The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, August 2018

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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 27 and 28 August 2018, during which the Committee discussed economic and financial market developments, the interest rate decision of 29 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 13 June 2018 interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2018/3 on 29 August.

Financial markets

Between meetings, the króna appreciated by 1.1% in trade-weighted terms. Over this same period it fell 0.5% against the US dollar but rose by 0.3% against the euro and 3.4% against the pound sterling. 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 eased slightly since the June meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.3%, or 0.3 percentage points lower than in June. In terms of twelve-month inflation, it was 1.5% and had fallen by 0.7 percentage points.

Interest rates in the interbank market for krónur were virtually unchanged between meetings, and turnover in the market amounted to 18 b.kr. during that period.

Yields on long-term nominal Treasury bonds had risen by 0.4-0.5 percentage points since the June meeting, but yields on indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.1-0.4 percentage points. One of the three large commercial banks' indexed mortgage lending rates had fallen by 0.05 percentage points between meetings, and one bank's deposit rates had fallen by 0.05 percentage points. Average interest rates on pension funds' loans to members were broadly unchanged since the MPC's June meeting.

The short-term interest rate differential versus the US and the euro area was virtually unchanged between meetings, at 2.4 and 5 percentage points, respectively. The long-term interest rate differential versus the US and Germany had widened by 0.3 percentage points, to 2.8 and 5.3 percentage points, respectively.

Measures of the risk premium on the Treasury's foreign obligations were largely unchanged since the MPC's June meeting. The CDS spread on the Treasury's five-year US dollar obligations was just over 0.7%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.4-0.6 percentage points.

Financial institutions' analysts had projected that the Bank's interest rates would be held unchanged in August, citing, among other things, the rise in inflation and inflation expectations, the slowdown in economic activity, and uncertainty about upcoming wage settlements.

According to the Central Bank's quarterly survey of market agents' expectations, carried out in mid-August, respondents expect the Bank's key interest rate to be held unchanged at 4.25% for the next two years, as they did in the last survey, taken in May. At the time the survey was conducted, 81% of respondents considered the monetary stance appropriate, as opposed to 77% in the last survey. About 19% of respondents considered it too tight, whereas no one considered it too loose.

Annual growth in M3 measured 6.3% in Q2/2018, after adjusting for deposits held by the failed financial institutions, about the same as in Q1. 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 8.1% year-on-year in Q2/2018. Over the same period, household lending grew by 6.3% year-on-year and corporate lending by 11.5%.

The Nasdaq OMXI8 index had fallen by 7.2% between meetings. Turnover in the main market totalled 296 b.kr. during the first seven months of the year, about 26% less than over the same period in 2017.

Global economy and external trade

According to the International Monetary Fund's (IMF) July forecast, global GDP growth is projected to measure 3.9% in 2018 and 2019. This is in line with the Fund's April forecast. In July, however, the IMF expected GDP growth to be more unevenly distributed across economies (both industrialised and emerging/developing countries) than in April. The GDP growth outlook for the US is unchanged since April, whereas growth is expected to ease in the eurozone, Japan, and the UK. Financial conditions have tightened in many emerging and developing economies, and in the IMF's opinion, the GDP growth outlook has deteriorated, owing in part to rising oil prices, rising US interest rates, the appreciation of the US dollar, and mounting tensions in global trade. On the other hand, the outlook is for increased GDP growth among oil-exporting emerging and developing countries. The Fund was also of the view that global economic uncertainty had increased since April and that it is now more likely that GDP growth will turn out less than forecast because of the increased risk of escalating tariffs and a trade war. This is reflected in the IMF's forecast for world trade. The Fund expects world trade to increase by 4.8% this year and 4.5% in 2019, or 0.2-0.3 percentage points below the April forecast, owing primarily to reduced growth in industrialised countries. Inflation among industrialised countries is projected at 2.2% in 2018 and 2019, about 0.2-0.3 percentage points above the April forecast.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 101 b.kr. deficit in the first seven months of the year, at constant exchange rates. The deficit over the same period in 2017 was 110 b.kr., also at constant exchange rates. Export values rose by 13.6% year-on-year at constant exchange rates, owing mainly to an increase in the value of marine products and industrial goods, aluminium in particular. The rise in marine product export values was due to base effects from the fishermen's strike in early 2017, which caused a sharp contraction in goods exports. Growth in import values has eased significantly, after measuring 7.7% year-on-year at constant exchange rates in the first seven months of 2018. Furthermore, in the past three months, import values have contracted slightly between years, falling to the weakest year-on-year growth rate since 2013. The main difference is in the contraction in passenger car import values.

Between MPC meetings, the listed global price of aluminium fell by 9.6% and was similar to the price seen at the same time last year. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 3.9% year-on-year in the first seven months of 2018. The global price of oil was 76 US dollars per barrel just before the MPC meeting. It had fallen slightly between meetings but was up by 48% compared with the same time in 2017.

In terms of relative consumer prices, the real exchange rate had risen 0.5% month-on-month in July, but had fallen 1.6% year-on-year. At that time, it was just over 20% above its 25-year average but 6.6% below its June 2017 peak. In the first seven months of 2018, it was down by 1.5% compared with the same period in 2017, as the nominal exchange rate of the króna was 1.8% lower and inflation in Iceland was about 0.4 percentage points above the trading partner average.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 0.6% year-on-year in Q2. According to the LFS, the number of jobs grew by 1.3% year-on-year, whereas the increase according to the pay-as-you-earn (PAYE) register was 3%. The employment rate fell between years but has hovered around 80% since peaking in Q3/2016. Seasonally adjusted unemployment measured 2.9% in Q2 and was broadly unchanged from the previous quarter.

Net migration of foreign nationals aged 20-59 was positive in H1 by 1.7% of the population, about the same as in H2/2017. In Q2, importation of workers via temporary employment agencies and foreign services companies was down about one-fifth from its peak.

In Q2, the wage index rose by 2.4% between quarters and by 6.5% year-on-year, and real wages were just over 4% higher than in the same quarter of 2017.

Key indicators of developments in private consumption at the beginning of Q3 suggest that household demand is on the wane, as it has been throughout the year.

The Gallup Consumer Confidence Index fell markedly between months in August, to 87.3, its lowest in over three years. All components of the index fell during the month, by 12-18 points.

Statistics Iceland's nationwide house price index, published in July, rose 0.7% month-on-month when adjusted for seasonality and by 6.2% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.3% month-on-month in July, adjusted for seasonality, and by 5.2% year-on-year. The twelve-month rise in real estate prices has picked up again, after tapering off virtually without interruption since May 2017, when prices in greater Reykjavík were up by nearly 24% between years. The number of purchase agreements registered nationwide in the first seven months of the year rose by 5.3% year-on-year, and the average time-to-sale for flats in greater Reykjavík was 2.3 months in July, as opposed to 2.5 months a year earlier. About 1,150 flats were advertised for sale in greater Reykjavík in August, down from 1,350 in August 2017.

The CPI rose by 0.04% month-on-month in July. Twelve-month inflation measured 2.7% and had risen by 0.7 percentage points between MPC meetings. The CPI excluding housing had risen by 1.4% since July 2017, and inflation thus measured has risen more rapidly than headline inflation in the recent past. The median value of various measures of underlying inflation was 2.9% in July, an increase of 0.4 percentage points since May.

The rise in house prices and airfares had a strong impact in July, offset by seasonal sales. The twelve-month rise in owner-occupied housing costs has continued to ease, however, measuring just under 6% in July. Imported goods prices were up 1.1% year-on-year, owing largely to the steep rise in petrol prices.

Market agents' short- and long-term inflation expectations have risen in recent months. According to the Central Bank survey carried out in mid-August, respondents expect inflation to measure 3% both one and two years ahead. They also expect inflation to average 2.8-3% over the next five and ten years, which is 0.2-0.4 percentage points more than in the May survey. The breakeven inflation rate in the bond market has also inched upwards in recent months. The ten-year breakeven rate has averaged 3.5% in Q3 to date, as opposed to 3.3% in Q2/2018 and 2.8% in Q3/2017.

According to the forecast published in *Monetary Bulletin* on 29 August 2018, the inflation outlook well into 2019 has deteriorated since the Bank's May forecast. Inflation measured 2.3% in Q2, but by July it had risen by nearly 1 percentage point year-on-year, to 2.7%. Underlying inflation has also risen somewhat. In addition, both short- and long-term inflation expectations have risen. Inflation is projected to measure 2.8% in Q3/2018 and about 3% from Q4 through mid-2019, whereupon it is expected to ease back to the target.

Iceland's external conditions have developed broadly in line with the May forecast, and the economic outlook is largely unchanged. Tourism appears set to grow more slowly this year than was forecast in May, but this is offset by considerably stronger growth in marine product exports. According to the forecast, the outlook is for stronger export growth, which will counterbalance the poorer outlook for terms of trade. GDP growth is projected to measure 3.6% this year, as it did in 2017. This is slightly above the May forecast, owing to a more favourable contribution from net trade, albeit offset by weaker growth in domestic demand. As in the Bank's previous forecasts, GDP growth is projected to ease in the next two years, measuring 2.7% in 2019 and then picking up slightly to 3% in 2020.

The assumptions concerning near-term wage developments have changed little since May. Unit labour costs are projected to rise somewhat less this year than was previously estimated, however, as the outlook is for stronger productivity growth. The increase in unit labour costs is expected to measure 5½% this year and then taper off to just over 5% in 2019 and 2½% in 2020. The rise in total hours worked has lost pace, and labour importation, although still strong, appears to have peaked. The number of firms having difficulties recruiting workers or responding to unexpected demand has begun to fall. Tension appears to be subsiding in the labour market and in the economy as a whole. The output gap remains positive, however, and according to the forecast it will not close until very late in the forecast horizon.

II The interest rate decision

The Governor updated Committee members on discussions with ministers and the Ministerial Committee on Economic Affairs and Financial System Restructuring on how the work carried out following the report from the committee reviewing the monetary policy framework might proceed, although conclusions have yet to be reached. In the near future, the MPC will review and formulate a position on the review committee's proposals. In this context, the MPC is planning to meet with the review committee.

MPC members 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. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as they had decided in June to keep interest rates unchanged because the outlook had been broadly unchanged between meetings.

In this context, Committee members took account of the Central Bank's updated macroeconomic forecast, published in *Monetary Bulletin* on 29 August, according to which GDP growth will be slightly stronger in 2018 than the bank had forecast in May. Committee members noted that according to the forecast, increased growth stemmed primarily from a more favourable contribution from net trade, which outweighed weaker growth in domestic demand. The MPC agreed that GDP growth was still expected to ease, with weaker export growth and a less rapid increase in domestic demand. The Committee also considered that developments in house prices and indicators from the labour market pointed in the same direction.

The MPC discussed developments in inflation, which measured 2.3% in Q2/2018 but had increased to 2.7% by July. Members noted that inflation excluding housing had risen as well, and the difference between measures of inflation including and excluding housing had narrowed considerably. As the Committee had expected, the year-on-year rise in house prices had continued to ease, and the opposing effects of the previous appreciation of the króna had diminished and petrol prices had risen. MPC members agreed that this trend would probably continue in the near term. Members also noted that the króna had depreciated slightly since the last MPC meeting, but that the foreign exchange market had remained well balanced.

They noted in particular that indicators implied that long-term inflation expectations had risen somewhat above the target. It emerged in the discussions that there was uncertainty about how to interpret the rise in inflation expectations. Some members considered it possible that uncertainty about the future monetary policy framework had already begun to de-anchor long-term inflation expectations. Higher inflation in the recent term and uncertainty in the labour market could also affect expectations, particularly in the short run. The MPC reiterated that it had both the will and the tools necessary to keep inflation at target over the long term, and members agreed that if inflation expectations continued to rise and remained persistently at a level above the target, it would call for a tighter monetary stance. It also emerged during the discussion that other decisions, particularly those relating to the labour market and fiscal policy, would then affect the sacrifice cost in terms of lower employment. It was pointed out that there was the risk that wage settlements would be inconsistent with the inflation target, but also that Government measures in connection with wage settlements might not be fully funded, resulting in a weakening of the fiscal stance. MPC members noted as well that inflation had risen by all measures and the inflation outlook well into 2019 had deteriorated since the Bank's May forecast. They agreed that developments in inflation would depend in large part on how well the anchor held in the near future. It emerged in the discussion that the increased credibility of monetary policy played a key role in the past several years' success, and that it was important to respond if inflation expectations were clearly becoming unmoored.

There was some discussion of the easing of the monetary stance since the last MPC meeting. Members agreed that tension in the labour market and the economy was subsiding. There were also indications that the adjustment of the economy could prove more sudden if, for instance, tourist numbers declined faster than was assumed in the forecast.

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.

MPC members agreed that 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 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 3 October 2018.