The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

22-23 March 2021 (101st 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 22 and 23 March 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 24 March.

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 3 February 2021.

Financial markets

Since the February meeting, the króna had appreciated by 4.6% in trade-weighted terms. The Bank's net foreign currency sales totalled 108 million euros (16.6 b.kr.) between meetings. Of that total, purchases under the intervention programme totalled 6 million euros (about 890 m.kr.), sales under the intervention programme totalled 6 million euros (about 938 m.kr.), and regular currency sales amounted to 108 million euros (16.6 b.kr.). The Central Bank's transactions accounted for about 30% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had tightened slightly since the MPC's February meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -2.4%, or 0.1 percentage points higher than just after the announcement of the February interest rate decision. In terms of twelve-month inflation, it was -3.2% and had risen by 0.2 percentage points between meetings.

Interest rates in the interbank market for krónur were broadly unchanged between meetings, and turnover in the market totalled 12.7 b.kr. during the period. Yields on long-term nominal Treasury bonds had risen by 0.3 percentage points, and yields on long-term indexed Treasury bonds had risen by just under 0.1 percentage points since the February meeting. Average mortgage lending rates had held broadly unchanged between meetings.

In terms of three-month interbank rates, the short-term interest rate differential remained unchanged between meetings, at 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 0.1 percentage points, to 3.9 percentage points, while the spread versus the US narrowed to 1.9 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 0.6-0.7 percentage points.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged, noting that even though inflation was above the upper deviation threshold of the target, the outlook was for it to ease in the coming term as the exchange rate pass-through from the depreciation of the króna subsided. Furthermore, inflation expectations were still firmly anchored to the target, giving the Bank the scope to hold interest rates unchanged.

Annual growth in money holdings (M3) gained considerable momentum in 2020 but there are signs that the pace has begun to ease. It is estimated at just under 11% in January. Annual growth in credit system lending to households is estimated at 9.7% in January and has been broadly steady in recent months. On the other hand, corporate lending has been virtually flat since the end of 2019.

The Nasdaq OMXI10 index had risen by 3.2% between meetings. Turnover in the Main Market totalled 173 b.kr. in the first two months of 2021, some 23% more than over the same period in 2020.

Global economy and external trade

According to the Organisation for Economic Cooperation and Development's (OECD) March forecast, the global economy is set to grow by 5.6% this year, 1.4 percentage points above its December forecast. Furthermore, the OECD projects global GDP growth in 2022 at 4%, or 0.3 percentage points above the December forecast. The change between forecasts reflects increased buoyancy due to stronger-than-expected economic activity in H2/2020, clearer indications of the efficacy of COVID-19 vaccines, and increased stimulus measures from many governments, especially the US. The OECD estimates that the proposed measures there could raise global output by around 1 percentage point in the first full year after they are executed, and it has revised its GDP growth forecast for the US upwards by a full 3.3 percentage points this year, to 6.5%. The economic recovery in India is also forecast to be stronger than previously projected. On the other hand, the OECD expects the largest European countries to see a slower turnaround than many other advanced economies in 2021, owing to stringent public health measures in the early months of the year and weaker government stimulus. Uncertainty about global economic developments remains significant, however, and depends on how persistent the COVID-19 pandemic proves to be. Global GDP growth could turn out as much as 1-1½ percentage points stronger in 2021 and 2022, according to the OECD, if vaccination roll-outs prove more successful and households tap their accumulated savings more quickly. On the other hand, growth could be 1-1¼ percentage points weaker if it takes longer to vaccinate the population or if the currently available vaccines prove less effective against new variants of the virus.

Preliminary figures suggest a deficit of 17 b.kr. on goods trade in the first two months of 2021, as compared with a deficit of 20 b.kr. at constant exchange rates over the same period in 2020. Excluding ships and aircraft, exported goods values contracted by nearly 3% year-on-year, as marine product export values fell by roughly 8%, whereas industrial export values increased by 3%, partly because of the rise in global aluminium prices in recent months. In the first two months of 2021, imported goods values (excluding ships and aircraft) were about 4% lower, at constant exchange rates, than in the same period in 2020, owing primarily to a more than 40% contraction in fuel imports and a contraction of a third in transport equipment imports. On the other hand, the value of imported investment goods (excluding transport equipment) increased 20% between years and has risen year-on-year for the past four months.

Global aluminium prices had risen by 11% since the MPC's February meeting and were 43% higher than in March 2020. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products had continued to fall and were down 10% year-on-year in January. The global price of Brent crude rose further between MPC meetings, to nearly 70 US dollars per barrel by mid-March. This reflects both expectations of increased demand and continued production cuts by OPEC countries and other oil producers. In the days just prior to the March meeting, however, oil prices began to give way again, at least partly because of rising inventories in the US, the appreciation of the US dollar, and fears that demand for oil would rebound more slowly than previously anticipated because of the resurgence of the pandemic and the slow progress of vaccinations in the euro area. Brent crude was selling at just under 61 US dollars per barrel at the time of the March meeting. This is about 6% higher than just before the February meeting but about 8% lower than at the beginning of 2020, before the pandemic struck.

The real exchange rate in terms of relative consumer prices rose by 0.8% month-on-month in February, when it was 1.4% above its 25-year average but 8% lower than at the beginning of 2020. In the first two months of 2021, it was down by 6.6% compared with the same period in 2020, as the nominal exchange rate of the króna was 9.3% lower and inflation in Iceland was about 3 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland in early March, GDP contracted by 5.1% year-on-year in Q4/2020, somewhat less than was forecast in the February *Monetary Bulletin.* Seasonally adjusted GDP grew by 4.8% between quarters in Q4, the second quarter-on-quarter increase in a row. Because of the steep contraction in H1, however, there was still a contraction between years despite positive growth in the last two quarters. Domestic demand declined by 2% year-on-year but, apart from public sector demand, was stronger than had been forecast. The contribution of net trade to GDP growth was negative by 3.2 percentage points during the quarter, and the lion's share of the contraction in both imports and exports was due to services.

For the year as a whole, GDP contracted by 6.6%, owing largely to the negative contribution from net trade, together with a nearly 2% decline in domestic demand. Figures from Statistics Iceland show that most subcomponents of domestic demand contracted less than had been assumed in the Bank's forecast, whereas on the other hand, public sector demand was weaker than projected. Private consumption contracted by 3.3%, the largest single-year contraction since 2009, albeit somewhat less than had been forecast. The main difference is that the contraction in investment was almost 5 percentage points less than forecast, or 6.8%. This difference in investment is due in large part to a revision of figures for the first three quarters of 2020. Exports contracted by 30.5% in 2020 as a whole, while the contraction in imports was smaller, at 22%; as a result, the contribution of net trade to output growth was negative by 4.9 percentage points for the year, slightly more negative than had been forecast.

In line with the Bank's forecast, the current account balance was positive in 2020, despite the largest contraction in exports since 1917. The current account surplus measured 1% of GDP, as compared with a surplus of 6.4% of GDP in 2019. The trade deficit for 2020, which measured 0.6% of GDP, stemmed mainly from the contraction in exports, although terms of trade also deteriorated between years. Services exports contracted by 51%, owing mainly to the substantial drop in tourist visits. The contraction in services imports, at 39%, was mainly attributable to the steep decline in Icelanders' overseas travel. The composition of the current account balance changed markedly in 2020 relative to previous years, as the weight of the balance on primary and secondary income increased.

Domestic payment card turnover figures suggest that household demand increased year-on-year in the first two months of 2021. Indicators show signs that household demand is recovering in the consumption categories hit hardest by public health measures, after contracting steeply in 2020. At the same time, growth in household spending on consumer durables was still robust, even though it lost pace slightly.

According to the Gallup Consumer Confidence Index in February, consumer sentiment has improved significantly since Q4/2020, probably because of progress made in COVID-19 vaccinations and reduced infection rates. Among subcomponents of the index, consumers' assessment of the current situation improved the most between months.

According to the results of Gallup's spring survey, conducted in March among Iceland's 400 largest firms, respondents' attitudes towards the current economic situation were more positive than in the winter survey. Their expectations six months ahead are also more positive than in the winter. About 62% of executives expect the economic situation to improve in the next six months, and about 14% expect them to deteriorate, somewhat fewer than in the winter. Executives are also more optimistic about domestic and foreign demand than in the winter survey, particularly those in retail and wholesale trade, manufacturing, and miscellaneous specialised services.

According to the survey, most companies' profit margins have declined since the previous survey. On the whole, however, it appears that executives expect their margins to increase slightly in the next six months, and they expect their profits for 2021 to be about the same as in 2020. Furthermore, the survey suggests that investment will contract between years, albeit somewhat less than it did in 2020.

The seasonally adjusted results of the same survey show that the share of firms planning to add staff exceeds the share planning to downsize by about 4 percentage points. This difference has widened slightly between surveys, after a strong turnaround in last year's winter survey, and is close to its historical average. About 12% of executives considered themselves short-staffed, a slightly higher percentage than in the previous survey. This percentage has risen in the past three surveys but remains well below its historical average. The share of firms operating at close to capacity tells a similar tale, with about 32% of executives reporting that they would have trouble responding to an unexpected increase in demand.

The wage index rose by 0.3% month-on-month in February and by about 10.6% year-on-year, owing both to the effects of contractual wage hikes in January 2021 and April 2020, as well as base effects due to delays in finalising public sector wage agreements during the current round of negotiations. Real wages were 6.2% higher during the month than at the same time in 2020.

According to preliminary figures from Statistics Iceland, the wage share (wages and related expenses relative to gross factor income) was 61% in 2020, or 0.5 percentage points higher than in 2019 and 1.4 percentage points above the twenty-year average. Historical figures for wages and related expenses were also revised slightly, with the largest revisions in 2019 figures. On the whole, however, the trend of the past two years was in line with the forecast in the February *Monetary Bulletin*.

Statistics Iceland's nationwide house price index, published in late February, rose by 0.4% month-on-month when adjusted for seasonality, and by 8.4% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.5% month-on-month in February, when adjusted for seasonality, and by 7.3% year-on-year. The number of purchase agreements registered nationwide rose by 30.8% year-on-year in the first two months of 2021, while the number of contracts for new construction increased by 69.4% over the same period.

The consumer price index (CPI) rose by 0.69% month-on-month in February, lowering twelve-month inflation to 4.1%. The CPI excluding the housing component had risen by 4.5% year-on-year in February. Underlying inflation was 4.4%, according to the average of various measures. 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.

The end of seasonal sales was the main driver of the rise in the CPI during the month, as is typical in February. The rise in the housing component also had some impact, particularly the rise in home maintenance costs. Domestic petrol prices rose for the third month in a row, in the wake of recent global oil price hikes.

Gallup's spring surveys indicate that executives expect inflation to measure 3% in one year, while households project it at 4%. Both figures are unchanged from the winter surveys. On the other hand, households' two-year inflation expectations rose by 1 percentage point between surveys, to 4%. Corporate executives' five-year expectations rose as well, by 0.3 percentage points, to 2.8%. Moreover, the five- and ten-year breakeven inflation rates in the bond market have inched upwards since the February meeting. The five-year breakeven rate was about 3% just before the March meeting, and the ten-year rate was 2.8%.

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 risen marginally since the February meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in February to hold interest rates unchanged. At that meeting, the outlook was for domestic demand to grow more than previously projected, whereas a weaker outlook for exports pulled in the opposite direction. Inflation had risen above the upper deviation threshold of the inflation target, but the Committee was of the opinion that it would fall relatively quickly as the year progressed.

Committee members discussed the newly published national accounts data, which showed that GDP had contracted by 6.6% in 2020, whereas the Bank's February forecast had assumed a contraction of 7.7%. It emerged that economic activity in Q4 had turned out stronger than projected, and the contraction in the first three quarters of the year had been somewhat smaller than previous figures from Statistics Iceland had indicated. The MPC also noted that recent surveys and high-frequency indicators suggested a continuing recovery in 2021 to date. It emerged in the discussion that pandemic response measures taken by the Central Bank and the Government had supported domestic demand and that the outcome was more favourable than had been expected. Considerable slack remained in the economy, however. The Committee stressed that uncertainty was nevertheless pronounced, and that economic developments in Iceland and abroad would depend to a considerable degree on the path the pandemic takes and the progress made in vaccinating the public.

The MPC discussed developments in inflation, which had eased to 4.1% in February. Members noted that the effects of last year's depreciation of the króna still weighed heavily but had probably begun to subside, as the króna had appreciated somewhat in the recent term. In their view, the outlook was for inflation to start tapering off this spring, although the near-term outlook had probably deteriorated since February. Global oil and commodity prices had risen recently, and there had been cost increases that could be attributed to pandemic-related disruptions in production. Committee members were concerned about inflation expectations having risen slightly, although it was too soon to determine whether they had become less firmly anchored to the Bank's inflation target.

The MPC discussed the status of the foreign exchange market, as the króna had appreciated between meetings. It emerged in the discussion that the intervention policy and the regular currency sales programme had been successful and had fostered greater stability in the foreign exchange market. It was pointed out that, in view of developments in inflation, the monetary stance had been tightened in this way, as the aforementioned measures had reduced the money supply. It was also noted that if the exchange rate of the króna should trend upwards, it would be possible to stop or reduce regular currency sales, as the programme was a temporary measure.

All members were of the opinion that the Bank's interest rates should be held unchanged. It was clear that inflation was still above the upper deviation threshold of the target and that domestic demand appeared stronger than had been expected. Activity had increased in the economic sectors that had performed well despite the pandemic. It was pointed out that there was the risk that inflation would prove more persistent, given the steep increase in global oil and commodity prices and the rise in inflation expectations. On the other hand, it appeared highly likely that the króna would appreciate and the slack in the economy would lead to a decline in inflation later in the year, as the Bank's previous forecasts had indicated. Furthermore, the Committee agreed that the outlook was cloudy as regarded developments in the pandemic abroad, as public health measures were being tightened once again in many places and there was the risk that the same situation would arise in Iceland. It emerged in the discussion that if the pandemic and the vaccination process dragged on, there would be greater risk of a permanent loss of resources and capacity.

The Committee discussed the Bank's purchases of Treasury bonds in the secondary market. Since inflation was still above target it was inadvisable for the Bank to participate actively in the bond market. Furthermore, the fiscal deficit in 2020 had been smaller than had been expected at the beginning of the pandemic, reducing the need for the Bank's bond purchases. On the other hand, the outlook was for a larger Treasury deficit in 2021, and it would therefore be important to keep close track of developments in the bond market. If inflation fell back to the target, it could create the scope for stronger bond market activity by the Central Bank if necessary. MPC members also discussed the past few months' rise in nominal Treasury bond yields, particularly at the long end of the yield curve, which was unsurprising in view of increased optimism about the long-term outlook. Price formation in the market was therefore normal.

The committee discussed the status of the commercial banks and their recent earnings reports, which showed that they were relatively well positioned. It was pointed out that demand for corporate loans was limited at present but that lending to households had continued to increase. The Committee was of the view that the banks would be well positioned to support corporate investment once the economic recovery began in earnest.

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 19 May 2021.