CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2023

February
113th meeting
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The Monetary Policy Committee of the Central Bank of Iceland

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 6 and 7 February 2023, 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 8 February.

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 previous meeting, on 23 November 2022, as published in the updated forecast in *Monetary Bulletin* 2023/1 on 8 February.

Financial markets

Since the November meeting, the króna had depreciated by 2.8% in trade-weighted terms. Between meetings, the Bank sold foreign currency for 18 million euros (2.8 b.kr.). The Bank's transactions during the period accounted for 5% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance eased since the November meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -0.7%, or 0.5 percentage points lower than just after the announcement of the November interest rate decision. In terms of twelve-month inflation, it was -3.5% and had fallen by 0.4 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 November, with turnover in the market totalling 15 b.kr. between meetings. Yields on long-term nominal Treasury bonds had risen by as much as 0.3 percentage points since the November meeting, and yields on long-term indexed Treasury bonds had risen by up to 0.1 percentage points. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in November, 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 0.4 percentage points between meetings, to 4.2 percentage points, but had widened by 0.2 percentage points against the US dollar, to 1.9 percentage points. At the same time, the long-term interest rate differential versus Germany had narrowed by 0.1 percentage points between meetings, to 4.3 percentage points, whereas the spread versus the US had widened by 0.3 percentage points, to 2.9 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 0.7%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 1.1 percentage points.

According to the Central Bank's quarterly market expectations survey, conducted in January 2023, respondents expected the Bank's key rate to rise to 6.25% in Q1 and then be lowered to 6% in Q4/2023. They expected it to measure 4.75% in two years' time. This is a higher interest rate than market agents expected at the time of the November survey. The share of respondents who considered the monetary stance too loose was 28%, up from 18% in the November survey. The share who considered it appropriate fell from 67% in November to 56% in January, while 16% of respondents considered the stance too tight.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 0.5 percentage points, as inflation had picked up again and was widespread. Furthermore, the breakeven inflation rate in the bond market had risen, inflation expectations were still high, the króna had depreciated in the recent term, and the labour market was quite tight. They noted, however, that the real estate market had begun to cool and that indicators implied a slowdown in private consumption growth.

Growth in M3 had eased slightly in H2 but measured 8.9% in December. Annual growth in credit system lending is estimated to have measured just over 9% at the same time, with growth easing slightly towards the end of the year. Annual growth in lending to businesses grew markedly in 2022 and measured 13% in December.

The Nasdaq OMXI10 index had risen by 0.2% between meetings. Turnover in the Main Market totalled 1,032 b.kr. in 2022 as a whole, nearly 3% less than in 2021.

Global economy and external trade

According to the International Monetary Fund's (IMF) late January forecast, global GDP growth is projected to measure 2.9% in 2023. This is 0.2 percentage points above the Fund's October 2022 forecast but well below the twenty-year average. Furthermore, GDP growth is expected to increase to 3.1% in 2024, slightly below the October forecast. Central bank interest rate hikes aimed at lowering inflation and Russia's war against Ukraine continue to weigh heavily on the global economy. The rapid spread of COVID-19 in China also lowered year-2022 GDP growth, although the recent easing of public health measures by the Chinese authorities suggests that this year's recovery will be stronger than previously anticipated. The IMF therefore projects that global inflation will fall from 8.8% in 2022 to 6.6% in 2023 and 4.3% in 2024. This is somewhat higher inflation than was forecast in October. Inflation in advanced economies is expected to measure 4.6% this year and 2.6% in 2024, which is also above the October forecast.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 240 b.kr. in 2022, as compared with a deficit of 165 b.kr. at constant exchange rates in 2021. The deficit therefore grew by nearly 46% year-on-year, primarily because of strong growth in imports in H2 – fuel and investment goods in particular. Goods export values rose 37% in 2022, with all key subcategories up sharply year-on-year, mainly because of steep price increases. The strongest impact was from industrial goods, particularly aluminium products, whose prices rose markedly in H1. At the same time, the value of imported goods rose by 38%, while its share in GDP in H2/2022 was the highest since 2006. All key subcategories of goods imports contributed to the increase in 2022, led by fuels, which rose in value by 173% year-on-year.

Global aluminium prices had risen by just over 3% since the MPC's November meeting, to 2,500 US dollars per tonne. This is about 22% below the price seen at the beginning of February 2022, however. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products rose by 2% quarter-on-quarter in Q4/2022 and by just under 21% year-on-year in 2022 as a whole. The global price of Brent crude fell by just over 5% between MPC meetings, to 84 US dollars per barrel by the time of the February meeting, a decline of nearly 10% relative to early February 2022.

The real exchange rate in terms of relative consumer prices fell by 1% month-on-month in December, when it was 2.1% above its 25-year average but 5.9% lower than in December 2019. It rose by 3.5% year-on-year in 2022, as the nominal exchange rate rose by 3.1%, while inflation in Iceland was 0.3 percentage points above the trading partner average.

Domestic economy and inflation

Private consumption grew by 10.9% year-on-year in the first three quarters of 2022. Household spending remained strong in Q4, although indicators suggest that year-on-year private consumption growth lost pace during the quarter. Furthermore, households have grown more pessimistic as inflation and debt service have risen, indicating that year-on-year growth in private consumption will continue to lose pace in Q1/2023.

In December, the National Budget for 2023 was approved by Parliament with a deficit amounting to 3% of GDP. This is a larger deficit than was originally provided for in the fiscal budget proposal, and the outlook is for a considerably more accommodative fiscal stance than was assumed in the Bank's November forecast.

According to the results of Gallup's winter survey, conducted in December among Iceland's 400 largest firms, respondents' assessment of the current economic situation was somewhat more negative than in the autumn survey. Their expectations six months ahead were also more negative than in the autumn. About 39% of executives – slightly fewer than in the autumn – expect economic conditions to improve over the next six months, while just under 40% expect them to be unchanged. In general, executives were more optimistic about foreign demand than about domestic demand, but their assessment is broadly unchanged since the autumn. The most optimistic among them were executives in manufacturing and in the transport, transit, and tourism sectors.

According to the seasonally adjusted survey results, many firms were still planning to add on staff. The balance of opinion on staffing plans was positive by 29 percentage points, and has remained close to that level since the summer 2021 survey. About 54% of executives considered themselves short-staffed, which is still close to the historical average. Furthermore, a comparable share of respondents reported 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 5.9% year-on-year in Q4/2022, owing entirely to a rise in the number of employed persons. The number of persons on the pay-as-you-earn (PAYE) register increased by about the same amount between years, or 5.7%.

Seasonally adjusted LFS figures for Q4/2022 show that the labour participation rate rose by 1 percentage point between quarters, to 80.4%. The employment rate increased slightly more, and unemployment therefore fell marginally between quarters, measuring 3.7%. At the same time, registered unemployment was even lower, at a seasonally adjusted 3.4%.

Iceland's population grew by 3.1% year-on-year in Q4/2022. The increase is attributable for the most part to growth in the foreign labour force, as net inward migration of foreign nationals was positive by 2,170 persons in Q4.

In Q4, the general wage index rose by 9.4% between quarters and by 8.3% year-on-year. At the same time, real wages in terms of the index were unchanged relative to Q4/2021.

Statistics Iceland's nationwide house price index, published in January, rose by 0.2% month-on-month, after adjusting for seasonality, and by 18.2% year-on-year. The capital area house price index, calculated by the Housing and Construction Authority, fell by 0.4% month-on-month in December when adjusted for seasonality, but rose by 17.4% year-on-year. The number of purchase agreements registered nationwide fell by 28.4% year-on-year in 2022, while the number of contracts for new construction increased by 27.1% over the same period. The number of homes for sale has increased markedly in recent months, and the average time-to-sale in the capital area was 3.3 months in December, considerably more than the December 2021 figure of 0.8 months.

The CPI rose by 0.85% month-on-month in January, and twelve-month inflation increased to 9.9%, thereby realigning with its July 2022 peak. Inflation excluding housing rose as well, to 8.3%. Underlying inflation was unchanged between December and January, however, at 7% in terms of the average of various measures.

A large share of the increases in January are attributable to price and price list increases set by the public sector, and the price of public services has risen by 7.5% in the past twelve months. Food and beverage prices have continued to rise unabated and are up 10.8% over the same period. A share of the recent price increases is due to the depreciation of the króna. Price cuts due to winter sales pulled in the opposite direction, however, and the effects of the sales were slightly stronger than they were last year.

Recent surveys show that inflation expectations are broadly unchanged between surveys by most measures. According to the Bank's market expectations survey, respondents still expect inflation to measure 4% in two years' time. Corporate executives and households are more pessimistic, however, and expect inflation to fall even more slowly. Executives still expect it to average 4% over the next five years, whereas households expect it to average 5% over the same period. Market agents are more upbeat about the long-term outlook, however. They expect inflation to average 3.5% in the next five years and 3.3% in the next ten years. Their expectations have also fallen marginally between surveys, as has the breakeven inflation rate in the bond market. The five-year breakeven rate five years ahead was 3.6% at the beginning of February, down from an average of 3.9% in November.

According to the updated forecast published in *Monetary Bulletin* on 8 February, the inflation outlook has deteriorated once again. Inflation is projected to average 9.5% in Q1/2023, which is 1 percentage point above the November forecast but in line with the August 2022 forecast. Long-term inflation expectations are broadly unchanged and remain well above the inflation target. It is still considered to have peaked but is now expected to ease considerably more slowly than was forecast in November:

Although pessimism about the global economy has receded, the GDP growth outlook for advanced economies remains poor. GDP growth in trading partner countries is expected to be only 0.6% this year, far below the average of recent decades. Global inflation remains high, although it has receded from last year's peak. It will probably take some time to bring it back to target, as underlying inflation is still high.

In Iceland, GDP growth measured 7.4% over the first nine months of 2022, outpacing the Bank's November forecast. To a large degree, the deviation reflects Statistics Iceland's upward revision of H1 GDP growth. Although indicators suggest that GDP growth eased in Q4, the growth rate for 2022 as a whole has been revised upwards from 5.6% to 7.1% – the fastest calendar-year growth rate since 2007, if the forecast materialises. GDP growth is still expected to lose pace in 2023. It is estimated at 2.6%, slightly below the November forecast. The outlook for the forecast horizon as a whole has also deteriorated marginally.

The new wage agreements are clearly costlier and more front-loaded than was assumed in the Bank's last baseline forecast, and the outcome is similar to that in the alternative scenario from *Monetary Bulletin* 2022/4 providing for larger pay rises. In the last baseline forecast, wages per hour were estimated to have increased by 7.8% between annual averages in 2022 and were projected to rise another 6% in 2023, for a total of 14.3% over the two years combined. They are now estimated to have risen by 8.6% in 2022, followed by 9.4% this year, or 18.8% over the same two-year period.

As before, the economic outlook is highly uncertain. The global economic situation will depend in large part on developments in the war in Ukraine, which unavoidably affects Iceland as well. Added to this is pronounced uncertainty about developments in the wake of the wage agreements, which provide for hefty pay rises at a time of little or no productivity growth, worsening terms of trade, a weakening currency, and less firmly anchored inflation expectations. Under such conditions, it is possible that the falling exchange rate and rising wages will push inflation higher than it has been in the past decade. Moreover, not all wage agreements have been finalised, and pay rises could turn out larger than is currently anticipated. Similarly, if the new wage agreements expiring a year from now are renewed on terms similar to those recently negotiated, wages could rise by more in the latter half of the forecast horizon than is provided for in the baseline.

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 November meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its November meeting to raise interest rates still further. At that time, both observed and underlying inflation had risen, and the economic outlook for 2023 had improved.

Members noted that inflation had gained pace in January, reaching 9.9%, while underlying inflation had remained flat at 7%. Although the housing market had begun to cool and global inflation had eased slightly, inflationary pressures were still pronounced and price increases widespread. Furthermore, the correlation between price increases of CPI subcomponents was growing stronger.

The Committee noted that the inflation outlook had worsened since the MPC's last meeting, and that although inflation had most likely peaked, bringing it back to target would take longer than previously anticipated. It emerged that the deterioration in the outlook stemmed in particular from the recently finalised private sector wage agreements, which entailed considerably larger pay rises than had been assumed in November. Furthermore, the króna had depreciated, and it emerged that the outlook was for a wider positive output gap over the forecast horizon. MPC members noted that this was compounded by the prospect of a more accommodative fiscal stance than had been provided for in the Bank's November forecast, even though the fiscal deficit would narrow this year. Moreover, long-term inflation expectations were still well above target, and the Bank's real rate had declined since the MPC's last meeting.

Members noted that according to the Bank's new macroeconomic forecast, year-2022 GDP growth had measured 7.1%, far above the November forecast and, if the forecast materialised, the strongest single-year GDP growth rate since 2007. The deviation was due mainly to private consumption growth, which had exceeded forecasts. It emerged that GDP growth was set to weaken in 2023, although the labour market was still expected to remain tight.

All members agreed that the Bank's key rate needed to be raised further, and they discussed rate increases ranging from 0.5-1 percentage point. The main arguments discussed centred on the significant worsening of the inflation outlook. Although the bleaker outlook could be traced in part to the initial position, owing to the steep increase in inflation in January, MPC members agreed that the January measurement had little effect on the decision now. What was important was that it would probably take longer than previously assumed to bring inflation back to target, due to steep pay rises and other signs of increased inflationary pressures. Inflation had remained high for some time, and consequently, there was greater risk of it becoming entrenched. It was pointed out that there were few signs that inflation had begun to subside, and the share of CPI components that had risen far in excess of the inflation target in the past year was still growing. Inflation excluding housing was still rising rapidly. Furthermore, the labour market was still considerably tight, and domestic demand was strong. The newly negotiated wage agreements were costlier and more front-loaded than had been assumed at the MPC's last meeting. The Committee was concerned that when large pay rises coincided with a tight labour market, it could lead to wage drift and stronger inflationary pressures. Moreover, not all wage agreements had been finalised, and pay rises therefore could turn out larger than is currently anticipated. Furthermore, the króna had depreciated recently, which would lead to higher imported inflation, all else being equal. This was particularly relevant when inflation was high and inflation expectations less firmly anchored to the target. The impact of a weaker króna and general cost increases could therefore turn out stronger than in the past decade. In the same vein, it was pointed out that this would make it less likely for recent reductions in commodity prices to pass through to prices in Iceland. In addition to this was the prospect that the fiscal stance in the National Budget would be more accommodative than had been provided for in the fiscal budget proposal. Furthermore, the monetary stance had eased between meetings despite the interest rate hike at the Committee's last meeting.

On the other hand, there were clear signs of a slowdown in the housing market, and nominal house prices in greater Reykjavík had fallen marginally. The Bank's policy actions had clearly begun to affect the market; for example, growth in lending to households had lost pace. Furthermore, there were signs of slower private consumption growth, and pessimism among households had grown in the recent term. It was pointed out that underlying inflation had been unchanged in January, although it was too soon to say whether it had peaked.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.5 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 6.5%, the current account rate 6.25%, the seven-day collateralised lending rate 7.25%, and the overnight lending rate 8.25%. All members voted in favour of the Governor's proposal, although Herdís Steingrímsdóttir would have preferred to raise rates by 0.75 percentage points.

It emerged at the meeting that the Committee considered it likely that the monetary stance would have to be tightened even further in the coming term so as to ensure that inflation eases back to 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

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 March 2023.