The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, February 2015

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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 2 and 3 February 2015, during which the Committee discussed economic and financial market developments, the interest rate decision of 4 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 10 December interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2015/1 on 4 February.

Financial markets

Since the December meeting, the króna had appreciated by just over 2% against the euro but had depreciated by just under ½% in trade-weighted terms and just under 6½% against the US dollar, which had appreciated somewhat against most other currencies. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 112 million euros (roughly 17 b.kr.), or 43% of total market turnover during the period. At the end of 2014, the foreign exchange reserves net of the Central Bank and central government's foreign-denominated debt were positive by 53 b.kr., whereas they had been negative in the amount of 28 b.kr. at year-end 2013.

The króna remained relatively stable in 2014, both in trade-weighted terms and against the euro. In trade-weighted terms, it appreciated by just under 2% over the year, as opposed to 11% in 2013. Strong foreign currency inflows supported the currency, and the Central Bank leaned against the appreciation in order to mitigate exchange rate volatility. The Bank's net foreign currency purchases in the interbank foreign exchange market amounted to roughly

5½% of estimated year-2014 GDP, the largest amount of currency the Bank has purchased in a single year.

Financial institutions' liquidity has remained abundant vis-à-vis the Central Bank, and overnight rates in the interbank market for krónur have been below the centre of the interest rate corridor. Interest rates have developed broadly in line with the Bank's nominal rates. Turnover in the interbank market increased sharply towards the end of 2014 but had been limited so far in 2015.

Yields on nominal and indexed Treasury and Housing Financing Fund (HFF) bonds declined marginally following the December interest rate reduction. Yields on nominal bonds had risen slightly in the interim, however, and were 0.1-0.3 percentage points higher at the February meeting than at the December meeting. They were about 0.1-0.7 percentage points lower than at the November meeting, however.

The lowest listed nominal mortgage rates offered by the three large commercial banks have fallen by an average of 0.5 percentage points since the December meeting and by up to 0.75 percentage points since the November meeting. The average of comparable commercial banks' indexed mortgage rates had risen since December, however, whereas they had been inching downwards in the preceding three years, even though other real market rates had risen in line with the increase in the Central Bank's real rate.

The monetary stance had tightened since the Central Bank lowered its interest rates in December as inflation and inflation expectations had subsided. The Bank's real rate was 2.4% in terms of the average of various measures of inflation and inflation expectations at the time of the meeting, but 3.7% in terms of twelve-month inflation, which is an increase of 0.2 percentage points since right after the interest rate decision was announced in December.

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 risen by 0.2 percentage points against US Treasury bonds but fallen by 0.1 percentage points against German bonds. Just before the February meeting, it measured 1.6-2.2 percentage points. The CDS spread on five-year Treasury obligations had risen by 0.2 percentage points between meetings, to roughly 1.7%.

Financial institutions' research departments had all projected that the Bank's nominal policy rate would be lowered by 0.25 percentage points in February, on the grounds that the Bank's real rate was higher than the inflation outlook warranted.

Growth in money holdings has slowed down, with M3 up just over 3% year-on-year in Q4/2014, 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 DMB loans to domestic borrowers had grown by 2.8% year-on-year in Q4/2014. Net new DMB lending to domestic borrowers totalled just over 170 b.kr. in 2014, almost ½% more than in 2013.

The NASDAQ OMXI8 index had risen by just under 6% between meetings. Turnover in the main market totalled around 277 b.kr. in 2014, an increase of about 10% from the prior year.

Outlook for the global real economy and international trade

The International Monetary Fund's (IMF) January forecast estimates global GDP growth at 3.5% in 2015 and 3.7% in 2016, or some 0.3 percentage points less in each of the two years than according to the Fund's October forecast. The GDP growth outlook is weaker for emerging and developing countries, especially those that export oil and commodities. For industrialised countries, however, the outlook is slightly better this year, particularly for the US, although the 2016 outlook is unchanged. In comparison with the October forecast, 2015 inflation forecasts for industrialised countries have been lowered by about 0.8 percentage points, to 1%, and 2016 forecasts have been lowered by 0.4 percentage points, whereas they have been raised slightly for emerging and developing countries. *Consensus Forecasts'* year-2015 GDP growth projections for Iceland's main trading partners are unchanged since the December MPC meeting, although the inflation forecasts have been lowered by 0.6 percentage points.

Iceland's goods trade surplus totalled 4.6 b.kr. in December 2014 and 4 b.kr. for the year as a whole. Import values rose by 8½% year-on-year in 2014 and export values by 0.7%. Growth in imports is due mainly to increased transport equipment and consumer goods values, while export growth stems mainly from an increase in the value of industrial exports.

The real exchange rate index measured 84.2 points in terms of relative prices in December, an increase of just over 1% month-on-month and nearly 4% year-on-year. The real exchange rate of the króna rose by 6.9% year-on-year in 2014. The increase is due primarily to a 5.7% nominal appreciation of the króna, but in addition, inflation in Iceland was about 1 percentage point above the average among its trading partners.

Aluminium prices have fallen by nearly 4% since the last MPC meeting, although the average price was up almost 5% year-on-year in January. Foreign currency prices of marine products had risen by 2.4% month-on-month in December, however, and by 12½% year-on-year. Oil prices fell nearly 28% year-on-year in Q4/2014, and it is estimated that terms of trade had improved by 5% over the same period.

The domestic real economy and inflation

According to the National Budget for 2015, Treasury revenues will be about 10 b.kr. more than was assumed when the initial budget proposal was prepared, and the entire amount will be used to offset increased expenditures. The budget was passed with a 3.6 b.kr. overall surplus and a 67.9 b.kr. primary surplus. The overall balance is ½ b.kr. less favourable than was assumed in the budget proposal, and the primary balance is 2.2 b.kr. less favourable. The fiscal stance has therefore eased slightly since the last MPC meeting.

According to the Statistics Iceland labour force survey (LFS), seasonally adjusted unemployment in Q4 was in line with the Bank's November forecast, measuring 4.8%. It was virtually unchanged between quarters but declined by 0.4 percentage points year-on-year. The survey-based unemployment rate was 5.4% in 2014, about 0.4 percentage points less than in 2013. According to figures from the Directorate of Labour, unemployment measured 3.6% in 2014, a decline of 0.8 percentage points year-on-year.

According to the LFS, total hours worked increased by 1.5% year-on-year in Q4/2014, in line with the Bank's November forecast. The rise in total hours worked in Q4 is due in large part to an increase in the number of employed (1%) and a slight increase in average hours worked (0.4%). All other measures of labour supply and demand pulled in the same direction. Total hours worked rose by nearly 2% year-on-year in 2014, following an increase of 3.8% in 2013.

The number of employed persons rose by 1.6% in 2014, as opposed to 3.4% in 2013. The increase in averaged hours worked was about 0.4% in both years, however.

In Q4/2014, net migration was positive for the ninth quarter in a row. In 2014 as a whole, immigrants outnumbered emigrants by just over 1,100, or 0.6% of the labour force. This is slightly less than in 2013, however, when net migration was positive by 0.9% of the labour force. The net increase in the past two years is due to foreign nationals.

In Q4/2014, the wage index rose by 1.4% between quarters and by 6.6% year-on-year, and real wages were 5.4% higher than in Q4/2013. In 2014 the wage index rose by 5.8% year-on-year, about the same as in 2013. Real wages rose about 3.7% between years, the largest increase since 2007.

Key indicators of private consumption growth in Q4/2014 imply that growth was relatively strong during the quarter. Payment card turnover grew 5.7% year-on-year and just over 3% quarter-on-quarter. Retail sales and new motor vehicle registrations also increased somewhat.

In Q4/2014, the Capacent Gallup Consumer Sentiment Index rose slightly year-on-year but fell quarter-on-quarter. The same occurred in January: the index declined from the previous month but rose year-on-year. The big-ticket index of planned major household purchases, which had risen to a six-year high in September 2014, remained unchanged in the December measurement.

The Statistics Iceland nationwide house price index rose by 1½% month-on-month in January, after adjusting for seasonality, and by 6.8% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose nearly 2½% in December 2014 when adjusted for seasonality. It rose by 9.6% year-on-year. The number of registered purchase agreements nationwide rose by nearly 12% year-on-year in 2014. The average time-to-sale for residential housing in the capital area was just over four months in 2014, as opposed to just under five months in 2013.

The CPI declined by 0.7% month-on-month in January, after rising by 0.3% in December. Twelve-month inflation measured 0.8% in January, after falling by 0.2 percentage points since the MPC's December meeting. At present, inflation is due largely to rising house prices, as CPI inflation excluding the housing component had been negative by 0.6% over the previous twelve months. Underlying inflation as measured by core index 3 excluding tax effects was 1.3% in January and had declined by 0.2 percentage points since the last meeting. According to statistical measures, underlying inflation ranged between 1.2% and 1.6%. The fall in the CPI in January was driven mainly by winter sales, the massive drop in petrol prices, and the cancellation of general excise taxes. Petrol prices declined 11% month-on-month and had fallen by 17% in the previous twelve months. Food and beverage prices rose by 2.6% month-on-month, however, owing to the increase in the lower value-added tax rate. Public services and house prices also rose somewhat. Inflation averaged 2% for the year, down from 3.9% in 2013 and 5.2% in 2012.

According to the Central Bank survey of market expectations, carried out in late January, respondents expect inflation to measure 2.6% in one year, slightly less than in the October 2014 survey. Market participants expect inflation to average about 3% over the next ten years, which is also somewhat lower than in the last survey. The five- and ten-year breakeven inflation rate in the bond market, as measured by the spread between indexed and non-indexed bond interest rates, measured 3.2-3.4%, slightly less than in December. Based on surveys, this is probably consistent with inflation expectations close to target, considering that the breakeven rate also includes a risk premium due to the uncertainty in the inflation outlook.

According to the forecast published in *Monetary Bulletin* on 4 February 2015, the inflation outlook has changed significantly from the Bank's November forecast. Inflation subsided to target early in 2014 and has declined still further in the wake of falling oil prices. It measured 0.8% in January, the lowest in two decades. According to the February forecast, inflation is forecast to remain below 1% until the latter half of 2015 and below 2% into 2016. This is lower than was forecast in November.

As always, the inflation outlook is uncertain. The upcoming wage negotiations are a particular source of concern, as large wage increases could erode the inflation outlook and cause a setback in the economic recovery if they cut into labour demand. There is also much uncertainty regarding the global economy, which has been subject to considerable unrest recently. Oil prices have fallen sharply, and even though the decline is generally conducive to GDP growth, the global GDP growth outlook has somewhat deteriorated since the forecast published in the November *Monetary Bulletin*, and uncertainty has escalated. The global inflation outlook has also changed markedly.

The decline in oil prices has made a strong impact on external conditions, and Iceland's terms of trade have improved substantially. As a result, the outlook is for a larger current account surplus than was assumed in November.

According to preliminary figures from Statistics Iceland, GDP growth was somewhat weaker in the first three quarters of 2014 than was forecast in November. Indicators suggest that these figures will be revised upwards. In spite of this, GDP growth for the year as a whole is expected to be weaker than previously estimated, or 2% instead of 2.9%. However, the forecast for GDP growth in 2015 has been revised upwards since November, from 3.5% to 4.2%, due to several factors: positive base effects from weaker output growth in 2014, the marked improvement in terms of trade, and prospects of strong growth in tourism and marine product exports. Nonetheless, the outlook for the next two years is broadly unchanged: GDP growth is forecast to ease somewhat as the demand-side effects of the Government's debt relief package taper off and energy-intensive investment subsides. Growth is projected at approximately 2¾% per year in 2016 and 2017.

As was forecast in November, the recovery of the labour market firmed up somewhat in Q4, after a relatively weak third quarter. The slack in the economy therefore continues to narrow and will probably disappear very soon, if it has not already done so.

II The interest rate decision

The Governor gave the Committee an update on developments since the last meeting, including the work done by the Bank and other authorities in relation to capital account liberalisation. The Committee had also met at an extraordinary meeting on 29 January to discuss possible amendments to the Bank's monetary policy instruments.

The Committee considered whether developments since the last regular meeting and the outlook based on the Bank's new forecast changed its assessment of the required monetary stance. Developments in inflation since the December meeting had been in line with the MPC's assessment. Inflation had subsided still further, measuring only 0.8% in December and January, and was slightly negative if the effects of housing costs are excluded. Inflation expectations had fallen as well since the December meeting and, by most measures, were close to target.

Committee members agreed that the inflation outlook had changed considerably from the Bank's November forecast. This had been broadly anticipated at the December meeting, however, when the Committee was of the view that inflation would probably remain somewhat below target at least through mid-2015.

Members discussed the updated forecast in *Monetary Bulletin* and were of the view that it was in line with the Committee's assessment from the December meeting that 2014 GDP growth had been weaker than forecast in November. The updated forecast estimated it at 2% instead of the previous 2.9%, based on Statistics Iceland's preliminary figures for the first three quarters of 2014. As was the case at the last meeting, members agreed that it was likely that Statistics Iceland's preliminary figures underestimated the actual pace of output growth, as they deviated markedly from other indicators of demand. On the other hand, GDP growth for 2015 is now forecast to be stronger than forecast in November, or 4.2% instead of 3.5%. This is partly due to base effects, as the preliminary figures suggest that 2014 GDP growth was weaker than previously estimated, and also due to expected stronger export growth and positive effects from terms of trade. Committee members agreed that the spare capacity in the economy had probably disappeared or was about to do so, and the slack in the labour market would probably disappear in 2015. The outlook was still for robust growth in domestic demand, as the forecasted GDP level in 2015 was similar to that forecast in November.

The Committee discussed in detail the labour market and wage developments among various groups, both in current wage agreements and over the long term. Members agreed that, as yet, the main reason for labour market unrest was not excess labour demand but, to an extent, conflicts about relative wages and income distribution. Furthermore, the easy access to the international labour market enjoyed by a portion of the employed could be another factor. Because of these conflicts, the likelihood of wage settlements in line with the inflation target had diminished.

Even though the Bank's real rate had risen by 0.2 percentage points since the nominal rate reduction in December, owing to the decline in inflation and inflation expectations, it was considered most appropriate to keep interest rates unchanged because, in deciding the monetary stance at the December meeting, the MPC had factored in that inflation would most likely fall between meetings. Members nonetheless agreed that the Bank's real rate was relatively high in view of the current business cycle position. The economic outlook was more uncertain than often before, however. In assessing the near-term inflation outlook, it was necessary to consider the offsetting effects of the growing uncertainty about upcoming wage agreements and the effects of the decline in global oil prices on inflation and inflation expectations. The MPC was of the view that the inflation forecast in the February *Monetary Bulletin* was more likely to be too low rather than too high. Members considered that the wage settlements since the December meeting and the indications that recent settlements would influence wage demands had reduced the likelihood that moderate three-year contracts would be landed.

Members noted that, following the broad-based disinflation over most of 2014, the recent decline in inflation was, for the most part, a direct effect of falling global oil prices. Reductions in fuel prices were beyond the scope of domestic monetary policy, however, and the disinflation resulting from them would be temporary. Therefore, members agreed that, in determining interest rates, it was not possible to take full account of the disinflation stemming from this source. It would therefore not be appropriate to simply consider the increase in the real rate that could be traced to low observed inflation caused by reduced oil prices. If developments in oil prices should begin to affect long-term inflation expectations, however, and spread to wage formation, thereby leading to a prolonged period of below-target inflation, a monetary policy response would be called for. The MPC considered it unlikely that this would happen, however. The spare capacity in the economy had more or less disappeared, and robust GDP growth was expected in the near future. Wage growth had been strong in Iceland, unlike in most trading partner countries, and mounting unrest in the domestic labour market could jeopardise the stability that had been achieved. For this reason, the Committee agreed that it was appropriate to wait until the economic situation became clearer, particularly as regards wage developments.

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

Committee members agreed that, as always, developments in nominal interest rates would depend on developments in demand and inflation. The Committee was of the opinion 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, 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 18 March 2015.