



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

December 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 6-7 December 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 8 December, 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 3 November interest rate decision.

Financial markets

The average trade-weighted value of the króna in the onshore market was 0.5% higher at the time of the December MPC meeting than at the November meeting. Between meetings, the króna depreciated by 0.7% against the pound sterling and by 2.3% against the US dollar but appreciated by 2% against the euro.

The volume in the interbank foreign exchange market continues to be low. The Central Bank has bought 29 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 230-242 against the euro.

Risk premia on the Republic of Iceland as measured by the CDS spread have been broadly stable since the November meeting, or 271 basis points at the December meeting, as opposed to 280 basis points at the November meeting.

About 57.8 b.kr. worth of certificates of deposit (CDs) were outstanding as of the December meeting, approximately 6 b.kr. less than at the time of the November meeting.

Overnight interbank market rates had continued to fluctuate between meetings. Trading volume in the interbank market amounted to 67 b.kr. since the last MPC meeting, with volume concentrated in overnight transactions, although there had also been transactions on other maturities for the first time since November 2008.

Since the November meeting, Treasury bond yields (apart from the series maturing in December 2010) had fallen by 0.66-1.22 percentage points. Yields on the shortest indexed HFF bond series had risen by 0.31 percentage points, while yields on other HFF series had fallen by 0.16-0.32 percentage points.

Preliminary figures on the banking system in October showed that outstanding loans to residents rose by 3.3% from the previous month. This increase is due mainly to the fact that Straumur, previously classified as a commercial bank, is now classified as a holding company. Loans to companies decreased by 0.7%, while total lending to households fell by 0.6%. M3 continued to decline as well; mainly reflecting a shift from deposits to mutual funds, whereas M1 and M2 have been broadly stable.

Since the announcement of the MPC decision on 3 November, the real effective policy rate (approximated as the simple average of Central Bank deposit and maximum CD rates) had risen by 0.7 percentage points in terms of current year-on-year inflation. In terms of the one-year breakeven inflation rate in the bond market, the real rate rose by 1.6 percentage points. The risk-adjusted short-term interest rate differential with main trading partners had fallen 0.5 percentage points due to movements in domestic rates.

Financial institutions' economics departments and market makers expected a 0.5-0.75 percentage point rate cut. A cut of this magnitude was also implied by developments in bond yields. Despite some difference in opinion on future rate decisions, the majority seems to expect further cuts in early 2011.

Outlook for the global real economy and international trade

According to the latest OECD forecast, published in November, global growth is expected to reach 4.6% in 2010, which is unchanged from the last OECD forecast in May 2010, and 4.2% in 2011, which is slightly more modest growth than previously expected. The forecast is broadly in line with the IMF forecast of October 2010. The OECD forecast for world trade continues to be revised upwards, however, and the OECD now expects trade to grow by 12.3% this year, almost 2 percentage points more than in its May forecast. The forecast for world trade in 2011 is broadly unchanged at 8.3%.

Iceland's goods trade surplus measured 10.1 b.kr. in October. Goods exports were valued at almost 47 b.kr., while imports totalled just under 37 b.kr. Exports contracted by roughly 5% month-on-month in October, with some contraction in most major export categories. Imports also contracted by roughly the same month-on-month, with

contractions in most major categories apart from investment goods, which increased by almost 15% month-on-month.

In October, the export value of aluminium fell by roughly 1% month-on-month, despite some rise in prices. Prices came down again in November, but the export value of aluminium is expected to increase somewhat due to delays in the price effects on the export value of aluminium from Iceland.

Marine product prices have been rising since late 2009, apart from a short downturn in July and August, and increased by 1% month-on-month in October.

Preliminary numbers suggest that the trade surplus in November was 10.4 b.kr., with both export and import values increasing by roughly 3% month-on-month. The rise in export values is led by a 7% increase month-on-month in the export value of industrial goods.

The domestic real economy and inflation

Preliminary quarterly national accounts figures from Statistics Iceland, published on 7 December, show that the Icelandic economy was somewhat weaker in Q3/2010 than was assumed in the Central Bank's latest forecast, which appeared in the *Monetary Bulletin* 2010/4 in November. All subgroups are weaker than forecast in November except private consumption, which was in line with the forecast.

All methods of seasonal adjustment suggest that GDP grew in Q3 from the previous quarter after having contracted since Q4/2008. This is in line with Central Bank of Iceland forecasts this year, but growth is weaker than was anticipated in the November forecast.

The contribution to quarterly GDP growth in Q3/2010 was negative from all subgroups except private consumption, with the negative contribution from net trade the most significant. After three years of a positive contribution, the contribution of net trade to GDP appears likely to be negative this year.

Compared to Q1 and Q2, Q3 shows a much smaller contraction year-on-year, or 1.6% compared to over 7% in Q1 and Q2. GDP fell by 5.5% in the first three quarters of the year, whereas a 4.2% decline was forecast in November.

Revised national accounts figures show that the economy was slightly weaker in the first half of 2010 of the year than preliminary figures from September had indicated, and ½ percentage point weaker than forecast in November. The main reason for the revision in the first half of the year is weaker private and public consumption according to Statistics Iceland, and weaker investment than assumed in the CBI forecast.

The current account surplus was 24 b.kr., or 5.9% of GDP, in Q3/2010. This is a significant improvement from the previous quarter when there was a deficit of 12% of GDP. The current account surplus is due to the 35 b.kr. surplus on the service account and a 22 b.kr. surplus on the goods account, which offset the 32 b.kr. deficit on the income account. The current account surplus adjusted for accrued income and expense of financial institutions in winding-up proceedings was still larger at almost 62 b.kr., or 15.3% of GDP.

Registered unemployment was 7.7% in October, up from 7.1% in August. Adjusted for seasonality, unemployment was unchanged at 9.0%.

The wage index rose by 0.3% month-on-month in October. The twelve month rise in nominal wages was 6.0%, while real wages increased by 2.2%.

Statistics Iceland's nationwide housing price index, published in November, rose by 0.4% from the previous month. The greater Reykjavík housing price index, calculated by the Icelandic Property Registry, increased by 0.9% month-on-month in October, and the same change was measured when adjusted for seasonality. Activity in the real estate market fell month-on-month in October and November, after a temporary pick-up in September. Some 38% more contracts were concluded in October and November than in the same period last year, although the number of contracts remains very low in a historical context.

Consumer sentiment improved somewhat in November after having fallen in October. All sub-indices rose, but not enough to reach the September values.

Inflation continued to subside in November, after a marked decline since March. The consumer price index (CPI) rose by 0.05% month-on-month and by 2.6% year-on-year, or 1.8% excluding consumption tax effects. Seasonally adjusted, the CPI has risen by just under 0.5% in the last three months, a 1.9% rise on an annual basis.

The main contribution to the CPI in November was an 18.7% decline in international airfares, following an almost 16% rise in October, but monthly developments in international airfares remain volatile. Prices of petrol and oil increased by 2.6%, and utility prices rose by 7%.

The exchange rate pass-through from the appreciation of the króna continues to emerge gradually in import prices. Prices of imported food and non-alcoholic beverages have declined by 3% year-on-year. Overall, imported goods prices (excluding alcohol and tobacco) are 1.4% higher than a year ago, compared to an annual increase of 14.6% last January.

II The interest rate decision

The Governor informed the Committee of the status of the dispute over compensation to depositors in foreign branches of Landsbanki and the agreement between the Government, on the one hand, and credit institutions and pension funds, on the other, concerning measures intended to respond to household debt problems. The Committee discussed the Central Bank's newly published *Financial Stability* report and recent steps in the financial sector restructuring process.

The MPC noted that the inflation target of 2½% had been achieved. Inflation continued to subside in November after a marked decline since March 2010. In the MPC's view, factors leading to the appreciation of the króna, declining inflation expectations, and the slack in the economy will continue to contribute to low and stable inflation.

The MPC observed that national accounts data released since the last decision suggested a somewhat weaker economy than was assumed in the November *Monetary Bulletin*, although early releases of national accounts data are often subject to major revisions. Recovery seems to have begun in Q3/2010, in line with the November

forecast, although the Committee noted that it seemed somewhat weaker than was projected then. On the other hand, inflation had been slightly lower than was implied in the November forecast but, as before, looks set to fall temporarily below the target in 2011.

The Committee noted that, since the MPC's November meeting, the króna had remained broadly unchanged in trade-weighted terms but had appreciated against the euro. 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 to date. In light of exchange rate developments and the experience of foreign currency purchases, the MPC discussed the advantages and disadvantages of stepping up regular purchases of foreign currency. In the MPC's view, the capital controls, developments in terms of trade and other factors affecting the current account balance, and the monetary policy stance relative to trading partner countries all continue to support the exchange rate.

The MPC discussed both the desirability and ways of reducing the volatility of short-term market rates and moving the overnight interbank rate closer to the centre of the Bank's interest-rate corridor. In light of the discussion, the Governor suggested that the corridor be narrowed by 1.0 percentage point, to 2.0 percentage points. Four members supported the Governor's proposal while one voted against it, arguing that there was no apparent need to narrow the corridor. This member also objected to the nature of the proposal, which was a departure from the usual procedure of voting on specific rates. This member also felt that not enough time was given to consider the proposal adequately.

Members discussed the possibility of lowering the policy rate by 0.75 to 1.0 percentage points. In light of the discussion, the range of views expressed, and the Committee's decision to narrow the interest rate corridor by 1.0 percentage point, the Governor proposed that the deposit rate (current account rate) be lowered by 0.5 percentage points, to 3.5%; that the maximum bid rate for 28-day certificates of deposit (CDs) and the seven-day collateralised rate be lowered by 1.0 percentage point each, to 4.25% and 4.5% respectively; and that the overnight lending rate be lowered by 1.5 percentage points, to 5.5%. The MPC members agreed that the Governor's proposal implied that the overall monetary stance would be eased by somewhat less than the change in the centre of the corridor, although an exact measurement of the change in the stance would be difficult.

Four MPC members supported the Governor's proposal, although two members would have preferred a slightly different decision. Of these two members, one would have preferred a 0.25 percentage point smaller cut in all Central Bank rates, while the other would have preferred a 0.5 percentage point smaller cut in the seven-day collateralised rate. One member voted against the Governor's proposal. While agreeing on narrowing the corridor, the member suggested reducing rates by 0.25 percentage points less than the Governor's proposal, thus lowering the centre of the interest rate corridor by 0.75 percentage points rather than 1.0 percentage point.

The Monetary Policy Committee considers that, if the króna remains stable or appreciates and inflation subsides as forecast, there may yet be some scope for further monetary easing. 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, 2 February 2011.