The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, June 2018

Published 27 June 2018

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

The following are the minutes of the MPC meeting held on 11 and 12 June 2018, during which the Committee discussed economic and financial market developments, the interest rate decision of 13 June, 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 16 May 2018 interest rate decision.

Financial markets

Between meetings, the króna depreciated by 2.4% in trade-weighted terms. Over this same period it fell 3.1% against the US dollar, and by 2% against both the euro and the pound sterling. The Central Bank conducted no transactions in the interbank foreign exchange market between meetings.

In terms of the Central Bank's real interest rate, the monetary stance was broadly the same as at the time of the MPC's May 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 May. In terms of twelve-month inflation, it was 2.2%.

Interest rates in the interbank market for krónur were virtually unchanged between meetings, and there was no turnover in the market during that period.

Yields on most non-indexed Treasury bonds had fallen somewhat since the May meeting, whereas yields on indexed Treasury and Housing Financing Fund (HFF) bonds had risen slightly. Interest rates on one of the three large commercial banks' non-indexed mortgage loans had risen between meetings, but the commercial banks' deposit rates were unchanged.

Average interest rates on pension funds' loans to members were broadly unchanged since the MPC's May meeting.

The short-term interest rate differential versus the US and the euro area was virtually unchanged between meetings, at 2.3 and 5 percentage points, respectively. The long-term interest rate differential versus the US and Germany was also virtually unchanged at 2.3 and 4.8 percentage points, respectively.

Measures of the risk premium on the Treasury's foreign obligations were largely unchanged since the MPC's May 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 projected that the Bank's interest rates would be held unchanged in June, noting, among other things, that recently published figures from Statistics Iceland showed stronger GDP growth in Q1/2018 than the Bank had forecast in May and the situation in the labour market was broadly unchanged, as was the fiscal stance.

Annual growth in M3 measured 5.2% in April, after adjusting for deposits held by the failed financial institutions. This is stronger than in March but about 1 percentage point weaker than in Q1/2018. As in the recent past, the growth in money holdings is due primarily to an increase in household deposits. After adjusting for the effects of the Government's debt relief measures, the stock of credit system loans to domestic borrowers grew in nominal terms by 7.4% year-on-year in April and by 6.9% in Q1/2018. Credit system lending to households increased in April by 6.4% year-on-year, or 0.7 percentage points more than in Q1 and just over 1 percentage point more than in Q4/2017. In April, corporate lending increased by 10.2% year-on-year in nominal terms, up from 9.7% growth in Q1.

The Nasdaq OMXI8 index had fallen by 0.5% between meetings. Turnover in the main market totalled around 228.4 b.kr. during the first five months of the year, about 28% less than over the same period in 2017.

Global economy and external trade

According to the forecast published by the Organisation for Economic Co-operation and Development (OECD) in May, global GDP growth will be somewhat stronger in 2018 and 2019 than in the OECD's November forecast. Growth is expected to increase from 3.7% in 2017 to 3.8% this year. For 2019, the OECD projects global output growth at 3.9%, some 0.3 percentage points more than in the November forecast, mainly due to the improved GDP growth outlook in the US. The outlook for world trade in 2018-2019 has also improved. For Iceland's main trading partners, the OECD forecasts somewhat stronger GDP growth than before in 2018 and 2019. It projects trading partner growth at 2.3% this year, followed by a slight decline in 2019, to 2.2%, which is nevertheless 0.2 percentage points more than was assumed in the November forecast. Inflation among Iceland's trading partners is forecast at 1.9% this year and 2% next year, or 0.1 percentage points more in both years than was forecast in November.

Iceland's external goods trade generated a deficit of 59 b.kr. for the first five months of the year, as opposed to a deficit of 71 b.kr. over the same period in 2017, at constant exchange rates. Export values rose by 16% year-on-year at constant exchange rates, while import values rose 8%. Marine product export values increased by one-fourth year-on-year, owing to base effects from the fishermen's strike in early 2017, which caused a sharp contraction in goods exports. Excluding ships and aircraft, the rapid growth in import values has eased significantly. Over the past three months, the twelve-month growth rate has been at its slowest since 2013, measuring 1.5%. The main difference is weaker growth in the import value of commodities and operational inputs, although the value of investment goods and passenger cars has also contracted year-on-year in the past three months.

Listed global aluminium prices remained virtually unchanged between MPC meetings but were just over one-fifth higher than at the same time in 2017. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products rose between months in April and were up 5.5% year-on-year in the first four months of 2018. Global oil prices were 76 US dollars per barrel just before the MPC meeting. They had declined slightly between meetings but were up by 58% year-on-year.

The real exchange rate in terms of relative consumer prices fell by 1.7% month-on-month in May, when it was nearly 22% above its twenty-five year average but 5.7% below its June 2017 peak. In the first five months of 2018, it was virtually unchanged compared with the same period in 2017, although the nominal exchange rate of the króna was 0.5% lower and inflation in Iceland was about 0.4 percentage points above the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in June, annual GDP growth measured 6.6% in Q1/2018. Domestic demand grew by 6.8% year-on-year during the quarter, as consumption and investment grew by 6.4%. Exports grew by 10.2%, but imports grew slightly more, or by 10.9%, and the contribution of net trade to GDP growth was therefore negative during the quarter.

GDP growth in Q1/2018 was 0.7 percentage points stronger than had been forecast in the May *Monetary Bulletin*. The deviation was due mainly to stronger-than-expected investment (residential investment in particular), public consumption, and effects of inventory changes. On the other hand, private consumption growth and the contribution from net trade were weaker than expected.

The current account balance was positive by 0.3 b.kr. in Q1, a smaller surplus than in the same quarter of 2017, when it measured 5.7 b.kr. The smaller surplus than over the same period in 2017 is due to a smaller surplus on services trade, albeit offset by more favourable goods trade, particularly because of increased marine product export revenues. The deficit on the balance on primary and secondary income grew slightly, particularly because of a smaller surplus on the wage item, which consists of wages earned by Icelanders abroad net of foreigners' wages in Iceland.

Key indicators of tourism exports suggest that growth will be weaker than was forecast in the May *Monetary Bulletin*. In the first five months of the year, foreign tourist arrivals have increased by 6% year-on-year, but ISAVIA's passenger forecast, published in late May, assumes an 8% year-on-year decline over the summer months. This is a significant change from the company's previous passenger forecast, which assumed an increase of 4%. For 2018 as a whole, ISAVIA projects a 2.6% increase year-on-year, whereas in November 2017 it projected a rise of nearly 11%.

Private consumption growth eased in Q1 relative to H2/2017. Key indicators for Q2 to date imply that household demand will continue to lose pace, although it is still relatively strong.

The Gallup Consumer Confidence Index has also fallen in recent months and, in the first two months of the quarter, was somewhat lower than over the same period in 2017.

According to the results of Gallup's summer survey, conducted in May among Iceland's 400 largest firms, respondents' assessment of the current economic situation was relatively positive, albeit less so than in the surveys taken this spring and in May 2017. Executives were also more downbeat about the outlook six months ahead than they were in the spring and in 2017. About 60% of respondents considered the current situation good, and about 28% considered it neither good nor poor. Just under 7% of executives were of the view that economic conditions would improve in the next six months, and just under 54% expected conditions to remain good. About 40% of respondents expected conditions to be worse in six months' time, somewhat more than in February and in May 2017. Executives' assessment of domestic and foreign demand was also more negative than in the surveys taken this spring and a year ago. Executives in retail and wholesale trade were less optimistic about developments in domestic demand than they were a year ago, but more optimistic than in the spring survey.

According to the survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by about 6 percentage points, after adjusting for seasonality. This is 11 percentage points less than in the spring survey and 17 percentage points less than in the survey from a year ago, and it is close to the long-term average. Executives in construction and miscellaneous specialised services were most optimistic, with firms interested in recruiting staff in the next six months outnumbering those planning redundancies by about one-fourth. As before, sentiment was most negative in the fishing industry, where firms interested in laying off staff outnumbered those planning to recruit by 29 percentage points. In other sectors, the share of companies planning recruitment net of those planning layoffs varied greatly, from being positive by 17 percentage points to being negative by 12 percentage points.

After adjusting for seasonality, about one-fourth of executives considered themselves short-staffed, about 8 percentage points less than in the spring survey and 14 percentage points less than in the survey from a year ago. The shortage of workers was greatest in the construction industry, where nearly half of executives considered themselves understaffed, whereas there was virtually no measured shortage in the financial and insurance sector.

About 43% of executives reported that they would have difficulty responding to unexpected demand, after adjusting for seasonality. This was about 9 percentage points less than in the spring survey and 12 percentage points less than in the summer 2017 survey. Just over 74% of construction industry executives reported that they would have difficulty responding to unexpected demand, as opposed to one-fourth of executives in transport, transit, and tourism.

The wage index rose by 0.3% month-on-month in April and by 7.3% year-on-year. Real wages were 4.9% higher than at the same time in 2017.

Statistics Iceland's nationwide house price index, published in late May, declined 0.3% month-on-month when adjusted for seasonality, but rose 7% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.1% month-on-month in April when adjusted for seasonality, but rose by 5.4% between years. The twelve-month rise in real estate prices has therefore continued to ease, after peaking in the greater Reykjavík area at nearly 24% in May 2017. The number of purchase agreements registered nationwide in the first four months of the year fell by 1% year-on-year, and the average time-to-sale for flats in greater

Reykjavík was 2.5 months in April, as opposed to 1.7 months a year earlier. Almost 1,600 flats were advertised for sale in greater Reykjavík in May, up from just over 1,000 in May 2017.

The consumer price index fell by 0.09% month-on-month in May. Twelve-month inflation measured 2% and had fallen by 0.3 percentage points since the MPC's last meeting. The CPI excluding housing had risen by 0.2% since May 2017 — the first positive inflation measurement by this criterion in two years. The median value of various measures of underlying inflation was 2.5% in May, an increase of 0.2 percentage points since April.

The decline in international airfares made the strongest impact on the CPI in May. The cost of owner-occupied housing also declined between months, for the second month in a row. The twelve-month rise in the housing component has eased significantly, to 6.3% in May.

Short-term inflation expectations have risen in recent months. According to Gallup's summer survey, household inflation expectations one year ahead measured 3.4%, or 0.4 percentage points more than in the spring survey. Households' two-year inflation expectations rose by a similar amount, to 4%. According to Gallup's summer survey of corporate inflation expectations, respondents' expectations one year ahead were unchanged at 3%, whereas their expectations two years ahead had risen by 0.5 percentage points between surveys, to 3.5%.

In this survey, executives were asked for the first time about long-term inflation expectations. Respondents indicated that they expect inflation to average 3% over the next five years. The five- and ten-year breakeven inflation rate in the bond market measured 2.9-3.2% just before the MPC meeting. It had fallen slightly since the May meeting but measured somewhat higher than at the turn of the year.

II The interest rate decision

The Deputy Governor updated the Committee on the status of the review of the framework for the special reserve requirement (SRR) on capital inflows to Iceland. The Committee also discussed the market response to the MPC's decision on 4 June to change the arrangements for credit institutions' general reserve requirement. The reserve requirement is to be divided into two parts: a 1% non-remunerated reserve requirement and a 1% reserve requirement of the type that had been in place heretofore. The changes are not intended to affect the monetary stance but to offset the cost borne by the Central Bank in implementing monetary policy while the international reserves are large and the interest rate differential with abroad remains wide. The Committee was of the opinion that this change had not affected either market developments or the monetary stance.

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 May to keep interest rates unchanged, mainly because the Bank's new forecast was broadly in line with the February forecast.

They discussed the preliminary national accounts figures recently published by Statistics Iceland, which showed that GDP growth in Q1/2018 was well above the growth rate in H2/2017. It was also slightly higher than the Bank projected in May. In Committee members' opinion, however, overall developments were broadly in line with the Bank's May forecast and reflected base effects from 2017 for the most part. The MPC still expected GDP growth to ease this year, with weaker export growth and a less rapid increase in domestic demand. The

Committee was of the opinion that developments in house prices and indicators from the labour market also pointed in the same direction.

The MPC also took account of developments in inflation, which had fallen to 2% in May, while both headline and underlying inflation had been close to the Bank's 2½% inflation target in the months beforehand. The year-on-year rise in house prices had continued to ease, and the opposing effects of previous appreciation of the króna had diminished. MPC members agreed that this trend would probably continue in the near term.

The króna had depreciated slightly since the last MPC meeting, but the foreign exchange market had remained well balanced. Members were of the opinion that, on the whole, inflation expectations appeared consistent with the target.

No members saw any reason to change interest rates at present. Only a short time had passed since the previous meeting, and the information published in the interim largely supported the Committee's previous assessment of the economy and the appropriate monetary stance.

It emerged in the discussion that, although Q1/2018 output growth appeared stronger than had been forecast, indicators from the labour market and the tourism industry suggested that the adjustment of the economy could prove more rapid than had previously been assumed. In addition, inflation had subsided more than had been forecast. The deviations were small, however, and did not give cause for a formal response; instead, it was appropriate to await further developments.

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 light of rapid demand growth and 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 29 August 2018.