The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

February 2012

Published: 22 February 2012

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 6 and 7 February 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 8 February, 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 7 December interest rate decision, as reflected in the updated forecast published in *Monetary Bulletin* 2012/1 on 8 February.

Financial markets

The trade-weighted value of the króna in the onshore market was 2.8% lower at the time of the February MPC meeting than at the December meeting. Between the two meetings, the króna depreciated by 1.4% against the euro, by 4.3% against the pound sterling, and by 3.4% against the US dollar.

The króna had appreciated against the euro in the offshore market since the last MPC meeting, trading at 248-267 against the euro, but the volume and frequency of trading remained low.

Reflecting temporarily tight liquidity conditions, overnight interbank interest rates had shifted up to the centre of the interest rate corridor for a short time in mid-December but had fallen to around 4% in January. Interbank market trading totalled 466 b.kr. in 2011 and 69.5 b.kr in January 2012.

There were 79.6 b.kr. worth of certificates of deposit (CDs) outstanding as of the February meeting, approximately 3 b.kr. less than at the December meeting.

Reflecting an increase in the inflation premium, nominal long-term yields in the secondary market had risen between the December and February meetings, while yields on indexed long-term bonds had declined.

The CDS spread on the Republic of Iceland had fallen since the meeting in December. In recent months this spread has been close to that of 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 had fallen since the December meeting, to -0.8% as of the February meeting. The real rate based on inflation over the past twelve months was more than a percentage point lower, at -2.2%. In terms of breakeven inflation rates, it was -0.9%.

Unchanged Central Bank rates appeared to be priced into the yield curve. Most market makers, brokers, and analysts from financial institutions' research departments expected the MPC to increase rates by 25 basis points, however. Most of them cited higher inflation, higher inflation expectations, depreciation of the króna, and economic growth as arguments for a rate increase.

Broad money (M3) remained unchanged month-on-month in December and increased by 8.6% year-on-year. M3 had decreased from mid-2009 until May 2011, when there was a sudden turnaround. The rate of growth gathered pace in the latter half of 2011, but that largely reflected the fact that deposits held by companies previously classified as financial companies, but reclassified as non-financial holding companies after restructuring, are now included in money supply data.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in January, the forecast for global growth and world trade has been revised downwards substantially from the September forecast. The IMF now expects lower economic growth in most industrial and emerging economies apart from the US. The forecast for global inflation is broadly unchanged, however. The forecast for growth in 2012 in Iceland's main trading partner countries was revised downwards from 1.9% in September to 0.4%. The Consensus Forecasts projections for Iceland's main trading partners in 2012 have also been revised downwards since the December MPC meeting.

In December, Iceland's trade account was in deficit for the first time since early 2009 with a balance of -0.6 b.kr. The value of exports had fallen from the previous month, while the value of imports had grown substantially, both month-on-month and year-on-year. According to preliminary data, the trade surplus in January 2012 was 12 b.kr. The trade surplus for 2011 as a whole was 97 b.kr., down from 120 b.kr. in 2010. The total value of both imports and exports rose substantially between years in 2011; the increase in the total volume of imports and exports was smaller. The largest components of imports in 2011 were industrial supplies and capital goods which accounted for 32% and 22% of the total import value, respectively. Both were down year-on-year, however. On the other hand, the share of transport equipment and fuels increased in 2011, accounting for 9% and 15% of total import value, respectively. The largest component of exports in 2011 was industrial goods, accounting for 54% of the total export value. Aluminium exports made up 75% of industrial goods exports. The export value of marine products rose by 2% to 41% of the total share, overtaking aluminium exports again.

The price of aluminium has risen since the last MPC meeting. The average price in January was almost 6% higher than the December average. Marine product prices have also continued to increase, rising by 0.8% month-on-month in December.

The domestic real economy and inflation

The public's expectations concerning the labour situation have fluctuated since the summer, but have been on the rise since October, according to the Capacent Gallup Consumer Sentiment Index. Corporate executives' expectations towards recruitment have also been edging slowly upwards, according to the Capacent Gallup December survey of Iceland's 400 largest firms. However, firms considering redundancies still outnumber those considering adding on staff by 7.5 percentage points.

Employment, as measured by total hours worked grew by 2.4% year-on-year in Q4 as measured by the Statistics Iceland labour survey. This follows increases in both Q2 and Q3. The number of people at work declined marginally but average hours worked increased by about an hour per week. The number of part-time workers fell while the number of people in full-time employment rose. Employment, measured in man-years, grew by 1.5% between 2010 and 2011.

Labour market participation, on the other hand, fell by 1.5 percentage points year-on-year in Q4/2011, to the lowest level since quarterly labour market surveys began in 2003. The participation rate measured 80.4% on average in 2011, declining by 0.7 percentage points (almost 1,000 persons) from 2010. The number of persons outside the labour market rose by almost 3,000 at the same time, due primarily to a rise in the number of disability pensioners and students.

Registered unemployment as recorded by the Directorate of Labour measured 7.1% in Q4/2011 and 7.4% for the year as a whole, down from 8.1% for 2010. Unemployment as measured by the Statistics Iceland labour market survey was broadly unchanged between quarters, measuring 6% in Q4/2011.

High-frequency indicators through December suggest that private consumption increased from the previous quarter. Payment card turnover grew by over 3% between quarters in Q4/2011 and by over 6% from Q4/2010. Other indicators such as imports of consumption goods and new motor vehicle registrations suggest further improvement in private consumption.

Measured consumer sentiment rose in January, for the third month in a row, and has not been higher since autumn 2008. All sub-indices were up between months, with sentiment towards the labour market increasing the most. Sentiment towards the current economic situation was also at its highest since autumn 2008.

According to Capacent Gallup's business sentiment survey, conducted in December 2011, expectations about the economic situation in six months ahead have improved, especially among executives in other specialised services and the industry and production sectors. Overall, almost 22% of participants expected the situation to improve, and around 60% expected it to remain unchanged, compared to 17% and 58%, respectively, in October/November. Expectations of foreign demand had deteriorated from previous surveys in 2011, most notably in the fisheries sector.

Executives' median expected inflation measured 4% one year ahead, according to the business sentiment survey, which was unchanged from the survey in October/ November. According to another Capacent Gallup survey in December, median household inflation expectations one year ahead declined by 0.5 percentage points to 6% from the previous survey in September. The median household expected twelve-month inflation to measure 5.5% in two years, which was also 0.5 percentage points less than in September.

Headline inflation measured 5.3% in Q4/2011, unchanged from Q3/2011. The CPI rose by 0.28% month-on-month in January 2012. Annual inflation measured 6.5% in January, compared to 5.2% in November. The CPI excluding tax effects increased by a smaller amount (0.13% month-on-month) and was 6.4% year-on-year. Annualised seasonally adjusted three-month inflation measured 5% in January, compared to 1.7% in November. Core index 3 excluding the effects of taxes (headline inflation excluding volatile items such as food and petrol, public services, and real mortgage interest rates) fell by 0.8% month-on-month in January and had risen by 5.7% year-on-year, compared to 4.7% in November.

All annual inflation measurements rose significantly in January, partly due to base effects, as one year had passed since the broadcasting fee was excluded from the CPI, leading to a decline in the index of 0.4 percentage points at that time. Various price increases for public services led to a 0.45 percentage point increase in the CPI in January. Price increases of petrol and oil, alcohol, tobacco, and groceries combined contributed 0.53 percentage points to the increase (partly due to higher special duties). However, winter sales on clothing, footwear and furniture led to a decline in the CPI of 0.75 percentage points, and a decrease in international airfares contributed a further 0.15 percentage points.

According to the updated forecast published in *Monetary Bulletin* on 8 February, the GDP growth outlook is broadly unchanged from the Bank's November forecast, despite the global economic outlook continuing to deteriorate. Output growth appears to have measured 3% in 2011 and is estimated at 2½% per year in 2012-2014.

Growth during the forecast horizon is expected to be driven by rising domestic demand, particularly private consumption and business investment, while the contribution from net exports is expected to be negative for most of the period. The contribution from private consumption is expected to be significant, although smaller than in 2011. Total investment is estimated to have grown by about 7% in 2011 and is projected to grow by nearly 18% in 2012, somewhat more than was forecast in November. Stronger growth is attributable mainly to a larger increase in business investment, although residential investment is expected to grow strongly. Public investment is projected to continue declining, although the contraction in the latter part of the forecast period will be smaller than was forecast in November. The forecast assumes, as was projected in November, that the labour market will continue to improve, with a continuing modest recovery in jobs and a decline in unemployment. Despite the remaining slack in the labour market, unit labour costs are expected to increase by just over 5% this year.

The inflation outlook is broadly similar to that in November. Inflation is projected to be just over 6% in Q1/2012 before falling to 3.6% in Q4/2012, some 0.5 percentage points higher than in the previous forecast. The increase in projected inflation is due in part to the delayed emergence of wage pressures and a weaker króna. Given a broadly unchanged exchange rate, the forecast is that inflation will align with the inflation target early in 2014, somewhat later than was forecast in November.

Projected spare capacity during the forecast horizon is broadly in line with the November forecast. It is estimated to have diminished sharply in 2011 and is forecast to decline still further in 2012 and 2013 in spite of modest GDP growth.

II The interest rate decision

The Governor informed the Committee of upcoming steps in the capital controls liberalisation strategy, the work within the Bank on a new balance of payment forecast, and the forthcoming Article 4 consultation with the IMF. The Committee discussed the Central Bank's *Financial Stability* report, published after the MPC's December meeting, financial institutions' accounts and restructuring measures, as well as progress in the private sector restructuring process.

The MPC discussed the recent depreciation of the króna. The exchange rate had depreciated by 2.8% in trade-weighted terms since the MPC's December meeting. The Committee discussed a number of potential factors behind this weakening. Among those viewed as most important were the seasonal variations in foreign currency inflows, the continued deleveraging of firms' and municipalities' foreign debt, and the deterioration of terms of trade. Some members highlighted that although this deleveraging of foreign debt was putting a short run pressure on the króna, it would eventually have a positive effect on the foreign debt position of the country and the current exchange rate effect should therefore reverse in the long run. It was also argued by some members that the current low domestic real interest rates could be encouraging rapid deleveraging of companies.

Three possible rate decisions were discussed: keeping rates unchanged or raising them by either 0.25 or 0.5 percentage points. Members agreed that there were arguments both for keeping rates unchanged at this meeting and for raising them.

The main argument for unchanged rates was the fact that the short-term deterioration in inflation was foreseen at the time of the November and December meetings and the outlook for the real economy according to the updated Central Bank forecast (published in *Monetary Bulletin* on 8 February) was broadly unchanged from the November forecast. Iceland's economic recovery is predicted to continue despite weakening global growth and elevated uncertainty. Furthermore, the risk-adjusted interest rate differential was slightly higher than at the last meeting. Some members argued that the deterioration of the inflation outlook was to a significant extent due to a weakening of the króna that might prove to be temporary. The impact on the króna of the upcoming Central Bank auctions, which are part of the process of lifting the capital controls, is uncertain and it was argued that the Committee would be in a better position to assess the situation at its next meeting in March. The fragility of the recovery, the slack in the economy, and international uncertainty were also put forward as arguments for unchanged rates.

The MPC discussed the possible effects of a rate hike on firms' and municipalities' deleveraging of foreign debt. To the extent that deleveraging was weakening the króna, it was argued that raising interest rates could reduce the speed of this deleveraging. Others argued that while this would strengthen the króna in the short run, it could weaken domestic balance sheets further, thus slowing the recovery of the real economy and putting downward pressure on the króna in the longer run.

Members agreed that the deterioration in the inflation outlook was the main argument for raising rates. As the MPC noted, although short-term inflation developments were in line with expectations, inflation was now projected to subside at a slightly slower pace over the course of 2012, and assuming a broadly unchanged exchange rate, it is forecast to remain above the Bank's inflation target for somewhat longer than was projected in November. Furthermore, inflation expectations were still elevated and the Bank's real interest rate had fallen since the last meeting. Thus, in light of the high inflation level and elevated inflation expectations, and given the fact that the inflation outlook for this year had deteriorated, some members argued that a rate increase at this juncture was necessary.

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%.

Three MPC members supported the Governor's proposal while two members voted against it, calling for rates to be raised by 25 basis points. These members placed more weight on the deterioration in the inflation outlook, the presence of persistent and high inflation expectations, and the need to reverse the decline in real rates since the last meeting.

Members agreed that, in the future, it would be necessary to withdraw the current degree of monetary accommodation as the recovery progresses and the slack in the economy disappears. They agreed that the degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. They also agreed that in the absence of an improvement in the inflation outlook, an increase in nominal interest rates would probably be required in the near term in order to bring the monetary policy stance, which is still quite accommodative, to an appropriate level.

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 21 March 2012.