The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, August 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 18 and 19 August 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 20 August, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 11 June interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2014/3 on 20 August.

Financial markets

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

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

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

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

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

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

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

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

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

Outlook for the global real economy and international trade

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

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

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

The domestic real economy and inflation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

II The interest rate decision

The Governor gave the Committee an update on the work done by the Bank and other authorities since the last meeting in relation to capital account liberalisation.

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

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

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

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

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

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 1 October 2014.