



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

## Minutes of the Monetary Policy Committee meeting, June 2014

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that “[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee’s decisions and the premises upon which they are based.” In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of individual Committee members will be made public in the Bank’s *Annual Report*.

The following are the minutes of the MPC meeting held on 10 June 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 11 June, and the communication of that decision.

### **I Economic and monetary developments**

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 21 May interest rate decision.

#### **Financial markets**

According to key indicators from the financial markets, the situation was broadly unchanged since the previous meeting.

The exchange rate of the króna was virtually unchanged. The Central Bank was an active participant in the domestic foreign exchange market, however, with net accumulated foreign currency purchases totalling approximately 42 million euros (roughly 6.5 b.kr.) since the last MPC meeting, or 46% of total market turnover during the period.

Financial institutions’ market liquidity was largely unchanged, and their market activity was very limited.

The monetary stance was broadly unchanged, as inflation changed little in May and nominal interest rates were unchanged. The Bank’s effective real rate was 2.9% in terms of twelve-month inflation in May, and 2.3% in terms of the average of various measures of inflation and inflation expectations.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged, measuring 2 percentage points just before the Committee met in June.

Unchanged Central Bank interest rates in June appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Analysts' expectations were based on the fact that so little time had passed since the last interest rate decision and that little had happened to call for a response by the MPC.

In April, growth in M3 was similar to that in Q1, while narrower measures of money holdings grew more markedly. Central Bank base money grew somewhat more slowly, however.

Net new lending from deposit money banks (DMB) to domestic borrowers totalled 37 b.kr., or about 2% of the total loan stock, in April. In the first four months of 2014, credit was up about 13% year-on-year.

The NASDAQ OMXI6 index had risen by 3% between meetings. During the first five months of the year, trading volume on the NASDAQ OMX Iceland Main Market was slightly less than in the same period in 2013.

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

According to preliminary figures from Statistics Iceland, Iceland's goods trade balance was positive by 2.4 b.kr. in May, about half of the surplus for the first five months of the year and the smallest goods account surplus since 2008. Over the first five months of the year, the value of imports grew by 2.9% year-on-year. The increase is due mainly to imports of transport equipment and consumer goods. Export values shrank by some 5.8% over the same period, however, owing to a contraction in the value of marine product exports and industrial exports.

In terms of relative consumer prices, the real exchange rate fell 0.3% month-on-month in May, to 83.8 points. In the first five months of the year, it was 8.7% higher than in the same period in 2013. This was due mainly to a higher nominal exchange rate, although domestic inflation was also 1.3 percentage points above the average for Iceland's trading partners.

Marine product prices rose in March and April, and were just over 1% higher the first four months of the year than at the same time last year. Aluminium prices have fluctuated somewhat in recent months. At the beginning of June, they were 3.5% above the May average.

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

According to the preliminary figures published by Statistics Iceland in June, GDP contracted by 0.1% year-on-year in Q1, reflecting the offsetting impact of a positive contribution from consumption and investment and a negative contribution from net trade and inventory changes. Consumption and investment grew by a total of 5.2% year-on-year during the quarter, but domestic demand growth measured 2.1%, with the difference due to a negative contribution from inventory changes.

GDP growth was considerably weaker than was forecast in the May issue of *Monetary Bulletin*, which assumed a growth rate of 4.1% for the quarter. The error in the forecast is

largely due to stronger-than-projected growth in services imports. Consumption and investment grew more strongly than was assumed in the forecast, however.

The underlying current account balance was negative by 3.5 b.kr., or 0.8% of GDP, while the measured deficit was 2.8% of GDP.

Key indicators of private consumption in April and May give an unclear picture of developments during the quarter. Growth in payment card turnover slowed markedly in April, but other indicators such as retail specialty items sales and new motor vehicle registrations suggest continued growth.

Consumer sentiment was more or less unchanged month-on-month in May, according to the Gallup Consumer Sentiment index; however, the index was down more than 17 points from the previous year. In May 2013 it rose sharply, although that increase was short-lived.

According to Capacent Gallup's June survey, executives were considerably more upbeat about the economy than they were in March 2014 or in May 2013. The subindex on the economy, which indicates respondents' attitudes towards the current situation, increased sharply, rising above 100 points for the first time since mid-2007. Executives in all sectors except industry and manufacturing were more optimistic about the economy than they were in the March survey. Expectations concerning domestic demand were somewhat more pessimistic than in the last survey, whereas expectations about demand in foreign markets were more optimistic than in the March survey or the May 2013 survey. According to the survey, firms interested in recruiting staff outnumbered those planning redundancies by about 12 percentage points, which is broadly unchanged from the March survey.

House prices rose somewhat more year-on-year in April and May than in the first quarter of the year. House prices nationwide rose by 9½% year-on-year in the first five months of 2014. Over the same period, construction costs only rose by nearly 1.5% year-on-year. In April, growth in turnover slowed somewhat in comparison with the first quarter of the year.

Key indicators of inflation expectations are unchanged since the MPC's May meeting. According to the Capacent Gallup survey of household expectations carried out in May, household inflation expectations one and two years ahead were unchanged since the February/March survey, at 4%. In a comparable survey conducted among firms in May and June, one-year inflation expectations measured 3%, which was also unchanged since the last survey. In terms of the breakeven inflation rate in the bond market, respondents expect twelve-month inflation to measure just over 3% in two years' time and nearly 4% in five years' time, which is unchanged since the May meeting. Long-term inflation expectations are also unchanged, at 4%.

The consumer price index (CPI) rose by 0.07% month-on-month in May, raising twelve-month inflation from 2.3% to 2.4%. The drop in airfares affected the CPI most, although it was offset by the increase in the cost of owner-occupied housing. Other subcomponents had little impact on the CPI. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 2.7%, in May, a slight increase from the prior month. However, underlying inflation according to core index 4 excluding tax effects (which excludes house prices) was unchanged month-on-month, at 1.3%. The contribution of private services to twelve-month inflation measured 0.5 percentage points in May, the lowest since March 2004.

## II The interest rate decision

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

The Committee discussed the experience gained from the Bank's foreign exchange market intervention in the past year. The exchange rate of the króna had remained virtually unchanged between meetings but had risen by some 2% year-to-date, even though the Bank bought significantly more foreign currency than it sold. Members agreed that the intervention had contributed to greater exchange rate stability. In view of exchange rate developments and the experience gained from the intervention programme, the Committee considered it timely to resume regular foreign currency purchases. The Committee was of the view that there was also some scope for action, as inflation was at target. Furthermore, the real exchange rate had risen markedly in the recent term and was not far from the level the MPC considered appropriate for the near future. Moreover, the season generally associated with strong foreign currency inflows was ahead. The amount purchased will be re-evaluated in the autumn, or earlier, if circumstances warrant it. As before, the Bank will intervene in the foreign exchange market as needed to mitigate exchange rate volatility. Therefore, there could be individual days or weeks when the Bank both bought and sold foreign currency.

Because of the short time since the previous meeting, very little new information had been published. Committee members agreed that the inflation and economic outlook was largely in line with the assumptions from the May meeting. Inflation measured 2.4% in May and has been close to target in recent months. According to the Bank's May forecast, it is expected to remain near target until next year, when it could rise as a positive output gap emerges. Households', businesses', and market agents' inflation expectations had remained broadly unchanged between meetings. Inflation expectations one to two years ahead have declined in the recent term, however, in line with falling inflation, although long-term inflation expectations are still somewhat above target.

The Committee discussed the first release of national accounts figures for Q1/2014 by Statistics Iceland. Members were of the view that the economy was stronger than the Q1 output growth figures suggested. According to those figures, domestic demand growth was somewhat stronger than had been forecast in the May issue of *Monetary Bulletin*. According to the national accounts, however, output growth was markedly weaker than was forecast in May, due primarily to strong services imports. Committee members agreed that it was often difficult to interpret quarterly output growth figures, particularly those from the first quarter of each year, in part because of wide fluctuations in export inventories. Imports were often stronger than they would otherwise be in a given quarter and GDP therefore weaker, but this was usually a sign of strength in the economy, not weakness.

The Committee discussed in particular the current situation and outlook for the housing market, especially in view of the uncertainty about whether the recent rise in house prices is an indication of future inflation or merely a reflection of a temporary shortage of supply.

On grounds similar to those from the previous meeting, Committee members were of the opinion that there were arguments both for unchanged rates and for a rate hike. The main argument in favour of a rate increase discussed at the meeting centred on the benefits of responding swiftly with a rate hike, as the most recent national accounts data suggested even stronger domestic demand than the MPC had assumed at the previous meeting.

Furthermore, new data showed that long-term inflation expectations are still somewhat above the inflation target and have changed little in spite of favourable developments in inflation in the recent term.

The main argument for unchanged interest rates was that the effects of the rise in the Bank's real rate had still not emerged in full. It was also pointed out that the level of the Bank's neutral real rate was still uncertain, in addition to the uncertainty about the size of the output slack and the speed at which it was vanishing. GDP growth figures for Q1 could also indicate that growth for the year as a whole would turn out somewhat weaker than according to the May forecast. The first national accounts figures were difficult to interpret, however, and it was therefore appropriate to await further data.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the seven-day term deposit rate at 5.25%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. All Committee members voted in favour of the proposal.

Committee members agreed that because of the decline in inflation and inflation expectations, the Bank's real rate had risen markedly year-to-date. The Committee was also of the opinion that the slack in the monetary policy stance had probably disappeared. With reservations concerning the uncertainty about the level of the Bank's neutral real rate, MPC members agreed that, increased growth in domestic demand in the near term would probably require further increases in the Bank's real interest rate, other things being equal. Whether the need for a higher real rate required a change in the Bank's nominal interest rates in the near future, however, would depend on developments in inflation and inflation expectations.

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 and external guests attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 20 August 2014.