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

# Minutes of the Monetary Policy Committee meeting, May 2015

## Published 27 May 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 6 and 12 May 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 13 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 18 March interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2015/2 on 13 May.

**Financial markets**

Since the March meeting, the króna had depreciated by 0.3% in trade-weighted terms, by 0.7% against the euro, and by 0.9% against the pound sterling, but had appreciated by 5.4% against the US dollar. It is still about 3.6% weaker against the US dollar than it was at the beginning of the year, and about 14% weaker than at the same time a year ago, which is in line with movements in other developed countries' exchange rates against the dollar.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 119 million euros (roughly 17.5 b.kr.) between meetings, or 41% of total market turnover. Purchases year-to-date totalled around 46 b.kr., much 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 141.5 b.kr. year-to-date, which is considerably more than in the same period in 2014 but well below the level seen in the same period of the three preceding years.

Yields on nominal Treasury bonds had risen by 0.4-0.7 percentage points since the March meeting, but yields on indexed Treasury and Housing Financing Fund (HFF) bonds were broadly unchanged.

The average of the lowest listed nominal mortgage rates offered by the three large commercial banks had declined slightly since the March meeting, and their real rates had fallen by approximately ⅔ of a percentage point. Comparable rates on indexed loans had also fallen slightly, therefore reversing in part the increase taking place in the first two months of the year.

The monetary stance had eased since the March meeting. At the time of the May meeting, the Bank's real rate was 1.7% in terms of the average of various measures of inflation and inflation expectations and 3% in terms of twelve-month inflation; that is, just over ½ a percentage point lower than just after the interest rate announcement 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 broadly unchanged since the March meeting, measuring about 1.1-1.6 percentage points just before the May meeting. It had fallen by about 0.3-0.6 percentage points since the beginning of the year, however. The CDS spread on five-year Treasury obligations had fallen by 0.2 percentage points between meetings, to 1.6%.

Financial market analysts had all expected the Central Bank's nominal interest rates to remain unchanged in May, citing uncertainty about the results of the ongoing wage negotiations.

M3 grew by about 8.9% year-on-year in Q1/2015, but by only 3.3% adjusted for deposits held by the failed banks' winding-up boards. Twelve-month growth in adjusted M3 has contracted in the past year and has been below nominal GDP growth for the last three quarters.

Net new lending from DMBs to domestic borrowers totalled 50 b.kr. in the first quarter of 2015, which is a large increase year-on-year but broadly in line with the previous three quarters. Net new DMB lending to households totalled about 9.7 b.kr. in the same quarter, a strong contraction between quarters but in line with Q1 lending in the previous two years. Prepayments of older household loans during the quarter are due largely to the Government's debt relief measures.

The NASDAQ OMXI8 index had risen by 4.1% between meetings and by 5% when adjusted for dividend payments. Turnover in the main market totalled 105 b.kr. during the first four months of 2015, an increase of nearly 13% year-on-year.

## Outlook for the global real economy and international trade

The International Monetary Fund (IMF) forecast in April that global output growth for 2015 would be broadly unchanged from the past two years, or 3.5%. This is the same as the Fund forecast in January. The Fund has revised its world trade forecast for 2015 and 2016 downwards since January. The overall GDP growth outlook for industrialised and emerging countries in 2015 and 2016 is broadly unchanged since January. The outlook for the US is somewhat poorer than was assumed in January, while the outlook for the euro area has improved. The outlook for the UK is virtually unchanged. The IMF's forecast for 2015 GDP growth among Iceland's main trading partners is about 0.2 percentage points lower than was assumed in January, or 1.9%. Overall, the IMF projects lower inflation than in January. Trading partner inflation is projected at 0.6% this year, about a percentage point below the Fund's January forecast.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 7.3 b.kr. surplus in April, following a surplus of 8.2 b.kr. in March. Export and import values grew year-on-year in April, by 52% and 12%, respectively. In the first four months of the year, export values grew by 28% year-on-year and import values by 22%. Export growth was due primarily to increased industrial and marine export values, while import growth stems from increased values of imported transport equipment, mainly aircraft, although imports of commodities and operational inputs increased considerably as well.

Aluminium prices have risen by 4.5% since the MPC's March meeting and were up 8.2% year-on-year, on average, in the first two weeks of May. Marine product prices rose by 1.7% month-on-month in March and had risen by 13% in the preceding twelve months.

In terms of relative consumer prices, the real exchange rate measured 85.1 points in April, an increase of 0.2% month-on-month and 1.3% year-on-year. The twelve-month increase is due mainly to the fact that inflation in Iceland was about 1 percentage point above the trading partner average, although the nominal exchange rate rose by 0.3% between years as well.

**The domestic real economy and inflation**

According to the Statistics Iceland labour force survey (LFS), total hours worked rose somewhat more rapidly in Q1/2015 than in the second half of 2014, or about 4.2% year-on-year. The increase in total hours worked is due entirely to an increase in the number of employed, as average hours worked declined marginally. The labour participation rate rose by 1.6 percentage points year-on-year during the quarter, the employment rate rose by 2.7 percentage points, and the number of persons outside the labour market fell by 6.8%.

Seasonally adjusted unemployment measured 3.8% in Q1, according to the LFS. It declined by 1 percentage point between quarters, after remaining virtually unchanged since Q2/2014.

In Q1/2015, net migration was positive for the tenth quarter in a row. The increase amounted to 0.2% of the labour force and was due entirely to foreign nationals.

The wage index rose by 1.2% between quarters in Q1, and by 6.1% year-on-year, and real wages rose by 5.4% over the same period.

Key indicators of private consumption in Q1/2015 suggest strong growth from the same quarter in 2014 and a continuation of the growth seen in Q4/2014. Payment card turnover grew by more than 5% year-on-year during the quarter. Retail turnover with goods such as electronic equipment and furniture grew year-on-year during the quarter, whereas groceries turnover declined slightly. New motor vehicle registrations also increased markedly during the quarter.

Statistics Iceland's nationwide house price index, published in late April, declined 0.3% month-on-month when adjusted for seasonality, but rose 8.6% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 0.3% month-on-month in March when adjusted for seasonality. It rose by 8.8% year-on-year. The number of purchase agreements finalised in March was about a third higher than in the same month in 2014, as many contract registrations were expedited in March because of the imminent strike among lawyers employed by the capital area Commissioners' offices, which began on 7 April. In the first quarter of 2015, the average time-to-sale for flats in the greater Reykjavík area was just over four months, about the same as in the same quarter of 2014.

The Gallup Consumer Sentiment Index declined month-on-month in April but was still 1.6 points higher than in April 2014. All components of the index declined between months. The big-ticket purchase index rose during the quarter to its highest value since March 2008.

The CPI rose by 0.14% month-on-month in April, following an increase in March of 1%, the largest single-month increase since February 2013. Twelve-month inflation measured 1.4% in April, after rising by over ½ a percentage point since the March meeting. The CPI excluding the housing component declined by 0.1% year-on-year. Underlying inflation in terms of core index 3 excluding tax effects was 1.6% in April and had increased by nearly ½ a percentage point since the last meeting. Statistical measures of underlying inflation also indicate a slight rise in the recent past. Using the weighted median and trimmed mean measures gives an underlying inflation figure of 1.7-2.2%. In terms of the dynamic factor model, however, underlying inflation is higher, about 3½%. The main change in April was a 0.7% month-on-month increase in house prices, with the twelve-month increase measuring 8.6% (based on the market value of housing in the CPI).

According to the Bank's survey of market agents' expectations, carried out at the beginning of May, respondents expect inflation to measure 3½% one year ahead. This is about 1 percentage point more than in the January survey. Market agents' long-term inflation expectations also rose slightly, with respondents projecting that inflation would average 3.2% in the next five and ten years. The breakeven inflation rate in the bond market has also risen since the March meeting. Furthermore, it contains a risk premium that has probably risen in recent weeks, in part due to the uncertainty prevailing in the labour market. The two-year breakeven inflation rate averaged 3.8% in April and had risen by over ½ a percentage point since March. The five- and ten-year breakeven rates averaged just under 5% in April and had also risen by just over ½ a percentage point. The increase since January 2015 is about 1½ percentage points, however.

According to the forecast published in *Monetary Bulletin* on 13 May, the effects of the recent drop in oil prices on observed inflation will taper off, and large wage increases and an increased output gap will cause inflation to rise again. Inflation is expected to be at target in the latter half of this year, nearly half a year earlier than was forecast in February. According to the baseline forecast, inflation will continue to rise, measuring just over 3% from mid-2016 to the end of the forecast horizon, when it will begin to subside to the target again.

The outlook for global output growth and growth in Iceland's main trading partners in 2015 and the following two years is broadly unchanged from the Bank's February forecast, although GDP growth prospects for individual countries and regions have changed. According to the forecast, trading partners' growth will average 2.2% per year over the next two years. Uncertainty about the global economic outlook is similarly unchanged since February.

Preliminary figures from Statistics Iceland indicate that terms of trade improved by 9% year-on-year in Q4/2014. The improvement during the year turned out to be 3.4%, or 1 percentage point more than was forecast in the February *Monetary Bulletin*, owing mainly to more favourable developments in aluminium and marine product prices. The outlook is for continuing improvement in terms of trade this year, not least because of the steep decline in oil prices and the appreciation of the US dollar against the euro since mid-2014. If the forecast materialises, terms of trade will have improved by about 8% in 2017 compared to the post-crisis trough in 2013, although they will remain 12% below the average for the period 1999-2008.

The outlook for exports in 2015 and the following two years has improved from the last forecast, however, and growth is now projected at nearly 7% this year. The increased growth is due primarily to stronger exports of services and marine products. Export growth will lose pace somewhat over the forecast horizon and is expected to align with growth in trading partner demand by the end of the period.

GDP growth measured 1.9% in 2014, well in line with the 2% forecast in the February *Monetary Bulletin*. It is projected at 4.6% this year, somewhat more than was forecast in February. The upward adjustment is due largely to stronger growth in investment and exports. The outlook for 2016 has also improved since February, with GDP growth for the year projected at 3.4%. GDP growth for 2017 is projected at 3%, about ½ a percentage point more than in the February forecast. As before, the main drivers of output growth during the forecast horizon will be private sector demand; i.e., private consumption and business investment.

According to the Statistics Iceland labour force survey (LFS), seasonally adjusted unemployment measured 3.8% in Q1/2015, in line with the Bank's February forecast. Jobs increased strongly in number in Q1, and total hours worked rose by over 4% year-on-year. Other labour market indicators also suggest that the recovery of the labour market has regained its previous strength after the slowdown in H2/2014. According to the baseline forecast, unemployment will continue to decline, to about 3½% in 2015 and 2016, and then rise to its estimated equilibrium level towards the end of the forecast horizon. Total hours worked will also continue to rise, as will the employment rate, which will measure about 79% from 2016 onwards. The outlook for the labour market has therefore improved somewhat from the February forecast, in line with improved GDP growth prospects. The outlook for productivity growth during the forecast horizon is broadly unchanged since February, however: productivity growth is still forecast to average about 1% per year.

Wages rose by nearly 6% in 2014, whereas labour productivity remained unchanged. Unit labour costs therefore rose sharply during the year, and the baseline forecast indicates that they will continue to do so for most of the forecast horizon. Unit labour costs are assumed to rise by an average of approximately 4% per year during the forecast horizon, slightly more than was forecast in February and somewhat above the level compatible with long-term price stability.

The margin of spare capacity in the economy is estimated to have closed and a positive output gap will gradually develop. It is projected to peak at 1¼% of potential output around mid-2016. This is a somewhat more pronounced output gap than was assumed in the February forecast, as the outlook is for stronger GDP growth during the forecast horizon. According to the forecast, the gap should narrow gradually in the latter half of the forecast horizon and will have almost disappeared by the end of the period.

The baseline forecast in *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are various uncertainties in the forecast that could change the inflation outlook from that assumed in the baseline scenario. The global economic recovery could prove weaker than is assumed in the baseline forecast, for instance, adversely affecting exports and perhaps terms of trade as well. Furthermore, exchange rate developments are uncertain due to the potential effects of settling the failed banks' estates and lifting the capital controls. One of the key uncertainties in the baseline forecast, however, is the outcome of the ongoing wage negotiations. There is also the risk that wage increases well in excess of productivity growth will prompt firms to seek ways to reduce wage costs by, for instance, slowing staff recruitment or laying off workers. The recent improvement in Iceland's competitive position, which can be seen, among other things, in strong export growth despite weak output growth among trading partners, would also be under threat. Large increases in wage costs would also tend to undermine the economic recovery and the trade surplus that pave the way for liberalisation of the capital controls. The uncertain outlook for the labour market implies considerable risk that near-term inflation is underestimated. That risk has increased in the recent term. This is offset in the long run by factors such as the risk of weaker economic activity than is provided for in the baseline forecast; therefore, the probability distribution is more symmetric towards the end of the forecast horizon, although the risk in the inflation forecast is still concentrated on the upside.

**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 capital account liberalisation. Committee members discussed the Bank's *Financial Stability* report, published on 22 April, the position of financial institutions, and risks to the financial system stemming from Iceland's balance of payments problem.

The Committee considered whether developments since the last meeting and the outlook based on the Bank's new forecast changed its assessment of the required monetary stance. Members agreed that economic activity was greater than previously estimated and the margin of spare capacity narrower. According to the Bank's newly published forecast, GDP growth will measure about 4½% this year and will average just under 4% per year over the forecast horizon. This is about ½ a percentage point more than the Bank forecast in February. It is also assumed that a positive output gap will develop this year and peak in 2016.

Committee members noted that the recovery of the labour market had gained momentum in the recent term. They were of the view that, given the substantial wage demands currently being put forward, it could be concluded that excess demand has already developed in the labour market, or at least that the labour market slack has narrowed more rapidly than is consistent with price stability. In the Committee's view it was uncertain, however, to what extent this explained the very high wage demands – which were well above what could be expected under conditions of a small output gap and still-low inflation. As had been discussed previously at MPC meetings, other explanations for high wage demands could be the breakdown of the social consensus and disagreement among labour organisations about relative wages and income distribution.

Committee members also noted that, according to the current forecast, unit labour costs were forecast to rise somewhat more than previously assumed, and somewhat more than is consistent with the inflation target. Members agreed that the scope for pay increases in the coming wage settlements was limited by the apparent weakness of productivity growth, although the improvement in terms of trade offset it somewhat.

The Committee examined several alternative scenarios involving significantly larger pay increases than are assumed in the baseline forecast and discussed the impact on inflation, the real economy, and the monetary policy response. The impact of one of these scenarios is discussed in detail in *Monetary Bulletin* 2015/2. The Committee considered it clear that even in the alternative scenario involving wage increases in line with what the Confederation of Icelandic Employers (SA) had offered to labour unions, substantial interest rate increases would be necessary, other things being equal, to ensure long-term price stability.

The Committee was also of the view that the effects of large pay rises on the real economy as portrayed in the alternative scenarios could be underestimated in macroeconomic models based on historical relationships, when conditions differed markedly from present ones. The króna would not depreciate now as it had following large pay increases in previous decades. Furthermore, the sectoral composition of the economy had changed, as small and medium-sized tourism companies weigh more heavily than before, and it is uncertain how much scope they have for large pay increases and changes in activities and staffing if needed. It was also pointed out that, in the past, the banking system had financed companies' losses, at least for a period of time, but that it was entirely uncertain whether this could be done to the same degree now. Members agreed that the effect on employment could therefore be greater than in the alternative scenarios. One member was of the view, however, that the impact could be non-linear and could emerge later, but then in a more pronounced manner. Committee members agreed that firms' capacity to increase wages varied and that wage increases as large as those in the scenarios could prove too onerous for some of them. Although it could be expected that the fishing and energy-intensive industries' large profits would enable firms in those sectors to absorb large pay increases, there was probably little scope among many domestic services firms and smaller companies in the tourism sector, which has seen the most rapid growth in employment since the banks failed. Members also noted the risk that tourism companies' competitive position would be eroded if they chose to raise prices in order to pay higher wages. On the other hand, it was pointed out that the companies that had paid down their debt in recent years would have more scope to absorb wage increases than in 2011.

The Committee was also of the view that the impact of large pay increases on inflation could be underestimated because the labour market situation had already begun to affect inflation expectations. Inflation could therefore increase rapidly, as it did following the 2011 wage settlements. The effects could even surface more quickly now, given that the spare capacity in the economy was all but absorbed, whereas in 2011 there was still some slack remaining.

MPC members agreed that the inflation outlook had deteriorated since the Bank's last forecast, although inflation was still low and slightly negative year-on-year if housing costs were excluded. According to the Bank's baseline forecast, inflation would rise above target at the beginning of 2016, about half a year earlier than was projected in February. Committee members also considered it more likely that inflation would overshoot the current forecast rather than fall below it, particularly in view of developments in wage negotiations after the forecast was prepared.

As before, the Committee was of the view that low global inflation and a stable króna had contained inflation and offset the effects of considerable domestic wage increases. They agreed, however, that the likelihood of a favourable interaction between low imported inflation and moderate wage settlements appeared negligible at present. They were also concerned that inflation expectations had risen after having subsided to target at the beginning of the year, marking an easing of the monetary stance since the March meeting.

The Bank's interest rate reductions late in 2014 were based on a sharp drop in inflation and the decline in inflation expectations, which had led to a larger rise in real rates than was considered warranted at that time by economic conditions and the near-term outlook. Members noted that, in previous MPC statements, the Committee had reiterated that large pay increases and strong growth in demand could undermine the recently achieved price stability and require that interest rates be raised again. The Committee was of the view that recent developments in wage negotiations, in conjunction with the increase in inflation expectations and indications of strong growth in demand, suggested strongly that such conditions could be materialising. Members did not agree on whether this situation called for an immediate rate increase or whether it would be better to wait and see to what extent pay increases were larger than was consistent with the inflation target. They agreed on the need to communicate the Committee's concerns explicitly, however.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 4.5%, the current account rate 4.25%, the seven-day collateralised lending rate 5.25%, and the overnight lending rate 6.25%.

Four Committee members voted in favour of the proposal. In their opinion, it did not matter whether interest rates were raised immediately or in June, after the labour market outlook had been clarified, as the Committee's statement would send an explicit message warning of an expected rate increase, the effects of which would surface immediately in the bond market. The possibility could not be excluded that a message from the MPC could affect wage settlements, so that pay increases might be smaller than the current situation suggested. Furthermore, a clear message in the MPC statement would better prepare market agents for a rate increase.

One member voted against the Governor's proposal, voting instead for an immediate rate increase of 0.5 percentage points. This member was of the view that, irrespective of the outcome of wage negotiations, conditions in the economy already called for a tighter monetary stance. Inflation expectations had risen somewhat, and economic activity appeared to be picking up strongly. The outlook was for more than 6% growth in domestic demand and GDP growth over 4%, at a time of rapid growth in employment. In addition, the outline of the forthcoming wage settlements were by now clear enough that it was obvious that pay increases would be far larger than is consistent with the Bank's inflation target and its baseline forecast. As a result, it was necessary to take the first step towards a tighter monetary stance immediately, as further interest rate increases would be necessary at the MPC's upcoming meetings.

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 10 June 2015.