The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, November 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 5 and 6 November 2018, during which the Committee discussed economic and financial market developments, the interest rate decision of 7 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 3 October interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2018/4 on 7 November.

Financial markets

Between meetings, the króna depreciated by 6.3% in trade-weighted terms. Over this same period it fell 7.5% against the pound sterling, 6.9% against the US dollar, and 5.9% against the euro. The Central Bank intervened in the foreign exchange market once during this period, selling foreign currency in the amount of 9 million euros (1.2 b.kr.), or roughly 4% of total market turnover.

In terms of the Central Bank's real rate, the monetary stance had eased since the MPC's October meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 0.8%, or 0.3 percentage points lower than in October. In terms of twelve-month inflation, it was 1.4%.

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 nominal Treasury bonds had risen by 0.1-0.3 percentage points since the October meeting, but yields on some indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.2 percentage points. Average rates on pension funds' non-indexed loans to fund members had risen by nearly 0.3 percentage points since the October meeting, but other mortgage lending rates were broadly unchanged.

In terms of three-month interbank rates, the interest rate differential versus the euro area was virtually unchanged between meetings, at 5 percentage points, but the spread versus the US had narrowed by 0.2 percentage points, to 2.1 percentage points. The long-term interest rate spread had narrowed slightly, measuring 2.6 percentage points versus the US and 5.3 percentage points versus Germany.

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

Financial institutions' analysts had projected that the Bank's interest rates would be either held unchanged or raised in November, citing, among other things, the slowdown in economic activity, and uncertainty about upcoming wage settlements. The main rationale for a rate hike, however, was the rise in inflation and inflation expectations.

Most market agents appeared to expect a rate hike, according to the Central Bank's quarterly survey, carried out in late October. Survey respondents expected the Bank's key rate to be raised by 0.25 percentage points in Q4/2018, followed by further increases in 2019. They also expected the key rate to rise to 5% by late 2019 and then begin to fall again. Moreover, 40% of respondents considered the monetary stance too loose at present, whereas no respondents were of this opinion in the August survey. About 48% of respondents considered the monetary stance appropriate, as compared with 81% in the previous survey. The share who considered the monetary stance too tight was 12%, down from 19% in the previous survey.

Annual growth in M3 measured just under 8½% in Q3/2018, after adjusting for deposits held by the failed financial institutions, its strongest in about a decade. As before, growth in M3 stemmed primarily from increased household deposits, although the financial sector's share in the growth rate has increased as well. 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 9% year-on-year in Q3/2018. Over the same period, household lending grew by just over 7% year-on-year and corporate lending by 12½%.

The Nasdaq OMXI8 index had risen by 2.8% between meetings. Turnover in the main market totalled 401 b.kr. during the first ten months of the year, about 27% less than over the same period in 2017.

Global economy and external trade

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 11.7 b.kr. deficit in October, as opposed to a deficit of 1.5 b.kr., at constant exchange rates, in October 2017. The deficit for the first ten months of the year was 104.7 b.kr. in 2018, as compared with 102 b.kr. in 2017. Export values rose by 11.3% year-on-year at constant exchange rates, owing mainly to an increase in the value of marine products and industrial goods, aluminium in particular. Import values increased by 9.8% year-on-year over the same period, due primarily to higher values of imported fuels and lubricants, commodities and operational inputs, and investment goods. The import value of passenger cars has declined between years, however. In the past three months, imports have grown by 13.6% year-on-year at constant exchange rates, a more rapid pace of growth than in the summer. The three-month growth rate was considerably slower than that measured earlier this year and for most of 2017.

Between MPC meetings, the listed global price of aluminium fell by just over 6% and was more than 9% below the price seen last year at this time. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 4.8% year-on-year in the first nine months of 2018. The global price of oil had fallen by 17.5% between MPC meetings, to about 71 US dollars per barrel. However, by the time of the November meeting it had risen by about 6% year-to-date and about 10% since the beginning of November 2017.

The real exchange rate in terms of relative consumer prices fell by 4.5% month-on-month in October, when it was about 11.5% above its twenty-five year average but 13.4% below its June 2017 peak. In the first ten months of 2018, it was down by 1.6% compared with the same period in 2017, as the nominal exchange rate of the króna was 2% lower and inflation in Iceland was 0.5 percentage points above the trading partner average.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 4.3% year-on-year in Q3/2018. The number of employed persons rose by 4.1%, and the average work week lengthened slightly. The labour participation rate rose by 0.4 percentage points year-on-year, to 81.7%, after adjusting for seasonality. The employment rate rose accordingly between years, to a seasonally adjusted 79.5%.

Seasonally adjusted unemployment measured 2.6% in Q3/2018, after declining by 0.3 percentage points from the previous quarter, but was unchanged between years.

Figures on net migration in Q3 show that importation of foreign workers is still strong, although it has receded from last year's peak level. Net migration was positive by 1% of the population during the quarter, and the number of foreign nationals living in Iceland has increased by 2.7% of the population year-to-date.

The wage index rose by 1.7% between quarters in Q3, and by 6.1% year-on-year, and real wages were 4.1% higher in Q3 than in the same quarter of 2017.

Leading indicators of developments in private consumption in Q3 suggest that the growth rate had eased since the first half of the year. During the quarter, growth in payment card turnover eased, domestic turnover in particular, and the number of new motor vehicle registrations declined.

The Gallup Consumer Confidence Index measured 92.1 in October and had risen between months, after falling in the two months beforehand. The greatest difference was an improvement in expectations six months ahead, which had fallen steeply since the summer. The index has fallen by over 33 points year-on-year.

Statistics Iceland's nationwide house price index, published in October, rose 0.6% month-on-month when adjusted for seasonality and by 5.8% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.4% month-on-month in September when adjusted for seasonality, and by 3.9% year-on-year. The twelve-month rise in real estate prices is at its smallest since May 2011. The number of purchase agreements registered nationwide in the first nine months of the year rose by 6.6% year-on-year, and the average time-to-sale for flats in greater Reykjavík was 1.6 months in September, as opposed to 2.9 months a year earlier. About 840 flats were advertised for sale in greater Reykjavík in October, as compared with just over 1,500 in October 2017.

The CPI rose by 0.57% month-on-month in October. Twelve-month inflation measured 2.8% and had risen by 0.1 percentage points between MPC meetings. The CPI excluding the housing component had risen by 1.7% year-on-year in October. In terms of the median of various measures, underlying inflation was 3% in October, about 1.8 percentage points higher than in the same month of 2017. This is the highest it has been by that measure since January 2014.

The increase in new vehicle prices was the main driver of the rise in the CPI in October, and the upward impact month-on-month was the strongest since July 2008. Housing and food prices also rose in October, with a decline in road tolls pulling in the opposite direction.

According to the Central Bank survey conducted in late October, market agents expected inflation to measure 3.6% one year ahead, or 0.6 percentage points more than in the August survey, and 3.2% two years ahead, an increase of 0.2 percentage points between surveys. They also expected inflation to average 3% over the next five and ten years, which is broadly unchanged from August but about ½ a percentage point higher than a year ago. The breakeven inflation rate in the bond market has also risen recently. Just before the MPC meeting, the five- and ten-year breakeven rate was 4.1-4.2%, after having risen by 0.2-0.4 percentage points since the October meeting and nearly 1½ percentage points in the preceding year.

According to the forecast published in *Monetary Bulletin* on 7 November 2018, the inflation outlook has deteriorated since the Bank’s August forecast. Inflation has been close to the target for most of 2018. It measured 2.7% in Q3 and 2.8% in October. Underlying inflation has risen as well, and long-term inflation expectations are now 3% or more by all measures. Because of the recent depreciation of the króna and the wider output gap early in the forecast horizon, the inflation outlook into H1/2020 has deteriorated since the August forecast. Inflation is expected to exceed 3% through 2019 and remain above the target until H2/2020.

The króna has depreciated in recent weeks and is now about 10% weaker against the average of other currencies than it was at the time of the August *Monetary Bulletin*. It is also nearly 8% weaker in Q4 to date than was projected in August. The króna is now at its lowest in more than two years. This decline is due to several interlinked factors, but the onset of the current slide can probably be traced to some extent to the temporary uncertainty about WOW Air’s financing in the first week of September. In addition, the macroeconomic factors that have generally driven the appreciation of the króna in recent years appear to have given way as well. Terms of trade have deteriorated, and export growth has slowed. The operating environment in the tourism industry has grown more difficult, and it appears as though GDP growth has lost pace in H2/2018. All of these factors, together with growing concerns about upcoming wage negotiations, appear to have contributed to investor pessimism, which in turn has led to a depreciation of the króna. The baseline forecast assumes that the exchange rate will remain broadly at its year-to-date average for the remainder of the forecast horizon. This entails a trade-weighted exchange rate index (TWI) about 3% lower, on average, in 2018 than in 2017, and a further 3% decline in 2019.

Global GDP grew by 3.7% in 2017, the strongest growth rate since 2011. It has softened slightly in 2018 to date, however, and the outlook has deteriorated marginally. Among

Iceland's main trading partners, GDP growth averaged 2.4% in 2017, the strongest since 2010. It is projected to ease slightly this year, to an average of 2.2%, and fall still further, to 1.8% by 2020.

After a marked improvement over the previous four years, terms of trade for goods and services deteriorated by 4.5% year-on-year in Q2/2018, owing largely to rising oil and alumina prices. The outlook is for a nearly 2% deterioration in terms of trade in 2018 as a whole, broadly as was forecast in August. In 2019, however, terms of trade are expected to remain unchanged instead of improving by 2%, as was forecast in August.

Exports are expected to grow by 3.9% year-on-year, somewhat below the average for the past three years but similar to the 2011-2014 average. This year's growth rate is due largely to just over 10% growth in marine product exports. Due to a contraction in the transport and services component of services exports in H1/2018, services exports are now expected to grow somewhat less than was forecast in August. In 2019, export growth will ease further, primarily because growth in marine product exports will give way to a contraction.

GDP growth measured 4% in 2017, about 0.4 percentage points more than Statistics Iceland's earlier figures had suggested. It was stronger than previously projected in H1/2018 as well. Growth was projected at 5.6% in the Bank's August forecast but measured 6.4%. The deviation is due primarily to a large increase in inventories in H1 and an unexpected contraction in goods imports. The outlook is for GDP growth to slow markedly in H2 and measure 4.4% for the year as a whole. As in the August forecast, GDP growth is expected to measure just over 2½% in the next three years.

Total hours worked are estimated to increase by 2.3% this year. In spite of a more than 2% increase in the number of jobs this year, the outlook is for the employment rate to fall by nearly 1 percentage point year-on-year, owing to the prospect of a more than 3% increase in the working-age population. Seasonally adjusted unemployment measured 2.6% in Q3. It is forecast to rise to 3% in 2019 and 3.3% by 2021, close to the level deemed consistent with price stability.

According to the Bank's forecast, wages per hour are projected to rise by an average of 7.8% this year. The outlook is for productivity growth of just over 2%; therefore, unit labour costs are projected to rise by just over 5½%, about the same as in the August forecast but more than in the past two years. The year-on-year rise in wages is expected to slow down during the forecast horizon, in line with weaker labour productivity growth, rising unemployment, and a negligible improvement in terms of trade. The rise in unit labour costs will therefore contract from 5½% this year and in 2019 to 2½% in 2021.

As is discussed above, GDP growth was stronger in 2017 and H1/2018 than previously projected. As a consequence, the output gap was slightly larger at year-end 2017 than was assumed in August, and the outlook is for it to be about 1 percentage point larger at the end of 2018. As the forecast horizon progresses, however, the gap will narrow faster than was forecast in August, and it will have virtually closed by the end of the horizon.

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 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.

Inflation could turn out higher than in the Bank's baseline forecast. The most important risk factor is uncertainty about the upcoming wage settlements. Although the baseline forecast already assumes relatively sizeable pay increases even though the wage share is above its historical average, it is not impossible that wage settlements will provide for even larger increases or that wage drift will be greater than assumed, not least in view of the fact that unemployment is still low and tension in the labour market remains. Various other factors could pull in the same direction, causing inflation to turn out higher than in the baseline forecast. For example, global oil prices have soared in the recent past, and the possibility of a further increase cannot be ruled out, opposite to the assumption in the baseline forecast. Although the risk of a depreciation of the króna due to a deterioration in external conditions, as was discussed in the Bank's previous risk assessment, has already materialised in part, the króna could continue to weaken instead of remaining broadly at the current level for the remainder of the forecast horizon, as the baseline forecast assumes. By the same token, house price inflation could pick up again if growth in mortgage lending continues to gain momentum. Furthermore, the strength of the economy in H1/2018 could indicate that the output gap will be more persistent than is currently assumed, particularly if the fiscal stance eases more than is forecast. Inflation could also rise higher and remain more persistent if long-term inflation expectations do not fall back to the target.

Neither can the possibility be excluded that inflation will turn out lower than is assumed in the baseline forecast. The króna could appreciate again, for example, if external conditions improve. The trade dispute between the US and China could also undermine global economic activity, which could weaken Iceland's exports and result in weaker GDP growth than in the baseline forecast. Moreover, productivity growth could be underestimated, and this could cause the output gap to narrow faster than is assumed in the baseline.

II The interest rate decision

The Committee discussed the status of the work underway following the report from the task force on monetary policy and the next steps, as the position on the task force's recommendations is being formulated. In this context, the MPC is planning an extraordinary meeting in December. The Committee also discussed the market's response to the decision to lower the special reserve requirement (SRR), announced on 2 November, and the next steps in that matter. Conditions had developed that permitted a reduction in the SRR, with a narrowing interest rate differential and a lower exchange rate of the króna, and the SRR was therefore lowered from 40% to 20%. There was some uncertainty about the impact the reduction would have, as there is little experience in Iceland of this type of capital flow management measure. In addition, Committee members discussed the Bank's most recent *Financial Stability* report; they also discussed financial institutions' position and risks in the financial system.

The MPC discussed the monetary stance in view of the most recent information on the economy and the decline in the Bank's real rate between meetings. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its October meeting to keep the Bank's key rate unchanged, partly because the overall situation had not changed materially since the previous meeting and it was deemed appropriate to await further indicators because of the high level of uncertainty.

In this context, Committee members took account of the Central Bank's new macroeconomic forecast, published in *Monetary Bulletin* on 7 November, according to which GDP growth in

2017 and H1/2018 was stronger than previously estimated. Committee members noted that even though growth was expected to slow down in H2, it was forecast at 4.4% for 2018 as a whole, nearly 1 percentage point more than the Bank had forecast in August. Members agreed that the outlook for the coming term was for GDP growth to ease and the output gap to close. Even so, GDP growth would remain just over 2½%, close to the level that would allow the economy to grow without importing labour. It was pointed out that recent news of Icelandair's acquisition of WOW Air had mitigated the uncertainty about disturbances in air travel, at least for the short term.

The Committee discussed developments in inflation, which measured 2.8% in October. Members noted that the difference between measures of inflation including and excluding housing was close to its smallest in over four years. The year-on-year rise in house prices had continued to ease, but it was offset by a sizeable increase in import prices in the recent term. This partly reflected the rise in global oil prices. The MPC also noted that the króna had depreciated since August. There was some discussion of the main reasons for this, and members agreed that the beginning of the depreciation episode could be traced to an extent to temporary uncertainty about WOW Air's financing in the first week of September. They were of the view that this may have triggered a reassessment of developments and prospects, as the macroeconomic factors that had been the key drivers of the appreciation of the króna had given way. The factors mentioned included terms of trade, which had deteriorated; export growth, which had slowed; and the prospect of weaker output growth in H2. On the other hand, it was pointed out that a lower real exchange rate could be favourable for tourism companies' operations. The exchange rate of the króna could also be falling because of the marked decline in real interest rates in the recent term. Exchange rate volatility had increased in recent months, and it emerged that this could be related to less firmly anchored long-term inflation expectations. It was pointed out as well that domestic financial market unrest coincided with increased uncertainty in global financial markets.

Committee members noted that according to the forecast, the inflation outlook had deteriorated relative to the August forecast. The outlook was for inflation to continue rising and be somewhat above the target next year. The MPC was also of the view that the recent rise in inflation expectations and the fact that expectations were now above target by all measures gave cause for concern. On the other hand, the outlook was for growth in economic activity to ease faster than previously expected, which could, in the Committee's view, offset the poorer inflation outlook. As before, the main uncertainty was the upcoming wage negotiations, and even though the Bank's forecast assumed sizeable pay increases, it was not impossible that wage settlements would provide for even larger increases or that wage drift would be greater than assumed. It was also pointed out that there was the risk that Government measures in connection with the wage settlements might not be fully funded, resulting in an easing of the fiscal stance.

The MPC emphasised that higher inflation and inflation expectations in recent months had lowered the Bank's real rate more than was desirable in view of current economic developments and prospects. It was pointed out that because one of the main changes since the October meeting was the marked deterioration in the inflation outlook, there were no grounds to wait before tightening the monetary stance. The risk assessment in the inflation forecast also indicated that risk was concentrated on the upside in the first half of the forecast horizon. Furthermore, the recent rise in inflation expectations could indicate that expectations had grown less securely anchored to the target. All members agreed that it was necessary to raise the Bank's key rate now, and they discussed whether it should be raised by 0.25 percentage points or 0.5 percentage points.

The main rationale for raising the key rate by 0.25 percentage points was the considerable uncertainty about how rapidly GDP growth would ease and how the króna would respond to a rate hike and the reduction in the SRR. The conditions could exist for a somewhat lower real rate than would otherwise be warranted, depending on developments in these factors and others, although not to the degree that had already materialised. As a result, it would be more cautious to take a smaller step now. The next steps would be determined by developments. The main rationale for raising the key rate by 0.5 percentage points, however, was that the inflation outlook had worsened materially and inflation expectations had risen such that a 0.25-point increase would not suffice, as the monetary stance would still be looser than at the time of the October meeting even after such a rate hike. In addition, the Bank's real rate was extremely low given the fact that the output gap remained positive.

In view of the discussion, the Governor proposed that the Bank's interest rates be increased by 0.25 percentage points, which would raise the key rate (the seven-day term deposit rate) to 4.5%, deposit rates (current account rates) to 4.25%, the seven-day collateralised lending rate to 5.25%, and the overnight rate to 6.25%. Four members voted in favour of the Governor's proposal. One member voted against the Governor's proposal, voting instead to raise rates by 0.5 percentage points.

In the Committee's view, the near-term monetary stance would depend on the interaction between a narrower output gap, wage-setting decisions, and developments in inflation and inflation expectations.

The MPC reiterated that it had both the will and the tools necessary to keep inflation at target over the long term, and members agreed that if inflation expectations continued to rise and remained persistently at a level above the target, it would call for a tighter monetary stance. Other decisions, particularly those relating to the labour market and fiscal policy, would then affect the sacrifice cost in terms of lower employment.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman 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 12 December 2018.