The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, December 2017

Published 27 December 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 11 and 12 December 2017, during which the Committee discussed economic and financial market developments, the interest rate decision of 13 December, 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 November interest rate decision.

Financial markets

Between meetings, the króna depreciated by 1.6% in trade-weighted terms. Over this same period it fell 1.3% against the US dollar, 1.8% against the euro, and 3.0% against the pound sterling. The Central Bank conducted no transactions in the interbank foreign exchange market between meetings. The Bank's net foreign exchange purchases year-to-date have totalled 70.3 b.kr. (603 million euros). Central Bank transactions have accounted for just under 21% of total foreign exchange market turnover this year.

In terms of the Central Bank's real interest rate, the monetary stance was broadly unchanged since the MPC's November meeting, and the Bank's real rate in terms of the average of various measures of inflation and inflation expectations was still about 1.8%.

Interest rates in the interbank market for krónur were unchanged between meetings. There was no turnover in the market during this period, but turnover year-to-date totalled 123.8 b.kr., a significant increase over the same period in 2016.

Treasury bond yields were broadly unchanged between meetings. Nominal Treasury bond yields had risen by as much as 0.1 percentage point, but yields on most indexed Treasury and Housing Financing Fund bonds had declined by 0.1 percentage point. Furthermore, financial institutions' deposit and lending rates were virtually unchanged since the November meeting.

Risk premia on Treasury foreign obligations had declined marginally between meetings. The CDS spread on the Treasury's five-year US dollar obligations had fallen by 0.1 percentage point, to 0.7%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany had fallen by nearly 0.3 percentage points, to around 0.8 percentage points.

Most financial institutions' research departments expected that the Bank's interest rates would be held unchanged in December, although some expected a 0.25-point reduction. As grounds for unchanged interest rates, they cited the virtually unchanged inflation outlook; the newly published national accounts, which showed that GDP growth in the first nine months of 2017 had outpaced the Central Bank's November forecast; and that uncertainty persisted concerning the near-term fiscal stance and the results of wage agreements. Weaker growth in exports and private consumption than had been forecast in November was considered the main rationale for a rate cut.

Broad money growth had eased slightly. M3 adjusted for the deposits held by the failed banks grew by 6.7% year-on-year in October but had grown 8.3% in Q3. Annual growth in household deposits was still rapid, while growth in corporate and financial company deposits had slowed.

Growth in lending to resident entities remained robust. After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers increased in nominal terms by just under 6% year-on-year in October, as opposed to 5½% in Q3. The October 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. Nominal lending to households increased by 5% year-on-year in October, after adjusting for the Government's debt relief measures, and nominal lending to businesses by 8%. Calculated at constant exchange rates, the stock of corporate loans had grown by approximately 9½% year-on-year in October.

The Nasdaq OMXI8 index had fallen by 4.4% between meetings and by 4.6% since the beginning of the year. Turnover in the NASDAQ Iceland main market totalled around 600 b.kr. over the first eleven months of the year, about 14% more than over the same period in 2016.

Global economy and external trade

According to the Organisation for Economic Co-operation and Development's (OECD) November forecast, GDP growth and world trade will be stronger in 2017 and 2018 than in the OECD's June forecast. Global GDP growth for 2017 and 2018 is projected at 3.6% and 3.7%, respectively, about 0.1 percentage points above the OECD's June forecast for both years. The forecast for 2017 GDP growth among Iceland's main trading partners has been revised upwards by 0.3 percentage points, to 2.3%. The forecast for 2018 has also been revised upwards, to 2.2%. Trading partners' GDP growth according to the OECD forecast outpaces the Central Bank's November forecast of 2.2% this year and 2% next year. The

OECD revised its inflation forecast for Iceland's trading partners downwards by 0.2 percentage points, to 1.8%, whereas the forecast for 2018, also 1.8%, is unchanged.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 13 b.kr. deficit in November and a 156 b.kr. deficit in the first eleven months of the year, at constant exchange rates. The deficit over the same period in 2016 was 88 b.kr. Export values rose by 9% year-on-year at constant exchange rates, while import values rose 21%. Three-month growth in imports measured 30%, the strongest since July 2006. The surge in import growth is due in particular to an increase in the value of imported transport equipment, petrol, lubricants, and investment goods. At the same time, nominal export growth has eased, owing especially to slower growth in marine product export values.

The listed global market price of aluminium had fallen by just over 4% since the MPC's November meeting, and the average November price was up more than 21% year-on-year. Preliminary figures on developments in foreign currency prices of marine products indicate that prices rose between months in October but declined by 0.6% year-on-year in the first ten months of 2017. Oil prices had risen by 1.8% between meetings and 14% between years.

In terms of relative consumer prices, the real exchange rate rose 1.1% month-on-month in November, to 99.3 points. It had risen by 3.2% from the September trough. Over the first eleven months of 2017, the real exchange rate rose 13% year-on-year because the nominal exchange rate rose 13.3% and inflation in Iceland was 0.1 percentage points below the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in December, GDP growth measured 3.1% in Q3/2017. Domestic demand grew by 10.7% during the quarter, as consumption and investment grew by 8.6% between years. The contribution of inventory changes was therefore unusually pronounced during the quarter. Exports were virtually unchanged year-on-year, while imports grew by 11.6%, and the contribution from net trade was therefore negative. For the first nine months of the year, GDP growth measured 4.3%, reflecting the offsetting effects of 7.4% growth in domestic demand and the negative contribution from net trade. The main drivers of GDP growth for the period were private consumption and services exports.

GDP growth in the first three quarters of 2017 outpaced the forecast in the November *Monetary Bulletin*. The main reason is that the contribution from inventory changes was considerably stronger than expected in Q3, investment grew more rapidly, and revised national accounts figures showed H1/2017 GDP growth at 4.9%, up from the previous estimate of 4.3%.

The current account balance was positive by 68.1 b.kr., or 9.9% of GDP, in Q3/2017. This is less than in Q3/2016, when the surplus measured 15.3% of GDP. The surplus for the quarter was due to a 118 b.kr. surplus on services trade, which was offset by a 47 b.kr. deficit on goods trade and a 2 b.kr. deficit on primary and secondary income. The revision of previously published figures showed that the surplus was about 1 b.kr. smaller in H1/2017.

The robust current account surplus during the quarter, plus favourable price and exchange rate effects, resulted in a positive net international investment position (NIIP) amounting to 4.3% of GDP, whereas the NIIP had been negative in Q2. Restructuring of pharmaceuticals companies led to significant changes in external assets and liabilities. Pharmaceuticals companies' assets declined by 365 b.kr. (14% of GDP) and their liabilities fell by 340 b.kr. (13% of GDP) in Q3.

In Q4 to date, key indicators of private consumption, such as payment card turnover and new motor vehicle registrations, suggest that household demand is still growing strongly. Leading indicators such as retail executives' expectations concerning domestic demand are also stronger than in Q3. Furthermore, the Gallup Consumer Confidence Index was higher, on average, in October and November than in Q3. In November the index measured 124, about 9 points lower than in November 2016, despite having risen since Q3.

According to the results of Gallup's winter survey, carried out in November and December among Iceland's 400 largest companies, executives were very upbeat about the current economic situation and less pessimistic about the outlook six months ahead than in the autumn survey. They were slightly less positive than in the summer survey, however. About 73% of respondents considered the current situation good, and about 23% considered it neither good nor poor. Just under 11% of executives expected economic conditions to improve in the next six months, and about 65% expected conditions to remain unchanged (i.e., good). Executives in all sectors except transport, tourism, and manufacturing were more optimistic than in September, while in all sectors except fishing they were more pessimistic than they were a year ago. Executives in manufacturing, fishing, transport, and tourism were more pessimistic than others about the outlook six months ahead, with sentiment among transport and tourism executives deteriorating the most since the autumn survey. Just over 24% of respondents expected conditions to be worse in six months' time, slightly more than in the survey taken a year ago. Attitudes towards domestic demand were slightly more optimistic than in the autumn survey, while attitudes towards foreign demand were considerably more positive.

According to the winter survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by about 15 percentage points, after adjusting for seasonality. The spread is somewhat narrower than in the autumn survey and about 14 percentage points narrower than in last year's winter survey. Sentiment was most pessimistic in the fishing industry, where firms planning redundancies outnumbered those planning to recruit by 18 percentage points, whereas sentiment was most positive in transport, transit, and tourism, where the share of firms planning to recruit outnumbered those planning to downsize by almost 50%. In other sectors, the share of companies planning to recruit was larger than the share planning to lay off staff by 15-22 percentage points.

After adjusting for seasonality, about 32% of executives considered themselves short-staffed, a slight decline since the last survey. The ratio was highest in the construction industry, where 40% of executives considered themselves understaffed, and lowest in retail and wholesale trade, where 19% of executives reported difficulties in filling available positions. In other sectors, the ratio lay in the 22-38% range.

About 53% of executives reported that they would have difficulty responding to unexpected demand, after adjusting for seasonality. This was a slightly higher ratio than in the autumn survey. About ⅔ of executives in the fishing and construction sectors were pessimistic about their ability to respond to an unexpected increase in demand. The least strain on production factors was in retail and wholesale trade, where about a third of executives said they would have difficulty responding to unexpected demand. In other sectors, the ratio lay in the 36-57% range.

The wage index rose by 0.1% month-on-month in October and by 7.2% year-on-year, and real wages according to the index were up 5.2% year-on-year in October.

Statistics Iceland's nationwide real estate price index, published at the end of November, rose 0.7% month-on-month when adjusted for seasonality, and by 18.1% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 0.7% month-on-month in October, adjusted for seasonality, and by about 17.6% year-on-year. The twelve-month rise in real estate prices therefore continues to ease, after peaking at nearly 24% in May. The number of purchase agreements registered nationwide declined by 6.4% year-on-year in the first ten months of 2017. The average time-to-sale for flats in the greater Reykjavík area was about 2.7 months in October, as compared with 1.8 months in October 2016.

The CPI declined by 0.16% month-on-month in November, and twelve-month inflation measured 1.7%. It had fallen by 0.2 percentage points between months. The CPI excluding the housing component had declined by 2.3% year-on-year, however. Most measures of underlying inflation suggested that it had risen in November and lay in the 0.7-2% range.

Reduced international airfares had the strongest effect in November, or about 0.2 percentage points. Reduced clothing and footwear prices also had a considerable impact, which is unusual in November. The clothing and footwear component has fallen nearly 9% between years. Offsetting this was an increase in the cost of owner-occupied housing in November, although the pace of the increase in this component has continued to ease in the recent term. Private services prices have fallen by 0.5% between years, and services inflation has subsided since the last meeting.

According to Gallup's winter survey, conducted in November and December, household inflation expectations were virtually unchanged since the autumn survey, at just under 3%, and their two-year expectations had fallen by 0.2 percentage points between surveys, to 3%. In a comparable survey among corporate executives, respondents expected inflation to measure 2.5% one year ahead and 3% two years ahead. Their expectations were broadly unchanged from the autumn survey. The breakeven inflation rate in the bond market has changed little since the MPC's November meeting, with the five-year breakeven rate measuring about 2.6% and the ten-year rate about 2.8%.

II The interest rate decision

The Governor updated the Committee on work beginning within the Bank on a review of all of the Bank's policy instruments.

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 unchanged between meetings. They also discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its November meeting to keep the Bank's key rate unchanged because most indicators implied that the output gap had peaked.

The MPC discussed the newly published national accounts, which assessed GDP growth for the first nine months of the year at 4.3%, more than previous figures had indicated. In the Committee's opinion, the national accounts suggested that GDP growth for the year as a whole would be stronger than was forecast in the November *Monetary Bulletin*. Members also agreed that the composition of GDP growth was less favourable than had been forecast in November, as export growth continued to ease, while domestic demand grew faster, owing in part to more fiscal slack in 2017 than had previously been expected.

The Committee agreed that the inflation outlook was broadly unchanged since the previous meeting, as headline inflation measured 1.7% in November and had fluctuated between 1½% and 2% for some time. Members considered it a positive sign that house price inflation had continued to ease, which, other things being equal, should contribute to lower inflation, although it would be offset by the waning effects of past appreciation of the króna. It was also pointed out that because GDP growth in Europe had firmed up, it was likely that imported deflation would be less than it had been in the recent term.

Committee members considered it positive that the foreign exchange market had been well balanced since the last MPC meeting. The exchange rate of the króna had been broadly stable, and exchange rate volatility had receded. Furthermore, recent measurements indicated that inflation expectations remained well in line with the target, and the Bank's real rate had been largely unchanged in recent months.

The Committee discussed whether to change interest rates or hold them unchanged. It was highlighted in the discussion that signs of diminishing demand pressures in the economy had been the main reason for the rate cut in October. National accounts figures now showed that domestic demand growth was stronger and the economy's adjustment to its long-term trend rate could prove more gradual than had been forecast in November. It was pointed out that new figures showed that H1 GDP growth had been more in line with the Bank's August forecast. It was noted as well that, as had often happened before, investment had been underestimated in the first national accounts release, and the latest figures indicated that it was growing rapidly. One of the reasons for the uptick in domestic demand was a sizable fiscal stimulus. It was therefore likely that year-2017 GDP growth would exceed previous forecasts. The view was expressed that the probability of a further reduction in interest rates had subsided. MPC members leaned towards keeping interest rates unchanged, but one member was of the view that there could even be grounds for a rate hike. The Committee agreed that it was appropriate to hold rates unchanged for the present and await further data.

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.

The committee agreed that the outlook was for continued strong demand pressures in the domestic economy, which called for a tight monetary stance. Members also agreed that, if fiscal policy in 2018 proved more accommodative than had been assumed in November, it would require a tighter monetary stance than would otherwise be needed. Committee members agreed that, in the coming term, the monetary stance 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 7 February 2018.