



*The Monetary Policy Committee of the Central Bank of Iceland*

## Minutes of the Monetary Policy Committee meeting

April 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 18-19 April 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 20 April, 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 16 March interest rate decision, as reflected in the updated forecast and risk analysis published in *Monetary Bulletin* 2011/2 on 20 April.

#### **Financial markets**

The trade-weighted value of the króna in the onshore market was 0.3% lower at the time of the April MPC meeting than at the March meeting. Between the two meetings, the króna depreciated by 0.7% against the euro, but appreciated by 2.1% against the US dollar and by 0.2% against the pound.

The Central Bank has bought 51 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 króna has traded at 248-267 against the euro in the offshore market since the last meeting.

The CDS spread on the Republic of Iceland was 224 basis points at the April meeting, compared to 243 at the March meeting. The rates continue to be based on very limited trade.

About 63.9 b.kr. worth of certificates of deposit (CDs) were outstanding as of the April meeting, approximately 7 b.kr. less than at the time of the March meeting.

Overnight interbank interest rates had been between 3.5-4.0% since the March meeting. Trading volume in the interbank market amounted to 73 b.kr. since the March meeting, with volume concentrated in overnight maturities, although there had also been transactions involving other maturities.

Yields on longer-term Treasury bonds had fallen by 0.04-0.22 percentage points since the March meeting, while shorter-term Treasury bonds had risen by 0.08-0.77 percentage points. Yields on the HFF bonds had at the same time fallen by 0.11-0.33 percentage points.

The spread between indexed and nominal bond yields had risen in recent months but the spread gives an indication of the development of inflation expectations. The average spread for the next five years measured 2.9% at the meeting, while the five-year ahead spread for 2016-2021 was 4.8%. This is an increase of about 1 percentage point on both of these figures since the end of January 2011. It is however, uncertain how much of this recent rise in breakeven inflation measures is due to rising risk premia reflecting inflation and liquidity risk.

Preliminary figures on the banking system in February showed that the net position of outstanding loans to residents decreased by 0.5% from the previous month. Loans to the corporate sector decreased by 0.3%, and total lending to households fell by 0.6%. Broad money (M3) decreased by 0.6% month-on-month in February.

The nominal effective policy rate is currently approximated as the simple average of the Central Bank deposit and maximum CD rates. Since the announcement of the MPC's 16 March decision, the real policy rates have fallen on most measures. Averaging across different measures of inflation and inflation expectations, real rates have fallen by roughly 1 percentage point to below 1%.

Most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to maintain either unchanged interest rates or to reduce rates by 0.25 percentage points in the April meeting. Similar expectations seemed to be priced into the yield curve. Most parties cited increased uncertainty due to the rejection of the Icesave contract as a key factor in their judgement.

### **Outlook for the global real economy and international trade**

Iceland's merchandise trade surplus was 10.4 b.kr. in February and, according to preliminary data, 6.5 b.kr. in March. As imports rose more than exports in Q1/2011, the merchandise trade surplus decreased by 13% year-on-year. The value of merchandise exports was roughly 42 b.kr. in February, while the value of merchandise imports was about 33 b.kr.

Both merchandise import and export values grew year-on-year in February. Export values rose by almost 5% year-on-year, led by a rise in the export value of ferrosilicon and other industrial products. Import values grew by 15%, led by increases in the import value of fuel and capital goods.

However, both import and export values fell month-on-month in February, export values by 0.7% and import values by almost 8%. This development was reversed in March, according to preliminary data, as export values increased by over 19% and import values by 37%. Both continued to rise year-on-year in March.

The price of aluminium was 1% higher on average in March than in February and has continued to rise in April. In the first two weeks of April, it was roughly 3% above the March average. The price of aluminium is now approaching a three-year high. The value of marine product exports has also been on the rise, increasing by 0.7% month-on-month in February. The February price level is nearly 14% higher than a year ago.

### **The domestic real economy and inflation**

The wage index rose by 0.2% month-on-month in February. Wages increased by 4.3% year-on-year, and real wages by 2.2%. Registered unemployment was unchanged in March, at 8.6%, and measured 8.6% as well in Q1/2011.

Seasonally adjusted payment card turnover rose in March from the previous two months, growing by 4.6% month-on-month, but contracted by 0.9% quarter-on-quarter in Q1/2011 after 3.4% growth in Q4/2010.

Statistics Iceland's nationwide housing price index, published in March, increased by 0.9% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, rose by 1% month-on-month in February, and by the same when adjusted for seasonal variability. Some 46% more contracts were concluded in February 2011 than in the same month in 2010, although the number of contracts remains very low in a historical context.

Consumer sentiment regarding the current economic situation and the future outlook continues to be weak. The consumer sentiment index declined slightly in March but is still higher than it was at the same time last year. According to quarterly results from a survey in March, expected big-ticket purchases declined from the previous survey in December, but were higher than at the same time last year.

According to Capacent Gallup's business sentiment survey, conducted in February and March 2011, corporate executives were slightly less pessimistic about the economic situation six months ahead than they were in December. Roughly half of participants expected the economic situation to remain unchanged, and over a fifth believed it will improve, compared to 46% and 25%, respectively, in December. Sentiment among firms in the construction and fisheries sectors, however, was more pessimistic about the outlook, with almost 40% of construction firms and 41% of fisheries expecting the economic situation to deteriorate.

When asked about firms' capacity to respond to an unexpected increase in demand, almost 80% of participants responded that it would not be a problem since operations were running below maximum production capacity, compared to 70% in September.

Slightly fewer firms expressed an interest in laying off staff in March than in the December survey, although firms wanting to shed staff in the next six months still outnumber those wanting to recruit by about 5 percentage points. Over 40% of firms in the construction sector are expecting to lay off workers. Exporters of goods and services are more likely to expect to add on staff than are other firms.

Executives' median expected inflation measured 4% one year ahead. This is a 2 percentage point increase from the survey in December. This is the first increase in their inflation expectations since Q4/2009. Executives also expected twelve-month inflation to measure 4% in two years, which is unchanged from the survey in September.

When asked about their firms' pricing decisions, 45% of executives expected a price rise over the next six months, compared to one-third in September. Just under 6% of executives said that their firms planned to cut prices in the near future, compared to 10% in September.

In another Capacent Gallup survey in March, household inflation expectations one year ahead declined from the previous survey in December by 0.5 percentage points, measuring 3.5% according to the median. The median household expected twelve-month inflation to measure 4% in two years, a 1 percentage point decline since December.

The CPI increased by 0.95% month-on-month in March, and annual inflation measured 2.3%, compared to 1.9% in February. Annual inflation excluding tax effects measured 2.1%. The seasonally adjusted CPI rose by 2.1% over the last quarter, or 8.6% on an annualised basis. Annual core inflation 3, that is headline inflation excluding tax effects, volatile items such as food and petrol, public services and mortgage interest payments, was much lower at 1.3%. 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 as of January 2011.

The rise in fuel prices had the largest effect on the CPI in March, or 0.4 percentage points. Petrol prices have risen by roughly 12% over the last three months. Due to the end of winter sales, clothing and footwear prices raised the CPI by 0.2 percentage points. An increase in the cost of owner-occupied housing had a further 0.1 percentage point effect on the CPI, mainly due to higher market prices, following a 0.2 percentage point CPI effect in February. The cost of owner-occupied housing is 1.7% higher than it was a year ago.

According to the estimate in the 20 April *Monetary Bulletin*, the economic contraction in 2010 was deeper than the Bank's February estimate, but somewhat smaller than was indicated by the preliminary Statistics Iceland figures from early March. Domestic demand has been broadly in line with the forecast, however; the difference is largely due to domestic demand being directed more towards imports than had been assumed. Stronger import growth is also the main reason for the outlook for smaller GDP growth in 2011 than was forecast in February. The prospects for GDP growth in the next two years have deteriorated as well. While the recovery in activity is still considered to have begun in mid-2010, it is quite weak.

Considerable spare capacity remains in the economy and appears likely to continue over the forecast horizon. The more pessimistic growth outlook has implications for the labour market outlook as well; unemployment is now expected to subside more slowly

than previously forecast. Although the Central Bank's real interest rate has continued to fall, the financial conditions of households and businesses remain difficult.

In spite of weaker activity, long-term inflation expectations have risen slightly in the recent term, and the inflation outlook has worsened. Inflation is now projected to peak at just over 3% later in 2011, due primarily to steep rises in commodity and oil prices. The króna is also expected to be weaker during the forecast horizon, and pay rises are expected to be larger and more front-loaded than Bank staff had previously assumed. Some of the increase in commodity and oil prices may be transitory, however, and the Central Bank forecasts that a dissipation of these transitory rises, combined with the slack in the economy, will have inflation returning to target again in the latter half of 2012.

As discussed in the current issue of *Monetary Bulletin*, the outlook is subject to considerable uncertainty. An important contributing factor is the outcome of the Icesave referendum. Even though some indicators give cause for greater optimism, the downside risks are considered to be greater than the upside risks.

## **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, the status of the fifth review of the IMF Stand-By Arrangement and the associated funding, and the outlook for the foreign exchange reserves. The Deputy Governor gave an account of the Icelandic delegation's meetings with IMF representatives and his meetings with government representatives and financial institutions at the International Monetary Fund's (IMF) Spring Meeting in Washington. The MPC was also informed of the recent meetings with the Confederation of Icelandic Employers (SA) and the Icelandic Federation of Labour (ASÍ) and with the management of Arion Banki, Landsbanki and Íslandsbanki.

The Committee observed that, in spite of weaker activity, inflation expectations over short and long horizons had risen recently and the medium-term inflation outlook had deteriorated.

According to the forecast published in *Monetary Bulletin* on 20 April, inflation is forecast to peak at just above 3% later this year and remain elevated until early next year. Assuming a stable króna and given the spare capacity in the economy, inflation is forecast to fall back to target in the latter half of 2012.

In the MPC's view, higher inflation than previously forecast is mainly a result of the lagged effects of a weaker króna and the recent rise in commodity and oil prices. The Committee argued that, to the extent that these price increases are temporary, they are unlikely to have a lasting effect on longer-term inflation expectations and wage and price-setting. However, the pay increases implied in draft wage agreements might prove larger over the medium term than is consistent with meeting the inflation target.

The first steps of the two-phase strategy for capital account liberalisation are intended to be broadly neutral in terms of their impact on the foreign exchange reserves. If this is the case then these initial steps should have limited short-term implications for the monetary policy stance.

In the Committee's view, the result of the Icesave referendum on 9 April has tilted risks to the exchange rate to the downside, as it may affect the sovereign credit rating and hence the terms at which Iceland can borrow in foreign capital markets. This may limit the MPC's room for manoeuvre over the medium term. It may also affect the pace of capital account liberalisation. Committee members thought, however, that this would be mitigated by the likelihood that the programme with the IMF will be unaffected.

The MPC discussed possible adjustments to the monetary stance. In the Committee's view, the inflation outlook has deteriorated, at least in the near term, and inflation expectations have drifted upwards. Moreover, the result of the Icesave referendum has tilted risk to the value of the króna to the downside. On the other hand, however, the baseline outlook for growth and employment has deteriorated.

Three alternative rate decisions were discussed: to keep rates unchanged or to raise them or lower 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. One member voted against the Governor's proposal, preferring to raise interest rates by 0.25 percentage points. This member put more weight on the factors leading to more persistent inflation, such as wage pressures, higher inflation expectations, and the possible weakening of the króna.

The Committee agreed that the direction of future policy moves remains uncertain. 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, 15 June 2011.