Statement of the Monetary Policy Committee 5 November 2014

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.25 percentage points.

According to the Bank's forecast, published in *Monetary Bulletin* today, the outlook for 2014 is for somewhat weaker output growth than was forecast in August. Domestic demand growth is still expected to be strong, with robust GDP growth in the next three years. The recovery of the labour market continues as well, although growth in labour demand has lost pace somewhat.

Inflation has been below the inflation target for nine consecutive months and has fallen still further this autumn. Rising house prices have been the main source of inflation, while low global inflation and a stable króna have contributed to low inflation in spite of considerable wage increases. The short-term inflation outlook has therefore improved since August. According to the Bank's forecast, inflation is likely to fall further in the next few months and remain at or below target through mid-2015. Inflation expectations have fallen in recent months and are approaching the inflation target.

Increased national saving and a larger current account surplus than foreseen in previous forecasts have contributed to continued strong foreign currency inflows, and the Bank has leaned against excessive appreciation of the króna and helped to stabilise the exchange rate.

The Central Bank's nominal interest rates have been unchanged for two years, but the Bank's real rate has risen more than previously anticipated, owing to a more rapid decline in inflation and inflation expectations. The monetary stance has therefore tightened more than is warranted by the current business cycle position and the near-term outlook. Containing the rise in the real rate is therefore appropriate.

As always, developments in nominal interest rates will depend on developments in demand and inflation. If 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.