The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

February 2020 (90th meeting)

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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 are also included in the minutes.

The following are the minutes of the MPC meeting held on 3 and 4 February 2020, during which the Committee discussed economic and financial market developments, the interest rate decision of 5 February, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 11 December 2019 interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2020/1 on 5 February.

Financial markets

Since the December meeting, the króna had depreciated by 2.2% in trade-weighted terms. Over this same period it fell 2.3% against the euro, 2.5% against the US dollar, and 1.3% against the pound sterling.

In terms of the Central Bank's real rate, the monetary stance had tightened since the MPC's December meeting. The Bank's real rate in terms of the average of various measures of inflation and one-year inflation expectations had risen by just under 0.3 percentage points between meetings, to 0.7%. In terms of twelve-month inflation, it was 1.3% and had risen by 1 percentage point between meetings.

Interest rates in the interbank market for krónur were broadly unchanged since the December meeting, and there was no turnover in the market between meetings. Yields on long-term nominal Treasury bonds had fallen by 0.7 percentage points since the December meeting, and yields on long-term indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.2 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 with abroad was largely unchanged between meetings, at 4.1 percentage points against the euro and 1.9 percentage points against the US dollar. The long-term interest rate spread versus Germany had narrowed by 0.5 percentage points, however, to 3.6 percentage points, and the spread versus the US had narrowed by 0.4 percentage points, to 1.6 percentage points. Measures of the risk premium on the Treasury's foreign obligations had fallen marginally 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 0.4-0.6 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, noting that inflation had fallen more than previously anticipated and was now below the Bank's target, that inflation expectations had subsided, and that the monetary stance had therefore tightened between meetings. They also assumed that the Bank's new forecast would provide for a slower economic recovery than the November forecast had. Among the main arguments in favour of unchanged interest rates were signs of stronger-than-expected private consumption and increased uncertainty in the labour market.

Year-on-year growth in broad money (M3) was just over 4% in Q4, 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 4½% year-on-year in Q4/2019, 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 slightly over ½%, somewhat less than in recent quarters.

The Nasdaq OMXI10 index had fallen by 3.3% between meetings. Turnover in the Main Market totalled 603 b.kr. in 2019 as a whole, nearly 23% more than in 2018.

Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in mid-January, the global GDP growth outlook has deteriorated slightly relative to the Fund's October forecast. Global output growth in 2019 is estimated at 2.9%, and the forecast for 2020 is 3.3%, which is 0.1 percentage points below the Fund's October forecast. The bleaker outlook is due for the most part to poorer prospects for some emerging market economies, India in particular. In spite of this, the IMF is of the view that uncertainty about the global economic outlook has receded since October and the risk of a further softening of GDP growth has eased. Uncertainty is still considerable, however, and remains concentrated on the downside.

Iceland's goods trade deficit totalled 10.7 b.kr. in December, about the same as in December 2018, at constant exchange rates. The deficit for 2019 as a whole amounted to 108 b.kr., some 78 b.kr. less than in 2018. The smaller deficit in 2019 was due partly to the exportation of aircraft early that year, although import values also contracted by 10.6%. The contraction in import values excluding ships and aircraft grew stronger in December. Import values have contracted by 19.8% year-on-year in the past three months, the largest contraction thus measured since

2009. All subcategories of imports contracted, with the strongest contraction in the import value of commodities, operational inputs, and petrol, although the import value of automobiles and consumer goods also declined. Export values contracted by 1.7% year-on-year in 2019. Excluding ships and aircraft, export values contracted by 5.4% between years, particularly as a result of reduced industrial product values. Marine product export values were flat between years, however, while agricultural goods export values rose 40%, largely due to aquaculture products.

Between MPC meetings, the listed global price of aluminium fell just over 5% and was 12.5% below the price seen at the beginning of February 2019. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 7.9% year-on-year in 2019. Global oil prices had fallen by 16% since the December meeting, due to expectations of reduced demand following the outbreak of a new virus in China. At the time of the February meeting, the price of oil was down nearly 14% between years, to 54 US dollars per barrel.

The real exchange rate in terms of relative consumer prices rose by 0.6% month-on-month in December, when it was 10.5% above its 25-year average but 13.7% below its June 2017 peak. It fell by 6.7% year-on-year in 2019, as the nominal exchange rate of the króna fell by 7.9%, while inflation in Iceland was 1.4 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 1.2% year-on-year in Q4/2019. The rise in total hours is due to a 0.4% increase in the number of employed persons and a 0.8% lengthening of the average work week. Data from the pay-as-you-earn (PAYE) register give a different impression, however. According to PAYE data, job numbers began to decline between years in Q2/2019 and, by October, were down 1.8% year-on-year. According to seasonally adjusted LFS figures, the labour participation rate rose and the employment rate increased marginally between Q3 and Q4/2019. In 2019 as a whole, the participation rate fell by 0.6 percentage points year-on-year, however, and the employment rate fell by 1.3 percentage points over the same period.

Seasonally adjusted unemployment was unchanged between quarters, measuring 3.8% in Q4/2019. Registered unemployment rose by 0.4 percentage points over the same period, however, to a seasonally adjusted 4.1%. For 2019 as a whole, unemployment measured 3.6% on both scales, rising somewhat year-on-year in the wake of the shocks that struck the economy. It rose by 0.8 percentage points according to the LFS and 1.2 percentage points according to the unemployment register.

In Q4/2019, year-on-year population growth measured 2%, including 1.4 percentage points due to immigration of foreign nationals. Growth in the foreign population is therefore still close to the level in the first half of 2017, the year that saw the largest single-year increase recorded to date. The number of active employees of employment agencies and foreign services firms has fallen, however. There were almost 950 such workers at the end of 2019, or about 300 fewer than at the end of Q3. This group is now at its smallest since mid-2016.

The general wage index rose by 0.3% month-on-month in December but had risen by 4.5% year-on-year, and real wages were 2.4% higher during the month than at the same time in 2018. The index rose by 4.9% between annual averages in 2019, and real wages grew by 1.8%.

Key indicators of private consumption in Q4/2019 suggest that it firmed up after a period of weaker growth in the previous year. For example, payment card turnover picked up during the quarter, and the decline in new motor vehicle registrations lost pace. The Gallup Consumer Confidence Index rose in January, to 94.9 points, after falling in the previous month. The index was also slightly higher year-on-year.

Statistics Iceland's nationwide house price index, published in late January, rose by 0.2% month-on-month when adjusted for seasonality, but rose 4% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.3% month-on-month in December, when adjusted for seasonality, and by 2.3% year-on-year. The number of purchase agreements registered nationwide fell by 3.4% year-on-year in 2019, while the number of contracts for new construction increased by 7.2% over the same period.

The consumer price index (CPI) rose by 0.11% month-on-month in December, lowering twelve-month inflation to 2%. Inflation continued to fall in January, when the CPI declined by 0.74% month-on-month, bringing the inflation rate to 1.7%, or 1 percentage point lower than at the time of the MPC's last meeting. This recent plunge in inflation was due in part to base effects, as inflation rose steeply a year ago. The CPI excluding the housing component had risen by 1.6% year-on-year in January. Underlying inflation had fallen more slowly, measuring 2.5% in January, according to the average of various measures.

The interest component of imputed rent has lowered inflation recently, as real mortgage interest expense has fallen in response to Central Bank rate cuts. Because of this, twelve-month inflation was an estimated 0.4 percentage points lower in January than it would have been otherwise.

Winter sales and lower owner-occupied housing costs were the main factors in the January price measurements. Owner-occupied housing costs have risen by 1.6% in the past twelve months. Various other subcomponents also declined in January, including airfares, health-related items, new motor vehicles, and telephone and internet services.

The Bank's most recent market expectations survey, conducted in January, suggests that, as in the October survey, market agents expect inflation to be at target in both one and two years' time. Market agents' long-term inflation expectations are also still at target. The breakeven inflation rate in the bond market has fallen in recent months, however. The five- and ten-year breakeven rate has averaged 2.1% in Q1 to date, or 0.3 percentage points lower than in Q4/2019.

According to the forecast published in *Monetary Bulletin* on 5 February 2020, the outlook is for somewhat lower inflation than was projected in November, owing to a more pronounced and persistent slack in the economy, as well as a more favourable initial position. Inflation is projected at 1.9% in H1/2020, some 0.5 percentage points less than in the previous forecast. It is expected to pick up again early in 2021 and measure 2.1% over the year as a whole, which is similar to the last forecast. It will therefore be below the target during the forecast horizon but then inch up to it towards the end of the period.

The global GDP growth outlook is broadly unchanged from the forecast in the November *Monetary Bulletin,* owing to the offsetting effects of growing concerns about the impact of the spread of a new virus originating in China versus the positive impact of the recent agreement reached by the US and China in partial resolution of their trade dispute. Terms of trade for goods and services are estimated to have deteriorated slightly more in 2019 than was forecast in November, owing mainly to a larger-than-expected increase in imported goods prices. The exchange rate of the króna was relatively stable in 2019, after having fallen in autumn 2018. In Q4/2019, it was about 0.5% lower than had been assumed in the November forecast. The Bank's baseline forecast assumes that the exchange rate index will average just under 183 points this year and that the króna will depreciate slightly in 2021. It is projected to be about 1½% weaker than in the November forecast by the end of the forecast horizon.

GDP growth slowed markedly in 2019, measuring only 0.2% for the first three quarters of the year. It outpaced the November forecast, however, which assumed a 0.1% contraction. Because of this, together with signs of stronger growth in private consumption and more favourable external trade in Q4, the GDP growth outlook for the year as a whole has improved since November. GDP is now projected to have grown by 0.6% in 2019 instead of contracting by 0.2%. The GDP growth outlook for 2020 and 2021 has deteriorated, however, owing to a poorer outlook for exports and the rise in corporate credit spreads in late 2019, which has led to a downward revision of the forecast for business investment. Year-2020 GDP growth is expected to measure only 0.8%, compared to 1.6% in the November forecast. Growth is expected to pick up in 2021, measuring about 2.5% in the next two years, somewhat below the November forecast.

Because of base effects and delays in public sector wage agreements, wages rose slightly less in 2019 than was projected in November. The wage agreements are now expected to be finalised before the end of Q1/2020, and this year's pay rises are therefore projected to be larger than was assumed in November. Productivity growth is expected to weaken this year and unit labour costs to rise more than was projected in November, or 5.4% instead of 4%. In 2021 and 2022, however, wage costs are expected to rise less than in the November forecast, or an average of 3¾% per year instead of 4%.

Unemployment has risen markedly in the past twelve months and is expected to rise further through this year, averaging just over 4% in 2020 and 2021. It will therefore be higher and take longer to subside than was projected in November. Thus the outlook is for the slack in the economy to persist longer than previously anticipated.

II The interest rate decision

The Governor discussed the new Act on the Central Bank of Iceland that entered into force at the turn of the year, noting that the new Deputy Governor for Financial Stability would begin work in March and would take a seat on the Monetary Policy Committee at that time.

MPC members discussed the monetary stance in view of economic developments and the fact that the Bank's real rate had risen slightly since the December meeting. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as they had decided in December to keep interest rates unchanged because the inflation outlook and the monetary stance had been broadly unchanged between meetings.

The Committee discussed economic developments and prospects as outlined in the Bank's new macroeconomic forecast, published in *Monetary Bulletin* on 5 February. According to the forecast, leading indicators suggested that GDP growth had been somewhat stronger in 2019 than previously assumed, while the outlook for 2020 and 2021 had deteriorated. It was noted that according to the baseline forecast, year-2020 GDP growth was expected to measure only 0.8%, as compared to 1.6% in the November forecast. Committee members agreed that the poorer outlook was due primarily to headwinds facing the export sector and tighter financing conditions for domestic firms. It emerged in the discussion that the repercussions of the shocks that had struck the tourism, aluminium, and fishing sectors would apparently be both more severe and more persistent than previously anticipated. Although global economic uncertainty had receded since November, there were growing concerns about the impact of the spread of the new coronavirus originating in China.

The MPC discussed developments in inflation, which had declined rapidly over the course of 2019 and had aligned with the target in Q4. It continued to fall in January, measuring 1.7%, the lowest observed inflation rate since autumn 2017. Members noted as well that underlying inflation had also fallen and was now at target, as were most measures of inflation expectations. They mentioned that according to the Bank's new forecast, inflation would be lower than was projected in November and below the target for most of the forecast horizon, and they agreed that this was because the slack in the economy was expected to be more persistent than had been previously assumed. The MPC considered it positive that inflation expectations were at target by most measures.

Committee members observed that the monetary stance as measured in terms of the Bank's real rate had tightened somewhat since the last meeting. The Committee discussed in particular the causes of the rise in credit spreads on the commercial banks' new corporate loans, agreeing that the increase had tightened the monetary stance still further. It emerged in the discussion that the widening of credit spreads reflected, among other things, a revaluation by financial institutions of loan pricing and credit risk in the wake of recent changes in their operating environment and reductions in their profitability. At the same time, growth in credit system lending had continued to ease, particularly corporate lending, which could be attributed in part to changes in the supply of corporate loans due to the aforementioned factors, plus the changed economic situation. As a result, there was the possibility that expected returns on firms' activities could now be lower than before, owing to declining demand. The MPC considered it likely that credit spreads would have widened even if the Bank's key rate had not been lowered in the recent past, but that the policy rate cuts had mitigated the impact of the wider credit spreads on companies.

The Committee discussed two possibilities: keeping interest rates unchanged or lowering them by 0.25 percentage points. The main argument in favour of keeping interest rates unchanged was that despite the deterioration of the economic outlook, domestic costs were high, partly because of the past few years' steep wage rises, which had weakened export companies' competitiveness. The economic adjustment would therefore have to take place increasingly through the real economy, with cost-cutting and higher unemployment. A policy rate reduction in and of itself would not solve the cost problems in the economy; instead, a decline in the real exchange rate, among other things, would be needed. Under these conditions, the current interest rate should suffice to ensure medium-term price stability and full capacity utilisation, provided that domestic costs declined in the coming term. The domestic economy had been stronger than expected in 2019, and the slack was still relatively small. Furthermore, the outlook was for unit labour costs to rise somewhat in excess of the inflation target over the forecast horizon, and wage agreements with some public employees were still pending. Labour market unrest had also increased recently.

The main arguments in favour of lowering interest rates further were that the economic outlook had deteriorated and inflation looked set to be lower in coming years than had previously been assumed. Moreover, inflation was projected to be somewhat below the target for most of the forecast horizon. Because the monetary stance had tightened and firms' financial conditions had deteriorated, it was appropriate to ease the monetary stance. The fact that inflation expectations were at target by most measures enabled monetary policy to use the scope available to it.

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 2.75%, the current account rate 2.5%, the seven-day collateralised lending rate 3.5%, and the overnight lending rate 4.5%. Ásgeir Jónsson, Rannveig Sigurdardóttir, and Katrín Ólafsdóttir voted in favour of the proposal. Gylfi Zoëga voted against the Governor's proposal, preferring to keep interest rates unchanged.

The MPC was of the view that because inflation expectations were anchored to the target more firmly than before, monetary policy had had the scope to respond to the deteriorating economic outlook. The task of monetary policy was to secure medium-term price stability, but also to use the scope that it had to support a normal level of capacity utilisation.

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 for Monetary Policy

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

The Chief Economist was in attendance for the entire meeting. 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 18 March 2020.