*Introduction*

# The policy interest rate needs to rise by more than previously expected

The inflation outlook has deteriorated significantly since the last edition of *Monetary Bulletin* was published in December and the Central Bank announced its last policy interest rate increase on January 26. To a significant degree this can be attributed to a substantial depreciation of the króna in recent weeks. Another crucial factor is the large upward revision of GDP growth for the past two years according to revised national accounts for 2004 and provisional data for 2005. As a result, the output gap is wider and the inflation outlook correspondingly less favourable than the Central Bank has expected hitherto, especially in light of the adverse effect that recent exchange rate developments have had on the prospects of attaining the inflation target. Last year's current account deficit also turned out considerably wider than forecast in December and wage costs have grown in excess of productivity. The combined effect of wage developments and the current account deficit has been to create an unacceptable inflation outlook, even beyond the forecast horizon.

On the technical assumption that the policy rate and exchange rate remain unchanged, the probability that the inflation target will be attained within the next two years now appears to be almost zero. Assuming that the policy rate follows financial market analysts' forecasts – which entails that the króna will weaken somewhat further – the prospects are even worse. In previous editions of *Monetary Bulletin*, the Central Bank has underlined the inflation risk posed by a too rapid adjustment of the exchange rate to its long-term equilibrium while inflationary pressures driven by rapidly growing demand and wage costs are still present. The Central Bank has emphasised that it would need to respond forcefully to such a development. Now the króna has depreciated sooner and faster than was generally expected. Inflation expectations have risen as a result, causing an easing of the monetary policy stance. Monetary policy must respond vigorously to these developments.

Uncertainty is not only one of the challenges of monetary policy decisions, but one of its defining features. The data underlying central bank decision-making is fraught with uncertainties, as clearly shown by the recent major revision to data on investment and GDP growth in 2004. The structure of the economy is also subject to change, not least the monetary policy transmission mechanism. Also, the economy is constantly hit by shocks which are either unforeseeable or at least whose impact is difficult to predict. For these reasons, most central banks have been reluctant to make unequivocal statements about the path of future interest rates. However, several central banks have recently begun publishing policy interest rate paths that are considered compatible with their respective inflation targets at any given time.

For the first time, the Central Bank of Iceland's inflation forecast has been prepared using a new macroeconomic model which enables more detailed analysis of the effect that different interest rate paths have on inflation. The model can provide indications of how high the policy rate might need to go in order to attain the target within an acceptable horizon. While all such projections must be interpreted with great caution, they do indicate beyond any doubt that inflation will not return to target within an acceptable period unless the policy rate is raised substantially from the current level, perhaps by several percentage points. Whether such a steep rise will actually prove necessary will depend on a variety of developments which simply remain to be seen. Nonetheless, the Central Bank will tighten the monetary stance until it is convinced that a sufficient degree of tightening has been achieved to channel inflation and inflation expectations back towards target. Although tight monetary policy may provoke a temporary contraction in the economy, too lax a stance under the present conditions will, in the Central Bank's view, eventually bring about a harder adjustment than a more frontloaded tightening would entail.

At the same time as incoming data show that the degree of overheating of the economy over the past two years was considerably in excess of previous estimates, rising inflation expectations have taken the bite out of the monetary policy stance. In light of this, an unusually large step has to be taken at this time. The Board of Governors has therefore decided to raise the policy interest rate by 0.75 percentage points to 11.5%. How many further steps need to be taken will depend on how economic developments unfold and the impact of the present policy rate hike on the exchange rate and on nominal and indexed interest rates.

Higher international interest rates and financial institutions' more restricted access to foreign credit could contribute to a faster transmission of policy rate changes than before. One of the reasons that the Icelandic banks' risk premia have gone up in international markets recently is the growing imbalances in the Icelandic economy. The sensitivity of financial institutions to these imbalances seems to be overstated – considering the large share of their operations abroad. Nonetheless, as a result of these perceptions it may prove more difficult than otherwise for the banks to bring down the risk premium on their bonds in full unless macroeconomic imbalance is reduced. Thus it is vital to promote a better economic balance as soon as possible, *inter alia* by a tighter monetary stance.