



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, June 2015

Published 24 June 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 8 and 9 June 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 10 June, 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 13 May interest rate decision.

Financial markets

The exchange rate of the króna had risen by 0.4% in trade-weighted terms and by 1.9% against the pound sterling but had fallen by 0.6% against the euro and the US dollar since the May meeting.

The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 87 million euros (roughly 12.9 b.kr.) between meetings, or 51% of total market turnover. Purchases year-to-date totalled 395 million euros (58.8 b.kr.), considerably more than over the same period in 2014.

Financial institutions’ liquidity has remained abundant vis-à-vis the Central Bank, and overnight rates in the interbank market for krónur have been below the centre of the interest rate corridor, close to the Bank’s key interest rate. Interbank market turnover totalled 188.5 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 risen by 0.1-0.7 percentage points since the May meeting. The greatest increase was in the shortest bonds. Yields on indexed Treasury and Housing Financing Fund bonds were broadly unchanged. Yields on nominal Treasury bonds had risen by 1-1½ percentage points year-to-date, while indexed bond yields had fallen by about ½ a percentage point.

The average of the lowest listed nominal mortgage rates offered by the three large commercial banks had risen slightly since the May meeting. Comparable rates on nominal variable-rate loans and indexed loans had remained unchanged, however.

The monetary stance had eased since the May meeting, owing primarily to higher inflation expectations. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.2% at the time of the June meeting. In terms of past twelve-month inflation, however, it was 2.8%. This is some 0.2-0.5 percentage points lower than just after the May interest rate decision and about 0.8-1.1 percentage points lower than just after the decision in March.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by the US and Germany, was about 1.2-1.7 percentage points, slightly higher than at the time of the May meeting. The CDS spread on five-year Treasury obligations was virtually unchanged between meetings, at 1.6%.

Financial market analysts had all predicted a 0.5 percentage point increase in the Central Bank's nominal interest rates in June, citing rising inflation expectations, the outcome of labour market negotiations, and the fiscal measures taken by the Government in connection with wage settlements.

M3 grew by just over 12% year-on-year in April, but by about 6.4% adjusted for deposits held by the failed banks' winding-up boards.

Net new lending from DMBs to resident borrowers totalled almost 70 b.kr. in the first four months of the year, an increase of 38% year-on-year. Net new corporate lending totalled 51 b.kr., about a third more than over the same period in 2014. Net new DMB lending to households totalled 12 b.kr. over the same period. Prepayments of older household loans during the period are due largely to the Government's debt relief measures.

The NASDAQ OMXI8 index had risen by 3.3% between meetings and by 3.8% when adjusted for dividend payments. Turnover in the main market totalled nearly 134 b.kr. during the first four months of 2015, an increase of just under 18% year-on-year.

Outlook for the global real economy and international trade

According to the Organisation for Economic Co-operation and Development's (OECD) June forecast, GDP growth will be somewhat weaker in 2015 and 2016 than in the OECD's November forecast. Global GDP growth is expected to decline from last year's rate of 3.3% to 3.1%, some 0.6 percentage points less than was forecast in November. Global output growth is forecast at 3.3% in 2016. The outlook for world trade in 2015-2016 is also slightly weaker. The OECD forecast for 2015 GDP growth among Iceland's main trading partners is about 0.1 percentage point lower than was assumed in November, or 1.8%. Trading partner inflation is projected at 0.6% this year, about 0.6 percentage points below the November forecast, owing to lower oil prices.

According to preliminary figures from Statistics Iceland, Iceland's surplus on goods trade totalled 200 m.kr. in May, as opposed to 5.2 b.kr. at constant exchange rates in May 2014. Over the first five months of the year, import values rose 21% year-on-year, or 13.5% excluding imports of ships and aircraft. Import growth is attributable primarily to a doubling of transport equipment values and an increase of over a fifth in the value of commodities and operational inputs. Export values rose by 21.5% over the same period, owing mainly to a one-third increase in the value of industrial exports.

Aluminium prices have fallen 8.6% since the MPC's May meeting and were down by an average of 6.1% year-on-year in the first week of June. Foreign currency prices of marine products had risen by 1.4% month-on-month in April and by 11.3% in the preceding twelve months.

In terms of relative consumer prices, the real exchange rate rose 0.2% month-on-month in May, to 85.2 points. It was up 1.5% year-on-year in the first five months of 2015, due mainly to the fact that inflation in Iceland was 0.8 percentage points above the average for Iceland's trading partners, whereas the nominal exchange rate rose by 0.6% over the same period.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in June, GDP growth measured 2.9% for the first quarter the year. Seasonally adjusted quarter-on-quarter GDP growth measured -1.2%, according to Central Bank figures. GDP growth for the period was somewhat weaker than in the forecast of 4.6% published in the May Monetary Bulletin. Growth for the quarter was driven by domestic demand, with consumption and total investment up by 6.4%. Even though growth was quite strong it was below the May forecast. Inventory changes increased markedly as well, owing primarily to an increase in marine product inventories. As a result, total domestic demand rose by 9.9%.

The contribution from net trade was negative, as import growth far outpaced export growth. This is due in part to the fact that a large portion of marine products were recognised as inventory changes and not as exports. In addition, imports of ships and aircraft were significant during the period, although these import items are also recognised as investment and therefore have very limited impact on overall GDP. The contribution from net trade was weaker than was provided for in the Bank's May forecast, primarily because of marine products allocated to inventories, as is mentioned above; furthermore, price increases were underestimated in the Bank's forecast of export values.

The underlying current account balance was positive by 10.4 b.kr., or 2% of GDP, in Q1. This is smaller than in the preceding quarter but larger than in Q1/2014, when the surplus measured 1% of GDP. The surplus this year is due primarily to a surplus on services trade of 17.9 b.kr., excluding the effects of the DMBs in winding-up proceedings; however, it is offset by a 2.1 b.kr. deficit on goods trade and a 5.4 b.kr. deficit on the underlying balance on primary and secondary income. Revised year-2014 figures show a larger surplus than was previously estimated, or 5.5% of GDP.

Key indicators of private consumption at the beginning of Q2/2014 suggest continued strong private consumption growth during the quarter. Payment card turnover increased by just over 3½% year-on-year in April, and new motor vehicle registrations in April and May were up roughly a third year-on-year. Offsetting this, growth in groceries turnover was much weaker.

According to the Statistics Iceland labour force survey (LFS), labour demand continued to grow in April. Seasonally adjusted unemployment measured 4.2%, a decline of ½ a percentage point between years. Unemployment year-to-date was about 1.2 percentage points lower than during the same period in 2014.

The wage index rose by 0.2% month-on-month in April and by 5.2% year-on-year. According to the index, real wages rose 3.7% over the same period.

According to the Gallup survey conducted among Iceland's 400 largest firms in May and June, executives were considerably more pessimistic about the economic situation than they were in March 2015 and June 2014. Executives in all sectors were more pessimistic than in the March survey. Expectations about both domestic and foreign demand were somewhat weaker than in the previous survey.

According to the survey, firms interested in recruiting staff outnumbered those planning redundancies by just over 5 percentage points. This is somewhat of a departure from the previous surveys, which indicated that firms interested in recruiting outnumbered those interested in downsizing by about 15 percentage points. The change is primarily because the number of firms planning to lay off staff has risen since the last survey. Compared with the last survey, more firms are planning laying off staff in all sectors except transport, and tourism. Among construction firms, however, the number of firms planning to recruit additional workers exceeded the number planning to downsize by over 40%, and transport, and tourism, the number of firms planning recruitment exceeded the number planning to cut staffing levels by about a fourth. The percentage of companies that report labour shortages is highest in these sectors, with nearly 20% reporting a shortage of workers. This percentage has risen steadily, adjusted for seasonality, since Q3/2013. Most companies planned to keep their staffing levels unchanged in the next six months, however. Firms selling their products overseas were considerably more positive about adding on staff than those selling their products domestically.

The Gallup Consumer Sentiment Index measured 83.3 points in May, slightly lower than in April and lower than in May 2014 as well. It was the first year-on-year decline since May 2014.

Statistics Iceland's nationwide house price index, published in late May, rose 0.2% month-on-month when adjusted for seasonality, but rose 7.6% year-on-year. Because of the strike among lawyers at the capital area Commissioner's offices, no purchase agreements have been registered since 6 April; therefore, Registers Iceland has published neither the house price index nor figures on housing market turnover in the greater Reykjavík area for the month of April.

The consumer price index (CPI) rose by 0.28% month-on-month in May, raising twelve-month inflation by 0.2 percentage points since April, to 1.6%. It can be assumed that twelve-month inflation is underestimated by nearly 0.2 percentage points because of the above-mentioned shortage of data on house prices. Twelve-month inflation excluding housing measured 0.3% but had been negative from November 2014 through April. By most measures, underlying twelve-month inflation was unchanged in May. In terms of core index 3 excluding tax effects, it measured 1.6%. According to various statistical measures, underlying inflation lay in the 1.6% to 2.3% range, but 3½% in terms of the dynamic factor model.

Food prices rose by nearly 1% month-on-month, accounting for about half of the rise in the CPI. The housing component was up 0.2% in May, due mainly to an increase in paid rent. This was the smallest increase since November 2014, largely because of the aforementioned

strike among lawyers at Commissioners' offices in the greater Reykjavík area. As a result of the strike, the market value of capital area housing was not based on new measurements.

According to the Gallup survey of household inflation expectations, carried out in May, respondents expect inflation to measure 4% one year ahead, an increase of 1 percentage point from the March survey. In the two previous surveys, however, households' expectations had fallen. Their expectations of inflation two years ahead were unchanged in the May survey, at 4%. According to a comparable survey carried out among executives in May and June, respondents' inflation expectations one year ahead also measured 4%, an increase of 1 percentage point since the March survey. The short-term breakeven inflation rate in the bond market had also risen since the MPC's May meeting. The two-year breakeven rate measured 4½% just before the June meeting and had risen by ½ a percentage point between meetings. The five- and ten-year breakeven rates were unchanged, however, at 5%. Since January, however, the increase has averaged just over 1½ percentage points.

II The interest rate decision

MPC members discussed whether developments since the previous meeting had changed the Committee's assessment of the required monetary stance and whether the outlook had changed. At the last meeting, members had agreed that the outcome of labour negotiations, the rise in inflation expectations, and indicators of robust demand growth suggested a need to tighten the monetary stance. Members were of the view that developments between meetings had not change this assessment. On the contrary, they agreed that, even though inflation was still low, the inflation outlook had deteriorated markedly in comparison with the Central Bank's last forecast.

The Committee discussed the results of the wage settlements that had been signed and were of the view that they would probably set a precedent for other agreements. In the Committee's view, it was clear that the pay increases provided for in the wage settlements already signed were larger than in the scenario considered at the May meeting, which was based on the Confederation of Icelandic Employers' offer to the labour unions. In May, the Committee had agreed that such an outcome would call for significant interest rate increases if long-term price stability were to be ensured.

In addition, members were concerned that most measurements of inflation expectations that had been published since the last meeting showed a continued increase. The monetary stance had therefore eased since the May meeting.

Committee members were of the view that the measures announced by the Government in order to facilitate wage settlements were not yet funded with expenditure cuts or increased Treasury revenues. If no such funding were forthcoming, it would entail a relaxation of the fiscal stance and contribute to tension in the economy and generate inflationary pressures.

Members also discussed the effects of the measures recently announced by the Government and the Central Bank to prepare for capital account liberalisation. As some of the measures would generate revenues for the Treasury, Committee members considered it important that those revenues not be allocated in ways that would stimulate the economy still further; i.e., by activating the hitherto sterile component of money holdings. Members considered it necessary to monitor developments closely and agreed to take appropriate countervailing measures if necessary.

In the Committee's opinion, economic activity year-to-date was broadly in line with the Bank's May forecast. Members discussed newly published Q1/2015 national accounts figures from Statistics Iceland, which indicated that GDP growth was 2.9%, consumption and investment had grown 6.4%, and total domestic demand had increased by nearly 10%. Although growth in economic activity appears somewhat weaker than according to the May forecast, MPC members saw no reason to change its assessment of economic developments. It was pointed out that the first publication of national accounts figures was usually accompanied by considerable uncertainty and that indicators implied more strength in the labour market than had been projected in May.

Members agreed that the outlook for developments in wage costs, the increase in inflation expectations, and indicators of robust demand growth made it unavoidable to respond to the worsening inflation outlook immediately, even though inflation was still below target. All members were of the opinion that it was appropriate to raise interest rates by at least 0.5 percentage points and that there were solid arguments for continuing rate increases. They did not agree, however, on how rapid the adjustment of the monetary stance should be.

The main arguments presented at the meeting in favour of a rate increase of 0.5 percentage points at this time were that inflation was still low and that it was not yet clear to what extent wage increases would be passed through to prices or to what extent firms would respond with streamlining, nor was it clear how much wage drift there would be in the wake of the wage settlements. Measurements indicating the first effects of the wage settlements on inflation would be available by the MPC's next meeting, as would the Bank's updated forecast. It was also pointed out that explicitly signalling upcoming rate hikes would prepare the market for them. To an extent, the effects of the announced interest rate increases would surface immediately, as was the case with the Committee's previous statement, which had an immediate effect on the bond market.

On the other hand it was pointed out that there was a risk that monetary policy was responding too little and too late. The momentum in the economy had already called for a tighter monetary stance by the time of the May meeting, irrespective of the outcome of labour negotiations, and that the case for monetary tightening had strengthened still further, as the stance had eased between meetings because of increased inflation expectations. This was compounded by the fact that recent wage increases had been larger than had been anticipated at the last meeting.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.5 percentage points, which would raise the Bank's key rate (the seven-day term deposit rate) to 5%, the current account rate to 4.75%, the seven-day collateralised lending rate to 5.75%, and the overnight lending rate to 6.75%. Four Committee members voted in favour of the Governor's proposal. One member would have preferred to raise interest rates by 0.75 percentage points at this time but, was willing to vote in favour of the Governor's proposal. One member voted against the Governor's proposal, voting instead to raise interest rates by 1 percentage point.

Committee members agreed that it seemed apparent that a sizeable rate increase would be necessary in August, followed by further rate hikes in the coming term, so as to ensure price stability over the medium term. They also agreed that it was appropriate to send a clear message to this effect with the June statement.

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 August 2015.