CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2022

May
108th meeting
Publ: 18 May 2022

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2022 (108th meeting)

Published: 18 May 2022

The Act on the Central Bank of Iceland states that decisions on the application of the Bank's monetary policy instruments shall be taken by the Monetary Policy Committee (MPC). It also states that the minutes of MPC meetings shall be made public and an account given of the Committee's decisions and the premises on which they are based. On the basis of this statutory authority, the MPC publishes the minutes of each meeting two weeks after the announcement of each decision. The minutes also include information on individual members' votes.

The following are the minutes of the MPC meeting held on 2 and 3 May 2022, 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 4 May.

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 9 February 2022, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2022/2 on 4 May.

Financial markets

Since the February meeting, the króna had appreciated by 1.9% in trade-weighted terms. Between meetings, the Bank's foreign currency purchases totalled 157 million euros (22 b.kr.), and its sales totalled 68 million euros (9.9 b.kr.). Therefore, the Bank's net purchases amounted to 89 million euros (12.2 b.kr.), and its transactions accounted for 27% of total foreign exchange market turnover for the period.

In terms of the Central Bank's real rate, the monetary stance had eased significantly since the February meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was -3.3%, or 1.4 percentage points lower than just after the publication of the February interest rate decision. In terms of twelve-month inflation, it was -4.2% and had fallen similarly over the same period.

Interest rates in the interbank market for krónur rose in line with the increase in the key rate in February, but there had been no turnover in the market since the MPC's last meeting. Yields on long-term nominal Treasury bonds had risen by as much as 0.6 percentage points since the February meeting, while yields on long-term indexed Treasury bonds had fallen by up to 0.3 percentage points. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in February, whereas average indexed mortgage rates had fallen marginally.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 1 percentage point versus the euro area, to 4.2 percentage points, whereas it was virtually unchanged at 2.5 percentage points versus the US. The long-term interest rate differential versus Germany had narrowed slightly between meetings, to 4.3 percentage points, whereas the spread versus the US had narrowed by 0.4 percentage points, to 2.3 percentage points. 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 0.8-1.0 percentage point.

According to the Central Bank's quarterly market expectations survey, conducted in April, respondents expected the Bank's key rate to be raised to 3.75% in Q2/2022, and by another 0.5 percentage points in Q3. They also expected the key rate to be 4.6% after one year. This is a higher interest rate than market agents expected at the time of the January survey. Respondents' position on the monetary stance was broadly similar to that in the last survey. The vast majority, or 79%, considered the monetary stance too loose, about the same as in January. The share who considered it appropriate fell to 17%, from 20% in the previous survey. Just over 4% of respondents considered the monetary stance too tight.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 0.5-1.0 percentage point, citing the recent surge in inflation and the deterioration in the inflation outlook since February, as well as the continued rise in house prices. There were also signs that inflation had become relatively widespread, and furthermore, global inflation had increased and inflation expectations had continued to rise. Analysts noted as well that the economic outlook remained positive despite the war in Ukraine, domestic demand had been brisk in the recent term, and the labour market was strong.

Annual growth in M3 gained pace slightly in late 2021, measuring just under 12% in March. At the same time, annual growth in credit system lending to households is estimated at just over 10%, roughly the same as in recent months. Corporate lending growth has held virtually unchanged during the year but seems to be picking up again now, after contracting continuously since the beginning of 2021.

The Nasdaq OMXI10 index had fallen by 7.2% between meetings. Turnover in the Main Market totalled 431 b.kr. in the first four months of 2022, some 27% more than over the same period in 2021.

Global economy and external trade

According to the International Monetary Fund's (IMF) April forecast, global GDP growth is projected to measure 3.6% in 2022, or 0.8 percentage points less than in the Fund's January forecast. The downward revision is due largely to the impact of the war in Ukraine and the sanctions on Russia on the global economy. The IMF has lowered its year-2022 GDP growth forecast by 0.6 percentage points for advanced economies and by 1 percentage point for emerging and developing countries. It also projects global GDP growth for 2023 at 3.6%, or 0.2 percentage points below the January forecast. The inflation outlook has deteriorated as well, in the IMF's opinion. Year-2022 inflation is projected to measure 5.7% among advanced economies, 1.8 percentage points above the Fund's January forecast and 3.4 percentage points above its October 2021 forecast. In 2023 it is forecast at 2.5%, or 0.4 percentage points above the January forecast.

The goods account deficit totalled 22 b.kr. in Q1/2022, as compared with just over 21 b.kr. (at constant exchange rates) for the same period in 2021. Goods export values increased by 55% during the quarter, with all key categories contributing to the rise except for ships and aircraft, whose export value contracted year-on-year. The strongest impact was from industrial goods exports, owing in particular to significant rises in the price of aluminium during the quarter. Marine product export values also rose markedly during the quarter, mainly because of a bountiful capelin season. At the same time, imported goods values rose by over 48% year-on-year, or by 38% excluding ships and aircraft. All key components of goods imports contributed to the increase.

Global aluminium prices fell by 10% after the MPC's February meeting, to around 3,000 US dollars per tonne just before the May meeting. They remain roughly a fourth higher than in May 2021, however. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 17.8% year-on-year in Q1/2022. The global price of Brent crude rose by nearly a fifth between MPC meetings, to about 108 US dollars per barrel by the beginning of May. This is 36% higher than at the beginning of 2022 and 60% above the early May 2021 price. Furthermore, various other global commodity prices have risen sharply since the last MPC meeting, owing to the effects of the war in Ukraine.

The real exchange rate in terms of relative consumer prices fell by 2% month-on-month in March, when it was 6.6% above its 25-year average but 2.9% lower than in December 2019. It rose by 5.4% year-on-year in the first three months of 2022, as the nominal exchange rate rose by 4.7%, while inflation in Iceland was 0.7 percentage points above the trading partner average.

Domestic economy and inflation

Private consumption grew by 7.6% in 2021, well above the Bank's February forecast of 6.8%. There are signs that growth eased in Q1/2022, however, and it is projected at 3.8% year-on-year. The outlook for private consumption growth has deteriorated, as the surge in inflation cuts into real incomes. This is offset by the strong position of most households and a high level of saving, however, and the Gallup Consumer Confidence Index suggests that there is still some optimism about the outlook.

According to the results of Gallup's spring survey, conducted in February and March among Iceland's 400 largest firms, respondents' attitudes towards the current economic situation were only slightly more positive than in the winter survey. Their expectations six months ahead were marginally more negative than they were this winter, however. About 21% of executives expected the economic situation to be worse in six months' time, somewhat more than in the winter survey, while 45% expected it to improve. Executives were also marginally more optimistic about domestic and foreign demand than in the winter survey, particularly those in the financial and insurance sector and in miscellaneous specialised services.

According to the survey, the outlook is for firms' performance to be broadly unchanged year-on-year in 2022, with about half of executives indicating that they expected their profit for the year to be similar to that in 2021. About a third of executives expected this year's profit to be larger than last year's. About 40% of firms saw their margins increase in the previous six months, and about a third of respondents expected margins to rise in the coming six months, while one-fifth expected a decline. This is a slightly poorer outlook than in the autumn survey. Furthermore, about a third of executives projected that they would invest more in 2022 than in 2021.

According to the seasonally adjusted results of Gallup's spring survey, labour demand was still strong. For the fourth survey in a row, the balance of opinion on staffing was 30 percentage points in favour of those planning to recruit. Furthermore, just under half of respondents considered their firms short-staffed, and just over half were of the opinion that they would have difficulty responding to an unexpected increase in demand. Both percentages have risen steeply in the recent past.

According to the Statistics Iceland labour force survey (LFS), total hours worked rose by 9% year-on-year in Q1/2022, as the number of employed persons rose by 10%, while the average work week was shorter by 1%. According to seasonally adjusted LFS results, the number of employed persons was about 6% higher in Q1/2022 than in Q4/2019, before the pandemic reached Iceland. In January, seasonally adjusted data taken from the pay-as-you-earn (PAYE) register suggested that the number of employed persons had risen by 1% over the same period.

According to seasonally adjusted LFS data, the labour participation rate increased in Q1/2022 by 1 percentage point from the previous quarter, and the employment rate by around 1½ percentage points. As a result, unemployment fell by nearly 1 percentage point between quarters, to 4.1%, slightly below the Q4/2019 rate. According to the LFS, the slack in the labour market has narrowed in tandem with declining unemployment. Registered unemployment according to the Directorate of Labour (DoL) measured 4.6% in Q1, after adjusting for seasonality, and has fallen by nearly 6 percentage points year-on-year.

Iceland's population grew by 2% year-on-year in Q1/2022. Just over half of the increase is due to labour importation, as net migration of foreign nationals was positive by 1,350 during the quarter.

The wage index rose by 4% between quarters in Q1, and by 7.2% year-on-year, while the real wage index rose by 2% between quarters. According to preliminary figures from Statistics Iceland, GDP per capita grew by just over 2.5% year-on-year in 2021; therefore, the provision in the wage agreements known as the GDP growth supplement will be activated, and wages will rise even further this year.

Statistics Iceland's nationwide house price index, published in late April, rose by 2.2% month-on-month when adjusted for seasonality, and by 19.1% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 2.9% month-on-month in March when adjusted for seasonality, and by 22.2% year-on-year. The number of purchase agreements registered nationwide fell by 35% year-on-year in the first three months of 2022, and the number of contracts for new construction declined by 53% over the same period. In March, the average time-to-sale for homes in the capital area was 1 month, only slightly above the March 2021 low, as the number of properties for sale has fallen steeply in recent months.

The CPI rose by 1.25% month-on-month in April, and twelve-month inflation increased to 7.2%. Inflation excluding housing rose as well, to 5.3%. Underlying inflation measured 5.3%, according to the average of various measures. There are signs that inflationary pressures are more widespread than they were in 2021, as all measures of underlying inflation have risen in the recent term.

Just over a third of the monthly rise in the CPI was attributable to increased owner-occupied housing costs, which have risen by more than 17% year-on-year. The rise in airfares and food and beverage prices (owing in particular to the increase in milk and dairy product prices) also had a significant impact.

Short-term inflation expectations have continued to increase, as they generally reflect developments in measured inflation. Market agents expect inflation to measure 3.5% after two years, which is about 0.5 percentage points above their response in the January survey. The results of Gallup's spring surveys suggest that corporate executives expect inflation to measure just under 4% in two years' time and that households expect it to measure 5%. Long-term inflation expectations have also risen, and market agents expect inflation to measure 3.5% over the next five years and 3% over the next ten. Corporate executives' and households' expectations concerning average inflation five years ahead have risen as well, to 3.2% and 4.4%, respectively. The breakeven inflation rate in the bond market has risen, with the five-year breakeven rate five years ahead measuring 3.4% at the end of April.

According to the forecast published in *Monetary Bulletin* on 4 May, the inflation outlook has deteriorated markedly. In April, inflation measured 7.2%, its highest since 2010. As before, it is driven mainly by surging house prices, plus sharply increasing global oil and commodity prices. The effects of strong domestic inflationary pressures are discernible as well, as can be seen, for instance, in steep wage rises. Inflation is expected to continue rising to an average of 8.1% in Q3/2022. It is not expected to fall below 3% until late 2024.

The economic outlook for Iceland's main trading partners has deteriorated relative to the Bank's previous forecast, in the wake of Russia's invasion of Ukraine, and inflation has surged worldwide, rising to levels not seen in decades. The outlook for Iceland has therefore worsened since February, as the GDP growth outlook for key trading partners has deteriorated, slower export growth is forecast, and greater uncertainty and higher input prices and living costs look set to impede growth in private consumption and investment. Offsetting this are signs of robust activity in 2022 to date, among other things. GDP growth for this year is projected at 4.6% instead of the 4.8% in the February forecast. As in February, the domestic economy is estimated to be running at full capacity, and capacity constraints are likely to slow down GDP growth as the forecast horizon advances.

Economic uncertainty has escalated sharply following the invasion of Ukraine. The war has upended global commodity markets and thrown trade relationships and supply chains into disarray. It is difficult to predict how deep and lasting these effects will be. The same is true of the effects of the war on global financial markets and on households' and businesses' spending and investment decisions. Added to this is uncertainty about the impact tightened public health measures in China will have on important supply chains. Given the recent rise in long-term inflation expectations, there is greater risk that the inflation outlook as depicted in the Bank's forecast is overly optimistic. Furthermore, the risk of a wage-price spiral could grow if next winter's wage settlements provide for large pay hikes, which could cause high inflation to become more firmly entrenched.

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 since the February meeting. Members discussed whether the monetary stance was appropriate in view of the considerably poorer inflation outlook, as they had decided in February to continue tightening it.

Members discussed the economic outlook, which had deteriorated relative to the Bank's February forecast, owing to the adverse impact of Russia's invasion of Ukraine. On the other hand, there were signs of strong domestic economic activity, as it appeared that growth in private consumption in Q1 had been more than expected. The slack in the economy appeared to have disappeared, and the labour market was tightening. It emerged that GDP growth was forecast at 4.6% this year, followed by a growth rate of just under 3% in 2023 and 2024.

The MPC noted that inflation had measured 7.2% in April and that the outlook had deteriorated markedly. They observed that as before, house prices and other domestic cost items were strong drivers of inflation, and global oil and commodity prices had risen sharply as well. Price increases were therefore broad-based, as could be seen in the rapid rise in underlying inflation, which measured just over 5%. Furthermore, inflation expectations had risen by all measures. The Committee discussed the Bank's forecast, according to which the outlook was for inflation to rise above 8% in Q3/2022, some 2.8 percentage points above the February forecast. Members assumed that the combination of interest rate hikes and tighter borrower-based measures would slow down house price inflation and domestic demand.

All members agreed that the Bank's key rate should be raised, and they discussed rate increases ranging from 0.75-1 percentage point. The main arguments discussed centred on the marked deterioration of the inflation outlook in the recent past. Furthermore, inflation expectations had risen by all measures, and therefore, there was greater risk that they had become unmoored from the target. The real rate had therefore fallen even further between meetings; it was significantly negative and far below the equilibrium real rate. It emerged in the discussion that there was also a greater risk that near-term inflation was underestimated rather than overestimated, and that uncertainty had increased. Members noted that the labour market had recovered quickly and job numbers had risen considerably. Real disposable income and real wages had also grown markedly in recent years in spite of the pandemic-related economic contraction. In many economies, the inflation outlook had deteriorated about as much as it had in Iceland, which would lead to higher imported inflation. In this context, concerns were expressed about potential second-round effects from higher imported goods prices and wage hikes. It was also pointed out that demand in the housing market was stronger, house price inflation higher, and growth in the housing supply weaker than previously projected. The main argument in favour of taking a smaller step at this time was the possibility that the global economic outlook could worsen more than expected, which would cut into domestic GDP growth, all else being equal. Furthermore, it was pointed out that many households were tapping their accumulated savings more rapidly than before, and a portion of the increase in private consumption was pandemic-related. Moreover, the outlook for real wages had deteriorated and, as a result, it was possible that domestic economic activity would slow abruptly as the year progressed.

The MPC also discussed the application of other monetary policy instruments. It emerged that, among other things, it would be necessary in the near future to examine the possible application of policy instruments that could be used to manage liquidity in circulation and to sterilise the Bank's foreign exchange market intervention when needed.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 1 percentage point. The Bank's key rate (the seven-day term deposit rate) would be 3.75%, the current account rate 3.5%, the seven-day collateralised lending rate 4.5%, and the overnight lending rate 5.5%. All Committee members voted in favour of the proposal.

The MPC discussed that it was likely that the monetary stance would have to be tightened even further in coming months so as to ensure that inflation eases back to target within an acceptable time frame. Decisions taken at the corporate level, in the labour market, and in public sector finances would be a major determinant of how high interest rates must rise.

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

Herdís Steingrímsdóttir, Associate Professor, external member

Thórarinn G. Pétursson, Chief Economist of the Central Bank, was present for the entire meeting. In addition, several 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 22 June 2022.