



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

February 2011

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

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

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, financial stability, the outlook for the global real economy and Iceland’s international trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the 8 December interest rate decision, as reflected in the updated forecast and risk analysis published in *Monetary Bulletin 2011/1* on 2 February.

Financial markets

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

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

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

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

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

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

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

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

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

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

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

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

Outlook for the global real economy and international trade

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

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

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

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

The domestic real economy and inflation

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

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

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

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

Indicators suggest that the labour market may soften somewhat further. Firms planning to shed staff in the next six months outnumber those planning to recruit by 13 percentage points, according to a Capacent Gallup survey carried out in December

among Iceland's 400 largest firms. The survey also indicates that more companies planned redundancies in December than in September, and that fewer were planning to recruit. The greatest change in staffing plans was among companies in the fisheries sector: some one-third were considering downsizing in December, as opposed to only 14% in September. A recent survey conducted by the Confederation of Icelandic Employers among its member organisations accords with this, indicating that companies intend to reduce staffing by 1,000 in the next six months. This corresponds to an increase in unemployment amounting to just over ½ percentage point.

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

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

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

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

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

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

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

Inflation continued to subside in December and January. Annual headline inflation measured 2.5% in December and fell further to 1.8% in January, when the consumer price index (CPI) decreased by 0.9% month-on-month. Excluding the effects of higher

duties on alcohol, tobacco and fuels, the CPI fell by 1.1% in January; thus twelve-month underlying inflation (excluding tax effects) was 1.6%. Seasonally adjusted, the CPI fell by 0.06% in the last three months, which is a 0.2% decline on an annual basis.

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

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

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

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

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

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

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

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

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

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

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

II The interest rate decision

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

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

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

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

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

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

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

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

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

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

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Anne Sibert, external member

Professor Gylfi Zoëga, external member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday, 16 March 2011.