SEÐLABANKI ÍSLANDS

MONETARY POLICY COMMITTEE REPORT TO ALTHINGI

2013 • 1

Monetary Policy Committee report to Parliament

5 July 2013

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

The Act requires that the MPC meet at least eight times each year. Since the last Report was sent to Parliament, the Committee has held four regular meetings, the last of them on 12 June, and two extraordinary meetings. The following report discusses the work of the Committee between January and June 2013.

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 Central Bank is also obliged to promote a safe and effective financial system, including domestic and cross-border payment systems. 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 that are intended to influence the exchange rate of the króna. The decisions of the MPC must be based on a thorough assessment of economic and monetary developments and prospects 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.

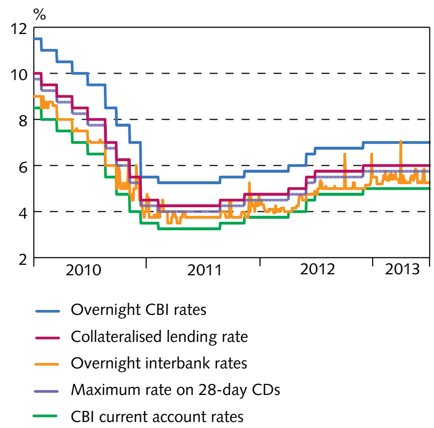
Table 1. Central Bank of Iceland interest rates 2013 (%)

Date	*Current account*	*28-day CDs (maximum)*	*7-day collateral lending rate*	*Overnight lending rate*
12 June	5.00	5.75	6.00	7.00
15 May	5.00	5.75	6.00	7.00
20 March	5.00	5.75	6.00	7.00
6 February	5.00	5.75	6.00	7.00

Chart 1

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

Daily data 1 January 2010 - 28 June 2013

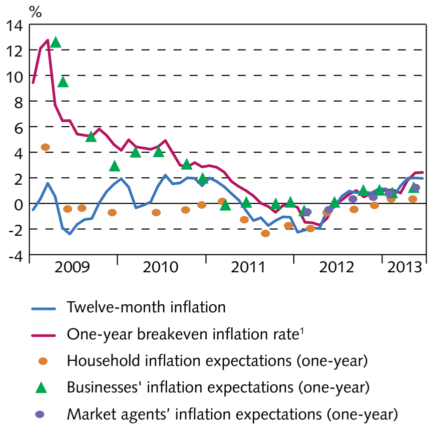


Source: Central Bank of Iceland.

Chart 2

Central Bank of Iceland real interest rates

January 2009 - June 2013



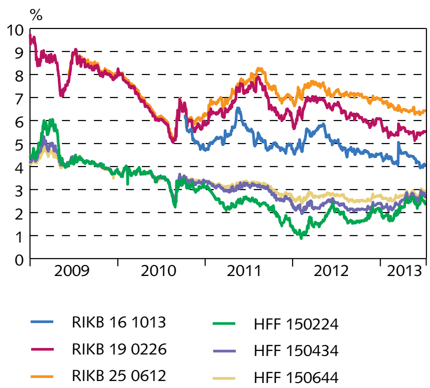
1. Real interest rates according to breakeven inflation rate are calculated based on the difference between the nominal and indexed yield curves (monthly average). Until April 2009, the Bank's effective policy rate was the seven-day collateralised lending rate, and from April to September 2009 it was the current account rate. Since September 2009, the effective policy rate has been the average of the current account rate and the maximum rate on 28-day CDs.

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

Chart 3

Bond yields

Daily data 2 January 2009 - 28 June 2013



Source: Central Bank of Iceland.

Developments from January to June 2013

The Central Bank's Monetary Policy Committee has held the Bank's interest rates unchanged since November 2012. The collateralised lending rate has therefore remained unchanged at 6%, the current account rate at 5%, the maximum rate on 28-day CDs 5.75%, and the overnight lending rate 7% (see Table 1 and Chart 1). Because financial system liquidity is relatively abundant, financial firms' demand for Central Bank liquidity facilities is limited, and the Bank's effective policy rate therefore lies close to its deposit rate. Calculated as the simple average of the interest rate on financial institutions' current accounts with the Central Bank and the maximum CD rate, the effective policy rate was therefore just under 5½% as of end-June 2013.

Even though the Bank's nominal interest rates have been unchanged since November 2012, the monetary stance has tightened in tandem with falling inflation and inflation expectations. The Bank's effective real policy rate is now about 2% in terms of the current inflation level and about 1½% in terms of the average of several measures of inflation and inflation expectations, or just over 0.7 percentage points higher than at the beginning of this year and roughly 1.7 percentage points higher than it was a year ago. The long-term real rate in the bond market has developed broadly in line with the Bank's interest rates. In the recent term, the Bank's real effective rate has been below that which could be assumed consistent with the inflation target once the slack has disappeared from the economy, and it has therefore supported the economic recovery.

Both at regular meetings and at its extraordinary meetings in January and April, the MPC discussed ways to make increased use of foreign exchange market intervention as one of the Bank's monetary policy instruments, in accordance with Article 24 of the Act on the Central Bank of Iceland, no. 36/2001,[1] which stipulates that the Committee shall take decisions on the application of the Bank's monetary policy instruments. The Act defines foreign exchange market transactions aimed at affecting the exchange rate of the króna as one of those instruments. Increased foreign exchange market intervention is also in line with the Bank's proposal for improvements to the inflation targeting framework (see, for example, the discussion in "Monetary Policy in Iceland After Capital Controls", Central Bank *Special Publication* no. 4, December 2010).

The Committee decided to step up foreign exchange market intervention because, beginning last summer, the exchange rate had been more volatile than in preceding quarters. It has fluctuated somewhat less than many other floating currencies, however, and

1. Article 24 [Decisions on applying the Central Bank's monetary policy control mechanisms shall be taken by the Monetary Policy Committee. In this context, the Bank's monetary policy control mechanisms include decisions on interest rates, transactions with credit institutions other than those listed in the second paragraph of Article 7, a decision on reserve requirements as provided for in Article 11, and currency market transactions as provided for in Article 18, intended to influence the ISK exchange rate. Decisions by the Monetary Policy Committee must be based on the Bank's objectives and a thorough assessment of the current situation of and outlook for the economy and monetary issues and financial stability.] http://www.althingi.is/lagas/nuna/2001036.html.

the spread between high and low values has not been wider than the norm. In the Committee's opinion, the objective of Central Bank intervention is not to maintain a given exchange rate level but to equalise foreign exchange market flows, and in that way attempt to mitigate volatility, and reduce the risk that self-fulfilling expectations will exacerbate volatility stemming from temporary factors. The Committee has been of the opinion that, through intervention, it is possible to facilitate earlier adjustment of the domestic price level to the currency appreciation from the first half of the year and thereby reduce inflation expectations. As before, the Central Bank will follow the general rule of expanding its non-borrowed reserves by buying foreign currency in the market, although this is a long-term objective.

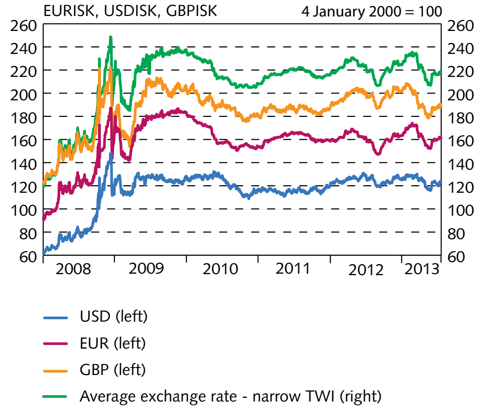
In the first half of 2013, the Central Bank of Iceland sold foreign currency for 7.1 b.kr. with direct intervention in the interbank foreign exchange market. In addition, the Bank concluded a forward three-month contract with Landsbankinn on 18 February 2013, according to which the Central Bank sold foreign currency to Landsbankinn in the amount of around 6 b.kr. in three separate transactions. From August 2010, when the Bank began buying foreign currency on a regular basis, until 4 January 2013, when it announced the temporary suspension of the purchase programme, its direct purchases totalled 59.7 b.kr.

The króna has appreciated by just over 7% in trade-weighted terms year-to-date. It had appreciated by over 12% by the beginning of May, but it has weakened by roughly 4½% since then. The appreciation in the first half of the year can be viewed in the context of the MPC's decision to step up foreign exchange market intervention.

Since the MPC sent its last report to Parliament, annual inflation according to the CPI has fallen by just over a percentage point, measuring 3.3% in June. Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense) has declined somewhat less, measuring 3.5% in June. Underlying inflation according to core index 4, which also excludes the market price of housing, measured 3.2%, down from 3.8% in December 2012. In the first two quarters of 2013, increases in the price of private services and increased housing costs were the principal drivers of inflation. The appreciation of the króna and the drop in petrol prices had an offsetting effect, however.

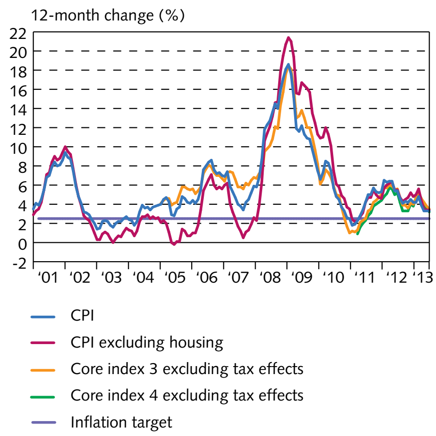
At the June meeting the MPC discussed the uncertainty about the path public sector finances would take in coming years. The MPC considered it critical that Treasury finances be brought into balance as soon as possible so that the monetary and fiscal policy mix would contribute to external balance of the economy, foster overall economic stability, and deliver inflation close to target, at the lowest possible cost.

Chart 4
Exchange rate of the króna
Daily data 3 January 2008 - 28 June 2013



Source: Central Bank of Iceland.

Chart 5
Various inflation measurements[1]
January 2001 - June 2013



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

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from February 2013 to the present
2. Minutes of Monetary Policy Committee meetings from February 2013 to the present
3. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001

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

Már Guðmundsson

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

Statement of the Monetary Policy Committee
6 February 2013

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

Recent economic indicators suggest that output growth was weaker in 2012 than previously anticipated, and the outlook for 2013 is for more modest growth than was forecast in November. Total hours worked have also risen less than previously forecast. Although a slower rate of growth will ease inflationary pressures somewhat as the forecast horizon progresses, near-term inflation is projected to be higher than was forecast in November, owing to a weaker króna. The inflation outlook for the forecast horizon as a whole is therefore broadly unchanged since then.

In the recent term, poorer terms of trade have reduced the trade surplus at a time of extensive currency accumulation for foreign loan payments. The króna has depreciated as a result. There is considerable uncertainty about the persistence of these effects and therefore about near-term exchange rate developments. There is also the risk that self-fulfilling expectations of a depreciation will weaken the króna still further. In view of these conditions, the Central Bank has decided to suspend its programme of regular foreign currency purchases for the time being and support the króna through foreign exchange intervention.

The accommodative monetary stance has supported the economic recovery in the recent term. The rise in interest rates in the past year and a half and the decline in inflation have withdrawn a considerable amount of that accommodation. As spare capacity disappears from the economy, it is necessary that monetary policy slack should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments, which in turn will depend on exchange rate movements and wage-setting decisions in the near future.

Statement of the Monetary Policy Committee 20 March 2013

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

Preliminary national account figures for 2012 suggest weaker growth than was forecast in February. Year-2011 growth figures have been revised upwards, however. The outlook is still for a gradual economic recovery, and leading indicators from the labour market are consistent with that prospect. Inflation, however, proved considerably higher in February than previously anticipated. On the other hand, the króna has appreciated from February onwards.

The Bank's decision to suspend its programme of regular foreign currency purchases and support the exchange rate of the króna with foreign exchange intervention has, together with other measures, proven effective. The Bank's actions have reduced the risk that self-fulfilling expectations of a depreciation will weaken the króna still further, and in this way they have supported monetary policy.

Although the economic recovery has lost some pace for the present, the margin of spare capacity in the economy has continued to narrow. The accommodative monetary stance supports the economic recovery. If inflation declines more slowly than was previously forecast, it will be necessary to reduce the monetary slack sooner than would otherwise be required. It is still the case that as spare capacity disappears from the economy, it is necessary that monetary policy slack should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments, which in turn will depend on exchange rate movements and wage-setting decisions in the near future.

Statement of the Monetary Policy Committee 15 May 2013

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

In line with weaker output growth globally, output growth has slowed down in Iceland and terms of trade have deteriorated. In 2013 and throughout the forecast horizon, the outlook is for output growth to be somewhat weaker than the Bank projected in February, albeit close to the 30-year average. The recovery in the labour market continues, with employment increasing and declining unemployment. Inflation has tapered off, in line with the Bank's forecasts, and now measures 3.3%. Measures of underlying inflation and inflation expectations are higher, however. Nonetheless, inflation is expected to reach the inflation target earlier than previously anticipated, with weaker output growth and a stronger króna offsetting larger wage increases and weaker productivity growth.

Inflation is now closer to target than it has been since it began rising in the wake of the spring 2011 wage settlements. Uncertainty about near-term exchange rate developments could contribute to more persistent inflation expectations, however, and slow down the disinflation process following this year's appreciation of the króna. Foreign exchange mismatches in financial institutions' balance sheets have been reduced recently, and the exchange rate of the króna has been close to a level that, other things being equal, could be considered sufficient to bring inflation back to target in the near term. The MPC is of the opinion that these conditions create the premises for increased Central Bank activity in the foreign exchange market in the near future, with the aim of reducing exchange rate fluctuation vis-à-vis recent levels of the exchange rate. This is in line with prior MPC statements emphasising the importance of using all of the monetary policy instruments at its disposal to promote price stability.

As circumstances permit, the Bank will attempt to increase its non-borrowed reserves. Increasing the non-borrowed reserves is a long-term goal, however, and the implementation of that aim depends on both the strength of the króna and movements in the exchange rate, which are determined in part by capital movements that vary in their predictability. The Bank's foreign exchange purchases will therefore take into account the strong tendency among other agents for foreign debt deleveraging, particularly while inflation remains above target. In line with this policy, the foreign currency that would be purchased to respond to temporary – in some instances, seasonal – inflows would then be used to support the króna when the currency flows reverse.

The MPC expects this policy to facilitate speedier adjustment of the domestic price level to a stronger króna and to reduce inflation expectations. In that case, the inflation target could conceivably be reached earlier than is forecast, although this depends on other factors as well. If there are major changes in external conditions or if other aspects of economic policy undermine economic stability, the foreign exchange market intervention policy will be reviewed. Particular attention will be given to fiscal policy and to whether wage settlements and wage developments are consistent with the inflation target. Before decisive steps are taken to lift controls on capital outflows, it will be necessary to re-evaluate this policy. The same applies if decisions are taken concerning the monetary policy framework.

Although the economic recovery has lost some pace for the present, the margin of spare capacity in the economy has continued to narrow. The accommodative monetary stance has supported the economic recovery in the recent term. It is still the case that as spare capacity disappears from the economy, it is necessary that slack in monetary policy should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements. In addition, monetary policy must at all times take account of fiscal policy and other factors that affect demand.

Statement of the Monetary Policy Committee 12 June 2013

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

GDP growth appears to have been somewhat weaker in the first quarter than was forecast in the May issue of *Monetary Bulletin*. It is too early to assert that the growth outlook for the year as a whole has deteriorated, however, because more often than not, output growth figures are revised upwards after the first estimates are published; furthermore, the most recent indicators of demand suggest that the economic recovery is developing broadly in line with the Bank's forecast.

The inflation outlook has changed little since the May forecast. Inflation has declined in recent months and now measures 3.3%. Underlying inflation and inflation expectations have declined as well but remain above the Bank's inflation target.

The exchange rate of the króna has been broadly unchanged since the last MPC meeting. The Bank's foreign exchange market intervention policy formulated by the MPC appears to have contributed to greater exchange rate stability and is therefore conducive to providing a firmer anchor for inflation expectations and promoting more rapid disinflation than would occur otherwise.

Monetary policy must always take account of fiscal policy and other factors that affect aggregate demand. There is some uncertainty about the path public sector finances will take in coming years. It is critical that Treasury finances be brought into balance as soon as possible so that the monetary and fiscal policy mix contributes to external balance of the economy, fosters overall economic stability, and delivers inflation close to target, at the lowest possible cost.

The accommodative monetary stance has supported the economic recovery in the recent term. It is still the case that as spare capacity disappears from the economy, it is necessary that slack in monetary policy should disappear as well. The degree to which such normalisation takes place through changes in nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

February 2013

Published 20 February 2013

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

The following are the minutes of the MPC meeting held on 4 and 5 February 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 6 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 12 December interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2013/1 on 6 February.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 2.6% lower at the time of the February meeting than at the December meeting. Between meetings, the króna had depreciated by 4.4% against the euro and by 0.1% against the US dollar but had appreciated by 1.8% against the pound sterling. Offshore trading was sparse and the offshore exchange rate broadly unchanged.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market were 0.1-0.75 percentage points above current account rates.

Interbank market turnover totalled 399 b.kr. in 2012, having decreased by 67 b.kr. from the previous year. It continued to contract year-on-year in January.

The five-year breakeven inflation rate in the bond market was slightly over 4% just before the MPC meeting, after falling slightly since the December meeting. The five-year breakeven inflation rate five years ahead was virtually unchanged between meetings, however, and also measured just over 4%. The results of the Central Bank's recent survey indicated that market participants expected inflation to average 4.5% over the next five years (see below for further discussion of the Central Bank survey).

The effective nominal policy rate can be estimated to lie very close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the real policy rate averaged 0.9% at the time of the February meeting, which was unchanged since the December meeting. In terms of twelve-month inflation and the breakeven inflation rate in the bond market, however, it had risen by 0.3 percentage points, to just over 1%.

The CDS spread on the Republic of Iceland was 1.7 percentage points at the time of the February meeting and had not changed between meetings, in spite of the EFTA Court ruling in the Icesave case. The risk premium on Treasury obligations, as expressed in terms of the spread between interest rates on the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, had fallen by 0.8 percentage points for five-year bonds and by 0.6 percentage points for 10-year bonds.

Unchanged Central Bank interest rates in February appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most analysts cited the slowdown in the economic recovery, the recent decline in inflation, and the extension of wage agreements without additional pay increases as grounds for unchanged rates.

The Central Bank conducted its market expectations survey between 29 January and 1 February. According to the median response, market participants expect interest rates to remain unchanged in the first half of the year but to be 0.25 percentage points higher by year-end, which is lower than in a comparable survey carried out in November. The majority of market participants considered the monetary stance appropriate at the time the survey was carried out.

M3 contracted by 1.1% month-on-month in December and by 1.6% year-on-year in Q4/2012. Excluding holding company deposits, however, M3 grew by 0.8% between years in Q4. The year-on-year contraction in the money supply is probably due primarily to residents' using savings to pay down loans and invest in other asset classes, and to the sale of assets acquired by deposit money banks (DMBs) in the wake of the financial crisis.

Outlook for the global real economy and international trade

In its most recent forecast, published in January, the International Monetary Fund (IMF) revised its estimates for global output growth in 2013 and 2014 slightly downwards from its October forecast. The forecast for world trade was revised sharply downwards for 2013, but less so for 2014. The IMF now anticipates somewhat weaker output growth in major industrialised and emerging economies apart from Japan, China, and Mexico, whose forecasts are unchanged from October. The forecast for inflation in industrialised countries is unchanged since October, while the inflation forecast for emerging economies has been revised upwards by 0.3 percentage points for 2013 and 0.2 percentage points for 2014. The year-2013 output growth forecast for Iceland's main trading partners is 0.2 percentage points lower than was assumed in the October forecast, at 1.1%. Consensus Forecasts' year-2013 projections for Iceland's trading partners are unchanged since the December MPC meeting.

The goods trade surplus measured nearly 3.5 b.kr. in December. Export values fell 18% month-on-month in December, the largest decline since April 2011. Import values fell by 9% between November and December. Export values contracted by 20% year-on-year, while import values contracted nearly 26%. Excluding irregular items such as ships and aircraft, however, import values were down 11½%. The goods trade surplus for 2012 as a whole totalled 78 b.kr., a decrease of 23 b.kr. from the previous year. Total export values fell by just under ½% year-on-year in 2012, while total import values rose 3.7%. The strongest components of imports in 2012 were commodities and operational inputs, on the one hand, and consumer goods, on the other. These two items accounted for 28% and 24%, respectively, of total import values. Commodity and operational input values contracted by 6½% between years, while consumer goods values rose by the same amount. As in 2011, the value of transport equipment and fuel rose most, or by 57% and 8%, respectively. The largest subcomponent of exports in 2012 was industrial goods, which accounted for 52% of total export values. Aluminium represented 68% of industrial export values. The export value of marine products rose 4½% year-on-year. Marine products constituted 43% of exports. According to preliminary figures, the goods trade surplus totalled 11.6 b.kr. in January 2013.

Aluminium prices had fallen since the last MPC meeting, with average prices just over 2% lower in January than in December. Marine product prices have fallen for three consecutive months, with the month-on-month decline measuring 0.8% in November.

The domestic real economy and inflation

The National Budget for 2013 was approved with a deficit of 3.7 b.kr. or 0.2% of GDP and is largely consistent with the original budget proposal as regards performance, although revenues and expenditures are higher by 9 b.kr. and 10 b.kr., respectively. The surplus on the primary balance is unchanged from the original budget proposal.

According to the Statistics Iceland labour market survey, growth in labour demand was somewhat weaker in Q4/2012 than in the forecast published in the November issue of *Monetary Bulletin*. The November forecast provided for a 2.2% year-on-year increase in total hours worked, while the actual increase was 1.2%. The rise is due to a 2% increase in the number of employed persons, while average hours worked contracted (by 0.8%), as they had in the two preceding quarters. The number of employed persons rose by 1.1% year-on-year in 2012, total hours worked rose 0.4%, and employed persons as a share of the total labour force increased by 0.8 percentage points. Labour supply was virtually unchanged between years, however.

Developments in unemployment as recorded by the Directorate of Labour (DoL) were in line with the last Central Bank forecast. Seasonally adjusted unemployment measured 5.5% in Q4/2012 and 5.8% for the year as a whole. Seasonally adjusted unemployment as measured by the Statistics Iceland labour market survey was also 5.5% in Q4, but it measured 6% for the year as a whole.

In Q4, the wage index rose by 0.7% between quarters and by 4.9% year-on-year. The average wage index value for 2012 was 7.8% higher than that for 2011.

Indications from the Capacent Gallup survey among executives, carried out in November and December 2012, suggest that, in the next six months, labour demand growth could slow down slightly in comparison with the findings from comparable surveys conducted earlier in the year.

The nationwide Statistics Iceland house price index, published in late January, fell by 0.4% from the previous month but rose by 0.7% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.4% month-on-month in December and by 1.2% when adjusted for seasonality. The number of purchase contracts concluded nationwide in the month of December was up 12% year-on-year, and there was an increase of 18% between 2011 and 2012. The number of purchase agreements is still low in historical context, however.

The main indicators of developments in private consumption suggest slower growth in Q4/2012. Payment card turnover increased by 0.8% in Q4 from the previous quarter but was up 0.5% year-on-year. This is in line with the slowdown in real wage growth in the latter half of the year, as well as the reduction in third-pillar pension savings withdrawals. Consumer sentiment as measured by the Capacent Gallup Consumer Sentiment Index deteriorated in the last months of 2012 but improved again in January.

According to the Capacent Gallup survey of corporate expectations, executives' attitudes towards the economic outlook are more negative than in the previous survey, which was conducted in September 2012. The greatest change was among executives in construction, utility, and retail companies, who considered the outlook poorer than in the last survey. Financial sector executives were somewhat more positive than before, however. Expectations concerning domestic demand also deteriorated between surveys, with over 18% expecting a contraction in the next six months, as opposed to 13% in September. According to the survey, executives' inflation expectations one year ahead measured 4.5%, an increase of 0.3 percentage points from the September survey.

According to the Central Bank's quarterly survey of market expectations, carried out in late January, just before the February *Monetary Bulletin* went to press, market participants expect twelve-month inflation to measure about 4½% one year ahead. They also expect inflation to average 4½% over the next decade. Market participants' inflation expectations had declined slightly since the November survey.

The CPI rose by 0.3% month-on-month in January, after remaining unchanged in December 2012. Annual inflation measured 4.2%, down from 4.5% in November. Core index 3, which excludes the effects of taxes, volatile food items, petrol, public services, and real mortgage interest expense, fell by 0.2% in January. Underlying twelve-month inflation according to core index 3 measured 4.6%, up from 4.1% in November. Inflation averaged 5.2% in 2012, up from 4% in 2011.

The increase in January is due primarily to the rise in the price of public services, new motor vehicles, and groceries, as well as the increase in tobacco taxes. In part, these price increases are due to the recent depreciation of the króna. The counteracting effect from winter sales was stronger this year than last, however.

Although the probability of major shocks such as the dissolution of the euro area or an abrupt increase in fiscal consolidation in the US has declined considerably, the global economic situation is still highly uncertain, and the outlook in Iceland's main export markets has deteriorated somewhat. This appears to have had some impact on the domestic economy in the recent term, although the positive outcome in the Icesave dispute could counteract it somewhat by reducing uncertainty and increasing optimism. The updated forecast in *Monetary Bulletin* 2013/1 therefore assumes that year-2012 output growth measured 2.2% instead of the 2.5% provided for in the Bank's November forecast. The outlook for 2013 has deteriorated as well, with output growth now projected at 2.1% instead of the nearly 3% in the November forecast. The poorer outlook for 2013 is due primarily to slower growth in energy-intensive investment, although slower growth in private consumption also plays a role. The current forecast assumes that a portion of energy-intensive investment will be shifted from 2013 to 2014-15, slightly brightening the output growth outlook for the latter half of the forecast horizon. Output growth is now expected to average approximately 3¾% over those two years, instead of the 3½% assumed in November. Nonetheless, GDP is lower throughout the horizon than in the November forecast.

Although unemployment declined broadly in line with the Central Bank's previous forecast, the increase in total hours worked was somewhat slower than previously assumed. Because of weaker economic activity, total hours worked are expected to rise less and unemployment to fall more slowly than was projected in November.

Private consumption and external trade are projected to contribute most to output growth in 2012 and 2013, while business investment and private consumption are the predominant contributors in the latter half of the forecast horizon. The contribution from net trade is forecast to be negative in 2014-15, particularly because of strong imports related to energy-intensive industrial development.

In keeping with the estimate of weaker output growth in 2012 and 2013 than previously forecast, the output slack is now projected to be larger than was forecast in November, or about 1% of potential output. The slack is expected to diminish in coming quarters and disappear in mid-2014.

The inflation outlook for the forecast horizon is broadly in line with the November forecast, albeit with a weaker króna and more front-loaded wage increases, on the one hand, and relatively weaker economic activity, on the other, than in the last forecast. Inflation is projected at 4% in Q1/2013, which is similar to the last forecast. The November forecast provided for larger increases in indirect taxes than the current forecast. Offsetting these, however, are the effects of the recent depreciation of the króna. Inflation is forecast to average 3.8% this year, slightly more than was projected in November. It is expected to range between 3% and 4% through mid-2014 and then remain in line with the inflation target thereafter, in line with the last forecast.

II The interest rate decision

The Governor informed Committee members of the status of work within the bank and with other authorities regarding the assessment of Iceland's external debt, the resolution of the failed banks' estates, and the liberalisation of the capital controls. He also discussed recent developments in the foreign exchange market and the Bank's intervention. Because of the conditions currently reigning in the foreign exchange market, the Committee had also held an extraordinary meeting on 4 January to review these issues and discuss temporary changes in the Bank's foreign exchange purchase programme and intervention policy.

In trade-weighted terms, the króna had depreciated by 2.6% since the MPC's mid-December meeting. The Bank intervened in the market three times during the interim, selling foreign currency for 4.1 b.kr. Committee members agreed that, because of the capital controls, the exchange rate was determined principally by market flows due to goods and services trade and less by expectations based on the domestic economic outlook and the interest rate differential with other countries. The króna had weakened because, in the recent term, poorer terms of trade had reduced the trade surplus at a time of extensive currency accumulation for foreign loan payments. Looking ahead, foreign currency inflows could be expected to be weaker than previously estimated because, according to the forecast in the *Monetary Bulletin* published on 6 February, terms of trade were likely to be poorer throughout the forecast horizon than in the November forecast. It was clear that foreign currency accumulation by borrowers facing sizeable foreign loan repayments would affect foreign currency outflows, although attempts to lengthen these loans, if successful, should mitigate those effects. The banks still had sizeable foreign exchange mismatches, and the Governor mentioned work that was being done to unwind the imbalances. The Committee also considered there to be some risk that self-fulfilling expectations of a depreciation could weaken the króna still further, for example, because exporters might postpone converting export revenues to krónur.

Because of significant uncertainty about the magnitude and persistence of these effects – and therefore about near-term exchange rate developments – the MPC had determined how the Bank should apply foreign exchange market intervention as one of its tools at its January meeting. According to Article 24 of the Act on the Central Bank of Iceland, no. 36/2001, the Committee shall take decisions on the application of the Bank's monetary policy instruments. The Act also specifies foreign exchange market transactions aimed at affecting the exchange rate of the króna as one of those instruments. It was decided that the Bank would suspend its programme of regular foreign currency purchases for the time being and support the króna through foreign exchange intervention.

In the Committee's opinion, views concerning the inflation target were also important in relation to decisions about the Bank's foreign exchange market intervention. It was necessary to try to prevent excessive depreciation stemming from temporary conditions affecting foreign currency inflows and outflows. Prolonged weakness of the króna could necessitate interest rate increases due to inflation developments at a time of excess slack in the economy.

Committee members agreed that the aim of the Bank's intervention in the market should not be to maintain a given exchange rate level but to equalise foreign exchange market flows, attempt to mitigate excessive volatility, and reduce the risk that self-fulfilling expectations would exacerbate volatility stemming from temporary factors. They also agreed to follow the general rule of trying to increase the Bank's non-borrowed reserves by buying foreign currency in the market when the exchange rate is relatively high and sell it in order to mitigate volatility when the exchange rate is low.

The Committee discussed the possibility of keeping the Bank's interest rates unchanged or raising or lowering them by 0.25 percentage points. The main grounds for keeping interest rates unchanged even though inflation and inflation expectations are still above target were that recent statistics suggested weaker output growth in 2012 than previously assumed and the updated forecast in *Monetary Bulletin* indicated that the outlook for 2013 had deteriorated as well. In addition, the number of hours worked had risen less than anticipated. The inflation outlook was broadly in line with expectations, however. Although a slower rate of growth would ease inflationary pressures somewhat over the course of the forecast horizon, near-term inflation was projected to be higher than was forecast in November, owing to a weaker króna. The main arguments in favour of a rate increase were persistent high inflation and long-term inflation expectations and the need to normalise monetary restraint as the slack in the economy disappeared. Owing to the poorer economic outlook, however, that could take longer than previously assumed. Some Committee members emphasised that, although the weak króna would cause inflation to be slightly higher in the near term than was forecast in November, it was highly likely that the foreign debt refinancing would improve during the year, thereby supporting the króna. If the króna appreciates again later in the year and the slack in the economy is as pronounced as is currently forecast, inflation could taper off quickly. The main reason for a reduction in interest rates was the concern that the domestic recovery could be adversely affected if the global economy should deteriorate further. Committee members also discussed the risk that slower domestic growth would develop into a contraction, but they considered this highly unlikely under current circumstances.

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

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They also agreed that the rise in interest rates in the past year and a half and the decline in inflation had withdrawn a considerable amount of that accommodation. As spare capacity disappeared from the economy, it would be necessary that monetary policy slack should disappear as well. The degree to which such normalisation took place through higher nominal Central Bank rates would depend on future inflation developments, which in turn would depend on exchange rate movements and wage-setting decisions in the near future.

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 20 March 2013.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

March 2013

Published 3 April 2013

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

The following are the minutes of the Monetary Policy Committee meeting held on 19 March 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 20 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 6 February interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 4.5% higher at the time of the March meeting than at the February meeting. Between meetings, the króna had appreciated by about 5.5% against the euro, 5.2% against the pound sterling, and 0.7% against the US dollar. The offshore exchange rate had changed little between meetings, however.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25-0.65 percentage points above current account rates. Turnover in the interbank market has totalled 121 b.kr. year-to-date, which is somewhat of an increase from the same period in 2012.

The five-year breakeven inflation rate in the bond market was 4.2% just before the MPC meeting, after rising slightly since the February meeting. The five-year breakeven inflation rate five years ahead was 3.7% and had fallen by just under 0.4 percentage points between meetings. To some extent, this is probably related to the rise in risk premia on indexed Housing Financing Fund (HFF) bonds following the downgrade of the HFF's credit rating and therefore does not reflect reduced inflation expectations.

The NASDAQ OMX Main List index, OMXI6, had risen by 3.5% between meetings. The market value of the 11 firms currently listed on the main market totalled around 360 b.kr. as of end-2012, or just over 20% of year-2012 GDP.

The effective nominal policy rate can be estimated to lie very close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the real policy rate averaged 0.8% at the time of the March meeting, about 0.1 percentage point lower than at the February meeting. In terms of twelve-month inflation, it had fallen by 0.6 percentage points, and in terms of the breakeven inflation rate in the bond market it had fallen 0.4 percentage points, to 0.5% and 0.7%, respectively.

The Republic of Iceland's sovereign CDS spread had fallen by almost 0.3 percentage points between meetings, to 1.5 percentage points. The risk premium on Treasury obligations, as expressed in terms of the spread between interest rates on the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, had fallen by 0.2 percentage points for five-year bonds, to 1.8 percentage points. For 10-year bonds, the premium had fallen by 0.3 percentage points, to about 2 percentage points.

Unchanged Central Bank interest rates in March appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most market analysts had cited last year's weaker-than-expected output growth and the recent appreciation of the króna and the associated reduction in inflationary pressures as grounds for unchanged interest rates.

Broad money (M3) contracted by 2.3% month-on-month in January and by 8% year-on-year. Excluding holding company deposits, M3 contracted by 2.7% between years in January. The year-on-year contraction in the money supply is probably due primarily to residents' using savings to pay down loans and invest in other asset classes, and to the sale of assets acquired by deposit money banks (DMBs) in the wake of the financial crisis.

Outlook for the global real economy and international trade

Consensus Forecasts has revised its forecast for 2013 output growth in Iceland's main trading partner countries downwards by 0.3 percentage points, to 0.9%, since the February MPC meeting.

Iceland's goods trade surplus totalled 11.6 b.kr. in January and, according to preliminary figures, 7.6 b.kr. in February. Export values rose sharply year-on-year in January but contracted again in February. Import values, however, contracted considerably year-on-year in January and had contracted marginally in February. The contraction in export values in February was due to a reduction in industrial exports, while the contraction in import values was due to a marked reduction in the value of imported transport equipment.

Aluminium prices had fallen considerably since the MPC's February meeting, and marine product prices declined month-on-month in January, for the fifth month in a row.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, output growth measured 1.6% in 2012 as a whole and 1.4% in Q4/2012. Year-2012 output growth was driven by increased private consumption and business investment, which contributed some 2.2 percentage points combined. The contribution from export growth was about 2.3 percentage points; however, imports grew in excess of exports, making the contribution from net trade negative by 0.1 percentage points. Public investment and public consumption both contracted, making a negative contribution to output growth in the amount of ½ a percentage point. Year-2012 output growth turned out 0.6 percentage points weaker than was assumed in the Bank's February forecast, due primarily to unexpectedly strong growth in services imports. Growth in overall domestic demand was well in line with the Bank's projections, however, or 1.9%, as opposed to the 2% in the forecast.

The trade surplus in Q4/2012 measured 4.8% of GDP, while the forecast in the February issue of *Monetary Bulletin* assumed 5.6%. The deviation is due in particular to the fact that services imports were estimated to be 3.7 b.kr. less in Q4, particularly in the category "other services."

The current account deficit measured just under 3% of GDP in Q4/2012 (or 12.6 b.kr.), as the income account deficit somewhat outweighed the trade surplus. The deficit in the income account balance in Q3 and Q4 was markedly smaller than the recent average. The current account deficit excluding the deposit money banks (DMBs) in winding-up proceedings measured 0.3% of GDP in Q4. Excluding the failed DMBs and pharmaceuticals company Actavis, the current account showed a surplus of 1.3%. Revised figures for the first three quarters of 2012 show a slightly larger deficit than was indicated by previous figures.

The Bank's February forecast provided for slow growth in private consumption in the first half of 2013 and an increased pace of growth over the course of the year. For Q1/2013, growth was forecast at 1.8% year-on-year, but this figure could be expected to turn out higher because of the downward revision of private consumption figures for the first half of 2012. On the other hand, high-frequency indicators suggest somewhat weaker quarter-on-quarter private consumption growth in Q1 than was forecast in February. For instance, payment card turnover was virtually unchanged year-on-year in January and February. On the other hand, growth in retail sales was stronger at the beginning of the year than in recent quarters, and new motor vehicle registrations continued to rise in January and February.

Treasury accounts for 2012 show that the Treasury's cash-based outcome was stronger than the Ministry of Finance and Economic Affairs had budgeted. The overall income balance was negative by 40.5 b.kr., which is a 3.8 b.kr. smaller deficit than expected. The primary balance was also more positive than expected, or 18 b.kr., as opposed to the estimate of 11.7 b.kr. The Treasury's performance on an accrual basis will probably be poorer than preliminary figures on a cash basis would indicate, however, partly because of the additional capital contribution to the Housing Financing Fund and the revaluation of the Treasury's pension obligations.

Registered unemployment according to the Directorate of Labour (DoL) usually rises month-on-month in January, but in January 2013 it declined by 0.3 percentage points. The drop is probably due primarily to the expiry at the end of last year of the temporary provision extending entitlement to unemployment benefits from three years to four. Unemployment remained flat month-on-month in February, at 5.5%. Seasonally adjusted unemployment fell from 5.4% in December to 4.5% in February, its lowest point since November 2008.

The wage index rose by 0.3% month-on-month in January and by 5% year-on-year. Real wages rose by 0.1% between months in January and by 0.8% year-on-year.

According to the Capacent Gallup survey carried out among corporate executives in February and March, respondents interested in recruiting staff members in the next six months outnumbered those interested in downsizing for the first time since March 2008. More companies are interested in recruiting than in the last survey, carried out in December, and a smaller number are interested in downsizing. Only in the fisheries and financial sectors did companies planning to downsize outnumber those interested in adding on staff. The most pronounced difference in corporate recruitment plans was in the construction sector, with over 44% of firms planning to increase their staffing levels.

The nationwide Statistics Iceland house price index, published in late February, rose by 0.5% from the previous month, and by 0.9% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.2% month-on-month in February and by 0.4% when adjusted for seasonality. About 14% more purchase agreements were concluded nationwide in February 2013 than in the same month in 2012. The number of purchase agreements is still low in historical context, however.

According to Capacent Gallup, consumer optimism dwindled month-on-month in February, as the Consumer Sentiment Index had risen sharply in January, following a steep decline. The Consumer Sentiment Index was 5% higher in February 2013 than in the same month in 2012.

According to the Capacent Gallup survey, executives were more upbeat about the economic outlook than in the December 2012 survey, although there was a smaller difference between the current findings and those in the survey carried out a year ago. About 28% of respondents expect conditions to improve in the next six months, as opposed to just over one-fifth a year ago and 15% in December. Executives in nearly all economic sectors were more optimistic than in December, although the change was greatest in construction and specialised services. Expectations concerning domestic demand increased markedly from the previous survey but were broadly unchanged from a year ago. Expectations concerning demand in foreign markets had also risen since the December survey but were still lower than in last year's survey. Furthermore, executives were more optimistic about developments in EBITDA margins in the upcoming six months than in both the last survey and the one performed a year ago. The outlook for investment appeared weaker than before, however.

According to the survey, executives' inflation expectations one year ahead measured 4.5%, the same as in the December survey. On the other hand, their inflation expectations two years ahead had declined by ½ a percentage point from the September survey and also measured 4.5%.

According to Capacent Gallup's February inflation expectations survey among households, inflation expectations one year ahead had declined by about ½ a percentage point since December 2012, to 5%. They have remained around 5% or more since June 2011. The same can be said of household inflation expectations two years ahead, which measured 5% and were unchanged since the last survey.

The consumer price index rose by 1.6% month-on-month in February, the largest increase in a single month since November 2008. Twelve-month inflation measured 4.8%, up from 4.2% in January. Underlying twelve-month inflation according to core index 3 measured 5.1%, up from 4.6% in January. According to the EU's Harmonised Index of Consumer Prices (HICP), however, it measured 6.1% in February.

End-of-sale effects made the strongest impact on the CPI in February, and it seemed that sales effects retreated more rapidly than in recent years, following strong sales effects in January. Price increases for clothing, footwear, furniture, and housewares contributed 0.7 percentage points to the rise in the CPI. The effect of the depreciation of the króna was pronounced as well, raising the price of most imported goods. Increases in petrol and oil prices raised the CPI by 0.3 percentage points, the most pronounced upward effect in a single month since March 2012.

II The interest rate decision

The Governor reported to Committee members on the amendments to the Foreign Exchange Act, passed by Parliament on 9 March, and described the bill of legislation currently before Parliament, which contains further amendments to the same Act. The Deputy Governor reported on the findings from the Bank's newly published report on Iceland's underlying international investment position (IIP) and balance of payments.

The Committee discussed recent exchange rate developments, with the trade-weighted exchange rate index (TWI) rising 4.5% since the MPC's February meeting. The Committee considered that the Bank's decision to suspend its programme of regular foreign currency purchases and support the exchange rate of the króna with foreign exchange intervention had, together with other measures, proven effective. The Bank's actions had reduced the risk that self-fulfilling expectations of a depreciation would weaken the króna still further, and in this way they had supported monetary policy.

The Committee was of the opinion that, based on information emerging since its last meeting, there were grounds for keeping interest rates unchanged or for raising them by 0.25 percentage points. Preliminary national account figures for 2012 suggested weaker growth than was forecast in February. Year-2011 growth figures had been revised upwards, however. The outlook was still for a gradual economic recovery, and leading indicators from the labour market were consistent with that prospect. Inflation, however, proved considerably higher in February than previously anticipated. On the other hand, the króna had appreciated from February onwards.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. Four members voted in favour of the Governor's proposal and agreed that new information was largely in line with the forecast in the February *Monetary Bulletin.* One member voted against the Governor's proposal, however, voting instead to raise interest rates by 0.25 percentage points. This member pointed out that the near-term inflation outlook had deteriorated since the last MPC meeting, in spite of the appreciation of the króna. Long-term inflation expectations were still high, and considerable underlying inflationary and wage pressures were discernible; therefore, it was crucial to tighten the monetary stance in spite of a weaker economic recovery.

Committee members agreed that, although the economic recovery had lost some pace for the present, the margin of spare capacity in the economy had continued to narrow. The accommodative monetary stance supported the economic recovery. If inflation declined more slowly than was previously forecast, it would be necessary to reduce the monetary slack sooner than would otherwise be required. It is still the case that as spare capacity disappeared from the economy, it would be necessary that monetary policy slack should disappear as well. The degree to which such normalisation took place through higher nominal Central Bank rates would depend on future inflation developments, which in turn would depend on exchange rate movements and wage-setting decisions in the near future.

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 15 May 2013.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2013

Published 29 May 2013

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

The following are the minutes of the MPC meeting held on 10 and 14 May 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 15 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 domestic economy, inflation, and the outlook for the global economy and Iceland's international trade, with emphasis on information that has emerged since the 20 March interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2013/2 on 15 May.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 2.6% higher at the time of the May meeting than at the March meeting. Between meetings, the króna had appreciated by about 2.4% against the euro, 2.5% against the US dollar, and 1.4% against the pound sterling. The offshore exchange rate had risen between meetings, with bids ranging from ISK 201-233 per euro.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25-0.65 percentage points above current account rates. Turnover in the interbank market has totalled 196 b.kr. year-to-date, which is somewhat of an increase from the same period in 2012.

The five-year breakeven inflation rate in the bond market was 3.2% just before the MPC meeting, after falling by just over a percentage point since the March meeting. The five-year breakeven inflation rate five years ahead was 3.5% and had fallen by just over 0.2 percentage points. The median results of the Central Bank's recent survey indicated that market participants expected inflation to average 4.2% over the next five years, which is slightly less inflation than they expected in the last survey (see below for further discussion of the Central Bank survey).

The effective nominal policy rate can be estimated to lie very close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the real policy rate averaged 1.5% at the time of the May meeting, about 0.7 percentage points higher than at the March meeting. In terms of twelve-month inflation, it had risen by 1.5 percentage points, to 2%, and in terms of the breakeven inflation rate in the bond market it had risen 1.6 percentage points, to 2.3%.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged between meetings, at about 1.5 percentage points. The risk premium on Treasury obligations, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, was also unchanged between meetings. The spread between five- and ten-year Treasury bonds issued by the two countries was about 1.8 and 2 percentage points, respectively.

Unchanged Central Bank interest rates in May appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most market analysts cited the appreciation of the króna since the last interest rate decision, the rise in the Bank's real interest rate in tandem with declining inflation, and recent indications of weaker output growth than in the Bank's February forecast as grounds for unchanged interest rates. Uncertainty about the policies of the new Government was mentioned as a reason for unchanged rates, while expansionary campaign promises were cited as grounds for a rate hike.

Broad money (M3) grew by 0.3% month-on-month in March but shrank by 2.6% year-on-year. Excluding holding company deposits, M3 contracted by 0.7% between years. The year-on-year contraction in the money supply is probably due primarily to residents' using savings to pay down loans and invest in other asset classes, and to the sale of assets acquired by deposit money banks (DMBs) in the wake of the financial crisis.

The NASDAQ OMX Main List index, OMXI6, had fallen by 5% between meetings. At the beginning of May, the market value of companies listed on the main market totalled 438 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

The most recent forecast from the International Monetary Fund (IMF), published in April, provided for weaker global output growth than the January forecast. The same applies to the forecast for world trade. The uncertainty in the forecast remains concentrated on the downside but has diminished in the wake of government stimulus measures in many countries. Output growth forecasts have been revised downwards for all countries except

Japan. A contraction is still expected in the euro area, while weak growth is projected in the UK and somewhat stronger growth in the US. In general, the IMF anticipates inflation rates similar to those in January. Inflation is expected to be slightly higher in developed countries and slightly lower in emerging countries. The Fund's output growth forecast for Iceland's main trading partners has been revised marginally downwards since January, from 1.2% to 0.9%.

According to preliminary figures from Statistics Iceland, Iceland's goods trade surplus totalled 9.3 b.kr. in March and 5.1 b.kr. in April. Import and export values rose markedly year-on-year in April, although imports slightly outpaced exports. In the first four months of the year, export values grew by just over 1½% year-on-year, while import values contracted by slightly more than ½%. The small increase in export values is due to a slight year-on-year contraction in the value of industrial exports in the first four months of the year. The contraction in import values is due primarily to reduced imports of transport equipment (mainly aircraft) and a slight contraction in the value of imported commodities and operational inputs.

The price of aluminium has fallen marginally since the MPC's March meeting. In April, the average price was nearly 3% lower than in March and more than 9% lower than at the same time in 2012. Marine product prices rose slightly month-on-month in March, after an uninterrupted six-month slide.

The domestic real economy and inflation

Registered unemployment according to the Directorate of Labour (DoL) usually rises between quarters in the first quarter of the year but remained unchanged this year, due to the expiry at the end of 2012 of the temporary provision extending entitlement to unemployment benefits from three years to four. Registered unemployment measured 5.4% during the quarter, while seasonally adjusted unemployment was 4.6%, and had declined by 0.7 percentage points between quarters. Those actively seeking work continue to be considered unemployed for the purposes of the Statistics Iceland labour market survey, irrespective of their entitlement to benefits. According to the survey, unemployment was somewhat higher during the quarter, or 5.8%, while seasonally adjusted unemployment was 5.3%, which is unchanged from the previous quarter.

The wage index rose by 2.4% quarter-on-quarter and 5.2% year-on-year in Q1/2013. Real wages rose by 0.8% between quarters and by 0.9% year-on-year.

According to the Statistics Iceland labour market survey, labour demand was somewhat stronger in Q1 than was assumed in the forecast published in the February issue of *Monetary Bulletin*. That forecast provided for a 1.5% year-on-year increase in total hours worked, while the actual increase was 2.5%. The rise was due to a 2.7% increase in the number of employed persons, while average hours worked per person remained almost unchanged.

The nationwide Statistics Iceland house price index, published in late April, rose by 1.8% from the previous month, and by about 1% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, was unchanged month-on-month in March but fell by nearly 0.2% when adjusted for seasonality. In Q1/2013, roughly 10% more purchase contracts were registered nationwide than in the same quarter of 2012.

Key high-frequency indicators of private consumption in Q1 suggest that growth had slowed somewhat. Payment card turnover in the first three months of the year contracted by 0.7% year-on-year, for example, and the rise in new motor vehicle registrations slowed markedly. Even so, new vehicle registrations rose by over 30% year-on-year in Q1, but this is significantly less than in the recent past, and in April they were down 13% year-on-year.

According to the consumer sentiment survey carried out by Capacent Gallup, consumer sentiment has been somewhat more positive year-to-date than at the end of 2012. In April, however, it turned slightly downward from the previous month. All subcomponents of the consumer sentiment index declined in April, with the assessment of the current situation falling most sharply. So far in 2013, the index has been an average of 17% higher than during the same period last year.

According to the quarterly Central Bank market expectations survey carried out in May, market agents' inflation expectations have fallen since the February survey. Market participants now expect annual inflation to measure 4% one and two years ahead, about ½ a percentage point lower than in the last survey. Their long-term inflation expectations are broadly unchanged, however, at just over 4%.

Inflation has subsided in recent months. The consumer price index (CPI) rose by 0.2% month-on-month in April, in the wake of a 0.2% increase in March. Annual inflation measured 3.3% in April, down from 4.8% in February. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 4.2%, as opposed to 5.1% in February.

Petrol prices have fallen sharply since February, with a downward CPI effect of about ½ a percentage point in March and April. The rise in the CPI in April was due primarily to an increase in house prices, primarily in regional Iceland. Prices were up 1.8% nationwide. The recent appreciation of the króna appears to have had a marginal impact on the price of imported goods in March and April, reducing the price of new motor vehicles in particular.

According to the forecast in the May issue of *Monetary Bulletin*, the inflation outlook has improved following the appreciation of the króna, even though inflation was higher in Q1 than was projected in the February *Monetary Bulletin*. A larger output slack next year than was previously assumed will also weaken inflationary pressures, although increased wage pressures will offset this. Inflation is forecast to average 3.8% this year and 2.7% in 2014. It is forecast to reach the inflation target in the first half of 2014, slightly earlier than was assumed in February.

Even though uncertainty and concerns about a new recession have abated, global economic activity has been weaker than previously forecast, and the global output growth outlook has deteriorated. Global output growth is expected to gain some momentum as the year progresses, however, although the economic recovery is still projected to be relatively weak.

The outlook is for lower commodity and oil prices than was projected in February. The outlook for terms of trade has deteriorated in spite of this, however, as marine product prices have fallen somewhat and are expected to decline further in the next two years, in line with trends in global food and commodity prices and the slow pace of growth in Iceland's main market areas. By the same token, developments in aluminium prices are considerably less favourable than was forecast in February. Offsetting this is the prospect of stronger growth in total exports for the majority of the forecast horizon, which is due to increased services exports, as the outlook for goods exports has deteriorated. Goods and services exports combined are expected to grow by almost 3% this year and over 2% per year, on average, for the following two years. Because of the improved outlook for exports and slower growth in imports, the contribution of net trade to output growth is expected to be larger this year and in the coming two years than was forecast in February.

The trade surplus is expected to be just under 7% of GDP this year, slightly less than was forecast in February. It is projected to shrink in the following two years, primarily because of poorer terms of trade, but also because of a slowdown in export growth. The surplus is forecast at 4½% of GDP in 2014 and just under 3½% in 2015.

The current account balance as calculated according to official standards is projected to show a deficit amounting to 1½% of GDP this year. On the other hand, the underlying current account balance (adjusted for the calculated income and expenses of DMBs in winding-up proceedings and the effects of the settlement of their estates and for pharmaceuticals company Actavis) is expected to show a surplus of just over 4%. The underlying surplus is expected to diminish as the forecast horizon progresses, however. It is forecast to measure just under 1% of GDP in 2014 and turn slightly negative in 2015, which is somewhat less favourable than in the February forecast.

Domestic demand is expected to remain virtually unchanged year-on-year in 2013, whereas the February forecast provided for 1.3% growth. Leading indicators suggest that private consumption was weak in Q1, and it is projected to grow by 2.2% this year, about ½ a percentage point below the February forecast. However, the slower growth in domestic demand in 2013 is due primarily to the considerably changed outlook for investment growth. Business investment is projected to contract by 23% year-on-year instead of the 11½% provided for in the February forecast, and total investment is expected to contract by 9% instead of the previously anticipated 1%. These figures are based in part on new information from the Central Bank's survey of domestic companies' investment plans. Domestic demand is expected to gain momentum and grow by about 4½% per year in 2014 and 2015. The outlook has worsened since February, however, when the forecast provided for almost a percentage point stronger growth in each of the two years.

Weaker global output growth and poorer terms of trade contribute to weaker output growth domestically. Output growth is projected at 1.8% in 2013, as opposed to 2.1% in the February forecast. Offsetting the slowdown in domestic demand growth, however, is a somewhat more positive contribution from net trade to output growth than in the February forecast.

The GDP growth outlook for the next two years is also weaker than in February. The current forecast estimates year-2014 growth at 3%, as opposed to 3.7% in the February forecast. For 2015, output growth is forecast at 3.5%, as compared with 3.9% in the February forecast. If the forecast materialises, output growth will average 2.8% over the forecast horizon, which is similar to the 30-year average.

The outlook for unemployment is broadly unchanged since February, in spite of the poorer output growth outlook. In the forecast, it is assumed that registered unemployment will measure 4.6% in Q4/2013 and about 4% by mid-2016, the end of the forecast horizon. Because of the poorer GDP growth outlook, however, labour demand is expected to grow more slowly in coming years than according to the February forecast. The slower growth in total hours worked is not sufficient to offset the poorer output growth outlook. As a result, productivity growth is expected to be weaker during the forecast horizon than was projected in February. According to the forecast, unit labour costs will rise by an average of just over 3½% per year, which is more than was forecast in February.

According to Statistics Iceland's output growth figures and the Central Bank's assessment of growth in potential output, the Bank estimates that the margin of spare capacity in the economy measured 1.3% in Q1, as was forecast in the February *Monetary Bulletin*. The estimate of spare capacity for 2013 as a whole is also virtually unchanged since February, at just under 1%. A small slack is now expected to remain at the end of 2014, whereas the February forecast assumed that it would have disappeared by then. This estimate assumes that, although growth in potential output is recovering gradually after the financial crisis, it will be below long-term trend growth for the majority of the forecast horizon.

The baseline forecast in the May issue of *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are a number of important uncertainties in the forecast. This is particularly the case regarding the growth outlook for Iceland's main export markets. Adverse developments in these areas could undermine export growth in Iceland and erode terms of trade still further. The exchange rate outlook is extremely uncertain and will be affected by, on the one hand, pressure on the króna due to foreign loan repayments, and on the other, the trade surplus, which is expected to be sizeable early in the forecast horizon, as the real exchange rate is probably below long-term equilibrium at present. There is considerable uncertainty about the outlook for public sector finances and how quickly they can be put on a sustainable footing. Another uncertainty centres on wage developments in light of the upcoming round of wage negotiations. If wages rise excessively, the inflation outlook could worsen because of increased domestic inflation. The domestic economic recovery could lose momentum as well, if firms respond to increased wage costs by cutting back labour use. Moreover, high private sector debt levels create uncertainty about the recovery of domestic demand, which could prove more of a hindrance to output growth than is assumed in the baseline forecast. Uncertainty about the inflation outlook centres primarily on the exchange rate, although developments in global commodity and oil prices and errors in estimates of the output gap could cause significant deviations from forecasted inflation, particularly given that a firm anchor for long-term inflation expectations has yet to be established.

II The interest rate decision

The Governor discussed recent developments in the foreign exchange market and the Bank's intervention. The MPC had also held an extraordinary meeting on 16 April to discuss the Bank's policy for foreign exchange purchases and foreign exchange market intervention. According to the Act on the Central Bank of Iceland, the Committee is tasked with taking decisions on the application of the Bank's monetary policy instruments. These provisions define foreign exchange market transactions aimed at affecting the exchange rate of the króna as one of those instruments. Increased foreign exchange market intervention is also in line with the Bank's proposal for improvements to the inflation targeting framework (see, for example, the discussion in "Monetary policy in Iceland after capital controls", Central Bank *Special Publication* no. 4, December 2010).

Since last summer, the exchange rate of the króna has been more volatile than in the preceding period, although it has been somewhat less volatile than various other floating currencies, and the peak-trough range has not been wider than the norm. By the time the MPC met on 16 April, the króna had appreciated in trade-weighted terms by 12.3% from its most recent trough, on 30 January. Committee members agreed that it was appropriate to affect foreign exchange transactions by parties faced with heavy foreign loan payments, in view of their impact on the exchange rate.

By the time of the May meeting, the króna had weakened by 3.1% in trade-weighted terms since the April meeting. Committee members were concerned that, even though inflation was now closer to target than it had been since it began rising in the wake of the spring 2011 wage settlements, uncertainty about near-term exchange rate developments could contribute to more persistent inflation expectations and slow down the disinflation process following this year's appreciation of the króna.

As foreign currency mismatches in financial institutions' balance sheets had been reduced and the exchange rate had been close to a level that, other things being equal, could be considered sufficient to bring inflation back to target in the near term, the Committee was of the opinion that there were further grounds for increased Central Bank activity in the foreign exchange market in the near future. In line with previous statements by the Committee, it was appropriate that the Bank use the monetary policy instruments at its disposal to reduce exchange rate volatility. Committee members agreed that, in this context, it was appropriate to use the recent exchange rate level as a reference, thereby promoting speedier adjustment of the domestic price level to a stronger króna and contributing to reduced inflation expectations. In that case, the inflation target could conceivably be reached earlier than in the current forecast, although this would depend on other factors as well. Committee members agreed that, if there were major changes in external conditions or if other aspects of economic policy should undermine economic stability, the foreign exchange market intervention policy would be reviewed. Particular attention would be given to fiscal policy and to whether wage settlements and wage developments were consistent with the inflation target. Before decisive steps could be taken to lift controls on capital outflows, it would also be necessary to re-evaluate this policy. The same would apply if decisions should be taken concerning the monetary policy framework.

The Committee emphasised that its near-term foreign exchange market intervention policy did not imply a declaration of an exchange rate peg since that would represent a change in the monetary policy framework, which, according to the Central Bank Act, cannot be undertaken without prior consent from the Government.

Committee members considered it appropriate that the Bank continue to attempt to expand its non-borrowed reserves as circumstances permit. Increasing the non-borrowed reserves is a long-term goal, however, and the implementation of that aim will depend on both the strength of the króna and movements in the exchange rate, which are determined in part by capital movements that vary in their predictability. The Bank's foreign exchange purchases should therefore take into account the strong tendency among other agents for foreign debt deleveraging, particularly while inflation remains above target. In line with this policy, the foreign currency that would be purchased to respond to temporary — and, in some instances, seasonal — inflows should then be used to support the króna when the currency flows reverse.

Finally, Committee members discussed the Bank's *Financial Stability* report, published on 30 April, the status of financial institutions, and the progress made with private sector debt restructuring.

Committee members agreed that, based on information emerging since its last meeting, there were grounds for keeping interest rates unchanged. In line with weaker output growth globally, output growth had slowed down in Iceland and terms of trade had deteriorated. According to the forecast in the May issue of *Monetary Bulletin*, the outlook is for output growth to be somewhat weaker, both in 2013 and throughout the forecast horizon, than the Bank projected in February, albeit close to the 30-year average. The recovery in the labour market continued, with rising employment and falling unemployment. Inflation had tapered off, in line with the Bank's forecasts, and measured 3.3% in April. Underlying inflation and inflation expectations were higher, however. Nonetheless, inflation was expected to reach the inflation target earlier than previously anticipated, with weaker output growth and a stronger króna offsetting larger wage increases and weaker productivity growth. On this basis, the Committee was of the opinion that the current interest rate level provided sufficient restraint and that the monetary stance could be assumed to tighten with declining inflation. As additional grounds for an unchanged policy rate, one committee member argued that as the economy is recovering, it is desirable that monetary policy encourage domestic saving, which is necessary to achieve a current account surplus large enough to support foreign loan repayments and the build-up of non-borrowed reserves, and is an important basis for increased domestic investment.

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

Committee members agreed that, although the economic recovery had lost some pace for the present, the margin of spare capacity in the economy had continued to narrow. The accommodative monetary stance had supported the economic recovery in the recent term. It was still the case that as spare capacity disappeared from the economy, it would be necessary that slack in monetary policy should disappear as well. The degree to which such normalisation took place through higher nominal Central Bank rates would depend on future inflation developments, which in turn would depend on wage developments and exchange rate movements. In addition, monetary policy must at all times take account of fiscal policy and other factors that affect demand.

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 12 June 2013.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

June 2013

Published 26 June 2013

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

The following are the minutes of the MPC meeting held on 11 June 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 12 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 domestic economy, inflation, and the outlook for the global economy and Iceland's international trade, with emphasis on information that has emerged since the 15 May interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.3% higher at the time of the June meeting than at the May meeting. Between meetings, the króna had depreciated by about 0.7% against the euro, remained broadly unchanged against the pound sterling, and appreciated by 1.8% against the US dollar. Bids for krónur in the offshore market lay in the range of 230-260 kr. per euro.

The Central Bank had sold 6 million euros (roughly 958 m.kr.) in the domestic foreign exchange market since the Committee's last meeting.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market remained below the centre of the interest rate corridor, at

0.25-0.85 percentage points above current account rates. Turnover in the interbank market totalled 245 b.kr. year-to-date, broadly unchanged from the same period in 2012.

Just before the MPC meeting, the five-year breakeven inflation rate in the bond market was about 3.2%, virtually unchanged from the May meeting. The five-year breakeven inflation rate five years ahead was 3.7% and had risen by just over 0.2 percentage points.

The effective nominal policy rate currently lies very close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the real policy rate averaged about 1½% at the time of the June meeting and was virtually unchanged since the May meeting. The average of the various measures of inflation and inflation expectations was 3.7% at that time. Excluding households, whose inflation expectations tend to follow past inflation, inflation expectations averaged 3.5%.

The Republic of Iceland's sovereign CDS spread remained virtually unchanged between meetings, measuring 1.5 percentage points. The risk premium on Treasury obligations, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, had fallen by 0.1 percentage points between meetings, to 1.7 percentage points, for five-year bonds; however, it was virtually unchanged at 2 percentage points for 10-year bonds.

Unchanged Central Bank interest rates in June appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. As grounds for unchanged interest rates, most analysts cited the stable exchange rate and unchanged twelve-month inflation between meetings, the decline in inflation expectations as reflected in the bond market, and the fact that Q1/2013 output growth was weaker than projected in the Bank's May forecast.

Broad money (M3) grew by 0.2% month-on-month in April but shrank by 2.5% year-on-year. Excluding holding company deposits, M3 contracted by 1.9% between years in April.

The NASDAQ OMXI6 index had fallen by 4.2% between meetings. Trading volume on the NASDAQ OMX Iceland Main Market totalled 38 b.kr. in May. At the beginning of June, the market value of companies listed on the main market totalled 438 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

The Organisation for Economic Co-operation and Development's (OECD) forecast for global output growth in 2014, published in May, was unchanged from its November forecast. Growth is expected to be marginally weaker in 2013, however. In Iceland's main trading partner countries, output growth is forecast to be weaker in 2013, owing in particular to weaker growth in the Nordic countries and a deeper contraction in the euro area. The forecast for world trade has also been revised downwards for 2013 and 2014. Although the risks to the outlook have diminished, they remain considerable and continue to be tilted to the downside. The OECD projects year-2013 inflation at 1.6% for Iceland's trading partners, which is unchanged from the November forecast.

According to preliminary figures from Statistics Iceland, Iceland's goods trade balance was negative by 6.6 b.kr. in May, the largest goods account deficit in a single month in nearly five years. Both import values and export values contracted sharply during the month. In the first five months of the year, the value of both imports and exports fell by about 2½% year-on-year. The contraction in import values is due to strong imports of transport equipment (primarily aircraft) early in 2012, although investment goods imports grew by 14% year-on-year in the first five months of 2013. The contraction in export values in the first five months of the year is due mainly to a contraction of over 3% in industrial export values and a ½% contraction in marine product exports.

The price of aluminium has risen marginally since the MPC's May meeting. Nonetheless, the average price was over 1½% lower in May than in April and almost 9% lower than at the same time in 2012. For the first weeks of June, the average price was 4½% above the May average. Marine product prices rose by 0.6% month-on-month in April, for the second month in a row, after having fallen for six consecutive months.

The domestic real economy and inflation

According to national accounts data published by Statistics Iceland in June, GDP growth measured 0.8% in Q1/2013, and seasonally adjusted quarter-on-quarter GDP growth measured 4.6%. The main driver of growth was the contribution from net trade, as imports contracted by 6.3% year-on-year and exports grew by 2.3%. Private consumption grew by 0.8% year-on-year and public consumption by 0.9%. Investment contracted by almost 20% between years, however, due mostly to the contraction in investment in ships and aircraft, which also accounts for a significant part of the contraction in imports. Excluding ships and aircraft, investment grew by just under 7% between years, due to an increase in residential investment and business investment excluding energy-intensive industry, ships and aircraft.

Output growth was somewhat weaker in Q1/2013 than according to the forecast in the May issue of *Monetary Bulletin*, which provided for 1.5% growth during the quarter. Consumption and total investment developed in line with the forecast, contracting by 2.7% year-on-year, whereas the contribution from net trade was more strongly positive than anticipated.

The weaker-than-expected output growth was due mainly to developments in inventory changes. As was the case at the same time in 2012, inventories grew between quarters, but the increase was smaller this year. As a result, the year-on-year growth in inventory changes was negative by 1.4 percentage points of GDP, while the forecast provided for no change. Based on previous experience, it is likely that the effects on GDP growth of the year-on-year contraction in inventory changes in Q1 will reverse to a large extent during the year. The growth in inventory changes was very strong quarter-on-quarter, however, and played a leading role in quarterly GDP growth in Q1.

The current account balance was positive by 1.3% of GDP in Q1, or 5.6 b.kr., whereas it has always been negative in Q1 in recent years. The forecast in the May issue of *Monetary Bulletin* provided for a 1.4% current account deficit in Q1. The underlying current account surplus was 2.5%, as opposed to 2.8% according to the forecast in *Monetary Bulletin*.

Payment card turnover figures from April and May indicated that private consumption was stronger than in Q1. Consumer sentiment appears to have improved as well, as the Capacent Gallup Consumer Sentiment Index rose somewhat in May, exceeding 100 points for the first time since the banks failed. Consumers were particularly optimistic about the six-month outlook and the prospects for the labour market. On the other hand, new motor vehicle registrations have declined considerably.

Registered unemployment as published by the Directorate of Labour (DoL) fell by 0.4 percentage points in April. Unemployment measured 4.9%, while seasonally adjusted unemployment was unchanged from the previous month, at 4.3%. Unemployment according to the Statistics Iceland labour force survey (LFS) was considerably higher, or 6.6%, which is 0.2 percentage points lower than in the previous month. After adjusting for seasonality, however, the LFS measurement was closer to the DoL unemployment rate, or 5.4%, down 0.6 percentage points month-on-month.

According to the LFS, total hours worked rose by 4.1% in April from the previous year. The rise was due to a 4.3% increase in the number of employed persons, while average hours worked per person fell by 1.6%.

According to the Capacent Gallup survey carried out among corporate executives in May, respondents in all sectors of the economy who were planning to recruit staff in the next six months outnumbered those planning to downsize, for the first time since June 2007. The ratio was somewhat higher than in the February/March survey, or 11% instead of 9.5%. About 70% of firms anticipate making no changes in their staffing levels. The greatest change in firms' interest in recruiting staff was in construction and utilities companies, where half of firms planned to recruit and about 57% considered themselves understaffed.

The wage index rose by 0.2% month-on-month in April and 5.8% year-on-year. Real wages rose by 2.4% between years.

The nationwide Statistics Iceland house price index, published in late May, rose by 0.6% from the previous month, and by about 0.3% adjusted for seasonality. House prices nationwide have therefore risen by 4.8% in the past twelve months. The Registers Iceland capital area real estate price index rose by 0.7% month-on-month in April, also when adjusted for seasonality. The index has therefore risen by 5.5% year-on-year. In the first four months of 2013, roughly 17% more purchase contracts were registered nationwide than during the same period in 2012.

According to the survey carried out by Capacent Gallup in May, corporate executives were still relatively pessimistic about the current economic situation, although they considered conditions marginally better than in the February/March survey. Just over 40% of respondents considered the current situation poor, and about half considered it neither poor nor good. Executives were considerably more upbeat, however, about the outlook for the future, with about half of respondents expecting conditions to improve in the next six months, as opposed to 28% in the February/March survey and about 15% in May 2012. The greatest improvement was among executives in fishing, construction, and utilities companies, both in comparison with the last survey and the one conducted in May last year. On the other hand, 44% of executives expected no change in the next six months.

According to the survey, executives' inflation expectations one year ahead measured 4%, a decline of ½ a percentage point from the February/March survey. They have ranged between 4.5% and 5% since the beginning of 2012.

According to Capacent Gallup's May 2013 survey among households, household inflation expectations were unchanged since the February survey. Households expect twelve-month inflation to measure 5% both one and two years ahead. Households' inflation awareness has not declined in line with the disinflation in recent months. According to the median response, households estimated inflation at 4.7% at the time the survey was carried out, whereas the CPI had risen by 3.3% year-on-year at that time.

The consumer price index (CPI) fell by 0.05% month-on-month in May. Twelve-month inflation measured 3.3%, which is unchanged from April. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 3.8%, and had declined by 4.2% in April. Underlying inflation according to core index 4 without tax effects, which also excludes the market price of housing, measured 3.5%, down from 4% in April.

The travel and transport component of the CPI was the largest driver of the decline in May, with reduced airfares and petrol prices weighing heaviest. In addition, the effects of the appreciation of the króna since February continued to emerge, with prices of new motor vehicles and imported foods declining, in addition to petrol prices. Offsetting these were price rises in private services and the housing component of the CPI. For example, the effects of price increases for telephone services, recreational and cultural activities, and hotel and restaurant services measured just under 0.2 percentage points in May.

II The interest rate decision

The Governor discussed recent developments in the foreign exchange market and the Bank's intervention. He also informed Committee members of the regularly scheduled meetings with the International Monetary Fund in connection with post-programme monitoring of the Stand-By Arrangement.

The Committee also discussed developments in the money supply before and after the collapse of the financial system and the potential impact of capital account liberalisation on the money supply.

Members agreed that, based on information emerging since its last meeting, there were grounds for keeping interest rates unchanged. Although GDP growth appeared to have been somewhat weaker in the first quarter than was forecast in the May issue of *Monetary Bulletin*, the MPC considered it too early to assert that the growth outlook for the year as a whole had deteriorated because, more often than not, output growth figures are revised upwards after the first estimates are published. Furthermore, the deviation from the forecast was attributable in large part to slower inventory growth than had been forecast, as inventory accumulation tended to fluctuate widely. Moreover, the most recent indicators of demand suggested that the economic recovery was developing broadly in line with the Bank's forecast.

Committee members also discussed recent inflation developments. In their view the inflation outlook had changed little since the May forecast. It emerged that inflation had declined in recent months and now measured 3.3%, and that underlying inflation and inflation expectations had declined as well, but remained above the Bank's inflation target.

The exchange rate of the króna had been broadly unchanged since the MPC meeting in May. It appeared to the Committee that the Bank's foreign exchange market intervention policy, formulated by the MPC at its last meeting, had contributed to greater exchange rate stability and was conducive to providing a firmer anchor for inflation expectations and promoting more rapid disinflation than would occur otherwise.

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

Committee members agreed that monetary policy must always take account of fiscal policy and other factors that affect aggregate demand. There was some uncertainty about the path public sector finances would take in coming years. The MPC considered it critical that Treasury finances be brought into balance as soon as possible so that the monetary and fiscal policy mix would contribute to external balance of the economy, foster overall economic stability, and deliver inflation close to target, at the lowest possible cost.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. It was still the case that as spare capacity disappeared from the economy, it would be necessary that slack in monetary policy should disappear as well. The degree to which such normalisation took place through changes in nominal Central Bank rates would depend on future inflation developments, which in turn would depend to a large extent on wage developments and exchange rate movements.

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 parts of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 21 August 2013.

March, 27 2001

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

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

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

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

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

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

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

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

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

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

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

(8) If inflation deviates by more than 1½ percentage point from the target, the Central Bank shall bring it inside that range as quickly as possible. In such circumstances, the Bank will be

obliged to submit a report to the Government explaining the reasons for the deviations from the target, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. The report of the Bank shall be made public.

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

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

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

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

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