The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, November 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 3 and 4 November 2014, during which the Committee discussed economic and financial market developments, the interest rate decision of 5 November, 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 1 October interest rate decision, as published in the forecast and analysis of uncertainties in *Monetary Bulletin* 2014/4 on 5 November.

Financial markets

The exchange rate of the króna had risen by 0.3% in trade-weighted terms since the last meeting and by 0.1% against the pound sterling but had fallen by 0.5% against the euro and about 1% against the US dollar. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled approximately 84 million euros (roughly 12.9 b.kr.), or 42% of total market turnover during the period.

Financial institutions' market liquidity was largely unchanged between meetings, and their market activity was very limited.

In terms of the average of various measures of inflation and inflation expectations, the monetary stance had tightened somewhat between meetings. The Bank's real rate thus measured had risen by 0.1 percentage points, to just under 2½%. In terms of annual inflation, the real rate was 3.4% and had declined by 0.1 percentage points between meetings.

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 increased slightly, to 1½-2 percentage points against US Treasury Bonds and 1.9 percentage points against German bonds, just before the November meeting. The CDS spread on five-year Treasury obligations had also risen slightly, to 1.4 percentage points.

Unchanged Central Bank interest rates in November 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, although twelve-month inflation was below target and the real policy rate had risen, inflation expectations were broadly unchanged and developments in the labour market were uncertain.

Money holdings continued to grow year-on-year in Q3, with M3 up 6.1%, excluding deposits owned by special purpose entities and the winding-up committees of the failed financial institutions. Growth is still driven primarily by an increase in corporate deposits, although household deposits are also on the rise.

The adjusted total stock of loans from deposit money banks (DMB) to resident borrowers grew by 1.4% year-on-year in Q3. Net new lending from DMBs to resident borrowers rose 4.3% year-on-year in the first nine months of the year, to 113 b.kr.

The NASDAQ OMXI8 index had risen by 4.2% between meetings, and accumulated Main Market turnover during the first ten months of the year had grown by just over 2% year-on-year.

Outlook for the global real economy and international trade

Iceland's external goods trade generated a deficit of just over 16 b.kr. for the first nine months of the year, as opposed to a surplus of almost 27 b.kr. over the same period in 2013. Export values contracted by 1.6% at constant exchange rates, while import values rose 8.9%. The contraction in exports is due mainly to a 7.7% decline in marine product exports and a 1% decline in industrial goods exports. The rise in imports stems primarily from an increase of 63% in transport equipment imports and a 15% increase in consumer goods imports.

In terms of relative consumer prices, the real exchange rate index stood at 83.5 points in September. It has been virtually unchanged for eight months but has risen 5.5% year-on-year. The year-on-year increase is due primarily to a 4.6% nominal appreciation of the króna, but in addition, inflation in Iceland was nearly a percentage point above the average among its trading partners.

Aluminium prices had risen by just over 7% since the MPC's last meeting, and the average price in October was 7% higher than it had been a year earlier. Foreign currency prices of marine products had declined by 1.7% month-on-month in September but had risen by 6.8% year-on-year.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked rose somewhat more slowly in Q3 than in previous quarters, or about 0.7% year-on-year. The rise in total hours worked is due primarily to an increase in the number of employed persons, while average hours worked declined by 0.7%.

Seasonally adjusted unemployment measured 5.2% in Q3, according to the LFS. It rose slightly between quarters but declined by 0.2 percentage points year-on-year. Unemployment as registered by the Directorate of Labour (DoL) measured 3.8% in Q3, after adjusting for seasonality. It had declined marginally between quarters and by 0.8 percentage points between years.

In Q3/2014, net migration was positive for the eighth quarter in a row. The increase amounted to 0.2% of the labour force and was due almost entirely to foreign nationals.

The wage index rose by 1.5% between Q2 and Q3 and by 6.1% year-on-year. Real disposable income rose by 4% over the same period.

Key indicators of private consumption in Q3/2014 suggest strong growth from the previous year. Payment card turnover was up nearly 4% year-on-year during the quarter, and card turnover abroad rose steeply. Retail sales also continued to grow, particularly sales of durable consumer goods such as electrical and electronic equipment. There was also a strong increase in new motor vehicle registrations during the quarter.

Statistics Iceland's nationwide house price index, published in late October, was up 0.6% month-on-month and 1.3% when adjusted for seasonality. It has risen 9.3% in the past twelve months. The capital area real estate price index calculated by Registers Iceland remained unchanged from the previous month in September but was up 8.4% year-on-year. The number of purchase agreements registered nationwide rose by just under 14% year-on-year in the first nine months of 2014. The average time-to-sale for flats in the greater Reykjavík area was just over four months in the first nine months of 2014, as opposed to five months during the same period in 2013.

According to a survey conducted by Capacent Gallup, consumer sentiment deteriorated month-on-month in October, with the Consumer Sentiment Index measuring 75.9 points, 8.4 points higher than in October 2013. All subcomponents of the index declined rather strongly between months, and all measured under 100 points. In September, the Capacent Gallup big-ticket index measured 59.7 points, its highest value since September 2008.

The CPI rose by 0.14% month-on-month in October, and twelve-month inflation measured 1.9%, an increase of 0.1 percentage points since September. The decline in petrol prices had the strongest effect, lowering the index by 0.15 percentage points, while rising house prices pulled in the opposite direction. An error was made in calculating airfares in September, resulting in an overestimation of the CPI effect of the month-on-month decline. This was corrected in October, and airfares had an upward effect on the index of 0.14 percentage points, whereas they would have been virtually unchanged otherwise. The CPI excluding housing rose 0.03% in October, and twelve-month inflation by that measure was 0.5%. Underlying inflation as measured by core index 3 excluding tax effects was 2.5% in September, and underlying inflation according to core index 4, which excludes house prices as well, measured 1%. By both measures, inflation rose between September and October, although it is still below the year-to-date average.

According to the Central Bank survey carried out in late October, market agents' short-term inflation expectations have declined since August. Respondents projected inflation at 2.8% in one year and 3% in two years, and their expectations have declined by ½ a percentage point from the August survey. Market agents' long-term inflation expectations have also fallen. Survey respondents expect inflation to average 3% over the next five years and 3.2% over the next ten years, which is a reduction of approximately 0.8 percentage points from the August survey. The two-year breakeven inflation rate in the bond market as calculated from the spread between indexed and non-indexed bond interest was just over 3% right before the meeting and was broadly unchanged since the October meeting. The five- and ten-year breakeven rate was about 3.7%, also virtually unchanged since the last meeting but almost ½ a percentage point less than in October 2013.

According to the forecast published in *Monetary Bulletin* on 5 November, if the effects of indirect taxes on the price level are excluded, the outlook through the end of next year is for lower inflation than was projected in August, owing to a more favourable initial position. Over time, pressures from the labour market and a diminishing slack in the economy will cause inflation to rise again. As in the August forecast, it is expected to measure 2½-3% in the latter half of the forecast horizon.

Global output growth for H1/2014 turned out weaker than previously assumed. The GDP growth outlook for Iceland's main trading partners is also poorer for H2/2014 and the upcoming three years than it was in August. This is due mainly to the bleaker outlook for emerging economies and the eurozone, although prospects have improved for the UK, the US, and the Nordic countries. Trading partners' GDP growth is projected at 1.8% for 2014 and just over 2% per year in the next three years. Uncertainty about the global economic outlook has also increased but is somewhat less than it was a year ago.

According to revised figures from Statistics Iceland, Iceland's terms of trade have deteriorated by 20% since 2006 instead of the previously estimated 17%. As was projected in August, terms of trade began to improve in Q2/2014, after a continuous erosion dating back to early 2011. They are now estimated to improve by some 1% this year, which is more than was forecast in August. The outlook for the next three years is somewhat poorer than was projected in August, however.

Statistics Iceland's revised year-2013 export figures show considerably stronger growth than previously estimated. This year's weaker growth therefore reflects negative base effects to some extent. In line with the poorer outlook for global output growth, export growth is forecast to be somewhat weaker than was assumed in August; exports are now projected to grow by an average of just under 3% per year, broadly in line with trading partners' import growth.

The output growth outlook for the year as a whole has deteriorated somewhat since August. Output growth is now expected to measure just over 5% in the latter half of the year and 2.9% for the year as a whole, about ½ a percentage point below the August forecast. As in August, it is expected to pick up again next year, rising to 3.5%, and then subside to just under 3% in 2016 and just under 2½% in 2017.

As before, it is expected that output growth will be driven primarily by growth in private sector demand and that the contribution from net trade will be negative during the forecast horizon. If the forecast materialises, output growth will average about 2.9% per year over the forecast horizon, slightly above the thirty-year average and well above the forecasted 2.1% average for Iceland's main trading partners.

It is still assumed that the slack in the labour market will disappear in the near future, even though labour demand growth has lost pace somewhat. Unemployment as defined by the Statistics Iceland labour force survey is forecast to continue declining and is expected to measure about 4% in coming years. Hours worked are expected to increase by an average of nearly 2% per year in the next three years, bringing the employment rate to 77½% by the end of the forecast horizon. Productivity growth over the three-year period will average only 1% per year, however, which is somewhat below the August forecast and just over half the historical average.

Owing to the revision of wages and related expenses, the rise in unit labour costs was slightly less, on average, in recent years than previously estimated. It is assumed that this year's increase in unit labour costs will be broadly in line with the August forecast, or just under 5%, as weaker productivity growth will offset smaller pay increases. The outlook is for growth to exceed the August forecast in the next two years, when larger pay increases and weaker productivity growth both pull in the same direction. If the forecast materialises, however, growth in unit labour costs will have aligned with the inflation target by 2017.

The slack in the economy is now thought to have been somewhat smaller in 2013 than was assumed in August, and it is projected to disappear in the latter half of this year, somewhat earlier than was forecast then. The positive output gap expected in coming quarters is also projected to be slightly larger than was forecast in August, although smaller than in the May forecast. The output gap is forecast to average just under 1% over the next two years and then begin to diminish. It will have all but disappeared by the end of the forecast horizon.

The baseline forecast in *Monetary Bulletin* reflects an assessment of the most likely economic developments over the next three years. As always, there are various uncertainties in the forecast that could change the inflation outlook from that assumed in the baseline scenario. For example, if the króna is weaker or wage increases larger than expected, there is the risk that the inflation outlook in the baseline forecast or the assumptions concerning the Central Bank interest rate level that will suffice to bring inflation back to target are too optimistic. The same is true if the slack in the economy is overestimated or if energy-intensive development activity turns out stronger in coming years than the forecast indicates. Because long-term inflation expectations are still insufficiently anchored, the deviations could prove larger than they would otherwise. Inflation could turn out lower than forecast, however, if the slack in the economy is underestimated, if domestic demand proves weaker than assumed, or if the global economic outlook is poorer than currently expected. The same applies if weaker global output growth also entails larger declines in global oil and commodity prices.

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 work done by the Bank concerning the request for exemptions from the Foreign Exchange Act in connection with the lengthening and amendment of the bonds between LBI hf. and Landsbankinn hf. Also discussed were the financial interactions between the Treasury and the Central Bank and the ongoing discussions concerning changes in the framework for these interactions.

Committee members discussed the Bank's *Financial Stability* report, published after the October MPC meeting, financial institutions' position and restructuring measures, and the progress made with private sector debt restructuring. They also discussed the risks facing the financial system because of Iceland's balance of payments problem, as well as the potential impact on overall financial stability and the financial position of Landsbankinn should the above-mentioned Landsbankinn-LBI bond not be lengthened.

The Committee discussed the outlook for the domestic economy, including the Bank's new macroeconomic forecast. Members agreed that the outlook for 2014 was for somewhat weaker output growth than was forecast in August, but that the short-term inflation outlook was better, with inflation falling still further this autumn. Rising house prices are the main source of inflation, while inflation stemming from domestic goods and services prices has lost pace and was at target in October. Low global inflation and a stable króna have contributed to low inflation in spite of considerable wage increases, however. The disinflation appears to be relatively broad-based. Inflation is expected to decline still further in the next few months and to remain at or below target through mid-2015. By the same token, it appears that some progress has been made in anchoring inflation expectations, which have fallen in recent months and are approaching the inflation target.

On the other hand, Committee members were concerned about the longer-term forecast of rising inflation. The forecast also assumed continued robust domestic demand growth and GDP growth in the next three years. The slack in the economy was about to turn around into a positive output gap, and the outlook was for increased wage pressures from the labour market, as the labour market is expected to continue recovering even though labour demand growth has slowed down in the recent term.

Committee members considered it positive that the outlook was for increased national saving and a larger current account surplus than had been foreseen in previous forecasts, thereby facilitating the resolution of Iceland's balance of payments problem. New figures also indicated that the current account deficit was smaller in H1/2014 than previously estimated. In the Committee's opinion, this has played a role in maintaining strong foreign currency inflows. The Central Bank has leaned against excessive appreciation of the króna and helped to stabilise the exchange rate.

In the Committee's opinion, there were grounds for lowering interest rates and for keeping them unchanged. As at the last MPC meeting, the main argument in favour of lowering interest rates was that the monetary stance had tightened more than previously expected. The Central Bank's nominal interest rates had been unchanged for two years, but the Bank's real rate had risen more than anticipated, owing to a more rapid decline in inflation and inflation expectations. The monetary stance had therefore tightened more than was warranted by the business cycle position and the near-term outlook. Inflation expectations had subsided towards the target in the recent past and, by some measures, were close to it, particularly short-term expectations. According to the forecast, inflation would be close to target for virtually the entire forecast horizon. As a result, it was appropriate to contain the rise in the real rate. Some Committee members also thought it likely that the rise in housing costs would ease soon because demand and construction costs had stabilised. The disinflation episode also appeared to be relatively broad-based, giving occasion to assume that inflation would remain low. By the same token, the global economic recovery was weaker and global inflation low, which would affect demand for Iceland's exported goods; however, imported inflation would be negligible and probably even negative in the near future. The output growth outlook in Iceland was also poorer than previously forecast. In addition, the recovery of the labour market was somewhat weaker than it had been in the recent past, and weaker than was forecast in August; for instance, the increase in total hours worked had lost pace steadily in the past year. Global price developments and declining inflation expectations also increased the likelihood that upcoming wage settlements would be in line with the inflation target. Inflationary pressures would therefore be limited if wage settlements were consistent with the inflation target and demand remained under control.

As before, the main reasons for keeping interest rates unchanged were that inflation expectations were still above target and that, in the past, they had declined as they have done recently, only to rise again. Furthermore, it was pointed out that an improved short-term inflation outlook was due to an improved initial position rather than to more positive prospects for the future. Further ahead, increased inflationary pressures could be expected, as domestic demand was still forecast to grow strongly in coming quarters, the slack in the economy was expected to disappear sooner than previously projected, and the slack in the labour market was almost fully absorbed. Unit labour costs were forecast to rise somewhat more than previously assumed, and more than is consistent with the inflation target. The scope for pay increases in upcoming wage negotiations was limited, given the slow rate of productivity growth. Therefore, there could be reason to wait until most wage settlements have been finalised, particularly in view of the lags in monetary policy transmission.

There was also some discussion about whether it was appropriate to wait until the next meeting, only a few weeks away, because the Q3 national accounts, a new inflation measurement, and new figures from the labour market would be available by that time.

In view of the discussion, the Governor proposed that the policy rate be reduced by 0.25 percentage points, which would lower the Bank's current account to 4.75%, the rate on seven-day term deposits to 5%, the seven-day collateralised lending rate to 5.75%, and the overnight rate to 6.75%.

Four members voted in favour of the Governor's proposal, although one of them would have preferred to keep rates unchanged at this time. This member agreed that the economic recovery had lost some momentum but was concerned about the unrest in the labour market and the effect of the Government's debt relief measures on demand once the results had been publicised. This member would have preferred to wait with a rate cut until December, when the decision could reflect new national accounts data, evidence on declining inflation and inflation expectations had been reconfirmed, the results of the debt relief measures had been publicised, and the market had been prepared by the MPC's November statement for a possible rate reduction. This member decided to vote in favour of the Governor's proposal, however, due to the small difference between the two.

One member who supported the Governor's proposal attributed the disinflation episode to moderate wage settlements in the past year, foreign currency inflows, and the Bank's policy on foreign exchange market intervention. A positive real rate had increased domestic saving and prevented bubble formation in the real estate and equity markets. On the other hand, the real rate was too high at present, particularly in terms of commercial banks' lending rates rather than Central Bank rates.

One member voted against the Governor's proposal, preferring to keep rates unchanged. This member was of the opinion that, in spite of positive developments in the recent past, each interest rate decision should be based on forward-looking considerations rather than current developments. Although inflation was projected to subside still further in the near future, it was expected to inch upwards again further ahead, owing to inflationary pressures from the labour market and the diminishing slack in the economy. Although long-term inflation expectations had moved towards the Bank's inflation target, it was appropriate to move cautiously in view of historical developments and the outlook for the labour market. Furthermore, the uncertainty concerning inflation was somewhat concentrated on the upside.

Committee members agreed that, as always, developments in nominal interest rates will depend on developments in demand and inflation. Members were of the view that if pay increases in upcoming wage settlements are consistent with the inflation target, the conditions could develop for further reductions in nominal interest rates, 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 10 December 2014.