The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

October 2020 (98th meeting)

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and the premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each decision. The votes of individual Committee members are also included in the minutes.

The following are the minutes of the MPC meeting held on 5 and 6 October 2020, during which the Committee discussed economic and financial market developments, decisions on the application of the Bank's monetary policy instruments, and the communication of those decisions on 7 October.

I Economic and monetary developments

Before turning to monetary policy decisions, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the Committee's last meeting, on 26 August 2020.

Financial markets

Since the August meeting, the króna had appreciated by 0.2% in trade-weighted terms. Over this same period it rose by 1.1% against the pound sterling and fell by 0.3% against the US dollar but remained broadly flat against the euro. The Central Bank decided to begin regular sales of foreign currency in the domestic foreign exchange market on 14 September. Between meetings, the Bank sold foreign currency in the amount of 177 million euros (28.8 b.kr.), including 51 million euros sold under the regular sales programme. The Bank's transactions accounted for 48% of total foreign exchange market turnover for the period.

In terms of the Central Bank's real rate, the monetary stance had eased slightly since the MPC's August meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -1.8%, or 0.1 percentage points lower than just after the publication of the August interest rate decision. In terms of twelve-month inflation, it was -2.4% and had fallen by 0.5 percentage points between meetings.

Interest rates in the interbank market for krónur were virtually unchanged between meetings, and there was no turnover in the interbank market during that period. Yields on long-term nominal Treasury bonds had risen by 0.2 percentage points since the August meeting, and yields on long-term indexed Treasury bonds had risen by 0.3 percentage points. Average mortgage lending rates had held broadly unchanged between meetings, however.

In terms of three-month interbank rates, the interest rate differential was virtually unchanged between meetings, at 2.1 percentage points versus the euro area and 1.3 percentage points versus the US. The long-term interest rate spread versus Germany had widened by 0.4 percentage points, to 3.4 percentage points, and the spread versus the US had widened by 0.3 percentage points, to 2.1 percentage points. Measures of the risk premium on the Treasury's foreign obligations were more or less unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.6%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.7-0.8 percentage points.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged, citing the onset of the third wave of the COVID-19 pandemic in Iceland, with continued adverse effects on the economy, even though inflation had risen more than expected.

Annual growth in M3 has gained pace as the year has progressed, measuring 13½% in August, adjusted for the deposits of the failed financial institutions. Growth in credit system lending to domestic borrowers lost pace over the course of 2019, but annual growth has been relatively stable at around 4-5% thus far in 2020. Household lending grew by just over 7% year-on-year in August, while corporate lending grew by just under 1%.

The Nasdaq OMXI10 index had fallen by 1.3% between meetings. Turnover in the Main Market totalled 397 b.kr. in the first nine months of 2020, some 11% less than over the same period in 2019.

Global economy and external trade

According to the Organisation for Economic Cooperation and Development's (OECD) September forecast, the global economy is set to shrink by 4.5% this year. This is 1.5-3.1 percentage points smaller than the contraction forecast in June, yet it remains the largest contraction in global output since World War II. The change from the June forecast is due mainly to an improved outlook for China and the US and to a smaller contraction in Europe. On the other hand, the GDP growth outlook has deteriorated in several emerging economies, and an even larger contraction is now forecast for India, Argentina, Mexico, and South Africa. The OECD forecasts a return to growth in 2021, with global GDP rising by 5%, broadly in line with its June forecast. Uncertainty about global economic developments remains pronounced, however, and depends on how persistent the COVID-19 pandemic proves to be. Global GDP growth could turn out as much as 3 percentage points less in 2021, according to the OECD, if the pandemic drags on or if public health measures must be tightened more than is assumed in the baseline forecast. However, it could turn out 2 percentage points stronger if more moderate public health measures suffice to keep the pandemic in check or if a vaccine or effective medical treatment is developed sooner than expected.

Iceland's goods account deficit totalled 58 b.kr. in the first eight months of 2020, at constant exchange rates. The deficit over the same period in 2018 was 98 b.kr., also at constant exchange rates. The smaller deficit now is due in particular to a large contraction in import values in 2020 to date, although aircraft exports in January 2019 also affected the comparison. Excluding ships and aircraft, the goods account showed a deficit of 51 b.kr. in the first eight months of 2020, as opposed to a 113 b.kr. deficit over the same period in 2019. The contraction in import values excluding ships and aircraft has eased recently, in line with expectations. In the past three months, import values have contracted by nearly 20% year-on-year, as opposed to 24% at the time of the MPC's last meeting. The main difference is a smaller contraction in imports of consumer goods and transport equipment. Export values excluding ships and aircraft contracted by 11% year-on-year in the first eight months of 2020, particularly for manufactured goods, although marine product export values fell by 10%.

The global price of aluminium had risen marginally since the August meeting but was broadly as it was in October 2019. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 0.7% year-on-year in the first eight months of 2020. Global Brent crude prices measured about 43 US dollars per barrel at the time of the October meeting, about 7% lower than at the August meeting. At the time of the October meeting, oil prices were down by just over a third year-to-date and about a fourth year-on-year.

The real exchange rate in terms of relative consumer prices was virtually unchanged month-on-month in September, when it was 3.1% below its 25-year average and 12.1% below its end-2019 level. In the first nine months of 2020, it was down by 7.4% compared with the same period in 2019, as the nominal exchange rate of the króna was 9.1% lower and inflation in Iceland was 1.7 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland at the end of August, GDP contracted by 9.3% year-on-year in Q2. Domestic demand declined by 7.1%, driven by a contraction in all components except public consumption and changes in inventories. There were significant changes in external trade, with both imports and exports declining markedly. Exports contracted considerably more than imports, however, and the contribution of net trade to GDP growth was therefore negative by 2.2 percentage points. GDP contracted by 5.7% in H1/2020. Domestic demand contracted by 2.4%, while the contribution from net trade was negative by 3.3 percentage points.

The contraction in Q2 was 1.4 percentage points smaller than was forecast in the August *Monetary Bulletin.* Developments in net trade and its contribution to GDP growth were broadly in line with the forecast. Domestic demand was more resilient than had been assumed, contracting by 1.4 percentage points less than projected. In particular, private consumption and residential investment contracted less than was forecast. Figures from Statistics Iceland show that the contraction was ½ a percentage point smaller in H1 than was forecast in August. The main difference was in stronger private consumption, in addition to somewhat stronger-than-expected business investment, although this was due in large part to a revision in Q1.

The current account balance was positive by 7 b.kr. in Q2, as compared with a surplus of 16 b.kr. in Q2/2019. The subcomponents of the current account balance have changed markedly in the wake of the COVID-19 pandemic. The services account surplus shrank by 48 b.kr. between years, although it was partially offset by a smaller goods account deficit. In addition, the balance on primary and secondary income was more positive this year than in 2019. Developments in the balance on goods and services trade were in line with the Bank's August forecast, but the balance on primary income was considerably more favourable than expected, and the current account surplus was therefore somewhat larger than was forecast in August.

After a strong contraction in private consumption in Q2, key indicators imply that consumption picked up in Q3. This was particularly the case with domestic consumption, as overseas travel was negligible during the summer. Household demand had clearly shifted in particular towards consumer durables this summer, and spending on categories that suffered from public health measures and changes in household consumption patterns this spring, increased considerably. On the whole, however, household payment card turnover in July and August was lower than at the same time in 2019, but even though turnover within Iceland surged, it did not suffice to offset the steep contraction in households' overseas card use.

The Gallup Consumer Confidence Index measured 60.6 points in September, or 16.8 points higher than in August, but 38.6 points less than at the same time in 2019. Consumers' expectations six months ahead improved, while their assessment of the current situation deteriorated. The big-ticket index fell significantly in September, driven by a sharp contraction in consumers' overseas travel plans.

According to the fiscal budget proposal for 2021, the Treasury is expected to show a deficit of 8.6% of GDP. According to the Ministry of Finance and Economic Affairs' revision of the 2020 outcome in comparison with the National Budget for the year, the outcome has deteriorated by 9.1 percentage points of GDP. According to the Ministry's estimate for 2020 as a whole and Statistics Iceland figures for 2019, the fiscal outcome deteriorated by 8.1 percentage points of GDP between the two years. The Ministry also estimates that the unadjusted primary surplus will narrow by as much as 8.2 percentage points of GDP between 2019 and 2020.

According to the results of Gallup's autumn survey, conducted in September among Iceland's 400 largest firms, respondents' assessment of the current economic situation was about the same as in the summer survey, but considerably more negative than in the survey taken in autumn 2019. Executives' expectations six months ahead are much more negative than they were in the summer, however. About 85% of respondents considered the current situation poor, and just under 13% considered it neither good nor poor. Some 43% of executives are of the view that economic conditions will deteriorate in the next six months, and 31% expect conditions to be neither better nor worse. Just over a fourth of executives expect conditions to improve in the next six months – somewhat fewer than in the summer. Executives are also more pessimistic about both domestic and foreign demand than in the summer survey, particularly those in transport, transit, and tourism and those in wholesale and retail trade. Respondents have not been more pessimistic about foreign demand since measurements began.

The outlook for firms' performance has deteriorated markedly since the spring survey, and more than half of executives now expect their profits to be weaker this year than in 2019. Most executives responded that their margins had declined since the spring survey, and a similar share expected margins to continue falling over the next six months. The assessment was most negative in transport, transit, and tourism and in the construction and fishing sectors. Overall, executives in all sectors expect to invest less in 2020 than in 2019, and they were considerably more pessimistic than in the spring.

According to the seasonally adjusted results of the autumn survey, the balance of opinion on staffing plans (i.e., firms planning to recruit as compared with those planning redundancies) was negative by 24 percentage points. However, survey respondents were somewhat less pessimistic than in the summer survey, when the same balance of opinion was negative by 32 percentage points. The outlook is still for job losses in all sectors, although job numbers could fall proportionally the most in transport, transit, and tourism, where the balance of opinion was negative by 53 percentage points. Among firms in wholesale and retail trade and in the financial and insurance sector, the balance of opinion was negative by about a third, whereas executives in the miscellaneous specialised services sector were less pessimistic, with the balance of opinion negative by 5 percentage points.

After adjusting for seasonality, 6% of executives considered themselves short-staffed, about the same as in the summer survey and close to the historical low. There was little or no reported shortage of workers in the construction, wholesale/retail trade, fishing, and financial/insurance sectors. Executives reporting staffing shortages were most likely to be in the industry and manufacturing sector, where 16% considered themselves understaffed, an increase of 8 percentage points between surveys. Just under one out of every 10 executives in miscellaneous specialised services and in transport, transit, and tourism reported being understaffed.

About 27% of executives reported that their firms would have difficulty responding to an unexpected increase in demand, after adjusting for seasonality. This percentage was broadly unchanged from the summer survey, and only 6 percentage points above the trough in the wake of the financial crisis. Proportionally, the largest share of construction company executives, or two out of five, reported that their firms would have difficulty responding to an unexpected uptick in demand, whereas fewer than one out of five in retail/wholesale trade and the financial/insurance sector were of the same opinion.

The wage index rose by 0.2% month-on-month in August and by 6.4% year-on-year. Real wages were 3.5% higher during the month than at the same time in 2019.

Statistics Iceland's nationwide house price index, published in late September, rose by 0.5% month-on-month when adjusted for seasonality, and by 7.8% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.9% month-on-month in August when adjusted for seasonality, and by 5.2% year-on-year. The number of purchase agreements registered nationwide rose by 5.1% year-on-year in the first eight months of 2020, while the number of contracts for new construction increased by 48.6% over the same period.

The consumer price index (CPI) rose by 0.39% month-on-month in September, raising twelve-month inflation to 3.5%. The CPI excluding the housing component had risen by 3.9% year-on-year in September. Underlying inflation measured 4.1% in September, in terms of the average of various measures, and therefore remains noticeably above observed inflation. This is partly because underlying inflation excludes the decline in petrol prices and the impact of lower real mortgage interest expense. The interest component of imputed rent has lowered inflation in the past year, causing twelve-month inflation to be lower by an estimated 0.8 percentage points.

The depreciation of the króna has significantly affected imported goods prices in recent months and still affected prices in September. The impact of seasonal sales reversed, and more besides, particularly because of a steep rise in furniture and electronic equipment prices. This was probably due as well to the impact of the recent surge in demand for these goods.

According to Gallup's autumn surveys, households' one- and two-year inflation expectations rose between surveys, with households expecting 4% inflation in one year and 3.2% inflation in two years. Their long-term inflation expectations were unchanged at 3%, however. Firms' short- and long-term inflation expectations were unchanged between surveys at 3%, however, and executives expect inflation to average 2.7% over the next five years. The five- and ten-year breakeven inflation rate in the bond market has risen slightly since the last MPC meeting, to 2.6-2.8% at the beginning of October.

II Decisions on the Bank's monetary policy instruments

Committee members discussed economic developments and prospects, the Bank's most recent *Financial Stability* report, financial institutions' position, and risks in the financial system. Representatives from the Ministry of Finance and Economic Affairs attended part of the meeting to introduce the fiscal budget proposal and fiscal plan to the Committee. The Committee also invited Ólafur Guðlaugsson, chair of the Disease Prevention Council, to the meeting to discuss the status of matters relating to the COVID-19 pandemic and the development of a vaccine.

The MPC discussed the monetary stance in view of economic developments and the fact that the Bank's real rate had fallen marginally since the August meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in August to hold the Bank's interest rates unchanged. At that time, the outlook was for the contraction in 2020 to be slightly smaller than had been expected in May, and inflation had risen slightly between meetings, as the Committee had expected.

The Committee discussed preliminary national accounts figures, which showed that GDP growth was slightly stronger in H1/2020 than had been forecast in the August *Monetary Bulletin*. On the other hand, high-frequency indicators and surveys suggested that demand growth had eased in late summer. Members noted that because of increased spread of the coronavirus in the recent past, the economic outlook had deteriorated relative to the August forecast. It emerged at the meeting that the negative impact on demand of the third wave of the pandemic gave cause for concern. The Committee emphasised, however, that uncertainty was pronounced and that economic developments would depend to a considerable degree on the path the pandemic took.

The MPC discussed developments in inflation, which rose between quarters in Q3/2020, measuring 3.2%, somewhat above the August forecast. Members noted that the exchange rate pass-through from the depreciation of the króna continued to affect imported goods prices, but they agreed that, other things being equal, the considerable slack in the domestic economy would cause inflation to subside as the effects of the depreciation tapered off. It was pointed out that increased demand for certain goods could nevertheless cause price hikes in those goods categories. Members considered it positive that medium- and long-term inflation expectations were broadly unchanged and appeared to remain anchored to the Bank's inflation target.

The Committee discussed the foreign exchange market. As in August, members were of the view that the real exchange rate of the króna was probably below its equilibrium at present. As long as that was the case, it was important that the Central Bank should continue intervening in the market in order to mitigate the depreciation of the króna. In addition, the Bank's regular sales of foreign currency at the market opening had deepened the market and improved price formation. The MPC was of the opinion that these measures had played a role in keeping the króna broadly stable between meetings.

The Committee discussed the Bank's quantitative easing programme. Thus far, there had not been a need for large-scale bond purchases, as the supply of Treasury bonds had not yet increased significantly and both price formation and market functioning were normal. Members agreed that even though long-term bond market yields had eased upwards recently, decisive action was not warranted, for the present.

All members were of the opinion that it was appropriate to keep the Bank's interest rates unchanged. It emerged in the discussion that lower interest rates had supported domestic demand and that rate cuts had been transmitted successfully to households, as the housing market had been relatively buoyant in recent months. Members also noted that it appeared as though the credit quality of new mortgages granted by the systemically important banks had improved in the recent past, as loan-to-disposable income ratios and loan-to-value ratios on new loans had fallen. That being the case, most new borrowers should generally be able to shoulder a heavier debt service burden if interest rates should rise. It also emerged at the meeting that issuance of new corporate loans was at a low ebb, as demand was weak. It was normal that investment should decline in the wake of a shock of the magnitude of the current one, and when uncertainty was at such a high level. The Committee considered it positive, however, that it seemed as though credit spreads on new corporate loans had peaked and had started to decline.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would be 1%, the current account rate 0.75%, the seven-day collateralised lending rate 1.75%, and the overnight lending rate 2.75%. All Committee members voted in favour of the proposal.

In the Committee's view, more firmly anchored inflation expectations provided monetary policy the scope to respond decisively to the deteriorating economic outlook. Members were also of the opinion that lower interest rates, together with actions taken by the Bank this spring, had supported domestic demand. They agreed that the impact of these measures had yet to emerge in full and that the measures would continue to support the economy and facilitate a more rapid recovery than would otherwise occur.

The MPC reiterated at the meeting that it would continue to monitor economic developments and would use the tools at its disposal to support the domestic economy and ensure that the more accommodative monetary stance was transmitted normally to households and businesses.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Monetary Policy Committee

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy

Gunnar Jakobsson, Deputy Governor for Financial Stability

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Associate Professor, external member

The Chief Economist was in attendance for the entire meeting. In addition, a number of Bank staff members attended part of the meeting.

Karen Á. Vignisdóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 18 November 2020.