CENTRAL BANK POLICY RATE

20.6.2019 | Íslandsbanki Research

Summary

- We forecast a 25-point rate cut on 26 June
- Policy rate will fall to 3.75%
- Inflation outlook more than acceptable; inflation expectations moderate
- Short-term economic outlook has clouded over in recent weeks
- Further rate cuts totalling 50 bp likely in H2/2019

Central Bank interest rate decisions						
	Proposed	**Pro**	**Con**	**Preferred other**	**Result**	**Policy rate**
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	-0.50	5/5	0	0	-0.50	4.00
Jun 19	**-0.25**				**-0.25**	**3.75**

CBI's monetary easing phase continues

We expect the Central Bank (CBI) Monetary Policy Committee (MPC) to announce a 25-point reduction in the CBI's policy interest rate on 26 June, the next interest rate decision date. The CBI's key interest rate – the seven-day term deposit rate – will then be 3.75%, its lowest since Q3/2011.

At its May meeting, the MPC voted unanimously in favour of a 50-bp rate cut, citing the marked deterioration in the economic outlook as portrayed in the CBI forecast published concurrent with the interest rate decision. In addition, the inflation outlook had improved relative to previous forecasts, in the CBI's opinion, and inflation expectations had fallen. And last but not least, the MPC emphasised the considerable scope it had to respond to economic headwinds, provided that inflation and inflation expectations remained moderate.

Arguments for an unchanged rate

- Inflation to remain above target in the near term
- Inflation expectations still above target by some measures
- Cost pressures from wages likely to increase in the medium term
- Fiscal policy likely to ease

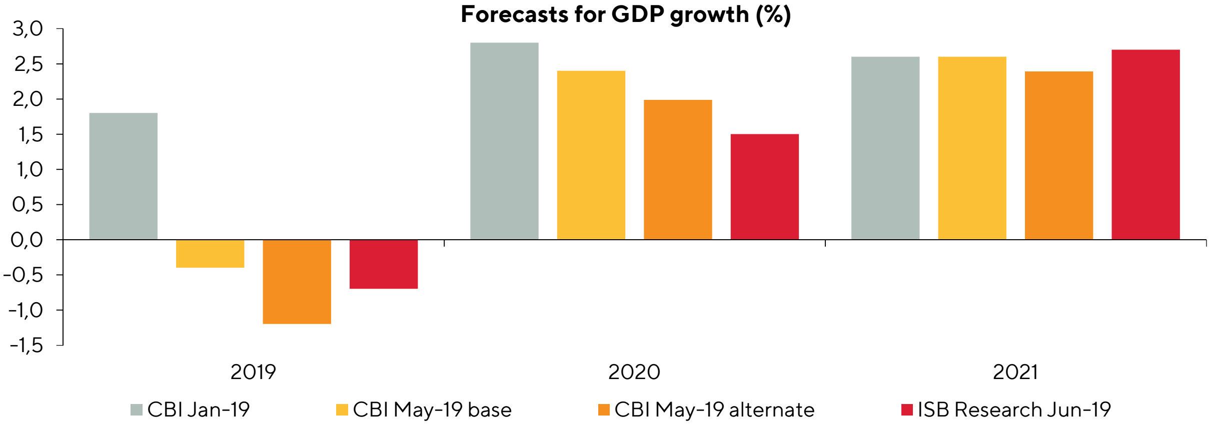
Arguments for a rate cut

- Inflation premium has declined
- Softer housing market
- Short term economic prospects have deteriorated since May
- Output gap likely to become negative in the very near term
- Interest rate differential on the rise again
- Tighter liquidity in the financial sector may translate into tighter monetary conditions in coming quarters

In our opinion, the economic outlook has deteriorated more since the May interest rate decision than was depicted in the baseline forecast published by the CBI at that time. As a result, an output slack will probably open up before the end of this year and could take longer to close again than the CBI projected in May. The MPC's statement and other comments by its members also suggest strongly that the Committee is ready to lower interest rates further in response to economic headwinds – and presumably, there is little reason to wait, as recent economic indicators have been consistent with the above-specified criteria concerning inflation expectations and prospects. And finally, recent developments in long-term breakeven inflation rates and inflation expectations indicate that the monetary policy is still retaining its overall credibility, which reduces the need for monetary tightening, absent other changes.

Economic outlook gloomier than the CBI projected in May

On the May interest rate decision date, the CBI released its most recent issue of *Monetary Bulletin*, which contains its new macroeconomic forecast. The forecast presented therein was considerably bleaker than its predecessor, which nevertheless provided for a very mild and short-lived contraction this year, followed by robust GDP growth in 2020.

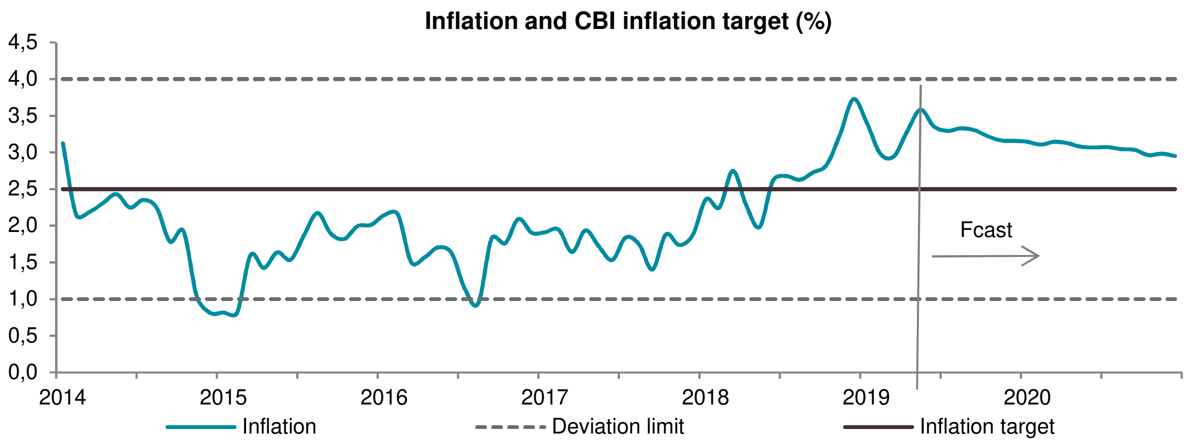


Source: The Central Bank of Iceland and ISB Research

Our recent macroeconomic forecast, published in early June, assumes that the economy will face much more resistance in coming months than the CBI projected in May, and developments in the interim appear to support our opinion. Isavia's newly published passenger forecast provides for an approximately 17% year-on-year decline in tourist visits to Iceland, whereas the CBI projected a reduction of 10.5%. Alongside its baseline forecast, the CBI published an alternative scenario providing for a larger decline in tourist arrivals and a slower rebound than was assumed in the baseline. Recent developments have increased the likelihood that the alternative scenario will carry the day, not the baseline forecast, as the alternative provides for a 1.2% contraction in GDP this year, followed by two years of more sluggish growth than in the baseline example.

At the May rate-setting meeting, MPC members mentioned the possibility of a deeper economic contraction than in the baseline forecast as a potential argument in favour of a 50-bp rate cut rather than a smaller one. We expect the MPC to share our concern that the probability of this outcome has increased in recent weeks.

According to the baseline forecast from May, the CBI assumed that the output slack would average 0.3% of GDP this year. It is quite conceivable that Committee members will conclude that the slack will be larger this year and will take longer to close than was projected in May. Other things being equal, this should call for further monetary easing.

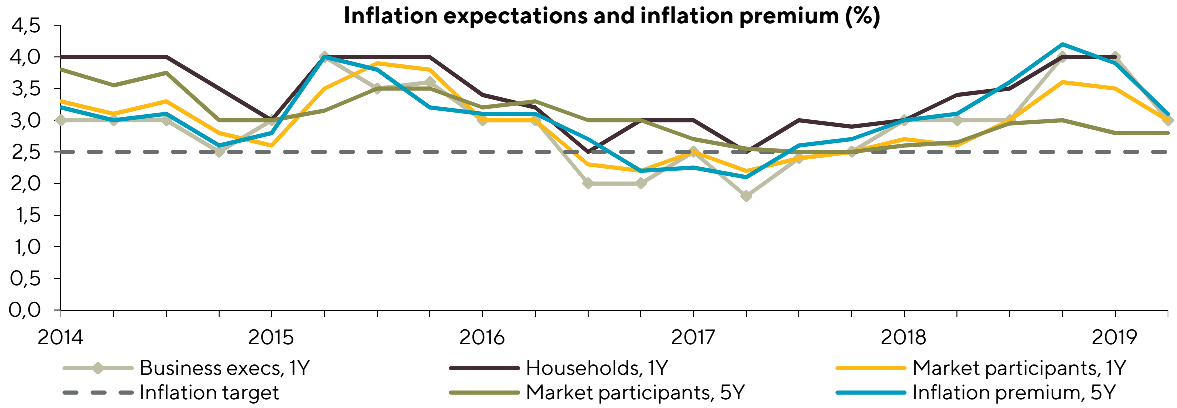


Source: Statistics Iceland and ISB Research forecast

Inflation expectations closing in on the target

Inflation has risen marginally since the CBI's May policy rate decision. It measured 3.6% in May, whereas the policy rate decision was based on the April measurement of 3.3%, the most recent available at the time. Developments have been in line with the CBI's May forecast, however, which provided for 3.4% average inflation in Q2. We expect inflation to taper off to 3.4% in June. In the quarters thereafter, the outlook is for it to subside somewhat, owing to a more favourable outlook for 2019 wage developments coupled with a slowdown in house price inflation. We forecast that inflation will measure 2.9% at the year-end, putting the Central Bank's (CBI) inflation target well within range, and then taper off to 2.8% at the end of 2020 and 2021.

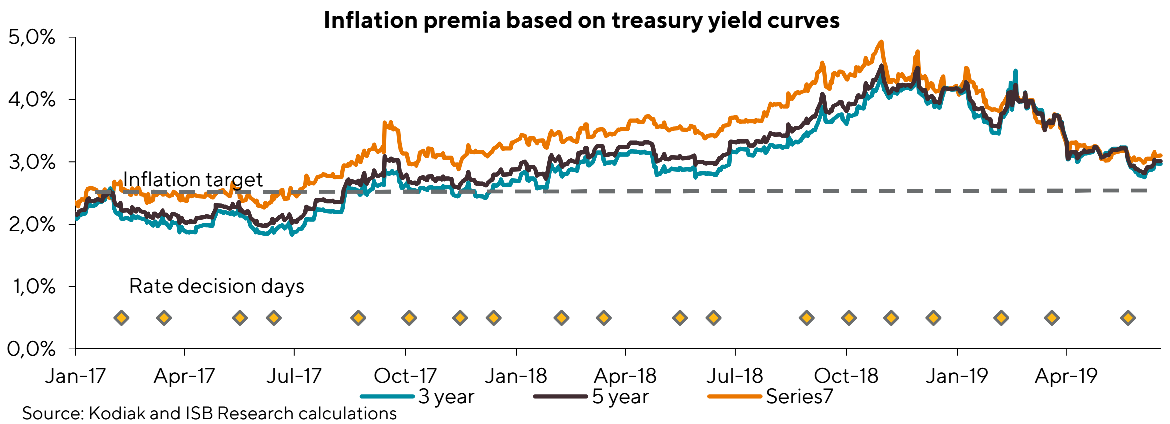
The CBI projected in May that inflation would average 3.1% in Q4/2019 and fall to the 2.5% inflation target in mid-2020. Subsequent developments should not change the CBI's assessment of the inflation outlook to any marked degree.



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

Also in May, the bank noted that the downward trend in market agents' inflation expectations was a positive development, emphasising that monetary policy had considerable scope to respond to an economic contraction — provided that inflation and inflation expectations remained close to the target. Although many measures of inflation expectations have not changed substantially, a newly published measurement of corporate expectations indicates that respondents expect inflation to measure 3% over the next twelve months, down from 4% in the previous expectations survey.

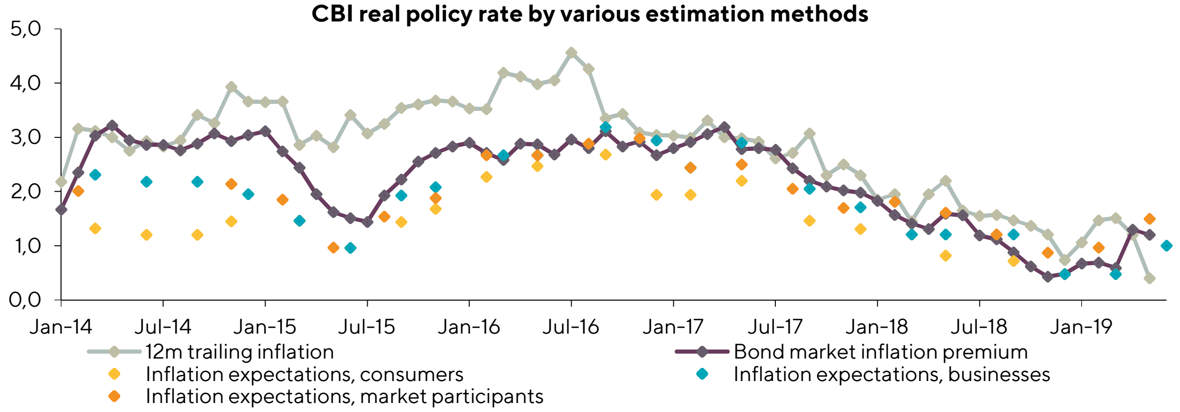
In the bond market, a lower breakeven inflation rate seems to have settled in, with the medium-term breakeven rate fluctuating in the 2.8-3.2% range thus far in Q2. Furthermore, the ten-year breakeven rate is at its lowest since the end of 2017. The CBI's monetary policy therefore appears to have gained credibility again, after a marked rise in inflation expectations and breakeven rates in H2/2018. As the MPC itself points out, these developments give the bank more room to use monetary easing as a cushion against the recent supply shocks.



Source: Kodiak and ISB Research calculations

Real policy rate high relative to the business cycle position

The recent decline in inflation expectations and the breakeven rate has been reflected in a rise in the real policy rate by most measures. After falling steeply from mid-2017 onwards, the real policy rate has turned around recently, except that rising inflation in the past few months has pushed it downwards in terms of past inflation. As is mentioned above, this was a temporary inflation spike, and furthermore, the CBI pays less heed to it than to forward-looking indicators. The real policy rate in terms of inflation expectations and breakeven rates in the market is now 1.0-1.5%, depending on the measure used.

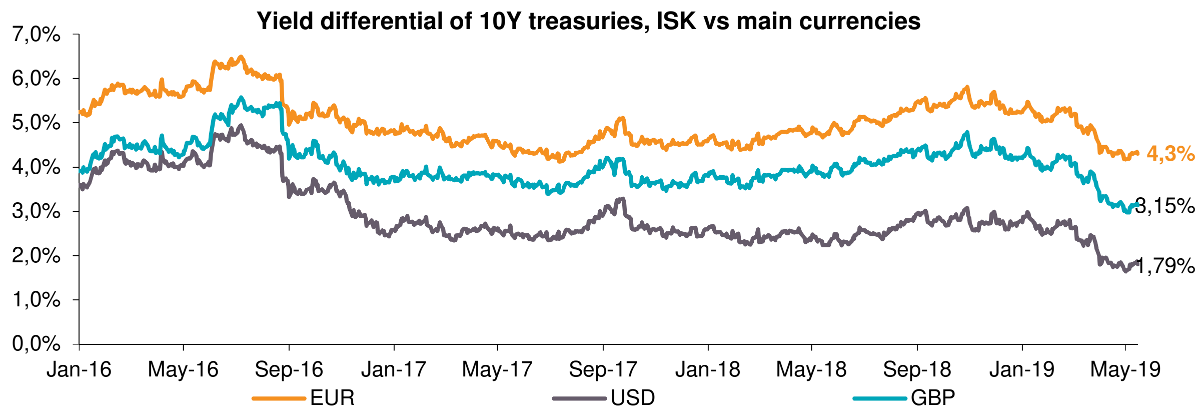


Source: Central bank of Iceland, ISB Research calculations

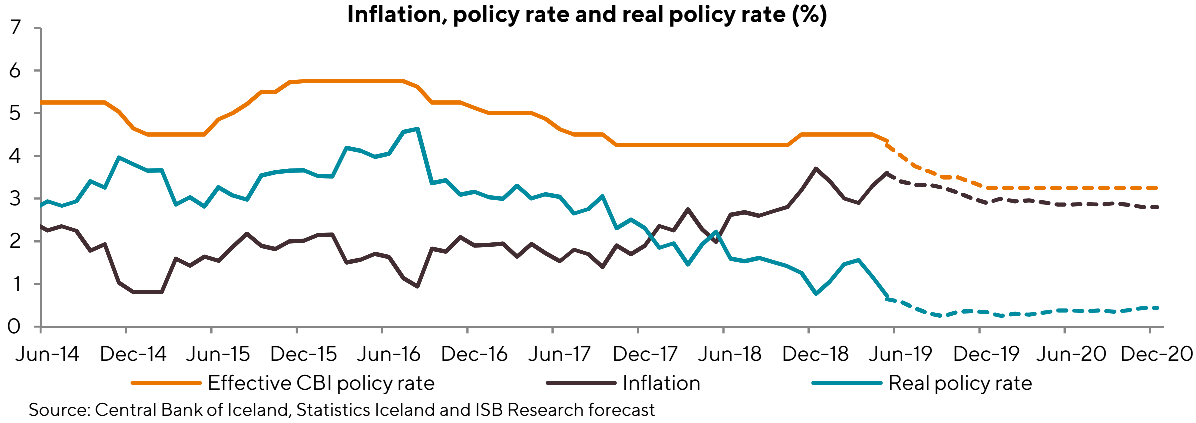
Considering how much the short-term economic outlook has deteriorated and how rapidly the output gap is narrowing, there are strong grounds for the view that the monetary stance is still too tight, in spite of the rate cut in May. In addition to this, monetary conditions in the financial system appear to be tightening, which tightens the effective monetary stance, other things being equal. It is possible, even, that the effective policy rate will shift 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 differential with abroad widens again

In terms of major currencies, the interest rate differential with abroad has widened in the recent past. In terms of 10-year government bonds, it currently ranges between 2.0% (USD) and 4.4% (EUR). Since May, it has widened by 0.1-0.4%, due to a decline in yields abroad. As the chart shows, the spread is quite wide, particularly in view of the fact that Iceland is moving closer to neighbouring economies as regards output gap and labour market situation. On the other hand, inflation in Iceland has been considerably 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 with an average maturity of five years are currently around 0.9%, as opposed to 0.3% for comparable US bonds and -1.3% for comparable German bonds.



In this context, it is also important to consider whether the real interest rate needs to compensate for a lack of monetary policy credibility; if so, the real interest rate spread will need to be wider. Given the growing credibility of the CBI's inflation target, the need for such a premium on the real rate should be diminishing.



Further interest rate cuts likely in 2019

In view of the improving inflation outlook and the deterioration of the short-term economic outlook, we think it likely that the MPC will decide to lower the policy rate further in coming months, once it becomes clearer just how much the economy is cooling and how much domestic cost pressure this year's wage agreements will entail. Based on our inflation forecast and the growing need for monetary easing while the economy is realigning itself, we expect the effective policy rate to have fallen to 3.25% by the year-end and then remain there through end-2020.

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 2.5% and the collateralised lending rate, currently 4.75%, could fall to 3.25-3.50% by the year-end if the effective interest rate corridor shifts in this way.

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