

Statement of the Monetary Policy Committee

21 May 2014

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

According to the Bank's new macroeconomic forecast, GDP growth will measure 3.7% this year, about 1 percentage point more than according to the previous forecast. Even stronger growth is projected for next year. Furthermore, the labour market continues to recover. Robust output growth will cause the slack in the economy to disappear earlier than previously forecast, and a positive output gap will develop, peaking in 2016. It is cause for concern that national saving is projected to diminish markedly and the current account surplus to turn into a deficit towards the end of the forecast horizon.

Inflation has been close to target in recent months and is expected to remain there until next year, when it is forecast to rise as a positive output gap emerges. Short-term inflation expectations have declined in the recent term, in line with falling inflation, although long-term inflation expectations are still somewhat above target.

The Bank's forecast assumes that the results of the wage agreements concluded late in 2013 will apply to most of the labour market and that similar agreements will be made for a longer term early next year. There is still some unrest in the labour market, however, which causes uncertainty about wage developments.

Because of the decline in inflation and inflation expectations, the Bank's real rate has risen markedly year-to-date. As a result, the slack in the monetary stance has probably disappeared. The level of the Bank's neutral real rate is uncertain, but increased growth in domestic demand in the near term will probably require further increases in the Bank's real interest rate, other things being equal. The more other measures, including restrictive fiscal policy, pull in the same direction as monetary policy, the less need there will be for a tighter monetary stance. This would also encourage increased national saving and lead to a more favourable current account balance.

Monetary policy has been successful in the recent term. Inflation has subsided to target, and the slack in the economy is vanishing. Volatility of inflation and output has also diminished. However, long-term inflation expectations are still somewhat above target, generating some uncertainty about the durability of this success. Whether a change in the Bank's nominal interest rates is warranted in the near future will depend on the future path of inflation and inflation expectations.

