The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, March 2017

Published 29 March 2017

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 and 14 March 2017, during which the Committee discussed economic and financial market developments, the 15 March interest rate decision, 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 8 February 2017 interest rate decision.

Financial markets

When the liberalisation of capital controls was announced on Sunday 12 March, the exchange rate of the króna had risen by approximately 6.1% in trade-weighted terms since the Committee's February meeting. The day after, however, the exchange rate fell by 2.7% in trade-weighted terms and by 0.7% on 14 March. Between meetings, the króna therefore appreciated by 2.4% in trade-weighted terms. Over the same period it had risen by 2% against the euro, 1.7% against the US dollar, and 3.8% against the pound sterling.

The Central Bank's net foreign currency purchases totalled approximately 318 million euros (36.7 b.kr.) between meetings, or 46% of total market turnover. After the announcement of liberalisation measures on Sunday 12 March, there was some volatility in the foreign exchange market, and the Central Bank traded on both buying and selling sides. The Bank had also sold foreign currency on 7 March, but that was the first time since November 2014 that it had sold currency in the interbank foreign exchange market.

In terms of the Central Bank's real interest rate, the monetary stance was broadly unchanged since the MPC's February meeting, and the Bank's real rate was 2.5% in terms of the average of various measures of inflation and inflation expectations.

Interest rates in the interbank market for krónur were virtually unchanged between meetings. Turnover in the market totalled 69 b.kr. and had been considerably greater year-to-date than over the same period in 2016. Yields on Treasury and Housing Financing Fund (HFF) bonds had fallen by up to 0.3 percentage points between meetings. At the time of the MPC meeting, the authorities' announcement on liberalisation had not yet had a significant impact on these yields. Furthermore, financial institutions' deposit and lending rates were virtually unchanged since the February meeting.

Risk premia on Treasury foreign obligations were broadly unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations measured 0.9%, and the spread vis-à-vis comparable bonds issued by Germany and the US was 1-1.1 percentage points.

Financial institutions' analysts expected either no change or a 0.25 percentage point interest rate reduction, but all of them agreed that the decision was uncertain. Those expecting a rate cut cited the appreciation of the króna between meetings and the reduced uncertainty in the labour market. Those expecting no change based their projections on the newly published national accounts, which indicated that GDP growth had been much stronger and the output gap much wider in 2016 than had been assumed in the Central Bank's February forecast, Analysts' forecasts were published before the authorities announced the capital account liberalisation measures, but afterwards those who had expected a rate cut said that the likelihood of a reduction had receded.

M3 grew by 3.3% year-on-year in January, after adjusting for deposits held by deposit institutions in winding-up proceedings. This is somewhat weaker growth than in the preceding three months, as financial sector deposits contracted between years and annual growth in households' and businesses' deposits was also somewhat less in January than in the months beforehand.

After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers grew by about 3% year-on-year in January, and by roughly 4½% after adjusting for the effects of exchange rate movements on the foreign-denominated credit stock. Growth is attributable to an increase in lending to households and businesses. Annual growth in credit system lending to households measured 3% in January after adjusting for the Government's debt relief measures.

The Nasdaq OMXI8 index had risen by 5.2% between meetings and by 0.6% since the beginning of the year. Turnover in the Nasdaq Iceland main market totalled just over 135 b.kr. over the first two months of the year, about 20% more than over the same period in 2016.

Global economy and external trade

Iceland's external goods trade generated a deficit of 19.5 b.kr. for the first two months of the year, as opposed to a deficit of 3.9 b.kr. over the same period in 2016. Export values contracted by 7.2% year-on-year at constant exchange rates, while import values rose 13.3%. The export value of marine products declined by 33% year-on-year, while the export value of industrial goods rose by nearly 9%. Import growth is due in particular to a year-on-year increase of 20% or more in imports of transport equipment, commodities, and operational inputs.

The listed global market price of aluminium had risen by 6% between meetings, and the average February price was up over 20% year-on-year. On the other hand, foreign currency prices of marine products had risen by 1% month-on-month and about 8% year-on-year in January. Oil prices had declined by 9% between meetings, after having held relatively stable since early December.

In terms of relative consumer prices, the real exchange rate measured 99.4 points in February, an increase of 2.5% month-on-month and 18.1% year-on-year. The increase is due primarily to a 17.8% nominal appreciation of the króna, but in addition, inflation in Iceland was about 0.3 percentage points above the average among its trading partners.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, GDP growth measured 11.3% in the fourth quarter of 2016. Domestic demand grew 8.4% year-on-year during the quarter. Of that total, consumption and investment grew by a total of 8.2%, and the contribution from inventory changes was slightly positive. Exports grew by about 14%, somewhat outpacing import growth; therefore, the contribution from net trade was positive during the quarter.

For the year as a whole, GDP growth measured 7.2% and was driven mainly by private consumption and business investment. Domestic demand grew by 8.7% during the year, but the contribution from net trade was negative by 0.8 percentage points in spite of strong export growth. GDP growth turned out much stronger than the 6% forecast in the February *Monetary Bulletin*. Domestic demand growth was well in line with the February forecast, however, which assumed 8.4% growth. Private consumption grew more than was forecast, while investment grew less. The main reason for the deviation is that external trade was expected to be a much greater drag on GDP growth than Statistics Iceland's figures indicate. Imports were weaker and exports stronger than was assumed in the February forecast.

The current account balance was positive by 194 b.kr., or 8% of GDP, in 2016. Only once before has Iceland's current account surplus measured as large: in 2009, when it was also 8% of GDP. The surplus on goods and services trade was smaller in 2016 than in 2015; however, the balance on primary and secondary income was considerably more favourable. The forecast in the February *Monetary Bulletin* assumed that the current account surplus would amount to 6.4% of GDP in 2016. The deviation is due to a more favourable balance on services than had been expected, plus greater returns on foreign direct investment, which derives in part from one-off effects from assets held by holding companies established on the foundations of the failed banks' estates.

Indicators of developments in private consumption at the beginning of the year suggests that household demand is still growing rapidly, although it could ease from the level seen in Q4/2016. In February, the Gallup Consumer Confidence Index measured 125.8 points, an increase of a full 4 points from January and 7.3 points from February 2016.

According to the results of Gallup's spring survey, carried out in February among Iceland's 400 largest firms, respondents were somewhat more positive about the current economic situation and the six-month outlook than they had been in the winter survey, taken in November. They were considerably more pessimistic than in the autumn survey, however. About 79% of respondents considered the current situation good, and about 18% considered it neither poor nor good. Just under 24% of executives were of the view that economic conditions would improve in the next six months, and 63% expected conditions to remain unchanged (i.e., good). Executives in retail and wholesale trade were more upbeat than other executives about the situation six months ahead, while optimism among financial and construction companies had diminished since the winter survey. Optimism was least pronounced among fishing companies. Executives in all sectors were generally more pessimistic than they were a year ago. About 13% of executives were of the opinion that conditions would deteriorate over the next six months.

According to the survey, there was an increase in the number of firms expecting their ratio of profit to turnover to decline year-on-year. The profit index declined by 16 points, to 99, after having remained relatively stable since September 2015. Expectations concerning EBITDA in the next six months had deteriorated also. The investment index had declined from the previous measurement, with the most pronounced change among construction companies.

According to the survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by just under one-fourth, adjusted for seasonality. This is a slight decline from the winter survey. The change is due both to a decline in the number interested in adding on staff and an increase in the number of firms considering redundancies. Optimism was greatest among executives in construction and utility companies, where those planning to recruit outnumbered those planning redundancies by some 64 percentage points. Fishing company executives were relatively pessimistic, however, with those planning redundancies outnumbering those planning to recruit by about 16 percentage points. In other sectors, the share of companies planning to recruit was larger than the share planning to lay off staff by 18-37 percentage points.

Adjusted for seasonality, about 40% of respondents considered themselves short-staffed, about the same as during the past year. An all-time high of 93% of construction companies considered themselves understaffed. In other sectors, the share of firms considering themselves short-staffed lay in the 24-59% range.

According to preliminary figures from Statistics Iceland, the wage share (wages and related expenses relative to gross factor income) was 62.4% in 2016, just over a percentage point above the twenty-year average. It rose by 2 percentage points between years, in line with the forecast in the February *Monetary Bulletin*.

Seasonally adjusted unemployment rose by approximately ½ a percentage point month-on-month in January, in terms of both the Statistics Iceland labour force survey and the Directorate of Labour's unemployment register. The increase in registered unemployment was attributable for the most part to the fishermen's strike, as seasonally adjusted unemployment excluding those on strike continued to fall in January.

The wage index rose by 0.1% month-on-month in January and by 8.7% year-on-year. Real wages in terms of the index had risen by 6.7% year-on-year in January.

Statistics Iceland's nationwide house price index, published at the end of February, rose by 1.5% month-on-month, after adjusting for seasonality, and by 16% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1.7% month-on-month in January when adjusted for seasonality, and by 16.3% year-on-year. The number of registered purchase agreements nationwide rose 11.5% between years in January. The average time-to-sale for flats in the greater Reykjavík area was about 1.2 months in January, down from 2.2 months in January 2016.

The CPI rose by 0.7% month-on-month in February. Twelve-month inflation measured 1.9% in February and had been unchanged for three months in a row. The CPI excluding the housing component had declined by 1% year-on-year, however. Most statistical measures of underlying inflation suggested that it had declined in February and lay in the 1.5-2.2% range.

The main drivers of the CPI increase in February were end-of-sale effects and rising house prices. Private services prices had risen by 0.1% between years, and the small increase is largely explained by a decline in telephone services prices and international airfares.

Household inflation expectations were unchanged between surveys, according to Gallup's spring survey, carried out in February. Households' one-year expectations measured 3%, and two-year expectations measured 3.5%. According to Gallup's spring survey among executives, one-year inflation expectations were up by ½ a percentage point from the previous survey, to 2.5%. On the other hand, two-year inflation expectations were unchanged at 3%. Indications of a decline in long-term inflation expectations could be seen in the breakeven inflation rate in the bond market. Since the MPC's last meeting, the ten-year breakeven rate had declined by 0.2 percentage points, to an average of 2.3%.

II The interest rate decision

The Governor updated the Committee on developments in connection with capital account liberalisation and on work in connection with the review of the monetary policy framework. In this context, a presentation was given on the work currently underway with respect to the review of the success of monetary policy in recent years, and a report was given to the Committee on the results of an assessment of developments in the Central Bank's earnings and equity under various scenarios.

The Committee discussed the monetary stance in view of the most recent information on developments in the economy and the fact that the monetary stance had remained broadly unchanged since the MPC's February meeting. Members discussed whether developments since the last meeting had changed their assessment of whether the monetary stance was appropriate in view of the inflation outlook. The Committee had been unanimous in February about its decision to keep the Bank's interest rates unchanged because rapid GDP growth and clear signs of growing demand pressures in the general economy and the labour market had called for a continued tight monetary stance. In particular, consideration had been given to the uncertainty then prevailing in connection with the wage settlement review in the labour market, which, in the Committee's view, also called for caution in interest rate setting.

The MPC discussed the recently published national accounts data, which showed that year-2016 GDP growth had been much stronger than had been projected in the Central Bank's February forecast, and which the Committee had taken into account at the February meeting. Members agreed that, although GDP growth had been export-driven to a considerable degree, it had been well in excess of long-term potential and had begun to strain domestic resources. Indicators also implied continued strong growth thus far in 2017. Job creation had been strong and unemployment low, and the labour participation rate had risen above the pre-crisis peak. Committee members considered it likely that the output gap had widened further than had been forecast in February and would continue to grow in spite of countervailing effects from labour importation.

Members discussed developments in inflation, which measured 1.9% in February, broadly similar to the level in the past six months. In the Committee's opinion, the appreciation of the króna and low global inflation continued to offset domestic inflationary pressures. Members noted that the gap between domestic price developments – housing costs in particular – and external factors had widened. In addition, a tight monetary stance had anchored inflation expectations and contained both credit growth and demand growth. They also noted that inflation expectations appeared to have withstood significant exchange rate volatility in recent days, as the breakeven inflation rate in the bond market was largely unchanged.

All members considered it appropriate to keep the Bank's interest rates unchanged. They agreed that rapid growth in economic activity and clear signs of demand pressures in the economy called for a tight monetary stance so as to ensure medium-term price stability. In the Committee's opinion, the new national accounts suggested that demand pressures in the economy were stronger than had been assumed in February. On the other hand, the exchange rate of the króna had continued to rise, thereby containing inflation, both by lowering imported inflation and by facilitating labour importation, which eased the tension in the labour market and held back wage drift. Members also noted that strong productivity growth in 2016 had eased domestic inflationary pressures. Doubts were expressed about whether this productivity growth had been as strong as was indicated in Statistics Iceland's preliminary figures, and some members thought it likely that the numbers indicated an underestimation of labour importation.

Members agreed that the virtually complete liberalisation of capital controls had somewhat exacerbated uncertainty about developments in the exchange rate and the general economy in the near term. They considered it too early to predict the economic impact of the liberalisation measures, as the market was still seeking a balance in the wake of the changes. Members considered it possible that a better balance would develop between foreign exchange market in- and outflows, but that short-term volatility could increase while the market was adjusting to the change, as could be seen on the days during which the meeting was held. Committee members agreed that the Central Bank's intervention in the foreign exchange market should continue to focus on mitigating short-term volatility when conditions warranted it. In this context, they considered it appropriate to emphasise that the Bank would not only purchase foreign currency, as had been customary since November 2014, but would also sell currency when conditions called for it, as the Bank had recently demonstrated.

There was some discussion of the appreciation of the króna in recent quarters. MPC members agreed that the appreciation was largely a reflection of economic fundamentals, which could be attributed to improved terms of trade and strong exports – tourism in particular – which delivered a sizeable trade surplus. They agreed that monetary policy neither could nor should try to halt the inevitable adjustment stemming from structural changes in export production and the rise in the equilibrium real exchange rate. On the other hand, there was considerable uncertainty about the equilibrium real exchange rate over the medium term. It was pointed out that the appreciation of the króna was an important factor in the success in keeping inflation at target and that, in view of the strong growth of the tourism industry, appreciation was an unavoidable part of easing the pace of growth in the sector and creating increased scope for it. On the other hand, it could tend to crowd out other export activities to some extent.

During the discussion, it also emerged that Committee members considered it desirable that other economic policy and monetary policy pull in the same direction, particularly if it were considered beneficial to counteract the rise in the exchange rate. The view was also expressed that it would be possible at the next MPC meeting to make a better assessment of the impact of capital account liberalisation on the exchange rate. A new macroeconomic forecast would also be ready by that time, including a better assessment of the degree to which strong GDP growth in the recent term had led to rising tension in the economy.

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%, the current account rate 4.75%, the seven-day collateralised lending rate 5.75%, and the overnight lending rate 6.75%. All Committee members voted in favour of the proposal.

Members agreed that a stronger anchor for inflation expectations at target and the appreciation of the króna had enabled the MPC to achieve its legally mandated price stability objective at a lower interest rate than would otherwise have been possible. Members 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 17 May 2017.