CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2023

October
117th 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 2-4 October 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 4 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 23 August 2023.

Financial markets

Since the August meeting, the króna had depreciated by 2.1% in trade-weighted terms. The Central Bank conducted no transactions in the market during the period.

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 2.9%, or 0.3 percentage points higher than just after the announcement of the August interest rate decision. In terms of twelve-month inflation, however, it was 1.2% and had fallen by 0.3 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 August, 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 0.6-0.8 percentage points since the August meeting, and yields on long-term indexed Treasury bonds had risen by 0.5-0.6 percentage points. Average non-indexed mortgage lending rates had risen following the rise in the key rate in August, and average indexed mortgage rates had also risen marginally. Furthermore, non-indexed rates on savings accounts had risen in line with the increase in the key rate in August.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 0.3-0.4 percentage points between meetings, to 6 percentage points versus the euro area and 4.3 percentage points versus the US. The long-term interest rate spread widened by 0.4-0.5 percentage points between meetings, to 2.9 percentage points versus the US and 4.7 percentage points versus Germany. Measures of the risk premium on the Treasury's foreign obligations were broadly unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.8%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 1.2-1.4 percentage points.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by either 0.25 percentage points or 0.5 percentage points, on the grounds that although indicators implied that domestic demand was easing and the housing market had cooled, inflation had increased again, the breakeven inflation rate in the bond market had risen, and long-term inflation expectations were still above target. Furthermore, the labour market was still tight and the real rate would possibly need to be higher given the demand pressures in the domestic economy.

Year-on-year growth in M3 gained pace strongly in August, measuring 13.3%. Part of the increase is probably due to payment made for the sale of a domestic biotech firm to foreign buyers. Year-on-year growth in credit system lending to households has continued to ease, even though indexation on inflation-linked loans has increased. Household lending growth measured 6.1% in August, as compared with the H1/2023 average of over 8%. Year-on-year growth in credit system lending to companies has begun to ease as well, as has net new corporate lending.

The Nasdaq OMXI10 index had fallen by 10.9% between meetings. Turnover in the Main Market totalled 156 b.kr. in Q3/2023, some 31% less than over the same period in 2022.

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 3% this year. This is 0.3 percentage points more than in the OECD's June 2023 forecast but below the average of recent decades. Improved prospects for the US and Japan are a major factor in the forecast, albeit offset by a poorer economic outlook for the eurozone and China. On the other hand, the OECD expects weaker global output growth in 2024, or 2.7% instead of the 2.9% provided for in its June forecast. The OECD projects that G20 inflation will fall from 7.8% in 2022 to 6% in 2023, which is slightly below its June forecast. Furthermore, inflation is projected to taper off to 4.8% in 2024, slightly more than in the June forecast.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 200 b.kr. in the first eight months of 2023, as compared with a deficit of 87 b.kr. at constant exchange rates over the same period in 2022. The year-on-year increase in the goods account deficit is attributable to an 11.6% contraction year-to-date in goods export values, with a decline in all key categories of exports. This, in turn, is due to a year-on-year reduction of 23% in the value of manufactured goods, aluminium products in particular, together with a sizeable contraction in marine product export values, owing to a downturn in capelin exports. At the same time, the value of imported goods rose by 5% at constant exchange rates, and growth remains positive in all key subcategories of imports, apart from commodities and operational inputs. Increased value of imported goods stems mainly from price increases, however, while volume remains broadly unchanged between years.

Global aluminium prices rose by 5.9% after the MPC's August meeting, to around 2,100 US dollars per tonne, which is 2% higher than in October 2022 but well below the level seen during the months following the invasion of Ukraine. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products fell marginally in August but were up by about 5% year-on-year over the first eight months of 2023. The global price of Brent crude rose by 8.2% between MPC meetings, to 91 US dollars per barrel at the time of the October meeting. This is about 2.3% below the price in October 2022. On the other hand, other global commodity prices have fallen since the August meeting.

The real exchange rate in terms of relative consumer prices rose by 2% month-on-month in August, when it was 12.5% above its 25-year average and 2.8% higher than in December 2019. In the first eight months of 2023, it was down by 0.9% compared with the same period in 2022, as the nominal exchange rate of the króna was 3.8% lower and inflation in Iceland was 3.1 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland at the end of August, GDP growth measured 4.5% in Q2, outpacing the forecast in the August *Monetary Bulletin*. The deviation is due largely to private consumption, which grew marginally instead of contracting as expected, and to a larger contribution of inventory changes to GDP. Growth in domestic demand weakened somewhat during the quarter, after growing strongly in the quarters beforehand, and measured 1.4% year-on-year, as compared with 4% in Q1 and 6.6% in 2022. The contribution of net trade to output growth was positive by 3.2 percentage points, which was in line with the August forecast and attributable to the tourism-generated increase in export revenues.

GDP growth measured 5.8% in H1/2023, owing mainly to favourable external trade and an increase in private consumption and gross capital formation. According to figures from Statistics Iceland, most subcomponents of domestic demand deviated slightly from the Bank's August forecast. The deviations are due in large part to revisions of previously published figures for 2022, as GDP growth for the year proved stronger than previously estimated. Exports grew by 9% in H1/2023 and imports by 1.6%; therefore, the contribution from net trade was positive by 3.2 percentage points, in line with the last forecast.

The main indicators of developments in private consumption in Q3 suggest a slight slowdown in household demand. Payment card turnover contracted marginally year-on-year in July and August, and according to the Gallup Consumer Confidence Index, pessimism increased among households in September, when the index declined between months.

According to the fiscal budget proposal for 2024, the Treasury is expected to show a deficit of 46 b.kr., or 1% of estimated GDP, which represents an improvement of 5 b.kr. between years. Furthermore, the Treasury primary balance is projected to be positive in 2024 by 28 b.kr., or 0.6% of GDP, which is a smaller surplus than is forecast for 2023. This is due in part to high inflation in 2023, which shows earlier on the revenues side than on the expenditures side. It has emerged that the output gap is projected to narrow in 2024 and that, in view of this and including the effects of one-off items, the fiscal stance is expected to tighten by 0.3% of GDP during the year.

According to the results of Gallup's autumn survey, conducted in August and September among Iceland's 400 largest firms, respondents' assessment of the current economic situation was somewhat more positive than in the summer survey. Their expectations six months ahead were also more positive, as nearly 28% of executives expected the economic situation to improve in six months' time, a somewhat larger share than in the summer. About 45% expected the economic situation to be unchanged over the next six months. Nevertheless, executives were somewhat more pessimistic about both domestic and foreign demand than in the summer survey, particularly those in the financial and insurance sector and in transport, transit, and tourism.

Prospects for firms' operating performance had improved relative to the spring survey, with nearly one-third of respondents expecting larger profits in 2023 than in 2022, while 36% expected their profits to shrink. Executives' expectations about profit margins in the next six months had improved slightly since the last survey: 28% expected profits to increase, while one-third expected them to decline. The outlook for investment during the year had improved significantly between surveys, as one-fifth of executives expected investment to be stronger than in 2022, whereas 55% expected no change year-on-year.

According to the seasonally adjusted survey results, labour demand remains robust, although it has begun to ease. The share of firms planning to recruit workers net of those planning to downsize was therefore positive by 16 percentage points. This difference has been broadly unchanged in 2023 to date, although it was 12 percentage points smaller than at the same time in 2022. Nevertheless, it was still somewhat above its historical average. Similarly, firms' staffing problems eased, even though a majority of them are still operating at full capacity. About 36% of executives considered themselves short-staffed, which is 7 percentage points lower than in the previous survey but still above the historical average. On the other hand, 58% of respondents were of the view that their firms would have difficulty responding to an unexpected increase in demand. This share has been at or close to its historical average in 2023 to date. The survey indicates persistent capacity constraints in most sectors of the economy, apart from transport, transit, and tourism.

The wage index rose by 0.3% month-on-month in August and by 10.8% year-on-year. Real wages were 2.8% higher during the month than at the same time in 2022.

Statistics Iceland's nationwide house price index, published in September, rose by 0.2% month-on-month when adjusted for seasonality, and by 2.3% year-on-year. The capital area house price index, calculated by the Housing and Construction Authority, rose by 0.5% month-on-month in August when adjusted for seasonality, and by 2% year-on-year. The number of purchase agreements registered nationwide fell by 22.4% year-on-year in the first eight months of 2023, and the number of contracts for new construction declined by 36.4% over the same period. The average time-to-sale in the capital area was 5.5 months in August, considerably more than the August 2022 figure of 1.8 months, and the number of homes for sale has continued to increase markedly in recent months.

The consumer price index (CPI) rose by 0.35% month-on-month in September, raising twelve-month inflation to 8%. Inflation excluding housing rose as well, to 7.7%. Underlying inflation was 6.5% according to the average of various measures. It therefore fell marginally between meetings and has fallen by 1 percentage point from its April 2023 peak.

Movements in the CPI in September were due mainly to end-of-sale effects, higher owner-occupied housing costs, and lower airfares. The overall effects of summer sales on inflation were similar to those in 2022, as retailers increased prices over and above the impact of the sales. The cost of owner-occupied housing rose by 0.9% month-on-month, after falling for two months in a row. The increase was due mainly to higher condominium prices in greater Reykjavík. Food prices also kept rising in September and are up 12.4% in the past twelve months.

According to Gallup's autumn survey, businesses' inflation expectations one and two years ahead declined, and executives now expect inflation to measure 6% in two years' time. Two-year inflation expectations remained unchanged at 5%, however. Both households' and businesses' long-term inflation expectations fell between surveys: households expect inflation to average 5% over the next five years, and businesses expect it to average 4%. The ten-year breakeven inflation rate in the bond market held more or less unchanged from the time of the August meeting, measuring 4% at the beginning of October. The five-year breakeven rate five years ahead had fallen, however, to just below 3.5%.

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 discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its August meeting to raise interest rates still further. At that time, the long-term inflation outlook was broadly unchanged, although the short-term outlook had improved and the labour market remained tight.

The Committee also discussed monetary policy instruments in general and the experience gained from applying different instruments in recent years. In this context, the MPC discussed the Bank's liquidity management, various market-based measures, the interest rate tool, and the transmission of monetary policy. Members discussed monetary policy transmission over various periods, as well as the times when failures had apparently emerged. An assessment of the monetary policy transmission mechanism with various methods was then presented, and Committee members discussed that the monetary policy transmission had been effective in the recent term. They also discussed the interactions between monetary policy and financial stability, and the experience gained in recent years from applying macroprudential tools in the context of monetary policy instruments.

They noted that on the whole, economic developments had been consistent with the assessment made by the MPC at its last meeting. As the Committee had expected, inflation had risen again, measuring 8% in September. It emerged that inflation excluding housing had risen as well, while underlying inflation had tapered off slightly. Members noted that there were signs that price increases were somewhat less frequent than before, and less widespread. They also observed that even if inflation expectations were still too high they had fallen by some measures.

The MPC discussed that GDP had measured 5.8% in H1/2023, as compared with just over 7% in 2022. Economic activity had therefore lost pace somewhat, and it emerged that indicators implied that growth in domestic demand had eased even further in Q3. On the other hand, the labour market and the economy as a whole remained rather tight. The Bank's real rate had risen in 2023 to date, however, and Committee members agreed that the impact of policy rate hikes had started to come more clearly to the fore.

The Committee discussed the possibility of keeping interest rates unchanged or raising them by 0.25 or 0.50 percentage points. The main arguments expressed in favour of keeping rates unchanged were that growth in economic activity had eased and indicators implied more clearly than before that private consumption growth had also tapered off. Payment card turnover had continued to shrink year-on-year, and import growth had abated. It emerged at the meeting that although inflation remained high, it had receded since the spring and price increases had slowed recently. Underlying inflation in terms of the average of various measures had also declined marginally since the Committee's August meeting. It emerged in the discussion that the task outlined by the Committee in the spring – to raise interest rates steeply so as to get results sooner – had been achieved. The real rate had risen somewhat recently which had among other things resulted in the rise of household savings. Furthermore, the effects of higher real rates had yet to emerge more clearly in the near future. Monetary policy transmission had been successful, and deposit and lending rates had increased in the recent term. It was pointed out that the real rates available to companies were somewhat higher than real rates in terms of the average of various measures, and that it could be assumed that under current circumstances, the monetary stance was now sufficient by that measure. It was also noted that it was likely that the monetary stance would continue to tighten in the coming term due to declining inflation, and therefore it was not clear whether interest rates needed to be raised further.

The main arguments in favour of raising rates were that the labour market was still tight and that indicators of reduced economic activity were still weak. According to preliminary national accounts figures, the output gap appears to have been wider in 2022 and H1/2023 than was anticipated at the last MPC meeting, perhaps necessitating higher interest rates. As a result, there was considerable uncertainty about whether the monetary stance was sufficient to bring inflation back to target within an acceptable time frame. It was also pointed out that there was greater risk in tightening the monetary stance too little than in tightening it too much, as real rates had only recently turned positive and it would not take much to push them lower once again. There were few indicators that the monetary stance was too tight, and therefore some risk entailed in concluding the monetary tightening phase too soon. In view of this, there were concerns that inflation expectations had become less firmly anchored, which could mean that the monetary stance would have to be that much tighter. The MPC also discussed that the króna had depreciated recently, which could be cause for concern if imported inflation should rise more than it might otherwise. It was pointed out that there was still a strong likelihood of second-round effects of cost increases on the price level.

It emerged at the meeting that at that point in time, there was some uncertainty about economic developments and about whether the current monetary stance was sufficient. Indicators implied that domestic economic activity had begun to ease by some measures, but that by other measures it had increased. Given that the overall situation had not changed appreciably since the last meeting, it could be appropriate to await further developments, as the Bank's new macroeconomic and inflation forecast would be available by the time of the Committee's next meeting.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would be 9.25%, the current account rate 9%, the seven-day collateralised lending rate 10%, and the overnight lending rate 11%.

Ásgeir Jónsson, Rannveig Sigurdardóttir, and Gunnar Jakobsson voted in favour of the proposal. Ásgerdur Ósk Pétursdóttir also voted in favour of the proposal but would have preferred to raise rates by 0.25 percentage points. Herdís Steingrímsdóttir voted against the proposal, voting instead to raise rates by 0.25 percentage points. She was of the opinion that indicators of a slowdown in economic activity were not convincing enough. She emphasised that demand pressures in the labour market remained strong and that even though the monetary stance had tightened and the real rate had recently turned positive, she was concerned that the policy stance was not sufficient to bring inflation back to target within an acceptable time frame. Ásgerdur concurred with these views but nevertheless thought it was possible to wait and see, as the MPC's next meeting would take place soon and the Bank's new macroeconomic forecast would then be available.

In the Committee's opinion, near-term monetary policy will be determined by developments in economic activity, inflation, and inflation expectations.

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

Herdís Steingrímsdóttir, Associate Professor, external member

Ásgerdur Ósk Pétursdóttir, Assistant 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 November 2023.