*The Monetary Policy Committee of the Central Bank of Iceland*

# Minutes of the Monetary Policy Committee meeting

## August 2019 (86th meeting)

## Published: 11 September 2019

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

The following are the minutes of the MPC meeting held on 26 and 27 August 2019, during which the Committee discussed economic and financial market developments, the interest rate decision of 28 August, 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 26 June 2019 interest rate decision, as published in the updated forecast in *Monetary Bulletin* 2019/3 on 28 August.

### Financial markets

Since the June meeting, the króna had appreciated by 2% in trade-weighted terms. Over this same period it rose by 2% against the euro and 3.5% against the pound sterling but fell by 0.5% against the US dollar. Between meetings, the Bank bought foreign currency for 3 million euros (0.4 b.kr.). The Bank's transactions accounted for just under 2% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had tightened slightly since just after the Committee's June interest rate decision. The Bank's real rate in terms of the average of various measures of inflation and inflation expectations had risen by 0.1 percentage points between meetings, to 0.6%. In terms of twelve-month inflation, it was also 0.6% and had risen by 0.2 percentage points.

Interest rates in the interbank market for krónur fell in line with the Central Bank's rate cut in June, and turnover in the market totalled roughly 12 b.kr. over the period.

Yields on long-term nominal Treasury bonds had fallen by 0.2 percentage points since the June meeting, and yields on long-term indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.1 percentage points. Average non-indexed residential mortgage rates had fallen more or less commensurably, whereas indexed mortgage rates had fallen less.

In terms of three-month interbank rates, the interest rate differential with abroad had remained broadly unchanged between meetings. It measured 4.7 percentage points against the euro area and 2.2 percentage points against the US. The long-term interest rate spread, however, had widened slightly, and measured 4.4 percentage points versus Germany and 2.2 percentage points versus the US. Measures of the risk premium on the Treasury's foreign obligations were also largely unchanged. The CDS spread on the Treasury's five-year US dollar obligations was 0.7%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.5-0.7 percentage points.

Financial institutions' analysts all expected the MPC to lower the Bank's interest rates by 0.25 percentage points, on the grounds that although inflation and inflation expectations remained above target, both had subsided; furthermore, the exchange rate of the króna had risen since the Committee's June meeting. The monetary stance had therefore tightened, and the expected contraction was likely to be more pronounced than had been forecast in May.

According to the Central Bank's quarterly market expectations survey, conducted in mid-August, respondents expected the Bank's key rate to be lowered by 0.25 percentage points in Q3/2019, to 3.5%, followed by another rate cut of 0.25 percentage points before the end of the year. They also expected the key rate to be 3.25% in one and two years' time. These are lower interest rates than they expected in the Bank's May survey. As in the previous survey, three out of every four respondents considered the monetary stance too tight at present, whereas the share considering it far too tight was 20 percentage points smaller than in the previous survey. About 22% of respondents considered the monetary stance appropriate, which is broadly in line with the last survey.

Annual growth in M3 measured just over 8% in Q2/2019, after adjusting for deposits held by the failed financial institutions, but had fallen to around 6½% by July. As before, the increase is due largely to growth 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 almost 9% year-on-year in Q2/2019. Over the same period, household lending grew by just under 8% year-on-year and corporate lending by just under 10%.

The Nasdaq OMXI10 index had fallen by some 3% between meetings. Turnover in the main market totalled 365 b.kr. during the first seven months of the year, about 23% more than over the same period in 2018.

### Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in July, the global GDP growth outlook has deteriorated since the Fund's April forecast. The IMF estimates global GDP growth at 3.2% in 2019 and 3.5% in 2020, or 0.1 percentage points below its April forecast. Weaker global GDP growth can be attributed to a poorer outlook in emerging and developing economies, particularly Brazil and Mexico. However, the Fund has revised its GDP growth forecast for advanced economies upwards by 0.1 percentage points, to 1.9%, owing mainly to

Q1 GDP growth in the US, which exceeded the April forecast. The Fund continues to consider the uncertainty in the output growth forecast to be concentrated on the downside, partly because of the risk that global trade disputes will escalate further. It expects growth in world trade to be even slower in 2019 and 2020 than it assumed in the April forecast. Inflation among advanced economies is forecast at 1.6% in 2019, which is unchanged from the April forecast. The outlook is for 2% in 2020, slightly less than in the spring forecast.

According to preliminary figures from Statistics Iceland, Iceland's goods trade generated a 67 b.kr. deficit in the first seven months of the year, at constant exchange rates. The deficit over the same period in 2018 was 115 b.kr., also at constant exchange rates. The smaller deficit now is due to the exportation of aircraft early in the year, although import values have also contracted by 8% in 2019 to date. The contraction in import values excluding ships and aircraft has grown larger as the year has progressed. Import values have shrunk by a full 12% year-on-year in the past three months, the largest contraction by this measure since 2009. The main difference lies in reduced import values of passenger cars and fuels and lubricants, although commodity prices contracted as well. Export values excluding ships and aircraft contracted by just over 3% year-on-year in the first seven months of 2019, particularly for aluminium exports, while marine product exports rose in value by 1%.

Between MPC meetings, the listed global price of aluminium fell by about 2% and was 16.5% below the price seen at the same time last year. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up by just over 6% year-on-year in H1/2019. The global price of oil had fallen by just under 9% between MPC meetings, to about 60 US dollars per barrel just before the August meeting. This is 22% lower than at the same time in 2018.

The real exchange rate in terms of relative consumer prices was virtually unchanged month-on-month in July, when it was 7% above its 25-year average but 16.5% below its June 2017 peak. In July, it had fallen 10.6% year-on-year, as the nominal exchange rate of the króna was 11.8% lower and inflation in Iceland was 1.4 percentage points above the trading partner average.

**Domestic economy and inflation**

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 2% year-on-year in Q2. The rise in total hours is due to a 2.7% increase in job numbers, offset by a shortening of the average work week by 0.7% between years. Although the number of jobs increased year-on-year, it fell 0.2% between quarters after adjusting for seasonality. The reversal in employment can be seen even more clearly in pay-as-you-earn (PAYE) data, which suggest that employment contracted by 1% year-on-year and by 0.9% quarter-on-quarter in Q2. According to the LFS the labour participation rate also fell quarter-on-quarter, and the employment rate declined for the third quarter in a row. Seasonally adjusted unemployment rose by 0.7 percentage points between quarters, to 3.8% in Q2.

Year-on-year population growth measured 2.1% in Q2, including 1.6 percentage points due to immigration of foreign nationals. The increase in foreign labour has eased somewhat in recent quarters, but the increase in Q2 remains similar to that observed in late 2016. Issuance of new temporary work permits slowed between years in the first seven months of 2019, and the number of active employees working for employment agencies and foreign services firms has held relatively steady year-to-date.

In Q2, the general wage index rose by 2.1% between quarters and by 5.4% year-on-year. Real wages were 1.9% higher in Q2 than in the same quarter of 2018.

Key indicators of developments in private consumption at the beginning of Q3 suggest that growth may have slowed. New motor vehicle registrations declined in number, and the rise in payment card turnover was relatively moderate. The Gallup Consumer Confidence Index rose slightly month-on-month in July, to 89.6 points. Nevertheless, this was still well below the July 2018 measurement.

Statistics Iceland's nationwide house price index, published in late July, was virtually unchanged month-on-month when adjusted for seasonality, but rose 3.5% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.2% month-on-month in July when adjusted for seasonality, and by 2.9% year-on-year. The number of purchase agreements registered nationwide fell by 10% year-on-year in the first seven months of 2019, while the number of contracts for new construction declined by nearly 21% over the same period. The average time-to-sale nationwide was 3.3 months in the first seven months of 2019, some 0.4 months longer than over the same period in 2018.

The CPI fell by 0.21% month-on-month in July. Twelve-month inflation measured 3.1% and had declined by 0.5 percentage points since the MPC's June meeting. The CPI excluding housing rose by 2.8% year-on-year in July, and the difference between inflation including and excluding housing has continued to narrow in recent months. However, inflation according to the HICP, which also excludes owner-occupied housing costs, was lower, measuring 1.6% in July. Underlying inflation measured 3.1% in July, according to the median of various measures, and also fell between meetings.

Seasonal sales had a stronger impact in July than at the same time last year or in January 2019. Owner-occupied housing costs were up 2.6% year-on-year in July, the smallest twelve-month increase since the beginning of summer 2013.

According to the Central Bank survey carried out in mid-August, market agents' inflation expectations declined between surveys. Respondents now expect inflation to measure just under 3% in one year and 2.5% in two years. They also expect inflation to average 2.5% over the next five years, which is 0.5 percentage points less than in the August 2018 survey. Their ten-year expectations have fallen back to the target as well. The breakeven inflation rate has also fallen marginally since the MPC's June meeting. The five- and ten-year breakeven rate has averaged 2.9% in Q3 to date, some 0.6-0.9 percentage points lower than in the same quarter of 2018.

According to the updated forecast published in *Monetary Bulletin* on 28 August, because of a better initial position, inflation is now expected to be lower for the remainder of the year than was projected in May. It is forecast to measure 3.2% in Q3 and then fall to 2.9% in Q4. The outlook for 2020 has also improved, due mainly to the prospect of lower imported inflation. Inflation expectations have fallen as well, after rising in 2018. Inflation is projected to align with the target in H1/2020, but as was forecast in May, it is expected to dip temporarily below the target in H2. According to the forecast, it will inch back up to the target in 2022.

Trading partners' GDP growth is projected to average 1.6% this year, some 0.1 percentage points below the May forecast. The prospects for GDP growth in the next two years are slightly weaker as well. Terms of trade improved by 1.7% between quarters in Q1/2019, supported by lower oil prices and favourable developments in marine product prices. They are expected to remain broadly flat in 2019, in line with the May forecast. The outlook for 2020 has improved, however, driven mainly by lower oil prices and more modest rises in import prices in general.

The króna depreciated last autumn following news of WOW Air's financing difficulties and the deterioration in terms of trade. It held relatively stable in H1/2019 but has appreciated since early July; nevertheless, it was broadly the same at the August meeting as it was at the time of the May *Monetary Bulletin*, and still about 10% weaker in trade-weighted terms than it was in August 2018. The trade-weighted index has been around 181 in the recent past, and the baseline forecast is based on the assumption that it will remain close to that level for the remainder of the forecast horizon. This is a slightly lower exchange rate than was assumed in May.

GDP growth measured 1.7% in Q1/2019, in line with the May forecast. The outlook is for GDP to contract this year by 0.2%, a slightly smaller contraction than was projected in May, even though tourist arrivals are projected to fall more than previously assumed and exports to contract more sharply. This is partly because underlying growth in private consumption appears more resilient, but no less because consumption spending is switching more towards domestic production, as can be seen in a marked contraction in imports. As in May, the economy is expected to rebound in 2020, with GDP measuring 1.9%. This is markedly below the May forecast, as it now appears that the tourism industry will take longer than previously assumed to recover after this year's setbacks. GDP growth is forecast to rise to 2.7% in 2021, broadly in line with the May forecast.

The assumptions concerning wage developments have changed little since May. The outlook for productivity growth is similarly unchanged, and unit labour costs are therefore expected to develop as in the May forecast. They are expected to rise by 6.8% this year and 4% per year, on average, in the two years thereafter.

Job numbers fell in Q2/2019, and unemployment rose to its highest since 2015. Capacity pressures that had accumulated after the recent boom have therefore eased. The output gap is estimated to have almost closed, and a modest slack is expected to develop by the end of this year. As 2020 progresses, unemployment will taper off again, and the slack will close by the end of the year.

## II The interest rate decision

MPC members discussed the monetary stance in view of the most recent information on the economy. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in June to lower interest rates because there were signs that the economic contraction could turn out deeper and longer than was assumed in May. In addition, inflation expectations had fallen between MPC meetings and the monetary stance had therefore tightened again.

The MPC discussed economic developments and prospects and, in this context, took account of the Central Bank's updated macroeconomic forecast, published in *Monetary Bulletin* on 28 August, according to which this year's economic contraction would measure 0.2%, slightly less than was forecast in May. Members agreed that this was due mainly to more resilient private consumption growth, although the contribution of net foreign trade was also more positive. It emerged in the discussion that this was because demand had shifted towards domestic production, partially offsetting the stronger contraction in tourism. The MPC noted, however, that the GDP growth outlook for 2020 had deteriorated, as it now appeared that it would take longer for the tourism sector to recover after this year's setbacks. The global GDP growth outlook had deteriorated as well, and uncertainty and pessimism had increased. Committee members agreed, however, that the previous assessment of the economic outlook was broadly unchanged and that despite the negative shocks to the economy in H1/2019, the outlook was for a relatively moderate adjustment, other things being equal.

The Committee discussed developments in inflation, which measured 3.4% in Q2 but eased to 3.1% in July. Members noted that underlying inflation had developed in a broadly similar manner. The outlook was for inflation to subside faster than was forecast in May and align with the target in H1/2020. MPC members also noted that the króna had appreciated by just over 2% between meetings, and the foreign exchange market appeared well balanced. They highlighted that inflation expectations had fallen back to target since the MPC's last meeting, and the monetary stance had therefore tightened slightly. The Committee discussed developments in the real rate and what real rate would be appropriate at this point in the business cycle. There was also a discussion of the recent slowdown in both real estate market activity and growth in lending to households and businesses. It was considered likely that this stemmed from declining demand, coupled with the liquidity position of some commercial banks, which must ensure that they comply with permissible liquidity ratios.

All members were of the opinion that it was appropriate to lower the Bank's interest rates still further. It emerged in the discussion that the GDP growth outlook could be overestimated, partly because of the possibility that global output growth could turn out weaker than is currently assumed — not least in view of growing global economic uncertainty. It was also pointed out that it had yet to come to light how tourism companies would fare in the coming winter. It emerged in the discussion that reduced real estate market activity and the contraction in investment and imports despite increased real disposable income could indicate a general perception that the economy was weaker than it actually is. In that case, it was appropriate to lower the Bank's interest rates in order to stimulate investment and the real estate market, as well as mitigating pessimism. On the other hand, it was pointed out that inflation was still above target, domestic inflationary pressures had increased by several measures, the outlook was for a nearly 7% rise in unit labour costs this year, and public sector wage settlements were still pending. As a result, it was also important to proceed with caution.

MPC members agreed that efforts to provide a firmer anchor for long-term inflation expectations had been successful, thereby providing the scope to respond to the economic contraction by easing the monetary stance. It was also pointed out that the pass-through from the depreciation of the króna to the price level had been relatively modest, and that this was probably due in part to increased credibility of monetary policy and more firmly anchored inflation expectations.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 3.5%, the current account rate 3.25%, the seven-day collateralised lending rate 4.25%, and the overnight lending rate 5.25%. All Committee members voted in favour of the proposal.

In the MPC's view, near-term monetary policy decisions would depend on the interaction between developments in economic activity, on the one hand, and inflation and inflation expectations, on the other.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Monetary Policy Committee

Rannveig Sigurdardóttir, Deputy Governor

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 2 October 2019.