The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

March 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 Monetary Policy Committee meeting held on 19 March 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 20 March, 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 6 February interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 4.5% higher at the time of the March meeting than at the February meeting. Between meetings, the króna had appreciated by about 5.5% against the euro, 5.2% against the pound sterling, and 0.7% against the US dollar. The offshore exchange rate had changed little between meetings, however.

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 0.25-0.65 percentage points above current account rates. Turnover in the interbank market has totalled 121 b.kr. year-to-date, which is somewhat of an increase from the same period in 2012.

The five-year breakeven inflation rate in the bond market was 4.2% just before the MPC meeting, after rising slightly since the February meeting. The five-year breakeven inflation rate five years ahead was 3.7% and had fallen by just under 0.4 percentage points between meetings. To some extent, this is probably related to the rise in risk premia on indexed Housing Financing Fund (HFF) bonds following the downgrade of the HFF's credit rating and therefore does not reflect reduced inflation expectations.

The NASDAQ OMX Main List index, OMXI6, had risen by 3.5% between meetings. The market value of the 11 firms currently listed on the main market totalled around 360 b.kr. as of end-2012, or just over 20% of year-2012 GDP.

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 0.8% at the time of the March meeting, about 0.1 percentage point lower than at the February meeting. In terms of twelve-month inflation, it had fallen by 0.6 percentage points, and in terms of the breakeven inflation rate in the bond market it had fallen 0.4 percentage points, to 0.5% and 0.7%, respectively.

The Republic of Iceland's sovereign CDS spread had fallen by almost 0.3 percentage points between meetings, to 1.5 percentage points. 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 0.2 percentage points for five-year bonds, to 1.8 percentage points. For 10-year bonds, the premium had fallen by 0.3 percentage points, to about 2 percentage points.

Unchanged Central Bank interest rates in March appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most market analysts had cited last year's weaker-than-expected output growth and the recent appreciation of the króna and the associated reduction in inflationary pressures as grounds for unchanged interest rates.

Broad money (M3) contracted by 2.3% month-on-month in January and by 8% year-on-year. Excluding holding company deposits, M3 contracted by 2.7% between years in January. 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

Consensus Forecasts has revised its forecast for 2013 output growth in Iceland's main trading partner countries downwards by 0.3 percentage points, to 0.9%, since the February MPC meeting.

Iceland's goods trade surplus totalled 11.6 b.kr. in January and, according to preliminary figures, 7.6 b.kr. in February. Export values rose sharply year-on-year in January but contracted again in February. Import values, however, contracted considerably year-on-year in January and had contracted marginally in February. The contraction in export values in February was due to a reduction in industrial exports, while the contraction in import values was due to a marked reduction in the value of imported transport equipment.

Aluminium prices had fallen considerably since the MPC's February meeting, and marine product prices declined month-on-month in January, for the fifth month in a row.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, output growth measured 1.6% in 2012 as a whole and 1.4% in Q4/2012. Year-2012 output growth was driven by increased private consumption and business investment, which contributed some 2.2 percentage points combined. The contribution from export growth was about 2.3 percentage points; however, imports grew in excess of exports, making the contribution from net trade negative by 0.1 percentage points. Public investment and public consumption both contracted, making a negative contribution to output growth in the amount of ½ a percentage point. Year-2012 output growth turned out 0.6 percentage points weaker than was assumed in the Bank's February forecast, due primarily to unexpectedly strong growth in services imports. Growth in overall domestic demand was well in line with the Bank's projections, however, or 1.9%, as opposed to the 2% in the forecast.

The trade surplus in Q4/2012 measured 4.8% of GDP, while the forecast in the February issue of *Monetary Bulletin* assumed 5.6%. The deviation is due in particular to the fact that services imports were estimated to be 3.7 b.kr. less in Q4, particularly in the category "other services."

The current account deficit measured just under 3% of GDP in Q4/2012 (or 12.6 b.kr.), as the income account deficit somewhat outweighed the trade surplus. The deficit in the income account balance in Q3 and Q4 was markedly smaller than the recent average. The current account deficit excluding the deposit money banks (DMBs) in winding-up proceedings measured 0.3% of GDP in Q4. Excluding the failed DMBs and pharmaceuticals company Actavis, the current account showed a surplus of 1.3%. Revised figures for the first three quarters of 2012 show a slightly larger deficit than was indicated by previous figures.

The Bank's February forecast provided for slow growth in private consumption in the first half of 2013 and an increased pace of growth over the course of the year. For Q1/2013, growth was forecast at 1.8% year-on-year, but this figure could be expected to turn out higher because of the downward revision of private consumption figures for the first half of 2012. On the other hand, high-frequency indicators suggest somewhat weaker quarter-on-quarter private consumption growth in Q1 than was forecast in February. For instance, payment card turnover was virtually unchanged year-on-year in January and February. On the other hand, growth in retail sales was stronger at the beginning of the year than in recent quarters, and new motor vehicle registrations continued to rise in January and February.

Treasury accounts for 2012 show that the Treasury's cash-based outcome was stronger than the Ministry of Finance and Economic Affairs had budgeted. The overall income balance was negative by 40.5 b.kr., which is a 3.8 b.kr. smaller deficit than expected. The primary balance was also more positive than expected, or 18 b.kr., as opposed to the estimate of 11.7 b.kr. The Treasury's performance on an accrual basis will probably be poorer than preliminary figures on a cash basis would indicate, however, partly because of the additional capital contribution to the Housing Financing Fund and the revaluation of the Treasury's pension obligations.

Registered unemployment according to the Directorate of Labour (DoL) usually rises month-on-month in January, but in January 2013 it declined by 0.3 percentage points. The drop is probably due primarily to the expiry at the end of last year of the temporary provision extending entitlement to unemployment benefits from three years to four. Unemployment remained flat month-on-month in February, at 5.5%. Seasonally adjusted unemployment fell from 5.4% in December to 4.5% in February, its lowest point since November 2008.

The wage index rose by 0.3% month-on-month in January and by 5% year-on-year. Real wages rose by 0.1% between months in January and by 0.8% year-on-year.

According to the Capacent Gallup survey carried out among corporate executives in February and March, respondents interested in recruiting staff members in the next six months outnumbered those interested in downsizing for the first time since March 2008. More companies are interested in recruiting than in the last survey, carried out in December, and a smaller number are interested in downsizing. Only in the fisheries and financial sectors did companies planning to downsize outnumber those interested in adding on staff. The most pronounced difference in corporate recruitment plans was in the construction sector, with over 44% of firms planning to increase their staffing levels.

The nationwide Statistics Iceland house price index, published in late February, rose by 0.5% from the previous month, and by 0.9% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.2% month-on-month in February and by 0.4% when adjusted for seasonality. About 14% more purchase agreements were concluded nationwide in February 2013 than in the same month in 2012. The number of purchase agreements is still low in historical context, however.

According to Capacent Gallup, consumer optimism dwindled month-on-month in February, as the Consumer Sentiment Index had risen sharply in January, following a steep decline. The Consumer Sentiment Index was 5% higher in February 2013 than in the same month in 2012.

According to the Capacent Gallup survey, executives were more upbeat about the economic outlook than in the December 2012 survey, although there was a smaller difference between the current findings and those in the survey carried out a year ago. About 28% of respondents expect conditions to improve in the next six months, as opposed to just over one-fifth a year ago and 15% in December. Executives in nearly all economic sectors were more optimistic than in December, although the change was greatest in construction and specialised services. Expectations concerning domestic demand increased markedly from the previous survey but were broadly unchanged from a year ago. Expectations concerning demand in foreign markets had also risen since the December survey but were still lower than in last year's survey. Furthermore, executives were more optimistic about developments in EBITDA margins in the upcoming six months than in both the last survey and the one performed a year ago. The outlook for investment appeared weaker than before, however.

According to the survey, executives' inflation expectations one year ahead measured 4.5%, the same as in the December survey. On the other hand, their inflation expectations two years ahead had declined by ½ a percentage point from the September survey and also measured 4.5%.

According to Capacent Gallup's February inflation expectations survey among households, inflation expectations one year ahead had declined by about ½ a percentage point since December 2012, to 5%. They have remained around 5% or more since June 2011. The same can be said of household inflation expectations two years ahead, which measured 5% and were unchanged since the last survey.

The consumer price index rose by 1.6% month-on-month in February, the largest increase in a single month since November 2008. Twelve-month inflation measured 4.8%, up from 4.2% in January. Underlying twelve-month inflation according to core index 3 measured 5.1%, up from 4.6% in January. According to the EU's Harmonised Index of Consumer Prices (HICP), however, it measured 6.1% in February.

End-of-sale effects made the strongest impact on the CPI in February, and it seemed that sales effects retreated more rapidly than in recent years, following strong sales effects in January. Price increases for clothing, footwear, furniture, and housewares contributed 0.7 percentage points to the rise in the CPI. The effect of the depreciation of the króna was pronounced as well, raising the price of most imported goods. Increases in petrol and oil prices raised the CPI by 0.3 percentage points, the most pronounced upward effect in a single month since March 2012.

II The interest rate decision

The Governor reported to Committee members on the amendments to the Foreign Exchange Act, passed by Parliament on 9 March, and described the bill of legislation currently before Parliament, which contains further amendments to the same Act. The Deputy Governor reported on the findings from the Bank's newly published report on Iceland's underlying international investment position (IIP) and balance of payments.

The Committee discussed recent exchange rate developments, with the trade-weighted exchange rate index (TWI) rising 4.5% since the MPC's February meeting. The Committee considered that the Bank's decision to suspend its programme of regular foreign currency purchases and support the exchange rate of the króna with foreign exchange intervention had, together with other measures, proven effective. The Bank's actions had reduced the risk that self-fulfilling expectations of a depreciation would weaken the króna still further, and in this way they had supported monetary policy.

The Committee was of the opinion that, based on information emerging since its last meeting, there were grounds for keeping interest rates unchanged or for raising them by 0.25 percentage points. Preliminary national account figures for 2012 suggested weaker growth than was forecast in February. Year-2011 growth figures had been revised upwards, however. The outlook was still for a gradual economic recovery, and leading indicators from the labour market were consistent with that prospect. Inflation, however, proved considerably higher in February than previously anticipated. On the other hand, the króna had appreciated from February onwards.

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%. Four members voted in favour of the Governor’s proposal and agreed that new information was largely in line with the forecast in the February *Monetary Bulletin.* One member voted against the Governor’s proposal, however, voting instead to raise interest rates by 0.25 percentage points. This member pointed out that the near-term inflation outlook had deteriorated since the last MPC meeting, in spite of the appreciation of the króna. Long-term inflation expectations were still high, and considerable underlying inflationary and wage pressures were discernible; therefore, it was crucial to tighten the monetary stance in spite of a weaker economic recovery.

Committee members agreed that, although the economic recovery had lost some pace for the present, the margin of spare capacity in the economy had continued to narrow. The accommodative monetary stance supported the economic recovery. If inflation declined more slowly than was previously forecast, it would be necessary to reduce the monetary slack sooner than would otherwise be required. It is still the case that 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 15 May 2013.