



MINUTES

MONETARY POLICY COMMITTEE



2022

June
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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 June 2022, 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 June.

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 4 May 2022.

Financial markets

Since the May meeting, the króna had depreciated by 0.1% in trade-weighted terms. Between meetings, the Bank bought foreign currency for 6 million euros (0.8 b.kr.). The Bank's transactions during the period accounted for 2% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had eased since the May meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -2.8%, or 0.4 percentage points lower than just after the announcement of the May interest rate decision. In terms of twelve-month inflation, it was -3.6% and had fallen similarly 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 May, 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 as much as 0.8 percentage points since the May meeting, and yields on long-term indexed Treasury bonds had risen by up to 0.4 percentage points. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in May, whereas average indexed mortgage rates had fallen marginally.

In terms of three-month interbank rates, the short-term interest rate differential versus the euro area had widened by 1 percentage points between meetings, to 5.2 percentage points,

while the spread versus the US had widened by 0.4 percentage points, to 2.9 percentage points. The long-term interest rate differential versus Germany had narrowed by 0.2 percentage points between meetings, to 4 percentage points, whereas the spread versus the US had widened by 0.2 percentage points, to 2.5 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 0.5%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 1-1.1 percentage points.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 0.75-1 percentage point, on the grounds that the real rate was still negative and the monetary stance too loose given the state of the economy. Furthermore, inflation had become rather widespread, house prices were still rising sharply, and the inflation outlook had deteriorated. Analysts also observed that newly published national accounts data and payment card turnover figures suggested that domestic demand had been robust recently, and furthermore, unemployment had fallen rapidly.

Annual growth in M3 gained pace slightly towards the end of 2021 but has remained broadly flat since then, measuring just over 12% in April. At the same time, annual growth in credit system lending to households is estimated at 10%, roughly the same as in recent months. Annual growth in corporate lending has gained pace over the course of the year, measuring just over 2% in April.

The Nasdaq OMXI10 index had fallen by 13.4% between meetings. Turnover in the Main Market totalled 519 b.kr. in the first five months of 2022, some 27% more than over the same period in 2021.

Global economy and external trade

According to the Organisation for Economic Cooperation and Development's (OECD) June forecast, global GDP growth is set to measure 3% this year and 2.8% in 2023, or 1.5 and 0.4 percentage points, respectively, below its December forecast. The downward revision is due largely to the impact of the war in Ukraine and the sanctions on Russia on the global economy. Tightened public health measures in China will also have an adverse effect on global economic activity. In addition, the inflation outlook has deteriorated markedly, according to the OECD, mainly because of the surge in energy and food prices. Inflation is forecast to measure 8.5% in OECD countries this year, more than 4 percentage points above the December forecast. The general expectation is still that inflation will ease in 2023, but that it will be considerably higher than previously projected.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 28 b.kr. in May and just over 92 b.kr. in the first five months of 2022, as compared with a deficit of 57 b.kr. at constant exchange rates over the same five-month period in 2021. Goods export values increased by 46% during the first five months of the year, with all key categories contributing to the rise except for agricultural products, whose export value contracted year-on-year. The strongest impact was from industrial goods exports, aluminium products in particular, which rose markedly in price. Import values increased by 49% over the same period, with all key categories contributing to the rise, particularly fuels and lubricants.

Global aluminium prices fell by 12% after the MPC's May meeting, to around 2,500 US dollars per tonne. They remain about 6% higher than in June 2021, however. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products had risen by 2% month-on-month in April and by 20% over the first four months of the year. The global price of

Brent crude rose by 9% between MPC meetings, to 115 US dollars per barrel by the time of the June meeting. This is 45% higher than at the beginning of 2022 and more than 50% above the June 2021 price.

The real exchange rate in terms of relative consumer prices rose by 1.2% month-on-month in May, when it was 9% above its 25-year average but 0.7% lower than in December 2019. It rose by 4.5% year-on-year in the first five months of 2022, as the nominal exchange rate rose by 4.7%, while inflation in Iceland was 0.2 percentage points below the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland in late May, GDP growth measured 8.6% in the first quarter of 2022, somewhat above the forecast in the May *Monetary Bulletin*. In seasonally adjusted terms, GDP grew by 1.1% between quarters, following robust growth in Q4/2021. Domestic demand grew by 11.2% year-on-year, with subcomponents increasing more than was assumed in the Bank's last forecast, particularly private consumption growth, which measured 8.8%, or 5 percentage points above the Bank's forecast. The difference is due in part to spending by Icelanders during their travels abroad and motor vehicle purchases, both of which exceeded expectations. The contribution of net trade to output growth was negative by 3.1 percentage points during the quarter, whereas the forecast had assumed a negative contribution of 1.9 percentage points. The difference lay mainly in services imports, which were underestimated.

Key indicators of developments in private consumption in Q2 are somewhat stronger than in Q1. Payment card turnover within Iceland suggests that household demand has increased, and as in recent months, Icelanders' card use abroad grew strongly. The Gallup Consumer Confidence Index indicates that sentiment among Icelanders has grown more tepid in the recent term, however. All subcomponents of the index fell month-on-month, led by the assessment of the economy.

According to the results of Gallup's summer survey, conducted in May and June among Iceland's 400 largest firms, respondents' assessment of the current economic situation was slightly more negative than in the spring survey. Their expectations six months ahead were also more negative, as 28% of executives expected the economic situation to deteriorate in six months' time, a somewhat larger share than in the spring. Roughly 34% of executives expected economic conditions to improve in the next six months. Executives were slightly more pessimistic about domestic and foreign demand than in the spring survey, especially those in the wholesale and retail trade, manufacturing, and construction sectors.

For the fifth survey in a row, seasonally adjusted survey results indicated that the balance of opinion on staffing was about 30 percentage points in favour of those planning to recruit. Furthermore, firms' problems with staffing and their capacity to increase production appear to have kept growing worse. The share of executives who considered their firms understaffed had risen above 50% and was only 0.1 percentage points below its 2007 peak. Furthermore, 60% of executives, an all-time high, reported that their firms would have difficulty responding to increased demand. Problems with staffing and production increases were most pronounced in the construction sector.

The general wage index rose by 1.6% month-on-month in April and by 8.5% year-on-year. Real wages were 1.2% higher in April than at the same time in 2021.

Statistics Iceland's nationwide house price index, published in late May, rose by 2.6% month-on-month when adjusted for seasonality, and by 20.1% year-on-year. The capital area house

price index, calculated by Registers Iceland, rose by 2.6% month-on-month in May when adjusted for seasonality, and by 24% year-on-year. The number of purchase agreements registered nationwide fell by 33% year-on-year in the first five months of 2022, and the number of contracts for new construction declined by 43% over the same period. The average time-to-sale measured about 1 month in May, as compared with one-and-a-half months in May 2021, but the number of available properties has fallen steeply in recent months.

The consumer price index (CPI) rose by 0.77% month-on-month in May, raising twelve-month inflation to 7.6%. Inflation excluding housing rose as well, to 5.5%. Underlying inflation also measured 5.5%, according to the average of various measures.

Just over half of the monthly rise in the CPI was attributable to owner-occupied housing costs, which have increased by about 18% year-on-year. Increased petrol and food prices also made a marked impact. Private services prices fell marginally in May, particularly as a result of reduced airfares, but have risen by 5% since May 2021.

Households' and businesses' short- and long-term inflation expectations have continued to rise, according to Gallup's summer survey. The survey results suggest that both corporate executives and households expect inflation to measure 5% in two years' time. Executives expect inflation to average 4% over the next five years, while households still expect it to average 5%. On the other hand, the breakeven inflation rate in the bond market held broadly unchanged between meetings, and the five-year breakeven rate five years ahead measured 3.4% just before the June meeting.

II Decisions on the Bank's monetary policy instruments

The MPC discussed the monetary stance in view of economic developments and the decline in the Bank's real rate since the May meeting. Members discussed whether the monetary stance was appropriate in light of the inflation outlook, as the Committee had decided in May to continue tightening it. At that time, there were signs of robust domestic economic activity in 2022 to date, although they were offset by the worsening outlook due to Russia's invasion of Ukraine. Furthermore, the inflation outlook had deteriorated markedly.

Committee members discussed preliminary national accounts data, which indicated that GDP growth was somewhat stronger in Q1/2022 than had been assumed in the Bank's May forecast. It emerged as well that there were signs that domestic economic activity would remain strong, and the share of firms reporting staffing shortages was at its highest since 2007. Households' and businesses' expectations about economic developments had grown more tepid, however, and the global economic outlook was highly uncertain.

MPC members discussed the rise in inflation to 7.6% in May. They also observed that as before, house prices and other domestic cost items were still strong drivers of inflation, and that global oil and commodity prices had risen sharply as well. They discussed the fact that price increases were widespread and that underlying inflation had risen. Furthermore, inflation expectations had risen by most measures and were above target.

All members agreed that the Bank's key rate should be raised and the monetary policy stance tightened considerably. They discussed rate increases ranging from 0.75-1 percentage point. The main arguments discussed centred on the real rate, which had continued to fall despite the nominal rate increase in May and was still significantly negative. It was also well below the equilibrium real rate, indicating that the monetary stance was still considerably accommodative. It would be necessary to withdraw this support with further nominal rate

hikes, although a decline in inflation expectations would also affect the real rate. Committee members stressed that the recent rise in inflation expectations was cause for concern but noted that higher interest rates would help to bring inflation and inflation expectations closer to the target again. It emerged in the discussion that the strength of domestic economic activity was reflected in brisk demand for housing and rising house prices, which kept climbing to new highs, especially because it would take time for supply to catch up with demand. The inflation outlook was bleak, and inflation looked set to rise higher in the near term than the Committee had assumed in May. Committee members were also concerned about the tight labour market, as unemployment had fallen, job numbers had risen rapidly, and staffing shortages had grown. It was pointed out that it could prove more difficult than before to address labour shortages with imported workers. As a result, the risk of wage drift had increased. In view of these factors, the Committee considered it necessary to tighten the monetary stance still further. It was pointed out that it could prove necessary to tighten the monetary policy stance even more, and raise the key rate by more than 1 percentage point.

The main arguments in favour of taking a smaller step at this time were that the global economic outlook had worsened between meetings and that trading partner GDP growth looked set to lose pace. It was pointed out that optimism had waned among households and businesses, both in Iceland and elsewhere. Furthermore, part of the increase in private consumption still stemmed from the pandemic, as consumers were tapping accumulated savings and only a short time had passed since public health measures had been lifted in full. The economic outlook in Iceland could therefore turn around more quickly than anticipated. It emerged in the discussion that the interaction between the Bank's interest rate hikes and the Financial Stability Committee's recent decisions to tighten borrower-based measures could also cause a more rapid easing of house price inflation and domestic demand than would otherwise occur.

The MPC also discussed the application of other monetary policy instruments. It emerged that there was reason for closer consideration of liquidity management tools, which could also be used, among other things, to sterilise the Bank's foreign exchange market intervention if the need should arise.

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 4.75%, the current account rate 4.5%, the seven-day collateralised lending rate 5.5%, and the overnight lending rate 6.5%. All members voted in favour of the Governor's proposal, although Gylfi Zoëga would have preferred to raise rates by 1.25 percentage points.

The MPC discussed that it was likely that the monetary stance would have to be tightened even further so as to ensure that inflation eases back to target within an acceptable time frame. Near-term monetary policy decisions would depend on developments in economic activity, inflation, and inflation expectations. Decisions taken at the corporate level, in the labour market, and in public sector finances would be a major determinant of how high interest rates must rise.

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

Herdís Steingrimsdóttir, Associate 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 August 2022.