The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

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

The following are the minutes of the MPC meeting held on 30 September and 1 October 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 2 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 21 August interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 1.7% lower at the time of the October meeting than at the August meeting. Between meetings, the króna had depreciated by about 1.6% against the euro, 3.9% against the pound sterling, and 0.5% against the US dollar. Bids for krónur in the offshore market lay in the range of 232-265 kr. per euro.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 3 million euros (roughly 465 m.kr.) since the last MPC meeting.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market remained below the centre of the interest rate corridor, at

0.25 percentage points above current account rates. Turnover in the interbank market totalled 326 b.kr. year-to-date, broadly unchanged from the same period in 2012.

The five-year breakeven inflation rate in the bond market was 4.1% just before the MPC meeting, after rising by about 0.3 percentage points since the August meeting. The five-year breakeven inflation rate five years ahead was 4.2% and had also risen by roughly 0.3 percentage points.

At present, the effective nominal policy rate lies 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 was about 1.3% at the time of the October meeting and was virtually unchanged since the August meeting. The average of the various measures of inflation and inflation expectations was 4% at the time of the October meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged between meetings, and stood at 1.6 percentage points right before the October meeting. The risk premium on Treasury obligations maturing in 2016, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, was also virtually unchanged between meetings, at 2.6 percentage points, whereas the spread between the two countries' comparable bonds maturing in 2022 had risen by 0.2 percentage points, to 3.0 percentage points.

Unchanged Central Bank interest rates in October appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most financial market analysts had forecast no change in interest rates, citing expectations that the MPC would await the presentation of the fiscal budget and the outcome of the forthcoming wage settlements before deciding to change the Bank's rates.

Broad money (M3) grew by 1.9% month-on-month in August and by about 2% year-on-year. This was the third consecutive month that broad money had grown between years, after having contracted steadily since September 2012. Excluding holding company deposits, M3 grew by 0.7% between years in August.

The NASDAQ OMX Main List index, OMXI6, had fallen by 4.3% between meetings. Trading volume on the NASDAQ OMX Iceland Main Market totalled 192 b.kr. during the first nine months of the year, up from 53.6 b.kr. over the same period in 2012. At the beginning of October, the market value of companies listed on the main market totalled 462 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

The trade surplus for the first eight months of the year was just under 31 b.kr., about 7 b.kr. less than over the same period in 2012. Import and export values contracted, by 2% and 4%, respectively. The contraction in import values is due to a marked reduction in the value of imported transport equipment (owing primarily to strong imports of ships and aircraft in 2012), although the value of imported fuels and lubricants declined as well. In most other categories, however, import values rose year-on-year. The value of investment goods imports grew by the largest margin, or about 11%. The contraction in export values during the first eight months of 2013 is attributable primarily to a 6% downturn in industrial export values, which in turn is due mostly to a contraction in the value of exported ferrosilicon and “other “ industrial goods. Marine product export values contracted by about ½% over the same period.

The domestic real economy and inflation

According to new national accounts data published by Statistics Iceland in September, GDP growth measured 4.2% in Q2/2013. According to the figures from Statistics Iceland, seasonally adjusted GDP contracted by 6.5% quarter-on-quarter in Q2/2013, whereas it had grown by 4.4% quarter-on-quarter in the first quarter of the year. For the most part, this wide fluctuation between quarters is due to inventory changes, which had fallen substantially in Q2 after sharp growth in Q1. Because of these fluctuations, underlying developments can be identified more clearly if the first two quarters of the year are examined together. GDP grew by 2.2% year-on-year in the first half of 2013, driven mainly by external trade – services trade in particular – although private consumption made a positive contribution as well.

Output growth was somewhat stronger in H1/2013 than estimated in the Bank’s August forecast, which provided for broadly unchanged GDP between years during the six-month period. The deviation is due to more favourable developments in external trade, particularly services imports, and stronger general business investment (i.e., excluding ships and aircraft and the energy-intensive sector), as both private and public consumption evolved in line with the August forecast in the first half of the year.

The current account deficit measured 2.6% of GDP, or 11 b.kr., in Q2, as opposed to over 14% of GDP during the same quarter in 2012. This year’s deficit stems from the balance on income, which was negative by 6.7% of GDP, whereas the balance on goods and services trade was positive by 4.2% of GDP. The underlying current account balance was positive by 0.6% of GDP.

Developments in business investment and goods imports reflect strong base effects due to last year’s substantial investment in ships and aircraft, which appears to a large degree as imports.

The Bank’s August forecast assumed that private consumption growth would gain pace in coming quarters. The main indicators of private consumption so far in Q3 indicate that growth during the quarter could prove somewhat less than the 2.7% annual growth forecast in the August *Monetary Bulletin*. For example, seasonally adjusted payment card turnover was virtually unchanged, on average, from the average for the preceding quarter, and about 1½% more in real terms than during the same period in 2012.

Consumer sentiment improved in September, according to the Capacent Gallup survey. Optimism has lagged somewhat in the third quarter, after picking up strongly in the spring. The same can be said of planned big-ticket purchases. Consumer interest in major purchases has tapered off slightly, both from the previous quarter and from the previous year.

According to Statistics Iceland’s labour market survey, total hours worked rose by an average of 4.4% year-on-year in July and August. The increase is due to a 5.3% rise in the number of working persons, while average hours worked contracted by 0.8%.

Unemployment as recorded by the Directorate of Labour (DoL) has remained unchanged, both measured and seasonally adjusted figures. In July and August, unemployment measured

4%, while seasonally adjusted unemployment was 4.7%. The unemployment rate according to the labour market survey was the same.

The wage index fell by 0.1% month -on-month in July but rose by 0.2% in August. The twelve-month rise in the index was 5.7% in August, which is similar to that a year earlier. Real wages had risen by an average of 1.5% year-on-year in July and August but had remained virtually unchanged from the previous quarter.

The nationwide Statistics Iceland house price index, published in late September, remained unchanged month-on-month but rose by 0.2% when adjusted for seasonality. House prices nationwide were up 6.1% year-on-year in Q3. The capital area Real Estate Price Index, calculated by Registers Iceland, fell by 0.1% month-on-month in August but rose by 0.4% when adjusted for seasonality. The index has risen by 6.8% since August 2012. The number of registered purchase agreements was up 16% year-on-year in August, and by just over 10% during the first eight months of the year.

According to the median response to the Capacent Gallup survey from September, households' inflation expectations both one and two years ahead measured 5%. One-year expectations were unchanged since February, and two-year expectations have been unchanged since September 2012.

The CPI rose by 0.34% in both August and September. Twelve-month inflation measured 3.9% in September, down from 4.3% in August. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 4.5% in September, down from 4.7% in August. Underlying inflation according to core index 4 without tax effects, which also excludes the market price of housing, also fell by 0.2 percentage points in September, to 4.1%. For the most part, inflation appears to be driven by domestic factors, as imported goods prices excluding alcoholic beverages and tobacco, which account for just under a third of the index, have risen by only 1.4% over the past twelve months.

The increase in August is due primarily to end-of-sale effects, which were offset in part by reduced international airfares. End-of-sale effects continued to emerge in September; however, the reduction in dental expense due to subsidy of children's dental care also made an impact. Some base effects were discernible as well, raising the CPI in August and lowering it in September.

II The interest rate decision

The Governor reported to the Committee on the work done by the Bank and other authorities since the last meeting, in relation to capital account liberalisation. He also informed the Committee of the correspondence between the Bank and the Glitnir hf. winding-up committee concerning the status of the Glitnir winding-up process and the Foreign Exchange Act. Furthermore, he discussed the report sent by the Central Bank to the Minister of Finance and Economic Affairs, as inflation had deviated by more than 1½ percentage points from the inflation target in August, when it measured 4.3%. Representatives from the Ministry of Finance and Economic Affairs also informed Committee members of the highlights of the new fiscal budget proposal.

Committee members agreed that the outlook for inflation and the economy was largely in line with the level anticipated at the previous meeting. Preliminary national accounts figures for Q2/2013 and revisions of previous figures indicated, however, that output growth had been somewhat stronger in H1 than assumed in the Bank's August forecast, with GDP growing by more than 2% instead of GDP remaining broadly unchanged. Committee members considered the deviation a reflection of intra year shifts in output growth rather than an indication that output growth for the year as a whole will be stronger than previously assumed. The deviation was due for the most part to more favourable developments in external trade and stronger general business investment in the first half of the year, as both private and public consumption had developed in line with the forecast. The recovery of the labour market had also continued, as was projected in August.

Even though the króna had depreciated since the previous meeting, Committee members agreed that the inflation outlook had not changed markedly in the interim. Inflation had risen somewhat in Q3, in line with the Bank's August forecast, which assumed that it would rise slightly in the latter half of the year and then begin to subside towards the target beginning in early 2014.

As in the August meeting, the MPC agreed that one of the main uncertainties in the inflation forecast was the outcome of the upcoming wage settlements, which would have a decisive effect on the Committee's near-term interest rate decisions. In the forecast, it was assumed, based on past experience, that the upcoming wage settlements will provide for larger pay increases than is consistent with price stability. The MPC agreed that, if pay increases are in line with the forecast, it will probably be necessary to raise the Bank's nominal interest rates, other things being equal, particularly if the margin of spare capacity in the economy continues to narrow. If wages should rise in excess of the forecast, the bank will be even more likely to raise interest rates. If wage increases should be consistent with the inflation target, however, inflation would fall more quickly than currently assumed and interest rates would be lower than would otherwise be necessary, other things being equal.

The Committee discussed the reasons why the Bank's intervention in the foreign exchange market had not moderated inflation expectations, even though it had contributed to reduced exchange rate volatility. Members considered it most likely that, in addition to uncertainty about the upcoming round of wage negotiations, the persistence of inflation expectations could be due to uncertainties related to the effects that foreign debt deleveraging, the settlement of the failed banks' estates, and capital account liberalisation would have on future exchange rate developments.

Committee members agreed that future fiscal policy had been clarified to some extent with the new fiscal budget proposal. In accordance with previous budget plans, the proposal assumes that the surplus before financial income and expense (i.e., the primary surplus) will increase from this year's level and that debt will decline as a share of GDP. On the other hand, the outlook is for a smaller overall surplus than previously anticipated. MPC members agreed on the importance of achieving an overall surplus as soon as possible so that the monetary and fiscal policy mix would contribute to external balance of the economy, foster overall economic stability, and deliver inflation close to target, at the lowest possible cost.

Committee members were somewhat concerned that it appeared as though the budget proposal assumed that the bond issued by the Treasury at the end of 2008 to recapitalise the Central Bank of Iceland would be settled with the delivery of a new bond of lesser value. This could be in contravention of the Act on the Central Bank of Iceland, which prohibits the Bank from lending money directly to the Treasury and assumes that the Treasury's share in the Bank's profits is in the form of a dividend. These plans could also be considered monetary financing by the Treasury and would therefore entail monetary easing to which the

Committee might need to respond with a tighter monetary stance than it would otherwise. On the other hand, it emerged that discussions of the financial interactions between the Treasury and the Central Bank were underway, including discussions of the bond in question, and that it was not timely to assume that this would be the result.

Committee members were concerned that national saving was on the decline and was insufficient to support an appropriate investment level at a time when a current account surplus would be required in order to reduce the risk related to a relatively heavy foreign debt service burden.

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. One member expressed concern, however, at the persistence of inflation and inflation expectations. This member nonetheless supported the Governor's proposal on the grounds that it was not appropriate to respond to these concerns specifically at the present time.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. It was still the case that as spare capacity disappeared from the economy, it would be necessary that the slack in monetary policy should disappear as well. The degree to which such normalisation took place through changes in nominal Central Bank rates would depend on future inflation developments, which in turn would depend to a large extent on wage developments and exchange rate movements.

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 and representatives of the Ministry of Finance and Economic Affairs attended part of the meeting.

Markús Möller wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 6 November 2013.