The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, October 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 1 and 2 October 2018, during which the Committee discussed economic and financial market developments, the interest rate decision of 3 October, 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 29 August 2018 interest rate decision.

Financial markets

Between meetings, the króna depreciated by 4.7% in trade-weighted terms. Over this same period it fell 5.4% against the US dollar, 3.9% against the euro, and 5.8% against the pound sterling. The Central Bank's foreign currency sales in the domestic foreign exchange market totalled 9 million euros (1.2 b.kr.) between meetings, or roughly 4% of total market turnover.

In terms of the Central Bank's real rate, the monetary stance was broadly the same as at the time of the MPC's August meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.2%, similar to the real rate in August. In terms of twelve-month inflation, it was 1.5%.

Interest rates in the interbank market for krónur were virtually unchanged between meetings, and turnover in the market amounted to 3 b.kr. during that period.

Yields on long-term nominal Treasury bonds had risen by 0.2 percentage points since the August meeting, but yields on indexed Treasury and Housing Financing Fund (HFF) bonds were unchanged. Interest rates on two of the three large commercial banks' non-indexed mortgage loans had risen by 0.1-0.3 percentage points between meetings. Average rates on pension funds' non-indexed loans to fund members had risen by just under 0.2 percentage points since the MPC's August meeting.

The short-term interest rate differential versus the US and the euro area was virtually unchanged between meetings, at 2.3 and 5 percentage points, respectively. The long-term interest differential versus the US and Germany was also virtually unchanged, at 2.8 and 5.4 percentage points, respectively.

Measures of the risk premium on the Treasury's foreign obligations were largely unchanged since the MPC's August meeting. The CDS spread on the Treasury's five-year US dollar obligations was about 0.7%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany was approximately 0.5-0.6 percentage points.

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

After adjusting for deposits held by the failed financial institutions, annual growth in M3 measured about 9% in August, the strongest growth rate since January 2016. 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 July. Over the same period, household lending grew by just under 7% year-on-year and corporate lending by 11%.

The Nasdaq OMXI8 index had risen by 0.8% between meetings. Turnover in the main market totalled 361 b.kr. during the first nine months of the year, about 27% less than over the same period in 2017.

Global economy and external trade

Iceland's goods trade generated a deficit of 114.5 b.kr. in the first eight months of the year, at constant exchange rates. The deficit over the same period in 2017 was approximately 116 b.kr., also at constant exchange rates. Export values rose by 14.4% year-on-year at constant exchange rates, owing mainly to an increase in the value of marine products and industrial goods, aluminium in particular. Import values increased by 10.5% year-on-year over the same period, due primarily to stronger imports of fuels and lubricants, commodities and operational inputs, and investment goods. The import value of passenger cars has declined between years, however.

The listed global price of aluminium was broadly unchanged between MPC meetings, but was slightly higher than at the same time in 2017. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 4.4% year-on-year in the first eight months of 2018. The global price of oil had risen by 13% between MPC meetings, to about 86 US dollars per barrel. Oil prices had risen by over a fourth year-to-date and by more than 50% since October 2017.

The real exchange rate in terms of relative consumer prices fell by 3.5% month-on-month in September, when it was nearly 17% above its twenty-five year average but about 9% below its June 2017 peak. In the first nine months of 2018, it was down by around 1% compared with the same period in 2017, as the nominal exchange rate of the króna was 1.4% lower and inflation in Iceland was about 0.5 percentage points above the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in September, GDP growth measured 7.2% in Q2/2018. Domestic demand grew 6.6% year-on-year during the quarter. Exports grew by 0.8% between years, while imports contracted by 0.4%; therefore, the contribution from net trade was positive. In H1/2018, GDP growth measured 6.4%, as domestic demand grew by 6.2% and export growth outpaced import growth.

GDP growth in Q2 far outpaced the August forecast of 4.6%. In addition, Statistics Iceland revised Q1 GDP growth figures; therefore, the deviation from the August forecast was considerably smaller for H1 growth, which measured 6.4%, whereas the August forecast assumed 5.6%. Even though business investment was somewhat stronger in H1 than was forecast in August, consumption and investment spending turned out in line with the forecast. Imports also grew somewhat less than projected, while the contribution from net trade was broadly consistent with the forecast. Most of the deviation in GDP growth from the August forecast is therefore due to a much stronger contribution from inventory changes. Upon review of previous figures, year-2017 output growth was revised upwards from 3.6% to 4%.

The current account balance was positive by 1.6 b.kr. in Q2, a considerably smaller surplus than in the same quarter of 2017, when it measured 11.9 b.kr. The contraction in the surplus is due largely to a smaller surplus on services trade. Furthermore, the goods account deficit was larger than it was a year ago, and the balance on primary and secondary income was more strongly negative.

Private consumption grew somewhat less than forecast in Q2, and the pace of growth has eased in the past year. Key indicators of private consumption growth in Q3 suggest that this trend will continue. The Gallup Consumer Confidence Index has fallen rather rapidly in recent months, to 85.3 points by September, some 21.5 points below the value a year earlier.

According to the assumptions in the fiscal budget proposal for 2019, Treasury performance is expected to be in line with the estimate according to the fiscal strategy for 2019-2023. The target for 2018 revenues according to that year's budget is ensured with extraordinary dividend payments by the commercial banks in the amount of just over 6 b.kr. The estimate of the fiscal stance does not take account of such one-off items. The unadjusted primary balance is projected to decline by up to 1 percentage point of GDP between 2018 and 2019. The extent to which this entails fiscal easing in 2019, as was forecast in *Monetary Bulletin* 2018/2, will depend on how much the output gap narrows. A new assessment of developments in the output gap and the fiscal stance will be available when the MPC meets in November.

According to the results of Gallup's autumn survey, conducted in September among Iceland's 400 largest firms, respondents' assessment of the current economic situation was relatively positive, but somewhat less so than in the surveys taken this summer and in autumn 2017. Executives were also more downbeat about the outlook six months ahead than they were in the summer and in 2017. About 45% of respondents considered the current situation good, and about 43% considered it neither good nor poor. About 54% of executives were of the view that economic conditions would deteriorate in the next six months, and just under 42% expected conditions to remain good. About 4% of respondents expected conditions to improve in the next six months. Pessimism among executives has therefore increased considerably since May and since last year. Executives' outlook on domestic demand was also much more negative than in the summer 2018 and autumn 2017 surveys, whereas their expectations concerning foreign demand were unchanged. In comparison with the summer survey, expectations concerning domestic demand deteriorated most among executives in the construction and industry/manufacturing sectors.

According to the survey, just over a third of firms expected their profit margins to remain broadly unchanged between 2017 and 2018, whereas the share that expected their margins to narrow was much larger than in the spring survey. Among the latter group were executives in transport, transit, tourism, and specialised services. In all sectors except construction and utilities, sentiment towards the operational outlook was considerably more negative than in the spring survey.

According to the survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by 4 percentage points, after adjusting for seasonality. This is broadly similar to the percentage in the summer survey but 13 percentage points lower than in the survey taken a year ago. The most positive executives were those in the specialised services sector, where firms planning to recruit outnumbered those planning redundancies by 17 percentage points. As before, sentiment was most negative in the fishing industry, where firms interested in laying off staff outnumbered those planning to recruit by 24 percentage points, as well as in transport, transit, and tourism, where the share was 22 percentage points.

After adjusting for seasonality, about one-fifth of executives considered themselves short-staffed, about 5 percentage points less than in the summer survey and 15 percentage points less than in the survey from a year ago. The share was largest in construction and in industry/manufacturing, with 30% of firms considering themselves understaffed. It was smallest in the financial services sector, where 8% of firms considered themselves understaffed, although a similar share of companies in retail and wholesale trade, transport, transit, and tourism considered themselves short-staffed.

Just under half of executives reported that they would have difficulty responding to unexpected demand, after adjusting for seasonality. This was 5 percentage points more than in the summer survey but about the same as in the autumn 2017 survey. Two-thirds of executives in the specialised services sector reported that they would have difficulty responding to unexpected demand, as opposed to only just over fourth in the transport, transit, and tourism sector. In other sectors, the same ratio ranged between 34% and 57%.

The wage index fell by 0.1% month-on-month in August and rose by 6% year-on-year. Real wages were 3.3% higher than at the same time in 2017.

Statistics Iceland's nationwide house price index, published in September, declined 0.3% month-on-month when adjusted for seasonality, but rose 5% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.2% month-on-month in August when adjusted for seasonality, and by 4.1% year-on-year. The twelve-month rise in real estate prices has therefore continued to ease, after peaking at nearly 24% in 2017. The number of purchase agreements registered nationwide in the first eight months of the year increased by 7.3% year-on-year, and the average time-to-sale for flats in greater Reykjavík was 1.7 months in August, as opposed to 2.4 months a year earlier. Just over 800 flats were advertised for sale in greater Reykjavík in September, down from nearly 1,500 in September 2017.

The CPI rose by 0.24% month-on-month in September, after rising 0.2% in August. Twelve-month inflation measured 2.7% and was unchanged since the MPC's last meeting. The CPI excluding housing had risen by 1.8% since September 2017 and by 0.4 percentage points between meetings. The median value of various measures of underlying inflation was 2.6% in September, a decline of 0.3 percentage points since July.

The reduction in international airfares made a strong impact in September but was offset by end-of-sale effects. The rise in owner-occupied housing costs has continued to lose pace, after measuring 4.7% in September, the smallest twelve-month increase since September 2013.

According to Gallup's autumn survey, households' inflation expectations one year ahead measured 3.5%, virtually the same as in the summer survey but about 0.4 percentage points higher than in February. Their expectations five years ahead were unchanged between surveys, at 3.5%. According to Gallup's autumn survey among corporate executives, respondents' one- and five-year inflation expectations were unchanged between surveys, both measuring 3%. The five- and ten-year breakeven inflation rate in the bond market was 3.7-4% just before the MPC meeting, after rising by 0.2 percentage points since the August meeting and nearly 1 percentage point since the beginning of the year.

II The interest rate decision

The Governor reported on the International Monetary Fund (IMF) mission's 13-25 September visit and the key findings from that visit, which was part of the Fund's annual review of economic developments and prospects in Iceland. The Governor also updated the MPC on ideas concerning the next steps in the implementation of the capital flow management tool. Furthermore, the Deputy Governor reported on meetings that she had had with the social partners.

The MPC discussed the monetary stance in view of the most recent information on the economy and the fact that the Bank's real rate had remained broadly unchanged between meetings. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as they had decided in August to keep interest rates unchanged, partly because the Bank's new forecast was broadly in line with the May forecast.

Members discussed the recently released preliminary national accounts figures, which indicated that GDP growth in 2017 and H1/2018 was stronger than had been assumed in the August *Monetary Bulletin*. The Committee agreed that the positive output gap may therefore have been wider than previously projected. On the other hand, high-frequency indicators and surveys suggested that demand growth might subside more rapidly than previously assumed. It emerged in the discussion that private consumption growth had probably subsided more rapidly than expected in the recent term, but that investment had outpaced expectations.

The MPC discussed developments in inflation, which rose quarter-on-quarter in Q3/2018, in line with the August forecast. Inflation excluding housing had risen as well, and the difference between measures of inflation including and excluding housing had narrowed considerably. Members noted that the year-on-year rise in house prices had continued to ease, but that it was offset by a sizeable increase in import prices in the recent term. This partly reflected the rapid rise in global oil prices. It emerged in the discussion that this surge in oil prices had strong direct and indirect effects on measured inflation, which the MPC should ignore insofar as they did not spread to long-term inflation expectations. The Committee also noted that the króna had depreciated since the last MPC meeting, and exchange rate volatility increased in September, in part due to uncertainty about one of Iceland's major airlines' financing.

Members noted that survey measures of inflation expectations were broadly unchanged since the last MPC meeting, whereas the breakeven inflation rate in the bond market had risen. Members discussed concerns about the recent rise in long-term inflation expectations, and that inflation expectations appeared to be somewhat above the target by all measures. It was pointed out that uncertainty about upcoming wage settlements could have prompted a rise in inflation expectations. 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. Members also agreed that other decisions, particularly those relating to the labour market and fiscal policy, would then affect the sacrifice cost in terms of lower employment.

Although output growth in 2017 and H1/2018 appeared stronger than had been forecast, indicators from the labour market and the tourism industry suggested that the adjustment of the economy could take place more quickly than had previously been assumed. These factors were therefore pulling in opposite directions as regards the outlook further ahead, but Committee members agreed that the overall situation had not changed materially since the previous meeting. As a result, they were of the view that a rate response was not warranted; instead it was appropriate to await further developments. One member pointed out, however, that the rise in inflation expectations could not be ignored for long and that, other things being equal, it would be necessary to tighten the monetary stance; however, in view of the uncertainty involved, this member agreed that it was appropriate at that time to await further developments.

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 7 November 2018.