The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

August 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 19 and 20 August 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 21 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 12 June interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2013/3 on 21 August.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.6% higher at the time of the August meeting than at the June meeting. Between meetings, the króna had depreciated by about 0.3% against the euro and 0.2% against the pound sterling but had appreciated by 0.6% against the US dollar. Bids for krónur in the offshore market lay in the range of 228-262 kr. per euro.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 6 million euros (roughly 950 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, normally at 0.25-0.4 percentage points above current account rates. Turnover in the interbank market totalled almost 320 b.kr. year-to-date, slightly more than over the same period in 2012.

The five-year breakeven inflation rate in the bond market was 3.8% just before the MPC meeting, after rising by 0.7 percentage points since the June meeting. The five-year breakeven inflation rate five years ahead was 3.9% and had risen by 0.4 percentage points. According to the median response in the Central Bank's recent market expectations survey, market agents expected inflation to average 4.2% over the next five years, which is unchanged from the survey conducted in May.

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 August meeting, after having fallen by 0.3 percentage points since the June meeting. The average of the various measures of inflation and inflation expectations was 4% at the time of the August meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged between meetings, at about 1.6 percentage points. The risk premium on five-year 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 virtually unchanged between meetings, at 1.7 percentage points, whereas the spread between the two countries' 10-year bonds had risen by 0.6 percentage points, to 2.6 percentage points.

Unchanged Central Bank interest rates in August appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most financial market analysts cited the minimal change in economic indicators between meetings as grounds for unchanged interest rates.

Broad money (M3) grew by 1.3% month-on-month in June and by 1.1% year-on-year. Excluding holding company deposits, however, M3 grew by 0.1% between years in June.

The NASDAQ OMXI6 index had risen by 6.4% between meetings. Trading volume on the NASDAQ OMX Iceland Main Market totalled 154 b.kr. during the first seven months of the year. At the beginning of August, 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

According to the International Monetary Fund's (IMF) mid-July forecast, the global output growth outlook for this year and next year is slightly weaker than in the April forecast, or 3.1% in 2013 and 3.8% in 2014. The forecast for world trade has also been revised downwards for 2013, while the forecast for 2014 is unchanged. Uncertainty in the forecast remains considerable and is tilted to the downside. In addition to the uncertainty factors already in place, there is now the risk that the period of weak growth in emerging economies will be more protracted than previously assumed. The inflation forecast for industrialised countries in 2013 is broadly unchanged, at 1.5%. Output growth is projected at 0.8% for Iceland's main trading partners in 2013, which is slightly weaker than the April forecast.

There was a deficit of 1.1 b.kr. on Iceland's goods trade in June, whereas preliminary figures indicated a 7.4 b.kr. surplus in July. Import values contracted by 3% in the first seven months of the year, while export values shrank by 1½% over the same period. The downturn in export values is due principally to a contraction in industrial goods exports, as the export value of marine products is virtually unchanged between years. The contraction in import values is due primarily to a contraction in transport equipment imports (due mainly to a reduction in aircraft imports); however, the value of imports of fuels and lubricants has also fallen, while the value of imported investment products, and miscellaneous industrial supplies has risen between years.

The price of aluminium is broadly the same as at the time of the MPC's June meeting. It remained relatively stable in July, after falling slightly in June. In July, the average price was about 2.7% lower than in June and almost 6% lower than in July 2012. It has then risen somewhat in August. Marine product prices rose in May, for the third month in a row, with the month-on-month increase measuring 0.2%.

The domestic real economy and inflation

According to the Statistics Iceland labour market survey, labour demand grew significantly more strongly in Q2 than was assumed in the Bank's May forecast, which provided for a 0.7% year-on-year increase in total hours worked, less than the actual 2.7%. Average hours worked grew by 0.8%, after having contracted steadily for four quarters, and the number of employed persons continued to rise. The increase in the number of employed measured 1.9% for the quarter, on the heels of a 2.5% rise in Q1.

Total hours worked rose by 3.2% among the full-time employed and fell by 0.9% among part-time workers. As in the past year, both the labour force participation rate and the employment rate rose, and the number of persons outside the labour market declined.

The net migration rate was positive in Q2, for the third quarter in a row. Unlike the previous two quarters, however, when the lion's share of the population increase came from foreign nationals, Icelandic nationals account for nearly half of the rise.

Unemployment as measured by the Directorate of Labour (DoL) was 4.4% in Q2 and 4.6% adjusted for seasonality. Unemployment according to the Statistics Iceland labour market survey was somewhat higher, however, or 6.8%. Excluding those who had become employed, it measured 5.8%, and when adjusted for seasonality it measured 5.5%.

DoL figures show that 63% of those who dropped off the unemployment register in the first half of the year had become employed. This is a somewhat lower percentage than in 2009-2011, when it was just under 70%. A far greater number take advantage of labour market initiatives than did previously, whereas emigration played a negligible part in declining unemployment in 2013. The percentage of those who leave the unemployment register because they are unable to work is broadly in line with the 2009-2011 average, at 3-4%.

The wage index rose by just under 2% quarter-on-quarter and 5.6% year-on-year in Q2. Wage developments have varied somewhat from sector to sector during the current wage settlement period. According to the Statistics Iceland wage index, wages rose by just over 16% from Q1/2011 to Q1/2013. Wages in the financial and transport sectors rose more, while pay increases in manufacturing, retail, and private services have been in line with the average. In the construction industry and the public sector, however, wage increases have been smaller.

The main indicators of private consumption in Q2 suggest modest growth year-on-year, and there are signs that consumption was still growing at the beginning of Q3. For instance, payment card turnover grew by 3% year-on-year in real terms in July.

The nationwide Statistics Iceland house price index, published in late July, rose by 1.4% from the previous month, and by about 1% adjusted for seasonality. House prices nationwide have therefore risen by 5.8% in the past twelve months. The capital area Real Estate Price Index, calculated by Registers Iceland, rose by 1.8% month-on-month in June, and by 1.3% when adjusted for seasonality. The index has risen by 6.9% since June 2012. The number of registered purchase agreements was up 13% year-on-year in July, and by just over 9% over the first seven months of the year.

According to the survey carried out by Capacent Gallup, consumer sentiment improved markedly in Q2, with the Consumer Sentiment Index rising above 100 points in May and June, for the first time since the collapse of the financial system in autumn 2008. Sentiment deteriorated in July, however, and the index fell to 78.5.

The CPI rose by 0.53% month-on-month in June and then fell by 0.27% in July. The decline in July was due largely to sales effects, which, was partially offset by higher owner-occupied housing costs and petrol prices. Annual inflation measured 3.8% in July, up from 3.3% in May. Some base effects were present, however, due to the marked drop in the CPI in July 2012. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 4%, in July up from 3.8% in May.

According to the Central Bank's quarterly market expectations survey, carried out in August, just before the publication of *Monetary Bulletin* 2013/3, market agents' inflation expectations both one and two years ahead have risen since the May survey. Market agents now expect twelve-month inflation to measure 4.2% in one year and 4½% in two years, as opposed to 4% both one and two years ahead in the previous survey. Their long-term inflation expectations are broadly unchanged, however, at just over 4%.

According to the updated forecast published in *Monetary Bulletin* 2013/3, the near-term inflation forecast has deteriorated somewhat since May. The main reason for the changed outlook is a larger increase in total hours worked, concurrent with the prospect of weaker output growth. Productivity will therefore grow more slowly than previously forecast in the next few years. In addition, inflation expectations are higher than in May. Inflation is projected to rise somewhat in the latter half of the year and then taper off again in the first half of 2014, and approach the inflation target in the second half of 2015, somewhat later than according to the May forecast. According to the forecast, inflation is projected to average 3.9% in 2013, 3.1% in 2014, and 2.9% in 2015, an increase of 0.1-0.4 percentage points from the May forecast.

Global output growth has been somewhat weaker year-to-date than was projected in May, although the most recent indicators suggest a gradual recovery, in line with the May forecast. In Iceland's main trading partner countries, the outlook is for weaker output growth in the next two years than was assumed in May. In line with weaker growth in economic activity, the outlook for growth in world trade and developments in Iceland's terms of trade have deteriorated.

In Q1, output growth in Iceland proved somewhat weaker than was assumed in May, primarily because of more unfavourable inventory changes than previously expected. Those effects are projected to smooth out within the year, and output growth is expected to be broadly in line with the May forecast. The output growth outlook for the upcoming two years has deteriorated somewhat since May, however, from just over 3% per year to just under 3%. As before, the main drivers of growth during the forecast horizon are private consumption and investment. One of the main reasons for the poorer output growth outlook is the fact that investment related to the expansion of the Straumsvík aluminium smelter will not take place. As a result, the investment level will be lower next year than was provided for in the May forecast, and export growth will be weaker in 2015.

The recovery of the domestic labour market has been much more robust than was projected in May, however. The number of employed persons has continued to grow, average hours worked have begun to rise again, and total hours worked increased somewhat more than was forecast in May. Seasonally adjusted unemployment continued to decline as well, and it appears as though the majority of those who leave the unemployment register find jobs. The labour market recovery is expected to continue, although the jobless rate will decline only slightly from the current level.

The estimated output slack during the forecast horizon is broadly in line with the May forecast. The margin of spare capacity has narrowed steadily since it peaked in 2010. It is estimated to have measured about 1.5% of potential output in 2012. It is expected to narrow still more this year and next year and to disappear early in 2015.

II The interest rate decision

The Governor reported to the Committee on the IMF Executive Board's discussion of the status and outlook for the Icelandic economy in connection with post-programme monitoring of the Stand-By Arrangement. He also discussed the amendments to the Act on the Central Bank of Iceland, passed by Parliament in July. In addition, he reported on the broad-based work underway within the Bank related to the capital controls, and the preparation of further strategies by the Bank and other authorities for their removal. The matters under scrutiny include work related to talks about the lengthening of Landsbankinn's debt to old Landsbanki, an examination of options for the settlement of the old banks' estates and further reduction of the stock of volatile króna assets, formulation of prudential rules, and an examination of the long-term effects of various measures on Iceland's external debt and balance of payments.

The Committee discussed recent developments in the foreign exchange market and the Bank's foreign exchange market activities. It appeared that the Central Bank's foreign exchange market strategy, introduced in May, had contributed to reduced exchange rate fluctuations. The króna had remained relatively stable since the MPC's last meeting. By the time the MPC met in August, the króna had appreciated by 0.6% in trade-weighted terms since the June meeting. As yet, however, this increased stability has not led to lower inflation expectations.

As has been discussed previously, the near-term inflation outlook has deteriorated since May. According to the Central Bank's updated forecast, inflation will rise slightly in the latter half of the year and then begin subsiding towards the target early in 2014. The main reason for the changed outlook is a larger increase in total hours worked, concurrent with a weaker output growth forecast, which implies that productivity growth will be weaker than previously forecast and the rise in unit labour costs correspondingly greater. In the forecast, unit labour costs are projected to rise by an average of 4.2% per year, well above the level that is consistent with the Bank's inflation target, which is an important reason why inflation falls slowly back to target according to the forecast.

The MPC discussed labour market conditions in depth. Members agreed that one of the main uncertainties in the inflation forecast was the upcoming round of wage negotiations. It was clear that the wage assumptions in the forecast were higher than was consistent with the inflation target in the long run. According to the forecast, inflation will nonetheless subside to target, owing to other factors that will offset the inflationary pressures from the forecasted wage increases. However, if the outlook changes on the upside – for instance, if negotiated pay increases are even larger than is projected in the forecast – the MPC could be required to respond more strongly than the forecast assumes. On the other hand, if wage increases in 2014 and 2015 are consistent with the inflation target, inflation will fall more quickly and reach the target sooner, and interest rates will be lower than would otherwise be necessary, other things being equal.

Members agreed that, based on information emerging since its last meeting, there were grounds for keeping interest rates unchanged. According to the forecast published in the 21 August issue of *Monetary Bulletin*, output growth will measure just under 2% in 2013, which is broadly in line with the Bank's May forecast. The outlook for output growth over the next two years has deteriorated, however, with growth projected at just under 3% per year instead of slightly more than 3%, owing primarily to less investment in the energy-intensive sector in the near term. The recovery of the labour market has been more robust than was forecast in May and is expected to continue on that path.

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 were of the opinion that monetary policy must always take account of fiscal policy and other factors that affect aggregate demand. They discussed the uncertainty about the path public sector finances will take in coming years and agreed that the uncertainty will diminish with the presentation of the fiscal budget proposal in early October. As a result, they considered it appropriate to wait until then to assess the need for a monetary policy response. In general, they deemed it critical that Treasury finances be brought into balance 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 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 attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 2 October 2013.