The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, August 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 22 and 23 August 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 24 August, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 1 June interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2016/3 on 24 August.

Financial markets

Since the June meeting, the króna had appreciated by 6.8% in trade-weighted terms, by 18.9% against the pound sterling, by 7.1% against the US dollar, and by 5.4% against the euro. The Central Bank's net foreign currency purchases in the domestic foreign exchange market totalled approximately 771 million euros (104 b.kr.) between meetings, or roughly 55% of total market turnover. The Bank's net purchases year-to-date totalled 1,810 million euros (251 b.kr.)

Interbank market rates had developed in line with the Bank's key rate, but no transactions had taken place in the market between meetings.

In terms of the Central Bank's real interest rate, the monetary stance had tightened since the June meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate had risen by 0.4 percentage points between meetings, to 3.2%, but in terms of past twelve-month inflation it had risen by 0.6 percentage points, to 4.6%.

Inflows of foreign capital to the domestic bond market had virtually halted after the Bank adopted its new temporary capital flow management measure in June. Yields on nominal Treasury bonds had remained more or less unchanged between meetings, however, after having risen somewhat just after the capital flow management measure was introduced. The yield on indexed Treasury and Housing Financing Fund (HFF) bonds had risen by nearly ½ a percentage point, however, in line with the rise in the Bank's real rate, and the liquidity premium on indexed bonds has probably risen as well, with the decline in the number of market makers.

The large commercial banks' indexed and non-indexed deposit and lending rates were unchanged since the June meeting, and the pension funds' average mortgage lending rate had changed very little.

Risk premia on Treasury foreign obligations had declined between meetings. The CDS spread on five-year Treasury obligations was just under 0.9% at the time of the August meeting, the lowest since the beginning of 2008. 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, had also declined by 0.3 percentage points, to about 1% and 1.4%, respectively.

Financial institutions' analysts had all expected the Bank's nominal interest rates to remain unchanged in August, with reference to the MPC's previous statements on the possible need for further rate hikes, but on the other hand, they were of the view that the inflation outlook had improved and the Bank's real rate had risen. They expected a change in tone in the MPC statement and made particular reference to the appreciation of the króna, which would probably reduce inflationary pressures.

In Q2/2016, M3 grew by about 1.8% year-on-year after adjusting for the deposits held by the financial institutions in winding-up proceedings, which is less growth than in the past year. The total stock of credit system lending to resident borrowers grew over the same period by 0.6%, and by just under 1.6% 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 fallen by 6.8% between meetings and by 9.3% since the beginning of the year. Turnover in the NASDAQ Iceland main market totalled just over 320 b.kr. over the first seven months of the year, about 70% more than over the same period in 2015.

Global economy and external trade

The global GDP growth outlook for 2016 and 2017 had deteriorated slightly, according to the International Monetary Fund's (IMF) July forecast. Global output growth was forecast at 3.1% in 2016, about 0.1 percentage point less than in the Fund's April forecast. The poorer outlook was due mainly to weaker GDP growth in the US, Japan, and the UK. The forecast for 2017 was 3.4%, 0.1 percentage point less than the fund's April forecast, owing primarily to weaker output growth in the UK. If the global GDP growth forecast for 2016 materialises, the rate of growth will be similar to that in 2015, and the weakest since 2009. The forecast for growth in world trade in 2016 was also revised downwards. Inflation in developed countries was projected at 0.7% for this year, the same as in April, but was forecast to rise to 1.6% in 2017. The 2016-2017 GDP growth forecast for Iceland's main trading partners was similar to the

April forecast, or 1.7% and 1.8%, respectively. The uncertainty in the GDP growth forecast is still considered tilted to the downside, particularly because of the uncertainty that has developed around the UK's decision to leave the EU.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 9.6 b.kr. deficit in July and a 72 b.kr. deficit in the first seven months of the year. Export values contracted by 10.4% year-on-year at constant exchange rates, while import values rose 7.6%. The contraction in exports is due primarily to a 16.5% contraction in industrial exports and a nearly 7% contraction in marine product exports. The rise in imports stems primarily from a year-on-year increase of 40% in transport equipment imports and 23% in "other" consumer goods imports.

The listed global market price of aluminium had risen by 6.8% since the June meeting, and by 6.6% year-on-year. Foreign currency prices of marine products rose by 1% between months in June and have risen by 2.6% year-on-year.

In terms of relative consumer prices, the real exchange rate rose 2.7% month-on-month in July, to 88.1 points. It was up 10.3% year-on-year in the first seven months of 2016, due mostly to the 9.4% nominal appreciation of the króna, although inflation in Iceland was 0.8 percentage points above the trading partner average.

The domestic real economy and inflation

The wage index rose by 2.8% between quarters in Q2, and by 13% year-on-year, while real wages rose 11.2% between years.

According to Statistics Iceland's labour force survey (LFS) for Q2, the number of jobs grew by 3% year-on-year, as was assumed in the Bank's May forecast, but the average work week continued to shorten instead of remaining unchanged, as was projected in May. Growth in total hours worked was therefore somewhat weaker than forecast, at 2.5% instead of 3%.

Q2 unemployment was broadly in line with the May forecast, measuring 3.6%, or 2.7% seasonally adjusted. The seasonally adjusted rate is at its lowest since Q2/2008.

Key indicators of private consumption growth in Q2 suggest a continuation of the pattern in the first quarter, when growth measured just over 7% year-on-year. Payment card turnover increased 12.7% year-on-year during the quarter and new motor vehicle registrations by 36.4%. Furthermore, growth in groceries turnover picked up during the quarter. Most indicators of private consumption showed marked growth in July, apart from a slight easing of payment card turnover growth.

Statistics Iceland's nationwide house price index, published at the end of July, rose 0.6% month-on-month when adjusted for seasonality and by 8.1% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 2.1% month-on-month in July when adjusted for seasonality, and by 12.4% year-on-year. During the first seven months of the year, the number of purchase agreements rose year-on-year by 7% nationwide and by 5% in the greater Reykjavík area. The average time-to-sale for capital area housing was two months over that same period, nearly one-and-a-half months shorter than during the same period in 2015.

The Gallup Consumer Confidence Index fell somewhat between June and July, after having risen significantly in the recent term. It measured just under 125 points, an increase of 25.6 points between years. In Q2/2016, the index was 42.6 points higher, on average, than in the same period in 2015.

The CPI fell 0.3% month-on-month in July, after rising by 0.2% in June. Twelve-month inflation measured 1.1% and had declined since the MPC's June meeting. However, excluding the housing component, it had fallen by 0.6% since July 2015. Most measures of underlying inflation indicate that it lay in the 1½-2½% range in July and had fallen by ½ a percentage point month-on-month.

The disinflation in July was affected, among other things, by stronger summer sale effects than in recent years and a decline in petrol prices. Pulling in the other direction were increases in house prices, airfares, and food prices. Private services prices had risen by only 0.5% in the past twelve months, as opposed to 2.1% in May.

According to the Central Bank's survey of market agents' inflation expectations, conducted just before the publication of *Monetary Bulletin* 2016/3, participants expect inflation to measure 2.3% in one year. This is 0.7 percentage points less than in the previous survey, taken in May 2016. Their expectations two years ahead also declined, measuring 3%. Furthermore, they expect inflation to average 3% over the next ten years, or 0.5 percentage points less than in the May survey. The decline in long-term inflation expectations can also be seen in the breakeven inflation rate in the bond market, as the ten-year rate measured more than 3% earlier this year but has been 2.8% so far in Q3.

According to the forecast published in *Monetary Bulletin* on 24 August 2016, the inflation outlook has improved since the Bank's May forecast. Inflation has declined in recent months in spite of a growing positive output gap. The exchange rate of the króna has risen, and deflation on imported goods and services has offset domestic inflationary pressures. Furthermore, inflation expectations have continued to ease downwards. The inflation outlook has therefore improved since the Bank's May forecast, mainly because of the marked appreciation of the króna and the prospect of somewhat stronger productivity growth in 2016 than was assumed in that forecast. As before, inflation is forecast to rise when the effects of the appreciation begin to taper off, provided that the króna does not appreciate further. Based on this assumption, it is assumed that inflation will peak at about 3¾% in the first half of 2018 and then begin to ease back towards the target in response to a tight monetary stance.

The global economic outlook had changed and uncertainty had increased since the publication of the May issue of *Monetary Bulletin*. The main factor was Britain's decision to leave the European Union. The financial markets responded strongly to the decision, but those effects had reversed somewhat by the time the forecast was prepared. The GDP growth outlook for Iceland's main trading partners has deteriorated since May and is subject to stronger headwinds than before.

For 2016, the outlook is for a somewhat smaller improvement in terms of trade than was forecast in May, whereas in the next two years terms of trade are forecast to improve more than was anticipated in May. Export growth is projected at 8.6% in 2016, a percentage point more than was forecast in May, while the forecast for the next two years is broadly in line with the 3-4% projected in May.

The assumptions in the forecast about wage developments are similar to those in May. The confidence interval of the forecast takes account of the fact that, given the tension that appears to be developing in the labour market, wage drift could be underestimated in the forecast, particularly later in the forecast horizon. According to the forecast, unit labour costs are projected to rise somewhat less this year than was previously estimated, as the outlook is for stronger productivity growth. The outlook for the forecast horizon overall is broadly unchanged, however.

Domestic demand grew by just over 8% in Q1/2016, and GDP growth measured 4.2%. GDP growth for the year as a whole is estimated at 4.9%, some 0.4 percentage points more than was forecast in May. The deviation is due mainly to indicators of stronger growth in private consumption and business investment, while external trade pulls in the opposite direction, owing to a surge in imports. As before, GDP growth is driven by rapid growth in disposable income and improvements in households' and businesses' balance sheets. This is compounded by fiscal easing, whereas on the other hand, monetary policy has slowed domestic demand growth and directed a portion of increased income towards domestic saving. GDP growth is still projected at over 4% in 2017. If the forecast materialises, it will be the third consecutive year with a GDP growth rate of 4% or more. As in the Bank's previous forecasts, it is assumed that GDP growth will gradually ease towards its long-term trend level, measuring about 2½% in 2018.

According to the forecast, the slack in the economy disappeared in 2015, and a positive output gap has developed in the recent term, concurrent with strong GDP growth. As in May, the output gap is expected to continue growing, peaking early next year before narrowing again.

II The interest rate decision

The Governor reported to the Committee on the experience of the new monetary policy instrument intended to temper and affect the composition of capital inflows to the country. He also updated the Committee on matters relating to the next steps in the general liberalisation of capital controls. The Bank's analysis of potential outflows upon liberalisation was discussed as well.

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 June meeting, the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, but considered it likely that the monetary stance would need to be tightened in the coming term.

In this context, the Committee took account of the Bank's new macroeconomic forecast, published in *Monetary Bulletin* on 24 August, according to which inflation will be somewhat lower in the coming term than had been forecast in May, but GDP growth will be stronger in 2016 and robust in 2017.

Members discussed the fact that in spite of large pay increases and a widening positive output gap, inflation had remained below target for two-and-a-half years. In July, inflation had measured 1.1%, the lowest rate since the beginning of 2015.

Committee members agreed that the inflation outlook had improved markedly since the Bank's May forecast and that the outlook was for inflation not to rise as much or as rapidly as had been projected in May. They also considered that if the exchange rate should continue to rise, inflation could turn out lower than was provided for in the baseline forecast, other things being equal.

The Committee discussed recent exchange rate developments, as the króna had appreciated by 6.8% since the June meeting. Although the appreciation could be attributed in part to global factors, members were of the view that it probably reflected to a large extent the strong foreign currency inflows stemming from the external trade surplus. Inflows related to new investment in the bond market had virtually halted, however, with the implementation of the new monetary policy instrument. Committee members were of the view that the equilibrium exchange rate had probably risen, although it was uncertain how much. To the extent that the adjustment of the real exchange rate to a higher equilibrium rate was inevitable following the commencement of general liberalisation of capital controls, it would be preferable that this adjustment take place through nominal appreciation rather than elevated inflation.

The Committee discussed the foreign exchange market intervention policy that has been pursued in recent weeks – a policy based on keeping the reserves close to the balance required in advance of the anticipated steps towards liberalisation. Members agreed that a temporary overshooting of the exchange rate during the prelude to liberalisation was not desirable, but neither did they consider it desirable to disconnect price formation of the króna in the market entirely. It was pointed out that, under normal circumstances, the aim of the Central Bank's foreign currency interventions was to counteract excessive exchange rate volatility and, under certain circumstances, excessive currency misalignments. The Committee decided not to make any changes to the intervention policy at this time but rather to discuss it at its next meeting, or at an extraordinary meeting if necessary, and to take account of the steps towards liberalisation that would presumably have been taken by that time.

The MPC discussed developments in terms of trade; and noted the fact that the improvement in terms of trade, the appreciation of the króna, and low global inflation had offset the effects of rising unit labour costs on the price level – thus contributing to lower inflation than would otherwise have resulted. The Committee also discussed the role of monetary policy. Considering the fact that inflation had been below target for nearly three years in spite of large wage increases, members were of the view that the role of monetary policy in containing inflation had been instrumental. Members agreed that this was too long a time for it to be explainable without reference to monetary policy. They were of the view that, over such a long period, an easier monetary stance would likely have resulted in higher inflation. The domestic disinflation and the appreciation of the króna supported the opinion that monetary policy was a factor. It was pointed out as well that a recent analysis of the factors affecting inflation developments over the past two years indicated that monetary policy also played a role in the disinflation process.

Committee members considered it likely that the monetary stance and credible MPC statements to the effect that the objective of keeping inflation at target would not be compromised had caused firms to hesitate before passing wage cost increases through to prices. They also pointed out that the nominal appreciation of the króna was not independent of monetary policy, as a tight monetary stance had, among other things, contributed to reduced demand for credit and increased saving, thereby supporting a current account surplus and a higher exchange rate.

In the Committee's opinion, the most important indication of increased credibility of monetary policy that had emerged since the last meeting was that short- and long-term inflation expectations had declined still further and were now, by most measures, at or near the target. Committee members considered it unlikely that favourable external conditions explained the decline in long-term inflation expectations to target. Large pay increases had at first resulted in a rise in inflation expectations, but recent developments had been more favourable than MPC members had dared hope.

Members agreed that monetary policy and favourable external conditions had led to lower inflation and contributed both to the recent decline in inflation and to the fact that inflation expectations were currently close to target. This development implied that, in the recent past, real interest rates had risen somewhat more than was provided for in the Bank's previous forecast. It was argued by some members that, due to the lack of monetary policy credibility, it would not have been prudent to respond sooner. In this context, it was pointed out that long-term inflation expectations had been above target until very recently. It was also noted that it would have been imprudent to assume in advance that the recent favourable economic developments, manifested in a significant improvement in terms of trade, foreign currency inflows, and the appreciation of the króna, would materialise, as these developments had exceeded previous forecasts.

Given that monetary policy seems to have been more successful than the Committee had anticipated earlier in 2016, members agreed that it looked as though it would be possible to keep inflation at target over the medium term with lower interest rates than had previously been thought possible. All members agreed that it was appropriate to lower interest rates at this time. On the other hand, they also considered it necessary to take account of the growing macroeconomic imbalances and the uncertainty ahead associated with capital account liberalisation.

The Committee discussed whether the Bank's interest rates should be lowered by 0.25 or 0.5 percentage points. The main arguments for the larger reduction were that the real rate had risen more than had been assumed in the Bank's last forecast. It was pointed out that the real rate was nearly 1 percentage point higher than it had been when the MPC had last decided to change interest rates. Furthermore, it was pointed out that, given how high the real rate was, the larger rate cut would better support neutral forward guidance. The main arguments expressed at the meeting in favour of the smaller rate cut were that it was appropriate to demonstrate caution in view of the significant uncertainty about the exchange rate following the next stages in capital account liberalisation, as there was the risk that inflation could rise rapidly if the króna depreciated afterwards. It was also pointed out that although inflation expectations had recently eased down to the target, it had yet to emerge how firmly anchored they were, and this would not become clear until inflation rose temporarily above target or the króna depreciated markedly. A more cautious step would also be justifiable in light of indications of robust growth in domestic demand and growing macroeconomic imbalances, particularly in the labour market. A further argument against a larger cut was that the rate cut would take the market by surprise. Members agreed, however, that even if the larger reduction were implemented, the interest rate differential with abroad would remain large enough to support the króna during the next steps towards capital account liberalisation.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.5 percentage points, which would lower the key rate (the seven-day term deposit rate) to 5.25%, deposit rates (current account rates) to 5%, the seven-day collateralised lending rate to 6%, and the overnight rate to 7%. Two members voted in favour of the Governor's proposal, and two voted against, preferring to lower interest rates by 0.25 percentage points. The Governor's proposal was therefore approved with three votes against two.

In the Committee's view, whether interest rates will be lowered further or must be raised again will depend on economic developments and on the success of the next steps in 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 5 October 2016.