SEÐLABANKI ÍSLANDS

MONETARY POLICY COMMITTEE REPORT TO ALTHINGI

2011 • 1

Monetary Policy Committee report to Althingi

1 July 2011

The Act on the Central Bank of Iceland stipulates that the Monetary Policy Committee (MPC) of the Central Bank of Iceland shall submit to Parliament a report on its activities twice a year and that the 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 MPC meet at least eight times each year. Since the Committee began its work on 26 February 2009, it has met twenty-one times, including four meetings since it last sent a report to Parliament. The following report discusses the work of the Committee between January and June 2011.

Monetary policy formulation

According to the Act on the Central Bank of Iceland, the principal objective of monetary policy is to promote price stability. This objective is further described in the joint declaration issued by the Bank and the Icelandic Government on 27 March 2001 as an inflation target of 2½%. In implementing monetary policy, the MPC 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*.

In addition to promoting price stability, monetary policy in the post-crisis period has aimed to preserve exchange rate stability in accordance with the joint economic policy agreed by the Government, the Central Bank, and the International Monetary Fund. As well as contributing to the disinflation process, this was judged a key during the stabilisation phase while private sector balance sheets were being restructured. As the share of foreign exchange denominated and linked loans has decreased and debt restructuring has progressed, the inflation outlook has regained its importance in monetary policy decisions. The MPC's statements and minutes, enclosed with this report, contain the arguments for the Committee's decisions.

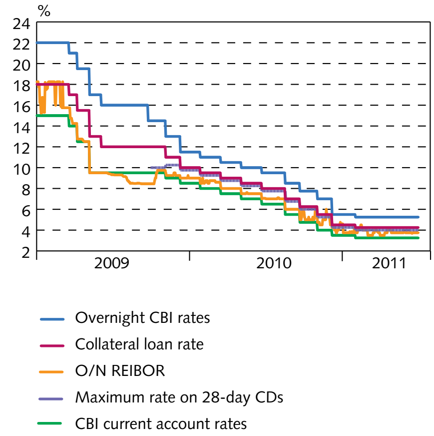
Table 1. Central Bank of Iceland interest rates 2011 (%)

Date	*Current account*	*28-day CDs (maximum)*	*7-day collateral lending rate*	*Overnight lending rate*
15 June	3.25	4.00	4.25	5.25
20 April	3.25	4.00	4.25	5.25
16 March	3.25	4.00	4.25	5.25
2 February	3.25	4.00	4.25	5.25
8 Dec. '10	3.50	4.25	4.50	5.50

Chart 1

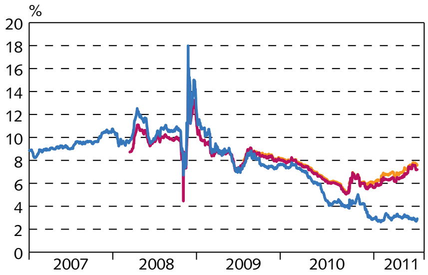
Central Bank of Iceland interest rates and short-term market interest rates

Daily data 1 January 2009 - 1 July 2011



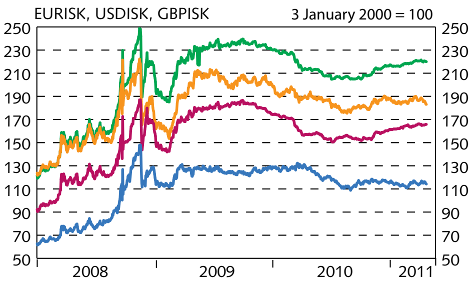
Source: Central Bank of Iceland.

Chart 2
Long-term nominal Treasury bond yields
Daily data 3 January 2007 - 1 July 2011



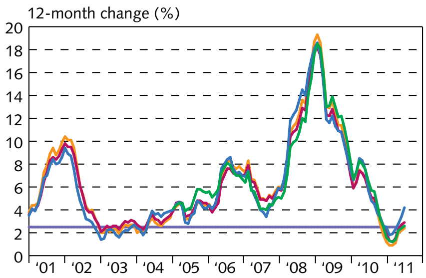
Source: Central Bank of Iceland.

Chart 3
Exchange rate of the króna
Daily data 3 January 2008 - 1 July 2011



Source: Central Bank of Iceland.

Chart 4
Inflation January 2001 - June 2011[1]



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

Developments in January to June 2011

The importance of the central bank's different policy rates in determining short-term market rates has varied over time, but since early 2009 the interest rates on deposit institutions' current accounts and the maximum bid rate on 28-day certificates of deposit have been predominant. At the end of 2010 these rates were 3.50% and 4.25%, respectively. Following the MPC's June meeting, the current account rate was 3.25%, the maximum bid rate on 28-day certificates of deposit was 4.00%, the seven-day collateralised lending rate was 4.25% and the overnight lending rate was 5.25% (see Chart 1).

In February of this year the MPC's bias signalling the likely direction of future monetary policy changed. Instead of indicating that future easing was likely, the Committee stated that future policy had become more uncertain. In June, increases in expected inflation led the Committee to suggest that future tightening had become more likely.

Since the beginning of the year, yields on Treasury bonds have risen by up to 2.2 percentage points while yields on HFF bonds have fallen by up to 0.5 percentage points (see Chart 2). The króna has depreciated by almost 7% against the euro since the beginning of January, roughly 5½% in trade-weighted terms, but strengthened by just over 1% against the US dollar (see Chart 3).

Inflation has increased since the beginning of the year and the inflation outlook has deteriorated (see Chart 4). In December 2010, annual headline inflation measured 2.5% as measured by the consumer price index. Annual core inflation 3 excluding tax effects, volatile items such as food and petrol, public services and mortgage interest payments measured 1%. In June, headline inflation had risen to 4.2% and annual core inflation 3 excluding taxes measured 2.5%. Headline inflation measured 3.5% in Q2/2011 up from 2% in Q1/2011. Annual headline inflation beyond 4% triggers a report from the Central Bank to the Government, explaining the reasons for the deviation from the inflation target, how monetary policy will respond, and how long it is expected before inflation returns to its target. This report was published on 30 June and is enclosed with the accompanying documents.

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from February 2011 to present.
2. Minutes of Monetary Policy Committee meetings from February 2011 to present.
3. Procedures of the Central Bank of Iceland Monetary Policy Committee, December 2010.
4. Capital account liberalisation strategy, March 2011.
5. Letter to the Minister of Economic Affairs and a report to the Government on inflation in excess of tolerance limits.

6. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001.

On behalf of the Central Bank of Iceland MPC,

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

No. 7/2011
2 February 2011

Statement of the Monetary Policy Committee 2 February 2011

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.25 percentage points. The deposit rate (current account rate) is lowered to 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) to 4.0%, the seven-day collateralised lending rate to 4.25% and the overnight lending rate to 5.25%.

Inflation continued to subside in December and January. The CPI rose 1.8% year-on-year in January, or 1.6% excluding consumption tax effects, significantly below the inflation target of 2½%. One-off factors added to the seasonal drop in January. Favourable exchange rate developments over the past year, declining inflation expectations, and the slack in the economy continue to contribute to low and stable inflation.

According to the forecast published in *Monetary Bulletin* today, economic recovery will be somewhat stronger this year than was forecast in November. Output is forecast to grow by 2.8% in 2011 and by just over 3% in 2012 and 2013. Inflation has been slightly lower than was implied in the November forecast, due mainly to a one-off change in public services charges; however, according to the Bank's forecast, it is expected to remain somewhat below the target until close to the end of the forecast period.

While economic fundamentals and the capital controls continue to support the króna, the exchange rate has depreciated by 4½% in trade-weighted terms since the MPC's December meeting. It is too early to determine to what degree this development has been driven by temporary factors. Moreover, the Central Bank's sizeable purchases of foreign exchange in December 2010, with the aim of reducing the banks' foreign exchange imbalances and bolstering the Bank's non-borrowed reserves, may have had some short-term effect.

With the prospect that inflation will remain near target and with interest rates at a historically low level, the direction of future policy moves becomes more uncertain. In addition, the prospect of removing the capital controls creates uncertainty about short-term room for manoeuvre. 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. 9/2011
16 March 2011

Statement of the Monetary Policy Committee 16 March 2011

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The deposit rate (current account rate) will remain 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) 4.0%, the seven-day collateralised lending rate 4.25%, and the overnight lending rate 5.25%.

Headline inflation currently measures 1.9%. The near-term outlook is for slightly higher inflation than previously forecast in spite of some indications of weaker economic activity. This is due primarily to substantial increases in international commodity and oil prices, which need not signal higher inflation over the medium term provided that long-term inflation expectations and wage formation remain unaffected. Short-term inflation expectations have indeed picked up somewhat recently; however, inflation is still expected to be below target in coming months and to approach the target over the medium term.

While economic fundamentals and the capital controls continue to support the króna, the exchange rate has fallen by about 1% in trade-weighted terms since the MPC's February meeting and by 5½% since peaking in November 2010. It is still too early to determine whether this development has been driven solely by temporary factors or whether the substantial narrowing of the risk-adjusted policy interest rate differential has also been a contributing factor.

Recently published GDP figures suggest somewhat weaker economic activity than previously expected. While domestic demand in 2010 turned out as expected, the contribution of net exports to growth was weaker than anticipated due to stronger imports, despite more robust export growth. Preliminary Statistics Iceland data therefore suggest a somewhat larger output contraction in 2010 than the Central Bank had previously forecast. However, early-vintage national accounts figures should always be interpreted with caution. On this occasion, strong imports of investment goods may signal stronger domestic demand than is indicated by the preliminary numbers.

The latest data on real economic developments, inflation, and the exchange rate provide somewhat conflicting guideposts for adjusting the monetary policy stance. In addition, the uncertainty stemming from the pending Icesave referendum and the fact that the capital account liberalisation strategy has not been finalised calls for extra caution at the current juncture.

With the prospect that inflation will remain near target and with interest rates at a historically low level, the direction of future policy moves remains uncertain. In addition, the prospect of removing the capital controls creates uncertainty about short-term room for manoeuvre. 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. 11/2011
20 April 2011

Statement of the Monetary Policy Committee 20 April 2011

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The deposit rate (current account rate) will remain 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) 4.0%, the seven-day collateralised lending rate 4.25%, and the overnight lending rate 5.25%.

The current interest rate decision is influenced by opposing factors. On the one hand, the inflation outlook has deteriorated, at least in the near term, inflation expectations have drifted upwards, and real Central Bank rates have fallen significantly. Moreover, risks to the exchange rate outlook have increased in the aftermath of the Icesave referendum. On the other hand, the outlook for growth and employment has deteriorated according to the Central Bank's baseline forecast published today in the *Monetary Bulletin*, with additional risk to growth stemming from the result of the referendum.

In spite of weaker activity, inflation expectations have risen recently and the medium-term inflation outlook has deteriorated. Headline inflation has increased for two consecutive months, to 2.3% in March. It is forecast to peak at just above 3% later this year and remain elevated until early next year. Higher inflation than previously forecast primarily reflects a weaker króna and the recent rise in commodity and oil prices. To the extent that these price increases are temporary, they are unlikely to have a lasting effect on longer-term inflation expectations and wage- and price-setting. Assuming a stable króna and given the spare capacity in the economy, inflation is forecast to fall back to target in the latter half of 2012. However, draft wage agreements imply pay increases that may prove larger over the medium term than is consistent with the inflation target.

The planned capital account liberalisation has limited short-term implications for the monetary policy stance because the first steps of the two-phase strategy should be broadly neutral in terms of their impact on the foreign exchange reserves.

The result of the Icesave referendum on 9 April has tilted risks to the exchange rate to the downside, as it may affect the sovereign credit rating and hence the terms at which Iceland can borrow in foreign capital markets. This may limit the MPC's room for manoeuvre over the medium term. It may also affect the pace of capital account liberalisation.

However, this is mitigated by the likelihood that the programme with the IMF will be unaffected.

The direction of future policy moves remains uncertain. 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. 16/2011
15 June 2011

Statement of the Monetary Policy Committee 15 June 2011

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged. The deposit rate (current account rate) will remain 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) 4.0%, the seven-day collateralised lending rate 4.25%, and the overnight lending rate 5.25%.

The inflation outlook has deteriorated since the last MPC meeting, at least in the near term, and real Central Bank rates have fallen. Recent data do not materially change the overall outlook for growth and employment. However, given recent announcements, the outlook is for a more expansionary fiscal stance than previously forecast.

Headline inflation has increased for four consecutive months, reaching 3.4% in May, and will likely remain elevated through next year. However, core inflation still remains close to target. The increase in inflation reflects a weak króna and the recent rise in commodity and oil prices. To the extent that the króna is broadly stable and these price increases are temporary, they are unlikely to have a lasting effect on inflation over the medium term.

Given the current exchange rate, however, pay increases implied in recent wage agreements are not consistent with the inflation target over the medium term. As the recovery progresses, wage pressures stemming from the traded goods sector may therefore cause longer-term inflation expectations to drift upwards. To reduce the risk of such an outcome, tighter monetary policy may become warranted in the near term, with actual policy moves depending, as always, on developments and prospects.

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

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

February 2011

Published: 16 February 2011

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and 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 31 January to 1 February 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 2 February, 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 8 December interest rate decision, as reflected in the updated forecast and risk analysis published in *Monetary Bulletin* 2011/1 on 2 February.

Financial markets

The trade-weighted value of the króna in the onshore market was 4.3% lower at the time of the February MPC meeting than at the December meeting. Between meetings, the króna depreciated by 3.5% against the pound sterling, by 1.6% against the US dollar, and by 4.2% against the euro.

The Central Bank had bought 34.5 million euros in the domestic interbank market for foreign exchange since it began regular purchases of foreign currency at the end of August. In addition to this, the Central Bank purchased foreign currency amounting to

160 million euros in the market in December 2010, so as to reduce financial institutions' FX imbalances and promote increased financial system stability.

In the offshore market, trading volume increased in late December but remains low. The offshore króna has weakened since the last meeting and has traded at 255-270 against the euro.

The CDS spread on the Republic of Iceland rose by around 50 basis points in early January but has since subsided. The spread was 274 basis points at the February meeting, as opposed to 271 at the December meeting.

About 86.7 b.kr. worth of certificates of deposit (CDs) were outstanding as of the February meeting, approximately 29 b.kr. less than at the time of the December meeting.

Overnight interbank market rates had been volatile between meetings. Trading volume in the interbank market amounted to 40 b.kr. since the last MPC meeting, with volume concentrated in overnight transactions, although there had also been transactions involving other maturities.

Yields on Treasury bonds maturing in the next five years had fallen by 0.24-0.60 percentage points since the December meeting. Yields on longer Treasury bonds had risen by 0.40-0.48 percentage points. Yields on the shortest indexed HFF bond series had fallen by 0.75 percentage points, while yields on other HFF series had risen by 0.01-0.06 percentage points.

In the week before the February meeting, the Government Debt Management auctioned a new twenty year bond series. The total amount issued was 11,282 m.kr. nominal value.

Preliminary figures on the banking system in December showed that outstanding loans to residents fell by 1.5% from the previous month. Loans to companies decreased by 0.7%, while total lending to households rose by 1.0%. M3 continued to decline as well, mainly reflecting a shift from deposits to mutual funds.

Since the announcement of the MPC's 8 December decision, the real policy rate (with the nominal effective rate currently approximated as the simple average of Central Bank deposit and maximum CD rates), across different measures of inflation and inflation expectations, had risen by 0.9 percentage points on average to 2.1%. It should be noted, however, that the improved inflation outlook partly reflects a one-off change in public services charges which explains half of the rise in the real rate. The risk-adjusted short-term interest rate differential with main trading partners had fallen by 0.6 percentage points to 0.8%, mainly due to movements in foreign rates.

Financial institutions' economics departments, market makers, and brokers expected a 0.25-0.75 percentage point rate cut in the February meeting, while a rate cut of 0.25 percentage points seemed to be priced into the yield curve. There was some difference in expectations of future rate decisions; two out of five economics departments expected further cuts in March 2011, while the others expected rates to be kept unchanged.

Outlook for the global real economy and international trade

According to the latest updated IMF forecast, published in January, global growth is expected to reach 4.4% in 2011, slightly higher than in the IMF forecast published in October 2010. The forecast for world trade in 2011 is in line with the October forecast, at 7%. The IMF projects 4.5% global output growth and 6.8% growth in world trade in 2012.

Iceland's merchandise trade surplus was 10.4 b.kr. in November, substantially higher than the 1.5 b.kr. measured at the same time last year. The value of merchandise exports was just over 48 b.kr., while the value of imports was around 38 b.kr. Both export and import values increased by roughly 3% month-on-month in November, and both were growing year-on-year. Export values rose by over 27% year-on-year, led by a rise in the export value of aluminium. Import values grew by 4%; however, excluding aircraft and ships, they grew by over 15%, led by an increase in the import value of capital and consumer goods.

According to preliminary data, both export and import values fell slightly month-on-month in December. Even though export values as a whole fell, the export value of industrial products increased by 6% month-on-month. According to preliminary figures, the trade surplus totalled 11.5 b.kr. in December. The value of merchandise exports was just over 47 b.kr., while the value of imports was just under 36 b.kr.

In the first three weeks of January, the price of aluminium rose by around 5% as compared with November. The value of marine product exports had also been on the rise, increasing by 1% in November.

The domestic real economy and inflation

Leading indicators suggest that private consumption continued to grow in Q4 after a robust increase in Q3. Seasonally adjusted payment card turnover rose by 2.9% between Q3 and Q4, while groceries turnover rose by 1%. According to a Capacent Gallup survey, seasonally adjusted planned big-ticket purchases increased by 1.2% between the September and December surveys.

Registered unemployment rose marginally quarter-on-quarter in Q4/2010, to 7.7%, and measured 8.1% for the year as a whole. Unemployment as measured by the Statistics Iceland labour force survey was 7.4% in Q4/2010 and 7.6% for the year as a whole.

The wage index rose by 0.7% quarter-on-quarter in Q4 and by 5.1% year-on-year. In 2010 the wage index rose by 4.8%, up from 3.9% a year earlier. Real wages fell by 0.6% between 2009 and 2010, after a 7.2% decline in 2009.

The Statistics Iceland labour market survey for Q4/2010 shows that labour demand contracted year-on-year by all criteria in Q4/2010. Total hours worked declined by 3.9% between years, due both to a reduction in the number of employed persons and to a shorter work week.

Indicators suggest that the labour market may soften somewhat further. Firms planning to shed staff in the next six months outnumber those planning to recruit by 13 percentage points, according to a Capacent Gallup survey carried out in December among Iceland's 400 largest firms. The survey also indicates that more companies planned redundancies in December than in September, and that fewer were planning to recruit. The greatest change in staffing plans was among companies in the fisheries sector: some one-third were considering downsizing in December, as opposed to only 14% in September. A recent survey conducted by the Confederation of Icelandic Employers among its member organisations accords with this, indicating that companies intend to reduce staffing by 1,000 in the next six months. This corresponds to an increase in unemployment amounting to just over ½ percentage point.

The commercial property real price index fell by 0.6% quarter-on-quarter in Q4/2010 and by nearly 30% year-on-year. The index decreased by 31% between 2010 and 2009, after a 22% decline a year earlier. Turnover in the commercial property market increased by 21% quarter-on-quarter in Q4/2010 and by 22% year-on-year for the year as a whole, after having contracted by 41% in 2009.

Statistics Iceland's nationwide housing price index, published in December, fell by 0.1% from the previous month. The index fell by 1.4% between years in 2010 after an 8.3% drop in 2009. The greater Reykjavík housing price index, calculated by Registers Iceland, decreased by 0.1% month-on-month in November and by 0.2% when adjusted for seasonality. Some 4,600 purchase contracts were concluded in 2010, an increase of 25% from 2009. Activity in the greater Reykjavík area increased by 41% between years. Total turnover amounted to almost 115 b.kr., an increase of 16% from 2009.

Consumer sentiment improved in January, and the sentiment index has almost reached the levels from last autumn, before its abrupt decline in October. At the beginning of 2011, consumer sentiment was somewhat stronger than on average in 2010.

According to Capacent Gallup's December 2010 business sentiment survey, executives remain pessimistic about the current and future economic situation. Roughly 75% of firms' executives expected the situation to remain unchanged or deteriorate in the next six months, a slightly smaller share than in the September 2010 survey. Firms located in regional Iceland are more pessimistic than those in greater Reykjavík, mostly due to bleak sentiment in the fisheries sector.

The overall outlook for domestic demand over the next six months was more pessimistic in December than in September. Roughly 28% of firms' executives expected domestic demand to decrease, as compared with a fifth in the last survey. Only 17% of companies assume demand will increase, as opposed to 25% in September. This rise in pessimism was particularly discernible in the fisheries sector and the transport/tourism sector.

Firms' executives expected inflation to measure 2% one year ahead (according to the median), a 0.5 percentage point decline from the survey in September. In the survey from December 2009, firms' one-year inflation expectations measured 6%.

In another Capacent Gallup survey in December, household inflation expectations one year ahead declined from the previous survey (in September) by two percentage points, measuring 4% according to the median. The median household expected twelve-month inflation to measure 5% in two years, which is unchanged from the September survey.

Inflation continued to subside in December and January. Annual headline inflation measured 2.5% in December and fell further to 1.8% in January, when the consumer price index (CPI) decreased by 0.9% month-on-month. Excluding the effects of higher duties on alcohol, tobacco and fuels, the CPI fell by 1.1% in January; thus twelve-month underlying inflation (excluding tax effects) was 1.6%. Seasonally adjusted, the CPI fell by 0.06% in the last three months, which is a 0.2% decline on an annual basis.

The main factor contributing to the January decline in the CPI was strong winter sales, which led to an almost 0.9% decline in the index. The second largest effect was due to a 0.4% one-off decline in the CPI since Statistics Iceland have decided to exclude broadcasting fees from the CPI because it should be treated as a direct tax. This affected both headline CPI inflation and CPI inflation excluding effects of changes in consumer taxes, and implies that both measures of year-on-year inflation will be 0.4 percentage points lower than otherwise until January 2012.

The cost of owner-occupied housing fell by 1.8% in January, mainly due to a decrease in market prices that stemmed mostly from a decline in prices of single-family houses in the capital area.

A 3.4% rise in the price of various other public services led to a 0.25% increase in the CPI. Prices of food and beverages rose by 1.4% in January. Prices of petrol and oil also increased leading to a 0.18% increase in the CPI.

According to the updated forecast published in *Monetary Bulletin* on 2 February, economic recovery will be somewhat stronger this year than was forecast in November. Output is forecast to grow by 2.8% in 2011. The February forecast also assumes somewhat stronger output growth in the next two years, or just over 3% each year.

It is expected that net trade will contribute more to GDP growth than projected in November, as terms of trade have improved somewhat more than was forecast then. The outlook for exports has improved for this year, due mainly to the prospect of a smaller contraction in marine exports than previously expected. Exports are also projected to increase more over the next two years than according to the November forecast.

Yet in spite of more advantageous terms of trade and stronger net trade, the króna is expected to remain more or less at current levels until year-end, some 3% weaker on average than was projected in November.

The surplus on goods and services trade in 2010 is estimated at 11% of GDP, somewhat more than was forecast in November. The headline current account deficit for 2010 will rise slightly from the November projection, or from 3% of GDP to 3.5%. It is projected to diminish significantly this year and average around 1% of GDP throughout the forecast horizon. The outlook for the current account balance excluding the DMBs in winding-up proceedings has improved by some 5-7 percentage points more than was projected in November, to about 6-8% of GDP during the forecast horizon.

Private consumption is expected to grow by about 3% annually, both this year and in 2012, somewhat outpacing the growth in real disposable income and thus eroding household savings until 2013, when savings will begin to pick up again.

Investment in 2010 is estimated to have been somewhat stronger than preliminary Statistics Iceland data suggests. The recovery of investment is forecast to continue in 2011, with an increase of nearly 10%. This is somewhat stronger growth than was projected in November, due mainly to stronger business investment.

Labour market developments are expected to accord with the Bank's previous forecast. The employment rate appears likely to begin rising again in the first half of 2011, with unemployment declining gradually as the year passes.

Inflation has developed broadly in line with the Central Bank's November forecast, and the inflation outlook is more or less unchanged from November. The outlook is for Q1/2011 inflation to be somewhat lower than according to the November forecast, due in particular to the change in Statistics Iceland's treatment of broadcasting fees in its calculation of the CPI and to stronger sales effects than previously anticipated. Inflation is forecast to remain below target in 2011 and bottom out in the first half of the year.

II The interest rate decision

The Governor informed the Committee of the recently completed fourth review of the IMF Stand-By Arrangement, the associated funding, and the outlook for reserves. The Committee was also informed of the status of the fifth review of the programme, the work underway within the Central Bank in consultations with other authorities in relation to removal of the capital controls, 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 Committee also discussed the uncertainty concerning the level of equilibrium real interest rate in Iceland, how much it had declined in the wake of the currency and financial crises, and what would be the long-run value once the post-crisis recovery was completed.

The MPC noted that inflation had continued to subside in December and January, although one-off factors had added to the seasonal drop in January. With headline inflation at 1.8% and inflation excluding consumption tax effects at 1.6%, inflation is currently significantly below the inflation target of 2½%, although some 0.4 percentage point of the deviation from the target is due to the aforementioned change in the treatment of radio service charges. In the MPC's view, favourable exchange rate developments over the past year, declining inflation expectations, and the slack in the economy will continue to contribute to low and stable inflation.

The Committee noted that, according to the forecast published in *Monetary Bulletin* on 2 February, economic recovery will be somewhat stronger this year than was forecast in November. Furthermore, inflation in January was slightly lower than was implied in the November forecast, due mainly to a one-off change in public services charges. However, according to the Bank's forecast, inflation is expected to remain somewhat below target until close to the end of the forecast period.

The MPC observed that the exchange rate had depreciated by 4½% in trade-weighted terms since the MPC's December meeting. In the Committee's view, economic fundamentals and the capital controls will continue to support the króna and the MPC considered it too early to determine to what degree the recent depreciation had been driven by temporary factors. Furthermore, the Central Bank's sizeable purchases of foreign exchange in December 2010, with the aim of reducing the banks' foreign exchange imbalances and bolstering the Central Bank's non-borrowed reserves, may have had some short-term effect. While the committee agreed that the recent weakness of the króna might be of a temporary nature, it could not be excluded that the significant narrowing of the risk-adjusted interest rate differential also played a role.

Some members were of the view that this called for some caution in any possible further easing of the monetary policy stance.

The MPC also discussed recent movements in short-term interest rates within the Bank's interest rate corridor with respect to the Bank's liquidity management and technical problems in the implementation of market operations.

The Committee stressed that, with the prospect that inflation will remain near target and with interest rates at a historically low level, the direction of future policy moves would become more uncertain. In addition and as before, the prospect of removing the capital controls creates uncertainty about short-term room for manoeuvre.

Members discussed the possibility of lowering the policy rate by 0 to 0.5 percentage points. In light of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points, which would lower the deposit rate (current account rate) to 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) to 4.0%, the seven-day collateralised lending rate to 4.25%, and the overnight lending rate to 5.25%.

The Committee voted unanimously in favour of the Governor's proposal, although one member would have preferred a 0.25 percentage point larger cut on the grounds that, while the beginning of a recovery was visible, it was still very weak and would benefit from some additional stimulus.

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

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor 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, 16 March 2011.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting
March 2011
Published: 30 March 2011

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

The following are the minutes of the MPC meeting held on 15 March 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 16 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 2 February interest rate decision.

Financial markets

The trade-weighted value of the króna in the onshore market was 1% lower at the time of the March MPC meeting than at the February meeting. Between the two meetings, the króna depreciated by 1.5% against the euro. However, it depreciated by only 0.4% against the US dollar and it appreciated by 0.2% against the pound sterling. The Central Bank has bought 43.5 million euros in the domestic interbank market for foreign exchange since it began regular purchases of foreign currency at the end of August 2010.

In the offshore market, the volume and frequency of trading has remained low so far in 2011. The offshore króna has traded at 260-271 against the euro since the last meeting.

The CDS spread on the Republic of Iceland was 243 basis points at the March meeting, as opposed to 274 at the February meeting.

About 70.5 b.kr. worth of certificates of deposit (CDs) were outstanding as of the March meeting, approximately 16 b.kr. less than at the time of the February meeting.

Overnight interbank market rates were volatile between meetings. Trading volume in the interbank market amounted to 72.3 b.kr. since the February meeting, with volume concentrated in overnight transactions, although there had also been transactions involving other maturities.

Yields on Treasury bonds had risen by 0.21-0.87 percentage points since the February meeting. Yields on the HFF bonds had fallen by 0.08-0.44 percentage points.

Preliminary figures on the banking system in January showed that the net position of outstanding loans to residents increased by 0.2% from the previous month, reflecting a slight decline in loan-loss provisions rather than any notable increase in new lending. Loans to the corporate sector decreased by 1.2%, and total lending to households fell by 1.7%. Broad money (M3) remained constant month-on-month in January, however.

Since the announcement of the MPC's 2 February decision, the real policy rate (with the nominal effective rate currently approximated as the simple average of Central Bank deposit and maximum CD rates) across different measures of inflation and inflation expectations had fallen by an average of 0.5 percentage points, to 1.3%. The risk-adjusted short-term interest rate differential with main trading partners had risen by 0.9 percentage points to 1.8%, due mainly to changes in domestic interest rates.

Most market makers, brokers, and analysts from financial institutions' research departments expected either unchanged interest rates or a rate cut of 0.25 percentage points in March. Similar expectations seemed to be priced into the yield curve. Most parties cited increased short-term market uncertainty due to the pending Icesave referendum, on the one hand, and the delay in publication of the capital account liberalisation strategy, on the other, as a key factor in their judgement.

Outlook for the global real economy and international trade

Iceland's merchandise trade surplus was 7.9 b.kr. in January and, according to preliminary data, 10.2 b.kr. in February. The trade surplus in January and February increased by 2% year-on-year. The value of merchandise exports was 43 b.kr. in January, while the value of imports was around 35 b.kr.

Both import and export values grew significantly year-on-year in January. Export values rose by 22% year-on-year, led by a rise in the export value of aluminium and marine products. Import values grew by 16%, led by an increase in the import value of capital goods, industrial supplies and fuels.

However, both import and export values fell month-on-month in January: export values excluding aircraft and ships by 10% and import values by 7%. This development continued in February, according to preliminary data, as export values fell by 0.7% and import values by 7%. Both continued to rise year-on-year in February.

The price of aluminium rose by almost 3% month-on-month in February and was around 7% higher than the average price in Q4/2010. It continued to rise in March and, in the first week of the month, was 1% higher above the February average. The price of aluminium is now at a two-year high. The value of marine product exports has also been on the rise, increasing by 1.5% month-on-month in January.

The domestic real economy and inflation

In March, Statistics Iceland published revised figures for the first three quarters of 2010. As expected in the Central Bank's February forecast, the GDP figures were revised upwards from Statistics Iceland's preliminary figures in December, mostly due to stronger investment than previously estimated. According to the new Statistics Iceland figures, GDP contracted by 4.6% from the same time the previous year, compared to 5.5% in the December vintage and 5.1% in the Central Bank's February forecast.

According to the Statistics Iceland preliminary figures, seasonally adjusted GDP contracted by 1.5% quarter-on-quarter in Q4/2010, after 2.2% growth in Q3. The contribution of private consumption and gross fixed capital formation to quarterly GDP growth in Q4 was positive, whereas the contribution from net exports was negative. In 2010, the contribution to GDP quarterly growth was negative from all subgroups except private consumption, which was virtually nil. These preliminary numbers indicate weaker activity in Q4 than expected in the February forecast, with the Statistics Iceland figures suggesting weaker investment and more robust imports compared to the Bank's forecast.

For the year as a whole, these preliminary numbers suggest that the contraction in GDP was 0.8 percentage points larger than according to the forecast, or 3.5% instead of 2.7% in the forecast. With the contraction in domestic demand close to what was forecasted (-2.4% compared to -2.5% in the forecast), the main difference lies in a much weaker contribution from net exports, due primarily to stronger imports of goods and services, mainly reflecting a revision of previous Statistics Iceland's figures on imported services and a smaller increase in import prices.

The current account deficit was 13.7% of GDP, or 54. b.kr., in Q4/2010. This is a reversal from the previous quarter, when the current account was positive by 3% of GDP. The underlying current account – that is, excluding banks in winding-up proceedings – was negative by 4.9% of GDP in Q4/2010.

For the year 2010 there was a current account deficit equal to almost 8% of GDP. If banks in winding-up proceedings are excluded, there was a current account surplus equal to almost 2% of GDP. This surplus is smaller than was previously expected and is due to a downward revision of the service account surplus and upward revision of the income account deficit – reflecting more complete information on foreign direct investment, which shows that losses among domestic firms owned by non-residents were smaller than had previously been estimated.

According to preliminary figures, the government budget deficit fell from roughly 10% of GDP in 2009 to around 8% in 2010. At the same time, the primary balance improved from -6½% of GDP to -4.0% of GDP.

The wage index was broadly unchanged month-on-month in January. Real wages rose by 0.9% month-on-month and by 2.5% year-on-year. Registered unemployment increased from 8.0% in December to 8.6% in February.

The high-frequency economic indicators that have appeared since the February meeting give somewhat conflicting signals. Seasonally adjusted payment card turnover suggests that domestic private consumption slowed down in January and February after an uptick in Q4/2010, while retail sales turnover has increased.

Statistics Iceland's nationwide housing price index, published in February, increased by 1.8% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, decreased by 0.8% month-on-month in January and by 0.3% when adjusted for seasonality. Some 39% more contracts were concluded in January 2011 than in the same month in 2010, although the number of contracts remains very low in a historical context.

Consumer sentiment deteriorated slightly in February and was just above its average over the previous twelve months. Sentiment towards the labour market declined the most. The only sub-index that rose slightly between months was the one measuring overall sentiment towards the economy.

The CPI increased by 1.18% month-on-month in February, and annual inflation measured 1.9%. Annual inflation excluding tax effects was 1.7%. The seasonally adjusted CPI rose by 0.7% over the last three months, or 2.9% on an annualised basis.

Prices of all major CPI components rose month-on-month in February. As expected, the end-of-winter sales led to price increases in clothing, furniture and other housing equipment, with an effect on the CPI of almost 0.5 percentage points. Prices of volatile subcomponents such as food items, oil and petrol, and international airfares also rose in February. The price increase in food items stemmed mainly from domestic products rather than imported items. Domestic petrol prices rose by roughly 9% over the previous three months and grocery prices by 2%. The cost of owner-occupied housing rose by 1.7% in February, due mainly to an increase in market prices, and is 1.1% lower than it was a year ago.

II The interest rate decision

The Governor informed the Committee of the consultations with other authorities in relation to the removal of the capital controls, the Governor's bi-annual meeting with three parliamentary committees on monetary policy and of the status of the fifth review of the IMF Stand-By Arrangement. The MPC was also informed of Arion Bank's and Íslandsbanki's year-end operating results for 2010 and of recent steps in the financial-sector restructuring process.

The Committee observed that the near-term outlook was for slightly higher inflation than previously forecast, in spite of some indications of weaker economic activity. Headline inflation currently measured 1.9%. In the MPC's view, the poorer inflation outlook is due primarily to substantial increases in international commodity and oil prices, which need not signal higher inflation over the medium term provided that long-term inflation expectations and wage formation remain unaffected. Although short-term inflation expectations had picked up somewhat recently, the Committee still expected inflation to remain below target in coming months and to approach the target over the medium term.

The MPC noted that recently published GDP figures suggested somewhat weaker economic activity than previously expected. While domestic demand in 2010 had turned out as expected, the contribution of net exports to growth was weaker than anticipated due to stronger imports, despite more robust export growth. Preliminary Statistics Iceland data therefore suggest a somewhat larger output contraction in 2010 than the Central Bank had previously forecast. In the MPC's view, however, early-vintage national accounts figures should always be interpreted with caution. On this occasion, for example, strong imports of investment goods may signal stronger domestic demand than is indicated by the preliminary numbers.

The MPC observed that the exchange rate had fallen by about 1% in trade-weighted terms since its February meeting and by 5½% since peaking in November 2010. Although economic fundamentals and the capital controls continue to support the króna, the MPC argued that it was still too early to determine whether this development had been driven solely by temporary factors or whether the substantial narrowing of the risk-adjusted policy interest rate differential had also been a contributing factor.

The MPC discussed possible adjustments to the monetary stance. In the Committee's view, the latest data on real economic developments, inflation, and the exchange rate provided somewhat conflicting guideposts for adjusting the stance. In addition, the uncertainty stemming from both the pending Icesave referendum and still-to-be-finalised capital account liberalisation strategy called for caution.

Two possibilities were discussed: keeping rates unchanged or lowering them by 0.25 percentage points. In light of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be kept unchanged: the deposit rate (current account rate) at 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) at 4.0%, the seven-day collateralised lending rate at 4.25%, and the overnight lending rate at 5.25%.

Four members voted in favour of the Governor's proposal, although one member would have preferred a 0.25 percentage point cut due to indications of slightly weaker economic activity than was forecast in the 2 February *Monetary Bulletin*. One member voted against the Governor's proposal, preferring to lower interest rates by 0.25 percentage points because of the on-going weakness of the economy and the absence of any domestic inflationary pressures. This member maintained that inflation caused by disturbances in international commodity markets was unlikely to generate a wage-price spiral in Iceland's weak economy and should not prevent the Central Bank from cutting interest rates.

Members stressed that, with the prospect that inflation will remain near target and with interest rates below the Central Bank's previous estimates of the neutral rate, the direction of future policy moves remains uncertain. In addition, the prospect of removing the capital controls creates uncertainty about short-term room for manoeuvre.

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

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor 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, 20 April 2011.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

April 2011

Published: 4 May 2011

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

The following are the minutes of the MPC meeting held on 18-19 April 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 20 April, 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 16 March interest rate decision, as reflected in the updated forecast and risk analysis published in *Monetary Bulletin* 2011/2 on 20 April.

Financial markets

The trade-weighted value of the króna in the onshore market was 0.3% lower at the time of the April MPC meeting than at the March meeting. Between the two meetings, the króna depreciated by 0.7% against the euro, but appreciated by 2.1% against the US dollar and by 0.2% against the pound.

The Central Bank has bought 51 million euros in the domestic interbank market for foreign exchange since it began regular purchases of foreign currency at the end of August 2010.

In the offshore market, the volume and frequency of trading has remained low so far in 2011. The króna has traded at 248-267 against the euro in the offshore market since the last meeting.

The CDS spread on the Republic of Iceland was 224 basis points at the April meeting, compared to 243 at the March meeting. The rates continue to be based on very limited trade.

About 63.9 b.kr. worth of certificates of deposit (CDs) were outstanding as of the April meeting, approximately 7 b.kr. less than at the time of the March meeting.

Overnight interbank interest rates had been between 3.5-4.0% since the March meeting. Trading volume in the interbank market amounted to 73 b.kr. since the March meeting, with volume concentrated in overnight maturities, although there had also been transactions involving other maturities.

Yields on longer-term Treasury bonds had fallen by 0.04-0.22 percentage points since the March meeting, while shorter-term Treasury bonds had risen by 0.08-0.77 percentage points. Yields on the HFF bonds had at the same time fallen by 0.11-0.33 percentage points.

The spread between indexed and nominal bond yields had risen in recent months but the spread gives an indication of the development of inflation expectations. The average spread for the next five years measured 2.9% at the meeting, while the five-year ahead spread for 2016-2021 was 4.8%. This is an increase of about 1 percentage point on both of these figures since the end of January 2011. It is however, uncertain how much of this recent rise in breakeven inflation measures is due to rising risk premia reflecting inflation and liquidity risk.

Preliminary figures on the banking system in February showed that the net position of outstanding loans to residents decreased by 0.5% from the previous month. Loans to the corporate sector decreased by 0.3%, and total lending to households fell by 0.6%. Broad money (M3) decreased by 0.6% month-on-month in February.

The nominal effective policy rate is currently approximated as the simple average of the Central Bank deposit and maximum CD rates. Since the announcement of the MPC's 16 March decision, the real policy rates have fallen on most measures. Averaging across different measures of inflation and inflation expectations, real rates have fallen by roughly 1 percentage point to below 1%.

Most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to maintain either unchanged interest rates or to reduce rates by 0.25 percentage points in the April meeting. Similar expectations seemed to be priced into the yield curve. Most parties cited increased uncertainty due to the rejection of the Icesave contract as a key factor in their judgement.

Outlook for the global real economy and international trade

Iceland's merchandise trade surplus was 10.4 b.kr. in February and, according to preliminary data, 6.5 b.kr. in March. As imports rose more than exports in Q1/2011, the merchandise trade surplus decreased by 13% year-on-year. The value of merchandise exports was roughly 42 b.kr. in February, while the value of merchandise imports was about 33 b.kr.

Both merchandise import and export values grew year-on-year in February. Export values rose by almost 5% year-on-year, led by a rise in the export value of ferrosilicon and other industrial products. Import values grew by 15%, led by increases in the import value of fuel and capital goods.

However, both import and export values fell month-on-month in February, export values by 0.7% and import values by almost 8%. This development was reversed in March, according to preliminary data, as export values increased by over 19% and import values by 37%. Both continued to rise year-on-year in March.

The price of aluminium was 1% higher on average in March than in February and has continued to rise in April. In the first two weeks of April, it was roughly 3% above the March average. The price of aluminium is now approaching a three-year high. The value of marine product exports has also been on the rise, increasing by 0.7% month-on-month in February. The February price level is nearly 14% higher than a year ago.

The domestic real economy and inflation

The wage index rose by 0.2% month-on-month in February. Wages increased by 4.3% year-on-year, and real wages by 2.2%. Registered unemployment was unchanged in March, at 8.6%, and measured 8.6% as well in Q1/2011.

Seasonally adjusted payment card turnover rose in March from the previous two months, growing by 4.6% month-on-month, but contracted by 0.9% quarter-on-quarter in Q1/2011 after 3.4% growth in Q4/2010.

Statistics Iceland’s nationwide housing price index, published in March, increased by 0.9% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, rose by 1% month-on-month in February, and by the same when adjusted for seasonal variability. Some 46% more contracts were concluded in February 2011 than in the same month in 2010, although the number of contracts remains very low in a historical context.

Consumer sentiment regarding the current economic situation and the future outlook continues to be weak. The consumer sentiment index declined slightly in March but is still higher than it was at the same time last year. According to quarterly results from a survey in March, expected big-ticket purchases declined from the previous survey in December, but were higher than at the same time last year.

According to Capacent Gallup’s business sentiment survey, conducted in February and March 2011, corporate executives were slightly less pessimistic about the economic situation six months ahead than they were in December. Roughly half of participants expected the economic situation to remain unchanged, and over a fifth believed it will improve, compared to 46% and 25%, respectively, in December. Sentiment among firms in the construction and fisheries sectors, however, was more pessimistic about the outlook, with almost 40% of construction firms and 41% of fisheries expecting the economic situation to deteriorate.

When asked about firms’ capacity to respond to an unexpected increase in demand, almost 80% of participants responded that it would not be a problem since operations were running below maximum production capacity, compared to 70% in September.

Slightly fewer firms expressed an interest in laying off staff in March than in the December survey, although firms wanting to shed staff in the next six months still outnumber those wanting to recruit by about 5 percentage points. Over 40% of firms in the construction sector are expecting to lay off workers. Exporters of goods and services are more likely to expect to add on staff than are other firms.

Executives' median expected inflation measured 4% one year ahead. This is a 2 percentage point increase from the survey in December. This is the first increase in their inflation expectations since Q4/2009. Executives also expected twelve-month inflation to measure 4% in two years, which is unchanged from the survey in September.

When asked about their firms' pricing decisions, 45% of executives expected a price rise over the next six months, compared to one-third in September. Just under 6% of executives said that their firms planned to cut prices in the near future, compared to 10% in September.

In another Capacent Gallup survey in March, household inflation expectations one year ahead declined from the previous survey in December by 0.5 percentage points, measuring 3.5% according to the median. The median household expected twelve-month inflation to measure 4% in two years, a 1 percentage point decline since December.

The CPI increased by 0.95% month-on-month in March, and annual inflation measured 2.3%, compared to 1.9% in February. Annual inflation excluding tax effects measured 2.1%. The seasonally adjusted CPI rose by 2.1% over the last quarter, or 8.6% on an annualised basis. Annual core inflation 3, that is headline inflation excluding tax effects, volatile items such as food and petrol, public services and mortgage interest payments, was much lower at 1.3%. It should be noted, however, that all measures of annual inflation are 0.4 percentage points lower than they would otherwise have been due to the exclusion of broadcasting fees from the CPI as of January 2011.

The rise in fuel prices had the largest effect on the CPI in March, or 0.4 percentage points. Petrol prices have risen by roughly 12% over the last three months. Due to the end of winter sales, clothing and footwear prices raised the CPI by 0.2 percentage points. An increase in the cost of owner-occupied housing had a further 0.1 percentage point effect on the CPI, mainly due to higher market prices, following a 0.2 percentage point CPI effect in February. The cost of owner-occupied housing is 1.7% higher than it was a year ago.

According to the estimate in the 20 April *Monetary Bulletin*, the economic contraction in 2010 was deeper than the Bank's February estimate, but somewhat smaller than was indicated by the preliminary Statistics Iceland figures from early March. Domestic demand has been broadly in line with the forecast, however; the difference is largely due to domestic demand being directed more towards imports than had been assumed. Stronger import growth is also the main reason for the outlook for smaller GDP growth in 2011 than was forecast in February. The prospects for GDP growth in the next two years have deteriorated as well. While the recovery in activity is still considered to have begun in mid-2010, it is quite weak.

Considerable spare capacity remains in the economy and appears likely to continue over the forecast horizon. The more pessimistic growth outlook has implications for the labour market outlook as well; unemployment is now expected to subside more slowly than previously forecast. Although the Central Bank’s real interest rate has continued to fall, the financial conditions of households and businesses remain difficult.

In spite of weaker activity, long-term inflation expectations have risen slightly in the recent term, and the inflation outlook has worsened. Inflation is now projected to peak at just over 3% later in 2011, due primarily to steep rises in commodity and oil prices. The króna is also expected to be weaker during the forecast horizon, and pay rises are expected to be larger and more front-loaded than Bank staff had previously assumed. Some of the increase in commodity and oil prices may be transitory, however, and the Central Bank forecasts that a dissipation of these transitory rises, combined with the slack in the economy, will have inflation returning to target again in the latter half of 2012.

As discussed in the current issue of *Monetary Bulletin,* the outlook is subject to considerable uncertainty. An important contributing factor is the outcome of the Icesave referendum. Even though some indicators give cause for greater optimism, the downside risks are considered to be greater than the upside risks.

II The interest rate decision

The Governor informed the Committee of the status of the dispute over compensation to depositors in foreign branches of Landsbanki, the status of the fifth review of the IMF Stand-By Arrangement and the associated funding, and the outlook for the foreign exchange reserves. The Deputy Governor gave an account of the Icelandic delegation’s meetings with IMF representatives and his meetings with government representatives and financial institutions at the International Monetary Fund’s (IMF) Spring Meeting in Washington. The MPC was also informed of the recent meetings with the Confederation of Icelandic Employers (SA) and the Icelandic Federation of Labour (ASÍ) and with the management of Arion Banki, Landsbanki and Íslandsbanki.

The Committee observed that, in spite of weaker activity, inflation expectations over short and long horizons had risen recently and the medium-term inflation outlook had deteriorated.

According to the forecast published in *Monetary Bulletin* on 20 April, inflation is forecast to peak at just above 3% later this year and remain elevated until early next year. Assuming a stable króna and given the spare capacity in the economy, inflation is forecast to fall back to target in the latter half of 2012.

In the MPC’s view, higher inflation than previously forecast is mainly a result of the lagged effects of a weaker króna and the recent rise in commodity and oil prices. The Committee argued that, to the extent that these price increases are temporary, they are unlikely to have a lasting effect on longer-term inflation expectations and wage and price-setting. However, the pay increases implied in draft wage agreements might prove larger over the medium term than is consistent with meeting the inflation target.

The first steps of the two-phase strategy for capital account liberalisation are intended to be broadly neutral in terms of their impact on the foreign exchange reserves. If this is the case then these initial steps should have limited short-term implications for the monetary policy stance.

In the Committee's view, the result of the Icesave referendum on 9 April has tilted risks to the exchange rate to the downside, as it may affect the sovereign credit rating and hence the terms at which Iceland can borrow in foreign capital markets. This may limit the MPC's room for manoeuvre over the medium term. It may also affect the pace of capital account liberalisation. Committee members thought, however, that this would be mitigated by the likelihood that the programme with the IMF will be unaffected.

The MPC discussed possible adjustments to the monetary stance. In the Committee's view, the inflation outlook has deteriorated, at least in the near term, and inflation expectations have drifted upwards. Moreover, the result of the Icesave referendum has tilted risk to the value of the króna to the downside. On the other hand, however, the baseline outlook for growth and employment has deteriorated.

Three alternative rate decisions were discussed: to keep rates unchanged or to raise them or lower by 0.25 percentage points. In light of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be kept unchanged: the deposit rate (current account rate) at 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) at 4.0%, the seven-day collateralised lending rate at 4.25%, and the overnight lending rate at 5.25%.

Four members voted in favour of the Governor's proposal. One member voted against the Governor's proposal, preferring to raise interest rates by 0.25 percentage points. This member put more weight on the factors leading to more persistent inflation, such as wage pressures, higher inflation expectations, and the possible weakening of the króna.

The Committee agreed that the direction of future policy moves remains uncertain. As before, the MPC stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor 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, 15 June 2011.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

June 2011

Published: 29 June 2011

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

The following are the minutes of the MPC meeting held on 14 June 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 15 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 20 April interest rate decision.

Financial markets

The trade-weighted value of the króna in the onshore market was 1.8% lower at the time of the June MPC meeting than at the April meeting. Between the two meetings, the króna depreciated by 2.1% against the euro, by 0.9% against the US dollar and by 1.6% against the pound.

The Central Bank has bought 63 million euros in the domestic interbank foreign exchange market since it began regular foreign currency purchases at the end of August 2010.

The króna has appreciated against the euro in the offshore market since the last MPC meeting, trading at 220-254 against the euro, but volume and frequency of trading remain low.

On 9 June 2011, the Republic of Iceland issued a five-year bond for USD 1 billion. The final book size was more than USD 2 billion, and the bond was issued at 320 basis points over the USD LIBOR rate.

The CDS spread on the reference five-year USD Republic of Iceland debt rose from 224 basis points at the time of the April meeting to 280 basis points at the time of the June meeting. This may have been a result of the issuance of the above-mentioned bond creating a demand for associated insurance. Prior to 9 June no five-year USD Republic of Iceland debt had existed for some time and trading in the reference Republic of Iceland CDS had been limited.

Overnight interbank interest rates had hovered between 3.5-4.0% since the April meeting. Trading in the interbank market amounted to 65 b.kr. since the April meeting, with volume concentrated in overnight maturities, although there had also been transactions involving other maturities. About 57.1 b.kr. worth of certificates of deposit (CDs) were outstanding as of the June meeting, approximately 7 b.kr. less than at the time of the April meeting.

Yields on longer-term Treasury bonds had risen by 0.72-1.20 percentage points since the April meeting, while shorter-term Treasury bonds had fallen by 0.2 percentage points. At the same time, yields on HFF bonds had risen by 0.19-0.28 percentage points.

Breakeven inflation, that is the difference between nominal and indexed bond yields, had risen in recent months and the average breakeven inflation rate for the next five years was estimated to be between 3.8% and 5% at the time of the meeting. This is an increase of about 2 percentage points since the end of January 2011. Preliminary attempts to separate breakeven inflation for one year into inflation expectations and inflation risk premium suggest that an increase in the inflation risk premium may have accounted for some of the rise in breakeven inflation.

Preliminary figures on the banking system in April showed that the net position of outstanding loans to residents decreased by 1.1% from the previous month. Loans to the corporate sector decreased by 0.1%, and total lending to households fell by 2.0%. Broad money (M3) decreased by 1.3% month-on-month in April and has decreased by 7.9% year-on-year.

The nominal effective policy rate is currently approximated as the simple average of the Central Bank deposit and maximum CD rates. Averaging across different measures of inflation and inflation expectations, real policy rates have fallen by roughly ½ percentage point to -½% since the 20 April meeting. Using the twelve-month rise in the consumer price index (CPI) the *ex post* real rate had fallen by 1.1 percentage points to 0.2%, while in terms of breakeven inflation rates it had fallen by 0.8 percentage points to 1.1%.

Although a 0.25 percentage point reduction in policy rates seemed to be priced into the yield curve, most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to maintain unchanged rates at the June meeting. Most parties cited the economic slack as a hindrance to raising interest rates.

The first step in the capital account liberalisation strategy, a multi-price auction in which the Central bank of Iceland offered to buy Icelandic krónur for euros, was successfully concluded on 7 June. In all, offers were submitted for 61 b.kr., and offers amounting to

13 b.kr. were accepted. The minimum price of accepted offers was 215 kr. per euro and the average accepted price was 218.9 kr. per euro.

Outlook for the global real economy and international trade

According to the latest OECD forecast, published in May, global growth is expected to reach 4.2% in 2011, which is in line with the OECD forecast published in November 2010. The forecast for growth in Iceland's main trading partner countries is somewhat higher than was expected in November, at 2.1%. The growth forecast for world trade is broadly unchanged, at 8.1% in 2011 and 8.4 % in 2012.

Iceland's merchandise trade surplus was 6 b.kr. in April and, according to preliminary data, 6.8 b.kr. in May. Despite a year-on-year increase in both exports and imports in the first five months of the year, the trade surplus fell by a fifth from a year earlier.

While both import and export values fell month-on-month in April, partly due to the effect of the Easter holidays, both import and export values grew year-on-year in April. Export values rose by 8% year-on-year, led by a rise in the export value of ferrosilicon and aluminium. Import values grew by 12%, led by increases in the import value of industrial supplies and consumer goods.

On average, the price of aluminium was 5% higher in April than in March. It peaked at the beginning of May and came down a bit during the month, but was back to early April values by the beginning of June. The value of marine product exports has continued to rise, increasing by 1.5% month-on-month in April, and the price level has risen by over 14% in the last twelve months.

The domestic real economy and inflation

Seasonally adjusted GDP grew by 2.0% quarter-on-quarter in Q1/2011, after falling by 1.5% in Q4/2010 according to Statistics Iceland preliminary national account numbers. The growth is almost entirely due to an increase in inventories amounting to 5.6% of GDP. Private domestic demand weakened with both private consumption and gross fixed capital formation contracting, while public consumption was broadly unchanged. Both exports and imports contracted between quarters, while the contribution of net exports to output growth was slightly positive. The large stock of inventories, however, is export goods which have been sold, but not yet shipped out, and it will contribute to exports in the next two quarters.

Statistics Iceland's preliminary figures show a 3.4% year-on-year growth in GDP for Q1/2011, much larger than the 0.8% forecast by the Central Bank. Some of this difference may be due to Statistics Iceland underestimating investment in 2010. Correcting for this would yield a year-on-year growth of 3.1%. Year-on-year growth in private consumption measured at 1.5%, in line with the Bank's forecast of 1.3% growth. Domestic investment was weaker than the Bank expected, however, growing by 13.3% year-on-year instead of the 20.1% forecast. Public consumption proved stronger, however, contracting by 0.7% year-on-year instead of the 2.1% contraction forecasted by the Bank. The deviation can be explained by a pick-up in local governments' nominal spending and differences in consumption deflator assumptions.

Exports of goods and services were weaker than forecast, partly due to the large inventories yet to be exported, contracting by 1.6% year-on-year as opposed to the 3.9% growth forecast. Imports of goods and services were also weaker than forecasted, growing by 1.3% instead of the 4.5% growth that was predicted. The trade balance was somewhat weaker than anticipated, with a surplus of 5.8% of GDP, instead of the forecasted surplus of 8.1% of GDP.

The current account deficit was almost 13% of GDP, or 48 b.kr., in Q1/2011. This is a smaller deficit than in the previous quarter but higher than the average deficit of 10% in 2010. The underlying current account balance – that is, excluding banks in winding-up proceedings – was negative by 2.5% of GDP.

There are signs of recovery in the labour market, according to the recent Statistics Iceland labour force survey. In Q1/2011, both the employment rate and the participation rate of core workers rose year-on-year, as it had done in Q4/2010 for the youngest workers. Total hours worked in the reference week increased by almost 2%, due to a 3.6% increase in the contribution of core workers.

The wage index rose by 0.1% in April after having risen by 0.3% in March. Year-on-year wages increased by 4.4% in April and real wages by 1.5%. Seasonally adjusted unemployment had fallen by 0.5 percentage points since the last meeting, to 7%, while registered unemployment was 7.4%.

New wage settlements were signed by the national member associations and the largest unions within the Icelandic Federation of Labour and the Confederation of Icelandic Employers on 5 May 2011. The wage settlements apply to roughly one-third of the labour force as measured in man-years, but their impact on the cost of labour will probably extend to most of the private and public sector. It is estimated that gross wage costs incurred by employers in the private sector will rise on average by 4½-5% a year during the three year term of the settlement. Net wage costs incurred by employers will probably rise less, however, as the Government has pledged to lower the payroll tax 2012 and 2013 in line with the decline in unemployment.

Statistics Iceland’s nationwide housing price index, published in May, increased by 0.4% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, rose by 0.7% month-on-month in April, and by 1.6% when adjusted for seasonal variability. Some 86% more contracts were concluded in April than during April 2010, and in the first four months of 2011, 66% more contracts were concluded than in the same period in 2010. The number of contracts remains very low in a historical context, however.

Seasonally adjusted payment card turnover suggests that private consumption will be stronger in Q2/2011 than in the previous quarter. Consumer sentiment improved in May, after having declined slightly in April. Expectations about the economic situation six months ahead and sentiment towards the labour market increased the most. Also in May, sentiment towards the current economic situation, which has remained very low over the past two years, showed its largest monthly improvement since before the financial crisis.

The CPI rose by 0.94% month-on-month in May following a 0.78% increase in April. Annual inflation measured 3.4% in May, compared to 2.3% in March. Annual inflation excluding tax effects measured 3.2% in May. The seasonally adjusted CPI rose by 2.5%

over the previous three months, or 10.3% on an annualised basis. Annual core inflation 3 (headline inflation excluding tax effects, volatile items such as food and petrol, public services, and mortgage interest payments) measured 2.3% in May, compared to 1.3% in March. It should be noted, however, that all measures of annual inflation are 0.4 percentage points lower than they would otherwise have been due to the exclusion of broadcasting fees from the CPI as of January 2011.

Many factors contributed to the rise in inflation in April and May, but the housing component had the largest effect, almost 0.5 percentage points in all. While the increase was mostly due to a rise in paid and owner-imputed rent, part of it was due to a correction in the building cost index, which affected the cost of housing maintenance. Other factors that contributed to recent inflation included increases in public service prices, international airfares, and petrol prices. Part of the recent rise in international airfares stems from higher global oil prices.

II The interest rate decision

The Governor informed the Committee of the recently completed fifth review of the IMF Stand-By Arrangement, the associated funding, and the outlook for reserves. He also informed the MPC of recent rating actions on Iceland, the issuance of euro-dollar bonds by the Republic of Iceland, and the results of the first foreign currency auction in relation to the capital account liberalisation strategy.

The Committee discussed the Central Bank's newly published *Financial Stability* report and recent steps in the financial sector restructuring process.

The MPC noted that headline inflation has increased for four consecutive months, reaching 3.4% in May. In the Committee's view, it will likely remain elevated through next year. Core inflation still remains close to the inflation target, however. The increase in inflation mainly reflects the lagged effects of a weak króna and the recent rise in commodity and oil prices. To the extent that the króna is broadly stable and these price increases are temporary, they are unlikely to have a lasting effect on inflation over the medium term.

The MPC discussed possible adjustments to the monetary stance. In the end, the Committee considered two options: keeping rates unchanged and raising them by 0.25 percentage points.

The recent rise in actual and expected inflation were arguments for monetary policy tightening. Stronger wage pressures, implied by the recent wage agreements also suggest mounting inflation risk, especially given the weak króna. In most members view, the latest national account data and labour market survey outcome were broadly in line, or even somewhat stronger, than the Bank's latest forecast. These members argued that together with an outlook for a more expansionary fiscal stance, this could suggest more robust demand growth going forward than the Bank's latest forecast assumes.

The arguments for keeping rates unchanged, however, are the continued significant slack in the economy and the contraction in money and credit aggregates. Both would suggest that the recent rise in inflation will be transitory and that inflation will thus return to target once the effects of these shocks peter out.

Members of the Committee had different views on the strength of the real economy, how much of the recent rise in long-term nominal interest rates actually reflected rising inflation expectations, the extent to which the supply shocks contributing to inflation were likely to be transitory, on the outlook for the króna and on the likely effects of a tighter monetary policy on the domestic economy.

In light of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be kept unchanged: the deposit rate (current account rate) at 3.25%, the maximum bid rate for 28-day certificates of deposit (CDs) at 4.0%, the seven-day collateralised lending rate at 4.25%, and the overnight lending rate at 5.25%.

The Committee voted unanimously in favour of the Governor's proposal, although one member would have preferred to raise interest rates by 0.25 percentage points, placing more emphasis on factors suggesting greater inflationary risks. Most members agreed that significant inflation risk remains and the danger is that inflation will prove more entrenched than is currently expected. With this in mind, the majority of the Committee agreed that it was appropriate to shift to a tightening bias in the Committee's statement, although future policy moves will, as always, depend on developments and prospects.

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

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor 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, 17 August 2011.

30 November 2010

Procedures of the Central Bank of Iceland Monetary Policy Committee[1]

According to the Act on the Central Bank of Iceland, the Bank's Monetary Policy Committee (MPC) takes decisions on interest rates and other monetary policy instruments at least eight times a year.

Before each interest rate decision, Committee members shall:

- Have access to all available data that they need to take an informed decision.
- Have sufficient opportunity to exchange views and discuss the decision.

In order to achieve these objectives, the Committee has agreed to the following procedure for its meetings:

- Four times a year, when the Central Bank publishes its assessment of the economic outlook in its *Monetary Bulletin*, or when substantial changes take place in the economic outlook, the regulatory framework, or matters related to financial stability, in-depth two-day meetings shall be held.
- In between these meetings, decisions may be taken at one-day meetings.

If members are unable to attend in person, it is permissible to participate via teleconference.

Monetary policy meetings

- *Preparation and presentation of documents:* Prior to each meeting, Committee members are sent documents and data on financial market developments, the state of the financial system, the state of economic affairs and indicators of economic outlook, and other data that could prove useful during the decision-making process. These documents shall be sent to Committee members no later than at the end of the week prior to each interest rate decision.

[1] Revised in November 2010.

- *Structure of meetings:* In general, meetings shall be divided into three sessions.
    - During the first session, recent events that could affect the assessment of the state of economic affairs and the interest rate decision are discussed. There is a presentation of financial market developments and Central Bank market actions, of recent economic developments and prospects and of major developments pertaining to financial stability. Also, there can be a presentation of special topics that are relevant to the role of the Committee and are included in the agenda by the Chairman or are requested by a majority of members.
    - During the second session, monetary policy is discussed and an interest rate decision taken. At the beginning of the session, the Chief Economist summarises the analysis from the first session and, on the basis of that analysis, presents his/her appraisal of whether there are grounds for changes in monetary policy. Following this is a discussion of the issues involved, and members explain their position on monetary policy. The Governor then presents a proposal for an interest rate decision and a vote is taken if Committee members are not all in agreement. Even though a consensus is reached, members may request that it be stated in the minutes that they would have chosen a different conclusion but considered the difference small enough that they were willing to agree with the Governor’s proposal.
    - During the third session, the Committee’s message is discussed and the monetary policy statement written. At the beginning of the session, a draft monetary policy statement is presented. The Committee works jointly on the statement, with the objective of reaching a consensus on the message and its wording.
- *Participants at meetings:* In addition to MPC members and the Committee secretary, the relevant specialists on the Bank’s staff participate in the first session. At the latter two sessions, participation is limited to MPC members and the Committee secretary unless otherwise decided.

Press releases and press conferences

The interest rate decision should be announced in a press release outside normal trading hours in Icelandic financial markets and explained in a press conference. The announcement should be made with a reasonable time lag needed to prepare and translate the communication.

Agenda

The secretary of the Committee prepares the agenda for each meeting upon consulting with the Chief Economist, Governor, and Deputy Governor. The agenda shall be sent to the Committee no later than at the end of the week prior to each interest rate decision.

Record of Minutes

The minutes of each Monetary Policy Committee meeting shall be published two weeks after each interest rate decision. The minutes shall contain a summary of the information presented to the Committee by Bank staff. They shall also describe the main points of view expressed by members and state the range in which members considered it appropriate to keep interest rates. In addition, they shall describe the Governor's proposal, other members' response to it, and the final decision. The Bank's *Annual Report* shall reveal the votes cast by each Committee member.

Comments by Monetary Policy Committee members

Committee members are free to express their opinions on the economic outlook and monetary policy, but they should bear the following in mind:

- When members discuss monetary policy, they shall avoid commenting on other members' viewpoints and should state clearly that their opinions need not reflect those of other members, unless this is not applicable.
- Members shall not express themselves publicly about the economic outlook and monetary policy for seven days prior to the announcement of the interest rate decision, nor shall they discuss these matters with investors or other parties that could profit from information on Committee members' views. This also applies to the publication of interviews granted in advance.
- Members shall also avoid making public statements on the day the announcement is published. The Governor, however, may

grant interviews to the media that day, or delegate to other members to do so.

Changes in procedure

If a Committee member wishes to propose a change in procedure, he/she must present a written proposal to the Committee. After the Governor has consulted other members, he/she will take a decision on whether to recommend that procedure be revised. Changes in procedure shall always be included in the agenda if requested by a majority of members.

Capital account liberalisation strategy

Report to the minister of economic affairs
25 March 2011

Capital account liberalisation strategy

This report contains a new strategy for liberalisation of capital controls. The experience with the previous strategy is discussed, the development of the various conditions for lifting capital controls are described, the two main phases of the strategy are explained in broad terms, and the individual steps of the first phase are outlined in some detail (see Sections III and IV). It is concluded that the conditions are in place for gradual relaxation of some parts of the controls, although more fundamental steps will have to wait until the Treasury has demonstrated through borrowing that it has the ability to refinance foreign loans. This has been delayed, partly as a result of the still-unresolved Icesave dispute. If the Icesave bill is rejected in the upcoming referendum, Phase II and part of Phase I of the strategy could be delayed. Hence, to begin with, the focus will be on steps that will not place strain on the foreign exchange reserves; i.e., auctions whose aim is to direct unstable króna holdings into the hands of long-term investors.

I. Introduction

Foreign exchange transactions have been subject to capital controls ever since the banking system collapsed in the autumn of 2008. Before the capital controls took effect, the Central Bank issued guidelines instructing the banks to limit foreign currency sales to essential transactions involving trade in goods and services. On 28 November 2008, the Rules on Foreign Exchange were adopted in accordance with temporary provisions in the Foreign Exchange Act. When the Rules took effect, all controls on current account foreign exchange transactions were lifted, but more stringent controls on cross-border movement of capital and related foreign exchange transactions were imposed. The Rules have been reviewed and amended several times. The amendments have aimed primarily at closing loopholes in the original Rules. One of the most important changes in this regard was made in late October 2009, when it was stated unequivocally that the unilateral importation of offshore krónur was prohibited.[1] Importation of offshore krónur had been a common means of circumventing the controls. At the same time, the controls were relaxed in other ways; for example, controls on inflows of foreign capital were lifted. Most likely, these actions played a role in stopping the virtually uninterrupted slide in the exchange rate of the króna, which had begun in March 2009.

[1] *Offshore krónur* are defined in this report as valuables (or a certificate for such valuables) that are denominated in domestic currency but owned or held in custody by non-residents and are subject to particular restrictions according to the Rules on Foreign Exchange. While most holders of off-shore krónur are probably non-residents, residents hold some as well, either directly or indirectly.

On 5 August 2009, the Central Bank of Iceland presented a capital account liberalisation strategy that it had prepared with technical assistance from the International Monetary Fund. It was quite unclear at the time whether it would be possible in the near future to fulfil the requirements necessary to lift the controls without jeopardising foreign exchange market stability. Consequently, the strategy was not set forth in terms of a timetable; instead, its progress would be subject to the fulfilment of stated conditions. Emphasis was placed on avoiding discrimination to the extent possible. The main feature of the strategy prepared in the summer of 2009 was that controls on capital inflows should be lifted first. This first phase of the strategy was implemented in late October 2009, but at the same time a strengthening of the regulatory framework was aimed at prohibiting inflows of offshore krónur, which were the main channel for circumvention until that time and had greatly undermined the foreign currency repatriation requirement. Subsequently, controls on long-term holdings – which were already held to a large extent by long-term investors or would soon find their way into the hands of such investors (such as domestic pension funds) – were to be lifted gradually. Finally, controls on short-term assets would be lifted, in part through auctions where market prices would determine which investors could convert ISK assets to foreign currency first. The strategy assumed that this problem would not be addressed until late in the liberalisation process, as a vast amount of highly liquid assets were owned by non-residents likely to want to or be forced to sell them at the first opportunity. It was also assumed that the offshore krónur problem would eventually diminish to some extent through internal trading by non-residents, where investors with a longer horizon and more tolerance for distress would acquire ISK assets from distressed investors willing to sell at lower prices.

Clearly, it has taken longer than originally estimated to create the conditions required to lift the capital controls without causing significant instability. There are a number of reasons for this. Disbursements under the IMF-supported programme were delayed markedly, in part because the Icesave dispute held up the disbursement of the bilateral Nordic loans. Furthermore, it took much longer than originally assumed to finalise the balance sheets of the new banks; the preparation of private sector debt restructuring measures proved a lengthy process; and substantial uncertainty was created by the Supreme Court decisions that deemed exchange rate linkage of loans illegal and non-binding. Moreover, conditions in foreign credit markets have been extremely adverse for a long period of time. Adverse market conditions and Iceland’s lower credit ratings have obstructed the Treasury’s access to foreign credit markets. For a number of reasons, the offshore krónur problem has not resolved itself sufficiently with the advent of new long-term investors.

Although disbursements under the Stand-by Arrangement have been delayed, the economic programme has progressed significantly, not least as regards exchange rate stability and accumulation of foreign exchange reserves, general macroeconomic equilibrium, and an improved fiscal balance. Moreover, non-residents’ ISK holdings have been downsized through the Avens agreement. External confidence in the economic programme has increased as progress has been made, which can be seen in the dramatic decline in Iceland's sovereign CDS spread since the original strategy on liberalising capital controls was published.

In spite of increased confidence on many fronts, confidence that the króna would preserve its onshore value in the absence of controls remains limited, at least among those investors that are trading offshore. This is reflected by the fact that the limited offshore trading in krónur still takes place at an exchange rate far below the onshore rate. The capital controls permit only internal trading in offshore krónur among non-residents, while they restrict capital transactions between residents and non-residents. Because of the controls, the foreign exchange markets do not converge to a joint equilibrium. A substantial portion of liquid ISK assets – for example, deposits in domestic banks and short-term Government bonds – remain in the hands of parties that are unable or unwilling to own them after the controls are lifted. As long as attempts to shift a large share of these unstable assets to long-term investors are unsuccessful, it is difficult to see how the controls can be removed without the risk of generating instability in the foreign exchange and bond markets.

The main problem with the previous liberalisation strategy lay in its lack of measures to channel these unstable assets into long-term investments before other controls were lifted. Holders have been given the chance to invest in only a relatively limited selection of assets, and various investor groups (such as domestic pension funds) have not been given the opportunity to acquire offshore krónur. Consequently, efforts to put these assets into the hands of long-term investors have made only slow progress.

The strategy described below deviates in many important respects from the August 2009 strategy. However, it retains its gradualist approach and continues to emphasise avoiding discrimination. The strategy is designed so that it can be adapted easily to a variety of outcomes, mainly through adjusting the speed of implementation. In addition to the measures that have already been taken to relax parts of the controls, such as those on capital inflow, the strategy comprises two main phases, each incorporating smaller steps. This report describes the conditions that are considered prerequisites for the completion of each phase and step. The phases and steps are not pinpointed in terms of dates, as it is impossible to state precisely when the conditions for implementing any given step will be in place; moreover, important information on when and how it is best to proceed will be obtained in each phase and step completed.

It is highly unlikely, to say the least, that the capital controls will have been lifted in full by the time the current statutory authority expires on 31 August 2011, without assuming unacceptable risk of financial and exchange rate stability. How rapidly the controls can be lifted will be determined by the development of the various conditions. The existence of forceful prudential rules to limit foreign exchange risk and other risks stemming from cross-border banking operations is also extremely important. Hence it is recommended that the statutory authority be extended by approximately four years, which should ensure that it is possible to lift the controls at a pace warranted by circumstances without generating instability, given appropriate prudential regulation. Nevertheless, every effort should be made to lift the controls earlier if conditions permit.

It is proposed that the currently operating committee comprising representatives of the Ministry of Economic Affairs, the Ministry of Finance, the Prime Minister's Office, the Financial Supervisory Authority, and the Central Bank continue working and that it supervise the implementation, pace and adaptation of the strategy. The same applies to the task force headed by the Minister of Economic Affairs, which also includes the Minister of Finance, the Director General of the Financial Supervisory Authority, and the Governor of the Central Bank.

The next section of this report provides a general description of the structure and phases of the new strategy and the conditions that must be fulfilled before each phase is implemented.[2] Section III examines the means by which offshore krónur can be channelled into the hands of long-term investors, for the benefit of the domestic economy. Section IV discusses the liberalisation of onshore krónur and the prudential rules pertaining to exchange rate risk and cross-border activities in domestic financial undertakings after controls on movement of capital have been lifted in other respects. Section V contains the conclusion.

II. Structure and phases of the new strategy

The current strategy deviates from the previous one in that it focuses on systematic measures aimed at transferring unstable ISK assets into the hands of long-term investors at an early stage. As with the previous strategy, it does not pinpoint times and dates, except that the next phase, which can actually be divided into as many smaller steps as is necessary, will begin after the publication of this strategy. However, it retains a gradualist approach towards removing controls. A key objective is to lift the capital controls in stages without jeopardising foreign exchange market stability.

The strategy is divided into two main phases. The Central Bank is of the view that the preconditions for taking the initial steps of Phase I have been met, but before the latter steps of Phase I are taken and before Phase II is implemented, additional conditions must be met (see Sections III and IV). As is discussed in Appendix I, the macroeconomic conditions for removal of the controls have been moving strongly in the right direction since the August 2009 liberalisation strategy was published. The same is true of the increased level of foreign

2 Appendix I contains a more detailed discussion of the macroeconomic, financial, and other conditions that must be fulfilled if capital controls are to be lifted without triggering instability.

exchange reserves (Appendix III). One of the principal obstacles to removing the controls is the potential instability of non-residents' deposits with domestic banks (Appendix II). That being the case, any new strategy for removing the controls must focus on reducing uncertainty associated with the large stock of short-term offshore assets by allowing them to exit in stages or by channelling them into the hands of parties (domestic or foreign) that wish to invest them in the domestic economy for the long term. The Central Bank is of the view that the prerequisites for taking steps in that direction have now been met, provided that such steps are taken cautiously. The measures described below should not deplete the foreign exchange reserves. On the contrary: some of them should induce net inflow of foreign exchange in the short term (purchases of operating companies) or at least in the long term via export expansion (green field investment in export industries). They do not depend on full recovery of confidence in the Treasury because the measures will be directed in large part towards the private sector and will, to an extent, enable the Treasury to finance its activities on more favourable terms than would otherwise be possible. Consequently, the Treasury's financing needs should be secured, even though some of the capital that has previously funded the Treasury should be channelled elsewhere – for example, into business investment – thus underpinning public sector finances indirectly. Moreover, the gradualist approach towards releasing off-shore krónur makes it possible to moderate the process should any problems emerge. Throughout this process, the existing controls will be enforced. Should circumvention arise, it will be dealt with by closing loopholes or, if needed, by modifying the strategy.

Phase I – reduction of offshore króna positions

Phase I of the liberalisation strategy provides for measures to reduce distressed investors' offshore króna holdings and channel offshore krónur into the Icelandic economy and the Treasury's long-term funding. The range of investment opportunities involving offshore króna will be expanded in a controlled way while the present controls remain in effect and are fully enforced.

To begin with, action will be taken to reduce non-residents' offshore króna holdings by authorising the exchange of such holdings, in two steps, for residents' FX holdings, without depleting the Central Bank's foreign exchange reserves, and then directing those holdings into long-term investments in Icelandic Treasury bonds, domestic corporate equity, real estate, and other long-term assets. The strategy lists the various options that will be authorised in this area and outlines the requirements that must be met, but without describing the technical implementation in minute detail. The guiding principle in the strategy is to create conditions so that distressed investors can sell their ISK assets to investors with a longer investment horizon and the capacity to invest in a greater range of assets; for example, through direct investment in the domestic economy. The steps will be implemented with an eye to minimising the risk of foreign exchange market instability, which could place excessive strain on the foreign exchange reserves and cause financial stability concerns (notably, liquidity problems in the banking system). Finally, the remaining owners of offshore krónur will be offered the chance to sell their ISK deposits for foreign exchange, subject to an exit levy, or to swap króna-denominated Treasury bonds for eurobonds issued by the Treasury. It is difficult to state when this phase will be concluded; this will be determined by the interplay of internal and external factors.

Phase II – removal of controls on onshore krónur

When sufficient progress has been made under Phase I – that is, when the stock of offshore ISK assets held by distressed investors has been reduced to a level the CBI deems manageable in terms of external reserves, and when the offshore exchange rate has approached the onshore rate – Phase II (the liberalisation of onshore króna holdings) can begin, provided that an assessment of the balance of payment outlook indicates that reserves will be adequate and other preconditions have been met. It is also possible that onshore króna holders' options for foreign direct investment will be expanded to some extent before measures to tie up offshore krónur are complete. The risk of foreign exchange market instability is much greater here than in Phase I. The likelihood that such a risk will materialise, however, diminishes with increased success in Phase I and with greater success in fulfilling the preconditions for liberalisation, which are described in Appendix I. The main requirement is that the Treasury and the banks engaged in foreign exchange transactions have adequate access to foreign credit markets. Consequently, before Phase II of the strategy commences, a careful analysis will be conducted so as to determine whether i) the banks are sufficiently liquid and will remain liquid as measured by liquidity ratios presently enforced by the Financial Supervisory Authority and the Central Bank and the envisaged revised prudential liquidity requirements in line with the Basel III framework (LCR, NSFR)[3] and can withstand volatility of capital flows and the exchange rate, ii) reserves are adequate to sustain reasonable foreign currency outflows, and iii) the Treasury finances are strong enough to sustain temporary volatility in demand for Government debt. The Treasury must also have confirmed its access to foreign credit markets by borrowing at acceptable terms.

Before the Phase II begins, prudential rules aimed at limiting financial institutions' exchange rate risk will be strengthened. Some further regulations on cross-border operations of banks headquartered in Iceland will also be considered, as long as Iceland remains outside the European Monetary Union (EMU) and a satisfactory pan-European safety net for such operations has not been established. A satisfactory long-term solution to this problem requires an international or EU-wide settlement, however. Furthermore, prudential rules that play a consumer protection role while possibly reducing risk in the financial sector (such as controls on foreign-denominated borrowings by households) will also be explored. Such prudential rules and restrictions could be seen as restricting capital movements and therefore must be discussed in due time with the parties to the EEA Agreement in order to

[3] In addition, the Central Bank is ready to take the action necessary to respond to negative effects on the liquidity of individual financial institutions and the system as a whole while liberalisation is underway.

investigate how they could be assimilated into the framework of the Agreement. Moreover, before Phase II begins, it is necessary to decide Iceland's future monetary policy framework, which will be put in place and could serve Iceland as long as it remains outside the EMU – or longer, if EU membership is voted down in the planned referendum.

If the above conditions are met, if efforts to reduce offshore ISK positions are successful, and if the financial institutions' liquidity and balance sheets are sound, it may be possible to lift the remaining controls rather quickly, which could be desirable because it may prove more difficult to enforce the controls once more exit paths are opened up. Whether this is indeed possible will depend on circumstances, however, and it could prove necessary to limit the risk associated with the impact of liberalisation on the exchange rate and the foreign exchange reserves by dividing the phase into several steps; for example, by easing rules on foreign direct investment before other steps are taken. The need for an even more gradualist approach will be assessed on the basis of the above-mentioned criteria.

III. Phase I – ways to reduce offshore króna positions

In this report, *offshore krónur* are defined as valuables (or a certificate for such valuables) that are denominated in domestic currency but owned or held in custody by non-residents and are subject to particular controls according to the Rules on Foreign Exchange.

At the present time, non-residents' króna-denominated bonds and ISK deposits in domestic banks total around 465 b.kr., which is equivalent to 30% of Iceland's GDP. Behind deposits held in domestic banks by non-residents, particularly foreign banks are end investors that own ISK deposits in foreign financial institutions. Information on the ultimate owners of these funds is limited, but it is known that they include banks, various institutional investors, hedge funds, and individuals. Presumably, most of them are non-residents, but there are some residents or non-resident corporations with links to residents. Because the interests and behaviour of these groups can vary greatly, it can be useful for analytical purposes to classify offshore owners into three categories:

- First, a significant group of distressed investors must (or wants to) sell at the first opportunity.
- Second, it is known that some non-residents ISK holders own krónur with the aim of investing in the domestic economy when the opportunity presents itself. In some instances, these are investors that purchased the krónur before the capital controls were imposed but have not been able to invest them domestically because of the controls. In addition, there could be parties that are interested in investing in Iceland but purchased their krónur after the controls were imposed. These investors are not likely to liquidate their positions when the controls are lifted.

- Third, a significant group of investors, perhaps the largest group, will easily adapt their behaviour to circumstances.

Apart from these three groups, it is appropriate to mention another group that will play a key role in the new strategy: investors that do not currently own offshore krónur but would like to buy them so as to invest in the domestic economy or in long-term Government-guaranteed bonds. This group is also quite diverse and includes both non-resident and resident holders of substantial foreign-denominated assets, such as pension funds. The key to successfully enhancing the stability of short-term ISK owners is channelling the krónur held by the first group into the hands of the second and fourth groups. If this is successful, there is a good chance that a considerable share of the investors that would otherwise sell their krónur when the controls are lifted will decide to hold them for the long term because, if the specified conditions exist, the risk of ISK appreciation or depreciation after the controls are lifted should be broadly balanced.

The strategy presented here aims to define the conditions that must be fulfilled by those wishing to import offshore krónur to Iceland or to take receipt of them. The first phase of the liberalisation strategy aims at authorising the sequenced importation of all *legally acquired offshore krónur*, according to terms and conditions described below. Legally acquired offshore krónur are defined as those held by the following parties:

- Residents or non-residents that can demonstrate continuous ownership of the offshore krónur from before the Rules on Foreign Exchange took effect (28 November 2008);
- Non-residents that acquired offshore krónur after the capital controls were imposed; and
- Residents and non-residents that meet the requirements for participation in the Central Bank's foreign exchange auctions, which are described further below. The Central Bank reserves the right to refuse participation to parties that have violated the Rules on Foreign Exchange or are being investigated for alleged violations of the Rules.

Described below are the main methods that will be deemed permissible for importing offshore krónur to Iceland and investing them in long-term Treasury bonds, in Icelandic corporate debt or equity, or in real estate. It is appropriate to note that the rules pertaining to repatriation of foreign currency, as well as parts of Rules on Foreign Exchange, no. 370/2010, will remain in effect as long as the capital controls are in place, and careful monitored will take place to ensure that those offering foreign currency in return for offshore krónur are not violating the repatriation rules. Investors that choose to participate in auctions but have previously liquidated investments according to Article 13 (on new domestic investment) will have to bring in additional foreign currency equivalent to the repatriated proceeds of the investment. The methods include a series of auctions and other measures that will be sequenced in order to control risk, although they can be implemented simultaneously to some extent.

Foreign exchange auctions of offshore krónur

Over the coming months, the Central Bank will conduct a series of foreign exchange auctions, with the objective of pairing foreign currency owners wishing to buy offshore krónur for investment in long-term Treasury bonds or Icelandic enterprises with owners of offshore krónur wishing to sell their krónur for foreign currency. The auctions are described in general terms below:[4]

- *Auctions of foreign currency for the purchase of offshore krónur, for investment in long-term Treasury bonds*
    - *Target group:* i) Residents that own foreign currency held in custody by a non-resident entity and wish to purchase long Treasury bonds to hold for the long term provided that they can enhance their returns through purchases of offshore krónur; ii) Non-residents owners of offshore krónur that wish to sell their krónur for foreign currency.[5]
    - *Objectives:* i) To release distressed investors so as to reduce pressure on the króna; ii) To give pension funds and others the opportunity to reduce their foreign exchange exposure and invest their portfolios effectively; and iii) To provide the Treasury with low-cost, long-term funding, thus reducing its re-financing need while the controls are being lifted.
    - *Execution:* The auctions will be carried out in two steps. i) Financial institutions, on behalf of the Central Bank, will offer owners of offshore krónur the chance to sell, in an auction, a specified amount of krónur against payment in foreign currency. ii) Financial institutions, on behalf of the Central Bank, invites owners of foreign currency held in the custody of non-resident entities to bid on Government bonds in an amount equivalent to the krónur bought in the previous auction, in exchange for foreign currency. The investment will be restricted to long-term Treasury bonds and will be locked in for a period of five years, but normal returns on the investment can be paid out during that period.
    - *Conditions:* The banks' liquidity position should be strong enough to sustain transfers of krónur between financial institutions and out of circulation if the Treasury increases its deposits with the Central Bank, or if special measures should be adopted to address this issue.[6] The Central Bank is ready to take the action necessary to respond to negative effects on the liquidity of individual financial institutions and the system as a whole while liberalisation is underway.

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[4] The terms and conditions of a tender will be described in more detail at later stage.

[5] While residents that hold foreign currency abroad and non-residents that hold offshore krónur are the *target* groups, the auctions will be open equally to residents and non-residents.

[6] Regular surveys of the banks' liquidity will be conducted.

- *Foreign exchange auctions for the purchase of offshore krónur, for investment in Icelandic corporate equity or debt or other domestic assets*
    - *Target group:* i) Non-residents planning to invest in Iceland and interested in purchasing offshore krónur in order to enhance their return on those investments;[7] ii) Non-residents owner of offshore krónur wishing to sell them in exchange for foreign currency.[8]
    - *Objectives:* i) To allow distressed owners of offshore krónur to sell them; and ii) To stimulate investment in the domestic economy, especially export activity.
    - *Execution:* The auction(s) will be structured as is described above, but with two differences:
        - It will also be permissible to invest in special closed funds (see the requirements for the establishment of such funds in Box 1) that invest in one or more domestic enterprises, properties, or specified bond series.[9]
        - The requirement for participation is that the investor contribute foreign currency equivalent to 50% of the value of the investment, according to terms and conditions described below.
    - *Conditions:* i) The financial institutions' liquidity should be strong enough to tolerate transfers of deposits, or special measures will be adopted in order to ensure that such transfers can be absorbed. ii) A sufficient number of auctions dedicated solely to investors in long-term Government bonds should have been carried out so as to minimise the risk of an abrupt increase in yields, depending on the outlook for Government access to credit markets.

If demand for offshore krónur for investment declines, the Central Bank may nonetheless conduct intermittent auctions of limited amounts of foreign currency in order to release ISK owners wishing to sell. The primary purpose of the auctions will be to gauge, on a regular basis, selling pressure on the króna from owners of offshore krónur. The amount of foreign currency auctioned on each occasion would be low, and the number of auctions would be determined by developments in the foreign exchange reserves and other economic conditions. Because these limited auctions will be held even in the absence of proven demand for these krónur from owners of foreign currency, the number and amounts of auctions of this type would depend on assessments of reserve adequacy and other economic conditions; i.e., whether the Treasury has demonstrated access to foreign capital markets.

[7] While residents that hold foreign currency abroad and non-residents that hold off-shore krónur are the *target* groups, the auctions will be open equally to residents and non-residents.
[8] As before, residents will not be excluded but are not expected to participate in great numbers.
[9] Amendments to existing legislation will be obtained as needed.

Repatriation of offshore krónur owned by parties wishing to invest in Iceland

As is mentioned above, some owners of offshore krónur have held them since before 28 November 2008, when the capital controls were imposed, because they planned to invest in Iceland. Others have acquired offshore krónur legally since the Rules on Foreign Exchange were tightened because of future plans to invest domestically. These parties will be permitted to transfer these krónur into domestic financial institutions so as to invest them *after one or more auctions are over (or simultaneous with subsequent auctions),* subject to requirements described below:

- *Target group:* Residents and non-residents that have held offshore krónur since before the controls were imposed or non-residents that have acquired them since (prior to the publication of the new strategy or in an auction afterwards), intend to invest them in Icelandic businesses, and are willing to contribute foreign currency amounting to 50% of the value of the investment, in the manner applicable to those acquiring them in auctions. Rules on foreign borrowings will be eased, in part with the objective of allowing residents that are adequately hedged against foreign exchange risk and own offshore krónur (or will be able to acquire them in auctions) to borrow abroad in order to buy offshore krónur for 50% of the value of domestic investments. Investors that have held offshore krónur since before 28 November 2008 will enjoy priority if there is need to increase steps in this phase.
- *Objectives:* To stimulate investment in the domestic economy and diminish the appearance of an offshore króna problem, which can contribute to undermining confidence, even though the holders of the offshore krónur that are likely to participate in this operation are long-term investors.
- *Execution:* A domestic financial institution, bank, pension fund or other financial institution subject to supervision by the Financial Supervisory Authority can apply to the Central Bank for authorisation to receive offshore krónur and deposit them to a closed investment fund that is tied for a period of five years (see Box 1).
- *Conditions:* i) The banks' liquidity position should be strong enough to sustain transfers of krónur between financial institutions.[10] ii) To ensure stability in the Government bond market, it would be desirable at this stage if the Treasury could demonstrate access to foreign credit markets. The number of auctions dedicated solely to investors in long-term Government bonds will be expanded as needed to avoid abrupt increases in yields.

The measures described above rely on the initiative of those that have information on investors and investment opportunities and are able to execute the measures that apply. Financial institutions can establish funds in various ways, provided that the structure of such funds meets the general requirements set by the Central Bank. The rules requiring that new inflows of foreign currency constitute 50% of the value of the investment should ensure that

[10] Regular surveys of the banks' liquidity will be conducted.

the króna will not be adversely affected in the short run, and if the measures stimulate investment in export-related business activities, the medium-term impact should be positive. In some instances, the share of imported inputs into the investment may exceed 50% of its value, but in cases involving the acquisition of a currently operating company, half of the value of the investment will be a net inflow of foreign currency. Domestic companies that own foreign currency exempt from repatriation requirements can acquire offshore krónur by participating in the auction.[11]

Box 1. Closed-end funds

A domestic financial institution, bank, or pension fund subject to supervision by the Financial Supervisory Authority can apply to the Central Bank for authorisation to receive offshore krónur and deposit them to a closed investment fund that is tied for a period of five years. It is possible to establish such a fund around one or more specific investments, and with the participation of a single party or several. The application shall state how the financial institution intends to meet the following requirements:

- That it be ascertained that the offshore krónur received by the financial undertaking were acquired legally.
- That the financial institution inform the Central Bank Capital Controls Surveillance Unit (CCSU) of the manner in which it intends to disclose information to the CCSU (monthly or more frequently), that it report on developments in the investment, and that it receive the CCSU's approval of its information disclosure plan.
- That account be given of the investment policy of the fund in question and the Central Bank's approval be received.
- That the fund be structured so as, in the opinion of the CCSU, to minimise the risk that it will be used to circumvent the Rules on Foreign Exchange.
- If authorised by the CCSU, foreign financial undertakings can establish corresponding funds in cooperation with domestic a financial undertaking that is authorised to receive offshore krónur and is responsible for ensuring that the investment can be supervised adequately.

Bond swaps and exit levy

When the above measures have produced the desired results and there is less probability of channelling the bulk of the remaining stock of offshore krónur into domestic long-term investment, the remaining owners of those krónur will be offered two different exit opportunities for a limited period of time:

[11] See Article 14 of the Rules on Foreign Exchange. This includes companies with 80% of revenue and expense from abroad.

- *Target group:* All owners of offshore krónur that, for any reason, have not participated in auctions but may wish to liquidate their ISK positions before the controls are lifted.
- *Objectives:* To reduce, to the extent possible, the risk of capital flight before the controls are lifted, while simultaneously providing offshore krónur owners the incentive to unwind their positions in increments.
- *Execution:* i) Owners of off-shore ISK-denominated Treasury bonds will be permitted to exchange them for foreign currency denominated bonds. The maturity and price of the eurobonds will be determined by market conditions at the time. ii) All owners of offshore króna deposits in domestic banks will be authorised to exchange them for foreign currency upon payment of a levy determined by the spread between the offshore and onshore ISK exchange rates in the preceding weeks, or by the price in the most recent auctions. The exit levy will taper off in monthly increments until it disappears entirely within a given period (for example, one year) of being imposed. iii) The phased removal of the remaining capital controls may start before the exit levy has declined to zero, provided that a comprehensive assessment of the macroeconomic situation, medium-term balance of payments outlook, and stability of the financial sector indicate that this can be done safely.
- *Conditions:* That the Treasury and Iceland's leading financial institutions have demonstrated access to foreign credit markets by borrowing there at acceptable rates. Banks' liquidity positions and balance sheets should be strong enough to withstand deposit outflows.[12] Reserves should be sufficient to tolerate potential drains on reserves during the exit levy phase, given the estimated remaining stock of potentially unstable offshore krónur.

Although the main emphasis in Phase I is on tying up offshore krónur, authorisations for medium- and long-term foreign borrowing by residents that are adequately hedged against foreign exchange risk will also be expanded so as to support this measure. Non-residents that own foreign currency in domestic financial institutions will also be authorised to expatriate that currency before this period is over.

IV. Liberalisation of onshore króna holdings

When the offshore króna problem has been resolved to a sufficient degree, controls on other krónur holdings will be liberalised in at least two phases and several gradual steps. The main prerequisites for the initiation of this phase are as follows:

- That the medium-term balance of payments position be sufficiently strong to withstand potential drains on reserves.

12 Regular surveys of the banks' liquidity will be conducted.

- That the Treasury and Icelandic financial institutions have demonstrated that they have access to foreign capital markets on acceptable terms.
- That the financial sector be able to withstand volatile flows.
- That non-residents' positions in krónur and other highly liquid assets be significantly reduced.
- That the offshore ISK exchange rate not deviate substantially from the onshore rate.
- That sufficiently robust prudential rules on financial institutions' foreign exchange risk be in place, which limit the size of foreign currency balance sheets of domestic banks and the currency and maturity mismatches contained in them. These rules should also have the effect of reducing the risk that these institutions will resort to measures that may appear to be in their own narrow interests but are detrimental to their collective interests and those of the public at large. Those rules should be in place well in advance of Phase I.
- That other prudential rules have been set that are deemed necessary before the capital controls have been fully lifted. Controls on foreign-denominated borrowings by households might be included.
- Prudential rules that limit foreign exchange risk of pension funds will temporarily be tightened and subsequently eased in stages.[13]
- That a decision has been made regarding the future monetary policy framework, either in the context of potential membership of EMU or a reformed inflation-targeting framework.

The aim is therefore to lift all controls relatively quickly if conditions permit. This could be desirable because it may prove more difficult to enforce the controls once more exit paths are opened. Whether this is indeed possible will depend on circumstances, however, and it could prove necessary to limit the risk associated with the impact of liberalisation on the exchange rate and the foreign exchange reserves by dividing the phase into several steps; for example, by easing rules on foreign direct investment before other steps are taken. The need for an even more gradualist approach will be assessed on the basis of the above-mentioned criteria.

V. Conclusion

The discussion above describes the capital account liberalisation strategy that is to replace the one published on 5 August 2009. The strategy has been prepared by the Central Bank, in close cooperation with the Ministry of Economic Affairs, Ministry of Finance, and Financial

[13] If the pension funds build their foreign exchange assets rapidly after reducing their foreign currency assets by participating in the auctions, this could lead to instability of the króna which could harm the funds and the economy as a whole. Hence, it is in the interest of the pension funds and the economy as a whole that such rebuilding of assets takes place at an appropriate pace.

Supervisory Authority. The IMF and a foreign consultant with experience in capital controls surveillance and the removal of capital controls rendered useful advice.

The core of the strategy is that offshore krónur will be gradually released before onshore krónur. In particular, authorisations to invest offshore krónur in the domestic economy will be expanded substantially, concurrent with measures to facilitate transactions between owners of offshore krónur wishing to sell and parties wishing to buy them for foreign currency that they own or can obtain. Emphasis is placed on executing the strategy in moderate steps that allow for adaptation in view of experience. The participation level in the auctions, financial stability (including the liquidity position of domestic banks), reserve adequacy, the Treasury's access to foreign credit markets, and the balance of payment outlook will be carefully monitored throughout the process in order to assess whether the strategy needs to be modified or the speed of the liberalisation process adjusted. It is assumed that these measures will gradually reduce the positions of parties wishing to sell ISK assets at low exchange rates. At the same time, the spread between offshore and onshore ISK exchange rates should narrow considerably. This and progress on other pre-conditions mentioned above will create the conditions for the removal of controls on onshore ISK holders. At the same time, these measures should stimulate investment in the domestic economy. The time it will take to fulfil all the preconditions is highly uncertain, however. The strategy may also need to be adjusted in line with experience gained throughout the process. Before Phase II of the strategy begins, a major review of the preconditions will be carried out and the sequencing of that phase will, if needed, be spelt out in more detail.

A committee comprising representatives from the Central Bank, the Financial Supervisory Authority, and the aforementioned Government ministries will supervise the implementation, pace, and adaptation of the strategy, and a task force led by the Minister of Economic Affairs and including the Minister of Finance, Director General of the Financial Supervisory Authority, and Governor of the Central Bank will assess the progress made and determine whether the strategy needs revision. Before Phase II begins, it will be necessary to set stricter prudential rules for financial institutions than those currently in effect, including those pertaining to foreign exchange risk and cross-border operations. The first phase of the new strategy begins with an auction that will be announced soon after the strategy is publicised.

Appendices

1. Appendix on reassessment of the requirements for removal of capital controls
2. Appendix on banking system liquidity
3. Appendix on the foreign exchange reserves
4. Appendix on ISK assets of non-residents

Appendix I: Reassessment of the requirements for removal of capital controls

In spite of delays, Iceland's IMF-supported programme has progressed apace since the previous liberalisation strategy was issued. In general terms, the conditions that must exist before the controls can be lifted in full involve macroeconomic stability, financial stability, and foreign exchange reserves. However, the three are interconnected.

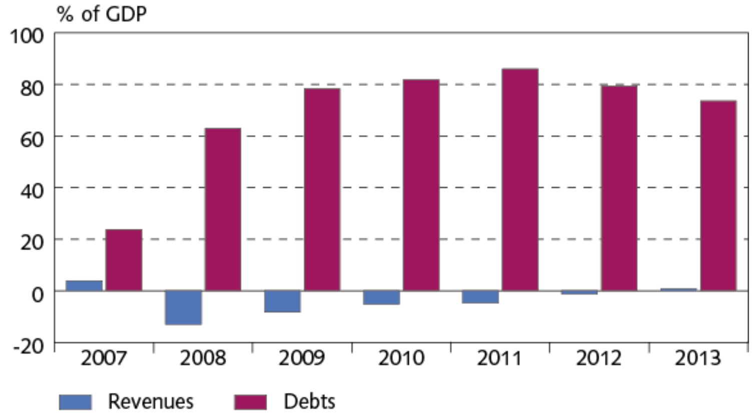
Macroeconomic stability

A great deal of progress has been made in terms of the macroeconomic conditions required to lift the controls. For example, a significant underlying current account surplus has developed, the króna has appreciated without foreign exchange market intervention, and inflation has subsided to the Central Bank inflation target. According to the National Budget, the Treasury's primary balance will be close to zero in 2011 and will show a significant surplus in 2012. One of the fundamental conditions necessary for liberalisation is that the Treasury enjoy confidence, both domestically and in foreign markets, and that it be able to fund the remaining deficit and refinance maturing obligations. This is necessary for obvious reasons. If investors are not confident that the Treasury will be able to service its debt, they will sell their Treasury bonds at the first opportunity and convert the proceeds into foreign currency.

The Treasury will have to demonstrate its access to foreign capital markets by issuing foreign-denominated bonds in international markets before any step is taken that could temporarily disrupt its source of funding, as is described below. The outlook for Iceland's sovereign credit ratings must improve, and ideally, the ratings themselves should rise from current levels. This is because Iceland's credit ratings are currently lower than is consistent with the investment criteria of various funds that hold Treasury bonds. These funds may therefore be forced to sell the bonds as soon as they can. If the Icesave agreements are approved in the upcoming referendum, an uncertainty factor will be eliminated in the view of many investors and credit rating agencies. This, in turn, could be an important step in facilitating the Treasury's access to foreign credit, which is a prerequisite for any major liberalisation steps in the strategy except the very first steps of Phase I, as is described below.

The Treasury plans to borrow funds abroad in 2011, and the outlook is for Iceland's sovereign credit rating to begin rising as the Treasury's position grows stronger, particularly if the Icesave dispute is resolved by negotiation. But it should be noted that the existence of the capital controls in and of itself could hinder the restoration of Iceland's credit rating. Thus there is no reason to delay starting the liberalisation process until the pre-crisis credit rating has been fully restored, although it is important that Iceland's credit ratings be comfortably above speculative grade before the exchange of ISK bonds for eurobonds is offered and Phase II begins. The steps that will be taken first towards removing the capital controls – that is, auctions aimed at foreign currency owners wishing to invest in long-term Treasury bonds and offshore króna owners wishing to sell – should facilitate long-term Treasury funding rather than causing complications.

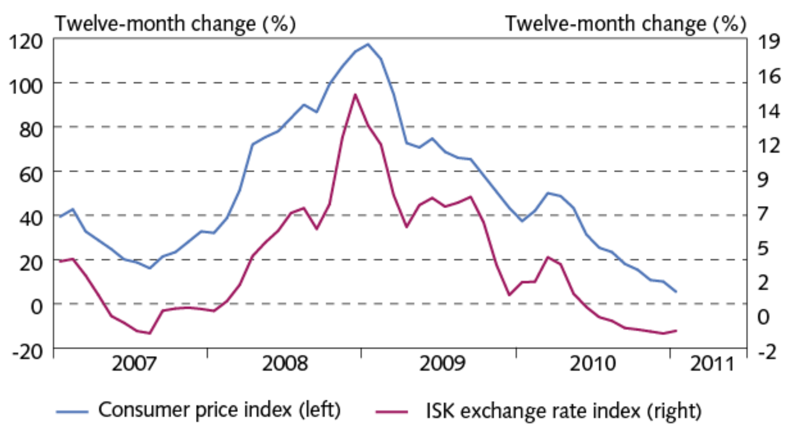
Treasury operating balance and liabilities 2007 - 2013[1]



1. Central Bank forecast 2011 - 2013.
Sources: Ministry of Finance, Statistics Iceland, Central Bank of Iceland.

Inflation is a general indicator of the health of the economy and plays an important part in shaping investors' expectations concerning exchange rate movements and general economic developments. Other things being equal, high and volatile inflation leads to higher bond market yields and generally higher interest rate levels in the country, which slows down the economy and ultimately undermines confidence in the currency. In August 2009, when the previous liberalisation strategy was published, inflation measured just under 11%, whereas it is now below the Central Bank's inflation target.

Inflation and exchange rate developments 2007 - 2011



Sources: Statistics Iceland, Central Bank of Iceland.

An important premise for this success in reducing inflation is the fact that the króna has been relatively stable and has appreciated since November 2009. The Central Bank managed to prevent large-scale circumvention of the capital controls through increased supervision and tighter regulation, when it stopped the repatriation of offshore krónur. Furthermore, it is clear that Iceland's external trade situation has changed radically and will support the exchange rate over the longer term. Iceland's underlying current account surplus – that is, after adjusting for the balance on income that can be assumed to remain when the failed financial institutions and holding companies have been settled, and excluding the debt of a single multinational company with headquarters in Iceland (Actavis Group) to its owners – probably exceeded 1/10 of GDP in 2010. The outlook is for a similar surplus in 2011 and the years to come. When all is said and done, Iceland's net international investment position in coming years will probably be more favourable than it has been in decades, although payment flow problems of various types could cause temporary instability.[14]

Breakdown of current account balance

% of GDP	*2010*	*2011*	*2012*	*2013*
Current account balance	-3.7	-1.9	-1.4	-2.0
- underlying balance based on calculated settlement of estates	6.4	7.4	7.4	5.4
- underlying balance based on calculated settlement of estates, but excl. Actavis	12.8	12.3	12.0	9.8

Sources: Statistics Iceland, Central Bank of Iceland.

However, a current account that is in balance or in surplus is a necessary but by no means sufficient precondition for removing the capital controls without causing instability. While the Treasury, the financial system, or corporations have limited access to foreign credit, outgoing capital flows will largely offset the impact of foreign exchange inflows resulting from trade in goods and services. Export-driven GDP growth and investment could change this situation radically. Increased investment is accompanied by inflows of foreign capital. Although export-driven growth has been slow in coming, the recession appears to have reached its trough. Thus significant progress has been made since the capital account liberalisation strategy was published in August 2009.

It might be possible to lift the capital controls under current conditions without prolonged instability if non-residents did not hold sizeable ISK positions and if the financial system were not so vulnerable to large movements in offshore krónur. Only about third of non-residents' ISK holdings, or 142 b.kr., is invested in long-term bonds. Should a large share of non-resident owners of short-term assets sell out of their positions after the controls are

[14] See the report by Arnór Sighvatsson, Ásgeir Daníelsson, Daníel Svavarsson, Freyr Hermannsson, Gunnar Gunnarsson, Hrönn Helgadóttir, Regína Bjarnadóttir, and Ríkardur Bergstad Ríkardsson, entitled "What Does Iceland Owe?" *Economic Affairs* no. 4, February 2011.

lifted, residents could follow suit, causing the króna to depreciate more than is acceptable, albeit temporarily. At this stage, the offshore króna problem is the largest impediment to liberalisation of controls on residents' capital outflows. But at the same time, this situation represents an opportunity to stimulate investment and export-driven growth, as is discussed further below. Before these options are explored, however, it is necessary to examine two factors that are closely linked to the resolution of the offshore króna problem: the stability of the financial system, on the one hand, and the expansion of the foreign exchange reserves, on the other.

Financial stability

Financial stability matters have progressed significantly since the original strategy was issued in the summer of 2009, in spite of the setback following the 2010 Supreme Court judgments on the legality of exchange rate-linked loans.[15] The recapitalisation of the three major banks is complete, and measures to address private sector debt are now finalised. The financial restructuring of the companies controlled temporarily by the banks is an important premise for recovery of investment, which in turn may be one of the keys to channelling offshore krónur into domestic business investment. One of the main risks that capital account liberalisation poses to the financial system lies in the substantial ISK assets held by non-residents in domestic financial institutions. Króna deposits on non-resident banks' Vostro accounts account for 164 b.kr.[16] A sudden outflow of all of these deposits would have an adverse impact on the banks' liquidity, particularly if residents' deposits and other short-term assets followed suit. Thus it is important to channel these deposits into long-term investments in stages, as is described more fully in Section IV (see also Appendix II on banking system liquidity). The financial system should already be in a position to tolerate relatively modest foreign exchange outflows. Before major steps towards lifting capital controls are taken, however, the banking system must have unrestricted access to foreign credit.

Foreign exchange reserves

Although the objective is to lift the capital controls in stages without jeopardising foreign exchange market stability, the possibility of some fluctuation in the exchange rate of the króna cannot be ruled out. In order to reduce the likelihood of prolonged exchange rate instability in connection with liberalisation, the Central Bank must have sufficient reserves to reduce foreign exchange market volatility and eliminate all doubt about the Treasury's ability to fulfil its obligations.

[15] These judgements dented the capital ratios of financial companies but helped to reduce the foreign-exchange imbalances in their accounts.

[16] Some of the end investors that are counterparties to the deposits of non-resident banks may be residents, but there are no data to verify to what extent this is so. Consequently, the analysis is based on the available data on non-resident ISK positions.

The foreign exchange reserves have never been larger in Iceland's history. In August 2009, the Central Bank's foreign exchange reserves net of the Bank and the Treasury's current liabilities[17] totalled ISK 250 b.kr., or 17% of year-2009 GDP. At end-January 2011, the same reserves totalled 303 b.kr., or 19% of GDP. The portion of the reserves that the Central Bank has at its disposal has therefore remained relatively stable since the last strategy was published, even though Treasury foreign obligations amounting to 13% of year-2010 GDP are set to mature in 2011. Three main factors have contributed to the stability of the disposable foreign exchange reserves in spite of large maturities in the coming year. First of all, the Treasury has bought back debt on advantageous terms, so that its current liabilities now amount to just under 8% of year-2010 GDP. Second, the Treasury and the Central Bank have refinanced debt with long-term loans from the Nordic countries, Poland, and the IMF. Third, the Central Bank has purchased a sizeable amount of foreign currency from the pension funds (in connection with the Avens bonds) and the commercial banks, and they receive foreign currency from collateralised loans granted in the fall of 2008. Other things being equal, the current reserves will suffice to pay down all of the Treasury's debt until 2015. However, in order to prepare for the removal of capital controls, it may be necessary to build up the reserves further by drawing on IMF and bilateral programme financing and through other Treasury foreign borrowing.

Although the foreign exchange reserves are sizeable, which ensures that the Treasury can service its debt for the next several years, even in the unlikely event that it could not borrow money in foreign capital markets, it is desirable that they be funded to a lesser degree with foreign debt. Since August 2010, the Central Bank has begun regular foreign exchange purchases in order to bolster its non-borrowed reserves. However, significantly raising the proportion of non-borrowed reserves will take time. The Central Bank is of the opinion that the foreign exchange reserves are large enough to support the start of phased removal of the capital controls. Further reserve build-up required for subsequent steps will be subject to the success in channelling krónur owned by distressed investors into the hands of long-term investors such as pension funds and other like parties. This would funnel a considerable share of short-term krónur into the domestic economy or into long-term Treasury funding without depleting the reserves. Over the medium term, after the removal of capital controls, there may be pent-up demand for foreign assets among residents, which could put strain on the reserves. While this will be addressed in part by prudential regulation, a comprehensive assessment will be made to determine whether the medium-term balance of payments and reserves outlook is sufficiently strong before an attempt is made to move to the final steps of Phase I and into Phase II. Developments in the foreign exchange reserves and in Government debt management are discussed in Appendix III.

[17] See Appendix III for further discussion of the foreign exchange reserves.

Appendix II: Banking system liquidity position

Both the Central Bank of Iceland and the Financial Supervisory Authority (FME) carry out off-site monitoring of liquidity positions. The FME also conducts on-site inspections. The FME´s monitoring is part of its supervision of risk assessment and internal controls of supervised entities.

Liquidity according to the Central Bank of Iceland Rules on Liquidity Ratio

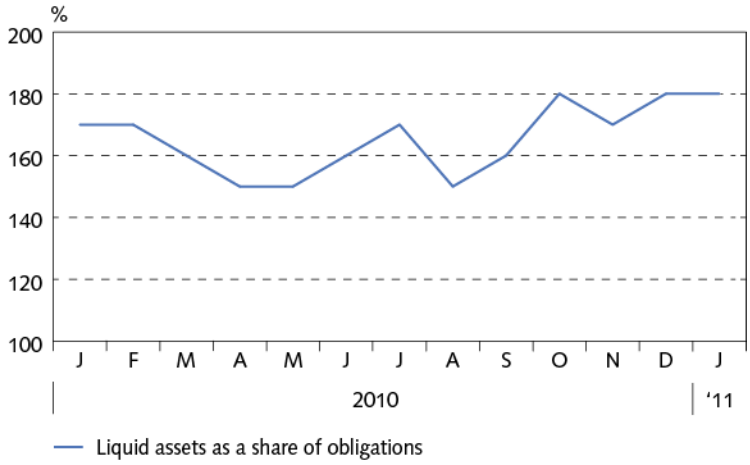
The Central Bank of Iceland sets rules on credit institutions' liquidity ratio; cf. Article 12 of the Central Bank Act, no. 36/2001.[18] The aim of the Rules is to ensure that credit institutions always have sufficient liquidity to meet foreseeable and potential payment obligations over a specified period of time.[19] In terms of the Central Bank Rules, the commercial banks' liquidity position has been ample in the recent term (see the chart below). In 2011, the Central Bank, in co-operation with the FME, plans to review its liquidity rules with regard to international developments, such as Basel III liquidity (LCR, NSFR).

The Rules entail a certain stress test where a discount is applied to various assets, but where it is assumed that all obligations must be paid upon maturity, as well as a portion of other obligations such as deposits. Because the commercial banks are now funded primarily with deposits, their liquidity risk is concentrated in the risk of withdrawal. A large share of deposits are demand deposits (sight deposits), and it is likely that depositors will move their funds when the capital controls are lifted or when investment options become more numerous. For this reason, the Central Bank has made regular assessments of the banks' liquidity ratios based on various assumptions concerning withdrawals of demand deposits. The commercial banks can tolerate substantial withdrawals without falling below the minimum specified in the Central Bank Rules. Because of the importance of deposit-based funding, the Financial Supervisory Authority has required that the new commercial banks have sufficient liquidity to address possible withdrawals at all times.

[18] Rules on Liquidity Ratio, no. 317/2006.

[19] Credit institutions are obliged to send the Central Bank monthly reports providing information underlying the calculation of their liquidity ratios. Claims and obligations that are included in the calculations are classified by type, maturity, and risk. The reports also specify what proportion in each category is included in the calculation. The liquidity ratio is calculated for four periods: < 1 month; 1–3 months; 3–6 months; and 6–12 months. The ratio of assets and liabilities that mature or can be converted to cash within one month and within three months shall not be lower than 1, or 100%. If the credit institution cannot fulfil this requirement, the Rules provide for sanctions in the form of per diem fines on the shortfall. Credit institutions shall disclose their liquidity ratios for other periods as well, even though there are no requirements concerning specific ratios for those periods.

Commercial banks' liquidity, 0-3 months[1]
According to Central Bank liquidity rules 2010



1. Largest commercial banks, parent companies.
Source: Central Bank of Iceland.

Liquidity according to the Financial Supervisory Authority's liquidity requirements

The Financial Supervisory Authority (FME) requires monthly liquidity reports from the three large commercial banks.[20]

The liquidity reports that the banks submit to the FME can be viewed as a sort of stress test. They reveal whether the banks are equipped to tolerate outflows of at least 20% of their deposits, as well as paying out at least 5% of demand deposits in cash. The banks have all been well above these thresholds, from the outset until the present time.

The FME liquidity reports include the sum of secure liquid assets at each month-end as a percentage of total deposits and the sum of cash as a percentage of demand deposits. The reports also reveal the balance of total deposits and their distribution among non-residents, households and smaller businesses, and larger businesses. They contain a time analysis of deposits as well.

[20] The liquidity report originates in the reconstruction of the banks and the Financial Supervisory Authority's requirements for their operating licences. The banks were subjected to a variety of requirements upon their reconstruction. The principal financial requirements were these: The minimum capital adequacy (CAD) ratio was raised to 16% and the ratio of Tier 1 capital to 12%. Because of uncertainty about capital flows, quality and recovery of loans, and developments in deposits, the banks were required to maintain secure liquid assets corresponding to at least 20% of total deposits, plus cash and cash equivalents corresponding to at least 5% of demand deposits. In addition to financial requirements, the banks were subjected to a number of requirements related to governance and risk management.

Liquidity and Deposits

Total numbers for Arion, Íslandsbanki and Landsbanki

Total 31 Jan. 2011	*ISK*	*FX (in ISK)*	*Total*
Liquidity			
Liquid assets, cash, etc.	52,216	150,846	203,062
Repurchase agreements, etc.	329,270	30,145	359,415
Secure liquidity, total	381,486	180,991	562,477
Total deposits			
Deposits of non-residents	176,197	9,339	185,536
Dep. of individuals and small businesses	593,297	44,604	637,901
Deposits of large businesses	500,104	148,136	648,240
Total	1,269,598	202,079	1,471,677
Demand deposits	1,232,886	84%	

Source: Financial Supervision Authority.

The summary shows that the total of the three banks' secure liquidity was just over 562 b.kr. as of 31 January 2011. Liquidity is specified as liquid assets totalling 203 b.kr., which comprise cash, Central Bank deposits, and deposits with domestic and foreign financial institutions, on the one hand; and repurchase agreements and other secure liquidity lines totalling 359 b.kr., on the other. The summary shows that the three banks' total deposits amount to 1,472 b.kr., 13% of which, or 185 b.kr., are held by non-residents. Demand deposits account for 84% of total deposits.[21]

Stress tests by FME

In order to assess the impact of capital account liberalisation on deposits – and therefore on the banks' liquidity – several scenarios have been prepared using various assumptions concerning what could happen if the capital controls were lifted entirely. All of these scenarios are simplified calculations at best, as actual responses to removal of the controls are extremely uncertain.

The first scenario assumes that all non-residents' deposits and all FX deposits will be withdrawn, together with 15% of other deposits. As things stood at end-January, such outflows would exhaust all liquidity and the banks' access to liquidity.[22]

The second scenario explores the simultaneous withdrawal of all non-residents' deposits, with no other withdrawals. The banks could handle withdrawals of this magnitude and still fulfil the FME's minimum requirements, although their liquidity would deteriorate.

---

21 As of end-January, the FME liquidity ratios for the three banks combined were, on the one hand, secure liquidity/total deposits, 38% (20% minimum); and, on the other hand, liquid assets/demand deposits, 16% (5% minimum). These ratios differ for individual banks and thus have different effects. The three banks are all well above the minimum requirements, however.

22 The definition of non-resident entities is set forth in Article 1 of Act no. 87/1992. All other entities are classified as residents. The old banks are thus classified as resident entities and have not been treated separately in this very simple stress test. The general outflow of deposits (other than non-resident investors) of 15% and 10%, as assumed in the stress test, would thus include the old banks.

The third scenario shows a milder effect than the first one: it assumes the withdrawal of half of non-residents' deposits, half of FX deposits, and 10% of other deposits. This would erode the three banks' liquidity significantly but not render it extremely weak.

In all of these scenarios, the banks' liquidity deteriorates substantially. The considerable uncertainty in the banks' post-crisis operating environment calls for a strong liquidity position. Lifting the capital controls in suitable increments so as to control the strain on banking system liquidity is consistent with this policy. Significant uncertainty remains in areas other than those related to capital account liberalisation; therefore, there is still a need for relatively high liquidity requirements, although with potential outflows of non-residents' deposits, uncertainty is reduced. Liberalisation of capital controls could have a varying effect on the banks' need for short- or long-term liquidity facilities. The Central Bank is ready to take the action necessary to respond to negative effects on the liquidity of individual financial institutions and the system as a whole while liberalisation is underway, consistent with its conventional liquidity management role and its role as a lender of last resort.

Possible effects of liberalisation on liquid assets and liquidity ratios

At the beginning of February 2011, the Central Bank of Iceland asked the largest commercial banks to estimate the effects of capital account liberalisation on their liquid assets and liquidity ratios. In preparing their estimates, they were to assume that the capital controls would be lifted in full, in a single action, and without any prior notice. They were also to assume that capital markets were closed and that all obligations would be paid when due. The banks were asked to estimate outflows of liquid assets due to withdrawals of deposits 10 days after the removal of the controls. They have substantial secure liquid assets that can be used to pay out deposits, but if withdrawals were at the upper end of the range of likely outcomes, the majority of the banks' liquidity ratios according to Central Bank of Iceland and Financial Supervisory Authority rules would fall below minimum levels, although secure liquid assets would be sufficient to cover outflows. The banks' responses illustrate the importance of keeping the size of the liberalisation steps appropriate, so that it will be possible to reassess liquidity ratios after the most volatile deposits have been withdrawn from the system.

The Central Bank has made an independent assessment of the banks' responses. If it is assumed that nearly all non-residents withdraw their deposits but that the majority of residents do not, the banks' secure liquid assets should suffice to pay out deposits. Their liquidity ratios according to Central Bank of Iceland and Financial Supervisory Authority rules may fall below minimum levels, however. If non-residents and a significant proportion of residents withdraw their deposits, however, the banking system will not be able to tolerate it. Nonetheless, these findings indicate that the banking system can well tolerate measures designed to channel offshore krónur into the Icelandic economy if such measures are executed in suitable increments, as is described in the new capital account liberalisation strategy. The bank's liquidity positions will be monitored closely throughout the liberalisation process, particularly in advance of any major liberalisation steps.

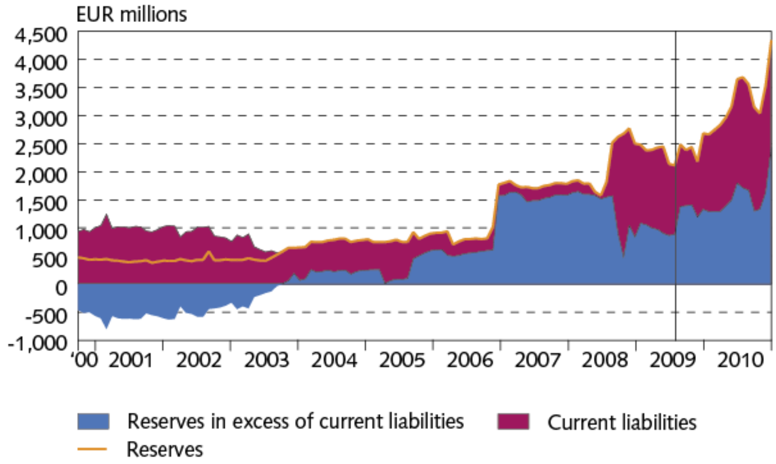
Appendix III – Foreign exchange reserves

While the basic aim of the current strategy for lifting capital controls is to increase reserve adequacy and minimise the risk of reserve outflow, some risk of turbulence during the liberalisation process is unavoidable. Hence adequate FX reserves are a precondition for any major steps. This appendix provides background on the developments in the foreign exchange reserves over the last decade, the composition of their funding, and the present size. Further, it describes the results of reserve adequacy tests performed on the strategy. Finally, the appendix explores how the reserves will develop given a baseline macro scenario based on current FX assets and accessible foreign borrowings, with consideration given to the maturity profile of the Treasury and the Central Bank's foreign debt.

Since the banking system collapsed in the fall of 2008, the Central Bank of Iceland's foreign exchange reserves have changed significantly in size and composition. Historically, the minimum size of the Bank's foreign exchange reserves has been determined by the country's need to import goods and services. In 2006, the reserves were augmented through foreign borrowing, due to the expansion of the banking system and the increase in foreign exchange transactions. In the fall of 2008, significant reserves were used to provide FX liquidity facilities to banks in distress and to ensure continued cross-border payment intermediation following the crash. One of the main objectives of the economic programme pursued by the Government in collaboration with the International Monetary Fund has been to strengthen the foreign exchange reserves in order to promote exchange rate stability and generate confidence in the Treasury's ability to fulfil its foreign obligations without causing instability in the foreign exchange market. The main text discusses the principal changes in the composition of the reserves from the time the original capital account liberalisation strategy was published in August 2009 until the publication of the new strategy.

The Central Bank's net foreign exchange reserves can be defined as the total reserves less the Central Bank and Treasury's current liabilities (debt maturing within 12 months). The net reserves can change quite rapidly, particularly as long-term debts approach maturity and begin to be viewed as current liabilities.

Distribution of FX reserves by funding source



Source: Central Bank of Iceland.

Shortly after the beginning of this century, the foreign exchange reserves were funded with short-term debt, and in 2001 the Central Bank sold a substantial amount of foreign currency in order to arrest the fall of the króna. By 2003, however, net reserves were positive once again, following foreign exchange purchases the year before. Foreign exchange inflows in 2003-2006 were used primarily to service the Treasury's foreign debt. In 2006, the reserves were expanded considerably with a five-year loan of one billion euros. By that time, then, the reserves were funded largely with long-term debt. Since the fall of 2008, they have been expanded further with long-term loans from the IMF, the Nordic countries, and Poland; transactions related to Avens B.V. bonds; foreign exchange transactions with the commercial banks; and recovery of loans associated with the banking collapse. Since that time, the foreign-denominated deposits of the resolution committees and of other domestic financial institutions have constituted a large share of the reserves. These deposits are considered current liabilities and do not change the net reserves, even though gross reserves may increase. As of January 2011, deposits comprised the vast majority of current liabilities; however, added to them are Treasury bonds maturing on 1 December 2011, the outstanding balance of a loan from Bayerische Landesbank, and other obligations such as interest expense.[23]

[23] Interest expense is included with current liabilities – that is, payments due in the next 12 months – but future interest income is not included in foreign reserves figures. To this extent, the figures on net reserves are underestimated.

Foreign reserves

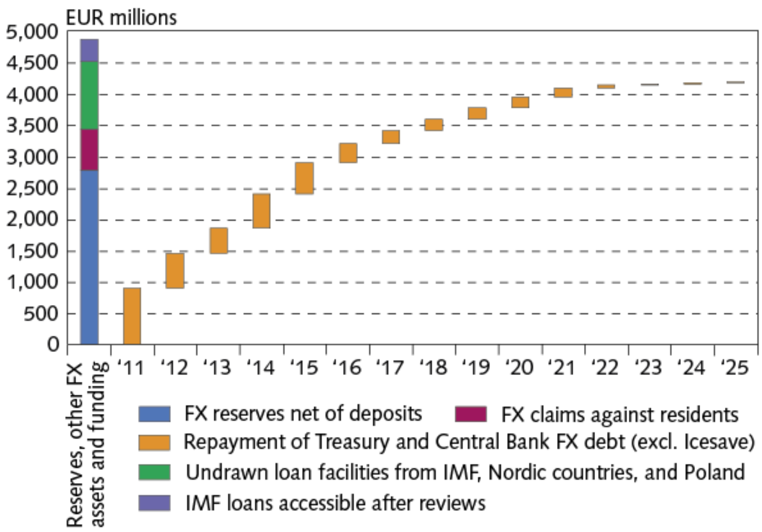
	Bn. ISK	January 2011 % GDP 2010
Foreign Reserves[1]	733	47
Current liabilities	-430	-27
- FX accounts of resolution committees and DMB's	-291	-19
- Treasury EMTN bonds (Dec 2011)	-103	-7
- Syndicated loan (Sep 2011)	-12	-1
- Other	-24	-2
Foreign reserves net of current liabilities	303	19

1. Data on the Central Bank of Iceland's total foreign exchange reserves and the Central Bank and Treasury's current liabilities can be found on the Central Bank website under *Statistics > International reserves and related items*: http://www.sedlabanki.is/?PageID=291.

Source: Central Bank of Iceland.

The Central Bank's foreign exchange reserves are now at a historical high in terms of size, at 47% of year-2010 GDP, but can be expected to contract once the winding-up committees begin making payment to the banks' creditors. However, the Central Bank has claims against resident entities that will bring in foreign currency in coming years but are not considered part of the reserves. These include the FX swap agreements with the commercial banks and the assets held by the Central Bank of Iceland Holding Company ehf. (ESÍ). Moreover, the Treasury and the Central Bank have negotiated loan facilities with the Nordic countries, Poland, and the IMF, and they can draw on those credit lines in order to expand the reserves. At their current size, the reserves suffice to pay interest and principal on the Treasury and Central Bank's FX debt through 2015. Several large loans taken by the Treasury are scheduled to mature in the near future. The aim is to refinance Treasury foreign debt when the opportunity presents itself and to maintain strong foreign exchange reserves over the next several years.

Developments in FX reserves and repayment profile for foreign loans



Source: Central Bank of Iceland.

The strategy for liberalising capital controls is designed to address reserve adequacy going forward. To stress test the strategy, two main measures of reserve adequacy are used, the ratio of reserves to short term external debt and the ratio of reserves to broad money. The tests were time-independent but sequenced in such a way that their interaction strengthens the overall implementation.

in the baseline macro scenario, reserve adequacy as measured by the ratio of reserves to short-term external debt is projected not to exceed 100%, the level according to the Greenspan-Guidotti rule of thumb, until 2015. As is described above, reserves have been growing and are at historically high levels. Building reserves to meet short-term liabilities can be expensive when the cost of funds is high and interest expense has a negative effect on the balance of payments. Hence the strategy addresses Iceland's short-term liabilities directly by converting them to long-term liabilities via market mechanisms. With the implementation of the liberalisation strategy, reserve adequacy will improve compared to the baseline, and the ratio of reserves to short-term external debt will exceed 100% early in the sequencing of the strategy. Throughout the implementation of the strategy, steps will be taken so as to maintain adequate reserves.

Reserve adequacy as measured by the ratio of reserves to broad money has been significantly above the 10-20% range, a rule-of-thumb range, and is high in international comparison. Potential capital flight may justify the need for a higher reserve level as measured by this metric but, as is mentioned above, building reserves can be costly. By allowing distressed investors to exit and by supporting direct investment in export generating investments, the strategy aims to contribute to sustainable growth and reduce the risk of capital flight. As the liberalisation process progresses, the projected ratio of reserves to broad money is gradually reduced but remains adequately above 20% throughout the process.

Balance of payment outlook and reserves

As is discussed above, capital account liberalisation may affect the level of the reserves. For example, there may be pent-up demand for foreign assets among residents, and some speculative outflows cannot be ruled out, although the strategy is designed to minimize this risk. Assuming some pent-up demand for foreign assets and the rather extreme assumption that the Treasury and the Central Bank do not roll over any debt or take on new loans, the full removal of the capital controls will have a significant effect on the reserves in 2014, and the ratio of reserves to short-term debt becomes very low. This ratio starts to decline as soon as 2013, and by 2015 the reserves have been depleted, despite a continued surplus on the current account, conservative assumptions concerning further FDI inflows, declining foreign debt, and a continuously improving international investment position (IIP).

Given another extreme assumption – i.e., that the Treasury and the Central Bank roll over all of their foreign debt from 2011 onward, which implies that their foreign debt is declining in relation to both GDP and the tax base of the government – reserves will be more than adequate to face the full liberalisation of the capital controls. In this case, the reserves as a percentage of short-term debt will be over 200% in 2012 and 2013 and remain well over 100% until 2016. If this reserve ratio is deemed more than adequate, the Treasury and the Central Bank could lower their foreign debt over the next few years. While both of the above assumptions are unrealistic, they mark the outer contour of possible outcomes.

A basic assumption in the rollover scenario is that the Treasury regains acceptable access to foreign capital markets. The Ministry of Finance's debt management strategy foresees significant reduction of debt in the years ahead. However, the foreign debt stock should only be reduced gradually to withhold an adequate reserve balance for removal of the capital controls. With the basic assumption that the Treasury has regained access to foreign capital markets, it can be assumed that the Treasury would seek to roll over or refinance around 85% of the foreign debt stock over the medium term. This would provide an ample reserve balance for removal of the capital controls, provided that preconditions are met. In this case, the reserves as a percentage of short-term debt will be between 150-200% in 2012 to 2014 but close to 100% by 2016.

The medium-term balance of payments outlook is obviously highly uncertain and must be reassessed before steps can be taken that could place significant strain on reserves.

Appendix IV: Non-residents' ISK assets

One of the main obstacles to relatively rapid removal of the capital controls is the large share of highly liquid ISK assets held by non-residents that, for a variety of reasons, either wish to sell them or must sell them as soon as the controls are lifted. For some investment funds, owning Icelandic Treasury bonds is no longer consistent with their investment policy because Iceland's sovereign credit rating has fallen below the minimum required rating. It is also possible that some residents want to sell their króna-denominated assets and would follow suit or will try to sell their assets ahead of non-residents if the controls are lifted, but in general, substantial home-bias makes them less likely to do so, particularly if attempts to channel distressed non-resident investors' short-term assets into the hands of investors with a longer investment horizon (which is the objective of the new liberalisation strategy) are successful.[24] It should be borne in mind, however, that resident investors or offshore companies owned by them may be the parties behind some portion of deposits held in foreign banks or króna-denominated bonds held in custody by non-residents.

Non-residents' ISK holdings, which total about 465 b.kr, are considered to give a reasonably good measure of offshore króna holdings.[25] They can be divided into three main categories:

- Deposits in financial institutions total approximately 185 b.kr.[26] Nearly all deposits held by non-residents in Icelandic financial institutions are in accounts in the three largest commercial banks: NBI, Íslandsbanki, and Arion Banki.
- Deposits with the Central Bank total 60 b.kr. These are related to foreign settlement systems' settlement of Icelandic securities.
- Bonds total 220 b.kr. Chief among them are long Treasury bonds and Treasury bills valued at 190 b.kr. and Housing Financing Fund (HFF) bonds in the amount of 30 b.kr.

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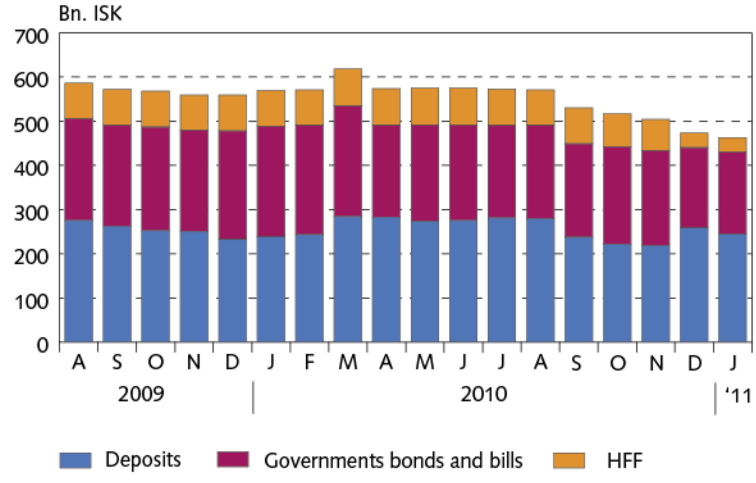
[24] Investors that, for regulatory reasons (e.g., as a result of Iceland's low credit ratings), because of economic conditions, or for some other reasons are forced to sell their ISK assets at a depressed value are referred to as *distressed investors*. Those can be distinguished from short-term investors that may take short-term speculative positions.

[25] In this report, data on non-resident ISK positions are used as a proxy for offshore króna positions. Information on the residence of the end investor is actually rather limited, although it is understood that a vast majority of them are non-residents. As the counterparty is typically a non-resident financial institution, for analytical purposes, end investors are treated as non-residents in this report. In some cases, a non-resident financial institution may have an unhedged ISK position. Hence the true size of non-resident retail investors' offshore króna positions may be somewhat smaller, but the difference is unlikely to be large enough to change major conclusions.

[26] Figures are as of January 2011.

Estimated non-resident ISK holdings



Source: Central Bank of Iceland.

It can be said that non-resident holders of (offshore) króna assets are funding the domestic banking system and the Treasury in an amount corresponding to their deposits in Icelandic financial institutions, on the one hand, and their bond holdings, on the other. Consequently, removal of the capital controls will have implications for the liquidity positions of these two entities. Movements that may take place in deposits with the Central Bank will not affect the liquidity of the financial institutions or the Treasury, however.

Deposits with financial institutions

In all likelihood, deposits are the most volatile ISK assets held by non-residents. Behind them are funds, banks, and individuals that participated actively in carry trading with the Icelandic banks before the crisis and found themselves locked out when the domestic foreign exchange market collapsed in October 2008. The Central Bank has been in contact with large depositors that are waiting for the opportunity to expatriate their assets. Many of them are not authorised to buy interest-bearing securities because of Iceland's low sovereign credit rating and are therefore waiting until the controls are lifted. A rough estimate of the characteristics of ISK asset owners indicates that 65-75% of them (representing 155-185 b.kr.) may want to exit at the earliest opportunity. A sizeable number of investors appear to be interested in using their offshore krónur to invest domestically. It is difficult to quantify this exactly, however.

Massive outflows of deposits will have an effect on the banks' liquidity positions (see Appendix II). On the other hand, in the Central Bank's assessment, the banks are relatively well prepared in terms of liquidity holdings to face a release of deposits for investment in long-term Government bonds provided that the auctions are of a suitable size. In this context, it is important to bear in mind the following:

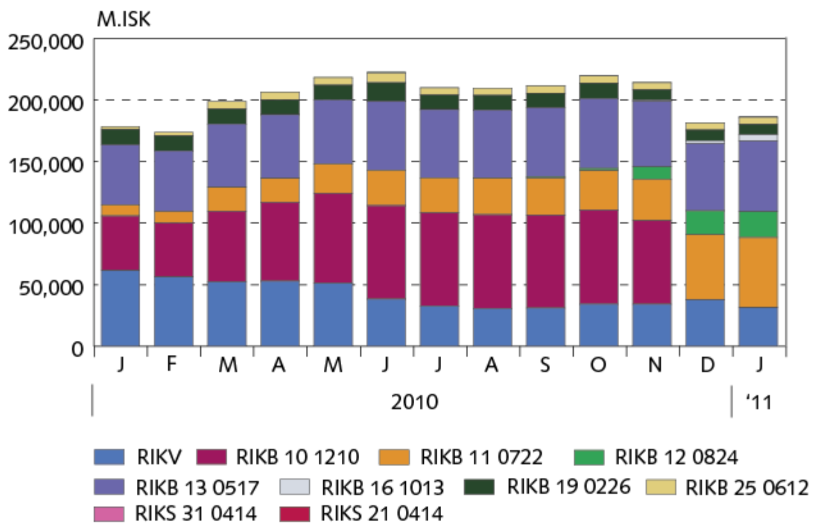
- The distribution of non-residents' deposits among financial institutions reflects their liquidity position.

- Withdrawals of deposits reduce the banks' need for liquidity, as a large share of them are demand deposits, which are the main focus of the liquidity requirements set by the Central Bank, the Financial Supervisory Authority, and the Basel III framework.
- The banks' possibilities of boosting their liquidity through collateralised loans from the Central Bank are substantial, should the need arise, but this facility is currently fairly little used by the banks.
- The króna system is a "closed" one in that the banks' liquidity will suffer only if the krónur end up in the Central Bank of Iceland and are not recycled back to the banks through the Central Bank's market operations. Foreign exchange interventions will only affect bank liquidity to the extent that they are not sterilised. However, it is current policy of the Central Bank to sterilise its interventions in order to prevent them from making liquidity conditions inconsistent with the monetary policy stance as decided by the Monetary Policy Committee. The same applies to Treasury debt transactions that affect bank liquidity. Krónur that will be used for investments other than the purchase of Government bonds will still be in the financial system and will therefore not affect the banks' liquidity.

Bonds

Non-residents own nearly 220 b.kr. worth of domestic bonds issued by the Treasury and the HFF. The majority of this capital, 190 b.kr., is invested in Government bonds, and the largest part is due to mature before mid-2013. The part that is invested in HFF bonds, around 30 b.kr., is relatively evenly distributed among all four HFF bond series.

Developments in estimated
non-resident Treasury bond holdings



Source: Central Bank of Iceland.

From the previous discussion, it is clear that removal of the capital controls will affect demand for Government bonds, particularly short ones. The Treasury's cash balance with the Central Bank is strong, however, and the State is well prepared for fluctuations in demand. In order to support the Treasury still further, long-term investors will first be authorised to purchase krónur for foreign exchange and use them to purchase long-term Treasury bonds. This will provide the Treasury with long-term funding that paves the way for lifting capital controls. However, it is conceivable that demand for short-term bonds will diminish.

There is no danger of significant impact on the HFF during the first steps of the strategy, as non-residents own a limited amount in each series. Moreover, the HFF's financing need is negligible at the present time.

Conclusion

To summarise, the impact of measures to channel offshore krónur into domestic long-term investment can be divided into four categories:

- The transfer of investors from short Treasury bonds to long ones will not affect the banks' liquidity positions and will improve the Treasury's liquidity position because it will reduce short-term liabilities.
- Investments in long Treasury bonds that are funded with deposits will reduce the banks' liquidity. However, it also reduces their liquidity need somewhat because the banks have been required to maintain strong liquidity positions precisely because of the potential volatility of these deposits (see appendix II).
- Investment of non-residents' ISK assets in the domestic economy does not affect banking system liquidity position overall, but it could affect the status of individual banks and reduce demand for short Treasury bonds.
- Using the Central Bank's foreign exchange reserves for FX market intervention will not affect the system's overall liquidity position to the extent that the Bank sterilises its operations. The same applies to Treasury bond sales funded with deposits within the Central Bank, which the Bank will offset through its conventional market operations.

The core principle behind this proposal for the removal of capital controls is that the reduction in the size of the stock of offshore krónur takes place in several small steps. This methodology should ensure that the impact on Treasury and financial system liquidity and on the foreign exchange market remains manageable at all times. This also enables the Central Bank and the Government to respond to risks that surface during the process.

30 June 2011
SI 76225

Árni Páll Árnason
Minister of Economic Affairs
Ministry of Economic Affairs
Skuggasund 3
150 Reykjavík

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

The enclosed report is submitted in accordance with the declaration of the Government and the Central Bank of Iceland, dated 27 March 2001, when the Bank adopted an inflation target. The declaration states that, on balance, the Central Bank shall aim for an annual rate of inflation, measured as the twelve-month increase in the CPI, as close as possible to 2½%. If inflation deviates more than 1½ percentage points from the target, the Central Bank is obliged to send the Government a report stating what, in the Bank's view, are the main reasons for the deviation, how the Bank intends to respond, and how long it anticipates that it will take to bring inflation back to target. This report shall be made public.

It is appropriate to reiterate that the above-mentioned deviation limits do not represent a formal requirement that the Bank take action other than to submit the specified report if inflation moves outside the stated limits. The inflation target entails keeping inflation as close as possible to 2½% on balance, and not merely in the 1-4% range. Thus it is not a given that special action will be taken at the boundaries of that range. The reason for defining such a range is that, even though inflation may be determined by long-term monetary policy, other factors could cause it to deviate temporarily from the target. The nature of deviations may be such that monetary policy action would be either inappropriate or untimely; for example, if inflation rises because of temporary external oil and commodity price hikes.

As is stated in the report, the increase in global oil and commodity prices is one of the main reasons for the inflation episode of the past few months and does not, in and of itself, require monetary policy response. Core inflation measures that exclude these and other volatile items are still close to the inflation target. Nevertheless, core inflation has also risen markedly in recent months. The Central Bank of Iceland's Monetary Policy Committee has therefore expressed the opinion that the likelihood of a rise in interest rates has increased. As always, individual interest rate decisions will depend on the conditions and outlook at any given time. Inflation will most likely rise further in coming months, but if the exchange rate of the króna holds stable, it should subside to the target next year. The outlook for these factors remains uncertain, however.

Respectfully yours,

CENTRAL BANK OF ICELAND

Már Guðmundsson
Governor

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

cc:
Prime Minister
Minister of Finance

30 June 2011
SÍ-76410

Report to the Government on inflation in excess of tolerance limits

According to measurements published by Statistics Iceland on 27 June 2011, twelve-month inflation in terms of the consumer price index (CPI) measured 4.2% in June. This is a deviation of more than 1½ percentage points from the inflation target. The limits for the deviation of inflation from target have thus been breached after inflation fell below them in September 2010, therefore necessitating this report.

Main reasons for rising inflation

In spite of a marked slack in the economy in the wake of the financial crisis and economic contraction, inflation has risen again after declining virtually unimpeded since January 2009, when it peaked at 18.6%. In terms of the CPI, inflation bottomed out at 1.8% in January 2011. It remained relatively stable until March but then began rising rapidly, measuring 2.8% in April, 3.4% in May, and the aforementioned 4.2% in June.

The main reasons for this sudden turnaround are well known and not restricted to Iceland. The principal cause is the steep rise in global commodity and oil prices in the recent term. Over the past twelve months, global oil and commodity prices have increased by almost half, causing inflation to rise rapidly in many countries; for example, to 3.6% in the US, 2.7% in the euro area, and about 4.5% in the UK.

The effects have been felt in Iceland as well. For example, petrol prices have climbed by over one-fifth in the past twelve months, according to Statistics Iceland, while food prices have risen by about 4½% over the same period.

In addition, the exchange rate of the króna has fallen by nearly 4% in trade-weighted terms, and almost 5% against the euro, in the past year. Since the beginning of 2011, the króna has depreciated by 7% against the euro and by 5½% in trade-weighted terms. As a result, imported goods and services have become more expensive. The króna depreciation is likely to have an effect for some time.

In addition to the impact of higher global oil and commodity prices and import prices in general, inflation has been affected by increased prices of public services and other goods and services whose prices are dependent on official decisions. These include Reykjavík Energy's (Orkuveita Reykjavíkur) heat and electricity price hikes and price increases in various public services, such as pre-school tuition, daycare, bus fares, and waste collection. The price of public services has therefore risen by about 8.4% in the past twelve months.

In part, the recent increase in inflation is attributable as well to consumption tax increases, which raise price levels and therefore inflation until the effects disappear from twelve-month inflation figures. In Statistics Iceland's estimation, consumption tax hikes added 1-1½ percentage points to annual inflation during the period from mid-2009 through year-end 2010. Since then, those effects have dissipated, but inflation excluding direct consumption tax effects is still about 0.2 percentage points less than CPI inflation.[1]

It is difficult to estimate exactly where inflation would lie if these price increases had not occurred, but it would probably have been considerably lower. Of the 2.4 percentage point rise in annual inflation from its trough in January through June, 0.7 percentage points are due to petrol price hikes, 0.4 percentage points to increased domestic food prices, and 0.2 percentage points to price increases of public services. In total, these three factors account for more than half of the increase in twelve-month inflation since the beginning of the year. This is reflected in developments in underlying inflation, which excludes these factors and others. In June, underlying inflation measured 2.5%, up from 1.2% in January, and was therefore considerably lower than CPI inflation, in addition to having risen less steeply.[2]

Another important factor in the recent rise in inflation is the increase in the housing component of the CPI. The contribution of the housing component to the increase in twelve-month inflation from January measured 0.8 percentage points in June. In part, the increase stems from various cost items related to housing operation and maintenance, but the bulk of it is due to rising market prices. Housing market turnover has increased in the recent term after the post-crisis slump,

[1] The Central Bank‘s current forecasts assume that consumption taxes will increase again in the beginning of 2012, based on the approved National Budget, which will also raise headline inflation, even though it is assumed that the effects will be less than in January 2011. In addition, Statistics Iceland changed its method for treating broadcasting fees, which led inflation to measure 0.4 percentage points less than it otherwise would have. Therefore, 0.4 percentage points will also add to headline inflation in January 2012, when these effects disappear from annual figures.

2 According to Core Inflation 3 without tax effects, which excludes prices of volatile items such as petrol and various food products, public services and mortgage payments.

and house prices have risen by an average of 3.8% over the past twelve months.

Although the recent inflation episode is attributable for the most part to the abovementioned factors, it is to some degree general in nature. The price of private services, for example, has risen by 4.3% in the past twelve months. Primarily, this development in inflation reflects increases in imported and domestic inputs, although the impact of contractual wage rises on the price level has yet to emerge. Inflation expectations have also risen by most measures. The breakeven inflation rate in the bond market has risen somewhat since the beginning of the year, and a recent survey indicates increased household inflation expectations as well. On the other hand, corporate inflation expectations have declined. By all measures, however, inflation expectations appear to be higher than is consistent with the inflation target.

Do these developments change the estimated inflation outlook?

In the Central Bank's last forecast, published in the April issue of *Monetary Bulletin*, it was assumed that inflation would peak at 3.3% in Q3 and then begin to subside again, reaching the target in the latter half of 2012. The inflation outlook had deteriorated from the Bank's February forecast. The April forecast for 2011 and the first half of 2012 allowed for a rise in inflation of 1 percentage point above and beyond the February forecast for that period. The main reasons for the deterioration in the inflation outlook were the aforementioned increases in oil and commodity prices, the weaker exchange rate, the stronger housing market, mounting inflation expectations, and the prospect of larger and more front-loaded wage rises than previously assumed.

The April forecast also stressed that the inflation outlook was extremely uncertain with the risk of short-term inflation being underforecast. It can be said that this concern has materialised. Oil and commodity prices have risen more than projected, the króna has been rather weaker, and the wage rises in the recent settlements have been larger. Overall, significant risk factors have contributed to making the inflation outlook worse than according to the April forecast.

Inflation measured 3.5% in Q2, as opposed to the 2.7% in the Bank's April forecast. It appears likely to continue rising in the next few months, as the effects of the recent increases in global commodity prices and the depreciation of the króna have yet to emerge. In addition, further price increases are expected as a result of the recent wage agreements. Based on current information, there is a material risk that inflation will exceed 5% in Q4/2011.

Oil and commodity price hikes and increases in public levies and services cannot drive inflation by themselves, however, unless they prove continuous. The current slack in the economy and the weakness of the recovery, which is reflected partly in high unemployment and limited growth in lending and money supply, should therefore ensure that inflation returns to the target when the effects of these increases have subsided. Based on the current outlook and the premises for developments in these factors, it is therefore likely that inflation will begin to abate once again as 2012 progresses and be close to target in the first half of 2013.

There is considerable uncertainty about these assumptions, however, and consequently about the pace at which inflation will subside. The increases in oil and commodity prices could prove more persistent, and the exchange rate outlook is uncertain, as is often the case. There is also some uncertainty about the magnitude of the slack in the economy and to what extent it weighs against further wage and price increases. Moreover, there is a certain risk that the recent spurt of inflation, although it stems from transitory factors, could develop into lasting inflation to some degree. Inflation could therefore become somewhat more entrenched than current forecasts indicate.

In August 2011, the Central Bank will publish its updated inflation forecast, which will include a more in-depth discussion of the inflation outlook and the main uncertainties in the forecast.

The response of monetary policy

As is described above, the Central Bank has broadly considered the main reasons for the rise in inflation being either transitory factors or factors outside the scope of monetary policy. A majority of Monetary Policy Committee members have been largely in agreement with this assessment by the Bank. In view of the weak domestic economy, the Committee has maintained unchanged interest rates at its last two rate-setting meetings, in spite of mounting inflation and rising inflation expectations.

However, the Committee has become increasingly concerned about the inflation outlook, and some members have already considered it necessary to begin tightening monetary policy. At the Committee's April meeting, one member was in favour of raising interest rates, and at the June meeting it was decided to amend the MPC's communication concerning upcoming decisions so as to imply that interest rates would be more likely to rise than to fall in the near future. The probability that it will be necessary to raise interest rates in the near future in order to ensure that inflation and inflation expectations are close to target in the medium term has therefore increased.

The Monetary Policy Committee's next interest rate announcement is scheduled for 17 August 2011.

27 March 2001

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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