



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2020 (95th 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 18 and 19 May 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 20 May.

I Economic and monetary developments

Before discussing decisions on the application of the Bank’s monetary policy instruments, 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, held on 2 April 2020, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin 2020/2* on 20 May.

Financial markets

The króna had depreciated by 1% in trade-weighted terms since the April meeting, and by 10% since the end of February. Between meetings, it fell 1.1% against the pound sterling, 0.5% against the US dollar, and 0.8% against the euro. Over the same period, the Bank sold foreign currency for just under 46 million euros (7.2 b.kr.). The Bank’s transactions accounted for roughly 30% of total turnover in the foreign exchange market.

In terms of the Bank’s real rate, the monetary stance was virtually unchanged since the early April meeting. The Bank’s real rate in terms of the average of various measures of inflation and one-year inflation expectations was -0.6%, and in terms of current twelve-month inflation it

was -0.4%. On the other hand, the Bank's real rate had fallen year-to-date by 1.2 percentage points in terms of various measures and by 1.4 percentage points in terms of current twelve-month inflation.

Interest rates in the interbank market for krónur were virtually unchanged between meetings, and there was no turnover in the market during that period. Yields on long-term nominal Treasury bonds had fallen by 0.4 percentage points since the April meeting, and yields on long-term indexed Treasury bonds had fallen by up to 0.3 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 0.3 percentage points between meetings, to 2.5 percentage points, but had widened by 0.8 percentage points against the US dollar, to 1.9 percentage points. The long-term interest rate spread versus Germany had narrowed by 0.2 percentage points, to 3 percentage points, and the spread versus the US had narrowed by 0.3 percentage points, to 1.8 percentage points. Risk premia on the Treasury's foreign obligations had risen between MPC meetings. The CDS spread on the Treasury's five-year US dollar obligations was unchanged at 0.8%, and the spread between the Treasury's eurobonds and comparable bonds issued by Germany had widened to 0.3-1.2 percentage points.

Financial institutions' analysts expected a policy rate cut ranging from 0.25 percentage points to 1 percentage point, citing the prospect of a severe economic contraction, increased unemployment, and a contraction in both private consumption and investment. Because inflation and inflation expectations had been stable at the Bank's target, analysts considered it appropriate to use the existing scope to lower interest rates further in order to support the economy.

According to the Central Bank's quarterly market expectations survey, conducted in early May, respondents expected the Bank's key rate to be lowered by 0.5 percentage points in Q2/2020, to 1.25%, followed by another rate cut of 0.25 percentage points in the latter half of the year. This is a significant change from the January survey, when participants expected interest rates to be 2.75% this year. In the survey, 11% of respondents considered the monetary stance too loose at present, whereas in the previous survey, 4% were of that opinion. About 19% of respondents considered the monetary stance appropriate, as compared with 35% in the last survey. The share that considered the monetary stance too tight or far too tight was about 71%, up from 61% in the January survey.

Annual growth in broad money (M3) has gained pace in the past half-year, measuring about 9½% in March, after adjusting for deposits held by the failed financial institutions. The main cause of the more rapid growth in the past three months is an increase in financial sector deposits; i.e., those held by other credit institutions, pension funds, and money market funds. Although lending growth has eased since the beginning of 2019, the stock of credit system loans to domestic borrowers grew in nominal terms by an estimated 5% year-on-year in March, after adjusting for the effects of the Government's debt relief measures. Over the same period, household lending grew by just under 7% year-on-year. Corporate lending grew by 1½% but contracted by just over ½% at constant exchange rates.

The Nasdaq OMXI10 index had risen by 14.2% between meetings but had fallen by 7% since the beginning of the year. Turnover in the Main Market totalled 241 b.kr. in the first four months of 2020, some 13% more than over the same period in 2019.

Global economy and external trade

According to the forecast published by the International Monetary Fund (IMF) in early April, the global economic outlook has deteriorated sharply due to the COVID-19 pandemic. The IMF expects the global economy to shrink by 3% in 2020, whereas in January it projected 3.3% growth for the year. Advanced economies are forecast to shrink by 6.1% and emerging economies by 1%. The IMF forecast assumes that the pandemic will peak in Q2 and then begin to subside. As it tapers off, public health measures adopted worldwide to curb the spread of the disease will be phased out gradually. According to this, the Fund assumes that global GDP growth will rebound to 5.8% in 2021. Uncertainty about global economic developments is unusually pronounced at present, however, and depends on how persistent the pandemic proves to be. Many economies are dealing with various other pandemic-related shocks as well, including large-scale capital outflows and a steep drop in commodity prices. As a result, the Fund considers the risk to its macroeconomic forecast to be concentrated on the downside.

The listed global price of aluminium had held broadly unchanged since the MPC's early April meeting. It was therefore still nearly one-fifth lower than at the beginning of 2020 and in May 2019. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were up 6% year-on-year in Q1/2020. Global Brent crude prices had risen 16% since the MPC's April meeting, to just under 35 US dollars per barrel at the time of the May meeting. Even so, oil prices were still about half of what they were at the beginning of 2020 and in May 2019. In particular, the decline reflects falling worldwide demand for oil, which in turn reflects measures taken by governments around the world to slow the spread of COVID-19, although reduced production in leading oil manufacturing countries pulls in the other direction.

The real exchange rate in terms of relative consumer prices fell by 5.4% month-on-month in April, when it was 2.9% below its 25-year average and 12% below its end-2019 level. In the first four months of 2020, it was down by 5.2% compared with the same period in 2019, as the nominal exchange rate of the króna was 6.3% lower and inflation in Iceland was 0.9 percentage points above the trading partner average.

Domestic economy and inflation

According to the Statistics Iceland labour force survey, total hours worked declined by 1.4% year-on-year in Q1/2020. The decline in total hours stemmed from a 0.3% reduction in the number of employed persons and a 1% shortening of the average work week. The number of individuals on the pay-as-you-earn (PAYE) register fell by 2.1% year-on-year in January, however. In addition, the labour participation rate fell by 1.8 percentage points between years in Q1, and the employment rate fell even more, or by 2.3 percentage points over the same period.

Seasonally adjusted unemployment measured 3.9% in Q1/2020, after rising by 0.5 percentage points between quarters and 0.7 percentage points between years. The number of individuals on the Directorate of Labour's (DoL) unemployment register rose more quickly, measuring just over 17.8% of the labour force in April. In this context, however, it should be noted that the DoL classifies recipients of part-time benefits as unemployed even though they still have jobs. If this

group is excluded, the unemployment rate rose from 5% at the beginning of the year to 7.5% in April.

Iceland's foreign labour force continued to grow in Q1/2020. Year-on-year population growth measured 2% during the quarter, including 1.4 percentage points due to immigration of foreign nationals.

The wage index rose by 1.1% between quarters in Q1, and by 4.9% year-on-year, and real wages in terms of the index were 2.8% higher in Q1/2020 than at the same time last year.

Early in Q1, key indicators of private consumption had developed broadly the same as in H2/2019. The situation changed dramatically in March, however, when COVID-19 began to spread in Iceland and the authorities introduced broad-based public health measures that affected a large share of households' consumption spending. Payment card turnover contracted year-on-year in March, and even more in April. Daily card turnover figures indicate, however, that use of domestic cards in Iceland picked up again in the first half of May and was only slightly less than at the same time in 2019. The contraction in new motor vehicles deepened markedly in April.

The Consumer Confidence Index rose by over 17 points between months, to 61.5 in May. This increase comes in the wake of a steep decline in recent months, with April showing the lowest index level since October 2010. The index was 34.5 points lower in May than in the same month of 2019. All subindices rose month-on-month apart from the assessment of the current situation.

Statistics Iceland's nationwide house price index, published in late April, rose by 0.7% month-on-month when adjusted for seasonality, and by 6.3% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.3% month-on-month in March when adjusted for seasonality, and by 3.6% year-on-year. The number of purchase agreements registered nationwide fell by 6.2% year-on-year in the first three months of 2020, while the number of contracts for new construction increased by 39.2% over the same period.

The CPI rose by 0.48% month-on-month in April, and twelve-month inflation increased to 2.2%. The CPI excluding the housing component had risen by 1.9% year-on-year in April. Underlying inflation has risen somewhat in recent months, however, measuring 3.1% in April, in terms of the average of various measures. This is partly because these measures exclude 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 0.5 percentage points.

To an extent, the impact of the recent weakening of the króna surfaced in April, in higher prices of food, furniture, electronics, and new motor vehicles. Among the items pulling in the opposite direction were petrol prices, which had fallen by 7.5% year-to-date and had lowered the CPI by 0.25 percentage points over that period.

According to the Bank's most recent survey, market agents expect inflation to be at target in the next few years. Market expectations are therefore broadly unchanged despite the recent depreciation of the króna. Surveys of corporate and household expectations sketch out a similar picture. The breakeven inflation rate in the bond market has fallen in recent months. The five- and ten-year breakeven rate has averaged 1.8% in Q2 to date, or 0.3 percentage points lower than in Q1/2020.

According to the forecast published in *Monetary Bulletin* on 20 May, the recent depreciation of the króna will cause inflation to be somewhat higher in coming months than was forecast in

February, although it is still expected to be at or below the Bank's target. Offsetting the lower exchange rate are the plunge in global oil prices and an overall decline in global food and commodity prices, although shortages and various types of production problems have pushed some goods prices upwards. As 2020 progresses, however, the impact of the sizeable slack that has opened up in the economy will carry the day, and inflation is therefore expected to be below 2% in the latter half of the forecast horizon.

The króna began to depreciate in late February, after the pandemic spread to Iceland, and by the time *Monetary Bulletin* was published it had fallen 12%. The baseline forecast is based on the assumption that the trade-weighted exchange rate index will remain broadly unchanged throughout the forecast horizon. If this assumption is borne out, the real exchange rate in 2020 will be relatively close to the level seen in H2/2015, when the tourism boom had just begun.

The global economic outlook changed abruptly when COVID-19 began to spread, and there is significant uncertainty about when economic activity will return to near-normal. Future developments will depend not least on how the pandemic is finally quelled. The forecast in *Monetary Bulletin* assumes that the contraction among Iceland's main trading partners will measure 6.4% this year, followed by a rebound to 5% GDP growth in 2021. The changed outlook and increased uncertainty have put global financial markets into a tailspin.

In Iceland, as in other countries, the economic outlook has changed radically. According to the baseline forecast, a contraction of 8% is expected in Iceland, instead of just under 1% growth, as was forecast in February. If this forecast materialises, it will be Iceland's largest single-year contraction in a century. A major factor in this is the prospect of a more than 80% year-on-year decline in tourist visits in 2020. Exports as a whole will therefore contract by nearly one-third, the largest single-year contraction in the history of Iceland's national accounts. Furthermore, domestic demand is expected to contract by nearly 4%, mainly as a result of the direct impact of pandemic-related public health measures on a significant part of private consumption. Economic activity is expected to normalise gradually in H2, but tourist visits are not expected to resume to any significant degree until 2021. Because of this year's deep economic contraction and the resulting slack in the economy, the outlook for 2021 is for robust GDP growth of about 4.8%. In spite of a strong recovery, GDP is projected to be some 6% lower at the end of the forecast horizon than it would have been without the pandemic and associated measures.

The current account surplus will be affected by the steep decline in exports, but imports are also expected to contract alongside the slowdown in economic activity. This, together with an improvement in terms of trade stemming mainly from lower oil prices, will prevent a further deterioration in the surplus on goods and services trade, which is expected to measure 1½% of GDP this year. The current account surplus is set to shrink even further, as the primary income flips from a surplus to a deficit, owing to a weaker operating performance from Icelandic-owned foreign companies.

The impact on the labour market is colossal. Unemployment is expected to peak at around 12% in Q3/2020 and average just under 9% for the year as a whole, the highest unemployment rate since measurements were introduced.

Disruption such as that caused by shocks like the pandemic make it unusually difficult to estimate normal capacity utilisation. It is likely, though, that departures of foreign workers and increased long-term unemployment due to the pandemic will cause growth in potential output to slow markedly this year. Nevertheless, a sizeable slack in output will open up this year because of the deep economic contraction that is forecast. The slack in output is estimated to

measure about 6% of potential output this year. It is assumed to narrow somewhat in 2021 but remain open throughout the forecast horizon.

The baseline forecast assumes that economic activity will start to return gradually to normal in Q3/2020. This forecast could prove overly optimistic, however, if the pandemic turns out more persistent than is currently assumed. Two alternative scenarios are presented in *Monetary Bulletin*. In one of them, the public health measures imposed by the authorities will remain in place through much of the year, and uncertainty will be further exacerbated, triggering a larger rise in risk premia in the financial markets and greater caution among households as regards spending decisions. In this example, the economic contraction will measure just over 10% this year, and the recovery in 2021 will be weaker. The other alternative scenario assumes that the turnaround will be stronger, which could happen if the pandemic tapers off more quickly and tourism recovers more strongly. Reduced uncertainty and greater optimism about the economic outlook could provide an incentive for increased consumption and investment spending. In this example, the contraction in 2020 could measure just under 6% and the recovery in 2021 could turn out stronger.

II Decisions on the Bank's monetary policy instruments

The Governor updated the Committee on the work relating to the finalisation of agreements between the Central Bank and the commercial banks concerning the provision of supplemental bridge loans to businesses. The loans were intended for companies – primarily small and medium-sized enterprises – that were facing temporary operational difficulties as a result of the COVID-19 pandemic.

MPC members discussed the monetary stance in view of economic developments and the fact that the Bank's real rate was virtually unchanged since the early April meeting. They discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided to lower interest rates twice in March, in response to the deteriorating economic outlook following the spread of COVID-19.

The Committee discussed the execution of the Central Bank's quantitative easing (QE) programme, as the Bank had recently begun buying Treasury bonds in the secondary market pursuant to the MPC's decision to this effect. According to the announcement published by the Bank on 22 April, the bond purchases would be carried out either through submittal of bids to the Nasdaq Iceland trading system or by holding auctions, and that it had been decided to begin with the former method. Members emphasised that the objective of the purchases was to ensure monetary policy transmission across the yield curve, so that reductions in Central Bank interest rates were transmitted normally to households and businesses, as it was foreseeable that, all else being equal, the Treasury's increased borrowing need could reduce the amount of liquidity in circulation and push market yields upwards. The Committee agreed that the announcement regarding the purchases had been effective and had unwound the spike in yields that followed the Government's announcement of increased bond issuance. Since then, it appeared that there had been no further signs of pressure on bond yields. Therefore, the Committee considered it appropriate to begin slowly and buy relatively small amounts, while monitoring the impact of the purchases on the bond market and determining whether difficulties in monetary policy transmission should develop. It was also pointed out that attention should be paid to the interactions between the QE programme and other Central Bank measures. Furthermore, the near-term impact of the pandemic on the domestic economy and the Treasury's borrowing need was highly uncertain. It emerged at the meeting that the Bank

had bought bonds for about 400 m.kr. in the first half of May, particularly short-term non-indexed Treasury bonds, and that developments in yields had not displayed any clear trend thereafter. MPC members agreed that the bond purchases should be aligned with economic developments, Treasury issuance, and the impact on the market, so as to ensure that the objective of the purchases was achieved.

The Committee discussed economic developments and prospects and, in this context, considered the Bank's new macroeconomic forecast, published in *Monetary Bulletin* on 20 May. According to the forecast, the outlook is for an 8% contraction in GDP in 2020, and the outlook has worsened since the MPC's previous meeting. The predominant factor underlying this forecast was a more than 80% decline in tourist visits to Iceland. Members also noted that the outlook was for a steep rise in unemployment, which appeared set to reach 12% in Q3 and measure just under 9% for the year as a whole. According to the Bank's forecast, economic activity would gradually normalise starting in H2/2020, with GDP growth projected at nearly 5% in 2021. The Committee emphasised, however, that uncertainty was unusually pronounced and that economic developments would depend on the path the pandemic took and the progress made in unwinding the associated public health measures.

The MPC discussed developments in inflation, which measured 2.2% in April and had been below the Bank's inflation target since December 2019. Members noted that the króna had depreciated since the pandemic reached Iceland, but that this was offset by the deflationary effect of the steep decline in oil prices and the decline in food and commodity prices. It emerged in the discussion, however, that the króna had appreciated slightly since the beginning of May, and that the foreign exchange market was relatively stable. Members also noted that inflation expectations were broadly unchanged and appeared to be firmly anchored to the target. It emerged at the meeting that, according to the Bank's forecast, inflation would rise marginally in coming months, due to exchange rate pass-through from the depreciation of the króna. The increased slack in the economy would weigh heavier as 2020 progressed, however, and the outlook was for inflation to measure below 2% in the latter half of the forecast horizon.

All members were of the opinion that it was appropriate to lower the Bank's interest rates still further. They agreed that the outlook for 2020 was for a sharp contraction in GDP and elevated unemployment, with below-target inflation during the forecast horizon. There was some discussion of the probable path the economic recovery would take, and it came to light that there was the risk of a fragile recovery, with protracted economic headwinds in the coming term. The MPC therefore considered it appropriate to lower interest rates significantly this time, as such a move could support the economy and expedite the recovery once the turnaround took hold. Concerns were expressed about how lower interest rates had not been transmitted effectively enough to businesses, and how the banking system had greater difficulty passing lower interest rates on to customers, as rate cuts had the effect of narrowing the banks' interest rate spreads still further. The viewpoint was expressed that if the króna should depreciate considerably more, it could weaken demand and activity levels in those sectors of the economy that are currently performing relatively well, and as a result, could cause labour market unrest. One Committee member therefore considered it appropriate that the Bank respond if significant pressure should reoccur in the foreign exchange market following the interest rate cut.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.75 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 Committee members voted in favour of the proposal.

The Committee also discussed the one-month term deposits offered by the Bank. They noted that when it was originally decided to offer these deposits, the aim had been to mop up excess liquidity and support the MPC's monetary tightening measures. The policy measure was supposed to remain in effect temporarily, while there was excess liquidity in the system, and to be used to sterilise a portion of the liquidity resulting from the Bank's large-scale foreign currency purchases at that time. Now, however, circumstances were different, and the monetary stance was being eased. As a result, the measure was no longer appropriate, although the possibility of it being reintroduced later could not be excluded. Ceasing to offer these deposits would entail even further monetary easing. It emerged that this would make the Bank's key rate more effective and its policy rate signal clearer, as well as supporting other measures taken by the Bank. In view of the discussion, the Governor proposed that the Bank stop offering one-month term deposits. All members voted in favour of the Governor's proposal, and the Committee agreed that, other things being equal, this measure should increase liquidity in circulation and further strengthen monetary policy transmission.

In the Committee's view, more firmly anchored inflation expectations provided monetary policy the scope to respond decisively to the deteriorating economic outlook. Furthermore, Committee members were of the opinion that lower interest rates, together with other actions taken by the Bank, would support the economic recovery and contribute to a more rapid recovery than would otherwise occur. In addition, fiscal policy measures had pulled in the same direction.

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, Assistant Professor, external member

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

Karen Áslaug Vignisdóttir wrote the minutes.

The next scheduled Statement of the Monetary Policy Committee will be published on Wednesday 26 August 2020.