MONETARY POLICY COMMITTEE REPORT TO ALTHINGI

2010 • 1

Monetary Policy Committee report to Althingi

1 September 2010

The Act on the Central Bank of Iceland stipulates that the Monetary Policy Committee of the Central Bank of Iceland shall submit to Parliament a report on its activities twice a year and that the contents of the report shall be discussed at a joint meeting of the Economics and Tax Committee, the Budget Committee, and the Commerce Committee.

The Act requires that the Monetary Policy Committee meet at least eight times each year. Since the Committee began its work on 26 February 2009, it has met fourteen times, including five meetings since it last sent a report to Parliament. The following report discusses the work of the Committee between January and August 2010.

The Monetary Policy Committee has adopted rules of procedure that include provisions on how its meetings shall be prepared, how they shall be structured, and in what manner its decisions shall be taken. These rules of procedure are among the documents accompanying this report.

Monetary policy formulation

According to the Act on the Central Bank of Iceland, the principal objective of the Monetary Policy Committee 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 2.5% (the declaration is enclosed with this report). In implementing monetary policy, the Monetary Policy Committee bases its decisions in part on an appraisal of economic affairs and the outlook for the national economy as it is presented in the Bank's *Monetary Bulletin* (the May and August issues are included with this report).

Since the financial and currency crisis struck Iceland so forcefully in 2008, the Monetary Policy Committee's main task has been to promote exchange rate stability in accordance with the joint economic policy agreed by the Government, the Central Bank, and the International Monetary Fund. Among the focuses of that policy has been to protect private sector balance sheets from further shock during the economic restructuring and rebuilding phase. A stable exchange rate also contributes toward bringing inflation into line with the inflation target. As economic structuring progresses, however, the inflation outlook will regain its importance in monetary policy decisions. The MPC's statements and minutes, enclosed with this report, contain the grounds for the Committee's decisions.

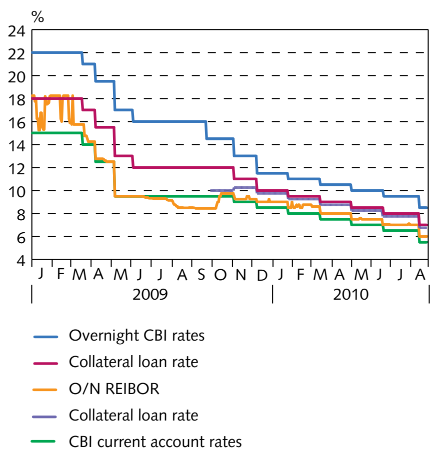
Table 1. Central Bank of Iceland interest rates 2010 (%)

Date	Current account	28-day CDs	7-day collateral lending rate	Overnight lending rate
18 Aug	5.50	6.75	7.00	8.50
23 Jun	6.50	7.75	8.00	9.50
5 May	7.00	8.25	8.50	10.00
17 Mar	7.50	8.75	9.00	10.50
27 Jan	8.00	9.25	9.50	11.00

Chart 1

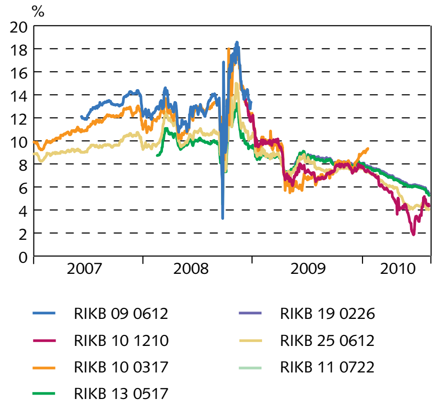
Central Bank of Iceland interest rates and short-term market interest rates

Daily data January 1, 2009 - 30 August 2010



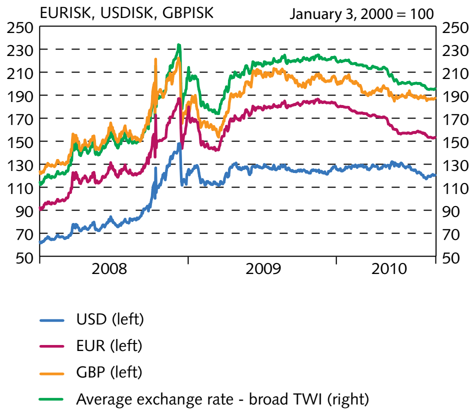
Source: Central Bank of Iceland.

Chart 2
Long-term nominal Treasury bond yields
Daily data 3 January 2007 - 27 August 2010



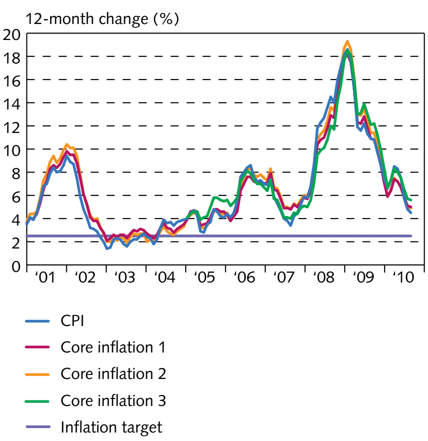
Source: Central Bank of Iceland.

Chart 3
Exchange rate of the króna
Daily data January 3, 2008 - 30 August, 2010



Source: Central Bank of Iceland.

Mynd 4
Inflation January 2001 - August 2010[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.
Sources: Statistics Iceland, Central Bank of Iceland.

Developments in 2010

At the beginning of the year, the interest rate on deposit institutions' current accounts was 8.5%, and the maximum bid rate on 28-day certificates of deposit was 9.75%, but these interest rates are the primary determinants of short-term market rates.[1] So far this year, the Monetary Policy Committee has continued the monetary easing that began in early 2009. Interest rates have been lowered by three percentage points in total during the year 2010, and following the MPC's August meeting, the current account rate was 5.5% and the maximum bid rate on 28-day certificates of deposit was 6.75%. Short- and long-term market rates on non-indexed obligations have also declined broadly in line with Central Bank interest rates (see Charts 1 and 2).

In trade-weighted terms, the króna has appreciated by 12% since the beginning of the year, including over 17% against the euro and 3.6% against the US dollar, while short-term volatility has decreased (see Chart 3). It has strengthened without any Central Bank intervention in the foreign exchange market since November 2009. The appreciation of the króna and the reduction in risk premia on Icelandic financial obligations gave the Central Bank the scope to embark on modest foreign currency purchases so as to strengthen its non-borrowed reserves. Consequently, the Monetary Policy Committee decided at its August meeting that such foreign currency purchases would begin on 31 August.

It should be borne in mind that that broad-based restrictions on movement of capital to and from Iceland were imposed in 2008. Without these capital controls, the Central Bank would have had to maintain much higher interest rates. The outlook is for the preconditions for capital account liberalisation to be in place as regards the foreign exchange reserves and macroeconomic stability once the Third Review of the Government-IMF economic programme is complete. However, there is still considerable uncertainty about the strength of the financial system in the wake of the recent Supreme Court judgments. As a result, the Monetary Policy Committee considers it necessary to review the existing capital account liberalisation strategy in view of changed circumstances and the delays that have already occurred (the current strategy is enclosed with this report).

The rising exchange rate and spare capacity have caused inflation to decline during the year (see Chart 4). In January, headline inflation measured 6.6% according to the consumer price index, as opposed to 18.6% at the same time in 2009. By August 2010, it had dropped to 4.5%, or to 3.8% excluding temporary consumption tax effects, which is the appropriate monetary policy criterion. Rises in food and energy prices will slow down the disinflation process temporarily; however, according to the forecast published in the last *Monetary Bulletin*, the outlook is for continuing disinflation, with

1. The Central Bank interest rate that is most important in determining short-term market rates may vary. For a long while, the Bank's 7-day collateral lending rate was the determinant of market rates, but since early in 2009, the interest rate on deposit institutions' current accounts with the Bank and the interest on certificates of deposit have been most important in interest rate formation. For further discussion, see *Monetary Bulletin* 2009/4, pp. 7-8 and 21-23.

inflation expected to fall to the 2.5% inflation target in mid-2011. Inflation excluding consumption tax effects is expected to reach the target at the beginning of 2011

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee rules of procedure on the preparation of, arguments for, and presentation of monetary policy decisions.
2. Joint declaration by the Government and the Central Bank on inflation targeting.
3. Capital account liberalisation strategy, August 2009.
4. Monetary Policy Committee statements from January 2010 to present.
5. Minutes of Monetary Policy Committee meetings from December 2009 to present.
6. *Monetary Bulletin* 2010/2.
7. *Monetary Bulletin 2010/3.*

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

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

April 7, 2009

PROCEDURE OF MPC MEETINGS

Prior to each monetary policy decision:

- MPC (Monetary Policy Committee) members should have access to all relevant data that they need to take an informed decision.
- MPC members should have ample opportunity to exchange views and debate the decision.

To meet these objectives the MPC has agreed to the following meeting structure:

There are at least eight monetary policy decisions each year and there are two types of procedure in the run-up to each monetary policy decision:

- At least four times a year, either when inflation forecasts are changed or when there are significant changes in the macroeconomic environment, regulatory structure or matters related to financial stability, there will be full-fledged procedures consisting of at least three sessions.
- At times there could also be interim decisions based on a more concentrated meeting structure. The concentrated procedure will consist of one to three sessions in a single day. The meeting may be held in person or by teleconference.

The structure of the two types of meetings is detailed below:

Full-fledged MPC meetings

At least three monetary policy sessions shall be concentrated in two days' time. The first session shall take place two days before the policy decision is announced, the second on the morning of the following day and the third in the afternoon of that day.

Session one (two days before announcement)
Attendees: MPC members, secretary of the MPC, key department heads and relevant staff.

Time: At 10:00

Preparation and documentation: Before the regular meetings, staff will present preliminary analysis or draft forecast (prior the publication of *Monetary Bulletin*) and discuss the analysis or forecast in internal meetings of the Governor, Deputy Governor and relevant staff. A final draft of forecasts and/or other relevant documentation and data will be sent to the external members three days before the regular meetings commence.

Topics: The meeting will focus on the economic outlook. Staff members will make short presentations of the relevant data and forecasts to MPC members. Among the topics that should be covered are:

- Market operations (presented by the International and Monetary Operations Department).
- Financial stability (if relevant, presented by the Financial Stability Department).
- Recent economic development and medium-term outlook (presented by the Economics Department).

Session two (one day before announcement)
Attendees: MPC members, Directors of International and Monetary Operations, Financial Stability and IT Departments and the secretary of the MPC.

Time: At 9:00

Preparation and documentation: The night before the session, MPC members shall receive a draft policy statement (in English) to guide the discussion. After a decision has been made, MPC members can comment on the general orientation of the draft statement.

Topics: This session will focus primarily on the monetary policy decision itself. The Chief Economist will begin by summarising the previous day's presentations. On the basis of that analysis, he or she will make a preliminary suggestion concerning the current policy stance. Subsequently, each MPC member will present his or her view on the general direction of policy. After the first round of discussion, the Governor will suggest a policy decision he or she considers to represent a broad consensus or the majority view of the MPC. The MPC members will then present their own views on the appropriate policy. The Governor will then propose a decision. This will be followed by further deliberation in order to seek a consensus. If there is no consensus, MPC members will vote on the decision.

Session three (one day before announcement)

Attendees: MPC members, Directors of International and Monetary Operations, Financial Stability and IT Departments and the secretary of the MPC.

Time: At 15:00

Preparation and documentation: Before the session, a second draft of the monetary policy statement will be written, reflecting the decision and discussion in the previous meeting.

Topics: The focus of the session will be the monetary policy statement and related communication. If needed, there could be a recess for further redrafting. After the statement is finalised in English it will be translated into Icelandic.

Interim MPC meetings

When new data or changes in other circumstances since the last MPC meeting do not warrant exhaustive presentation of economic developments and forecasts, monetary policy decisions can be taken on the basis of the following simplified procedure. There will be at least one session, either in person or by teleconference

Attendees: MPC members, Directors of International and Monetary Operations, Financial Stability and IT Departments and the secretary of the MPC.

Time: At 10:00 *(the day before announcement)*

Preparation and documentation: Three days prior to the meeting, MPC members shall receive data and other relevant documentation. One day before the meeting, members will receive a draft of the monetary policy statement.

Topics: The focus of the meeting will be on new data or circumstances since the last monetary policy decision and what these data imply for the policy rate path envisaged at that time. The monetary policy statement shall be shorter, confirming the main points of the previous policy statement and focusing on deviation from the envisaged path. If needed, there could be a recess for redrafting of the statement. After it has been discussed in detail, the final statement in English shall be translated into Icelandic.

Press release and meetings with journalist and analysts

The policy decision will be announced in a press release at 9:00 on the morning on the announcement date (the day after the meeting and policy rate decision), followed by a press conference at 11:00. Analyst from banks, ministries and other relevant economic institutions can also attend this press conference.

Modification of approach

If an MPC member wishes to suggest a change in the above guidelines, he or she should present a proposal in writing to the MPC. After consulting other members of MPC, the Governor will make a decision on whether or not to modify the procedure.

Agenda

The agenda for each meeting is prepared by the Chief Economist subject to the approval of the Governor and the Deputy Governor. It should be submitted to MPC members no later than three days in advance of the first session of each MPC meeting.

Minutes

Minutes of MPC meetings will include a short description of the main arguments put forward, the policy decision proposed by the Governor, the policy decision taken and whether it was unanimous or not. The voting record will be published if the decision is not unanimous. The minutes will be published two weeks after each monetary policy decision.

Communication among MPC members

MPC members are free to voice their opinions concerning the economic outlook and monetary policy, subject to the following guidelines:

- When commenting on monetary policy, MPC members should refrain from commenting on the views of other members of the Committee.
- MPC member should not make public comments on the economic outlook and monetary policy during the last *seven* days prior to the announcement of the policy decision, nor should they discuss this with investors or other parties that might benefit from insider information on the views of MPC

members. These restrictions also include publication of an interview given beforehand.
- MPC members should also avoid making public statements on the day of the announcement.

The same guidelines apply to other CBI officials who participate in MPC meetings.

March 27, 2001

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

August 5, 2009

Capital Control Liberalisation

A. Introduction

While controls were deemed necessary to stabilise the Icelandic economy following the financial crisis of October 2008, gradual removal of the controls is an important step towards normalising economic conditions. Icelandic businesses view access to capital markets, international funding, and investments as one of the main preconditions for economic recovery.

Even though gradual removal of the controls is a priority, the sequencing must be carefully designed in light of the remaining imbalances of the Icelandic economy. The sequence of the policy mix is thus designed in a way that allows each step to be taken while preserving the stability of the króna.

During the liberalization phase, underlying economic developments and policies will be in place that should contribute to the stability of the króna: 1) Each liberalization step will only be taken when the certain preconditions are in place, 2) Monetary policy will be conducted in a way that promotes stability, 3) Expected progress on the recovery program and a prospective current account surpluses will support the krona, 4) The Central Bank will have in place very sizeable currency reserves.

This document is divided into the following sections:

- Reasons for introducing controls
- Current capital controls regime
- Preconditions for liberalisation
- Liberalisation strategy
- Administration and enforcement

B. Reasons for introducing controls

The period 2005-2008 saw significant capital inflow into Iceland. The combination of wide interest rate differentials and an appreciating currency attracted international capital, some through ‘normal’ financial investments and some through instruments (e.g., glacier bonds) constructed to benefit from this combination. Some inflow was also linked to the Icelandic financial system and international borrowing by Icelandic companies. As a result, non-residents held large positions in Icelandic krónur (ISK), some immediately available and some available through 2009-2010 as the instruments matured. Non-residents’ ISK positions totalled 680 b.kr. in late 2008. Short-term positions totalled approximately 330 b.kr.

In October 2008, Iceland suffered a banking crisis of extraordinary proportions. The ensuing loss of confidence threatened to trigger large capital outflows, with highly adverse effects on an already weakened exchange rate. Such capital outflows (immediate and delayed) could have led to further depreciation of the króna, and higher inflation. Because private sector balance sheets are characterised by both high leverage and a large proportion of foreign-denominated and inflation-indexed debt, this could trigger a wave of defaults, with adverse macroeconomic implications. Consequently, on October 10, the Central Bank introduced measures to temporary modify currency outflow.

Given the substantial macroeconomic risks, capital controls were an unfortunate but indispensable ingredient in the policy mix that was adopted to stabilise the króna when the interbank foreign-exchange market was restarted in early December 2008.

C. Current capital controls regime

The current capital controls were adopted on November 28, 2008, according to the Rules on Foreign Exchange (the Rules), which were authorised by a provision in the Act on Foreign Exchange. The Rules were reissued on December 15, 2008, and in mid-March the Foreign Exchange Act was amended so as to tighten the controls. In parallel, clarifications of the Rules have been issued on numerous occasions.

Payments linked to current account transactions and inward FDI were released after a short period of time. Thus, transactions involving actual imports and exports of goods and services are allowed and so are interest payments, if exchanged within a specified time limit. Most capital transactions are controlled both for residents and non-residents;

that is, their ability to shift between ISK and FX is restricted. Króna-denominated bonds and other like instruments cannot be converted to foreign currency upon maturity. The proceeds must be reinvested in other ISK instruments. Furthermore, the Rules require residents to repatriate all foreign currency that they acquire.

Certain companies, including major exporters and firms with large international operations, were given full or partial exemption from the Rules upon fulfilment of certain criteria.

The Foreign Exchange Act is under the auspices of the Ministry of Business Affairs; however, the Act authorises the CBI to issue the Rules on Foreign Exchange, which are subject to the Minister of Business Affairs' approval. The CBI is responsible for the overall surveillance of the capital controls and for the day-to-day administration of the Rules. That surveillance has gradually been stepped up. According to the Foreign Exchange Act, the Financial Supervisory Authority (FME) shall investigate possible violations of the capital controls when notified of such suspected violations by the CBI. To ensure effective and efficient cooperation between the CBI and the FME, the two institutions signed a collaboration agreement in June 2009.

Circumvention of the capital controls is to be identified by the CBI. Data on transactions and flows are monitored, and possible circumvention is identified. The general impression is that the majority of Iceland's largest companies and financial institutions are operating according to the letter and intention of the law. However, many are building up their own FX reserves (primarily in Icelandic banks) as a buffer/hedge that limits their conversion to krónur.

With effective controls in place, exchange rate developments will be determined largely by current account flows (i.e., exports, imports, interest payments, and debt repayment), but not, as has been for the last 5 to 8 years, predominantly by capital flows. However, the market is shallow.

Because the current account has been broadly balanced, capital controls have helped to stabilise the exchange rate by preventing large capital outflows and thereby enabling the CBI to lower its policy rate. The controls have also provided a relatively stable environment for bank restructuring and have kept liquidity in the system.

In general, it appears as if the tension in the system has been reduced over the past few months. The spread between the ISK exchange rate in the onshore and offshore markets has narrowed. According to CBI statistics, ISK holdings of non-residents have declined from approximately 680 b.kr. at year-end 2008 to roughly 610 b.kr. at end-July 2009. Long-term holdings have increased slightly, while short-term positions have fallen from about 330 b.kr. to 260 b.kr. Although these figures are somewhat uncertain, they suggest a significant reduction in the possible overhang of non-resident ISK positions.

Non-residents appear to be relatively comfortable holding ISK assets in the form of Government bonds/HFF bonds, and CBI and bank deposits. There has been limited interest in shifting from such ISK positions to longer-term euro positions through the ‘impatient investor’ measures introduced in May 2009.

Overall the estimate is that at least half the ISK positions are attractive for non-residents in the longer term; e.g., long-term HFF bonds. In May 2009, the CBI estimated that around 250-300 b.kr. were held by “impatient” non-resident investors who would either need to be given incentive to stay, substituted by other non-resident or resident investors establishing ISK positions, or locked in during the initial phases of liberalization .

After the recent turbulence, it should be expected that some residents may want to shift out of the króna in order to balance their risks (earnings, currency, and solvency) and perhaps access instruments that cannot be fully acquired in krónur (equity, equity portfolios, and some fund categories). However, Icelandic instruments may be seen to provide an attractive mix of direct earnings and/or currency upside.

D. Preconditions for liberalisation

A significant reduction in the perceived risk of investments in Icelandic assets is a precondition for removing the capital controls. The Icelandic króna has depreciated some 5% against the euro since January 1, 2009; however, model projections (see the CBI’s *Monetary Bulletin* 2009/2) suggest that the króna may appreciate substantially more than 5% by 2011, while still allowing for necessary improvements in the current account. With such developments, and with ISK interest rates currently well above international rates, the fundamental incentives for investors to hold their ISK positions should be in place. However, even though Iceland’s risk premium has declined in line with and beyond international trends, it remains relatively high.

Over the past few months, many important steps have been taken to alleviate this situation. With the adoption of a medium-term fiscal plan, the Government has taken an important first step towards fiscal consolidation. Substantial progress has been made on the bank recapitalisation process, which is facilitated by new legislation on an asset management company and a bill of law on State banking agency. The IceSave loans and loan agreements with the Nordic countries have been signed. Together with the IMF loan facility, the Nordic loans bring total reserves to about 5 bn US dollars. The monetary policy has been focused on currency stability as and interim objective, and inflation has lost pace. A Stability Pact has been concluded between the Government and the social partners. Furthermore, exports have proven strong and imports weaker than expected, translating a sharp drop in domestic demand into a relatively moderate drop in GDP combined with a positive trade balance.

Against this background, the stage should be set for the achievement of the following preconditions over the next several months.

i. Full implementation of the macroeconomic stabilisation package. This includes the following:
    a. Confidence in the sustainability of government debt must be enhanced by a strong commitment to a medium term plan of fiscal consolidation. This would demonstrate that, although burdensome adjustments will be required, the Republic will be fully able to service its debt.
    b. Communication of the sustainability of the external debt situation, the mechanisms by which sufficient FX earnings to strengthen the króna will be ensured and a capital control liberalisation strategy designed to preserve the stability of the króna.
    c. Continued disinflation and a monetary policy focused on exchanged rate stability, as is illustrated in the last statement from the Monetary Policy Committee (MPC).
    d. The availability of instruments with attractive characteristics (deposits, bonds, FDI) to induce residents and non-residents to hold or establish longer-term ISK positions.

ii. Establishment of a strong, well-managed, and adequately supervised financial sector.

iii. Implementation and operation of an efficient liquidity management framework.

iv. Accumulation of adequate reserves (to support exchange rate stability and banking system liquidity, if necessary).

Stage 1 of the capital control liberalisation strategy – liberalising inflows – should only take place when the above preconditions have been met. It is expected that these preconditions will be in place well before November 1, 2009.

After Stage 1 is completed, later stages of the liberalisation process (liberalising outflows) will be initiated gradually, at the CBI's discretion, concurrent with the accumulation of surplus reserves to help cushion potential exchange rate volatility. Restored confidence in the Icelandic banking sector and equity market will be a particularly important prerequisite for liberalising capital outflows.

E. Liberalisation strategy

The liberalisation process will be closely managed to support the CBI's reserve management policy and the main monetary policy objectives of exchange rate and price stability. It takes place according to a sequence that is defined yet flexible, so as to allow for adjustments.

During Stage 1, controls on all foreign exchange capital inflows will be removed in a relatively short time frame. During Stage 2, the strategy distinguishes accounts, asset classes, and transactions to be liberalised early in the process from others that are to remain controlled for a longer period of time. The latter group – the so-called blocked accounts – will include those with significant potential for outflows and those whose early liberalisation could undermine the effectiveness of the system. Stage 2 will begin with the gradual liberalisation of outflows from specified accounts with the longest maturities, asset classes, and transactions, commensurate with the external reserves, the balance of payments outlook and increased confidence in the domestic banking sector. Once the release of these accounts is complete and sufficient surplus reserves have been accumulated, the next group of accounts and asset classes will be gradually released. The use of Icelandic krónur for international transactions will remain controlled until the final stage of liberalisation.

Stage 1: Liberalisation of foreign exchange inflows

At the beginning of Stage 1, new investments involving new FX inflows will be liberalised. New FX inflows exclude current FX deposits with domestic banks and FX current account transfers (e.g., export revenues). The new FX inflow shall be converted into krónur at a financial institution supervised by the FME. Such ISK holdings will be fully convertible and transferable. The new investment must be registered with the CBI in order to be eligible for re-exit. This will enable the CBI to monitor the inflow and possibly intervene by acquiring FX to build surplus reserves. No distinction will be made between investors making such an FX-to-ISK conversion. To minimise possible circumventions, certain investments, such as leveraged derivative instruments, will not qualify for re-exit.

Stage 1 is expected to have a positive or limited effect on the reserves. Initial inflows should strengthen the króna, providing the CBI with an opportunity to intervene to limit volatility and build up reserves for possible outflows stemming from the new investment.

Stage 2: Liberalisation of foreign exchange outflows

Stage 2 is based on a distinction made between accounts, assets, and transactions that can be released without the risk of large capital outflows, on the one hand, and blocked accounts that must remain controlled for a longer period of time, on the other. As an example liberalisation of long-term holdings is not considered likely to generate a substantial outflow of capital. These holdings will therefore be liberalised, gradually, before short-term holdings. Such accounts are and will remain blocked.

The CBI stands ready to tighten administration of "blocked accounts" if the situation requires.

Batch A:

In Batch A, holdings that meet specific long term maturity criteria, to be determined by the CBI, can be sold and the investor can convert the proceeds from krónur to foreign currency. In general the liberalization process will gradually allow the convertibility of the longest term investments. All such conversion must be made with a financial institution supervised by the FME. To avoid churning by investors, the investor must provide documentation to verify a given holding period up to a specific cut-off date to be determined by the CBI. This will enable the CBI to monitor the outflow. The CBI will implement procedures for this process.

These holdings will gradually be made convertible and transferable according to a threshold schedule consistent with the availability of surplus reserves. The transferability of residents' proceeds may initially be limited, according to current repatriation requirements, which stipulate that the proceeds must be deposited in specific accounts with domestic financial institutions. The use of these holdings will gradually be allowed for specified outward investments, sequenced from long-term to short-term AAA bonds and securities.

Stage 2 will be carefully managed and sequenced in line with the CB's reserve policy and the broader objective of exchange rate and price stability. The timing, conditions and thresholds for liberalization will be chosen in line with these objectives. Reserves will be available for intervention in the FX market to reduce excess volatility If a large number of investors choose to convert their assets, it will tend to lower the market value; that is, to a level that is not attractive for conversion. This will limit the total amount converted into FX.

Batch B:

Liberalization of asset categories as defined in Stage 2, Batch A can continue, gradually liberating the medium to short-term instruments. In addition, as sufficient reserves are accumulated, the Government will issue and auction short-term euro-denominated bills under its EMTN programme. In the auctions, successful bidders will be offered to convert krónur to euros at the CBI's official rate in order to purchase the bills. In essence, investors will be converting their ISK holdings into a transferable euro-denominated asset.

The price, amount, and timing of the procedure will be controlled by the CBI. It will provide all investors intending to exit with equal treatment, and the exit will be regulated by a price-based control. The decision to exit or not will be left to the investor; however, the total amount of foreign exchange used for this purpose will be subject to a predetermined limit. Since the auction mechanism will allow those who are willing to pay the highest amount to exit, it will permit the most impatient investors to leave first and immediately lessen the incentive to circumvent. This will allow for a flexible management of both reserve positions and exits, depending on balance of payments flows, yet without requiring long-term reliable balance of payments projections.

As the total amount of foreign exchange used is kept within a predetermined limit, reserves will remain within comfortable levels. The process will not have a direct effect on the interbank market. The cost effects of reserves used will be minimised, as the price is determined by the market.

All the above mechanisms are consistent with the international obligations of Iceland.

F. Administration and enforcement

Surveillance by the CBI

The administration of the strategy will be carefully designed to ensure compliance. The CBI is responsible for the surveillance of the capital controls, and it will devote to the task the resources and remedies necessary to carry it out successfully. The surveillance operation will cover the following three areas:

a) General surveillance

The CBI will have in place a general surveillance operation carried out on a daily, weekly and/or monthly basis, depending on the subject. The scope of such general surveillance will be extensive enough to enable the Capital Control Surveillance Unit (CCSU) to monitor and spot out possible violations of the Rules on Foreign Exchange. Such monitoring requires access to a range of data that will be obtained both within the CBI's systems and from other sources. Such data access must be continuous; i.e., it must not be dependent on the CBI's requesting it on a case-by-case basis. As a result, the CBI will need to establish collaboration with various sources from the public sector. As regards the private sector, the CBI will make general requests for the provision of specific data on a regular basis; e.g., in reports. The scope of the general surveillance operation will be as exhaustive as possible, and every data process will be described in as much detail as possible. This will allow the CCSU to determine certain references or benchmarks in its monitoring, which will give the general surveillance operation a sufficient overview. Such definitions, descriptions, and determinations will be reviewed regularly to ensure the best results possible.

b) Specific surveillance

In certain business sectors, companies and individuals have greater incentive and opportunities to circumvent the Rules on Foreign Exchange. The CCSU's surveillance will therefore target such high-risk sectors on regular basis. The specific surveillance operation will also target companies and individuals that have been granted exemptions from the Rules.

c) Case-by-case inspection

If the CCSU becomes aware of a possible violation of the Rules, either through its surveillance operations or through information provided by a third party, the CCSU will investigate such possible violations and may request additional data. Such inspections would be made on a case-by-case basis and, if applicable, would form the basis for the CBI's reporting of suspected violations to the FME.

CBI's resources and remedies

In order to fulfil its surveillance obligations, the CCSU will need additional staff. The CBI has already committed to recruit new members to the unit in response to the immediate need.

As regards data collection, the CBI will request clearer regulatory authority to request data pertaining to foreign exchange matters, and remedies at its disposal if such requests are ignored. In order to ensure adequate data collection, it is necessary to amend the Foreign Exchange Act and to adopt additional rules. Furthermore, the CBI will have to be able to oblige the financial sector to implement internal rules on observance of foreign exchange matters and to report any possible violation of the Rules on Foreign Exchange to the CBI. Therefore the CBI will request amendments to the Foreign Exchange Act to include such an obligation.

In addition to the surveillance operations described above, the CBI in collaboration with the FME enhance monitoring the commercial banks' compliance with the regular supervisory work of the FME. These steps are currently being prepared by the CBI and the FME.

Steps to increase voluntary compliance

The CBI will take measures to make the interpretation and implementation of the Rules on Foreign Exchange more transparent and accessible to interested market participants. The CBI's responses to questions and interpretations will be published regularly on its website. This should increase transparency and minimise the risk of unequal treatment.

In general, the CBI has begun to interact more frequently with the financial sector regarding the capital controls. The knowledge and actual overview that can be obtained through the financial institutions is vital to the efficient surveillance of the controls. Enhanced collaboration with the financial sector, including the Icelandic Financial Services Association, has commenced.

No. 2/2010
27 January 2010

Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank rates lowered

The Monetary Policy Committee (MPC) has voted to lower Central Bank interest rates by 0.5 percentage points. The deposit rate (current account rate) will be lowered to 8%. The maximum bid rate for 28-day certificates of deposit (CDs) will be 9.25%. The seven-day collateral lending rate will be 9.5% and the overnight lending rate 11%.

The króna has been broadly stable since the last MPC meeting, and indeed since last summer, without any Central Bank intervention since early November. This stability has continued despite internal and external developments that could have been expected to affect the króna negatively, in particular the recent turmoil caused by the president's decision not to sign the Icesave legislation. This reflects the effectiveness of the capital controls, as well as a gradual improvement in the underlying current account balance.

The failure to resolve the dispute over compensation of depositors in foreign branches of Landsbanki has already triggered a sovereign credit rating downgrade to non-investment grade by one of the rating agencies and could delay the second review of the IMF programme. Consequently, access to bilateral and multilateral financing, a prerequisite for successful access to international capital markets, might also be delayed. Given the effectiveness of the capital controls, the short-run effect on the króna should be modest; however, further steps towards removing the capital controls would be risky given the above uncertainties.

Inflation continued to decline in December and January, slightly more than in the November forecast, measuring 6.6% year-on-year in January, or 5.2% excluding the impact of higher consumption taxes. The 0.3% drop in the CPI in January was unexpected; however, underlying inflation is forecast to subside more slowly than in the November forecast throughout 2010, although it is still expected to reach the inflation target late this year.

If the króna remains stable or appreciates, and if inflation continues to fall as forecast, there should be scope for continued gradual monetary easing. However, as long as there is significant uncertainty about Iceland's future access to foreign capital markets, the MPC will have limited room for manoeuvre. As always, 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.

No. 5/2010
17 March 2010

Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank rates lowered

The Monetary Policy Committee (MPC) has voted to lower Central Bank interest rates by 0.5 percentage points. The deposit rate (current account rate) will be lowered to 7.5%. The maximum bid rate for 28-day certificates of deposit (CDs) will be 8.75%. The seven-day collateral lending rate will be 9% and the overnight lending rate 10.5%.

Supporting an interest rate cut is the appreciation of the króna in trade-weighted terms since the last MPC meeting, despite the absence of Central Bank intervention in the FX market. This development, in an external environment of elevated sovereign risk premia and continued uncertainty about Iceland’s medium-term access to global financial markets, reflects the effectiveness of the capital controls and more favourable current account developments.

Inflation picked up in February, after a decline in December and January, to 7.3% year-on-year, or 5.9% excluding the impact of higher consumption taxes. The pick-up in inflation was broadly anticipated and does not fundamentally change the conclusion of the January forecast. Inflation is assumed to rise further year-on-year in March due to unfavourable base effects, but underlying inflation is still expected to reach the target late this year.

Elevated CDS spreads and a negative rating outlook associated with uncertainty about Iceland’s access to global financial markets support a relatively cautious move, due to potential negative pressure on the króna going forward. The delay in resolving the dispute over compensation of depositors in foreign branches of Landsbanki has triggered a sovereign credit rating downgrade to non-investment grade by one of the rating agencies and continues to delay the Second Review of the IMF programme and the associated financing. Given the continued effectiveness of the capital controls, this is not expected to have a substantial immediate effect on the exchange rate. However, in the absence of multilateral and bilateral financing or full access to international capital markets on acceptable terms, removal of capital controls or sizeable interest rate cuts would be risky until this matter is resolved.

If the króna remains stable or appreciates, and if inflation develops as forecast, there should be scope for continued gradual monetary easing. However, as long as there is significant uncertainty about Iceland’s future access to international capital markets, the MPC will have limited room for manoeuvre. As always, 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.

No.10/2010
5 May 2010

Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank rates lowered

The Monetary Policy Committee (MPC) has voted to lower Central Bank interest rates by 0.5 percentage points. The deposit rate (current account rate) will be 7.0%, and the maximum bid rate for 28-day certificates of deposit (CDs) will be 8.25%. The seven-day collateral lending rate will be 8.5% and the overnight lending rate 10.0%.

Since the last MPC meeting, the króna has been broadly unchanged in trade-weighted terms but has appreciated against the euro. There has been no Central Bank intervention in the FX market. Sovereign risk premia have come down but are still high due to remaining uncertainty concerning Iceland's medium-term access to global financial markets and possible contagion from the European sovereign debt crisis. Capital controls, current account developments, and the interest rate differential with major currencies continue to support the króna.

As expected, inflation picked up in February and March, partly due to unfavourable base effects, but resumed a downward trend in April. Inflation measured 8.3% year-on-year, or 6.9% excluding the impact of higher consumption taxes. According to the forecast published today, the medium-term inflation outlook remains broadly in line with the January forecast. As before, underlying inflation is expected to reach the target late this year. The contraction in the economy last year turned out smaller than previously forecast, with private consumption stabilising at an earlier stage of the cycle. Growth of fixed investment, on the other hand, will be weaker this year due to delays in aluminium sector-related projects and slower recovery of other business investment. As in January, the forecast is based on the assumption of a gradually strengthening króna, but on average it will be slightly stronger over the medium term than in the January forecast.

While a forecast of lower inflation in the context of a weak economy could be an argument for a larger reduction in interest rates, several opposing factors call for some caution. The recovery of the króna has been weak since the last interest rate decision. CDS spreads remain high, although they have come down significantly since early this year and were only modestly affected by the turmoil caused by Greece's fiscal problems. While the credit rating outlook has stabilised, there is still residual uncertainty concerning Iceland's access to global financial markets.

With the Second Review of the IMF programme in place, concerns about Iceland's ability to service debt falling due in 2011 and 2012 should be alleviated. Hence, further delay in resolving the Icesave dispute is less likely than before to affect Iceland's credit rating. The removal of capital controls, which have shielded the króna from the effects of delays in the past, would be risky, however, until access to further programme financing is guaranteed. Hence, the planned liberalisation of capital controls is likely to be delayed until an agreement is in place, or after the Third Review.

The uncertainty concerning Iceland's future access to international capital markets continues to limit the MPC's room for manoeuvre, albeit less so than before the Second Review. However, if the króna remains stable or appreciates, and if inflation develops as forecast, there should be some scope for continued gradual monetary easing. As always, 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.

No.19/2010
23 June 2010

Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank lowers rates

The Monetary Policy Committee (MPC) has voted to lower Central Bank interest rates by 0.5 percentage points. The deposit rate (current account rate) will be 6.5% and the maximum bid rate for 28-day certificates of deposit (CDs) will be 7.75%. The seven-day collateralised lending rate will be 8% and the overnight lending rate 9.5%.

Since the last MPC meeting, the króna has appreciated by 5% in trade-weighted terms and 6% against the euro, or slightly more than assumed in the forecast published in the *Monetary Bulletin* in May. There has been no Central Bank intervention in the FX market. Furthermore, Icelandic sovereign risk premia have fallen since the last MPC meeting. Capital controls, current account developments and the risk-adjusted interest rate differential with major currencies continue to support the króna.

In May, inflation declined to 7.5% year-on-year, or 6.1% excluding the impact of higher consumption taxes. This is broadly in line with the forecast published in May. As before, inflation excluding consumption tax effects is expected to reach the target early next year. National accounts for Q1 2010 and other recent data do not fundamentally change the picture outlined in the May forecast.

Continued easing of monetary policy at this stage is justified by the appreciation of the króna and lower external risk premia, driven by better fundamentals and improved access to foreign liquidity through multilateral and bilateral agreements. These developments should facilitate the eventual removal of capital controls. The first steps towards complete liberalisation of the capital account could be taken relatively soon after the Third Review of the IMF-supported programme is completed.

Over time, the Central Bank will have to replace borrowed reserves with non-borrowed reserves. The appreciating króna and lower external risk premia could allow modest regular purchases of foreign currency. The timing and quantity of such purchases will be conducted so as to minimise the effect on the króna. No decisions on such purchases will be taken before the August MPC meeting.

The MPC's room for manoeuvre is limited by remaining uncertainty concerning Iceland's medium-term access to global financial markets and the prospect of capital account liberalisation. The additional uncertainty caused by the recent Supreme Court ruling on the legality of FX-linked loans could, if not resolved promptly, undermine confidence and further constrain monetary policy.

As before, if the króna remains stable or appreciates, and if inflation develops as forecast, there should be some scope for continued gradual monetary easing. The MPC stands ready to adjust its monetary policy stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.

No. 24/2010
18 August 2010

Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank lowers interest rates

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by one percentage point. The deposit rate (current account rate) will be 5.5%, and the maximum bid rate for 28-day certificates of deposit (CDs) will be 6.75%. The seven-day collateralised lending rate will be 7.0% and the overnight lending rate 8.5%.

Inflation has declined markedly in recent months. Twelve-month inflation fell from 7.5% in May to 4.8% in July, or 4% excluding consumption tax effects. This is more rapid disinflation than in the Central Bank's May forecast, due in large part to a stronger-than-expected exchange rate. According to the updated inflation forecast, which appears in today's *Monetary Bulletin*, inflation excluding tax effects will reach the Bank's inflation target by year-end and will fall somewhat below target early in 2011. Inflation expectations have also declined sharply in the recent term.

In trade-weighted terms, the króna has appreciated by over 2½% since the MPC's last meeting, held in June, and by over 2% against the euro, without any foreign exchange market intervention by the Central Bank. Over this same period, the CDS spread on sovereign debt has remained broadly unchanged. The capital controls, developments in terms of trade and the current account balance, and the interest rate differential with major currencies all continue to support the exchange rate.

Lower inflation, lower inflation expectations, a stronger króna, and the prospect of more rapid disinflation than previously expected provide the scope for a larger interest rate reduction than has generally been the case in the past year. Declining inflation and inflation expectations have caused real Central Bank interest rates to rise since the last interest rate decision date. Although recovery appears to be underway, it is still weak at present, and the outlook is for an output slack to remain for the next few years.

Given the inflation outlook, the Central Bank's interest rates are still rather high, and there are grounds for continuing to lower them; however, it is not yet clear to what extent the recent disinflation episode reflects short-term factors. Moreover, it should be borne in mind that, when capital account liberalisation begins, the risk-weighted interest rate differential between Iceland and abroad must provide sufficient support to the króna. However, there is still some uncertainty about when it will be possible to begin lifting the capital controls. Consequently, it is difficult to state what this entails for interest rate policy over the next few months.

When the Third Review of the Government-IMF economic programme is complete, the preconditions for capital account liberalisation will be in place as regards the foreign exchange reserves and macroeconomic stability. However, there is still considerable uncertainty about the strength of the financial system in the wake of the recent Supreme Court judgments. As a result, it is necessary to review the existing capital account liberalisation strategy in view of changed circumstances and the delays that have already occurred.

As was stated in the last MPC statement, it is important to replace the Central Bank’s borrowed foreign exchange reserves with non-borrowed reserves in the medium term. The appreciation of the króna and the decline in risk premia on Icelandic financial obligations provide now the scope for modest foreign currency purchases for this purpose. Such purchases will begin on 31 August, and the quantity will be decided with the aim of minimising the impact on the króna.

As before, the Committee considers that the premises for continued monetary easing should be in place, provided that the króna remains stable or appreciates and inflation subsides as forecast. 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 Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting
December 2009
Published: 23 December 2009

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 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 meetings held on 9 December 2009, during which the Committee discussed economic and financial market developments, the interest rate decision of 10 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 real economy and Iceland's international trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the previous interest rate decision on 5 November.

Financial markets

The average trade-weighted value of the króna was 0.6% lower in November then it was in October. Foreign exchange market intervention by the Central Bank of Iceland had remained moderate since the last MPC meeting, with no intervention since early November. Residents' FX account balances at domestic banks also remained fairly stable since the last MPC meeting.

Tighter enforcement of the capital controls in early November probably led to a depreciation of the króna in the offshore market, with the króna trading at above 260 against the euro. In the discussion it was argued that this depreciation should not be seen as a negative development as it reflects the effects of tighter capital controls rather than higher risk premia.

Five certificates of deposit (CD) auctions were held since the November meeting, and about 48.6 b.kr. worth of CDs were outstanding at the time of the December meeting.

Overnight interbank market rates moved into the Central Bank's interest rate corridor and were 0.25 percentage points above the current account rate as of the December meeting. Trading volume in the interbank market was however still limited in comparison with 2008.

The yield in the mid-November Treasury bill auction fell to 8.0%, compared with 8.5% in the mid-October auction. Only one-third of the bids were accepted. After the legislative bill on the Depositors' and Investors' Guarantee Fund became public, the yield curve for indexed bonds shifted downwards and the slope of the short end of the curve became significantly steeper than before. The nominal yield curve also shifted downwards and flattened.

Risk premia on the Republic of Iceland, as measured by the CDS spread, rose somewhat since the November meeting and increased slightly following the publication of negative news from Greece and Dubai. However, developments in the CDS spread should be interpreted with caution, as they may reflect limited trading.

Outlook for the global real economy and international trade

According to the latest OECD forecast, the outlook for trade has improved since the Bank published its last forecast in the November *Monetary Bulletin*. The OECD forecast assumes that world trade has already begun to recover, led by Asian non-OECD countries, whereas the Central Bank's forecast has been based on the assumption that world trade would not begin to grow until 2010.

At 16.4 b.kr., the October merchandise trade surplus was the largest monthly surplus so far this year. According to preliminary numbers, the trade surplus was smaller in November, or 6 b.kr., mainly due to increased imports.

The value of exports in domestic currency was almost 7% higher in October than in September, while the value of imports declined by 25% month-on-month, mainly due to a drop in imports of fuels and industrial supplies.

The value of imports in domestic currency contracted by 28% year-on-year in October. This is a substantial decline, as it comes on the back of a prior 50% year-on-year contraction in October 2008, the month the financial crisis struck. The value of exports in domestic currency fell by 16% year-on-year, as the value of industrial goods exports declined by 23% and the value of marine products exports fell by 4%.

Aluminium prices continued to rise since the last MPC meeting and were 4% higher on average in November than in October. Rising aluminium prices contributed to a 12% month-on-month increase in the value of aluminium exports in October export. The value of marine products exports increased by 3% between October and September, as the average price of all marine products rose by 3.4% month-on-month.

The domestic real economy and inflation

Preliminary quarterly national accounts figures from Statistics Iceland show that the Icelandic economy was somewhat stronger in Q3/2009 than was assumed in the Central Bank's November forecast, which appeared in *Monetary Bulletin* 2009/4.

After little change in Q2, seasonally adjusted GDP fell by 5.7% in Q3/2009 quarter-on-quarter. In Q1, GDP fell by 5.1%. The decline in GDP increased in year-on-year terms as well, rising from 6.2% in Q2 to 7.2% in Q3. GDP has fallen by 6% in real terms in the first three quarters of 2009 and was 1,111 b.kr. in nominal terms.

The contribution to quarterly GDP growth in Q3/2009 was negative from all subgroups except private consumption. The negative contribution from net trade was the largest, however, caused by a substantially larger increase in imports (12.9%) than exports (1.3%). The contribution of private consumption to quarterly GDP growth amounted to 2.8%, after having been negative quarter-on-quarter since Q1/2008. The contraction in private consumption has been subsiding year-on-year throughout 2009, measuring 13% in Q3. Public consumption fell by 1.4% year-on-year in Q3/2009. The quarterly contraction in public consumption measured 4.5% after being close to zero in Q1 and Q2. In Q3, the year-on-year decline in gross fixed capital formation was similar to that in the preceding quarter (48%). The most pronounced change from Q2/2009 was in residential investment, which contracted by 57% in Q3/2009 and by 45% in Q2/2009. Business sector investment is still sharply lower than year ago (56%), but quarter-on-quarter numbers show a small increase in both Q2/2009 (1%) and Q3/2009 (0.5%). Public investment grew by 2.8% between quarters in Q3/2009, after having contracted since Q4/2008.

The current account deficit was 36. b.kr., or 9.3% of GDP, in Q3/2009. This is significantly smaller than the Q2 deficit, which measured 17.5%. The current account deficit is due to a 72 b.kr. deficit on the income account, while the merchandise account and the service account were positive by 16.3 b.kr. and 20.8 b.kr., respectively. The large income deficit is mainly a result of interest payments related to the "old banks". Most of this interest is accrued but has not been paid; therefore, it has not resulted in actual payment outflows. Excluding this item, the income account deficit was 46 b.kr. and the current account deficit 9.5 b.kr., or 2% of GDP.

Revised national accounts figures for the first two quarters of 2009 show that the economy was marginally stronger than preliminary figures from September had indicated. The main reason for the revision is a larger increase in public and private consumption and a larger surplus on services than in the September numbers.

Registered unemployment, which had been falling since April, rose by 0.4 percentage points month-on-month in October, to 7.6%. Seasonally adjusted unemployment had been rising since last fall, but fell slightly between months in October, measuring 9.2%.

In October, as in September, the wage index was up 0.25% from the previous month and had risen by 1.9% year-on-year. In Q3/2009, the index rose by 0.7% from the previous quarter and by 2.3% year-on-year. Real wages were down by 0.8% month-on-month in October, and by 7.1% compared to the same month in 2008. Real wages have fallen by 12½% since they began to decline in March 2008.

The Consumer Sentiment Index and all of its sub-indices fell slightly in November. The largest decline was in sentiment towards the economy. Sentiment towards the economic situation in six months' time and towards the economy and labour market turned downwards for the first time since July 2009.

Annual inflation continued to decline in November. The CPI rose by 0.74% in November, bringing the twelve-month inflation rate down to 8.6%, from 9.7% in October. Excluding the effects of recent excise tax hikes, year-on-year inflation was 7.7% in November. Annualised seasonally adjusted three-month inflation was 8.7%, down from 8.9% in October.

The increase in inflation is explained primarily by the weaker króna. Imported goods prices accounted for 0.84% of the November rise in the CPI. The contribution to inflation from domestic components accounted for 0.1% of the fall in the CPI in November.

The Statistics Iceland housing price index for the entire country, published in November, was unchanged from the month before. Turnover in the market is still limited. In October, only 190 flats and houses were sold in the greater Reykjavik area, compared to 1,000 at the peak in turnover five years ago.

II The interest rate decision

The Governor informed the MPC of developments in financial sector restructuring, the status of the Second Review of the IMF Stand-By Agreement, and the results so far of the first phase of capital account liberalisation, implemented on 31 October.

The MPC noted that the preconditions for further monetary easing, outlined in its 5 November statement, had materialised. The króna has remained broadly stable since the last MPC meeting, with limited intervention by the Central Bank and no intervention at all since early November. Although the króna remained weaker than the MPC deemed desirable, the Committee believed that the prospects for the currency over the medium term had improved. Tighter regulation, enhanced surveillance, and more effective enforcement had made circumvention of the capital controls more difficult. Some MPC members argued that although significant uncertainty remained concerning short-term capital flows, the króna should be supported by a growing trade surplus in the period ahead.

Inflation has also continued to decline, broadly in line with the latest forecast, falling from 9.7% year-on-year in October to 8.6% in November, or 7.7% excluding the impact of higher consumption taxes. The MPC was of the view that the risk of second-round effects on inflation was moderate and that inflation was driven primarily by exchange rate movements; thus the pace of disinflation would depend mostly on near-term exchange rate movements.

The MPC discussed recent financial market developments. The Committee was of the opinion that auctions of 28-day CDs had been successful in draining liquidity from the market and that monetary policy had begun to affect market rates more effectively.

The Committee also discussed changes in the procedure of the auctions for the CDs in light of the experience so far. As the Central Bank now has a reasonable idea about the volume sold, it was argued that it was no longer necessary for the Committee to announce rates other than the maximum bid rate. From now on, it would be sufficient that the Central Bank announce the amount of CDs to be auctioned one business day in advance of each auction on the basis of its liquidity forecast.

The Committee noted, however, that some important issues were still outstanding that are relevant for the process of rebuilding confidence in the króna and the economy. The negotiated settlement of the dispute with the UK and the Netherlands regarding deposit insurance had not yet been ratified by Parliament, and the 2010 National Budget was not yet completed.

On the whole, the Committee agreed that developments since the last meeting allowed for some monetary easing. Maximum CD bid rates of 9.75% to 10.0% were discussed. The range discussed for the deposit rate was from 8.5% to 9.0%, and for the collateralised lending rate 10.0% to 10.5%. For the overnight lending rate, the Committee discussed lowering it by 0.75 to 1.50 percentage points.

In light of the discussion, the Governor proposed a 0.5 percentage point easing of the monetary policy stance. This implied that the deposit rate (current account rate) and the CD rate would be lowered by 0.5 percentage points to 8.5% and 9.75%, respectively. In addition, in order to further align the Central Bank interest rate corridor with the effective monetary policy stance, the Governor proposed that the seven-day collateral lending rate be lowered by 1 percentage point to 10%, and the overnight lending rate lowered by 1.5 percentage points to 11.5%.

The Governor invited other MPC members to vote on the proposal. Three members voted in favour of the Governor's proposal, with one member pointing out that the smaller gap between the CD rate and the seven day collateral lending rate might result in a somewhat less easing that actually suggested by a 0.5 percentage points lowering of the CD and deposit rates.

Two members voted against the proposal and wanted to take a smaller step, relaxing the monetary policy stance by 0.25 percentage points. Favouring greater caution, they preferred to lower the deposit rate and the CD rate by 0.25 percentage points to 8.75% and 10.0%, respectively. They also suggested that the seven-day collateral lending rate would only be lowered by 0.5 percentage points to 10.5%, and the overnight lending rate by 0.75 percentage points to 12.25%. These two members argued that some major issues were still unresolved and this could raise the risk premium on króna-denominated financial assets. A resolution of the Icesave dispute, which is needed to clarify the public debt situation, was not yet in hand, and the 2010 National Budget had not been passed by Parliament. Furthermore, one member was of the view that some risk to the near-term inflation outlook remained. The effect of second-round effects on inflation could therefore not be ignored.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation continues to fall as forecast, there should be scope for continued gradual monetary easing. Furthermore, the MPC reiterated that, as always, it 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 Anne Sibert, external member
Professor Gylfi Zoëga, external member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 27 January 2010.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

January 2010

Published: 10 February 2010

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 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 meetings held on 25 and 26 January 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 27 January, 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 real economy and Iceland's international trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the 10 December interest rate decision, as reflected in the updated forecast published in *Monetary Bulletin* 2010/1 on 27 January.

Financial markets

The average trade-weighted value of the króna in the onshore market was 0.5% higher one week before the January MPC meeting than in the week prior to the December meeting. Volume in the foreign exchange market has been low, at 21 m. euros in December and 3 m. euros the first three weeks in January and the Central Bank has not intervened in the market since early November. The króna has appreciated by approximately 2% against the euro since the last MPC meeting, due to the weakening of the euro against other currencies. Residents' FX account balances at domestic banks have remained fairly stable since the last MPC meeting.

Five certificate of deposit (CD) auctions had been held since the December meeting, and about 48.6 b.kr. worth of CDs were outstanding at the time of the January meeting.

Overnight interbank market rates remained within the Central Bank's interest rate corridor and were 0.5 percentage points above the current account rate as of the January meeting. Trading volume in the interbank market was 296 b.kr. in 2009, about one third of 2008 volume. No transactions have occurred in the market so far in 2010.

The króna weakened in the offshore market in mid-December, following a stronger enforcement of the capital controls, trading at 290-300 against the euro. Offshore market demand for krónur has increased in the new year, causing the exchange rate to recover again towards 245-275 against the euro. Turnover appears, nevertheless, to be low.

Risk premia on the Republic of Iceland, as measured by the CDS spread, rose relative to comparators in the beginning of January following the president's decision not to sign the Icesave legislation. At the January meeting the CDS spread had risen by 220 basis points from the beginning of December. The Icelandic Republic's sovereign credit rating also deteriorated in the wake of the president's decision.

The yield in the mid-January Treasury bill auction was 8.0%, compared with 7.5% in the mid-December auction. The yield on T-notes had also risen by 0.14 to 0.30 percentage points from the December meeting. At the same time, the yield on indexed HFF bonds had declined by up to 0.30 percentage points at the shortest maturity, following the president's announcement that he would not sign the Icesave law.

Outlook for the global real economy and international trade

At 6.2 b.kr., the November merchandise trade surplus was similar to the average surplus for the first eleven months of the year. According to preliminary numbers, the trade surplus was somewhat larger in December, or 7 b.kr., due mainly to a decline in imports.

Import values in domestic currency rose by 24% month-on-month in November, owing mainly to an increase in imports of fuels and industrial supplies. The value of exports in domestic currency was almost 6% lower in November than in October, despite a further increase in aluminium prices, as volumes fell.

Aluminium prices have continued to rise since the last MPC meeting and were 7% higher on average in the first half of January than in the first two weeks of December. The value of marine product exports dropped by 6% between November and October as a result of lower export volumes, as the average price of all marine products remained stable month-on-month.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey, total hours worked fell by 5½% year-on-year in Q4/2009. The fall in hours worked was due to both a half-hour decline in average weekly hours worked and a drop of nearly 5% in the number of people working during the reference week. Labour market participation fell by 1.2 percentage points in Q4/2009 from the same quarter the year before.

Registered unemployment rose from 7.6% in October to 8.2% in December. Seasonally adjusted unemployment measured 7.7% in December, having fallen by 1.3 percentage points from October, and was less than registered unemployment for the first time since April 2009.

Indicators suggest that the labour market has yet to soften further. According to the Capacent Gallup business sentiment survey, carried out among Iceland's 400 largest firms over a three-week period from 7-18 December 2009, nearly 40% of companies intend to lay off staff in the next six months, while 14% expressed an interest in recruiting staff. Moreover, general labour market sentiment is more pessimistic than in October, according to the Gallup Consumer Sentiment Index. Directorate of Labour figures on new unemployment registrations so far in 2010 indicate that the jobless rate will rise again.

The wage index rose by 1.5% month-on-month in November and by 0.3% in December. Wages increased by 3.6% year-on-year in December, and real wages fell by the same amount.

Payroll taxes were raised by 1.6% on 1 January 2010. Since June 2009, they have been raised from 5.34% to 8.65%.

According to the Capacent Gallup survey of business sentiment that was done in December, roughly 90% of firms considered the current economic situation bleak and were more pessimistic about the outlook six months ahead than they were in September. Around 43% of companies believed that the economic situation would deteriorate in six months' time, compared to about 34% in September. Less than one-fifth of companies expected the economic situation to improve, down from one-fourth of the companies in the September survey.

About 42% of companies expected that domestic demand would decline over the next six months, up from 30% in September, and 17% of companies expected demand to strengthen, as opposed to one-fourth of companies in September. More firms were pessimistic about profits for the next six months, or 83%, up from 56% in September.

Executives of export firms were less pessimistic than executives of firms selling in the domestic market. For the first time since March executives of export firms were more pessimistic about foreign demand than they were in the previous survey, however.

A number of economic indicators, such as payment card and groceries turnover, retail sales, and unemployment suggest that private consumption remained relatively stable between Q3 and Q4/2009 after starting to increase again between Q2 and Q3.

The consumer price index (CPI) decreased by 0.31% in January, or 1.05% excluding indirect tax effects. Annual inflation measured 6.6%, or 5.2% excluding direct tax effects.

The decline in inflation is explained primarily by a stronger-than-usual effect of winter sales, with the total effect amounting to a 0.94% drop in the CPI. Imported goods added a further 0.26% to the decline in the CPI. The cost of owner-occupied housing decreased by 2.9%, causing the CPI to fall by 0.37%. Price increases for public services were smaller than typically found in January, adding 0.23% to the CPI. The effect of indirect tax increases was also somewhat less than anticipated or 0.74%.

The Statistics Iceland housing price index for the entire country, published in January, decreased by 2.7% from the month before. Housing market turnover remains limited.

The updated baseline forecast, published in the 27 January issue of the *Monetary Bulletin*, indicates that while last year's contraction was smaller than previously estimated, the contraction in 2010 will be larger. Recovery will be weaker, due in particular to delays in aluminium and power sector activity.

Inflation will be lower in Q1/2010 but will nonetheless remain higher throughout 2011 than was projected in November, owing to larger rises in unit labour costs, a somewhat weaker króna, and higher inflation expectations.

Uncertainty about the economic outlook has increased because of greater uncertainty about the progress of the economic programme of the Government and the International Monetary Fund (IMF). An important assumption underlying the baseline forecast is that this uncertainty will subside in the near term; otherwise, the outlook is for a slower pick-up in investment, a larger contraction in GDP, and higher unemployment than assumed in the baseline forecast.

II The interest rate decision

The Governor informed the MPC of the status of the Second Review of the IMF Stand-By Arrangement and the status of the dispute over compensation of depositors in foreign branches of Landsbanki. The MPC was also informed of the recent steps in the financial sector restructuring process.

The Committee noted that the króna had been broadly stable in the onshore market since the last MPC meeting, and indeed since last summer, without any Central Bank intervention since early November. It noted especially that this stability had continued despite internal and external developments that could have been expected to affect the króna negatively, in particular the turmoil caused by the president's decision not to sign the Icesave legislation. In the MPC's view, this reflects the effectiveness of the capital controls, as well as a gradual improvement in the underlying current account balance.

The Committee observed that the failure to resolve the dispute over compensation of depositors had already triggered a sovereign credit rating downgrade to non-investment grade by one of the rating agencies and could delay the Second Review of the IMF programme. Risk premia on the Republic of Iceland, as measured by the CDS spread, had also risen. Consequently, access to bilateral and multilateral financing, a prerequisite for successful access to international capital markets and a sustainable balance of payments outlook, might also be delayed.

MPC members agreed, though, that given the effectiveness of the capital controls, the short-run effect on the króna should be modest, but that further steps towards removing the capital controls would be risky given these uncertainties.

The Committee discussed economic developments and prospects as presented in the forecast published in the *Monetary Bulletin* 2010/1. Inflation had continued to decline in December and January, slightly more than in the November forecast. The 0.3% drop in the CPI in January was unexpected, and while inflation will be lower in the first quarter than was projected in November, it is expected to remain higher throughout 2011 as a result of a somewhat weaker króna, higher unit labour costs, and higher inflation expectations.

The Committee agreed that the pace of disinflation would depend to a large extent on near-term exchange rate movements. Some MPC members argued that there was only a modest risk of second-round effects on inflation as long as the labour market remains weak. Others voiced concerns about rising profitability in the traded goods sector, which they argued could generate wage pressures as soon as the labour market stabilises; however, they envisaged that a gradual appreciation of the króna from its current low level could alleviate such pressures. There were also concerns about a looser fiscal stance compared to previous assumptions and the possible implications of fiscal sustainability on exchange rate and price stability over the longer term.

Although last year's contraction of output was smaller than forecast in November, mostly because of temporary effects, recovery would be weaker due to delays in investments. Uncertainty about the economic outlook had also increased because of greater uncertainty about the progress of the economic programme set forth by the Government and the IMF. The MPC noted that if uncertainty were not resolved soon, the effect could curtail access to international capital markets and reduce the likelihood of new foreign direct investment in the short to medium term. This would lead to less investment and higher unemployment than in the baseline forecast and a larger GDP contraction, as any new investment projects would have to be financed through domestic savings which would only be generated through a larger contraction of private consumption and government expenditure. With the funding of the IMF programme also in doubt, this would also call for the need to generate large current account surpluses in the next few years in order to ensure balance of payments sustainability.

The committee discussed the effects of the changes in outlook since the last rate-setting meeting. With increased risk premia, the current risk-adjusted rates of return on domestic assets had fallen and the incentive for investors to hold or buy króna-denominated assets, calling for higher rates. On the other hand, the bleaker outlook for the real economy and lower inflation called for lower rates.

In light of the discussion, the Governor proposed that Central Bank interest rates be cut by 0.5 percentage points. This implied that the deposit rate (current account rate) and the CD rate would be lowered to 8.0% and 9.25%, respectively, the seven-day collateral lending rate to 9.5%, and the overnight lending rate to 11.0%.

The Governor invited other MPC members to vote on the proposal. Three members voted in favour of the Governor's proposal, while two members voted against it. One of the dissenting members wanted to take a smaller step and cut rates by 0.25 percentage points, arguing that uncertainty had increased and the inflation outlook had deteriorated from the November forecast. The other dissenting member called for unchanged rates. This member argued that uncertainty had escalated following the president's decision not to sign the Icesave legislation, thus lowering the risk-adjusted interest rate differential needed to support the króna. A resolution of that dispute was therefore needed before monetary policy easing could continue.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation continues to subside as forecast, there should be scope for continued gradual monetary easing. However, the MPC stressed that, as long as there is significant uncertainty about Iceland's future access to foreign capital markets, it will limit the Committee's room for manoeuvre. Furthermore, the MPC agreed that it should stand 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 Anne Sibert, external member

Professor Gylfi Zoëga, external member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 17 March 2010.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

March 2010

Published: 31 March 2010

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 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 meetings held on 16 March 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 17 March, 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 real economy and Iceland's international trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the 27 January interest rate decision.

Financial markets

The average trade-weighted value of the króna in the onshore market was 3.2% higher at the time of the March MPC meeting than at the January meeting. The króna has appreciated by approximately 4.2% against the euro and 8% against the pound in the on-shore market since the last MPC meeting, but has remained broadly unchanged against US dollar. The Central Bank has not intervened in the foreign exchange market since early November. Volume in the foreign exchange market has been low, at 4 m. euros in February and another 4 m. euros during the first two weeks in March. Residents' FX account balances at domestic banks have remained fairly stable since the last MPC meeting.

The króna weakened in the offshore market since the last MPC meeting, trading at 270-290 against the euro. Trading volume remains low.

Risk premia on the Republic of Iceland, as measured by the CDS spread, had subsided since the January meeting and were in line with the levels at the time of Fitch Ratings' downgrade following the president's decision not to sign the Icesave legislation. This may reflect external factors, however, as CDS spreads on Portuguese, Irish, Italian, Greek and Spanish sovereign debt had also declined since their peaks at the beginning of February.

Seven certificate of deposit (CD) auctions had been held since the January meeting, and about 37.1 b.kr. worth of CDs were outstanding at the time of the March meeting.

Overnight interbank market rates remained within the Central Bank's interest rate corridor and were 0.6 percentage points above the current account rate as of the March meeting. Trading volume in the interbank market had been 86 b.kr. since the last MPC meeting, which is just under one-third of last year's trading. Trading is limited primarily to overnight transactions.

The yield in the mid-March Treasury bill auction was 7.75%, compared with 8.0% in the mid-January auction. The yield on T-notes had also declined by 0.4 to 1.45 percentage points from the January meeting. At the same time, yields on indexed HFF bonds were broadly unchanged.

Banknotes and coins in circulation increased towards the end of 2009, particularly in December, but subsided somewhat in the first two months of 2010. Towards the end of the year, M3 declined year-on-year, with a measurable contraction in both November and December after substantial growth in previous years. A portion of this can be attributed to a contraction in the shortest-term time deposits.

Outlook for the global real economy and international trade

According to the latest IMF forecast from January 2010, global growth is expected to be 4% in 2010, 0.75 percentage points higher than predicted in the October 2009 forecast. Economic growth in Iceland's main trading partner countries has therefore been revised up from 0.7% to 1.3%. Furthermore, world trade volumes have been revised upwards by 3.3 percentage points to 5.8% in 2010.

The merchandise trade surplus was 7 b.kr. in January, little changed from the 6.5 b.kr. surplus in December. According to preliminary numbers, the trade surplus rose to 13 b.kr. in February, mainly due to a 16% rise in exports since January. The merchandise trade surplus for 2009 was 93.4 b.kr.: a substantial change from the 38 b.kr. deficit in 2008.

Export values in domestic currency declined by 7% month-on-month in January because of smaller export volumes, most likely due to fewer shipments of aluminium in January than in a typical month. The value of imports in domestic currency declined by just over 7% month-on-month, mainly due to a substantial fall in imports of consumer goods and transport equipments.

The 15% fall in aluminium prices in the latter half of January had reversed and aluminium prices had returned to mid-January levels by the time of the MPC meeting. The value of marine product exports fell by 20% month-on-month in January.

The domestic real economy and inflation

Preliminary quarterly national accounts figures indicate that the Icelandic economy was somewhat stronger in Q4/2009 than was assumed in the Central Bank's January forecast, which appeared in *Monetary Bulletin* 2010/1.

All of the main subgroups of GDP experienced positive (seasonally adjusted) growth in Q4 except public consumption. Private consumption grew for the second consecutive quarter, rising by 1.4%, quarter-on-quarter. Exports grew by 3%, while imports grew by 1.5%, down from 10.3% in Q3. Government final consumption has contracted quarter-on-quarter for the whole of 2009. The Statistic Iceland numbers indicate that GDP grew by 3.3% quarter-on-quarter in Q4; however, this result is critically dependent on the method used for seasonal adjustment, which leads to an upward bias of GDP growth between Q3 and Q4/2009, and therefore to a downward bias of GDP growth between other quarters of that year. Other approaches to seasonal adjustment suggest that GDP was still contracting between quarters in Q4, which is more in line with the January forecast.

GDP fell by 6.5% in 2009. As in 2007 and 2008, the decline in GDP was much less than the decline in gross domestic final expenditure, which was 21% in 2009. This was because of a substantial positive contribution from the trade account. Exports of goods and services increased by 6.2% in 2009, while imports fell by 24%.

The current account deficit was 13. b.kr., or 3.4% of GDP, in Q4/2009. This is a reversal from the previous quarter, when the current account was positive by 1.6% of GDP, but the deficit was smaller than those of the first two quarters of 2009. The current account deficit is due to a 41 b.kr. income account deficit; the merchandise and service accounts were positive at 8 b.kr. and 21 b.kr., respectively.

For the year as a whole, the current account deficit totalled 3.3% of GDP, compared with 18.5% in 2008. The current account balance excluding accrued interest rates related to the undergoing winding up proceedings of the failed deposit-taking institutes, as a share of GDP, was a 3% surplus for the year 2009.

Registered unemployment increased from 8.2% in December to 9.3% in February. The wage index rose by 0.1% month-on-month in January and by 3.1% year-on-year. Real wages fell by the same amount.

A number of economic indicators, such as payment card and groceries turnover, retail sales, and unemployment suggest that private consumption remained relatively stable, although contracting slightly, in January and February from Q4/2009.

The consumer sentiment index and all its sub-indices, apart from the index measuring sentiment towards the current economic situation, increased slightly in February.

After a steady decline since June 2009, end-of-winter sales caused inflation to rise from 6.6% to 7.3% in February, with the CPI rising by 1.15% from the previous month. Annual inflation in February was lower, however, than in December, when it measured 7.5%. Annualised seasonally adjusted three-month inflation measured 7.1%, compared to 6.1% in January. There were no monthly consumer tax effects in February.

End-of-winter sales accounted for almost 0.6 percentage points of the increase in the CPI, private services contributed 0.2 percentage points, and the transport component contributed 0.17 percentage points. The overall housing component accounted for 0.07 percentage points of the increase in the CPI, due to an increase in paid rent and a sizeable increase in the price of repair costs, but owner-imputed rent was unchanged from January.

The Statistics Iceland housing price index for the entire country, published in February, rose by 0.4% from the month before. The housing price index for the greater Reykjavík area, calculated by the Icelandic Property Registry, increased by the same amount, but adjusted to seasonality it decreased by 0.1%. Housing market turnover remains limited.

II The interest rate decision

The Governor informed the MPC of the status of the Second Review and the IMF Stand-By Arrangement, as well as the status of the dispute over compensation to depositors in foreign branches of Landsbanki. The MPC was also informed of the recent steps in the financial sector restructuring process.

The Committee noted that the króna had strengthened in trade-weighted terms in the onshore market since the last MPC meeting, without any Central Bank intervention. Furthermore, this had occurred at the same time as there was continued uncertainty about Iceland´s medium term access to global financial markets and Iceland´s sovereign rating was on a negative outlook. In the MPC's view, this reflected the effectiveness of the capital controls and more favourable current account developments.

The Committee noted that inflation had picked up in February, after declining in December and January. Inflation measured to 7.3% year-on-year in February, or 5.9% excluding the impact of higher consumption taxes. Although inflation is assumed to rise further year-on-year in March due to unfavourable base effects, members agreed that the pick-up in inflation was broadly anticipated and did not fundamentally change the conclusion of the January forecast as published in *Monetary Bulletin* 2010/1. According to that forecast, underlying inflation is expected to reach the target late this year. Some members expressed concerns over the risk of second-round effects on inflation from wage pressures caused by rising profitability in the traded goods sector while one member argued that there was only a modest risk of second-round effects on inflation as long as the unemployment rate remains high.

The MPC discussed the implications of the delay in resolving the dispute over compensation to depositors in foreign branches of Landsbanki, which was delaying the Second Review of the IMF programme and the associated financing, with further effects on private funding of many new investment projects. Although the Committee did not expect it to have a substantial immediate effect on the exchange rate, given the continued effectiveness of the capital controls, the delay had already triggered a sovereign credit rating downgrade to non-investment grade by one rating agency.

Although last year's contraction in output was smaller than forecast in January, mostly because of temporary effects, uncertainty about the economic outlook had mounted because of greater uncertainty about the progress of the economic programme set forth by the Government and the IMF. The MPC noted that if uncertainty were not resolved soon, the result could be curtailed access to international capital markets and reduced likelihood of new foreign direct investment in the short to medium term.

Members discussed effects of and responses to a prolonged absence of both multilateral and bilateral financing or full access to international capital markets on acceptable terms. They agreed that this would call for even tighter fiscal policy than is currently projected, in order to ensure the sustainability of government debt and bolster Iceland's creditworthiness. The Central Bank would in this case also have at some point to enter the foreign exchange market and buy significant amounts of foreign currency in order to ensure that foreign exchange reserves do not become dangerously low after big repayments of sovereign debt in the winter of 2011/12. The result would be a lower value of the króna and higher inflation than otherwise. The short-to-medium term objective of the current economic programme of shielding living standards following the collapse of the banking system would thus be jeopardised.

The delay would also lead to less investment and higher unemployment, as any new investment projects would have to be financed through domestic savings, which would only be generated either through a larger contraction in private or public consumption without putting downward pressure on the exchange rate. Moreover, it would be risky to lift the capital controls under these circumstances.

On the other hand, if the capital controls should remain in effect and effective for an extended period, the Committee agreed that it could have some additional room for manoeuvre in its interest rate decisions in favour of the real domestic economy. However, it was important that the Government either secured the Second Review of the IMF programme or decided to follow an alternative plan of action, since following the current programme without the Second Review being completed and the associated external financing could lead to balance of payments problems. One member expressed the view that the design of such an alternative economic programme, based on the assumption of continued lack of access to international capital markets, IMF funding and the Nordic loans, was timely.

Some members of the Committee discussed the possibility that the committee should, in accordance with Article 24 of the Central Bank Act, issue a warning of a serious threat to the financial system. Their concern was the increased likelihood of a prolonged delay in access to external financing because of the delay of the Second Review of the IMF programme. Such a prolonged delay might bring reserves down to critically low levels after big sovereign debt amortisations in 2011 and 2012, which could in turn undermine creditworthiness and the króna. The Committee decided that issuing such a warning was premature. However, it decided to investigate the matter further and study updated detailed balance of payments projections at its next meeting in May.

As before, members agreed that the current state and outlook for the real economy and limited inflation pressures called for lower interest rates, while elevated CDS spreads and a negative rating outlook associated with uncertainty about Iceland's access to global financial markets supported a relatively cautious move this time, due to potential negative pressure on the króna.

Members discussed the possibility of keeping interest rates unchanged or lowering the policy rate by up to 1.5 percentage points. In light of the discussions and the range of views expressed, the Governor proposed a rate cut of 0.5 percentage points. This implied that the deposit rate (current account rate) and the CD rate would be lowered to 7.5% and 8.75%, respectively, the seven-day collateral lending rate to 9.0%, and the overnight lending rate to 10.5%. Although three MPC members would have preferred a slightly different decision, all viewed that the difference was small enough to accept the Governor’s proposal.

Of the three members airing different moves, one suggested a rate cut of 1.0 percentage point, emphasising that a larger cut would facilitate the restructuring of domestic balance sheets by shifting income from creditors to debtors and help offset some of the effects of the fiscal policy contraction under way. The other two members suggested a smaller step, with one suggesting unchanged rates and one suggesting a 0.25 percentage points cut. Both recommended caution, expressing concerns about the near-term inflation outlook.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation continues to subside as forecast, there should be scope for continued gradual monetary easing. However, the MPC stressed that, as long as there is significant uncertainty about Iceland’s future access to foreign capital markets, it will limit the Committee’s room for manoeuvre. Furthermore, the MPC agreed that it should stand 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 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 5 May 2010.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2010

Published: 19 May 2010

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 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 meetings held on 3 - 4 of May 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 5 May, 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 real economy and Iceland's international trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the 17 March interest rate decision, as reflected in the baseline forecast and risk analysis published in *Monetary Bulletin* 2010/2 on 5 May.

Financial markets

The average trade-weighted value of the króna in the onshore market was 0.2% higher at the time of the May MPC meeting than at the March meeting. Between meetings, the króna had appreciated by 1.3% against the euro, but depreciated by 2.9% against the pound, and 1.4% against the US dollar.

The Central Bank has not intervened in the foreign exchange market since early November. Volume in the foreign exchange market has been low, amounting to 3 m. euros in April.

Residents' FX account balances at domestic banks have remained fairly stable since the last MPC meeting.

In the offshore market, the króna had traded at 270-290 against the euro since the last MPC meeting. Trading volume remains low in that market as well.

Risk premia for the Republic of Iceland, as measured by the CDS spread, had subsided since the March meeting, while increasing substantially for many other countries, with increasing concerns about sovereign debt. The CDS spread for the Republic of Iceland was 376 basis points at the May meeting, down from 411 basis points at the March meeting.

Seven auctions of certificates of deposit (CDs) had been held since the March meeting, and about 77.2 b.kr. worth of CDs were outstanding as of the May meeting.

Overnight interbank market rates remained within the Central Bank's interest rate corridor and were 0.5 percentage points above the current account rate as of the May meeting. Trading volume in the interbank market had been 115 b.kr. since the last MPC meeting. Trading is limited, with volumes concentrated in overnight transactions.

The yield in the mid-April Treasury bill auction was 6.74%, compared with 7.75% in the mid-March auction. The yield on T-notes had also declined by 0.6 to 1 percentage points from the March meeting. At the same time, yields on indexed HFF bonds were broadly unchanged.

Since the MPC meeting in March, the Treasury has issued a 12.3 b.kr. worth of a new series of index-linked bonds, RIKS 21 0414. Their average yield in the last auction was 3.69%.

Since beginning of the year, the growth of banknotes and coins in circulation has subsided. Broader money has also started to decline year-on-year, mainly due to a contraction in the shortest-term time deposits. This contraction in money holdings is consistent with the banks' limited lending activity.

With the exception of HFF and pension fund mortgages, data on credit supply is not complete; however, based on the available information, the total stock of bank lending may have decreased in recent months. New HFF lending increased by 6% quarter-on-quarter in Q1/2010 but decreased by a third year-on-year.

Since the March meeting, the change in the monetary stance as measured by the real interest rate had varied, depending on the measure of inflation and inflation expectations. In terms of current inflation, the level of restraint had declined, measuring 0.2%. It had remained broadly unchanged in terms of the breakeven inflation rate in the bond market, which was 4.2%. It had increased in terms of household and corporate inflation expectations, which were 0.1% and 4.0% respectively, and the inflation forecast published in the 5 May *Monetary Bulletin,* which resulted in 2.1% real interest rates.

The risk-adjusted short-term interest rate differential against the major currencies has stayed broadly unchanged or decreased slightly since the last MPC meeting.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in April 2010, global growth is expected to reach 4.2% in 2010, which is similar to the IMF forecast published in January 2010. The forecast for output growth in Iceland's main trading-partner countries is also unchanged at 1.3% in 2010. However, world trade has been revised upwards and is now expected to grow by 7% this year, 1.2 percentage points higher than in the previous forecast. This revision is due mainly to a projected rise in trade volumes in emerging and developing economies.

The merchandise trade surplus in Iceland was roughly 14 b. kr. in February and 11.5 b.kr. in March. The merchandise trade surplus in Q1/2010 was 32 b.kr., 3% larger than in the same quarter in 2009.

Export values in domestic currency, excluding irregular items such as aircraft and ships, increased by 2% quarter-on-quarter in Q1/2010 and were 18% higher than in the same quarter in 2009. The value of imports in domestic currency declined by 3% quarter-on-quarter in Q1, due to a fall in imports of consumer goods and a substantial decline in imports of transport equipment. The value of imports rose by 27% year-on-year in March, reaching 41.4 b.kr. The value of imports has not been this high in a single month since October 2008.

In March, nominal exports of aluminium increased by 12% month-on-month, as aluminium prices have continued to rise. Quarter-on-quarter, nominal exports of aluminium rose by 14%, while nominal exports of marine products fell by 9%. In total, nominal exports of industrial products increased by 11% quarter-on-quarter in Q1/2010.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey, labour force participation was unchanged year-on-year in Q1/2010, as was the average work week. The decline in total hours worked was much smaller than it has been since the onset of the crisis, or 2.2% year-on-year, after a 6.7% drop in Q4/2009 and an 11% fall in 2009.

The wage index rose by 0.5%, month-on-month, in February and by 0.1% in March. Wages increased by 3.5%, year-on-year, in Q1/2010, and real wages fell by 3.7%

Registered unemployment rose from 7.9% in Q4/2009 to 9.2% in Q1/2010. According to the labour force survey, unemployment was 7.7% in Q1/2010, up from 6.7% in Q4/2009.

Indicators suggest that the labour market may soften somewhat further. According to the Capacent Gallup business sentiment survey carried out among Iceland's 400 largest firms, more firms intend to lay off staff in March than in a comparable survey carried out in December, and more are considering adding on staff. An April 2010 survey conducted by the Confederation of Icelandic Employers among its members also indicated that companies planning layoffs outnumber those planning new recruitment. It is estimated that the net reduction in staffing could amount to about 1,500 employees during the year.

A number of economic indicators, such as payment card and groceries turnover, as well as retail sales, suggest that domestic private consumption remained broadly unchanged between Q4/2009 and Q1/2010, while seasonally adjusted payment card turnover abroad rose for the second consecutive quarter, by roughly one-fifth.

After staying almost unchanged in March, the consumer sentiment index increased by 11 points in April, measuring over 50 points for the first time since October 2008. All sub-indices rose, led by the sub-index for expectations about the future economic situation.

According to the Capacent Gallup business sentiment survey in February and March, executives continue to be downbeat about the current economic situation. While roughly 86% of firms considered the current economic situation bleak, they were less pessimistic about the outlook six months ahead than they were in December. In March, around 25% of companies believed that the economic situation would improve in six months' time, compared to 18% in December, and 26% of companies expected further deterioration of the economic situation, down from 43% in December. Roughly one-fourth of companies expected domestic demand to decline over the next six months, down from 42% in December, and slightly more companies expected domestic demand to strengthen, or one-fifth. One-third of companies expected profits in 2010 as a share of turnover to be less than in 2009. Executives of export firms were less pessimistic than executives of firms selling in the domestic market.

Inflation expectations one year ahead had fallen. According to an inflation expectations survey conducted by Capacent Gallup in February and March, the median household expects inflation over the next twelve months to be 8%, which is 2 percentage points lower than in the last survey in December. Household inflation expectations have not fallen below 10% in the last two years. Household expectations for inflation two years ahead have increased, however, since the last survey in December. Households now expect inflation to be 6.5% in two years' time, as opposed to roughly 6% in December.

According to the Capacent Gallup business sentiment survey, firms' inflation expectations had decreased since December, with the median company expecting 4% inflation over the next twelve months, compared to 6% in the December survey. Inflation expectations 24 months ahead remained broadly unchanged since the survey in September, with the median company expecting 5% annual inflation in two years' time.

Based on the spread between nominal and index-linked bonds with a three- to four-year maturity, the breakeven inflation rate in the bond market has declined markedly. At the May MPC meeting, the breakeven rate measured 1.7%, as opposed to 2.7% in March. Long-term (five-year/five-year forward) inflation expectations from the bond market have also declined and are now consistent with the inflation target, after rising temporarily during and after the financial crisis.

Annual inflation declined slightly in April, measuring 8.3%, as the CPI rose by 0.25% month-on-month. Underlying inflation, measured by the CPI excluding tax effects, was 6.9% year-on-year. Annualised seasonally adjusted three-month inflation measured 7.2% in April, compared to 7.9% in March.

Domestic goods and services contributed most to inflation in April. Food and beverage prices accounted for 0.17 percentage points of the increase in the CPI, due mainly to a 2.2% increase in agricultural products and vegetables. Prices of private services contributed to 0.1 percentage points, reflecting a roughly 2% increase in phone services and a 0.5% increase in hotel and restaurant services. Prices of various imported goods other than food, beverages and transport items declined in April.

The housing component rose by 0.3%, reflecting a 0.6% increase in housing repair costs and a 1.8% increase in paid rent, whereas owner-imputed rent decreased slightly. The increase in paid rent is mostly due to the large share of rental contracts that are indexed to inflation.

The Statistics Iceland housing price index for the entire country, published in April, rose by 0.1% from the month before. The housing price index for the greater Reykjavík area, calculated by the Icelandic Property Registry, rose by 0.5%, but adjusted to seasonality it increased by 0.2%. Housing market turnover remains limited.

The updated baseline forecast, published in the 5 May issue of *Monetary Bulletin*, indicates that the contraction in GDP will be one percentage point smaller in 2010 than was forecast in January, or 2½%, with the recently published national accounts showing a somewhat stronger performance in late 2009 and leading indicators suggesting a continuation of that development for the beginning of 2010. On the other hand, the outlook is for recovery to begin in Q3/2010, one quarter later than was forecast in January. The growth outlook for 2011-2012 is similar to that in the January forecast, about 3½% in 2011 and 2% in 2012.

The delay in recovery this year is due in large part to weaker investment than previously assumed, owing primarily to further delays in aluminium and power sector projects, although other business investment will also contract more than was assumed in January. Total investment is projected to contract by just over 10% this year, but as aluminium and power sector projects are expected to commence in 2011, growth in total investment is estimated to approach 25% in 2011. The forecast for 2012, however, is broadly unchanged.

The outlook for private consumption in 2010 has improved since January because of a more advantageous initial position in Q4/2009. It is now estimated that private consumption will grow by just over 1% this year instead of contracting by that amount. The outlook for private consumption in 2011 and 2012 is broadly in line with the January forecast, and assumes that private consumption will grow by 3-4% per year.

Developments in public consumption are projected to be similar to the last forecast. However, new figures from Statistics Iceland suggest that the contraction was considerably more pronounced in 2009 than previous figures indicated. The need for fiscal tightening this year will therefore be slightly less than previously thought, and it is assumed that the resulting leeway will be used to support economic recovery. Indirect tax increases will thus be smaller than projected in January during the forecast horizon.

On the whole, the outlook is for domestic demand to contract somewhat less in 2010 than forecast in January, or by just under 2% rather than nearly 3%. Domestic demand growth is also estimated to be somewhat more in 2011. More robust domestic demand will lead to stronger recovery in imports in 2010 and 2011. A stronger króna and accumulation of inventories following destocking by importers enhance the effect.

The króna had strengthened somewhat since the last *Monetary Bulletin*, and exchange rate developments are currently forecasted to be similar to those in the January forecast, although the króna is expected to be 3% stronger on average than was envisaged then.

A considerable surplus has already emerged in the trade account and the current account balance, excluding accrued interest expenses related to the settlement of banks in winding-up proceedings. A trade surplus of 9-10% of GDP is expected in 2010-2012.

The fall in employment in 2009 is more than was assumed in the January forecast. It is now thought that employment declined by about 10% year-on-year in 2009, whereas the January forecast projected a contraction of 7%. Because employment contracted more than GDP did last year, labour productivity increased by 2½%.

Wage costs on a national accounts basis rose by just under 1% in 2009, as opposed to the 5% envisaged in the January forecast. Unit labour costs therefore contracted slightly instead of the estimated rise of nearly 7% in the January forecast. Greater productivity growth will raise unit labour costs by one percentage point less in 2010 than was assumed in the last forecast. Larger nominal wage rises in the latter part of the forecast period and a somewhat smaller increase in productivity at the end of the period imply that unit labour costs will rise by 4½% in 2012, which is somewhat more than previously anticipated.

Employment is forecast to continue declining until mid-2011. Unemployment is projected to be in line with the January forecast, and will remain high throughout 2010, and begin to taper off early next year.

Inflation was higher than anticipated in January, measuring 7.4% in Q1/2010, as opposed to 7.1%, and the outlook is for inflation to be somewhat higher in Q2 as well. Significant spare capacity and the relative stability of the króna will ensure that underlying inflation will decline rapidly in 2010 and reach the inflation target in Q1/2011, one quarter later than in the January forecast. Headline inflation is forecast at 6.2% in 2010 and about 3% in 2011, and looks set to approach the inflation target towards the end of 2011.

The output slack is forecast to be smaller than assumed in January, peaking in mid-2010 at just under 5% of potential output. As before, the slack is expected to diminish gradually and disappear in early 2013.

II The interest rate decision

The Governor informed the MPC of the results of the Second Review and the IMF Stand-By Arrangement and associated funding, as well as the status of the dispute over compensation to depositors in foreign branches of Landsbanki. The MPC was also informed of the recent steps in the financial sector restructuring process.

The Committee noted that the króna had been broadly unchanged in trade-weighted terms in the onshore market since the last MPC meeting, but had appreciated against the euro without any Central Bank intervention in the FX market. Furthermore, sovereign risk premia had come down, although they were still high due to remaining uncertainty concerning Iceland’s medium-term access to global financial markets and possible contagion from the European sovereign debt crisis. In the MPC’s view, the króna continued to be supported by the capital controls, more favourable current account developments, and the interest rate differential with major currencies.

As the Committee had expected, inflation picked up in February and March, partly due to unfavourable base effects, but resumed a downward trend in April. Inflation measured 8.3% year-on-year, or 6.9% excluding the impact of higher consumption taxes. Furthermore, the medium-term inflation outlook remained broadly in line with the January forecast, according to the forecast published in the *Monetary Bulletin*

2010/2 on 5 May. As before, underlying inflation is expected to reach the target late this year. The forecast is based on the assumption of a gradually strengthening króna, which is expected to be slightly stronger, on average, in the onshore market over the medium term than in the January forecast. Some members expressed concerns over the risk of second-round effects on inflation from wage pressures caused by rising profitability in the traded goods sector, while one member argued that there was only a modest risk of second-round effects on inflation as long as the unemployment rate remains high.

The MPC noted that, according to the May forecast, growth of fixed investment will be weaker in 2010 due to delays in aluminium sector-related projects and slower recovery of other business investment. On the other hand, private consumption had stabilised at an earlier stage of the cycle, and the output contraction in 2009 had turned out smaller than previously forecast.

The Committee discussed the change in the monetary stance from the March meeting. The change in the real interest rate differed depending on the measure of inflation. The level of restraint had diminished measured by past inflation, stayed broadly unchanged measured by the breakeven inflation rate in the bond market, and increased measured by household and corporate inflation expectations and the inflation forecast published in the 5 May *Monetary Bulletin*. The range was from slightly negative measured by past inflation to around 4% measured by corporate inflation expectations and the breakeven inflation rate in the bond market. The MPC also noted that the risk-adjusted short-term interest rate differential against major currencies had stayed broadly unchanged or decreased slightly since the last MPC meeting, and was currently at 3 percentage points when using the CDS spread as a measure of the risk premium.

Members discussed the possibility of lowering the policy rate by 0.5 to 1.5 percentage points. As before, members agreed that a forecast of reduced inflation in the context of a weak economy was an argument for a reduction in interest rates. Furthermore, since the last MPC meeting, the Second Review of the IMF programme had been approved. Concerns about the Icelandic Government's ability to service its external debt falling due in 2011 and 2012 should therefore be alleviated, and further delay in resolving the Icesave dispute is less likely than before to affect Iceland's credit rating.

The MPC stated, however, that the removal of capital controls, which have shielded the króna from the effects of delays in the past, would be risky until access to further programme financing is guaranteed. The planned liberalisation of capital controls was therefore likely to be delayed until an agreement is in place, or after the Third Review.

The Committee discussed several opposing factors that still called for more cautious steps. The recovery of the króna had been weak since the last interest rate decision. The CDS spread remained high, although it had come down significantly since early in 2010 and was only modestly affected by the turmoil stemming from Greece's fiscal problems. The MPC agreed that, while the credit rating outlook had stabilised, there were still residual uncertainties concerning Iceland's access to global financial markets.

In light of the discussions and the range of views expressed, the Governor proposed a rate cut of 0.5 percentage points. This implied that the deposit rate (current account rate) and the CD rate would be lowered to 7.0% and 8.25%, respectively, the seven-day collateral lending rate to 8.5%, and the overnight lending rate to 10.0%. Although two

MPC members would have preferred to take a larger step this time, all viewed that the difference was small enough to accept the Governor's proposal.

Of the two members wanting to take larger steps, one suggested a rate cut of a 0.75 percentage points, citing a more positive outlook after the completion of the Second Review of the IMF programme, as the financing associated with the Review was secured although he argued that it had not been fully priced in by the markets. With that more fully priced in, the risk adjusted interest rate differential with major currencies would be more than needed to support exchange rate stability. Given that the monetary policy stance was significantly tighter than warranted by inflation prospects and domestic economic conditions, this implied room of manoeuvre could be used for a somewhat bigger cut in interest rates. The other member suggested a 1.0 percentage point cut, emphasising that the real economy, as well as domestic balance sheet restructuring, called for a larger reduction of interest rates. Furthermore, the calculation of real interest rates as the difference between nominal rates and past inflation underestimated the contractionary effect of the monetary policy stance, as measured inflation mainly reflected changes in the price of imports, which were becoming relatively more expensive. This member also argued that the current short-term interest rate differential was unnecessarily large.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation continues to subside as forecast, there should be scope for continued gradual monetary easing. The MPC noted, however, that although the uncertainty about Iceland's future access to foreign capital markets is less than before the Second Review, some uncertainty still exists and will limit the Committee's room for manoeuvre. Furthermore, the MPC agreed that it should stand 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 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 23 June 2010.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

June 2010

Published: 7 July 2010

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 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 22 June 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 23 June 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 real economy and Iceland's international trade, the domestic real economy and inflation, with emphasis on information that has emerged since the interest rate decision on 5 May.

Financial markets

The average trade-weighted value of the króna in the onshore market was 5% higher at the time of the June MPC meeting than at its May meeting. Between meetings, the króna had appreciated by 6% against the euro, 4.1% against the pound sterling and 1.4% against the US dollar.

The Central Bank has not intervened in the foreign exchange market since early November. The volume of trading in the foreign exchange market has picked up recently and amounted to 19.5 m. euros since the May meeting.

Residents' FX account balances in domestic banks have decreased slightly since the last MPC meeting, which can probably be attributed to the appreciation of the króna against the euro.

In the offshore market, trading volume has been low since the last MPC meeting and the króna continued to trade at 270-290 against the euro, although it has appreciated in the offshore market to 235-255 following the announcement on 31 May that pension funds would buy Housing Finance Fund bonds from the government and the announcement on 9 June of a bilateral swap agreement between the People´s Bank of China and the Central Bank of Iceland.

Risk premia for the Republic of Iceland, as measured by the CDS spread, had subsided since the May meeting. The CDS spread for the sovereign was 327 basis points at the June meeting, down from 376 basis points at the May meeting. This has occurred despite a concurrent rise in CDS spreads for many European countries reflecting the European debt crisis.

An invitation was issued by the Central Bank on 16 June to buy back foreign currency bonds due in 2011 and 2012. At the MPC meeting it was announced that the buybacks would total 160 m. and 32 m. euros nominal value of the respective series. Over the past six months the Central Bank had already acquired notes from the same series on the secondary market. Total purchases, including the buybacks in June, amount to 362 m. and 42 m. euros nominal value of the respective series. This will reduce the outstanding stock of foreign currency bonds maturing in 2011 and 2012 by 404 m. euros.

Seven auctions of certificates of deposit (CDs) had been held since the May meeting, and about 101.2 b.kr. worth of CDs were outstanding as of the June meeting.

Overnight interbank market rates remained within the Central Bank's interest rate corridor and were 0.5 percentage points above the current account rate as of the June meeting. Trading volume in the interbank market since the last MPC meeting remains relatively low, at 52 b.kr. and is concentrated in overnight transactions.

The yield in the mid-June Treasury bill auction was 5.95%, compared with 6.74% in the mid-April auction. The yield on Treasury notes had also declined by 0.39-0.52 percentage points from the May meeting. At the same time, yields on indexed HFF bonds had declined by 0.37-0.41 percentage points.

Revised data on money holdings in March 2010 shows that the money supply has contracted since the beginning of the year, with narrow money (M1) contracting by 5% and broad money (M3) by 2%, consistent with the bank's limited lending activity. The year-on-year increase is 3% in both cases.

New preliminary figures on the banking system have now been published. Deposit institutions´ total assets amounted to 2,956 b.kr. at year-end 2009, as opposed to 14,895 b.kr. at the end of September 2008. Loans accounted for approximately 70% of total assets at the end of 2009. As of year-end 2009, deposit institutions' loans to residents totalled just under 1,769 b.kr., decreasing from 4,786 b.kr. at the end of September 2008. Changes in residents´ deposits have been much less. Since September 2008 residents´ deposits have increased by 167 b.kr. to total 1,580 b.kr. at year-end 2009.

Outlook for the global real economy and international trade

According to the latest OECD forecast, published in May 2010, growth in OECD countries is expected to reach 2.7% in 2010, which is higher than in the OECD forecast published in November 2009. The forecast for average output growth in Iceland's main trading-partners is also somewhat higher, at 1.5% in 2010. Furthermore, the forecast for world trade has continued to be revised upwards and trade is now expected to grow by 10.6% this year, 4.6 percentage points more than in the previous forecast, and 3.6 percentage points more than IMF assumed in their latest forecast in April 2010. This revision is due mainly to a very strong start to the year.

The merchandise trade surplus in Iceland was roughly 6 b.kr. in April but rose to 16.8 b.kr. in May, according to preliminary figures, due primarily to a substantial increase in exports. The merchandise trade surplus in the first five months of the year was 52 b.kr., 51% larger than in the same period in 2009.

The króna value of exports increased by 25% year-on-year in April, with the value of all main export products rising significantly. According to preliminary data, exports increased even further in May and were 39% higher than a year ago. The króna value of imports increased by 6% year-on-year in April, due to an increase in imports value of capital goods and industrial supplies. According to preliminary figures, króna value of imports grew by almost 16% year-on-year in May, with increases recorded in most components.

The price of aluminium peaked in mid-April and has since fallen somewhat; at the beginning of June aluminium prices were 10% lower than in April and 5% lower than in May. Nominal exports of aluminium fell by 39% in April, due to fewer shipments that month than in a normal month.

The domestic real economy and inflation

Preliminary quarterly national accounts figures for Q1/2010 were broadly in line with the Central Bank's May forecast in *Monetary Bulletin* 2010/2, although the figures suggest that economic activity was slightly weaker than predicted. Q1 data, however, tends to be revised substantially after its first preliminary publication.

The contribution to GDP quarterly growth in Q1/2010 (seasonally adjusted) was positive from both private and public consumption, while the contribution from gross fixed capital formation and net trade was negative. Private consumption grew for the third consecutive quarter, rising by 2.7% quarter-on-quarter. Public consumption grew by 0.2% quarter-on-quarter, after declining for the whole of 2009. Exports, on the other hand fell by 9.4%, resulting in a negative contribution from net trade of 4.9%.

Statistics Iceland numbers indicate that seasonally adjusted GDP grew by 0.6% quarter-on-quarter in Q1, while Central Bank of Iceland seasonally adjusted figures suggest that GDP was still contracting between quarters in Q1, in line with the May forecast. Thus, the interpretation of the Q1 GDP data and the perceived timing of the recovery critically depends on the seasonal adjustment method used.

The current account deficit was 27 b.kr., or 7.2% of GDP, in Q1/2010. This is a reversal from the previous quarter, when the current account was positive by 6% of GDP. In Q1-Q3 2009, the deficit amounted to 6-8% of GDP. Although the current account deficit is mainly due to a 54 b.kr. income account deficit, the services account was also negative by 3.6 b.kr. The merchandise account, on the other hand, remained positive, as in previous quarters, in the amount of 31 b.kr.

The current account deficit excluding accrued interest arising from the ongoing winding-up proceedings of the failed DMBs, was much smaller or 0.7% of GDP in Q1/2010.

Registered unemployment fell from 9.3% in March to 8.3% in May. Unemployment usually declines in April and May, although other factors also appear to be involved here. The fall in unemployment may also reflect changes in methods of calculating unemployment and changes in entitlement to unemployment benefits.

Indicators suggest that the labour market may soften somewhat further. According to the Capacent Gallup business sentiment survey carried out among Iceland's 400 largest companies, with the exception of the wholesale sector, more firms in all sectors expected to lay off staff in June than in a comparable survey carried out in March, and a proportion similar to that of the March survey are considering hiring staff. The wage index rose by 0.1% month-on-month in April and by 0.2% in May.

A number of indicators, such as payment card and groceries turnover, as well as retail sales, suggest that domestic private consumption weakened somewhat in April and May from Q1/2010, and residents' seasonally adjusted payment card turnover abroad has started to decline month-on-month. Nevertheless, the Consumer Confidence Index increased by further 2.7 points in May to its highest level since the onset of the financial crisis.

According to the Capacent Gallup business sentiment survey in June, executives continue to be pessimistic about the current economic situation. While 87% of firms' executives considered the current economic situation bleak, they were less pessimistic about the outlook six months ahead than they were in March. In June, roughly 30% of executives believed that the economic situation would improve in six months' time, compared to 25% in March, while 28% of executives expected further deterioration of the economic situation, slightly higher than in March. Despite the improved overall outlook among businessmen they were more pessimistic concerning domestic demand. Roughly 30% of executives expected domestic demand to decline over the next six months, compared to 27% in March, and only 17% of respondents assume it will increase. Also according to the survey, corporate inflation expectations have continued to decrease, with the median company expecting 3% inflation over the next twelve months, or 1 percentage point lower than in the March survey.

Annual inflation continued to decline in May, measuring 7.5%, as the CPI rose by 0.41% month-on-month. Underlying inflation, measured by the CPI excluding tax effects, was 6.1% year-on-year. Annualised seasonally adjusted three-month inflation measured 3.6% in May, compared to 7.1% in April.

Base effects played a significant part in the annual measure in May as the May 2009 increase of 1.1% disappeared from twelve-month measurements. Cost of owner-occupied housing rose by 1.2%, the highest month-on-month since October 2009, and reverses the steady downward trend since that month. Prices of various other components increased in May mainly due to seasonal effects.

The appreciation of the króna since January has affected prices of imported goods to some extent. Prices of groceries decreased by 0.6% in May mainly reflecting price decreases for domestic food products.

II The interest rate decision

The Governor informed the MPC of the status of the dispute over compensation to depositors in foreign branches of Landsbanki. The MPC was also informed of the recent steps in the financial sector restructuring process, the Supreme Court ruling on the legality of FX-linked loans, the agreement with the Banque centrale de Luxembourg and the liquidator of Landsbanki Luxembourg SA, concerning the purchase of outstanding Avens BV bonds, the decision to buy back some of the outstanding euro notes due in 2011 and 2012, the request to draw on bilateral credit lines negotiated with the other Nordic countries and Poland, and the signing of a bilateral currency swap agreement between the People´s Bank of China and the Central Bank of Iceland.

The Committee discussed the strategy for relaxing capital controls and the need to replace borrowed reserves with non-borrowed reserves. The appreciating króna and lower external risk premia could allow modest regular purchases of foreign currency. The committee was of the view that it was important that the timing and quantity of such purchases would be conducted so as to minimise the effect on the króna. Furthermore, the committee agreed that no decision on such purchases would be taken before the August MPC meeting.

The Committee noted that the króna had strengthened, both in trade-weighted terms and against the euro, in the onshore market since the last MPC meeting, without any Central Bank intervention. Furthermore, Icelandic sovereign risk premia have fallen since the last MPC meeting. In the MPC's view, the króna continued to be supported by the capital controls, current account developments and the risk-adjusted interest rate differential with major currencies.

As the Committee had expected, inflation declined in May. Furthermore, this was broadly in line with the forecast published in the *Monetary Bulletin* 2010/2 on 5 May. Inflation excluding consumption tax effects is expected to reach the target early next year. All members agreed that the macroeconomic outlook was broadly unchanged from the last meeting.

The Committee also discussed the possible macroeconomic effects of the Supreme Court ruling on the legality of FX-linked loans. The committee was of the view that in the short term this might boost private consumption, but that offsetting negative effects on aggregate demand are likely over the medium term due to a greater fiscal burden and the negative effects on bank balance sheets. This would reduce their readiness and ability to supply new credit to the private sector and their capacity to continue ongoing debt restructuring. There was therefore a risk that the ruling could slow the economic recovery. The Committee agreed that the ruling could also have financial stability implications and if not resolved promptly, could undermine confidence and further constrain monetary policy.

The Committee discussed the evolution of the real stance on monetary policy as measured by real policy rate and the risk-adjusted interest rate differential with major currencies. Overall, its stance was deemed to be broadly unchanged or to have tightened somewhat, depending on different measures of the policy stance.

In light of the discussion, Committee members discussed the possibility of keeping the policy rate unchanged or lowering the policy rate by up to 0.75 percentage points. As before, members agreed that a forecast of declining inflation in the context of a weak economy was an argument for a reduction in interest rates. Furthermore, the improving current account, declining CDS spreads, rising risk-adjusted interest rates and the appreciation of the króna provided scope for continued cautious easing of monetary policy.

The MPC noted, however, the need to take into account the planned removal of capital controls. Furthermore, the MPC was of the view that uncertainty arising from the Supreme Court ruling could affect confidence in the króna and public finances. This argued for smaller rate cuts than otherwise would be advisable.

In light of the discussion and the range of views expressed, the Governor proposed a rate cut of 0.5 percentage points. This implied that the deposit rate (current account rate) and the CD rate would be lowered to 6.5% and 7.75%, respectively, the seven-day collateralised lending rate to 8.0%, and the overnight lending rate to 9.5%. All the MPC members accepted the Governor's proposal. Although two MPC members would have preferred a slightly different decision, their view was that the difference was small enough to accept the Governor's proposal.

Of the two members favouring a different action, one suggested a rate cut of a 0.25 percentage points, arguing that the true risk premium on Icelandic assets was underestimated by the CDS spread and that scope for easing without undermining the króna was therefore less than suggested by the CDS spread. The other member argued that the declining inflation rate reflected the final stages of the exchange rate pass-through following the weakening of the króna last year. With falling inflation, steady inflation expectations, and the króna appreciating, an interest rate cut of 0.75 percentage points would therefore be warranted. This member also added that the uncertainty created by the recent Supreme Court ruling could deepen the financial crisis by weakening the banking system, favouring lower rates, but could also magnify the currency crisis, making higher rates advisable. However, this member argued that the effect on the currency crisis would be best dealt with by through capital controls, enabling lower interest rates to respond to the financial crisis.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation develops as forecast, there should be some scope for continued gradual monetary easing. It was noted, however, that the room for manoeuvre is limited by remaining uncertainty concerning Iceland´s medium-term access to global financial markets and the prospect of capital account liberalisation. The additional uncertainty caused by the recent Supreme Court ruling on the legality of FX-linked loans could, if not resolved promptly, undermine confidence and further constrain monetary policy. Furthermore, the MPC agreed that it should stand ready to adjust its 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 Anne Sibert, external member

Professor Gylfi Zoëga, external member

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

Regína Bjarnadóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday, 18 August 2010.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

August 2010

Published: 1 September 2010

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 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 16-17 August 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 18 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 real economy and Iceland's international trade, the domestic real economy and inflation, with emphasis on information that has emerged since the interest rate decision on 23 June, as reflected in the updated forecast published in *Monetary Bulletin* 2010/3 on 18 August.

Financial markets

The average trade-weighted value of the króna in the onshore market was 2.6% higher at the time of the August MPC meeting than at its June meeting. Between meetings, the króna appreciated by 2.2% against the euro, 0.8% against the pound sterling, and 7.1% against the US dollar.

The Central Bank has not intervened in the foreign exchange market since early November. The volume of trading in the foreign exchange market has been extremely low during the summer holiday season, amounting to 8 m. euros since the June meeting.

Since the last MPC meeting, residents' FX account balances in domestic banks have declined, due to the appreciation of the króna and debt restructuring measures within the banks.

In the offshore market, trading volume picked up over the summer and the appreciation that had begun in early June continued. The króna has traded at 215-220 against the euro since mid-July.

Risk premia for the Republic of Iceland, as measured by the CDS spread, has been broadly stable since the June meeting. The CDS spread fell below 300 basis points before rising again following international developments. The CDS spread for the sovereign was 320 basis points at the August meeting, compared to 327 basis points at the June meeting. The results of the Central Bank's buy back in June of government bonds expiring in 2011 and 2012 implied a cash-market risk premium of 570 basis points on these bonds.

About 73 b.kr. worth of certificates of deposit (CDs) were outstanding as of the August meeting, compared to 101 b.kr. at the June meeting.

Overnight interbank market rates were 0.5 percentage points above the current account rate as of the August meeting. Trading volume in the interbank market has been steady at 52 b.kr. since the last MPC meeting, concentrated in overnight transactions.

The yield in the mid-August Treasury bill auction was 4.68%, compared with 5.49% in the mid-July auction and 5.95% in the June auction. The yield on long Treasury bonds had declined by 0.26-0.09 percentage points since the June meeting. At the same time, yields on indexed HFF bonds had gone up by 0.05-0.1 percentage points, except for the shortest bond, which declined by 0.08 percentage points from the June meeting.

Preliminary figures on the banking system show that total assets of deposit money banks amounted to roughly 2,959 b.kr. at the end of May. Lending to residents amounted to 1,717 b.kr., including nearly 503 b.kr. to households and 1,091 b.kr. to companies. Total liabilities amounted to 2,577 b.kr., including almost 1,503 b.kr. in deposits held by residents.

The lending position to residents has decreased by almost 1% from March, due primarily to a 1.2% decrease in lending to companies. Foreign currency-denominated loans have declined by 3.2%, mainly due to the appreciation of the króna. Non-indexed loans have risen by 6.5%, in part due to restructuring measures involving conversion of foreign currency-denominated loans to domestic currency loans. Even though these figures should be interpreted with caution, as they are preliminary and are strongly affected by the restructuring of the banking system, they do indicate that credit growth is limited or non-existent. This suggestion is supported by money supply figures, with broad money (M3) contracting by nearly 5% from year-end 2009 to end-May 2010 – mainly due to a decline in domestic FX accounts.

Since the announcement of the MPC decision on 23 June, the change in the monetary stance as measured by the real interest rate depends on the measure of inflation and inflation expectations. In terms of current inflation and the Central Bank inflation forecast for the next six months published in the 18 August *Monetary Bulletin*, the level of restraint had increased markedly, or by around 2.5 percentage points, but in terms of one-year ahead inflation expectations (for households, firms and the bond market) it remained unchanged. This was also broadly true for the risk-adjusted short-term interest rate differential with main trading partners.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in July, global growth is expected to reach 4.5% in 2010, which is 0.5 percentage points higher than in the IMF forecast published in April 2010. Furthermore, the forecast for world trade continues to be revised upwards, and the IMF now expects trade to grow by 9% this year, 2 percentage points more than in its April forecast. The latest OECD forecast, published in May 2010, projects 10.6% growth in world trade this year. The IMF forecast for economic growth and world trade in 2011 is unchanged.

Iceland's merchandise trade surplus was 8.7 b.kr. in June, somewhat below the average for 2010. The trade surplus measured 35 b.kr. in Q2/2010, increasing by 9% quarter-on-quarter. According to preliminary numbers, the trade surplus fell to 4.5 b.kr., although the trade balance was positive for the first time in July since 1995.

The króna value of exports increased by 28% year-on-year in June, led by a 55% rise in the export value of aluminium. According to preliminary data, exports continued to increase in July and were 16% higher than a year ago. The króna value of imports rose by 23% year-on-year in June, as the value of imports in all categories increased, with the strongest increase coming from imports of capital goods, which rose by 50% year-on-year. According to preliminary figures, króna import values grew by 4% year-on-year in July, with increases recorded in most major components apart from consumer goods.

The price of aluminium had risen since the time of the June MPC meeting and, at the beginning of August, was 12% higher than in June. The value of marine product exports had also been on the rise, increasing by 1.5% month-on-month in June.

The domestic real economy and inflation

The labour market survey conducted by Statistics Iceland in Q2/2010 indicated that the labour market has already begun to recover. Demand for labour increased on all measures in Q2/2010, for the first time since 2007. Employed persons as a share of the population aged 16-74 rose by 1.6 percentage points year-on-year, and total hours worked rose by 1.1% due to an increase in hours worked and the number of persons at work. The increase was most prominent in the oldest and youngest age groups, whereas the core age group (25-54 years) saw a decrease.

Registered unemployment was 7.6% in June and 7.5% in July, down from 8.3% in May and 9.3% in March. Seasonally adjusted unemployment has remained broadly stable at around 8% since April, but inched upwards to 8.3% in July.

The wage index rose by 2.2% month-on-month in June, due to a contractual wage increase taking effect on 1 June in the labour market as a whole. Nominal wages rose by 6.1% year-on-year. As a result of this wage increase and the 0.3% decrease in the CPI in June, real wages rose for the first time since January 2008, by 2.6% month-on-month and 0.3% year-on-year.

Indicators of demand differ as to where private consumption is heading. Payment card turnover and retail sales suggest that private consumption continued to shrink in Q2/2010. On the other hand, consumer goods imports have been growing. Furthermore, consumer expectations appear to have improved over the summer, and quarterly results from a June survey of expected purchases of real estate, motor vehicles, and travel showed an increase in households' expected purchases, mostly of motor vehicles.

The consumer sentiment index has continued to increase in recent months, rising to a post-crisis peak in July. Moreover, the sub-index measuring expectations toward the economic situation six months ahead exceeded 100 points for the first time since May 2008, indicating that more respondents were positive regarding the future economic situation than negative.

Statistics Iceland's nationwide housing price index, published in July, declined by 0.5% from the month before. The housing price index for the greater Reykjavík area, calculated by the Icelandic Property Registry, fell by 0.7% in June and by 0.4% adjusted to seasonality. Activity in the real estate market has picked up somewhat. Accumulated turnover in June was about 19% higher than in June 2009, although turnover remains very low in a historical context.

In Capacent Gallup's June survey among households, inflation expectations were unchanged since April, at 8%. On the other hand, household expectations of twelve-month inflation two years ahead had risen to 7% in June, as opposed to 6.5% in the last survey.

Inflation has abated rapidly since the MPC's June meeting. The consumer price index (CPI) fell by 0.66% in July, following a 0.33% decline in June. Twelve-month inflation measured 4.8% in July, and 4% excluding indirect tax effects. Seasonally adjusted, the CPI fell by 0.58% in the last three months, which is a 2.3% decline on an annual basis.

The decline in the CPI in June was due mainly to a 5.9% decrease in petrol and oil prices owing to a temporary price war between oil companies. Price decreases of domestic food and beverages also had a strong effect on the CPI in June, while prices of various other domestic items, such as private services, increased by 0.7% in June. Base effects played a significant part, as the June 2009 rise in the CPI of 1.4% disappeared from twelve-month measurements. The main factor contributing to the July decline in the CPI was stronger-than-expected summer sales. The effect on the CPI was -0.68 percentage points, well in excess of the five-year average of -0.46 percentage points. Exchange rate pass-through due to the strengthening of the króna has emerged slowly in recent months, mostly in prices of groceries and petrol. The housing component increased by 0.4% in June but declined by 0.02% month-on-month in July.

The updated forecast, published in the 18 August issue of *Monetary Bulletin*, assumes that this year's contraction in GDP will be 1.9% in 2010, roughly half a percentage point less than was projected in May. GDP is forecasted to return to year-on-year growth in Q3/2010, for the first time since Q2/2008. The improved outlook is attributable in large part to a smaller contraction in investment than previously assumed, in spite of further delays in energy-intensive industrial investment.

The contraction in domestic demand is estimated to be about one percentage point less in 2010 than was forecast in May, and because of the negative contribution from external trade, the contraction in GDP will be greater than it would otherwise have been.

On the other hand, the GDP growth outlook for the next two years has deteriorated slightly since May. Output is now expected to grow by 2.4% for 2011, instead of the 3.4% forecast in May, and to grow by 1.7% in 2012, as compared to 1.9% according to the May forecast. These changes are due largely to less growth in domestic demand in 2011 and weaker exports in 2012, the latter of which is due to delays in industrial investment projects.

Private consumption growth is expected to be around half a percentage point weaker in 2010 than was assumed in the May forecast. This is in line with high-frequency indicators of private consumption developments, although these indicators are not unambiguous. The forecast for the next two years, however, is broadly in line with the May forecast.

Indicators imply that general business investment has begun recovering. Imports of investment goods increased significantly in Q2/2010, after contracting without interruption since 2006. The updated forecast assumes that general business investment will grow by about 15% in 2010, while the last forecast suggested a rise of only 8.4%. The outlook for general business investment in 2011, however, is similar to that in the May forecast, and business investment as a share of GDP is expected to have risen to its long-term average level by the end of the forecast horizon.

Because of stronger business investment and a smaller contraction in residential and public investment, gross capital formation is estimated to shrink by just under 4% this year, whereas the May forecast assumed a contraction of over 10%. The outlook for general investment in 2011 is broadly unchanged from the May forecast, while stronger growth is projected for 2012, with a greater share of energy-intensive investment shifting to that year.

Developments in public consumption are expected to be similar to the last forecast. Public consumption will contract by about 2½-3½% per year during the forecast horizon, and public expenditure will contract until 2012. It is assumed that public sector finances will be broadly in line with the May forecast, and in line with the economic programme.

According to the August forecast, labour demand will not increase year-on-year until mid-2011, although there are indications of a turnaround in the labour market already. The employment rate, however, will be just over half a percentage point higher in 2010 than was forecast in May. Furthermore, unemployment is expected to be about one percentage point lower throughout the forecast horizon than in the May forecast, peaking at 9% in Q1/2011 before gradually tapering off as the economy recovers and falling to about 6% in 2012.

Wage growth is projected to be similar to the last forecast; however, the larger-than-expected growth in the labour force implies that productivity will be somewhat lower this year than was previously assumed. As a result, unit labour costs will increase by about 6% this year, one percentage point more than was forecast in May. Developments of the next two years, however, are expected to be in line with the May forecast.

Since the publication of the May issue of *Monetary Bulletin*, the króna has strengthened by about 8% in trade-weighted terms. According to the updated forecast, the exchange rate will remain near current levels throughout the forecast horizon, just over 7% stronger against the euro than was forecast in May.

The measured current account deficit for 2010 is projected to be somewhat larger than in the last forecast. The trade surplus will be slightly less than in the previous forecast, or 9.6% of GDP in 2010, largely due to a stronger contraction in marine product export production than previously expected. The forecast assumes as well that the deficit in the balance on income will be larger than previously projected, as revised figures for 2009 revealed a wider deficit than previous figures suggested. The underlying current account surplus for 2010 (the current account surplus less accrued interest due to credit institutions in winding-up proceedings) will be slightly smaller, however, than in the last forecast. It is assumed that the measured current account deficit will rise again temporarily in 2011, and that the underlying surplus will narrow, in line with the May forecast.

The outlook is for inflation to subside more rapidly this year than was assumed in the May issue of *Monetary Bulletin*. This is attributable to a considerably stronger exchange rate and lower inflation expectations, among other factors. In addition, summer sales effects proved stronger than in recent years but it is uncertain whether these effects will reverse in full when new goods are purchased at a stronger exchange rate. Headline inflation is projected to reach the Central Bank's inflation target in the second quarter of 2011, while inflation excluding consumer tax effects is expected to reach the target at year-end 2010, somewhat earlier than in the May forecast.

The outlook is for a slightly smaller output slack early in the forecast horizon than was projected in May, or 4% instead of 4½% in 2010. As was forecast in May, the slack will narrow gradually and will almost disappear by the end of the forecast period.

II The interest rate decision

The Governor informed the MPC of the status of the Third Review of the IMF Stand-By Arrangement, associated funding and the outlook for reserves, the status of the dispute over compensation to depositors in foreign branches of Landsbanki, and the recent meeting with the executive board of the Confederation of Icelandic Employers (SA). The MPC was also informed of the work currently underway relating to the effect on financial stability of the Supreme Court rulings on the legality of exchange rate-linked loans and the agreement on financial stability recently signed by the Nordic and Baltic governmental ministries, central banks and supervisory authorities.

The Committee observed that inflation had declined markedly in recent months. Twelve-month inflation fell from 7.5% in May to 4.8% in July, or 4% excluding consumption tax effects. This is more rapid disinflation than in the Central Bank's May forecast, due in large part to a stronger-than-expected exchange rate. According to the updated inflation forecast, published in the *Monetary Bulletin* 2010/3 on 18 August, inflation excluding tax effects will reach the Bank's inflation target by year-end and fall somewhat below target early in 2011. Inflation expectations had also declined sharply in the recent term.

The Committee noted that the króna had appreciated by over 2½% in trade-weighted terms since the MPC's last meeting, held in June, and by over 2% against the euro, without any foreign exchange market intervention by the Central Bank. Furthermore, over the same period, the CDS spread on sovereign debt had remained broadly unchanged. The capital controls, developments in terms of trade and the current account balance, and the interest rate differential with major currencies all continue to support the exchange rate.

The Committee discussed the change in the monetary stance from the June meeting. It agreed that given the inflation outlook, the Central Bank's interest rates were rather high, and that there were scope for continuing to lower them. Declining inflation and inflation expectations had caused real Central Bank interest rates to rise since the last interest rate decision date. Furthermore, although recovery appears to be underway, it is still weak at present, and the outlook is for a significant output slack for the next few years. The MPC saw that lower inflation, lower inflation expectations, a stronger króna, and the prospect of more rapid disinflation than previously expected provided the scope for a larger interest rate reduction than had generally been justifiable in the past year.

In the Committee's view, other factors called for more cautious steps, however. It is not yet clear to what extent the recent disinflation episode reflects short-term factors.

Furthermore, the MPC stressed the need to take into account that when capital account liberalisation begins, the risk-weighted interest rate differential between Iceland and abroad must provide sufficient support to the króna. In the MPC's view, there is still some uncertainty about when it will be possible to begin lifting the capital controls. Consequently, it is difficult to state what this entails for interest rate policy over the next few months.

Members discussed the possibility of lowering the policy rate by 0.5 to 1.5 percentage points. In light of the discussions, the Governor proposed a rate cut of one percentage point, which would lower the deposit rate (current account rate) and the CD rate to 5.5% and 6.75%, respectively, the seven-day collateral lending rate to 7.0%, and the overnight lending rate to 8.5%. The Committee voted unanimously in favour of the Governor‘s proposal.

The MPC discussed the strategy for relaxing capital controls. When the Third Review of the Government-IMF economic programme is complete, the preconditions for capital account liberalisation will be in place as regards the foreign exchange reserves and macroeconomic stability. However, there is still considerable uncertainty about the strength of the financial system in the wake of the recent Supreme Court judgments. The Committee therefore judged it necessary to review the existing capital account liberalisation strategy in view of changed circumstances and the delays that have already occurred.

The Committee also discussed the Bank's foreign reserves level and its composition and the need to replace the Central Bank's borrowed foreign exchange reserves with non-borrowed reserves. In the Committee's view, the appreciation of the króna and the decline in risk premia on Icelandic financial obligations provide the scope for modest foreign currency purchases for this purpose; consequently, it was decided to begin FX purchases on 31 August. The quantity and implementation will be decided with the aim of minimising the impact on the króna.

As before, the Committee agreed that the premises for continued monetary easing should be in place, provided that the króna remains stable or appreciates and inflation subsides as forecast. Furthermore, the MPC agreed that it 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, 22 September 2010.