CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

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The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2024 (122nd meeting)
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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 6-7 May 2024, 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 8 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 20 March 2024, as published in the new forecast and analysis of uncertainties in *Monetary Bulletin* 2024/2 on 8 May.

Financial markets

Since the March meeting, the króna had depreciated by 0.8% 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 tightened 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 3.9%, or 0.1 percentage points higher than just after the announcement of the March interest rate decision. In terms of twelve-month inflation, it was 3.1% and had risen by 0.6 percentage points over the same period.

Interest rates on unsecured overnight deposits (the Icelandic króna overnight rate, or IKON) declined marginally between MPC meetings. Interest rates in the interbank market for krónur also fell slightly between meetings, and turnover in the interbank market totalled 10 b.kr. during the period. Yields on long-term nominal Treasury bonds had risen by as much as 0.6 percentage points since the March meeting, and yields on long-term indexed Treasury bonds had risen by 0.1 percentage points. The average interest rate on inflation-indexed mortgages rose marginally between meetings, whereas fixed rates on non-indexed mortgages declined.

In terms of three-month interbank rates, the short-term interest rate differential had narrowed between meetings by 0.1 percentage points versus the US, to 4.1 percentage points, whereas it was unchanged at 5.9 percentage points versus the euro area. The long-term interest rate spread widened between meetings, however. It rose by 0.4 percentage points versus the US, to 2.8 percentage points, and by 0.6 percentage points versus Germany, to 4.8 percentage points. The CDS spread on the Treasury's five-year obligations in

US dollars was 0.4% and had narrowed slightly between MPC meetings. The spread between the Treasury's euro-denominated issues and German government bonds narrowed by 0.1 percentage points at the same time, to 0.8-0.9 percentage points.

According to the Bank's quarterly survey of market agents' expectations, carried out in April, respondents were of the view that the Bank's key interest rate had peaked at 9.25%. They expected the key rate to be lowered in Q3/2024, which is later than according to the January survey. Market agents also expected the key rate to fall more slowly than in the last survey: they expected it to be 7.75% in one year and 6% in two years. The share of respondents who considered the monetary stance too tight continued to rise between surveys, from 42% in January to 62% in this survey. On the other hand, the share who considered the monetary stance appropriate declined from 42% in the January survey to 34% in this one, and the share who considered it too loose declined from 15% in January to 3% in this survey.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged in May, on the grounds that inflation and inflation expectations were still well above target, the outlook was for inflation not to fall significantly in coming months, and there was still a positive output gap. On the other hand, inflation and underlying inflation had fallen, and indicators continued to suggest that economic activity had subsided.

Annual growth in M3 measured 10% in March, and as before, household deposits accounted for the majority of the increase. Annual growth in credit system lending grew marginally between months, to 6.3% in March, but has lost pace considerably in the past year. Lending to households grew by 6.1% between years in March, while lending to businesses grew 6.5%.

The Nasdaq OMXI15 index had fallen by 3.8% between meetings. Turnover in the Main Market totalled 376 b.kr. in the first four months of 2024, some 20% more than over the same period in 2023.

Global economy and external trade

According to the International Monetary Fund's (IMF) mid-April forecast, global GDP growth is projected to be unchanged at 3.2% in 2024. This is 0.1 percentage points above the Fund's January forecast but below the twenty-year average. For 2025, the growth rate is also expected to measure 3.2%. The 2024 output growth outlook has improved especially for the US, owing to stronger-than-expected growth in late 2023. In the euro area, however, growth in 2024 and 2025 is expected to be slightly weaker than previously forecast. The Fund forecasts that global inflation will subside from 6.8% in 2023 to 5.9% in 2024 and 4.5% in 2025. Furthermore, inflation is projected to fall to central bank targets sooner in advanced economies than in emerging and developing economies.

The IMF forecast aligns well with the May forecast from the Organisation for Economic Co-operation and Development (OECD). According to the OECD forecast, global output growth will measure 3.1% in 2024 and 3.2% in 2025. This is 0.2 percentage points above the OECD's February forecast. To a large extent, the upward revision is due to an improved outlook for the US, although prospects for GDP growth have also improved for China and India since the OECD's February forecast. In the Organisation's opinion, inflation in the G20 countries will average 5.9% this year and 3.6% in 2025. It is expected to be back to target in most countries by the end of 2025.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 57 b.kr. in Q1/2024, as compared with a deficit of 44 b.kr. at constant exchange rates over the same period in 2023. Export values shrank by 6.7% year-on-year at constant exchange rates, with a contraction in the export value of manufactured goods and marine products, owing in particular to the capelin catch failure. Aquaculture product values increased, however. At the same time, import values shrank by about 1%, due mainly to an increase in the value of investment goods and consumer goods, which was offset by a decrease in the value of commodities and operational inputs, transport equipment, and fuel.

Global aluminium prices rose by nearly 14% after the MPC's March meeting, to just over 2,500 US dollars per tonne by time of the May meeting. This is also about 9% higher than in May 2023. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were down 2.3% year-on-year in Q1/2024. The global price of Brent crude fell by just under 5% between MPC meetings, to 83 US dollars per barrel by the time of the May meeting. Nevertheless, this is roughly 8% higher than at the beginning of 2024 and in early May 2023. Other commodity prices had risen since the March meeting, however.

The real exchange rate in terms of relative consumer prices rose by 1% month-on-month in April, when it was 10% above its 25-year average and 0.6% higher than in December 2019. In the first four months of 2024, it had risen by 5.4% year-on-year, as the nominal exchange rate of the króna was 1.7% higher and inflation in Iceland was 3.7 percentage points above the trading partner average.

Domestic economy and inflation

According to Statistics Iceland's labour market survey (LFS), total hours worked grew by 4.1% year-on-year in the three months to February. Of that amount, the number of employed persons grew by 3.7%, and the average work week grew longer by 0.4%. Therefore, job creation remains strong according to the LFS, although it is weaker than in 2023. Clearer signs of slower job growth can be seen in the number of persons on the pay-as-you-earn (PAYE) register. By that measure, year-on-year job growth started to decline more rapidly in mid-2023, to 2.7% by Q1/2024.

The seasonally adjusted labour participation rate has held close to 80.5% since end-2022. The employment rate was also relatively stable early in the period but has eased since late 2023. As a result, unemployment has inched upwards, measuring 3.9% in the three months to February. A broader definition of unemployment, which includes groups that are close to being considered unemployed, indicates that labour market tightness has eased somewhat more quickly in the recent past. However, seasonally adjusted registered unemployment remained virtually unchanged at 3.4% from October 2023 through March 2024.

New population data from Statistics Iceland show that population growth slowed more in 2023 than previously thought. In Q4, the population increased 2.3% year-on-year, and the annual growth rate was flat between quarters. In comparison, previous figures had indicated 3% population growth in Q3/2023.

The general wage index rose by 1.6% between quarters in Q1, and by 7.4% between years, while real wages rose 0.2% quarter-on-quarter and 0.6% year-on-year.

The revision of historical national accounts figures indicates that the saving rate was somewhat higher in recent years than previously estimated, which enables households to maintain a higher spending level despite bleaker income prospects. Year-on-year growth in private consumption slowed over the course of 2023, turning negative by 2.3% in Q4. Indicators of developments in private consumption in Q1/2024 are somewhat ambiguous, however. Icelanders' payment card turnover in the domestic market contracted between years, while their card use abroad increased. Total payment card turnover therefore grew year-on-year, and the Gallup Consumer Confidence Index indicates that household sentiment has improved as well. On the other hand, new motor vehicle registrations declined somewhat, perhaps due partly to changes in tax concessions for electric car purchases. Private consumption is estimated to have contracted by 1.6% year-on-year in Q1.

Statistics Iceland's nationwide house price index, published at the end of April, rose by 0.5% month-on-month in April, after adjusting for seasonality, and by 6.4% year-on-year. The nationwide house price index compiled by the Housing and Construction Authority (HMS) rose by 0.8% between months and 5.2% between years in March. The HMS index of capital area house prices increased by 4.8%, and the index for regional Iceland, also compiled by the HMS, rose by 6.8%. The number of purchase agreements registered nationwide rose by 26.4% year-on-year in the first three months of 2024, while the number of contracts for new construction increased by 73.4% over the same period. The increase in turnover is probably due in part to purchases made by Grindavík residents. The average time-to-sale for homes in greater Reykjavík was 3.5

months in March. It has grown shorter in recent months but remains slightly longer than in March 2023, when it measured 3.4 months. The number of homes for sale has fallen by just under 400 from its November 2023 peak.

The CPI rose by 0.55% month-on-month in April, and twelve-month inflation measured 6%. It fell somewhat relative to March, but fairly strong base effects were in evidence. Inflation excluding housing declined as well, to 3.9%. The difference between inflation including and excluding housing therefore continued to grow. Underlying inflation also eased between months, to 5% according to the average of various measures.

The main drivers of the April rise in the CPI were owner-occupied housing costs and higher airfares. Airfares continued to be affected by the Easter holidays, whereas fares have been an average of 9% lower year-to-date than over the same period in 2023. The twelve-month rise in domestic goods and services has eased gradually, but imported inflation has subsided more rapidly. Grocery prices were 5.3% higher in April than in the same month of 2023.

According to the Central Bank's market expectations survey, respondents' two-year inflation expectations have fallen since the previous survey and now measure 4%. Their long-term inflation expectations also fell between surveys. They expect inflation to average 3.8% in the next five years and 3.5% in the next ten years. The breakeven inflation rate in the bond market rose after the MPC's March meeting but has fallen again. The ten-year breakeven rate was just under 3.5% at the beginning of May, broadly unchanged from the time of the Committee's last meeting. The five-year breakeven rate five years ahead has developed similarly, measuring 3½% at the beginning of May.

According to the forecast published in *Monetary Bulletin* on 8 May, inflation is expected to be higher over most of the forecast horizon than was projected in February. The bleaker outlook is due largely to a poorer initial position, as inflation was higher in Q1 than was forecast in February. In addition, the outlook is for stronger housing market activity in the coming term, owing partly to home purchases by Grindavík residents, and moreover, the positive output gap looks set to be larger and more persistent than previously estimated. This is offset by the prospect of slower wage growth. Inflation is projected at 6% in Q2 but is forecast to fall to 5.8% in Q3, which is just over 1 percentage point above the February forecast. It is forecast to fall to 3.5% by the end of 2025 and reach the target in H2/2026, conditional upon the interest rate path in the forecast.

The GDP growth outlook for Iceland's main trading partners is broadly unchanged since February. In the US, growth continues to exceed expectations, but growth remains weak in large parts of Europe. GDP growth in trading partner countries is projected to average 1.2% this year and then inch up to just above 1½% in the two years thereafter. Trading partner inflation tumbled in 2023 but has fallen more slowly in 2024. As in February, it is forecast to measure 2.5% in 2024 and ease to 2% by late 2025.

In Iceland, GDP growth measured 4.1% in 2023, on the heels of 8.9% growth in 2022, the country's strongest output growth rate in over half a century. This is considerably stronger growth than previous estimates from Statistics Iceland had suggested. Statistics Iceland's revision of GDP growth figures for the first three quarters of 2023 is also the main reason growth for the year exceeded the Bank's February forecast. Economic activity began to subside as 2023 advanced, however, and GDP is estimated to have contracted in Q1/2024. The contraction appears to have been larger than was forecast in February, and the outlook for the year as a whole has worsened. Year-2024 GDP growth is now projected at 1.1%, as compared with the February forecast of 1.9%. The deviation is due primarily to a bleaker outlook for domestic demand growth. As in the previous forecast, GDP growth is expected to gain pace in 2025. It is projected to average 2½% over the next two years.

Unemployment has inched upwards since mid-2023, and job growth has slowed. A positive output gap remains, however, and is estimated to be larger than previously thought because of Statistics Iceland's revisions of historical data. It is now estimated to have been 3.8% of capacity in 2023, well above the February forecast of 2.3%. As before, however, the output gap is expected to narrow over the forecast horizon and a small slack to open up in 2025, a year later than previously projected.

The global economic situation remains uncertain, not least because of the wars in Ukraine and the Middle East. In Iceland as well, uncertainty has mounted in the wake of the volcanic eruption on the Reykjanes peninsula. On the other hand, uncertainty about wage developments has subsided with the signing of private sector wage agreements. The risk remains, though, that weakly anchored inflation expectations will cause inflation to be more persistent than is currently assumed. On top of this is uncertainty about how the change in the calculation of the housing component of the CPI, which Statistics Iceland has announced, will affect near-term measured inflation.

II Decisions on the Bank's monetary policy instruments

At an extraordinary meeting in April 2024, the MPC decided to increase credit institutions' fixed reserve requirements from 2% to 3% of the reserve base. At that meeting, the Committee reviewed the Central Bank's capital position and capital target and discussed various ways to strengthen the Bank's performance. As was noted in the MPC statement published on 4 April, the decision is part of the Bank's comprehensive review of its key counterparties' interest rate terms, with the aim of distributing the cost of monetary policy conduct more evenly while ensuring sustainable financing of Iceland's international reserves, thereby supporting monetary policy credibility. The Committee was of the opinion that in the longer term, higher reserve requirements would provide a more solid foundation for monetary policy conduct, thereby enhancing the credibility and efficacy of monetary policy and contributing to lower inflation expectations. The primary purpose of the decision was not to affect the short-term monetary stance. On the other hand, the possibility that it would have some impact on the policy stance could not be excluded, although in view of deposit institutions' ample liquidity position with the Central Bank, the short-term effects of the change should be limited. Furthermore, an analysis of the potential impact of higher reserve requirements on economic activity and inflation showed that such impact would be negligible. In the long run, greater credibility should enhance efficacy and improve the transmission of monetary policy. All MPC members in attendance at the extraordinary meeting – Ásgeir Jónsson, Rannveig Sigurdardóttir, Ásgerdur Ósk Pétursdóttir, and Herdís Steingrímsdóttir – supported the decision.

At its May meeting, the MPC discussed the monetary stance in view of economic developments and the increase in the Bank's real rate since the March meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its March meeting to hold interest rates unchanged. At that time, inflation had fallen marginally between meetings, but the positive output gap appeared to be larger than previously estimated.

Committee members noted that inflation had continued to ease, measuring 6% in April. Inflation excluding housing had fallen more rapidly, and underlying inflation was down to 5%. Inflation expectations had declined by some measures but remained above target.

In their discussion, MPC members noted that growth in domestic demand had subsided, as the monetary stance was tight and the outlook was for a slowdown in GDP growth this year. Members were concerned that the output gap was larger than previously estimated, however, and that inflation was therefore projected to fall more slowly, according to the Bank's new forecast.

They observed that the effects of the recent wage agreements and fiscal measures on demand had not yet come fully to the fore. Although the labour market had eased, demand pressures remained, which could give rise to wage drift, with the associated impact on inflation.

The MPC discussed whether to hold interest rates unchanged or to lower them. Members agreed that the outlook was for inflation to fall more slowly than previously expected and that inflation expectations remained too high. Although the monetary stance was tight and economic activity had subsided, domestic demand was still relatively strong. Furthermore, there was still considerable strain on capacity, and indicators of a slowdown in the labour market were not unequivocal. It was pointed out that the economic situation had actually not changed significantly since the MPC's March meeting. Recent wage rises and fiscal measures could also support demand, and the risk existed that companies would pass higher wage costs through to prices to some extent while demand pressures still remained.

The Committee was of the opinion that the monetary stance was probably sufficient and that it was fairly likely that the stance would grow tighter in coming months, even if interest rates were held unchanged. It emerged in the discussion that this was acceptable, given that domestic economic activity was still strong overall, not least because revised figures indicated that the output gap was wider than previously estimated and would take longer to close. In this context, it was also important that the household saving rate had proven higher than previously thought, which could cause private consumption to pick up sooner; therefore, the monetary stance would have to be tighter than would otherwise be needed, given how persistent inflation had been.

In the Committee's opinion, recent developments in the housing market had been affected to a degree by the seismic activity on the Reykjanes peninsula. It was appropriate at present to look past these effects to a large extent, as developments in house prices differed from developments in other economic variables, and the situation partly reflected a change in relative prices. On the other hand, it was not possible to ignore them entirely, partly because both house prices and the number of first-time buyers had started to rise before the earthquakes and eruptions began. It was still unclear whether overall demand for housing had eased, and in addition, the rise in house prices could have a ripple effect and stimulate domestic demand, not least because inflation expectations were high.

The MPC observed that on the other hand, activity in the tourism industry had begun to ease, which would affect the housing market. Furthermore, the impact of recent cost increases on the price level had receded. The rise in goods prices had lost pace, and global commodity prices had fallen year-on-year, which probably had yet to come more clearly to the fore in Iceland. Also, mortgage interest rate reviews were in the offing for a large number of households, which could support the monetary stance.

In the Committee's opinion, it was clear that the past year's interest rate hikes continued to affect economic activity. On the other hand, indications that inflationary pressures were subsiding to a sufficient degree had not yet come clearly enough to the fore. Of particular concern was the fact that inflation expectations remained significantly above target. For this reason, it would be riskier to lower interest rates too soon than to hold them unchanged for the present. It was also important to begin lowering interest rates at a credible point in time, as even a relatively small reduction in the Bank's key rate could have a strong impact on expectations, as it would signal the start of a monetary easing phase. Future policy decisions would be determined by developments in inflation and inflation expectations in the coming term, as it was important to maintain an appropriate policy stance.

In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would be 9.25%, the current account rate 9%, the seven-day collateralised lending rate 10%, and the overnight lending rate 11%.

Ásgeir Jónsson, Rannveig Sigurdardóttir, Herdís Steingrímsdóttir, and Ásgerdur Ósk Pétursdóttir voted in favour of the proposal. Arnór Sighvatsson voted against the proposal and wanted to lower rates by 0.25 percentage points. In his opinion, the risk existed that the monetary stance would become too tight in the near future. Given that the rise in the housing component of the CPI originated to an extent in supply shocks that would have only a transitory impact on the index, it would be appropriate to look past the recent increase in that component for the most part. The underlying real rate was therefore higher than generally assumed and could continue to rise over the summer months. For this reason, he expected housing market activity to taper off earlier than was generally thought, which would show in more rapid disinflation.

The MPC was of the view that there was an increased probability that the current monetary stance was sufficient to bring inflation back to target within an acceptable time frame. As before, monetary policy formulation would be determined by developments in economic activity, inflation, and inflation expectations.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Monetary Policy Committee

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy

Arnór Sighvatsson, Deputy Governor for Financial Stability

Herdís Steingrímsdóttir, Associate Professor, external member

Ásgerdur Ósk Pétursdóttir, Assistant 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 21 August 2024.