The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, March 2018

Published: 28 March 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 12 and 13 March 2018, during which the Committee discussed economic and financial market developments, the interest rate decision of 14 March, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 7 February 2018 interest rate decision.

Financial markets

Between meetings, the króna appreciated by 1.5% in trade-weighted terms. Over this same period it appreciated by 1.5% against the euro, 1.4% against the pound sterling, and 1% against the US dollar. 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 February meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 1.5%, or 0.1 percentage points lower than in February. In terms of twelve-month inflation, it was 1.9%.

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

When the Committee met in March, yields on nominal Treasury bonds were similar to those seen at the time of the February meeting. Yields on long-term indexed Treasury and Housing

Financing Fund bonds were also largely unchanged, while yields on shorter indexed bonds had fallen by 0.2 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 0.3 percentage points since the February meeting, to 2.5 percentage points, whereas the differential versus the euro area was virtually unchanged at 5 percentage points. The long-term interest rate differential vis-à-vis both economies was also virtually unchanged between meetings, at 2.4 percentage points and 4.7 percentage points, respectively.

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

Financial institutions' analysts had all projected that the Bank's interest rates would be held unchanged in February, noting that little had changed since the MPC's last interest rate decision and that the newly published national accounts had been in line with the Bank's February forecast.

M3 adjusted for the deposits of the failed financial institutions grew by 6.3% year-on-year in January, below the growth rate in the three preceding quarters. Household deposits continued to increase rapidly, while growth in corporate and financial sector deposits had slowed.

The stock of credit system loans grew by 6.3% year-on-year in nominal terms in January, after adjusting for the Government's debt reduction measures. Corporate lending increased by 8.7% year-on-year in nominal terms, while household lending grew by 5.5% year-on-year, about the same as in Q4/2017.

The Nasdaq OMXI8 index had risen by 3.5% between meetings. Turnover in the main market totalled 109 b.kr. during the first two months of the year, 19% less than over the same period in 2017.

Global economy and external trade

Iceland's external goods trade generated a deficit of 10.9 b.kr. for the first two months of the year, as opposed to a deficit of 20.6 b.kr. over the same period in 2017. Export values rose by 39% year-on-year at constant exchange rates, while import values rose 19%. The substantial increase in export values reflects the fishermen's strike in 2017, as marine product export values rose by 67% year-on-year in the first two months of 2018. Import growth in 2018 to date is mainly attributable to a 94% increase in imports of fuels and lubricants. All components of imports show robust year-on-year growth, apart from transport equipment imports, whose value had contracted by 9% between years.

The listed global market price of aluminium had fallen by nearly 5% between meetings, but the average February price was up 18% year-on-year. However, foreign currency prices of marine products, according to the marine product price index calculated by Statistics Iceland, rose by 1% between months in January, and by 2.6% between years. Oil prices had fallen by nearly 4% between meetings.

In terms of relative consumer prices, the real exchange rate rose 1.3% month-on-month in February and had risen by 3.4% from the September 2017 trough. In February, it was 21.5%

above its 25-year average but 6% below its June 2017 peak. In the first two months of 2018, it was 0.9% higher than over the same period in 2017, due to the 0.7% nominal appreciation of the króna and to the fact that inflation in Iceland was 0.2 percentage points above the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, GDP growth measured 1.5% in Q4/2017 and 2.5% in H2/2017. Domestic demand grew by 4.4% year-on-year during the quarter, as consumption and investment grew by 4.8%. After an unusually strong Q3, the contribution from inventory changes was negative in Q4/2017. Exports grew by 7½%, but imports grew considerably more, or by 15.4%, and the contribution of net trade to GDP growth was therefore negative.

GDP growth measured 3.6% in 2017, reflecting the offsetting effects of 6.8% growth in domestic demand and the negative contribution from net trade. GDP growth was driven mainly by private consumption and services exports, and was in line with the Bank's February forecast of 3.4%. While services exports grew more strongly than expected, the contribution from inventory changes was weaker, and the two items more or less offset one another. Consumption and investment grew broadly in line with the Bank's forecast.

The current account balance was positive by 93 b.kr., or 3.7% of GDP, in 2017. The surplus on goods and services trade was smaller in 2017 than in 2016, and the balance on primary and secondary income was considerably weaker, as developments in the primary income balance were extremely favourable in 2016. The forecast in the February *Monetary Bulletin* assumed that the current account surplus would amount to 3.5% of GDP in 2017. The larger-than-expected surplus was due to stronger-than-projected services exports in Q4.

Key indicators of developments in private consumption in Q1 to date suggest that household demand is still growing strongly, although it may ease from the level seen in the recent term. Leading indicators, such as retail executives' expectations concerning domestic demand, are somewhat weaker than in the previous quarter. The Gallup Consumer Confidence Index has also fallen in recent months.

According to the results of Gallup's spring survey, conducted in February among Iceland's 400 largest firms, respondents' attitudes towards the current economic situation were very positive. Their attitudes towards the six-month outlook were more pessimistic than in the winter survey, however, but about the same as in the autumn survey. About 70% of executives considered the current situation good, and about one-fourth considered it neither good nor poor. Just under 8% of executives were of the view that economic conditions would improve in the next six months, and just under 62% expected conditions to remain good. About 30% of respondents expected conditions to be worse in six months' time, somewhat more than in December and in February 2017. Survey participants' views on domestic demand were not significantly more negative than in the winter survey but were much more negative than in the survey conducted a year ago.

According to the survey, a smaller number of firms expect their profit margins to decline in the near future, and about half of firms expect their margins to be broadly unchanged from 2017. Attitudes towards the operational outlook were more positive than in the autumn survey, particularly among executives in transport, transit, tourism, and fishing companies. Over half of executives expected their firms' investment level to be about the same this year as in 2017. The share who expected investment to increase this year was largest among executives in transport, transit, and tourism, at 35%.

According to the survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by 17 percentage points, adjusted for seasonality. This is similar to the share measured in the winter survey but lower than in the survey taken a year ago. Sentiment continued to be most positive in transport, transit, and tourism, where firms planning to recruit outnumbered those planning redundancies by about 24 percentage points, whereas sentiment was most negative in the fishing industry, where firms interested in downsizing outnumbered those planning to recruit by about 10 percentage points. In other sectors, firms interested in recruiting exceeded the share interested in downsizing by 13-23 percentage points.

As in the winter survey, a third of executives considered themselves understaffed, after adjusting for seasonality, whereas the same ratio was 6½ percentage points higher in the survey taken a year ago. About 47% of manufacturing executives considered themselves short-staffed. The shortage of workers was least pronounced in the financial and insurance sector, where 8% of executives considered themselves understaffed. In other sectors, the same ratio ranged between 27% and 36%.

After adjusting for seasonality, 52% of respondents were of the view that their firms would have difficulty responding to unexpected demand, broadly unchanged from the winter survey. Nearly 70% of executives in the fishing industry considered themselves likely to have difficulty responding to unexpected demand, as were just over a third of executives in the financial and insurance sector. In other sectors, the ratio lay in the 40-60% range.

The wage index rose by 0.4% month-on-month in January and by 7.3% year-on-year. Real wages rose by 4.8% from the previous year.

According to preliminary figures from Statistics Iceland, wages and related expenses totalled 64.8% of gross factor income in 2017, about 3½ percentage points above the 20-year average. The ratio rose by 3.8 percentage points between years, somewhat more than was assumed in the Bank's February forecast.

Statistics Iceland's nationwide house price index, published in February, rose 0.5% month-on-month when adjusted for seasonality and by 13.4% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.7% month-on-month in January, when adjusted for seasonality, and by 12.8% between years. The twelve-month rise in house prices has slowed markedly after peaking at nearly 24% in May 2017. The number of purchase agreements registered nationwide fell by 6.6% year-on-year in January, when around 1,500 flats were advertised for sale, as opposed to around 800 in January 2017. The average time-to-sale for capital area housing was 2.4 months in January, more than a month longer than during the same period in 2017.

The CPI rose by 0.6% month-on-month in February. Twelve-month inflation measured 2.3% and had fallen by 0.1 percentage points since the February meeting. The CPI excluding the housing component had declined by 0.9% since February 2017. Most measures of underlying inflation suggested that it had declined in February and lay in the 1¼-2½% range.

The main drivers of the increase in the CPI in February were end-of-sale effects and rising house prices. Private services prices fell by 0.2% between months, primarily because of a reduction in international airfares, but have risen by 0.7% between years.

According to Gallup's spring survey, households' inflation expectations one year ahead measured 3% and were virtually unchanged from the winter survey, but their two-year expectations had risen by 0.5 percentage points between surveys, to 3.5%. In this survey, the first to include a question on households' long-term inflation expectations, respondents indicated that they expect inflation to average 3.5% over the next five years. According to Gallup's spring survey among executives, one-year inflation expectations had risen by ½ a percentage point from the previous survey, to 3%. The five- and ten-year breakeven inflation rate in the bond market has averaged 2.9-3.2% in Q1/2018 to date and is therefore broadly unchanged since the February meeting.

II The interest rate decision

The Governor updated the Committee on his recent meeting with Government ministers and the social partners. The Deputy Governor then reported to the Committee on the status of work on the review of the statutory and technical foundations for the capital flow management measure.

Committee members agreed that because the interest rate differential with abroad was still sizeable, it was advisable to keep the special reserve requirement (SRR) unchanged for the time being. Members agreed that the SRR had shifted monetary policy transmission more to the interest rate channel and that, without it, domestic interest rates would be lower, which was not desirable given the demand pressures in the economy. Available data indicated that the Bank's interest rate reductions had been transmitted normally to households and businesses, in terms of either lending rates or market rates. MPC members were also of the view that without the SRR, the exchange rate of the króna would be higher, which was not desirable, as the real exchange rate was very high in historical context and, if it rose much further, would exacerbate the risk of instability. Members agreed that conditions for modifying the SRR could develop in the coming term, if forecasts materialise.

The MPC discussed the monetary stance in view of the most recent information on the economy and the marginal decline in the Bank's real rate between meetings. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as they had decided in February to keep interest rates unchanged because the inflation outlook had been broadly unchanged between meetings.

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. Members noted that, according to newly published national accounts figures, the economic outlook had changed little since the Bank's last forecast, and year-2017 GDP growth had been well in line with that forecast.

They discussed developments in inflation, which had measured 2.3% in February, down from 2.4% in January. Underlying inflation had also declined slightly. This was in line with the last forecast. The year-on-year rise in house prices had continue to ease, and the effects of previous appreciation of the króna had diminished. In the MPC's view, the inflation outlook was broadly unchanged. Although the króna had appreciated between meetings, members agreed that the gap between domestic price developments and external factors would probably continue to grow narrower in the near future. The MPC considered it positive that the foreign exchange market had remained well balanced.

Members noted that inflation expectations appeared to have risen marginally. They considered it premature to draw the conclusion that inflation expectations had become less firmly anchored to the Bank's inflation target, however.

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 MPC's opinion, the high real exchange rate has slowed export growth, and 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 domestic demand growth. The MPC is of the view that the recent decision not to terminate wage settlements reduces the short-term risk of unsustainable wage increases, but there are 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 16 May 2018.