The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

Meeting 1-2 February 2021 (100th meeting)

Published 17 February 2021

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 1 and 2 February 2021, 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 3 February.

I Economic and monetary developments

Before discussing 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 18 November 2020, and the updated forecast in *Monetary Bulletin* 2021/1, published on 3 February.

Financial markets

Since the November meeting, the króna had appreciated by 3.1% in trade-weighted terms. Between meetings, the Bank sold foreign currency in the amount of 280.5 million euros (43.9 b.kr.), including 159 million euros sold under the regular sales programme. The Bank's transactions accounted for 47% 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 November meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was -2.5%, or 0.2 percentage points lower than just after the announcement of the November interest rate decision. In terms of twelve-month inflation, it was -3.4% and had fallen by 0.9 percentage points between meetings.

Interest rates in the interbank market for krónur fell slightly between meetings, and turnover in the market totalled 10 b.kr. during the period. Yields on long-term indexed and nominal Treasury bonds had risen by 0.2 percentage points since the November meeting. Average mortgage lending rates had held broadly unchanged between meetings, however.

In terms of three-month interbank rates, the interest rate differential had narrowed slightly between meetings, to 1.9 percentage points versus the euro area and 1.2 percentage points versus the US. The long-term interest rate spread versus Germany had widened by 0.2 percentage points, to 3.8 percentage points, while the spread versus the US was unchanged at 2.2 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 0.5%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.6-0.7 percentage points.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged. They noted that because inflation had risen and was above the upper deviation threshold of the inflation target, there was no prospect of further rate cuts at present. Stable inflation expectations and the prospect that inflation would fall quickly over the course of the year would give the Bank the scope to keep interest rates unchanged.

According to the Central Bank's quarterly market expectations survey, conducted in January 2021, respondents expected the Bank's key rate to remain unchanged at 0.75% in Q1/2021, followed by either no change or a rate cut of 0.25 percentage points in Q2. This is a lower rate than survey participants expected in November, when they projected that the Bank's key rate would be 1% in 2021. In the survey, about 46% of respondents considered the monetary stance appropriate at present, down from 58% in the previous survey. The share who considered the monetary stance too tight increased to 38%, however, from 31% in the November survey. Roughly 15% of respondents considered the stance too loose, as compared with just under 12% in the Bank's previous survey.

Annual growth in M3 has gained pace as the year has progressed. It is estimated to have measured just over 13% in December. Twelve-month growth in credit system lending to households has measured just over 6% since the beginning of 2020, but by the end of the year it had risen to roughly 8½%, as interest rates have fallen steeply and real estate market activity has been brisk. On the other hand, corporate lending has been virtually flat since the end of 2019.

The Nasdaq OMXI10 index had risen by 14.2% between meetings. Turnover in the Main Market totalled 600 b.kr. in 2020, some ½% less than in 2019.

Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in late January, global GDP growth contracted by 3.5% in 2020. This is a 0.9 percentage point smaller contraction than the Fund had projected in October, reflecting stronger economic activity in H2/2020 than had been expected at the time of that forecast. The GDP growth outlook has also improved for 2021, in view of progress made in developing vaccines against the pandemic and additional financial measures announced towards the end of the year in several large economies, particularly the US and Japan. Pulling in the other direction is the weaker near-term outlook due to increased COVID-19 infection numbers and tighter public health measures, particularly in Europe. The IMF forecasts global GDP growth at 5.5% in 2021, some 0.3 percentage points above the October forecast. The GDP growth outlook has improved particularly in the US, where it is projected at 5.1%, a full 2 percentage points above the October forecast. In Japan, the outlook has improved as well, with GDP growth expected to measure 3.1%, 0.8 percentage points above the October forecast. The outlook has worsened for the eurozone and the UK, however. In both cases, the GDP growth forecasts have been revised downwards by 1-1.4 percentage points since October, to 4.2% for the eurozone and 4.5% for the UK. The outlook for 2022 is unchanged, however, with global GDP growth projected at 4.2%.

Iceland's deficit on goods trade totalled 1.3 b.kr. in December, down from more than 13 b.kr. in December 2019, at constant exchange rates. The deficits for 2020 and 2019 as a whole were 97.5 b.kr. and 128 b.kr., respectively, at constant exchange rates. The smaller deficit in 2020 than in 2019 is due primarily to a larger contraction in import values than in export values. In the last three months of 2020, however, the decline in import values eased. Excluding ships and aircraft, the contraction measured 5% year-on-year, as opposed to 13% just before the MPC's previous meeting. Excluding ships and aircraft, goods export values were down by 7% year-on-year in the final three months of 2020, as opposed to nearly 11% just before the Committee's last meeting. This was due mainly to a contraction in the value of exported industrial goods.

Global aluminium prices had risen slightly since the MPC's November meeting and were just over 19% higher than in early February 2020. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were down 1.9% year-on-year in 2020. Global Brent crude prices were about 57 US dollars per barrel at the time of the February meeting, about a third higher than at the November meeting. The increase reflects expectations that demand for oil will recover more quickly than previously thought, owing to success with the development of COVID-19 vaccines. Reduced production among OPEC countries and other oil producers has also supported prices. Nevertheless, oil prices were still about 13% lower in February than they were before the pandemic struck at the beginning of 2020.

The real exchange rate in terms of relative consumer prices rose by 5.4% month-on-month in December, when it was 2.8% above its 25-year average but 6.8% lower than in December 2019. It fell by 8% year-on-year in 2020, as the nominal exchange rate of the króna fell by 10%, while inflation in Iceland was 2.1 percentage points above the trading partner average.

Domestic economy and inflation

Indicators of private consumption in Q4/2020 suggest a wide difference in household demand within the quarter, which is attributable in large part to the effects of public health measures. High-frequency indicators imply that early in the quarter, after COVID-19 case numbers rose and public health measures were tightened, developments were similar to those in spring 2020, when household spending on various services gave way and traffic declined. At the same time, there was still relatively strong demand for goods such as groceries. Once the public health measures were eased in November, demand for services picked up again, but on the whole, indicators imply that the year-on-year contraction in private consumption was somewhat larger than in Q3.

The Gallup Consumer Confidence Index measured 94.4 points in January, after falling only marginally month-on-month. This could indicate increased consumer optimism relative to the previous autumn, as it is primarily consumer expectations six months ahead that have improved.

According to the results of Gallup's winter survey, conducted in December 2020 among Iceland's 400 largest firms, executives' expectations six months ahead are considerably more positive than they were in the autumn. About 80% of respondents considered the current situation poor, and just under 18% considered it neither good nor poor. Some 51% of executives are of the view that economic conditions will improve in the next six months, and 24% expect conditions to be neither better nor worse. Just under a fourth of executives expect conditions to deteriorate in the next six months – somewhat fewer than in the autumn. Executives were also more optimistic about domestic and foreign demand than they were in the autumn, particularly those in transport, transit, and tourism and financial services.

According to seasonally adjusted results from Gallup's winter survey, the employment outlook brightened significantly between surveys. Responses on staffing plans (i.e., firms planning to recruit as compared with those planning redundancies) were broadly in balance in the winter survey, whereas the balance of opinion had been negative by 21 percentage points in the autumn. About 8% of executives considered themselves short-staffed, a slightly higher percentage than in the previous survey but still relatively close to the historical low. In addition, 32% of executives reported that their firms would have difficulty responding to an unexpected increase in demand. This is an increase of 4 percentage points relative to the previous survey.

According to the Statistics Iceland labour force survey (LFS), total hours worked declined by 5.9% year-on-year in Q4/2020, reflecting a 3.6% drop in the number of employed persons and a 2.4% shortening of the average work week. Measurements of the number of employed persons still diverge widely, as data from the pay-as-you-earn (PAYE) register indicate that job numbers fell 7.3% year-on-year in October.

Seasonally adjusted LFS data for Q4/2020 show that the labour participation rate declined between quarters, but the employment rate fell somewhat more. In 2020 as a whole, the participation rate fell by 1.4 percentage points year-on-year, however, and the employment rate fell by 2.9 percentage points over the same period. Unemployment according to the LFS therefore rose by just over 1 percentage point between quarters, to nearly 7%. On the other hand, seasonally adjusted registered employment rose by almost 2 percentage points quarter-on-quarter, to 10.5%. In 2020, unemployment according to the LFS measured 5.5%, but registered unemployment rose to 7.9% – or 10.2%, including recipients of part-time unemployment benefits.

Population growth has slowed markedly since the pandemic struck, although it was positive by 1.2% year-on-year in Q4/2020. Among foreign nationals, net migration was slightly negative in Q4, whereas for Icelandic nationals it was positive for the third quarter in a row.

In Q4/2020, the wage index rose by 1.6% between quarters and by 7.2% year-on-year, and real wages in terms of the index were 3.5% higher during the quarter than at the same time in 2019. The index rose by 6.3% between annual averages in 2020, and real wages grew by 3.4%.

Statistics Iceland's nationwide house price index, published in late January, rose by 1.2% month-on-month when adjusted for seasonality, but rose 8.9% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.8% month-on-month in December, when adjusted for seasonality, and by 7.7% year-on-year. The number of purchase agreements registered nationwide rose by 14.8% year-on-year in 2020, while the number of contracts for new construction increased by 54% over the same period.

Inflation averaged 2.8% in 2020. The CPI declined by 0.06% month-on-month in January, and twelve-month inflation measured 4.3%. This is the first time since December 2013 that inflation has breached the upper deviation threshold of the inflation target. The rise in inflation between December and January was due in part to unfavourable base effects, as the CPI had fallen steeply in January 2020. Winter sales affected prices in January, but were smaller in scope than those held a year ago. In addition, the price of housing, food, and petrol rose in January.

The CPI excluding the housing component had risen by 4.7% year-on-year in January. Underlying inflation in terms of the average of various measures was 4.5%, its highest since June 2012. Some measures of underlying inflation exclude the effects of real mortgage interest expense, which has fallen steeply in the recent term. Because of this, twelve-month inflation was an estimated 0.9 percentage points lower than it would have been otherwise.

Gallup's winter surveys indicate that executives expect inflation to measure 3% in one year, while households project it at 4%. Both figures are unchanged from the autumn surveys. According to the winter survey, corporate executives' expectations concerning average inflation over the next five years had fallen to the target. Market agents' short- and long-term inflation expectations are still at target, according to the Central Bank's market expectations survey. The ten-year breakeven inflation rate in the bond market has averaged 2.6% in Q1/2021 to date, roughly the same as in Q4/2020.

According to the forecast published in *Monetary Bulletin* on 3 February, the outlook is for inflation to measure 3.9% in Q1/2021, slightly more than was forecast in November, and then taper off relatively quickly, to 3.3% in Q2. Inflation is expected to align with the target in Q4/2021. The short-term inflation outlook has therefore deteriorated slightly, owing to a weaker initial position, together with the prospect of stronger domestic demand in H1/2021 than was previously forecast. On the other hand, the exchange rate pass-through from last year's depreciation has receded, and the króna is somewhat stronger now than was previously forecast. The inflation outlook for the latter half of the forecast horizon is broadly similar to the November forecast, however. As was projected in November, a relatively stable króna, low global inflation, and a continued slack in the economy will cause inflation to ease in 2022 and be just below the target until the end of the forecast horizon.

Global economic activity rebounded strongly in Q3/2020, after COVID-19 infection rates began to fall, but then softened again in Q4, when case numbers started to rise once more. Despite a weakening outlook for Q1/2021, a robust recovery is expected among Iceland's main trading partners as the year progresses and widespread vaccination is achieved. For Iceland's main trading partners, growth in 2021 is projected at 4.3%, or 0.3 percentage points less than was assumed in November. On the other hand, trading partner growth is expected to be stronger in 2022, while the outlook for 2023 is broadly in line with the November forecast.

The króna began to appreciate in early November, bolstered by positive news about the development of COVID-19 vaccines, but it has been relatively stable since early December. Before then, there had been downward pressure on the króna, as foreign investors had been closing out bond positions and exporting the proceeds. In addition, the pension funds stepped up their foreign currency purchases in August, although some of them also sold currency late in the year. The baseline forecast assumes that the exchange rate will be somewhat lower, on average, in 2022 than in 2021, then rise slightly in the latter half of the forecast horizon and be above the level projected in November throughout the entire period.

In Iceland, GDP grew more strongly in Q3/2020 than had been forecast in the November *Monetary Bulletin*. Nevertheless, it was still 10.4% lower than in Q3/2019. Indicators imply that GDP continued to grow in Q4 and that it contracted by 7.7% in 2020 as a whole, as opposed to the 8.5% contraction forecast in November. The outlook for 2021 has also improved somewhat, with a poorer outlook for exports offset by more favourable prospects for domestic demand.

GDP growth is forecast to measure 2.5% in 2021 as a whole, then rise to 5.1% in 2022 before easing back to 4.1% in 2023.

Total hours worked are expected to fall by just under 1% this year and then begin to rise in 2022. Unemployment is expected to peak in H1 and average just over 7% in 2021 as a whole, according to the Statistics Iceland labour force survey. Unemployment is forecast to start falling in mid-2021 and continue to ease throughout the forecast horizon.

A sizeable slack in output developed in 2020 but is expected to narrow over the course of this year. Nevertheless, it is expected to measure about 2% of potential output by the year-end. This is a larger slack than was assumed in the November forecast, owing to more rapid population growth versus more favourable developments in GDP growth.

To a large extent, economic developments will depend on how successful efforts to control the pandemic prove to be, both in Iceland and elsewhere. Vaccinations began in late 2020 and, as in the Bank's November forecast, it is assumed that a majority of the population in Iceland and trading partner countries will be vaccinated by mid-year. The forecast also assumes that the current public health measures at the border will remain in effect broadly unchanged until then. All of these assumptions are highly uncertain, however, as the pandemic has been spreading strongly in many areas and new variants have been identified. Furthermore, vaccine distribution has been erratic in some places, and there is some uncertainty about participation levels among the general public. As a result, the economic outlook as presented in the baseline forecast could prove to be overly optimistic. On the other hand, the recovery could be swifter and stronger if efforts to control the pandemic are more successful.

II Decisions on the Bank's monetary policy instruments

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 November meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in November to lower interest rates. At the time of the November meeting, the economic outlook had deteriorated between meetings, owing to a surge in COVID-19 infections and tightened public health measures during the autumn.

Committee members noted that according to the Bank's new macroeconomic forecast, published in the February *Monetary Bulletin*, domestic demand appeared to have been stronger in 2020 than was previously assumed, and the economic contraction therefore smaller than the Bank forecast in November. It emerged that private consumption had rebounded more strongly in recent months and that households had drawn more quickly on their savings than had been assumed at the last meeting. They discussed that according to the forecast, the outlook was for domestic demand to grow more in 2021 than previously projected, whereas the outlook for exports had deteriorated. The Committee stressed that economic developments would nevertheless be affected by the path taken by the pandemic.

The MPC discussed developments in inflation, which rose to 4.3% in January. Members noted that the exchange rate pass-through from the depreciation of the króna still weighed heavily in imported goods prices. It also emerged that at the same time, domestic goods prices had risen as well, to some extent reflecting strong domestic demand. This was compounded by the rise in global oil and commodity prices and unfavourable base effects from January 2020. It emerged in the discussion that pandemic-induced disruptions in production abroad and domestic demand had probably fuelled inflationary pressures as well, which could push prices upwards in coming months. The Committee considered it likeliest, however, that inflation would fall relatively quickly over the course of the year, as was assumed in the Bank's forecast, as there was a sizeable slack in the economy and the króna had appreciated in recent months.

The MPC discussed the status of the foreign exchange market, as the króna had appreciated between meetings. Members agreed that the Bank's intervention policy had contributed to a better balanced market and mitigated volatility. In addition, the Bank's regular sales of foreign currency had deepened the market and improved price formation. It was pointed out that downward pressure on the króna had eased in the wake of large-scale outflows stemming from the sale of foreign-owned Treasury bonds in Q4/2020. Furthermore, the stock of such foreign-owned assets was now limited. Committee members considered it likely that the króna would appreciate once the tourism industry rebounded, all else being equal, because of increased foreign currency inflows.

All members were of the opinion that the Bank's interest rates should be held unchanged. In recent months, low interest rates had both supported domestic demand and stimulated the real estate market significantly. On the other hand, inflation had risen above the upper deviation threshold of the inflation target, and underlying inflation had continued to rise. The Committee agreed that conditions in the domestic economy were actually split in two, where certain sectors and their employees – the tourism industry, for instance – had been hit hard by the pandemic and public health measures, while activity in other sectors had increased markedly. Household saving had increased, and private consumption that had previously centred on travel and spending abroad, for example, had shifted back into the domestic market. It emerged in the discussion that there was the risk that increased domestic demand would lead to more persistent inflation and that the slack in the economy would actually reduce inflation less than it might otherwise, owing to the extraordinary conditions in the economy. It was also pointed out that there was the risk of excessive fiscal easing in the coming term. On the other hand, MPC members agreed that the short-term economic outlook in trading partner countries had deteriorated, and the economic recovery might therefore turn out weaker than currently assumed.

The Committee discussed the Bank's quantitative easing programme. It emerged that the Bank had been relatively neutral in the bond market recently, intervening only when long-term yields had risen steeply, so as to prevent the disruption of monetary policy transmission. Members also discussed the commercial banks' liquidity position and developments in liquidity ratios, given the rapid growth in lending in H2/2020.

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 0.75%, the current account rate 0.5%, the seven-day collateralised lending rate 1.5%, and the overnight lending rate 2.5%. All Committee members voted in favour of the proposal. Members also agreed to maintain an unchanged policy regarding other monetary policy instruments.

It emerged at the meeting that the MPC would apply the tools at its disposal to support the domestic economy and ensure that inflation eases back to the target within an acceptable time frame.

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 24 March 2021.