MONETARY POLICY COMMITTEE REPORT TO ALTHINGI

2012 • 1

Monetary Policy Committee report to Parliament

27 June 2012

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

The Act requires that the MPC meet at least eight times each year. Since the last Report was sent to Parliament, the Committee has met four times, most recently on 13 June. The following report discusses the work of the Committee between January and June 2012.

Monetary policy formulation

According to the Act on the Central Bank of Iceland, the principal goal of monetary policy 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%. Other monetary policy tasks involve contributing to financial and overall economic stability. In implementing monetary policy, the Monetary Policy Committee 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 2012

Central Bank interest rates have been increased since the MPC's last report was submitted to Parliament. At the end of 2011, the Bank's collateralised lending rate was 4.75%. During the period under consideration here, however, the Bank's effective policy rate – that is, the rate that has the greatest effect on money market rates – was close to the average of its deposit rates, as relatively strong financial system liquidity has reduced domestic credit institutions' demand for Central Bank liquidity facilities. The effective policy rate was therefore just over 4% at year-end 2011.

Interest rates were then raised by 0.25 percentage points in March and by 0.5 percentage points in May. In the wake of the MPC's decision on 13 June to raise interest rates by a further 0.25 percentage points, the Bank's collateralised lending rate is 5.75% and the effec-

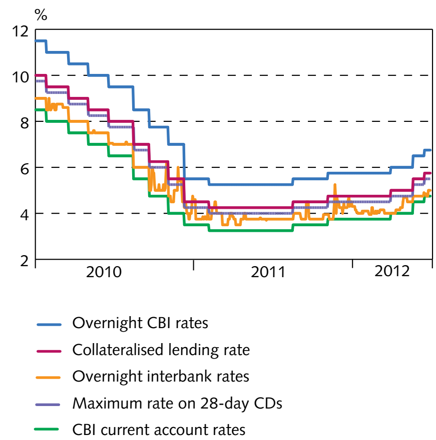
Table 1. Central Bank of Iceland interest rates 2012 (%)

Date	*Current account*	*28-day CDs (maximum)*	*7-day collateral lending rate*	*Overnight lending rate*
13 June	4.75	5.50	5.75	6.75
16 May	4.50	5.25	5.50	6.50
21 March	4.00	4.75	5.00	6.00
8 February	3.75	4.50	4.75	5.75

Chart 1

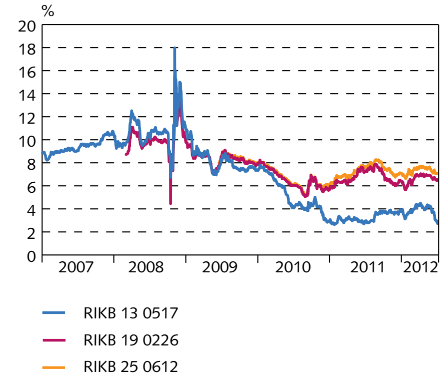
Central Bank of Iceland interest rates and short-term market interest rates

Daily data 1 January 2010 - 26 June 2012



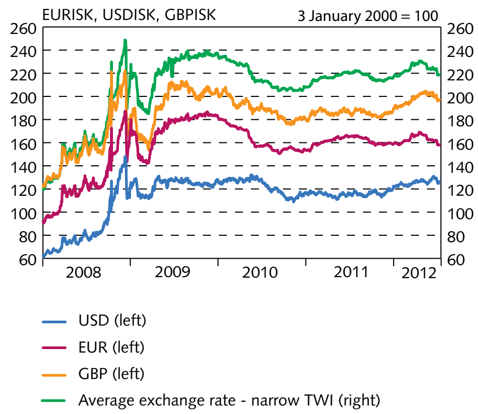
Source: Central Bank of Iceland.

Chart 2
Long-term nominal Treasury bond yields
Daily data 3 January 2007 - 26 June 2012



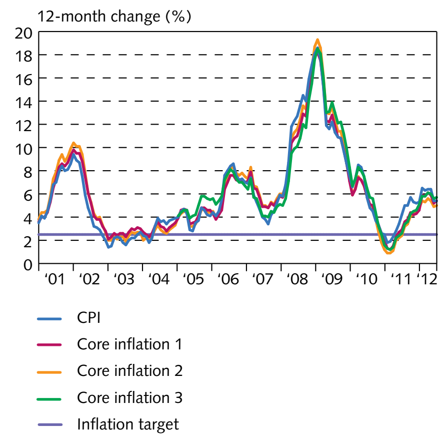
Source: Central Bank of Iceland.

Chart 3
Exchange rate of the króna
Daily data 3 January 2008 - 26 June 2012



Source: Central Bank of Iceland.

Chart 4
Inflation January 2001 - June 2012[1]



1. The core indices measure underlying inflation, with Core Index 1 excluding prices of agricultural products and petrol, and Core Index 2 excluding prices of public services as well. Core Index 3 also excludes the effect of changes in real interest rates on owner-equivalent rent.
Source: Statistics Iceland, Central Bank of Iceland.

tive policy rate just over 5%. Other Central Bank interest rates have risen commensurably (see Table 1 and Chart 1).

As the statements of the MPC indicate, the inflation outlook has deteriorated since the beginning of the year, and inflation looks set to remain above the target for longer than is acceptable, particularly if the króna remains weak. Furthermore, the economic recovery is broadly based, and growth in domestic demand is robust.

The accommodative monetary stance has supported the economic recovery in the recent term. The recent interest rate hikes have withdrawn some of that accommodation, however, as is appropriate in view of the recovery of the real economy and the deteriorating inflation outlook. The real interest rate has risen in tandem with the Bank's rate hikes, and is now somewhat higher than when the last MPC report was submitted to Parliament. It is now -0.3% in terms of current inflation and -0.2% in terms of the average of various measures of inflation and inflation expectations, or 0.2 percentage points higher than at end-December 2011.

Since the beginning of the year, yields on long Treasury bonds and indexed Housing Financing Fund (HFF) bonds have risen by up to 0.9 percentage points, although yields on the longest bonds have increased the least (see Chart 2). The króna depreciated by 0.7% in trade-weighted terms over this period (see Chart 3) but has been appreciating again in the recent term.

Headline inflation as measured by the consumer price index (CPI) has subsided somewhat since peaking at 6.5% last January, measuring 5.4% in June (see Chart 4). Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and the cost of real mortgage interest) peaked at 6% in March but had fallen back to 5.6% by June. In the first two quarters of 2012, increases in the price of public and private services and petrol were the principal drivers of inflation. Miscellaneous imports and groceries also contributed significantly to inflation.

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from February 2012 to the present
2. Minutes of Monetary Policy Committee meetings from February 2012 to the present
3. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001

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

Már Guðmundsson

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

Statement of the Monetary Policy Committee 8 February 2012

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

According to the updated Central Bank forecast, published in *Monetary Bulletin* today, Iceland's economic recovery continues despite weakening global growth and elevated uncertainty. The outlook for the real economy is broadly unchanged from the November forecast. Short-term inflation developments are also in line with expectations, although inflation is now projected to subside at a slightly slower pace over the course of 2012. Assuming a broadly unchanged exchange rate, inflation is forecast to remain above the Bank's inflation target for somewhat longer than was projected in November.

Moving forward, it will be necessary to withdraw the current degree of monetary accommodation as the recovery progresses and the slack in the economy disappears. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. In the absence of an improvement in the inflation outlook, an increase in nominal interest rates will probably be required in the near term in order to bring the monetary policy stance, which is still quite accommodative, to an appropriate level.

Statement of the Monetary Policy Committee 21 March 2012

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

The economic outlook is broadly in line with the Central Bank's February forecast. The króna is weaker than in February, however, and the short-term inflation outlook has deteriorated somewhat from the forecast prepared at that time. Further ahead, there is the risk that inflation will remain above the Bank's inflation target for a longer period than projected unless the króna appreciates in coming months. The extent to which closing the loopholes in the Foreign Exchange Act affects the exchange rate will emerge in the near future.

Moving forward, it will be necessary to withdraw the current degree of monetary accommodation as the recovery progresses and the slack in the economy diminishes. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. In the absence of an improvement in the inflation outlook, a further increase in nominal interest rates will probably be required in the near term in order to bring the monetary policy stance, which is still quite accommodative, to an appropriate level.

Statement of the Monetary Policy Committee 16 May 2012

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.5 percentage points.

The macroeconomic forecast published in *Monetary Bulletin* today confirms that the recovery that began in late 2010 is continuing and is broadly based. Domestic demand is quite strong, and the labour and real estate markets are showing clear signs of recovery. Private sector financial conditions continue to improve.

The outlook is for slightly stronger output growth than in the Bank's February forecast. On the other hand, inflation has been higher than was forecast in February and the inflation outlook has deteriorated, in part because of a weaker króna. Other things being equal, the outlook is for inflation to remain above the inflation target longer than was forecast in February, particularly if the króna remains weak.

Moving forward, it will be necessary to continue withdrawing the current degree of monetary accommodation as the recovery progresses further and the margin of spare capacity diminishes. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. If inflation does not subside in the next few months, other things being equal, it will be necessary to raise nominal interest rates further in order to ensure that inflation returns to target.

Statement of the Monetary Policy Committee 13 June 2012

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

National accounts data for Q1/2012 are broadly in line with the Bank's May forecast, which stated that GDP growth would continue to reduce the margin of spare capacity in the economy. The economic recovery is broadly based, and the growth in domestic demand is robust. Signs of recovery in the labour and real estate markets are steadily growing stronger.

Inflation subsided somewhat in May; however, the outlook is for it to remain above the Bank's target for longer than is acceptable, particularly if the króna remains weak.

Uncertainty about the global economy has increased in recent weeks, not least because of the financial crisis in Europe. This causes additional uncertainty about the domestic economic and inflation outlook. In the near future, monetary policy may need to respond to developments that could significantly affect output growth and inflation in Iceland. In such circumstances, the MPC will aim, as before, to achieve the inflation target over the medium term while attempting to stabilise fluctuations in domestic output.

The accommodative monetary stance has supported the economic recovery in the recent term. Raising interest rates in May and again now, in June, has withdrawn some of that accommodation, as is appropriate in view of the recovery of the real economy and the deteriorating inflation outlook. As the recovery continues and spare capacity disappears, it is necessary that the monetary policy slack should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

February 2012

Published: 22 February 2012

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 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 the individual MPC members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meeting held on 6 and 7 February 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 8 February, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed 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 7 December interest rate decision, as reflected in the updated forecast published in *Monetary Bulletin* 2012/1 on 8 February.

Financial markets

The trade-weighted value of the króna in the onshore market was 2.8% lower at the time of the February MPC meeting than at the December meeting. Between the two meetings, the króna depreciated by 1.4% against the euro, by 4.3% against the pound sterling, and by 3.4% against the US dollar.

The króna had appreciated against the euro in the offshore market since the last MPC meeting, trading at 248-267 against the euro, but the volume and frequency of trading remained low.

Reflecting temporarily tight liquidity conditions, overnight interbank interest rates had shifted up to the centre of the interest rate corridor for a short time in mid-December but had fallen to around 4% in January. Interbank market trading totalled 466 b.kr. in 2011 and 69.5 b.kr in January 2012.

There were 79.6 b.kr. worth of certificates of deposit (CDs) outstanding as of the February meeting, approximately 3 b.kr. less than at the December meeting.

Reflecting an increase in the inflation premium, nominal long-term yields in the secondary market had risen between the December and February meetings, while yields on indexed long-term bonds had declined.

The CDS spread on the Republic of Iceland had fallen since the meeting in December. In recent months this spread has been close to that of the Baltic countries.

The nominal effective policy rate is estimated as the simple average of the Central Bank deposit and maximum CD rates. Averaging across different measures of inflation and inflation expectations, the real policy rate had fallen since the December meeting, to -0.8% as of the February meeting. The real rate based on inflation over the past twelve months was more than a percentage point lower, at -2.2%. In terms of breakeven inflation rates, it was -0.9%.

Unchanged Central Bank rates appeared to be priced into the yield curve. Most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to increase rates by 25 basis points, however. Most of them cited higher inflation, higher inflation expectations, depreciation of the króna, and economic growth as arguments for a rate increase.

Broad money (M3) remained unchanged month-on-month in December and increased by 8.6% year-on-year. M3 had decreased from mid-2009 until May 2011, when there was a sudden turnaround. The rate of growth gathered pace in the latter half of 2011, but that largely reflected the fact that deposits held by companies previously classified as financial companies, but reclassified as non-financial holding companies after restructuring, are now included in money supply data.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in January, the forecast for global growth and world trade has been revised downwards substantially from the September forecast. The IMF now expects lower economic growth in most industrial and emerging economies apart from the US. The forecast for global inflation is broadly unchanged, however. The forecast for growth in 2012 in Iceland's main trading partner countries was revised downwards from 1.9% in September to 0.4%. The Consensus Forecasts projections for Iceland's main trading partners in 2012 have also been revised downwards since the December MPC meeting.

In December, Iceland's trade account was in deficit for the first time since early 2009 with a balance of -0.6 b.kr. The value of exports had fallen from the previous month, while the value of imports had grown substantially, both month-on-month and year-on-year. According to preliminary data, the trade surplus in January 2012 was 12 b.kr. The trade surplus for 2011 as a whole was 97 b.kr., down from 120 b.kr. in 2010. The total value of both imports and exports rose substantially between years in 2011; the increase in the total volume of imports and exports was smaller. The largest components of imports in 2011 were industrial supplies and capital goods which accounted for 32% and 22% of the total import value, respectively. Both were down year-on-year, however. On the other hand, the share of transport equipment and fuels increased in 2011, accounting for 9% and 15% of total import value, respectively. The largest component of exports in 2011 was industrial goods, accounting for 54% of the total export value. Aluminium exports made up 75% of industrial goods exports. The export value of marine products rose by 2% to 41% of the total share, overtaking aluminium exports again.

The price of aluminium has risen since the last MPC meeting. The average price in January was almost 6% higher than the December average. Marine product prices have also continued to increase, rising by 0.8% month-on-month in December.

The domestic real economy and inflation

The public's expectations concerning the labour situation have fluctuated since the summer, but have been on the rise since October, according to the Capacent Gallup Consumer Sentiment Index. Corporate executives' expectations towards recruitment have also been edging slowly upwards, according to the Capacent Gallup December survey of Iceland's 400 largest firms. However, firms considering redundancies still outnumber those considering adding on staff by 7.5 percentage points.

Employment, as measured by total hours worked grew by 2.4% year-on-year in Q4 as measured by the Statistics Iceland labour survey. This follows increases in both Q2 and Q3. The number of people at work declined marginally but average hours worked increased by about an hour per week. The number of part-time workers fell while the number of people in full-time employment rose. Employment, measured in man-years, grew by 1.5% between 2010 and 2011.

Labour market participation, on the other hand, fell by 1.5 percentage points year-on-year in Q4/2011, to the lowest level since quarterly labour market surveys began in 2003. The participation rate measured 80.4% on average in 2011, declining by 0.7 percentage points (almost 1,000 persons) from 2010. The number of persons outside the labour market rose by almost 3,000 at the same time, due primarily to a rise in the number of disability pensioners and students.

Registered unemployment as recorded by the Directorate of Labour measured 7.1% in Q4/2011 and 7.4% for the year as a whole, down from 8.1% for 2010. Unemployment as measured by the Statistics Iceland labour market survey was broadly unchanged between quarters, measuring 6% in Q4/2011.

High-frequency indicators through December suggest that private consumption increased from the previous quarter. Payment card turnover grew by over 3% between quarters in Q4/2011 and by over 6% from Q4/2010. Other indicators such as imports of consumption goods and new motor vehicle registrations suggest further improvement in private consumption.

Measured consumer sentiment rose in January, for the third month in a row, and has not been higher since autumn 2008. All sub-indices were up between months, with sentiment towards the labour market increasing the most. Sentiment towards the current economic situation was also at its highest since autumn 2008.

According to Capacent Gallup's business sentiment survey, conducted in December 2011, expectations about the economic situation in six months ahead have improved, especially among executives in other specialised services and the industry and production sectors. Overall, almost 22% of participants expected the situation to improve, and around 60% expected it to remain unchanged, compared to 17% and 58%, respectively, in October/November. Expectations of foreign demand had deteriorated from previous surveys in 2011, most notably in the fisheries sector.

Executives' median expected inflation measured 4% one year ahead, according to the business sentiment survey, which was unchanged from the survey in October/November. According to another Capacent Gallup survey in December, median household inflation expectations one year ahead declined by 0.5 percentage points to 6% from the previous survey in September. The median household expected twelve-month inflation to measure 5.5% in two years, which was also 0.5 percentage points less than in September.

Headline inflation measured 5.3% in Q4/2011, unchanged from Q3/2011. The CPI rose by 0.28% month-on-month in January 2012. Annual inflation measured 6.5% in January, compared to 5.2% in November. The CPI excluding tax effects increased by a smaller amount (0.13% month-on-month) and was 6.4% year-on-year. Annualised seasonally adjusted three-month inflation measured 5% in January, compared to 1.7% in November. Core index 3 excluding the effects of taxes (headline inflation excluding volatile items such as food and petrol, public services, and real mortgage interest rates) fell by 0.8% month-on-month in January and had risen by 5.7% year-on-year, compared to 4.7% in November.

All annual inflation measurements rose significantly in January, partly due to base effects, as one year had passed since the broadcasting fee was excluded from the CPI, leading to a decline in the index of 0.4 percentage points at that time. Various price increases for public services led to a 0.45 percentage point increase in the CPI in January. Price increases of petrol and oil, alcohol, tobacco, and groceries combined contributed 0.53 percentage points to the increase (partly due to higher special duties). However, winter sales on clothing, footwear and furniture led to a decline in the CPI of 0.75 percentage points, and a decrease in international airfares contributed a further 0.15 percentage points.

According to the updated forecast published in *Monetary Bulletin* on 8 February, the GDP growth outlook is broadly unchanged from the Bank's November forecast, despite the global economic outlook continuing to deteriorate. Output growth appears to have measured 3% in 2011 and is estimated at 2½% per year in 2012-2014.

Growth during the forecast horizon is expected to be driven by rising domestic demand, particularly private consumption and business investment, while the contribution from net exports is expected to be negative for most of the period. The contribution from private consumption is expected to be significant, although smaller than in 2011. Total investment is estimated to have grown by about 7% in 2011 and is projected to grow by nearly 18% in 2012, somewhat more than was forecast in November. Stronger growth is attributable mainly to a larger increase in business investment, although residential investment is expected to grow strongly. Public investment is projected to continue declining, although the contraction in the latter part of the forecast period will be smaller than was forecast in November. The forecast assumes, as was projected in November, that the labour market will continue to improve, with a continuing modest recovery in jobs and a decline in unemployment. Despite the remaining slack in the labour market, unit labour costs are expected to increase by just over 5% this year.

The inflation outlook is broadly similar to that in November. Inflation is projected to be just over 6% in Q1/2012 before falling to 3.6% in Q4/2012, some 0.5 percentage points higher than in the previous forecast. The increase in projected inflation is due in part to the delayed emergence of wage pressures and a weaker króna. Given a broadly unchanged exchange rate, the forecast is that inflation will align with the inflation target early in 2014, somewhat later than was forecast in November.

Projected spare capacity during the forecast horizon is broadly in line with the November forecast. It is estimated to have diminished sharply in 2011 and is forecast to decline still further in 2012 and 2013 in spite of modest GDP growth.

II The interest rate decision

The Governor informed the Committee of upcoming steps in the capital controls liberalisation strategy, the work within the Bank on a new balance of payment forecast, and the forthcoming Article 4 consultation with the IMF. The Committee discussed the Central Bank's *Financial Stability* report, published after the MPC's December meeting, financial institutions' accounts and restructuring measures, as well as progress in the private sector restructuring process.

The MPC discussed the recent depreciation of the króna. The exchange rate had depreciated by 2.8% in trade-weighted terms since the MPC's December meeting. The Committee discussed a number of potential factors behind this weakening. Among those viewed as most important were the seasonal variations in foreign currency inflows, the continued deleveraging of firms' and municipalities' foreign debt, and the deterioration of terms of trade. Some members highlighted that although this deleveraging of foreign debt was putting a short run pressure on the króna, it would eventually have a positive effect on the foreign debt position of the country and the current exchange rate effect should therefore reverse in the long run. It was also argued by some members that the current low domestic real interest rates could be encouraging rapid deleveraging of companies.

Three possible rate decisions were discussed: keeping rates unchanged or raising them by either 0.25 or 0.5 percentage points. Members agreed that there were arguments both for keeping rates unchanged at this meeting and for raising them.

The main argument for unchanged rates was the fact that the short-term deterioration in inflation was foreseen at the time of the November and December meetings and the outlook for the real economy according to the updated Central Bank forecast (published in *Monetary Bulletin* on 8 February) was broadly unchanged from the November forecast. Iceland's economic recovery is predicted to continue despite weakening global growth and elevated uncertainty. Furthermore, the risk-adjusted interest rate differential was slightly higher than at the last meeting. Some members argued that the deterioration of the inflation outlook was to a significant extent due to a weakening of the króna that might prove to be temporary. The impact on the króna of the upcoming Central Bank auctions, which are part of the process of lifting the capital controls, is uncertain and it was argued that the Committee would be in a better position to assess the situation at its next meeting in March. The fragility of the recovery, the slack in the economy, and international uncertainty were also put forward as arguments for unchanged rates.

The MPC discussed the possible effects of a rate hike on firms' and municipalities' deleveraging of foreign debt. To the extent that deleveraging was weakening the króna, it was argued that raising interest rates could reduce the speed of this deleveraging. Others argued that while this would strengthen the króna in the short run, it could weaken domestic balance sheets further, thus slowing the recovery of the real economy and putting downward pressure on the króna in the longer run.

Members agreed that the deterioration in the inflation outlook was the main argument for raising rates. As the MPC noted, although short-term inflation developments were in line with expectations, inflation was now projected to subside at a slightly slower pace over the course of 2012, and assuming a broadly unchanged exchange rate, it is forecast to remain above the Bank's inflation target for somewhat longer than was projected in November. Furthermore, inflation expectations were still elevated and the Bank's real interest rate had fallen since the last meeting. Thus, in light of the high inflation level and elevated inflation expectations, and given the fact that the inflation outlook for this year had deteriorated, some members argued that a rate increase at this juncture was necessary.

In light of the discussion, the Governor proposed that the Bank's interest rates be kept unchanged: the deposit rate (current account rate) at 3.75%, the maximum bid rate for 28-day certificates of deposit (CDs) at 4.5%, the seven-day collateralised lending rate at 4.75%, and the overnight lending rate at 5.75%.

Three MPC members supported the Governor's proposal while two members voted against it, calling for rates to be raised by 25 basis points. These members placed more weight on the deterioration in the inflation outlook, the presence of persistent and high inflation expectations, and the need to reverse the decline in real rates since the last meeting.

Members agreed that, in the future, it would be necessary to withdraw the current degree of monetary accommodation as the recovery progresses and the slack in the economy disappears. They agreed that the degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. They also agreed that in the absence of an improvement in the inflation outlook, an increase in nominal interest rates would probably be required in the near term in order to bring the monetary policy stance, which is still quite accommodative, to an appropriate level.

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Anne Sibert, External Member

Professor Gylfi Zoëga, External Member

In addition, a number of staff members participated in the meeting.

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 21 March 2012.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting
March 2012
Published 4 April 2012

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 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 the individual MPC members will be made public in the Bank's Annual Report.

The following are the minutes of the MPC meeting held on 20 March 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 21 March, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, the Committee discussed 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 8 February interest rate decision.

Financial markets

The Central Bank sold 12 million euros in the interbank market at the beginning of March in order to partly offset the currency outflows caused by exemptions the Central Bank had granted from the capital controls. This is in accordance with previous actions, particularly when the Bank has purchased about half of large temporary inflows.

The average trade-weighted exchange rate in the domestic foreign exchange market was 2.3% lower at the time of the March meeting than at the February meeting. Between meetings, the króna had depreciated by about 2.9% against the euro, 2.5% against the pound sterling, and 1.8% against the US dollar.

In the offshore market, the króna had appreciated against the euro since the last MPC meeting. Trading took place in the range of 237-242 kr. per euro, but complete information on the extent of trading with offshore-krónur is not available.

Because of ample liquidity, overnight interbank interest rates were broadly unchanged at about 4% since the February meeting. Interbank market trading totalled 24 b.kr. in February 2012.

At the time of the March meeting, outstanding certificates of deposit (CDs) amounted to 85.9 b.kr., roughly 6.4 b.kr. more than at the February meeting.

The breakeven inflation rate in the bond market rose in the wake of the Supreme Court's decision, handed down in February, on the settlement of illegal exchange rate-linked loans, but after the Foreign Exchange Act was amended in mid-March it fell back near the level at the February meeting. In mid-March, yields on indexed Treasury bonds were broadly unchanged since the February meeting, but they rose by up to half a percentage point after the amendment of the Foreign Exchange Act. Secondary market yields on nominal Treasury bonds also rose between meetings, by almost half a percentage point.

The CDS spread on the Republic of Iceland had fallen marginally since the February meeting, as had the spread between the Icelandic Treasury's US dollar bond and a comparable bond issued by the US Treasury.

The effective nominal policy rate is defined as a simple average of the Central Bank's deposit and maximum CD rates. According to various measures of inflation and inflation expectations, the average real interest rate was virtually unchanged since the February meeting, and was -1.1% at the time of the March meeting. It was also almost unchanged in terms of the breakeven inflation rate in the bond market, at -1.5%, but had risen slightly relative to twelve-month inflation, to -2.0%.

Unchanged Central Bank interest rates appeared to have been priced into the yield curve; however, most market makers, brokers, and research department analysts from financial firms expected the MPC to raise interest rates by 0.25 percentage points. Most of them cited the deterioration in the inflation outlook and the depreciation of the króna as grounds for a rate hike.

Broad money (M3) increased by 1.9% month-on-month in January and by 9.5% year-on-year. M3 had contracted between mid-2009 and May 2011, but since then it has increased in tandem with growing economic activity. The pace of growth increased even further in the latter half of 2011, largely because the commercial banking licences of some of the old banks' resolution committees were revoked. Thereafter, the resolution committees were reorganised as holding companies and their deposits were subsequently included with the money supply.

Outlook for the global real economy and international trade

The Consensus Forecasts projections for 2012 output growth in Iceland's main trading partner countries in the aggregate are unchanged since the February meeting; however, the outlook has changed for some individual countries. The forecast for output growth in the US has risen somewhat since February, while the forecast for the euro area has been adjusted slightly downwards. The forecast for inflation among Iceland's main trading partners has been revised upwards for the year, from 1.8% to 2.1%.

The surplus on goods trade has been significantly larger than at this time a year ago, measuring 10.1 b.kr. in January and 12.5 b.kr. in February according to preliminary figures. Import and export values have continued to rise rapidly year-on-year, with exports slightly outpacing imports. The rise in export values is mainly attributable to growth in exported marine products. Increased import values stem from rises in the import value of fuel, transport equipment, and food and beverages.

Aluminium prices have remained broadly unchanged since the last MPC meeting. The average price in February was about 9% above the last trough, which occurred in December, but it was still down markedly year-on-year. Marine product prices have continued to increase, with the month-on-month increase measuring 0.7% in January.

The domestic real economy and inflation

According to the national accounts published by Statistics Iceland in March, output growth measured 3.1% in 2011 as a whole and 2.7% in Q4/2011. Growth was driven primarily by increases in private consumption and business investment, each of which contributed 2 percentage points. The contribution from net trade was negative by just over 1% of GDP, however, and public investment and public consumption contracted as well. The figures from Statistics Iceland are largely in line with the Central Bank's February forecast, which assumed 3% GDP growth for the year. Business investment grew considerably more than forecast. A significant portion of the deviation is due to revision of previous statistics.

The current account deficit amounted to just under 12% of GDP in Q4/2011 (49 b.kr.). Excluding the banks in winding-up proceedings, it measured roughly 5% of GDP. Revised figures show that the deficit was about 8 b.kr. more in the first three quarters of the year than was indicated by previous numbers, with the difference due to a larger deficit in the balance on income. For the year as a whole, the current account deficit amounted to 7% of GDP (116 b.kr.). Excluding the banks in winding-up proceedings, however, it was considerably smaller, at 0.6% of GDP (10 b.kr.). Excluding the pharmaceuticals company Actavis, the current account showed a surplus of over 3% (50 b.kr.).

According to the survey conducted by Capacent Gallup in February and March among Iceland's 400 largest firms, companies planning to recruit outnumbered those planning to downsize their staff in the coming six months, for the first time since March 2008. Over 60% of firms anticipated unchanged staffing levels, which is similar to the past two years.

According to the Statistics Iceland labour force survey, employment as measured by total hours worked rose by about 1.5% year-on-year in January and February, owing primarily to an increase in the number of employed persons. The labour participation rate contracted by 0.5 percentage points, however.

In a departure from the usual trend, unemployment as measured by the Directorate of Labour remained unchanged at 7.3% between December and February. After adjusting for seasonality, however, it declined by roughly a percentage point, to 6.2%. The reason the jobless rate did not rise as it usually does is deregistration of 1,400 people in

January. About two-thirds of those deregistered had participated in an initiative that gave jobless people the opportunity to study while collecting unemployment benefits during the autumn 2011 semester. Those who decided to continue their studies during the spring term no longer receive unemployment benefits. The others who left the jobless rolls did so because of the expiration of a temporary provision added to the Act on Unemployment Benefits in autumn 2008.

In the Central Bank's February forecast it was assumed that private consumption would continue to grow in 2012, but at a decreasing pace over the course of the year. Growth was projected at 4.3% year-on-year in Q1, and key high-frequency indicators suggest that developments in private consumption during the quarter are in line with that forecast. For example, payment card turnover in January and February was up by nearly 5½% year-on-year in real terms, and new motor vehicle registrations have continued to rise.

According to the Capacent Gallup survey, consumer sentiment improved in February, for the fourth month in a row. The three-month average of the Consumer Sentiment Index has therefore risen by almost 30% year-on-year. Expectations concerning the economic situation in six months' time rose most sharply in February, whereas sentiment towards the current situation and the labour market situation declined month-on-month.

According to Capacent Gallup's February/March survey among corporate executives, a sizeable majority still consider the current economic situation poor. Over 66% of executives expected no change in the next six months. The number who assumed that the economic situation would deteriorate in the next six months declined somewhat from the December survey. Executives in regional Iceland were markedly more downbeat than those in the greater Reykjavík area, particularly due to pessimism among fisheries, 37% of which considered conditions likely to deteriorate.

According to the survey, executives' inflation expectations one year ahead measured 5%, an increase of one percentage point from the December survey. Executives also assumed that twelve-month inflation would still be 5% in two years' time, also an increase of one percentage point since the survey carried out in October.

According to another Capacent Gallup carried out in March, household inflation expectations one year ahead had risen by ½ a percentage point since December, to 6.5%. Households expected twelve-month inflation to measure 6% in two years' time, which is also ½ a percentage point more than in the last survey.

Beginning in Q1/2012, the Central Bank will conduct quarterly surveys of market agents' long- and short-term expectations concerning a variety of economic variables. The Central Bank's first such survey was conducted in February. On average, market participants expected twelve-month inflation to measure 5% one year ahead and 4.7% two years ahead. They also assumed, on average, that inflation would be 5% in Q4/2012. For the longer term, they anticipated on average 4.6% inflation five years ahead and 4.3% ten years ahead.

The consumer price index rose by 1% month-on-month in February 2012, and annual inflation measured 6.3%, down from 6.5% in January. Annual core inflation 3 excluding tax effects (measured inflation excluding volatile items such as food, petrol, public services, and real mortgage interest rates) measured 5.7% in February, as it did in

January. Annual inflation excluding the housing component rose month-on-month, however, to 6%.

Price increases in clothing and furniture after the end of winter sales raised the CPI by 0.48 percentage points in February, and rises in petrol and oil added almost 0.2 percentage points. The decline in the housing component had a CPI effect of -0.11 percentage points, owing primarily to falling market prices.

II The interest rate decision

The Governor informed the Committee of the Government and the Central Bank's prepayment of loans from the IMF and the Nordic countries. He also discussed the recent amendments to the Foreign Exchange Act and the Central Bank's sale of foreign currency in the interbank market early in March.

Committee members discussed recent exchange rate movements, as the króna had depreciated by a full 2% in trade-weighted terms since the February meeting. Members agreed that seasonal fluctuations in foreign currency inflows and deleveraging by firms and municipalities had made an impact. The Committee expected the amendments to the Foreign Exchange Act to shore up the króna or at least to limit the depreciation.

The MPC discussed the possibility of raising interest rates by 0.25-0.5 percentage points. All agreed that there were strong grounds for either decision. They agreed that the bleaker inflation outlook was the main argument for a rate hike. Because of the weaker currency, the near-term inflation outlook had deteriorated relative to the February forecast. Further ahead, it was likely that inflation would prove more persistent than was forecast in February unless the króna appreciated in coming months. Furthermore, inflation expectations had risen by all measures and were still considerably above target, and anchoring expectations more firmly was of utmost importance.

It was also considered necessary to keep interest rates sufficiently high to support the króna, as the risk-adjusted interest rate differential had narrowed since the MPC's last meeting. It was pointed out that a rate hike could also promote slower deleveraging of foreign debt.

Committee members agreed that the results of the most recent national accounts and labour market survey showed that the overall economic outlook was broadly unchanged from the Bank's February forecast. Uncertainty about fiscal restraint was certainly greater than in February, but the composition of year-2011 output growth was more advantageous because of stronger business investment. Furthermore, uncertainty about the global economy had subsided.

The arguments in favour of a smaller rate increase were that a new Central Bank forecast would be available at the next meeting, as would two new CPI numbers. Furthermore, the effects of the amendments to the Foreign Exchange Act on the exchange rate would have come to the fore by that time. Committee members agreed that, unless the inflation outlook improved, it would probably be necessary to raise rates further.

One member pointed out that raising interest rates at this juncture could adversely affect vulnerable corporate balance sheets. Although doubting that a modest rate increase would affect the exchange rate under current conditions, this member was nonetheless willing to support a rate hike at this time because the general wage and price increases of the past few months and the risk of a wage-price spiral suggested that the slack in the economy needed to be greater, which in turn called for higher real interest rates.

In view of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be raised by 0.25 percentage points, which would raise the current account rate to 4.0%, the maximum rate on 28-day CDs to 4.75%, the seven-day collateralised lending rate to 5.0%, and the overnight lending rate to 6.0%.

Four members voted in favour of the Governor's proposal, and one voted against it, preferring to raise rates by 0.5 percentage points. This member considered it necessary to raise rates by more because of the possibility that the Committee was already too late in withdrawing the accommodative monetary stance. This member was of the opinion that raising rates by only 0.25 percentage points would merely suffice to maintain the level of monetary restraint prevailing at the last meeting.

Members agreed that, in the future, it would be necessary to continue to withdraw the current degree of monetary accommodation as the recovery progresses and the slack in the economy diminishes. They agreed that the degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. They also agreed that in the absence of an improvement in the inflation outlook, an increase in nominal interest rates would probably be required in the near term in order to bring the monetary policy stance, which is still quite accommodative, to an appropriate level.

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 the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 16 May 2012.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2012

Published 30 May 2012

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 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 the individual MPC members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meeting held on 14 and 15 May 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 16 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 21 March interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2012/2 on 16 May.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 1.6% higher at the time of the May meeting than at the March meeting. Between meetings, the króna had appreciated by about 2.2% against the euro but had depreciated by 1.6% against the pound sterling and 0.5% against the US dollar.

Trading in the offshore market had been limited between meetings. It appears as though the Central Bank's foreign currency auctions have substituted for the offshore market to some extent, as the offshore exchange rate had been in the range of 237-242 kr. per euro during the weeks prior to the meeting, which is similar to the exchange rate offered in the last foreign currency auctions.

Because of ample liquidity, overnight rates in the interbank market had remained below the centre of the interest rate corridor between meetings, in the 4-4.7% range. Interbank market trading totalled 60 b.kr. in April 2012.

At the time of the May meeting, outstanding certificates of deposit (CDs) amounted to 125 b.kr.

The breakeven inflation rate in the bond market rose shortly after the rate hike in March but then fell again after the CPI was published in late April. It was 0.5 percentage points higher at the time of the May meeting than at the March meeting. Yields on indexed Treasury bonds had remained broadly unchanged between meetings, as had secondary market yields on nominal Treasury bonds, with the exception of the Treasury bond maturing in October 2016, which rose by 0.5 percentage points.

The CDS spread on the Republic of Iceland had fallen slightly since the March meeting, as had the spread between the Icelandic Treasury's US dollar bond and a comparable bond issued by the US Treasury. At the beginning of May, the Treasury issued a 10-year US dollar bond at 6% interest, implying a 4 percentage point premium on a comparable US Treasury bond.

The effective nominal policy rate is defined as a simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the average real interest rate fell by 0.1 percentage points between meetings, to -1.2%. It had fallen by 0.3 percentage points in terms of the breakeven inflation rate in the bond market, to -1.8%, but had risen slightly relative to twelve-month inflation, to -1.9%.

Unchanged Central Bank interest rates appeared to have been priced into the yield curve; however, most market makers, brokers, and research department analysts from financial firms expected the MPC to raise interest rates by 0.25-0.5 percentage points. Most of them cited the deterioration in the inflation outlook as grounds for a rate hike. According to the median response to the Central Bank survey of market expectations, market agents expected the Bank's interest rates to be 0.5 percentage points higher at the end of Q2/2012 than they were at the time of the May meeting. They also expect the policy rate to be 1 percentage point higher at year-end, which is half a percentage point more than in the Bank's February survey.

Broad money (M3) contracted by 3.1% month-on-month in March but grew by 4.4% year-on-year. M3 had contracted between mid-2009 and May 2011, but since then it has increased in tandem with growing economic activity.

Outlook for the global real economy and international trade

According to the most recent forecast from the International Monetary Fund (IMF), issued in April, the forecast for world output growth has been revised upwards from the January forecast. The same applies to global trade. Considerable uncertainty remains, particularly on the downside, and a mild contraction is expected in the euro area this year. Inflation is expected to remain broadly unchanged, although it is projected to rise marginally in industrialised countries during the year. The IMF forecast for output growth in 2012 in Iceland's main trading partners is virtually unchanged, or 0.8% as opposed to the January forecast of 0.7%.

According to preliminary figures, Iceland's goods trade surplus totalled 5.4 b.kr. in March and 9.4 b.kr. in April. Both import and export values have continued to grow between years, with the increase measuring just under 7% for the first four months of the year. Increases in export values are due primarily to growth in exported marine products but also to growth in exportation of agricultural products and other industrial goods. The rise in import values stem from rises in the import value of fuel, investment goods excluding transport equipment, and food and beverages.

The price of aluminium has fallen slightly since the MPC's March meeting. In April, the average price was over 6% lower than in March and more than 23% lower than at the same time in 2011. Marine product prices were unchanged month-on-month in March.

The domestic real economy and inflation

Registered unemployment as measured by the Directorate of Labour (DoL) was 7.1% in March, or 5.9% when adjusted for seasonality. Unemployment measured 7.2% in Q1/2012 according to both the DoL and the Statistics Iceland labour market survey. Seasonally adjusted unemployment measured 6.4% during the quarter.

According to the Statistics Iceland labour market survey, employment in terms of total hours worked (a measure of man-years) grew by 1.1% year-on-year, primarily due to an increase in the number of employed persons, whereas the initial rise in employment, in Q2/2011, was concentrated in longer average hours worked.

The labour participation rate was 78.9% in Q1/2012, the same as at the bottom of the last downward cycle, in Q1/2004. Adjusted for seasonality, it rose by 1.1 percentage points between quarters, to 80.4% in Q1/2012.

The wage index rose by 2.1% quarter-on-quarter in Q1, largely due to a general 3.5% contractual increase and a 11,000 kr. rise in pay scales below 314,000 kr. per month. The contractual increases in February and March were offset by a 1.2% decline in the wage index, however, because the effect of the 50,000 kr. one-time payment implemented at the time the wage settlements were signed last year disappeared from the index. The twelve-month rise in the index amounted to 10.8% in Q1/2012, but it should be borne in mind that two contractual wage increases were implemented during the period.

Key high-frequency indicators of private consumption suggest that seasonally adjusted private consumption grew somewhat less in Q1 than in the previous quarter but that year-on-year growth has continued. Payment card turnover in Iceland and abroad grew by 4.6% year-on-year during the quarter, and by 6% year-on-year in April. New motor vehicle registrations continued to increase between years in Q1, as did consumer goods imports.

According to the consumer sentiment survey carried out by Capacent Gallup, consumer sentiment improved in April. The survey has shown rising consumer sentiment measurements each month since November 2011, apart from a decline in March. The Consumer Sentiment Index has risen by 23% in the past twelve months, based on the three-month average. Sentiment towards the labour market and the current economic and labour market situation rose the most in April.

Figures from the quarterly survey of planned big-ticket purchases, published in March, indicated that interest in major purchases had increased since the December survey. Planned purchases of housing and motor vehicles rose between surveys, although the index for planned house purchases was roughly the same as a year ago.

According to the Central Bank's survey of market inflation expectations, conducted in early May, expectations among market participants have risen somewhat since the February survey. According to the median response, market participants project annual inflation at 5½% after both one and two years. Expectations further ahead are broadly in line with the February survey, with respondents expecting inflation to average approximately 5% five and 10 years ahead.

The CPI rose by 0.8% month-on-month in April, after having risen by 1% in March. Annual inflation therefore measured 6.4%, which is virtually unchanged from February. Annual core inflation 3 excluding tax effects (observed inflation excluding the effects of volatile food items, petrol, public services, and the cost of real mortgage interest) was 5.9% in April, as opposed to 5.7% in February. Statistics Iceland has published a new core index (core index 4) which excludes the market price of housing as well as the items excluded in core index 3. Annual core inflation 4 measured 5.6% in April, as opposed to 5.1% in February.

The rise in the index between March and April is due in large part to increases in the price of clothing (owing partly to end-of-sale effects), food and beverages, and petrol, although house prices also contributed somewhat.

Inflation developments have been poorer than was forecast in February, and the inflation outlook has deteriorated sharply, according to the forecast in the 16 May *Monetary Bulletin*. Inflation measured 6.4% in Q1/2012, 0.3 percentage points above the February forecast. The deviation stems primarily from larger-than-anticipated increases in the price of oil and private services and a weaker-than-expected króna. The outlook is also for inflation to subside much more slowly than previously forecast. According to the forecast, it will subside only slightly over the remainder of the year, unlike the February forecast, and will remain significantly above previously projected levels well into 2014. This is due to a number of factors: a somewhat weaker króna, relatively less slack in the economy, rising inflation expectations, and high inflation persistence. The inflation target will not be reached until year-end 2014, almost a year later than was forecast in February.

Monetary policy has continued to support the economic recovery with an extremely low real interest rate. In spite of the interest rate hike in March, the Central Bank's real rate has fallen slightly because inflation and inflation expectations have risen according to most measures.

This low real interest rate has also contributed to the gradual improvement in households' and businesses' financial conditions. Rising asset prices, including house prices, and reduction of debt following restructuring and write-offs in connection with court judgments have improved private sector finances. Households' and businesses' net worth has therefore increased, enhancing their willingness and ability to step up spending.

Although uncertainty remains, the global economic outlook has improved, and optimism is on the rise. International forecasts suggest stronger output growth among Iceland's major trading partners, which will support exports. However, the outlook is poor for the euro area, Iceland's most important export market. Iceland's terms of trade are poorer than previously expected, as price hikes for marine products have slowed down while oil and commodity prices have risen.

Export growth has been stronger than in the February forecast, and the outlook for 2012 has improved, primarily due to a brighter outlook for exports of marine products and services. Total exports are forecast to increase by almost 4% this year and over 3% per year in 2013 and 2014. The forecast for 2012 import growth has also been revised upwards. The contribution of net trade to output growth will be negative this year but is projected to be positive in 2013. A setback is expected in 2014 as a result of strong investment goods imports in connection with energy-intensive investment projects. The trade surplus will be somewhat smaller over the forecast horizon than was forecast in February.

The forecast assumes reasonably strong growth in private consumption and investment this year, offset by a contraction in public consumption. Private consumption growth will be somewhat stronger than previously forecast, and private business investment excluding energy-intensive industry, ships, and aircraft is expected to grow more as well. On the other hand, delays are expected in investments in the energy-intensive sector. As a result, total investment is projected to be somewhat weaker than in the February forecast.

Total national expenditure is forecast to grow by 3.7% in 2012, which is 0.3 percentage points more than was assumed in February. It is expected to grow by 2½% in 2013, as was projected in February, and by 3.8% in 2014, somewhat more than the 2.7% in the February forecast, primarily because some energy-intensive development projects have been shifted back to that year.

As a result, growth will be driven primarily by domestic demand, with roughly equal contributions from private consumption and investment for most of the forecast horizon. GDP is forecast to grow by an average of just over ½% between quarters in 2012, or about 2½% over the year as a whole, which is virtually identical to the February forecast. The GDP growth outlook for 2013 has improved since February, and growth is now forecast at 2.8%, owing to stronger private consumption growth and, in particular, a more positive contribution from net trade. GDP growth is projected to remain broadly unchanged in 2014, or 2.7%, and gain momentum in the first half of 2015, rising to 4% on a year earlier. In part, this surge in growth in the latter half of the forecast horizon is due to delays in energy-intensive industrial projects.

Labour market developments have been broadly in line with the last forecast, and the outlook for the forecast horizon is similar as well. Slow improvements in employment are expected, with unemployment forecast at 6½% in 2012 and then tapering off gradually to just over 4% by mid-2015, the end of the forecast horizon. According to the forecast, the recovery of employment will lag somewhat behind output growth, boosting labour force productivity during the forecast period. Productivity growth will not be sufficient to prevent a sizeable increase in unit labour costs in 2012, however.

The assessment of the current slack in the economy has changed little since February. Output is estimated to have been about 2% below potential output in 2011 and about 1% below it this year, somewhat less slack than was assumed in February. The economy is projected to approach full capacity utilisation by the beginning of 2014.

As is discussed in *Monetary Bulletin*, the outlook is highly uncertain. Although the global economic outlook has improved somewhat in the recent term, the possibility of a reversal in the most debt-ridden European countries and a resurgence of investors' fears cannot be ruled out. The outlook for exports could deteriorate as a result. The high level of household indebtedness in Iceland could also hinder recovery of private consumption to a larger extent. Furthermore, the demand-side effects of the recent Supreme Court judgment could be overestimated, as the Court's decision could erode credit institutions' asset portfolios, reduce financial institutions' willingness and ability to finance new investment, and raise financing costs. It is uncertain whether the Government's fiscal balance targets will be met. The exchange rate of the króna is another source of uncertainty. There is also considerable uncertainty about next year's wage settlement review and about how quickly inflation will subside to target. The output slack could be too small to ensure that inflation gradually returns to the inflation target. If high inflation expectations have become entrenched because inflation has been well above target for a prolonged period and because firms' pricing decisions appear to be based on past inflation, inflation persistence could be underestimated.

II The interest rate decision

The Governor informed Committee members of the Treasury's issuance of US dollar bonds and the results of the Bank's foreign currency auctions in March and May. He also reported on the IMF Executive Board's Article IV Consultation on the status and outlook for the Icelandic economy, the meetings of the Icelandic representatives with IMF staff, and his own meetings with other central bankers, rating agencies, and financial institutions at the spring meetings of the IMF, held in Washington, DC, in April. Also discussed was the joint financial stability meeting of the Central Bank of Iceland and the Financial Supervisory Authority in early May.

The Committee discussed recent exchange rate developments, as the króna had appreciated in trade-weighted terms since the March meeting, although it was still weaker than at the beginning of the year. As before, Committee members considered the depreciation early in the year primarily the result of foreign currency hoarding by parties with foreign-denominated loan payments in the offing and of reduced foreign exchange inflows through the current account balance, owing to seasonality, poorer terms of trade, and higher domestic costs. The recent amendments to the Foreign Exchange Act, changes in foreign currency hoarding related to servicing of foreign-denominated loans, and a seasonal upswing have contributed to the recent appreciation of the króna.

The Committee was of the view that the macroeconomic forecast published in *Monetary Bulletin* on 16 May confirmed that the recovery beginning in late 2010 had continued and extended to most sectors of the economy. Domestic demand was quite strong, and the labour and real estate markets were showing clear signs of recovery. Asset prices had risen and debt had declined, and private sector financial conditions therefore continued to improve. According to the forecast, output growth is expected to measure 2½-3% per year in 2012 and the two years following, which is somewhat more than in the Bank's February forecast.

The Committee discussed the possibility of raising interest rates by 0.5-1.0 percentage points. All members agreed that there were arguments in favour of a hike of either 0.5 or

0.75 percentage points and that the poorer inflation outlook was the strongest reason for an increase; cf. the discussion above.

The need for high enough interest rates to support the króna was highlighted. Higher interest rates could contribute to slower payment of foreign debt and could affect the incentive to convert foreign currency in foreign-denominated accounts to krónur.

It was pointed out that the slack in the economy could be smaller and inflationary pressures from the labour market greater than forecast, as the equilibrium unemployment rate was highly uncertain at present. In addition, fiscal austerity could turn out to be less pronounced than was assumed in the May forecast.

Some Committee members considered that there were strong grounds for a much larger rate hike than the market generally expected. There was a genuine risk that high and rising inflation expectations would lead to higher and more persistent inflation than was currently forecast.

Although there were grounds for a rate hike of up to 1 percentage point, most members considered that other arguments supported a smaller step. It was possible that recent exchange rate developments stemmed in part from seasonal volatility. If so, the króna would be likely to appreciate in the next few months. There was also the prospect of a decline in global energy prices, which could have direct and indirect effects on domestic prices. It was also pointed out that the global economic outlook was very uncertain. In view of these factors, some members considered it possible that inflation was overestimated in the forecast, which assumed that the low exchange rate would prevail throughout the forecast horizon. Furthermore, some members considered it necessary to exercise caution in view of the still-difficult financial conditions faced by the private sector. Although recovery was clearly underway, it was still fragile, and too steep a rate hike could have adverse supply-side effects.

In view of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be raised by 0.5 percentage points, which would raise the current account rate to 4.5%, the maximum rate on 28-day CDs to 5.25%, the seven-day collateralised lending rate to 5.5%, and the overnight lending rate to 6.5%.

Four members voted in favour of the Governor's proposal, and one voted against it, preferring to raise rates by 0.75 percentage points. This member considered it necessary to raise rates by more because of the possibility that the Committee was already too late in withdrawing the accommodative monetary stance. In order to keep the level of monetary restraint unchanged from the last meeting, rates would have to be raised by 0.5-0.75 percentage points. The Bank's new inflation forecast also showed that it was necessary to continue withdrawing monetary accommodation with an additional rate hike of at least 0.25-0.5 percentage points.

In spite of differing opinions on the size of the step that should be taken at this meeting, all Committee members agreed that it would be necessary to continue withdrawing the current degree of monetary accommodation as the recovery progresses further and the margin of spare capacity diminishes. They agreed that the degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. Moreover, they agreed that, other things being equal, if inflation does not subside in the next few months, it will be necessary to raise nominal interest rates further in order to ensure that inflation returns to target.

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 the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 13 June 2012.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting
June 2012

Published 27 June 2012

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 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 the individual MPC members will be made public in the Bank’s *Annual Report*.

The following are the minutes of the MPC meeting held on 12 June 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 13 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 16 May interest rate decision.

Financial markets

The average trade-weighted exchange rate of the króna in the domestic foreign exchange market was 0.1% lower at the time of the June meeting than at the May meeting. Offshore market trading was sparse.

Because of ample liquidity, overnight rates in the interbank market had remained below the centre of the interest rate corridor since the May meeting. Interbank market trading totalled 54.5 b.kr. in May.

Since May, nominal long-term bond yields had fallen more than corresponding indexed yields, partly reflecting reduced inflation expectations.

The Republic of Iceland's sovereign CDS spread was virtually unchanged between meetings, but the risk premium on Treasury obligations rose in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury. The spread between five- and ten-year Treasury bonds issued by the two countries widened by 0.3 and 0.5 percentage points, respectively, between meetings.

The effective nominal policy rate can be estimated to be close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the average real policy rate had risen by 0.8 percentage points since the May meeting, to -0.4%. The real rate was -0.5% in terms of twelve-month inflation and 0% in terms of the breakeven inflation rate from bond yields.

Unchanged Central Bank interest rates appeared to have been priced into the yield curve; however, most research department analysts from financial firms expected the MPC to raise interest rates by 0.25 percentage points, citing positive Q1 output growth figures as grounds for a rate hike.

Broad money (M3) remained flat month-on-month in April but rose by 5.9% year-on-year.

Outlook for the global real economy and international trade

The global output growth forecast published by the Organisation for Economic Co-operation and Development (OECD) in May was virtually unchanged from the previous forecast, issued in November. The forecast for world trade in 2012 has been revised slightly downwards, however. Uncertainty in the forecast remains tilted strongly to the downside, owing in particular to the difficulties in the euro area. The inflation forecast for OECD countries has risen marginally since the last forecast, due primarily to higher oil prices. The OECD's 2012 output growth forecast for Iceland's main trading partners is somewhat lower than in November, at 1% instead of the previous 1.6%.

According to preliminary figures, Iceland's goods trade surplus totalled 9.3 b.kr. in April and 0.2 b.kr. in May. Both import and export values have continued to grow between years, with the increase measuring 5.4% for imports and 11.7% for exports in the first five months of the year. Increases in export values are due primarily to growth in exported marine products but also to growth in exportation of agricultural products. The increase in import values is due to increased values of imported transport equipment (primarily due to imports of aircraft in January and one ship in May), fuels, and lubricants.

The price of aluminium has fallen marginally since the MPC's May meeting. In May, the average price was over 2% lower than in April and 23% lower than at the same time in 2011. Marine product prices were up 0.8% month-on-month in April.

The domestic real economy and inflation

According to new national accounts data published by Statistics Iceland in June, GDP growth measured 4.5% in Q1/2012, and seasonally adjusted quarter-on-quarter GDP growth was 2.4%. Growth stemmed from most subcomponents, with national expenditure up by 3.9% between years and by 3.4% from the previous quarter (seasonally adjusted). The contribution from net trade was positive in terms of the year-on-year change but negative compared to the previous quarter when adjusted for seasonality. Developments in most subcomponents of GDP were in line with the Central Bank's May forecast, which assumed 1.4% growth during the quarter. The MPC was also informed that 9.6 b.kr. in aircraft imports, previously published in Statistics Iceland's external trade figures, was missing from the national accounts data. A corresponding amount was also missing from the investment figures in the national accounts. Statistics Iceland's preliminary estimate of GDP growth in the first quarter should therefore remain unchanged even though this flaw affects measured domestic investment: instead of business investment growth of 12.9%, according to Statistics Iceland figures, it should have been 42%. Total investment growth is also stronger, at 29.3% instead of the 9.3% in the Statistics Iceland numbers. Business investment as a share of GDP therefore measured 11% instead of 8.7%, and gross capital formation relative to GDP was 14.7% instead of 12.5%. After adjusting for this correction, investment growth in Q1 is somewhat stronger than according to the Central Bank forecast in May instead of being somewhat weaker, as was provided for in Statistics Iceland's unadjusted figures. The main deviation from the Central Bank forecast therefore lies in considerably greater inventory accumulation than was previously projected.

The Bank's May forecast assumed continuing growth in private consumption in coming quarters. Private consumption growth was forecast at 3.9% year-on-year in Q2, and key high-frequency indicators at the beginning of the quarter suggest that this forecast will materialise. Payment card turnover grew by 6% in real terms in April, and new motor vehicle registrations continued to increase in number in April and May.

The trade surplus in Q1 measured 3.2% of GDP, while the forecast in the May issue of *Monetary Bulletin* assumed 6.5%. The deviation is caused primarily by higher import values than the first figures indicated, particularly aircraft imports measuring 9.6 b.kr.

The current account deficit was just over 10% of GDP, or 43 b.kr., in Q1. While this is smaller than the Q4/2011 deficit, it is above the year-2011 average of almost 7% of GDP. The current account deficit was just over 3% of GDP excluding the DMBs in winding-up proceedings, and 0.2% if the pharmaceuticals company Actavis is excluded as well.

Unemployment as measured by the Directorate of Labour was 5.6% in May, after having declined 0.9 percentage points from the previous month. Seasonally adjusted unemployment declined by 0.2 percentage points, to 5.5%, at the same time.

The wage index rose by 10.3% year-on-year in Q1, with the increase varying across sectors. Wage increases were smallest among building and construction workers and public sector employees (8½%) and largest among workers in financial services and those employed by pension funds and insurance companies (just under 14%). The wage index fell by 0.1% month-on-month in April, after having risen by 11.9% over the previous twelve months.

According to the survey carried out by Capacent Gallup in May, consumer sentiment improved slightly during the month. The Consumer Sentiment Index has risen by 17% in the past twelve months, based on the three-month average. Sentiment towards the economic situation improved most in May, whereas the assessment of the labour market deteriorated between months.

According to the Capacent Gallup survey among households, carried out in May and June, inflation expectations one year ahead had declined by 0.2 percentage points since March, to 6.3%. Household inflation expectations two years ahead measured 5.5%, a drop of ½ a percentage point since the last survey.

The consumer price index (CPI) fell by 0.03% month-on-month in May. Annual inflation measured 5.4%, down from 6.4% in April. Core index 3 (the CPI excluding volatile food items, petrol, public services, and the cost of real mortgage interest) rose by 0.4% between months, however. Annual inflation according to core index 3 (excluding tax effects) measured 5.5%, as opposed to 5.9% in April. The decline in petrol prices affected the CPI most strongly in May (-0.24 percentage points), the largest downward effect from this subcomponent in over two years.

II The interest rate decision

The Governor informed Committee members of the Bank's analysis of the risk to the Icelandic economy and the Central Bank as a result of the European financial crisis. The Deputy Governor also discussed the updated balance of payments estimate for coming years. Members discussed the Bank's *Financial Stability* report, published on 6 June, the status of financial institutions, and the progress in private sector debt restructuring.

The Committee also discussed recent exchange rate developments, as the króna had remained virtually unchanged in trade-weighted terms since the May meeting. Newly released figures show an external trade deficit (excluding the DMBs in winding-up proceedings and the pharmaceutical company Actavis) in the past two quarters. Committee members were of the opinion that this reflected, among other things, deteriorating terms of trade, which – together with seasonal factors, steep increases in domestic cost levels and repayments of foreign-denominated loans – could explain last winter's exchange rate developments.

In the MPC's opinion, the national accounts for Q1/2012 were broadly in line with the Bank's May forecast and showed that GDP growth would continue to reduce the margin of spare capacity in the economy. It was clear that the economic recovery was broadly based and that domestic demand was robust. In addition, signs of recovery in the labour and real estate markets were steadily growing stronger.

The Committee discussed the possibility of keeping interest rates unchanged or raising them by 0.25-0.5 percentage points. All members agreed that there were grounds for either a rate hike or unchanged rates. Even though inflation had subsided somewhat in May, it would be imprudent to read too much into a single inflation figure. As before, the outlook is for inflation to remain above the Bank's target for longer than is acceptable, particularly if the króna remains weak. As a result, it is necessary to continue withdrawing the accommodative monetary stance.

On the other hand, the Committee also thought there were arguments in favour of holding rates unchanged: on this occasion, because of the recent escalation in uncertainty about the global economy, particularly in view of the financial crisis in Europe. These conditions cause particular uncertainty about the domestic economic and inflation outlook. The Committee was of the opinion that, in the near future, monetary policy might need to respond to developments that could significantly affect output growth and inflation in Iceland. In such circumstances, the MPC would aim, as before, to achieve the inflation target over the medium term while attempting to stabilise fluctuations in domestic output.

In view of the discussion and the range of views expressed, the Governor proposed that the Bank’s interest rates be raised by 0.25 percentage points, which would raise the current account rate to 4.75%, the maximum rate on 28-day CDs to 5.5%, the seven-day collateralised lending rate to 5.75%, and the overnight lending rate to 6.75%. All members voted in favour of the Governor’s proposal, although one member would have preferred to keep interest rates unchanged in view of increased global economic uncertainty.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They were also of the opinion that raising interest rates in May and again in June had withdrawn some of that accommodation, as was appropriate in view of the recovery of the real economy and the deteriorating inflation outlook. As the recovery continued and spare capacity disappeared, it would be necessary that the monetary policy slack should disappear as well. The degree to which such normalisation took place through higher nominal Central Bank rates would depend on future inflation developments.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

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

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 22 August 2012.

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.