



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

June 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 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 11 June 2013, during which the Committee discussed economic and financial market developments, the interest rate decision of 12 June, 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 domestic economy, inflation, and the outlook for the global economy and Iceland’s international trade, with emphasis on information that has emerged since the 15 May interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.3% higher at the time of the June meeting than at the May meeting. Between meetings, the króna had depreciated by about 0.7% against the euro, remained broadly unchanged against the pound sterling, and appreciated by 1.8% against the US dollar. Bids for krónur in the offshore market lay in the range of 230-260 kr. per euro.

The Central Bank had sold 6 million euros (roughly 958 m.kr.) in the domestic foreign exchange market since the Committee’s last 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

0.25-0.85 percentage points above current account rates. Turnover in the interbank market totalled 245 b.kr. year-to-date, broadly unchanged from the same period in 2012.

Just before the MPC meeting, the five-year breakeven inflation rate in the bond market was about 3.2%, virtually unchanged from the May meeting. The five-year breakeven inflation rate five years ahead was 3.7% and had risen by just over 0.2 percentage points.

The effective nominal policy rate currently lies 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 about 1½% at the time of the June meeting and was virtually unchanged since the May meeting. The average of the various measures of inflation and inflation expectations was 3.7% at that time. Excluding households, whose inflation expectations tend to follow past inflation, inflation expectations averaged 3.5%.

The Republic of Iceland's sovereign CDS spread remained virtually unchanged between meetings, measuring 1.5 percentage points. The risk premium on Treasury obligations, measured in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury, had fallen by 0.1 percentage points between meetings, to 1.7 percentage points, for five-year bonds; however, it was virtually unchanged at 2 percentage points for 10-year bonds.

Unchanged Central Bank interest rates in June appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. As grounds for unchanged interest rates, most analysts cited the stable exchange rate and unchanged twelve-month inflation between meetings, the decline in inflation expectations as reflected in the bond market, and the fact that Q1/2013 output growth was weaker than projected in the Bank's May forecast.

Broad money (M3) grew by 0.2% month-on-month in April but shrank by 2.5% year-on-year. Excluding holding company deposits, M3 contracted by 1.9% between years in April.

The NASDAQ OMXI6 index had fallen by 4.2% between meetings. Trading volume on the NASDAQ OMX Iceland Main Market totalled 38 b.kr. in May. At the beginning of June, the market value of companies listed on the main market totalled 438 b.kr., or approximately 25% of year-2012 GDP.

Outlook for the global real economy and international trade

The Organisation for Economic Co-operation and Development's (OECD) forecast for global output growth in 2014, published in May, was unchanged from its November forecast. Growth is expected to be marginally weaker in 2013, however. In Iceland's main trading partner countries, output growth is forecast to be weaker in 2013, owing in particular to weaker growth in the Nordic countries and a deeper contraction in the euro area. The forecast for world trade has also been revised downwards for 2013 and 2014. Although the risks to the outlook have diminished, they remain considerable and continue to be tilted to the downside. The OECD projects year-2013 inflation at 1.6% for Iceland's trading partners, which is unchanged from the November forecast.

According to preliminary figures from Statistics Iceland, Iceland's goods trade balance was negative by 6.6 b.kr. in May, the largest goods account deficit in a single month in nearly five years. Both import values and export values contracted sharply during the month. In the first

five months of the year, the value of both imports and exports fell by about 2½% year-on-year. The contraction in import values is due to strong imports of transport equipment (primarily aircraft) early in 2012, although investment goods imports grew by 14% year-on-year in the first five months of 2013. The contraction in export values in the first five months of the year is due mainly to a contraction of over 3% in industrial export values and a ½% contraction in marine product exports.

The price of aluminium has risen marginally since the MPC's May meeting. Nonetheless, the average price was over 1½% lower in May than in April and almost 9% lower than at the same time in 2012. For the first weeks of June, the average price was 4½% above the May average. Marine product prices rose by 0.6% month-on-month in April, for the second month in a row, after having fallen for six consecutive months.

The domestic real economy and inflation

According to national accounts data published by Statistics Iceland in June, GDP growth measured 0.8% in Q1/2013, and seasonally adjusted quarter-on-quarter GDP growth measured 4.6%. The main driver of growth was the contribution from net trade, as imports contracted by 6.3% year-on-year and exports grew by 2.3%. Private consumption grew by 0.8% year-on-year and public consumption by 0.9%. Investment contracted by almost 20% between years, however, due mostly to the contraction in investment in ships and aircraft, which also accounts for a significant part of the contraction in imports. Excluding ships and aircraft, investment grew by just under 7% between years, due to an increase in residential investment and business investment excluding energy-intensive industry, ships and aircraft.

Output growth was somewhat weaker in Q1/2013 than according to the forecast in the May issue of *Monetary Bulletin*, which provided for 1.5% growth during the quarter. Consumption and total investment developed in line with the forecast, contracting by 2.7% year-on-year, whereas the contribution from net trade was more strongly positive than anticipated.

The weaker-than-expected output growth was due mainly to developments in inventory changes. As was the case at the same time in 2012, inventories grew between quarters, but the increase was smaller this year. As a result, the year-on-year growth in inventory changes was negative by 1.4 percentage points of GDP, while the forecast provided for no change. Based on previous experience, it is likely that the effects on GDP growth of the year-on-year contraction in inventory changes in Q1 will reverse to a large extent during the year. The growth in inventory changes was very strong quarter-on-quarter, however, and played a leading role in quarterly GDP growth in Q1.

The current account balance was positive by 1.3% of GDP in Q1, or 5.6 b.kr., whereas it has always been negative in Q1 in recent years. The forecast in the May issue of *Monetary Bulletin* provided for a 1.4% current account deficit in Q1. The underlying current account surplus was 2.5%, as opposed to 2.8% according to the forecast in *Monetary Bulletin*.

Payment card turnover figures from April and May indicated that private consumption was stronger than in Q1. Consumer sentiment appears to have improved as well, as the Capacent Gallup Consumer Sentiment Index rose somewhat in May, exceeding 100 points for the first time since the banks failed. Consumers were particularly optimistic about the six-month outlook and the prospects for the labour market. On the other hand, new motor vehicle registrations have declined considerably.

Registered unemployment as published by the Directorate of Labour (DoL) fell by 0.4 percentage points in April. Unemployment measured 4.9%, while seasonally adjusted unemployment was unchanged from the previous month, at 4.3%. Unemployment according to the Statistics Iceland labour force survey (LFS) was considerably higher, or 6.6%, which is 0.2 percentage points lower than in the previous month. After adjusting for seasonality, however, the LFS measurement was closer to the DoL unemployment rate, or 5.4%, down 0.6 percentage points month-on-month.

According to the LFS, total hours worked rose by 4.1% in April from the previous year. The rise was due to a 4.3% increase in the number of employed persons, while average hours worked per person fell by 1.6%.

According to the Capacent Gallup survey carried out among corporate executives in May, respondents in all sectors of the economy who were planning to recruit staff in the next six months outnumbered those planning to downsize, for the first time since June 2007. The ratio was somewhat higher than in the February/March survey, or 11% instead of 9.5%. About 70% of firms anticipate making no changes in their staffing levels. The greatest change in firms' interest in recruiting staff was in construction and utilities companies, where half of firms planned to recruit and about 57% considered themselves understaffed.

The wage index rose by 0.2% month-on-month in April and 5.8% year-on-year. Real wages rose by 2.4% between years.

The nationwide Statistics Iceland house price index, published in late May, rose by 0.6% from the previous month, and by about 0.3% adjusted for seasonality. House prices nationwide have therefore risen by 4.8% in the past twelve months. The Registers Iceland capital area real estate price index rose by 0.7% month-on-month in April, also when adjusted for seasonality. The index has therefore risen by 5.5% year-on-year. In the first four months of 2013, roughly 17% more purchase contracts were registered nationwide than during the same period in 2012.

According to the survey carried out by Capacent Gallup in May, corporate executives were still relatively pessimistic about the current economic situation, although they considered conditions marginally better than in the February/March survey. Just over 40% of respondents considered the current situation poor, and about half considered it neither poor nor good. Executives were considerably more upbeat, however, about the outlook for the future, with about half of respondents expecting conditions to improve in the next six months, as opposed to 28% in the February/March survey and about 15% in May 2012. The greatest improvement was among executives in fishing, construction, and utilities companies, both in comparison with the last survey and the one conducted in May last year. On the other hand, 44% of executives expected no change in the next six months.

According to the survey, executives' inflation expectations one year ahead measured 4%, a decline of $\frac{1}{2}$ a percentage point from the February/March survey. They have ranged between 4.5% and 5% since the beginning of 2012.

According to Capacent Gallup's May 2013 survey among households, household inflation expectations were unchanged since the February survey. Households expect twelve-month inflation to measure 5% both one and two years ahead. Households' inflation awareness has not declined in line with the disinflation in recent months. According to the median response, households estimated inflation at 4.7% at the time the survey was carried out, whereas the CPI had risen by 3.3% year-on-year at that time.

The consumer price index (CPI) fell by 0.05% month-on-month in May. Twelve-month inflation measured 3.3%, which is unchanged from April. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 3.8%, and had declined by 4.2% in April. Underlying inflation according to core index 4 without tax effects, which also excludes the market price of housing, measured 3.5%, down from 4% in April.

The travel and transport component of the CPI was the largest driver of the decline in May, with reduced airfares and petrol prices weighing heaviest. In addition, the effects of the appreciation of the króna since February continued to emerge, with prices of new motor vehicles and imported foods declining, in addition to petrol prices. Offsetting these were price rises in private services and the housing component of the CPI. For example, the effects of price increases for telephone services, recreational and cultural activities, and hotel and restaurant services measured just under 0.2 percentage points in May.

II The interest rate decision

The Governor discussed recent developments in the foreign exchange market and the Bank's intervention. He also informed Committee members of the regularly scheduled meetings with the International Monetary Fund in connection with post-programme monitoring of the Stand-By Arrangement.

The Committee also discussed developments in the money supply before and after the collapse of the financial system and the potential impact of capital account liberalisation on the money supply.

Members agreed that, based on information emerging since its last meeting, there were grounds for keeping interest rates unchanged. Although GDP growth appeared to have been somewhat weaker in the first quarter than was forecast in the May issue of *Monetary Bulletin*, the MPC considered it too early to assert that the growth outlook for the year as a whole had deteriorated because, more often than not, output growth figures are revised upwards after the first estimates are published. Furthermore, the deviation from the forecast was attributable in large part to slower inventory growth than had been forecast, as inventory accumulation tended to fluctuate widely. Moreover, the most recent indicators of demand suggested that the economic recovery was developing broadly in line with the Bank's forecast.

Committee members also discussed recent inflation developments. In their view the inflation outlook had changed little since the May forecast. It emerged that inflation had declined in recent months and now measured 3.3%, and that underlying inflation and inflation expectations had declined as well, but remained above the Bank's inflation target.

The exchange rate of the króna had been broadly unchanged since the MPC meeting in May. It appeared to the Committee that the Bank's foreign exchange market intervention policy, formulated by the MPC at its last meeting, had contributed to greater exchange rate stability and was conducive to providing a firmer anchor for inflation expectations and promoting more rapid disinflation than would occur otherwise.

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.

Committee members agreed that monetary policy must always take account of fiscal policy and other factors that affect aggregate demand. There was some uncertainty about the path public sector finances would take in coming years. The MPC considered it critical that Treasury finances be brought into balance as soon as possible so that the monetary and fiscal policy mix would contribute to external balance of the economy, foster overall economic stability, and deliver inflation close to target, at the lowest possible cost.

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 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 parts of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 21 August 2013.