

Statement of the Monetary Policy Committee

19 August 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.5 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 5.5%.

According to the Bank's new forecast, GDP growth will be just over 4% this year and about 3% per year for the two years thereafter. Over the forecast period, growth will be about ½ a percentage point below the Bank's May forecast per year. It will be robust nevertheless, and a positive output gap will widen in the coming term, with GDP growth driven by domestic demand – especially private consumption – to a greater extent than in recent years. Investment will be weaker than previously forecast, however, and labour demand will grow more slowly.

Inflation has risen in the recent term but is still below the Bank's inflation target, particularly if the housing component of the CPI is excluded. However, the inflation outlook has deteriorated markedly since the last forecast, owing to the recent wage settlements, and inflation expectations have risen. Inflation is forecast to rise to 4% early in 2016 and to hover in the 4-4½% range over the next two years before easing towards the target, as the forecast implies that the monetary stance will be tightened in the near future.

Changes in the economic outlook since May are attributable primarily to the effects of large pay increases following the wage settlements and the monetary tightening that inevitably accompanies pay hikes of such size. The changes also stem from global factors, which have contributed to a more pronounced decline in import prices than previously expected, and improved terms of trade, which counteract the inflationary effects of the pay rises. Furthermore, the króna has appreciated slightly, in spite of substantial foreign currency purchases by the Central Bank.

If inflation rises in the wake of the wage settlements, as is forecast, the MPC will have to raise interest rates still further in order to bring inflation back to target over the medium term. How much and how quickly will depend on future developments and on how the current uncertainty plays out, including the degree to which large pay increases are passed through to prices, on the one hand, and the degree to which they prompt rationalisation and productivity growth, on the other. Developments in terms of trade, credit growth, and real estate prices are important factors as well. In addition, the interest rate path will depend on whether other policy instruments are used to contain demand-side pressures in the coming term.