The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, February 2016

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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 1 and 8 February 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 10 February, 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 9 December interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2016/1 on 10 February.

Financial markets

The exchange rate of the króna had risen by 1.2% in trade-weighted terms, by 5.9% against the pound sterling, and by 2.2% against the US dollar since the December meeting. It had fallen by 1% against the euro, however. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 636 million euros (90 b.kr.) between meetings, or about 67% of total market turnover.

The króna appreciated by nearly 8% in trade-weighted terms during 2015, as opposed to 1.7% in 2014. Improved terms of trade, continuing tourism-generated foreign currency inflows, and capital inflows in connection with increased new investment have supported the currency. Offsetting factors were the substantial foreign currency purchases made by the Central Bank so as to mitigate exchange rate volatility. The Bank's net foreign exchange purchases in the interbank market totalled 272.4 b.kr. in 2015, far exceeding the 2014 total of 111.4 b.kr. Foreign exchange market turnover rose by 85% year-on-year in 2015, totalling

492.7 b.kr. The Bank's transactions accounted for about 55% of total turnover in 2015, as opposed to about 43% in 2014. At the end of 2015, the foreign exchange reserves net of the Central Bank and central government's foreign-denominated debt were positive by 313 b.kr. and had grown by 256 b.kr. since year-end 2014.

As before, overnight interest rates in the interbank market for krónur were below the centre of the interest rate corridor, close to the Bank's key rate. Interbank market turnover totalled 23 b.kr. in January, broadly the same as in the past two months.

The monetary stance had remained broadly unchanged since the MPC's December meeting. At the time of the February meeting, the Bank's real rate was 2.6% in terms of the average of various measures of inflation and inflation expectations and 3.6% in terms of past twelve-month inflation.

When the Committee met in February, yields on nominal Treasury bonds were similar to those seen at the time of the December meeting, or 5.8-6.0%. Yields on indexed Government and Housing Financing Fund (HFF) bonds were also about the same as at the time of the December meeting, or 2.8-3.0%. According to the issuance plans published by Government Debt Management, net issuance of Treasury securities will be negative by nearly 30 b.kr. in 2016.

The large commercial banks' indexed and non-indexed deposit and lending rates were unchanged since the December meeting, as was the pension funds' average mortgage lending rate.

The risk premium on the Republic of Iceland's foreign obligations rose at the start of the year, as it did for many other developed countries, in response to increased unrest in global financial markets. The CDS spread on five-year Treasury obligations declined again in late January, however, and measured just under 1.3% at the time of the February meeting, or about 0.1 percentage point lower than at the time of the December meeting. The risk premium as measured by the interest rate spread between Icelandic Treasury bonds and comparable bonds issued by the US and Germany had increased by 0.2-0.5 percentage points since December, however, to 1.7-2.0 percentage points.

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

M3 grew by 7.6% year-on-year in Q4/2015 and by 7.1% excluding deposits held by financial institutions in winding-up proceedings. The total stock of deposit institutions' loans to resident borrowers contracted by nearly 1% year-on-year in Q4/2015, and by approximately 3½% if loans from the HFF and the pension funds are included. The contraction is due for the most part to the Government's debt relief measures. Adjusted for these measures, the credit stock is estimated to have contracted by just over 1%. The contraction is also due in part to a reduction in corporate lending, which is owing partly to refinancing of older loans through other forms of credit, including marketable bonds.

The Nasdaq Iceland OMXI8 index had fallen by nearly 4½% year-to-date, in line with developments in global financial markets. The decline between MPC meetings was almost 3%. Turnover in the main market totalled just under 392 b.kr. in 2015, an increase of about 42% from the prior year. Furthermore, turnover was about 58.5 b.kr. in January 2016, considerably more than in January 2015.

Global economy and external trade

The global GDP growth outlook has deteriorated somewhat and has grown more uncertain. The International Monetary Fund's (IMF) January forecast estimates global GDP growth at 3.4% in 2016 and 3.6% in 2017, or some 0.2 percentage points less in each of the two years than in its October forecast. The poorer outlook is attributable mainly to a weaker economic recovery in both the US and emerging economies, particularly Brazil and the Middle East. In industrialised countries, inflation is projected at 1.1% in 2016, or 0.1 percentage point less than in the October forecast, but the outlook for 2017 is unchanged. In emerging and developing countries, however, inflation is expected to pick up over the next two years. It is forecast at 5.6% this year and 5.9% in 2017. *Consensus Forecasts'* year-2016 GDP growth projections for Iceland's main trading partners were unchanged between MPC meetings, although the inflation forecasts had been lowered by 0.2 percentage points.

The deficit on Iceland's goods trade totalled 8.7 b.kr. in December and, according to preliminary figures from Statistics Iceland, 1.2 b.kr. in January. The deficit totalled 31.3 b.kr. in 2015, as opposed to a surplus of 5.5 b.kr. in 2014. Import values rose by 14.9% year-on-year in 2015 and export values by 8.2%. Import growth in 2015 is due mainly to increased transport equipment imports, while export growth is due to an increase in the export value of marine products.

In terms of relative consumer prices, the real exchange rate measured 92.2 points in January, an increase of almost 1% month-on-month and nearly 10% year-on-year. The increase is due primarily to a 9% nominal appreciation of the króna, but in addition, inflation in Iceland was nearly 1 percentage point above the average among its trading partners. In 2015, the real exchange rate rose by an average of 4% in terms of relative consumer prices and by 12% in terms of relative unit labour costs.

Listed global aluminium prices had risen by just over 2% between MPC meetings, but the average January price was down more than 18% year-on-year. Foreign currency prices of marine products rose by 1½% between months in December and had risen 4½% year-on-year at that time. In all, marine product prices rose by nearly 9% year-on-year in 2015.

The domestic real economy and inflation

The wage index rose by 2.2% between quarters and by 8.8% year-on-year in Q4/2015, and real wages were 6.7% higher than in Q4/2014.

The results of the Statistics Iceland labour force survey (LFS) show that total hours worked grew by 3% in Q4/2015, in line with the Bank's November forecast. The increase was due entirely to a rise in the number of employed persons. Total hours worked increased by 3.3% between yearly averages in 2015, while the participation rate rose by 1.1 percentage points and the employment rate by 1.8 percentage points. Because of increased labour participation, the decline in unemployment was smaller than the rise in the employment rate, or about 1 percentage point. The number of persons outside the labour market declined by nearly 5% year-on-year in 2015.

Unemployment according to the LFS was considerably lower in Q4 than was projected in November, or 3.1% as opposed to 4.9%, and declined by 1 percentage point between years. Seasonally adjusted unemployment fell by half a percentage point between quarters, to 3.6%. Unemployment was 4% in 2015, down from 5% in 2014. Unemployment as measured by the Directorate of Labour (DoL) measured 3% in 2015 and had fallen by just over half a percentage point between years.

Key indicators of developments in private consumption imply that growth gathered pace in Q4/2015. Payment card turnover rose by nearly 6½% year-on-year, broadly in line with developments during the year as a whole. The number of new motor vehicle registrations picked up in the latter half of 2015 and, in Q4, was up nearly 70% year-on-year, while groceries turnover contracted year-on-year during the quarter.

Statistics Iceland’s nationwide house price index, published at the end of January, rose by 0.9% month-on-month, after adjusting for seasonality, and by 8.6% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by just over 1% month-on-month in December when adjusted for seasonality and by 8.9% year-on-year. It rose by 9.4% between yearly averages in 2015, and the number of registered purchase agreements nationwide rose 21% between years. The average time-to-sale for residential property in the greater Reykjavík area declined by a month between 2014 and 2015, to just under 3½ months.

In January, the Gallup Consumer Sentiment Index rose slightly between months and by 42.5 points year-on-year. In Q4/2015, the index was 32.5 points higher, on average, than in the same period in 2014.

The CPI declined by 0.6% month-on-month in January, after rising by 0.3% in December. Twelve-month inflation measured 2.1% and had therefore risen marginally since the previous MPC meeting. The CPI excluding the housing component fell by 1.1% month-on-month in January, and inflation by that measure was 0.6%, or 0.3 percentage points higher than just before the Committee’s December meeting. Underlying inflation in terms of core index 3 excluding tax effects had also risen slightly between meetings, to 2.4%. Statistical measures of underlying inflation suggest that it lay in the 2-3½% range. Inflation averaged 1.6% in 2015, down from 2% in 2014.

Winter sales lowered the index by 0.9 percentage points in January, in addition to the drop in petrol prices. Pulling in the opposite direction were house prices and various private services, as well as seasonal price list increases. The price of private services has risen by 2.6% in the past twelve months, and the year-on-year rate of increase has remained broadly unchanged in recent months. Domestic petrol prices have fallen by 5.6% in the past three months, whereas global oil prices have declined by approximately 30% over the same period.

Some base effects could be seen in January, as the increase in the lower value-added tax threshold, implemented at the beginning of 2015, no longer affects the twelve-month rise in food prices. By the same token, petrol prices fell considerably less month-on-month in January 2016 than they did a year ago, which is the main reason imported deflation was less pronounced than it has been in the recent term.

According to the Central Bank’s survey of market agents’ inflation expectations, conducted at the beginning of February, participants expect inflation to measure 3% in one year. This is 0.8 percentage points lower than in the previous survey, taken in October 2015, as the inflation outlook has improved since the year-end. Respondents’ expectations two years ahead had declined by 0.5 percentage points and measured 3.5%. Market agents expect inflation to average 3.3% over the next ten years, which is unchanged from the previous survey but 0.3 percentage points higher than in a comparable survey carried out a year ago. The breakeven inflation rate in the bond market has declined markedly since mid-2015, due for the most part to unusual conditions in the bond market rather than to an actual decline in inflation expectations. The breakeven rate five and ten years ahead averaged 3% in January, about 0.2 percentage points lower than it was in December and ½ a percentage point lower than a year ago.

According to the forecast published in *Monetary Bulletin* on 10 February 2016, the outlook is for inflation to be below the November forecast into 2017. Imported deflationary pressures have proven stronger than previously assumed, as global oil prices have continued to fall and are considerably lower than was projected in November. The inflation outlook for 2016 has therefore improved. However, in line with international forecasts, it is assumed that oil and commodity prices will begin to rise later this year and that inflation will therefore pick up, due to growing tension in the economy and large pay increases in the recent past. Inflation is expected to rise above 3% by the year-end, peak at 4.2% in Q4/2017, and then subside to just below 3% by the end of the forecast horizon.

The inflation outlook is highly uncertain, however, because the timing and extent of an increase in oil and commodity prices is uncertain, as is the extent to which pay rises will be passed through to prices and whether the increase in real disposable income leads to stronger private consumption growth than is provided for in the forecast.

The economic recovery among Iceland's trading partners slowed down over the course of 2015. Global economic uncertainty has also increased, and the GDP growth outlook is considered to have deteriorated since the November forecast. The impact on the domestic economy has been limited thus far, however: export growth has been strong, terms of trade have improved, and both look set to continue in a favourable pattern this year.

Because wages have risen more this year than was assumed in November and wage-related expenses will rise more strongly over the next two years, unit labour costs are now projected to rise by over 9% this year, on the heels of a 9½% increase in 2015. This increase is 1¼ percentage points larger than was forecast in November. The increase in the next two years is also greater, or about 5% per year, on average, as opposed to 4¾% in the November forecast.

Year-2015 output growth is estimated to have been somewhat below the Bank's November forecast, or 4.1% instead of 4.6%, owing mainly to stronger-than-expected import growth. The GDP growth outlook for 2016 has changed markedly, however, because the outlook is now for much stronger growth in real disposable income than was previously forecast, owing to more robust employment growth, larger pay increases, and the prospect of lower inflation during the year. GDP growth for 2016 is projected at 4.2%, 1 percentage point more than was forecast in November. As in the Bank's previous forecasts, it is expected to slow somewhat in the next two years, to about 3-3½% per year in 2017 and 2018.

The post-crisis slack in output is considered to have been fully absorbed last year and a positive output gap has opened up. This shows, for instance, in strong growth in real disposable income and rapidly declining unemployment.

II The interest rate decision

Committee members discussed whether developments since the last meeting had changed its assessment of whether the monetary stance was appropriate and whether the economic outlook had changed. In December the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, although the Committee considered it likely that the monetary stance would have to be tightened in the coming term.

Members noted that inflation had been lower than was forecast in November and that, based on the new forecast, it appears set to remain so into 2017, as oil prices had fallen more than previously projected. As at previous meetings, members agreed that these favourable conditions could change quickly if deflation in global goods markets comes to a halt and turns around. Members considered the extent and timing of such developments uncertain and were of the view that this uncertainty had increased between meetings.

Members agreed with the assessment of the Central Bank's baseline forecast, that economic activity was growing somewhat more strongly than had been foreseeable at the time of the December meeting, although the broad outlines of economic developments were the same as before. Although year-2015 GDP growth had turned out slightly weaker than was forecast in November, according to Statistics Iceland's most recent estimates, the outlook was for stronger growth in 2016, due in particular to more robust private consumption growth than had previously been assumed. This was due primarily to the outlook for larger wage increases, more rapid growth in employment, and lower inflation than previously forecast.

Committee members also noted that the margin of spare capacity was estimated to have disappeared last year and that the outlook was for the output gap to widen in the near future – and somewhat more than previously estimated. In view of this, MPC members were concerned that the fiscal stance had eased still further with the passage of the National Budget for 2016. Based on the Budget and the outlook for a widening output gap, the fiscal stance is now estimated to ease by over 2% of GDP in 2015 and 2016, or by just over 50 b.kr. This development places greater burden on monetary policy than would otherwise exist, which is unfortunate under current circumstances, given the wide interest rate differential with abroad and the inflows of foreign capital into the domestic Treasury bond market. If such a policy mix persists in coming years, it could result in growing economic instability.

Members were also concerned that the inflationary pressures caused by pay rises had grown even stronger, as recent negotiations had resulted in further wage increases even though wage hikes were already well in excess of the inflation target plus productivity growth. As it had done at previous meetings, the Committee discussed the reasons why large wage increases had not affected domestic inflation more strongly than they had actually done. It was pointed out that wage hikes well in excess of the inflation target and productivity growth could take place over a short period of time without commensurate inflationary effects if terms of trade improved at the same time. The labour market may also have grown more flexible, as the influx of foreign labour had increased in response to a shortage of labour instead of employers' competing for employees by outbidding each other in terms of wages. It was also mentioned that in spite of the possibility that unemployment has fallen below the level consistent with low and stable inflation, it was also conceivable that the equilibrium unemployment rate was lower than currently thought. It was pointed out that the impact of wage hikes materialises with somewhat of a lag, however, and it was therefore possible that last year's contractual wage increases had not yet come fully to the fore. It was also possible that the monetary tightening implemented by the MPC in the wake of the wage settlements was having some effect. Signs of growing confidence in monetary policy could be seen in long-term developments in inflation expectations and in the prospect that it would be possible to hold inflation at target during the current upswing at a lower interest rate level than in previous upswings, even though wage increases had been large in historical context.

Committee members discussed whether the monetary stance was too tight, given that according to the Bank's most recent market expectations survey, the share of respondents who considered the monetary stance too tight was larger than in the previous survey, conducted in October. It was mentioned that this development was in line with the rise in real interest rates. On the other hand, it was pointed out that a majority of survey respondents still considered the monetary stance appropriate or too loose. It was also pointed out that investment and private consumption were growing strongly and that unemployment was low, which did not indicate that the real rate was too high. Emphasis was placed on the need for the MPC to be forward-looking in its decisions and to respond promptly to a deteriorating long-term inflation outlook. The history of poorly anchored inflation expectations in Iceland must be borne in mind. All Committee members agreed that it was positive that the interest rate level appeared to support increased saving, which reduced the likelihood that the current account surplus would turn around into a deficit in the near future and that asset prices would rise excessively.

The Committee discussed whether the Bank's interest rates should be changed. No members were of the view that there were clear reasons to take action at this meeting. In members' view, domestic inflationary pressures had increased somewhat since the last meeting. The deflationary effects of developments in global energy and commodity prices and the exchange rate of the króna were stronger than previously assumed, however, and appeared likely to persist longer. Inflation was still below target, and opposing forces would continue to affect it. MPC members were of the view that uncertainty about the interaction between these factors had grown. They agreed that the overall picture had not changed much since the previous meeting. They had differing opinions about the weight of the factors that could affect inflation in the coming term, however. While some placed more emphasis on the global economy and considered it possible that global deflation could prove more pronounced and more protracted than previously thought, others were more concerned about the widening positive output gap and increased domestic inflationary pressures.

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.

Committee members agreed that even though global price developments and a stronger króna 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 February 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.

Members also agreed that no further changes should be made to reserve requirements at this time. There was continuing discussion of additional policy instruments other than interest rates that could be used to restrict capital inflows related to carry trade, and of the work being done towards developing such instruments. MPC members agreed on the importance of concluding this work as soon as possible.

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 16 March 2016.