



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 2010

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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 1-2 November 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 3 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 real economy and Iceland’s international trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the 22 September interest rate decision, as reflected in the baseline forecast and risk analysis published in *Monetary Bulletin* 2010/4 on 3 November.

Financial markets

The average trade-weighted value of the króna in the onshore market was 0.4% higher at the time of the November MPC meeting than at the September meeting. Between meetings, the króna appreciated by 1.5% against pound sterling and by 5.1% against the US dollar but depreciated by 1.1% against the euro.

The volume in the interbank foreign exchange market continues to be low. The Central Bank has bought 21.5 million euros from market makers since it began regular purchases of foreign currency at the end of August.

In the offshore market, trading volume has been low since the last MPC meeting, and the króna has traded at 225-245 against the euro.

Risk premia on the Republic of Iceland as measured by the CDS spread have been broadly stable since the September meeting. The CDS spread on sovereign debt was 280 basis points at the November meeting, as opposed to 300 basis points at the September meeting. Iceland's CDS spread has not followed the developments seen in other high-CDS European countries, whose spreads have risen in recent weeks.

About 64 b.kr. worth of certificates of deposit (CDs) were outstanding as of the November meeting, approximately 8 b.kr. more than at the time of the September meeting.

Overnight interbank market rates had temporarily risen from 5.0% to 6.25% in the week prior to the meeting, reflecting unforeseen fluctuations in the liquidity position of financial institutions close to the end of the month. Trading volume in the interbank market amounted to 41.5 b.kr. since the last MPC meeting, with volume concentrated in overnight transactions.

Since the September meeting, Treasury bond yields had increased by 0.55-1.18 percentage points, and yields on indexed HFF bonds had risen by 0.51-0.77 percentage points.

Preliminary figures on the banking system in September showed that outstanding loans to residents decreased by 2.8% from the previous month, with foreign currency-denominated loans declining by 4.2%. Loans to companies decreased by 2.5%, while total lending to households fell by 0.3%. The money supply also continued to decline.

Since the announcement of the MPC decision on 22 September, the real effective policy rate (approximated as the simple average of Central Bank deposit and maximum CD rates) had increased by 1.2 percentage points in terms of current year-on-year inflation. In terms of most forward-looking measures (Central Bank inflation forecast and corporate and household inflation expectations), the real rate rose after the September meeting but fell in terms of the breakeven inflation rate in the bond market. The risk-adjusted short-term interest rate differential with main trading partners had increased by 0.3 percentage points.

Market expectations concerning the forthcoming rate decision indicated that financial institutions' economics departments expected the MPC to lower the policy rate by 0.5-0.75 percentage points, based on inflation prospects and the domestic economic situation. They argued that uncertainty related to the liberalisation of the capital controls would prevent the MPC from taking bigger steps in easing the policy stance. Market makers and brokers expected rates to be lowered by 0.5-1.0 percentage points (with most expecting a 0.75 percentage points cut), and they viewed the MPC's emphasis on the capital controls as weighing more heavily than the emphasis on the domestic economy and inflation outlook.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in October, global growth is expected to reach 4.8% in 2010 and 4.2% in 2011, broadly in line with the IMF forecast of July 2010. The forecast for world trade continues to be revised upwards, and the IMF now expects

trade to grow by 11.4% this year, roughly 2 percentage points more than in its July forecast. The latest OECD forecast, published in May 2010, projects 10.6% growth in world trade this year. The IMF forecast for world trade in 2011 has also been revised upwards, by 1 percentage point, to 7%.

Iceland's merchandise trade surplus was 10.6 b.kr. in September. The value of merchandise exports was almost 50 b.kr., while the value of imports was 39 b.kr. Exports grew by roughly 20% month-on-month in September, with a substantial increase in all major export categories. Imports grew by almost 14%, with an increase in the range of 6-19% month-on-month recorded in most major import components except fuel, which declined by 10% from the previous month.

In September, the export value of aluminium increased by 21% month-on-month, following a contraction in the three preceding months. There was some rise in aluminium prices in September, but growth in exports was due mainly to unexpectedly low exports in previous months. The price of aluminium continued to rise in the first part of October and should raise the value of aluminium exports in October, as production levels have been stable.

The price of marine products has been rising since late 2009, albeit with an interlude in July and August, and increased by 5% month-on-month in September.

The domestic real economy and inflation

All indicators of labour utilisation show a year-on-year decline in Q3/2010. Employed persons as a share of the population aged 16-74 fell by 1 percentage point year-on-year in Q3. Total hours worked fell by 2.1% due to a ½-hour shorter work week and a 0.9% fall in the number of persons at work. The drop in total hours was most prominent in the core age group (25-54 years), whereas the oldest age group saw an increase.

The wage index rose by 0.3%, month-on-month in September, after no change in August. Wages increased by 1.9% quarter-on-quarter in Q3/2010, while inflation fell by 0.6%; thus real wages rose by 2.5%.

Registered unemployment fell from 7.7% in Q2 to 7.1% in Q3. Adjusted for seasonality, unemployment rose by 0.6 percentage points in Q3, to 8.7%. According to the Statistics Iceland labour force survey, unemployment was 6.4% in Q3, down from 8.7% in Q2.

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 10 percentage points, according to the Capacent Gallup survey carried out in September among Iceland's 400 largest firms. However, fewer firms were considering laying off staff in September than in a comparable survey in June, or a quarter of firms, and more were considering adding on staff. However, firms' plans to recruit and lay off staff are broadly unchanged from the same time last year.

A number of economic indicators, such as payment card turnover, groceries turnover, and retail sales, suggest that private consumption was stronger in Q3 than in Q2.

Statistics Iceland's nationwide housing price index, published in October, declined by 1% from the month before. The greater Reykjavík housing price index, calculated by the Icelandic Property Registry, increased by 0.4% in September from the previous month,

and the change was the same when adjusted for seasonality. The index had fallen by 3.2% year-on-year in nominal terms and by 6.7% in real terms.

After a slight decline in September, the Consumer Sentiment Index plunged in October, hitting its lowest point since August 2009. Only once before – in November 2008, following the financial crisis – has the index fallen so sharply month-on-month. All sub-indices fell considerably in October, with the index of expectations towards the overall economic situation six months ahead declining the most.

According to Capacent Gallup's September business sentiment survey, executives continue to be pessimistic about the current economic situation. Furthermore, they were more pessimistic about the economic situation six months ahead than in the last survey in June, with roughly half of firms' executives expecting the situation to remain unchanged and 29% expecting it to deteriorate. In comparison, when asked in June, 31% of firms expected the economic situation to improve over the next six months. On the other hand, they were more optimistic looking twelve months ahead, with 45% of firms expecting economic conditions to improve.

Despite firms' bleak view of the overall economic outlook, they were slightly more upbeat about domestic demand, with a quarter of executives expecting domestic demand to grow over the next six months, as compared with 17% in June. Compared to the survey in June, all sectors except financial services have a higher share of participants expecting domestic demand to increase, with the largest increase in construction and specialised services sectors.

The median executive expects inflation to measure 2.5% one year ahead, a 0.5 percentage point decline from the survey in June. However, the median executive expects inflation to measure 4% in two years, 1 percentage point less than in the survey in March.

When asked about firms' pricing decisions, 58% of executives expected their prices to remain unchanged over the next six months, and a third believed prices would rise, which is in line with the survey carried out in March. A third of retail firms expect to cut prices in the next six months, compared to 6% in March.

In another Capacent Gallup survey in September, household inflation expectations one year ahead also declined from the previous survey (in June), by two percentage points, measuring 6% according to the median. They remain high despite the rapid decline in inflation over the course of the year. The median household expected twelve-month inflation to measure 5% in two years, which is two percentage points lower than in June.

The consumer price index (CPI) increased by 0.74% month-on-month in October, after remaining unchanged in September. Annual inflation measured 3.3% in October, down from 3.7% the month before. Underlying inflation as measured by the CPI excluding tax effects was close to the inflation target, at 2.6%.

In October, the largest contribution to the rise in the CPI was the pre-announced increase in utility prices, which rose by 23.5% (CPI effect 0.27%). Prices of food and non-alcoholic beverages rose by 0.7% (CPI effect 0.1%), due mainly to higher domestic grocery prices, as imported grocery prices remained unchanged month-on-month. The cost of owner-occupied housing increased by 0.9% and is now 4.5% lower than a year ago. International airfares, a very volatile sub-component, increased by 15.6% (CPI

effect 0.13%), after having declined by roughly 11% in September. On an annual basis, they are 3% lower than a year ago.

According to the baseline forecast published in the *Monetary Bulletin* on 3 November, the króna will appreciate slightly as the forecast horizon progresses. Global economic developments have been broadly in line with the Bank's earlier forecasts, but in the first half of the year the domestic economy has been somewhat less resilient than expected. There are signs, however, that the contraction in Q2 was smaller than preliminary figures from Statistics Iceland suggest. The outlook is for GDP to contract more this year, and grow less in 2011, than was forecast in August. It is still assumed, however, that GDP bottomed out in Q2 and recovery began in Q3. The forecast assumes that output growth will be almost 3% 2012-2013. As a result, it is projected that employment levels will start to rise beginning in mid-2011 and that unemployment will gradually fall throughout the forecast period.

The exchange rate of the króna has remained relatively stable since the publication of the *Monetary Bulletin* in August, even though the Central Bank has lowered interest rates by 1.75 percentage points in two steps. Inflation has subsided more quickly than was forecast in August and is now expected to align with the Bank's inflation target at year-end, somewhat earlier than previous forecasts suggested. Inflation is also forecasted to rise less than previously anticipated in early 2011 because of smaller consumption tax hikes. Owing to a stable exchange rate, modest wage rises during the forecast horizon, declining inflation expectations, and spare output capacity, inflation will decline more rapidly through mid-2011, when it will begin to rise again towards the inflation target.

The *Monetary Bulletin* also discusses key risks to the outlook, which are judged to be more on the downside. Recovery could prove weaker if the global recovery suffers a setback, if heavy household indebtedness curtails private consumption growth more than the forecast assumes, and if investments in energy-intensive industry are delayed still further. The same applies if wage rises are larger than is consistent with price stability and if the restraint measures in the National Budget bill are not successful, although this could have a transitory stimulative effect. On the other hand, the recovery could be stronger if a sharper decline in risk premia leads to a more rapid appreciation of the real exchange rate towards its long-term equilibrium, or if stronger FDI inflows lead to a more rapid recovery of business investment compared to the baseline forecast.

II The interest rate decision

The Governor gave an account of the Icelandic delegation's meetings with IMF representatives, and his meetings with other central bankers, rating agencies and financial institutions at the IMF's Annual Meeting in Washington, DC. Also discussed were the recently completed third review and the preparation of the fourth review of the economic programme supported by the IMF Stand-By Arrangement. The Governor also informed the MPC of the restructuring of private debt.

The Committee observed that inflation had continued to subside in September and October, after a marked decline since March of this year. In the MPC's view, weak

economic activity, declining inflation expectations, and this year's appreciation of the króna will continue to support low and stable inflation.

The Committee noted that, according to the forecast published in *Monetary Bulletin* on 3 November, the economy will be somewhat weaker this year and in 2011 than the Central Bank had forecast in August. However, recovery is still expected to begin in the second half of this year. Furthermore, inflation had subsided faster than was forecast in August.

The MPC observed that since the MPC's September meeting, the króna had appreciated by nearly 1% in trade-weighted terms but had weakened slightly against the euro. As the Committee had expected, the Central Bank's regular purchases of foreign currency, which commenced on 31 August, appeared not to have had any marked effect on the króna. In the MPC's view, the capital controls, developments in the terms of trade and other factors affecting the current account balance, and the monetary policy stance relative to trading partner countries will all continue to support the exchange rate.

The Committee discussed prospects for the lifting of the capital controls and the implications for monetary policy. The Committee also discussed the role of exchange rate stabilisation as an interim goal of monetary policy and some members argued that the importance of that goal was gradually declining as disinflation continued and the restructuring of domestic balance sheets progressed while others maintained that a lower exchange rate might generate increased wage inflation.

Members discussed the possibility of lowering the policy rate by 0.75 to 1.0 percentage points. In light of the discussion and the range of views expressed, the Governor proposed a rate cut of 0.75 percentage points, which would lower the deposit rate (current account rate) and the CD rate to 4.0% and 5.25%, respectively, the seven-day collateral lending rate to 5.5%, and the overnight lending rate to 7.0%.

All MPC members supported the Governor's proposal, although one member would have preferred a somewhat larger rate cut, arguing that the economy had turned out weaker than expected and that inflation was subsiding faster. This member agreed, however that the difference was small enough to accept the Governor's proposal.

The Monetary Policy Committee considers that, if the króna remains stable or appreciates and inflation subsides as forecast, the premises for some further monetary easing should be in place. However, the prospect of removing the capital controls creates uncertainty about short-term room for manoeuvre. 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, 8 December 2010.