The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

August 2020 (97th meeting)

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and the premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each decision. The votes of individual Committee members are also included in the minutes.

The following are the minutes of the MPC meeting held on 24 and 25 August 2020, 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 26 August.

I Economic and monetary developments

Before turning to the interest rate decision, 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 May meeting, as published in the updated forecast in *Monetary Bulletin* 2020/3 on 26 August.

Financial markets

Since the May meeting, the króna had depreciated by 2.5% in trade-weighted terms. Over this same period it fell by 3.2% against the pound sterling and 3.9% against the euro but rose by 3.8% against the US dollar. Between meetings, the Bank purchased foreign currency in the amount of 60 million euros (9.1 b.kr.) and sold currency for 141 million euros (22.5 b.kr.). The Bank's transactions accounted for just over 30% of total foreign exchange market turnover for the period.

In terms of the Central Bank's real rate, the monetary stance eased since the May meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was -1.7%, or 0.4 percentage points lower than just after the publication of the

May interest rate decision. In terms of twelve-month inflation, it was -1.9% and had fallen by 0.8 percentage points between meetings.

Interest rates in the interbank market for krónur fell in line with the Central Bank's rate reduction in May, but there was no turnover in the market during the period. Yields on long-term nominal Treasury bonds had risen by up to 0.2 percentage points since the May meeting, while yields on long-term indexed Treasury bonds had fallen by 0.4 percentage points. Average rates on non-indexed mortgage loans had fallen between meetings, and average rates on indexed mortgage loans had also fallen slightly.

In terms of three-month interbank rates, the interest rate differential had narrowed against the euro by 0.4 percentage points between meetings, to 2.1 percentage points, and had narrowed by 0.5 percentage points against the US dollar, to 1.3 percentage points. The long-term interest rate spread versus Germany was broadly unchanged between meetings, at 3 percentage points, whereas the spread versus the US had widened slightly, to 1.9 percentage points. 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 0.7 percentage points.

Financial institutions' analysts expected the MPC either to hold the Bank's interest rates unchanged or to lower them by 0.25 percentage points, noting that despite persistent uncertainty about the path the COVID-19 pandemic would take, the economy had in many ways been more resilient than expected. On the other hand, inflation had risen in excess of expectations and the real rate had fallen, thereby easing the monetary stance.

According to the Central Bank's quarterly market expectations survey, conducted in mid-August, respondents expected the Bank's key rate to remain unchanged at 1% in Q3/2020, followed by a rate cut of 0.25 percentage points in Q4. This is a lower rate than survey participants expected in May, when they projected that the Bank's key rate would bottom out at 1% in Q4/2020. In the August survey, about half of respondents considered the monetary stance appropriate at present, up from 19% in the previous survey. However, the share who considered the monetary stance too tight or far too tight declined from just over 70% in the May survey to 28% in this survey. Roughly 23% of respondents considered the stance too loose or far too loose, as compared with 11% in the Bank's previous survey.

Annual growth in M3 has gained pace as the year has progressed, measuring 13½% in July, adjusted for the deposits of the failed financial institutions. Growth in credit system lending to domestic borrowers lost pace over the course of 2019, but annual growth has been relatively stable at around 4% thus far in 2020. In June, household lending grew by just over 6% year-on-year, while corporate lending contracted by 0.7%.

The Nasdaq OMXI10 index had risen by 5% between meetings. Turnover in the Main Market totalled 341 b.kr. in the first seven months of 2020, some 6.7% less than over the same period in 2019.

Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in late June, the global economic outlook has deteriorated even further due to the COVID-19 pandemic. The adverse impact of the pandemic was more pronounced in H1/2020 than the Fund projected in the spring, and the recovery in H2 now expected to be weaker as well. Global GDP is expected to contract by 4.9% this year, as opposed to 3% in the IMF's April forecast. The outlook for 2020 has worsened for advanced economies and emerging economies alike. Advanced economies are forecast to shrink by 8% and emerging economies by 3%, approximately 2 percentage points more than in the April forecast. Furthermore, the IMF expects the turnaround in 2021 to be weaker globally, with GDP growth projected at 5.4%, or 0.4 percentage points less than in the spring forecast. Uncertainty about global economic developments remains unusually pronounced, however, and depends on how persistent the pandemic proves to be. As it did in the spring, the Fund considers the risk to its macroeconomic forecast to be concentrated on the downside.

Iceland's external goods trade generated a deficit of about 47.2 b.kr. for the first seven months of the year, as opposed to a deficit of 81.5 b.kr. over the same period in 2019. Exports of ships and aircraft strongly affected the figures, however. If they are excluded, the goods account deficit in 2020 to date measured 40 b.kr., as opposed to 95.7 b.kr. over the same period in 2019. This year's smaller deficit is due to a contraction in import values over and above export values, particularly to include investment goods and tourism-related inputs. Exports excluding ships and aircraft contracted by 11% year-on-year in the first seven months of 2020, owing mainly to a contraction in the value of exported industrial goods and marine products.

Global aluminium prices have risen by 19% since the MPC's May meeting but remain slightly lower than they were both at the beginning of 2020 and in August 2019. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products fell between Q1 and Q2 but were up 3.5% year-on-year in H1/2020. Global Brent crude prices had risen by about a third since the MPC's May meeting, to just under 46 US dollars per barrel at the time of the August meeting. The increase reflects, on the one hand, a surge in demand following the reduction in COVID-19 infection rates and the relaxation of public health measures in late spring and early summer, and on the other hand, the impact of reduced production among leading oil manufacturing countries. Oil prices were still down by roughly a third in 2020 to date, and by about a fifth since August 2019.

The real exchange rate in terms of relative consumer prices fell by 3.3% month-on-month in July, when it was 2.2% below its 25-year average and 11.4% below its end-2019 level. In the first seven months of 2020, it was down by 6.4% compared with the same period in 2019, as the nominal exchange rate of the króna was 7.8% lower and inflation in Iceland was 1.3 percentage points above the trading partner average.

Domestic economy and inflation

Indicators of private consumption in Q2 suggested a significant change in household consumption patterns. Spending in categories most strongly affected by public health measures shrank considerably, while spending on consumer durables increased. This trend eased as the pandemic receded and public health measures were relaxed. Payment card turnover was still down markedly between years in July, with turnover abroad contracting sharply and domestic turnover rising strongly.

In August, the Gallup Consumer Confidence Index measured 43.8 points, more than 47 points less than in August 2019. After an improvement in the spring, the index has fallen in the past two months.

According to the results of Gallup's summer survey, conducted in June among Iceland's 400 largest firms, respondents' assessment of the current economic situation was much more negative than in the surveys taken both this spring and in summer 2019. In the summer 2020 survey, however, executives' attitudes towards the outlook six months ahead are more positive than in both the spring survey and the summer 2019 survey. About 87% of respondents considered the current situation poor, and about 13% considered it neither good nor poor. Just under 49% of executives were of the view that economic conditions would improve in the next six months, while 19% expected conditions to be neither good nor poor. About 32% of respondents expect conditions to be worse in six months' time, a somewhat smaller share than in the last survey. They were slightly more pessimistic about developments in domestic demand over the next six months than they were in the spring survey. On the other hand, they were considerably more pessimistic about developments in foreign demand than they were in the spring.

According to the seasonally adjusted results of the Gallup survey carried out this summer among Iceland's 400 largest firms, the balance of opinion on staffing plans (i.e., firms planning to recruit as compared with those planning redundancies) was negative by 32 percentage points. The same balance of opinion was negative by just over 17 points in the spring and has therefore nearly doubled between surveys. Furthermore, only 5% of executives consider themselves understaffed. This percentage returned to its historical low in the summer survey, when it fell to its post-crisis trough. In addition, about 28% of executives report that their firms would have difficulty responding to an unexpected increase in demand, about 10 percentage points less than in the last survey.

According to the Statistics Iceland labour force survey (LFS), total hours worked fell by 7.2% between years in Q2/2020, the largest single-quarter contraction since Q3/2009. The decline in total hours stemmed from a 5.1% reduction in the number of employed persons and a 2.3% shortening of the average work week. The steep reduction in working hours, part of it due to the part-time option, showed more clearly in the working hours of those at work during the reference week, as they were a full 7% shorter than at the same time in 2019.

According to seasonally adjusted LFS data, the labour participation rate was 78.3% in Q2, its lowest since Statistics Iceland began the quarterly survey in 2003. This is also true of the employment rate, which measured 72.8% at the same time. Unemployment rose less as a result, measuring 5.1%, an increase of 1.2 percentage points from the previous quarter. The unemployment rate would presumably have risen even more if the adjustment of the labour market following the economic shock had not taken place through declining labour participation and the Government's part-time option.

Net migration of foreign nationals was negative in Q2/2020, for the first time since Q2/2012. This is due primarily to a smaller number of foreign immigrants and a slight increase in emigration during the quarter.

In Q2/2020, the wage index rose by 3.8% between quarters and by 6.7% year-on-year, and real wages in terms of the index were 4.1% higher during the quarter than in Q2/2019.

Statistics Iceland's nationwide house price index, published in late July, rose by 0.1% month-on-month when adjusted for seasonality, and by 6.7% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1.2% month-on-month in July when adjusted for seasonality, and by 4.9% year-on-year. The number of purchase agreements registered nationwide fell by 7.2% year-on-year in the first seven months of 2020, while the number of contracts for new construction increased by 40.5% over the same period.

The CPI rose by 0.15% month-on-month in July, and twelve-month inflation increased to 3%. The CPI excluding the housing component had risen by 3.3% year-on-year in July. Underlying inflation measured 3.7% in July, in terms of the average of various measures, and was therefore noticeably above observed inflation. This is partly because this calculation excludes the decline in petrol prices and the impact of lower real mortgage interest expense. The interest component of imputed rent has lowered inflation in the past year, causing twelve-month inflation to be lower by an estimated 0.7 percentage points.

The main reason for the inflation spike in July was that summer sales lowered the index far less than in the same month of 2019. This could be due to the depreciation of the króna, but increased spending on consumer goods could have been a factor as well.

According to Gallup's summer survey, households and businesses expect inflation to measure 3-3.5% in one year's time, or 0.5 percentage points more than in the last survey. Their long-term inflation expectations have either remained unchanged or fallen, however. Market agents' short- and long-term inflation expectations have also remained unchanged at 2.5%. The five- and ten-year breakeven rate in the bond market is now at target or slightly below it, although it has risen marginally in the recent term.

According to the forecast published in *Monetary Bulletin* on 26 August 2020, the outlook is for inflation to average about 3% for the remainder of the year. The significant slack in the economy and low global inflation indicate that it will begin to taper off in 2021, and it is projected to average 2% in the latter half of the forecast horizon. For the first half of the forecast period, this is a higher inflation rate than was projected in May, as inflation is higher at the outset and the slack in the economy is smaller now than previously expected.

In Q2/2020, GDP among Iceland's main trading partners is estimated to have contracted by nearly 13%, partly because of governmental measures to curb the spread of the pandemic. This is a somewhat larger contraction than was forecast in the May *Monetary Bulletin*. Indicators imply that global economic activity picked up as the quarter progressed, but the outlook for H2/2020 has deteriorated since May because of the resurgence of the pandemic in many parts of the world. Trading partner countries are forecast to see a contraction of just over 7% in 2020, more than was projected in May. GDP growth in 2021 and 2022 looks set to be stronger, however.

The króna began to depreciate when the pandemic reached Iceland, and by early May it had fallen by more than 12% since end-February. It appreciated over the course of the month, possibly in response to increased optimism following successful public health measures and a steep decline in the domestic infection rate, as well as the hope of a stronger recovery of tourism than had previously been expected. The appreciation reversed course over the summer months, however, and just before the August *Monetary Bulletin* went to press, the króna had fallen in trade-weighted terms by just over 12% since end-February and by more than 14% year-to-date. In Q2, the trade-weighted exchange rate index stood at just over 203 points, and the króna was therefore a full 2% stronger than was forecast in May. The index has been around 207 thus far in August, and the baseline forecast is based on the assumption that it will remain close to that level throughout the forecast horizon.

Domestic economic activity had begun to slow before the pandemic reached Iceland, contracting by just over 1% year-on-year in Q1/2020. The effects of the pandemic started to show towards the end of that quarter and intensified in April. On the other hand, there were signs that domestic demand had gained momentum in May and June, when the pandemic eased and public health measures were relaxed. Nevertheless, the forecast assumes a nearly 11% year-on-year contraction in GDP in Q2. This is a smaller contraction than was forecast in May, mainly because household consumption spending did not suffer as much as was feared at that time. Although the outlook for H2 is rather poorer than was forecast in May, GDP is expected to contract by approximately 7% in 2020 as a whole, instead of the previously projected 8%. The smaller contraction in 2020 explains in part why 2021 GDP growth is projected to be weaker than was assumed in the May forecast. GDP growth is expected to measure 3½% per year in 2021 and 2022. If this forecast materialises, GDP will not return to its end-2019 level until the end of the forecast horizon.

Total hours worked are expected to fall by over 7% this year. In addition, unemployment is expected to rise as the year progresses, peak at around 10% towards the year-end, and average just over 7% for 2020 as a whole. This represents a smaller decline in total hours and a lower unemployment rate than in the May forecast, and it is due for the most part to the economy's having weathered the pandemic better than was expected in May. Job numbers are expected to rise slightly and unemployment to fall again in 2021.

A sizeable output slack is believed to have developed, and according to the forecast, it will grow over the course of this year. It is expected to measure just under 6% in 2020, slightly less than was forecast in May. As was forecast then, the slack in the economy is expected to narrow in 2021 and more or less close by the end of the forecast horizon. This forecast is more uncertain than usual, however.

II Decisions on the Bank's monetary policy instruments

MPC members discussed the monetary stance in view of economic developments and the fact that the Bank's real rate had fallen since the May meeting. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had lowered interest rates further in May, owing to the prospect of a sharp contraction in GDP and a surge in unemployment in 2020, coupled with low inflation over the forecast horizon.

The MPC discussed economic developments and prospects and, in this context, considered the Bank's new macroeconomic forecast, published in the August *Monetary Bulletin*. According to that forecast, the outlook is for a 7% contraction in GDP this year and roughly 10% unemployment by the year-end. Members noted that although the outlook for H2 was somewhat poorer than had been forecast in May, the contraction for the year as a whole was expected to be smaller than was projected then. This was due mainly to more robust private consumption in the spring and summer than had been forecast in May. It emerged at the meeting that, although the tourism industry had rebounded more strongly than expected during the summer, the outlook for the coming months was broadly unchanged since spring. The Committee emphasised, however, that uncertainty was unusually pronounced and that economic developments would depend on the path the pandemic took.

The Committee discussed developments in inflation, which measured 2.5% in Q2 but had risen to 3% in July. Members noted that the uptick in inflation was driven largely by the more than 12% depreciation of the króna since the pandemic reached Iceland. It also emerged that medium- and long-term inflation expectations were broadly unchanged, and the Committee considered it positive that expectations appeared to remain anchored to the Bank's inflation target, which would be important for near-term developments in inflation. It emerged at the meeting that, according to the Bank's forecast, inflation was expected to average about 3% over the remainder of 2020 but, because of the significant slack in the economy and low global inflation, it would taper off in 2021.

The MPC discussed recent intervention in the foreign exchange market in the context of the Bank’s strategy, formulated just over a decade earlier and referred to as “inflation targeting-plus”. An important part of that strategy is to mitigate short-term exchange rate volatility and counteract excessive fluctuations, including those that persist longer than a single day and could otherwise lead to overshooting and a correction later on. It emerged in the discussion that the real exchange rate of the króna was probably below its equilibrium level, at the same time as inflation was above the target.

All members were of the opinion that it was appropriate to keep the Bank’s interest rates unchanged. The outlook was for the contraction in 2020 to be somewhat smaller than had been forecast in May, which was also reflected in higher inflation than had been expected then. It was pointed out that the impact of the measures adopted when the economic shock struck earlier in the year was still coming to the fore. The Committee discussed the transmission of lower interest rates to the terms enjoyed by households and businesses. Members agreed that rate cuts had been transmitted effectively to households and that the housing market had firmed up somewhat in recent months. The discussion touched on whether the increase in non-indexed variable-rate loans would cause households’ debt service to exceed their debt service capacity when conditions changed and interest rates started to rise again. Furthermore, Committee members were still concerned that lower interest rates had not been transmitted effectively to companies, although indicators implied that corporate credit spreads may have peaked. It emerged in the discussion of financial institutions’ and credit institutions’ position that the weaker transmission of rate cuts to corporate borrowers stemmed partly from a repricing of risk and a significant increase in risk premia and uncertainty. It was also pointed out that there was limited demand for corporate loans at present.

The Committee discussed the execution of the Central Bank’s quantitative easing programme, noting that it had gone smoothly thus far but was affected by the fact that the supply of Treasury bonds had not yet increased to any marked degree. It could be assumed that the supply would increase, although it remained to be seen how much and how quickly it would do so. Committee members agreed that the continuation of the quantitative easing programme would be based on those developments and on market yields.

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 1%, the current account rate 0.75%, the seven-day collateralised lending rate 1.75%, and the overnight lending rate 2.75%. All Committee members voted in favour of the proposal.

In the Committee's view, more firmly anchored inflation expectations provided monetary policy the scope to respond decisively to the deteriorating economic outlook. Members were also of the opinion that lower interest rates, together with actions taken by the Bank this spring, had supported domestic demand. They agreed that the impact of these measures had yet to emerge in full, however, and that the measures would continue to support the economy and facilitate a more rapid recovery than would otherwise occur.

The MPC reiterated at the meeting that it would continue to monitor economic developments and would use the tools at its disposal to support the domestic economy and ensure that the more accommodative monetary stance was transmitted normally to households and businesses.

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

The Chief Economist was in attendance 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 on Wednesday 7 October 2020.