CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2023

May
115th meeting
Published 7 June 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 22 and 23 May 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 24 May.

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 22 March 2023, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2023/2 on 24 May.

Financial markets

Since the March meeting, the króna had depreciated by 0.6% 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 had eased since the March meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was 0.3%, or 0.2 percentage points lower than just after the announcement of the March interest rate decision. In terms of twelve-month inflation, however, it was -2.2% and had risen by 0.3 percentage points 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 March, but there had been no turnover in the market since the MPC's last meeting. Yields on long-term nominal Treasury bonds had fallen by 0.6 percentage points since the March meeting, whereas yields on long-term indexed Treasury bonds were virtually unchanged. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in March, and average indexed mortgage rates had increased marginally.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 0.7-0.8 percentage points between meetings, to 5.3 percentage points versus the euro area and 3.3 percentage points versus the US. At the same time, the long-term interest rate differential had narrowed by 0.7-0.8 percentage points, to 4.2 percentage points versus Germany and 2.9 percentage points versus the US. Measures of the risk premium on the Treasury's foreign obligations had fallen marginally 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 1.1-1.4 percentage points.

According to the Central Bank's quarterly market expectations survey, conducted in May 2023, respondents expected the Bank's key rate to rise to 8.5% in Q2 and then begin to fall in Q1/2024. They expected the key rate to be 8.25% one year ahead and 6% two years ahead. The share of respondents who considered the monetary stance too loose had more than doubled between surveys, from 28% to 66%. The share who considered it appropriate declined accordingly, from 56% to 17%, while another 17% considered the monetary stance too tight.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 1 percentage point, on the grounds that inflation had been more persistent than expected and increasingly broad-based. Furthermore, underlying inflation had continued to rise and inflation expectations were still high, and it was important to bring expectations down because of how soon the next round of wage negotiations was set to begin. They also mentioned the tight labour market, strong demand, and the improved outlook for year-2023 GDP growth. On the other hand, there were signs that demand could ease in coming months.

Year-on-year growth in M3 slowed marginally at the beginning of the year and measured 9% in March. The weight of household deposits in year-on-year growth increased again, while growth in corporate deposits eased, although it remains robust. Year-on-year growth in household lending eased at the same time, measuring 8.5% in March, while corporate lending growth remained strong, at 13.9% year-on-year as of March. According to the lending survey conducted by the Central Bank in April, commercial banks assume that the supply of credit to businesses will decline somewhat in the next six months.

The Nasdaq OMXI10 index had fallen by 7.4% between meetings. Turnover in the Main Market totalled 312 b.kr. in the first four months of 2023, some 28% less than over the same period in 2022. The difference between years is due in large part to the March 2022 auction of a portion of the State's holding in Íslandsbanki.

Global economy and external trade

According to the International Monetary Fund's (IMF) April forecast, global GDP growth is projected to shrink from 3.4% in 2022 to 2.8% in 2023 and then ease upwards to 3% in 2024. This output growth rate is broadly in line with the Fund's January 2023 and October 2022 forecasts, but far below the twenty-year average. According to the forecast, growth will subside particularly in advanced economies, falling from 2.7% in 2022 to 1.3% in 2023. Global GDP growth could turn out even weaker this year, however, if there is further turmoil in the financial markets. According to the likely alternative scenario presented by the IMF, global output growth could fall to around 2.5% this year and dip below 1% in advanced economies if such turmoil materialises. The IMF forecasts that global inflation will subside from 8.7% in 2022 to 7% in 2023, in tandem with the decline in global commodity prices. For 2024, global inflation is forecast at 4.9%. The Fund is of the opinion that underlying inflation will probably ease more slowly, however. Furthermore, in most cases inflation will not fall back to central bank targets until 2025 at the earliest.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 45 b.kr. in Q1/2023, as compared with a deficit of 20 b.kr. at constant exchange rates over the same period in 2022. Export values rose by 1% year-on-year during the quarter, reflecting an increase in the value of marine products and pharmaceutical and medical equipment, offset by a decrease in the value of aluminium and ferrosilicon as a result of lower prices. At the same time, goods imports rose in value by 12%, with all key import components still growing rather strongly, apart from transport equipment.

Global aluminium prices had declined by just over 1% since the MPC's March meeting, to about 2,200 US dollars per tonne, which is one-fourth below the May 2022 price. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine product exports fell by 1.2% quarter-on-quarter in Q1/2023 but were around 13% higher than in the same quarter of 2022. The global price of Brent crude rose by 2% between MPC meetings, to 77 US dollars per barrel by the time of the May meeting. Nevertheless, this is about a third below the May 2022 price.

The real exchange rate in terms of relative consumer prices rose by 1.4% month-on-month in April, when it was 7.6% above its 25-year average but 1.8% lower than in December 2019. In Q1/2023, it was down by 2.1% compared with the same period in 2022, as the nominal exchange rate of the króna was 4.5% lower and inflation in Iceland was 2.7 percentage points above the trading partner average.

Domestic economy and inflation

According to the seasonally adjusted results of Gallup's spring survey among executives from Iceland's 400 largest companies, 30% of firms were planning to recruit staff in the next six months, and only 12% were planning to downsize. The balance of opinion is therefore positive by 18 percentage points, or more than 10 percentage points above the historical average, even though it has narrowed relative to the winter survey. Furthermore, 44% of respondents considered their firms short-staffed, and 58% were of the opinion that they would have difficulty responding to an unexpected increase in demand.

According to the Statistics Iceland labour force survey (LFS), total hours worked rose by 4.4% year-on-year in Q1/2023, as the number of employed persons increased by 4% and the average work week was longer by 0.4%. Seasonally adjusted job numbers and hours worked increased only marginally between quarters, after strong job growth in Q4/2022. The number of workers on the pay-as-you-earn (PAYE) register rose accordingly, and seasonally adjusted figures show that employment in most sectors is broadly back to the pre-pandemic level.

According to seasonally adjusted LFS data, the labour participation rate fell quarter-on-quarter by 0.1 percentage points and the employment rate by fell by 0.2 percentage points in Q1/2023. Unemployment therefore rose by 0.1 percentage points between quarters, to 3.7%. The LFS measure of the slack in the labour market increased more between quarters, however. Nevertheless, it, like unemployment, is still ½ a percentage point lower than just before the pandemic hit Iceland. Seasonally adjusted registered unemployment continued to fall, however, to 2.6% by April, its lowest since summer 2018.

Iceland's population grew by 3.6% year-on-year in Q1/2023. The increase is due mostly to immigration, as net migration of foreign nationals was positive by 2,790 persons during the quarter.

The general wage index rose by 3.5% between quarters in Q1, and by 8.9% year-on-year, while real wages rose 1% quarter-on-quarter but fell by 1% year-on-year.

Key indicators of developments in private consumption in Q1/2023 suggest continued strong growth during the quarter. Payment card turnover in Iceland and abroad grew markedly between years in Q1, and the Gallup Consumer Confidence Index suggests that consumers are slightly less pessimistic than they were in H2/2022. The Central Bank's baseline forecast therefore assumes considerably stronger private consumption growth in Q1 than was projected in February.

Statistics Iceland's nationwide house price index, published in late April, rose by 1.2% month-on-month, after adjusting for seasonality, and by 12.4% year-on-year. The capital area house price index, calculated by the Housing and Construction Authority, rose by 0.2% month-on-month in April when adjusted for seasonality, but rose by 8.6% year-on-year. The number of purchase agreements registered nationwide fell by 25.5% year-on-year in the first four months of 2023, and the number of contracts for new construction declined by 29.4% over the same period. The average time-to-sale in the capital area was 5.4 months in April, considerably more than the April 2022 figure of 0.9 months, as the number of homes for sale has increased significantly in recent months.

The CPI rose by 1.31% month-on-month in April, pushing twelve-month inflation up slightly, to 9.9%. Inflation excluding housing rose as well, to 8.7%. Underlying inflation also increased between months, to 7.5% according to the average of various measures.

The main driver of the April rise in the CPI was the cost of owner-occupied housing. House prices rose month-on-month throughout the country but increased the most in regional Iceland. Food and beverage prices continued to climb in April, when the year-on-year increase measured 12.5%. Private services also jumped in price between months, driven largely by the rise in airfares. In the past year, however, price increases have been distributed across a large number of services items.

According to the Central Bank's market expectations survey, respondents' two-year inflation expectations have risen since the previous survey and now measure 4.5%. Their long-term inflation expectations have also risen between surveys. Market participants expect inflation to average 4% over the next five years – the highest measurement since 2013 – and 3.5% over the next ten years. However, the breakeven inflation rate in the bond market has fallen since the last MPC meeting. The ten-year breakeven rate was just over 4% in mid-May, after falling by ½ a percentage point between meetings, and the five-year breakeven rate five years ahead had fallen by a similar amount over the same period.

According to the forecast published in *Monetary Bulletin* on 24 May 2023, the outlook is for inflation to ease more slowly than previously projected. Underlying inflation has increased, and steep price hikes can be seen in a steadily growing share of the consumption basket. Although offset by declining global inflation, domestic inflationary pressures are strong, and more so than was assumed in the Bank's February forecast. As a result, the outlook is for inflation to exceed that forecast in both 2023 and 2024. This is due largely to a more unfavourable initial position, but also to greater demand pressures in 2023, albeit mitigated by a stronger króna. According to the forecast, inflation will exceed 8% throughout this year. It will not fall below 4% until late in 2024 and will not fall below 3% until well into 2026.

Although trading partner GDP growth has softened recently, it has been more resilient than was assumed in the February forecast. The GDP growth outlook for 2023 has therefore improved. Nevertheless, growth is still expected to be sluggish in 2023 and 2024, averaging about 1% per year. Global inflation has fallen, but underlying inflation remains high, indicating that there is still some ground to cover before measured inflation can be brought back to target.

Preliminary figures from Statistics Iceland indicate that GDP growth in Iceland measured 6.4% in 2022, the strongest growth rate since 2007. It was driven by a surge in domestic demand – especially private consumption, which grew by 8.6% year-on-year. GDP growth was slightly below the Bank's February forecast, however, reflecting, on the one hand, less favourable external trade and the effects of changes in Statistics Iceland's treatment of intellectual property in the pharmaceuticals sector, and on the other, stronger growth in domestic demand. GDP growth for Q1/2023 appears to have far outpaced the February forecast and therefore looks set to exceed it for the year as a whole as well. This year's GDP growth is now projected at 4.8%, as compared with 2.6% in the February forecast. This mainly reflects the impact of stronger growth in domestic demand, plus improved prospects for tourism and the effects of the above-mentioned methodological changes by Statistics Iceland. The outlook for output growth in the coming two years is more or less unchanged from the February forecast, however.

The global economic situation has been unusually uncertain for quite some time and still remains so. The shocks of recent years have been numerous and unprecedented: a global pandemic and war in Europe led to severe supply chain disruptions and soaring energy and commodity prices, which the global economy is still grappling with. The global economic outlook could therefore be overestimated. The same is true of the domestic inflation outlook, as the anchoring of inflation expectations to the target has weakened, thereby exacerbating the risk of larger pass-through of exchange rate and wage shocks, which in turn increases the risk that a wage-price spiral will develop.

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 March meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its March meeting to raise interest rates still further. At that time, inflationary pressures had continued to grow, the Bank's real rate had fallen, and domestic demand had grown more than anticipated.

Committee members noted that economic activity had been strong in 2023 to date and that the Central Bank's new macroeconomic forecast assumed that GDP growth would measure 4.8% this year instead of the 2.6% projected in February. This was due in large part to the prospect of stronger growth in domestic demand, although the outlook was also for more robust activity in the tourism industry.

The MPC noted that inflation had measured 9.9% in April, after rising slightly between months. It emerged that underlying inflation was still increasing and that steep price hikes could be seen in a steadily growing share of the consumption basket. Members noted as well that the outlook was for considerably stronger inflationary pressures in 2023 and 2024 than had previously been assumed. They also observed that long-term inflation expectations had risen and were well above target. Thus, there was a greater risk that inflation would become entrenched.

All members agreed that the Bank's key rate needed to be raised further, and they discussed rate increases ranging from 1-1.5 percentage points. The main arguments expressed were that inflationary pressures were still growing and the domestic economy remained quite strong. Although monetary policy had clearly had an impact on the housing market, there were few other definite indications of a turnaround. There were signs that firms' cost increases were being passed through to the price level to a large extent, as domestic demand was strong. Furthermore, the real rate had fallen between meetings, although it was slightly positive. The MPC was also concerned about how soon the next round of wage negotiations were due to begin and how little time there was to make discernible progress. The labour market remained quite tight, unemployment was low, and worker shortages were widespread. In this context, Committee members discussed how the past few years' developments in real wages in Iceland had differed from those in other advanced economies. Real wages had risen far more in Iceland in 2020-2021 and had fallen less in H2/2022 than in Iceland's main trading partner countries. Robust real wage growth was therefore one of the reasons inflation had been above target for so long and had apparently become persistent. Committee members also discussed the fiscal stance, and asserted that tighter fiscal policy would support monetary policy and result in a more effective economic policy mix. Furthermore, they agreed that all else being equal, with a more favourable policy mix, interest rates might not have to be raised as high and the opportunity cost in the form of weaker economic activity might turn out lower in the long term than it would be otherwise.

It was pointed out that there were several countervailing factors that could cause demand to weaken rapidly. Households had drawn down their accumulated savings more quickly than previously estimated in order to finance increased consumption, and the outlook was for a slowdown in private consumption growth. Housing market activity had eased, and financial conditions were growing tighter. Moreover, a large share of households would be faced with mortgage interest rate reviews in the coming term and could expect their debt service burden to rise, all else being equal. It was also pointed out that the impact of recent rate hikes had not yet come fully to the fore.

The MPC considered it important to bring inflation and inflation expectations down over the course of the current year. High inflation expectations could lead to higher wage demands in the upcoming negotiation round, and large pay rises could lead to a wage-price spiral, particularly if demand were still strong enough to make it easy to pass cost increases through to prices. This could result in even more persistent inflation, which would necessitate larger rate hikes and rates would have to be higher over a longer period of time. In view of this, it would be better to raise interest rates now and take larger steps, in order to make progress sooner than to take smaller steps and be faced with the need to keep interest rates high for a longer period of time. Although it could put strain on the real economy in the short run, it would be beneficial in the long run to bring inflation down rapidly, and then be able to start cutting rates sooner than would otherwise be possible. If bringing inflation and inflation expectations under control required an abrupt cooling of the economy, that was what would be done.

Members discussed whether deposit institutions' minimum reserve requirements should be increased, as the MPC had decided in March 2020 to lower them to give those institutions greater flexibility to respond to the changed circumstances brought on by the pandemic. Members were of the view that increasing minimum reserve requirements would lead to a rise in deposit institutions' marginal funding costs, which would reduce their scope for lending, all else being equal. They agreed, however, that increasing reserve requirements would not substitute for an increase in interest rates, which were the main monetary policy instrument.

In view of the discussion, the Governor proposed that deposit institutions' fixed reserve requirement be increased from 1% to 2%. All Committee members voted in favour of the proposal. It also emerged that if the need arose, the MPC could decide later to apply reserve requirements to a greater extent.

The Governor also proposed that the Bank's interest rates be raised by 1.25 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 8.75%, the current account rate 8.5%, the seven-day collateralised lending rate 9.5%, and the overnight lending rate 10.5%. Ásgeir Jónsson, Rannveig Sigurdardóttir, Ásgerdur Ósk Pétursdóttir, and Herdís Steingrímsdóttir voted in favour of the proposal. Gunnar Jakobsson voted against the Governor's proposal and wanted to raise rates by 1 percentage point, as he was of the opinion that the impact of previous rate hikes had not yet fully come to the fore and a larger rate increase was therefore not necessary at this time.

It emerged at the meeting that, in view of circumstances, it would be necessary to tighten the monetary stance still further. The Committee considered it especially important to prevent a wage-price spiral, particularly in view of the strong demand pressures in the economy and how soon the round of next wage negotiations was due to begin. In the MPC's opinion, the outlook was therefore for further rate hikes in order 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 23 August 2023.