Statement of the Central Bank of Iceland Monetary Policy Committee

Interest rate corridor aligned to the effective monetary policy stance

The Monetary Policy Committee (MPC) has voted to lower the deposit rate (current account rate) by 0.5 percentage points to 9%. The maximum volume at weekly auctions of 28-day certificates of deposit (CDs) will be increased from 25 b.kr. to 30 b.kr., with a minimum bid rate of 9.5% and a maximum of 10.25%. This implies a 0.25 percentage point increase in the maximum interest rate. The seven-day collateral lending rate will be lowered from 12% to 11% and the overnight lending rate from 14.5% to 13%. These rate changes will align the Central Bank interest rate corridor more closely with the effective monetary policy stance, which, before this decision, featured interest rates ranging from 9.5% to 10.0%. The current decision entails an unchanged or slightly easier stance, depending on the volume and rates on CDs in coming weeks.

Measures to drain liquidity from the market by auctioning 28-day CDs, announced after the last MPC meeting, have been successful. Interbank rates have moved within the Central Bank interest rate corridor. This amounted to some tightening of the monetary stance, however, with the effective policy rate remaining below 10%.

The króna has remained broadly stable since late summer, although at a lower value than is desirable. Central Bank intervention in the foreign exchange market has remained moderate, and the volume is considerably smaller than during the summer. The weakness of the króna may also be somewhat less of a danger to private sector balance sheets, as recent indications suggest that balance sheets are less exposed to foreign exchange risk than previously thought. Ongoing debt restructuring should reduce this exposure further.

The First Review of the Stand-by Agreement with the International Monetary Fund is now complete. This is an important element in restoring confidence and was a prerequisite for the first stage of capital account liberalisation, implemented on 31 October. In accordance with the liberalisation strategy, inflows of foreign currency for new investments are now permitted, and investors are permitted to convert the sales proceeds of new investments into foreign currency. The first-round effect of these measures, if any, should be to support the króna. However, once a stock of new investment has been built up, the impact on the currency could be in either direction. This implies that the exchange rate becomes more sensitive to current and expected monetary policy.

The disinflation process has been slower than anticipated, in large part because the króna has been weaker than previously forecast. Inflation has continued to decline, however, measuring 9.7% year-on-year in October, or 8.8% excluding the impact of higher consumption taxes. Due to the somewhat weaker currency and slightly smaller contraction in domestic demand, inflation is projected to decline more slowly than previously forecast. Inflation is still expected to fall sharply in 2010, and underlying inflation will be close to target during the latter half of the year. The risk that currency depreciation will result in second-round effects on inflation is moderate. Because inflation is now driven primarily by exchange rate movements, with a small contribution from wage costs and a negative contribution from housing costs, a faster recovery of the króna than is assumed in the forecast would bring inflation down significantly more swiftly than projected.

Provided that the króna remains stable or appreciates and inflation continues to fall as forecast, conditions for further easing of monetary policy should soon be in place. The MPC intends to move cautiously, however, and 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.