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

# Minutes of the Monetary Policy Committee meeting

## November 2019 (88th meeting)

## Published 20 November 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 November 2019, during which the Committee discussed economic and financial market developments, the interest rate decision of 6 November, and the communication of that decision.

## I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 2 October 2019 interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2019/4 on 6 November.

### Financial markets

Since the October meeting, the króna had depreciated by 1.7% in trade-weighted terms. Over this same period, it fell by 1.9% against the euro and 4.5% against the pound sterling but rose by 0.2% against the US dollar.

In terms of the Central Bank's real rate, the monetary stance had tightened slightly since just after the Committee's October interest rate decision. The Bank's real rate in terms of the average of various measures of inflation and one-year inflation expectations had risen by 0.2 percentage points between meetings, to 0.7%. In terms of twelve-month inflation, it was 0.4% and had risen by 0.2 percentage points.

Interest rates in the interbank market for krónur fell in line with the Central Bank's rate reduction in October, but there was no turnover in the market between meetings.

Yields on long-term nominal Treasury bonds had risen by 0.2 percentage points since the October meeting, but yields on long-term indexed Treasury and Housing Financing Fund (HFF) bonds had risen by 0.1 percentage points. Average rates on non-indexed mortgage loans had fallen slightly between meetings, whereas average rates on indexed mortgage loans were broadly unchanged.

In terms of three-month interbank rates, the interest rate differential versus the euro area had narrowed by 0.3 percentage points between meetings, to 4.3 percentage points, and the spread versus the US narrowed by 0.1 percentage points, to 2 percentage points. The long-term interest rate spread had narrowed slightly, to 3.8 percentage points versus Germany and 1.6 percentage points versus the US. Measures of the risk premium on the Treasury's foreign obligations were largely unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.8%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.5 percentage points.

Financial institutions' analysts expected the MPC either to lower the Bank's interest rates by 0.25 percentage points or to hold them unchanged. They noted that lower inflation and inflation expectations had created scope for interest rate cuts and that there were signs that a further slack was opening up in the economy. Their views diverged, however, on whether it was more appropriate to lower rates this time or wait until December, once inflation had fallen further.

According to the Central Bank's quarterly market expectations survey, conducted on 21-23 October 2019, respondents expected the Central Bank's key interest rate to remain unchanged at 3.25% in Q4/2019 and then fall to 3% in Q1/2020. They expected rates to remain at 3% one year ahead but then fall slightly after that. This is a change from the August survey, where they did not expect further rate cuts in 2020. A majority of respondents considered the monetary stance too tight at present, or 56%, as compared with 74% in the last survey. On the other hand, there was an increase in the number of respondents who consider the monetary stance appropriate. As in the previous survey, few respondents considered the monetary stance too loose, or 4%.

Annual growth in M3 was about 5½% in Q3, after adjusting for deposits held by the failed financial institutions. This is a weaker growth rate than in the past year. Although lending growth has eased in the recent term, the stock of credit system loans to domestic borrowers grew in nominal terms by an estimated 6½% year-on-year in Q3/2019, after adjusting for the effects of the Government's debt relief measures. Over the same period, household lending grew by just under 7% year-on-year and corporate lending by 5%.

The Nasdaq OMXI10 index had risen by 6.9% between meetings. Turnover in the main market totalled 447 b.kr. during the first nine months of the year, about 24% more than over the same period in 2018.

## Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in October, the global GDP growth outlook has deteriorated still further relative to the Fund's previous forecasts. Global GDP growth measured 3.6% in 2018, and the IMF expects it to shrink to 3% in 2019. This is 0.2 percentage points below the Fund's July forecast and 0.3 points below its April forecast. If this forecast materialises, global GDP growth will be the weakest since 2009. The deterioration in the outlook since the spring is due in particular to a poorer GDP growth outlook for some emerging market economies, but also for advanced economies. The IMF still expects global GDP growth to pick up in 2020, to 3.4%, which nevertheless is 0.2 percentage points below its spring 2019 forecast. The Fund continues to consider the uncertainty in the output growth forecast to be concentrated on the downside, especially because of the risk that global trade disputes will escalate further. It forecasts that world trade will grow by only 1.1% in 2019, instead of the previously projected 3.4%.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 17.5 b.kr. deficit in September, as opposed to a deficit of 15.4 b.kr., at constant exchange rates, in September 2018. The deficit for the first nine months of the year was 95.5 b.kr., as compared with 149 b.kr. for the same period in 2018. The smaller deficit now is due to the exportation of aircraft early in the year, although import values have also contracted by 9% in 2019 to date. The contraction in import values excluding ships and aircraft eased in September. In the past three months, import values have shrunk by 11% year-on-year. The main difference lies in reduced import values of fuels and lubricants, although the value of transport equipment, commodities, and operational inputs contracted as well. Export values were unchanged year-on-year in the first nine months of 2019. Excluding ships and aircraft, they contracted by 5% year-on-year, particularly manufacturing goods exports, while marine product export values were unchanged between years.

Between MPC meetings, the listed global price of aluminium rose by just over 6% but was just over 7% below the price seen at the beginning of November 2018. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up just over 8% year-on-year in the first nine months of 2019. The global price of oil had risen by 7% since the October meeting, to just under 63 US dollars per barrel at the time of the November meeting. Nevertheless, oil prices remain 14% lower than in November 2018.

The real exchange rate in terms of relative consumer prices rose by 0.4% month-on-month in September, when it was 9.2% above its 25-year average but 14.7% below its June 2017 peak. In the first nine months of 2019, it was down by 9.1% compared with the same period in 2018, as the nominal exchange rate of the króna was 10.5% lower and inflation in Iceland was 1.6 percentage points above the trading partner average.

**Domestic economy and inflation**

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 0.4% year-on-year in Q3/2019. The labour force also shrank by 0.4% year-on-year, but the average work week was about the same as in 2018. The seasonally adjusted labour participation rate was 80.9%, after falling by 0.4 percentage points between quarters. At the same time, the employment rate fell by a similar amount, 0.5 percentage points, to a seasonally adjusted 77.7%.

Seasonally adjusted unemployment fell by 0.1 percentage points between quarters, to 3.7%; however, it had risen by 0.6 percentage points since Q1, before WOW Air failed.

Figures from Registers Iceland on the number of foreign nationals living in Iceland suggest that the foreign labour force is still growing. In Q3, the foreign population increased by nearly 1,600 quarter-on-quarter, somewhat more than in the first two quarters of the year. Workers from temporary employment agencies and foreign services firms increased slightly in number, to just under 1,300, or 0.6% of the labour force, as of September. Issuance of new temporary work permits has continued to lose pace, however, with the number of new permits down by nearly 80 year-on-year in the first nine months of 2019.

The general wage index rose by 0.6% between quarters in Q3, and by 4.3% year-on-year. Real wages were 1.2% higher in Q3 than in the same quarter of 2018.

Leading indicators of developments in private consumption in Q3 suggest that the growth rate had eased relative to the first half of the year. New motor vehicle registrations declined less markedly in Q3, however, while growth in payment card turnover subsided more.

The Gallup Consumer Confidence Index measured 86.9 points in October, a decline of 12.3 points between months and of 5.2 points between years. All components of the index fell during the month, led by the assessment of the economic situation, which was down nearly 14 points. Apart from the assessment of the current situation, all components measured below 100 points, indicating that pessimistic respondents outnumber optimistic ones.

Statistics Iceland's nationwide house price index, published in late October, rose by 1.5% month-on-month when adjusted for seasonality, but rose 4.2% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.5% month-on-month in September when adjusted for seasonality, and by 3.5% year-on-year. The number of purchase agreements registered nationwide fell by 5.7% year-on-year in the first nine months of 2019, while the number of contracts for new construction declined by 3.5% over the same period.

The CPI rose by 0.36% month-on-month in October. Headline inflation measured 2.8% and had declined since the MPC's October meeting. The CPI excluding the housing component had risen by 2.6% year-on-year in October. Underlying inflation has been more persistent, however, at 3.4% in terms of the median of various measures. Rising house prices were the main driver of developments in the CPI in October. The "travel and transport" component also rose somewhat month-on-month, owing in particular to an increase in airfares and the price of new motor vehicles.

The interest component of imputed rent has lowered inflation recently, as real mortgage interest expense has fallen in response to Central Bank rate cuts. As a result, the CPI is estimated to be 0.2-0.3 percentage points lower than it would be otherwise.

According to the Central Bank survey conducted in late October, market agents' short-term inflation expectations are at target, and their one-year expectations have fallen significantly since the August survey. Their long-term inflation expectations remain at target and are down by ½ a percentage point since autumn 2018. The five- and ten-year breakeven inflation rate in the bond market is unchanged since the last MPC meeting, averaging 2.4% in Q4 to date. This is a full 1½ percentage points lower than it was in Q4/2018.

According to the forecast published in *Monetary Bulletin* on 6 November 2019, the inflation outlook has improved since the Bank's August forecast. Inflation was slightly below the August forecast in Q3 and is expected to fall even faster in Q4. It is projected to average 2.5% during the quarter, as opposed to the August forecast of 2.9%. The changed outlook is due primarily to a faster-than-projected decline in inflation this autumn, but in other respects, the inflation outlook for the rest of 2019 is largely unchanged. According to the forecast, inflation will be at target for most of the forecast horizon, although it will fall slightly below target in H2/2020 and remain below it into 2021. From mid-2020 onwards, the inflation outlook is therefore very similar to the August forecast.

The trade-weighted exchange rate index (TWI) has hovered around 180 points in the past year, after the króna had depreciated by over 10% in autumn 2018. In H2 to date, the króna has developed broadly as was projected in August. As a result, the exchange rate assumptions in the baseline forecast are similar to those in the August forecast. The TWI is projected to average about 181 points this year and about 182 points in the years to follow. Therefore, the adjustment of the exchange rate to recent external shocks has already come largely to the fore through a decline in the equilibrium real exchange rate (i.e., the real exchange rate consistent with internal and external balance in the economy) and a narrowing of the exchange rate differential with abroad.

Among Iceland's main trading partners, output growth averaged 2.3% in H1/2018 but had receded to 1.8% by Q4. The downward trend has continued in 2019 to date. Output growth among trading partners averaged 1.6% in Q2. GDP growth among Iceland's main trading partners is forecast to average 1.5% in 2019 and 2020, and about 1.6% in the years thereafter. Headline inflation among Iceland's trading partners is projected to average 1.5% in 2019, 0.1 percentage points below the August forecast, and is expected to be slightly lower in 2020 as well.

Terms of trade deteriorated by 3.6% in 2018, after improving substantially from 2014 well into 2017. They are forecast to deteriorate by 0.4% this year. This reflects offsetting factors: the positive impact of lower imported goods prices (i.e., alumina, oil, and other commodities) and higher marine product export prices, on the one hand, and the negative impact of lower aluminium prices and lower foreign currency prices of services exports, on the other. As in the August forecast, terms of trade are expected to improve by a total of 3% over the next three years.

The outlook is for exports to contract more in H2 than was forecast in August. The contraction in air transport is expected to be larger, albeit offset by a smaller contraction in tourists' spending while in Iceland. Furthermore, figures on net trade suggest that goods exports contracted strongly in Q3, driven largely by reduced aluminium exports in the wake of production problems in the domestic aluminium industry. In 2019 as a whole, combined goods and services exports are expected to contract by 5.8% year-on-year. As in the August forecast, they are expected to pick up slightly in 2020 and then grow by an average of 3% per year in 2021 and 2022.

According to preliminary figures from Statistics Iceland, GDP growth measured 0.9% in H1/2019, down from 3.2% in H2/2018 and 6.7% in H1/2018. Even though domestic demand contracted more in H1 than was assumed in the August forecast, GDP growth turned out 0.4 percentage points above that forecast, mainly because of a stronger-than-anticipated expenditure switch towards domestic goods and services. GDP is assumed to have contracted in Q3, owing largely to a sharp contraction in goods exports. According to the forecast, GDP is expected to contract by 1.2% in H2 and by 0.2% in 2019 as a whole, the same as in the August forecast. The output growth outlook for 2020 has been revised downwards, however, reflecting the bleaker outlook for growth in domestic demand, albeit offset by a more favourable contribution from net trade. GDP growth is projected to measure 1.6% in 2020 and align with long-term potential in 2021.

The outlook is for total hours worked to fall still further in Q4 and to be an average of 0.1% fewer in 2019 than in 2018. The employment rate is therefore expected to fall for the third year in a row. Although this will be mitigated by a declining labour participation rate, unemployment is set to continue rising, measuring 3.7% for the year as a whole, or 1 percentage point more than in 2018. Total hours worked are projected to pick up again in 2020, as is the employment rate; however, unemployment will keep rising during the year, measuring 3.8% for 2020 as a whole, before starting to ease once more. Wages have risen steeply in the recent term, and based on estimated productivity growth, unit labour costs are expected to rise by an average of just over 6% this year. This is a slightly smaller increase than was forecast in August, owing in part to more favourable developments in productivity. The outlook for the next three years is broadly unchanged, however, with unit labour costs forecast to rise by 4% per year.

Leading indicators imply that capacity utilisation has begun to improve again and that the contraction following the recent economic shocks will be relatively brief. The output gap that developed following the past several years' surge in output growth is estimated to have closed and a small slack to have opened up. The slack in output is expected to peak in mid-2020 and close by the end of the year.

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

However, the inflation outlook is less uncertain than it was in 2018, when the outcome of private sector wage negotiations was still entirely unknown. Added to this was increased uncertainty following the depreciation of the króna and the rise in inflation expectations in the autumn. Although uncertainty has diminished, it has not disappeared, as wage agreements for a large segment of the public sector work force are still pending. Furthermore, there is always uncertainty about wage drift and about the degree to which large pay rises for the lowest-paid workers will spread up the pay scale. Underlying inflationary pressures could therefore be underestimated, as the share of wages in domestic value creation has risen steeply in the recent term, cutting into firms' profit margins. Another major uncertainty concerns the exchange rate of the króna. The exchange rate assumptions in the baseline forecast could prove overly optimistic; for instance, if the setbacks in the tourism industry prove more long-lasting, or if terms of trade deteriorate further. Furthermore, the impact of recent export sector shocks on potential output could be underestimated and the slack in the economy therefore smaller than is assumed in the baseline forecast. Moreover, inflation expectations may be less firmly anchored to the target than is currently assumed.

Neither can the possibility be excluded that inflation will turn out lower than is assumed in the baseline forecast. The króna could appreciate further, for instance, if external conditions improve. The global economic outlook could prove to be overestimated, and exports and GDP growth could therefore turn out weaker than is currently forecast. Inflation could therefore subside faster if the króna does not lose ground. Furthermore, it could take longer than currently expected to resolve the supply problems in the airline sector, and the forecast for the recovery of tourism could prove too optimistic. The productivity growth forecast could also be too pessimistic, and the slack in the economy could turn out deeper and more persistent than is currently projected.

## II The interest rate decision

MPC members discussed the monetary stance in view of economic developments and the fact that the Bank's real rate had risen marginally since the October meeting. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at the October meeting to lower interest rates because of the increased risk that the GDP growth outlook was too optimistic. This was due in particular to the poorer economic outlook abroad, the outlook for domestic inflation to align with the target sooner than previously expected, and the continued decline in inflation expectations.

The MPC discussed economic developments and prospects and, in this context, took into consideration the new macroeconomic forecast as published in *Monetary Bulletin* on 6 November, which stated that the GDP growth outlook for H2/2019 had deteriorated relative to the August forecast. It emerged, however, that GDP growth in H1 had exceeded the forecast, and a contraction of 0.2% was therefore expected for the year as a whole, as had been projected in August. Committee members agreed that the outlook for 2020 had also deteriorated, as the Bank's baseline forecast assumed that GDP growth for the year would measure 1.6%. The MPC discussed the importance of a rebound in investment in the coming term, noting that one of the risks was that such a rebound would not occur. It emerged in the discussion that the Bank's interest rate cuts should stimulate investment and demand in the coming term. It was also noted that if the Bank's interest rates had not been lowered, and all else being equal, the outlook would have been for investment to grow by a full 1½ percentage points less in 2020-2021, according to the Bank's macroeconomic model. GDP growth would also have been nearly 1 percentage point lower in each of the two years.

MPC members discussed developments in inflation, which had been at or above 3% since the spring but had eased to 2.8% in October. They noted, however, that underlying inflation had been more persistent, measuring 3.4% in October, according to the median of various measures. Headline inflation was expected to subside faster than was forecast in August and align with the target towards the end of this year. Committee members welcomed the fact that inflation expectations had continued to fall and were at target by most measures. They noted that the monetary stance had therefore tightened slightly between MPC meetings.

They discussed how the Bank's rate cuts since the spring had been transmitted to private sector interest rates. Rates had been cut by 1.25 percentage points since spring, and the impact on the real economy had yet to come fully to the fore. According to the Bank's data, the rate cuts had for the most part been transmitted effectively to long-term market rates and to rates offered to borrowers, yet access to credit had tightened, particularly access to corporate loans. Members were of the view that lower interest rates had supported demand, and based on the Bank's baseline forecast, the current interest rate level should suffice to ensure medium-term price stability and full capacity utilisation. They also discussed the Bank's new assessment of its neutral real rate, which indicated that the neutral real rate had fallen in the past decade and was now around 2%. It emerged that the rate cuts since the spring would therefore support demand now, when economic activity had slowed. MPC members also agreed that the forthcoming fiscal easing would pull in the same direction by boosting disposable income and stimulating demand. It was pointed out, however, that the economic outlook could be overly optimistic, particularly in view of global economic uncertainty.

The Committee discussed two possibilities: keeping interest rates unchanged or lowering them by 0.25 percentage points. The main reason to keep rates unchanged was that underlying inflation had fallen more slowly and was somewhat above target. Easing the fiscal stance meant that less monetary easing would be needed than would otherwise be required; furthermore, interest rates were well below the estimated neutral real rate. There were several signs that the cycle could be turning and that the contraction could therefore prove relatively short-lived. In addition, according to the baseline forecast, the slack in the economy was relatively small even though GDP growth had slowed markedly, as significant strains on capacity had built up after several years of strong output growth. It could therefore be appropriate to wait and see what impact the measures already in place would have.

The main rationale for lowering interest rates still further was that the GDP growth outlook had deteriorated and pessimism had increased. Headline inflation was expected to subside faster than was forecast in August and fall temporarily below target during the forecast horizon. Inflation expectations had also continued to fall, and the Bank's real rate had therefore risen slightly between meetings. In view of the uncertainty at hand, it could be appropriate to lower rates further in order to reduce the risk of a stronger economic contraction.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 3%, the current account rate 2.75%, the seven-day collateralised lending rate 3.75%, and the overnight lending rate 4.75%. All Committee members voted in favour of the proposal.

In the MPC's view, near-term monetary policy decisions would depend on the interaction between developments in economic activity, on the one hand, and inflation and inflation expectations, on the other.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair 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 11 December 2019.