Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank rates lowered

The Monetary Policy Committee (MPC) has voted to lower Central Bank interest rates by 0.5 percentage points. The deposit rate (current account rate) will be 7.0%, and the maximum bid rate for 28-day certificates of deposit (CDs) will be 8.25%. The seven-day collateral lending rate will be 8.5% and the overnight lending rate 10.0%.

Since the last MPC meeting, the króna has been broadly unchanged in trade-weighted terms but has appreciated against the euro. There has been no Central Bank intervention in the FX market. Sovereign risk premia have come down but are still high due to remaining uncertainty concerning Iceland's medium-term access to global financial markets and possible contagion from the European sovereign debt crisis. Capital controls, current account developments, and the interest rate differential with major currencies continue to support the króna.

As expected, inflation picked up in February and March, partly due to unfavourable base effects, but resumed a downward trend in April. Inflation measured 8.3% year-on-year, or 6.9% excluding the impact of higher consumption taxes. According to the forecast published today, the medium-term inflation outlook remains broadly in line with the January forecast. As before, underlying inflation is expected to reach the target late this year. The contraction in the economy last year turned out smaller than previously forecast, with private consumption stabilising at an earlier stage of the cycle. Growth of fixed investment, on the other hand, will be weaker this year due to delays in aluminium sector-related projects and slower recovery of other business investment. As in January, the forecast is based on the assumption of a gradually strengthening króna, but on average the króna will be slightly stronger over the medium term than in the January forecast.

While a forecast of lower inflation in the context of a weak economy could be an argument for a larger reduction in interest rates, several opposing factors call for some caution. The recovery of the króna has been weak since the last interest rate decision. CDS spreads remain high, although they have come down significantly since early this year and were only modestly affected by the turmoil caused by Greece's fiscal problems. While the credit rating outlook has stabilised, there is still residual uncertainty concerning Iceland's access to global financial markets.

With the Second Review of the IMF programme in place, concerns about Iceland's ability to service debt falling due in 2011 and 2012 should be alleviated. Hence, further delay in resolving the Icesave dispute is less likely than before to affect Iceland's credit rating. The removal of capital controls, which have shielded the króna from the effects of delays in the past, would be risky, however, until access to further programme financing is guaranteed. Hence, the planned liberalisation of capital controls is likely to be delayed until an agreement is in place, or after the Third Review.

The uncertainty concerning Iceland's future access to international capital markets continues to limit the MPC's room for manoeuvre, albeit less so than before the Second Review. However, if the króna remains stable or appreciates, and if inflation develops as forecast, there should be some scope for continued gradual monetary easing. As always, the MPC 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.