The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

September 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 20 September 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 21 September, 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 17 August interest rate decision.

Financial markets

The trade-weighted value of the króna in the onshore market was 1.8% higher at the time of the September MPC meeting than at the August meeting. Between the two meetings, the króna appreciated by 2.7% against the euro and by 2.0% against the pound sterling, while depreciating by 2.2% against the US dollar.

The Central Bank had bought 84 million euros in regular purchases in the domestic interbank foreign exchange market since it began its programme of 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 220-232 against the euro, but volume and frequency of trading remained low.

The CDS spread on the Republic of Iceland rose from 242 basis points at the time of the August meeting to about 306 basis points at the time of the September meeting. The spread between the recently issued US dollar government bond and an equivalent US Treasury bond rose at the same time from 340 basis points to 408 basis points.

Overnight interbank interest rates rose by 25 basis points to 4% just after the MPC's decision to increase interest rates in August. They fell back to 3.75% in early September but had risen to 4.5% by the September MPC meeting. Interbank market trading since the August meeting totalled 21 b.kr., with volume concentrated in overnight maturities.

About 135 b.kr. worth of certificates of deposit (CDs) were outstanding as of the September meeting, approximately 36 b.kr. more than at the August meeting.

The nominal short-term yield in the secondary market rose by 60 basis points after the announcement of the 25 basis points interest rate increase in August and the publication of the Central Bank's more pessimistic inflation forecast, while the yield on nominal long-term bonds rose by 50-60 basis points. The yield on long-term bonds peaked at 8.3% in the last week of August but was around 8.0% at the time of the September meeting. Yields on HFF bonds were broadly unchanged or fell slightly between meetings.

The breakeven inflation rate (the difference between nominal and indexed bond yields) was around 4.8% at the time of the September meeting and had risen by 50 basis points since the August meeting.

Data on Deposit Money Banks' retail interest rates, the interest rate corridor on deposits and lending and the interest rate margins showed that nominal rates of non-indexed customer loans averaged around 8% at the beginning of September, indicating that the spread over the policy rate could be significantly lower than in many countries going through financial stress.

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 had risen slightly since the August meeting, to -0.9%. Based on the twelve-month rise in the consumer price index (CPI), the *ex post* real rate had increased by 20 basis points to -1.1%, while in terms of breakeven inflation rates it had fallen by 30 basis points to -0.2%.

Although unchanged policy rates seemed to be priced into the yield curve, most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to increase rates by 25 basis points at the September meeting. Most parties cited the rise in inflation and higher inflation expectations as the main arguments for an increase in interest rates. However, one analyst predicted a 50 basis points increase, referring to implications from a simple Taylor rule.

New lending to the private sector continues to be limited and is mostly a part of debt restructuring measures. Preliminary figures on the banking system in July, which reflect both revaluation of loans and movement of funds, showed that the net position of outstanding loans to residents decreased by almost 0.5% from the previous month.

Loans to the corporate sector fell by 0.3%, while total lending to households fell by 1.7%. Broad money (M3) increased by 3.3% month-on-month in July but remained 2% lower than at the same time in 2010.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in September, global growth is expected to reach 4.2% in 2011 and 4.3% in 2012, which is slightly lower than in the IMF forecast published in June 2011. However, the forecast for inflation is unchanged. The IMF forecast for world trade has been revised downwards by 0.5 percentage points, and trade is expected to grow by 7.7%. According to the IMF forecast, economic growth in Iceland's main trading partner countries has also been revised downwards. Revised forecasts from *Consensus Forecasts* suggest a large downward revision for Iceland's main trading partner countries. Output is now expected to grow by 1.8% in 2011, down from 2.2% at the time of the August MPC meeting, and for 2012 it has been revised down by 0.7 percentage points to 1.6%. Indicators of risks in the global economy have also risen sharply since the August meeting.

Iceland's merchandise trade surplus was 8.2 b.kr. in August, according to preliminary data, which is somewhat higher than at the same time last year. The value of exports increased by 27% year-on-year, led by a 29% increase in exported marine products. Exports of industrial goods were also strong, growing by 28% year-on-year. In the first eight months of the year, export values rose by 11%. Import values also increased strongly in August, by 30% year-on-year, despite a 15% drop in the import value of fuel. The rise in import values was led by a 61% increase in the import value of investment goods and a 51% increase in the import value of industrial supplies.

The mid-September price of aluminium was similar to that at the time of the August MPC meeting but had fallen by around 10% since the end of July. The price of marine products was unchanged month-on-month in July but had risen by 11% year-on-year.

The domestic real economy and inflation

On 8 September, Statistics Iceland published the Q2/2011 national accounts and a revision of previously published preliminary figures. The revised figures show a 0.2 percentage points smaller contraction of GDP in 2009 (6.7%) than previously published figures and a 0.5 percentage point larger contraction, or 4%, in 2010.

According to the national accounts numbers for Q2/2011, seasonally adjusted GDP fell by 2.8% from the previous quarter, after three quarters of quarterly growth. GDP grew by 1.4% year-on-year, however. Private consumption grew by 1.8% quarter-on-quarter after a contraction in Q1 and government final consumption increased by 0.4% for the third consecutive quarter. Gross fixed capital formation grew by 7.7% quarter-on-quarter in Q2 and by 1% from the same quarter in the previous year. Growth in business investment other than energy-intensive sectors, ships, and aircraft measured over 19% year-on-year. Government investment continued to contract between quarters in Q2, by 9.5% from Q1. Change in inventory growth reduced quarterly GDP growth by 5.5% of GDP. This change in stock had a sizable negative impact on gross domestic final expenditure, which fell by 3.9% in spite of growth in all other subcomponents, while growing by 6.0% year-on-year. Exports grew by 1.4% quarter-on-quarter in Q2, while imports remained unchanged.

Because of the offsetting revision to Q1 data, a comparison of the first two quarters in 2011 together is more reliable when comparing the national accounts numbers to the forecast published in the August *Monetary Bulletin*. Overall, domestic demand in H1/2011 was in line with the August forecast, growing by 5% compared to a forecast of 4.9% in August. As regards individual expenditure items, private consumption was somewhat weaker than forecast, whereas government consumption was stronger. Investment was stronger as well, driven by stronger than anticipated business investment excluding power-intensive investment, ships, and aircraft. Net exports underperformed in comparison to the forecast, mainly on the export side – mainly reflecting an offsetting build up of export inventories. The August forecast overestimated GDP growth by a half a percentage point in H1: output was assumed to grow by 3% in H1 from the first half of 2010, while the Statistics Iceland national account numbers indicate a growth rate of 2.5%.

The current account deficit was almost 15% of GDP in Q2/2011, or 58 b.kr, following a deficit of 12% of GDP in Q1. The deficit in Q2 was caused by a large income account deficit (87 b.kr.), which more than offset service and goods account surpluses of 16 b.kr. and 15 b.kr. respectively. The current account balance excluding banks in winding-up proceedings was negative by roughly 5% of GDP in Q2.

While the preliminary Statistics Iceland data could suggest a somewhat weaker growth rate in H1 than expected in August, leading indicators suggest that Q3 may turn out stronger than the August forecast assumed. For example, payment card turnover and retail sales for July and August suggest that private consumption will be somewhat stronger than expected.

Against the indications of weaker output in 2010 and the first half of 2011, revised analysis of the economy’s output capacity suggests that the level of potential output has also been somewhat weaker than previously estimated. This suggests that the spare capacity in the economy is, if anything, smaller than previously thought, not withstanding the downward revision of GDP data from Statistics Iceland.

Unemployment adjusted for seasonality rose from 7.1% in July to 7.5% in August, while registered unemployment has been broadly unchanged since June, at roughly 6.7%.

The wage index rose by 1% month-on-month in July and by 7.8% since July 2010. Real wages increased by 0.9% month-on-month in July and by 2.6% year-on-year.

Consumer sentiment deteriorated in August, due mainly to bleaker expectations towards the future economic situation. The decline was the largest in a single month since October 2010. In August, the consumer sentiment index was at its lowest level in 2011.

Statistics Iceland’s nationwide housing price index, published in August, fell by 0.15% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, decreased by 0.1% month-on-month in July (seasonally adjusted). House prices remain 5.9% higher in July than at the same time a year ago, however. Some 61% more contracts were concluded in July than during the same month in 2010, and in the first seven months of 2011, 72% more contracts were concluded than in the same period in 2010. The number of contracts remains very low in historical context, however.

The CPI rose by 0.26% month-on-month in August, and annual inflation measured 5.0%, unchanged from July. Annual inflation excluding tax effects measured 4.8%. The seasonally adjusted CPI had risen by 1.5% over the previous three months, or 6.3% on an annualised basis. Annual core inflation 3 (headline inflation excluding the effects of taxes, volatile items such as food and petrol, public services, and changes in real interest rates) measured 3.5% in August, up from 3.3% in July. It should be noted, however, that all measures of annual inflation are 0.4 percentage points lower than they would otherwise have been due to the exclusion of broadcasting fees from the CPI in January 2011.

The main contribution to the CPI increase in August came from increases in the price of clothing, footwear and furniture due to the end of summer sales, raising the index by 0.3 percentage points. Increased food prices, mainly vegetables and meat, had an effect of 0.12 percentage points. However, the cost of owner-occupied housing fell by 0.4% in August and has not declined between months since January 2011. Prices of petrol and oil fell by 1.7%, with an effect of -0.1 percentage points on the CPI.

II The interest rate decision

The Governor informed the Committee of his meeting with the Council of Ministers on the National Economy (the Prime Minister, the Minister of Finance and the Minister of Economic Affairs) where the effects of international financial and economic developments on the Icelandic economy were discussed. The MPC was also informed of the amendments to the Foreign Exchange Act recently passed by Parliament and the preparation for the IMF's Annual Meeting in Washington.

The Committee observed that newly released data broadly confirmed the updated Central Bank forecast, published in the August *Monetary Bulletin*. According to the forecast, a recovery of output and employment is underway and, in the absence of a significant appreciation of the króna, inflation will remain well above the Bank's inflation target for some time but return to target over the medium term.

The MPC observed that even though inflation has risen sharply in the past five months, the August inflation measurement had been somewhat more favourable than expected. However, the Committee remained of the view that the inflation outlook had not materially been altered. At the same time however, the recent increase in unrest in global financial markets, and the weaker-than-expected output growth in the world economy created increased uncertainty about inflation and growth prospects in Iceland.

Two alternative rate decisions were discussed: keeping rates unchanged or raising 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 3.5%, the maximum bid rate for 28-day certificates of deposit (CDs) at 4.25%, the seven-day collateralised lending rate at 4.5%, and the overnight lending rate at 5.5%. Four MPC members supported the Governor's proposal on the grounds that more favourable than expected inflation figures in August, continued strengthening of the króna, and a weaker outlook for the global economy provided scope to keep rates on hold at present. One member voted against the Governor's proposal, preferring to raise interest rates by 25 basis points. This member placed more weight on persistent and high inflation expectations and the risk of high inflation becoming entrenched. This member also argued that the momentum in the domestic economy suggested that a continuation of a gradual withdrawal of monetary accommodation was appropriate at this juncture, and that international developments would have limited effects on the domestic real economy in the short run, due to small weight of manufacturing exports, which tend to be most sensitive to the global business cycle. This member also raised concerns that keeping rates on hold at this meeting could potentially undermine the signalling effect achieved with the August decision.

The majority of Committee members agreed that inflation prospects suggested that, over the medium term, it would be appropriate to continue the gradual withdrawal of monetary accommodation begun in August. They also agreed that there was only limited risk that a modest interest rate hike would derail the economic recovery.

Thus, the Committee remained of the view that, in order to contain inflation, it could prove necessary to raise interest rates further but that monetary policy decisions would depend, as always, on recent developments and prospects.

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 2 November 2011.