

# Statement of the Monetary Policy Committee

## 20 April 2011

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The deposit rate (current account rate) will remain 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) 4.0%, the seven-day collateralised lending rate 4.25%, and the overnight lending rate 5.25%.

The current interest rate decision is influenced by opposing factors. On the one hand, the inflation outlook has deteriorated, at least in the near term, inflation expectations have drifted upwards, and real Central Bank rates have fallen significantly. Moreover, risks to the exchange rate outlook have increased in the aftermath of the Icesave referendum. On the other hand, the outlook for growth and employment has deteriorated according to the Central Bank's baseline forecast, published today in the *Monetary Bulletin*, with additional risk to growth stemming from the result of the referendum.

In spite of weaker activity, inflation expectations have risen recently and the medium-term inflation outlook has deteriorated. Headline inflation has increased for two consecutive months, to 2.3% in March. It is forecast to peak at just above 3% later this year and remain elevated until early next year. Higher inflation than previously forecast primarily reflects a weaker króna and the recent rise in commodity and oil prices. To the extent that these price increases are temporary, they are unlikely to have a lasting effect on longer-term inflation expectations and wage- and price-setting. Assuming a stable króna and given the spare capacity in the economy, inflation is forecast to fall back to target in the latter half of 2012. However, draft wage agreements imply pay increases that may prove larger over the medium term than is consistent with the inflation target.

The planned capital account liberalisation has limited short-term implications for the monetary policy stance because the first steps of the two-phase strategy should be broadly neutral in terms of their impact on the foreign exchange reserves.

The result of the Icesave referendum on 9 April has tilted risks to the exchange rate to the downside, as it may affect the sovereign credit rating and hence the terms at which Iceland can borrow in foreign capital markets. This may limit the MPC's room for manoeuvre over the medium term. It may also affect the pace of capital account liberalisation. However, this is mitigated by the likelihood that the programme with the IMF will be unaffected.

The direction of future policy moves remains uncertain. 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.

