The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2019 (84th meeting)

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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 are also included in the minutes.

The following are the minutes of the MPC meeting held on 20 and 21 May 2019, during which the Committee discussed economic and financial market developments, the interest rate decision of 22 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 20 March 2019 interest rate decision, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2019/2 on 22 May.

Financial markets

Since the March meeting, the króna had depreciated by 3.5% in trade-weighted terms. Over this same period it fell 3.7% against the euro, 5.5% against the US dollar, and 1.1% against the pound sterling. Between meetings, the Central Bank sold foreign currency for 15 million euros (2.1 b.kr.). The Central Bank's transactions accounted for just over 5% of total turnover in the foreign exchange market.

Based on the average of various measures of inflation and one-year inflation expectations, the monetary stance in terms of the Central Bank's real rate was broadly unchanged since the MPC's March meeting. By this measure, the Bank's real rate was 1%. In terms of twelve-month inflation, it was 1.2% and had fallen by 0.3 percentage points between meetings.

Interest rates in the interbank market for krónur had fallen slightly between meetings, and turnover in the market totalled 34 b.kr. during the period.

Yields on long-term nominal Treasury bonds had fallen by 0.6 percentage points since the March meeting, and yields on long-term indexed Treasury and Housing Financing Fund (HFF) bonds had declined by 0.3 percentage points. Average interest rates on non-indexed mortgage loans and pension fund loans had fallen slightly since the March meeting. Over the same period, the average rate on indexed fixed-rate mortgage loans and indexed variable-rate pension fund loans had also fallen slightly.

In terms of three-month interbank rates, the interest rate differential versus the euro area had narrowed slightly between meetings, to 5.2 percentage points, whereas the spread versus the US was broadly unchanged, at 2.4 percentage points. The long-term interest rate differential versus Germany had fallen by 0.5 percentage points between meetings, to 4.3 percentage points, and the spread versus the US had narrowed by 0.5 percentage points, to 1.8 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 virtually unchanged at just under 0.8%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany widened slightly, to 0.5-0.7 percentage points.

Financial institutions' analysts all expected a rate cut of either 0.25 or 0.5 percentage points, citing the improved inflation outlook stemming in part from the prospect of a rapid unwinding of demand pressures in 2019, the finalisation of wage agreements more consistent with the Bank's inflation target than had been expected, and the recent stability of the króna.

According to the Central Bank's quarterly market expectations survey, conducted in early May, respondents expected the Bank's key rate to be lowered by 0.5 percentage points in Q2/2019, to 4%, followed by another rate cut of 0.25 percentage points in the first half of 2020. They also expected the key rate to be 3.75% in one and two years' time. This is a major change from the January survey, when market agents expected a rate increase this year. In the most recent survey, no respondents considered the monetary stance too loose at present, whereas in the previous survey, 24% were of that opinion. About 24% of respondents considered the monetary stance appropriate, as compared with 57% in the last survey. The share that considered the monetary stance too tight or far too tight was 76%, up from 19% in the January survey.

Annual growth in M3 measured 8% in Q1/2019, after adjusting for deposits held by the failed financial institutions. This is slightly below the growth rate in late 2018. As before, growth in M3 stemmed primarily from increased household deposits, although the commercial sector's share in the growth rate has also continued to increase. 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 10% year-on-year in Q1/2019. Over the same period, household lending grew by about 8½% year-on-year and corporate lending by around 12%, whereas the growth rate adjusted for exchange rate movements was about 9½%.

The Nasdaq OMXI8 index had risen by 12% between meetings. Turnover in the Main Market totalled 213 b.kr. in the first four months of 2019, almost 14% 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 April, the global GDP growth outlook has deteriorated still further since the Fund's previous forecasts. Global GDP growth is forecast at 3.3% in 2019, some 0.2 percentage points below the Fund's January forecast and 0.4 percentage points below its October forecast. The weaker growth rate is due largely to a poorer outlook for advanced economies, especially in the eurozone, and also for some developing and emerging countries. Output growth among Iceland's main trading partners is projected at 1.7%, or 0.3 percentage points below the October forecast. The IMF projects that global output growth will pick up next year to 3.6%, which is 0.1 percentage points below the October forecast. The Fund continues to consider the uncertainty in the output growth forecast to be concentrated on the downside, particularly because of the risk that global trade disputes will escalate further. World trade is forecast to increase by 3.4% this year instead of the previously projected 4%. Inflation among Iceland's trading partners is forecast at 1.6% this year, as opposed to 1.9% in the October forecast.

Iceland's external goods trade generated a surplus of just under 1 b.kr. for Q1/2019 at constant exchange rates, as opposed to a deficit of 33.4 b.kr. over the same period in 2018. The turnaround between years is due primarily to increased exports of aircraft, as well as of ships. In addition, aircraft imports contracted year-on-year. Excluding ships and aircraft, the goods account showed a deficit of nearly 22 b.kr. in Q1, as opposed to a 25 b.kr. deficit at constant exchange rates in Q1/2018. This year's smaller deficit is due to a contraction in import values, particularly to include fuels and lubricants and passenger cars. Furthermore, exports excluding ships and aircraft contracted marginally, owing largely to a reduction in industrial goods exports — aluminium in particular — caused by a temporary cut in production at a domestic aluminium smelter.

Between MPC meetings, the listed global price of aluminium fell by about 7.4% and was 22.5% 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 6.8% year-on-year in Q1/2019. The global price of oil had risen by nearly 7% between MPC meetings, to 72 US dollars per barrel just before the May meeting. Despite an increase of over a third year-to-date, oil prices were down almost 9% between years and were more than 16% below the early October peak.

The real exchange rate in terms of relative consumer prices fell by 0.3% month-on-month in April, when it was 10% above its twenty-five year average but 14% below its June 2017 peak. In the first four months of 2019, it was down by 9.4% compared with the same period in 2018, as the nominal exchange rate of the króna was 10.5% lower and inflation in Iceland was 1.3 percentage points above the trading partner average.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey (LFS), growth in total hours worked measured 1.8% in Q1/2019, which was 0.7 percentage points lower than in Q4/2018 and nearly 1 percentage point below the average of the last six years. The increase was due to a 2.6% rise in the number of employed persons, although it was offset by a shortening of the average work week by nearly 1%. The labour participation rate and the employment rate were broadly unchanged year-on-year in Q1. Data from the pay-as-you-earn (PAYE) register show clearer signs of a slowdown in job growth. According to PAYE records, year-on-year growth in employee numbers has slowed almost uninterrupted since mid-2017, a trend that appears to have continued in Q1/2019.

Seasonally adjusted unemployment measured 3% in Q1, up 0.4 percentage points from the previous quarter and up slightly from the same quarter in 2018. At the same time, the seasonally adjusted registered unemployment rate was 2.8%, after rising slightly between quarters and by 0.7 percentage points since Q1/2018. It rose to 3.5% in April, when the impact of WOW Air's insolvency took hold.

Net migration figures for Q1/2019 show that Iceland's foreign work force continues to grow, but at a slower pace than in the past year. The population increased by 1.8% year-on-year in Q1/2019 due to positive net migration of foreign nationals, as compared with a growth rate of 2.5% in Q1/2018. In addition, employees of temporary employment agencies and foreign services firms declined in number between years in the first four months of 2019, as did the number of new temporary work permits issued.

The general wage index rose by 0.5% between quarters in Q1, and by 5.7% year-on-year, and real wages were 2.5% higher in Q1 than in the same quarter of 2018.

Key indicators of developments in private consumption in Q1 suggest that the growth rate had eased since H2/2018. New motor vehicle registrations declined in number, and growth in payment card turnover subsided during the quarter. At the beginning of Q2/2019, the indicators available suggest a continuation of the pattern set in Q1.

The Gallup Consumer Confidence Index measured 96.9 points in April, an increase of just over 5 points between months but a decline of 19½ points between years. There were several changes in components of the index, with expectations six months ahead improving noticeably while the assessment of the current situation deteriorated.

Statistics Iceland's nationwide house price index, published in late April, declined 0.1% month-on-month when adjusted for seasonality, but rose 4.6% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.1% month-on-month in March when adjusted for seasonality, and by 4.3% year-on-year. The twelve-month rise in real estate prices has therefore held steady at about 5% since April 2018. The number of purchase agreements registered nationwide fell by 1.4% year-on-year in the first three months of 2019, while the number of contracts for new construction declined by 16.9% over the same period.

The consumer price index (CPI) rose by 0.52% month-on-month in March, and twelve-month inflation measured 2.9%. Inflation picked up to 3.3% in April, however, when the CPI rose 0.37% month-on-month. Twelve-month inflation had therefore risen by 0.3 percentage points since the MPC's March meeting. The CPI excluding housing had risen by 2.8% since April 2018, whereas twelve-month HICP inflation measured 3.2%. Underlying inflation picked up slightly between meetings, measuring 3.2% in April, according to the median of various measures.

The April measurement was affected mainly by rising airfares and petrol prices. The increase in airfares was larger than usual for this time of year, owing partly to the collapse of WOW Air, although prices generally rise around the Easter holidays. The pass-through from the depreciation of the króna to import prices has tapered off in the recent past, and the price of imported goods in the CPI has risen by 3.3% in the past twelve months.

According to the Central Bank survey carried out in early May, market agents' short-term inflation expectations fell between surveys, to 3% one year ahead and 2.8% two years ahead. Respondents also expected inflation to average 2.8% over the next five years and 2.7% over the next ten years. Five-year expectations were unchanged between surveys, but ten-year expectations fell marginally. Survey participants' long-term inflation expectations were broadly unchanged from a year earlier. The breakeven inflation rate in the bond market has also fallen in recent months. The ten-year breakeven rate was slightly less than 3% just before the MPC meeting, after falling by 0.4 percentage points since the March meeting. It was also 0.4 percentage points lower than it was a year earlier.

According to the forecast published in *Monetary Bulletin* on 22 May 2019, the inflation outlook has improved since the Bank's February forecast. Inflation rose following the depreciation of the króna last autumn, peaking at 3.7% in December. It fell to 3.1% in Q1/2019 but rose again in April, to 3.3%. Inflation expectations have fallen as well, after rising in 2018. Inflation is expected to pick up slightly until mid-year, albeit less than was assumed in February. It is expected to align with the target in mid-2020 and then dip temporarily below it late in the year. The changed inflation outlook is due primarily to the sharp turnaround in the economy, which is offset in part by a larger rise in unit labour costs and import prices.

The króna has been relatively stable in 2019 to date, after depreciating last autumn. It is expected to hold more or less steady at the current level throughout the forecast horizon, and if the forecast materialises, the trade-weighted average exchange rate will be just over 2% lower in 2020 and 2021 than was forecast in February. The prospect of a weaker króna reflects, among other things, the deterioration of the growth outlook and the expectation of lower domestic interest rates than before, as can be seen in both the market expectations survey and forward interest rates.

In Iceland's main trading partner countries, GDP growth averaged 2.1% in 2018 and the outlook for 2019 has worsened since the February *Monetary Bulletin*. Trading partners' GDP growth is now expected to average 1.7% this year, as opposed to 1.9% in the February forecast and 2.2% in the November 2018 forecast.

After a virtually uninterrupted improvement beginning in mid-2014, terms of trade started to deteriorate in mid-2017. They deteriorated by 3.9% in 2018, owing mainly to rising prices of oil and alumina, although this was offset somewhat by a robust rise in key exported goods prices. As in February, terms of trade are projected to improve by an average of ½% per year in 2019 through 2021, owing to a continued rise in exported goods prices and a decline in oil and alumina prices. If the forecast materialises, terms of trade will be 1½% weaker by the end of the forecast horizon than was projected in February.

The outlook is for a sharp turnaround in exports in 2019 as compared with the previous two years. This is due mainly to the strong contraction in tourism exports, as it was clear early this year that tourist arrivals would be fewer in 2019 than in 2018. Now, with WOW Air's collapse, tourist arrivals are expected to be 10½% fewer in 2019 than in 2018, and services exports are therefore projected to contract by nearly 9%.The outlook for goods exports has deteriorated as well, owing largely to the failure of the capelin catch and the generally poorer outlook for marine product exports. Therefore, the outlook is for combined goods and services exports to contract by nearly 4% in 2019 instead of remaining broadly flat year-on-year, as in the February forecast. Tourist numbers are expected to increase again next year, and total exports are forecast to grow by an average of 2½% year-on-year in 2020 and 2021, mainly as a result of a rebound in services exports.

Output growth is estimated to have slowed in Q1/2019, and GDP is expected to contract by just over 1% year-on-year in Q2. This is a marked change from the February forecast, owing to the external shocks recently hitting the economy, which are described above. For the year as a whole, GDP is expected to shrink by 0.4%, the first contraction in Iceland since 2010. This is also a significant change from the 1.8% growth assumed in the February forecast. The downward revision of the output growth forecast is driven mainly by the poorer outlook for tourism, although reduced marine product exports owing to this year's capelin catch failure weigh heavily as well. Added to this is the impact of slower growth among trading partners, plus a revision of public expenditure growth since February. The baseline forecast assumes that the economic contraction will be relatively brief and that GDP growth will rebound to 2½% in 2020. Even so, this is below the growth rate forecast in February.

The outlook is for total hours worked to decline well into the year but remain virtually flat between annual averages, whereas the February forecast assumed an increase of 1.4%. Thus the outlook is for a noticeable rise in unemployment in Q2. Unemployment is projected to average 3.9% this year, 0.8 percentage points above the February forecast. According to the forecast, it will subside again in 2020 and 2021 but remain well above the February forecast, and above the level considered consistent with price stability.

The year-2019 pay hikes provided for in the new wage agreements are broadly in line with the February forecast, but the wage rises for the two years following are somewhat larger. The outlook is also for weaker productivity growth than was projected in February and thus a larger increase in unit labour costs, which are now forecast to rise by 7% this year and 4%, on average, in 2020 and 2021.

Because of Statistics Iceland's revision of historical GDP growth figures, the output gap is now estimated to have been larger in the past two years than previous figures indicated. This year's abrupt turnaround in economic activity means, however, that the output gap will close much more quickly than previously projected. It is now assumed that an output slack will develop by the end of this year and then close again by the end of 2020.

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 domestic economic policy, developments in the external environment of the Icelandic economy, and 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 baseline forecast even though uncertainty about the inflation outlook has receded with the approval of private sector wage agreements. Uncertainty has not disappeared entirely, as public sector wage settlements are still outstanding and could affect private sector agreements. Furthermore, there is always uncertainty about wage drift and about how far up the pay scale the generous pay rises for the lowest-paid workers will spread. The exchange rate of the króna is another important uncertainty. It is not impossible, for example, that some of the H2/2018 depreciation has yet to pass through to domestic inflation. In addition, the exchange rate assumptions in the baseline forecast could prove overly optimistic; e.g., if the shocks to the tourism industry prove long-lasting or if terms of trade deteriorate further. Demand pressures in the economy could also turn out more persistent than is currently assumed. By the same token, inflation could turn out higher than is forecast if inflation expectations start to rise again.

Nor can the possibility be excluded that inflation will turn out lower than is assumed in the baseline forecast. The króna could appreciate again, for instance, if external conditions improve. The global economic outlook could prove overly optimistic, and exports and GDP growth could therefore turn out weaker than is currently forecast. Productivity growth could prove stronger than is forecast, and the output slack that appears to be opening up could be underestimated.

II The interest rate decision

The MPC discussed the proposed amendments to the Rules on Central Bank Facilities for Financial Undertakings, which would add covered bonds (bonds secured by individuals' mortgage loans) to the list of securities eligible as collateral. The proposal was discussed and then approved by the Committee.

MPC members discussed the monetary stance in view of the most recent information on the economy and the fact that the Bank's real rate was broadly unchanged since the March meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as they had decided in March to keep the Bank's interest rates unchanged, partly because of uncertainty about wage agreements. The Committee had also met twice in April to discuss the most recent economic developments, including the outcome of wage settlements and the changes in the tourism industry.

Members discussed economic developments and prospects, taking into account the Bank's new macroeconomic forecast, published in *Monetary Bulletin* on 22 May, which stated that the GDP growth outlook had changed markedly since the Bank's last forecast. According to the forecast, the outlook is for a contraction of 0.4% this year, as opposed to 1.8% growth according to the February forecast. Members agreed that this deterioration in the outlook was due primarily to a contraction in tourism and reduced marine product exports because of the capelin catch failure. They were of the view that as a result, the positive output gap would close and a slack emerge in the near future; that is, if it had not already done so. It emerged in the discussion that in the short run, there was a risk that economic activity would contract more than was assumed in the baseline forecast. It was also pointed out that it was uncertain whether the contraction would be short-lived and a recovery would begin as soon as 2020. On the other hand, it was pointed out that underlying economic activity could also be underestimated.

The MPC discussed developments in inflation, which measured 3.1% in Q1/2019 and rose to 3.3% in April. Members noted that underlying inflation had developed in broadly the same manner, and the difference between inflation including and excluding housing was at its smallest since autumn 2013. It came to light in the discussion that the króna had held relatively stable in 2019 to date, and the inflationary effects of the autumn 2018 depreciation had thus far been smaller than anticipated. It was pointed out that the Central Bank had intervened very little in the foreign exchange market in the recent past and that the real exchange rate was close to its estimated equilibrium value. Committee members agreed that the deterioration in the economic outlook had caused the inflation outlook to change markedly in a short period of time, and they noted that the Bank's forecast assumed that inflation would peak at 3.4% in mid-2019 and then ease back to the target by mid-2020.

The MPC emphasised that although the recently finalised private sector wage agreements provided for sizeable pay increases, the outcome was better in line with the inflation target than had widely been expected. It emerged in the discussion that uncertainty about the inflation outlook had subsided thereafter. Inflation expectations had therefore moderated again after having risen markedly over the course of 2018. Members considered it very positive that long-term inflation expectations in the market had fallen below 3%.

They noted that the economic contraction would be challenging for households and businesses but emphasised that the economy was much more resilient than before. In this context, they noted that underlying economic fundamentals and conditions were entirely different now than, for example, during the economic crisis a decade ago. The MPC emphasised that monetary policy had considerable scope to respond to the contraction, particularly if inflation and inflation expectations remained close to the target, as is currently envisioned. It emerged in the discussion that because of this ample scope, monetary policy could be applied to mitigate the downturn ahead. Moreover, members considered it positive that the Government's proposed fiscal measures in connection with wage settlements would pull in the same direction.

All members agreed that it was necessary to lower the Bank's key rate now, and they discussed whether it should be lowered by 0.25 percentage points or 0.5 percentage points. The main argument discussed at the meeting in favour of the smaller step, a 0.25-point rate cut, was that inflation was still above target and would probably continue to rise in coming months. Furthermore, inflation expectations were still above target. Moreover, the outlook was for a sizeable rise in unit labour costs in coming years, and public sector wage settlements were still outstanding. The main argument in favour of the larger step, a rate cut of 0.5 percentage points, was the abrupt deterioration of the economic outlook as a result of the recent negative shocks. In addition, the economic outlook was highly uncertain, and the possibility of a deeper and longer contraction than in the Bank's forecast could not be ruled out. Also, the inflation outlook had improved, and long-term inflation expectations had fallen and were closing in on the target, giving the MPC greater scope to respond with a larger rate cut than would otherwise have been possible.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.5 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 4.0%, the current account rate 3.75%, the seven-day collateralised lending rate 4.75%, and the overnight lending rate 5.75%. All Committee members voted in favour of the proposal.

In the Committee'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:

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 26 June 2019.