CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2023

November
118th meeting
Published 6 December 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 20-21 November 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 22 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 4 October 2023, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2023/4 on 22 November.

Financial markets

Since the October meeting, the króna had depreciated by 3.5% in trade-weighted terms. Between meetings, the Bank sold foreign currency for 18 million euros (2.8 b.kr.). The Bank's transactions during the period accounted for 7% of total turnover in the foreign exchange market.

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 2.7%, or 0.1 percentage points lower than just after the announcement of the October interest rate decision. In terms of twelve-month inflation, however, it was 1.3% and had risen by 0.1 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 were virtually unchanged between meetings, but there had been no turnover in the market during the period. Yields on long-term nominal Treasury bonds had fallen by as much as 0.3 percentage points since the October meeting, and yields on long-term indexed Treasury bonds had fallen by up to 0.4 percentage points. Furthermore, average rates on non-indexed and indexed mortgage loans had risen between meetings.

In terms of three-month interbank rates, the short-term interest rate differential had narrowed by 0.1 percentage points versus the euro between meetings, to 6 percentage points, but was unchanged at 4.3 percentage points versus the US. The long-term interest rate spread widened by 0.1 percentage points between meetings, to 4.9 percentage points versus Germany and 3 percentage points versus the US. Measures of the risk premium on the Treasury's foreign obligations were broadly unchanged between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.8%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 1.2-1.3 percentage points.

According to the Bank's quarterly survey of market agents' expectations, carried out in early November, respondents were of the view that the Bank's key rate had peaked at 9.25% and would start to fall in Q2/2024. They also expected the key rate to measure 8.25% in one year and 6.25% in two years. This is a somewhat higher interest rate than they expected in the August survey. Survey participants' responses on the monetary stance changed somewhat between surveys. Most participants still considered the monetary stance appropriate at present, with 60% reporting this opinion, up from 44% in the previous survey. The share that considered the monetary stance too loose fell between surveys from 30% to 13%, and around 27% of respondents considered the monetary stance too tight.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged, on the grounds that although inflation was still high and the labour market still tight, uncertainty about the seismic activity on Reykjanes peninsula would weigh heavier in the decision-making process.

Annual growth in M3 measured 10.4% in September. The pace slowed after a brief increase in August, which was due in part to the sale of a domestic biotech firm to foreign investors. Twelve-month growth in credit system lending to households has eased, measuring 6.1% in September. Net new lending to households has picked up since mid-year, however. Furthermore, year-on-year growth in credit system lending to companies has lost pace, measuring 7.7% in September after averaging 14% in H1/2023.

The Nasdaq OMXI10 index had fallen by 5.6% between meetings. Turnover in the Main Market totalled 624 b.kr. in the first ten months of 2023, some 29% less than over the same period in 2022.

Global economy and external trade

According to the International Monetary Fund's (IMF) October forecast, global GDP growth is projected to fall from last year's 3.5% to 3% this year and 2.9% in 2024. This is in line with the Fund's recent forecasts, but well below the twenty-year average. Weaker output growth in 2023 can be attributed in particular to advanced economies, where growth is projected to fall from 2.6% in 2022 to 1.5% this year and 1.4% in 2024. Prospects have improved for the US, according to the IMF, but have worsened for the eurozone and China. In addition, the outlook is for a marked slowdown in world trade, which is expected to decline more than GDP growth. Prospects for advanced economies' imports have deteriorated in particular this year, according to the IMF. The Fund therefore projects that global headline inflation will fall from 8.7% in 2022 to 6.9% in 2023 and then expected to drop to an average of 5.8% in 2024, reflecting the impact of monetary tightening by major central banks and lower global commodity prices. Core inflation will fall more slowly, in the IMF's opinion, and in most cases headline inflation will not return to target until 2025.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 95.7 b.kr. in Q3/2023 and 223.7 b.kr. in the first three quarters of the year, as compared with a deficit of 121.8 b.kr. at constant exchange rates over the first three quarters of 2022. Export values shrank by 11% year-on-year at constant exchange rates, with contractions in all key export categories. The year-on-year decline in values is due both to lower prices in most categories and to a contraction in marine product exports. At the same time, import values rose by about 2% at constant exchange rates, owing to an increase in the value of investment goods, consumer goods, and transport equipment, which was offset by a decrease in the value of fuels and commodities and operational inputs. The year-on-year increase in imported goods values is due to price hikes, as the volume of imports contracted between years.

The global price of aluminium had risen slightly since the MPC's October meeting, to 2,200 US dollars per tonne. Nevertheless, this is nearly 6% lower than in November 2022. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products rose again between quarters in Q3 and were an average of 7% higher over the first three quarters of 2023 than in the same period of 2022. The global price of Brent crude had fallen by nearly 4% between MPC meetings, to about 82 US dollars per barrel by the time of the November meeting, some 6% lower than in November 2022. Other commodity prices had also fallen since the October meeting.

The real exchange rate in terms of relative consumer prices fell by 1.15% month-on-month in October, when it was 10.5% above its 25-year average and 1% higher than in December 2019. By this measure, it was unchanged year-on-year during the first ten months of 2023, as the króna depreciated by just over 3% in nominal terms, while inflation in Iceland was just over 3% above the trading partner average.

Domestic economy and inflation

According to the Statistics Iceland labour force survey (LFS), total hours worked rose by 6.4% year-on-year in Q3/2023. Job creation measured slightly less than 5.7% year-on-year, and the average work week grew longer by 0.7%. Growth in jobs and total hours worked during the quarter were affected strongly by the quarter-on-quarter decline a year earlier. In terms of seasonally adjusted LFS data, job numbers rose negligibly between quarters, while total hours worked increased by ½%, as did the seasonally adjusted number of wage-earners according to the pay-as-you-earn (PAYE) register.

Seasonally adjusted LFS data for Q3 show strong labour participation and employment rates. By the same token, unemployment is low, at 3.3% during the quarter, broadly in line with the H1 average. Seasonally adjusted registered unemployment is low as well, but it rose slightly between quarters, for the first time since late 2020. It measured 3.2% in Q3, or 0.1 percentage points more than in the quarter beforehand, and continued to rise to 3.4% in October.

Iceland's population grew by 3% year-on-year in Q3. Net inward migration of foreign nationals – the main driver of job creation in the recent term – was just over 2,400 during the quarter. Increased inflows of refugees have also explained a fair share of population growth from 2022 onwards. Although population growth is still strong in historical context, it has eased somewhat in the past two quarters.

The general wage index rose by 1.2% between quarters in Q3, and by 10.8% year-on-year. Real wages were 2.8% higher in Q3 than in the same quarter of 2022.

Key indicators of private consumption suggest broadly unchanged year-on-year growth between Q2 and Q3. Total payment card turnover continued to shrink between years and the Gallup Consumer Confidence Index showed that consumer pessimism had risen again, although these were offset by a minor increase in new motor vehicle registrations. If the Bank's forecast of private consumption in Q3 materialises, households have stepped up their saving again, pushing the saving rate above its pre-pandemic average once more.

Statistics Iceland's nationwide house price index, published at the end of October, rose by 0.3% month-on-month, after adjusting for seasonality, and by 2% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1.1% month-on-month in October when adjusted for seasonality, and by 2.9% year-on-year. The number of purchase agreements registered nationwide fell by 15.8% year-on-year in the first ten months of 2023, and the number of contracts for new construction declined by 23% over the same period. The average time-to-sale in the capital area was 5.6 months in October, considerably more than the October 2022 figure of three months, and the number of homes for sale has continued to increase markedly in recent months.

The CPI rose by 0.6% month-on-month in October, and twelve-month inflation eased marginally, from 8% to 7.9%. Inflation excluding housing declined as well, to 7,3%. Underlying inflation was 6.3% according to the average of various measures and has fallen steadily from its spring 2023 peak of 7.5%.

Increased owner-occupied housing costs, higher food prices, and higher prices for recreation and cultural activities were the main drivers of the rise in the CPI in October. Owner-occupied housing costs rose 2% month-on-month, and the housing component is once again the main contributor to twelve-month inflation. Year-on-year house price inflation nationwide increased from September, measuring 3.2%. Food prices rose by 1% in October and are up 11.7% in the past twelve months.

According to the Bank's market expectations survey, participants' one- and two-year inflation expectations fell marginally, to 5.5% and 4.2%, respectively. As in August, they expected inflation to average 4% over the next five years, while their ten-year expectations fell slightly, to 3.5%. However, the breakeven inflation rate in the bond market rose between MPC meetings. The five-year breakeven rate five years ahead was just under 4% in mid-November, some 0.6 percentage points higher than at the beginning of October.

According to the forecast published in *Monetary Bulletin* on 22 November, the near-term inflation outlook has deteriorated again. Inflation is now projected to measure 7.9% in Q4 and fall to 6.8% in Q1/2024, which is 1 percentage point above the August forecast. It is also expected to fall more slowly next year than previously anticipated, to 4.9% at the end of 2024 and an average of 3.6% in 2025. The poorer outlook is due in part to a larger output gap than was assumed in August; furthermore, the króna has depreciated more than was forecast then. There are also signs that cost hikes have a stronger and more persistent impact on inflation than before.

Global GDP growth has softened due to steep cost hikes and rising household living expenses. As in August, trading partner GDP growth is forecast at roughly 1% in both 2023 and 2024. Global inflation is also expected to continue easing. Underlying inflation has fallen less, however, and the outlook is for policy rates in major advanced economies to remain high.

After Statistics Iceland's revision, year-2022 GDP growth proved 0.8 percentage points stronger than previously projected, or 7.2%, in line with the Bank's February forecast, which was prepared before the 2022 national accounts were available. The revised figures imply as well that the output gap was wider in 2022 than previously estimated. GDP growth in Iceland measured 5.8% in H1/2023, or 0.4 percentage points above the Bank's August forecast. Although private consumption growth has eased, domestic demand has been a major driver of economic activity in 2023. Added to this is favourable external trade, fuelled by strong growth in tourism. The outlook is for 3.7% GDP growth in 2023 as a whole, up from 3.5% in the August forecast. This represents a sharp decline relative to 2022, although it remains well above estimated long-term potential output. As in August, GDP growth is expected to continue easing, to an average of 2¾% per year over the next three years; however, it is assumed both that the output gap will be wider than was estimated in August and that a small positive output gap will remain at the end of the forecast horizon.

The supply side of the global economy has largely normalised after recent shocks, and non-energy commodity prices have fallen. The outlook is ambiguous, however, not least because of the wars in Ukraine and the Middle East. The resilience of the recovery in major advanced economies and China remains uncertain as well. Although measured inflation has eased, underlying inflation has proven stubborn. The inflation outlook is uncertain in Iceland as well, as inflation expectations seem less firmly anchored to the target and the upcoming wage negotiations could throw the prospect of continued disinflation into disarray.

Domestic uncertainty has also escalated due to increased seismic activity on the Reykjanes peninsula. If a large eruption takes place near key infrastructure, the resulting damage could be substantial. The economy could also be strongly affected by a protracted eruption. A major eruption could have a profound impact on tourism, other exports, public sector performance, the exchange rate, and inflation.

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 fallen marginally since the October meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its October meeting to hold interest rates unchanged. At that time, economic developments had been consistent overall with the assessment made by the MPC at its August meeting. Inflation had risen again, while economic activity had lost pace, and indicators implied that growth in domestic demand had eased even further in Q3.

The MPC noted that inflation had fallen slightly between months, to 7.9% in October. Underlying inflation had subsided as well. It came to light that indicators continued to suggest a slowdown in private consumption and investment.

The Committee discussed the fact that the inflation outlook had nevertheless deteriorated according to the Bank's forecast. They noted that the output gap had been larger than previously anticipated, and the króna had depreciated. Committee members were concerned that inflation expectations remained high and that cost increases appeared to have a stronger and more persistent impact on inflation than they had previously.

All members agreed that interest rates should be held unchanged for the time being, owing to uncertainty about the economic impact of the seismic activity on the Reykjanes peninsula. It emerged in the discussion that it was highly uncertain how the seismic unrest would affect the economy, especially Government finances, tourism, and the housing market, and therefore inflation, depending on how the situation developed. The MPC therefore considered it appropriate to wait and see how matters played out. It also emerged in the discussion that economic activity had continued to lose pace and that growth in private consumption and investment had subsided. It was clear that the effects of the previous interest rate hikes were coming to the fore, the real rate had risen since H1/2023, and consumers were more pessimistic about the economic outlook. It was pointed out that indexed lending rates had risen as well in the recent past, in tandem with the rise in the real rate, which could reduce demand for loans, all else being equal.

On the other hand, the Committee considered it cause for considerable concern that inflation was so persistent and that the inflation outlook had deteriorated again. The outlook was still for robust GDP growth, the output gap was larger than previously estimated, and the labour market remained quite tight. House prices were still rising, and mortgage lending growth had picked up again. It was pointed out as well that, even though indicators implied that domestic demand had eased, they were not unequivocal. Thus it was probable that the monetary stance was not tight enough to bring inflation back to target within an acceptable time frame. Had it not been for the uncertainty about a possible volcanic eruption, the need for a tighter stance would therefore have been broadly the same as at the previous meeting. It was pointed out that given how persistent inflation was, and given the outlook for a slow disinflation process, there was greater risk that inflation would become entrenched at a level well above the target. As a consequence, tightening the monetary stance too little was riskier than tightening it too much. It was pointed out that in view of the poorer inflation outlook, and because economic activity was still relatively brisk, it would probably have been appropriate to raise interest rates further had it not been for the uncertainty arising from the Reykjanes situation. In addition, concerns were expressed that if inflationary pressures should begin mounting again, it could prove necessary to raise interest rates more, and keep them high for longer, than would otherwise be needed. MPC members also discussed whether fiscal easing in connection with the seismic activity would possibly push inflation higher in the future.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would be 9.25%, the current account rate 9%, the seven-day collateralised lending rate 10%, and the overnight lending rate 11%. All Committee members voted in favour of the proposal.

It emerged at the meeting that although the effects of recent interest rate hikes were coming more clearly to the fore, the poorer inflation outlook suggested that it could prove necessary to tighten the monetary stance still further. The Committee was of the opinion that as before, near-term monetary policy formulation would be determined by developments in economic activity, inflation, and inflation expectations.

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 7 February 2024.