



MONETARY BULLETIN

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The objective of the Central Bank of Iceland's monetary policy is to contribute to general economic well-being in Iceland. The Central Bank does so by promoting price stability, which is its main objective. In the joint declaration made by the Government of Iceland and Central Bank of Iceland on 27 March 2001, this is defined as aiming at an average rate of inflation, measured as the 12-month increase in the CPI, of as close to 2½% as possible. Professional analysis and transparency are prerequisites for credible monetary policy. In publishing *Monetary Bulletin* four times a year, the Central Bank aims to fulfil these principles.

Monetary Bulletin includes a detailed analysis of economic developments and prospects, on which the Monetary Policy Committee's interest rate decisions are based. It also represents a vehicle for the Bank's accountability towards Government authorities and the public.

The framework of monetary policy and its implementation and instruments are described in the chapter entitled "Monetary policy and instruments", on pp. 51-53 of this edition of *Monetary Bulletin*.

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Icelandic letters:

ð/Ð (pronounced like th in English this)

þ/Þ (pronounced like th in English think)

In *Monetary Bulletin*, ð is transliterated as d and þ as th in personal names, for consistency with international references, but otherwise the Icelandic letters are retained.

Symbols:

- * Preliminary or estimated data.
- 0 Less than half of the unit used.
- Nil.
- ... Not available.
- . Not applicable.

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.

Weaker outlook and greater uncertainty

Although the Central Bank's real interest rate has continued to fall, the financial conditions of households and businesses remain difficult. It is now estimated that the economic contraction in 2010 was deeper than according to the Bank's February forecast. Domestic demand was broadly in line with the forecast, however, and the difference is largely because domestic demand was directed more towards imports than had been assumed. Stronger import growth is also the main reason the GDP growth outlook for 2011 is poorer than in February. The prospects for GDP growth in 2012 and 2013 have also deteriorated. Current data suggest that the recovery in activity began in mid-2010, yet the recovery is weak. Considerable spare capacity remains in the economy and appears likely to continue over the forecast horizon. The poorer growth outlook has implications for the labour market outlook as well, and unemployment is now expected to subside more slowly than previously forecast. 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 the Bank previously assumed. Nonetheless, when the impact of these transitory factors dissipates, the slack in the economy is expected to ensure that inflation subsides to target again in the latter half of 2012. The outlook is quite uncertain, however, and uncertainty has increased significantly due to the outcome of the Icesave referendum. Even though some indicators give cause for greater optimism, the downside risks to the outlook are considered to be greater than the upside risks.

I Economic outlook and main uncertainties

Central Bank rates lower than at last *Monetary Bulletin* publication

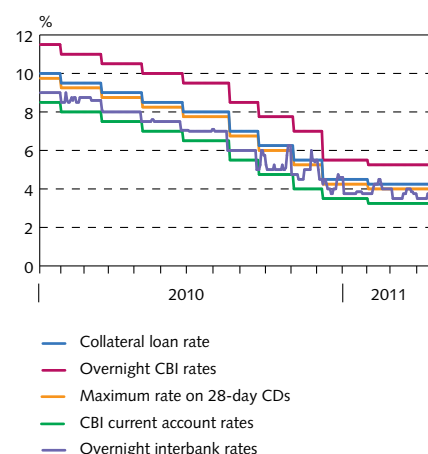
The Central Bank's Monetary Policy Committee decided to lower the Bank's interest rates by 0.25 in early February, when the last *Monetary Bulletin* was published, but then kept rates unchanged in March. As this *Monetary Bulletin* went to press, the current account rate was 3.25%, the maximum rate on 28-day CDs 4.0%, the collateralised lending rate 4.25%, and the overnight lending rate 5.25%.

Given the ample liquidity in the financial system, the Bank's effective interest rate can be considered to lie near the average of its deposit rates – currently about 3.6% – and to have recently moved closer to the CD rate and the centre of the interest rate corridor. This can be seen, for example, in the fact that short-term interbank rates have been closer to the centre of the corridor in 2011 than they were in 2010. Overnight market rates have averaged just under 4% since the rate cut in early February.

Real short-term interest rate has fallen, but financial conditions remain difficult for households and firms

Concurrent with the reduction in Central Bank rates and rising inflation expectations, the Bank's real rate has fallen markedly and is currently below 1% averaging over different measures, which is a significant decline since the publication of *Monetary Bulletin* in early February. This reduction in the Bank's real interest rate helps support recovery.

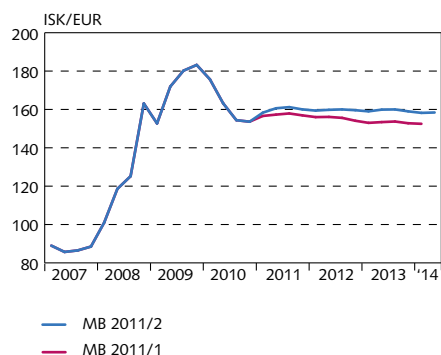
Chart I-1
Central Bank of Iceland interest rates
and short-term market interest rates
Daily data 1 January 2010 - 15 April 2011



Source: Central Bank of Iceland.

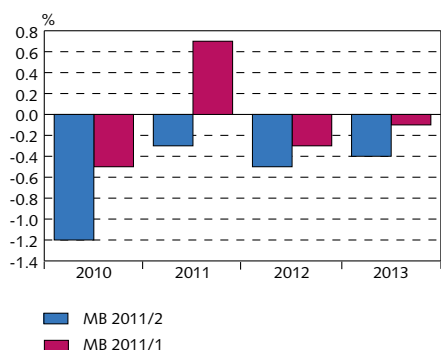
1. The analysis presented in this *Monetary Bulletin* is based on data available in mid-April.

Chart I-2
The ISK exchange rate against the euro -
comparison with MB 2011/1



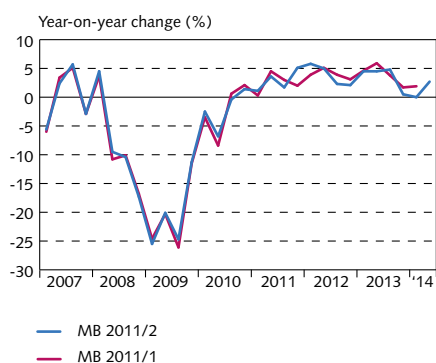
Source: Central Bank of Iceland.

Chart I-3
Net exports - contribution to GDP growth



Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-4
Domestic demand - comparison
with MB 2011/1



Sources: Statistics Iceland, Central Bank of Iceland.

This substantial easing of monetary policy has only partially been passed through to households and businesses, as their financial conditions remain difficult. These problems in monetary policy transmission reflect, among other things, uncertainty about the financial strength of financial institutions and the quality of their assets, and higher levies on banking operations. As a result, access to credit remains tight, and lending rates are somewhat high. Interest rate developments and financial conditions are discussed in greater detail in Section III.

The króna slightly weaker than projected

The króna has weakened by about 1% in trade-weighted terms since *Monetary Bulletin* appeared in early February, due primarily to its depreciation against the euro, which more than offsets the appreciation against other major currencies.

Owing to the steep rise in global oil and commodity prices, terms of trade are expected to improve less decisively than previously forecast, and the real exchange rate is likely to be somewhat lower. Due to the prospect of a lower real exchange rate and a poorer initial position, the króna is expected to be about 2-3½% weaker during the forecast horizon than according to the February forecast. As before, it is assumed that the exchange rate will remain relatively stable during the forecast period, owing to the offsetting effects of strong fundamentals and possible short-term pressure on the króna in relation to uncertainty stemming from the Icesave dispute. Short-term pressure on the króna could also emerge in relation to the capital account liberalisation strategy, but it is more likely to surface only at the latter stages of the second phase strategy. The strategy does, not envisage any major steps towards liberalisation until the risks of a depreciation and an appreciation of the króna are broadly balanced. The timing of the second phase is extremely uncertain, however, and may need to be delayed because the Icesave dispute still is unresolved. Further discussion of developments in the foreign exchange market can be found in Sections II and III.

Improved export outlook but smaller contribution of net exports to GDP growth due to strong imports

Global economic activity has developed broadly in line with the February forecast. Increased international trade and a low real exchange rate have lent strong support to the domestic tradable sector. Export growth is projected at about 2½-3% per year in 2011-2013. The outlook has improved slightly since early February. Expected export growth is modest in historical context, however, particularly in view of the low real exchange rate and strong growth in international trade. To a large degree, this reflects the fact that a significant share of Iceland's goods exports are subject to capacity constraints that cannot be eased without further investment. By the same token, the domestic capacity to respond to increased demand for domestic production following a drop in the real exchange rate is limited as well, at least in the short run. The recovery of domestic demand has therefore surfaced to some degree in increased imports. As a result, the contribution of net trade to output growth will be limited, at least for a while. Because

import growth is stronger than was projected in February, this year's contribution from net exports will be slightly negative, whereas a positive contribution was expected in February. As in that forecast, it is assumed that the contribution from net trade will continue to be negative throughout the forecast horizon. The trade surplus is expected to be large over the forecast horizon, at 9-10% of GDP, although it will be somewhat smaller than was forecast in February. Global economic developments, exports, external conditions, and the external balance are discussed more thoroughly in Sections II and VII.

Outlook for domestic demand broadly unchanged

Domestic demand is now estimated to have contracted by 2.1% in 2010, as opposed to 2.4% in the February forecast. This is somewhat less than according to Statistics Iceland's preliminary figures, which indicated a contraction of 2.5%. The main difference is due to divergent assessments of the strength of investment, as indicators such as robust growth in imports of investment goods and the results of a Central Bank survey support the assumption that 2010 investment is underestimated in the current Statistics Iceland figures.

On the whole, national expenditure is assumed to increase by nearly 3% in 2011, roughly half a percentage point more than was forecast in February. Private consumption is projected to continue growing, supported by factors such as third-pillar pension savings withdrawals, reimbursement of overpaid exchange rate-linked loans, rising asset prices, and lower interest rates. Similarly, investment is expected to be stronger due to the prospect of more investment in aluminium production and related industries than had been decided at the beginning of the year. Offsetting this, however, public consumption is expected to contract more sharply in volume terms than according to the February forecast, owing for the most part to a larger rise in the price deflator of public consumption.

Over the next two years, national expenditure is expected to grow by 3½-4% on average each year, slightly less than was forecast in February. For the forecast horizon as a whole, however, the outlook for domestic demand is similar to that in the February forecast. Further discussion of private and public sector demand can be found in Sections IV and V.

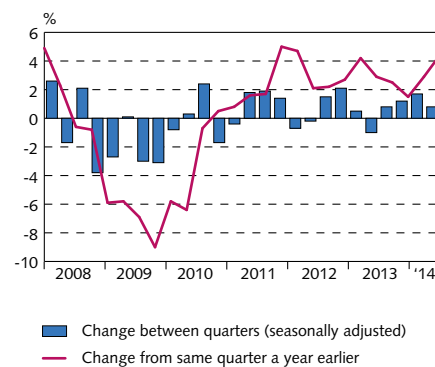
Outlook for weaker GDP growth for most of the forecast horizon

It appears that the contraction in GDP in 2010 was sharper than the Central Bank assumed in early February, or 3.1% instead of 2.7%. Statistics Iceland's preliminary figures, however, indicate an even deeper contraction, at 3.5%.

GDP is still considered to have begun growing quarter-on-quarter in mid-2010. The Central Bank's February forecast had assumed that the recovery would be uneven and that a temporary setback would occur in quarterly GDP growth in the first half of 2011. Now, however, it appears as though the setback occurred as early as Q4/2010, due mostly to stronger-than-expected spending on imports.

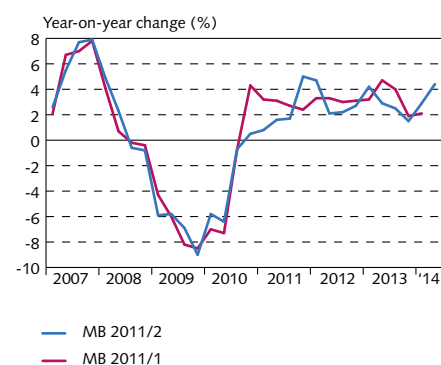
GDP is expected to grow by 2.3% this year, somewhat less than was forecast in February. It is also expected to grow less over the

Chart I-5
Gross domestic product
Q1/2008 - Q2/2014¹



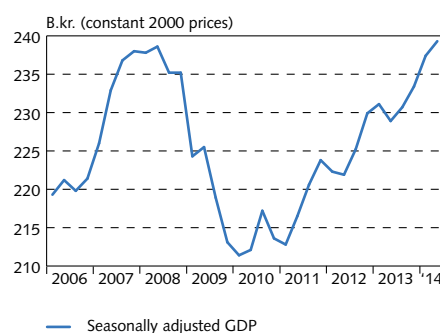
1. Central Bank baseline forecast Q1/2011 - Q2/2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-6
Output growth - comparison with MB 2011/1



Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-7
Gross domestic product
Q1/2006 - Q2/2014¹



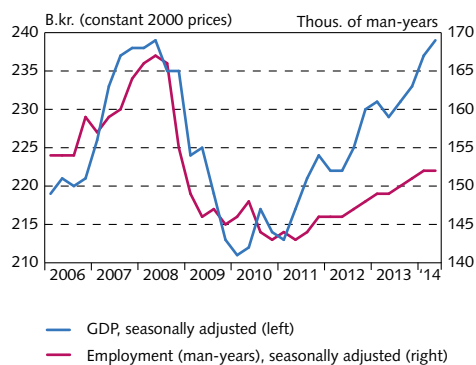
1. Central Bank baseline forecast Q1/2011 - Q2/2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-8
Unemployment - comparison with MB 2011/1



Sources: Directorate of Labour, Central Bank of Iceland.

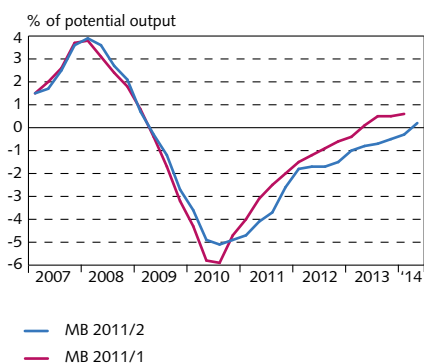
Chart I-9
GDP and employment
Q1/2006 - Q2/2014¹



1. Central Bank baseline forecast Q1/2011 - Q2/2014.

Sources: Directorate of Labour, Statistics Iceland, Central Bank of Iceland.

Chart I-10
Output gap - comparison with MB 2011/1



Source: Central Bank of Iceland.

ensuing two years, or just under 3% per year instead of just over 3%, in addition to the fact that last year's contraction is now considered to have been deeper. The larger import component of the domestic demand recovery explains this year's poorer GDP growth outlook, in spite of stronger growth in national spending and exports. As in the Central Bank's previous forecasts, domestic demand is expected to be the main driver of output growth in coming years, while the contribution from net trade will be negative.

At its trough in mid-2010, GDP had contracted by about 11½% from its pre-crisis peak. It is now estimated to be nearly 11% below the peak. It should be borne in mind, however, that GDP was well above sustainable levels in the run-up to the crisis. Based on the outlook for GDP growth over the next two years, this output loss should have been reversed in full by the end of the forecast horizon, around mid-2014. Section IV discusses the developments and prospects for GDP growth in greater detail.

Unemployment expected to taper off slowly

Recent developments in the labour market have been broadly in line with the Bank's February forecast. Firms considering shedding staff still outnumber those planning to recruit. Seasonally adjusted unemployment has risen marginally after a temporary dip last year. Stronger wage growth and weaker activity are expected to contribute to a persistently higher unemployment level than previously forecast. Weaker activity and higher labour costs are expected to weaken labour demand, while weaker activity may also impair labour supply through loss of skills and reduced matching ability of the labour market. It is now assumed that unemployment will average about 7.7% in 2011 and taper off to 5% in 2013, a percentage point higher than in the February forecast. Although employment is expected to begin rising again in the first half of 2011, as in the Bank's earlier forecasts, job creation will be slower than the recovery of output, and the employment rate will remain below the pre-crisis peak, as the sectors that suffered most from the crisis are quite labour-intensive. Further discussion of the labour market can be found in Section VI.

Slack in the economy more persistent than forecast in February

In mid-2010, the output slack peaked at about 5%, which is less than was assumed in the February forecast. On the other hand, it is expected to close more slowly than was projected in February, in line with poorer GDP growth prospects. It is now assumed that capacity will be more or less fully utilised again by mid-2014, roughly a year later than according to the February forecast. Further discussion of production capacity and output slack can be found in Section IV.

Inflation outlook deteriorates

Inflation proved somewhat higher in Q1/2011 than was forecast in February, due primarily to the unexpectedly strong recent upsurge in commodity and oil prices and the slight weakening of the króna. Higher imported inflation, larger and more front-loaded pay hikes, and a weaker initial position all contribute to a somewhat poorer infla-

tion outlook. In addition, long-term inflation expectations have risen slightly above the inflation target in the recent term.

As a result, inflation is projected to be higher than previously forecast through 2013 and to peak in Q3/2011 at about 3.3%, about a percentage point higher than was forecast in February. It is still assumed, however, that once international commodity and oil price increases have passed through the retail chain, and when the impact of the recent depreciation of the króna has dissipated, the slack in the economy will ensure that inflation falls back to target late in 2012. Further discussion of global price level developments can be found in Section II, and developments in domestic inflation and inflation expectations are discussed in Section VIII.

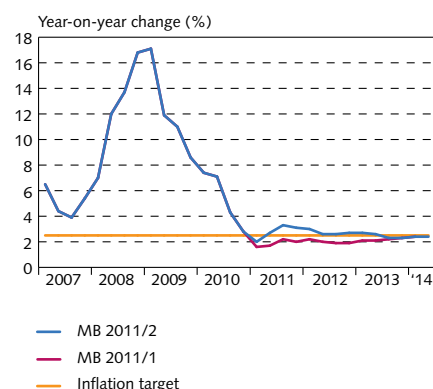
Key uncertainties

The baseline forecast reflects an assessment of the most likely economic developments over the next three years. It is based on forecasts and assumptions concerning developments in the external environment of the Icelandic economy, and the effects of those developments on the Icelandic economy. The forecast is also based on an assessment of how individual markets function and how monetary policy is transmitted to the economy. All of these factors are quite uncertain, however, partly because of the virtually unprecedented scope of the current financial crisis. The economic outlook, domestic or global, could easily diverge from the assumptions in the baseline forecast. The following discussion outlines several important uncertainties in the baseline forecast, but the possible uncertainties are obviously far greater in number. Two important uncertainties in addition to these are examined through alternative scenarios.

The economic outlook has become significantly more uncertain in the wake of the Icesave referendum. Domestic agents' access to international financial markets may become more difficult, at least for some time. Uncertainty concerning foreign direct investment and hence the status of several investment projects has therefore increased. The same applies to the capital account liberalisation strategy. The second phase of the strategy may have to be delayed, as the Treasury's access to foreign capital markets has become more uncertain. Stronger accumulation of domestic savings will be needed if the Treasury's refinancing needs must be directed more towards domestic savings. This can only happen through lower domestic spending and higher interest rates. The recovery of activity could therefore be weaker than reflected in the baseline forecast. Uncertainty about exchange rate developments has also increased, and the Central Bank may need to expedite the accumulation of foreign reserves so as to service the Government's foreign debt in late 2011 and 2012.

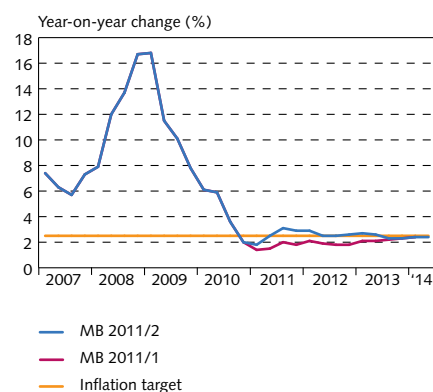
In the wake of the financial crisis, the channels through which monetary policy affects the financial system and the real economy became severely impeded. Risk premia on household and business liabilities rose sharply, and access to credit became much tighter. The baseline forecast assumes that the transmission channels will continue to be obstructed but will gradually normalise, even though risk premia will remain somewhat above pre-crisis levels for most of the forecast

Chart I-11
Inflation - comparison with MB 2011/1



Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-12
Inflation excluding tax effects - comparison with MB 2011/1



Sources: Statistics Iceland, Central Bank of Iceland.

horizon. How quickly the transmission channels normalise is subject to considerable uncertainty, however, and it could take a longer time than is assumed in the baseline forecast for laxer monetary policy to be transmitted to the real economy in the form of improved private sector financial conditions.

Private consumption began to grow year-on-year in Q3/2010, after a continuous contraction lasting over two years. Leading indicators suggest that it will continue to grow, although both the growth rate of consumption and its share in GDP will remain below historical averages. Despite declining debt levels, household debt is still elevated and household balance sheets will remain fragile for some time. The uncertain economic outlook could also lead to more precautionary saving. Moreover, there is some uncertainty about the extent to which households will use reimbursements from financial institutions and the Government to pay down debt and build up their savings instead of spending them on consumption. In the same vein, it is uncertain to what extent higher income will be directed towards imported goods and services, which will determine to some degree the impact on output growth.

Unusually large discrepancies between leading indicators and official figures on investment cause uncertainty about the investment outlook. The baseline forecast takes account of these indicators in assessing investment. It also assumes that investment will continue to recover during the forecast horizon. This assessment is uncertain, however, because corporate balance sheets are impaired and businesses' overall situation is unclear, access to credit is tight, spare capacity is considerable, and the economic environment is shrouded in uncertainty, especially in light of the Icesave dispute. A more rapid turnaround is also possible if access to domestic and foreign capital markets normalises sooner, as investment is at a very low level in historical context. These uncertainties are explored in greater depth in the two alternative scenarios described below.

The baseline forecast assumes that the exchange rate will remain close to current levels for most of the forecast horizon. As always, the exchange rate outlook is extremely uncertain. As is mentioned above, the exchange rate outlook has become even more uncertain following the Icesave referendum. Uncertainty about exchange rate developments is also related to the plan for capital account liberalisation. Part of the first phase of the liberalisation strategy should be able to proceed as planned, despite the outcome of the referendum, and is not assumed to place undue strain on the Central Bank's foreign exchange reserves or the exchange rate. How long the first phase will take is unknown, but in the second phase (the removal of restrictions on residents' capital outflows) both the reserves and the exchange rate could come under pressure. On the other hand, because the timing and conditions related to liberalisation are uncertain, it is difficult to take account of the strategy in the baseline forecast. For the longer term, however, the uncertainty is greater on the upside, as the real exchange rate is at a historical low – and probably somewhat below long-term equilibrium – and a sizeable underlying current account surplus has already emerged. All of the fundamentals point towards

a real exchange rate appreciation in the long run. This is reflected in the baseline forecast, although the adjustment is assumed to be slow, in part because of Iceland's substantial external debt. The speed and strength of the adjustment are quite uncertain, however, and the possibility of a rapid appreciation at some point in the next few years cannot be ruled out.

Unemployment began to rise again towards the end of 2010, although the baseline forecast assumes that it will begin to taper off later this year. How much and how fast unemployment declines is quite uncertain, though. Corporate debt restructuring is proceeding slowly, and it appears as though firms have resisted laying off employees, even though the level of activity has contracted in the wake of the financial crisis. The average number of hours worked has also fallen off significantly; therefore, it can be assumed that hours can be increased markedly before the increased activity associated with economic recovery will begin to show in a rise in the number of jobs. There is also considerable uncertainty about the supply side of the labour market. Long-term unemployment has diminished, however, probably due in large part to the increased flow of unemployed persons into the labour market. There is also the risk of loss of job skills, making it difficult both for employers to find workers with the appropriate skills and for workers to find suitable jobs. This, together with more generous unemployment benefits, could result in a permanent rise in the equilibrium unemployment rate, which would offset the drag on wage growth provided by high unemployment. As a result, there is considerable uncertainty about both the assumption in the baseline forecast that the equilibrium unemployment rate will gradually return to its pre-crisis level as the forecast horizon progresses and the effect that the current slack in the labour market has on wage developments and how it offsets wage pressures stemming from the favourable position of the tradable sector.

Potential output has been reduced by the financial crisis. The baseline forecast assumes that it will begin recovering in mid-2011. In international context, this is an unusually long adjustment. Both the historical development and the future prospects for potential output are subject to significant uncertainty because of the lack of direct measurement of potential output. It is not impossible that the adjustment could occur more rapidly than is assumed here. This would affect the assessment of the underlying output slack and the associated inflationary pressures. If potential output rises more rapidly than the baseline forecast assumes, the economy could grow more quickly without increasing inflationary pressures. Potential output could also contract more steeply and grow more slowly if demand proves weaker than is forecast here; for example, if firms consider it necessary to cut back production levels permanently; e.g., through selling machinery and equipment abroad.

Global commodity and oil prices have risen sharply in the recent term, pushing import prices upwards. The baseline forecast assumes that these increases will lose momentum in the latter half of the year and the associated inflationary pressures will ease once they have passed through the retail chain to final prices. How persistent the

increases are and how strongly they affect domestic inflation – and therefore, how strongly monetary policy must respond – is highly uncertain. If the supply shock turns out short-lived, the impact will probably be relatively transitory. The increases could prove more persistent, however, if global recovery turns out stronger than assumed, or if unrest in areas such as North Africa and the Middle East escalates further. The inflationary impact could also prove greater if inflation expectations are affected and spread to wage demands and companies' pricing decisions; for example, if firms choose to take the opportunity to rebuild damaged balance sheets by raising margins and passing more cost increases through to prices than is warranted by weak demand. Inflationary pressures could prove weaker than currently forecast, however, if the output slack is more pronounced, either because of weaker demand or because of more robust recovery of potential output.

Alternative scenarios

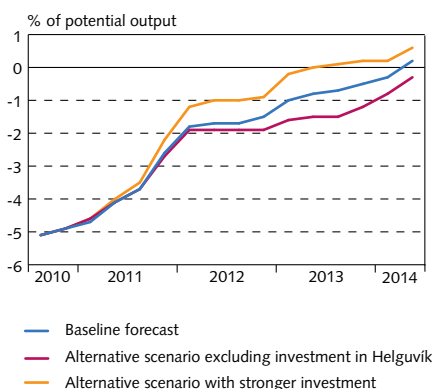
Alternative scenarios can provide useful indications of the effects of important assumptions in the baseline forecast on the economic outlook, and how these deviations interact with monetary policy. Two alternative scenarios are described below. In the first scenario, the construction of the Helgúvík aluminium smelter and associated power plant does not take place, while the second assumes a more rapid recovery of investment than in the baseline forecast.

Weaker output growth if the Helgúvík project does not materialise

The baseline forecast assumes that the first phase of the aluminium smelter construction at Helgúvík will take place. According to the forecast, construction of the aluminium smelter and related power plant will be well underway in 2012 and will peak in 2013. As has been discussed in previous issues of *Monetary Bulletin*, the Helgúvík project has been postponed numerous times due to funding difficulties, uncertainty about access to sufficient energy, and problems with planning and permits. At this point, the probability that the project will be shelved for an undetermined length of time has increased, especially after the results of the Icesave referendum. This alternative scenario therefore assumes that the Helgúvík project will not be undertaken, at least not during the forecast horizon.

In comparison with the baseline forecast, this will primarily affect economic activity in 2012-13. Growth in total investment will probably be about 10 percentage points less in 2012 and 5 percentage points less in 2013. Growth in domestic demand would therefore be about 2 percentage points less in both years, and output growth would be about ½ a percentage point less. Furthermore, demand for labour will be weaker, and unemployment will be higher by ½ a percentage point in 2012 and 1½ percentage points in 2013. Exports will also suffer, although the full effect will only emerge beyond the forecast horizon. Weaker investment will also lead to lower potential output. Nevertheless, the output slack would be nearly 1 percentage point more in 2013 than in the baseline forecast (see Chart I-13). A

Chart I-13
Output gap - alternative scenarios



Source: Central Bank of Iceland.

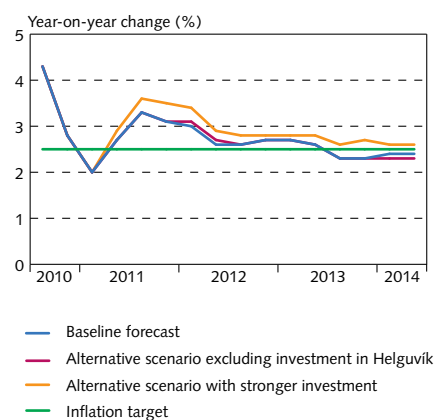
more pronounced slack in the economy also means that interest will be lower, which in turn implies a lower exchange rate than in the baseline forecast. This is offset by the effects of the slack on inflation; therefore, the inflation rate in this scenario is very similar to that in the baseline forecast (Chart I-14).

Stronger recovery of investment expedites economic recovery

Business investment is still low in historical context, and according to the baseline forecast, the recovery of general business investment will be relatively slow. Furthermore, it is assumed both that risk premia on domestic financial obligations will decline relatively slowly and that foreign direct investment will not begin to recover to any marked degree before the latter half of 2012. The alternative scenario assumes a stronger recovery of investment, which could occur if Iceland's access to global capital markets improves sooner than is currently expected. Such a development would emerge in a speedier decline in risk premia and stronger recovery of foreign direct investment. In that instance, the recovery of investment in the wake of the financial crisis would more closely resemble that in the countries that have recovered most swiftly from financial crises.

Investment as a share of GDP will therefore rise more quickly than in the baseline forecast and will have returned to its long-term average by the end of the forecast horizon; hence recovery will be stronger and more investment-driven than in the baseline forecast. Potential output will also be greater with the expansion of the capital stock. Output growth in 2011 will be about half a percentage point greater than in the baseline forecast, and about 1 percentage point more over the forecast horizon as a whole. As a result, the output slack will be somewhat smaller than in the baseline forecast, although it is offset by a stronger recovery of potential output (Chart I-13). Unemployment also declines more rapidly and will be nearly 1 percentage point lower in 2012, and about $\frac{1}{2}$ a percentage point lower in 2013, than in the baseline forecast. Less spare capacity also implies higher interest rates, which, together with greater foreign investment inflows and a more rapid decline in risk premia, will contribute to a higher exchange rate than in the baseline forecast. This will offset the increased inflationary pressures resulting from a smaller output slack (Chart I-14).

Chart I-14
Inflation - alternative scenarios

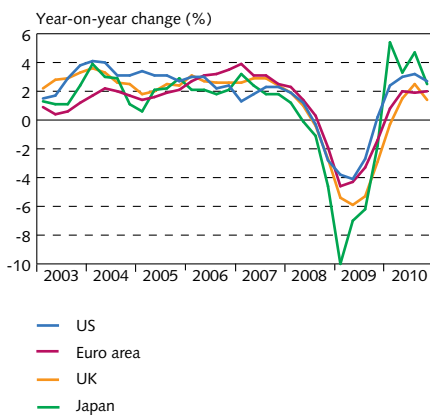


Sources: Statistics Iceland, Central Bank of Iceland.

II External conditions and exports

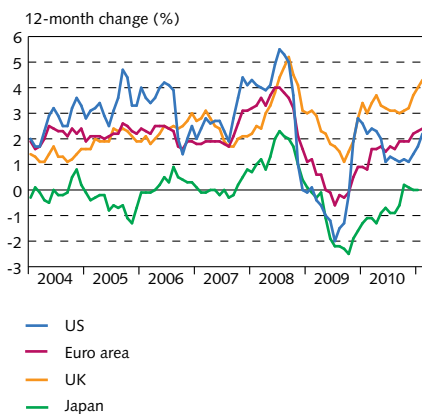
The economic outlook in Iceland's main trading partner countries is somewhat improved since the beginning of the year, but considerable uncertainty remains. Inflation has increased due to rising oil and commodity prices, yet underlying inflationary pressures are limited by high unemployment and significant spare capacity in the economy. The monetary stance has remained unchanged in most countries, although some central banks have raised interest rates in recent months. A slow recovery appears to have taken hold in foreign financial markets, although lending is still limited. Oil and commodity prices rose steeply at the beginning of 2011, and it appears as though prices for 2011 as a whole will be much higher than previously projected. The price of Iceland's main exports is rising as well, fuelling forecasts of continued improvement in terms of trade in 2011. The real exchange rate has remained low, contributing to continuing growth of exports in coming years.

Chart II-1
International growth
Real GDP growth Q1/2003 - Q4/2010



Source: Macrobond.

Chart II-2
Inflation in the US, UK, Japan and euro area
January 2004 - February 2011



Source: Macrobond.

Economic outlook broadly unchanged ...

GDP growth tapered off somewhat in Iceland's major trading partner countries in Q4/2010, but the year as a whole represented a turnaround from the contraction of 2009. The global economic outlook is broadly unchanged since February, when the *Monetary Bulletin* was last published. Emerging countries continue to drive growth, although the key emerging countries have seen GDP growth figures decline. The most recent projections for 2011 from Consensus Forecasts indicate that Iceland's main trading partners will see slightly stronger GDP growth than was assumed in the last *Monetary Bulletin*, owing primarily to improved growth prospects in the US, Sweden and Norway. Some uncertainty remains, however, even though growth has been underpinned, as both private consumption and investment have begun to recover. The natural disaster in Japan has exacerbated the uncertainty about near-term developments, although most analysts believe its economic effects will be temporary.

... and underlying inflationary pressures still limited

Inflation has continued to rise in Iceland's main trading partner countries in the past few months, driven by higher oil and commodity prices. Underlying inflationary pressures appear quite limited, however, and core inflation has remained broadly unchanged since the last forecast was prepared. Core inflation appears unlikely to rise much in coming months, due to the continuing slack in the goods and labour markets. In the UK and the euro area, inflation is somewhat above the respective central banks' inflation targets, and it has risen sharply in recent months, particularly in the UK. Inflation is assumed to be somewhat higher this year in Iceland's main trading partner countries than was projected in the last *Monetary Bulletin*. It is expected to peak just after mid-year and then begin to subside again. The outlook for 2012 and 2013 is broadly unchanged, however.

The lack of underlying inflationary pressure is the reason the central banks in the UK, US and most other trading partner countries

have maintained unchanged interest rates since the last publication of *Monetary Bulletin*. Some central banks have altered their monetary stance, however: the European Central Bank raised interest rates by 0.25 percentage points in early April, after keeping them constant for almost two years, and Sweden's Riksbank raised interest rates once again in February, to a level higher than at any time since the end of 2008. Interest rates have also been raised in several emerging market economies. They were cut in New Zealand in March, however, in an attempt to counteract the economic impact of the recent earthquake there.

Global financial markets recovering slowly

Share prices around the world rose markedly in 2010, driven by low interest rates and improving corporate operating results. Among Iceland's trading partners, the increase was greatest in the Nordic region. Global market prices have continued to climb so far in 2011, although some markets have seen some weakening, particularly in March. Uncertainty is considerable in the wake of the earthquake and tsunami in Japan, which triggered the collapse of the stock market in the world's third-largest economy. The impact on share prices outside Japan is expected to be temporary, however.

The global financial markets have continued to improve, although risk premia remain higher, turnover lower, and access to credit tighter than before the financial crisis, and appear likely to remain so in the near future. Although financial conditions are gradually normalising, difficulties in the financial markets will probably impede global output growth for a while, particularly in industrial countries.

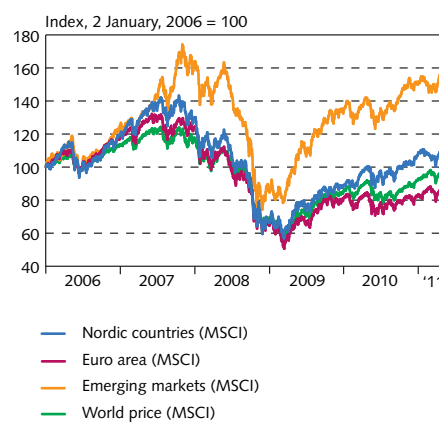
Steep rises in commodity and oil prices

Oil prices increased sharply in the first months of 2011 and are now expected to rise by 33% over the course of the year, as opposed to the 15% projected in the last *Monetary Bulletin*. In its forecast, which takes account of both futures and major analysts' projections, the Central Bank assumes prices will hold unchanged in 2012 after peaking late in 2011. Commodity prices have also continued to climb, with great rises in the first two months of 2011. Early on, higher prices were fuelled by greater demand and concurrent crop failures in many parts of the world, whereas increased demand in emerging countries has been the primary driver in recent months. Changes in inventories and market expectations have also made an impact and will continue to affect the extent of the increase. The Central Bank projects a 23% rise in commodity prices in 2011, some 5 percentage points more than in its last forecast. Commodity prices are projected to continue rising next year, but far less than in 2011, as supply is expected to respond to the recent surge in prices. Uncertainty about near-term oil and commodity prices has increased, however, with the escalation of unrest in North Africa and on the Arabian peninsula.

Global trade one of the main drivers of world output growth

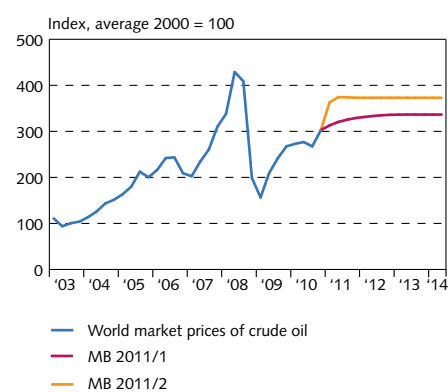
Global trade increased markedly in the latter half of 2010 and has continued to be one of the primary drivers of output growth worldwide.

Chart II-3
Equity prices
Daily data 2 January 2006 - 15 April 2011



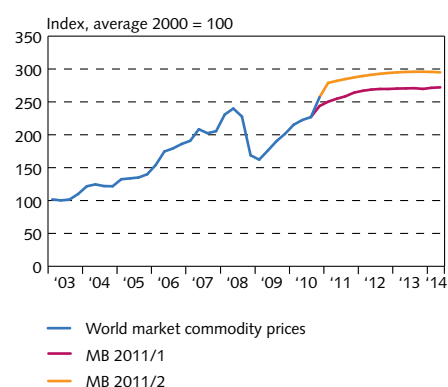
Source: Macrobond.

Chart II-4
Oil prices
Q1/2003 - Q2/2014



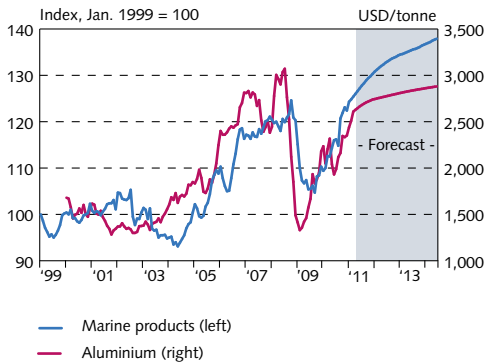
Sources: Bloomberg, Central Bank of Iceland.

Chart II-5
Commodity prices¹
Q1/2003 - Q2/2014



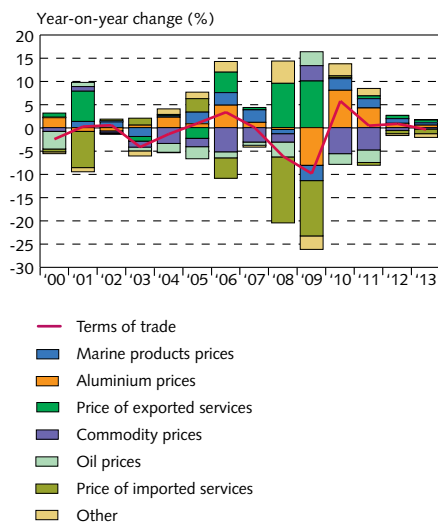
1. Non-oil commodity prices in USD.
Sources: Macrobond, Central Bank of Iceland.

Chart II-6
Prices of marine exports and aluminium
In foreign currency



Sources: London Metal Exchange, Statistics Iceland, Central Bank of Iceland.

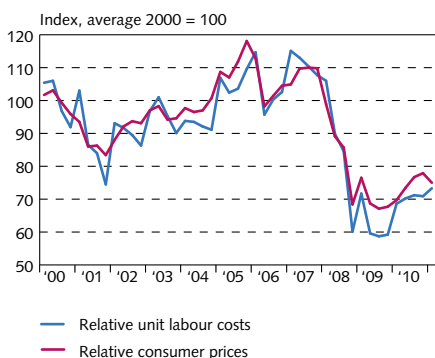
Chart II-7
Terms of trade and its main components
2000-2013¹



1. Central Bank baseline forecast 2010 - 2013. The contribution of the main sub-indices to year-on-year changes in terms of trade is determined by weighting the annual change in the sub-index concerned together with its weight in the import or export of goods and services. The item "other" is a residual.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart II-8
Real exchange rate
Q1/2000 - Q1/2011



Source: Central Bank of Iceland.

Both the IMF and the OECD forecast that global trade will continue to grow in 2011 and 2012, although by a smaller margin than in 2010, as that year's growth came on the heels of a steep contraction and was thus unlikely to be sustainable. The most recent IMF projection is virtually unchanged from the beginning of the year. The forecast published in this *Monetary Bulletin* assumes, as did the Bank's last forecast, that imports in Iceland's major trading partner countries will grow by just over 5% in 2011 and just under 5% in 2012.

Export prices rise

Marine product prices have continued to rise and have regained the levels preceding the general drop in commodity prices in the winter of 2008. Most marine products are expected to rise still further in 2011. The current forecast for marine product prices has been adjusted upwards, both for 2011 and in 2012. According to the current forecast, prices will rise by 8% year-on-year in 2011 and by 4% in 2012, whereas the last *Monetary Bulletin* assumed increases of 5% and 3%, respectively.

Aluminium prices have also continued to climb and appear set to rise more than was assumed in the last *Monetary Bulletin*. According to the current forecast, aluminium prices are expected to rise by 17% year-on-year in 2011 and by an average of 3% per year over the ensuing three years, whereas the February forecast assumed a 15% increase in 2011 and an average annual increase of just under 1% for the two years thereafter.

Terms of trade to improve less than previously expected

This year's increase in export prices, while substantial, is not expected to outweigh the rise in oil and commodity prices. As a result, terms of trade are expected to improve by just under 1 percentage point less than according to the last forecast, or by ½%. Offsetting this, however, terms of trade are now estimated to have improved by more than previously forecast in 2010, or by just under 6%. The outlook for 2012 and 2013 is broadly unchanged.

Real exchange rate remains low

The real exchange rate climbed steadily through November 2010, by which time it had risen by 15% during the year, but from then onwards it began to fall again, and by March it was almost 5% lower than in November. As a result, it remains roughly 22% below the average over the past thirty years. It is projected to hold broadly unchanged year-on-year in 2011 and then rise marginally over the subsequent two years. It is likely to remain relatively low in coming years, further supporting exports – particularly services exports – and ensuring a substantial surplus on external trade, which will improve Iceland's international investment position.

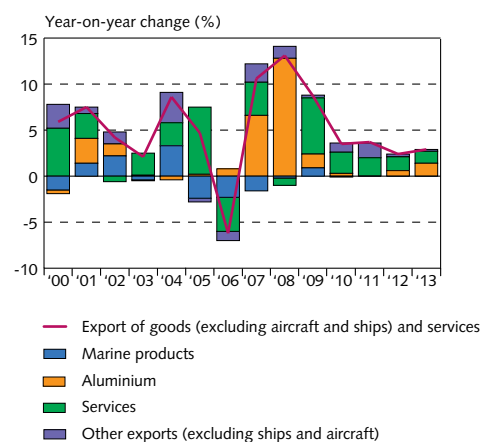
Export growth to continue in coming years

Due to an increase in the capelin quota, it is now assumed that exports of marine products and aluminium will remain unchanged in volume terms between 2010 and 2011, whereas the last forecast assumed a

2% contraction in marine product exports. The fisheries and heavy metals sectors account for 4/5 of Iceland's goods exports, with the remaining 1/5 coming mainly from exports of pharmaceuticals, medical supplies, food processing equipment, and electrolytic capacitors. The combined exports of industrial products other than aluminium are expected to increase by 11-12% in 2011. Services exports have also been growing considerably in recent years, supported by a low real exchange rate. The forecast assumes that services exports will increase by just under 6% in 2011 and by 3-4% in the two years following.

The prospects for goods export growth have improved as well, and a modest increase is now assumed instead of the slight contraction projected in the last forecast, due primarily to the improvement in the outlook for marine product exports. The outlook for the next two years has improved as well, in part because of the prospect of stronger growth in aluminium exports than was assumed at the beginning of the year. The forecast assumes that total exports will increase by 2½% in 2011 and by 2½-3% per year in 2012-2013. Excluding the effects of transactions with aircraft and ships, growth will be more in 2011, or 3.7%.

Chart II-9
Export development (excl. ships and aircraft)
and its main components 2000-2013¹



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

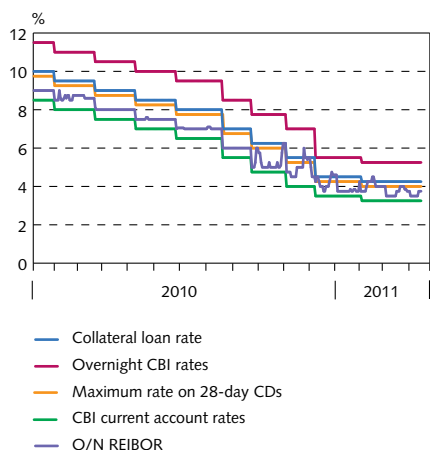
Table II-1 Exports and main assumptions for developments in external conditions

	Change from prior year (%) unless otherwise specified ¹			
	2010	2011	2012	2013
Exports of goods and services	1.1 (0.0)	2.5 (2.5)	2.4 (2.2)	2.9 (2.4)
Exports of goods and services, excl. aircraft and ships	3.5 (2.6)	3.7 (3.0)	2.4 (2.2)	2.9 (2.4)
Marine production for export	-0.4 (-1.6)	0.0 (-2.0)	0.0 (0.0)	0.0 (0.0)
Metals production for export	1.7 (3.0)	0.1 (-0.2)	2.4 (0.0)	5.3 (2.7)
Export prices of marine products in foreign currency	9.7 (9.9)	8.0 (5.1)	4.0 (3.0)	2.0 (2.0)
Aluminium prices in USD ²	31.5 (27.9)	17.0 (14.1)	3.9 (1.1)	2.2 (0.9)
Fuel prices in USD ³	28.0 (28.0)	32.5 (14.9)	0.2 (3.7)	0.0 (0.8)
Terms of trade for goods and services	5.8 (5.2)	0.5 (1.4)	0.9 (0.9)	-0.3 (0.0)
Inflation in main trading partners ⁴	1.9 (1.9)	2.4 (2.0)	1.9 (1.8)	1.9 (1.9)
GDP growth in main trading partners ⁴	2.1 (2.0)	2.1 (2.0)	2.2 (2.2)	2.3 (2.4)
Short-term interest rates in main trading partners (%) ⁵	0.9 (0.9)	1.2 (1.2)	2.0 (2.0)	2.7 (2.7)

1. Figures in parentheses from forecast in *Monetary Bulletin* 2011/1. 2. Forecast based on aluminium futures and analysts' forecasts. 3. Forecast based on fuel futures and analysts' forecasts. 4. Forecast from Consensus Forecasts and Global Insight. 5. Based on weighted average forward interest rates of Iceland's main trading partner countries.

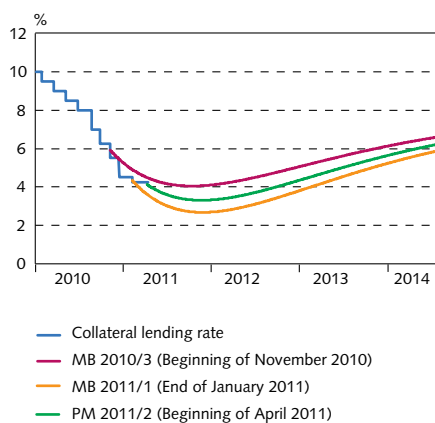
Sources: Bloomberg, Consensus Forecasts, Global Insight, IMF, Macrobond, OECD Economic Outlook, Statistics Iceland, Central Bank of Iceland.

Chart III-1
Central Bank of Iceland interest rates
and short-term market interest rates
Daily data 1 January 2010 - 15 April 2011



Source: Central Bank of Iceland.

Chart III-2
Collateral lending rate and forward
market interest rates¹
Daily data 1 January 2010 - 30 June 2014



1. Using interbank and government bond rates (with weekly rates as the shortest maturity) before publication of *Monetary Bulletin*.
Source: Central Bank of Iceland.

III Financial conditions

Monetary easing has continued, and further interest rate cuts appear to be priced into long-term market rates, which have inched upwards in the recent term, however, in part due to rising inflation expectations. The financial conditions of households and firms remain difficult in spite of continued monetary easing. Increased real estate market turnover could improve the financial conditions of households that have been unable to sell property heretofore.

Easing cycle slows down

In early February, when *Monetary Bulletin* was last published, the Central Bank Monetary Policy Committee (MPC) lowered interest rates by 0.25 percentage points. The current account rate was reduced to 3.25%, maximum rates on 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%. On the last interest rate decision date, 16 March, the Committee decided to keep the Bank's interest rates unchanged.

Overnight interbank market rates near the centre of the interest rate corridor

For most of 2010, the overnight interbank market lending rate hovered near the bottom of the interest rate corridor, just above the current account rate. So far in 2011, however, it has been closer to the centre of the corridor, in line with the MPC's declared aim of moving market rates closer to the centre. Short-term market rates still fluctuate within the interest rate corridor, as the Bank's market activity still takes place only on a weekly basis. Market trading remains relatively sparse, with lending restricted almost entirely to overnight loans, although a few seven-day loans have been granted.

Monetary easing continues

The Central Bank's real interest rate is now just over 1% in terms of the twelve-month rise in the consumer price index (CPI), but around ½% when compared to the Central Bank's one-year inflation forecast. According to different measurements of inflation and inflation expectations, the real interest rate level has fallen and currently averages almost 1%. This is a substantial decline since just before the last *Monetary Bulletin* was published (see Table III-1).

Further interest rate reductions priced into the yield curve

Forward interest rates imply that market participants expect the MPC to keep rates unchanged in April, but to lower rates by 0.75 percentage points by the autumn and keep them unchanged for the remainder of the year. Gradual tightening is priced into the yield curve in the first half of 2012. The expected rate path is higher than it was when *Monetary Bulletin* was published in February, but lower than at the time of the November *Monetary Bulletin*.

Table III-1 Monetary stance (%)

	Current stance (15 April)	Change from MB 2011/1 (1 February)	Change from MB 2010/2 (4 May)
Real interest rate based on: ¹			
Twelve-month inflation	1.3	-0.7	1.5
Three-month seasonally adjusted inflation	-4.6	-8.3	-5.5
Business inflation expectations (one-year)	-0.6	-2.4	-4.5
Household inflation expectations (one-year)	0.4	0.5	0.3
One-year breakeven inflation rate ²	2.2	-1.5	-2.1
Central Bank inflation forecast ³	0.6	-1.2	-4.0
Average	-0.1	-2.3	-2.4
Average excl. three-month seasonally adj. inflation	0.8	-1.1	-1.8
Risk-adjusted three-month interest rate differential based on:			
Historical exchange rate volatility ⁴	0.9	0.3	-1.6
CDS spread on the Republic of Iceland ⁵	1.6	0.8	-1.7

1. The effective Central Bank nominal policy rate is the average of the current account rate and the maximum rate on 28-day CDs.
2. The one-year breakeven inflation rate, based on the difference between the nominal and indexed yield curves (five-day rolling average).
3. The Central Bank forecast of twelve-month inflation four quarters ahead.
4. The ratio of the three-month interest rate differential and the three-month standard deviation of the EURISK exchange rate.
5. The interest rate differential in terms of various short-term rates in Iceland and trade-weighted foreign interest, adjusted for the difference in CDS spreads ((five-day rolling average).

Long-term nominal interest rates have risen slightly in spite of lower Central Bank rates

Yields on Housing Financing Fund (HFF) bonds have declined by up to 0.8 percentage points so far this year. The yield on the shortest bonds has fallen by 1½ percentage points, but trading is very thin and price formation inefficient. Yields on nominal Treasury bonds have risen since the beginning of the year, however, with yields on the longest bonds rising by approximately 2/3 percentage point but somewhat less on the shortest bonds. This probably mostly reflects rising inflation expectations, which stem from steep rises in commodity and oil prices and the depreciation of the króna year-to-date (See Section VIII).

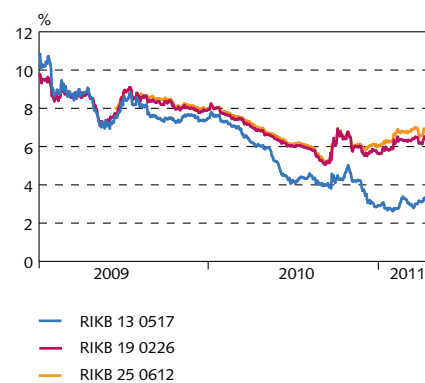
Risk premia on Treasury debt have declined in the past year

Iceland's CDS spread has fallen by half a percentage point since the last *Monetary Bulletin* appeared, and now stands at roughly 2.2 percentage points. Since February, the differential with German Treasury bonds has risen marginally, with the short-term differential about 3½% and the long-term differential about 3%. In terms of the CDS spread, the differential is therefore in the ½-1½% range.

Króna continues to depreciate

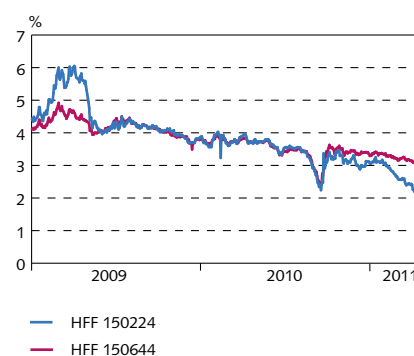
Just before the publication of this *Monetary Bulletin*, the exchange rate of the króna was about 4½% lower in trade-weighted terms, and about 6% lower against the euro, than at the beginning of 2011. The króna was trading at about 163 against the euro, which is almost 3% lower than in February, when the last issue of *Monetary Bulletin* appeared. This depreciation reflects some decline in the real exchange rate. It is likely that seasonal fluctuations in foreign currency flows made an impact, as net inflows associated with external trade are generally less during the first months of the year. The possibility cannot be ruled out, however, that rapid interest rate reduction and the diminishing interest rate differential with abroad are reflected to some degree in the depreciation of the króna; for example, non-resident owners of domestic bonds may be choosing to expatriate a larger

Chart III-3
Long-term nominal Treasury bond yields
Daily data 2 January 2009 - 15 April 2011



Source: Central Bank of Iceland.

Chart III-4
Yields on indexed HFF bonds
Daily data 2 January 2009 - 15 April 2011



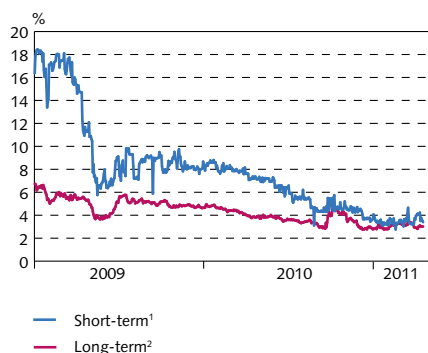
Source: Central Bank of Iceland.

Chart III-5
CDS Iceland
Daily data 29 March 2007 - 15 April 2011



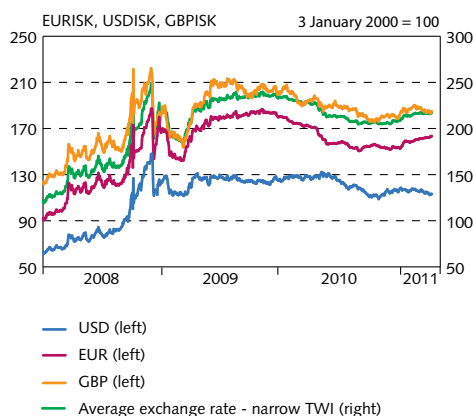
Source: Bloomberg.

Chart III-6
Interest rate differential
Daily data 2 January 2009 - 15 April 2011



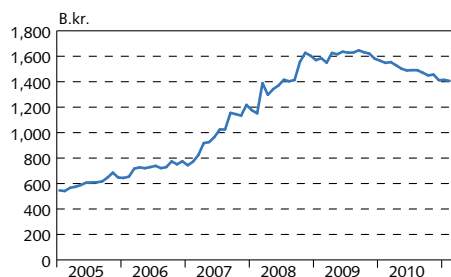
1. Differential between yields on 3-month Treasury bills in Iceland and Germany. 2. Differential between yield on RIKB 19 and 8-year Treasury bonds in Germany.
Source: Macrobond.

Chart III-7
Exchange rate of the króna
Daily data 3 January 2008 - 15 April 2011



Source: Central Bank of Iceland.

Chart III-8
Residents' DMB deposits
January 2005 - February 2011



Source: Central Bank of Iceland.

share of their interest income than before, or domestic firms with foreign exchange revenues may elect not to convert them to krónur because of lower returns on domestic króna-denominated assets.

According to the Central Bank's forecast, the króna will continue to depreciate over the next quarter but then remain broadly stable for the remainder of the forecast horizon, and will be about 3½% weaker at the end of the forecast horizon than was projected in February. This is subject to considerable uncertainty, however, due to the offsetting effects of positive fundamentals such as the outlook for improved terms of trade and sizeable trade surplus versus the short-term uncertainty associated with the Icesave dispute and the plan to begin lifting the capital controls.

Deposits have contracted

Between 2007 and 2009, residents' deposits in the domestic banking system doubled, but now they have fallen off by over 240 b.kr., or nearly 15%, since peaking in September 2009. Analysis of the money supply reveals that this is due in large part to substitution between different asset classes and a run-down of precautionary savings. Broad money (M3) has been contracting since October 2009 and had declined 8.5% year-on-year by February 2011. Narrower forms of money (M1 and M2) peaked in October 2008, however.

As Chart III-9 shows, deposits have been shifted to less liquid forms, such as shares in mutual funds. The supply of investment funds has been on the rise in the past two years, particularly those funds that invest only in Treasury bonds. Their structure is reminiscent of the money market funds that were closed in the wake of the banking collapse, although those money market funds invested primarily in corporate bonds.¹ The sharp decline in deposit rates has certainly fuelled this trend. In addition, it could be that investment risk is being reassessed, as most types of investment appeared risky at the height of the financial crisis. It seems that investors' interest in real estate and equities has risen. Investment in unlisted assets has increased as well.

Credit creation remains limited

Even though housing market activity is still limited in historical context, recent months have seen rising turnover. This spurt in activity appears not to have been accompanied by an increase in mortgage lending, however. The Housing Financing Fund (HFF) and the pension funds, currently Iceland's main mortgage lenders, have more stringent collateral requirements than the banks did before the crisis; thus it is clear that purchasers must have more equity than they did previously. In spite of this, it can be seen that HFF loaned more to households in Q1/2011 than in the same period a year ago. The number of properties sold currently exceeds the number of new mortgage loans. This is probably due in part to swap agreements, although housing swaps have declined as a share of total turnover over the past year. The main explanation, however, appears to be that investors are bringing increased equity into the real estate market because of the dearth of

1. A dramatic reduction took place in the wake of the banks' collapse, when many of the funds were dissolved.

investment options in an environment of capital controls and impaired domestic financial markets. To the extent that the banks are selling off property to the private sector from their own balance sheets, this would coincide with a contraction in deposits and money supply as long as the banks do not redirect these funds again to the non-financial private sector through new lending.

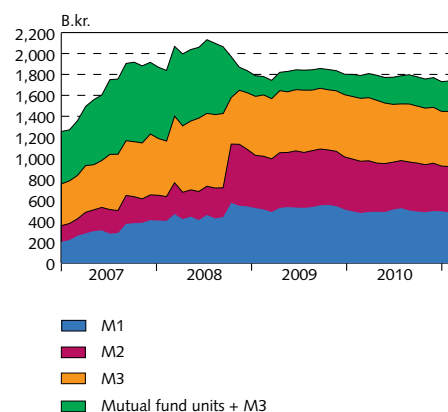
Real estate market turnover on the rise

Turnover in the real estate market has crept upwards in recent months. A livelier housing market could ease financial conditions of households, for example those that wish to move into smaller housing but have been unable to sell their property. If house prices rise notably in the wake of increased demand, this could also strengthen households' financial position and improve financial institutions' balance sheets, thus enabling them to begin lending once again. The Capacent Gallup Consumer Sentiment Index for the month of March reveals that the subindex for planned house purchases has virtually stood still since December but has risen year-on-year. In real terms, house prices in the greater Reykjavik area rose marginally between January and February and were up year-on-year for the first time since March 2008. According to the baseline forecast, real house prices will bottom out in the latter half of 2011 and then begin to recover slowly. By the end of the forecast horizon, however, real house prices will still be 35% below the pre-crisis peak at the end of 2007.

Financial conditions of households and businesses remain difficult

Households' financial conditions remain difficult, even though the resolution of exchange rate-linked loan agreements doubtless reduces many households' debt service burden and many borrowers have been reimbursed by their financial institutions for overpayments of the loans in question and loans have been written down. Households that took exchange rate-linked loans have received an estimated 8.5 b.kr. in reimbursements from financial institutions, most of it payable at the end of 2010. In addition, a special interest rebate will be paid out in 2011 and 2012. The amount will be calculated as 0.6% of the outstanding balance of mortgage loans as of year-end 2010 and 2011. The interest rebate is not income-linked, but payments are limited to the recipient's net equity. Total payments are expected to equal about 12 b.kr. Among the measures to assist distressed households is the reduction of outstanding loan principal to 110% of the value of the mortgaged property. HFF estimates the cost of writing down individuals' loan principal to 110% of the property value to be 22.8 b.kr. Deposit money banks are also offering such a write-down, but no information on the total volume is available at present. This measure is available to borrowers until 1 July 2011. In addition, a number of households have utilised the authorisation to withdraw third-pillar pension savings. Since such withdrawals were authorised, over 45 b.kr. have been paid out, with another 10 b.kr. in payouts approved through February 2013. These factors may explain the increase in HFF lending to households, although such lending is still limited in a historical context.

Chart III-9
Money holdings
January 2007 - February 2011¹



1. Data from October 2008 are preliminary.
Source: Central Bank of Iceland.

Chart III-10
Mutual fund units
January 2000 - February 2011

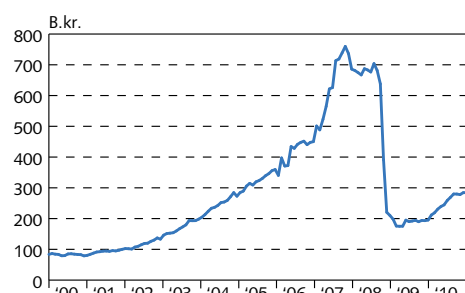
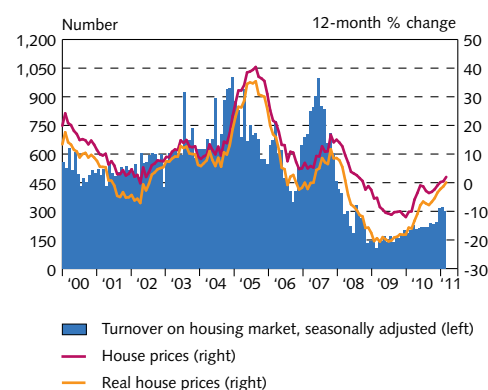
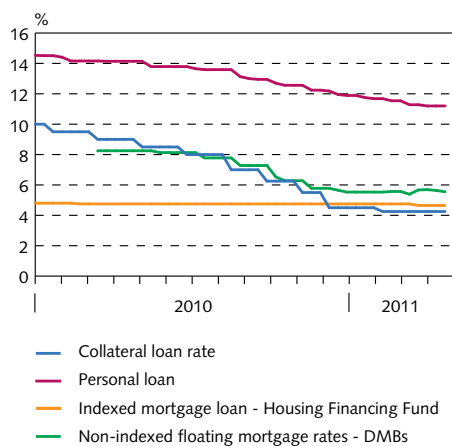


Chart III-11
Housing market prices and turnover
in greater Reykjavik¹
January 2000 - February 2011



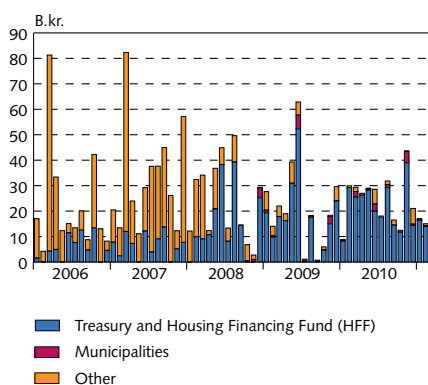
1. Turnover is based on the number of purchase agreements on the date of purchase. Monthly data.
Sources: Registers Iceland, Central Bank of Iceland.

Chart III-12
Collateral loan rate and retail lending rates
1 January 2010 - 15 April 2011



Source: Central Bank of Iceland.

Chart III-13
Bond auctions
January 2006 - February 2011



Source: Central Bank of Iceland.

Households' access to credit remains tight and lending rates are relatively high, even though the Central Bank has lowered its interest rates significantly. A number of factors may play a role in this. Uncertainty about the quality of the banks' loan portfolios and the general economic outlook probably makes financial institutions reluctant to begin lending to any marked degree and stands in the way of a more rapid reduction in lending rates. In addition, increased capital adequacy and liquidity requirements make financial institutions' funding more expensive and call for higher lending rates than would otherwise be necessary.

As a consequence, interest on general consumer loans and mortgages has not declined to the same degree as Central Bank interest rates. For example, the listed interest rate for general consumer loans still averages over 11%, whereas the Central Bank's collateralised lending rate is 4.25%. Indexed mortgage interest has declined little: for instance, interest on new loans taken from the HFF has fallen by only 0.15 percentage points since the beginning of 2010, even though HFF bond yields have fallen by nearly 1 percentage point on average. This growing discrepancy between central bank rates and retail lending rates is not restricted to Iceland, however, and larger spreads can even be found in some neighbouring countries. Interest on general consumer loans in the UK and Germany is about 8-9% and nominal interest on two-year fixed-rate mortgages is in the 4-6% range, whereas the two countries' policy rates are 0.5-1.25%.

Businesses' financial conditions are difficult as well, and there is little new lending for new projects. Corporate debt restructuring has been delayed. The implementation of the so-called "Straight Path," a mid-December agreement providing for co-ordinated action to resolve the debt problems of small and medium-sized companies, is proceeding slower than originally expected.² Firms' lack of confidence in credit institutions and the uncertainty about the legality of exchange rate-linked loan agreements have deterred borrowers from participating in the programme, although this uncertainty should not impede the progress of the Straight Path, as participating firms do not relinquish any rights by availing themselves of the solutions offered.³ Most likely, the increased number of unsuccessful distraint cases in the past few months is a normal after-effect of the financial crisis rather than a sign of increased corporate financial distress. Unsuccessful distraint is a more accurate gauge of small and medium-sized companies' problems than bankruptcy is, as many smaller companies have no assets and are therefore not subjected to bankruptcy proceedings.

Larger companies have found it difficult to obtain new capital through bond issues, and the corporate bond market is largely inactive. As Chart III-13 shows, the Treasury and the HFF have virtually taken over the market for initial bond issues.

2. This information emerged at a conference on the progress of the Straight Path, held on 22 March 2011. The conference was sponsored by the Iceland Chamber of Commerce, Confederation of Icelandic Employers, Icelandic Financial Services Association, Ministry of Economic Affairs, and Ministry of Finance.

3. It should be borne in mind that corporate debt restructuring is a time-consuming and costly process that is particularly difficult for small companies. Presumably, small companies fear the cost that could accrue upon repeating the process once updated information is available.

When the international financial crisis began in late summer 2007, real house prices (deflated by the CPI) had been rising steeply for about a decade. In Iceland, real house prices rose by about 120% from the trough in 1997 to the peak in 2007, an increase of 8% per year on average. Similar developments could be seen around the world. In the US, for example, real house prices rose 81% from trough to peak (1997-2006), or an average of 7.2% per year. As Chart 1 shows, the rise in Iceland and the US was far larger than could be explained by increases in construction costs.¹

A number of other countries saw similar trends. Of the countries compared in Chart 2, Iceland experienced the smallest price increases in the early part of the last decade. In 2005, however, real prices in Iceland rose by one-fourth, the largest increase by far. It is logical to link this surge in house prices to the structural changes in the market at the time: the Housing Financing Fund (HFF) raised its loan-to-value (LTV) ratio to 90% in late 2004, real mortgage rates fell from 5.1% to 4.15% at the same time, and the banks began competing with the HFF and in a short period of time acquired a sizable share of the mortgage lending market.² At the same time, loan terms were also very attractive in the US and other countries, output growth was strong, unemployment low, wages on the rise, and equities and real estate values soaring, all of which fuelled optimism and demand. As Chart 2 shows, the downturn was a global phenomenon as well. Of the countries in Chart 2, the US was first, with prices beginning to fall in early 2006. However, prices continued to rise until end-2007 in the UK and Iceland, which were last to see their housing markets collapse.

Can bubbles be prevented?

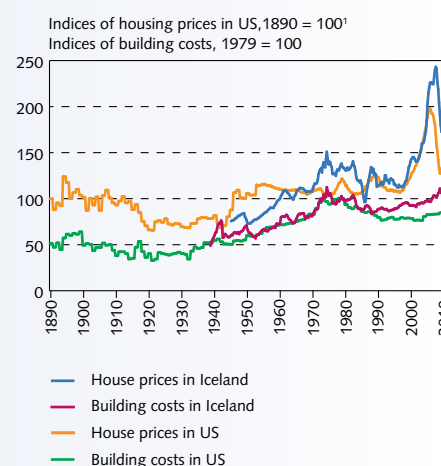
Economists generally agree that asset price bubbles are harmful.³ They disagree, however, on whether bubbles can be prevented and what tools are best suited to the job. The disagreement centres in part on whether it is possible to identify price bubbles. It is usually easy to pinpoint bubbles after the fact. The question is, however, whether it is possible to identify them during the upswing, and well before they burst. Although it is desirable that action be taken in order to prevent severe imbalances in asset markets, it is also important to prevent bubbles from bursting with a bang; i.e., to ensure that the actions taken do not lead to a steep, abrupt decline in prices, with the associated implications for the entire economy. It is also important to bear in mind that attempts to contain price developments driven by fundamentals could be costly. The soaring house prices in the US after World War II are an obvious example of rising prices that did not reflect a housing bubble.

1. Robert Shiller's index of real US house prices is used in the United States, while the Icelandic index is compiled using data from Statistics Iceland. The real building cost index for the US is also obtained from Shiller, whereas the Statistics Iceland building cost index and the CPI are used for Iceland. The Shiller Home Price Index for the US is assigned a value of 100 for the year 1890. The Icelandic index was assigned a value of 107.9 as of Q1/1970, aligning it with the Shiller index value for that period. The Icelandic building cost index is assigned a value of 100 for 1979, aligning it with the Shiller index for the US.
2. See, for example, Lúdvík Eliasson and Thórarinn G. Pétursson (2009), "The residential housing market in Iceland: Analysing the effects of mortgage market restructuring", *Housing Studies*, 24, 25-45, which analyses the impact of these factors on house prices in Iceland. According to their findings, the reduction in mortgage lending rates and increased access to credit through laxer lending requirements led house prices to rise by 25% more than they would have otherwise and prompted a similar increase in residential investment. They found these effects to reverse over a period of 3-5 years, over which time house prices fell again and residential investment contracted.
3. This is discussed in the report compiled by the Central Bank of Iceland for the Minister of Economic Affairs, "Monetary policy in Iceland after capital controls," Central Bank of Iceland, *Special Publication* no. 4., pp 29-30.

Box III-1

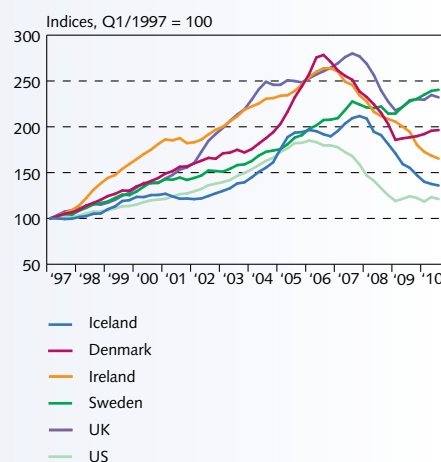
Housing bubbles

Chart 1
Real house prices and building costs in the US 1890-2010 and Iceland 1945-2010



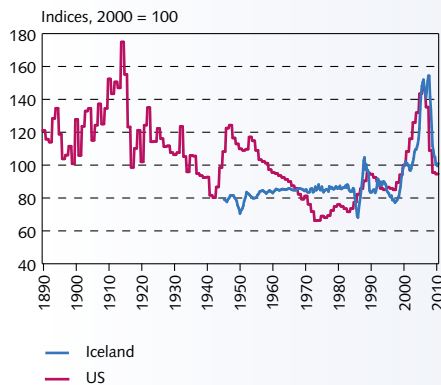
1. The Icelandic index was assigned a value of 107.9 as of Q1/1970, aligning it with the housing price index in the US.
Sources: Roberts J. Shiller's webpage, <http://www.econ.yale.edu/~shiller/data.htm>, Statistics Iceland, Central Bank of Iceland.

Chart 2
Real house prices in selected countries
Q1/1997 - Q3/2010



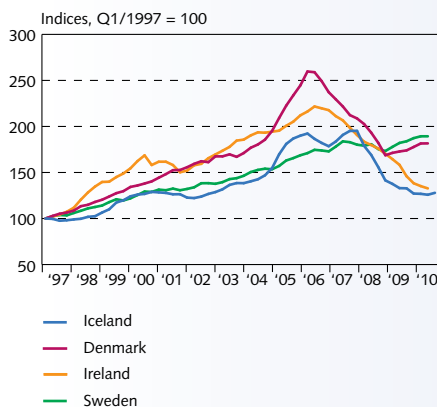
Sources: Macrobond, Statistics Iceland.

Chart 3
The ratio of real house prices and building costs in the US 1890-2010 and Iceland 1945-2010



Sources: Roberts J. Shiller's webpage, www.econ.yale.edu/~shiller/data.htm, Statistics Iceland, Central Bank of Iceland.

Chart 4
The ratio of house prices to building costs in selected countries
Q1/1997 - Q4/2010



Sources: Macrobond, Statistics Iceland.

Measures to combat asset price bubbles – whether these include interest rate hikes, reduction of LTV ratios, or actions to reduce the credit system's lending capacity – all have a direct effect on lending and demand, but they also make an indirect impact by affecting expectations of house price developments and other economic variables in the future. Once an asset price bubble is well established, strong faith in its longevity begins to take hold – until the bubble bursts and the market collapses. It appears that this belief is not limited to the general public but extends as well to market analysts, brokers, and financial institution staff. After the bubble bursts, it usually appears obvious in retrospect that different decisions would have been more beneficial to investors trading in the market shortly before the collapse. It is often extremely uncertain when bubbles will burst, but an examination of Charts 1 and 2 shows clearly that it would have been appropriate to warn of a potential housing bubble well before the financial crisis struck.

Many economists are of the opinion that central bank interest rates are a blunt tool in the fight to contain housing bubbles. When annual house price increases are as large as they were in many markets before the current crisis, modest interest rate hikes are of limited use. Consequently, in order to control bubbles, it is necessary to use policy instruments that affect banks' lending capacity and/or borrowers' ability to borrow. The success of such measures depends to a large degree on individuals' and analysts' understanding of the measures and the authorities' ability to apply the correct tools in a timely manner. If the authorities apply policy incorrectly and/or the general public does not understand the measures used, the public could become convinced that the authorities are keeping prices low with restrictive measures in order to prevent a bubble that never developed.

Has the housing market normalised?

Chart 1 shows that, even though house prices have fallen sharply from their peak, real prices are still much higher than in 1997, when the upswing began, and well above historical averages. Chart 2 reveals that real house prices have fallen farther towards equilibrium in Iceland and the US than in the other countries included in the chart.

One way to gain a more accurate view of whether house prices are approaching equilibrium is to compare them with construction costs. If house prices are low relative to building costs, construction will not be overly profitable and investment in the sector will be limited. When house prices are high relative to building costs, however, profitability is considerable. According to Chart 3, the ratio of house prices to building costs is still above the long-term average in both the US and Iceland. Chart 4, which illustrates developments in Iceland, Ireland, Denmark, and Sweden from 1997 onward, indicates that this ratio is still dozens of percentage points above 1997 levels, in spite of the recent plunge in house prices. The chart shows that prices are now rising again in Denmark and Sweden. They rose in the UK as well, as can be seen in Chart 2. In Sweden they dropped slightly during the financial crisis but have already risen above pre-crisis levels.

IV Domestic demand and production

A shift towards a better balanced economy continued in 2010, after the abrupt adjustment in 2009. Even though GDP continued to contract, the economy seems to have turned around in the latter half of the year. The conditions for lasting recovery developed during the year: interest rates were lowered significantly, inflation fell sharply and now lies near the Central Bank's inflation target, and both house prices and the exchange rate have been relatively stable. GDP is assumed to grow by 2-3% in 2011 and the following two years, driven primarily by domestic private sector demand. The contribution of net trade to GDP growth will be negative, however, and fiscal austerity measures will hold back demand growth through 2012.

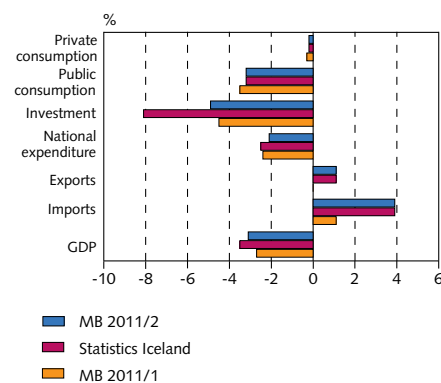
Contraction in investment in 2010 appears sharper than forecast but less than indicated by preliminary Statistics Iceland figures

In March, Statistics Iceland published its first national accounts estimates for the full year 2010. According to those figures, investment contracted somewhat more during the year than the Central Bank estimated in February. The greatest difference is in growth in business investment, which the Bank's February forecast estimated at 14.4%, whereas Statistics Iceland's preliminary numbers indicate 0.9% growth. As in February, however, the Bank expects Statistics Iceland's preliminary figures to be revised upwards. This is based in part on the fact that imports of investment goods excluding heavy industry increased by nearly 20% in 2010. By the same token, the results of a survey the Bank conducted among Iceland's 56 largest firms (which account for about 60% of total business investment) suggest that general business investment grew by just over 8% in real terms in 2010 (see Box IV-1). Based on these findings, the Capacent Gallup corporate survey from February and March, and indications from simple statistical models, the Bank estimates that business investment in 2010 was some 7 b.kr. greater than according to Statistics Iceland estimates and that it increased by about 6.5% year-on-year in volume terms.¹ Total investment is therefore estimated to have contracted by 4.9%, as opposed to 8.1% according to Statistics Iceland. This is slightly more than the 4.5% contraction the Bank projected in February.

2010 GDP contraction outstrips previous forecast despite smaller decline in domestic demand

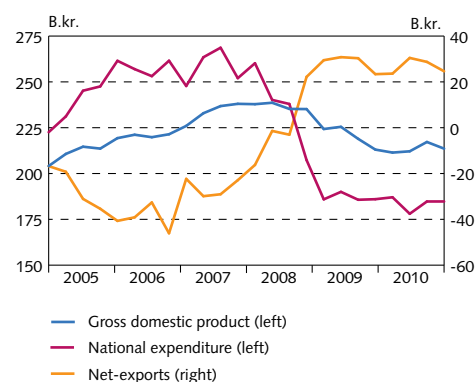
According to Statistics Iceland's preliminary figures, private and public consumption were slightly stronger than the Central Bank forecast in February. After adjusting for the Bank's estimate of developments in investment during the year, the contraction in national expenditure was 2.1% in 2010, instead of the 2.4% projected in February. The contraction in GDP is estimated to have been somewhat larger, how-

Chart IV-1
National accounts 2010 and
Central Bank estimate



Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-2
GDP, national expenditure and net-exports
Seasonally adjusted at year 2000 prices¹

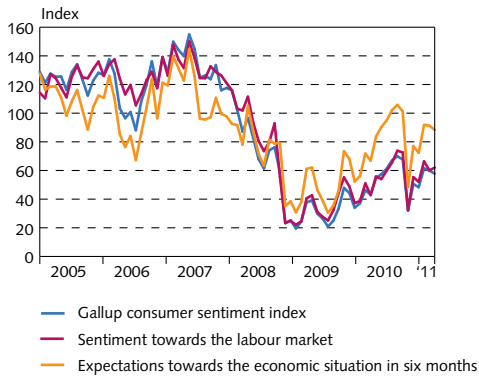


1. Figures for GDP and national expenditure are seasonally adjusted by the Central Bank. Because of the chain linkage, the sum does not necessarily add up to GDP.

Sources: Statistics Iceland, Central Bank of Iceland.

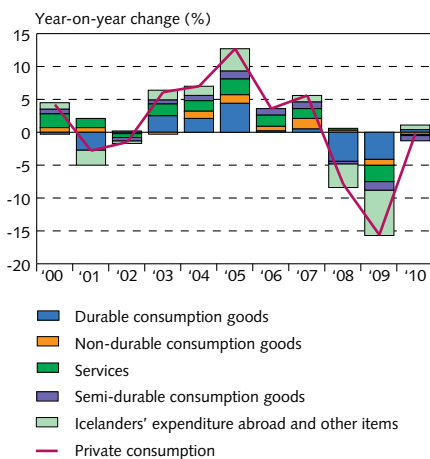
1. Capacent Gallup conducts a quarterly survey of the status and future prospects of Iceland's 400 largest firms. Two of the surveys are rather broad in scope and are carried out in February/March and September each year, while the other two, carried out in May/June and December, are more limited.

Chart IV-3
Consumer confidence indices
January 2005 - March 2011



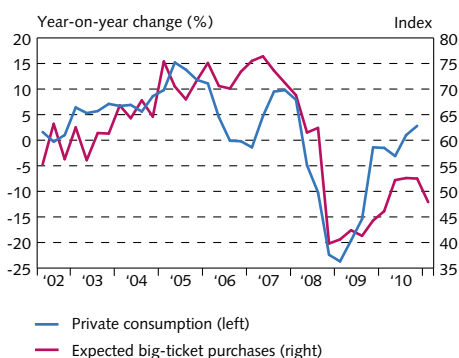
Source: Capacent Gallup.

Chart IV-4
Private consumption development
and main components 2000-2010



Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-5
Private consumption and expected
big-ticket purchase index
Q2/2002 - Q1/2011¹



1. Figures for private consumption are only available until Q4/2010.
Sources: Capacent Gallup, Statistics Iceland.

ever, or 3.1%, as opposed to the 2.7% in the February forecast.² A larger contraction in GDP despite a smaller contraction in national expenditure is due to the fact that the contribution of net trade to output growth was more strongly negative than previously expected. Export growth proved stronger than forecast, however; thus the deviation stemmed from an unexpected surge in imports, which in turn was due largely to the revision of Statistics Iceland figures on services imports in the first three quarters of the year. Thus domestic demand has been directed more outside the domestic economy than was assumed in the February forecast.³

Household spending rose as 2010 progressed ...

After a long contractionary period, private consumption began growing again in Q3/2010. In terms of seasonally adjusted quarter-on-quarter growth, it rose still more in Q4. Also in the latter half of the year, private consumption grew year-on-year for the first time since Q1/2008. Conventional factors such as a rise in real wages or asset prices cannot be identified as the drivers of increased private consumption. A more likely explanation is a cutback in households' precautionary saving, which rose in the wake of the banks' collapse. It is well known that consumers step up their saving in times of great uncertainty about economic developments and labour market prospects. As time passes and private sector balance sheets are clarified, this uncertainty diminishes. In the latter half of 2010, for instance, consumers' assessment of the labour market and the economic outlook six months ahead indicated increased optimism about the future. This should lead to a decline in precautionary saving and a pickup in spending.

The recovery of private consumption in the second half of 2010 was probably directed mainly towards durable and semi-durable consumer goods, as spending on these items contracted sharply in the wake of the financial crisis and the collapse of the króna. The Icelandic Centre for Retail Studies' examination of trends in sales of electronic equipment and furniture during 2010 supports this conclusion. In addition, the Capacent Gallup surveys of planned big-ticket purchases show that, in 2010, planned motor vehicle purchases and overseas travel rose markedly from their post-crisis trough. Statistics Iceland's preliminary figures on private consumption, itemised by major consumption categories, reveal a similar trend.

Households were also able to ease temporary financial problems by tapping into third-pillar pension savings. Furthermore, it can be assumed that the Supreme Court rulings on the illegality of exchange-rate linked loans and the reimbursement of overpayments on such loans supported this development. The reduction of loan principal and

2. This is a smaller contraction than the 3.5% indicated by Statistics Iceland figures, however. The stronger contraction in Statistics Iceland numbers is due entirely to an extremely weak fourth quarter, as measured annual growth in the first three quarters of the year according to Statistics Iceland figures is greater than was assumed in the Bank's February forecast.
3. In the national accounts for 2010, it is also interesting to note how widely changes in inventory fluctuate within the year. Statistics Iceland figures include inventories of aluminium, ferrosilicon, marine products, and imported petroleum products. Imports and exports of these products take place in very large units. As a result, the date of their import or export could make a decisive difference in inventory figures.

debt service contributes as well, as does the fact that a great deal of the uncertainty about household balance sheets has been eliminated. Another indicator of increased consumer spending is the rise in real estate market turnover and planned big-ticket purchases. Further discussion of households' financial conditions can be found in Section III.

... and slow recovery of private consumption is expected to continue

Private consumption is expected to continue growing in 2011, albeit slowly. In examining year-on-year growth in private consumption, it is necessary to consider the base effects of private consumption in the prior year. Owing to the developments within the last year, a comparison of annual averages reveals a considerable increase in 2011 even though quarter-on-quarter growth is moderate. It can be assumed, then, that the year-on-year change in Q2/2011 reflects to some extent the base effects from last year. Because of the timing of last year's Easter holidays, many purchases related to Easter took place in Q1, whereas most of the same purchases will be made in Q2 this year.

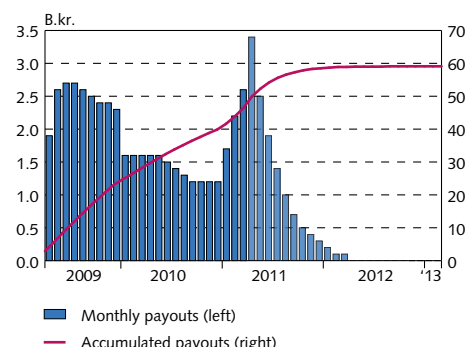
Leading high-frequency indicators for Q1/2011 indicate that private consumption declined somewhat quarter-on-quarter. However, payment card turnover figures, which suggest a slight decline, are offset by groceries turnover figures, which indicate a slight increase. In the forecast presented here, seasonally adjusted private consumption is projected to decline by 0.5% quarter-on-quarter in Q1/2011 but to increase by 1.3% year-on-year. The forecast assumes 2.7% growth for the year as a whole, but unlike earlier recoveries, sharp rises in real income or asset prices are not the drivers of the increase. Most likely, the spurt in household spending is due to the reduction of uncertainty about households' financial position and the reimbursements of overpaid exchange rate-linked loans. Real disposable income is projected to rise slightly in 2011, after a 3.6% contraction last year and a 20% contraction over the past two years. In this respect, the projected recovery of consumer spending is considerably more fragile than growth driven by a sound recovery of income.

Further along in the forecast horizon, real disposable income is projected to grow by about 1% on average over the next two years, as unemployment declines and household wealth begins to rise again. These factors will support private consumption, which is projected to grow by approximately 3% per year in the next two years, slightly below historical averages. Private consumption as a share of GDP will therefore remain somewhat below the average of recent decades over the next two years. The forecast assumes that the share of private consumption in GDP will be just over 50% during the forecast horizon, as opposed to an average of over 58% during the period 1980-2008.

Fiscal restraint contains domestic demand

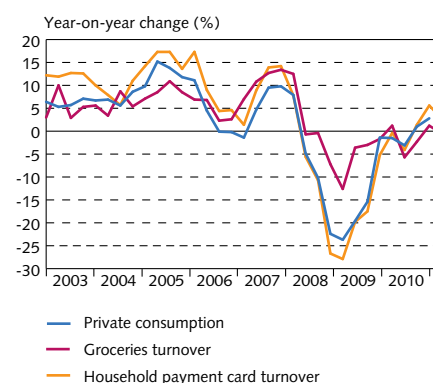
Domestic demand contracted steeply in the wake of the financial crisis. In spite of fiscal austerity measures, public expenditure in real terms contracted much less than private expenditure in 2009. The reduction in private expenditure totalled 26%, whereas public

Chart IV-6
Third-pillar pension fund payouts¹
April 2009 - February 2013



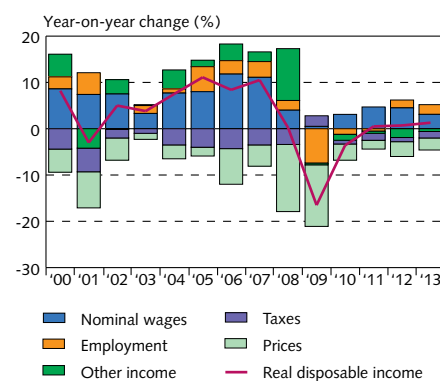
1. The chart shows monthly payouts and accumulated payouts from third-pillar pension funds according to applications filed by end-March 2011. Sources: Directorate of Internal Revenue, Central Bank of Iceland.

Chart IV-7
Private consumption, groceries and household payment card turnover
Q1/2003 - Q1/2011¹



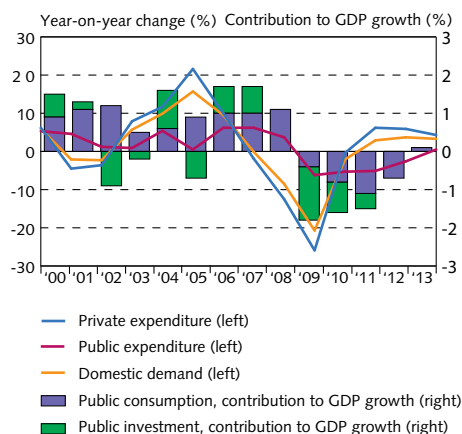
1. Figures for private consumption are only available until Q4/2010. Sources: Centre for Retail Studies, Statistics Iceland, Central Bank of Iceland.

Chart IV-8
Developments in real disposable
and its main components 2000-2013¹



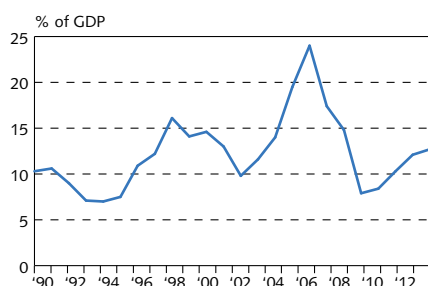
1. Central Bank baseline forecast 2011-2013. The contribution of the main underlying factors in the yearly changes in real disposable income is calculated based on each factor's weight in disposable income. The combined contribution of underlying factors does not add up to the total change due to rounding and incomplete income accounts for households from Statistics Iceland. Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-9
Private and public expenditure
and domestic demand
2000-2013¹



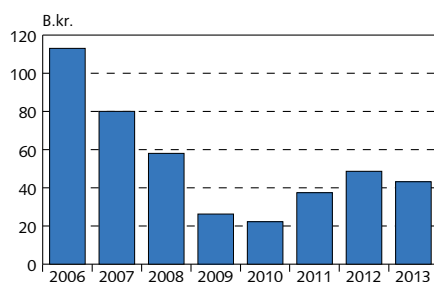
1. Central Bank baseline forecast 2011-2013
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-10
Business fixed investment 1990-2013¹



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

Chart IV-11
Large scale investment 2006-2013¹



1. Constant 2000 prices. Central Bank baseline forecast 2011-2013.
Source: Central Bank of Iceland.

expenditure contracted by 6%. As a result, the fiscal deficit moderated the contraction in 2009, but this was reversed in 2010 when private expenditure declined by only 0.4% year-on-year, concurrent with a 5.2% drop in public expenditure.⁴

Public expenditure is expected to contract still further in 2011. Public consumption is projected to contract by over 4% and public investment by nearly 15%. In 2012, public consumption is expected to continue to decline, whereas public investment is expected to remain broadly flat. Beginning in 2013, however, public expenditure will begin to rise again in volume terms. If the forecast materialises, the contribution of public expenditure to GDP growth will remain negative in 2011 and 2012, even though improved public sector performance will probably make a positive impact on the economy through other factors such as lower risk premia and lower interest rates.

Outlook for stronger business investment than previously forecast

The present forecast assumes considerably more investment in energy-intensive industry than did the February forecast. The increase is due primarily to two factors. The first is the new silicon plant that the Icelandic Silicon Corporation plans to build at Helguvík. Construction is expected to begin this year and continue until 2013. The annual production value of the plant is estimated at 10 b.kr. The second is the expansion of the Alcoa-Fjarðaál plant in Reyðarfjörður, which will add increased production capacity for export in 2013-2014. The growth in investment due to both projects totals some 35 b.kr., with a portion occurring in 2011 and the bulk occurring in 2012. On the whole, it is estimated that investment in energy-intensive industry, together with initial investments those sectors, will increase by 68% in volume terms and equal about 74 b.kr. in 2011. For 2012, this investment is estimated to total almost 97 b.kr., which corresponds to a 30% volume increase. In comparison, the February forecast assumed a 36% increase in energy-intensive investment in 2011 and a 27% increase in 2012.

According to the Bank's survey of larger firms' investment plans (see Box IV-1), business investment apart from heavy industry, ships, and aircraft is assumed to contract in 2011. On the other hand, a substantial increase in investment in energy-intensive industry is expected. Based on the survey and other indicators, total business investment can be expected to increase by 24½% this year and by 21% in 2012. Growth is expected to slow down to just over 8% in 2013, however, by which time the energy-intensive investment projects will be more or less complete.

4. Here private expenditure is the sum of expenditure for private consumption, business investment, residential investment, and inventory changes. Public expenditure is therefore the sum of expenditure for public consumption and public investment.

Business investment is unusually uncertain at the present juncture. The Central Bank's analysis has usually been based on information on investment goods imports and the Capacent Gallup survey among Iceland's 400 largest firms of investments in 2011 and 2012, but it is difficult to draw conclusions about the scope of investment based on these data. As a result, the Bank carried out its own survey among firms whose turnover exceeded 4 b.kr. in 2009. Respondents were asked for information on investment in the past two years and planned investments in 2011. A total of 43 firms were selected, and all of them submitted responses. In addition, over the past several years the Central Bank has compiled detailed information on investments by Iceland's 13 energy producers, utility companies, and companies in energy-intensive industries. This information provides an important indication of developments in investment in 2010 and planned investment for 2011, as the firms participating in the survey, together with energy producers, utility companies, and companies in energy-intensive industries, accounted for about 60% of total business investment in 2009.

Box IV-1

Survey of large corporations' investment

Table 1 Nominal corporate investment 2009-2011

<i>Largest 43 firms (number)</i>				<i>Change between '09-'10, %</i>	<i>Change between '10-'11, %</i>
<i>Amounts in ISK millions</i>	2009	2010	2011		
Fisheries (10)	5,638	6,743	3,820	19.6	-43.3
IT and communications (6)	4,392	4,476	3,683	1.9	-17.7
Wholesale and retail sales (10)	4,222	2,185	2,400	-48.2	9.8
Manufacturing (9)	2,441	3,106	3,312	27.2	6.6
Services, transport, etc. (8)	7,389	8,065	11,170	9.1	38.5
Total (43)	24,082	24,575	24,385	2.0	-0.8

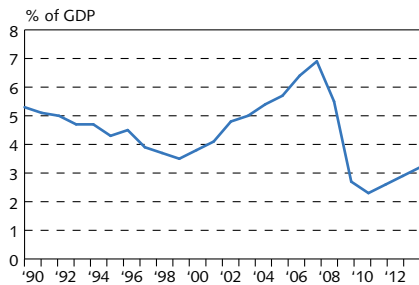
Indications for 2010

Investment by the 43 firms in the survey accounted for about one-fifth of business investment in 2009. The survey shows that these companies' investment rose by about 2% in nominal terms between 2009 and 2010. Twenty-one firms invested more in 2010 than in 2009, whereas 18 invested less. If it is assumed that general investment followed roughly the same pattern between the two years, and if investment in energy-intensive industry, the Harpa concert and conference centre, and ships and aircraft is included as well, total business investment rose by over 8% in real terms in 2010.

Indications for 2011

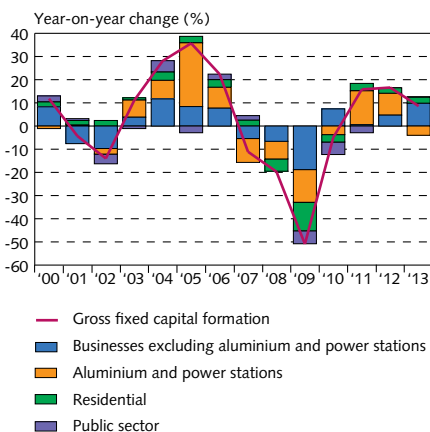
The results of the survey of the 43 firms' investment plans for 2011 indicate that nominal investment will be nearly 1% less this year than in 2010. A breakdown by sector reveals that fisheries' planned investments for 2011 will be about half of last year's total. A contraction is indicated in the information technology and communications sector as well. On the other hand, the survey suggests a marked increase in investment by companies in transport, retail and wholesale trade, manufacturing, and miscellaneous other operations. According to the findings, 19 firms intend to step up investment, while 11 intend to reduce it. It is also revealed that average growth in investment during the year is considerably below the median, indicating that the average is lower because a small number of firms intend to scale down investment significantly. When the plans of energy producers, utility companies, and companies in energy-intensive industries are added, together with ships, aircraft, and the Harpa concert and conference centre, the survey suggests that business investment will increase by nearly 23% in real terms in 2011.

Chart IV-12
Investment in residential housing 1990-2013¹



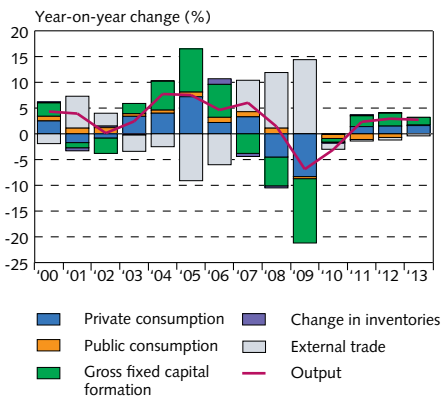
1. Central Bank baseline forecast 2011-2013.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-13
Gross fixed capital formation and contributions of its main components 2000-2013¹



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

Chart IV-14
Output growth and contribution of underlying components 2000-2013¹



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

Residential investment at a low ebb

Residential investment contracted steeply in 2009 and continued to decline in 2010. According to preliminary figures from Statistics Iceland, last year's contraction amounted to 17%, slightly less than according to the February *Monetary Bulletin*. A marked year-on-year increase was then measured in Q4/2010, but it should be borne in mind that, in the deep slump that has characterised the housing market since the onset of the crisis, the amounts behind these percentage increases are not large in a national accounts context. Residential investment was at a historical low in 2010, as was other investment. Residential investment has long hovered around 4-5% as a share of GDP, peaking at nearly 7% in 2007. By 2010, it was down to 2.3%, its lowest point in recent history.

The number of homes under construction rose dramatically around the middle of the last decade. During the financial crisis, the trend turned around and, in 2009, construction began on only 155 homes and only 484 were completed during the year. During the period 1983-2000, however, between 1,100 and 1,200 properties on average were begun and completed. At year-end 2009, 3,549 homes were under construction. Sources from the master carpenters' labour union indicate that few new construction projects began in early 2010 and that continuing work on unfinished property was very limited. The work available centred on repair and maintenance, due in part to the stimulus provided by recent tax incentives. Later in 2010, demand for new housing increased, and contractors began work on some of the homes under construction, in a bid to finish them. The outlook is for new construction to remain limited in 2011 and for emphasis to be on completion of buildings currently under construction. The present forecast assumes that residential investment will gradually recover in the next few years, rising to just over 3% of GDP by the end of the forecast horizon.

Total investment projected to grow markedly in 2011 and 2012

Investment is expected to grow by nearly 16% in 2011, whereas the February forecast assumed just under 10%. For 2012, it is assumed to remain broadly in line with the February forecast, or about 16½%. According to the forecast, growth is expected to slow down to about 8½% in 2013, slightly less than was projected in February. The forecast assumes that investment growth will be driven primarily by investment in energy-intensive industry. Investment in other sectors will support overall investment growth in 2012 and will be the main driver of growth in 2013.

Negative contribution of net trade to GDP growth despite low real exchange rate

The steep decline in the real exchange rate called for a major re-balancing of the economy, mainly through reduced imports of goods and services. In 2010, imports totalled 33½% of GDP at constant exchange rates, as opposed to an average of 41½% during the period 2000-2008. Imports showed increasing signs of recovery later in the year, however, growing by nearly 4% year-on-year. The recovery

of domestic demand that became more and more evident as the year passed was directed in ever greater measure towards imports, whereas domestic suppliers' ability to meet increased demand was somewhat limited, at least in the short run.

As Section II explains, exports have not increased to the same degree, as a large share of Iceland's goods exports are limited either by capacity constraints that take time to address or by fishing quotas. As a result, the contribution of net trade to GDP growth was negative last year and appears set to remain negative in 2011 and 2012.

Slow GDP growth on the horizon

National expenditure is projected to increase by nearly 3% in 2011 and by 3½-4% per year in the two years following. The growth forecast for 2011 is roughly ½ a percentage point more than was projected in February, while slightly weaker growth is expected for 2012 and 2013.

According to the forecast, GDP growth will be about 2.3% this year. In 2012 and 2013, the continued recovery of domestic demand is expected to be the main driver of 3% output growth for each of the two years. This forecast is an average of ½ a percentage point lower per year than was projected in February, due primarily to a more negative contribution from net trade.

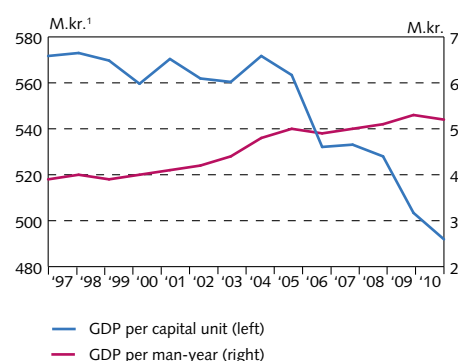
Implications of the economic slump generate uncertainty about estimates of potential output

The Icelandic economy has contracted sharply since the onset of the financial crisis in 2008, and a substantial slack has developed. The clearest manifestation of this is an unemployment rate well above any estimate of its natural level. Assessments of potential output are generally subject to considerable uncertainty, but after turmoil like that reigning in Iceland in the past few years, there is particular uncertainty about how potential output has developed and is likely to develop in the short and long term. The labour market is undergoing a sharp adjustment, but when output begins to increase, employment is expected to start rising again, reducing the jobless rate. Exactly how much potential output has been lost permanently as a result of the past few years' contraction is highly uncertain. It will be determined in part by the long-term effect on labour supply and skills, and how successful the authorities are in protecting the human resources that are not utilised during a period of high unemployment. As regards the capital stock, it is clear that considerable capital exists, both production machinery and buildings, although a part of the capital stock has been lost; for example, through sales abroad. As is shown in Chart IV-15, the remaining production capital has been underutilised in the past two years, and it can be time-consuming to shift those factors into use in competitive sectors. As a result, the speed of the recovery will depend greatly on how successful this rebalancing of production factors towards the tradable sector proves to be.

Sizeable output slack

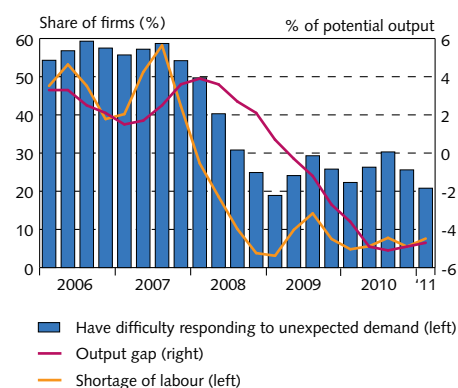
In spite of great uncertainty, the Central Bank considers it likely that the past two years' GDP contraction did not emerge fully in the out-

Chart IV-15
Capital and labour productivity 1997-2010
Constant 2000 prices



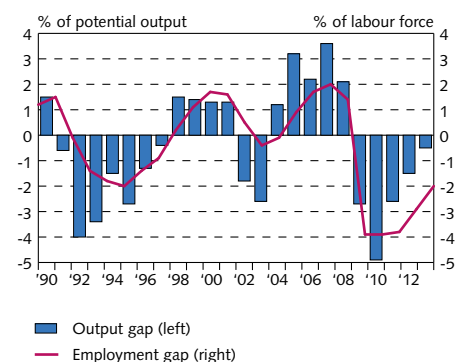
1. GDP in m.kr. per b.kr. of capital excluding residential housing capital. Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-16
Indicators of use of production factors and output gap¹
Q1/2006 - Q1/2011



1. According to Capacent Gallup Sentiment Survey among Iceland's 400 largest firms. Data on the difficulty of responding to unexpected demand are reported semiannually, and therefore a linear interpolation is used to generate quarterly data. Output gap is the Central Bank's estimate. Sources: Capacent Gallup, Central Bank of Iceland.

Chart IV-17
Output and employment gap
1990-2013¹



1. Central Bank baseline forecast 2011-2013. Sources: Statistics Iceland, Directorate of Labour, Central Bank of Iceland.

put slack because some potential output has been lost, both in terms of declining labour supply and reduction of the capital stock, and in terms of weaker total factor productivity. The results of the Capacent Gallup opinion survey among Iceland's 400 largest firms suggest a sizeable output slack. Only a small percentage of firms indicate that they would have difficulty responding to unexpected demand, and even fewer say they are short-staffed. As is mentioned above, output growth is projected at just over 2% in 2011. Consequently, the output slack is forecast to diminish slightly during the year, to about 2½% of potential output, although it will continue until the latter half of 2014, by which time the remaining spare capacity will have disappeared.

V Public sector finances

The Government-IMF programme for balanced public sector finances has included expense related to the Icesave dispute in accordance with the draft agreement as current at any given time. The Central Bank's current assessment of the Treasury's debt and interest expense does not include obligations related to Icesave, however, because the agreement was rejected in the 9 April referendum. Given the scope of the uncertainty about the ultimate conclusion of the dispute, it would be difficult to try to estimate the final expense. Government sector performance therefore improves in the short run, but in other respects, the outlook is broadly in line with previous Central Bank forecasts.

Fiscal plan on track ...

The adjustment of public sector finances to a reduced tax base and increased debt continues and was broadly on schedule in 2010. The Government's plan assumes that a primary surplus will be achieved this year through broad-based austerity measures. The surplus is expected to be less than 1% of GDP for 2011. The last time the primary balance was positive was in 2007, when it amounted to 5.7% of GDP. The primary deficit was largest in 2009, at 6.5% of GDP.

... but further austerity measures will be necessary in the next two years

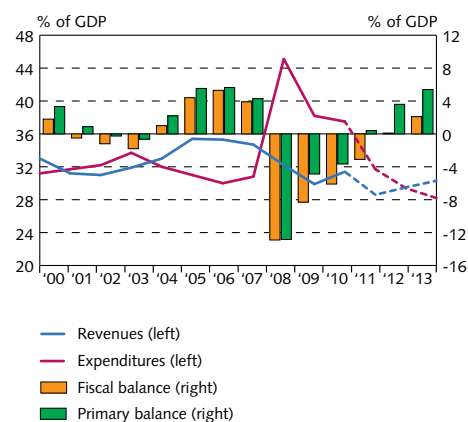
The Government-IMF plan to achieve a fiscal balance provides for further measures to bring about a primary surplus amounting to 6% of GDP in 2013, the plan's final year. If this is successful, the overall balance will be positive by 2.1% of GDP, preventing further debt accumulation and securely anchoring expectations of fiscal sustainability.

Nominal public consumption unchanged since crisis struck

Since Q4/2008, public consumption – consumption by the Treasury, the municipalities, and the social security system – has remained unchanged in nominal terms, at close to 100 b.kr. each quarter. This is a dramatic turnaround from the decade before the crisis, when nominal public consumption growth averaged nearly 11% per year. If current plans materialise, nominal public consumption will remain unchanged for at least the next two years but will decline as a share of GDP.

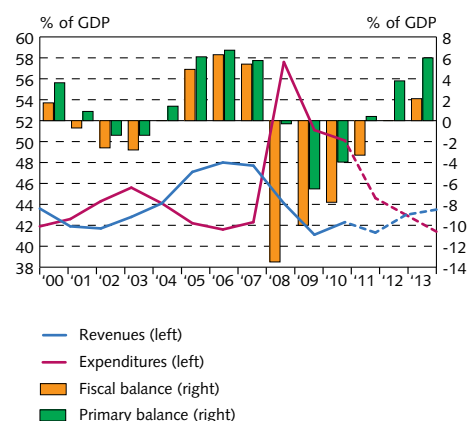
Public consumption contracted by 3.2% in volume terms in 2010, as opposed to the 3.5% assumed in the last *Monetary Bulletin*. The forecast for a contraction this year is broadly unchanged, but in 2012 the contraction is expected to be larger than previously assumed because of the increase in the price of public consumption. Public consumption has been unchanged in nominal terms for the past two years but has declined in real terms because of price level changes. This trend is assumed to continue over the next two years. Changes in the forecasted volume change of public consumption do not imply a changed assessment of fiscal policy or a different interpretation of the budget proposal, but rather a change in the outlook for public

Chart V-1
Treasury finance 2000-2013¹



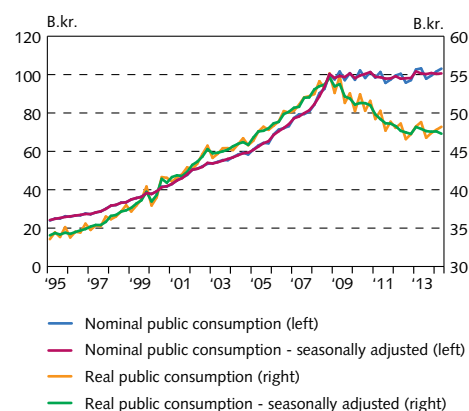
1. Central Bank baseline forecast 2011-2013.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-2
Government sector finance 2000-2013¹



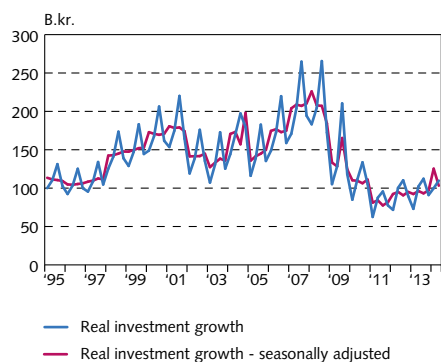
1. Central Bank baseline forecast 2011-2013.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-3
Nominal and real public consumption growth Q1/1995 - Q2/2014¹



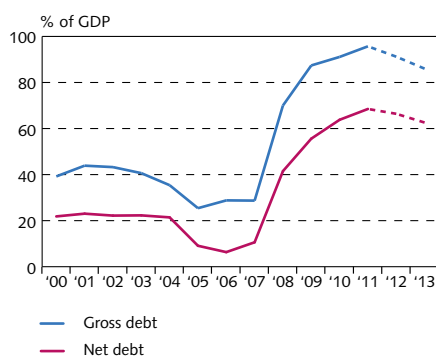
1. Central Bank baseline forecast Q1/2011 - Q2/2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-4
Real public investment growth
Q1/1995 - Q2/2014¹



1. Central Bank baseline forecast Q1/2011 - Q2/2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-5
Government sector debt
2000-2013¹



1. Central Bank baseline forecast 2011-2013.
Sources: Ministry of finance, Central Bank of Iceland.

consumption prices. The outlook for nominal consumption spending over the forecast horizon is broadly unchanged since the last forecast.

Investment continues to contract sharply

The Association of Local Authorities in Iceland estimates that municipal investment will contract by as much as 30% year-on-year in nominal terms in 2011, and according to the National Budget, nominal Treasury investment is estimated to contract by 24%. Two factors raise the projected investment level over and above the last forecast. First, the Vaðlaheiðar tunnel is included in the forecast, as construction is to begin this year. Second, the new coast guard vessel, Þór, is expected at the end of August, but it will not be included in the national accounts until delivery, although payments for its construction have been included in the National Budget in recent years. As a result, the Q3 national accounts specify investment in the amount of 4.9 b.kr., even though the 2011 National Budget only allows 530 m.kr. for the construction of the ship.

Total public investment for 2011 is therefore estimated at 35 b.kr., as opposed to 41 b.kr. for 2010. When public investment peaked in 2008, it amounted to 64 b.kr. at that year's price level. At the 2008 price level, investment for this year totalled 28 b.kr., which is equivalent to a 56% contraction in volume terms over three years.

Negative contribution of investment and public consumption to GDP growth

The contribution of public investment and public consumption to GDP growth has been negative since 2009. Other things being equal, cumulative GDP growth for the years 2009 to 2013 is nearly 3 percentage points less due to the contraction in public consumption and 2½ percentage points less due to the contraction in investment. The contribution of the public sector to GDP growth is assumed to be neutral or slightly positive in 2013.

Treasury debt level still unclear

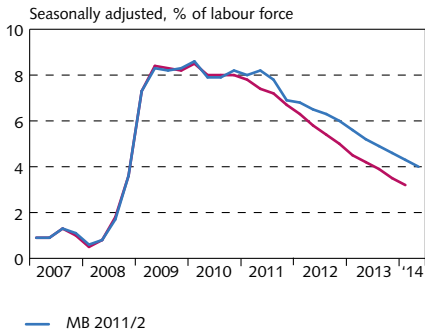
The last *Monetary Bulletin* presented the public sector debt position without the possible Icesave obligation because of the uncertainty about its size. That uncertainty still exists even though the Icesave agreement was rejected in the recent referendum.

The net public debt ratio is projected to peak this year at nearly 69% of GDP and then, beginning in 2012, decline gradually to 51% of GDP in 2015. The assessment of net debt includes only the public sector's cash assets. This is the method used by the IMF for countries that have received emergency loan facilities from the Fund. It is intended to show what the financing need would be if it should prove necessary to pay off the debt over a short period of time. As a result, net debt is not considered comparable to net debt in other countries, where it is the custom to include other monetary assets excluding capital stock, equity holdings, and initial capital. If Iceland's net public sector debt is calculated in this manner, it amounts to about 45% of GDP. It is also assumed that gross public debt will peak this year at slightly under 100% of GDP.

Relatively favourable funding conditions

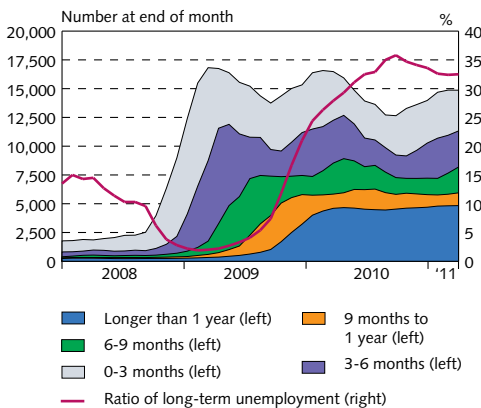
The increase in external debt since 2006 stems solely from the expansion of the Central Bank of Iceland's foreign exchange reserves, as the deficit operations of the Treasury and the municipalities have been funded entirely in the domestic bond market. This has not led to a marked rise in domestic real interest rates, however, in part because of the reduction of Central Bank interest rates and declining inflation and also because of the capital controls, as capital that would otherwise have been invested abroad has been invested in Treasury and municipal bonds.

Chart VI-1
Unemployment - comparison with MB 2011/1



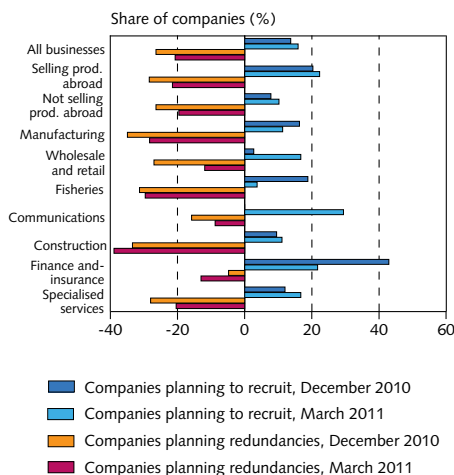
Sources: Directorate of Labour, Central Bank of Iceland.

Chart VI-2
Unemployment by duration
January 2008 - March 2011



Source: Directorate of labour.

Chart VI-3
Companies planning to change staffing levels during the next 6 months



Source: Capacent Gallup.

VI Labour market and wage developments

So far this year, unemployment has been in line with the February forecast. There are indications that unemployment has yet to rise. The current forecast assumes that it will peak in the first half of the year, with employment starting to rise at the same time. The negotiated pay rises in the upcoming wage settlements will probably be larger and more front-loaded than was assumed in the February forecast, and unit labour costs will therefore increase somewhat more than is consistent with the Central Bank's inflation target over the longer term. The prospects for employment growth and declining unemployment have deteriorated since February, due to a poorer output growth outlook and larger increases in wage costs than was previously forecast.

Unemployment broadly in line with the February forecast

Unemployment as recorded by the Directorate of Labour (DoL) measured 8.6% in Q1/2011, which is in line with the forecast published in the February *Monetary Bulletin* and somewhat lower than the 9.2% measured at the same time a year ago. The number of long-term unemployed has remained broadly unchanged in the past year, with an average of 4,700 persons unemployed for more than one year. Among workers aged 16-24, it has been stable as well, at about 500 persons.

Firms considering redundancies outnumber those interested in recruiting

Households' expectations concerning the employment situation are broadly unchanged, although slightly more upbeat than in December, according to the Capacent Gallup Consumer Sentiment Index. The same is true of corporate expectations, according to Capacent Gallup in the survey carried out among Iceland's 400 largest firms in February and March. Slightly fewer firms expressed an interest in laying off staff in the February-March survey than in the December survey. The results of the survey indicate, however, that the labour market has yet to weaken somewhat, as firms wanting to shed staff in the next six months outnumber those wanting to recruit by about 5 percentage points. Over 40% of firms in the construction sector are interested in laying off workers, however. Exporters of goods and services are more likely to want to add on staff than are other firms.

The so-called "Straight Path", a joint Bank-Government debt restructuring programme for small and medium-sized companies, which is to be completed by the beginning of the summer, will probably raise unemployment temporarily, although it could secure a higher employment rate in the long run.

Labour market outlook deteriorates

Indicators of developments in unemployment over the next few months suggest that unemployment has yet to rise. According to the baseline forecast, seasonally adjusted unemployment is expected to peak in Q2/2011 and then gradually taper off as economic activity increases, to just over 4% by mid-2014. The outlook for the next two

years is somewhat worse than according to the last forecast, which projected that unemployment would fall to about 3% by the end of the forecast horizon. The difference stems from several factors: economic recovery is now expected to be slower; pay increases are larger than previously forecast; and the equilibrium unemployment rate, which is assumed to have risen temporarily following the crash, is expected to be slower to return to its previous level. It is likely that persistent unemployment has caused a loss of skills and that it will be more difficult to match workers with given skills and employers needing those skills. This problem may also lengthen the time it takes for the output slack to close (see Section IV).

Employment to rise slower than GDP during the forecast horizon

Employment is assumed to begin rising quarter-on-quarter in the first half of 2011, similar to the last forecast. On the other hand, it is expected to rise somewhat slower over the forecast horizon than was assumed in February. The number of jobs will therefore rise later and more slowly than GDP growth throughout the forecast horizon. The baseline forecast assumes that the employment rate (employed persons as a percentage of the population aged 16-64) will be somewhat lower than according to the February forecast throughout the forecast horizon, and 6-7 percentage points below the 2006-2007 peak at the end of the horizon, as the sectors hardest hit by the crisis are quite labour-intensive. Labour participation will therefore remain broadly in line with the previous forecast throughout the forecast horizon, about 3 percentage point less in 2013 than in 2007.

Unit labour costs set to rise more than in February forecast

So far this year, wage developments have been in line with the last forecast. Revised national account data shows, however, that wages rose more in 2007 and 2008, and less in 2009, than previous figures had indicated. The first numbers for 2010 suggest that wages rose slightly less than the Central Bank had projected. It is assumed that the figures for the past two years will be adjusted upwards once updated information is available from firms (see also the discussion of preliminary figures on investment in Section IV).

In mid-April, contractual wage negotiations between the Icelandic Federation of Labour and the Confederation of Icelandic Employers came to a halt after failing to produce a consensus, although draft short-term and long-term contracts had been under discussion. As a result, wage increases in coming years are highly uncertain. Based on the information currently available, wage increases appear likely to be larger and more front-loaded than was assumed in the February *Monetary Bulletin*. This would result in a larger increase in unit labour costs than was provided for in the last forecast. Unit labour costs are assumed to rise by about 3½% in 2011 and 2012, and by just over 2% in 2013. The increase in 2011 and 2012 is therefore somewhat more than is consistent with the Central Bank inflation target in the long run. Because nominal wage hikes will slightly outpace inflation during the forecast horizon, real wages will rise as well, most decisively in 2011, or 2%, and then by an average of 1% per year in 2012 and 2013.

Chart VI-4
Employment
Q1/2007 - Q2/2014¹

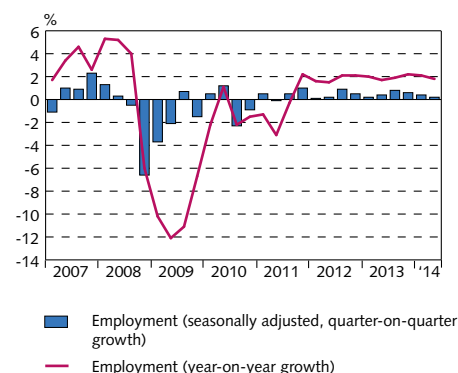


Chart VI-5
GDP and employment
Q1/2006 - Q2/2014¹

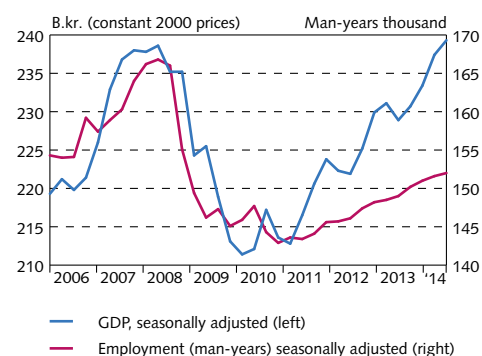


Chart VI-6
Unit labour costs and contributions
of underlying components 2000-2013¹

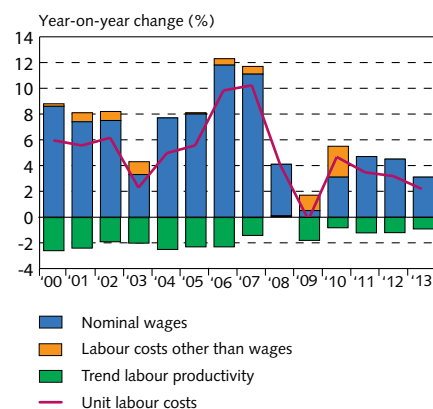
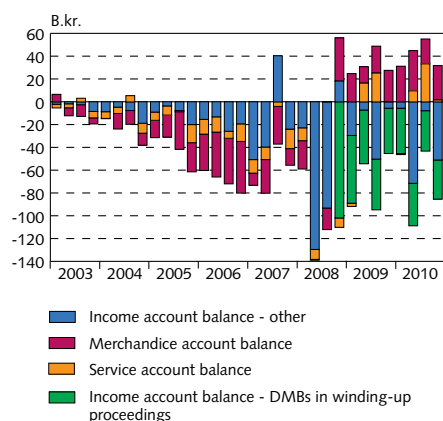
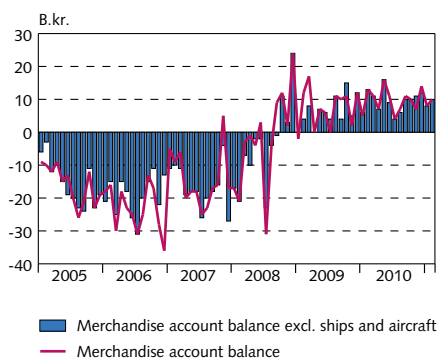


Chart VII-1
Current account balance components¹
Q1/2003 - Q4/2010



1. Net current transfer is included in the balance on income.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart VII-2
Merchandise account balance
At fixed exchange rate, January 2005 - February 2011



Sources: Statistics Iceland, Central Bank of Iceland.

VII External balance

The current account balance was negative by roughly 8% of GDP, or 120 b.kr., in 2010, a considerably smaller deficit than in 2009. The trade account showed a surplus, while there was a 274 b.kr. deficit in the balance on income. The income account figures include accrued interest income and expenses due to deposit money banks (DMBs) in winding-up proceedings. As the majority of these will never be paid and will simply be eliminated when the estates are settled, it is appropriate to ignore them in analysing the external balance. If they are excluded, the balance on income shows a deficit of 128 b.kr., and the current account balance was therefore positive by 1.7% of GDP in 2010. The outlook is for a continued surplus on the current account after adjusting for the DMBs in winding-up proceedings.

Continued trade surpluses

The balance of trade was positive each month in 2010 and has been so since early 2009. The goods surplus for 2010 was almost 119 b.kr. Goods imports have been on the rise year-on-year since March 2010; they were up by over 11% year-on-year at constant exchange rates, and by nearly 4% in volume terms for 2010 as a whole. Exports also rose markedly in 2010, or by 16.5% at constant exchange rates, fuelled by a steep rise in aluminium and marine product prices during the year. In volume terms, however, goods exports contracted by 1.6%, due in particular to a downturn in exports of irregular items such as aircraft, although there was also a small contraction in marine product exports. Goods imports and exports have continued to rise in value so far in 2011, with a 25 b.kr. surplus in external goods trade in the first quarter of the year.

The services trade balance was positive by 44 b.kr. in 2010, a considerably larger surplus than in 2009. The first quarter saw a slight deficit, but the second and third quarters showed strong surpluses. Increased revenue from transport is the main cause of last year's larger service account surplus.

The outlook is for a surplus on the trade account this year. It is expected that export prices will keep rising, the real exchange rate will remain low, and demand for imports among Iceland's main trading partners will increase. Foreign payment card use in the first two months of the year suggests that the current tourist season has begun rather slowly as compared with 2010, although figures from the Icelandic Tourist Board suggest a year-on-year increase in the number of tourists in the first few months of 2011. The outlook is for a strong spring and summer in the tourism sector. The dramatic increase in air travel to Iceland should encourage rising revenues from service exports, and bookings have been going well so far. In spite of stronger import growth, the trade surplus is projected at 10.5% of GDP for 2011 as a whole, roughly 1½ percentage points lower than in the last forecast. Imports are expected to grow more rapidly than exports during the forecast horizon, spurred by increased domestic demand, yet the trade surplus is forecast at 9-10% of GDP for the next two years.

Revised figures reveal a larger current account deficit in 2010

The Central Bank's previously released income account figures for the first three quarters of 2010 have undergone major revision since *Monetary Bulletin* was published in February. The changes can be attributed to the receipt of new information, particularly concerning foreign direct investment, which strongly affected factor income, as expatriated reinvested earnings were much higher than previous figures suggested. Losses incurred by non-resident-owned domestic firms were much less than previously assumed; thus reinvested earnings were higher and the deficit in the balance on income correspondingly greater. It is worth mentioning that factor income figures for 2010 are not yet final and revisions often prove to be sizable. Services trade figures were also revised for the first three quarters of the year, resulting in a smaller surplus than previous numbers indicated. According to official data, the current account deficit for the first three quarters of 2010 was roughly 47 b.kr. less than previously expected, or about 3% of GDP.

Balance on income shows large deficit

In spite of a large surplus on the trade account in 2010, there was a large deficit on the income account. The deficit amounted to 274 b.kr., due primarily to a sizeable interest deficit. It was negative by 191 b.kr., and in addition dividends and reinvested earnings were negative by 85 b.kr. On the whole, the deficit in the balance on income was nearly 17% of GDP, which is almost the same as in the previous year. Nonetheless, the interest deficit narrowed by about 28% year-on-year, although it was more than offset by negative returns on dividends and reinvested earnings.

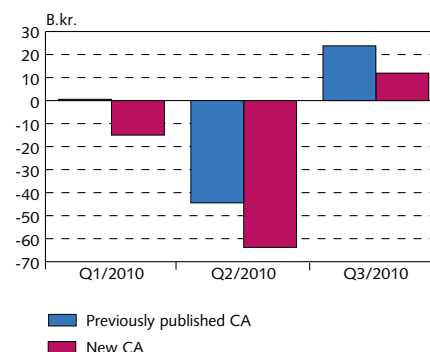
The deficit in the balance on income excluding DMBs in winding-up proceedings was much smaller, however, or 128 b.kr., because the interest deficit was only 45 b.kr., down substantially from 73 b.kr. in the previous year. Excluding the DMBs being wound up, returns on dividends and reinvested earnings were by far the largest negative item in 2010.

Increased trade surplus in 2010 after adjusting for income and expenses of DMBs in winding-up proceedings

The balance on the trade account was positive by almost 162 b.kr. in 2010, while the deficit in the balance on income plus transfers totalled 283 b.kr. The current account balance was therefore negative by 120 b.kr., or 7.8% of GDP, but after adjusting for accrued interest due to the DMBs being wound up, it is positive by just over 26 b.kr., or 1.7% of GDP.

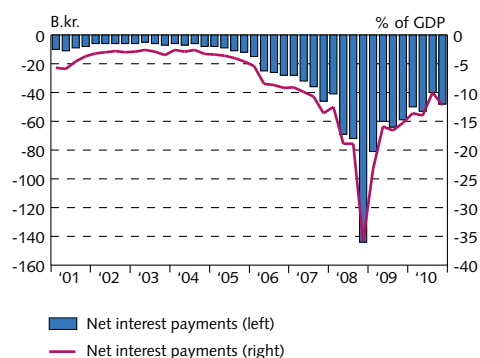
In spite of increased imports, the outlook is for a substantial surplus on the goods and services accounts in 2011, as the low real exchange rate supports continued export growth, particularly in the tourism sector. This will be offset by the negative balance on income. For the year as a whole, it is assumed that the official current account balance will be negative by nearly 102 b.kr., or 6.2% of GDP. After adjusting for the failed DMBs' accrued income and expenses, however, the current account balance turns positive by 39 b.kr., or 2.4%

Chart VII-3
Current account Q1-Q3/2010



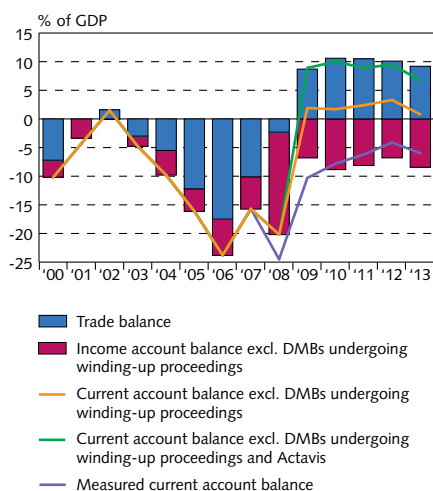
Sources: Statistics Iceland, Central Bank of Iceland.

Chart VII-4
Net foreign interest payments
Q1/2001 - Q4/2010



Sources: Statistics Iceland, Central Bank of Iceland.

Chart VII-5
Current account balance 2000-2013¹



1. Net current transfer is included in the balance on income. Central Bank baseline forecast 2011-2013.

Source: Statistics Iceland, Central Bank of Iceland.

of GDP. As in recent years, unpaid accrued interest due to the banks being wound up weighs heavily in official current account balance statistics.

A recent *Economic Affairs* paper estimates the current account balance excluding both the DMBs being wound up and the international pharmaceutical company Actavis.¹ Because of the significant foreign borrowing undertaken by this international company headquartered in Iceland, Actavis' accrued interest has a strong effect on the balance on income. Clearly, the company's ability to service its debt will be determined by foreign sales and will therefore not affect the domestic foreign exchange market. For this reason, it is considered appropriate to ignore its factor income and expense when assessing the external position of the Icelandic economy. These conclusions have no effect, of course, on the importance of Actavis to the Icelandic economy and the value of the work done there.² If Actavis is excluded, the deficit in the balance on income is much less for 2011. Moreover, the current account balance excluding both Actavis and the DMBs being wound up is positive by 8.9% of GDP, instead of 1.7% of GDP if Actavis is included.

Underlying current account balance to remain positive in coming years

Interest income and interest expense are by far the largest items in the balance on income, if both Actavis and the failed DMBs are excluded, and their development will be an important determinant of developments in the current account balance over the next few years. Interest on foreign loans has declined steeply in recent years, as is reflected in falling interest expense. The current baseline forecast assumes, other things being equal, that international interest rates will rise gradually in coming years and that the interest balance will therefore deteriorate.

It is assumed that the deficit in the balance on income will narrow in 2011 and 2012, mainly because of lower interest payments. On the other hand, the deficit is projected to grow once again in 2013 due to rising interest rates in Iceland's main trading partners. The calculation of the balance on income is also based on the assumption that the settlement of the DMBs being wound up will be largely complete by 2013 and that an increased negative external balance will have developed, on which interest and dividends must be paid.

The official current account deficit will fall to around 4% of GDP in 2012 and then rise to 6% of GDP in 2013. The current account balance excluding the DMBs in winding-up proceedings is expected to remain positive in coming years. It is projected to grow to 3.3% of GDP in 2012 and then decline to less than 1% in 2013. If Actavis is excluded

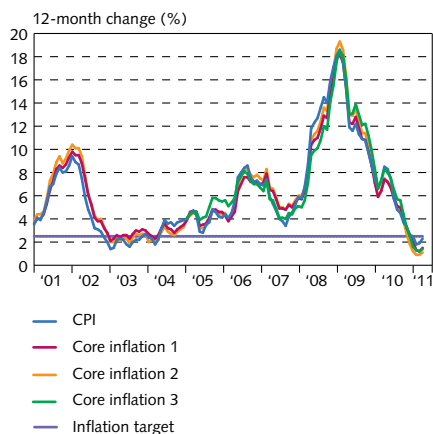
1. Arnór Sighvatsson, Ásgeir Danielsson, Daniel Svavarsson, Freyr Hermannsson, Gunnar Gunnarsson, Hrönn Helgadóttir, Regína Bjarnadóttir, and Ríkarður B. Ríkarðsson (2011), *Economic Affairs* no. 4, February 2011.

2. Actavis also has a significant effect on figures on residents' foreign debt, and because there are few assets to offset the debt, the company has a strong negative impact on Iceland's international investment position. This is partly because the assets of a knowledge-based company such as Actavis are intangible and are thus not included in official figures. Such figures therefore give an incomplete view of the company's assets and liabilities. Consequently, there are grounds for ignoring this large company when assessing Iceland's future debt position.

as well, the current account balance is even more strongly positive, or about 10% of GDP in 2012 and then declining to roughly 7% in 2013. This large surplus has a positive impact on the balance of payments and facilitates the rapid reduction of debt in coming years.

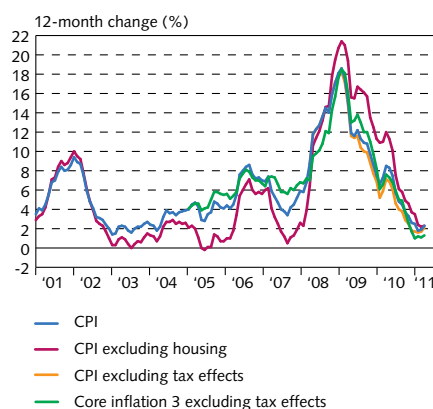
VIII Price developments and inflation outlook

Chart VIII-1
Inflation
January 2001 - March 2011¹



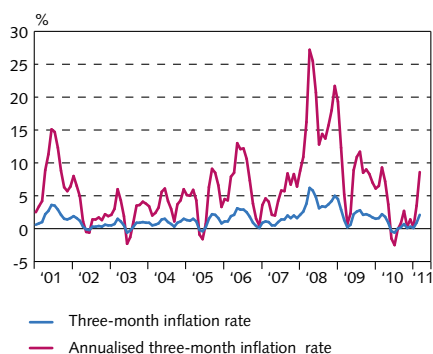
1. The core indices are compiled on the same basis as the CPI, with Core Index 1 excluding prices of agricultural products and petrol, and Core Index 2 excluding prices of public services as well. Core Index 3 also excludes the effect of changes in mortgage rates.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart VIII-2
Various inflation measurements
January 2001 - March 2011



Source: Statistics Iceland.

Chart VIII-3
Seasonally adjusted inflation
January 2001 - March 2011



Sources: Statistics Iceland, Central Bank of Iceland.

Inflation measured 2% in Q1/2011, somewhat above the forecast in the last *Monetary Bulletin*. The outlook is for higher inflation during the forecast horizon as well. Higher global oil and commodity prices, a weaker króna, and larger and more front-loaded wage rises during the forecast period leads to increased inflationary pressures, particularly in the short run. House prices have also begun to edge upwards. Inflation is forecast to average 2.8% in 2011, and 2.6% excluding consumption tax effects. Inflation expectations have risen by most measures, reflecting both a poorer inflation outlook and, to some extent, uncertainty about capital account liberalisation and its effect on the exchange rate. Uncertainty about the inflation outlook centres particularly on developments in inflation expectations, the exchange rate, and foreign price developments.

Inflation has risen again in recent months

At the beginning of this year, twelve-month inflation fell off sharply, to 1.8% in January, after reaching the 2½% inflation target at year-end 2010. It has eased upwards again in the past two months, however, showing the first increase in annual inflation since March 2010. The consumer price index (CPI) rose by 0.95% in March, and twelve-month inflation measured 2.3%. Underlying inflation – which excludes the effects of taxes, volatile items, public services, and interest expense – measured only 1.3%.

Inflation was 2% in Q1/2011, as opposed to 7.4% for the same period in 2010. Excluding tax effects, it measured 1.8% during the quarter. Consequently, inflation is still below the inflation target in spite of the recent increase. It should be noted, however, that because broadcasting fees were excluded from CPI measurements as of January 2011, this year's inflation is somewhat lower than it would otherwise have been. Other things being equal, inflation would have been 2.4% in Q1 if broadcasting fees were still included in the calculation of the CPI.

Several explanations for increased inflation

Several factors explain the past few months' rise in inflation. First of all, global oil prices have soared, pushing domestic petrol prices up by over 12% in the past three months (see Section II). The króna has depreciated by 4½% in trade-weighted terms since the beginning of the year, but the depreciation has not passed through to domestic food prices to any discernible degree. The contribution of petrol prices to 2.3% twelve-month inflation amounted to 0.7 percentage points in March. Only private services (CPI effect 0.8 percentage points) contributed more to inflation. The only component that has reduced twelve-month inflation is the price of other imported goods such as clothing, furniture, and miscellaneous housewares, which contributed to a 0.5 percentage point decline.

Another important factor in the recent rise in inflation is house prices. The twelve-month increase in house prices nationwide was 3½% in March, the highest measurement since before the banks

collapsed.¹ Housing market turnover has risen somewhat in recent months, and the market appears to be perking up, although it is too early to say how lasting the trend will be. On the other hand, it is possible that support measures for indebted households, third-pillar pension payouts, and reimbursement or netting of overpayments of exchange rate-linked loans have clarified many households' financial position, thus facilitating housing market recovery (see Sections III and IV).

The price of private services has also risen somewhat since January, with the twelve-month increase measuring 3.8% in March. The price increase is due mainly to a rise in airfares, usually a very volatile item, and price hikes in telephone services and miscellaneous recreational activities. The effect of these price increases on the CPI in the past two months totals 0.3 percentage points, virtually the same as the effect of house price increases over the same period.

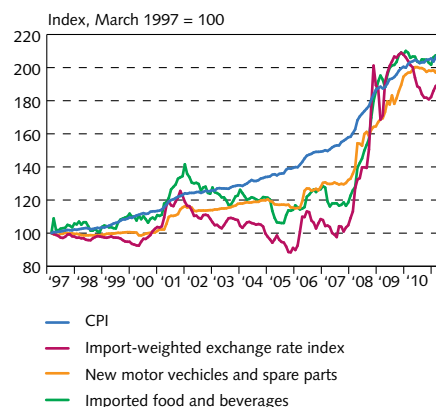
Inflation expectations have risen by most measures

Short-term inflation expectations have risen by most measures in the recent term, since the inflation outlook is poorer than generally expected. Inflation expectations based on the breakeven inflation rate, which is the spread between indexed and nominal bond yields, have risen since the last *Monetary Bulletin* was published, particularly for the long term. Based on the breakeven inflation rate, the expected average inflation rate in the next five years measures almost 3%, while the expected five-year average inflation rate five years ahead (expected average inflation in 2016-2021) is currently almost 5%. At the end of January 2011, long-term inflation expectations according to this measurement were 3.8%, after having been close to the inflation target last September.

The Central Bank has used the breakeven inflation rate as a means of assessing investors' inflation expectations. It should be borne in mind, however, that the yield spread reflects not only inflation expectations but also risk premia, reflecting uncertainty about factors such as inflation and liquidity risk. For example, it is not impossible that an increase in the yield spread could be related to fear of possible short-term selling pressure on nominal Treasury bonds in connection with capital account liberalisation or its effect on the inflation risk premium rather than a rise in inflation expectations. In addition, it is particularly difficult to assess inflation expectations based on bond market spreads at the present time because of the lack of marketable indexed short- and medium-term bonds. Market making with the Housing Financing Fund (HFF) bond series maturing in 2014 is very limited, affecting price formation for the series. The yield spread has increased enough in the recent term, however, that there is reason to suspect that long-term inflation expectations are above the inflation target and have risen recently. Thus it is clear that further work must be done in order to anchor inflation expectations securely. Such anchoring can be achieved only if the Central Bank is successful in keeping inflation at target for a sufficiently long period of time.

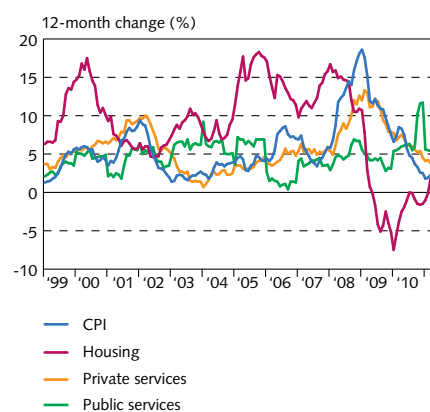
1. In the greater Reykjavík area, the price of condominium housing rose 1.9% year-on-year in March, and single-family home prices rose 1.2%. In regional Iceland, the annual increase was 8%.

Chart VIII-4
Import-weighted exchange rate and import prices
March 1997 - March 2011



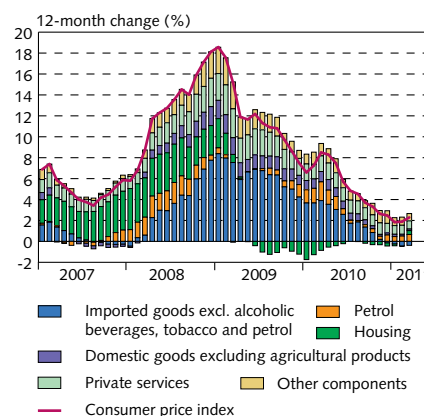
Source: Statistics Iceland.

Chart VIII-5
Consumer prices: housing and services
January 1999 - March 2011



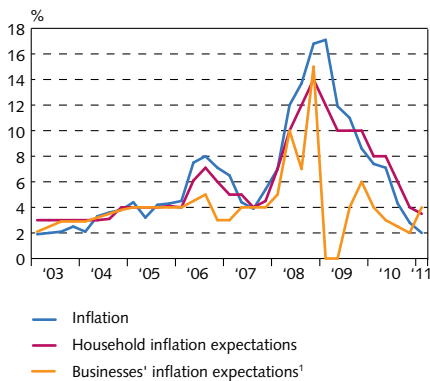
Source: Statistics Iceland.

Chart VIII-6
Components of CPI inflation
Contribution to inflation
January 2007 - March 2011



Source: Statistics Iceland.

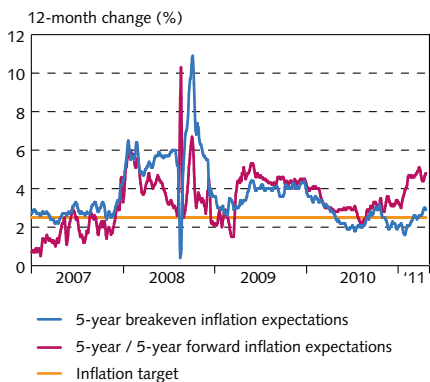
Chart VIII-7
Inflation expectations of businesses and households one year ahead and current inflation



1. Businesses' inflation expectations were measured on an irregular basis before 2006/Q3 so until then measurements are interpolated.
Sources: Capacent Gallup, Statistics Iceland, Central Bank of Iceland.

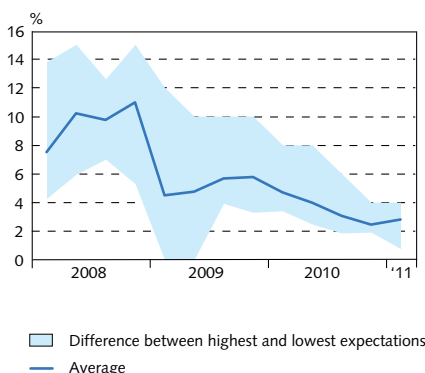
Chart VIII-8
Inflation expectations according to the difference between nominal and indexed interest rates¹

Daily data, 2 April 2007 - 15 April 2011



1. Breakeven inflation expectations are calculated from yield spreads between nominal and index-linked Government and Government-backed bonds (5-day moving averages).
Source: Central Bank of Iceland.

Chart VIII-9
Inflation expectations one year ahead according to various measurements¹
Q1/2008 - Q1/2011



1. Based on corporate, household, and bond market inflation expectations one year ahead and the Central Bank inflation forecast one year ahead.
Sources: Capacent Gallup, Central Bank of Iceland.

According to the median response in Capacent Gallup's quarterly survey of corporate inflation expectations, last carried out in February and March, corporate executives' inflation expectations one year ahead had risen by two percentage points, to 4%, since the December 2010 survey. Executives also expect inflation to remain at 4% in two years' time, as they did in the September 2010 survey. Inflationary pressures appear to have mounted, according to corporate executives, as 45% of them indicated that the price of their company's goods and services would increase over the next six months, as opposed to one-third in September. This may be due in part to recent oil price hikes, however.

Unlike other indicators of inflation expectations, the March Capacent Gallup survey showed that household inflation expectations one year ahead declined by 0.5 percentage points since the December 2010 survey, to 3.5%. Expectations concerning inflation two years ahead had fallen by 1 percentage point since the last survey, measuring 4%. In spite of rapid disinflation and an improved inflation outlook in 2010, household inflation expectations remained elevated for a long time and subsided rather slowly. Perhaps, then, it is not surprising that they should continue to decline in March, contrary to other indicators. As a result, household and corporate inflation expectations are closely aligned at present. The difference between their inflation expectations one year ahead has not been smaller since Q2/2008.

Outlook for higher inflation

Inflation measured 2% in Q1/2011, 0.4 percentage points more than was forecast in the last *Monetary Bulletin*. Underlying inflation (excluding the effects of changes in consumption taxes) measured 1.8% in Q1, while the last forecast assumed 1.4%. The forecasting error is due primarily to unexpectedly steep increases in global oil prices and domestic real estate prices.

The outlook is for higher inflation in the short term than previously forecast. Underlying inflation appears set to measure 2.5% in Q2/2011, approximately 1 percentage point more than in the last forecast, and to peak at around 3% in Q3.² Simple statistical models indicate slightly higher inflation, between 2.3% and 3%, in Q2. Unexpectedly high inflation can be attributed to several factors. The initial position is poorer after the unexpected increase in inflation over the past two months. The recent spike in oil and commodity prices was unexpected as well. As is discussed above, the surge in oil prices has largely passed through to domestic petrol prices, while commodity price increases have not passed through to imported food prices to any marked degree. The full extent of these effects is still uncertain, however. The króna is expected to be weaker than was projected in the last forecast, possibly exacerbating the effects of global price hikes. In addition, wage increases will probably be somewhat larger and more front-loaded than was assumed in the February forecast (see Section VI). Orkuveita Reykjavíkur announced increase in hot water prices

2. If the broadcasting fee had not been excluded from CPI calculation in January, the outlook would be for underlying inflation to approach 3% in Q2, other things being equal.

and drainage fees will also raise the CPI by approximately 0.14 percentage points in May 2011. Finally, inflation expectations have crept upwards. It appears as though most of the near-term uncertainties discussed in the last *Monetary Bulletin* in relation to developments in inflation are now creating increased inflationary pressures.

Inflation near target during the forecast horizon

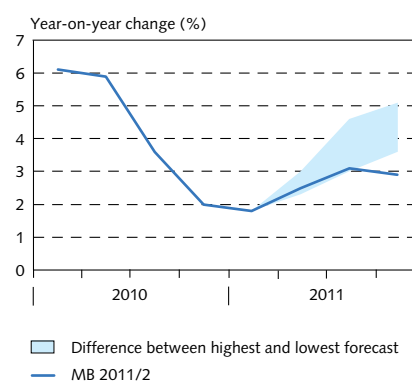
Due to the factors mentioned above, inflation is expected to be slightly higher for the majority of the forecast horizon. It is expected to subside again, however, after peaking later this year, owing to the continued slack in the economy, and to hover near the inflation target beginning in mid-2012. Headline inflation is projected at 2.8% this year and 2.7% in 2012, whereas underlying inflation is expected to be 2.6% in both years. The long-term inflation outlook is therefore relatively benign despite the prospect of a temporary rise above the inflation target.

Various risks present

The temporary spike in inflation due to external shocks need not cause grave concerns in and of itself. There is always the risk, however, that inflation caused by price hikes abroad will become entrenched and spread to inflation expectations, and from there to corporate pricing decisions and wage formation.

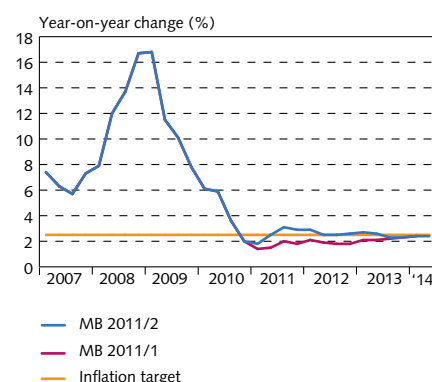
The uncertainties that will probably affect near-term inflation developments most strongly are the exchange rate, on the one hand, and global oil and commodity prices, on the other, as they pass quickly through to domestic prices (see Box VIII-1). It is also uncertain whether house prices will continue to rise and, if so, how much. The housing component weighs heavily in the CPI and would have a marked effect if the market were to strengthen. Other uncertainties centre on the risk that wage pressures will prove even stronger than is assumed in the forecast. There is also the possibility that economic recovery will be slower than according to the forecast, and inflationary pressures correspondingly weaker. Further discussion of major uncertainties can be found in Section I.

Chart VIII-10
Inflation forecasts using different models
Inflation excluding tax effects Q1/2010 - Q4/2011



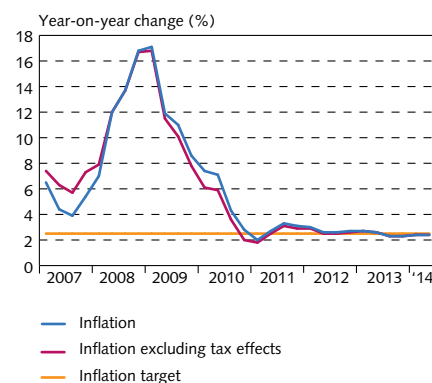
Sources: Statistics Iceland, Central Bank of Iceland.

Chart VIII-11
Inflation excluding tax effects - comparison with MB 2011/1



Sources: Statistics Iceland, Central Bank of Iceland.

Chart VIII-12
Inflation including and excluding tax effects
Q1/2007 - Q2/2014¹



1. Central Bank baseline forecast Q2/2011 - Q2/2014.
Sources: Statistics Iceland, Central Bank of Iceland.

Box VIII-1

Exchange rate
pass-through

The Central Bank of Iceland's December 2010 report *Monetary Policy in Iceland after Capital Controls* explores the main reasons for Iceland's poor track record in controlling inflation in recent years. Among other things, the report seeks to explain why exchange rate pass-through is more pronounced in Iceland than in other inflation-targeting countries. Furthermore, the pass-through effect appears not to have diminished in Iceland since the adoption of the inflation target, as it has in other countries (see Pétursson, 2010).¹

This Box presents a brief outline of leading economic theories on the determinants of exchange rate pass-through and attempts to shed light on which ones might explain the difference between Iceland's experience and that of other countries. The theories fall into three broad categories: those that seek explanations in competition in the domestic market, those based on the share of marketing and distribution costs in domestic consumer prices, and those that link the level of pass-through to the credibility of monetary policy.

Competition theories

According to competition theories, more active competition in domestic markets prompts foreign manufacturers to raise import prices less (or makes them less likely to raise them) in the wake of a currency depreciation (see, for example, Dornbusch, 1987, and Bacchetta and van Wincoop, 2005). As a result, the price of imported goods and consumer goods rises less than it would otherwise and exchange rate pass-through is less pronounced.

It can be concluded from these theories that the exchange rate affects domestic consumer prices through prices of imported consumer goods and competing domestic goods. Presumably, then, the greater the competition in the domestic market, the weaker the pass-through.

Based on competition theories, it can also be assumed that exchange rate movements affect domestic consumer prices because they affect the price of imported inputs used in domestic production. Thus it can be assumed that, the more competitive the domestic input market is, the less impact exchange rate movements will have on domestic input prices and the less the overall exchange rate pass-through.

Cost theories

According to cost theories, incomplete exchange rate pass-through – that is, when a 1% currency depreciation leads to less than a 1% rise in domestic prices – can be explained by domestic marketing and distribution costs, which are an important factor in domestic consumer prices. Penetration from currency depreciation to price increase is therefore dependent upon marketing and distribution costs relative to the price of the product; that is, the greater these costs are as a share of the product price, the weaker the pass-through will be.

According to Burstein, Neves, and Rebelo (2003), for example, marketing and distribution costs for a typical consumer product in the US constitute about 40% of the retail price of that product.

Credibility of monetary policy

According to Taylor (2000), lower and more stable inflation is likely to lead to weaker exchange rate pass-through. An example of a

1. According to Pétursson (2010), the level of pass-through in Iceland is 0.4. In other words, other things being equal, a 1% currency depreciation leads to a 0.4% rise in inflation. The level of pass-through has changed very little in Iceland in recent years, while it is much weaker and has been on the decline in other countries. The average level of pass-through in the 42 countries surveyed in Pétursson's study has declined from 0.36 to 0.11 in the past several years.

model that explains this is Gestsson's (2010) general equilibrium model, where uncertainty about monetary policy affects wage formation and therefore domestic production costs. Increased uncertainty reduces the number of domestically produced goods priced with reference to domestic market conditions. This, in turn, strengthens the exchange rate pass-through into prices of imports and consumer goods. Devereux, Engel, and Storgaard (2004) came to a similar conclusion. In their model, uncertainty about monetary policy can affect whether producers decide to determine their prices in domestic or foreign currency. As uncertainty about domestic monetary policy escalates, it becomes more likely that foreign producers will choose to price their goods in foreign currency. This, in turn, strengthens the pass-through to the price of imports and consumer goods. These results indicate that a lack of monetary policy credibility exacerbates exchange rate pass-through. The theory is strengthened by the fact that it can be supported using a number of different models.

Application to Iceland

Iceland is a small, open economy. It is smaller than most others, so it can be assumed that foreign producers are faced with less competition in the Icelandic market than in comparison markets. This is reflected in a relatively homogeneous domestic manufacturing sector, which often necessitates importation of a rather large proportion of necessities for domestic consumption, ranging from foodstuffs and other consumer goods to inputs for domestic production. Because of the nature of these goods, domestic demand for them is likely to be relatively immune to price movements. The homogeneity of domestic production also makes it likely that importers of goods to small countries are in competition not with domestic producers of comparable products but with other importers of the same products, which will be affected in the same way by exchange rate movements. Domestic purchasers therefore have greater difficulty switching their demand towards comparable domestic goods when the currency depreciates. Presumably, it is proportionally more expensive for foreign sellers of a product to survey market conditions in small countries, and therefore more common that goods are priced in the producer's currency than it would be in larger markets. This tendency tends to exacerbate exchange rate pass-through.

The main reason that exchange rate pass-through has not diminished in Iceland, as it has elsewhere, appears to be the relative lack of credibility (and success) of domestic monetary policy. Moreover, it could be that the limited competition in Iceland delays the dampening impact of enhanced credibility on pass-through. In any event, it appears unlikely that the explanation lies in a decline in competition (for other reasons) or a lower share of marketing and distribution costs in domestic consumer prices.

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Appendix 1

Baseline macroeconomic and inflation forecast 2011/2

Table 1 Macroeconomic forecast¹

	B.kr.	Volume change on previous year (%) unless otherwise stated			
		Forecast			
	2010	2010	2011	2012	2013
<i>GDP and its main components</i>					
Private consumption	782.6	-0.2 (-0.3)	2.7 (3.1)	3.0 (2.9)	3.2 (2.2)
Public consumption	399.0	-3.2 (-3.5)	-4.1 (-4.1)	-2.8 (-2.2)	0.4 (0.5)
Gross capital formation	205.9	-4.9 (-4.5)	15.8 (9.6)	16.6 (17.1)	8.5 (14.2)
Business investment	129.6	6.5 (14.4)	24.4 (17.8)	20.6 (18.4)	8.1 (15.2)
Residential investment	35.5	-17.0 (-25.2)	18.6 (14.7)	14.0 (17.5)	15.7 (18.1)
Public investment	40.8	-22.4 (-30.9)	-14.7 (-24.8)	0.0 (9.1)	1.8 (2.0)
National expenditure	1,384.1	-2.1 (-2.4)	2.9 (2.4)	3.8 (4.0)	3.5 (4.0)
Exports of goods and services	869.3	1.1 (0.0)	2.5 (2.5)	2.4 (2.2)	2.9 (2.4)
Imports of goods and services	706.9	3.9 (1.1)	3.7 (1.6)	3.9 (3.6)	4.4 (3.2)
Contribution of net trade to growth		-1.2 (-0.5)	-0.3 (0.7)	-0.5 (-0.3)	-0.4 (-0.1)
Gross domestic product	1,546.5	-3.1 (-2.7)	2.3 (2.8)	2.9 (3.2)	2.7 (3.4)
<i>Other key aggregates</i>					
GDP at current prices (in b.kr.)		1,547 (1.563)	1,630 (1.639)	1,738 (1.730)	1,824 (1.820)
Trade account balance (% of GDP)		10.5 (11.0)	10.5 (12.0)	10.1 (11.5)	9.2 (10.9)
Current account balance (% of GDP)		-7.8 (-3.5)	-6.2 (-1.0)	-4.1 (-0.9)	-6.0 (-1.3)
Current account balance excl. DMBs undergoing winding-up proceedings (% of GDP)		1.7 (6.6)	2.4 (8.3)	3.3 (8.0)	0.8 (6.1)
Output gap (% of potential output)		-4.9 (-4.7)	-2.6 (-2.0)	-1.5 (-0.6)	-0.5 (0.5)
Unit labour costs (change in average year-on-year)		4.7 (6.3)	3.5 (2.5)	3.2 (3.1)	2.2 (1.8)
Real disposable income (change in average year-on-year)		-3.6 (-7.7)	0.3 (0.4)	0.6 (1.5)	1.2 (2.1)
Unemployment (% of labour force)		8.1 (8.1)	7.7 (7.3)	6.4 (5.6)	5.1 (4.0)
EURISK exchange rate		161.7 (161.7)	160.0 (157.2)	159.7 (155.5)	159.5 (153.2)

1. Figures in parentheses are from the forecast in *Monetary Bulletin* 2011/1.Table 2 Inflation forecast (%)¹

Quarter	Inflation (change year-on-year)	Inflation excluding tax effects (change year-on-year)	Inflation (annualised quarter-on-quarter change)
2010:1	7.4 (7.4)	6.1 (6.1)	4.9 (4.9)
2010:2	7.1 (7.1)	5.9 (5.9)	4.7 (4.7)
2010:3	4.3 (4.3)	3.6 (3.6)	-2.3 (-2.3)
2010:4	2.8 (2.8)	2.0 (2.0)	4.0 (4.0)
2011:1	2.0 (1.6)	1.8 (1.4)	1.8 (0.0)
Forecasted value			
2011:2	2.7 (1.7)	2.5 (1.5)	7.5 (5.2)
2011:3	3.3 (2.2)	3.1 (2.0)	0.1 (-0.1)
2011:4	3.1 (2.0)	2.9 (1.8)	3.4 (3.0)
2012:1	3.0 (2.2)	2.9 (2.1)	1.4 (0.8)
2012:2	2.6 (2.0)	2.5 (1.9)	5.7 (4.4)
2012:3	2.6 (1.9)	2.5 (1.8)	-0.1 (-0.4)
2012:4	2.7 (1.9)	2.6 (1.8)	3.8 (3.0)
2013:1	2.7 (2.1)	2.7 (2.1)	1.4 (1.5)
2013:2	2.6 (2.1)	2.6 (2.1)	5.3 (4.5)
2013:3	2.3 (2.2)	2.3 (2.2)	-1.1 (0.0)
2013:4	2.3 (2.3)	2.3 (2.3)	3.7 (3.4)
2014:1	2.4 (2.4)	2.4 (2.4)	1.7 (1.7)
2014:2	2.4	2.4	5.4
<i>Annual average</i>			
	Inflation	Inflation excl. tax effects	
2010	5.4 (5.4)	4.4 (4.4)	
2011	2.8 (1.9)	2.6 (1.6)	
2012	2.7 (2.0)	2.6 (1.9)	
2013	2.5 (2.2)	2.5 (2.2)	

1. Figures in parentheses are from the forecast in *Monetary Bulletin* 2011/1.

Monetary policy and instruments

The objective and implementation of monetary policy

The objective of monetary policy is to ensure price stability. On 27 March 2001, a formal inflation target was adopted, as follows:¹

- The Central Bank aims for an annual rate of inflation, measured as the twelve-month increase in the CPI, which in general will be as close as possible to 2½%.
- If inflation deviates by more than 1½ percentage points from the target, the Central Bank shall be obliged to submit a report to the Government explaining the reason for the deviation, how it intends to respond, and when it expects the inflation target to be reached again. This report shall be made public.
- The Central Bank shall publish macroeconomic and inflation forecasts, projecting three years into the future. Forecasts shall be published in the Bank's *Monetary Bulletin*, which 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.

Because monetary policy aims at maintaining price stability, it will not be applied in order to achieve other economic targets, such as a balance on the current account or a high level of employment, except insofar as these are consistent with the Bank's inflation target.

Main monetary policy instruments

In particular, the Central Bank implements its monetary policy by managing money market interest rates, primarily by determining its own interest rates, which then affect other interest rates. Yields in the money market also have a strong impact on currency flows and thereby on the exchange rate, and in the long run on domestic demand. Transactions between financial institutions and the Central Bank are subject to the Rules on Central Bank of Iceland Facilities for Financial Undertakings, no. 553 of 26 June 2009.

Fixed trading instruments

- Current accounts: Current accounts are deposits of financial institutions' undisposed assets. They also function as settlement accounts for financial institutions' transactions and are used for reserve requirements. The current account rate forms the floor of the Central Bank interest rate corridor and the interest rate floor in the interbank market for krónur. Current accounts must always have a positive balance at the end of each business day.
- Overnight loans: Overnight loans are loans granted by the Central Bank to financial institutions, upon the request of the latter, until the following business day. Their primary purpose is to provide

1. Joint declaration of the Government of Iceland and the Central Bank of Iceland. Published on the Central Bank of Iceland website.

financial institutions with access to liquidity so as to ensure that they fulfil reserve requirements and have a positive current account balance at the end of the day. Overnight loans are granted against collateral in securities. Overnight lending rates form the ceiling of the Central Bank interest rate corridor and the ceiling for overnight rates in the interbank market for krónur.

Regular facilities

Regular facilities can be granted for up to seven days. Their purpose is to increase or decrease the supply of liquidity in the financial system. The Central Bank decides in each instance how much liquidity it lends to financial institutions or drains from the market. In general, Central Bank facilities are transacted on Wednesdays; however, the Bank may engage in transactions on other days if necessary. The main types of regular facilities are:

- Collateralised loans: Collateralised loans have a maturity of seven days or less. Financial institutions must provide collateral that the Bank deems eligible for Central Bank facilities.
- Certificates of deposit: Certificates of deposit are issued with a maturity of seven days or less and are sold by the Central Bank to financial institutions.

In its auctions, the Central Bank may decide to keep interest rates and prices fixed or give financial institutions the option of bidding on either or both. The Bank may reject all bids or a portion of them.

Other financial instruments that the Central Bank may use to increase or decrease market liquidity are repurchase agreements, currency swap agreements, and term deposits.

Other facilities

The Central Bank may decide to carry out transactions with financial institutions for other periods, but with the same financial instruments as are used in regular facilities. Since autumn 2009, the Central Bank has issued 28-day certificates of deposits on a weekly basis.

Reserve requirements

Required reserves apply to financial institutions that are not dependent on Treasury budget allocations for their operations. The required reserve base comprises deposits, issued securities, and money market instruments. The required reserve ratio is 2% for the part of the required reserve base that is tied for two years or less. The maintenance period is from the 21st day of each month until the 20th of the following month, and the two-month average reserve must reach the stipulated ratio during the period. Reserve requirements do not apply to foreign branches of Icelandic financial institutions.

Intervention in the foreign exchange market

The Central Bank can intervene in the foreign exchange market if it considers it necessary, in order to support its inflation target or mitigate extreme exchange rate volatility so as to enhance the stability

of the financial system. It can also intervene in the foreign exchange market in order to build up its foreign exchange reserves.

Overview of Central Bank interest rates 20 April 2011

<i>Traditional instruments</i>	<i>Current rate (%)</i>	<i>Change (percentage points)</i>	<i>Last interest rate decision</i>	<i>Rate one year ago (%)</i>
Current accounts	3.25	0.00	16 March 2011	7.50
Overnight loans	5.25	0.00	16 March 2011	10.50
Required reserves	3.25	0.00	16 March 2011	7.50
Collateralised loans	4.25	0.00	16 March 2011	9.00
Certificates of deposit, 28 days	4.00	0.00	16 March 2011	8.75

Central Bank of Iceland interest rate decisions

<i>Interest rate decision date</i>	<i>Central Bank key interest rates, %¹</i>				
	<i>Collateralised lending rate</i>	<i>Financial institutions' current account rates</i>	<i>Maximum rate on 28-day CDs</i>		
20 April 2011	4.25 (0.00)	3.25 (0.00)	4.00 (0.00)		
16 March 2011	4.25 (0.00)	3.25 (0.00)	4.00 (0.00)		
2 February 2011	4.25 (-0.25)	3.25 (-0.25)	4.00 (-0.25)		
8 December 2010	4.50 (-1.00)	3.50 (-0.50)	4.25 (-1.00)		
3 November 2010	5.50 (-0.75)	4.00 (-0.75)	5.25 (-0.75)		
22 September 2010	6.25 (-0.75)	4.75 (-0.75)	6.00 (-0.75)		
18 August 2010	7.00 (-1.00)	5.50 (-1.00)	6.75 (-1.00)		
23 June 2010	8.00 (-0.50)	6.50 (-0.50)	7.75 (-0.50)		
5 May 2010	8.50 (-0.50)	7.00 (-0.50)	8.25 (-0.50)		
17 March 2010	9.00 (-0.50)	7.50 (-0.50)	8.75 (-0.50)		
27 January 2010	9.50 (-0.50)	8.00 (-0.50)	9.25 (-0.50)		
10 December 2009	10.00 (-1.00)	8.50 (-0.50)	9.75 (-0.25)		
5 November 2009	11.00 (-1.00)	9.00 (-0.50)	10.00		
24 September 2009	12.00 (0.00)	9.50 (0.00)			
13 August 2009	12.00 (0.00)	9.50 (0.00)			
2 July 2009	12.00 (0.00)	9.50 (0.00)			
4 June 2009	12.00 (-1.00)	9.50 (0.00)			
7 May 2009	13.00 (-2.50)	9.50 (-3.00)			
8 April 2009	15.50 (-1.50)	12.50 (-1.50)			
19 March 2009	17.00 (-1.00)	14.00 (-1.00)			
29 January 2009	18.00 (0.00)	15.00 (0.00)			
17 December 2008	18.00 (0.00)	15.00 (-2.50)			
6 November 2008	18.00 (0.00)	17.50 (0.00)			
28 October 2008	18.00 (6.00)	17.50 (6.00)			
15 October 2008	12.00 (-3.50)	11.50 (-3.50)			
11 September 2008	15.50 (0.00)	15.00 (0.00)			
3 July 2008	15.50 (0.00)	15.00 (0.00)			
22 May 2008	15.50 (0.00)	15.00 (0.00)			
10 April 2008	15.50 (0.50)	15.00 (0.50)			
25 March 2008	15.00 (1.25)	14.50 (1.25)			
20 December 2007	13.75 (0.00)	13.25 (0.00)			
1 November 2007	13.75 (0.45)	13.25 (0.50)			
6 September 2007	13.30 (0.00)	12.75 (0.00)			
5 July 2007	13.30 (0.00)	12.75 (0.00)			

1. Change from last decision in parentheses.

Economic and monetary chronicle

October 2010

On 5 October, the report of the monitoring committee on measures to assist individuals, households, and businesses due to extraordinary circumstances in the financial market was presented to the Government and the opposition party leaders. The aim of the Act on Problem Debt Restructuring is to expedite the reconstruction of the Icelandic economy and establish equilibrium in private sector debt. The committee assessed the financial institutions' work on private sector debt mitigation and made suggestions for improvements in its report.

On 14 October, Parliament passed Act no. 128/2010 amending the Act on Debt Mitigation for Individuals, no. 101/2010, due to the extremely heavy workload at the newly established Office of the Debtors' Ombudsman. The amendments were intended to ease debtors' position by granting applicants a deferral of payment upon submittal of the application for debt mitigation and not upon approval.

On 14 October, the Ministry of Finance, the Byr Savings Bank winding-up committee, and the Byr hf. board of directors signed an agreement on the settlement and ownership of Byr hf. with the takeover of the savings bank by the Byr winding-up committee. The State's holding in Byr hf. will be 5.2%. Byr Savings Bank's stake, 94.8%, will be in the custody and oversight of the Ministry of Finance until the winding-up committee requests it, probably within two years. With this action, Byr hf. is fully capitalised and meets the capital adequacy and liquidity requirements of the Financial Supervisory Authority and the Central Bank of Iceland. The Treasury grants Byr hf. a subordinated loan of up to 5 b.kr. at market rates for a period of 10 years, which Byr hf. is expected to pay in full in five years' time. Byr Savings Bank's claim against Byr hf. will be converted to share capital.

On 15 October, the Financial Supervisory Authority authorised Arion Bank hf. to own a qualifying holding in Valitor hf. Arion Bank hf. requested permission to increase its qualifying holding in Valitor hf. indirectly, through its holding in Valitor Holding hf., cf. Article 40 of the Act on Financial Undertakings. The Financial Supervisory Authority considers Arion Bank eligible to own and administer the holding, partly because of Valitor's sound and reliable operations. On 12 October, the Financial Supervisory Authority authorised Arion Bank to own a stake of over 50% in Valitor.

On 15 October, the Ministry of Fisheries authorised a 15,000-tonne quota for Icelandic summer spawning herring, for the fishing year 2010/2011.

On 15 October, the committee on foreign investment submitted its third report on the legality of Magma Energy Sweden's investment in the subsidiaries of HS Orka. The committee expressed the opinion that there was no further reason to comment on the acquisition, citing two previous opinions wherein the majority of the committee considered Magma's purchase of HS Orka in compliance with the law.

On 18 October, the Financial Supervisory Authority announced that, on 1 October, it had recalled ALMC hf.'s (previously Straumur-Burdaras Investment Bank) commercial banking licence, as the company was dissolved pursuant to Chapter XII of the Act on Financial Undertakings, no. 161/2002; cf. Article 9, Paragraph 1, Subparagraph 6 of the same Act.

On 20 October, Parliament passed Act no. 129/2010 amending the Act on Forced Sale, no. 90/1991. Because the Office of the Debtors' Ombudsman had only recently commenced operation and because of the time required to resolve pending cases, the Act on Forced Sale was amended, and the respondent's deadline for requesting that the Commissioner postpone the continuation of a forced sale be deferred for three months was extended until 31 March 2011.

On 21 October, it was decided at a meeting of coastal nations that the total catch of the Norwegian spring spawning herring stock should be 988,000 tonnes in 2011. The total blue whiting catch was set at 44,000 tonnes. Iceland's share of the quotas is 143,000 tonnes of herring and 6,500 tonnes of blue whiting.

November 2010

On 1 November, the Central Bank announced that the review of the Rules on Foreign Exchange, no. 370/2010, was complete. The Bank considered it unnecessary to amend the Rules; therefore, they remained in effect unchanged.

On 3 November, the Monetary Policy Committee of the Central Bank of Iceland decided to lower the Bank's interest rates by 0.75 percentage points. Interest rates were lowered to the following amounts: interest on deposit institutions' current accounts, to 4.0%; the maximum rate on 28-day certificates of deposit (CDs), to 5.25%; seven-day collateralised loans, to 5.5%; and overnight loans, to 7.0%.

On 3 November, Már Guðmundsson issued a statement explaining the policy framework and plans for the removal of the capital controls. In the statement, the Governor reviewed the status of the controls and described the conditions that must be in place in order for liberalisation to take place.

On 3 November, the Ministry of Fisheries increased the maximum quota for Icelandic summer spawning herring from 15,000 tonnes to 40,000 tonnes.

On 14 November, a two-week visit to Iceland by an IMF mission under the leadership of Julie Kozack was completed. The mission discussed the fourth review of the IMF-supported economic programme with the Icelandic authorities. Meetings were held with the authorities, members of Parliament, academics, private sector representatives, and labour market representatives.

On 16 November, Parliament passed Act no. 132/2010 amending the Act on Financial Undertakings, no. 161/2002, as regards provisions concerning winding-up proceedings and bankruptcy proceedings for the failed commercial banks. The amendment was made following

comments by the resolution committees and winding-up committees of the failed banks as a result of judgments handed down by an appeals court in France on 4 November 2010. It can be concluded from the judgment that there could be some legal uncertainty pertaining to the origination of financial institutions' winding-up proceedings according to general rules. Because significant interests were at stake, it was considered necessary to eliminate all doubt about the involvement of the courts in winding-up proceedings and to ensure that there was no doubt about whether the formal requirements set forth in Directive 2001/24/EC on reorganisation and winding up of credit institutions were fulfilled.

On 19 November, the Ministry of Fisheries issued a capelin quota of 200,000 tonnes for the winter fishing season dating from 23 November 2010 – 30 April 2011.

On 25 November, the Supreme Court of Iceland handed down Decision no. 274/2010 concerning the Act on Guarantors, no. 32/2009. In the case, payment was demanded of two guarantors for a debt of which the District Court had relieved a debtor with a composition of creditors agreement involving debt mitigation. The Supreme Court upheld the District Court decision, which was that the creditor's right against the guarantors of the debt was protected by Article 72 of the Constitution and that those rights could not be curtailed without compensation by means of retroactive legislation. The provisions of the Act on Guarantors were therefore in contravention of the Constitution.

On 30 November, Parliament passed Act no. 135/2010 amending the Act on Debt Mitigation for Individuals, no. 101/2010, and other Acts, with the aim of rectifying various flaws in the Act on Debt Mitigation, clarifying provisions and ensuring the effectiveness of debt mitigation, and co-ordinating the implementation of the debt mitigation measure.

December 2010

On 1 December, the Enterprise Investment Fund announced that the Competition Authority's examination and due diligence analysis of the Fund's purchase of the holding company Vestia from Landsbanki was complete. The valuation changed somewhat during the process, and Landsbanki retains more of the company's assets than was assumed at the time of the purchase on 20 August. As a result, the purchase price is 15.5 b.kr. instead of the 19.5 b.kr. assumed in August.

On 3 December, the Government announced an agreement with credit institutions and pension funds concerning measures to assist distressed households. Distressed borrowers with over-leveraged assets are offered the opportunity to reduce their outstanding debt to 110% of the value of the asset concerned. The original debt service burden must be at least 20% of the income tax base plus investment income. Collateralised debt could be reduced by as much as 4 m.kr. for individuals and 7 m.kr. for couples or single parents. A much more detailed appraisal of assets and capacity to pay must be carried out if a larger write-down is needed, up to a maximum of 15 m.kr. for individuals and 30 m.kr. for couples and single parents. Changes were also made

to problem debt restructuring measures so that they would benefit a larger number of households. Over 2 b.kr. would be allocated to the maintenance of a special increase in mortgage interest allowances that was implemented in 2009-2010. A new temporary measure would then be created to pay down interest expense due to residential housing. Lenders will also attempt to reach all households that are in arrears and offer them satisfactory solutions before 1 May 2011. In connection with the agreement on debt problems, the Government declared that it would reduce the linkage between pension benefits and social security benefits and that the tax-free threshold for pensioners would be raised in stages during the period 2013-2015.

On 7 December, the supplementary budget for 2010 was approved by Parliament. Estimated revenues for 2010 rise by 16 b.kr., due primarily to stronger asset sales, while estimated expenditures decline by 0.9 b.kr., because a 24 b.kr. increase stemming from appropriated bank debt offsets a 24 b.kr. reduction in interest expense.

On 8 December, the Monetary Policy Committee of the Central Bank of Iceland decided to narrow the Bank's interest rate corridor by 1 percentage point. Interest on deposit institutions' current accounts was reduced by 0.5 percentage points, to 3.5%. The maximum rate on 28-day CDs and the interest on seven-day collateralised loans were reduced by 1.0 percentage point each, to 4.25% and 4.5%, respectively. The overnight lending rate was lowered by 1.5 percentage points, to 5.5%. According to the MPC statement, the objective of the changes was to reduce volatility in short-term rates and move the overnight lending rate closer to the centre of the corridor.

On 9 December, the Icelandic negotiating committee in the Icesave dispute announced the results of discussions with the British and Dutch negotiating committees and presented a draft of a new agreement. The draft provides for an average interest rate of 2.64% until 2016 instead of the 5.5% in the previous agreement. It also provides for flexible repayment time if the outstanding balance in 2016 is higher than expected. In addition, annual payments are subject to a maximum of 1.3% of GDP, or 5% of Government revenues, whichever is lower. On 15 December, the Government presented a bill of legislation authorising the approval of the agreement.

On 15 December, Parliament passed Act no. 141/2010 amending the Act on Securities Transactions, which expands the exemptions from the takeover requirement when a company is listed on the market or lists financial instruments on the market.

On 15 December, the Ministry of Economic Affairs, Icelandic Federation of Trade, Ministry of Finance, Confederation of Icelandic Employers, Icelandic Financial Services Association, and Iceland Chamber of Commerce signed an agreement concerning a plan to expedite the settlement of small and medium-sized companies' debt with financial institutions. The agreement covers companies whose continued operation is most likely, in the opinion of the financial institution concerned, to protect the interests of creditors, employees, and owners. The objective is that companies' total indebtedness following finan-

cial restructuring not exceed their restated asset value or operational value, whichever is higher, plus the value of other collateral backing the debt of the company in question. Monthly goals will be set for the number of processed offers for the period January to May 2011. The State will facilitate the agreement by lengthening the payment deadlines for public levies and increasing authorisations to cancel public claims that are considered unlikely to be collected. The agreement was announced under the title "the Straight Path."

On 16 December, the National Budget for 2011 was approved by Parliament. Revenues are estimated at 473 b.kr., expenditures at 510 b.kr., and the deficit at 37 b.kr. The surplus before interest income and expense is estimated at 15 b.kr. Revenues are estimated to decline by 1% from the increased 2010 National Budget due to lower sales revenues and the transfer of revenue bases to municipalities. Tax revenues are estimated to rise by 3%, even though the transfer of revenues for the affairs of the disabled to municipalities will cause a 2.4% reduction. Expenditures are projected to decrease by 9%, including 1.6% due to the transfer of the affairs of the disabled.

On 16 December, the EFTA Surveillance Authority (ESA) confirmed its previously issued preliminary conclusion that the provisions of Act no. 125/2008, the so-called Emergency Act, were in compliance with the EEA Agreement and fulfilled other legal requirements. This included both the provisions assigning higher priority to deposits than to general claims and the actions taken by the Icelandic authorities on the basis of the Act. ESA was of the opinion that the actions to which the authorities resorted were the only options that could have averted the complete collapse of the Icelandic economy.

On 16 December, the Financial Supervisory Authority announced that it had granted T Plús hf. in Akureyri a licence to operate as a securities undertaking in accordance with Article 4 of the Act on Financial Undertakings, no. 161/2002.

On 17 December, Parliament decided that it would have an impartial and independent investigation carried out of the operations of the Housing Financing Fund during the period 2004-2010.

On 17 December, Parliament passed Act no. 142/2010 amending the Act on Bankruptcy, Etc., which aimed at enabling individuals who have undergone bankruptcy proceedings but are still responsible for debt not paid during the proceedings to stabilise their finances. The changes entailed shortening the expiry deadline for those claims, or for the portion not paid during bankruptcy proceedings, so that the expiry date of all claims in the estate will be the same – two years – irrespective of the type of claim.

On 17 December, Parliament passed Act no. 144/2010 amending the Act on the Establishment of the Partnership Orkuveita Reykjavíkur, which limits the owners' liability in the wake of the EFTA Surveillance Authority's decision that unlimited owner liability is not consistent with the EEA Agreement provisions on state aid.

On 17 December, Parliament passed Act no. 152/2010, which stipulates that the municipalities of Iceland shall assume professional and financial responsibility for the provision of services for the disabled, and that this responsibility shall be transferred from the State to the municipalities as of 1 January 2011, in return for increased local tax revenues.

On 17 December, the Minister of Fisheries allocated a 147,000-tonne mackerel quota to Icelandic fishing vessels for 2011, a 17,000-tonne increase from the prior year.

On 18 December, Parliament passed Act no. 150/2010, which provided for a 40% year-on-year increase in supervisory fees paid to the Financial Supervisory Authority by financial institutions.

On 18 December, Parliament passed Act no. 151/2010 amending the Act on Interest and Price Indexation; the Act on Measures to Assist Individuals, Households, and Businesses due to Extraordinary Circumstances in the Financial Markets; and the Act on the Debtors' Ombudsman. The amendments were intended to reduce the uncertainty that developed in the wake of the Supreme Court judgments on exchange rate-linked loans, as regards the legality of contractual agreements covering a wide range of short- and long-term financing. The objectives were to ensure, to the extent possible, that comparable cases would receive comparable treatment, and to ensure legal security in the settlement of loan agreements with non-binding exchange rate linkage clauses.

On 18 December, Parliament passed Act no. 153/2010, amending legislation on unemployment benefits. For those who lost their jobs after end-April 2008, the period of entitlement to benefits was lengthened from three years to four, and the authorisation to pay benefits commensurate with reduced employment was extended by six months, until 30 June 2011. Benefits are only paid if the reduction in employment is at least 30% of a full-time position, as opposed to the previous 20%.

On 18 December, Parliament passed Act no. 155/2010, imposing a special tax on financial institutions in the amount of 0.041% of a base equal to total liabilities.

On 18 December, Parliament passed Act no. 156/2010, which changes the structure of the excise tax on imported motor vehicles, the motor vehicle tax, and the oil charge, so that levies rise with increased CO₂ emissions.

On 18 December, Parliament passed Act no. 163/2010 amending the Value-Added Tax Act, so as to enable monitoring and follow-up by the tax authorities, to clarify provisions on tax deductions for exported electronic services, including data centre services, and to discontinue rebates for indoor heating while extending authorisations for special rebates due to distance coaches and construction work done on residential housing until year-end 2011.

On 18 December, Parliament passed Act no. 164/2010, which sets forth various fiscal measures. The main features of the Act are i) the

investment tax is increased from 18% to 20%; ii) the corporate income tax is raised from 18% to 20%; iii) the wealth tax is raised from 1.25% to 1.5%, and tax-free threshold is reduced by 16.7%; iv) the inheritance tax is raised from 5% to 10%; v) the tobacco tax is raised by 7%, and a special, limited tobacco levy is imposed at the duty-free store upon arrival in Iceland; vi) the carbon tax is increased by 50% by raising the reference from 50% to 75% of the price of emissions allocations at EU auctions; vii) the overall authorisation to withdraw third-pillar pension savings before 1 April 2011 is raised from 2.5 m.kr. to 5 m.kr. per person. These changes are expected to generate a total of 11 b.kr. in tax revenues for the Treasury in 2011.

On 18 December, Parliament passed Act no. 165/2010, amending various pieces of tax legislation. Chief among them were i) the transfer of local tax revenues to municipalities due to the transfer of the affairs of the disabled; ii) the authorisation for companies to distribute the tax base due to cancelled debt over the years 2010-2014 and to pay the outstanding balance over five years; iii) the expansion of authorisations to defer or cancel businesses' tax debt; iv) the cancellation of the equity securities discount on individuals' income tax, in view of comments from EFTA, and increased authorisations for tax deductions for innovation companies; v) amendments to the statutory framework for tax investigations, so as to expedite case handling.

On 22 December, Parliament passed Act no. 141/2010 amending the Act on Securities Transactions, no. 108/2007, as regards mandatory takeover bids due to control of a company upon its listing on a stock exchange. The amendment was made because of comments indicating that the previous provisions could harm the securities market and could pose a serious risk that companies would remove their shares from trading in Iceland.

On 22 December, the Ministry of Finance published the tax brackets for withholding tax in 2011. The average local tax rate will be 14.41%, 66 of a total of 76 municipalities will levy the maximum local tax, and two municipalities will levy the minimum tax. The withholding percentages for income tax and local tax will be in three brackets: 37.31%, 40.21% and 46.21%. The monthly income thresholds for the three brackets will be 209,400 kr. for the first bracket; 471,150 kr. for the second bracket, and 680,550 kr. for the third bracket. The personal deduction will be unchanged at 44,205 kr. per month, and the tax-free income threshold will be 123,417 kr., after wage earners' mandatory 4% pension fund contribution. Municipalities' minimum and maximum local tax rates will rise by 1.20% due to the transfer of the affairs of the disabled to the local authorities, and the national tax percentages will decline accordingly, in each tax bracket. The tax-free income threshold and the thresholds between tax brackets will increase proportional to the twelve-month rise in the wage index, now about 4.7%.

On 30 December, the Central Bank of Iceland announced that it had concluded contractual agreements concerning the debt of five savings banks that did not meet minimum capital adequacy requirements

in the wake of the banking collapse. The savings banks in question are: Sparisjóður Bolungarvíkur, Sparisjóður Norðfjarðar, Sparisjóður Svarfdæla, Sparisjóður Vestmannaeyja, and Sparisjóður Þórshafnar og nágrennis. In addition, Sparisjóður Suður-Pingeyinga and Sparisjóður Höfðhverfinga have paid their debts to the Central Bank. During the restructuring process, the Central Bank acquired a large part of the savings banks' guarantee capital. The guarantee capital shares have been transferred to Icelandic State Financial Investments, which administers the holding on behalf of the State.

Near the end of the year, the Central Bank purchased foreign currency for 24.6 b.kr. (160 million euros), as well as negotiating forward contracts amounting to 47.9 b.kr. (312 million euros). These transactions will expand the Central Bank's foreign exchange reserves by about 72.5 b.kr. (472 million euros) during the term of the agreement. These transactions were undertaken so as to correct imbalances between foreign assets and liabilities on the balance sheets of various financial institutions. In addition, they promote increased financial system stability and bolster the Central Bank's non-borrowed foreign exchange reserves.

January 2011

On 1 January, the asset and income thresholds according to the rules on State-subsidised residential housing were raised by 2.46%. The asset limit for rent subsidy allowances was raised by the same percentage. The increases accord with the rise in consumer prices from the beginning of 2010 to the beginning of 2011.

On 4 January, the Minister of Welfare called for the municipalities to increase financial assistance to individuals so that such assistance would equal the amount of unemployment benefits.

On 5 January, an agreement between the Government and the Icelandic Pension Funds' Association was announced. The agreement stipulates as follows: i) general increases in pension payments within the year 2011 will not reduce State payments through income linkage; ii) during the same period, the pension funds will not use income linkage to reduce payments because of new disability pension decisions or increases in State pensions; iii) the tax-free threshold for pensioners will increase in three stages over the period 2013-2015, in accordance with the increase in the tax-free threshold for disability benefits.

On 6 January, the Central Bank and the Financial Supervisory Authority announced the conclusion of a new co-operation agreement. The aim of the agreement is to promote a sound, effective, and safe financial system in Iceland, including payment and settlement systems. Among new provisions, senior management and relevant experts from both institutions are to meet regularly, at least twice a year, so as to assess systemic risk in the financial system, including macroeconomic risk factors, risks in financial institutions' operations, the interplay of risk factors, the status of payment systems, the need for amendment of regulatory instruments, and improvements in contingency plans.

On 7 January, the Government agreed to extend the incentive programme called "Back to Work," which was established in collaboration

with the Icelandic Federation of Labour, the Confederation of Icelandic Employers, the Federation of Icelandic Industries, and others. The authorisation for reimbursement of value-added tax on labour costs for work done on residential housing will be extended until year-end 2011 and will remain in effect for the same length of time as the authorised income tax deduction.

On 10 January, the Executive Committee of the International Monetary Fund (IMF) approved the fourth review of Iceland's economic programme. The approval by the Executive Board released the fifth tranche of the IMF loan facility, in the amount of SDR 105 million (just under 19 b.kr.). Iceland is also authorised to draw further funds on the loan facilities from the Nordic countries and Poland.

On 28 January, the Financial Supervisory Authority decided that the holding company Eignarhaldsfélag NBI ehf. is eligible to own qualifying holdings large enough that Landsvaki hf. and SP-Fjármögnun hf. will be considered its subsidiaries.

On 28 January, it was announced that the Competition Authority had approved the Central Bank's sale of its stake in the Icelandic Banks' Data Centre, concurrent with its takeover of Fjölgreiðslumiðlun hf., which will henceforth be called Greiðsluveitan. Before this change was implemented, Fjölgreiðslumiðlun operated the netting system and the joint payment channel for payment card transactions. Henceforth, it will also operate the RTGS system, the SWIFT-Alliance system for cross-border payments, the collections system for electronic claims and remittance slips (payables pool), and the system that handles the posting of electronic documents to online banking accounts (the check-free system). In its approval of the change, the Competition Authority makes reference to its ruling on the card companies' violation in 2008 and sets requirements for Greiðsluveitan's conduct in the market.

On 31 January, the Financial Supervisory Authority concluded that NBI hf. was eligible to own and administer up to a 33% qualifying holding in Borgun hf.

On 31 January, the Central Bank announced a minor change in the announcement of decisions by the Monetary Policy Committee. Beginning with the Committee's 2 February decision, the MPC statement announcing and explaining the decision will be published at 9:00 on the interest rate decision date instead of 11:00, as had previously been done. The change was made primarily to allow market agents to assess the Committee's decision before markets open. This arrangement allows members of the media, financial analysts, and other interested parties to acquaint themselves with the MPC statement prior to the press conference.

February 2011

On 2 February, the Monetary Policy Committee of the Central Bank of Iceland decided to lower the Bank's interest rates by 0.25 percentage points. The current account rate was reduced to 3.25%, the maximum rate on 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%.

On 2 February, Parliament passed Act no. 9/2011, amending the Act on Responsible Utilisation of Fish Stocks. The amendment authorises the Minister of Fisheries to impose per diem fines in order to enforce submittal of catch reports.

On 2 February, the Minister of Finance publicised the Government's debt management strategy for 2011-2014 and its plans for borrowing. The plans aim to reduce total Treasury debt from 83% of GDP at end-2010 to 70% of GDP at end-2014, and to reduce net debt from 43% of GDP to 35% of GDP over the same period. According to the strategy, annual repayments on domestic Treasury bonds should be less than 6% of GDP, balances on the Treasury's current accounts should equal at least 80 b.kr. at all times, and Treasury debt should be 60-80% domestic and non-indexed, 20-40% indexed, and 0-20% foreign.

On 3 February, Parliament passed Act no. 12/2011, which increased the number of judges in the judicial system. Three new Supreme Court judges and five new District Court judges will be appointed because of the strain on the judicial system in the wake of the financial crisis.

On 7 February, the Minister of Welfare presented a report on consumption criteria for Icelandic households, prepared by a group of experts. Three types of consumption criteria were presented: i) typical criteria, which represent modest consumption; that is, the median expenses of Icelandic households; ii) short-term criteria based on the same assumptions, but assuming a temporary reduction in consumption and postponement of expenditure items; and iii) basic criteria, which indicate the minimum a household needs to support itself.

On 16 February, Parliament passed the so-called Icesave Act, no. 13/2011, which authorises the Government to guarantee repayment by the Depositors' and Investors' Guarantee Fund to the British and Dutch governments for the compensation paid for Icesave deposits.

On 18 February, the Ministry of Agriculture and Fisheries announced that the capelin quota for the year had been increased to 390,000 tonnes. The original quota was 200,000 tonnes.

On 20 February, the president of Iceland refused to sign Act no. 13/2011, the so-called Icesave Act, which confirmed the agreements providing for a State guarantee of the Depositors' and Investors' Guarantee Fund repayment to the British and Dutch governments. In so doing, the president referred the matter to the electorate for a national referendum, which was subsequently scheduled for 9 April.

On 23 February, the Financial Supervisory Authority revoked the operating licenses of the old financial institutions Byr Savings Bank, Frjálsi Investment Bank hf., and Reykjavík Savings Bank (SPRON) hf., in the wake of a ruling winding up these institutions pursuant to Chapter XII of the Act on Financial Undertakings, no. 161/2002.

On 23 February, rating agency Moody's Investors Service issued a special opinion on the results of the Icesave referendum. The opinion stated that if the Icesave agreements were approved in the referendum, the outlook for Iceland's sovereign credit rating would probably

be changed from negative to stable. On the other hand, if the agreements were rejected in the referendum, the rating would probably be downgraded to non-investment grade.

On 23 February, Parliament passed Act no. 14/2011 in order to reinforce the Competition Act, no. 44/2005. Provisions include authorising the Competition Authority to take action against conditions or conduct that prevents, restricts, or is detrimental to competition and is contrary to the public interest. The Competition Authority is now authorised to initiate legal proceedings before the courts in order to revoke rulings by the Competition Appeals Committee.

On 25 February, the Financial Supervisory Authority concluded that the holding company Eignarhaldsfélag NBI ehf. was eligible to own a large enough qualifying holding in Rose Invest hf., a UCITS management company, that Rose Invest would be considered a subsidiary of the holding company.

March 2011

On 1 March, Parliament passed amendments to the Electricity Act. Among other changes, the amended Act eases the requirements for connecting to distribution systems. It also stipulates that Landsnet shall be directly owned by the State and/or the municipalities beginning no later than 1 January 2015. Furthermore, price lists shall be structured so that they can support average operating expenses plus a profit equivalent to taxes and cost of capital. The Act also requires a licence to operate a market for energy distribution.

On 3 March, Parliament approved amendments to the Act on Landsvirkjun, no. 42/1983, so as to comply with ESA guidelines and to ensure that State guarantees for Landsvirkjun are in compliance with the EEA Agreement provisions on State aid. According to the amendment, the State guarantee is not unlimited; that is, the Act on Bankruptcy, Etc., no. 21/1991, can apply to the company, the guarantee covers only credit obligations, and a suitable guarantee fee must be paid for the State guarantee.

On 3 March, Parliament passed an amendment to the Act on State Guarantees, no. 121/1997. According to the amendment, instead of the general State guarantee fee (0.25%) pursuant to Article 6, Paragraph 2 of the Act, Landsvirkjun and others specified in Article 6, Paragraph 1 of the Act on State Guarantees shall pay a guarantee fee that fully corresponds to the concession enjoyed by the company on the basis of the State guarantee, in the form of credit terms more beneficial than those generally available in the market without such a guarantee. With Act no. 144/2010 amending the Act on the Establishment of the Partnership Orkuveita Reykjavíkur, no. 139/2001, with subsequent amendments, Parliament approved the same type of changes as regards owner liability for Orkuveita Reykjavíkur's credit obligations.

On 5 March, the Minister of Finance concluded an agreement with Landsbanki Íslands concerning the latter's takeover of Spkef Savings Bank. This was done in consultation with Icelandic State Financial Investments and with the approval of the Financial Supervisory Au-

thority. On 5 February, Spkef's capital was assessed as negative in the amount of 11 b.kr. In all, the savings bank was deemed in need of 19.4 b.kr. in order to fulfil the FME's minimum capital adequacy requirements. The savings bank had been in liquidity difficulties as well. The agreement with Landsbanki limits the Treasury's expense to the funds necessary to cover deposits. The additional economic capital necessary to fulfill the FME requirements was estimated at 8.2 b.kr.

On 16 March, the Central Bank of Iceland Monetary Policy Committee decided to hold the Bank's interest rates unchanged. The current account rate therefore remained 3.25%, the maximum rate on 28-day certificates of deposit (CDs) was 4.0%, the seven-day collateralised lending rate was 4.25%, and the overnight lending rate was 5.25%.

On 16 March, Parliament authorised the Government to confirm various decisions of the EEA Committee on amendments to the following annexes to the EEA Agreement: Annex IX (on financial reporting standards, Parliamentary Document 1056; and electronic payment intermediation, Parliamentary Document 1057); Annex XIII (on maritime insurance, Parliamentary Document 1058); Annex XIX (on consumer protection, Parliamentary Document 1055); Annex XX (on environmental affairs, Parliamentary Document 1054); and Annex XXII (on company law, Parliamentary Document 1060).

On 16 March, Parliament passed Act no. 24/2011, amending the Act on Withholding of Public Levies, the Value-Added Tax Act, and the Act on Withholding of Investment Tax. Provisions were added to all of these Acts, authorising freezing of assets if the risk is considered to exist that the taxable party could avoid payment of public levies by transferring assets to another party. A comparable provision was added to the Income Tax Act in 2010.

On 17 March, an agreement was reached among major fishing nations apart from Russia, concerning fishing of the ocean perch stock around the Reykjanes peninsula. The agreement was reached after many years of discussions. The objective is that fishing will be carried out as advised and that Iceland's share will be 31%.

On 22 March, the Prime Minister issued a code of conduct for Government ministers. The code includes provisions on connections and conflicts of interest, finances and wage payments, conduct and demeanour, interactions between ministers and ministerial employees, and disclosure of information to the public.

On 22 March, Parliament authorised the Government to confirm two decisions of the EEA Committee on amendments to Annex XX to the EEA Agreement (on environmental issues, Parliamentary Documents 1090 and 1091).

On 25 March, it was announced that the Financial Supervisory Authority's advisory committee on board member eligibility had evaluated 47 insurance and financial company board members, including eight board members from holding companies. The conclusion was that the expertise, understanding, and attitudes of the board members as regards the main topics related to their sphere of activity was adequate in 35 instances and inadequate in 12 instances.

On 25 March, the Central Bank of Iceland published its capital account liberalisation strategy report. The report discusses the experience gained from the Central Bank's previous strategy and the conditions that must be met in order for it to be possible to lift the controls. In addition, two main phases of the strategy are described, as are smaller increments in the first phase. The report concludes that the conditions required to begin careful removal of some controls already exist, while major steps cannot be taken until the Treasury has demonstrated, through borrowing, that it is able to refinance its foreign loans.

On 28 March, Parliament agreed to add a temporary provision to the Housing Affairs Act, no. 44/1998, authorising the Housing Financing Fund (HFF), upon fulfilment of specified conditions, to write individual mortgage loans down to 110% of the value of the underlying residential property. The amendment is in accordance with the 3 December 2010 agreement between the Government, on the one hand, and credit institutions and pension funds, on the other. The cost of the HFF write-down is estimated at 21.8 b.kr.

Tables and charts

Tables and charts are generally based on statistical information available on 15 April 2011. A list of symbols is on p. 2.

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Table 1 Main monthly indicators

	Consumer prices		Exchange rate		Yields (end of period, %)				Money and credit (end of period) ⁵				
	% change in CPI ¹ over the previous		% ch. in effective exchange rate ^{1,2}		Money market		Bond market ⁶		12-month % change		DMB foreign liabilities ⁷		
	1 month	12 months	1 month	12 months	Central Bank col-lateral loans ³	3-month REIBOR ⁴	RIKB 13 0517	RIKB 19 0226	HFF 150644	Base money	M3	DMB lending	DMB foreign liabilities ⁷
2009													
January	0.6	18.6	6.4	-44.5	18.0	18.4	9.1	8.8	4.1	88.9	29.3	-56.0	-89.7
February	0.5	17.6	1.3	-41.7	18.0	18.3	9.2	9.0	4.8	-9.8	27.1	-57.3	-90.3
March	-0.6	15.2	11.7	-32.5	17.0	15.8	8.9	8.8	4.6	-18.5	4.0	-70.3	-95.8
April	0.4	11.9	-1.5	-25.8	15.5	13.5	7.9	8.2	4.4	-18.7	25.6	-69.6	-95.7
May	1.1	11.6	-10.7	-31.1	13.0	7.5	7.2	7.4	4.1	8.2	20.5	-69.6	-95.9
June	1.4	12.2	-2.9	-32.6	12.0	8.0	8.3	8.5	4.4	99.9	29.0	-71.2	-95.6
July	0.2	11.3	-2.2	-30.8	12.0	8.2	8.4	8.8	4.5	49.8	14.7	-71.6	-95.7
August	0.5	10.9	-1.3	-31.7	12.0	8.1	7.6	8.4	4.2	46.3	25.3	-71.8	-95.8
September	0.8	10.8	-1.3	-32.6	12.0	8.5	7.5	8.4	4.1	-3.5	25.8	-76.4	-96.7
October	1.1	9.7	0.5	-26.6	12.0	8.5	7.3	7.9	3.9	-18.8	-3.1	-16.7	-47.7
November	0.7	8.6	-0.8	-13.9	11.0	8.8	7.6	8.0	3.9	-32.1	-0.7	-26.8	-54.5
December	0.5	7.5	-0.6	-3.1	10.0	8.4	7.5	7.9	3.8	1.3	-5.3	-22.5	-57.4
2010													
January	-0.3	6.6	0.6	-8.3	9.5	8.3	7.3	7.8	3.8	-21.7	-5.9	-14.3	-52.7
February	1.1	7.3	0.7	-8.8	9.5	8.3	7.1	7.4	3.7	-18.7	-6.6	-14.5	-51.1
March	0.6	8.5	1.2	-17.3	9.0	8.0	6.3	7.5	3.8	-15.8	0.1	5.3	5.2
April	0.2	8.3	1.2	-15.1	9.0	8.0	5.9	7.4	3.7	-40.8	-6.9	2.5	-6.0
May	0.4	7.5	0.6	-4.4	8.5	7.5	5.1	7.4	3.6	-20.7	-8.8	1.0	-6.2
June	-0.3	5.7	3.5	1.9	8.0	7.1	4.2	7.4	3.4	-40.0	-3.6	1.4	-17.9
July	-0.7	4.8	2.8	7.2	8.0	7.1	4.3	7.3	3.5	-50.7	-0.5	1.9	-18.8
August	0.2	4.5	0.4	9.0	7.0	6.1	4.0	7.2	2.9	-49.6	-6.0	2.6	-21.7
September	0.0	3.7	2.0	12.7	6.3	5.4	4.2	7.2	3.4	-55.2	-10.7	0.3	-40.2
October	0.7	3.3	1.1	13.4	6.3	5.3	4.8	7.3	3.5	-38.1	-12.6	-0.3	-42.5
November	0.1	2.6	0.0	14.2	5.5	4.8	3.7	7.2	3.4	-3.7	-8.4	3.8	-40.7
December	0.3	2.5	0.5	15.5	4.5	4.2	2.9	7.2	3.3	-19.4	-3.5	2.3	-34.7
2011													
January	-0.9	1.8	-0.8	13.8	4.5	4.1	2.6	7.2	3.3	-3.3	-2.2	-3.1	-39.8
February	1.2	1.9	-2.1	10.6	4.3	4.0	3.3	7.2	3.2	15.6	1.8	-3.2	-41.8
March	1.0	2.3	-1.6	7.5	4.3	4.0	3.0	7.2	3.2	...	...	...	...

1. Percentage changes between period averages. 2. Based on the official effective exchange rate basket (trade-weighted). A positive sign indicates appreciation of the Icelandic króna. 3. From June 2007, the presentation of the policy rate has been changed. It is now presented as a nominal rate instead of a yield. 4. Average yield on the interbank market in Icelandic krónur. 5. For Treasury bonds and HFF bonds, the quoted yield is in excess of changes in the CPI. Trading with HFF bonds began in July 2004; prior figures are for housing bonds. 6. Annual figures are changes over one year. Domestic borrowers only as of January 2002. Latest figures are preliminary. 7. DMBs = deposit money banks = commercial and savings banks and other institutions permitted to accept deposits from the public. Since July 2007, derivatives have been considered to foreign liabilities and the presentation of Central Banks' short-term position has been changed.

Table 1 (continued) Main monthly indicators

2009	Foreign exchange market and reserves				Foreign trade and external conditions					Public finance				
	Gross foreign currency reserves:			CB	Trade balance (b.kr.)	Merchandise exports (b.kr.)	Merchandise imports (b.kr.)	Marine product prices 12-mo. % ch. ¹⁰	Real exchange rate of króna ¹¹	Unemployment %	Wages, 12-mo. % change ¹²	Reg. Treasury financial balance, % of reg. revenues, from Jan. ¹³	Asset prices 12-mo. % changes	
	Position B.kr.	Merch. imports ⁸	For short-term liabil. ⁹	as ratio of:										net purchases (b.kr.)	Equity prices^{14}	Housing prices^{15}
January	364.2	7.4	...	-1.3	-1.8	33.6	35.4	-4.3	71.0	6.6	7.5	29.4	...	-5.5
February	341.0	7.4	...	-1.5	10.8	38.7	27.8	-8.1	79.7	8.2	6.7	11.2	...	-5.3
March	382.5	8.0	...	-0.2	15.8	43.6	27.8	-10.6	77.7	8.9	5.5	-1.1	...	-8.5
April	413.7	8.7	...	-1.1	0.4	31.5	31.2	-10.3	69.5	9.1	4.4	-11.1	...	-9.4
May	426.1	9.8	...	-2.0	7.4	38.7	31.3	-8.9	68.1	8.7	4.1	-21.7	...	-10.5
June	384.1	9.0	...	-2.5	6.6	40.6	34.0	-12.6	67.2	8.1	3.0	-26.5	...	-10.8
July	385.1	9.8	...	-1.3	0.4	41.5	41.1	-12.0	66.7	8.0	2.6	-36.4	...	-11.2
August	449.3	12.2	...	-1.2	12.4	44.1	31.6	-12.1	66.1	7.7	2.2	-25.6	...	-10.3
September	434.7	12.3	...	-0.5	10.8	51.3	40.5	-13.9	66.9	7.2	1.9	-25.4	...	-10.2
October	451.0	12.8	...	-1.4	12.1	46.9	34.8	-13.2	67.1	7.6	1.9	-29.5	...	-10.0
November	402.8	11.5	...	-1.7	2.1	44.3	42.2	-10.4	67.0	8.0	4.0	-31.8	...	-11.1
December	484.9	13.8	2.2	0.0	13.2	46.0	32.8	-8.3	67.7	8.2	3.6	-33.4	...	-12.0
2010														
January	475.0	13.5	2.0	0.0	5.8	38.8	32.9	-5.0	68.1	9.0	3.1	-56.9	...	-10.2
February	480.1	13.9	2.0	0.0	14.0	44.4	30.4	0.0	69.4	9.3	3.6	-8.3	...	-10.0
March	489.9	14.0	1.9	0.0	11.5	52.9	41.3	5.0	70.2	9.3	3.6	-18.2	...	-5.9
April	506.3	14.5	2.2	0.0	7.2	41.1	33.9	5.4	70.6	9.0	4.0	-16.6	...	-3.6
May	506.1	14.6	2.2	0.0	16.6	52.3	35.7	6.4	73.2	8.3	4.0	-21.6	...	-1.0
June	573.1	16.3	2.5	0.0	11.4	50.7	39.3	10.1	75.0	7.6	6.1	-22.8	...	-1.3
July	570.0	16.7	2.5	0.0	4.0	44.0	39.9	10.1	74.9	7.5	6.0	-31.7	...	-2.9
August	546.3	15.8	2.8	1.0	7.1	41.9	34.8	8.1	76.6	7.3	6.0	-25.3	...	-3.6
September	487.2	14.5	3.6	1.4	10.7	49.7	39.1	15.3	77.3	7.1	6.0	-24.0	...	-3.2
October	468.3	13.8	3.6	0.9	10.1	47.0	36.9	12.7	77.5	7.5	6.0	-21.3	...	-2.3
November	542.5	15.5	4.1	1.2	6.9	48.4	41.5	13.6	77.8	7.7	4.7	-20.2	...	-0.9
December	667.0	18.9	3.4	25.5	13.1	49.6	36.4	11.0	77.1	8.0	4.5	-20.1	...	0.2
2011														
January	...	...	...	0.9	7.8	42.3	34.5	13.6	75.1	8.5	4.4	-39.4	...	0.5
February	...	...	...	1.0	10.2	42.7	32.5	13.8	74.4	8.6	4.2	...	...	2.0
March	...	...	...	1.0	...	...	...	...	74.2	8.6	...	...	...	...

8. Gross foreign exchange reserves at end of period as a ratio of the average monthly value of merchandise imports. Calculated at fixed exchange rates. 9. The denominator is foreign short-term liabilities of credit institutions and investment banks and includes derivatives as of July 2007. 10. Foreign currency prices of marine products are calculated by dividing marine products prices in Icelandic krónur by the export-weighted trade basket. Annual figures are % changes between annual averages. 11. Real effective exchange rate of the Icelandic króna based on relative consumer prices (a trade-weighted average of 17 trading partner countries' consumer prices is used), 2000 = 100. Average over periods. 12. Annual figures show change in annual averages. 13. Cash basis. Without privatisation revenues. A charge of 192 b.kr. in December 2008 is excluded. Adjusted for changed timing of expenditure changes in January - November 2004. 14. OMXI15 index. Annual figures are % changes over year. 15. Residential housing in greater Reykjavík area. Annual figures are % changes over year.

Sources: Statistics Iceland, Directorate of Labour, State Accounting Office, Nasdaq OMX Iceland, Registers Iceland, Central Bank of Iceland.

Table 2 Historical economic indicators

Year	Consumer prices ¹		Króna effective exchange rate		Interest rates (%)		Money and credit			Ratio of gr. reserves to merch. imports ⁵	Net ext. debt ⁶ GDP (%)	Growth of real GDP (%)		
	Consumer price index ¹	CPI inflation (%)	Nominal exchange rate ²	Real exchange rate ³		Gov. bonds average yield ⁴	Banks' secured lending (real yield)		DMB lending				Credit system lending	
				Relative CPI	Relative ULC		Non-indexed	Indexed						
1981	12.2	50.8	34.7	106.2	115.9	3.2	-1.7	2.5	70.5	72.2	54.1	3.0	36.5	4.3
1982	18.4	51.0	54.5	97.7	113.5	3.5	-9.4	2.9	58.0	92.0	100.2	2.1	46.4	2.2
1983	33.9	84.2	100.0	91.8	94.9	3.8	-14.2	3.0	78.7	85.6	82.9	2.5	57.2	-2.2
1984	43.7	29.2	116.3	96.3	92.1	7.0	3.4	5.5	33.4	43.0	40.2	2.1	60.2	4.1
1985	57.9	32.4	148.7	94.8	92.0	6.9	-2.3	5.0	47.6	29.7	35.2	2.8	63.6	3.3
1986	70.2	21.3	171.0	97.1	92.9	8.5	4.3	5.2	35.0	19.1	20.1	3.6	56.5	6.3
1987	83.4	18.8	177.3	106.0	118.3	8.7	4.7	7.7	35.2	42.1	31.4	2.4	49.4	8.5
1988	104.6	25.4	202.6	111.4	127.9	8.7	11.8	9.2	16.5	37.2	34.0	2.4	51.3	-0.1
1989	126.7	21.1	254.7	102.4	111.5	7.4	6.5	7.8	32.8	25.2	33.8	3.0	56.8	0.3
1990	145.5	14.8	283.7	99.1	99.6	7.0	9.3	8.0	24.9	11.0	12.5	3.3	43.8	1.2
1991	155.4	6.8	283.6	101.7	101.5	8.1	10.0	9.2	19.9	11.6	15.4	3.2	44.9	-0.2
1992	161.2	3.7	285.0	101.7	102.8	7.4	11.8	9.3	1.3	5.3	11.8	4.0	53.0	-3.4
1993	167.8	4.1	308.8	96.2	94.6	6.7	11.5	9.1	5.4	5.0	11.1	4.3	58.9	1.3
1994	170.3	1.5	324.8	91.0	83.2	5.0	9.5	7.9	10.7	-21.7	4.5	2.6	53.3	3.6
1995	173.2	1.7	322.3	91.1	88.0	5.6	10.1	8.7	9.6	477.3	5.9	2.4	52.0	0.1
1996	177.1	2.3	322.9	91.3	88.9	5.5	10.5	8.9	8.5	11.5	9.3	3.0	49.8	4.8
1997	180.3	1.8	318.7	92.2	90.3	5.3	11.1	9.0	16.5	12.4	11.8	2.6	51.3	4.9
1998	183.3	1.7	313.6	93.8	92.8	4.7	11.8	8.8	20.2	30.0	15.1	2.2	57.6	6.3
1999	189.6	3.4	313.1	96.3	96.8	4.4	8.0	8.6	19.3	23.1	17.3	2.5	67.1	4.1
2000	199.1	5.0	313.3	100.0	100.0	5.1	12.7	9.5	4.4	50.1	17.2	2.1	94.0	4.3
2001	212.4	6.7	376.3	87.3	86.7	5.1	9.4	10.2	-2.3	12.6	19.2	2.1	102.0	3.9
2002	222.5	4.8	365.2	91.7	90.7	5.2	13.7	10.1	23.8	2.7	3.2	2.5	89.8	0.1
2003	227.3	2.2	343.3	96.0	95.9	4.4	9.4	9.1	22.6	18.3	11.4	3.5	93.1	2.4
2004	234.6	3.2	336.3	98.1	93.1	3.9	8.3	8.0	30.1	39.0	19.9	3.6	113.5	7.7
2005	244.1	4.0	301.8	111.4	104.8	3.7	10.7	7.2	23.5	50.6	31.1	2.9	152.1	7.5
2006	260.6	6.8	337.2	104.2	102.0	4.6	10.9	7.1	22.4	41.5	31.0	4.8	201.7	4.6
2007	273.7	5.0	329.1	108.6	110.4	6.0	14.2	8.9	94.2	30.8	22.7	4.9	227.1	6.0
2008	307.7	12.4	462.1	85.5	85.7	4.6	7.9	10.1	32.1	-31.2	...	7.7	735.6	1.0
2009	344.6	12.0	622.3	70.0	63.9	4.4	4.2	8.0	-5.3	-15.3	...	13.8	750.3	-6.8
2010	363.2	5.4	604.0	74.5	72.2	3.4	4.9	6.4	-3.5	2.2	...	18.9	640.0	0

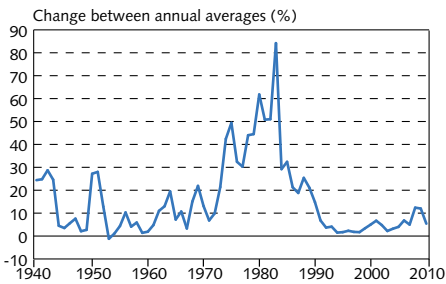
1. Annual averages (May 1988=100) and changes between years. 2. Annual averages. Exchange rate of the króna against a trade-weighted average of foreign currencies. 1983=100. 3. 2000=100. ULC=unit labour costs. 4. Annual average yield of indexed Treasury bonds of all maturities. Yields on Iceland Stock Exchange (OMX Iceland) from 1987. Before that, primary market yields. 5. Cross foreign exchange reserves at end of period as a ratio of the average monthly value of merchandise imports in the last 12 months. Calculated at fixed exchange rates. 6. External debt ratio is calculated as a percentage of accumulated GDP for the last four quarters at current exchange rate.

Table 2 (continued) Historical economic indicators

	Components of GDP			External trade			General government (% of GDP) ⁷			Labour market (% of labour force)		Wages (% change from previous year)	
	(% change from previous year)		National expenditure	(% change from previous year)		Terms of trade	Financial balance	Revenues	Expenditures	Unemployment	Labour participation ⁸	Real wages ⁹	Real disp. income
	Private consumption	Gross fixed cap. formation		Exports (volume changes)	Imports									Curr. acc. balance (% of GDP)	Unemployment	Labour participation^{8}	Real wages^{9}	Real disp. income
1981	6.2	1.2	5.6	3.2	7.1	-0.4	1.3	36.8	35.5	0.4	76.8	0.7	5.4
1982	5.0	0.1	5.0	-8.9	-0.6	-0.7	1.7	37.9	36.2	0.8	77.6	1.7	2.2
1983	-5.6	-12.7	-8.6	11.0	-9.7	-1.4	-2.0	35.8	37.8	1.0	77.4	-16.7	-12.5
1984	3.7	9.4	6.4	2.4	9.1	0.7	2.2	36.9	34.7	1.3	77.6	-3.1	-2.5
1985	4.2	1.0	2.7	11.1	9.4	-0.9	-1.6	35.4	37.0	0.9	79.3	1.2	10.8
1986	6.9	-1.6	4.5	5.9	0.9	5.4	-4.0	35.4	39.4	0.7	80.9	5.7	9.5
1987	16.2	18.8	15.7	3.3	23.3	4.3	-0.8	35.6	36.5	0.4	84.1	9.0	25.8
1988	-3.8	-0.2	-0.6	-3.6	-4.6	-0.8	-2.0	39.5	41.5	0.6	80.1	2.2	-2.2
1989	-4.2	-7.9	-4.4	2.9	-10.3	-3.9	-4.4	38.5	43.0	1.7	78.7	-9.1	-9.0
1990	0.5	3.0	1.5	0.0	1.0	-3.2	-3.3	38.1	41.4	1.8	77.5	-4.9	-4.1
1991	3.0	2.6	3.5	-5.9	5.3	3.5	-2.9	39.8	42.7	1.5	81.0	1.4	3.1
1992	-3.2	-10.4	-4.6	-2.0	-6.0	-0.5	-2.8	40.8	43.6	3.1	81.8	-0.8	-3.0
1993	-4.6	-9.8	-2.9	6.5	-7.5	-3.7	-4.5	39.0	43.4	4.4	81.1	-2.6	-2.1
1994	2.9	-0.2	1.8	9.3	3.8	0.2	-4.7	38.6	43.2	4.8	81.3	-0.3	4.7
1995	2.2	-1.7	2.2	-2.3	3.6	1.1	-3.0	39.6	42.5	5.0	82.9	2.8	2.7
1996	5.7	25.0	6.8	9.9	16.5	-3.2	-1.6	40.5	42.0	4.4	81.6	4.0	4.2
1997	6.3	9.3	5.8	5.6	8.0	2.1	0.0	40.5	40.5	3.9	81.0	3.6	7.3
1998	10.2	34.4	13.8	2.5	23.4	5.1	-0.4	40.8	41.2	2.8	82.3	7.6	8.7
1999	7.9	-4.1	4.2	4.0	4.4	-0.6	1.1	43.1	41.9	1.9	83.2	3.3	6.3
2000	4.2	11.8	5.9	4.2	8.6	-2.4	1.7	43.5	41.8	1.3	83.5	1.6	8.2
2001	-2.8	-4.3	-2.1	7.4	-9.1	0.3	-0.7	41.8	42.5	1.4	83.6	2.0	-3.0
2002	-1.5	-14.0	-2.3	3.8	-2.6	0.6	-2.6	41.6	44.1	2.5	82.8	2.3	5.0
2003	6.1	11.1	5.7	1.6	10.7	-4.1	-2.8	42.7	45.6	3.4	82.1	3.4	3.8
2004	7.0	28.1	9.9	8.4	14.5	-1.3	0.0	44.1	44.0	3.1	80.7	1.4	7.5
2005	12.7	35.7	15.7	7.5	29.3	1.0	4.9	47.0	42.1	2.1	81.9	2.6	11.1
2006	3.6	22.4	9.5	-4.6	10.4	3.4	6.3	47.9	41.6	1.2	83.1	2.6	8.3
2007	5.6	-11.1	-0.1	17.7	-0.7	0.1	5.4	47.7	42.2	1.0	83.3	3.8	10.5
2008	-7.9	-19.7	-8.5	7.0	-18.4	-6.1	-13.5	44.1	57.5	1.6	82.6	-3.8	0.5
2009	-15.6	-50.9	-20.7	7.0	-24.0	-9.8	-10.0	41.1	51.0	8.0	80.9	-7.2	-17.7
2010	-0.2	-8.1	-2.5	1.1	3.9	5.8	-6.3	42.2	48.6	8.1	81.1	-0.6	-3.6

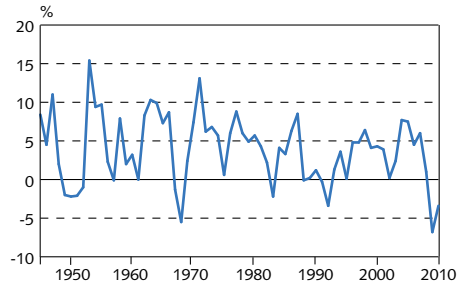
7. Central and local governments and the social security system. 8. Participation rate as per National Economic Institute definition until 1990, but based on Statistics Iceland labour market survey from 1991. 9. Statistics Iceland wage index. Deflated by consumer prices. Sources: Directorate of Labour, Iceland Stock Exchange (Nasdaq OMX Iceland), Ministry of Finance. Statistics Iceland, Central Bank of Iceland.

Chart 1
Consumer price inflation 1940-2010
 Yearly averages of CPI



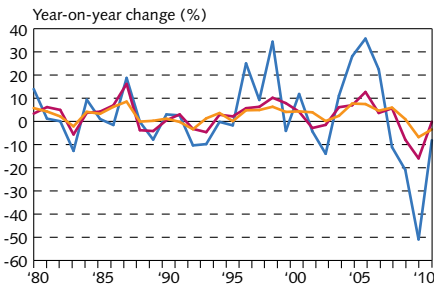
Source: Statistics Iceland.

Chart 2
Economic growth 1945-2010¹
 Change in real GDP between years



1. Preliminary 2010.
 Source: Statistics Iceland.

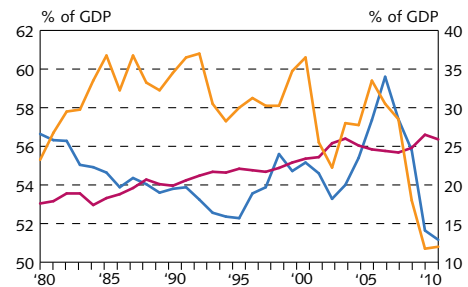
Chart 3
Growth of GDP, private consumption and gross fixed capital formation 1980-2010¹
 Year-on-year change (%)



— Gross fixed capital formation
 — Private consumption
 — GDP

1. Preliminary 2010.
 Source: Statistics Iceland.

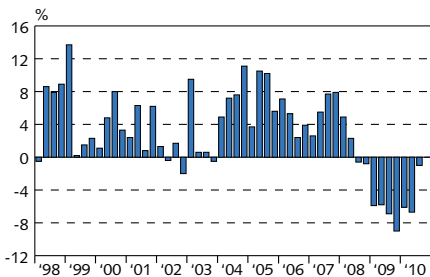
Chart 4
Private consumption, public consumption and gross fixed capital formation 1980-2010¹
 % of GDP



— Gross fixed capital formation (right)
 — Public consumption (right)
 — Private consumption (left)

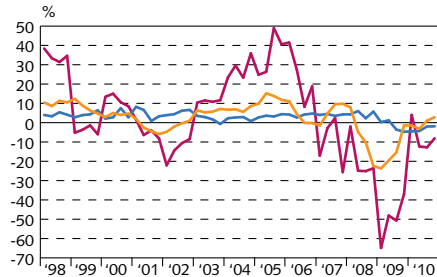
1. Preliminary 2010.
 Source: Statistics Iceland.

Chart 5
Economic growth Q1/1998 - Q4/2010¹
 Volume change in GDP on a year earlier



1. Latest data are preliminary.
 Source: Statistics Iceland.

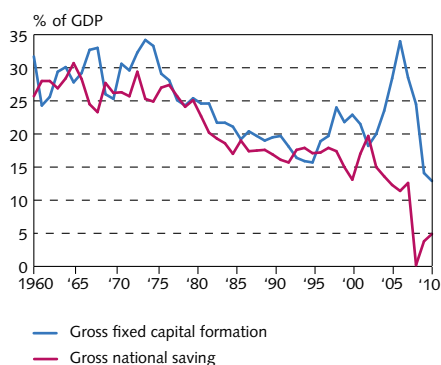
Chart 6
Components of economic growth Q1/1998 - Q4/2010¹
 Volume change on a year earlier



— Public consumption
 — Gross fixed capital formation
 — Private consumption

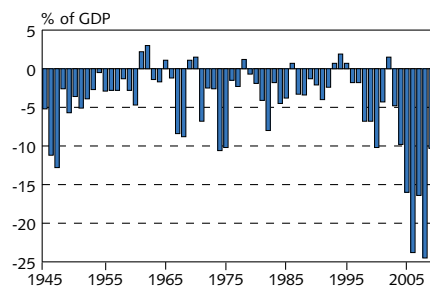
1. Latest data are preliminary.
 Source: Statistics Iceland.

Chart 7
Gross national saving and fixed capital formation 1960-2010¹



1. Preliminary 2010.
Source: Statistics Iceland.

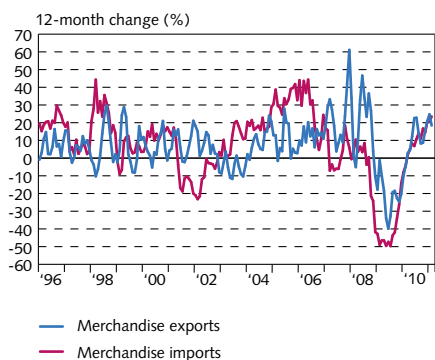
Chart 8
Current account balance 1945-2010¹



1. Preliminary 2010.
Source: Statistics Iceland.

Chart 9
Merchandise trade
January 1996 - February 2011

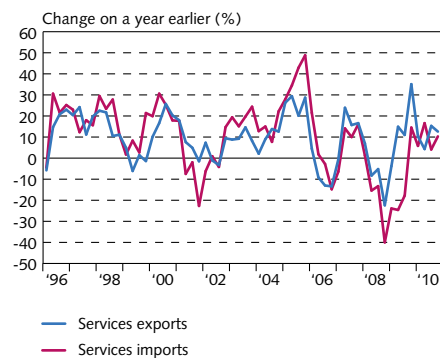
3-month moving averages at fixed exchange rates



Sources: Statistics Iceland, Central Bank of Iceland.

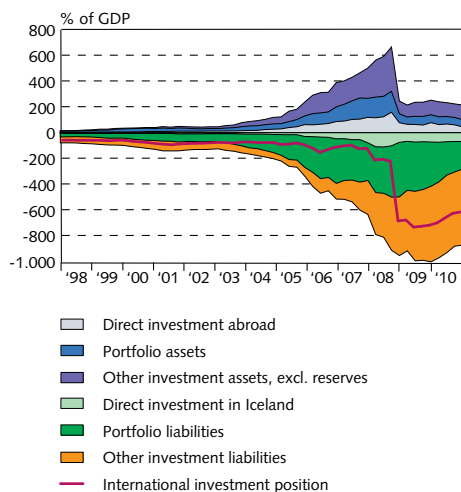
Chart 10
Exports and imports of services
Q1/1996 - Q4/2010¹

At constant exchange rate



1. Latest data are preliminary.
Sources: Statistics Iceland, Central Bank of Iceland.

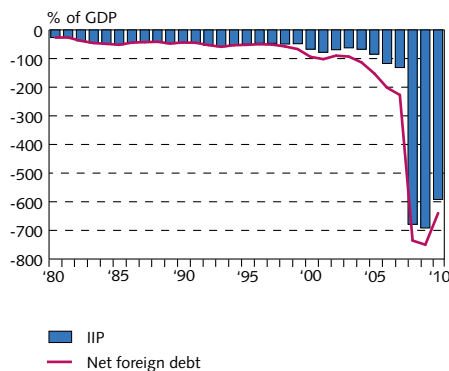
Chart 11
External debt and assets Q1/1998 - Q4/2010¹
At current prices



1. Latest data are preliminary.
Sources: Statistics Iceland, Central Bank of Iceland.

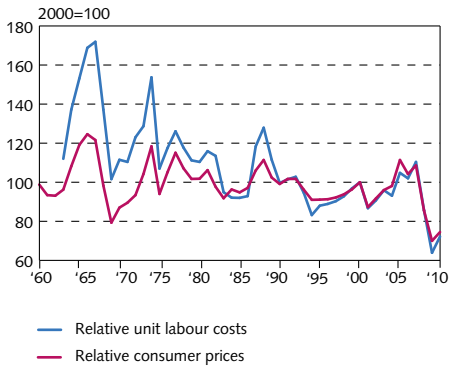
Chart 12
Net external debt position 1980-2010¹

At end of year



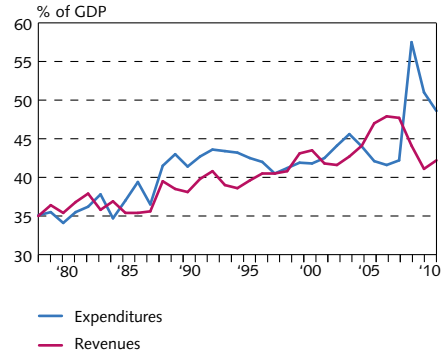
1. Latest data are preliminary.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 13
Real effective exchange rate
of the Icelandic króna 1960-2010¹



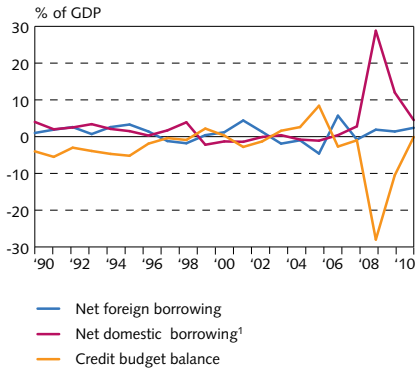
1. Preliminary 2010.
Source: Central Bank of Iceland.

Chart 14
General government revenues
and expenditures 1978-2010



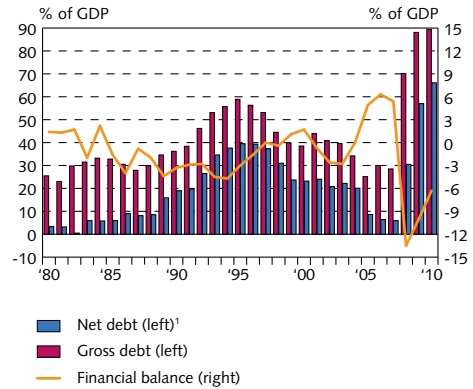
Source: Statistics Iceland.

Chart 15
Treasury borrowing and credit budget balance
1990-2010



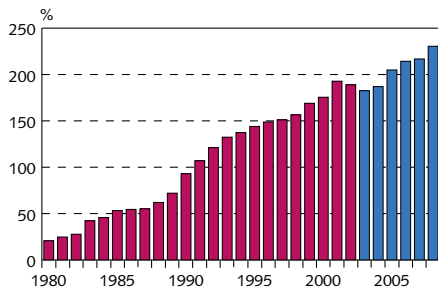
1. Including increase in pension fund commitments and outstanding long-term interest. FMS's preliminary calculations for 2010.
Source: Financial Management Authority, Treasury accounts.

Chart 16
General government balance and debt
1980-2010



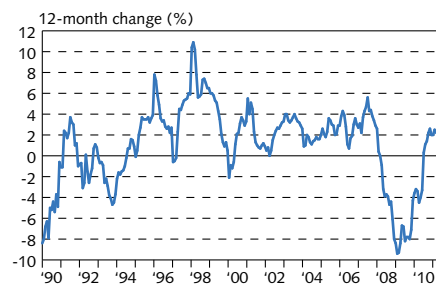
1. Debt is excluding civil service pension liabilities, assets including cash position but excluding equity holdings.
Sources: Statistics Iceland, Treasury accounts.

Chart 17
Household debt as percentage
of disposable income 1980-2008¹



1. New classification from 2003 (blue columns). Estimate for 2008.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 18
Real wages January 1990 - February 2011



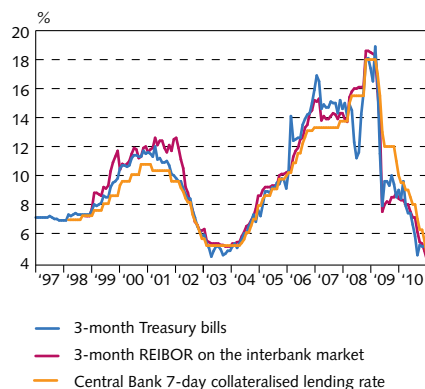
Source: Statistics Iceland.

Chart 19
Unemployment and labour participation
January 1996 - February 2011¹



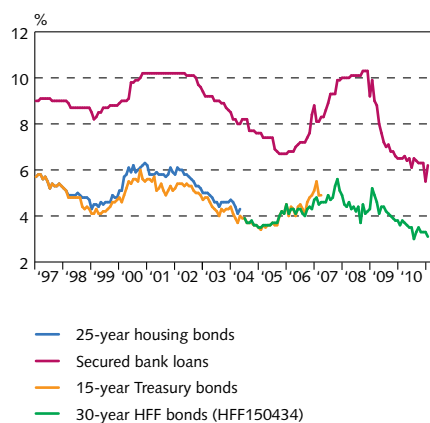
1. Statistics Iceland's labour market survey 1996-2011.
Sources: Directorate of Labour, Statistics Iceland, Central Bank of Iceland.

Chart 20
Short-term interest rates
January 1997 - February 2011
At month-end



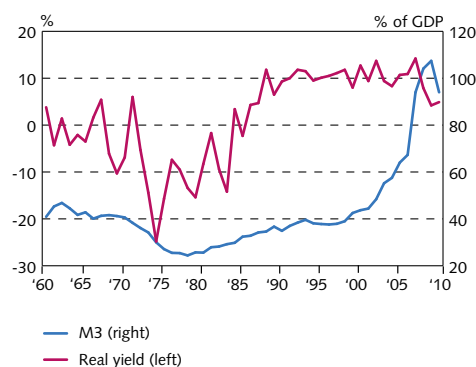
Source: Central Bank of Iceland.

Chart 21
Long-term interest rates
January 1997 - February 2011
At month-end



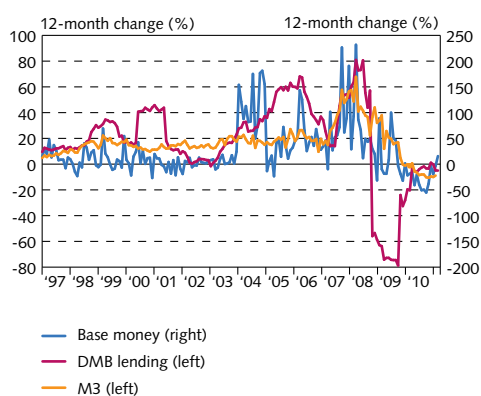
Source: Central Bank of Iceland.

Chart 22
Real yield and broad money 1960-2010¹
Real yield on non-indexed bank loans and M3 as percent of GDP



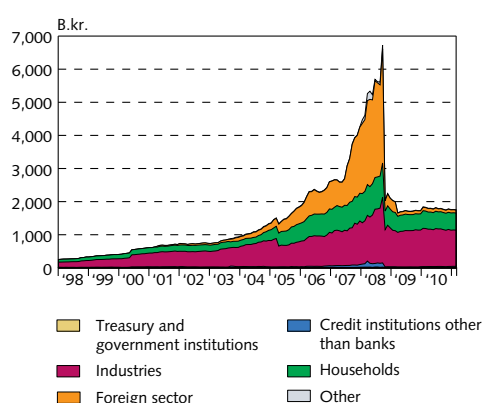
1. Latest data are preliminary.
Source: Central Bank of Iceland.

Chart 23
M3, DMB lending and base money
January 1997 - February 2011¹



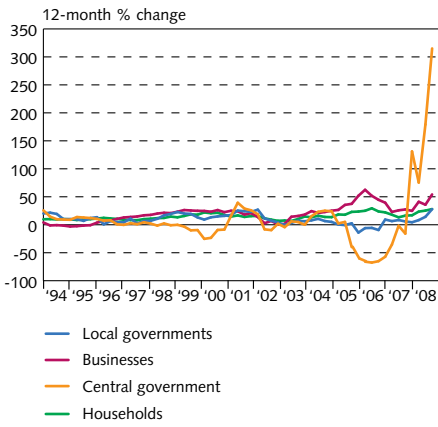
1. Latest data are preliminary.
Source: Central Bank of Iceland.

Chart 24
Deposit money bank lending by sector
January 1998 - February 2011¹



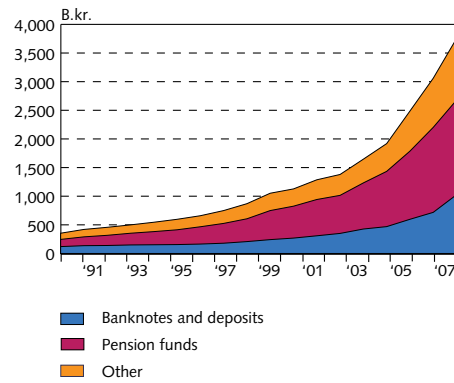
1. Reclassification of lending in September 2003 based on the ISAT-95 standard led to a reduction in household debt figures and an increase in business and municipalities' debt figures. Latest figures are preliminary.
Source: Central Bank of Iceland.

Chart 25
Growth of credit system lending
Q1/1994 - Q3/2008
 Lending by sectors¹



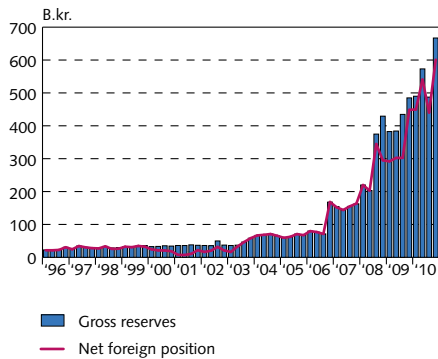
1. Reclassification of lending in September 2003 based on the ÍSAT-95 standard led to a reduction in household debt figures and an increase in business and municipalities' debt figures. Latest figures are preliminary.
 Source: Central Bank of Iceland.

Chart 26
Credit system liabilities at end of year
1990-2007
 Balance at year-end at current prices



Source: Central Bank of Iceland.

Chart 27
Reserve assets and Central Bank
net foreign position, Q1/1996- Q4/2010¹
 At current exchange rates



1. Latest data are preliminary.
 Source: Central Bank of Iceland.

Boxes and appendices

Inflation and prices

- 2008/2 Inflation developments in emerging market economies and monetary policy restraint
- 2008/2 The effect of exchange rate movements on inflation
- 2008/1 The importance of anchoring inflation expectations

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- 2010/4 The Icelandic contraction and timing of recovery in international context
- 2010/4 Assumptions concerning investment in the Central Bank's baseline forecasts
- 2010/2 Fluctuations in private consumption
- 2010/2 Real estate market developments
- 2009/4 Developments in house prices: Different calculation methods point in the same direction
- 2009/2 The outlook for aluminium prices
- 2008/3 Global financial crisis deepens
- 2008/2 The housing market in a global context
- 2008/2 Iceland and Latvia: Macroeconomic and monetary policy
- 2008/2 Outlook for EMU expansion in coming years

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- 2010/2 Terms of trade and real exchange rate
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- 2010/2 The balance of payments outlook
- 2009/2 Foreign debt and balance on income

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- 2010/2 Capital controls and their role in the economic recovery
- 2009/2 The offshore market for krónur
- 2009/2 Facing the "impatient investor" challenge
- 2008/3 Sudden stop of international capital flows
- 2008/3 Domestic asset prices and the Bank of England financial market liquidity index
- 2008/2 The importance of well-functioning financial markets
- 2008/1 The impact of the US sub-prime crisis
- 2008/1 The recent turmoil in the Icelandic foreign exchange market

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- 2008/1 Government involvement in wage settlements: Cost to the Treasury
- 2008/1 The macroeconomic impact of fiscal policy

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- 2010/2 Errors in Central bank forecasts
- 2009/2 Updated macroeconomic model
- 2009/2 Forecast errors in Central Bank of Iceland inflation forecasts
- 2008/1 Forecast errors in Central Bank of Iceland inflation forecasts

Periodical boxes and appendices

- 2011/1 Baseline macroeconomic and inflation forecast 2011/1
- 2010/4 Baseline macroeconomic and inflation forecast 2010/4
- 2010/3 Baseline macroeconomic and inflation forecast 2010/3
- 2010/2 Baseline macroeconomic and inflation forecast 2010/2
- 2010/1 Baseline macroeconomic and inflation forecast 2010/1
- 2009/4 Baseline macroeconomic and inflation forecast 2009/4
- 2009/3 Baseline macroeconomic and inflation forecast 2009/3
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- 2009/1 Baseline macroeconomic and inflation forecast 2009/1
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- 2008/2 Financial market analysts' assessments of the economic outlook
- 2008/2 Changes in the macroeconomic forecast since *Monetary Bulletin* 2008/1
- 2008/2 Changes in the inflation forecast since *Monetary Bulletin* 2008/1
- 2008/2 Alternative scenarios
- 2008/2 Baseline macroeconomic and inflation forecast 2008/2
- 2008/1 Financial market analysts' assessments of the economic outlook
- 2008/1 Changes in the macroeconomic forecast since *Monetary Bulletin* 2007/3
- 2008/1 Changes in the inflation forecast since *Monetary Bulletin* 2007/3
- 2008/1 Alternative scenarios
- 2008/1 Baseline macroeconomic and inflation forecast 2008/1