The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, October 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 3 and 4 October 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 5 October, 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 24 August interest rate decision.

Financial markets

Since the August meeting, the króna had appreciated by 3.1% in trade-weighted terms, by 2.1% against the US dollar, by 3.6% against the euro, and by 5.5% against the pound sterling. The Central Bank's net foreign currency purchases in the domestic foreign exchange market totalled approximately 333 million euros (roughly 43 b.kr.) between meetings, or 53.2% of total market turnover. The Bank's net purchases year-to-date totalled 2,143 million euros (294 b.kr.)

Interest rates in the interbank market for krónur had developed in line with the Bank's key rate, and there was some trading after a long hiatus. In terms of the Central Bank's real interest rate, the monetary stance was virtually unchanged since just after the rate cut in August. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 2.8%.

Yields on most nominal Treasury bonds declined by 0.5-0.6 percentage points following the Bank's interest rate reduction in August, and by another 0.2-0.4 percentage points after Statistics Iceland published the August consumer price index (CPI) and Moody's announced its upgrade of Iceland's sovereign credit ratings in early September. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds declined by 0.3-0.5 percentage points over the same period, however. The five-and ten-year breakeven inflation rate in the bond market was 2.1% at the beginning of September, 0.5-0.6 percentage points lower than it had been at the time of the August meeting. The decline reversed in part after the publication of the CPI in late September, and the breakeven rate was 2.4% at the time of the October meeting.

The three large commercial banks' deposit rates and mortgage lending rates had declined in line with the Bank's interest rate reduction in August, but indexed mortgage rates were broadly unchanged.

Risk premia on Treasury foreign obligations were broadly unchanged between meetings. The CDS spread on five-year Treasury obligations was 0.9%, and the risk premium as measured in terms of the interest rate spread between the Treasury's eurobond issues and comparable government bonds issued by Germany, on the one hand, and the United States, on the other, was 1.1-1.2 percentage points.

After the correction of the error in Statistics Iceland's inflation measurement at the end of September, all of the financial institutions' analysts expected the Bank's nominal interest rates to remain unchanged, arguing that the previously cited grounds for a rate reduction no longer existed, as the correction had entailed that real interest rates in terms of twelve-month inflation were considerably lower than previously thought.

In August, M3 grew by about 1.9% 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 2016. As in recent months, the rise is due primarily to increased household deposits. The total stock of credit system lending to resident borrowers grew over the same period by 0.7%, and by approximately 1.5% adjusted for the Government's debt relief measures. As before, this growth seems to be driven largely by increased corporate lending, although household lending grew marginally year-on-year as well, when adjusted for the aforementioned debt relief measures.

The Nasdaq OMXI8 index had risen by 1.8% between meetings but had fallen by 7.7% since the beginning of the year. Turnover in the Nasdaq Iceland main market totalled just over 427 b.kr. over the first nine months of the year, about 63% more than over the same period in 2015.

Global economy and external trade

Iceland's external goods trade generated a deficit of 84.4 b.kr. for the first eight months of the year, as opposed to a deficit of 12 b.kr. over the same period in 2015. Export values contracted by 9.5% at constant exchange rates, while import values rose 9.5%. The downturn in exports is due primarily to a contraction of 16% in industrial exports and nearly 5% in marine product exports. The rise in imports stems primarily from a year-on-year increase of 42% in transport equipment imports and about one-fifth in imports of consumer goods and investment goods.

The listed global market price of aluminium was virtually unchanged since the August meeting, and the average September price was unchanged year-on-year as well. However, foreign currency prices of marine products rose by about 1.7% between months in August and had risen 6.6% year-on-year at that time.

In terms of relative consumer prices, the real exchange rate measured 90.5 points in August and had risen each month since December 2015. It was up 10.7% year-on-year in the first eight months of 2016, due mostly to the 9.9% nominal appreciation of the króna, although inflation in Iceland was 0.7 percentage points above the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in September, GDP growth measured 3.7% in Q2/2016. Domestic demand grew 9.7% year-on-year during the quarter. Of that total, consumption and investment grew by a total of 10.9%, whereas the contribution from inventory changes was negative during the quarter. The contribution from net trade was negative in spite of nearly 5% growth in exports, as import growth was much stronger, at 16.7%.

GDP growth therefore measured 4.1% in the first half of the year, reflecting the offsetting effects of 9.4% growth in domestic demand and the negative contribution from net trade. The national accounts are broadly in line with the Central Bank's August forecast. However, domestic demand was somewhat stronger than was projected there, but was offset by somewhat weaker contribution from net trade because of weaker-than-expected services exports. GDP growth was somewhat above the Bank's forecast of 3.6% for the period.

The current account balance was positive by 31.8 b.kr., or 5.4% of GDP, in Q2. This is a larger surplus than in the previous quarter but similar to that in the same quarter of 2015. The surplus for the second quarter was due to a 62.3 b.kr. surplus on services trade and an 8 b.kr. surplus on primary and secondary income, which were offset by a 38.5 b.kr. deficit on goods trade. A revision of earlier figures also shows a larger surplus in 2015 and Q1/2016, owing to more strongly positive services and income balances than previously anticipated.

Private consumption grew by 8.2% in Q2 and by 7.7% in the first half of the year. Key indicators such as payment card turnover, new motor vehicle registrations, and retail sales figures for the first two months of Q3 suggest continued strong growth; furthermore, developments in real wages and house prices support household demand. The Gallup Consumer Confidence Index measured 131.9 in September, more than 28 points higher than in September 2015. The big-ticket index, which measures households' planned major purchases, declined between measurements, however, to 65 points in September.

According to Gallup's autumn survey among Iceland's 400 largest firms, carried out in August and September, executives are optimistic about the economic outlook. The index for the current state of the economy measured 194.3, the fourth-highest value ever recorded. The indices for transport and tourism, construction, financial services, and retail and wholesale trade all measured 200, the highest value the indices permit. More than half of executives expect economic conditions to be unchanged (i.e., still favourable) six months ahead. According to the survey, respondents were not as optimistic as in the summer survey but somewhat more so than in September 2015.

According to Gallup's autumn survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by nearly a third. This is a somewhat smaller percentage than in the summer survey but a marked increase from the survey taken a year earlier. As in the summer survey, about 42% of firms considered themselves short-staffed, an increase of over 16 percentage points in the past year.

The wage index rose by 0.3% month-on-month in August and by 11.2% year-on-year, while real wages rose by 10.1% year-on-year.

Statistics Iceland's nationwide house price index rose by 4.2% quarter-on-quarter in Q3 when adjusted for seasonality and 10.2% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 1.7% month-on-month in August, when adjusted for seasonality, and by 13.1% year-on-year. The number of purchase agreements registered nationwide rose by 9% year-on-year in the first eight months of 2016.

The CPI rose by 0.48% month-on-month in September, after rising 0.34% in August. Twelve-month inflation measured 1.8% in September and had risen significantly since the MPC's August meeting. However, excluding the housing component, it had fallen by 0.4% since September 2015. Most measures of underlying inflation indicate that it lay in the 2-2.5% range in September and had risen between months.

The inflation spike in September is due mainly to two factors: base effects from a steep decline in prices in September 2015 and increases in the cost of owner-occupied housing. The correction of Statistics Iceland's measurement error strongly affected the rise in the housing component of the CPI, as price increases in August were included in September inflation figures. Because of the correction, the CPI rose 0.27 percentage points more during the month than it would have otherwise. Furthermore, seasonal factors affected the September inflation measurement. End-of-sale-effects pushed prices upwards, while airfares pulled in the opposite direction. Private services prices had risen by 0.8% year-on-year in September, as opposed to a 0.5% rise in July.

In the third quarter, inflation measured 1.3% but would have been 1.5% if the aforementioned measurement error had not taken place. This is well in line with the Bank's forecast of 1.2%, published in *Monetary Bulletin* 2016/3. Statistics Iceland's correction also shows that the Bank's overestimation in the beginning of the year was somewhat smaller than previously thought.

According to the Gallup survey, household inflation expectations were at an all-time low in September. One-year expectations measured 2.5%, a decline of 0.7 percentage points since the previous survey, conducted in May, and two-year expectations were 3%, a decline of 1 percentage point between surveys. According to Gallup's autumn survey of corporate inflation expectations, one-year expectations had fallen by 1 percentage point, to 2%, and two-year expectations had fallen by 0.5 percentage points, to 3%.

II The interest rate decision

The Governor updated the Committee on matters relating to capital account liberalisation. The Committee discussed the Bank's foreign exchange market intervention policy. Members agreed to maintain an unchanged intervention policy at this juncture, as the bill of legislation amending the Foreign Exchange Act had not yet been passed, as the Committee had assumed it would be at its last meeting, and the easing of controls provided for immediately upon passage of the bill had not yet taken place. The MPC decided, however, to review the situation at its next meeting or at an extraordinary meeting, if necessary.

Committee members 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 August meeting, the MPC had decided to lower the Bank's interest rates by 0.5 percentage points because it appeared likely that inflation could be kept at target over the medium term with lower interest rates than previously considered possible.

Committee members discussed the information that had emerged between meetings and agreed that the overall situation was broadly unchanged since the previous meeting. The Committee was of the view that continued strong GDP growth could be expected in the near term, as the most recent indicators suggested that growth could turn out even stronger than members had previously expected.

As the MPC had anticipated, inflation rose again in September because of unfavourable base effects. The rise in the CPI was somewhat larger than had been expected, however, because of the correction of Statistics Iceland's measurement error covering the period from March to August. In spite of the correction, members agreed that the inflation outlook was broadly unchanged from the Bank's August forecast. It was noted in discussion that the change was within the 50% confidence interval of the forecast, and it was also pointed out that the króna had appreciated even more than the forecast had provided for. Furthermore, inflation expectations had remained close to the inflation target by most measures. Members also considered it positive that households' and businesses' inflation expectations had fallen significantly since the last meeting. They also noted that the Bank's overestimation of inflation in Q2 and Q3 in the forecasts published in the first half of the year had proven to be smaller than previously thought. Moreover, it was pointed out that if correctly measured, inflation had not fallen below the 1% lower deviation limit of the inflation target in August; therefore, the Bank would not have had to send a special report to the Government about the deviation.

Committee members considered the fact that in spite of large pay increases and rapid demand growth, inflation had remained below target for two-and-a-half years. They agreed, as before, that improved terms of trade, low global inflation, tight monetary policy, and the appreciation of the króna in spite of large foreign currency purchases by the Central Bank had offset the effects of wage increases on the price level. Some concerns were expressed about the large rise in the real exchange rate in a short period of time, and it was pointed out that there was some uncertainty about the sustainability of the rise in the long run; that is, the improvement in terms of trade and the steady stream of tourists to Iceland. Various signs of impending overheating had emerged, but on the other hand, credit growth was within moderate limits, and Iceland's external balance and net position did not indicate that the premises for GDP growth would be derailed in the coming term. The Committee decided to discuss developments and prospects for the exchange rate at its next meeting, when it could be expected that the first effects of general capital account liberalisation would have emerged.

No 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 5.25%, the current account rate 5%, the seven-day collateralised lending rate 6%, and the overnight lending rate 7%. All Committee members voted in favour of the proposal.

Committee members agreed that the likelihood of increased macroeconomic imbalances and the uncertainty associated with capital account liberalisation argued for caution in interest rate setting. The monetary stance in the coming term would depend on economic developments and the success of the capital account liberalisation process.

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 16 November 2016.