CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2023

August
116th meeting
Published 6 September 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 21 and 22 August 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 23 August.

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 had emerged since the Committee's last meeting, on 24 May 2023, as published in the updated forecast in *Monetary Bulletin* 2023/3 on 23 August.

Financial markets

Since the May meeting, the króna had appreciated by 5.5% 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 tightened since the May meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was 2.1%, or 0.6 percentage points higher than just after the announcement of the May interest rate decision. In terms of twelve-month inflation, it was 1.1% and had risen by 2.1 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 rose in line with the increase in the key rate in May, but there had been no turnover in the market since the MPC's last meeting. Yields on long-term nominal Treasury bonds had risen by 0.2 percentage points since the May meeting, and yields on long-term indexed Treasury bonds had risen by 0.2-0.3 percentage points. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in May, whereas average indexed mortgage rates had held broadly unchanged.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 0.3-0.5 percentage points between meetings, to 5.6 percentage points versus the euro area and 3.8 percentage points versus the US. At the same time, the long-term interest rate differential versus the US had narrowed by 0.4 percentage points, to 2.5 percentage points, whereas the spread versus Germany had remained unchanged at 4.2 percentage points. The CDS spread on the Treasury's five-year obligations in US dollars was 0.8% and had increased slightly between MPC meetings. The spread between the Treasury's euro-denominated issues and German government bonds narrowed slightly at the same time, to 1.2-1.4 percentage points.

According to the Central Bank's quarterly market expectations survey, conducted in mid-August 2023, respondents expected the Bank's key rate to rise to 9% in Q3 and then begin to fall in Q1/2024. They expected the key rate to be 6% in two years' time, as they had in the May 2023 survey. Survey participants' responses on the monetary stance changed markedly between surveys. Most respondents, or 44%, considered the current monetary stance appropriate, up from 17% in the previous survey. The share who considered the monetary stance too loose declined from 66% to 30%, and the share who considered the stance too tight increased from 17% to 26%.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by either 0.25 percentage points or 0.5 percentage points, citing indicators implying that private consumption had begun to contract in Q2, the housing market had cooled more than anticipated, and inflation had fallen relatively quickly in the recent term. As a result, it would not be necessary to raise rates as much as in the first half of the year. On the other hand, the fall in inflation during the summer had been due partly to base effects, in line with expectations, while the labour market was still fairly tight and the next wage negotiations were due to begin soon. Furthermore, long-term inflation expectations were largely unchanged since the MPC's last meeting, and somewhat above the Bank's inflation target, which supported a larger interest rate hike.

Annual growth in M3 averaged about 8½% in H1/2023. Growth in household deposits had gained pace, whereas corporate deposit growth had eased. Year-on-year growth in credit system lending to households had lost pace, even though price indexation on indexed loans had increased. Household lending had grown by 7½% in Q2, as compared with an average of nearly 10% in 2022. Year-on-year growth in the corporate loan stock had also begun to subside, to 11.9% in June. According to the Bank's lending survey from August, the banks expected household demand for credit to remain unchanged in the next six months; however, they expected a small increase in demand for corporate loans. They projected a slight increase in the supply of residential mortgages but expected the supply of other loans to remain unchanged.

The Nasdaq OMXI10 index had risen by 5.4% between meetings. Turnover in the Main Market totalled 467 b.kr. in the first seven months of 2023, some 26% less than over the same period in 2022. The difference between years is due largely 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) July forecast, global GDP growth is projected to shrink from 3.5% in 2022 to 3% in 2023. Although this is somewhat above the IMF's April forecast, it is well below the average of recent decades. As in the Fund's April forecast, GDP growth is also expected to measure 3% in 2024. According to the forecast, growth will subside particularly in advanced economies, falling from 2.7% in 2022 to 1.5% in 2023 and 1.4% in 2024. Although the supply side of the global economy has largely normalised, other factors have impeded global economic activity. Factors that weigh heavily are the recent surge in inflation, which has eroded real disposable income, and the effects of continuing central bank policy rate hikes. The IMF therefore projects that global inflation will fall from 8.7% in 2022 to 6.8% in 2023 and an average of 5.2% in 2024. Underlying inflation will fall more slowly, however, according to the Fund, and has been revised upwards for 2024. Uncertainty about the global GDP growth forecast is still considered concentrated on the downside.

According to preliminary figures from Statistics Iceland, the goods account deficit totalled 78.5 b.kr. in Q2/2023 and 124.5 b.kr. in H1, as compared to a deficit of 56 b.kr. at constant exchange rates in H1/2022. Export values contracted by just over 7% year-on-year at constant exchange rates, as the value of most categories of exports contracted between years. The largest downward impact stemmed from the value of industrial goods, mainly aluminium, owing to a reduction in prices between years. At the same time, the value of goods imports increased by nearly 6% at constant exchange rates, driven mainly by investment goods and transport equipment.

Global aluminium prices fell by 3.3% after the MPC's May meeting, to around 2,100 US dollars per tonne. This is 13% lower than in August 2022. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products fell by just over 1% quarter-on-quarter in Q2/2023 but were around 10% higher in H1 than in H1/2022. The global price of Brent crude rose by 9.4% between MPC meetings, to 84 US dollars per barrel by the time of the August meeting. This is 13% lower than in August 2022, however. On the other hand, other commodity prices have fallen since the May meeting.

The real exchange rate in terms of relative consumer prices rose by 1.65% month-on-month in July, when it was 10.2% above its 25-year average and 0.75% higher than in December 2019. In the first seven months of 2023, it was down by 1.6% compared with the same period in 2022, as the nominal exchange rate of the króna was 4.4% lower and inflation in Iceland was 3.1 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland in late May, GDP grew by 7% year-on-year in Q1/2023, slightly less than was forecast in the May *Monetary Bulletin*. Strong household demand and favourable external trade were the main drivers of growth during the quarter. Domestic demand grew by 4.5%, and its subcomponents were weaker than projected in the last forecast.

Indicators suggest that household spending contracted in Q2, and it appears that private consumption subsided more quickly than was assumed in May. In addition, households appear to have grown more pessimistic, which may have prompted more precautionary saving and dampened appetite for spending, as can be seen in data on domestic payment card use.

According to the results of Gallup's summer survey, conducted in May and June among Iceland's 400 largest firms, respondents' assessment of the current economic situation was slightly more negative than in the spring survey. Their expectations six months ahead were also more negative, as 37% of executives expected the economic situation to deteriorate in six months' time, a slightly larger share than in the spring. Roughly a fifth of executives expected economic conditions to improve in the next six months. Executives were slightly more pessimistic about domestic and foreign demand than in the spring survey.

Seasonally adjusted survey results indicated that the balance of opinion on staffing was 12 percentage points in favour of those planning to recruit in the next six months. The balance of opinion narrowed between surveys but was still above its historical average. The shortage of staff is still significant, and broadly unchanged between surveys, with around 43% of executives reporting shortages of workers. At the same time, the share of firms operating at full capacity rose to an all-time high of 62%. The share of companies operating at full capacity was highest in the construction sector and in miscellaneous specialised services, while understaffing was most pronounced in construction and in industry and manufacturing.

According to the Statistics Iceland labour force survey (LFS), the number of employed persons increased by 5.5% year-on-year in Q2, whereas the average work week grew shorter by 0.8%. Thus the total number of hours worked rose by about 4.6% year-on-year. According to seasonally adjusted LFS results, the labour participation rate fell marginally between quarters, while the employment rate rose by 0.6 percentage points. Unemployment therefore fell by roughly 1 percentage point between quarters, to 2.8%. Thus it has continued to decline and was down to its autumn 2017 level. Seasonally adjusted unemployment according to the Directorate of Labour was slightly higher, or 3% in Q2.

Iceland's population grew by 3.4% year-on-year in Q2/2023. In H1, net migration was positive by 5,500, which represents an increase relative to H1/2022, when immigrants outnumbered emigrants by 4,520.

In Q2, the general wage index rose by 3.1% between quarters and by 10% year-on-year. The year-on-year rise grew by just over 1 percentage point relative to the previous quarter, when new wage agreements between large worker federations, on the one hand, and State and municipal employees, on the other, entered into effect. Real wages increased by only 0.5% between years in Q2, however.

Statistics Iceland's nationwide house price index, published at the end of July, fell by 1% month-on-month when adjusted for seasonality but rose by 3.8% year-on-year. The capital area house price index, calculated by the Housing and Construction Authority, fell by 0.5% month-on-month in July when adjusted for seasonality, but rose by 0.8% year-on-year. The number of purchase agreements registered nationwide fell by 26.3% year-on-year in the first seven months of 2023, and the number of contracts for new construction declined by 41% over the same period. The average time-to-sale in the capital area was 6.3 months in July, considerably more than the July 2022 figure of 1.5 months, and the number of homes for sale has increased markedly in recent months.

The CPI rose by 0.03% month-on-month in July, and twelve-month inflation measured 7.6%. It has fallen in the recent term, partly because of strong base effects due to substantial price increases in July 2022, which have now dropped out of the twelve-month measurement. Inflation excluding housing declined as well, to 7.1% in July. Underlying inflation was 6.7% according to the average of various measures and has fallen by 0.8 percentage points from its April 2023 peak.

The decline in owner-occupied housing costs had a strong downward impact on the CPI in July. Housing market prices fell between months, both in greater Reykjavík and in regional Iceland. The cost of owner-occupied housing has risen by about 9.6% in the past twelve months, whereas the year-on-year increase peaked at 22.4% in July 2022. The effects of summer sales were about the same as in 2022 but remain more modest than they generally were before the pandemic. International airfares and hotel and restaurant prices rose between months, as is typical at this time of year. Food prices continued to rise and are now 12.4% higher than they were a year ago.

According to Gallup's summer surveys, households' two-year inflation expectations rose to 7%, while their long-term inflation expectations were unchanged at 6%. On the other hand, businesses' long-term inflation expectations increased to an average of 5% over the next five years. According to the market expectations survey taken this August, respondents expect inflation to average 4% over the next five years, although their ten-year expectations inched upwards from the May survey, to 3.6%. The long-term breakeven inflation rate in the bond market has risen as well, and the five-year breakeven rate five years ahead was 3.6% in mid-August, whereas it had fallen to around 3% in May. The breakeven rate for periods up to five years has declined, however.

According to the forecast in the *Monetary Bulletin* issued on 23 August, inflation is expected to be slightly lower in the near term than was forecast in May. Inflation has eased recently. In July it fell to 7.6%, the same level as in May 2022. However, the disinflation in July is due in large part to strong base effects, as substantial price hikes a year earlier have now dropped out of twelve-month measurements. The impact of imported inflation has diminished, partly because of the recent appreciation of the króna, whereas domestic price hikes have been more persistent. The general wage index rose by 10% year-on-year in Q2, and the price of groceries and private services has kept climbing. Furthermore, medium- and long-term inflation expectations are broadly unchanged, although inflation fell more than expected in July. Thus the long-term inflation outlook has changed little since May.

GDP growth has eased in Iceland's main trading partner countries, albeit less than was assumed in the Bank's May forecast. Nevertheless, the outlook is for weak output growth in 2023 and 2024 – about 1% per year. Falling energy prices have lowered headline inflation in advanced economies, but underlying inflation has proven far more persistent despite steep interest rate hikes implemented by major central banks.

Preliminary figures from Statistics Iceland indicate that Iceland's GDP growth measured 7% in Q1/2023, owing mainly to strong growth in private consumption and exports, plus an increase in inventories during the quarter. Although GDP growth was above the 2022 average, it fell short of the May forecast. The Bank had expected private consumption growth to be even stronger, and investment – especially in residential construction and energy-intensive industry – proved far weaker than projected. Indicators imply that domestic demand growth softened still further in Q2/2023. Because of weaker growth in H1, GDP growth is now forecast at 3.5% for 2023 as a whole, well below the 4.8% forecast in May. The GDP growth outlook for the next two years is broadly unchanged, however.

Total hours worked increased somewhat in Q2, and unemployment continued to fall, averaging 2.8% in Q2, its lowest since autumn 2017. Although job vacancies have declined in number recently, there are still clear signs that the labour market is quite tight. The baseline forecast assumes, however, that unemployment will gradually inch upwards to a level consistent with a balanced economy and price stability.

Although the supply side of the global economy appears largely to have normalised after the shocks of the past few years, there is still considerable uncertainty about the global economic outlook and about how costly it will be to re-establish price stability in major advanced economies. This applies to Iceland as well, as inflation expectations have apparently become less firmly anchored to the target. As a result, inflation could prove more persistent than is currently forecast, which would call for a stronger contraction in domestic economic activity to bring it under control again.

II Decisions on the Bank's monetary policy instruments

The MPC discussed the monetary stance in view of economic developments and the increase in the Bank's real rate since the May meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its May meeting to raise interest rates still further. At that time, the inflation outlook had continued to deteriorate, long-term inflation expectations had risen, and economic activity was stronger than previously anticipated.

Committee members noted that inflation had eased in the recent past, measuring 7.6% in July. It emerged that the contribution of the housing component to inflation had diminished, global price hikes had subsided, and the króna had appreciated. Members also discussed that domestic price increases had proven persistent and remained widespread. Underlying inflation had therefore fallen more slowly than headline inflation, to 6.7% in July.

The MPC noted that GDP growth had measured 7% in Q1/2023 and that unemployment had continued to fall. The Committee was of the view that the labour market was therefore still very tight and strong demand pressures remained in the overall economy, although there were signs that economic activity had begun to slow down.

Members noted that the long-term inflation outlook was broadly unchanged, even though the short-term outlook had improved since May. Furthermore, long-term inflation expectations were well above target, and therefore the risk remained that inflation would prove persistent.

Committee members agreed that the effects of interest rate hikes were coming more strongly to the fore, as could be seen in developments in private consumption and investment. It was pointed out, however, that based on experience, the first national accounts estimates would probably be revised upwards. It also emerged that the króna had appreciated recently, and imported inflation should therefore taper off, all else being equal. It was uncertain, however, how much of the appreciation would pass through to the price level while inflation remained as demand-driven as it indeed was.

The Committee's discussion centred mainly on how much to raise the key rate after having raised it by 1.25 percentage points at the last meeting in May. The main arguments expressed in favour of a larger rate hike were that the labour market remained very tight, a large share of firms were operating at full capacity, and unemployment was low and had fallen between meetings. Few clear indications were present of a turnaround in the labour market. The MPC agreed that the recent large wage increases, together with other factors, had driven domestic demand. It was noted that medium- and long-term inflation expectations had been broadly unchanged in the recent term, even though inflation had fallen and the short-term inflation outlook had improved. Committee members were of the view that it was cause for considerable concern that inflation expectations were well above target and appeared less anchored to the target. This could lead to too little resistance against cost increases being passed through to prices, as well as to higher wage demands in the upcoming negotiations. This could in turn lead to a wage-price spiral and persistent inflation. The economy was still quite strong, albeit less so than had been forecast. It was positive that inflation had subsided somewhat recently, although a large share of the disinflation had been due to base effects, as had been expected. The long-term inflation outlook was broadly unchanged since May, and the risk remained that inflation would continue to be persistent. Given these factors and the outlook for disinflation to remain slow, the Central Bank's real rate would probably have to be somewhat above the equilibrium real rate and would have to remain high for a longer period. It was pointed out that, although the monetary stance had tightened between meetings, it was not clear that it had tightened enough to bring inflation under control. In light of the demand pressures present in the economy, it would be riskier for the monetary stance to remain too loose than too tight.

The main arguments expressed in favour of taking a smaller step, or even keeping rates unchanged, was that the effects of interest rate hikes were coming more strongly to the fore, and growth in the economy appeared to have lost pace compared to assumptions in previous forecasts. A number of factors contributed to weaker inflationary pressures, including the appreciation of the króna, which had yet to pass through to the price level. Housing market activity had continued to subside, and the outlook was for a slowdown in private consumption in Q2. Moreover, mortgage interest rate reviews had already begun for some households, and these borrowers would be faced with a rising debt service burden. Furthermore, deposit interest rates had risen somewhat, which should encourage an increase in saving. Both of these factors should dampen household demand. It was therefore possible that a large rate hike would not be needed to push the real rate higher.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.5 percentage points. 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%. 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 0.25 percentage points. He pointed out that the impact of the most recent rate hikes might be underestimated, as interest rates had risen sharply in the recent past and their effects had yet to come fully to the fore. He stressed that the real rate had increased steadily and the monetary stance had tightened in the past year. Therefore, the odds were that large rate increases would not be needed in order to tighten the monetary stance still further.

Committee members agreed that, in view of circumstances, it was now necessary to tighten the monetary stance still further. They considered it particularly important to prevent a wage-price spiral. In the MPC's opinion, indicators implied that the effects of recent interest rate hikes were coming more clearly to the fore and that near-term monetary policy 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 4 October 2023.