Statement of the Monetary Policy Committee 6 November 2013

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 forecast, the outlook for 2013 is for somewhat stronger output growth than in the August forecast, or 2.3%, whereas the outlook for the next two years is broadly unchanged. The recovery of the labour market continues with increased strength, with total hours worked rising more this year than in any year since 2007.

After having risen somewhat in the third quarter, inflation has tapered off again. According to the Bank's forecast, the outlook is for gradual disinflation in coming quarters. Inflation will be lower than previously assumed in the near term, but the outlook through 2016 is broadly in line with the previous forecast. Inflation is expected to subside to target towards the end of 2015. Disinflation will therefore be slow and, as before, depend on near-term exchange rate and wage developments.

Iceland's terms of trade have continued to deteriorate for some time, eroding the current account surplus and putting pressure on the exchange rate of the króna. Looking ahead, there is uncertainty about how foreign debt deleveraging, the settlement of the failed banks' estates, and capital account liberalisation will affect the exchange rate.

At present, however, the upcoming wage negotiations are the most important source of uncertainty. As before, the forecast assumes, based on past experience, that wage increases in the forthcoming wage settlements will be larger than is consistent with the inflation target. If wage increases are in line with the forecast, it will probably be necessary to raise the Bank's nominal interest rates, other things being equal, particularly if the margin of spare capacity in the economy continues to narrow. If wages rise in excess of the forecast, it is even more likely that the Bank will raise interest rates. If wage increases are consistent with the inflation target, however, inflation will fall more quickly than is currently forecast and interest rates will be lower than would otherwise be necessary, other things being equal. Fiscal policy will also affect the monetary stance. Therefore, it is important that the final Budget maintain a level of fiscal consolidation at least equivalent to that provided for in the proposal.

The accommodative monetary stance has supported the economic recovery in the recent term. It is still the case that as spare capacity disappears from the economy, it is necessary that slack in monetary policy should disappear as well. The degree to which such normalisation takes place through changes in nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements.