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 from the level since December, at 14.25%. Inflation has slowed down and the inflation outlook has improved since the Central Bank's previous forecast in November 2006. This development is due not least to a tight monetary stance and more efficient transmission of the policy rate, along with favourable external conditions. Nonetheless, underlying inflation remains far above the inflation target, and in fact has risen over the past two months.

Lower inflation, a better inflation outlook and a considerable increase in the policy rate in 2006 have caused the policy rate to rise substantially in real terms. Higher yields on indexed and nominal bonds in recent months reflect expectations that the real policy rate will remain high. An impact on lending rates of commercial and savings banks is also evident and could become more pronounced.

The Central Bank's inflation forecast is now presented in a new format. The forecast horizon spans three years and the baseline forecast is based on a policy rate path that the Central Bank's staff considers compatible with bringing inflation down to the 2½% target within that period. This new format will enhance the credibility of the forecast compared with the earlier arrangement, when it was based on an unchanged policy rate over the forecast horizon or on market agents' expectations of the policy rate path, which could be at odds with the Central Bank's own policy communication. According to the baseline forecast, all things being equal, there will be no need to raise the policy rate further and it will remain unchanged until Q4/2007. Subsequently the policy rate is forecast to begin to decrease and will have come down to 6% at the end of the forecast horizon. On this projection, headline inflation will decrease rapidly in 2007, move below the target for some time and remain very close to it from mid-2008 onwards. Underlying inflation, i.e. excluding the effect of cuts in indirect taxation, will also decrease fairly rapidly towards the target, and lie close to it from mid-2008.

The policy rate path in the baseline forecast does not entail a declaration or commitment by the Board of Governors. It should be regarded as an important indicator of the policy rate level required under the current outlook to ensure that the inflation target is attained within the forecast horizon. It depends on economic developments unfolding broadly in line with the inflation forecast. If indicators emerging in the coming months show that demand, employment, the exchange rate and other major drivers of inflation diverge from the current forecast, the policy rate path may well shift from that in the baseline forecast. This will be reflected in policy rate decisions.

The large current account deficit and very tight labour market entail a long-term inflationary risk, i.e. that inflation will exceed the baseline forecast. Notwithstanding a substantial shrinking of the current account deficit, it is a cause for concern that even with the sizeable contraction in domestic demand in the baseline forecast, it will still not have reached a sustainable position at the end of the forecast horizon. A downturn in global financial conditions could, for example, increase the cost of funding the deficit, causing the króna to depreciate and the inflation outlook to deteriorate once more, especially if the labour market is so tight as to pose the risk of a wage-price spiral. The Central Bank will then need to make a firm response to such a development. An alternative scenario to the baseline forecast describes the Central Bank's probable response to a substantial exchange rate shock.

Another risk that must be heeded involves plans for further investment in aluminium production facilities and accompanying power plants. If the planned projects go ahead during the forecast horizon, they will slow down the closure of the output gap, which is a precondition for a lasting reduction in the inflation rate. In such a case it could prove necessary to raise the policy rate, or at least keep it high for longer than is implied by the baseline forecast in order to contain inflation, as described in a second alternative scenario. This would squeeze profits in the traded goods sector, and thus create sufficient space for these investments so that inflation would remain close to target. If such investments go ahead, therefore, it is vital for decisions on their timing and speed to take macroeconomic conditions into account.

The next interest rate decision by the Board of Governors of the Central Bank will be announced on May 16.