The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting
March 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 March 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 21 March, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, the Committee discussed 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 8 February interest rate decision.

Financial markets

The Central Bank sold 12 million euros in the interbank market at the beginning of March in order to partly offset the currency outflows caused by exemptions the Central Bank had granted from the capital controls. This is in accordance with previous actions, particularly when the Bank has purchased about half of large temporary inflows.

The average trade-weighted exchange rate in the domestic foreign exchange market was 2.3% lower at the time of the March meeting than at the February meeting. Between meetings, the króna had depreciated by about 2.9% against the euro, 2.5% against the pound sterling, and 1.8% against the US dollar.

In the offshore market, the króna had appreciated against the euro since the last MPC meeting. Trading took place in the range of 237-242 kr. per euro, but complete information on the extent of trading with offshore-krónur is not available.

Because of ample liquidity, overnight interbank interest rates were broadly unchanged at about 4% since the February meeting. Interbank market trading totalled 24 b.kr. in February 2012.

At the time of the March meeting, outstanding certificates of deposit (CDs) amounted to 85.9 b.kr., roughly 6.4 b.kr. more than at the February meeting.

The breakeven inflation rate in the bond market rose in the wake of the Supreme Court's decision, handed down in February, on the settlement of illegal exchange rate-linked loans, but after the Foreign Exchange Act was amended in mid-March it fell back near the level at the February meeting. In mid-March, yields on indexed Treasury bonds were broadly unchanged since the February meeting, but they rose by up to half a percentage point after the amendment of the Foreign Exchange Act. Secondary market yields on nominal Treasury bonds also rose between meetings, by almost half a percentage point.

The CDS spread on the Republic of Iceland had fallen marginally since the February meeting, as had the spread between the Icelandic Treasury's US dollar bond and a comparable bond issued by the US Treasury.

The effective nominal policy rate is defined as a simple average of the Central Bank's deposit and maximum CD rates. According to various measures of inflation and inflation expectations, the average real interest rate was virtually unchanged since the February meeting, and was -1.1% at the time of the March meeting. It was also almost unchanged in terms of the breakeven inflation rate in the bond market, at -1.5%, but had risen slightly relative to twelve-month inflation, to -2.0%.

Unchanged Central Bank interest rates appeared to have been priced into the yield curve; however, most market makers, brokers, and research department analysts from financial firms expected the MPC to raise interest rates by 0.25 percentage points. Most of them cited the deterioration in the inflation outlook and the depreciation of the króna as grounds for a rate hike.

Broad money (M3) increased by 1.9% month-on-month in January and by 9.5% year-on-year. M3 had contracted between mid-2009 and May 2011, but since then it has increased in tandem with growing economic activity. The pace of growth increased even further in the latter half of 2011, largely because the commercial banking licences of some of the old banks' resolution committees were revoked. Thereafter, the resolution committees were reorganised as holding companies and their deposits were subsequently included with the money supply.

Outlook for the global real economy and international trade

The Consensus Forecasts projections for 2012 output growth in Iceland's main trading partner countries in the aggregate are unchanged since the February meeting; however, the outlook has changed for some individual countries. The forecast for output growth in the US has risen somewhat since February, while the forecast for the euro area has been adjusted slightly downwards. The forecast for inflation among Iceland's main trading partners has been revised upwards for the year, from 1.8% to 2.1%.

The surplus on goods trade has been significantly larger than at this time a year ago, measuring 10.1 b.kr. in January and 12.5 b.kr. in February according to preliminary figures. Import and export values have continued to rise rapidly year-on-year, with exports slightly outpacing imports. The rise in export values is mainly attributable to growth in exported marine products. Increased import values stem from rises in the import value of fuel, transport equipment, and food and beverages.

Aluminium prices have remained broadly unchanged since the last MPC meeting. The average price in February was about 9% above the last trough, which occurred in December, but it was still down markedly year-on-year. Marine product prices have continued to increase, with the month-on-month increase measuring 0.7% in January.

The domestic real economy and inflation

According to the national accounts published by Statistics Iceland in March, output growth measured 3.1% in 2011 as a whole and 2.7% in Q4/2011. Growth was driven primarily by increases in private consumption and business investment, each of which contributed 2 percentage points. The contribution from net trade was negative by just over 1% of GDP, however, and public investment and public consumption contracted as well. The figures from Statistics Iceland are largely in line with the Central Bank's February forecast, which assumed 3% GDP growth for the year. Business investment grew considerably more than forecast. A significant portion of the deviation is due to revision of previous statistics.

The current account deficit amounted to just under 12% of GDP in Q4/2011 (49 b.kr.). Excluding the banks in winding-up proceedings, it measured roughly 5% of GDP. Revised figures show that the deficit was about 8 b.kr. more in the first three quarters of the year than was indicated by previous numbers, with the difference due to a larger deficit in the balance on income. For the year as a whole, the current account deficit amounted to 7% of GDP (116 b.kr.). Excluding the banks in winding-up proceedings, however, it was considerably smaller, at 0.6% of GDP (10 b.kr.). Excluding the pharmaceuticals company Actavis, the current account showed a surplus of over 3% (50 b.kr.).

According to the survey conducted by Capacent Gallup in February and March among Iceland's 400 largest firms, companies planning to recruit outnumbered those planning to downsize their staff in the coming six months, for the first time since March 2008. Over 60% of firms anticipated unchanged staffing levels, which is similar to the past two years.

According to the Statistics Iceland labour force survey, employment as measured by total hours worked rose by about 1.5% year-on-year in January and February, owing primarily to an increase in the number of employed persons. The labour participation rate contracted by 0.5 percentage points, however.

In a departure from the usual trend, unemployment as measured by the Directorate of Labour remained unchanged at 7.3% between December and February. After adjusting for seasonality, however, it declined by roughly a percentage point, to 6.2%. The reason the jobless rate did not rise as it usually does is deregistration of 1,400 people in

January. About two-thirds of those deregistered had participated in an initiative that gave jobless people the opportunity to study while collecting unemployment benefits during the autumn 2011 semester. Those who decided to continue their studies during the spring term no longer receive unemployment benefits. The others who left the jobless rolls did so because of the expiration of a temporary provision added to the Act on Unemployment Benefits in autumn 2008.

In the Central Bank's February forecast it was assumed that private consumption would continue to grow in 2012, but at a decreasing pace over the course of the year. Growth was projected at 4.3% year-on-year in Q1, and key high-frequency indicators suggest that developments in private consumption during the quarter are in line with that forecast. For example, payment card turnover in January and February was up by nearly 5½% year-on-year in real terms, and new motor vehicle registrations have continued to rise.

According to the Capacent Gallup survey, consumer sentiment improved in February, for the fourth month in a row. The three-month average of the Consumer Sentiment Index has therefore risen by almost 30% year-on-year. Expectations concerning the economic situation in six months' time rose most sharply in February, whereas sentiment towards the current situation and the labour market situation declined month-on-month.

According to Capacent Gallup's February/March survey among corporate executives, a sizeable majority still consider the current economic situation poor. Over 66% of executives expected no change in the next six months. The number who assumed that the economic situation would deteriorate in the next six months declined somewhat from the December survey. Executives in regional Iceland were markedly more downbeat than those in the greater Reykjavík area, particularly due to pessimism among fisheries, 37% of which considered conditions likely to deteriorate.

According to the survey, executives' inflation expectations one year ahead measured 5%, an increase of one percentage point from the December survey. Executives also assumed that twelve-month inflation would still be 5% in two years' time, also an increase of one percentage point since the survey carried out in October.

According to another Capacent Gallup carried out in March, household inflation expectations one year ahead had risen by ½ a percentage point since December, to 6.5%. Households expected twelve-month inflation to measure 6% in two years' time, which is also ½ a percentage point more than in the last survey.

Beginning in Q1/2012, the Central Bank will conduct quarterly surveys of market agents' long- and short-term expectations concerning a variety of economic variables. The Central Bank's first such survey was conducted in February. On average, market participants expected twelve-month inflation to measure 5% one year ahead and 4.7% two years ahead. They also assumed, on average, that inflation would be 5% in Q4/2012. For the longer term, they anticipated on average 4.6% inflation five years ahead and 4.3% ten years ahead.

The consumer price index rose by 1% month-on-month in February 2012, and annual inflation measured 6.3%, down from 6.5% in January. Annual core inflation 3 excluding tax effects (measured inflation excluding volatile items such as food, petrol, public services, and real mortgage interest rates) measured 5.7% in February, as it did in

January. Annual inflation excluding the housing component rose month-on-month, however, to 6%.

Price increases in clothing and furniture after the end of winter sales raised the CPI by 0.48 percentage points in February, and rises in petrol and oil added almost 0.2 percentage points. The decline in the housing component had a CPI effect of -0.11 percentage points, owing primarily to falling market prices.

II The interest rate decision

The Governor informed the Committee of the Government and the Central Bank's prepayment of loans from the IMF and the Nordic countries. He also discussed the recent amendments to the Foreign Exchange Act and the Central Bank's sale of foreign currency in the interbank market early in March.

Committee members discussed recent exchange rate movements, as the króna had depreciated by a full 2% in trade-weighted terms since the February meeting. Members agreed that seasonal fluctuations in foreign currency inflows and deleveraging by firms and municipalities had made an impact. The Committee expected the amendments to the Foreign Exchange Act to shore up the króna or at least to limit the depreciation.

The MPC discussed the possibility of raising interest rates by 0.25-0.5 percentage points. All agreed that there were strong grounds for either decision. They agreed that the bleaker inflation outlook was the main argument for a rate hike. Because of the weaker currency, the near-term inflation outlook had deteriorated relative to the February forecast. Further ahead, it was likely that inflation would prove more persistent than was forecast in February unless the króna appreciated in coming months. Furthermore, inflation expectations had risen by all measures and were still considerably above target, and anchoring expectations more firmly was of utmost importance.

It was also considered necessary to keep interest rates sufficiently high to support the króna, as the risk-adjusted interest rate differential had narrowed since the MPC's last meeting. It was pointed out that a rate hike could also promote slower deleveraging of foreign debt.

Committee members agreed that the results of the most recent national accounts and labour market survey showed that the overall economic outlook was broadly unchanged from the Bank's February forecast. Uncertainty about fiscal restraint was certainly greater than in February, but the composition of year-2011 output growth was more advantageous because of stronger business investment. Furthermore, uncertainty about the global economy had subsided.

The arguments in favour of a smaller rate increase were that a new Central Bank forecast would be available at the next meeting, as would two new CPI numbers. Furthermore, the effects of the amendments to the Foreign Exchange Act on the exchange rate would have come to the fore by that time. Committee members agreed that, unless the inflation outlook improved, it would probably be necessary to raise rates further.

One member pointed out that raising interest rates at this juncture could adversely affect vulnerable corporate balance sheets. Although doubting that a modest rate increase would affect the exchange rate under current conditions, this member was nonetheless willing to support a rate hike at this time because the general wage and price increases of the past few months and the risk of a wage-price spiral suggested that the slack in the economy needed to be greater, which in turn called for higher real interest rates.

In view of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be raised by 0.25 percentage points, which would raise the current account rate to 4.0%, the maximum rate on 28-day CDs to 4.75%, the seven-day collateralised lending rate to 5.0%, and the overnight lending rate to 6.0%.

Four members voted in favour of the Governor's proposal, and one voted against it, preferring to raise rates by 0.5 percentage points. This member considered it necessary to raise rates by more because of the possibility that the Committee was already too late in withdrawing the accommodative monetary stance. This member was of the opinion that raising rates by only 0.25 percentage points would merely suffice to maintain the level of monetary restraint prevailing at the last meeting.

Members agreed that, in the future, it would be necessary to continue to withdraw the current degree of monetary accommodation as the recovery progresses and the slack in the economy diminishes. They agreed that the degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. They also agreed that in the absence of an improvement in the inflation outlook, an increase in nominal interest rates would probably be required in the near term in order to bring the monetary policy stance, which is still quite accommodative, to an appropriate level.

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 the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 16 May 2012.