The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, December 2016

Published 28 December 2016

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 13 December 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 14 December, 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 November interest rate decision.

Financial markets

Since the November meeting, the króna had appreciated by 1.3% in trade-weighted terms, by 2.6% against the euro, by 0.8% against the US dollar, and depreciated by 1.4% against the pound sterling. The Central Bank's net foreign currency purchases in the domestic foreign exchange market totalled approximately 171 million euros (roughly 20.5 b.kr.) between meetings, or 53% of total market turnover. The Bank's net purchases year-to-date totalled 2,789 million euros (374 b.kr.)

Interest rates in the interbank market for krónur had developed in line with the Bank's key rate. The Bank's real rate, in terms of the average of various measures of inflation and inflation expectations, was virtually unchanged at 2.9%.

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 unchanged since the November meeting, as was the pension funds' average mortgage lending rate.

Risk premia on Treasury foreign obligations were broadly unchanged since the Committee's last meeting. The CDS spread on five-year Treasury obligations in US dollars was still about 0.9%, and the risk premium as measured in terms of the interest rate spread between the Treasury's foreign currency issues and comparable bonds issued by the US and Germany had increased by about 0.1-0.2 percentage points.

Financial institutions' analysts had expected either no change or a reduction in the Central Bank's nominal interest rates in December. As grounds for an unchanged key rate, they cited strong growth in domestic demand, tension in the labour market, and uncertainty about fiscal policy and capital account liberalisation. The main grounds for a rate cut were that, even though the national accounts for the first nine months of the year showed stronger GDP growth than the Bank had forecast in November, the composition of GDP growth indicated that inflationary pressures were probably less pronounced. The appreciation of the króna in the recent term had also tightened the monetary stance more than the Central Bank had forecast.

M3 grew by 4.1% year-on-year in September and by 5.7% in October, after adjusting for deposits held by financial institutions in winding-up proceedings, a stronger growth rate than in the preceding six months. As before, the increase is due primarily to a rise in household deposits, although non-financial company deposits have also increased year-on-year.

After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers grew by 1.9% year-on-year in nominal terms in October, and by roughly 3.4% 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 funds' and deposit institutions' household lending has continued to increase, while the stock of Housing Financing Fund (HFF) loans has contracted. The combined increase in credit system lending to households therefore remains relatively modest at 2.4% year-on-year in October, adjusted for the effects of the Government's debt relief measures.

The Nasdaq OMXI8 index was virtually unchanged between meetings but had fallen by 9.5% since the beginning of the year. Turnover in the Nasdaq Iceland main market totalled just over 520 b.kr. over the first eleven months of the year, about 42% more than over the same period in 2015.

Global economy and external trade

According to the Organisation for Economic Co-operation and Development's (OECD) November forecast, GDP growth and world trade will be marginally weaker in 2016 than in the OECD's June forecast. Global GDP growth is projected at 2.9% this year, about 0.1 percentage point below the OECD's June forecast; however, the forecast for the next year is unchanged at 3.3%. The OECD's 2016 GDP growth forecast for Iceland's main trading partners is virtually unchanged since June, at 1.6%, but the forecast for 2017 has been revised downward by 0.2 percentage points, to 1.7%, which is in line with the forecast in the November *Monetary Bulletin*. The OECD slightly increased its 2016 inflation forecast for Iceland's trading partners but kept the 2017 forecast unchanged. Trading partner inflation is forecast at 1% in 2016, 1.6% in 2017, and 1.9% in 2018.

Iceland's external goods trade generated a deficit of 92 b.kr. for the first eleven months of the year, as opposed to a deficit of 24 b.kr. over the same period in 2015. Export values contracted by 4.8% at constant exchange rates, while import values rose 9.2%. The export value of industrial goods contracted by nearly 11% and the export value of marine products by nearly 2%. The rise in imports stems primarily from a year-on year increase of 39% in transport equipment imports, a rise of a fifth in imports of "other consumer goods", and a 15% increase in imports of investment goods.

The listed global market price of aluminium had risen by about 1.6% since the November meeting, and the average price in November was up about 18.4% year-on-year. This was the largest year-on-year increase since July 2011. Foreign currency prices of marine products rose by about 1.7% between months in October and had risen 8.3% year-on-year at that time.

In terms of relative consumer prices, the real exchange rate has risen each month for a year. It measured 98.1 points in November and was therefore nearly 21% above its 25-year average. It was up 12.2% year-on-year in the first eleven months of 2016, due primarily to a 11.2% 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

According to preliminary figures published by Statistics Iceland in December, GDP growth measured 10.2% in the third quarter of the year. Domestic demand grew 9.6% year-on-year during the quarter. Of that total, consumption and investment grew by a total of 8.7%, whereas the contribution from inventory changes was positive during the quarter. Exports grew by 16.4%, while imports grew slightly more, or by 16.9%. For the first nine months of the year, GDP growth measured 6.2%, reflecting the offsetting effects of 9.3% in domestic demand and the negative contribution from net trade.

The revision of older data complicates any comparison with the Bank's forecast from November, as it involves reclassifying private consumption as services exports. GDP growth for the first nine months of the year measured 6.2%, some 1.2 percentage points more than had been forecast. If the reclassification of private consumption as exports is ignored, the greatest difference is that business investment grew somewhat more than projected during the period, or just over 34%, as opposed to 31% in the November forecast.

The current account balance was positive by 100.4 b.kr., or 15.3% of GDP, in Q3/2016. This is the largest surplus on external trade ever recorded in Iceland. The surplus for the quarter was due to a 121.6 b.kr. surplus on services trade and a 1.3 b.kr. surplus on primary and secondary income, which were offset by a 22.5 b.kr. deficit on goods trade. A revision of previously published figures shows a surplus of nearly 2 b.kr. more in the first half of the year, owing mainly to the aforementioned reclassification of private consumption to the services account surplus.

Even though the national accounts show that private consumption growth year-to-date was weaker than previously expected, it was robust, and indications of private consumption in the beginning of the fourth quarter suggest that it will remain so, although it may be less strong than it was early in the year.

The Gallup Consumer Confidence Index measured 133.2 points in November, some 15 points more than at the same time in 2015, but more than 11 points less than in October.

According to the results of Gallup's winter survey, carried out in November among Iceland's 400 largest companies, executives were slightly more pessimistic about the current economic situation than in the autumn survey, conducted in September, and considerably more pessimistic about the outlook six months ahead. After adjusting for seasonality, 78% of respondents considered current conditions good and just under 19% considered them neither good nor poor. About 59% of executives were of the view that conditions would remain unchanged (i.e., good) and about a fifth expected them to improve. Executives in all sectors were more pessimistic about the situation six months ahead than in the autumn survey, after adjusting for seasonality, and those in the fishing industry were most pessimistic. All respondents were more pessimistic than they were at the same time in 2015. Just over a fifth of executives were of the opinion that conditions would deteriorate over the next six months. Respondents were very upbeat about domestic demand, with 57% expecting it to increase in the next six months, adjusted for seasonality, although the number expecting an increase declined marginally from the autumn survey. Expectations about foreign demand were strong as well, with about 38% of respondents expecting an increase. This is a slight decline from the autumn survey, however.

According to the survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by about 30 percentage points, adjusted for seasonality. This is a slightly lower percentage than in the autumn survey. The share is large in most sectors, or between 35% and 65% in manufacturing, transport, construction, and other services, but about 20% in retail and wholesale trade and 17% in financial services. In the fishing industry, however, the number of firms planning to recruit was equal to the number planning to downsize.

About 38% of firms considered themselves short-staffed in the winter survey, adjusted for seasonality. This percentage has fluctuated around 40% in the past three surveys. The share of construction firms considering themselves short-staffed increased by nearly 30 percentage points, to 83% in the winter survey.

The wage index rose by 0.3% month-on-month in October and by 10.4% year-on-year. Real wages in terms of the index had risen by 8.5% year-on-year in October.

The Statistics Iceland nationwide house price index, published at the end of November, rose by 1.7% month-on-month after adjusting for seasonality, and by 13.3% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 1.9% month-on-month in October, adjusted for seasonality, and by about 13.6% year-on-year. The number of purchase agreements registered nationwide rose by 8.9% year-on-year in the first ten months of 2016.

The CPI was unchanged month-on-month in November, for the second month in a row. Twelve-month inflation measured 2.1% and had risen from 1.8% since the MPC's November meeting. The rise in inflation was due to unfavourable base effects stemming from a steep drop in prices in November 2015. However, excluding the housing component, prices had fallen by 0.3% since November 2015. Most measures of underlying inflation suggested that it had been unchanged month-on-month in November, in the 2-2.5% range. Underlying inflation has therefore been somewhat closer to target than measured inflation has in the recent past.

The main driver of inflation in November was the rise in the cost of owner-occupied housing, with reduced food prices and a seasonal decline in international airfares pulling in the opposite direction. Private services prices had risen by 1.4% between years in November, after a 0.9% rise in October, owing largely to base effects.

Households' inflation expectations rose, according to the quarterly Gallup survey. Their one-year expectations were 3%, up from 2.5% in a comparable survey carried out in September.

Households' two-year inflation expectations also rose by ½ a percentage point from the previous survey, to 3.5%. According to Gallup's winter survey of corporate inflation expectations, respondents' expectations were unchanged from the autumn survey, at 2%. However, indicators of reduced long-term inflation expectations could be seen in the breakeven inflation rate in the bond market, as the ten-year breakeven rate had lain in the 2.1-2.3% range thus far in Q4, as opposed to just over 2.5% in Q3. No new measurements of market agents' inflation expectations were available, but according to the survey carried out in November, respondents expected inflation to average 2.8% over the next ten years, or 0.2 percentage points less than they expected in August.

II The interest rate decision

The Committee discussed developments in connection with capital account liberalisation and the Bank's foreign exchange market intervention policy. It decided not to change the intervention policy but to review the situation at its next meeting, after the next step towards liberalisation of capital controls on individuals and firms had been taken.

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 November meeting, the Committee had decided to keep the Bank's interest rates unchanged, even though the appreciation of the króna represented monetary policy tightening. The main grounds for the majority opinion within the Committee had been that uncertainty had increased, both domestically and abroad, and that strong demand growth argued for caution in interest rate setting.

The newly published national accounts for the first nine months of 2016 show stronger GDP growth than the Central Bank had forecast in November, but broadly similar growth in domestic demand. Committee members considered it positive that the composition of domestic demand was more favourable than had been forecast, in that business investment growth was stronger than projected and private consumption growth was weaker. They also observed that export growth had been a stronger driver of GDP growth than had been forecast, mainly because of robust services exports. In addition, the MPC noted that there had been a record current account surplus in the third quarter. The Committee agreed that current account balance figures for the third quarter of the year confirmed its assessment at the previous meeting: that the recent appreciation of the króna largely reflected trade surplus-related foreign currency inflows stemming from increased exports, tourism exports in particular.

The MPC noted that inflation had been in line with the Bank's November forecast and with the Committee's expectations at its previous meeting. It had measured 2.1% in November and had therefore remained below target for nearly three years in spite of large pay increases and rapid demand growth. In the Committee's opinion, favourable external conditions and the appreciation of the króna had offset the effects of wage costs and domestic demand, while a tight monetary stance had also anchored inflation expectations, promoted saving, and contained credit growth.

The MPC discussed the monetary stance, which in terms of the Bank's real rate was virtually unchanged since the November meeting. The króna had appreciated further, however. As at the November meeting, Committee members were of the view that there were grounds for keeping interest rates unchanged and for lowering them by 0.25 percentage points. In taking the interest rate decision, the MPC gave consideration to the Bank's last forecast, and new information that had been published since the November meeting.

The main argument in favour of a rate reduction that was expressed at the meeting was that the króna had appreciated by 1½% since the Committee's last meeting. As a result, the exchange rate was already above the projected 2017 average according to the Bank's November forecast. Committee members were of the view that the medium-term inflation outlook had therefore probably improved even more than was assumed in the forecast. Some members were therefore of the opinion that there was scope to lower nominal interest rates, although various uncertainties mentioned at the time of the previous interest rate decision still existed. In view of the uncertainty, however, premises for signalling the probable near-term interest rate path were still lacking. Upcoming interest rate decisions would depend on developments, and as before, there were grounds for caution in rate setting. One argument in favour of a rate cut that had been expressed at the previous meeting was also expressed at this meeting: that it could be desirable to narrow the interest rate differential with abroad in order to encourage residents to invest abroad, as this could mitigate the underlying upward pressure on the króna. Among MPC members who supported a rate cut, it was also important for their risk assessment that the composition of GDP growth was more favourable than had been forecast in November, in that exports and business investment weighed more heavily.

The main argument in favour of unchanged interest rates that was expressed at the meeting was that there was still considerable uncertainty about near-term wage developments and about the fiscal stance. It was pointed out that, although the composition of domestic demand was more favourable than had been assumed in the November forecast, the national accounts indicated that year-2016 GDP growth would turn out even stronger than had been forecast, and the output gap would therefore be wider. It was also pointed out that there was the risk that lowering interest rates in order to narrow the interest rate differential with abroad during the current overheating of the domestic economy would undermine the recently achieved anchor for inflation expectations.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points, which would lower the key rate (the seven-day term deposit rate) to 5%, deposit rates (current account rates) to 4.75%, the seven-day collateralised lending rate to 5.75%, and the overnight rate to 6.75%. Four members voted in favour of the Governor's proposal and one voted against it, preferring to keep interest rates unchanged.

MPC members agreed that inflation expectations appeared more firmly anchored to the target than before and that the monetary stance had tightened somewhat because of the appreciation of the króna. In the view of the majority of Committee members, this gave the MPC scope to lower nominal interest rates now. Nevertheless, members were of the view that strong demand growth and the aforementioned uncertainties called for caution in interest rate setting. They agreed that in the coming term, the monetary stance would 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 8 February 2017.