The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, October 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 30 September 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 1 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 outlook for the global economy and Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 20 August 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 in trade-weighted terms, even though the Central Bank’s net purchases in the domestic foreign exchange market had totalled 157 million euros (about 24.1 b.kr.), or around 51% of market turnover.

The risk premium on the Treasury’s foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by other countries, had narrowed somewhat just before the meeting, to 1.1-1.5 percentage points against US Treasury Bonds and 1.8 percentage points against German bonds. The CDS spread on five-year Treasury obligations had narrowed somewhat as well, to 1.3 percentage points.

Money holdings continued to grow year-on-year, with M3 up 5.5% in August, excluding deposits owned by special purpose entities and the winding-up committees of the failed financial institutions.

The total adjusted stock of loans from deposit money banks (DMB) to resident borrowers grew slightly in August. Over the first eight months of the year, the accumulated increase in lending to resident borrowers was almost 8½% greater than over the same period in 2013.

The Nasdaq OMX Iceland exchange's OMXI8 index had risen slightly between meetings, and turnover in the main market had contracted.

However, the monetary stance had tightened between meetings in terms of twelve-month inflation, which had declined somewhat between August and September. The Bank's effective real rate was about 2.3% in terms of various measures of inflation and inflation expectations, slightly higher than at the previous meeting.

Unchanged Central Bank interest rates in October 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, although twelve-month inflation was below target and the real policy rate had risen, inflation expectations were still above target and the economic outlook was broadly unchanged since the last meeting.

Outlook for the global real economy and international trade

According to the International Monetary Fund (IMF) forecast published in early September, the outlook is for weaker global output growth in 2014 and 2015 than was assumed in the Fund's July forecast. The same applies to the forecast for world trade. The output growth outlook for industrialised countries is unchanged for 2014. For Iceland's main trading partners, growth for the year is projected at 1.7%, or 0.1 percentage points less than was assumed in July. The uncertainty in the IMF's output growth forecast has increased somewhat and is tilted to the downside. In general, the Fund expects an unchanged inflation outlook. The Organisation for Economic Co-operation and Development's (OECD) updated forecast for output growth among Iceland's trading partners, published in September, accords with the IMF forecast.

Iceland's external goods trade generated a deficit of 9 b.kr. for the first eight months of the year, as opposed to a surplus of 26 b.kr. over the same period in 2013. Export values contracted by 3.9% at constant exchange rates, while import values rose 5.9%. The contraction in exports is due mainly to a 7.4% decline in marine product exports and a 2% decline in industrial goods exports. The rise in imports over the first eight months of the year stems primarily from an increase of 38% in transport equipment imports.

In terms of relative consumer prices, the real exchange rate index was 83.8 points in August. It has been virtually unchanged for seven months but has risen 4.2% year-on-year. The increase is due primarily to a 3.1% nominal appreciation of the króna, but in addition, inflation in Iceland was above the average among its trading partners.

Aluminium prices have fallen by nearly 7% since the last MPC meeting, although the average price in September was up roughly 13% year-on-year. The foreign currency price of marine product prices rose in August by 2.4% month-on-month and 8.6% year-on-year.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in September, GDP growth measured 0.6% in H1/2014 and 2.4% in Q2/2014. Seasonally adjusted GDP grew by 3.9%

quarter-on-quarter, according to seasonally adjusted Central Bank figures. The national accounts are now published according to new standards, and other improvements have been made as well. This complicates all comparison with previously published figures and forecasts. Year-2013 GDP was adjusted upwards by 4.9% in nominal terms from Statistics Iceland's previous figures, and GDP growth increased by 0.2 percentage points, to 3.5%.

Other improvements had some impact on private consumption growth, which is now assumed to have increased by 4% year-on-year in the first half of 2014. Other components of domestic demand contributed less to GDP growth, and overall domestic demand growth measured 2.8% in the first half of the year. The contribution from net trade was negative, as import growth measured 9% in the first half of the year, as opposed to 3.7% for export growth.

GDP growth was half a percentage point more in Q2 than was forecast in the August *Monetary Bulletin*, but after a downward revision of Q1 figures, GDP growth for H1 turned out slightly weaker, or 0.6% instead of the 0.9% provided for in the forecast.

Upon revision of the national accounts, the year-2013 investment-to-GDP ratio rose from the previously published 13.6% to 15.1%, and the underlying current account surplus rose from 6.2% of GDP to 7.8%. National saving for the year therefore rose from 19.7% of GDP to 22.5% upon revision. According to new figures, in 2013 national saving also increased somewhat more year-on-year than previous figures had indicated, or 2.9 percentage points, as opposed to the previously published 2 percentage points.

The underlying current account surplus measured 2.7% of GDP, or 12.8 b.kr., in Q2, as opposed to 2.3% of GDP during the same quarter in 2013. This year's surplus stems from a surplus on goods and services trade in the amount of 3.2% of GDP and a surplus on the primary income balance amounting to 0.2%. Secondary income was negative, however, by 0.7% of GDP.

Key indicators of developments in private consumption suggest continuing growth in Q3; for instance, payment card turnover was up 4% year-on-year in July and August. New motor vehicles registrations increased markedly, and retail sales were up substantially, particularly for specialty items.

Measurements of consumer sentiment in August and September indicate that optimism is on the rise. The big-ticket index, also published in September, rose 0.6 points quarter-on-quarter and almost 6 points between years, to its highest measurement since September 2008.

According to the fiscal budget proposal for 2015, the surplus on Treasury operations is projected to be considerably larger this year than was assumed in the 2014 National Budget, owing to much larger dividend payments from Landsbankinn and the Central Bank of Iceland. According to the budget proposal, the aim is to achieve a Treasury surplus on an accrual basis in 2014-2018. If the proposal is passed unamended, it can be assumed that the primary and overall balances will deteriorate by 1.8% of GDP in 2015. Between 2015 and 2018, it is estimated that the overall balance will improve by 1.2% of GDP and the primary balance by 0.8%. If the assumptions in the budget proposal prove accurate, the fiscal stance will ease slightly, as the cyclically adjusted primary surplus will decline by 0.1% of GDP between 2014 and 2015.

Seasonally adjusted unemployment as registered by the Directorate of Labour (DoL) averaged 3.8% in July and August, a decline of 0.8 percentage points year-on-year.

According to the Statistics Iceland labour market survey, however, unemployment was unchanged year-on-year at 5.1%.

The wage index rose by 0.6% month-on-month in August, and by 6.3% year-on-year. Real wages in terms of the wage index rose by 0.3% between months and about 3.9% year-on-year.

According to Capacent Gallup's September survey among executives from Iceland's 400 largest firms, the share of respondents interested in adding on staff in the next six months exceeded the share interested in downsizing by about 7.4 percentage points. This indicates slightly less optimism than in the survey carried out in June but much more than in the survey from September 2013.

In the September survey, executives were much more optimistic about the economic outlook than in the June survey. Just under a third of respondents considered the current situation good, and just over half considered it neither poor nor good. On the other hand, executives were more optimistic about the future situation, with nearly 46% of respondents indicating that they expected conditions to improve in the next six months and a similar share of respondents indicating that they expected no change. Executives from all sectors except fisheries were more optimistic than in June, with the greatest improvement in the retail and financial services sectors.

The nationwide house price index compiled by Statistics Iceland rose by 0.8% quarter-on-quarter in Q3 adjusted for seasonality, and 7.6% year-on-year. The Registers Iceland capital area real estate price index rose by 3% month-on-month in August adjusted for seasonality, and 9.3% year-on-year. The number of purchase agreements registered nationwide rose by 14% year-on-year in the first eight months of 2014. The average time-to-sale for flats in the greater Reykjavík area was just over four months in the first eight months of 2014, as opposed to five months during the same period in 2013.

The CPI declined by 0.12% month-on-month in September, after rising by 0.24% in August. A steep drop in international airfares was the main driver of the decline, lowering the index by 0.5 percentage points. Various imported goods prices fell as well, including imported food, petrol, and housewares and furniture. Summer sales continued to wind down, and clothing and footwear prices rose by 3.3% between August and September. It appears that the effects of summer sales have not reversed in full, however, probably due to the appreciation of the króna and the increased exchange rate stability recently. Twelve-month inflation measured 1.8% in September, a decline of 0.6 percentage points since the last MPC meeting. The housing component has been the main driver of inflation, accounting for 1.4 percentage points. The CPI excluding housing fell 0.4% in September, and twelve-month inflation excluding housing measured 0.4%. Underlying inflation measured by core index 3 excluding tax effects was 2.1% in September, and underlying inflation according to core index 4, which excludes house prices as well, measured 0.8%. Both measures of inflation had fallen markedly since the August meeting.

According to the Capacent Gallup survey of household expectations carried out in September, household inflation expectations one and two years ahead were unchanged since the May survey, at 4%. In a comparable survey conducted among firms in September, one-year inflation expectations measured 3%, which was also unchanged since the last survey, whereas two-year expectations had fallen by ½ a percentage point and also measured 3%. The breakeven inflation rate in the bond market had subsided somewhat since the MPC's August meeting, which could indicate that inflation expectations are falling.

The two-year breakeven inflation rate was around 3.2%, as compared with 3.4% in mid-August. Long-term inflation expectations appear to have subsided as well. The five- and ten-year breakeven inflation rate was about 3½%, a decline of ½ a percentage point since August.

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. He also reported to the Committee on the work done by the Bank concerning the request for exemptions from the Foreign Exchange Act in connection with the lengthening and amendment of the bonds between LBI hf. and Landsbankinn hf.

The Committee discussed new national accounts data and the impact that new standards and other changes had made on the results. Members considered it a positive development that national saving was now estimated to have been greater in 2013 than previous figures had indicated, as increased national saving facilitates the resolution of Iceland's balance of payments problem.

They also discussed the fiscal budget proposal for 2015 and the medium-term fiscal consolidation programme.

Committee members noted that the exchange rate of the króna had remained virtually unchanged between meetings in spite of continued foreign exchange inflows. They agreed that the Central Bank's intervention in the foreign exchange market had supported increased stability, which had contributed to below-target inflation for eight consecutive months, as well as improved prospects for inflation in coming months than was projected in August.

In the Committee's opinion, there were grounds for either keeping interest rates unchanged or lowering them. The main argument in favour of a rate reduction discussed at the meeting was that the monetary stance had tightened more than previously expected, owing to more rapid disinflation. Furthermore, the outlook for the next few months was for more favourable developments in inflation than was forecast in August. As a result, current interest rates could be too high. Moreover, it was pointed out that inflation expectations had moved towards the Bank's inflation target in the recent term, although the Committee agreed that it was cause for concern that they were still somewhat above target. As before, inflation expectations above target were an argument in favour of unchanged interest rates, in spite of a decline in observed inflation. By the same token, Committee members were of the view that robust near-term growth in domestic demand and growing tension in the labour market could generate increased inflationary pressures and necessitate an increase in the Bank's nominal interest rates.

In the Committee's opinion, uncertainty about economic developments was greater than usual at present. In particular, members were concerned that the recent implementation of new national accounts standards had added temporarily to uncertainty about the interpretation of data, complicating the assessment of the appropriate monetary stance.

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.

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 representatives of the Ministry of Finance and Economic Affairs attended parts of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 5 November 2014.