



# MINUTES

## MONETARY POLICY COMMITTEE



2022

October  
111th meeting  
Published 19 Oct. 2022

## Minutes of the Monetary Policy Committee meeting

October 2022 (111th 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 3 and 4 October 2022, during which the Committee discussed economic and financial market developments, decisions on the application of the Bank's monetary policy instruments, and the communication of those decisions on 5 October.

### **I Economic and monetary developments**

Before turning to 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 24 August 2022.

#### **Financial markets**

Since the August meeting, the króna had remained unchanged in trade-weighted terms. Between meetings, the Bank sold foreign currency for 42 million euros (5.9 b.kr.). The Bank's transactions during the period accounted for 13% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had tightened since the August meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -1.2%, or 0.3 percentage points higher than just after the announcement of the August interest rate decision. In terms of twelve-month inflation, however, it was -3.5% and had risen by 0.5 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 August, 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 0.1 percentage points since the August meeting, and yields on long-term indexed Treasury bonds had risen by up to 0.6 percentage points. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in August, and average indexed mortgage rates had risen marginally.

In terms of three-month interbank rates, the interest rate differential was virtually unchanged between meetings, at 5.1 percentage points versus the euro area and 2.6 percentage points versus the US. The long-term interest rate differential versus Germany had narrowed by 0.5 percentage points between meetings, to 3.9 percentage points, and the spread versus the US had narrowed to 2.2 percentage points. Measures of the risk premium on the Treasury's foreign obligations had risen between meetings. The CDS spread on the Treasury's five-year US dollar obligations was 0.7%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 1.6 percentage points.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 0.25-0.5 percentage points, citing that inflation had most likely peaked, the inflation outlook had improved, and inflation expectations had declined since the last interest rate decision. Real estate prices had turned around sharply, and the global economic outlook had generally worsened. Analysts mentioned, however, that there were significant signs of overheating in the economy, the labour market was still characterised by labour shortages, and inflation expectations were above the Central Bank's inflation target.

Annual growth in M3 has eased slightly over the course of the year, measuring just above 8½% in August. At the same time, annual growth in credit system lending to households is estimated at 10%, roughly the same as in 2022 to date. Annual growth in corporate lending has gained pace somewhat over the course of the year, measuring just over 7% in August.

The Nasdaq OMXI10 index had fallen by 11.9% between meetings. Turnover in the Main Market totalled 808 b.kr. in the first nine months of 2022, some 6% more than over the same period in 2021.

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

According to the Organisation for Economic Cooperation and Development's (OECD) September forecast, the global economy is set to grow by 3% this year, the same as in the June forecast. For 2023, growth is projected at 2.2%, or 0.6 percentage points below the June forecast. The inflation outlook has also deteriorated, with inflation in OECD countries forecast at 8.2% this year and 6.6% in 2023. This is 0.6 and 0.3 percentage points, respectively, above the June forecast. The worsening global economic outlook is largely attributable to the repercussions of the war in Ukraine, particularly the rise in energy and food prices that has pushed inflation upwards worldwide. Shrinking household purchasing power and increased pessimism, together with rising energy prices – particularly natural gas prices in Europe – are expected to have a dampening effect on both private consumption and investment worldwide. The tighter monetary stance in most of the world's largest economies, in response to the deterioration of the inflation outlook over the past year, is also a key factor in weaker global economic activity. Furthermore, economic activity has slowed markedly in China, owing to the repercussions of the pandemic and weaknesses in the Chinese real estate market.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 12 b.kr. in August and 112 b.kr. in the first eight months of 2022, as compared with a deficit of 117 b.kr. at constant exchange rates over the same period in 2021 (FOB/FOB). Goods export values increased by 47% over the first eight months of the year, with all categories except agricultural products contributing to the rise. The strongest impact was from industrial goods exports, aluminium products in particular, whose prices rose markedly between years. Import values

increased by 36% over the same period, with all key categories contributing to the rise, particularly fuels and lubricants.

Global aluminium prices fell by 4% after the MPC's August meeting, to around 2,300 US dollars per tonne, which is about 20% below the price at the beginning of October 2021. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products had risen by 2.6% month-on-month in August and by 22% over the first eight months of the year. The global price of Brent crude fell by just over 8% between MPC meetings, to 92 US dollars per barrel by the time of the August meeting. Nevertheless, it is 16% higher than at the beginning of 2022 and 13% above the early October 2021 price.

The real exchange rate in terms of relative consumer prices fell by 0.9% month-on-month in August, when it was 8.1% above its 25-year average but 1.4% lower than in December 2019. It rose by 4% year-on-year in the first eight months of 2022, owing almost entirely to the rise in the nominal exchange rate, as inflation in Iceland was broadly in line with the trading partner average.

### **Domestic economy and inflation**

According to preliminary figures published by Statistics Iceland at the end of August, GDP growth measured 6.1% in Q2, slightly below the forecast in the August *Monetary Bulletin*. In seasonally adjusted terms, GDP grew by 3.9% between quarters, after contracting in Q1. Domestic demand grew by 4.8% year-on-year in Q2, and most components developed in line with the last forecast, apart from residential investment and the contribution from inventory changes. The contribution from net trade to changes in GDP was positive by 1 percentage point during the quarter, slightly more than was assumed in the forecast.

GDP growth measured 6.8% in H1/2021. According to figures from Statistics Iceland, most components of domestic demand were in line with the Bank's August forecast, although the contribution from inventory changes was smaller than projected. Exports were up 23.3% year-on-year and imports by 24.5%, and the contribution from net trade was therefore negative by 1.4 percentage points. It was slightly less negative than in the Bank's forecast, owing in part to a revision of Q1 data.

Key indicators of developments in private consumption in Q3 suggest continued strong demand. Year-on-year growth in payment card turnover was still robust, although it had slowed somewhat. Nevertheless, households are still relatively pessimistic, according to the Gallup Consumer Confidence Index, which measured just under 100 points in September, indicating that consumers are optimistic and pessimistic in roughly equal numbers.

According to the fiscal budget proposal for 2023, the Treasury is expected to show a deficit of 89 b.kr., or 2.3% of GDP, which represents an improvement of nearly 53 b.kr. between years. This is a smaller deficit than was assumed in the fiscal plan introduced this past summer, mainly because of stronger economic activity, which is expected to deliver increased revenues in 2023, and because of measures on the revenues side that will pull in the same direction. Furthermore, the Treasury primary balance is projected to be negative by 0.7% of GDP in 2023. Expenditure growth according to the budget proposal is less than the increase in revenues and the projected increase in GDP; therefore, expenditures will decline as a share of GDP during the year. After significant fiscal easing during the pandemic, the fiscal stance tightened markedly in 2022, owing to the expiry of the Government's discretionary pandemic response measures, and is expected to tighten further in 2023.

According to the results of Gallup's autumn survey, conducted in August and September among Iceland's 400 largest firms, respondents' assessment of the current economic situation was somewhat more negative than in the summer survey. Their expectations six months ahead were also more negative, as nearly 41% of executives expected the economic situation to deteriorate in six months' time, a somewhat larger share than in the summer. About one-fourth of executives expected economic conditions to improve in the next six months. Executives were also somewhat more pessimistic about both domestic and foreign demand than in the summer survey, particularly those in transport, transit, and tourism.

Prospects for firms' performance had worsened since the spring survey, but about a third of executives expected to record larger profits in 2022 than in 2021. A majority of survey respondents reported increased margins in the past six months, while about half of them expected their margins to remain unchanged in the next six months and 28% expected them to increase. Prospects for investment also deteriorated slightly between surveys, although the outlook was still for stronger investment in 2022 than in 2021.

The seasonally adjusted results of Gallup's autumn survey showed that labour demand was still strong, although it had contracted marginally between surveys. One-third of firms were planning to add on staff, while just under 7% were planning to downsize. The balance of opinion was therefore positive by 27 percentage points, whereas it has been close to 30 percentage points since the spring 2021 survey. Firms are still faced with significant staffing problems and have difficulty increasing production. About 54% of executives considered themselves short-staffed, the same as in the previous survey. In addition, somewhat fewer executives reported difficulty responding to an unexpected increase in demand than in the previous survey, or 56%. Problems relating to staffing and boosting production were most pronounced in construction, wholesale and retail trade, and transport, transit, and tourism.

The wage index rose by 0.2% month-on-month in August and by 8% year-on-year. Real wages were 1.6% lower than at the same time in 2021.

Statistics Iceland's nationwide house price index, published at the end of September, was virtually unchanged when adjusted for seasonality but rose by 22.6% year-on-year. The capital area house price index, calculated by the Housing and Construction Authority (HMS), fell by 0.4% month-on-month in August when adjusted for seasonality, but rose by 23% year-on-year. The number of purchase agreements registered nationwide fell by 28.1% year-on-year in the first eight months of 2022, while the number of contracts for new construction declined by 26.4% over the same period. The average time-to-sale in the capital area was 1.8 months in August, considerably more than the August 2021 figure of 1.1 months, as the number of homes for sale has increased markedly in recent months.

The consumer price index (CPI) rose by 0.09% month-on-month in September, lowering twelve-month inflation for the second month in a row, to 9.3%. Inflation excluding housing declined as well, to 7%. Underlying inflation was 6.7%, according to the average of various measures, and has increased since the MPC's August meeting.

Reduced airfares and higher prices for clothing, furniture, and housewares (owing to the end of seasonal sales) had the strongest impact in September. Fuel prices also fell somewhat. The cost of owner-occupied housing was unchanged between months and just over a fifth higher than at the same time in 2021. The price of food and various subcomponents of services continued to rise in September.

Businesses' inflation expectations one and two years ahead declined, according to Gallup's autumn survey, and executives now expect inflation to measure 4.5% in two years' time.

Households' two-year inflation expectations rose, however, to 6%. On the other hand, both households' and businesses' long-term inflation expectations were unchanged between surveys: households expect inflation to average 5% over the next five years, and businesses expect it to average 4%. The breakeven inflation rate in the bond market has declined since August, and the five-year breakeven rate five years ahead was roughly 3.3% at the beginning of October.

## **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 risen since the August meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in August to raise interest rates still further. At that time, the outlook had been for stronger GDP growth in 2022 than previously forecast, and a wider positive output gap had developed in the economy. The inflation outlook had continued to deteriorate, and inflation expectations had risen by most measures.

MPC members agreed that clearer indications had emerged between meetings to suggest that the recent interest rate hikes had slowed overall demand growth and housing market activity. Headline inflation measured 9.3% in September and had fallen by 0.6 percentage points since the MPC's August meeting. It emerged, however, that underlying inflation had risen between meetings, possibly indicating that inflationary pressures were still underestimated. There were signs that inflation expectations had begun to decline again, although they were still above the Bank's inflation target.

The MPC discussed preliminary national accounts data, which showed that GDP growth measured 6.8% in H1/2022. It emerged that demand appeared to have been strong in Q3, although the outlook was for a slowdown as the winter advanced. Committee members discussed recent indicators from the labour market, which suggested that the positive output gap in the domestic economy had peaked. Moreover, the global economic outlook had deteriorated and uncertainty had grown, which could cause domestic demand to ease more quickly than had previously been assumed.

MPC members were of the opinion that there were grounds to either hold the key rate unchanged or to raise it by 0.25-0.5 percentage points. The main arguments in favour of keeping the key rate unchanged were that inflation had proven lower than expected recently and the short-term inflation outlook had improved. In addition, inflation expectations had fallen by some measures. The Bank's real rate had therefore risen between meetings and looked set to rise further if inflation continued to fall. Members agreed that there were now clear signs that the Bank's actions had begun to affect demand, as housing market activity and house price inflation had begun to ease. Tensions in the labour market also appeared to have eased in the recent term. Furthermore, private consumption growth could be expected to lose pace, all else being equal, as real wages had begun to contract. Moreover, the global economic outlook was worse than expected, particularly in view of the rising cost of living in Europe and the troubled outlook for energy supply. In the Committee's opinion, this could have a negative impact on the outlook for Iceland's exports.

The arguments in favour of raising interest rates were that inflation remained far above the target even though it had eased between meetings, and underlying inflation had risen. Long-term inflation expectations were above target as well, and the inflation outlook in trading partner countries had deteriorated. By the same token, the risk of second-round effects on

domestic inflation would increase if firms passed higher input costs through to domestic prices. Annual wage inflation had also been strong for some time, and in the MPC's opinion, the labour market was still tight and domestic demand strong. It was pointed out that as a result, the monetary stance was not tight enough given the business cycle position and the positive output gap, as the Bank's real rate was still negative and below its equilibrium level. It was important to avoid easing the policy stance too soon, as this could make bringing inflation down costlier than it would be otherwise.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.25 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

Members agreed that it was vital to ensure that the monetary stance was tight enough to bring inflation back to target within an acceptable time frame. Near-term monetary policy decisions would depend on developments in economic activity, inflation, and inflation expectations. Decisions taken at the corporate level, in the labour market, and in public sector finances would be a major determinant of developments in interest rates in the coming term.

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

Herdís Steingrímisdóttir, Associate Professor, external member

Thórarinn G. Pétursson, Chief Economist of the Central Bank, was present for the entire meeting. In addition, several Bank staff members attended part of the meeting.

Karen Á. Vignisdóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 23 November 2022.