CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2024

August
123rd meeting
Published 4 September 2024

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

August 2024 (123rd meeting)
Published: 4 September 2024

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 19-20 August 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 21 August.

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 had emerged since the Committee's last meeting, on 8 May 2024, as published in the updated forecast in *Monetary Bulletin* 2024/3 on 21 August.

Financial markets

Since the May meeting, the króna had depreciated by 0.7% 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 May meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was 4.2%, or 0.3 percentage points higher than just after the announcement of the May interest rate decision. In terms of twelve-month inflation, however, it was 2.8% and had fallen by 0.3 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 13 b.kr. during the period. Yields on long-term nominal Treasury bonds had risen by as much as 0.3 percentage points since the May meeting, and yields on long-term indexed Treasury bonds had risen by up to 0.1 percentage points over the same period. The average interest rate on inflation-indexed mortgages rose marginally between meetings, as did fixed rates on non-indexed mortgages.

In terms of three-month interbank rates, the short-term interest rate differential had widened by 0.2 percentage points between meetings, to 4.1 percentage points versus the US and 6.1 percentage points versus the euro area. The long-term interest rate spread also widened between meetings. It rose by 0.6 percentage points versus the US, to 3.4 percentage points, and by 0.2 percentage points versus Germany, to 5 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 was also largely unchanged, at 0.8-0.9 percentage points.

According to the Bank's quarterly survey of market agents' expectations, carried out in August, 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 Q4/2024, which is later than according to the April survey. Market agents also expected the key rate to fall somewhat more slowly than in the last survey: they expected it to be 7.75% in one year and 6.25% in two years. The share of respondents who considered the monetary stance too tight declined between surveys, from 62% in April to 52% in the August survey. On the other hand, the share who considered the monetary stance appropriate rose between surveys, from 34% to 40%, and the share who considered it too loose rose from 3% to 8%.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged, as inflation had picked up during the summer and was still well above target, and underlying inflationary pressures were widespread. Furthermore, the labour market remained tight, and the housing market was still buoyant, albeit due in part to home purchases made by Grindavík residents. On the other hand, there were signs that economic activity would ease in the near term, and the impact of the current monetary stance had not yet come fully to the fore.

Annual growth in M3 measured nearly 12% in June, and as before, household deposits accounted for the majority of the increase. Growth in credit system lending had gained pace slightly during the year, measuring 7.1% in June. Loans to households were up by 6.1% in June, and growth has been stable in the recent term. Growth in loans to companies had gained momentum in 2024, measuring nearly 9% year-on-year.

The Nasdaq OMXI15 index had risen by 2.1% between meetings. Turnover in the Main Market totalled 542 b.kr. in the first seven months of 2024, some 16% more than over the same period in 2023.

Global economy and external trade

According to the International Monetary Fund's (IMF) July forecast, global GDP growth is projected to measure 3.2% in 2024, the same as in the Fund's forecast from April. Now, however, the IMF projects that global GDP growth will pick up to 3.3% in 2025, or 0.1 percentage points above its previous forecast. This is due to a slightly more favourable output growth outlook for emerging and developing economies, particularly China and India, whereas the outlook for advanced economies is unchanged overall. The IMF projects that global inflation will measure 5.9% in 2024 and 4.4% in 2025, which is broadly in line with its April forecast. However, the Fund expects somewhat lower inflation in emerging and developing economies, while the inflation outlook for advanced economies has worsened slightly, owing to persistent year-on-year rises in services prices and higher commodity prices.

According to preliminary figures from Statistics Iceland, the goods account deficit totalled 98 b.kr. in Q2/2024 and 155 b.kr. in H1, as compared to a deficit of 128 b.kr. at constant exchange rates in H1/2023. The value of exported goods contracted by 2½% between years, owing in large part to lower aluminium and marine product values. At the same time, imported goods values rose by 2½% year-on-year, or by 1% excluding ships and aircraft. The value of all key categories of imports except transport equipment increased between years, owing to a decline in importation of passenger cars.

Global aluminium prices fell by just over 2% after the MPC's May meeting, to around 2,470 US dollars per tonne by the time of the August meeting. This is a full 5% higher than at the beginning of 2024, however, and 18% above the August 2023 price. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products fell marginally between quarters in Q2/2024 and were around 2% lower in H1 than in H1/2023. The global price of Brent crude fell by just over 7% between MPC meetings, to 77 US dollars per barrel by the time of the August meeting. This is about the same as at the beginning of 2024 but nearly 9% below the August 2023 price. Other commodity prices had also fallen since the May meeting.

The real exchange rate in terms of relative consumer prices rose by 0.8% month-on-month in July, when it was 12% above its 25-year average and 2.7% higher than in December 2019. In the first seven months of 2024, it had risen by 4.3% year-on-year, as the nominal exchange rate of the króna was 0.7% higher and inflation in Iceland was 3.6 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland at the end of May, GDP contracted by 4% year-on-year in Q1/2024, broadly as was forecast in the May *Monetary Bulletin*. The contraction is due primarily to inventory changes, which had a negative impact on GDP growth in the amount of 3.5 percentage points. This stemmed largely from the capelin catch failure and the fact that, unlike in Q1/2023, no capelin inventories were accumulated in Q1 of this year. Excluding inventory changes, domestic demand grew by 0.9% between years, slightly more than was forecast in May.

Private consumption was stronger than expected in Q1/2024, and developments were more closely aligned with recently revised payment card turnover data, which show stronger growth in household spending during the quarter than was indicated by the previous figures. The new card turnover data also suggest continued private consumption growth in Q2. Other indicators are not so unequivocal, however. Households have grown more pessimistic since Q1, and new motor vehicle registrations excluding car rental agencies have contracted. The Bank's baseline forecast therefore assumes that private consumption was flat year-on-year during the quarter, which is roughly in line with the May forecast.

According to the results of Gallup's summer survey, conducted in May and June among Iceland's 400 largest firms, respondents' assessment of the current economic situation was slightly more positive than in the spring survey. Their expectations six months ahead were also more positive, as one-third of executives expected the economic situation to improve in six months' time, a slightly larger share than in the spring. Half of executives expected the economic situation to be unchanged in six months' time. However, respondents were slightly more pessimistic about domestic demand but marginally more optimistic about foreign demand than in the spring survey.

The seasonally adjusted results of Gallup's summer survey indicated that the balance of opinion on staffing was 10 percentage points in favour of those planning to recruit in the next six months. The balance of opinion narrowed between surveys and was close to its historical average. Just under 30% of firms considered themselves short-staffed, far fewer than in the previous survey, but just over half of firms still report operating at full capacity. Both shares remain above their historical averages.

According to the Statistics Iceland labour force survey (LFS), total hours worked rose by 4.5% year-on-year in Q2/2024. Of that amount, job growth measured 4.9%, while the average work week grew shorter by 0.3%. However, the twelve-month increase in the number of wage-earners on the pay-as-you-earn (PAYE) register was only half as large as the increase in job numbers according to the LFS during the quarter, or 2.3%, and job creation by this measure has been losing pace almost continuously since spring 2023. According to seasonally adjusted LFS results, the labour participation rate was close to its historical average, and unemployment fell to 3.1% during the quarter. Seasonally adjusted registered unemployment rose marginally between quarters, however, to 3.5%.

The general wage index rose by 2.4% between quarters in Q2, and by 6.6% year-on-year, while real wages rose 0.5% over the same period.

Statistics Iceland's nationwide house price index rose 2.2% month-on-month in July, when adjusted for seasonality, and by 9.9% year-on-year. The nationwide house price index compiled by the Housing and Construction Authority (HMS) rose by 1.4% between months and 9.1% between years in June. The HMS index of capital area house prices increased by 9.8% year-on-year, and the index for regional Iceland rose by 7.2%. The number of purchase agreements registered nationwide rose by 72% year-on-year in the first six months of 2024, while the number of contracts for new construction increased by 86.3% over the same period. The jump in turnover is due partly to real estate firm Þórkatla's buy-up of properties in Grindavík and to Grindavík residents' having moved out of the town. The average time-to-sale nationwide increased again between May and June, to 3.3 months, but the number of homes for sale has risen marginally in the past three months.

The CPI rose by 0.46% month-on-month in July, and twelve-month inflation measured 6.3%, markedly higher than in June. Inflation excluding housing rose as well, to 4.2%, and the difference between measures of inflation including and excluding housing widened again slightly between months. Underlying inflation also increased between months, to 5.3% according to the average of various measures.

Higher international airfares and food prices were the main drivers of the rise in the CPI in July. Food and beverage price inflation gained steam again, after having eased since the turn of the year. The overall impact of summer sales on inflation was slightly less pronounced than at the same time in 2023. Imputed rent rose 0.5% between months, its smallest monthly increase since August 2023, whereas it increased by 13.6% year-on-year and still accounts for nearly half of headline inflation. In June, Statistics Iceland changed its methodology for calculating imputed rent, adopting the rental equivalence method. The change will probably dampen volatility in the housing component of the CPI.

According to the Bank's most recent survey, market agents' inflation expectations were largely unchanged relative to the April survey. Respondents expect inflation to measure 4% two years from now. Furthermore, market agents' long-term inflation expectations were broadly unchanged, both between surveys and between years. Market participants expect inflation to average 3.6% over the next ten years, which is slightly higher than in the April survey. Gallup's summer survey indicates that households and businesses expect inflation to measure 5-6% a year from now. Business executives still expect inflation to average 4% over the next five years, but households are more pessimistic. Furthermore, the breakeven inflation rate in the bond market has started rising again since May, measuring 4.2% in mid-August.

According to the forecast published in *Monetary Bulletin* on 21 August 2024, the outlook is for twelve-month inflation to measure 6.3% in Q3 and then fall to 5.8% in Q4, which is somewhat higher than was forecast in May. This is due to a poorer initial position, as the inflation outlook is largely unchanged since the May forecast. The positive output gap is estimated to be slightly smaller and is expected to close and a slack to open next year, as was previously expected. In addition, the outlook is for wage costs to rise less in 2024 and 2025 than was previously assumed. On the other hand, inflation expectations are broadly unchanged and are poorly anchored to the target. Inflation is forecast to fall to 3.6% by the end of 2025 and reach the target in H2/2026, conditional upon the interest rate path in the forecast.

The global GDP growth outlook is broadly unchanged relative to the Bank's May forecast. GDP growth in major trading partner countries is projected to average 1.3% this year and then inch up to just above 1½% in the two years thereafter. Uncertainty about the global economic outlook has increased, however. Global inflation has continued to subside thus far in 2024, and more central banks in advanced economies have begun to lower interest rates. As in May, inflation is expected to keep falling in major advanced economies and return to target in H2/2025.

Output growth slowed markedly over the course of 2023, and in Q1/2024 it shrank by 4% year-on-year, close to the May forecast of a 3.7% contraction. The negative impact of reduced inventory accumulation due to the failed capelin catch early this year was a major factor, as domestic demand excluding inventory changes grew by 0.9% year-on-year during the quarter, outpacing the 0.6% growth rate projected in May. GDP is estimated to have grown by 2% between years in Q2, and GDP growth for the year as a whole is forecast at only 0.5%, well below the May forecast of 1.1%. The deviation is due primarily to a poorer outlook for tourism. The output growth outlook for 2025 and 2026 has also deteriorated slightly since May.

Job growth has slowed since H1/2023. Unemployment is broadly unchanged, however, owing to the offsetting effect of a rising labour participation rate. Unemployment remains low, although indicators imply that labour market tightness is easing. The positive output gap is expected to keep narrowing and flip to a modest slack around mid-2025, largely as was forecast in May.

The global economic situation remains uncertain, not least because of the wars in Ukraine and the Middle East. Trading partner GDP growth has been muted, and it is unclear how solid the foundations for growth are. In Iceland, activity in the tourism industry has slowed, and the GDP growth outlook could prove overly optimistic if the sector loses more ground. On the other hand, GDP growth could turn out to be underestimated, given households' significant accumulated savings, which they could choose to draw down more quickly than is assumed in the forecast. There is also considerable uncertainty about developments in inflation over the forecast horizon, not least because inflation expectations are less firmly anchored, which could cause inflation to be more persistent than is currently anticipated. This is compounded by uncertainty about how measured inflation will be affected by the forthcoming changes to taxes on motor vehicle use, which are set to take effect at the turn of the year.

II Decisions on the Bank's monetary policy instruments

At the August meeting, the MPC discussed the monetary stance, in view of developments in the economy and the real interest rate since the May meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its May meeting to hold interest rates unchanged. At that meeting, members took into account that inflation had continued to ease and growth in domestic demand had slowed. The positive output gap appeared to have been wider than previously assumed, however, and the outlook was for a slower rate of disinflation.

The MPC discussed developments in inflation, noting that it had risen marginally since the May meeting, after having eased earlier in the year. Underlying inflation had also risen between meetings and remained high; furthermore, price increases were widespread even though the contribution of the housing component was still significant. MPC members noted as well that inflation expectations were broadly unchanged and had remained above target.

The Committee observed that domestic demand had eased in the past year, in line with a tighter monetary stance. Some demand pressures remained in the domestic economy, however, and they had subsided very little since the MPC's May meeting based on recent data. The Committee therefore considered that it could take some time to achieve an acceptable rate of disinflation.

All members agreed that interest rates should be held unchanged. Inflation was still persistent, and inflation expectations were broadly unchanged. Although activity in the domestic economy had eased since 2023, the situation was largely similar to that prevailing at the time of the May meeting. In the MPC's view, domestic demand was still relatively strong and there were few indications that the domestic economy had slowed markedly since the previous meeting, whether in terms of the labour market or the housing market. Furthermore, pay rises in recent months and fiscal measures in the wake of wage agreements seemed to have supported demand. Pay rises were also reflected to an extent in strong growth in household deposits in line with higher interest rates. The household saving rate was still relatively high, and it was positive to see how effectively that channel of monetary policy had functioned in the recent term, although a high saving rate could conceivably fuel demand further ahead. It was also evident that the Government's buy-up of residential property in Grindavík had boosted the housing market, but in the Committee's view, those effects were temporary. Even so, looking past the impact from Grindavík residents' moving, activity in the housing market seemed to be quite strong.

It emerged in the discussion that given strong domestic activity and how persistent inflation had been, it could prove necessary to maintain a tight monetary stance for longer than would otherwise be necessary, as it would take some time for the tight monetary stance to have the intended effect. This was particularly the case when inflation had been persistently above target and inflation expectations had become less firmly anchored to the target. Furthermore, it was difficult to curb demand in view of persistent wage rises and increased transfers from the Government. It was pointed out that it could be difficult to bring inflation back to target within an acceptable time frame without a substantial slowdown in the economy.

The MPC was of the opinion that because indications that inflationary pressures and inflation expectations were subsiding to a sufficient degree had not come clearly enough to the fore, the monetary stance should remain tight. Although the Bank's interest rate hikes had been effective in reducing demand pressures and fostering disinflation, progress had been slower than anticipated.

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%. All members voted in favour of the proposal.

The MPC was of the view that the current monetary stance was sufficient to bring inflation back to target, but persistent inflation and strong domestic demand called for caution. 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

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 2 October 2024.