The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

June 2019 (85th meeting)

Published 10 July 2019

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 24 and 25 June 2019, during which the Committee discussed economic and financial market developments, the interest rate decision of 26 June, 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 22 May 2019 interest rate decision.

Financial markets

Since the May meeting, the króna had depreciated by 2.3% in trade-weighted terms. Over this same period it fell 2.6% against the euro, 0.5% against the US dollar, and 1% against the pound sterling. Between meetings, the Bank sold foreign currency for 21 million euros (3 b.kr.), in part to prevent outflows of offshore krónur from lowering the exchange rate. The Central Bank's transactions accounted for just under 18% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had tightened slightly since just after the Committee's May interest rate decision. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate had risen by 0.1 percentage points between meetings, to 0.7%. In terms of twelve-month inflation, it was 0.4% and had fallen by 0.3 percentage points between meetings.

Interest rates in the interbank market for krónur declined in line with the Central Bank's 0.5-point rate cut in May, but turnover totalled about 21 b.kr. during the period.

Yields on long-term nominal Treasury bonds had fallen by 0.3 percentage points since the May meeting, and yields on long-term indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.1 percentage points. Average interest rates on fixed- and variable-rate mortgages had fallen in a similar manner, apart from average indexed rates on pension fund loans, which were broadly unchanged.

In terms of three-month interbank rates, the interest rate differential versus the euro area had narrowed by 0.3 percentage points between meetings, to 4.9 percentage points. The corresponding spread versus the US had narrowed by 0.2 percentage points, to 2.2 percentage points. The long-term interest rate differential versus Germany was broadly unchanged between meetings, at 4.2 percentage points, whereas the spread versus the US had widened by 0.1 percentage points, to 1.9 percentage points.

Measures of the risk premium on the Treasury's foreign obligations were largely unchanged since the MPC's May meeting. The CDS spread on the Treasury's five-year US dollar obligations was virtually unchanged at just over 0.7%, 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 expected a rate cut of 0.25 percentage points, citing the decline in corporate inflation expectations and the breakeven inflation rate in the market, as well as the deterioration in the economic outlook since the last interest rate decision. Even though the króna had weakened recently and inflation was above target, analysts expected the MPC to lower interest rates further so as to soften the imminent economic contraction.

Annual growth in M3 measured just under 9% in May, after adjusting for deposits held by the failed financial institutions. This was broadly similar to the growth rate in the two months beforehand. As before, the increase is due largely to growth in household deposits. After adjusting for the effects of the Government's debt relief measures, the stock of credit system loans to domestic borrowers grew in nominal terms by 8½% year-on-year in May 2019. Over the same period, household lending grew by 7½% year-on-year and corporate lending by 9½%, whereas the growth rate adjusted for exchange rate movements was about 6%.

The Nasdaq OMXI8 index had fallen by 2.3% between meetings. Turnover in the main market totalled around 281 b.kr. during the first five months of the year, 23% more than over the same period in 2018.

Global economy and external trade

According to the Organisation for Economic Co-operation and Development's (OECD) May forecast, global GDP growth will be weaker in both 2019 and 2020 than in the OECD's November forecast. It is forecast to measure 3.2% this year and 3.4% next year, which is 0.1-0.3 percentage points below the November forecast. Weaker GDP growth is forecast for nearly all countries worldwide, and particularly for the euro area. The outlook for growth in world trade has deteriorated as well. Growth for this year is projected at just over 2%, the weakest in the post-crisis period. The OECD continues to consider the uncertainty in the output growth forecast to be concentrated on the downside, partly because of the risk that global trade disputes will escalate further and prove more protracted than is currently expected. For Iceland's main trading partners, the OECD forecasts 1.8% GDP growth in both 2019 and 2020, which is 0.1-0.3 percentage points below its November forecast. Trading partner inflation is projected at 1.5% this year and 1.8% next year, some 0.3-0.6 percentage points below the November forecast.

Iceland's external goods trade generated a deficit of just over 15 b.kr. for the first four months of the year (at constant exchange rates), as opposed to a deficit of nearly 52 b.kr. over the same period in 2018. The smaller deficit this year is due for the most part to increased exports of aircraft early in 2019. In addition, aircraft imports contracted year-on-year. Excluding ships and aircraft, the goods account showed a deficit of nearly 37 b.kr. in the first four months of 2019, as opposed to a 38½ b.kr. deficit at constant exchange rates over the same period in 2018. Import values excluding ships and aircraft contracted by 2% year-on-year, particularly imports of passenger cars and fuels and lubricants. Furthermore, exports contracted by 1.7%, especially aluminium exports.

Between MPC meetings, the listed global price of aluminium rose by 0.6% but was 18% 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 6.3% year-on-year in the first four months of 2019. The global price of oil had risen by nearly 10% between MPC meetings, to 65 US dollars per barrel just before the June meeting. This is 13% below the price seen at the same time in 2018.

The real exchange rate in terms of relative consumer prices fell by 1.6% month-on-month in May, when it was 8.5% above its twenty-five year average but 15.4% below its June 2017 peak. In the first five months of 2019, it was down by 9.5% compared with the same period in 2018, as the nominal exchange rate of the króna was 10.7% lower and inflation in Iceland was 1.4 percentage points above the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in May, GDP growth measured 1.7% for the first quarter of the year. Domestic demand contracted by 2.8% between years, whereas the contribution of net trade to output growth was positive by 4.4 percentage points. Private and public consumption grew by 2.8% year-on-year, while investment shrank 9.4% and total consumption and investment were unchanged between years. The contribution from inventory changes was negative during the quarter, however, causing the contraction in domestic demand. Q1/2019 GDP growth was 0.1 percentage points stronger than had been forecast in the May *Monetary Bulletin*. Consumption and investment were somewhat stronger than forecast, while inventory changes were weaker. As a result, domestic demand as a whole developed in line with the Bank's forecast. Export growth was weaker than projected, but on the other hand, imports contracted more strongly and the contribution from net trade was in line with the forecast.

The current account balance was positive by just over 35 b.kr. in Q1/2019, as opposed to a surplus of 6.7 b.kr. at the same time in 2018. The larger surplus now is due for the most part to a turnaround in goods trade, owing in particular to increased exports of ships and aircraft, although there was also a contraction in aircraft imports. The balance on primary income was also more positive this year than in 2018, although the surplus on services trade was smaller. Excluding ships and aircraft, the current account showed a surplus of 13.2 b.kr. in Q1/2019, as opposed to a 14.1 b.kr. surplus in the same quarter of 2018.

Key indicators of developments in private consumption in Q2 are rather more robust than in Q1, which could suggest that private consumption growth will firm up between quarters. The Gallup Consumer Confidence Index measured 96 points in May, slightly lower than in the previous month, but on the whole it has been on the rise in recent months, after a steep drop in H2/2018.

According to the approved amendments to the Parliamentary resolutions on the 2018-2022 fiscal strategy and the 2020-2024 fiscal plan, the fiscal outcome will deteriorate markedly, by nearly 1% of GDP each year. One of the reasons for this is the sharp downturn in economic activity this year, which erodes the economic outlook relative to the Government's previous estimates. As a result, the output gap — changes in which greatly affect the fiscal outcome, particularly on the revenues side — will narrow more rapidly. In addition, a number of special measures that have been resolved upon will tend to weaken the fiscal performance, especially measures in connection with the recent wage settlements. Preliminary fiscal performance figures from Statistics Iceland show nearly 8% year-on-year expenditure growth in Q1, while regular revenues grew by just over 2%.

According to the results of Gallup's summer survey, conducted in May among Iceland's 400 largest firms, respondents' assessment of the current economic situation was more positive than in the spring survey but less positive than in the summer 2018 survey. Executives' expectations over the next six months are somewhat more positive, however, than in either the spring survey or the survey taken in summer 2018. About 56% of respondents consider the current situation neither good nor poor, and about 23% consider it good. Just under 41% of executives are of the view that economic conditions will deteriorate in the next six months, and 46% expect conditions to be neither better nor worse. About 14% of executives expect the situation to improve in six months' time, somewhat more than in the last survey. Executives are more optimistic about developments in domestic demand in the next six months than they were in the spring survey, particularly those in retail and wholesale trade and construction.

According to the seasonally adjusted results of the summer survey, about one-fourth of firms are planning to reduce staffing levels in the next six months. The share of firms planning to downsize exceeds the share planning to recruit staff by 12 percentage points, which suggests a downturn in labour demand since the spring survey. The balance of opinion is 16 percentage points below its long-term average. The only sector with the prospect of job growth is specialised services, where the balance of opinion is positive by 11 percentage points, whereas the outlook is for reduced staffing in all other sectors, where the balance of opinion is negative by 16-26 percentage points. Executives in construction and utilities, as well as in retail and wholesale trade, are considerably more pessimistic than in the spring survey, whereas pessimism has retreated among executives in transport, transit, and tourism and in miscellaneous specialised services.

After adjusting for seasonality, 11% of executives considered themselves short-staffed, about the same as in the spring survey but 14 percentage points fewer than in the summer 2018 survey. The shortage was greatest in miscellaneous specialised services and in construction and utilities, where nearly one in five respondents considered themselves understaffed. On the other hand, there was only a negligible shortage in retail and wholesale trade and none in financial and insurance firms and fishing companies. Staffing shortages were below their long-term averages in all sectors.

About 40% of executives reported that they would have difficulty responding to unexpected demand, after adjusting for seasonality. This ratio was broadly unchanged since the spring survey, and very close to its long-term average. Nearly three of five executives in specialised services reported that they would have difficulty responding to unexpected demand, as were about a fifth of executives in retail and wholesale trade.

The wage index rose by 0.5% month-on-month in May and by 5.1% year-on-year. Real wages were 1.4% higher than at the same time in 2018.

Statistics Iceland’s nationwide house price index, published in late May, was virtually unchanged month-on-month when adjusted for seasonality, but rose 5.4% year-on-year. The capital area house price index, calculated by Registers Iceland, fell by 0.1% month-on-month in May when adjusted for seasonality, but rose by 3.9% year-on-year. The number of purchase agreements registered nationwide fell by 10% year-on-year in the first five months of 2019, while the number of contracts for new construction declined by 23% over the same period.

The consumer price index CPI rose by 0.21% month-on-month in May. Twelve-month inflation measured 3.6% and had risen by 0.3 percentage points between MPC meetings. The CPI excluding the housing component had risen by 3.1% year-on-year in May. Underlying inflation also picked up between meetings, measuring 3.4% in May, according to the median of various measures. The reduction in airfares had the strongest impact on the CPI in May, affecting the index about the same as in May of the previous two years. Increased petrol and food prices also made some impact.

According to Gallup’s summer survey, household inflation expectations one year ahead measured 4%, which was unchanged from the spring survey but 0.6 percentage points more than in the summer 2018 survey. Corporate inflation expectations one year ahead fell from the previous survey, however, to 3%, the same as in the summer 2018 survey. Households’ and businesses’ long-term inflation expectations fell by 0.5 percentage points between surveys, to 3-3.5%. The five- and ten-year breakeven inflation rate in the bond market was 2.7-2.9% just before the MPC meeting, after falling by approximately 0.2 percentage points since the May meeting. The ten-year breakeven rate has averaged 2.8% in Q2 to date, which is 0.5 percentage points lower than in Q2/2018.

II The interest rate decision

The MPC discussed monetary policy instruments and Central Bank transactions, as a working group within the Bank has been examining whether monetary policy instruments should be reviewed from the standpoint of efficacy and economy. The Committee also discussed financial institutions’ liquidity position and the Bank’s foreign exchange market intervention policy. Foreign exchange intervention has been limited in recent months, and some of the transactions have been undertaken in response to outflows of offshore krónur.

MPC 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 risen by 0.1 percentage points since the May meeting. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as they had decided in May to lower the Bank’s interest rates, partly because of the imminent turning point in the economy, the improved inflation outlook, and the decline in long-term inflation expectations. Furthermore, uncertainty about the inflation outlook had abated with the approval of private sector wage agreements.

Members discussed the newly published preliminary national accounts figures but agreed that the most recent data on economic developments did not change the assessment of the economic outlook as presented to the Committee at its last meeting. They noted that GDP growth in Q1/2019 was in line with the Central Bank's May forecast. Furthermore, stronger private consumption in Q1 and leading indicators for Q2 could imply that domestic demand had been more resilient than previously assumed. On the other hand, it emerged that total turnover on foreign credit cards had contracted year-on-year in April and May in foreign currency terms, although turnover per tourist had increased somewhat. This, together with recent data and forecasts concerning tourist numbers, indicated that the contraction in tourism could turn out more pronounced than had been forecast in May. The MPC agreed that, as regards the short-term outlook, stronger-than-expected domestic demand growth partially offset the stronger impact of the negative economic shocks recently hitting the economy. In the Committee's assessment, however, this did not change the outlook for a contraction in the domestic economy that is expected to show more clearly in coming months.

MPC members discussed developments in inflation, which had been in line with the Bank's last forecast. According to that forecast, inflation had peaked and would ease back to target as the year progressed. It emerged in the discussion, however, that further depreciation of the króna could change these prospects. Inflation expectations had also fallen since the Committee's last meeting, whereas long-term expectations as measured by the breakeven inflation rate in the bond market appeared to have been inching upwards again in recent weeks.

In the Committee's view, although the economic contraction will be challenging for households and businesses, the economy was much more resilient than before. The MPC emphasised that monetary policy had considerable scope to respond to the contraction, particularly if inflation and inflation expectations remained close to the target, as is currently envisioned. In addition, members agreed that the proposed fiscal easing would pull in the same direction.

The Committee discussed awaiting further developments and keeping interest rates unchanged versus lowering them by 0.25 percentage points. The main arguments in favour of an unchanged policy rate were that inflation and inflation expectations were still above target and the breakeven inflation rate in the bond market appeared to have begun rising again. Furthermore, the króna had weakened in the recent term and public sector wage agreements were still pending. Moreover, the underlying resilience of domestic demand had been greater than previously assumed. As a result, it could be appropriate to wait for clearer signs of disinflation and falling inflation expectations before lowering interest rates further.

The main argument in favour of a rate cut was that while economic developments had been broadly in line with expectations, there were signs that the economic contraction could turn out deeper and longer than had been forecast in May. Inflation expectations had fallen between MPC meetings and the monetary stance had therefore tightened again. It was also pointed out that the outlook was still for inflation to ease back towards the target in 2019. Consequently, it was appropriate to loosen the monetary stance further, in response to the economic contraction.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 3.75%, the current account rate 3.5%, the seven-day collateralised lending rate 4.5%, and the overnight lending rate 5.5%. Már Gudmundsson, Rannveig Sigurdardóttir, Gylfi Zoëga, and Katrín Ólafsdóttir voted in favour of the proposal. Thórarinn G. Pétursson voted against the Governor's proposal, preferring to keep rates unchanged.

In the Committee’s view, near-term monetary policy decisions would depend on the interaction between developments in economic activity, on the one hand, and inflation and inflation expectations, on the other.

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 28 August 2019.