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

# Minutes of the Monetary Policy Committee meeting

## February 2019 (82nd meeting)

## Published 20 February 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 4 and 5 February 2019, during which the Committee discussed economic and financial market developments, the interest rate decision of 6 February, 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 12 December 2018 interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2019/1 on 6 February.

### Financial markets

Since the December meeting, the króna appreciated by 1.8% in trade-weighted terms. Over this same period it appreciated by 2.3% against the euro and 2.7% against the US dollar, but depreciated by 0.5% against the pound sterling. Between meetings, the Bank sold foreign currency for approximately 33 million euros (4.5 b.kr.) and bought currency for just under 3 million euros (0.4 b.kr.), for a net sale of about 30 million euros (4.1 b.kr.). The Central Bank’s transactions accounted for about 13% of total turnover in the foreign exchange market.

In terms of the Central Bank’s real rate, the monetary stance had tightened marginally since the MPC’s December meeting, based on the average of various measures of inflation and one-year inflation expectations. By this measure, the Bank’s real rate was 0.9%, or 0.1 percentage points higher than after the December meeting. In terms of twelve-month inflation, it was 1.1% and had fallen by 0.1 percentage points between meetings.

Interest rates in the interbank market for krónur were virtually unchanged between meetings, and turnover in the market totalled 2 b.kr. during the period.

Yields on long-term nominal Treasury bonds had fallen by 0.4 percentage points since the December meeting, and yields on long-term indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.1 percentage points. Average fixed non-indexed lending rates on pension fund loans and mortgage loans were unchanged from the December meeting, while variable non-indexed rates on pension fund loans had risen by 0.6 percentage points. Over the same period, the average rate on indexed fixed-rate mortgage loans and indexed variable-rate pension fund loans had fallen slightly.

In terms of three-month interbank rates, the interest rate differential versus the euro area was virtually unchanged between meetings, at 5.2 percentage points, but the spread versus the US had risen slightly, to 2.2 percentage points. The long-term interest rate differential versus Germany had fallen by 0.3 percentage points between meetings, to 5.1 percentage points, and the spread versus the US had narrowed by 0.2 percentage points, to 2.5 percentage points.

Measures of the risk premium on the Treasury's foreign obligations had fallen marginally since the MPC's December meeting. The CDS spread on the Treasury's five-year US dollar obligations was just over 0.5%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.6-0.7 percentage points.

Financial institutions' analysts had projected that the Bank's interest rates would be held unchanged, citing, among other things, the prospect of weaker economic activity in the coming term, the fact that the Bank's real rate was broadly unchanged since the MPC's last meeting, and the decline in inflation expectations.

According to the Central Bank's quarterly survey, carried out in January, most market agents expected the Bank's key rate to be held unchanged at 4.5% in Q1/2019. On the other hand, they expected a 0.25 percentage point rate hike in Q2. Furthermore, they expect the key rate to be 4.75% in one year but 4.5% again in two years. In the survey, 24% of respondents considered the monetary stance too loose at present, which is a smaller share than in the last survey. About 57% of respondents considered the monetary stance appropriate, as compared with 48% in the last survey. The share who considered the monetary stance too tight measured 19%, up from 12% in the October survey.

Annual growth in M3 measured just under 7½% in December, after adjusting for deposits held by the failed financial institutions. This is slightly below the growth rate in the months beforehand. As before, growth in M3 stemmed primarily from increased household deposits, although the commercial sector's share in the growth rate has increased as well. After adjusting for the impact of the Government's debt relief measures, the stock of credit system loans to resident borrowers had grown in nominal terms by 9½% in December. At constant exchange rates, the stock of foreign-denominated loans grew by just over 8%. Over the same period, household lending grew by 8% year-on-year and corporate lending by just over 11%, whereas the growth rate adjusted for exchange rate movements was about 8%.

The Nasdaq OMXI8 index had risen by 4.6% between meetings. Turnover in the Main Market totalled 492 b.kr. in 2018, some 22% less than in 2017.

## Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in January, the global GDP growth outlook has deteriorated still further since the Fund's October forecast. The IMF estimates global GDP growth at 3.5% in 2019 and 3.6% in 2020, or 0.1-0.2 percentage points below its October forecast. GDP growth in advanced economies is expected to be weaker this year, owing mainly to a bleaker outlook for the euro area. However, the GDP growth outlook is unchanged for the US and the UK, although the outlook for the UK is highly uncertain because of the significant uncertainty about how Britain's exit from the EU will play out. The IMF also forecasts weaker year-2019 output growth in emerging and developing countries than it did in October. The Fund continues to consider the uncertainty in the output growth forecast to be concentrated on the downside because of the risk that global trade disputes will escalate further. For advanced economies, the IMF projects even slower growth in world trade in 2019 and 2020 than it did in October. The outlook for emerging and developing countries has changed much less, however. Among advanced economies, inflation is forecast at 1.7% in 2019, some 0.2 percentage points below the Fund's October forecast. The outlook for 2020 is unchanged, however.

According to preliminary figures from Statistics Iceland, Iceland's goods trade deficit totalled 11 b.kr. in December and about 191 b.kr. (at constant exchange rates) in 2018 as a whole. The deficit was therefore 7.5 b.kr. smaller than in 2017. Goods export values rose by just over 10% year-on-year in 2018, while import values rose by just over 7%. Export growth in 2018 is due primarily to an increase in exports of marine products and industrial goods, whereas the rise in import values is due mainly to an increase in the value of fuels and lubricants, as well as commodities and operational inputs.

Between MPC meetings, the listed global price of aluminium fell by nearly 3% and was just over 14% 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 4.8% year-on-year in 2018. The global price of oil had risen by just over 3% between MPC meetings, to 62 US dollars per barrel as of early February. By the time of the February meeting, however, oil prices were some 9% lower than they were a year earlier and just over one-fourth below their early October 2018 peak.

In terms of relative consumer prices, the real exchange rate rose by 0.6% month-on-month in January but fell by 8.3% year-on-year. In January, it was about 10% above its 25-year average but 14.4% below its June 2017 peak. By this same measure, it fell 2.9% year-on-year in 2018. The decline is due primarily to a 3.8% nominal depreciation of the króna, but in addition, inflation in Iceland was about 0.7 percentage points above the average among Iceland's trading partners.

## The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 2.5% year-on-year in Q4/2018. Job creation measured 2.3% year-on-year, and the average work week grew slightly longer. Growth in the number of employed persons according to pay-as-you-earn (PAYE) data has continued to ease, after measuring 2.3% year-on-year in Q3/2018. The labour participation rate was nearly 1 percentage point lower in Q4/2018 than in the same quarter of 2017, and the employment rate fell by 0.5 percentage points over the same period. In 2018 as a whole, both ratios were about 1 percentage point lower than they were in 2017.

Seasonally adjusted unemployment measured 2.8% in Q4/2018, slightly more than in the previous quarter but 0.4 percentage points less than in the same quarter of 2017. In 2018, it measured 2.7%, or 0.1 percentage points lower than in the previous year. Registered unemployment rose by 0.5 percentage points year-on-year in Q4/2018, however, and by 0.2 percentage points for the year as a whole. Foreign nationals accounted for about ⅔ of the increase. Because the LFS response ratio among foreign nationals working in Iceland has been on the decline, it could be that the survey fails to capture the turnaround observed in registered unemployment.

Net migration of foreign nationals aged 20-59 was positive by 0.4% of the population in Q4/2018. For the year as a whole, however, the foreign labour force grew by 3.1% of the population, the second-largest calendar-year increase ever measured. Active employees working for temporary employment agencies and foreign services companies accounted for about 0.8-0.9% of the labour force in the first eleven months of 2018, but only 0.7% in December.

The wage index was virtually unchanged month-on-month in December but had risen by 6% year-on-year, and real wages were 2.2% higher during the month than at the same time in 2017. The wage index rose by 6.5% between annual averages in 2018, and real wages grew by 3.7%.

Key indicators of developments in private consumption in Q4/2018 suggest a slowdown in household demand. Growth in payment card turnover slowed markedly, and new motor vehicle registrations declined in number. The Gallup Consumer Confidence Index rose in January, for the second month in a row, to 93.7 points. Nevertheless, this was well below the January 2018 measurement.

Statistics Iceland's nationwide house price index, published in January, rose by 0.3% month-on-month after adjusting for seasonality, and by 6% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.3% month-on-month in December when adjusted for seasonality, and by 5.9% year-on-year. The twelve-month rise in house prices has gained pace since October, when it measured about 4%. The number of purchase agreements registered nationwide rose by 4.8% year-on-year in 2018, and the average time-to-sale for flats in greater Reykjavík was 1.6 months in December, as opposed to 2.4 months a year earlier.

The consumer price index (CPI) rose by 0.74% month-on-month in December 2018, raising twelve-month inflation to 3.7%. Inflation fell again in January, however, when the CPI declined by 0.41% month-on-month, to 3.4%, or 0.1 percentage points more than at the time of the MPC's last meeting. The CPI excluding the housing component had risen by 2.6% year-on-year in January. The difference between inflation including and excluding housing is at its narrowest since autumn 2013. Underlying inflation measured 3.4% in January, according to the median of various measures, as did headline inflation, and had risen by 1.4 percentage points between years.

Winter sales weighed heavily on the January measurement, together with a drop in new motor vehicle prices, offset by a seasonal increase in public services prices. International airfares fell by 6% between months and were down 5.7% between years. The twelve-month decline has slowed from its average of 12% in H2/2018.

According to the Central Bank survey carried out in January, market agents' short-term inflation expectations fell marginally between surveys, to 3.5% one year ahead and 3% two years ahead. Market agents' long-term inflation expectations also fell, to an average of 2.8%

over the next five and ten years, a 0.2-point decline from the previous survey but a corresponding increase from the survey a year earlier. The breakeven inflation rate in the bond market has also fallen recently. Just before the MPC meeting, the five- and ten-year breakeven rate was 3.5%, after having fallen by approximately 0.4 percentage points since the December meeting; however, it was 0.3-0.5 percentage points higher than it was a year earlier.

**Summary from *Monetary Bulletin* 2019/1**

According to the forecast published in *Monetary Bulletin* on 6 February 2019, the outlook is for inflation to be higher in 2019 and 2020 than was forecast in November. Inflation has risen somewhat in the recent term, measuring 3.4% in January, as opposed to 2.4% a year earlier. Underlying inflation has risen similarly. Long-term inflation expectations have fallen since November, however, although they remain above the inflation target. The outlook is for inflation to keep rising to a peak of 3.8% in Q3/2019 and remain at or above 3% through mid-2020 before falling back to the target again towards the end of that year. The poorer inflation outlook is due primarily to a lower exchange rate than was assumed in November, albeit offset by a narrower output gap and lower oil prices.

External conditions have developed less favourably than was projected in the Bank's last forecast, and the outlook is for weaker global GDP growth than was assumed at that time. Terms of trade deteriorated more in 2018 than was assumed in November, even though the steep rise in oil prices early in the year reversed towards the year-end. The króna started to appreciate again at the end of 2018 after a sharp depreciation last autumn, but that appreciation reversed for the most part early in 2019.

GDP growth for 2018 is estimated at 4.3%. The outlook is for a significant slowdown in 2019, to only 1.8%, Iceland's weakest output growth rate since 2012 and a steep decline from the November forecast. There are signs that growth in tourism has slowed markedly and that services exports will contract this year, for the first time since 2008. Weaker export growth and the prospect of somewhat slower growth in domestic demand therefore pull in the same direction. As in November, GDP growth for the next two years is expected to be close to 2¾% per year.

The assumptions in the forecast concerning near-term wage developments have changed little since November. However, the revision of the GDP growth outlook entails the prospect of somewhat weaker productivity growth, and therefore a larger rise in unit labour costs this year than was forecast in November. The increase is projected at just under 6%, about the same as in 2018, but is expected to align with the inflation target by the end of the forecast horizon.

Job growth has slowed, and firms' recruitment plans indicate that job numbers may fall in H1/2019. There are therefore signs of reduced strain on domestic resources, and the output gap is now expected to have more or less closed in late 2020, earlier than previously forecast.

## II The interest rate decision

The Governor discussed the status of the recent bill of legislation on the release of the last of the offshore króna assets that were locked in by the capital controls in the aftermath of the financial crisis. MPC members also discussed the Bank's foreign exchange market intervention strategy. As the Bank stated in its report on responses to some of the proposals from the task force on the monetary policy framework, it intends to establish a working group whose task will be to submit recommendations to the MPC on the intervention policy and information disclosure about its implementation. In this context, members discussed the Bank's intervention in previous months and the objectives of the intervention policy.

The Committee also discussed the special reserve requirement (SRR) on capital inflows and whether conditions for lowering the SRR, or setting it at zero, would develop once the offshore krónur were released in accordance with the pending bill of legislation. These conditions reflected, among other things, the narrowing of the interest rate differential and the recent decline in the exchange rate, which Committee members considered likely to be below its equilibrium value. There had also been a turnaround in capital flows to and from Iceland in Q4/2018, when net capital flows from new investment were negative for the first time. Furthermore, it had always been the goal to lower the SRR to zero once conditions warranted it, and to keep it inactive whenever possible. The SRR would then be a third line of defence, to supplement conventional economic policy and micro- and macroprudential tools, as had always been the objective. On the other hand, it was necessary to be able to activate it at short notice in order to support monetary and macroprudential policies in response to elevated risk of excess carry trade-related capital inflows. During the discussion, the concerns emerged that unrestricted capital inflows could lead to excessive inflows, which could once again weaken monetary policy transmission along the interest rate channel. The risk was then that the transmission mechanism would shift to the less predictable exchange rate channel, which could also give rise to macroeconomic and financial imbalances. It was pointed out that the domestic foreign exchange market was small and it would not take much to affect the transmission mechanism significantly. MPC members agreed, however, that it was not advisable that the exchange rate channel should be inactive, as it was an important part of the transmission mechanism, without which monetary policy would be less effective. It was also pointed out that it would be possible to activate the capital flow management measure at short notice if conditions changed rapidly. Committee members agreed that conditions had now developed so as to permit the next steps in lowering the SRR.

MPC members also discussed general reserve requirements. At the December meeting, they had noted that conditions for an increase might be developing, given the recent increase in credit growth. The MPC noted that credit growth had certainly gained pace but that the credit stock relative to GDP had remained broadly unchanged since 2016. Members agreed that credit growth was not excessive. Furthermore, the Financial Supervisory Authority had recently decided to increase the countercyclical capital buffer on financial institutions' domestic exposures, in line with the recommendation of the Financial Stability Council in December 2018. To some extent, this could reduce credit growth relative to the level that would otherwise have occurred. As a result, it was not considered necessary to increase general reserve requirements, although developments would continue to be monitored closely.

The MPC discussed the monetary stance in view of the most recent information on the economy and the marginal rise in the Bank's real rate between meetings. Members also discussed whether the stance was appropriate in light of the inflation outlook, as the Committee had decided in December to keep the Bank's key rate unchanged, partly because of indications that demand pressures in the economy were continuing to ease, the depreciation of the króna had slowed down, and the increase in inflation expectations since the last meeting was limited primarily to short-term expectations.

In this context, the MPC took account of the Bank's updated macroeconomic forecast, published in *Monetary Bulletin* on 6 February, which indicated that GDP growth would slow markedly this year, to 1.8%. Members noted that this was about 1 percentage point less than the Bank projected in November, and if the forecast materialised, it would be Iceland's weakest output growth since 2012. Members agreed that the slowdown in growth was due in particular to a contraction in tourism and that the outlook was for the positive output gap to narrow faster than previously assumed.

The MPC discussed developments in inflation, which rose over the course of 2018, measuring 3.7% in December. Members noted that weighing heaviest was the rise in import prices, a result of the depreciation of the króna in the autumn. Although inflation had eased to 3.4% in January and the króna had appreciated since the MPC's December meeting, Committee members noted that the outlook was for inflation to pick up this year and remain above the target until H2/2020. On the other hand, they noted that market agents' inflation expectations and the breakeven inflation rate in the bond market had declined since the December meeting. The monetary stance as measured by the Central Bank's real rate had therefore tightened again.

The Committee discussed the possibility of keeping interest rates unchanged or raising them by 0.25 percentage points. The main argument in favour of keeping rates unchanged was the outlook for the output gap to narrow more rapidly than previously projected. It was pointed out that most high-frequency indicators and sentiment surveys also suggested that GDP growth would be weaker in 2019 than previously assumed. Members also noted that if workers went on strike, it could cause the domestic economy to cool quickly. This would have a strong negative impact on tourism, for instance. It emerged in the discussion that it was positive that long-term inflation expectations had fallen since the December meeting and the monetary stance had therefore tightened slightly.

The main arguments in favour of raising interest rates, however, were that inflation was somewhat above the target and the inflation outlook had deteriorated. It was pointed out that even though long-term inflation expectations had fallen, the fact that expectations were above target by all measures gave cause for concern. Although increased inflation in previous months was due in part to exchange rate pass-through from the depreciation of the króna, there was the risk of second-round effects. A lack of response could affect the anchor for inflation expectations and the credibility of monetary policy. During the discussion, it emerged 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. The situation was therefore that the MPC needed to weigh together the impact of weaker GDP growth and higher inflation but, as always, under conditions of uncertainty about the estimate of the output gap.

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 4.5%, the current account rate 4.25%, the seven-day collateralised lending rate 5.25%, and the overnight lending rate 6.25%. All Committee members voted in favour of the proposal.

In the Committee's view, 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 MPC reiterated that it had both the will and the tools necessary to keep inflation and inflation expectations at target over the long term, and members agreed that this could call for a tighter monetary stance in coming months. Other decisions, particularly those relating to the labour market and fiscal policy, would be important in determining whether that would be the case and would affect the sacrifice cost in terms of lower employment.

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 20 March 2019.