The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, November 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 14 and 15 November 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 16 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 5 October interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2016/4 on 16 November.

Financial markets

Since the October meeting, the króna had appreciated by 4.6% in trade-weighted terms, by 4.9% against the euro, by 4.1% against the pound sterling, and by 1.4% against the US dollar. The Central Bank's net foreign currency purchases in the domestic foreign exchange market totalled approximately 475 million euros (roughly 59.4 b.kr.) between meetings, or 54.4% of total market turnover. The Bank's net purchases year-to-date totalled 2,618 million euros (353.6 b.kr.) Since August, the Bank has bought a smaller share of foreign exchange market inflows than it did earlier in the year.

Interest rates in the interbank market for krónur had developed in line with the Bank's key rate, and there was moderate trading. In terms of the Bank's real rate, the monetary stance had tightened marginally since the October meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate had risen by 0.2 percentage points between meetings, to 3.0%.

Yields on nominal Treasury bonds and indexed Treasury and Housing Financing Fund (HFF) bonds were broadly unchanged between meetings.

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

Risk premia on Treasury foreign obligations were broadly unchanged between meetings. The CDS spread on five-year Treasury obligations measured 0.9%. The risk premium as measured in terms of the interest rate spread between the Treasury's eurobond issue and a comparable bond issued by Germany was 1.1 percentage points, whereas a comparable spread against US Treasury bonds had narrowed by 0.2 percentage points, to 0.9 percentage points. The spread against US and German bonds is now at its smallest since the issuance of the Icelandic bonds in 2012 and 2014.

Financial institutions' analysts expected either no change or a 0.25 percentage point interest rate cut this time. They agreed, however, that the interest rate decision was uncertain, as there were differing factors pulling in opposite directions. They made reference, on the one hand, to a sizeable output gap, which called for an unchanged policy stance, and on the other, to the marked improvement in the inflation outlook, owing to the appreciation of the króna, which could call for easing the monetary stance.

M3 grew by 2.8% year-on-year in Q3/2016, after adjusting for deposits held by financial institutions in winding-up proceedings, which is similar to the growth rate in Q2 but somewhat slower than in the four quarters before that. Deposit institutions' excess reserves with the Central Bank – i.e., their current account deposits in excess of required reserves – have remained relatively stable, while banknotes and coin in circulation have increased in tandem with the rise in foreign tourists visiting Iceland.

After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers grew by 1.8% year-on-year in nominal terms in Q3, and by just under 3% after adjusting for the effects of exchange rate movements on the foreign-denominated credit stock. As before, growth is due mainly to an increase in corporate lending. Pension fund loans to households have increased markedly in the past year, and the stock of loans to fund members grew by a fourth year-on-year in Q3. The pension funds' share in the total increase in lending to households is now similar to that of deposit institutions. On the other hand, the stock of HFF loans has continued to contract, and the combined increase in credit system lending to households is still relatively modest in spite of robust growth in domestic demand.

The Nasdaq OMXI8 index had fallen by 2.2% between meetings between meetings and by nearly 10% since the beginning of the year. Turnover in the Nasdaq Iceland main market totalled just over 480 b.kr. over the first ten months of the year, about 50% more than over the same period in 2015.

Global economy and external trade

Iceland's external goods trade generated a deficit of 82.2 b.kr. for the first ten months of the year, as opposed to a deficit of 25.3 b.kr. over the same period in 2015. Export values contracted by 4.8% at constant exchange rates, while import values rose 7.7%. The downturn in exports is due primarily to an 11.5% contraction in industrial exports. The rise in imports stems primarily from a year-on year increase of 37% in transport equipment imports, a rise of a fifth in imports of "other consumer goods", and a 14% increase in imports of investment goods.

The listed global market price of aluminium had risen by about 3.4% since the October meeting, and the average price in October was up about 9.2% year-on-year. On the other hand, foreign currency prices of marine products had declined by 0.6% month-on-month in September but had risen by 6% year-on-year.

In terms of relative consumer prices, the real exchange rate has risen each month since December 2015. In October it measured 95 points, nearly 17% above its 25-year average. It was up 11.4% year-on-year in the first ten months of 2016, due primarily to a 10.5% nominal appreciation of the króna, but in addition, inflation in Iceland was 0.7 percentage points above the average among its trading partners.

The domestic real economy and inflation

The wage index rose by 1.6% between quarters in Q3, and by 11% year-on-year, while real wages rose 8.5% between years.

According to the Statistics Iceland labour force survey for Q3, total hours worked rose by 3.2% year-on-year, as the Bank had forecast in August. The rise in total hours can be attributed to a 4.5% increase in the number of employed persons, although the average work week was shortened by 1.2%.

Seasonally adjusted unemployment measured 3.1% in Q3, having declined by about a percentage point year-on-year. Labour participation increased by just over 1 percentage point year-on-year and is now back to the early 2007 peak.

Key indicators of private consumption indicate continued strong growth in Q3. Payment card turnover increased by slightly more than 11% year-on-year and new motor vehicle registrations by just over 41%. Groceries turnover also grew considerably during the quarter, and other retail indices rose year-on-year.

Statistics Iceland's nationwide house price index, published at the end of October, rose by 1.4% month-on-month, after adjusting for seasonality, and by 12.7% year-on-year. The capital area real estate price Index, calculated by Registers Iceland, rose by 0.3% month-on-month in September when adjusted for seasonality, and by about 12.2% between years. The number of purchase agreements registered nationwide rose by 9.1% year-on-year in the first nine months of 2016.

The Gallup Consumer Confidence Index measured 144.3 points in October, an increase of 12.4 points between months and about 35.4 points between years. This is the highest measurement since June 2007. All sub-indices rose between months and between years.

The CPI remained unchanged between months in October, and headline inflation measured 1.8%. The CPI excluding the housing component had declined by 0.5% in the past twelve months, however. Most measures of underlying inflation suggested that it had been unchanged month-on-month in October, in the 2-2.5% range.

The main driver in October was the rise in the cost of owner-occupied housing, while the decline in food prices and postal and telephone services prices pulled in the opposite direction. Private services prices had risen by 0.9% year-on-year in October, as opposed to a 0.8% rise in September.

According to the Central Bank's survey of market agents' inflation expectations, conducted at the beginning of November, participants expect inflation to measure 2.2% in one year. This is 0.1 percentage point less than in the previous survey, taken in August 2016. Their expectations two years ahead were unchanged at 3%. Furthermore, market agents expect inflation to average 2.8% over the next ten years, or 0.2 percentage points less than in the August survey. Indicators of reduced long-term inflation expectations could also be seen in the breakeven inflation rate in the bond market, as the ten-year breakeven rate had measured 2.2-2.3% thus far in Q4, as opposed to just over 2.5% in Q3.

According to the forecast published in *Monetary Bulletin* on 16 November 2016, inflation will rise in the coming term, but more slowly than previously projected. Inflation averaged 1.3% in Q3, which is broadly in line with the August forecast. As in August, it is forecast to rise in Q4, to 2.1%, owing in part to unfavourable base effects. As 2017 progresses, however, the new baseline forecast deviates markedly from the Bank's previous forecast. Instead of continuing to rise, peaking at almost 3¾% in H1/2018, as was projected in August, inflation will remain in the 2.5-3% range throughout the forecast horizon. The main reason for reduced inflation is that the new forecast is not based on the technical assumption that the exchange rate of the króna will remain constant throughout the forecast horizon; instead, it is based on an endogenous exchange rate path. The current forecast assumes that the exchange rate will continue to rise over the majority of the forecast horizon. In addition, it is assumed that the output gap will be narrower and the rise in unit labour costs smaller.

Among Iceland's main trading partners, GDP growth has been weak for some time. It averaged 1.6% in H1/2016 and, according to the baseline forecast, will be close to that level for the year as a whole. The GDP growth outlook for 2016 is more or less unchanged from the forecast in the August *Monetary Bulletin*, as the outlook for weaker growth in the US offsets a pickup in several other advanced economies. The outlook is for growth in trading partner countries to remain broadly unchanged over the next two years and edge upwards to about 1.9% by 2019.

Over the past two years, the price of Iceland's exported goods has risen markedly in comparison with trading partner exports. Terms of trade have therefore improved by nearly 10% over this period and look set to improve by a further 3% this year. Even though global oil prices have risen more strongly and marine and aluminium product prices have developed less favourably than was assumed in August, this is a larger improvement in terms of trade than was projected at that time, owing mainly to more favourable developments in other import and export prices. Terms of trade are expected to improve marginally next year but, as was assumed in August, deteriorate slightly in the latter half of the forecast horizon.

The outlook for exports in 2016 is broadly unchanged from the Bank's August forecast. Because of base effects attributable to national accounts revision in September, exports are expected to grow by nearly 1 percentage point less in real terms than was forecast in August. Because of the reduced capelin quota, marine product exports are now expected to contract by 2% in 2017 instead of growing by 3½%. On the other hand, the outlook is for stronger exports of services and miscellaneous manufactured goods. Export growth is then projected to ease in 2018-2019, in line with the rising real exchange rate and weaker growth in global economic activity.

According to preliminary figures from Statistics Iceland, output growth measured 4.1% in H1/2016. This is similar to the growth rate for 2015 as a whole but above the Bank's August forecast of 3.6% for H1. Year-on-year GDP growth is estimated to have picked up even further in the third quarter, to 6¾%. According to the forecast, it will measure 5% for 2016 as a whole, broadly in line with the August forecast. As before, strong growth in private consumption and investment pull in one direction and the negative contribution from net trade – in spite of nearly 8% export growth – in the other. As in the Bank's previous forecasts, it is assumed that GDP growth will gradually ease towards its long-term trend rate, measuring about 3% in 2018 and 2¾% in 2019.

Excluding the stability contributions, the cyclically adjusted primary balance is estimated to deteriorate by about 1.2% of GDP this year, in addition to last year's fiscal easing of 1.3%, making for a total easing of 2.5% of GDP in 2015-2016. The fiscal stance is expected to ease by a further 1% of GDP in 2017 and then be broadly neutral over 2018-2019.

The domestic labour market is strong as well. Total hours worked have risen by 2.7% year-on-year in 2016 to date, and the increase for the year as a whole is estimated at 3%, slightly more than was forecast in August. Total hours are expected to rise by 3½% in 2017 and then taper off slightly in 2018, as GDP growth moves towards its long-term trend rate. According to the forecast, unemployment will average 3.1% this year, slightly more than was forecast in August. It is expected to be broadly unchanged next year and then gradually rise to the level consistent with low and stable inflation.

It is still the case that the main source of domestic inflationary pressures is in the labour market, as the large pay hikes provided for in the last wage agreements stimulate demand through rising household income and could induce firms to pass rising wage costs through to prices.

Firms' wage costs are estimated to rise by 9½% over the year as a whole, somewhat less than was assumed in the Bank's August forecast. As in August, the rise in wages is expected to lose pace in coming years. Although unit labour costs are expected to rise more slowly than was forecast in August, owing to the expectation of more rapid productivity growth in the coming two years, they are still expected to increase well above the level that is consistent with medium-term price stability.

As unemployment has declined, it has become more difficult for firms to hire workers, and there is a growing labour shortage in nearly all sectors. As a result, there are indications of growing demand pressures in the economy. As in the Bank's previous forecasts, the output slack is considered to have disappeared in 2015 and the positive output gap is projected at just over 2% of potential output in 2016. To a degree, though, labour shortages have been addressed with imported labour, which increases potential output and eases pressures on domestic resources. It is assumed that there will be more importation of labour during the forecast horizon than was projected in August. As a result, the output gap will be smaller from 2017 onwards than was forecast at that time.

The baseline forecast reflects the assessment of the most likely economic developments during the forecast horizon. 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 specific 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 November *Monetary Bulletin* show clearly that the inflation outlook for the next three years could easily deviate from the scenario presented in the baseline forecast. Inflation could turn out higher, for example, if households step up consumption more than is assumed in the baseline forecast. A wage settlement review early in 2017 could bring about larger pay rises than are forecast, and tension in the labour market could result in more wage drift than is projected. Firms' capacity and willingness to absorb the associated cost increases could also be overestimated. A limited supply of housing, increasing rentals to tourists, and significant importation of labour could also cause house prices to rise more rapidly than is assumed. This would raise headline inflation directly, through the housing component of the CPI, and indirectly, through stronger demand stemming from homeowners increased wealth. Demand pressures could also prove to be underestimated if the fiscal stance is eased even further in the wake of the recent elections. Furthermore, it is uncertain how firmly anchored inflation expectations are and how they will develop if the króna should depreciate in the future.

Inflation could also be overestimated in the forecast. For example, the global economic outlook could turn out too optimistic and projections for the domestic economy likewise, and imported deflation could prove more persistent than is currently assumed – that is, as long as the króna does not give way. The króna could also appreciate further and productivity growth could rise towards its trend rate more quickly than the baseline forecast indicates. Firms' willingness to streamline so as to absorb the cost increases stemming from wage settlements could also be underestimated in the baseline forecast – e.g., if competition proves stiffer than is currently assumed.

II The interest rate decision

The Governor updated the Committee on matters relating to capital account liberalisation. The Committee also discussed the Bank's foreign exchange market intervention policy, particularly in view of the fact that amendments to the Foreign Exchange Act had recently been passed and the liberalisation of capital controls on individuals and businesses had therefore begun. Capital outflows had not been substantial as yet, however. Inflows into the foreign exchange market had been significant since the Committee's last meeting, however, and appeared to stem primarily from the external trade surplus – due mainly to improved terms of trade and growth in exports, in particular tourism – and to capital inflows unconnected to carry trade-related investment in the bond market. Committee members agreed that the recent appreciation of the króna was due at least partly to an adjustment to a higher equilibrium real exchange rate. The Central Bank had bought substantial amounts of foreign currency during the prelude to capital account liberalisation in order to build up the foreign exchange reserves, but the MPC was of the view that the reserves were now sufficiently large in terms of the criteria the Bank had set. Since August, the Bank had bought a smaller share of foreign currency inflows than it had earlier in the year. Members agreed that, other things being equal, it was appropriate to continue in this vein and to review the situation at the Committee's next regular meeting.

The MPC discussed whether developments since the previous meeting had changed its assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the October meeting, the Committee had decided to keep the Bank's interest rates unchanged, as the growing macroeconomic imbalances and uncertainties associated with capital account liberalisation argued for caution in interest rate setting.

In this context, the MPC took account of the new baseline forecast published in *Monetary Bulletin* on 16 November. According to the forecast, GDP growth appears set to be strong in 2016 and 2017 and the outlook is for stronger growth in economic activity than the Bank had projected in August. The Committee also considered that GDP growth was driven more by domestic demand than before, job creation had been strong, unemployment had fallen swiftly, and there were clearer signs than before that rapid demand growth had begun to strain domestic resources. Members agreed, however, that increased labour importation appeared to ease the pressure somewhat.

Members discussed developments in inflation, which had measured 1.8% in October and had remained below target for nearly three years in spite of large pay increases and rapid demand growth. Underlying inflation had also been below target, although by a smaller margin than headline inflation. As they had done at previous meetings, they discussed the reasons for low inflation in spite of increased demand pressures in the economy. They agreed, as before, that improved terms of trade, low global inflation, and the appreciation of the króna had offset the effects of wage increases on the price level.

They also agreed that a tight monetary stance had played an important role in containing inflation and anchoring inflation expectations more securely. It had done this by slowing demand growth, directing some of the steep rise in income and wealth towards saving, and containing credit growth. The Committee was of the view that in this way, monetary policy had supported the exchange rate of the króna, which had lowered import prices even further and shifted some of the strong demand towards imports.

The MPC noted that according to the Bank's new inflation forecast, the outlook is for inflation to be below target until mid-2017 and in the 2½-3% range from then until the end of the forecast horizon. The discussion turned to the outlook for considerably lower inflation than in the Bank's previous forecasts, which had indicated that inflation would rise over the course of the horizon. Members agreed that the more favourable developments in inflation were due in large part to the fact that the baseline forecast is now based on an endogenous exchange rate path and not on the technical assumption of a constant exchange rate throughout the forecast horizon. The transmission of monetary policy through the exchange rate channel was therefore more effective and inflation would remain moderate for a longer period. The Committee also discussed the fact that in its recent decisions, most members had expected a significant appreciation of the króna. The change in the inflation forecast therefore provided less grounds for monetary policy response than might be expected based on changes in the Bank's published forecasts. In the MPC's opinion, the inflation outlook had also improved, even taking account of this, particularly the short-term outlook.

The MPC discussed the monetary stance, which had tightened marginally since the October meeting, in terms of both the Bank's real rate and the appreciation of the króna. In the Committee's opinion, there were grounds for keeping interest rates unchanged and for lowering them by 0.25 percentage points.

The main argument in favour of unchanged interest rates that was expressed at the meeting was that, even though conditions for a rate cut could be developing, it was not timely to take such a decision because uncertainty about important factors had increased, at least in the short run. Most important among them were the uncertainties about the fiscal stance following the recent elections and the incoming Government's economic policy. Members also agreed that unrest in the labour market had increased, particularly in the wake of the recent ruling providing for pay increases for elected officials. If a wage settlement revision is triggered next year, it could entail larger pay increases than were assumed in the Bank's forecast. Furthermore, there was still some uncertainty about the impact of capital account liberalisation, although members agreed that the process had been smooth thus far. Added to domestic uncertainties was the fact that uncertainty about the global economic outlook had increased between meetings. Those members who leaned most strongly towards keeping interest rates unchanged were also of the view that even though there could be grounds for increasing incentives for foreign investment, a 0.25-point rate cut would probably have little effect. In order to increase foreign investment, a substantial rate reduction would be needed, together with a clear message that rates would be kept low for some time. This, however, would be at odds with the interest rate needed to contain domestic demand pressures.

The main grounds for a rate cut that were expressed at the meeting were that the monetary stance had tightened more than previously expected, owing to the appreciation of the króna. The outlook was for the króna to keep strengthening well into 2017. Such a tight stance was not entirely appropriate in view of developments in inflation, and therefore, it could be appropriate to ease temporarily the tightening caused by the currency appreciation. A smaller interest rate spread with abroad could encourage residents to invest abroad, thereby mitigating the appreciation, which had recently been both steep and rapid. Those members who considered conditions appropriate for a rate reduction nevertheless thought there was reason for caution. They were not convinced that monetary easing could continue but were of the view that the situation would have to be reviewed in light of developments in other factors that affect the monetary stance. These members considered it unlikely that the fiscal stance would change radically from that assumed in the baseline forecast before the presentation of the 2018 fiscal budget. As a result, it would be pointless to wait with a rate cut until fiscal policy was clarified. They also emphasised that the risk of a steep post-liberalisation drop in the exchange rate had subsided markedly, as such pressures would presumably have come to the fore already.

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 5.25%, the current account rate 5%, the seven-day collateralised lending rate 6%, and the overnight lending rate 7%. Three members voted in favour of the Governor’s proposal. Two members voted against the Governor’s proposal, voting instead to lower interest rates by 0.25 percentage points.

MPC members agreed that although inflation expectations appeared to be more firmly anchored to target and the monetary stance had tightened to some extent through the appreciation of the króna, strong demand growth and the aforementioned uncertainties called for caution in interest rate setting. The Committee was of the view that in the coming term, the monetary stance will be determined by economic developments and actions taken in other policy spheres.

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 14 December 2016.