The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, May 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 14 and 15 May 2018, during which the Committee discussed economic and financial market developments, the interest rate decision of 16 May, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 14 March 2018 interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2018/2 on 16 May.

Financial markets

Between meetings, the króna depreciated by 0.3% in trade-weighted terms. Over this same period it fell 0.4% against the pound sterling and 3% against the US dollar, but rose by 0.4% against the euro. The Central Bank conducted no transactions in the interbank foreign exchange market between meetings.

In terms of the Central Bank’s real rate, the monetary stance was broadly the same as at the time of the MPC’s March meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank’s real rate was 1.5%, as it was in March. In terms of twelve-month inflation, it was 1.9%.

Interest rates in the interbank market for krónur declined slightly between meetings, but there was no turnover in the market during that period.

When the Committee met in May, yields on nominal Treasury bonds were up to 0.1 percentage points higher than at the time of the March meeting. Yields on long-term indexed Treasury and Housing Financing Fund bonds were broadly unchanged, while yields on shorter indexed bonds had risen by 0.3-0.4 percentage points. Furthermore, financial institutions' deposit and lending rates had developed broadly in line with Central Bank rates between meetings.

The short-term interest rate differential vis-à-vis the US had narrowed by 0.2 percentage points since the March meeting, to 2.3 percentage points, whereas the differential versus the euro area was virtually unchanged at 5 percentage points. The long-term interest rate differential versus the US had also narrowed slightly between meetings, to 2.2 percentage points, but the spread versus Germany was unchanged at 4.7 percentage points.

Measures of the risk premium on the Treasury's foreign obligations were largely unchanged since the MPC's March meeting. The CDS spread on the Treasury's five-year US dollar obligations was just under 0.7%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.5-0.6 percentage points.

Financial institutions' analysts had all projected that the Bank's interest rates would be held unchanged in May, noting that little had changed since the MPC's last interest rate decision and that inflation had developed in line with expectations.

According to the Central Bank's quarterly survey of market agents' expectations, carried out in early May, respondents expected the Bank's key interest rate to be held unchanged at 4.25% for the next two years, as they did in the last survey, taken in January. At the time the survey was conducted, 81% of respondents considered the monetary stance appropriate, as compared with 68% in the last survey. About 19% of respondents considered it too tight, whereas no one considered it too loose.

Annual growth in M3 measured 6.2% in Q1/2018, after adjusting for deposits held by the failed financial institutions. This is weaker than in the three previous quarters. As in the recent past, the growth in money holdings is due primarily to an increase in household deposits, which grew by 10.3% year-on-year in Q1. The annual growth rate has averaged just under 10% since Q3/2016.

Growth in lending to resident entities has also increased. After adjusting for the effects of the Government's debt relief measures, the stock of credit system loans to resident borrowers grew by 6.9% year-on-year, the fastest pace in a decade. In Q1/2018, corporate lending increased by 9.7% year-on-year in nominal terms, and household lending by 5.7%.

The Nasdaq OMXI8 index had fallen by 1.9% between meetings. Turnover in the main market totalled around 187 b.kr. during the first four months of the year, nearly one-fourth less than over the same period in 2017.

Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in April, the short-term economic outlook gives cause for increased optimism, yet some uncertainty remains, particularly as regards the long-term outlook. As in recent years, the Fund considers the global GDP growth risk profile to be tilted to the downside. Global output growth is expected to gain momentum, measuring 3.9% this year and next year. For both years, the GDP growth outlook has improved by 0.2 percentage points since the IMF's October forecast, with the improvement concentrated more in advanced economies than elsewhere.

The tax cuts in the US early this year are an important factor, as they explain about half of the GDP growth revision. Among Iceland's main trading partners, GDP growth is forecast to increase by 0.4 percentage points, to 2.5%. In both advanced and emerging economies, inflation is expected to be higher during the forecast horizon than was forecast in October. Year-2018 inflation is projected at 2% for Iceland's trading partners, as it was in October.

Iceland's external goods trade generated a deficit of 43.3 b.kr. for the first four months of the year, as opposed to a deficit of 45.5 b.kr. at constant exchange rates over the same period in 2017. Export values rose by 22% year-on-year at constant exchange rates, while import values rose 16%. Marine product export values increased by 34% year-on-year, owing to base effects from the fishermen's strike in early 2017, which caused a sharp contraction in goods exports. The year-on-year increase in imports in 2018 to date is due in particular to 56% growth in fuel imports, in addition to a 20% rise in the import value of transport equipment, ships and aircraft in particular. On the other hand, the surge in passenger car imports has eased.

The listed global market price of aluminium had risen by 11% between MPC meetings, and the average price in April was up 16% year-on-year. According to preliminary figures from Statistics Iceland, foreign currency prices of marine products rose between months in March, and the year-on-year rise in Q1 measured 3.1%. Oil prices have risen steadily since mid-2017, with the twelve-month increase measuring 22% in Q1/2018. Prices have fluctuated somewhat in the recent past, owing partly to increased geopolitical tension. In mid-May, the price of oil had risen to 77 US dollars per barrel, the highest since year-end 2014.

The real exchange rate in terms of relative consumer prices rose by 0.3% month-on-month in April, when it was about 24% above its twenty-five year average but 4% below its June 2017 peak. In the first four months of 2018, it was about 1% higher than over the same period in 2017, due to the 0.6% nominal appreciation of the króna and to the fact that inflation in Iceland was 0.4 percentage points above the trading partner average.

The domestic real economy and inflation

According to a parliamentary resolution on the fiscal strategy and fiscal plan for the next five years, which was presented before Parliament in December and early April, the fiscal stance for the period will ease more this year than was assumed in the Bank's February forecast. The primary Treasury surplus is expected to shrink this year, after adjusting for one-off items. After adjusting for the business cycle position, the fiscal stance is expected to tighten by 0.3% of GDP, which is 0.5 percentage points less than was forecast in February. As in February, the fiscal stance is expected to ease again in 2019, owing to the planned personal income tax and payroll tax cuts and the substantial increase in investment spending, which are estimated to lead to fiscal easing in the amount of 0.6% of GDP. Significant expenditure growth will also lead to some easing in 2020, albeit less than in 2019, or 0.3% of GDP. If this materialises, the fiscal stance will ease by a total of 0.9% of GDP over the next two years. This is about the same amount as was forecast in February, even though it is no longer assumed that the upper value-added tax bracket will be lowered.

According to the Statistics Iceland labour force survey (LFS), total hours worked increased in Q1 by 2.3% year-on-year, broadly in line with the average since the labour market recovery began. The rise in total hours reflected a 1.6% increase in the number of employed persons and a 0.7% increase in the length of the average work week. The seasonally adjusted labour participation rate measured 82% during the quarter, slightly below the previous quarter's figure but close to the long-term average. Similarly, the employment rate was unchanged between quarters, at 79.8%, and was 1 percentage point above its long-term average.

Seasonally adjusted unemployment measured 2.6% in Q1, broadly the same as in Q1/2017 but 0.5 percentage points less than in Q4/2017.

The labour supply is still increasing as foreign workers continue to arrive in Iceland. Net migration of foreign nationals aged 20-59 was positive by 0.8% of the population in Q1. Employees of temporary employment agencies and foreign services companies accounted for 1% of the working population during the quarter, or 0.3 percentage points more than in Q1/2017.

The wage index rose by 1% between quarters in Q1, and by 7.2% year-on-year, and real wages were 4.6% higher in Q1/2018 than in the same quarter of 2017.

Key indicators of developments in private consumption in Q1 suggest that growth was similar to that in H2/2017. Payment card turnover increased by just over 10½% year-on-year during the quarter, although the rise in new motor vehicle registrations has eased, probably due in part to car rental agencies.

The Gallup Consumer Confidence Index measured 116.4 in April. It was broadly unchanged between months but somewhat lower than in April 2017. The assessment of the current situation and the labour market declined somewhat month-on-month, whereas the assessment of the economy and expectations six months ahead rose slightly.

Statistics Iceland's nationwide house price index, published in late April, declined 0.2% month-on-month when adjusted for seasonality, but rose 10.1% year-on-year. The capital area house price index, calculated by Registers Iceland, fell by 0.2% month-on-month in March when adjusted for seasonality but rose by 7.7% between years. The twelve-month rise in real estate prices therefore continues to ease, after peaking at nearly 24% in May 2017. The number of purchase agreements registered nationwide in the first three months of the year fell by 9% year-on-year, and the average time-to-sale for flats in greater Reykjavík was 2.6 months in March, as opposed to 1.2 months a year earlier. About 1,600 flats were advertised for sale in greater Reykjavík in April, up from just over 800 in April 2017.

The consumer price index (CPI) rose by 0.56% in March, and twelve-month inflation measured 2.8%. The CPI then rose by 0.04% month-on-month in April, however, bringing headline inflation back down to 2.3%, the same as at the time of the MPC's March meeting. The CPI excluding the housing component had declined by 0.2% year-on-year, however. Underlying inflation was 2.3% in April, as was headline inflation, and was broadly unchanged from the time of the last MPC meeting, although it was 0.8 percentage points higher than in April 2017.

Developments in the CPI in April were driven mainly by rising petrol prices. The cost of owner-occupied housing declined between months, owing mainly to a decline in house prices in regional Iceland, which was somewhat unexpected in the wake of marked price increases in Q1.

Market agents' short- and long-term inflation expectations have been broadly unchanged in recent months. According to the Central Bank survey carried out in early May, market agents expect inflation to measure 2.6% in one year and (on average) over the next five and ten years. Market agents' long-term inflation expectations therefore appear broadly in line with the target. The breakeven inflation rate in the bond market was largely unchanged since the

MPC's March meeting, and the ten-year rate has measured 3.3% in Q2 to date. It is 1 percentage point higher than it was a year ago, however.

According to the forecast published in *Monetary Bulletin* on 16 May 2018, the inflation outlook is broadly unchanged from the Bank's February forecast. Inflation measured 2.5% in Q1/2018, after rising by 0.6 percentage points from the previous quarter. Underlying inflation has risen as well and, like headline inflation, is close to the Bank's inflation target. Inflation is expected to rise over the course of the year, measuring 2.9% in Q4, and then taper off again in 2019 and hover around the target for the remainder of the forecast horizon. This is similar to the assumptions in February, reflecting the expectation of a higher exchange rate well into 2019 versus a larger increase in wage costs and a slightly wider output gap early in the forecast horizon.

The króna has appreciated by 1½% versus the average of other currencies since the February *Monetary Bulletin* and has been a full 1% higher in Q2 to date than was assumed in February. According to the Central Bank's baseline forecast, the króna is expected to appreciate slightly more this year and be about 1½% above the 2017 average. As in February, it is assumed to continue strengthening next year, and the exchange rate path is therefore broadly unchanged. The rise in the equilibrium real exchange rate is considered to have played a major role in the recent appreciation of the króna; however, the real exchange rate is now estimated to be close to its equilibrium level.

Global GDP growth gained further momentum last year. It measured 3.8% in 2017, and among Iceland's main trading partners it was 2.4%, the strongest since 2010. This recovery has benefited the Icelandic economy, boosting exports strongly last year and further improving terms of trade. Last year's improvement in external conditions was slower, however, than in 2015-2016. In spite of the recent surge in aluminium prices, the outlook is for terms of trade for goods and services to deteriorate by 0.4% this year, after four years of uninterrupted improvement. The most important factor is a 20% rise in oil prices this year and an increase of nearly 6% in other commodities prices.

Growth in services exports slowed markedly in 2017, after booming in the years beforehand. Developments in tourism are the main factor in this trend, although growth in the sector has eased after the enormous growth of the recent past. As before, export growth is expected to ease during the forecast horizon, in line with a rising real exchange rate. Growth in tourism is expected to keep subsiding, although the slowdown will be offset by increased marine product exports, which are projected to grow by 4% this year, after shrinking by a similar amount last year and by a total of more than 16% over the past four years.

According to preliminary figures from Statistics Iceland, output growth measured 3.6% in 2017, which was well in line with the forecast in the February *Monetary Bulletin*. The GDP growth outlook for 2018 and the following two years is also largely unchanged. Growth is projected to measure 3.3% this year, close to last year's level, and then subside further in the next two years, approaching its long-term potential of just under 3%. This will be driven by weaker growth in exports and in private sector consumption and investment spending, but offset by increased public sector activity. Even though domestic demand growth will ease as well, it appears set to continue outpacing GDP growth, further narrowing the current account surplus.

Total hours worked are estimated to have increased by 2.2% this year and the employment rate to have declined marginally since 2017. As in the February forecast, it is assumed that total hours will rise more slowly in the coming two years, in line with slower GDP growth.

Unemployment is projected to remain broadly the same, on average, this year as in 2017, or 2.9%, and then inch upwards gradually to 3½%, the level considered consistent with price stability.

Wage costs seem to have risen more in 2017 than was assumed in the Bank's February forecast. This revision of last year's twelve-month wage increases also affects the measured twelve-month increase for this year. In addition, wage drift has been stronger year-to-date than was assumed in February. Estimates of productivity growth are broadly unchanged, however, and unit labour costs therefore appear to have risen more in 2017 than was projected in February. The increase is projected at 5.2% in 2017 and 6.7% in 2018. As in February, it is assumed that this rise in unit labour costs will ease over the next two years and converge with the inflation target by the end of the forecast horizon.

As in the Bank's February forecast, the output gap is considered to have peaked at year-end 2016. Revised GDP figures for the past few years increase the end-2016 output gap by ⅓ of a percentage point relative to the February forecast, however. Furthermore, the outlook for this year and next year is for a slightly wider gap, which will almost close in 2020, as was projected in February.

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 developments in the external environment of the Icelandic economy, as well as assessments of the effectiveness of specific markets and on the transmission of monetary policy to the real economy. All of these factors are subject to uncertainty. Changes in key assumptions could lead to developments different from those provided for in the baseline forecast.

Inflation could turn out higher than in the Bank's baseline forecast. The most important uncertainty centres on near-term developments in wages. Although wage settlements were not terminated in February 2018, the underlying dissatisfaction with wages and income distribution remains, and this could lead to larger pay rises than the baseline forecast assumes, particularly given the current low unemployment and palpable tension in the labour market. Wage drift could also be underestimated. Various other factors could cause inflation to rise more during the forecast period than is provided for in the baseline example. For example, global inflation could rise faster and the króna could weaken more than is currently expected, house price inflation could prove more persistent, and demand pressures in the domestic economy could be underestimated, especially if the fiscal stance eases more than is anticipated. The strength of the recently achieved anchoring of inflation expectations will be of considerable importance in determining the impact of these factors on inflation.

Neither can the possibility be excluded that inflation will turn out lower than is assumed in the baseline forecast. The króna could appreciate more strongly than forecast – if external conditions prove more favourable, for instance. Weaker global GDP growth and lower global oil and commodity prices could further impede domestic economic activity and reduce import prices. In addition, house price inflation could subside faster than is currently forecast. The baseline forecast could also underestimate growth in productivity and potential output, thereby resulting in an underestimation of the speed at which the output gap narrows.

II The interest rate decision

Committee members discussed the Bank's most recent *Financial Stability* report. Also discussed were financial institutions' position and risks to the financial system. For some time, the Bank has been reviewing its policy instruments, including the general reserve requirement on deposit institutions' deposits with the Central Bank. The Committee discussed the status and upcoming steps of that work. The status of the review of the framework for the special reserve requirement (SRR) on capital inflows to Iceland was discussed as well. In this context, the MPC discussed the potential impact of the SRR on the transmission of monetary policy to other interest rates, a topic analysed in a Box in *Monetary Bulletin* 2018/2.

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 discussed whether the monetary stance was appropriate in view of the inflation outlook, as they had decided in March to keep interest rates unchanged because the inflation outlook had been broadly unchanged between meetings.

In this context, the MPC took account of the Central Bank's new macroeconomic forecast, published in the May issue of *Monetary Bulletin*, which states that the outlook is for GDP growth to ease slightly between 2017 and 2018. Members noted that, according to the forecast, weaker export growth combined with a less rapid increase in domestic demand would be offset by increased public sector activity, and that GDP growth would be broadly in line with the Bank's February forecast. They noted as well that, as in February, the Bank's new forecast assumed that GDP growth would continue easing, as the Committee had intended with a tight monetary stance. They expressed concern, however, about the expected fiscal easing. Although GDP growth had slowed, there was not yet a need for stimulative public measures, as there was still a sizeable output gap. It was also mentioned that, although there were clear indications that GDP was easing, year-2017 activity could turn out stronger than currently estimated. For instance, based on historical experience, it was possible that investment in 2017 was underestimated.

The MPC discussed developments in inflation, which had been broadly in line with the Bank's 2½% inflation target in recent months. Although inflation had risen above the target in March, the Bank's forecast indicated that it would hover around the target over the forecast horizon. Members noted as well that underlying inflation was in the same range. As the Committee had expected, the year-on-year rise in house prices had eased, and the opposing effects of previous appreciation of the króna on inflation had diminished. The Committee was of the view that this trend would continue in the near term. Members also noted that the exchange rate of the króna had been broadly stable since the last MPC meeting, and the foreign exchange market had remained well balanced. The Committee's assessment was that neither the inflation outlook nor inflation expectations had changed to any marked degree since its last meeting. Nevertheless, the increase in inflation expectations by some measures gave cause for caution. Members agreed that developments in inflation would depend in large part on how well the anchor held in the near future.

Given that there had been no major changes since the Bank's last forecast, none of the MPC members saw reason to change interest rates at present. There was some discussion, however, of the uncertainties in the forecast. MPC members agreed that the greatest uncertainty centred on developments in the labour market during coming winter. The outcome of wage agreements could lead to considerably larger pay rises than were consistent with price stability. It was pointed out that attitudes in the labour market differed, however, and that some emphasised ensuring real wages. Furthermore, weaker GDP growth and higher unemployment could ease wage pressures. It was also pointed out that the adjustment of the economy could prove more rapid if, for instance, tourist numbers declined faster than was assumed in the forecast. A sharp contraction in tourism could either cause inflation to be higher than in the forecast or cause it to turn out lower. A downturn in the number of tourists visiting Iceland could cause the króna to weaken, leading to higher inflation, but reduced tourist demand for housing could also lower house prices, thereby causing lower inflation than was assumed in the forecast. In this context, it was also noted that the supply of flats under construction had increased, and although the impact of increased supply on house prices would not show immediately, it could begin to show as the year progressed. It was pointed out, that weaker export growth — and even a slight contraction — was unlikely to lead to undue pressures in the foreign exchange market and the financial system, as the current account was in surplus and exchange rate-linked lending to unhedged borrowers limited. Therefore, the adjustment of the exchange rate could contribute more fully to an appropriate adjustment of the economy to changed external conditions.

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.

In the Committee’s opinion, the outlook is for the positive output gap to narrow. Members agreed that nevertheless, a tight monetary stance would still be needed in order to contain rapid demand growth. Although the short-term risk of unsustainable wage increases had receded, members agreed that there were still underlying pressures in the labour market.

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 13 June 2018.