The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

23-24 August 2021 (103rd 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 23 and 24 August 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 25 August.

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 had emerged since the Committee's last meeting, on 19 May 2021, as published in the updated forecast in *Monetary Bulletin* 2021/3 on 25 August.

Financial markets

Since the May meeting, the króna had depreciated by 0.4% in trade-weighted terms. The Bank's net foreign currency purchases totalled 138 million euros (20.2 b.kr.) between meetings. Of that total, purchases under the intervention programme totalled 65 million euros (about 9.5 b.kr.), and sales under the intervention programme totalled 18 million euros (about 2.7 b.kr.) The Central Bank's transactions accounted for about 26.3% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had tightened since the May 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 0.1 percentage points higher than just after the announcement of the May 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 rose in line with the increase in the key rate in May, but there had been no turnover in the market since the MPC's last meeting. Yields on long-term nominal Treasury bonds had fallen by 0.4 percentage points since the May meeting, and yields on long-term indexed Treasury bonds had declined by 0.1 percentage points. Furthermore, average non-indexed mortgage lending rates had risen by 0.2 percentage points following the May rate hike.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 0.3 percentage points, to 2.2 percentage points versus the euro area and 1.5 percentage points versus the US. The long-term interest rate spread was virtually unchanged between meetings, at 4.1 percentage points versus Germany and 2.4 percentage points versus the US. Measures of the risk premium on the Treasury's foreign obligations had risen marginally 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 the Bank's interest rates unchanged, noting that even though inflation had proven higher and more persistent in the recent term than previously expected, inflation expectations still appeared firmly anchored; furthermore, the effects of the May rate hike and the reduction in maximum loan-to-value ratios on new mortgages, introduced in June, had not yet come fully to the fore. Moreover, the outlook suggested that the setback in the battle with the COVID-19 pandemic might slow down the economic recovery, and unemployment remained high.

According to the Central Bank's quarterly market expectations survey, conducted in August, respondents expected the Bank's key rate to be raised to 1.25% in Q3/2021. They also expected another rate hike in Q4, bringing the key rate to 1.5% by the year-end. This is a higher rate than survey participants expected in the survey from May, when they projected that the Bank's key rate would be 1% in Q3 and 1.25% at the end of 2021. In the survey, about 67% of respondents considered the monetary stance appropriate at present, up from 54% in the previous survey. The share who considered the monetary stance too loose had fallen, however, from 46% in May to 33%. As in the previous survey, no respondents considered the stance too tight.

Annual growth in M3 has gained pace since the spring and is estimated to have measured 8.2% in June. At the same time, annual growth in credit system lending to households is estimated at just over 11%, slightly more than in recent months. Corporate lending contracted by about 2%, however.

The Nasdaq OMXI10 index had risen by 12.9% between meetings. Turnover in the Main Market totalled 568 b.kr. in the first seven months of 2021, some 67% more than over the same period in 2020.

Global economy and external trade

According to the International Monetary Fund's (IMF) July forecast, global GDP growth is projected to measure 6% in 2021. Although this is the same as the Fund's forecast from April, the composition of GDP growth has changed. The outlook for this year has improved for advanced economies but deteriorated for emerging and developing economies, particularly in Asia, reflecting regional differences in vaccine rollouts and in the path of the pandemic itself.

For advanced economies, increased fiscal stimulus plays a major role in the brighter outlook, particularly in the US, where additional measures are planned. The IMF forecasts year-2022 global GDP growth at 4.9%, some 0.5 percentage points above its April forecast, with most of the growth due to the aforementioned fiscal stimulus package in the US. Global economic uncertainty remains pronounced, however, according to the Fund, and the GDP growth risk profile is tilted to the downside.

Iceland's external goods trade generated a deficit of 16.9 b.kr. in July and 126 b.kr. for the first seven months of the year, as opposed to a deficit of 88 b.kr. at constant exchange rates over the same period in 2020. The value of exported goods excluding ships and aircraft rose by just over 19% year-on-year during the first seven months of 2021. The rise is due largely to increased aluminium export values, as global aluminium prices have risen virtually unimpeded since April 2020. Furthermore, increased marine product export values had a strong impact, mainly because of a favourable capelin season in Q2. The value of imported goods excluding ships and aircraft was up 20% year-on-year at constant exchange rates in the first seven months of 2021, but this reflects a number of contributing factors, with all key subcategories increasing markedly in value relative to the same time in 2020.

Global aluminium prices had risen 7½% since the May meeting, by a third year-to-date, and by nearly 50% since the onset of the pandemic. Preliminary figures from Statistics Iceland indicate that the year-on-year decline in foreign currency prices of marine products lost pace in June, with prices down just over 4%. Global Brent crude prices had risen by 3½% between MPC meetings, to around 71 US dollars per barrel by the time of the August meeting. This is almost 8% higher than before the pandemic. Other commodity prices have also risen since May.

The real exchange rate in terms of relative consumer prices fell by 0.4% month-on-month in July, when it was 6.1% above its 25-year average and 10% above its October 2020 trough. It rose by 2% year-on-year in the first seven months of 2021, as inflation in Iceland was 2 percentage points above the trading partner average. The nominal exchange rate was virtually unchanged.

Domestic economy and inflation

Private consumption grew by 2.5% quarter-on-quarter in Q1/2021, about half the growth rate forecast in the May *Monetary Bulletin*. Year-on-year growth measured only 0.8%, well below the May forecast of 5%. Payment card turnover and other high-frequency indicators had suggested much stronger growth during the quarter, and card turnover, both within Iceland and overall, had continued to increase in Q2, as had new motor vehicle registrations (excluding car rental agencies). It therefore appears that private consumption grew somewhat between Q1 and Q2, and will measure about 10% higher in Q2 than in the same quarter of 2020.

The Gallup Consumer Confidence Index measured 123.4 points in July, a decline of 8.4 points between months but an increase of 71.2 points between years. All sub-indices rose markedly year-on-year but fell month-on-month, apart from the assessment of the current situation, which improved by 18.5 points.

According to the results of Gallup's summer survey, conducted in June among Iceland's 400 largest firms, respondents' assessment of the current economic situation was much more positive than in spring survey. Their expectations six months ahead were also more positive than in the spring. About 84% of executives expected the economic situation to improve in the next six months, and about 4% expected it to deteriorate, somewhat fewer than in the spring.

Executives were also more optimistic about domestic and foreign demand than in the spring survey, particularly those in the financial and insurance sector, the fishing industry, and transport, transit, and tourism.

The seasonally adjusted survey results show that 39% of firms were planning to recruit staff, while only 8% were planning redundancies. The balance of opinion is therefore positive by 31 percentage points, about the same as during the strong upswing in 2016. About 22% of executives considered themselves short-staffed, which is 10 percentage points higher than in the previous survey and at the historical average. In addition, a third of executives – roughly the same as in the previous survey – were of the view that their firms would have difficulty responding to an unexpected increase in demand.

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 2.7% year-on-year in Q2/2021, owing to a 3.9% rise in the number of jobs, as average hours worked declined by 1.2%. The number of workers on the pay-as-you-earn (PAYE) register has also begun to rise, after declining more during the pandemic than the number of employed people according to the LFS.

According to seasonally adjusted LFS data, the labour participation and employment rates increased by nearly 1 percentage point between quarters in Q2. This brought labour participation more or less back to the pre-pandemic rate, whereas the employment rate was still down by about 2½ percentage points. Unemployment measured 6.6% in Q2 and was therefore 1.8 percentage points below its Q4/2020 peak. Registered unemployment has declined by nearly half in the past six months. It measured 6.1% in July, only 1 percentage point higher than before the pandemic.

Iceland's population grew by 1.3% year-on-year in Q2, slightly more than in the quarters beforehand. This increased population growth is due mostly to a turnaround in immigration.

In Q2/2021, the wage index rose by 1.2% between quarters and by 7.5% year-on-year, and real wages in terms of the index were 3% higher during the quarter than at the same time in 2020.

Statistics Iceland's nationwide house price index, published in late July, rose by 0.9% month-on-month when adjusted for seasonality, and by 13.2% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.7% month-on-month in July when adjusted for seasonality, and by 15.4% year-on-year. The number of purchase agreements registered nationwide rose by 39% year-on-year in the first seven months of 2021, while the number of contracts for new construction increased by 56% over the same period.

The CPI rose by 0.16% month-on-month in July, and twelve-month inflation remained unchanged at 4.3%. Inflation excluding housing tapered off between months, to 3.4%. Underlying inflation also declined between June and July, to 3.8% according to the average of various measures.

Rising prices for items relating to travel and tourism had the most impact on the CPI in July, with airfares, petrol, and other items rising somewhat between months. House prices also continued to rise. As in 2020, the effects of summer sales were weaker than they had generally been before the onset of the pandemic. This is probably due in part to strong domestic demand.

According to the Central Bank's market expectations survey, respondents' inflation expectations one and two years ahead are unchanged from the May survey. Survey participants expect inflation to measure 3% in one year's time and align with the target after two years.

Gallup's summer survey indicates that households and businesses expect inflation to measure 3.5-4% a year from now and then fall to 3% in two years' time.

Market agents' and corporate executives' inflation expectations five years ahead rose slightly in the last survey. Corporate expectations are now 3%. On the other hand, market agents' ten-year expectations are still at target. The breakeven inflation rate in the bond market has begun to fall again after rising over the course of the year, and the five-year breakeven rate five years ahead has returned to target.

According to the forecast published in *Monetary Bulletin* on 25 August 2021, inflation appears likely to measure just over 4% in H2, slightly higher than was projected in May. The outlook is for inflation to continue falling in H1/2022, albeit somewhat more slowly than was forecast in May. This reflects several factors, including larger rises in global commodity prices and more persistent cost pressures stemming from COVID-related supply chain disruptions. In addition, the slack in the domestic economy has narrowed faster than previously forecast. Inflation is projected to align with the target in Q3/2022, slightly later than was forecast in May. On the other hand, the baseline forecast assumes that the króna will be stronger in the coming term than was assumed in May. The inflation outlook for the latter half of the forecast horizon is somewhat poorer than was envisioned in May, but inflation is expected to hold close to target, on average, over the period.

The exchange rate index was just under 194 points in Q2, which is in line with the Bank's May forecast. According to the baseline forecast, the outlook is for the króna to be about 1½% stronger in Q3 and hold steady at roughly that level for the remainder of the forecast horizon.

GDP among Iceland's main trading partners contracted by 0.1% quarter-on-quarter in Q1, somewhat less than was assumed in the Bank's May forecast. Economic activity picked up again in major advanced economies in Q2, when new COVID case numbers started to fall, vaccination rollouts gained momentum, and public health measures were eased. Trading partner GDP is estimated to have grown by 2.2% quarter-on-quarter in Q2. COVID-19 case numbers started to rise again worldwide over the summer, but even so, the outlook is for a continued economic recovery in major advanced economies. This is due in particular to more widespread vaccination; furthermore, businesses have grown more adept at keeping economic activity up and running despite public health restrictions. According to the Bank's baseline forecast, year-2021 GDP growth among Iceland's main trading partners is projected at 5.3%, some 0.5 percentage points above the May forecast. The trading partner growth rate is expected to rise in 2022 as well.

Preliminary figures from Statistics Iceland indicate that Iceland's GDP declined by 5.2% quarter-on-quarter in Q1/2021, twice the contraction provided for in the Bank's May forecast. This was due largely to weaker-than-expected domestic demand, whereas external trade developed in line with the Bank's forecast. As a result, GDP was still 1.7% lower than in Q1/2020, whereas the May forecast assumed it would rise by 2% year-on-year. Indicators imply that GDP grew by 11% year-on-year in Q2, mainly because of base effects from the sharp contraction in Q2/2020. GDP growth is projected at 4% for the year as a whole, some 0.9 percentage points above the May forecast, owing in large part to the more rapid opening of the country to tourists. As a result, the contribution of net trade to output growth will be over 1.4 percentage points more than previously forecast, although slightly weaker growth in domestic demand will pull in the opposite direction. Output growth is expected to be similar in 2022 and then taper off to just over 2% in 2023, as in the May forecast.

Unemployment is projected to decline more than previously forecast, both this year and over the forecast horizon as a whole. The unemployment rate based on Statistics Iceland's labour force survey is forecast to measure 6.5% in 2021 and fall to 5% by the final year of the forecast horizon. If this forecast materialises, registered unemployment will average just over 8% this year and 4.3% in 2023. It is assumed that the slack in output that opened up in 2020 will narrow rapidly, measuring 1% this year. As in the Bank's May forecast, an output gap is expected to open up in late 2022.

As before, both domestic and global economic developments will depend in large part on how successful efforts to control the pandemic prove to be. Although a large percentage of Iceland's population has been fully vaccinated, the current vaccines' effectiveness against the Delta variant and its potential successors remains uncertain. The Bank's baseline forecast assumes that the current set of public health measures will remain in place for a while but will have relatively little impact on domestic economic activity. This assessment could change, however, if there is a setback in the response to the pandemic and restrictions must be tightened once again, or if individuals refrain increasingly from their usual activities due to fear of contagion.

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 May meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in May to raise interest rates. At that time, the economic outlook was better than had been assumed in the Bank's February forecast, and inflation had turned out higher and more persistent than previously projected.

In their discussion, Committee members noted that the economic outlook had improved still further relative to the Bank's previous forecast, and according to the new macroeconomic forecast, published in the August *Monetary Bulletin*, the outlook was for GDP growth to measure 4% this year, some 0.9 percentage points above the May forecast. It came to light that the improvement was driven mainly by tourist arrivals, which had increased more rapidly this summer than was previously expected. The MPC also noted that unemployment had subsided more than previously forecast, although it remained high, and the slack in the economy had narrowed more quickly. Moreover, it emerged in the discussion that the pandemic and related public health measures appeared to have less and less effect on economic activity.

The MPC discussed the fact that a large share of Iceland's population had been vaccinated against COVID-19 but that case numbers had risen once again, and there was still some uncertainty about the path the pandemic would take, owing to the increased spread of the Delta variant of the virus. The Committee also noted that the impact of temporary supply-chain disruptions abroad could therefore persist longer than previously anticipated, and that these disruptions had pushed manufacturing and distribution costs upwards all over the world. This could be attributed both to stronger global demand for consumer goods and to disruptions in output at factories and harbours around the world due to elevated infection rates. It emerged in the discussion that the effects of these supply-chain disruptions in 2021 to date had to some extent been underestimated.

The Committee discussed developments in inflation, which measured 4.4% in Q2 but was 4.3% in July. It emerged that overall inflationary pressures appeared to be subsiding, particularly according to underlying inflation, but nevertheless remained relatively high. Members also noted that the rise in inflation expectations earlier this year seemed to be reversing. They noted as well, however, that according to the Central Bank's forecast, the outlook was for inflation to ease somewhat more slowly than had been projected in May. It also emerged that inflation was expected to remain above 4% through the year-end but align with the target in H2/2022.

The MPC discussed the situation in the housing market, in view of rising house prices and the role the Bank's interest rate cuts had played in that trend. Members noted that there were signs that house prices had begun to diverge from fundamentals that generally determine house price developments, and that the spread between house price inflation, on the one hand, and wage and income growth, on the other, had widened in the recent term. Household debt had increased at the same time, although this could be due in part to a rise in the number of first-time homebuyers. The Committee also heard a presentation on the Financial Stability Committee's recent decision to lower maximum loan-to-value ratios on consumer mortgages and to consider applying other borrower-based measures to offset debt-driven house price inflation. The Committee discussed the interaction between those decisions and monetary policy – among other things, whether applying these policy instruments could mitigate house price volatility in the long run, thereby supporting monetary policy.

Members discussed the foreign exchange market and the fact that the króna had been relatively stable and the market well balanced in the recent term. They also discussed the Bank's intervention in the foreign exchange market, which had been sparse between meetings and concentrated primarily on transactions due to inflows in connection with Íslandsbanki's initial public offering.

In addition, the MPC discussed the Bank's purchases of Treasury bonds in the secondary market. The Committee was of the view that the bond purchases had been successful and had prevented a rise in long-term yields when the pandemic struck and fiscal uncertainty was high. Nevertheless, the need for the measure had proven less pronounced than had been anticipated at the onset of the pandemic. Members agreed that the Bank should suspend the purchases and stop submitting bids for the present, but should keep the tool at their disposal so that they could use it if conditions called for it; e.g., in response to bond market unrest or a significant shift in the yield curve, to sterilise foreign exchange market intervention, or to affect money holdings.

The Committee discussed whether to hold the Bank's key interest rate unchanged or to raise it by 0.25-0.5 percentage points. The main arguments in favour of keeping the key rate unchanged centred on the persistent uncertainty about the effects of the current wave of the pandemic on economic activity, and the scope and consequences of public health measures. It emerged as well that the current inflation rate could be attributed in part to temporary factors that would subside in the coming term, and that inflation expectations had begun falling by several measures. It was also pointed out that there was only a short time until the MPC's next meeting, and that further data on developments and prospects would be available then.

The main arguments presented at the meeting in favour of a rate hike centred on inflation, which had proven more persistent than previously assumed, and the prospect that it would take longer to bring inflation back to target. It emerged in the discussion that there was the risk that elevated global inflation, the inflationary impact of supply-chain disruptions, and domestic wage rises would cause inflation to remain high, potentially leading to a further rise in inflation expectations. Members also noted that domestic demand had picked up strongly, as could be seen in factors such as increased payment card turnover, stronger growth in lending to households, and brisk activity and rising prices in the housing market. Furthermore, the recovery of the labour market had been stronger and the slack in output smaller than had been estimated at the time of the MPC's last meeting. It was preferable to respond in a timely manner by raising interest rates now, thereby reducing the likelihood that rapid monetary tightening would be needed later on. The arguments in favour of taking a larger step and raising rates by 0.5 percentage points included the fact that uncertainty had receded since the May meeting, as a large share of the population was now vaccinated and it was clear that the vaccines were effective in preventing severe illness in COVID-19 patients. Furthermore, it was clear that the link between public health measures and economic activity had weakened and that households' and businesses' adaptability, together with Government measures, kept the economy moving, for the most part, despite the pandemic. Moreover, tourist numbers and tourist spending had increased more rapidly this summer than previously expected, and the GDP growth outlook had improved markedly.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.25 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 1.25%, the current account rate 1%, the seven-day collateralised lending rate 2%, and the overnight lending rate 3%. All members voted in favour of the Governor's proposal, although Gunnar Jakobsson and Gylfi Zoëga would have preferred to raise rates by 0.5 percentage points.

It emerged at the meeting that the MPC would apply the tools at its disposal to 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

Thórarinn G. Pétursson, Chief Economist of the Central Bank, was present 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 6 October 2021.