MONETARY POLICY COMMITTEE REPORT TO ALTHINGI

2013 • 2

Monetary Policy Committee report to Parliament

27 January 2014

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

The Act requires that the MPC meet at least eight times each year. Since the last Report was sent to Parliament, the Committee has held four regular meetings, most recently on 11 December. The following report discusses the work of the Committee between July and December 2013.

Monetary policy formulation

According to the Act on the Central Bank of Iceland, the Central Bank's principal objective is to promote price stability. This objective is further described in the joint declaration issued by the Bank and the Icelandic Government on 27 March 2001 as an inflation target of 2½%. Furthermore, the Act stipulates that the Central Bank shall promote the implementation of the economic policy of the Government as long as it does not consider this policy inconsistent with its main objective of price stability. The Bank shall also promote financial stability. By law, the MPC takes decisions on the application of the Bank's monetary policy instruments, which are its interest rates; its transactions with credit institutions other than last-resort loans; reserve requirements; and foreign exchange market transactions aimed at affecting the exchange rate of the króna. The decisions of the MPC must be based on a thorough assessment of economic and monetary developments and prospects and financial stability.

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

Developments from July to December 2013

The MPC has held the Bank's interest rates unchanged since November 2012. The collateralised lending rate has therefore remained unchanged at 6%, the current account rate at 5%, the maximum rate on 28-day CDs 5.75%, and the overnight lending rate 7% (see Table 1 and Chart 1). Because financial system liquidity is relatively abundant, financial firms' demand for Central Bank liquidity facilities is

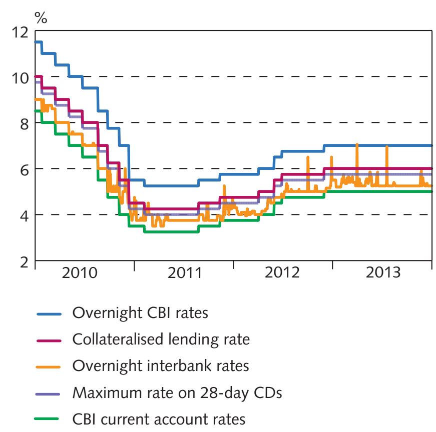
Table 1. Central Bank of Iceland interest rates 2013 (%)

Date	*Current account*	*28-day CDs (maximum)*	*7-day collateral lending rate*	*Overnight lending rate*
11 December	5.00	5.75	6.00	7.00
6 November	5.00	5.75	6.00	7.00
2 October	5.00	5.75	6.00	7.00
21 August	5.00	5.75	6.00	7.00

Chart 1

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

Daily data 1 January 2010 - 31 December 2013

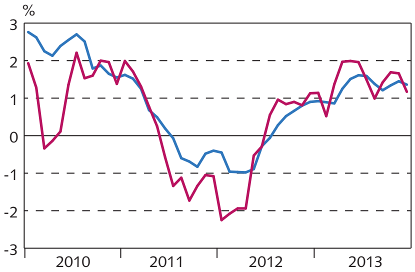


Source: Central Bank of Iceland.

Chart 2

Real effective Central Bank of Iceland interest rates1[1]

January 2010 - December 2013



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

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

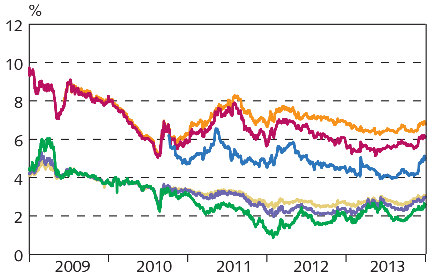
1. Until January 2012, according to twelve-month inflation, one-year business inflation expectations, one-year household inflation expectations, the one-year breakeven inflation rate, and the Central Bank forecast of twelve-month inflation four quarters ahead. From February 2012 onwards, according to the above criteria, plus one-year market inflation expectations based on a quarterly Central Bank survey.

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

Chart 3

Bond yields

Daily data 2 January 2009 - 30 December 2013



— RIKB 16 1013 — HFF 150224

— RIKB 19 0226 — HFF 150434

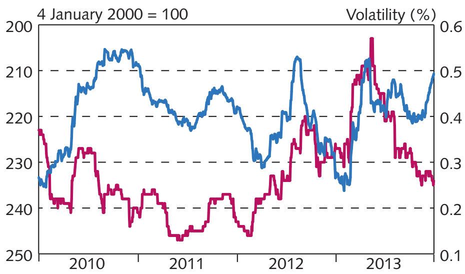
— RIKB 25 0612 — HFF 150644

Source: Central Bank of Iceland.

Chart 4

Exchange rate and volatility of the króna

Daily data 4 January 2010 - 31 December 2013



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

— Volaility of the króna, standard deviation of daily change in past 3 months (right)[2]

1. Price of foreign currency in terms of króna. Inverted axes shows a stronger króna as a rise. 2. Volatility is measured by standard deviation of daily changes in past 3 months (right).

Source: Central Bank of Iceland.

limited, and money market rates lie close to the Bank's deposit rate. Therefore, the simple average of Central Bank current account rates and the maximum rate on certificates of deposit is currently close to being the best measurement of the effect of Central Bank rates on money market rates. This average, which can be termed the effective interest rate, was just under 5½% as of year-end 2013.

Even though the Bank's nominal interest rates have been unchanged since November 2012, the monetary stance has changed as inflation and inflation expectations change. The Bank's real rate in terms of twelve-month inflation was about 2% at mid-year 2013 but 1.1% by the year-end. In terms of the average of several measures of inflation and inflation expectations, the Bank's real rate was 1.3% as of end-2013 and had fallen by just over 0.3 percentage points since mid-year. It was 0.3 percentage points higher at the end of 2013 than at the end of 2012. The long-term real rate in the bond market has developed broadly in line with the Bank's interest rates.

In May 2013, the MPC decided to step up the Bank's foreign exchange market intervention, in accordance with the authorisation set forth in the Act on the Central Bank of Iceland and with the Bank's recommendations for improvements to the framework for the inflation target (see, for instance, "Monetary Policy in Iceland After Capital Controls," Central Bank *Special Publication* no. 4, December 2010). The objective of increased foreign exchange market intervention is to mitigate exchange rate volatility, thereby promoting a speedier adjustment of the domestic price level to a more stable króna. As before, the Central Bank will aim to increase the portion of its reserves that is not funded with foreign borrowing by buying foreign currency in the market, although this is a long-term goal.

In the latter half of 2013, the Central Bank bought foreign currency for just over 10 b.kr. through direct intervention in the interbank foreign exchange market and sold foreign currency for 1.9 b.kr. Since the MPC decided in May 2013 to step up intervention in the market, the Bank's net foreign exchange purchases have totalled just over 7 b.kr. For 2013 as a whole, net purchases totalled just over 1 b.kr. Including payments on forward contracts, the Bank acquired foreign currency in the amount of 22.7 b.kr. in excess of the amount sold in 2013. This amount was used to reinforce the foreign exchange reserves.

The króna has appreciated by just over 3% in trade-weighted terms since mid-2013, when the Bank sent its last report to Parliament. In the latter half of the year, the exchange rate was also less volatile against other currencies. The appreciation and enhanced stability of the króna in the second half of the year can be viewed in the context of the MPC's decision to step up foreign exchange market intervention.

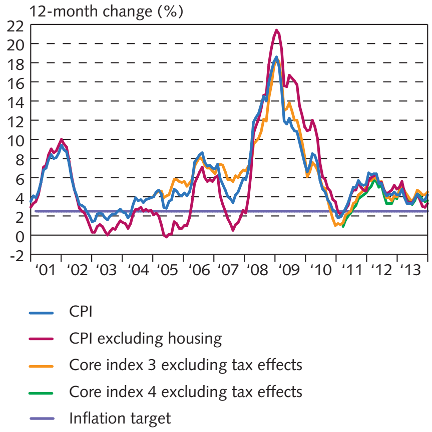
Twelve-month inflation in terms of the CPI has risen by nearly a percentage point since the last MPC report to Parliament. CPI inflation measured 4.2% in December, as opposed to 3.3% in June.[1]

1. According to measurements from Statistics Iceland, twelve-month inflation in terms of the CPI rose above 4%, the upper tolerance threshold of the inflation target, in August 2013 and again in December 2013. This triggered reports from the Central Bank to the Minister of Finance and Economic Affairs, explaining the reasons for the deviation, the Bank's proposed responses, and the probable length of time needed to bring inflation back within the tolerance limits. These reports are enclosed with the present report.

Underlying twelve-month inflation as measured by core index 3 excluding indirect tax effects (which also excludes the effects of volatile food items, petrol, public services, and real mortgage interest expense) rose by nearly a percentage point, measuring 4.5% in December. Underlying inflation according to core index 4 excluding tax effects, which also excludes the market price of housing, measured 3.6% in December, up from 3.3% in June. In the latter half of 2013, increases in food prices and rising housing costs were the main drivers of inflation.

In its statements from the second half of 2013, the MPC emphasised the necessity of implementing wage settlements, fiscal policy, and other factors affecting domestic demand in a manner allowing the attainment of external balance of the economy, economic stability, and inflation in close to target at the lowest possible cost. Since 11 December, when the MPC held its last 2013 meeting, the 2014 National Budget has been approved, Government measures for household debt relief have been introduced, and private sector wage settlements have been signed. At its first 2014 meeting, the MPC will assess the impact of these factors, and other new information concerning economic developments, on the monetary stance.

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



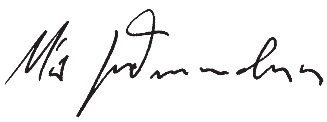
1. Core Index 3 is the CPI excluding prices of agricultural products, petrol, public services and the cost of real mortgage interest. Core Index 4 excludes the market price of housing as well.
Sources: Statistics Iceland, Central Bank of Iceland.

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from August to December 2013.
2. Minutes of Monetary Policy Committee meetings from August to December 2013.
3. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001.
4. Reports to the Government on inflation in excess of tolerance limits, 12 September 2013 and 7 January 2014.
5. Press release from 14 January 2014 on the domestic foreign exchange market and the foreign exchange reserves in 2013.

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. 26/2013
21 August 2013

Statement of the Monetary Policy Committee 21 August 2013

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

According to the updated forecast published in *Monetary Bulletin* today, output growth will measure just under 2% in 2013, which is broadly in line with the Bank's May forecast. The outlook for output growth over the next two years has deteriorated, however, with growth projected at just under 3% per year instead of slightly more than 3%, owing primarily to less investment in the energy-intensive sector in the near term. The recovery of the labour market has been more robust than was forecast in May and is expected to continue on that path.

According to the current forecast, inflation will rise slightly in the latter half of the year and then begin subsiding towards the target early in 2014. If wage increases are consistent with the inflation target, inflation will fall more quickly and interest rates will be lower than would otherwise be necessary, other things being equal.

The Central Bank's foreign exchange market strategy, introduced in May, has contributed to reduced exchange rate fluctuations, and the króna has remained relatively stable since the MPC's last meeting. As yet, however, this development has not led to lower inflation expectations.

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

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

No. 33/2013
2 October 2013

Statement of the Monetary Policy Committee 2 October 2013

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. According to first estimates, GDP growth in the first half of 2013 measured just over 2%, somewhat stronger than was assumed in the Bank's August forecast. The recovery of the labour market also continues.

Inflation rose somewhat in the third quarter, in line with the Bank's August forecast. The Bank's intervention in the foreign exchange market has contributed to reduced exchange rate volatility. Inflation expectations have not fallen, however, which could be due to uncertainty about the effects of foreign debt deleveraging, the settlement of the failed banks' estates, and capital account liberalisation on future exchange rate developments. Uncertainty about the upcoming round of wage negotiations is also a contributing factor.

In the Bank's August forecast, it was assumed, based on past experience, that wage increases in the forthcoming wage settlements would be larger than is consistent with the inflation target. If wage increases are in line with the forecast, it will probably be necessary to raise the Bank's nominal interest rates, other things being equal, particularly if the margin of spare capacity in the economy continues to narrow. If wages rise in excess of the forecast, it is even more likely that the Bank will raise interest rates. If wage increases are consistent with the inflation target, however, inflation will fall more quickly than is currently predicted and interest rates will be lower than would otherwise be necessary, other things being equal.

Monetary policy must always take account of fiscal policy and other factors that affect aggregate demand. Future fiscal policy has been clarified to some extent with the presentation of the new fiscal budget proposal. In accordance with previous budget plans, the new budget proposal assumes that the surplus before financial income and expense (i.e., the primary surplus) will increase from this year's level and that debt will decline as a share of GDP. It is important that an overall surplus be achieved as soon as possible so that the monetary and fiscal policy mix contributes to external balance of the economy, fosters overall economic stability, and delivers inflation close to target, at the lowest possible cost.

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

No. 37/2013
6 November 2013

Statement of the Monetary Policy Committee 6 November 2013

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

According to the Bank's forecast, the outlook for 2013 is for somewhat stronger output growth than in the August forecast, or 2.3%, whereas the outlook for the next two years is broadly unchanged. The recovery of the labour market continues with increased strength, with total hours worked rising more this year than in any year since 2007.

After having risen somewhat in the third quarter, inflation has tapered off again. According to the Bank's forecast, the outlook is for gradual disinflation in coming quarters. Inflation will be lower than previously assumed in the near term, but the outlook through 2016 is broadly in line with the previous forecast. Inflation is expected to subside to target towards the end of 2015. Disinflation will therefore be slow and, as before, depend on near-term exchange rate and wage developments.

Iceland's terms of trade have continued to deteriorate for some time, eroding the current account surplus and putting pressure on the exchange rate of the króna. Looking ahead, there is uncertainty about how foreign debt deleveraging, the settlement of the failed banks' estates, and capital account liberalisation will affect the exchange rate.

At present, however, the upcoming wage negotiations are the most important source of uncertainty. As before, the forecast assumes, based on past experience, that wage increases in the forthcoming wage settlements will be larger than is consistent with the inflation target. If wage increases are in line with the forecast, it will probably be necessary to raise the Bank's nominal interest rates, other things being equal, particularly if the margin of spare capacity in the economy continues to narrow. If wages rise in excess of the forecast, it is even more likely that the Bank will raise interest rates. If wage increases are consistent with the inflation target, however, inflation will fall more quickly than is currently forecast and interest rates will be lower than would otherwise be necessary, other things being equal. Fiscal policy will also affect the monetary stance. Therefore, it is important that the final Budget maintain a level of fiscal consolidation at least equivalent to that provided for in the proposal.

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

No. 42/2013
11 December 2013

Statement of the Monetary Policy Committee 11 December 2013

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

According to recently published national accounts figures, GDP growth for the first three quarters of the year measured 3.1%. This is considerably above the Central Bank’s November forecast and is consistent with previous indications of a strong labour market recovery.

After having risen somewhat in the third quarter, inflation has tapered off again, measuring 3.7% in November. The exchange rate of the króna is somewhat higher than at the time of the last interest rate decision but is broadly at the level assumed in the Bank’s last inflation forecast.

The outcome of the current wage negotiations will have a decisive effect on the inflation outlook and therefore on near-term interest rates developments. Rates are likely to rise if wage increases are larger than is consistent with the inflation target, other things being equal, particularly if the margin of spare capacity in the economy continues to narrow.

As before, it is important that the final Budget maintains a level of medium-term fiscal consolidation at least equivalent to that provided for in the budget proposal.

The Government’s main proposals for reduction of indexed household debt have now been presented. Other things being equal, they will stimulate domestic demand. Because the spare capacity in the economy is disappearing, increased demand will raise inflation unless there is a change in the monetary stance. Stronger demand will also stimulate imports and narrow the current account surplus, which will contribute to a weaker króna than otherwise.

Given the scope of the debt relief measures and their distribution over time, a tighter monetary stance should suffice to bring inflation back to target in coming quarters, other things being equal. In implementing the measures, the authorities should consider ways to mitigate the negative side effects on the current account balance and inflation, thus reducing the need for countervailing monetary policy action.

A stronger economic recovery and the above-mentioned Government measures will require more rapid monetary tightening than previously expected, other things being equal. The degree to which such tightening takes place through changes in nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

August 2013

Published 4 September 2013

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

The following are the minutes of the MPC meeting held on 19 and 20 August 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 21 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 12 June interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2013/3 on 21 August.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.6% higher at the time of the August meeting than at the June meeting. Between meetings, the króna had depreciated by about 0.3% against the euro and 0.2% against the pound sterling but had appreciated by 0.6% against the US dollar. Bids for krónur in the offshore market lay in the range of 228-262 kr. per euro.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 6 million euros (roughly 950 m.kr.) since the last MPC meeting.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market remained below the centre of the interest rate corridor, normally at 0.25-0.4 percentage points above current account rates. Turnover in the interbank market totalled almost 320 b.kr. year-to-date, slightly more than over the same period in 2012.

The five-year breakeven inflation rate in the bond market was 3.8% just before the MPC meeting, after rising by 0.7 percentage points since the June meeting. The five-year breakeven inflation rate five years ahead was 3.9% and had risen by 0.4 percentage points. According to the median response in the Central Bank's recent market expectations survey, market agents expected inflation to average 4.2% over the next five years, which is unchanged from the survey conducted in May.

At present, the effective nominal policy rate lies close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the real policy rate was about 1.3% at the time of the August meeting, after having fallen by 0.3 percentage points since the June meeting. The average of the various measures of inflation and inflation expectations was 4% at the time of the August meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged between meetings, at about 1.6 percentage points. The risk premium on five-year Treasury obligations, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, was also virtually unchanged between meetings, at 1.7 percentage points, whereas the spread between the two countries' 10-year bonds had risen by 0.6 percentage points, to 2.6 percentage points.

Unchanged Central Bank interest rates in August appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most financial market analysts cited the minimal change in economic indicators between meetings as grounds for unchanged interest rates.

Broad money (M3) grew by 1.3% month-on-month in June and by 1.1% year-on-year. Excluding holding company deposits, however, M3 grew by 0.1% between years in June.

The NASDAQ OMXI6 index had risen by 6.4% between meetings. Trading volume on the NASDAQ OMX Iceland Main Market totalled 154 b.kr. during the first seven months of the year. At the beginning of August, the market value of companies listed on the main market totalled 462 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

According to the International Monetary Fund's (IMF) mid-July forecast, the global output growth outlook for this year and next year is slightly weaker than in the April forecast, or 3.1% in 2013 and 3.8% in 2014. The forecast for world trade has also been revised downwards for 2013, while the forecast for 2014 is unchanged. Uncertainty in the forecast remains considerable and is tilted to the downside. In addition to the uncertainty factors already in place, there is now the risk that the period of weak growth in emerging economies will be more protracted than previously assumed. The inflation forecast for industrialised countries in 2013 is broadly unchanged, at 1.5%. Output growth is projected at 0.8% for Iceland's main trading partners in 2013, which is slightly weaker than the April forecast.

There was a deficit of 1.1 b.kr. on Iceland's goods trade in June, whereas preliminary figures indicated a 7.4 b.kr. surplus in July. Import values contracted by 3% in the first seven months of the year, while export values shrank by 1½% over the same period. The downturn in export values is due principally to a contraction in industrial goods exports, as the export value of marine products is virtually unchanged between years. The contraction in import values is due primarily to a contraction in transport equipment imports (due mainly to a reduction in aircraft imports); however, the value of imports of fuels and lubricants has also fallen, while the value of imported investment products, and miscellaneous industrial supplies has risen between years.

The price of aluminium is broadly the same as at the time of the MPC's June meeting. It remained relatively stable in July, after falling slightly in June. In July, the average price was about 2.7% lower than in June and almost 6% lower than in July 2012. It has then risen somewhat in August. Marine product prices rose in May, for the third month in a row, with the month-on-month increase measuring 0.2%.

The domestic real economy and inflation

According to the Statistics Iceland labour market survey, labour demand grew significantly more strongly in Q2 than was assumed in the Bank's May forecast, which provided for a 0.7% year-on-year increase in total hours worked, less than the actual 2.7%. Average hours worked grew by 0.8%, after having contracted steadily for four quarters, and the number of employed persons continued to rise. The increase in the number of employed measured 1.9% for the quarter, on the heels of a 2.5% rise in Q1.

Total hours worked rose by 3.2% among the full-time employed and fell by 0.9% among part-time workers. As in the past year, both the labour force participation rate and the employment rate rose, and the number of persons outside the labour market declined.

The net migration rate was positive in Q2, for the third quarter in a row. Unlike the previous two quarters, however, when the lion's share of the population increase came from foreign nationals, Icelandic nationals account for nearly half of the rise.

Unemployment as measured by the Directorate of Labour (DoL) was 4.4% in Q2 and 4.6% adjusted for seasonality. Unemployment according to the Statistics Iceland labour market survey was somewhat higher, however, or 6.8%. Excluding those who had become employed, it measured 5.8%, and when adjusted for seasonality it measured 5.5%.

DoL figures show that 63% of those who dropped off the unemployment register in the first half of the year had become employed. This is a somewhat lower percentage than in 2009-2011, when it was just under 70%. A far greater number take advantage of labour market initiatives than did previously, whereas emigration played a negligible part in declining unemployment in 2013. The percentage of those who leave the unemployment register because they are unable to work is broadly in line with the 2009-2011 average, at 3-4%.

The wage index rose by just under 2% quarter-on-quarter and 5.6% year-on-year in Q2. Wage developments have varied somewhat from sector to sector during the current wage settlement period. According to the Statistics Iceland wage index, wages rose by just over 16% from Q1/2011 to Q1/2013. Wages in the financial and transport sectors rose more, while pay increases in manufacturing, retail, and private services have been in line with the average. In the construction industry and the public sector, however, wage increases have been smaller.

The main indicators of private consumption in Q2 suggest modest growth year-on-year, and there are signs that consumption was still growing at the beginning of Q3. For instance, payment card turnover grew by 3% year-on-year in real terms in July.

The nationwide Statistics Iceland house price index, published in late July, rose by 1.4% from the previous month, and by about 1% adjusted for seasonality. House prices nationwide have therefore risen by 5.8% in the past twelve months. The capital area Real Estate Price Index, calculated by Registers Iceland, rose by 1.8% month-on-month in June, and by 1.3% when adjusted for seasonality. The index has risen by 6.9% since June 2012. The number of registered purchase agreements was up 13% year-on-year in July, and by just over 9% over the first seven months of the year.

According to the survey carried out by Capacent Gallup, consumer sentiment improved markedly in Q2, with the Consumer Sentiment Index rising above 100 points in May and June, for the first time since the collapse of the financial system in autumn 2008. Sentiment deteriorated in July, however, and the index fell to 78.5.

The CPI rose by 0.53% month-on-month in June and then fell by 0.27% in July. The decline in July was due largely to sales effects, which, was partially offset by higher owner-occupied housing costs and petrol prices. Annual inflation measured 3.8% in July, up from 3.3% in May. Some base effects were present, however, due to the marked drop in the CPI in July 2012. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 4%, in July up from 3.8% in May.

According to the Central Bank’s quarterly market expectations survey, carried out in August, just before the publication of *Monetary Bulletin* 2013/3, market agents’ inflation expectations both one and two years ahead have risen since the May survey. Market agents now expect twelve-month inflation to measure 4.2% in one year and 4½% in two years, as opposed to 4% both one and two years ahead in the previous survey. Their long-term inflation expectations are broadly unchanged, however, at just over 4%.

According to the updated forecast published in *Monetary Bulletin* 2013/3, the near-term inflation forecast has deteriorated somewhat since May. The main reason for the changed outlook is a larger increase in total hours worked, concurrent with the prospect of weaker output growth. Productivity will therefore grow more slowly than previously forecast in the next few years. In addition, inflation expectations are higher than in May. Inflation is projected to rise somewhat in the latter half of the year and then taper off again in the first half of 2014, and approach the inflation target in the second half of 2015, somewhat later than according to the May forecast. According to the forecast, inflation is projected to average 3.9% in 2013, 3.1% in 2014, and 2.9% in 2015, an increase of 0.1-0.4 percentage points from the May forecast.

Global output growth has been somewhat weaker year-to-date than was projected in May, although the most recent indicators suggest a gradual recovery, in line with the May forecast. In Iceland’s main trading partner countries, the outlook is for weaker output growth in the next two years than was assumed in May. In line with weaker growth in economic activity, the outlook for growth in world trade and developments in Iceland’s terms of trade have deteriorated.

In Q1, output growth in Iceland proved somewhat weaker than was assumed in May, primarily because of more unfavourable inventory changes than previously expected. Those effects are projected to smooth out within the year, and output growth is expected to be broadly in line with the May forecast. The output growth outlook for the upcoming two years has deteriorated somewhat since May, however, from just over 3% per year to just under 3%. As before, the main drivers of growth during the forecast horizon are private consumption and investment. One of the main reasons for the poorer output growth outlook is the fact that investment related to the expansion of the Straumsvík aluminium smelter will not take place. As a result, the investment level will be lower next year than was provided for in the May forecast, and export growth will be weaker in 2015.

The recovery of the domestic labour market has been much more robust than was projected in May, however. The number of employed persons has continued to grow, average hours worked have begun to rise again, and total hours worked increased somewhat more than was forecast in May. Seasonally adjusted unemployment continued to decline as well, and it appears as though the majority of those who leave the unemployment register find jobs. The labour market recovery is expected to continue, although the jobless rate will decline only slightly from the current level.

The estimated output slack during the forecast horizon is broadly in line with the May forecast. The margin of spare capacity has narrowed steadily since it peaked in 2010. It is estimated to have measured about 1.5% of potential output in 2012. It is expected to narrow still more this year and next year and to disappear early in 2015.

II The interest rate decision

The Governor reported to the Committee on the IMF Executive Board's discussion of the status and outlook for the Icelandic economy in connection with post-programme monitoring of the Stand-By Arrangement. He also discussed the amendments to the Act on the Central Bank of Iceland, passed by Parliament in July. In addition, he reported on the broad-based work underway within the Bank related to the capital controls, and the preparation of further strategies by the Bank and other authorities for their removal. The matters under scrutiny include work related to talks about the lengthening of Landsbankinn's debt to old Landsbanki, an examination of options for the settlement of the old banks' estates and further reduction of the stock of volatile króna assets, formulation of prudential rules, and an examination of the long-term effects of various measures on Iceland's external debt and balance of payments.

The Committee discussed recent developments in the foreign exchange market and the Bank's foreign exchange market activities. It appeared that the Central Bank's foreign exchange market strategy, introduced in May, had contributed to reduced exchange rate fluctuations. The króna had remained relatively stable since the MPC's last meeting. By the time the MPC met in August, the króna had appreciated by 0.6% in trade-weighted terms since the June meeting. As yet, however, this increased stability has not led to lower inflation expectations.

As has been discussed previously, the near-term inflation outlook has deteriorated since May. According to the Central Bank's updated forecast, inflation will rise slightly in the latter half of the year and then begin subsiding towards the target early in 2014. The main reason for the changed outlook is a larger increase in total hours worked, concurrent with a weaker output growth forecast, which implies that productivity growth will be weaker than previously forecast and the rise in unit labour costs correspondingly greater. In the forecast, unit labour costs are projected to rise by an average of 4.2% per year, well above the level that is consistent with the Bank's inflation target, which is an important reason why inflation falls slowly back to target according to the forecast.

The MPC discussed labour market conditions in depth. Members agreed that one of the main uncertainties in the inflation forecast was the upcoming round of wage negotiations. It was clear that the wage assumptions in the forecast were higher than was consistent with the inflation target in the long run. According to the forecast, inflation will nonetheless subside to target, owing to other factors that will offset the inflationary pressures from the forecasted wage increases. However, if the outlook changes on the upside – for instance, if negotiated pay increases are even larger than is projected in the forecast – the MPC could be required to respond more strongly than the forecast assumes. On the other hand, if wage increases in 2014 and 2015 are consistent with the inflation target, inflation will fall more quickly and reach the target sooner, and interest rates will be lower than would otherwise be necessary, other things being equal.

Members agreed that, based on information emerging since its last meeting, there were grounds for keeping interest rates unchanged. According to the forecast published in the 21 August issue of *Monetary Bulletin*, output growth will measure just under 2% in 2013, which is broadly in line with the Bank's May forecast. The outlook for output growth over the next two years has deteriorated, however, with growth projected at just under 3% per year instead of slightly more than 3%, owing primarily to less investment in the energy-intensive sector in the near term. The recovery of the labour market has been more robust than was forecast in May and is expected to continue on that path.

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

Committee members were of the opinion that monetary policy must always take account of fiscal policy and other factors that affect aggregate demand. They discussed the uncertainty about the path public sector finances will take in coming years and agreed that the uncertainty will diminish with the presentation of the fiscal budget proposal in early October. As a result, they considered it appropriate to wait until then to assess the need for a monetary policy response. In general, they deemed it critical that Treasury finances be brought into balance as soon as possible, so that the monetary and fiscal policy mix would contribute to external balance of the economy, foster overall economic stability, and deliver inflation close to target, at the lowest possible cost.

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

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

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

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 2 October 2013.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

October 2013

Published 16 October 2013

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and 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 30 September and 1 October 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 2 October, 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 global outlook and the outlook for Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 21 August interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 1.7% lower at the time of the October meeting than at the August meeting. Between meetings, the króna had depreciated by about 1.6% against the euro, 3.9% against the pound sterling, and 0.5% against the US dollar. Bids for krónur in the offshore market lay in the range of 232-265 kr. per euro.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 3 million euros (roughly 465 m.kr.) since the last MPC meeting.

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

0.25 percentage points above current account rates. Turnover in the interbank market totalled 326 b.kr. year-to-date, broadly unchanged from the same period in 2012.

The five-year breakeven inflation rate in the bond market was 4.1% just before the MPC meeting, after rising by about 0.3 percentage points since the August meeting. The five-year breakeven inflation rate five years ahead was 4.2% and had also risen by roughly 0.3 percentage points.

At present, the effective nominal policy rate lies close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the real policy rate was about 1.3% at the time of the October meeting and was virtually unchanged since the August meeting. The average of the various measures of inflation and inflation expectations was 4% at the time of the October meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged between meetings, and stood at 1.6 percentage points right before the October meeting. The risk premium on Treasury obligations maturing in 2016, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, was also virtually unchanged between meetings, at 2.6 percentage points, whereas the spread between the two countries' comparable bonds maturing in 2022 had risen by 0.2 percentage points, to 3.0 percentage points.

Unchanged Central Bank interest rates in October appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most financial market analysts had forecast no change in interest rates, citing expectations that the MPC would await the presentation of the fiscal budget and the outcome of the forthcoming wage settlements before deciding to change the Bank's rates.

Broad money (M3) grew by 1.9% month-on-month in August and by about 2% year-on-year. This was the third consecutive month that broad money had grown between years, after having contracted steadily since September 2012. Excluding holding company deposits, M3 grew by 0.7% between years in August.

The NASDAQ OMX Main List index, OMXI6, had fallen by 4.3% between meetings. Trading volume on the NASDAQ OMX Iceland Main Market totalled 192 b.kr. during the first nine months of the year, up from 53.6 b.kr. over the same period in 2012. At the beginning of October, the market value of companies listed on the main market totalled 462 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

The trade surplus for the first eight months of the year was just under 31 b.kr., about 7 b.kr. less than over the same period in 2012. Import and export values contracted, by 2% and 4%, respectively. The contraction in import values is due to a marked reduction in the value of imported transport equipment (owing primarily to strong imports of ships and aircraft in 2012), although the value of imported fuels and lubricants declined as well. In most other categories, however, import values rose year-on-year. The value of investment goods imports grew by the largest margin, or about 11%. The contraction in export values during the first eight months of 2013 is attributable primarily to a 6% downturn in industrial export values, which in turn is due mostly to a contraction in the value of exported ferrosilicon and "other " industrial goods. Marine product export values contracted by about ½% over the same period.

The domestic real economy and inflation

According to new national accounts data published by Statistics Iceland in September, GDP growth measured 4.2% in Q2/2013. According to the figures from Statistics Iceland, seasonally adjusted GDP contracted by 6.5% quarter-on-quarter in Q2/2013, whereas it had grown by 4.4% quarter-on-quarter in the first quarter of the year. For the most part, this wide fluctuation between quarters is due to inventory changes, which had fallen substantially in Q2 after sharp growth in Q1. Because of these fluctuations, underlying developments can be identified more clearly if the first two quarters of the year are examined together. GDP grew by 2.2% year-on-year in the first half of 2013, driven mainly by external trade – services trade in particular – although private consumption made a positive contribution as well.

Output growth was somewhat stronger in H1/2013 than estimated in the Bank's August forecast, which provided for broadly unchanged GDP between years during the six-month period. The deviation is due to more favourable developments in external trade, particularly services imports, and stronger general business investment (i.e., excluding ships and aircraft and the energy-intensive sector), as both private and public consumption evolved in line with the August forecast in the first half of the year.

The current account deficit measured 2.6% of GDP, or 11 b.kr., in Q2, as opposed to over 14% of GDP during the same quarter in 2012. This year's deficit stems from the balance on income, which was negative by 6.7% of GDP, whereas the balance on goods and services trade was positive by 4.2% of GDP. The underlying current account balance was positive by 0.6% of GDP.

Developments in business investment and goods imports reflect strong base effects due to last year's substantial investment in ships and aircraft, which appears to a large degree as imports.

The Bank's August forecast assumed that private consumption growth would gain pace in coming quarters. The main indicators of private consumption so far in Q3 indicate that growth during the quarter could prove somewhat less than the 2.7% annual growth forecast in the August *Monetary Bulletin*. For example, seasonally adjusted payment card turnover was virtually unchanged, on average, from the average for the preceding quarter, and about 1½% more in real terms than during the same period in 2012.

Consumer sentiment improved in September, according to the Capacent Gallup survey. Optimism has lagged somewhat in the third quarter, after picking up strongly in the spring. The same can be said of planned big-ticket purchases. Consumer interest in major purchases has tapered off slightly, both from the previous quarter and from the previous year.

According to Statistics Iceland's labour market survey, total hours worked rose by an average of 4.4% year-on-year in July and August. The increase is due to a 5.3% rise in the number of working persons, while average hours worked contracted by 0.8%.

Unemployment as recorded by the Directorate of Labour (DoL) has remained unchanged, both measured and seasonally adjusted figures. In July and August, unemployment measured

4%, while seasonally adjusted unemployment was 4.7%. The unemployment rate according to the labour market survey was the same.

The wage index fell by 0.1% month -on-month in July but rose by 0.2% in August. The twelve-month rise in the index was 5.7% in August, which is similar to that a year earlier. Real wages had risen by an average of 1.5% year-on-year in July and August but had remained virtually unchanged from the previous quarter.

The nationwide Statistics Iceland house price index, published in late September, remained unchanged month-on-month but rose by 0.2% when adjusted for seasonality. House prices nationwide were up 6.1% year-on-year in Q3. The capital area Real Estate Price Index, calculated by Registers Iceland, fell by 0.1% month-on-month in August but rose by 0.4% when adjusted for seasonality. The index has risen by 6.8% since August 2012. The number of registered purchase agreements was up 16% year-on-year in August, and by just over 10% during the first eight months of the year.

According to the median response to the Capacent Gallup survey from September, households' inflation expectations both one and two years ahead measured 5%. One-year expectations were unchanged since February, and two-year expectations have been unchanged since September 2012.

The CPI rose by 0.34% in both August and September. Twelve-month inflation measured 3.9% in September, down from 4.3% in August. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 4.5% in September, down from 4.7% in August. Underlying inflation according to core index 4 without tax effects, which also excludes the market price of housing, also fell by 0.2 percentage points in September, to 4.1%. For the most part, inflation appears to be driven by domestic factors, as imported goods prices excluding alcoholic beverages and tobacco, which account for just under a third of the index, have risen by only 1.4% over the past twelve months.

The increase in August is due primarily to end-of-sale effects, which were offset in part by reduced international airfares. End-of-sale effects continued to emerge in September; however, the reduction in dental expense due to subsidy of children's dental care also made an impact. Some base effects were discernible as well, raising the CPI in August and lowering it in September.

II The interest rate decision

The Governor reported to the Committee on the work done by the Bank and other authorities since the last meeting, in relation to capital account liberalisation. He also informed the Committee of the correspondence between the Bank and the Glitnir hf. winding-up committee concerning the status of the Glitnir winding-up process and the Foreign Exchange Act. Furthermore, he discussed the report sent by the Central Bank to the Minister of Finance and Economic Affairs, as inflation had deviated by more than 1½ percentage points from the inflation target in August, when it measured 4.3%. Representatives from the Ministry of Finance and Economic Affairs also informed Committee members of the highlights of the new fiscal budget proposal.

Committee members agreed that the outlook for inflation and the economy was largely in line with the level anticipated at the previous meeting. Preliminary national accounts figures for Q2/2013 and revisions of previous figures indicated, however, that output growth had been somewhat stronger in H1 than assumed in the Bank's August forecast, with GDP growing by more than 2% instead of GDP remaining broadly unchanged. Committee members considered the deviation a reflection of intra year shifts in output growth rather than an indication that output growth for the year as a whole will be stronger than previously assumed. The deviation was due for the most part to more favourable developments in external trade and stronger general business investment in the first half of the year, as both private and public consumption had developed in line with the forecast. The recovery of the labour market had also continued, as was projected in August.

Even though the króna had depreciated since the previous meeting, Committee members agreed that the inflation outlook had not changed markedly in the interim. Inflation had risen somewhat in Q3, in line with the Bank's August forecast, which assumed that it would rise slightly in the latter half of the year and then begin to subside towards the target beginning in early 2014.

As in the August meeting, the MPC agreed that one of the main uncertainties in the inflation forecast was the outcome of the upcoming wage settlements, which would have a decisive effect on the Committee's near-term interest rate decisions. In the forecast, it was assumed, based on past experience, that the upcoming wage settlements will provide for larger pay increases than is consistent with price stability. The MPC agreed that, if pay increases are in line with the forecast, it will probably be necessary to raise the Bank's nominal interest rates, other things being equal, particularly if the margin of spare capacity in the economy continues to narrow. If wages should rise in excess of the forecast, the bank will be even more likely to raise interest rates. If wage increases should be consistent with the inflation target, however, inflation would fall more quickly than currently assumed and interest rates would be lower than would otherwise be necessary, other things being equal.

The Committee discussed the reasons why the Bank's intervention in the foreign exchange market had not moderated inflation expectations, even though it had contributed to reduced exchange rate volatility. Members considered it most likely that, in addition to uncertainty about the upcoming round of wage negotiations, the persistence of inflation expectations could be due to uncertainties related to the effects that foreign debt deleveraging, the settlement of the failed banks' estates, and capital account liberalisation would have on future exchange rate developments.

Committee members agreed that future fiscal policy had been clarified to some extent with the new fiscal budget proposal. In accordance with previous budget plans, the proposal assumes that the surplus before financial income and expense (i.e., the primary surplus) will increase from this year's level and that debt will decline as a share of GDP. On the other hand, the outlook is for a smaller overall surplus than previously anticipated. MPC members agreed on the importance of achieving an overall surplus as soon as possible so that the monetary and fiscal policy mix would contribute to external balance of the economy, foster overall economic stability, and deliver inflation close to target, at the lowest possible cost.

Committee members were somewhat concerned that it appeared as though the budget proposal assumed that the bond issued by the Treasury at the end of 2008 to recapitalise the Central Bank of Iceland would be settled with the delivery of a new bond of lesser value. This could be in contravention of the Act on the Central Bank of Iceland, which prohibits the Bank from lending money directly to the Treasury and assumes that the Treasury's share in the Bank's profits is in the form of a dividend. These plans could also be considered monetary financing by the Treasury and would therefore entail monetary easing to which the

Committee might need to respond with a tighter monetary stance than it would otherwise. On the other hand, it emerged that discussions of the financial interactions between the Treasury and the Central Bank were underway, including discussions of the bond in question, and that it was not timely to assume that this would be the result.

Committee members were concerned that national saving was on the decline and was insufficient to support an appropriate investment level at a time when a current account surplus would be required in order to reduce the risk related to a relatively heavy foreign debt service burden.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. All Committee members voted in favour of the proposal. One member expressed concern, however, at the persistence of inflation and inflation expectations. This member nonetheless supported the Governor's proposal on the grounds that it was not appropriate to respond to these concerns specifically at the present time.

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

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

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

Markús Möller wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 6 November 2013.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 2013

Published 20 November 2013

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and 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 4 and 5 November 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 6 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 global outlook and the outlook for Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 2 October interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2013/4 on 6 November.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.7% lower at the time of the November meeting than at the October meeting. Between meetings, the króna had depreciated by about 0.7% against the euro and 1.1% against the US dollar but had appreciated by 0.1% against the pound sterling. Bids for krónur in the offshore market lay in the range of 219-253 kr. per euro.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 3 million euros (roughly 492 m.kr.) since the last MPC meeting.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25 percentage points above current account rates. Interest rates were thus unchanged since the previous meeting. Turnover in the interbank market totalled about 337 b.kr. year-to-date, broadly unchanged from the same period in 2012.

At present, the effective nominal policy rate lies close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the real policy rate was about 1.4% at the time of the November meeting, after having risen by about 0.1 percentage points since the October meeting. The average of the various measures of inflation and inflation expectations was 3.9% at the time of the November meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged between meetings and measured about 1.6 percentage points just before the 5 November meeting. The risk premium on five-year Treasury obligations maturing in 2016, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, was also virtually unchanged between meetings, at 2.7 percentage points, and the spread between the two countries' comparable bonds maturing in 2022 was broadly unchanged as well, at 2.9 percentage points.

Unchanged Central Bank interest rates in November appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most financial market analysts had forecast no change in interest rates, citing recent disinflation, a more positive inflation outlook, and declining short-term inflation expectations. They also considered it likely that the MPC would await the outcome of wage negotiations before deciding to change interest rates.

Broad money (M3) grew by 2.7% quarter-on-quarter in Q3 and by about 2.3% year-on-year. For the fourth consecutive month, broad money had grown between years, after having contracted steadily since September 2012. Excluding holding company deposits, M3 grew by 0.7% between years in Q3.

The total stock of loans to households declined by 0.9% year-on-year in Q3 and by 1.6% year-to-date. The stock of deposit money bank (DMB) loans to households grew by 2.0% in the first three quarters of 2013, however, and by 3.3% year-on-year in Q3. The adjusted total stock of DMB and Housing Financing Fund (HFF) loans to non-holding companies declined by 2.5% year-on-year in the first three quarters of 2013 and about 4.8% year-on-year in Q3.

At mid-year, the Central Bank began compiling more detailed information on new DMB loans to households and firms. Previous figures did not take full account of prepayments, making it difficult for the Bank to assess the extent of new banking system lending. According to the new data, net new lending by the three large commercial banks to households – that is, new lending net of prepayments – has grown in 2013, totalling some 38 b.kr. in the first three quarters of the year. Net new lending to non-holding companies totalled almost 51 b.kr. over this period, or an average of about 5.6 b.kr. per month

The NASDAQ OMX Main list index, OMXI6, had risen by 2.4% between meetings. Trading volume on the NASDAQ OMX Iceland Main Market totalled 212 b.kr. during the first 10 months of the year, up from 63 b.kr. over the same period in 2012. At the beginning of

November, the market value of companies listed on the main market totalled 489 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

According to the International Monetary Fund's (IMF) October forecast, the outlook for 2013 is for slightly weaker global output growth than in the July forecast, or 2.9% instead of 3.1%. The forecast for world trade in 2013 has also been revised downwards slightly. Major output growth forecasts for emerging economies have been revised downwards, while forecasts for industrialised countries are broadly unchanged since July. The inflation forecast is broadly unchanged for industrialised countries but is slightly lower for emerging countries. The forecast for output growth in 2013 in Iceland's main trading partners is virtually unchanged, or 0.7%.

The goods trade surplus totalled 8.7 b.kr. in September. Import and export values grew marginally year-on-year in September but contracted in the first nine months of the year, export values by 2.3% and import values by just under 2%. The contraction in export values is due mainly to a contraction of over 3% in industrial export values, whereas marine product export values rose by 1½% year-on-year. Excluding imports of ships and aircraft in the early months of 2012, import values rose by 5% year-on-year in the first nine months of 2013. The value of industrial imports and consumer durables (household appliances, etc.) has risen most between years, or by over 12%.

Aluminium prices fell month-on-month in September but rose again in October. The average October price was similar to that in August, at the time of the Bank's last forecast, but more than 8% lower than in October 2012.

The domestic real economy and inflation

The fiscal budget proposal for 2014 provides for a considerably larger deficit this year than was assumed in the 2013 National Budget. According to the proposal, the aim is to achieve a Treasury surplus on an accrual basis in 2014. If the proposal is passed unamended, the year-on-year improvement in the primary and overall balance would be nearly 1.5% of GDP. The Government's fiscal strategy for the next several years is not included in the budget proposal, and the medium-term plan is a simple extrapolation based on the economic forecast underlying the proposal. According to the extrapolation, a sizeable surplus on the overall balance will not be achieved in the next four years.

Unemployment as registered by the Directorate of Labour (DoL) was 3.9% in Q3/2013, while seasonally adjusted unemployment was 4.5%. Unemployment according to the Statistics Iceland labour market survey was somewhat higher, however, or 4.4%. Excluding those who had become employed, it measured 4.1%, and when adjusted for seasonality it measured 5.4%.

In Q3, the wage index rose by about 0.5% quarter-on-quarter and 5.7% year-on-year. Real wages in terms of the wage index rose by 0.1% between quarters and by 1.6% year-on-year.

According to the labour market survey, labour demand grew significantly more strongly in Q3 than was assumed in the Bank's August forecast, which provided for a 0.5% increase in total hours worked, as opposed to the actual increase of 5.6%. The year-on-year increase during the quarter is attributable to both a 4.3% rise in the number of employed persons and a 1.2% year-on-year increase in average hours worked. This is the second consecutive quarter to see an increase in average hours worked, which had contracted for four quarters in a row.

According to Capacent Gallup's September survey among executives from Iceland's 400 largest firms, the number of respondents interested in laying off staff in the next six months roughly equalled the number interested in recruiting. This is somewhat of a departure from surveys conducted earlier this year, which indicated that firms interested in recruiting outnumbered those interested in downsizing by about 10 percentage points. The change is due both to an increase in the number of firms considering redundancies and to a decline in the number interested in adding on staff. As could be expected, export firms tend to be relatively upbeat, and exporters interested in recruiting outnumber those considering redundancies by 8 percentage points. Firms in the non-tradable sector are more pessimistic, however, with companies considering downsizing outnumbering those interested in recruiting by 5 percentage points.

Key indicators of developments in private consumption in Q3 suggest that it remained broadly unchanged quarter-on-quarter and that it may have grown by nearly 2% year-on-year. Payment card turnover grew 2.7% year-on-year during the quarter, primarily due to a strong increase in September, as growth was more modest in July and August. Retail sales turnover continued to increase during the quarter, particularly in electronic equipment stores. New motor vehicle registrations increased only slightly during the third quarter, and the pace of growth has slowed markedly this year.

According to the Capacent Gallup survey, consumer optimism diminished considerably between September and October. The Consumer Sentiment Index measured 67.5 points in October, a decline of 10.5 points year-on-year. All subindices fell in October, with the assessment of the economy declining most.

The nationwide Statistics Iceland house price index, published in late October, was unchanged from the previous month but was up by about 0.3% when adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.9% month-on-month in September and by about ½% when adjusted for seasonality. The index has risen by about 7% since September 2012. The nationwide number of registered purchase agreements was up by nearly a fourth year-on-year in September, and by roughly 12% year-on-year during the first nine months of 2013.

According to the Capacent Gallup survey carried out in September, executives were slightly more pessimistic about the economic outlook than in the previous survey, conducted in May, when the corporate sentiment index reached its highest point since March 2008. Just under 43% of respondents considered the current situation poor, and about half considered it neither poor nor good. On the other hand, executives were more optimistic about the future situation, with roughly 30% of respondents indicating that they expected conditions to improve in the next six months. Executives in all sectors were more pessimistic than they were in May, and the downturn in sentiment was most pronounced in the construction and fisheries sectors. All executives except those in the construction industry are more optimistic than they were a year ago, however. About 57% were of the opinion that conditions would remain unchanged in the next six months.

The CPI remained unchanged between months in October. Annual inflation measured 3.6%, down from 3.9% in September. Core indices 3 and 4, excluding tax effects, both rose by 0.06%. Twelve-month inflation by these measures declined by 0.3-0.4 percentage points to 4.2% and 3.7%, respectively. The drop in petrol prices had the strongest downward effect on the index, although the price of other imported goods and private services declined as well. Offsetting this was an increase in paid rent. Some base effects were present in October, as the CPI had risen by 0.3% in October 2012.

Inflation expectations have changed little in the recent past. According to the quarterly survey carried out by Capacent Gallup in September, household inflation expectations measured about 5% one and two years ahead and had remained unchanged for some time. According to a comparable survey among businesses, also carried out in September, corporate executives expect inflation to measure 4% in one year (the same as in the May survey) as well as in two years (a decline of ½ percentage point from the last survey). According to the Central Bank's quarterly survey of market expectations, conducted in late October, market participants expect twelve-month inflation to measure 4% in one year and to average 4% over the next 10 years, which is similar to the survey results in August, when the Bank's last forecast was published, but about 0.8 percentage points lower than at the same time a year ago. The breakeven inflation rate in the bond market has also fluctuated around 4%. The five-year breakeven rate measured 3.7% just before the MPC meeting, after having declined marginally since the October meeting, but was virtually unchanged since August. The five-year breakeven rate five years ahead measured 3.9% and had developed in broadly the same manner. By both measures, inflation expectations were up to 1 percentage point lower than at the same time a year ago.

According to the revised forecast published in *Monetary Bulletin* on 6 November, the inflation outlook is similar to that in August. According to the forecast, inflation will measure 3.9% this year. It is assumed that the slack in the economy and the relative stability of the króna over the forecast horizon will ensure that inflation begins to taper off early next year and align with the target late in 2015.

Uncertainty about the global economic situation has subsided but is still discernible. Output growth has gained strength among Iceland's main trading partners as the year has progressed. Output growth in trading partner countries is projected to average just under 1% this year, just under 2% in 2014, and just over 2% per year in 2015-2016.

Iceland's terms of trade have deteriorated almost without interruption for about six years and are projected to be nearly 17% poorer this year than in 2007, owing to the combined effects of weak global output growth and adverse developments in the price of its main export products, particularly marine products. The outlook for developments in terms of trade has nonetheless improved since August, but it is still assumed that they will deteriorate during the forecast horizon. They are expected to be about 2% poorer in 2016 than in 2013.

The outlook is for the surplus on goods and services trade to be just over 6% of GDP in 2013, as was forecast in August. Although the surplus in the following years is expected to be larger than was projected then, it is still expected to shrink over the course of the forecast horizon. The underlying current account surplus will also shrink in line with reduced gross national saving and will flip from a surplus of just over 3% this year to a deficit of about 2% by 2015, which is nonetheless smaller than was forecast in August.

GDP growth for 2013 is estimated at 2.3% instead of the 1.9% assumed in the August forecast. The increase in growth is due primarily to stronger investment, as other expenditure items and the contribution from net trade are more or less unchanged. The output growth outlook for the next two years is slightly weaker than in the August forecast. Growth is projected at 2.6% in 2014, as opposed to the previous forecast of 2.8%, and 2.8% in 2015, instead of 2.9%. It is expected to lose pace in 2016 and measure 2% that year. If the forecast materialises, output growth will average 2.4% over the forecast horizon, which is close to the 30-year average. As in previous Central Bank forecasts, domestic private sector demand is the main driver of growth.

The recovery of the labour market has been stronger than was forecast in August. Most labour market indicators imply that the labour market recovery will continue. As a result, total hours worked are projected to rise more rapidly this year than previously forecast, and unemployment is expected to be lower. Seasonally adjusted registered unemployment is forecast at just under 4% by the end of the forecast horizon, in Q4/2016. The outlook for underlying productivity is broadly unchanged, and it is expected to grow by an average of roughly 1½% per year during the forecast horizon. This is somewhat weaker than in earlier recovery periods but close to the 30-year average. According to the forecast, productivity growth will not suffice to contain the cost effects of wage increases during the forecast horizon, as in light of previous experience, it is assumed that wage increases in the upcoming settlements will not be in line with the inflation target.

The slack in the economy is estimated to narrow by just under a percentage point this year, to just over 1% of potential output. It is slightly larger than was forecast in August but, as was projected then, it is expected to continue to narrow and to disappear by the second half of 2015, somewhat later than previously thought. The current forecast assumes that, although growth in potential output is recovering gradually after the financial crisis, it will be below long-term trend growth for the majority of the forecast horizon.

The baseline forecast in *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are several key uncertainties that could change the inflation outlook from that assumed in the baseline forecast. For example, if the króna is weaker or wage increases larger than in the baseline forecast, there is the risk that the inflation outlook in the forecast or the assumptions concerning the Central Bank interest rate level that will suffice to bring inflation back to target are too optimistic. The same is true if the level of fiscal consolidation is overestimated in the baseline forecast or if the slack in the economy proves to be less than is currently thought. The risk that underlying inflationary pressures are underestimated is also greater than it would be otherwise because long-term inflation expectations appear poorly anchored. If the global economic recovery proves weaker than is assumed in the baseline forecast, however, economic activity in Iceland will be weaker and inflationary pressures correspondingly less. The same applies if a weaker global economic recovery also entails larger declines in global oil and commodity prices, at least insofar as the króna does not weaken as a result. Domestic inflationary pressures could also prove less pronounced than in the baseline forecast if pay increases in the upcoming wage settlements are better aligned with the inflation target or if the domestic economic recovery is weaker; for instance, if energy-intensive investment is weaker than is assumed in the forecast.

II The interest rate decision

The Governor reported to the Committee on the work done by the Bank and other authorities since the last meeting, in relation to capital account liberalisation. He also informed the Committee of the status of discussions concerning the financial interactions between the Treasury and the Central Bank. Furthermore, the Governor gave an account of the Icelandic delegation's meetings with IMF representatives and his meetings with other central bankers, rating agencies, and financial institutions at the IMF's Annual Meeting in Washington, DC.

Committee members discussed the Bank's *Financial Stability* report, published after the October MPC meeting, the status of financial institutions', financial institutions' restructuring measures, and the progress in private sector debt restructuring. Also discussed was the joint financial stability meeting of the Central Bank of Iceland and the Financial Supervisory Authority in early October.

The Committee agreed that the outlook for output growth this year had improved. The forecast published in *Monetary Bulletin* on 6 November indicates stronger output growth in 2013 than was provided for in the August forecast, or 2.3%, but suggests that the outlook for the next two years is similar. The most recent indicators from the labour market also suggested that the recovery there was gaining strength. Total hours worked have increased more this year than in any single year since 2007.

The Committee discussed recent developments in the foreign exchange market and the Bank's activity in the market. The Bank's intervention policy appears to continue to contribute to reduced exchange rate volatility. The exchange rate had remained virtually unchanged since the last MPC meeting, and volatility had been negligible.

The Committee also discussed the recent deterioration in Iceland's terms of trade, which had eroded the current account surplus and put pressure on the exchange rate of the króna. Looking ahead, there was also uncertainty about how heavy foreign debt deleveraging, the settlement of the failed banks' estates, and capital account liberalisation would affect the exchange rate.

Committee members also discussed recent inflation developments and prospects. After having risen somewhat in the third quarter, inflation had tapered off again. The inflation outlook according to the Bank's forecast was broadly similar to that projected in August, however, and it was not assumed that inflation would subside to target until late in 2015. In the Committee's opinion, the pace of disinflation according to the forecast was unacceptably slow. It was also clear that, as before, inflation would be sensitive to near-term exchange rate and wage developments. Furthermore, inflationary pressures remain significant, underlying inflation is still above the Bank's inflation target, and inflation expectations are broadly unchanged.

At present, however, the Committee considered the upcoming wage negotiations to be the most important source of uncertainty. The Bank's forecast, based as before on past experience, assumed that the wage increases in the forthcoming wage settlements would be larger than was consistent with the inflation target, as it assumed that unit labour costs would rise by 4½% in 2013 and about 3.7% per year, on average, over the forecast horizon. As at the previous meeting, Committee members agreed that if wage increases were in line with the forecast, it would probably be necessary to raise the Bank's nominal interest rates, other things being equal, particularly if the margin of spare capacity in the economy continued to narrow. If wages should rise in excess of the forecast, it would be even more likely that the Bank would raise interest rates. If wage increases proved to be consistent with the inflation target, however, inflation would fall more quickly than currently assumed and interest rates would be lower than would otherwise be necessary, other things being equal.

The Committee was of the opinion that fiscal policy would also affect the monetary stance. As a result, it was important that the final Budget maintain a level of fiscal consolidation at least equivalent to that provided for in the budget proposal for 2014.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. All Committee members voted in favour of the proposal. Two members expressed mounting concern, however, at the persistence of inflation and inflation expectations. Both nonetheless supported the Governor's proposal, as they considered it appropriate to await the outcome of the wage settlements.

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

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

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

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 11 December 2013.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

December 2013

Published 25 December 2013

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and 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 9 and 10 December 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 11 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 global outlook and the outlook for Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 6 November interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 2.7% higher at the time of the December meeting than at the November meeting. Between meetings, the króna had appreciated by about 1.6% against the euro, 3.5% against the US dollar, and 1.0% against the pound sterling. Bids for krónur in the offshore market were broadly unchanged and lay in the range of 226-260 kr. per euro.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 15 million euros (roughly 2.4 b.kr.) since the last MPC meeting, or 16% of total market turnover during the period.

In general, liquidity had remained ample between meetings in the interbank market for krónur, and as before, overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25-0.9 percentage points above current account rates. Turnover in the interbank market totalled about 376 b.kr. year-to-date, broadly unchanged from the same period in 2012.

At present, the effective nominal policy rate lies close to the simple average of the Central Bank's current account rate and the maximum CD rate. The average of the various measures of inflation and inflation expectations was 3.9% at the time of the December meeting. According to this, the real policy rate was 1.4% at the time of the December meeting; i.e., it was virtually unchanged since the November meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged since the November meeting, measuring 1.8 percentage points just before the Committee met in December. The risk premium on five-year Treasury obligations maturing in 2016, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, measured 2.8 percentage points, an increase of 0.2 percentage points since the last meeting, whereas the spread between the two countries' comparable bonds maturing in 2022 had narrowed slightly, to 2.8 percentage points.

Unchanged Central Bank interest rates in December appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most analysts cited stable inflation and the appreciation of the króna since the last MPC meeting as grounds for unchanged interest rates. They expected the Committee to await the results of wage settlements and Parliamentary handling of the Government's proposals for indexed household debt relief before deciding to change interest rates.

Broad money (M3) contracted by 1.2% month-on-month in October but grew by 3.2% year-on-year. This was the fifth month in a row to see a year-on-year increase in M3, which had previously contracted uninterrupted since September 2012. Excluding holding company deposits, however, M3 grew by ½% between years in October. Narrower measures of the money supply also grew year-on-year in October, as in September, after having contracted uninterrupted since July 2012. M2 grew by 0.9% between years, and M1 by 2.8%.

At mid-year, the Central Bank began compiling more detailed information on new DMB loans to households and firms. Previous figures did not take full account of prepayments, making it difficult for the Bank to assess the extent of new banking system lending.

According to information on new loans granted by the three large commercial banks, net new lending to households (loans net of prepayments) totalled 44 b.kr. during the first 10 months of the year, or about 6% of the total stock of household loans as of the beginning of 2013, and increased as the year progressed. Net new lending to non-holding companies grew as well, totalling almost 66 b.kr. over this period, or almost 6½% of the total stock of corporate loans as of the beginning of 2013.

The NASDAQ OMXI6 index had risen by 8.6% between meetings. Turnover in the NASDAQ OMX Iceland main market totalled 232 b.kr. over the first 11 months of the year, as compared with 76 b.kr. during the same period in 2012. At the beginning of December, the market value of companies listed on the main market totalled 507 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

According to the most recent forecast from the Organisation for Economic Co-operation and Development (OECD), published in November, global output growth and world trade will be weaker in 2013 than according to its May forecast, although the inflation forecast was unchanged. Weaker output growth in 2013 is attributable primarily to weaker growth in emerging economies. In the euro area, a contraction of 0.4% is expected, which is 0.2 percentage points less than previously forecast. Global output growth is forecast at 3.6% in 2014. The year-2013 output growth forecast for Iceland's main trading partners has been revised upwards slightly, to 0.7%, whereas the forecast for 2014 has been lowered slightly since May to 1.8%. *Consensus Forecasts'* year-2013 projections for Iceland's trading partners are unchanged since the November MPC meeting.

Iceland's goods trade surplus totalled 7.2 b.kr. in October and, according to preliminary figures, 12.3 b.kr. in November. Both import and export values have contracted year-on-year for the past two months. The decline in export values is due to a contraction in industrial export values, and the drop in import values is due to a contraction in the price of imported commodities and operational inputs.

Aluminium prices have fallen slightly since the MPC's last meeting, and marine product prices declined in both September and October. Terms of trade deteriorated by just over 4% year-on-year in Q3.

The domestic real economy and inflation

According to new national accounts data published by Statistics Iceland in December, GDP growth measured 4.9% in Q3/2013, and seasonally adjusted quarter-on-quarter. GDP growth was positive by 3.7% according to seasonally adjusted figures from the Central Bank. In the first three quarters of the year GDP grew by 3.1% year-on-year. Previously published figures for the first half of the year were revised as well, with GDP growth for H1/2013 adjusted downwards, from 2.2% to 2.1%.

The contribution from net trade was the main driver of GDP growth in Q3, as exports grew much more strongly than imports. Exports grew 8.3% year-on-year and imports by 1.6%. Of domestic demand-side items, private consumption growth contributed most. In terms of total consumption and investment, developments in Q3 and in the first nine months of the year were broadly similar to the forecast in the November issue of *Monetary Bulletin*. GDP growth measured 4.9% in Q3, however, far outpacing the 2.5% provided for in the November forecast. Figures for the first three quarters developed in a similar manner, with GDP growth measuring 3.1%, as opposed to 2.4% in the forecast. The deviation is due to a more favourable contribution from net trade, owing to stronger exports and weaker imports than in the forecast.

The current account surplus in Q3 was 54 b.kr, or 11.5% of GDP. The surplus is due largely to a 46 b.kr. surplus on services trade and a 21 b.kr. surplus on goods trade. The income account showed a deficit of 9.6 b.kr., however. Revision of previously published figures for 2012 and the first half of 2013 has revealed that the current account deficit was smaller than previously thought. The underlying current account surplus measured 13.3% of GDP during the quarter, whereas the forecast in the November *Monetary Bulletin* assumed a surplus of 11.1%. The deviation is due primarily to the larger surplus on goods and services trade.

Key indicators of private consumption in October suggest that developments in the beginning of the quarter were broadly similar to those in Q3. Payment card turnover, for instance, was up 2.6% year-on-year in October. Furthermore, retail sales have increased somewhat in recent months, particularly for big-ticket items such as furniture and electronic equipment.

According to the Capacent Gallup survey, consumer sentiment improved slightly in November. The Consumer Sentiment Index measured 68.4, which is markedly lower than it was a year ago. In November, the most pronounced change was the increase in the sub-index on the assessment of the economy, but all sub-indices were below 100, which means that pessimistic respondents outnumbered the optimists.

Unemployment as registered by the Directorate of Labour (DoL) measured 3.9% in October. It has remained virtually unchanged since May, whereas seasonally adjusted unemployment has fallen by 0.3 percentage points, to 4.1%.

The wage index rose by 0.2% month-on-month in October and by 6% year-on-year. Real wages in terms of the wage index rose by 0.2% between months and about 2.3% year-on-year.

According to Capacent Gallup's November survey among Iceland's 400 largest firms, the number of respondents interested in laying off staff in the next six months somewhat exceeded the number interested in recruiting. This is broadly similar to the results of the last survey, carried out in September, but a change from earlier 2013 surveys, when firms interested in recruiting outnumbered those interested in downsizing by some 10 percentage points.

In the November Capacent Gallup survey, executives were marginally more optimistic about the economic situation six months ahead than in the September survey. Just under 46% of respondents considered the current situation poor, however, and about 47% considered it neither poor nor good. On the other hand, executives were more optimistic about the future situation. The percentage of respondents who expected conditions to improve in the next six months increased between surveys, to nearly 33%. Executives in the construction sector were more pessimistic than other respondents about the situation six months ahead, and they, as well as respondents from the retail and transport sectors, were more pessimistic in November than in September. All respondents were more optimistic than they were a year ago, however. About 56% were of the opinion that conditions would remain unchanged in the next six months.

The nationwide Statistics Iceland house price index, published in late November, rose by 1½% from the previous month, and by 0.9% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 1.6% month-on-month in October, and by about 1% when adjusted for seasonality. The number of registered purchase agreements was up 6% year-on-year in November, and by just over 9% during the first 11 months of the year.

The five-year breakeven inflation rate in the bond market was about 3.9% just before the MPC meeting, after rising by about 0.3 percentage points since the November meeting. The five-year breakeven inflation rate five years ahead was 4.3% and had risen by roughly 0.6 percentage points. Households' and businesses' inflation expectations have changed very little in the recent term, however. According to the quarterly survey carried out by Capacent Gallup in November, household inflation expectations measured about 5% both one and two years ahead and had remained unchanged for some time. According to a comparable survey conducted among firms in November, executives expect inflation to measure 3.9% in one year, as opposed to 4% in the September survey.

The consumer price index (CPI) rose by 0.36% month-on-month in November. Twelve-month inflation measured 3.7%, up from 3.6% in October. Underlying annual inflation rose 0.6% between months as measured by core index 3, and by 0.4% in terms of core index 4, bringing twelve-month inflation by these two criteria to 4.2% and 3.5%, respectively. Increases in the housing component and in airfares had the most pronounced upward impact, while petrol prices pulled in the opposite direction.

II The interest rate decision

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

Committee members agreed that the inflation outlook was broadly in line with the Bank's November forecast. After having risen somewhat in the third quarter, inflation had tapered off again, measuring 3.7% in November. The exchange rate of the króna was also somewhat higher than at the time of the previous meeting, although broadly at the level assumed in the Bank's November forecast.

The economic outlook had improved from November, in the Committee's opinion. According to recently published national accounts figures, GDP growth for the first three quarters of the year measured 3.1%. This is considerably above the Central Bank's forecast and is consistent with previous indications of a strong labour market recovery.

As before, the Committee was of the opinion that the outcome of the current wage negotiations would have a decisive effect on the inflation outlook and therefore on near-term developments in interest rates. Members agreed that, if wage increases should prove larger than is consistent with the inflation target, it would probably be necessary to raise the Bank's nominal interest rates, other things being equal, particularly if the margin of spare capacity in the economy continues to narrow.

As before, members agreed that it was important that the National Budget maintain a level of medium-term fiscal consolidation at least equivalent to that provided for in the budget proposal for 2014.

The Committee discussed in detail the effects of the indexed household debt relief measures, the broad outlines of which have now been presented by the Government. The chair of the expert committee on indexed household debt relief, the committee's economic advisor, and representatives from the Ministry of Finance and Economic Affairs reported to the MPC on the committee's main proposals and their assessment of their economic impact. The Bank has begun work on its own assessment of the effect of the proposals on the economic outlook, financial stability, and Government finances. Although the assessment is not yet complete, the MPC was of the opinion that the measures would stimulate domestic demand, other things being equal. Because the spare capacity in the economy is disappearing, increased demand will raise inflation unless there is a change in the monetary stance. Stronger demand will also stimulate imports and narrow the current account surplus, which will contribute to a lower exchange rate than would otherwise develop.

Although Committee members were of the opinion that the inflationary effects of the debt relief package were underestimated in the available assessments, they considered that, based on the scope of the measures and their distribution over time, a tighter monetary stance should suffice to bring inflation back to target in coming quarters, other things being equal. They considered it important nonetheless that the authorities consider ways to mitigate the negative side effects on the current account balance and inflation, thus reducing the need for countervailing monetary policy action.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. All Committee members voted in favour of the proposal. As before, some members were very concerned about the persistence of inflation and inflation expectations, the latter of which had risen in the recent term. In this context, it was mentioned that the economy was more robust than had been assumed and that considerable uncertainty remained concerning wage settlements. In addition, the Government's debt relief measures would increase inflationary pressures still further. For these reasons, one Committee member would have preferred to raise interest rates by 0.25 percentage points but agreed that it was premature to respond to the impact of the measures before the results of the wage settlements, the National Budget, and the effects of the debt relief package had become clear.

The Committee also discussed the proposed sale of Arion Bank hf. contractual covered bonds, which was announced publicly on 16 December. The Committee considered it necessary to spread the sale over a period of time. The Central Bank will monitor financial system liquidity closely to ensure that the monetary stance is consistent with the decisions of the MPC and is not affected by the sale. The MPC will otherwise take into consideration the potential effects of the sales, both on the financial market and on long-term interest rates, when assessing the appropriate monetary stance at any given time.

Committee members agreed that, other things being equal, a stronger economic recovery and the above-mentioned Government measures would require more rapid monetary tightening than previously expected. The degree to which such tightening took place through changes in nominal Central Bank rates would depend on future inflation developments, which in turn would depend to a large extent on wage developments and exchange rate movements.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting. Also attending parts of the meeting were the chair of the expert committee on indexed household debt relief, the committee's economic advisor, and representatives from the Ministry of Finance and Economic Affairs.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 12 February 2014.

March, 27 2001

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

12 September 2013

Report to the Government on inflation in excess of tolerance limits

According to the Act on the Central Bank of Iceland, no. 36/2001, the principal objective of monetary policy is to promote price stability. In the joint declaration issued by the Government of Iceland and the Central Bank of Iceland on 27 March 2001, an inflation target was set for the Bank; that is, the Bank shall aim at a rate of inflation, measured as the twelve-month increase in the consumer price index (CPI), of as close to 2½% as possible. According to the declaration, if inflation deviates more than 1½ percentage points from the target, the Central Bank is obliged to send the Government a report stating what it considers the main reasons for the deviation, how it intends to respond, and how long the Bank anticipates that it will take to bring inflation back to target. This report is to be made public. It is appropriate to reiterate that the above-mentioned tolerance limits do not represent a formal requirement that the Bank take any other action. The Bank's objective is to keep inflation as close to 2½% as possible, on average, and not merely within the tolerance limits.

According to measurements published by Statistics Iceland on 28 August 2013, twelve-month inflation according to the CPI measured 4.3% in August. This is more than 1½ percentage points above the inflation target. The tolerance limits for the inflation target have thus been breached again after inflation fell below the upper limit in March 2013, therefore triggering this report.

Recent developments in inflation

Inflation fell to its post-crisis trough early in 2011. It then began to rise slightly as the year progressed, first due to rising oil prices and the depreciation of the króna, and later, primarily due to sizeable pay increases in the wake of the spring 2011 wage settlements. After it peaked at 6.4% in April 2012, inflation began to taper off again, falling to 3.3% by June 2013. It then began to rise once more, reaching 4.3% by August. The rise in August was attributable in some measure to adverse base effects; that is, the decline in the CPI a year earlier, which can be attributed to the strong appreciation of the króna during the summer.

Two factors have weighed heavily in recent inflation developments. First of all, domestic services prices have increased markedly in the past year; private services rose by 6.7% year-on-year in August, and public services rose by 5%. These two items combined account for almost a third of the CPI. Another important contributor to inflation is the rise in the housing component of the CPI, due partly to increases in various cost items related to operation and maintenance and partly to rising market prices.

Recent inflation appears to be rooted primarily in domestic rather than imported costs. For instance, the twelve-month rise in the price of imported goods excluding alcoholic beverages and tobacco measured only 2% in August. In addition, price increases appear to be rather broad-based. This is also reflected in measures of underlying inflation, which have also risen somewhat since June. Inflation according to core index 3 excluding tax effects measured 4.7%, as opposed to 3.5% in June. Underlying inflation according to core index 4 excluding tax effects has risen as well, from 3.2% in June to 4.2% in August.[1]

Inflation expectations are also around 4% and above. They have developed broadly in line with observed inflation and have risen by most measures since the spring.

Do these developments change the Bank’s assessment of the inflation outlook?

According to the Central Bank’s last inflation forecast, published in *Monetary Bulletin* 2013/3 on 21 August, inflation was projected to rise from 3.3% in Q2/2013 to 4% in Q3 and 4.1% in Q4. Subsequently, it was forecast to subside, falling to approximately 3% in Q4/2014, approaching the 2½% inflation target in the latter half of 2015, and reaching it early in 2016.

The spurt of inflation in late summer was thus foreseen to a large degree and in line with the Bank’s forecast, although the increase is larger than anticipated. At this juncture, there is no reason to change the assessment of the inflation outlook as presented in the Bank’s forecast in *Monetary Bulletin* 2013/3.

The Bank will release a new inflation forecast in *Monetary Bulletin* 2013/4, which will be published on 6 November.

[1] Core index 3 excluding tax effects excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense. Core index 4 excluding tax effects also excludes the effects of changes in the market value of housing.

Monetary policy responses

Because the breach of the tolerance limits was foreseen, for the most part, it is reflected in the Monetary Policy Committee's (MPC) last interest rate decision and, in and of itself, does not require special monetary policy responses.

According to the Bank's August forecast, inflation will start to taper off at the beginning of 2014 but will subside gradually and will not reach the inflation target until early in 2016. This very slow pace of disinflation is hardly acceptable; therefore, it is essential to take steps to speed the process up.

To a large extent, this slow pace stems from the fact that the forecast takes account of past experience and assumes that the pay increases following the upcoming wage settlements will be relatively large. Unit labour costs will therefore rise by about 4½% this year and by 4% per year in 2014 and 2015. Other things being equal, this is considerably above the level that is consistent with the 2½% inflation target. According to the forecast, these sizeable wage increases will counterbalance the relatively stable exchange rate and the continued slack in the economy. This development could call for further increases in the Bank's interest rates in the near term, and in any case, interest rates will be higher than they would be if wage increases prove consistent with the inflation target. It is therefore inevitable that, if wage increases are larger than is assumed in the forecast, the MPC will need to respond by raising interest rates.

On the other hand, if pay increases in the upcoming wage settlements are more modest than is assumed in the forecast, inflation will fall more rapidly, other things being equal. Interest rates would then be lower and domestic demand, labour use, and output growth would be stronger than is provided for in the Bank's forecast. To illustrate the advantages of such a development for the Bank's inflation target, if wage increases are in line with both the inflation target and estimated productivity growth in 2014 and 2015, inflation will, other things being equal, return to target in late 2014 or early 2015, a year earlier than is assumed in the baseline forecast. It is vital to take steps to ensure this outcome.

The Bank's principal tool for controlling inflation is its interest rates for transactions with deposit money banks (DMBs). In general, the outlook for inflation persistently above target calls for higher interest rates, with the aim of dampening economic activity and reducing inflationary pressures. In assessing the current situation, it should be borne in mind that the Central Bank has already raised its interest rates significantly since they bottomed out, and the effects of those rate hikes have hardly materialised in full yet.

Another important channel for monetary policy transmission is its influence on the exchange rate of the króna, which also affects wage and price developments. Other things being equal, higher interest rates tend to appreciate the króna, at least temporarily, but because of the capital controls, using the interest rate channel to affect the exchange rate is less effective than it would otherwise be. Both of these channels for monetary policy transmission are highly uncertain. As a result, interest rate decisions and possible foreign exchange market intervention are always a matter of judgement, despite decisions being based on all the relevant information and the best models available for assessing the economic outlook.

In the MPC's view, there has been some spare capacity in the economy since the financial collapse of autumn 2008; that is, capacity has not been utilised to a degree that would stimulate inflation. Therefore, there has been some scope to keep the Bank's real rate temporarily lower than is necessary when capacity is more or less fully utilised. In this way, monetary policy has supported the economic recovery. On the other hand, the MPC has repeatedly emphasised that, as spare capacity disappears from the economy, it is necessary that the slack in monetary policy should disappear as well. The Bank has therefore raised its nominal interest rates by 1.75 percentage points from their historical low in 2011, in order to respond to the inflation outlook and move the real rate closer to its neutral level, i.e. the level that is consistent with low, stable inflation when capacity is close to full utilisation.

Under certain circumstances, interbank foreign exchange market transactions undertaken by a central bank with the aim of mitigating exchange rate volatility can prove to be an important monetary policy instrument, particularly in a small, open economy where exchange rate movements have a strong, rapid effect on the domestic price level. For some time, the Central Bank has announced in its publications that it would step up its foreign exchange market activity with the aim of smoothing out fluctuations in the exchange rate. Under the present circumstances, where inflation expectations have been volatile and insufficiently anchored to the inflation target, it can be expected that wide exchange rate fluctuations could cause inflation expectations to be more volatile than they would otherwise be. In that instance, the inflation target would be harder to attain.

Last May, the Central Bank increased its foreign exchange market activity, with the aim of smoothing out exchange rate fluctuations and thereby contributing to more rapid disinflation than would occur otherwise. The premise for this decision was that foreign exchange imbalances in financial institutions' balance sheets had been reduced considerably and the exchange rate of the króna had for some time been close to the level that, other things being equal, could be considered sufficient to bring inflation back to target in the near future.

During the period since the Central Bank increased its market activity, the daily fluctuation in the exchange rate has been reduced by about half in comparison with a period of equal length prior to the Bank's decision, and fluctuations over a longer period have diminished as well. The MPC hopes that, over time, a more stable exchange rate will provide a better anchor for inflation expectations, thereby contributing to more modest wage settlements and lower inflation. While it is too early to draw conclusions about its success, the intervention policy will remain in place in coming months.

In this context, it is appropriate to emphasise that increased foreign exchange market activity by the Central Bank does not entail a declaration of an exchange rate peg, as Iceland's fundamental exchange rate policy may not be changed in this way without ministerial approval. As was stated when the Bank's intervention policy was announced in May, the policy may be reviewed as decisive steps are taken towards removing the capital controls, as it would be imprudent to use borrowed foreign reserves to reduce the risk of those wishing to convert króna-denominated assets to foreign currency at that time. The exchange rate uncertainty attached to this and the uncertainty about the debt service burden of foreign loans inevitably work against the reduction of inflation expectations to a degree. Successful measures to reduce this uncertainty could therefore contribute to lower inflation expectations.

In addition to the effect of foreign debt service and capital account liberalisation on the exchange rate, two other uncertainty factors will determine the level of Central Bank interest rates required to bring inflation back to target. First, the results of the upcoming wage negotiations will have a strong impact on the speed at which inflation converges to the target, because of the direct effect on firms' wage costs and the indirect effect on the exchange rate. Second, fiscal policy will have a significant impact in the long run, as sufficiently tight fiscal policy can lighten the burden on interest rate policy.

The Monetary Policy Committee's next interest rate decision will be announced on 2 October.

6 January 2014
1401006

Bjarni Benediktsson
Minister of Finance and Economic Affairs
Ministry of Finance and Economic Affairs
Arnarhvoll, Lindargata
150 Reykjavík

Re: Report to the Government on inflation in excess of tolerance limits

Twelve-month CPI inflation was 4.2% in December, according to measurements published by Statistics Iceland on 20 December 2013. Inflation therefore exceeded 4%, the upper tolerance limit for the inflation target. According to the joint declaration on the inflation target, issued by the Government of Iceland and the Central Bank on 27 March 2001, this obliges the Bank to submit a report to the Government. Previous reports submitted by the Bank on like occasions give a further explanation of the Bank's understanding of this obligation (see, for example, the last report, dated 12 September 2013, and the aforementioned declaration of 2001).

At its last two meetings, the Monetary Policy Committee has taken account of the Bank's November 2013 forecast, which indicated that inflation could rise temporarily above 4%. The recently concluded wage settlements and the appreciation of the króna in the past several weeks enhance the likelihood that inflation will subside quickly in the early months of 2014, as the Bank projected in November. Therefore, there is no reason at this time for a more detailed report than is included in this letter. This letter will be published on the Central Bank of Iceland website tomorrow, Tuesday 7 January 2014.

The increased inflation in December is due mainly to rising housing costs. Excluding the housing component, the CPI has risen by 3.3% in the past twelve months. However, service prices have risen well in excess of other prices, although this is offset by the fact that imported goods prices have risen by only 1.2% (or 0.6% excluding alcohol and tobacco) over the same period.

In Q4/2013, inflation measured 3.8%, as provided for in the Bank's November forecast, published in *Monetary Bulletin* 2013/4. According to that forecast, it will subside to 3.3% as early as Q1/2014. The króna has appreciated since the November forecast was prepared and was 2½% stronger by end-2013 than was assumed in the forecast. Furthermore, the newly finalised wage settlements imply that unit labour costs could rise somewhat less in 2014 than in the Bank's forecast, although this depends on successfully containing wage drift. On the other hand, household debt relief measures could stimulate inflation, but these effects will emerge over a longer period of time and will hardly have a noticeable effect in the next few months. On the whole, it is therefore highly likely that inflation will decline rapidly in the near term and that the current period of inflation in excess of tolerance limits will be very short.

According to the Bank's November forecast, inflation will subside only gradually towards the target after the rapid initial decline. The Bank's next inflation forecast, to be published on 12 February, will analyse the extent to which wage settlements, recent exchange rate developments, debt relief measures, and other factors change this outlook.

The Monetary Policy Committee's statement from December states as follows: "A stronger economic recovery and the above-mentioned Government measures will require more rapid monetary tightening than previously expected, other things being equal. The degree to which such tightening takes place through changes in nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements."

The December CPI measurement does not change this, for the reasons specified above. When the next Monetary Policy Committee statement is published on 12 February, the effects of recent exchange rate developments, wage settlements, and debt relief measures on monetary policy will be further clarified.

Respectfully yours,
Central Bank of Iceland

Már Guðmundsson
Governor

cc:
Prime Minister

No. 1/2014
14 January 2014

Domestic foreign exchange market and foreign exchange reserves 2013

From now on, the Central Bank will report at the beginning of each year on foreign exchange market developments and changes in the foreign exchange reserves during the preceding year. Early in 2013, after a period of marked ISK depreciation in the final months of 2012, the Central Bank decided to suspend its programme of regular foreign currency purchases, and the króna appreciated significantly thereafter. On 15 May 2013, the Bank's Monetary Policy Committee (MPC) introduced a new policy of more active intervention in the foreign exchange market, which significantly reduced day-to-day fluctuations and overall exchange rate volatility for the remainder of the year. The króna appreciated by nearly 11% in trade-weighted terms in 2013. During the year, the Bank's net foreign exchange purchases totalled 9 million euros, or just over 1.0 b.kr.[1] Some of the forward agreements concluded at the end of 2010 in order to reduce foreign currency imbalances in the banking system were settled, strengthening the Bank's foreign exchange position by over 29 b.kr. Also concluded during the year were foreign exchange agreements entailing foreign currency outflows in the amount of 6 b.kr.

Foreign exchange market

The exchange rate of the króna fluctuated somewhat during the first half of the year, bottoming out in January and peaking in May. The difference between peak and trough measured 12.2%. During the period from 2 January through 15 May, the day the Bank announced its new intervention policy, the exchange rate rose by about 7%, after having fallen significantly from its strongest point. The appreciation over the summer was less pronounced than often before, but towards the end of the year the króna strengthened markedly, in a departure from the seasonal pattern of recent years.

[1] Calculated using the exchange rate in each individual transaction.

As is stated above, the Bank announced early in 2013 that it would suspend its regular foreign currency purchases temporarily, in part due to heavy debt service on Icelandic residents' foreign loans. During the first quarter, the Bank sold 36 million euros (6.1 b.kr.) in the foreign exchange market, in addition to selling the equivalent of 6 b.kr. in forward transactions.

According to the MPC's statement of 15 May 2013, the Bank intended to intervene in the market with the aim of mitigating short-term exchange rate volatility.[2] In July, the Bank began buying foreign currency in the market. From 15 May until year-end, it bought 63 million euros (19 b.kr.) and sold 18 million euros (2.9 b.kr.). For the year as a whole, the Bank's net foreign currency purchases in the interbank market totalled 9 million euros, or just over 1.0 b.kr. Including payments on forward contracts, the Bank acquired foreign currency in the amount of 143.4 million euros, or 22.7 b.kr. in excess of the amount sold. This amount was used to reinforce the foreign exchange reserves. Foreign exchange market turnover was virtually unchanged from the prior year, at 166 b.kr., and the Central Bank accounted for 11.5%, a somewhat smaller share than in 2012.

Exchange rate volatility diminished substantially in the wake of the MPC's May 2013 announcement. Volatility in the trade-weighted exchange rate index (measured in terms of the standard deviation of daily changes) measured just under 0.4% over the year as a whole. It had measured 0.6% before the Bank stepped up its intervention in the market but diminished sharply thereafter. It measured 0.3% after 15 May and has been negligible in the recent past. The MPC's announcement and the Bank's foreign exchange market activity therefore appear to have contributed, along with other factors, to reduced exchange rate volatility during the year.

Foreign exchange reserves

The Central Bank's foreign exchange reserves grew by 45 million US dollars in 2013, to a year-end total of 4,228 million US dollars. Foreign exchange transactions and settlement of forward contracts increased the reserves by the equivalent of 22.7 b.kr. over the same period. By the end of the year, the foreign exchange reserves totalled 29% of GDP. This corresponds to about 11 months' worth of imports, a slight decline from the previous year. The book value of foreign

[2] See Central Bank of Iceland press release no. 16/2013: Monetary Policy Committee statement of 15 May 2013: http://www.cb.is/publications-news-and-speeches/news-and-speeches/news/2013/05/15/Statement-of-the-Monetary-Policy-Committee-15-May-2013/

assets held in the reserves declined by 52 b.kr. during the year, owing primarily to the appreciation of the króna, but also to changes in the value of gold and securities held in the reserves.

At the end of 2013, the Central Bank purchased a foreign-denominated claim against a domestic financial institution from the Central Bank of Iceland Holding Company (ESÍ). The amount of the claim was 52 b.kr. At the same time, ESÍ settled a foreign-denominated loan with the Central Bank. The claim in question will not increase the foreign exchange reserves until it is settled, as claims against domestic parties are not included in the reserves.

The following table explains these items.

Domestic foreign exchange market and foreign exchange reserves

		2009	*2010*	*2011*	*2012*	*2013*
Exchange rate (-depreciation/+appreciation)	%	-7.0%	11.9%	-4.3%	-6.6%	10.8%
Exchange rate volatility	%	0.8%	0.3%	0.2%	0.3%	0.4%
FX market turnover	m.kr.	62,427	45,212	89,864	167,115	165,873
- FX market turnover, Central Bank		23.9%	66.3%	14.0%	13.8%	11.6%
FX market purchases, Central Bank	m.kr.	0	29,980	12,612	20,109	10,088
FX market sales, Central Bank	m.kr.	14,937	0	0	3,012	9,068
Net purchases, Central Bank	m.kr.	-14,937	29,980	12,612	17,097	1,020
Net forward purchases, Central Bank	m.kr.	-	47,900	-	-	-6,000
Net settlement of forward FX purchases	m.kr.		0	-	-	21,300
Foreign exchange reserves, in US dollars*	m. USD	3,883	5,798	8,535	4,182	4,228
Foreign exchange reserves, in krónur	b.kr.	484.9	667.0	1.047.3	539.8	496.6
Foreign exchange reserves, as % of GDP		32.4%	43.4%	64.3%	33.0%	29.0%
Foreign exchange reserves, equivalent months of imports		14	17	26	13	11

*The reduction in the foreign exchange reserves in 2012 is due to reduced foreign exchange balances of the financial institutions undergoing winding-up proceedings. Other changes were due to Treasury borrowings in the market and the Treasury and Central Bank's prepayment of loans from the Nordic countries and the IMF.

Further information can be obtained from Arnór Sighvatsson, Deputy Governor, and Sturla Pálsson, Director of Treasury and Market Operations, at tel +354 569-9600.