



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

June 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 12 June 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 13 June, 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 outlook for the global economy and Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 16 May interest rate decision.

Financial markets

The average trade-weighted exchange rate of the króna in the domestic foreign exchange market was 0.1% lower at the time of the June meeting than at the May meeting. Offshore market trading was sparse.

Because of ample liquidity, overnight rates in the interbank market had remained below the centre of the interest rate corridor since the May meeting. Interbank market trading totalled 54.5 b.kr. in May.

Since May, nominal long-term bond yields had fallen more than corresponding indexed yields, partly reflecting reduced inflation expectations.

The Republic of Iceland's sovereign CDS spread was virtually unchanged between meetings, but the risk premium on Treasury obligations rose in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury. The spread between five- and ten-year Treasury bonds issued by the two countries widened by 0.3 and 0.5 percentage points, respectively, between meetings.

The effective nominal policy rate can be estimated to be 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 0.8 percentage points since the May meeting, to -0.4%. The real rate was -0.5% in terms of twelve-month inflation and 0% in terms of the breakeven inflation rate from bond yields.

Unchanged Central Bank interest rates appeared to have been priced into the yield curve; however, most research department analysts from financial firms expected the MPC to raise interest rates by 0.25 percentage points, citing positive Q1 output growth figures as grounds for a rate hike.

Broad money (M3) remained flat month-on-month in April but rose by 5.9% year-on-year.

Outlook for the global real economy and international trade

The global output growth forecast published by the Organisation for Economic Co-operation and Development (OECD) in May was virtually unchanged from the previous forecast, issued in November. The forecast for world trade in 2012 has been revised slightly downwards, however. Uncertainty in the forecast remains tilted strongly to the downside, owing in particular to the difficulties in the euro area. The inflation forecast for OECD countries has risen marginally since the last forecast, due primarily to higher oil prices. The OECD's 2012 output growth forecast for Iceland's main trading partners is somewhat lower than in November, at 1% instead of the previous 1.6%.

According to preliminary figures, Iceland's goods trade surplus totalled 9.3 b.kr. in April and 0.2 b.kr. in May. Both import and export values have continued to grow between years, with the increase measuring 5.4% for imports and 11.7% for exports in the first five months of the year. Increases in export values are due primarily to growth in exported marine products but also to growth in exportation of agricultural products. The increase in import values is due to increased values of imported transport equipment (primarily due to imports of aircraft in January and one ship in May), fuels, and lubricants.

The price of aluminium has fallen marginally since the MPC's May meeting. In May, the average price was over 2% lower than in April and 23% lower than at the same time in 2011. Marine product prices were up 0.8% month-on-month in April.

The domestic real economy and inflation

According to new national accounts data published by Statistics Iceland in June, GDP growth measured 4.5% in Q1/2012, and seasonally adjusted quarter-on-quarter GDP growth was 2.4%. Growth stemmed from most subcomponents, with national expenditure up by 3.9% between years and by 3.4% from the previous quarter (seasonally

adjusted). The contribution from net trade was positive in terms of the year-on-year change but negative compared to the previous quarter when adjusted for seasonality. Developments in most subcomponents of GDP were in line with the Central Bank's May forecast, which assumed 1.4% growth during the quarter. The MPC was also informed that 9.6 b.kr. in aircraft imports, previously published in Statistics Iceland's external trade figures, was missing from the national accounts data. A corresponding amount was also missing from the investment figures in the national accounts. Statistics Iceland's preliminary estimate of GDP growth in the first quarter should therefore remain unchanged even though this flaw affects measured domestic investment: instead of business investment growth of 12.9%, according to Statistics Iceland figures, it should have been 42%. Total investment growth is also stronger, at 29.3% instead of the 9.3% in the Statistics Iceland numbers. Business investment as a share of GDP therefore measured 11% instead of 8.7%, and gross capital formation relative to GDP was 14.7% instead of 12.5%. After adjusting for this correction, investment growth in Q1 is somewhat stronger than according to the Central Bank forecast in May instead of being somewhat weaker, as was provided for in Statistics Iceland's unadjusted figures. The main deviation from the Central Bank forecast therefore lies in considerably greater inventory accumulation than was previously projected.

The Bank's May forecast assumed continuing growth in private consumption in coming quarters. Private consumption growth was forecast at 3.9% year-on-year in Q2, and key high-frequency indicators at the beginning of the quarter suggest that this forecast will materialise. Payment card turnover grew by 6% in real terms in April, and new motor vehicle registrations continued to increase in number in April and May.

The trade surplus in Q1 measured 3.2% of GDP, while the forecast in the May issue of *Monetary Bulletin* assumed 6.5%. The deviation is caused primarily by higher import values than the first figures indicated, particularly aircraft imports measuring 9.6 b.kr.

The current account deficit was just over 10% of GDP, or 43 b.kr., in Q1. While this is smaller than the Q4/2011 deficit, it is above the year-2011 average of almost 7% of GDP. The current account deficit was just over 3% of GDP excluding the DMBs in winding-up proceedings, and 0.2% if the pharmaceuticals company Actavis is excluded as well.

Unemployment as measured by the Directorate of Labour was 5.6% in May, after having declined 0.9 percentage points from the previous month. Seasonally adjusted unemployment declined by 0.2 percentage points, to 5.5%, at the same time.

The wage index rose by 10.3% year-on-year in Q1, with the increase varying across sectors. Wage increases were smallest among building and construction workers and public sector employees (8½%) and largest among workers in financial services and those employed by pension funds and insurance companies (just under 14%). The wage index fell by 0.1% month-on-month in April, after having risen by 11.9% over the previous twelve months.

According to the survey carried out by Capacent Gallup in May, consumer sentiment improved slightly during the month. The Consumer Sentiment Index has risen by 17% in the past twelve months, based on the three-month average. Sentiment towards the economic situation improved most in May, whereas the assessment of the labour market deteriorated between months.

According to the Capacent Gallup survey among households, carried out in May and June, inflation expectations one year ahead had declined by 0.2 percentage points since March, to 6.3%. Household inflation expectations two years ahead measured 5.5%, a drop of ½ a percentage point since the last survey.

The consumer price index (CPI) fell by 0.03% month-on-month in May. Annual inflation measured 5.4%, down from 6.4% in April. Core index 3 (the CPI excluding volatile food items, petrol, public services, and the cost of real mortgage interest) rose by 0.4% between months, however. Annual inflation according to core index 3 (excluding tax effects) measured 5.5%, as opposed to 5.9% in April. The decline in petrol prices affected the CPI most strongly in May (-0.24 percentage points), the largest downward effect from this subcomponent in over two years.

II The interest rate decision

The Governor informed Committee members of the Bank's analysis of the risk to the Icelandic economy and the Central Bank as a result of the European financial crisis. The Deputy Governor also discussed the updated balance of payments estimate for coming years. Members discussed the Bank's *Financial Stability* report, published on 6 June, the status of financial institutions, and the progress in private sector debt restructuring.

The Committee also discussed recent exchange rate developments, as the króna had remained virtually unchanged in trade-weighted terms since the May meeting. Newly released figures show an external trade deficit (excluding the DMBs in winding-up proceedings and the pharmaceutical company Actavis) in the past two quarters. Committee members were of the opinion that this reflected, among other things, deteriorating terms of trade, which – together with seasonal factors, steep increases in domestic cost levels and repayments of foreign-denominated loans – could explain last winter's exchange rate developments.

In the MPC's opinion, the national accounts for Q1/2012 were broadly in line with the Bank's May forecast and showed that GDP growth would continue to reduce the margin of spare capacity in the economy. It was clear that the economic recovery was broadly based and that domestic demand was robust. In addition, signs of recovery in the labour and real estate markets were steadily growing stronger.

The Committee discussed the possibility of keeping interest rates unchanged or raising them by 0.25-0.5 percentage points. All members agreed that there were grounds for either a rate hike or unchanged rates. Even though inflation had subsided somewhat in May, it would be imprudent to read too much into a single inflation figure. As before, the outlook is for inflation to remain above the Bank's target for longer than is acceptable, particularly if the króna remains weak. As a result, it is necessary to continue withdrawing the accommodative monetary stance.

On the other hand, the Committee also thought there were arguments in favour of holding rates unchanged: on this occasion, because of the recent escalation in uncertainty about the global economy, particularly in view of the financial crisis in Europe. These conditions cause particular uncertainty about the domestic economic and inflation outlook. The Committee was of the opinion that, in the near future, monetary policy might need to respond to developments that could significantly affect output growth and inflation in Iceland. In such circumstances, the MPC would aim, as before, to achieve the

inflation target over the medium term while attempting to stabilise fluctuations in domestic output.

In view 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 4.75%, the maximum rate on 28-day CDs to 5.5%, the seven-day collateralised lending rate to 5.75%, and the overnight lending rate to 6.75%. All members voted in favour of the Governor's proposal, although one member would have preferred to keep interest rates unchanged in view of increased global economic uncertainty.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They were also of the opinion that raising interest rates in May and again in June had withdrawn some of that accommodation, as was appropriate in view of the recovery of the real economy and the deteriorating inflation outlook. As the recovery continued and spare capacity disappeared, it would be necessary that the 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.

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 the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 22 August 2012.