CENTRAL BANK POLICY RATE

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Summary

- We forecast a 25-point rate cut on 22 May
- Policy rate will fall to 4.25%
- A 50-point rate cut is not impossible
- The inflation outlook has improved, and the breakeven rate in the market has fallen
- The short-term economic outlook has worsened markedly
- Further policy rate cuts are probable in coming months

Central Bank interest rate decisions

	Proposed	Pro	Con	Preferred other	Result	Policy rate
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	+25	4/5	1 (+50)	0	+25	4.50
Dec 18	Unch.	4/5	1 (+25)	0	Unch.	4.50
Feb 19	Unch.	5/5	0	0	Unch.	4.50
Mar 19	Unch.	5/5	0	0	Unch.	4.50
May 19	**-0.25**				**-0.25**	**4.25**

Changed outlook calls for lower interest rates

We expect the Central Bank (CBI) Monetary Policy Committee (MPC) to announce a 25-point reduction in the CBI's policy interest rate on 22 May, the next interest rate decision date. This would bring the CBI's key rate – the rate on seven-day term deposits – back to 4.25%, where it was until Q4/2018. A larger rate cut next week is not beyond the realm of possibility, but we think it likelier that the MPC will choose to dish out a larger number of smaller rate cuts in the near future. We would be quite surprised if the MPC decided not to lower rates on Wednesday, as the monetary stance is now tighter than is warranted by fundamentals, in our view.

At its last meeting, in March, the Committee decided unanimously to keep the CBI's interest rates unchanged. That decision was determined, on the one hand, by the prospect of diminishing demand pressures in the economy and a falling breakeven inflation rate, and on the other hand, by short-term uncertainty about wage settlements plus relatively high long-term inflation expectations among households and businesses.

Arguments for an unchanged policy rate

- Inflation still above target and likely to remain above target in the short term
- Inflation expectations still above target by some measures
- Considerable wage increases probable in the medium term
- Fiscal constraint likely to loosen in coming quarters

Arguments for a lower policy rate

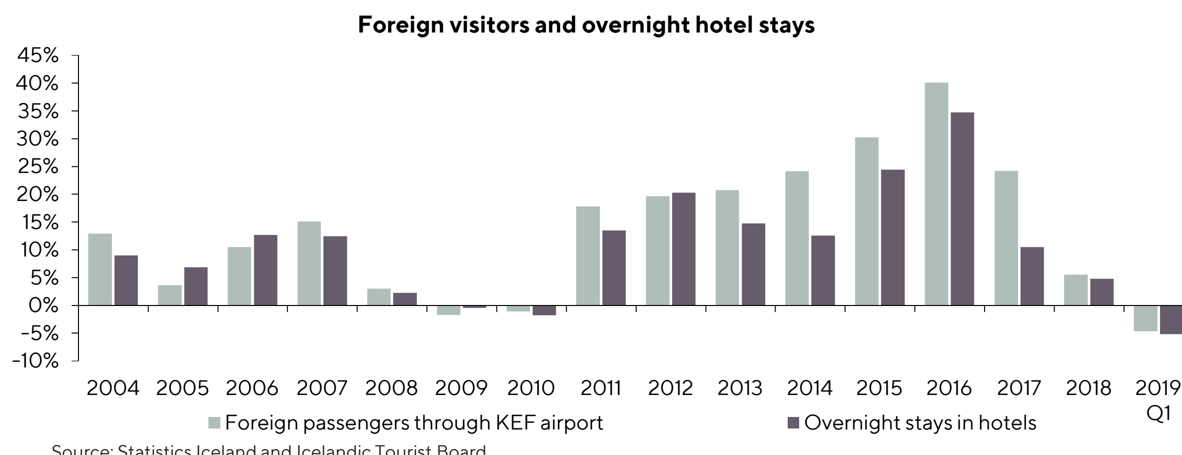
- Inflation premia have gone down in recent weeks
- Housing market slowing
- Short term economic prospects have worsened
- Output gap closing rapidly
- Interest rate differential still considerable
- Decreasing liquidity in the financial sector could tighten monetary conditions on coming quarters

Since the March decision, most of the factors underlying the monetary stance have changed in favour of monetary easing. The short-term inflation outlook has improved, and uncertainty relating to domestic cost pressures has subsided with relatively favourable private sector wage agreements. Furthermore, the economic outlook for 2019 has dimmed noticeably with the collapse of WOW Air and Icelandair's persistent problems with its Boeing 737 MAX aircraft. And finally, it appears that monetary policy has retained its credibility – at least, according to recent

developments in long-term inflation expectations and the long-term breakeven rate, which reduce the need for a tight monetary stance, other things being equal.

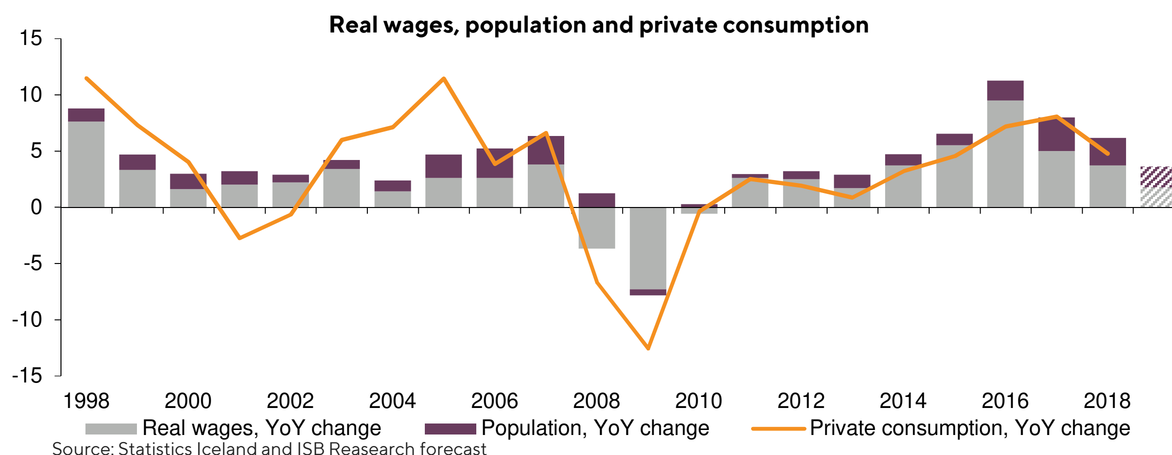
Marked deterioration in the short-term economic outlook

March and April 2019 brought a spate of big news for the Icelandic economy. The economic outlook for the year has worsened significantly since the CBI's last macroeconomic forecast, published in February. The collapse of WOW Air in March slashed jobs in or connected with the tourism industry by over 1,400, or 5% of total jobs in the sector. The first effects can already be seen in unemployment as registered by the Directorate of Labour, which rose 0.5% between March and April, to 3.7%. The most recent survey of Iceland's 400 largest firms suggests further layoffs to come, with 23% of survey respondents planning to cut staffing levels and only 14% planning to recruit. In the tourism sector, 31% of firms are planning to downsize and only 3% are planning to add on staff.



The shock stemming from WOW's collapse and Icelandair's problems with its Boeing 737 MAX jets compounds the contraction already projected for the tourism sector in 2019. Isavia's summer schedule assumes a 28% year-on-year contraction in flight offerings to and from Iceland. And to add insult to injury, there will be no capelin catch this year. A steep decline in export revenues is therefore expected. This will be partially offset, however, by a marked YoY contraction in imports relating to tourism and business investment.

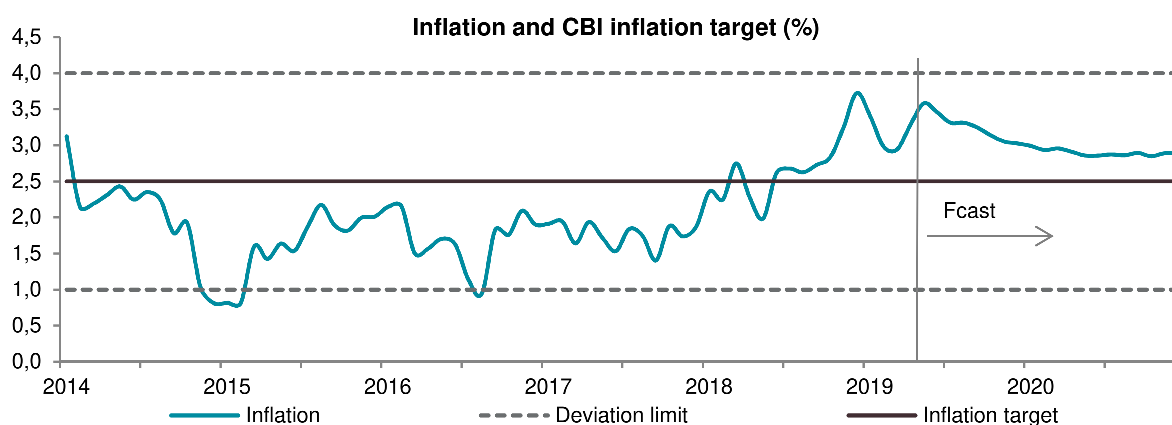
A rather sharp contraction in business investment is also expected for 2019, not least in the tourism industry. This, though, will be counterbalanced to a degree by robust growth in public investment and residential investment.



Real growth in Icelandic households' payment card turnover was only 0.9% in Q1/2019, the weakest in six years. Icelanders' card use abroad has slowed markedly since last autumn, after a very rapid increase during the period beforehand. Other consumption-related indicators, such as the Gallup Consumer Confidence Index, suggest that households are planning to scale down spending this year.

Real wage growth has lost pace in recent quarters, and we expect growth in purchasing power lose steam relative to the past few years. Moderate real wage growth and relatively low population growth will probably keep private consumption growth in check, as households appear disinclined to finance consumption spending with credit at the moment.

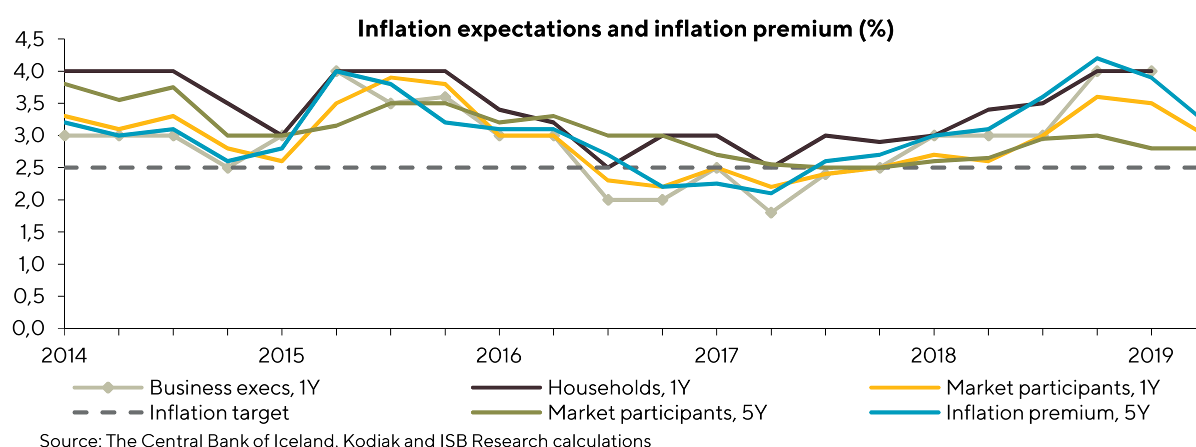
On the whole, we expect Iceland's output gap to narrow rapidly and output growth to be negligible at best. The CBI's upcoming macroeconomic forecast, to be published concurrent with next week's interest rate decision, will probably sketch out a similar picture. In February, the CBI projected year-2019 GDP growth at 1.8%. If that forecast is revised downwards, as we think is patently obvious, the scope will develop for a lower real interest rate than was previously indicated – all else being equal, of course.



Source: Statistics Iceland and ISB Research forecast

Inflation expectations careening towards the target

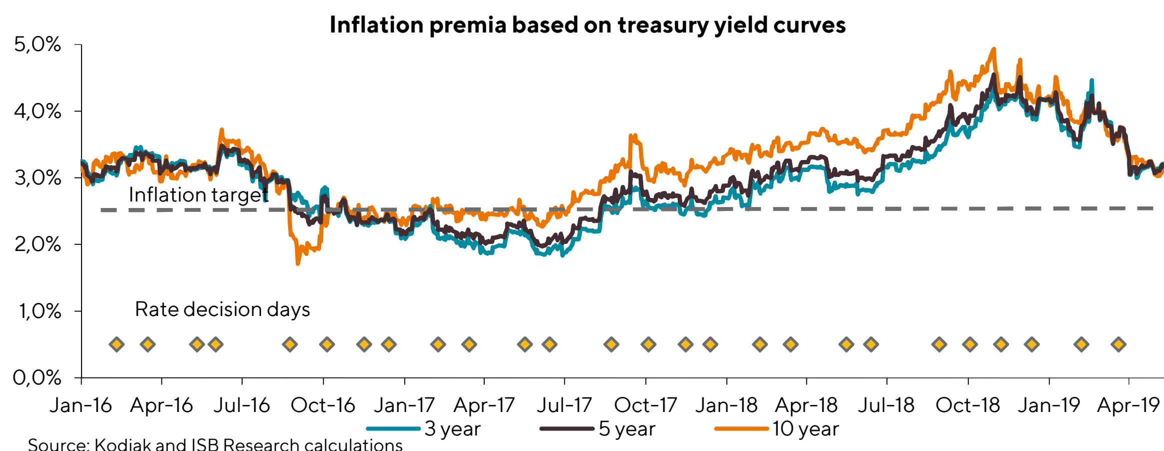
Inflation has risen marginally since the CBI's policy rate decision in March. It measured 3.3% in April, but at the time the MPC met in March, the most recent inflation measurement – 3.0% – was from February. We expect inflation to measure 3.6% in May and taper off again thereafter, to 3.3% in Q3 and 3.0% in Q4. For 2020, we project an average inflation rate of 2.9%. The CBI's February forecast assumed that inflation would measure 3.8% in Q3 and 3.3% in Q4 of this year. Since that forecast was prepared, the outlook for domestic cost pressures has improved markedly: private sector wage agreements provide for more moderate pay hikes in 2019 than many had feared, and dwindling demand pressures will probably keep wage drift and firms' mark-ups in check. As a result, we expect the CBI to be more optimistic about the short-term inflation outlook in its May forecast.



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

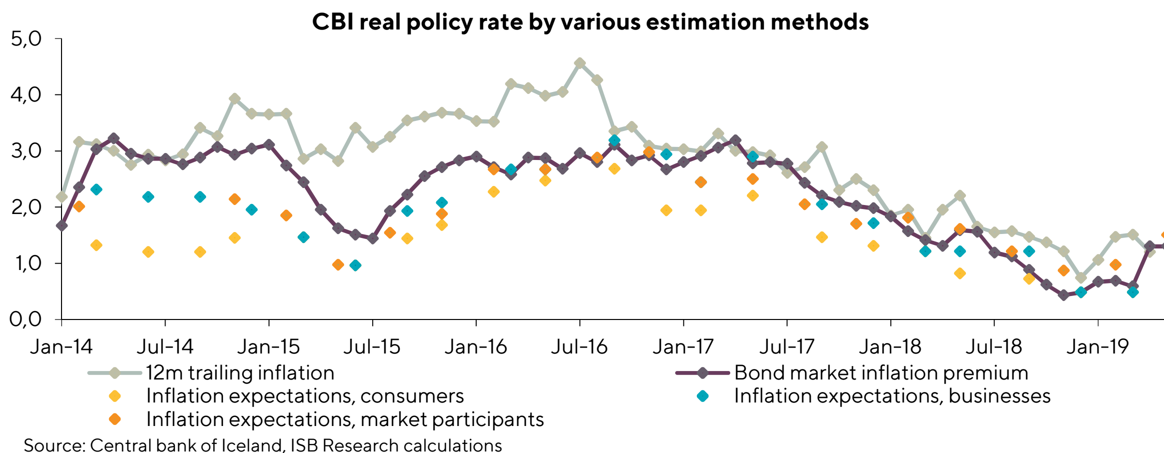
In March, the MPC voiced concerns about long-term inflation expectations, which were above the target by all measures. Subsequent developments should therefore ease Committee members' minds as they ponder the

optimum monetary stance for the months to come. In this regard, it is important to consider trends and not focus solely on the specific numeric value assigned to inflation expectations or the breakeven rate at any given point in time. If rising inflation expectations caused concern among MPC members, the current trajectory towards the target should alleviate that concern.



Real policy rate higher by most measures

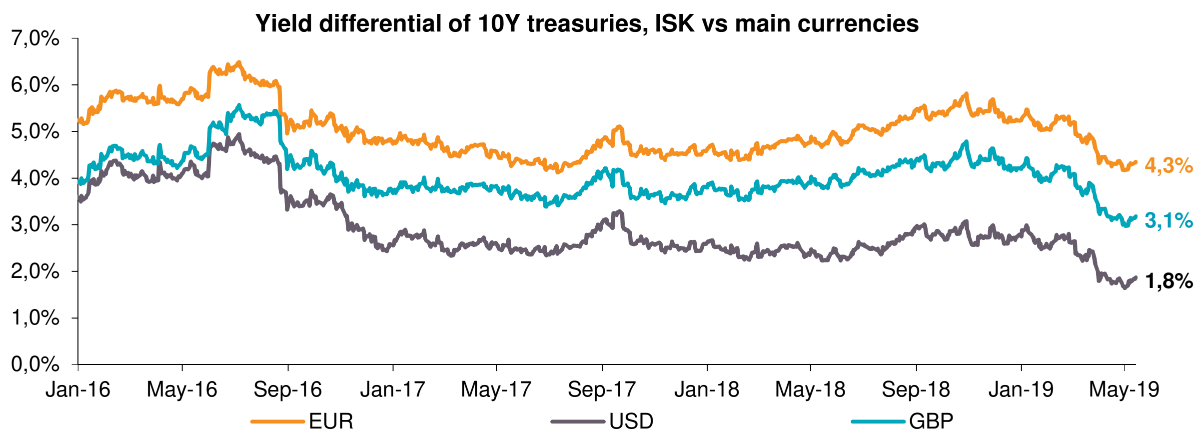
The recent decline in inflation expectations and the breakeven rate is reflected in a rise in the real policy rate. After falling steeply by all measures from mid-2017 onwards, the short-term real policy rate has turned upwards in the recent past. It is now 0.5-1.5%, depending on the measure used. It should be noted that the lowest values in the chart below are based on months-old surveys of households' and businesses' expectations, whereas the most recent expectations survey and the breakeven inflation rate in the bond market over the past few weeks suggest a much higher value. The latter measures should therefore carry considerably more weight in the MPC's assessment next week.



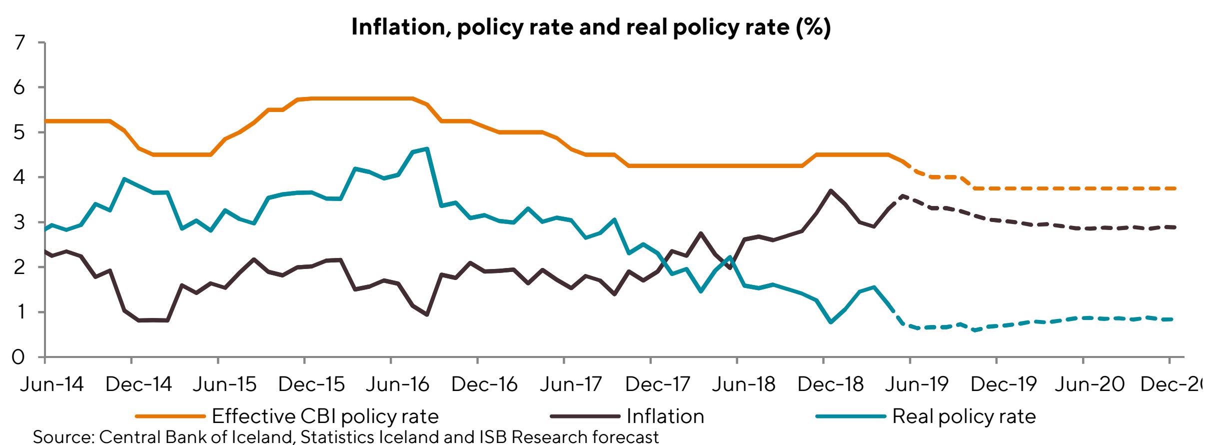
If this is placed in the context of a worsening short-term economic outlook and a narrowing output gap, it can be argued that the monetary stance is tighter than warranted at present. In addition to this, monetary conditions in the financial system appear to be tightening, which tightens the monetary stance, other things being equal. It could even transpire that the effective policy rate shifts quickly from the deposit side to the rate on the CBI's loans to commercial banks sometime during the quarters to come. If so, and absent other changes, the CBI should respond by lowering the entire short-term interest rate corridor by 50-75 points.

Interest rate differential with abroad has narrowed

In terms of major currencies, the interest rate differential with abroad has narrowed in the recent past. In terms of 10-year government bonds, it ranges between 1.8% (USD) and 4.3% (EUR). It has narrowed by 0.4-0.5% since the March policy rate decision. As the chart shows, the spread is still quite wide, particularly in view of the fact that Iceland is moving closer to neighbouring economies as regards output gap and labour market position. On the other hand, inflation in Iceland has been higher than in comparison countries, and the output gap has been sizeable in recent quarters. But the real interest rate spread has been wide as well. For example, yields on indexed Treasury bonds are currently around 1.0%, as opposed to 0.5% for comparable US bonds and -1.0% for comparable German bonds.



In this context, a key factor is whether there is a need to pull the domestic long-term real rate upwards because of diminishing monetary policy credibility. Developments in inflation expectations and the breakeven rate suggest, however, that confidence in the inflation target is rising, not falling, so the need for such a real interest rate spread should be waning.



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

Further interest rate cuts likely in 2019

In view of the changed inflation and macroeconomic outlook, we think it likely that the MPC will significantly revise its assessment of the optimum monetary stance in coming months. If it does not decide to lower the policy rate by 50 basis points in May, a second 25-point rate cut in June is highly likely. There are only five weeks between the May and June policy rate decisions, but in the interim, the MPC will gain access to national accounts and balance of payments figures for Q1.

Further rate cuts could be forthcoming later in the year, once it becomes clearer how quickly the economy is cooling and how strong the wage pressures from the recent wage agreements turn out to be. Based on our forecast of falling

inflation, such a rate cut may be needed for the sole purpose of putting the brakes on the real interest rate while the economy is righting itself. We therefore expect the effective policy rate to fall below 4.0% by the end of this year.

But it should be noted that this forecast applies to the *effective* policy rate. If, as a result of tighter monetary conditions, the CBI lending rate takes the place of the deposit rate as the effective policy rate, the CBI will presumably lower the entire interest rate corridor by 50-75 points to compensate. The seven-day deposit rate could therefore fall to around 3.0% and the collateralised lending rate, currently 5.25%, could fall to 3.75-4.0% by the year-end if the effective interest rate corridor shifts in this way.

Author

Jon Bentsson, chief economist +354 440 4634

research@islandsbanki.is
http://www.islandsbanki.is/English/

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