



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting October 2012

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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 2 October 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 3 October, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the global outlook and the outlook for Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 22 August interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was about 6% lower at the time of the October meeting than at the August meeting. Between meetings, the króna had depreciated by 7.2% against the euro, almost 6% against the pound sterling, and just over 3% against the US dollar. Offshore trading was sparse and the offshore exchange rate therefore broadly unchanged.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market were 0.25 percentage points above current account rates. On 17-18 September, however, rates rose because of strong inflows to the Treasury and were above the centre of the interest rate corridor.

According to the breakeven inflation rate in the bond market, calculated in terms of the spread between indexed and nominal bond yields, short-term inflation expectations had declined slightly since the August meeting. The five-year breakeven inflation rate measured 4½%, broadly unchanged from the August meeting, while longer-term breakeven inflation (five-year expectations five years ahead) had risen between meetings.

The effective nominal policy rate can be estimated to lie very close to the simple average of the Central Bank's current account rate and the maximum CD rate. According to various measures of inflation and inflation expectations, the average real policy rate had risen by 0.3 percentage points since the August meeting, to 0.7%. The real rate was 0.8% in terms of twelve-month inflation and 1.4% in terms of the breakeven inflation rate calculated from bond yields.

The Republic of Iceland's sovereign CDS spread had fallen by 0.3 percentage points between meetings, to 2.2 percentage points. The risk premium on Treasury obligations, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, had declined as well. The spread between five- and ten-year Treasury bonds issued by the two countries narrowed by 0.2-0.3 percentage points between meetings, to about 3 percentage points.

Unchanged Central Bank interest rates in October appeared to have been priced into the yield curve; with financial firms' analysts divided into two camps, one expecting unchanged rates and the other expecting a 0.25 percentage point increase.

M3 grew by 0.9% month-on-month in August but had contracted by 0.2% year-on-year. Excluding holding company deposits, M3 contracted by 3.3% between years. A similar development was seen in narrow money.

Nominal lending grew somewhat in July and August. Part of that increase was due to refinancing of existing loans, although some credit creation also took place.

Outlook for the global real economy and international trade

The *Consensus Forecasts* projections for 2012 output growth in Iceland's main trading partner countries were unchanged, on average, since the August meeting, or 0.7%; however, the outlook has changed for some individual countries. The output growth forecast for the Nordic region has been revised upwards since August, while the forecasts for the euro area and the US are unchanged. The 2012 inflation forecast for Iceland's main trading partners was also unchanged from August, at 2.2%.

Iceland's goods trade surplus totalled 12.5 b.kr. in August and, according to preliminary figures, 5.5 b.kr. in September. Import values have continued to rise between years, while export values have shrunk. In the first nine months of the year, imports grew by over 5½% and exports contracted by just over 1% compared with the same period in 2011. The rise in import values is due both to higher prices and to increased volume of fuel and lubricants, as well as an increase in imports of transport equipment (in particular the importation of aircraft in January and one ship in May), and the contraction in export values is due to a decline in the value of industrial goods exports, primarily aluminium.

The price of aluminium rose slightly after the MPC's August meeting. In September, the average price was roughly 11.7% higher than in August but 10½% lower than at the same

time in 2011. Marine product prices rose by 0.4% month-on-month in August and have risen by 6.5% in the past 12 months.

The domestic real economy and inflation

According to new national accounts data published by Statistics Iceland in September, GDP growth measured 0.5% in Q2/2012, and seasonally adjusted quarter-on-quarter GDP growth was negative by 6.5%. Because inventories grew sharply during the previous quarter, underlying developments can be identified more clearly if the first two quarters of the year are examined together. GDP grew by 2.4% year-on-year in the first half of 2012. The main drivers of growth in the first half were private consumption and business investment, while national expenditure rose by a total of 4.2%. The contribution of net trade to output growth was negative by 1.5% of GDP, as import growth (8.8%) outpaced export growth (4.9%). In the main, developments in the first half of the year were well in line with the Bank's August forecast. Private consumption growth was somewhat stronger than forecast; however, growth in public consumption and public investment was weaker and the contraction in stockbuilding greater than projected. As a result, output growth in the first half was roughly 0.8 percentage points less than was forecast in August. The difference in the forecast of national expenditure was relatively less, or 0.6 percentage points.

The Bank's August forecast assumed that private consumption would continue to grow in coming quarters. The main indications of private consumption suggest that this will be the case in Q3, although there may be a contraction between quarters after adjusting for seasonality. In real terms, monthly payment card turnover was 0.6% less in July and August than in Q2; however, July-August turnover was up 1.5%, on average, from the same period in 2011.

The current account deficit was just under 12% of GDP, or 50 b.kr., in Q2, as opposed to a deficit of 11.3% of GDP in Q1. The Q2 deficit was owing to a large deficit in the balance on income (74 b.kr.), which far outweighed the 24.8 b.kr. trade surplus. The current account balance excluding the deposit money banks (DMBs) in winding-up proceedings was negative by just over 3% of GDP but was positive by ½% of GDP if pharmaceuticals company Actavis is excluded as well.

According to the fiscal budget proposal for 2013, the long-term fiscal consolidation plan is virtually unchanged from that in the 2012 budget proposal. It appears that the 2012 budgetary goal of a primary surplus in the amount of 2% of GDP will be met, as the primary balance looks set to be positive by 1.8% of GDP. The proposal for the coming year also aims for a 1% surplus on the overall balance in 2014, as did the 2012 proposal. About 90% of the consolidation measures provided for in 2009-2013 are complete. In line with the original plan, 55% of these measures were on the expenditures side and 45% on the revenues side. There is some uncertainty about some key revenue items, such as whether an 8 b.kr. asset sale will materialise, while uncertainties on the expenditures side centre on the construction of the new national hospital and whether it will be included in the budget or not. Total Government expenditure as a share of GDP has declined steadily since 2009 and is approaching its pre-crisis share.

According to the Statistics Iceland labour market survey, total hours worked declined by 0.6% year-on-year in July and August. So far in 2012, they have increased slightly (0.2%),

primarily due to an increase among the 25-and-over age group, which compensated for the 2% decline among workers aged 16-24.

Unemployment as measured by the Directorate of Labour was virtually unchanged between June and August, at 4.8%, but measured about 5½% when adjusted for seasonality.

The wage index rose by 0.1% month-on-month in August and by 5.9% year-on-year. Real wages increased by 0.2% between July and August and by 1.7% year-on-year.

The nationwide Statistics Iceland house price index, published in late September, rose by 0.5% from the previous month, and by 0.3% adjusted for seasonality. In Q3/2012, it had risen by 6.7% year-on-year. The capital area real estate price index, calculated by Registers Iceland, fell by 0.2% month-on-month in August. The seasonally adjusted change was the same. About 4% more purchase agreements were concluded in August nationwide than in the same month a year ago, and 15% more contracts were finalised in the first eight months of the year than in the same period in 2011. The number of purchase agreements is still low in historical context, however.

According to the Capacent Gallup Consumer Sentiment Survey, consumer expectations rose in September, for the sixth consecutive month, to the highest point since April 2008. Sentiment towards the economic and labour market situation in six months' time improved markedly between months. The assessment of the labour market situation also increased, with that subindex breaking the 100-point threshold for the first time since the financial crisis struck. A score over 100 means that respondents who take a positive view of the situation outnumber those who are pessimistic about it.

The results of the quarterly survey of planned big-ticket purchases, also published in September, indicate a slight decline in planned housing and motor vehicle purchases and an increase in planned overseas travel since the June survey. Planned housing and travel purchases both increased year-on-year, however.

According to Capacent Gallup's September inflation expectations survey among households, inflation expectations one year ahead had declined by 0.7 percentage points since May/June, to 5.6%. Household inflation expectations two years ahead measured 5%, a drop of ½ a percentage point since the last survey.

The CPI rose by 0.8% month-on-month in September, after falling by 0.15% in August. Annual inflation measured 4.3% in September, down from 4.6% in July. Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and the cost of real mortgage interest) measured 3.9% in September, down from 4.7% in July.

Reduced prices of items such as food and new motor vehicles, due in part to the appreciation of the króna during the summer, had some impact in August. End-of-sale effects in August and September then led to a combined 0.5 percentage point rise in the index. Petrol prices had risen for two consecutive months in September, with the increase since July measuring 6.8%. Airfares have been quite volatile in recent months, causing the index to rise by just over 0.1 percentage point in September after a steep decline in July and August.

II The interest rate decision

The Governor informed Committee members of the meetings with the International Monetary Fund in connection with post-programme monitoring of the Stand-By Arrangement. The Deputy Governor reported on the work underway in connection with the execution and implementation of the capital account liberalisation strategy.

Committee members discussed the Bank's *Financial Stability* report, published on 5 October, the status of financial institutions, and the progress made with private sector debt restructuring. They also discussed the fiscal budget proposal for 2013 and the long-term fiscal consolidation programme.

Committee members agreed that the most recent indicators could imply a slower recovery of domestic demand than was provided for in the forecast published in the August issue of *Monetary Bulletin*. On the other hand, risks due to the European financial crisis appear to have diminished somewhat, although the situation in the euro area remains extremely sensitive.

Committee members discussed recent exchange rate developments and the near-term outlook. The króna had depreciated by 6% in trade-weighted terms between meetings. The Committee considered near-term exchange rate developments highly uncertain, especially as regards foreign currency accumulation by parties faced with large foreign-denominated loan repayments.

Committee members agreed that, although inflation had been somewhat lower than was forecast in August, the long-term inflation outlook had not changed significantly since the MPC's last meeting. In addition, inflation expectations remained above the Bank's inflation target, although they had declined slightly by some measures.

The Committee discussed the possibility of keeping the Bank's interest rates unchanged or raising them by 0.25 percentage points. In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 4.75%, the maximum rate on 28-day certificates of deposit at 5.5%, the seven-day collateralised lending rate at 5.75%, and the overnight lending rate at 6.75%.

Three members voted in favour of the Governor's proposal to keep interest rates unchanged. They considered a rate increase untimely at this juncture, as there were indications of weaker growth in domestic demand than previously assumed, the recovery of the labour market was slow, inflation was lower, and the monetary stance had been tightened rapidly in recent months. The króna had weakened, but the depreciation came on the heels of an appreciation during the summer, and near-term exchange rate movements were uncertain. One member who supported the Governor's proposal was of the opinion that too steep a rate increase would also have negative supply-side effects, which, among other things, would raise businesses' fixed costs.

Two members voted against the Governor's proposal, preferring that rates be raised by 0.25 percentage points. They cited the risk that a weaker króna would exacerbate wage pressures in the tradable sector, thus triggering second-round inflationary effects, in spite of indications of slower growth in demand. In addition, inflation was still high and long-term inflation expectations had changed little, despite the recent decline in inflation. They therefore argued that it would be desirable to continue withdrawing monetary accommodation because otherwise, there was the risk that the monetary policy response would come too late to counteract inflationary pressures.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They also agreed that the interest rate increases in May and June, together with reduced inflation, had resulted in the withdrawal of some of that accommodation. As spare capacity disappeared from the economy, it would be necessary that monetary policy slack should disappear as well. The degree to which such normalisation took place through higher nominal Central Bank rates would depend on future inflation developments, but in the absence of changes in the outlook for inflation and the economic recovery, it was likely that further interest rate increases would be needed in the near future.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 14 November 2012.