The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

February 2013

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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 Committee members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meeting held on 4 and 5 February 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 6 February, 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 12 December interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2013/1 on 6 February.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 2.6% lower at the time of the February meeting than at the December meeting. Between meetings, the króna had depreciated by 4.4% against the euro and by 0.1% against the US dollar but had appreciated by 1.8% against the pound sterling. 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 0.1-0.75 percentage points above current account rates.

Interbank market turnover totalled 399 b.kr. in 2012, having decreased by 67 b.kr. from the previous year. It continued to contract year-on-year in January.

The five-year breakeven inflation rate in the bond market was slightly over 4% just before the MPC meeting, after falling slightly since the December meeting. The five-year breakeven inflation rate five years ahead was virtually unchanged between meetings, however, and also measured just over 4%. The results of the Central Bank's recent survey indicated that market participants expected inflation to average 4.5% over the next five years (see below for further discussion of the Central Bank survey).

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 real policy rate averaged 0.9% at the time of the February meeting, which was unchanged since the December meeting. In terms of twelve-month inflation and the breakeven inflation rate in the bond market, however, it had risen by 0.3 percentage points, to just over 1%.

The CDS spread on the Republic of Iceland was 1.7 percentage points at the time of the February meeting and had not changed between meetings, in spite of the EFTA Court ruling in the Icesave case. The risk premium on Treasury obligations, as expressed in terms of the spread between interest rates on the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, had fallen by 0.8 percentage points for five-year bonds and by 0.6 percentage points for 10-year bonds.

Unchanged Central Bank interest rates in February appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most analysts cited the slowdown in the economic recovery, the recent decline in inflation, and the extension of wage agreements without additional pay increases as grounds for unchanged rates.

The Central Bank conducted its market expectations survey between 29 January and 1 February. According to the median response, market participants expect interest rates to remain unchanged in the first half of the year but to be 0.25 percentage points higher by year-end, which is lower than in a comparable survey carried out in November. The majority of market participants considered the monetary stance appropriate at the time the survey was carried out.

M3 contracted by 1.1% month-on-month in December and by 1.6% year-on-year in Q4/2012. Excluding holding company deposits, however, M3 grew by 0.8% between years in Q4. The year-on-year contraction in the money supply is probably due primarily to residents' using savings to pay down loans and invest in other asset classes, and to the sale of assets acquired by deposit money banks (DMBs) in the wake of the financial crisis.

Outlook for the global real economy and international trade

In its most recent forecast, published in January, the International Monetary Fund (IMF) revised its estimates for global output growth in 2013 and 2014 slightly downwards from its October forecast. The forecast for world trade was revised sharply downwards for 2013, but less so for 2014. The IMF now anticipates somewhat weaker output growth in major industrialised and emerging economies apart from Japan, China, and Mexico, whose forecasts are unchanged from October. The forecast for inflation in industrialised countries is unchanged since October, while the inflation forecast for emerging economies has been revised upwards by 0.3 percentage points for 2013 and 0.2 percentage points for 2014. The year-2013 output growth forecast for Iceland's main trading partners is 0.2 percentage points lower than was assumed in the October forecast, at 1.1%. Consensus Forecasts' year-2013 projections for Iceland's trading partners are unchanged since the December MPC meeting.

The goods trade surplus measured nearly 3.5 b.kr. in December. Export values fell 18% month-on-month in December, the largest decline since April 2011. Import values fell by 9% between November and December. Export values contracted by 20% year-on-year, while import values contracted nearly 26%. Excluding irregular items such as ships and aircraft, however, import values were down 11½%. The goods trade surplus for 2012 as a whole totalled 78 b.kr., a decrease of 23 b.kr. from the previous year. Total export values fell by just under ½% year-on-year in 2012, while total import values rose 3.7%. The strongest components of imports in 2012 were commodities and operational inputs, on the one hand, and consumer goods, on the other. These two items accounted for 28% and 24%, respectively, of total import values. Commodity and operational input values contracted by 6½% between years, while consumer goods values rose by the same amount. As in 2011, the value of transport equipment and fuel rose most, or by 57% and 8%, respectively. The largest subcomponent of exports in 2012 was industrial goods, which accounted for 52% of total export values. Aluminium represented 68% of industrial export values. The export value of marine products rose 4½% year-on-year. Marine products constituted 43% of exports. According to preliminary figures, the goods trade surplus totalled 11.6 b.kr. in January 2013.

Aluminium prices had fallen since the last MPC meeting, with average prices just over 2% lower in January than in December. Marine product prices have fallen for three consecutive months, with the month-on-month decline measuring 0.8% in November.

The domestic real economy and inflation

The National Budget for 2013 was approved with a deficit of 3.7 b.kr. or 0.2% of GDP and is largely consistent with the original budget proposal as regards performance, although revenues and expenditures are higher by 9 b.kr. and 10 b.kr., respectively. The surplus on the primary balance is unchanged from the original budget proposal.

According to the Statistics Iceland labour market survey, growth in labour demand was somewhat weaker in Q4/2012 than in the forecast published in the November issue of *Monetary Bulletin*. The November forecast provided for a 2.2% year-on-year increase in total hours worked, while the actual increase was 1.2%. The rise is due to a 2% increase in the number of employed persons, while average hours worked contracted (by 0.8%), as they had in the two preceding quarters. The number of employed persons rose by 1.1% year-on-year in 2012, total hours worked rose 0.4%, and employed persons as a share of the total labour force increased by 0.8 percentage points. Labour supply was virtually unchanged between years, however.

Developments in unemployment as recorded by the Directorate of Labour (DoL) were in line with the last Central Bank forecast. Seasonally adjusted unemployment measured 5.5% in Q4/2012 and 5.8% for the year as a whole. Seasonally adjusted unemployment as measured by the Statistics Iceland labour market survey was also 5.5% in Q4, but it measured 6% for the year as a whole.

In Q4, the wage index rose by 0.7% between quarters and by 4.9% year-on-year. The average wage index value for 2012 was 7.8% higher than that for 2011.

Indications from the Capacent Gallup survey among executives, carried out in November and December 2012, suggest that, in the next six months, labour demand growth could slow down slightly in comparison with the findings from comparable surveys conducted earlier in the year.

The nationwide Statistics Iceland house price index, published in late January, fell by 0.4% from the previous month but rose by 0.7% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.4% month-on-month in December and by 1.2% when adjusted for seasonality. The number of purchase contracts concluded nationwide in the month of December was up 12% year-on-year, and there was an increase of 18% between 2011 and 2012. The number of purchase agreements is still low in historical context, however.

The main indicators of developments in private consumption suggest slower growth in Q4/2012. Payment card turnover increased by 0.8% in Q4 from the previous quarter but was up 0.5% year-on-year. This is in line with the slowdown in real wage growth in the latter half of the year, as well as the reduction in third-pillar pension savings withdrawals. Consumer sentiment as measured by the Capacent Gallup Consumer Sentiment Index deteriorated in the last months of 2012 but improved again in January.

According to the Capacent Gallup survey of corporate expectations, executives' attitudes towards the economic outlook are more negative than in the previous survey, which was conducted in September 2012. The greatest change was among executives in construction, utility, and retail companies, who considered the outlook poorer than in the last survey. Financial sector executives were somewhat more positive than before, however. Expectations concerning domestic demand also deteriorated between surveys, with over 18% expecting a contraction in the next six months, as opposed to 13% in September. According to the survey, executives' inflation expectations one year ahead measured 4.5%, an increase of 0.3 percentage points from the September survey.

According to the Central Bank's quarterly survey of market expectations, carried out in late January, just before the February *Monetary Bulletin* went to press, market participants expect twelve-month inflation to measure about 4½% one year ahead. They also expect inflation to average 4½% over the next decade. Market participants' inflation expectations had declined slightly since the November survey.

The CPI rose by 0.3% month-on-month in January, after remaining unchanged in December 2012. Annual inflation measured 4.2%, down from 4.5% in November. Core index 3, which excludes the effects of taxes, volatile food items, petrol, public services, and real mortgage interest expense, fell by 0.2% in January. Underlying twelve-month inflation according to core index 3 measured 4.6%, up from 4.1% in November. Inflation averaged 5.2% in 2012, up from 4% in 2011.

The increase in January is due primarily to the rise in the price of public services, new motor vehicles, and groceries, as well as the increase in tobacco taxes. In part, these price increases are due to the recent depreciation of the króna. The counteracting effect from winter sales was stronger this year than last, however.

Although the probability of major shocks such as the dissolution of the euro area or an abrupt increase in fiscal consolidation in the US has declined considerably, the global economic situation is still highly uncertain, and the outlook in Iceland's main export markets has deteriorated somewhat. This appears to have had some impact on the domestic economy in the recent term, although the positive outcome in the Icesave dispute could counteract it somewhat by reducing uncertainty and increasing optimism. The updated forecast in *Monetary Bulletin* 2013/1 therefore assumes that year-2012 output growth measured 2.2% instead of the 2.5% provided for in the Bank's November forecast. The outlook for 2013 has deteriorated as well, with output growth now projected at 2.1% instead of the nearly 3% in the November forecast. The poorer outlook for 2013 is due primarily to slower growth in energy-intensive investment, although slower growth in private consumption also plays a role. The current forecast assumes that a portion of energy-intensive investment will be shifted from 2013 to 2014-15, slightly brightening the output growth outlook for the latter half of the forecast horizon. Output growth is now expected to average approximately 3¾% over those two years, instead of the 3½% assumed in November. Nonetheless, GDP is lower throughout the horizon than in the November forecast.

Although unemployment declined broadly in line with the Central Bank's previous forecast, the increase in total hours worked was somewhat slower than previously assumed. Because of weaker economic activity, total hours worked are expected to rise less and unemployment to fall more slowly than was projected in November.

Private consumption and external trade are projected to contribute most to output growth in 2012 and 2013, while business investment and private consumption are the predominant contributors in the latter half of the forecast horizon. The contribution from net trade is forecast to be negative in 2014-15, particularly because of strong imports related to energy-intensive industrial development.

In keeping with the estimate of weaker output growth in 2012 and 2013 than previously forecast, the output slack is now projected to be larger than was forecast in November, or about 1% of potential output. The slack is expected to diminish in coming quarters and disappear in mid-2014.

The inflation outlook for the forecast horizon is broadly in line with the November forecast, albeit with a weaker króna and more front-loaded wage increases, on the one hand, and relatively weaker economic activity, on the other, than in the last forecast. Inflation is projected at 4% in Q1/2013, which is similar to the last forecast. The November forecast provided for larger increases in indirect taxes than the current forecast. Offsetting these, however, are the effects of the recent depreciation of the króna. Inflation is forecast to average 3.8% this year, slightly more than was projected in November. It is expected to range between 3% and 4% through mid-2014 and then remain in line with the inflation target thereafter, in line with the last forecast.

II The interest rate decision

The Governor informed Committee members of the status of work within the bank and with other authorities regarding the assessment of Iceland's external debt, the resolution of the failed banks' estates, and the liberalisation of the capital controls. He also discussed recent developments in the foreign exchange market and the Bank's intervention. Because of the conditions currently reigning in the foreign exchange market, the Committee had also held an extraordinary meeting on 4 January to review these issues and discuss temporary changes in the Bank's foreign exchange purchase programme and intervention policy.

In trade-weighted terms, the króna had depreciated by 2.6% since the MPC's mid-December meeting. The Bank intervened in the market three times during the interim, selling foreign currency for 4.1 b.kr. Committee members agreed that, because of the capital controls, the exchange rate was determined principally by market flows due to goods and services trade and less by expectations based on the domestic economic outlook and the interest rate differential with other countries. The króna had weakened because, in the recent term, poorer terms of trade had reduced the trade surplus at a time of extensive currency accumulation for foreign loan payments. Looking ahead, foreign currency inflows could be expected to be weaker than previously estimated because, according to the forecast in the *Monetary Bulletin* published on 6 February, terms of trade were likely to be poorer throughout the forecast horizon than in the November forecast. It was clear that foreign currency accumulation by borrowers facing sizeable foreign loan repayments would affect foreign currency outflows, although attempts to lengthen these loans, if successful, should mitigate those effects. The banks still had sizeable foreign exchange mismatches, and the Governor mentioned work that was being done to unwind the imbalances. The Committee also considered there to be some risk that self-fulfilling expectations of a depreciation could weaken the króna still further, for example, because exporters might postpone converting export revenues to krónur.

Because of significant uncertainty about the magnitude and persistence of these effects – and therefore about near-term exchange rate developments – the MPC had determined how the Bank should apply foreign exchange market intervention as one of its tools at its January meeting. According to Article 24 of the Act on the Central Bank of Iceland, no. 36/2001, the Committee shall take decisions on the application of the Bank's monetary policy instruments. The Act also specifies foreign exchange market transactions aimed at affecting the exchange rate of the króna as one of those instruments. It was decided that the Bank would suspend its programme of regular foreign currency purchases for the time being and support the króna through foreign exchange intervention.

In the Committee's opinion, views concerning the inflation target were also important in relation to decisions about the Bank's foreign exchange market intervention. It was necessary to try to prevent excessive depreciation stemming from temporary conditions affecting foreign currency inflows and outflows. Prolonged weakness of the króna could necessitate interest rate increases due to inflation developments at a time of excess slack in the economy.

Committee members agreed that the aim of the Bank's intervention in the market should not be to maintain a given exchange rate level but to equalise foreign exchange market flows, attempt to mitigate excessive volatility, and reduce the risk that self-fulfilling expectations would exacerbate volatility stemming from temporary factors. They also agreed to follow the general rule of trying to increase the Bank's non-borrowed reserves by buying foreign currency in the market when the exchange rate is relatively high and sell it in order to mitigate volatility when the exchange rate is low.

The Committee discussed the possibility of keeping the Bank's interest rates unchanged or raising or lowering them by 0.25 percentage points. The main grounds for keeping interest rates unchanged even though inflation and inflation expectations are still above target were that recent statistics suggested weaker output growth in 2012 than previously assumed and the updated forecast in *Monetary Bulletin* indicated that the outlook for 2013 had deteriorated as well. In addition, the number of hours worked had risen less than anticipated. The inflation outlook was broadly in line with expectations, however. Although a slower rate of growth would ease inflationary pressures somewhat over the course of the forecast horizon, near-term inflation was projected to be higher than was forecast in November, owing to a weaker króna. The main arguments in favour of a rate increase were persistent high inflation and long-term inflation expectations and the need to normalise monetary restraint as the slack in the economy disappeared. Owing to the poorer economic outlook, however, that could take longer than previously assumed. Some Committee members emphasised that, although the weak króna would cause inflation to be slightly higher in the near term than was forecast in November, it was highly likely that the foreign debt refinancing would improve during the year, thereby supporting the króna. If the króna appreciates again later in the year and the slack in the economy is as pronounced as is currently forecast, inflation could taper off quickly. The main reason for a reduction in interest rates was the concern that the domestic recovery could be adversely affected if the global economy should deteriorate further. Committee members also discussed the risk that slower domestic growth would develop into a contraction, but they considered this highly unlikely under current circumstances.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. All Committee members voted in favour of the proposal.

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 in the past year and a half 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, which in turn would depend on exchange rate movements and wage-setting decisions 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 20 March 2013.