Statement of the Monetary Policy Committee 12 February 2014

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

GDP growth is estimated to have been considerably stronger in 2013 than the Bank projected last November. This is consistent with previous indications of a strong labour market recovery. According to the Bank's forecast published today, GDP growth will gain pace in the next two years and the slack in the economy will disappear earlier than previously expected.

The króna has appreciated in recent weeks, in spite of substantial foreign exchange purchases by the Central Bank. The increase in unit labour costs will be smaller in 2014 than was previously forecast, provided that the main results of the wage settlements concluded in late December 2013 apply to the labour market as a whole. Inflation will therefore be lower this year than previously anticipated and will be close to target. The inflation outlook for the coming two years has deteriorated since the November forecast, however, as the outlook is for the slack in the economy to give way to an output gap during the period.

Measures to reduce households' indexed debt will have some effect on the medium-term economic outlook. Other things being equal, they will stimulate private consumption and imports, and reduce national saving and the current account surplus, which will contribute to a weaker króna than would otherwise result.

In the absence of other changes, the outlook for stronger domestic demand growth will require that the monetary stance be tightened sooner and more than previously expected. This could be offset by other measures that support monetary policy, however. Medium-term fiscal policy will be very important in this context. Furthermore, measures that strengthen the supply side of the economy could ease supply constraints, thereby weakening the inflationary effects of increased demand.

To the extent that inflation continues to abate, the monetary stance will grow tighter without nominal interest rate increases. However, the Bank's forecast implies that, other things being equal, it will be necessary to raise nominal interest rates as spare capacity in the economy disappears and an output gap emerges. Developments in the Bank's nominal interest rates will therefore depend, as before, on the future path of inflation.