The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

October 2019 (87th 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 30 September and 1 October 2019, during which the Committee discussed economic and financial market developments, the interest rate decision of 2 October, 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 28 August 2019 interest rate decision.

Financial markets

Since the August meeting, the króna had appreciated by 1.8% in trade-weighted terms. Over this period, it appreciated by 2.5% against the euro, 0.3% against the pound sterling, and 0.6% against the US dollar. Between meetings, the Bank bought foreign currency for 15 million euros (2 b.kr.). The Bank's transactions accounted for roughly 11% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had tightened since just after the Committee's August interest rate decision. The Bank's real rate in terms of the average of various measures of inflation and one-year inflation expectations had risen by 0.3 percentage points between meetings, to 0.7%. In terms of twelve-month inflation, it was 0.5% and had risen by 0.1 percentage points.

Interest rates in the interbank market for krónur declined in line with the Central Bank's rate reduction in August, and turnover in the market totalled roughly 1 b.kr. over the period.

Yields on long-term nominal Treasury bonds had fallen by 0.3 percentage points since the August 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 average indexed mortgage rates had fallen less.

In terms of three-month interbank rates, the interest rate differential with abroad had narrowed between meetings. It measured 4.6 percentage points against the euro area and 2.1 percentage points against the US. The long-term interest rate spread had narrowed by 0.5 percentage points, to 3.9 percentage points versus Germany and 1.7 percentage points versus the US. Measures of the risk premium on the Treasury's foreign obligations were largely unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.8%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.5-0.7 percentage points.

Financial institutions' analysts expected the MPC either to lower the Bank's interest rates by 0.25 percentage points or to hold them unchanged. Their main rationale for a rate cut was that inflation expectations had fallen and the króna had appreciated between meetings. The main arguments for unchanged interest rates were the uncertainty about still-pending public sector wage agreements, and the tourism sector's apparently stronger-than expected performance during the summer season.

Year-on-year growth in broad money (M3) measured just under 5% in August, after adjusting for deposits held by the failed financial institutions. 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 an estimated 6½% year-on-year in August. Over the same period, household lending grew by 6½% year-on-year and corporate lending by just under 5%.

The Nasdaq OMXI10 index had fallen by 4% between meetings. Turnover in the main market totalled 410 b.kr. during the first eight months of the year, about 23% more than over the same period in 2018.

Global economy and external trade

According to the Organisation for Economic Cooperation and Development's (OECD) updated forecast, published in September, the global economic outlook has deteriorated. The OECD estimates global GDP growth at 2.9% in 2019 and 3% in 2020, or 0.3-0.4 percentage points below its May forecast. If this forecast materialises, the growth rate will be the weakest since the financial crisis. Weaker global GDP growth is attributable to a poorer outlook for both advanced economies and emerging market economies, as the OECD has revised its output growth forecast downwards for most G20 countries. Among advanced economies projected to record weaker output growth are the US and Australia, as well as the UK and the euro area. The OECD considers the uncertainty in the forecast to be concentrated on the downside. GDP growth could turn out weaker if global trade disputes escalate further and if the UK leaves the European Union (EU) without an exit agreement.

Iceland's goods account deficit totalled 79 b.kr. in the first eight months of 2019, at constant exchange rates. The deficit over the same period in 2018 was 134 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 10% 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 nearly 15% 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 fuels and lubricants, although the value of transport equipment, commodities, and operational inputs contracted as well. Export values excluding ships and aircraft contracted by just under 6% year-on-year in the first eight months of 2019, particularly manufacturing export values, although marine product exports also fell in value by a full 1%.

Between MPC meetings, the listed global price of aluminium fell just over 2% and was 17% 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 7% year-on-year in the first eight months of 2019. Global oil prices spiked suddenly in mid-September in the wake of an attack on oil processing facilities in Saudi Arabia. The increase reversed, however, and oil was selling at just under 59 US dollars per barrel just before the MPC's October meeting. This is roughly the same as just before the August meeting but over 30% below the price in early October 2018.

The real exchange rate in terms of relative consumer prices rose by 2.6% month-on-month in August, when it was 9.7% above its 25-year average but 14.4% below its June 2017 peak. In the first eight months of 2019, it was down by 9.5% compared with the same period in 2018, as the nominal exchange rate of the króna was 10.9% lower and inflation in Iceland was 1.5 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland in late August, GDP growth measured 2.7% for the second quarter of the year. Domestic demand increased by 0.2%, but the contribution of net trade to output growth was positive by 2.6 percentage points. Both exports and imports contracted year-on-year during the period, although imports contracted much more strongly.

GDP growth measured 0.9% in H1/2019. Consumption and investment fell by 1.4% between years during this period, but due to a strong contraction in inventory changes in Q1, the contraction in domestic demand was much stronger, at 2.4%. In spite of the contraction in exports, the contribution of net trade to output growth was positive by 3.3 percentage points, as imports were down 10.6% year-on-year. GDP growth was nearly ½ a percentage point above the forecast published in the August *Monetary Bulletin*. Developments in private consumption, residential investment, and public expenditure in H1 were in line with the forecast, but business investment contracted more than expected. The contribution from net trade was more favourable than expected, primarily because of weaker imports.

The current account balance was positive by 11.1 b.kr. in Q2, a major improvement over the Q2/2018 deficit of 4.4 b.kr. The change is due for the most part to a smaller deficit on goods trade. In addition, the balance on primary and secondary income was more positive this year than in 2018. The surplus on services trade grew slightly between years, a more positive outcome than was assumed in the Bank's August forecast.

Key indicators of private consumption were weaker in Q3 than in Q2, suggesting that private consumption growth will continue to lose pace. The Gallup Consumer Confidence Index measured 99.2 points in September, an improvement from the previous month and from the previous year. The index also rose slightly between Q2 and Q3.

The fiscal budget proposal for 2020 assumes that the Treasury outcome will be in line with estimates contained in the fiscal plan for 2020-2024. According to the Ministry of Finance and Economic Affairs' revision of the 2019 outcome in comparison with the National Budget for the year, the outcome has deteriorated by 1.3 percentage points of GDP. According to the Ministry's estimate for 2019 as a whole and Statistics Iceland figures for 2018, the fiscal outcome deteriorated by 1.2 percentage points of GDP between the two years. The Ministry also estimates that the unadjusted primary surplus will decline by as much as 1.4 percentage points of GDP between 2018 and 2019. The extent to which this estimate entails a change in the Bank's assessment of the fiscal stance in 2019 and 2020 will depend on developments in forecasts of fiscal performance and the output gap.

According to the results of Gallup's autumn survey, conducted in September among Iceland's 400 largest firms, respondents' assessment of the current economic situation was more positive than in the summer survey, but somewhat more negative than in the survey taken in autumn 2018. Executives' attitudes towards the outlook six months ahead is more positive, however, than in both the summer survey and the autumn 2018 survey. About 56% of respondents considered the current situation neither good nor poor, and about 29% considered it good. Some 30% of executives are of the view that economic conditions will deteriorate in the next six months, and 49% expect conditions to be neither better nor worse. About one-fifth of executives expect conditions to improve in the next six months – an increase since the summer. Executives are marginally more pessimistic about developments in domestic demand than they were in the summer survey, particularly those in construction and retail and wholesale trade.

According to the survey, attitudes towards the operational outlook are more positive than in the spring survey, and the number of respondents who expect their profit margins to increase between 2018 and 2019 is roughly the same as the number expecting a decrease. Sentiment has improved among executives in all sectors, particularly among those in the fishing industry and the financial and insurance sector. As before, a larger number expect investment in 2019 to be less than in 2018.

According to the seasonally adjusted results of the autumn survey, the balance of opinion on staffing plans (i.e., firms planning to recruit as compared with those planning redundancies) was negative by 7 percentage points. Therefore, survey respondents were somewhat less pessimistic than in the summer survey, when the same balance of opinion was negative by 12 percentage points. As before, the outlook is for increased job numbers in miscellaneous specialised services. Furthermore, downbeat sentiment receded markedly between surveys in the fishing and transport, transit, and tourism sectors, where the balance of opinion on staffing plans was broadly neutral. On the other hand, sentiment among executives in construction and utilities and in retail and wholesale trade deteriorated since the summer survey. In both of these sectors, as well as in financial services, the outlook is for a drop in job numbers.

After adjusting for seasonality, 15% of executives considered themselves short-staffed. This is a slightly higher percentage than in the summer survey. The shortage is still most pronounced in miscellaneous specialised services, where 25% of respondents consider themselves understaffed, and in fishing, where the share considering themselves short-staffed rose by 17 percentage points between surveys, to 21%. Worker shortages were negligible in retail and wholesale trade, and no respondents in the financial and insurance sector reported a shortage of staff. Staffing shortages were below their long-term averages in all sectors except fishing.

About 41% of executives reported that they would have difficulty responding to unexpected demand, after adjusting for seasonality. This percentage was broadly unchanged from the summer survey and has been close to its long-term average since the autumn 2018 survey. Nearly three-fifths of executives in the specialised services sector reported that they would have difficulty responding to unexpected demand, as opposed to only a fourth in retail and wholesale trade, financial services, and the transport, transit, and tourism sector.

In August, the wage index was virtually unchanged month-on-month and rose by 4.3% year-on-year, and real wages were 1.1% higher during the month than at the same time in 2018.

Statistics Iceland's nationwide house price index, published in late September, rose by 0.2% month-on-month when adjusted for seasonality, but rose 3.3% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.7% month-on-month in August when adjusted for seasonality, and by 3.6% year-on-year. The number of purchase agreements registered nationwide fell by 8.5% year-on-year in the first eight months of 2019, while the number of contracts for new construction declined by 14.1% over the same period.

The consumer price index CPI rose by 0.09% month-on-month in September. Headline inflation measured 3% and had declined since the MPC's August meeting. The CPI excluding the housing component had risen by 2.9% year-on-year in September. Underlying inflation picked up between meetings, however, measuring 3.4% in September, according to the median of various measures. Price hikes due to the end of seasonal sales were the main driver of inflation in September, albeit offset in part by lower airfares. The year-on-year rise in imputed rent (i.e., owner-occupied housing costs) continued to ease, measuring just over 2% in September.

According to Gallup's autumn surveys, households' and businesses' one-year inflation expectations fell between surveys. Households expect inflation to measure 3% in one year's time, and businesses' expectations have fallen back to the inflation target. Households' and businesses' two-year inflation expectations are around or slightly above 3%, and have fallen in the past year. Both groups' long-term expectations also measure 3%, and households' long-term expectations have fallen since the summer survey. The five- and ten-year breakeven inflation rate in the bond market was about 2.4% just before the MPC meeting, after falling by 0.3 percentage points since the August meeting. In Q3, the ten-year breakeven rate was down by 1 percentage point year-on-year, to 2.7%.

II The interest rate decision

The Committee discussed proposed restrictions on transactions with the Central Bank and, in this context, amendments to rules on Central Bank facilities for credit institutions and other entities and the reserve requirements of credit institutions. The proposals were discussed and then approved by the Committee.

MPC members discussed the monetary stance in view of the most recent information on economic developments and the fact that the Bank's real rate had risen since the August meeting. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in August to lower interest rates because the GDP growth outlook for 2020 had deteriorated and the outlook was for inflation to subside faster than had been forecast in May. In addition, it was possible that the GDP growth outlook was too optimistic, given the worsening conditions in the global economy.

The Committee discussed the preliminary national accounts figures, which indicated output growth had continued to ease in H1/2019, even though it was somewhat stronger than had been forecast in the August *Monetary Bulletin*. Members noted that this relatively stronger growth was due mainly to a more favourable contribution of net foreign trade, as demand had shifted towards domestic production, partially offsetting the contraction in exports. They agreed that leading indicators implied that economic activity would continue to slow down, but they considered it positive that there were visible signs that the economy might be regaining a foothold. It emerged in the discussion that indicators suggested that executives were slightly more positive about the current situation and economic outlook than they had been in H1/2019. It was noted, however, that there was uncertainty in the labour market and that conditions could deteriorate over the winter, especially for the tourism sector.

The MPC discussed developments in inflation, which measured 3.1% in Q3 and had fallen between quarters. Members noted, though, that underlying inflation had risen month-on-month in September. Headline inflation was slightly lower than had been forecast in August, and members also noted that the outlook was for it to ease faster than had been assumed there. Members stressed that the króna had appreciated and inflation expectations had fallen since the MPC's last meeting. The monetary stance had therefore tightened slightly. It emerged in the discussion that it was positive that inflation expectations had continued to fall, and that this was a sign of increased credibility of monetary policy.

Members agreed that recent developments suggested that economic activity had been stronger than previously assumed. It emerged that the real economy was relatively strong given the economic shocks that had struck early in the year. In members' view, this was due in part to the recent easing of monetary policy. The economic outlook was uncertain, however, particularly the global outlook, and domestic GDP growth could therefore contract more rapidly than was currently assumed. It was also noted that despite a slowdown in lending growth, particularly in lending to the corporate sector, growth in lending to both households and businesses was still relatively robust. It also emerged in the discussion that, in view of the fact that lenders appeared to have tightened lending requirements, Central Bank interest rate cuts might in some cases be transmitted less effectively to market rates than they would be otherwise. On the other hand, mortgage lending rates had fallen somewhat, and there were signs that companies were increasingly seeking financing outside the bank lending market. The MPC discussed the outlook for the real estate market, noting that, in the recent term, the number of purchase agreements had fallen and the supply of housing had increased, particularly the supply of relatively more expensive properties. It was noted that the number of residential purchase agreements was close to its seven-year average, and roughly at the level seen in 2006.

The Committee discussed two possibilities: keeping interest rates unchanged or lowering them by 0.25 percentage points. The main grounds for holding rates constant were that the economy had been more resilient than expected in H1/2019, and the recent increase in the real policy rate could be in line with that development. It was not impossible that private consumption would turn out stronger than expected, as disposable income had risen markedly in the recent term, saving had increased, and household net worth was high in historical terms. In addition, inflation and several measures of inflation expectations were still above target, and underlying inflation had inched upwards. Furthermore, the easing of the fiscal stance meant that less monetary easing would be needed, and moreover, public sector wage agreements were still pending.

The main grounds for easing rates further were that even though the current economic situation was better than had been forecast, there was increased risk that the GDP growth outlook was too optimistic, particularly because of the bleaker economic outlook abroad, and uncertainty had increased. As a result, it could be appropriate to lower interest rates in order to reduce the risk of a further weakening of demand. Furthermore, inflation had been slightly lower than expected in Q3, and the outlook was for it to align with the target earlier than previously anticipated. Inflation expectations had continued to fall, and the króna had appreciated in the recent past.

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 3.25%, the current account rate 3%, the seven-day collateralised lending rate 4%, and the overnight lending rate 5%. 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 6 November 2019.