SEÐLABANKI ÍSLANDS

MONETARY POLICY COMMITTEE REPORT TO PARLIAMENT

2015•2

Monetary Policy Committee report to Parliament

15 January 2016

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

The Act requires that the MPC meet at least eight times each year. Since early July 2015, when the last Report was sent to Parliament, the Committee has held four regular meetings, most recently on 9 December. The following report discusses the work of the Committee between July and December 2015.

Monetary policy formulation

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

In implementing monetary policy, the MPC bases its decisions in part on an analysis of current economic conditions and the outlook for the economy as presented in the Bank's *Monetary Bulletin*. The MPC's statements and minutes, enclosed with this report, contain the arguments for the Committee's decisions in the latter half of 2015.

Developments from July to December 2015

The Central Bank's interest rates have been raised by 0.75 percentage points since the last MPC report was sent to Parliament. At its August meeting, the Committee decided to raise rates by 0.5 percentage points, and in November it raised them by 0.25 percentage points. At the end of 2015, the Bank's key interest rate – that is, the seven-day term deposit rate – was 5.75%, up from 5% at the end of June.[1]

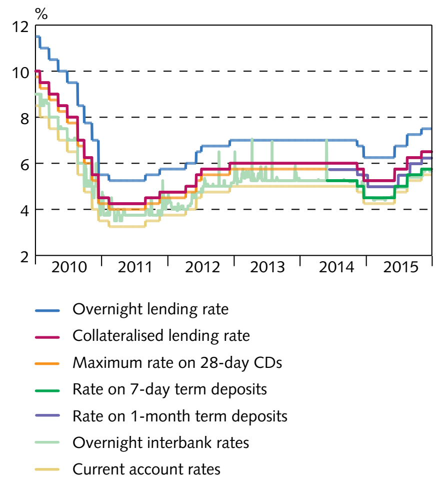
Table 1. Central Bank of Iceland interest rates 2015 (%)

Date	*Current accounts*	*Seven-day term deposits*	*Collateralised loans*	*Overnight loans*
9 December	5.50	5.75	6.50	7.50
4 November	5.50	5.75	6.50	7.50
30 September	5.25	5.50	6.25	7.25
19 August	5.25	5.50	6.25	7.25

Chart 1

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

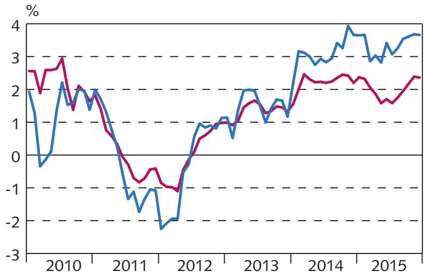
Daily data 1 January 2010 - 31 December 2015



Source: Central Bank of Iceland.

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

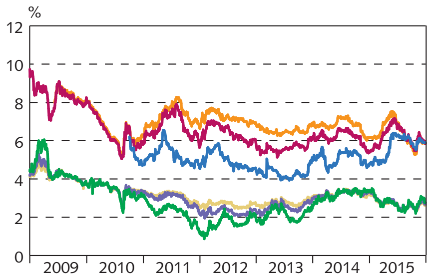
Chart 2
Real Central Bank of Iceland interest rates[1]
January 2010 - December 2015



— Real Central Bank of Iceland interest rate in terms of twelve-month inflation
— Real Central Bank of Iceland interest rate in terms of various measures of inflation and inflation expectations[2]

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

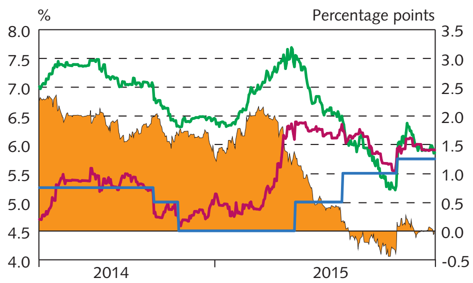
Chart 3
Bond yields
Daily data 2 January 2009 - 31 December 2015



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

Source: Central Bank of Iceland.

Chart 4
Key Central Bank rate and nominal Treasury bond yields
Daily data 21 May 2014 - 31 December 2015



— Key CBI rate (seven-day term deposit rate) (left)
— Treasury bond maturing in 2016 (left)
— Treasury bond maturing in 2031 (left)
■ Spread between Treasury bonds maturing in 2031 and 2016 (right)

Source: Central Bank of Iceland.

The monetary stance has tightened following the increase in the Bank's nominal interest rates. At the end of December 2015, the Bank's real rate was 2.4% in terms of the average of various measures of inflation and inflation expectations and about 3.7% in terms of twelve-month inflation. The real rate was about 0.3-0.7 percentage points higher at the year-end than at the end of June.

In the past few years, changes in Central Bank interest rates have been transmitted more or less appropriately to other market rates and to the interest rates offered to households and businesses. However, the transmission of monetary policy along the interest rate channel has weakened just recently: as of late October, higher Central Bank rates had not been transmitted to other market rates to the degree that could be expected under normal market conditions, and in some instances interest rates had fallen. This was particularly the case for yields on long nominal Treasury bonds, which fell by approximately 2 percentage points from mid-June to end-October. This development is related in part to increased capital inflows associated with non-residents' new investment in these bonds following the presentation of the capital account liberalisation strategy in early June (see Box 1 in *Monetary Bulletin* 2015/4). These inflows have made it more difficult for the MPC to achieve the intended monetary stance, and monetary policy transmission has shifted increasingly to the less reliable exchange rate channel. As a result, the Committee has been examining ways to use other policy instruments in order to restrict carry trade-related inflows and discussed the matter at a joint meeting with the Systemic Risk Committee on 30 November. Proposals for such instruments are currently in preparation within the Bank. The decline in bond market yields reversed to a degree following the interest rate increase in November, perhaps in part due to statements accompanying the interest rate decision concerning the development of instruments to curtail carry trade; however, the fact that the rate increase appears to have taken the market by surprise could also be a factor. At the end of December, yields on nominal Treasury bonds were 0.3-1.2 percentage points lower than at the end of June, while indexed Treasury and Housing Financing Fund bond yields were about the same.

The exchange rate of the króna has risen somewhat in recent months, most likely due in large part to tourism-related foreign currency inflows and improved terms of trade. The króna has appreciated by nearly 6½% in trade-weighted terms since end-June. In the recent past, the Central Bank's foreign exchange market activity has significantly mitigated the appreciation of the króna. This is in line with the Bank's declared objective of mitigating exchange rate volatility and expanding the foreign exchange reserves. In the latter half of 2015, the Bank bought currency for 191 b.kr. (1.3 billion euros) from market makers. This is considerably more than it bought during the same period in 2014.

Inflation has risen somewhat since the MPC submitted its last report to Parliament, but it remains below the Bank's inflation target. In terms of the consumer price index (CPI), twelve-month inflation measured 2% in December, as opposed to 1.5% in June. It has been consistently below target for nearly two years. Underlying twelve-month inflation as measured by core index 3 (which excludes volatile food items, petrol, public services, real mortgage interest expense, and the effects of indirect taxes) was 2.2% in December, up from 1.5% in June. By most other measures, it has risen somewhat less. The main driver of inflation in the recent term has been rising house prices, as inflation excluding the housing component measured 0.4% in December. Domestic inflationary pressures have increased following the wage settlements negotiated in mid-2015, which provided for substantial pay increases. On the other hand, the appreciation of the króna and falling global goods prices – oil prices in particular – have offset increased cost pressures. The decline in imported goods prices (especially petrol) had the strongest effect on the CPI in the second half of 2015.

Developments in inflation expectations since the last MPC report was sent to Parliament have been somewhat ambiguous. According to Gallup's November survey of household inflation expectations, one-year expectations were unchanged since the summer, at 4%. In a comparable survey carried out among executives in November, respondents expected inflation to measure 3.6% one year ahead, which was nearly ½ a percentage point less than in the summer. According to the Central Bank survey of market agents' expectations, carried out in late October, respondents expected inflation to measure 3.8% one year ahead, or 0.3 percentage points more than in the May survey.

However, the breakeven inflation rate in the bond market, as calculated from the spread between indexed and non-indexed bond interest, has fallen since June. This development is affected to a large degree by the aforementioned impact of capital inflows on the bond market in H2/2015, as the decline in the breakeven rate is due more to the drop in the term premium in the bond market than to a decline in inflation expectations. The two-year breakeven inflation rate averaged 3.3% in December, or 1.3 percentage points less than in June. The breakeven rate five and ten years ahead averaged about 3% in December and had fallen by roughly 2 percentage points since June.

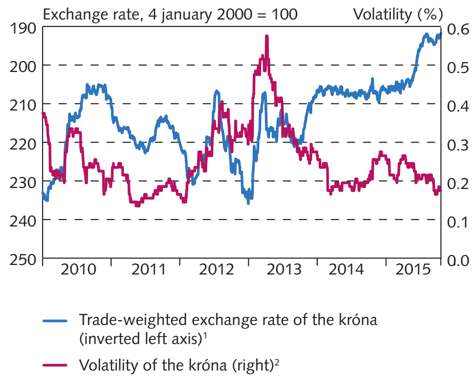
At its September meeting, the MPC decided to increase reserve requirements from 2% to 4% as of the reserve maintenance period beginning on 21 October. This was done to strengthen the Bank's liquidity management in connection with its foreign currency purchases, the settlement of the failed banks' estates, and the planned foreign currency auction. At its December meeting, the Committee decided to lower reserve requirements from 4% to 2.5% so as to mitigate the liquidity effect of the stability contributions paid by the failed banks' estates. Committee members agreed that raising reserve requirements in October had had the intended effect and had encouraged financial institutions to prepare for the settlement of the estates. Other things being equal, the MPC plans to lower the reserve requirements back to 2% in connection with the planned auction of offshore krónur.

At its November meeting, the Committee considered it appropriate to continue tightening the monetary stance and raised interest rates by 0.25 percentage points. Members agreed that there was

Chart 5

Exchange rate and volatility of the króna

Daily data 4 January 2010 - 31 December 2015

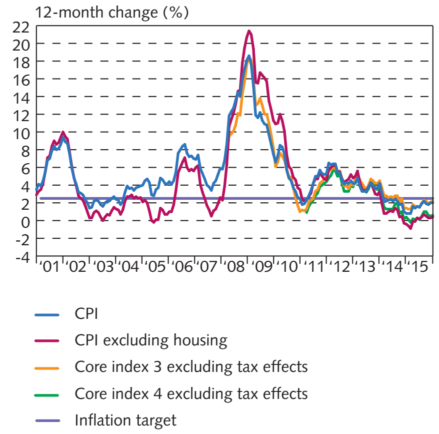


1. Price of foreign currency in terms of the króna. Inverted axis shows a stronger króna as a rise. 2. Volatility is measured by the standard deviation of daily changes in the past 3 months.
Source: Central Bank of Iceland.

Chart 6

Various inflation measurements[1]

January 2001 - December 2015

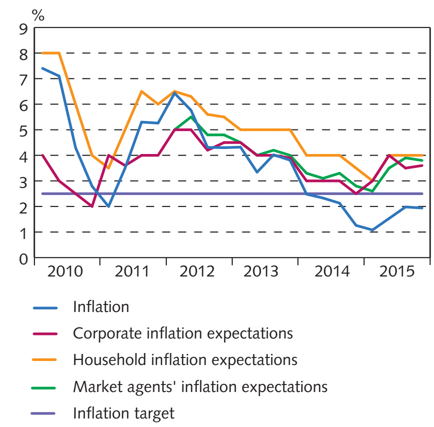


1. Core index 3 is the CPI excluding prices of agricultural products, petrol, and public services and the cost of real mortgage interest. Core index 4 excludes the market price of housing as well.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7

Inflation and inflation expectations one year ahead

Q1/2010 - Q4/2015

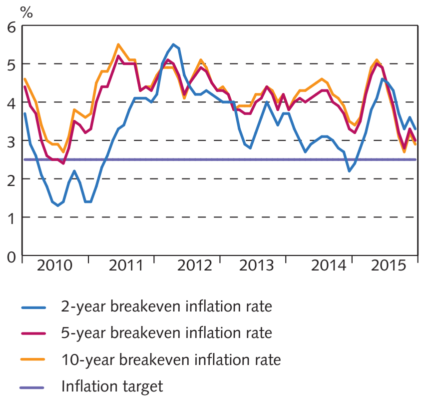


Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 8

Breakeven inflation rate[1]

January 2010 - December 2015



1. Forward breakeven inflation rate based on nominal and indexed yield curves (monthly averages). The breakeven rate indicates the expected annual inflation rate in two, five, and ten years.

Source: Central Bank of Iceland.

considerable strength in the domestic economy, that the spare capacity had been absorbed, and that a positive output gap was developing, which would lead to increased inflation once the effects of the ISK appreciation and the decrease in commodity and fuel prices had tapered off. It was therefore likely that the resilience of the economy was already being tested. Inflation has risen less in the recent term than previously forecast, however, particularly because the decline in global oil and commodity prices and the appreciation of the króna have offset domestic price increases more strongly than had been assumed in the Bank's forecasts. At the December meeting, MPC members considered it likely that this development would persist for some time and that uncertainty about near-term interactions among these factors had grown since the previous meeting. However, Committee members agreed that even though a stronger króna and more favourable global price developments had provided the scope to raise interest rates more slowly than had previously been considered necessary, this did not change the fact that, according to the Bank's November forecast of growing domestic inflationary pressures, a tighter monetary stance would probably be needed in the coming term. How much and how quickly the monetary stance must be tightened would depend on future developments.

Accompanying documents

The following documents are enclosed with this report:

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

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

Már Guðmundsson

Governor of the Central Bank of Iceland

and Chair of the Monetary Policy Committee

Accompanying documents

No. 16/2015
19 August 2015

Statement of the Monetary Policy Committee
19 August 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.5 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 5.5%.

According to the Bank's new forecast, GDP growth will be just over 4% this year and about 3% per year for the two years thereafter. Over the forecast period, growth will be about ½ a percentage point below the Bank's May forecast per year. It will be robust nevertheless, and a positive output gap will widen in the coming term, with GDP growth driven by domestic demand – especially private consumption – to a greater extent than in recent years. Investment will be weaker than previously forecast, however, and labour demand will grow more slowly.

Inflation has risen in the recent term but is still below the Bank's inflation target, particularly if the housing component of the CPI is excluded. However, the inflation outlook has deteriorated markedly since the last forecast, owing to the recent wage settlements, and inflation expectations have risen. Inflation is forecast to rise to 4% early in 2016 and to hover in the 4-4½% range over the next two years before easing towards the target, as the forecast implies that the monetary stance will be tightened in the near future.

Changes in the economic outlook since May are attributable primarily to the effects of large pay increases following the wage settlements and the monetary tightening that inevitably accompanies pay hikes of such size. The changes also stem from global factors, which have contributed to a more pronounced decline in import prices than previously expected, and improved terms of trade, which counteract the inflationary effects of the pay rises. Furthermore, the króna has appreciated slightly, in spite of substantial foreign currency purchases by the Central Bank.

If inflation rises in the wake of the wage settlements, as is forecast, the MPC will have to raise interest rates still further in order to bring inflation back to target over the medium term. How much and how quickly will depend on future developments and on how the current uncertainty plays out, including the degree to which large pay increases are passed through to prices, on the one hand, and the degree to which they prompt rationalisation and productivity growth, on the other. Developments in terms of trade, credit growth, and real estate prices are important factors as well. In addition, the interest rate path will depend on whether other policy instruments are used to contain demand-side pressures in the coming term.

No. 20/2015
30 September 2015

Statement of the Monetary Policy Committee
30 September 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The Bank's key interest rate – the rate on seven-day term deposits – will therefore remain 5.5%.

During the first half of the year, domestic demand growth was broadly in line with the Central Bank's August forecast, but GDP growth measured much stronger. Although the forecast error probably reflects temporary factors, the outlook is for continued robust GDP growth and a widening positive output gap in the coming term.

Inflation is still below the Bank's inflation target – particularly if the housing component of the CPI is excluded – and has risen more slowly than was assumed in the Bank's last forecast. This is due in part to the higher exchange rate of the króna, but volatile items play a part as well. As a result, the medium-term inflation outlook has not changed markedly, although the short-term outlook has improved. As before, the outcome of wage settlements and somewhat elevated inflation expectations indicate that inflation will gain momentum in the near future. This is offset by falling global goods prices and a nearly 4% appreciation of the króna since the last interest rate decision date, in spite of sizeable foreign currency purchases by the Central Bank.

If inflation rises in the wake of the wage settlements, as forecasts indicate, the MPC will have to raise interest rates still further in order to bring inflation back to target over the medium term. How much and how quickly will depend on future developments and on how the current uncertainty plays out. A stronger króna and global price developments have provided the scope to raise interest rates somewhat more slowly than was previously considered necessary, but they do not change the need for a tighter monetary stance in the near future. In addition, the interest rate path will depend on whether other policy instruments are used to contain demand-side pressures in the coming term. After adjusting for cyclical factors, the expected Treasury outcome for 2015 and the fiscal budget proposal for 2016 entail an easing of fiscal policy, which will call for a tighter monetary stance, other things being equal.

The MPC has decided to increase reserve requirements from 2% to 4% as of the next reserve maintenance period, which begins on 21 October. The purpose of this is to strengthen the Bank's liquidity management, in the wake of its substantial foreign currency purchases in the recent term and in connection with the winding-up of the failed banks' estates and the planned auction to release or tie up offshore krónur. New Rules on Reserve Requirements will be sent today for publication in the *Law and Ministerial Gazette.*

No. 23/2015
4 November 2015

Statement of the Monetary Policy Committee
4 November 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.25 percentage points. The Bank's key interest rate – the rate on seven-day term deposits – will therefore be 5.75%.

GDP is projected to grow at 4.6% this year, about ½ a percentage point more than the Bank forecast in August, and the medium-term GDP growth outlook has improved as well. GDP growth is driven mainly by domestic demand, which is projected to increase by more than 7% this year.

Inflation has been somewhat lower recently than was forecast in August and is still below the target, especially if the housing component of the CPI is excluded. This is due mainly to a continued decline in global oil and commodity prices and the appreciation of the króna, which has offset increased domestic inflationary pressures.

As a result, the short-term inflation outlook is considerably better than the Bank projected in August, although the longer-term outlook is broadly unchanged. It is still expected that large pay increases will cause inflation to rise above the target as 2016 progresses and the effects of low global inflation taper off. Inflation will not return to target until 2018. The forecast is based on the assumption that the monetary stance will be tightened as the positive output gap widens and inflation rises. It also takes account of the fact that the fiscal budget proposal for 2016 entails some fiscal easing after adjusting for the business cycle.

A stronger króna and more favourable global price developments have provided the scope to raise interest rates more slowly than was previously considered necessary. However, this does not change the need for a tighter monetary stance in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened will depend on future developments and on how the current economic uncertainty plays out. There is, among other things, considerable uncertainty at present about the transmission of monetary policy as the effects of unusually low global interest rates have been felt increasingly in Iceland. Monetary policy formulation will also depend on developments in liquidity in connection with capital account liberalisation and whether other policy instruments are applied in order to contain demand-side pressures in the coming term.

No. 26/2015
9 December 2015

Statement of the Monetary Policy Committee
9 December 2015

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The Bank's key interest rate – the rate on seven-day term deposits – will therefore remain 5.75%. The Committee has also decided to lower reserve requirements by 1.5 percentage points.

According to newly published preliminary figures from Statistics Iceland, year-on-year GDP growth over the first three quarters of 2015 measured 4.5%, which is broadly in line with the Bank's November forecast. Furthermore, the labour market continues to recover strongly.

The short-term inflation outlook has improved since the November forecast. Inflation measured 2% in November and has risen less rapidly in the recent term than had been projected, as the decline in global oil and commodity prices and the appreciation of the króna have offset domestic price increases.

A stronger króna and more favourable global price developments have provided the scope to raise interest rates more slowly than was previously considered necessary. However, this does not change the fact that, according to the Bank's November forecast, a tighter monetary stance will probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened will depend on future developments.

At its September meeting, the MPC decided to raise reserve requirements temporarily from 2% to 4% so as to strengthen the Central Bank's liquidity management in connection with its foreign currency purchases and the liberalisation of the capital controls. The Committee has now decided to lower reserve requirements from 4% to 2.5% as of the next reserve maintenance period, which begins on 21 December, so as to mitigate the liquidity effect of the stability contributions paid by the failed banks' estates. Other things being equal, the MPC plans to lower the reserve requirements back to 2% in connection with the planned auction of offshore krónur.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, August 2015

Published 2 September 2015

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

The following are the minutes of the MPC meeting held on 17 and 18 August 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 19 August, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 10 June interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2015/3 on 19 August.

Financial markets

Since the June meeting, the króna had appreciated by 1.9% in trade-weighted terms and by 1.6% against the euro, but depreciated by 0.2% against the US dollar and 2.8% against the pound sterling.

The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled 562 million euros (82.9 b.kr.) between meetings, or 60% of total market turnover. Purchases year-to-date totalled 957 million euros (141.6 b.kr.), considerably more than over the same period in 2014.

Interest rates in the interbank market for krónur rose in line with the Central Bank’s rate increase in June, and as before, overnight rates in the market are below the centre of the interest rate corridor, close to the Bank’s key rate. Interbank market turnover totalled 235.5 b.kr. year-to-date, which is considerably more than in the same period in 2014 but somewhat below the level seen in the same period of the three preceding years.

Yields on short-term nominal Treasury bonds had increased by 0.2-0.3 percentage points between meetings, in line with the Bank's rate increase, while yields on long-term nominal bonds had declined by 0.3-0.9 percentage points. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds had fallen by 0.3 percentage points since the June meeting. To some extent, this decline may reflect non-residents' increased new investment in long Treasury bonds following the announcement of important steps in the capital account liberalisation strategy in early June. The decline could also reflect expectations of an improved Treasury position following the liberalisation of the capital controls, which can also be seen in rating upgrades from all three international rating agencies.

The average of the lowest listed nominal mortgage rates offered by the three large commercial banks had risen slightly since the June meeting, in line with the Bank's rate increase. The banks' real rates were broadly unchanged, however, as were comparable rates on indexed loans.

The monetary stance had eased since the June meeting, owing primarily to higher inflation and inflation expectations. At the time of the August meeting, the Bank's real rate was 1.3% in terms of the average of various measures of inflation and inflation expectations, and 3.1% in terms of twelve-month inflation. This is about 0.2-0.4 percentage points lower than just after the interest rate announcement in June.

Increased optimism about the Treasury's position is also reflected in falling risk premia. Since June, the CDS spread on five-year Treasury obligations has fallen by 0.3 percentage points, to the current 1.4%. Furthermore, the risk premium on the Treasury's foreign obligations, in terms of the spread between long-term foreign-denominated Treasury bonds and comparable bonds issued by the US and Germany, has also fallen after an uptick in June in connection with uncertainty about the possibility of a Greek default. It measured about 1½ percentage points, roughly the same as at the time of the June meeting.

Financial institutions' analysts all expected a 0.5 percentage point increase in the Central Bank's nominal interest rates in August, mainly citing the clear forward guidance in the MPC's previous statement and meeting minutes.

M3 grew by over 12.8% year-on-year in Q2/2015, or by 6.8% excluding deposits held by the winding-up boards of the failed deposit money banks (DMB).

Net new loans from DMBs to the non-financial corporate sector (i.e., new loans net of prepayments) had nearly doubled year-on-year in the first half of 2015. The vast majority of this increase is due to loans to services firms and retail trade firms. New loans to households have probably increased as well, but the assessment of the situation is complicated by problems relating to the treatment of data in connection with the Government's debt relief measures.

The NASDAQ OMXI8 index had risen by 6.5% between meetings. Turnover in the NASDAQ Iceland main market totalled 188 b.kr. over the first seven months of the year, about 23% more than over the same period in 2014.

Outlook for the global real economy and international trade

According to the International Monetary Fund's (IMF) July forecast, the global output growth outlook has deteriorated for 2015 but is unchanged for 2016. Global output growth is forecast at 3.3% this year, some 0.2 percentage points less than in the Fund's April forecast, mainly due to weaker growth prospects in the US and in emerging countries. Global GDP growth is forecast at 3.8% in 2016. If the forecast for 2015 materialises, growth will be the weakest since 2009. The Fund's forecast for growth in world trade in 2015 has been revised upwards by 0.4 percentage points, to 4.1%, whereas it has been revised downwards to 4.4% for 2016. Inflation in developed countries is forecast at 0% this year, about 0.4 percentage points below the previous forecast, and is projected to rise to 1.2% next year. The forecast for 2015 output growth among Iceland's main trading partners has been revised downwards, to 1.8%. The risk to the GDP growth outlook is still considered concentrated on the downside.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 4.5 b.kr. deficit in July and a 9 b.kr. deficit over the first seven months of the year. Exports grew by 18% year-on-year at constant exchange rates in the first seven months of the year, whereas imports grew by 19%. Stronger exports are due mainly to a one-fourth increase in industrial exports and a one-fifth increase in marine product exports. Import growth is due mainly to an 80% year-on-year increase in transport equipment imports and a 27% increase in food and beverage imports.

Aluminium prices have fallen 11% since the MPC's June meeting and were down by an average of 22.7% year-on-year in the first half of August. Foreign currency prices of marine products were up 1% month-on-month in June and had risen by 9.5% in the preceding twelve months.

In terms of relative consumer prices, the real exchange rate rose 0.8% month-on-month in July, to 86.2 points. It was up 1.7% year-on-year in the first seven months of 2015, due equally to the nominal appreciation of the króna and to the fact that inflation in Iceland was above the trading partner average.

The domestic real economy and inflation

The results of the Statistics Iceland labour force survey (LFS) show that labour demand in Q2/2015 was broadly in line with the forecast in the May *Monetary Bulletin*. The May forecast provided for a 4.3% year-on-year increase in total hours worked, whereas the actual increase was 3.9%. The increase in total hours worked during the quarter is due to a 4.3% increase in the number of employed persons, as average hours worked were 0.4% less than over the same period in 2014. Developments during the quarter were very similar to those in the preceding quarter. The reduction in working hours is due entirely to shorter hours among the youngest worker group.

Seasonally adjusted unemployment according to the LFS was virtually unchanged between quarters but declined by 0.8 percentage points year-on-year. It measured 3.9%, somewhat more than was assumed in the Bank's May forecast.

Net migration was positive in Q2/2015, due entirely to an increase in foreign nationals, as has been the case for the past two years.

In Q2/2015, the wage index rose by 1.7% between quarters and by 7.1% year-on-year, and real wages were 4.3% higher than in Q2/2014.

Key indicators of developments in private consumption during Q2/2015 suggest that it continued to grow at about the same pace as in previous quarters. Payment card turnover grew more than 4½% year-on-year during the quarter and, in July, had grown by just over 9%. New motor vehicle registrations increased by a third during the quarter, although there was a slowdown in groceries turnover.

The Gallup Consumer Sentiment Index declined month-on-month in July, to just over 99 points, but was up more than 14 points year-on-year. In Q2 it was slightly above the Q2/2014 level, on average. The big-ticket index, which measures households' planned major purchases, measured 66.8 points in June. It has risen steadily in the recent past and is higher than at any time since March 2008.

Statistics Iceland's nationwide house price index, published in late July, was up 0.4% month-on-month when adjusted for seasonality, and about 8.7% year-on-year. The capital area real estate price index, calculated by Registers Iceland, declined by 0.4% month-on-month in June when adjusted for seasonality. It rose by 10% year-on-year. During the first seven months of the year, housing market turnover nationwide was up 14.7% year-on-year and turnover in the greater Reykjavík area was up 9.6%. The average time-to-sale for capital area housing was four months during the first six months of the year, about half a month shorter than during the same period in 2014.

The CPI rose 0.16% month-on-month in July, after rising by just under 0.3% in June. This is the first rise in the CPI in the month of July since 2011. Twelve-month inflation measured 1.9% in July, slightly more than at the time of the MPC's June meeting. Inflation is still due primarily to rising house prices, as it measured only 0.4% excluding the housing component. Underlying inflation has also increased in recent months. Twelve-month inflation in terms of core index 3 excluding tax effects was 2% in July, nearly ½ a percentage point higher than at the last meeting. Statistical measures of underlying inflation suggest that it lay in the 1.9-3.8% range. Summer sales on clothing and footwear had the greatest impact on the CPI in July, lowering it by 0.5 percentage points. A 33% month-on-month rise in international airfares and an increase in imputed rent outweighed the downward effect of seasonal sales, however.

According to the Bank's survey of market agents' expectations, carried out in mid-August, respondents expect inflation to measure just under 4% one year ahead. This is about ½ a percentage point more than in the May survey. Their inflation expectations two years ahead also rose by ½ a percentage point, to 3.5%. The same is true of market agents' long-term inflation expectations: Survey respondents indicated that they expected inflation to average 3.5% over the next five years. The long-term breakeven inflation rate in the bond market has fallen since the MPC's last meeting, however; the five- and ten-year breakeven rates were just under 4% in mid-August, about 1 percentage point lower than at the time of the June meeting. As is discussed in *Monetary Bulletin*, this decline probably reflects to some extent non-residents' appetite for nominal Treasury bonds rather than a reduction in residents' inflation expectations.

According to the forecast published in the 19 August 2015 issue of *Monetary Bulletin*, the inflation outlook has deteriorated markedly since May. Inflation now looks set to rise above 4% early in 2016 and hover in the 4-4½% range over the next two years before falling back towards the target late in the forecast horizon. The main cause of the changed outlook is the recently concluded wage agreements, which provide for much larger pay rises in 2015 and the ensuing two years than previously assumed. The outlook is for unit labour costs to rise by more than 9% this year and over 7% per year, on average, over the forecast horizon – far more than was forecast in May. This is offset by the prospect of somewhat smaller increases in import prices during the forecast horizon than was projected in May.

There is some uncertainty about possible deviations in inflation from the above-described forecast, mainly because of uncertainty about the degree to which pay rises will be passed through to prices or absorbed through increased streamlining, resulting in a lower employment level, and uncertainty about global price developments and whether the improvement in terms of trade will continue.

The gradual global economic recovery continues, although some uncertainty remains, including that stemming from the recent unrest in the Chinese financial market and the expected interest rate hikes by the US Federal Reserve Bank. Oil prices have fallen still further in global markets, and Iceland's terms of trade have therefore continued to improve.

Preliminary figures from Statistics Iceland suggest that GDP growth was 2.9% in the first quarter of the year. The outlook is for it to gather pace and measure 4.2% for the year as a whole. Nevertheless, this is about ½ a percentage point below the forecast in the May *Monetary Bulletin*, as Q1/2015 GDP growth turned out weaker than was projected in May. The GDP growth outlook for the upcoming two years has also been revised downwards, from the previous 3½% per year to 3%. The composition of GDP growth has changed as well, with growth now expected to be driven more by domestic demand, private consumption in particular.

Sizeable wage increases in the wake of the wage settlements will inevitably call for a tighter monetary stance, which will hinder investment growth and labour demand growth. As a result, it is assumed that total hours worked will increase more slowly and unemployment will be higher during the forecast horizon than was projected in May. It is assumed that the post-crisis slack in the domestic economy is now fully absorbed and that a positive output gap has begun to develop. The output gap is projected to peak in early 2016 at just over 1% of potential output. As in May, it is assumed that the output gap will have disappeared again by the end of the forecast horizon and that unemployment will be close to its equilibrium level.

The underlying current account balance is expected to be positive by 4½% this year, about twice the surplus forecast in May. The underlying surplus is forecast to shrink year-on-year, however, as soon as the failed banks' estates have been settled in early 2016 and the effect on the underlying current account balance has become clear. It is expected to be positive by nearly 1½% of GDP in 2017, about ½ a percentage point less than was forecast in May.

II The interest rate decision

The Governor gave the Committee an update on developments since the last meeting, including the work done by the Bank and other authorities in relation to the capital account liberalisation strategy. He also reported to the Committee that the three large international rating agencies had all upgraded Iceland's sovereign credit ratings after the liberalisation strategy was announced in June. Furthermore, he updated the Committee on the Treasury's buyback of its own US dollar-denominated bonds maturing in June 2016 and reported on non-residents' purchases of domestic Treasury bonds.

The Committee discussed whether developments since the last meeting had changed its assessment of the necessary monetary stance. At the last meeting, the Committee had raised interest rates by 0.5 percentage points and had agreed that, in response to the effects of large pay rises in the recent wage settlements, it was apparent that a sizeable rate increase would be necessary in August, followed by further rate hikes in the coming term, so as to ensure that inflation would stay close to target over the medium term.

Committee members agreed that there was considerable strength in the economy. The Bank's new forecast, which took account of the results of wage negotiations, was available at the time of the August meeting. According to the forecast, GDP growth will be just over 4% this year and about 3% per year for the two years thereafter. The Committee agreed that, even though the growth rate was weaker than the Bank had forecast in May, it was quite robust. The slack in the economy and the labour market had disappeared, and the output gap would widen in the coming term. According to the forecast, GDP growth would be driven by domestic demand, especially private consumption, to a greater extent than in recent years, and investment would probably be weaker than previously forecast. Furthermore, it was assumed that labour demand would grow more slowly than was projected in May, due both to streamlining by firms in response to large pay increases and to the monetary policy response. The Committee also noted that it appeared likely that lending and growth in the money stock were picking up.

The Committee discussed developments in inflation since the last meeting. In line with the assessment from the last meeting, the August forecast showed that the inflation outlook had deteriorated markedly from the May forecast. According to the new forecast, inflation is projected to rise to 4% early in 2016 and to hover in the 4-4½% range over the next two years before subsiding towards the target, as the forecast implies that the monetary stance will be tightened in the near future. Committee members were concerned that inflation expectations had risen between meetings.

They agreed that changes in the economic outlook since May were attributable primarily to the effects of large pay increases following the recent wage settlements and the monetary tightening that inevitably accompanies pay hikes of such size. Offsetting the inflationary effects of the pay rises, however, were global factors, which have contributed to a more pronounced decline in import prices than previously expected, and improved terms of trade.

The Committee discussed the Central Bank's large-scale purchases of foreign currency between meetings, as the króna had appreciated marginally in spite of the purchases. Members agreed that the purpose of the Bank's foreign currency purchases was not to prevent appreciation of the króna based on fundamentals but to shore up the Bank's non-borrowed reserves during the prelude to capital account liberalisation and to mitigate excessive exchange rate volatility deriving, for instance, from temporary inflows or outflows.

The Committee discussed various uncertainties and their effect on GDP growth, demand, and inflation. Members were of the view that there was particularly pronounced uncertainty about the degree to which firms would pass wage increases through to prices or respond to them with internal streamlining. The effect on prices could therefore prove less pronounced than was assumed in the forecast, although the risk assessment indicated that the risk profile was tilted to the upside. There was also considerable uncertainty about global developments and their impact on commodity prices – and therefore about Iceland's terms of trade. If terms of trade improve more than is forecast, there could be increased scope for pay rises and the inflationary effects of such rises could therefore prove to be less. The Committee also discussed the fact that inflation was driven primarily by the housing component of the CPI. House prices have risen somewhat recently but still do not seem out of line with developments in other economic variables and have kept pace with the long-term house price-to-income ratio. Committee members agreed, however, that it would be necessary to keep close track of developments in house prices and lending.

The Committee also discussed the connection between interest rate decisions and indications of increased capital inflows. Members agreed that, as yet, inflows were not substantial, although they could grow rapidly. Increased demand had led to a one percentage point decline in interest rates on long-term Treasury bonds, however. It was pointed out that there could also be other explanations for the increased inflows and lower interest rates, such as improved credit ratings and lower credit spreads on Treasury debt. It was also pointed out that while excessive outflows had previously been considered the greatest risk, the discussion appeared to have turned around, with the focus now on increased inflows. It must not be forgotten that increased inflows were a positive development in the run-up to capital account liberalisation and that the balance was still skewed by the fact that the controls sequestered significant amounts of capital that would otherwise flow out. It was pointed out that if interest rates in Iceland were to be reasonably close to those elsewhere, domestic demand and inflation would have to be at a level consistent with a balanced economy and inflation at target. Committee members agreed that it was necessary to prevent interest rate decisions from focusing on capital inflows. If inflows related to carry trade became substantial, it would be necessary to use other policy instruments to restrict them. In this context, the Committee discussed possible application of such instruments and the work underway within the Bank in developing them.

Committee members all agreed that it was necessary to raise the Bank's interest rates by at least 0.5 percentage points. The discussion centred on whether to raise them by 0.5 or 0.75 percentage points. The main arguments in favour of the smaller step were the considerable uncertainty about how successful firms would be in streamlining in response to cost increases and the fact that global price developments tended increasingly to offset domestic inflationary pressures. It was also pointed out that the MPC's recent forward guidance had to some extent affected the yield curve over and above the interest rate increase.

The main argument in favour of the larger rate hike was that a 0.5 percentage point increase would merely return the monetary stance to its position prior to the MPC's June decision. The Central Bank's baseline forecast indicated that the effects of wage settlements on inflation would be in line with the MPC's assessment in June and that the Committee had deemed it apparent that further rate hikes would be needed in the coming term. The risk assessment in the inflation forecast indicated that risk was concentrated on the upside. Both the new forecast and indicators of demand suggested that domestic demand was growing rapidly and would be the main driver of GDP growth during the forecast horizon. The rise in inflation expectations between meetings also indicated that expectations were not firmly enough anchored to the inflation target. As a result, there was the risk that the monetary stance would be tightened too little and too late.

In view of the discussion, the Governor proposed that the Bank's interest rates be increased by 0.5 percentage points, which would raise the key rate (the seven-day term deposit rate) to 5.5%, deposit rates (current account rates) to 5.25%, the seven-day collateralised lending rate to 6.25%, and the overnight rate to 7.25%. Four members voted in favour of the Governor's proposal. One member voted against the Governor's proposal, voting instead to raise rates by 0.75 percentage points.

Committee members agreed that if inflation rises in the wake of the wage settlements, as is forecast, the MPC will have to raise interest rates still further in order to bring inflation back to target over the medium term. How much and how quickly will depend on future developments and on how the current uncertainty plays out, including the degree to which large pay increases are passed through to prices, on the one hand, and the degree to which they prompt rationalisation and productivity growth, on the other. Developments in terms of trade, credit growth, and real estate prices are important factors as well. Committee members were of the view that the interest rate path would depend on whether other policy instruments were used to contain demand-side pressures in the coming term.

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 30 September 2015.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, September 2015

Published 14 October 2015

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

The following are the minutes of the MPC meeting held on 29 September 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 30 September, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 19 August interest rate decision.

Financial markets

Since the August meeting, the króna had appreciated by 4.3% in trade-weighted terms, by 2.5% against the euro, by 4.1% against the US dollar, and by 7.6% against the pound sterling.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 346 million euros (50.3 b.kr.) between meetings, or 60% of total market turnover. Purchases year-to-date totalled roughly 1.3 billion euros (191.9 b.kr.), considerably more than over the same period in 2014.

Interest rates in the interbank market for krónur rose in line with the Central Bank's rate increase in August, and as before, overnight rates in the market are below the centre of the interest rate corridor, close to the Bank's key rate. Interbank market turnover totalled 257.5 b.kr. year-to-date, which is considerably more than in the same period in 2014 but somewhat below the level seen in the same period of the three preceding years.

Yields on nominal Treasury bonds had declined by 0.4-0.7 percentage points between meetings. The reduction is due in large part to increased new investment by non-residents that have invested primarily in long-term bonds since last summer. The yields on these bonds have therefore declined more, leading to a change in the yield curve, which is now downward-sloping rather than upward-sloping. Furthermore, the market's response to the 2016 fiscal budget proposal, which indicates that the Treasury's financing need will be reduced in coming years, could play a role in the decline. Furthermore, some analysts have opined that the MPC's August statement implies that interest rate increases will be smaller in the near future than had previously been forecast. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds rose over the same period by 0.1-0.3 percentage points. The breakeven inflation rate in the bond market has therefore fallen.

The lowest variable rates on non-indexed mortgages offered by the three large commercial banks had risen by about ½ a percentage point since the August meeting, in line with the Bank's rate increase. Fixed rates on comparable loans were virtually unchanged, however, as were the banks' indexed mortgage rates, but variable rates on some pension funds' indexed loans to fund members had declined.

Interest rates on the three banks' non-indexed deposits had risen by 0.4-0.6 percentage points since the August meeting, whereas indexed deposit rates were unchanged.

The monetary stance had tightened slightly since the August meeting, owing to reduced inflation expectations. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.9% at the time of the September meeting, or about 0.2 percentage points higher than just after the August interest rate announcement. In terms of past twelve-month inflation, however, it was unchanged at about 3½%.

The risk premium on the Treasury's foreign obligations had risen slightly since the August meeting. The CDS spread on five-year Treasury obligations had increased by 0.2 percentage points and was 1.6% at the September meeting. Furthermore, the risk premium on the Treasury's foreign obligations, in terms of the spread between long-term foreign-denominated Treasury bonds and comparable bonds issued by the US and Germany, had risen by 0.1-0.3 percentage points, to 1.6-1.8% just before the September meeting.

Financial institutions' research department analysts had all forecast that the MPC would hold the Bank's nominal interest rates unchanged in September, citing the milder tone in the Committee's last statement and pointing out that inflation had turned out lower than the Bank had forecast.

M3 grew by nearly 12% year-on-year in August, or by 7.3% excluding deposits held by the winding-up boards of the failed deposit money banks (DMB).

Net new lending (new loans net of prepayments of older loans) from DMBs to the non-financial corporate sector seems to have increased markedly in the first eight months of the year, compared to the same period in 2014. Adjusted for prepayments of HFF loans and the Government's debt reduction measures, net new lending in the first eight months of the year was higher than in either 2014 or 2013.

The NASDAQ OMXI8 index had risen by 7.7% between meetings. Turnover in the NASDAQ Iceland main market totalled around 225 b.kr. over the first eight months of the year, about 35% more than over the same period in 2014.

Outlook for the global real economy and international trade

Iceland's external goods trade generated a deficit of 6.7 b.kr. for the first eight months of the year, as opposed to a deficit of nearly 1.8 b.kr. over the same period in 2014. Export values grew by 16% at constant exchange rates, while import values rose 17.2%. The increase in exports is due primarily to 23% growth in industrial goods exports and nearly 16% growth in marine product exports. Import growth derives in particular from a more than 53% year-on-year increase in transport equipment imports and a one-fourth increase in imports of both goods and beverages and commodities and operational goods.

In terms of relative consumer prices, the real effective exchange rate index measured 88.3 in August, having risen in each month since last February. The average increase over this eight-month period was 2.2% year-on-year. It is due primarily to a 1.2% nominal appreciation of the króna, but in addition, inflation in Iceland was 1 percentage point above the average among its trading partners.

Aluminium prices were roughly unchanged since the last MPC meeting, although the average price in September was down by over a fifth year-on-year. Foreign currency prices of marine products rose by 1.1% between months in July and had risen 9.7% year-on-year at that time.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in September, GDP growth measured 5.6% in Q2/2015. Domestic demand grew by 5.4% year-on-year, and the contribution from net trade was positive during the quarter. In H1/2015, GDP growth measured 5.2%, with offsetting effects of 7.3% growth in domestic demand and a negative contribution from net trade in the amount of almost 2 percentage points.

GDP growth in the first six months of the year was 2.1 percentage points stronger than was assumed in the forecast in the August *Monetary Bulletin*, which provided for 3.1% growth. The deviation can be attributed to a much more favourable contribution from net trade than was forecast; furthermore, a revision of Q1 national accounts figures revealed much stronger GDP growth than the preliminary figures from June indicated. Domestic demand developed largely in line with the forecast. Consumption and total investment grew by 6.8%. GDP growth in H1/2015, however, was very similar to the forecast in May, before Statistics Iceland's first release of Q1 figures.

The underlying current account balance was positive by 26.5 b.kr., or 4.9% of GDP, in Q2. This is a larger surplus than in both the preceding quarter and Q2/2014, when it measured 2.5% of GDP. The surplus in Q2 is due to a surplus on services trade of 53.3 b.kr., excluding the effects of the DMBs in winding-up proceedings; however, it is offset by a 12.8 b.kr. deficit on goods trade and a 14.1 b.kr. deficit on the underlying balance on primary and secondary income. A revision of previously published figures for Q1/2015 shows that, as a share of GDP, the surplus was more than ½ a percentage point larger than previously estimated. In 2014, however, the surplus was smaller by 0.8% of GDP. The smaller surplus last year is due to a larger deficit on primary income, as bond interest expense turned out higher than previously projected.

Key indicators of private consumption growth in Q3, available at the time of the MPC meeting, indicate that private consumption grew markedly during the quarter, perhaps even exceeding the growth rate year-to-date. In July and August, payment card turnover was up by 7.5% year-on-year and new motor vehicle registrations by roughly 64%. On the other hand, groceries turnover was down year-on-year by nearly 1% during the same period.

In September, the Gallup Consumer Sentiment Index was virtually unchanged since August but had risen slightly between years. The big-ticket index measured 64 points, which is 2.8 points less than in June. Two of its three sub-indices – planned motor vehicle purchases and planned overseas travel – were lower than in June, while the index of planned house purchases rose somewhat, to its highest level since September 2007. All sub-indices rose year-on-year.

According to the fiscal budget proposal for 2016, the primary balance for 2016-2019 is projected to deteriorate slightly from the fiscal plan presented in the spring. The primary balance is estimated to deteriorate between 2014 and 2016, and the output gap is expected to widen by about 1.2 percentage points over the same period. Measured as a change in the cyclically adjusted primary balance, the fiscal stance will ease by a total of approximately 1½% of GDP this year and next year. The consolidation on the expenditures side does not fully offset the relaxation on the revenues side, as real primary expenditures are expected to increase by 1-1.6% during the period. Excluding the tax on financial institutions, relinquishment of revenues due to systemic changes from 2013 will total 1.6% of GDP in 2016. The financial balance will improve rapidly between 2016 and 2019, causing the overall surplus to increase from 0.7% of GDP in 2016 to 1.7% of GDP by 2019, even though the primary balance will remain virtually unchanged.

According to the Statistics Iceland labour force survey (LFS), labour demand growth continued to gain pace in July and August. Seasonally adjusted unemployment measured 4.2% in August, having declined by nearly a percentage point year-on-year.

The wage index rose by 0.3% month-on-month in August, after rising 1.1% in July. The twelve-month rise in the index measured 7.7% in August and 7.9% in July. Real wages in terms of the index had risen by 5.4% year-on-year in August.

According to the Gallup survey among executives from Iceland's 400 largest firms, carried out in August and September, the share of respondents interested in adding on staff in the next six months exceeded the share interested in downsizing by more than 17 percentage points. This is considerably more optimism than was indicated in a comparable survey carried out in May. More companies are planning to recruit and fewer are planning to reduce staffing. Executives in all sectors except tourism were more optimistic about recruitment than in the May survey. Just over a fourth of firms consider themselves short-staffed, an increase of nearly 7 percentage points between surveys. About ⅔ of construction firms consider themselves short-staffed, and over 70% are planning to recruit workers in the next six months.

According to the survey, executives were much more upbeat about the economic outlook than in the previous survey. For the first time since September 2007, a majority of executives considered current conditions good. About 39% considered them neither good nor bad. Executives were also very optimistic about the future situation, with nearly 39% of respondents indicating that they expected conditions to improve in the next six months and about half indicating that they expected no change (i.e., that conditions would remain good). Executives in all sectors except construction were more optimistic than in May, with the change most pronounced among those in the financial and fisheries sectors.

The nationwide house price index compiled by Statistics Iceland rose by 1.1% quarter-on-quarter in Q3 and 8.1% year-on-year after adjusting for seasonality. The Registers Iceland capital area real estate price index rose by 0.9% month-on-month in August adjusted for seasonality, and 8.1% year-on-year. The number of purchase agreements registered nationwide rose by 10.5% year-on-year in the first eight months of 2014.

The CPI declined by 0.39% month-on-month in September, after rising 0.53% in August. Twelve-month inflation measured 1.9% in September. It was unchanged from the MPC's August meeting but had declined month-on-month. Inflation excluding the housing component measured 0.5%. Underlying annual inflation in terms of core index 3 excluding tax effects had fallen slightly between months, to 2.2%. Statistical measures of underlying inflation suggest that it lay in the 2.1-4% range.

The steep drop in international airfares had the strongest effect on the CPI in September, causing a 0.4-percentage point decline. Falling oil and petrol prices lowered the index by 0.2 percentage points, triggered by a marked decline in global oil prices in the recent term. The increase in clothing and footwear prices at the end of seasonal sales had an upward impact on the CPI of 0.2 percentage points. The recent appreciation of the króna had somewhat of an impact, as reduced prices due to sales did not reverse in full. Even though inflation is low, domestic inflationary pressures appear to have increased somewhat. Domestic inflation (excluding housing) measured 3.8% over the previous twelve months, as compared with 3% in July.

According to the Gallup survey of household expectations carried out in September, household inflation expectations one and two years ahead were unchanged since the May survey, at 4%. According to a comparable survey carried out among executives in August and September, respondents' inflation expectations one year ahead had fallen by ½ a percentage point since May, to 3.5%. Executives also expected inflation to measure 3.5% in two years' time, a slight increase from the previous survey.

The breakeven inflation rate in the bond market has fallen since the last meeting. It is difficult to interpret developments in market inflation expectations, however, because of the recent surge in capital inflows, which has led to a significant decline in yields on long nominal Treasury bonds. The breakeven inflation rate two years ahead averaged 3.8% in September, having declined by ½ a percentage point since August. The breakeven inflation rate five and ten years ahead averaged just over 3% in September, about 0.7 percentage points lower than in August.

II The interest rate decision

The Governor gave the Committee an update on developments since the last meeting, including the work done by the Bank and other authorities in relation to the capital account liberalisation strategy. Representatives from the Ministry of Finance and Economic Affairs also reported to Committee members on the highlights of the new fiscal budget proposal.

MPC members discussed whether developments since the previous meeting had changed the Committee's assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the last meeting, the Committee had raised interest rates by 0.5 percentage points and had agreed that if, in the wake of wage settlements, inflation rose in line with the forecast in the August *Monetary Bulletin*, it would be necessary to raise rates even higher in order to bring inflation to target over the medium term.

In the Committee's opinion, growth in economic activity was broadly in line with the August forecast. Members discussed the recently published national accounts figures from Statistics

Iceland, which show that in the first half of the year, domestic demand growth was broadly in line with the August forecast, but GDP growth measured much stronger. Although GDP growth turned out stronger than had been forecast, Committee members were of the view that the forecast error largely reflected temporary factors. They agreed that in the coming term, the outlook still remained for robust GDP growth and a widening positive output gap, as was provided for in the August forecast.

Committee members discussed developments in inflation since the last meeting. They noted that inflation had risen more slowly than was assumed in the Bank's last forecast and that it was still below the inflation target, particularly if the housing component of the CPI is excluded. The Committee was of the view that this was due in part to the stronger króna but that volatile items played a part as well. Members agreed that in spite of favourable developments, the medium-term inflation outlook had probably not changed markedly, although the short-term outlook had improved. As before, the outcome of wage settlements and somewhat elevated inflation expectations indicated that inflation would gain momentum in the near future. This was offset, however, by falling global goods prices, and uncertainty about developments in goods prices had increased between meetings. The appreciation of the króna (about 4% since the previous interest rate decision) in spite of sizeable foreign currency purchases by the Central Bank had also offset increased domestic inflationary pressures.

In the Committee's opinion, the recent appreciation of the króna was due mainly to developments in the real economy. Members agreed that it was inappropriate to lean too strongly against underlying market developments. Several members emphasised their opinion that the objective with the Bank's foreign exchange market intervention was not to support a specific exchange rate but to stabilise flows in the market and attempt to mitigate excessive exchange rate volatility.

The Committee discussed the possibility of waiting and keeping interest rates unchanged at this time in view of reduced inflation in the recent past, or to continue the monetary tightening phase by raising interest rates by 0.25-0.5 percentage points. The chief argument in favour of unchanged interest rates discussed at the meeting was that inflation had risen more slowly than had been provided for in the Bank's August forecast. This would give the Committee increased scope to decide how rapidly to respond to the prospect of increased inflation. It would also entail increased scope to see how the current uncertainty played out. Inflation was still low, which could indicate that wage increases had been responded to with more streamlining than had been anticipated. It was also pointed out that the scope for pay increases could be greater than previously thought. Productivity growth could also be underestimated, and the greater-than-expected improvement in terms of trade could provide additional scope for wage increases. Uncertainty about developments in global inflation, which increasingly offset domestic inflationary pressures, had also escalated. It was also stated at the meeting that it should be safe to wait at this juncture, as interest rates had been raised by a total of 1 percentage point at the last two meetings. Furthermore, by the next meeting the Bank's new forecast would be available, including an assessment of the effects of recent developments on the near-term inflation outlook.

The main argument in favour of continuing the monetary tightening was that monetary policy decisions should be based more on the inflation outlook than on current inflation measures. Although inflation had been lower than expected in September, it was due mainly to temporary factors related to the steep reduction in airfares. For instance, services inflation, which was an indication of the impact of wage rises on inflation, had risen since the spring wage settlements and was now 3.6%. All economic indicators published since the Committee's last meeting indicated considerable strength in the domestic economy. Fiscal policy also indicated that there was need for a tighter monetary stance than previously thought. As a result, there was the risk that the monetary stance was being tightened too little and too late.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.5%, the current account rate 5.25%, the seven-day collateralised lending rate 6.25%, and the overnight lending rate 7.25%. Four members voted in favour of the Governor's proposal. One of the four would have preferred to raise rates by 0.25 percentage points but was nonetheless willing to vote in favour of the Governor's proposal. One member voted against the Governor's proposal and would have chosen to raise rates by 0.25 percentage points.

All Committee members agreed that if inflation rises in the wake of the wage settlements, as forecasts indicate, the MPC will have to raise interest rates still further in order to bring inflation back to target over the medium term. How much and how quickly would depend on future developments and on how the current uncertainty plays out. Although a stronger króna and global price developments had provided the scope to raise interest rates somewhat more slowly than was previously considered necessary, they do not change the need for a tighter monetary stance in the near future. The Committee also agreed that the interest rate path will depend on whether other policy instruments are used to contain demand-side pressures in the coming term. In the MPC's estimation, after adjusting for cyclical factors, the expected Treasury outcome for 2015 and the fiscal budget proposal for 2016 entail an easing of fiscal policy, which will call for a tighter monetary stance, other things being equal.

The Committee discussed in particular the indicators of increased capital inflows between meetings, as increased demand for Treasury bonds had led to a continuing decline in interest rates on long-term Treasury bonds. As at the previous meeting, members agreed that in the event of substantial inflows due to carry trade, it would be necessary to use tools other than interest rates to restrict them. It was decided to hold a meeting with the Systemic Risk Committee before the end of November in order to discuss possibilities for such tools.

In the wake of the Bank's substantial foreign currency purchases in the recent term, and in order to encourage financial institutions to prepare themselves for the settlement of the failed banks' estates and the planned auction for the purpose of releasing or tying up offshore krónur, the Committee decided at the meeting to increase reserve requirements from 2% to 4% as of the next reserve maintenance period, which begins on 21 October. Changes in reserve requirements had been discussed at recent meetings of the MPC. Members agreed that the aim of raising reserve requirements was not to affect the monetary stance but to strengthen the financial institutions' liquidity position through the settlement of the failed banks' estates and the auction of offshore krónur. Therefore, it was assumed that reserve requirements would be lowered again in connection with the auction. The sterilisation of large foreign currency purchases would also be improved with these measures. Furthermore, the Committee decided to amend the Rules on Reserve Requirements so as to obviate the need to amend the Rules each time the MPC decides to change reserve requirements. Henceforth, it will be sufficient that such changes be announced in Monetary Policy Committee statements. The Rules were also adapted to the current Central Bank Act.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members and representatives of the Ministry of Finance and Economic Affairs attended parts of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 4 November 2015.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, November 2015

Published 18 November 2015

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

The following are the minutes of the MPC meeting held on 2 and 3 November 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 4 November, 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 30 September interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2015/4 on 4 November.

Financial markets

In trade-weighted terms, the exchange rate of the króna was virtually unchanged since the September meeting, as movements against major currencies offset one another. The króna appreciated by 1.4% against the euro but depreciated by 2.3% against the pound sterling, and 0.8% against the US dollar.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 198 million euros (28.1 b.kr.) between meetings, or 57% of total market turnover. Purchases year-to-date totalled 1.5 billion euros (220 b.kr.), more than twice the total for the same period in 2014.

Interest rates in the interbank market for krónur have developed in line with the Central Bank's key rate, and as before, overnight rates in the market are below the centre of the interest rate corridor, close to the key rate. Interbank market turnover totalled 305.5 b.kr.

year-to-date, considerably more than in the same period in 2014 but somewhat below the level seen in the same period of the three preceding years.

In terms of the Central Bank's real rate, the monetary stance had tightened slightly since the MPC's September meeting, owing to lower inflation and inflation expectations. At the time of the November meeting, the Bank's real rate was 3.6% in terms of the current inflation level and 2.2% in terms of the average of various measures of inflation and inflation expectations. This is about 0.1-0.2 percentage points higher than just after the September interest rate announcement.

The transmission of Central Bank rates to other interest rates has been broadly smooth in the recent term. The transmission through the interest rate channel has weakened recently, however, as higher Central Bank interest rates have not been transmitted fully to long-term bond market rates. Yields on nominal Treasury bonds had fallen by 0.3-0.6 percentage points between meetings. Since the June meeting, however, the decline had totalled up to 2.1 percentage points, whereas the Bank's nominal interest rates had been raised by 1 percentage points over the same period. Yields on the longest bonds had fallen most. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds had fallen by 0.2-0.4 percentage points between meetings and by as much as ½ a percentage point since June. Yields on the commercial banks' covered bonds had also fallen in line with bond interest rates. This development may be due in part to lower inflation expectations and reduced concerns about inflation in the wake of wage settlements, as well as expectations of reduced Treasury bond issuance and an improved Treasury debt position following the publication of the capital account liberalisation strategy. However, the reduction is probably due to a large extent to an increase in non-residents' investment in long-term nominal Treasury bonds, which has lowered term premia in the bond market. This is in line with the views of the majority of respondents in the Bank's recent survey of market agents' expectations. Non-residents' new investment in long nominal Treasury bonds had totalled nearly 49 b.kr. since mid-June.

The reduction in bond market yields has also lowered interest rates on some of the pension funds' loans to fund members, which are now approximately ½ a percentage point lower than comparable rates offered by the commercial banks. Interest rates on mortgage loans from the three large commercial banks have broadly followed Central Bank rates, although one of the large banks recently announced a rate reduction.

Risk premia on Treasury foreign obligations had declined between meetings. The CDS spread on five-year Treasury obligations had narrowed by 0.3 percentage points, to about 1.2% just before the November meeting. Furthermore, the risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by the US, had also fallen by 0.3 percentage points, to about 1.5 percentage points just before the November meeting. The risk premium vis-à-vis German bonds was virtually unchanged, however, at 1.6 percentage points.

Financial institutions' analysts all expected that Central Bank interest rates would be held unchanged in November, citing the improvement in the short-term inflation outlook and reasoning that a stronger króna and lower commodity prices had created the scope to delay further rate increases in spite of underlying inflationary pressures and growing domestic demand.

M3 grew by just over 13% year-on-year in Q3/2015, or by 7% excluding deposits held by the winding-up boards of the failed deposit money banks (DMB).

The exchange rate- and price-adjusted stock of DMB loans to households grew by ½% in the first nine months of the year but contracted by nearly 5% if loans from the Housing Financing Fund (HFF) are included. If adjustments are made for the Government's debt relief measures, the credit stock contracted by approximately 1%. There is some uncertainty about this development, however, as it appears inconsistent with other indicators from the credit market. In the first nine months of the year, net new loans granted to households by deposit institutions and the Housing Financing Fund (HFF) – i.e., new loans less prepayments of older loans – totalled 24 b.kr., but when adjusted for the Government's debt relief programme, the increase is estimated at just over 70 b.kr. Loans to the non-financial corporate sector have also been on the rise during the year. The adjusted stock of deposit money bank (DMB) loans to firms increased by nearly 4% in the first nine months of the year, whereas it contracted by approximately 1½% over the same period in 2014. Net new lending from deposit institutions to the non-financial corporate sector totalled just over 126 b.kr. in the first nine months of 2015, a significant increase year-on-year.

The NASDAQ OMXI8 index had risen by 9.3% between meetings. Turnover in the NASDAQ Iceland main market totalled almost 263 b.kr. over the first nine months of the year, about 43% more than over the same period in 2014.

Global economy and external trade

GDP growth among Iceland's main trading partners measured 1.9% in the first half of the year, slightly more than was forecast in the August *Monetary Bulletin*. The outlook for the year as a whole is slightly weaker than was forecast in August, however.

The deficit on goods trade totalled 13.6 b.kr. in the first nine months of the year, some 2 b.kr. more than over the same period in 2014. Export values grew by 12.7% at constant exchange rates, while import values rose 12.9%. The increase in exports is due primarily to 17% growth in industrial goods exports and 13% growth in marine product exports. Import growth is due mainly to a year-on-year increase of nearly 35% in transport equipment imports, 24% in consumer goods imports, and 23% in imports of commodities and operational inputs.

In terms of relative consumer prices, the real exchange rate measured 90.4 points in September, an increase of 2.3% month-on-month and 8.4% year-on-year. In the first nine months of the year, it was 2.9% higher than in the same period in 2014. This was due mainly to the nominal exchange rate, which was 1.8% higher, although domestic inflation was also about 1 percentage point above the average for Iceland's trading partners during the period.

Listed global aluminium prices had fallen by over 5% since the MPC's September meeting, and the average October price was down more than 21% year-on-year. Foreign currency prices of marine products were unchanged between months in September but had risen by 7% year-on-year.

Terms of trade improved by about 10½% year-on-year in the first half of 2015, following a roughly 3% improvement in 2014. The improvement is due primarily to a decline in global oil and commodity prices and an increase in marine product prices.

The domestic real economy and inflation

The wage index rose by 3.5% between quarters in Q3, and by 7.9% year-on-year, and real wages were up 2.8% quarter-on-quarter in Q3 and 5.8% year-on-year.

The results of the Statistics Iceland labour force survey show that labour demand in Q3/2015 was slightly stronger than was assumed in the forecast in the August *Monetary Bulletin*. The August forecast provided for a 1.9% year-on-year increase in total hours worked, whereas the actual increase was 2.4%. Unlike the situation in the first half of the year, the increase is due both to a rise in the number of employed and to longer average hours worked. Seasonally adjusted unemployment measured 4% in Q3, having declined by 0.2 percentage points between quarters.

Key indicators of private consumption in Q3 indicate that growth has continued and even accelerated. Payment card turnover rose nearly 7% year-on-year during the quarter, although the increase was larger at the beginning of the quarter than at the end. New motor vehicle registrations increased by just over 55% during the quarter. Groceries turnover declined slightly between years, but most other retail sales indices had risen.

The Gallup Consumer Sentiment Index measured 108.9 points in October, an increase of 5.3 points between months and about 33 points between years. This is the highest value of the index since January 2008. The index has been rising more or less steadily in the recent term, and consumers have not been this optimistic about the labour market situation since October 2007.

The nationwide Statistics Iceland house price index, published in late October, rose by 1.2% from the previous month, and by about 1.3% adjusted for seasonality. It has risen 7.9% in the past twelve months. The capital area real estate price index calculated by Registers Iceland rose by 1.2% month-on-month in September and 9.3% year-on-year. The number of residential purchase agreements registered nationwide rose by just under 16% year-on-year in the first nine months of 2015.

The CPI rose by 0.07% month-on-month in October. Twelve-month inflation measured 1.8% and had subsided slightly since the previous MPC meeting. The CPI excluding the housing component fell by 0.2% month-on-month, and inflation was 0.3% by that measure. Underlying inflation in terms of core index 3 excluding tax effects had also fallen slightly between meetings, to 1.9%. Statistical measures of underlying inflation suggest that it lay in the 2-4% range. The main driver of inflation in October was rising house prices, which increased the CPI by 0.17 percentage points. Reductions in the price of imported goods and private services pulled in the opposite direction.

The breakeven inflation rate in the bond market has fallen markedly since the summer. To some extent, the decline probably reflects the appreciation of the króna, low global inflation, and less pessimism about inflation in the wake of wage agreements than could be discerned during the prelude to the settlements. It is difficult to interpret developments in the breakeven inflation rate, however, because of the recent surge in capital inflows, which has led to a significant decline in yields on long nominal Treasury bonds, as has been discussed. The breakeven inflation rate two years ahead averaged 3.3% in October, having declined by nearly ½ a percentage point since September. The breakeven rate five and ten years ahead averaged 2.7% in October and had also fallen by nearly ½ a percentage point since September. The decline since June was just over 2 percentage points.

According to the Bank’s survey of market agents’ expectations, carried out at the end of October, respondents expect inflation to measure 3.8% one year ahead. This is about 0.1 percentage point less than in the August survey. Their inflation expectations two years ahead had risen by ½ a percentage point since August, to 4%. Their long-term inflation expectations were broadly unchanged between surveys, with respondents indicating that they expected inflation to average just under 3½% over the next ten years. These results therefore indicate that only a small part of the decline in the breakeven rate can be attributed to an actual decline in inflation expectations.

According to the forecast published in *Monetary Bulletin* on 4 November 2015, the long-term inflation outlook is broadly unchanged from the August forecast, even though the short-term outlook has improved somewhat. Inflation averaged 2% in the third quarter of the year, 0.4 percentage points below the forecast in the August *Monetary Bulletin*. The deviation is due primarily to a stronger króna and steeper declines in global oil and commodity prices than in the August forecast. Furthermore, the inflationary effects of the recent wage settlements appear to be more modest than was assumed then, probably due in part to the appreciation of the króna and the improvement in terms of trade in recent months. According to the forecast, there are significant and growing domestic inflationary pressures, which could take hold once the effects of a stronger króna and lower import prices begin to taper off. Inflation is projected to measure 2.3% in the fourth quarter of the year, or 1½ percentage points less than was forecast in August. It is expected to continue to inch upwards, albeit somewhat more slowly than was forecast then, and to be at or above 4% from the end of 2016 into H2/2017 and then begin to taper off again.

Trading partners' GDP growth is expected to be unchanged year-on-year, at 1.7%, rising to 2% in 2016 and averaging 2¼% in 2017-2018. The GDP growth outlook for the forecast horizon as a whole has therefore deteriorated since August, and uncertainty about the global economy has increased again.

Terms of trade are expected to improve by just over 5% this year, or ½ a percentage point less than was forecast in August. The outlook for coming years is unchanged since August, however, although uncertainty has grown in tandem with increased uncertainty globally.

According to the forecast, export growth will slow down somewhat in the next three years, in line with the rising real exchange rate. Goods exports are expected to be weaker next year than was projected in August, as the rise in the real exchange rate is larger and trading partner demand weaker than was forecast then. This is offset by the improved outlook for tourism, however.

According to preliminary figures from Statistics Iceland, GDP growth measured 5.6% in Q2/2015, the strongest single-quarter growth rate seen since the beginning of 2008. Statistics Iceland also revised previously published figures and now estimates Q1 GDP growth at 4.8% instead of the previous 2.9%. H1 GDP growth is now estimated at 5.2%, somewhat more than was assumed in the Bank's August forecast. Although strong GDP growth in the first half reflects to some extent the one-off effects from services exports, the outlook for the year as a whole has been revised upwards since the August forecast, with 2015 GDP growth now forecast at 4.6%. This is 0.4 percentage points above the August forecast but in line with the forecast from May. The improved outlook reflects both strong growth in domestic demand and a slightly more positive contribution from net trade. As in the August forecast, GDP growth is assumed to ease in coming years, although it is still expected to remain above its long-term average for the majority of the forecast horizon. It is projected at 3.2% in 2016, 3% in 2017, and 2½% in 2018.

The recovery of the labour market continues, and by most measures the slack has disappeared. Declining unemployment is due to job creation; however, this is offset somewhat by a marked rise in the participation rate. The seasonally adjusted labour participation rate is now 3 percentage points above the post-crisis trough from Q4/2011 and is closing in on its peak from early 2007. The employment rate has risen as well and was up 1½ percentage points year-on-year in Q3. Other indicators from the labour market point in the same direction. As in the Bank's previous forecasts, the recovery of the labour market is projected to continue, with declining unemployment and an increase in the number of jobs and total hours worked. The recovery is forecast to be somewhat weaker than was assumed in August, however, due to the expectation of larger rises in unit labour costs. Unemployment will fall from 4.4% this year to about 4% in 2018, and total hours worked will increase, on average, by just over 2% per year.

The arbitration panel ruling from August and the subsequent agreement among the social partners has entailed a larger rise in wages during the forecast horizon than was assumed in the August forecast. Although offset by somewhat more rapid productivity growth in the latter half of the forecast horizon, unit labour costs are still projected to rise steeply, or by 9% this year and 8% in 2016. If the forecast materialises, the increase in 2015 and the ensuing three years will average 6.7% per year, far in excess of the level compatible with medium-term price stability.

In line with Statistics Iceland's revision of historical GDP growth figures, the slack in the economy between 2011 and 2014 is now considered to have been just under ½ a percentage point per year larger than previous figures indicated. As in August, however, the spare capacity is considered to have disappeared early this year, and owing to stronger GDP growth both in 2015 and over the forecast horizon as a whole, the outlook is for a somewhat wider positive output gap than was previously projected. It is forecast to peak at 1½% of potential output early in 2016 and to remain at about that level until mid-2017 before narrowing once again.

The baseline forecast reflects an assessment of the most likely economic developments over the next three years. It is based on forecasts and assumptions concerning developments in the external environment of the Icelandic economy, as well as assessments of the effectiveness of specific markets and on the transmission of monetary policy to the real economy. All of these factors are subject to uncertainty. The uncertainties described in the November *Monetary Bulletin* show clearly that the inflation outlook for the next three years could easily deviate from the scenario presented in the baseline forecast. Inflationary pressures could be underestimated, which (other things being equal) would call for higher interest rates than are implied in the baseline forecast in order to keep inflation at target if, for instance, firms pass the cost increases from the recent wage settlements through to price levels more than is assumed in the forecast or if the impact on private consumption of the strong temporary rise in real disposable income is underestimated. Inflation could also prove more persistent than is forecast if the hefty pay increases de-anchor inflation expectations still further. The same applies if the króna proves weaker over the forecast horizon than is assumed in the baseline forecast or if the tension in the economy is more pronounced; for instance, if activity in the energy-intensive sector is greater than forecast, or if there is more slack in fiscal policy. The recent weakening of the monetary policy transmission mechanism could also make it more difficult for monetary policy to contain domestic demand, which could lead to higher inflation than is forecast, other things being equal. On the other hand, inflation could prove lower than is forecast if the global economic outlook worsens or global oil and commodity prices fall still further. The króna could also turn out stronger than is assumed in the baseline forecast, and firms could respond to the steep rise in wage costs by cutting their own profit margins or with increased streamlining. Productivity growth could also prove stronger than in the baseline forecast, which would counteract to a greater degree the inflationary pressures from the labour market.

II The interest rate decision

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

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

In addition, they discussed the effects of the increase in minimum reserve requirements on deposit-taking institutions' liquidity. The increase in reserve requirements appeared to have had the intended effect and contributed to the institutions' preparation for the settlement of the failed banks' estates and the planned auction intended to release or tie up offshore krónur. Members agreed that no further changes should be made to reserve requirements at this time.

MPC members discussed whether developments since the previous meeting had changed the Committee's assessment that the monetary stance was appropriate and whether the outlook had changed. At the last meeting, the Committee had decided to pause and keep interest rates on hold because the stronger króna and global price developments had provided the scope to raise interest rates somewhat more slowly than had previously been considered necessary. Members agreed, however, that the improved near-term outlook did not change the need for a tighter monetary stance in the near future.

In the Committee's opinion, economic growth as set out in the Bank's new forecast was broadly in line with the MPC's assessment at the September meeting, albeit slightly stronger, as GDP growth would measure 4.6% this year according to the new forecast, or ½ a percentage point more than was assumed in the August forecast. Members were of the view that the medium-term GDP growth outlook had improved as well. They noted that domestic demand growth is projected to be considerably stronger than year-2015 GDP growth.

They discussed the fact that inflation had turned out somewhat lower in Q3 than was forecast in August and was still below the target, especially if the housing component of the CPI were excluded. They considered this to stem mainly from larger declines in global oil and commodity prices and a stronger appreciation of the króna than had been assumed in the Bank's previous forecasts, which had offset domestic inflationary pressures. As a result, the short-term inflation outlook was better than the Bank had projected in August.

Members agreed, however, that the inflation outlook for the longer term was broadly unchanged because domestic inflationary pressures – particularly those due to wage increases – would cause inflation to rise above the target when the effects of low global inflation tapered off.

Because the long-term outlook according to the forecast was in line with the assessment at the September meeting, the Committee considered it appropriate to continue to tighten the monetary stance, as it had signalled at previous meetings. Members agreed that there was considerable strength in the domestic economy, that the spare capacity had been absorbed and a positive output gap was developing, which would lead to increased inflation once the effects of the ISK appreciation and the drop in commodity and fuel prices had tapered off. It was therefore likely that the resilience of the economy was already being tested. It was noted that strong demand would be addressed to an extent with imported labour, although it was also pointed out that there were signs that firms were having greater difficulty in addressing labour shortages in this way. It was pointed out as well that importation of labour entailed increased demand – for housing, among other things – which would further exacerbate demand-side pressures.

As at the previous meeting, there was some discussion of whether low inflation in the recent past indicated that wage increases had been responded to with more streamlining than had been assumed in the forecast. It was also mentioned that both productivity and the improvement in terms of trade could be underestimated in the forecast and that the scope for wage increases without commensurable inflationary effects could therefore be greater than was assumed in the forecast. On the other hand, it was pointed out that, even though the forecast assumed large pay increases, they were probably underestimated because the forecast only took account of a portion of the pay rises currently being discussed by the social partners. Given the tension that appeared to be developing in the labour market, wage drift could also have been underestimated in the forecast. Moreover, although inflation was still low, it could rise rapidly in view of the underlying domestic inflationary pressures from the labour market, even though these pressures were still largely concealed by the offsetting effects of lower global oil and commodity prices and the appreciation of the króna. Even in the event of a delay in the global economic recovery, if oil and commodity prices stopped falling and the effects of the previous decline tapered off, inflationary pressures could surface for this reason alone.

Committee members discussed the outlook for central government finances, as the fiscal budget proposal for 2016 entailed increased easing of fiscal policy. Members agreed that there was some risk that the fiscal stance would be even more accommodative than was provided for in the budget proposal. As a result, inflationary pressures could be underestimated in the forecast, as it only took account of fiscal easing after adjusting for the business cycle, as is provided for in the budget proposal. It was also emphasised that the forecast was based on the assumption that the monetary stance would be tightened as the positive output gap widens and inflation rises. If this were done too late, or not at all, inflation would be higher during the forecast horizon than was provided for in the November forecast.

MPC members discussed the uncertainty about monetary policy transmission and agreed that it had grown because unusually low global interest rates had an increasing impact in Iceland. As a result, it was likely that monetary policy transmission would be shifted over to the exchange rate channel, which is generally less reliable than the interest rate channel, to an even greater degree than before. This could make it more difficult for the MPC to achieve the intended monetary stance. One member was of the view that the risk of excessive capital inflows could therefore interfere with a timely monetary policy response to the worsening long-term inflation outlook. The Committee agreed that if inflows related to carry trade proved to be substantial, it would be necessary to use tools other than interest rates to restrict them. This would be discussed at a joint meeting with the Systemic Risk Committee before the end of November.

The Committee discussed developments in liquidity in connection with capital account liberalisation. Members considered it likely that there could be changes in the liquidity position, which could affect the need for further interest rate changes. The need for a tighter monetary stance would also depend on whether other policy instruments were applied in order to contain demand-side pressures in the coming term.

Committee members discussed the interest rate decision and were of the view that two options were available: to keep interest rates unchanged or to raise them. In light of the Committee's previous messages about the need for continued monetary tightening, some members were of the view that keeping rates unchanged for too long a time could send a misleading message about the MPC's assessment of the need for a tighter stance over the longer term.

In view of the discussion, the Governor proposed that the Bank's interest rates be increased by 0.25 percentage points, which would raise the key rate (the seven-day term deposit rate) to 5.75%, deposit rates (current account rates) to 5.5%, the seven-day collateralised lending rate to 6.5%, and the overnight rate to 7.5%. All Committee members voted in favour of the proposal.

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 9 December 2015.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, December 2015

Published 23 December 2015

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

The following are the minutes of the MPC meeting held on 8 December 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 9 December, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 4 November interest rate decision.

Financial markets

The exchange rate of the króna had risen slightly in trade-weighted terms and against the euro and by 1.7% against the pound sterling but had fallen by 1.1% against the US dollar since the November meeting.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 114 million euros (16 b.kr.) between meetings, or 48% of total market turnover. Purchases year-to-date totalled 1.6 billion euros (236 b.kr.), more than twice the total for the same period in 2014.

Interest rates in the interbank market for krónur rose in line with the increase in Central Bank rates in November, and overnight rates are close to the Bank's key rate. Interbank market turnover totalled 351.5 b.kr. year-to-date, considerably more than in the same period in 2014 but somewhat below the level seen in the same period of the three preceding years.

In early December, the monetary stance was similar to that measured prior to the November meeting. The Bank's real rate was 3.7% in terms of twelve-month inflation and 2.4% in terms of the average of various measures of inflation and inflation expectations.

The MPC's decision to raise the Bank's interest rates by 0.25 percentage points in November appeared to have taken bond market agents by surprise, as most analysts had forecast that rates would remain unchanged. Yields on nominal and indexed Treasury and Housing Financing Fund (HFF) bonds rose following the decision and had risen by 0.4-1.1 percentage points in mid-November, mostly at the long end of the nominal yield curve. Yields on nominal bonds then began to decline again. At the time of the Committee's December meeting, the yields on nominal and indexed Treasury and HFF bonds had risen by 0.3-0.7 percentage points since the November meeting.

Interest rates on non-indexed mortgage loans from two of the large commercial banks had also risen in line with the rise in Central Bank rates in November, but rates on indexed mortgages from the large commercial banks and the average of rates on indexed mortgages from the pension funds remained unchanged.

Interest rates on non-indexed deposits with the large commercial banks also rose in line with the increase in Central Bank rates in November, but indexed deposit rates were unchanged since the November meeting.

Risk premia on Treasury obligations had changed little since the November meeting.

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

M3 grew by just under 7½% year-on-year in October and by almost 7% excluding deposits held by the financial institutions in winding-up proceedings.

The total stock of deposit institutions' loans to resident borrowers contracted by 0.8% year-on-year in October, and by just over 3% if loans from the HFF and the pension funds are included. If adjustments are made for the Government's debt relief measures, the credit stock contracted by approximately 1% year-on-year in October. In spite of this contraction between years, net new lending – i.e., new loans net of payments in excess of contractual requirements – increased somewhat in the first ten months of the year, and when adjusted for the Government's debt relief programme, the credit stock had grown by about 1½% year-to-date, owing mainly to an increase in lending to the non-financial corporate sector.

The NASDAQ OMX Main List index, OMXI8, had risen by 0.7% between meetings. Turnover in the NASDAQ Iceland main market was just over 320 b.kr. in the first ten months of the year, about 48% more than over the same period in 2014.

Global economy and external trade

According to the Organisation for Economic Co-operation and Development's (OECD) November forecast, GDP growth and world trade will be somewhat weaker in 2015 than in the OECD's June forecast. Global GDP growth is projected at 2.9% this year, about 0.2 percentage points below the OECD's June forecast; however, the forecast for next year is unchanged. The OECD's 2015 GDP growth forecast for Iceland's main trading partners is unchanged since June, at 1.8%, but has been revised downward by 0.3 percentage points, to 2%, for 2016, which is in line with the forecast in the November *Monetary Bulletin*. The OECD revised its inflation forecast for Iceland's trading partners slightly upwards for 2015 and downwards by 0.3 percentage points for 2016. Trading partner inflation is projected at 1.3% in 2016 and 1.7% in 2017. Both figures are about 0.2 percentage points below the forecast in the last *Monetary Bulletin*.

Iceland's external goods trade generated a deficit of about 18.6 b.kr. for the first eleven months of the year, as opposed to a surplus of just over 4 b.kr. over the same period in 2014. Export values grew by 8.6% at constant exchange rates, while import values rose 13.1%. The export value of marine products rose by nearly 11% and the export value of industrial goods by almost 10½%. Import growth is due mainly to a 37% year-on-year increase in transport equipment imports, a 23½% increase in food and beverage imports, and a 20% increase in imports of commodities and operational inputs.

The real exchange rate measured 90.5 points in terms of relative prices in November and rose about 8.7% year-on-year. The increase is due primarily to a 7.5% nominal appreciation of the króna, but in addition, inflation in Iceland was about 1.1 percentage point above the average among its trading partners.

Listed global aluminium prices were broadly unchanged since the MPC's November meeting, and the average November price was down more than 28% year-on-year. Foreign currency prices of marine products had declined by ½% month-on-month in October but had risen by nearly 4½% year-on-year.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in December, year-on-year GDP growth measured 2.6% in Q3/2015. Domestic demand grew by 3.4% year-on-year, and the contribution from net trade was negative during the quarter. For the first nine months of the year, GDP growth measured 4.5%, reflecting the offsetting effects of 6.2% growth in domestic demand and a negative contribution from net trade.

GDP growth in the first nine months of the year was 0.6 percentage points below the Bank's November forecast of 5.1%. The deviation is due to somewhat weaker-than-expected domestic demand and a marginally weaker contribution from net trade. GDP growth for the first half of the year was revised upwards and is now estimated at 5.6%, some 0.4 percentage points more than previously projected. In the first nine months of the year, growth in domestic demand was broadly in line with the November forecast, although public expenditures turned out somewhat less than expected.

The surplus on the underlying current account balance measured 53 b.kr., or 9.3% of GDP, in Q3, similar to the projection in the Bank's last forecast. The surplus is due primarily to a surplus on services trade of 90 b.kr., whereas goods trade generated a 12 b.kr. deficit and the underlying balance on primary and secondary income showed a deficit of 24 b.kr. There was an unusually large deficit on secondary income because of the Depositors' and Investors' Guarantee Fund's payment to the British deposit guarantee scheme and the Dutch central bank. A revision of previously published figures shows that the surplus for H1/2015 was slightly larger than previously projected, while the 2014 surplus was marginally smaller.

Key indicators of private consumption at the beginning of Q4 suggest that private consumption will be strong during the quarter. Payment card turnover was up almost 7% year-on-year in October and new motor vehicle registrations were up 56% in October and

November. Furthermore, most retail price indices had risen significantly year-on-year in October, while groceries turnover was down 0.8%.

The Gallup Consumer Sentiment Index measured 117.9 points in November, nine points more than in October and nearly 38 points higher than in November 2014. This was the highest index value since October 2007. All sub-indices rose between months and between years.

According to the Gallup survey among executives from Iceland’s 400 largest firms, carried out in November, respondents were considerably more optimistic about the economic outlook six months ahead than in the September survey. About 63% of respondents considered the current situation good, and nearly 34% considered it neither poor nor good. Just over 42% of executives were of the view that economic conditions would improve in the next six months, and a slightly larger group, or 46%, expected conditions to remain unchanged (i.e., good). Executives in the construction industry were more upbeat than others about the situation six months ahead. They were also more optimistic than they were in September, as were respondents from all sectors other than fishing. Only executives in construction and retail trade were more optimistic than at the same time in 2014. Just over 11% of executives were of the opinion that conditions would deteriorate over the next six months.

Executives were more optimistic about domestic demand than at any time since September 2004, with about half indicating that they expected demand to increase in the next six months. Expectations concerning foreign demand in the next six months were strong as well but have subsided somewhat since year-end 2014.

According to the survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by about 24 percentage points. This represents somewhat greater optimism than was shown in the September survey and the survey carried out a year ago. Executives in all sectors except fishing were more optimistic about recruiting staff than in the September survey. In addition, over a fourth of firms considered themselves short-staffed. Nearly 60% of construction firms and just over 40% of companies in transport and tourism considered themselves understaffed.

The wage index rose by 0.3% month-on-month in October and by 7.9% year-on-year. Real wages in terms of the index had risen by 6% year-on-year in October.

According to the majority opinion of the Parliamentary Budget Committee, the primary surplus will measure 67.6 b.kr. in 2016, roughly 5.5 b.kr. (0.2% of GDP) smaller than was assumed in the fiscal budget proposal. The fiscal stance will weaken commensurably. It is estimated to weaken by the equivalent of 0.9% of GDP each year, or a total of nearly 2% of GDP.

The Statistics Iceland nationwide house price index, published in late November, rose by 1.1% from the previous month, after adjusting for seasonality, and by 9.1% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 0.5% month-on-month in October, adjusted for seasonality, and by about 10% year-on-year. The number of purchase agreements registered nationwide rose by about 18.4% year-on-year in the first ten months of 2015. The average time-to-sale for flats in the greater Reykjavík area was about 3.5 months in the first ten months of 2015, as opposed to 4.4 months during the same period in 2014.

The CPI declined by 0.35% month-on-month in November, and twelve-month inflation measured 2%. Owing to base effects, inflation increased since the MPC’s November meeting, as the CPI fell steeply a year ago. The CPI excluding the housing component fell by 0.6% month-on-month, and inflation was 0.3% by that measure. Underlying inflation according to core index 3 excluding tax effects had also risen between meetings, owing to the aforementioned base effects, and measured 2.1%. Statistical measures of underlying inflation suggest that it lay in the 1.9-3.9% range.

A large share of CPI components declined in November. The drop in international airfares had the strongest effect, lowering the index by nearly 0.2 percentage points. The effects of the recent appreciation of the króna continued to emerge, with imported goods prices falling markedly. The increase in the housing component raised the index by 0.12 percentage points, the only component with a significant upward effect. Private services prices have risen by 2.7% in the past twelve months, and it appears that domestic inflationary pressures by this criterion have subsided since the autumn.

According to the Gallup survey of household inflation expectations carried out in November, expectations one and two years ahead were unchanged at 4% since the September survey. In a comparable survey carried out among executives in November, respondents expected inflation to measure 3.6% one year ahead, which was virtually unchanged from the September survey.

The breakeven inflation rate in the bond market has fluctuated somewhat since the MPC's November meeting. It rose somewhat following the meeting but has fallen again since end-November. The breakeven inflation rate two years ahead measured 3.3% just before the December meeting, or broadly the same as at the time of the previous meeting. The breakeven rate five and ten years ahead was about 3% and had risen by 0.2-0.3 percentage points.

II The interest rate decision

The Governor gave the Committee an update on developments since the last meeting, including the work done by the Bank and other authorities in relation to the capital account liberalisation strategy. In this context, the Committee discussed whether it was timely to lower reserve requirements again in order to mitigate the liquidity effect caused by the stability contributions to be paid by the old banks, presumably around the turn of the year. Members agreed that raising reserve requirements in October had had the intended effect and had encouraged financial institutions to prepare for the settlement of the failed banks' estates. As a result, it was deemed appropriate to lower them again, as had been planned at the outset. The MPC therefore decided to lower reserve requirements from 4% to 2.5% as of the next reserve maintenance period, which begins on 21 December. Furthermore, the MPC decided to aim at lowering them back to 2% in connection with the planned auction of offshore krónur.

MPC members discussed whether developments since the previous meeting had changed the Committee's assessment that the monetary stance was appropriate and whether the outlook had changed since that meeting, when it had been decided to raise the Bank's interest rates by 0.25 percentage points. Members agreed that a stronger króna and global price developments had provided the scope to raise interest rates more slowly than had previously been considered necessary, but that it was less certain whether, and to what degree, the improved near-term outlook changed the need for a tighter monetary stance in the near future. Some members were of the view that recent developments changed little in this respect, while others thought the possibility could not be excluded.

Members discussed the information that had been published between meetings, and they agreed that the short-term inflation outlook was better than had been assumed in the Bank's November forecast. They considered the fact that inflation had measured 2% in November and had risen less in the recent term than had been projected, particularly because the decline in global oil and commodity prices and the appreciation of the króna had offset domestic price increases. Committee members considered it likely that this development would persist for some time but that uncertainty about near-term interactions among these factors had grown since the previous meeting. Based on the most recent information, it could be assumed that oil and commodity prices would fall even further and remain low for a longer time. As a result, terms of trade could improve more than had been projected in the last forecast, thereby weakening the inflationary impact of wage increases for as long as the effect of improved terms of trade lasted.

Committee members also thought it likely that the effects of unusually low global interest rates could be felt in Iceland in the coming term. MPC members considered it of great importance to continue exploring policy instruments that could be applied so as to restrict inflows from carry trade. The Committee had discussed this topic at a joint meeting with the Systemic Risk Committee on 30 November, and proposals for such tools are under preparation within the Central Bank.

In the MPC's opinion, growth in economic activity was broadly in line with the Committee's assessment at the previous meeting. According to newly published preliminary figures from Statistics Iceland, year-on-year GDP growth over the first three quarters of 2015 measured 4.5%, which Committee members considered broadly in line with the Bank's November forecast, as it was likely that investment figures would be revised upwards. Furthermore, members noted that as before, GDP growth was driven primarily by domestic demand. Members were of the view that the most recent information indicated also that the labour market continued to recover strongly.

In view of the improved near-term outlook, none of the MPC members saw any reason to change interest rates at present; instead, they thought it appropriate to pause and keep rates on hold at this time. In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

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

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

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

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 10 February 2016.

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.