The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

June 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 14 June 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 15 June, 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 20 April interest rate decision.

Financial markets

The trade-weighted value of the króna in the onshore market was 1.8% lower at the time of the June MPC meeting than at the April meeting. Between the two meetings, the króna depreciated by 2.1% against the euro, by 0.9% against the US dollar and by 1.6% against the pound.

The Central Bank has bought 63 million euros in the domestic interbank foreign exchange market since it began regular foreign currency purchases at the end of August 2010.

The króna has appreciated against the euro in the offshore market since the last MPC meeting, trading at 220-254 against the euro, but volume and frequency of trading remain low.

On 9 June 2011, the Republic of Iceland issued a five-year bond for USD 1 billion. The final book size was more than USD 2 billion, and the bond was issued at 320 basis points over the USD LIBOR rate.

The CDS spread on the reference five-year USD Republic of Iceland debt rose from 224 basis points at the time of the April meeting to 280 basis points at the time of the June meeting. This may have been a result of the issuance of the above-mentioned bond creating a demand for associated insurance. Prior to 9 June no five-year USD Republic of Iceland debt had existed for some time and trading in the reference Republic of Iceland CDS had been limited.

Overnight interbank interest rates had hovered between 3.5-4.0% since the April meeting. Trading in the interbank market amounted to 65 b.kr. since the April meeting, with volume concentrated in overnight maturities, although there had also been transactions involving other maturities. About 57.1 b.kr. worth of certificates of deposit (CDs) were outstanding as of the June meeting, approximately 7 b.kr. less than at the time of the April meeting.

Yields on longer-term Treasury bonds had risen by 0.72-1.20 percentage points since the April meeting, while shorter-term Treasury bonds had fallen by 0.2 percentage points. At the same time, yields on HFF bonds had risen by 0.19-0.28 percentage points.

Breakeven inflation, that is 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 to be between 3.8% and 5% at the time of the meeting. This is an increase of about 2 percentage points since the end of January 2011. Preliminary attempts to separate breakeven inflation for one year into inflation expectations and inflation risk premium suggest that an increase in the inflation risk premium may have accounted for some of the rise in breakeven inflation.

Preliminary figures on the banking system in April showed that the net position of outstanding loans to residents decreased by 1.1% from the previous month. Loans to the corporate sector decreased by 0.1%, and total lending to households fell by 2.0%. Broad money (M3) decreased by 1.3% month-on-month in April and has decreased by 7.9% year-on-year.

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 to -½% since the 20 April meeting. Using the twelve-month rise in the consumer price index (CPI) the *ex post* real rate had fallen by 1.1 percentage points to 0.2%, while in terms of breakeven inflation rates it had fallen by 0.8 percentage points to 1.1%.

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 June meeting. Most parties cited the economic slack as a hindrance to raising interest rates.

The first step in the capital account liberalisation strategy, a multi-price auction in which the Central bank of Iceland offered to buy Icelandic krónur for euros, was successfully concluded on 7 June. In all, offers were submitted for 61 b.kr., and offers amounting to

13 b.kr. were accepted. The minimum price of accepted offers was 215 kr. per euro and the average accepted price was 218.9 kr. per euro.

Outlook for the global real economy and international trade

According to the latest OECD forecast, published in May, global growth is expected to reach 4.2% in 2011, which is in line with the OECD forecast published in November 2010. The forecast for growth in Iceland's main trading partner countries is somewhat higher than was expected in November, at 2.1%. The growth forecast for world trade is broadly unchanged, at 8.1% in 2011 and 8.4 % in 2012.

Iceland's merchandise trade surplus was 6 b.kr. in April and, according to preliminary data, 6.8 b.kr. in May. Despite a year-on-year increase in both exports and imports in the first five months of the year, the trade surplus fell by a fifth from a year earlier.

While both import and export values fell month-on-month in April, partly due to the effect of the Easter holidays, both import and export values grew year-on-year in April. Export values rose by 8% year-on-year, led by a rise in the export value of ferrosilicon and aluminium. Import values grew by 12%, led by increases in the import value of industrial supplies and consumer goods.

On average, the price of aluminium was 5% higher in April than in March. It peaked at the beginning of May and came down a bit during the month, but was back to early April values by the beginning of June. The value of marine product exports has continued to rise, increasing by 1.5% month-on-month in April, and the price level has risen by over 14% in the last twelve months.

The domestic real economy and inflation

Seasonally adjusted GDP grew by 2.0% quarter-on-quarter in Q1/2011, after falling by 1.5% in Q4/2010 according to Statistics Iceland preliminary national account numbers. The growth is almost entirely due to an increase in inventories amounting to 5.6% of GDP. Private domestic demand weakened with both private consumption and gross fixed capital formation contracting, while public consumption was broadly unchanged. Both exports and imports contracted between quarters, while the contribution of net exports to output growth was slightly positive. The large stock of inventories, however, is export goods which have been sold, but not yet shipped out, and it will contribute to exports in the next two quarters.

Statistics Iceland's preliminary figures show a 3.4% year-on-year growth in GDP for Q1/2011, much larger than the 0.8% forecast by the Central Bank. Some of this difference may be due to Statistics Iceland underestimating investment in 2010. Correcting for this would yield a year-on-year growth of 3.1%. Year-on-year growth in private consumption measured at 1.5%, in line with the Bank's forecast of 1.3% growth. Domestic investment was weaker than the Bank expected, however, growing by 13.3% year-on-year instead of the 20.1% forecast. Public consumption proved stronger, however, contracting by 0.7% year-on-year instead of the 2.1% contraction forecasted by the Bank. The deviation can be explained by a pick-up in local governments' nominal spending and differences in consumption deflator assumptions.

Exports of goods and services were weaker than forecast, partly due to the large inventories yet to be exported, contracting by 1.6% year-on-year as opposed to the 3.9% growth forecast. Imports of goods and services were also weaker than forecasted, growing by 1.3% instead of the 4.5% growth that was predicted. The trade balance was somewhat weaker than anticipated, with a surplus of 5.8% of GDP, instead of the forecasted surplus of 8.1% of GDP.

The current account deficit was almost 13% of GDP, or 48 b.kr., in Q1/2011. This is a smaller deficit than in the previous quarter but higher than the average deficit of 10% in 2010. The underlying current account balance – that is, excluding banks in winding-up proceedings – was negative by 2.5% of GDP.

There are signs of recovery in the labour market, according to the recent Statistics Iceland labour force survey. In Q1/2011, both the employment rate and the participation rate of core workers rose year-on-year, as it had done in Q4/2010 for the youngest workers. Total hours worked in the reference week increased by almost 2%, due to a 3.6% increase in the contribution of core workers.

The wage index rose by 0.1% in April after having risen by 0.3% in March. Year-on-year wages increased by 4.4% in April and real wages by 1.5%. Seasonally adjusted unemployment had fallen by 0.5 percentage points since the last meeting, to 7%, while registered unemployment was 7.4%.

New wage settlements were signed by the national member associations and the largest unions within the Icelandic Federation of Labour and the Confederation of Icelandic Employers on 5 May 2011. The wage settlements apply to roughly one-third of the labour force as measured in man-years, but their impact on the cost of labour will probably extend to most of the private and public sector. It is estimated that gross wage costs incurred by employers in the private sector will rise on average by 4½-5% a year during the three year term of the settlement. Net wage costs incurred by employers will probably rise less, however, as the Government has pledged to lower the payroll tax 2012 and 2013 in line with the decline in unemployment.

Statistics Iceland's nationwide housing price index, published in May, increased by 0.4% from the previous month. The greater Reykjavík housing price index, calculated by Registers Iceland, rose by 0.7% month-on-month in April, and by 1.6% when adjusted for seasonal variability. Some 86% more contracts were concluded in April than during April 2010, and in the first four months of 2011, 66% more contracts were concluded than in the same period in 2010. The number of contracts remains very low in a historical context, however.

Seasonally adjusted payment card turnover suggests that private consumption will be stronger in Q2/2011 than in the previous quarter. Consumer sentiment improved in May, after having declined slightly in April. Expectations about the economic situation six months ahead and sentiment towards the labour market increased the most. Also in May, sentiment towards the current economic situation, which has remained very low over the past two years, showed its largest monthly improvement since before the financial crisis.

The CPI rose by 0.94% month-on-month in May following a 0.78% increase in April. Annual inflation measured 3.4% in May, compared to 2.3% in March. Annual inflation excluding tax effects measured 3.2% in May. The seasonally adjusted CPI rose by 2.5%

over the previous three months, or 10.3% on an annualised basis. Annual core inflation 3 (headline inflation excluding tax effects, volatile items such as food and petrol, public services, and mortgage interest payments) measured 2.3% in May, compared to 1.3% in March. 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.

Many factors contributed to the rise in inflation in April and May, but the housing component had the largest effect, almost 0.5 percentage points in all. While the increase was mostly due to a rise in paid and owner-imputed rent, part of it was due to a correction in the building cost index, which affected the cost of housing maintenance. Other factors that contributed to recent inflation included increases in public service prices, international airfares, and petrol prices. Part of the recent rise in international airfares stems from higher global oil prices.

II The interest rate decision

The Governor informed the Committee of the recently completed fifth review of the IMF Stand-By Arrangement, the associated funding, and the outlook for reserves. He also informed the MPC of recent rating actions on Iceland, the issuance of euro-dollar bonds by the Republic of Iceland, and the results of the first foreign currency auction in relation to the capital account liberalisation strategy.

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 headline inflation has increased for four consecutive months, reaching 3.4% in May. In the Committee's view, it will likely remain elevated through next year. Core inflation still remains close to the inflation target, however. The increase in inflation mainly reflects the lagged effects of a weak króna and the recent rise in commodity and oil prices. To the extent that the króna is broadly stable and these price increases are temporary, they are unlikely to have a lasting effect on inflation over the medium term.

The MPC discussed possible adjustments to the monetary stance. In the end, the Committee considered two options: keeping rates unchanged and raising them by 0.25 percentage points.

The recent rise in actual and expected inflation were arguments for monetary policy tightening. Stronger wage pressures, implied by the recent wage agreements also suggest mounting inflation risk, especially given the weak króna. In most members view, the latest national account data and labour market survey outcome were broadly in line, or even somewhat stronger, than the Bank's latest forecast. These members argued that together with an outlook for a more expansionary fiscal stance, this could suggest more robust demand growth going forward than the Bank's latest forecast assumes.

The arguments for keeping rates unchanged, however, are the continued significant slack in the economy and the contraction in money and credit aggregates. Both would suggest that the recent rise in inflation will be transitory and that inflation will thus return to target once the effects of these shocks peter out.

Members of the Committee had different views on the strength of the real economy, how much of the recent rise in long-term nominal interest rates actually reflected rising inflation expectations, the extent to which the supply shocks contributing to inflation were likely to be transitory, on the outlook for the króna and on the likely effects of a tighter monetary policy on the domestic economy.

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%.

The Committee voted unanimously in favour of the Governor's proposal, although one member would have preferred to raise interest rates by 0.25 percentage points, placing more emphasis on factors suggesting greater inflationary risks. Most members agreed that significant inflation risk remains and the danger is that inflation will prove more entrenched than is currently expected. With this in mind, the majority of the Committee agreed that it was appropriate to shift to a tightening bias in the Committee's statement, although future policy moves will, as always, depend on 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 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, 17 August 2011.