



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

August 2012

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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 MPC members will be made public in the Bank’s *Annual Report*.

The following are the minutes of the MPC meeting held on 20 and 21 August 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 22 August, 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 13 June interest rate decision, as published in the updated forecast in *Monetary Bulletin 2012/3* on 22 August.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was about 8% higher at the time of the August meeting than at the June meeting. Between meetings, the króna had appreciated by about 9.3% against the euro, almost 7% against the pound sterling, and about 8.4% against the US dollar. Offshore trading was sparse and the offshore exchange rate broadly unchanged.

Because of ample liquidity, overnight rates in the interbank market had remained below the centre of the interest rate corridor between meetings, at about 0.25-0.5 percentage points

above current account rates. Trading in the interbank market for krónur was similar to the level a year ago, although slightly less.

According to the spread between indexed and nominal bond yields, expectations of average inflation over the next five years were 0.3 percentage points lower at the time of the August MPC meeting than at the June meeting or just under 4½%.

The effective nominal policy rate can be estimated to be 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 average real policy rate had risen by 0.7 percentage points since the June meeting, to 0.5%. The real rate was 0.5% in terms of twelve-month inflation and 0.9% in terms of the breakeven inflation rate calculated from bond yields.

The Republic of Iceland's sovereign CDS spread was unchanged between meetings, but the risk premium on Treasury obligations fell in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury. The spread between five- and ten-year Treasury bonds issued by the two countries narrowed by 1 percentage point between meetings.

Unchanged Central Bank interest rates appeared to have been priced into the yield curve, in line with the expectations of most financial firms' research departments, with analysts citing positive inflation developments, the appreciation of the króna, and increased uncertainty about the global economic outlook as grounds for unchanged rates. The Bank's market expectations survey was carried out during the week of 13-17 August. According to the median response, the survey results indicate that market participants expect interest rates to be 0.25 percentage points higher at year-end than they were prior to the August meeting. This is in line with the results of the Bank's May survey.

M3 contracted by about 0.7% month-on-month in June but grew by 5.9% year-on-year in Q2. Excluding holding company deposits, however, M3 was unchanged between years.

Indexed lending grew somewhat in May and June. Part of that increase was due to refinancing of older loans, although some credit creation also took place.

Outlook for the global real economy and international trade

The International Monetary Fund's (IMF) global output growth forecast for 2012, published in mid-July, has been adjusted slightly downwards from its April forecast, to 3.5%. The forecast for world trade has also been revised slightly downwards, for 2012 and 2013. Uncertainty in the forecast remains tilted strongly to the downside, owing in particular to the difficulties in the euro area. The inflation forecast for industrialised countries in 2012 is broadly unchanged since the Fund's last forecast, at 2%. The 2012 output growth forecast for Iceland's main trading partners is unchanged since April, at 0.8%.

Iceland's goods trade surplus totalled 4.4 b.kr. in June and, according to preliminary figures, 3.5 b.kr. in July. Both import and export values have continued to grow between years, with the increase measuring over 2½% for exports and over 6½% for imports in the first seven months of 2012. The increase in export values is due primarily to growth in marine product exports, as industrial exports contracted in value, owing largely to a decrease in the export value of aluminium. The increase in import is mainly attributable to increased imports of transport equipment (primarily imports of aircraft in January and one

ship in May), fuels, and lubricants, as the value of commodities and operational inputs declined year-on-year.

The price of aluminium had fallen marginally since the MPC's June meeting. In July, the average price was roughly 0.8% lower than in June and 25½% lower than at the same time in 2011. Marine product prices were up 0.7% month-on-month in June.

The domestic real economy and inflation

According to the Statistics Iceland labour market survey, labour demand was somewhat stronger in Q2 than in the forecast published in the May issue of *Monetary Bulletin*. The last forecast projected a 0.4% year-on-year contraction in total hours worked, while the actual figure was virtually unchanged, as shorter working hours offset the 1.2% increase in the number of employed persons. The unchanged number of total hours worked is due entirely to the youngest age group. The employment rate rose by just under a percentage point, due mainly to an increase in the core age group, whereas the labour participation rate was virtually unchanged.

Unemployment declined faster than was assumed in the May forecast. According to Directorate of Labour (DoL) calculations, unemployment fell from 7.2% to 5.6% between Q1 and Q2, and from 6.4% to 5.7% adjusted for seasonality. The forecast estimated 6% unemployment during the quarter.

In Q2, the wage index rose by 1.6% between quarters and by 8.2% year-on-year.

Major indicators of private consumption in Q2 suggest slight growth from the previous quarter, after adjusting for seasonality. Indicators for July imply that Q3 began strongly in terms of private consumption. For instance, payment card turnover grew by 4.6% year-on-year in real terms in July.

The Treasury accounts for 2011, published in July, reveal that Government operations were within budgetary allocations if the one-time write-offs due to SpKef savings bank, the Icelandic Regional Development Institute, and the New Business Venture Fund are excluded.

Statistics Iceland's nationwide house price index, published at the end of July, rose by 0.5% from the previous month (also seasonally adjusted). The capital area Real Estate Price Index, calculated by Registers Iceland, rose by 0.9% month-on-month in July, and by 1.4% when adjusted for seasonality. About 10% more purchase agreements were concluded in July 2012 than in July 2011, and in the first seven months of 2012, purchase agreements were up 17% year-on-year. The number of purchase agreements is still low in historical context, however.

According to the survey carried out by Capacent Gallup, consumer sentiment improved in June and July. The Consumer Sentiment Index had risen by 22½% between July 2011 and July 2012, based on the three-month average. Sentiment towards the economy rose most sharply in the past two months. The assessment of the current situation has also improved considerably in the recent term.

According to the Capacent Gallup survey among corporate executives, carried out in May and June, executives were somewhat more pessimistic about the economic situation six months ahead than they were in the last survey, conducted in February/March. Just under 18% of executives expect conditions to worsen, as opposed to 13% in the last survey.

Pessimism is strongest among executives in the fishing industry, with about half of them expecting conditions to deteriorate in the next six months. On the other hand, optimism is most pronounced among executives in the financial and insurance sector. The survey indicates that firms considering increasing their staffing levels in the next six months outnumber those considering downsizing. Most companies plan to keep their staffing levels unchanged, however.

According to the survey conducted in August, market participants' short-term inflation expectations have declined since May. According to the median response, market participants expect annual inflation to measure 4.8% in one year and 4½% in two years. Furthermore, they expect inflation to average 4½% over the next 10 years, or ½ a percentage point less than in the May survey. If only the responses of those who also participated in the May survey are included, however, 10-year expectations are virtually unchanged.

The CPI fell by 0.7% month-on-month in July, after rising by 0.5% in June. Annual inflation measured 4.6% in July, down from 5.4% in May. Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and the cost of real mortgage interest) measured 4.7% in July, down from 5.5% in May. The July decrease was due to summer sales and cuts in airfares and petrol prices, although it was offset to a degree by rising food prices.

According to the updated forecast appearing in *Monetary Bulletin* 2012/3 on 22 August, the two-year inflation outlook has improved since the May forecast. Inflation has been somewhat lower than was assumed then, due primarily to positive exchange rate developments and lower petrol prices. Average inflation for 2012 is projected at 5.4%, or 0.6 percentage points below the May forecast. The stronger króna also leads to expectations of more rapid disinflation in 2013 than was assumed in May, with inflation falling to around 3% by the latter half of the year. Inflation is projected to reach the Central Bank's inflation target by end-2014, which is broadly in line with the May forecast.

According to the August forecast, the GDP growth outlook for 2012 has also improved relative to the May forecast, in spite of the worsening global economic situation. GDP growth in 2012 will be driven primarily by private consumption and business investment and is estimated at 3.1% instead of the previous 2.6%, due to stronger export growth. For 2013, it is assumed that export growth will be correspondingly lower and output growth therefore weaker than was forecast in May. The outlook for 2014 has improved somewhat, however, with GDP growth projected at 3.4% instead of 2.7%, as in the last forecast. During the forecast horizon, GDP growth will be driven by domestic demand. The contribution from net trade will be negative in spite of moderate export growth.

As has been forecast in the past year, it is assumed that the labour market will continue to improve, with gradual employment growth and declining unemployment. In spite of the remaining slack in the labour market, unit labour costs are expected to increase by 5% in 2012 and then rise more or less in line with the Central Bank's inflation target from 2013 onwards.

The estimated output slack during the forecast horizon is broadly in line with the May forecast. It is assumed to have contracted sharply in 2011. It is also expected to shrink still further in 2012 and 2013 and then disappear early in 2014, which also accords with the May forecast.

II The interest rate decision

The Governor informed Committee members of the results of the June foreign currency auction, the prepayment of the Treasury and the Central Bank's foreign loans from the IMF and the Nordic countries, and the increase in the Bank's regular foreign currency purchases. The MPC was also informed of the outlook for government finances and the fiscal consolidation plan by representatives from the Ministry of Finance.

The MPC was of the view that the macroeconomic forecast appearing in the 22 August *Monetary Bulletin* confirmed that the economic recovery beginning in mid-2010 was gaining momentum. According to the forecast, the outlook for 2012 is for somewhat stronger output growth than in the May forecast, although the outlook for 2013 and 2014 as a whole is broadly unchanged. The domestic labour market has also recovered more strongly than previously forecast. The MPC considered that, although growth in total hours worked had been insignificant in the second quarter, this did not indicate a reversal in labour demand, as it was due entirely to a reduced contribution from the youngest age group. The global economic outlook remained uncertain, however, in part due to the financial crisis in Europe, which created potential headwinds for the domestic economic and inflation outlook.

Committee members discussed recent exchange rate developments and the near-term outlook. In trade-weighted terms, the króna had appreciated by over 8% since the May forecast. In the MPC's opinion, the stronger currency was mainly attributable to reduced currency accumulation by parties with current and expected foreign loan repayments and increased tourism-related inflows.

The Committee considered the recent rise in the exchange rate to explain the rapid disinflation to a large degree. The inflation outlook for the next two years had therefore improved, according to the revised forecast, although inflation was not expected to reach the Bank's inflation target until the end of the period.

As before, the Committee considered the inflation outlook uncertain, as inflation could turn out higher should the króna depreciate again, as it was uncertain how much of the recent appreciation would be sustained over the coming winter. Furthermore, the MPC considered that inflation inertia could be underestimated, partly in view of long-term inflation expectations, which are still noticeably above the target. On the other hand, inflation could subside more quickly over the forecast horizon, especially if the króna strengthens further.

The Committee discussed the possibility of keeping the Bank's interest rates unchanged or raising them by 0.25 percentage points. In view of the discussion, the Governor proposed that rates be held unchanged: the current account at 4.75%, the maximum rate on 28-day certificates of deposit at 5.5%, the seven-day collateralised lending rate at 5.75%, and the overnight lending rate at 6.75%.

Four members voted in favour of the Governor's proposal, in view of the recent tightening of the monetary stance. They also considered it appropriate to wait and see how sustainable the appreciation of the króna, and therefore the recent disinflation episode, would prove to be. One member voted against the Governor's proposal, voting instead to raise interest rates by 0.25 percentage points. This member stressed the still high inflation and that long-term inflation expectations had not changed much in response to the recent

decline in inflation. There was therefore a significant risk that high inflation expectations would lead to higher and more persistent inflation than forecasts provided for.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They also agreed that the interest rate increases in May and June, together with reduced inflation, had resulted in the withdrawal of some 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.

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, as did representatives from the Ministry of Finance.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 3 October 2012.