



*The Monetary Policy Committee of the Central Bank of Iceland*

## Minutes of the Monetary Policy Committee meeting

May 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 14 and 15 May 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 16 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 outlook for the global economy and Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 21 March interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin 2012/2* on 16 May.

#### **Financial markets**

The average trade-weighted exchange rate in the domestic foreign exchange market was 1.6% higher at the time of the May meeting than at the March meeting. Between meetings, the króna had appreciated by about 2.2% against the euro but had depreciated by 1.6% against the pound sterling and 0.5% against the US dollar.

Trading in the offshore market had been limited between meetings. It appears as though the Central Bank’s foreign currency auctions have substituted for the offshore market to some extent, as the offshore exchange rate had been in the range of 237-242 kr. per euro

during the weeks prior to the meeting, which is similar to the exchange rate offered in the last foreign currency auctions.

Because of ample liquidity, overnight rates in the interbank market had remained below the centre of the interest rate corridor between meetings, in the 4-4.7% range. Interbank market trading totalled 60 b.kr. in April 2012.

At the time of the May meeting, outstanding certificates of deposit (CDs) amounted to 125 b.kr.

The breakeven inflation rate in the bond market rose shortly after the rate hike in March but then fell again after the CPI was published in late April. It was 0.5 percentage points higher at the time of the May meeting than at the March meeting. Yields on indexed Treasury bonds had remained broadly unchanged between meetings, as had secondary market yields on nominal Treasury bonds, with the exception of the Treasury bond maturing in October 2016, which rose by 0.5 percentage points.

The CDS spread on the Republic of Iceland had fallen slightly since the March meeting, as had the spread between the Icelandic Treasury's US dollar bond and a comparable bond issued by the US Treasury. At the beginning of May, the Treasury issued a 10-year US dollar bond at 6% interest, implying a 4 percentage point premium on a comparable US Treasury bond.

The effective nominal policy rate is defined as a 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 interest rate fell by 0.1 percentage points between meetings, to -1.2%. It had fallen by 0.3 percentage points in terms of the breakeven inflation rate in the bond market, to -1.8%, but had risen slightly relative to twelve-month inflation, to -1.9%.

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 0.25-0.5 percentage points. Most of them cited the deterioration in the inflation outlook as grounds for a rate hike. According to the median response to the Central Bank survey of market expectations, market agents expected the Bank's interest rates to be 0.5 percentage points higher at the end of Q2/2012 than they were at the time of the May meeting. They also expect the policy rate to be 1 percentage point higher at year-end, which is half a percentage point more than in the Bank's February survey.

Broad money (M3) contracted by 3.1% month-on-month in March but grew by 4.4% year-on-year. M3 had contracted between mid-2009 and May 2011, but since then it has increased in tandem with growing economic activity.

### **Outlook for the global real economy and international trade**

According to the most recent forecast from the International Monetary Fund (IMF), issued in April, the forecast for world output growth has been revised upwards from the January forecast. The same applies to global trade. Considerable uncertainty remains, particularly on the downside, and a mild contraction is expected in the euro area this year. Inflation is expected to remain broadly unchanged, although it is projected to rise marginally in industrialised countries during the year. The IMF forecast for output growth

in 2012 in Iceland's main trading partners is virtually unchanged, or 0.8% as opposed to the January forecast of 0.7%.

According to preliminary figures, Iceland's goods trade surplus totalled 5.4 b.kr. in March and 9.4 b.kr. in April. Both import and export values have continued to grow between years, with the increase measuring just under 7% for the first four months of the year. Increases in export values are due primarily to growth in exported marine products but also to growth in exportation of agricultural products and other industrial goods. The rise in import values stem from rises in the import value of fuel, investment goods excluding transport equipment, and food and beverages.

The price of aluminium has fallen slightly since the MPC's March meeting. In April, the average price was over 6% lower than in March and more than 23% lower than at the same time in 2011. Marine product prices were unchanged month-on-month in March.

### **The domestic real economy and inflation**

Registered unemployment as measured by the Directorate of Labour (DoL) was 7.1% in March, or 5.9% when adjusted for seasonality. Unemployment measured 7.2% in Q1/2012 according to both the DoL and the Statistics Iceland labour market survey. Seasonally adjusted unemployment measured 6.4% during the quarter.

According to the Statistics Iceland labour market survey, employment in terms of total hours worked (a measure of man-years) grew by 1.1% year-on-year, primarily due to an increase in the number of employed persons, whereas the initial rise in employment, in Q2/2011, was concentrated in longer average hours worked.

The labour participation rate was 78.9% in Q1/2012, the same as at the bottom of the last downward cycle, in Q1/2004. Adjusted for seasonality, it rose by 1.1 percentage points between quarters, to 80.4% in Q1/2012.

The wage index rose by 2.1% quarter-on-quarter in Q1, largely due to a general 3.5% contractual increase and a 11,000 kr. rise in pay scales below 314,000 kr. per month. The contractual increases in February and March were offset by a 1.2% decline in the wage index, however, because the effect of the 50,000 kr. one-time payment implemented at the time the wage settlements were signed last year disappeared from the index. The twelve-month rise in the index amounted to 10.8% in Q1/2012, but it should be borne in mind that two contractual wage increases were implemented during the period.

Key high-frequency indicators of private consumption suggest that seasonally adjusted private consumption grew somewhat less in Q1 than in the previous quarter but that year-on-year growth has continued. Payment card turnover in Iceland and abroad grew by 4.6% year-on-year during the quarter, and by 6% year-on-year in April. New motor vehicle registrations continued to increase between years in Q1, as did consumer goods imports.

According to the consumer sentiment survey carried out by Capacent Gallup, consumer sentiment improved in April. The survey has shown rising consumer sentiment measurements each month since November 2011, apart from a decline in March. The Consumer Sentiment Index has risen by 23% in the past twelve months, based on the three-month average. Sentiment towards the labour market and the current economic and labour market situation rose the most in April.

Figures from the quarterly survey of planned big-ticket purchases, published in March, indicated that interest in major purchases had increased since the December survey. Planned purchases of housing and motor vehicles rose between surveys, although the index for planned house purchases was roughly the same as a year ago.

According to the Central Bank's survey of market inflation expectations, conducted in early May, expectations among market participants have risen somewhat since the February survey. According to the median response, market participants project annual inflation at 5½% after both one and two years. Expectations further ahead are broadly in line with the February survey, with respondents expecting inflation to average approximately 5% five and 10 years ahead.

The CPI rose by 0.8% month-on-month in April, after having risen by 1% in March. Annual inflation therefore measured 6.4%, which is virtually unchanged from February. Annual core inflation 3 excluding tax effects (observed inflation excluding the effects of volatile food items, petrol, public services, and the cost of real mortgage interest) was 5.9% in April, as opposed to 5.7% in February. Statistics Iceland has published a new core index (core index 4) which excludes the market price of housing as well as the items excluded in core index 3. Annual core inflation 4 measured 5.6% in April, as opposed to 5.1% in February.

The rise in the index between March and April is due in large part to increases in the price of clothing (owing partly to end-of-sale effects), food and beverages, and petrol, although house prices also contributed somewhat.

Inflation developments have been poorer than was forecast in February, and the inflation outlook has deteriorated sharply, according to the forecast in the 16 May *Monetary Bulletin*. Inflation measured 6.4% in Q1/2012, 0.3 percentage points above the February forecast. The deviation stems primarily from larger-than-anticipated increases in the price of oil and private services and a weaker-than-expected króna. The outlook is also for inflation to subside much more slowly than previously forecast. According to the forecast, it will subside only slightly over the remainder of the year, unlike the February forecast, and will remain significantly above previously projected levels well into 2014. This is due to a number of factors: a somewhat weaker króna, relatively less slack in the economy, rising inflation expectations, and high inflation persistence. The inflation target will not be reached until year-end 2014, almost a year later than was forecast in February.

Monetary policy has continued to support the economic recovery with an extremely low real interest rate. In spite of the interest rate hike in March, the Central Bank's real rate has fallen slightly because inflation and inflation expectations have risen according to most measures.

This low real interest rate has also contributed to the gradual improvement in households' and businesses' financial conditions. Rising asset prices, including house prices, and reduction of debt following restructuring and write-offs in connection with court judgments have improved private sector finances. Households' and businesses' net worth has therefore increased, enhancing their willingness and ability to step up spending.

Although uncertainty remains, the global economic outlook has improved, and optimism is on the rise. International forecasts suggest stronger output growth among Iceland's major trading partners, which will support exports. However, the outlook is poor for the

euro area, Iceland's most important export market. Iceland's terms of trade are poorer than previously expected, as price hikes for marine products have slowed down while oil and commodity prices have risen.

Export growth has been stronger than in the February forecast, and the outlook for 2012 has improved, primarily due to a brighter outlook for exports of marine products and services. Total exports are forecast to increase by almost 4% this year and over 3% per year in 2013 and 2014. The forecast for 2012 import growth has also been revised upwards. The contribution of net trade to output growth will be negative this year but is projected to be positive in 2013. A setback is expected in 2014 as a result of strong investment goods imports in connection with energy-intensive investment projects. The trade surplus will be somewhat smaller over the forecast horizon than was forecast in February.

The forecast assumes reasonably strong growth in private consumption and investment this year, offset by a contraction in public consumption. Private consumption growth will be somewhat stronger than previously forecast, and private business investment excluding energy-intensive industry, ships, and aircraft is expected to grow more as well. On the other hand, delays are expected in investments in the energy-intensive sector. As a result, total investment is projected to be somewhat weaker than in the February forecast.

Total national expenditure is forecast to grow by 3.7% in 2012, which is 0.3 percentage points more than was assumed in February. It is expected to grow by 2½% in 2013, as was projected in February, and by 3.8% in 2014, somewhat more than the 2.7% in the February forecast, primarily because some energy-intensive development projects have been shifted back to that year.

As a result, growth will be driven primarily by domestic demand, with roughly equal contributions from private consumption and investment for most of the forecast horizon. GDP is forecast to grow by an average of just over ½% between quarters in 2012, or about 2½% over the year as a whole, which is virtually identical to the February forecast. The GDP growth outlook for 2013 has improved since February, and growth is now forecast at 2.8%, owing to stronger private consumption growth and, in particular, a more positive contribution from net trade. GDP growth is projected to remain broadly unchanged in 2014, or 2.7%, and gain momentum in the first half of 2015, rising to 4% on a year earlier. In part, this surge in growth in the latter half of the forecast horizon is due to delays in energy-intensive industrial projects.

Labour market developments have been broadly in line with the last forecast, and the outlook for the forecast horizon is similar as well. Slow improvements in employment are expected, with unemployment forecast at 6½% in 2012 and then tapering off gradually to just over 4% by mid-2015, the end of the forecast horizon. According to the forecast, the recovery of employment will lag somewhat behind output growth, boosting labour force productivity during the forecast period. Productivity growth will not be sufficient to prevent a sizeable increase in unit labour costs in 2012, however.

The assessment of the current slack in the economy has changed little since February. Output is estimated to have been about 2% below potential output in 2011 and about 1% below it this year, somewhat less slack than was assumed in February. The economy is projected to approach full capacity utilisation by the beginning of 2014.

As is discussed in *Monetary Bulletin*, the outlook is highly uncertain. Although the global economic outlook has improved somewhat in the recent term, the possibility of a reversal in the most debt-ridden European countries and a resurgence of investors' fears cannot be ruled out. The outlook for exports could deteriorate as a result. The high level of household indebtedness in Iceland could also hinder recovery of private consumption to a larger extent. Furthermore, the demand-side effects of the recent Supreme Court judgment could be overestimated, as the Court's decision could erode credit institutions' asset portfolios, reduce financial institutions' willingness and ability to finance new investment, and raise financing costs. It is uncertain whether the Government's fiscal balance targets will be met. The exchange rate of the króna is another source of uncertainty. There is also considerable uncertainty about next year's wage settlement review and about how quickly inflation will subside to target. The output slack could be too small to ensure that inflation gradually returns to the inflation target. If high inflation expectations have become entrenched because inflation has been well above target for a prolonged period and because firms' pricing decisions appear to be based on past inflation, inflation persistence could be underestimated.

## **II The interest rate decision**

The Governor informed Committee members of the Treasury's issuance of US dollar bonds and the results of the Bank's foreign currency auctions in March and May. He also reported on the IMF Executive Board's Article IV Consultation on the status and outlook for the Icelandic economy, the meetings of the Icelandic representatives with IMF staff, and his own meetings with other central bankers, rating agencies, and financial institutions at the spring meetings of the IMF, held in Washington, DC, in April. Also discussed was the joint financial stability meeting of the Central Bank of Iceland and the Financial Supervisory Authority in early May.

The Committee discussed recent exchange rate developments, as the króna had appreciated in trade-weighted terms since the March meeting, although it was still weaker than at the beginning of the year. As before, Committee members considered the depreciation early in the year primarily the result of foreign currency hoarding by parties with foreign-denominated loan payments in the offing and of reduced foreign exchange inflows through the current account balance, owing to seasonality, poorer terms of trade, and higher domestic costs. The recent amendments to the Foreign Exchange Act, changes in foreign currency hoarding related to servicing of foreign-denominated loans, and a seasonal upswing have contributed to the recent appreciation of the króna.

The Committee was of the view that the macroeconomic forecast published in *Monetary Bulletin* on 16 May confirmed that the recovery beginning in late 2010 had continued and extended to most sectors of the economy. Domestic demand was quite strong, and the labour and real estate markets were showing clear signs of recovery. Asset prices had risen and debt had declined, and private sector financial conditions therefore continued to improve. According to the forecast, output growth is expected to measure 2½-3% per year in 2012 and the two years following, which is somewhat more than in the Bank's February forecast.

The Committee discussed the possibility of raising interest rates by 0.5-1.0 percentage points. All members agreed that there were arguments in favour of a hike of either 0.5 or

0.75 percentage points and that the poorer inflation outlook was the strongest reason for an increase; cf. the discussion above.

The need for high enough interest rates to support the króna was highlighted. Higher interest rates could contribute to slower payment of foreign debt and could affect the incentive to convert foreign currency in foreign-denominated accounts to krónur.

It was pointed out that the slack in the economy could be smaller and inflationary pressures from the labour market greater than forecast, as the equilibrium unemployment rate was highly uncertain at present. In addition, fiscal austerity could turn out to be less pronounced than was assumed in the May forecast.

Some Committee members considered that there were strong grounds for a much larger rate hike than the market generally expected. There was a genuine risk that high and rising inflation expectations would lead to higher and more persistent inflation than was currently forecast.

Although there were grounds for a rate hike of up to 1 percentage point, most members considered that other arguments supported a smaller step. It was possible that recent exchange rate developments stemmed in part from seasonal volatility. If so, the króna would be likely to appreciate in the next few months. There was also the prospect of a decline in global energy prices, which could have direct and indirect effects on domestic prices. It was also pointed out that the global economic outlook was very uncertain. In view of these factors, some members considered it possible that inflation was overestimated in the forecast, which assumed that the low exchange rate would prevail throughout the forecast horizon. Furthermore, some members considered it necessary to exercise caution in view of the still-difficult financial conditions faced by the private sector. Although recovery was clearly underway, it was still fragile, and too steep a rate hike could have adverse supply-side effects.

In view of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be raised by 0.5 percentage points, which would raise the current account rate to 4.5%, the maximum rate on 28-day CDs to 5.25%, the seven-day collateralised lending rate to 5.5%, and the overnight lending rate to 6.5%.

Four members voted in favour of the Governor's proposal, and one voted against it, preferring to raise rates by 0.75 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. In order to keep the level of monetary restraint unchanged from the last meeting, rates would have to be raised by 0.5-0.75 percentage points. The Bank's new inflation forecast also showed that it was necessary to continue withdrawing monetary accommodation with an additional rate hike of at least 0.25-0.5 percentage points.

In spite of differing opinions on the size of the step that should be taken at this meeting, all Committee members agreed that it would be necessary to continue withdrawing the current degree of monetary accommodation as the recovery progresses further and the margin of spare capacity diminishes. They agreed that the degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. Moreover, they agreed that, other things being equal, if inflation does not subside in the next few months, it will be necessary to raise nominal interest rates further in order to ensure that inflation returns to target.

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 13 June 2012.