The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, August 2017

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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 21 and 22 August 2017, during which the Committee discussed economic and financial market developments, the interest rate decision of 23 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 14 June interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2017/3 on 23 August.

Financial markets

Between meetings, the króna depreciated by 8% in trade-weighted terms. Over this same period it fell 4.8% against the US dollar, 9.2% against the euro, and 5.6% against the pound sterling. Between meetings, the Bank bought foreign currency for 1.1 b.kr. and sold currency for 4.6 b.kr., for a net sale of 3.5 b.kr. (30 million euros). The Central Bank's transactions accounted for 7% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had eased between meetings. The Bank's real rate in terms of the average of various measures of inflation and inflation expectations had fallen by 0.2 percentage points since just after the Bank's rate reduction in June, to 2.3%.

Interest rates in the interbank market for krónur had changed in line with the Bank's key rate between meetings. Turnover in the market had been limited over the summer, totalling 5.4

b.kr. between meetings, but had been considerably greater year-to-date than over the same period in 2016.

Yields on nominal Treasury bonds fell slightly following the reduction in the Bank's key rate in June, but the decline reversed for the most part in July. In particular, yields on long-term bonds had risen between meetings. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds declined by up to 0.5 percentage points between meetings.

The commercial banks' nominal deposit and lending rates were 0.2-0.5 percentage points lower than before the Committee's June meeting. The pension funds' nominal lending rates also declined between meetings. The pension funds' indexed lending rates declined marginally between meetings, in line with yields on indexed Treasury and HFF bonds, while the commercial banks' indexed lending rates were unchanged.

Risk premia on Treasury foreign obligations were virtually unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.8%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany was approximately 1 percentage point.

Financial institutions' analysts had all expected that the Bank's interest rates would be held unchanged in August, noting that the exchange rate of the króna had fallen somewhat between MPC meetings and that exchange rate volatility had increased, leading to a rise in the breakeven inflation rate in the bond market, a poorer inflation outlook, and a decline in the real rate.

According to the Bank's market expectations survey, carried out in mid-August, respondents expected the Bank's key rate to be lowered by 0.25 percentage points at the MPC's August meeting and to be held unchanged for the two years thereafter. At the time the survey was conducted, about 67% of respondents considered the monetary stance appropriate, as opposed to 43% in the last survey.

Annual growth in money holdings has gained pace in the past year, exceeding nominal GDP growth in Q2. M3 adjusted for deposits held by failed financial institutions grew by 8.1% year-on-year in Q2/2017. As was the case last year, growth in money holdings is due largely to increased household deposits, although corporate deposits also grew between years.

After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers grew by roughly 3½% year-on-year in Q1, and by just over 4% after adjusting for the effects of exchange rate movements on the foreign-denominated credit stock. As before, credit growth is due to increased lending to households and businesses, with lending to both sectors rising year-on-year by roughly 4% in Q2.

The Nasdaq OMXI8 index had fallen by 4.6% between meetings but had risen by 2.2% since the beginning of the year. Turnover in the NASDAQ Iceland main market totalled 400 b.kr. over the first seven months of the year, about 25% more than over the same period in 2016.

Global economy and external trade

According to the International Monetary Fund's (IMF) July forecast, the global GDP growth outlook is unchanged from the Fund's April forecast. Global GDP growth is projected at 3.5% this year and 3.6% next year. Uncertainty about the outlook is considered to have receded, as the economic recovery in the eurozone and Japan has exceeded expectations. The IMF revised its GDP growth forecasts for the UK and the US downwards, however. The outlook for growth in world trade has also improved for this year, particularly for advanced economies. Growth is now projected at 4%. Inflation in developed countries is forecast at 1.9% this year and 1.8% next year, about 0.1 percentage points below the April forecast. Among Iceland's main trading partners, GDP growth is projected at 2%, or 0.1 percentage point above the April forecast, whereas the forecast for 2018 is unchanged at 1.9%.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 21.3 b.kr. deficit in July and a 108 b.kr. deficit in the first seven months of the year. The deficit over the same period in 2016 was 72 b.kr. Export values rose by 5.9% year-on-year at constant exchange rates, while import values rose 18%. Industrial export values rose by 16%, whereas marine product export values contracted by 8%. Strong growth in imports is due in particular to growth of one-fifth in imports of investment goods, commodities, and operational inputs.

The listed global market price of aluminium had risen by nearly 10% since the June meeting and by 28% year-on-year. Foreign currency prices of marine products rose by about 0.7% month-on-month in June and have risen by 7% year-on-year.

In terms of relative consumer prices, the real exchange rate measured 100.8 points in July, a decline of 4.8% month-on-month but a year-on-year increase of 18.8% in the first seven months of the year. The rise is due almost entirely to the nominal appreciation of the króna, as inflation has been about the same as the trading partner average.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 2.1% year-on-year in Q2, considerably less than had been assumed in the Bank's May forecast. The number of employed persons rose by 1.8%, and the average work week lengthened slightly. After adjusting for seasonality, the labour participation rate and the employment rate declined, but both were still high, and close to their pre-crisis peak.

Seasonally adjusted unemployment was broadly in line with the May forecast in Q2, measuring 2.5%, the lowest since Q2/2008.

Other indicators suggested increased demand in the labour market. Migration figures showed that the increase in foreign nationals equalled 2.1% of the population aged 20-59 in H1/2017, a larger rise than in all of 2016. About ¾ of this year's increase is due to an unusual surge in immigration taking place in Q2. The number of workers on the pay-as-you-earn register rose by 4.8% during the quarter, and there was continued robust growth in the number of workers on behalf of temporary employment agencies and foreign service companies.

The wage index was virtually unchanged in July, after having risen by 3.1% between quarters in Q2, when contractual pay rises for a majority of workers took effect. The year-on-year increase measured 7.2% in July, whereas real wages rose 5.3% in terms of the index.

Key indicators of developments in private consumption in Q2 and the beginning of Q3 suggest that private consumption may grow more this year than previously forecast. Payment card turnover was up nearly 13% year-on-year in the first seven months of the year. New motor vehicle registrations are also rising briskly, albeit less rapidly than in 2016.

The Gallup Consumer Confidence Index fell slightly month-on-month in July, to 108.5 points. All sub-indices fell during the month, especially those measuring expectations for the next six months and the assessment of the current economic situation.

Statistics Iceland's nationwide real estate price index, published at the end of July, rose 1.9% month-on-month when adjusted for seasonality and by 24.2% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 0.2% month-on-month in July when adjusted for seasonality, and by 19% year-on-year. The number of registered purchase agreements nationwide fell year-on-year, by 5.2% over the first seven months of the year and by just over 21% in July. The average time-to-sale for residential property in the greater Reykjavík area was 2.8 months in July, over half a month longer than during the same period in 2016.

The CPI fell by 0.02% month-on-month in July. Twelve-month inflation measured 1.8% and had risen by 0.3 percentage points since the MPC's June meeting. The CPI excluding housing had fallen by 3.1% since July 2016, however, and the HICP fell by 1.9% over the same period. Most measures of underlying inflation declined in July, however, and lay in the 0.4-1.5% range.

Summer sales were one of the major determinants of inflation in July, although they were offset by rising owner-occupied housing costs and seasonal spikes in airfares. Private services prices rose by 0.2% year-on-year in July, but the price of imported goods apart from alcoholic beverages and tobacco fell by 8% over the same period.

According to the Central Bank's survey of market agents' inflation expectations, conducted in mid-August, participants expect inflation to measure 2.4% in one year. This is 0.2 percentage points more than in the previous survey, taken in May. Survey participants' inflation expectations two years ahead had declined, however, from 2.6% in the last survey to 2.5%. Furthermore, market agents expect inflation to average 2.6% over the next ten years, the same as in the May survey. The ten-year breakeven inflation rate in the bond market had risen during the days preceding the MPC meeting. It averaged 2.3% in Q2 and has hovered in the 2.3-2.9% range in Q3 to date.

According to the forecast published in *Monetary Bulletin* on 23 August 2017, the inflation outlook is broadly unchanged from the May forecast. Inflation is expected to measure 2% in the latter half of this year and rise to the target by mid-2018. As in the Bank's previous forecasts, the higher exchange rate and increased demand pressures in the economy tend to offset one another. The impact of both factors has receded in comparison with the May forecast, but next year the effects of an exchange rate below the May forecast will be stronger. As a result, inflation is expected to be higher than was projected in May. Inflation is projected to peak at just over 3% late in 2018 and then begin to subside to the target.

Domestic demand has grown rapidly, and GDP growth has been strong, measuring 7.2% in 2016, and is set to remain robust this year. It is projected to measure 5.2% for 2017 as a whole, about 1 percentage point less than was forecast in May, primarily because of a less favourable outlook for external trade than was assumed at that time. As in the Bank's previous forecasts, GDP growth is expected to ease still further over the next two years, as it approaches its long-term trend rate.

Job creation has been strong, concurrent with rapid growth in economic activity, and unemployment has declined. Nearly half of firms have had difficulty filling available positions, and an increasing number are operating at capacity. Increased labour demand has been met to a considerable degree with importation of labour, which has increased rapidly in the recent term.

Assumptions about wage developments are similar to those in May. As was the case then, it is assumed that agreements made this year will be accommodated within the scope provided for under the SALEK agreement and will not trigger a review of private sector wage settlements in February 2018. Because labour productivity is expected to increase less in 2017 than was previously projected, unit labour costs will rise more, or by 5.5% instead of the previously forecast 5%. The outlook for the remainder of the forecast horizon is broadly unchanged, however, and the rise is projected at close to 5% per year.

According to the forecast, the output gap that opened up early in 2015 will disappear during the forecast horizon. The output gap is projected at just under 3% of potential output this year, about the same as in 2016 but slightly less than was forecast in May.

II The interest rate decision

The Governor reported to the Committee on work done in connection with the review of the statutory and technical foundations for the capital flow management measure. He also reported on the Bank's analysis of developments in the foreign exchange market year-to-date.

The MPC discussed the monetary stance in view of the most recent information on the economy and the decline in the Bank's real rate between meetings. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in June to lower the Bank's key rate by 0.25 percentage points, partly because the Bank's real rate had risen between meetings and entailed a somewhat tighter monetary stance than the Committee had intended and considered sufficient to support medium-term price stability.

In this context, the Committee took into consideration the Central Bank's new forecast, published in *Monetary Bulletin* on 23 August, according to which the outlook is for robust GDP growth this year, as in 2016, albeit somewhat less than had been forecast in May. The forecast assumed that GDP growth would be driven in particular by growth in tourism and private consumption; furthermore, the outlook was for fiscal easing this year.

Members discussed developments in inflation, which had been marginally lower in Q2 than had been projected in May. They also noted that inflation had risen in July, although underlying inflation appeared to have continued to fall. As before, the Committee was of the view that the opposing forces that had affected inflation over the past year would cause considerable uncertainty about the inflation outlook. In particular, they observed that the gap between domestic price developments – housing costs in particular – and external factors had continued to widen in recent months. The appreciation of the króna in the past year and low global inflation had offset domestic inflationary pressures, but there was uncertainty about both further ahead.

The Committee discussed the depreciation of the króna since the June meeting. The opinion was expressed that the appreciation early in the spring had probably entailed a temporary overshooting that had reversed in part in recent months; therefore, the impact was probably limited. It was considered likely that increased demand for hedging instruments and changing exchange rate expectations had had an increased effect on exchange rate developments following the liberalisation of the capital controls. It was also pointed out that, in spite of the depreciation, the króna was still nearly 8% stronger just before the August meeting than it had been a year earlier, and that it was broadly the same as at the end of 2016.

Members also discussed whether it would be desirable to intervene more frequently in the foreign exchange market so as to mitigate exchange rate movements further. The Bank has substantially reduced its foreign exchange market activity after the virtually complete liberalisation of the capital controls in mid-March. The Bank's transactions in the market have aimed primarily at stopping spirals from emerging in the market. It was noted that it could prove difficult to intervene more actively in the market, as strong opposing forces were at work, making it difficult to distinguish between volatility and underlying exchange rate trends. The opinion was expressed that fluctuations in the exchange rate were likely to diminish from their recent levels, as revaluation and the shift towards a new post-liberalisation equilibrium were further advanced than before. The market was still in the rebalancing process, however. Many important events had taken place in a relatively short period of time, and when shocks were large, the ripple effect would take longer to subside.

The Committee also discussed developments in inflation expectations, as short-term expectations had risen slightly since the previous meeting. Members were of the view that the rise in short-term inflation expectations probably reflected the recent depreciation of the króna to some extent. The longer-term breakeven inflation rate in the bond market had also risen in the past few days, although it had been well in line with the Bank's inflation target during the quarter to date. It was pointed out that a rise in the breakeven inflation rate need not mean that long-term inflation expectations were rising. It could also reflect a rise in the inflation risk premium or other determinants of bond market pricing. Long-term inflation expectations were broadly unchanged, according to the Bank's recent market expectations survey. It was pointed out as well that by most measures, inflation expectations were at target. Committee members were of the view that these two factors were a sign of enhanced credibility of monetary policy, although it was not a given that expectations would remain at target in the event of a further steep depreciation of the króna followed by a temporary inflation spike.

The Committee discussed whether to keep interest rates unchanged or to lower them. All members agreed that clear signs of demand pressures in the economy called for a continued tight monetary stance so as to ensure medium-term price stability. At the last two meetings, members had agreed to lower the Bank's key rate in spite of the demand pressures in the economy, as the rise in the real rate between MPC meetings had entailed a somewhat tighter monetary stance than the Committee had intended and considered sufficient to support price stability over the medium term. Now, however, the monetary stance had eased, as the Bank's real rate had fallen since the June meeting as a result of a rise in inflation and inflation expectations. Nevertheless, members did not consider it necessary to raise the key rate in order to maintain an unchanged monetary stance between meetings, as demand pressures in the economy were now expected to be weaker than previously forecast and inflation expectations had thus far withstood the volatility in the foreign exchange market.

In addition, members emphasised that there was considerable uncertainty about recent developments in external trade and the housing market, which could indicate weaker growth and a smaller output gap. As a result, it was too early to draw conclusions about the scope and implications of such changes. It was pointed out that the housing supply appeared to be increasing and the average time-to-sale was on the rise. There was still some uncertainty about the upcoming wage settlements and about whether the current contracts would be subject to a review early next year. Inflation expectations were relatively stable, and all were at target. It would therefore be appropriate to wait and see how the situation developed.

The Committee was of the view that although the Bank's real rate had declined slightly since the last meeting, it appeared under current conditions to be consistent with inflation at target. One member was of the opinion, however, that there might possibly be scope for a further rate cut. This member pointed out that there was more than 3% deflation in terms of the CPI excluding housing, and that the rise in the housing component was due not to low interest rates but to limited supply, which stemmed from other causes.

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. One member would have preferred to lower rates by 0.25 percentage points but was nonetheless willing to vote in favour of the Governor's proposal.

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 4 October 2017.