The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

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

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

I Economic and monetary developments

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

Financial markets

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

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

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

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

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

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

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

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

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

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

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

Outlook for the global real economy and international trade

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

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

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

The domestic real economy and inflation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

economy, although the recent debt restructuring is likely to improve the effectiveness of monetary policy.

II The interest rate decision

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

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

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

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

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

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

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

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

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

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

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Anne Sibert, External Member

Professor Gylfi Zoëga, External Member

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

Rannveig Sigurdardóttir wrote the Minutes.

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