CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2022

November
112th meeting
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Minutes of the Monetary Policy Committee meeting

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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 21 and 22 November 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 23 November.

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 5 October 2022, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2022/4 on 23 November.

Financial markets

Since the October meeting, the króna had depreciated by 1.9% in trade-weighted terms. Between meetings, the Bank sold foreign currency for 33 million euros (4.9 b.kr.). The Bank's transactions during the period accounted for 8% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance was broadly unchanged since the MPC's October meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -0.4%, or 0.1 percentage points higher than just after the announcement of the October interest rate decision. In terms of twelve-month inflation, it was -3.3% and had fallen by 0.1 percentage points over the same period.

Interest rates on unsecured overnight loans (the Icelandic króna overnight rate, or IKON) and rates in the interbank market for krónur rose in line with the increase in the key rate in October, 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 0.9 percentage points since the October meeting, and yields on long-term indexed Treasury bonds had risen by up to 0.3 percentage points. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in October, and average indexed mortgage rates had risen marginally.

In terms of three-month interbank rates, the interest rate differential had narrowed against the euro by 0.6 percentage points between meetings, to 4.6 percentage points, and had narrowed by 0.8 percentage points against the US dollar, to 1.7 percentage points. The long-term interest rate differential versus Germany had widened by 0.5 percentage points between meetings, to 4.4 percentage points, whereas the spread versus the US had narrowed by 0.4 percentage points, to 2.6 percentage points. Measures of the risk premium on the Treasury's foreign obligations had fallen between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.5%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 1.4 percentage points.

According to the Central Bank's quarterly market expectations survey, conducted in November 2022, respondents expected the Bank's key rate to remain unchanged at 5.75% in the near term and then be lowered to 5.5% in Q3/2023. They expected it to measure 4.5% in two years' time. This is a lower interest rate than market agents expected at the time of the August survey. Participants' responses on the monetary stance changed between surveys: 18% considered the current stance too loose, down from 67% in April. The share who considered the monetary stance appropriate rose from 29% to 67%. About 15% of respondents considered the monetary stance too tight, as compared with only 4% in the previous survey.

Financial institutions' analysts expected the MPC either to hold the Bank's interest rates unchanged or to raise them by 0.25 percentage points, citing the recent depreciation of the króna, the rise in the breakeven inflation rate in the bond market, and the persistent strength of the housing market. Furthermore, domestic demand had grown considerably, and the labour market was tight. They mentioned, however, that the full impact of recent interest rate hikes had yet to come to the fore, there was considerable uncertainty about wage negotiations, and the economic outlook abroad had deteriorated further.

Year-on-year growth in M3 declined slightly during the summer but picked up again in October, measuring around 11½%. At the same time, annual growth in credit system lending to households is estimated at just under 10%, roughly the same as in 2022 to date. Annual growth in corporate lending has gained pace over the course of the year, measuring just below 10% in October.

The Nasdaq OMXI10 index had risen by 7.9% between meetings. Turnover in the Main Market totalled 881 b.kr. in the first ten months of 2022, similar to that in the same period in 2021.

Global economy and external trade

According to the International Monetary Fund's (IMF) mid-October forecast, global GDP growth is projected to shrink from 6% in 2021 to 3.2% in 2022. It is expected to contract still further in 2023, to 2.7%. This would be the weakest global output growth rate since 2001, apart from the contractions that occurred in the wake of the financial crisis and the pandemic. The IMF's GDP growth projection for 2022 is unchanged from its July forecast, whereas its 2023 forecast has been revised downwards by 0.2 percentage points. Projections for both years were revised significantly downwards from the April forecast, however, particularly for developed countries. The bleaker outlook reflects the impact of higher global inflation, poorer financial conditions alongside expectations of more interest rate hikes by leading central banks, and the adverse effect of Russia's invasion of Ukraine on the global economy – and particularly on Europe, owing to reduced energy supplies from Russia. Furthermore, economic activity in China has slowed more than expected in the wake of tighter public health measures and weaknesses in the Chinese real estate market. The global inflation outlook has continued to worsen, according to the IMF. Inflation in advanced economies is forecast at 7.2% this year and 4.4% in 2023. These figures are above the Fund's July forecast by 0.6 and 1.1 percentage points, respectively.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured just over 49 b.kr. in October, the largest single-month deficit recorded to date (FOB/FOB). In comparison, the goods account deficit in October 2021 was just under 7 b.kr. at constant exchange rates. This year's October deficit is due to strong growth in imports, particularly oil and investment goods, but in addition, goods export values were a full 15% lower than in the previous month. For the first ten months of the year, the goods account deficit therefore totalled 196 b.kr., as compared with a deficit of 128 b.kr. at constant exchange rates for the same period in 2021. The deficit in the first ten months of this year is larger than that recorded in 2021 as a whole and about the same (at constant exchange rates) as the deficit for 2018 as a whole. The value of exported goods rose by 41% in the first ten months of the year, with all key components contributing to the increase. The strongest impact was from industrial goods exports, particularly aluminium products, whose prices rose markedly in H1. At the same time, imported goods values rose by 43%, with all key components contributing to the increase. The main drivers of the increase were petrol and lubricants, which have increased by more than 200% between years.

The global price of aluminium had risen slightly since the MPC's October meeting, to 2,400 US dollars per tonne. Nevertheless, this is about 11% lower than in November 2021. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products rose by 4.5% quarter-on-quarter in Q3/2022 and by 22% year-on-year in the first nine months of 2022. The global price of Brent crude rose by 4% between MPC meetings, to 88 US dollars per barrel at the time of the November meeting. It is just over 10% higher, however, than at the beginning of 2022 and in November 2021.

The real exchange rate in terms of relative consumer prices fell by 1.1% month-on-month in October, when it was 7.5% above its 25-year average but 2.8% lower than in December 2019. It rose by 4.1% year-on-year in the first ten months of 2022, owing almost entirely to the rise in the nominal exchange rate, as inflation in Iceland was broadly in line with the trading partner average.

Domestic economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked were 3.2% higher in Q3/2022 than in the same quarter of 2021. Job growth measured 3.7% but was offset by a 0.4% reduction in average hours worked. Although job numbers are still rising between years, the pace of growth has eased in recent months, and in seasonally adjusted terms, job numbers actually declined slightly between quarters in Q3. The number of employees on the pay-as-you-earn (PAYE) register is now growing more slowly, and it remained flat between quarters in Q3.

Seasonally adjusted LFS data for Q3 suggest that the labour participation rate has begun to fall again. It measured 79.3% during the quarter, or 0.7 percentage points lower than in Q2. The employment rate fell by a slightly larger margin. Unemployment therefore rose by 0.5 percentage points between quarters, to 4%. Registered unemployment was unchanged quarter-on-quarter, however, at a seasonally adjusted 3.7% in Q3. Nevertheless, it continued to fall in October, to 3.3%.

Iceland’s population grew by 2.8% year-on-year in Q3, and net migration of foreign nationals was positive by 3,410 during the quarter. This comes on top of more than 3,500 foreign nationals who migrated to Iceland in Q2, in the largest single-quarter influx in the history of Statistics Iceland’s quarterly population data.

The general wage index rose by 0.4% between quarters in Q3, and by 8.1% year-on-year. Real wages were 1.4% lower in Q3 than in the same quarter of 2021.

Key indicators of developments in private consumption imply a slower growth rate in H2, as it is likely that to some extent, pent-up desire to travel has been satisfied recently after the pandemic-era restrictions. The Gallup Consumer Confidence Index suggests, too, that consumers have grown more pessimistic. The Central Bank’s baseline forecast assumes a private consumption growth rate of 5.7% year-on-year in Q3, which is similar to the August forecast. The outlook for private consumption growth in 2022 as a whole is also largely unchanged since August, at just over 7%.

Statistics Iceland’s nationwide house price index, published at the end of October, rose by 0.4% month-on-month, after adjusting for seasonality, and by 21.6% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.6% month-on-month in October when adjusted for seasonality, and by 21.5% year-on-year. The number of purchase agreements registered nationwide fell by 28.4% year-on-year in the first ten months of 2022, and the number of contracts for new construction declined by 26.1% over the same period. The average time-to-sale in the capital area was 3.3 months in October, considerably more than the October 2021 figure of 1.2 months, as the number of homes for sale has increased significantly in recent months.

The consumer price index (CPI) rose by 0.67% month-on-month in October, pushing twelve-month inflation upwards again, to 9.4%. Inflation excluding housing rose as well in October, to 7.2%. Underlying inflation was 6.9%, according to the average of various measures, and has risen without interruption in the past year. The main drivers of inflation in October were, on the one hand, owner-occupied housing costs, and on the other, food prices, which have risen by 9.6% in the past twelve months. The price of furniture and housewares also rose considerably in October.

According to the Bank’s market expectations survey, respondents’ one-year inflation expectations have fallen to just over 5%. Their expectations of inflation two years ahead were unchanged at 4%, however. Survey participants expect inflation to average 3½% in the next five and ten years, and overall, their long-term expectations have fallen marginally relative to the August survey. The breakeven inflation rate in the bond market has risen again in recent months, however. The five-year breakeven rate five years ahead was around 4% in mid-November, some 0.8 percentage points higher than at the beginning of October.

According to the forecast published in *Monetary Bulletin* on 23 November, the short-term inflation outlook has improved, while the long-term outlook is broadly unchanged. Headline inflation measured 9.4% in October after ticking upwards month-on-month, but has fallen by 0.5 percentage points from its July 2022 peak. Underlying inflation is high as well, and inflation has grown ever more widespread, with a majority of CPI subcomponents up sharply in price in the past year. Inflation has risen less than was forecast in August, however, reflecting a more rapid shift in the housing market and larger-than-expected declines in petrol prices and airfares this autumn. Inflation is now projected to measure 9.4% in Q4 and then gradually start easing at roughly the pace forecast in August.

Although global GDP growth somewhat outpaced forecasts in H1/2022, indicators imply that it softened more than projected in H2. The outlook for 2023 has deteriorated as well. The energy crisis that struck Europe in the wake of Russia's invasion of Ukraine continues to deepen, and global inflation has surged. For Iceland's main trading partners, GDP growth prospects have therefore deteriorated still further, with year-2023 growth set to be the weakest since 2008, apart from the pandemic-related contraction in 2020.

Preliminary national accounts data suggest that GDP growth in Iceland measured 6.8% in H1, somewhat below the Bank's August forecast. GDP growth for 2022 as a whole is therefore estimated at 5.6%, or 0.3 percentage points less than previously forecast. The outlook for 2023 has improved, however, and growth is now projected at 2.8%, up from the August forecast of 1.9%. This is due largely to the prospect of more rapid growth in domestic demand, which in turn is due in part to revised disposable income data indicating that households are better able to support their expenses than was previously assumed. As in August, GDP growth is expected to average 2½% per year in the latter half of the forecast horizon.

The economic situation is highly uncertain. The war in Ukraine has upended global commodity markets and thrown trade relationships and supply chains into disarray. It has caused an energy crisis in Europe, with no end yet in sight. A severe energy shortage could ensue, requiring widespread energy rationing and causing major economic hardship on the Continent. If this happens, GDP growth in Iceland will probably be weaker and inflation higher than in the Bank's baseline forecast. The inflation outlook could also prove overly optimistic if the current wage negotiations lead to larger pay rises than are assumed in the baseline. There is also increased risk of a wage-price spiral, as indicators imply that inflation expectations are less firmly anchored to the target than before.

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 was still negative and had remained broadly unchanged since the October meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its October meeting to raise interest rates, but by a smaller increment than before. At that time, inflation had eased between meetings, but underlying inflation had continued to rise. Furthermore, demand appeared to have been strong in Q3.

Committee members discussed the fact that inflation had picked up again slightly in October, to 9.4%. Price increases were widespread, and underlying inflation had continued to rise. It emerged that inflation was expected to average 9.4% in Q4/2022 and then begin to ease gradually, measuring about 4½% in Q4/2023. The short-term inflation outlook had therefore improved relative to the Bank's August forecast, but not as rapidly as was envisioned at the October meeting.

The MPC noted that the króna had depreciated since the October meeting, and the long-term breakeven inflation rate in the bond market had risen somewhat. It emerged that in addition, indicators implied that inflation expectations had become less firmly anchored to the target, and it could therefore take longer than it would otherwise to bring inflation back to target.

Committee members discussed that according to the Central Bank's new macroeconomic forecast, GDP growth was projected to measure 5.6% in 2022. It emerged that the outlook for 2023 had improved and that growth was now projected at 2.8%, up from the August forecast of 1.9%. This was due to the prospect of more rapid growth of domestic demand than was previously assumed. Furthermore, the labour market was still quite tight, although tension had eased somewhat.

The MPC also discussed the commercial banks' position and their recent earnings reports. It emerged that growth in the banks' mortgage lending to households had eased and that demand for loans had tapered off as well. On the other hand, corporate lending had gathered pace. It was pointed out that arrears did not appear to have increased despite interest rate hikes, and that non-performing loan ratios were very low in historical context. Moreover, the share of forborne loans was falling.

MPC members were of the opinion that there were grounds to either hold the key rate unchanged or raise it by 0.25-0.5 percentage points. The main arguments expressed at the meeting in favour of keeping interest rates unchanged were that although inflation had risen between meetings, it looked set to start falling; furthermore, the housing market had continued to lose momentum, although it appeared that it would take longer than previously anticipated. Moreover, there still seemed to be signs that tension in the labour market had peaked.

The arguments expressed in favour of raising interest rates were that the domestic economy still appeared quite strong, the output growth outlook for 2023 had improved markedly, and the output gap was expected both to be wider in 2023 than previously assumed and to narrow more slowly. It emerged that the outlook was for more rapid growth of domestic demand, partly because disposable income had risen more swiftly than previously projected. The MPC considered it cause for concern that underlying inflation had continued to rise and that price increases were so widespread. A majority of CPI subcomponents had risen sharply in price recently, and that share was still growing. Furthermore, the króna had depreciated since the MPC's previous meeting, and the global inflation outlook had deteriorated, which would lead to higher imported inflation, all else being equal. Inflation expectations were high by all measures and appeared to be less firmly anchored to the target. There was a significant risk that inflation would remain high for a protracted period of time. It also emerged that the inflation risk profile was tilted to the upside. Moreover, it was pointed out that the real rate was still negative and that in view of the tension in the labour market and the economy, it needed to be higher.

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 6%, the current account rate 5.75%, the seven-day collateralised lending rate 6.75%, and the overnight lending rate 7.75%. All members voted in favour of the Governor's proposal, although Gylfi Zoëga would have preferred to raise rates by 0.5 percentage points.

Members agreed that it was vital to ensure that the monetary stance was tight enough to bring inflation back to target within an acceptable time frame. Near-term monetary policy decisions would depend on developments in economic activity, inflation, and inflation expectations. Decisions taken at the corporate level, in the labour market, and in public sector finances would be a major determinant of developments in interest rates in the coming term.

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 8 February 2023.