CENTRAL BANK POLICY RATE

11 Dec 2017 | Íslandsbanki Research

Summary

- We forecast an unchanged policy rate on 13 December
- Fiscal uncertainty and the need for a continued tight monetary stance outweigh low short-term inflation and signs of a cooling housing market
- Unchanged policy rate in line with forward guidance and recent economic developments
- Rate cut not impossible
- We forecast a 50-point rate cut in the coming term

Central Bank interest rate decisions

	Proposed	Pro	Con	Preferred other	Result	Policy rate
Aug 16	-50	3/5	2 (-25)	0	-50	5.25
Oct 16	Unch.	5/5	0	0	Unch.	5.25
Nov 16	Unch.	3/5	2 (-25)	0	Unch.	5.25
Dec 16	-25	4/5	1 (unch.)	0	-25	5.00
Feb 17	Unch.	5/5	0	0	Unch.	5.00
Mar 17	Unch.	5/5	0	0	Unch.	5.00
May 17	-25	5/5	0	0	-25	4.75
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.**	**4.25**

Unchanged policy rate for the holiday season

We expect the Central Bank (CBI) Monetary Policy Committee (MPC) to decide to hold the policy rate unchanged on 13 December, the next interest rate announcement date. Although a rate cut is not out of the question, economic and inflation developments have been in line with the CBI and MPC's expectations from the last interest rate decision. During the prelude to that decision, no Committee member mentioned the possibility of lowering the policy rate in view of the economic outlook.

Arguments in favour of an unchanged rate

- Less fiscal restraint
- Rapid private consumption growth
- Demand pressures in the labour market
- Prospect of rising inflation in coming quarters
- Need for continued monetary restraint

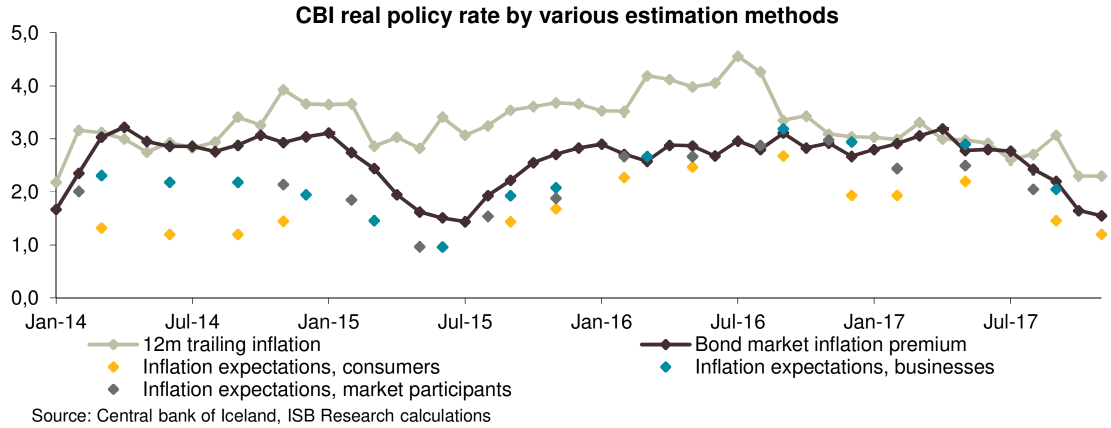
Arguments in favour of a lower policy rate

- Inflation still below target
- Inflation expectations still at target
- Housing market cooling
- Slowing GDP growth
- Narrower output gap

The November interest rate decision was consistent with both published forecasts and the forward guidance issued by the MPC. In the recent past, we have actually found the Committee's forward guidance less useful than would have been optimal. That said, there is no reason to ignore the MPC's latest message, particularly when recent economic developments have not included any unexpected events that should vastly change the Committee's view as published in its last announcement. It is ultimately in the service of the CBI's objective of low and stable inflation that monetary policy should be transparent and predictable. The bank's success in enhancing confidence in that objective is an extremely welcome improvement from previous decades, and it is vital to take maximum advantage of the opportunities the bank has to buttress that success. One tool it can use to this end is forward guidance.

The real policy rate has fallen

Since mid-year, the real policy rate has fallen markedly by all measures. In terms of the five-year breakeven inflation rate in the bond market, interest rates fell from 2.8% in June to 1.6% in November. By other measures, the decline in the breakeven rate lies in the 0.8-1.2 percentage point range. The real policy rate has been broadly unchanged since October, however.



This development in the real policy rate appears to be to the MPC's liking. According to the minutes of the Committee's last meeting, members considered the then-current real policy rate appropriate, as none of them raised the possibility of changing interest rates at that time. The real policy rate has risen slightly since then in terms of past inflation but is unchanged in terms of the breakeven rate in the bond market. Broadly, then, the monetary stance is unchanged since the last policy rate decision, at which time the MPC said the current stance appeared appropriate to achieve monetary policy objectives.

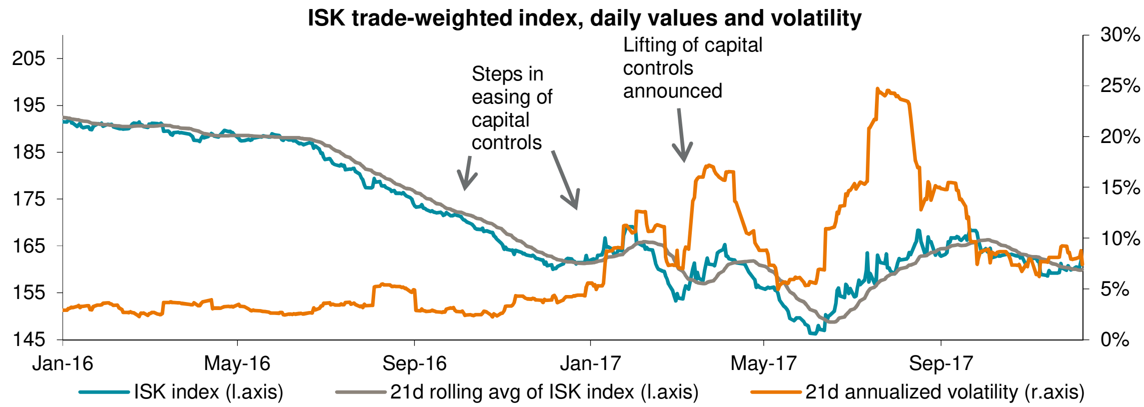
New Government, same fiscal restraint?

A new Government coalition has taken the reins since the last policy rate decision, reducing political uncertainty. The impact of the change at the helm should be less than it would have been under other circumstances, however, given the MPC's relative unconcern about the political unrest during the autumn.

The new Government will not present its fiscal budget proposal until after the 13 December interest rate decision, but based on statements from the leaders of the new coalition, spending increases will be financed with commensurate revenue increases from expanded tax bases. Opinion is divided on how successful this will turn out to be, and the Confederation of Icelandic Employers, among others, has voiced the opinion that the fiscal stance is likely to ease in coming quarters. If the MPC shares this opinion, it will reduce the Committee's willingness to ease the monetary stance. At all events, it must be deemed sensible to wait and see both the 2018 budget proposal and the medium-term fiscal plan before implementing any significant monetary easing.

ISK stability episode grows still longer

The ISK has been stable since mid-August, a most positive development given that the capital controls have largely been lifted and the CBI has hardly touched the interbank foreign exchange market in the interim.

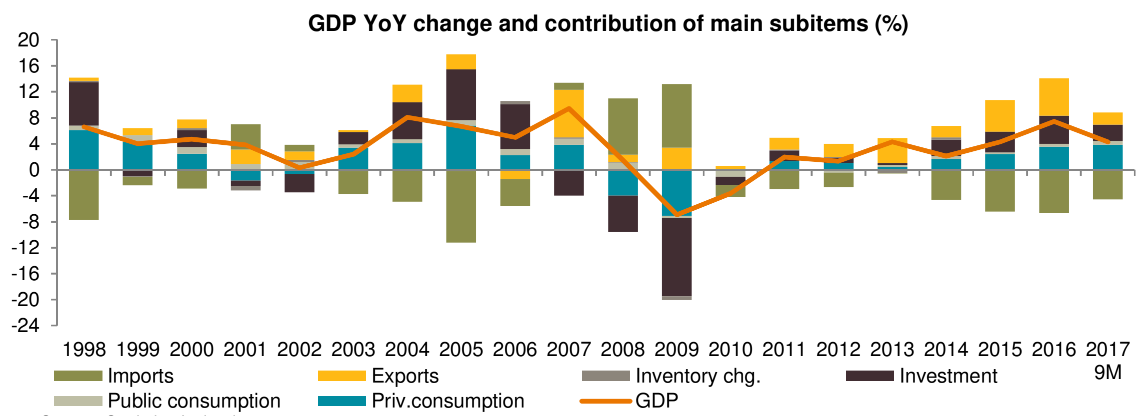


Source: Central Bank of Iceland and ISB Research calculations

At the beginning of October, the MPC noted that it was positive that exchange rate volatility had receded in recent months and that exchange rate fluctuations in 2017 to date had made relatively little impact on inflation and inflation expectations. Presumably, then, the Committee will be delighted at this continued exchange rate stability when it convenes for its next decision.

GDP growth eases, while private consumption surges

In the November issue of *Monetary Bulletin*, the CBI projected that year-2017 GDP growth would be somewhat weaker than the bank had forecast in August. At the time of the November decision, the Committee noted that this change was in line with its October assessment, on which it had based its decision to lower the policy rate at that time.

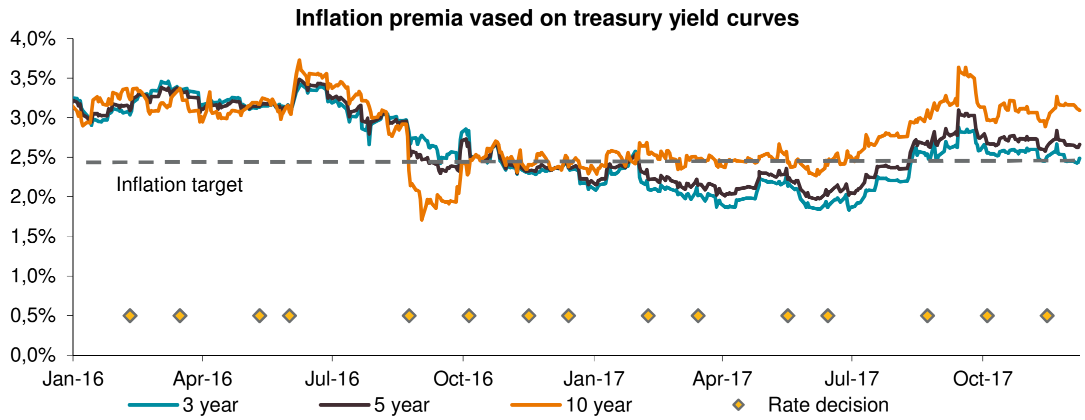


Source: Statistics Iceland

The national accounts for the first three quarters of 2017, published by Statistics Iceland (SI) at the beginning of December, are well in line with the CBI's revised forecast. According to the accounts, GDP growth measured 4.3% over the first nine months of the year, with growth driven mainly by private consumption and residential investment, as we had assumed in our autumn macroeconomic forecast. Weaker GDP growth and a less favourable composition of growth should therefore not take the MPC by surprise and will presumably not have much impact on the Committee's decisions now.

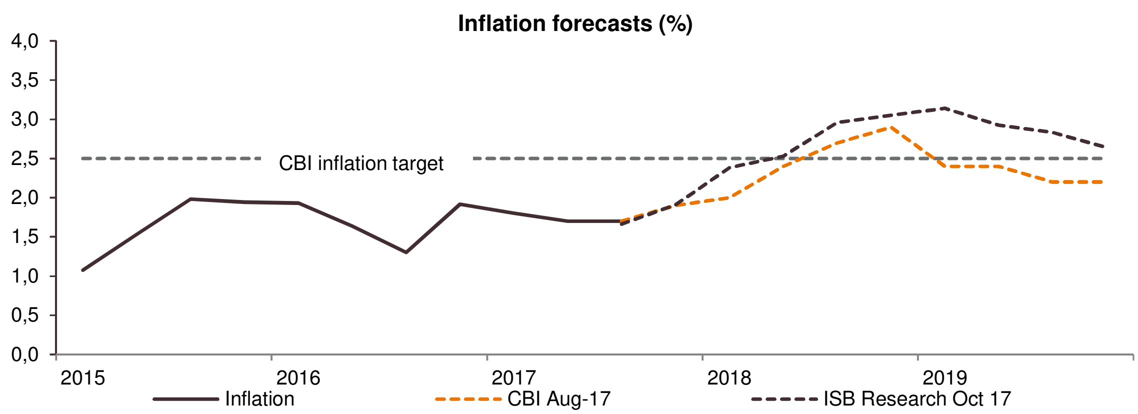
Inflation falls slightly, and inflation expectations still close to target

Inflation measured 1.7% in November, and SI's November measurement was below official forecasts because of an unexpected decline in clothing prices and a steep drop in airfares. Inflation has averaged 1.8% in Q4 to date, whereas the CBI's November forecast assumed an average of 1.9% for the quarter. Inflation has therefore developed well in line with the CBI's forecast thus far.



Source: Kodiak and ISB Research calculations

The breakeven rate in the market has been relatively stable since the beginning of October, at 2.6% (five-year rate) and 3.1% (ten-year). After adjusting for the uncertainty premium, the breakeven rate therefore remains quite well in line with the inflation target, reflecting the market's overall confidence that inflation in Iceland will be much more moderate in coming years than it has been in recent decades.



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

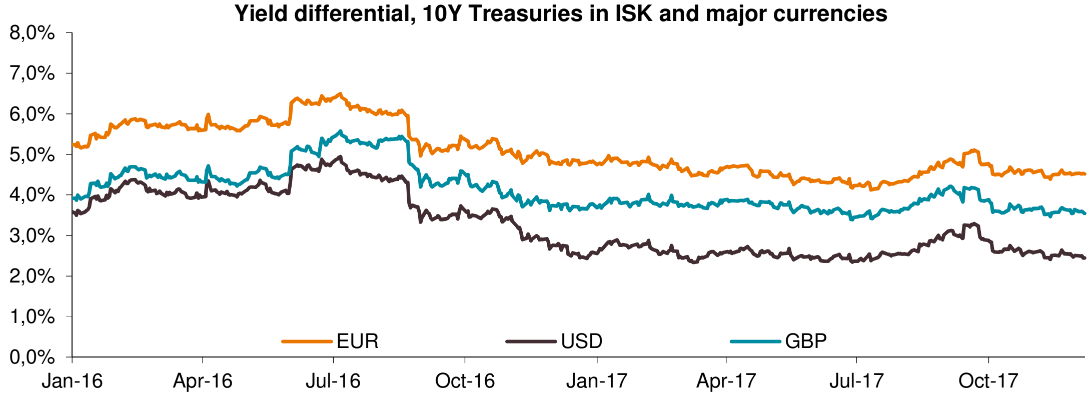
The MPC will not have a new CBI inflation forecast in hand when it convenes for the upcoming interest rate decision. The bank's November forecast assumed that inflation would rise steadily until well into H2/2018, peak at 2.9% in Q4, and then subside to below the target in 2019. Our own most recent inflation forecast paints a broadly similar picture but assumes that inflation will be slightly above the inflation target from mid-2018 through 2019. The difference is discernible but not substantial, however, and we consider the inflation outlook generally good. Other things being equal, then, the MPC should not need to be deeply concerned about persistent inflation in coming quarters.

Interest rate differential with abroad largely unchanged

The long-term interest rate differential with abroad is virtually unchanged since the last policy rate decision. The ten-year differential is 4.5% against the euro, 2.5% against the US dollar, and 3.6% against the pound sterling. Therefore, it remains relatively broad in spite of the recent reductions in Iceland's long-term rates.

During the autumn, the market expected the CBI to consider easing the stringent controls currently in place on inflows of foreign capital for investment in Icelandic interest-bearing

Yield differential, 10Y Treasuries in ISK and major currencies



Source: Reuters Eikon

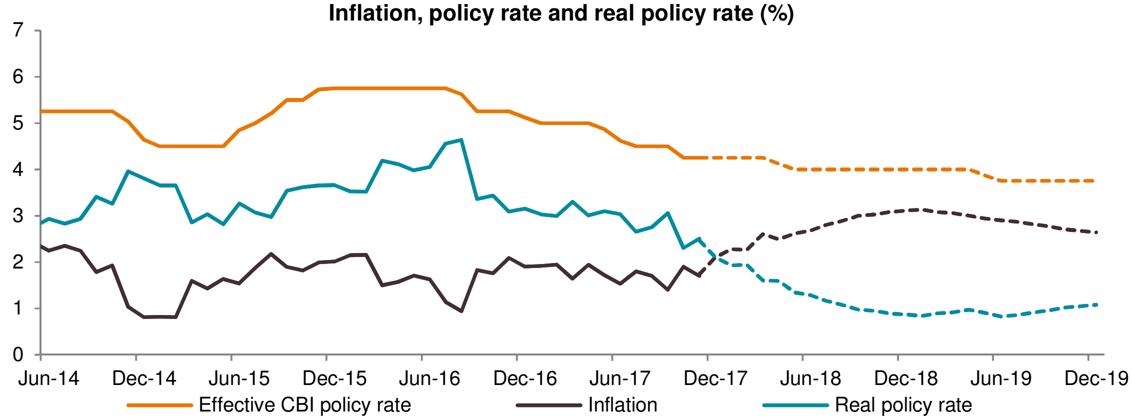
instruments. The CBI has rained on that parade, however, including via Governor Már Guðmundsson's speech at the Chamber of Commerce's annual monetary policy meeting, held just after the November policy rate decision. In that speech, the Governor made it clear that conditions did not yet warrant lifting the special reserve requirement on capital inflows of this type, and that when they did, such easing should be implemented in stages as GDP growth eased in Iceland and gained momentum in trading partner countries. The CBI therefore sees the cause-and-effect relationship thus: a narrower interest rate spread will create conditions for easing the inflow controls further ahead, and not the reverse – or to spell it out, the need to lift the special reserve requirement will not call for a narrower short-term spread, as some have argued.

We forecast a rate cut in the coming term

Rising inflation will push the real policy rate downwards in coming months, other things being equal, and we expect the CBI to hold the effective policy rate unchanged in the near term, so as not to accelerate the decline in the real rate. We think, however, that developments will go more or less hand-in-hand with reduced need for a tight monetary stance as the economy slows down and the output gap narrows.

As next year advances and the output gap shrinks further, the scope for a rate cut could develop, bringing the real policy rate down around 1% by end-2018. If inflation falls thereafter, as both we and the CBI expect to happen in 2019, when GDP will be more modest, there could be room for an even larger policy rate cut.

Inflation, policy rate and real policy rate (%)



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

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