CENTRAL BANK POLICY RATE

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Summary

- We forecast an unchanged policy rate on 7 November
- Deteriorating inflation outlook versus a deteriorating economic outlook
- Increased uncertainty about the policy rate decision; rate hike considerably likely before the year-end
- Uncertainty about the need for a tight policy due to wage settlements could prove protracted
- Developments in long-term inflation expectations a key factor in upcoming policy rate developments
- Recalibration of capital flow management measure timely

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.	5/5	0	0	Unch.	4.25
Oct 18	Unch.	5/5	0	0	Unch.	4.25
Nov 18	**Unch.**				**Unch.**	**4.25**

Diverging views within the MPC?

We expect the Central Bank (CBI) Monetary Policy Committee (MPC) to hold the policy rate unchanged on 7 November, the next interest rate decision date. The bank's key rate will therefore remain 4.25%. If our forecast materialises, this will be the ninth time in a row that the MPC has kept CBI interest rates unchanged.

Uncertainty about the interest rate decision and upcoming MPC decisions has escalated in recent weeks. Opinion will probably be divided among Committee members, and a rate hike is quite possible, although we think an unchanged policy rate is the more likely outcome. At the time of the last decision, one member was of the view that the monetary stance should be tightened, all else being equal. This member will presumably advocate for a rate hike now, and the ultimate result will depend on how many other members vote likewise. One of the key factors will doubtless be the new measurements of inflation expectations. Given that no other members were in favour of a rate hike in October, it would be surprising if the next decision turned out unanimous.

Arguments for a higher policy rate

- Deteriorating short-term inflation prospects
- Increasing inflation premia
- Robust increase in domestic demand in H1 2018
- Outcome from upcoming wage bargaining likely to entail more wage hikes and/or less fiscal restraint than is consistent with price stability
- Still no slack in the economy

Arguments for an unchanged policy rate

- Inflation expectations still not far above target
- Residential housing price increases moderating
- GDP growth couldsubside quickly
- Less demand pressures in coming quarters
- Increased rate differentials
- Increase in long-term yield translates into more de facto monetary restraint

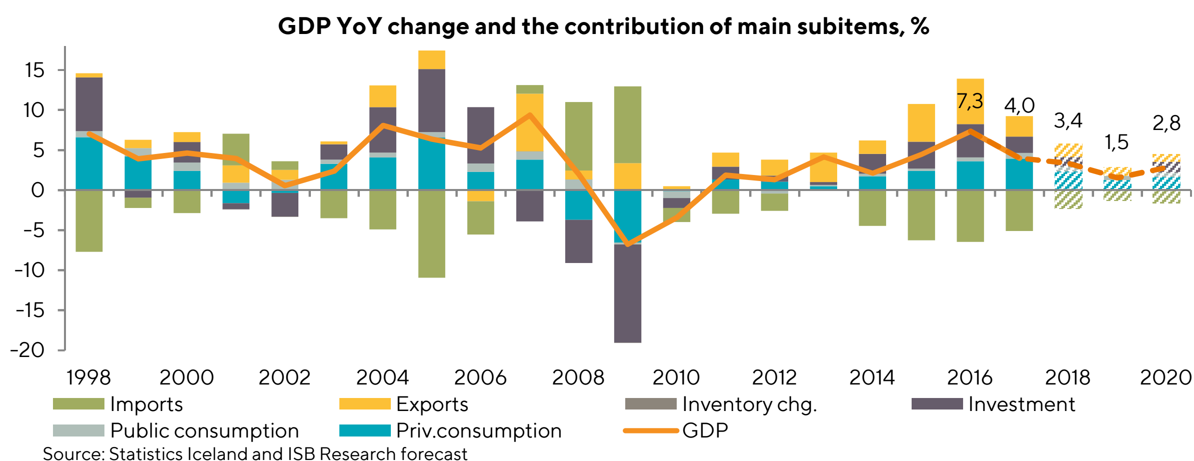
The forward guidance from the Committee will probably signal upcoming monetary tightening, and the tone in the MPC statement will presumably be relatively stern, in view of the current uncertainty and the poorer short-term inflation outlook. If it is revealed that long-term inflation expectations are settling at a level considerably above the

inflation target, the Committee will probably respond by raising the policy rate sooner rather than later, as it has repeatedly emphasised its willingness to take action to safeguard the inflation target in recent statements.

Economy still chugging along, but households and businesses are downshifting

After a robust H1, there are strong indications that GDP growth will slow markedly in H2. Businesses as well as households are considerably less optimistic about the economic outlook than they were in the spring. Furthermore, imports and payment card turnover figures show clearly that private consumption growth is slowing significantly. There are signs as well of weaker growth in business investment, and even a contraction in some subcategories.

GDP YoY change and the contribution of main subitems, %



Source: Statistics Iceland and ISB Research forecast

Our macroeconomic forecast from this September assumes that GDP growth will measure 3.4% this year and 1.5% in 2019. If the CBI's new forecast is similar to ours, this will be reflected in projections of a smaller output gap in the coming term than in the bank's August forecast. Other things being equal, this should call for a lower real interest rate than was previously envisioned.

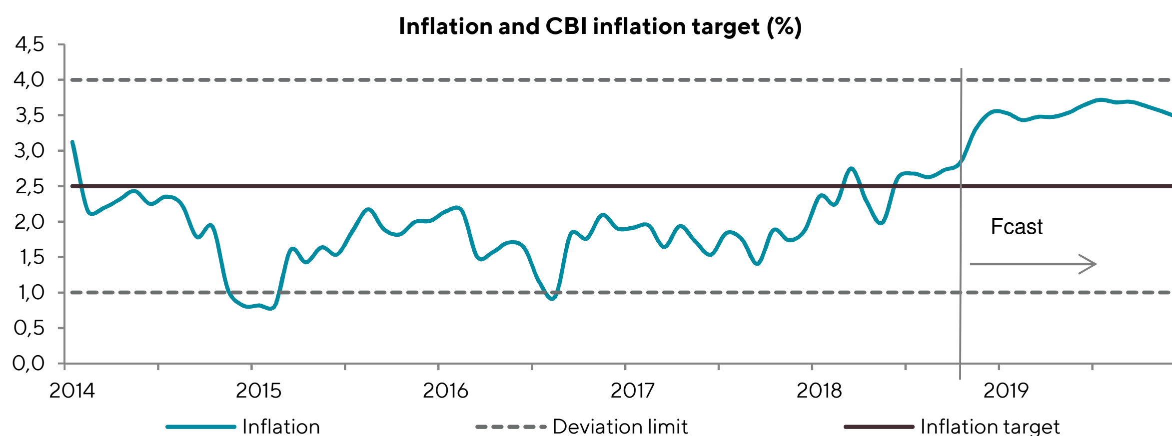
Will inflation expectations keep pace with a rising inflation premium in the market?

Inflation has risen marginally since the early October policy rate decision. According to Statistics Iceland's (SI) October measurement, CPI inflation was 2.8%, broadly in line with expectations. Inflation is therefore still within the deviation band of the CBI's 2.5% inflation target.

In our opinion, however, the short-term inflation outlook has deteriorated somewhat in the past month. There are three reasons for this.

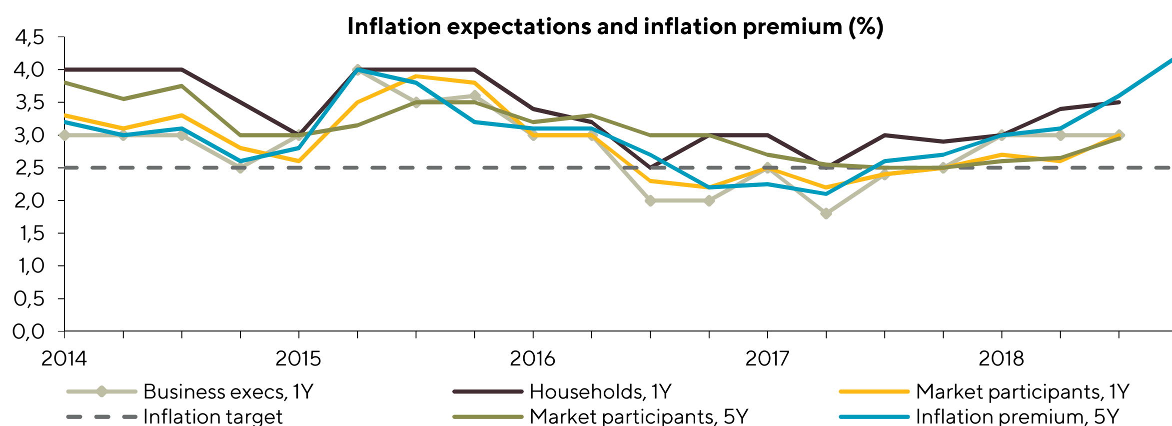
- The ISK has depreciated again. In terms of the trade-weighted exchange rate index, it is about 6% weaker than at the time of the last policy rate decision.
- The Icelandic Federation of General and Special Workers (SGS) and the Commercial Workers' Union of Reykjavík (VR) published their demands for the upcoming wage negotiations in October. These entail both a much larger pay rise than is consistent with price stability and, if they are accommodated to any substantial degree, considerable pressure to ease the fiscal stance.
- The most recent figures from the housing market suggest that prices are still rising somewhat faster than we had expected.

As regards uncertainty about inflationary pressures due to wage settlements this winter, it is well to bear in mind that the negotiations will probably be protracted, both because of the gap between the wage demands and the scope employers consider themselves to have to accommodate them, and because of the many and various demands concerning Government involvement in the wage agreements. As a result, it is not certain that private sector negotiations will reach a conclusion until very late in the winter. If the unrest escalates into strikes and so forth, the economy could slow down temporarily, which would mitigate the need for monetary tightening until the collective bargaining results are forthcoming.



Source: Statistics Iceland and ISB Research forecast

According to our preliminary forecast, inflation will measure 3.5% at the end of 2018 and average 3.6% in 2019. According to the forecast, it will begin to taper off again after mid-2019, although this will depend on whether wage negotiations end with relatively moderate agreements, whether the ISK holds stable, and in particular, whether long-term inflation expectations remain close to the inflation target.



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

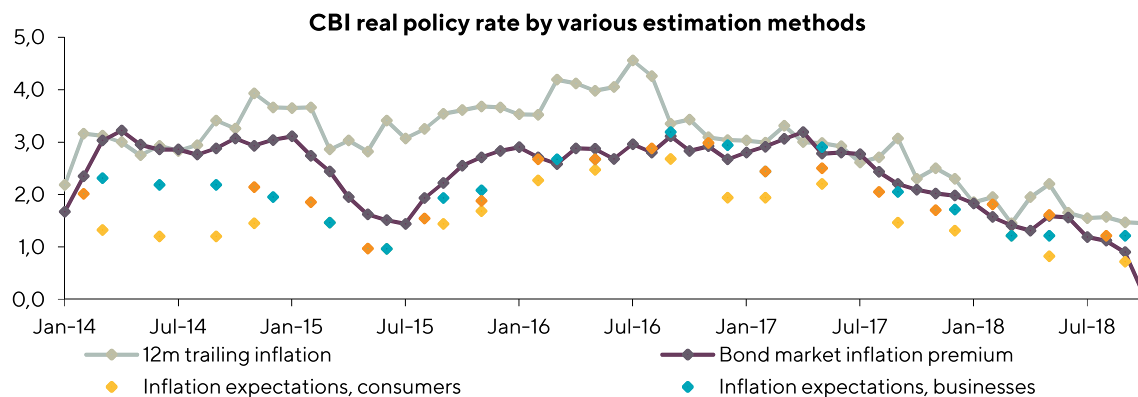
New surveys of inflation expectations were not available at the time this report went to press. The last measurements of corporate, household, and market expectations indicated that respondents expect inflation to be noticeably above the CBI's inflation target in coming years. The MPC was concerned about this at its last meeting, although it decided not to take action at the time.

The breakeven inflation rate in the market has risen steeply so far this year. Based on Treasury yield curves, the five-year breakeven rate is now about 4.2%, up from the Q3 average of 3.6%. Even so, we believe a sizeable portion of it represents a premium due to the uncertain inflation outlook, on the one hand, and a mismatch between the relative supply and demand for indexed and nominal Treasury bonds, on the other. For example, the breakeven rate on covered bonds has been somewhat below the breakeven rate for Treasury bonds in the recent past. If this is so, it could be argued that the rise in long-term nominal market interest rates entails a tighter stance as regards that segment of the interest market. There are already signs that pricing of lending rates has begun to take account of the rise in nominal market yields. This, in turn, would imply a less urgent need to raise short-term interest rates in order to affect long-term rates.

In our estimation, the new measurements of inflation expectations will affect the MPC more strongly than the above-mentioned developments in the breakeven inflation rate. The results of the new market expectations survey will be published on Monday 5 November, and if they indicate a marked rise in expectations, this could be the straw that breaks the camel's back in terms of the 7 November policy rate decision.

What is the effective real policy rate?

The various measures of the real policy rate have begun to diverge in the recent term. In terms of past inflation, the real policy rate is still relatively high, but in terms of inflation expectations it has fallen, and in terms of the breakeven inflation rate in the market, it is very low. It is appropriate to interpret the last of these will considerable caution, however, in view of the above discussion of the breakeven rate. Excluding that measure, we estimate the real policy rate at about 1.1% in terms of the simple average of various measures. The range is unusually large, however, from 0.1% (in terms of the five-year breakeven rate) to 1.5% in terms of past inflation. As is mentioned above, the new inflation expectations figures will give a clearer view of where the real policy rate lies, and in turn, what the monetary stance is.



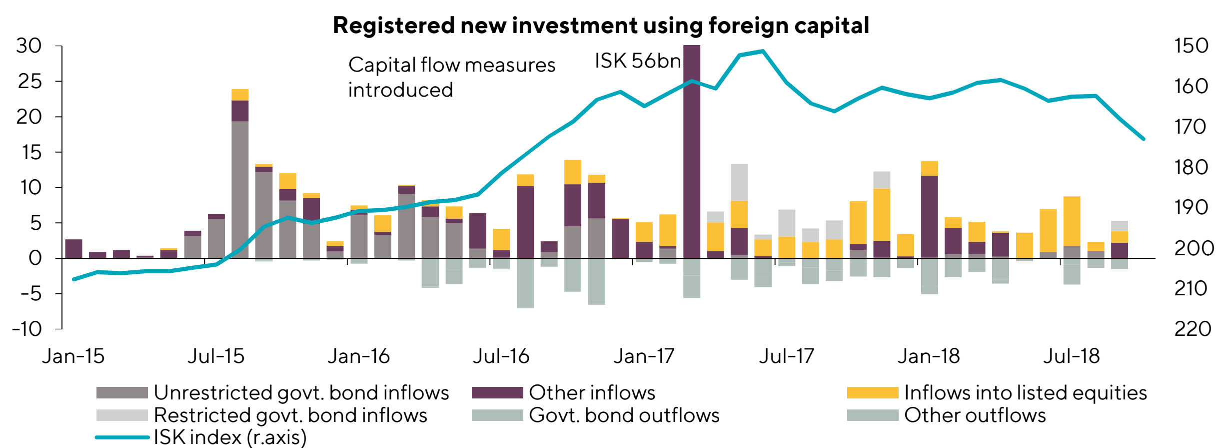
Source: Central bank of Iceland, ISB Research calculations

Recalibration of capital flow management measure timely

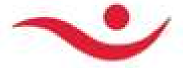
In the recent past, questions about possible changes in the so-called capital flow management measure (the special reserve requirement, SRR, on selected capital inflows) have been a regular feature of CBI press conferences on policy rate decision dates. The SRR entails a requirement that non-residents wishing to import capital to Iceland for investment in interest-bearing assets or deposits in ISK must deposit 40% of the total to a non-remunerated account with a commitment period of 12 months.

The SRR is intended to reduce the incentive for carry trade, thereby mitigating the risk of excessive exchange rate volatility due to non-residents' position-taking in the ISK. As the ISK has depreciated and economic growth has eased, thereby reducing the pressure for a higher real rate, this restriction on capital inflows has become less logical. It must be considered peculiar that an economy with a current account surplus and a strong external position should experience downward pressure on its currency because resident investors are eager to step up their foreign investments at a time when non-residents are hindered by the authorities in their efforts to invest their sterling, euros, or dollars in interest-bearing domestic assets.

In our opinion, it is high time to ease these inflow restrictions, to call the capital flow management measure (or SRR) by its true name. Such a move could mitigate the need for a policy rate hike in the near term, to the extent that a more stable ISK (resulting from better-balanced investment flows) would have a positive impact on inflation expectations. It would be possible to exclude the classes of interest-bearing assets with the greatest market risk (such as corporate bonds and asset-backed bonds), lower the special reserve ratio, and/or shorten the commitment



period on the non-remunerated accounts. In an economy where demand pressures are dwindling and the need for a high real rate should therefore decline, it must be more desirable to promote normal, reciprocal cross-border capital flows than to widen the interest rate differential in an attempt to hinder outward investment flows. It will be interesting to see whether the SRR is modified next Wednesday.



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