SEÐLABANKI ÍSLANDS

MONETARY POLICY COMMITTEE REPORT TO PARLIAMENT

2014•1

Monetary Policy Committee report to Parliament

4 July 2014

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 (Alþingi) 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 11 June. The following report discusses the work of the Committee between January and June 2014.

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, which are its interest rates, its transactions with credit institutions other than last-resort loans, reserve requirements, and foreign exchange market transactions aimed at affecting the exchange rate of the króna. The decisions of the MPC shall be based on a thorough 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.

Developments from January to June 2014

The Central Bank's Monetary Policy Committee (MPC) has held the Bank's interest rates unchanged since November 2012. At its May meeting, the MPC approved the Governor's proposed modifications to the Bank's monetary policy instruments. At previous meetings, the Committee had discussed such changes, as well as possible changes to the Bank's liquidity management. The objective of the changes is

Table 1. Central Bank of Iceland interest rates 2014 (%)

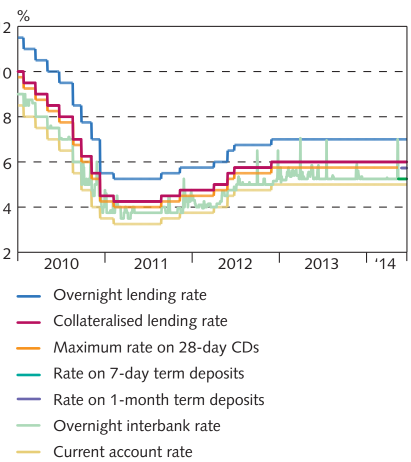
Date	*Current account rate*	*Rate on 7-day term deposit*[1]	*Rate on 28-day CDs (max.)*	*Collateral lending rate*	*Overnight lending rate*
11 June	5.00	5.25	.	6.00	7.00
21 May	5.00	5.25	.	6.00	7.00
19 March	5.00	.	5.75	6.00	7.00
12 Feb.	5.00	.	5.75	6.00	7.00

1. Beginning in autumn 2009, the Central Bank sold 28-day certificates of deposit to financial institutions on a weekly basis, with the aim of reducing market liquidity and supporting interest rate formation in the interbank market for krónur. In May 2014, however, it began selling seven-day certificates of deposit, as well as monthly certificates of deposit that are offered once a month.

Chart 1

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

Daily data 1 January 2010 - 30 June 2014

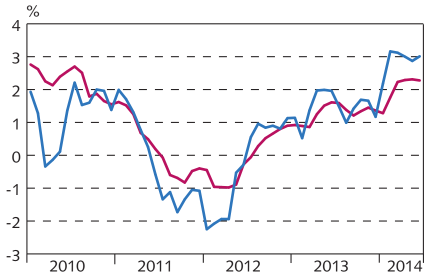


Source: Central Bank of Iceland.

Chart 2

Real effective Central Bank of Iceland interest rates[1]

January 2010 - June 2014



— Real effective Central Bank of Iceland interest rate in terms of twelve-month inflation

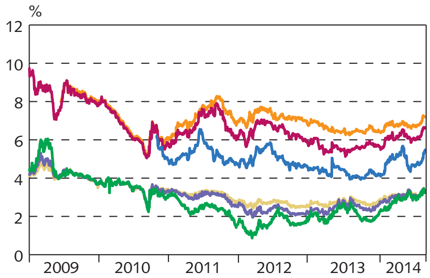
— Real effective Central Bank of Iceland interest rate in terms of various measures of inflation and inflation expectations

1. 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: Capacent Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 3

Bond yields

Daily data 2 January 2009 - 30 June 2014



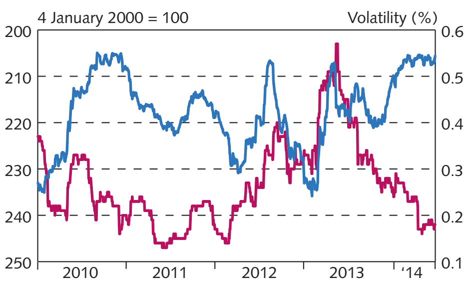
— RIKB 16 1013 — HFF 150224
— RIKB 19 0226 — HFF 150434
— RIKB 25 0612 — HFF 150644

Source: Central Bank of Iceland.

Chart 4

Exchange rate and volatility of the króna

Daily data 4 January 2010 - 30 June 2014



— Trade-weighted exchange rate of the króna (inverted left axis)[1]

— Volatility of the króna (right)[2]

1. Price of foreign currency in terms of the króna. Inverted axes 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.

to enhance the effectiveness of the Bank's liquidity management and, insofar as is possible, to promote greater efficiency in the management of its balance sheet. The modifications should also prepare for the changes in the monetary policy environment upon the sale of Central Bank of Iceland Holding Company (ESÍ) assets and the liberalisation of the capital controls. One of the changes entails the discontinuation of weekly auctions of 28-day certificates of deposit. Instead, financial institutions that engage in transactions with the Central Bank will be offered two types of term deposits that will be eligible as collateral for Central Bank facilities. Seven-day term deposits will bear fixed interest, and one-month term deposits will be auctioned on the first business day for regular facilities each month.

Since November 2012, the collateralised lending rate has remained unchanged at 6%, the current account rate at 5%, the maximum rate on 28-day CDs 5.75%, and the overnight lending rate 7% (see Table 1 and Chart 1). Following the above-described changes, the interest rate on seven-day term deposits is 5.25%. Because financial system liquidity is relatively abundant, the simple average of Central Bank current account rates and the maximum rate on certificates of deposit (now term deposits) has been the best approximation of the effect of Central Bank rates on money market rates. This average, which can be termed the effective interest rate, has been unchanged at approximately 5.4% since the beginning of 2014.

Even though the Bank's nominal interest rates have been unchanged since November 2012, the monetary stance has changed as inflation and inflation expectations change. For example, the Bank's real rate in terms of the average of several measures of inflation and inflation expectations, was 2.3% at the end of June 2014 and had risen by 1 percentage point since year-end 2013. The long-term real rate in the bond market has developed broadly in line with the Bank's interest rates.

At its June meeting, the MPC decided to reinstate the Bank's programme of regular purchases of foreign currency in the interbank foreign exchange market, similar to the one in place during the period 31 August 2010 through year-end 2012. Since mid-May 2013, the Bank has been more active in the foreign exchange market than it was previously, intervening in the market with the aim of mitigating exchange rate volatility. This policy will remain in place despite the resumption of regular foreign currency purchases. In the first half of 2014, the Bank purchased foreign currency from market makers in the amount of 40.6 b.kr. and sold approximately 470 m.kr. Since the MPC decided in May 2013 to step up intervention in the market, the Bank's net foreign exchange purchases have totalled 47.3 b.kr.

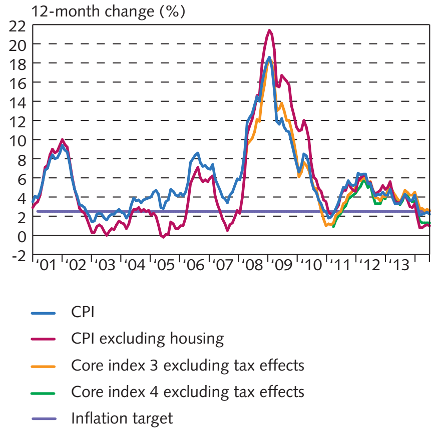
The króna has appreciated by 2.3% in trade-weighted terms year-to-date and is 5.7% stronger than it was at the end of June 2013. The continued growth in foreign tourism and the surplus on external trade have supported the exchange rate, and the decline in foreign loan repayments by firms and municipalities has probably reduced foreign exchange outflows. On the other hand, foreign exchange transactions deriving from domestic interest payments to non-residents have increased markedly, and the Central Bank has bought currency in the market.

Twelve-month inflation in terms of the CPI has declined rapidly since the last MPC report was sent to Parliament. CPI inflation measured 2.2% in June 2014, as opposed to 4.2% in December 2013. Furthermore, it has been below the Central Bank's inflation target over the past five months. Underlying twelve-month inflation as measured by core index 3 excluding indirect tax effects (which also excludes the effects of volatile food items, petrol, public services, and real mortgage interest expense) declined by nearly 2 percentage points over the same period, measuring 2.6% in June. Underlying inflation according to core index 4 excluding tax effects, which also excludes the market price of housing, measured 1.3% in June, as compared with 3.6% in December 2013. In the first half of 2014, increases in housing costs and services prices were the main drivers of the rise in the CPI, while the decline in import prices and prices of domestic food products reduced inflation.

Chart 5

Various inflation measurements[1]

January 2001 - June 2014



1. Core Index 3 is the CPI excluding prices of agricultural products, petrol, 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.

Monetary policy has been successful in the recent term. Inflation has subsided to target, and the slack in the economy is disappearing. Volatility of inflation and output has also diminished. Because of the decline in inflation and inflation expectations, the Bank's real rate has risen markedly year-to-date, and the slack in the monetary policy stance has probably disappeared. Increased growth in domestic demand in the near term will probably require further increases in the Bank's real interest rate, other things being equal. Whether the need for a higher real rate requires a change in the Bank's nominal interest rates in the near future, however, will depend on developments in inflation and inflation expectations. The more other measures, including restrictive fiscal policy, pull in the same direction as monetary policy, the less need there will be for a tighter monetary stance.

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from February through June 2014.
2. Minutes of Monetary Policy Committee meetings from February through June 2014.
3. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001.
4. Press release of 21 May 2014 on modifications to monetary policy instruments.
5. Press release from 11 June 2014 on regular foreign currency purchases.

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

Accompanying documents

No. 4/2014
12 February 2014

Statement of the Monetary Policy Committee 12 February 2014

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

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

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

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

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

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

No. 8/2014
19 March 2014

Statement of the Monetary Policy Committee 19 March 2014

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

Inflation measured 2.1% in February and has subsided quite rapidly. Furthermore, newly published national accounts indicate that, over the past two years, wage costs per man-year rose considerably less than previous data had suggested. Furthermore, the outlook is that the results of the wage settlements concluded in late 2013 will apply to most of the labour market.

Because inflation is lower, the króna stronger, and wage increases smaller than was forecast in February, the medium-term inflation outlook has improved from previous estimates. Short-term inflation expectations have also declined in line with falling inflation, although long-term inflation expectations are still well above target.

The outlook for increased growth in domestic demand in coming quarters will, other things being equal, call for an increase in the Central Bank's real rate. Measures that support monetary policy, including medium-term fiscal policy, could offset this, however. Furthermore, measures that strengthen the supply side of the economy could ease supply constraints, thereby weakening the inflationary effects of increased demand.

The monetary stance at any given time is determined by the inflation outlook. For the short term, the inflation outlook has improved, but as has been forecast previously, inflation is expected to rise again as domestic demand growth gains momentum and the slack in the economy gives way to a positive output gap. Whether there is scope for a nominal interest rate reduction will depend on developments in inflation and inflation expectations in coming months. Further ahead, the Bank's real rate must be raised further if the above-described outlook materialises. The extent to which this takes place through nominal rate increases will depend, as before, on the future path of inflation.

No. 15/2014
21 May 2014

Statement of the Monetary Policy Committee 21 May 2014

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

According to the Bank's new macroeconomic forecast, GDP growth will measure 3.7% this year, about 1 percentage point more than according to the previous forecast. Even stronger growth is projected for next year. Furthermore, the labour market continues to recover. Robust output growth will cause the slack in the economy to disappear earlier than previously forecast, and a positive output gap will develop, peaking in 2016. It is cause for concern that national saving is projected to diminish markedly and the current account surplus to turn into a deficit towards the end of the forecast horizon.

Inflation has been close to target in recent months and is expected to remain there until next year, when it is forecast to rise as a positive output gap emerges. Short-term inflation expectations have declined in the recent term, in line with falling inflation, although long-term inflation expectations are still somewhat above target.

The Bank's forecast assumes that the results of the wage agreements concluded late in 2013 will apply to most of the labour market and that similar agreements will be made for a longer term early next year. There is still some unrest in the labour market, however, which causes uncertainty about wage developments.

Because of the decline in inflation and inflation expectations, the Bank's real rate has risen markedly year-to-date. As a result, the slack in the monetary stance has probably disappeared. The level of the Bank's neutral real rate is uncertain, but increased growth in domestic demand in the near term will probably require further increases in the Bank's real interest rate, other things being equal. The more other measures, including restrictive fiscal policy, pull in the same direction as monetary policy, the less need there will be for a tighter monetary stance. This would also encourage increased national saving and lead to a more favourable current account balance.

Monetary policy has been successful in the recent term. Inflation has subsided to target, and the slack in the economy is vanishing. Volatility of inflation and output has also diminished. However, long-term inflation expectations are still somewhat above target, generating some uncertainty about the durability of this success. Whether a change in the Bank's nominal interest rates is warranted in the near future will depend on the future path of inflation and inflation expectations.

No. 19/2014
11 June 2014

Statement of the Monetary Policy Committee

11 June 2014

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

Newly published national accounts figures from Statistics Iceland indicate that domestic demand growth was somewhat stronger in Q1 than had been forecast in the May issue of *Monetary Bulletin*. Output growth appears to have been markedly weaker than was forecast in May, however, due primarily to strong services imports. It should be noted, though, that it is difficult to interpret quarterly output growth figures, particularly in the first quarter of any given year, in part because of wide fluctuations in export inventories.

Inflation has been close to target in recent months and, according to the Bank's May forecast, is expected to remain near target until next year, when it is forecast to rise as a positive output gap emerges. Inflation expectations one to two years ahead have declined in the recent term, in line with falling inflation, although long-term inflation expectations are still somewhat above target.

The Bank's foreign exchange intervention has contributed to greater exchange rate stability over the past twelve-month period. In addition, the Bank has been a net purchaser of foreign currency in recent months, and the season generally associated with strong foreign currency inflows lies ahead. The Bank has therefore decided to resume regular foreign currency purchases. The amount purchased will be re-evaluated in the autumn, or earlier if circumstances warrant it. As before, the Bank will intervene in the foreign exchange market as needed to mitigate exchange rate volatility.

Because of the decline in inflation and inflation expectations, the Bank's real rate has risen markedly year-to-date. As a result, the slack in the monetary policy stance has probably disappeared. The level of the Bank's neutral real rate is uncertain, but increased growth in domestic demand in the near term will probably require further increases in the Bank's real interest rate, other things being equal. Whether this requires a change in the Bank's nominal interest rates in the near future will depend on developments in inflation and inflation expectations.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, February 2014

Published 26 February 2014

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 10 and 11 February 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 12 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 11 December interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2014/1 on 12 February.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 3.3% higher at the time of the February meeting than at the December meeting. Between meetings, the króna had appreciated by about 3.3% against the euro, 2.8% against the US dollar, and 3% against the pound sterling. Bids for krónur in the offshore market lay in the range of 214-250 kr. per euro and had decreased slightly.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 113 million euros (roughly 17.8 b.kr.) since the last MPC meeting, around 41% of total market turnover during the period.

In general, liquidity had remained ample in the interbank market for krónur, and as before, overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25 percentage points above current account rates. From the beginning of the year to the time of the February meeting, interbank market turnover had been at a low, or about 2 b.kr., as opposed to 47 b.kr. over the same period in 2013.

Owing to abundant financial system liquidity, the simple average of Central Bank current account rates and the maximum rate on certificates of deposit is at present the best approximation of the effect of Central Bank rates on money market rates. This average, which can be termed the effective interest rate, was just under 5½% at the time of the February meeting. Even though nominal interest rates have remained unchanged, the monetary stance has tightened somewhat since December, in line with falling inflation and inflation expectations. In January, the Bank's real effective rate was 2.2% in terms of twelve-month inflation and 1.8% in terms of the average of various measures of inflation and inflation expectations, or about ½ a percentage point higher than at the time of the December meeting. The average of the various measures of inflation and inflation expectations was 3.5% at the time of the February meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged since the December meeting, measuring 1.9 percentage points just before the Committee met in February. The risk premium on Treasury obligations in terms of the spread between the Icelandic Treasury's US dollar bonds maturing in 2016 and 2022 and comparable bonds issued by the US Treasury measured about 2½ percentage points just before the MPC's February meeting, after declining nearly ½ a percentage point since the December meeting.

Unchanged Central Bank interest rates in December appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most analysts cited the decline in inflation, the increase in the real policy rate, and the appreciation of the króna since the last MPC meeting as grounds for unchanged interest rates. According to the Bank's survey of market expectations survey, carried out in early February, market participants expect Central Bank rates to be lower in 2014 than they did in a comparable survey conducted in late October. The survey results indicate that they expect the Bank's collateralised lending rate to remain unchanged at 6% until the end of 2014, which is 0.5 percentage points lower than in the previous survey. On the other hand, they now appear to expect a 0.25-point rate increase in Q1/2015, and they project that the policy rate will be 6.5% in two years' time. Forward interest rates indicate, however, that market agents expect the Bank's policy rate to rise by 0.5 percentage points this year, to 6.5% by the year-end. This is 0.25 percentage points higher than they indicated in late October.

Broad money (M3) grew by 4.1% year-on-year in Q4/2013. Excluding holding company deposits, it grew by 1.3%. Narrower measures of the money supply also increased year-on-year, with growth measuring 2-3¾% in Q4/2013. Central Bank base money grew by about 4.2% over the same period.

Net new lending to households by deposit money banks (DMB) – that is, new loans net of prepayments – totalled about 55 b.kr., or just around 7.5% of the total stock of DMB loans to households at the beginning of 2013. New corporate loans (loans to non-holding companies) totalled 84 b.kr. last year, or just over 8% of the total stock of DMB loans to firms at the beginning of 2013. Most new corporate loans were non-indexed, while most new household loans have been indexed, although prepayments of indexed loans have been more widespread as well.

The NASDAQ OMX Main List index, OMXI6, declined slightly between meetings. Turnover in the NASDAQ OMX Iceland main market totalled about 251 b.kr. during the year, nearly three times that in 2012. In January, it was virtually unchanged year-on-year at 27.4 b.kr. At the beginning of February, the market value of companies listed on the main market totalled 543 b.kr., or approximately one third of year-2012 GDP.

Outlook for the global real economy and international trade

According to the most recent forecast from the International Monetary Fund (IMF), published in January, global output growth will be marginally stronger in 2014 than according to the IMF’s October forecast. The estimate for 2015 is unchanged. In industrialised countries, growth is expected to exceed the October forecast in 2014 but fall short of it in 2015. This year’s improvement is due to stronger a GDP growth outlook in the UK, Japan, and the US. In emerging countries, the forecast is unchanged for 2014 but has been revised slightly upwards for 2015. The inflation forecast for both industrialised and emerging countries is virtually unchanged from the October forecast. *Consensus Forecasts’* projections for Iceland’s trading partners were about 0.2 percentage points higher than at the time of the December meeting.

Iceland’s goods trade surplus measured 4.3 b.kr. in December and, according to preliminary figures, 7.3 b.kr. in January. Import values have risen somewhat in the past two months, while export values have risen very slightly. The rise in import values is due to an increase in the value of transport equipment, commodities, and operational inputs, and the rise in export values is due to increased marine export values.

Aluminium prices had fallen somewhat since the MPC’s last meeting, while marine product prices rose marginally in November and December. Terms of trade improved by more than 2½% year-on-year in Q4/2013.

The domestic real economy and inflation

According to the Statistics Iceland labour market survey, growth in labour demand was considerably stronger in Q4/2013 than in the forecast published in the November issue of *Monetary Bulletin*. The November forecast provided for a 1% year-on-year increase in total hours worked, while the actual increase was 4.3%. The increase is due to a 4.6% rise in the number of working persons, as average hours worked contracted by 0.3%. In 2013, total hours worked rose by 3.7% year-on-year, as the number of employed persons increased by 3.4% and average hours worked rose by 0.3%.

Other measures of labour supply and demand pulled in the same positive direction in 2013. The employment rate rose by 1.4 percentage points year-on-year, the participation rate rose by 0.9 percentage points, and the number of persons outside the labour market fell by 3.3%.

In Q4/2013, net migration was positive for the fifth quarter in a row. For the first time since the collapse of the banking system, the immigrants to Iceland outnumbered emigrants for the year as a whole, with net migration for 2013 positive by 0.9% of the labour force. The net increase is due entirely to an increase in foreign immigrants, which supports other indicators of growing labour demand.

Unemployment as registered by the Directorate of Labour (DoL) was somewhat lower in Q4/2013 than according to the Bank's last forecast. Seasonally adjusted unemployment was 4.1% as measured by the DoL, but 5.3% according to the Statistics Iceland labour market survey. According to the DoL, unemployment fell by 1.3 percentage points in 2013, to 4.4%, whereas according to the labour market survey it fell 0.6 percentage points, to 5.4%.

Wages rose somewhat more in Q4/2013 than was assumed in the forecast appearing in the November *Monetary Bulletin.* The wage index rose by just under 1% quarter-on-quarter and 6% year-on-year during the quarter. The annual average rose by 5.7% in 2013.

Key indicators of private consumption in Q4 imply that growth was relatively strong. Payment card turnover grew 4.5% year-on-year and 2.3% quarter-on-quarter in Q4. Retail sales grew rather strongly as well. This was offset by a marked slowdown in new motor vehicle registrations, however. Furthermore, consumers were more pessimistic in Q4/2013 than they were a year earlier, although sentiment improved somewhat in December.

The nationwide Statistics Iceland house price index, published in late January, rose by just over ½% from the previous month, and by about 1.2% adjusted for seasonality. It was up 9.7% from the previous January. The capital area real estate price index, calculated by Registers Iceland, fell by about ½% month-on-month in December 2013 but was unchanged when adjusted for seasonality. Between 2012 and 2013 it rose 6½%, while the Statistics Iceland house price index rose by 5.8%. The number of purchase agreements concluded in the month of December was up 32% year-on-year, and there was an increase of 11% on average between 2012 and 2013. The average time-to-sale for residential property in greater Reykjavík was about five months in 2013, down from seven in 2012.

The consumer price index fell by 0.72% month-on-month in January. The decline is due primarily to sales effects, although international airfares and petrol prices also had a downward effect. Pulling in the other direction were increases in housing costs and health care services. The twelve-month increase in private services prices measured 3.3% in January, down from 6.1% in December.

Twelve-month inflation measured 3.1%, after falling from 4.2% in December. Excluding the housing component, it measured 1.9%. Without tax effects, underlying annual inflation fell 0.8 percentage points between months as measured by core index 3, and by 1.2 percentage points in terms of core index 4, bringing twelve-month inflation by these two criteria to 3.7% and 2.4%, respectively. Statistical measures of underlying inflation suggest that it lies in the 2½-3% range.

Inflation expectations have subsided in the wake of the decline in inflation in January and expectations of more modest wage rises this year. The short- and long-term breakeven inflation rates in the bond market had fallen by an average of 0.4-0.6 percentage points since the MPC's December meeting. By all these measures, inflation expectations ranged between 3.3% and 3.7% just before the Committee met in February. According to the Central Bank's quarterly survey of market expectations, conducted in early February, market participants expect inflation to be about 3.5% in two years' time, which is about 0.5-0.7 percentage points lower than in a comparable survey carried out in November. Longer-term inflation expectations among market participants were unchanged, however, averaging 4% over the next ten years.

According to the updated forecast in *Monetary Bulletin* 2014/1, the inflation outlook for 2014 has improved from the Bank's November forecast, mainly because of a stronger króna and smaller rises in unit labour costs than were anticipated at that time. If assumptions concerning developments in wages and the exchange rate are borne out, inflation will approach the inflation target this year. On the other hand, the outlook is for inflation to rise again early in 2015, when the effects of the recent currency appreciation taper off and the slack in the economy turns into an output gap. According to the forecast, inflation will exceed 3% over the next two years, peaking at about 3½% late in 2015 and then tapering off in 2016, due to monetary tightening. If the forecast materialises, inflation will nonetheless be somewhat above target at the end of the forecast horizon, although the target is well within the 50% confidence band of the forecast.

The global output growth outlook has improved since the publication of the November *Monetary Bulletin*, although considerable uncertainty remains, particularly in relation to recent headwinds facing emerging economies. The outlook for Iceland's terms of trade has improved as well, but the outlook for exports has deteriorated, owing in particular to poorer prospects for capelin fishing this year.

Last year's GDP growth appears to have been considerably stronger than previously anticipated, or 3% instead of the 2.3% in the November forecast, due to a much stronger contribution from net trade, while domestic demand developed in line with the forecast. The domestic labour market has also recovered more strongly than previously forecast. On the strength of unexpectedly robust output growth, the slack in the economy will narrow more quickly than previously projected, and an output gap could develop early next year.

The Government's proposed household debt relief package and other stimulative policy measures strongly affect the economic outlook. The debt reduction measures will increase private consumption considerably in the near term. The increased demand will also stimulate imports, reduce national saving and cut into the current account surplus. The GDP growth effect of the measures will therefore be less pronounced than the effect on domestic demand.

As in November, GDP growth for 2014 is estimated at 2.6%, reflecting the stimulative effects of the Government debt relief package and the offsetting outlook for weaker export growth, coupled with delays in energy-intensive industrial development projects. The GDP growth outlook for the next two years has improved considerably, with growth projected at 3.7% in 2015 and 3% in 2016. If the forecast materialises, GDP growth will average about 3.1% per year over the forecast horizon, which is above the 30-year average of 2.5% and well above the average projection for Iceland's main trading partners.

II The interest rate decision

The Governor reported to the Committee on the work done by the Bank and other authorities since the last meeting in relation to capital account liberalisation.

Members agreed that recent economic developments had been in line with the Committee's assessment at the December meeting, with year-2013 GDP growth estimated to have been considerably stronger than the Bank projected in November. The Committee noted that this was consistent with previous indications of a strong labour market recovery.

The Committee discussed that the outlook for this year had improved, according to the Bank's forecast as published in *Monetary Bulletin* on 12 February. Committee members also considered the fact that the króna had appreciated in recent weeks in spite of substantial foreign currency purchases by the Bank, and that the outlook was for unit labour costs to rise less markedly this year than previously forecast, provided that the main results of the wage settlements concluded in late December 2013 applied to the labour market as a whole.

The Committee considered it likely that inflation would be lower this year than previously anticipated and would be close to target. Some members even considered it relatively likely, in view of recent exchange rate movements, that inflation would fall temporarily below the inflation target. In this context, the Committee discussed the extent to which the increase in house prices was an indication of future inflation and to which extent it reflected changes in relative prices.

Members agreed that the inflation outlook for the coming two years had deteriorated since the November forecast because the outlook was for the slack in the economy to give way to an output gap during the period. The Committee noted that, according to the Bank's updated forecast, GDP growth would gain pace in the next two years and the slack in the economy would disappear earlier than previously expected. Measures to reduce households' indexed debt would have some effect on the medium-term economic outlook. Committee members agreed with the results of the analysis published in *Monetary Bulletin*: that the debt relief measures would stimulate private consumption and imports, other things being equal, and reduce national saving and the current account surplus, thereby contributing to a weaker króna than would otherwise result. Members were concerned that by the time the measures were implemented, the spare capacity would have almost disappeared from the economy, which would exacerbate the risk that increased economic activity would surface in higher inflation. It was therefore important that the Government adopt other measures to promote saving and ease downward pressure on the exchange rate, which could increase the nominal principal of indexed loans.

Members also agreed that, in the absence of other changes, the prospect of stronger domestic demand growth would require that the monetary stance be tightened sooner and more than previously expected. This could be offset by other measures that support monetary policy, however. Medium-term fiscal policy would be very important in this context. Also discussed was the Committee's view that measures that strengthen the supply side of the economy could ease supply constraints, thereby weakening the inflationary effects of increased demand.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. Four Committee members voted in favour of the proposal. They considered the uncertainty that still existed concerning key aspects of the forecast and other economic policy actions that could support monetary policy argued against a rate increase at this time. Furthermore, there was considerable uncertainty about the impact of the Government's debt relief measures and the recent strengthening of the króna could, furthermore, continue. Even though the medium-term inflation outlook had deteriorated, there was still ample time to respond to it. It was also pointed out that the Bank's real rate had already risen due to declining inflation. One member voted against the Governor's proposal, however, voting instead to raise interest rates by 0.25 percentage points. This member pointed out that, even though the near-term inflation outlook had improved, the outlook for the upcoming two years had deteriorated. Furthermore, long-term inflation expectations were still close to 4% and had changed little in spite of favourable developments in inflation in the recent term.

Committee members were of the view that, to the extent that inflation continued to abate, the monetary stance would grow tighter without nominal interest rate increases, but that the Bank's inflation forecast implied that it would be necessary to raise nominal interest rates as spare capacity in the economy disappeared and an output gap emerged. However, developments in the Bank's nominal interest rates would depend, as before, on the future path of inflation.

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 19 March 2014.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, March 2014

Published 2 April 2014

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 Monetary Policy Committee meeting held on 17 and 18 March 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 19 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 12 February interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.5% higher at the time of the March meeting than at the February meeting. Between meetings, the króna had appreciated by about 1.7% against the US dollar and about 0.4% against the pound sterling, but was broadly unchanged against the euro. Bids for krónur in the offshore market lay in the range of 214-250 kr. per euro and were broadly unchanged.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 45 million euros (roughly 7 b.kr.) since the last MPC meeting, or 38% of total market turnover during the period.

In general, financial institutions' liquidity had remained ample between meetings and, as before, overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25 percentage points above current account rates. From the beginning of the year to the time of the March meeting, interbank market turnover had been limited, or about 10 b.kr., as opposed to 132 b.kr. over the same period in 2013.

Owing to abundant financial system liquidity, the simple average of Central Bank current account rates and the maximum rate on certificates of deposit is the best approximation of the effect of Central Bank rates on money market rates. This average, which can be termed the effective policy rate, was just under 5½% at the time of the March meeting, while the interbank overnight rate was 5.25%. Even though nominal interest rates have remained unchanged, the monetary stance had tightened somewhat between meetings, in line with falling inflation and inflation expectations. The Bank's effective real rate was 3.2% in terms of twelve-month inflation in February and 2.3% in terms of the average of various measures of inflation and inflation expectations, or about ½-1 percentage point higher than at the time of the February meeting. The average of the various measures of inflation and inflation expectations was 3.0% at the time of the March meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged since the February meeting, measuring 2 percentage points just before the Committee met in March. The risk premium on Treasury obligations in terms of the spread between the Icelandic Treasury's US dollar bonds maturing in 2016 and 2022 and comparable bonds issued by the US Treasury had declined by about 0.1 percentage points since the previous meeting. Just before the March meeting, it measured about 2 percentage points for the bonds maturing in 2016 and about 2½ percentage points for the bonds maturing in 2022.

Unchanged Central Bank interest rates in March appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Analysts cited the appreciation of the króna since the MPC's previous meeting, among other factors, but pointed out that inflation expectations in the market were still well above target even though current inflation was below it.

Broad money (M3) grew by about 1.6% month-on-month in January and by 8.3% year-on-year. The increase excluding holding company deposits was smaller, at 4.6%. Narrower measures of the money supply also increased year-on-year, with M2 growing by 9.6% and M1 by 15.7% in January. Excluding holding company deposits, M2 and M1 grew by 6.2% and 12.3%, respectively. Based on a twelve-month moving average, Central Bank base money contracted by 0.9% over the same period. Broad and narrow money therefore grew significantly year-on-year in January, after contracting in 2012 and into January 2013. In January 2014, M3 was broadly at its early 2012 level. Real growth in the money supply was less, however, and nominal growth remains less than nominal GDP growth.

Slow credit growth has continued: net new lending to households by deposit money banks (DMB) – i.e., new loans net of prepayments – totalled about 2.4 b.kr. in January, or just under 0.3% of the total stock of DMB loans to households. Net new corporate loans (to non-holding companies) totalled 10.7 b.kr. in January, or 1.1% of the total stock of DMB loans to firms.

The NASDAQ OMX Main List index, OMXI6, had fallen by 6.3% between meetings. Turnover in the NASDAQ OMX Iceland main market totalled about 251 b.kr. in 2013, nearly three times that in 2012. Turnover in February totalled 59 b.kr., an increase of about 25% year-on-year. At the beginning of March, the market value of companies listed on the main market totalled 520 b.kr., or approximately 30% of year-2013 GDP.

Outlook for the global real economy and international trade

Iceland's goods trade surplus totalled 7.1 b.kr. in January and, according to preliminary figures, 4 b.kr. in February. Export values contracted by 7.2% year-on-year in the first two months of the year, due to a contraction in the value of exported marine and industrial products. Import values contracted by 1.7% over the same period, mostly due to a contraction in the import value of commodities and operational inputs.

The abrupt drop in aluminium prices at the beginning of the year has reversed for the most part, and prices were relatively stable between the Committee's February and March meetings. The price index for marine products has continued to fall year-on-year, however, and had declined by 1.3% between years in January.

The real exchange rate index in terms of relative consumer prices was 83.9 points in February, or 5.2% higher than in Q4/2013. The increase is due primarily to nominal appreciation of the króna, but in addition, inflation was 0.7% higher in Iceland than among its trading partners. The outlook is for inflation to remain low in trading partner countries. It measured 0.7% in the euro area and 1.1% in the US in February. In the UK, it measured 1.9% in January.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, output growth measured 3.3% in 2013 as a whole and 3.8% in Q4/2013. Seasonally adjusted GDP contracted by 0.2% quarter-on-quarter, according to seasonally adjusted figures from the Central Bank. Previous figures for the first three quarters of 2013 were revised, but they did not have a tangible effect on GDP growth for the period, which measured 3.1%.

The main driver of Q4 growth was the contribution from net trade, as exports grew by 8.4% and imports by 5.1%. Consumption and investment grew by a total of 2% year-on-year during the quarter, but domestic demand growth measured 1.6%, as the contribution from inventory changes was negative by 0.4 percentage points. Net trade was also the main driver of GDP growth for the year as a whole, contributing about 3.2 percentage points. Private and public consumption grew by about 1.2-1.3%, investment contracted by 3.4%, and domestic demand as a whole grew by only 0.1%.

GDP growth was somewhat stronger than according to the forecast published in the February issue of *Monetary Bulletin*, which provided for 2.7% growth in Q4 and 3% for the year as a whole. In both instances, the deviation from the forecast was due to an unexpectedly strong contribution from net trade.

The underlying current account balance was positive by 111 b.kr. in 2013, or 6.2% of GDP, as opposed to 2.8% of GDP in 2012. The larger surplus in 2013 is due primarily to a larger surplus on services trade (36 b.kr.) and a smaller income account deficit (36 b.kr.) than in 2012; however, the surplus on goods trade was smaller (8 b.kr.). The forecast published in the February *Monetary Bulletin* assumed that the current account surplus would amount to 5.3% of GDP in 2013. The deviation is due primarily to stronger returns on Icelanders' assets than was assumed in the forecast.

Investment as a share of GDP declined slightly between 2012 and 2013, but national saving rose from 17.7% of GDP in 2012 to 19.8% of GDP in 2013.

Key indicators of private consumption at the beginning of the year suggest relatively strong growth during the quarter; for instance, payment card turnover in January and February was up 7.5% year-on-year. Motor vehicle sales grew strongly as well, as did general retail sales, particularly specialty items.

Unemployment as registered by the Directorate of Labour (DoL) rose by 0.3 percentage points in January, to 4.5%, but remained unchanged between January and February. Seasonally adjusted unemployment fell by 0.2 percentage points from December, to 3.7% in February.

New national accounts indicate that wage costs per man-year have risen significantly less over the past two years than was previously assumed. The share of wages in gross factor income rose by 0.7 percentage points year-on-year in 2013, to 62.8%, the same as in 2001. Since it bottomed out in 2009, the wage share has risen by about 6 percentage points.

The wage index rose by 1% month-on-month in January and by 6.7% year-on-year. Real wages in terms of the wage index rose by 1.7% between months and about 3.4% year-on-year.

According to Capacent Gallup's March survey among executives from Iceland's 400 largest firms, the number of respondents interested in adding on staff in the next six months exceeded the number interested in downsizing by about 14 percentage points. This is a slight improvement over the results of the surveys conducted in the first half of 2013 and a significant improvement over the surveys from the second half of the year, when the number of firms interested in recruiting and downsizing were roughly equal. In all sectors except fisheries and financial and insurance activities, interest in recruiting has increased since the last survey, and only in retail trade and financial and insurance activities has the number of firms planning to downsize risen between surveys.

According to the survey, executives are considerably more optimistic about economic conditions than they were last November. The economy-wide index, which measures respondents' attitude towards current conditions, rose markedly and is at its highest point since December 2007. The share of respondents who consider conditions good, or neither good nor bad, rose considerably between surveys. About 62% of participants consider current conditions neither good nor bad, while 18% considered them good. Executives are also more positive about the situation six months ahead than they were last November. About 42% of respondents indicated that they expect conditions to improve in the next six months, while 7% indicated that they expect them to deteriorate. Executives in all sectors except fishing and transport and transportation were more optimistic than they were last November. The improvement between surveys was most pronounced in the retail trade sector. All executives except those in the construction industry and transport and transportation are more optimistic than they were at this time a year ago.

Expectations concerning domestic demand increased markedly, both from the previous survey and from a year ago. Expectations concerning demand in foreign markets are a little weaker than in November but have improved markedly in the past year. Executives were somewhat more optimistic about developments in firms' margins (EBITDA) in the next six months than they were in September and in March 2013. The outlook for investment has also improved from a year ago.

According to the Capacent Gallup survey of consumer expectations, consumer sentiment improved in February. The Consumer Sentiment Index measured 85.9 points, which is an increase of over 5 points year-on-year. In February, the assessment of the labour market and the situation six months ahead improved most.

The nationwide Statistics Iceland house price index, published in late February, rose by 0.2% from the previous month and by ½% adjusted for seasonality. It had risen by about 9% from February 2013. The capital area real estate price index, calculated by Registers Iceland, rose by 0.3% month-on-month in January and by about 0.6% when adjusted for seasonality. The index has risen by 7.4% since January 2013. About 17% more purchase agreements were concluded nationwide in February 2013 than in the same month in 2013. The average time-to-sale for residential property in greater Reykjavík was just over four months in February. It averaged just under five months in 2013, down from seven in 2012.

The consumer price index (CPI) rose by 0.67% month-on-month in February, but twelve-month inflation fell from 3.1% to 2.1%. Strong base effects were present, as the CPI had risen by 1.6% in February 2013. End-of-sale effects had the strongest impact on the index in February. International airfares also had an upward effect, while groceries prices declined. Underlying annual inflation fell 0.9 percentage points between months in terms of both core index 3 and core index 4 excluding tax effects, measuring 2.8% and 1.5%, respectively. Statistical measures of underlying inflation give similar results.

The housing component of the CPI has risen most in the past twelve months, or by 7.4%, and inflation excluding housing measured only 0.8% in February. Increases in other domestic items have lost pace, although the annual increase in those items measured 3.4% in February. The contribution of imported goods to the rise in the index was negative, however, with the twelve-month reduction measuring 2.1%. The króna appreciated by about 12% over the same period.

Inflation expectations two years ahead continue to decline in line with the slowdown in inflation. Household inflation expectations measured 4% in March, both one and two years ahead, as opposed to 5% over the past 4-6 quarters. In addition, corporate inflation expectations one year ahead have fallen from 3.9% to 3%, and two-year expectations have fallen from 4% to 3.5%. In terms of the breakeven inflation rate in the bond market, one- and two-year inflation expectations measured 2.8% and 3.3%, respectively, and had declined by 0.3-0.6 percentage points since the previous meeting. Longer-term inflation expectations appeared not to have fallen commensurably, however; just before the meeting, measurements of the long-term breakeven rate indicated that market agents expected inflation to measure 4% five to 10 years ahead. Those expectations have remained broadly unchanged for some time.

II The interest rate decision

The Governor gave the Committee an update on the work done by the Bank and other authorities since the last meeting in relation to capital account liberalisation. The balance of payments model to be used to evaluate various scenarios and assess the sensitivity of the balance of payments outlook to different shocks was presented to the Committee. The model will play a key role as a tool for evaluating various ways of lifting the controls. In particular, the Committee discussed expected foreign exchange outflows for the year, recent developments in the real exchange rate, and how the real exchange rate compared with the most recent estimation of the equilibrium real exchange rate.

The MPC also discussed monetary policy conduct and possible changes in the Bank's liquidity management. It emerged that monetary policy implementation had changed little in recent years. ESÍ's planned asset sales and the possible easing of the capital controls would imply significant changes for the monetary policy environment in the near future, however. The Committee agreed that monetary policy conduct must support monetary policy goals, but that it was also important that monetary policy be straightforward, easily understood, and economical in terms of the Bank's balance sheet. The time had come to review it with an eye to these objectives. It would not be necessary to make fundamental changes in monetary policy conduct, however, and the changes would take place in stages. Among possible options were changes in the form and duration of deposits/CDs, the relationship between CD issuance and collateralised loans, amount restrictions on collateralised and overnight loans, definitions of counterparties, and the number of trading days. The MPC authorised the Governor to work on implementing improvements to monetary policy conduct, in line with the ideas discussed within the Committee.

Committee members discussed recent inflation developments. Inflation had measured 2.1% in February and had subsided relatively quickly. There were also signs that domestic inflation and underlying inflationary pressures had subsided. Furthermore, newly published national accounts show that, over the past two years, wage costs per man-year rose considerably less than previous indicators had suggested. In addition, the outlook was that the main results of the wage settlements concluded in late 2013 would apply to most of the labour market.

Committee members agreed that the short-term inflation outlook had improved. Recent inflation developments had been marginally better than had been assumed at the February meeting. The Committee also considered it likely that because of a better initial position characterised by lower inflation than was forecast in February, a stronger króna, and smaller wage increases, the short-term inflation outlook had improved from previous estimates. Furthermore, members welcomed the decline in short-term inflation expectations in line with falling inflation. On the other hand, they were still quite concerned that long-term inflation expectations had remained close to 4%.

The Committee was of the view that the two-year inflation outlook had improved somewhat, but not decisively enough, in spite of positive recent developments and an improved outlook for 2014. As had been forecast previously, the outlook was for inflation to rise again as domestic demand growth gained momentum and the slack in the economy gave way to a positive output gap. Based on the most recent year-2013 GDP growth figures, the spare capacity in the economy was about to disappear. Indicators of private consumption in the current quarter also suggested that growth was considerably stronger than previously projected. The Committee was of the opinion that, other things being equal, this would call for an increase in the Bank's real rate. One member was less concerned about future developments in inflation to the extent that GDP growth was driven by tourism, which has spare capacity during the winter. Migrant labour could also help to meet increased demand and higher tourist numbers could strengthen the króna. It was therefore not clear that tourism-driven GDP growth would exacerbate inflation risk or necessitate an interest rate increase to the same degree as GDP growth driven by domestic demand would. Others were of the view that even though various factors tended to contribute to lower short-term inflation, they could stimulate inflation later on.

The Committee was of the view that there might be less need for a higher real rate if countervailing measures were introduced that pulled in the same direction as monetary policy, including medium-term fiscal policy. Furthermore, the MPC considered that measures that strengthen the supply side of the economy could ease supply constraints, thereby weakening the inflationary effects of increased demand.

As before, the monetary stance at any given time will be determined by the inflation outlook. Committee members discussed various possible changes in the Bank's interest rates. The most likely options were to keep rates unchanged or to lower them by 0.25 percentage points. Members agreed that the short-term inflation outlook had improved but that the time to reduce rates had not arrived as long-term inflation expectations were still markedly above the target.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. All Committee members voted in favour of the proposal.

Members agreed that whether there was scope for a nominal interest rate reduction would depend on developments in inflation and inflation expectations in coming months. Further ahead, the Committee was of the view that the Bank's real rate would have to be raised further if the above-described outlook materialised. The extent to which this took place through nominal rate increases would depend, as before, on the future path of inflation.

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 21 May 2014.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, May 2014

Published 4 June 2014

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 19 and 20 May 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 21 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 19 March interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2014/2 on 21 May.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.7% higher at the time of the May meeting than at the March meeting. Between meetings, the króna had appreciated by about 1.7% against the euro and 0.2% against the US dollar but had depreciated by 1.1% against the pound sterling. Bids for krónur in the offshore market lay in the range of 192-216 kr. per euro and had decreased somewhat between meetings.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 46 million euros (roughly 7.1 b.kr.) since the last MPC meeting, or 25% of total market turnover during the period.

In general, financial institutions' liquidity had remained ample between meetings and, as before, overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25 percentage points above current account rates, with the exception of 19 and 20 May, when they moved towards the upper half of the corridor, owing to a temporary liquidity shortage in the interbank market. Interbank market turnover has been very limited, totalling 49.5 b.kr. from the beginning of the year until the May meeting, as opposed to 205 b.kr. over the same period in 2013.

Owing to abundant financial system liquidity, the simple average of Central Bank current account rates and the maximum rate on certificates of deposit is the best approximation of the effect of Central Bank rates on money market rates. This average, which can be termed the effective policy rate, was 5.4% at the time of the May meeting. The monetary stance was broadly unchanged since the March meeting but had tightened somewhat year-to-date, in line with falling inflation and inflation expectations. In April, the Bank's effective real rate was 3% in terms of twelve-month inflation and 2.3% in terms of the average of various measures of inflation and inflation expectations, or about 0.5-0.8 percentage points higher than at the March meeting, and nearly a percentage point higher than at the meeting in May 2013. The average of the various measures of inflation and inflation expectations was 3% at the time of the May meeting.

The Republic of Iceland's sovereign CDS spread had fallen by 0.2 percentage points since the March meeting, measuring 1.7% just before the Committee met in May. The risk premium on Treasury obligations in terms of the spread between the Icelandic Treasury's US dollar bonds maturing in 2016 and 2022 and comparable bonds issued by the US Treasury measured about 2 percentage points just before the May meeting. The premium on the longer bond had declined by about 0.2 percentage points since the March meeting but was broadly unchanged on the shorter bond. It has declined by just over ½% year-to-date. It reached a historical low in April but has risen slightly since then.

Unchanged Central Bank interest rates in May appeared to have been priced into the yield curve, in line with the expectations of most financial institutions' market analysts. In explaining the grounds for their expectations, analysts noted in particular that, in spite of the improved short-term inflation outlook and the higher real Central Bank rate, long-term inflation expectations were still above target. Analysts also cited growing domestic demand, uncertainty about wage agreements and the recovery of the labour market as grounds for unchanged interest rates.

Broad money (M3) grew by about 1% quarter-on-quarter in Q1/2014, and about 6.9% year-on-year. The year-on-year increase excluding holding company deposits was smaller, at 4.1%. Narrower measures of money holdings also increased year-on-year, with M2 growing by 7.9% and M1 by 11.4%. Excluding holding company deposits, year-on-year growth measured 6.4% (M2) and 11.1% (M1). Central Bank base money grew by 8.8% over the same period.

Net new lending from deposit money banks (DMB) to domestic borrowers – i.e., new loans net of prepayments – totalled about 26 b.kr. in Q1. The year-on-year increase was about 12% less than in Q1/2013. Growth in lending to households and businesses has slowed down in 2014. Net new DMB loans to households totalled 10.4 b.kr. in Q1. The increase was about 8.5% less than in Q1/2013. Net new lending to non-holding companies totalled 9.7 b.kr. in Q1, a contraction of 28% year-on-year.

The NASDAQ OMX Main List index, OMXI6, had fallen by 3.6% between meetings. Turnover in the NASDAQ OMX Iceland main market totalled 93 b.kr. over the first four months of the year, slightly more than in the same period in 2013. At the beginning of May, the market value of companies listed on the main market totalled nearly 590 b.kr., or approximately a third of year-2013 GDP.

Outlook for the global real economy and international trade

According to the most recent forecast from the International Monetary Fund (IMF), published in April, global output growth in 2014 and 2015 will be broadly unchanged from the Fund's January forecast. The same applies to the forecast for world trade. In industrialised countries, growth is expected to exceed the Fund's January forecast in 2014 but fall short of it in 2015. The output growth outlook appears to be improving, although some downside uncertainty remains. Output growth in the US is forecast at 2.6% in 2014 and 3½% in 2015, while the outlook for the euro area is slightly better than was forecast in January, and for the UK it is considerably better. Overall, the IMF projects lower inflation than in January. Its forecast for output growth in 2014 in Iceland's main trading partners is unchanged, at 1.9%.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 0.6 b.kr. surplus in March but showed a 7 b.kr. deficit in April. Import and export values contracted year-on-year in April, with exports contracting slightly more than imports. In the first four months of the year, import values grew by about 4% year-on-year, while export values have contracted by roughly 11%. The reduction in export values is due primarily to a 13% contraction in the value of exported marine products and industrial goods. The rise in import values is due mainly to an increase in the value of imported transport equipment and consumer goods, although imports of investment goods, commodities, and operational inputs also grew during the first four months of the year.

The price of aluminium has risen marginally since the MPC's March meeting. In the first two weeks of May, the average price was 1.6% above the March average. Marine product prices were up 1.5% month-on-month in March.

The domestic real economy and inflation

According to the Statistics Iceland labour market survey, growth in labour demand was somewhat stronger in Q1 than in the forecast published in the February issue of *Monetary Bulletin*. The February forecast provided for a 2.5% year-on-year increase in total hours worked, while the actual increase was 3%. As before, the rise in total hours worked is due primarily to a 2.1% increase in the number of employed persons, while average hours worked rose by 0.9%.

In Q1/2014, net migration was positive for the sixth quarter in a row. The net increase was due entirely to foreign nationals, indicating that migrant labour could meet the increase in demand to some extent.

In Q1/2014, unemployment as registered by the Directorate of Labour (DoL) was broadly in line with the Bank's last forecast. Seasonally adjusted unemployment was 3.8% as measured by the DoL, as opposed to 5.2% according to the Statistics Iceland labour market survey. The survey-based rate adjusted for those who had been hired during the reference week but had not yet begun work was 4.7%. Unemployment declined slightly between quarters by both measures. According to the DoL, unemployment was nearly a percentage point lower than at the same time in 2013, whereas it was virtually unchanged year-on-year according to the labour market survey.

The wage index rose by 1.7% quarter-on-quarter and 5.2% year-on-year in Q1/2014.

Key indicators of private consumption in Q1/2014 suggest strong growth from the previous year. Payment card turnover was up more than 7% year-on-year during the quarter, and retail sales continued to grow, particularly sales of durable consumer goods such as electronic equipment. New motor vehicle registrations increased somewhat during the quarter, after the pace of the increase slowed down in the second half of 2013.

According to a survey conducted by Capacent Gallup, consumer sentiment deteriorated markedly in April, with the Consumer Sentiment Index measuring 82.7 points, a decline of about 4 points year-on-year. All components of the index fell between months, with the largest declines in the assessment of the labour market and the situation six months ahead.

The nationwide Statistics Iceland house price index, published in late April, rose by roughly 1½% from the previous month, and by about 0.4% adjusted for seasonality. It was up 9.3% from April 2013. The capital area real estate price index, calculated by Registers Iceland, rose by 2.2% month-on-month in March and by about 2% when adjusted for seasonality. The index has risen by 11.1% since March 2013. Since the beginning of the year, the Statistics Iceland house price index has risen by 9.5% from the same period a year ago. Over the same period, the building cost index has risen 1.3%. About 35% more purchase agreements were concluded nationwide in March 2014 than in the same month in 2013. The average time-to-sale for residential property in greater Reykjavík was about four months during Q1, a little more than a month shorter than during the same period in 2013.

According to the Central Bank's quarterly survey of market agents' expectations, conducted just before the publication of the May *Monetary Bulletin*, respondents' short-term inflation expectations were about 0.2-0.7 percentage points lower than in a comparable survey from February. Market agents expect twelve-month inflation to be close to the inflation target, on average, through the end of 2014. They expect inflation to measure 3.1% in one year and 3.5% in two years. Their longer-term inflation expectations have changed very little, however, averaging 3.8% over the next ten years. The vast majority of market agents cited external conditions as the main reason the Bank would be unable to keep inflation at target for the long term. Indicators of market agents' inflation expectations based on the spread between nominal and indexed bond yields also suggest that short-term expectations have declined, while long-term expectations are virtually unchanged. The five- and ten-year breakeven inflation rate in the bond market was about 4% just before the May meeting.

The consumer price index (CPI) rose by 0.24% month-on-month in March, raising twelve-month inflation from 2.1% to 2.2%. End-of-sale effects had the strongest upward impact on the index, while reductions in petrol prices pulled in the opposite direction. In April, the CPI rose by 0.31%, bringing year-on-year inflation to 2.3%. The increase in the CPI was driven primarily by a rise in imputed rent, while mobile phone service and groceries prices declined. Underlying twelve-month inflation declined marginally in March and April, with core index 3 excluding tax effects measuring 2.7% in April and core index 4 excluding tax effects measuring 1.3%.

The housing component of the CPI has risen most in the past twelve months, or by 7.1%, and inflation excluding housing measured only 1% in April. The twelve-month rise in the housing component explained nearly two-thirds of inflation in April. The increase in other domestic components has slowed down markedly, with the twelve-month rise close to the inflation target in April, for the first time since autumn 2007. The decline in domestic inflation has therefore pulled in the same direction as imported inflation, while the price of imported goods had declined by nearly 1% year-on-year in April.

According to the forecast published in *Monetary Bulletin* 2014/2 on 21 May, the inflation outlook has improved slightly since the February forecast was published, due primarily to a stronger króna and smaller rises in unit labour costs in the recent term. Inflation was at the Bank's 2.5% inflation target in Q1/2014 and will remain at target through this year, according to the forecast. As in February, however, it is expected to begin rising again next year, measuring 3-3½% in the latter half of the forecast horizon, whereupon it will begin to fall back towards the target in response to monetary tightening.

The GDP growth outlook for Iceland's main trading partners is broadly unchanged from the February forecast, and is projected to average 2% this year and just over 2% per year in 2015-2016. Domestic demand is forecast to take over from exports as the main driver of trading partners' GDP growth.

Terms of trade are forecast to improve slightly year-on-year in 2014, after continuous erosion since 2010. The outlook for the next two years has also improved, primarily because of a brighter outlook for export prices, marine product prices in particular. The total improvement is projected at nearly 1% over the forecast horizon, as opposed to a deterioration of just over 2% according to the February forecast.

Export growth was nearly 1 percentage point stronger in 2013 than was provided for in the February forecast, due to more robust services exports. The outlook for export growth in 2014 has improved since February, also because of services exports. This improvement outweighs the poorer outlook for goods exports, which is attributable to a contraction in marine product exports. The outlook for exports has also improved for 2015 and 2016. Export growth is now projected to average 2.7% per year during the forecast horizon, as opposed to just under 2% in the February forecast, and the trade surplus will increase accordingly.

The GDP growth outlook for this year has improved markedly from the February forecast. Growth is now projected at 3.7%, over a percentage point more than was forecast in February. The improvement is due to greatly increased investment growth. GDP growth is forecast to rise to 3.9% in 2015 and then fall back to 2.7% in 2016, as opposed to the February forecast of 3%.

Indicators imply that there is still some slack in the labour market, but it is forecast to disappear in the near future, although the timing is uncertain. New figures from Statistics Iceland indicate that unit labour costs rose less in the past two years than previous figures had suggested. Wage agreements have been concluded with the majority of the labour market since the February forecast was published. Even though negotiated pay rises have been broadly consistent with the private sector agreement concluded in December, the wage increases taking effect this year and next year are somewhat larger than was assumed in the last forecast. This is offset by somewhat more rapid growth in underlying productivity. The outlook for unit labour costs is broadly unchanged from February, with growth projected to average just under 3% per year, slightly above the inflation target.

According to the forecast, the margin of spare capacity in the economy measured about ½% of potential output in 2013. Owing to continued strong GDP growth, it is expected to disappear by mid-2014, about half a year earlier than according to the February forecast. Strong growth in domestic demand is expected to contribute to the gradual development of a positive output gap that will peak at 1½% of potential output in mid-2016 and then narrow to about ½% by mid-2017, the end of the forecast horizon.

The baseline forecast in *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are several key uncertainties that could change the inflation outlook from that assumed in the baseline forecast. For example, if the króna is weaker or wage increases larger than in the baseline forecast, there is the risk that the inflation outlook in the forecast or the assumptions concerning the Central Bank interest rate level that will suffice to bring inflation back to target are too optimistic. The same is true if the slack in the economy is overestimated in the baseline forecast. The risk that underlying inflationary pressures are underestimated is also greater than it would be otherwise because long-term inflation expectations are poorly anchored. If domestic demand has been overestimated, however, or if global output growth proves weaker than is assumed in the forecast, the domestic economy could turn out weaker and inflationary pressures therefore less pronounced. A weaker global economic recovery could also lead to weaker domestic growth and lower global commodity and oil prices, but on the other hand, the exchange rate of the króna could fall.

II The interest rate decision

The Governor gave the Committee an update on the work done by the Bank and other authorities since the last meeting in relation to capital account liberalisation.

The Committee discussed the Bank's *Financial Stability* report, published in early April, the status of financial institutions, their restructuring measures, and the progress made with private sector debt restructuring. It also discussed the risks facing the financial system as a result of Iceland's balance of payments problem.

At recent meetings, the MPC had discussed altering the Bank's monetary policy instruments, as well as possibly modifying its liquidity management measures. In accordance with Article 24 of the Act on the Central Bank of Iceland, the MPC approved the Governor's proposed changes in its monetary policy instruments (discussed in greater detail in the Bank's press release of 21 May 2014). The objective of the changes is to enhance the effectiveness of the Bank's liquidity management and, insofar as is possible, to promote greater efficiency in the use of its balance sheet. The modifications should also prepare for the changes in the monetary policy environment upon the sale of Central Bank of Iceland Holding Company (ESÍ) assets and the liberalisation of the capital controls. Further changes are under analysis within the Committee and could be implemented at a later date.

The Committee discussed the outlook for the domestic economy, including the Bank's new macroeconomic forecast. According to the forecast, GDP growth will measure 3.7% this year, about 1 percentage point more than according to the previous forecast. Even stronger growth is projected for next year. Furthermore, the labour market continues to recover. Because of this strong growth, the slack is expected to disappear from the domestic economy sooner than previously anticipated. It has diminished rapidly in the recent term. Indicators from the labour market point in the same direction. Furthermore, a positive output gap is forecast to develop next year, owing to strong growth in domestic demand. The output gap is expected to be more pronounced than previously projected and to peak in 2016. In view of the balance of payments problem, the Committee was concerned about the forecast showing declining national saving and the current account surplus turning into a deficit towards the end of the forecast horizon.

Committee members also discussed recent inflation developments and prospects. The inflation outlook has improved since the last forecast, owing to a stronger króna and smaller rises in unit labour costs. Inflation has been close to target in recent months and is expected to remain there until next year, when it is forecast to rise as a positive output gap emerges. Short-term inflation expectations have also declined in the recent term, in line with falling inflation, although long-term inflation expectations are still somewhat above target.

Committee members agreed that there was some uncertainty about wage developments, particularly in view of the unrest in the labour market. The Bank's forecast assumes that the results of the wage agreements concluded late in 2013 will apply to most of the labour market and that similar agreements will be made for a longer term early next year.

The Committee also discussed the extent to which the increase in house prices was an indication of future inflation and the extent to which it reflected changes in relative prices. Members were of the view that, because house prices had risen somewhat in excess of building costs in the recent term, the supply of housing could be expected to grow, thereby slowing down price increases.

In the Committee's opinion, there were grounds for keeping interest rates unchanged or for raising them. The main argument in favour of a rate increase discussed at the meeting centred on the benefits of responding swiftly, as the slack in the economy is expected to disappear in mid-2014, about half a year earlier than was forecast in February. There were also signs of wage pressures in the labour market and possible difficulties related to next year's wage negotiations. Even though the near-term inflation outlook had improved, the long-term outlook had deteriorated. Long-term inflation expectations were still close to 4% and had changed little in spite of favourable developments in inflation in the recent term.

The main argument in favour of unchanged interest rates was that the Bank's real rate had increased markedly year-to-date, as a result of the decline in inflation and inflation expectations. The Committee was of the opinion that the monetary slack had probably disappeared. The effects of the rise in the Bank's real rate had not emerged in full, however. Furthermore, the level of the Bank's neutral real rate was uncertain, and there was also considerable uncertainty about the size of the slack and the speed at which it was vanishing. In this context, it was pointed out that the next MPC's meeting was only a few weeks away, and by then the national accounts for Q1 would be available, as would a new inflation measurement. It was also mentioned that, even though the slack in the labour market was disappearing, surveys showed that employers envisioned no difficulty in hiring new workers, as the increased demand was met to a degree with imported labour. Moreover, it was pointed out that inflation excluding housing was very low and that the housing inflation could possibly reflect a temporary shortage of supply. In addition, some members considered it possible that inflation was overestimated in the forecast. Developments in imported inflation were uncertain, and global inflation was low. Domestic inflation could even fall below target in the near future, particularly in view of recent exchange rate developments.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. The Committee also decided that the interest rate on seven-day term deposits would be 5.25%. All Committee members voted in favour of the proposal.

Committee members agreed that monetary policy had been successful in the recent term. Inflation had subsided to target, and the slack in the economy was vanishing. Volatility of inflation and GDP had also diminished. However, Committee members were concerned that long-term inflation expectations were still somewhat above target, generating some uncertainty about the durability of this success.

Members agreed that, other things being equal, increased growth in domestic demand in the near term would probably require further increases in the Bank's real interest rate. Whether a change in the Bank's nominal interest rates is warranted in the near future would therefore depend on the future path of inflation and inflation expectations.

In the Committee's opinion, the more other measures, including restrictive fiscal policy, pulled in the same direction as monetary policy, the less need there would be for a tighter monetary stance. Such measures would also encourage increased saving and lead to a more favourable current account balance.

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 June 2014.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, June 2014

Published 25 June 2014

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 10 June 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 11 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 21 May interest rate decision.

Financial markets

According to key indicators from the financial markets, the situation was broadly unchanged since the previous meeting.

The exchange rate of the króna was virtually unchanged. The Central Bank was an active participant in the domestic foreign exchange market, however, with net accumulated foreign currency purchases totalling approximately 42 million euros (roughly 6.5 b.kr.) since the last MPC meeting, or 46% of total market turnover during the period.

Financial institutions' market liquidity was largely unchanged, and their market activity was very limited.

The monetary stance was broadly unchanged, as inflation changed little in May and nominal interest rates were unchanged. The Bank's effective real rate was 2.9% in terms of twelve-month inflation in May, and 2.3% in terms of the average of various measures of inflation and inflation expectations.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged, measuring 2 percentage points just before the Committee met in June.

Unchanged Central Bank interest rates in June appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Analysts' expectations were based on the fact that so little time had passed since the last interest rate decision and that little had happened to call for a response by the MPC.

In April, growth in M3 was similar to that in Q1, while narrower measures of money holdings grew more markedly. Central Bank base money grew somewhat more slowly, however.

Net new lending from deposit money banks (DMB) to domestic borrowers totalled 37 b.kr., or about 2% of the total loan stock, in April. In the first four months of 2014, credit was up about 13% year-on-year.

The NASDAQ OMXI6 index had risen by 3% between meetings. During the first five months of the year, trading volume on the NASDAQ OMX Iceland Main Market was slightly less than in the same period in 2013.

Outlook for the global real economy and international trade

According to preliminary figures from Statistics Iceland, Iceland's goods trade balance was positive by 2.4 b.kr. in May, about half of the surplus for the first five months of the year and the smallest goods account surplus since 2008. Over the first five months of the year, the value of imports grew by 2.9% year-on-year. The increase is due mainly to imports of transport equipment and consumer goods. Export values shrank by some 5.8% over the same period, however, owing to a contraction in the value of marine product exports and industrial exports.

In terms of relative consumer prices, the real exchange rate fell 0.3% month-on-month in May, to 83.8 points. In the first five months of the year, it was 8.7% higher than in the same period in 2013. This was due mainly to a higher nominal exchange rate, although domestic inflation was also 1.3 percentage points above the average for Iceland's trading partners.

Marine product prices rose in March and April, and were just over 1% higher the first four months of the year than at the same time last year. Aluminium prices have fluctuated somewhat in recent months. At the beginning of June, they were 3.5% above the May average.

The domestic real economy and inflation

According to the preliminary figures published by Statistics Iceland in June, GDP contracted by 0.1% year-on-year in Q1, reflecting the offsetting impact of a positive contribution from consumption and investment and a negative contribution from net trade and inventory changes. Consumption and investment grew by a total of 5.2% year-on-year during the quarter, but domestic demand growth measured 2.1%, with the difference due to a negative contribution from inventory changes.

GDP growth was considerably weaker than was forecast in the May issue of *Monetary Bulletin*, which assumed a growth rate of 4.1% for the quarter. The error in the forecast is largely due to stronger-than-projected growth in services imports. Consumption and investment grew more strongly than was assumed in the forecast, however.

The underlying current account balance was negative by 3.5 b.kr., or 0.8% of GDP, while the measured deficit was 2.8% of GDP.

Key indicators of private consumption in April and May give an unclear picture of developments during the quarter. Growth in payment card turnover slowed markedly in April, but other indicators such as retail specialty items sales and new motor vehicle registrations suggest continued growth.

Consumer sentiment was more or less unchanged month-on-month in May, according to the Gallup Consumer Sentiment index; however, the index was down more than 17 points from the previous year. In May 2013 it rose sharply, although that increase was short-lived.

According to Capacent Gallup's June survey, executives were considerably more upbeat about the economy than they were in March 2014 or in May 2013. The subindex on the economy, which indicates respondents' attitudes towards the current situation, increased sharply, rising above 100 points for the first time since mid-2007. Executives in all sectors except industry and manufacturing were more optimistic about the economy than they were in the March survey. Expectations concerning domestic demand were somewhat more pessimistic than in the last survey, whereas expectations about demand in foreign markets were more optimistic than in the March survey or the May 2013 survey. According to the survey, firms interested in recruiting staff outnumbered those planning redundancies by about 12 percentage points, which is broadly unchanged from the March survey.

House prices rose somewhat more year-on-year in April and May than in the first quarter of the year. House prices nationwide rose by 9½% year-on-year in the first five months of 2014. Over the same period, construction costs only rose by nearly 1.5% year-on-year. In April, growth in turnover slowed somewhat in comparison with the first quarter of the year.

Key indicators of inflation expectations are unchanged since the MPC's May meeting. According to the Capacent Gallup survey of household expectations carried out in May, household inflation expectations one and two years ahead were unchanged since the February/March survey, at 4%. In a comparable survey conducted among firms in May and June, one-year inflation expectations measured 3%, which was also unchanged since the last survey. In terms of the breakeven inflation rate in the bond market, respondents expect twelve-month inflation to measure just over 3% in two years' time and nearly 4% in five years' time, which is unchanged since the May meeting. Long-term inflation expectations are also unchanged, at 4%.

The consumer price index (CPI) rose by 0.07% month-on-month in May, raising twelve-month inflation from 2.3% to 2.4%. The drop in airfares affected the CPI most, although it was offset by the increase in the cost of owner-occupied housing. Other subcomponents had little impact on the CPI. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 2.7%, in May, a slight increase from the prior month. However, underlying inflation according to core index 4 excluding tax effects (which excludes house prices) was unchanged month-on-month, at 1.3%. The contribution of private services to twelve-month inflation measured 0.5 percentage points in May, the lowest since March 2004.

II The interest rate decision

The Governor gave the Committee an update on the work done by the Bank and other authorities since the last meeting in relation to capital account liberalisation.

The Committee discussed the experience gained from the Bank's foreign exchange market intervention in the past year. The exchange rate of the króna had remained virtually unchanged between meetings but had risen by some 2% year-to-date, even though the Bank bought significantly more foreign currency than it sold. Members agreed that the intervention had contributed to greater exchange rate stability. In view of exchange rate developments and the experience gained from the intervention programme, the Committee considered it timely to resume regular foreign currency purchases. The Committee was of the view that there was also some scope for action, as inflation was at target. Furthermore, the real exchange rate had risen markedly in the recent term and was not far from the level the MPC considered appropriate for the near future. Moreover, the season generally associated with strong foreign currency inflows was ahead. The amount purchased will be re-evaluated in the autumn, or earlier, if circumstances warrant it. As before, the Bank will intervene in the foreign exchange market as needed to mitigate exchange rate volatility. Therefore, there could be individual days or weeks when the Bank both bought and sold foreign currency.

Because of the short time since the previous meeting, very little new information had been published. Committee members agreed that the inflation and economic outlook was largely in line with the assumptions from the May meeting. Inflation measured 2.4% in May and has been close to target in recent months. According to the Bank's May forecast, it is expected to remain near target until next year, when it could rise as a positive output gap emerges. Households', businesses', and market agents' inflation expectations had remained broadly unchanged between meetings. Inflation expectations one to two years ahead have declined in the recent term, however, in line with falling inflation, although long-term inflation expectations are still somewhat above target.

The Committee discussed the first release of national accounts figures for Q1/2014 by Statistics Iceland. Members were of the view that the economy was stronger than the Q1 output growth figures suggested. According to those figures, domestic demand growth was somewhat stronger than had been forecast in the May issue of *Monetary Bulletin*. According to the national accounts, however, output growth was markedly weaker than was forecast in May, due primarily to strong services imports. Committee members agreed that it was often difficult to interpret quarterly output growth figures, particularly those from the first quarter of each year, in part because of wide fluctuations in export inventories. Imports were often stronger than they would otherwise be in a given quarter and GDP therefore weaker, but this was usually a sign of strength in the economy, not weakness.

The Committee discussed in particular the current situation and outlook for the housing market, especially in view of the uncertainty about whether the recent rise in house prices is an indication of future inflation or merely a reflection of a temporary shortage of supply.

On grounds similar to those from the previous meeting, Committee members were of the opinion that there were arguments both for unchanged rates and for a rate hike. The main argument in favour of a rate increase discussed at the meeting centred on the benefits of responding swiftly with a rate hike, as the most recent national accounts data suggested even stronger domestic demand than the MPC had assumed at the previous meeting.

Furthermore, new data showed that long-term inflation expectations are still somewhat above the inflation target and have changed little in spite of favourable developments in inflation in the recent term.

The main argument for unchanged interest rates was that the effects of the rise in the Bank's real rate had still not emerged in full. It was also pointed out that the level of the Bank's neutral real rate was still uncertain, in addition to the uncertainty about the size of the output slack and the speed at which it was vanishing. GDP growth figures for Q1 could also indicate that growth for the year as a whole would turn out somewhat weaker than according to the May forecast. The first national accounts figures were difficult to interpret, however, and it was therefore appropriate to await further data.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the seven-day term deposit rate at 5.25%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. All Committee members voted in favour of the proposal.

Committee members agreed that because of the decline in inflation and inflation expectations, the Bank's real rate had risen markedly year-to-date. The Committee was also of the opinion that the slack in the monetary policy stance had probably disappeared. With reservations concerning the uncertainty about the level of the Bank's neutral real rate, MPC members agreed that, increased growth in domestic demand in the near term would probably require further increases in the Bank's real interest rate, other things being equal. Whether the need for a higher real rate required a change in the Bank's nominal interest rates in the near future, however, would depend on developments in inflation and inflation expectations.

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 and external guests attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 20 August 2014.

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.

No. 14/2014
21 May 2014

Modifications to monetary policy instruments

At its recent meetings, the Central Bank's Monetary Policy Committee (MPC) has discussed altering the Bank's monetary policy instruments. The objective of the proposed changes is to enhance the effectiveness of the Bank's liquidity management and, insofar as is possible, to promote greater efficiency as regards its balance sheet. These modifications should also prepare for the changes in the monetary policy environment upon the sale of Central Bank of Iceland Holding Company (ESÍ) assets and the liberalisation of the capital controls. At its 20 May 2014 meeting, the MPC approved the Governor's proposal for modifications in this direction. Further changes are under analysis within the Bank and could be implemented at a later date.

In accordance with the above and with Article 24 of the Act on the Central Bank of Iceland, the MPC has decided to change the Bank's monetary policy instruments as follows:

- Weekly auctions of 28-day certificates of deposit will be discontinued. Instead, financial institutions that engage in transactions with the Central Bank will be offered two types of term deposits that will be eligible as collateral for Central Bank facilities.
- As a rule, the Bank will not offer deposits and collateralised loans at the same time.
- From now on, the Bank will set ceilings on the collateralised loans or term deposits available at any given time.
- Each week, term deposits maturing in one week will be offered at a fixed interest rate.
- Each month, on the first business day for regular facilities, term deposits with a maturity of one month will be offered in an auction. Financial institutions will place bids for both the amount and the interest rate. The auction will be structured with a single-price format; i.e., all accepted bids will be offered at the highest interest rate among accepted bids. The first auction will be held on 4 June 2014.

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

No. 18/2014
11 June 2014

Central Bank resumes regular foreign currency purchases

The Central Bank has decided to reinstate a programme of regular purchases of foreign currency in the interbank foreign exchange market, similar to the one in place during the period 31 August 2010 through year-end 2012. At the beginning of that period, the Bank bought 500 thousand euros per week from each market maker in the market, and later it stepped up its purchases to 1 million euros per week from each market maker. The Bank bought a total of 216 million euros (the equivalent of 33.3 b.kr.) under this programme.

The Central Bank discontinued its regular purchase programme at year-end 2012. Since mid-May 2013, the Bank has been more active in the foreign exchange market than it was previously, intervening in the market with the aim of mitigating exchange rate volatility. That policy will remain in place despite the resumption of regular foreign currency purchases. From 15 May 2013 until the present date, the Bank has bought 288 million euros (45.1 b.kr.) and sold 21 million euros (3.4 b.kr.), for a net purchase amount of 41.7 b.kr. So far in 2014, the Bank's net purchases have totalled 222 million euros, or 34.5 b.kr. The Central Bank has therefore bought an average of just over 9 million euros per week this year.

From now until end-September, the Bank intends to purchase 3 million euros per week in the foreign exchange market. The purchases will take place on Tuesdays, right after the market opens. If a holiday falls on a Tuesday, the purchases will take place on the business day immediately following. The first such purchase will take place on Wednesday 18 June 2014.

The amount purchased according to this programme will be re-evaluated in the autumn, or earlier if circumstances warrant it. This decision has been taken in view of the sizeable foreign currency inflows in recent months and the prospect of continued strong inflows in the months to come, as well as developments in inflation and the rise in the real exchange rate of the króna over the past few years.

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