



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

## Minutes of the Monetary Policy Committee meeting

December 2013

Published 25 December 2013

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 9 and 10 December 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 11 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 6 November interest rate decision.

#### **Financial markets**

The average trade-weighted exchange rate in the domestic foreign exchange market was 2.7% higher at the time of the December meeting than at the November meeting. Between meetings, the króna had appreciated by about 1.6% against the euro, 3.5% against the US dollar, and 1.0% against the pound sterling. Bids for krónur in the offshore market were broadly unchanged and lay in the range of 226-260 kr. per euro.

The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 15 million euros (roughly 2.4 b.kr.) since the last MPC meeting, or 16% of total market turnover during the period.

In general, liquidity had remained ample between meetings in the interbank market for krónur, and as before, overnight rates in the interbank market remained below the centre

of the interest rate corridor, at 0.25-0.9 percentage points above current account rates. Turnover in the interbank market totalled about 376 b.kr. year-to-date, broadly unchanged from the same period in 2012.

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. The average of the various measures of inflation and inflation expectations was 3.9% at the time of the December meeting. According to this, the real policy rate was 1.4% at the time of the December meeting; i.e., it was virtually unchanged since the November meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged since the November meeting, measuring 1.8 percentage points just before the Committee met in December. The risk premium on five-year Treasury obligations maturing in 2016, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, measured 2.8 percentage points, an increase of 0.2 percentage points since the last meeting, whereas the spread between the two countries' comparable bonds maturing in 2022 had narrowed slightly, to 2.8 percentage points.

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 analysts cited stable inflation and the appreciation of the króna since the last MPC meeting as grounds for unchanged interest rates. They expected the Committee to await the results of wage settlements and Parliamentary handling of the Government's proposals for indexed household debt relief before deciding to change interest rates.

Broad money (M3) contracted by 1.2% month-on-month in October but grew by 3.2% year-on-year. This was the fifth month in a row to see a year-on-year increase in M3, which had previously contracted uninterrupted since September 2012. Excluding holding company deposits, however, M3 grew by ½% between years in October. Narrower measures of the money supply also grew year-on-year in October, as in September, after having contracted uninterrupted since July 2012. M2 grew by 0.9% between years, and M1 by 2.8%.

At mid-year, the Central Bank began compiling more detailed information on new DMB loans to households and firms. Previous figures did not take full account of prepayments, making it difficult for the Bank to assess the extent of new banking system lending.

According to information on new loans granted by the three large commercial banks, net new lending to households (loans net of prepayments) totalled 44 b.kr. during the first 10 months of the year, or about 6% of the total stock of household loans as of the beginning of 2013, and increased as the year progressed. Net new lending to non-holding companies grew as well, totalling almost 66 b.kr. over this period, or almost 6½% of the total stock of corporate loans as of the beginning of 2013.

The NASDAQ OMXI6 index had risen by 8.6% between meetings. Turnover in the NASDAQ OMX Iceland main market totalled 232 b.kr. over the first 11 months of the year, as compared with 76 b.kr. during the same period in 2012. At the beginning of December, the market value of companies listed on the main market totalled 507 b.kr., or approximately 25% of year-2012 GDP.

## **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, global output growth and world trade will be weaker in 2013 than according to its May forecast, although the inflation forecast was unchanged. Weaker output growth in 2013 is attributable primarily to weaker growth in emerging economies. In the euro area, a contraction of 0.4% is expected, which is 0.2 percentage points less than previously forecast. Global output growth is forecast at 3.6% in 2014. The year-2013 output growth forecast for Iceland's main trading partners has been revised upwards slightly, to 0.7%, whereas the forecast for 2014 has been lowered slightly since May to 1.8%. *Consensus Forecasts'* year-2013 projections for Iceland's trading partners are unchanged since the November MPC meeting.

Iceland's goods trade surplus totalled 7.2 b.kr. in October and, according to preliminary figures, 12.3 b.kr. in November. Both import and export values have contracted year-on-year for the past two months. The decline in export values is due to a contraction in industrial export values, and the drop in import values is due to a contraction in the price of imported commodities and operational inputs.

Aluminium prices have fallen slightly since the MPC's last meeting, and marine product prices declined in both September and October. Terms of trade deteriorated by just over 4% year-on-year in Q3.

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

According to new national accounts data published by Statistics Iceland in December, GDP growth measured 4.9% in Q3/2013, and seasonally adjusted quarter-on-quarter. GDP growth was positive by 3.7% according to seasonally adjusted figures from the Central Bank. In the first three quarters of the year GDP grew by 3.1% year-on-year. Previously published figures for the first half of the year were revised as well, with GDP growth for H1/2013 adjusted downwards, from 2.2% to 2.1%.

The contribution from net trade was the main driver of GDP growth in Q3, as exports grew much more strongly than imports. Exports grew 8.3% year-on-year and imports by 1.6%. Of domestic demand-side items, private consumption growth contributed most. In terms of total consumption and investment, developments in Q3 and in the first nine months of the year were broadly similar to the forecast in the November issue of *Monetary Bulletin*. GDP growth measured 4.9% in Q3, however, far outpacing the 2.5% provided for in the November forecast. Figures for the first three quarters developed in a similar manner, with GDP growth measuring 3.1%, as opposed to 2.4% in the forecast. The deviation is due to a more favourable contribution from net trade, owing to stronger exports and weaker imports than in the forecast.

The current account surplus in Q3 was 54 b.kr, or 11.5% of GDP. The surplus is due largely to a 46 b.kr. surplus on services trade and a 21 b.kr. surplus on goods trade. The income account showed a deficit of 9.6 b.kr., however. Revision of previously published figures for 2012 and the first half of 2013 has revealed that the current account deficit was smaller than previously thought. The underlying current account surplus measured 13.3% of GDP during the quarter, whereas the forecast in the November *Monetary Bulletin* assumed a surplus of 11.1%. The deviation is due primarily to the larger surplus on goods and services trade.

Key indicators of private consumption in October suggest that developments in the beginning of the quarter were broadly similar to those in Q3. Payment card turnover, for instance, was up 2.6% year-on-year in October. Furthermore, retail sales have increased somewhat in recent months, particularly for big-ticket items such as furniture and electronic equipment.

According to the Capacent Gallup survey, consumer sentiment improved slightly in November. The Consumer Sentiment Index measured 68.4, which is markedly lower than it was a year ago. In November, the most pronounced change was the increase in the sub-index on the assessment of the economy, but all sub-indices were below 100, which means that pessimistic respondents outnumbered the optimists.

Unemployment as registered by the Directorate of Labour (DoL) measured 3.9% in October. It has remained virtually unchanged since May, whereas seasonally adjusted unemployment has fallen by 0.3 percentage points, to 4.1%.

The wage index rose by 0.2% month-on-month in October and by 6% year-on-year. Real wages in terms of the wage index rose by 0.2% between months and about 2.3% year-on-year.

According to Capacent Gallup's November survey among Iceland's 400 largest firms, the number of respondents interested in laying off staff in the next six months somewhat exceeded the number interested in recruiting. This is broadly similar to the results of the last survey, carried out in September, but a change from earlier 2013 surveys, when firms interested in recruiting outnumbered those interested in downsizing by some 10 percentage points.

In the November Capacent Gallup survey, executives were marginally more optimistic about the economic situation six months ahead than in the September survey. Just under 46% of respondents considered the current situation poor, however, and about 47% considered it neither poor nor good. On the other hand, executives were more optimistic about the future situation. The percentage of respondents who expected conditions to improve in the next six months increased between surveys, to nearly 33%. Executives in the construction sector were more pessimistic than other respondents about the situation six months ahead, and they, as well as respondents from the retail and transport sectors, were more pessimistic in November than in September. All respondents were more optimistic than they were a year ago, however. About 56% were of the opinion that conditions would remain unchanged in the next six months.

The nationwide Statistics Iceland house price index, published in late November, rose by 1½% from the previous month, and by 0.9% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 1.6% month-on-month in October, and by about 1% when adjusted for seasonality. The number of registered purchase agreements was up 6% year-on-year in November, and by just over 9% during the first 11 months of the year.

The five-year breakeven inflation rate in the bond market was about 3.9% just before the MPC meeting, after rising by about 0.3 percentage points since the November meeting. The five-year breakeven inflation rate five years ahead was 4.3% and had risen by roughly 0.6 percentage points. Households' and businesses' inflation expectations have changed very little in the recent term, however. According to the quarterly survey carried out by Capacent Gallup in November, household inflation expectations measured about 5% both

one and two years ahead and had remained unchanged for some time. According to a comparable survey conducted among firms in November, executives expect inflation to measure 3.9% in one year, as opposed to 4% in the September survey.

The consumer price index (CPI) rose by 0.36% month-on-month in November. Twelve-month inflation measured 3.7%, up from 3.6% in October. Underlying annual inflation rose 0.6% between months as measured by core index 3, and by 0.4% in terms of core index 4, bringing twelve-month inflation by these two criteria to 4.2% and 3.5%, respectively. Increases in the housing component and in airfares had the most pronounced upward impact, while petrol prices pulled in the opposite direction.

## **II The interest rate decision**

The Governor reported to the Committee on the work done by the Bank and other authorities since the last meeting in relation to capital account liberalisation.

Committee members agreed that the inflation outlook was broadly in line with the Bank's November forecast. After having risen somewhat in the third quarter, inflation had tapered off again, measuring 3.7% in November. The exchange rate of the króna was also somewhat higher than at the time of the previous meeting, although broadly at the level assumed in the Bank's November forecast.

The economic outlook had improved from November, in the Committee's opinion. According to recently published national accounts figures, GDP growth for the first three quarters of the year measured 3.1%. This is considerably above the Central Bank's forecast and is consistent with previous indications of a strong labour market recovery.

As before, the Committee was of the opinion that the outcome of the current wage negotiations would have a decisive effect on the inflation outlook and therefore on near-term developments in interest rates. Members agreed that, if wage increases should prove larger than is consistent with the inflation target, it would probably be necessary to raise the Bank's nominal interest rates, other things being equal, particularly if the margin of spare capacity in the economy continues to narrow.

As before, members agreed that it was important that the National Budget maintain a level of medium-term fiscal consolidation at least equivalent to that provided for in the budget proposal for 2014.

The Committee discussed in detail the effects of the indexed household debt relief measures, the broad outlines of which have now been presented by the Government. The chair of the expert committee on indexed household debt relief, the committee's economic advisor, and representatives from the Ministry of Finance and Economic Affairs reported to the MPC on the committee's main proposals and their assessment of their economic impact. The Bank has begun work on its own assessment of the effect of the proposals on the economic outlook, financial stability, and Government finances. Although the assessment is not yet complete, the MPC was of the opinion that the measures would stimulate domestic demand, other things being equal. Because the spare capacity in the economy is disappearing, increased demand will raise inflation unless there is a change in the monetary stance. Stronger demand will also stimulate imports and narrow the current account surplus, which will contribute to a lower exchange rate than would otherwise develop.

Although Committee members were of the opinion that the inflationary effects of the debt relief package were underestimated in the available assessments, they considered that, based on the scope of the measures and their distribution over time, a tighter monetary stance should suffice to bring inflation back to target in coming quarters, other things being equal. They considered it important nonetheless that the authorities consider ways to mitigate the negative side effects on the current account balance and inflation, thus reducing the need for countervailing monetary policy action.

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. As before, some members were very concerned about the persistence of inflation and inflation expectations, the latter of which had risen in the recent term. In this context, it was mentioned that the economy was more robust than had been assumed and that considerable uncertainty remained concerning wage settlements. In addition, the Government's debt relief measures would increase inflationary pressures still further. For these reasons, one Committee member would have preferred to raise interest rates by 0.25 percentage points but agreed that it was premature to respond to the impact of the measures before the results of the wage settlements, the National Budget, and the effects of the debt relief package had become clear.

The Committee also discussed the proposed sale of Arion Bank hf. contractual covered bonds, which was announced publicly on 16 December. The Committee considered it necessary to spread the sale over a period of time. The Central Bank will monitor financial system liquidity closely to ensure that the monetary stance is consistent with the decisions of the MPC and is not affected by the sale. The MPC will otherwise take into consideration the potential effects of the sales, both on the financial market and on long-term interest rates, when assessing the appropriate monetary stance at any given time.

Committee members agreed that, other things being equal, a stronger economic recovery and the above-mentioned Government measures would require more rapid monetary tightening than previously expected. The degree to which such tightening 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. Also attending parts of the meeting were the chair of the expert committee on indexed household debt

relief, the committee's economic advisor, and representatives from the Ministry of Finance and Economic Affairs.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 12 February 2014.