



# MINUTES

## MONETARY POLICY COMMITTEE



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## Minutes of the Monetary Policy Committee meeting

7-8 February 2022 (107th 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 7 and 8 February 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 9 February.

### **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 meeting of 17 November 2021, as published in the updated forecast in *Monetary Bulletin 2022/1* on 9 February.

#### **Financial markets**

Since the November meeting, the króna had appreciated by 5.9% in trade-weighted terms. Between meetings, the Bank bought foreign currency for 76.9 million euros (11 b.kr.). The Bank's transactions accounted for 15% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance eased significantly since the November meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was -2.7%, or 0.4 percentage points lower than just before the announcement of the November interest rate decision. In terms of twelve-month inflation, it was -3.5% and had fallen by 0.6 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 November, 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 0.6 percentage points since the November meeting, and yields on long-term indexed Treasury bonds had risen by up to 0.3 percentage points. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in November, whereas average indexed mortgage rates had fallen marginally.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 0.4-0.5 percentage points between meetings, to 3.3 percentage points versus the euro area

and 2.3 percentage points versus the US. The long-term interest rate differential versus Germany was broadly unchanged between meetings, at 4.4 percentage points, whereas the spread versus the US had widened by 0.2 percentage points, to 2.7 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 0.5-0.8 percentage points.

According to the median response in the Central Bank's quarterly market expectations survey, conducted in January 2022, respondents expected the Bank's key rate to be raised by 0.5 percentage points in Q1, to 2.5%, followed by a rate hike of 0.25 percentage points in each remaining quarter of 2022, bringing the key rate to 3.5% in one year's time. They also expected the key rate to be unchanged at 3.5% in two years' time. This is considerably higher than in the survey from November, when they expected the key rate to be 2.5% after one year and 3% in two years' time. Participants' responses on the monetary stance had changed somewhat, and a majority, 76%, considered the current stance too loose, up from 56% in November. On the other hand, the share who considered it appropriate fell to 20%, from 44% in the previous survey. Only 4% of respondents considered the monetary stance too tight.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 0.75 percentage points, citing the recent spike in inflation and the deterioration of the near-term inflation outlook. Furthermore, inflation expectations had risen and were less firmly anchored to the inflation target. In addition, inflation had risen in trading partner countries, which could affect the domestic price level, although the recent appreciation of the króna would offset this to some extent. They noted as well that domestic demand had been strong in the recent term and house price inflation was still very high.

Annual growth in M3 gained pace slightly in late 2021, measuring just under 11% in December. At the same time, annual growth in credit system lending to households is estimated at just over 10%, roughly the same as in recent months. Corporate lending continued to decline, however, contracting by just over 2% in December.

The Nasdaq OMXI10 index had fallen by 4.4% between meetings. Turnover in the Main Market totalled 1,060 b.kr. in 2021 as a whole, some 77% more than in 2020.

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

According to the International Monetary Fund's (IMF) January forecast, global GDP growth is projected to measure 4.4% in 2022, or 0.5 percentage points below the Fund's October forecast. The downward revision is due in particular to the bleaker outlook for the US and China, two of the world's largest economies. For 2023, global GDP growth is forecast at 3.8%, or 0.2 percentage points above the IMF's October forecast. The inflation outlook for 2022 has deteriorated, in the IMF's opinion, in line with continued supply-chain disruptions and high energy prices. Among advanced economies, inflation is forecast at 3.9%, or 1.6 percentage points above the October forecast. Nevertheless, inflation is still expected to taper off to around 2% in 2023.

Iceland's goods account deficit totalled 40 b.kr. in Q4, and for 2021 as a whole it came to 168 b.kr., as compared with 94 b.kr. in 2020, at constant exchange rates. The value of exported goods excluding ships and aircraft rose by 25% in 2021, with all key components contributing to the increase. The strongest impact was from industrial goods exports, owing in particular to significant rises in the price of aluminium and ferrosilicon during the year. Marine product

export volumes rose by nearly 10% in 2021, largely because of increased capelin exports. At the same time, the value of imported goods excluding ships and aircraft rose by 28%, with all key components contributing to the increase.

Global aluminium prices had risen by a fourth since the MPC's November meeting, to 3,200 US dollars per tonne. This is about 80% higher than before the pandemic and the highest price since mid-2008. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up sharply at the end of 2021, rising by 11.7% year-on-year in Q4, whereas for the year as a whole they were an average of 1.2% higher than in 2020. The global price of Brent crude rose by 10% between MPC meetings, to nearly 91 US dollars per barrel by the beginning of February. This is over a third higher than before the pandemic.

The real exchange rate in terms of relative consumer prices rose by 1.4% month-on-month in December, when it was 4.3% above its 25-year average but 5.1% lower than in December 2019. It rose by 3.6% year-on-year in 2021, as the nominal exchange rate rose by 2.5%, while inflation in Iceland was 1.3 percentage points above the trading partner average.

### **Domestic economy and inflation**

In the first three quarters of 2021, private consumption grew 5.4% year-on-year, slightly below the Bank's November forecast. Indicators imply that private consumption growth picked up strongly in Q4. Because of the setback in the battle against the pandemic, however, the outlook for Q1/2022 has deteriorated. Even so, the Gallup Consumer Confidence Index indicates increased optimism among consumers.

In December, the National Budget for 2022 was approved by Parliament with a deficit of 186 b.kr., or 5.2% of GDP. The primary balance according to the Budget is negative by 3.7% of GDP. The outcome improves considerably between years, owing to strong economic activity and the expiry of temporary measures to mitigate the effects of the pandemic. Pulling in the other direction are measures on the revenues side that will reduce Treasury revenues during the year. On the whole, the fiscal stance will tighten in 2022 after easing over the past few years, concurrent with the expiry of the pandemic response measures.

According to the results of Gallup's winter survey, conducted in December among Iceland's 400 largest firms, respondents' assessment of the current economic situation was somewhat more negative than in the autumn survey. Their expectations six months ahead were also more negative than in the autumn. About 46% of executives – somewhat fewer than in the autumn – expect economic conditions to improve over the next six months, while 39% expect them to be unchanged. In general, executives were very optimistic about both domestic and foreign demand, but their assessment is broadly unchanged since the autumn. The most optimistic among them were executives in the transport, transit, and tourism sectors.

According to the seasonally adjusted survey results, many firms were still planning to add on staff. The balance of opinion on staffing plans (i.e., firms planning to recruit as compared with those planning redundancies) was positive by 30 percentage points, broadly the same as in the autumn survey. The share of respondents who considered themselves short-staffed (40%) was slightly higher than in the last survey, and the share who reported that their firm would have difficulty responding to an unexpected increase in demand had risen marginally, to around 50%.

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 8.2% year-on-year in Q4/2021, owing to an 8.8% rise in the number of employed persons and a 0.5% reduction in average hours worked. Based on the LFS, job numbers were nearly 4%

higher than before the pandemic, but the number of employees on the pay-as-you-earn (PAYE) register was similar to the pre-pandemic level.

Seasonally adjusted LFS data for Q4/2021 show that the labour participation rate rose somewhat more than the employment rate. As a result, unemployment inched upwards during the quarter, to 4.9%. Registered unemployment measured 4.9% in December, as it did in October and November, but 4.8% adjusted for seasonality.

Iceland's population grew by 2% year-on-year in Q4/2021. About half of the increase is due to labour importation, as net migration of foreign nationals was positive by 710 during the quarter.

In Q4, the general wage index rose by 1.3% between quarters and by 7.5% year-on-year, and real wages in terms of the index were 2.5% higher during the quarter than at the same time in 2020.

Statistics Iceland's nationwide house price index, published in late January, rose by 1.7% month-on-month when adjusted for seasonality, and by 16.7% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1.9% month-on-month in December, when adjusted for seasonality, and by 18.4% year-on-year. The number of purchase agreements registered nationwide rose by 10.1% year-on-year in 2021, while the number of contracts for new construction increased by 11.9% over the same period. In December 2021, the average time-to-sale for homes in the capital area was 0.9 months, close to the March 2021 trough, as the number of flats for sale has fallen steeply in recent months.

Inflation averaged 4.4% in 2021, as compared with 2.8% in 2020. The CPI rose by 0.5% month-on-month in January, and headline inflation measured 5.7%, its highest in roughly a decade. Inflation excluding housing also rose, to 3.7%. Underlying inflation was 4.4%, according to the average of various measures, and has risen more slowly than measured inflation in recent months.

Rising house prices continued to be the main driver of the rise in the CPI in January, supplemented by the effects of seasonal price list increases for various public services, which were considerably stronger than at the same time in recent years. Food and new motor vehicles rose in price as well. The price of clothing, footwear, and furniture fell as a result of seasonal sales, albeit less than was customary before the pandemic.

Short-term inflation expectations have risen, according to recent surveys, but inflation is generally expected to subside in the next two years. Market agents and corporate executives expect it to measure 3% in two years' time, while households project it at 4%. Households' and businesses' long-term inflation expectations are unchanged at 3-3.5%, but market agents' expectations have risen. Market agents expect inflation to average 3% in the next five years and 2.75% in the next ten years. The breakeven inflation rate in the bond market has risen again, with the five-year breakeven rate five years ahead measuring 3% at the beginning of February.

According to the forecast published in *Monetary Bulletin* on 9 February 2022, the inflation outlook has deteriorated markedly since November, owing mainly to a stronger domestic economic recovery, more persistent house price inflation, and larger-than-expected global price increases. It appears that it takes longer than previously expected for global cost increases to pass through to prices in Iceland. Because of these factors, together with the sharp increase in unit labour costs and the rise in long-term inflation expectations, inflation will ease slowly back to target. Inflation is forecast to decline in 2023, when the effects of global price increases begin to subside and house price inflation starts to ease; however, it is not expected to fall below 3% until the latter half of the forecast horizon.

A strong economic recovery took place among Iceland's main trading partners in 2021, but because of a setback in the pandemic and continued global supply-chain bottlenecks, the outlook is for relatively weaker GDP growth in 2022. Indicators suggest robust growth in domestic demand in Q4, however, and GDP growth for 2021 as a whole is therefore estimated at 4.9%, a percentage point more than in the November forecast. On the other hand, the GDP growth forecast for Q1/2022 has been revised downwards in response to the recent spike in COVID infections, and growth is now projected at 4.8% for 2022 as a whole. Furthermore, job numbers are still rising rapidly, and unemployment is approaching its pre-pandemic level. Leading indicators also imply that the slack in output has closed. The forecast assumes that there will not be a severe setback in the battle against the pandemic and that continuing progress will be made in unwinding the supply-chain disruptions that have pushed various commodity prices sharply higher. There is considerable uncertainty about this, however. Moreover, the rise in inflation expectations could indicate that inflation will turn out even more persistent than is currently forecast.

## **II Decisions on the Bank's monetary policy instruments**

The MPC held an extraordinary meeting in January 2022, where proposals to open a new liquidity window, cancel the special temporary COVID-19-related credit facilities, and make seven-day term deposits redeemable, subject to a redemption fee, were presented. The liquidity window and the changes in terms and conditions for term deposits had already been approved at a meeting of the Financial Stability Committee (FSN) in December 2021. After having discussed these matters, the MPC declared itself in agreement with the changes and concurred with the FSN that it was appropriate to close the temporary collateralised lending framework. The MPC decided to confirm these decisions at its February meeting. Furthermore, the Committee agreed that it was appropriate to review and revise the rules on Central Bank facilities and current accounts, with an eye to safeguarding the Bank's legally mandated monetary policy objectives and its scope to apply monetary policy so as to promote price stability.

The MPC discussed the monetary stance in view of economic developments and the fact that the Bank's real rate had fallen since the November meeting. Members discussed whether the monetary stance was appropriate in view of the considerably poorer inflation outlook, as they had decided in November to continue tightening it.

They also noted that according to the Bank's new macroeconomic forecast, published in the February *Monetary Bulletin*, GDP growth measured 4.9% in 2021, about 1 percentage point above the November forecast. Similar growth was projected for 2022. It emerged that private consumption growth had been robust in Q4/2021, as real disposable income had risen in the recent term. The Committee noted that job numbers had continued to rise and unemployment to fall, and the slack in output that opened up in the wake of the COVID-19 pandemic was estimated to have closed. Members were of the view that considerable uncertainty remained, however.

The MPC discussed the marked deterioration of the inflation outlook since the November meeting, noting that headline inflation had measured 5.7% in January. Underlying inflation had also risen and was estimated at just over 4%. Furthermore, inflation expectations had risen by some measures. Members noted that the rise in house prices was a major factor, although other domestic cost items had risen as well. Added to this was the rise in global oil and commodity prices. They noted that according to the Central Bank's forecast, the outlook was for inflation to measure 5.8% in Q1/2022 and remain above 5% well into this year. It emerged as well that

inflation would ease when house price inflation slowed down and global price hikes tapered off, but that inflation would not align with the target until the end of the forecast horizon.

All members agreed that the Bank's key rate should be raised, and they discussed rate increases ranging from 0.5-1 percentage point. One of the main arguments discussed at the meeting in favour of taking a smaller step centred on the fact that higher inflation had been expected at the time of the November meeting, even though it had turned out somewhat above those expectations. It was pointed out that some of the price increases were pandemic-related and beyond the scope of monetary policy, and that their impact would subside in the coming term. It was pointed out as well that a larger share of households now had non-indexed variable-rate mortgages, and that the effects of interest rate hikes would come to the fore more quickly than they had in the past. Furthermore, the effects of the macroprudential tools introduced in mid-2021 had yet to emerge in full, and the impact of the maximum debt service-to-income ratio for mortgage loans would not emerge until later in 2022. In view of these factors, it would be better to take a smaller step in raising interest rates.

The main arguments discussed at the meeting in favour of a larger step were that the inflation outlook had worsened markedly and inflation appeared likely to subside to target more slowly than had previously been expected. Furthermore, long-term inflation expectations had risen since the Committee's November meeting. Concerns were expressed about potential second-round effects from higher imported goods prices and wage hikes. These could show in larger and more widespread rises in goods and services prices in response to stronger imported inflationary pressures and higher wage costs, which could trigger a wage-price spiral. Inflation was already relatively widespread, as underlying inflation had also risen and had been persistent. In the wake of a rate hike now, the Bank's key rate would be close to the pre-pandemic level, while domestic economic activity was, if anything, stronger than before the pandemic. Now that the economic recovery had begun, the slack in output had probably closed, and unemployment was set to continue falling, it would be appropriate to respond more decisively to the persistent rise in inflation, worsening inflation outlook, and rise in inflation expectations. Moreover, the real rate had fallen markedly between MPC meetings, and it would be necessary to raise nominal interest rates somewhat in order to tighten the monetary stance.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.75 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 2.75%, the current account rate 2.5%, the seven-day collateralised lending rate 3.5%, and the overnight lending rate 4.5%. All Committee members voted in favour of the proposal.

At the meeting, the MPC reiterated 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, 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 4 May 2022.