The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, October 2017

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

The following are the minutes of the MPC meeting held on 2 and 3 October 2017, during which the Committee discussed economic and financial market developments, the interest rate decision of 4 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 23 August interest rate decision.

Financial markets

Between meetings, the króna depreciated by 0.3% in trade-weighted terms. Over the same period it was virtually unchanged against the US dollar and the euro but fell by 3.4% against the pound sterling. Between meetings, the Central Bank conducted no transactions in the interbank foreign exchange market. The Bank's net foreign exchange purchases year-to-date totalled 70 b.kr. (600 million euros), or about 24% of total turnover for the period.

In terms of the Central Bank's real rate, the monetary stance had eased slightly between meetings. The Bank's real rate in terms of the average of various measures of inflation and inflation expectations had fallen by 0.2 percentage points between meetings, to 2.1%.

Interest rates in the interbank market for krónur were unchanged between meetings. Turnover in the market totalled 6.2 b.kr. between meetings, but about 123.2 b.kr. year-to-date, much more than over the same period in 2016.

Nominal Treasury bond yields rose somewhat after the last MPC meeting and again after the collapse of the Government in mid-September. The rise reversed in part following the publishing of the September CPI, just before the October meeting, but was still as much as 0.3 percentage points higher than at the August meeting. Yields on indexed Treasury and Housing Financing Fund (HFF) bonds had also risen by up to 0.2 percentage points between meetings.

The commercial banks' non-indexed deposit and lending rates were unchanged between meetings. The banks' comparable indexed lending rates and the pension funds' fixed rates on indexed loans to fund members were also broadly unchanged. Non-indexed lending rates and variable rates on the pension funds' indexed loans fell slightly between meetings, however.

Risk premia on Treasury foreign obligations were virtually unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.8%, while the spread between the Treasury's eurobonds and comparable bonds issued by Germany was approximately 1 percentage point.

Financial institutions' analysts had all projected that the Bank's interest rates would be held unchanged in October, mainly on the grounds that the collapse of the Government had exacerbated uncertainty about the near-term fiscal stance and caused a marked rise in the breakeven inflation rate in the bond market.

M3 adjusted for the deposits held by the failed financial institutions grew by 8.9% year-on-year in August, about the same as in previous months. As was the case last year, growth in money holdings is due largely to increased household deposits.

Lending to resident entities has also increased. After adjusting for the Government's debt relief measures, the total stock of credit system loans to resident borrowers increased by 5.4% year-on-year in August, and by just over 6% if the foreign-denominated credit stock is calculated at constant exchange rates. As before, credit growth is due to an increase in lending to households and businesses. Lending to households increased by 5% year-on-year in August, after adjusting for the Government's debt relief measures, and loans to businesses by 7.3%. Calculated at constant exchange rates, the stock of corporate loans rose by approximately 10% year-on-year in August, much more than in the first half of the year.

The Nasdaq OMXI8 index had fallen by 4.3% between meetings and by 2.2% since the beginning of the year. Turnover in the NASDAQ Iceland main market totalled approximately 450 b.kr. over the first eight months of the year, about 21% more than over the same period in 2016.

Global economy and external trade

Iceland's external goods trade generated a deficit of 120 b.kr. in the first eight months of the year, as opposed to a deficit of 79 b.kr. over the same period in 2016. Export values rose by 8% year-on-year at constant exchange rates, while import values rose 17%. Export growth was due to 16% growth in industrial goods exports, whereas marine product exports contracted by 6%. Import growth stemmed mainly from a 22% increase in imports of commodities and operational imports, a 44% rise in passenger car imports, and a 15% rise in investment goods imports.

The listed global market price of aluminium was unchanged since the August meeting, and the average price in September was up almost a third year-on-year. Foreign currency prices of marine products were also unchanged between months in August but had risen by 2.5% year-on-year.

In terms of relative consumer prices, the real exchange rate had fallen three months in a row in September, by a total of 8.8% since June. The decline is due primarily to a 9% nominal depreciation of the króna, but offsetting that, inflation in Iceland was about 0.2 percentage points above the trading partner average. On the other hand, the real exchange rate was still 15.7% higher in the first eight months of the year than it was in the same period of 2016.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in September, GDP growth measured 3.4% in Q2/2017. During the quarter, 6.7% growth in domestic demand was offset by a negative contribution from net trade, with import growth measuring 16.2%, far outpacing export growth, which measured 8%. During the first half of the year, GDP growth measured 4.3%, driven mainly by private consumption and exports.

GDP growth was weaker in H1 than had been forecast in the August *Monetary Bulletin*, which provided for 5.6% growth during the half. The main reason for the deviation is a more negative contribution from net trade, owing to the combined effect of weaker exports and stronger imports than had been forecast. Consumption and investment grew more strongly than forecast, but this was offset by the contribution from inventory changes, which was smaller than expected. Growth in domestic demand as a whole was therefore close to the forecast, or 5.2% instead of the projected 5.4%.

In Q2/2017, the current account surplus totalled 16.3 b.kr., or 2.6% of GDP. This is a smaller surplus than in the previous quarter and in the same period in 2016. The balance on services was positive by 60.5 b.kr., and the balance on primary and secondary income was 1.6 b.kr., whereas the goods account showed a deficit of 45.8 b.kr.

Key indicators of developments in private consumption in Q3 suggest that household demand growth remains strong. On the other hand, leading indicators imply that growth will ease in coming quarters. The Gallup Consumer Confidence Index measured 106.8 points in September, about 25 points lower than a year earlier. The big-ticket index, which measures households' planned major purchases, measured 69.3 points, a decline of 2.5 points between measurements.

According to the fiscal budget proposal for 2018, Treasury performance is expected to be in line with the estimate according to the fiscal strategy for 2018-2022. The performance target for 2017 according to that year's budget is to be ensured with extraordinary dividend payments by the commercial banks in the amount of 20.3 b.kr. In assessing the fiscal stance, such one-off items are excluded; therefore, this year's cyclically adjusted primary balance corrected for one-off items declines by 0.8% of GDP from the estimate published in *Monetary Bulletin* 2017/2. The fiscal easing between 2016 and 2017 amounts to 1.9% of GDP. The fiscal stance is expected to tighten by a total of 1.7% of GDP in 2018.

According to the results of Gallup's autumn survey, conducted in September among Iceland's 400 largest firms, respondents were very upbeat about the current economic situation but considerably more pessimistic about the outlook six months ahead than they were in the summer survey, carried out in May. Their attitudes were also markedly more pessimistic than in the spring survey. About 70% of respondents considered the current situation good, and about 24% considered it neither good nor poor. Some 7.5% of executives were of the view that economic conditions would improve in the next six months, and 64% expected conditions to remain unchanged (i.e., good). In all sectors, however, executives' attitudes were more negative than they were either in May or in September 2016. In particular, executives in the fishing and construction sectors were more pessimistic about the situation six months ahead than other executives were. Sentiment among executives in specialised services firms deteriorated most from the summer survey. About 29% of respondents expected conditions to be worse in six months' time, as opposed to just under 10% a year earlier. Attitudes towards domestic demand were considerably less positive than before, while attitudes towards external demand were unchanged from the summer survey.

According to the autumn survey, there was an increase in the number of firms that expect their EBITDA to shrink in the next six months compared to the spring survey. The EBITDA index fell by 15 points between surveys, and the number of firms expecting their EBITDA to rise in the next six months was roughly equal to the number expecting them to decline. Sentiment among executives in transport, transit, tourism, and retail and wholesale trade deteriorated the most. The investment index also fell somewhat from the previous measurement, and there, too, the change was greatest among transport, transit, and tourism companies.

According to the seasonally adjusted results of the autumn survey, the share of respondents interested in adding on staff in the next six months exceeded the share interested in downsizing by 17 percentage points. This is 6 percentage points less than in the summer survey and 19 percentage points less than in the survey a year ago. Sentiment was most positive among executives from firms in transport, transit, and tourism. In these sectors, firms interested in recruiting exceeded the share interested in downsizing by 40 percentage points. Attitudes were most pessimistic among companies in the fishing industry, where 15 percentage points more firms were considering laying off staff than recruiting, while the same ratio in the retail and wholesale trade sector was 5 percentage points. In other sectors, the ratio of firms interested in recruiting net of the share wanting to downsize lay in the range of 15-26 percentage points.

After adjusting for seasonality, 35% of executives considered themselves understaffed, about 5 percentage points less than in the previous survey. This ratio had been close to 40% for more than a year. It was highest in the construction industry, where almost half of executives considered themselves short-staffed, and lowest in financial services, where 17% considered themselves short-staffed. In other sectors it ranged between 28% and 40%.

Half of executives were of the view that their firms would have trouble responding to unexpected demand, after adjusting for seasonality. This share was slightly lower than in the surveys conducted this past summer and in autumn 2016. About 68% of construction company executives were of the opinion that it would be difficult to respond to unexpected demand, whereas the smallest share was in retail and wholesale trade, at 29%. In other sectors, the ratio lay in the 44-55% range.

The wage index rose by 0.2% month-on-month in August and by 7.2% year-on-year. Real wages in terms of the index had risen by 5.3% year-on-year in August.

Statistics Iceland's nationwide real estate price index, published at the end of September, rose by 4.7% quarter-on-quarter in Q3 when adjusted for seasonality, and 22.5% year-on-year. The capital area real estate price index, calculated by Registers Iceland, rose by 1.2% month-on-month in August when adjusted for seasonality, and by 19.1% year-on-year. The pace of the twelve-month increase has eased somewhat since peaking at 23.5% in May. The number of purchase agreements registered nationwide declined by 5.1% year-on-year in the first eight months of 2017. The average time-to-sale for flats in the greater Reykjavík area was about 2.5 months in August, as compared with 2 months in August 2016.

The CPI rose by 0.14% month-on-month in September, after rising 0.25% in August. Twelve-month inflation measured 1.4% and had fallen by 0.4 percentage points since the MPC's August meeting. The CPI excluding the housing component had declined by 3.1% year-on-year in September, however. Most measures of underlying inflation suggested that it had declined in September and lay in the 0.3-1.9% range.

The drivers of the increase in the CPI in September were rising house prices and end-of-sale effects. These were offset by the seasonal decline in international airfares and a drop in food prices, which had declined by a total of 5% year-on-year by September. Private services prices had fallen by 0.4% between years, and services inflation had subsided since the last meeting.

According to Gallup's autumn survey, conducted in September, household inflation expectations rose between surveys, to 3% one year ahead and 3.2% two years ahead. Corporate executives' inflation expectations also rose between surveys, with respondents expecting inflation to measure 2.4% one year ahead. Their two-year inflation expectations were unchanged, however, at 3%. The five- and ten-year breakeven inflation rates in the bond market rose after the Government collapsed in mid-September, but the increase had reversed by end-September, when the five-year rate measured 2.6% and the ten-year rate 2.9%.

II The interest rate decision

The Governor reported to the MPC on the authorities' ongoing work in connection with the review of the monetary policy framework. In addition, the Deputy Governor updated the Committee on the work underway on the review of the statutory and technical foundations for the capital flow management measure.

The MPC discussed the monetary stance in view of the most recent information on the economy and the decline in the Bank's real rate between meetings. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in August to keep interest rates unchanged even though the monetary stance had eased between meetings, due to indications of weaker output growth and a narrower output gap than had previously been assumed.

Committee members were of the view that the information that had emerged between meetings pointed in the same direction. According to the national accounts for H1/2017, the outlook is for GDP growth to be weaker in 2017 than in 2016, and weaker than had been forecast in the August *Monetary Bulletin*. There were clear signs that growth in tourism had eased. Gallup's autumn survey also indicated that corporate executives were more pessimistic than they had been in the previous survey. Furthermore, labour demand appeared somewhat weaker and the shortage of workers smaller, albeit still significant. The year-on-year rise in house prices had continued to ease. It was mentioned that labour demand was greatest in the sectors that had been hiring foreign workers. In Committee members' opinion, the adjustment to sustainable GDP growth seemed more rapid than they had previously expected, although it was considered clear that the growth rate would remain robust. Committee members agreed that because of this, it would be possible to keep inflation at target with a lower real interest rate.

The Committee discussed the disinflation of the previous two months. Inflation had measured 1.4% in September, and measures of underlying inflation suggested that inflation was even lower, and falling. Some members emphasised the fact that inflation excluding the housing component was negative, and one member stressed that by this measure, the real rate was high. On the other hand, it was pointed out that based on the same kind of argument, real disposable income had risen even more if income was deflated by the headline CPI. In the discussion, it was also pointed out that because inflation is due almost entirely to rising housing costs, there was a significant likelihood that it would subside still further when the rise in housing costs eased, as signs already indicated, or when house prices began to fall again. Real house prices were already at a historical high, which increased the likelihood of such a development. Committee members agreed that housing inflation stemmed not from low interest rates but from excess demand. The supply of housing had begun to rise, however, and because of this the rise in house prices could slow markedly. It was also mentioned that if the exchange rate of the króna reached a new equilibrium at its current level, which was higher than it was a year ago, it was unlikely to push inflation towards the target.

The Committee discussed recent developments in the exchange rate, which had been broadly unchanged since the August meeting, after falling during the summer. It was still 4.5% higher than it had been a year earlier, however. The Central Bank had not considered it necessary to intervene in the foreign exchange market between meetings. Short-term exchange rate volatility had receded, which the Committee considered a possible indication that the foreign exchange market was rebalancing after the liberalisation of the capital controls.

MPC members considered it positive that all measures of inflation expectations remained broadly in line with the inflation target. Members considered it an indication of enhanced credibility of monetary policy that the fluctuations in the exchange rate in the past few months, and even the depreciation of the króna during the summer, had had relatively little impact on inflation and only transitory effects on inflation expectations. It was pointed out that the rise in the breakeven inflation rate in the bond market following the collapse of the Government stemmed from a rise in risk premia and not in inflation expectations, as the increase had reversed quickly.

The MPC also noted that growth in credit and money holdings somewhat outpaced nominal GDP growth. Members agreed that such credit growth could be a danger sign that should be monitored closely but that it was too early to conclude that this was the case, as excess growth was still relatively limited. One member noted that credit growth was concentrated mainly in loans to businesses, some of it to construction companies, which was conducive to restoring equilibrium in the housing market. On the other hand, the increased supply of housing enhanced the likelihood of household credit growth later on.

The Committee also discussed the impact on monetary policy of the fall of the Government and the forthcoming elections. In the Committee's view, increased uncertainty – political and otherwise – could contain demand if it caused households and businesses to exercise caution. Increased uncertainty could also lead to cross-border capital outflows, which could cause the exchange rate to fall and could call for changes in interest rates. In the MPC's opinion, however, there were no clear signs of capital outflows due to these factors as yet. On the other hand, members were of the view that there was some risk that as a consequence of the election campaign, the cyclically adjusted Treasury balance could deteriorate, which would call for higher interest rates than would otherwise be needed. It was mentioned as well that increased credibility of monetary policy made it easier for the Committee to look through the temporary impact of increased political unrest now than it had been, for example, when the Government fell in 2016, as there was now less risk that such temporary unrest would affect long-term inflation expectations.

The Committee discussed whether to keep interest rates unchanged or lower them. Members agreed that demand pressures in the economy called for a tight monetary stance so as to ensure medium-term price stability. On the other hand, the Committee agreed that developments in inflation and inflation expectations, together with clear signs of diminishing demand pressures, provided the scope to lower interest rates by 0.25 percentage points. Members were of the view that, with that reduction, the Bank's real rate would suffice to keep inflation broadly at target. The main arguments expressed at the meeting in favour of unchanged interest rates were related to uncertainty about the fiscal stance in the wake of the coming elections.

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 4.25%, the current account rate to 4%, the seven-day collateralised lending rate to 5%, and the overnight rate to 6%. All Committee members voted in favour of the proposal.

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 15 November 2017.