The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, March 2014

Published 2 April 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 Monetary Policy Committee meeting held on 17 and 18 March 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 19 March, 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 12 February interest rate decision.

Financial markets

The average trade-weighted exchange rate in the domestic foreign exchange market was 0.5% higher at the time of the March meeting than at the February meeting. Between meetings, the króna had appreciated by about 1.7% against the US dollar and about 0.4% against the pound sterling, but was broadly unchanged against the euro. Bids for krónur in the offshore market lay in the range of 214-250 kr. per euro and were broadly unchanged.

The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 45 million euros (roughly 7 b.kr.) since the last MPC meeting, or 38% of total market turnover during the period.

In general, financial institutions' liquidity had remained ample between meetings and, as before, overnight rates in the interbank market remained below the centre of the interest rate corridor, at 0.25 percentage points above current account rates. From the beginning of the year to the time of the March meeting, interbank market turnover had been limited, or about 10 b.kr., as opposed to 132 b.kr. over the same period in 2013.

Owing to abundant financial system liquidity, the simple average of Central Bank current account rates and the maximum rate on certificates of deposit is the best approximation of the effect of Central Bank rates on money market rates. This average, which can be termed the effective policy rate, was just under 5½% at the time of the March meeting, while the interbank overnight rate was 5.25%. Even though nominal interest rates have remained unchanged, the monetary stance had tightened somewhat between meetings, in line with falling inflation and inflation expectations. The Bank's effective real rate was 3.2% in terms of twelve-month inflation in February and 2.3% in terms of the average of various measures of inflation and inflation expectations, or about ½-1 percentage point higher than at the time of the February meeting. The average of the various measures of inflation and inflation expectations was 3.0% at the time of the March meeting.

The Republic of Iceland's sovereign CDS spread had remained virtually unchanged since the February meeting, measuring 2 percentage points just before the Committee met in March. The risk premium on Treasury obligations in terms of the spread between the Icelandic Treasury's US dollar bonds maturing in 2016 and 2022 and comparable bonds issued by the US Treasury had declined by about 0.1 percentage points since the previous meeting. Just before the March meeting, it measured about 2 percentage points for the bonds maturing in 2016 and about 2½ percentage points for the bonds maturing in 2022.

Unchanged Central Bank interest rates in March appeared to have been priced into the yield curve, in line with the expectations of financial institutions' market analysts. Analysts cited the appreciation of the króna since the MPC's previous meeting, among other factors, but pointed out that inflation expectations in the market were still well above target even though current inflation was below it.

Broad money (M3) grew by about 1.6% month-on-month in January and by 8.3% year-on-year. The increase excluding holding company deposits was smaller, at 4.6%. Narrower measures of the money supply also increased year-on-year, with M2 growing by 9.6% and M1 by 15.7% in January. Excluding holding company deposits, M2 and M1 grew by 6.2% and 12.3%, respectively. Based on a twelve-month moving average, Central Bank base money contracted by 0.9% over the same period. Broad and narrow money therefore grew significantly year-on-year in January, after contracting in 2012 and into January 2013. In January 2014, M3 was broadly at its early 2012 level. Real growth in the money supply was less, however, and nominal growth remains less than nominal GDP growth.

Slow credit growth has continued: net new lending to households by deposit money banks (DMB) – i.e., new loans net of prepayments – totalled about 2.4 b.kr. in January, or just under 0.3% of the total stock of DMB loans to households. Net new corporate loans (to non-holding companies) totalled 10.7 b.kr. in January, or 1.1% of the total stock of DMB loans to firms.

The NASDAQ OMX Main List index, OMXI6, had fallen by 6.3% between meetings. Turnover in the NASDAQ OMX Iceland main market totalled about 251 b.kr. in 2013, nearly three times that in 2012. Turnover in February totalled 59 b.kr., an increase of about 25% year-on-year. At the beginning of March, the market value of companies listed on the main market totalled 520 b.kr., or approximately 30% of year-2013 GDP.

Outlook for the global real economy and international trade

Iceland's goods trade surplus totalled 7.1 b.kr. in January and, according to preliminary figures, 4 b.kr. in February. Export values contracted by 7.2% year-on-year in the first two months of the year, due to a contraction in the value of exported marine and industrial products. Import values contracted by 1.7% over the same period, mostly due to a contraction in the import value of commodities and operational inputs.

The abrupt drop in aluminium prices at the beginning of the year has reversed for the most part, and prices were relatively stable between the Committee's February and March meetings. The price index for marine products has continued to fall year-on-year, however, and had declined by 1.3% between years in January.

The real exchange rate index in terms of relative consumer prices was 83.9 points in February, or 5.2% higher than in Q4/2013. The increase is due primarily to nominal appreciation of the króna, but in addition, inflation was 0.7% higher in Iceland than among its trading partners. The outlook is for inflation to remain low in trading partner countries. It measured 0.7% in the euro area and 1.1% in the US in February. In the UK, it measured 1.9% in January.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, output growth measured 3.3% in 2013 as a whole and 3.8% in Q4/2013. Seasonally adjusted GDP contracted by 0.2% quarter-on-quarter, according to seasonally adjusted figures from the Central Bank. Previous figures for the first three quarters of 2013 were revised, but they did not have a tangible effect on GDP growth for the period, which measured 3.1%.

The main driver of Q4 growth was the contribution from net trade, as exports grew by 8.4% and imports by 5.1%. Consumption and investment grew by a total of 2% year-on-year during the quarter, but domestic demand growth measured 1.6%, as the contribution from inventory changes was negative by 0.4 percentage points. Net trade was also the main driver of GDP growth for the year as a whole, contributing about 3.2 percentage points. Private and public consumption grew by about 1.2-1.3%, investment contracted by 3.4%, and domestic demand as a whole grew by only 0.1%.

GDP growth was somewhat stronger than according to the forecast published in the February issue of *Monetary Bulletin*, which provided for 2.7% growth in Q4 and 3% for the year as a whole. In both instances, the deviation from the forecast was due to an unexpectedly strong contribution from net trade.

The underlying current account balance was positive by 111 b.kr. in 2013, or 6.2% of GDP, as opposed to 2.8% of GDP in 2012. The larger surplus in 2013 is due primarily to a larger surplus on services trade (36 b.kr.) and a smaller income account deficit (36 b.kr.) than in 2012; however, the surplus on goods trade was smaller (8 b.kr.). The forecast published in the February *Monetary Bulletin* assumed that the current account surplus would amount to 5.3% of GDP in 2013. The deviation is due primarily to stronger returns on Icelanders' assets than was assumed in the forecast.

Investment as a share of GDP declined slightly between 2012 and 2013, but national saving rose from 17.7% of GDP in 2012 to 19.8% of GDP in 2013.

Key indicators of private consumption at the beginning of the year suggest relatively strong growth during the quarter; for instance, payment card turnover in January and February was up 7.5% year-on-year. Motor vehicle sales grew strongly as well, as did general retail sales, particularly specialty items.

Unemployment as registered by the Directorate of Labour (DoL) rose by 0.3 percentage points in January, to 4.5%, but remained unchanged between January and February. Seasonally adjusted unemployment fell by 0.2 percentage points from December, to 3.7% in February.

New national accounts indicate that wage costs per man-year have risen significantly less over the past two years than was previously assumed. The share of wages in gross factor income rose by 0.7 percentage points year-on-year in 2013, to 62.8%, the same as in 2001. Since it bottomed out in 2009, the wage share has risen by about 6 percentage points.

The wage index rose by 1% month-on-month in January and by 6.7% year-on-year. Real wages in terms of the wage index rose by 1.7% between months and about 3.4% year-on-year.

According to Capacent Gallup's March survey among executives from Iceland's 400 largest firms, the number of respondents interested in adding on staff in the next six months exceeded the number interested in downsizing by about 14 percentage points. This is a slight improvement over the results of the surveys conducted in the first half of 2013 and a significant improvement over the surveys from the second half of the year, when the number of firms interested in recruiting and downsizing were roughly equal. In all sectors except fisheries and financial and insurance activities, interest in recruiting has increased since the last survey, and only in retail trade and financial and insurance activities has the number of firms planning to downsize risen between surveys.

According to the survey, executives are considerably more optimistic about economic conditions than they were last November. The economy-wide index, which measures respondents' attitude towards current conditions, rose markedly and is at its highest point since December 2007. The share of respondents who consider conditions good, or neither good nor bad, rose considerably between surveys. About 62% of participants consider current conditions neither good nor bad, while 18% considered them good. Executives are also more positive about the situation six months ahead than they were last November. About 42% of respondents indicated that they expect conditions to improve in the next six months, while 7% indicated that they expect them to deteriorate. Executives in all sectors except fishing and transport and transportation were more optimistic than they were last November. The improvement between surveys was most pronounced in the retail trade sector. All executives except those in the construction industry and transport and transportation are more optimistic than they were at this time a year ago.

Expectations concerning domestic demand increased markedly, both from the previous survey and from a year ago. Expectations concerning demand in foreign markets are a little weaker than in November but have improved markedly in the past year. Executives were somewhat more optimistic about developments in firms' margins (EBITDA) in the next six months than they were in September and in March 2013. The outlook for investment has also improved from a year ago.

According to the Capacent Gallup survey of consumer expectations, consumer sentiment improved in February. The Consumer Sentiment Index measured 85.9 points, which is an increase of over 5 points year-on-year. In February, the assessment of the labour market and the situation six months ahead improved most.

The nationwide Statistics Iceland house price index, published in late February, rose by 0.2% from the previous month and by ½% adjusted for seasonality. It had risen by about 9% from February 2013. The capital area real estate price index, calculated by Registers Iceland, rose by 0.3% month-on-month in January and by about 0.6% when adjusted for seasonality. The index has risen by 7.4% since January 2013. About 17% more purchase agreements were concluded nationwide in February 2013 than in the same month in 2013. The average time-to-sale for residential property in greater Reykjavík was just over four months in February. It averaged just under five months in 2013, down from seven in 2012.

The consumer price index (CPI) rose by 0.67% month-on-month in February, but twelve-month inflation fell from 3.1% to 2.1%. Strong base effects were present, as the CPI had risen by 1.6% in February 2013. End-of-sale effects had the strongest impact on the index in February. International airfares also had an upward effect, while groceries prices declined. Underlying annual inflation fell 0.9 percentage points between months in terms of both core index 3 and core index 4 excluding tax effects, measuring 2.8% and 1.5%, respectively. Statistical measures of underlying inflation give similar results.

The housing component of the CPI has risen most in the past twelve months, or by 7.4%, and inflation excluding housing measured only 0.8% in February. Increases in other domestic items have lost pace, although the annual increase in those items measured 3.4% in February. The contribution of imported goods to the rise in the index was negative, however, with the twelve-month reduction measuring 2.1%. The króna appreciated by about 12% over the same period.

Inflation expectations two years ahead continue to decline in line with the slowdown in inflation. Household inflation expectations measured 4% in March, both one and two years ahead, as opposed to 5% over the past 4-6 quarters. In addition, corporate inflation expectations one year ahead have fallen from 3.9% to 3%, and two-year expectations have fallen from 4% to 3.5%. In terms of the breakeven inflation rate in the bond market, one- and two-year inflation expectations measured 2.8% and 3.3%, respectively, and had declined by 0.3-0.6 percentage points since the previous meeting. Longer-term inflation expectations appeared not to have fallen commensurably, however; just before the meeting, measurements of the long-term breakeven rate indicated that market agents expected inflation to measure 4% five to 10 years ahead. Those expectations have remained broadly unchanged for some time.

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 balance of payments model to be used to evaluate various scenarios and assess the sensitivity of the balance of payments outlook to different shocks was presented to the Committee. The model will play a key role as a tool for evaluating various ways of lifting the controls. In particular, the Committee discussed expected foreign exchange outflows for the year, recent developments in the real exchange rate, and how the real exchange rate compared with the most recent estimation of the equilibrium real exchange rate.

The MPC also discussed monetary policy conduct and possible changes in the Bank's liquidity management. It emerged that monetary policy implementation had changed little in recent years. ESÍ's planned asset sales and the possible easing of the capital controls would imply significant changes for the monetary policy environment in the near future, however. The Committee agreed that monetary policy conduct must support monetary policy goals, but that it was also important that monetary policy be straightforward, easily understood, and economical in terms of the Bank's balance sheet. The time had come to review it with an eye to these objectives. It would not be necessary to make fundamental changes in monetary policy conduct, however, and the changes would take place in stages. Among possible options were changes in the form and duration of deposits/CDs, the relationship between CD issuance and collateralised loans, amount restrictions on collateralised and overnight loans, definitions of counterparties, and the number of trading days. The MPC authorised the Governor to work on implementing improvements to monetary policy conduct, in line with the ideas discussed within the Committee.

Committee members discussed recent inflation developments. Inflation had measured 2.1% in February and had subsided relatively quickly. There were also signs that domestic inflation and underlying inflationary pressures had subsided. Furthermore, newly published national accounts show that, over the past two years, wage costs per man-year rose considerably less than previous indicators had suggested. In addition, the outlook was that the main results of the wage settlements concluded in late 2013 would apply to most of the labour market.

Committee members agreed that the short-term inflation outlook had improved. Recent inflation developments had been marginally better than had been assumed at the February meeting. The Committee also considered it likely that because of a better initial position characterised by lower inflation than was forecast in February, a stronger króna, and smaller wage increases, the short-term inflation outlook had improved from previous estimates. Furthermore, members welcomed the decline in short-term inflation expectations in line with falling inflation. On the other hand, they were still quite concerned that long-term inflation expectations had remained close to 4%.

The Committee was of the view that the two-year inflation outlook had improved somewhat, but not decisively enough, in spite of positive recent developments and an improved outlook for 2014. As had been forecast previously, the outlook was for inflation to rise again as domestic demand growth gained momentum and the slack in the economy gave way to a positive output gap. Based on the most recent year-2013 GDP growth figures, the spare capacity in the economy was about to disappear. Indicators of private consumption in the current quarter also suggested that growth was considerably stronger than previously projected. The Committee was of the opinion that, other things being equal, this would call for an increase in the Bank's real rate. One member was less concerned about future developments in inflation to the extent that GDP growth was driven by tourism, which has spare capacity during the winter. Migrant labour could also help to meet increased demand and higher tourist numbers could strengthen the króna. It was therefore not clear that tourism-driven GDP growth would exacerbate inflation risk or necessitate an interest rate increase to the same degree as GDP growth driven by domestic demand would. Others were of the view that even though various factors tended to contribute to lower short-term inflation, they could stimulate inflation later on.

The Committee was of the view that there might be less need for a higher real rate if countervailing measures were introduced that pulled in the same direction as monetary policy, including medium-term fiscal policy. Furthermore, the MPC considered that measures that strengthen the supply side of the economy could ease supply constraints, thereby weakening the inflationary effects of increased demand.

As before, the monetary stance at any given time will be determined by the inflation outlook. Committee members discussed various possible changes in the Bank's interest rates. The most likely options were to keep rates unchanged or to lower them by 0.25 percentage points. Members agreed that the short-term inflation outlook had improved but that the time to reduce rates had not arrived as long-term inflation expectations were still markedly above the target.

In view of the discussion, the Governor proposed that rates be held unchanged: the current account rate at 5%, the maximum rate on 28-day certificates of deposit at 5.75%, the seven-day collateralised lending rate at 6%, and the overnight lending rate at 7%. All Committee members voted in favour of the proposal.

Members agreed that whether there was scope for a nominal interest rate reduction would depend on developments in inflation and inflation expectations in coming months. Further ahead, the Committee was of the view that the Bank's real rate would have to be raised further if the above-described outlook materialised. The extent to which this took place through nominal rate increases would depend, as before, on the future path of inflation.

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 21 May 2014.