CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2023

March
114th meeting
Published 5 April 2023

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 20 and 21 March 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 22 March.

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 8 February 2023.

Financial markets

Since the February meeting, the króna had appreciated by 1.5% 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 eased since the February meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -0.5%, or 0.3 percentage points lower than just after the announcement of the February interest rate decision. In terms of twelve-month inflation, it had fallen by 0.3 percentage points over the same period, to -3.4%.

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 February, with turnover in the market totalling 3 b.kr. between meetings. Yields on long-term nominal Treasury bonds had risen by as much as 0.6 percentage points since the February meeting, while yields on long-term indexed Treasury bonds had only risen marginally. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in February, and average indexed mortgage rates had risen marginally.

In terms of three-month interbank rates, the short-term interest rate differential versus the euro area had widened by 0.5 percentage points between meetings, to 4.6 percentage points, while the spread versus the US had widened by 0.6 percentage points, to 2.5 percentage points. At the same time, the long-term interest rate differential versus Germany had widened by 0.7 percentage points between meetings, to 5 percentage points, whereas the spread versus the US had widened by 0.7 percentage points, to 3.7 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 0.8%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 1.2 percentage points.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 0.75 percentage points, as inflation had picked up, price increases were widespread, and underlying inflationary pressures were strong. Furthermore, the breakeven inflation rate in the bond market had increased and the Bank's real rate had fallen. Moreover, the labour market was tight and domestic demand could prove more resilient than expected. Analysts mentioned, however, that the króna had strengthened recently and that higher interest rates and tighter borrower-based measures had cooled the housing market.

Growth in M3 had eased slightly in H2/2022 but measured 9.2% in January 2023. At the same time, annual growth in credit system lending to households was estimated at just under 10%. Year-on-year growth was still strong, but net new lending to households had begun to ease. Annual growth in corporate lending had continued to gain pace, measuring about 14.8% in January.

The Nasdaq OMXI10 index had fallen by 4.8% between meetings. Turnover in the Main Market totalled 171 b.kr. in the first two months of 2023, just over 3% less than during the same period in 2022.

Global economy and external trade

According to the Organisation for Economic Cooperation and Development's (OECD) mid-March forecast, global GDP growth is set to measure 2.6% this year and 2.9% in 2024. This is 0.4 and 0.2 percentage points more, respectively, than in the OECD's November 2022 forecast, but is still below the average of recent decades. Global economic activity has proven more robust year-to-date than the OECD had expected in November, and labour market conditions have remained favourable, supporting private consumption growth. Furthermore, expectations about the economic situation have improved, and leading indicators suggest that economic activity has gained pace in major advanced economies. A major factor in this is the slide in global energy and commodity prices, which contributes to the decline in global inflation and has a positive effect on households' purchasing power. In addition, the relaxation of public health measures in China and the ensuing improvement in the economic outlook there will have a positive impact on the global economy. On the other hand, financial conditions have deteriorated in line with the continued rise in central bank interest rates. The OECD expects inflation in the G20 countries to ease from last year's 8.1% to 5.9% this year, slightly below its November forecast. In addition, inflation is projected to fall to 4.5% in 2024, or 0.9 percentage points lower than in the previous forecast.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 28 b.kr. in the first two months of 2023, as compared with a deficit of 10 b.kr. at constant exchange rates over the same five-month period in 2022. Imported goods values increased by 13% at constant exchange rates in the first two months of 2023, and all key subcomponents of imports apart from transport equipment are still growing markedly. At the same time, exported goods values rose by around 2% at constant exchange rates, due to the offsetting effects of higher marine and industrial goods export values and lower aluminium and ferrosilicon values, which declined because of falling prices.

Global aluminium prices fell by 10% after the MPC's February meeting, to just over 2,200 US dollars per tonne, about a third below the March 2022 price. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products fell by 0.5% month-on-month in January but had risen by 12% year-on-year. The global price of Brent crude fell by 12% between MPC meetings, to 74 US dollars per barrel by the time of the March meeting, about 36% below the March 2022 price. The recent decline in oil prices is due largely to increased global economic uncertainty following the collapse of a few financial institutions in the US earlier in March.

The real exchange rate in terms of relative consumer prices rose by 1.6% month-on-month in January, when it was 3.1% above its 25-year average but 5.8% lower than in December 2019. In the first two months of 2023, it was down by 3.6% compared with the same period in 2022, as the nominal exchange rate of the króna was 5.5% lower and inflation in Iceland was 2.2 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland at the end of February, GDP growth measured 3.1% in Q4/2022, somewhat below the forecast in the February *Monetary Bulletin*. For the most part, the deviation is due to the fact that Statistics Iceland no longer includes intellectual property with services trade, whereas if it had been included, GDP growth would have measured 6.7%, thereby exceeding the forecast. Domestic demand remained relatively strong during the quarter, even though the pace eased slightly. National expenditure increased by 3.4% in Q4 and was therefore stronger than forecast, if public consumption and residential investment are excluded.

GDP growth measured 6.4% in 2022, as compared with the Bank's forecast of 7.1%, but it would have measured 6.6% if intellectual property had been included. Last year's GDP growth is attributable to a strong increase in private consumption and investment. According to Statistics Iceland's figures, private consumption growth was in line with the February forecast and investment growth somewhat above it. Exports were up 20.6% year-on-year and imports by 19.7%, and the contribution from net trade was therefore negative by 0.1 percentage points.

Key indicators of developments in private consumption in Q1/2023 suggest continued strong demand. Year-on-year growth in payment card turnover was robust, exceeding expectations. Households are still relatively pessimistic according to the Gallup Consumer Confidence Index, which averaged 96.5 points in January and February. Nevertheless, they are slightly less pessimistic than in Q4/2022, when the index averaged 93.7 points.

According to the results of Gallup's spring survey, conducted in February and March among Iceland's 400 largest firms, respondents' attitudes towards the current economic situation were slightly more negative than in the winter survey. Their expectations six months ahead were also negative, albeit less so than in the winter, as just under 28% of executives expected the economic situation to improve in six months' time, a somewhat larger share than in the winter. Nearly 35% of executives expected economic conditions to deteriorate in the next six months. Executives were marginally more optimistic about domestic demand and far more optimistic about foreign demand than in the winter survey, particularly those in miscellaneous specialised services and retail and wholesale trade.

Companies' earnings prospects have deteriorated since the autumn survey, with only a fourth of executives expecting this year's profits to exceed those in 2022, while a third of them expected profits to be lower this year. Some 32% of firms saw their margins contract in the previous six months, while

26% of firms' margins increased. Executives' expectations about margins in the next six months had also worsened, with a third of respondents expecting margins to contract over the period and another 44% expecting them to remain unchanged. Furthermore, the number of executives expecting to invest more this year than in 2022 declined between surveys, although 52% of respondents expect their investment to remain unchanged year-on-year.

The seasonally adjusted results of Gallup's spring survey show that firms still expect to recruit large numbers of workers, although they have scaled down their plans since the previous survey. The balance of opinion on staffing plans (i.e., firms planning to recruit as compared with those planning redundancies) was positive by 18 percentage points, whereas it had been positive by 28 percentage points in the winter survey. Nevertheless, it was still a full 10 percentage points above its historical average. About 44% of executives considered themselves short-staffed, a somewhat smaller share than in the previous survey but still large in historical context. The share of companies operating at close to full capacity rose between surveys, though, to 58%, and is therefore near its historical peak of 60%.

The wage index rose by 0.2% month-on-month in January and by 8.6% year-on-year, and real wages were 1.3% lower during the month than at the same time in 2022. According to preliminary figures from Statistics Iceland, the wage share (wages and related expenses relative to gross factor income) was 59.2% in 2022, or 1.2 percentage points lower than in 2021 and 0.5 percentage points below the twenty-year average. Statistics Iceland revised salaries and related expenses downwards, mostly in 2020 and 2021; therefore, the increase in 2022 was somewhat smaller than had been assumed in the Bank's February forecast.

Statistics Iceland's nationwide house price index, published in late February, declined 0.2% month-on-month when adjusted for seasonality, but rose 15.9% year-on-year. The capital area house price index, calculated by the Housing and Construction Authority, was flat month-on-month in January when adjusted for seasonality, but rose by 14.9% year-on-year. The number of purchase agreements registered nationwide fell by 42% year-on-year in January, while the number of contracts for new construction declined by nearly 62% over the same period. The average time-to-sale in the capital area was 4.2 months in January, considerably more than the January 2022 figure of 0.8 months, as the number of homes for sale has increased significantly in recent months.

The CPI rose by 1.39% month-on-month in February, and twelve-month inflation increased to 10.2%, its highest since September 2009. Inflation excluding housing also rose in February, to 8.9%. The difference between inflation including and excluding housing has shrunk recently. Underlying inflation also increased between months, to 7.2% according to the average of various measures.

As is customary at this time of year, end-of-sale effects were discernible in February, and the price of clothing, footwear, furniture, and housewares rose. Furniture and housewares prices rose well in excess of end-of-sale effects. Food prices continued to rise and are now more than 12% higher than they were a year ago. The price of various subcomponents of services has increased as well, and private services prices are now up 7.6% year-on-year. Price increases were therefore very widely distributed in February.

Households' and businesses' two-year inflation expectations were unchanged, according to Gallup's spring survey. Corporate executives expect inflation to measure 5% in two years' time, while households expect it to measure 6%. Businesses' long-term inflation expectations were unchanged as well, at 4%, whereas households' long-term expectations rose, and they now expect inflation to average 6% over the next five years. The breakeven inflation rate in the bond market had risen since the Committee's February meeting, and the five-year breakeven rate five years ahead was around 3.7% in mid-March.

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 February meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its February meeting to raise interest rates still further. At that time, inflation had risen and the inflation outlook had continued to deteriorate. The bleaker outlook stemmed mainly from the recently finalised private sector wage agreements, which entail considerably larger pay rises than previously assumed, and the prospect of a larger positive output gap and a more accommodative fiscal stance.

Committee members noted that inflationary pressures were still growing and price increases were becoming ever more widespread. Headline inflation was currently 10.2%, and underlying inflation was 7.2%. Moreover, long-term inflation expectations were still well above target, and the Bank's real rate had declined since the MPC's last meeting. The Committee discussed the outlook for inflation, which was set to be higher in the near future than had been forecast in February, even though the housing market had cooled.

Members noted that GDP growth had been strong in 2022, and well above the level the economy could sustain in the long run. Furthermore, domestic demand had grown more than was projected in February, and indicators implied that it was stronger at the beginning of 2023 than had previously been anticipated. Furthermore, the labour market was tight.

All members agreed that the Bank's key rate needed to be raised further, and they discussed rate increases ranging from 0.75-1 percentage point. The main arguments expressed were that inflationary pressures were still considerable and the domestic economy strong. Domestic demand had been more resilient than expected, and large pay rises and tension in the labour market manifested themselves in increased cost pressures. Committee members agreed that the concerns expressed at the February meeting, which centred on the inflationary impact of wage agreements and the depreciation of the króna at the beginning of the year, had apparently materialised. It seemed that a large proportion of the increased cost pressures had been passed directly through to the price level, and there was the risk that this would continue in coming months. Given the strength of overall demand, it was possible that last year's decline in global oil and commodity prices and the reduction in shipping costs would be less likely to lead to lower prices in Iceland. Furthermore, inflation was still on the rise in many trading partner countries. It emerged that growth in credit system lending to businesses was still gaining pace in spite of interest rate hikes, and that the majority of the loans bore variable interest rates. Nominal year-on-year growth in total credit system lending was therefore still strong even though net new lending to households had lost pace. The MPC also discussed the fiscal stance and the forthcoming fiscal plan, but as had emerged at the February meeting, the outlook was still for a more accommodative fiscal stance than had previously been assumed. As a result, the MPC considered it apparent that few factors were in place at present that would dampen the strength of the domestic economy. However, housing market activity had slowed down, and it was clear that the Bank's actions affected the market. Members also discussed the past few weeks' unrest in international financial markets. They noted that poorer financial conditions could accelerate the downturn in economic activity and that inflation could therefore fall faster than was currently projected. The Committee was therefore of the view that the global economic outlook had grown more uncertain.

In the Committee's opinion, it was vital to make discernible progress quickly, given how widespread inflation was, how high inflation expectations were, and how little time there was until the next wage agreements. Members therefore considered it crucial to ensure that inflation would fall swiftly and reliably in the near future, even though the measures taken could have a substantial impact on economic activity. It was essential to push back against the second-round effects of cost increases on the price level that now appeared to have emerged, and to ensure that the monetary stance would tighten quickly.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 1 percentage point. The Bank's key rate (the seven-day term deposit rate) would be 7.5%, the current account rate 7.25%, the seven-day collateralised lending rate 8.25%, and the overnight lending rate 9.25%. All Committee members voted in favour of the proposal.

Members agreed that under these circumstances, it was important to prevent a wage-price spiral, particularly in view of the strong demand pressures in the economy and the upcoming wage negotiations. The MPC would apply its policy instruments so as to ensure a better balanced economy and bring inflation back to target.

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 24 May 2023.