The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 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 4 and 5 November 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 6 November, 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 2 October interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2013/4 on 6 November.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.7% lower at the time of the November meeting than at the October meeting. Between meetings, the króna had depreciated by about 0.7% against the euro and 1.1% against the US dollar but had appreciated by 0.1% against the pound sterling. Bids for krónur in the offshore market lay in the range of 219-253 kr. per euro.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 3 million euros (roughly 492 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, at 0.25 percentage points above current account rates. Interest rates were thus unchanged since the previous meeting. Turnover in the interbank market totalled about 337 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. According to various measures of inflation and inflation expectations, the real policy rate was about 1.4% at the time of the November meeting, after having risen by about 0.1 percentage points since the October meeting. The average of the various measures of inflation and inflation expectations was 3.9% at the time of the November meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged between meetings and measured about 1.6 percentage points just before the 5 November meeting. 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, was also virtually unchanged between meetings, at 2.7 percentage points, and the spread between the two countries' comparable bonds maturing in 2022 was broadly unchanged as well, at 2.9 percentage points.

Unchanged Central Bank interest rates in November appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most financial market analysts had forecast no change in interest rates, citing recent disinflation, a more positive inflation outlook, and declining short-term inflation expectations. They also considered it likely that the MPC would await the outcome of wage negotiations before deciding to change interest rates.

Broad money (M3) grew by 2.7% quarter-on-quarter in Q3 and by about 2.3% year-on-year. For the fourth consecutive month, broad money had grown between years, after having contracted steadily since September 2012. Excluding holding company deposits, M3 grew by 0.7% between years in Q3.

The total stock of loans to households declined by 0.9% year-on-year in Q3 and by 1.6% year-to-date. The stock of deposit money bank (DMB) loans to households grew by 2.0% in the first three quarters of 2013, however, and by 3.3% year-on-year in Q3. The adjusted total stock of DMB and Housing Financing Fund (HFF) loans to non-holding companies declined by 2.5% year-on-year in the first three quarters of 2013 and about 4.8% year-on-year in Q3.

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 the new data, net new lending by the three large commercial banks to households – that is, new lending net of prepayments – has grown in 2013, totalling some 38 b.kr. in the first three quarters of the year. Net new lending to non-holding companies totalled almost 51 b.kr. over this period, or an average of about 5.6 b.kr. per month

The NASDAQ OMX Main list index, OMXI6, had risen by 2.4% between meetings. Trading volume on the NASDAQ OMX Iceland Main Market totalled 212 b.kr. during the first 10 months of the year, up from 63 b.kr. over the same period in 2012. At the beginning of

November, the market value of companies listed on the main market totalled 489 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) October forecast, the outlook for 2013 is for slightly weaker global output growth than in the July forecast, or 2.9% instead of 3.1%. The forecast for world trade in 2013 has also been revised downwards slightly. Major output growth forecasts for emerging economies have been revised downwards, while forecasts for industrialised countries are broadly unchanged since July. The inflation forecast is broadly unchanged for industrialised countries but is slightly lower for emerging countries. The forecast for output growth in 2013 in Iceland's main trading partners is virtually unchanged, or 0.7%.

The goods trade surplus totalled 8.7 b.kr. in September. Import and export values grew marginally year-on-year in September but contracted in the first nine months of the year, export values by 2.3% and import values by just under 2%. The contraction in export values is due mainly to a contraction of over 3% in industrial export values, whereas marine product export values rose by 1½% year-on-year. Excluding imports of ships and aircraft in the early months of 2012, import values rose by 5% year-on-year in the first nine months of 2013. The value of industrial imports and consumer durables (household appliances, etc.) has risen most between years, or by over 12%.

Aluminium prices fell month-on-month in September but rose again in October. The average October price was similar to that in August, at the time of the Bank's last forecast, but more than 8% lower than in October 2012.

The domestic real economy and inflation

The fiscal budget proposal for 2014 provides for a considerably larger deficit this year than was assumed in the 2013 National Budget. According to the proposal, the aim is to achieve a Treasury surplus on an accrual basis in 2014. If the proposal is passed unamended, the year-on-year improvement in the primary and overall balance would be nearly 1.5% of GDP. The Government's fiscal strategy for the next several years is not included in the budget proposal, and the medium-term plan is a simple extrapolation based on the economic forecast underlying the proposal. According to the extrapolation, a sizeable surplus on the overall balance will not be achieved in the next four years.

Unemployment as registered by the Directorate of Labour (DoL) was 3.9% in Q3/2013, while seasonally adjusted unemployment was 4.5%. Unemployment according to the Statistics Iceland labour market survey was somewhat higher, however, or 4.4%. Excluding those who had become employed, it measured 4.1%, and when adjusted for seasonality it measured 5.4%.

In Q3, the wage index rose by about 0.5% quarter-on-quarter and 5.7% year-on-year. Real wages in terms of the wage index rose by 0.1% between quarters and by 1.6% year-on-year.

According to the labour market survey, labour demand grew significantly more strongly in Q3 than was assumed in the Bank's August forecast, which provided for a 0.5% increase in total hours worked, as opposed to the actual increase of 5.6%. The year-on-year increase during the quarter is attributable to both a 4.3% rise in the number of employed persons and a 1.2% year-on-year increase in average hours worked. This is the second consecutive quarter to see an increase in average hours worked, which had contracted for four quarters in a row.

According to Capacent Gallup's September survey among executives from Iceland's 400 largest firms, the number of respondents interested in laying off staff in the next six months roughly equalled the number interested in recruiting. This is somewhat of a departure from surveys conducted earlier this year, which indicated that firms interested in recruiting outnumbered those interested in downsizing by about 10 percentage points. The change is due both to an increase in the number of firms considering redundancies and to a decline in the number interested in adding on staff. As could be expected, export firms tend to be relatively upbeat, and exporters interested in recruiting outnumber those considering redundancies by 8 percentage points. Firms in the non-tradable sector are more pessimistic, however, with companies considering downsizing outnumbering those interested in recruiting by 5 percentage points.

Key indicators of developments in private consumption in Q3 suggest that it remained broadly unchanged quarter-on-quarter and that it may have grown by nearly 2% year-on-year. Payment card turnover grew 2.7% year-on-year during the quarter, primarily due to a strong increase in September, as growth was more modest in July and August. Retail sales turnover continued to increase during the quarter, particularly in electronic equipment stores. New motor vehicle registrations increased only slightly during the third quarter, and the pace of growth has slowed markedly this year.

According to the Capacent Gallup survey, consumer optimism diminished considerably between September and October. The Consumer Sentiment Index measured 67.5 points in October, a decline of 10.5 points year-on-year. All subindices fell in October, with the assessment of the economy declining most.

The nationwide Statistics Iceland house price index, published in late October, was unchanged from the previous month but was up by about 0.3% when adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.9% month-on-month in September and by about ½% when adjusted for seasonality. The index has risen by about 7% since September 2012. The nationwide number of registered purchase agreements was up by nearly a fourth year-on-year in September, and by roughly 12% year-on-year during the first nine months of 2013.

According to the Capacent Gallup survey carried out in September, executives were slightly more pessimistic about the economic outlook than in the previous survey, conducted in May, when the corporate sentiment index reached its highest point since March 2008. Just under 43% of respondents considered the current situation poor, and about half considered it neither poor nor good. On the other hand, executives were more optimistic about the future situation, with roughly 30% of respondents indicating that they expected conditions to improve in the next six months. Executives in all sectors were more pessimistic than they were in May, and the downturn in sentiment was most pronounced in the construction and fisheries sectors. All executives except those in the construction industry are more optimistic than they were a year ago, however. About 57% were of the opinion that conditions would remain unchanged in the next six months.

The CPI remained unchanged between months in October. Annual inflation measured 3.6%, down from 3.9% in September. Core indices 3 and 4, excluding tax effects, both rose by 0.06%. Twelve-month inflation by these measures declined by 0.3-0.4 percentage points to 4.2% and 3.7%, respectively. The drop in petrol prices had the strongest downward effect on the index, although the price of other imported goods and private services declined as well. Offsetting this was an increase in paid rent. Some base effects were present in October, as the CPI had risen by 0.3% in October 2012.

Inflation expectations have changed little in the recent past. According to the quarterly survey carried out by Capacent Gallup in September, household inflation expectations measured about 5% one and two years ahead and had remained unchanged for some time. According to a comparable survey among businesses, also carried out in September, corporate executives expect inflation to measure 4% in one year (the same as in the May survey) as well as in two years (a decline of ½ percentage point from the last survey). According to the Central Bank's quarterly survey of market expectations, conducted in late October, market participants expect twelve-month inflation to measure 4% in one year and to average 4% over the next 10 years, which is similar to the survey results in August, when the Bank's last forecast was published, but about 0.8 percentage points lower than at the same time a year ago. The breakeven inflation rate in the bond market has also fluctuated around 4%. The five-year breakeven rate measured 3.7% just before the MPC meeting, after having declined marginally since the October meeting, but was virtually unchanged since August. The five-year breakeven rate five years ahead measured 3.9% and had developed in broadly the same manner. By both measures, inflation expectations were up to 1 percentage point lower than at the same time a year ago.

According to the revised forecast published in *Monetary Bulletin* on 6 November, the inflation outlook is similar to that in August. According to the forecast, inflation will measure 3.9% this year. It is assumed that the slack in the economy and the relative stability of the króna over the forecast horizon will ensure that inflation begins to taper off early next year and align with the target late in 2015.

Uncertainty about the global economic situation has subsided but is still discernible. Output growth has gained strength among Iceland's main trading partners as the year has progressed. Output growth in trading partner countries is projected to average just under 1% this year, just under 2% in 2014, and just over 2% per year in 2015-2016.

Iceland's terms of trade have deteriorated almost without interruption for about six years and are projected to be nearly 17% poorer this year than in 2007, owing to the combined effects of weak global output growth and adverse developments in the price of its main export products, particularly marine products. The outlook for developments in terms of trade has nonetheless improved since August, but it is still assumed that they will deteriorate during the forecast horizon. They are expected to be about 2% poorer in 2016 than in 2013.

The outlook is for the surplus on goods and services trade to be just over 6% of GDP in 2013, as was forecast in August. Although the surplus in the following years is expected to be larger than was projected then, it is still expected to shrink over the course of the forecast horizon. The underlying current account surplus will also shrink in line with reduced gross national saving and will flip from a surplus of just over 3% this year to a deficit of about 2% by 2015, which is nonetheless smaller than was forecast in August.

GDP growth for 2013 is estimated at 2.3% instead of the 1.9% assumed in the August forecast. The increase in growth is due primarily to stronger investment, as other expenditure items and the contribution from net trade are more or less unchanged. The output growth outlook for the next two years is slightly weaker than in the August forecast. Growth is projected at 2.6% in 2014, as opposed to the previous forecast of 2.8%, and 2.8% in 2015, instead of 2.9%. It is expected to lose pace in 2016 and measure 2% that year. If the forecast materialises, output growth will average 2.4% over the forecast horizon, which is close to the 30-year average. As in previous Central Bank forecasts, domestic private sector demand is the main driver of growth.

The recovery of the labour market has been stronger than was forecast in August. Most labour market indicators imply that the labour market recovery will continue. As a result, total hours worked are projected to rise more rapidly this year than previously forecast, and unemployment is expected to be lower. Seasonally adjusted registered unemployment is forecast at just under 4% by the end of the forecast horizon, in Q4/2016. The outlook for underlying productivity is broadly unchanged, and it is expected to grow by an average of roughly 1½% per year during the forecast horizon. This is somewhat weaker than in earlier recovery periods but close to the 30-year average. According to the forecast, productivity growth will not suffice to contain the cost effects of wage increases during the forecast horizon, as in light of previous experience, it is assumed that wage increases in the upcoming settlements will not be in line with the inflation target.

The slack in the economy is estimated to narrow by just under a percentage point this year, to just over 1% of potential output. It is slightly larger than was forecast in August but, as was projected then, it is expected to continue to narrow and to disappear by the second half of 2015, somewhat later than previously thought. The current forecast assumes that, although growth in potential output is recovering gradually after the financial crisis, it will be below long-term trend growth for the majority of the forecast horizon.

The baseline forecast in *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are several key uncertainties that could change the inflation outlook from that assumed in the baseline forecast. For example, if the króna is weaker or wage increases larger than in the baseline forecast, there is the risk that the inflation outlook in the forecast or the assumptions concerning the Central Bank interest rate level that will suffice to bring inflation back to target are too optimistic. The same is true if the level of fiscal consolidation is overestimated in the baseline forecast or if the slack in the economy proves to be less than is currently thought. The risk that underlying inflationary pressures are underestimated is also greater than it would be otherwise because long-term inflation expectations appear poorly anchored. If the global economic recovery proves weaker than is assumed in the baseline forecast, however, economic activity in Iceland will be weaker and inflationary pressures correspondingly less. The same applies if a weaker global economic recovery also entails larger declines in global oil and commodity prices, at least insofar as the króna does not weaken as a result. Domestic inflationary pressures could also prove less pronounced than in the baseline forecast if pay increases in the upcoming wage settlements are better aligned with the inflation target or if the domestic economic recovery is weaker; for instance, if energy-intensive investment is weaker than is assumed in the forecast.

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. He also informed the Committee of the status of discussions concerning the financial interactions between the Treasury and the Central Bank. Furthermore, the Governor gave an account of the Icelandic delegation's meetings with IMF representatives and his meetings with other central bankers, rating agencies, and financial institutions at the IMF's Annual Meeting in Washington, DC.

Committee members discussed the Bank's *Financial Stability* report, published after the October MPC meeting, the status of financial institutions', financial institutions' restructuring measures, and the progress in private sector debt restructuring. Also discussed was the joint financial stability meeting of the Central Bank of Iceland and the Financial Supervisory Authority in early October.

The Committee agreed that the outlook for output growth this year had improved. The forecast published in *Monetary Bulletin* on 6 November indicates stronger output growth in 2013 than was provided for in the August forecast, or 2.3%, but suggests that the outlook for the next two years is similar. The most recent indicators from the labour market also suggested that the recovery there was gaining strength. Total hours worked have increased more this year than in any single year since 2007.

The Committee discussed recent developments in the foreign exchange market and the Bank's activity in the market. The Bank's intervention policy appears to continue to contribute to reduced exchange rate volatility. The exchange rate had remained virtually unchanged since the last MPC meeting, and volatility had been negligible.

The Committee also discussed the recent deterioration in Iceland's terms of trade, which had eroded the current account surplus and put pressure on the exchange rate of the króna. Looking ahead, there was also uncertainty about how heavy foreign debt deleveraging, the settlement of the failed banks' estates, and capital account liberalisation would affect the exchange rate.

Committee members also discussed recent inflation developments and prospects. After having risen somewhat in the third quarter, inflation had tapered off again. The inflation outlook according to the Bank's forecast was broadly similar to that projected in August, however, and it was not assumed that inflation would subside to target until late in 2015. In the Committee's opinion, the pace of disinflation according to the forecast was unacceptably slow. It was also clear that, as before, inflation would be sensitive to near-term exchange rate and wage developments. Furthermore, inflationary pressures remain significant, underlying inflation is still above the Bank's inflation target, and inflation expectations are broadly unchanged.

At present, however, the Committee considered the upcoming wage negotiations to be the most important source of uncertainty. The Bank's forecast, based as before on past experience, assumed that the wage increases in the forthcoming wage settlements would be larger than was consistent with the inflation target, as it assumed that unit labour costs would rise by 4½% in 2013 and about 3.7% per year, on average, over the forecast horizon. As at the previous meeting, Committee members agreed that if wage increases were in line with the forecast, 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 continued to narrow. If wages should rise in excess of the forecast, it would be even more likely that the Bank would raise interest rates. If wage increases proved to be consistent with the inflation target, however, inflation would fall more quickly than currently assumed and interest rates would be lower than would otherwise be necessary, other things being equal.

The Committee was of the opinion that fiscal policy would also affect the monetary stance. As a result, it was important that the final Budget maintain a level of fiscal consolidation at least equivalent to that provided for in the budget proposal for 2014.

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. Two members expressed mounting concern, however, at the persistence of inflation and inflation expectations. Both nonetheless supported the Governor’s proposal, as they considered it appropriate to await the outcome of the wage settlements.

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 11 December 2013.