



MONETARY POLICY COMMITTEE REPORT TO PARLIAMENT

2015 • 1

Monetary Policy Committee report to Parliament

7 July 2015

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 10 June 2015. The following report discusses the work of the Committee between January and June 2015.

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 and careful assessment of developments and prospects for the economy, monetary policy, and financial stability.

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

Developments from January to June 2015

At its June meeting, the Monetary Policy Committee (MPC) of the Central Bank of Iceland decided to raise the Bank's interest rates by 0.5 percentage points. At that time, the Bank's interest rates had been unchanged since the beginning of the year, after having been lowered by 0.75 percentage points in the latter half of 2014. At the end of

Table 1. Central Bank of Iceland interest rates 2015 (%)

Date	Current account rate	Rate on 7-day term deposit	Collateralised lending rate	Overnight lending rate
10 June	4,75	5,00	5,75	6,75
13 May	4,25	4,50	5,25	6,25
18 March	4,25	4,50	5,25	6,25
4 February	4,25	4,50	5,25	6,25

Chart 1
Central Bank of Iceland interest rates and short-term market interest rates
Daily data 1 January 2010 - 30 June 2015

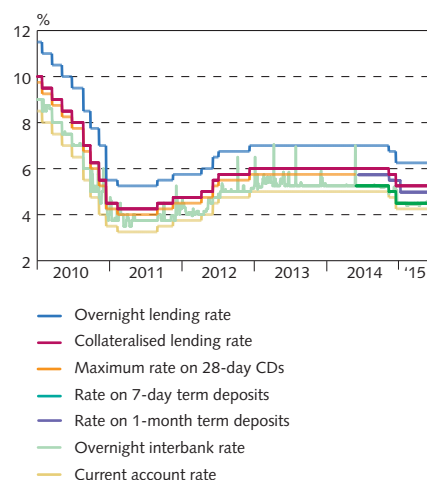
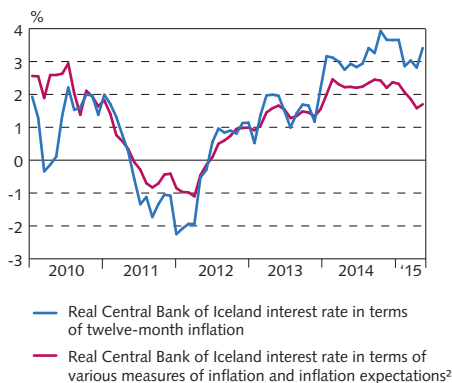
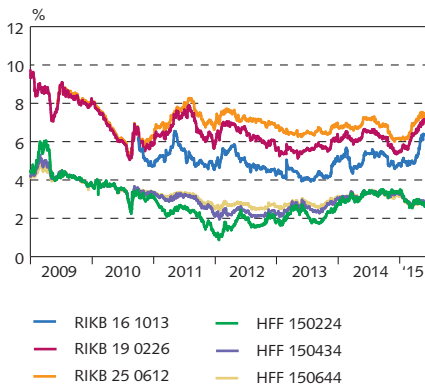


Chart 2
Real Central Bank of Iceland interest rates¹
January 2010 - June 2015



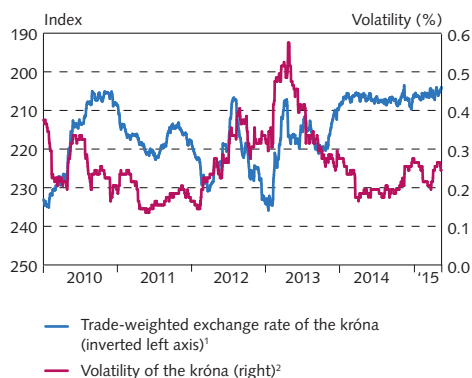
1. From 2010 to May 2014, the nominal policy rate was the average of the current account rate and the maximum rate on 28-day CDs. From May 2014, the policy rate has been the seven-day term deposit rate.
2. Until January 2012, according to twelve-month inflation, one-year business inflation expectations,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

Chart 3
Bond yields
Daily data 2 January 2009 - 30 June 2015



Source: Central Bank of Iceland.

Chart 4
Exchange rate and volatility of the króna
Daily data 4 January 2010 - 30 June 2015



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

June 2015, the Bank's key rate – the rate on seven-day term deposits – was 5%, up from 4.5% at the beginning of the year.¹

Although the Bank's nominal interest rates have been raised, the monetary stance has eased since the beginning of the year, when the MPC submitted its last report to Parliament. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.7% as of end-June and 3.4% in terms of past twelve-month inflation, or 0.2-0.5 percentage points lower than at year-end 2014. Yields on indexed Treasury and Housing Financing Fund bonds have developed broadly in line with the Bank's real rate, whereas real yields on longer nominal bonds are almost unchanged. The long-term breakeven inflation rate in the bond market has risen by approximately 1½ percentage points year-to-date.

The exchange rate of the króna has held relatively stable in trade-weighted terms so far this year, as it did in 2014. The króna has appreciated year-to-date by 1.4% in trade-weighted terms and by 4.8% against the euro. However, it has weakened by 3½% against the US dollar since the beginning of the year, and by 14.2% since mid-2014, which is in line with movements in other developed countries' exchange rates against the dollar. The Central Bank has continued to purchase currency in the foreign exchange market. In the first half of 2015, the Bank bought currency from market makers in the amount of 81.4 b.kr. (548 million euros), which is double the amount bought over the same period in 2014.

Inflation has risen since the MPC submitted its last report to Parliament. Twelve-month inflation in terms of the CPI measured 1.5% in June, up from 0.8% in December 2014. Inflation has been at or below the Central Bank's inflation target for seventeen consecutive months. Underlying twelve-month inflation as measured by core index 3 (which, in addition to the effects of indirect taxes, excludes volatile food items, petrol, public services, and real mortgage interest expense) was also 1.5% in June, having increased slightly since December. The main driver of inflation in the recent term has been the rise in house prices. The rise in the housing component therefore accounts to a large degree for the rise in inflation in the first half of the year, although the price of private services also rose somewhat.² Excluding the housing component, twelve-month inflation measured 0.2% in June, whereas it was negative November 2014 through April 2015. Inflation excluding housing had risen slightly less than observed inflation since the beginning of the year. Food and beverage prices have risen by 2.7% since December 2014, in part due to the increase in the lower value-added tax bracket in January.

1. The key rate is the interest rate that is the most important determinant of short-term market rates and therefore is the best measure of the monetary stance. At present, this is the seven-day term deposit rate. Other Central Bank interest rates have risen correspondingly, as can be seen in Table 1.
2. It should be borne in mind that, owing to the strike among lawyers at Commissioner's offices in the greater Reykjavík area, no house purchase agreements were registered during the period from 7 April through 14 June 2015. Therefore, calculations of the market price of capital area housing in May and June are not based on new measurements.

Although inflation is still low, the inflation outlook has deteriorated in comparison with the Bank's May forecast, as the wage increases negotiated since then are much larger than is consistent with medium-term price stability. Furthermore, the measures announced by the Government in connection with wage settlements will increase Treasury expenditures and reduce tax revenues and, other things being equal, entail a relaxation of the fiscal stance. There are indications of robust growth in demand, and inflation expectations have risen markedly in the past few months. These factors made it unavoidable to respond to the worsening inflation outlook by raising interest rates in June. Furthermore, it seems apparent that more rate increases will be needed in the coming term, in order to ensure price stability over the medium term.

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from February to June 2015.
2. Minutes of Monetary Policy Committee meetings from February to June 2015.
3. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001.

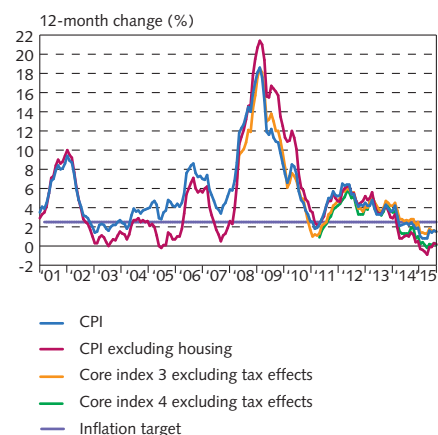
On behalf of the Central Bank of Iceland Monetary Policy Committee,



Már Guðmundsson

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

Chart 5
Various inflation measurements¹
January 2001 - June 2015



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

Accompanying documents

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Statement of the Monetary Policy Committee 4 February 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The Bank's key interest rate – the rate on seven-day term deposits – will therefore remain 4.5%.

According to preliminary figures from Statistics Iceland, GDP growth was somewhat weaker in the first three quarters of 2014 than was forecast in the Bank's November *Monetary Bulletin*. There are indications that these preliminary figures may be underestimated; nevertheless, the Bank's updated forecast assumes that GDP growth in 2014 was weaker than in the November forecast, or 2% instead of 2.9%. On the other hand, GDP growth in 2015 is expected to be stronger than previously projected, or 4.2% instead of 3.5%.

Inflation has subsided still further since the last interest rate decision. It measured only 0.8% in December and January and was slightly negative if the effects of housing costs are excluded. The outlook is for inflation to remain below 2% into 2016, which is below the November forecast. Low global inflation and a stable króna contain inflation and offset the effects of considerable domestic wage increases. Inflation expectations have fallen as well in recent months and are now close to target by most measures.

In many respects, the economic outlook is more uncertain than often before. The drop in petrol prices has had a strong impact on price developments in Iceland and abroad, but it is uncertain how long these conditions will persist. Wage growth has been strong in Iceland, unlike in most trading partner countries, and mounting unrest in the domestic labour market could jeopardise the stability that has been achieved.

The Bank's real rate has risen in the recent past, owing to declining inflation and inflation expectations. It is relatively high in view of the current business cycle position and the near-term outlook. Reductions in global fuel prices are beyond the scope of domestic monetary policy, however, and the disinflation resulting from them is temporary. Therefore, in determining interest rates, it is not possible to take full account of the disinflation stemming from this source. The outlook for the labour market is also highly uncertain, and at the same time, there are signs of strong GDP growth in the near future. For this reason, the MPC considers it appropriate to wait until the economic situation becomes clearer, particularly as regards wage developments.

As always, developments in nominal interest rates depend on developments in demand and inflation. If inflation remains below target and pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop. Large pay increases and strong growth in demand could undermine the recently achieved price stability, however, and require that interest rates be raised again.

Statement of the Monetary Policy Committee 18 March 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The Bank's key interest rate – the rate on seven-day term deposits – will therefore remain 4.5%.

According to recently published national accounts, GDP growth measured 1.9% in 2014, in line with what the Bank had projected in February. The new data confirm the MPC's assessment, published in its last statement, that the preliminary GDP growth numbers for the first nine months of the year had been underestimated and do not therefore materially change the Committee's assessment of recent GDP growth and the economic outlook.

Inflation has measured 0.8% in recent months and has been slightly negative if housing costs are excluded. Low global inflation and a stable króna contain inflation and offset the effects of considerable domestic wage increases. Inflation expectations had subsided to target at the beginning of the year. However, there are indications that they have risen again in recent weeks, possibly reflecting expectations that the results of the forthcoming wage settlements will not be in line with the inflation target.

The recent episode of low inflation is attributable in part to falling global fuel prices. Reductions in global fuel prices are beyond the scope of domestic monetary policy, however, and the disinflation resulting from them is temporary. The outlook for the labour market is also highly uncertain, and at the same time, there are signs of robust GDP growth in the near future. For this reason, the Committee considers it appropriate, as before, to wait until the economic situation becomes clearer, particularly as regards wage developments.

As always, developments in nominal interest rates depend on developments in demand and inflation. If inflation remains below target and pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop. Large pay increases and strong growth in demand could undermine the recently achieved price stability, however, and require that interest rates be raised again.

Statement of the Monetary Policy Committee 13 May 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The Bank's key interest rate – the rate on seven-day term deposits – will therefore remain 4.5%.

According to the Bank's newly published forecast, GDP growth will measure about 4½% this year and will average just under 4% per year over the forecast horizon, which is more than was forecast in February. A positive output gap will develop this year and peak in 2016. The recovery of the labour market has gained momentum in the recent term. Given substantial wage demands currently being put forward, it could be concluded that excess demand has already developed in the labour market, or at least that the labour market slack has narrowed more rapidly than is consistent with price stability.

Inflation is still low and has been slightly negative if housing costs are excluded. Low global inflation and a stable króna have contained inflation and offset the effects of considerable domestic wage increases. The inflation outlook has deteriorated, however, since the Bank's last forecast. The likelihood of a favourable interaction between low imported inflation and modest wage settlements appears negligible at present, as inflation expectations have risen since the last forecast, after having subsided to target at the beginning of the year. According to the Bank's baseline forecast, inflation will already have risen above the target by the beginning of 2016 and is more likely to overshoot the forecast than to fall below it. Developments taking place in wage negotiations since the forecast was prepared have further exacerbated this risk.

The Bank's interest rate reduction late in 2014 was based on a sharp drop in inflation and the decline in inflation expectations, which led to a larger rise in real rates than was considered warranted at that time by economic conditions and the near-term outlook. At that time, however, the Committee pointed out that large pay increases and strong growth in demand could undermine the recently achieved price stability and require that interest rates be raised again. Recent developments in wage negotiations, in conjunction with the increase in inflation expectations and indications of strong growth in demand, suggest that these conditions are now materialising; therefore, it is likely that it will be necessary to raise interest rates at the MPC's next meeting, which will take place in June.

Statement of the Monetary Policy Committee 10 June 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.5 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 5%.

According to newly published national accounts, GDP growth measured 2.9% in Q1/2015. Consumption and investment grew by 6.4% and domestic demand by almost 10%. These figures, together with the strong recovery of the labour market, indicate that economic activity is growing broadly in line with the Bank's May forecast.

Although inflation is still low, the inflation outlook has deteriorated markedly from the Bank's last forecast, and inflation expectations have continued to rise. The outlook is for higher inflation than the Bank projected in May because wage increases recently negotiated have been significantly larger than was assumed in the May forecast.

In order to facilitate the conclusion of wage settlements, the Government has announced measures that will increase public expenditures and reduce tax revenues. This will entail an easing of the fiscal stance, other things being equal, as they have not been financed. Furthermore, the authorities have announced measures aimed to prepare for liberalisation of the capital controls. Some of these measures will generate revenues for the Treasury, and it is important that these revenues be allocated so as not to stimulate the domestic economy still further, i.e. by activating the hitherto sterile component of money holdings. The MPC will monitor developments closely and will take appropriate countervailing measures if necessary. In recent MPC statements, the Committee has repeatedly pointed out that large pay increases and strong growth in demand could undermine the recently achieved price stability and require that interest rates be raised again. The outlook for developments in wage costs, the increase in inflation expectations, and indicators of robust demand growth make it unavoidable to respond to the worsening inflation outlook now, even though inflation is still below target. Furthermore, it seems apparent that a sizeable rate increase will be necessary in August, followed by further rate hikes in the coming term, so as to ensure price stability over the medium term.



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, February 2015

Published 18 February 2015

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 2 and 3 February 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 4 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 10 December interest rate decision, as published in the updated forecast in *Monetary Bulletin 2015/1* on 4 February.

Financial markets

Since the December meeting, the króna had appreciated by just over 2% against the euro but had depreciated by just under ½% in trade-weighted terms and just under 6½% against the US dollar, which had appreciated somewhat against most other currencies. The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 112 million euros (roughly 17 b.kr.), or 43% of total market turnover during the period. At the end of 2014, the foreign exchange reserves net of the Central Bank and central government’s foreign-denominated debt were positive by 53 b.kr., whereas they had been negative in the amount of 28 b.kr. at year-end 2013.

The króna remained relatively stable in 2014, both in trade-weighted terms and against the euro. In trade-weighted terms, it appreciated by just under 2% over the year, as opposed to 11% in 2013. Strong foreign currency inflows supported the currency, and the Central Bank leaned against the appreciation in order to mitigate exchange rate volatility. The Bank’s net foreign currency purchases in the interbank foreign exchange market amounted to roughly

5½% of estimated year-2014 GDP, the largest amount of currency the Bank has purchased in a single year.

Financial institutions' liquidity has remained abundant vis-à-vis the Central Bank, and overnight rates in the interbank market for krónur have been below the centre of the interest rate corridor. Interest rates have developed broadly in line with the Bank's nominal rates. Turnover in the interbank market increased sharply towards the end of 2014 but had been limited so far in 2015.

Yields on nominal and indexed Treasury and Housing Financing Fund (HFF) bonds declined marginally following the December interest rate reduction. Yields on nominal bonds had risen slightly in the interim, however, and were 0.1-0.3 percentage points higher at the February meeting than at the December meeting. They were about 0.1-0.7 percentage points lower than at the November meeting, however.

The lowest listed nominal mortgage rates offered by the three large commercial banks have fallen by an average of 0.5 percentage points since the December meeting and by up to 0.75 percentage points since the November meeting. The average of comparable commercial banks' indexed mortgage rates had risen since December, however, whereas they had been inching downwards in the preceding three years, even though other real market rates had risen in line with the increase in the Central Bank's real rate.

The monetary stance had tightened since the Central Bank lowered its interest rates in December as inflation and inflation expectations had subsided. The Bank's real rate was 2.4% in terms of the average of various measures of inflation and inflation expectations at the time of the meeting, but 3.7% in terms of twelve-month inflation, which is an increase of 0.2 percentage points since right after the interest rate decision was announced in December.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by other countries, had risen by 0.2 percentage points against US Treasury bonds but fallen by 0.1 percentage points against German bonds. Just before the February meeting, it measured 1.6-2.2 percentage points. The CDS spread on five-year Treasury obligations had risen by 0.2 percentage points between meetings, to roughly 1.7%.

Financial institutions' research departments had all projected that the Bank's nominal policy rate would be lowered by 0.25 percentage points in February, on the grounds that the Bank's real rate was higher than the inflation outlook warranted.

Growth in money holdings has slowed down, with M3 up just over 3% year-on-year in Q4/2014, excluding deposits owned by special purpose entities and the winding-up boards of the failed financial institutions. Growth has been driven mainly by increased household and corporate deposits.

The adjusted total stock of DMB loans to domestic borrowers had grown by 2.8% year-on-year in Q4/2014. Net new DMB lending to domestic borrowers totalled just over 170 b.kr. in 2014, almost ½% more than in 2013.

The NASDAQ OMXI8 index had risen by just under 6% between meetings. Turnover in the main market totalled around 277 b.kr. in 2014, an increase of about 10% from the prior year.

Outlook for the global real economy and international trade

The International Monetary Fund's (IMF) January forecast estimates global GDP growth at 3.5% in 2015 and 3.7% in 2016, or some 0.3 percentage points less in each of the two years than according to the Fund's October forecast. The GDP growth outlook is weaker for emerging and developing countries, especially those that export oil and commodities. For industrialised countries, however, the outlook is slightly better this year, particularly for the US, although the 2016 outlook is unchanged. In comparison with the October forecast, 2015 inflation forecasts for industrialised countries have been lowered by about 0.8 percentage points, to 1%, and 2016 forecasts have been lowered by 0.4 percentage points, whereas they have been raised slightly for emerging and developing countries. *Consensus Forecasts'* year-2015 GDP growth projections for Iceland's main trading partners are unchanged since the December MPC meeting, although the inflation forecasts have been lowered by 0.6 percentage points.

Iceland's goods trade surplus totalled 4.6 b.kr. in December 2014 and 4 b.kr. for the year as a whole. Import values rose by 8½% year-on-year in 2014 and export values by 0.7%. Growth in imports is due mainly to increased transport equipment and consumer goods values, while export growth stems mainly from an increase in the value of industrial exports.

The real exchange rate index measured 84.2 points in terms of relative prices in December, an increase of just over 1% month-on-month and nearly 4% year-on-year. The real exchange rate of the króna rose by 6.9% year-on-year in 2014. The increase is due primarily to a 5.7% nominal appreciation of the króna, but in addition, inflation in Iceland was about 1 percentage point above the average among its trading partners.

Aluminium prices have fallen by nearly 4% since the last MPC meeting, although the average price was up almost 5% year-on-year in January. Foreign currency prices of marine products had risen by 2.4% month-on-month in December, however, and by 12½% year-on-year. Oil prices fell nearly 28% year-on-year in Q4/2014, and it is estimated that terms of trade had improved by 5% over the same period.

The domestic real economy and inflation

According to the National Budget for 2015, Treasury revenues will be about 10 b.kr. more than was assumed when the initial budget proposal was prepared, and the entire amount will be used to offset increased expenditures. The budget was passed with a 3.6 b.kr. overall surplus and a 67.9 b.kr. primary surplus. The overall balance is ½ b.kr. less favourable than was assumed in the budget proposal, and the primary balance is 2.2 b.kr. less favourable. The fiscal stance has therefore eased slightly since the last MPC meeting.

According to the Statistics Iceland labour force survey (LFS), seasonally adjusted unemployment in Q4 was in line with the Bank's November forecast, measuring 4.8%. It was virtually unchanged between quarters but declined by 0.4 percentage points year-on-year. The survey-based unemployment rate was 5.4% in 2014, about 0.4 percentage points less than in 2013. According to figures from the Directorate of Labour, unemployment measured 3.6% in 2014, a decline of 0.8 percentage points year-on-year.

According to the LFS, total hours worked increased by 1.5% year-on-year in Q4/2014, in line with the Bank's November forecast. The rise in total hours worked in Q4 is due in large part to an increase in the number of employed (1%) and a slight increase in average hours worked (0.4%). All other measures of labour supply and demand pulled in the same direction. Total hours worked rose by nearly 2% year-on-year in 2014, following an increase of 3.8% in 2013.

The number of employed persons rose by 1.6% in 2014, as opposed to 3.4% in 2013. The increase in averaged hours worked was about 0.4% in both years, however.

In Q4/2014, net migration was positive for the ninth quarter in a row. In 2014 as a whole, immigrants outnumbered emigrants by just over 1,100, or 0.6% of the labour force. This is slightly less than in 2013, however, when net migration was positive by 0.9% of the labour force. The net increase in the past two years is due to foreign nationals.

In Q4/2014, the wage index rose by 1.4% between quarters and by 6.6% year-on-year, and real wages were 5.4% higher than in Q4/2013. In 2014 the wage index rose by 5.8% year-on-year, about the same as in 2013. Real wages rose about 3.7% between years, the largest increase since 2007.

Key indicators of private consumption growth in Q4/2014 imply that growth was relatively strong during the quarter. Payment card turnover grew 5.7% year-on-year and just over 3% quarter-on-quarter. Retail sales and new motor vehicle registrations also increased somewhat.

In Q4/2014, the Capacent Gallup Consumer Sentiment Index rose slightly year-on-year but fell quarter-on-quarter. The same occurred in January: the index declined from the previous month but rose year-on-year. The big-ticket index of planned major household purchases, which had risen to a six-year high in September 2014, remained unchanged in the December measurement.

The Statistics Iceland nationwide house price index rose by 1½% month-on-month in January, after adjusting for seasonality, and by 6.8% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose nearly 2½% in December 2014 when adjusted for seasonality. It rose by 9.6% year-on-year. The number of registered purchase agreements nationwide rose by nearly 12% year-on-year in 2014. The average time-to-sale for residential housing in the capital area was just over four months in 2014, as opposed to just under five months in 2013.

The CPI declined by 0.7% month-on-month in January, after rising by 0.3% in December. Twelve-month inflation measured 0.8% in January, after falling by 0.2 percentage points since the MPC's December meeting. At present, inflation is due largely to rising house prices, as CPI inflation excluding the housing component had been negative by 0.6% over the previous twelve months. Underlying inflation as measured by core index 3 excluding tax effects was 1.3% in January and had declined by 0.2 percentage points since the last meeting. According to statistical measures, underlying inflation ranged between 1.2% and 1.6%. The fall in the CPI in January was driven mainly by winter sales, the massive drop in petrol prices, and the cancellation of general excise taxes. Petrol prices declined 11% month-on-month and had fallen by 17% in the previous twelve months. Food and beverage prices rose by 2.6% month-on-month, however, owing to the increase in the lower value-added tax rate. Public services and house prices also rose somewhat. Inflation averaged 2% for the year, down from 3.9% in 2013 and 5.2% in 2012.

According to the Central Bank survey of market expectations, carried out in late January, respondents expect inflation to measure 2.6% in one year, slightly less than in the October 2014 survey. Market participants expect inflation to average about 3% over the next ten years, which is also somewhat lower than in the last survey. The five- and ten-year breakeven inflation rate in the bond market, as measured by the spread between indexed and non-indexed bond interest rates, measured 3.2-3.4%, slightly less than in December. Based on surveys, this is probably consistent with inflation expectations close to target, considering

that the breakeven rate also includes a risk premium due to the uncertainty in the inflation outlook.

According to the forecast published in *Monetary Bulletin* on 4 February 2015, the inflation outlook has changed significantly from the Bank's November forecast. Inflation subsided to target early in 2014 and has declined still further in the wake of falling oil prices. It measured 0.8% in January, the lowest in two decades. According to the February forecast, inflation is forecast to remain below 1% until the latter half of 2015 and below 2% into 2016. This is lower than was forecast in November.

As always, the inflation outlook is uncertain. The upcoming wage negotiations are a particular source of concern, as large wage increases could erode the inflation outlook and cause a setback in the economic recovery if they cut into labour demand. There is also much uncertainty regarding the global economy, which has been subject to considerable unrest recently. Oil prices have fallen sharply, and even though the decline is generally conducive to GDP growth, the global GDP growth outlook has somewhat deteriorated since the forecast published in the November *Monetary Bulletin*, and uncertainty has escalated. The global inflation outlook has also changed markedly.

The decline in oil prices has made a strong impact on external conditions, and Iceland's terms of trade have improved substantially. As a result, the outlook is for a larger current account surplus than was assumed in November.

According to preliminary figures from Statistics Iceland, GDP growth was somewhat weaker in the first three quarters of 2014 than was forecast in November. Indicators suggest that these figures will be revised upwards. In spite of this, GDP growth for the year as a whole is expected to be weaker than previously estimated, or 2% instead of 2.9%. However, the forecast for GDP growth in 2015 has been revised upwards since November, from 3.5% to 4.2%, due to several factors: positive base effects from weaker output growth in 2014, the marked improvement in terms of trade, and prospects of strong growth in tourism and marine product exports. Nonetheless, the outlook for the next two years is broadly unchanged: GDP growth is forecast to ease somewhat as the demand-side effects of the Government's debt relief package taper off and energy-intensive investment subsides. Growth is projected at approximately 2¼% per year in 2016 and 2017.

As was forecast in November, the recovery of the labour market firmed up somewhat in Q4, after a relatively weak third quarter. The slack in the economy therefore continues to narrow and will probably disappear very soon, if it has not already done so.

II The interest rate decision

The Governor gave the Committee an update on developments since the last meeting, including the work done by the Bank and other authorities in relation to capital account liberalisation. The Committee had also met at an extraordinary meeting on 29 January to discuss possible amendments to the Bank's monetary policy instruments.

The Committee considered whether developments since the last regular meeting and the outlook based on the Bank's new forecast changed its assessment of the required monetary stance. Developments in inflation since the December meeting had been in line with the MPC's assessment. Inflation had subsided still further, measuring only 0.8% in December and January, and was slightly negative if the effects of housing costs are excluded. Inflation

expectations had fallen as well since the December meeting and, by most measures, were close to target.

Committee members agreed that the inflation outlook had changed considerably from the Bank's November forecast. This had been broadly anticipated at the December meeting, however, when the Committee was of the view that inflation would probably remain somewhat below target at least through mid-2015.

Members discussed the updated forecast in *Monetary Bulletin* and were of the view that it was in line with the Committee's assessment from the December meeting that 2014 GDP growth had been weaker than forecast in November. The updated forecast estimated it at 2% instead of the previous 2.9%, based on Statistics Iceland's preliminary figures for the first three quarters of 2014. As was the case at the last meeting, members agreed that it was likely that Statistics Iceland's preliminary figures underestimated the actual pace of output growth, as they deviated markedly from other indicators of demand. On the other hand, GDP growth for 2015 is now forecast to be stronger than forecast in November, or 4.2% instead of 3.5%. This is partly due to base effects, as the preliminary figures suggest that 2014 GDP growth was weaker than previously estimated, and also due to expected stronger export growth and positive effects from terms of trade. Committee members agreed that the spare capacity in the economy had probably disappeared or was about to do so, and the slack in the labour market would probably disappear in 2015. The outlook was still for robust growth in domestic demand, as the forecasted GDP level in 2015 was similar to that forecast in November.

The Committee discussed in detail the labour market and wage developments among various groups, both in current wage agreements and over the long term. Members agreed that, as yet, the main reason for labour market unrest was not excess labour demand but, to an extent, conflicts about relative wages and income distribution. Furthermore, the easy access to the international labour market enjoyed by a portion of the employed could be another factor. Because of these conflicts, the likelihood of wage settlements in line with the inflation target had diminished.

Even though the Bank's real rate had risen by 0.2 percentage points since the nominal rate reduction in December, owing to the decline in inflation and inflation expectations, it was considered most appropriate to keep interest rates unchanged because, in deciding the monetary stance at the December meeting, the MPC had factored in that inflation would most likely fall between meetings. Members nonetheless agreed that the Bank's real rate was relatively high in view of the current business cycle position. The economic outlook was more uncertain than often before, however. In assessing the near-term inflation outlook, it was necessary to consider the offsetting effects of the growing uncertainty about upcoming wage agreements and the effects of the decline in global oil prices on inflation and inflation expectations. The MPC was of the view that the inflation forecast in the February *Monetary Bulletin* was more likely to be too low rather than too high. Members considered that the wage settlements since the December meeting and the indications that recent settlements would influence wage demands had reduced the likelihood that moderate three-year contracts would be landed.

Members noted that, following the broad-based disinflation over most of 2014, the recent decline in inflation was, for the most part, a direct effect of falling global oil prices. Reductions in fuel prices were beyond the scope of domestic monetary policy, however, and the disinflation resulting from them would be temporary. Therefore, members agreed that, in determining interest rates, it was not possible to take full account of the disinflation

stemming from this source. It would therefore not be appropriate to simply consider the increase in the real rate that could be traced to low observed inflation caused by reduced oil prices. If developments in oil prices should begin to affect long-term inflation expectations, however, and spread to wage formation, thereby leading to a prolonged period of below-target inflation, a monetary policy response would be called for. The MPC considered it unlikely that this would happen, however. The spare capacity in the economy had more or less disappeared, and robust GDP growth was expected in the near future. Wage growth had been strong in Iceland, unlike in most trading partner countries, and mounting unrest in the domestic labour market could jeopardise the stability that had been achieved. For this reason, the Committee agreed that it was appropriate to wait until the economic situation became clearer, particularly as regards wage developments.

In view of the discussion, the Governor recommended that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 4.5%, the current account rate 4.25%, the seven-day collateralised lending rate 5.25%, and the overnight lending rate 6.25%. The proposal was approved unanimously.

Committee members agreed that, as always, developments in nominal interest rates would depend on developments in demand and inflation. The Committee was of the opinion that, if inflation remains below target and pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop, other things being equal. On the other hand, they were of the opinion that large pay increases and strong growth in demand could undermine the recently achieved price stability and require that interest rates be raised again.

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 18 March 2015.



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, March 2015

Published 1 April 2015

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 17 March 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 18 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 4 February interest rate decision.

Financial markets

The exchange rate of the króna had risen by 2.2% against the euro and by 0.6% in trade-weighted terms since the February meeting but had fallen by 4.4% against the US dollar and 2.5% against the pound sterling. The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 129 million euros (roughly 19 b.kr.), or just under half of total market turnover during the period.

Financial institutions’ liquidity has remained abundant vis-à-vis the Central Bank, and overnight rates in the interbank market for krónur have been below the centre of the interest rate corridor. Turnover in the interbank market has been extremely limited year-to-date.

Yields on long-term nominal Treasury bonds had risen by 0.1-0.4 percentage points since the February meeting, but yields on indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.3-0.5 percentage points.

The lowest listed nominal mortgage rates offered by the three large commercial banks had remained unchanged since the February meeting. Comparable rates on indexed loans were also unchanged, apart from one commercial bank's variable rates, which had risen by ½ a percentage point.

The monetary stance was broadly unchanged since the Committee's February meeting. At the time of the March meeting, the Bank's real rate was still 2.3% in terms of the average of various measures of inflation and inflation expectations, and 3.7% in terms of twelve-month inflation.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by the US and Germany, had declined by 0.3-0.4 percentage points and measured about 1.1-1.7 percentage points just before the March meeting. The CDS spread on five-year Treasury obligations had risen by 0.1 percentage points between meetings, to 1.8%.

Financial market analysts had all expected the Central Bank's nominal interest rates to remain unchanged in March. They cited the uncertainty about ongoing wage negotiations and the fact that year-2014 GDP growth had been in line with the Bank's forecast as grounds for their projections.

Growth in money holdings has slowed down in the recent term, with M3 down by just under 2% year-on-year in January, excluding deposits owned by special purpose entities and the winding-up boards of the failed financial institutions. The contraction is due mainly to a contraction in financial institutions' deposits.

The adjusted total stock of deposit money banks' (DMB) loans to domestic borrowers declined by 2.3% year-on-year in January. DMBs' net new lending (new loans net of prepaid older loans) to domestic borrowers totalled just over 4 b.kr. in January. At the same time, households' prepayments exceeded new loans taken by 166 m.kr. A large share of households' mortgage prepayments during the month can be traced to loan write-downs and accumulated mortgage payments made with third-pillar pension savings associated with the Government's debt relief package.

The NASDAQ OMXI8 index had fallen by just over 2% between meetings. Turnover in the main market totalled around 59 b.kr. during the first two months of the year, about the same as in the corresponding period in 2014.

Outlook for the global real economy and international trade

Iceland's goods trade surplus measured 7.1 b.kr. in January and, according to preliminary figures, 6.6 b.kr. in February. Export values rose 11.7% year-on-year at constant exchange rates in the first two months of the year, due to an increase in marine and industrial product exports. Import values rose by 9% over the same period, owing mainly to increased imports of commodities, operational inputs, and food and beverages.

Terms of trade for goods and services improved by 3.4% year-on-year in 2014, a percentage point more than was forecast in *Monetary Bulletin* 2015/1. The greater improvement is due to favourable developments in export prices of aluminium and marine products during the fourth quarter of the year.

Aluminium prices had fallen by 7% since the last MPC meeting, although the average price was up 4% year-on-year during the first two weeks of March. Foreign currency prices of marine products rose slightly between months in January and had risen 14% year-on-year at

that time. Oil prices had fluctuated somewhat between meetings. In the first half of March, they were 3.5% below the February average and 47% below March 2014 prices.

The real exchange rate in terms of relative consumer prices measured 85.1 points in February, 1.4% above the Q4/2014 average and 1.5% higher than in February 2014. The increase is due primarily to a 0.7% nominal appreciation of the króna, but in addition, inflation in Iceland was about 0.8 percentage points above the average among its trading partners. The outlook is for inflation to remain low in trading partner countries. In February, there was 0.3% deflation in the euro area. In January, there was 0.1% deflation in the US and 0.3% inflation in the UK.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, GDP grew by about 3% in Q4/2014. Quarter-on-quarter GDP growth measured 0.8%, according to the Central Bank's seasonally adjusted figures.

GDP growth measured 1.9% for 2014, as compared with the Bank's projection in February of 2%. Year-2014 growth was driven mainly by growth in domestic demand, private consumption and business investment in particular. Domestic demand grew by 5.3% during the year, although the contribution of net trade to GDP growth was negative by 3 percentage points.

GDP growth figures for the first three quarters of the year were revised, and growth is now estimated at 1.5%, about a percentage point more than previous figures had indicated. This is in line with the Bank's November forecast, which was published before Q3 national accounts figures were released in December. At that time, however, domestic demand growth was expected to be somewhat weaker. The discrepancy is due in large part to the revision of public consumption figures for the first nine months, although the contribution from inventory changes was greater than previously expected. Offsetting this, exports grew less than previously forecast, and the contribution from net trade was accordingly weaker.

According to preliminary figures from Statistics Iceland, the central government's underlying operating performance in 2014 was broadly in line with the forecast in *Monetary Bulletin*. There was some difference, however, between the results and the forecast, owing to differing methods of accounting for dividend payments.

The underlying current account balance was positive by just under 100 b.kr. in 2014, or about 5% of GDP, as opposed to a surplus of 7.3% of GDP in the previous year. The smaller surplus in 2014 was due to a smaller surplus on goods trade (19 b.kr.), a smaller surplus on services trade (7 b.kr.), and a weaker primary income balance (15 b.kr.). The forecast in *Monetary Bulletin* 2015/1 assumed that the current account surplus would amount to 4.4% of GDP in 2014. The deviation is due primarily to returns on foreign direct investment, which were better than in the forecast, although the surplus on combined goods and services trade was smaller than forecast.

Key indicators of developments in private consumption at the beginning of the year suggest developments similar to those at the end of 2014. For example, in January and February, payment card turnover was up nearly 3½% year-on-year, and new motor vehicle registrations were up 36.5%.

The wage index rose by just under 1.3% quarter-on-quarter and 6.7% year-on-year in Q4/2014. Wage developments have varied somewhat from one group to another during the

current wage settlement period. Of all employee groups, municipal employees' wages rose most year-on-year, or 10.3%. In the private sector, wages rose most in the transport and communications sector (7.2%) and least in the industrial sector (4.2%). The wage index rose by 1% month-on-month in January and by 6.7% year-on-year. Real wages rose by 1.7% between months and about 3.4% year-on-year.

According to Gallup's survey among executives from Iceland's 400 largest firms, conducted in February and March, about one-fourth of respondents were considering adding on staff in the next six months, and just under 10% were considering downsizing. This result is similar to that in both the previous survey and the survey carried out in February/March 2014. In all sectors, there is greater interest in expanding staffing levels than in cutting back. The most pronounced change from the last survey was among firms in communications, transport, and tourism, where nearly half of firms are considering recruiting and only 4% are considering downsizing. Just over 17% of firms consider themselves understaffed, whereas in the communications, transport, and tourism sector and in construction, about 30% of firms consider themselves understaffed. Just over a third of respondents were of the opinion that they would have some difficulty responding to an unexpected surge in demand or sales. The share of firms in this position has increased steadily over the past four years.

New national accounts figures show that the wage share rose by about 0.9 percentage points year-on-year in 2014, to 59.9% of gross factor income, which is about 0.7 percentage points below the twenty-year average. Since it bottomed out in 2009, the wage share has risen by just over 6 percentage points.

Statistics Iceland's nationwide house price index, published in late February, was up 1.7% month-on-month when adjusted for seasonality, and about 8.2% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 1.6% month-on-month in January, when adjusted for seasonality. It rose by 10.4% year-on-year. The number of purchase agreements concluded nationwide in January 2015 slightly exceeded the number concluded in January 2014. The average time-to-sale for flats in the greater Reykjavík area was just over five months in January, as opposed to an average of just over four months in 2014.

According to the Gallup survey carried out in February and March, corporate executives were much more upbeat about the current economic situation than they were in the December survey. Over 40% of them considered the current situation good, as compared with approximately one-third in the previous survey. Furthermore, nearly 40% of executives expected conditions to improve in the next six months – a slight downturn from December – and just under half expected them to remain unchanged. Respondents in all sectors were somewhat more pessimistic about the future than they were in December, particularly those in the retail sector. In spite of this, nearly half of them – somewhat more than in the last survey – indicated that they expected domestic demand to grow in the next six months.

According to Gallup's consumer sentiment survey, carried out in February, respondents were also more optimistic than in both the previous month and the same month in 2014. The Consumer Sentiment Index measured 91.5 points in February, an increase of nearly 10 points from the previous month and 5.6 points from February 2014.

The CPI rose 0.7% month-on-month in February, and twelve-month inflation was unchanged at 0.8% since the MPC's previous meeting. However, the CPI excluding the housing component had declined by 0.9% in the past twelve months. Underlying twelve-month inflation in terms of core index 3 excluding tax effects measured 1.2% in February, also virtually unchanged since the last MPC meeting. According to statistical measures, however,

underlying inflation had risen between months and ranged between 1.5% and 2%. The main drivers of the increase in the CPI in February were end-of-sale effects and rising house and petrol prices. The increase in the housing component strongly affected the index, raising it by 0.25 percentage points, as the market price of housing had risen relatively strongly in recent months. Food and beverage prices declined by 0.7% between months. The price reductions came in the wake of strong increases in January, which were due to the increase in the lower value-added tax bracket.

According to the Gallup survey of household expectations, carried out in February and March, household inflation expectations one year ahead measured 3%, down ½ a percentage point from the November survey, whereas two-year inflation expectations were unchanged at 4%. According to a comparable survey carried out among executives at around the same time, respondents' inflation expectations one year ahead also measured 3%, an increase of ½ a percentage point since the December survey. This was the first increase in corporate inflation expectations in quite some time. Corporate expectations two years ahead measured 3.1% and had also risen slightly since the last survey. The five- and ten-year breakeven inflation rate in the bond market, as measured by the spread between indexed and non-indexed bond interest rates, averaged approximately 4% in the first half of March and had risen by just over ½ a percentage point since January. It is now roughly where it was a year ago.

II The interest rate decision

The Governor gave the Committee an update on developments since the last meeting, including the work done by the Bank and other authorities in relation to capital account liberalisation. He also reported to the Committee on the Executive Board of the International Monetary Fund's (IMF) Article IV discussion about the current situation and future prospects for the Icelandic economy during its last Board meeting.

Because of the short time since the previous MPC meeting, little new information had been published. The Committee agreed that developments since the last meeting had not changed its assessment of the necessary monetary stance. Members were of the view that the recently published national accounts did not materially change their assessment of recent GDP growth and the economic outlook. Some members were of the view, however, that there were signs that the economy was even stronger than Statistics Iceland's figures indicated. The Committee agreed that these new data confirmed its assessment, published in its last statement, that last year's GDP growth was stronger than the preliminary GDP growth numbers for the first nine months of the year suggested.

Members noted that recent developments among Iceland's main trading partners, particularly in Europe, had exceeded expectations, even though inflation had not yet risen.

They agreed that the inflation outlook was broadly unchanged since the last meeting, as inflation had remained very low in recent months, and slightly negative if housing costs were excluded. The Committee was of the view that low global inflation and a stable króna had contained inflation and offset the effects of considerable domestic wage increases. They were also of the view that the inflation forecast in the February *Monetary Bulletin* was more likely to be too low than too high, particularly in view of the growing unrest in the labour market. Furthermore, they considered it possible that inflation could exceed the forecast in the next few months, owing in part to a larger rise in domestic petrol prices than assumed in February. Further disinflation was therefore unlikely.

The Committee had some concern about recent developments in inflation expectations. At its previous meeting, inflation expectations had subsided between meetings and were at target by most measures. At the time of the March meeting, however, there were indications that they had risen again in recent weeks. In the Committee's view, this might reflect expectations that the results of the forthcoming wage settlements would not be in line with the inflation target, although some of the increase could also be due to unfavourable developments in risk premia. In the Committee's opinion, this development suggested that inflation expectations were not yet firmly anchored at target.

They considered it most appropriate to keep interest rates unchanged. Given that the recent episode of low inflation was attributable in part to falling global fuel prices, which were beyond the scope of domestic monetary policy, and the disinflation resulting from the drop in fuel prices was temporary, Committee members agreed, as before, that in determining interest rates, it was not appropriate to take full account of the disinflation stemming from this source. They were also of the view that the outlook for the labour market remained highly uncertain, and at the same time, there were signs of robust GDP growth in the near future. For this reason, the Committee agreed that it was still appropriate to keep interest rates unchanged until the economic situation became clearer, particularly as regards wage developments.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 4.5%, the current account rate 4.25%, the seven-day collateralised lending rate 5.25%, and the overnight lending rate 6.25%. The proposal was approved unanimously.

Committee members agreed that, as always, developments in nominal interest rates would depend on developments in demand and inflation. The Committee was of the opinion that, if inflation remained below target and pay increases in upcoming wage settlements were consistent with the inflation target, conditions for further reductions in nominal interest rates could develop, other things being equal. On the other hand, they were of the opinion that large pay increases and strong growth in demand could undermine the recently achieved price stability and require that interest rates be raised again.

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 13 May 2015.



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, May 2015

Published 27 May 2015

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 6 and 12 May 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 13 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 18 March interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2015/2 on 13 May.

Financial markets

Since the March meeting, the króna had depreciated by 0.3% in trade-weighted terms, by 0.7% against the euro, and by 0.9% against the pound sterling, but had appreciated by 5.4% against the US dollar. It is still about 3.6% weaker against the US dollar than it was at the beginning of the year, and about 14% weaker than at the same time a year ago, which is in line with movements in other developed countries’ exchange rates against the dollar.

The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 119 million euros (roughly 17.5 b.kr.) between meetings, or 41% of total market turnover. Purchases year-to-date totalled around 46 b.kr., much more than over the same period in 2014.

Financial institutions’ liquidity has remained abundant vis-à-vis the Central Bank, and overnight rates in the interbank market for krónur have been below the centre of the interest rate corridor, close to the Bank’s key interest rate. Interbank market turnover

totalled 141.5 b.kr. year-to-date, which is considerably more than in the same period in 2014 but well below the level seen in the same period of the three preceding years.

Yields on nominal Treasury bonds had risen by 0.4-0.7 percentage points since the March meeting, but yields on indexed Treasury and Housing Financing Fund (HFF) bonds were broadly unchanged.

The average of the lowest listed nominal mortgage rates offered by the three large commercial banks had declined slightly since the March meeting, and their real rates had fallen by approximately $\frac{2}{3}$ of a percentage point. Comparable rates on indexed loans had also fallen slightly, therefore reversing in part the increase taking place in the first two months of the year.

The monetary stance had eased since the March meeting. At the time of the May meeting, the Bank's real rate was 1.7% in terms of the average of various measures of inflation and inflation expectations and 3% in terms of twelve-month inflation; that is, just over $\frac{1}{2}$ a percentage point lower than just after the interest rate announcement in March.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by the US and Germany, was broadly unchanged since the March meeting, measuring about 1.1-1.6 percentage points just before the May meeting. It had fallen by about 0.3-0.6 percentage points since the beginning of the year, however. The CDS spread on five-year Treasury obligations had fallen by 0.2 percentage points between meetings, to 1.6%.

Financial market analysts had all expected the Central Bank's nominal interest rates to remain unchanged in May, citing uncertainty about the results of the ongoing wage negotiations.

M3 grew by about 8.9% year-on-year in Q1/2015, but by only 3.3% adjusted for deposits held by the failed banks' winding-up boards. Twelve-month growth in adjusted M3 has contracted in the past year and has been below nominal GDP growth for the last three quarters.

Net new lending from DMBs to domestic borrowers totalled 50 b.kr. in the first quarter of 2015, which is a large increase year-on-year but broadly in line with the previous three quarters. Net new DMB lending to households totalled about 9.7 b.kr. in the same quarter, a strong contraction between quarters but in line with Q1 lending in the previous two years. Prepayments of older household loans during the quarter are due largely to the Government's debt relief measures.

The NASDAQ OMXI8 index had risen by 4.1% between meetings and by 5% when adjusted for dividend payments. Turnover in the main market totalled 105 b.kr. during the first four months of 2015, an increase of nearly 13% year-on-year.

Outlook for the global real economy and international trade

The International Monetary Fund (IMF) forecast in April that global output growth for 2015 would be broadly unchanged from the past two years, or 3.5%. This is the same as the Fund forecast in January. The Fund has revised its world trade forecast for 2015 and 2016 downwards since January. The overall GDP growth outlook for industrialised and emerging countries in 2015 and 2016 is broadly unchanged since January. The outlook for the US is somewhat poorer than was assumed in January, while the outlook for the euro area has

improved. The outlook for the UK is virtually unchanged. The IMF's forecast for 2015 GDP growth among Iceland's main trading partners is about 0.2 percentage points lower than was assumed in January, or 1.9%. Overall, the IMF projects lower inflation than in January. Trading partner inflation is projected at 0.6% this year, about a percentage point below the Fund's January forecast.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 7.3 b.kr. surplus in April, following a surplus of 8.2 b.kr. in March. Export and import values grew year-on-year in April, by 52% and 12%, respectively. In the first four months of the year, export values grew by 28% year-on-year and import values by 22%. Export growth was due primarily to increased industrial and marine export values, while import growth stems from increased values of imported transport equipment, mainly aircraft, although imports of commodities and operational inputs increased considerably as well.

Aluminium prices have risen by 4.5% since the MPC's March meeting and were up 8.2% year-on-year, on average, in the first two weeks of May. Marine product prices rose by 1.7% month-on-month in March and had risen by 13% in the preceding twelve months.

In terms of relative consumer prices, the real exchange rate measured 85.1 points in April, an increase of 0.2% month-on-month and 1.3% year-on-year. The twelve-month increase is due mainly to the fact that inflation in Iceland was about 1 percentage point above the trading partner average, although the nominal exchange rate rose by 0.3% between years as well.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked rose somewhat more rapidly in Q1/2015 than in the second half of 2014, or about 4.2% year-on-year. The increase in total hours worked is due entirely to an increase in the number of employed, as average hours worked declined marginally. The labour participation rate rose by 1.6 percentage points year-on-year during the quarter, the employment rate rose by 2.7 percentage points, and the number of persons outside the labour market fell by 6.8%.

Seasonally adjusted unemployment measured 3.8% in Q1, according to the LFS. It declined by 1 percentage point between quarters, after remaining virtually unchanged since Q2/2014.

In Q1/2015, net migration was positive for the tenth quarter in a row. The increase amounted to 0.2% of the labour force and was due entirely to foreign nationals.

The wage index rose by 1.2% between quarters in Q1, and by 6.1% year-on-year, and real wages rose by 5.4% over the same period.

Key indicators of private consumption in Q1/2015 suggest strong growth from the same quarter in 2014 and a continuation of the growth seen in Q4/2014. Payment card turnover grew by more than 5% year-on-year during the quarter. Retail turnover with goods such as electronic equipment and furniture grew year-on-year during the quarter, whereas groceries turnover declined slightly. New motor vehicle registrations also increased markedly during the quarter.

Statistics Iceland's nationwide house price index, published in late April, declined 0.3% month-on-month when adjusted for seasonality, but rose 8.6% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 0.3% month-on-month

in March when adjusted for seasonality. It rose by 8.8% year-on-year. The number of purchase agreements finalised in March was about a third higher than in the same month in 2014, as many contract registrations were expedited in March because of the imminent strike among lawyers employed by the capital area Commissioners' offices, which began on 7 April. In the first quarter of 2015, the average time-to-sale for flats in the greater Reykjavík area was just over four months, about the same as in the same quarter of 2014.

The Gallup Consumer Sentiment Index declined month-on-month in April but was still 1.6 points higher than in April 2014. All components of the index declined between months. The big-ticket purchase index rose during the quarter to its highest value since March 2008.

The CPI rose by 0.14% month-on-month in April, following an increase in March of 1%, the largest single-month increase since February 2013. Twelve-month inflation measured 1.4% in April, after rising by over $\frac{1}{2}$ a percentage point since the March meeting. The CPI excluding the housing component declined by 0.1% year-on-year. Underlying inflation in terms of core index 3 excluding tax effects was 1.6% in April and had increased by nearly $\frac{1}{2}$ a percentage point since the last meeting. Statistical measures of underlying inflation also indicate a slight rise in the recent past. Using the weighted median and trimmed mean measures gives an underlying inflation figure of 1.7-2.2%. In terms of the dynamic factor model, however, underlying inflation is higher, about 3 $\frac{1}{2}$ %. The main change in April was a 0.7% month-on-month increase in house prices, with the twelve-month increase measuring 8.6% (based on the market value of housing in the CPI).

According to the Bank's survey of market agents' expectations, carried out at the beginning of May, respondents expect inflation to measure 3 $\frac{1}{2}$ % one year ahead. This is about 1 percentage point more than in the January survey. Market agents' long-term inflation expectations also rose slightly, with respondents projecting that inflation would average 3.2% in the next five and ten years. The breakeven inflation rate in the bond market has also risen since the March meeting. Furthermore, it contains a risk premium that has probably risen in recent weeks, in part due to the uncertainty prevailing in the labour market. The two-year breakeven inflation rate averaged 3.8% in April and had risen by over $\frac{1}{2}$ a percentage point since March. The five- and ten-year breakeven rates averaged just under 5% in April and had also risen by just over $\frac{1}{2}$ a percentage point. The increase since January 2015 is about 1 $\frac{1}{2}$ percentage points, however.

According to the forecast published in *Monetary Bulletin* on 13 May, the effects of the recent drop in oil prices on observed inflation will taper off, and large wage increases and an increased output gap will cause inflation to rise again. Inflation is expected to be at target in the latter half of this year, nearly half a year earlier than was forecast in February. According to the baseline forecast, inflation will continue to rise, measuring just over 3% from mid-2016 to the end of the forecast horizon, when it will begin to subside to the target again.

The outlook for global output growth and growth in Iceland's main trading partners in 2015 and the following two years is broadly unchanged from the Bank's February forecast, although GDP growth prospects for individual countries and regions have changed. According to the forecast, trading partners' growth will average 2.2% per year over the next two years. Uncertainty about the global economic outlook is similarly unchanged since February.

Preliminary figures from Statistics Iceland indicate that terms of trade improved by 9% year-on-year in Q4/2014. The improvement during the year turned out to be 3.4%, or 1

percentage point more than was forecast in the February *Monetary Bulletin*, owing mainly to more favourable developments in aluminium and marine product prices. The outlook is for continuing improvement in terms of trade this year, not least because of the steep decline in oil prices and the appreciation of the US dollar against the euro since mid-2014. If the forecast materialises, terms of trade will have improved by about 8% in 2017 compared to the post-crisis trough in 2013, although they will remain 12% below the average for the period 1999-2008.

The outlook for exports in 2015 and the following two years has improved from the last forecast, however, and growth is now projected at nearly 7% this year. The increased growth is due primarily to stronger exports of services and marine products. Export growth will lose pace somewhat over the forecast horizon and is expected to align with growth in trading partner demand by the end of the period.

GDP growth measured 1.9% in 2014, well in line with the 2% forecast in the February *Monetary Bulletin*. It is projected at 4.6% this year, somewhat more than was forecast in February. The upward adjustment is due largely to stronger growth in investment and exports. The outlook for 2016 has also improved since February, with GDP growth for the year projected at 3.4%. GDP growth for 2017 is projected at 3%, about ½ a percentage point more than in the February forecast. As before, the main drivers of output growth during the forecast horizon will be private sector demand; i.e., private consumption and business investment.

According to the Statistics Iceland labour force survey (LFS), seasonally adjusted unemployment measured 3.8% in Q1/2015, in line with the Bank's February forecast. Jobs increased strongly in number in Q1, and total hours worked rose by over 4% year-on-year. Other labour market indicators also suggest that the recovery of the labour market has regained its previous strength after the slowdown in H2/2014. According to the baseline forecast, unemployment will continue to decline, to about 3½% in 2015 and 2016, and then rise to its estimated equilibrium level towards the end of the forecast horizon. Total hours worked will also continue to rise, as will the employment rate, which will measure about 79% from 2016 onwards. The outlook for the labour market has therefore improved somewhat from the February forecast, in line with improved GDP growth prospects. The outlook for productivity growth during the forecast horizon is broadly unchanged since February, however: productivity growth is still forecast to average about 1% per year.

Wages rose by nearly 6% in 2014, whereas labour productivity remained unchanged. Unit labour costs therefore rose sharply during the year, and the baseline forecast indicates that they will continue to do so for most of the forecast horizon. Unit labour costs are assumed to rise by an average of approximately 4% per year during the forecast horizon, slightly more than was forecast in February and somewhat above the level compatible with long-term price stability.

The margin of spare capacity in the economy is estimated to have closed and a positive output gap will gradually develop. It is projected to peak at 1¼% of potential output around mid-2016. This is a somewhat more pronounced output gap than was assumed in the February forecast, as the outlook is for stronger GDP growth during the forecast horizon. According to the forecast, the gap should narrow gradually in the latter half of the forecast horizon and will have almost disappeared by the end of the period.

The baseline forecast in *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are various

uncertainties in the forecast that could change the inflation outlook from that assumed in the baseline scenario. The global economic recovery could prove weaker than is assumed in the baseline forecast, for instance, adversely affecting exports and perhaps terms of trade as well. Furthermore, exchange rate developments are uncertain due to the potential effects of settling the failed banks' estates and lifting the capital controls. One of the key uncertainties in the baseline forecast, however, is the outcome of the ongoing wage negotiations. There is also the risk that wage increases well in excess of productivity growth will prompt firms to seek ways to reduce wage costs by, for instance, slowing staff recruitment or laying off workers. The recent improvement in Iceland's competitive position, which can be seen, among other things, in strong export growth despite weak output growth among trading partners, would also be under threat. Large increases in wage costs would also tend to undermine the economic recovery and the trade surplus that paved the way for liberalisation of the capital controls. The uncertain outlook for the labour market implies considerable risk that near-term inflation is underestimated. That risk has increased in the recent term. This is offset in the long run by factors such as the risk of weaker economic activity than is provided for in the baseline forecast; therefore, the probability distribution is more symmetric towards the end of the forecast horizon, although the risk in the inflation forecast is still concentrated on the upside.

II The interest rate decision

The Governor gave the Committee an update on developments since the last meeting, including the work done by the Bank and other authorities in relation to capital account liberalisation. Committee members discussed the Bank's *Financial Stability* report, published on 22 April, the position of financial institutions, and risks to the financial system stemming from Iceland's balance of payments problem.

The Committee considered whether developments since the last meeting and the outlook based on the Bank's new forecast changed its assessment of the required monetary stance. Members agreed that economic activity was greater than previously estimated and the margin of spare capacity narrower. According to the Bank's newly published forecast, GDP growth will measure about 4½% this year and will average just under 4% per year over the forecast horizon. This is about ½ a percentage point more than the Bank forecast in February. It is also assumed that a positive output gap will develop this year and peak in 2016.

Committee members noted that the recovery of the labour market had gained momentum in the recent term. They were of the view that, given the substantial wage demands currently being put forward, it could be concluded that excess demand has already developed in the labour market, or at least that the labour market slack has narrowed more rapidly than is consistent with price stability. In the Committee's view it was uncertain, however, to what extent this explained the very high wage demands – which were well above what could be expected under conditions of a small output gap and still-low inflation. As had been discussed previously at MPC meetings, other explanations for high wage demands could be the breakdown of the social consensus and disagreement among labour organisations about relative wages and income distribution.

Committee members also noted that, according to the current forecast, unit labour costs were forecast to rise somewhat more than previously assumed, and somewhat more than is consistent with the inflation target. Members agreed that the scope for pay increases in

the coming wage settlements was limited by the apparent weakness of productivity growth, although the improvement in terms of trade offset it somewhat.

The Committee examined several alternative scenarios involving significantly larger pay increases than are assumed in the baseline forecast and discussed the impact on inflation, the real economy, and the monetary policy response. The impact of one of these scenarios is discussed in detail in *Monetary Bulletin* 2015/2. The Committee considered it clear that even in the alternative scenario involving wage increases in line with what the Confederation of Icelandic Employers (SA) had offered to labour unions, substantial interest rate increases would be necessary, other things being equal, to ensure long-term price stability.

The Committee was also of the view that the effects of large pay rises on the real economy as portrayed in the alternative scenarios could be underestimated in macroeconomic models based on historical relationships, when conditions differed markedly from present ones. The króna would not depreciate now as it had following large pay increases in previous decades. Furthermore, the sectoral composition of the economy had changed, as small and medium-sized tourism companies weigh more heavily than before, and it is uncertain how much scope they have for large pay increases and changes in activities and staffing if needed. It was also pointed out that, in the past, the banking system had financed companies' losses, at least for a period of time, but that it was entirely uncertain whether this could be done to the same degree now. Members agreed that the effect on employment could therefore be greater than in the alternative scenarios. One member was of the view, however, that the impact could be non-linear and could emerge later, but then in a more pronounced manner. Committee members agreed that firms' capacity to increase wages varied and that wage increases as large as those in the scenarios could prove too onerous for some of them. Although it could be expected that the fishing and energy-intensive industries' large profits would enable firms in those sectors to absorb large pay increases, there was probably little scope among many domestic services firms and smaller companies in the tourism sector, which has seen the most rapid growth in employment since the banks failed. Members also noted the risk that tourism companies' competitive position would be eroded if they chose to raise prices in order to pay higher wages. On the other hand, it was pointed out that the companies that had paid down their debt in recent years would have more scope to absorb wage increases than in 2011.

The Committee was also of the view that the impact of large pay increases on inflation could be underestimated because the labour market situation had already begun to affect inflation expectations. Inflation could therefore increase rapidly, as it did following the 2011 wage settlements. The effects could even surface more quickly now, given that the spare capacity in the economy was all but absorbed, whereas in 2011 there was still some slack remaining.

MPC members agreed that the inflation outlook had deteriorated since the Bank's last forecast, although inflation was still low and slightly negative year-on-year if housing costs were excluded. According to the Bank's baseline forecast, inflation would rise above target at the beginning of 2016, about half a year earlier than was projected in February. Committee members also considered it more likely that inflation would overshoot the current forecast rather than fall below it, particularly in view of developments in wage negotiations after the forecast was prepared.

As before, the Committee was of the view that low global inflation and a stable króna had contained inflation and offset the effects of considerable domestic wage increases. They

agreed, however, that the likelihood of a favourable interaction between low imported inflation and moderate wage settlements appeared negligible at present. They were also concerned that inflation expectations had risen after having subsided to target at the beginning of the year, marking an easing of the monetary stance since the March meeting.

The Bank's interest rate reductions late in 2014 were based on a sharp drop in inflation and the decline in inflation expectations, which had led to a larger rise in real rates than was considered warranted at that time by economic conditions and the near-term outlook. Members noted that, in previous MPC statements, the Committee had reiterated that large pay increases and strong growth in demand could undermine the recently achieved price stability and require that interest rates be raised again. The Committee was of the view that recent developments in wage negotiations, in conjunction with the increase in inflation expectations and indications of strong growth in demand, suggested strongly that such conditions could be materialising. Members did not agree on whether this situation called for an immediate rate increase or whether it would be better to wait and see to what extent pay increases were larger than was consistent with the inflation target. They agreed on the need to communicate the Committee's concerns explicitly, however.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 4.5%, the current account rate 4.25%, the seven-day collateralised lending rate 5.25%, and the overnight lending rate 6.25%.

Four Committee members voted in favour of the proposal. In their opinion, it did not matter whether interest rates were raised immediately or in June, after the labour market outlook had been clarified, as the Committee's statement would send an explicit message warning of an expected rate increase, the effects of which would surface immediately in the bond market. The possibility could not be excluded that a message from the MPC could affect wage settlements, so that pay increases might be smaller than the current situation suggested. Furthermore, a clear message in the MPC statement would better prepare market agents for a rate increase.

One member voted against the Governor's proposal, voting instead for an immediate rate increase of 0.5 percentage points. This member was of the view that, irrespective of the outcome of wage negotiations, conditions in the economy already called for a tighter monetary stance. Inflation expectations had risen somewhat, and economic activity appeared to be picking up strongly. The outlook was for more than 6% growth in domestic demand and GDP growth over 4%, at a time of rapid growth in employment. In addition, the outline of the forthcoming wage settlements were by now clear enough that it was obvious that pay increases would be far larger than is consistent with the Bank's inflation target and its baseline forecast. As a result, it was necessary to take the first step towards a tighter monetary stance immediately, as further interest rate increases would be necessary at the MPC's upcoming meetings.

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 10 June 2015.



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, June 2015

Published 24 June 2015

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 8 and 9 June 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 10 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 13 May interest rate decision.

Financial markets

The exchange rate of the króna had risen by 0.4% in trade-weighted terms and by 1.9% against the pound sterling but had fallen by 0.6% against the euro and the US dollar since the May meeting.

The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 87 million euros (roughly 12.9 b.kr.) between meetings, or 51% of total market turnover. Purchases year-to-date totalled 395 million euros (58.8 b.kr.), considerably more than over the same period in 2014.

Financial institutions’ liquidity has remained abundant vis-à-vis the Central Bank, and overnight rates in the interbank market for krónur have been below the centre of the interest rate corridor, close to the Bank’s key interest rate. Interbank market turnover totalled 188.5 b.kr. year-to-date, which is considerably more than in the same period in 2014 but somewhat below the level seen in the same period of the three preceding years.

Yields on nominal Treasury bonds had risen by 0.1-0.7 percentage points since the May meeting. The greatest increase was in the shortest bonds. Yields on indexed Treasury and Housing Financing Fund bonds were broadly unchanged. Yields on nominal Treasury bonds had risen by 1-1½ percentage points year-to-date, while indexed bond yields had fallen by about ½ a percentage point.

The average of the lowest listed nominal mortgage rates offered by the three large commercial banks had risen slightly since the May meeting. Comparable rates on nominal variable-rate loans and indexed loans had remained unchanged, however.

The monetary stance had eased since the May meeting, owing primarily to higher inflation expectations. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.2% at the time of the June meeting. In terms of past twelve-month inflation, however, it was 2.8%. This is some 0.2-0.5 percentage points lower than just after the May interest rate decision and about 0.8-1.1 percentage points lower than just after the decision in March.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by the US and Germany, was about 1.2-1.7 percentage points, slightly higher than at the time of the May meeting. The CDS spread on five-year Treasury obligations was virtually unchanged between meetings, at 1.6%.

Financial market analysts had all predicted a 0.5 percentage point increase in the Central Bank's nominal interest rates in June, citing rising inflation expectations, the outcome of labour market negotiations, and the fiscal measures taken by the Government in connection with wage settlements.

M3 grew by just over 12% year-on-year in April, but by about 6.4% adjusted for deposits held by the failed banks' winding-up boards.

Net new lending from DMBs to resident borrowers totalled almost 70 b.kr. in the first four months of the year, an increase of 38% year-on-year. Net new corporate lending totalled 51 b.kr., about a third more than over the same period in 2014. Net new DMB lending to households totalled 12 b.kr. over the same period. Prepayments of older household loans during the period are due largely to the Government's debt relief measures.

The NASDAQ OMXI8 index had risen by 3.3% between meetings and by 3.8% when adjusted for dividend payments. Turnover in the main market totalled nearly 134 b.kr. during the first four months of 2015, an increase of just under 18% year-on-year.

Outlook for the global real economy and international trade

According to the Organisation for Economic Co-operation and Development's (OECD) June forecast, GDP growth will be somewhat weaker in 2015 and 2016 than in the OECD's November forecast. Global GDP growth is expected to decline from last year's rate of 3.3% to 3.1%, some 0.6 percentage points less than was forecast in November. Global output growth is forecast at 3.3% in 2016. The outlook for world trade in 2015-2016 is also slightly weaker. The OECD forecast for 2015 GDP growth among Iceland's main trading partners is about 0.1 percentage point lower than was assumed in November, or 1.8%. Trading partner inflation is projected at 0.6% this year, about 0.6 percentage points below the November forecast, owing to lower oil prices.

According to preliminary figures from Statistics Iceland, Iceland's surplus on goods trade totalled 200 m.kr. in May, as opposed to 5.2 b.kr. at constant exchange rates in May 2014. Over the first five months of the year, import values rose 21% year-on-year, or 13.5% excluding imports of ships and aircraft. Import growth is attributable primarily to a doubling of transport equipment values and an increase of over a fifth in the value of commodities and operational inputs. Export values rose by 21.5% over the same period, owing mainly to a one-third increase in the value of industrial exports.

Aluminium prices have fallen 8.6% since the MPC's May meeting and were down by an average of 6.1% year-on-year in the first week of June. Foreign currency prices of marine products had risen by 1.4% month-on-month in April and by 11.3% in the preceding twelve months.

In terms of relative consumer prices, the real exchange rate rose 0.2% month-on-month in May, to 85.2 points. It was up 1.5% year-on-year in the first five months of 2015, due mainly to the fact that inflation in Iceland was 0.8 percentage points above the average for Iceland's trading partners, whereas the nominal exchange rate rose by 0.6% over the same period.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in June, GDP growth measured 2.9% for the first quarter the year. Seasonally adjusted quarter-on-quarter GDP growth measured -1.2%, according to Central Bank figures. GDP growth for the period was somewhat weaker than in the forecast of 4.6% published in the May Monetary Bulletin. Growth for the quarter was driven by domestic demand, with consumption and total investment up by 6.4%. Even though growth was quite strong it was below the May forecast. Inventory changes increased markedly as well, owing primarily to an increase in marine product inventories. As a result, total domestic demand rose by 9.9%.

The contribution from net trade was negative, as import growth far outpaced export growth. This is due in part to the fact that a large portion of marine products were recognised as inventory changes and not as exports. In addition, imports of ships and aircraft were significant during the period, although these import items are also recognised as investment and therefore have very limited impact on overall GDP. The contribution from net trade was weaker than was provided for in the Bank's May forecast, primarily because of marine products allocated to inventories, as is mentioned above; furthermore, price increases were underestimated in the Bank's forecast of export values.

The underlying current account balance was positive by 10.4 b.kr., or 2% of GDP, in Q1. This is smaller than in the preceding quarter but larger than in Q1/2014, when the surplus measured 1% of GDP. The surplus this year is due primarily to a surplus on services trade of 17.9 b.kr., excluding the effects of the DMBs in winding-up proceedings; however, it is offset by a 2.1 b.kr. deficit on goods trade and a 5.4 b.kr. deficit on the underlying balance on primary and secondary income. Revised year-2014 figures show a larger surplus than was previously estimated, or 5.5% of GDP.

Key indicators of private consumption at the beginning of Q2/2014 suggest continued strong private consumption growth during the quarter. Payment card turnover increased by just over 3½% year-on-year in April, and new motor vehicle registrations in April and May

were up roughly a third year-on-year. Offsetting this, growth in groceries turnover was much weaker.

According to the Statistics Iceland labour force survey (LFS), labour demand continued to grow in April. Seasonally adjusted unemployment measured 4.2%, a decline of $\frac{1}{2}$ a percentage point between years. Unemployment year-to-date was about 1.2 percentage points lower than during the same period in 2014.

The wage index rose by 0.2% month-on-month in April and by 5.2% year-on-year. According to the index, real wages rose 3.7% over the same period.

According to the Gallup survey conducted among Iceland's 400 largest firms in May and June, executives were considerably more pessimistic about the economic situation than they were in March 2015 and June 2014. Executives in all sectors were more pessimistic than in the March survey. Expectations about both domestic and foreign demand were somewhat weaker than in the previous survey.

According to the survey, firms interested in recruiting staff outnumbered those planning redundancies by just over 5 percentage points. This is somewhat of a departure from the previous surveys, which indicated that firms interested in recruiting outnumbered those interested in downsizing by about 15 percentage points. The change is primarily because the number of firms planning to lay off staff has risen since the last survey. Compared with the last survey, more firms are planning laying off staff in all sectors except transport, and tourism. Among construction firms, however, the number of firms planning to recruit additional workers exceeded the number planning to downsize by over 40%, and transport, and tourism, the number of firms planning recruitment exceeded the number planning to cut staffing levels by about a fourth. The percentage of companies that report labour shortages is highest in these sectors, with nearly 20% reporting a shortage of workers. This percentage has risen steadily, adjusted for seasonality, since Q3/2013. Most companies planned to keep their staffing levels unchanged in the next six months, however. Firms selling their products overseas were considerably more positive about adding on staff than those selling their products domestically.

The Gallup Consumer Sentiment Index measured 83.3 points in May, slightly lower than in April and lower than in May 2014 as well. It was the first year-on-year decline since May 2014.

Statistics Iceland's nationwide house price index, published in late May, rose 0.2% month-on-month when adjusted for seasonality, but rose 7.6% year-on-year. Because of the strike among lawyers at the capital area Commissioner's offices, no purchase agreements have been registered since 6 April; therefore, Registers Iceland has published neither the house price index nor figures on housing market turnover in the greater Reykjavík area for the month of April.

The consumer price index (CPI) rose by 0.28% month-on-month in May, raising twelve-month inflation by 0.2 percentage points since April, to 1.6%. It can be assumed that twelve-month inflation is underestimated by nearly 0.2 percentage points because of the above-mentioned shortage of data on house prices. Twelve-month inflation excluding housing measured 0.3% but had been negative from November 2014 through April. By most measures, underlying twelve-month inflation was unchanged in May. In terms of core index 3 excluding tax effects, it measured 1.6%. According to various statistical measures, underlying inflation lay in the 1.6% to 2.3% range, but $3\frac{1}{2}\%$ in terms of the dynamic factor model.

Food prices rose by nearly 1% month-on-month, accounting for about half of the rise in the CPI. The housing component was up 0.2% in May, due mainly to an increase in paid rent. This was the smallest increase since November 2014, largely because of the aforementioned strike among lawyers at Commissioners' offices in the greater Reykjavík area. As a result of the strike, the market value of capital area housing was not based on new measurements.

According to the Gallup survey of household inflation expectations, carried out in May, respondents expect inflation to measure 4% one year ahead, an increase of 1 percentage point from the March survey. In the two previous surveys, however, households' expectations had fallen. Their expectations of inflation two years ahead were unchanged in the May survey, at 4%. According to a comparable survey carried out among executives in May and June, respondents' inflation expectations one year ahead also measured 4%, an increase of 1 percentage point since the March survey. The short-term breakeven inflation rate in the bond market had also risen since the MPC's May meeting. The two-year breakeven rate measured 4½% just before the June meeting and had risen by ½ a percentage point between meetings. The five- and ten-year breakeven rates were unchanged, however, at 5%. Since January, however, the increase has averaged just over 1½ percentage points.

II The interest rate decision

MPC members discussed whether developments since the previous meeting had changed the Committee's assessment of the required monetary stance and whether the outlook had changed. At the last meeting, members had agreed that the outcome of labour negotiations, the rise in inflation expectations, and indicators of robust demand growth suggested a need to tighten the monetary stance. Members were of the view that developments between meetings had not change this assessment. On the contrary, they agreed that, even though inflation was still low, the inflation outlook had deteriorated markedly in comparison with the Central Bank's last forecast.

The Committee discussed the results of the wage settlements that had been signed and were of the view that they would probably set a precedent for other agreements. In the Committee's view, it was clear that the pay increases provided for in the wage settlements already signed were larger than in the scenario considered at the May meeting, which was based on the Confederation of Icelandic Employers' offer to the labour unions. In May, the Committee had agreed that such an outcome would call for significant interest rate increases if long-term price stability were to be ensured.

In addition, members were concerned that most measurements of inflation expectations that had been published since the last meeting showed a continued increase. The monetary stance had therefore eased since the May meeting.

Committee members were of the view that the measures announced by the Government in order to facilitate wage settlements were not yet funded with expenditure cuts or increased Treasury revenues. If no such funding were forthcoming, it would entail a relaxation of the fiscal stance and contribute to tension in the economy and generate inflationary pressures.

Members also discussed the effects of the measures recently announced by the Government and the Central Bank to prepare for capital account liberalisation. As some of

the measures would generate revenues for the Treasury, Committee members considered it important that those revenues not be allocated in ways that would stimulate the economy still further; i.e., by activating the hitherto sterile component of money holdings. Members considered it necessary to monitor developments closely and agreed to take appropriate countervailing measures if necessary.

In the Committee's opinion, economic activity year-to-date was broadly in line with the Bank's May forecast. Members discussed newly published Q1/2015 national accounts figures from Statistics Iceland, which indicated that GDP growth was 2.9%, consumption and investment had grown 6.4%, and total domestic demand had increased by nearly 10%. Although growth in economic activity appears somewhat weaker than according to the May forecast, MPC members saw no reason to change its assessment of economic developments. It was pointed out that the first publication of national accounts figures was usually accompanied by considerable uncertainty and that indicators implied more strength in the labour market than had been projected in May.

Members agreed that the outlook for developments in wage costs, the increase in inflation expectations, and indicators of robust demand growth made it unavoidable to respond to the worsening inflation outlook immediately, even though inflation was still below target. All members were of the opinion that it was appropriate to raise interest rates by at least 0.5 percentage points and that there were solid arguments for continuing rate increases. They did not agree, however, on how rapid the adjustment of the monetary stance should be.

The main arguments presented at the meeting in favour of a rate increase of 0.5 percentage points at this time were that inflation was still low and that it was not yet clear to what extent wage increases would be passed through to prices or to what extent firms would respond with streamlining, nor was it clear how much wage drift there would be in the wake of the wage settlements. Measurements indicating the first effects of the wage settlements on inflation would be available by the MPC's next meeting, as would the Bank's updated forecast. It was also pointed out that explicitly signalling upcoming rate hikes would prepare the market for them. To an extent, the effects of the announced interest rate increases would surface immediately, as was the case with the Committee's previous statement, which had an immediate effect on the bond market.

On the other hand it was pointed out that there was a risk that monetary policy was responding too little and too late. The momentum in the economy had already called for a tighter monetary stance by the time of the May meeting, irrespective of the outcome of labour negotiations, and that the case for monetary tightening had strengthened still further, as the stance had eased between meetings because of increased inflation expectations. This was compounded by the fact that recent wage increases had been larger than had been anticipated at the last meeting.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.5 percentage points, which would raise the Bank's key rate (the seven-day term deposit rate) to 5%, the current account rate to 4.75%, the seven-day collateralised lending rate to 5.75%, and the overnight lending rate to 6.75%. Four Committee members voted in favour of the Governor's proposal. One member would have preferred to raise interest rates by 0.75 percentage points at this time but, was willing to vote in favour of the Governor's proposal. One member voted against the Governor's proposal, voting instead to raise interest rates by 1 percentage point.

Committee members agreed that it seemed apparent that a sizeable rate increase would be necessary in August, followed by further rate hikes in the coming term, so as to ensure price stability over the medium term. They also agreed that it was appropriate to send a clear message to this effect with the June statement.

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 August 2015.



March 27, 2001

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

(From March 27, 2001 – as amended by agreement 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.