Statement of the Monetary Policy Committee 4 February 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The Bank's key interest rate – the rate on seven-day term deposits – will therefore remain 4.5%.

According to preliminary figures from Statistics Iceland, GDP growth was somewhat weaker in the first three quarters of 2014 than was forecast in the Bank's November *Monetary Bulletin*. There are indications that these preliminary figures may be underestimated; nevertheless, the Bank's updated forecast assumes that GDP growth in 2014 was weaker than in the November forecast, or 2% instead of 2.9%. On the other hand, GDP growth in 2015 is expected to be stronger than previously projected, or 4.2% instead of 3.5%.

Inflation has subsided still further since the last interest rate decision. It measured only 0.8% in December and January and was slightly negative if the effects of housing costs are excluded. The outlook is for inflation to remain below 2% into 2016, which is below the November forecast. Low global inflation and a stable króna contain inflation and offset the effects of considerable domestic wage increases. Inflation expectations have fallen as well in recent months and are now close to target by most measures.

In many respects, the economic outlook is more uncertain than often before. The drop in petrol prices has had a strong impact on price developments in Iceland and abroad, but it is uncertain how long these conditions will persist. Wage growth has been strong in Iceland, unlike in most trading partner countries, and mounting unrest in the domestic labour market could jeopardise the stability that has been achieved.

The Bank's real rate has risen in the recent past, owing to declining inflation and inflation expectations. It is relatively high in view of the current business cycle position and the near-term outlook. Reductions in global fuel prices are beyond the scope of domestic monetary policy, however, and the disinflation resulting from them is temporary. Therefore, in determining interest rates, it is not possible to take full account of the disinflation stemming from this source. The outlook for the labour market is also highly uncertain, and at the same time, there are signs of strong GDP growth in the near future. For this reason, the MPC considers it appropriate to wait until the economic situation becomes clearer, particularly as regards wage developments.

As always, developments in nominal interest rates depend on developments in demand and inflation. If inflation remains below target and pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop. Large pay increases and strong growth in demand could undermine the recently achieved price stability, however, and require that interest rates be raised again.