The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, May 2014

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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 19 and 20 May 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 21 May, 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 March interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2014/2 on 21 May.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.7% higher at the time of the May meeting than at the March meeting. Between meetings, the króna had appreciated by about 1.7% against the euro and 0.2% against the US dollar but had depreciated by 1.1% against the pound sterling. Bids for krónur in the offshore market lay in the range of 192-216 kr. per euro and had decreased somewhat between meetings.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 46 million euros (roughly 7.1 b.kr.) since the last MPC meeting, or 25% of total market turnover during the period.

In general, financial institutions' liquidity had remained ample between meetings 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, with the exception of 19 and 20 May, when they moved towards the upper half of the corridor, owing to a temporary liquidity shortage in the interbank market. Interbank market turnover has been very limited, totalling 49.5 b.kr. from the beginning of the year until the May meeting, as opposed to 205 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 the best approximation of the effect of Central Bank rates on money market rates. This average, which can be termed the effective policy rate, was 5.4% at the time of the May meeting. The monetary stance was broadly unchanged since the March meeting but had tightened somewhat year-to-date, in line with falling inflation and inflation expectations. In April, the Bank's effective real rate was 3% in terms of twelve-month inflation and 2.3% in terms of the average of various measures of inflation and inflation expectations, or about 0.5-0.8 percentage points higher than at the March meeting, and nearly a percentage point higher than at the meeting in May 2013. The average of the various measures of inflation and inflation expectations was 3% at the time of the May meeting.

The Republic of Iceland's sovereign CDS spread had fallen by 0.2 percentage points since the March meeting, measuring 1.7% just before the Committee met in May. 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 2 percentage points just before the May meeting. The premium on the longer bond had declined by about 0.2 percentage points since the March meeting but was broadly unchanged on the shorter bond. It has declined by just over ½% year-to-date. It reached a historical low in April but has risen slightly since then.

Unchanged Central Bank interest rates in May appeared to have been priced into the yield curve, in line with the expectations of most financial institutions' market analysts. In explaining the grounds for their expectations, analysts noted in particular that, in spite of the improved short-term inflation outlook and the higher real Central Bank rate, long-term inflation expectations were still above target. Analysts also cited growing domestic demand, uncertainty about wage agreements and the recovery of the labour market as grounds for unchanged interest rates.

Broad money (M3) grew by about 1% quarter-on-quarter in Q1/2014, and about 6.9% year-on-year. The year-on-year increase excluding holding company deposits was smaller, at 4.1%. Narrower measures of money holdings also increased year-on-year, with M2 growing by 7.9% and M1 by 11.4%. Excluding holding company deposits, year-on-year growth measured 6.4% (M2) and 11.1% (M1). Central Bank base money grew by 8.8% over the same period.

Net new lending from deposit money banks (DMB) to domestic borrowers – i.e., new loans net of prepayments – totalled about 26 b.kr. in Q1. The year-on-year increase was about 12% less than in Q1/2013. Growth in lending to households and businesses has slowed down in 2014. Net new DMB loans to households totalled 10.4 b.kr. in Q1. The increase was about 8.5% less than in Q1/2013. Net new lending to non-holding companies totalled 9.7 b.kr. in Q1, a contraction of 28% year-on-year.

The NASDAQ OMX Main List index, OMXI6, had fallen by 3.6% between meetings. Turnover in the NASDAQ OMX Iceland main market totalled 93 b.kr. over the first four months of the year, slightly more than in the same period in 2013. At the beginning of May, the market value of companies listed on the main market totalled nearly 590 b.kr., or approximately a third of year-2013 GDP.

Outlook for the global real economy and international trade

According to the most recent forecast from the International Monetary Fund (IMF), published in April, global output growth in 2014 and 2015 will be broadly unchanged from the Fund's January forecast. The same applies to the forecast for world trade. In industrialised countries, growth is expected to exceed the Fund's January forecast in 2014 but fall short of it in 2015. The output growth outlook appears to be improving, although some downside uncertainty remains. Output growth in the US is forecast at 2.6% in 2014 and 3½% in 2015, while the outlook for the euro area is slightly better than was forecast in January, and for the UK it is considerably better. Overall, the IMF projects lower inflation than in January. Its forecast for output growth in 2014 in Iceland's main trading partners is unchanged, at 1.9%.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 0.6 b.kr. surplus in March but showed a 7 b.kr. deficit in April. Import and export values contracted year-on-year in April, with exports contracting slightly more than imports. In the first four months of the year, import values grew by about 4% year-on-year, while export values have contracted by roughly 11%. The reduction in export values is due primarily to a 13% contraction in the value of exported marine products and industrial goods. The rise in import values is due mainly to an increase in the value of imported transport equipment and consumer goods, although imports of investment goods, commodities, and operational inputs also grew during the first four months of the year.

The price of aluminium has risen marginally since the MPC's March meeting. In the first two weeks of May, the average price was 1.6% above the March average. Marine product prices were up 1.5% month-on-month in March.

The domestic real economy and inflation

According to the Statistics Iceland labour market survey, growth in labour demand was somewhat stronger in Q1 than in the forecast published in the February issue of *Monetary Bulletin*. The February forecast provided for a 2.5% year-on-year increase in total hours worked, while the actual increase was 3%. As before, the rise in total hours worked is due primarily to a 2.1% increase in the number of employed persons, while average hours worked rose by 0.9%.

In Q1/2014, net migration was positive for the sixth quarter in a row. The net increase was due entirely to foreign nationals, indicating that migrant labour could meet the increase in demand to some extent.

In Q1/2014, unemployment as registered by the Directorate of Labour (DoL) was broadly in line with the Bank's last forecast. Seasonally adjusted unemployment was 3.8% as measured by the DoL, as opposed to 5.2% according to the Statistics Iceland labour market survey. The survey-based rate adjusted for those who had been hired during the reference week but had not yet begun work was 4.7%. Unemployment declined slightly between quarters by both measures. According to the DoL, unemployment was nearly a percentage point lower than at the same time in 2013, whereas it was virtually unchanged year-on-year according to the labour market survey.

The wage index rose by 1.7% quarter-on-quarter and 5.2% year-on-year in Q1/2014.

Key indicators of private consumption in Q1/2014 suggest strong growth from the previous year. Payment card turnover was up more than 7% year-on-year during the quarter, and retail sales continued to grow, particularly sales of durable consumer goods such as electronic equipment. New motor vehicle registrations increased somewhat during the quarter, after the pace of the increase slowed down in the second half of 2013.

According to a survey conducted by Capacent Gallup, consumer sentiment deteriorated markedly in April, with the Consumer Sentiment Index measuring 82.7 points, a decline of about 4 points year-on-year. All components of the index fell between months, with the largest declines in the assessment of the labour market and the situation six months ahead.

The nationwide Statistics Iceland house price index, published in late April, rose by roughly 1½% from the previous month, and by about 0.4% adjusted for seasonality. It was up 9.3% from April 2013. The capital area real estate price index, calculated by Registers Iceland, rose by 2.2% month-on-month in March and by about 2% when adjusted for seasonality. The index has risen by 11.1% since March 2013. Since the beginning of the year, the Statistics Iceland house price index has risen by 9.5% from the same period a year ago. Over the same period, the building cost index has risen 1.3%. About 35% more purchase agreements were concluded nationwide in March 2014 than in the same month in 2013. The average time-to-sale for residential property in greater Reykjavík was about four months during Q1, a little more than a month shorter than during the same period in 2013.

According to the Central Bank's quarterly survey of market agents' expectations, conducted just before the publication of the May *Monetary Bulletin*, respondents' short-term inflation expectations were about 0.2-0.7 percentage points lower than in a comparable survey from February. Market agents expect twelve-month inflation to be close to the inflation target, on average, through the end of 2014. They expect inflation to measure 3.1% in one year and 3.5% in two years. Their longer-term inflation expectations have changed very little, however, averaging 3.8% over the next ten years. The vast majority of market agents cited external conditions as the main reason the Bank would be unable to keep inflation at target for the long term. Indicators of market agents' inflation expectations based on the spread between nominal and indexed bond yields also suggest that short-term expectations have declined, while long-term expectations are virtually unchanged. The five- and ten-year breakeven inflation rate in the bond market was about 4% just before the May meeting.

The consumer price index (CPI) rose by 0.24% month-on-month in March, raising twelve-month inflation from 2.1% to 2.2%. End-of-sale effects had the strongest upward impact on the index, while reductions in petrol prices pulled in the opposite direction. In April, the CPI rose by 0.31%, bringing year-on-year inflation to 2.3%. The increase in the CPI was driven primarily by a rise in imputed rent, while mobile phone service and groceries prices declined. Underlying twelve-month inflation declined marginally in March and April, with core index 3 excluding tax effects measuring 2.7% in April and core index 4 excluding tax effects measuring 1.3%.

The housing component of the CPI has risen most in the past twelve months, or by 7.1%, and inflation excluding housing measured only 1% in April. The twelve-month rise in the housing component explained nearly two-thirds of inflation in April. The increase in other domestic components has slowed down markedly, with the twelve-month rise close to the inflation target in April, for the first time since autumn 2007. The decline in domestic inflation has therefore pulled in the same direction as imported inflation, while the price of imported goods had declined by nearly 1% year-on-year in April.

According to the forecast published in *Monetary Bulletin* 2014/2 on 21 May, the inflation outlook has improved slightly since the February forecast was published, due primarily to a stronger króna and smaller rises in unit labour costs in the recent term. Inflation was at the Bank's 2.5% inflation target in Q1/2014 and will remain at target through this year, according to the forecast. As in February, however, it is expected to begin rising again next year, measuring 3-3½% in the latter half of the forecast horizon, whereupon it will begin to fall back towards the target in response to monetary tightening.

The GDP growth outlook for Iceland's main trading partners is broadly unchanged from the February forecast, and is projected to average 2% this year and just over 2% per year in 2015-2016. Domestic demand is forecast to take over from exports as the main driver of trading partners' GDP growth.

Terms of trade are forecast to improve slightly year-on-year in 2014, after continuous erosion since 2010. The outlook for the next two years has also improved, primarily because of a brighter outlook for export prices, marine product prices in particular. The total improvement is projected at nearly 1% over the forecast horizon, as opposed to a deterioration of just over 2% according to the February forecast.

Export growth was nearly 1 percentage point stronger in 2013 than was provided for in the February forecast, due to more robust services exports. The outlook for export growth in 2014 has improved since February, also because of services exports. This improvement outweighs the poorer outlook for goods exports, which is attributable to a contraction in marine product exports. The outlook for exports has also improved for 2015 and 2016. Export growth is now projected to average 2.7% per year during the forecast horizon, as opposed to just under 2% in the February forecast, and the trade surplus will increase accordingly.

The GDP growth outlook for this year has improved markedly from the February forecast. Growth is now projected at 3.7%, over a percentage point more than was forecast in February. The improvement is due to greatly increased investment growth. GDP growth is forecast to rise to 3.9% in 2015 and then fall back to 2.7% in 2016, as opposed to the February forecast of 3%.

Indicators imply that there is still some slack in the labour market, but it is forecast to disappear in the near future, although the timing is uncertain. New figures from Statistics Iceland indicate that unit labour costs rose less in the past two years than previous figures had suggested. Wage agreements have been concluded with the majority of the labour market since the February forecast was published. Even though negotiated pay rises have been broadly consistent with the private sector agreement concluded in December, the wage increases taking effect this year and next year are somewhat larger than was assumed in the last forecast. This is offset by somewhat more rapid growth in underlying productivity. The outlook for unit labour costs is broadly unchanged from February, with growth projected to average just under 3% per year, slightly above the inflation target.

According to the forecast, the margin of spare capacity in the economy measured about ½% of potential output in 2013. Owing to continued strong GDP growth, it is expected to disappear by mid-2014, about half a year earlier than according to the February forecast. Strong growth in domestic demand is expected to contribute to the gradual development of a positive output gap that will peak at 1½% of potential output in mid-2016 and then narrow to about ½% by mid-2017, the end of the forecast horizon.

The baseline forecast in *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are several key uncertainties that could change the inflation outlook from that assumed in the baseline forecast. For example, if the króna is weaker or wage increases larger than in the baseline forecast, there is the risk that the inflation outlook in the forecast or the assumptions concerning the Central Bank interest rate level that will suffice to bring inflation back to target are too optimistic. The same is true if the slack in the economy is overestimated in the baseline forecast. The risk that underlying inflationary pressures are underestimated is also greater than it would be otherwise because long-term inflation expectations are poorly anchored. If domestic demand has been overestimated, however, or if global output growth proves weaker than is assumed in the forecast, the domestic economy could turn out weaker and inflationary pressures therefore less pronounced. A weaker global economic recovery could also lead to weaker domestic growth and lower global commodity and oil prices, but on the other hand, the exchange rate of the króna could fall.

II The interest rate decision

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

The Committee discussed the Bank's *Financial Stability* report, published in early April, the status of financial institutions, their restructuring measures, and the progress made with private sector debt restructuring. It also discussed the risks facing the financial system as a result of Iceland's balance of payments problem.

At recent meetings, the MPC had discussed altering the Bank's monetary policy instruments, as well as possibly modifying its liquidity management measures. In accordance with Article 24 of the Act on the Central Bank of Iceland, the MPC approved the Governor's proposed changes in its monetary policy instruments (discussed in greater detail in the Bank's press release of 21 May 2014). The objective of the changes is to enhance the effectiveness of the Bank's liquidity management and, insofar as is possible, to promote greater efficiency in the use of its balance sheet. The modifications should also prepare for the changes in the monetary policy environment upon the sale of Central Bank of Iceland Holding Company (ESÍ) assets and the liberalisation of the capital controls. Further changes are under analysis within the Committee and could be implemented at a later date.

The Committee discussed the outlook for the domestic economy, including the Bank's new macroeconomic forecast. According to the forecast, GDP growth will measure 3.7% this year, about 1 percentage point more than according to the previous forecast. Even stronger growth is projected for next year. Furthermore, the labour market continues to recover. Because of this strong growth, the slack is expected to disappear from the domestic economy sooner than previously anticipated. It has diminished rapidly in the recent term. Indicators from the labour market point in the same direction. Furthermore, a positive output gap is forecast to develop next year, owing to strong growth in domestic demand. The output gap is expected to be more pronounced than previously projected and to peak in 2016. In view of the balance of payments problem, the Committee was concerned about the forecast showing declining national saving and the current account surplus turning into a deficit towards the end of the forecast horizon.

Committee members also discussed recent inflation developments and prospects. The inflation outlook has improved since the last forecast, owing to a stronger króna and smaller rises in unit labour costs. Inflation has been close to target in recent months and is expected to remain there until next year, when it is forecast to rise as a positive output gap emerges. Short-term inflation expectations have also declined in the recent term, in line with falling inflation, although long-term inflation expectations are still somewhat above target.

Committee members agreed that there was some uncertainty about wage developments, particularly in view of the unrest in the labour market. The Bank's forecast assumes that the results of the wage agreements concluded late in 2013 will apply to most of the labour market and that similar agreements will be made for a longer term early next year.

The Committee also discussed the extent to which the increase in house prices was an indication of future inflation and the extent to which it reflected changes in relative prices. Members were of the view that, because house prices had risen somewhat in excess of building costs in the recent term, the supply of housing could be expected to grow, thereby slowing down price increases.

In the Committee's opinion, there were grounds for keeping interest rates unchanged or for raising them. The main argument in favour of a rate increase discussed at the meeting centred on the benefits of responding swiftly, as the slack in the economy is expected to disappear in mid-2014, about half a year earlier than was forecast in February. There were also signs of wage pressures in the labour market and possible difficulties related to next year's wage negotiations. Even though the near-term inflation outlook had improved, the long-term outlook had deteriorated. Long-term inflation expectations were still close to 4% and had changed little in spite of favourable developments in inflation in the recent term.

The main argument in favour of unchanged interest rates was that the Bank's real rate had increased markedly year-to-date, as a result of the decline in inflation and inflation expectations. The Committee was of the opinion that the monetary slack had probably disappeared. The effects of the rise in the Bank's real rate had not emerged in full, however. Furthermore, the level of the Bank's neutral real rate was uncertain, and there was also considerable uncertainty about the size of the slack and the speed at which it was vanishing. In this context, it was pointed out that the next MPC's meeting was only a few weeks away, and by then the national accounts for Q1 would be available, as would a new inflation measurement. It was also mentioned that, even though the slack in the labour market was disappearing, surveys showed that employers envisioned no difficulty in hiring new workers, as the increased demand was met to a degree with imported labour. Moreover, it was pointed out that inflation excluding housing was very low and that the housing inflation could possibly reflect a temporary shortage of supply. In addition, some members considered it possible that inflation was overestimated in the forecast. Developments in imported inflation were uncertain, and global inflation was low. Domestic inflation could even fall below target in the near future, particularly in view of recent exchange rate developments.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. The Committee also decided that the interest rate on seven-day term deposits would be 5.25%. All Committee members voted in favour of the proposal.

Committee members agreed that monetary policy had been successful in the recent term. Inflation had subsided to target, and the slack in the economy was vanishing. Volatility of inflation and GDP had also diminished. However, Committee members were concerned that long-term inflation expectations were still somewhat above target, generating some uncertainty about the durability of this success.

Members agreed that, other things being equal, increased growth in domestic demand in the near term would probably require further increases in the Bank's real interest rate. Whether a change in the Bank's nominal interest rates is warranted in the near future would therefore depend on the future path of inflation and inflation expectations.

In the Committee's opinion, the more other measures, including restrictive fiscal policy, pulled in the same direction as monetary policy, the less need there would be for a tighter monetary stance. Such measures would also encourage increased saving and lead to a more favourable current account balance.

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 11 June 2014.