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

# Minutes of the Monetary Policy Committee meeting

# August 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 15-16 August 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 17 August, 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 15 June interest rate decision, as reflected in the updated forecast and risk analysis published in *Monetary Bulletin* 2011/3 on 17 August.

### Financial markets

The trade-weighted value of the króna in the onshore market was 0.9% higher at the time of the August MPC meeting than at the June meeting. Between the two meetings, the króna appreciated by 1.1% against the euro, 0.6% against the US dollar, and 0.8% against the pound. The króna had depreciated by 5.1% in trade-weighted terms since the start of the year, however.

The Central Bank has bought in regular purchases 76.5 million euros in the domestic interbank foreign exchange market since it began 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 220-245 against the euro, but volume and frequency of trading remained low.

The CDS spread on the Republic of Iceland rose from 276 basis points at the time of the June meeting to over 306 basis points in the wake of turbulence in global markets. At the time of the August meeting, however, the CDS spread had eased back to 242 basis points. In June the Republic of Iceland issued a five-year bond at 320 basis points over USD LIBOR swap rates. From the date of the issue to the August meeting, the spread over comparable five-year US Treasury bonds had risen from 340 basis points to 430 basis points.

Overnight interbank interest rates had been stable at 3.75% since the June meeting. Trading in the interbank market amounted to 75 b.kr. since the June meeting, with volume concentrated in overnight maturities, although there had also been transactions involving other maturities.

About 99 b.kr. worth of certificates of deposit (CDs) were outstanding as of the August meeting, approximately 40 b.kr. more than at the time of the June meeting. The main reasons for this increase is a redemption of a Treasury note in July and tax repayments in early August.

Except for the yield on the bond maturing in 2016, which had fallen by roughly 1 percentage point, yields on longer-term Treasury bonds had fallen slightly since the June meeting. At the same time, yields on shorter-term Treasury bonds had risen slightly, while yields on HFF bonds were almost unchanged.

Breakeven inflation (the difference between nominal and indexed bond yields) had risen in recent months, and the average breakeven inflation rate for the next five years was estimated at around 4.3% at the time of the meeting. This is an increase of about 2.4 percentage points since the end of January 2011.

Preliminary figures on the banking system in June showed that the net position of outstanding loans to residents was virtually unchanged from the previous month. Loans to the corporate sector decreased by 1.2%, while total lending to households rose by 0.7%. Broad money (M3) increased by 1.3% month-on-month in June but remains 5.0% lower than at the same time in 2010.

The nominal effective policy rate is currently approximated as the simple average of the Central Bank deposit and maximum CD rates. Averaging across different measures of inflation and inflation expectations, real policy rates have fallen by roughly ½ percentage point since the 15 June meeting, to -1.2%. Based on the twelve-month rise in the consumer price index (CPI), the *ex post* real rate had fallen by 1.5 percentage points to -1.3%, while in terms of breakeven inflation rates, it had fallen by 0.9 percentage points to 0.1%.

Although a 0.25 percentage point reduction in 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 maintain unchanged rates at the August meeting. Most parties cited the economic slack as a hindrance to an increase in interest rates. However, one analyst predicted 0.25 percentage point increase in interest rates based on deteriorating inflation prospects and higher inflation expectations.

The second auction related to the capital account liberalisation strategy was concluded on 16 August. The Central Bank offered to buy 72 million euros against payment in Treasury bonds. Offers were submitted for 3.4 million euros, and all offers were accepted. The auction was a single-price auction, so that all accepted offers were made available to primary dealers at the same price, which was set at 210.00 kr. to the euro.

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

According to the latest IMF forecast, published in June, global growth is expected to reach 4.3% in 2011, which is in line with the IMF forecast published in April 2011. However, the forecast for inflation has been revised upwards, and the IMF now expects global inflation to measure 2.6% this year, 0.4 percentage points more than in its April forecast. The forecast for world trade has also been revised upwards by 0.8 percentage points, and trade is expected to increase by 8.2% in 2011. Prior to the meeting, new forecasts from *Consensus Forecasts* emerged, suggesting a downward revision of growth in 2011 in Iceland's main trading partners by roughly 0.2 percentage points.

Iceland's merchandise trade surplus was just over 12 b.kr. in June and July (according to preliminary numbers), down by 3.5 b.kr. from the same period last year. The value of exports was broadly unchanged year-on-year, but up by 3% excluding irregular items such as airplanes and ships. Export values of marine products increased by 8%, while exports of industrial products fell by 0.7%. The value of imports in June and July increased by 4.5% year-on-year, led by a 24% increase in the import value of fuels, while import values of investment goods fell by 7% and industrial supplies were down 1%.

The average price of aluminium was almost 1% lower in the first two weeks of August than during the two weeks preceding the June MPC meeting. The value of marine products had continued to rise, increasing by 1.1% month-on-month in June, and was 12.8% higher in Q2/2011 than a year ago.

**The domestic real economy and inflation**

The Statistics Iceland labour market survey for Q2 suggests that labour demand is on the rise again. The number of persons in the labour market rose year-on-year, as did the average number of hours worked. The number of full-time workers rose, and the number of part-time workers fell for the second consecutive quarter. Thus the total number of hours worked rose, by about 1% year-on-year.

Seasonally adjusted unemployment has remained unchanged at 7% since May, while registered unemployment fell by 0.8 percentage points to 6.6% in July.

The wage index rose by 3.9% month-on-month in June, and has increased by 7.1% since June 2010. Real wages increased by 3.4% month-on-month in June and by 2.7% year-on-year.

According to the Capacent Gallup business sentiment survey conducted in May and June, more firms in all sectors were considering laying off staff than in the March survey. Firms planning to shed staff in the next six months outnumbered those planning to recruit by 17 percentage points.

Consumer sentiment has deteriorated slightly over the past two months, due mainly to bleaker sentiment about the economic situation in six months. Sentiment towards the current economic situation, however, has not measured higher since October 2008.

According to quarterly results from a survey in June, expected big-ticket purchases declined from the previous survey in March, and were lower than at the same time last year. Expected housing purchases were lower than a year ago, despite the increased turnover and recent price rises in the housing market.

A Central Bank survey of planned investment among 114 firms suggests that business investment apart from energy-intensive industry and ships and aircraft will be significantly stronger in 2011 than was assumed in the April forecast, suggesting an increase of around 6% instead of a decline by 3% in the April forecast.

According to Capacent Gallup's business sentiment survey, conducted in May and June, corporate executives were more pessimistic about the economic situation six months ahead than they were in March. Almost a third of participants expected the situation to worsen, while half believed it would remain unchanged, compared to 24% and 54%, respectively, in March. Executives were also more pessimistic regarding the outlook for domestic demand over the next six months, especially in construction and transport/tourism. Expectations of foreign demand remained almost the same in June as they have been since March 2009.

Indicators of domestic demand suggest a strong pick up in private consumption in Q2/2011 compared to Q1. Households' seasonally adjusted payment card turnover in Iceland and abroad was about 2.6% higher in real terms in Q2 than in Q1. In July, seasonally adjusted payment card turnover rose by 0.7% month-on-month. Retail turnover had also been on the rise quarter-on-quarter in Q2/2011, although developments in individual components varied; sales of electronic equipment and furniture had risen sharply, while groceries turnover had grown more slowly and clothing and alcoholic beverage sales have contracted.

Statistics Iceland's nationwide housing price index, published in July, increased by 1.3% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, rose by 0.5% month-on-month in June, and by 1.1% when adjusted for seasonal variability. Some 71% more contracts were concluded in June than during the same month in 2010, and in the first six months of 2011, 73% more contracts were concluded than in the same period in 2010. The number of contracts remains very low in historical context, however.

Executives' median expected inflation measured 3.6% one year ahead, according to the Capacent Gallup business sentiment survey conducted in May and June, and had declined by 0.4 percentage points since the survey in March. In March, however, executives' inflation expectations had risen by 2 percentage points from the survey in December.

In another Capacent Gallup survey in June, household inflation expectations one year ahead increased by 1.5 percentage points from the previous survey in March, and measured 5% according to the median. Households' one-year inflation expectations have not risen between surveys since October 2008. The median household expected twelve-month inflation to measure 5% in two years, a 1 percentage point increase from March.

The CPI rose by 0.1% month-on-month in July, following a 0.5% increase in June. Annual inflation measured 5.0% in July, compared to 3.4% in May. Annual inflation excluding tax effects measured 4.8% in July. In July, the seasonally adjusted CPI had risen by 1.7% over the previous three months, or 7.0% 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 real interest rates) measured 3.3% in July, up from 2.3% in May. It should be noted 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.

Many factors contributed to the rise in inflation in June and July, but the housing component had the largest effect, almost 0.5 percentage points in all. According to Statistics Iceland, market prices of housing have risen by 5.7% year-on-year, the largest annual increase since autumn 2008. Other factors that contributed significantly to inflation were rising food and services prices. The summer sales effect on the CPI in July was -0.4 percentage points, which was less than at the same time last year.

According to the updated forecast published in *Monetary Bulletin* on 17 August, growth during the forecast horizon is expected to be driven by rising domestic demand, particularly private consumption and business investment. GDP growth for 2011 is forecast at 2.8%, 0.5 percentage points more than was assumed in April, due to stronger private and public consumption and stronger business investment (excluding energy-intensive industry, ships, and aircraft). The forecast assumes weaker growth in 2012, at 1.6%, mainly due to a more front-loaded private consumption path and delays in projects related to energy-intensive industry. Thus, some of the growth envisaged in 2012 has now shifted to 2013, with the forecast assuming a 3.7% growth, up by roughly one percentage point from the previous forecast. The estimate of spare capacity during the forecast horizon is broadly in line with the April forecast.

It is expected that exports of goods and services will be weaker in 2011, or 1.9%, due primarily to more modest growth in services exports in the first quarter. The forecast for exports of goods and services in 2012 is somewhat lower as well, but somewhat stronger in 2013 than was anticipated in April. Excluding exports of ships and aircraft, however, the outlook during the forecast horizon is broadly in line with the April forecast.

Due mainly to the prospect of poorer terms of trade, the forecast assumes that the trade surplus will amount to 8.6% of GDP in 2011, some 2 percentage points less than was forecast in April. The current account surplus excluding deposit money banks (DMBs) in winding-up proceedings will be just under 1% of GDP, instead of the 2.4% forecast in April, and is expected to remain just under 1% by this measure in 2012, followed by a modest deficit in 2013.

Private consumption has been stronger so far this year, reflecting transitory factors, and is expected to rise by roughly a percentage point more than according to the April forecast, or by 3.8%. The effect of the transitory factors is expected to subside as the year progresses, and rising inflation is projected to cut into the increase in disposable income produced by the recent wage settlements. Private consumption is therefore forecast to grow by ½ a percentage point less per year over the next two years, or by 2½% per year.

Nominal public consumption, which has remained unchanged since Q4/2008, is expected to rise again this year, primarily due to contractually agreed rises in nominal public sector wages. In real terms, public consumption is expected to continue contracting in 2011 and 2012, but by less than in the Bank's last forecast.

Gross capital formation is estimated to increase by just over 10% this year. Growth will be concentrated in business and residential investment, as public investment is expected to contract. Even though the lion's share of the increase in investment during 2012 (16%) and 2013 (11%) is expected to come from business investment, growth is expected in all components of investment.

The turnaround in the labour market appears to be sharper than previously projected, and employment is therefore expected to rise by 1.2% year-on-year in 2011, whereas the April forecast assumed a contraction of 0.7%. Moderate growth is still expected during the forecast horizon.

Unemployment is expected to be 7% this year, or ½ a percentage point less than according to the last forecast. However, it is projected to fall back to about 4½% by the end of the forecast horizon, somewhat higher than was forecast in April.

The increase in wage costs associated with recent wage settlements in the labour market is considerably higher than was assumed in the April forecast. The outlook is therefore for unit labour costs to rise far more during the forecast horizon than according to the last forecast. They are expected to increase by about 5.7% in 2011, some 2 percentage points more than was projected in April, and by 4.3% in 2012, about 1 percentage point more than in the April forecast. In the latter half of the forecast horizon, however, it is assumed that the increase in unit labour costs will be in line with the Central Bank's inflation target.

The short- and medium-term inflation outlook has deteriorated sharply since the last *Monetary Bulletin*. Inflation is likely to measure 5.6% in Q3, whereas it was projected at 3.3% in the last forecast. Inflation is expected to peak at 6.8% in Q1/2012 and to begin to taper off again late in 2012 and reach the inflation target in the latter half of 2013, about a year later than according to the April forecast.

## II The interest rate decision

The Governor informed the Committee of the status of the sixth and final review of the IMF Stand-By Arrangement, the associated funding, and the results of the foreign currency auctions in relation to the capital account liberalisation strategy completed since the Committee's last meeting. The MPC was also informed of the outlook for government finances and the fiscal consolidation plan by representatives from the Ministry of Finance.

The Committee discussed the likely reasons why favourable current account developments in an environment characterised by restrictions on capital flows had not led to a strengthening of the króna so far this year. Possible explanations put forward at the meeting include: domestic companies are in some cases forced to reduce their foreign debt rapidly because of their inability to roll loans over due to lack of access to foreign credit, some companies might only bring enough currency into the country to pay domestic expenses, and the Central Bank's currency purchases might have impeded the appreciation of the króna. Also, the share of interest payments received by foreign holders of securities that are withdrawn has been higher in 2011 than in 2010. Some members were of the view that this might be the result of a lower risk-adjusted interest rate differential with abroad than in previous years and could herald a more general tendency to reduce ISK exposure in the period ahead, e.g. among domestic exporters. The MPC noted that there were no apparent indications that the capital controls were becoming less effective.

In the view of the majority of the Committee, the inflation outlook remained the key upside risk. Inflation had risen sharply in the past five months. Headline inflation had risen by over 3 percentage points from January to 5% in July, while underlying inflation had risen by little less, or by over 2 percentage points to 3.3%. The outlook according to the updated Central Bank forecast published in *Monetary Bulletin* on 17 August, based on a broadly stable króna, is for inflation to rise well into next year and not return to the inflation target until the latter half of 2013.

In the Committee's view, higher inflation is due in part to a weak króna and rising house and oil prices, but the outlook is for contractual wage rises to increase inflation still further in the near future, in spite of the recent modest appreciation of the króna.

While significant downside risks remain for the real economy, upside risks had also increased since the last meeting, as newly released data and the updated Central Bank forecast indicated that domestic demand and employment will grow more strongly in 2011 than was assumed in the Bank's April forecast.

Developments in recent months had also intensified the risk that higher inflation expectations and a weak currency would cause inflation to become entrenched, particularly once economic recovery gains further momentum. In the potential worst-case scenario, the expectation of higher inflation, a negative real interest rate, and a narrow risk-adjusted interest rate differential with major trading partners could further undermine the króna and cause a spiral of rising inflation and falling exchange rate, although the spare capacity in the economy should mitigate such a development to some extent.

The Committee noted the significant fall in the real effective policy rate in recent months. By that measure, monetary policy was accommodative, which is appropriate given the slack in the economy and the domestic debt crisis. However, in light of the relatively weak exchange rate and deteriorating inflation outlook, the Committee discussed whether it was appropriate to start withdrawing some of the monetary stimulus.

In the Committee's view, the recent unrest in global financial markets and weaker-than-expected output growth in major industrial countries in Q2/2011 create downward risks to the real economy. These external factors could weigh against the recent strength of domestic demand in the coming period and have a negative impact on the Icelandic economy over the medium term, although it was difficult to estimate the magnitude of this effect at the time of the meeting.

MPC members expressed divergent views about the necessity of changing the monetary stance at this meeting. The majority were of the view that is was appropriate to withdraw some monetary stimulus and reduce potential pressure on the króna in order to contain the risk of second-round effects. They are reflected in, for example, rising inflation expectations, more widespread price increases, and large wage increases which could result in the current high inflation becoming entrenched. Furthermore, the majority argued that, in view of the growing momentum in the domestic economy, the risk that a modest interest rate hike at the current juncture would derail the economic recovery was low, as the past few months' steep decline in short-term real interest rates would only be reversed to a small degree. For one member, the uncertainty regarding international developments and the continued fragility of domestic balance sheets carried greater weight than inflationary risks, and was therefore an argument in favour of maintaining the current monetary policy stance at this meeting. This member argued that the aftermath of the financial crisis called for interest rates to remain low, provided that the exchange rate did not depreciate much further. Vulnerable balance sheets, an uncertain exchange rate outlook, and high bank interest rates on new loans were holding back investment and growth. This member therefore argued that an interest rate rise would further delay the economic recovery, with additional risks to the recovery arising from the increased uncertainty in international developments. He viewed the recent rise in domestic inflation as mainly reflecting global developments, which are likely to be temporary. Although he agreed that the recent wage hikes were excessive, this member argued that a monetary tightening at the current juncture would have limited effects to offset any inflationary pressures originating in the labour market, as new lending is limited and domestic demand is weak. He also warned against raising interest rates with the aim of counteracting inflation through an appreciating exchange rate, which could also reduce Iceland's exports.

Three alternative rate decisions were discussed: keeping rates unchanged or raising them by 0.25 or 0.5 percentage points. In light of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be raised by 0.25 percentage points, which would raise the current account rate to 3.5%, the maximum rate on 28-day certificates of deposit (CDs) to 4.25%, the seven-day collateralised lending rate to 4.5%, and the overnight lending rate to 5.5%. Three members voted in favour of the Governor's proposal. One member voted against the Governor's proposal, preferring to delay the consideration of monetary tightening until the September MPC meeting.

In the view of the majority of the Committee, the interest rate increase is in accordance with recent MPC statements and reflects the fact that the inflation outlook for the coming two years has deteriorated still further since the Committee's last meeting. As a consequence, the inflation outlook might call for further interest rate hikes. As always, however, monetary policy decisions will depend on recent developments and prospects.

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 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 21 September 2011.