The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

Meeting held 17-18 May 2021 (102nd meeting)

Published 2 June 2021

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 17 and 18 May 2021, 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 19 May.

I Economic and monetary developments

Before discussing monetary policy decisions, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland's international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the Committee's last meeting, on 24 March 2021, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2021/2 on 19 May.

Financial markets

Since the March meeting, the króna had depreciated by 1% in trade-weighted terms. The Bank's net foreign currency sales totalled 53 million euros (8 b.kr.) between meetings. Of that total, purchases under the intervention programme totalled 12 million euros (about 1.8 b.kr.), sales under the intervention programme totalled 14 million euros (about 2.1 b.kr.), and regular currency sales amounted to 51 million euros (7.7 b.kr.). The Central Bank's transactions accounted for almost 19% 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 March meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was -2.8%, or 0.4 percentage points lower than just after the publication of the March interest rate decision. In terms of twelve-month inflation, it was -3.7% and had fallen by 0.5 percentage points between meetings.

Interest rates in the interbank market for krónur were broadly unchanged between meetings, and there was no turnover in the market during that period. Yields on long-term nominal Treasury bonds had risen by 0.5 percentage points since the March meeting, whereas yields on long-term indexed Treasury bonds were more or less unchanged. Average mortgage lending rates had held broadly unchanged between meetings.

In terms of three-month interbank rates, the short-term interest rate differential remained unchanged between meetings, at 1.9 percentage points versus the euro area and 1.2 percentage points versus the US. The long-term interest rate spread versus Germany had widened by 0.2 percentage points, to 4.1 percentage points, and the spread versus the US had widened by 0.5 percentage points, to 2.4 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 0.5%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany was 0.5-0.6 percentage points.

Financial institutions' analysts expected the MPC either to raise the Bank's interest rates by 0.25 percentage points or to hold them unchanged. They noted that inflation had proven higher and more persistent in the recent term than had been expected, and that the Bank's real rate had therefore fallen since the effects of the pandemic had peaked. It was also pointed out that in view of the high level of uncertainty, care must be taken not to stand in the way of further economic recovery even though the economic outlook was now improving.

According to the Central Bank's quarterly market expectations survey, conducted in May 2021, respondents expected the Bank's key rate to remain unchanged at 0.75% in Q2/2021, based on the median response, followed by a rate hike of 0.25 percentage points, to 1%, in Q3. Respondents also expected the key rate to be 1.25% at the end of the year. This is a higher rate than survey participants expected in January, when they projected that the Bank's key rate would be 0.75% at the end of 2021. In the survey, about 56% of respondents considered the monetary stance appropriate at present, up from 46% in the previous survey. The share who considered the monetary stance too loose increased, however, from 15% in the January survey to 44% in the May survey. No respondents considered the stance too tight, whereas 38% did so in the Bank's last survey.

Growth in M3 has eased, and annual growth is estimated at just under 6.3% in March. At the same time, annual growth in credit system lending to households is estimated at about 10%, roughly the same as in recent months. Corporate lending contracted by just under 4%, however.

The Nasdaq OMXI10 index had risen by 7.3% between meetings. Turnover in the Main Market totalled 340 b.kr. in the first four months of 2021, some 41% more than over the same period in 2020.

Global economy and external trade

According to the International Monetary Fund's (IMF) April forecast, global GDP growth is projected to measure 6% in 2021, or 0.5 percentage points more than in the Fund's January forecast. Furthermore, global GDP growth is forecast at 4.4% in 2022, or 0.2 percentage points above the IMF's most recent forecasts. World trade is also expected to recover strongly. The change between forecasts reflects the increased fiscal stimulus provided by several large economies and the expectation of a vaccine-driven recovery in H2/2021. Uncertainty about developments in the global economy remains significant, however, not least as regards the pandemic, vaccination efforts, and whether vaccines will provide satisfactory protection against new variants of the virus. Global GDP growth could therefore turn out 1-1½ percentage points weaker in 2021 and 2022, in the IMF's opinion, if the battle against the pandemic proves to be more protracted than is assumed in the baseline forecast. Conversely, it could be ½-1 percentage points stronger if efforts to control the pandemic are more successful than is currently projected.

Iceland's external goods trade generated a deficit of 23 b.kr. for the first three months of the year, as opposed to a deficit of 26 b.kr. over the same period in 2020 (at constant exchange rates). The value of exported goods excluding ships and aircraft rose by just over 1% year-on-year. The increase is due primarily to exports of agricultural products, particularly farmed fish, whose value rose by nearly one-third between years. On the other hand, marine product export values fell by 3% due to price cuts. In Q1/2021, the value of imported goods excluding ships and aircraft rose year-on-year for the first time since the end of 2018. It increased by 2.5% at constant exchange rates, mainly because of a 22% rise in the value of investment goods, although consumer goods, particularly consumer durables, rose in value by over 12%. Offsetting this was a decline of one-third in the value of imported transport equipment, owing mainly to base effects from the prior year; furthermore, the value of imported petrol is still down considerably.

Global aluminium prices were up 12% since the March meeting. They have risen by a fourth year-to-date and by more than a third since the onset of the pandemic. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products had continued to fall and were down 9% year-on-year in March. Global Brent crude prices had risen by 13% between MPC meetings, to around 69 US dollars per barrel by mid-May. Oil prices have nearly doubled since early November, following positive news reports about the development of vaccines, and prices are now roughly at pre-pandemic levels. Other commodity prices have also risen rapidly since spring 2020 and are at their highest in eight years. This is due both to a burst of demand, particularly from China, and supply disruptions that impede the production of many commodities.

The real exchange rate in terms of relative consumer prices rose by 1.2% month-on-month in April, when it was 4.2% above its 25-year average but 5.4% lower than at the beginning of 2020. In the first four months of 2021, it was down by 1.6% compared with the same period in 2020, as the nominal exchange rate of the króna was 4% lower and inflation in Iceland was 2.7 percentage points above the trading partner average.

Domestic economy and inflation

According to the Statistics Iceland labour force survey, total hours worked fell by 3.5% year-on-year in Q1/2021. The decline in total hours stemmed from a 2.4% reduction in the number of employed persons and a 1.1% shortening of the average work week. When adjusted for seasonality, job numbers and total hours worked rose quarter-on-quarter after having declined somewhat in Q4/2020. Data from the pay-as-you-earn register (PAYE) suggest, however, that the number of wage-earners fell between quarters. During the quarter, the labour participation rate was about the same as it was a year earlier, whereas the employment rate was still down by roughly 2.5 percentage points.

Seasonally adjusted unemployment measured 7.6% in Q1, having declined by nearly 1 percentage point between quarters; however, it was still 3.2 percentage points higher than in

Q1/2020. Registered unemployment according to the Directorate of Labour was somewhat higher. It had peaked at 11.6% in January and measured 10.4% in April.

Population growth has slowed markedly since the pandemic struck. The population grew by 1% year-on-year in Q1/2021, which is only 0.4 percentage points more than if no migration had taken place during the quarter.

The wage index rose by 4.3% between quarters in Q1, and by 10.5% year-on-year, and real wages in terms of the index were 6% higher during the quarter than at the same time in 2020.

It appears that private consumption grew again quarter-on-quarter in Q1/2021, after contracting in Q4/2020, and there are signs that strong growth will continue. At the beginning of the year, traffic was back to the pre-pandemic level, there was solid growth in payment card turnover within Iceland, and household spending in contact-intensive sectors began to recover. In spite of more stringent public health measures in March, card turnover continued to increase, and new motor vehicle registrations (excluding car rental agencies) also suggest a robust recovery of private consumption year-to-date.

Households have grown increasingly more optimistic about the economic and employment outlook as the vaccine roll-out has progressed, and the Gallup Consumer Confidence Index reached a four-year high of 134 points in May. All components of the index rose month-on-month, and expectations six months ahead hit an all-time high.

Statistics Iceland's nationwide house price index, published in late April, rose by 2.5% month-on-month when adjusted for seasonality, and by 10.6% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 3.3% month-on-month in March when adjusted for seasonality, and by 10.7% year-on-year. Detached housing prices were up by 13.6% and condominium prices by 9.5%. The number of purchase agreements registered nationwide rose by 47% year-on-year in the first three months of 2021, while the number of contracts for new construction increased by 73% over the same period.

The CPI rose by 0.71% month-on-month in April, and twelve-month inflation increased to 4.6%. This was the second consecutive monthly rise in inflation, pushing it to its highest since February 2013. Inflation excluding housing tapered off between months, however, but it also measured 4.6%. Underlying inflation also declined between March and April, to 4.3% according to the average of various measures.

The April rise in the CPI was due largely to the steep rise in house prices, although higher food prices, particularly for dairy products, also had some impact. The contribution of housing to inflation has increased in recent months, and the housing component accounts for one-fifth of headline inflation. On the other hand, the contribution of imported goods (excluding petrol) has declined over the same period.

According to the market expectations survey carried out in May, respondents expect inflation to measure 3% in one year's time, whereas in the January survey they expected it to be at the Bank's 2.5% inflation target. Market agents' long-term inflation expectations are still at target, however. The five- and ten-year breakeven inflation rates in the bond market have risen by an average of 0.4 percentage points since the March meeting. The five-year breakeven rate was about 3.5% just before the May meeting, and the ten-year rate was just over 3%.

According to the forecast published in *Monetary Bulletin* on 19 May 2021, the outlook is for inflation to ease more slowly than previously projected. It is forecast to measure 4.4% in Q2 and fall to 3.8% by Q4. Inflation will therefore be considerably more persistent than previously forecast, as the February forecast assumed that it would align with the target by the year-end, whereas now it is not expected to return to target until mid-2022. This is due mainly to higher imported inflation, although the króna is now expected to be stronger than previously projected. Furthermore, in the latter half of the forecast horizon, the outlook is for inflation to be higher than was assumed in February, as an output gap is now expected to open up earlier than was forecast then.

The trade-weighted exchange rate index (TWI) stood at 200 points in Q1/2021, and the króna was therefore about 1½% stronger, on average, than was forecast in the February *Monetary Bulletin*. Since mid-March, the TWI has fluctuated between 193 and 198. According to the baseline forecast, it will remain broadly in this range throughout the forecast horizon; therefore, the króna will be nearly 5% stronger in 2022 than was projected in February. As a result, the real exchange rate will rise by a full 5% over the forecast period, although at the end of the forecast horizon it will still be more than 12% below its 2017 peak.

GDP growth among Iceland's main trading partners contracted by 5.2% in 2020. Although most advanced economies experienced a downturn in economic activity in Q4, they proved to be generally more resilient than had been assumed in the Bank's February forecast. The continued rapid spread of COVID-19 and tight public health restrictions in the early months of 2021 have constrained the economic recovery in major advanced economies. Overall, the global GDP growth outlook for 2021 has improved, and it appears that economic activity will rebound quickly this summer, once vaccinations are well in hand and public health measures are relaxed again.

In Iceland, the contraction in GDP in 2020 was smaller than anticipated, or 6.6% instead of the 7.7% provided for in the February forecast. Moreover, the outlook for 2021 has improved marginally, and output growth for the year is forecast at 3.1%, owing primarily to indications of strong growth in private consumption. Offsetting this, infection rates are still rising rapidly in many parts of the world, and tourism is now expected to recover more slowly than previously forecast.

The unemployment outlook has improved, although the jobless rate is still expected to taper off slowly and remain somewhat higher than before the pandemic. Unemployment according to the Statistics Iceland labour force survey is forecast to average just under 7% this year and then ease to around 6% near the end of the forecast horizon. Registered unemployment will be higher this year, or slightly over 9%, but will fall faster during the forecast horizon.

The pandemic has caused significant disruption on the supply side of the economy. As a result, growth in potential output is estimated to have fallen well below its historical average in 2020 and is expected to be below average in 2021 as well. The output slack that developed in the economy in the wake of the pandemic is therefore expected to close more rapidly than it would otherwise. It is projected to narrow from 5% of capacity in 2020 to 2% this year, and then flip to a small output gap in H2/2022. This is a smaller slack than was forecast in February and will close more quickly than was assumed then, reflecting both revisions of historical data and a more favourable GDP growth outlook.

If the forecast materialises, GDP will not return to its 2019 level until 2022, and in 2023 it will still be 3% below the level projected in the Bank's last pre-pandemic forecast. It is therefore clear that the economic damage done by the pandemic will be long-lasting, although it will apparently be less severe than was initially feared. This outlook is subject to considerable uncertainty, however, and in *Monetary Bulletin* are alternative scenarios that describe various possible output growth paths, depending on how successfully the pandemic can be brought under control. The economic recovery could be delayed if vaccination proceeds more slowly and if it proves difficult to stop further spread of COVID-19 and new variants of the virus.

Conversely, the recovery could prove stronger if the pandemic recedes more quickly and widespread vaccination is achieved earlier than is assumed in the baseline forecast.

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 March meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in March to hold interest rates unchanged.

In their discussion, Committee members noted that the economic recovery in H2/2020 had been stronger than previously estimated and that according to the new macroeconomic forecast, published in the May issue of *Monetary Bulletin*, the outlook was for GDP growth to measure just over 3% in 2021 and more than 5% in 2022. Members also noted that the outlook had improved since the Bank's last forecast, owing largely to signs of a stronger recovery of domestic demand. They discussed unemployment, which had eased but remained high. Furthermore, according to the forecast, the slack in the economy appeared to be smaller and looked set to close sooner than previously estimated. It emerged in the discussion that the economy – private consumption in particular – had thus far withstood the crisis better than expected. It was pointed out that household sentiment had improved markedly and that on the whole, household saving was above its historical average; as a result, private consumption was likely to continue recovering strongly.

The Committee discussed developments in inflation, which had proven higher and more persistent than previously forecast, measuring 4.6% in April. It was pointed out that inflationary pressures appeared to be widespread, as underlying inflation was broadly similar to headline inflation. It emerged in the discussion that this stemmed from a number of factors: supply-side disruptions due to the pandemic, which had raised production and distribution costs worldwide; rising oil and commodity prices; domestic wage and house price increases; and exchange rate pass-through from the depreciation of the króna in 2020. It also emerged, however, that some of these increases could prove to be temporary. The MPC noted as well that strong demand and a smaller slack in output than previously assumed had led to increased inflationary pressures.

Committee members discussed the housing market, in view of increased activity and rising house prices. They noted that interest rate cuts in the past year had supported demand and enabled more people to enter the housing market, particularly young first-time buyers. They also discussed developments in house prices and mortgage lending, and the various macroprudential tools that the Bank's Financial Stability Committee could apply if signs that imbalances were developing in the housing market should appear.

Members discussed the foreign exchange market and the fact that the króna had been relatively stable in the recent term. In early May, supply and demand in the foreign exchange market appeared better balanced than before; therefore, it had been decided to discontinue the regular currency sales programme, which the Bank had launched in September 2020. It emerged in the discussion that this measure had been successful.

All MPC members agreed that it was necessary to raise the Bank's interest rates now, in order to ensure that inflation expectations are anchored to the target. The Committee discussed whether interest rates should be raised by 0.25 or 0.5 percentage points. The main arguments in favour of a 0.25-point rate hike were that although domestic demand was stronger than previously expected and the economic outlook had improved, unemployment remained high and the recovery was fragile. Because of this, it was important to proceed with caution. It emerged that, given the uncertainty currently prevailing, the economic turnaround could prove weak. It was also pointed out that part of the spike in inflation could be attributed to temporary factors that would subside in H2/2021 and that long-term inflation expectations were still close to target by several measures. It was important to contain inflationary pressures by raising rates, but to take smaller steps so as to safeguard the economic recovery at the same time. It was also pointed out that a 0.25-point rate hike would send a clear message that the Committee had the tools to bring inflation back to target and would not hesitate to use them.

The main arguments expressed at the meeting in favour of raising rates by 0.5 percentage points were that inflation had increased in the recent term and had been above the upper deviation threshold of the target since the turn of the year. Although uncertainty remained, the economic outlook had improved markedly. In addition, it was clear that domestic demand was stronger than previously estimated, and furthermore, the slack in the economy was smaller and would close sooner than previously expected. It was therefore important to take more decisive action, as unemployment had probably peaked and was beginning to taper off. Furthermore, inflation expectations – short-term expectations in particular – had risen in the recent term, and the long-term breakeven inflation rate was above the target.

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 1%, the current account rate 0.75%, the seven-day collateralised lending rate 1.75%, and the overnight lending rate 2.75%. All members voted in favour of the Governor's proposal, although Gunnar Jakobsson would have preferred to raise rates by 0.5 percentage points. Members also agreed to maintain an unchanged policy regarding other monetary policy instruments.

It emerged at the meeting that the MPC would apply the tools at its disposal to ensure that inflation eases back to the target within an acceptable time frame.

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 25 August 2021.