

Statement of the Monetary Policy Committee

15 May 2013

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged.

In line with weaker output growth globally, output growth has slowed down in Iceland and terms of trade have deteriorated. In 2013 and throughout the forecast horizon, the outlook is for output growth to be somewhat weaker than the Bank projected in February, albeit close to the 30-year average. The recovery in the labour market continues, with increasing employment and declining unemployment. Inflation has tapered off, in line with the Bank's forecasts, and now measures 3.3%. Measures of underlying inflation and inflation expectations are higher, however. Nonetheless, inflation is expected to reach the inflation target earlier than previously anticipated, with weaker output growth and a stronger króna offsetting larger wage increases and weaker productivity growth.

Inflation is now closer to target than it has been since it began rising in the wake of the spring 2011 wage settlements. Uncertainty about near-term exchange rate developments could contribute to more persistent inflation expectations, however, and slow down the disinflation process following this year's appreciation of the króna. Foreign exchange mismatches in financial institutions' balance sheets have been reduced recently, and the exchange rate of the króna has been close to a level that, other things being equal, could be considered sufficient to bring inflation back to target in the near term. The MPC is of the opinion that these conditions create the premises for increased Central Bank activity in the foreign exchange market in the near future, with the aim of reducing exchange rate fluctuation vis-à-vis recent levels of the exchange rate. This is in line with prior MPC statements emphasising the importance of using all of the monetary policy instruments at its disposal to promote price stability.

As circumstances permit, the Bank will attempt to increase its non-borrowed reserves. Increasing the non-borrowed reserves is a long-term goal, however, and the implementation of that aim depends on both the strength of the króna and movements in the exchange rate, which are determined in part by capital movements that vary in their predictability. The Bank's foreign exchange purchases will therefore take into account the strong tendency among other agents for foreign debt deleveraging, particularly while inflation remains above target. In line with this policy, the foreign currency that would be purchased to respond to temporary – in some instances, seasonal – inflows would then be used to support the króna when the currency flows reverse.

The MPC expects this policy to facilitate speedier adjustment of the domestic price level to a stronger króna and to reduce inflation

expectations. In that case, the inflation target could conceivably be reached earlier than is forecast, although this depends on other factors as well. If there are major changes in external conditions or if other aspects of economic policy undermine economic stability, the foreign exchange market intervention policy will be reviewed. Particular attention will be given to fiscal policy and to whether wage settlements and wage developments are consistent with the inflation target. Before decisive steps are taken to lift controls on capital outflows, it will be necessary to re-evaluate this policy. The same applies if decisions are taken concerning the monetary policy framework.

Although the economic recovery has lost some pace for the present, the margin of spare capacity in the economy has continued to narrow. The accommodative monetary stance has supported the economic recovery in the recent term. It is still the case that as spare capacity disappears from the economy, it is necessary that slack in monetary policy should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements. In addition, monetary policy must at all times take account of fiscal policy and other factors that affect demand.