The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, February 2018

Published 21 February 2018

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 5 and 6 February 2018, during which the Committee discussed economic and financial market developments, the interest rate decision of 7 February, 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 13 December 2017 interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2018/1 on 7 February.

Financial markets

Between meetings, the króna depreciated by 0.3% in trade-weighted terms. Over this same period it fell 1.3% against the euro and 0.8% against the pound sterling, but rose by 4% against the US dollar. The Central Bank conducted no transactions in the interbank foreign exchange market between meetings.

In terms of the Central Bank's real rate, the monetary stance had eased since the MPC's December meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.6%, or 0.2 percentage points lower than in December. In terms of twelve-month inflation, it was 1.8% and had fallen by 0.7 percentage points.

Interest rates in the interbank market for krónur were unchanged between meetings, and there was no turnover in the market during that period.

Nominal Treasury bond yields had risen by as much as 0.4 percentage points since the December meeting. Yields on longer bonds had risen most, and the spread between long and short bonds had therefore widened. Yields on long-term indexed Treasury and Housing Financing Fund bonds had also risen slightly, while yields on shorter indexed bonds had fallen. Furthermore, financial institutions' deposit and lending rates had developed broadly in line with Central Bank rates between meetings.

Measures of risk premia on the Treasury's foreign obligations declined in December after Fitch Ratings upgraded Iceland's sovereign credit rating to A and the Treasury issued a new eurobond. The CDS spread on the Treasury's five-year US dollar obligations had fallen by 0.1 percentage points, to 0.6%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany had fallen by almost 0.3 percentage points, to 0.5 percentage points.

Financial institutions' analysts had all projected that the Bank's interest rates would be held unchanged in February, citing the decline in the real rate between meetings and the continued uncertainty about the outcome of wage settlements.

According to the Central Bank survey carried out in late January, market agents expected the Bank's key rate to be kept unchanged at 4.25% over the next two years. At the time the survey was conducted, about 68% of respondents considered the monetary stance appropriate, as opposed to 59% in the last survey. A roughly equal number of respondents considered the monetary stance too tight versus too loose.

M3 adjusted for the deposits of the failed financial institutions grew by 7.1% year-on-year in Q4/2017, below the growth rate in Q2 and Q3 but well above estimated nominal GDP growth. Household deposits are still increasing rapidly, while growth in financial sector deposits has eased.

The stock of credit system loans grew by 6.3% year-on-year in nominal terms in Q4/2017, after adjusting for the Government's debt reduction measures. Corporate lending grew by 9% in nominal terms in Q4, while household lending grew by 5.3% year-on-year, about the same as in Q3.

The Nasdaq OMXI8 index had risen by 4.4% between meetings. Turnover in the main market totalled 53 b.kr. in January, 6.6% more than over the same period in 2017.

Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in January, the global GDP growth outlook has improved from the Fund's October forecast. The IMF estimates global GDP growth at 3.9% in both 2018 and 2019, or 0.2 percentage points more in each of the two years than according to its October forecast. Growth is expected to be stronger in advanced economies, particularly the US, Japan, and the euro area. The forecast for world trade was also revised upwards for both years. The inflation outlook for industrialised countries has been revised upwards as well, with inflation forecast at 1.9% this year and 2.1% in 2019. Inflation in emerging and developing countries is expected to be somewhat higher in both 2018 and 2019 than was projected in October. The *Consensus Forecasts* projections for 2018 GDP growth among Iceland's trading partners had increased by 0.1 percentage points between meetings, to 2.3%, while the inflation outlook was unchanged.

The deficit on goods trade totalled 26.6 b.kr. in December, the largest deficit since July 2006, at constant exchange rates. According to preliminary figures from Statistics Iceland, it measured 5.4 b.kr. in January. In 2017, the goods account deficit totalled 178 b.kr., as opposed to 95 b.kr. in 2016. Import values rose by 21% year-on-year at constant exchange rates in 2017, while export values rose by 8%. Last year's growth in imports was due for the most part to an increase in imports of passenger cars, commodities, and operational inputs, whereas the increase in exports is due primarily to manufacturing exports.

The listed global market price of aluminium had risen by 10% between MPC meetings, and the average price in January was up about 24% year-on-year. Preliminary figures from Statistics Iceland suggest that foreign currency prices of marine products declined month-on-month in December and fell by 2.2% year-on-year in Q4/2017. Overall, marine product prices fell by 1% year-on-year in 2017. Global oil prices have risen virtually unimpeded since the summer and, in January 2018, were 24% higher, on average, than in January 2017.

In terms of relative consumer prices, the real exchange rate rose by 11.8% year-on-year in 2017. By the same metric, it measured 98 points in January. It had fallen by 1% between months but risen by 1.2% between years. The year-on-year increase was due entirely to the nominal appreciation of the króna, as inflation in Iceland was broadly similar to inflation in main trading partner countries.

The domestic real economy and inflation

As expected, the reduction in total hours worked and in the labour participation rate measured in Statistics Iceland's Q3/2017 labour force survey (LFS) reversed in Q4, as job creation remained strong according to pay-as-you-earn (PAYE) records and labour importation remained robust. According to the LFS, total hours worked increased by 0.8% year-on-year in Q4/2017. The rise was due to a 1.4% increase in the number of employed persons, as the average work week grew shorter by 0.6%. The seasonally adjusted labour participation rate rose by nearly a percentage point between quarters, and the employment rate rose by ½ a percentage point. Both the participation rate and the employment rate declined by nearly a percentage point between 2016 and 2017.

Seasonally adjusted unemployment measured 3% in Q4/2017, an increase of 0.4 percentage points between quarters. It measured 2.8% in 2017 as a whole, as opposed to 3% in 2016. Unemployment as measured by the Directorate of Labour (DoL) was 2.2% in 2017 and had fallen by 0.1 percentage points between years.

Other indicators suggested stronger demand for labour. Preliminary figures on the number of workers on the pay-as-you-earn (PAYE) register showed a 3.6% year-on-year increase in October, and net migration of persons aged 20-59 was positive by 0.6% of the population. Net migration was positive by 3.8% for the year as a whole, the largest single-year increase ever measured. Employees of employment agencies and foreign services firms accounted for 1% of the labour force as of year-end 2017, an increase of 57% between years.

The wage index rose by 0.2% month-on-month in December 2017 and by 6.9% year-on-year, and real wages according to the index were 4.8% higher during the month than they were at the same time in 2016. The wage index rose by 6.8% between annual averages in 2017, and real wages grew by 5%.

Indicators of private consumption in Q4/2017 imply that household demand continued to increase year-on-year during the quarter, albeit somewhat slower than in H1.

The Gallup Consumer Confidence Index fell month-on-month in January, to 121.5 points. All sub-indices fell during the month, especially those measuring consumers' assessment of the economic situation and expectations six months ahead. The decline in January reversed the previous months' rise in the index.

Statistics Iceland's nationwide house price index, published at the end of January, rose by 0.6% month-on-month after adjusting for seasonality, and by 14.5% year-on-year. The capital area house price index, calculated by Registers Iceland, declined by 0.2% month-on-month in December when adjusted for seasonality, but rose by 13.7% year-on-year. The twelve-month rise in house prices therefore continues to ease, after peaking at nearly 24% in May. In 2017, the Registers Iceland index rose by an average of 18.9% from the previous year, and the number of registered purchase agreements nationwide fell by 6.4% between years, while the number of flats advertised for sale rose markedly. The average time-to-sale for residential property in the greater Reykjavík area therefore lengthened slightly between 2016 and 2017, to just over 2 months.

The CPI rose by 0.27% month-on-month in December 2017 and then fell by 0.09% in January. Twelve-month inflation measured 2.4%, an increase of 0.6 percentage points since the Committee's December meeting. The CPI excluding the housing component had declined by 0.9% since January 2017, however. Measures of underlying inflation suggested that it had risen in January and lay in the 1⅓-2½% range.

Seasonal sales pushed the CPI downwards in January, as usual, but were offset by rising house prices and annual price list increases. The increase in house prices was due in particular to rising prices in regional Iceland. Private services prices have risen by 1% between years, whereas in November they had fallen by 0.5%.

According to the Bank's most recent survey, market agents' one- and two-year inflation expectations have risen slightly since November, to 2.6-2.7%. Their long-term inflation expectations appear broadly unchanged, however; survey respondents expected inflation to average 2.6% in the next five and ten years. The breakeven inflation rate in the bond market has risen since the MPC's December meeting, however, and the five- and ten-year breakeven rate has averaged 2.8-3.1% in Q1/2018 to date. The increase could reflect a rise in the risk premium, although it is not impossible that long-term inflation expectations have inched upwards.

According to the forecast published in *Monetary Bulletin* on 7 February 2018, inflation will be close to target throughout the forecast horizon. It has risen since mid-2017, measuring 1.8% in Q4/2017 and 2.4% in January 2018. Inflation expectations also appear broadly consistent with the target. For much of this year, inflation will be higher than was forecast in November, but from end-2018 onwards it will be somewhat lower. This is mainly because the output gap is projected to be smaller than was assumed in November, owing to weaker output growth in 2017 and 2018 and the prospect of more rapid growth in the working-age population.

According to the 2018 National Budget, the fiscal stance will tighten this year, but somewhat less than was projected in the Bank's November forecast. The tightening is estimated at 0.8% of GDP, as opposed to an estimate of 1.3% in November. The new Government's fiscal strategy for the upcoming five years was presented in December. Even though it is assumed that the Treasury will be operated at a surplus over the period, the strategy entails significant fiscal easing relative to the strategy presented by the previous Government in January 2017. The assessment of the fiscal stance in the Bank's February forecast indicates that, in 2017-2020, the stance will ease by as much as 2% of GDP relative to the Bank's November forecast.

Because export growth has eased, GDP growth has retreated from its 2016 peak. According to preliminary figures from Statistics Iceland, it measured 4.3% in the first three quarters of 2017.

It is estimated at 3.4% for the year as a whole, slightly below the November forecast, owing primarily to the more rapid decline in export growth. The outlook for 2018 is similar, with GDP growth projected at 3.2%, marginally below the November forecast. As in November, GDP growth is expected to ease slowly towards its long-term trend rate over the next two years. In spite of weaker GDP growth in 2017 and 2018, domestic demand growth has been stronger than previously anticipated, at an estimated 7% in 2017 and a projected 4.4% this year. This stronger demand growth is due primarily to more rapid investment growth and greater fiscal easing than previously forecast.

Wages and related expenses are expected to rise by 6.5% this year, about the same as in 2017. Labour productivity is estimated to have grown somewhat more slowly in 2017 than was projected in November, and the forecast for this year has also been revised downwards. As a result, unit labour costs are forecast to rise more than previously assumed, or by 4.3% in 2017 and 5.5% in 2018. As in the November forecast, the rise in unit labour costs will slow down in the next two years, to just under 3% by 2020.

Large-scale importation of labour has offset rapid demand growth and caused the output gap to narrow from the late-2016 peak. Because of slower GDP growth in 2017 and 2018, the output gap will be somewhat narrower than was projected in November. As before, it is assumed to have peaked in 2016 and is expected to close by the end of the forecast horizon.

II The interest rate decision

The Governor reported to the Committee on the status of ongoing work on the review of the statutory and technical foundations for the capital flow management measure.

The MPC discussed the monetary stance in view of the most recent information on the economy and the marginal decline in the Bank's real rate between meetings. The Committee discussed whether the monetary stance was appropriate in view of the inflation outlook, as it had decided in December to keep interest rates unchanged even though recent national accounts figures showed that domestic demand growth was stronger and the economy's adjustment to its long-term trend rate could prove more gradual than had been forecast in November.

In this context, members took into consideration the Bank's updated macroeconomic forecast, published in *Monetary Bulletin* on 7 February, according to which the outlook was for GDP growth to be somewhat weaker in 2017 and 2018 than was forecast in November. Members noted that, according to the forecast, this was because exports grew more slowly than expected last year, while domestic demand growth would be stronger in both years. Committee members agreed that this stemmed from increased investment and a more accommodative fiscal stance.

The Committee discussed developments in inflation, which had risen from 1.9% in December to 2.4% in January, mainly because of increased house prices in regional Iceland. It emerged that there was considerable uncertainty about how to interpret this increase: whether it was a one-off measurement deviation or an indication of an underlying trend in the housing market. On the other hand, underlying inflation had also risen, although it remained below target. It was pointed out that, in spite of the rise in house prices in regional Iceland, house price inflation had subsided and the effects of past appreciation of the króna had tapered off, as the MPC had previously expected. The Committee was of the view that this trend would continue in the near term.

Members agreed that the inflation outlook was largely unchanged since the last meeting and that inflation appeared set to remain close to target over the forecast horizon. The Committee considered it positive that, on the whole, inflation expectations had been in line with the target for some time. Although the breakeven inflation rate in the market had risen, it was probably due to an increase in the risk premium. Furthermore, the MPC noted that the foreign exchange market had been well balanced since the last meeting and the exchange rate broadly stable. It was pointed out that inflation was at target, which was positive, although the probability that it would be below target in the near future had receded. The slack abroad had narrowed, and import prices could therefore rise rapidly. It was mentioned in the discussion that there was no reason to respond to minor deviations in inflation from target, as long as the fluctuations were moderate and inflation expectations remained at target.

Given that there had been no major changes since the last forecast, none of the MPC members saw compelling reason to change interest rates at present. Members agreed that the outlook was for the positive output gap to narrow in the coming term. As the MPC had assumed, the high real exchange rate had slowed export growth in the recent past. There was some discussion, however, of the uncertainties in the forecast. It emerged that the economy's adjustment to equilibrium appeared to be taking place even faster than had been assumed in the November forecast. It was pointed out that the adjustment could prove even more rapid if the influx of tourists should ease more quickly than the forecast provided for, or if terms of trade deteriorated significantly. Others emphasised that the adjustment could also be overestimated in the forecast, as the slowdown in GDP growth in 2017 stemmed mainly from unique factors relating to the pharmaceuticals industry. It was also pointed out that investment was often underestimated in the first national accounts figures, as had come to light, for example, in December.

The Committee agreed that strong growth in domestic demand was attributable in part to fiscal easing, which was unnecessary given the business cycle position, as some demand pressures remained. Some members were of the view that the fiscal stance could turn out more accommodative than estimated, which can happen during times of rapid growth in Treasury revenues. It emerged that, although pressures had eased due to importation of production factors, it was appropriate to bear in mind that less slack in Europe could make it more difficult to recruit foreign workers. Furthermore, the outcome of wage settlements could prove less favourable than was assumed in the forecast. Members noted that the pace of the global economic recovery could have considerable implications for the domestic economy in the longer term.

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 4.25%, the current account rate 4%, the seven-day collateralised lending rate 5%, and the overnight lending rate 6%. All Committee members voted in favour of the proposal.

Members agreed that a tight monetary stance was needed to contain rapid domestic demand growth, in part because the outlook was for a less restrictive fiscal stance than previously expected. Furthermore, the outcome of wage settlements is still uncertain.

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 14 March 2018.