Box I-1

Inflation above tolerance limits

A declaration made by the Government of Iceland and the Central Bank of Iceland on 27 March 2001 stated: "The Central Bank will aim at an annual inflation rate of about 2½ per cent. If inflation deviates by more than 1½ percentage point from the target, the Bank shall bring it inside that range as quickly as possible. In such circumstances, the Bank will be obliged to submit a report to the Government explaining the reasons for the deviations from the target, how the Bank intends to react, and how long it will take to reach the inflation target again in the Bank's assessment. The report of the Bank shall be made public."

The range specified in this declaration has sometimes been referred to as "tolerance limits". In a sense, this is an unfortunate term, as it can contribute to the misconception that inflation of up to 4% is considered acceptable. This is far from the truth. The inflation target is 2½ per cent – no more and no less. The main reason for specifying a benchmark of 1½ per cent deviation is to increase monetary policy transparency. In 2001 the Central Bank of Iceland, like most of the world's central banks over the past two decades, had full authority to use the policy interest rate to achieve its publicly stated objective of maintaining price stability. It is quite normal that an independent central bank with such political power be required to account for its actions. The Central Bank of Iceland fulfils this requirement primarily through the thrice-yearly publication of *Monetary Bulletin*. When the inflation target was determined, it was considered realistic to contain inflation within 1½ per cent of that target most of the time. Greater deviations would generally be attributed to temporary external factors or to errors in monetary policy implementation. It is considered appropriate that the Central Bank explain such deviations. Since the publication of the 2001 declaration, there has been a fundamental change in the way the Central Bank communicates its assessment of the inflation outlook. Instead of publishing two-year forecasts assuming no change in the policy interest rate or in market expectations, *Monetary Bulletin* presents a policy rate path that, in the opinion of the Bank's staff, is the path most conducive to the attainment of the inflation target across the three-year forecast horizon. Together, the policy rate path and the Bank's monetary policy statement describe the means by which the Central Bank intends to achieve its inflation target during the ensuing three years, given the information available at the time of publication. It can therefore be said that each issue of *Monetary Bulletin* meets the transparency requirements set forth in the declaration.