



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, June 2016

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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 31 May 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 1 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 11 May interest rate decision.

Financial markets

The exchange rate of the króna had fallen in trade-weighted terms and against the US dollar and the pound sterling since the last meeting, held in the first half of May, but had risen slightly against the euro. The Central Bank’s net accumulated foreign currency purchases totalled approximately 150 million euros (20.9 b.kr.) between meetings, or just over half of total market turnover.

Non-residents’ net new investment in the bond market was virtually unchanged since the beginning of May, according to preliminary figures.

As before, overnight interest rates in the interbank market for krónur were close to the Bank’s key rate, but turnover had been limited since the last MPC meeting. Yields on Treasury and Housing Financing Fund (HFF) bonds were broadly unchanged, as was the risk premium on the Treasury’s foreign obligations. The NASDAQ Iceland OMXI8 had fallen by over 3% between meetings, however.

The large commercial banks' indexed and non-indexed deposit and lending rates were virtually unchanged between meetings, as was the pension funds' average mortgage lending rate.

The monetary stance as reflected in the Central Bank's real interest rate had been unchanged since just after the MPC's last decision in terms of the average of various measures of inflation and inflation expectations but had weakened by 0.1 percentage point in terms of past twelve-month inflation.

Financial institutions' analysts had all expected the Central Bank's nominal interest rates to be held unchanged in June, mainly because little had happened since the previous interest rate decision that called for a change in interest rates.

Growth in M3 had eased in March and April after adjusting for the deposits of deposit money banks (DMB) in winding-up proceedings. The slower growth rate stems in particular from weaker growth in deposits of non-deposit-taking financial institutions and a contraction in corporate deposits, while there is stronger growth in household deposits. The total stock of loans from DMBs and the HFF to resident borrowers grew slightly year-on-year in April, after adjusting for the Government's debt relief measures. As before, the increased growth is due to an increase in lending to businesses, services companies in particular.

Global economy and external trade

The listed global market price of aluminium has been virtually unchanged since the May MPC meeting but is down 13.6% year-on-year. Foreign currency prices of marine products rose slightly between months in April and have risen by just over 2% year-on-year.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), labour demand growth continued in April. Unemployment rose slightly, however, due to the seasonal entry of students into the labour market during the spring.

The wage index rose in April by 0.4% month-on-month and by 13.4% year-on-year, the second-strongest year-on-year growth rate since measurements were introduced. Real wages in terms of the index rose 11.6% between years, as in March, the largest rise ever measured.

In April, key indicators of private consumption such as payment card turnover and new motor vehicle registrations indicated that developments in Q1/2016 had continued, in line with the Bank's forecast, as rapid real wage growth contributes to increased household demand. The Gallup Consumer Sentiment Index rose somewhat in May. It has risen virtually without interruption in the past year and is at its highest since mid-2007.

According to the results of Gallup's summer survey, carried out among Iceland's 400 largest firms in May, executives were somewhat more optimistic about the economy than in both the spring survey (conducted in February) and in the survey taken in May 2015. The index now stands at 195 points, the highest measurement since September 2004. Transport and tourism, construction, financial services, and miscellaneous specialised services now show an index value of 200, the highest possible measurement. Nearly half of executives expect economic conditions to be unchanged six months ahead. Expectations about both domestic and foreign demand were slightly better than in the previous survey.

According to Gallup's summer survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by nearly 40 percentage points. About 42% of firms considered themselves short-staffed, an increase of over 11 percentage points from the previous survey and 22 percentage points from the summer 2015 survey. This percentage is at its highest since year-end 2007. The shortage of labour was similar to that in the spring survey for firms in construction and transport/tourism, while the number of firms in industry, fishing, and retail trade that consider themselves understaffed has risen sharply.

Statistics Iceland's nationwide house price index, published in late May, rose 0.7% month-on-month when adjusted for seasonality and by 7.3% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1% month-on-month in April when adjusted for seasonality, and by 8.5% year-on-year.

The consumer price index (CPI) rose by 0.4% month-on-month in May, raising twelve-month inflation marginally, to 1.7%. The CPI excluding the housing component had risen by only 0.3% in the past twelve months, however. Underlying inflation in terms of core index 3 had risen since the MPC's May meeting, to 2.2%. Statistical measures of underlying inflation suggest that it lay in the 1.6-3.8% range, with a median value of 2.3%.

The main driver in May was the rise in the cost of owner-occupied housing. Price increases were distributed over a number of sub-components in May, however, with food, petrol and oil, and recreation and culture affecting the index considerably. In addition were seasonal increases in the price of hotel and restaurant services. Private services prices have risen by 2.2% in the past twelve months.

According to Gallup's summer survey of household inflation expectations, conducted in May, households expect inflation to measure 3.2% one year ahead, a slight decline from the spring survey. On the other hand, two-year inflation expectations were unchanged at 4%. According to Gallup's summer survey of corporate inflation expectations, respondents expect inflation to measure 3% one year ahead, the same as in the previous survey.

II The interest rate decision

The Governor reported to the MPC on the status of work underway in connection with special capital flow management tools designed to affect carry trade-related capital flows. He also updated the Committee on matters relating to capital account liberalisation.

Because the planned auction of offshore krónur will take place on 16 June, the Committee considered it appropriate to lower minimum reserve requirements by 0.5 percentage points beginning with the next reserve maintenance period, which begins on 21 June. The Committee had decided at its December meeting that, other things being equal, it would lower reserve requirements to 2% in connection with the auction.

Committee members discussed whether developments since the last meeting had changed its assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the meeting, the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, although the Committee considered it likely that the monetary stance would have to be tightened in the coming term.

Because of the short time since the previous meeting, little new information had emerged. Committee members agreed that the inflation and economic outlook was largely in line with the assumptions from the previous meeting. In the Committee's opinion, most new indicators implied that the outlook was still for rapid GDP growth, and members agreed that new

information from the labour market indicated increasing tension there. On the other hand, inflation was low, credit growth was weak and, because of a favourable debt position and the prospect of a continued current account surplus, upward pressures on the exchange rate could continue.

Inflation measured 1.7% in May, similar to the rate a year ago, and has been below target for over two years. As in recent meetings, the MPC discussed the reasons why inflation is still well below the target in spite of large pay increases and a widening positive output gap. Members agreed, as before, that it was due mainly to the appreciation of the króna, the decline in oil and commodity prices, very low inflation in trading partner countries, and improved terms of trade, which had thus far been sufficient to offset domestic inflationary pressures. Committee members also agreed with the assessment in the Bank's most recent forecast, published in *Monetary Bulletin* 2016/2 in May, that other things being equal, the outlook was for inflation to remain below target well into this year and then rise when import prices stopped falling.

None of the Committee members saw any reason to change interest rates at present. 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 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

MPC members agreed that global price developments and a stronger króna had provided the scope to raise interest rates more slowly than had previously been considered necessary. By the same token, in the Committee's opinion there were signs that monetary policy had anchored inflation expectations more securely than before and contributed to a more moderate rise in inflation than could have been expected in the wake of large pay increases. However, members agreed that this did not change the fact that, according to the Bank's forecast from early May, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future developments.

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 24 August 2016.