CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2024

November
125th meeting
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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 18-19 November 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 20 November.

I Economic and monetary developments

Before turning to 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 2 October 2024.

Financial markets

Since the October meeting, the króna had appreciated by 2.5% 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 MPC's October meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was 4.4%, or 0.2 percentage points higher than just after the announcement of the October interest rate decision. In terms of twelve-month inflation, it was 3.7% and had risen by 0.3 percentage points over the same period.

Interest rates on unsecured overnight deposits (the Icelandic króna overnight rate, or IKON) fell in tandem with the Bank's interest rate cut in October. Interest rates in the interbank market for krónur declined as well, while rates on maturities longer than seven days fell more than the Bank's key rate did. Interbank market turnover totalled 1 b.kr. between meetings. Yields on long-term nominal Treasury bonds had fallen marginally since the October meeting, whereas yields on long-term indexed Treasury bonds had risen slightly over the same period. Interest rates on inflation-indexed mortgages rose between meetings, whereas rates on non-indexed mortgages declined.

In terms of three-month interbank rates, the short-term interest rate differential had narrowed between meetings by 0.4 percentage points versus the euro area, to 5.9 percentage points, and by 0.6 percentage points versus the US, to 4.1 percentage points. The long-term interest rate spread also narrowed between meetings. It fell by 0.4 percentage points versus Germany, to 4.3 percentage points, and by 0.8 percentage points versus the US, to 2.2 percentage points. The CDS spread on the Treasury's five-year obligations in US dollars was 0.4% and had held virtually unchanged between MPC meetings. The spread between the Treasury's euro-denominated issues and German government bonds narrowed slightly, to 0.6-0.7 percentage points.

According to the Bank's quarterly market expectations survey, conducted at the beginning of November, market agents expected the Central Bank's key interest rate to be lowered by an additional 0.5 percentage points in Q4. They also expected further rate cuts in 2025, leaving the key rate at 5.75% in two years' time. This is a lower interest rate than they expected at the time of the previous survey, taken in August. Survey participants' responses on the monetary stance changed markedly between surveys. The share of respondents that considered the monetary stance too tight was 87%, up from 52% in the August survey. About 13% considered the monetary stance appropriate, down from 40% in August, and none considered it too loose.

Financial institutions' analysts expected the MPC to lower the Bank's interest rates by either 0.25 percentage points or 0.5 percentage points, on the grounds that inflation had continued to ease, the real rate was high, the housing market had cooled, and domestic demand was also on the decline. On the other hand, there was uncertainty about the fiscal stance in the coming term and about public sector wage disputes; furthermore, inflation and inflation expectations were still above target.

Annual growth in M3 measured just under 10% in September. As before, household deposits account for much of the increase, as growth in company deposits has lost pace since H1/2024. Growth in credit system lending had picked up during the year, measuring just over 8% in September. Growth in lending to households held steady at 6% year-on-year, while lending to companies grew 12% in September. Year-on-year growth in corporate lending has gained momentum in 2024 to date, while net new lending slowed during the summer.

The Nasdaq OMXI15 index had risen by 10.5% between meetings. Turnover in the Main Market totalled 826 b.kr. in the first ten months of 2024, roughly one-third more than over the same period in 2023.

Global economy and external trade

According to the International Monetary Fund's (IMF) October forecast, global GDP growth is projected to ease from 3.3% in 2023 to 3.2% in 2024, the same as in its forecasts from April and July. For 2025, global GDP growth is projected to remain flat at 3.2%. In the IMF's opinion, prospects for GDP growth in 2024 and 2025 have improved for the US but worsened for Japan and the eurozone, mainly due to poorer prospects for Germany. The Fund forecasts average global inflation at 5.8% in 2024 and 4.3% in 2025. This is slightly below its last forecast, owing mainly to an improved outlook for advanced economies, where average inflation is projected to fall from 2.6% this year to 2% in 2025. The Fund still assumes that world trade will rebound this year and gain further momentum in 2025, after sluggish growth in 2023. The growth rate is still expected to fall short of the average of recent decades, however, in line with weaker global GDP growth and an increase in protectionist policies. The IMF also assumes that import and export growth in advanced economies will be weaker than in its previous forecast.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 229 b.kr. in the first nine months of 2024, as compared with a deficit of 219 b.kr. at constant exchange rates over the same period in 2023. Goods export values contracted between years by 0.4%, and by 1% excluding ships and aircraft. The contraction is due largely to reduced aluminium values as a result of cutbacks in electricity supply to large-scale users, which affected aluminium production, and to reduced marine product values stemming from the capelin catch failure. On the other hand, the value of aquaculture products, medical equipment, and pharmaceuticals increased. At the same time, import values rose by about 0.8% year-on-year, owing to an increase in the value of commodities, operational inputs, investment goods, and consumer goods, offset by a decrease in the value of transport equipment and fuels.

The global price of aluminium had held broadly unchanged since the MPC's October meeting, at 2,600 US dollars per tonne at the time of the November meeting. This is about one-fifth higher than in November

2023. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products were down 1.4% year-on-year in the first nine months of 2024. The global price of Brent crude was just over 73 US dollars per barrel at the time of the November meeting. It was similar to the price at the time of the October meeting but about 11% lower than in November 2023. The price of other commodities rose marginally between meetings, however, especially metals and fertilisers.

The real exchange rate in terms of relative consumer prices rose by 2% month-on-month in October, when it was 12% above its twenty–five-year average and 2.9% higher than in December 2019. In the first ten months of 2024, it had risen by 2.8% year-on-year, as inflation in Iceland was 3.6 percentage points above the trading partner average, while the nominal exchange rate of the króna had fallen by 0.6%.

Domestic economy and inflation

According to the Iceland Revenue and Customs pay-as-you-earn (PAYE) register, the number of employed persons rose by 1.8% year-on-year. Over a three-month period, however, job numbers had fallen marginally since June, and in September the three-month decline in jobs measured 0.5% in annualised terms. The results of Statistics Iceland's labour force survey (LFS) are affected by problems relating to declining response ratios and difficulties in estimating recent population developments, which apparently lead to a significant overestimation of job numbers and total hours worked.

Seasonally adjusted unemployment was unchanged month-on-month in October, at 3.6%. It has therefore risen by 0.4 percentage points from its post-pandemic trough in May 2023, which equates to an increase of 1,700 persons on the unemployment register. Seasonally adjusted unemployment according to the LFS was similar during the quarter.

Iceland's population grew by 1.7% year-on-year in Q3. The growth rate has slowed since mid-2023, as the number of immigrants has slowed and more foreign nationals are leaving the country. This is due in part to a reduced influx of refugees.

The general wage index rose by 0.9% between quarters in Q3, and by 6.3% year-on-year. Real wages were 0.4% higher in Q3 than in the same quarter of 2023.

The outlook for private consumption in Q3 is broadly unchanged overall, as payment card turnover rose 4.4% year-on-year due to an increase in card use abroad. Furthermore, households' motor vehicle purchases contracted between years, albeit less than in the two quarters beforehand. The Gallup Consumer Confidence Index continued to fall in Q3, and although it rose again in October, it is still below 100 points. Private consumption is estimated to have grown by 1.5% year-on-year in Q3. However, recently revised household disposable income figures indicate that real disposable income grew far more in 2022, 2023, and 2024 to date than was previously estimated, and that the household saving rate is therefore somewhat higher. Thus the outlook is for private consumption growth in Q4/2024 and 2025 as a whole to be stronger than previously estimated.

Statistics Iceland's nationwide house price index fell 0.3% month-on-month in October, when adjusted for seasonality, but rose by 10% year-on-year. The nationwide house price index compiled by the Housing and Construction Authority (HMS) fell by 0.3% between months but rose 9.5% between years in September. The HMS index of capital area house prices increased by 8.5% between years, and the index for regional Iceland rose by 12.8%. The number of purchase agreements registered nationwide rose by 59.2% year-on-year in the first nine months of 2024, while the number of contracts for new construction increased by 66.6% over the same period. The jump in turnover is due largely to real estate firm Þórkatla's buy-up of properties in Grindavík, Grindavík residents' relocation to other communities, and an increase in the number of first-time buyers in the market. The average time-to-sale nationwide lengthened to 3.9 months between August and September, as the number of homes for sale has risen in the past five months, particularly newly built homes, which accounted for an all-time high of over 36% of all properties on the market in September.

The CPI rose by 0.28% month-on-month in October, and twelve-month inflation eased from 5.4% to 5.1%, its lowest since December 2021. Inflation excluding housing measured 2.8%, as in September. Underlying inflation measured 4.7%, according to the average of various measures.

Higher food prices and international airfares were the main drivers of the rise in the CPI in October. Food prices rose by 1% month-on-month and 4.2% year-on-year. Price hikes on domestic goods and services have eased, and imported inflation has fallen. Domestic goods prices were up 3.6% year-on-year in October, and the twelve-month increase has slowed steadily since the beginning of the year. Private services prices have risen 4.4% in the past twelve months, and the twelve-month increase has accelerated since September.

According to the Central Bank's market expectations survey, respondents' one- and two-year inflation expectations have fallen since the previous survey, to 3.5%. Their long-term inflation expectations also fell between surveys. Respondents expect inflation to average 3.3% in the next five years and 3% in the next ten years. The short-term breakeven inflation rate in the bond market has fluctuated in the recent past, owing to uncertainty about how Statistics Iceland would handle the proposed changes in taxation of motor vehicle use. The two-year breakeven inflation rate was just under 3% in mid-November and had been unchanged since the MPC's October meeting. The ten-year breakeven rate has fallen marginally, to 3.6% as of mid-November, and the five-year breakeven rate five years ahead has fallen as well, to 4.1% as of mid-November.

According to the forecast published in *Monetary Bulletin* on 20 November, the inflation outlook through year-end 2025 has improved somewhat, owing to a more favourable initial position, as inflation in Q3/2024 was below the August forecast. Inflation is projected to measure 4.8% in Q4, which is 1 percentage point below the August forecast, and fall to 4.1% in Q1/2025. This is supported by a slightly stronger króna but offset by a larger positive output gap. Therefore, the inflation outlook for the latter half of the forecast horizon is broadly as in August. Inflation is projected to fall below 3% in H1/2026 and return to target by the middle of that year.

Trading partner GDP growth has developed in line with the August forecast, and the outlook is broadly unchanged. GDP growth in trading partner countries is expected to inch upwards from 1.4% in 2024 to 1.7% by 2026. As before, robust output growth in the US weighs heavily, while the outlook for the eurozone remains relatively poor. Global inflation has continued to ease. It averaged 2.2% in Q3/2024, but as in the August forecast, it is projected to fall to 2% late in 2025.

In Iceland, GDP rose again between Q1 and Q2, but because of a sizeable Q1 contraction stemming from the negative effects of inventory changes due to the failed capelin catch, GDP was still down by 1.9% year-on-year in H1. This represents a significant reversal, as GDP growth measured 5% in 2023 and 9% in 2022. GDP is projected to be flat year-on-year in 2024, as compared with the August forecast of 0.5% growth. The poorer outlook is due primarily to the H1 contraction, which turned out larger than previously expected. As in August, GDP growth is projected to rebound to 2% in 2025 and then average 2½% per year in the latter half of the forecast horizon. As was assumed in August, output growth during the forecast horizon will be driven largely by domestic demand – private consumption in particular.

According to PAYE tax data, job numbers have fallen and unemployment continues to inch upwards. Thus the positive output gap continues to narrow, even though it is now wider than previously estimated because of Statistics Iceland's revision of 2023 GDP growth figures. The output gap is projected to close and a slack to open up in late 2025, slightly later than previously forecast.

The risk of a hard landing in the US has receded, but the global economic outlook remains quite uncertain, owing chiefly to concerns about the protracted war in Ukraine and escalation of the war in the Middle East. Global commodity prices could therefore rise more than is currently forecast, and imported inflationary pressures in Iceland could prove stronger. Furthermore, because inflation expectations are less firmly anchored, the effects of higher commodity prices and recent pay rises in Iceland could be underestimated in the Bank's forecast. Developments in domestic economic activity will also affect the inflation outlook. For instance, inflation could prove more persistent than is currently forecast if households draw down their recently accumulated savings more quickly. It could fall more rapidly, though, if tourism sector activity subsides more than currently expected.

II Decisions on the Bank's monetary policy instruments

At the November meeting, the MPC discussed the monetary stance, in view of developments in the economy and the real interest rate since the October meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its October meeting to lower interest rates by 0.25 percentage points. At the time of that meeting, inflation had subsided and economic activity had apparently continued to ease in tandem with the tighter monetary stance.

Committee members noted that inflation had eased in the recent past, measuring 5.1% in October. The decline in inflation had been broad-based, and underlying inflation had fallen as well. The Committee also noted that inflation expectations had declined overall and the real rate had therefore risen.

Members observed that the effects of a tight monetary stance could still be seen in economic activity, and growth in domestic demand had lost pace. They noted as well that unemployment continued to inch upwards, and the outlook was for demand pressures in the economy to subside, albeit more slowly than previously assumed.

All members agreed to lower the Bank's key rate, and they discussed whether it should be lowered by 0.25 percentage points or 0.5 percentage points. The MPC agreed that economic activity had continued to taper off and that many factors had moved in the right direction. Price increases were less broad-based, and both domestic and imported inflation had declined. It was mentioned that the outlook was for inflation to fall more rapidly than previously assumed, and that the inflation outlook had therefore improved. If developments continued as expected, short-term inflation expectations were likely to fall even further. Pressures in both the labour market and the housing market had continued to ease. House prices had fallen since the last MPC meeting, and the average time-to-sale had increased. The Committee was of the view that most of the impact of Grindavík residents' relocation appeared to have already come to the fore and that the housing market was therefore becoming better balanced.

Members also observed that, although growth in domestic demand had lost pace, it was doing so very slowly, and there were various indicators of continued resilience in the economy. Members did not exclude the possibility that economic activity was underestimated, given Statistics Iceland's recent revisions of historical data. It was quite likely that services exports had been underestimated, for instance, and that GDP growth in H1/2024 had been stronger than preliminary figures had indicated. Furthermore, revised figures on households' disposable income suggested that real disposable income had grown more in recent years than previously estimated, and that the household saving rate was therefore higher. Private consumption growth could therefore turn out stronger than forecast and wage rises were still supporting demand. It emerged that the construction industry still appeared to be tight, although indicators of strain on production factors had subsided in other sectors. It was also pointed out that lowering interest rates by large increments too early could weaken the credibility of monetary policy, especially if it led to a resurgence of underlying strength in the economy and a rise in inflation and inflation expectations. The MPC discussed the uncertainty about outstanding public sector wage agreements and noted that Parliamentary elections were imminent.

Members agreed that the monetary stance had tightened in the recent past. It also emerged that the rise in the commercial banks' indexed mortgage lending rates and tighter borrowing requirements would presumably continue to dampen housing market activity, and that mortgage debt service would increase for those households facing an interest rate review on their loans. It was noted that the Committee's next regularly scheduled meeting would not take place until 2025, and members considered that there was scope to implement a larger rate reduction, while still maintaining a monetary stance that would support continued disinflation and a narrower output gap in the coming term. It looked as though it would still be necessary to maintain a tight monetary stance.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.5 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 8.5%, the current account rate 8.25%, the seven-day collateralised lending rate 9.25%, and the overnight lending rate 10.25%. All members voted in favour of the proposal.

The MPC also decided to coordinate the publication of interest rates in the Bank's interest rate table so that all rates would thenceforth be published as nominal interest rates. The change, which took effect on 20 November 2024, only affects rates on current accounts with the Central Bank.

The Committee was of the view that persistent inflation and inflation expectations above target called for caution. As a result, it was still necessary to maintain an appropriately tight monetary stance in order to bring inflation back to target within an acceptable time frame. 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

Tómas Brynjólfsson, 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 5 February 2025.