The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

December 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 11 December 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 12 December, 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 global outlook and the outlook for Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 14 November interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.5% higher at the time of the December meeting than at the November meeting. Between meetings, the króna had depreciated by about 0.2% against the euro but appreciated by 0.9% against the pound sterling, and 2.1% against the US dollar. Offshore trading was sparse and the offshore exchange rate broadly unchanged.

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 0.25-0.5 percentage points above current account rates. On 10 and 11 December, however, interest rates rose due to temporary imbalances in payment flows. Trading in the interbank market for krónur has contracted slightly year-on-year so far in 2012.

The five-year breakeven inflation rate in the bond market was 4.3% just before the MPC meeting, after falling slightly since the November meeting. The five-year breakeven inflation rate five years ahead was 4% and had fallen by just under ½ a percentage point.

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 0.9% at the time of the December meeting, which was unchanged since the November meeting. They were also unchanged based on the breakeven inflation rate in the bond market, at 0.8%, but had fallen by 0.3 percentage points, to 0.8%, in terms of twelve-month inflation.

The Republic of Iceland's sovereign CDS spread had fallen by 0.2 percentage points between meetings, to 1.7 percentage points. The risk premium on Treasury obligations, as expressed in terms of the spread between interest rates on the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, had fallen by 0.1 percentage points between meetings for 10-year bonds but had risen by 0.2 percentage points for five-year bonds.

Unchanged Central Bank interest rates in December appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts, most of whom cited the MPC's November statement as grounds for unchanged rates.

Broad money (M3) contracted by 0.5% month-on-month in October and by 0.4% year-on-year. Excluding holding company deposits, M3 grew by 1.6% between years.

Outlook for the global real economy and international trade

According to the most recent forecast from the Organisation for Economic Co-operation and Development (OECD), published in November, the forecast for global output growth, world trade, and inflation has been revised downwards since the last forecast, which appeared in May. The OECD now expects a stronger contraction in the euro area in 2012 than in the May forecast, or 0.4% instead of 0.1%. A 0.1% contraction is forecast for 2013. The 2012 output growth forecast for Iceland's major trading partners has been revised downwards, from 1% in May to the current 0.7%. Growth is expected to measure 1.1% in 2013, as opposed to 1.9% in the May forecast. The projections for 2012 from Consensus Forecasts for Iceland's trading partners are unchanged since the November MPC meeting.

Iceland's goods trade surplus totalled 15.2 b.kr. in October and, according to preliminary figures, 12.3 b.kr. in November. Export values have risen slightly from the previous year in the past two months, whereas import values contracted year-on-year in November. The increase in export values is due to growth in industrial export values, and the drop in import values is due to a sizeable contraction in the value of imported commodities and operational inputs.

Aluminium prices have risen steeply since the MPC's last meeting, whereas marine product prices declined in September and October.

The domestic real economy and inflation

According to new national accounts data published by Statistics Iceland in December, GDP growth measured 2.1% in Q3/2012, and seasonally adjusted quarter-on-quarter GDP growth was positive by 3.5%. GDP grew by 2% year-on-year in the first three quarters of 2012. Previously published figures for the first half of the year were revised as well, with GDP growth for H1/2012 adjusted downwards to 1.9% from the previous estimate of 2.4%.

Of the components of domestic demand, business investment and private consumption were the main drivers of growth in the first three quarters, and national expenditure grew by 3.7% year-on-year over the period. The contribution of net trade to output growth was negative by 1.5 percentage points of GDP over this period, as import growth (6.6%) outpaced export growth (3%).

Developments in the first three quarters were broadly in line with the forecast published in the Bank's November *Monetary Bulletin*, which provided for 2.1% output growth during the period. According to Statistics Iceland figures, national expenditure growth was weaker than in the November forecast, which provided for 4.5% growth. The deviation is due largely to the fact that private consumption and energy-intensive industrial investment were weaker than forecast and the contraction in public expenditure greater than was projected in November. Offsetting weaker national expenditure, however, the contribution from net trade was less negative than in the November forecast.

The trade surplus in Q3 measured 12.6% of GDP, while the forecast in the November issue of *Monetary Bulletin* assumed 9.6%. The deviation is due primarily to the fact that the forecast in *Monetary Bulletin* assumed 9 b.kr. in aircraft imports in Q3. Figures from Statistics Iceland indicate, however, that aircraft imports totalling 5.8 b.kr. took place in Q2 and no aircraft were imported in Q3. The forecast in *Monetary Bulletin* 2012/4 therefore allows for 3.5 b.kr. in aircraft imports, which have not yet emerged in preliminary figures from Statistics Iceland.

The surplus on the current account amounted to just over 6½% of GDP in Q3 (29 b.kr.), as the large surplus on the trade account far outweighed the income account deficit, which also proved smaller than in recent quarters.

The current account surplus excluding the deposit money banks (DMBs) in winding-up proceedings amounted to just over 11% of GDP in Q3. Furthermore, revised figures for the first half of 2012 showed a slightly larger deficit than previous figures indicated, or 11.8% of GDP. The revision for 2011 showed that the current account deficit was 12.6 b.kr. smaller than previously estimated, or 6.2% of GDP.

Major indicators of developments in private consumption have implied that private consumption growth has lost pace in recent months. The indicators available at the time of the December meeting suggested, however, that household demand in October had been above the average for the third quarter. After adjusting for seasonality, household payment card turnover in October was 2.7% above the Q3 average in real terms.

According to the Statistics Iceland labour market survey, total hours worked grew by 0.7% year-on-year in October, as the rise in the number of working persons outpaced the reduction in average hours worked.

Registered unemployment as published by the Directorate of Labour (DoL) rose by 0.3 percentage points in October. Unemployment measured 5.2%, while seasonally adjusted unemployment was 5.7%, unchanged from the previous month.

The wage index rose by 0.1% month-on-month in October and by 5.1% year-on-year. Real wages fell by 0.2% between months in October but rose by 0.9% year-on-year.

The nationwide Statistics Iceland house price index, published in late November, rose by 0.6% from the previous month, and by 0.2% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.9% month-on-month in October, and by 0.3% when adjusted for seasonality. The number of purchase agreements concluded nationwide rose 13% year-on-year in November, which is similar to the annual increase for the first 11 months of the year. The number of purchase agreements is still low in historical context, however.

According to the Capacent Gallup survey, consumer sentiment fell slightly in November, following a steep drop in October, but is still somewhat more upbeat than a year ago. Sentiment towards the economy declined most between months, and the only subcomponent that rose in November was the assessment of the labour market.

According to Capacent Gallup's household survey, carried out in November and December, household inflation expectations one year ahead were 5.5%, virtually unchanged since the last survey in September. Household inflation expectations two years ahead measured 5%, also unchanged since the last survey.

The consumer price index (CPI) rose by 0.3% month-on-month in November. Annual inflation measured 4.5%, up from 4.2% in October. Core index 3, which excludes the effects of taxes, volatile food items, petrol, public services, and real mortgage interest expense, rose by 0.6% between months, however. Underlying inflation according to this measure was 4.1% in November, having risen from 3.6% in October following a virtually uninterrupted decline since March 2012.

The effects of the depreciation of the króna in the autumn continued to emerge in imported goods prices, as imported food products, new motor vehicles, and other imports rose somewhat in price in November. Petrol prices fell month-on-month, however, leading to a nearly 0.2 percentage point decline in the CPI.

II The interest rate decision

The Governor informed Committee members of the status of work within the bank and with other authorities regarding the assessment of Iceland's external debt, the resolution of the failed banks' estates, and the liberalisation of the capital controls. The Committee also discussed the Central Bank's liquidity management and the status of the fiscal budget proposal following the second round of Parliamentary discussions.

The Committee discussed the possibility of keeping the Bank's interest rates unchanged or raising them by 0.25 percentage points. The main argument in favour of unchanged interest rates was that the most recent indicators suggested that economic developments had been well in line with the Bank's November forecast. According to preliminary figures from Statistics Iceland, output growth in the first three quarters of the year measured 2%, while in November the Central Bank forecast 2.1% growth for the period. Developments in the labour market were also broadly in line with expectations. Furthermore, the exchange rate of the króna had remained broadly stable since the last interest rate decision date and inflation had developed in line with the forecast.

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 members voted in favour of the Governor’s proposal, although one member would have preferred to raise rates by 0.25 percentage points at this time, in view of still-high inflation and long-term inflation expectations. This member agreed, however, that the difference was small enough to justify a vote in favour of the Governor’s proposal.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They also agreed that the rise in interest rates since August 2011 and the decline in inflation had withdrawn a considerable amount 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, which in turn would depend to a large extent on exchange rate movements and wage-setting decisions. Whether the Bank’s nominal interest rates would remain unchanged in the near term would depend, among other things, on whether the outcome of the forthcoming wage settlement review at the beginning of next year was consistent with inflation declining to the 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 part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 6 February 2013.