Statement of the Monetary Policy Committee 16 November 2016

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 5.25%.

According to the baseline forecast published in the November issue of *Monetary Bulletin*, GDP growth is expected to be robust in 2016 and 2017 and to exceed the Bank's August forecast. To a greater degree than before, GDP growth is supported by domestic demand, which grew by nearly 10% in H1/2016. Job creation remains strong, unemployment is declining, and there are clearer signs that rapid demand growth is straining domestic resources, although this is offset somewhat by increased importation of foreign labour.

Inflation measured 1.8% in October and has remained below target for nearly three years despite large pay increases and rapid demand growth. Improved terms of trade, low global inflation, and the appreciation of the króna have offset the effects of wage increases on inflation. A tight monetary stance has also played an important role in containing inflation and anchoring inflation expectations. It has done this by slowing demand growth, directing some of the steep rise in income and wealth towards saving, and containing credit growth. In this way, monetary policy has supported the exchange rate of the króna, which has lowered import prices even further and shifted some of the demand towards imports.

According to the Bank's new inflation forecast, the outlook is for inflation to be below target until mid-2017 and then hover in the 2½-3% range for the remainder of the forecast horizon. This is a significant change from the Bank's previous forecast, owing mainly to the fact that the baseline forecast is now based on an endogenous exchange rate path and not on the technical assumption that the exchange rate will be constant throughout the forecast period. The inflation outlook has also improved, however, particularly in the short run. The change in the Bank's inflation forecast does not provide as much scope for monetary policy response as might be expected, as the MPC had already incorporated a strong probability of further appreciation of the currency into its recent policy decisions.

In recent months, the Central Bank has purchased a smaller share of foreign currency inflows than it did earlier in the year. The MPC is of the view that, other things being equal, it is appropriate to continue in this vein.

The MPC's decision to keep interest rates unchanged is taken upon consideration of the Bank's current forecast and the Committee's risk assessment. This includes, in particular, the uncertainty about the fiscal stance, which has eased in the past two years and remains uncertain because it is unclear at present what the next Government's economic policy will be. In addition, there is unrest in the labour market, not least in the wake of the recent ruling providing for pay increases for elected officials. Moreover, there is continued uncertainty about the impact of capital account liberalisation, although the process has been smooth thus far. Added to this is uncertainty about the global economic outlook.

Although inflation expectations appear to be more firmly anchored to target and the monetary stance has tightened to some extent through the appreciation of the króna, strong demand growth and the aforementioned uncertainties call for caution in interest rate setting. The monetary stance in the coming term will depend on economic developments and actions taken in other policy spheres.