II Monetary policy and domestic financial markets

Monetary policy and market interest rates

Key rate unchanged since May …

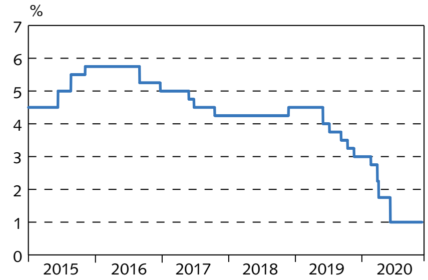
The Central Bank's key interest rate (the rate on seven-day term deposits) has been unchanged since May, when the Bank's Monetary Policy Committee (MPC) decided to lower it by 0.75 percentage points. Just before this *Monetary Bulletin* went to press, the key rate was 1% and had fallen by a total of 2 percentage points since the turn of the year (Chart II-1). The Central Bank has also adopted other measures in order to increase market liquidity, with the aim of improving access to credit and stimulating demand. According to the Central Bank survey carried out in early November, market agents expect rates to remain unchanged until the end of 2021 but to measure 1.25% in two years' time.

The Bank's real rate has fallen in line with the decline in the key rate. In terms of the average of various measures of inflation and one-year inflation expectations, the real rate is now -2.1%. It has fallen by 0.7 percentage points since the end of May and by 2.5 percentage points since November 2019. The interest rate differential with abroad has also narrowed during the year, and short-term real rates in Iceland are now 2 percentage points below the trading partner average.

Chart II-1

Central Bank of Iceland key interest rate[1]

1 January 2015 - 13 November 2020



1. The Central Bank's key interest rate is the rate on seven-day term deposits.
Source: Central Bank of Iceland.

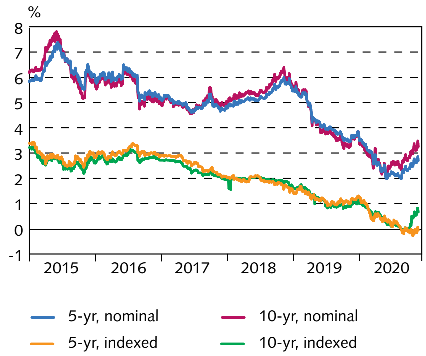
… but long-term rates have risen

The yield on ten-year nominal Treasury bonds began rising this summer, to 3.2% just before this *Monetary Bulletin* was published. This represents an increase of 0.5 percentage points since the end of February, when Iceland's first COVID-19 case was diagnosed. It is still 0.3 percentage points lower than it was a year ago, however (Chart II-2). Yields on shorter bonds have not risen as much, as increased liquidity and declining short-term rates have boosted demand for Treasury bills and short-term Treasury bonds. The yield on ten-year indexed Treasury bonds also started rising this summer, to 0.7% just before this *Monetary Bulletin* was published. The Treasury's financing need has grown as the pandemic has dragged on, and expectations of increased Treasury debt in coming years probably weigh heavily in the recent rise in long-term interest rates. Furthermore, non-residents have sold Treasury bonds in the amount of 45 b.kr. since the beginning of August. In addition, positive news in early November about the development of a vaccine have kindled investors' optimism about a speedier recovery from the economic shock. In March 2020, the Central Bank announced plans to begin buying Treasury bonds in the secondary market so as to ensure that the more accommodative monetary stance would be transmitted to households and businesses. The Bank's bond purchases to date come to 2 b.kr. market value but, according to the decision taken by the MPC, may range up to 150 b.kr.

Chart II-2

Government-guaranteed bond yields[1]

2 January 2015 - 13 November 2020



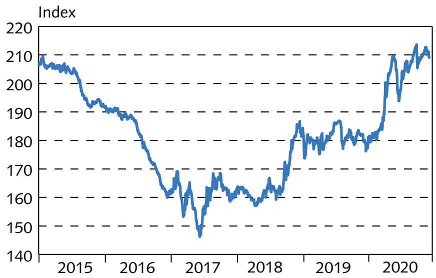
1. Based on the zero-coupon yield curve, estimated with the Nelson-Siegel method, using money market interest rates and government-guaranteed bonds.
Source: Central Bank of Iceland.

Despite the prospect of increased Treasury debt in coming years (see Box 3) and the turmoil in the global economy and financial markets, risk premia on the Treasury's foreign obligations have held rela-

Chart II-3

Exchange rate of the króna[1]

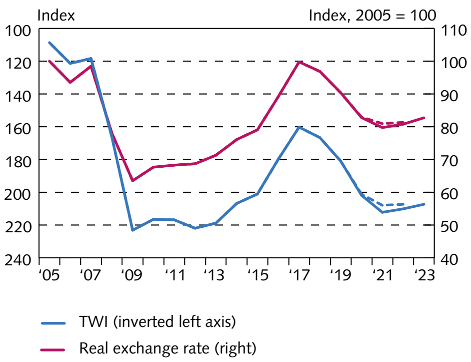
2 January 2015 - 13 November 2020



1. Price of foreign currency in krónur (narrow trade index).
Source: Central Bank of Iceland.

Chart II-4

Exchange rate of the króna 2005-2023[1]

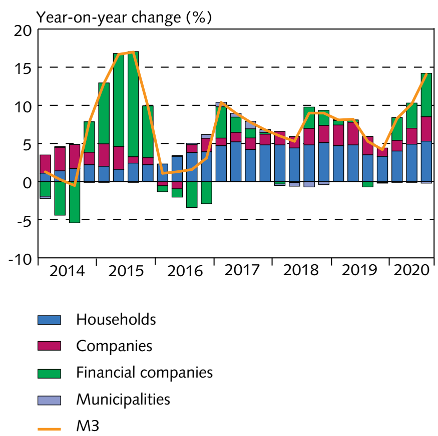


1. The trade-weighted exchange rate index (TWI) is based on a narrow trade basket. Real exchange rate in terms of relative consumer prices. Central Bank baseline forecast 2020-2023. Broken lines show forecast from MB 2020/3.
Source: Central Bank of Iceland.

Chart II-5

Money holdings[1]

Q1/2014 - Q3/2020



1. M3 is adjusted for deposits of failed financial institutions. Companies include non-financial companies and non-profit institutions serving households.
Source: Central Bank of Iceland.

tively stable this year. Therefore, the foreign borrowing terms available to the Treasury appear generally good at present.

Exchange rate of the króna

The króna has depreciated recently, and the Bank has begun regular currency sales

The exchange rate of the króna fell markedly after the pandemic reached Iceland and its effects on the economy grew clearer. From end-February until early May, it fell by 12% relative to the trading partner average. The króna began appreciating again over the course of May, however, as optimism about increased tourist numbers took hold and efforts to control the first wave of the pandemic proved successful. But that appreciation quickly reversed. Since June, there has been downward pressure on the króna, with non-residents increasingly selling Treasury bonds and exporting the proceeds and, from August onwards, with the pension funds stepping up their foreign asset purchases. Foreign currency inflows have also been limited, although the current account is in surplus. The pressure on the króna eased temporarily in early September, when the Central Bank announced plans to begin regular foreign currency sales so as to deepen the foreign exchange market and improve price formation. The average exchange rate is currently about 2.2% higher than it was before that announcement, but 12% lower than at the time of the first domestic COVID case in late February (Chart II-3).

In addition to its regular currency sales, the Central Bank has intervened more in the foreign exchange market this year than in the previous two. The objective of the intervention is to reduce exchange rate volatility, but it also reflects the fact that the real exchange rate is probably below its equilibrium at present, at a time when inflation is above the target. Thus far in 2020, the Bank's net foreign currency sales total 105 b.kr., or 34% of total market turnover.

The exchange rate index was 207.8 points in Q3, which is well in line with the Bank's August forecast. However, the króna is weaker now than was projected in August, and the baseline forecast assumes that the index will average close to 212 points over the next two years, followed by a slight appreciation of the króna towards the end of the forecast horizon (Chart II-4). The real exchange rate will therefore fall even further this year but then rise gradually from 2022 onwards. By the end of the forecast horizon, it will still be almost 17% below its 2017 peak.

Money holdings and lending

Money holdings have increased rapidly in the recent term

Money holdings have increased considerably this year, and annual growth in M3 measured 14% in Q3, as compared with 5% in Q3/2019 (Chart II-5). The easing of the monetary stance and special Central Bank measures to increase market liquidity play a major role in this shift. Furthermore, households' bank deposits have grown significantly in the wake of the COVID-19 pandemic. Household deposits increased by 11% year-on-year in Q3, as opposed to 7.4% at the same time in 2019. General wage rises, reduced consumption spending associated with public health measures, pandemic-related support measures for households, and increased lending due to lively real estate market activity all play a part in the increase. In addition, a high level of uncertainty has prompted households to observe more caution in their spending decisions, and because of the various Government support measures, the impact of the economic shock on those who have lost income has probably come to the fore only to a limited degree. Households' saving has therefore grown substantially in recent months, as can be seen in the increase in banking system deposits (for further discussion, see Box 1).

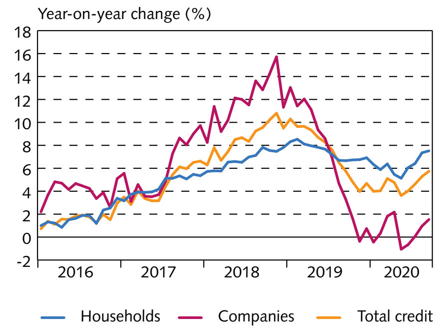
Growth in money holdings also reflects an increase in other financial institutions' banking system deposits. This is due largely to an increase in pension fund deposits, which in turn stems in part from their reduced foreign currency purchases and from households' having shifted their mortgage financing from the pension funds to the commercial banks. Furthermore, HF Fund (formerly the Housing Financing Fund) moved its deposits from the Central Bank to the commercial banks after the autumn 2019 announcement reducing the number of parties eligible to hold deposits with the Bank.

Household lending up strongly, while corporate lending has stalled

Lending growth lost pace last year, but thus far in 2020, annual growth in credit system lending has held steady at around 5% (Chart II-6). As the year has passed, lending to households has increased, due almost entirely to mortgage loans, as lending rates fell sharply in the wake of Central Bank rate cuts and housing market turnover has been brisk. Rising house prices, increased saving, and lower interest rates also give households the option of refinancing, thereby lowering their debt service burden and perhaps affording them the scope to withdraw equity to finance home improvements or other consumption spending. The banks' share in the mortgage lending market has been on the rise this year, as pension fund lending has slowed and the banks generally offer more favourable rates at present. Furthermore, the share of non-indexed mortgage loans has risen in recent months, as has the share of variable-rate loans.

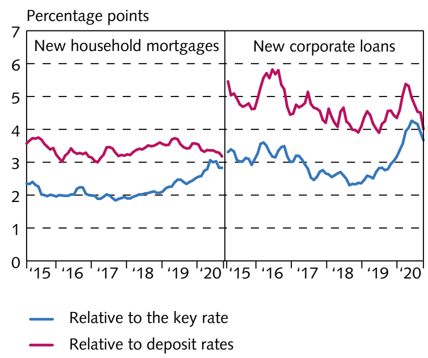
On the other hand, corporate loans have virtually stood still this year. The growth rate began to slow as early as 2019, with declining economic activity and higher returns required by commercial banks on corporate loans. Support loans, bridge loans, and other measures have supported growth in lending to the companies affected most severely by the pandemic, however. Credit spreads on new corporate loans also started to rise in 2019, but they have fallen again in the recent term (Chart II-7). Although low-interest Government-guaranteed support loans have some downward impact on average lending rates, they do not appear to weigh heavily in the trend; therefore, firms' borrowing terms appear to have improved overall.

Chart II-6
Credit system lending[1]
January 2016 - September 2020



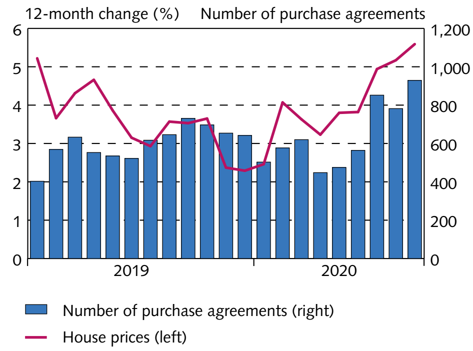
1. Credit stock adjusted for reclassification and effects of Government debt relief measures. Excluding loans to deposit institutions, failed financial institutions, and the Government. Companies include non-financial companies and non-profit institutions serving households.
Source: Central Bank of Iceland.

Chart II-7
Credit spreads[1]
March 2015 - September 2020



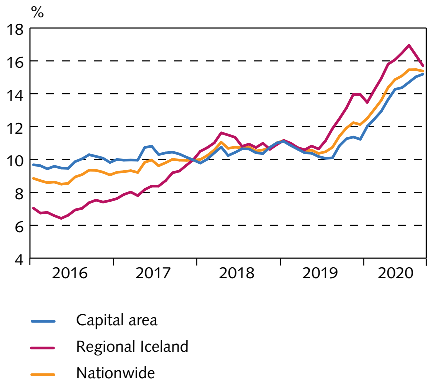
1. The difference between a weighted average of the large commercial banks' non-indexed lending rates and the Central Bank's key rate, on one hand and a weighted average of their deposit rates on the other. Three-month moving average.
Source: Central Bank of Iceland.

Chart II-8
Capital area house prices and number of purchase agreements[1]
January 2019 - September 2020



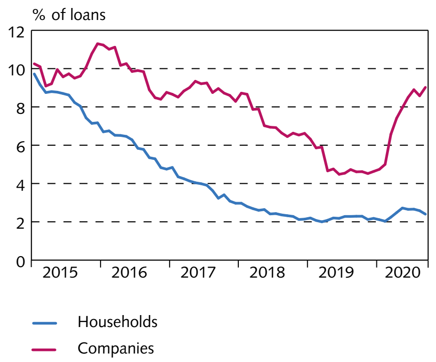
1. Number of purchase agreements on date of purchase.
Sources: Registers Iceland, Central Bank of Iceland.

Chart II-9
House purchase agreements: share due to newly built flats[1]
January 2016 - September 2020



1. Number of purchase agreements on date of purchase. Twelve-month moving average.
Source: Registers Iceland.

Chart II-10
Non-performing loan ratios[1]
January 2015 - September 2020



1. Loans granted by systemically important financial institutions. This includes Landsbankinn, Arion Bank, Íslandsbanki and, until end-2019, the Housing Financing Fund. Non-performing loans are defined as loans that are frozen, in arrears by more than 90 days or those for which payment is deemed unlikely. If one loan taken by a customer is in arrears by 90 days or more, all of that party's loans are considered non-performing (cross-default). Parent companies, book value.
Source: Central Bank of Iceland.

Asset prices and financial conditions

House prices buoyant in a busy market

House prices in greater Reykjavík rose by 5.6% year-on-year in September and have risen by 4% since the pandemic struck Iceland in late February (Chart II-8). Housing market turnover has been strong in the recent past, with Central Bank rate cuts stimulating demand and partly offsetting the adverse economic impact of the pandemic. The number of registered purchase agreements in greater Reykjavík rose by roughly 10% year-on-year in the first nine months of 2020, while contracts for new construction rose far more, or by nearly 59%. Newly constructed homes therefore account for a much larger share of purchase agreements than in 2019 (Chart II-9). The change in the proportion of newly built versus older flats may exaggerate the increase in house prices, as new flats generally sell at a higher price per square metre than older ones. Furthermore, the share of first-time buyers in the capital area has risen in recent years, to a record high of 29% in H1/2020.

The OMXI10 share price index has risen by 10.2% since the August *Monetary Bulletin*, with all listed companies' shares rising in price in the interim. The OMXI10 is now higher than it was before the pandemic arrived in Iceland. Stock market turnover has declined, however, and was down 7% year-on-year over the first ten months of 2020.

Corporate arrears are rising rapidly, while household arrears are broadly unchanged

The non-performing household loan ratio is marginally higher now than at the turn of the year, but it remains relatively low in historical context (Chart II-10). As of end-October, less than 2% of loans to households were in moratorium, which means they are not classified as non-performing, but this percentage has fallen steadily from its late May peak. The small increase in household arrears is a sign that households' debt position is good overall; however, arrears can be expected to rise as unemployment increases and special labour market measures start to expire.

Non-performing corporate loan ratios have risen steeply, however, nearly doubling year-to-date. This increase in business arrears is one manifestation of the difficulties firms are facing at present. Furthermore, as of end-October, 4% of corporate loans were protected by special pandemic-related deferral measures and are therefore not classified as non-performing. A third of companies with loans currently in moratorium were in the tourism industry, and another third were in other services sectors. Presumably, the measures enacted by the Government and financial institutions have mitigated the effect of the pandemic on firms' debt service capacity and helped many companies to remain solvent for a longer period. Even so, corporate insolvencies are up by about a fifth year-on-year in 2020 to date, although they are only slightly above the ten-year average.