The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, December 2018

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that “[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee’s decisions and the premises upon which they are based.” In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of individual Committee members will be made public in the Bank’s *Annual Report*.

The following are the minutes of the MPC meeting held on 10 and 11 December 2018, during which the Committee discussed economic and financial market developments, the interest rate decision of 12 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 7 November 2018 interest rate decision.

Financial markets

Between meetings, the króna depreciated by 1.2% in trade-weighted terms. Over this same period it fell 1.6% against the euro, 1.8% against the US dollar, but appreciated by 1.5% against the pound sterling. The Central Bank intervened in the foreign exchange market once during this period, selling foreign currency in the amount of 6 million euros (0.8 b.kr.), or about 5% of total market turnover.

In terms of the Central Bank’s real rate, the monetary stance eased since the November meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank’s real rate was 0.8%, or 0.3 percentage points lower than just after the November meeting. In terms of twelve-month inflation, it was 1.2% and had fallen by 0.5 percentage points between meetings.

Interest rates in the interbank market for krónur rose in line with the Central Bank’s rate hike in November, but there was no turnover in the market during this period.

Yields on long-term nominal Treasury bonds had fallen by 0.2 percentage points since the November meeting, and yields on indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.1-0.2 percentage points. The average interest rate on pension funds' non-indexed fixed-rate loans to fund members had risen by slightly less than 0.1 percentage points since the November meeting, and the average rate on non-indexed fixed-rate mortgage loans had risen by just under 0.5 percentage points. Over the same period, the average rate on indexed fixed-rate mortgage loans had fallen slightly.

In terms of three-month interbank rates, the interest rate differential versus the euro area had widened by 0.2 percentage points between meetings, to 5.2 percentage points, but the spread versus the US was virtually unchanged at 2.1 percentage points. The long-term interest rate differential versus Germany was broadly unchanged between meetings, at 5.4 percentage points, whereas the spread versus the US had widened by 0.2 percentage points, to 2.7 percentage points.

Measures of the risk premium on the Treasury's foreign obligations had risen marginally since the MPC's November meeting. The CDS spread on the Treasury's five-year US dollar obligations was just over 0.6%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.6-0.8 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, declining oil prices, and uncertainty about the impact of legislative amendments lifting capital controls on holders of offshore krónur and changes in the implementation of the special reserve requirement on capital inflows.

After adjusting for deposits held by the failed financial institutions, annual growth in M3 picked up relative to the first half of the year, measuring nearly 10½% in October. As before, growth in M3 stemmed primarily from increased household deposits, although the financial and commercial sectors' 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 10% in October, but if the stock of foreign-denominated loans is held at constant exchange rates, it grew by just over 9%. Over the same period, household lending grew by just over 7% year-on-year and corporate lending by 14%, whereas the growth rate adjusted for exchange rate movements was 12%.

The Nasdaq OMXI8 index had fallen by 2.2% between meetings. Turnover in the main market totalled 459 b.kr. during the first eleven months of the year, about 23% less than over the same period in 2017.

Global economy and external trade

According to the Organisation for Economic Co-operation and Development's (OECD) November forecast, global output growth will remain relatively robust, although it has peaked and will taper off in the next few years. In many countries, unemployment is lower now than before the financial crisis and labour shortages have begun to surface, although inflation has been moderate. At the same time, however, growth in world trade and investment has slowed in the wake of rising protective tariffs, while many emerging economies have been beset by increased capital outflows and falling currency exchange rates. The OECD forecasts, that global output growth will measure 3.7% this year, or 0.1 percentage points less than was forecast in May, and then taper off to 3.5% in 2019, some 0.4 percentage points below the last forecast. The OECD forecast for 2018 GDP growth among Iceland's main trading partners has been revised downwards by 0.2 percentage points, to 2.1%. The forecast for 2019 has also been revised downwards, to 2.1%. According to that forecast, trading partners' GDP growth will be weaker in 2018 than was assumed in the Central Bank's November forecast of 2.2%. The OECD revised its inflation forecast for Iceland's trading partners upwards by 0.1 percentage points in both 2018 and 2019, to 2% and 2.1%, respectively.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 17.7 b.kr. deficit in November, as opposed to a deficit of 12.4 b.kr., at constant exchange rates, in November 2017. The deficit for the first eleven months of the year was 181.7 b.kr. in 2018, as compared with 174 b.kr. in 2017. Export values rose by 10.5% year-on-year at constant exchange rates, owing mainly to an increase in the value of marine products and industrial goods. At the same time, import values increased by 9.1%, due primarily to an increase in the value of imported fuels and lubricants and commodities and operational inputs. The import value of passenger cars has declined between years, however.

Listed global aluminium prices remained virtually unchanged between MPC meetings but were just over 2% lower than at the same time in 2017. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 4.9% year-on-year in the first ten months of 2018. Global oil prices rose year-on-year by slightly more than 40% in the first three quarters of 2018. They peaked at just over 86 US dollars per barrel in early October, nearly 30% higher than at the end of 2017 and a full 50% higher than in early October 2017. Since then, they have fallen once again, to about 60 US dollars per barrel by the time of the MPC's December meeting, or about a third below the early-October price. At the time of the December meeting, oil prices were about 9% below mid-December 2017 prices.

In terms of relative consumer prices, the real exchange rate fell by 4% month-on-month in November, and by 11.9% year-on-year. In November, it was 7% above its 25-year average but 16.9% below its June 2017 peak. In the first eleven months of 2018, it was down by 2.5% compared with the same period in 2017, as the nominal exchange rate of the króna was 3.1% lower and inflation in Iceland was about 0.6 percentage points above the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in December, GDP growth measured 2.6% in Q3/2018. Domestic demand grew 0.5% year-on-year during the quarter. Exports grew by 5.1% between years, while imports grew by only 0.6%; therefore, the contribution from net trade was positive. In the first three quarters of the year, GDP growth measured 5%, as domestic demand grew by 4.3% and the contribution from net trade was positive by nearly 1 percentage point. GDP growth in 2018 to date slightly exceeded the forecast in the November *Monetary Bulletin*, which provided for 4.3% growth in the first three quarters of the year. Private consumption growth was stronger than forecast, albeit offset by weaker growth in investment. Consumption and investment spending therefore turned out broadly in line with the November forecast. The contribution from inventory changes was more than had been forecast, however, and therefore, domestic demand as a whole grew more than had been forecast in November, or 4.3% instead of the projected 3.8%. In the first nine months of the year, exports grew slightly more than had been projected in November, whereas imports developed broadly in line with the forecast. As a result, the contribution from net trade was largely as expected.

The current account surplus was 76.5 b.kr. in Q3/2018, as opposed to a surplus of 65 b.kr. at the same time in 2017. The larger surplus now is due mainly to a larger surplus on services trade, although the deficit on goods trade was also smaller. In spite of this, the current account surplus for the first three quarters of the year was smaller than in the same period of 2017, owing primarily to a smaller surplus on services trade in the first half of the year.

Key indicators of developments in private consumption at the beginning of Q4 suggest that private consumption growth will ease during the quarter. The Gallup Consumer Confidence Index has fallen somewhat in recent months, to 75.8 points by November, more than 48 points below the value a year earlier.

According to the results of Gallup's winter survey, conducted in December among Iceland's 400 largest firms, respondents' assessment of the current economic situation was neither positive nor negative, and therefore somewhat weaker than in the surveys taken this autumn and a year ago. Executives were also more downbeat about the outlook six months ahead than they were this autumn and in the winter 2017 survey. About 46% of respondents considered the current situation neither good nor poor, and about 31% considered it good. About 68% of executives were of the view that economic conditions would deteriorate in the next six months, and 27% expected conditions to be neither good nor poor. About 5% of respondents expected conditions to improve in the next six months. The number of pessimistic executives has therefore grown markedly since the autumn survey, when about half of respondents expected conditions to worsen, and since last year's winter survey, when just under one-fourth were of that opinion. Executives' outlook on domestic demand was also much more negative than in the surveys taken this autumn and in winter 2017, whereas their expectations concerning foreign demand have been unchanged from the survey taken in May 2018. The most marked deterioration in expectations about domestic demand between the autumn and winter surveys was among executives in retail and wholesale trade.

According to the seasonally adjusted results of the winter survey, the share of respondents interested in laying off staff in the next six months exceeded the share interested in recruiting by 18 percentage points. This is a marked turnaround since the autumn, when firms interested in recruiting slightly outnumbered those planning to downsize. Sentiment was most negative in industry and manufacturing, where firms interested in laying off staff outnumbered those planning to recruit by 42 percentage points. The only sector planning to add on staff was miscellaneous specialised services, where the number of firms planning to recruit exceeded the number planning redundancies by 5 percentage points.

After adjusting for seasonality, 18% of executives considered themselves short-staffed, a slight decline since the last survey. The ratio was highest in industry and manufacturing, where nearly a fourth of executives considered themselves short-staffed, and it was lowest in transport, transit, and tourism, where 5% of executives reported difficulties in filling available jobs.

The share of executives who reported difficulty in responding to unexpected demand declined by 7 percentage points between surveys, to 41%. The strain on production factors was least in transport, transit, and tourism, where just under one-fifth of executives reported difficulty in responding to unexpected demand. About 58% of executives in miscellaneous specialised services were pessimistic about responding to unexpected demand, whereas in other sectors, the ratio lay in the 31-45% range.

The wage index rose by 0.4% month-on-month in October and by 6.2% year-on-year, and real wages were 3.2% higher during the month than at the same time in 2017.

Statistics Iceland's nationwide house price index, published in November, rose 0.5% month-on-month when adjusted for seasonality, and by 5.7% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.7% month-on-month in October, adjusted for seasonality, and by about 4.1% year-on-year. The twelve-month rise in real estate prices has therefore held steady at about 4% since August. The number of purchase agreements registered nationwide in the first ten months of the year increased by 7.6% year-on-year, and the average time-to-sale for flats in greater Reykjavík was 1.4 months in October, as opposed to 2.6 months a year earlier. Just over 800 flats were advertised for sale in greater Reykjavík in November, down from more than 1,500 in November 2017.

The CPI rose by 0.24% month-on-month in November. Twelve-month inflation measured 3.3% and had risen by 0.5 percentage points between MPC meetings. Inflation is at its highest in five years. The CPI excluding the housing component had risen by 2.4% year-on-year in November. The difference between inflation including and excluding housing continued to narrow and is now at its smallest in over five years. In terms of the median of various measures, underlying inflation was 3.3% in November, nearly 2 percentage points higher than in the same month of 2017.

The seasonal decline in international airfares made the strongest impact on the CPI in November. Petrol and telephone services prices also fell. On the other hand, imported goods prices raised the CPI by 0.3 percentage points, with the increase in new motor vehicle prices weighing heaviest.

According to Gallup's winter surveys of household and corporate inflation expectations, respondents' one-year expectations had risen by 0.5-1 percentage point from the autumn survey, to 4%. Their expectations five years ahead were unchanged between surveys, however, at 3-3.5%. The five- and ten-year breakeven inflation rate in the bond market was 3.9% just before the MPC meeting, after falling slightly since the November meeting.

II The interest rate decision

The Governor discussed 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. He emphasised that the arrangements would be structured so as to ensure equal treatment and to avoid discriminating among foreign investors in offshore krónur that had been released at various points in time. In addition, it would be necessary to ensure that complexity be minimised so as to facilitate efficient supervision. Therefore, those offshore króna holders that had not owned their króna assets continuously since before the capital controls were introduced and wished to invest in Icelandic bonds would have to exit through the foreign exchange market and then re-enter, subject to the special reserve requirement.

In this context, Committee members discussed the Central Bank's intervention in the foreign exchange market. They agreed that the resolution of such a legacy problem that was unrelated to current underlying economic conditions should not be allowed to lower the exchange rate of the króna; therefore, the Bank would intervene in the foreign exchange market, in line with previous statements. In this context, the Bank would also take into consideration that there were signs that the recent currency depreciation had pushed the real exchange rate below its equilibrium value. MPC members agreed that it was likely that the depreciation represented in part an undershooting stemming from greater pessimism in the market than was warranted, which in turn was driven by expectations of further depreciation, a reassessment of the position of the economy, and uncertainty about operating conditions in the tourism sector.

The Committee also discussed the Central Bank's forthcoming report to the Prime Minister concerning the Bank's position on the proposals presented by the task force on monetary policy pertaining to changes in working procedures of the MPC and the Bank more generally.

Members discussed whether the monetary stance was appropriate in view of the economic situation and outlook, as the Committee had decided in November to raise the Bank's interest rates because higher inflation and inflation expectations had lowered the Bank's real rate more than was desirable in view of then-current economic developments and prospects.

MPC members discussed the recently published preliminary national accounts figures, according to which GDP growth measured 5% for the first nine months of the year, slightly more than the Central Bank had assumed in its November forecast. The Committee agreed that the positive output gap had possibly been somewhat larger than expected, but that developments had been broadly in line with the Bank's forecast.

Members discussed developments in inflation, which had risen over the course of the year, in line with the Bank's forecast, measuring 3.3% in November. The main driver of the increase was the steep rise in import prices in recent months, as the króna had depreciated by over 11% year-to-date. MPC members noted that this currency depreciation and concerns about upcoming wage settlements had shown in expectations of a further rise in inflation, as households' and businesses' short-term inflation expectations had risen since the Committee's November meeting. The monetary stance as measured by the Central Bank's real rate had therefore eased again. It emerged in the discussion that the Bank's real rate was about where it had been before the November policy rate hike. In the Committee's opinion, this was offset by signs that the positive output gap would continue to narrow in the near term. It was also pointed out that the likelihood of adverse effects in Iceland of the United Kingdom's exit from the European Union had increased in the recent term, as a result of increased uncertainty about the post-Brexit situation. Members noted that the rise in inflation expectations since the last MPC meeting was still by and large limited to short-term expectations, and the depreciation of the króna had slowed. At the meeting, they also discussed the possibility of raising general reserve requirements in response to the recent surge in credit growth.

The Committee discussed awaiting further developments and keeping interest rates unchanged versus raising them by 0.25 percentage points. The main rationale for keeping rates unchanged was that the decline in the real rate between meetings was due primarily to the short-term impact of the depreciation of the króna on inflation and short-term inflation expectations. Although developments in the real economy and inflation had been largely as was anticipated at the last MPC meeting and the economic outlook was broadly unchanged, the inflation outlook was probably more favourable than at the previous meeting, as oil prices had fallen in the recent term. Furthermore, there might be grounds for a lower real rate than would otherwise be justifiable, as high-frequency indicators and sentiment surveys had suggested greater pessimism, indicating that demand could taper off more quickly than previously expected. It was also mentioned that the probability of strikes in the new year had increased, which could cause the domestic economy to cool more quickly.

The main rationale for a rate hike was the need for a larger increase than had been decided in November, in view of higher underlying inflation and rising inflation expectations. Moreover, the real rate had fallen once again and was now back to the level prior to the November rate increase. As a result, the monetary stance was too loose, given that domestic demand had been stronger than forecast in Q3 and inflation expectations were above target by all measures. It was also pointed out that the recent decline in real rates, while there was still a positive output gap, could partly explain the depreciation of the króna.

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%. Four members voted in favour of the Governor's proposal. One member voted against the Governor's proposal, voting instead to raise rates by 0.25 percentage points.

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 at target over the long term, and members agreed that if inflation expectations continued to rise and remained persistently at a level above the target, it would call for a tighter monetary stance. Other decisions, particularly those relating to the labour market and fiscal policy, would then 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 6 February 2019.