Monetary policy and domestic financial markets

II

Monetary policy and market interest rates

The key interest rate has risen this year ...

Prior to the publication of this *Monetary Bulletin*, the Bank's key interest rate – the rate on seven-day term deposits – was 1.5% (Chart II-1). It has been raised three times since May, each time by 0.25 percentage points, but is still 1.25 percentage points lower than when the COVID-19 pandemic reached Iceland in late February 2020. The baseline forecast assumes that, during the forecast horizon, the key rate will develop in line with the monetary policy rule in the Bank's quarterly macroeconomic model, which ensures that inflation will be broadly at the Bank's inflation target over the medium term.

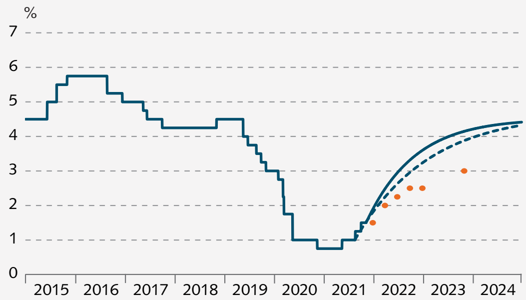
According to the Bank's early-November survey, market agents expect no additional rate hikes this year; however, they expect further monetary tightening in 2022. They expect the key rate to measure 2.25% in mid-2022 and 3% two years from now. This is a higher interest rate than in the Bank's August survey. Forward interest rates have risen slightly since August. They continue to suggest expectations of more rapid rate hikes than are indicated by the Bank's market expectations survey.

The Bank's real rate has risen since H1/2021, alongside the increase in the key rate. In terms of the average of various measures of inflation and one-year inflation expectations, it is now -2.2% and has risen by about 0.6 percentage points since mid-May. The interest rate differential with abroad has also widened during the year, and short-term real rates in Iceland are now 0.6 percentage points above the trading partner average.

Chart II-1

Central Bank of Iceland key interest rate[1]

1 January 2015 - 31 December 2024



CBI key interest rate (seven-day term deposit rate)

Market agents' expectations[2]

1. The Central Bank's key interest rate and Treasury bond yields are used to estimate the yield curve. The broken line shows forward market interest rates prior to MB 2021/3. 2. Estimated from the median response in the Central Bank's survey of market agents' expectations concerning the collateralised lending rate. The survey was carried out during the period 1-3 November 2021.

Source: Central Bank of Iceland.

… and long-term nominal rates are above the pre-pandemic level

The yield on ten-year nominal Treasury bonds has risen by 0.9 percentage points year-to-date. It was 4.2% just before this *Monetary Bulletin* was published and is now higher than before the pandemic (Chart II-2). The yield on five-year nominal bonds has risen somewhat more over the same period, or 1.4 percentage points, and the slope of the yield curve has flattened slightly. On the other hand, the yield on ten-year indexed Treasury bonds has fallen by 0.2 percentage points year-to-date, to 0.6% just before this *Monetary Bulletin* went to press.

The H1/2021 rise in nominal yields was due largely to an increase in the breakeven inflation rate, which in turn stemmed from the worsening inflation outlook (see Chapter V). The breakeven rate began to ease again this summer, however, following the policy rate hike in May (Chart II-3). It has risen again since August, though, and has pushed long-term nominal rates upwards, albeit offset by the decline in the long-term real rate.

Concurrent with the interest rate hike in August, the Central Bank decided to stop buying Treasury bonds in the secondary market, although it did not rule out the possibility of reinstating the bond purchase programme if conditions should warrant it. It appears that the Treasury will have less need to issue domestic bonds than was envisioned at the beginning of the pandemic, as financing efforts have been successful, including foreign borrowing and the sale of a portion of the State's holding in Íslandsbanki. From the onset of the pandemic until the present, the Bank has bought Treasury bonds in the secondary market in the amount of 22.6 b.kr.

Exchange rate of the króna

The króna has depreciated since this summer …

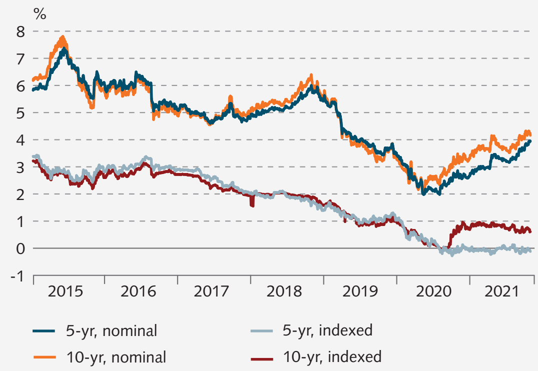
The exchange rate of the króna has fallen by 2.3% relative to the trading partner average since the August *Monetary Bulletin*, but it is nearly 7½% above its early September 2020 trough (Chart II-4). Nevertheless, the average exchange rate is still about 7½% lower than when the pandemic reached Iceland.

The króna weakened again this summer in spite of a strong rebound in tourism and increased foreign payment card use in Iceland. Outflows relating to new investments are still considerable, as foreign investors have sold sizeable holdings in domestic equities and Treasury bonds, with net sales totalling 62 b.kr. in the first ten months of this year. Over the same period, the pension funds' net foreign currency purchases

Chart II-2

Government-guaranteed bond yields[1]

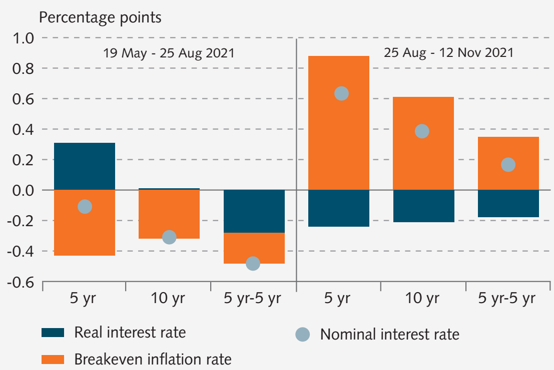
2 January 2015 - 12 November 2021



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.

Chart II-3

Breakdown of change in nominal bond interest rate[1]



1. Change in nominal Treasury bond yields (estimated using the Nelson-Siegel method) and the contribution of corresponding changes in indexed bond yields and the breakeven inflation rate.
Source: Central Bank of Iceland.

Chart II-4

Exchange rate of the króna[1]

2 January 2015 - 12 November 2021

1. Price of foreign currency in krónur. Narrow trade index.
Source: Central Bank of Iceland.

were broadly unchanged year-on-year, at just under 55 b.kr. Their purchases have declined relative to the pre-pandemic period, although their foreign assets have grown markedly, owing in part to rising prices in foreign asset markets. Some of the funds have approached their internal benchmarks for foreign assets as a share of total assets and have therefore pulled back on new investments abroad. At the same time, the Bank's intervention in the foreign exchange market has been relatively limited, as the market appears to be fairly well balanced.

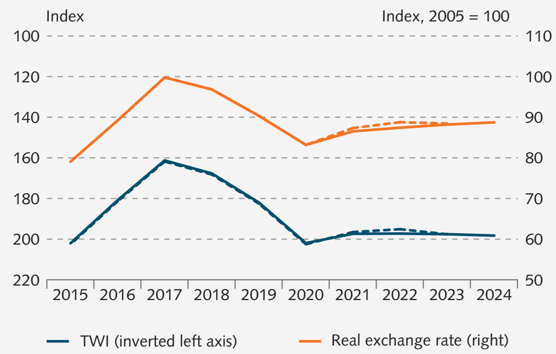
... but will remain relatively stable during the forecast horizon, according to the baseline forecast
The trade-weighted exchange rate index (TWI) stood at 194 points in Q3/2021, and the króna was therefore about 1% weaker, on average, than was forecast in the August *Monetary Bulletin*. According to the baseline forecast, the average exchange rate will remain broadly stable over the forecast horizon, and therefore slightly lower than was assumed in the August forecast (Chart II-5). If the forecast materialises, the real exchange rate will rise by 2½% over the forecast horizon, although at the end of the period it will still be 11% below its 2017 peak.

Money holdings and lending

Growth in money holdings has eased in 2021 to date ...
In H2/2020, growth in money holdings accelerated as the impact of falling interest rates and Central Bank liquidity measures came to the fore. Year-on-year growth peaked at about 14% in November 2020 but has lost pace since then. It measured 8.1% in Q3/2021, about the same as in Q2 (Chart II-6). Household deposits with the banking system increased by 8½% year-on-year in Q3/2021. The rate of growth has eased somewhat, although it remains relatively robust. Furthermore, financial companies' deposits have contracted in 2021 to date, particularly those held by pension funds and money market funds.

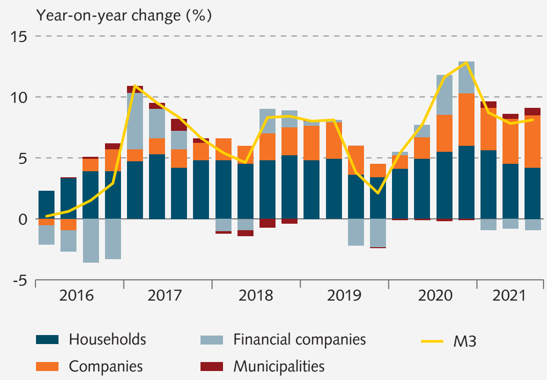
Rapid growth in money holdings in the wake of the pandemic is not a uniquely Icelandic phenomenon (Chart II-7). It reflects the significant monetary easing adopted widely by monetary authorities, in addition to extensive fiscal support measures. Moreover, households found their consumption options significantly limited by the pandemic, and some of the savings they accumulated as a result were held in deposit accounts with the banking system (see Chapter III). The increase in household deposits also reflects strong growth in mortgage lending.

Chart II-5
Exchange rate of the króna 2015-2024[1]



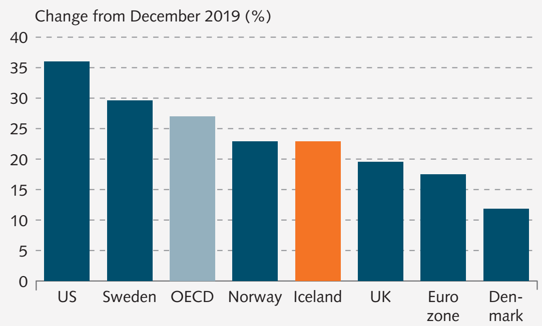
1. The trade-weighted exchange rate index (TWI) is based on a narrow trade basket. Real exchange rate in terms of relative consumer prices. Central Bank baseline forecast 2021-2024. The broken lines show the forecast from MB 2021/3.
Source: Central Bank of Iceland.

Chart II-6
Money holdings[1]
Q1/2016 - Q3/2021



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.

Chart II-7
Money holdings[1]



1. M3 except for the US, which is M2. Change from December 2019 through September 2021 except OECD, which is through August 2021.
Source: Refinitiv Datastream, Central Bank of Iceland.

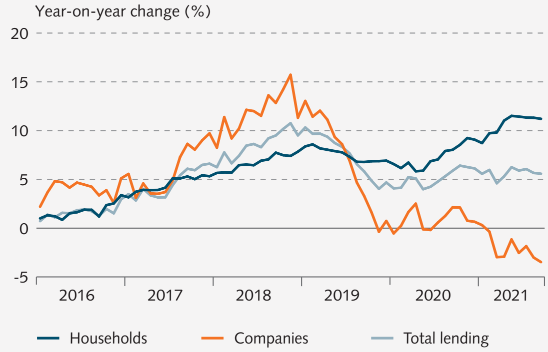
… but mortgage lending is still growing apace …
Year-on-year growth in credit system lending has held relatively stable in 2021 to date, hovering around 5½% after rising above 6% in Q4/2020 (Chart II-8). As before, a large share of this stems from loans to households, which have grown by 9-11% thus far in 2021. As in the recent past, this growth is due almost entirely to increased mortgage lending, reflecting brisk activity in the real estate market. The share attributable to refinancing has fallen, however, in line with the recent rise in interest rates. The commercial banks' share in the outstanding mortgage stock has continued to increase and is now around 70%, up from 55% at the beginning of 2020. At the same time, the banks' covered bond issues have increased only slightly, indicating that the banks rely more heavily on deposits for funding than before.

… while corporate lending continues to contract
Corporate lending has contracted in 2021 to date. In Q3, the corporate credit stock was 2.9% smaller than in Q3/2020, whereas it was 1% smaller after adjusting for the impact of exchange rate movements on foreign-denominated corporate loans. Lending to nearly all sectors has contracted, even though economic activity has picked up strongly. The downturn in lending has been offset to a degree by financing through market issues and institutional investment funds.

Debt ratios and credit spreads have been broadly unchanged recently
The household debt-to-GDP ratio is higher than before the pandemic, but household indebtedness is still relatively modest (Chart II-9). Loan-to-value (LTV) ratios on new mortgages have increased, on average, partly because of rising house prices, although the increased share of first-time buyers is also a factor. Furthermore, the share of non-performing household loans has fallen year-to-date, after rising temporarily last year. The share of non-performing corporate loans has fallen as well, although it is still considerably above its pre-pandemic level (for further discussion, see *Financial Stability* 2021/2). At the same time, the number of business insolvencies was up 28% year-on-year in the first nine months of 2021.

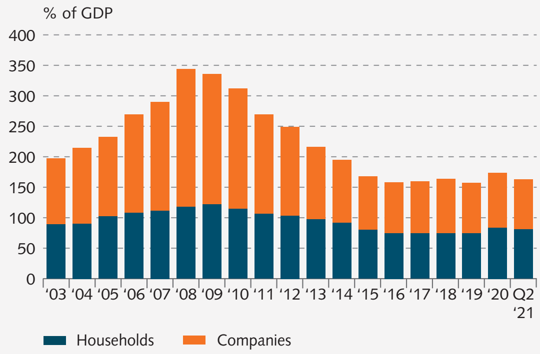
The share of non-indexed loans in the household mortgage stock is at an all-time high, as is the share of variable-rate loans. The effects of changes in Central Bank interest rates therefore show more quickly than before, and it is clear that recent interest rate hikes have already started to affect some households' debt service burden. Demand for fixed-rate mortgages – on which interest is generally fixed for either three or five years

Chart II-8
Credit system lending[1]
January 2016 - September 2021



1. Credit stock adjusted for reclassification and effect 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-9
Household and non-financial corporate debt[1]
2003-2021



1. Debt owed to financial undertakings and market bonds issued. Excluding financial institutions (which includes holding companies). GDP for 2021 is based on the Central Bank's latest baseline forecast.
Sources: Statistics Iceland, Central Bank of Iceland.

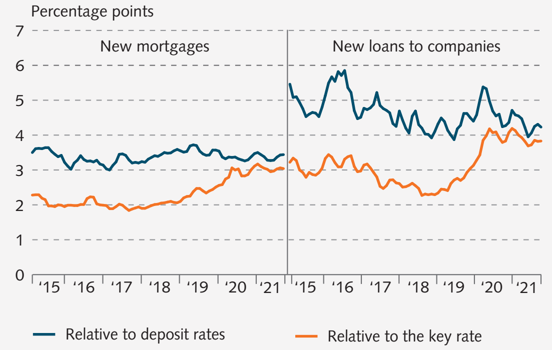
– has increased since the summer. Such loans typically bear higher interest than variable-rate loans; therefore, households that opt for fixed interest increase their debt service burden immediately.

Interest on new mortgage loans has developed broadly in line with deposit rates and the Central Bank key rate (Chart II-10). Credit spreads on mortgage loans have therefore held relatively stable. Interest rates on corporate loans have risen this year, but in terms of the deposit rates offered to businesses, credit spreads are still reasonably low in comparison with recent years.

Chart II-10

Credit spreads[1]

March 2015 - September 2021



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

Source: Central Bank of Iceland.

Asset prices

House prices still rising steeply ...

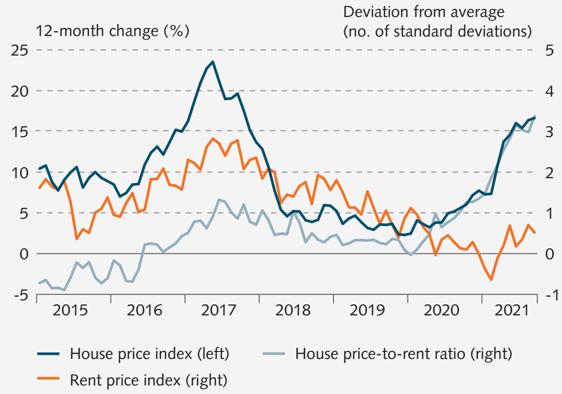
House prices have surged since late last year, and the market has been buoyant, with turnover peaking in March 2021. Lower interest rates and increased savings enabled households to buy larger homes and helped first-time buyers to enter the market. The share of first-time buyers has soared, while the year-on-year increase in rent prices has slowed down significantly. Real estate market activity has contracted in recent months, however, and the number of registered purchase agreements was nearly 40% lower in September than in March. In spite of this, house prices are still climbing, and the year-on-year increase in greater Reykjavík measured 16.6% in September, its largest since October 2017 (Chart II-11).

Alongside last year's burst of activity, the number of flats for sale began to fall. By October 2021, the number of properties listed for sale nationwide had fallen to just under 1,500, the lowest ever measured in a single month. Reduced supply explains the continued rise in prices to some extent; however, the share of properties that sell at a premium on the asking price has trebled nationwide since mid-2020, peaking in May at 32% (Chart II-12). By the same token, the average time-to-sale has been very short, at 1.7 months in September. There are signs of a rebound in new construction, however, as is discussed in Chapter III.

Chart II-11

House prices and rent[1]

January 2015 - September 2021



1. House prices and rent in the greater Reykjavík area. Deviation of the house price-to-rent ratio from the 2011-2021 average, measured in number of standard deviations.

Sources: Registers Iceland, Central Bank of Iceland.

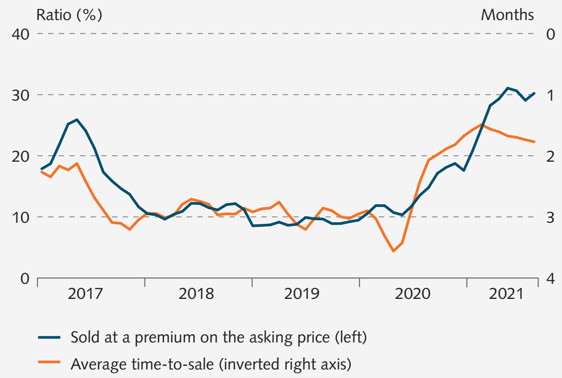
... outpacing developments in macroeconomic fundamentals in recent months

The ratio of house prices to rent is now just over three standard deviations above the mean for the past decade (Chart II-11). This trend can also be seen abroad, as the recent rise in house prices is similar to that in many other advanced economies (Chart II-13).[1] Although this

Chart II-12

Flats sold at a premium on the asking price and average time-to-sale nationwide[1]

January 2017 - September 2021



1. Flats sold at a premium on the asking price as a percentage of flats for sale. Three-month moving average. The number of purchase agreements is seasonally adjusted by the Central Bank.

Sources: Housing and Construction Authority, Morgunbladid Real Estate Website (mbl.is), Registers Iceland, Central Bank of Iceland.

1 See, for example, Box 1.1 International Monetary Fund (2010), *World Economic Outlook*, October 2021.

largely reflects lower global interest rates and broad-based government support measures, the steep rise in forced saving caused by restricted consumption options and the subsequent channelling of accumulated savings into the housing market plays a role as well. However, as in other countries, there are increasing signs that house prices have risen more than can be attributed to developments in the macroeconomic fundamentals that generally determine long-term house price movements. For example, Chart II-14 gives a comparison of developments in house prices with a dynamic forecast using the house price equation from the Bank's macroeconomic model, from Q1/2020 through Q3/2021. House prices rose less in 2020 than could have been expected based on the historical relationship between house prices, real disposable income, and real mortgage interest rates, but the increase over the past two quarters has been larger than the forecast indicates.

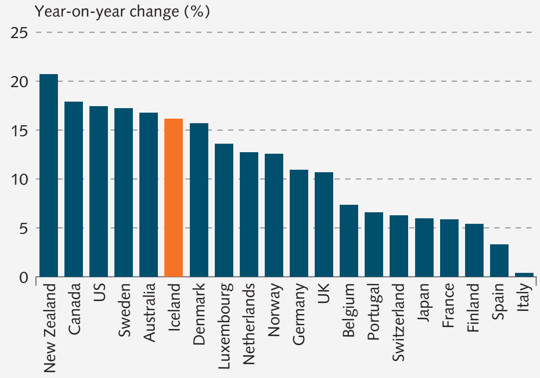
In view of the above-described developments, the Bank's Financial Stability Committee (FSC) decided earlier this year to lower the maximum LTV ratio on new mortgages from 85% to 80% and, effective 1 December 2021, to cap the debt service ratio on new mortgages at 35% of the borrower's disposable income. The rules are more lenient, however, for first-time buyers. The FSC also decided to increase the countercyclical capital buffer for financial institutions, effective a year from now. This will require that financial institutions set aside additional capital to cover unexpected shocks. These measures, together with the Bank's interest rate hikes, should help to ease house price inflation. The baseline forecast assumes that the year-on-year rise in house prices will begin to slow down in H2/2022.

Share prices keep rising

The OMXI10 index has risen by 31% year-to-date and by 73% since the pandemic reached Iceland in late February 2020. However, it has declined by 0.4% since the last *Monetary Bulletin*, owing to a just under 9% drop in the price of shares in one company that comprises about half of the index. Over the same period, shares in other companies in the Main Market rose in price by an average of 12%. Stock market turnover was 89% higher in the first ten months of the year than over the same period in 2020.

Chart II-13

House prices in selected OECD countries[1]



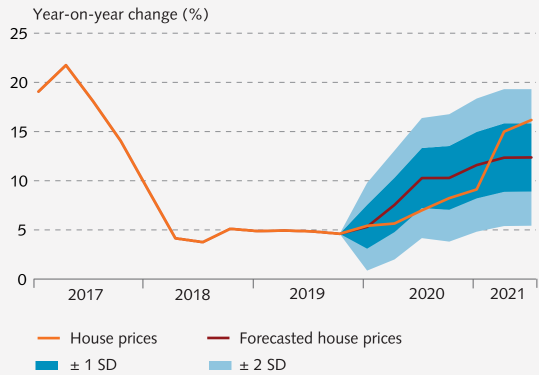
1. Year-on-year house price inflation in Q3/2021 for Iceland and Canada, in Q1/2021 for New Zealand, and in Q2/2021 for all other countries.

Sources: Refinitiv Datastream, Registers Iceland.

Chart II-14

Actual and forecasted house prices[1]

Q1/2017 - Q3/2021



1. Forecasted year-on-year change in house prices from Q1/2020 through Q3/2021, obtained with a dynamic forecast using a house price equation similar to the one from the Bank's macroeconomic model, estimated for the period from Q3/2001 through Q4/2017.

Sources: Registers Iceland, Central Bank of Iceland.