The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, August 2015

Published 2 September 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 17 and 18 August 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 19 August, 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 10 June interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2015/3 on 19 August.

Financial markets

Since the June meeting, the króna had appreciated by 1.9% in trade-weighted terms and by 1.6% against the euro, but depreciated by 0.2% against the US dollar and 2.8% against the pound sterling.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 562 million euros (82.9 b.kr.) between meetings, or 60% of total market turnover. Purchases year-to-date totalled 957 million euros (141.6 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 June, 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 235.5 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 short-term nominal Treasury bonds had increased by 0.2-0.3 percentage points between meetings, in line with the Bank's rate increase, while yields on long-term nominal bonds had declined by 0.3-0.9 percentage points. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds had fallen by 0.3 percentage points since the June meeting. To some extent, this decline may reflect non-residents' increased new investment in long Treasury bonds following the announcement of important steps in the capital account liberalisation strategy in early June. The decline could also reflect expectations of an improved Treasury position following the liberalisation of the capital controls, which can also be seen in rating upgrades from all three international rating agencies.

The average of the lowest listed nominal mortgage rates offered by the three large commercial banks had risen slightly since the June meeting, in line with the Bank's rate increase. The banks' real rates were broadly unchanged, however, as were comparable rates on indexed loans.

The monetary stance had eased since the June meeting, owing primarily to higher inflation and inflation expectations. At the time of the August meeting, the Bank's real rate was 1.3% in terms of the average of various measures of inflation and inflation expectations, and 3.1% in terms of twelve-month inflation. This is about 0.2-0.4 percentage points lower than just after the interest rate announcement in June.

Increased optimism about the Treasury's position is also reflected in falling risk premia. Since June, the CDS spread on five-year Treasury obligations has fallen by 0.3 percentage points, to the current 1.4%. 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, has also fallen after an uptick in June in connection with uncertainty about the possibility of a Greek default. It measured about 1½ percentage points, roughly the same as at the time of the June meeting.

Financial institutions' analysts all expected a 0.5 percentage point increase in the Central Bank's nominal interest rates in August, mainly citing the clear forward guidance in the MPC's previous statement and meeting minutes.

M3 grew by over 12.8% year-on-year in Q2/2015, or by 6.8% excluding deposits held by the winding-up boards of the failed deposit money banks (DMB).

Net new loans from DMBs to the non-financial corporate sector (i.e., new loans net of prepayments) had nearly doubled year-on-year in the first half of 2015. The vast majority of this increase is due to loans to services firms and retail trade firms. New loans to households have probably increased as well, but the assessment of the situation is complicated by problems relating to the treatment of data in connection with the Government's debt relief measures.

The NASDAQ OMXI8 index had risen by 6.5% between meetings. Turnover in the NASDAQ Iceland main market totalled 188 b.kr. over the first seven months of the year, about 23% more than over the same period in 2014.

Outlook for the global real economy and international trade

According to the International Monetary Fund's (IMF) July forecast, the global output growth outlook has deteriorated for 2015 but is unchanged for 2016. Global output growth is forecast at 3.3% this year, some 0.2 percentage points less than in the Fund's April forecast, mainly due to weaker growth prospects in the US and in emerging countries. Global GDP growth is forecast at 3.8% in 2016. If the forecast for 2015 materialises, growth will be the weakest since 2009. The Fund's forecast for growth in world trade in 2015 has been revised upwards by 0.4 percentage points, to 4.1%, whereas it has been revised downwards to 4.4% for 2016. Inflation in developed countries is forecast at 0% this year, about 0.4 percentage points below the previous forecast, and is projected to rise to 1.2% next year. The forecast for 2015 output growth among Iceland's main trading partners has been revised downwards, to 1.8%. The risk to the GDP growth outlook is still considered concentrated on the downside.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 4.5 b.kr. deficit in July and a 9 b.kr. deficit over the first seven months of the year. Exports grew by 18% year-on-year at constant exchange rates in the first seven months of the year, whereas imports grew by 19%. Stronger exports are due mainly to a one-fourth increase in industrial exports and a one-fifth increase in marine product exports. Import growth is due mainly to an 80% year-on-year increase in transport equipment imports and a 27% increase in food and beverage imports.

Aluminium prices have fallen 11% since the MPC's June meeting and were down by an average of 22.7% year-on-year in the first half of August. Foreign currency prices of marine products were up 1% month-on-month in June and had risen by 9.5% in the preceding twelve months.

In terms of relative consumer prices, the real exchange rate rose 0.8% month-on-month in July, to 86.2 points. It was up 1.7% year-on-year in the first seven months of 2015, due equally to the nominal appreciation of the króna and to the fact that inflation in Iceland was above the trading partner average.

The domestic real economy and inflation

The results of the Statistics Iceland labour force survey (LFS) show that labour demand in Q2/2015 was broadly in line with the forecast in the May *Monetary Bulletin*. The May forecast provided for a 4.3% year-on-year increase in total hours worked, whereas the actual increase was 3.9%. The increase in total hours worked during the quarter is due to a 4.3% increase in the number of employed persons, as average hours worked were 0.4% less than over the same period in 2014. Developments during the quarter were very similar to those in the preceding quarter. The reduction in working hours is due entirely to shorter hours among the youngest worker group.

Seasonally adjusted unemployment according to the LFS was virtually unchanged between quarters but declined by 0.8 percentage points year-on-year. It measured 3.9%, somewhat more than was assumed in the Bank's May forecast.

Net migration was positive in Q2/2015, due entirely to an increase in foreign nationals, as has been the case for the past two years.

In Q2/2015, the wage index rose by 1.7% between quarters and by 7.1% year-on-year, and real wages were 4.3% higher than in Q2/2014.

Key indicators of developments in private consumption during Q2/2015 suggest that it continued to grow at about the same pace as in previous quarters. Payment card turnover grew more than 4½% year-on-year during the quarter and, in July, had grown by just over 9%. New motor vehicle registrations increased by a third during the quarter, although there was a slowdown in groceries turnover.

The Gallup Consumer Sentiment Index declined month-on-month in July, to just over 99 points, but was up more than 14 points year-on-year. In Q2 it was slightly above the Q2/2014 level, on average. The big-ticket index, which measures households' planned major purchases, measured 66.8 points in June. It has risen steadily in the recent past and is higher than at any time since March 2008.

Statistics Iceland's nationwide house price index, published in late July, was up 0.4% month-on-month when adjusted for seasonality, and about 8.7% year-on-year. The capital area real estate price index, calculated by Registers Iceland, declined by 0.4% month-on-month in June when adjusted for seasonality. It rose by 10% year-on-year. During the first seven months of the year, housing market turnover nationwide was up 14.7% year-on-year and turnover in the greater Reykjavík area was up 9.6%. The average time-to-sale for capital area housing was four months during the first six months of the year, about half a month shorter than during the same period in 2014.

The CPI rose 0.16% month-on-month in July, after rising by just under 0.3% in June. This is the first rise in the CPI in the month of July since 2011. Twelve-month inflation measured 1.9% in July, slightly more than at the time of the MPC's June meeting. Inflation is still due primarily to rising house prices, as it measured only 0.4% excluding the housing component. Underlying inflation has also increased in recent months. Twelve-month inflation in terms of core index 3 excluding tax effects was 2% in July, nearly ½ a percentage point higher than at the last meeting. Statistical measures of underlying inflation suggest that it lay in the 1.9-3.8% range. Summer sales on clothing and footwear had the greatest impact on the CPI in July, lowering it by 0.5 percentage points. A 33% month-on-month rise in international airfares and an increase in imputed rent outweighed the downward effect of seasonal sales, however.

According to the Bank's survey of market agents' expectations, carried out in mid-August, respondents expect inflation to measure just under 4% one year ahead. This is about ½ a percentage point more than in the May survey. Their inflation expectations two years ahead also rose by ½ a percentage point, to 3.5%. The same is true of market agents' long-term inflation expectations: Survey respondents indicated that they expected inflation to average 3.5% over the next five years. The long-term breakeven inflation rate in the bond market has fallen since the MPC's last meeting, however; the five- and ten-year breakeven rates were just under 4% in mid-August, about 1 percentage point lower than at the time of the June meeting. As is discussed in *Monetary Bulletin*, this decline probably reflects to some extent non-residents' appetite for nominal Treasury bonds rather than a reduction in residents' inflation expectations.

According to the forecast published in the 19 August 2015 issue of *Monetary Bulletin*, the inflation outlook has deteriorated markedly since May. Inflation now looks set to rise above 4% early in 2016 and hover in the 4-4½% range over the next two years before falling back towards the target late in the forecast horizon. The main cause of the changed outlook is the recently concluded wage agreements, which provide for much larger pay rises in 2015 and the ensuing two years than previously assumed. The outlook is for unit labour costs to rise by more than 9% this year and over 7% per year, on average, over the forecast horizon – far more than was forecast in May. This is offset by the prospect of somewhat smaller increases in import prices during the forecast horizon than was projected in May.

There is some uncertainty about possible deviations in inflation from the above-described forecast, mainly because of uncertainty about the degree to which pay rises will be passed through to prices or absorbed through increased streamlining, resulting in a lower employment level, and uncertainty about global price developments and whether the improvement in terms of trade will continue.

The gradual global economic recovery continues, although some uncertainty remains, including that stemming from the recent unrest in the Chinese financial market and the expected interest rate hikes by the US Federal Reserve Bank. Oil prices have fallen still further in global markets, and Iceland's terms of trade have therefore continued to improve.

Preliminary figures from Statistics Iceland suggest that GDP growth was 2.9% in the first quarter of the year. The outlook is for it to gather pace and measure 4.2% for the year as a whole. Nevertheless, this is about ½ a percentage point below the forecast in the May *Monetary Bulletin*, as Q1/2015 GDP growth turned out weaker than was projected in May. The GDP growth outlook for the upcoming two years has also been revised downwards, from the previous 3½% per year to 3%. The composition of GDP growth has changed as well, with growth now expected to be driven more by domestic demand, private consumption in particular.

Sizeable wage increases in the wake of the wage settlements will inevitably call for a tighter monetary stance, which will hinder investment growth and labour demand growth. As a result, it is assumed that total hours worked will increase more slowly and unemployment will be higher during the forecast horizon than was projected in May. It is assumed that the post-crisis slack in the domestic economy is now fully absorbed and that a positive output gap has begun to develop. The output gap is projected to peak in early 2016 at just over 1% of potential output. As in May, it is assumed that the output gap will have disappeared again by the end of the forecast horizon and that unemployment will be close to its equilibrium level.

The underlying current account balance is expected to be positive by 4½% this year, about twice the surplus forecast in May. The underlying surplus is forecast to shrink year-on-year, however, as soon as the failed banks' estates have been settled in early 2016 and the effect on the underlying current account balance has become clear. It is expected to be positive by nearly 1½% of GDP in 2017, about ½ a percentage point less than was forecast in May.

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. He also reported to the Committee that the three large international rating agencies had all upgraded Iceland's sovereign credit ratings after the liberalisation strategy was announced in June. Furthermore, he updated the Committee on the Treasury's buyback of its own US dollar-denominated bonds maturing in June 2016 and reported on non-residents' purchases of domestic Treasury bonds.

The Committee discussed whether developments since the last meeting had changed its assessment of the necessary monetary stance. At the last meeting, the Committee had raised interest rates by 0.5 percentage points and had agreed that, in response to the effects of large pay rises in the recent wage settlements, it was apparent that a sizeable rate increase would be necessary in August, followed by further rate hikes in the coming term, so as to ensure that inflation would stay close to target over the medium term.

Committee members agreed that there was considerable strength in the economy. The Bank's new forecast, which took account of the results of wage negotiations, was available at the time of the August meeting. According to the forecast, GDP growth will be just over 4% this year and about 3% per year for the two years thereafter. The Committee agreed that, even though the growth rate was weaker than the Bank had forecast in May, it was quite robust. The slack in the economy and the labour market had disappeared, and the output gap would widen in the coming term. According to the forecast, GDP growth would be driven by domestic demand, especially private consumption, to a greater extent than in recent years, and investment would probably be weaker than previously forecast. Furthermore, it was assumed that labour demand would grow more slowly than was projected in May, due both to streamlining by firms in response to large pay increases and to the monetary policy response. The Committee also noted that it appeared likely that lending and growth in the money stock were picking up.

The Committee discussed developments in inflation since the last meeting. In line with the assessment from the last meeting, the August forecast showed that the inflation outlook had deteriorated markedly from the May forecast. According to the new forecast, inflation is projected to rise to 4% early in 2016 and to hover in the 4-4½% range over the next two years before subsiding towards the target, as the forecast implies that the monetary stance will be tightened in the near future. Committee members were concerned that inflation expectations had risen between meetings.

They agreed that changes in the economic outlook since May were attributable primarily to the effects of large pay increases following the recent wage settlements and the monetary tightening that inevitably accompanies pay hikes of such size. Offsetting the inflationary effects of the pay rises, however, were global factors, which have contributed to a more pronounced decline in import prices than previously expected, and improved terms of trade.

The Committee discussed the Central Bank's large-scale purchases of foreign currency between meetings, as the króna had appreciated marginally in spite of the purchases. Members agreed that the purpose of the Bank's foreign currency purchases was not to prevent appreciation of the króna based on fundamentals but to shore up the Bank's non-borrowed reserves during the prelude to capital account liberalisation and to mitigate excessive exchange rate volatility deriving, for instance, from temporary inflows or outflows.

The Committee discussed various uncertainties and their effect on GDP growth, demand, and inflation. Members were of the view that there was particularly pronounced uncertainty about the degree to which firms would pass wage increases through to prices or respond to them with internal streamlining. The effect on prices could therefore prove less pronounced than was assumed in the forecast, although the risk assessment indicated that the risk profile was tilted to the upside. There was also considerable uncertainty about global developments and their impact on commodity prices – and therefore about Iceland's terms of trade. If terms of trade improve more than is forecast, there could be increased scope for pay rises and the inflationary effects of such rises could therefore prove to be less. The Committee also discussed the fact that inflation was driven primarily by the housing component of the CPI. House prices have risen somewhat recently but still do not seem out of line with developments in other economic variables and have kept pace with the long-term house price-to-income ratio. Committee members agreed, however, that it would be necessary to keep close track of developments in house prices and lending.

The Committee also discussed the connection between interest rate decisions and indications of increased capital inflows. Members agreed that, as yet, inflows were not substantial, although they could grow rapidly. Increased demand had led to a one percentage point decline in interest rates on long-term Treasury bonds, however. It was pointed out that there could also be other explanations for the increased inflows and lower interest rates, such as improved credit ratings and lower credit spreads on Treasury debt. It was also pointed out that while excessive outflows had previously been considered the greatest risk, the discussion appeared to have turned around, with the focus now on increased inflows. It must not be forgotten that increased inflows were a positive development in the run-up to capital account liberalisation and that the balance was still skewed by the fact that the controls sequestered significant amounts of capital that would otherwise flow out. It was pointed out that if interest rates in Iceland were to be reasonably close to those elsewhere, domestic demand and inflation would have to be at a level consistent with a balanced economy and inflation at target. Committee members agreed that it was necessary to prevent interest rate decisions from focusing on capital inflows. If inflows related to carry trade became substantial, it would be necessary to use other policy instruments to restrict them. In this context, the Committee discussed possible application of such instruments and the work underway within the Bank in developing them.

Committee members all agreed that it was necessary to raise the Bank's interest rates by at least 0.5 percentage points. The discussion centred on whether to raise them by 0.5 or 0.75 percentage points. The main arguments in favour of the smaller step were the considerable uncertainty about how successful firms would be in streamlining in response to cost increases and the fact that global price developments tended increasingly to offset domestic inflationary pressures. It was also pointed out that the MPC's recent forward guidance had to some extent affected the yield curve over and above the interest rate increase.

The main argument in favour of the larger rate hike was that a 0.5 percentage point increase would merely return the monetary stance to its position prior to the MPC's June decision. The Central Bank's baseline forecast indicated that the effects of wage settlements on inflation would be in line with the MPC's assessment in June and that the Committee had deemed it apparent that further rate hikes would be needed in the coming term. The risk assessment in the inflation forecast indicated that risk was concentrated on the upside. Both the new forecast and indicators of demand suggested that domestic demand was growing rapidly and would be the main driver of GDP growth during the forecast horizon. The rise in inflation expectations between meetings also indicated that expectations were not firmly enough anchored to the inflation target. As a result, there was the risk that the monetary stance would be tightened too little and too late.

In view of the discussion, the Governor proposed that the Bank's interest rates be increased by 0.5 percentage points, which would raise the key rate (the seven-day term deposit rate) to 5.5%, deposit rates (current account rates) to 5.25%, the seven-day collateralised lending rate to 6.25%, and the overnight rate to 7.25%. Four members voted in favour of the Governor's proposal. One member voted against the Governor's proposal, voting instead to raise rates by 0.75 percentage points.

Committee members agreed that if inflation rises in the wake of the wage settlements, as is forecast, 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 will depend on future developments and on how the current uncertainty plays out, including the degree to which large pay increases are passed through to prices, on the one hand, and the degree to which they prompt rationalisation and productivity growth, on the other. Developments in terms of trade, credit growth, and real estate prices are important factors as well. Committee members were of the view that the interest rate path would depend on whether other policy instruments were used to contain demand-side pressures in the coming term.

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 30 September 2015.