The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, December 2014

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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 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 6.25%. 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.