CENTRAL BANK POLICY RATE

17.8.2018 | Íslandsbanki Research

Summary

- Our forecast: unchanged policy rate on 29 August
- Increased inflation and rising inflation expectations pull against diminishing demand pressures in the economy
- Unchanged policy rate in line with forward guidance and recent economic developments
- We forecast an unchanged rate through 2018, followed by a 25- to 50-point reduction in 2019 if inflation remains close to target

Central Bank interest rate decisions						
	Proposed	**Pro**	**Con**	**Preferred other**	**Result**	**Policy rate**
Jun 17	-25	5/5	0	2 (-50)	-25	4.50
Aug 17	Unch.	5/5	0	1 (-25)	Unch.	4.50
Oct 17	-25	5/5	0	0	-25	4.25
Nov 17	Unch.	5/5	0	0	Unch.	4.25
Dec 17	Unch.	5/5	0	0	Unch.	4.25
Feb 18	Unch.	5/5	0	0	Unch.	4.25
Mar 18	Unch.	5/5	0	0	Unch.	4.25
May 18	Unch.	5/5	0	0	Unch.	4.25
Jun 18	Unch.	5/5	0	0	Unch.	4.25
Aug 18	**Unch.**				**Unch.**	**4.25**

With the choice comes the challenge

We expect the Central Bank (CBI) Monetary Policy Committee (MPC) to hold the policy rate unchanged on 29 August, the next interest rate decision date. The bank's key rate will therefore remain 4.25%. If our forecast materialises, this will be the seventh time in a row that the MPC has kept CBI interest rates unchanged.

It will be more challenging for the MPC to choose the most appropriate monetary stance this time than it generally has been in the recent term. For one thing, inflation and inflation expectations have risen. As a consequence, MPC members will probably have to give more consideration to whether monetary policy credibility is under threat. On the other hand, it appears that some parts of the economy will lose momentum more quickly in coming quarters than was expected earlier in the year.

Arguments for a higher policy rate

- Increased inflation
- Inflation expectations/premia rising
- Uncertainties about medium-term wage developments
- Need for continued monetary restraint

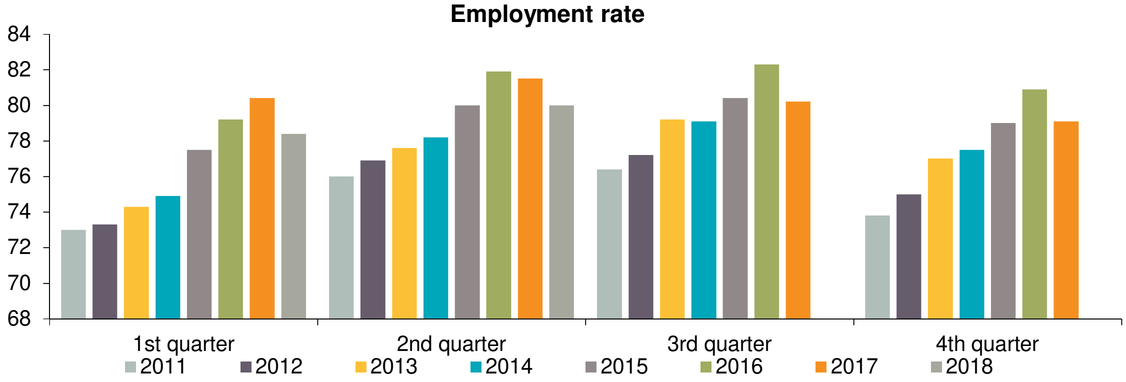
Arguments for a lower policy rate

- Inflation expectations still broadly in line with target
- Slower residential house price increases
- Moderating growth in service exports, private consumption and investment
- Stable ISK
- Considerable interest rate differential

The forward guidance from the Committee will probably be neutral, as it has been recently. Inflation has picked up, and inflation expectations have risen in the past few months. The ISK has been stable, however, and indicators imply that tensions in the labour market and the economy as a whole are receding somewhat. The real policy rate has fallen in the recent past, but the interest rate differential with abroad remains sizeable.

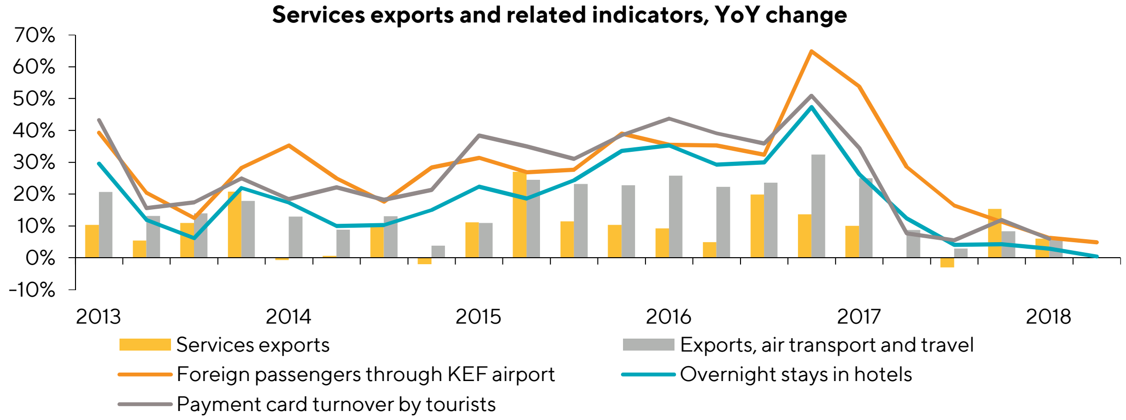
Signs of diminishing tension in the economy

Recent indicators imply that GDP growth is easing and that tension in the economy is beginning to taper off. The employment rate is declining, and growth in total hours worked slowed quarter-on-quarter in Q2.



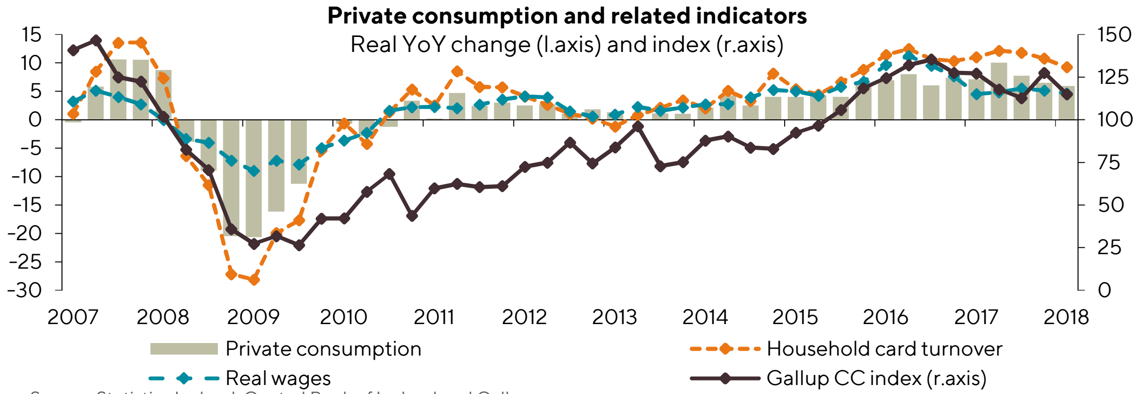
Source: Statistics Iceland

In 2018 to date, growth in tourism-related services exports has slowed markedly year-on-year. Foreign nationals' departures via Keflavík Airport increased by 5.5% YoY in H1/2018, and hotel bed-nights by 1.6% — a major change from double-digit increases of the past few years.



Source: Statistics Iceland, Iceland Tourist Board and Centre for Retail Studies

Furthermore, private consumption growth appears to have been weaker in Q2 than in the quarters preceding and, in our opinion, looks set to be more modest in H2 as well. Real growth in payment card turnover has lost pace, consumer sentiment is less buoyant, and real wage growth has eased in the recent term. Growth in consumer goods imports has slowed as well, and in some categories — passenger automobiles, for instance — imports have actually contracted, as can be seen in Statistics Iceland's (SI) figures for H1/2018.

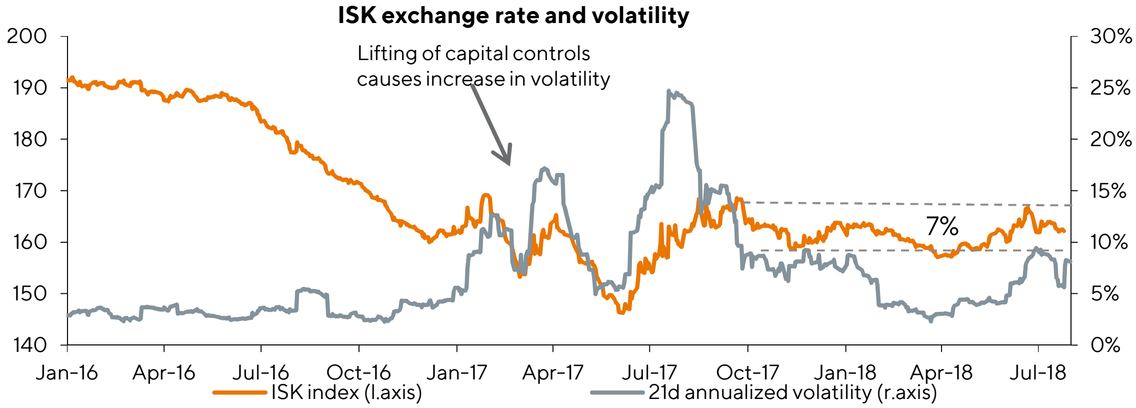


Source: Statistics Iceland, Central Bank of Iceland and Gallup

To summarise, it is likely that the CBI's new macroeconomic forecast, to be published in *Monetary Bulletin* on the August interest rate decision date, will provide for weaker growth and a smaller output gap than the CBI's last forecast did. If so, there will be grounds for a lower real interest rate in coming quarters than in the recent past.

ISK still calm and stable

The exchange rate of the Icelandic króna has been quite stable in recent quarters, even though most of the capital controls have been liberalised and the Central Bank (CBI) has held itself aloof from the foreign exchange market. Although volatility increased at the peak of the summer, the ISK has continued to fluctuate within a relatively narrow range, and there are no clear signs of a trend towards either appreciation or depreciation.

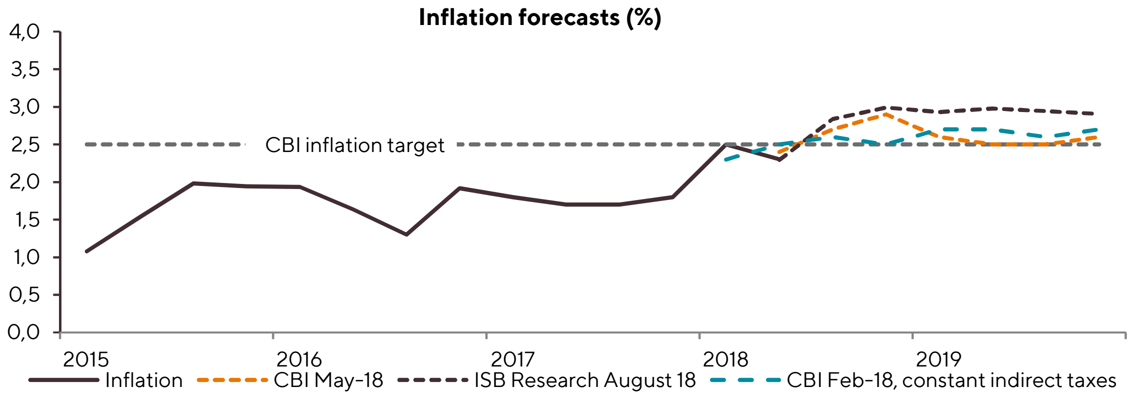


Source: The Central Bank of Iceland and ISB Research calculations

As before, MPC members can be expected to welcome the ISK's stability, which is conducive to a lower real interest rate than would otherwise occur.

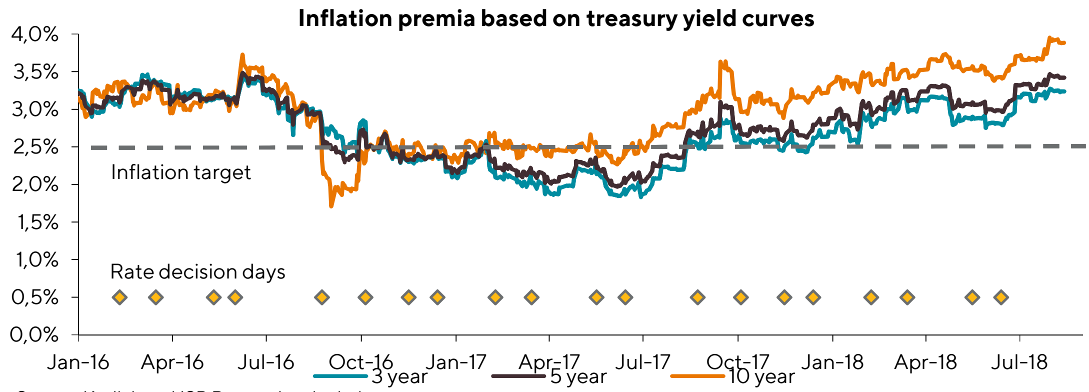
Increased inflation and inflation expectations

Inflation has risen from 2.0% to 2.7% since the CBI's June interest rate decision date. Therefore, it is no longer below the 2.5% inflation target and, in our opinion, will not fall below it again in the quarters ahead. In our most recent forecast, we project that inflation will be in the neighbourhood of 3.0% through the end of 2019.



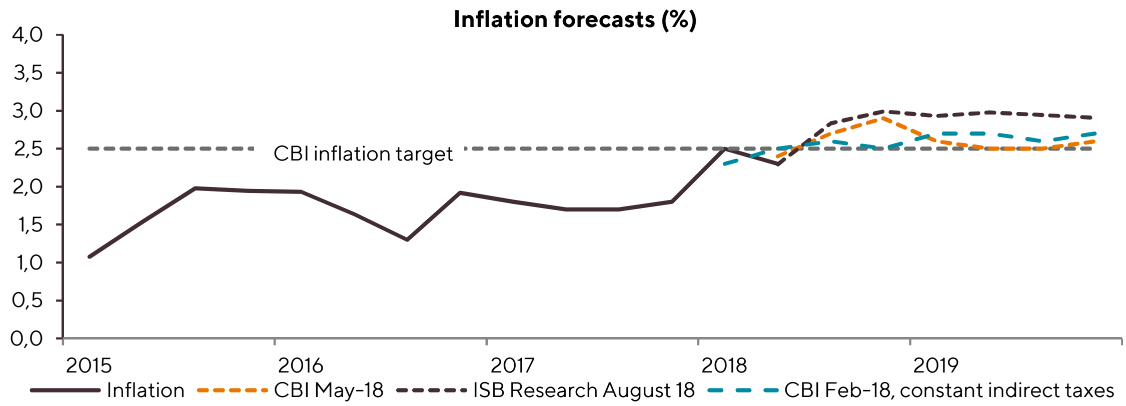
Source: Central Bank of Iceland, Statistics Iceland and ISB Research

If our forecast materialises, the CBI will have been overly optimistic about the inflation outlook in its last few forecasts. But the difference is relatively small, given how volatile short-term inflation generally is in Iceland. Even so, it is difficult to imagine that the MPC will be thrilled about these developments in inflation. We consider it likelier than not that the CBI's upcoming inflation forecast will be noticeably more pessimistic than its immediate predecessors.



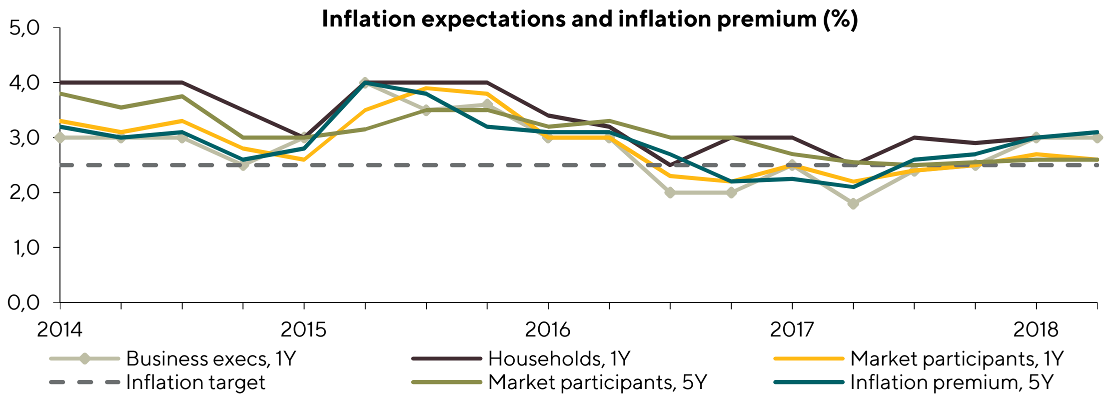
Source: Kodiak and ISB Research calculations

The breakeven inflation rate in the market has risen quite a bit since the last interest rate decision. On 13 June, the five-year breakeven rate in the bond market was close to 3.0%, but in August 2018 to date, it has averaged just over 3.4%, its highest level in two years. The rise in the breakeven rate is due in part to a much more limited supply of indexed Treasury bonds than of nominal bonds. To a degree, it also reflects uncertainty about real returns on nominal bonds. It will be difficult for the MPC to reject the idea that this trend partly reflects higher market inflation expectations – or, at least, increased uncertainty about developments in inflation.



Source: Central Bank of Iceland, Statistics Iceland and ISB Research

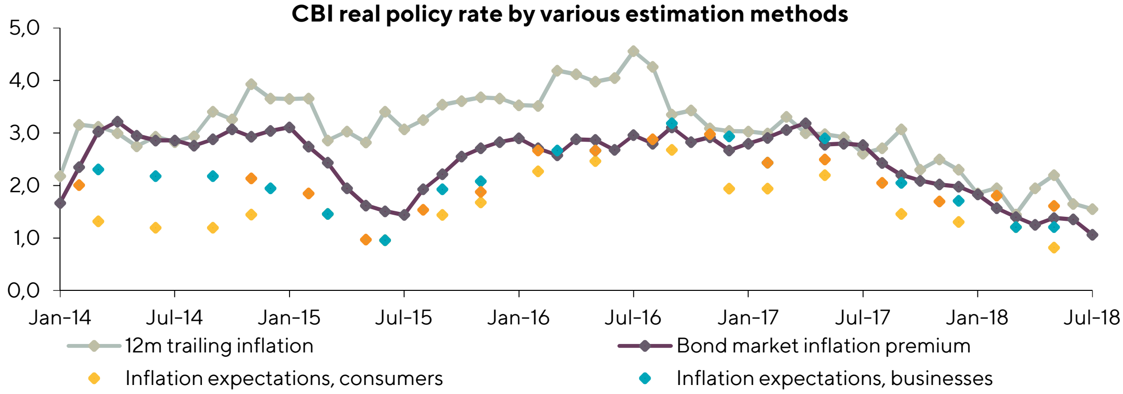
Many other measures of inflation expectations have risen in recent quarters as well. In June, the MPC was of the opinion that on the whole, inflation expectations were still quite well in line with the Inflation target. However, the last few months could cause some Committee members to waver in that conviction.



Source: The Central Bank of Iceland, Kodiak and ISB Research calculations

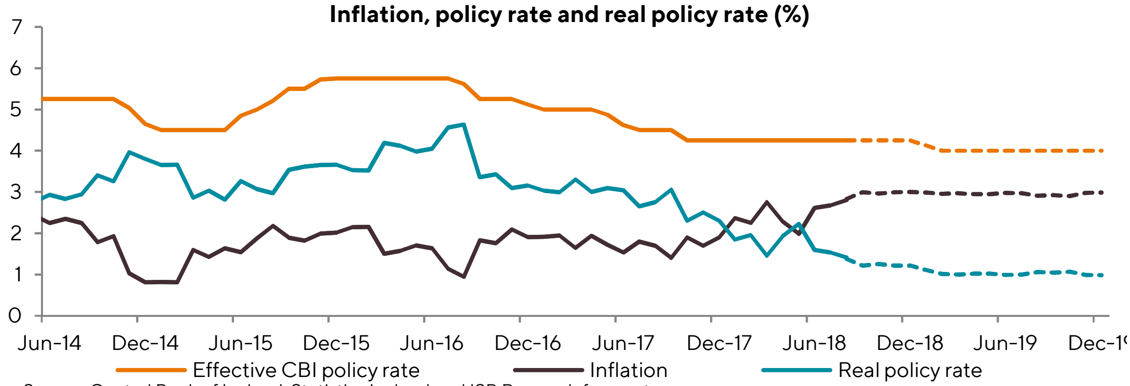
The real policy rate fallen steeply in the past year

In the past year, the real policy rate has fallen markedly by all measures. In terms of the simple average of various measures, it is now around 1.3%, down from 1.4% at the time of the June rate-setting meeting and 2.9% in mid-2017. A decline in the real policy rate is normal given the various indicators that the economy is slowing and monetary policy credibility successfully withstood the stress test represented by the removal of capital controls in March 2017.



Source: Central bank of Iceland, ISB Research calculations

Hitherto, the MPC has considered a falling real policy rate to go hand-in-hand with a diminishing need for a tight monetary stance and has opted not to change the nominal policy rate. But whether Committee members think it has fallen further than is justified by fundamentals could depend on the next real policy rate measurements, which will be published in *Monetary Bulletin* concurrent with the interest rate decision.



Source: Central Bank of Iceland, Statistics Iceland and ISB Research forecast

Modest rate cut probable during the coming year

In our opinion, rising inflation will continue to push the real policy rate downwards in coming months, all else being equal. But given the reasonably favourable inflation outlook and the expectation that the economy will slow down a bit over time, it is not impossible that the CBI will lower the policy rate further ahead, as demand pressures subside and the inflation outlook remains stable. A nominal policy rate cut of 25-50 points in 2019 is therefore a distinct possibility, in our opinion.

If inflation rises significantly above target in the coming year, however — due to large wage rises, continued pressure in the housing market, and/or a depreciation of the ISK — the CBI will hardly lower the policy rate further. It might even decide to signal the possibility of rate hikes as the winter progresses.

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