7 January 2021

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.

A number of events in 2020 were arguably unprecedented in Icelandic history – and therefore in Iceland's economic history. The coronavirus had a profound impact on the domestic economy, and economic policy responses were unparalleled. At the start of the year, the outlook was for GDP to be weaker than in 2019. It was in the latter part of Q1/2020, when COVID-19 had arrived in Iceland, that it became clear that a massive economic contraction lay ahead. Furthermore, the economic situation was highly uncertain, as it was impossible to project how the pandemic would develop in Iceland or in other countries.

Robust research carried out in recent years and the lessons learned from the banking crisis of 2008 have greatly expanded existing knowledge about both the repercussions of economic shocks and the economic policy methods that are most helpful in mitigating the impact of such shocks. With a crisis of the magnitude of the COVID-19 pandemic, it pays to take aggressive, decisive, and timely action and to use all of the instruments in the policy toolbox. I think it is safe to say that this was the guiding principle behind the MPC's decisions over the course of the year. Since the pandemic struck, the Committee's decisions have been in the direction of easing the monetary stance, both with interest rate reductions equivalent to 2.25 percentage points and with other policy instruments such as reduced minimum reserve requirements and announcements of plans to purchase Treasury bonds. One of the key reasons it was possible to use the interest rate tool as much as has been done is that inflation expectations have remained at target, even though the exchange rate has fallen and inflation has risen above the target.

Although the outlook has improved somewhat in the past few months with the arrival of vaccines, it is clear that the economic crisis is far from over. The question of when and how GDP growth picks up again remains unanswered. Furthermore, the crisis affects different groups in society to differing degrees. This can be seen not least in unemployment, which is at a historical high and affects some groups much more than others, with young people and immigrants faring the worst. It can be said that unemployment and measures to reduce it will be Iceland's most important economic challenge in years to come.

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 3-4 February

It emerged at the February meeting that the domestic GDP growth outlook had worsened. Real interest rates had risen, thereby tightening the monetary stance. At that meeting, the Governor proposed that the Bank's key rate be lowered by 0.25 percentage points. I voted in favour of that proposal.

2. Meeting of 9 March

The MPC's regular meeting was moved forwards because COVID-19 cases had been diagnosed in Iceland by this time. In view of the marked deterioration in the economic outlook, the Governor proposed that the Bank's key rate be lowered by 0.50 percentage points. I voted in favour of the proposal. At that time, the MPC also decided to lower the commercial banks' minimum reserve requirements.

3. Meeting of 17 March

An extraordinary meeting was held on 17 March, in view of the imposition of the ban on public gatherings. The economic outlook, already bleak, had worsened still further. At that meeting, the Governor proposed that the Bank's key rate be lowered by 0.50 percentage points. I voted in favour of the proposal.

4. Meeting of 18-19 May

It was decided to lower interest rates again, this time by 0.75 percentage points, bringing the key rate to 1%. Available at the time of the meeting was the Bank's new macroeconomic forecast, which assumed that GDP would contract by 8% and tourist visits to Iceland by 80%. The forecast also assumed that unemployment for 2020 as a whole would measure 9%. Even though the króna had depreciated, the outlook was still for inflation to be at target. Because of this, I considered it appropriate to support the Governor's proposal to lower interest rates decisively at that time.

5. Meeting of 24-25 August

The Central Bank's new macroeconomic and inflation forecast, introduced at the meeting, assumed a slightly smaller contraction in GDP but a somewhat higher unemployment rate. The first half of 2020 turned out a bit more favourable than had been projected, but the outlook was for a somewhat weaker second half. No change in interest rates was considered necessary at the time, and I supported the Governor's proposal to this effect.

6. Meeting of 5-6 October

A short time had passed since the previous meeting, and little new information had emerged; therefore, the outlook was considered to be broadly unchanged since the August meeting. As a result, I voted in favour of the Governor's proposal to keep the policy rate unchanged.

7. Meeting of 16-17 November

The Central Bank's new forecast was available at the time of the November meeting. According to that forecast, the GDP growth outlook had deteriorated, but foreign exchange market volatility had eased. The króna had appreciated since the previous MPC meeting, and inflation expectations had remained at target. I therefore considered it appropriate to lower interest rates even though headline inflation was above the target. Consequently, I voted in favour of the Governor's proposal to lower the key rate by 0.25 percentage points, to 0.75%.

In addition to these meetings, where the Committee took interest rate decisions, was an extraordinary meeting held on 22 March, which merits a separate discussion.

At this extraordinary meeting, it was decided to respond to the prospect of an increased fiscal deficit and its potential impact on monetary policy. A larger deficit could push Treasury bond yields upwards, which could disrupt normal monetary policy transmission. The Committee therefore decided that it would begin direct purchases of Treasury bonds in the secondary market. This additional instrument in the policy toolbox is designed to prevent an abnormal increase in long-term interest rates. The Bank has bought some Treasury bonds in recent months. How much this policy instrument will be needed will depend on Treasury bond issuance and the impact such issuance has on interest rates.