



# MINUTES

## MONETARY POLICY COMMITTEE



2022

August  
110th meeting  
Published 7 Sept. 2022

## Minutes of the Monetary Policy Committee meeting

August 2022 (110th meeting)

Published: 7 September 2022

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 22 and 23 August 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 24 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 22 June 2022, as published in the updated forecast in *Monetary Bulletin 2022/3* on 24 August.

#### **Financial markets**

Since the June meeting, the króna had depreciated by 2.8% 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 eased since the June meeting. In terms of the average of various measures of inflation and inflation expectations, the Bank's real rate was -2.3%, or 0.5 percentage points lower than just after the announcement of the June interest rate decision. In terms of twelve-month inflation, it was -4.7% and had fallen by 2 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 June, but there had been no turnover in the market since the MPC's last meeting. Yields on long-term nominal Treasury bonds had fallen by up to 0.3 percentage points since the June meeting, whereas yields on long-term indexed Treasury bonds were more or less unchanged. Furthermore, average non-indexed mortgage lending rates had risen following the rise in the key rate in June, whereas average indexed mortgage rates had fallen marginally.

In terms of three-month interbank rates, the short-term interest rate differential was virtually unchanged versus the euro area, at 5.1 percentage points, whereas it narrowed versus the US

by 0.3 percentage points, to 2.6 percentage points. The long-term interest rate differential versus Germany had widened by 0.4 percentage points between meetings, to 4.4 percentage points, and the spread versus the US had widened by 0.2 percentage points, to 2.7 percentage points. Measures of the risk premium on the Treasury's foreign obligations had risen 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 1.4-1.5 percentage points.

According to the Central Bank's quarterly market expectations survey, conducted in August, respondents expected the Bank's key rate to be raised to 5.5% in Q3/2022, then increase still further in Q4 and measure 6% in Q1/2023. Thereafter, they expected interest rates to be lowered again, to 5.5% one year ahead and 4.5% two years ahead. This is a higher interest rate than market agents expected at the time of the April survey. Participants' responses on the monetary stance changed somewhat: and 67% considered the current stance too loose, down from 79% in April. On the other hand, the share who considered it appropriate rose to 29%, from 17% in the previous survey. Just over 4% of respondents in the August survey – the same as in the April survey – considered the monetary stance too tight.

Financial institutions' analysts expected the MPC to raise the Bank's interest rates by 0.75 percentage points, citing the continued rise in inflation since the previous MPC meeting and the persistent increase in house prices. Furthermore, real interest rates were negative, and short-term inflation expectations had risen. Analysts also noted that economic activity was strong at present, and a significant labour shortage had developed in some sectors. The economic outlook abroad had deteriorated in the recent term, however, and the impact of the Bank's recent interest rate hikes and tightening of macroprudential tools had yet to come to the fore.

Annual growth in M3 has eased marginally in 2022 to date and measured just over 10% in June. At the same time, annual growth in credit system lending to households is estimated at 10%, roughly the same as in recent months. Annual growth in corporate lending has gained pace over the course of the year, measuring just over 6% in June.

The Nasdaq Iceland OMXI10 index rose by 8.7% between meetings but was down 15.5% year-on-year in the first seven months of 2022. Turnover in the Main Market totalled 634 b.kr. in the first seven months of the year, or just under 12% more than over the same period in 2021.

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

According to the International Monetary Fund's (IMF) July forecast, global GDP growth is projected to measure 3.2% in 2022, or 0.4 percentage points less than in the Fund's April forecast. For 2023, growth is projected at 2.9%, or 0.7 percentage points below the April forecast. The bleaker global economic outlook is due largely to a poorer outlook for the US and China. The GDP growth outlook for the euro area has also deteriorated markedly because of the negative impact of the war in Ukraine, particularly for 2023. The global inflation outlook has also worsened further, in the IMF's opinion, owing to higher food and energy prices, and to the effects of persistent supply-demand imbalances in the global economy. Among advanced economies, inflation is forecast at 6.6%, or 0.9 percentage points above the April forecast. For 2023 it is forecast at 3.3%, or 0.8 percentage points above the April forecast.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured just over 10 b.kr. in June and 72 b.kr. in the first six months of 2022, as compared with a deficit of 77 b.kr. at constant exchange rates over the same period in 2021. The deficit excluding ships and aircraft was smaller, or 51 b.kr., which is similar to the deficit for the same period in 2021.

Goods export values increased by 48% during the first six months of the year, with all key categories contributing to the rise except for agricultural products, whose export value contracted year-on-year. As before, the strongest impact was from industrial goods exports, aluminium products in particular, which rose markedly in price. At the same time, imported goods values rose by 37% year-on-year, or by 42% excluding ships and aircraft, with all key categories contributing to the rise, particularly fuels and lubricants.

Global aluminium prices fell by 3% between meetings, to around 2,400 US dollars per tonne. This is about 13% lower than at the beginning of 2022 and 7% lower than in August 2021. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products had risen 3% month-on-month in June and 21% over the first six months of 2022. The global price of Brent crude fell by 13% between MPC meetings, to 100 US dollars per barrel by the time of the August meeting. This is 27% higher than at the beginning of 2022, however, and just under 50% above the August 2021 price. Various other commodity prices have also fallen in global markets since the last MPC meeting, and overall they are similar to those seen in late 2021. The price of natural gas has risen sharply since the June meeting, however, particularly in Europe, as a result of further cutbacks in gas flows from Russia. Uncertainty about supplies for the coming winter has increased. Natural gas prices in Europe have more than doubled since June and increased more than six-fold since August 2021.

The real exchange rate in terms of relative consumer prices fell by 0.4% month-on-month in July, when it was 9.1% above its 25-year average but 0.5% lower than in December 2019. It rose by 4.1% year-on-year in the first seven months of 2022, as the nominal exchange rate rose by 4.2%, while inflation in Iceland was broadly in line with the trading partner average.

### **Domestic economy and inflation**

According to the Statistics Iceland labour force survey (LFS), job numbers rose 8.3% year-on-year in Q2/2022, and average hours worked increased between years for the first time since 2019. Total hours worked therefore rose by 9.1% year-on-year, the steepest increase in the history of the survey. According to seasonally adjusted LFS results, the labour participation rate fell by 0.7 percentage points between quarters, while the employment rate held unchanged. Unemployment fell by 0.7 percentage points between quarters, to 3.3%. The seasonally adjusted unemployment rate according to the Directorate of Labour was 3.7% in Q2. Unemployment has therefore fallen rapidly from its 2021 peak and is now broadly as it was in 2019. According to the LFS, the slack in the labour market has narrowed concurrent with declining unemployment and is now roughly as it was in late 2018.

Iceland's population grew by 2.6% year-on-year in Q2/2022. Net inward migration was positive by 3,600, including 3,510 foreign nationals, or 1.3% of the population aged 16-74. This is roughly equal to the peak percentage from Q2/2017.

The general wage index rose by 8.4% year-on-year in Q2, and the annual increase was 1.1 percentage points larger compared to Q1, as the GDP growth supplement provided for in wage agreements was activated in April. Real wages in terms of the index were 0.4% higher during the quarter than at the same time in 2021, whereas in July they declined by 1.7% year-on-year.

Key indicators of developments in private consumption in Q2 suggest that it remained strong. It is estimated to have grown by 14% year-on-year during the quarter. A major contributor was the surge in Icelanders' overseas travel this spring and summer, although consumption spending within Iceland also continued to grow strongly. Households are now more pessimistic about the economic outlook than they were earlier in the year.

Statistics Iceland's nationwide house price index, published at the end of July, rose 2.7% month-on-month when adjusted for seasonality and by 24.9% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 1.4% month-on-month in July when adjusted for seasonality, and by 25.5% year-on-year. The number of purchase agreements registered nationwide fell by 29.6% year-on-year in the first seven months of 2022, and the number of contracts for new construction declined by 30.8% over the same period. The average time-to-sale in the capital area was 1.7 months in July, considerably more than the July 2021 figure of 1.1 months, and the number of homes for sale has increased markedly in recent months.

The CPI rose by 1.17% month-on-month in July, and twelve-month inflation increased to 9.9%. Inflation excluding housing rose as well, to 7.5%. Underlying inflation measured 6.5%, according to the average of various measures.

Private services prices rose sharply in July, particularly because of a surge in airfares, and measured 8.5% higher than in July 2021. Owner-occupied housing costs, which rose by over 22% year-on-year, were another major factor, as they have been in the recent past. The price of clothing, shoes, and furniture declined because of summer sales, which had a stronger impact than in the previous two years. In addition, the rise in food and petrol prices lost momentum.

According to the Central Bank's market expectations survey, carried out in early August, their inflation expectations rose; they expect inflation to measure 4% two years ahead and then on average 3.8% over the next five years and 3.5% over the next ten. Market agents' long-term inflation expectations have therefore continued to rise. On the other hand, the five- and ten-year breakeven inflation rate in the bond market has fallen since June, while the five-year breakeven rate five years ahead was broadly unchanged at 3.6% in mid-August.

According to the updated forecast published in *Monetary Bulletin* on 24 August, the inflation outlook has deteriorated once again. Inflation has risen, measuring 9.9% in July. Although the surge in the housing component of the CPI and in global oil and commodity prices weighs heavily, inflation is quite widespread: inflation excluding housing measures 7.5%, and underlying inflation is 6.5%. Inflation expectations have also continued to rise by most measures. Inflation is forecast to move still higher, to 10.8% in Q4, and then subside gradually.

Global GDP growth has slowed since mid-2021, and pessimism about the economic outlook has increased since the Bank's last forecast, despite the recent decline in oil and commodity prices and reduced strain on global supply chains. Inflation has continued to rise worldwide, and the outlook for 2022 and 2023 is for weaker GDP growth among trading partners than was assumed in the May *Monetary Bulletin*.

In spite of the bleaker global outlook, Iceland's GDP growth prospects have improved since the May forecast. There are signs of continued strong private consumption in Q2, and it appears that households have drawn down their savings faster than was assumed in the Bank's last forecast. Furthermore, tourist visits to Iceland increased more rapidly this summer than previously forecast, and domestic firms appear to have been more successful in resolving the supply chain problems that developed in the wake of the war in Ukraine. GDP growth is projected at 5.9% this year, some 1.3 percentage points above the May forecast. As in May, GDP growth is projected to measure around 2% per year in 2023 and 2024.

There is still considerable uncertainty about the effects of the war in Ukraine. It is difficult to predict how deep and protracted these effects will be, and the outlook could deteriorate even more if natural gas imports from Russia to Europe are shut off. Furthermore, household

sentiment in Iceland and abroad has deteriorated, and it is difficult to assess the extent to which increased pessimism will affect consumers' spending decisions later this year and into 2023.

## **II Decisions on the Bank's monetary policy instruments**

The MPC discussed the monetary stance in view of economic developments and the decline in the Bank's real rate since the June meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided in June to raise interest rates still further. At that time, there were signs that domestic economic activity would remain strong, but on the other hand, sentiment among both households and businesses had deteriorated. Furthermore, inflation had continued to rise, and inflation expectations had increased by most measures.

Committee members noted that, according to the updated macroeconomic forecast, published in the *August Monetary Bulletin*, GDP growth looks set to measure nearly 6% this year, some 1.3 percentage points above the May forecast, owing mainly to more robust private consumption growth and a more rapid rebound in tourism than was projected then. It emerged that job numbers had continued to rise and unemployment to fall, and a wider positive output gap had developed in the domestic economy than was estimated in May.

The MPC noted that the inflation outlook had continued to deteriorate and that inflation had risen to 9.9% in July. It emerged that inflation was forecast to peak at nearly 11% late this year. The bleaker inflation outlook reflected stronger economic activity than was forecast in May, as well as more persistent house price inflation and higher global inflation. In addition, inflation expectations had risen even further by most measures.

All members agreed that the Bank's key rate should be raised further, and they discussed rate increases ranging from 0.5-1 percentage point. An important factor was that domestic demand had proven stronger than the MPC had anticipated, and there was clearly considerable momentum in the economy. There were signs that private consumption had grown significantly more than the Committee had assumed, and it appeared that households were drawing down their savings more quickly than previously estimated. By the same token, the tourism industry was recovering more rapidly than previously expected. In the MPC's opinion, this could be seen in, among other things, a significant tightening of the labour market by all measures. The inflation outlook had therefore continued to deteriorate. In the Committee's opinion, the continued rise in inflation expectations was also cause for concern, as it could exacerbate the risk that companies, prompted by strong demand and recent wage and input cost increases, would pass these costs through to prices to a greater extent.

The MPC's main arguments in favour of taking a smaller step were that the rapid increase in the key rate in the recent term had begun to have an effect, including on the housing market, and that the full impact had not yet come to the fore. In addition, steep cost of living increases and the prospect of reduced purchasing power could cause a reversal of the economic outlook. Furthermore, the global economic outlook had continued to worsen between meetings, which could affect Iceland's exports, and in many countries households' and businesses' had never been as pessimistic about the economic outlook. Moreover, global oil and commodity prices had fallen in the recent term, reducing inflationary pressures. The arguments in favour of taking a larger step were that it was vital to give increased weight to how rapidly pressures in the labour market had grown, and there were clear signs of overheating in the economy. It was pointed out that if the monetary stance were not tightened fast enough, high inflation would be more likely to become entrenched and it would be more difficult to bring it back to target.

In view of the discussion, the Governor proposed that the Bank's interest rates be raised by 0.75 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 5.5%, the current account rate 5.25%, the seven-day collateralised lending rate 6.25%, and the overnight lending rate 7.25%. All members voted in favour of the Governor's proposal, although Gylfi Zoëga would have preferred to raise rates by 1 percentage point.

The MPC discussed that it was likely that the monetary stance would have to be tightened even further so as to ensure that inflation eases 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 how high interest rates must rise.

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 5 October 2022.