



*The Monetary Policy Committee of the Central Bank of Iceland*

## Minutes of the Monetary Policy Committee meeting, February 2014

Published 26 February 2014

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 10 and 11 February 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 12 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 11 December interest rate decision, as published in the updated forecast in *Monetary Bulletin 2014/1* on 12 February.

#### **Financial markets**

The average trade-weighted exchange rate in the domestic foreign exchange market was 3.3% higher at the time of the February meeting than at the December meeting. Between meetings, the króna had appreciated by about 3.3% against the euro, 2.8% against the US dollar, and 3% against the pound sterling. Bids for krónur in the offshore market lay in the range of 214-250 kr. per euro and had decreased slightly.

The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 113 million euros (roughly 17.8 b.kr.) since the last MPC meeting, around 41% of total market turnover during the period.

In general, liquidity had remained ample in the interbank market for krónur, and as before, overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25 percentage points above current account rates. From the beginning of the

year to the time of the February meeting, interbank market turnover had been at a low, or about 2 b.kr., as opposed to 47 b.kr. over the same period in 2013.

Owing to abundant financial system liquidity, the simple average of Central Bank current account rates and the maximum rate on certificates of deposit is at present the best approximation of the effect of Central Bank rates on money market rates. This average, which can be termed the effective interest rate, was just under 5½% at the time of the February meeting. Even though nominal interest rates have remained unchanged, the monetary stance has tightened somewhat since December, in line with falling inflation and inflation expectations. In January, the Bank's real effective rate was 2.2% in terms of twelve-month inflation and 1.8% in terms of the average of various measures of inflation and inflation expectations, or about ½ a percentage point higher than at the time of the December meeting. The average of the various measures of inflation and inflation expectations was 3.5% at the time of the February meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged since the December meeting, measuring 1.9 percentage points just before the Committee met in February. The risk premium on Treasury obligations in terms of the spread between the Icelandic Treasury's US dollar bonds maturing in 2016 and 2022 and comparable bonds issued by the US Treasury measured about 2½ percentage points just before the MPC's February meeting, after declining nearly ½ a percentage point since the December meeting.

Unchanged Central Bank interest rates in December appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Most analysts cited the decline in inflation, the increase in the real policy rate, and the appreciation of the króna since the last MPC meeting as grounds for unchanged interest rates. According to the Bank's survey of market expectations survey, carried out in early February, market participants expect Central Bank rates to be lower in 2014 than they did in a comparable survey conducted in late October. The survey results indicate that they expect the Bank's collateralised lending rate to remain unchanged at 6% until the end of 2014, which is 0.5 percentage points lower than in the previous survey. On the other hand, they now appear to expect a 0.25-point rate increase in Q1/2015, and they project that the policy rate will be 6.5% in two years' time. Forward interest rates indicate, however, that market agents expect the Bank's policy rate to rise by 0.5 percentage points this year, to 6.5% by the year-end. This is 0.25 percentage points higher than they indicated in late October.

Broad money (M3) grew by 4.1% year-on-year in Q4/2013. Excluding holding company deposits, it grew by 1.3%. Narrower measures of the money supply also increased year-on-year, with growth measuring 2-3¼% in Q4/2013. Central Bank base money grew by about 4.2% over the same period.

Net new lending to households by deposit money banks (DMB) – that is, new loans net of prepayments – totalled about 55 b.kr., or just around 7.5% of the total stock of DMB loans to households at the beginning of 2013. New corporate loans (loans to non-holding companies) totalled 84 b.kr. last year, or just over 8% of the total stock of DMB loans to firms at the beginning of 2013. Most new corporate loans were non-indexed, while most new household loans have been indexed, although prepayments of indexed loans have been more widespread as well.

The NASDAQ OMX Main List index, OMXI6, declined slightly between meetings. Turnover in the NASDAQ OMX Iceland main market totalled about 251 b.kr. during the year, nearly three times that in 2012. In January, it was virtually unchanged year-on-year at 27.4 b.kr. At the beginning of February, the market value of companies listed on the main market totalled 543 b.kr., or approximately one third of year-2012 GDP.

### **Outlook for the global real economy and international trade**

According to the most recent forecast from the International Monetary Fund (IMF), published in January, global output growth will be marginally stronger in 2014 than according to the IMF's October forecast. The estimate for 2015 is unchanged. In industrialised countries, growth is expected to exceed the October forecast in 2014 but fall short of it in 2015. This year's improvement is due to stronger a GDP growth outlook in the UK, Japan, and the US. In emerging countries, the forecast is unchanged for 2014 but has been revised slightly upwards for 2015. The inflation forecast for both industrialised and emerging countries is virtually unchanged from the October forecast. *Consensus Forecasts'* projections for Iceland's trading partners were about 0.2 percentage points higher than at the time of the December meeting.

Iceland's goods trade surplus measured 4.3 b.kr. in December and, according to preliminary figures, 7.3 b.kr. in January. Import values have risen somewhat in the past two months, while export values have risen very slightly. The rise in import values is due to an increase in the value of transport equipment, commodities, and operational inputs, and the rise in export values is due to increased marine export values.

Aluminium prices had fallen somewhat since the MPC's last meeting, while marine product prices rose marginally in November and December. Terms of trade improved by more than 2½% year-on-year in Q4/2013.

### **The domestic real economy and inflation**

According to the Statistics Iceland labour market survey, growth in labour demand was considerably stronger in Q4/2013 than in the forecast published in the November issue of *Monetary Bulletin*. The November forecast provided for a 1% year-on-year increase in total hours worked, while the actual increase was 4.3%. The increase is due to a 4.6% rise in the number of working persons, as average hours worked contracted by 0.3%. In 2013, total hours worked rose by 3.7% year-on-year, as the number of employed persons increased by 3.4% and average hours worked rose by 0.3%.

Other measures of labour supply and demand pulled in the same positive direction in 2013. The employment rate rose by 1.4 percentage points year-on-year, the participation rate rose by 0.9 percentage points, and the number of persons outside the labour market fell by 3.3%.

In Q4/2013, net migration was positive for the fifth quarter in a row. For the first time since the collapse of the banking system, the immigrants to Iceland outnumbered emigrants for the year as a whole, with net migration for 2013 positive by 0.9% of the labour force. The net increase is due entirely to an increase in foreign immigrants, which supports other indicators of growing labour demand.

Unemployment as registered by the Directorate of Labour (DoL) was somewhat lower in Q4/2013 than according to the Bank's last forecast. Seasonally adjusted unemployment was 4.1% as measured by the DoL, but 5.3% according to the Statistics Iceland labour market survey. According to the DoL, unemployment fell by 1.3 percentage points in 2013, to 4.4%, whereas according to the labour market survey it fell 0.6 percentage points, to 5.4%.

Wages rose somewhat more in Q4/2013 than was assumed in the forecast appearing in the November *Monetary Bulletin*. The wage index rose by just under 1% quarter-on-quarter and 6% year-on-year during the quarter. The annual average rose by 5.7% in 2013.

Key indicators of private consumption in Q4 imply that growth was relatively strong. Payment card turnover grew 4.5% year-on-year and 2.3% quarter-on-quarter in Q4. Retail sales grew rather strongly as well. This was offset by a marked slowdown in new motor vehicle registrations, however. Furthermore, consumers were more pessimistic in Q4/2013 than they were a year earlier, although sentiment improved somewhat in December.

The nationwide Statistics Iceland house price index, published in late January, rose by just over ½% from the previous month, and by about 1.2% adjusted for seasonality. It was up 9.7% from the previous January. The capital area real estate price index, calculated by Registers Iceland, fell by about ½% month-on-month in December 2013 but was unchanged when adjusted for seasonality. Between 2012 and 2013 it rose 6½%, while the Statistics Iceland house price index rose by 5.8%. The number of purchase agreements concluded in the month of December was up 32% year-on-year, and there was an increase of 11% on average between 2012 and 2013. The average time-to-sale for residential property in greater Reykjavík was about five months in 2013, down from seven in 2012.

The consumer price index fell by 0.72% month-on-month in January. The decline is due primarily to sales effects, although international airfares and petrol prices also had a downward effect. Pulling in the other direction were increases in housing costs and health care services. The twelve-month increase in private services prices measured 3.3% in January, down from 6.1% in December.

Twelve-month inflation measured 3.1%, after falling from 4.2% in December. Excluding the housing component, it measured 1.9%. Without tax effects, underlying annual inflation fell 0.8 percentage points between months as measured by core index 3, and by 1.2 percentage points in terms of core index 4, bringing twelve-month inflation by these two criteria to 3.7% and 2.4%, respectively. Statistical measures of underlying inflation suggest that it lies in the 2½-3% range.

Inflation expectations have subsided in the wake of the decline in inflation in January and expectations of more modest wage rises this year. The short- and long-term breakeven inflation rates in the bond market had fallen by an average of 0.4-0.6 percentage points since the MPC's December meeting. By all these measures, inflation expectations ranged between 3.3% and 3.7% just before the Committee met in February. According to the Central Bank's quarterly survey of market expectations, conducted in early February, market participants expect inflation to be about 3.5% in two years' time, which is about 0.5-0.7 percentage points lower than in a comparable survey carried out in November. Longer-term inflation expectations among market participants were unchanged, however, averaging 4% over the next ten years.

According to the updated forecast in *Monetary Bulletin 2014/1*, the inflation outlook for 2014 has improved from the Bank's November forecast, mainly because of a stronger króna and smaller rises in unit labour costs than were anticipated at that time. If assumptions concerning developments in wages and the exchange rate are borne out, inflation will approach the inflation target this year. On the other hand, the outlook is for inflation to rise again early in 2015, when the effects of the recent currency appreciation taper off and the slack in the economy turns into an output gap. According to the forecast, inflation will exceed 3% over the next two years, peaking at about 3½% late in 2015 and then tapering off in 2016, due to monetary tightening. If the forecast materialises, inflation will nonetheless be somewhat above target at the end of the forecast horizon, although the target is well within the 50% confidence band of the forecast.

The global output growth outlook has improved since the publication of the November *Monetary Bulletin*, although considerable uncertainty remains, particularly in relation to recent headwinds facing emerging economies. The outlook for Iceland's terms of trade has improved as well, but the outlook for exports has deteriorated, owing in particular to poorer prospects for capelin fishing this year.

Last year's GDP growth appears to have been considerably stronger than previously anticipated, or 3% instead of the 2.3% in the November forecast, due to a much stronger contribution from net trade, while domestic demand developed in line with the forecast. The domestic labour market has also recovered more strongly than previously forecast. On the strength of unexpectedly robust output growth, the slack in the economy will narrow more quickly than previously projected, and an output gap could develop early next year.

The Government's proposed household debt relief package and other stimulative policy measures strongly affect the economic outlook. The debt reduction measures will increase private consumption considerably in the near term. The increased demand will also stimulate imports, reduce national saving and cut into the current account surplus. The GDP growth effect of the measures will therefore be less pronounced than the effect on domestic demand.

As in November, GDP growth for 2014 is estimated at 2.6%, reflecting the stimulative effects of the Government debt relief package and the offsetting outlook for weaker export growth, coupled with delays in energy-intensive industrial development projects. The GDP growth outlook for the next two years has improved considerably, with growth projected at 3.7% in 2015 and 3% in 2016. If the forecast materialises, GDP growth will average about 3.1% per year over the forecast horizon, which is above the 30-year average of 2.5% and well above the average projection for Iceland's main trading partners.

## **II The interest rate decision**

The Governor reported to the Committee on the work done by the Bank and other authorities since the last meeting in relation to capital account liberalisation.

Members agreed that recent economic developments had been in line with the Committee's assessment at the December meeting, with year-2013 GDP growth estimated to have been considerably stronger than the Bank projected in November. The Committee noted that this was consistent with previous indications of a strong labour market recovery.

The Committee discussed that the outlook for this year had improved, according to the Bank's forecast as published in *Monetary Bulletin* on 12 February. Committee members also considered the fact that the króna had appreciated in recent weeks in spite of substantial foreign currency purchases by the Bank, and that the outlook was for unit labour costs to rise less markedly this year than previously forecast, provided that the main results of the wage settlements concluded in late December 2013 applied to the labour market as a whole.

The Committee considered it likely that inflation would be lower this year than previously anticipated and would be close to target. Some members even considered it relatively likely, in view of recent exchange rate movements, that inflation would fall temporarily below the inflation target. In this context, the Committee discussed the extent to which the increase in house prices was an indication of future inflation and to which extent it reflected changes in relative prices.

Members agreed that the inflation outlook for the coming two years had deteriorated since the November forecast because the outlook was for the slack in the economy to give way to an output gap during the period. The Committee noted that, according to the Bank's updated forecast, GDP growth would gain pace in the next two years and the slack in the economy would disappear earlier than previously expected. Measures to reduce households' indexed debt would have some effect on the medium-term economic outlook. Committee members agreed with the results of the analysis published in *Monetary Bulletin*: that the debt relief measures would stimulate private consumption and imports, other things being equal, and reduce national saving and the current account surplus, thereby contributing to a weaker króna than would otherwise result. Members were concerned that by the time the measures were implemented, the spare capacity would have almost disappeared from the economy, which would exacerbate the risk that increased economic activity would surface in higher inflation. It was therefore important that the Government adopt other measures to promote saving and ease downward pressure on the exchange rate, which could increase the nominal principal of indexed loans.

Members also agreed that, in the absence of other changes, the prospect of stronger domestic demand growth would require that the monetary stance be tightened sooner and more than previously expected. This could be offset by other measures that support monetary policy, however. Medium-term fiscal policy would be very important in this context. Also discussed was the Committee's view that measures that strengthen the supply side of the economy could ease supply constraints, thereby weakening the inflationary effects of increased demand.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. Four Committee members voted in favour of the proposal. They considered the uncertainty that still existed concerning key aspects of the forecast and other economic policy actions that could support monetary policy argued against a rate increase at this time. Furthermore, there was considerable uncertainty about the impact of the Government's debt relief measures and the recent strengthening of the króna could, furthermore, continue. Even though the medium-term inflation outlook had deteriorated, there was still ample time to respond to it. It was also pointed out that the Bank's real rate had already risen due to declining inflation. One member voted against the Governor's proposal, however, voting instead to raise interest rates by 0.25 percentage points. This member pointed out that,

even though the near-term inflation outlook had improved, the outlook for the upcoming two years had deteriorated. Furthermore, long-term inflation expectations were still close to 4% and had changed little in spite of favourable developments in inflation in the recent term.

Committee members were of the view that, to the extent that inflation continued to abate, the monetary stance would grow tighter without nominal interest rate increases, but that the Bank's inflation forecast implied that it would be necessary to raise nominal interest rates as spare capacity in the economy disappeared and an output gap emerged. However, developments in the Bank's nominal interest rates would depend, as before, on the future path of inflation.

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 19 March 2014.