The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, December 2015

Published 23 December 2015

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 8 December 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 9 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 outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 4 November interest rate decision.

Financial markets

The exchange rate of the króna had risen slightly in trade-weighted terms and against the euro and by 1.7% against the pound sterling but had fallen by 1.1% against the US dollar since the November meeting.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 114 million euros (16 b.kr.) between meetings, or 48% of total market turnover. Purchases year-to-date totalled 1.6 billion euros (236 b.kr.), more than twice the total for the same period in 2014.

Interest rates in the interbank market for krónur rose in line with the increase in Central Bank rates in November, and overnight rates are close to the Bank's key rate. Interbank market turnover totalled 351.5 b.kr. year-to-date, considerably more than in the same period in 2014 but somewhat below the level seen in the same period of the three preceding years.

In early December, the monetary stance was similar to that measured prior to the November meeting. The Bank's real rate was 3.7% in terms of twelve-month inflation and 2.4% in terms of the average of various measures of inflation and inflation expectations.

The MPC's decision to raise the Bank's interest rates by 0.25 percentage points in November appeared to have taken bond market agents by surprise, as most analysts had forecast that rates would remain unchanged. Yields on nominal and indexed Treasury and Housing Financing Fund (HFF) bonds rose following the decision and had risen by 0.4-1.1 percentage points in mid-November, mostly at the long end of the nominal yield curve. Yields on nominal bonds then began to decline again. At the time of the Committee's December meeting, the yields on nominal and indexed Treasury and HFF bonds had risen by 0.3-0.7 percentage points since the November meeting.

Interest rates on non-indexed mortgage loans from two of the large commercial banks had also risen in line with the rise in Central Bank rates in November, but rates on indexed mortgages from the large commercial banks and the average of rates on indexed mortgages from the pension funds remained unchanged.

Interest rates on non-indexed deposits with the large commercial banks also rose in line with the increase in Central Bank rates in November, but indexed deposit rates were unchanged since the November meeting.

Risk premia on Treasury obligations had changed little since the November meeting.

Financial institutions' analysts had all expected the Central Bank's nominal interest rates to be held unchanged in December, citing low inflation that is still below the Bank's inflation target.

M3 grew by just under 7½% year-on-year in October and by almost 7% excluding deposits held by the financial institutions in winding-up proceedings.

The total stock of deposit institutions' loans to resident borrowers contracted by 0.8% year-on-year in October, and by just over 3% if loans from the HFF and the pension funds are included. If adjustments are made for the Government's debt relief measures, the credit stock contracted by approximately 1% year-on-year in October. In spite of this contraction between years, net new lending – i.e., new loans net of payments in excess of contractual requirements – increased somewhat in the first ten months of the year, and when adjusted for the Government's debt relief programme, the credit stock had grown by about 1½% year-to-date, owing mainly to an increase in lending to the non-financial corporate sector.

The NASDAQ OMX Main List index, OMXI8, had risen by 0.7% between meetings. Turnover in the NASDAQ Iceland main market was just over 320 b.kr. in the first ten months of the year, about 48% more than over the same period in 2014.

Global economy and external trade

According to the Organisation for Economic Co-operation and Development's (OECD) November forecast, GDP growth and world trade will be somewhat weaker in 2015 than in the OECD's June forecast. Global GDP growth is projected at 2.9% this year, about 0.2 percentage points below the OECD's June forecast; however, the forecast for next year is unchanged. The OECD's 2015 GDP growth forecast for Iceland's main trading partners is unchanged since June, at 1.8%, but has been revised downward by 0.3 percentage points, to 2%, for 2016, which is in line with the forecast in the November *Monetary Bulletin*. The OECD revised its inflation forecast for Iceland's trading partners slightly upwards for 2015 and downwards by 0.3 percentage points for 2016. Trading partner inflation is projected at 1.3% in 2016 and 1.7% in 2017. Both figures are about 0.2 percentage points below the forecast in the last *Monetary Bulletin*.

Iceland's external goods trade generated a deficit of about 18.6 b.kr. for the first eleven months of the year, as opposed to a surplus of just over 4 b.kr. over the same period in 2014. Export values grew by 8.6% at constant exchange rates, while import values rose 13.1%. The export value of marine products rose by nearly 11% and the export value of industrial goods by almost 10½%. Import growth is due mainly to a 37% year-on-year increase in transport equipment imports, a 23½% increase in food and beverage imports, and a 20% increase in imports of commodities and operational inputs.

The real exchange rate measured 90.5 points in terms of relative prices in November and rose about 8.7% year-on-year. The increase is due primarily to a 7.5% nominal appreciation of the króna, but in addition, inflation in Iceland was about 1.1 percentage point above the average among its trading partners.

Listed global aluminium prices were broadly unchanged since the MPC's November meeting, and the average November price was down more than 28% year-on-year. Foreign currency prices of marine products had declined by ½% month-on-month in October but had risen by nearly 4½% year-on-year.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in December, year-on-year GDP growth measured 2.6% in Q3/2015. Domestic demand grew by 3.4% year-on-year, and the contribution from net trade was negative during the quarter. For the first nine months of the year, GDP growth measured 4.5%, reflecting the offsetting effects of 6.2% growth in domestic demand and a negative contribution from net trade.

GDP growth in the first nine months of the year was 0.6 percentage points below the Bank's November forecast of 5.1%. The deviation is due to somewhat weaker-than-expected domestic demand and a marginally weaker contribution from net trade. GDP growth for the first half of the year was revised upwards and is now estimated at 5.6%, some 0.4 percentage points more than previously projected. In the first nine months of the year, growth in domestic demand was broadly in line with the November forecast, although public expenditures turned out somewhat less than expected.

The surplus on the underlying current account balance measured 53 b.kr., or 9.3% of GDP, in Q3, similar to the projection in the Bank's last forecast. The surplus is due primarily to a surplus on services trade of 90 b.kr., whereas goods trade generated a 12 b.kr. deficit and the underlying balance on primary and secondary income showed a deficit of 24 b.kr. There was an unusually large deficit on secondary income because of the Depositors' and Investors' Guarantee Fund's payment to the British deposit guarantee scheme and the Dutch central bank. A revision of previously published figures shows that the surplus for H1/2015 was slightly larger than previously projected, while the 2014 surplus was marginally smaller.

Key indicators of private consumption at the beginning of Q4 suggest that private consumption will be strong during the quarter. Payment card turnover was up almost 7% year-on-year in October and new motor vehicle registrations were up 56% in October and

November. Furthermore, most retail price indices had risen significantly year-on-year in October, while groceries turnover was down 0.8%.

The Gallup Consumer Sentiment Index measured 117.9 points in November, nine points more than in October and nearly 38 points higher than in November 2014. This was the highest index value since October 2007. All sub-indices rose between months and between years.

According to the Gallup survey among executives from Iceland's 400 largest firms, carried out in November, respondents were considerably more optimistic about the economic outlook six months ahead than in the September survey. About 63% of respondents considered the current situation good, and nearly 34% considered it neither poor nor good. Just over 42% of executives were of the view that economic conditions would improve in the next six months, and a slightly larger group, or 46%, expected conditions to remain unchanged (i.e., good). Executives in the construction industry were more upbeat than others about the situation six months ahead. They were also more optimistic than they were in September, as were respondents from all sectors other than fishing. Only executives in construction and retail trade were more optimistic than at the same time in 2014. Just over 11% of executives were of the opinion that conditions would deteriorate over the next six months.

Executives were more optimistic about domestic demand than at any time since September 2004, with about half indicating that they expected demand to increase in the next six months. Expectations concerning foreign demand in the next six months were strong as well but have subsided somewhat since year-end 2014.

According to the survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by about 24 percentage points. This represents somewhat greater optimism than was shown in the September survey and the survey carried out a year ago. Executives in all sectors except fishing were more optimistic about recruiting staff than in the September survey. In addition, over a fourth of firms considered themselves short-staffed. Nearly 60% of construction firms and just over 40% of companies in transport and tourism considered themselves understaffed.

The wage index rose by 0.3% month-on-month in October and by 7.9% year-on-year. Real wages in terms of the index had risen by 6% year-on-year in October.

According to the majority opinion of the Parliamentary Budget Committee, the primary surplus will measure 67.6 b.kr. in 2016, roughly 5.5 b.kr. (0.2% of GDP) smaller than was assumed in the fiscal budget proposal. The fiscal stance will weaken commensurably. It is estimated to weaken by the equivalent of 0.9% of GDP each year, or a total of nearly 2% of GDP.

The Statistics Iceland nationwide house price index, published in late November, rose by 1.1% from the previous month, after adjusting for seasonality, and by 9.1% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 0.5% month-on-month in October, adjusted for seasonality, and by about 10% year-on-year. The number of purchase agreements registered nationwide rose by about 18.4% year-on-year in the first ten months of 2015. The average time-to-sale for flats in the greater Reykjavík area was about 3.5 months in the first ten months of 2015, as opposed to 4.4 months during the same period in 2014.

The CPI declined by 0.35% month-on-month in November, and twelve-month inflation measured 2%. Owing to base effects, inflation increased since the MPC's November meeting, as the CPI fell steeply a year ago. The CPI excluding the housing component fell by 0.6% month-on-month, and inflation was 0.3% by that measure. Underlying inflation according to core index 3 excluding tax effects had also risen between meetings, owing to the aforementioned base effects, and measured 2.1%. Statistical measures of underlying inflation suggest that it lay in the 1.9-3.9% range.

A large share of CPI components declined in November. The drop in international airfares had the strongest effect, lowering the index by nearly 0.2 percentage points. The effects of the recent appreciation of the króna continued to emerge, with imported goods prices falling markedly. The increase in the housing component raised the index by 0.12 percentage points, the only component with a significant upward effect. Private services prices have risen by 2.7% in the past twelve months, and it appears that domestic inflationary pressures by this criterion have subsided since the autumn.

According to the Gallup survey of household inflation expectations carried out in November, expectations one and two years ahead were unchanged at 4% since the September survey. In a comparable survey carried out among executives in November, respondents expected inflation to measure 3.6% one year ahead, which was virtually unchanged from the September survey.

The breakeven inflation rate in the bond market has fluctuated somewhat since the MPC's November meeting. It rose somewhat following the meeting but has fallen again since end-November. The breakeven inflation rate two years ahead measured 3.3% just before the December meeting, or broadly the same as at the time of the previous meeting. The breakeven rate five and ten years ahead was about 3% and had risen by 0.2-0.3 percentage points.

II The interest rate decision

The Governor gave the Committee an update on developments since the last meeting, including the work done by the Bank and other authorities in relation to the capital account liberalisation strategy. In this context, the Committee discussed whether it was timely to lower reserve requirements again in order to mitigate the liquidity effect caused by the stability contributions to be paid by the old banks, presumably around the turn of the year. Members agreed that raising reserve requirements in October had had the intended effect and had encouraged financial institutions to prepare for the settlement of the failed banks' estates. As a result, it was deemed appropriate to lower them again, as had been planned at the outset. The MPC therefore decided to lower reserve requirements from 4% to 2.5% as of the next reserve maintenance period, which begins on 21 December. Furthermore, the MPC decided to aim at lowering them back to 2% in connection with the planned auction of offshore krónur.

MPC members discussed whether developments since the previous meeting had changed the Committee's assessment that the monetary stance was appropriate and whether the outlook had changed since that meeting, when it had been decided to raise the Bank's interest rates by 0.25 percentage points. Members agreed that a stronger króna and global price developments had provided the scope to raise interest rates more slowly than had previously been considered necessary, but that it was less certain whether, and to what degree, the improved near-term outlook changed the need for a tighter monetary stance in the near future. Some members were of the view that recent developments changed little in this respect, while others thought the possibility could not be excluded.

Members discussed the information that had been published between meetings, and they agreed that the short-term inflation outlook was better than had been assumed in the Bank's November forecast. They considered the fact that inflation had measured 2% in November and had risen less in the recent term than had been projected, particularly because the decline in global oil and commodity prices and the appreciation of the króna had offset domestic price increases. Committee members considered it likely that this development would persist for some time but that uncertainty about near-term interactions among these factors had grown since the previous meeting. Based on the most recent information, it could be assumed that oil and commodity prices would fall even further and remain low for a longer time. As a result, terms of trade could improve more than had been projected in the last forecast, thereby weakening the inflationary impact of wage increases for as long as the effect of improved terms of trade lasted.

Committee members also thought it likely that the effects of unusually low global interest rates could be felt in Iceland in the coming term. MPC members considered it of great importance to continue exploring policy instruments that could be applied so as to restrict inflows from carry trade. The Committee had discussed this topic at a joint meeting with the Systemic Risk Committee on 30 November, and proposals for such tools are under preparation within the Central Bank.

In the MPC's opinion, growth in economic activity was broadly in line with the Committee's assessment at the previous meeting. According to newly published preliminary figures from Statistics Iceland, year-on-year GDP growth over the first three quarters of 2015 measured 4.5%, which Committee members considered broadly in line with the Bank's November forecast, as it was likely that investment figures would be revised upwards. Furthermore, members noted that as before, GDP growth was driven primarily by domestic demand. Members were of the view that the most recent information indicated also that the labour market continued to recover strongly.

In view of the improved near-term outlook, none of the MPC members saw any reason to change interest rates at present; instead, they thought it appropriate to pause and keep rates on hold at this time. In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

However, Committee members agreed that even though a stronger króna and more favourable global price developments had provided the scope to raise interest rates more slowly than had previously been considered necessary, this did not change the fact that, according to the Bank's November forecast, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future 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.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 10 February 2016.