The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

4-5 October 2021 (104th meeting)

Published: 20 October 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 4 and 5 October 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 6 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 25 August 2021.

Financial markets

Since the August meeting, the króna had appreciated by 0.6% in trade-weighted terms. The Bank's net foreign currency sales totalled 21 million euros (3.2 b.kr.) between meetings. Of that total, purchases under the intervention programme totalled 9 million euros (about 1.3 b.kr.), and sales under the intervention programme totalled 30 million euros (about 4.6 b.kr.) The Central Bank's transactions accounted for about 9.6% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had tightened since the August meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was -2.2%, or 0.3 percentage points higher than just before the announcement of the August interest rate decision. In terms of twelve-month inflation, it was -3% and had risen by 0.1 percentage points over the same period.

Interest rates in the interbank market for krónur rose in line with the increase in the key rate in August, but there was no turnover in the market between meetings. Yields on long-term nominal Treasury bonds had risen by 0.4 percentage points since the August meeting, whereas yields on long-term indexed Treasury bonds were more or less unchanged. Furthermore, average non-indexed mortgage lending rates had risen marginally following the August rate hike.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 0.3 percentage points between meetings, to 2.4 percentage points versus the euro area and 1.8 percentage points versus the US. The long-term interest rate spread had widened slightly, to 4.2 percentage points versus Germany and 2.5 percentage points versus the US. Measures of risk premia on the Treasury's foreign obligations were virtually 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 expected the MPC to raise the Bank's interest rates by 0.25 percentage points, citing the fact that inflation had been higher in the recent term and more persistent than previously expected and that it would take longer to bring inflation back to target. Indicators implied that domestic demand had rebounded decisively, and the recovery of the labour market had been stronger than previously expected. Furthermore, real estate prices had continued to rise rapidly, although the impact of recent Central Bank measures had yet to come to the fore.

Growth in broad money (M3) has been relatively stable in recent months, with the twelve-month growth rate estimated at 8.2% in August. At the same time, annual growth in credit system lending to households is estimated at just over 11%, roughly the same as in recent months. Corporate lending continued to decline, however, contracting by just over 3% in August.

The Nasdaq OMXI10 index had fallen by 3.3% between meetings. Turnover in the Main Market totalled 759 b.kr. in the first nine months of 2021, some 86% more than over the same period in 2020.

Global economy and external trade

According to the Organisation for Economic Cooperation and Development's (OECD) September forecast, the global economy is set to grow by 5.7% this year, about 0.1 percentage points less than the OECD had forecast in May. The near-term outlook has deteriorated in several countries because of the impact of the Delta variant of the COVID-19 virus and temporary supply-chain disruptions. In particular, GDP growth is expected to be weaker in the US, although the outlook has also deteriorated for Canada, the UK, and Japan. In the eurozone, however, GDP growth is expected to gain pace. For 2022, the OECD projects global output growth at 4.5%, up from 4.4% in its May forecast. Inflation has risen rapidly in the US, Canada, and the UK, as well as in several emerging market economies, whereas it has remained low in many other advanced economies. In the OECD's view, the past year's elevated inflation in the G20 countries is due mainly to rising commodity prices and international shipping costs. In those countries, inflation is forecast to peak at roughly 4½% towards the end of this year but fall to

3½% by late 2022. According to the OECD's baseline forecast, G20 inflation will average 3.7% this year and 3.9% in 2022, about 0.2-0.5 percentage points above the May forecast.

Global aluminium prices had risen 10½% since the August meeting, by nearly 50% year-to-date, and by over 60% since the onset of the pandemic. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products rose by 4.7% year-on-year in August, although in the first eight months of 2021, prices were down by an average of 2.5% year-on-year. The global price of Brent crude rose by 16% between MPC meetings, to nearly 83 US dollars per barrel by the beginning of October. This is almost one-fourth higher than before the pandemic. The price of other commodities has fallen slightly since August, however.

Iceland's external goods trade generated a deficit of 30.6 b.kr. in August and 121 b.kr. for the first eight months of the year, as opposed to a deficit of 92 b.kr. at constant exchange rates over the same period in 2020. The value of exported goods excluding ships and aircraft rose by just under 21% year-on-year in the first eight months of 2021. As before, the increase is due largely to higher aluminium and marine product prices, although marine product exports have declined in volume. The value of imported goods excluding ships and aircraft was up 25% year-on-year at constant exchange rates in the first eight months of 2021, with all key subcategories continuing to increase in value relative to the same period in 2020.

The real exchange rate in terms of relative consumer prices fell by 1.4% month-on-month in September, when it was 3.5% above its 25-year average and 7.5% above its October 2020 trough. It rose by 3.2% year-on-year in the first nine months of 2021, as inflation in Iceland was 1.9 percentage points above the trading partner average and the nominal exchange rate rose by 1.6%.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland in August, GDP grew by 7.3% year-on-year in Q2/2021, slightly less than was forecast in the August *Monetary Bulletin*. In seasonally adjusted terms, GDP grew by 4.2% between quarters, after contracting in Q1. Domestic demand grew by 9.4% year-on-year, and most components – excluding private consumption and public investment – showed stronger growth than was assumed in the August forecast. The main difference, however, was in investment, which grew nearly 26%, exceeding the forecast by more than 9 percentage points. The deviation from the forecast stems mainly from changes made by Statistics Iceland to its methodology for the treatment of aircraft leasing contracts. Because of this change, business investment increased far more than had been assumed. Another result of the change in methodology was that the contribution of net trade to the change in GDP was negative by 2.3 percentage points, whereas the forecast had assumed a positive contribution of 2.9 percentage points. Apart from changes in methodology and their effect on imports, export growth turned out weaker, mainly because of Statistics Iceland's revision of historical data.

GDP growth measured 3.5% in H1/2021. According to figures from Statistics Iceland, growth in domestic demand was stronger than had been assumed in the Bank's August forecast. Exports were up 1.6% year-on-year and imports by 8.2%, and the contribution from net trade was negative by 2.4 percentage points, which was somewhat more negative than in the forecast.

The current account showed a deficit of 31 b.kr. in Q2, or 3.9% of GDP, as opposed to the 1% surplus forecast in August. The deficit was due in large part to a deficit of 56 b.kr. on the goods account, which was offset in part by a larger services account surplus measuring just over 25 b.kr. Services exports increased by 55% year-on-year during the quarter, owing largely to increased revenues from tourism. The surplus on primary income declined by 11 b.kr. year-on-year and was slightly smaller than previously expected.

Domestic payment card turnover suggests that household demand grew in Q3, even though COVID-19 case numbers began to rise again during the summer. In the past six months, spending in contact-intensive sectors has regained momentum, and by the summer it had returned broadly to the pre-pandemic level. Ever since the onset of the pandemic, household spending on consumer durables has been rising steadily. This trend appears to be continuing, and spending on consumer durables is now somewhat above the pre-pandemic level.

All components of the Gallup Consumer Confidence Index rose markedly in September, both year-on-year and month-on-month. The assessment of the current situation rose the most and is now at its highest since end-2017. The index shows that optimism among consumers has increased greatly since Q1.

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 more positive than in the summer survey. Their expectations six months ahead are somewhat more negative than they were this summer, however. Just over 60% of executives – somewhat fewer than in the summer – expect economic conditions to improve over the next six months, and another 30% expect them to be unchanged. Executives are somewhat more pessimistic about both domestic and foreign demand than in the summer survey, particularly those in wholesale and retail trade and in the financial and insurance sector.

The outlook for firms' performance has improved since the spring survey, and nearly half of executives now expect their profits to be stronger this year than in 2020. Most companies in the survey saw an increase in margins in the past six months, and a full 40% expect margins to keep growing in the next six months, whereas 16% expect them to shrink. The investment outlook also improved between surveys, and investment is now expected to be stronger in 2021 than in 2020.

The seasonally adjusted results of the autumn survey show that labour demand remains strong. Just over 35% of firms want to add on staff, while just over 7% are planning to downsize, leaving a positive balance of opinion of 28 percentage points. Furthermore, firms' problems with staffing and with boosting production appear to have grown worse since the summer survey. About 33% of executives considered themselves short-staffed, which is 10 percentage points higher than in the previous survey. In addition, nearly half of executives reported difficulty responding to an unexpected increase in demand. This is 14 percentage points higher than in the summer survey and the steepest rise ever recorded between two consecutive surveys. Problems relating to staffing and boosting production were most pronounced in transport, transit, and tourism, as well as in miscellaneous specialised services.

The wage index rose by 0.3% month-on-month in August and by 7.9% year-on-year. Real wages were 3.4% higher during the month than at the same time in 2020.

Statistics Iceland's nationwide house price index, published in late September, rose by 1.7% month-on-month when adjusted for seasonality, and by 14.7% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1.4% month-on-month in August when adjusted for seasonality, and by 16.4% year-on-year. The number of purchase agreements registered nationwide rose by 30% year-on-year in the first eight months of 2021, while the number of contracts for new construction increased by 45% over the same period. The average time-to-sale in the capital area has lengthened by about two weeks since bottoming out in March, measuring 1.3 months in August.

The consumer price index (CPI) rose by 0.47% month-on-month in September, raising twelve-month inflation to 4.4%. Inflation excluding housing continued to taper off between months, however, falling to 2.9%. Underlying inflation also declined between August and September, to 3.7% according to the average of various measures.

Most of the rise in the CPI in September is due to house price inflation, although clothing and footwear prices rose as well, due to end-of-sale effects. The price of imported goods as a whole has risen 2.6% in the past twelve months, and imported inflation has eased recently. On the other hand, private services prices have risen by 3.8% in the past year, and their contribution to headline inflation has gradually increased in the recent term.

According to Gallup's autumn survey, corporate executives project both short- and long-term inflation at 3%. Their one-year expectations have fallen since the summer survey, while their long-term expectations are unchanged. Households' inflation expectations two and five years ahead have risen since the previous survey, however, to 3.5%. Furthermore, the breakeven inflation rate in the bond market has risen since the August MPC meeting, and the ten-year breakeven rate was 3.4% at the beginning of October.

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 since the August meeting. Members also discussed whether the monetary stance was appropriate in view of the inflation outlook, as they had decided in August to continue tightening it. At that time, the economic outlook had continued to improve relative to the Bank's previous forecast, but it appeared that inflation would subside somewhat more slowly than previously anticipated.

Members discussed the newly released preliminary national accounts figures, which indicated that GDP growth in H1/2021 was slightly weaker than had been forecast in the August *Monetary Bulletin*. They noted, however, that growth in domestic demand was well in line with the Bank's forecast. It emerged that indicators implied a continued strong domestic economic recovery in Q3, and the GDP growth outlook for 2021 as a whole was broadly unchanged. The Committee also noted that indicators from the labour market implied that the economy was rebounding quickly.

Members noted that inflation had risen to 4.4% in September. They discussed the contribution from the housing component, which had continued to increase, and noted that housing accounted for a large share of headline inflation in September. It also emerged that the twelve-month rise in wages was strong and that private services prices had increased somewhat in the recent term. MPC members also noted that underlying inflation had continued to ease, although it remained significant. On the other hand, it emerged that the impact of temporary supply-chain disruptions, which had pushed manufacturing and distribution costs upwards all over the world, could persist longer than previously anticipated. It was pointed out that increased global inflationary pressures could also result in more persistent inflation.

The MPC was of the view that, although underlying inflation was declining, there was cause for concern in that inflation expectations appeared to have begun rising again, although it was too soon to say whether they had become less firmly anchored to the inflation target.

Committee members discussed the Bank's intervention in the foreign exchange market. The Bank had intervened relatively little between meetings, and the MPC considered the market quite well balanced. The Bank's intervention in recent months had included both purchases and sales, in line with the Committee's policy of mitigating short-term exchange rate volatility. The MPC also discussed developments in the real exchange rate in the context of the assessment of the equilibrium real exchange rate. Members were of the opinion that the conditions created in the wake of the economic shock in 2020, when the depreciation of the króna temporarily pushed the real exchange rate below its equilibrium value, no longer appeared to be in place.

All members agreed that the Bank's key rate should be raised, and they discussed whether it should be raised by 0.25 percentage points or 0.5 percentage points. The main arguments discussed at the meeting in favour of taking a smaller step centred on the continued uncertainty about the global economic outlook. Uncertainty about developments in the labour market was another factor. Even though labour demand had been strong since the spring, there is some uncertainty about how durable the recovery will prove to be once Government support measures are gradually unwound. Unemployment could rise again, particularly if activity in the tourism sector declines during the coming winter. It also emerged in the discussion that inflation was probably due in part to temporary factors such as supply-chain disruptions abroad. It was pointed out as well that, in view of the recent decisions by the Bank's Financial Stability Committee to lower the maximum loan-to-value (LTV) ratio on consumer mortgages and impose a cap on debt service-to-income (DSTI) ratios, it would be more appropriate to continue to take cautious steps, as significant uncertainty remained about the interaction between the Bank's interest rate hikes and the application of macroprudential tools such as LTV and DSTI ratios. It emerged that the transmission mechanism of monetary policy was probably more efficient than before, as borrowers had turned increasingly to non-indexed variable-rate loans in the recent term.

The main arguments for raising interest rates by 0.5 percentage points were the many indications that economic activity had rebounded strongly, as could be seen, for instance, in steeply rising property prices, strong household lending growth, and shortages of labour in certain sectors. It was pointed out that a third of firms were having difficulty filling job vacancies. It also emerged that there was the risk of higher imported inflation in the coming term; furthermore, surveys showed that a majority of executives anticipate having to raise the price of their own products and services, and expect price increases from their suppliers. In this light, it was important to tighten the monetary stance decisively, so as to minimise the risk that inflation would be even more persistent, and to respond strongly to the rise in long-term inflation expectations.

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 1.5%, the current account rate 1.25%, the seven-day collateralised lending rate 2.25%, and the overnight lending rate 3.25%. Ásgeir Jónsson, Rannveig Sigurdardóttir, and Katrín Ólafsdóttir voted in favour of the proposal. Gunnar Jakobsson and Gylfi Zoëga voted against the Governor's proposal and wanted 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 17 November 2021.