The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, March 2015

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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 17 March 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 18 March, 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 February interest rate decision.

Financial markets

The exchange rate of the króna had risen by 2.2% against the euro and by 0.6% in trade-weighted terms since the February meeting but had fallen by 4.4% against the US dollar and 2.5% against the pound sterling. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 129 million euros (roughly 19 b.kr.), or just under half of total market turnover during the period.

Financial institutions' liquidity has remained abundant vis-à-vis the Central Bank, and overnight rates in the interbank market for krónur have been below the centre of the interest rate corridor. Turnover in the interbank market has been extremely limited year-to-date.

Yields on long-term nominal Treasury bonds had risen by 0.1-0.4 percentage points since the February meeting, but yields on indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.3-0.5 percentage points.

The lowest listed nominal mortgage rates offered by the three large commercial banks had remained unchanged since the February meeting. Comparable rates on indexed loans were also unchanged, apart from one commercial bank's variable rates, which had risen by ½ a percentage point.

The monetary stance was broadly unchanged since the Committee's February meeting. At the time of the March meeting, the Bank's real rate was still 2.3% in terms of the average of various measures of inflation and inflation expectations, and 3.7% in terms of twelve-month inflation.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by the US and Germany, had declined by 0.3-0.4 percentage points and measured about 1.1-1.7 percentage points just before the March meeting. The CDS spread on five-year Treasury obligations had risen by 0.1 percentage points between meetings, to 1.8%.

Financial market analysts had all expected the Central Bank's nominal interest rates to remain unchanged in March. They cited the uncertainty about ongoing wage negotiations and the fact that year-2014 GDP growth had been in line with the Bank's forecast as grounds for their projections.

Growth in money holdings has slowed down in the recent term, with M3 down by just under 2% year-on-year in January, excluding deposits owned by special purpose entities and the winding-up boards of the failed financial institutions. The contraction is due mainly to a contraction in financial institutions' deposits.

The adjusted total stock of deposit money banks' (DMB) loans to domestic borrowers declined by 2.3% year-on-year in January. DMBs' net new lending (new loans net of prepaid older loans) to domestic borrowers totalled just over 4 b.kr. in January. At the same time, households' prepayments exceeded new loans taken by 166 m.kr. A large share of households' mortgage prepayments during the month can be traced to loan write-downs and accumulated mortgage payments made with third-pillar pension savings associated with the Government's debt relief package.

The NASDAQ OMXI8 index had fallen by just over 2% between meetings. Turnover in the main market totalled around 59 b.kr. during the first two months of the year, about the same as in the corresponding period in 2014.

Outlook for the global real economy and international trade

Iceland's goods trade surplus measured 7.1 b.kr. in January and, according to preliminary figures, 6.6 b.kr. in February. Export values rose 11.7% year-on-year at constant exchange rates in the first two months of the year, due to an increase in marine and industrial product exports. Import values rose by 9% over the same period, owing mainly to increased imports of commodities, operational inputs, and food and beverages.

Terms of trade for goods and services improved by 3.4% year-on-year in 2014, a percentage point more than was forecast in *Monetary Bulletin* 2015/1. The greater improvement is due to favourable developments in export prices of aluminium and marine products during the fourth quarter of the year.

Aluminium prices had fallen by 7% since the last MPC meeting, although the average price was up 4% year-on-year during the first two weeks of March. Foreign currency prices of marine products rose slightly between months in January and had risen 14% year-on-year at that time. Oil prices had fluctuated somewhat between meetings. In the first half of March, they were 3.5% below the February average and 47% below March 2014 prices.

The real exchange rate in terms of relative consumer prices measured 85.1 points in February, 1.4% above the Q4/2014 average and 1.5% higher than in February 2014. The increase is due primarily to a 0.7% nominal appreciation of the króna, but in addition, inflation in Iceland was about 0.8 percentage points above the average among its trading partners. The outlook is for inflation to remain low in trading partner countries. In February, there was 0.3% deflation in the euro area. In January, there was 0.1% deflation in the US and 0.3% inflation in the UK.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, GDP grew by about 3% in Q4/2014. Quarter-on-quarter GDP growth measured 0.8%, according to the Central Bank's seasonally adjusted figures.

GDP growth measured 1.9% for 2014, as compared with the Bank's projection in February of 2%. Year-2014 growth was driven mainly by growth in domestic demand, private consumption and business investment in particular. Domestic demand grew by 5.3% during the year, although the contribution of net trade to GDP growth was negative by 3 percentage points.

GDP growth figures for the first three quarters of the year were revised, and growth is now estimated at 1.5%, about a percentage point more than previous figures had indicated. This is in line with the Bank's November forecast, which was published before Q3 national accounts figures were released in December. At that time, however, domestic demand growth was expected to be somewhat weaker. The discrepancy is due in large part to the revision of public consumption figures for the first nine months, although the contribution from inventory changes was greater than previously expected. Offsetting this, exports grew less than previously forecast, and the contribution from net trade was accordingly weaker.

According to preliminary figures from Statistics Iceland, the central government's underlying operating performance in 2014 was broadly in line with the forecast in *Monetary Bulletin*. There was some difference, however, between the results and the forecast, owing to differing methods of accounting for dividend payments.

The underlying current account balance was positive by just under 100 b.kr. in 2014, or about 5% of GDP, as opposed to a surplus of 7.3% of GDP in the previous year. The smaller surplus in 2014 was due to a smaller surplus on goods trade (19 b.kr.), a smaller surplus on services trade (7 b.kr.), and a weaker primary income balance (15 b.kr.). The forecast in *Monetary Bulletin* 2015/1 assumed that the current account surplus would amount to 4.4% of GDP in 2014. The deviation is due primarily to returns on foreign direct investment, which were better than in the forecast, although the surplus on combined goods and services trade was smaller than forecast.

Key indicators of developments in private consumption at the beginning of the year suggest developments similar to those at the end of 2014. For example, in January and February, payment card turnover was up nearly 3½% year-on-year, and new motor vehicle registrations were up 36.5%.

The wage index rose by just under 1.3% quarter-on-quarter and 6.7% year-on-year in Q4/2014. Wage developments have varied somewhat from one group to another during the current wage settlement period. Of all employee groups, municipal employees' wages rose most year-on-year, or 10.3%. In the private sector, wages rose most in the transport and communications sector (7.2%) and least in the industrial sector (4.2%). The wage index rose by 1% month-on-month in January and by 6.7% year-on-year. Real wages rose by 1.7% between months and about 3.4% year-on-year.

According to Gallup's survey among executives from Iceland's 400 largest firms, conducted in February and March, about one-fourth of respondents were considering adding on staff in the next six months, and just under 10% were considering downsizing. This result is similar to that in both the previous survey and the survey carried out in February/March 2014. In all sectors, there is greater interest in expanding staffing levels than in cutting back. The most pronounced change from the last survey was among firms in communications, transport, and tourism, where nearly half of firms are considering recruiting and only 4% are considering downsizing. Just over 17% of firms consider themselves understaffed, whereas in the communications, transport, and tourism sector and in construction, about 30% of firms consider themselves understaffed. Just over a third of respondents were of the opinion that they would have some difficulty responding to an unexpected surge in demand or sales. The share of firms in this position has increased steadily over the past four years.

New national accounts figures show that the wage share rose by about 0.9 percentage points year-on-year in 2014, to 59.9% of gross factor income, which is about 0.7 percentage points below the twenty-year average. Since it bottomed out in 2009, the wage share has risen by just over 6 percentage points.

Statistics Iceland's nationwide house price index, published in late February, was up 1.7% month-on-month when adjusted for seasonality, and about 8.2% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 1.6% month-on-month in January, when adjusted for seasonality. It rose by 10.4% year-on-year. The number of purchase agreements concluded nationwide in January 2015 slightly exceeded the number concluded in January 2014. The average time-to-sale for flats in the greater Reykjavík area was just over five months in January, as opposed to an average of just over four months in 2014.

According to the Gallup survey carried out in February and March, corporate executives were much more upbeat about the current economic situation than they were in the December survey. Over 40% of them considered the current situation good, as compared with approximately one-third in the previous survey. Furthermore, nearly 40% of executives expected conditions to improve in the next six months – a slight downturn from December – and just under half expected them to remain unchanged. Respondents in all sectors were somewhat more pessimistic about the future than they were in December, particularly those in the retail sector. In spite of this, nearly half of them – somewhat more than in the last survey – indicated that they expected domestic demand to grow in the next six months.

According to Gallup's consumer sentiment survey, carried out in February, respondents were also more optimistic than in both the previous month and the same month in 2014. The Consumer Sentiment Index measured 91.5 points in February, an increase of nearly 10 points from the previous month and 5.6 points from February 2014.

The CPI rose 0.7% month-on-month in February, and twelve-month inflation was unchanged at 0.8% since the MPC's previous meeting. However, the CPI excluding the housing component had declined by 0.9% in the past twelve months. Underlying twelve-month inflation in terms of core index 3 excluding tax effects measured 1.2% in February, also virtually unchanged since the last MPC meeting. According to statistical measures, however, underlying inflation had risen between months and ranged between 1.5% and 2%. The main drivers of the increase in the CPI in February were end-of-sale effects and rising house and petrol prices. The increase in the housing component strongly affected the index, raising it by 0.25 percentage points, as the market price of housing had risen relatively strongly in recent months. Food and beverage prices declined by 0.7% between months. The price reductions came in the wake of strong increases in January, which were due to the increase in the lower value-added tax bracket.

According to the Gallup survey of household expectations, carried out in February and March, household inflation expectations one year ahead measured 3%, down ½ a percentage point from the November survey, whereas two-year inflation expectations were unchanged at 4%. According to a comparable survey carried out among executives at around the same time, respondents' inflation expectations one year ahead also measured 3%, an increase of ½ a percentage point since the December survey. This was the first increase in corporate inflation expectations in quite some time. Corporate expectations two years ahead measured 3.1% and had also risen slightly since the last survey. The five- and ten-year breakeven inflation rate in the bond market, as measured by the spread between indexed and non-indexed bond interest rates, averaged approximately 4% in the first half of March and had risen by just over ½ a percentage point since January. It is now roughly where it was a year ago.

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 capital account liberalisation. He also reported to the Committee on the Executive Board of the International Monetary Fund's (IMF) Article IV discussion about the current situation and future prospects for the Icelandic economy during its last Board meeting.

Because of the short time since the previous MPC meeting, little new information had been published. The Committee agreed that developments since the last meeting had not changed its assessment of the necessary monetary stance. Members were of the view that the recently published national accounts did not materially change their assessment of recent GDP growth and the economic outlook. Some members were of the view, however, that there were signs that the economy was even stronger than Statistics Iceland's figures indicated. The Committee agreed that these new data confirmed its assessment, published in its last statement, that last year's GDP growth was stronger than the preliminary GDP growth numbers for the first nine months of the year suggested.

Members noted that recent developments among Iceland's main trading partners, particularly in Europe, had exceeded expectations, even though inflation had not yet risen.

They agreed that the inflation outlook was broadly unchanged since the last meeting, as inflation had remained very low in recent months, and slightly negative if housing costs were excluded. The Committee was of the view that low global inflation and a stable króna had contained inflation and offset the effects of considerable domestic wage increases. They were also of the view that the inflation forecast in the February *Monetary Bulletin* was more likely to be too low than too high, particularly in view of the growing unrest in the labour market. Furthermore, they considered it possible that inflation could exceed the forecast in the next few months, owing in part to a larger rise in domestic petrol prices than assumed in February. Further disinflation was therefore unlikely.

The Committee had some concern about recent developments in inflation expectations. At its previous meeting, inflation expectations had subsided between meetings and were at target by most measures. At the time of the March meeting, however, there were indications that they had risen again in recent weeks. In the Committee's view, this might reflect expectations that the results of the forthcoming wage settlements would not be in line with the inflation target, although some of the increase could also be due to unfavourable developments in risk premia. In the Committee's opinion, this development suggested that inflation expectations were not yet firmly anchored at target.

They considered it most appropriate to keep interest rates unchanged. Given that the recent episode of low inflation was attributable in part to falling global fuel prices, which were beyond the scope of domestic monetary policy, and the disinflation resulting from the drop in fuel prices was temporary, Committee members agreed, as before, that in determining interest rates, it was not appropriate to take full account of the disinflation stemming from this source. They were also of the view that the outlook for the labour market remained highly uncertain, and at the same time, there were signs of robust GDP growth in the near future. For this reason, the Committee agreed that it was still appropriate to keep interest rates unchanged until the economic situation became clearer, particularly as regards wage developments.

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 4.5%, the current account rate 4.25%, the seven-day collateralised lending rate 5.25%, and the overnight lending rate 6.25%. The proposal was approved unanimously.

Committee members agreed that, as always, developments in nominal interest rates would depend on developments in demand and inflation. The Committee was of the opinion that, if inflation remained below target and pay increases in upcoming wage settlements were consistent with the inflation target, conditions for further reductions in nominal interest rates could develop, other things being equal. On the other hand, they were of the opinion that large pay increases and strong growth in demand could undermine the recently achieved price stability and require that interest rates be raised again.

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 13 May 2015.