CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2024

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The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee 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 5 and 6 February 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 7 February.

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 previous meeting, on 22 November 2023, as published in the updated forecast in *Monetary Bulletin* 2024/1 on 7 February.

The Committee was given a presentation by Statistics Iceland on proposed changes in the methodology used to calculate the housing component of the consumer price index. Statistics Iceland estimates that the change will be implemented in spring 2024.

Financial markets

Since the November meeting, the króna had appreciated by 2.2% 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 since the November meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was 3.3%, or 0.6 percentage points higher than just after the announcement of the November interest rate decision. In terms of twelve-month inflation, it was 2.4% and had risen by 1.1 percentage points over the same period.

Interest rates on unsecured overnight deposits (the Icelandic króna overnight rate, or IKON) and rates in the interbank market for krónur were virtually unchanged between meetings, and turnover in the market totalled 10 b.kr. during the period. Yields on long-term nominal Treasury bonds had fallen by as much as 0.6 percentage points since the November meeting, while yields on long-term indexed Treasury bonds had held broadly unchanged. The average interest rate on inflation-indexed mortgages rose between meetings, whereas non-indexed mortgage rates were broadly unchanged.

In terms of three-month interbank rates, the short-term interest rate differential was unchanged between meetings, at 5.9 percentage points versus the euro area and 4.3 percentage points versus the US. The long-term interest rate spread narrowed by 0.4 percentage points between meetings, however, to 4.5 percentage points versus Germany and 2.7 percentage points versus the US. The CDS spread on the Treasury's five-year obligations in US dollars was 0.6% and had narrowed 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 1.1-1.2 percentage points.

According to the Bank's quarterly survey of market agents' expectations, carried out in January, respondents were of the view that the Bank's key rate had peaked at 9.25% and would start to fall in Q2/2024. They expected the key rate to measure 7.75% in one year and 5.75% in two years. This is a lower interest rate than they expected in the November survey. Survey participants' responses on the monetary stance changed somewhat between surveys. The share of respondents who considered the current monetary stance appropriate was 42%, down from 60% in the November survey. The share who considered the current monetary stance too tight rose to 42% from the previous 27%. Roughly 15% of respondents considered the monetary stance too loose.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged, on the grounds that inflation and inflationary pressures had eased and private consumption had contracted, even though house prices had begun to rise again and inflation and inflation expectations were still above target. Furthermore, there was considerable uncertainty about both the forthcoming wage agreements and the Government's actions in response to the seismic activity in Grindavík.

Annual growth in M3 measured 8½% in December. Households' share in growth increased during the year, whereas businesses' share declined. Annual growth in credit system lending to households measured 6.4% in December, after increasing month-on-month. Net new lending to households had begun to pick up in mid-2023. Year-on-year growth in credit system lending to companies had lost pace, measuring 6.7% in December after averaging 14% in H1/2023.

The Nasdaq OMXI15 index had risen by 23.5% between meetings. Turnover in the Main Market totalled 121 b.kr. in January, about 50% more than for the same period in 2023.

Global economy and external trade

According to the International Monetary Fund's (IMF) January forecast, global GDP growth is projected to measure 3.1% in 2024, or 0.2 percentage points above the Fund's October 2023 forecast. The upward revision is due mainly to stronger-than-expected GDP growth in the US and several large emerging market economies. Nevertheless, this is well below the twenty-year average, as central bank interest rates have been raised steeply, fiscal consolidation has been stepped up because of increased indebtedness in recent years, and underlying productivity growth has been limited. The IMF assumes that global output growth will be broadly unchanged in 2025, at 3.2%. Inflation has fallen faster than expected in most countries around the world, however, concurrent with the unwinding of the supply chain bottlenecks of recent years and the tightening of monetary policy. The Fund forecasts that global inflation will subside to 5.8% in 2024 and fall to an average of 4.4% in 2025. In advanced economies, inflation is projected at 2.6% in 2024 and 2% in 2025, which is below the October forecast.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 91.9 b.kr. in Q4/2023 and 326.2 b.kr. in 2023 as a whole, as compared with a deficit of 213.4 b.kr. at constant exchange rates in 2022 as a whole. Export values contracted by 11% year-on-year at constant exchange rates, with the value of most categories of exports declining between years. Lower prices for aluminium products and ferrosilicon, together with a downturn in exports of marine products, particularly capelin products, weighed heaviest in the contraction, but were offset by higher values of pharmaceuticals and medical products. At the same time, the value of imports contracted by ½% year-on-year at constant exchange rates, whereas import values excluding ships and aircraft were more or less flat. This is due to an increase in the value of investment goods, consumer goods, and transport equipment, which was offset by a decrease in the value of fuels and commodities and operational inputs. The year-on-year decline in imported goods values is attributable mainly to a contraction in import volumes, as most categories of imports rose in price between years.

Global aluminium prices fell marginally after the MPC's November meeting, to just under 2,200 US dollars per tonne by the time of the February meeting. This is 12% lower than in February 2023. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products fell by 3% quarter-on-quarter in Q4/2023 but were an average of 3% higher in 2023 as a whole than in the year beforehand. The global price of Brent crude fell by just under 5% between MPC meetings, to 79 US dollars per barrel by the time of the February meeting. This is 3% lower than in February 2023. Other commodity prices had also fallen since the November meeting.

The real exchange rate in terms of relative consumer prices rose by 0.2% month-on-month in January, when it was 9.1% above its 25-year average but broadly the same as in December 2019. It rose by 0.8% year-on-year in 2023, as the nominal exchange rate fell by 2.6%, while inflation in Iceland was 3.6 percentage points above the trading partner average.

Domestic economy and inflation

Indicators of developments in private consumption suggest that it contracted by about the same in Q4 as in Q3, when it shrank by 1.7% year-on-year. Preliminary payment card turnover figures indicate declining household demand, and the end-2023 drop in the Gallup Consumer Confidence Index suggests increased pessimism. Household spending is therefore estimated to have contracted even further in Q4/2023.

In December, the National Budget for 2024 was approved by Parliament with a deficit amounting to 1.1% of GDP. This is only a slight change from the original budget proposal, but the Treasury performance is highly uncertain because of measures relating to the seismic activity in the Reykjanes area and the possibility of fiscal measures related to the ongoing wage negotiations.

According to the results of Gallup's winter survey, conducted in December among Iceland's 400 largest firms, respondents' assessment of the current economic situation was slightly more negative than in the autumn survey. Their expectations six months ahead were also more negative than in the autumn. About 37% of executives – somewhat more than in the autumn – expect economic conditions to deteriorate over the next six months, while 46% expect them to be unchanged. In general, though, executives were relatively optimistic about both domestic and foreign demand, but their assessment was broadly unchanged since the autumn. Executives in finance and insurance, miscellaneous specialised services, and industry and manufacturing were the most optimistic.

According to the seasonally adjusted survey results, job numbers will continue to rise in the coming term. The share of firms planning to recruit net of those planning to downsize was therefore slightly above its historical average during the quarter. Furthermore, one-third of executives consider themselves short-staffed, and just over half say their firms are working at full capacity. Both ratios declined in the winter survey but are still high in historical terms.

According to the Statistics Iceland labour force survey (LFS), total hours worked increased by 4.5% year-on-year in Q4/2023. Job creation measured 3.7% year-on-year, and the average work week grew longer by 0.7%. Figures from the pay-as-you-earn (PAYE) register suggest weaker job creation than is indicated by the LFS, as the number of employed persons rose by 3.1% year-on-year in Q4.

Seasonally adjusted LFS figures for Q4/2023 show that growth in the working-age population continued to lose pace, albeit offset by a higher labour participation rate. The employment rate rose as well, and unemployment was therefore relatively stable between quarters, measuring 3.5%. Seasonally adjusted registered unemployment also measured 3.5% in December. Registered unemployment has increased somewhat and was 0.4 percentage points higher in December 2023 than at mid-year.

In Q4, the general wage index rose by 1.3% between quarters and by 9.4% year-on-year. At the same time, real wages in terms of the index were 1.4% higher than in Q4/2022.

Statistics Iceland's nationwide house price index, published at the end of January, rose by 0.8% month-on-month after adjusting for seasonality, and by 4.7% year-on-year. The capital area house price index, calculated by the Housing and Construction Authority, rose by 1% month-on-month in December when adjusted for seasonality, and by 4.5% year-on-year. The number of purchase agreements registered nationwide fell by 12.5% year-on-year in 2023, while the number of contracts for new construction increased by 12.4% over the same period. The average time-to-sale for homes in greater Reykjavík was 4.4 months in December, up from 2.9 months in December 2022, as the number of homes on the market has increased somewhat in the past twelve months.

Inflation averaged 8.8% in 2023, as compared with 8.3% in 2022. The CPI declined by 0.16% month-on-month in January, and twelve-month inflation therefore fell sharply, from 7.7% to 6.7%. Inflation excluding housing declined as well, to 5.2%. Underlying inflation measured 5.8% according to the average of various measures, its lowest since May 2022.

In January, increased owner-occupied housing costs and higher electricity and heating costs had the largest upward effect on the CPI, while winter sales were the strongest downward-pushing factor. This year's sales were somewhat deeper than the average of the past few years. The cost of owner-occupied housing has increased by 12.7% in the past twelve months, driven to a large degree by the rise in real mortgage interest expense. Food prices also rose in January, mainly because of the agricultural product pricing committee's decision to raise the price of dairy products. Furthermore, public services prices rose due to various price list increases. Airfares fell in January and were nearly 11% lower than in the same month of 2023.

According to the Bank's market expectations survey, market agents' one-year inflation expectations declined marginally, and they now expect inflation to measure 5.3% one year ahead. Their longer-term expectations rose, however, and survey respondents now expect inflation to measure 4.4% in two years' time and 4.1%, on average, over the next five years. Corporate executives and households are more pessimistic, however, and expect inflation to fall more slowly. Executives expect it to average 4.5% over the next five years, whereas households expect it to average 6% over the same period. The breakeven inflation rate in the bond market fell between MPC meetings, however, and the five-year breakeven rate five years ahead was 3.6% at the beginning of February.

According to the forecast published in *Monetary Bulletin* on 8 February, the inflation outlook has improved since November and overall inflationary pressures have subsided. Headline inflation is expected to continue falling, to 6.3% in Q1/2024 and 5% in Q2, which is 0.7 percentage points below the November forecast. The outlook for the next two years has also improved somewhat. Inflation is expected to average 3.3% in 2025 and align with the target in H2/2026, conditional upon the interest rate path in the baseline forecast. This is somewhat earlier than was forecast in November. The improved outlook reflects, among other things, the fact that domestic demand has fallen more rapidly than was forecast in November, and a negative output gap is expected to open up at the end of this year. Global inflation has also fallen faster than was projected in November. On the other hand, the outlook is for wage costs to rise more during the forecast horizon, and some inflationary pressures still remain in the housing market.

GDP growth among key trading partner countries continued to soften over the course of 2023. Since November, the GDP growth outlook has deteriorated somewhat for most trading partners apart from the US, where growth has exceeded expectations. Global inflation has kept easing, as has underlying inflation, albeit more slowly. The war in the Middle East could impede the decline in global inflation, partly because of the recent rise in shipping costs.

In Iceland, GDP growth measured 4.2% for the first three quarters of 2023, in line with the Bank's November forecast. The growth rate slowed markedly as Q3 advanced, measuring 1.1% for the quarter, somewhat less than was forecast in November. Domestic demand appears to have subsided more rapidly than was expected then, however, which is the main reason for the downward revision of the year-2024 GDP growth forecast. Despite indications that domestic demand had continued to ease in Q4/2023, favourable external trade is estimated to have pushed GDP growth marginally higher again during the quarter. For 2023 as a whole it is projected at 3.6%, which is broadly in line with the November forecast. In 2024, GDP growth is projected to soften further and measure 1.9%, well below the November forecast of 2.6%. On the whole, though, prospects for 2025 and 2026 are in line with the November forecast.

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. Actions taken by the Government in response to the situation could cause the economic outlook to differ from that provided for in the baseline forecast, but it is difficult to assess the impact of such measures before their scope and execution have been determined. The results of the ongoing wage negotiations and the possibility of related fiscal measures could also cause the economic and inflation outlook to change relative to the baseline forecast. Another source of concern is still-high inflation expectations, which could make bringing inflation to target more difficult than is assumed in the baseline scenario.

II Decisions on the Bank's monetary policy instruments

The MPC discussed the monetary stance in view of economic developments and the fact that the Bank's real rate had risen since the November meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its November meeting to hold interest rates unchanged. At that time, the poorer inflation outlook suggested that it could prove necessary to tighten the monetary stance still further, but in view of the economic uncertainty relating to the seismic activity on the Reykjanes peninsula, the Committee decided to wait and see.

Members considered it favourable that the effects of monetary policy were coming ever more clearly to the fore. They noted that the real rate had risen and inflation had fallen since the MPC's November meeting. Underlying inflation had eased as well. Indicators suggested also that economic activity had subsided faster than previously expected. It also emerged that according to the Central Bank's new forecast, the positive output gap was narrowing and would give way to a slack towards the end of the year. The inflation outlook had improved as a result.

Nevertheless, MPC members were concerned that long-term inflation expectations were virtually unchanged and remained above target. They also noted that although labour market tightness had eased somewhat, pressures remained. As a consequence, inflation could remain persistent. The Committee observed as well that there was uncertainty about the results of the ongoing wage negotiations and about possible fiscal measures relating to both the wage negotiations and the seismic unrest in the Reykjanes area.

Members discussed that inflation remained high and that the inflation outlook had primarily improved for 2024, while the longer-term outlook had improved only marginally. They observed that because the labour market was still quite tight, unit labour costs could rise more than they would otherwise. Moreover, it emerged that there was significant uncertainty about both the results of wage agreements and the forthcoming fiscal measures, as well as their impact on economic activity and inflationary pressures. Furthermore, the way in which these measures were financed would be important in the context of the fiscal stance. Although domestic economic activity had eased, there was still the risk that firms would to some extent pass cost increases through to prices following the wage settlements. Housing market activity appeared to be picking up again, and house prices had risen in the recent term. In addition, long-term inflation expectations had held broadly unchanged, even though growth in domestic demand had lost pace and the inflation outlook had improved. Inflation expectations were less firmly anchored to the target, which could affect developments in inflation. It was important to bring inflation expectations down in order to ensure that inflation would realign with the target. It emerged that in view of the high level of uncertainty, it was not a given that the monetary tightening phase was at an end, and because demand pressures still remained in the economy, it would be better to keep interest rates high for longer than to lower them too soon.

Committee members agreed as well that the impact of the tighter monetary stance was coming rapidly to the fore, as private consumption and investment had begun to contract, which was also reflected in a contraction in imports. As a result, domestic demand had begun to lose momentum, and more rapidly than expected. It also emerged that tourism activity could turn out weaker than expected, both because of the volcanic activity on the Reykjanes peninsula and because of global economic uncertainty. It was pointed out that as a result, there was the risk that the real rate would rise more than necessary at a time of rapidly declining growth in economic activity, as the Bank's real rate was considerably higher than that in trading partner countries.

On the other hand, it emerged that although a turning point was probably close at hand, there was still a need for a high real rate in the economy. It was therefore important to await clearer signs that disinflation was on a solid footing and to proceed carefully in easing the monetary stance, as there was still considerable uncertainty about many key economic variables.

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. Gunnar Jakobsson voted against the proposal and wanted to lower rates by 0.25 percentage points. He was of the opinion that the most recent data showed that the monetary stance had been sufficient in the recent past, as economic activity had subsided steadily. Furthermore, recent developments in the economy, the inflation outlook, and the real rate suggested that the time had come to lower the policy rate. He pointed out that the Bank's real rate was at its highest since 2012 and that all indicators implied that it would rise considerably more in coming months. It was therefore appropriate to begin easing the monetary stance, but in small increments, given the existing uncertainty.

The Committee was of the opinion that as before, near-term 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

Gunnar Jakobsson, 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 20 March 2024.