



*The Monetary Policy Committee of the Central Bank of Iceland*

## Minutes of the Monetary Policy Committee meeting, November 2017

Published 29 November 2017

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 10 and 14 November 2017, during which the Committee discussed economic and financial market developments, the interest rate decision of 15 November, 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 4 October interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin 2017/4* on 15 November.

#### **Financial markets**

Between meetings, the króna appreciated by 3.3% in trade-weighted terms. Over this period it appreciated by 2.5% against the US dollar, 2.8% against the euro, and 3.8% against the pound sterling. The Central Bank bought foreign currency in the amount of about 362 m.kr. (EUR 3 million) between meetings, and its net foreign exchange purchases year-to-date have totalled 70.3 b.kr. (603 million euros). Central Bank transactions accounted for just under 22% of total foreign exchange market turnover for the period.

In terms of the Central Bank’s real rate, the monetary stance was virtually unchanged since right after the publication of the October interest rate decision. The Bank’s real rate in terms of the average of various measures of inflation and inflation expectations had fallen by 0.1 percentage points between meetings, to 1.8%.

Interest rates in the interbank market for krónur fell in line with the Central Bank interest rate cut in October. Turnover in the market totalled 600 m.kr. between meetings and about 123.8 b.kr. year-to-date, a significant increase over the same period in 2016.

Nominal Treasury bond yields had fallen in line with the Central Bank interest rate cut in October and fell still further in the first half of November. As a result, they were about ½ a percentage point lower than at the time of the October meeting. Yields on comparable indexed bonds had fallen between meetings, by 0.1-0.4 percentage points.

The commercial banks' nominal deposit and lending rates declined broadly in line with the October reduction in the Bank's key rate. Interest rates on comparable indexed loans were unchanged, however. The average rate on pension funds' loans to members were also virtually unchanged between meetings.

Risk premia on Treasury foreign obligations were virtually unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was about 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 projected that the Bank's interest rates would be held unchanged in November, citing in particular the reduction in the real rate between meetings and the continued uncertainty about the near-term fiscal stance.

M3 adjusted for the deposits held by the failed banks grew by 8.3% year-on-year in Q3, about the same as in the previous quarter. As was the case last year, growth in money holdings in Q3 is due largely to increased household deposits, although it was broader-based.

Growth in lending to resident entities has continued to gain pace. After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers increased by 5½% year-on-year in Q3, as opposed to approximately 3½% in the first two quarters of the year. The Q3 growth rate was about 6½% if the foreign credit stock is calculated at constant exchange rates. As before, credit growth is due to an increase in lending to households and businesses. Lending to households increased by nearly 5½% year-on-year in Q3, after adjusting for the Government's debt relief measures, and loans to businesses by almost 7%, the strongest growth rate since just after the financial crisis. Calculated at constant exchange rates, the stock of corporate loans rose by approximately 9½% year-on-year in Q3.

The Nasdaq OMXI8 index had risen by 2.1% between meetings and was broadly unchanged from the beginning of the year. Turnover in the NASDAQ Iceland main market totalled about 550 b.kr. over the first ten months of the year, about 13.5% more than over the same period in 2016.

### **Global economy and external trade**

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 9.8 b.kr. deficit in October, as opposed to a surplus of 1.8 b.kr. in October 2016, at constant exchange rates. Import growth had picked up since the October meeting, after a slowdown during the summer following a surge in the spring. In the past two months, the value of imports excluding ships and aircraft had increased by 35% year-on-year, the strongest two-month growth rate since February 2006. The spurt in import growth is due in particular to an increase in the value of imported investment goods, petrol, and lubricants. At the same

time, nominal export growth has eased, owing to slower growth in manufacturing and marine product export values. Iceland's external goods trade generated a deficit of 149 b.kr. for the first ten months of the year, as opposed to a deficit of 79 b.kr. over the same period in 2016. Export values grew by 7% at constant exchange rates over the period, while import values rose 20%.

Global aluminium prices were unchanged since the October meeting, although the average October price was up 28% year-on-year. Preliminary figures on foreign currency prices of marine products indicate that prices fell by 1.3% between quarters in Q3, after having risen by just over 1% in Q2. Oil prices had risen by 12.5% between meetings and were up by over a third year-on-year.

In terms of relative consumer prices, the real exchange rate had risen by 2.4% month-on-month in October, to 98.9 points, after an 8.8% decline between June and September. The year-on-year increase in October was 4%. It is due primarily to a 3.5% nominal appreciation of the króna, but in addition, inflation in Iceland was about 0.5 percentage points above the trading partner average. In October, the real exchange rate was 21% above its twenty-five year average, and over the first ten months of 2017 it was up by 14% year-on-year.

### **The domestic real economy and inflation**

The wage index rose by 2.1% between quarters in Q3, and by 7.3% year-on-year, and real wages in terms of the index were 5.5% higher in Q3/2017 than in Q3/2016.

Leading indicators of developments in private consumption suggest that developments in Q3 were broadly similar to those in H1/2017. Payment card turnover increased by just under 13% during the quarter, and the number of new motor vehicle registrations increased by 29%.

The Gallup Consumer Confidence Index rose 18.5 points month-on-month in October, to 125.3, which is 19 points lower than at the same time in 2016. Optimism among households had receded in recent months, after historically high measurements earlier in the year.

Statistics Iceland's nationwide real estate price index, published in late October, was virtually unchanged month-on-month when adjusted for seasonality but had risen 18.9% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 0.5% month-on-month in September when adjusted for seasonality, and by 19.6% year-on-year. The year-on-year rise in real estate prices has eased somewhat since peaking in May at 23.5%. The number of purchase agreements registered nationwide declined by 7% year-on-year in the first nine months of 2017. The average time-to-sale for flats in the greater Reykjavík area was about 3.2 months in September, as compared with 1.7 months a year earlier.

The CPI rose by 0.5% month-on-month in October, and twelve-month inflation measured 1.9%. Headline inflation had therefore risen by 0.5 percentage points since the October meeting. The CPI excluding the housing component had declined by 2.3% year-on-year, however. Measures of underlying inflation suggested that it had risen between months and lay in the ½-2% range.

The main factor in the CPI rise in October was a surge in food prices. The cost of owner-occupied housing fell marginally between months, however – the first month-on-month decline in over two years. Private services prices had risen by 0.2% year-on-year in October.

Market agents' short- and long-term inflation expectations had been broadly unchanged in recent months. According to the Central Bank survey carried out in early November, market agents expect inflation to measure 2.5% in one year, two years, and (on average) over the next five and ten years. The breakeven inflation rate in the bond market had changed little between meetings, with the five-year breakeven rate measuring 2.5% and the ten-year rate 2.8%.

According to the forecast published in *Monetary Bulletin* on 15 November 2017, inflation will rise to 1.9% in Q4/2017. If the forecast materialises, inflation will average 1.8% over the year as a whole and 2017 will be the fourth consecutive year with average inflation measuring 2% or less. This is the longest episode of such low and stable inflation since the economic crisis of the early 1990s. The baseline forecast assumes that inflation will inch upwards toward the target over the course of next year and will be close to target for the bulk of the forecast horizon. The outlook is for inflation to be lower than was forecast in August for most of the forecast horizon, mainly because the output gap is expected to be smaller and unit labour costs are expected to rise less than previously thought.

According to the baseline forecast, the exchange rate of the króna will continue to rise early in the forecast horizon. This technical assumption concerning the exchange rate is affected, on the one hand, by the GDP growth outlook and the interest rate differential with abroad, and on the other, by the estimated equilibrium real exchange rate of the króna, which is considered to have risen in the recent term, concurrent with improved terms of trade, a larger current account surplus, and improvements in Iceland's external position. The revised estimate of the equilibrium real exchange rate suggests that the real exchange rate is close to equilibrium or perhaps slightly below it. But this assumption is subject to considerable uncertainty. There is also significant uncertainty about capital flows to and from Iceland, which could affect short-term exchange rate developments. No signs of large-scale capital outflows have been seen since the capital controls were lifted earlier this year.

According to the baseline forecast, GDP growth among Iceland's main trading partners will measure 2.2% this year, a marginal improvement from the last forecast. The most important factor is the strong economic recovery in the eurozone, although the GDP growth outlook in the US is considered slightly improved. On the other hand, indicators suggest that GDP growth in the UK will be weaker than previously forecast. As in August, output growth among Iceland's trading partners is expected to weaken slightly next year, to an annual average of 2% over the next three years.

In 2016, terms of trade for goods deteriorated by just over 2%, whereas overall terms of trade improved. This trend looks set to continue this year: terms of trade for goods will deteriorate by another 2%, while overall terms of trade will improve by nearly 1%. This is less favourable than was forecast in August and is due primarily to much lower marine product prices in Q3/2017, plus a more rapid rise in oil and commodity prices, although more favourable developments in aluminium prices pull in the opposite direction. According to the forecast, terms of trade for goods will continue to weaken in the next few years, while for goods and services combined they will remain broadly unchanged.

In H1, exports of goods and services grew by just over 6% year-on-year, and the outlook is for broadly similar growth for the year as a whole. Although the growth rate has eased in comparison with that a few years ago, it remains robust, particularly given that growth in trading partner demand has averaged roughly 3% annually in recent years. It is somewhat below the August forecast, however, because services exports grew less in H1 than previously assumed and are expected to grow less strongly for the remainder of the year.

The poorer outlook for exports in 2017 is due to marine product export growth, which was much weaker than expected in Q3, as it has taken longer than expected to make up the production losses from the fishermen's strike early in the year. In addition, this year's silicon exports are expected to be weaker than previously estimated. As in the Bank's previous forecast, export growth is expected to slow down still further in the next few years.

GDP growth measured 10.4% in H2/2016, but preliminary figures from Statistics Iceland indicate that it slowed markedly in the first half of this year. It measured 5.2% in Q1 and then subsided still further in Q2, to 3.4%. The decline in GDP growth was foreseeable to an extent, given developments in exports. It was steeper, however, than had been assumed in the August forecast, which provided for 5.6% GDP growth in H1/2017, whereas Statistics Iceland's preliminary figures indicate a growth rate of 4.3%. GDP growth for the year as a whole will be weaker than previously forecast, or 3.7% instead of 5.2%. The outlook for the next two years is broadly unchanged, however: GDP growth is forecast to measure 3.4% in 2018, which is similar to this year's growth rate and slightly above the August forecast, and then ease towards long-term trend growth and measure approximately 2.5% per year in 2019 and 2020.

Indications that growth in economic activity is moderating can be found in the labour market. According to the Statistics Iceland labour force survey (LFS), the number of jobs rose by 1.8% in Q2 but stood still in Q3. Because of a reduction in average hours worked, total hours contracted in Q3, for the first time since 2012. This is surprising because the number of foreign nationals migrating to Iceland is still rising fast, as is the working-age population. It is not impossible that this reflects in part a measurement problem with the LFS; therefore, the results should be interpreted with some caution. It is clear, however, that growth in labour demand has subsided. Unemployment is still falling, to a seasonally adjusted rate of 2.3% in Q3.

For the remainder of the year, total hours are expected to rise broadly as they have in 2017 to date, or just over 1%. This is a considerably slower growth rate than was forecast in August. As a result, the employment rate will be almost 1 percentage point lower this year than previously estimated, a difference that will remain for the rest of the forecast horizon. Unemployment is forecast to average 2.6%, a reduction of 0.4 percentage points year-on-year and almost 6 percentage points from its late 2010 peak. The large-scale importation of labour is expected to hold back wage increases, and the equilibrium unemployment rate is therefore lower than previously thought. As a result, measured unemployment will rise somewhat more slowly in coming years than previously forecast, to just over 3% by the end of the forecast horizon.

Wages have risen steeply in the recent term, mitigating the deflationary effects of imported deflation and the appreciation of the króna. Increased labour productivity also counteracts the effects of wage increases on inflation. Unit labour costs are forecast to rise by nearly 4% this year. However, this is subject to considerable uncertainty, which is related to possible errors in measuring the foreign labour force in Iceland. Underestimating the foreign labour force leads to an overestimation of labour productivity and an underestimation of unit labour costs. Unit labour costs are projected to rise by about 5% per year in 2018 and 2019, much more than is consistent with 2.5% inflation over the medium term. By 2020 the rise in wage costs is expected to be better aligned with the target. The outlook is for unit labour costs to rise less in 2017 than was projected in August but to rise broadly in line with the August forecast in the next few years.

Because of Statistics Iceland's revision of GDP growth figures for the past few years, the output gap is estimated to have been larger at year-end 2016 than was assumed in the Bank's August forecast. The prospect of weaker GDP growth this year means that the output gap is expected to be smaller, however. It is estimated to measure just under 2% of potential output by the end of the year, down by about 1 percentage point from the August forecast. As was the case in August, it is expected to narrow further and virtually disappear by end-2020.

The baseline forecast reflects the assessment of the most likely economic developments during the forecast horizon. It is based on forecasts and assumptions concerning developments in the external environment of the Icelandic economy, as well as an assessment of activities in individual markets and how monetary policy is transmitted to the real economy. All of these factors are subject to uncertainty. Changes in key assumptions could lead to developments different from those provided for in the baseline forecast.

Inflation could rise higher than is provided for in the baseline example. Unemployment is very low, for instance, and many wage settlements are set to expire soon. As a result, contractual wage increases could turn out larger than is assumed in the baseline forecast, and wage drift could be underestimated. Because firms have at best limited scope for pay increases – particularly firms in the tradable sector – there is a risk that large wage rises will pass more quickly and more strongly through to prices than they did following the last wage settlements, when improved terms of trade gave companies greater ability to absorb cost increases. The assumptions in the baseline forecast concerning continued appreciation of the króna through 2018 and slower rises in house prices could also prove incorrect. Demand pressures in the economy could be underestimated, in part because of an overestimation of growth in potential output, which is considered to have been well above its historical average in the recent term as a result of strong importation of production factors. Demand pressures could also prove to be underestimated if the fiscal stance eases more than is assumed in the baseline forecast. All of this could test the newly established anchor for inflation expectations.

Inflation could also turn out lower than is assumed in the baseline forecast. The króna could appreciate more strongly than forecast – if external conditions prove more favourable, for instance. Weaker global GDP growth and a weaker recovery of global oil and commodity prices could also dampen domestic economic activity and prolong the impact of imported deflation on domestic inflation. The rise in house prices could slow more abruptly than is assumed in the forecast. The impact of increased international competition on domestic retailers' scope to raise prices could also be underestimated. Although the baseline forecast attempts to account for the effects of strong factor importation, potential output could nevertheless be underestimated and the inflationary pressures based on the cyclical position of the economy could therefore be overestimated.

## **II The interest rate decision**

The MPC discussed the Bank's most recent *Financial Stability* report; they also discussed financial institutions' position and risks to the financial system.

Committee 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 remained virtually unchanged between meetings. Members also discussed whether the monetary stance was appropriate

in view of the inflation outlook, as the Committee had decided to lower the Bank's key rate by 0.25 percentage points in October in response to signs of diminishing demand pressures in the economy.

In this context, the MPC took account of the Central Bank's new macroeconomic forecast, published in *Monetary Bulletin* on 15 November, according to which GDP growth would slow significantly this year. This easing was more pronounced than the Bank had projected in August, but consistent with the Committee's assessment at its October meeting. According to the forecast, this was a result of a slowdown in export growth, after several strong years, and a pickup in import growth. Some members were of the opinion that some indicators implied that economic activity had not slowed as much as was suggested by the data underlying the forecast. In this context, it was pointed out that the first national accounts figures commonly underestimated investment. Furthermore, credit growth had gained pace in the recent term.

Committee members discussed developments in inflation, including the fact that inflation had been below target for nearly four years and, according to the forecast, would align with the target in mid-2018 and stay close to target for the remainder of the forecast horizon. They noted the slowdown in house price inflation, which had been the main driver of inflation during this period of below-target inflation. The Committee's assessment was that if this trend continued, it would offset the diminishing effects of the appreciation of the króna. It was pointed out that, based on the most recent figures, the difference between inflation measures with and without housing had begun to narrow.

Members also noted that the króna had appreciated since the last meeting. They considered it positive that exchange rate volatility had eased in recent months, inflation expectations were in line with the inflation target, and exchange rate movements during the year had had limited impact on inflation and inflation expectations.

The MPC discussed the easing of the fiscal stance in 2017 and the two preceding years, although the fiscal budget proposal for 2018 indicated that this should reverse in part in the years to come. They considered the fate of the budget proposal highly uncertain, however, and were of the view that further fiscal easing in coming years would require a correspondingly tighter monetary stance.

Members agreed that most indicators implied that the output gap had peaked but would remain relatively wide. They were of the view that this would call for a continued tight monetary stance so as to ensure medium-term price stability. The Committee considered reduced demand pressures and an improved inflation outlook broadly consistent with its expectations at the October meeting, when it had decided to lower the Bank's key rate; furthermore, the Bank's real rate was broadly the same as it had been after the October interest rate decision. In view of this, no members saw any reason to change interest rates at present.

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 current monetary stance appeared sufficient at present to keep inflation broadly at target. Whether this would turn out to be the case in the coming term would depend on economic developments, including fiscal policy and the results of wage settlements.

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 13 December 2017.