



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

December 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 1 and 6 December 2011, during which the Committee discussed economic and financial market developments, the interest rate decision of 7 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 economy and Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 2 November interest rate decision.

Financial markets

The trade-weighted value of the króna in the onshore market was 1.1% lower at the time of the December MPC meeting than at the November meeting. In the offshore market, the króna had depreciated against the euro since the last MPC meeting, but volume and frequency of trading remained low.

Interbank market trading totalled 40 b.kr. in November, and turnover for 2011 had already exceeded 2010 turnover. Due to temporarily tight liquidity conditions in the interbank market, overnight interbank interest rates had shifted to the centre of the interest rate corridor in mid-November.

Reflecting a decline in long-term inflation expectations, nominal long-term yields in the secondary market had fallen between the November and December meetings, while yields on indexed long-term bonds were broadly unchanged.

The CDS spread on the Republic of Iceland had risen from the meeting in November, broadly following the trend in the Baltic countries.

The nominal effective policy rate is estimated as the simple average of the Central Bank deposit and maximum CD rates. Averaging across different measures of inflation and inflation expectations, the real policy rate was broadly unchanged since the November meeting, at -0.4%. The real rate based on inflation over the past twelve months was broadly unchanged at -1.0%. In terms of breakeven inflation rates, it was 0.1%.

Unchanged Central Bank rates appeared to be priced into the yield curve, and most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to keep rates unchanged. Most commercial banks' research departments expect unchanged interest rates throughout 2012.

Broad money (M3) decreased by 1.1% month-on-month in October and increased by 5.1% year-on-year.

Outlook for the global real economy and international trade

According to the latest OECD forecast, published in November, the forecast for global growth and world trade has been revised downwards substantially from the May forecast. The OECD expects a mild recession in the euro area and only 0.2% output growth in 2012. However, the forecast for inflation is unchanged. The forecast for growth in 2011 in Iceland's main trading partner countries has been revised downwards from 2.1% in May to 1.6%, and output growth in 2012 is expected to be 0.8%, down from 2.3% in the May forecast. The *Consensus Forecasts* projections for Iceland's main trading partner countries in 2012 have also been revised downwards since the November MPC meeting.

Iceland's merchandise trade surplus was 15.5 b.kr. in September and, according to preliminary data, 8 b.kr. in October. The value of both exports and imports is still growing strongly year-on-year, with export growth led by robust growth in exported marine products and import growth by substantially increased imported fuel values.

The price of aluminium has continued to fall since the last MPC meeting, while marine product prices have continued to rise.

The current account was in surplus by almost 3% of GDP in Q3/2011 (12 b.kr.), as the large surplus on the trade account more than offset the deficit on the income account. The current account balance excluding banks in winding-up proceedings was positive by almost 9% of GDP in Q3. Furthermore, revised data for the first half of 2011 showed a smaller deficit (33 b.kr.) in the first half of the year, leaving the deficit at 9% of GDP (71 b.kr.). The smaller deficit is due to both a larger surplus on the trade account and a smaller deficit on the income account.

The domestic real economy and inflation

The wage index rose by 0.7% month-on-month in October, leaving the twelve-month rise at 8.9%. Seasonally adjusted unemployment was unchanged between months at 7.6% in October, while registered unemployment increased slightly.

According to the Capacent Gallup business sentiment survey conducted in October and November, executives' expectations concerning the labour situation were slightly more positive than in June. Fewer firms were considering laying off staff, and a slightly larger number of firms were considering adding on staff. The results of the survey indicate, however, that the labour market could still weaken somewhat, as firms planning to shed staff in the next six months outnumber those planning to recruit by 10%.

High-frequency indicators suggest that private consumption might turn out stronger in Q4 than according to the Central Bank's latest forecast. The increase in turnover in October was larger than the Q3 average, and the withdrawal of third-pillar pension funds in Q4 larger than expected.

Consumer sentiment rose in November, after having fluctuated widely in recent months, although the consumer sentiment index was almost one-fourth higher than at the same time last year, based on a three-month average. All subindices rose, with sentiment towards the labour market increasing the most, following a large decline in October.

According to Capacent Gallup's business sentiment survey, conducted in October and November, corporate executives were slightly less pessimistic about the economic situation six months ahead than they were in June. The outlook for domestic demand was more optimistic than in June, while expectations of foreign demand had deteriorated.

The median executive expected inflation to measure 4% one year ahead, according to the business sentiment survey, an increase of 0.4 percentage points since the survey in June. Executives also expected twelve-month inflation to measure 4% in two years, which is unchanged from the survey in March 2011.

The CPI remained unchanged month-on-month in November. Annual inflation measured 5.2% in November, compared to 5.3% in October. Annualised seasonally adjusted three-month inflation measured 1.6%, compared to 3.4% in October. Annual core inflation 3 excluding the effects of taxes (headline inflation excluding volatile items such as food and petrol, public services, and real interest rates on mortgages) measured 4.7% in November, up from 4.4% in October. 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 in January 2011.

The largest effect on the CPI stemmed from an increase in the cost of housing, mainly due to a 1.3% rise in market prices of housing, which have increased by 7.2% year-on-year. A decline in groceries prices had an effect of -0.1 percentage points on the CPI, which stemmed mainly from a drop in domestic food and beverage prices, even though imported food prices also fell in November.

II The interest rate decision

The Governor informed the Committee of recent steps in the capital account liberalisation strategy.

The committee discussed new data on the economy that had emerged since the last meeting and agreed that they were broadly in line with the Central Bank forecast published in the November *Monetary Bulletin*. The data showed that Iceland's economic recovery continues despite weakening global growth and increased uncertainty.

The MPC noted as well that, although recent inflation outcomes have been slightly better than expected, inflation was still above the Bank's inflation target. However, recent developments were consistent with inflation returning to the target over the medium term.

The MPC members argued that, in the near term, the current interest rate level seemed broadly appropriate in light of the economic outlook and potential international headwinds. Looking further ahead, however, the Committee agreed that, as the recovery progresses and the slack in the economy disappears, it would be necessary to continue withdrawing the current degree of monetary accommodation. The degree to which such normalisation takes place through higher nominal rates would depend on future developments in inflation, however.

In light of the discussion, the Governor proposed that the Bank's interest rates be kept unchanged: the deposit rate (current account rate) at 3.75%, the maximum bid rate for 28-day certificates of deposit (CDs) at 4.5%, the seven-day collateralised lending rate at 4.75%, and the overnight lending rate at 5.75%.

The Committee voted unanimously in favour of the Governor's proposal.

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 February 2012.