

30 June 2011  
SI 76225

Árni Páll Árnason  
Minister of Economic Affairs  
Ministry of Economic Affairs  
Skuggasund 3  
150 Reykjavík

*Re:* Report to the Government on inflation in excess of tolerance limits

The enclosed report is submitted in accordance with the declaration of the Government and the Central Bank of Iceland, dated 27 March 2001, when the Bank adopted an inflation target. The declaration states that, on balance, the Central Bank shall aim for an annual rate of inflation, measured as the twelve-month increase in the CPI, as close as possible to 2½%. If inflation deviates more than 1½ percentage points from the target, the Central Bank is obliged to send the Government a report stating what, in the Bank's view, are the main reasons for the deviation, how the Bank intends to respond, and how long it anticipates that it will take to bring inflation back to target. This report shall be made public.

It is appropriate to reiterate that the above-mentioned deviation limits do not represent a formal requirement that the Bank take action other than to submit the specified report if inflation moves outside the stated limits. The inflation target entails keeping inflation as close as possible to 2½% on balance, and not merely in the 1-4% range. Thus it is not a given that special action will be taken at the boundaries of that range. The reason for defining such a range is that, even though inflation may be determined by long-term monetary policy, other factors could cause it to deviate temporarily from the target. The nature of deviations may be such that monetary policy action would be either inappropriate or untimely; for example, if inflation rises because of temporary external oil and commodity price hikes.

As is stated in the report, the increase in global oil and commodity prices is one of the main reasons for the inflation episode of the past few months and does not, in and of itself, require monetary policy response. Core inflation measures that exclude these and other volatile items are still close to the inflation target. Nevertheless, core inflation has also risen markedly in recent months. The Central Bank of Iceland's Monetary Policy Committee has therefore expressed the opinion that the likelihood of a rise in interest rates has increased. As

always, individual interest rate decisions will depend on the conditions and outlook at any given time. Inflation will most likely rise further in coming months, but if the exchange rate of the króna holds stable, it should subside to the target next year. The outlook for these factors remains uncertain, however.

Respectfully yours,

CENTRAL BANK OF ICELAND

Már Guðmundsson  
Governor

*enc:* Report to the Government on inflation in excess of tolerance limits

*cc:*  
Prime Minister  
Minister of Finance