



# MONETARY POLICY COMMITTEE REPORT TO ALTHINGI

2012 • 2



# Monetary Policy Committee report to Parliament

31 December 2012

The Act on the Central Bank of Iceland stipulates that the Monetary Policy Committee (MPC) of the Central Bank of Iceland shall submit to Parliament (Althingi) a report on its activities twice a year and that the contents of the report shall be discussed in the Parliamentary committee of the Speaker's choosing.

The Act requires that the MPC meet at least eight times each year. Since the last Report was sent to Parliament, the Committee has met four times, most recently on 12 December. The following report discusses the work of the Committee between July and December 2012.

## Monetary policy formulation

According to the Act on the Central Bank of Iceland, the principal goal of monetary policy is to promote price stability. This objective is further described in the joint declaration issued by the Bank and the Icelandic Government on 27 March 2001 as an inflation target of 2½%. Other monetary policy tasks involve contributing to financial and overall economic stability. In implementing monetary policy, the Monetary Policy Committee bases its decisions in part on an analysis of current economic conditions and the outlook for the economy as presented in the Bank's *Monetary Bulletin*. The MPC's statements and minutes, enclosed with this report, contain the arguments for the Committee's decisions.

## Developments from July to December 2012

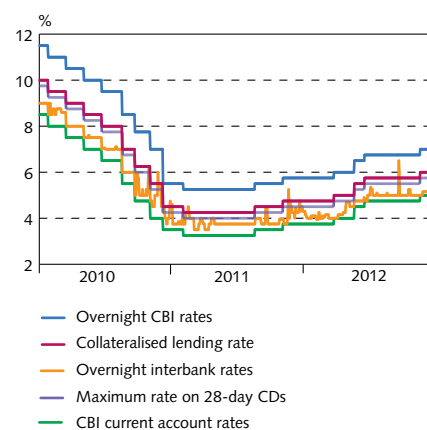
Central Bank interest rates have increased since the MPC's last report was submitted to Parliament. The Bank's collateralised lending rate was 5.75% at the end of June 2012 but was 6% at year-end 2012. The Bank's effective policy rate – that is, the rate that most strongly influences money market rates – has been close to the simple average of the Bank's current account rate and the maximum CD rate in the recent term. It was just over 5% as of end-June but was just under 5½% at the end of December (see Table 1 and Chart 1).

The MPC decided to keep interest rates unchanged at its August and October meetings but raised them by 0.25 percentage points in November. At the December meeting, the Committee decided to keep rates unchanged. The Bank's interest rates have risen by 1.75 percent-

Table 1. Central Bank of Iceland interest rates 2012 (%)

Date	Current account	28-day CDs (maximum)	7-day collateral lending rate	Overnight lending rate
12 Dec.	5.00	5.75	6.00	7.00
14 Nov.	5.00	5.75	6.00	7.00
3 Oct.	4.75	5.50	5.75	6.75
22 Aug.	4.75	5.50	5.75	6.75

Chart 1  
Central Bank of Iceland interest rates and short-term market interest rates  
Daily data 1 January 2010 - 31 December 2012

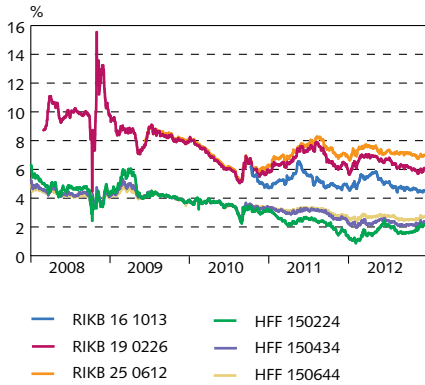


Source: Central Bank of Iceland.

Chart 2

Bond yields

Daily data 3 January 2008 - 31 December 2012

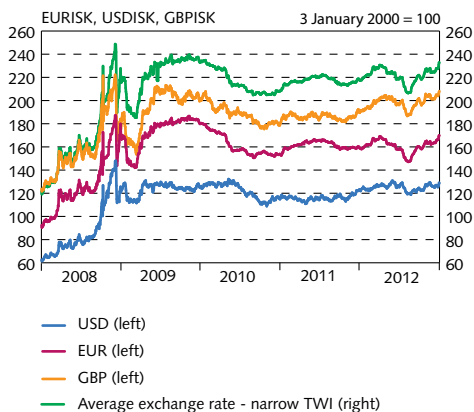


Source: Central Bank of Iceland.

Chart 3

Exchange rate of the króna

Daily data 3 January 2008 - 31 December 2012

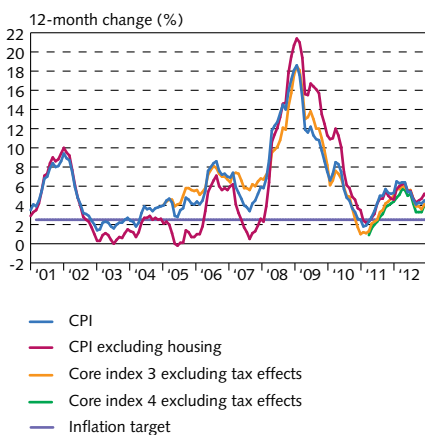


Source: Central Bank of Iceland.

Chart 4

Various inflation measurements<sup>1</sup>

January 2001 - December 2012



1. Core index 3 is the CPI excluding prices of agricultural products, petrol, public services and real mortgage interest expense. Core index 4 excludes the market price of housing as well.  
Sources: Statistics Iceland, Central Bank of Iceland.

age points from the trough in August 2011 and by 1.25 percentage points since this time last year.

In spite of the rate increase since June, long-term nominal and real rates have fallen (see Chart 2). At the same time, the exchange rate of the króna has fallen somewhat after rising from spring to mid-August. At the end of December, it was just over 6% lower in trade-weighted terms than when the MPC sent its last report to Parliament and nearly 11½% below the mid-August peak (see Chart 3).

Annual inflation as measured by the consumer price index (CPI) has fallen by just over a percentage point since end-June and measured 4.2% in December 2012 (see Chart 4). Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of indirect taxes, volatile food items, petrol, public services, and real mortgage interest expense) was somewhat lower, or 4%, down from 5.6% last June. The appreciation of the króna that began in the spring of 2012 led to some declines in import prices, which, in addition to a notable drop in fares, had the greatest effect on the CPI in Q3. In recent months, however, inflation has been rather stable despite price increases in imported goods prices following the depreciation of the króna since last August.

In the recent past, the Central Bank's real effective policy rate has been considerably below the level that can be expected to be consistent with the inflation target once the slack has disappeared from the economy. The accommodative monetary stance as represented by the Bank's real rate has therefore supported the economic recovery. The recent interest rate increases have withdrawn some of this monetary accommodation, although it has not disappeared entirely. The Bank's real effective rate was about 1% at the end of December 2012, or about a percentage point higher than at the end of June 2012. As the economic recovery has progressed and the spare capacity in the economy has diminished, the MPC has considered it appropriate to withdraw monetary accommodation so as to ensure continuing recovery without posing a threat to continued disinflation.

**Accompanying documents**

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from August 2012 to the present
2. Minutes of Monetary Policy Committee meetings from August 2012 to the present
3. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001

On behalf of the Central Bank of Iceland Monetary Policy Committee,

Már Guðmundsson  
Governor of the Central Bank of Iceland  
and Chair of the Monetary Policy Committee



## Statement of the Monetary Policy Committee 22 August 2012

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged.

The outlook for 2012 is for somewhat stronger output growth than in the Bank's May forecast, but the outlook for 2013 and 2014 as a whole is broadly unchanged. The domestic labour market has also recovered more strongly than previously forecast. The economic recovery therefore continues to gain momentum. The global economic outlook remains uncertain, however, in part due to the financial crisis in Europe, which creates potential headwinds for the domestic economic and inflation outlook.

The inflation outlook for the next two years has improved since the MPC's last meeting, although inflation is not expected to reach the Bank's inflation target until the end of the period. The expectation of more rapid disinflation this year and next is due largely to the more than 8% rise in the trade-weighted exchange rate index since May, when the Bank published its last macroeconomic and inflation forecast.

As before, the inflation outlook is uncertain, and inflation could subside more quickly; for instance, if the króna strengthens further. On the other hand, it is uncertain how much of the recent appreciation will be sustained over the coming winter. Furthermore, inflation inertia could be underestimated, partly in view of long-term inflation expectations, which are still noticeably above the target.

The accommodative monetary stance has supported the economic recovery. The interest rate increases in May and June, together with reduced inflation, have withdrawn some of that accommodation. As spare capacity disappears from the economy, it is necessary that monetary policy slack should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments.





## Statement of the Monetary Policy Committee 3 October 2012

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged.

Recent economic indicators suggest a slower recovery of domestic demand than was forecast in August. On the other hand, risks stemming from the financial crisis in Europe have abated.

Inflation has been somewhat lower than was forecast in August. On the other hand, the króna is weaker than was assumed at that time, and the near-term exchange rate outlook is quite uncertain. On balance, the inflation outlook has not changed significantly since the MPC's last meeting. Inflation expectations remain above the Bank's inflation target, although they have declined slightly by some measures.

The accommodative monetary stance has supported the economic recovery in the recent term. The interest rate increases in May and June, together with reduced inflation, have withdrawn some of that accommodation. As spare capacity disappears from the economy, it is necessary that monetary policy slack should disappear as well. The degree to which such normalisation takes place through higher nominal Bank rates will depend on future inflation developments, but in the absence of changes in the outlook for inflation and the economic recovery, it is likely that further interest rate increases will be needed in the near future.







## Statement of the Monetary Policy Committee 14 November 2012

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to raise the Bank's interest rates by 0.25 percentage points.

The Bank's macroeconomic forecast indicates that output growth in 2012 will be somewhat weaker than was projected in August. In 2013, however, it is expected to be stronger than previously forecast; hence the outlook over the forecast horizon is broadly unchanged in spite of global headwinds. The economic recovery will continue, with growing investment and stable private consumption growth, and the slack in the economy will disappear during the forecast horizon.

Inflation has been somewhat lower than was forecast in August. Looking ahead, a greater margin of spare capacity in the economy compared to August and a significantly lower exchange rate of the króna, will have offsetting effects on inflation developments. On the whole, the inflation outlook is deemed broadly unchanged. Uncertainty about exchange rate developments during the forecast horizon leads to corresponding uncertainty about developments in inflation and inflation expectations. Inflation expectations are still above the Bank's inflation target, although they have fallen somewhat by some measures.

The accommodative monetary stance has supported the economic recovery in the recent term. The rise in interest rates since August 2011 and the decline in inflation have withdrawn a considerable amount of that accommodation. As spare capacity disappears from the economy, it is necessary that monetary policy slack should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments. The current baseline forecast indicates that the Bank's present nominal interest rate is sufficient to bring inflation back to the inflation target during the forecast horizon. However, this depends, among other things, on whether the outcome of the forthcoming wage settlement review at the beginning of next year is consistent with inflation declining to the target.





## Statement of the Monetary Policy Committee 12 December 2012

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged.

The most recent indicators suggest that economic developments have been 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. The exchange rate of the króna has remained broadly stable since the last interest rate decision date, and inflation has developed in line with the forecast.

The accommodative monetary stance has supported the economic recovery in the recent term. The rise in interest rates since August 2011 and the decline in inflation have withdrawn a considerable amount of that accommodation. As spare capacity disappears from the economy, it is necessary that monetary policy slack should disappear as well. The degree to which such normalisation takes place through higher nominal Central Bank rates will depend on future inflation developments, which in turn will depend to a large extent on exchange rate movements and wage-setting decisions. Whether the Bank's nominal interest rates remain unchanged in the near term will depend, among other things, on whether the outcome of the forthcoming wage settlement review at the beginning of next year is consistent with inflation declining to the target.





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

## Minutes of the Monetary Policy Committee meeting

August 2012

Published 5 September 2012

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 20 and 21 August 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 22 August, 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 13 June interest rate decision, as published in the updated forecast in *Monetary Bulletin 2012/3* on 22 August.

#### **Financial markets**

The average trade-weighted exchange rate in the domestic foreign exchange market was about 8% higher at the time of the August meeting than at the June meeting. Between meetings, the króna had appreciated by about 9.3% against the euro, almost 7% against the pound sterling, and about 8.4% against the US dollar. Offshore trading was sparse and the offshore exchange rate broadly unchanged.

Because of ample liquidity, overnight rates in the interbank market had remained below the centre of the interest rate corridor between meetings, at about 0.25-0.5 percentage points

above current account rates. Trading in the interbank market for krónur was similar to the level a year ago, although slightly less.

According to the spread between indexed and nominal bond yields, expectations of average inflation over the next five years were 0.3 percentage points lower at the time of the August MPC meeting than at the June meeting or just under 4½%.

The effective nominal policy rate can be estimated to be 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 average real policy rate had risen by 0.7 percentage points since the June meeting, to 0.5%. The real rate was 0.5% in terms of twelve-month inflation and 0.9% in terms of the breakeven inflation rate calculated from bond yields.

The Republic of Iceland's sovereign CDS spread was unchanged between meetings, but the risk premium on Treasury obligations fell in terms of the spread between the Icelandic Treasury's US dollar bonds and comparable bonds issued by the US Treasury. The spread between five- and ten-year Treasury bonds issued by the two countries narrowed by 1 percentage point between meetings.

Unchanged Central Bank interest rates appeared to have been priced into the yield curve, in line with the expectations of most financial firms' research departments, with analysts citing positive inflation developments, the appreciation of the króna, and increased uncertainty about the global economic outlook as grounds for unchanged rates. The Bank's market expectations survey was carried out during the week of 13-17 August. According to the median response, the survey results indicate that market participants expect interest rates to be 0.25 percentage points higher at year-end than they were prior to the August meeting. This is in line with the results of the Bank's May survey.

M3 contracted by about 0.7% month-on-month in June but grew by 5.9% year-on-year in Q2. Excluding holding company deposits, however, M3 was unchanged between years.

Indexed lending grew somewhat in May and June. Part of that increase was due to refinancing of older loans, although some credit creation also took place.

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

The International Monetary Fund's (IMF) global output growth forecast for 2012, published in mid-July, has been adjusted slightly downwards from its April forecast, to 3.5%. The forecast for world trade has also been revised slightly downwards, for 2012 and 2013. Uncertainty in the forecast remains tilted strongly to the downside, owing in particular to the difficulties in the euro area. The inflation forecast for industrialised countries in 2012 is broadly unchanged since the Fund's last forecast, at 2%. The 2012 output growth forecast for Iceland's main trading partners is unchanged since April, at 0.8%.

Iceland's goods trade surplus totalled 4.4 b.kr. in June and, according to preliminary figures, 3.5 b.kr. in July. Both import and export values have continued to grow between years, with the increase measuring over 2½% for exports and over 6½% for imports in the first seven months of 2012. The increase in export values is due primarily to growth in marine product exports, as industrial exports contracted in value, owing largely to a decrease in the export value of aluminium. The increase in import is mainly attributable to increased imports of transport equipment (primarily imports of aircraft in January and one

ship in May), fuels, and lubricants, as the value of commodities and operational inputs declined year-on-year.

The price of aluminium had fallen marginally since the MPC's June meeting. In July, the average price was roughly 0.8% lower than in June and 25½% lower than at the same time in 2011. Marine product prices were up 0.7% month-on-month in June.

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

According to the Statistics Iceland labour market survey, labour demand was somewhat stronger in Q2 than in the forecast published in the May issue of *Monetary Bulletin*. The last forecast projected a 0.4% year-on-year contraction in total hours worked, while the actual figure was virtually unchanged, as shorter working hours offset the 1.2% increase in the number of employed persons. The unchanged number of total hours worked is due entirely to the youngest age group. The employment rate rose by just under a percentage point, due mainly to an increase in the core age group, whereas the labour participation rate was virtually unchanged.

Unemployment declined faster than was assumed in the May forecast. According to Directorate of Labour (DoL) calculations, unemployment fell from 7.2% to 5.6% between Q1 and Q2, and from 6.4% to 5.7% adjusted for seasonality. The forecast estimated 6% unemployment during the quarter.

In Q2, the wage index rose by 1.6% between quarters and by 8.2% year-on-year.

Major indicators of private consumption in Q2 suggest slight growth from the previous quarter, after adjusting for seasonality. Indicators for July imply that Q3 began strongly in terms of private consumption. For instance, payment card turnover grew by 4.6% year-on-year in real terms in July.

The Treasury accounts for 2011, published in July, reveal that Government operations were within budgetary allocations if the one-time write-offs due to SpKef savings bank, the Icelandic Regional Development Institute, and the New Business Venture Fund are excluded.

Statistics Iceland's nationwide house price index, published at the end of July, rose by 0.5% from the previous month (also seasonally adjusted). The capital area Real Estate Price Index, calculated by Registers Iceland, rose by 0.9% month-on-month in July, and by 1.4% when adjusted for seasonality. About 10% more purchase agreements were concluded in July 2012 than in July 2011, and in the first seven months of 2012, purchase agreements were up 17% year-on-year. The number of purchase agreements is still low in historical context, however.

According to the survey carried out by Capacent Gallup, consumer sentiment improved in June and July. The Consumer Sentiment Index had risen by 22½% between July 2011 and July 2012, based on the three-month average. Sentiment towards the economy rose most sharply in the past two months. The assessment of the current situation has also improved considerably in the recent term.

According to the Capacent Gallup survey among corporate executives, carried out in May and June, executives were somewhat more pessimistic about the economic situation six months ahead than they were in the last survey, conducted in February/March. Just under 18% of executives expect conditions to worsen, as opposed to 13% in the last survey.

Pessimism is strongest among executives in the fishing industry, with about half of them expecting conditions to deteriorate in the next six months. On the other hand, optimism is most pronounced among executives in the financial and insurance sector. The survey indicates that firms considering increasing their staffing levels in the next six months outnumber those considering downsizing. Most companies plan to keep their staffing levels unchanged, however.

According to the survey conducted in August, market participants' short-term inflation expectations have declined since May. According to the median response, market participants expect annual inflation to measure 4.8% in one year and 4½% in two years. Furthermore, they expect inflation to average 4½% over the next 10 years, or ½ a percentage point less than in the May survey. If only the responses of those who also participated in the May survey are included, however, 10-year expectations are virtually unchanged.

The CPI fell by 0.7% month-on-month in July, after rising by 0.5% in June. Annual inflation measured 4.6% in July, down from 5.4% in May. Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and the cost of real mortgage interest) measured 4.7% in July, down from 5.5% in May. The July decrease was due to summer sales and cuts in airfares and petrol prices, although it was offset to a degree by rising food prices.

According to the updated forecast appearing in *Monetary Bulletin* 2012/3 on 22 August, the two-year inflation outlook has improved since the May forecast. Inflation has been somewhat lower than was assumed then, due primarily to positive exchange rate developments and lower petrol prices. Average inflation for 2012 is projected at 5.4%, or 0.6 percentage points below the May forecast. The stronger króna also leads to expectations of more rapid disinflation in 2013 than was assumed in May, with inflation falling to around 3% by the latter half of the year. Inflation is projected to reach the Central Bank's inflation target by end-2014, which is broadly in line with the May forecast.

According to the August forecast, the GDP growth outlook for 2012 has also improved relative to the May forecast, in spite of the worsening global economic situation. GDP growth in 2012 will be driven primarily by private consumption and business investment and is estimated at 3.1% instead of the previous 2.6%, due to stronger export growth. For 2013, it is assumed that export growth will be correspondingly lower and output growth therefore weaker than was forecast in May. The outlook for 2014 has improved somewhat, however, with GDP growth projected at 3.4% instead of 2.7%, as in the last forecast. During the forecast horizon, GDP growth will be driven by domestic demand. The contribution from net trade will be negative in spite of moderate export growth.

As has been forecast in the past year, it is assumed that the labour market will continue to improve, with gradual employment growth and declining unemployment. In spite of the remaining slack in the labour market, unit labour costs are expected to increase by 5% in 2012 and then rise more or less in line with the Central Bank's inflation target from 2013 onwards.

The estimated output slack during the forecast horizon is broadly in line with the May forecast. It is assumed to have contracted sharply in 2011. It is also expected to shrink still further in 2012 and 2013 and then disappear early in 2014, which also accords with the May forecast.



## II The interest rate decision

The Governor informed Committee members of the results of the June foreign currency auction, the prepayment of the Treasury and the Central Bank's foreign loans from the IMF and the Nordic countries, and the increase in the Bank's regular foreign currency purchases. The MPC was also informed of the outlook for government finances and the fiscal consolidation plan by representatives from the Ministry of Finance.

The MPC was of the view that the macroeconomic forecast appearing in the 22 August *Monetary Bulletin* confirmed that the economic recovery beginning in mid-2010 was gaining momentum. According to the forecast, the outlook for 2012 is for somewhat stronger output growth than in the May forecast, although the outlook for 2013 and 2014 as a whole is broadly unchanged. The domestic labour market has also recovered more strongly than previously forecast. The MPC considered that, although growth in total hours worked had been insignificant in the second quarter, this did not indicate a reversal in labour demand, as it was due entirely to a reduced contribution from the youngest age group. The global economic outlook remained uncertain, however, in part due to the financial crisis in Europe, which created potential headwinds for the domestic economic and inflation outlook.

Committee members discussed recent exchange rate developments and the near-term outlook. In trade-weighted terms, the króna had appreciated by over 8% since the May forecast. In the MPC's opinion, the stronger currency was mainly attributable to reduced currency accumulation by parties with current and expected foreign loan repayments and increased tourism-related inflows.

The Committee considered the recent rise in the exchange rate to explain the rapid disinflation to a large degree. The inflation outlook for the next two years had therefore improved, according to the revised forecast, although inflation was not expected to reach the Bank's inflation target until the end of the period.

As before, the Committee considered the inflation outlook uncertain, as inflation could turn out higher should the króna depreciate again, as it was uncertain how much of the recent appreciation would be sustained over the coming winter. Furthermore, the MPC considered that inflation inertia could be underestimated, partly in view of long-term inflation expectations, which are still noticeably above the target. On the other hand, inflation could subside more quickly over the forecast horizon, especially if the króna strengthens further.

The Committee discussed the possibility of keeping the Bank's interest rates unchanged or raising them by 0.25 percentage points. In view of the discussion, the Governor proposed that rates be held unchanged: the current account at 4.75%, the maximum rate on 28-day certificates of deposit at 5.5%, the seven-day collateralised lending rate at 5.75%, and the overnight lending rate at 6.75%.

Four members voted in favour of the Governor's proposal, in view of the recent tightening of the monetary stance. They also considered it appropriate to wait and see how sustainable the appreciation of the króna, and therefore the recent disinflation episode, would prove to be. One member voted against the Governor's proposal, voting instead to raise interest rates by 0.25 percentage points. This member stressed the still high inflation and that long-term inflation expectations had not changed much in response to the recent

decline in inflation. There was therefore a significant risk that high inflation expectations would lead to higher and more persistent inflation than forecasts provided for.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They also agreed that the interest rate increases in May and June, together with reduced inflation, had resulted in the withdrawal of some 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.

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, as did representatives from the Ministry of Finance.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 3 October 2012.



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

## Minutes of the Monetary Policy Committee meeting

October 2012

Published 17 October 2012

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 2 October 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 3 October, 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 22 August interest rate decision.

#### **Financial markets**

The average trade-weighted exchange rate in the domestic foreign exchange market was about 6% lower at the time of the October meeting than at the August meeting. Between meetings, the króna had depreciated by 7.2% against the euro, almost 6% against the pound sterling, and just over 3% against the US dollar. Offshore trading was sparse and the offshore exchange rate therefore broadly unchanged.

In general, liquidity had remained ample in the interbank market for krónur, and overnight rates in the interbank market were 0.25 percentage points above current account rates. On 17-18 September, however, rates rose because of strong inflows to the Treasury and were above the centre of the interest rate corridor.

According to the breakeven inflation rate in the bond market, calculated in terms of the spread between indexed and nominal bond yields, short-term inflation expectations had declined slightly since the August meeting. The five-year breakeven inflation rate measured 4½%, broadly unchanged from the August meeting, while longer-term breakeven inflation (five-year expectations five years ahead) had risen between meetings.

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 average real policy rate had risen by 0.3 percentage points since the August meeting, to 0.7%. The real rate was 0.8% in terms of twelve-month inflation and 1.4% in terms of the breakeven inflation rate calculated from bond yields.

The Republic of Iceland's sovereign CDS spread had fallen by 0.3 percentage points between meetings, to 2.2 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 declined as well. The spread between five- and ten-year Treasury bonds issued by the two countries narrowed by 0.2-0.3 percentage points between meetings, to about 3 percentage points.

Unchanged Central Bank interest rates in October appeared to have been priced into the yield curve; with financial firms' analysts divided into two camps, one expecting unchanged rates and the other expecting a 0.25 percentage point increase.

M3 grew by 0.9% month-on-month in August but had contracted by 0.2% year-on-year. Excluding holding company deposits, M3 contracted by 3.3% between years. A similar development was seen in narrow money.

Nominal lending grew somewhat in July and August. Part of that increase was due to refinancing of existing loans, although some credit creation also took place.

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

The *Consensus Forecasts* projections for 2012 output growth in Iceland's main trading partner countries were unchanged, on average, since the August meeting, or 0.7%; however, the outlook has changed for some individual countries. The output growth forecast for the Nordic region has been revised upwards since August, while the forecasts for the euro area and the US are unchanged. The 2012 inflation forecast for Iceland's main trading partners was also unchanged from August, at 2.2%.

Iceland's goods trade surplus totalled 12.5 b.kr. in August and, according to preliminary figures, 5.5 b.kr. in September. Import values have continued to rise between years, while export values have shrunk. In the first nine months of the year, imports grew by over 5½% and exports contracted by just over 1% compared with the same period in 2011. The rise in import values is due both to higher prices and to increased volume of fuel and lubricants, as well as an increase in imports of transport equipment (in particular the importation of aircraft in January and one ship in May), and the contraction in export values is due to a decline in the value of industrial goods exports, primarily aluminium.

The price of aluminium rose slightly after the MPC's August meeting. In September, the average price was roughly 11.7% higher than in August but 10½% lower than at the same

time in 2011. Marine product prices rose by 0.4% month-on-month in August and have risen by 6.5% in the past 12 months.

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

According to new national accounts data published by Statistics Iceland in September, GDP growth measured 0.5% in Q2/2012, and seasonally adjusted quarter-on-quarter GDP growth was negative by 6.5%. Because inventories grew sharply during the previous quarter, underlying developments can be identified more clearly if the first two quarters of the year are examined together. GDP grew by 2.4% year-on-year in the first half of 2012. The main drivers of growth in the first half were private consumption and business investment, while national expenditure rose by a total of 4.2%. The contribution of net trade to output growth was negative by 1.5% of GDP, as import growth (8.8%) outpaced export growth (4.9%). In the main, developments in the first half of the year were well in line with the Bank's August forecast. Private consumption growth was somewhat stronger than forecast; however, growth in public consumption and public investment was weaker and the contraction in stockbuilding greater than projected. As a result, output growth in the first half was roughly 0.8 percentage points less than was forecast in August. The difference in the forecast of national expenditure was relatively less, or 0.6 percentage points.

The Bank's August forecast assumed that private consumption would continue to grow in coming quarters. The main indications of private consumption suggest that this will be the case in Q3, although there may be a contraction between quarters after adjusting for seasonality. In real terms, monthly payment card turnover was 0.6% less in July and August than in Q2; however, July-August turnover was up 1.5%, on average, from the same period in 2011.

The current account deficit was just under 12% of GDP, or 50 b.kr., in Q2, as opposed to a deficit of 11.3% of GDP in Q1. The Q2 deficit was owing to a large deficit in the balance on income (74 b.kr.), which far outweighed the 24.8 b.kr. trade surplus. The current account balance excluding the deposit money banks (DMBs) in winding-up proceedings was negative by just over 3% of GDP but was positive by ½% of GDP if pharmaceuticals company Actavis is excluded as well.

According to the fiscal budget proposal for 2013, the long-term fiscal consolidation plan is virtually unchanged from that in the 2012 budget proposal. It appears that the 2012 budgetary goal of a primary surplus in the amount of 2% of GDP will be met, as the primary balance looks set to be positive by 1.8% of GDP. The proposal for the coming year also aims for a 1% surplus on the overall balance in 2014, as did the 2012 proposal. About 90% of the consolidation measures provided for in 2009-2013 are complete. In line with the original plan, 55% of these measures were on the expenditures side and 45% on the revenues side. There is some uncertainty about some key revenue items, such as whether an 8 b.kr. asset sale will materialise, while uncertainties on the expenditures side centre on the construction of the new national hospital and whether it will be included in the budget or not. Total Government expenditure as a share of GDP has declined steadily since 2009 and is approaching its pre-crisis share.

According to the Statistics Iceland labour market survey, total hours worked declined by 0.6% year-on-year in July and August. So far in 2012, they have increased slightly (0.2%),

primarily due to an increase among the 25-and-over age group, which compensated for the 2% decline among workers aged 16-24.

Unemployment as measured by the Directorate of Labour was virtually unchanged between June and August, at 4.8%, but measured about 5½% when adjusted for seasonality.

The wage index rose by 0.1% month-on-month in August and by 5.9% year-on-year. Real wages increased by 0.2% between July and August and by 1.7% year-on-year.

The nationwide Statistics Iceland house price index, published in late September, rose by 0.5% from the previous month, and by 0.3% adjusted for seasonality. In Q3/2012, it had risen by 6.7% year-on-year. The capital area real estate price index, calculated by Registers Iceland, fell by 0.2% month-on-month in August. The seasonally adjusted change was the same. About 4% more purchase agreements were concluded in August nationwide than in the same month a year ago, and 15% more contracts were finalised in the first eight months of the year than in the same period in 2011. The number of purchase agreements is still low in historical context, however.

According to the Capacent Gallup Consumer Sentiment Survey, consumer expectations rose in September, for the sixth consecutive month, to the highest point since April 2008. Sentiment towards the economic and labour market situation in six months' time improved markedly between months. The assessment of the labour market situation also increased, with that subindex breaking the 100-point threshold for the first time since the financial crisis struck. A score over 100 means that respondents who take a positive view of the situation outnumber those who are pessimistic about it.

The results of the quarterly survey of planned big-ticket purchases, also published in September, indicate a slight decline in planned housing and motor vehicle purchases and an increase in planned overseas travel since the June survey. Planned housing and travel purchases both increased year-on-year, however.

According to Capacent Gallup's September inflation expectations survey among households, inflation expectations one year ahead had declined by 0.7 percentage points since May/June, to 5.6%. Household inflation expectations two years ahead measured 5%, a drop of ½ a percentage point since the last survey.

The CPI rose by 0.8% month-on-month in September, after falling by 0.15% in August. Annual inflation measured 4.3% in September, down from 4.6% in July. Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and the cost of real mortgage interest) measured 3.9% in September, down from 4.7% in July.

Reduced prices of items such as food and new motor vehicles, due in part to the appreciation of the króna during the summer, had some impact in August. End-of-sale effects in August and September then led to a combined 0.5 percentage point rise in the index. Petrol prices had risen for two consecutive months in September, with the increase since July measuring 6.8%. Airfares have been quite volatile in recent months, causing the index to rise by just over 0.1 percentage point in September after a steep decline in July and August.

## II The interest rate decision

The Governor informed Committee members of the meetings with the International Monetary Fund in connection with post-programme monitoring of the Stand-By Arrangement. The Deputy Governor reported on the work underway in connection with the execution and implementation of the capital account liberalisation strategy.

Committee members discussed the Bank's *Financial Stability* report, published on 5 October, the status of financial institutions, and the progress made with private sector debt restructuring. They also discussed the fiscal budget proposal for 2013 and the long-term fiscal consolidation programme.

Committee members agreed that the most recent indicators could imply a slower recovery of domestic demand than was provided for in the forecast published in the August issue of *Monetary Bulletin*. On the other hand, risks due to the European financial crisis appear to have diminished somewhat, although the situation in the euro area remains extremely sensitive.

Committee members discussed recent exchange rate developments and the near-term outlook. The króna had depreciated by 6% in trade-weighted terms between meetings. The Committee considered near-term exchange rate developments highly uncertain, especially as regards foreign currency accumulation by parties faced with large foreign-denominated loan repayments.

Committee members agreed that, although inflation had been somewhat lower than was forecast in August, the long-term inflation outlook had not changed significantly since the MPC's last meeting. In addition, inflation expectations remained above the Bank's inflation target, although they had declined slightly by some measures.

The Committee discussed the possibility of keeping the Bank's interest rates unchanged or raising them by 0.25 percentage points. In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 4.75%, the maximum rate on 28-day certificates of deposit at 5.5%, the seven-day collateralised lending rate at 5.75%, and the overnight lending rate at 6.75%.

Three members voted in favour of the Governor's proposal to keep interest rates unchanged. They considered a rate increase untimely at this juncture, as there were indications of weaker growth in domestic demand than previously assumed, the recovery of the labour market was slow, inflation was lower, and the monetary stance had been tightened rapidly in recent months. The króna had weakened, but the depreciation came on the heels of an appreciation during the summer, and near-term exchange rate movements were uncertain. One member who supported the Governor's proposal was of the opinion that too steep a rate increase would also have negative supply-side effects, which, among other things, would raise businesses' fixed costs.

Two members voted against the Governor's proposal, preferring that rates be raised by 0.25 percentage points. They cited the risk that a weaker króna would exacerbate wage pressures in the tradable sector, thus triggering second-round inflationary effects, in spite of indications of slower growth in demand. In addition, inflation was still high and long-term inflation expectations had changed little, despite the recent decline in inflation. They therefore argued that it would be desirable to continue withdrawing monetary accommodation because otherwise, there was the risk that the monetary policy response would come too late to counteract inflationary pressures.

Committee members agreed that the accommodative monetary stance had supported the economic recovery in the recent term. They also agreed that the interest rate increases in May and June, together with reduced inflation, had resulted in the withdrawal of some 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, but in the absence of changes in the outlook for inflation and the economic recovery, it was likely that further interest rate increases would be needed in the near future.

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 14 November 2012.





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

## Minutes of the Monetary Policy Committee meeting

November 2012

Published 28 November 2012

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 12 and 13 November 2012, during which the Committee discussed economic and financial market developments, the interest rate decision of 14 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 external trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 3 October interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin 2012/4* on 14 November.

#### **Financial markets**

The average trade-weighted exchange rate in the domestic foreign exchange market was about 3.5% lower at the time of the November meeting than at the October meeting. Between meetings, the króna had depreciated by about 3.0% against the euro, 3.5% against the pound sterling, and 4.8% 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 were 0.25-0.5 percentage points above current account

rates. Trading in the interbank market for krónur has contracted slightly year-on-year so far in 2012.

Just before the MPC meeting, the five-year breakeven inflation rate in the bond market was about 4½%, which was unchanged from the October meeting. The five-year breakeven inflation rate five years ahead was also 4½%, which was about ½ a percentage point lower than at the beginning of October.

The effective nominal policy rate can be estimated to lie 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 average real policy rate had risen by 0.1 percentage points since the October meeting, to 0.7%. It measured 0.9% in terms of twelve-month inflation and 0.5% in terms of the breakeven inflation rate in the bond market (the Treasury bond maturing in 2014 is no longer used to estimate the breakeven rate, as its pricing is considered to be skewed by the capital controls).

The Republic of Iceland's sovereign CDS spread had fallen by 0.2 percentage points between meetings, to 1.9 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 also declined over this period. The spread between five- and ten-year Treasury bonds issued by the two countries narrowed by 0.3 and 0.1 percentage points, respectively, between meetings.

Unchanged Central Bank interest rates in October appeared to have been priced into the yield curve, although most financial firms' analysts expected a 0.25-point increase.

The Central Bank conducted its market expectations survey during the week of 5-9 November. According to the median response, the survey results indicate that market participants expect interest rates to be 0.25 percentage points higher at year-end than they were prior to the November meeting. This is in line with the results of the Bank's August survey.

M3 contracted by 0.6% month-on-month in September and by 1.4% year-on-year in Q3. However, the contraction was strongly affected by the reclassification of winding-up committees' and mutual and investment funds' deposits, the shift of savings to other asset classes offering higher returns, and the sale of assets acquired by deposit money banks (DMBs) in the wake of the financial crisis to individuals and companies.

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

According to the International Monetary Fund's (IMF) October forecast, the outlook for 2012 is for slightly weaker global output growth than in the July forecast, or 3.3%. The forecast for world trade has also been revised slightly downwards. The uncertainty in the forecast has also escalated since July, and in the Fund's opinion, there is now some risk of a new economic contraction. In developed countries, output growth is too weak to reduce unemployment, and in large emerging economies, the robust growth projected in previous forecasts has lost momentum as well. Inflation is expected to be broadly at July levels this year, as the outlook is for a decline in both industrialised and emerging countries. The forecast for output growth in 2012 in Iceland's main trading partners is virtually unchanged, or 0.7% as opposed to the July forecast of 0.8%.

Iceland's goods trade surplus totalled 5.6 b.kr. in September and, according to preliminary figures, 15.7 b.kr. in October. Import values contracted somewhat year-on-year in September but then grew marginally in October. Export values developed in a like manner, contracting markedly year-on-year in September and then growing again in October. In the first 10 months of the year, imports grew by over 6½% and exports by only 0.7% compared with the same period in 2011. The rise in import values stems both from increased imported transport equipment values, owing to strong imports of ships and aircraft during the year, and the rise in fuel and lubricant values, due to marked price increases. The increase in the value of marine product exports, which is due to increased export volume, explains the increase in export values.

Aluminium prices rose by nearly 12% month-on-month in September. Marine product prices fell 1.7% month-on-month in September but have risen by about 3% in the past 12 months.

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

According to the Statistics Iceland labour market survey, labour demand was somewhat weaker in Q3 than in the forecast published in the August issue of *Monetary Bulletin*. At that time, total hours worked were expected to increase by over 1%, whereas they contracted by 0.6%. The contraction occurred in spite of a ½% year-on-year increase in the number of employed persons, as average hours worked declined by over 1%. The last year-on-year contraction in total hours worked occurred in Q1/2011.

A recent survey of firms' staffing plans shows that, although public institutions are most likely to address fluctuations in staffing needs by recruiting temporary workers, firms in the private sector plan instead to increase the working hours of their current employees, both by raising employment percentages and through overtime.

According to Capacent Gallup's September survey among Icelandic executives, respondents' plans to recruit or lay off staff in the next six months have changed very little since the June survey. The percentage interested in recruiting is about the same as that planning redundancies.

The October survey conducted by the Confederation of Icelandic Employers (SA) among its member organisations yielded results similar to those from the Capacent Gallup survey. If the SA results are weighted together with company size and proportional sector weight, they indicate that the number of employees in SA member companies could fall by 0.3% during the year.

The labour participation rate rose slightly year-on-year in Q3, to 81.2%, and has been about 84% year-to-date, which is broadly unchanged from last year. The employment rate has also increased year-to-date, by 0.9 percentage points. It measured just over 77% in Q3, 0.8 percentage points higher than in Q3/2011.

Q3 unemployment as measured by the Statistics Iceland labour market survey was 5%, but slightly less, or 4.7%, excluding those who had been hired but not yet begun work. Unemployment as measured by the Directorate of Labour (DoL) was similar, or 4.8% in Q3, slightly below the level forecast in August. After adjusting for seasonality, however, it measured 5½%.

The wage index rose 0.5% between quarters and about 5.8% year-on-year in Q3, broadly in line with the Bank's August forecast, while real wages rose by 0.7% between quarters and 1.5% year-on-year.

Key indicators of developments in private consumption in Q3 suggest a contraction from the second quarter and a slowdown in year-on-year growth. Payment card turnover grew 1.4% between years during the quarter but has lost pace in recent months. New motor vehicle registrations continued to rise, however, and were up 54% year-on-year in the first nine months of 2012.

The nationwide Statistics Iceland house price index, published in late October, rose by 0.7% from the previous month, and by 0.9% adjusted for seasonality. The capital area real estate price index, calculated by Registers Iceland, rose by 0.7% month-on-month in September and by 0.3% when adjusted for seasonality. Roughly 29% more purchase agreements were concluded nationwide in October 2012 than in October 2011, and in the first 10 months of 2012 they were up almost 15% year-on-year. The number of purchase agreements is still low in historical context, however.

According to the Capacent Gallup survey, consumer sentiment deteriorated considerably month-on-month in October, after having improved steadily for six months, but the Consumer Sentiment Index is still somewhat higher than it was a year ago. All subcomponents fell in October, led by the assessment of the labour market situation.

According to Capacent Gallup's September survey among executives, respondents remained downbeat about the current state of the economy, although their pessimism appears to have abated somewhat since the last survey, carried out in May and June 2012. Furthermore, a large majority of executives expected the situation to remain unchanged in six months' time. Executives in regional Iceland were markedly more downbeat than those in the greater Reykjavik area, particularly due to pessimism among fisheries executives, over 60% of whom considered conditions likely to deteriorate, as opposed to about half in the June survey.

According to the survey, executives' inflation expectations one year ahead measured 4.2%, a decline of almost one percentage point from the June survey. On the other hand, their two-year inflation expectations are unchanged at 5% since the February survey.

According to the Central Bank's quarterly survey of market expectations, carried out just before the November *Monetary Bulletin* went to press, market agents expect twelve-month inflation to measure 4.8% one and two years ahead. They also expect inflation to average 4.5% over the next 10 years. According to the responses of those who also participated in the August survey, market agents' short-term inflation expectations appear to have inched upwards, while long-term expectations are unchanged.

The consumer price index (CPI) rose by 0.3% month-on-month in October. Annual inflation measured 4.2%, down from 4.3% in September. Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and real mortgage interest expense) measured 3.6% in October, down from 3.9% in September.

Exchange rate pass-through from the recent depreciation of the króna had some effect in October, with import price increases contributing 0.3 percentage points to the rise in the CPI. The decline in the housing component offset the pass-through effect, however, lowering the market price of housing nationwide by about 0.7% month-on-month in

October. On a twelve-month basis, however, nominal house prices were up by just over 5% in October.

Developments in inflation have been rather more positive than was projected in the August *Monetary Bulletin*, with inflation measuring 4.3% in Q3, 0.4 percentage points below the forecast. The outlook is also for inflation to be below the August forecast in Q4 but broadly in line with it in Q1/2013. This is due to the offsetting effects of a stronger initial position and a larger-than-forecast margin of spare capacity in the economy, on the one hand, and a weaker currency and unexpectedly larger increases in indirect taxes, on the other. After a temporary spike in Q4/2012, however, inflation is expected to taper off. It is projected at about 4½% in Q4/2012 and about 3½% in the fourth quarter of 2013. According to the forecast, it will reach the inflation target in the first half of 2014, about half a year earlier than was forecast in August.

As the economic recovery continues concurrent with high inflation and inflation expectations, the monetary stance has tightened, particularly over the course of 2012. Most likely, though, the Central Bank's real interest rate is still somewhat below the level that is consistent in the long run with full factor utilisation and, as such, should support the economic recovery. At the same time, asset prices have continued rising and private sector debt has continued to fall.

As the year has progressed, the economic recovery has receded in several of Iceland's main trading partner countries. According to forecasts from international agencies, the global GDP growth outlook has deteriorated since August, and uncertainty has escalated in spite of stimulus measures by governments and central banks. The outlook for the euro area, Iceland's most important export market, is particularly bleak. Iceland's terms of trade have deteriorated as well and appear likely to worsen somewhat more than was assumed in August; however, the November forecast provides for more improvement than previously expected in 2013.

The outlook is also for weaker export growth this year than in the last forecast, due mostly to Statistics Iceland's revision of 2011 export figures. Exports are expected to grow about 1½-2% per year in the upcoming two years, somewhat less than in the August forecast. They will pick up somewhat in 2015, however, with increased aluminium exports. Import growth is projected to be weaker during the forecast horizon than was projected in August, due largely to the expectation of reduced imports related to energy-intensive development. On the whole, net trade will contribute somewhat more to output growth during the forecast horizon than was projected in August.

The outlook for the current account balance improves in tandem with the expectation of a larger trade surplus. The current account balance excluding the deposit money banks (DMBs) in winding-up proceedings and the effects of pharmaceuticals company Actavis is expected to be positive by an average of approximately 2½% throughout the forecast horizon but diminish over the course of the horizon, as in previous Central Bank forecasts, reflecting the fact that savings will not keep pace with growth in domestic investment.

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 in line with the August forecast but based on a lower level, as year-2011 private consumption figures were adjusted downwards when the national accounts were revised. Investment growth is forecast to be more robust than before, as business investment outside the energy-intensive sector is expected to grow more strongly than previously anticipated. On

the other hand, investment in the energy-intensive sector is expected to be smaller in scope.

Total national expenditure is projected to grow by 2.8% in 2012, which is 0.4 percentage points less than was assumed in August. Growth is estimated at 2.6% in 2013, also 0.4 percentage points less than in August. Expenditure growth is projected at 4.9% in 2014, in line with the August forecast, and at 3½% in 2015.

Growth will be driven primarily by domestic demand during the forecast horizon, with roughly equal contributions from private consumption and investment for the forecast horizon as a whole. According to the current forecast, quarterly GDP growth will measure just under 2% in Q3 and just under 1% in Q4. This corresponds to about 2.6% growth year-on-year in H2/2012 and 2.5% for 2012 as a whole, as opposed to 3.1% in the August forecast. Offsetting the weaker output growth outlook for 2012 is a stronger outlook for the years thereafter. GDP growth for 2013 is estimated at 2.9% instead of the 2.2% assumed in the August forecast. It is expected to gain momentum in 2014, measuring about 3.5%, in line with the August forecast, and to remain at about that level in 2015.

Slow improvements in employment are expected, with unemployment forecast at 4.7% in Q4/2012 and then tapering off to about 3.5% by the end of the forecast horizon. This is broadly similar to the August forecast. In spite of this, recent indicators suggest that the labour market recovery has lost pace, as is reflected in the slowdown in the rise in total hours worked. The forecast assumes that total hours worked will continue to grow gradually, at a rate somewhat below output growth. As a result, productivity will increase during the forecast horizon. This will not suffice, however, to prevent unit labour costs from rising markedly this year, although they are expected to rise more modestly for the remainder of the forecast horizon.

The assessment of spare capacity in the economy has changed somewhat since August, in line with the downward adjustment of the year-2011 GDP level in conjunction with the revision of the national accounts, published in September, and weaker-than-forecast output growth in the first half of 2012. It is now estimated that output was about 2.5% below capacity in 2011 and will be about 1.6% below capacity this year, whereas the last forecast assumed that spare capacity would amount to 0.8% of potential output this year. The economy is projected to approach full capacity utilisation by the latter half of 2014.

As is discussed in *Monetary Bulletin*, the outlook is highly uncertain. The forecast takes account of the worsening economic outlook in Iceland's main trading partners, but more adverse developments could weaken export growth and erode terms of trade. The outlook for the exchange rate of the króna is another source of uncertainty. In part, this is related to uncertainty about the global economy and global financial markets, but it is difficult as well to assess the long-term outlook for the exchange rate because of uncertainty about capital account liberalisation and foreign debt refinancing in the private sector. The upcoming wage settlement review and its effects are another source of uncertainty. There is uncertainty as well about public sector finances, owing to expenditure pressures related to the upcoming elections and possible Government involvement in the wage settlement review, which create uncertainty regarding assumptions in the budget. Figures from the labour market suggest that the economic recovery has been reflected to only a limited degree in labour use, which could indicate that the national accounts have overestimated economic activity or that productivity growth has been greater than previously assumed. Another possibility is the presence of errors in labour market statistics. The inflation

outlook is uncertain because of several factors, some of which are detailed above. In addition, persistent, high inflation expectations give cause for concern, as they increase the risk of a wage-price spiral that would cause inflation to become even more persistent.

## **II The interest rate decision**

The Governor reported to the Committee on the IMF Executive Board's discussion of the status and outlook for the Icelandic economy in connection with post-programme monitoring of the Stand-By Arrangement. The Governor and Deputy Governor informed members of the discussion and work underway concerning the assessment of Iceland's external debt, the resolution of the failed banks' estates, and the removal of the capital controls.

The MPC was of the opinion that the macroeconomic forecast in the 14 November *Monetary Bulletin* indicated somewhat weaker output growth in 2012 than was projected in August. Output growth would be stronger than previously forecast in 2013, however. The outlook for the forecast horizon was therefore broadly unchanged in spite of global headwinds. The economic recovery would therefore continue, with growing investment and stable private consumption growth, and the slack in the economy expected to disappear during the forecast horizon.

The Committee discussed recent developments in the exchange rate of the króna, which had depreciated by over 2% in trade-weighted terms since the MPC's meeting at the beginning of October and by about 8.5% since peaking for the year in mid-August. As before, Committee members considered the depreciation 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 Committee considered near-term exchange rate developments highly uncertain, due especially to uncertainty about foreign currency accumulation by parties faced with large foreign-denominated loan repayments and possible extension of the maturity of such loans.

The MPC was of the opinion that the appreciation of the króna until mid-August was responsible for lower-than-forecast inflation. Members agreed that there was still spare capacity in the economy, but opinion was divided on the extent to which it would contain inflation, given the presence of high long-term inflation expectations, among other things. Discussion also focused on the extent to which the low exchange rate was driving inflation; that is, through increased profits in the tradable sector, which has led to significant wage inflation, with second-round effects on inflation. By the same token, volatile exchange rate movements could fuel inflation, as indications suggested that exchange rate pass-through was asymmetric.

Looking ahead, the Committee was of the opinion that a greater margin of spare capacity in the economy compared to the August forecast and a significantly lower exchange rate of the króna, would have offsetting effects. On the whole, the inflation outlook was broadly unchanged, although uncertainty about exchange rate developments during the forecast horizon led to corresponding uncertainty about developments in inflation and inflation expectations. Inflation expectations were still above the Bank's inflation target, although they had fallen somewhat by some measures.

The Committee discussed the possibility of keeping the Bank's interest rates unchanged or raising them by 0.25 percentage points. In view of the discussion and the range of views expressed, the Governor proposed that the Bank's interest rates be raised by 0.25 percentage points, which would raise the current account rate to 5%, the maximum rate on 28-day CDs to 5.75%, the seven-day collateralised lending rate to 6%, and the overnight lending rate to 7%.

Four Committee members voted in favour of the proposal. The main arguments in favour of a rate increase were that the current forecast confirmed that the economic recovery would continue and that the margin of spare capacity would disappear from the economy in the near future. It would be desirable to continue withdrawing monetary accommodation because otherwise there was the risk that monetary policy would respond too late to inflationary pressures. Inflation was still above target and long-term inflation expectations had changed little, despite the recent decline in inflation. There was also a significant risk that a weaker króna would exacerbate wage pressures still further in the tradable sector, thus triggering stronger second-round effects than had already come to the fore. One member who supported the Governor's proposal would have preferred to keep rates unchanged at this time because of weak signs of recovery in the labour market, which exacerbated the existing uncertainty about the strength of the economic recovery.

One member voted against the Governor's proposal, however, preferring to keep rates unchanged. This member considered the recovery still quite fragile, in view of indications that domestic demand growth had lost pace and the labour market recovery was still proceeding slowly. This member thought it unlikely that strong domestic demand caused increasing inflation, particularly due to the economic situation in Iceland's main trading partners. In addition, this member considered the effect of higher interest rates on the exchange rate of the króna uncertain under capital controls. Finally, a rate hike would have negative supply-side effects that would surface, among other things, in increased fixed costs for businesses, which would increase labour market pressures.

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, but the current baseline forecast indicated that the Bank's present nominal interest rate was sufficient to bring inflation back to the inflation target during the forecast horizon. However, this depended, 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 12 December 2012.





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

## Minutes of the Monetary Policy Committee meeting

December 2012

Published 26 December 2012

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.







March, 27 2001

## **Declaration on inflation target and a change in the exchange rate policy**

(From March 27, 2001 – as amended by agreement between between the Prime Minister of Iceland and the Board of Governors of the Central Bank of Iceland on November 11, 2005, cf. Press release no. 35/2005)

On March 27, 2001 the Prime Minister and the Governors of the Central Bank of Iceland signed a declaration on changes in the framework of monetary policy in Iceland. The declaration is as follows:

The Government of Iceland and the Central Bank of Iceland have decided the following changes in the framework of monetary policy in Iceland, effective March 28, 2001:

(1) The main target of monetary policy will be price stability as defined below. The Central Bank shall also promote financial stability and the main objectives of the economic policy of the Government as long as it does not deem it inconsistent with the Bank's main objective of price stability.

(2) Rather than basing monetary policy on keeping the exchange rate within a fluctuation band, the Central Bank will aim at keeping inflation within defined limits as specified below.

(3) The change described above implies that the fluctuation limits for the króna are abolished. Nevertheless, the exchange rate will continue to be an important indicator in the conduct of monetary policy.

(4) The Government grants full authority to the Central Bank to use its instruments in order to attain the inflation target.

(5) Later this week, the Government will submit to Parliament a bill on a new Central Bank Act which, once enacted, will legally confirm the decisions described above on making price stability the main objective of monetary policy and on the independence of the Central Bank to use its instruments.

(6) The inflation target of the Central Bank will be based on 12-month changes in the consumer price index as calculated by Statistics Iceland. Statistics Iceland will also be asked to calculate one or more indices which may be used to assess the underlying rate of inflation, as will be further agreed between the Central Bank and Statistics Iceland. The Central Bank will take note of such indices in its assessment of inflation and in the implementation of monetary policy.

(7) The Central Bank will aim at an annual inflation rate of about 2½ per cent.

(8) If inflation deviates by more than 1½ percentage point from the target, the Central Bank shall bring it inside that range as quickly as possible. In such circumstances, the Bank will be

obliged to submit a report to the Government explaining the reasons for the deviations from the target, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. The report of the Bank shall be made public.

(9) The Central Bank shall aim at attaining the inflation target of 2½ percent not later than by the end of 2003. In the year 2001, the upper Declaration on inflation target and a change in the exchange rate policy limit for inflation shall be 3½ percentage points above the inflation target but 2 percentage points above it in the year 2002. The lower limit for inflation will always be 1½ percentage point below the inflation target. Should inflation move outside the target range in 2001 and 2002, the Bank shall respond as set out in item 8 above.

(10) Despite the elimination of the fluctuation limits for the króna, the Central Bank will intervene in the foreign exchange market if it deems such action necessary in order to promote the inflation objective described above or if it thinks that exchange rate fluctuations might undermine financial stability.

(11) The Central Bank shall publish inflation forecasts, projecting inflation at least two years into the future. Forecasts shall be published in the Bank's Monetary Bulletin. This shall also contain the Bank's assessment of the main uncertainties pertaining to the inflation forecast. The Bank shall also publish its assessment of the current economic situation and outlook.

**[Amended text by agreement between the Prime Minister of Iceland and the Board of Governors of the Central Bank of Iceland on November 11, 2005]**

(12) The Central Bank shall in its publications explain how successful it is in implementing the inflation target policy. The Governors will also report to the Minister, the Government and committees of the Parliament on the policy of the Bank and its assessment of current economic trends and prospects.