The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 2020 (99th meeting)

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and the premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each decision. The votes of individual Committee members are also included in the minutes.

The following are the minutes of the MPC meeting held on 16 and 17 November 2020, 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 18 November. In addition, the Committee's updated rules of procedure were approved at the meeting.

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 last meeting, on 7 October 2020, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2020/4 on 18 November.

Financial markets

Since the October meeting, the króna had depreciated by 0.8% in trade-weighted terms. Over this same period it fell by 0.8% against the pound sterling but rose by 0.8% against the euro and 1.5% against the US dollar. Between meetings, the Bank sold foreign currency in the amount of 275 million euros (45.1 b.kr.), including 90 million euros sold under the regular sales programme. The Bank's transactions accounted for 61% of total foreign exchange market turnover for the period.

In terms of the Central Bank's real rate, the monetary stance had eased slightly since the MPC's October meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -2.1%, or 0.2 percentage points lower than just after the announcement of the October interest rate decision. In terms of twelve-month inflation, it was -2.5% and had fallen by 0.1 percentage points between meetings.

Interest rates in the interbank market for krónur were virtually unchanged between meetings, and there was no turnover in the interbank market during that period. Yields on long-term nominal Treasury bonds had risen by 0.2 percentage points since the October meeting, and yields on long-term indexed Treasury bonds had risen by 0.3 percentage points. Average mortgage lending rates had held broadly unchanged between meetings, however.

In terms of three-month interbank rates, the interest rate differential was virtually unchanged between meetings, at 2 percentage points versus the euro area and 1.3 percentage points versus the US. The long-term interest rate spread versus Germany had widened by 0.2 percentage points, to 3.6 percentage points, while the spread versus the US was unchanged at 2.2 percentage points. Measures of the risk premium on the Treasury's foreign obligations were more or less unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.6%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.7-0.8 percentage points.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged, noting that even though inflation had risen above the target, it was expected to ease over the course of 2021, all else being equal. Furthermore, analysts stressed the necessity of continuing to ensure that lower interest rates would be transmitted to households and businesses, but they considered it more effective to do so through Central Bank bond purchases than through further interest rate cuts.

According to the Central Bank's quarterly market expectations survey, conducted in early November, respondents expected the Central Bank's key interest rate to remain unchanged at 1% in Q4/2020 and until the end of 2021, and then begin to rise. This represents a change from the survey taken in August, when respondents expected that the key rate would be lowered by 0.25 percentage points in Q4 and remain unchanged at 0.75% until Q3/2021. A majority of respondents considered the monetary stance appropriate at present, or 58%, as compared with 49% in the last survey. The share of respondents who considered the stance too loose declined. The share who considered the monetary stance too tight was about the same as in the last survey, at just under one-third.

Annual growth in M3 has gained pace as the year has progressed, measuring 15.2% in September, adjusted for the deposits of the failed financial institutions. Growth in credit system lending to domestic borrowers lost pace over the course of 2019, but annual growth has been relatively stable at around 4-5% thus far in 2020. Household lending grew by 7.5% year-on-year in September, while corporate lending grew by 1%.

The Nasdaq OMXI10 index had risen by 15.6% between meetings. Turnover in the Main Market totalled 460 b.kr. in the first ten months of 2020, some 7% less than over the same period in 2019.

Global economy and external trade

According to the International Monetary Fund's (IMF) mid-October forecast, global GDP growth is projected to contract by 4.4% this year, or 0.8 percentage points less than was forecast in June. The revision is due to an improved outlook for advanced economies, which in turn is due primarily to a smaller Q2 contraction in the US and the eurozone than had previously been expected. GDP growth in China has also rebounded more quickly than expected, although the outlook is poorer for other emerging market economies, India in particular, and a slightly larger contraction is now forecast for emerging and developing economies as a whole. For 2021, global GDP growth is projected at 5.2%, or 0.2 percentage points less than was forecast in June. Global economic uncertainty therefore remains significant, however, and developments will depend on how successful efforts to control the COVID-19 pandemic prove to be. Global GDP growth could turn out nearly 3 percentage points weaker in 2021, according to the IMF, if the pandemic proves more persistent than is assumed in the baseline forecast. On the other hand, it could be ½ a percentage point stronger if efforts to control the pandemic are more successful.

Iceland's goods account deficit totalled 66 b.kr. in the first ten months of 2020, at constant exchange rates. The deficit over the same period in 2019 was 113 b.kr., also at constant exchange rates. The smaller deficit now is due in particular to a large contraction in import values in 2020 to date, although aircraft exports in January 2019 also affected the comparison. Excluding ships and aircraft, the goods account showed a deficit of 58 b.kr. in the first ten months of 2020, as opposed to a 124 b.kr. deficit over the same period in 2019. Import values excluding ships and aircraft have contracted by nearly 15% year-on-year in the past three months, as opposed to a contraction of 20% by the same measure at the time of the MPC's last meeting. The main difference is a weaker contraction in imports of commodities and operational inputs, as well as fuels and transport equipment. Export values excluding ships and aircraft contracted by 12% year-on-year in the first ten months of 2020, particularly to include manufactured goods, although marine product export values fell by 10% at constant exchange rates.

Global aluminium prices had risen by nearly 13% since the MPC's October meeting and were roughly 13% higher than in mid-November 2019. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 0.9% year-on-year in the first nine months of 2020. Global Brent crude prices measured about 44 US dollars per barrel at the time of the November meeting, nearly 3% higher than at the October meeting. However, oil prices were still about one-third lower at the time of the November meeting than in mid-November 2019 and at year-end 2019.

The real exchange rate in terms of relative consumer prices fell by 0.4% month-on-month in October, when it was 3.7% below its 25-year average and 12.7% below its end-2019 level. In the first ten months of 2020, it was down by 7.8% compared with the same period in 2019, as the nominal exchange rate of the króna was 9.6% lower and inflation in Iceland was 1.8 percentage points above the trading partner average.

Domestic economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked declined by 3.7% year-on-year in Q3/2020, with the number of employed falling by 1.3% and average hours worked by 2.4%. The survey indicates that total hours rose considerably between Q2 and Q3, after a steep decline between Q1 and Q2. According to the pay-as-you-earn (PAYE) register, job numbers also rose during the summer, but much less than LFS figures suggest. For example, the number of wage-earners was still 5.7% lower in Q3/2020 than in the same quarter of 2019. Both the LFS and data from the PAYE register indicate that job numbers declined again in September, when economic activity started to slide once more.

Seasonally adjusted LFS measurements indicate that labour participation rose markedly and that the employment rate rose as well in Q3, after a steep drop in Q2. At the same time, the survey-based unemployment rate rose by 0.7 percentage points, to 5.8%. The seasonally adjusted registered unemployment rate excluding workers receiving part-time unemployment benefits has risen much more, however. In October, it measured 10.1%, its highest since measurements were introduced in 1957.

Year-on-year population growth measured 1.4% in Q3, including 0.7 percentage points due to immigration of foreign nationals. Although growth in the foreign labour force has slowed in the past two years, it has slowed even more sharply since the pandemic struck. However, net migration was positive in Q3, whereas it was negative in the quarter beforehand.

The general wage index rose by 0.5% between quarters in Q3, and by 6.5% year-on-year. Real wages were 4.1% higher in Q3 than in the same quarter of 2019.

After a rebound during the summer, indicators of private consumption began to suggest in late Q3 and early Q4 that the rebound was losing pace, in tandem with rising infection rates and tightened public health measures. Payment card turnover was down 12% year-on-year in October: card use within Iceland was virtually unchanged, while turnover abroad declined by more than half. Information from the Icelandic Centre for Retail Studies shows that, as was the case during the first wave of the pandemic this spring, consumer spending varied across categories in October. Sales of goods and services susceptible to public health measures declined markedly, while sales of household staples and various consumer durables increased. Daily data on payment card turnover within Iceland indicate that household demand weakened still further in the first week of November.

The Gallup Consumer Confidence Index measured 47.2 points in October, a decline of 13.4 points between months and about 39.7 points between years. All subcomponents of the index fell between months, with the assessment of the labour market declining the most.

Statistics Iceland’s nationwide house price index, published in late October, rose by 0.8% month-on-month when adjusted for seasonality, and by 7.3% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.8% month-on-month in September when adjusted for seasonality, and by 5.6% year-on-year. The number of purchase agreements registered nationwide rose by 9.9% year-on-year in the first nine months of 2020, while the number of contracts for new construction increased by 47% over the same period.

The consumer price index (CPI) rose by 0.43% month-on-month in October, raising twelve-month inflation to 3.6%. The CPI excluding the housing component had risen by 4.1% year-on-year in October. Underlying inflation also measured 4.1% in October, in terms of the average of various measures. This is partly because underlying inflation excludes the decline in petrol prices and the impact of lower real mortgage interest expense. The interest component of imputed rent has lowered inflation in the past year, causing twelve-month inflation to be lower by an estimated 0.8 percentage points. Imported goods prices still show the effects of the depreciation of the króna, with food and beverage prices rising by 1% month-on-month in October. In addition, the cost of owner-occupied housing was up 2.2% between years.

According to the market expectations survey, market agents expect inflation to average 3.7% in Q4/2020 and just under 3.8% in Q1/2021. This is higher than in the August survey. Expectations one, two, five, and ten years ahead were unchanged since the last survey, however, at 2.5%. The five- and ten-year breakeven inflation rate in the bond market has averaged 2.6-2.7% in Q4 to date and is therefore close to the target as well, albeit somewhat higher than it was a year ago.

According to the forecast published in *Monetary Bulletin* on 18 November 2020, the outlook is for inflation to average 3.7% until early 2021, and then, once the effects of the depreciation of the króna disappear from measurements, it is expected to begin to ease relatively quickly, owing to the sizeable slack that has developed in the economy. This is above the August forecast, owing mainly to stronger imported inflationary pressures.

The króna is slightly weaker now than was assumed in the Bank's August forecast. The baseline forecast assumes that the trade-weighted exchange rate index (TWI) will remain close to 212 points, on average, over the next two years, and that the króna will appreciate slightly towards the end of the forecast horizon. The real exchange rate will therefore fall even further this year but then rise gradually from 2022 onwards. By the end of the forecast horizon, it will still be nearly 17% below its 2017 peak.

The COVID-19 pandemic profoundly affected the global economy in H1/2020. GDP in Iceland's main trading partner countries contracted by more than 12% year-on-year in Q2, the largest single-quarter contraction on record. As the summer passed, the pandemic appeared to be receding, but it has surged in recent months, forcing a re-tightening of public health measures virtually all over the world. Thus the outlook is for a renewed contraction in trading partners' GDP in Q4, followed by a weaker recovery in H1/2021 than was forecast in the August *Monetary Bulletin*. The 2020 contraction is projected at just under 6%, and the growth rate in 2021 is forecast at 4.6%.

In Iceland, GDP contracted by 5.7% year-on-year in H1/2020 but is expected to hold virtually unchanged in H2. As a result, the outlook is for an 8.5% contraction in 2020 as a whole, somewhat more than was forecast in August but broadly in line with the forecast from May. The outlook for 2021 has worsened as well, as the forecast assumes that bringing the pandemic under control will take longer than was projected in the last forecast. Fewer tourists are expected to visit Iceland; therefore, exports will take longer to recover and will grow more slowly. As a consequence, GDP growth will measure only 2.3% in 2021, as compared with the August forecast of 3.4%.

The current account surplus measured 1.7% of GDP in H1, reflecting a deficit on goods and services trade versus a surplus on the primary income balance. The trade balance is expected to return to positive territory in H2, resulting in a surplus of nearly 1% of GDP for 2020 as a whole. This is a slightly smaller surplus than was forecast in August, owing to the bleaker outlook for export growth and the prospect of less favourable terms of trade. Pulling in the other direction is the larger surplus on primary income in H1, which stems in part from record returns on foreign direct investment. The current account surplus for 2020 will therefore be well in line with the August forecast, at about 2½% of GDP. The surplus is projected to widen slightly in 2021, although it will be smaller than previously projected, or 3% of GDP instead of nearly 4%, as was forecast in August. This is due primarily to the prospect of more sluggish growth in tourism in 2021 and a weaker improvement in terms of trade.

The baseline forecast assumes that unemployment will rise somewhat in Q4 and will average 6% this year, according to the Statistics Iceland labour force survey. It will not peak, however, until H1/2021, when seasonally adjusted unemployment is projected to overtake the post-crisis peak. It will then start to fall in H2 and continue declining throughout the forecast horizon. Growth in potential output is expected to slow markedly in the first half of the period, but demand is projected to contract more, and a sizeable slack is set to develop in the economy.

The slack is estimated to measure about 6% of potential output this year. It will gradually narrow from early 2021 onwards but is not expected to close until H2/2022.

According to the baseline forecast, GDP will not return to its 2019 level until 2023, but nevertheless, it will remain nearly 6% below the pre-pandemic forecast from February 2020. This is highly uncertain, however, and it is possible that the baseline forecast is too optimistic. As is discussed in the alternative scenarios in Box 1 of *Monetary Bulletin*, the economic recovery will be weaker if it proves more difficult to control the pandemic. The same is true if households are slower to tap the savings they have built up during the pandemic. GDP could therefore contract even further in 2021. By the same token, GDP growth could pick up more strongly than is assumed in the baseline forecast if efforts to control the pandemic bear fruit and households spend more of their savings.

II Decisions on the Bank's monetary policy instruments

The MPC discussed the monetary stance in view of economic developments and the marginal decline in the Bank's real rate since the October meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in October to hold the Bank's interest rates unchanged. Furthermore, the economic outlook had deteriorated because of increased spread of COVID-19. On the other hand, inflation had risen between Q2 and Q3 and was above the Bank's August forecast.

Committee members noted that the autumn surge in COVID-19 cases and the tightened public health measures had weakened the economic rebound that had begun in Q3, following a historically large contraction in Q2. In the MPC's view, the economic outlook had therefore deteriorated, and according to the forecast in the November *Monetary Bulletin*, GDP was set to contract by 8.5% this year, a full 1 percentage point more than was forecast in August. GDP growth was projected to be weaker in 2021 as well. The Committee emphasised that the economic outlook was highly uncertain and that economic developments would depend to a considerable degree on the path the pandemic took.

The MPC discussed the foreign exchange market, noting that the króna had been relatively stable in the recent term, although it had depreciated after the pandemic reached Iceland. Inflation had risen since the spring, measuring 3.6% in October. However, Committee members considered it important that medium- and long-term inflation expectations were broadly unchanged. It emerged at the meeting that, according to the Bank's forecast, the outlook was for inflation to average about 3.7% until early 2021 and then begin to ease, owing to the sizeable slack in the economy. In the MPC's opinion, because of the slack in the economy, it was most likely that inflation would ease back to the target if the króna remained relatively stable. It was pointed out that, given the current situation and outlook, there were few factors that could increase inflationary pressures to any marked degree. On the other hand, it was noted that if the recovery proved relatively swift once a vaccine was widely available, inflationary pressures could develop because of pent-up demand if households were quick to tap into the savings they had accumulated during the pandemic.

The MPC discussed whether to lower interest rates further or to hold them unchanged. The main arguments in favour of lowering interest rates were the economic outlook, which had deteriorated markedly in the recent term, and the expectations that it would take longer than previously projected for the recovery to begin. It emerged at the meeting that it was appropriate to support domestic demand even more strongly, as the outlook was for unemployment to rise higher and persist longer than had previously been assumed. Members noted that the exchange rate of the króna was close to the level seen in May, and that the outlook was for the pressure on the exchange rate to ease in the coming term, in part because of positive news about the development of a COVID-19 vaccine and reduced capital outflows from Iceland. Furthermore, the Bank's intervention in the foreign exchange market had been effective and had tamped down on expectations of a further depreciation. Positive news about the development of a vaccine should also ease uncertainties and stimulate companies' appetite for investment. Long-term inflation expectations were still at or near the target, enabling the Bank to lower interest rates further. It was pointed out that if asset prices should rise excessively or debt levels should surge because of lower interest rates, the Central Bank could apply other policy instruments to counter the trend.

The main argument in favour of unchanged interest rates was that inflation was above the target and had risen more than had been assumed in the Bank's last forecast. There was some risk that a further interest rate cut could deanchor inflation expectations and undermine the credibility of monetary policy. A smaller interest rate differential could also put greater pressure on the exchange rate. It was also noted that a rate cut could stimulate the segment of the economy where there was little or no slack in output and could push house prices higher.

The Committee discussed the Bank's quantitative easing programme. It emerged at the meeting that it had not been considered advisable for the Bank to enter the bond market decisively while it was intervening in the foreign exchange market, partly due to outflows relating to non-residents' Treasury bond sales. In some respects, the conditions for quantitative easing were different in Iceland than in countries where inflation was low and inflation expectations had fallen steeply, in addition to being below the respective central banks' inflation targets. In Iceland, inflation had risen and was above target, yet the anchor to the target appeared not to have weakened in the same way. Moreover, interest rates in those economies were down to zero or even negative, while rates in Iceland were still positive. The Committee discussed monetary policy transmission, and it was noted that household lending rates had begun to rise in some cases, while credit spreads on corporate loans had fallen recently. Committee members agreed that conditions were now more favourable for the Bank to enter the Treasury bond market more decisively, as the foreign exchange market had grown more stable, although the MPC would continue to monitor market yields and the pace of the increase in the Treasury bond supply. These matters would always be assessed based on conditions, however.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 0.75%, the current account rate 0.5%, the seven-day collateralised lending rate 1.5%, and the overnight lending rate 2.5%. All Committee members voted in favour of the proposal.

Committee members were of the view that although inflation had risen temporarily and appeared set to be higher than was assumed in August, more firmly anchored inflation expectations provided the MPC the scope to respond decisively to the deteriorating economic outlook. They were also of the opinion that interest rate reductions and other measures taken by the Central Bank in the past few months had supported domestic demand and mitigated the adverse impact of the economic shock.

The MPC stressed that it would continue to use the tools at its disposal, including Treasury bond purchases by the Central Bank, to support the domestic economy and ensure that the more accommodative monetary stance was transmitted normally to households and businesses.

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

Katrín Ólafsdóttir, Associate Professor, external member

The Chief Economist was in attendance for the entire meeting. In addition, a number of 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 3 February 2021.