The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

March 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 meeting held on 15 March 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 16 March, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, financial stability, the outlook for the global real economy and Iceland's international trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the 2 February interest rate decision.

Financial markets

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

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

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

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

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

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

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

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

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

Outlook for the global real economy and international trade

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

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

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

The price of aluminium rose by almost 3% month-on-month in February and was around 7% higher than the average price in Q4/2010. It continued to rise in March and, in the

first week of the month, was 1% higher above the February average. The price of aluminium is now at a two-year high. The value of marine product exports has also been on the rise, increasing by 1.5% month-on-month in January.

The domestic real economy and inflation

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

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

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

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

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

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

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

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

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

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

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

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

II The interest rate decision

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

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

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

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

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

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

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

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

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

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Anne Sibert, external member

Professor Gylfi Zoëga, external member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday, 20 April 2011.