

14 January 2020

To: Parliamentary Economic Affairs and Trade Committee

From: Katrín Ólafsdóttir, external member, Central Bank of Iceland Monetary Policy Committee

Re: Decisions at Monetary Policy Committee meetings

Press releases and minutes from Monetary Policy Committee (MPC) meetings are published by the Central Bank of Iceland on behalf of the Committee as a whole. In order to make the role of external Committee members more visible, the MPC decided that, once a year, each external member shall submit to Parliament a report in their own name, providing rationale for their decisions during the prior year.

In 2019, the policy interest rate was lowered by a total of 1.5 percentage points, from 4.5% to 3.0%. The main reason for the rate cuts was the slowdown in GDP growth during the year, although developments were broadly in line with the Central Bank's forecasts. The output gap at the beginning of the year is estimated to have closed by now and given way to an output slack, although it is probably not a large one. GDP growth has eased among Iceland's trading partners, and uncertainty about future developments has persisted, not least because of threats of a trade war.

In Iceland, the impact of weaker growth has shown clearly in the labour market, with a rapid rise in unemployment in 2019 and a decline in total hours worked.

At MPC meetings, numerous factors underlie each decision. Below is a brief account of the factors of greatest importance in my decisions at each meeting.

1. Meeting of 4-5 February

By the time of the meeting, the GDP growth forecast for the year had been revised downwards from the previous forecast, to 1.8%. It was clear as well that the global economic outlook was deteriorating. Furthermore, the inflation outlook was deteriorating and inflation expectations were above the target. At this meeting, I voted in favour of the Governor's proposal to keep the policy rate unchanged.

2. Meeting of 18-19 March

At the time of this meeting, amendments to the Rules on Special Reserve Requirements for New Foreign Currency Inflows had taken effect, and the special reserve ratio had been lowered to 0%. It can therefore be said that this was the first meeting at which the Committee did not need to take capital controls into consideration. The economic outlook as presented at the meeting was broadly unchanged since the previous meeting. On the other hand, the labour market situation was uncertain and it was unclear when collective bargaining agreements would be finalised, and on what terms. At this meeting, I voted in favour of the Governor's proposal to keep the policy rate unchanged.

3. Meeting of 20-21 May

By the time of the Committee's May meeting, the so-called Living Standards agreements had been signed and domestic airline WOW Air had been declared insolvent. The global economic outlook had deteriorated and uncertainty had mounted. The new macroeconomic forecast assumed that GDP growth had turned from positive to negative and that inflation expectations had simultaneously moved closer to the target. It appeared that a slack had opened up in the domestic economy. At the meeting, I voted in favour of the Governor's proposal to lower the policy rate by 0.5 percentage points.

4. Meeting of 24-25 June

At the June meeting, inflation was still above target, while inflation expectations were falling back towards the target. Private consumption had turned out stronger than expected, but both imports and exports had contracted. Developments in tourism-generated revenues had proven more favourable than expected. Although the number of tourists visiting Iceland had fallen, average spending per tourist had increased. With lower inflation expectations, the monetary stance had tightened since the previous meeting; therefore, I voted in favour of the Governor's proposal to lower the policy rate by 0.25 percentage points. This was Már Guðmundsson's last meeting as Governor, and at the end of the meeting the Committee thanked him for fruitful collaboration in recent years.

5. Meeting of 26-27 August

This was the first meeting under the leadership of new Governor Ásgeir Jónsson. According to the new macroeconomic forecast, which was presented at the meeting, economic developments had been in line with expectations. Global economic uncertainty remained, GDP growth in Iceland was negligible, and tourist numbers were on the decline. Inflation expectations had fallen since the previous meeting, and the monetary stance had therefore tightened. Because I saw no reason to tighten the monetary stance, I voted in favour of the Governor's proposal to lower the policy rate by 0.25 percentage points.

6. Meeting of 30 September-1 October

At this meeting, it emerged that the economic outlook among Iceland's trading partners was still highly uncertain. Domestic GDP growth continued to lose pace. The outlook was for inflation to fall more rapidly than previously forecast and inflation expectations to continue declining. As a result, the monetary stance had tightened; therefore, I voted in favour of the Governor's proposal to lower the policy rate by 0.25 percentage points.

7. Meeting of 4-5 November

At the November meeting, discussion topics included the continued slide in global GDP growth and increased uncertainty resulting from imminent trade disputes. The labour market was cooling, as unemployment had risen and total hours worked had fallen. Inflation had tapered off, and inflation expectations were at target. It appeared as though the interest rate reductions during the year had been transmitted relatively effectively to the lending terms offered to borrowers. The main argument in favour of a rate cut was that although the GDP growth outlook

was broadly unchanged, uncertainty had increased and was skewed more to the downside. Furthermore, inflation and inflation expectations had fallen since the previous meeting, and the monetary stance had therefore tightened slightly. Based on these considerations, I voted in favour of the Governor's proposal to lower the policy rate by 0.25 percentage points.

8. Meeting of 9-10 December

In December, the global outlook was largely as before. The first figures suggested that Iceland's GDP growth rate for the first nine months of 2019 had been marginally stronger than previously assumed. The inflation outlook was broadly unchanged, and inflation expectations were at target. The monetary stance was therefore largely unchanged. At this meeting, I voted in favour of the Governor's proposal to keep the policy rate unchanged.