# MONETARY POLICY COMMITTEE REPORT TO PARLIAMENT

2014 • 2

# Monetary Policy Committee report to Parliament

## 16 January 2015

The Act on the Central Bank of Iceland stipulates that the Monetary Policy Committee (MPC) of the Central Bank of Iceland shall submit to Parliament (Alþingi) a report on its activities twice a year and that the contents of the report shall be discussed in the Parliamentary committee of the Speaker's choosing.

The Act requires that the MPC meet at least eight times each year. Since the last Report was sent to Parliament, the Committee has held four regular meetings, most recently on 10 December 2014. The following report discusses the work of the Committee between July and December 2014.

**Monetary policy formulation**

According to the Act on the Central Bank of Iceland, the Central Bank's principal objective is to promote price stability. This objective is further described in the joint declaration issued by the Bank and the Icelandic Government on 27 March 2001 as an inflation target of 2½%. Furthermore, the Act stipulates that the Central Bank shall promote the implementation of the economic policy of the Government as long as it does not consider this policy inconsistent with its main objective of price stability. The Bank shall also promote financial stability. By law, the MPC takes decisions on the application of the Bank's monetary policy instruments, which are its interest rates, its transactions with credit institutions other than last-resort loans, reserve requirements, and foreign exchange market transactions aimed at affecting the exchange rate of the króna. The decisions of the MPC shall be based on a thorough and careful assessment of developments and prospects for the economy, monetary policy, and financial stability.

In implementing monetary policy, the MPC bases its decisions in part on an analysis of current economic conditions and the outlook for the economy as presented in the Bank's *Monetary Bulletin*. The MPC's statements and minutes, enclosed with this report, contain the arguments for the Committee's decisions.

**Developments from July to December 2014**

At its November meeting, the MPC decided to lower the Bank's interest rates by 0.25 percentage points, after having kept them unchanged for two years. Then, in December, interest rates were lowered by an additional 0.5 percentage points. At the end of 2014,

Table 1. Central Bank of Iceland interest rates 2014 (%)

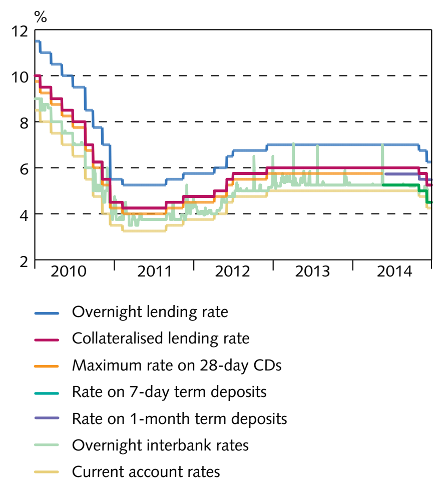
| *Date* | *Current account rate* | *Rate on 7-day term deposit*[1] | *Collateral lending rate* | *Overnight lending rate* |
|---|---|---|---|---|
| 10 December | 4.25 | 4.50 | 5.25 | 6.25 |
| 5 November | 4.75 | 5.00 | 5.75 | 6.75 |
| 1 October | 5.00 | 5.25 | 6.00 | 7.00 |
| 20 August | 5.00 | 5.25 | 6.00 | 7.00 |

1. Beginning in autumn 2009, the Central Bank sold 28-day certificates of deposit to financial institutions on a weekly basis, with the aim of reducing market liquidity and supporting interest rate formation in the interbank market for krónur. In May 2014, however, it began offering seven-day term deposits, as well as one-month term deposits that are offered once a month.

Chart 1

Central Bank of Iceland interest rates and short-term market interest rates

Daily data 1 January 2010 - 31 December 2014

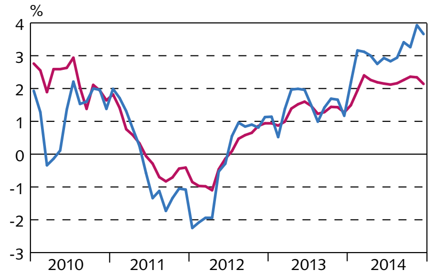



*Source:* Central Bank of Iceland.

Chart 2

Real Central Bank of Iceland interest rates[1]

January 2010 - December 2014




Real Central Bank of Iceland interest rate in terms of twelve-month inflation

Real Central Bank of Iceland interest rate in terms of various measures of inflation and inflation expectations[2]

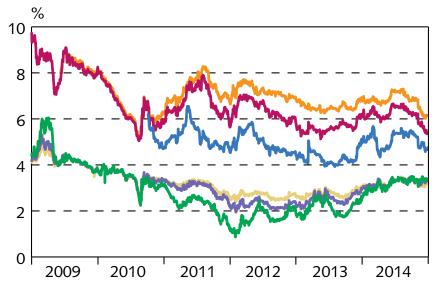
1. From 2010 to May 2014, the nominal policy rate was the average of the current account rate and the maximum rate on 28-day CDs. From May 2014, the policy rate has been the seven-day term deposit rate.
2. Until January 2012, according to twelve-month inflation, one-year business inflation expectations, one-year household inflation expectations, the one-year breakeven inflation rate, and the Central Bank forecast of twelve-month inflation four quarters ahead. From February 2012 onwards, according to the above criteria, plus one-year market inflation expectations based on a quarterly Central Bank survey.

*Sources:* Capacent Gallup, Statistics Iceland, Central Bank of Iceland.

Chart 3

Bond yields

Daily data 2 January 2009 - 31 December 2014



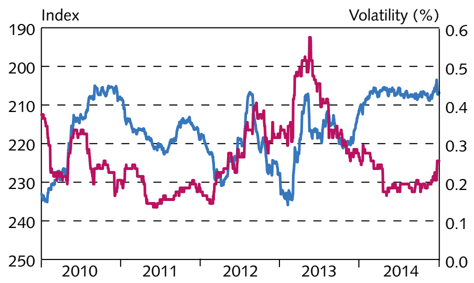

RIKB 16 1013
RIKB 19 0226
RIKB 25 0612
HFF 150224
HFF 150434
HFF 150644

*Source:* Central Bank of Iceland.

Chart 4

Exchange rate and volatility of the króna

Daily data 4 January 2010 - 31 December 2014




Trade-weighted exchange rate of the króna (inverted left axis)[1]

Volatility of the króna (right)[2]

1. Price of foreign currency in terms of the króna. Inverted axis shows a stronger króna as a rise. 2. Volatility is measured by the standard deviation of daily changes in the past 3 months.

*Source:* Central Bank of Iceland.

the Bank's key interest rate – that is, the seven-day term deposit rate – was 4.5%, down from 5.25% at the end of June.[1]

Even though the Bank's nominal interest rates have been lowered, the monetary stance has not eased since the Monetary Policy Committee's last report was submitted to Parliament. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 2.2% at the end of December 2014, which is broadly similar to that as of end-June. In terms of past twelve-month inflation, the Bank's real rate has risen since June, but it is difficult to estimate the effects of this development on demand because of the dramatic decline in oil prices, the duration of which is uncertain. The long-term real rate in the bond market has developed broadly in line with the Bank's interest rates.

In trade-weighted terms, the króna has depreciated by just over ½% since end-June but has appreciated by 1.7% since the end of 2013. In the recent term, the Central Bank's foreign exchange market intervention had significantly mitigated the appreciation of the króna and contributed to increased exchange rate stability. In the second half of 2014, the Bank bought currency from market makers for 72.2 b.kr. and sold for just under 1 b.kr.

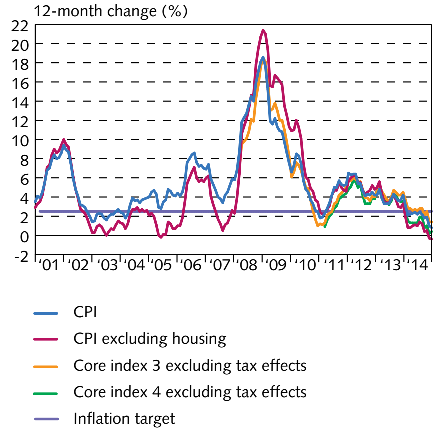
Inflation has subsided markedly in recent months. Twelve-month inflation in terms of the CPI measured 0.8% in December, down from 2.1% in June 2014. Inflation has been below the Central Bank's inflation target for eleven consecutive months. Underlying twelve-month inflation as measured by core index 3 (which, in addition to the effects of indirect taxes, excludes volatile food items, petrol, public services, and real mortgage interest expense) was 1.4% in December, down from 2.6% in June. Price reductions on imported goods – petrol and miscellaneous imports such as housewares and electronic equipment – had the most pronounced effect in the latter half of the year, together with reduced airfares. The rise in house prices pulled in the opposite direction, however. Excluding the housing component, disinflation has been even more pronounced, with the CPI excluding housing declining by 0.4% year-on-year in December.

Low underlying inflation indicates that the disinflation episode is relatively broad-based. Low global inflation and a stable króna have therefore contained inflation in spite of considerable wage increases in 2014. This development, together with the fact that long-term inflation expectations have fallen to target by most measures, enabled the Monetary Policy Committee to lower interest rates twice in late 2014. The Committee was of the opinion that, after this rate reduction, the Bank's nominal rate was close to the level consistent with full capacity utilisation and inflation at target. On the other hand, they were of the opinion that, looking ahead, large pay increases and strong growth in demand could undermine the recently achieved price stability and require that interest rates be raised again.

1. The key rate is the interest rate that is the most important determinant of short-term market rates and therefore is the best measure of the monetary stance. At present, this is the seven-day term deposit rate. Other Central Bank interest rates have fallen correspondingly, as can be seen in Table 1.

Because CPI inflation fell below 1%, the lower deviation limit of the inflation target, in December 2014, the Bank submitted a report to the Minister of Finance and Economic Affairs, explaining the reasons for the deviation and estimating how long it will take to bring inflation back within the deviation band (see accompanying materials). The report stated, among other things, that underlying inflation was low and that, excluding the housing component of the CPI, was slightly negative. The substantial disinflation at the end of 2014, together with a steep decline in oil prices, will probably keep inflation below the level forecast in the November *Monetary Bulletin* well into 2015. On the other hand, there is little likelihood of a protracted deflation episode, as nominal demand growth is still robust and it is likely that the slack in the economy is close to disappearing. As a result, conditions in Iceland are different from those in most trading partner countries. In addition, Iceland is a small, open, and export-driven economy where it should be possible to impede deflation by contributing to the depreciation of the króna through interest rate reductions and purchases of foreign currency.

Chart 5
Various inflation measurements[1]
January 2001 - December 2014



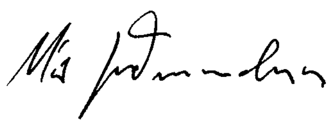

1. Core index 3 is the CPI excluding prices of agricultural products, petrol, and public services and the cost of real mortgage interest. Core index 4 excludes the market price of housing as well.
*Sources:* Statistics Iceland, Central Bank of Iceland.

**Accompanying documents**

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from August to December 2014.
2. Minutes of Monetary Policy Committee meetings from August to December 2014.
3. Joint declaration by the Government and the Central Bank on inflation targeting, March 2001
4. Report to the Government on inflation below limits, 29 December 2014

On behalf of the Central Bank of Iceland Monetary Policy Committee,



*Már Guðmundsson*

*Governor of the Central Bank of Iceland*
*and Chair of the Monetary Policy Committee*

## Accompanying documents

No. 26/2014
20 August 2014

# Statement of the Monetary Policy Committee 20 August 2014

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged.

According to the Bank's updated forecast, published today, the outlook for the real economy over the next three years is broadly similar to that described in the May issue of *Monetary Bulletin*. However, the outlook is for slightly stronger growth in domestic demand this year and throughout the forecast horizon.

The inflation outlook has improved somewhat since May, and it now appears that inflation will remain close to target during the forecast horizon. A positive output gap is forecast to develop later than was assumed in the last forecast and will be less pronounced. Inflation expectations have changed little in the recent past, and long-term expectations are still above target.

The Bank's foreign exchange transactions in the past year have contributed to greater exchange rate stability. This year the Bank has bought significantly more foreign currency than it has sold, in both regular and *ad hoc* purchases. The Bank intends to continue its regular purchases in the current amount as long as conditions remain relatively unchanged. As before, the Bank will intervene in the foreign exchange market as needed to mitigate exchange rate volatility.

The slack in the monetary policy stance has probably disappeared, and it appears, based on the Bank's baseline forecast, that the current interest rate will suffice to keep inflation at target. Robust growth in domestic demand in the near term and growing tension in the labour market could generate increased inflationary pressures, however, and necessitate an increase in the Bank's nominal interest rates.

No. 33/2014
1 October 2014

# Statement of the Monetary Policy Committee 1 October 2014

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to keep the Bank's interest rates unchanged.

GDP growth lost pace somewhat in the first half of the year but was broadly in line with the August forecast as published in *Monetary Bulletin* 2014/3.

Inflation, which now measures 1.8%, has been below target for eight consecutive months, and the outlook for coming months is for lower inflation than was projected in August. Inflation expectations have moved towards the target in the recent term, while long-term expectations remain somewhat above it. Foreign exchange inflows have continued, but the Central Bank's intervention in the foreign exchange market has helped to stabilise the króna.

The monetary stance has tightened more than previously expected, due to more rapid disinflation and declining inflation expectations. Recent implementation of new national accounts standards introduces a measure of uncertainty about the interpretation of new data, temporarily complicating the assessment of the appropriate monetary stance. As before, robust near-term growth in domestic demand and growing tension in the labour market could generate increased inflationary pressures, however, and necessitate an increase in the Bank's nominal interest rates.

No. 36/2014
5 November 2014

# Statement of the Monetary Policy Committee
## 5 November 2014

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.25 percentage points.

According to the Bank's forecast, published in *Monetary Bulletin* today, the outlook for 2014 is for somewhat weaker output growth than was forecast in August. Domestic demand growth is still expected to be strong, with robust GDP growth in the next three years. The recovery of the labour market continues as well, although growth in labour demand has lost pace somewhat.

Inflation has been below the inflation target for nine consecutive months and has fallen still further this autumn. Rising house prices have been the main source of inflation, while low global inflation and a stable króna have contributed to low inflation in spite of considerable wage increases. The short-term inflation outlook has therefore improved since August. According to the Bank's forecast, inflation is likely to fall further in the next few months and remain at or below target through mid-2015. Inflation expectations have fallen in recent months and are approaching the inflation target.

Increased national saving and a larger current account surplus than foreseen in previous forecasts have contributed to continued strong foreign currency inflows, and the Bank has leaned against excessive appreciation of the króna and helped to stabilise the exchange rate.

The Central Bank's nominal interest rates have been unchanged for two years, but the Bank's real rate has risen more than previously anticipated, owing to a more rapid decline in inflation and inflation expectations. The monetary stance has therefore tightened more than is warranted by the current business cycle position and the near-term outlook. Containing the rise in the real rate is therefore appropriate.

As always, developments in nominal interest rates will depend on developments in demand and inflation. If pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop. Large pay increases and strong growth in demand could undermine the recently achieved price stability, however, and require that interest rates be raised again.

No. 44/2014
10 December 2014

# Statement of the Monetary Policy Committee
## 10 December 2014

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.5 percentage points.

According to the most recent national accounts figures, GDP growth – private consumption growth in particular – is likely to be weaker this year than was previously forecast. These figures deviate markedly from other indicators of domestic demand growth, however, including imports and various measures of turnover. The recovery of the labour market continues, although growth in labour demand has lost pace somewhat. The near-term outlook is for strong growth in domestic demand and GDP.

Inflation fell to 1% in November and was slightly negative excluding the housing component. Low global inflation and a stable króna have contained inflation in spite of considerable wage increases. As a result, the outlook for the near term is for lower inflation than was expected at the time of the November interest rate decision. Inflation is therefore likely to be markedly below target at least through mid-2015. Inflation expectations have fallen as well in recent months and, by most measures, are now close to target.

In spite of the nominal interest rate reduction in November, the Bank's real rate has risen further, owing to the significant decline in inflation and inflation expectations, and is higher than is warranted by the business cycle position and the near-term outlook. It is therefore appropriate to offset a portion of this increase.

As always, the nominal interest rate path will depend on developments in demand and inflation. The effective policy rate is now close to the level consistent with full capacity utilisation and inflation at target. If inflation remains below target and pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop. Large pay increases and strong growth in demand could undermine the recently achieved price stability, however, and require that interest rates be raised again.

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

# Minutes of the Monetary Policy Committee meeting, August 2014

## Published 3 September 2014

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 18 and 19 August 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 20 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 11 June interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2014/3 on 20 August.

### Financial markets

Since the MPC's June meeting the exchange rate of the króna had fallen slightly in trade-weighted terms and against the euro, and by between 1% and 1½% against the US dollar and the pound sterling. The Central Bank was an active participant in the domestic foreign exchange market over this period, with net accumulated foreign currency purchases totalling 176 million euros (roughly 27.2 b.kr.), or 47% of total market turnover during the period.

Financial institutions' market liquidity was largely unchanged between meetings, and interbank market turnover was very limited.

The monetary stance was broadly unchanged, as inflation changed little in July and nominal interest rates were unchanged. The Bank's effective real rate was 2.9% in terms of twelve-month inflation in July, and 2.2% in terms of the average of various measures of inflation and inflation expectations.

On 8 July 2014, the Republic of Iceland issued a five-year bond in the amount of 750 million euros, or the equivalent of 116 b.kr. The bonds bear 2.5% fixed interest and are issued for six years at a yield of 2.56%.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by other countries, had narrowed to 1.4-1.8 percentage points against US Treasury Bonds and 2.1 percentage points against German bonds. The CDS spread on five-year Treasury obligations had narrowed as well, to 1.4 percentage points just before the August meeting.

Unchanged Central Bank interest rates in August appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Analysts' expectations were based on the fact that a short time had passed since the last interest rate decision and that little had happened to call for a response by the MPC.

Money holdings continued to grow year-on-year in Q2, with M3 up 4.8% during the quarter, whereas M3 excluding deposits owned by special purpose vehicles and the winding-up committees of the failed financial institutions was up 5.7%.

The adjusted total stock of domestic money bank (DMB) loans to domestic borrowers grew by 1.4% year-on-year in June. Net new DMB lending to domestic borrowers totalled 11.1 b.kr., or 0.5% of the total credit stock.

The NASDAQ OMXI8 index had declined by 3% between meetings, and accumulated Main Market turnover during the first seven months of the year had contracted by about 0.7% year-on-year.

**Outlook for the global real economy and international trade**

According to the International Monetary Fund (IMF) forecast published in late July, the outlook for 2014 is for slightly weaker global output growth than in the April forecast, whereas the forecast for 2015 is unchanged. Output growth is projected at 3.4% this year instead of 3.7%, as in the last forecast, and 4% in 2015. The Fund's forecast for growth in world trade in 2014 has been revised downwards as well, by 0.3 percentage points, to 4%, whereas for 2015 it is unchanged at 5.3%. The inflation forecast for industrialised countries in 2014 is broadly unchanged, at 1.6%. The forecast for output growth among Iceland's main trading partners has been revised downwards slightly, to 1.8%. The IMF forecast remains highly uncertain, with the risk in the output growth forecast tilted to the downside.

Iceland's goods trade balance was negative in June and July, with the deficit measuring 7.6 b.kr. in June and 1.2 b.kr. in July, according to preliminary figures from Statistics Iceland. Export values contracted by nearly 5½% year-on-year in real terms in the first seven months of the year, while import values rose 6%. The downturn in export values is due principally to an 8% contraction in marine product exports, although the export value of industrial goods also contracted between years. The rise in import values stems primarily from a year-on-year increase in imports of transport equipment and consumer goods.

The price of aluminium has risen rather sharply since the MPC's June meeting. The average price in early August was about 9% above the June average. In foreign currency terms, marine product prices rose in June, for the fourth month in a row, with the month-on-month increase measuring 1.2%.

## The domestic real economy and inflation

As in the forecast published in the May issue of *Monetary Bulletin*, seasonally adjusted unemployment as registered by the Directorate of Labour (DoL) was broadly unchanged quarter-on-quarter in Q2/2014. In terms of the Statistics Iceland labour market survey, however, unemployment declined by 0.6 percentage points between quarters. In Q2, unemployment declined by 0.7-0.9 percentage points year-on-year on both measures. Adjusted for seasonality, it measured 3.8% according to the DoL and 4.6% according to the labour market survey.

According to the labour market survey, total hours worked rose by 2.6% year-on-year in Q2. As before, the rise in total hours worked is due primarily to an increase in the number of employed persons, while average hours worked rose by 0.7%.

In Q2/2014, net migration was positive for the seventh quarter in a row. The increase measured 0.1% of the labour force and was due almost entirely to an increase in foreign immigrants, which supports other indicators of growing labour demand.

According to the Statistics Iceland wage index, pay increases were somewhat larger in Q2 than was provided for in the Bank's last forecast. The wage index rose 5.2% year-on-year in H1/2014 and has risen by just over 4% since the first wage settlements were concluded in December. In June, the twelve-month rise in the index measured 5.4%, and real wages had risen by 3.1% over the same period.

Key indicators of private consumption growth in Q2 imply that growth was relatively strong during the quarter. Payment card turnover in Q2 grew 5.2% year-on-year and 1.4% quarter-on-quarter. There was also modest growth in retail sales, as well as an increase in new motor vehicle registrations. In addition, the big-ticket index rose to a new post-crisis high.

The nationwide Statistics Iceland house price index, published in late July, was unchanged from the previous month but was down by about 0.4% when adjusted for seasonality. House prices nationwide have therefore risen by 6.9% in the past twelve months, and in the first seven months of 2014 they had risen by 9% year-on-year. The capital area house price index compiled by Registers Iceland showed similar developments for the first six months of the year. The number of registered purchase agreements in the first half of 2014 was up by about 15% year-on-year, and the average time-to-sale for capital area housing was about 4½ months in June. The time-to-sale has risen somewhat in recent months but is still nearly a month shorter than it was in June 2013.

The CPI rose by 0.4% month-on-month in June and then fell by 0.17% in July. The drop in July, due to summer sales, was offset primarily by hikes in international airfares. Sales effects were similar to those from last year but somewhat weaker than during winter sales in January. Twelve-month inflation measured 2.4% in July. Underlying twelve-month inflation according to core index 3, excluding tax effects, measured 2.8% in July, and was virtually unchanged since May. However, underlying inflation according to core index 4 excluding tax effects (which excludes house prices) measured 1.9% in July, up from 1.3% in May. The increase was due to base effects from the sharp drop in core index 4 in July 2013.

Market agents' short-term inflation expectations as measured by the Central Bank's inflation expectations survey, carried out in mid-August, were broadly unchanged since the previous survey, conducted in May. Furthermore, inflation expectations in terms of the breakeven inflation rate in the bond market had changed little since the MPC's June meeting. According to these measures, inflation expectations two years ahead are around

3½%. Long-term inflation expectations (based on both the market expectations survey and the spread between indexed and non-indexed bond yields) are also broadly unchanged at about 4%, both five and ten years ahead.

Inflation has been at target since early this year, and according to the updated forecast presented in *Monetary Bulletin* 2014/3, the inflation outlook has improved somewhat since May, primarily because the slack in the economy is now considered somewhat more pronounced. On the other hand, unit labour costs are now estimated to grow more rapidly, due mainly to slower productivity growth than previously projected, although wages have also risen more this year than was previously assumed. The short-term inflation outlook is similar to that in May. According to the forecast, inflation will average 2.4% this year. Next year it is expected to rise modestly as spare capacity disappears from the economy, averaging about 2.8% in 2015 and 2.9% in 2016. According to the forecast, inflation will peak at 3% in the latter half of the forecast horizon and then begin to subside to target in mid-2017.

Global output growth has been relatively weaker year-to-date than was forecast in May but is expected to gain momentum over the next two years. The improvement in terms of trade is becoming ever more obvious, however, and the outlook for export prices has improved still further. The outlook for exports has improved as well, due mainly to growth in services exports this year.

Furthermore, the labour market continues to recover. Total hours worked rose somewhat more in Q2 than was forecast in May. The outlook for the upcoming two years has also improved since May, with growth projected to average 1.8% over the forecast horizon. Registered unemployment is projected at 3.7% this year and is expected to fall to 3.4% in 2016, which is broadly in line with the May forecast.

Preliminary figures from Statistics Iceland indicate that GDP was unchanged in Q1, in spite of more than 5% growth year-on-year in consumption and investment combined. This is considerably weaker GDP growth than was forecast in May, due primarily to one-off items that are not considered to reflect underlying developments in GDP growth. As a result, GDP growth is projected at 3.4% this year, slightly below the May forecast. It is expected to gain momentum next year, measuring 3.9%, owing to strong investment in the energy-intensive sector and to stimulative Government measures. As in May, GDP growth is expected to decline to 2.8% in 2016, when domestic demand growth loses momentum. Domestic demand is now projected to grow by an average of 5½% per year during the forecast horizon, instead of just over 4½%, as was forecast in May.

It is assumed there will be an underlying current account surplus of about 1% of GDP this year. However, as in the May forecast, a deficit is expected to develop beginning next year and amount to about 2½% of GDP in 2016, a somewhat larger deficit than was forecast in May.

## 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 experience gained from the Bank's foreign exchange market intervention in the past year. It noted that the exchange rate of the króna had remained virtually unchanged between meetings despite substantial foreign currency purchases by the Central Bank. This year the Bank had bought significantly more foreign currency than it had sold, in both regular and *ad hoc* purchases. Committee members agreed that the Bank's foreign exchange transactions in the past year had contributed to greater exchange rate stability. In view of this, the Committee considered it appropriate to continue regular purchases in the current amount as long as conditions remain relatively unchanged, and to continue intervening in the foreign exchange market as needed to mitigate exchange rate volatility.

The Committee discussed the outlook for the domestic economy, including the Bank's new macroeconomic forecast. The Committee noted that Statistics Iceland's GDP growth figures for Q1/2014 were affected by strong services imports and an unusually marked contraction in marine product inventories. Members were of the view that these figures were not indicative of underlying developments in GDP growth. They agreed that the economic outlook for the next three years, as presented in the Bank's updated forecast, was broadly in line with the forecast in the May issue of *Monetary Bulletin*. However, they noted that the outlook was now for somewhat stronger growth in domestic demand, both this year and throughout the forecast horizon, than was assumed in May. As before, members were concerned about reduced national saving in view of Iceland's balance of payments problem, particularly because the current account deficit is now projected to be slightly larger in the latter half of the forecast horizon than was provided for in the May forecast. In part, however, the deficit reflects increased investment in sectors that will generate export revenues in the future.

Members agreed that the inflation outlook had improved somewhat from the Bank's last forecast. To a large extent, this is because the positive output gap is expected to develop later and to be less pronounced than previously assumed. As a result, the outlook was for inflation to remain close to target during the forecast horizon. Members agreed, however, that near-term inflation risk remained tilted to the upside because of growing tension in the labour market during the run-up to the forthcoming wage negotiations. On the other hand, the risk related to global inflation was tilted to the downside. In view of low global inflation, recent exchange rate developments, and recent developments in imported inflation, the Committee discussed whether inflation was likely to subside still further in coming months. As before, however, Committee members were concerned that inflation expectations had changed little in the recent term and that long-term expectations were still somewhat above the inflation target.

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

The Committee agreed that the slack in the monetary policy stance had probably disappeared and that it appeared, in view of the Bank's baseline forecast, that the current interest rate would suffice to keep inflation at target. Nonetheless, the Committee was of the view that robust growth in domestic demand in the near term and growing tension in the labour market could generate increased inflationary pressures and necessitate an increase in the Bank's nominal interest rates.

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 1 October 2014.

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

# Minutes of the Monetary Policy Committee meeting, October 2014

## Published 15 October 2014

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 30 September 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 1 October, 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 20 August interest rate decision.

### Financial markets

According to key indicators from the financial markets, the situation was broadly unchanged since the previous meeting.

The exchange rate of the króna was virtually unchanged in trade-weighted terms, even though the Central Bank's net purchases in the domestic foreign exchange market had totalled 157 million euros (about 24.1 b.kr.), or around 51% of market turnover.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by other countries, had narrowed somewhat just before the meeting, to 1.1-1.5 percentage points against US Treasury Bonds and 1.8 percentage points against German bonds. The CDS spread on five-year Treasury obligations had narrowed somewhat as well, to 1.3 percentage points.

Money holdings continued to grow year-on-year, with M3 up 5.5% in August, excluding deposits owned by special purpose entities and the winding-up committees of the failed financial institutions.

The total adjusted stock of loans from deposit money banks (DMB) to resident borrowers grew slightly in August. Over the first eight months of the year, the accumulated increase in lending to resident borrowers was almost 8½% greater than over the same period in 2013.

The Nasdaq OMX Iceland exchange's OMXI8 index had risen slightly between meetings, and turnover in the main market had contracted.

However, the monetary stance had tightened between meetings in terms of twelve-month inflation, which had declined somewhat between August and September. The Bank's effective real rate was about 2.3% in terms of various measures of inflation and inflation expectations, slightly higher than at the previous meeting.

Unchanged Central Bank interest rates in October appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Analysts' expectations were based on the fact that, although twelve-month inflation was below target and the real policy rate had risen, inflation expectations were still above target and the economic outlook was broadly unchanged since the last meeting.

**Outlook for the global real economy and international trade**

According to the International Monetary Fund (IMF) forecast published in early September, the outlook is for weaker global output growth in 2014 and 2015 than was assumed in the Fund's July forecast. The same applies to the forecast for world trade. The output growth outlook for industrialised countries is unchanged for 2014. For Iceland's main trading partners, growth for the year is projected at 1.7%, or 0.1 percentage points less than was assumed in July. The uncertainty in the IMF's output growth forecast has increased somewhat and is tilted to the downside. In general, the Fund expects an unchanged inflation outlook. The Organisation for Economic Co-operation and Development's (OECD) updated forecast for output growth among Iceland's trading partners, published in September, accords with the IMF forecast.

Iceland's external goods trade generated a deficit of 9 b.kr. for the first eight months of the year, as opposed to a surplus of 26 b.kr. over the same period in 2013. Export values contracted by 3.9% at constant exchange rates, while import values rose 5.9%. The contraction in exports is due mainly to a 7.4% decline in marine product exports and a 2% decline in industrial goods exports. The rise in imports over the first eight months of the year stems primarily from an increase of 38% in transport equipment imports.

In terms of relative consumer prices, the real exchange rate index was 83.8 points in August. It has been virtually unchanged for seven months but has risen 4.2% year-on-year. The increase is due primarily to a 3.1% nominal appreciation of the króna, but in addition, inflation in Iceland was above the average among its trading partners.

Aluminium prices have fallen by nearly 7% since the last MPC meeting, although the average price in September was up roughly 13% year-on-year. The foreign currency price of marine product prices rose in August by 2.4% month-on-month and 8.6% year-on-year.

**The domestic real economy and inflation**

According to preliminary figures published by Statistics Iceland in September, GDP growth measured 0.6% in H1/2014 and 2.4% in Q2/2014. Seasonally adjusted GDP grew by 3.9%

quarter-on-quarter, according to seasonally adjusted Central Bank figures. The national accounts are now published according to new standards, and other improvements have been made as well. This complicates all comparison with previously published figures and forecasts. Year-2013 GDP was adjusted upwards by 4.9% in nominal terms from Statistics Iceland's previous figures, and GDP growth increased by 0.2 percentage points, to 3.5%.

Other improvements had some impact on private consumption growth, which is now assumed to have increased by 4% year-on-year in the first half of 2014. Other components of domestic demand contributed less to GDP growth, and overall domestic demand growth measured 2.8% in the first half of the year. The contribution from net trade was negative, as import growth measured 9% in the first half of the year, as opposed to 3.7% for export growth.

GDP growth was half a percentage point more in Q2 than was forecast in the August *Monetary Bulletin*, but after a downward revision of Q1 figures, GDP growth for H1 turned out slightly weaker, or 0.6% instead of the 0.9% provided for in the forecast.

Upon revision of the national accounts, the year-2013 investment-to-GDP ratio rose from the previously published 13.6% to 15.1%, and the underlying current account surplus rose from 6.2% of GDP to 7.8%. National saving for the year therefore rose from 19.7% of GDP to 22.5% upon revision. According to new figures, in 2013 national saving also increased somewhat more year-on-year than previous figures had indicated, or 2.9 percentage points, as opposed to the previously published 2 percentage points.

The underlying current account surplus measured 2.7% of GDP, or 12.8 b.kr., in Q2, as opposed to 2.3% of GDP during the same quarter in 2013. This year's surplus stems from a surplus on goods and services trade in the amount of 3.2% of GDP and a surplus on the primary income balance amounting to 0.2%. Secondary income was negative, however, by 0.7% of GDP.

Key indicators of developments in private consumption suggest continuing growth in Q3; for instance, payment card turnover was up 4% year-on-year in July and August. New motor vehicles registrations increased markedly, and retail sales were up substantially, particularly for specialty items.

Measurements of consumer sentiment in August and September indicate that optimism is on the rise. The big-ticket index, also published in September, rose 0.6 points quarter-on-quarter and almost 6 points between years, to its highest measurement since September 2008.

According to the fiscal budget proposal for 2015, the surplus on Treasury operations is projected to be considerably larger this year than was assumed in the 2014 National Budget, owing to much larger dividend payments from Landsbankinn and the Central Bank of Iceland. According to the budget proposal, the aim is to achieve a Treasury surplus on an accrual basis in 2014-2018. If the proposal is passed unamended, it can be assumed that the primary and overall balances will deteriorate by 1.8% of GDP in 2015. Between 2015 and 2018, it is estimated that the overall balance will improve by 1.2% of GDP and the primary balance by 0.8%. If the assumptions in the budget proposal prove accurate, the fiscal stance will ease slightly, as the cyclically adjusted primary surplus will decline by 0.1% of GDP between 2014 and 2015.

Seasonally adjusted unemployment as registered by the Directorate of Labour (DoL) averaged 3.8% in July and August, a decline of 0.8 percentage points year-on-year.

According to the Statistics Iceland labour market survey, however, unemployment was unchanged year-on-year at 5.1%.

The wage index rose by 0.6% month-on-month in August, and by 6.3% year-on-year. Real wages in terms of the wage index rose by 0.3% between months and about 3.9% year-on-year.

According to Capacent Gallup's September survey among executives from Iceland's 400 largest firms, the share of respondents interested in adding on staff in the next six months exceeded the share interested in downsizing by about 7.4 percentage points. This indicates slightly less optimism than in the survey carried out in June but much more than in the survey from September 2013.

In the September survey, executives were much more optimistic about the economic outlook than in the June survey. Just under a third of respondents considered the current situation good, and just over half considered it neither poor nor good. On the other hand, executives were more optimistic about the future situation, with nearly 46% of respondents indicating that they expected conditions to improve in the next six months and a similar share of respondents indicating that they expected no change. Executives from all sectors except fisheries were more optimistic than in June, with the greatest improvement in the retail and financial services sectors.

The nationwide house price index compiled by Statistics Iceland rose by 0.8% quarter-on-quarter in Q3 adjusted for seasonality, and 7.6% year-on-year. The Registers Iceland capital area real estate price index rose by 3% month-on-month in August adjusted for seasonality, and 9.3% year-on-year. The number of purchase agreements registered nationwide rose by 14% year-on-year in the first eight months of 2014. The average time-to-sale for flats in the greater Reykjavík area was just over four months in the first eight months of 2014, as opposed to five months during the same period in 2013.

The CPI declined by 0.12% month-on-month in September, after rising by 0.24% in August. A steep drop in international airfares was the main driver of the decline, lowering the index by 0.5 percentage points. Various imported goods prices fell as well, including imported food, petrol, and housewares and furniture. Summer sales continued to wind down, and clothing and footwear prices rose by 3.3% between August and September. It appears that the effects of summer sales have not reversed in full, however, probably due to the appreciation of the króna and the increased exchange rate stability recently. Twelve-month inflation measured 1.8% in September, a decline of 0.6 percentage points since the last MPC meeting. The housing component has been the main driver of inflation, accounting for 1.4 percentage points. The CPI excluding housing fell 0.4% in September, and twelve-month inflation excluding housing measured 0.4%. Underlying inflation measured by core index 3 excluding tax effects was 2.1% in September, and underlying inflation according to core index 4, which excludes house prices as well, measured 0.8%. Both measures of inflation had fallen markedly since the August meeting.

According to the Capacent Gallup survey of household expectations carried out in September, household inflation expectations one and two years ahead were unchanged since the May survey, at 4%. In a comparable survey conducted among firms in September, one-year inflation expectations measured 3%, which was also unchanged since the last survey, whereas two-year expectations had fallen by ½ a percentage point and also measured 3%. The breakeven inflation rate in the bond market had subsided somewhat since the MPC's August meeting, which could indicate that inflation expectations are falling.

The two-year breakeven inflation rate was around 3.2%, as compared with 3.4% in mid-August. Long-term inflation expectations appear to have subsided as well. The five- and ten-year breakeven inflation rate was about 3½%, a decline of ½ a percentage point since August.

**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. He also reported to the Committee on the work done by the Bank concerning the request for exemptions from the Foreign Exchange Act in connection with the lengthening and amendment of the bonds between LBI hf. and Landsbankinn hf.

The Committee discussed new national accounts data and the impact that new standards and other changes had made on the results. Members considered it a positive development that national saving was now estimated to have been greater in 2013 than previous figures had indicated, as increased national saving facilitates the resolution of Iceland's balance of payments problem.

They also discussed the fiscal budget proposal for 2015 and the medium-term fiscal consolidation programme.

Committee members noted that the exchange rate of the króna had remained virtually unchanged between meetings in spite of continued foreign exchange inflows. They agreed that the Central Bank's intervention in the foreign exchange market had supported increased stability, which had contributed to below-target inflation for eight consecutive months, as well as improved prospects for inflation in coming months than was projected in August.

In the Committee's opinion, there were grounds for either keeping interest rates unchanged or lowering them. The main argument in favour of a rate reduction discussed at the meeting was that the monetary stance had tightened more than previously expected, owing to more rapid disinflation. Furthermore, the outlook for the next few months was for more favourable developments in inflation than was forecast in August. As a result, current interest rates could be too high. Moreover, it was pointed out that inflation expectations had moved towards the Bank's inflation target in the recent term, although the Committee agreed that it was cause for concern that they were still somewhat above target. As before, inflation expectations above target were an argument in favour of unchanged interest rates, in spite of a decline in observed inflation. By the same token, Committee members were of the view that robust near-term growth in domestic demand and growing tension in the labour market could generate increased inflationary pressures and necessitate an increase in the Bank's nominal interest rates.

In the Committee's opinion, uncertainty about economic developments was greater than usual at present. In particular, members were concerned that the recent implementation of new national accounts standards had added temporarily to uncertainty about the interpretation of data, complicating the assessment of the appropriate monetary stance.

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

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 and representatives of the Ministry of Finance and Economic Affairs attended parts of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 5 November 2014.

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

# Minutes of the Monetary Policy Committee meeting, November 2014

## Published 19 November 2014

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 3 and 4 November 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 5 November, 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 1 October interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2014/4 on 5 November.

### Financial markets

The exchange rate of the króna had risen by 0.3% in trade-weighted terms since the last meeting and by 0.1% against the pound sterling but had fallen by 0.5% against the euro and about 1% against the US dollar. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 84 million euros (roughly 12.9 b.kr.), or 42% of total market turnover during the period.

Financial institutions' market liquidity was largely unchanged between meetings, and their market activity was very limited.

In terms of the average of various measures of inflation and inflation expectations, the monetary stance had tightened somewhat between meetings. The Bank's real rate thus measured had risen by 0.1 percentage points, to just under 2½%. In terms of annual inflation, the real rate was 3.4% and had declined by 0.1 percentage points between meetings.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by other countries, had increased slightly, to 1½-2 percentage points against US Treasury Bonds and 1.9 percentage points against German bonds, just before the November meeting. The CDS spread on five-year Treasury obligations had also risen slightly, to 1.4 percentage points.

Unchanged Central Bank interest rates in November appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Analysts' expectations were based on the fact that, although twelve-month inflation was below target and the real policy rate had risen, inflation expectations were broadly unchanged and developments in the labour market were uncertain.

Money holdings continued to grow year-on-year in Q3, with M3 up 6.1%, excluding deposits owned by special purpose entities and the winding-up committees of the failed financial institutions. Growth is still driven primarily by an increase in corporate deposits, although household deposits are also on the rise.

The adjusted total stock of loans from deposit money banks (DMB) to resident borrowers grew by 1.4% year-on-year in Q3. Net new lending from DMBs to resident borrowers rose 4.3% year-on-year in the first nine months of the year, to 113 b.kr.

The NASDAQ OMXI8 index had risen by 4.2% between meetings, and accumulated Main Market turnover during the first ten months of the year had grown by just over 2% year-on-year.

### Outlook for the global real economy and international trade

Iceland's external goods trade generated a deficit of just over 16 b.kr. for the first nine months of the year, as opposed to a surplus of almost 27 b.kr. over the same period in 2013. Export values contracted by 1.6% at constant exchange rates, while import values rose 8.9%. The contraction in exports is due mainly to a 7.7% decline in marine product exports and a 1% decline in industrial goods exports. The rise in imports stems primarily from an increase of 63% in transport equipment imports and a 15% increase in consumer goods imports.

In terms of relative consumer prices, the real exchange rate index stood at 83.5 points in September. It has been virtually unchanged for eight months but has risen 5.5% year-on-year. The year-on-year increase is due primarily to a 4.6% nominal appreciation of the króna, but in addition, inflation in Iceland was nearly a percentage point above the average among its trading partners.

Aluminium prices had risen by just over 7% since the MPC's last meeting, and the average price in October was 7% higher than it had been a year earlier. Foreign currency prices of marine products had declined by 1.7% month-on-month in September but had risen by 6.8% year-on-year.

### The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked rose somewhat more slowly in Q3 than in previous quarters, or about 0.7% year-on-year. The rise in total hours worked is due primarily to an increase in the number of employed persons, while average hours worked declined by 0.7%.

Seasonally adjusted unemployment measured 5.2% in Q3, according to the LFS. It rose slightly between quarters but declined by 0.2 percentage points year-on-year. Unemployment as registered by the Directorate of Labour (DoL) measured 3.8% in Q3, after adjusting for seasonality. It had declined marginally between quarters and by 0.8 percentage points between years.

In Q3/2014, net migration was positive for the eighth quarter in a row. The increase amounted to 0.2% of the labour force and was due almost entirely to foreign nationals.

The wage index rose by 1.5% between Q2 and Q3 and by 6.1% year-on-year. Real disposable income rose by 4% over the same period.

Key indicators of private consumption in Q3/2014 suggest strong growth from the previous year. Payment card turnover was up nearly 4% year-on-year during the quarter, and card turnover abroad rose steeply. Retail sales also continued to grow, particularly sales of durable consumer goods such as electrical and electronic equipment. There was also a strong increase in new motor vehicle registrations during the quarter.

Statistics Iceland's nationwide house price index, published in late October, was up 0.6% month-on-month and 1.3% when adjusted for seasonality. It has risen 9.3% in the past twelve months. The capital area real estate price index calculated by Registers Iceland remained unchanged from the previous month in September but was up 8.4% year-on-year. The number of purchase agreements registered nationwide rose by just under 14% year-on-year in the first nine months of 2014. The average time-to-sale for flats in the greater Reykjavík area was just over four months in the first nine months of 2014, as opposed to five months during the same period in 2013.

According to a survey conducted by Capacent Gallup, consumer sentiment deteriorated month-on-month in October, with the Consumer Sentiment Index measuring 75.9 points, 8.4 points higher than in October 2013. All subcomponents of the index declined rather strongly between months, and all measured under 100 points. In September, the Capacent Gallup big-ticket index measured 59.7 points, its highest value since September 2008.

The CPI rose by 0.14% month-on-month in October, and twelve-month inflation measured 1.9%, an increase of 0.1 percentage points since September. The decline in petrol prices had the strongest effect, lowering the index by 0.15 percentage points, while rising house prices pulled in the opposite direction. An error was made in calculating airfares in September, resulting in an overestimation of the CPI effect of the month-on-month decline. This was corrected in October, and airfares had an upward effect on the index of 0.14 percentage points, whereas they would have been virtually unchanged otherwise. The CPI excluding housing rose 0.03% in October, and twelve-month inflation by that measure was 0.5%. Underlying inflation as measured by core index 3 excluding tax effects was 2.5% in September, and underlying inflation according to core index 4, which excludes house prices as well, measured 1%. By both measures, inflation rose between September and October, although it is still below the year-to-date average.

According to the Central Bank survey carried out in late October, market agents' short-term inflation expectations have declined since August. Respondents projected inflation at 2.8% in one year and 3% in two years, and their expectations have declined by ½ a percentage point from the August survey. Market agents' long-term inflation expectations have also fallen. Survey respondents expect inflation to average 3% over the next five years and 3.2% over the next ten years, which is a reduction of approximately 0.8 percentage points from the August survey. The two-year breakeven inflation rate in the bond market as calculated from the spread between indexed and non-indexed bond interest was just over 3% right before the meeting and was broadly unchanged since the October meeting. The five- and ten-year breakeven rate was about 3.7%, also virtually unchanged since the last meeting but almost ½ a percentage point less than in October 2013.

According to the forecast published in *Monetary Bulletin* on 5 November, if the effects of indirect taxes on the price level are excluded, the outlook through the end of next year is for lower inflation than was projected in August, owing to a more favourable initial position. Over time, pressures from the labour market and a diminishing slack in the economy will cause inflation to rise again. As in the August forecast, it is expected to measure 2½-3% in the latter half of the forecast horizon.

Global output growth for H1/2014 turned out weaker than previously assumed. The GDP growth outlook for Iceland's main trading partners is also poorer for H2/2014 and the upcoming three years than it was in August. This is due mainly to the bleaker outlook for emerging economies and the eurozone, although prospects have improved for the UK, the US, and the Nordic countries. Trading partners' GDP growth is projected at 1.8% for 2014 and just over 2% per year in the next three years. Uncertainty about the global economic outlook has also increased but is somewhat less than it was a year ago.

According to revised figures from Statistics Iceland, Iceland's terms of trade have deteriorated by 20% since 2006 instead of the previously estimated 17%. As was projected in August, terms of trade began to improve in Q2/2014, after a continuous erosion dating back to early 2011. They are now estimated to improve by some 1% this year, which is more than was forecast in August. The outlook for the next three years is somewhat poorer than was projected in August, however.

Statistics Iceland's revised year-2013 export figures show considerably stronger growth than previously estimated. This year's weaker growth therefore reflects negative base effects to some extent. In line with the poorer outlook for global output growth, export growth is forecast to be somewhat weaker than was assumed in August; exports are now projected to grow by an average of just under 3% per year, broadly in line with trading partners' import growth.

The output growth outlook for the year as a whole has deteriorated somewhat since August. Output growth is now expected to measure just over 5% in the latter half of the year and 2.9% for the year as a whole, about ½ a percentage point below the August forecast. As in August, it is expected to pick up again next year, rising to 3.5%, and then subside to just under 3% in 2016 and just under 2½% in 2017.

As before, it is expected that output growth will be driven primarily by growth in private sector demand and that the contribution from net trade will be negative during the forecast horizon. If the forecast materialises, output growth will average about 2.9% per year over the forecast horizon, slightly above the thirty-year average and well above the forecasted 2.1% average for Iceland's main trading partners.

It is still assumed that the slack in the labour market will disappear in the near future, even though labour demand growth has lost pace somewhat. Unemployment as defined by the Statistics Iceland labour force survey is forecast to continue declining and is expected to measure about 4% in coming years. Hours worked are expected to increase by an average of nearly 2% per year in the next three years, bringing the employment rate to 77½% by the end of the forecast horizon. Productivity growth over the three-year period will average only 1% per year, however, which is somewhat below the August forecast and just over half the historical average.

Owing to the revision of wages and related expenses, the rise in unit labour costs was slightly less, on average, in recent years than previously estimated. It is assumed that this year's increase in unit labour costs will be broadly in line with the August forecast, or just under 5%, as weaker productivity growth will offset smaller pay increases. The outlook is for growth to exceed the August forecast in the next two years, when larger pay increases and weaker productivity growth both pull in the same direction. If the forecast materialises, however, growth in unit labour costs will have aligned with the inflation target by 2017.

The slack in the economy is now thought to have been somewhat smaller in 2013 than was assumed in August, and it is projected to disappear in the latter half of this year, somewhat earlier than was forecast then. The positive output gap expected in coming quarters is also projected to be slightly larger than was forecast in August, although smaller than in the May forecast. The output gap is forecast to average just under 1% over the next two years and then begin to diminish. It will have all but disappeared by 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 various uncertainties in the forecast that could change the inflation outlook from that assumed in the baseline scenario. For example, if the króna is weaker or wage increases larger than expected, there is the risk that the inflation outlook in the baseline 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 or if energy-intensive development activity turns out stronger in coming years than the forecast indicates. Because long-term inflation expectations are still insufficiently anchored, the deviations could prove larger than they would otherwise. Inflation could turn out lower than forecast, however, if the slack in the economy is underestimated, if domestic demand proves weaker than assumed, or if the global economic outlook is poorer than currently expected. The same applies if weaker global output growth also entails larger declines in global oil and commodity prices.

## 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. He also reported to the Committee on the work done by the Bank concerning the request for exemptions from the Foreign Exchange Act in connection with the lengthening and amendment of the bonds between LBI hf. and Landsbankinn hf. Also discussed were the financial interactions between the Treasury and the Central Bank and the ongoing discussions concerning changes in the framework for these interactions.

Committee members discussed the Bank's *Financial Stability* report, published after the October MPC meeting, financial institutions' position and restructuring measures, and the progress made with private sector debt restructuring. They also discussed the risks facing the financial system because of Iceland's balance of payments problem, as well as the potential impact on overall financial stability and the financial position of Landsbankinn should the above-mentioned Landsbankinn-LBI bond not be lengthened.

The Committee discussed the outlook for the domestic economy, including the Bank's new macroeconomic forecast. Members agreed that the outlook for 2014 was for somewhat weaker output growth than was forecast in August, but that the short-term inflation outlook was better, with inflation falling still further this autumn. Rising house prices are the main source of inflation, while inflation stemming from domestic goods and services prices has lost pace and was at target in October. Low global inflation and a stable króna have contributed to low inflation in spite of considerable wage increases, however. The disinflation appears to be relatively broad-based. Inflation is expected to decline still further in the next few months and to remain at or below target through mid-2015. By the same token, it appears that some progress has been made in anchoring inflation expectations, which have fallen in recent months and are approaching the inflation target.

On the other hand, Committee members were concerned about the longer-term forecast of rising inflation. The forecast also assumed continued robust domestic demand growth and GDP growth in the next three years. The slack in the economy was about to turn around into a positive output gap, and the outlook was for increased wage pressures from the labour market, as the labour market is expected to continue recovering even though labour demand growth has slowed down in the recent term.

Committee members considered it positive that the outlook was for increased national saving and a larger current account surplus than had been foreseen in previous forecasts, thereby facilitating the resolution of Iceland's balance of payments problem. New figures also indicated that the current account deficit was smaller in H1/2014 than previously estimated. In the Committee's opinion, this has played a role in maintaining strong foreign currency inflows. The Central Bank has leaned against excessive appreciation of the króna and helped to stabilise the exchange rate.

In the Committee's opinion, there were grounds for lowering interest rates and for keeping them unchanged. As at the last MPC meeting, the main argument in favour of lowering interest rates was that the monetary stance had tightened more than previously expected. The Central Bank's nominal interest rates had been unchanged for two years, but the Bank's real rate had risen more than anticipated, owing to a more rapid decline in inflation and inflation expectations. The monetary stance had therefore tightened more than was warranted by the business cycle position and the near-term outlook. Inflation expectations had subsided towards the target in the recent past and, by some measures, were close to it, particularly short-term expectations. According to the forecast, inflation would be close to target for virtually the entire forecast horizon. As a result, it was appropriate to contain the rise in the real rate. Some Committee members also thought it likely that the rise in housing costs would ease soon because demand and construction costs had stabilised. The disinflation episode also appeared to be relatively broad-based, giving occasion to assume that inflation would remain low. By the same token, the global economic recovery was weaker and global inflation low, which would affect demand for Iceland's exported goods; however, imported inflation would be negligible and probably even negative in the near future. The output growth outlook in Iceland was also poorer than previously forecast. In addition, the recovery of the labour market was somewhat weaker than it had been in the recent past, and weaker than was forecast in August; for instance, the increase in total hours worked had lost pace steadily in the past year. Global price developments and declining inflation expectations also increased the likelihood that upcoming wage settlements would be in line with the inflation target. Inflationary pressures would therefore be limited if wage settlements were consistent with the inflation target and demand remained under control.

As before, the main reasons for keeping interest rates unchanged were that inflation expectations were still above target and that, in the past, they had declined as they have done recently, only to rise again. Furthermore, it was pointed out that an improved short-term inflation outlook was due to an improved initial position rather than to more positive prospects for the future. Further ahead, increased inflationary pressures could be expected, as domestic demand was still forecast to grow strongly in coming quarters, the slack in the economy was expected to disappear sooner than previously projected, and the slack in the labour market was almost fully absorbed. Unit labour costs were forecast to rise somewhat more than previously assumed, and more than is consistent with the inflation target. The scope for pay increases in upcoming wage negotiations was limited, given the slow rate of productivity growth. Therefore, there could be reason to wait until most wage settlements have been finalised, particularly in view of the lags in monetary policy transmission.

There was also some discussion about whether it was appropriate to wait until the next meeting, only a few weeks away, because the Q3 national accounts, a new inflation measurement, and new figures from the labour market would be available by that time.

In view of the discussion, the Governor proposed that the policy rate be reduced by 0.25 percentage points, which would lower the Bank's current account to 4.75%, the rate on seven-day term deposits to 5%, the seven-day collateralised lending rate to 5.75%, and the overnight rate to 6.25%.

Four members voted in favour of the Governor's proposal, although one of them would have preferred to keep rates unchanged at this time. This member agreed that the economic recovery had lost some momentum but was concerned about the unrest in the labour market and the effect of the Government's debt relief measures on demand once the results had been publicised. This member would have preferred to wait with a rate cut until December, when the decision could reflect new national accounts data, evidence on declining inflation and inflation expectations had been reconfirmed, the results of the debt relief measures had been publicised, and the market had been prepared by the MPC's November statement for a possible rate reduction. This member decided to vote in favour of the Governor's proposal, however, due to the small difference between the two.

One member who supported the Governor's proposal attributed the disinflation episode to moderate wage settlements in the past year, foreign currency inflows, and the Bank's policy on foreign exchange market intervention. A positive real rate had increased domestic saving and prevented bubble formation in the real estate and equity markets. On the other hand, the real rate was too high at present, particularly in terms of commercial banks' lending rates rather than Central Bank rates.

One member voted against the Governor's proposal, preferring to keep rates unchanged. This member was of the opinion that, in spite of positive developments in the recent past, each interest rate decision should be based on forward-looking considerations rather than current developments. Although inflation was projected to subside still further in the near future, it was expected to inch upwards again further ahead, owing to inflationary pressures from the labour market and the diminishing slack in the economy. Although long-term inflation expectations had moved towards the Bank's inflation target, it was appropriate to move cautiously in view of historical developments and the outlook for the labour market. Furthermore, the uncertainty concerning inflation was somewhat concentrated on the upside.

Committee members agreed that, as always, developments in nominal interest rates will depend on developments in demand and inflation. Members were of the view that if pay increases in upcoming wage settlements are consistent with the inflation target, the conditions could develop for further reductions in nominal interest rates, other things being equal. On the other hand, they were of the opinion 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 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 December 2014.

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

# Minutes of the Monetary Policy Committee meeting, December 2014

## Published 24 December 2014

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 9 December 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 10 December, 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 5 November interest rate decision.

**Financial markets**

Since the Committee's last meeting, the exchange rate of the króna had risen by just over ½% in trade-weighted terms and by ¾% against the pound sterling but had fallen by just over 0.1% against the euro and 1.4% against the US dollar. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 60 million euros (roughly 9.2 b.kr.), or 35% of total market turnover during the period.

Financial institutions' liquidity has remained abundant, and overnight interbank market rates have been below the centre of the interest rate corridor. Interest rates fell by 0.35 percentage points following the Central Bank's rate reduction on 5 November but had risen again, in line with increased market turnover, to around 5.25% just before the Committee's December meeting. Interbank market turnover totalled just under 102 b.kr. between meetings and about 188 b.kr. year-to-date, about half that recorded during the same eleven-month period in 2013.

Yields on nominal and indexed bonds declined by 0.2-0.4 percentage points following the November interest rate reduction. Yields on nominal bonds fell still further, both after the November CPI was published at the end of the month and after the national accounts were published in December, whereas real yields rose. Indexed bond yields had risen again, however, and were close to the level seen at the time of the November meeting.

In spite of the nominal policy rate reduction, the monetary stance had tightened between meetings, owing to declining inflation and inflation expectations. The Bank's real rate was 2.6% in terms of the average of various measures of inflation and inflation expectations, an increase of 0.2 percentage points; however, in terms of measures for which new data were available since November, it had risen by 0.4 percentage points. In terms of twelve-month inflation, the real rate was 4% and had risen by 0.7 percentage points.

The risk premium on the Treasury's foreign obligations, in terms of the spread between foreign-denominated Treasury bonds and comparable bonds issued by other countries, was broadly unchanged. Just before the December meeting, it measured about 1½ percentage points against US Treasury Bonds and 2 percentage points against German bonds. The CDS spread on five-year Treasury obligations was also broadly unchanged, at 1.4%.

Financial institutions' research departments had projected that the Bank's nominal policy rate would be lowered by 0.25-0.50 percentage points in December. They based their forecasts on the rise in the Bank's real rate in spite of the rate cut in November and the fact that nine-month GDP growth figures had been well below expectations.

Money holdings continued to grow year-on-year in October, with M3 up 4.7%, excluding deposits owned by special purpose entities and the winding-up boards of the failed financial institutions. Growth has been driven mainly by increased household and corporate deposits.

The adjusted total stock of loans from deposit money banks (DMB) to resident borrowers grew by 2.6% year-on-year in October. Net new lending from DMBs to resident borrowers rose 1.8% year-on-year in the first ten months of the year, to 137 b.kr.

The NASDAQ OMXI8 index had risen by nearly 10% between meetings, and accumulated Main Market turnover during the first eleven months of the year had grown by almost 9% year-on-year.

**Outlook for the global real economy and international trade**

According to the Organisation for Economic Co-operation and Development's (OECD) November forecast, GDP growth and inflation in member states will be somewhat weaker this year than in the OECD's May forecast. The same applies to the OECD's forecast for world trade. The weaker GDP growth forecast for 2014 is due primarily to a downward revision of the forecasts for the US, the euro area, Japan, and the Nordic region. For 2015, GDP growth is projected at 2.3%, about half a percentage point below the May forecast. The main difference lies in a 0.6 percentage point reduction in the forecasts for the euro area and Norway and a 0.4 percentage point reduction for the US, Japan, and Denmark. For Iceland's main trading partners, the forecast for year-2015 GDP growth has therefore been revised downwards by 0.6 percentage points, to 1.9%. The OECD forecast assumes 2.3% growth for Iceland's main trading partners in 2016. *Consensus Forecasts'* 2014 and 2015 projections for Iceland's trading partners were unchanged since the November MPC meeting.

Iceland's external goods trade generated a surplus of 900 m.kr. for the first eleven months of the year, as opposed to a surplus of just under 47 b.kr. for the same period in 2013. Export values were unchanged at constant exchange rates, while import values rose 9.2%. Industrial goods export values rose by just over 3%, while marine product export values contracted by nearly 8%. The growth in imports is due primarily to a 52% rise in imports of transport equipment, a nearly 8% increase in good and beverage imports, and a 7% increase in imports of other consumer goods.

The real exchange rate measured 83.1 points in terms of relative prices in November and has been virtually unchanged for ten months but has risen about 5.7% year-on-year. The increase is due almost entirely to a 5.6% nominal appreciation of the króna, but in addition, inflation in Iceland was marginally above the average among its trading partners.

Aluminium prices have fallen by just over 5% since the last MPC meeting, although the average price was up 17½% year-on-year in November. Foreign currency prices of marine products had risen by 2.1% month-on-month in October, however, and by just over 10% year-on-year.

**The domestic real economy and inflation**

According to preliminary figures published by Statistics Iceland in December, GDP contracted by 0.2% year-on-year in Q3. GDP growth was therefore considerably weaker than was forecast in the November issue of *Monetary Bulletin*, which assumed a growth rate of 3.2% for the quarter. The discrepancy is explained by weaker growth in private consumption and investment. GDP grew by 5.8% year-on-year in nominal terms in spite of a small contraction in real terms. To an extent, this weakness in Q3 is probably due to the fact that Statistics Iceland lacks data on domestic retailers' inventory accumulation when compiling the expenditure accounts. Large increases in consumer goods imports during the quarter therefore emerge as a deduction in GDP accounting, whereas the positive effect of inventory accumulation is missing. When the accumulated inventories sell, this is recorded as private consumption; however, there is no offsetting negative effect from inventory depletion. Therefore, the imports create fluctuations in GDP from one period to another – fluctuations that should be eliminated if data on retail inventories were available.

Previously published figures for the first half of the year were revised as well, with GDP growth for H1/2014 adjusted upwards to 0.9% from the previous estimate of 0.6%. In the first three quarters of the year, GDP grew by 0.5% year-on-year in real terms, whereas the Bank's November forecast had assumed 1.5% growth for the period. The deviation is due primarily to a steep rise in the GDP price deflator in Q3, as the nominal increase in GDP measured 3.4% in the first three quarters of the year, which is in line with the forecasted increase of 3.7%. GDP growth was driven by domestic demand, which grew by 3% (including 3.9% growth in consumption and investment), whereas the contribution from net trade was negative by just over 2 percentage points during the period. Investment grew by 12%, with all subcomponents rising considerably between years.

Private consumption was up 2.8% year-on-year in the first three quarters of 2014, according to figures from Statistics Iceland, although growth in Q3 turned out considerably weaker than key indicators suggested. For instance, payment card turnover grew nearly 4% in real terms during the quarter, and consumer goods imports were up more than 15% at constant exchange rates.

The surplus on the underlying current account balance measured 55 b.kr., or 10.7% of GDP, in Q3, in line with the Bank's last forecast. The surplus is due primarily to a surplus on services trade of 80 b.kr., whereas goods trade generated a nearly 10 b.kr. deficit and the underlying balance on primary and secondary income showed a deficit of 12.9 b.kr. The revision of previously published year-2013 figures and figures for H1/2014 shows that last year's surplus was slightly smaller than previously estimated and the H1/2014 surplus slightly larger.

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 1% year-on-year in October, with the number of employed persons rising 1.5% and average hours worked declining by 0.5%.

Seasonally adjusted unemployment measured 5.6% in October, according to the LFS. It had risen slightly between months but declined year-on-year, and it has hovered just over 5% since H2/2012. Seasonally adjusted unemployment as measured by the Directorate of Labour declined, however, both between months and between years, and measured 3.4% in October.

The wage index rose by 0.6% month-on-month in October and by 6.6% year-on-year, and real disposable income rose by 4.6% over the same period.

Key indicators of private consumption growth at the beginning of Q4 suggest relatively strong growth; for instance, real payment card turnover was up 5.5% year-on-year in October. Motor vehicle sales grew strongly as well, as did general retail sales, particularly specialty items.

The Capacent Gallup Consumer Sentiment Index rose by 4.3 points between October and November and by over 12 points from November 2013, to 80.2 points.

The Statistics Iceland nationwide house price index, published in late November, declined by 0.6% month-on-month after adjusting for seasonality, and by 7.4% year-on-year. The capital area real estate price index, calculated by Registers Iceland, fell by 0.3% month-on-month in October when adjusted for seasonality but rose 6.6% year-on-year. The number of purchase agreements registered nationwide rose by 12% year-on-year in the first ten months of 2014. The average time-to-sale for flats in the greater Reykjavík area was just over four months in the first ten months of 2014, as opposed to five months during the same period in 2013.

According to Capacent Gallup's corporate sentiment survey, carried out in November and December among executives from Iceland's 400 largest firms, respondents were somewhat more optimistic about the economic situation six months ahead than in the September survey. Just under 55% of respondents considered the current situation neither good nor poor, however, and about 35% considered it good. About 48% of executives expected the economy to improve in the next six months, as opposed to 46% who expected conditions to remain unchanged. Executives in the construction industry were more upbeat than others about the situation six months ahead. They were also more optimistic than they were in September, as were respondents from industrial, manufacturing, and fisheries companies. All respondents were more optimistic than they were a year ago, however. Only about 6% of executives expected conditions to deteriorate over the next six months.

According to the corporate sentiment survey, the share of respondents interested in adding on staff in the next six months exceeded the share interested in downsizing by about 15 percentage points. This indicates somewhat greater optimism than was revealed by the

September survey but broadly in line with the surveys from the first half of the year. In November 2013, the share of firms considering downsizing exceeded the share interested in recruiting by 2 percentage points.

The consumer price index declined by 0.5% month-on-month in November, and twelve-month inflation measured 1%, down from 1.9% in October. The CPI excluding the housing component declined by 0.6% between months and has fallen 0.3% in the past twelve months. Underlying inflation as measured by core index 3 excluding tax effects was 1.4% in November and had declined by a percentage point since October. Statistical measures of underlying inflation gave similar results, yielding figures in the 0.8-1.3% range. Most subcomponents of the CPI declined in November. The 17% drop in airfares had the most pronounced effect, or -0.25 percentage points. Falling petrol prices also had some impact, as global oil prices have declined significantly in recent months. Other imported goods categories declined in price as well. Some of it was due to anticipatory reductions in the price of electrical equipment and household appliances in advance of the cancellation of excise taxes in January 2015.

According to the Capacent Gallup survey of household expectations carried out in November, household inflation expectations one year ahead measured 3.5%, down ½ a percentage point from the September survey, whereas two-year inflation expectations were unchanged at 4%. According to a comparable survey conducted among firms in November and December, one-year inflation expectations had also declined by ½ a percentage point from the September survey, to 2.5%. The two-year breakeven inflation rate in the bond market as calculated from the spread between indexed and non-indexed bond interest was 2.5% right before the meeting and had declined by 0.7 percentage points since the November meeting. The five- and ten-year breakeven inflation rate was around 3.2%, down by just over ½ a percentage point since November and by more than a percentage point since December 2013. Based on a risk premium of approximately ½%, inflation expectations in the bond market appear to be very close to the inflation target.

## 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. He also reported to the committee on the Bank’s decision to grant LBI hf. an exemption from the Foreign Exchange Act and to grant a conditional pledge of further exemptions for partial payments to priority creditors using future asset recoveries.

In addition, the Committee discussed the effects of the amendments made to the 2015 fiscal budget proposal and the revision of the 2014 National Budget as regards the fiscal stance. The MPC was of the opinion that, even though the surplus on Treasury operations had grown, fiscal stance had eased somewhat.

Committee members discussed recent inflation developments. Inflation had fallen to 1% in November and, excluding the housing component, was slightly negative. The Committee was of the opinion that low global inflation and a stable króna had contained inflation in spite of considerable wage increases during the year.

Inflation expectations had also fallen in recent months and, by most measures, were close to target, which the Committee considered extremely positive. The Bank’s real rate had therefore risen markedly from the last meeting, owing to the significant decline in inflation and inflation expectations.

In view of recent developments in inflation, there was some discussion of the probability that inflation would return to target early in 2015, as was assumed in the Bank's last forecast. It emerged that the outlook was highly uncertain, with various factors pulling in opposite directions. For example, external demand growth has been weak and appears likely to remain so in coming months. Recent developments in trading partner countries have repeatedly been weaker than expected, and the outlook was for the global recovery to be sluggish well into 2015. Therefore, imported inflation would probably remain negative in coming months. On the other hand, the slack in the labour market had all but disappeared; therefore, it was likely that upcoming wage settlements would at least tend to push inflation back up to target. It was uncertain when in 2015 contracts would be finalised, however.

The Committee examined in detail Statistics Iceland's first national accounts figures for Q3/2014, which had been extremely surprising. According to the figures, GDP growth so far in 2014 – private consumption growth in particular – would probably be weaker than previously forecast. Committee members were of the view, however, that the domestic economy was stronger than these first figures indicated, as they deviated markedly from other indicators of domestic demand growth, including imports and various measures of turnover. Members agreed that the near-term outlook was still for robust growth in domestic demand and GDP. Furthermore, the recovery of the labour market continued, although growth in labour demand had lost pace somewhat. The main change since the last interest rate decision was that the short-term outlook was for lower inflation than had been assumed at that time. The Committee was of the opinion that inflation would probably be well below target at least through mid-2015.

Members agreed that, in spite of the nominal interest rate cut in November, the Bank's real rate was higher than was warranted by the business cycle position and the near-term outlook. Citing grounds similar to those expressed at the last meeting, members considered it appropriate to offset some of the increase and reduce nominal interest rates. In the Committee's opinion, there were grounds for lowering rates by 0.25 and 0.5 percentage points. The discussion of these two options focused to an extent on the assessment of the outlook for next year and the extent to which the current monetary stance should reflect the risk that 2015 wage settlements would entail excessive pay increases.

The main argument in favour of the larger reduction was that otherwise, the monetary stance would be tighter than had been intended with the November reduction, but without support from new indicators of demand and inflation expectations, or recent developments in inflation. In spite of such a reduction, the interest rate level would continue to reflect to some extent the risk related to the labour market. In this context, the nature of the current unrest in the labour market was important. There was no sign as yet that this unrest stemmed from an overall excess of labour demand. Instead, it seemed to indicate the conflict about relative wages that could occur at any inflation rate. Therefore, at this stage, it would be appropriate to respond to the risk of excessive pay rises that would jeopardise the inflation target by explaining in detail that such a development would call for interest rate increases. It was also important to consider that inflation would likely fall still further in the near future and that this must be factored into an assessment of developments in the monetary stance until the next meeting.

The main argument in favour of the smaller rate reduction was that inflation was likely to rise again in the medium term, driven by pressures from the labour market and the diminishing slack in the economy. It was also pointed out that although the recent decline in inflation expectations had finally opened up the possibility to lower rates, it was still too early to claim that expectations had firmly been anchored at the inflation target. Hence there was a risk that inflation would rise rapidly once the conditions that had contained it were no longer present. It would therefore be appropriate to wait with a larger reduction until major wage settlements had been finalised. It was also pointed out that most indicators of domestic demand suggested that growth was much stronger than was implied by the national accounts. It was also uncertain whether the effects of lower petrol prices, which had contributed temporarily to disinflation, would last; furthermore, the unrest in the labour market indicated that there was still a significant risk that inflation would rise above target again. As a result, it was desirable to reduce rates in small increments until conditions had been clarified, and in view of indicators implying strong demand growth, it would be unlikely to cause any harm if the monetary stance were temporarily tighter than had been intended in November.

In view of the discussion, the Governor proposed that the Bank's interest rates be reduced by 0.5 percentage points, which would lower the seven-day term deposits (the Bank's main monetary policy instrument) to 4.5%. Other rates would fall accordingly: the current account rate to 4.25%, the seven-day collateralised lending rate to 5.25%, and the overnight lending rate to 5.75%. Three members voted in favour of the Governor's proposal. Two members voted against the Governor's proposal, voting instead to lower interest rates by 0.25 percentage points.

Committee members agreed that, as always, the nominal interest rate path will depend on developments in demand and inflation. The Committee was of the opinion that, after this rate reduction, the Bank's key policy rate was close to the level consistent with full capacity utilisation and inflation at target. Members also agreed that, other things being equal, if inflation remains below target and pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop. On the other hand, they were of the opinion 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 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 and representatives of the Ministry of Finance and Economic Affairs attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 4 February 2015.

March 27, 2001

# Declaration on inflation target and a change in the exchange rate policy

(From March 27, 2001 – as amended by agreement between between the Prime Minister of Iceland and the Board of Governors of the Central Bank of Iceland on November 11, 2005, cf. Press release no. 35/2005)

On March 27, 2001 the Prime Minister and the Governors of the Central Bank of Iceland signed a declaration on changes in the framework of monetary policy in Iceland. The declaration is as follows:

The Government of Iceland and the Central Bank of Iceland have decided the following changes in the framework of monetary policy in Iceland, effective March 28, 2001:

(1) The main target of monetary policy will be price stability as defined below. The Central Bank shall also promote financial stability and the main objectives of the economic policy of the Government as long as it does not deem it inconsistent with the Bank's main objective of price stability.

(2) Rather than basing monetary policy on keeping the exchange rate within a fluctuation band, the Central Bank will aim at keeping inflation within defined limits as specified below.

(3) The change described above implies that the fluctuation limits for the króna are abolished. Nevertheless, the exchange rate will continue to be an important indicator in the conduct of monetary policy.

(4) The Government grants full authority to the Central Bank to use its instruments in order to attain the inflation target.

(5) Later this week, the Government will submit to Parliament a bill on a new Central Bank Act which, once enacted, will legally confirm the decisions described above on making price stability the main objective of monetary policy and on the independence of the Central Bank to use its instruments.

(6) The inflation target of the Central Bank will be based on 12-month changes in the consumer price index as calculated by Statistics Iceland. Statistics Iceland will also be asked to calculate one or more indices which may be used to assess the underlying rate of inflation, as will be further agreed between the Central Bank and Statistics Iceland. The Central Bank will take note of such indices in its assessment of inflation and in the implementation of monetary policy.

(7) The Central Bank will aim at an annual inflation rate of about 2½ per cent.

(8) If inflation deviates by more than 1½ percentage point from the target, the Central Bank

shall bring it inside that range as quickly as possible. In such circumstances, the Bank will be obliged to submit a report to the Government explaining the reasons for the deviations from the target, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. The report of the Bank shall be made public.

(9) The Central Bank shall aim at attaining the inflation target of 2½ percent not later than by the end of 2003. In the year 2001, the upper Declaration on inflation target and a change in the exchange rate policy limit for inflation shall be 3½ percentage points above the inflation target but 2 percentage points above it in the year 2002. The lower limit for inflation will always be 1½ percentage point below the inflation target. Should inflation move outside the target range in 2001 and 2002, the Bank shall respond as set out in item 8 above.

(10) Despite the elimination of the fluctuation limits for the króna, the Central Bank will intervene in the foreign exchange market if it deems such action necessary in order to promote the inflation objective described above or if it thinks that exchange rate fluctuations might undermine financial stability.

(11) The Central Bank shall publish inflation forecasts, projecting inflation at least two years into the future. Forecasts shall be published in the Bank's Monetary Bulletin. This shall also contain the Bank's assessment of the main uncertainties pertaining to the inflation forecast. The Bank shall also publish its assessment of the current economic situation and outlook.

**[Amended text by agreement between the Prime Minister of Iceland and the Board of Governors of the Central Bank of Iceland on November 11, 2005]**

(12) The Central Bank shall in its publications explain how successful it is in implementing the inflation target policy. The Governors will also report to the Minister, the Government and committees of the Parliament on the policy of the Bank and its assessment of current economic trends and prospects.

29 December 2014
*1412189*

# Report to the Government on inflation below limits

According to data published by Statistics Iceland on 19 December 2014, twelve-month inflation in terms of the consumer price index (CPI) measured 0.8% during the month of December. Therefore, for the first time since the 2½% inflation target was adopted, inflation fell below the lower limit set forth in the joint declaration made by the Government and the Central Bank of Iceland on 27 March 2001, which defined the inflation target and limits for deviation. According to the declaration, the Central Bank must submit a report to the Government if inflation exceeds 4% or falls below 1%. These limits do not entail any other formal requirement vis-à-vis the Central Bank except to oblige the Bank to submit a report explaining the reasons for the deviation from the 2½% inflation target, estimating how long the deviation will endure and, as applicable, stating whether the Bank considers it necessary to take action in response to the deviation from the inflation target.

## Recent developments in inflation

After peaking at 18.6% in January 2009, inflation gradually subsided to target by end-2010. In the wake of the spring 2011 wage settlements, which provided for wage increases well in excess of the level compatible with the inflation target, inflation began to increase again, rising to 6.5% in January 2012. It was brought under control with tight monetary policy, however, and fell back to target in early 2014. Since then, it has been at or below target, and by the end of the year it had fallen below the lower limit, to 0.8%.

The recent disinflation episode was even more pronounced in terms of the CPI excluding the housing component, according to which inflation measured 1% early in the year, then fell below 1% in September, and was slightly negative in November. In December, the CPI excluding housing had fallen 0.4% in the previous twelve months.

The decline in inflation has been rather broadly based, and underlying inflation has fallen markedly as well. Various measures of core inflation and statistical measures of inflation indicate that underlying inflation lay in the 0.4-1.4% range in December. The median value of these measures was 1%.

In the recent term, inflation has been driven primarily by domestic factors. Early on, it stemmed from increases in domestic goods and services prices. These increases have lost pace, however, and by this criterion domestic inflation measured 1.8% in December. In 2014, domestic inflation has therefore been driven primarily by the rise in the housing component. The twelve-month increase in the housing component measured 7.6% at the beginning of the year but had tapered off to 4.8% by December.

Global inflation has been very low in the recent past and has been on the decline over the course of the year. The sharp drop in oil prices – some 50% since the summer – has been a major factor in the recent term. This steep decline has been reflected not only in domestic petrol prices; it has also affected the price of a wide range of goods and services, specifically to include transport and transit prices. At the same time, the króna has appreciated by around 2½% in trade-weighted terms in the past year, even though the Central Bank has leaned against the rise with substantial foreign currency purchases. As of 23 December, the Bank's net foreign currency purchases year-to-date totalled 112 b.kr., or 5½% of estimated year-2014 GDP. In nominal terms, prices of imported goods and services have declined markedly in the recent term. The twelve-month decline has accelerated in the latter half of the year, measuring 2.8% in December.

Short-term inflation expectations have fallen somewhat, in line with falling inflation. Corporate inflation expectations one year ahead recently measured 2.5%. After having hovered around 4% for some time, long-term inflation expectations have also approached the target – both survey-based rates and those determined by the spread between indexed and non-indexed bonds. Given that interest rate spreads reflect both a risk premium and market agents' expectations concerning inflation, it can be assumed that they suggest that long-term inflation expectations are now close to target.

## Do recent economic developments change the assessment of the inflation outlook?

The Central Bank published its last inflation forecast in *Monetary Bulletin* 2014/4 on 5 November. According to that forecast, inflation was projected to fall from 2.1% in Q3/2014 to 1.7% in Q4, rise to 2% in Q1/2015, reach the target at mid-year, and remain close to target throughout the forecast horizon, which extended until year-end 2017.

Inflation declined markedly in November, however, and measured 1.3% in Q4, somewhat below the Bank's forecast. This decline will have a marked effect on twelve-month inflation in coming months and, combined with the steep drop in petrol prices, will cause inflation to be somewhat below the November forecast well into 2015.

The Bank will release a new inflation forecast in *Monetary Bulletin* 2015/1, which will be published on 4 February. That forecast will contain a more detailed assessment of the economic and inflation outlook and the key risks to the forecast.

## The Monetary Policy Committee's response

The Central Bank's Monetary Policy Committee (MPC) has responded twice to the recent decline in inflation and long-term inflation expectations, lowering the Bank's interest rates by 0.25 percentage points in November and another 0.5 percentage points in December. The Bank's key rate is now 4.5%, down from 5.25% at the beginning of 2014.[1] As is stated in the MPC statement of 10 December, the Committee is of the view that the current interest rate level is close to the level consistent with full capacity utilisation and inflation at target. However, the Committee's statement also says that if inflation remains below target and pay increases in upcoming wage settlements are consistent with the inflation target, conditions for further reductions in nominal interest rates could develop. On the other hand, excessive pay increases and strong growth in demand could undermine the recently achieved price stability, however, and require that interest rates be raised again.

As is stated above, underlying inflation is low, and CPI inflation excluding the housing component is negative. In spite of this, a protracted deflation episode is unlikely. Nominal demand growth is still significant. Nominal GDP growth measured 3½% in the first three quarters of the year, and nominal wages as measured by the Statistics Iceland wage index grew 5½% over the same period. The margin of

[1] The key rate is the interest rate that is the most important determinant of short-term market rates and therefore is the best measure of the monetary stance. At present, this is the seven-day term deposit rate.

spare capacity in the economy has narrowed. It is expected to disappear soon and give way to a small positive output gap. As a result, conditions in Iceland differ markedly from those in many trading partner countries. In most of Iceland's trading partners, spare capacity still exists, nominal growth in demand and wages is negligible, and inflation expectations have fallen below target. This is why their nominal interest rates are considerably lower than in Iceland.

Protracted deflation can be a serious problem, particularly for indebted countries with weak economic growth. Thus there is as much reason to be on the watch against deflation as against inflation. This risk is less pronounced in Iceland than in other developed countries, however, and the negative side-effects of deflation are probably less pronounced as well, as Iceland is a small, open, and export-driven economy where it should be possible to impede deflation by forcing a currency depreciation by lowering interest rates or purchasing foreign currency. Furthermore, the widespread indexation of financial obligations in Iceland means that, in the absence of changes in income, real debt services does not increase during deflation episodes but declines. Unlike the situation in neighbouring countries, where interest rates are as low as can be achieved through conventional monetary policy instruments, the Central Bank's current interest rate level provides the Bank with the latitude to respond to deflation by lowering interest rates.

Prolonged deflation is undesirable for a number of reasons. Although such a situation is unlikely to develop in Iceland at this point, it is the role of monetary policy to direct inflation towards the target specified in the 2001 declaration. In this context, however, it is important to consider three factors that, at this stage, call for a cautious response. First of all, inflation is well below target at present mainly because of declining import prices, which in turn stem from price developments abroad and exchange rate stability at home. On the other hand, wage rises have been far larger than is consistent with the inflation target in the recent past. A turnaround in foreign inflation or in the exchange rate of the króna could cause domestic inflation to rise quickly. Second, inflation expectations have only recently fallen to target, and it has yet to be seen how firmly anchored they are at that level. Third, and certainly not least important, the current unrest in the labour market could trigger an abrupt rise in domestic inflation, irrespective of developments abroad. Therefore, the scope for a further reduction in

Central Bank interest rates will remain unclear until the uncertainty in the labour market has subsided.

The Monetary Policy Committee's next interest rate decision will be published on 4 February 2015.