The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, September 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 29 September 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 30 September, 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 19 August interest rate decision.

Financial markets

Since the August meeting, the króna had appreciated by 4.3% in trade-weighted terms, by 2.5% against the euro, by 4.1% against the US dollar, and by 7.6% against the pound sterling.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 346 million euros (50.3 b.kr.) between meetings, or 60% of total market turnover. Purchases year-to-date totalled roughly 1.3 billion euros (191.9 b.kr.), considerably more than over the same period in 2014.

Interest rates in the interbank market for krónur rose in line with the Central Bank's rate increase in August, and as before, overnight rates in the market are below the centre of the interest rate corridor, close to the Bank's key rate. Interbank market turnover totalled 257.5 b.kr. year-to-date, which is considerably more than in the same period in 2014 but somewhat below the level seen in the same period of the three preceding years.

Yields on nominal Treasury bonds had declined by 0.4-0.7 percentage points between meetings. The reduction is due in large part to increased new investment by non-residents that have invested primarily in long-term bonds since last summer. The yields on these bonds have therefore declined more, leading to a change in the yield curve, which is now downward-sloping rather than upward-sloping. Furthermore, the market's response to the 2016 fiscal budget proposal, which indicates that the Treasury's financing need will be reduced in coming years, could play a role in the decline. Furthermore, some analysts have opined that the MPC's August statement implies that interest rate increases will be smaller in the near future than had previously been forecast. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds rose over the same period by 0.1-0.3 percentage points. The breakeven inflation rate in the bond market has therefore fallen.

The lowest variable rates on non-indexed mortgages offered by the three large commercial banks had risen by about ½ a percentage point since the August meeting, in line with the Bank's rate increase. Fixed rates on comparable loans were virtually unchanged, however, as were the banks' indexed mortgage rates, but variable rates on some pension funds' indexed loans to fund members had declined.

Interest rates on the three banks' non-indexed deposits had risen by 0.4-0.6 percentage points since the August meeting, whereas indexed deposit rates were unchanged.

The monetary stance had tightened slightly since the August meeting, owing to reduced inflation expectations. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.9% at the time of the September meeting, or about 0.2 percentage points higher than just after the August interest rate announcement. In terms of past twelve-month inflation, however, it was unchanged at about 3½%.

The risk premium on the Treasury's foreign obligations had risen slightly since the August meeting. The CDS spread on five-year Treasury obligations had increased by 0.2 percentage points and was 1.6% at the September meeting. Furthermore, the risk premium on the Treasury's foreign obligations, in terms of the spread between long-term foreign-denominated Treasury bonds and comparable bonds issued by the US and Germany, had risen by 0.1-0.3 percentage points, to 1.6-1.8% just before the September meeting.

Financial institutions' research department analysts had all forecast that the MPC would hold the Bank's nominal interest rates unchanged in September, citing the milder tone in the Committee's last statement and pointing out that inflation had turned out lower than the Bank had forecast.

M3 grew by nearly 12% year-on-year in August, or by 7.3% excluding deposits held by the winding-up boards of the failed deposit money banks (DMB).

Net new lending (new loans net of prepayments of older loans) from DMBs to the non-financial corporate sector seems to have increased markedly in the first eight months of the year, compared to the same period in 2014. Adjusted for prepayments of HFF loans and the Government's debt reduction measures, net new lending in the first eight months of the year was higher than in either 2014 or 2013.

The NASDAQ OMXI8 index had risen by 7.7% between meetings. Turnover in the NASDAQ Iceland main market totalled around 225 b.kr. over the first eight months of the year, about 35% more than over the same period in 2014.

Outlook for the global real economy and international trade

Iceland's external goods trade generated a deficit of 6.7 b.kr. for the first eight months of the year, as opposed to a deficit of nearly 1.8 b.kr. over the same period in 2014. Export values grew by 16% at constant exchange rates, while import values rose 17.2%. The increase in exports is due primarily to 23% growth in industrial goods exports and nearly 16% growth in marine product exports. Import growth derives in particular from a more than 53% year-on-year increase in transport equipment imports and a one-fourth increase in imports of both goods and beverages and commodities and operational goods.

In terms of relative consumer prices, the real effective exchange rate index measured 88.3 in August, having risen in each month since last February. The average increase over this eight-month period was 2.2% year-on-year. It is due primarily to a 1.2% nominal appreciation of the króna, but in addition, inflation in Iceland was 1 percentage point above the average among its trading partners.

Aluminium prices were roughly unchanged since the last MPC meeting, although the average price in September was down by over a fifth year-on-year. Foreign currency prices of marine products rose by 1.1% between months in July and had risen 9.7% year-on-year at that time.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in September, GDP growth measured 5.6% in Q2/2015. Domestic demand grew by 5.4% year-on-year, and the contribution from net trade was positive during the quarter. In H1/2015, GDP growth measured 5.2%, with offsetting effects of 7.3% growth in domestic demand and a negative contribution from net trade in the amount of almost 2 percentage points.

GDP growth in the first six months of the year was 2.1 percentage points stronger than was assumed in the forecast in the August *Monetary Bulletin*, which provided for 3.1% growth. The deviation can be attributed to a much more favourable contribution from net trade than was forecast; furthermore, a revision of Q1 national accounts figures revealed much stronger GDP growth than the preliminary figures from June indicated. Domestic demand developed largely in line with the forecast. Consumption and total investment grew by 6.8%. GDP growth in H1/2015, however, was very similar to the forecast in May, before Statistics Iceland's first release of Q1 figures.

The underlying current account balance was positive by 26.5 b.kr., or 4.9% of GDP, in Q2. This is a larger surplus than in both the preceding quarter and Q2/2014, when it measured 2.5% of GDP. The surplus in Q2 is due to a surplus on services trade of 53.3 b.kr., excluding the effects of the DMBs in winding-up proceedings; however, it is offset by a 12.8 b.kr. deficit on goods trade and a 14.1 b.kr. deficit on the underlying balance on primary and secondary income. A revision of previously published figures for Q1/2015 shows that, as a share of GDP, the surplus was more than ½ a percentage point larger than previously estimated. In 2014, however, the surplus was smaller by 0.8% of GDP. The smaller surplus last year is due to a larger deficit on primary income, as bond interest expense turned out higher than previously projected.

Key indicators of private consumption growth in Q3, available at the time of the MPC meeting, indicate that private consumption grew markedly during the quarter, perhaps even exceeding the growth rate year-to-date. In July and August, payment card turnover was up by 7.5% year-on-year and new motor vehicle registrations by roughly 64%. On the other hand, groceries turnover was down year-on-year by nearly 1% during the same period.

In September, the Gallup Consumer Sentiment Index was virtually unchanged since August but had risen slightly between years. The big-ticket index measured 64 points, which is 2.8 points less than in June. Two of its three sub-indices – planned motor vehicle purchases and planned overseas travel – were lower than in June, while the index of planned house purchases rose somewhat, to its highest level since September 2007. All sub-indices rose year-on-year.

According to the fiscal budget proposal for 2016, the primary balance for 2016-2019 is projected to deteriorate slightly from the fiscal plan presented in the spring. The primary balance is estimated to deteriorate between 2014 and 2016, and the output gap is expected to widen by about 1.2 percentage points over the same period. Measured as a change in the cyclically adjusted primary balance, the fiscal stance will ease by a total of approximately 1½% of GDP this year and next year. The consolidation on the expenditures side does not fully offset the relaxation on the revenues side, as real primary expenditures are expected to increase by 1-1.6% during the period. Excluding the tax on financial institutions, relinquishment of revenues due to systemic changes from 2013 will total 1.6% of GDP in 2016. The financial balance will improve rapidly between 2016 and 2019, causing the overall surplus to increase from 0.7% of GDP in 2016 to 1.7% of GDP by 2019, even though the primary balance will remain virtually unchanged.

According to the Statistics Iceland labour force survey (LFS), labour demand growth continued to gain pace in July and August. Seasonally adjusted unemployment measured 4.2% in August, having declined by nearly a percentage point year-on-year.

The wage index rose by 0.3% month-on-month in August, after rising 1.1% in July. The twelve-month rise in the index measured 7.7% in August and 7.9% in July. Real wages in terms of the index had risen by 5.4% year-on-year in August.

According to the Gallup survey among executives from Iceland's 400 largest firms, carried out in August and September, the share of respondents interested in adding on staff in the next six months exceeded the share interested in downsizing by more than 17 percentage points. This is considerably more optimism than was indicated in a comparable survey carried out in May. More companies are planning to recruit and fewer are planning to reduce staffing. Executives in all sectors except tourism were more optimistic about recruitment than in the May survey. Just over a fourth of firms consider themselves short-staffed, an increase of nearly 7 percentage points between surveys. About ⅔ of construction firms consider themselves short-staffed, and over 70% are planning to recruit workers in the next six months.

According to the survey, executives were much more upbeat about the economic outlook than in the previous survey. For the first time since September 2007, a majority of executives considered current conditions good. About 39% considered them neither good nor bad. Executives were also very optimistic about the future situation, with nearly 39% of respondents indicating that they expected conditions to improve in the next six months and about half indicating that they expected no change (i.e., that conditions would remain good). Executives in all sectors except construction were more optimistic than in May, with the change most pronounced among those in the financial and fisheries sectors.

The nationwide house price index compiled by Statistics Iceland rose by 1.1% quarter-on-quarter in Q3 and 8.1% year-on-year after adjusting for seasonality. The Registers Iceland capital area real estate price index rose by 0.9% month-on-month in August adjusted for seasonality, and 8.1% year-on-year. The number of purchase agreements registered nationwide rose by 10.5% year-on-year in the first eight months of 2014.

The CPI declined by 0.39% month-on-month in September, after rising 0.53% in August. Twelve-month inflation measured 1.9% in September. It was unchanged from the MPC's August meeting but had declined month-on-month. Inflation excluding the housing component measured 0.5%. Underlying annual inflation in terms of core index 3 excluding tax effects had fallen slightly between months, to 2.2%. Statistical measures of underlying inflation suggest that it lay in the 2.1-4% range.

The steep drop in international airfares had the strongest effect on the CPI in September, causing a 0.4-percentage point decline. Falling oil and petrol prices lowered the index by 0.2 percentage points, triggered by a marked decline in global oil prices in the recent term. The increase in clothing and footwear prices at the end of seasonal sales had an upward impact on the CPI of 0.2 percentage points. The recent appreciation of the króna had somewhat of an impact, as reduced prices due to sales did not reverse in full. Even though inflation is low, domestic inflationary pressures appear to have increased somewhat. Domestic inflation (excluding housing) measured 3.8% over the previous twelve months, as compared with 3% in July.

According to the Gallup survey of household expectations carried out in September, household inflation expectations one and two years ahead were unchanged since the May survey, at 4%. According to a comparable survey carried out among executives in August and September, respondents' inflation expectations one year ahead had fallen by ½ a percentage point since May, to 3.5%. Executives also expected inflation to measure 3.5% in two years' time, a slight increase from the previous survey.

The breakeven inflation rate in the bond market has fallen since the last meeting. It is difficult to interpret developments in market inflation expectations, however, because of the recent surge in capital inflows, which has led to a significant decline in yields on long nominal Treasury bonds. The breakeven inflation rate two years ahead averaged 3.8% in September, having declined by ½ a percentage point since August. The breakeven inflation rate five and ten years ahead averaged just over 3% in September, about 0.7 percentage points lower than in August.

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. Representatives from the Ministry of Finance and Economic Affairs also reported to Committee members on the highlights of the new fiscal budget proposal.

MPC members discussed whether developments since the previous meeting had changed the Committee's assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the last meeting, the Committee had raised interest rates by 0.5 percentage points and had agreed that if, in the wake of wage settlements, inflation rose in line with the forecast in the August *Monetary Bulletin*, it would be necessary to raise rates even higher in order to bring inflation to target over the medium term.

In the Committee's opinion, growth in economic activity was broadly in line with the August forecast. Members discussed the recently published national accounts figures from Statistics

Iceland, which show that in the first half of the year, domestic demand growth was broadly in line with the August forecast, but GDP growth measured much stronger. Although GDP growth turned out stronger than had been forecast, Committee members were of the view that the forecast error largely reflected temporary factors. They agreed that in the coming term, the outlook still remained for robust GDP growth and a widening positive output gap, as was provided for in the August forecast.

Committee members discussed developments in inflation since the last meeting. They noted that inflation had risen more slowly than was assumed in the Bank's last forecast and that it was still below the inflation target, particularly if the housing component of the CPI is excluded. The Committee was of the view that this was due in part to the stronger króna but that volatile items played a part as well. Members agreed that in spite of favourable developments, the medium-term inflation outlook had probably not changed markedly, although the short-term outlook had improved. As before, the outcome of wage settlements and somewhat elevated inflation expectations indicated that inflation would gain momentum in the near future. This was offset, however, by falling global goods prices, and uncertainty about developments in goods prices had increased between meetings. The appreciation of the króna (about 4% since the previous interest rate decision) in spite of sizeable foreign currency purchases by the Central Bank had also offset increased domestic inflationary pressures.

In the Committee's opinion, the recent appreciation of the króna was due mainly to developments in the real economy. Members agreed that it was inappropriate to lean too strongly against underlying market developments. Several members emphasised their opinion that the objective with the Bank's foreign exchange market intervention was not to support a specific exchange rate but to stabilise flows in the market and attempt to mitigate excessive exchange rate volatility.

The Committee discussed the possibility of waiting and keeping interest rates unchanged at this time in view of reduced inflation in the recent past, or to continue the monetary tightening phase by raising interest rates by 0.25-0.5 percentage points. The chief argument in favour of unchanged interest rates discussed at the meeting was that inflation had risen more slowly than had been provided for in the Bank's August forecast. This would give the Committee increased scope to decide how rapidly to respond to the prospect of increased inflation. It would also entail increased scope to see how the current uncertainty played out. Inflation was still low, which could indicate that wage increases had been responded to with more streamlining than had been anticipated. It was also pointed out that the scope for pay increases could be greater than previously thought. Productivity growth could also be underestimated, and the greater-than-expected improvement in terms of trade could provide additional scope for wage increases. Uncertainty about developments in global inflation, which increasingly offset domestic inflationary pressures, had also escalated. It was also stated at the meeting that it should be safe to wait at this juncture, as interest rates had been raised by a total of 1 percentage point at the last two meetings. Furthermore, by the next meeting the Bank's new forecast would be available, including an assessment of the effects of recent developments on the near-term inflation outlook.

The main argument in favour of continuing the monetary tightening was that monetary policy decisions should be based more on the inflation outlook than on current inflation measures. Although inflation had been lower than expected in September, it was due mainly to temporary factors related to the steep reduction in airfares. For instance, services inflation, which was an indication of the impact of wage rises on inflation, had risen since the spring wage settlements and was now 3.6%. All economic indicators published since the Committee’s last meeting indicated considerable strength in the domestic economy. Fiscal policy also indicated that there was need for a tighter monetary stance than previously thought. As a result, there was the risk that the monetary stance was being tightened too little and too late.

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 5.5%, the current account rate 5.25%, the seven-day collateralised lending rate 6.25%, and the overnight lending rate 7.25%. Four members voted in favour of the Governor’s proposal. One of the four would have preferred to raise rates by 0.25 percentage points but was nonetheless willing to vote in favour of the Governor’s proposal. One member voted against the Governor’s proposal and would have chosen to raise rates by 0.25 percentage points.

All Committee members agreed that if inflation rises in the wake of the wage settlements, as forecasts indicate, the MPC will have to raise interest rates still further in order to bring inflation back to target over the medium term. How much and how quickly would depend on future developments and on how the current uncertainty plays out. Although a stronger króna and global price developments had provided the scope to raise interest rates somewhat more slowly than was previously considered necessary, they do not change the need for a tighter monetary stance in the near future. The Committee also agreed that the interest rate path will depend on whether other policy instruments are used to contain demand-side pressures in the coming term. In the MPC’s estimation, after adjusting for cyclical factors, the expected Treasury outcome for 2015 and the fiscal budget proposal for 2016 entail an easing of fiscal policy, which will call for a tighter monetary stance, other things being equal.

The Committee discussed in particular the indicators of increased capital inflows between meetings, as increased demand for Treasury bonds had led to a continuing decline in interest rates on long-term Treasury bonds. As at the previous meeting, members agreed that in the event of substantial inflows due to carry trade, it would be necessary to use tools other than interest rates to restrict them. It was decided to hold a meeting with the Systemic Risk Committee before the end of November in order to discuss possibilities for such tools.

In the wake of the Bank’s substantial foreign currency purchases in the recent term, and in order to encourage financial institutions to prepare themselves for the settlement of the failed banks’ estates and the planned auction for the purpose of releasing or tying up offshore krónur, the Committee decided at the meeting to increase reserve requirements from 2% to 4% as of the next reserve maintenance period, which begins on 21 October. Changes in reserve requirements had been discussed at recent meetings of the MPC. Members agreed that the aim of raising reserve requirements was not to affect the monetary stance but to strengthen the financial institutions’ liquidity position through the settlement of the failed banks’ estates and the auction of offshore krónur. Therefore, it was assumed that reserve requirements would be lowered again in connection with the auction. The sterilisation of large foreign currency purchases would also be improved with these measures. Furthermore, the Committee decided to amend the Rules on Reserve Requirements so as to obviate the need to amend the Rules each time the MPC decides to change reserve requirements. Henceforth, it will be sufficient that such changes be announced in Monetary Policy Committee statements. The Rules were also adapted to the current Central Bank Act.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members and representatives of the Ministry of Finance and Economic Affairs attended parts of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 4 November 2015.