The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, February 2017

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and the premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of individual Committee members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meeting held on 6 and 7 February 2017, during which the Committee discussed economic and financial market developments, the interest rate decision of 8 February, 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 14 December interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2017/1 on 8 February.

Financial markets

After a protracted appreciation phase, the króna began to weaken in early December and, by end-January, had depreciated by about 5% in trade-weighted terms. It then turned around and, by the time of the February meeting, was 2.3% above the January trough, although it remained 2.5% lower in trade-weighted terms than at the time of the December meeting. Over the same period, it had depreciated by 2.6% against the euro, and 2.1% against the US dollar, whereas it had risen by 0.6% against the pound sterling. The Central Bank's net foreign currency purchases in the domestic foreign exchange market totalled approximately 186 million euros (roughly 22.3 b.kr.) between meetings, or 34% of total market turnover.

In terms of the Central Bank's real interest rate, the monetary stance was broadly the same as after the December interest rate reduction. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was unchanged between meetings, at about 2½%.

Interest rates in the interbank market for krónur had developed in line with the Bank's key rate. Yields on nominal Treasury bonds and indexed Treasury and Housing Financing Fund (HFF) bonds were broadly unchanged between meetings but have fallen in the recent term, in line with the Bank's key rate. Most financial institutions' non-indexed deposit and lending rates had fallen in the wake of the December interest rate reduction, while indexed rates remained unchanged.

Risk premia on Treasury foreign obligations were broadly unchanged between meetings, even though Standard & Poor's had upgraded Iceland's sovereign credit rating to A- and Fitch Ratings had changed the outlook on Iceland's sovereign ratings to positive in mid-January. The CDS spread measured about 0.9%, but the spread between the Treasury's foreign currency issues and comparable bonds issued by Germany and the US was 1.1-1.2 percentage points.

Financial institutions' analysts had all projected that the Bank's nominal policy rate would be held unchanged in February, and they agreed that the depreciation of the króna had reduced the likelihood of a rate cut. They also noted that GDP growth had been strong and that uncertainty remained in the labour market. In most analysts' view, the króna would probably appreciate over the course of 2017, which could give cause for further rate cuts during the year.

According to the Central Bank's market expectations survey, conducted at the end of January, respondents expected the Bank's key rate to be lowered by 0.25 percentage points during the first half of 2017 and then raised again to 5% at the beginning of 2018, after which it would remain unchanged for the rest of the forecast horizon. In the survey, market agents were also asked what they considered an appropriate Central Bank key rate at present. Answers ranged between 3.5% and 5.5%, with over half of them in the 4.75-5% range; i.e., at or 0.25 percentage points below the current rate. Just under a fifth of survey participants considered 4.5% appropriate.

Year-on-year growth in M3 accelerated in Q4/2016 in comparison with the previous two quarters but was still below nominal GDP growth. M3 grew by 5.9% year-on-year in Q4/2016, after adjusting for deposits held by deposit institutions in winding-up proceedings. As was the case last year, growth in money holdings is due largely to increased household deposits, although corporate deposits also increased between years.

After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers grew by just over 2% year-on-year in nominal terms in Q4, and by just under 4% after adjusting for the effects of exchange rate movements on the foreign-denominated credit stock. Growth is attributable to an increase in lending to households and businesses. Pension fund loans to households have increased significantly in the past year, and the pension funds' share of new household lending now exceeds that of deposit institutions. On the other hand, HFF lending has continued to contract. Therefore, credit system lending to households is still modest overall. In Q4/2016, the year-on-year increase measured 2.8%, after adjusting for the Government's debt relief measures.

The Nasdaq OMXI8 index had fallen by 3.8% between meetings and by 9% in 2016. Turnover in the main market was just over 560 b.kr. in 2016, or about 43% more than in 2015. Equity securities prices fluctuated widely shortly before the MPC meeting, after Icelandair published a profit warning.

Global economy and external trade

The global economic outlook was broadly unchanged since the Committee's December meeting, with the new US administration's fiscal and trade policy considered the predominant uncertainty. According to the International Monetary Fund's January forecast, global GDP growth is projected at 3.4% in 2017 and 3.6% in 2018, which is unchanged from the Fund's October forecast. The forecast for growth in world trade was also unchanged for 2017, whereas the 2018 projection has been revised slightly downwards since October. The inflation outlook for industrialised countries is unchanged as well, with inflation forecast at 1.7% this year and 1.9% in 2018. In emerging and developing countries, however, inflation is expected to be somewhat higher in both 2017 and 2018 than in the October forecast. *Consensus Forecasts*' year-2017 GDP growth and inflation projections for Iceland's main trading partners were unchanged between MPC meetings.

The deficit on goods trade totalled 8.4 b.kr. in December. According to preliminary figures from Statistics Iceland, it measured 6.6 b.kr. in January. The deficit totalled 101.2 b.kr. in 2016 and 33.7 b.kr. in 2015. Import values rose by 8.6% year-on-year in 2016, whereas export values contracted by 4.1%. Import growth in 2016 was due mainly to an increase in imports of transport equipment and consumer goods, while the contraction in exports stemmed mainly from reduced exports of industrial goods.

The listed global market price of aluminium had risen by about 3,1% between MPC meetings, and the average price in January was up about 20.7% year-on-year. This was the largest year-on-year increase since July 2011. In December, foreign currency prices of marine products rose by about 1.1% between months and 6.4% between years. In all, marine product prices rose by nearly 4.3% year-on-year in 2016.

In terms of relative consumer prices, the real exchange rate measured 96.7 points in January, a 2.8% decline from the previous month but a 15.5% increase year-on-year. The rise is due primarily to a 15.7% nominal appreciation of the króna, but in addition, inflation in Iceland was about 0.1 percentage point below the average among its trading partners. In terms of relative consumer prices, the real exchange rate rose by an average of 12.8% in 2016.

The domestic real economy and inflation

According to the 2017 National Budget, the fiscal stance will ease this year, but somewhat less than was projected in the Bank's November forecast. The easing is estimated at 0.5% of GDP, as opposed to an estimate of 0.9% in November. The new Government's fiscal strategy for the upcoming five years was presented at the end of January. Even though it is assumed that the Treasury will be operated at a surplus this year, the fiscal strategy entails some fiscal easing when cyclical adjustments have been made. According to the Bank's February forecast, the 2017 outcome would have needed to be ½% of GDP more favourable than is implied in the strategy in order to maintain the same fiscal stance as in 2016. In 2018, the outcome is expected to improve by ½% of GDP, and if this materialises, the fiscal stance will then be similar to that in 2016.

According to Statistics Iceland's labour force survey (LFS) for Q4/2016, the number of jobs increased year-on-year by 4.6%, much more than was assumed in the Bank's November forecast. The average work week continued to grow shorter, however, and total hours worked increased by 4.1%, in line with the forecast. Total hours worked rose by 3% between yearly averages.

The labour participation rate rose sharply during the year. By Q4/2016 it was above its pre-crisis peak, and the employment rate was very close to its pre-crisis high. The labour participation rate rose by 1 percentage point year-on-year and the employment rate by 1.8 percentage points.

Unemployment was somewhat lower in Q4 than the Bank had forecast in November, at 2.5%, or 2.9% when adjusted for seasonality. The seasonally adjusted unemployment rate is at its lowest since Q3/2008. Measured unemployment was 3% in 2016 as a whole, as opposed to 4% in 2015. Unemployment as measured by the Directorate of Labour (DoL) measured 2.1% in 2015 and had fallen by just over half a percentage point between years.

In 2016, immigrants outnumbered emigrants by just over 4,000, or 2% of the labour force. In 2016, the migration balance among foreign nationals aged 20-59 was positive by 2% of the population aged 20-59, up from 1.3% in 2015.

In Q4/2016, the wage index rose by 1% between quarters and by 9.7% year-on-year. Real wages in terms of the index were 7.7% higher in Q4/2016 than in Q4/2015. Neither nominal nor real wages have ever risen as much in terms of the wage index as they did in 2016, when the index rose by 11.4% real wages by 9.5% between yearly averages.

Key indicators of developments in private consumption in Q4/2016 suggest that year-on-year growth was moderate but somewhat weaker than it had been earlier in the year. This development is in line with the Bank's private consumption growth forecast. Payment card turnover increased by nearly 8% during the quarter and nearly 12½% over the year as a whole. Similar developments can be seen in new motor vehicle registrations, which increased by just over a fifth during the quarter and by 38.5% during the year.

The Gallup Consumer Confidence Index declined between months in both December and January. In January, it declined between years for the first time since 2014 but nonetheless measured 121.6 points, and all of its components measured over 100 points.

The Statistics Iceland's nationwide house price index, published at the end of January, rose by 1.1% month-on-month after adjusting for seasonality, and by 15.2% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 1% month-on-month in December when adjusted for seasonality, and by 15% year-on-year. In 2016, the index rose by an average of 11.1% from the previous year, and the number of registered purchase agreements nationwide rose 7.8% between years. The average time-to-sale for residential property in the greater Reykjavík area declined by just over a month between 2015 and 2016, to just under 2 months.

The CPI rose by 0.14% month-on-month in December and then fell by 0.6% in January. Twelve-month inflation measured 1.9% in January, down from 2.1% at the time of the MPC's December meeting. The CPI excluding the housing component had declined by 0.9% in the past twelve months, however. Most measures of underlying inflation suggested that it had declined in January and lay in the 1.7-2.1% range.

Winter sales were the major determinant of inflation in January, although they were offset by an increase in the cost of owner-occupied housing and in various public levies. Private services prices had fallen by 0.3% year-on-year in January, after having risen in the two preceding months: by 0.8% in December and by 1.4% in November.

According to the Central Bank's survey of market agents' inflation expectations, conducted at the end of January, participants expect inflation to measure 2.5% in one year, an increase of 0.3 percentage points from the previous survey, taken in November 2016. Survey participants' inflation expectations two years ahead had declined, however, from 3% in the last survey to 2.8%. Furthermore, market agents expect inflation to average 2.7% over the next ten years, or 0.1 percentage points less than in the November survey. The ten-year breakeven inflation rate in the bond market had measured in the 2.1-2.5% range during the quarter to date, as opposed to 3% in Q1/2016.

According to the forecast published in *Monetary Bulletin* on 8 February 2017, the inflation outlook has improved since the Bank's November forecast. Domestic inflationary pressures are considerable, however, and stronger than was forecast in November. Pulling in the other direction are low global inflation and the appreciation of the króna. The króna is projected to be stonger during the forecast horizon than was assumed in the November forecast. The inflation outlook has therefore improved slightly, in spite of the prospect of a larger output gap. Inflation is projected to measure about 2% through mid-2017 and then inch upwards, reaching the target in the latter half of 2018. It looks set to rise temporarily above target as the forecast horizon progresses, once the effects of the higher exchange rate subside, but to be close to target by the end of the horizon.

GDP growth is considered to have picked up slightly in leading advanced economies in the latter half of 2016, and there is increased optimism about the global economy. Oil and major commodity prices have risen, and global inflation is on the rise. Increased optimism about the economic outlook and expectations of higher inflation have led to a marked increase in long-term interest rates in the US, with rates in other developed countries following suit.

In spite of the rise in oil and commodity prices, the outlook is for a further improvement in Iceland's terms of trade this year. Indeed, improved terms of trade and rapid growth in tourism have been the main drivers of Iceland's economic recovery. Icelandic exports are estimated to have grown by just over 10% in 2016. Of that total, activity in the tourism industry grew by over 37% in real terms and has nearly quadrupled 2010.

Year-2016 GDP growth is estimated at 6%, a full percentage point more than was assumed in the November *Monetary Bulletin*. The deviation is due primarily to business investment and services exports, both of which were much stronger in the first nine months of the year. Furthermore, GDP growth is expected to be strong again this year, or around 5⅓%, but to ease towards the 2½-3% range over the next two years. GDP growth both in 2016 and over most of the forecast horizon is somewhat stronger than was forecast in November and will therefore put greater strain on domestic resources and result in a wider output gap. The labour market will be tighter, with rapid job creation and unemployment below 3%. The labour participation rate has also risen above its pre-crisis peak, albeit offset by significant importation of foreign labour. The pay increases provided for in wage agreements have shown in the Statistics Iceland wage index, as was assumed in the Bank's November forecast, and wage drift has been broadly as projected. On the other hand, wages are expected to rise this year by about ½ a percentage point more than was forecast in November, in part because of newly approved wage settlements. Unit labour costs will therefore rise by about 4% this year, on the heels of a 6½-7% increase in the past two years. Unit labour costs are also projected to rise significantly in the next two years, by an average of roughly 5% per year.

According to the forecast, the slack in the economy is considered to have disappeared some time ago and a growing positive output gap has begun to open up. The output gap is estimated to have widened over the course of 2016, to about 2.2% of potential output. The outlook is for it to grow still further this year and become wider than was forecast in November, as GDP growth in 2016 and 2017 is projected to be somewhat stronger than was assumed in the November forecast. As in the Bank's previous forecasts, the output gap is expected to narrow in coming years as GDP growth subsides.

II The interest rate decision

The Governor updated the Committee on developments in connection with capital account liberalisation and on the preparation for the planned review of the monetary policy framework.

The Committee discussed the Bank's foreign exchange market intervention policy. Furthermore, on 23 December, it had held an extraordinary meeting on foreign exchange issues, where members agreed with the Governor's proposal to step up foreign currency purchases if needed so as to lean against the appreciation of the króna just before important steps were taken towards capital account liberalisation at the beginning of 2017. Members considered it timely to review the Bank's intervention policy in the wake of the significant easing of capital controls on individuals and companies at the turn of the year. They agreed that the experience of this had been positive, as no instability had been detected. Capital outflows had not been substantial as yet. This could have played some part in the depreciation of the króna in December and January, but Committee members were of the view that the main causes were the seasonal drop in tourism-generated foreign exchange revenues and the fishermen's strike. Short-term volatility – intraday fluctuations in particular – had been greater year-to-date than in the previous two years. The Committee was also of the view that the risk of a temporary overshooting of the exchange rate prior to full liberalisation had diminished after these steps were taken. Furthermore, there was currently no need to build up the foreign exchange reserves further. Because there was no longer a need to take these temporary factors into account, the MPC decided that the objective of intervention in the foreign exchange market in the near future would be to mitigate short-term volatility. Committee members were of the view that the intervention policy should include not only buying foreign currency, as the Bank had done in the recent past, but also selling it if conditions warranted it. It was emphasised that this must not be interpreted to mean that the Bank was targeting a particular exchange rate. It was pointed out that it was not desirable to disconnect price formation of the króna in the market entirely. The exchange rate must be allowed to move and to play a role in the adjustment of the economy.

The MPC also discussed the findings of a recent working paper that estimated the equilibrium real interest rate in Iceland using different methods. During the discussions at the meeting, Committee members expressed a range of views, both on what the equilibrium real rate could be at present and on the methods used to estimate it. Members agreed, however, that the equilibrium real rate had declined after inflation expectations became more firmly anchored, and that the research findings provided useful input for continued discussion within the Committee.

The MPC also examined the current Central Bank interest rate in relation to a number of different monetary policy rules. The results showed that the current rate was within the range given by different monetary policy rules and various assumptions concerning the equilibrium rate.

The monetary stance had remained unchanged since the December meeting. Committee members discussed whether developments since the previous meeting had changed its assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the December meeting, the MPC had decided to lower the Bank's interest rates by 0.25 percentage points. The majority's arguments for the December decision were that there was scope to lower nominal interest rates, as inflation expectations appeared more firmly anchored to target, and that the appreciation of the króna had tightened the monetary stance somewhat. However, the minority view was that it was imprudent to lower interest rates further because of the risk of overheating in the economy.

In this context, MPC members took account of the Central Bank's new forecast, published in *Monetary Bulletin* on 8 February, estimating that year-2016 GDP growth had been very strong, and well above the Bank's November forecast, owing mainly to stronger-than-projected business investment and services exports. They also took note of the forecast of continued rapid GDP growth. The MPC also noted the marked tension in the labour market and the outlook for lower unemployment than had previously been forecast. In particular, the Committee considered that the output gap was growing and appeared likely to be wider than previously projected in spite of the offsetting impact of labour importation.

Committee members agreed with the assessment in the forecast that the inflation outlook had improved slightly since the November forecast, even though the output gap was wider. They also observed that domestic inflationary pressures were offset by low global inflation, the appreciation of the króna during the forecast horizon, and a tight monetary stance.

In the MPC's view, uncertainty about the fiscal stance had subsided since the Committee's last meeting because the 2017 National Budget had been approved. According to the budget, the fiscal stance will ease in 2017, but less than had been assumed in the November forecast. The Government's five-year fiscal strategy includes plans to reverse this easing in 2018.

All members considered it appropriate to keep the Bank's interest rates unchanged. In their view, rapid growth in economic activity and clear signs of growing demand pressures in the economy called for a continued tight monetary stance so as to ensure medium-term price stability. Although the November forecast indicated that the inflation outlook had improved somewhat, this assessment was based on the assumption that wage agreements would not be reviewed in the near future, a premise that MPC members agreed was highly uncertain. This uncertainty and strong growth in demand called for caution in setting interest rates.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5%, the current account rate 4.75%, the seven-day collateralised lending rate 5.75%, and the overnight lending rate 6.75%. All Committee members voted in favour of the proposal.

Members were of the view that monetary policy had anchored inflation expectations, contained credit growth, and contributed to more saving than would otherwise have occurred. They agreed that a stronger anchor for inflation expectations at target and the appreciation of the króna had enabled the MPC to achieve its legally mandated price stability objective at a lower interest rate than would otherwise have been possible. This had made it possible for the MPC to lower interest rates in the latter half of 2016. Members agreed that in the coming term, the monetary stance would be determined by economic developments and actions taken in other policy spheres.

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 15 March 2017.