



*The Monetary Policy Committee of the Central Bank of Iceland*

## Minutes of the Monetary Policy Committee meeting

15-16 November 2021 (105th meeting)

Published: 1 December 2021

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 15 and 16 November 2021, 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 17 November.

### **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 6 October 2021, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin 2021/4* on 17 November.

#### **Financial markets**

Since the October meeting, the króna had depreciated by 2.3% in trade-weighted terms. The Central Bank conducted no transactions in the foreign exchange market between meetings.

In terms of the Bank's real rate, the monetary stance was virtually unchanged since the October meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was broadly unchanged since just before the announcement of the October decision, at -2.2%. In terms of twelve-month inflation, it was -2.9% and had risen by 0.1 percentage points over the same period.

Interest rates in the interbank market for krónur rose in line with the increase in the key rate in October, and market turnover totalled 2 b.kr. between meetings. Yields on long-term nominal Treasury bonds had risen marginally since the October meeting, whereas yields on long-term indexed Treasury bonds had fallen slightly. Furthermore, average non-indexed mortgage lending rates had risen marginally following the October rate hike.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 0.2-0.3 percentage points between meetings, to 2.7 percentage points versus the euro area and 2 percentage points versus the US. The long-term interest rate differential versus Germany had widened by 0.2 percentage points between meetings, to 4.4 percentage points, whereas the spread versus the US was broadly unchanged, at 2.5 percentage points. Measures of risk premia on the Treasury's foreign obligations were virtually unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.5%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.6-0.8 percentage points.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 0.25 percentage points, noting that inflation had been higher and more persistent than previously expected and that near-term inflation forecasts had deteriorated. They also mentioned that although uncertainty had increased because of the recent rise in COVID-19 case numbers and despite remaining signs of a slack in the economy, the overall economic outlook had improved, real incomes had risen, and indicators implied continued growth in domestic demand.

According to the Central Bank's quarterly market expectations survey, conducted in November 2021, respondents expected the Bank's key rate to remain unchanged at 1.5% at the end of 2021, followed by a rate hike of 0.5 percentage points in Q1/2022 and a further rate hike of 0.25 percentage points in Q2. They also expected the key rate to measure 2.5% in one year and 3% in two years. This is higher than in the survey from August, when they expected the key rate to be 2% after one year and 2.25% in two years' time. Participants' responses on the monetary stance changed somewhat in the November survey, and a majority, 56%, considered the current stance too loose, up from 33% in August. On the other hand, the share who considered it appropriate fell to 44%, from 67% in the last survey. As before, no respondents considered the monetary stance too tight.

Year-on-year growth in M3 has been relatively stable in recent months, measuring 8.6% in September. At the same time, annual growth in credit system lending to households is estimated at just over 11%, roughly the same as in recent months. Corporate lending continued to decline, however, contracting by 3½% in September.

The Nasdaq OMXI10 index had risen by 3.4% between meetings. Turnover in the Main Market totalled 870 b.kr. in the first ten months of 2021, some 89% more than over the same period in 2020.

### **Global economy and external trade**

According to the International Monetary Fund's (IMF) October forecast, global GDP growth is projected to measure 5.9% in 2021, which is 0.1 percentage points below the Fund's July forecast. The slight downward revision stems from weaker output growth in advanced economies, mainly the US, Canada, Japan, and Germany. Elsewhere in the euro area, however, the outlook has improved, and stronger GDP growth is now forecast for the region as a whole. Furthermore, the IMF forecasts stronger GDP growth in emerging and developing countries this year. For 2022, global output growth is forecast at 4.9%, as in July.

Iceland's external goods trade generated a deficit of 12.5 b.kr. in October and 192 b.kr. for the first ten months of the year, as opposed to a deficit of 127 b.kr. at constant exchange rates over the same period in 2020. The value of exported goods excluding ships and aircraft rose by just over 21% year-on-year in the first ten months of 2021. As before, the increase is due largely to higher industrial goods values, particularly aluminium products, owing to steep price hikes, but

the value of all key subcategories of exported goods has risen year-on-year. The value of imported goods excluding ships and aircraft was up 24% year-on-year at constant exchange rates in the first ten months of 2021, with all key subcategories continuing to increase in value, while the rise in investment goods values had the most impact.

The global price of aluminium had fallen by almost 11% since the MPC's October meeting. Even so, prices were nearly one-third higher than at the beginning of 2021 and about 45% higher than before the pandemic struck. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 2.9% year-on-year in Q3/2021; however, in the first nine months of the year, prices were 2.2% lower, on average, than over the same period in 2020. The global price of Brent crude fell marginally between MPC meetings, to just over 82 US dollars per barrel by mid-November. This is about one-fourth higher than before the pandemic.

The real exchange rate in terms of relative consumer prices rose by 0.4% month-on-month in October, when it was 3.6% above its 25-year average and 7.7% above its October 2020 trough. It rose by 3.6% year-on-year in the first ten months of 2021, as the nominal exchange rate rose by 2.1%, while inflation in Iceland was 1.7 percentage points above the trading partner average.

### **Domestic economy and inflation**

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 3.5% year-on-year in Q3/2021, as the number of employed persons rose 4.3%, while the average work week was shorter by 0.8%. The number of employed persons has increased sharply since the beginning of 2021 and, in Q3, was a full 2% above the year-2019 average. Offsetting this is a more than 3% shorter work week. As a result, the rise in total hours worked has not kept pace with job growth, and in Q3/2021 total hours were 1% fewer than in 2019. The number of wage earners has also risen rapidly in 2021 to date. Data from the pay-as-you-earn (PAYE) register indicate that some 18,000 jobs were lost during the pandemic, but that around 16,700 jobs had been created by August 2021.

Seasonally adjusted LFS data show that the labour participation rate rose quarter-on-quarter in Q3 but that the employment rate rose considerably more. Seasonally adjusted unemployment measured 4.6% in Q3, after declining by about 2 percentage points quarter-on-quarter, as compared with just under 4% in 2019. Registered unemployment continued to fall, to a seasonally adjusted rate of 5.1% in October, and was ½ a percentage point higher than in February 2020.

Iceland's population grew by 1.9% year-on-year in Q3, considerably more than in Q2. The uptick in population growth is due mostly to immigration. It appears that importation of foreign workers will continue in tandem with the recovery of the domestic economy, owing to the large number of job vacancies that have not yet been filled.

The general wage index rose by 0.7% between quarters in Q3, and by 7.8% year-on-year. Real wages were 3.4% higher in Q3 than in the same quarter of 2020.

Private consumption contracted marginally quarter-on-quarter in Q2, after growing 1.6% in Q1. This is somewhat weaker than was assumed in the August forecast. There are signs that the impact of the pandemic and public health measures on consumption and travel patterns has continued to subside. Real incomes have also been on the rise, and the employment outlook has improved markedly. As a result, the outlook is for private consumption growth in H2/2021 to outpace the August forecast.

Consumers are increasingly optimistic, and in September the Gallup Consumer Confidence Index was at its highest in five years. In October, it measured 130, a 10.8-point decline from the previous month but an increase of 82.8 points year-on-year. All components of the index fell during the month, led by the assessment of the economic situation, which was down 17.5 points.

Statistics Iceland's nationwide house price index, published in late October, rose by 1% month-on-month when adjusted for seasonality, and by 15.1% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1% month-on-month in September when adjusted for seasonality, and by 16.6% year-on-year. The number of purchase agreements registered nationwide rose by 22% year-on-year in the first nine months of 2021, while the number of contracts for new construction increased by 32% over the same period. The average time-to-sale in the capital area measured 1.3 months in September and has lengthened by 0.4 months since bottoming out in March.

The consumer price index (CPI) rose by 0.59% month-on-month in October, raising twelve-month inflation to 4.5%. Inflation excluding housing also rose marginally, to 3%. Underlying inflation was unchanged between September and October and measured 3.7% in terms of the average of various measures.

As before, rising house prices explained most of the increase in the CPI in October, and the cost of owner-occupied housing has risen by 11.8% in the past twelve months. Petrol prices also rose somewhat in October.

According to the Bank's market expectations survey, market agents expect inflation to measure 3.3% one year ahead, which is higher than in the August survey, whereas they still expect it to be at target in two years' time. They also expect inflation to be close to target, on average, in the long run. The breakeven inflation rate in the bond market has risen in the recent past, however, and the five-year breakeven rate five years ahead was just over 3% in mid-November.

According to the forecast published in *Monetary Bulletin* on 17 November 2021, the outlook is for inflation to ease more slowly than previously projected. In Q3/2021, inflation was marginally above the August forecast, and the near-term outlook has deteriorated significantly. Inflation is forecast at 4.7% in Q4/2021 and 4.4% in Q1/2022. The bleaker inflation outlook is due in particular to a poorer initial position and higher imported inflation than was assumed in August. Furthermore, in Iceland, a larger output gap is expected in the next two years, wages and house prices are projected to rise more than previously forecast, and the exchange rate of the króna is expected to be slightly lower over the forecast horizon than was projected in August. Moreover, because of the recent rise in long-term inflation expectations, it will take longer for the inflationary impact of cost increases to subside. According to the baseline forecast, inflation will be close to target by the end of 2022 and then rise slightly in the latter half of the forecast horizon, averaging 2.9% in 2023. It is expected to ease back towards the target thereafter.

The trade-weighted exchange rate index (TWI) stood at 194 points in Q3/2021, and the króna was therefore about 1% weaker, on average, than was forecast in the August *Monetary Bulletin*. According to the baseline forecast, the average exchange rate will remain broadly stable over the forecast horizon, and therefore slightly lower than was assumed in the August forecast. If the forecast materialises, the real exchange rate will rise by 2½% over the forecast horizon, although at the end of the period it will still be 11% below its 2017 peak.

Among Iceland's main trading partners, economic activity picked up rapidly after public health measures were eased in Q2, when GDP grew by 2.2% quarter-on-quarter, one of the strongest average quarterly growth rates ever measured for this group of countries. Trading partner GDP

growth measured 6.3% year-on-year in H1/2021, about 0.3 percentage points above the Bank's August forecast. Leading indicators and international forecasts suggest that economic activity will continue to gain strength in H2/2021, but more slowly than was forecast in August. This is due mainly to weaker activity in manufacturing, which in turn is due to a shortage of inputs and problems with shipping. The Bank's baseline forecast assumes that trading partners' GDP growth will measure 5.5% this year, about 0.2 percentage points above the August forecast. The upward revision is attributable to stronger growth in H1. For 2022, trading partners' GDP growth is projected to measure 4.3%, or 0.2 percentage points below the August forecast.

In Iceland, GDP grew by 3.5% year-on-year in H1, according to preliminary figures from Statistics Iceland; however, the outlook is for a growth rate of 6½% in Q3 and 3.9% for 2021 as a whole. This is 0.1 percentage points below the August forecast. The poorer outlook for 2021 reflects more sluggish growth in H1 than was previously expected, although it will be offset in part by stronger GDP growth in H2. Furthermore, GDP growth is expected to accelerate still further in 2022, owing mainly to strong growth in exports as a result of increased revenues from tourism and a more favourable capelin season. The contribution of net trade to output growth will therefore be positive by 2.7 percentage points – the first positive contribution since 2019. The contribution of private consumption growth to GDP growth will also be positive, but gradually less so than in 2021. GDP growth is projected to measure 5.1% in 2022, some 1.2 percentage points above the August forecast. About half of this revision is attributable to the expectation of an increased capelin catch. The GDP growth outlook for the long term is more or less unchanged. Growth is set to ease to 2.6% in 2023 and remain around that level in 2024.

The current account deficit measured 3.9% of GDP in Q2/2021, reflecting a larger surplus on services trade versus a larger deficit on goods trade. The current account is expected to show a surplus again in Q3, followed by a larger one in Q4. The main drivers of the improvement are tourism-related services exports and more favourable terms of trade. Even so, a deficit measuring 0.9% of GDP is expected for 2021 as a whole. The current account balance is projected to turn positive again in 2022, fuelled by increased growth in services exports and improved terms of trade. The surplus for the year as a whole is forecast at 1.9% of GDP, which is ½ a percentage point below the August forecast. As in August, the surplus is expected to narrow again in the latter half of the forecast horizon.

The unemployment outlook is ambiguous for the near term but looks set to improve over time. A large number of hiring subsidies will expire in Q4/2021, creating greater uncertainty about the short-term outlook for unemployment. In the long run, however, the unemployment outlook is more favourable than in the Bank's August forecast, in part because activity in the domestic economy has picked up more than was projected then. The baseline forecast assumes that job creation will continue and that LFS-based unemployment will measure 6%, falling to around 4% towards the end of the forecast horizon. Registered unemployment is estimated to be higher this year, at nearly 8%, but is also expected to fall to 4% by the end of the forecast horizon.

If the Bank's forecast materialises, GDP will return to its 2019 level slightly earlier in 2022 than was assumed in August. It will also remain higher over the entire period than in the Bank's previous forecasts. Leading indicators also imply that the slack in output is narrowing quickly and may even have closed already, and with stronger GDP growth in 2022, the expected output gap will be wider than was assumed in the August forecast. As before, the outlook is highly uncertain, and forecasts of the economic recovery in Iceland and elsewhere are based to some extent on the assumption that there will not be a setback in the fight against the pandemic. Another major uncertainty lies in how quickly the supply-chain disruptions underlying the surge in global commodity prices and shipping costs can be unwound. Added to this is uncertainty

about fiscal policy in the wake of Iceland's recent Parliamentary elections, about wage developments, and about how rapidly households will tap into the savings they built up during the pandemic. The inflation outlook could therefore be overly optimistic, particularly if inflation expectations have become unmoored from the target.

## **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 remained broadly unchanged since the October meeting. Members discussed whether the monetary stance was appropriate in view of the worsening inflation outlook, as they had decided in October to continue tightening it. At that time, there were indications of a continued strong economic recovery, and inflation had risen.

Members noted that according to the Bank's new macroeconomic forecast, published in the November *Monetary Bulletin*, the outlook was for year-2021 GDP growth to measure about 4%, broadly in line with the August forecast. Furthermore, better prospects for exports had resulted in an improved outlook for year-2022 GDP growth, which was expected to measure just over 5%. Nevertheless, the Committee was of the opinion that significant uncertainty remained and that, as before, economic developments would depend on the path taken by the pandemic.

The MPC discussed the rise in inflation to 4.5% in October. Members noted that the contribution from domestic cost pressures, rising house prices, and wage growth had accounted for a large share of inflation recently, but that the effects of rising global oil and commodity prices had also grown stronger. It emerged that underlying inflation was lower, however, and had declined in recent months.

The Committee discussed the deterioration in the inflation outlook since the August forecast, which was due in part to more persistent global price increases, a more rapid rebound in domestic economic activity, and rising wage costs. It emerged that the outlook was for inflation to continue rising in coming months but then start to ease, given that inflation expectations remained anchored to the target. The MPC also discussed the Bank's intervention in the foreign exchange market, which had been infrequent in recent months, and noted that the market appeared well balanced.

All members agreed that the Bank's key rate should be raised, and they discussed rate increases ranging from 0.25 to 0.75 percentage points. The main argument presented in favour of taking a smaller step was that the impact of rate hikes on households' debt service burden would presumably be greater now than it had been before, in view of the larger share of non-indexed variable-rate mortgages, making it preferable to continue taking cautious steps. Furthermore, the impact of the interaction between rate hikes and the recent application of macroprudential tools had yet to come to the fore. Moreover, it was pointed out that unemployment could rise again when Government support measures were withdrawn. In view of this, there were concerns that the economic recovery could prove fragile. It also emerged in the discussion that a portion of inflation was due to temporary factors outside monetary policy control – i.e., rising petrol prices and supply-chain disruptions – as underlying inflation had declined in recent months. It was pointed out that by the time the impact of a November rate hike had peaked, inflationary pressures stemming from these factors and from house price inflation would probably have begun to subside.

The main argument presented in favour of taking a larger step was that inflation had been more persistent and the inflation outlook had deteriorated at the same time as long-term inflation expectations had risen by some measures. Furthermore, the labour market was recovering

strongly, unemployment had declined, and the outlook was for wage cost increases in the coming term to be larger than previously assumed. It emerged in the discussion that there was the risk that higher imported inflation would push domestic inflation upwards; for instance, through further rises in the price of services. This being the case, it was important to act decisively so as to minimise the risk that inflation would turn out even more persistent and inflation expectations would become unmoored from the target.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.5 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 2%, the current account rate 1.75%, the seven-day collateralised lending rate 2.75%, and the overnight lending rate 3.75%. All Committee members voted in favour of the proposal.

The MPC reiterated at the meeting that it would apply the tools at its disposal to ensure that inflation eases back to the target within an acceptable time frame.

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

Thórarinn G. Pétursson, Chief Economist of the Central Bank, was present 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 Wednesday on 9 February 2022.