

Statement of the Monetary Policy Committee

4 November 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.25 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 5.75%.

GDP is projected to grow at 4.6% this year, about ½ a percentage point more than the Bank forecast in August, and the medium-term GDP growth outlook has improved as well. GDP growth is driven mainly by domestic demand, which is projected to increase by more than 7% this year.

Inflation has been somewhat lower recently than was forecast in August and is still below the target, especially if the housing component of the CPI is excluded. This is due mainly to a continued decline in global oil and commodity prices and the appreciation of the króna, which has offset increased domestic inflationary pressures.

As a result, the short-term inflation outlook is considerably better than the Bank projected in August, although the longer-term outlook is broadly unchanged. It is still expected that large pay increases will cause inflation to rise above the target as 2016 progresses and the effects of low global inflation taper off. Inflation will not return to target until 2018. The forecast is based on the assumption that the monetary stance will be tightened as the positive output gap widens and inflation rises. It also takes account of the fact that the fiscal budget proposal for 2016 entails some fiscal easing after adjusting for the business cycle.

A stronger króna and more favourable global price developments have provided the scope to raise interest rates more slowly than was previously considered necessary. However, this does not change the need for a tighter monetary stance in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened will depend on future developments and on how the current economic uncertainty plays out. There is, among other things, considerable uncertainty at present about the transmission of monetary policy as the effects of unusually low global interest rates have been felt increasingly in Iceland. Monetary policy formulation will also depend on developments in liquidity in connection with capital account liberalisation and whether other policy instruments are applied in order to contain demand-side pressures in the coming term.