The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2013

Published 29 May 2013

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 10 and 14 May 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 15 May, 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 domestic economy, inflation, and the outlook for the global economy and Iceland's international trade, with emphasis on information that has emerged since the 20 March interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2013/2 on 15 May.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 2.6% higher at the time of the May meeting than at the March meeting. Between meetings, the króna had appreciated by about 2.4% against the euro, 2.5% against the US dollar, and 1.4% against the pound sterling. The offshore exchange rate had risen between meetings, with bids ranging from ISK 201-233 per euro.

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 196 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 3.2% just before the MPC meeting, after falling by just over a percentage point since the March meeting. The five-year breakeven inflation rate five years ahead was 3.5% and had fallen by just over 0.2 percentage points. The median results of the Central Bank's recent survey indicated that market participants expected inflation to average 4.2% over the next five years, which is slightly less inflation than they expected in the last survey (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 1.5% at the time of the May meeting, about 0.7 percentage points higher than at the March meeting. In terms of twelve-month inflation, it had risen by 1.5 percentage points, to 2%, and in terms of the breakeven inflation rate in the bond market it had risen 1.6 percentage points, to 2.3%.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged between meetings, at about 1.5 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, was also unchanged between meetings. The spread between five- and ten-year Treasury bonds issued by the two countries was about 1.8 and 2 percentage points, respectively.

Unchanged Central Bank interest rates in May appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most market analysts cited the appreciation of the króna since the last interest rate decision, the rise in the Bank's real interest rate in tandem with declining inflation, and recent indications of weaker output growth than in the Bank's February forecast as grounds for unchanged interest rates. Uncertainty about the policies of the new Government was mentioned as a reason for unchanged rates, while expansionary campaign promises were cited as grounds for a rate hike.

Broad money (M3) grew by 0.3% month-on-month in March but shrank by 2.6% year-on-year. Excluding holding company deposits, M3 contracted by 0.7% between years. 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.

The NASDAQ OMX Main List index, OMXI6, had fallen by 5% between meetings. At the beginning of May, the market value of companies listed on the main market totalled 438 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

The most recent forecast from the International Monetary Fund (IMF), published in April, provided for weaker global output growth than the January forecast. The same applies to the forecast for world trade. The uncertainty in the forecast remains concentrated on the downside but has diminished in the wake of government stimulus measures in many countries. Output growth forecasts have been revised downwards for all countries except

Japan. A contraction is still expected in the euro area, while weak growth is projected in the UK and somewhat stronger growth in the US. In general, the IMF anticipates inflation rates similar to those in January. Inflation is expected to be slightly higher in developed countries and slightly lower in emerging countries. The Fund's output growth forecast for Iceland's main trading partners has been revised marginally downwards since January, from 1.2% to 0.9%.

According to preliminary figures from Statistics Iceland, Iceland's goods trade surplus totalled 9.3 b.kr. in March and 5.1 b.kr. in April. Import and export values rose markedly year-on-year in April, although imports slightly outpaced exports. In the first four months of the year, export values grew by just over 1½% year-on-year, while import values contracted by slightly more than ½%. The small increase in export values is due to a slight year-on-year contraction in the value of industrial exports in the first four months of the year. The contraction in import values is due primarily to reduced imports of transport equipment (mainly aircraft) and a slight contraction in the value of imported commodities and operational inputs.

The price of aluminium has fallen marginally since the MPC's March meeting. In April, the average price was nearly 3% lower than in March and more than 9% lower than at the same time in 2012. Marine product prices rose slightly month-on-month in March, after an uninterrupted six-month slide.

The domestic real economy and inflation

Registered unemployment according to the Directorate of Labour (DoL) usually rises between quarters in the first quarter of the year but remained unchanged this year, due to the expiry at the end of 2012 of the temporary provision extending entitlement to unemployment benefits from three years to four. Registered unemployment measured 5.4% during the quarter, while seasonally adjusted unemployment was 4.6%, and had declined by 0.7 percentage points between quarters. Those actively seeking work continue to be considered unemployed for the purposes of the Statistics Iceland labour market survey, irrespective of their entitlement to benefits. According to the survey, unemployment was somewhat higher during the quarter, or 5.8%, while seasonally adjusted unemployment was 5.3%, which is unchanged from the previous quarter.

The wage index rose by 2.4% quarter-on-quarter and 5.2% year-on-year in Q1/2013. Real wages rose by 0.8% between quarters and by 0.9% year-on-year.

According to the Statistics Iceland labour market survey, labour demand was somewhat stronger in Q1 than was assumed in the forecast published in the February issue of *Monetary Bulletin*. That forecast provided for a 1.5% year-on-year increase in total hours worked, while the actual increase was 2.5%. The rise was due to a 2.7% increase in the number of employed persons, while average hours worked per person remained almost unchanged.

The nationwide Statistics Iceland house price index, published in late April, rose by 1.8% from the previous month, and by about 1% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, was unchanged month-on-month in March but fell by nearly 0.2% when adjusted for seasonality. In Q1/2013, roughly 10% more purchase contracts were registered nationwide than in the same quarter of 2012.

Key high-frequency indicators of private consumption in Q1 suggest that growth had slowed somewhat. Payment card turnover in the first three months of the year contracted by 0.7% year-on-year, for example, and the rise in new motor vehicle registrations slowed markedly. Even so, new vehicle registrations rose by over 30% year-on-year in Q1, but this is significantly less than in the recent past, and in April they were down 13% year-on-year.

According to the consumer sentiment survey carried out by Capacent Gallup, consumer sentiment has been somewhat more positive year-to-date than at the end of 2012. In April, however, it turned slightly downward from the previous month. All subcomponents of the consumer sentiment index declined in April, with the assessment of the current situation falling most sharply. So far in 2013, the index has been an average of 17% higher than during the same period last year.

According to the quarterly Central Bank market expectations survey carried out in May, market agents' inflation expectations have fallen since the February survey. Market participants now expect annual inflation to measure 4% one and two years ahead, about ½ a percentage point lower than in the last survey. Their long-term inflation expectations are broadly unchanged, however, at just over 4%.

Inflation has subsided in recent months. The consumer price index (CPI) rose by 0.2% month-on-month in April, in the wake of a 0.2% increase in March. Annual inflation measured 3.3% in April, down from 4.8% in February. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 4.2%, as opposed to 5.1% in February.

Petrol prices have fallen sharply since February, with a downward CPI effect of about ½ a percentage point in March and April. The rise in the CPI in April was due primarily to an increase in house prices, primarily in regional Iceland. Prices were up 1.8% nationwide. The recent appreciation of the króna appears to have had a marginal impact on the price of imported goods in March and April, reducing the price of new motor vehicles in particular.

According to the forecast in the May issue of *Monetary Bulletin*, the inflation outlook has improved following the appreciation of the króna, even though inflation was higher in Q1 than was projected in the February *Monetary Bulletin*. A larger output slack next year than was previously assumed will also weaken inflationary pressures, although increased wage pressures will offset this. Inflation is forecast to average 3.8% this year and 2.7% in 2014. It is forecast to reach the inflation target in the first half of 2014, slightly earlier than was assumed in February.

Even though uncertainty and concerns about a new recession have abated, global economic activity has been weaker than previously forecast, and the global output growth outlook has deteriorated. Global output growth is expected to gain some momentum as the year progresses, however, although the economic recovery is still projected to be relatively weak.

The outlook is for lower commodity and oil prices than was projected in February. The outlook for terms of trade has deteriorated in spite of this, however, as marine product prices have fallen somewhat and are expected to decline further in the next two years, in line with trends in global food and commodity prices and the slow pace of growth in Iceland's main market areas. By the same token, developments in aluminium prices are considerably less favourable than was forecast in February. Offsetting this is the prospect of stronger growth in total exports for the majority of the forecast horizon, which is due to increased services exports, as the outlook for goods exports has deteriorated. Goods and services exports combined are expected to grow by almost 3% this year and over 2% per year, on average, for the following two years. Because of the improved outlook for exports and slower growth in imports, the contribution of net trade to output growth is expected to be larger this year and in the coming two years than was forecast in February.

The trade surplus is expected to be just under 7% of GDP this year, slightly less than was forecast in February. It is projected to shrink in the following two years, primarily because of poorer terms of trade, but also because of a slowdown in export growth. The surplus is forecast at 4½% of GDP in 2014 and just under 3½% in 2015.

The current account balance as calculated according to official standards is projected to show a deficit amounting to 1½% of GDP this year. On the other hand, the underlying current account balance (adjusted for the calculated income and expenses of DMBs in winding-up proceedings and the effects of the settlement of their estates and for pharmaceuticals company Actavis) is expected to show a surplus of just over 4%. The underlying surplus is expected to diminish as the forecast horizon progresses, however. It is forecast to measure just under 1% of GDP in 2014 and turn slightly negative in 2015, which is somewhat less favourable than in the February forecast.

Domestic demand is expected to remain virtually unchanged year-on-year in 2013, whereas the February forecast provided for 1.3% growth. Leading indicators suggest that private consumption was weak in Q1, and it is projected to grow by 2.2% this year, about ½ a percentage point below the February forecast. However, the slower growth in domestic demand in 2013 is due primarily to the considerably changed outlook for investment growth. Business investment is projected to contract by 23% year-on-year instead of the 11½% provided for in the February forecast, and total investment is expected to contract by 9% instead of the previously anticipated 1%. These figures are based in part on new information from the Central Bank’s survey of domestic companies’ investment plans. Domestic demand is expected to gain momentum and grow by about 4½% per year in 2014 and 2015. The outlook has worsened since February, however, when the forecast provided for almost a percentage point stronger growth in each of the two years.

Weaker global output growth and poorer terms of trade contribute to weaker output growth domestically. Output growth is projected at 1.8% in 2013, as opposed to 2.1% in the February forecast. Offsetting the slowdown in domestic demand growth, however, is a somewhat more positive contribution from net trade to output growth than in the February forecast.

The GDP growth outlook for the next two years is also weaker than in February. The current forecast estimates year-2014 growth at 3%, as opposed to 3.7% in the February forecast. For 2015, output growth is forecast at 3.5%, as compared with 3.9% in the February forecast. If the forecast materialises, output growth will average 2.8% over the forecast horizon, which is similar to the 30-year average.

The outlook for unemployment is broadly unchanged since February, in spite of the poorer output growth outlook. In the forecast, it is assumed that registered unemployment will measure 4.6% in Q4/2013 and about 4% by mid-2016, the end of the forecast horizon. Because of the poorer GDP growth outlook, however, labour demand is expected to grow more slowly in coming years than according to the February forecast. The slower growth in total hours worked is not sufficient to offset the poorer output growth outlook. As a result, productivity growth is expected to be weaker during the forecast horizon than was projected in February. According to the forecast, unit labour costs will rise by an average of just over 3½% per year, which is more than was forecast in February.

According to Statistics Iceland's output growth figures and the Central Bank's assessment of growth in potential output, the Bank estimates that the margin of spare capacity in the economy measured 1.3% in Q1, as was forecast in the February *Monetary Bulletin*. The estimate of spare capacity for 2013 as a whole is also virtually unchanged since February, at just under 1%. A small slack is now expected to remain at the end of 2014, whereas the February forecast assumed that it would have disappeared by then. This estimate assumes that, although growth in potential output is recovering gradually after the financial crisis, it will be below long-term trend growth for the majority of the forecast horizon.

The baseline forecast in the May issue of *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are a number of important uncertainties in the forecast. This is particularly the case regarding the growth outlook for Iceland's main export markets. Adverse developments in these areas could undermine export growth in Iceland and erode terms of trade still further. The exchange rate outlook is extremely uncertain and will be affected by, on the one hand, pressure on the króna due to foreign loan repayments, and on the other, the trade surplus, which is expected to be sizeable early in the forecast horizon, as the real exchange rate is probably below long-term equilibrium at present. There is considerable uncertainty about the outlook for public sector finances and how quickly they can be put on a sustainable footing. Another uncertainty centres on wage developments in light of the upcoming round of wage negotiations. If wages rise excessively, the inflation outlook could worsen because of increased domestic inflation. The domestic economic recovery could lose momentum as well, if firms respond to increased wage costs by cutting back labour use. Moreover, high private sector debt levels create uncertainty about the recovery of domestic demand, which could prove more of a hindrance to output growth than is assumed in the baseline forecast. Uncertainty about the inflation outlook centres primarily on the exchange rate, although developments in global commodity and oil prices and errors in estimates of the output gap could cause significant deviations from forecasted inflation, particularly given that a firm anchor for long-term inflation expectations has yet to be established.

II The interest rate decision

The Governor discussed recent developments in the foreign exchange market and the Bank's intervention. The MPC had also held an extraordinary meeting on 16 April to discuss the Bank's policy for foreign exchange purchases and foreign exchange market intervention. According to the Act on the Central Bank of Iceland, the Committee is tasked with taking decisions on the application of the Bank's monetary policy instruments. These provisions define foreign exchange market transactions aimed at affecting the exchange rate of the króna as one of those instruments. Increased foreign exchange market intervention is also in line with the Bank's proposal for improvements to the inflation targeting framework (see, for example, the discussion in "Monetary policy in Iceland after capital controls", Central Bank *Special Publication* no. 4, December 2010).

Since last summer, the exchange rate of the króna has been more volatile than in the preceding period, although it has been somewhat less volatile than various other floating currencies, and the peak-trough range has not been wider than the norm. By the time the MPC met on 16 April, the króna had appreciated in trade-weighted terms by 12.3% from its most recent trough, on 30 January. Committee members agreed that it was appropriate to affect foreign exchange transactions by parties faced with heavy foreign loan payments, in view of their impact on the exchange rate.

By the time of the May meeting, the króna had weakened by 3.1% in trade-weighted terms since the April meeting. Committee members were concerned that, even though inflation was now closer to target than it had been since it began rising in the wake of the spring 2011 wage settlements, uncertainty about near-term exchange rate developments could contribute to more persistent inflation expectations and slow down the disinflation process following this year's appreciation of the króna.

As foreign currency mismatches in financial institutions' balance sheets had been reduced and the exchange rate had been close to a level that, other things being equal, could be considered sufficient to bring inflation back to target in the near term, the Committee was of the opinion that there were further grounds for increased Central Bank activity in the foreign exchange market in the near future. In line with previous statements by the Committee, it was appropriate that the Bank use the monetary policy instruments at its disposal to reduce exchange rate volatility. Committee members agreed that, in this context, it was appropriate to use the recent exchange rate level as a reference, thereby promoting speedier adjustment of the domestic price level to a stronger króna and contributing to reduced inflation expectations. In that case, the inflation target could conceivably be reached earlier than in the current forecast, although this would depend on other factors as well. Committee members agreed that, if there were major changes in external conditions or if other aspects of economic policy should undermine economic stability, the foreign exchange market intervention policy would be reviewed. Particular attention would be given to fiscal policy and to whether wage settlements and wage developments were consistent with the inflation target. Before decisive steps could be taken to lift controls on capital outflows, it would also be necessary to re-evaluate this policy. The same would apply if decisions should be taken concerning the monetary policy framework.

The Committee emphasised that its near-term foreign exchange market intervention policy did not imply a declaration of an exchange rate peg since that would represent a change in the monetary policy framework, which, according to the Central Bank Act, cannot be undertaken without prior consent from the Government.

Committee members considered it appropriate that the Bank continue to attempt to expand its non-borrowed reserves as circumstances permit. Increasing the non-borrowed reserves is a long-term goal, however, and the implementation of that aim will depend on both the strength of the króna and movements in the exchange rate, which are determined in part by capital movements that vary in their predictability. The Bank's foreign exchange purchases should therefore take into account the strong tendency among other agents for foreign debt deleveraging, particularly while inflation remains above target. In line with this policy, the foreign currency that would be purchased to respond to temporary — and, in some instances, seasonal — inflows should then be used to support the króna when the currency flows reverse.

Finally, Committee members discussed the Bank's *Financial Stability* report, published on 30 April, the status of financial institutions, and the progress made with private sector debt restructuring.

Committee members agreed that, based on information emerging since its last meeting, there were grounds for keeping interest rates unchanged. In line with weaker output growth globally, output growth had slowed down in Iceland and terms of trade had deteriorated. According to the forecast in the May issue of *Monetary Bulletin*, the outlook is for output growth to be somewhat weaker, both in 2013 and throughout the forecast horizon, than the Bank projected in February, albeit close to the 30-year average. The recovery in the labour market continued, with rising employment and falling unemployment. Inflation had tapered off, in line with the Bank's forecasts, and measured 3.3% in April. Underlying inflation and inflation expectations were higher, however. Nonetheless, inflation was expected to reach the inflation target earlier than previously anticipated, with weaker output growth and a stronger króna offsetting larger wage increases and weaker productivity growth. On this basis, the Committee was of the opinion that the current interest rate level provided sufficient restraint and that the monetary stance could be assumed to tighten with declining inflation. As additional grounds for an unchanged policy rate, one committee member argued that as the economy is recovering, it is desirable that monetary policy encourage domestic saving, which is necessary to achieve a current account surplus large enough to support foreign loan repayments and the build-up of non-borrowed reserves, and is an important basis for increased domestic investment.

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, 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 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 slack in monetary policy 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 wage developments and exchange rate movements. In addition, monetary policy must at all times take account of fiscal policy and other factors that affect demand.

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 June 2013.