



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

December 2019 (89th meeting)

Published: 25 December 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 9 and 10 December 2019, during which the Committee discussed economic and financial market developments, the interest rate decision of 11 December, 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 November 2019 interest rate decision.

Financial markets

Since the November meeting, the króna had appreciated by 2% in trade-weighted terms. Over this same period it rose by 2.4% against the euro and 1.9% against the US dollar but fell by 0.2% against the pound sterling.

In terms of the Central Bank’s real rate, the monetary stance had remained broadly unchanged since just after the Committee’s November interest rate decision. The Bank’s real rate in terms of the average of various measures of inflation and one-year inflation expectations had risen by 0.1 percentage points between meetings, to 0.5%. In terms of twelve-month inflation, it was 0.3% and had also risen by 0.1 percentage points.

Interest rates in the interbank market for krónur fell in line with the Central Bank’s rate reduction in November, but there was no turnover in the market between meetings. Yields on long-term nominal Treasury bonds had risen by 0.3 percentage points since the November

meeting, however, and yields on long-term indexed Treasury and Housing Financing Fund (HFF) bonds had also risen by 0.3 percentage points. Average rates on non-indexed mortgage loans had fallen slightly between meetings, whereas average rates on indexed mortgage loans were broadly unchanged.

In terms of three-month interbank rates, the interest rate differential had narrowed by 0.2 percentage points between meetings, to 4.1 percentage points against the euro and 1.8 percentage points against the US dollar. The long-term interest rate spread versus Germany had widened by 0.3 percentage points, to 4.1 percentage points, and the spread versus the US had widened by 0.4 percentage points, to 2 percentage points. Measures of the risk premium on the Treasury's foreign obligations had risen marginally between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.8%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.5-0.6 percentage points.

Financial institutions' analysts had all projected that the MPC would hold interest rates unchanged, citing the Committee's November statement, which indicated that the then-current interest rate level should suffice to ensure medium-term price stability. They also noted that the Bank's real rate had remained largely unchanged since November and that the newly published national accounts had been broadly in line with the Central Bank's last forecast.

Annual growth in M3 was about 3% in October, after adjusting for deposits held by the failed financial institutions. This is a weaker growth rate than in the past year. Although lending growth has eased in the recent term, the stock of credit system loans to domestic borrowers grew in nominal terms by an estimated 5% year-on-year in October, after adjusting for the effects of the Government's debt relief measures. Over the same period, household lending grew by just under 7% year-on-year and corporate lending by 1½%, somewhat less than in recent quarters.

The Nasdaq OMXI10 index had risen by 4.3% between meetings. Turnover in the main market totalled 558 b.kr. during the first eleven months of the year, nearly 22% more than over the same period in 2018.

Global economy and external trade

According to the Organisation for Economic Cooperation and Development's (OECD) November forecast, global GDP growth is projected at 2.9% in both 2019 and 2020. This is similar to the OECD's forecast from September but below its May forecast by 0.3 and 0.5 percentage points, respectively. If this forecast materialises, the growth rate will be the weakest since the financial crisis. Weaker global output growth can be attributed to a poorer outlook in both advanced and emerging economies, as growth has slowed in nearly all economies worldwide in 2019. The OECD continues to consider the uncertainty in the forecast to be concentrated on the downside. GDP growth could turn out weaker, for instance, if global trade disputes escalate further, if the UK leaves the European Union (EU) without an exit agreement, or if the EU and the UK do not reach an agreement on future trade arrangements between them within the timeframe specified in the exit agreement. The global economy could also grow more slowly if GDP growth in China slows more, and faster, than is assumed in the OECD's baseline forecast.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 3.1 b.kr. deficit in November, as opposed to a deficit of 18.2 b.kr., at constant exchange rates, in November 2018. The deficit for the first eleven months of the year was 96 b.kr., as compared with 176 b.kr. for the same period in 2018. The smaller deficit now is due partly to the exportation of aircraft early in the year, although import values have also contracted by 10.4%

in 2019 to date. The contraction in import values excluding ships and aircraft grew stronger in November. In the past three months, import values have shrunk by 13.5% year-on-year. The main difference lies in reduced import values of commodities and fuels and lubricants, although the value of imported investment goods contracted as well. Export values were unchanged year-on-year in the first nine months of 2019. Excluding ships and aircraft, export values contracted by 4% year-on-year, particularly for industrial goods, whereas the export value of marine products and agricultural products rose year-on-year by 2% and 41%, respectively, owing in particular to aquaculture products.

Between MPC meetings, the listed global price of aluminium fell just over 3.5% and was more than 10% below the price seen in December 2018. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 6.7% year-on-year in the first ten months of 2019. The global price of oil had risen by 2% since the November meeting, to just over 64 US dollars per barrel at the time of the December meeting. The price of oil was also up by more than 7% year-on-year at the time of the December meeting.

The real exchange rate in terms of relative consumer prices rose by 0.3% month-on-month in November, when it was 9.5% above its 25-year average but 14.4% below its June 2017 peak. In the first eleven months of 2019, it was down by 7.5% compared with the same period in 2018, as the nominal exchange rate of the króna was 8.7% lower and inflation in Iceland was 1.5 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland at the end of November, GDP contracted by 0.1% year-on-year in Q3. Domestic demand increased by 3.2%, as there was a significant positive contribution from inventory changes during the quarter, in addition to 2.5% growth in consumption and investment. Offsetting this was the contribution of net trade to GDP growth, which was negative by 3.2 percentage points. Both exports and imports contracted year-on-year during the period, although exports contracted somewhat more strongly. GDP growth for the first three quarters of 2019 measured 0.2%. Consumption and investment fell by 0.4% between years during this period, but due to a strong negative contribution from inventory changes in H1, the contraction in domestic demand was stronger, at 0.9%. Although the contribution of net trade to output growth was negative in Q3, it was positive by 1 percentage point for the first three quarters of the year.

GDP growth for the three-quarter period was 0.3 percentage points stronger than was forecast in the November *Monetary Bulletin*. Growth in residential investment year-to-date has been surprisingly strong, but this probably reflects a lag in registration of new construction rather than a steep rise in construction activity. Furthermore, private consumption was stronger and the contribution from inventory changes more favourable than previously forecast, albeit offset by a less favourable contribution of net trade to output growth. The lion's share of the deviation in the forecast of the contribution from net trade can be attributed, however, to the part of services exports that includes intellectual property-related services, which will show in Q4 instead of Q3, as was previously expected.

The current account surplus was 63 b.kr. in Q3/2019. This is a smaller surplus than in Q3/2018, when it measured 74 b.kr. The contraction in the surplus is due to a smaller surplus on services trade, although the balance on primary income improved. In spite of this, the current account surplus in 2019 to date measures 5.5% of GDP, more than in the previous two years but slightly

below the post-crisis average. More favourable goods trade and a larger surplus on primary income offset the smaller surplus on services trade thus far in 2019.

Leading indicators of private consumption at the beginning of Q4 developed broadly as they have in recent months. Payment card turnover increased modestly and new motor vehicle registrations contracted, albeit at a reduced rate. The Gallup Consumer Confidence Index measured 95.7 points in November, an increase of 8.8 points month-on-month and nearly 20 points year-on-year.

The 2020 National Budget was approved with a deficit of 0.3% of GDP, whereas the forecast in *Monetary Bulletin* assumes that the fiscal outcome will be in balance at that time. The outcome provided for in the Budget is 0.5 percentage points within the boundaries provided for in the 2018-2022 fiscal strategy.

According to the results of Gallup's winter survey, conducted in December among Iceland's 400 largest firms, respondents' assessment of the current economic situation was more positive than in both the autumn survey and the winter 2018 survey. Executives are considerably more upbeat about the outlook six months ahead, however, than they were in autumn 2019 and winter 2018. About 55% of respondents considered the current situation neither good nor poor, and about 31% considered it good. Just under 28% of executives are of the view that economic conditions will improve in the next six months, and 46% expect conditions to be neither better nor worse. Just over a fifth expect conditions to be worse in six months' time, a somewhat smaller share than in the autumn survey. Executives are slightly more pessimistic about developments in domestic demand than they were in the autumn survey, however, especially those in the construction industry and in transport, transit, and tourism. Expectations about external demand improved slightly since the autumn, particularly among executives in financial services and retail and wholesale trade.

According to the seasonally adjusted results of the winter survey, the balance of opinion on staffing plans (i.e., firms planning to recruit as compared with those planning redundancies) was negative by 11 percentage points. Survey respondents were somewhat more pessimistic than in the autumn survey, when the same balance of opinion was negative by 7 percentage points. Prospects are bleakest in the construction sector, where the outlook is for a marked decrease in job numbers. Furthermore, there is once again considerable pessimism in the transport, transit, and tourism sector, where the outlook is similar to that in the construction sector. The only sector expecting an increase in staffing levels is miscellaneous specialised services, where the balance of opinion was positive by 18 percentage points.

After adjusting for seasonality, 16% of executives considered themselves short-staffed, about the same as in the previous survey. As before, the reported shortage was largest in miscellaneous specialised services, where about 28% of firms considered themselves understaffed. On the other hand, there was no reported shortage of workers in the construction and financial/insurance sectors. Staffing shortages were at or below their long-term averages in all sectors.

The share of executives who reported difficulty in responding to unexpected demand declined marginally between surveys, to 36%. Nearly half of fishing industry executives and more than two of every five in miscellaneous specialised services were of the view that their firms would have difficulty responding to unexpected demand. In transport, transit, and tourism, as well as in the construction and financial/insurance sectors, the strain on production factors was least, with ratios in the 20-25% range.

The general wage index rose by 0.4% month-on-month in October and by 4.2% year-on-year, and real wages were 1.3% higher during the month than at the same time in 2018.

Statistics Iceland's nationwide house price index, published in late November, rose by 1% month-on-month when adjusted for seasonality, and by 4.8% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.8% month-on-month in October when adjusted for seasonality, and by 3.6% year-on-year. The number of purchase agreements registered nationwide fell by 4.6% year-on-year in the first ten months of 2019, while the number of contracts for new construction increased by 5.2% over the same period.

The consumer price index CPI rose by 0.13% month-on-month in November. Headline inflation measured 2.7% and had declined since the MPC's previous meeting. The CPI excluding the housing component had risen by 2.4% year-on-year in November. Underlying inflation measured 3.1%, according to the median of various measures, and fell between months. The decline in international airfares made the strongest impact on the CPI in November. For the second month in a row, imputed rent (owner-occupied housing costs) rose somewhat, owing mainly to higher house prices in regional Iceland.

The interest component of imputed rent has lowered inflation recently, as real mortgage interest expense has fallen in response to Central Bank rate cuts. Because of this, twelve-month inflation was an estimated 0.3 percentage points lower than it would have been otherwise.

According to Gallup's winter survey, households' and businesses' one-year inflation expectations were unchanged between surveys, at 2.5-3%. Households' two-year inflation expectations fell, however, to 3%. Corporate long-term inflation expectations also fell slightly, to 2.9%. The five- and ten-year breakeven inflation rate in the bond market was about 2.5% just before the MPC meeting, after rising slightly since the November meeting. The ten-year breakeven rate has averaged 2.5% in Q4 to date, some 1.6 percentage points lower than in the same quarter of 2018.

II The interest rate decision

The Committee discussed draft amendments to the Rules on Minimum Reserve Requirements and a draft of new Rules on Central Bank Facilities for Financial Undertakings, in accordance with its approval at the October meeting of proposed restrictions on Central Bank facilities and amendments to the Rules on such facilities. The drafts were discussed and then approved by the Committee.

MPC members discussed the monetary stance in view of economic developments and the fact that the Bank's real rate was broadly unchanged since the November meeting. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in November to lower interest rates because the GDP growth outlook had deteriorated and the outlook was for inflation to subside faster than previously forecast. Inflation expectations had also continued to fall, and the Bank's real rate had therefore risen slightly.

The MPC discussed the recently published national accounts figures, according to which output growth measured 0.2% for the first nine months of the year. Members noted that this was slightly stronger growth than the Bank forecast in November, but they agreed that overall developments year-to-date had been broadly in line with the Bank's projections. It emerged in the discussion that the slowdown in tourist numbers had eased and that recent developments had been more favourable than expected.

Committee members discussed inflation, which measured 2.7% in November and had fallen between months, as had underlying inflation. They noted that the inflation outlook had held broadly unchanged since the previous meeting and that inflation expectations were at target by most measures. The monetary stance had therefore remained largely unchanged between MPC meetings.

Members discussed how the Bank's rate cuts since the spring had been transmitted to private sector interest rates. Rates had been lowered by 1.5 percentage points, and the impact on the real economy had yet to come fully to the fore. They noted that household lending rates had fallen in the wake of reductions in the Bank's key rate and that lending growth to households was still relatively robust. On the other hand, it emerged in the discussion that the spread between the Bank's key rate and rates on new corporate loans granted by the commercial banks had widened recently, and that net new corporate lending had continued to ease. The Committee was of the opinion, however, that the slowdown in corporate lending was expected in light of the strong increase in recent years and the possibility that expected returns on firms' activities could now be lower than before, owing to declining demand. Furthermore, various elements in financial institutions' operations had affected access to credit, including their revaluation of loan pricing and credit risk in the wake of recent changes in their operating environment. The Committee agreed that it was appropriate to keep abreast of this situation in the near future, and its potential impact on monetary policy formulation.

The Committee considered it appropriate this time to wait and see what impact the measures already in place would have. Spare capacity was relatively limited, according to the Bank's baseline forecast from November, although GDP growth had slowed markedly. Furthermore, in view of the easing of the fiscal stance, less monetary easing would be needed than would otherwise be required; furthermore, interest rates were well below the estimated neutral real rate. Although underlying inflation had subsided in November, it was still above the inflation target.

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 be 3%, the current account rate 2.75%, the seven-day collateralised lending rate 3.75%, and the overnight lending rate 4.75%. All Committee members voted in favour of the proposal.

In the MPC'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:

Ásgeir Jónsson, Governor and Chair 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 5 February 2020.