The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

March 2019 (83rd meeting)

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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 are also included in the minutes.

The following are the minutes of the MPC meeting held on 18 and 19 March 2019, during which the Committee discussed economic and financial market developments, the 20 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 6 February 2019 interest rate decision.

Financial markets

Since the February meeting, the króna had appreciated by 2.9% in trade-weighted terms. Over this same period it appreciated by 3.2% against the euro, 2.7% against the US dollar, and 0.6% against the pound sterling. Between meetings, the Central Bank sold foreign currency for just under 18 million euros (2.5 b.kr.). The Central Bank's transactions accounted for about 9% of total turnover in the foreign exchange market.

Based on the average of various measures of inflation and one-year inflation expectations, the monetary stance in terms of the Central Bank's real rate was unchanged since the MPC's February meeting. By this measure, the Bank's real rate was 0.9%. In terms of twelve-month inflation, it was 1.5% and had risen by 0.4 percentage points between meetings.

Interest rates in the interbank market for krónur were virtually unchanged between meetings, and turnover in the market totalled 17 b.kr. during the period.

Yields on long-term nominal Treasury bonds had fallen by 0.4 percentage points since the February meeting, and yields on indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.2-0.4 percentage points. The average rate on non-indexed mortgage loans and pension fund loans was virtually unchanged since the February meeting. Over the same period, the average rate on indexed fixed-rate mortgage loans and indexed variable-rate pension fund loans had fallen slightly.

In terms of three-month interbank rates, the interest rate differential had increased slightly between meetings, to 5.3 percentage points versus the euro area and 2.4 percentage points versus the US. The long-term interest rate differential versus Germany had fallen by 0.3 percentage points between meetings, to 4.7 percentage points, and the spread versus the US had narrowed by 0.3 percentage points, to 2.2 percentage points.

Measures of risk premia on the Treasury's foreign obligations had diverged since the MPC's February meeting. The CDS spread on the Treasury's five-year US dollar obligations widened to just under 0.8%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany narrowed slightly, to 0.5-0.6 percentage points.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged, citing, among other things, the prospect of weaker economic activity in the coming term, the fact that the Bank's real rate was broadly unchanged since the MPC's last meetings, and the improvement in the inflation outlook.

Annual growth in M3 measured just over 7½% in January, after adjusting for deposits held by the failed financial institutions. This is slightly below the growth rate in autumn 2018. As before, growth in M3 stemmed primarily from increased household deposits, although the commercial sector's share in the growth rate has increased as well. After adjusting for the impact of the Government's debt relief measures, the stock of credit system loans to resident borrowers had grown in nominal terms by about 10½% year-on-year in January. The stock grew by just over 9%, however, if the stock of foreign-denominated loans is calculated at constant exchange rates. Over the same period, household lending grew by about 8½% year-on-year and corporate lending by nearly 13%, whereas the growth rate adjusted for exchange rate movements was about 10%.

The Nasdaq OMXI8 index had risen by 11.7% between meetings. Turnover in the Main Market totalled 85 b.kr. in the first two months of 2019, some 22% less than in the same period in 2018.

Global economy and external trade

According to preliminary figures from Statistics Iceland, Iceland's goods trade deficit totalled 15.3 b.kr. in February, which is virtually unchanged from the same period in 2018 (at constant exchange rates). In the first two months of 2019, however, the deficit was only 8.2 b.kr., as opposed to a deficit of 18.4 b.kr. over the same period in 2018. Export values were virtually unchanged year-on-year in the first two months of 2019, while import values contracted by 8.3%. The downturn in imports is due to reduced imports of transport equipment, as well as fuels and lubricants.

Between MPC meetings, the listed global price of aluminium rose by just over 1% but was around 8% below the price seen at the same time last year. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 5.5% year-on-year in January. Global oil prices rose by more than 9% between meetings, to just over 67 US dollars per barrel just before the March meeting, or nearly 4% higher than the price a year earlier. It was still about one-fourth below its early October 2018 peak, however.

The real exchange rate in terms of relative consumer prices rose by 0.8% month-on-month in February, when it was 11.4% above its 25-year average but 13.2% below its June 2017 peak. In the first two months of 2019, it was down by 8% compared with the same period in 2018, as the nominal exchange rate of the króna was 9.6% lower and inflation in Iceland was 1.8 percentage points above the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, GDP growth measured 4% in Q4/2018 and domestic demand grew by 4.1% year-on-year during the quarter. Exports declined by 5.9% between years, owing to an 11.4% contraction in services exports. At the same time, imports contracted by 6%, but the contribution of net trade to GDP growth was negative by 0.1 percentage points. GDP growth measured 4.6% for the year as a whole, as domestic demand grew by 4.1% and the contribution from net trade was positive by 0.7 percentage points. Export growth measured 1.6% in 2018, while total imports were flat between years because of the contraction in goods imports. Year-2018 GDP growth was 0.3 percentage points stronger than had been forecast in the February *Monetary Bulletin*, mainly because the contribution from net trade was 0.3 percentage points more positive than had been projected. Growth in domestic demand was broadly in line with the forecast, however.

The current account balance was positive by 0.3 b.kr. in Q4/2018. This is a smaller surplus than in Q4/2017, when it measured 6.7 b.kr. The contraction in the surplus is due to a smaller surplus on services trade. On the other hand, the goods trade deficit was smaller and the surplus on primary and secondary income was larger. In 2018 as a whole, the current account balance was positive by 81.5 b.kr., or 2.9% of GDP, whereas the surplus in 2017 measured 3.6% of GDP, the smallest in six years. The surplus on services trade contracted between years, but on the other hand, the deficits on goods trade and on primary and secondary income were smaller.

Key indicators of developments in private consumption in Q1 suggest that growth continued to ease during the quarter and that it will be weaker this year than it was for most of 2018. The Gallup Consumer Confidence Index measured 90.3 in February. After a steep decline in H2/2018, the index inched upwards in early 2019, although it is still lower than it was a year ago.

According to the results of Gallup's spring survey, conducted in February among Iceland's 400 largest firms, respondents' assessment of the current economic situation was neither positive nor negative, and therefore weaker than in the surveys taken this winter and a year ago. However, executives were more upbeat about the outlook six months ahead than they were in the winter survey, albeit more pessimistic than in the spring 2018 survey. About 42% of respondents considered the current situation neither good nor poor, and about 32% considered it poor. About 60% of executives were of the view that economic conditions would deteriorate in the next six months, and a third expected conditions to be neither better nor worse. About 7.5% of respondents expected conditions to improve in the next six months. The share of pessimistic executives has therefore declined since the winter, when just over ⅔ were of the view that conditions would worsen, but it has increased markedly since the spring 2018 survey, when 30% were of that opinion. Executives' expectations about domestic demand improved slightly from the winter survey but were more downbeat than they were a year ago.

The most marked improvement in expectations about domestic demand between the winter and spring surveys was among executives in manufacturing and miscellaneous specialised services. Attitudes towards foreign demand are broadly unchanged since May 2018, with about half of executives expecting it to remain unchanged in the next six months.

According to the spring survey, just over 36% of firms expected their profit margins to remain broadly unchanged between 2018 and 2019, whereas the share that expected their margins to narrow increased by 2 percentage points relative to the autumn survey. Chief among the latter group were executives in transport, transit, and tourism; construction; and retail and wholesale trade. Furthermore, respondents in all sectors except industry and manufacturing were somewhat more negative about the operational outlook than in the autumn survey.

According to the seasonally adjusted results of the spring survey, 14% of firms were planning to recruit, while 23% were planning to downsize. The balance of opinion was therefore negative by 9 percentage points, whereas in the winter survey it was negative by nearly 19 percentage points. This is a marked turnaround from the spring 2018 survey, however, when the balance of opinion was positive by 16 percentage points. Pessimism was most pronounced in transport, transit, and tourism where the balance of opinion was negative by 25 percentage points, while the outlook was for only a slight increase in staffing in construction, utilities, and miscellaneous specialised services.

After adjusting for seasonality, 12% of firms considered themselves short-staffed. This was about 6 percentage points less than in the winter survey and 21 percentage points less than in the spring 2018 survey. About 30% of executives in construction and utilities considered themselves understaffed, as opposed to only 5% of fishing companies. In other sectors, the ratio lay in the 7-22% range.

About 38% of executives reported that they would have difficulty responding to unexpected demand, after adjusting for seasonality. This was slightly less than in the winter survey but 14 percentage points less than in the spring 2018 survey. The problem was most pronounced in the fishing industry, where nearly three of every five executives were pessimistic about being able to respond to unexpected demand, while it was least pronounced in retail and wholesale trade, where just over one of every five were of that opinion.

The wage index rose by 0.3% month-on-month in January and by 5.8% year-on-year, and real wages were 2.3% higher during the month than at the same time in 2018. According to preliminary figures from Statistics Iceland, the wage share (wages and related expenses relative to gross factor income) was 64.3% in 2018, which is 0.5 percentage points higher than in 2017 and 3.8 percentage points above the twenty-year average. Previous figures were also revised, mostly for 2017, but on the whole, developments in the past two years were in line with the forecast in the February *Monetary Bulletin*.

Statistics Iceland's nationwide house price index, published in February, rose 0.3% month-on-month when adjusted for seasonality and by 5.6% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.2% month-on-month in January, adjusted for seasonality, and by about 5.2% year-on-year. The twelve-month rise in real estate prices has therefore held steady at about 5% since April 2018. The number of purchase agreements registered nationwide declined by 9.4% year-on-year in January, while the number of purchase agreements for new construction rose by 2.6% over the same period.

The consumer price index (CPI) rose by 0.19% month-on-month in February. Twelve-month inflation measured 3% and had fallen by 0.4 percentage points since the MPC's last meeting. The CPI excluding the housing component had risen by 2.1% year-on-year in February. In terms of the median of various measures, underlying inflation was 3.1% in February, about 1 percentage point higher than in the same month of 2018.

In February, end-of-sale effects on furniture and housewares prices were the main driver of the rise in the CPI. International airfares fell for the second month in a row and were nearly 12% lower than at the same time in 2018. Imported food prices and new motor vehicle prices also fell between months.

According to Gallup's spring surveys of household and corporate inflation expectations, respondents expected inflation to measure 4% one year ahead; this was unchanged from the winter surveys but 1 percentage point higher than in the spring 2018 surveys. Expectations concerning average inflation over the next five years rose by 0.5 percentage points between surveys, however, to 3.5-4%. The five- and ten-year breakeven inflation rate in the bond market was 3.4% just before the MPC meeting, after falling slightly since the February meeting. The ten-year breakeven rate has averaged 3.7% in Q1 to date, which is 0.4 percentage points lower than in Q4/2018.

II The interest rate decision

The Governor updated the Committee on developments in the domestic foreign exchange market following the passage of the bill of legislation releasing the last of the offshore króna assets and the decision taken simultaneously to lower the special reserve requirement (SRR) on capital inflows to 0%. Outflows through the foreign exchange market had been less than expected, and inflows for new investment in the bond market had offset them. In addition, there had been some inflows into the equity market, and pension funds' outflows had eased. The Central Bank had only intervened once in the market, selling foreign currency, since the bill of legislation passed, and the króna had appreciated between MPC meetings.

The Deputy Governor explained the highlights of the bill of legislation on the Central Bank, which had been in the Government's consultation portal since 7 March, together with a bill of legislation amending various acts of law due to the merger of the Central Bank and the Financial Supervisory Authority.

Members discussed the monetary stance in view of the most recent information on the economy and the fact that the Bank's real rate had remained unchanged between meetings. They discussed whether the stance was appropriate in view of the inflation outlook, as they had decided at the February meeting to keep the Bank's key rate unchanged, partly because the outlook was for demand pressures in the economy to subside faster than previously expected and the monetary stance had tightened again.

Committee members discussed the newly published preliminary national accounts figures, which indicated that GDP growth had eased between H1 and H2/2018. It measured 4.6% for the year as a whole, whereas the Bank had projected a growth rate of 4.3% in its February forecast. MPC members noted that growth in goods and services imports was negligible in 2018, alongside robust growth in domestic demand. Recent indicators of economic activity and the labour market suggested that demand pressures in the economy had continued to subside. Committee members discussed the uncertainty in the tourism industry because of difficulties in airline operations. It was noted that the ongoing strikes could lead to more rapid cooling in the economy and that the outlook for goods exports had deteriorated because of the poor capelin season.

The Committee discussed developments in inflation, which measured 3% in February, down from 3.7% in December 2018. They noted that the main factors in the decline were the reduced effect of the rise in import prices stemming from the depreciation of the króna in autumn 2018, and a weaker contribution of housing to inflation. It was pointed out that in view of the operational difficulties faced by domestic airlines, airfares could rise and the inflation outlook could therefore deteriorate. Members also noted that the króna had appreciated by just under 3% since the MPC's February meeting. Inflation was still likely to rise somewhat over most of the year, however, although actual developments would depend on the results of the ongoing wage negotiations.

The MPC discussed the possible causes of the situation that had developed in the labour market and the extent to which it stemmed from significant capacity pressures. It emerged in the discussion that the likely cause was the interaction of several factors: strong growth in tourism, a sector with lower productivity than other sectors; increased labour demand; dissatisfaction with income distribution in society; and new priorities among labour union leaders. It was also pointed out that the tight housing market — resulting from steep price increases and a shortage of supply — had made a strong impact, as had probably household debt relief measures. MPC members discussed possible responses in the event that wage settlements caused a deterioration in the inflation outlook. If negotiated pay rises were out of line with the inflation target, and to the extent that they could be traced to strong labour demand and a persistent output gap, it would be unavoidable to tighten the monetary stance, all else being equal.

Members noted that households' and businesses' long-term inflation expectations had risen while the breakeven inflation rate in the bond market had fallen, and that long-term inflation expectations were above the target by all measures. As the MPC had pointed out previously, the steep rise in inflation expectations in H2/2018 probably stemmed in part from the rise in the risk premium and not solely from expectations of higher inflation. The recent decline in the breakeven inflation rate could also be attributed in part to a reduction in the risk premium. MPC members also noted that short-term inflation expectations were broadly unchanged since the MPC's last meeting, and the monetary stance in terms of the Bank's real rate was therefore unchanged between meetings.

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 4.5%, the current account rate 4.25%, the seven-day collateralised lending rate 5.25%, and the overnight lending rate 6.25%. All Committee members voted in favour of the proposal.

In the Committee's view, the near-term monetary stance would depend on the interaction between a narrower output gap, wage-setting decisions, and developments in inflation and inflation expectations.

The MPC reiterated that it had both the will and the tools necessary to keep inflation and inflation expectations at target over the long term, and members agreed that a tighter monetary stance could be called for in coming months. Other decisions, particularly those relating to the labour market and fiscal policy, would be important in determining whether that would be the case and would affect the sacrifice cost in terms of lower employment.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Rannveig Sigurdardóttir, 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.

Karen Áslaug Vignisdóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 22 May 2019.