The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, May 2016

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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 4 and 10 May 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 11 May, 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 16 March interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2016/2 on 11 May.

Financial markets

Since the March meeting, the króna had appreciated by 0.9% in trade-weighted terms, by 3.3% against the US dollar, by 0.5% against the euro, and by 1.2% against the pound sterling. The Central Bank's net accumulated foreign currency purchases in the domestic foreign exchange market totalled 330 million euros (46.4 b.kr.) between meetings, or about 55% of total market turnover. The Bank's net purchases year-to-date totalled approximately 889 million euros (125.5 b.kr.)

As before, overnight interest rates in the interbank market for krónur were below the centre of the interest rate corridor, close to the Bank's key rate. Turnover in the interbank market totalled 10 b.kr. since the last meeting, considerably less than over the same period in 2015.

In terms of the Central Bank's real interest rate, the monetary stance was broadly unchanged since just after the Committee's last interest rate decision. Just before the May meeting, the Bank's real rate was 2.8% in terms of the average of various measures of inflation and inflation expectations. In terms of past twelve-month inflation, however, it rose by 0.6 percentage points since the March meeting, to 4.1%.

Non-residents' new investment in the bond market has increased year-to-date, after declining towards the end of 2015. As before, the investment was mostly in nominal Treasury bonds. It totalled about 24.3 b.kr. in the first four months of 2016, as opposed to about 54.1 b.kr. in 2015. In spite of increased inflows, bond market yields have remained relatively stable, unlike in 2015, when they declined markedly, particularly yields on long-term nominal Treasury bonds. When the Committee met in May, yields on nominal Treasury bonds were similar to those seen at the time of the March meeting, or about 5.9-6%. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds were also about the same as at the time of the March meeting, or 2.8-3%. The nominal Treasury yield curve is virtually flat even though the MPC has stated that it will probably be necessary to raise the interest rates further. Therefore, there are still some flaws in monetary policy transmission as a result of capital inflows into the bond market, although the impact of the inflows on domestic interest rates appears to have weakened.

The large commercial banks' indexed and non-indexed deposit and lending rates were broadly unchanged since the March meeting, as was the pension funds' average mortgage lending rate.

The risk premium on the Republic of Iceland's foreign obligations had remained broadly unchanged between meetings. The CDS spread on five-year Treasury obligations had risen slightly, to just under 1.1% at the time of the May meeting. The risk premium as measured by the interest rate spread between the Treasury's eurobond and a comparable bond issued by the German government was broadly unchanged and still measured about 1½ percentage points, whereas a comparable spread between Icelandic and US bonds had increased by 0.3 percentage points, to 1.9 percentage points.

Financial institutions' analysts had all expected the Central Bank's nominal interest rates to be held unchanged in May, mainly because little had happened since the previous meeting that called for a change in interest rates.

In Q1/2016, M3 grew by 6.1% year-on-year after adjusting for the deposits held by the financial institutions in winding-up proceedings, about the same rate of growth as in most of 2015. However, the total stock of loans from deposit money banks, the HFF, and pension funds to resident borrowers contracted by ½% over the same period but increased by nearly 1% after adjusting for the Government's debt relief measures. The increase is due mainly to a rise in lending to businesses, while lending to households also grew marginally year-on-year after adjusting for the debt relief package. The pension funds have stepped up their mortgage lending activity in the recent past, alongside easing of borrowing requirements, more favourable interest rates, and a wider variety of loan forms. Their lending activity is still relatively limited, however, and loans to pension fund members still constitute a historically small share of the pension funds' net assets.

The Nasdaq OMXI8 index had fallen by 1.3% between meetings in May but had risen by 0.4% since the beginning of the year. Turnover in the Nasdaq Iceland main market totalled just over 190 b.kr. in the first four months of the year, about 85% more than over the same period in 2015.

Global economy and external trade

In April, the International Monetary Fund (IMF) forecast that global GDP growth would be broadly unchanged year-on-year in 2016, at 3.2%, and revised its January forecast downwards by 0.2 percentage points. The Fund also lowered its forecast for world trade growth in 2016 and 2017. Similarly, the outlook for industrialised and emerging economies' GDP growth in 2016 and 2017 is worse than was forecast in January. The outlook for GDP growth in the US, UK, and euro area is somewhat weaker for both years than was assumed in January. The IMF's forecast for 2016 output growth in Iceland's main trading partners is 0.2 percentage points lower, or 1.7%. The Fund also assumes that, during the forecast horizon, inflation will be lower in industrialised countries and higher in emerging countries than was forecast in January. Among Iceland's main trading partners, inflation is expected to be 1% this year, which is 0.4 percentage points less than according to the IMF's October forecast.

Iceland's external goods trade generated a deficit of 31.7 b.kr. for the first four months of the year, as opposed to a surplus of 7.4 b.kr. over the same period in 2015. Export values contracted by 13% year-on-year at constant exchange rates, while import values rose 6.2%. The export value of industrial goods declined by 21% year-on-year and the export value of marine products by nearly 7%. The increase in import values is due for the most part to a roughly 28% increase in the value of both transport equipment and investment goods. In addition, the value of "other" consumer goods rose by over a fifth from the previous year.

In terms of relative consumer prices, the real exchange rate increased by 0.8% month-on-month in April and 10.1% year-on-year. The increase is due primarily to a 9% nominal appreciation of the króna, but in addition, inflation in Iceland was 0.9 percentage points above the average among its trading partners.

The listed global market price of aluminium had risen by over 2% since the March meeting, and the average April price was down almost 14% year-on-year. Foreign currency prices of marine products had declined by 0.5% month-on-month in March but had risen by 1.4% year-on-year.

The domestic real economy and inflation

The wage index rose by 4% quarter-on-quarter and 11.8% year-on-year in Q1/2016; however, it should be noted that the twelve-month rise includes two contractual pay increases in the private sector. Real wages in terms of the index had risen by 9.8% year-on-year in Q1/2016.

In Q1, year-on-year growth in labour demand was broadly in line with the February forecast. According to the Statistics Iceland labour force survey (LFS), total hours worked rose by 2.3%, while the forecast assumed an increase of 2.1%. The rise in total hours is due to a 2.8% increase in the number of employed persons, whereas average hours worked declined by 0.5% because hours worked by the youngest age group fell by nearly 4%. The labour participation rate and the employment rate also rose between years, and the number of persons outside the labour market continued to fall. Seasonally adjusted unemployment measured 3.1% in Q1, having declined by 0.4 percentage points between quarters. Unemployment figures show that long-term unemployment has almost disappeared.

Key indicators of private consumption in Q1 suggest that growth has continued and even accelerated in comparison with late 2015. Payment card turnover grew by nearly 12% year-on-year during the quarter, and new motor vehicle registrations increased by more than 59%. Groceries turnover also grew considerably more than in previous quarters, and most other retail indices rose year-on-year.

The Gallup Consumer Sentiment Index measured 131.1 points in April, an increase of 7.1 points between months and nearly 47 points between years. This is the highest measurement of the index since October 2007. In the past two measurements, consumers' assessment of the current situation has measured higher than their expectations six months ahead, a development that has not been seen since early 2008.

The Government's statement of fiscal policy for 2017-2021 was presented before Parliament at the end of April, with proposed Parliamentary resolutions concerning fiscal policy, on the one hand, and a fiscal plan, on the other. According to the Parliamentary resolution on fiscal policy, the Treasury primary surplus will decline during the 2017-2021 period, during which the positive output gap is expected to narrow. If this materialises, the fiscal stance will be close to neutral. According to the fiscal plan, however, there will be slight fiscal tightening in 2018, when the Treasury primary surplus is expected to grow. Thereafter, the surplus is projected to narrow by nearly 1 percentage point until 2021, but based on these assumptions, the fiscal stance will be broadly neutral due to the diminishing output gap during the period.

Statistics Iceland's nationwide house price index, published in late April, declined 0.4% month-on-month when adjusted for seasonality, but rose 6.5% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.3% month-on-month in March when adjusted for seasonality, and by 7.4% year-on-year. The number of registered purchase agreements nationwide rose 1.7% between years in March. The average time-to-sale for flats in the greater Reykjavík area was 1.6 months in March, down from 2.5 months in March 2015.

The CPI rose by 0.2% month-on-month in April, after rising by 0.4% in March. Some base effects were present in March, as the CPI rose by a full 1% between months in March 2015. Twelve-month inflation had therefore declined somewhat since the last MPC meeting, or by 0.6 percentage points, and measured 1.6% in April. The CPI excluding the housing component rose by 0.1% month-on-month in April, and inflation was 0.2% by that measure. Underlying inflation according to core index 3 excluding tax effects had also fallen since the March meeting and measured 1.9%. Statistical measures of underlying inflation suggest that it lay in the 1½-3½% range.

The main drivers in April were the rise in the housing component and the rise in petrol prices. Increased food prices also made some impact. Telephone services fell in price in April, as did most recreation and entertainment items. Private services prices were broadly unchanged month-on-month and have risen by 1.8% in the past twelve months. The effect of the cancellation of import duties on clothing and footwear at the beginning of the year has been less than could have been expected, as these items have declined in price by only 3% in the past twelve months, in spite of the import duty cancellation and the appreciation of the króna. It is clear that this is partly due to rising domestic cost factors in the past year.

According to the Central Bank's survey of market agents' inflation expectations, carried out at the beginning of May, participants expect inflation to measure 3.2% in one year. This is 0.2 percentage points more than in the previous survey, taken in February 2016. Their expectations two years ahead measured 3.4%, about the same as in February. Respondents' long-term inflation expectations rose slightly in comparison with the previous survey but have been broadly unchanged in the past year. They expect inflation to average 3.5% over the next ten years, which is 0.2 percentage points higher than in February. The five- and ten-year breakeven inflation rate in the bond market is somewhat below market agents' expectations, averaging about 3% in April, roughly the same as in recent months.

According to the forecast published in *Monetary Bulletin* on 11 May 2016, inflation is expected to rise when the effects of the higher exchange rate and imported factors taper off. How quickly it does so will depend on the timing and scope of the turnaround in imported inflation. Inflation was in line with the February forecast during the first quarter of the year, averaging 1.9%.

Import price deflation has offset domestic inflationary pressures, which can be seen in an increased output gap and large pay rises. Inflation is expected to measure 3% in Q4/2016 and about 4½% in the second half of 2017, but then begin to ease back to target in response to monetary tightening. The outlook for this year is similar to the February forecast, but inflation is expected to be higher in H2/2017 and early 2018, as the outlook is now for stronger growth in economic activity than was assumed then. However, the marked improvement in terms of trade in recent years is considered to have increased companies' scope to absorb the cost increases stemming from pay rises. By the same token, monetary policy seems to provide a firmer anchor for inflation expectations than before, which can be seen in a more moderate rise in inflation following large pay increases than historical experience has given cause to expect.

Among Iceland's main trading partners, GDP growth measured 1.8% in 2015 and is expected to weaken somewhat this year, to 1.6% instead of the 1.9% provided for in the Bank's February forecast. Trading partner growth is forecast to measure about 2% per year in the following two years. The GDP growth outlook for the forecast horizon as a whole has therefore deteriorated since February, and uncertainty about the global economy has increased again.

Terms of trade improved by nearly 7% in 2015 and have improved by over 10% in the past two years, more than in other developed countries. It is assumed that terms of trade will improve still further this year but then deteriorate marginally in the following two years, as oil prices begin to rise and marine product prices start to taper off after the strong increase in recent years.

According to the forecast, in spite of the rise in the real exchange rate and forecasts of weaker global GDP growth, the outlook is for stronger export growth in 2016 than was forecast in February. The improved outlook is due primarily to even stronger growth in services exports; furthermore, information from exporters indicates that miscellaneous manufacturing exports will grow more than was envisioned in February. As in February, export growth is projected to ease slightly in the next two years.

According to preliminary figures from Statistics Iceland, year-2015 GDP growth measured 4%, while the February forecast had assumed 4.1% growth. GDP growth appears set to gain further momentum, rising to 4.5% this year. It is driven by strong growth in domestic demand and exports, although the contribution of net trade to output growth is negative for the third year in a row, with indicators implying strong import growth, partly due to significant imports of ships and aircraft this year. The GDP growth outlook for 2017 has also changed somewhat. Growth is now projected to measure 4%, as opposed to 3.4% in the February forecast. As before, it is expected to be driven by growth in domestic demand, particularly private consumption. If the forecast materialises, 2017 will be the third consecutive year with GDP growth of 4% or more. This is significantly above long-term trend growth and, other things being equal, it is inevitable that the rate of growth will slow down somewhat in coming years. According to the forecast, it will ease in 2018.

The domestic labour market is strong as well. Total hours worked rose by 2.3% year-on-year in Q1/2016. The participation rate is now nearly 83% after adjusting for seasonality and is close to its early-2007 peak. Seasonally adjusted unemployment measured 3.1% during the quarter. The unemployment rate is therefore most likely below the level that is estimated to be consistent with price stability and is expected to be 3.3% in 2016 as a whole. Other labour market indicators point in the same direction. Total hours worked are projected to increase by 3% this year, and a greater increase is expected next year, reflecting a stronger output growth outlook. The employment rate is expected to continue to rise, peaking next year at nearly 81%, close to the 2007 peak of 81.5%. Productivity growth is still expected to grow by an average of 1% per year over the forecast horizon. This is somewhat below the historical average but in line with the ten-year average.

As before, the pay rises are the main cause of increasing inflationary pressures, both directly – through firms' cost increases – and indirectly – through growing demand and a widening output gap. Unit labour costs are estimated to have grown somewhat less than previously thought in 2015; however, they are expected to rise by nearly 10% this year and by an average of 6½% over the forecast horizon, which is far more than is consistent with the inflation target in the medium term.

Alongside the projection of stronger GDP growth in 2016 and 2017 than was forecast in February, the output gap is expected to be somewhat larger this year. It is expected to peak at 2½% of potential output this year, or about ½ a percentage point more than in the February forecast. According to the current forecast, it will begin to narrow again in 2017.

The baseline forecast reflects an assessment of the most likely economic developments over the next three years. It is based on forecasts and assumptions concerning developments in the external environment of the Icelandic economy, as well as assessments of the effectiveness of markets and on the transmission of monetary policy to the real economy. All of these factors are subject to uncertainty. The uncertainties described in the May issue of *Monetary Bulletin* show clearly that the inflation outlook for the next three years could easily deviate from the scenario presented in the baseline forecast. Inflationary pressures could be underestimated, which (other things being equal) would call for higher interest rates than in the baseline forecast in order to keep inflation at target. Among possible causes of such a deviation, the demand-side effects of the recent wage settlements and the stimulative Government measures could be underestimated, or firms could have greater difficulty absorbing large cost increases following wage settlements than is assumed in the baseline forecast. Furthermore, inflation could be underestimated if house prices rise even further than is assumed or if the króna depreciates. Moreover, if inflation expectations are more poorly anchored than is assumed, inflation could prove more persistent than is forecast. In addition, the fiscal stance could ease still further, particularly in view of the upcoming Parliamentary elections. Although monetary policy transmission via interest rates has normalised somewhat in the recent past, the interest rate channel is still not fully functional; therefore, it could prove more difficult for monetary policy to contain domestic demand than is assumed in the baseline forecast. Inflation could also be overestimated in the forecast. For instance, it could turn out lower than projected if the global economic outlook deteriorates still further or if global oil and commodity prices are lower than is assumed in the forecast. The króna could also appreciate, and firms' ability to absorb increased costs could be underestimated. Moreover, productivity growth, which is weak in historical context, could be underestimated, which would mitigate the inflationary effects of recent pay rises.

II The interest rate decision

The Governor reported to the MPC on the status of work underway in connection with special capital flow management tools designed to affect carry trade-related capital flows. He also updated the Committee on matters relating to the Bank's capital account liberalisation strategy, including the planned auction of offshore krónur.

Committee members did not consider it timely to change reserve requirements, as the auction of offshore krónur would take place after the next MPC meeting, with settlement to take place after that. The Committee had decided at its December meeting that, other things being equal, it would lower reserve requirements back to 2% in connection with the auction.

Committee members discussed the Bank's most recent *Financial Stability* report; they also discussed financial institutions' position, the risks to the financial system in connection with capital account liberalisation, and the progress made in private sector debt restructuring.

The MPC also discussed the main issues of the Government's statement of fiscal policy for 2017-2021, presented before Parliament at the end of April in Parliamentary resolutions concerning fiscal policy, on the one hand, and a fiscal plan, on the other.

Committee members discussed whether developments since the last meeting had changed its assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the meeting, the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, although the Committee considered it likely that the monetary stance would have to be tightened in the coming term.

In this context, the MPC took into account the Bank's new forecast, published in *Monetary Bulletin* on 11 May. Members agreed with the assessment in the May forecast, that economic activity was stronger than previously thought, as the forecast indicated that the outlook was for stronger GDP growth than had been projected in February.

Members also agreed that the slack in the labour market had probably disappeared, with growth showing in rapid job creation, a rising participation rate, and declining unemployment. Moreover, long-term unemployment had nearly disappeared, and firms were having more difficulty filling available positions than they had had for quite a long time.

In the Committee's opinion, most indicators implied that growth in the domestic economy was somewhat in excess of potential output. Members considered it likely that the rate of growth would ease at some point, but according to the forecast this will not be until 2018.

In April, inflation measured 1.6%, close to what it was a year ago. In the Committee's opinion, inflation is still well below the target in spite of growing economic activity and large wage increases because the appreciation of the króna, the drop in oil and other commodity prices, very low inflation in trading partner countries, and the improvement in terms of trade had been enough to counteract these upward pressures. Committee members agreed that, other things being equal, the outlook was for inflation to remain below target well into the year but to rise when import prices stopped declining. Members noted that according to the Bank's forecast, inflation will be higher than forecast in February, as the outlook was for stronger than previously forecast growth in economic activity.

As it had done at previous meetings, the Committee discussed the reasons why large pay increases had not affected domestic inflation more strongly than they had actually done. As before, members agreed that the strong improvement in terms of trade in the recent past had probably enabled firms to absorb the cost increases instead of passing them through to prices. They also argued that it was likely that the labour market had grown more flexible, as the influx of foreign labour had increased in response to a shortage of labour instead of employers' competing for employees by outbidding each other in terms of wages. Furthermore, members agreed that the fact that inflation had risen less than could have been expected in the wake of large pay rises indicated that the credibility of monetary policy had increased.

The Committee also discussed the results of the recent assessment of the equilibrium real exchange rate, which indicates that the recent rise in the real exchange rate is due largely to an adjustment to a higher equilibrium level. In this context, it was pointed out that in the long run, the Central Bank should avoid leaning against the normal adjustment of the real exchange rate to a higher equilibrium level. It was pointed out that the aim of the Central Bank's foreign currency purchases was, under normal circumstances, to counteract excessive exchange rate volatility and, under certain circumstances, to keep the exchange rate from deviating from its equilibrium value. At present, the objective was also to build up the foreign exchange reserves in the run-up to capital account liberalisation. The planned auction of offshore krónur was a certain turning point in this regard, and the situation would be re-evaluated during the prelude to liberalisation of controls on residents.

None of the Committee members saw any reason to change interest rates at present. In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

Committee members agreed that global price developments and a stronger króna had provided the scope to raise interest rates more slowly than had previously been considered necessary. By the same token, in the Committee's opinion there were signs that monetary policy had anchored inflation expectations more securely than before and contributed to a more moderate rise in inflation than could have been expected in the wake of large pay increases. However, members agreed that this did not change the fact that, according to the Bank's May forecast, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future developments.

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 June 2016.