SEÐLABANKI ÍSLANDS

MONETARY POLICY COMMITTEE REPORT TO ALTHINGI

2011•2

Monetary Policy Committee report to Althingi

30 December 2011

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 a report on its activities twice a year and that the report shall be discussed in the Parliamentary Committee of the Speaker of Parliament's choice.

The Act requires that the MPC meet at least eight times each year. Since the last Report was sent to Parliament, the Committee has met four times, most recently on 7 December. The following report discusses the work of the Committee between July and December 2011.

Monetary policy formulation

According to the Act on the Central Bank of Iceland, the principal goal of monetary policy is to promote price stability. This objective is further described in the joint declaration issued by the Bank and the Icelandic Government on 27 March 2001 as an inflation target of 2½%. Other goals of monetary policy include promoting financial stability and overall economic stability in general. In implementing monetary policy, the MPC bases its decisions in part on analysing current economic conditions and the outlook for the economy as presented in the Bank's quarterly *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 2011

The Central Bank interest rate that is the most relevant measure of the monetary policy stance may change over time. In general, the key rate has been the seven-day collateralised lending rate offered by the Bank to commercial banks. Since early 2009, however, the interest rates on deposit institutions' current accounts and the maximum bid rate on 28-day certificates of deposit have been more relevant, as the Bank's lending activity has been limited. At the end of June 2011, these rates were 3.25% and 4.25%, respectively. At both the August and November meetings, the committee decided to raise its interest rates by 0.25 percentage points. Following the MPC's decision to keep rates unchanged at its December meeting, the current account rate is currently 3.75%, the maximum bid rate on 28-day certificates of

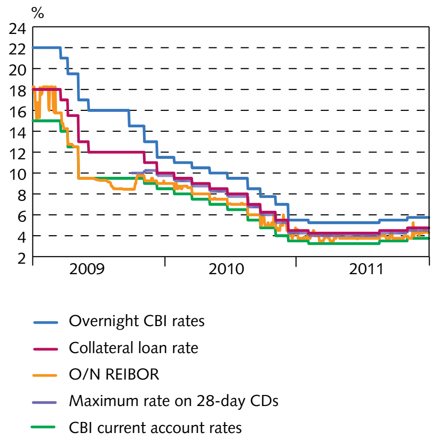
Table 1. Central Bank of Iceland interest rates 2011 (%)

Date	*Current account*	*28-day CDs (maximum)*	*7-day collateral lending rate*	*Overnight lending rate*
7 December	3.75	4.50	4.75	5.75
2 November	3.75	4.50	4.75	5.75
21 September	3.50	4.25	4.50	5.50
17 August	3.50	4.25	4.50	5.50
15 June	3.25	4.00	4.25	5.25

Chart 1

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

Daily data 1 January 2009 - 30 December 2011

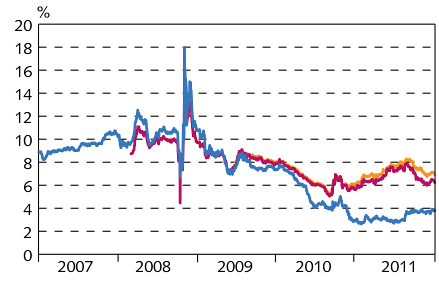


Source: Central Bank of Iceland.

Chart 2

Long-term nominal Treasury bond yields

Daily data 3 January 2007 - 30 December 2011

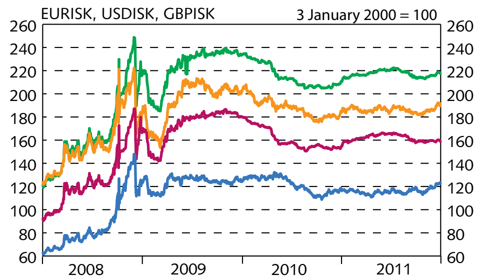


Source: Central Bank of Iceland.

Chart 3

Exchange rate of the króna

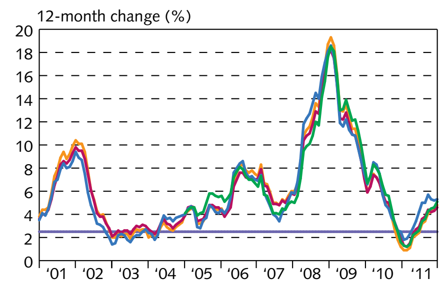
Daily data 3 January 2008 - 30 December 2011



Source: Central Bank of Iceland.

Chart 4

Inflation January 2001 - December 2011[1]



1. The core indices measure underlying inflation, with Core Index 1 excluding prices of agricultural products and petrol, and Core Index 2 excluding prices of public services as well. Core Index 3 also excludes the effect of changes in mortgage rates.

Source: Statistics Iceland, Central Bank of Iceland.

deposit 4.50%, the seven-day collateralised lending rate 4.75% and the overnight lending rate 5.75% (Chart 1).

Despite the interest rate hikes in August and November, the Bank's real rate has declined since the MPC report was last sent to Parliament. The real rate is now -1.1% based on the current inflation rate, and -0.4% based on the average of different measures of inflation and inflation expectations, or 0.7 percentage points lower than at the end of June. An accommodative monetary stance has therefore supported the economic recovery.

As is noted in the MPC's statements, the main reason for the two rate hikes was the fact that the inflation outlook had deteriorated significantly, and the majority of the Committee feared that higher inflation expectations and a weak currency would cause inflation to become entrenched, particularly once the economic recovery gained pace. In the November statement, the Committee argued that the current nominal interest rate seemed to be broadly appropriate but added that, looking further ahead, it would be necessary to continue to withdraw the current degree of monetary accommodation.

Since the beginning of July, yields on short-term Treasury bonds have risen by up to 1 percentage point, while yields on long-term Treasury bonds and indexed HFF bonds have fallen by roughly the same (Chart 2). At the same time, the exchange rate of the króna has risen by 4.3% against the euro, but fallen by 6.7% against the US dollar. In trade-weighted terms, the króna has appreciated by 1.3% since July (Chart 3).

Annual headline inflation has moderated somewhat since it peaked at 5.7% in September and measured 5.3% in December (Chart 4). Underlying annual inflation (i.e. inflation excluding tax effects, volatile items such as food and petrol, public services and real interest rates on mortgages) has however continued to increase and measured 5% in December.

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from August 2011 to the present.
2. Minutes of Monetary Policy Committee meetings from August 2011 to the present.
3. Governor's speech at a meeting of the Icelandic Chamber of Commerce on 4 November 2011.
4. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001.

On behalf of the Central Bank of Iceland MPC,

Már Guðmundsson

Governor of the Central Bank of Iceland
and Chair of the MPC

Statement of the Monetary Policy Committee 17 August 2011

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.25 percentage points. The current account rate will therefore be 3.5%, the maximum rate on 28-day certificates of deposit (CDs) 4.25%, the seven-day collateralised lending rate 4.50%, and the overnight lending rate 5.5%.

The interest rate increase is in accordance with recent MPC statements and reflects the fact that the inflation outlook for the coming two years has deteriorated still further since the Committee's last meeting. Furthermore, newly released data and the updated Central Bank forecast, published in *Monetary Bulletin* today, indicate that domestic demand and employment will grow more strongly in 2011 than was assumed in the last forecast.

The unrest in global financial markets and weaker-than-expected output growth in major industrial countries could in the coming period weigh against the recent strength of domestic demand and have a negative impact on the Icelandic economy over the medium term. The size of this effect is extremely difficult to estimate at this moment, however. In view of the growing momentum in the domestic economy, as is described in the Bank's updated forecast, the risk that a modest interest rate hike at the current juncture will derail the economic recovery is low, as the past few months' steep decline in short-term real interest rates is only reversed to a small degree.

Inflation has risen sharply in the past five months. Headline inflation measured 5% in July, and underlying inflation – defined as CPI inflation excluding the effects of consumption taxes, volatile food items, petrol, public services, and interest expense – was 3.3%, up from 1.2% in January. Higher inflation is due in part to a weak króna and rising house and oil prices. Contractual wage rises will raise inflation still further in the near future, in spite of the recent modest appreciation of the króna. Based on the current exchange rate, the outlook is for inflation to rise well into next year and not return to the inflation target until the latter half of 2013.

Developments in recent months have increased the risk that higher inflation expectations and a weak currency will cause inflation to become entrenched, particularly once economic recovery gains pace. In the worst-case scenario, the expectation of higher inflation, a negative real interest rate, and a narrow risk-adjusted interest rate differential with major trading partners could further undermine the króna and cause a spiral of rising inflation and falling exchange rate, although the amount of spare capacity in the economy should mitigate such a development to some extent.

In order to reduce the risk of such a turn of events, it is necessary to act now to contain inflation and reduce potential pressure on the króna. This may call for further interest rate hikes. As always, however, monetary policy decisions will depend on recent developments and prospects.

The MPC stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.

Statement of the Monetary Policy Committee 21 September 2011

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

Newly released data broadly confirm the updated Central Bank forecast, published in the August *Monetary Bulletin*, according to which recovery of output and employment is underway and, in the absence of a significant appreciation of the króna, inflation will remain well above the Bank's inflation target for some time but return to target over the medium term.

Global financial market unrest and weaker-than-expected output growth in the world economy create uncertainty about inflation and growth prospects in Iceland. The risk of an adverse effect on the domestic economy has grown since the last MPC meeting.

Nevertheless, inflation prospects suggest that, over the medium term, it is appropriate to continue the gradual withdrawal of monetary accommodation begun in August. The risk that a modest interest rate hike will derail the economic recovery is low. However, somewhat more favourable than expected inflation figures in August, continued strengthening of the króna, and a weaker outlook for the global economy allow the Committee to keep rates on hold at present.

The Committee remains of the view that, in order to contain inflation, it may prove necessary to raise interest rates further. As always, however, monetary policy decisions depend on recent developments and prospects.

Statement of the Monetary Policy Committee
2 November 2011

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

Recent data and the Central Bank forecast published today in the *Monetary Bulletin* confirm that Iceland's economic recovery continues, despite weakening global growth and increased uncertainty. Output is expected to grow slightly faster in 2011 and 2012 than was forecast in August, and inflation is projected to be somewhat lower in coming quarters as a result of a stronger króna and lower imported inflation.

The nominal policy rate path required to bring inflation back to target is highly uncertain. In the near term, the current level seems broadly appropriate in light of the economic outlook, the continued appreciation of the króna, and potential international headwinds. Looking further ahead, however, it will be necessary to withdraw the current degree of monetary accommodation as the recovery progresses and the slack in the economy disappears. The degree to which such normalisation takes place through higher nominal rates will depend on future developments in inflation.

Statement of the Monetary Policy Committee 7 December 2011

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

Recent data are broadly in line with the Central Bank forecast published in the November *Monetary Bulletin*. Iceland's economic recovery continues despite weakening global growth and increased uncertainty. Inflation is still above the Bank's inflation target but recent developments are consistent with its returning to the target over the medium term.

The nominal policy rate path required to bring inflation back to target is highly uncertain. In the near term, the current level seems broadly appropriate in light of the economic outlook and potential international headwinds. Looking further ahead, however, it will be necessary to withdraw the current degree of monetary accommodation as the recovery progresses and the slack in the economy disappears. The degree to which such normalisation takes place through higher nominal rates will depend on future inflation developments.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

August 2011

Published: 31 August 2011

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

The following are the minutes of the MPC meeting held on 15-16 August 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 17 August, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 15 June interest rate decision, as reflected in the updated forecast and risk analysis published in *Monetary Bulletin* 2011/3 on 17 August.

Financial markets

The trade-weighted value of the króna in the onshore market was 0.9% higher at the time of the August MPC meeting than at the June meeting. Between the two meetings, the króna appreciated by 1.1% against the euro, 0.6% against the US dollar, and 0.8% against the pound. The króna had depreciated by 5.1% in trade-weighted terms since the start of the year, however.

The Central Bank has bought in regular purchases 76.5 million euros in the domestic interbank foreign exchange market since it began regular foreign currency purchases at the end of August 2010.

The króna had depreciated against the euro in the offshore market since the last MPC meeting, trading at 220-245 against the euro, but volume and frequency of trading remained low.

The CDS spread on the Republic of Iceland rose from 276 basis points at the time of the June meeting to over 306 basis points in the wake of turbulence in global markets. At the time of the August meeting, however, the CDS spread had eased back to 242 basis points. In June the Republic of Iceland issued a five-year bond at 320 basis points over USD LIBOR swap rates. From the date of the issue to the August meeting, the spread over comparable five-year US Treasury bonds had risen from 340 basis points to 430 basis points.

Overnight interbank interest rates had been stable at 3.75% since the June meeting. Trading in the interbank market amounted to 75 b.kr. since the June meeting, with volume concentrated in overnight maturities, although there had also been transactions involving other maturities.

About 99 b.kr. worth of certificates of deposit (CDs) were outstanding as of the August meeting, approximately 40 b.kr. more than at the time of the June meeting. The main reasons for this increase is a redemption of a Treasury note in July and tax repayments in early August.

Except for the yield on the bond maturing in 2016, which had fallen by roughly 1 percentage point, yields on longer-term Treasury bonds had fallen slightly since the June meeting. At the same time, yields on shorter-term Treasury bonds had risen slightly, while yields on HFF bonds were almost unchanged.

Breakeven inflation (the difference between nominal and indexed bond yields) had risen in recent months, and the average breakeven inflation rate for the next five years was estimated at around 4.3% at the time of the meeting. This is an increase of about 2.4 percentage points since the end of January 2011.

Preliminary figures on the banking system in June showed that the net position of outstanding loans to residents was virtually unchanged from the previous month. Loans to the corporate sector decreased by 1.2%, while total lending to households rose by 0.7%. Broad money (M3) increased by 1.3% month-on-month in June but remains 5.0% lower than at the same time in 2010.

The nominal effective policy rate is currently approximated as the simple average of the Central Bank deposit and maximum CD rates. Averaging across different measures of inflation and inflation expectations, real policy rates have fallen by roughly ½ percentage point since the 15 June meeting, to -1.2%. Based on the twelve-month rise in the consumer price index (CPI), the *ex post* real rate had fallen by 1.5 percentage points to -1.3%, while in terms of breakeven inflation rates, it had fallen by 0.9 percentage points to 0.1%.

Although a 0.25 percentage point reduction in policy rates seemed to be priced into the yield curve, most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to maintain unchanged rates at the August meeting. Most parties cited the economic slack as a hindrance to an increase in interest rates. However, one analyst predicted 0.25 percentage point increase in interest rates based on deteriorating inflation prospects and higher inflation expectations.

The second auction related to the capital account liberalisation strategy was concluded on 16 August. The Central Bank offered to buy 72 million euros against payment in Treasury bonds. Offers were submitted for 3.4 million euros, and all offers were accepted. The auction was a single-price auction, so that all accepted offers were made available to primary dealers at the same price, which was set at 210.00 kr. to the euro.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in June, global growth is expected to reach 4.3% in 2011, which is in line with the IMF forecast published in April 2011. However, the forecast for inflation has been revised upwards, and the IMF now expects global inflation to measure 2.6% this year, 0.4 percentage points more than in its April forecast. The forecast for world trade has also been revised upwards by 0.8 percentage points, and trade is expected to increase by 8.2% in 2011. Prior to the meeting, new forecasts from *Consensus Forecasts* emerged, suggesting a downward revision of growth in 2011 in Iceland's main trading partners by roughly 0.2 percentage points.

Iceland's merchandise trade surplus was just over 12 b.kr. in June and July (according to preliminary numbers), down by 3.5 b.kr. from the same period last year. The value of exports was broadly unchanged year-on-year, but up by 3% excluding irregular items such as airplanes and ships. Export values of marine products increased by 8%, while exports of industrial products fell by 0.7%. The value of imports in June and July increased by 4.5% year-on-year, led by a 24% increase in the import value of fuels, while import values of investment goods fell by 7% and industrial supplies were down 1%.

The average price of aluminium was almost 1% lower in the first two weeks of August than during the two weeks preceding the June MPC meeting. The value of marine products had continued to rise, increasing by 1.1% month-on-month in June, and was 12.8% higher in Q2/2011 than a year ago.

The domestic real economy and inflation

The Statistics Iceland labour market survey for Q2 suggests that labour demand is on the rise again. The number of persons in the labour market rose year-on-year, as did the average number of hours worked. The number of full-time workers rose, and the number of part-time workers fell for the second consecutive quarter. Thus the total number of hours worked rose, by about 1% year-on-year.

Seasonally adjusted unemployment has remained unchanged at 7% since May, while registered unemployment fell by 0.8 percentage points to 6.6% in July.

The wage index rose by 3.9% month-on-month in June, and has increased by 7.1% since June 2010. Real wages increased by 3.4% month-on-month in June and by 2.7% year-on-year.

According to the Capacent Gallup business sentiment survey conducted in May and June, more firms in all sectors were considering laying off staff than in the March survey. Firms planning to shed staff in the next six months outnumbered those planning to recruit by 17 percentage points.

Consumer sentiment has deteriorated slightly over the past two months, due mainly to bleaker sentiment about the economic situation in six months. Sentiment towards the current economic situation, however, has not measured higher since October 2008.

According to quarterly results from a survey in June, expected big-ticket purchases declined from the previous survey in March, and were lower than at the same time last year. Expected housing purchases were lower than a year ago, despite the increased turnover and recent price rises in the housing market.

A Central Bank survey of planned investment among 114 firms suggests that business investment apart from energy-intensive industry and ships and aircraft will be significantly stronger in 2011 than was assumed in the April forecast, suggesting an increase of around 6% instead of a decline by 3% in the April forecast.

According to Capacent Gallup's business sentiment survey, conducted in May and June, corporate executives were more pessimistic about the economic situation six months ahead than they were in March. Almost a third of participants expected the situation to worsen, while half believed it would remain unchanged, compared to 24% and 54%, respectively, in March. Executives were also more pessimistic regarding the outlook for domestic demand over the next six months, especially in construction and transport/tourism. Expectations of foreign demand remained almost the same in June as they have been since March 2009.

Indicators of domestic demand suggest a strong pick up in private consumption in Q2/2011 compared to Q1. Households' seasonally adjusted payment card turnover in Iceland and abroad was about 2.6% higher in real terms in Q2 than in Q1. In July, seasonally adjusted payment card turnover rose by 0.7% month-on-month. Retail turnover had also been on the rise quarter-on-quarter in Q2/2011, although developments in individual components varied; sales of electronic equipment and furniture had risen sharply, while groceries turnover had grown more slowly and clothing and alcoholic beverage sales have contracted.

Statistics Iceland's nationwide housing price index, published in July, increased by 1.3% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, rose by 0.5% month-on-month in June, and by 1.1% when adjusted for seasonal variability. Some 71% more contracts were concluded in June than during the same month in 2010, and in the first six months of 2011, 73% more contracts were concluded than in the same period in 2010. The number of contracts remains very low in historical context, however.

Executives' median expected inflation measured 3.6% one year ahead, according to the Capacent Gallup business sentiment survey conducted in May and June, and had declined by 0.4 percentage points since the survey in March. In March, however, executives' inflation expectations had risen by 2 percentage points from the survey in December.

In another Capacent Gallup survey in June, household inflation expectations one year ahead increased by 1.5 percentage points from the previous survey in March, and measured 5% according to the median. Households' one-year inflation expectations have not risen between surveys since October 2008. The median household expected twelve-month inflation to measure 5% in two years, a 1 percentage point increase from March.

The CPI rose by 0.1% month-on-month in July, following a 0.5% increase in June. Annual inflation measured 5.0% in July, compared to 3.4% in May. Annual inflation excluding tax effects measured 4.8% in July. In July, the seasonally adjusted CPI had risen by 1.7% over the previous three months, or 7.0% on an annualised basis. Annual core inflation 3 (headline inflation excluding the effects of taxes, volatile items such as food and petrol, public services, and real interest rates) measured 3.3% in July, up from 2.3% in May. It should be noted that all measures of annual inflation are 0.4 percentage points lower than they would otherwise have been due to the exclusion of broadcasting fees from the CPI as of January 2011.

Many factors contributed to the rise in inflation in June and July, but the housing component had the largest effect, almost 0.5 percentage points in all. According to Statistics Iceland, market prices of housing have risen by 5.7% year-on-year, the largest annual increase since autumn 2008. Other factors that contributed significantly to inflation were rising food and services prices. The summer sales effect on the CPI in July was -0.4 percentage points, which was less than at the same time last year.

According to the updated forecast published in *Monetary Bulletin* on 17 August, growth during the forecast horizon is expected to be driven by rising domestic demand, particularly private consumption and business investment. GDP growth for 2011 is forecast at 2.8%, 0.5 percentage points more than was assumed in April, due to stronger private and public consumption and stronger business investment (excluding energy-intensive industry, ships, and aircraft). The forecast assumes weaker growth in 2012, at 1.6%, mainly due to a more front-loaded private consumption path and delays in projects related to energy-intensive industry. Thus, some of the growth envisaged in 2012 has now shifted to 2013, with the forecast assuming a 3.7% growth, up by roughly one percentage point from the previous forecast. The estimate of spare capacity during the forecast horizon is broadly in line with the April forecast.

It is expected that exports of goods and services will be weaker in 2011, or 1.9%, due primarily to more modest growth in services exports in the first quarter. The forecast for exports of goods and services in 2012 is somewhat lower as well, but somewhat stronger in 2013 than was anticipated in April. Excluding exports of ships and aircraft, however, the outlook during the forecast horizon is broadly in line with the April forecast.

Due mainly to the prospect of poorer terms of trade, the forecast assumes that the trade surplus will amount to 8.6% of GDP in 2011, some 2 percentage points less than was forecast in April. The current account surplus excluding deposit money banks (DMBs) in winding-up proceedings will be just under 1% of GDP, instead of the 2.4% forecast in April, and is expected to remain just under 1% by this measure in 2012, followed by a modest deficit in 2013.

Private consumption has been stronger so far this year, reflecting transitory factors, and is expected to rise by roughly a percentage point more than according to the April forecast, or by 3.8%. The effect of the transitory factors is expected to subside as the year progresses, and rising inflation is projected to cut into the increase in disposable income produced by the recent wage settlements. Private consumption is therefore forecast to grow by ½ a percentage point less per year over the next two years, or by 2½% per year.

Nominal public consumption, which has remained unchanged since Q4/2008, is expected to rise again this year, primarily due to contractually agreed rises in nominal public sector wages. In real terms, public consumption is expected to continue contracting in 2011 and 2012, but by less than in the Bank's last forecast.

Gross capital formation is estimated to increase by just over 10% this year. Growth will be concentrated in business and residential investment, as public investment is expected to contract. Even though the lion's share of the increase in investment during 2012 (16%) and 2013 (11%) is expected to come from business investment, growth is expected in all components of investment.

The turnaround in the labour market appears to be sharper than previously projected, and employment is therefore expected to rise by 1.2% year-on-year in 2011, whereas the April forecast assumed a contraction of 0.7%. Moderate growth is still expected during the forecast horizon.

Unemployment is expected to be 7% this year, or ½ a percentage point less than according to the last forecast. However, it is projected to fall back to about 4½% by the end of the forecast horizon, somewhat higher than was forecast in April.

The increase in wage costs associated with recent wage settlements in the labour market is considerably higher than was assumed in the April forecast. The outlook is therefore for unit labour costs to rise far more during the forecast horizon than according to the last forecast. They are expected to increase by about 5.7% in 2011, some 2 percentage points more than was projected in April, and by 4.3% in 2012, about 1 percentage point more than in the April forecast. In the latter half of the forecast horizon, however, it is assumed that the increase in unit labour costs will be in line with the Central Bank's inflation target.

The short- and medium-term inflation outlook has deteriorated sharply since the last *Monetary Bulletin*. Inflation is likely to measure 5.6% in Q3, whereas it was projected at 3.3% in the last forecast. Inflation is expected to peak at 6.8% in Q1/2012 and to begin to taper off again late in 2012 and reach the inflation target in the latter half of 2013, about a year later than according to the April forecast.

II The interest rate decision

The Governor informed the Committee of the status of the sixth and final review of the IMF Stand-By Arrangement, the associated funding, and the results of the foreign currency auctions in relation to the capital account liberalisation strategy completed since the Committee's last meeting. The MPC was also informed of the outlook for government finances and the fiscal consolidation plan by representatives from the Ministry of Finance.

The Committee discussed the likely reasons why favourable current account developments in an environment characterised by restrictions on capital flows had not led to a strengthening of the króna so far this year. Possible explanations put forward at the meeting include: domestic companies are in some cases forced to reduce their foreign debt rapidly because of their inability to roll loans over due to lack of access to foreign credit, some companies might only bring enough currency into the country to pay domestic expenses, and the Central Bank's currency purchases might have impeded the appreciation of the króna. Also, the share of interest payments received by foreign holders of securities that are withdrawn has been higher in 2011 than in 2010. Some members were of the view that this might be the result of a lower risk-adjusted interest rate differential with abroad than in previous years and could herald a more general tendency to reduce ISK exposure in the period ahead, e.g. among domestic exporters. The MPC noted that there were no apparent indications that the capital controls were becoming less effective.

In the view of the majority of the Committee, the inflation outlook remained the key upside risk. Inflation had risen sharply in the past five months. Headline inflation had risen by over 3 percentage points from January to 5% in July, while underlying inflation had risen by little less, or by over 2 percentage points to 3.3%. The outlook according to the updated Central Bank forecast published in *Monetary Bulletin* on 17 August, based on a broadly stable króna, is for inflation to rise well into next year and not return to the inflation target until the latter half of 2013.

In the Committee's view, higher inflation is due in part to a weak króna and rising house and oil prices, but the outlook is for contractual wage rises to increase inflation still further in the near future, in spite of the recent modest appreciation of the króna.

While significant downside risks remain for the real economy, upside risks had also increased since the last meeting, as newly released data and the updated Central Bank forecast indicated that domestic demand and employment will grow more strongly in 2011 than was assumed in the Bank's April forecast.

Developments in recent months had also intensified the risk that higher inflation expectations and a weak currency would cause inflation to become entrenched, particularly once economic recovery gains further momentum. In the potential worst-case scenario, the expectation of higher inflation, a negative real interest rate, and a narrow risk-adjusted interest rate differential with major trading partners could further undermine the króna and cause a spiral of rising inflation and falling exchange rate, although the spare capacity in the economy should mitigate such a development to some extent.

The Committee noted the significant fall in the real effective policy rate in recent months. By that measure, monetary policy was accommodative, which is appropriate given the slack in the economy and the domestic debt crisis. However, in light of the relatively weak exchange rate and deteriorating inflation outlook, the Committee discussed whether it was appropriate to start withdrawing some of the monetary stimulus.

In the Committee's view, the recent unrest in global financial markets and weaker-than-expected output growth in major industrial countries in Q2/2011 create downward risks to the real economy. These external factors could weigh against the recent strength of domestic demand in the coming period and have a negative impact on the Icelandic economy over the medium term, although it was difficult to estimate the magnitude of this effect at the time of the meeting.

MPC members expressed divergent views about the necessity of changing the monetary stance at this meeting. The majority were of the view that is was appropriate to withdraw some monetary stimulus and reduce potential pressure on the króna in order to contain the risk of second-round effects. They are reflected in, for example, rising inflation expectations, more widespread price increases, and large wage increases which could result in the current high inflation becoming entrenched. Furthermore, the majority argued that, in view of the growing momentum in the domestic economy, the risk that a modest interest rate hike at the current juncture would derail the economic recovery was low, as the past few months' steep decline in short-term real interest rates would only be reversed to a small degree. For one member, the uncertainty regarding international developments and the continued fragility of domestic balance sheets carried greater weight than inflationary risks, and was therefore an argument in favour of maintaining the current monetary policy stance at this meeting. This member argued that the aftermath of the financial crisis called for interest rates to remain low, provided that the exchange rate did not depreciate much further. Vulnerable balance sheets, an uncertain exchange rate outlook, and high bank interest rates on new loans were holding back investment and growth. This member therefore argued that an interest rate rise would further delay the economic recovery, with additional risks to the recovery arising from the increased uncertainty in international developments. He viewed the recent rise in domestic inflation as mainly reflecting global developments, which are likely to be temporary. Although he agreed that the recent wage hikes were excessive, this member argued that a monetary tightening at the current juncture would have limited effects to offset any inflationary pressures originating in the labour market, as new lending is limited and domestic demand is weak. He also warned against raising interest rates with the aim of counteracting inflation through an appreciating exchange rate, which could also reduce Iceland's exports.

Three alternative rate decisions were discussed: keeping rates unchanged or raising them by 0.25 or 0.5 percentage points. In light of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be raised by 0.25 percentage points, which would raise the current account rate to 3.5%, the maximum rate on 28-day certificates of deposit (CDs) to 4.25%, the seven-day collateralised lending rate to 4.5%, and the overnight lending rate to 5.5%. Three members voted in favour of the Governor's proposal. One member voted against the Governor's proposal, preferring to delay the consideration of monetary tightening until the September MPC meeting.

In the view of the majority of the Committee, the interest rate increase is in accordance with recent MPC statements and reflects the fact that the inflation outlook for the coming two years has deteriorated still further since the Committee's last meeting. As a consequence, the inflation outlook might call for further interest rate hikes. As always, however, monetary policy decisions will depend on recent developments and prospects.

As before, the MPC stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Gylfi Zoëga, external member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 21 September 2011.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

September 2011

Published: 5 October 2011

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

The following are the minutes of the MPC meeting held on 20 September 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 21 September, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 17 August interest rate decision.

Financial markets

The trade-weighted value of the króna in the onshore market was 1.8% higher at the time of the September MPC meeting than at the August meeting. Between the two meetings, the króna appreciated by 2.7% against the euro and by 2.0% against the pound sterling, while depreciating by 2.2% against the US dollar.

The Central Bank had bought 84 million euros in regular purchases in the domestic interbank foreign exchange market since it began its programme of regular foreign currency purchases at the end of August 2010.

The króna had depreciated against the euro in the offshore market since the last MPC meeting, trading at 220-232 against the euro, but volume and frequency of trading remained low.

The CDS spread on the Republic of Iceland rose from 242 basis points at the time of the August meeting to about 306 basis points at the time of the September meeting. The spread between the recently issued US dollar government bond and an equivalent US Treasury bond rose at the same time from 340 basis points to 408 basis points.

Overnight interbank interest rates rose by 25 basis points to 4% just after the MPC's decision to increase interest rates in August. They fell back to 3.75% in early September but had risen to 4.5% by the September MPC meeting. Interbank market trading since the August meeting totalled 21 b.kr., with volume concentrated in overnight maturities.

About 135 b.kr. worth of certificates of deposit (CDs) were outstanding as of the September meeting, approximately 36 b.kr. more than at the August meeting.

The nominal short-term yield in the secondary market rose by 60 basis points after the announcement of the 25 basis points interest rate increase in August and the publication of the Central Bank's more pessimistic inflation forecast, while the yield on nominal long-term bonds rose by 50-60 basis points. The yield on long-term bonds peaked at 8.3% in the last week of August but was around 8.0% at the time of the September meeting. Yields on HFF bonds were broadly unchanged or fell slightly between meetings.

The breakeven inflation rate (the difference between nominal and indexed bond yields) was around 4.8% at the time of the September meeting and had risen by 50 basis points since the August meeting.

Data on Deposit Money Banks' retail interest rates, the interest rate corridor on deposits and lending and the interest rate margins showed that nominal rates of non-indexed customer loans averaged around 8% at the beginning of September, indicating that the spread over the policy rate could be significantly lower than in many countries going through financial stress.

The nominal effective policy rate is estimated as the simple average of the Central Bank deposit and maximum CD rates. Averaging across different measures of inflation and inflation expectations, the real policy rate had risen slightly since the August meeting, to -0.9%. Based on the twelve-month rise in the consumer price index (CPI), the *ex post* real rate had increased by 20 basis points to -1.1%, while in terms of breakeven inflation rates it had fallen by 30 basis points to -0.2%.

Although unchanged policy rates seemed to be priced into the yield curve, most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to increase rates by 25 basis points at the September meeting. Most parties cited the rise in inflation and higher inflation expectations as the main arguments for an increase in interest rates. However, one analyst predicted a 50 basis points increase, referring to implications from a simple Taylor rule.

New lending to the private sector continues to be limited and is mostly a part of debt restructuring measures. Preliminary figures on the banking system in July, which reflect both revaluation of loans and movement of funds, showed that the net position of outstanding loans to residents decreased by almost 0.5% from the previous month.

Loans to the corporate sector fell by 0.3%, while total lending to households fell by 1.7%. Broad money (M3) increased by 3.3% month-on-month in July but remained 2% lower than at the same time in 2010.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in September, global growth is expected to reach 4.2% in 2011 and 4.3% in 2012, which is slightly lower than in the IMF forecast published in June 2011. However, the forecast for inflation is unchanged. The IMF forecast for world trade has been revised downwards by 0.5 percentage points, and trade is expected to grow by 7.7%. According to the IMF forecast, economic growth in Iceland's main trading partner countries has also been revised downwards. Revised forecasts from *Consensus Forecasts* suggest a large downward revision for Iceland's main trading partner countries. Output is now expected to grow by 1.8% in 2011, down from 2.2% at the time of the August MPC meeting, and for 2012 it has been revised down by 0.7 percentage points to 1.6%. Indicators of risks in the global economy have also risen sharply since the August meeting.

Iceland's merchandise trade surplus was 8.2 b.kr. in August, according to preliminary data, which is somewhat higher than at the same time last year. The value of exports increased by 27% year-on-year, led by a 29% increase in exported marine products. Exports of industrial goods were also strong, growing by 28% year-on-year. In the first eight months of the year, export values rose by 11%. Import values also increased strongly in August, by 30% year-on-year, despite a 15% drop in the import value of fuel. The rise in import values was led by a 61% increase in the import value of investment goods and a 51% increase in the import value of industrial supplies.

The mid-September price of aluminium was similar to that at the time of the August MPC meeting but had fallen by around 10% since the end of July. The price of marine products was unchanged month-on-month in July but had risen by 11% year-on-year.

The domestic real economy and inflation

On 8 September, Statistics Iceland published the Q2/2011 national accounts and a revision of previously published preliminary figures. The revised figures show a 0.2 percentage points smaller contraction of GDP in 2009 (6.7%) than previously published figures and a 0.5 percentage point larger contraction, or 4%, in 2010.

According to the national accounts numbers for Q2/2011, seasonally adjusted GDP fell by 2.8% from the previous quarter, after three quarters of quarterly growth. GDP grew by 1.4% year-on-year, however. Private consumption grew by 1.8% quarter-on-quarter after a contraction in Q1 and government final consumption increased by 0.4% for the third consecutive quarter. Gross fixed capital formation grew by 7.7% quarter-on-quarter in Q2 and by 1% from the same quarter in the previous year. Growth in business investment other than energy-intensive sectors, ships, and aircraft measured over 19% year-on-year. Government investment continued to contract between quarters in Q2, by 9.5% from Q1. Change in inventory growth reduced quarterly GDP growth by 5.5% of GDP. This change in stock had a sizable negative impact on gross domestic final expenditure, which fell by 3.9% in spite of growth in all other subcomponents, while growing by 6.0% year-on-year. Exports grew by 1.4% quarter-on-quarter in Q2, while imports remained unchanged.

Because of the offsetting revision to Q1 data, a comparison of the first two quarters in 2011 together is more reliable when comparing the national accounts numbers to the forecast published in the August *Monetary Bulletin*. Overall, domestic demand in H1/2011 was in line with the August forecast, growing by 5% compared to a forecast of 4.9% in August. As regards individual expenditure items, private consumption was somewhat weaker than forecast, whereas government consumption was stronger. Investment was stronger as well, driven by stronger than anticipated business investment excluding power-intensive investment, ships, and aircraft. Net exports underperformed in comparison to the forecast, mainly on the export side – mainly reflecting an offsetting build up of export inventories. The August forecast overestimated GDP growth by a half a percentage point in H1: output was assumed to grow by 3% in H1 from the first half of 2010, while the Statistics Iceland national account numbers indicate a growth rate of 2.5%.

The current account deficit was almost 15% of GDP in Q2/2011, or 58 b.kr, following a deficit of 12% of GDP in Q1. The deficit in Q2 was caused by a large income account deficit (87 b.kr.), which more than offset service and goods account surpluses of 16 b.kr. and 15 b.kr. respectively. The current account balance excluding banks in winding-up proceedings was negative by roughly 5% of GDP in Q2.

While the preliminary Statistics Iceland data could suggest a somewhat weaker growth rate in H1 than expected in August, leading indicators suggest that Q3 may turn out stronger than the August forecast assumed. For example, payment card turnover and retail sales for July and August suggest that private consumption will be somewhat stronger than expected.

Against the indications of weaker output in 2010 and the first half of 2011, revised analysis of the economy's output capacity suggests that the level of potential output has also been somewhat weaker than previously estimated. This suggests that the spare capacity in the economy is, if anything, smaller than previously thought, not withstanding the downward revision of GDP data from Statistics Iceland.

Unemployment adjusted for seasonality rose from 7.1% in July to 7.5% in August, while registered unemployment has been broadly unchanged since June, at roughly 6.7%.

The wage index rose by 1% month-on-month in July and by 7.8% since July 2010. Real wages increased by 0.9% month-on-month in July and by 2.6% year-on-year.

Consumer sentiment deteriorated in August, due mainly to bleaker expectations towards the future economic situation. The decline was the largest in a single month since October 2010. In August, the consumer sentiment index was at its lowest level in 2011.

Statistics Iceland's nationwide housing price index, published in August, fell by 0.15% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, decreased by 0.1% month-on-month in July (seasonally adjusted). House prices remain 5.9% higher in July than at the same time a year ago, however. Some 61% more contracts were concluded in July than during the same month in 2010, and in the first seven months of 2011, 72% more contracts were concluded than in the same period in 2010. The number of contracts remains very low in historical context, however.

The CPI rose by 0.26% month-on-month in August, and annual inflation measured 5.0%, unchanged from July. Annual inflation excluding tax effects measured 4.8%. The seasonally adjusted CPI had risen by 1.5% over the previous three months, or 6.3% on an annualised basis. Annual core inflation 3 (headline inflation excluding the effects of taxes, volatile items such as food and petrol, public services, and changes in real interest rates) measured 3.5% in August, up from 3.3% in July. It should be noted, however, that all measures of annual inflation are 0.4 percentage points lower than they would otherwise have been due to the exclusion of broadcasting fees from the CPI in January 2011.

The main contribution to the CPI increase in August came from increases in the price of clothing, footwear and furniture due to the end of summer sales, raising the index by 0.3 percentage points. Increased food prices, mainly vegetables and meat, had an effect of 0.12 percentage points. However, the cost of owner-occupied housing fell by 0.4% in August and has not declined between months since January 2011. Prices of petrol and oil fell by 1.7%, with an effect of -0.1 percentage points on the CPI.

II The interest rate decision

The Governor informed the Committee of his meeting with the Council of Ministers on the National Economy (the Prime Minister, the Minister of Finance and the Minister of Economic Affairs) where the effects of international financial and economic developments on the Icelandic economy were discussed. The MPC was also informed of the amendments to the Foreign Exchange Act recently passed by Parliament and the preparation for the IMF's Annual Meeting in Washington.

The Committee observed that newly released data broadly confirmed the updated Central Bank forecast, published in the August *Monetary Bulletin*. According to the forecast, a recovery of output and employment is underway and, in the absence of a significant appreciation of the króna, inflation will remain well above the Bank's inflation target for some time but return to target over the medium term.

The MPC observed that even though inflation has risen sharply in the past five months, the August inflation measurement had been somewhat more favourable than expected. However, the Committee remained of the view that the inflation outlook had not materially been altered. At the same time however, the recent increase in unrest in global financial markets, and the weaker-than-expected output growth in the world economy created increased uncertainty about inflation and growth prospects in Iceland.

Two alternative rate decisions were discussed: keeping rates unchanged or raising them by 0.25 percentage points. In light of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be kept unchanged: the deposit rate (current account rate) at 3.5%, the maximum bid rate for 28-day certificates of deposit (CDs) at 4.25%, the seven-day collateralised lending rate at 4.5%, and the overnight lending rate at 5.5%. Four MPC members supported the Governor's proposal on the grounds that more favourable than expected inflation figures in August, continued strengthening of the króna, and a weaker outlook for the global economy provided scope to keep rates on hold at present. One member voted against the Governor's proposal, preferring to raise interest rates by 25 basis points. This member placed more weight on persistent and high inflation expectations and the risk of high inflation becoming entrenched. This member also argued that the momentum in the domestic economy suggested that a continuation of a gradual withdrawal of monetary accommodation was appropriate at this juncture, and that international developments would have limited effects on the domestic real economy in the short run, due to small weight of manufacturing exports, which tend to be most sensitive to the global business cycle. This member also raised concerns that keeping rates on hold at this meeting could potentially undermine the signalling effect achieved with the August decision.

The majority of Committee members agreed that inflation prospects suggested that, over the medium term, it would be appropriate to continue the gradual withdrawal of monetary accommodation begun in August. They also agreed that there was only limited risk that a modest interest rate hike would derail the economic recovery.

Thus, the Committee remained of the view that, in order to contain inflation, it could prove necessary to raise interest rates further but that monetary policy decisions would depend, as always, on recent developments and prospects.

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Anne Sibert, external member

Professor Gylfi Zoëga, external member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 2 November 2011.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 2011

Published: 16 November 2011

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

The following are the minutes of the MPC meeting held on 31 October and 1 November 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 2 November, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 21 September interest rate decision, as reflected in the forecast and risk analysis published in *Monetary Bulletin* 2011/4 on 2 November.

Financial markets

The trade-weighted value of the króna in the onshore market was 0.71% higher at the time of the November MPC meeting than at the September meeting. Between the two meetings, the króna appreciated by 0.92% against the euro and by 0.92% against the US dollar, while depreciating by 0.53% against the pound sterling.

The Central Bank had bought 93 million euros in regular purchases in the domestic interbank foreign exchange market since it began regular foreign currency purchases at the end of August 2010.

The króna had depreciated against the euro in the offshore market since the last MPC meeting, trading at 230-243 against the euro, but volume and frequency of trading remained low.

The CDS spread on the Republic of Iceland fell from 310 bp at the time of the September meeting to about 292 bp at the time of the November meeting. Over that period, the spread between the recently issued US dollar Government bond and an equivalent US Treasury bond rose from 408 bp to 452 bp.

Overnight interbank interest rates remained unchanged at 3.75% from the September MPC meeting until October 24, when they rose by 20 bp. Interbank market trading since the September meeting totalled 44 b.kr., with volume concentrated in overnight maturities.

About 109 b.kr. worth of certificates of deposit (CDs) were outstanding as of the November meeting, approximately 26 b.kr. less than at the September meeting.

At the time of the November meeting, nominal short-term yields in the secondary market had risen by less than 10 bp from the last meeting, the yield on the nominal medium-term bond fell by almost 20 bp, while the yield on nominal long-term bonds fell by 70-100 bp. Yields on HFF bonds fell by 30-40 bp between meetings.

The breakeven inflation rate (the spread between nominal and indexed bond yields) was around 4.6% at the time of the November meeting and had fallen by 0.2 percentage points since the September meeting.

The nominal effective policy rate is estimated as the simple average of the Central Bank deposit and maximum CD rates. Averaging across different measures of inflation and inflation expectations, the real policy rate was broadly unchanged since the September meeting, at -0.6%. The real rate based on inflation over the past twelve months had fallen by 30 bp to -1.4%, while in terms of breakeven inflation rates it had fallen by 70 bp to -0.7%.

Unchanged policy rates appeared to be priced into the yield curve, and most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to keep rates unchanged at the November meeting. Lower inflation in October than in September and lower inflation expectations were the main arguments given.

Although data suggests that new lending to the private sector is gradually picking up, it remains low. New housing mortgages granted by the Housing Financing Fund, pension funds and DMBs totalled 3.7 b.kr. on average per month during the first eight months of this year, which is equivalent to a minor year-on-year increase for the period. However, other new lending, such as lending for new projects in the corporate sector, still appears to be limited, which could be both due to low loan demand for such purposes and still somewhat tight financial conditions. Corporate restructuring, however, appears to finally be progressing and the number of companies placed in a sales process has increased. Broad money (M3) increased by 1.2% month-on-month in September and by 2.5% year-on-year. This is the fourth consecutive month with month-on-month growth and the first time since March 2010 that growth has been observed between years.

Outlook for the global real economy and international trade

The August merchandise trade surplus was 11 b.kr. This was 2.6 b.kr. higher than the preliminary numbers had indicated, as the value of manufacturing exports was higher than the preliminary data showed and the import value of investment goods was lower. The September trade surplus was 15.5 b.kr. according to preliminary data. Export values increased by 20% year-on-year in September, led by a 27% rise in exported marine products. Manufacturing exports were strong as well, growing by 20% year-on-year.

Iceland's merchandise trade surplus was 80% higher in Q3/2011 than at the same time last year, or 39 b.kr. In the first nine months of the year, export values rose year-on-year by 12.5%, and import values were up 15%. The rise in import values was led by a 113% increase in the import value of fuel, while the import value of industrial supplies and other consumer goods fell by 15% and 4% year-on-year, respectively.

The price of aluminium continued to fall during the second half of September and at the time of the November meeting it had fallen by 10% from the previous meeting. The average price of aluminium in October was around 8% lower than at the same time a year ago. The average price of marine products increased month-on-month in August and was around 13% higher in the first eight months of 2011 than at the same time in 2010.

The domestic real economy and inflation

Registered unemployment as recorded by the Directorate of Labour has been broadly unchanged from June, measuring 6.6% in Q3, while adjusted for seasonality it measured at 7.7% in September, up from 7.5% in August. The sharp increase in unemployment after the financial crisis, however, makes the interpretation of seasonally adjusted unemployment somewhat difficult. Unemployment according to the Statistics Iceland labour force survey was 5.9% in Q3.

The wage index rose by 0.1% month-on-month in August and by 0.8% in September. The twelve-month rise was 8.4% in September, and real wages rose by 2.6%. In Q3, the wage index rose by 4.3% quarter-on-quarter and by 8.1% year-on-year. Real wages increased by 1.1% quarter-on-quarter in Q3 and by 5.3% year-on-year.

According to the Statistics Iceland labour force survey, labour demand increased significantly in Q3. The total number of hours worked, which is a measure of employment in man-years, rose by 3.3% year-on-year. The increase in employment was due to both a rise in the number of employed persons and longer working hours. Total hours worked increased by 5.3%, if only those who were at work during the reference week are considered. Another indication of growing labour demand is that the rise in the number of full-time workers was almost double the fall in the number of those working part-time.

Indicators of demand point to weaker private consumption growth in Q3 than in Q2. Seasonally adjusted payment card turnover increased slightly (0.2%) between quarters in Q3/2011, while total retail sales and daily groceries turnover were broadly unchanged.

Statistics Iceland's nationwide housing price index, published in October, increased by 0.6% from the previous month. The greater Reykjavík housing price index, calculated by

Registers Iceland, increased by 0.7% month-on-month in September (seasonally adjusted) and was 7.3% higher in September than at the same time a year ago. In Q3, house prices rose by 0.7% quarter-on-quarter and 5% fewer contracts were concluded. In the first nine months of 2011, 68% more contracts had been concluded than over the same period in 2010. The number of contracts is very small in historical context, however.

Consumer sentiment rose in September, mainly due to improving expectations about the future. It fell again in October, however, almost reversing the September increase – a repeat of a similar decline in October 2010. Labour market sentiment declined most sharply, with expectations about the economic situation in six months deteriorating considerably more than sentiment towards the current economic situation.

According to quarterly results from a September survey, expected big-ticket purchases increased from the previous survey in June but are still slightly lower than in September 2010. Expected housing purchases measured somewhat higher than at the same time last year, however.

According to the September Capacent Gallup survey, median household inflation expectations increased by 1.5 percentage points from the previous survey in June, measuring 6.5%. They have risen by 2.5 percentage points from the survey conducted in December 2010. The median household expected twelve-month inflation to measure 6% in two years, an increase of 1 percentage point since June.

Headline inflation measured 5.3% in Q3/2011, up from 3.5% in Q2. The CPI rose by 0.34% month-on-month in October, following a 0.63% increase in September. Annual inflation measured 5.3% in October, compared to 5.7% in September and 5% in August. Annualised seasonally adjusted three-month inflation measured 3.6% in October. Annual core inflation 3 (headline inflation excluding the effects of taxes, volatile items such as food and petrol, public services, and real interest rates on mortgages) measured 4.4% in October, up from 4.2% in September and 3.5% in August. It should be noted that all measures of annual inflation are 0.4 percentage points lower than they would otherwise have been due to the exclusion of broadcasting fees from the CPI in January 2011.

The main contribution to the CPI increase in September and October came from rising prices of various imported items (other than petrol, food, and new motor vehicles), partly due to the end of summer sales, raising the index by almost 0.6 percentage points. Housing costs contributed 0.12 percentage points to the CPI increase and have risen by 5.5% year-on-year. Housing cost increases have slowed down over the past few months, while housing costs rose by almost 1% on average per month in the first half of 2011. Petrol prices fell by almost 2% month-on-month in October and groceries prices fell also slightly, for the first time since last April.

Overall, the domestic economic recovery has continued and the financial conditions of households and firms have improved. GDP growth in the first half of 2011 was 2.5% and the forecast published in the 2 November *Monetary Bulletin* suggests that growth will be just over 3% for the year as a whole. This is slightly higher than in the August forecast, due primarily to a more favourable contribution from net trade. The outlook for 2012 has also improved, with GDP expected to grow by 2.3%. Growth averaging 2½% annually is forecast for the next three years.

So far, the deteriorated international economic outlook has had limited impact on the Icelandic economy, and the outlook is for considerably more favourable developments in Iceland's terms of trade.

The forecast assumes that higher private consumption will account for more than half of GDP growth during the forecast period, with growth averaging around 3% per year over the next three years. Investment is expected to grow by roughly 10% per year on average over the forecast horizon, driven by energy-intensive investment in 2011 and 2012 and by regular business investment in 2013-2014. The public consumption path is higher than previously forecast, especially in 2011 and 2012, when public consumption is expected to decrease by 0.2% and 1.2%, respectively. A slight increase is expected in 2013-2014.

According to the forecast, imports will grow by 2-4% annually during the forecast period, in line with continuing recovery in domestic demand. The outlook is for somewhat weaker export growth than was forecast in August. The contribution of net trade to GDP growth will therefore be negative throughout the forecast horizon, but less so than expected in August for most of the forecast period.

Employment growth turned out stronger in Q3 than was forecast in August, and total hours worked increased by 3.3% year-on-year instead of 1.6%. The labour market outlook during the forecast horizon is broadly unchanged, however, with a continuing modest recovery in jobs and a decline in unemployment expected. Despite the remaining slack in the labour market, unit labour costs are expected to increase well above the level consistent with price stability for much of the forecast horizon.

Inflation appears likely to be somewhat lower in H2/2011 than was forecast in August. It is expected to peak in Q1/2012 at 6% and remain below the August forecast for the remainder of next year. A stronger króna and lower imported inflation are offset by less spare capacity and slightly higher wage increases than were anticipated in August. According to the forecast, inflation will fall back to target by the end of 2013.

Somewhat more of the economy's production capacity is now estimated to have been lost following the financial crisis than was assumed in August. Hence, the slack in 2010 and 2011 is now estimated to be less than previously forecast. Spare capacity is assumed to have peaked around mid-2010. Until the latter half of 2013, the output slack will be somewhat less than estimated in August, but full factor utilisation will not be achieved until the first half of 2014, which accords broadly with the projection in August.

However, as discussed in *Monetary Bulletin,* there are also important risks to the outlook. Risks to the global economy have risen markedly since the summer and high private sector debt levels could prove a bigger drag on growth than the baseline forecast assumes. The path of fiscal consolidation might be eased further. The pace of recovery of investment is also highly uncertain, as is the outlook for the króna. The size of the margin of spare capacity in the economy, and how effective it is to hold back excessive wage and price pressures, is also uncertain. Furthermore, the risk is that inflation will prove more entrenched than assumed in the baseline forecast, especially given the apparent weak anchoring of inflation expectations. Finally, there is also considerable uncertainty concerning the transmission of monetary policy to the real economy, although the recent debt restructuring is likely to improve the effectiveness of monetary policy.

II The interest rate decision

The Governor informed the Committee of the 25 October Supreme Court ruling on the emergency legislation and the prioritisation of bankruptcy claims, and of preparations for the next steps in the capital account liberalisation strategy. The MPC also discussed the 27 October conference co-hosted by the Icelandic authorities and the International Monetary Fund, on lessons learned in Iceland from the economic crisis and the challenges ahead.

The Committee noted that newly released data and the forecast published in the 2 November *Monetary Bulletin* confirmed that Iceland's economic recovery continues despite weakening global growth and increased uncertainty. According to the forecast, output is expected to grow slightly faster in 2011 and 2012 than was forecast in August. Employment growth was also considerably stronger than expected in Q3.

The MPC observed that the turmoil in global financial markets and lower growth in some advanced countries had so far made only a limited impact on economic growth in Iceland. Furthermore, according to the forecast, the outlook was that international developments would have a favourable effect on Iceland's terms of trade. However, there are some wealth effects through the decline in the value of Icelandic foreign assets, such as those of pension funds.

The Committee noted that inflation is projected to be somewhat lower in coming quarters than was forecast, as a result of a stronger króna and lower imported inflation. It is expected to peak in Q1/2012 at 6%, remain slightly below the levels forecast in August through 2012, and decline to target by the end of 2013. Inflation expectations had also fallen since the last meeting.

In the view of the majority of the Committee, the inflation outlook remained the key upside risk. Although the inflation outlook was somewhat more positive than previously expected, it had not altered materially. Inflation was still high and the outlook was for inflation to remain above target for the next two years. Inflation expectations were still elevated, although slightly lower than at the September meeting. One member, in particular, stressed that the current level of the króna exchange rate was incompatible with the inflation target. Inflationary pressures stemmed mainly from the traded goods sector, where the weakness of the króna fostered excessively generous wage settlements and wage drift. These inflationary impulses could only be alleviated via significant further appreciation of the króna. In view of the gradual appreciation taking place since last summer, however, the risk-adjusted interest rate differentials could be considered as broadly sufficient to support a stronger króna, but some further increase in interest rates would offer further confidence.

Committee members discussed future monetary policy actions. They agreed that the nominal policy rate path required to bring inflation back to target was highly uncertain. The majority of the Committee argued that it would be appropriate to reduce somewhat the current accommodative stance of monetary policy in light of current and prospective inflation developments and indications of elevated inflation expectations.

The risk that a modest interest rate hike would derail the economic recovery was judged to be limited. One member argued for keeping rates unchanged at this meeting, as the króna had appreciated and the inflation outlook improved. Furthermore, this member argued that although the recovery of the real economy was underway, it was still fragile, especially given the high private sector debt levels.

The majority of MPC members argued that in the near term, the current interest rate level seemed broadly appropriate in light of the economic outlook, the continued appreciation of the króna, and the global economic risks. Looking further ahead, however, the Committee agreed that as the recovery progresses and the slack in the economy disappears it would be necessary to continue to withdraw the current degree of monetary accommodation. The degree to which such normalisation takes place through higher nominal rates would, however, depend on future developments in inflation.

Two alternative rate decisions were discussed: keeping rates unchanged or raising them by 25 bp. In light of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be raised by 25 bp, which would raise the current account rate to 3.75%, the maximum rate on 28-day certificates of deposit (CDs) to 4.5%, the seven-day collateralised lending rate to 4.75%, and the overnight lending rate to 5.75%.

Four members voted in favour of the Governor's proposal on the grounds that inflation was still high and forecast to remain elevated throughout the forecast horizon and that there remained material risks that the current high inflation rate could become entrenched. Furthermore, these members argued that the domestic recovery was gaining momentum and the weaker global economic outlook had appeared to have had only a limited effect on Iceland's economic recovery. One member voted against the Governor's proposal, preferring to keep rates unchanged. This member maintained that the main effect of raising interest rates would be to redistribute income from firms, households and the sovereign to creditors, which would further damage fragile balance sheets and delay the resolution of the debt crisis. Moreover, the exchange rate stability in recent months and the lower-than-expected inflation numbers supported the argument for keeping rates unchanged. This member also argued that the precarious international situation created increased uncertainty for the Icelandic economy and that a decision to raise interest rates under these circumstances was difficult to understand, especially in the light of the improved inflation forecast.

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Anne Sibert, External Member

Professor Gylfi Zoëga, External Member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 7 December 2011.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

December 2011

Published: 21 December 2011

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

The following are the minutes of the MPC meeting held on 1 and 6 December 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 7 December, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 2 November interest rate decision.

Financial markets

The trade-weighted value of the króna in the onshore market was 1.1% lower at the time of the December MPC meeting than at the November meeting. In the offshore market, the króna had depreciated against the euro since the last MPC meeting, but volume and frequency of trading remained low.

Interbank market trading totalled 40 b.kr. in November, and turnover for 2011 had already exceeded 2010 turnover. Due to temporarily tight liquidity conditions in the interbank market, overnight interbank interest rates had shifted to the centre of the interest rate corridor in mid-November.

Reflecting a decline in long-term inflation expectations, nominal long-term yields in the secondary market had fallen between the November and December meetings, while yields on indexed long-term bonds were broadly unchanged.

The CDS spread on the Republic of Iceland had risen from the meeting in November, broadly following the trend in the Baltic countries.

The nominal effective policy rate is estimated as the simple average of the Central Bank deposit and maximum CD rates. Averaging across different measures of inflation and inflation expectations, the real policy rate was broadly unchanged since the November meeting, at -0.4%. The real rate based on inflation over the past twelve months was broadly unchanged at -1.0%. In terms of breakeven inflation rates, it was 0.1%.

Unchanged Central Bank rates appeared to be priced into the yield curve, and most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to keep rates unchanged. Most commercial banks' research departments expect unchanged interest rates throughout 2012.

Broad money (M3) decreased by 1.1% month-on-month in October and increased by 5.1% year-on-year.

Outlook for the global real economy and international trade

According to the latest OECD forecast, published in November, the forecast for global growth and world trade has been revised downwards substantially from the May forecast. The OECD expects a mild recession in the euro area and only 0.2% output growth in 2012. However, the forecast for inflation is unchanged. The forecast for growth in 2011 in Iceland's main trading partner countries has been revised downwards from 2.1% in May to 1.6%, and output growth in 2012 is expected to be 0.8%, down from 2.3% in the May forecast. The *Consensus Forecasts* projections for Iceland's main trading partner countries in 2012 have also been revised downwards since the November MPC meeting.

Iceland's merchandise trade surplus was 15.5 b.kr. in September and, according to preliminary data, 8 b.kr. in October. The value of both exports and imports is still growing strongly year-on-year, with export growth led by robust growth in exported marine products and import growth by substantially increased imported fuel values.

The price of aluminium has continued to fall since the last MPC meeting, while marine product prices have continued to rise.

The current account was in surplus by almost 3% of GDP in Q3/2011 (12 b.kr.), as the large surplus on the trade account more than offset the deficit on the income account. The current account balance excluding banks in winding-up proceedings was positive by almost 9% of GDP in Q3. Furthermore, revised data for the first half of 2011 showed a smaller deficit (33 b.kr.) in the first half of the year, leaving the deficit at 9% of GDP (71 b.kr.). The smaller deficit is due to both a larger surplus on the trade account and a smaller deficit on the income account.

The domestic real economy and inflation

The wage index rose by 0.7% month-on-month in October, leaving the twelve-month rise at 8.9%. Seasonally adjusted unemployment was unchanged between months at 7.6% in October, while registered unemployment increased slightly.

According to the Capacent Gallup business sentiment survey conducted in October and November, executives' expectations concerning the labour situation were slightly more positive than in June. Fewer firms were considering laying off staff, and a slightly larger number of firms were considering adding on staff. The results of the survey indicate, however, that the labour market could still weaken somewhat, as firms planning to shed staff in the next six months outnumber those planning to recruit by 10%.

High-frequency indicators suggest that private consumption might turn out stronger in Q4 than according to the Central Bank's latest forecast. The increase in turnover in October was larger than the Q3 average, and the withdrawal of third-pillar pension funds in Q4 larger than expected.

Consumer sentiment rose in November, after having fluctuated widely in recent months, although the consumer sentiment index was almost one-fourth higher than at the same time last year, based on a three-month average. All subindices rose, with sentiment towards the labour market increasing the most, following a large decline in October.

According to Capacent Gallup's business sentiment survey, conducted in October and November, corporate executives were slightly less pessimistic about the economic situation six months ahead than they were in June. The outlook for domestic demand was more optimistic than in June, while expectations of foreign demand had deteriorated.

The median executive expected inflation to measure 4% one year ahead, according to the business sentiment survey, an increase of 0.4 percentage points since the survey in June. Executives also expected twelve-month inflation to measure 4% in two years, which is unchanged from the survey in March 2011.

The CPI remained unchanged month-on-month in November. Annual inflation measured 5.2% in November, compared to 5.3% in October. Annualised seasonally adjusted three-month inflation measured 1.6%, compared to 3.4% in October. Annual core inflation 3 excluding the effects of taxes (headline inflation excluding volatile items such as food and petrol, public services, and real interest rates on mortgages) measured 4.7% in November, up from 4.4% in October. It should be noted that all measures of annual inflation are 0.4 percentage points lower than they would otherwise have been, due to the exclusion of broadcasting fees from the CPI in January 2011.

The largest effect on the CPI stemmed from an increase in the cost of housing, mainly due to a 1.3% rise in market prices of housing, which have increased by 7.2% year-on-year. A decline in groceries prices had an effect of -0.1 percentage points on the CPI, which stemmed mainly from a drop in domestic food and beverage prices, even though imported food prices also fell in November.

II The interest rate decision

The Governor informed the Committee of recent steps in the capital account liberalisation strategy.

The committee discussed new data on the economy that had emerged since the last meeting and agreed that they were broadly in line with the Central Bank forecast published in the November *Monetary Bulletin*. The data showed that Iceland's economic recovery continues despite weakening global growth and increased uncertainty.

The MPC noted as well that, although recent inflation outcomes have been slightly better than expected, inflation was still above the Bank's inflation target. However, recent developments were consistent with inflation returning to the target over the medium term.

The MPC members argued that, in the near term, the current interest rate level seemed broadly appropriate in light of the economic outlook and potential international headwinds. Looking further ahead, however, the Committee agreed that, as the recovery progresses and the slack in the economy disappears, it would be necessary to continue withdrawing the current degree of monetary accommodation. The degree to which such normalisation takes place through higher nominal rates would depend on future developments in inflation, however.

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

The Committee voted unanimously in favour of the Governor's proposal.

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Anne Sibert, External Member

Professor Gylfi Zoëga, External Member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 8 February 2012.

4 November 2011

Monetary policy

Már Guðmundsson, Governor. Speech at a breakfast meeting of the Iceland Chamber of Commerce, 4 November 2011

The Iceland Chamber of Commerce has a long-standing tradition of holding a breakfast meeting like this one on economic developments and prospects and monetary policy, following the publication of the Central Bank's autumn forecast. As before, I would like to thank the Chamber of Commerce for this initiative, as there is a great need for informed discourse on monetary matters.

In my speech a year ago, I discussed the progress made in stabilising the economy as is evidenced by the underlying current account surplus, the stable and subsequently strengthening currency, and inflation that was rapidly approaching the Central Bank's inflation target. I mentioned, however, that robust recovery had not yet taken hold. It seemed to me then that the recovery had begun, and this has since been corroborated. At that time, GDP was projected to grow by just over 2% in 2011 – which was not considered terribly strong in view of the slack in the economy. I was concerned as well about the low level of investment and the prospect of weak export growth in spite of a very low real exchange rate. The inflation outlook seemed much better, though, due to a rising exchange rate and the slack in the economy. Therefore, it was forecast that inflation would fall below 2% as 2011 progressed and then rise back to target by the end of 2013. As always, it was emphasised that the outlook was uncertain – which indeed proved to be the case.

So where do we stand now, a year later? I think the big picture is this: economic recovery has materialised, while stability has proven more elusive.

GDP growth this year will be slightly over 3%, which is above the forecasts from a year ago, largely due to changes in inventories and a smaller-than-forecasted contraction in public consumption. GDP growth is projected at 2½% annually for the next three years. I wouldn't be surprised if it proves higher for 2011, once final figures are in a few years from now. The most recent *Monetary Bulletin* contains a discussion of forecasts and forecasting errors, which shows that final figures on investment and GDP growth tend to lie above the first figures.

Employment has been increasing, and unemployment has fallen. It is cause for relief that the Directorate of Labour's analysis indicates that most people leaving the unemployment register at present are going back to work. On the other hand, my concerns from last year concerning the low investment level and relatively weak export growth have not disappeared. It is true that business investment excluding energy-intensive industry and ships and aircraft is strengthening and, according to the forecast, will grow by 8% this year, while total business investment as a share of GDP will rise over the forecast horizon, to about 11% in 2014. It will still be below the 30-year average of 12½%, however. On the other hand, exports of goods and services will grow by about 2½% this year and by an average of just under 2% per year in 2012 and 2013. This is not a very cheery prospect, given that the real exchange rate of the króna is currently over 20% below the historical average. It is important to bear in mind that low investment levels and weak export growth are related phenomena. A large share of Iceland's exports (marine products and aluminium) are subject to capacity constraints, and in some instances, increased export levels would require substantial investment. Thus it is important to facilitate investment in export sectors. Those who believe that monetary policy has been a critical factor after the real policy rate fell to the current -1% are mistaken, however. Much more important are risk aversion in the markets, limited access to foreign credit, an uncertain operational environment, and impaired corporate balance sheets.

Chart 1

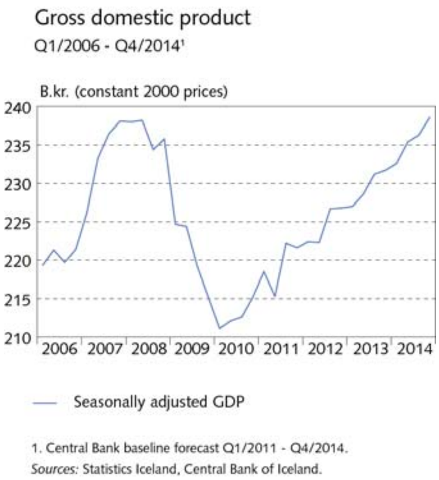


Chart 2

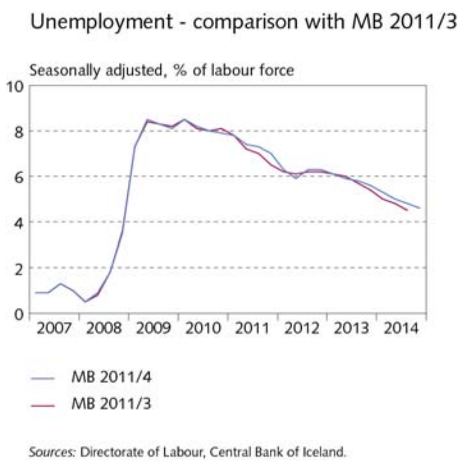


Chart 1 shows, on the one hand, how the economic recovery looks so far and how it compares with the Central Bank's forecast through 2014 and, on the other, developments in unemployment over the same period. According to these data, GDP was similar to Q4/2006 levels in Q3/2011 but will rise back to the peak of the boom years towards the end of the forecast horizon. At the same time, unemployment will decline steadily to 4½% near the end of the forecast horizon, and according to the forecast, the slack in the economy will have vanished by 2014. It is highly uncertain, however, just how much slack exists at this juncture.

But inflation is the big change from the outlook around this time last year. Instead of falling slightly below target and remaining there for some time, inflation has taken quite a jump in 2011. It did fall below target, but it stayed there only three months before taking off again, peaking at 5.7% in September. That figure actually corresponds to over 6% inflation, however, if one takes into account the change in treatment of broadcasting fees earlier in the year. According to the Bank's forecast, inflation will remain at this level until early next year and then begin to taper off. It will be reasonably close to the inflation target around the end of 2012. The inflation target will be fully reached towards the end of 2013, which is broadly in line with last year's forecast. The difference is that the target will be reached from above, and not below.

What caused such a radical change? First of all, there were increases in oil and other commodity prices. Second, the króna depreciated by 6½% in the first half of the year, bottoming out in mid-July before reclaiming about 4% of that loss. Third, house prices rose. Fourth, wages rose far in excess of productivity increases.

Early in the year, it was primarily external – and presumably transitory – factors that caused the spurt in inflation. But as the year progressed, domestic cost pressures played a progressively larger role – wage increases in particular. For example, unit labour costs are expected to increase by 5½% this year and core inflation 3 excluding tax effects was up by 4½% in October, as opposed to just over 1% at the beginning of the year.

Now let us look at monetary policy year-to-date. At the Monetary Policy Committee's first meeting of the year, in February, it was decided to cut the Bank's interest rates by 0.25 percentage points and communicate a neutral bias regarding the future interest rate path. This proved to be the last interest rate cut of the year. What we call the "effective policy rate", which is where the Bank's interest rate spectrum has maximum effect on short-term market rates, was then 3.6%. In 2011, the effective policy rate has been the average of the current account rate and the maximum rate on 28-day certificates of deposit. Interest rates were then held unchanged and the neutral bias was retained at the MPC meetings in March and April. In June, however, the Committee indicated that, other things being equal, it was likelier to raise interest rates than to cut them at upcoming meetings, owing to strong wage increases, marked depreciation of the króna, and rising domestic inflation. Consequently, it should have taken no one by surprise that the MPC should raise interest rates in mid-August, when the Bank's forecast stated that inflation would gain momentum in coming months and the economic recovery would remain on track. And indeed, insightful analysts predicted a rate hike. In September, interest rates were kept unchanged and the positive bias was kept. It was stressed that the decision did not represent a change in policy. A number of observers speculated that it did, though, perhaps motivated by the increasingly uncertain global situation. This is probably why the Committee's decision to raise interest rates in November took the market more by surprise than might have been expected.

Before I explore the November interest rate decision further, I must mention two things. First, while Iceland was engaged in its IMF-supported programme, exchange rate stability was given priority over the determination of interest rates based on the domestic inflation outlook and economic conditions. This is why interest rates were so high in 2009 and in the first half of 2010. On the other hand, as I have previously explained in speeches and papers, it was appropriate that emphasis should shift back to the inflation outlook and the economic slack as the danger of further currency depreciation dissipated and exchange rate-linked loans became less prominent in the balance sheets of Icelandic households and businesses without foreign-denominated income. When the IMF-supported programme concluded at the end of August, monetary policy shifted back to the inflation targeting regime provided for by law and the March 2001 agreement between the Central Bank and the Government.

Second, a considerable body of experience and theoretical study indicates that acceptable monetary policy can roughly be captured with an equation in which the policy rate is determined by the deviation of inflation from target and the output gap. In addition, the nominal interest rate level is determined by the equilibrium real interest rate, which is the real interest rate that is consistent with inflation at target and demand in line with potential output. This is the so-called Taylor rule. But note that I refer to “acceptable” monetary policy. Truly sound monetary policy is always more complex, as it takes account of forecasts of inflation and GDP growth, financial market conditions, and a variety of risk factors. But the Taylor rule is a good test because, other things being equal, the policy rate should be reasonably well in line with it unless there are convincing reasons for a deviation.

With this in mind, let us turn to the November interest rate decision. The Monetary Policy Committee decided to raise interest rates by 0.25 percentage points. That decision, of course, was based on the most recent statistics and the indications in the Bank’s forecast. First of all, inflation is far above target and is forecast to continue rising until early in 2012 before tapering off as the year progresses. Second, available measures of inflation expectations indicate that longer-term expectations are considerably above target. These measures of inflation expectations are flawed, of course – perhaps especially so at this time. Survey measures have a tendency to take excessive account of recent inflation, and bond market measures of inflation expectations are skewed by a variety of market imperfections at present. But flawed though they may be, these are the only measures we have, and it would be irresponsible simply to ignore them. Third, indicators suggest that domestic demand was strong in Q3 in spite of the global situation, and that the economic recovery is strong enough not to be derailed by resistance to inflationary pressures through modest rate interest hikes. Fourth, we have the global situation, which is mainly a risk factor at this juncture and has not yet had a measurable impact on domestic economic developments.

But we did not merely raise interest rates. We also stated that, in view of the economic situation and outlook, the current interest rate level appeared broadly appropriate for the next several months. In other words, significant new developments would be required for the MPC to raise interest rates – or lower them – at upcoming rate-setting meetings. I notice that the bond market seems to have realised the implications of this, as yields at the longer end of the market have not risen since the last interest rate announcement. But looking further ahead, it should be clear to everyone that if GDP growth forecasts materialise in coming years and the slack in the economy disappears, the monetary slack manifested in a negative real policy rate of over 1% must be removed over time.

So where do we stand with respect to the monetary policy stance? Is monetary policy lax or tight? Chart 3 shows the Central Bank's real interest rate measured by the effective policy rate and twelve-month inflation. The chart shows that, in spite of two recent rate hikes, the real interest rate will be lower in Q4/2011 (assuming unchanged interest rates in December) than at any time since the financial crisis struck, with the exception of Q1/2009, when inflation soared up above 18% and a dramatic disinflation episode was in the offing.

Chart 3

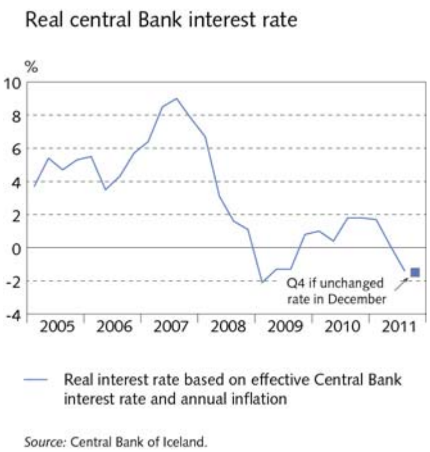
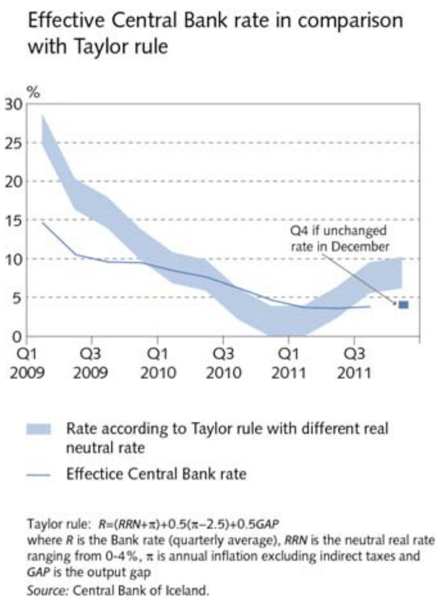


Chart 4



But what about the Taylor rule, shown in Chart 4? There is a significant deviation at the moment – one that perhaps requires some explanation. But there's something wrong. Interest rates are on the wrong side of the argument! They are too low, not too high, even if we assume that the equilibrium real interest rate is zero.

Chart 5

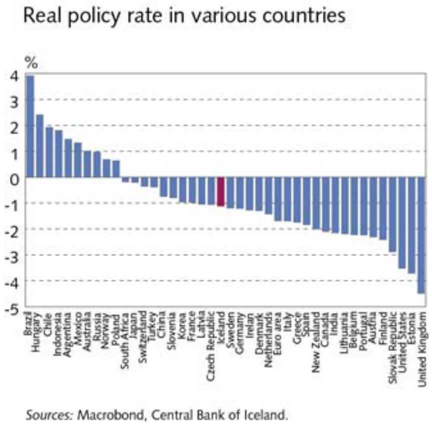
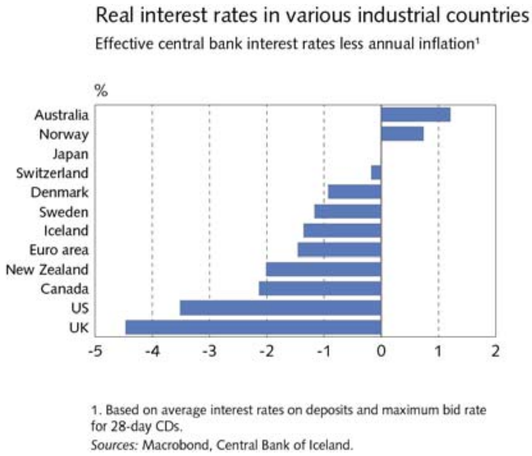


Chart 6



Neither does international comparison suggest that Iceland is off the charts. Chart 5 shows a comparison of the real policy rates in a number of countries, based on the most recent interest rate decisions and the most recent twelve-month inflation figures. Iceland is somewhere in the middle. In Chart 6 we see several industrialised countries. Iceland is at about the same level as Sweden. Interest rates are higher in countries that are further along in the business cycle and have less slack, and they are lower in countries where the slack is greater, monetary policy is more credible, and long-term inflation expectations are near target in spite of higher current inflation.

Chart 7

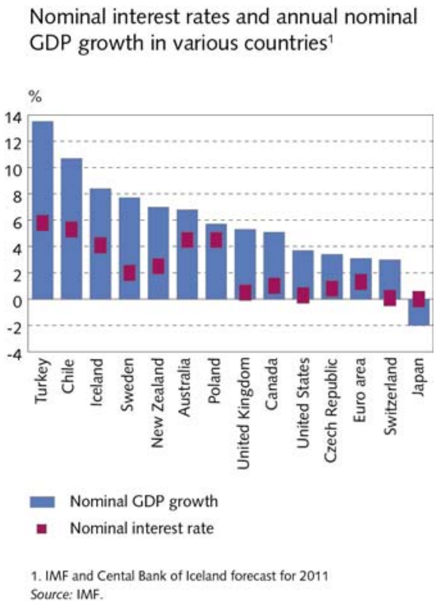
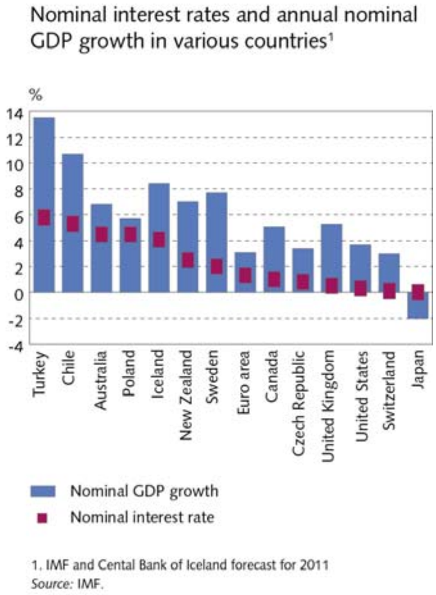


Chart 8



Finally, I show charts that illustrate, on the one hand, nominal GDP growth as forecasted for 2011 and, on the other, the current nominal policy rate. Some have posited that monetary policy should aim at keeping nominal GDP growth as stable as possible at a level that, in equilibrium, would deliver a desirable inflation target. I have certain doubts about how this would work in practice, but that is beyond the scope of my speech today. But if such a rule were followed, the results would depend on the inflation target and the GDP growth target. If the inflation target is perhaps 2½% and potential output growth in the 2½-3% range, it would be around 5-6%. In Chart 7, we can see that the countries fall into three categories. First are the countries significantly below this level. All of them have relatively low policy rates in accordance with the rule. Then we have the countries that are more or less on the right track and, finally, three countries above that. Iceland is in this last group, and the other two are emerging countries with much more GDP growth potential than developed industrialised economies have. It is interesting to note that Iceland is in third place as regards nominal GDP growth and in fifth place as regards the policy rate.

All of this comparison points in the same direction. It simply cannot be argued that Iceland is out of sync with other countries because of excessive monetary restraint. Quite the contrary: some indicators suggest the reverse.

I know that I am not addressing all possible criticism with these points, but I hope that those listening to me will begin to ponder whether some of that criticism has perhaps been somewhat unbalanced. Some criticism of monetary policy is more pertinent, however, and I would like to address three points.

It has been asked why the Monetary Policy Committee raised interest rates when the Bank has forecast that inflation will subside markedly next year. Does that forecast make the rate hike unnecessary? There are two answers to this. First, the rate hike is a part of the forecast, and if it is not implemented, the forecasted inflation path will no longer be the most likely one. Second, the inflation outlook is uncertain and, in light of current inflation expectations, it would be imprudent not to take action.

It has also been asked whether there is a transmission mechanism in place at present. Do higher interest rates reduce inflation? It is a bit paradoxical to say that interest rates have little impact and then make a terrific fuss about them. Be that as it may, the transmission mechanism is certainly damaged at the moment, and it was somewhat damaged before the crash as well. But there is a transmission mechanism in place. The weight of non-indexed, variable-rate loans has increased. Low deposit rates have fostered a shift towards investment in real estate in the recent term, and some have expedited purchases of consumer durables. Finally, there is some impact on the exchange rate in spite of the capital controls, both because of decisions by owners of offshore krónur on whether they expatriate their interest and because domestic residentsare subject to a repatriation requirement but not a conversion requirement.

It has been asked why we are raising interest rates when there is no economic overheating and investment is at a minimum. It is true that the economy is not overheated, so rate hikes do not have the intention of affecting that. But interest rates do affect inflation even though the current situation does not entail overheating. These effects come through a stronger currency and lower wage drift. Furthermore, it is very common that central banks begin to shift towards a neutral monetary stance by raising nominal interest rates before the slack has disappeared so as to avoid sharper increases later at the tipping point between slack and excess demand. Examples of this are the European Central Bank's rate hike earlier this year and the Swedish Riksbank's increases in mid-2010, when unemployment in Sweden topped 8% and the output slack measured almost 4%. Iceland's output slack is just under 2% this year.

I will conclude my remarks now. I know there are a number of questions I have not answered, and a number of aspects of this complex situation that I have not addressed. My answers to the questions you ask me now may fill in some of the gaps. On the other hand, it is important that we discuss these matters calmly and try to promote the best possible understanding of how monetary policy works, as this will make a genuine contribution to the current discussion of Iceland's future monetary policy regime. It is well to remember, though, that no monetary policy will be successful if the tools it offers are never used to tighten the stance. Naturally, opinion differs on the appropriate monetary stance at any given time, as uncertainty is a permanent feature of economic life – not only uncertainty about the future, but also about the present and the recent past.

27 March 2001

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

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

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

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

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

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

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

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

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

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

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

(8) If inflation deviates by more than 1½ percentage point from the target, the Central Bank shall bring it inside that range as quickly as possible. In such circumstances, the Bank will be obliged to submit a report to the Government explaining the reasons for the deviations from the target, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. The report of the Bank shall be made public.

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

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

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

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

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