The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, November 2015

Published 18 November 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 2 and 3 November 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 4 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 outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 30 September interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2015/4 on 4 November.

Financial markets

In trade-weighted terms, the exchange rate of the króna was virtually unchanged since the September meeting, as movements against major currencies offset one another. The króna appreciated by 1.4% against the euro but depreciated by 2.3% against the pound sterling, and 0.8% against the US dollar.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 198 million euros (28.1 b.kr.) between meetings, or 57% of total market turnover. Purchases year-to-date totalled 1.5 billion euros (220 b.kr.), more than twice the total for the same period in 2014.

Interest rates in the interbank market for krónur have developed in line with the Central Bank's key rate, and as before, overnight rates in the market are below the centre of the interest rate corridor, close to the key rate. Interbank market turnover totalled 305.5 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 terms of the Central Bank's real rate, the monetary stance had tightened slightly since the MPC's September meeting, owing to lower inflation and inflation expectations. At the time of the November meeting, the Bank's real rate was 3.6% in terms of the current inflation level and 2.2% in terms of the average of various measures of inflation and inflation expectations. This is about 0.1-0.2 percentage points higher than just after the September interest rate announcement.

The transmission of Central Bank rates to other interest rates has been broadly smooth in the recent term. The transmission through the interest rate channel has weakened recently, however, as higher Central Bank interest rates have not been transmitted fully to long-term bond market rates. Yields on nominal Treasury bonds had fallen by 0.3-0.6 percentage points between meetings. Since the June meeting, however, the decline had totalled up to 2.1 percentage points, whereas the Bank's nominal interest rates had been raised by 1 percentage points over the same period. Yields on the longest bonds had fallen most. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds had fallen by 0.2-0.4 percentage points between meetings and by as much as ½ a percentage point since June. Yields on the commercial banks' covered bonds had also fallen in line with bond interest rates. This development may be due in part to lower inflation expectations and reduced concerns about inflation in the wake of wage settlements, as well as expectations of reduced Treasury bond issuance and an improved Treasury debt position following the publication of the capital account liberalisation strategy. However, the reduction is probably due to a large extent to an increase in non-residents' investment in long-term nominal Treasury bonds, which has lowered term premia in the bond market. This is in line with the views of the majority of respondents in the Bank's recent survey of market agents' expectations. Non-residents' new investment in long nominal Treasury bonds had totalled nearly 49 b.kr. since mid-June.

The reduction in bond market yields has also lowered interest rates on some of the pension funds' loans to fund members, which are now approximately ½ a percentage point lower than comparable rates offered by the commercial banks. Interest rates on mortgage loans from the three large commercial banks have broadly followed Central Bank rates, although one of the large banks recently announced a rate reduction.

Risk premia on Treasury foreign obligations had declined between meetings. The CDS spread on five-year Treasury obligations had narrowed by 0.3 percentage points, to about 1.2% just before the November meeting. Furthermore, 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, had also fallen by 0.3 percentage points, to about 1.5 percentage points just before the November meeting. The risk premium vis-à-vis German bonds was virtually unchanged, however, at 1.6 percentage points.

Financial institutions' analysts all expected that Central Bank interest rates would be held unchanged in November, citing the improvement in the short-term inflation outlook and reasoning that a stronger króna and lower commodity prices had created the scope to delay further rate increases in spite of underlying inflationary pressures and growing domestic demand.

M3 grew by just over 13% year-on-year in Q3/2015, or by 7% excluding deposits held by the winding-up boards of the failed deposit money banks (DMB).

The exchange rate- and price-adjusted stock of DMB loans to households grew by ½% in the first nine months of the year but contracted by nearly 5% if loans from the Housing Financing Fund (HFF) are included. If adjustments are made for the Government's debt relief measures, the credit stock contracted by approximately 1%. There is some uncertainty about this development, however, as it appears inconsistent with other indicators from the credit market. In the first nine months of the year, net new loans granted to households by deposit institutions and the Housing Financing Fund (HFF) – i.e., new loans less prepayments of older loans – totalled 24 b.kr., but when adjusted for the Government's debt relief programme, the increase is estimated at just over 70 b.kr. Loans to the non-financial corporate sector have also been on the rise during the year. The adjusted stock of deposit money bank (DMB) loans to firms increased by nearly 4% in the first nine months of the year, whereas it contracted by approximately 1½% over the same period in 2014. Net new lending from deposit institutions to the non-financial corporate sector totalled just over 126 b.kr. in the first nine months of 2015, a significant increase year-on-year.

The NASDAQ OMXI8 index had risen by 9.3% between meetings. Turnover in the NASDAQ Iceland main market totalled almost 263 b.kr. over the first nine months of the year, about 43% more than over the same period in 2014.

Global economy and external trade

GDP growth among Iceland's main trading partners measured 1.9% in the first half of the year, slightly more than was forecast in the August *Monetary Bulletin*. The outlook for the year as a whole is slightly weaker than was forecast in August, however.

The deficit on goods trade totalled 13.6 b.kr. in the first nine months of the year, some 2 b.kr. more than over the same period in 2014. Export values grew by 12.7% at constant exchange rates, while import values rose 12.9%. The increase in exports is due primarily to 17% growth in industrial goods exports and 13% growth in marine product exports. Import growth is due mainly to a year-on-year increase of nearly 35% in transport equipment imports, 24% in consumer goods imports, and 23% in imports of commodities and operational inputs.

In terms of relative consumer prices, the real exchange rate measured 90.4 points in September, an increase of 2.3% month-on-month and 8.4% year-on-year. In the first nine months of the year, it was 2.9% higher than in the same period in 2014. This was due mainly to the nominal exchange rate, which was 1.8% higher, although domestic inflation was also about 1 percentage point above the average for Iceland's trading partners during the period.

Listed global aluminium prices had fallen by over 5% since the MPC's September meeting, and the average October price was down more than 21% year-on-year. Foreign currency prices of marine products were unchanged between months in September but had risen by 7% year-on-year.

Terms of trade improved by about 10½% year-on-year in the first half of 2015, following a roughly 3% improvement in 2014. The improvement is due primarily to a decline in global oil and commodity prices and an increase in marine product prices.

The domestic real economy and inflation

The wage index rose by 3.5% between quarters in Q3, and by 7.9% year-on-year, and real wages were up 2.8% quarter-on-quarter in Q3 and 5.8% year-on-year.

The results of the Statistics Iceland labour force survey show that labour demand in Q3/2015 was slightly stronger than was assumed in the forecast in the August *Monetary Bulletin*. The August forecast provided for a 1.9% year-on-year increase in total hours worked, whereas the actual increase was 2.4%. Unlike the situation in the first half of the year, the increase is due both to a rise in the number of employed and to longer average hours worked. Seasonally adjusted unemployment measured 4% in Q3, having declined by 0.2 percentage points between quarters.

Key indicators of private consumption in Q3 indicate that growth has continued and even accelerated. Payment card turnover rose nearly 7% year-on-year during the quarter, although the increase was larger at the beginning of the quarter than at the end. New motor vehicle registrations increased by just over 55% during the quarter. Groceries turnover declined slightly between years, but most other retail sales indices had risen.

The Gallup Consumer Sentiment Index measured 108.9 points in October, an increase of 5.3 points between months and about 33 points between years. This is the highest value of the index since January 2008. The index has been rising more or less steadily in the recent term, and consumers have not been this optimistic about the labour market situation since October 2007.

The nationwide Statistics Iceland house price index, published in late October, rose by 1.2% from the previous month, and by about 1.3% adjusted for seasonality. It has risen 7.9% in the past twelve months. The capital area real estate price index calculated by Registers Iceland rose by 1.2% month-on-month in September and 9.3% year-on-year. The number of residential purchase agreements registered nationwide rose by just under 16% year-on-year in the first nine months of 2015.

The CPI rose by 0.07% month-on-month in October. Twelve-month inflation measured 1.8% and had subsided slightly since the previous MPC meeting. The CPI excluding the housing component fell by 0.2% month-on-month, and inflation was 0.3% by that measure. Underlying inflation in terms of core index 3 excluding tax effects had also fallen slightly between meetings, to 1.9%. Statistical measures of underlying inflation suggest that it lay in the 2-4% range. The main driver of inflation in October was rising house prices, which increased the CPI by 0.17 percentage points. Reductions in the price of imported goods and private services pulled in the opposite direction.

The breakeven inflation rate in the bond market has fallen markedly since the summer. To some extent, the decline probably reflects the appreciation of the króna, low global inflation, and less pessimism about inflation in the wake of wage agreements than could be discerned during the prelude to the settlements. It is difficult to interpret developments in the breakeven inflation rate, however, because of the recent surge in capital inflows, which has led to a significant decline in yields on long nominal Treasury bonds, as has been discussed. The breakeven inflation rate two years ahead averaged 3.3% in October, having declined by nearly ½ a percentage point since September. The breakeven rate five and ten years ahead averaged 2.7% in October and had also fallen by nearly ½ a percentage point since September. The decline since June was just over 2 percentage points.

According to the Bank's survey of market agents' expectations, carried out at the end of October, respondents expect inflation to measure 3.8% one year ahead. This is about 0.1 percentage point less than in the August survey. Their inflation expectations two years ahead had risen by ½ a percentage point since August, to 4%. Their long-term inflation expectations were broadly unchanged between surveys, with respondents indicating that they expected inflation to average just under 3½% over the next ten years. These results therefore indicate that only a small part of the decline in the breakeven rate can be attributed to an actual decline in inflation expectations.

According to the forecast published in *Monetary Bulletin* on 4 November 2015, the long-term inflation outlook is broadly unchanged from the August forecast, even though the short-term outlook has improved somewhat. Inflation averaged 2% in the third quarter of the year, 0.4 percentage points below the forecast in the August *Monetary Bulletin*. The deviation is due primarily to a stronger króna and steeper declines in global oil and commodity prices than in the August forecast. Furthermore, the inflationary effects of the recent wage settlements appear to be more modest than was assumed then, probably due in part to the appreciation of the króna and the improvement in terms of trade in recent months. According to the forecast, there are significant and growing domestic inflationary pressures, which could take hold once the effects of a stronger króna and lower import prices begin to taper off. Inflation is projected to measure 2.3% in the fourth quarter of the year, or 1½ percentage points less than was forecast in August. It is expected to continue to inch upwards, albeit somewhat more slowly than was forecast then, and to be at or above 4% from the end of 2016 into H2/2017 and then begin to taper off again.

Trading partners' GDP growth is expected to be unchanged year-on-year, at 1.7%, rising to 2% in 2016 and averaging 2¼% in 2017-2018. The GDP growth outlook for the forecast horizon as a whole has therefore deteriorated since August, and uncertainty about the global economy has increased again.

Terms of trade are expected to improve by just over 5% this year, or ½ a percentage point less than was forecast in August. The outlook for coming years is unchanged since August, however, although uncertainty has grown in tandem with increased uncertainty globally.

According to the forecast, export growth will slow down somewhat in the next three years, in line with the rising real exchange rate. Goods exports are expected to be weaker next year than was projected in August, as the rise in the real exchange rate is larger and trading partner demand weaker than was forecast then. This is offset by the improved outlook for tourism, however.

According to preliminary figures from Statistics Iceland, GDP growth measured 5.6% in Q2/2015, the strongest single-quarter growth rate seen since the beginning of 2008. Statistics Iceland also revised previously published figures and now estimates Q1 GDP growth at 4.8% instead of the previous 2.9%. H1 GDP growth is now estimated at 5.2%, somewhat more than was assumed in the Bank's August forecast. Although strong GDP growth in the first half reflects to some extent the one-off effects from services exports, the outlook for the year as a whole has been revised upwards since the August forecast, with 2015 GDP growth now forecast at 4.6%. This is 0.4 percentage points above the August forecast but in line with the forecast from May. The improved outlook reflects both strong growth in domestic demand and a slightly more positive contribution from net trade. As in the August forecast, GDP growth is assumed to ease in coming years, although it is still expected to remain above its long-term average for the majority of the forecast horizon. It is projected at 3.2% in 2016, 3% in 2017, and 2½% in 2018.

The recovery of the labour market continues, and by most measures the slack has disappeared. Declining unemployment is due to job creation; however, this is offset somewhat by a marked rise in the participation rate. The seasonally adjusted labour participation rate is now 3 percentage points above the post-crisis trough from Q4/2011 and is closing in on its peak from early 2007. The employment rate has risen as well and was up 1½ percentage points year-on-year in Q3. Other indicators from the labour market point in the same direction. As in the Bank's previous forecasts, the recovery of the labour market is projected to continue, with declining unemployment and an increase in the number of jobs and total hours worked. The recovery is forecast to be somewhat weaker than was assumed in August, however, due to the expectation of larger rises in unit labour costs. Unemployment will fall from 4.4% this year to about 4% in 2018, and total hours worked will increase, on average, by just over 2% per year.

The arbitration panel ruling from August and the subsequent agreement among the social partners has entailed a larger rise in wages during the forecast horizon than was assumed in the August forecast. Although offset by somewhat more rapid productivity growth in the latter half of the forecast horizon, unit labour costs are still projected to rise steeply, or by 9% this year and 8% in 2016. If the forecast materialises, the increase in 2015 and the ensuing three years will average 6.7% per year, far in excess of the level compatible with medium-term price stability.

In line with Statistics Iceland's revision of historical GDP growth figures, the slack in the economy between 2011 and 2014 is now considered to have been just under ½ a percentage point per year larger than previous figures indicated. As in August, however, the spare capacity is considered to have disappeared early this year, and owing to stronger GDP growth both in 2015 and over the forecast horizon as a whole, the outlook is for a somewhat wider positive output gap than was previously projected. It is forecast to peak at 1½% of potential output early in 2016 and to remain at about that level until mid-2017 before narrowing once again.

The baseline forecast reflects an assessment of the most likely economic developments over the next three years. It is based on forecasts and assumptions concerning developments in the external environment of the Icelandic economy, as well as assessments of the effectiveness of specific markets and on the transmission of monetary policy to the real economy. All of these factors are subject to uncertainty. The uncertainties described in the November *Monetary Bulletin* show clearly that the inflation outlook for the next three years could easily deviate from the scenario presented in the baseline forecast. Inflationary pressures could be underestimated, which (other things being equal) would call for higher interest rates than are implied in the baseline forecast in order to keep inflation at target if, for instance, firms pass the cost increases from the recent wage settlements through to price levels more than is assumed in the forecast or if the impact on private consumption of the strong temporary rise in real disposable income is underestimated. Inflation could also prove more persistent than is forecast if the hefty pay increases de-anchor inflation expectations still further. The same applies if the króna proves weaker over the forecast horizon than is assumed in the baseline forecast or if the tension in the economy is more pronounced; for instance, if activity in the energy-intensive sector is greater than forecast, or if there is more slack in fiscal policy. The recent weakening of the monetary policy transmission mechanism could also make it more difficult for monetary policy to contain domestic demand, which could lead to higher inflation than is forecast, other things being equal. On the other hand, inflation could prove lower than is forecast if the global economic outlook worsens or global oil and commodity prices fall still further. The króna could also turn out stronger than is assumed in the baseline forecast, and firms could respond to the steep rise in wage costs by cutting their own profit margins or with increased streamlining. Productivity growth could also prove stronger than in the baseline forecast, which would counteract to a greater degree the inflationary pressures from the labour market.

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.

Committee members discussed the Bank's most recent *Financial Stability* report, published after the September meeting; they also discussed financial institutions' position, the risks to the financial system in connection with capital account liberalisation, and the progress made in private sector debt restructuring.

In addition, they discussed the effects of the increase in minimum reserve requirements on deposit-taking institutions' liquidity. The increase in reserve requirements appeared to have had the intended effect and contributed to the institutions' preparation for the settlement of the failed banks' estates and the planned auction intended to release or tie up offshore krónur. Members agreed that no further changes should be made to reserve requirements at this time.

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. At the last meeting, the Committee had decided to pause and keep interest rates on hold because the stronger króna and global price developments had provided the scope to raise interest rates somewhat more slowly than had previously been considered necessary. Members agreed, however, that the improved near-term outlook did not change the need for a tighter monetary stance in the near future.

In the Committee's opinion, economic growth as set out in the Bank's new forecast was broadly in line with the MPC's assessment at the September meeting, albeit slightly stronger, as GDP growth would measure 4.6% this year according to the new forecast, or ½ a percentage point more than was assumed in the August forecast. Members were of the view that the medium-term GDP growth outlook had improved as well. They noted that domestic demand growth is projected to be considerably stronger than year-2015 GDP growth.

They discussed the fact that inflation had turned out somewhat lower in Q3 than was forecast in August and was still below the target, especially if the housing component of the CPI were excluded. They considered this to stem mainly from larger declines in global oil and commodity prices and a stronger appreciation of the króna than had been assumed in the Bank's previous forecasts, which had offset domestic inflationary pressures. As a result, the short-term inflation outlook was better than the Bank had projected in August.

Members agreed, however, that the inflation outlook for the longer term was broadly unchanged because domestic inflationary pressures – particularly those due to wage increases – would cause inflation to rise above the target when the effects of low global inflation tapered off.

Because the long-term outlook according to the forecast was in line with the assessment at the September meeting, the Committee considered it appropriate to continue to tighten the monetary stance, as it had signalled at previous meetings. Members agreed that there was considerable strength in the domestic economy, that the spare capacity had been absorbed and a positive output gap was developing, which would lead to increased inflation once the effects of the ISK appreciation and the drop in commodity and fuel prices had tapered off. It was therefore likely that the resilience of the economy was already being tested. It was noted that strong demand would be addressed to an extent with imported labour, although it was also pointed out that there were signs that firms were having greater difficulty in addressing labour shortages in this way. It was pointed out as well that importation of labour entailed increased demand – for housing, among other things – which would further exacerbate demand-side pressures.

As at the previous meeting, there was some discussion of whether low inflation in the recent past indicated that wage increases had been responded to with more streamlining than had been assumed in the forecast. It was also mentioned that both productivity and the improvement in terms of trade could be underestimated in the forecast and that the scope for wage increases without commensurable inflationary effects could therefore be greater than was assumed in the forecast. On the other hand, it was pointed out that, even though the forecast assumed large pay increases, they were probably underestimated because the forecast only took account of a portion of the pay rises currently being discussed by the social partners. Given the tension that appeared to be developing in the labour market, wage drift could also have been underestimated in the forecast. Moreover, although inflation was still low, it could rise rapidly in view of the underlying domestic inflationary pressures from the labour market, even though these pressures were still largely concealed by the offsetting effects of lower global oil and commodity prices and the appreciation of the króna. Even in the event of a delay in the global economic recovery, if oil and commodity prices stopped falling and the effects of the previous decline tapered off, inflationary pressures could surface for this reason alone.

Committee members discussed the outlook for central government finances, as the fiscal budget proposal for 2016 entailed increased easing of fiscal policy. Members agreed that there was some risk that the fiscal stance would be even more accommodative than was provided for in the budget proposal. As a result, inflationary pressures could be underestimated in the forecast, as it only took account of fiscal easing after adjusting for the business cycle, as is provided for in the budget proposal. It was also emphasised that the forecast was based on the assumption that the monetary stance would be tightened as the positive output gap widens and inflation rises. If this were done too late, or not at all, inflation would be higher during the forecast horizon than was provided for in the November forecast.

MPC members discussed the uncertainty about monetary policy transmission and agreed that it had grown because unusually low global interest rates had an increasing impact in Iceland. As a result, it was likely that monetary policy transmission would be shifted over to the exchange rate channel, which is generally less reliable than the interest rate channel, to an even greater degree than before. This could make it more difficult for the MPC to achieve the intended monetary stance. One member was of the view that the risk of excessive capital inflows could therefore interfere with a timely monetary policy response to the worsening long-term inflation outlook. The Committee agreed that if inflows related to carry trade proved to be substantial, it would be necessary to use tools other than interest rates to restrict them. This would be discussed at a joint meeting with the Systemic Risk Committee before the end of November.

The Committee discussed developments in liquidity in connection with capital account liberalisation. Members considered it likely that there could be changes in the liquidity position, which could affect the need for further interest rate changes. The need for a tighter monetary stance would also depend on whether other policy instruments were applied in order to contain demand-side pressures in the coming term.

Committee members discussed the interest rate decision and were of the view that two options were available: to keep interest rates unchanged or to raise them. In light of the Committee's previous messages about the need for continued monetary tightening, some members were of the view that keeping rates unchanged for too long a time could send a misleading message about the MPC's assessment of the need for a tighter stance over the longer term.

In view of the discussion, the Governor proposed that the Bank's interest rates be increased by 0.25 percentage points, which would raise the key rate (the seven-day term deposit rate) to 5.75%, deposit rates (current account rates) to 5.5%, the seven-day collateralised lending rate to 6.5%, and the overnight rate to 7.5%. 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 attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 9 December 2015.