The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, June 2017

Published 28 June 2017

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

The following are the minutes of the MPC meeting held on 12 and 13 June 2017, during which the Committee discussed economic and financial market developments, the interest rate decision of 14 June, 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 17 May 2017 interest rate decision.

Financial markets

Between meetings, the króna appreciated by 1.1% in trade-weighted terms. Over this period it appreciated by 1.8% against the US dollar, 0.4% against the euro, and 3.1% against the pound sterling. The Central Bank's net foreign currency purchases in the domestic foreign exchange market totalled approximately 54 million euros (roughly 6.03 b.kr.) between meetings, or 22% of total market turnover.

In terms of the Central Bank's real rate, the monetary stance tightened slightly between meetings. The Bank's real rate in terms of the average of various measures of inflation and inflation expectations had risen by 0.3 percentage points since just after the Bank's rate reduction in May, to 2.7%.

Interest rates in the interbank market for krónur had developed in line with the Bank's key rate between meetings. Turnover in the market had been considerably greater year-to-date than over the same period in 2016, totalling 111.6 b.kr.

Yields on nominal Treasury bonds had fallen by up to 0.4 percentage points following the reduction in the Bank's key rate and the publication of the minutes of the last MPC meeting.

Yields on indexed Treasury and Housing Financing Fund (HFF) bonds declined by up to 0.2 percentage points between meetings.

The commercial banks' nominal deposit and lending rates fell by 0.1-0.3 percentage points, in line with the Bank's rate cut in May, whereas the pension funds' nominal lending rates remained unchanged between meetings. The pension funds' indexed lending rates declined marginally between meetings, in line with yields on indexed Treasury and HFF bonds, but the commercial banks' indexed lending rates were unchanged.

Risk premia on Treasury foreign obligations were broadly unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was unchanged since the May meeting, at 0.8%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany rose slightly, to 1 percentage point.

Financial institutions' analysts expected either no change or a rate reduction of 0.25 or 0.5 percentage points in June. As grounds for a rate cut, they cited improvement in the inflation outlook because of the appreciation of the króna and signs of a slower rise in house prices in the near future, as well as the rise in the real rate between MPC meetings. The main grounds cited in favour of an unchanged key rate were the tight labour market, the strength of the economy, and the accommodative fiscal stance.

Growth in money holdings has picked up in the past two months. Annual growth in M3 was almost 9% in March and 7½% in April, after adjusting for deposits held by the failed financial institutions. As in 2016, annual growth is due primarily to an increase in household deposits. The quicker pace of growth in money holdings in the past two months is also due to a larger year-on-year increase in corporate and financial sector deposits than in previous months.

After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers grew by nearly 3½% year-on-year in April, and by just under 4½% after adjusting for the effects of exchange rate movements on the foreign-denominated credit stock. Growth is attributable to an increase in lending to households and businesses. Annual growth in credit system lending to households measured nearly 4% in April after adjusting for the Government's debt relief measures.

The Nasdaq OMXI8 index had fallen by 2.7% between meetings but had risen by 7.2% since the beginning of the year. Turnover in the Nasdaq Iceland main market totalled almost 318 b.kr. in the first five months of the year, about 26% more than over the same period in 2016.

Global economy and external trade

According to the Organisation for Economic Co-operation and Development's (OECD) June forecast, GDP growth will be somewhat stronger in 2016 and 2017 than in the OECD's November forecast. Global GDP growth is expected to increase from last year's rate of 3% to 3.5%, some 0.2 percentage points more than was forecast in November. Global GDP growth is forecast at 3.6% in 2018. The outlook for world trade in 2017-2018 has also improved. The OECD forecast for 2017 GDP growth among Iceland's main trading partners is about 0.2 percentage points higher than was expected in November, or 2%. Trading partner inflation is projected at 1.9% this year, or 0.3 percentage points higher than was assumed in the November forecast, owing to the recent rise in commodity prices.

Iceland's external goods trade generated a deficit of 61 b.kr. for the first five months of the year, as opposed to a deficit of 41 b.kr. over the same period in 2016. Export values rose by 7% year-on-year at constant exchange rates, while import values rose 15%. The export value of industrial goods rose by 18% year-on-year, while the export value of marine products contracted nearly 6%. Import growth is attributable in particular to a rise of roughly one-fourth in the value of imported commodities and operational inputs and a 40% rise in the value of imported fuels and lubricants.

The listed global market price of aluminium was unchanged between MPC meetings, and in the first week of June the average price was up by nearly one-fifth year-on-year. Foreign currency prices of marine products rose by about 2.5% between months in April and had by 7.9% year-on-year.

In terms of relative consumer prices, the real exchange rate had risen 5.6% month-on-month in May, to 105.2 points. In the first five months of 2017, it was up 18.8% year-on-year, owing to a corresponding rise in the nominal exchange rate, as inflation was the same as the trading partner average.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in June, annual GDP growth measured 5% in Q1/2017, somewhat below the H2/2016 growth rate. This was due mainly to the effects of the fishermen's strike in Q1, which showed in a contraction in good exports and explains in part the negative contribution from inventory changes. In addition, investment growth slowed markedly, mainly due to reduced investment in ships and aircraft. Domestic demand grew 3.2% year-on-year during the quarter. Of that total, consumption and investment grew by a total of 4.7%, with the difference reflecting the negative contribution from inventory changes. In spite of the impact of the fishermen's strike on exports, the contribution from net trade was positive during the quarter, as exports grew by 5.4% and imports by 3.1%.

GDP growth in Q1/2017 measured marginally below the forecast in the May issue of *Monetary Bulletin*. Investment was somewhat weaker than forecast, owing almost entirely to less residential investment than was reported in Statistics Iceland's figures. Private consumption growth was stronger, however, and the negative contribution from inventory changes was expected to be greater than Statistics Iceland's figures indicate. Growth in domestic demand turned out broadly as had been forecast. Growth in services exports was strong during the quarter but less than had been projected. The contribution from net trade was therefore smaller than had been assumed in the forecast in *Monetary Bulletin*.

The current account balance was positive by 11.1 b.kr., or 1.9% of GDP, in Q1/2017. This is a considerably smaller surplus than in the previous quarter and somewhat smaller than in Q1/2016, when it measured 2.6% of GDP. The surplus for this year was due to a 43.1 b.kr. surplus on services trade and a 3.1 b.kr. surplus on primary and secondary income, which were offset by a 35.1 b.kr. deficit on goods trade.

Indicators of developments in private consumption at the beginning of the quarter suggest that household demand growth is still robust but may have eased from the Q1/2017 measurement. The Gallup Consumer Confidence Index measured 123.6 points in May, a full 3 points lower than in April and about 12 points lower than in May 2016. Even though the index has fallen, it still indicates that households are optimistic, however.

According to the results of Gallup's summer survey, conducted in May among Iceland's 400 largest firms, respondents were very upbeat about the current economic situation but slightly more pessimistic about the outlook six months ahead than they were in the spring survey, conducted in March. They were slightly more optimistic than they were in the winter survey, however. About 80% of respondents considered the current situation good, and about 14% considered it neither poor nor good. Just under 19% of executives were of the view that economic conditions would improve in the next six months, and 65% expected conditions to remain unchanged (i.e., good). Executives in the construction and fishing industries were more pessimistic than other about the situation six months ahead, while optimism among companies in retail and wholesale trade diminished most in comparison with the spring survey. Executives in all sectors were more pessimistic than they were a year ago. About 16% of respondents expected conditions to be worse in six months' time, as opposed to 8% a year earlier. There was considerable optimism about domestic and foreign demand, albeit somewhat less than in the last survey.

According to the survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by about 22 percentage points, after adjusting for seasonality. This is broadly similar to the percentage in the spring survey but lower than in the survey taken a year ago. The most positive executives were those in the financial and insurance sector, where firms planning to recruit outnumbered those planning redundancies by 38 percentage points. The most pronounced change was in the fishing industry, where firms planning to recruit outnumbered those planning redundancies by 14 percentage points in the summer survey, whereas in the spring survey the opposite was true: firms planning redundancies outnumbered those planning to add staff by 16 percentage points. In other sectors, the ratio lay in the range of 15-35 percentage points.

Adjusted for seasonality, 41% of firms considered themselves short-staffed, broadly the same as in the past year or so. The percentage of firms that considered themselves understaffed was highest in the financial and insurance sector, at 48%, and lowest in transport, transit, and tourism, at 31%. In other sectors it ranged between 35% and 45%.

The wage index rose by 0.2% month-on-month in April and by 4.9% year-on-year. Real wages in terms of the index had risen by 2.9% year-on-year in April.

Statistics Iceland's nationwide house price index, published at the end of May, rose 2.6% month-on-month after adjusting for seasonality, and by 22.5% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 2.7% month-on-month in April when adjusted for seasonality, and by 22.7% year-on-year. The number of purchase agreements registered nationwide in the first four months of 2017 were unchanged between years. The average time-to-sale for residential property in the greater Reykjavík area was about 1.4 months in the first four months of 2017, as opposed to 2 months during the same period in 2016.

The CPI rose by 0.2% month-on-month in May. Twelve-month inflation measured 1.7% in May and had tapered off since the MPC's March meeting. The CPI excluding the housing component had declined by 2.6% year-on-year, however. Most measures of underlying inflation suggested that it had declined even further in May and lay in the 0.6-1.7% range.

As before, the main driver of the CPI increase in May was the rise in house prices. Offsetting this was the seasonal decline in international airfares, although a reduction in the price of motor vehicle tyres also had a significant downward impact on the index. Private services prices fell by 0.6% year-on-year, mainly because of reductions in telephone services prices and international airfares, although rises in other services prices have also subsided recently.

According to Gallup's summer survey, conducted in May, household inflation expectations declined between surveys, to 2.5% one year ahead and 3% two years ahead. Corporate executives' expectations also fell between surveys, to an all-time low of 1.8% one year ahead.

II The interest rate decision

The Governor reported to the Committee on the Executive Board of the International Monetary Fund's (IMF) Article IV discussion about the current situation and future prospects for the Icelandic economy. The Chief Economist reported on a discussion of the same topic at a meeting at the OECD in connection with the OECD's report on Iceland in which he had participated on behalf of the Bank. At both meetings, the capital flow management measure was discussed in particular.

The MPC discussed the monetary stance in view of the most recent information on the economy and the rise in the Bank's real rate between meetings. Members discussed whether this changed their assessment of whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had been unanimous in May about its decision to lower the Banks's key rate by 0.25 percentage points, because the real rate had risen between meetings and the appreciation of the króna had contained demand.

Only a short time had passed since the previous meeting, and the information published in the interim largely supported the Committee's previous assessment of the economy. Members discussed the newly published national accounts figures for Q1/2017, which they considered to show that the outlook was broadly unchanged from the Bank's last forecast. GDP growth was weaker in Q1 than it had been in H2/2016, although it was in line with the forecast in the May issue of *Monetary Bulletin*. The GDP growth outlook for 2017 as a whole was therefore broadly unchanged. The national accounts figures showed that, as before, GDP growth was driven in particular by tourism and private consumption. The MPC also considered that the outlook was for significant fiscal easing in 2017, in addition to the easing in the previous two years.

Members noted that inflation was broadly as it had been over the past half-year but that underlying inflation appeared to have subsided in recent months. The gap between domestic price developments – housing costs in particular – and external factors had also widened significantly in recent months. As before, the MPC was of the view that opposing forces affected the inflation outlook, with the appreciation of the króna and low global inflation offsetting domestic inflationary pressures.

In addition, members noted that both short- and long-term inflation expectations had continued to fall since the last meeting and the Bank's real rate had therefore risen. Inflation expectations had been relatively stable in spite of exchange rate movements, indicating, in the Committee's opinion, that monetary policy had anchored them more securely.

The Committee discussed whether to keep interest rates unchanged or lower them. All members agreed that clear signs of demand pressures in the economy called for a continued tight monetary stance so as to ensure medium-term price stability. However, they were of the view that the increase in the Bank's real rate since the last MPC meeting entailed a somewhat tighter stance than the Committee had intended and considered sufficient to support price stability. As a result, there were grounds for a nominal rate cut so that the Bank's real rate would remain unchanged from the previous meeting.

Committee members did not agree, however, on whether other factors warranted a further reduction in interest rates. One member preferred to take a larger step because real rates on loans to borrowers outside the real estate market were very high as a result of deflation as measured by the CPI excluding housing. Deflation by that measure had accelerated by 0.8 percentage points since the May meeting. Furthermore, this member was of the view that the strength of the króna dampened demand and gradually eroded exporters' equity, particularly in the case of exporters with króna-denominated debt. An interest rate reduction could therefore be seen as a measure to counterbalance the high and rising exchange rate. He also pointed out that increased competition in the goods market could lead to lower mark-ups, which would deliver higher real incomes and reduce the level of unemployment consistent with stable inflation.

The view was expressed that although the króna had not appreciated substantially between meetings, the accumulated appreciation over a longer period of time had already exerted considerable restraint, as did the strong króna. In addition to the effect on export sectors, there was probably some impact on the labour market as well. The rise in the exchange rate made it more economical for firms to import workers and mitigated outward migration. This had already resulted in less wage drift than could have been expected given the demand pressures in the labour market; furthermore, it could result in wage increases more in line with the inflation target and productivity growth in the coming round of wage negotiations.

Some members thought the probability that the rise in house prices in excess of the general price level and wages would reverse without also reversing the recent appreciation of the króna was no less than the probability of a less favourable interaction between house prices and the exchange rate. This warranted a continued cautious reduction in nominal interest rates, provided that credit growth did not accelerate too much.

One member pointed out that it was difficult to see how the current situation and near-term outlook called for monetary easing and that it was therefore only appropriate to reverse the increase in the real rate that had occurred between meetings. The fiscal stance had eased significantly; therefore, it was difficult to see where a tight stance would come from if not from monetary policy. This member also pointed out that the purpose of a tight monetary stance had indeed been to slow down economic activity, and that this purpose was being achieved. Furthermore, this member pointed out that with monetary policy stabilising inflation including housing, it was inevitable that inflation excluding housing would be very low or even negative when house prices rose steeply.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points, which would lower 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%. All Committee members voted in favour of the proposal. Two of them would have preferred to lower rates by 0.5 percentage points but were nonetheless willing to vote in favour of the Governor's proposal.

Members agreed that a stronger anchor for inflation expectations at target and the appreciation of the króna had enabled the MPC to achieve its legally mandated price stability objective with a lower interest rate than would otherwise have been possible. Members agreed that in the coming term, the monetary stance would be determined by economic developments and actions taken in other policy spheres.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 23 August 2017.