The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 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 and 13 November 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 14 November, 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 external trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 3 October interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2012/4 on 14 November.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was about 3.5% lower at the time of the November meeting than at the October meeting. Between meetings, the króna had depreciated by about 3.0% against the euro, 3.5% against the pound sterling, and 4.8% against the US dollar. Offshore trading was sparse and the offshore exchange rate broadly unchanged.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market were 0.25-0.5 percentage points above current account rates. Trading in the interbank market for krónur has contracted slightly year-on-year so far in 2012.

Just before the MPC meeting, the five-year breakeven inflation rate in the bond market was about 4½%, which was unchanged from the October meeting. The five-year breakeven inflation rate five years ahead was also 4½%, which was about ½ a percentage point lower than at the beginning of October.

The effective nominal policy rate can be estimated to lie 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 0.1 percentage points since the October meeting, to 0.7%. It measured 0.9% in terms of twelve-month inflation and 0.5% in terms of the breakeven inflation rate in the bond market (the Treasury bond maturing in 2014 is no longer used to estimate the breakeven rate, as its pricing is considered to be skewed by the capital controls).

The Republic of Iceland's sovereign CDS spread had fallen by 0.2 percentage points between meetings, to 1.9 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 also declined over this period. The spread between five- and ten-year Treasury bonds issued by the two countries narrowed by 0.3 and 0.1 percentage points, respectively, between meetings.

Unchanged Central Bank interest rates in October appeared to have been priced into the yield curve, although most financial firms' analysts expected a 0.25-point increase.

The Central Bank conducted its market expectations survey during the week of 5-9 November. According to the median response, the survey results indicate that market participants expect interest rates to be 0.25 percentage points higher at year-end than they were prior to the November meeting. This is in line with the results of the Bank's August survey.

M3 contracted by 0.6% month-on-month in September and by 1.4% year-on-year in Q3. However, the contraction was strongly affected by the reclassification of winding-up committees' and mutual and investment funds' deposits, the shift of savings to other asset classes offering higher returns, and the sale of assets acquired by deposit money banks (DMBs) in the wake of the financial crisis to individuals and companies.

Outlook for the global real economy and international trade

According to the International Monetary Fund's (IMF) October forecast, the outlook for 2012 is for slightly weaker global output growth than in the July forecast, or 3.3%. The forecast for world trade has also been revised slightly downwards. The uncertainty in the forecast has also escalated since July, and in the Fund's opinion, there is now some risk of a new economic contraction. In developed countries, output growth is too weak to reduce unemployment, and in large emerging economies, the robust growth projected in previous forecasts has lost momentum as well. Inflation is expected to be broadly at July levels this year, as the outlook is for a decline in both industrialised and emerging countries. The forecast for output growth in 2012 in Iceland's main trading partners is virtually unchanged, or 0.7% as opposed to the July forecast of 0.8%.

Iceland's goods trade surplus totalled 5.6 b.kr. in September and, according to preliminary figures, 15.7 b.kr. in October. Import values contracted somewhat year-on-year in September but then grew marginally in October. Export values developed in a like manner, contracting markedly year-on-year in September and then growing again in October. In the first 10 months of the year, imports grew by over 6½% and exports by only 0.7% compared with the same period in 2011. The rise in import values stems both from increased imported transport equipment values, owing to strong imports of ships and aircraft during the year, and the rise in fuel and lubricant values, due to marked price increases. The increase in the value of marine product exports, which is due to increased export volume, explains the increase in export values.

Aluminium prices rose by nearly 12% month-on-month in September. Marine product prices fell 1.7% month-on-month in September but have risen by about 3% in the past 12 months.

The domestic real economy and inflation

According to the Statistics Iceland labour market survey, labour demand was somewhat weaker in Q3 than in the forecast published in the August issue of *Monetary Bulletin*. At that time, total hours worked were expected to increase by over 1%, whereas they contracted by 0.6%. The contraction occurred in spite of a ½% year-on-year increase in the number of employed persons, as average hours worked declined by over 1%. The last year-on-year contraction in total hours worked occurred in Q1/2011.

A recent survey of firms' staffing plans shows that, although public institutions are most likely to address fluctuations in staffing needs by recruiting temporary workers, firms in the private sector plan instead to increase the working hours of their current employees, both by raising employment percentages and through overtime.

According to Capacent Gallup's September survey among Icelandic executives, respondents' plans to recruit or lay off staff in the next six months have changed very little since the June survey. The percentage interested in recruiting is about the same as that planning redundancies.

The October survey conducted by the Confederation of Icelandic Employers (SA) among its member organisations yielded results similar to those from the Capacent Gallup survey. If the SA results are weighted together with company size and proportional sector weight, they indicate that the number of employees in SA member companies could fall by 0.3% during the year.

The labour participation rate rose slightly year-on-year in Q3, to 81.2%, and has been about 84% year-to-date, which is broadly unchanged from last year. The employment rate has also increased year-to-date, by 0.9 percentage points. It measured just over 77% in Q3, 0.8 percentage points higher than in Q3/2011.

Q3 unemployment as measured by the Statistics Iceland labour market survey was 5%, but slightly less, or 4.7%, excluding those who had been hired but not yet begun work. Unemployment as measured by the Directorate of Labour (DoL) was similar, or 4.8% in Q3, slightly below the level forecast in August. After adjusting for seasonality, however, it measured 5½%.

The wage index rose 0.5% between quarters and about 5.8% year-on-year in Q3, broadly in line with the Bank's August forecast, while real wages rose by 0.7% between quarters and 1.5% year-on-year.

Key indicators of developments in private consumption in Q3 suggest a contraction from the second quarter and a slowdown in year-on-year growth. Payment card turnover grew 1.4% between years during the quarter but has lost pace in recent months. New motor vehicle registrations continued to rise, however, and were up 54% year-on-year in the first nine months of 2012.

The nationwide Statistics Iceland house price index, published in late October, rose by 0.7% from the previous month, and by 0.9% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.7% month-on-month in September and by 0.3% when adjusted for seasonality. Roughly 29% more purchase agreements were concluded nationwide in October 2012 than in October 2011, and in the first 10 months of 2012 they were up almost 15% year-on-year. The number of purchase agreements is still low in historical context, however.

According to the Capacent Gallup survey, consumer sentiment deteriorated considerably month-on-month in October, after having improved steadily for six months, but the Consumer Sentiment Index is still somewhat higher than it was a year ago. All subcomponents fell in October, led by the assessment of the labour market situation.

According to Capacent Gallup's September survey among executives, respondents remained downbeat about the current state of the economy, although their pessimism appears to have abated somewhat since the last survey, carried out in May and June 2012. Furthermore, a large majority of executives expected the situation to remain unchanged in six months' time. Executives in regional Iceland were markedly more downbeat than those in the greater Reykjavík area, particularly due to pessimism among fisheries executives, over 60% of whom considered conditions likely to deteriorate, as opposed to about half in the June survey.

According to the survey, executives' inflation expectations one year ahead measured 4.2%, a decline of almost one percentage point from the June survey. On the other hand, their two-year inflation expectations are unchanged at 5% since the February survey.

According to the Central Bank's quarterly survey of market expectations, carried out just before the November *Monetary Bulletin* went to press, market agents expect twelve-month inflation to measure 4.8% one and two years ahead. They also expect inflation to average 4.5% over the next 10 years. According to the responses of those who also participated in the August survey, market agents' short-term inflation expectations appear to have inched upwards, while long-term expectations are unchanged.

The consumer price index (CPI) rose by 0.3% month-on-month in October. Annual inflation measured 4.2%, down from 4.3% in September. Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and real mortgage interest expense) measured 3.6% in October, down from 3.9% in September.

Exchange rate pass-through from the recent depreciation of the króna had some effect in October, with import price increases contributing 0.3 percentage points to the rise in the CPI. The decline in the housing component offset the pass-through effect, however, lowering the market price of housing nationwide by about 0.7% month-on-month in

October. On a twelve-month basis, however, nominal house prices were up by just over 5% in October.

Developments in inflation have been rather more positive than was projected in the August *Monetary Bulletin*, with inflation measuring 4.3% in Q3, 0.4 percentage points below the forecast. The outlook is also for inflation to be below the August forecast in Q4 but broadly in line with it in Q1/2013. This is due to the offsetting effects of a stronger initial position and a larger-than-forecast margin of spare capacity in the economy, on the one hand, and a weaker currency and unexpectedly larger increases in indirect taxes, on the other. After a temporary spike in Q4/2012, however, inflation is expected to taper off. It is projected at about 4½% in Q4/2012 and about 3½% in the fourth quarter of 2013. According to the forecast, it will reach the inflation target in the first half of 2014, about half a year earlier than was forecast in August.

As the economic recovery continues concurrent with high inflation and inflation expectations, the monetary stance has tightened, particularly over the course of 2012. Most likely, though, the Central Bank's real interest rate is still somewhat below the level that is consistent in the long run with full factor utilisation and, as such, should support the economic recovery. At the same time, asset prices have continued rising and private sector debt has continued to fall.

As the year has progressed, the economic recovery has receded in several of Iceland's main trading partner countries. According to forecasts from international agencies, the global GDP growth outlook has deteriorated since August, and uncertainty has escalated in spite of stimulus measures by governments and central banks. The outlook for the euro area, Iceland's most important export market, is particularly bleak. Iceland's terms of trade have deteriorated as well and appear likely to worsen somewhat more than was assumed in August; however, the November forecast provides for more improvement than previously expected in 2013.

The outlook is also for weaker export growth this year than in the last forecast, due mostly to Statistics Iceland's revision of 2011 export figures. Exports are expected to grow about 1½-2% per year in the upcoming two years, somewhat less than in the August forecast. They will pick up somewhat in 2015, however, with increased aluminium exports. Import growth is projected to be weaker during the forecast horizon than was projected in August, due largely to the expectation of reduced imports related to energy-intensive development. On the whole, net trade will contribute somewhat more to output growth during the forecast horizon than was projected in August.

The outlook for the current account balance improves in tandem with the expectation of a larger trade surplus. The current account balance excluding the deposit money banks (DMBs) in winding-up proceedings and the effects of pharmaceuticals company Actavis is expected to be positive by an average of approximately 2½% throughout the forecast horizon but diminish over the course of the horizon, as in previous Central Bank forecasts, reflecting the fact that savings will not keep pace with growth in domestic investment.

The forecast assumes reasonably strong growth in private consumption and investment this year, offset by a contraction in public consumption. Private consumption growth will be in line with the August forecast but based on a lower level, as year-2011 private consumption figures were adjusted downwards when the national accounts were revised. Investment growth is forecast to be more robust than before, as business investment outside the energy-intensive sector is expected to grow more strongly than previously anticipated. On the other hand, investment in the energy-intensive sector is expected to be smaller in scope.

Total national expenditure is projected to grow by 2.8% in 2012, which is 0.4 percentage points less than was assumed in August. Growth is estimated at 2.6% in 2013, also 0.4 percentage points less than in August. Expenditure growth is projected at 4.9% in 2014, in line with the August forecast, and at 3½% in 2015.

Growth will be driven primarily by domestic demand during the forecast horizon, with roughly equal contributions from private consumption and investment for the forecast horizon as a whole. According to the current forecast, quarterly GDP growth will measure just under 2% in Q3 and just under 1% in Q4. This corresponds to about 2.6% growth year-on-year in H2/2012 and 2.5% for 2012 as a whole, as opposed to 3.1% in the August forecast. Offsetting the weaker output growth outlook for 2012 is a stronger outlook for the years thereafter. GDP growth for 2013 is estimated at 2.9% instead of the 2.2% assumed in the August forecast. It is expected to gain momentum in 2014, measuring about 3.5%, in line with the August forecast, and to remain at about that level in 2015.

Slow improvements in employment are expected, with unemployment forecast at 4.7% in Q4/2012 and then tapering off to about 3.5% by the end of the forecast horizon. This is broadly similar to the August forecast. In spite of this, recent indicators suggest that the labour market recovery has lost pace, as is reflected in the slowdown in the rise in total hours worked. The forecast assumes that total hours worked will continue to grow gradually, at a rate somewhat below output growth. As a result, productivity will increase during the forecast horizon. This will not suffice, however, to prevent unit labour costs from rising markedly this year, although they are expected to rise more modestly for the remainder of the forecast horizon.

The assessment of spare capacity in the economy has changed somewhat since August, in line with the downward adjustment of the year-2011 GDP level in conjunction with the revision of the national accounts, published in September, and weaker-than-forecast output growth in the first half of 2012. It is now estimated that output was about 2.5% below capacity in 2011 and will be about 1.6% below capacity this year, whereas the last forecast assumed that spare capacity would amount to 0.8% of potential output this year. The economy is projected to approach full capacity utilisation by the latter half of 2014.

As is discussed in *Monetary Bulletin*, the outlook is highly uncertain. The forecast takes account of the worsening economic outlook in Iceland’s main trading partners, but more adverse developments could weaken export growth and erode terms of trade. The outlook for the exchange rate of the króna is another source of uncertainty. In part, this is related to uncertainty about the global economy and global financial markets, but it is difficult as well to assess the long-term outlook for the exchange rate because of uncertainty about capital account liberalisation and foreign debt refinancing in the private sector. The upcoming wage settlement review and its effects are another source of uncertainty. There is uncertainty as well about public sector finances, owing to expenditure pressures related to the upcoming elections and possible Government involvement in the wage settlement review, which create uncertainty regarding assumptions in the budget. Figures from the labour market suggest that the economic recovery has been reflected to only a limited degree in labour use, which could indicate that the national accounts have overestimated economic activity or that productivity growth has been greater than previously assumed. Another possibility is the presence of errors in labour market statistics. The inflation outlook is uncertain because of several factors, some of which are detailed above. In addition, persistent, high inflation expectations give cause for concern, as they increase the risk of a wage-price spiral that would cause inflation to become even more persistent.

II The interest rate decision

The Governor reported to the Committee on the IMF Executive Board's discussion of the status and outlook for the Icelandic economy in connection with post-programme monitoring of the Stand-By Arrangement. The Governor and Deputy Governor informed members of the discussion and work underway concerning the assessment of Iceland's external debt, the resolution of the failed banks' estates, and the removal of the capital controls.

The MPC was of the opinion that the macroeconomic forecast in the 14 November *Monetary Bulletin* indicated somewhat weaker output growth in 2012 than was projected in August. Output growth would be stronger than previously forecast in 2013, however. The outlook for the forecast horizon was therefore broadly unchanged in spite of global headwinds. The economic recovery would therefore continue, with growing investment and stable private consumption growth, and the slack in the economy expected to disappear during the forecast horizon.

The Committee discussed recent developments in the exchange rate of the króna, which had depreciated by over 2% in trade-weighted terms since the MPC's meeting at the beginning of October and by about 8.5% since peaking for the year in mid-August. As before, Committee members considered the depreciation primarily the result of foreign currency hoarding by parties with foreign-denominated loan payments in the offing and of reduced foreign exchange inflows through the current account balance, owing to seasonality, poorer terms of trade, and higher domestic costs. The Committee considered near-term exchange rate developments highly uncertain, due especially to uncertainty about foreign currency accumulation by parties faced with large foreign-denominated loan repayments and possible extension of the maturity of such loans.

The MPC was of the opinion that the appreciation of the króna until mid-August was responsible for lower-than-forecast inflation. Members agreed that there was still spare capacity in the economy, but opinion was divided on the extent to which it would contain inflation, given the presence of high long-term inflation expectations, among other things. Discussion also focused on the extent to which the low exchange rate was driving inflation; that is, through increased profits in the tradable sector, which has led to significant wage inflation, with second-round effects on inflation. By the same token, volatile exchange rate movements could fuel inflation, as indications suggested that exchange rate pass-through was asymmetric.

Looking ahead, the Committee was of the opinion that a greater margin of spare capacity in the economy compared to the August forecast and a significantly lower exchange rate of the króna, would have offsetting effects. On the whole, the inflation outlook was broadly unchanged, although uncertainty about exchange rate developments during the forecast horizon led to corresponding uncertainty about developments in inflation and inflation expectations. Inflation expectations were still above the Bank's inflation target, although they had fallen somewhat 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 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 5%, the maximum rate on 28-day CDs to 5.75%, the seven-day collateralised lending rate to 6%, and the overnight lending rate to 7%.

Four Committee members voted in favour of the proposal. The main arguments in favour of a rate increase were that the current forecast confirmed that the economic recovery would continue and that the margin of spare capacity would disappear from the economy in the near future. It would be desirable to continue withdrawing monetary accommodation because otherwise there was the risk that monetary policy would respond too late to inflationary pressures. Inflation was still above target and long-term inflation expectations had changed little, despite the recent decline in inflation. There was also a significant risk that a weaker króna would exacerbate wage pressures still further in the tradable sector, thus triggering stronger second-round effects than had already come to the fore. One member who supported the Governor's proposal would have preferred to keep rates unchanged at this time because of weak signs of recovery in the labour market, which exacerbated the existing uncertainty about the strength of the economic recovery.

One member voted against the Governor's proposal, however, preferring to keep rates unchanged. This member considered the recovery still quite fragile, in view of indications that domestic demand growth had lost pace and the labour market recovery was still proceeding slowly. This member thought it unlikely that strong domestic demand caused increasing inflation, particularly due to the economic situation in Iceland's main trading partners. In addition, this member considered the effect of higher interest rates on the exchange rate of the króna uncertain under capital controls. Finally, a rate hike would have negative supply-side effects that would surface, among other things, in increased fixed costs for businesses, which would increase labour market pressures.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They also agreed that the rise in interest rates since August 2011 and the decline in inflation had withdrawn a considerable amount 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 the current baseline forecast indicated that the Bank's present nominal interest rate was sufficient to bring inflation back to the inflation target during the forecast horizon. However, this depended, among other things, on whether the outcome of the forthcoming wage settlement review at the beginning of next year was consistent with inflation declining to the target.

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 12 December 2012.