The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, May 2017

Published 31 May 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 15 and 16 May 2017, during which the Committee discussed economic and financial market developments, the interest rate decision of 17 May, 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 15 March 2017 interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2017/2 on 17 May.

Financial markets

Exchange rate volatility has subsided after a temporary spike after the capital controls were lifted in mid-March. Between meetings, the króna appreciated by 6.2% in trade-weighted terms. Over this period it appreciated by 9.2% against the US dollar, 5.1% against the euro, and 2.7% against the pound sterling. The Central Bank’s net foreign currency purchases in the domestic foreign exchange market totalled approximately 174 million euros (roughly 20.4 b.kr.) between meetings, or 27.4% of total market turnover.

In terms of the Central Bank’s real rate, the monetary stance tightened slightly between meetings, and the Bank’s real rate in terms of the average of various measures of inflation and inflation expectations had risen by 0.2 percentage points, to 2.7%.

Interest rates in the interbank market for krónur were virtually unchanged between meetings. Turnover in the market had been considerably greater year-to-date than over the same period in 2016, totalling almost 101.6 b.kr. Yields on nominal Treasury bonds were broadly unchanged since the March meeting, and yields on indexed Treasury and Housing Financing Fund (HFF) bonds had fallen by as much as 0.2 percentage points. Furthermore, financial institutions' deposit and lending rates were virtually unchanged since the March meeting.

Risk premia on Treasury foreign obligations had declined by as much as 0.3 percentage points between meetings, after Standard & Poor's upgraded Iceland's sovereign ratings from A- to A. The CDS spread on the Treasury's five-year US dollar obligations measured 0.8% just before the May meeting, and the spread vis-à-vis comparable bonds issued by Germany was 0.8 percentage points.

Financial institutions' analysts expected either no change or a 0.25 percentage point interest rate reduction in May, but they considered the decision uncertain. As grounds for a rate cut, they cited improvements in the short-term inflation outlook and the continued appreciation of the króna despite the removal of most of the capital controls. The main grounds cited for unchanged interest rates pertained to the growing output gap and the situation in the housing and labour markets.

According to the Central Bank's survey of market agents' expectations, carried out in May, respondents expected the Bank's key rate to be lowered by 0.25 percentage points in Q2/2017 to 4.75%, followed by a further reduction in Q4. They expected the key rate to be raised back to 4.75% in Q2/2018, however. In the survey, participants were also asked about near-term developments in house prices. About 60% of respondents expected the year-on-year rise in house prices to be slower in the next six months than it had been in April, when it measured 20%, and 95% of respondents expected the pace to ease in the next twelve months.

M3 grew by about 6% year-on-year in Q1/2017, after adjusting for deposits held by the failed financial institutions. The growth rate is similar to that in the previous quarter but still below nominal GDP growth. As was the case last year, growth in money holdings is due largely to increased household deposits, although corporate deposits also grew between years.

After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers grew by 3½% year-on-year in Q1, and by just over 4½% after adjusting for the effects of exchange rate movements on the foreign-denominated credit stock. Growth is attributable to an increase in lending to households and businesses. Annual growth in credit system lending to households measured 3.7% in Q1, after adjusting for the Government's debt relief measures.

The Nasdaq OMXI8 index had risen by 9.5% between meetings and by 10.1% since the beginning of the year. Turnover in the Nasdaq Iceland main market totalled 246 b.kr. in the first four months of the year, about 27% more than over the same period in 2016.

Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in April, the global GDP growth outlook has improved from the Fund's January forecast, particularly for advanced economies. According to the forecast, global GDP growth will measure 3.5% this year. The Fund's output growth forecast for Iceland's main trading partners is 0.1 percentage points higher this year, or 1.9%. The Fund also expects inflation in advanced and emerging market economies to be higher over the forecast horizon than it projected in January. Among Iceland's main trading partners, inflation is expected to measure 1.9% this year, which is 0.3 percentage points above the IMF's October forecast.

Iceland's external goods trade generated a deficit of 48.3 b.kr. for the first four months of the year, as opposed to a deficit of 28.4 b.kr. over the same period in 2016. Export values contracted by 0.5% year-on-year at constant exchange rates, while import values rose 10.7%. The export value of marine products declined by 16% year-on-year and the export value of industrial products rose by nearly 13%. Import growth is attributable mainly to a 24% increase in imports of commodities and operational inputs, whereas the import value of petrol rose by 29%. In spite of strong growth in passenger car imports, there was a contraction of nearly 13% in the import value of transport equipment, as imports of aircraft were much less this year than over the same period in 2016.

The listed global market price of aluminium was unchanged between MPC meetings, and the average price in April was up by just over a fifth year-on-year. Foreign currency prices of marine products rose by about 1.5% between months in March and by about 5.7% year-on-year.

In terms of relative consumer prices, the real exchange rate measured 99.7 points in April, a decline of 0.9% month-on-month but an increase of 17.6% year-on-year. The rise is due primarily to a 17.5% nominal appreciation of the króna, but in addition, inflation in Iceland was about 0.1 percentage point above the trading partner average.

The domestic real economy and inflation

According to parliamentary resolutions on the five-year fiscal strategy and fiscal plan presented before Parliament in January and at the end of March, the fiscal stance for the period will ease more this year than was assumed in the Bank's February forecast. It is assumed that, after adjusting for one-off items, the Treasury primary surplus will contract from last year's 3.3% of GDP to 2.5% this year. Adjusting for business cycle effects, the primary balance is expected to deteriorate year-on-year by 1.4% of GDP in 2017. It is estimated that the proposed increase in value-added tax (VAT) on tourism will result in consolidation of about 0.7% of GDP in 2018, followed by easing in the amount of 0.2% of GDP in 2019, when the planned reduction of the general VAT rate takes effect.

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 3.5% in Q1, slightly more than had been assumed in the Bank's February forecast. The increase was due to a 3.9% rise in the number of employed persons, as the average work week continued to grow shorter. In Q1/2017, as in the previous quarter, the seasonally adjusted labour participation rate was 83.8%, which is equal to the pre-crisis peak, although the employment rate is still ½ a percentage point below the previous peak, at 81.6%.

Seasonally adjusted unemployment measured 2.7% in Q1, having declined by 0.4 percentage points between years. This was the lowest unemployment rate since H1/2008.

The wage index rose by 0.8% between quarters in Q1, and by 6.4% year-on-year, and real wages in terms of the index were 4.5% higher in Q1/2017 than in Q1/2016.

Key indicators of developments in private consumption suggest that growth remained strong at the beginning of the year. Payment card turnover was up by nearly 12% year-on-year in the first four months of 2017, and new motor vehicle registrations were up by over a fifth.

The Gallup Consumer Confidence Index measured 126.6 points in April, a full four points less than in April 2016 and 2.6 points less than in March 2017. It is high in historical context, however, indicating significant optimism among households.

Statistics Iceland’s nationwide house price index, published at the end of April, rose by 2% month-on-month after adjusting for seasonality, and by 20.4% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 2.4% month-on-month in March when adjusted for seasonality, and by 20.9% year-on-year. The number of registered purchase agreements nationwide rose 12.3% between years in March. The average time-to-sale for residential property in the greater Reykjavík area was about 1.2 months in March, down from 2 months in March 2016.

The CPI rose by 0.5% month-on-month in April, after rising by 0.1% in March. Twelve-month inflation measured 1.9% in April and was unchanged since the Committee’s March meeting. The CPI excluding the housing component had declined by 1.8% year-on-year, however. Most measures of underlying inflation suggested that it had declined in April and lay in the 1-2% range.

The main driver of the CPI increase in April was the rise in house prices. International airfares also rose but were offset by the drop in food prices. Private services prices had risen by 0.3% year-on-year. The small increase is explained largely by a decline in two service-related subcomponents of the CPI: telephone services and international airfares.

According to the Central Bank’s survey of market agents’ inflation expectations, conducted at the beginning of May, participants expect inflation to measure 2.2% in one year. This is 0.3 percentage points less than in the previous survey, taken in February 2017. Survey participants’ inflation expectations two years ahead had also declined, from 2.8% in the last survey to 2.6%. Furthermore, market agents expect inflation to average 2.6% over the next ten years, or 0.1 percentage points less than in the February survey. The ten-year breakeven inflation rate in the bond market had measured in the 2.2-2.4% range during the quarter to date, as opposed to 3.1% in Q2/2016.

According to the baseline forecast published in *Monetary Bulletin* on 17 May, inflation will be around 2% well into 2018 and then rise to approximately 3% in mid-2019 before subsiding towards the target. Because of Statistics Iceland’s error in measuring the CPI in 2016, inflation was underestimated during the first three quarters of the year. At the turn of the year, excise taxes rose on a number of products, including petrol, alcoholic beverages, and tobacco. The impact of this on the CPI is roughly equal to the aforementioned measurement error. Furthermore, the authorities are planning changes to indirect taxes in the coming term. Once adjustments are made for these factors, the inflation outlook for 2017 is broadly unchanged, whereas the outlook for 2018 is slightly improved. The situation will change at the beginning of 2019, however, when inflation is projected to be ½ a percentage point more than was forecast in February, owing to the prospect of a wider output gap than was assumed then.

According to the baseline forecast, the króna will continue to appreciate until end-2018. If the forecast materialises, the exchange rate will be a full 14½% higher, on average, in 2017 than in 2016 and will rise by an additional 6% in the coming two years. By 2019, the króna would be 3½% stronger than was assumed in February, although these forecasts are highly uncertain. Therefore, according to the forecast, the real exchange rate will rise more than previously anticipated. If this is borne out, the real exchange rate in terms of relative consumer prices will be 11% higher by the end of the forecast horizon than in Q1/2017. In terms of relative unit labour costs, the increase is somewhat larger.

In Q4/2016, global output growth exceeded the forecast in the February *Monetary Bulletin*, and the outlook for this year has improved. GDP growth among Iceland’s main trading partners looks set to rise to 1.9% this year, from last year’s 1.6%. As in February, trading partners' GDP growth is assumed to measure about 1.9% per year throughout the forecast horizon.

The ratio of Iceland's export prices to those of trading partner countries rose more at the end of 2016 than had been projected in the last *Monetary Bulletin*. The outlook for developments in marine and aluminium product prices has also improved this year, with relative export prices expected to rise by 4½%, nearly 2 percentage points more than was forecast in February. Nevertheless, a more rapid rise in import prices will cut into this improvement in terms of trade, which is now projected at 1% instead of the 1.9% provided for in the February forecast. The outlook for the next two years is broadly unchanged, however, and no major changes in terms of trade are expected.

It is mainly because of strong growth in services exports that total exports are forecast to grow by 10½% this year, considerably more than was projected in February. The difference is due mainly to the prospect of an even larger increase in tourist arrivals than was previously assumed. Even though marine product exports contracted in Q1/2017 because of the fishermen's strike, they are expected to increase somewhat more this year than was forecast in February, owing to a much stronger capelin fishery than previously anticipated. Aluminium exports are also expected to be stronger this year. As in the Bank's previous forecasts, export growth is expected to ease in the next two years, in line with a rising real exchange rate and relatively weak global export growth.

According to preliminary figures from Statistics Iceland, GDP growth picked up strongly as 2016 progressed, measuring 10.4% in H2 and 7.2% for the year as a whole. This is just over 1 percentage point more than had been assumed in the Bank's February forecast. There are signs that GDP growth eased somewhat in Q1/2017. Clearly, the fishermen's strike early in the year caused a steep drop in marine product exports, causing fisheries to export inventories. Because the impact of the strike was temporary, GDP growth is expected to rally in Q2 and measure 6.3% for 2017 as a whole, 1 percentage point above the February forecast. The changed outlook is due mainly to the prospect of stronger-than-expected export growth, and the greater-than-expected fiscal easing provided for in the new National Budget is a factor as well. Robust export growth also affects the outlook for 2018 GDP growth, which is now projected at 3.5% instead of the 3.1% in the February forecast. As in the February forecast, GDP growth is projected to keep subsiding as the forecast horizon progresses, easing to 2.5% by 2019, close to estimated long-term potential output.

Total hours worked increased by 3% in 2016 and 3.5% in Q1/2017, slightly outpacing the February forecast. Total hours are expected to keep rising through this year, to about 4.1% more than in 2016. The working-age population grew by about 2% year-on-year, owing in part to significant importation of foreign labour. The labour participation rate is also on the rise and will be some ¾ of a percentage point higher this year than in 2016.

Unemployment continued to decline as well, to a seasonally adjusted rate of 2.7% in Q1. It is expected to measure 2.6% for the year as a whole, as was forecast in February. As in previous forecasts, it is projected to rise gradually to the level deemed consistent with low and stable inflation. It is forecast to average 3% in 2018 and 3½% in 2019.

Wages have risen steeply in the recent term, offsetting imported deflation and the appreciation of the króna. This year's pay rises will be large as well, nearly 7%, but the pace will then ease in 2018 and 2019. Offsetting these hefty pay increases is last year's unusually strong productivity growth and the prospect of the same this year. It is possible, however, that productivity growth has been overestimated – for instance, because of an underestimation of the increase in foreign labour. In 2017-2019, unit labour costs are forecast to rise by about the same as in 2016, or an average of nearly 5% per year. If the forecast materialises, there will be significant inflationary pressures from the labour market during the forecast horizon.

Strong demand growth and job creation have caused a persistent shortage of workers in spite of increased labour importation, and representatives of a steadily growing number of firms indicate that they are operating at or above capacity. As a result, the output gap appears to be growing. It is estimated to measure 3⅓% of potential output at the end of this year. It will therefore grow more rapidly than was assumed in February and will be nearly 1 percentage point more during the forecast horizon, at just under 1% of potential output by mid-2020, the end of the forecast horizon.

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 assessments of the effectiveness of specific markets and on the transmission of monetary policy 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.

The inflation outlook could turn out poorer than in the forecast if domestic demand is underestimated or the flexibility of the supply side of the economy is overestimated. Furthermore, a number of wage agreements are up for negotiation soon, and the resulting pay rises could prove larger than is assumed in the baseline forecast. The tension in the labour market could also generate more wage drift than the forecast provides for. Furthermore, the scope for domestic companies to absorb further cost increases could be exhausted – particularly in the tradable sector, where firms' competitive position has been eroded significantly by the rising real exchange rate. The imbalances in the housing market could also be underestimated, which could kindle even more demand pressures and exacerbate the risk of a hard landing later on. Moreover, if the fiscal stance eases more than is currently expected, demand pressures could be underestimated. All of this could test the newly established anchor for inflation expectations.

The inflation outlook presented in the baseline forecast could be overly pessimistic, however. The outlook is for sustained large current account surpluses and a continued improvement in Iceland's external position. The equilibrium exchange rate of the króna could therefore rise more than is assumed in the forecast, pulling the nominal exchange rate upwards even further than is currently projected. Weaker GDP growth among Iceland's main trading partners and a more sluggish recovery of global oil and commodity prices could also cut into domestic economic activity and prolong the impact of imported deflation, which has helped keep inflation low in Iceland. The effects of increased global competition on domestic retailers' pricing decisions could also be underestimated. And finally, the cyclical expansion of potential output could still be underestimated.

II The interest rate decision

The Governor reported to the MPC on the Icelandic mission's meetings with representatives of the International Monetary Fund (IMF) and its meetings with other central bankers, rating agencies, and financial institutions at the IMF's spring meetings in Washington, DC. In this context, he also reported on discussions of the capital flow management measure.

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

The MPC discussed the monetary stance in view of the most recent information on the economy and the slight rise in the Bank's real rate between meetings. Members discussed whether this had changed their assessment of whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had been unanimous in March about its decision to keep the Bank's interest rates unchanged, owing to rapid growth in economic activity and clear signs of growing demand pressures in the economy, which, in MPC members' view, called for a tight monetary stance. The Committee had also considered, at its March meeting, that the virtually complete liberalisation of capital controls had somewhat exacerbated uncertainty about developments in the exchange rate and the general economy.

In this context, members took account of the Central Bank's new forecast, published in *Monetary Bulletin* on 17 May, which indicated that GDP growth would be strong in 2017, as it had been in 2016, and that growth would exceed the February forecast in both years. Members noted that the deviation from the February forecast stems mainly from stronger-than-expected growth in tourism, although the outlook was also for more fiscal easing in 2017 than was previously projected. In particular, the MPC noted that demand pressures in the labour market and the general economy had grown despite increased importation of labour and strong productivity growth. The appreciation of the króna offset the increased tension, and members agreed that it had played a key role in the economy's adjustment to the positive shocks attributable to improved terms of trade and growth in the tourism sector.

The Committee discussed developments in inflation since the last meeting; inflation had measured 1.9% in April, broadly similar to the level in the previous six months. As at previous meetings, members agreed that the currency appreciation and low global inflation offset domestic inflationary pressures.

In particular, they discussed different measures of inflation, as the gap between domestic price developments – housing costs in particular – and external factors had widened even further since the last MPC meeting. Members noted that underlying inflation appeared to have tapered off in recent months. They also observed that underlying the recent developments in inflation were wide fluctuations in relative prices, with the housing component one of the main drivers of inflation. It was not appropriate to ignore the housing component, however, because house prices were an indicator of future inflation just as they had been during the pre-crisis period, when different measures of inflation also diverged. It was also mentioned that the small rise in domestic prices excluding housing was due primarily to a decline in two items falling under private services. Other labour-intensive items had risen as could have been expected given the rise in wage costs.

Members also took account of the inflation forecast published in *Monetary Bulletin*, which shows that the inflation outlook for 2017 and 2018 has improved since the February forecast, while the outlook further out the forecast horizon has deteriorated. Committee members agreed that two opposing forces were at work and were affecting the outlook. One was the demand pressures in the economy, which had proven stronger than had been projected in

February, and the other, offsetting domestic inflationary pressures, was the impact of a higher exchange rate.

The Committee discussed recent exchange rate developments, as the króna had appreciated somewhat since the March meeting. The MPC considered it positive that short-term exchange rate volatility had receded since the beginning of April. As before, members agreed that the appreciation of the króna was largely a reflection of economic fundamentals, which could be attributed to improved terms of trade and strong exports – tourism in particular – which delivered a sizeable trade surplus. They were of the view that monetary policy neither could nor should try to halt the resulting adjustment of the real exchange rate, which was inevitable. It was pointed out that the alternative scenario published in *Monetary Bulletin* illustrated clearly the impact of the exchange rate on the adjustment of the economy to positive shocks. Nevertheless, Committee members agreed that the Bank should continue to intervene in the foreign exchange market in order to mitigate volatility when it considered such intervention warranted.

In the Committee's opinion, there were grounds for keeping interest rates unchanged and for lowering them by 0.25 percentage points. All members agreed that the main rationale for keeping interest rates unchanged was the rapid growth in economic activity and the clear signs of demand pressures in the economy, which called for a tight monetary stance in order to ensure medium-term price stability. It was therefore difficult to see how the current situation and near-term outlook called for monetary easing. By the same token, it was necessary to take into account that the fiscal stance provided for considerable easing; therefore, it was difficult to see where a tight stance should come from if not from monetary policy.

The main argument in favour of a rate reduction that was expressed at the meeting was that the Bank's real rate had risen since the Committee's last meeting. At the same time, the appreciation of the króna had also contained demand and economic activity. These two factors created the scope for a rate reduction. There was some discussion of how much tightening the higher exchange rate entailed, with some members considering it to be significant. It was mentioned that the rise in the exchange rate and the proposed increase in VAT on tourism had already begun to affect tourism companies' investment plans. Committee members agreed that the exchange rate uncertainty associated with capital account liberalisation, which they had taken into account at the last meeting, was no longer a factor. Some members emphasised that inflation was due entirely to increased housing costs. They considered it likely that the rise in house prices in excess of the general price level and wages would reverse within a few years or at least halt earlier than currently expected, once housing supply had caught up with demand, as property prices were close to a historical high. If this should occur without a reversal of the recent appreciation of the króna, the combined developments in house prices and the exchange rate could lead to rapid disinflation. These members were of the view that such a scenario was no less probable than a scenario involving a less favourable interaction between exchange rate and house prices. It was therefore appropriate to continue lowering interest rates cautiously, provided that credit growth did not accelerate.

It was also mentioned that the supply side of the economy was more flexible than before. More importation of labour, together with growth in investment and productivity, had increased potential output well in excess of the long-term trend growth rate. As a result, it could grow more rapidly without significant wage drift or excessive demand pressures. Furthermore, it was pointed out that the near-term inflation outlook was better than had been anticipated at the previous meeting. Consequently, some members were of the view that a small interest rate reduction would not pose a risk as regarded future inflation, and one member thought it possible that the scope for a rate cut was underestimated. It was pointed out that a tight monetary stance had anchored inflation expectations more firmly at target and that it was therefore safe to lower the Bank's key rate despite the strength of the economy, as such a move would not bring the Bank's real rate below the level just before the March meeting.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points, which would lower the key rate (the seven-day term deposit rate) to 4.75%, deposit rates (current account rates) to 4.5%, the seven-day collateralised lending rate to 5.5%, and the overnight rate to 6.5%. All Committee members voted in favour of the proposal.

Members agreed that a stronger anchor for inflation expectations at target and the appreciation of the króna had enabled the MPC to achieve its legally mandated price stability objective with a lower interest rate than would otherwise have been possible. Members agreed that in the coming term, the monetary stance would be determined by economic developments and actions taken in other policy spheres.

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 14 June 2017.