

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

Central Bank of Iceland raises the policy rate

The Board of Governors of the Central Bank of Iceland has decided to raise its policy interest rate by 0.5 percentage points to 15.5%. This increase follows a 1.25 percentage point increase announced on March 25, 2008. During the first quarter of this year, inflation was 2 percentage points higher than was forecast last November, and following the recent depreciation of the króna, it appears set to rise even further before beginning to taper off once again. The March 25 policy rate increase is followed with the decision announced today because inflation expectations remain very high. They have escalated and are now higher than they have been in a long time. It is imperative that they be reduced.

The macroeconomic forecast in the current *Monetary Bulletin* indicates that the economy will contract during the forecast horizon. Such a development is an inevitable adjustment after many years of economic imbalance. Despite the projected contraction, however, average output growth for the period 2005-2010 will be quite acceptable.

The inflow of foreign capital has shrunk, and funding the current account deficit will become more expensive than it has been in the past few years. Because of the high level of household and business indebtedness, the recent depreciation of the króna will contribute to a contraction of the economy. Persistent inflation will be most damaging to indebted businesses and households and can undermine financial stability for the long term. It is therefore of paramount importance that inflation be brought under control.

Low inflation is a precondition for applying monetary policy to soften contraction in the economy. The real exchange rate has approached its historical low, and the króna is undesirably weak. The real effective exchange rate may rise to its long-term equilibrium either through an appreciation of the króna or through rising prices. Under the current conditions, a prolonged low exchange rate passes quickly through to the domestic price level. There is still considerable tension in the labour market, and the output gap remains substantial. It is desirable that the króna recover from the sharp decline in March. The March 25 policy rate increase and the other measures announced at that time have supported the króna. It has appreciated as a result.

A policy rate increase in and of itself does not solve the problems that have developed in the FX swap market. Increased issuance of risk-free bonds that are accessible to foreign investors should open up other channels for currency inflow, however.

The Central Bank's most critical task is to reach the inflation target as soon as possible. The demand shocks of the past few years and unusual conditions in the global financial markets delayed the process. There is no reason to surrender any ground in the battle against inflation.

