MONETARY POLICY COMMITTEE REPORT TO PARLIAMENT

2016 • 1

Monetary Policy Committee report to Parliament

1 July 2016

The Act on the Central Bank of Iceland stipulates that the Monetary Policy Committee (MPC) of the Central Bank of Iceland shall submit to Parliament (Althingi) a report on its activities twice a year and that the contents of the report shall be discussed in the Parliamentary committee of the Speaker's choosing.

The Act requires that the MPC meet at least eight times each year. Since the last Report was sent to Parliament, the Committee has held four regular meetings, most recently on 1 June 2016. The following report discusses the work of the Committee between January and June 2016.

Monetary policy formulation

According to the Act on the Central Bank of Iceland, the Central Bank's principal objective is to promote price stability. This objective is further described in the joint declaration issued by the Bank and the Icelandic Government on 27 March 2001 as an inflation target of 2½%. Furthermore, the Act stipulates that the Central Bank shall promote the implementation of the economic policy of the Government as long as it does not consider this policy inconsistent with its main objective of price stability. The Bank shall also promote financial stability. By law, the MPC takes decisions on the application of the Bank's monetary policy instruments; furthermore, the MPC's decisions shall be based on a thorough and careful assessment of developments and prospects for the economy, monetary policy, and financial stability.

In implementing monetary policy, the MPC bases its decisions in part on an analysis of current economic conditions and the outlook for the economy as presented in the Bank's *Monetary Bulletin*. The MPC's statements and minutes, enclosed with this report, contain the arguments for the Committee's decisions in the first half of 2016.

Developments from January to June 2016

After having raised the Bank's interest rates by 0.75 percentage points in the latter half of 2015, the MPC decided to keep rates unchanged at all four of its meetings in the first half of 2016. At the end of June 2016, the Bank's key interest rate – that is, the seven-day term deposit rate – was 5.75%, up from 5% at the end of June 2015.[1] The Committee also decided at its June meeting to lower reserve require-

1. The key rate is the interest rate that is the most important determinant of short-term market rates and therefore is the best measure of the monetary stance. At present, this is the seven-day term deposit rate. Other Central Bank interest rates have also remained unchanged from the beginning of the year, as can be seen in Table 1.

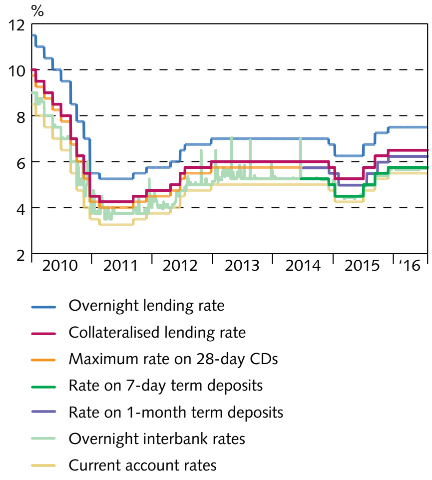
Table 1. Central Bank of Iceland interest rates 2016 (%)

Date	*Current accounts*	*Seven-day term deposits*	*Collateralised loans*	*Overnight loans*
1 June	5.5	5.75	6.5	7.5
11 May	5.5	5.75	6.5	7.5
16 March	5.5	5.75	6.5	7.5
10 February	5.5	5.75	6.5	7.5

Chart 1

Central Bank of Iceland interest rates and short-term market rates

Daily data 1 January 2010 - 30 June 2016

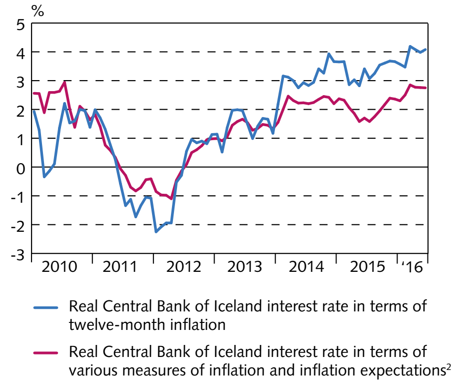


Source: Central Bank of Iceland.

Chart 2

Real Central Bank of Iceland interest rates[1]

January 2010 - June 2016

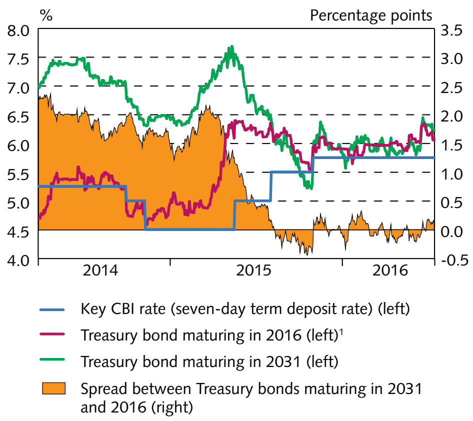


1. From 2010 to May 2014, the nominal policy rate was the average of the current account rate and the maximum rate on 28-day CDs. From May 2014, the policy rate has been the seven-day term deposit rate.
2. Until January 2012, according to twelve-month inflation, one-year business inflation expectations, one-year household inflation expectations, the one-year breakeven inflation rate, and the Central Bank forecast of twelve-month inflation four quarters ahead. From February 2012 onwards, according to the above criteria, plus one-year market inflation expectations based on a quarterly Central Bank survey.
Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 3

Key Central Bank rate and nominal Treasury bond yields

Daily data 21 May 2014 - 30 June 2016



1. From 14 April 2016, Treasury bond maturing in 2017 instead of 2016.
Source: Central Bank of Iceland.

ments from 2.5% to 2%, where they had been in autumn 2015, before the final steps were taken in the financial institutions' preparation for the settlement of the failed banks' estates and the auction of offshore krónur.[2]

Although the Bank's nominal interest rates remained unchanged, the monetary stance has tightened since the beginning of the year, when the MPC submitted its last report to Parliament. At the end of June 2016, the Bank's real rate was 2.8% in terms of the average of various measures of inflation and inflation expectations and 4.1% in terms of past twelve-month inflation. It was therefore 0.4 percentage points higher than at the beginning of the year. Yields on Treasury and Housing Financing Fund (HFF) bonds had remained relatively stable during the first five months of the year, in spite of increased new investment by non-residents. This is different from developments in 2015, when bond market yields declined sharply, particularly on long-term nominal Treasury bonds, concurrent with increased capital inflows.

However, yields on nominal Treasury bonds rose by about 0.3-0.6 percentage points in early June, after Parliament passed a new Temporary Provision of the Foreign Exchange Act, no. 87/1992, on 2 June and the Central Bank Rules on Special Reserve Requirements for New Foreign Currency Inflows took effect on 4 June. The main purpose of the Temporary Provision is to provide the Central Bank of Iceland with a new policy instrument, generally referred to as a capital flow management measure, to temper inflows of foreign currency and to affect the composition of such inflows. The capital flow management measure is intended to reduce the risk that could accompany excessive capital inflows by directly affecting the incentive for carry trade, thereby promoting more effective monetary policy transmission and contributing to macroeconomic and financial stability. Treasury bond yields have reversed in part and lay in the 6.1-6.2% range at the end of June, as much as 0.4 percentage points higher than at the beginning of the month and 0.2-0.4 percentage points higher than at the beginning of the year. In spite of this rise in bond market yields and the MPC's repeated statements that further interest rate increases would probably be necessary, the nominal Treasury bond yield curve has remained virtually flat. It therefore appears that there are still some flaws in monetary policy transmission along the interest rate channel as a result of capital inflows to the bond market, even though the impact on domestic interest rates has abated somewhat, in part due to the implementation of the Bank's capital flow management measure on 4 June.

The exchange rate of the króna has risen somewhat in the recent term. The króna has appreciated by 4.2% year-to-date in trade-weighted terms, by 3.3% against the euro, by 16.4% against the pound sterling and by 5.7% against the US dollar.[3] The apprecia-

2. The MPC decided at its meeting in December 2015 to lower reserve requirements from 4% to 2.5%, as they had been increased from 2% to 4% in September 2015 in order to strengthen the Bank's liquidity management in connection with its foreign currency purchases and capital account liberalisation. It was assumed that, other things equal, reserve requirements would be lowered again to 2% in connection with the auction of offshore krónur.

3. These figures apply to the appreciation of the króna from the turn of the year through 30 June. On 22 June, the day before the British approved the Brexit referendum, the króna had appreciated by 2.5% year-to-date in trade-weighted terms and by 6.8% against the pound sterling.

tion appears to be due primarily to favourable developments in terms of trade, tourism-related foreign currency inflows, and continued inflows in connection with new investment in the bond market. In the recent past, however, the Central Bank's foreign exchange market activity has mitigated the appreciation of the króna. In the first half of 2016, the Bank bought about 189 b.kr. in foreign currency from market makers in the foreign exchange market, a considerably larger amount than over the same period in 2015. The main objective of the Bank's foreign currency purchases is to counteract excessive exchange rate volatility, but it has also been necessary to build up the foreign exchange reserves during the prelude to capital account liberalisation.

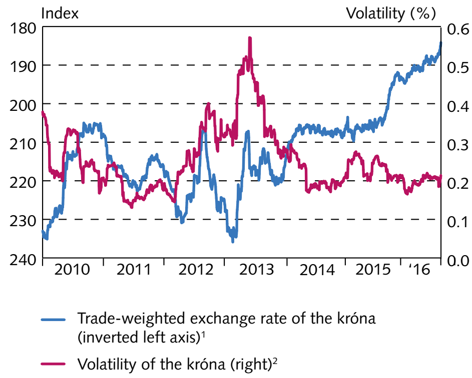
Inflation has fallen since the MPC submitted its last report to Parliament. In terms of the consumer price index (CPI), twelve-month inflation measured 1.6% in June, as opposed to 2.1% in January 2016. It has been at or below target for more than two years. Underlying inflation as measured by core index 3 (which excludes volatile food items, petrol, public services, real mortgage interest expense, and the effects of indirect taxes) measured 2.1% in June and has also declined since January.

The main drivers of inflation in the first half of 2016 were house prices and services prices. The CPI excluding the housing component remained unchanged year-on-year in June. The appreciation of the króna and a marked improvement in terms of trade over the past two years have given firms greater scope to absorb cost increases. As a result, sizeable wage rises and increased economic activity have not surfaced in rising domestic goods and services prices to any significant degree. In addition, monetary policy appears to have anchored inflation expectations more securely than before. To an extent, this could explain why inflation has not risen as high in the wake of the wage increases as historical experience has given cause to expect.

Short-term inflation expectations have subsided since the end of 2015. They are still above target, however, even though both headline and underlying inflation have been below target for over two years. According to recent surveys, market agents, households, and executives expect inflation to measure roughly 3% in one year's time, and their inflation expectations have fallen by just over ½ a percentage point since year-end 2015. As of the beginning of June, the breakeven inflation rate in the bond market was virtually unchanged year-to-date. Both the short-term and the long-term breakeven rate measured roughly 3%. It rose slightly, however, after Parliament passed the aforementioned Temporary Provision of the Foreign Exchange Act and the publication of the Bank's Rules on Special Reserve Requirements for New Foreign Currency Inflows. The increase therefore appears to stem from factors other than changes in market agents' inflation expectations. At the end of June, the two-year breakeven rate measured 3.3%, or similar to what it was at year-end 2015.

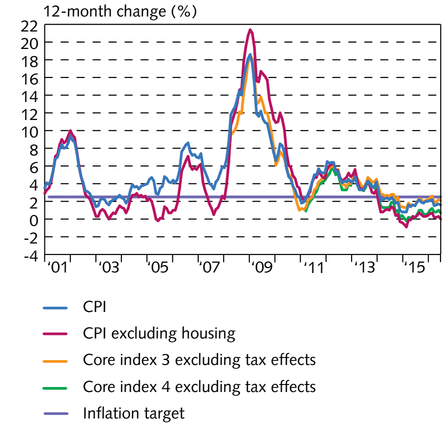
Long-term inflation expectations have remained relatively stable in the past year and are about the same as at the time of the MPC's last report to Parliament. Market agents expect inflation to average 3.5% in the next ten years, or 0.2 percentage points higher than they did in October. At the end of June, the five- and ten-year breakeven

Chart 4
Exchange rate and volatility of the króna
Daily data 4 January 2010 - 30 June 2016



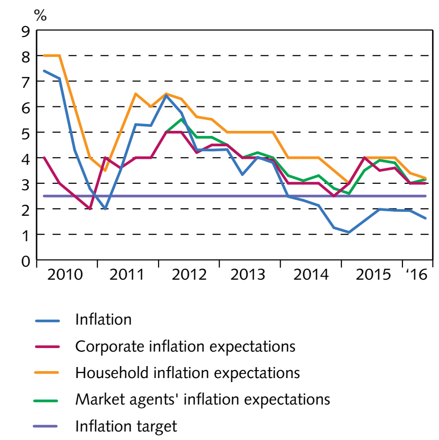
1. Price of foreign currency in terms of the króna. Inverted axis shows a stronger króna as a rise. 2. Volatility is measured by the standard deviation of daily changes in the past 3 months.
Source: Central Bank of Iceland.

Chart 5
Various measures of inflation[1]
January 2001 - June 2016



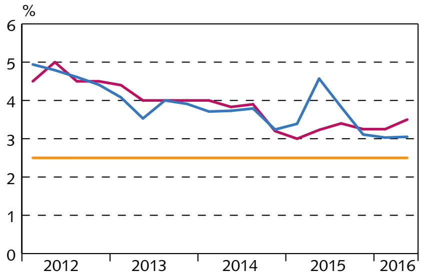
1. Core index 3 is the CPI excluding prices of agricultural products, petrol, and public services and the cost of real mortgage interest. Core index 4 excludes the market price of housing as well.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6
Inflation and inflation expectations one year ahead
Q1/2010 - Q2/2016



Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 7
Long-term inflation expectations
Q1/2012 - Q2/2016



Source: Central Bank of Iceland.

inflation rate was virtually unchanged since end-December 2015, at just over 3%.

Although inflation is still low, the inflation outlook is uncertain, as it was in January. As before, the pay rises are the main cause of increasing inflationary pressures, both directly – through firms' cost increases – and indirectly – through growing demand and a widening output gap. According to the forecast published in *Monetary Bulletin* on 11 May 2016, inflation is expected to rise, other things being equal, when the effects of a higher exchange rate and imported factors subside. How quickly it does so will depend on the timing and scope of the turnaround in imported inflation. According to the May forecast, inflation is expected to measure about 3% in Q4/2016 and approximately 4½% in the second half of 2017, but then begin to ease back to target in response to monetary tightening. The outlook is therefore similar to that at the beginning of the year, but inflation is expected to be higher in H2/2017 and early in 2018, as the outlook is now for stronger growth in economic activity than was assumed then.

In view of the interactions among these factors, the MPC has not considered it necessary to change interest rates thus far in 2016. On the other hand, members agreed at the June meeting that although global price developments and a stronger króna had provided the scope to raise interest rates more slowly than had previously been considered necessary, this did not change the fact that, according to the Bank's May forecast, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future developments.

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from February through June 2016.
2. Minutes of Monetary Policy Committee meetings from February through June 2016.
3. Press release on a new policy instrument to temper and affect the composition of capital inflows.
4. Press release on the Central Bank foreign currency auction of 16 June.
5. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001.

On behalf of the Central Bank of Iceland Monetary Policy Committee,

Már Guðmundsson

Governor of the Central Bank of Iceland
and Chair of the Monetary Policy Committee

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No. 4/2016
10 February 2016

Statement of the Monetary Policy Committee
10 February 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 5.75%.

Year-2015 GDP growth is estimated to have been weaker than was projected in the Bank's November forecast, or 4.1% instead of 4.6%. The outlook is for broadly similar GDP growth this year, or 4.2%. This is 1 percentage point stronger growth than was forecast in November. The difference is due to the prospect of stronger private consumption growth than was projected then, as the outlook is for larger pay increases, more rapid growth in employment, and lower inflation.

The margin of spare capacity is estimated to have disappeared last year, and the outlook is for a widening positive output gap. Pay rises well in excess of the inflation target and productivity growth exacerbate inflationary pressures, which are offset by developments in global energy and commodity prices and the exchange rate of the króna. Inflation has been lower than was forecast in November and appears set to remain so into 2017. Deflation in global goods markets could come to a halt, however, and eventually turn around in the coming term. According to international forecasts, this is expected to happen later in 2016. For this reason, among others, inflation is assumed to rise above 3% by end-2016 and reach 4% a year later. The extent and timing of these developments are uncertain, however.

Global price developments and a stronger króna have provided the scope to raise interest rates more slowly than was previously considered necessary. However, this does not change the fact that, according to the Bank's forecast, a tighter monetary stance will probably be needed 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.

No. 7/2016
16 March 2016

Statement of the Monetary Policy Committee
16 March 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 5.75%.

According to Statistics Iceland estimates, GDP growth measured 4% in 2015, well in line with the Central Bank's February forecast. Furthermore, indicators year-to-date suggest that the outlook for 2016 is broadly unchanged and that GDP growth will be robust in the coming term.

Inflation measured 2.2% in February and has risen by just over 1 percentage point in the past year. As before, domestic inflationary pressures and imported global deflation tend to offset one another. Inflation looks set to remain below the target well into this year, but the outlook is uncertain, including for import prices.

Global price developments and a stronger króna have provided the scope to raise interest rates more slowly than was previously considered necessary. However, this does not change the fact that, according to the Bank's forecast, a tighter monetary stance will probably be needed 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.

No. 8/2016
11 May 2016

Statement of the Monetary Policy Committee
11 May 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 5.75%.

According to Statistics Iceland estimates, GDP growth measured 4% in 2015, well in line with the Central Bank's February forecast. The outlook is for even stronger GDP growth this year, or 4.5%, according to the forecast published in *Monetary Bulletin* today. This is slightly more than was forecast in February. The outlook for 2017 has also been revised upwards, with GDP growth now projected at 4% instead of the 3.4% forecast in February. In the domestic labour market, growth can be seen in rapid job creation, a rising participation rate, and declining unemployment. Long-term unemployment has nearly disappeared, and firms are having more difficulty filling available positions than they have for quite a long time.

In spite of large pay increases and a widening positive output gap, inflation has remained below target for over two years. In April, inflation measured 1.6%, about the same as a year ago. As before, this reflects the offsetting effects of domestic inflationary pressures versus the appreciation of the króna and unusually low global inflation. Other things being equal, the outlook is for inflation to remain below target well into this year but then rise when import prices stop falling. According to the Central Bank forecast, inflation will measure 3% in Q4/2016 and 4½% in the second half of 2017, but then begin to ease back to target in response to monetary tightening. This is somewhat higher inflation than was forecast in February, as the outlook is now for stronger growth in economic activity than was assumed then.

Global price developments and a stronger króna have provided the scope to raise interest rates more slowly than was previously considered necessary. By the same token, there are signs that monetary policy has anchored inflation expectations more securely than before and contributed to a more moderate rise in inflation than could have been expected in the wake of large pay increases. However, this does not change the fact that, according to the Bank's forecast, a tighter monetary stance will probably be needed 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.

No. 11/2016
1 June 2016

Statement of the Monetary Policy Committee
1 June 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 5.75%. The Committee has also decided to lower reserve requirements by 0.5 percentage points, in line with previous statements.

The economic outlook is broadly unchanged since the last interest rate decision. The outlook is still for rapid GDP growth, and there is increased tension in the labour market. In spite of large pay increases and a widening positive output gap, inflation has remained below target for over two years. In May, inflation measured 1.7%, about the same as it did a year ago. As before, this reflects the offsetting effects of domestic inflationary pressures versus the appreciation of the króna and unusually low global inflation. Other things being equal, the outlook is for inflation to remain below target well into this year but then rise when import prices stop falling, as was assumed in the Bank's last forecast, published in *Monetary Bulletin* 2016/2 in May.

Global price developments and a stronger króna have provided the scope to raise interest rates more slowly than was previously considered necessary. By the same token, there are signs that monetary policy has anchored inflation expectations more securely than before and contributed to a more moderate rise in inflation than could have been expected in the wake of large pay increases. However, this does not change the fact that, according to the Bank's forecast from early May, a tighter monetary stance will probably be needed 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.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, February 2016

Published 24 February 2016

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and the premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of individual Committee members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meeting held on 1 and 8 February 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 10 February, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 9 December interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2016/1 on 10 February.

Financial markets

The exchange rate of the króna had risen by 1.2% in trade-weighted terms, by 5.9% against the pound sterling, and by 2.2% against the US dollar since the December meeting. It had fallen by 1% against the euro, however. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 636 million euros (90 b.kr.) between meetings, or about 67% of total market turnover.

The króna appreciated by nearly 8% in trade-weighted terms during 2015, as opposed to 1.7% in 2014. Improved terms of trade, continuing tourism-generated foreign currency inflows, and capital inflows in connection with increased new investment have supported the currency. Offsetting factors were the substantial foreign currency purchases made by the Central Bank so as to mitigate exchange rate volatility. The Bank's net foreign exchange purchases in the interbank market totalled 272.4 b.kr. in 2015, far exceeding the 2014 total of 111.4 b.kr. Foreign exchange market turnover rose by 85% year-on-year in 2015, totalling

492.7 b.kr. The Bank's transactions accounted for about 55% of total turnover in 2015, as opposed to about 43% in 2014. At the end of 2015, the foreign exchange reserves net of the Central Bank and central government's foreign-denominated debt were positive by 313 b.kr. and had grown by 256 b.kr. since year-end 2014.

As before, overnight interest rates in the interbank market for krónur were below the centre of the interest rate corridor, close to the Bank's key rate. Interbank market turnover totalled 23 b.kr. in January, broadly the same as in the past two months.

The monetary stance had remained broadly unchanged since the MPC's December meeting. At the time of the February meeting, the Bank's real rate was 2.6% in terms of the average of various measures of inflation and inflation expectations and 3.6% in terms of past twelve-month inflation.

When the Committee met in February, yields on nominal Treasury bonds were similar to those seen at the time of the December meeting, or 5.8-6.0%. Yields on indexed Government and Housing Financing Fund (HFF) bonds were also about the same as at the time of the December meeting, or 2.8-3.0%. According to the issuance plans published by Government Debt Management, net issuance of Treasury securities will be negative by nearly 30 b.kr. in 2016.

The large commercial banks' indexed and non-indexed deposit and lending rates were unchanged since the December meeting, as was the pension funds' average mortgage lending rate.

The risk premium on the Republic of Iceland's foreign obligations rose at the start of the year, as it did for many other developed countries, in response to increased unrest in global financial markets. The CDS spread on five-year Treasury obligations declined again in late January, however, and measured just under 1.3% at the time of the February meeting, or about 0.1 percentage point lower than at the time of the December meeting. The risk premium as measured by the interest rate spread between Icelandic Treasury bonds and comparable bonds issued by the US and Germany had increased by 0.2-0.5 percentage points since December, however, to 1.7-2.0 percentage points.

Financial institutions' analysts had all expected the Central Bank's nominal interest rates to be held unchanged in February, mainly citing low inflation that was still below the Bank's inflation target.

M3 grew by 7.6% year-on-year in Q4/2015 and by 7.1% excluding deposits held by financial institutions in winding-up proceedings. The total stock of deposit institutions' loans to resident borrowers contracted by nearly 1% year-on-year in Q4/2015, and by approximately 3½% if loans from the HFF and the pension funds are included. The contraction is due for the most part to the Government's debt relief measures. Adjusted for these measures, the credit stock is estimated to have contracted by just over 1%. The contraction is also due in part to a reduction in corporate lending, which is owing partly to refinancing of older loans through other forms of credit, including marketable bonds.

The Nasdaq Iceland OMXI8 index had fallen by nearly 4½% year-to-date, in line with developments in global financial markets. The decline between MPC meetings was almost 3%. Turnover in the main market totalled just under 392 b.kr. in 2015, an increase of about 42% from the prior year. Furthermore, turnover was about 58.5 b.kr. in January 2016, considerably more than in January 2015.

Global economy and external trade

The global GDP growth outlook has deteriorated somewhat and has grown more uncertain. The International Monetary Fund's (IMF) January forecast estimates global GDP growth at 3.4% in 2016 and 3.6% in 2017, or some 0.2 percentage points less in each of the two years than in its October forecast. The poorer outlook is attributable mainly to a weaker economic recovery in both the US and emerging economies, particularly Brazil and the Middle East. In industrialised countries, inflation is projected at 1.1% in 2016, or 0.1 percentage point less than in the October forecast, but the outlook for 2017 is unchanged. In emerging and developing countries, however, inflation is expected to pick up over the next two years. It is forecast at 5.6% this year and 5.9% in 2017. *Consensus Forecasts'* year-2016 GDP growth projections for Iceland's main trading partners were unchanged between MPC meetings, although the inflation forecasts had been lowered by 0.2 percentage points.

The deficit on Iceland's goods trade totalled 8.7 b.kr. in December and, according to preliminary figures from Statistics Iceland, 1.2 b.kr. in January. The deficit totalled 31.3 b.kr. in 2015, as opposed to a surplus of 5.5 b.kr. in 2014. Import values rose by 14.9% year-on-year in 2015 and export values by 8.2%. Import growth in 2015 is due mainly to increased transport equipment imports, while export growth is due to an increase in the export value of marine products.

In terms of relative consumer prices, the real exchange rate measured 92.2 points in January, an increase of almost 1% month-on-month and nearly 10% year-on-year. The increase is due primarily to a 9% nominal appreciation of the króna, but in addition, inflation in Iceland was nearly 1 percentage point above the average among its trading partners. In 2015, the real exchange rate rose by an average of 4% in terms of relative consumer prices and by 12% in terms of relative unit labour costs.

Listed global aluminium prices had risen by just over 2% between MPC meetings, but the average January price was down more than 18% year-on-year. Foreign currency prices of marine products rose by 1½% between months in December and had risen 4½% year-on-year at that time. In all, marine product prices rose by nearly 9% year-on-year in 2015.

The domestic real economy and inflation

The wage index rose by 2.2% between quarters and by 8.8% year-on-year in Q4/2015, and real wages were 6.7% higher than in Q4/2014.

The results of the Statistics Iceland labour force survey (LFS) show that total hours worked grew by 3% in Q4/2015, in line with the Bank's November forecast. The increase was due entirely to a rise in the number of employed persons. Total hours worked increased by 3.3% between yearly averages in 2015, while the participation rate rose by 1.1 percentage points and the employment rate by 1.8 percentage points. Because of increased labour participation, the decline in unemployment was smaller than the rise in the employment rate, or about 1 percentage point. The number of persons outside the labour market declined by nearly 5% year-on-year in 2015.

Unemployment according to the LFS was considerably lower in Q4 than was projected in November, or 3.1% as opposed to 4.9%, and declined by 1 percentage point between years. Seasonally adjusted unemployment fell by half a percentage point between quarters, to 3.6%. Unemployment was 4% in 2015, down from 5% in 2014. Unemployment as measured by the Directorate of Labour (DoL) measured 3% in 2015 and had fallen by just over half a percentage point between years.

Key indicators of developments in private consumption imply that growth gathered pace in Q4/2015. Payment card turnover rose by nearly 6½% year-on-year, broadly in line with developments during the year as a whole. The number of new motor vehicle registrations picked up in the latter half of 2015 and, in Q4, was up nearly 70% year-on-year, while groceries turnover contracted year-on-year during the quarter.

Statistics Iceland's nationwide house price index, published at the end of January, rose by 0.9% month-on-month, after adjusting for seasonality, and by 8.6% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by just over 1% month-on-month in December when adjusted for seasonality and by 8.9% year-on-year. It rose by 9.4% between yearly averages in 2015, and the number of registered purchase agreements nationwide rose 21% between years. The average time-to-sale for residential property in the greater Reykjavík area declined by a month between 2014 and 2015, to just under 3½ months.

In January, the Gallup Consumer Sentiment Index rose slightly between months and by 42.5 points year-on-year. In Q4/2015, the index was 32.5 points higher, on average, than in the same period in 2014.

The CPI declined by 0.6% month-on-month in January, after rising by 0.3% in December. Twelve-month inflation measured 2.1% and had therefore risen marginally since the previous MPC meeting. The CPI excluding the housing component fell by 1.1% month-on-month in January, and inflation by that measure was 0.6%, or 0.3 percentage points higher than just before the Committee's December meeting. Underlying inflation in terms of core index 3 excluding tax effects had also risen slightly between meetings, to 2.4%. Statistical measures of underlying inflation suggest that it lay in the 2-3½% range. Inflation averaged 1.6% in 2015, down from 2% in 2014.

Winter sales lowered the index by 0.9 percentage points in January, in addition to the drop in petrol prices. Pulling in the opposite direction were house prices and various private services, as well as seasonal price list increases. The price of private services has risen by 2.6% in the past twelve months, and the year-on-year rate of increase has remained broadly unchanged in recent months. Domestic petrol prices have fallen by 5.6% in the past three months, whereas global oil prices have declined by approximately 30% over the same period.

Some base effects could be seen in January, as the increase in the lower value-added tax threshold, implemented at the beginning of 2015, no longer affects the twelve-month rise in food prices. By the same token, petrol prices fell considerably less month-on-month in January 2016 than they did a year ago, which is the main reason imported deflation was less pronounced than it has been in the recent term.

According to the Central Bank's survey of market agents' inflation expectations, conducted at the beginning of February, participants expect inflation to measure 3% in one year. This is 0.8 percentage points lower than in the previous survey, taken in October 2015, as the inflation outlook has improved since the year-end. Respondents' expectations two years ahead had declined by 0.5 percentage points and measured 3.5%. Market agents expect inflation to average 3.3% over the next ten years, which is unchanged from the previous survey but 0.3 percentage points higher than in a comparable survey carried out a year ago. The breakeven inflation rate in the bond market has declined markedly since mid-2015, due for the most part to unusual conditions in the bond market rather than to an actual decline in inflation expectations. The breakeven rate five and ten years ahead averaged 3% in January, about 0.2 percentage points lower than it was in December and ½ a percentage point lower than a year ago.

According to the forecast published in *Monetary Bulletin* on 10 February 2016, the outlook is for inflation to be below the November forecast into 2017. Imported deflationary pressures have proven stronger than previously assumed, as global oil prices have continued to fall and are considerably lower than was projected in November. The inflation outlook for 2016 has therefore improved. However, in line with international forecasts, it is assumed that oil and commodity prices will begin to rise later this year and that inflation will therefore pick up, due to growing tension in the economy and large pay increases in the recent past. Inflation is expected to rise above 3% by the year-end, peak at 4.2% in Q4/2017, and then subside to just below 3% by the end of the forecast horizon.

The inflation outlook is highly uncertain, however, because the timing and extent of an increase in oil and commodity prices is uncertain, as is the extent to which pay rises will be passed through to prices and whether the increase in real disposable income leads to stronger private consumption growth than is provided for in the forecast.

The economic recovery among Iceland's trading partners slowed down over the course of 2015. Global economic uncertainty has also increased, and the GDP growth outlook is considered to have deteriorated since the November forecast. The impact on the domestic economy has been limited thus far, however: export growth has been strong, terms of trade have improved, and both look set to continue in a favourable pattern this year.

Because wages have risen more this year than was assumed in November and wage-related expenses will rise more strongly over the next two years, unit labour costs are now projected to rise by over 9% this year, on the heels of a 9½% increase in 2015. This increase is 1¼ percentage points larger than was forecast in November. The increase in the next two years is also greater, or about 5% per year, on average, as opposed to 4¾% in the November forecast.

Year-2015 output growth is estimated to have been somewhat below the Bank's November forecast, or 4.1% instead of 4.6%, owing mainly to stronger-than-expected import growth. The GDP growth outlook for 2016 has changed markedly, however, because the outlook is now for much stronger growth in real disposable income than was previously forecast, owing to more robust employment growth, larger pay increases, and the prospect of lower inflation during the year. GDP growth for 2016 is projected at 4.2%, 1 percentage point more than was forecast in November. As in the Bank's previous forecasts, it is expected to slow somewhat in the next two years, to about 3-3½% per year in 2017 and 2018.

The post-crisis slack in output is considered to have been fully absorbed last year and a positive output gap has opened up. This shows, for instance, in strong growth in real disposable income and rapidly declining unemployment.

II The interest rate decision

Committee members discussed whether developments since the last meeting had changed its assessment of whether the monetary stance was appropriate and whether the economic outlook had changed. In December the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, although the Committee considered it likely that the monetary stance would have to be tightened in the coming term.

Members noted that inflation had been lower than was forecast in November and that, based on the new forecast, it appears set to remain so into 2017, as oil prices had fallen more than previously projected. As at previous meetings, members agreed that these favourable conditions could change quickly if deflation in global goods markets comes to a halt and turns around. Members considered the extent and timing of such developments uncertain and were of the view that this uncertainty had increased between meetings.

Members agreed with the assessment of the Central Bank's baseline forecast, that economic activity was growing somewhat more strongly than had been foreseeable at the time of the December meeting, although the broad outlines of economic developments were the same as before. Although year-2015 GDP growth had turned out slightly weaker than was forecast in November, according to Statistics Iceland's most recent estimates, the outlook was for stronger growth in 2016, due in particular to more robust private consumption growth than had previously been assumed. This was due primarily to the outlook for larger wage increases, more rapid growth in employment, and lower inflation than previously forecast.

Committee members also noted that the margin of spare capacity was estimated to have disappeared last year and that the outlook was for the output gap to widen in the near future – and somewhat more than previously estimated. In view of this, MPC members were concerned that the fiscal stance had eased still further with the passage of the National Budget for 2016. Based on the Budget and the outlook for a widening output gap, the fiscal stance is now estimated to ease by over 2% of GDP in 2015 and 2016, or by just over 50 b.kr. This development places greater burden on monetary policy than would otherwise exist, which is unfortunate under current circumstances, given the wide interest rate differential with abroad and the inflows of foreign capital into the domestic Treasury bond market. If such a policy mix persists in coming years, it could result in growing economic instability.

Members were also concerned that the inflationary pressures caused by pay rises had grown even stronger, as recent negotiations had resulted in further wage increases even though wage hikes were already well in excess of the inflation target plus productivity growth. As it had done at previous meetings, the Committee discussed the reasons why large wage increases had not affected domestic inflation more strongly than they had actually done. It was pointed out that wage hikes well in excess of the inflation target and productivity growth could take place over a short period of time without commensurate inflationary effects if terms of trade improved at the same time. The labour market may also have grown more flexible, as the influx of foreign labour had increased in response to a shortage of labour instead of employers' competing for employees by outbidding each other in terms of wages. It was also mentioned that in spite of the possibility that unemployment has fallen below the level consistent with low and stable inflation, it was also conceivable that the equilibrium unemployment rate was lower than currently thought. It was pointed out that the impact of wage hikes materialises with somewhat of a lag, however, and it was therefore possible that last year's contractual wage increases had not yet come fully to the fore. It was also possible that the monetary tightening implemented by the MPC in the wake of the wage settlements was having some effect. Signs of growing confidence in monetary policy could be seen in long-term developments in inflation expectations and in the prospect that it would be possible to hold inflation at target during the current upswing at a lower interest rate level than in previous upswings, even though wage increases had been large in historical context.

Committee members discussed whether the monetary stance was too tight, given that according to the Bank's most recent market expectations survey, the share of respondents who considered the monetary stance too tight was larger than in the previous survey, conducted in October. It was mentioned that this development was in line with the rise in real interest rates. On the other hand, it was pointed out that a majority of survey respondents still considered the monetary stance appropriate or too loose. It was also pointed out that investment and private consumption were growing strongly and that unemployment was low, which did not indicate that the real rate was too high. Emphasis was placed on the need for the MPC to be forward-looking in its decisions and to respond promptly to a deteriorating long-term inflation outlook. The history of poorly anchored inflation expectations in Iceland must be borne in mind. All Committee members agreed that it was positive that the interest rate level appeared to support increased saving, which reduced the likelihood that the current account surplus would turn around into a deficit in the near future and that asset prices would rise excessively.

The Committee discussed whether the Bank's interest rates should be changed. No members were of the view that there were clear reasons to take action at this meeting. In members' view, domestic inflationary pressures had increased somewhat since the last meeting. The deflationary effects of developments in global energy and commodity prices and the exchange rate of the króna were stronger than previously assumed, however, and appeared likely to persist longer. Inflation was still below target, and opposing forces would continue to affect it. MPC members were of the view that uncertainty about the interaction between these factors had grown. They agreed that the overall picture had not changed much since the previous meeting. They had differing opinions about the weight of the factors that could affect inflation in the coming term, however. While some placed more emphasis on the global economy and considered it possible that global deflation could prove more pronounced and more protracted than previously thought, others were more concerned about the widening positive output gap and increased domestic inflationary pressures.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

Committee members agreed that even though global price developments and a stronger króna had provided the scope to raise interest rates more slowly than had previously been considered necessary, this did not change the fact that, according to the Bank's February forecast, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future developments.

Members also agreed that no further changes should be made to reserve requirements at this time. There was continuing discussion of additional policy instruments other than interest rates that could be used to restrict capital inflows related to carry trade, and of the work being done towards developing such instruments. MPC members agreed on the importance of concluding this work as soon as possible.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 16 March 2016.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, March 2016

Published 30 March 2016

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and the premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of individual Committee members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meeting held on 15 March 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 16 March, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 10 February interest rate decision.

Financial markets

The exchange rate of the króna had risen by 0.4% in trade-weighted terms, by 0.2% against the US dollar, by 1.3% against the euro, and by 2.5% against the pound sterling since the February meeting. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 180 million euros (25.5 b.kr.) between meetings, or about 52% of total market turnover.

As before, overnight interest rates in the interbank market for krónur were below the centre of the interest rate corridor, close to the Bank's key rate. Turnover in the interbank market totalled 25.5 b.kr. in February, similar to that in the preceding three months.

In terms of the Central Bank's real interest rate, the monetary stance was broadly unchanged since the Committee's February meeting. At the time of the March meeting, the Bank's real rate was 2.7% in terms of the average of various measures of inflation and inflation expectations and 3.5% in terms of past twelve-month inflation.

When the Committee met in March, yields on nominal Treasury bonds were similar to those seen at the time of the February meeting, or 6.0-6.2%. Yields on indexed Government and Housing Financing Fund (HFF) bonds were also about the same as at the time of the February meeting, or 2.7-2.8%.

The large commercial banks' indexed and non-indexed deposit and lending rates were unchanged since the February meeting, as was the pension funds' average mortgage lending rate.

The risk premium on the Republic of Iceland's foreign obligations had declined between meetings, and the rise at the beginning of the year had reversed. The CDS spread on five-year Treasury obligations was about 0.3 percentage points less than at the time of the February meeting. It measured just under 1%, the lowest since the beginning of 2008. The risk premium as measured by the interest rate spread between Icelandic Treasury bonds and comparable bonds issued by the US and Germany had narrowed by roughly 0.3 percentage points since February, however, to about 1½ percentage points.

Financial institutions' analysts had all expected the Central Bank's nominal interest rates to be held unchanged in March, mainly citing, as before, low inflation that was still below the Bank's inflation target.

M3 grew by 3.2% year-on-year in January. The annual growth rate is lower than it has been in recent months, owing mainly to a contraction in deposits held by financial institutions in winding-up proceedings. After adjusting for these deposits, year-on-year growth in M3 was much stronger, or 11%. The total stock of loans from deposit institutions, the Housing Financing Fund (HFF), and pension funds to resident borrowers contracted by about 1½% year-on-year in January. The credit stock adjusted for the Government's debt relief measures was estimated to have grown by 0.2% year-on-year.

The NASDAQ OMXI8 index had risen by 6.4% between meetings in March. The index had risen by 1.7% since year-end 2015, and the decline at the beginning of this year had therefore reversed. Turnover in the main market totalled just over 112 b.kr. in the first two months of the year, considerably more than during the same period in 2015.

Global economy and external trade

The deficit on Iceland's goods trade totalled about 2.8 b.kr. in the first two months of the year, about the same as during the same period in 2015. Export values contracted by 6.8% year-on-year at constant exchange rates, while import values fell by 6.4%. The export value of industrial goods declined by 21% year-on-year while the export value of marine products rose by nearly 9%. The contraction in imports is due mainly to a 37% year-on-year contraction in transport equipment imports, a 32% contraction in imports of fuel and lubricants, and a more than 12% contraction in imports of commodities and operational inputs.

In terms of relative consumer prices, the real exchange rate rose by 10% year-on-year in February. The increase is due primarily to a 8.2% nominal appreciation of the króna, but in addition, inflation in Iceland was about 1.7 percentage points above the average among its trading partners.

The listed global market price of aluminium was virtually unchanged since the February meeting, and the average February price was down almost 16% year-on-year. Foreign currency prices of marine products had declined by 1% month-on-month in January but had risen by over 3% year-on-year.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, year-on-year GDP growth measured 3.2% in Q4/2015. Domestic demand grew 7.5% year-on-year during the quarter. Of that total, consumption and total investment grew by 9%. Imports grew strongly, and the contribution from net trade was therefore negative in spite of 10.6% export growth.

GDP growth measured 4% in 2015, reflecting the offsetting effects of 6.3% growth in domestic demand and the negative contribution from net trade. GDP growth for the year was in line with the Bank's February forecast of 4.1%. The composition of GDP growth for the year was also well in line with the forecast. The forecast had assumed stronger growth in domestic demand than Statistics Iceland figures indicated, however. Consumption and investment developed in line with the forecast, and the deviation in domestic demand was therefore due to inventory changes. The contribution from net trade was more positive than was provided for in the forecast, however, primarily due to stronger exports.

The underlying current account balance was positive by 108 b.kr. in 2015, or 4.9% of GDP, broadly the same as in 2014. The surplus on goods and services trade was larger than in the previous year, while secondary income was more strongly negative, largely due to the 20 b.kr. settlement payment made by the Depositors' and Investors' Guarantee Fund (DIGF) to the British deposit guarantee scheme and the Dutch central bank. The forecast in the February *Monetary Bulletin* assumed that the current account surplus had amounted to 3.7% of GDP in 2015. The deviation is due largely to stronger-than-expected returns on foreign direct investment, although the surplus on services trade was also larger than anticipated. Iceland's international investment position also improved markedly in 2015 following the conclusion of composition agreements by the failed banks' estates, measuring -14.5% of GDP at the end of the year.

In Q4/2015, private consumption growth was somewhat stronger than in the first three quarters of the year. Key indicators from Q1/2016 suggest that growth will pick up even more. Payment card turnover in January and February was up by just over 13% year-on-year. There was also a marked increase in the number of new motor vehicle registrations in the first two months of 2016, and most retail sales indices indicate that sales were up at the start of the year.

The Gallup Consumer Sentiment Index measured 118.5 points in February, slightly lower than in January but 27 points higher than in February 2015. All subindices declined between January and February; however, they were much higher than in 2015, owing mainly to an improvement in the assessment of the current situation.

According to the results of Gallup's spring survey, carried out in February among executives from Iceland's 400 largest firms, optimism about the economic outlook six months ahead increased somewhat in comparison with the winter survey, conducted in November. About 76% of respondents considered the current situation good, and a fifth considered it neither poor nor good. Just under 44% of executives were of the view that economic conditions would improve in the next six months, and about 47% expected conditions to remain unchanged (i.e., good). Construction industry executives were more optimistic than others about the six-month outlook, and their assessment improved most from the winter survey. In addition, executives in transport and tourism were somewhat more optimistic than in November. Overall, executives were more optimistic than they were a year ago, except for those in the financial services and fishing sectors. About 9% of executives were of the opinion that conditions would deteriorate over the next six months.

Executives seem more optimistic about domestic demand than at any time since measurements began in 2004, with about 60% indicating that they expected demand for their goods and services to increase in the next six months. Expectations concerning foreign demand in the next six months were strong as well but have subsided somewhat since year-end 2014.

According to Gallup's spring survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by nearly a third. This indicates considerably more optimism than in both the winter survey and the survey conducted a year ago. The percentage is at its highest since 2007, as is the number of firms planning to hire employees in coming months. The change since the last survey is due both to an increase in the number of firms planning to recruit and to a decline in the number planning to lay workers off. Executives in all industries except fishing were more optimistic about staff recruitment than in the last survey, and those selling their products overseas were more so than those selling their products domestically.

Just under a third of firms considered themselves short-staffed, the largest share since year-end 2007 and an increase of more than 13 percentage points year-on-year. Almost 60% of construction firms and nearly 40% of firms in transport and tourism considered themselves short-staffed. Construction companies planning to add on staff in the next six months outnumbered those planning redundancies by about 70 percentage points, and in the transport and tourism sector, almost half of firms were planning to recruit and none were planning to downsize.

Just over half of respondents in the spring survey considered themselves able to respond to an unexpected surge in demand, a decline of 10 percentage points year-on-year and more than 25 percentage points from the 2011 peak.

According to the Statistics Iceland labour force survey (LFS), labour demand growth continued in January. Seasonally adjusted unemployment measured 2.5% in January, having declined by 1½ percentage points between years. Seasonally adjusted unemployment has therefore been below 3% for two months in a row, the lowest level seen since mid-2008.

The wage index rose by 0.4% month-on-month in January and by 9.4% year-on-year. Real wages in terms of the index had risen by 6.5% year-on-year in January.

Statistics Iceland's nationwide house price index, published at the end of February, rose by 1.1% month-on-month, after adjusting for seasonality, and by 8.5% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.9% month-on-month in January when adjusted for seasonality, and by 8.5% year-on-year. The number of registered purchase agreements nationwide rose 26.7% between years in January. The average time-to-sale for flats in the greater Reykjavík area was about 3.5 months in January, down from 4.1 months in January 2015.

The consumer price index (CPI) rose by 0.7% month-on-month in February, raising twelve-month inflation to 2.2%, slightly more than in January. The CPI excluding the housing component had risen by only 0.7% in the past twelve months, however. Underlying inflation according to core index 3 excluding tax effects had risen since the February meeting and measured 2.6%, its highest since summer 2014. Statistical measures of underlying inflation suggest that it lay in the 2-3½% range.

The main drivers of the increase in the CPI in February were end-of-sale effects and rising house prices. The reductions in furniture, housewares, and electronic equipment prices in January reversed in full, and the effects were stronger than they were a year earlier. International airfares declined somewhat in February and were 5.4% lower than they were at the same time in 2015. Other services items rose somewhat in price, however. Private services prices had risen by 2.2% in the past twelve months, as opposed to 2.6% in January.

According to Gallup's spring survey of household inflation expectations, carried out in February, households expected inflation to measure 3.4% one year ahead, or 0.6 percentage points less than in the winter survey, carried out in November. Households' one-year expectations are still nearly ½ a percentage point higher than they were a year ago, however. On the other hand, two-year inflation expectations were unchanged at 4%. According to Gallup's spring survey among executives, respondents' one-year inflation expectations had declined by 0.6 percentage points between surveys, to 3%, whereas two-year inflation expectations were unchanged at 3.5%.

The breakeven inflation rate in the bond market was broadly unchanged between meetings. The breakeven rate two year ahead was 3.3% just before the March meeting, or about 0.2 percentage points higher than at the February meeting, while the breakeven rate five and ten years ahead was unchanged at just over 3%. In February, the ten-year breakeven rate averaged just under 1 percentage point lower than at the same time in 2015.

II The interest rate decision

The Governor informed the MPC that the analysis in connection with special capital flow management tools designed to affect carry trade-related capital inflows was well advanced. He also updated the Committee on matters relating to the Bank's capital account liberalisation strategy, including the planned auction of offshore krónur.

Because the timing of the auction had not been decided, members did not consider it timely to change reserve requirements, although the Committee had decided in December that, other things being equal, reserve requirements should be lowered back to 2% in connection with the auction.

Committee members discussed whether developments since the last meeting had changed its assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the February meeting, the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, although the Committee considered it likely that the monetary stance would have to be tightened in the coming term.

Only a short time had passed since the previous meeting, and the information published in the interim largely supported the Committee's previous assessment of the economy. In the MPC's opinion, growth in economic activity was broadly in line with the Committee's assessment at the February meeting. According to preliminary figures from Statistics Iceland, GDP growth measured 4% in 2015, well in line with the Central Bank's February forecast. Committee members agreed that the indicators that had emerged year-to-date suggested that the outlook for 2016 was broadly unchanged, with the prospect of robust GDP growth in the coming term. Indicators of private consumption and from the labour market also implied that demand had grown rapidly in the recent past.

Members also noted that the inflation outlook was broadly as assumed in the Bank's February forecast. Inflation measured 2.2% in February and had risen by just over 1 percentage point in the past year. As before, Committee members were of the view that domestic inflationary pressures and imported global deflation tended to offset one another. In their opinion, inflation looked set to remain below target well into the year, but the outlook was still uncertain, including for import prices.

In view of this, no members saw any reason to change interest rates at present. Committee members agreed that it was appropriate to pause and hold rates unchanged, as the Bank's new forecast, including an assessment of the effects of recent developments on the medium-term inflation outlook, would be available at the time of the next meeting. In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

Committee members agreed that even though global price developments and a stronger króna had provided the scope to raise interest rates more slowly than had previously been considered necessary, this did not change the fact that, according to the Bank's February forecast, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future developments.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 11 May 2016.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, May 2016

Published 25 May 2016

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and the premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of individual Committee members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meeting held on 4 and 10 May 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 11 May, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 16 March interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2016/2 on 11 May.

Financial markets

Since the March meeting, the króna had appreciated by 0.9% in trade-weighted terms, by 3.3% against the US dollar, by 0.5% against the euro, and by 1.2% against the pound sterling. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 330 million euros (46.4 b.kr.) between meetings, or about 55% of total market turnover. The Bank's net purchases year-to-date totalled approximately 889 million euros (125.5 b.kr.)

As before, overnight interest rates in the interbank market for krónur were below the centre of the interest rate corridor, close to the Bank's key rate. Turnover in the interbank market totalled 10 b.kr. since the last meeting, considerably less than over the same period in 2015.

In terms of the Central Bank's real interest rate, the monetary stance was broadly unchanged since just after the Committee's last interest rate decision. Just before the May meeting, the Bank's real rate was 2.8% in terms of the average of various measures of inflation and inflation expectations. In terms of past twelve-month inflation, however, it rose by 0.6 percentage points since the March meeting, to 4.1%.

Non-residents' new investment in the bond market has increased year-to-date, after declining towards the end of 2015. As before, the investment was mostly in nominal Treasury bonds. It totalled about 24.3 b.kr. in the first four months of 2016, as opposed to about 54.1 b.kr. in 2015. In spite of increased inflows, bond market yields have remained relatively stable, unlike in 2015, when they declined markedly, particularly yields on long-term nominal Treasury bonds. When the Committee met in May, yields on nominal Treasury bonds were similar to those seen at the time of the March meeting, or about 5.9-6%. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds were also about the same as at the time of the March meeting, or 2.8-3%. The nominal Treasury yield curve is virtually flat even though the MPC has stated that it will probably be necessary to raise the interest rates further. Therefore, there are still some flaws in monetary policy transmission as a result of capital inflows into the bond market, although the impact of the inflows on domestic interest rates appears to have weakened.

The large commercial banks' indexed and non-indexed deposit and lending rates were broadly unchanged since the March meeting, as was the pension funds' average mortgage lending rate.

The risk premium on the Republic of Iceland's foreign obligations had remained broadly unchanged between meetings. The CDS spread on five-year Treasury obligations had risen slightly, to just under 1.1% at the time of the May meeting. The risk premium as measured by the interest rate spread between the Treasury's eurobond and a comparable bond issued by the German government was broadly unchanged and still measured about 1½ percentage points, whereas a comparable spread between Icelandic and US bonds had increased by 0.3 percentage points, to 1.9 percentage points.

Financial institutions' analysts had all expected the Central Bank's nominal interest rates to be held unchanged in May, mainly because little had happened since the previous meeting that called for a change in interest rates.

In Q1/2016, M3 grew by 6.1% year-on-year after adjusting for the deposits held by the financial institutions in winding-up proceedings, about the same rate of growth as in most of 2015. However, the total stock of loans from deposit money banks, the HFF, and pension funds to resident borrowers contracted by ½% over the same period but increased by nearly 1% after adjusting for the Government's debt relief measures. The increase is due mainly to a rise in lending to businesses, while lending to households also grew marginally year-on-year after adjusting for the debt relief package. The pension funds have stepped up their mortgage lending activity in the recent past, alongside easing of borrowing requirements, more favourable interest rates, and a wider variety of loan forms. Their lending activity is still relatively limited, however, and loans to pension fund members still constitute a historically small share of the pension funds' net assets.

The Nasdaq OMXI8 index had fallen by 1.3% between meetings in May but had risen by 0.4% since the beginning of the year. Turnover in the Nasdaq Iceland main market totalled just over 190 b.kr. in the first four months of the year, about 85% more than over the same period in 2015.

Global economy and external trade

In April, the International Monetary Fund (IMF) forecast that global GDP growth would be broadly unchanged year-on-year in 2016, at 3.2%, and revised its January forecast downwards by 0.2 percentage points. The Fund also lowered its forecast for world trade growth in 2016 and 2017. Similarly, the outlook for industrialised and emerging economies' GDP growth in 2016 and 2017 is worse than was forecast in January. The outlook for GDP growth in the US, UK, and euro area is somewhat weaker for both years than was assumed in January. The IMF's forecast for 2016 output growth in Iceland's main trading partners is 0.2 percentage points lower, or 1.7%. The Fund also assumes that, during the forecast horizon, inflation will be lower in industrialised countries and higher in emerging countries than was forecast in January. Among Iceland's main trading partners, inflation is expected to be 1% this year, which is 0.4 percentage points less than according to the IMF's October forecast.

Iceland's external goods trade generated a deficit of 31.7 b.kr. for the first four months of the year, as opposed to a surplus of 7.4 b.kr. over the same period in 2015. Export values contracted by 13% year-on-year at constant exchange rates, while import values rose 6.2%. The export value of industrial goods declined by 21% year-on-year and the export value of marine products by nearly 7%. The increase in import values is due for the most part to a roughly 28% increase in the value of both transport equipment and investment goods. In addition, the value of "other" consumer goods rose by over a fifth from the previous year.

In terms of relative consumer prices, the real exchange rate increased by 0.8% month-on-month in April and 10.1% year-on-year. The increase is due primarily to a 9% nominal appreciation of the króna, but in addition, inflation in Iceland was 0.9 percentage points above the average among its trading partners.

The listed global market price of aluminium had risen by over 2% since the March meeting, and the average April price was down almost 14% year-on-year. Foreign currency prices of marine products had declined by 0.5% month-on-month in March but had risen by 1.4% year-on-year.

The domestic real economy and inflation

The wage index rose by 4% quarter-on-quarter and 11.8% year-on-year in Q1/2016; however, it should be noted that the twelve-month rise includes two contractual pay increases in the private sector. Real wages in terms of the index had risen by 9.8% year-on-year in Q1/2016.

In Q1, year-on-year growth in labour demand was broadly in line with the February forecast. According to the Statistics Iceland labour force survey (LFS), total hours worked rose by 2.3%, while the forecast assumed an increase of 2.1%. The rise in total hours is due to a 2.8% increase in the number of employed persons, whereas average hours worked declined by 0.5% because hours worked by the youngest age group fell by nearly 4%. The labour participation rate and the employment rate also rose between years, and the number of persons outside the labour market continued to fall. Seasonally adjusted unemployment measured 3.1% in Q1, having declined by 0.4 percentage points between quarters. Unemployment figures show that long-term unemployment has almost disappeared.

Key indicators of private consumption in Q1 suggest that growth has continued and even accelerated in comparison with late 2015. Payment card turnover grew by nearly 12% year-on-year during the quarter, and new motor vehicle registrations increased by more than 59%. Groceries turnover also grew considerably more than in previous quarters, and most other retail indices rose year-on-year.

The Gallup Consumer Sentiment Index measured 131.1 points in April, an increase of 7.1 points between months and nearly 47 points between years. This is the highest measurement of the index since October 2007. In the past two measurements, consumers' assessment of the current situation has measured higher than their expectations six months ahead, a development that has not been seen since early 2008.

The Government's statement of fiscal policy for 2017-2021 was presented before Parliament at the end of April, with proposed Parliamentary resolutions concerning fiscal policy, on the one hand, and a fiscal plan, on the other. According to the Parliamentary resolution on fiscal policy, the Treasury primary surplus will decline during the 2017-2021 period, during which the positive output gap is expected to narrow. If this materialises, the fiscal stance will be close to neutral. According to the fiscal plan, however, there will be slight fiscal tightening in 2018, when the Treasury primary surplus is expected to grow. Thereafter, the surplus is projected to narrow by nearly 1 percentage point until 2021, but based on these assumptions, the fiscal stance will be broadly neutral due to the diminishing output gap during the period.

Statistics Iceland's nationwide house price index, published in late April, declined 0.4% month-on-month when adjusted for seasonality, but rose 6.5% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.3% month-on-month in March when adjusted for seasonality, and by 7.4% year-on-year. The number of registered purchase agreements nationwide rose 1.7% between years in March. The average time-to-sale for flats in the greater Reykjavík area was 1.6 months in March, down from 2.5 months in March 2015.

The CPI rose by 0.2% month-on-month in April, after rising by 0.4% in March. Some base effects were present in March, as the CPI rose by a full 1% between months in March 2015. Twelve-month inflation had therefore declined somewhat since the last MPC meeting, or by 0.6 percentage points, and measured 1.6% in April. The CPI excluding the housing component rose by 0.1% month-on-month in April, and inflation was 0.2% by that measure. Underlying inflation according to core index 3 excluding tax effects had also fallen since the March meeting and measured 1.9%. Statistical measures of underlying inflation suggest that it lay in the 1½-3½% range.

The main drivers in April were the rise in the housing component and the rise in petrol prices. Increased food prices also made some impact. Telephone services fell in price in April, as did most recreation and entertainment items. Private services prices were broadly unchanged month-on-month and have risen by 1.8% in the past twelve months. The effect of the cancellation of import duties on clothing and footwear at the beginning of the year has been less than could have been expected, as these items have declined in price by only 3% in the past twelve months, in spite of the import duty cancellation and the appreciation of the króna. It is clear that this is partly due to rising domestic cost factors in the past year.

According to the Central Bank's survey of market agents' inflation expectations, carried out at the beginning of May, participants expect inflation to measure 3.2% in one year. This is 0.2 percentage points more than in the previous survey, taken in February 2016. Their expectations two years ahead measured 3.4%, about the same as in February. Respondents' long-term inflation expectations rose slightly in comparison with the previous survey but have been broadly unchanged in the past year. They expect inflation to average 3.5% over the next ten years, which is 0.2 percentage points higher than in February. The five- and ten-year breakeven inflation rate in the bond market is somewhat below market agents' expectations, averaging about 3% in April, roughly the same as in recent months.

According to the forecast published in *Monetary Bulletin* on 11 May 2016, inflation is expected to rise when the effects of the higher exchange rate and imported factors taper off. How quickly it does so will depend on the timing and scope of the turnaround in imported inflation. Inflation was in line with the February forecast during the first quarter of the year, averaging 1.9%.

Import price deflation has offset domestic inflationary pressures, which can be seen in an increased output gap and large pay rises. Inflation is expected to measure 3% in Q4/2016 and about 4½% in the second half of 2017, but then begin to ease back to target in response to monetary tightening. The outlook for this year is similar to the February forecast, but inflation is expected to be higher in H2/2017 and early 2018, as the outlook is now for stronger growth in economic activity than was assumed then. However, the marked improvement in terms of trade in recent years is considered to have increased companies' scope to absorb the cost increases stemming from pay rises. By the same token, monetary policy seems to provide a firmer anchor for inflation expectations than before, which can be seen in a more moderate rise in inflation following large pay increases than historical experience has given cause to expect.

Among Iceland's main trading partners, GDP growth measured 1.8% in 2015 and is expected to weaken somewhat this year, to 1.6% instead of the 1.9% provided for in the Bank's February forecast. Trading partner growth is forecast to measure about 2% per year in the following two years. The GDP growth outlook for the forecast horizon as a whole has therefore deteriorated since February, and uncertainty about the global economy has increased again.

Terms of trade improved by nearly 7% in 2015 and have improved by over 10% in the past two years, more than in other developed countries. It is assumed that terms of trade will improve still further this year but then deteriorate marginally in the following two years, as oil prices begin to rise and marine product prices start to taper off after the strong increase in recent years.

According to the forecast, in spite of the rise in the real exchange rate and forecasts of weaker global GDP growth, the outlook is for stronger export growth in 2016 than was forecast in February. The improved outlook is due primarily to even stronger growth in services exports; furthermore, information from exporters indicates that miscellaneous manufacturing exports will grow more than was envisioned in February. As in February, export growth is projected to ease slightly in the next two years.

According to preliminary figures from Statistics Iceland, year-2015 GDP growth measured 4%, while the February forecast had assumed 4.1% growth. GDP growth appears set to gain further momentum, rising to 4.5% this year. It is driven by strong growth in domestic demand and exports, although the contribution of net trade to output growth is negative for the third year in a row, with indicators implying strong import growth, partly due to significant imports of ships and aircraft this year. The GDP growth outlook for 2017 has also changed somewhat. Growth is now projected to measure 4%, as opposed to 3.4% in the February forecast. As before, it is expected to be driven by growth in domestic demand, particularly private consumption. If the forecast materialises, 2017 will be the third consecutive year with GDP growth of 4% or more. This is significantly above long-term trend growth and, other things being equal, it is inevitable that the rate of growth will slow down somewhat in coming years. According to the forecast, it will ease in 2018.

The domestic labour market is strong as well. Total hours worked rose by 2.3% year-on-year in Q1/2016. The participation rate is now nearly 83% after adjusting for seasonality and is close to its early-2007 peak. Seasonally adjusted unemployment measured 3.1% during the quarter. The unemployment rate is therefore most likely below the level that is estimated to be consistent with price stability and is expected to be 3.3% in 2016 as a whole. Other labour market indicators point in the same direction. Total hours worked are projected to increase by 3% this year, and a greater increase is expected next year, reflecting a stronger output growth outlook. The employment rate is expected to continue to rise, peaking next year at nearly 81%, close to the 2007 peak of 81.5%. Productivity growth is still expected to grow by an average of 1% per year over the forecast horizon. This is somewhat below the historical average but in line with the ten-year average.

As before, the pay rises are the main cause of increasing inflationary pressures, both directly – through firms' cost increases – and indirectly – through growing demand and a widening output gap. Unit labour costs are estimated to have grown somewhat less than previously thought in 2015; however, they are expected to rise by nearly 10% this year and by an average of 6½% over the forecast horizon, which is far more than is consistent with the inflation target in the medium term.

Alongside the projection of stronger GDP growth in 2016 and 2017 than was forecast in February, the output gap is expected to be somewhat larger this year. It is expected to peak at 2½% of potential output this year, or about ½ a percentage point more than in the February forecast. According to the current forecast, it will begin to narrow again in 2017.

The baseline forecast reflects an assessment of the most likely economic developments over the next three years. It is based on forecasts and assumptions concerning developments in the external environment of the Icelandic economy, as well as assessments of the effectiveness of markets and on the transmission of monetary policy to the real economy. All of these factors are subject to uncertainty. The uncertainties described in the May issue of *Monetary Bulletin* show clearly that the inflation outlook for the next three years could easily deviate from the scenario presented in the baseline forecast. Inflationary pressures could be underestimated, which (other things being equal) would call for higher interest rates than in the baseline forecast in order to keep inflation at target. Among possible causes of such a deviation, the demand-side effects of the recent wage settlements and the stimulative Government measures could be underestimated, or firms could have greater difficulty absorbing large cost increases following wage settlements than is assumed in the baseline forecast. Furthermore, inflation could be underestimated if house prices rise even further than is assumed or if the króna depreciates. Moreover, if inflation expectations are more poorly anchored than is assumed, inflation could prove more persistent than is forecast. In addition, the fiscal stance could ease still further, particularly in view of the upcoming Parliamentary elections. Although monetary policy transmission via interest rates has normalised somewhat in the recent past, the interest rate channel is still not fully functional; therefore, it could prove more difficult for monetary policy to contain domestic demand than is assumed in the baseline forecast. Inflation could also be overestimated in the forecast. For instance, it could turn out lower than projected if the global economic outlook deteriorates still further or if global oil and commodity prices are lower than is assumed in the forecast. The króna could also appreciate, and firms' ability to absorb increased costs could be underestimated. Moreover, productivity growth, which is weak in historical context, could be underestimated, which would mitigate the inflationary effects of recent pay rises.

II The interest rate decision

The Governor reported to the MPC on the status of work underway in connection with special capital flow management tools designed to affect carry trade-related capital flows. He also updated the Committee on matters relating to the Bank's capital account liberalisation strategy, including the planned auction of offshore krónur.

Committee members did not consider it timely to change reserve requirements, as the auction of offshore krónur would take place after the next MPC meeting, with settlement to take place after that. The Committee had decided at its December meeting that, other things being equal, it would lower reserve requirements back to 2% in connection with the auction.

Committee members discussed the Bank's most recent *Financial Stability* report; they also discussed financial institutions' position, the risks to the financial system in connection with capital account liberalisation, and the progress made in private sector debt restructuring.

The MPC also discussed the main issues of the Government's statement of fiscal policy for 2017-2021, presented before Parliament at the end of April in Parliamentary resolutions concerning fiscal policy, on the one hand, and a fiscal plan, on the other.

Committee members discussed whether developments since the last meeting had changed its assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the meeting, the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, although the Committee considered it likely that the monetary stance would have to be tightened in the coming term.

In this context, the MPC took into account the Bank's new forecast, published in *Monetary Bulletin* on 11 May. Members agreed with the assessment in the May forecast, that economic activity was stronger than previously thought, as the forecast indicated that the outlook was for stronger GDP growth than had been projected in February.

Members also agreed that the slack in the labour market had probably disappeared, with growth showing in rapid job creation, a rising participation rate, and declining unemployment. Moreover, long-term unemployment had nearly disappeared, and firms were having more difficulty filling available positions than they had had for quite a long time.

In the Committee's opinion, most indicators implied that growth in the domestic economy was somewhat in excess of potential output. Members considered it likely that the rate of growth would ease at some point, but according to the forecast this will not be until 2018.

In April, inflation measured 1.6%, close to what it was a year ago. In the Committee's opinion, inflation is still well below the target in spite of growing economic activity and large wage increases because the appreciation of the króna, the drop in oil and other commodity prices, very low inflation in trading partner countries, and the improvement in terms of trade had been enough to counteract these upward pressures. Committee members agreed that, other things being equal, the outlook was for inflation to remain below target well into the year but to rise when import prices stopped declining. Members noted that according to the Bank's forecast, inflation will be higher than forecast in February, as the outlook was for stronger than previously forecast growth in economic activity.

As it had done at previous meetings, the Committee discussed the reasons why large pay increases had not affected domestic inflation more strongly than they had actually done. As before, members agreed that the strong improvement in terms of trade in the recent past had probably enabled firms to absorb the cost increases instead of passing them through to prices. They also argued that it was likely that the labour market had grown more flexible, as the influx of foreign labour had increased in response to a shortage of labour instead of employers' competing for employees by outbidding each other in terms of wages. Furthermore, members agreed that the fact that inflation had risen less than could have been expected in the wake of large pay rises indicated that the credibility of monetary policy had increased.

The Committee also discussed the results of the recent assessment of the equilibrium real exchange rate, which indicates that the recent rise in the real exchange rate is due largely to an adjustment to a higher equilibrium level. In this context, it was pointed out that in the long run, the Central Bank should avoid leaning against the normal adjustment of the real exchange rate to a higher equilibrium level. It was pointed out that the aim of the Central Bank's foreign currency purchases was, under normal circumstances, to counteract excessive exchange rate volatility and, under certain circumstances, to keep the exchange rate from deviating from its equilibrium value. At present, the objective was also to build up the foreign exchange reserves in the run-up to capital account liberalisation. The planned auction of offshore krónur was a certain turning point in this regard, and the situation would be re-evaluated during the prelude to liberalisation of controls on residents.

None of the Committee members saw any reason to change interest rates at present. In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

Committee members agreed that global price developments and a stronger króna had provided the scope to raise interest rates more slowly than had previously been considered necessary. By the same token, in the Committee's opinion there were signs that monetary policy had anchored inflation expectations more securely than before and contributed to a more moderate rise in inflation than could have been expected in the wake of large pay increases. However, members agreed that this did not change the fact that, according to the Bank's May forecast, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future developments.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 1 June 2016.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, June 2016

Published 15 June 2016

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and the premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of individual Committee members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meeting held on 31 May 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 1 June, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 11 May interest rate decision.

Financial markets

The exchange rate of the króna had fallen in trade-weighted terms and against the US dollar and the pound sterling since the last meeting, held in the first half of May, but had risen slightly against the euro. The Central Bank's net accumulated foreign currency purchases totalled approximately 150 million euros (20.9 b.kr.) between meetings, or just over half of total market turnover.

Non-residents' net new investment in the bond market was virtually unchanged since the beginning of May, according to preliminary figures.

As before, overnight interest rates in the interbank market for krónur were close to the Bank's key rate, but turnover had been limited since the last MPC meeting. Yields on Treasury and Housing Financing Fund (HFF) bonds were broadly unchanged, as was the risk premium on the Treasury's foreign obligations. The NASDAQ Iceland OMXI8 had fallen by over 3% between meetings, however.

The large commercial banks' indexed and non-indexed deposit and lending rates were virtually unchanged between meetings, as was the pension funds' average mortgage lending rate.

The monetary stance as reflected in the Central Bank's real interest rate had been unchanged since just after the MPC's last decision in terms of the average of various measures of inflation and inflation expectations but had weakened by 0.1 percentage point in terms of past twelve-month inflation.

Financial institutions' analysts had all expected the Central Bank's nominal interest rates to be held unchanged in June, mainly because little had happened since the previous interest rate decision that called for a change in interest rates.

Growth in M3 had eased in March and April after adjusting for the deposits of deposit money banks (DMB) in winding-up proceedings. The slower growth rate stems in particular from weaker growth in deposits of non-deposit-taking financial institutions and a contraction in corporate deposits, while there is stronger growth in household deposits. The total stock of loans from DMBs and the HFF to resident borrowers grew slightly year-on-year in April, after adjusting for the Government's debt relief measures. As before, the increased growth is due to an increase in lending to businesses, services companies in particular.

Global economy and external trade

The listed global market price of aluminium has been virtually unchanged since the May MPC meeting but is down 13.6% year-on-year. Foreign currency prices of marine products rose slightly between months in April and have risen by just over 2% year-on-year.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), labour demand growth continued in April. Unemployment rose slightly, however, due to the seasonal entry of students into the labour market during the spring.

The wage index rose in April by 0.4% month-on-month and by 13.4% year-on-year, the second-strongest year-on-year growth rate since measurements were introduced. Real wages in terms of the index rose 11.6% between years, as in March, the largest rise ever measured.

In April, key indicators of private consumption such as payment card turnover and new motor vehicle registrations indicated that developments in Q1/2016 had continued, in line with the Bank's forecast, as rapid real wage growth contributes to increased household demand. The Gallup Consumer Sentiment Index rose somewhat in May. It has risen virtually without interruption in the past year and is at its highest since mid-2007.

According to the results of Gallup's summer survey, carried out among Iceland's 400 largest firms in May, executives were somewhat more optimistic about the economy than in both the spring survey (conducted in February) and in the survey taken in May 2015. The index now stands at 195 points, the highest measurement since September 2004. Transport and tourism, construction, financial services, and miscellaneous specialised services now show an index value of 200, the highest possible measurement. Nearly half of executives expect economic conditions to be unchanged six months ahead. Expectations about both domestic and foreign demand were slightly better than in the previous survey.

According to Gallup's summer survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by nearly 40 percentage points. About 42% of firms considered themselves short-staffed, an increase of over 11 percentage points from the previous survey and 22 percentage points from the summer 2015 survey. This percentage is at its highest since year-end 2007. The shortage of labour was similar to that in the spring survey for firms in construction and transport/tourism, while the number of firms in industry, fishing, and retail trade that consider themselves understaffed has risen sharply.

Statistics Iceland's nationwide house price index, published in late May, rose 0.7% month-on-month when adjusted for seasonality and by 7.3% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1% month-on-month in April when adjusted for seasonality, and by 8.5% year-on-year.

The consumer price index (CPI) rose by 0.4% month-on-month in May, raising twelve-month inflation marginally, to 1.7%. The CPI excluding the housing component had risen by only 0.3% in the past twelve months, however. Underlying inflation in terms of core index 3 had risen since the MPC's May meeting, to 2.2%. Statistical measures of underlying inflation suggest that it lay in the 1.6-3.8% range, with a median value of 2.3%.

The main driver in May was the rise in the cost of owner-occupied housing. Price increases were distributed over a number of sub-components in May, however, with food, petrol and oil, and recreation and culture affecting the index considerably. In addition were seasonal increases in the price of hotel and restaurant services. Private services prices have risen by 2.2% in the past twelve months.

According to Gallup's summer survey of household inflation expectations, conducted in May, households expect inflation to measure 3.2% one year ahead, a slight decline from the spring survey. On the other hand, two-year inflation expectations were unchanged at 4%. According to Gallup's summer survey of corporate inflation expectations, respondents expect inflation to measure 3% one year ahead, the same as in the previous survey.

II The interest rate decision

The Governor reported to the MPC on the status of work underway in connection with special capital flow management tools designed to affect carry trade-related capital flows. He also updated the Committee on matters relating to capital account liberalisation.

Because the planned auction of offshore krónur will take place on 16 June, the Committee considered it appropriate to lower minimum reserve requirements by 0.5 percentage points beginning with the next reserve maintenance period, which begins on 21 June. The Committee had decided at its December meeting that, other things being equal, it would lower reserve requirements to 2% in connection with the auction.

Committee members discussed whether developments since the last meeting had changed its assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the meeting, the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, although the Committee considered it likely that the monetary stance would have to be tightened in the coming term.

Because of the short time since the previous meeting, little new information had emerged. Committee members agreed that the inflation and economic outlook was largely in line with the assumptions from the previous meeting. In the Committee's opinion, most new indicators implied that the outlook was still for rapid GDP growth, and members agreed that new information from the labour market indicated increasing tension there. On the other hand, inflation was low, credit growth was weak and, because of a favourable debt position and the prospect of a continued current account surplus, upward pressures on the exchange rate could continue.

Inflation measured 1.7% in May, similar to the rate a year ago, and has been below target for over two years. As in recent meetings, the MPC discussed the reasons why inflation is still well below the target in spite of large pay increases and a widening positive output gap. Members agreed, as before, that it was due mainly to the appreciation of the króna, the decline in oil and commodity prices, very low inflation in trading partner countries, and improved terms of trade, which had thus far been sufficient to offset domestic inflationary pressures. Committee members also agreed with the assessment in the Bank's most recent forecast, published in *Monetary Bulletin* 2016/2 in May, that other things being equal, the outlook was for inflation to remain below target well into this year and then rise when import prices stopped falling.

None of the Committee members saw any reason to change interest rates at present. In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

MPC members agreed that global price developments and a stronger króna had provided the scope to raise interest rates more slowly than had previously been considered necessary. By the same token, in the Committee's opinion there were signs that monetary policy had anchored inflation expectations more securely than before and contributed to a more moderate rise in inflation than could have been expected in the wake of large pay increases. However, members agreed that this did not change the fact that, according to the Bank's forecast from early May, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future developments.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 24 August 2016.

No.13/2016
4 June 2016

New policy instrument to temper and affect the composition of capital flows

The Central Bank of Iceland has published the Rules on Special Reserve Requirements for New Foreign Currency Inflows in accordance with the new Temporary Provision of the Foreign Exchange Act, no. 87/1992. The main purpose of the Temporary Provision is to provide the Central Bank of Iceland with a new policy instrument, generally referred to as a capital flow management measure, to temper inflows of foreign currency and to affect the composition of such inflows. It is therefore intended to reduce the risk that could accompany excessive capital inflows under the current regulatory framework for foreign exchange, support other aspects of domestic economic policy, and contribute to macroeconomic and financial stability.

The Central Bank's capital flow management tool is based on the application of special reserve requirements for new inflows of foreign currency, in accordance with rules set by the Bank on the basis of the Foreign Exchange Act. The capital flow management measure is structured so as to reduce the risk potentially accompanying strong capital inflows by directly affecting the incentives for carry trade. The tool is therefore intended, among other things, to support effective monetary policy transmission. Furthermore, the structure is intended to ensure that the measure is flexible, effective, and efficient in implementation so as to make it possible to respond quickly to changed circumstances.

The Rules contain provisions on the implementation of special reserve requirements for new foreign currency inflows, including the special reserve base, holding period, special reserve ratio, settlement currency, and interest rates on deposit institutions' capital flow accounts with the Central Bank of Iceland. The special reserve base is defined as new inflows of foreign currency in connection with specified types of capital, particularly to include new investment in electronically registered bonds and bills, and deposits. In addition, new inflows related to loans taken for investment in such instruments can create the special reserve base. Further details regarding the special reserve base are provided in the Rules. The Foreign Exchange Act states that the holding period may range up to five years and that the special reserve ratio may range up to 75%; however, the Rules set the holding period at one year and the special reserve ratio at 40%. The Rules also set the interest rate on capital flow accounts with the Central Bank of Iceland at 0% and specify the Icelandic króna as the settlement currency.

The Rules are accessible here: Rules no. 490 2016

No. 19/2016
June 29, 2016

The Central Bank foreign currency auction of 16 June

Prior to the auction that took place on 16 June 2016, the Central Bank of Iceland solicited offers for the sale of offshore króna assets versus cash payment in foreign currency. On 21 June, the Bank announced the main results of the auction and offered to purchase, at an exchange rate of 190 kr. per euro, the offshore króna assets not sold in the auction. The Terms of Tender for these transactions were announced on 22 June 2016.

The final results of the 16 June auction are now available, including the transactions taking place on the basis of the Bank's tender offer of 21 June. A total of 1,715 offers were submitted and 1,688, or 98.4% of the total, were accepted. Accepted offers amounted to 83 b.kr., of a total of 188 b.kr. submitted in the auction and the post-auction tender. The Central Bank of Iceland's foreign exchange reserves will be reduced by just over 54 b.kr. as a result.

The offshore krónur offered for sale in the auction fall into the asset classes shown in the following table:

Asset class	*m.kr.*
Cash	46,260
Central Bank certificates of deposit	5,448
Treasury bonds	15,484
Treasury bills	7,163
Housing Financing Fund bonds	559
Other securities*	7,971
Total	82,885

**Do not directly affect the foreign exchange reserves*

The auction was part of the comprehensive action plan to lift the capital controls; cf. the Government and Central Bank's capital account liberalisation strategy of 8 June 2015. The 16 June 2016 auction was the last in a series of twenty-three auctions in which owners of offshore krónur were invited to purchase foreign currency before the authorities begin lifting capital controls on resident entities; i.e., pension funds, other legal entities, and individuals. The aim is to present a strategy for liberalisation of capital controls on residents in late summer and to present bills of legislation relating to the next steps in liberalisation before Parliament at the legislative session beginning in August. Thereafter, the authorities will examine when and how to lift controls on the offshore króna owners that chose not to participate in the auction. It is clear that participation in the 16 June auction will simplify this process considerably. The remaining owners are fewer in number and form a more homogeneous group, and the outstanding amount of offshore krónur has been reduced markedly.

Governor Már Guðmundsson wishes to state the following in this connection: "The auction and the recent legislative amendments have removed the last major obstacle to our being able to take large steps towards lifting capital controls on residents without running the risk of instability. The offshore overhang has been reduced by more than one-third of GDP in 2009 to approximately 11% of GDP following the auction. Although it was not possible to accept offers for offshore krónur in the amount of 105 b.kr., the number of investors involved has been considerably reduced, thereby facilitating the solution to the remaining problem. Matters have been structured in such a way that the remaining offshore krónur will not cause instability while controls on residents are being lifted. Contagion should be almost non-existent and the risk of instability limited."

Further information can be obtained from Már Guðmundsson, Governor of the Central Bank of Iceland, at tel: +354 569-9600.

March 27, 2001

Declaration on inflation target and a change in the exchange rate policy

(From March 27, 2001 – as amended by agreement between between the Prime Minister of Iceland and the Board of Governors of the Central Bank of Iceland on November 11, 2005, cf. Press release no. 35/2005)

On March 27, 2001 the Prime Minister and the Governors of the Central Bank of Iceland signed a declaration on changes in the framework of monetary policy in Iceland. The declaration is as follows:

The Government of Iceland and the Central Bank of Iceland have decided the following changes in the framework of monetary policy in Iceland, effective March 28, 2001:

(1) The main target of monetary policy will be price stability as defined below. The Central Bank shall also promote financial stability and the main objectives of the economic policy of the Government as long as it does not deem it inconsistent with the Bank's main objective of price stability.

(2) Rather than basing monetary policy on keeping the exchange rate within a fluctuation band, the Central Bank will aim at keeping inflation within defined limits as specified below.

(3) The change described above implies that the fluctuation limits for the króna are abolished. Nevertheless, the exchange rate will continue to be an important indicator in the conduct of monetary policy.

(4) The Government grants full authority to the Central Bank to use its instruments in order to attain the inflation target.

(5) Later this week, the Government will submit to Parliament a bill on a new Central Bank Act which, once enacted, will legally confirm the decisions described above on making price stability the main objective of monetary policy and on the independence of the Central Bank to use its instruments.

(6) The inflation target of the Central Bank will be based on 12-month changes in the consumer price index as calculated by Statistics Iceland. Statistics Iceland will also be asked to calculate one or more indices which may be used to assess the underlying rate of inflation, as will be further agreed between the Central Bank and Statistics Iceland. The Central Bank will take note of such indices in its assessment of inflation and in the implementation of monetary policy.

(7) The Central Bank will aim at an annual inflation rate of about 2½ per cent.

(8) If inflation deviates by more than 1½ percentage point from the target, the Central Bank shall bring it inside that range as quickly as possible. In such circumstances, the Bank will be obliged to submit a report to the Government explaining the reasons for the deviations from the target, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. The report of the Bank shall be made public.

(9) The Central Bank shall aim at attaining the inflation target of 2½ percent not later than by the end of 2003. In the year 2001, the upper Declaration on inflation target and a change in the exchange rate policy limit for inflation shall be 3½ percentage points above the inflation target but 2 percentage points above it in the year 2002. The lower limit for inflation will always be 1½ percentage point below the inflation target. Should inflation move outside the target range in 2001 and 2002, the Bank shall respond as set out in item 8 above.

(10) Despite the elimination of the fluctuation limits for the króna, the Central Bank will intervene in the foreign exchange market if it deems such action necessary in order to promote the inflation objective described above or if it thinks that exchange rate fluctuations might undermine financial stability.

(11) The Central Bank shall publish inflation forecasts, projecting inflation at least two years into the future. Forecasts shall be published in the Bank's Monetary Bulletin. This shall also contain the Bank's assessment of the main uncertainties pertaining to the inflation forecast. The Bank shall also publish its assessment of the current economic situation and outlook.

[Amended text by agreement between the Prime Minister of Iceland and the Board of Governors of the Central Bank of Iceland on November 11, 2005]

(12) The Central Bank shall in its publications explain how successful it is in implementing the inflation target policy. The Governors will also report to the Minister, the Government and committees of the Parliament on the policy of the Bank and its assessment of current economic trends and prospects.