No. 10/2019
22 May 2019

Statement of the Monetary Policy Committee
22 May 2019

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.5 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 4%.

According to the Bank's new macroeconomic forecast, published in the May issue of *Monetary Bulletin*, the GDP growth outlook has changed markedly since the Bank's last forecast. Output is now forecast to contract by 0.4% this year instead of rising by 1.8%, as was forecast in February. This deterioration in the outlook is due primarily to a contraction in tourism and reduced marine product exports because of the capelin catch failure. As a result, the positive output gap will close and a slack emerge in the near future.

Inflation measured 3.1% in Q1/2019 but rose to 3.3% in April. Underlying inflation has developed in broadly the same manner, and the difference between measures of inflation including and excluding housing is at its smallest since autumn 2013. The króna has held relatively stable in 2019 to date, and the inflationary effects of the autumn 2018 depreciation have thus far been smaller than anticipated. The deterioration in the economic outlook has caused the inflation outlook to change markedly in a short period of time, and the Bank's forecast assumes that inflation will peak at 3.4% in mid-2019 and then ease back to the target by mid-2020.

Although the recently finalised private sector wage agreements provide for sizeable pay increases, the outcome was better in line with the inflation target than was widely expected. Inflation expectations have therefore moderated again after having risen markedly over the course of 2018. Market agents' long-term inflation expectations have now eased back below 3%.

Although the economic contraction will be challenging for households and businesses, the economy is much more resilient than before. Furthermore, monetary policy has considerable scope to respond to the contraction, particularly if inflation and inflation expectations remain close to the target, as is currently envisioned. Moreover, the Government's proposed fiscal measures in connection with wage settlements will pull in the same direction.

Near-term monetary policy decisions will depend on the interaction between developments in economic activity, on the one hand, and inflation and inflation expectations, on the other.