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

Tighter monetary policy needed

The Board of Governors of the Central Bank of Iceland has decided to raise the Bank's policy interest rate by 0.45 percentage points to 13.75%. Inflation has gained pace recently and is likely to be higher in 2007 and 2008 than previous forecasts have indicated. The policy interest rate path that the Central Bank's July forecast was based on is insufficient to control inflation quickly enough and thereby anchor inflation expectations. The inflation forecast presented in this issue of *Monetary Bulletin* allows for the attainment of the inflation target within an acceptable time frame; that is, in the third quarter of 2009. The baseline forecast assumes an immediate policy rate increase of 0.2 percentage points, followed by an increase of 0.25 percentage points in December, after which the policy rate remains unchanged from December until mid-2008 and then falls rather quickly, approaching 4% by 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.

The Board of Governors' decision to raise the policy rate immediately by 0.45 percentage points demonstrates an unswerving commitment to a tight monetary stance. It does not change the policy rate path in the baseline forecast in other respects than raising the rate in one step instead of two.

The indicators that have appeared since the last issue of *Monetary Bulletin* and, in particular, following the Board of Governors' policy rate decision of 6 September show that demand has grown faster than was projected in July. It has also emerged that output growth in 2006 exceeded previous estimates. Private consumption growth resumed in Q2/2007, and there are signs that it will grow even faster in Q3. Investment has been greater in 2006 and 2007 than previously projected. The growth in public investment has been large in spite of commitments and expectations to the contrary. Prolonged excess demand has caused a persistent shortage of labour and a resultant wage drift, and unit labour costs appear to have risen more than expected in 2006. In 2006 and 2007, disposable income has grown unusually rapidly as a result of wage increases and tax cuts. Real estate prices have been climbing rapidly, which largely explains the recent surge in inflation. The Housing Financing Fund's interest rates have not risen in line with the interest rate changes in the market, and this promotes higher housing inflation.

As before, the exchange rate of the króna causes uncertainty concerning the inflation outlook for the next few years. A high real exchange rate and the prospect of continuing external debt accumulation weaken the foundations of the króna. The króna could depreciate abruptly if global market conditions deteriorate to any substantial degree.

There is significant uncertainty surrounding wage developments. The labour market is still extremely tight and, as is stated above, inflation is higher than was forecast in July. Both of these factors enhance the likelihood that wages will rise more than is compatible with price stability. These uncertainties and others increase the risk that inflation will be greater than is assumed in the baseline forecast. If wage and exchange rate developments prove more negative than the baseline forecast allows for, there will be a sharper contraction in demand and employment than would otherwise occur, even though the contraction might come later.

Over the course of the forecast horizon, factors that have deterred disinflation could change. Conditions have deteriorated in the global financial markets, and higher mortgage rates could cool the real estate market, as has already happened in many other countries. The baseline forecast takes such developments into account, but the contraction could be greater than projected, although signs to that effect have yet to emerge.

Chronic inflation and the wide current account deficit indicate that domestic demand must contract if the economy is to achieve a sustainable balance. Postponing such an adjustment will not soften its effects in the long run. The decision to raise the policy rate reflects the Board of Governors' view that the long-term interests of the nation are best served by attaining the inflation target within an acceptable time frame. Other things being equal, this cannot be achieved except through a tighter monetary stance, as is reflected in today's decision.

Had monetary policy not been as tight as it has been, inflation would be even higher than it is, with well-known consequences for the income and balance sheets of businesses and households. Thus it is necessary to break out of the snare of inflation that has tethered the Icelandic economy. This cannot happen without its being felt. A laxer monetary stance now would only trigger more persistent inflation and a more painful adjustment later on. It should be obvious to all that the less restraint there is in other areas of the economy – in public finance, in the labour market, and in lending activity by financial institutions – the greater the burden on monetary policy.

The next policy interest rate decision by the Board of Governors of the Central Bank will be announced on Thursday 20 December 2007.