changes in global financial market conditions. The Central Bank does not attempt to manage the exchange rate. However, it may need to respond to the impact of exchange rate movements on inflation and inflation expectations.

In the forecast presented in the current *Monetary Bulletin*, inflation moves very close to target in the second half of 2008 and the target is attained before mid-2009. Due to lags in monetary policy transmission, a substantially higher policy rate would have been required in order to attain the target slightly sooner. The benefits of doing so do not justify the economic cost that it would have entailed. However, the Board of Governors will take measures if the inflation outlook deteriorates markedly from the current baseline forecast. Similarly, it will respond if prospects improve. A tight fiscal stance definitely reduces the likelihood that the inflation outlook will worsen. Given the strong inflationary pressures apparently still at work in the economy, it would be very misguided to ease the fiscal stance now. Greater expenditure restraint will enable the policy rate to be lowered sooner. Changes in the status and lending policies of the Housing Financing Fund operate in the same direction. The reduction in the Fund's maximum loan-to-value ratio, which was announced on July 3, represents an important first step.

Among the assumptions behind the baseline forecast is a 17% cutback in the cod quota. No new quota has been announced yet, but the impact of it and related measures will be assessed in the Board of Governors' later policy rate decisions.

The next policy interest rate decision by the Board of Governors of the Central Bank will be announced on September 6.