CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2025

February
126th meeting
Published 19 February 2025

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 3-4 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 5 February.

I Economic and monetary developments

Before turning to monetary policy decisions, members discussed the domestic financial markets, 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 20 November 2024.

Financial markets

The monetary stance, as reflected in the Central Bank's real interest rate, 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 4.5%, or 0.5 percentage points higher than just after the announcement of the November interest rate decision. Based on the twelve-month inflation rate, it was 3.7% and had also risen by 0.5 percentage points over the same period.

Interest rates on unsecured overnight deposits (the Icelandic króna overnight rate, or IKON) fell in the wake of the Bank's interest rate cut in November. Interest rates in the interbank market for krónur declined as well, but interbank market turnover totalled 12 b.kr. between MPC meetings. Yields on long-term nominal Treasury bonds had risen marginally since the November meeting, whereas yields on long-term indexed Treasury bonds were broadly unchanged over the same period. Interest rates on inflation-indexed mortgages rose between meetings, while rates on non-indexed mortgages declined.

In terms of three-month interbank rates, the short-term interest rate differential had narrowed between meetings by 0.2 percentage points versus the euro area, to 5.7 percentage points, and by 0.4 percentage points versus the US, to 3.9 percentage points. The long-term interest rate spread widened slightly between meetings, however. It rose by 0.2 percentage points versus Germany, to 4.4 percentage points, and 0.1 percentage points versus the US, to 2.3 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 0.5-0.6 percentage points.

According to the Bank's quarterly market expectations survey, conducted at the beginning of January, market agents expected the Central Bank's key interest rate to be lowered by 0.75 percentage points in Q1/2025. They also expected the Bank's interest rates to continue falling, to 6.75% after one year and to 5.75% after two years. This is the same interest rate as expected in the November survey. The share of respondents who considered the monetary stance too tight declined from 87% in the November survey to 80% in this one. About 20% of respondents considered the monetary stance appropriate, up from 13% in last survey, and none considered it too loose.

Financial institutions' analysts expected the MPC to lower the Bank's interest rates by either 0.25 or 0.5 percentage points at the February meeting, on the grounds that inflation had continued to ease, inflation expectations had fallen by most measures, and the real rate had risen since the last interest rate decision. Furthermore, housing market pressures had subsided, and indicators implied that the labour market was better balanced. On the other hand, the economy still appeared resilient. There was also uncertainty about public sector labour disputes, and there was only a short time until the MPC's next meeting, which possibly warranted a smaller interest rate cut.

Annual growth in M3 measured just under 12% in December. As before, household deposits account for much of the increase, while growth in company deposits gained pace in late 2024. Year-on-year growth in credit system lending measured just over 7% in December and gained momentum slightly during the year. Growth in lending to households had eased marginally, to 5½% between years, while year-on-year growth in corporate lending had increased to nearly 11% by December.

Since the previous meeting, the króna had depreciated by 1.6% in trade-weighted terms. The Central Bank conducted no market transactions during the period.

The Nasdaq OMXI15 index had risen by 9.5% between meetings. Turnover in the Main Market totalled 1,249 b.kr. in 2024 as a whole, an increase of over 60% relative to 2023, with a fourth of the year's turnover occurring in December.

Global economy and external trade

The global GDP growth outlook had held broadly unchanged since November, but developments varied from one country to another, with the US showing robust growth and the eurozone lagging behind. Trading partner GDP growth is expected to inch upwards relative to 2024, to an average of 1.7% this year. The global inflation outlook is also largely unchanged, and inflation is expected to keep falling. Central banks in major advanced economies have therefore continued to lower interest rates in line with the improved inflation outlook, but rates remain far higher than before the pandemic.

According to the International Monetary Fund's (IMF) January forecast, global GDP growth is projected to measure 3.3% in both 2025 and 2026. This is broadly similar to the Fund's October forecast but well below the average of the past few decades. The inflation outlook is also largely unchanged, in the IMF's assessment, and inflation in advanced economies is still forecast to average 2.1% in 2025 and 2% in 2026. On the other hand, the outlook is for international trade in goods and services to increase somewhat less in the next two years than was forecast in October, owing to a poorer outlook for advanced economies.

Iceland's goods account deficit totalled 107 b.kr. in Q4/2024, as compared with 77 b.kr. (at constant exchange rates) for the same period in 2023. The larger deficit is due mainly to growth in imports, particularly imports of investment goods. In 2024 as a whole, the goods account deficit measured 320 b.kr., or 6.7% of GDP, as compared to a deficit of 287 b.kr. (5.2% of GDP) in 2023. The value of exported goods grew by 2% year-on-year at constant exchange rates in 2024, owing to reduced aluminium and marine product export values, on the one hand, and an increase in the export value of pharmaceuticals and medical equipment, on the other. At the same time, import values rose by about 4%, owing to an increase in the value of investment goods, consumer goods, and operational inputs, which was offset by a decrease in the value of transport equipment and fuels.

The foreign currency price of marine product exports was flat between years in 2024, according to preliminary figures from Statistics Iceland. The global price of aluminium had held broadly unchanged since the MPC's November meeting, at just over 2,600 US dollars per tonne, or about one-fifth higher than in February 2024. The price of Brent crude was about 76 US dollars per barrel, which was nearly 4% higher than just before the November meeting but roughly 3% lower than in February 2024. Other commodity prices also rose slightly between meetings.

The real exchange rate in terms of relative consumer prices rose by 0.5% month-on-month in January, when it was 13% above its 25-year average and 4% higher than in December 2019. It rose by 3.2% year-on-year in 2024, as inflation in Iceland was 3.4 percentage points above the trading partner average, while the nominal exchange rate was unchanged between years.

Domestic economy and inflation

Private consumption grew by 0.2% in the first three quarters of 2024, as was assumed in November. As was projected then, household spending appeared to have picked up further in Q4. Preliminary payment card turnover figures suggest an uptick in household demand, as total card turnover grew by 6.1% year-on-year in Q4. The Gallup Consumer Confidence Index rose towards the end of 2024, indicating greater consumer optimism, although the strong contraction in households' motor vehicle purchases continued. Private consumption is estimated to have grown by 0.9% in 2024, as compared with the November forecast of 1% growth. As in November, growth is projected to gather pace this year, albeit more slowly than was assumed then.

According to preliminary figures from Statistics Iceland, GDP shrank by 1% in the first three quarters of 2024. This is a larger contraction than was forecast in November, owing mainly to a more negative contribution from inventory changes and net trade. However, economic activity could be underestimated; for instance, if earlier figures on exports and investment are revised upwards.

Year-on-year GDP growth is estimated to have turned positive again in Q4, but a contraction of 0.4% is projected for the year as a whole. In November, however, GDP was forecast to remain flat between years. Furthermore, year-2025 GDP growth is expected to be slightly weaker than previously estimated, or 1.6%, and a slack is projected to open up in the economy this year, about half a year earlier than was assumed in November. The poorer outlook is due mainly to more muted growth in private consumption and a more negative contribution from net trade, mitigated by stronger investment. As in November, GDP growth is forecast to continue gaining pace in the coming two years.

The number of persons on the pay-as-you-earn (PAYE) register increased in November by 2% year-on-year, close to its historical average. As before, the Statistics Iceland labour force survey (LFS) is considered to overestimate job numbers and total hours worked, but according to the survey, the number of working persons rose far more from mid-year 2024 than the number on the PAYE register.

According to the seasonally adjusted Gallup survey results, job numbers will continue to rise in the coming term. The share of companies planning to recruit workers net of those planning to downsize was positive by 7 percentage points. Furthermore, 24% of executives reported being short-staffed and about 46% said their firms would have difficulty responding to an unexpected increase in demand. In all cases, the percentages were at or slightly above their historical average.

Seasonally adjusted unemployment inched upwards for just over a year and a half. It measured 3.6% in December, as it had in the three months beforehand, after falling to a post-pandemic low of 3.1% in May 2023. Seasonally adjusted unemployment according to the LFS measured 3.2% in Q4/2024 but has been far more volatile in the recent past. The baseline forecast in *Monetary Bulletin* assumes that unemployment will continue to rise to an average of 4.5% in 2025, concurrent with a slack developing in the economy around mid-year, somewhat earlier than previously estimated.

Iceland's population grew by 1.5% year-on-year in Q4/2024. As in the recent past, population growth stems primarily from a rise in the number of foreign nationals. The growth rate has slowed since mid-2023, as the number of immigrants has fallen 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 1.1% between quarters and by 6.2% year-on-year in Q4/2024. Real wages were 0.7% higher in Q4 than in the same quarter of 2023.

The number of purchase agreements registered nationwide rose by 41.7% year-on-year in 2024, while the number of contracts for new construction increased by 25.6%. The jump in turnover is due 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 increased between November and December, to 5.3 months, but the number of homes for sale has begun to decline marginally in the past two months, after a strong surge starting in April 2024. Newly built homes accounted for 40.5% of properties for sale in December, the largest share since data collection began in 2017.

The nationwide house price index fell by 0.6% month-on-month in December but was up 7.7% between years. The index of capital area house prices increased by 8% between years, and the index for regional Iceland rose by 6.7%.

Inflation averaged 5.9% in 2024, as compared with 8.7% in 2023. Inflation averaged 4.9% in Q4/2024, slightly above the forecast published in the November *Monetary Bulletin*. The CPI declined by 0.27% month-on-month in January, and twelve-month inflation fell from 4.8% to 4.6%. Nevertheless, inflation excluding housing rose to 3%, while underlying inflation continued to fall, reaching 4.1% in January.

Airfares and winter sales made the strongest downward impact on the CPI in January, whereas price list increases for miscellaneous public services pushed upwards. The cost of owner-occupied housing declined month-on-month in January and had risen by 9.6% between years. The housing component still accounts for nearly half of headline inflation, although its share in inflation has fallen recently. Private services prices fell between months, primarily because of a steep drop in airfares, and rose by 3.4% between years. Services inflation as a whole has therefore eased, to 4% in January. On the other hand, food prices increased relative to December, and the impact of winter sales was somewhat weaker than is typical for January. Imported inflation rose overall, measuring 2% in January.

According to the Bank's market expectations survey, respondents' short-term inflation expectations were broadly unchanged since November, whereas their long-term inflation expectations rose once again. Survey participants expect inflation to measure 3.4% or less, both in two years' time and as an average over the next ten years. According to Gallup's winter survey, households' and businesses' short- and long-term inflation expectations declined. Corporate executives expect 3.5% inflation, both two years from now and as an average over the next five years, while households expect it to measure 4%. The breakeven inflation rate in the bond market had risen since November, though, and the ten-year breakeven rate was about 4% at the end of January.

According to the forecast in *Monetary Bulletin*, the outlook is for inflation to keep falling, reaching 4.2% in Q1/2025 and 3.5% in Q2, which is somewhat higher than was assumed in November. It is projected that inflation will ease still further in Q3 but then pick up again slightly in Q4 because of unfavourable base effects. The overall inflation outlook is similar to that in November, and inflation is expected to ease to the target in mid-2026, conditional upon the interest rate path in the baseline forecast. A slack in the economy is expected to open up earlier than previously projected, but on the other hand, house prices and import prices are expected to rise more.

II Decisions on the Bank's monetary policy instruments

At the February meeting, the MPC discussed the monetary stance and whether it was appropriate, in view of the inflation outlook and developments in the economy and the real interest rate since the November meeting. At that meeting, the Committee had decided to lower the Bank's key rate by 0.5 percentage points, as inflation and inflation expectations had fallen, and the real rate had therefore risen.

Committee members discussed the fact that inflation had continued to subside, reaching 4.6% in January. Underlying inflation had eased as well and was at its lowest in three years. The outlook was for continued disinflation in coming months.

MPC members observed that demand growth had subsided in line with a tight monetary stance, and the positive output gap in the economy was narrowing. Housing market activity had eased, and house price inflation had lost pace. In Committee members' assessment, however, there were signs that economic activity was stronger than preliminary national accounts figures had implied, and furthermore, they noted that wage costs had continued to rise.

All members agreed that the Bank's key rate should be lowered, and they discussed whether it should be cut by 0.25 percentage points or 0.5 percentage points. They agreed that inflationary pressures had eased and that disinflation was broad-based. Furthermore, there were signs that housing market pressures were subsiding. The average time-to-sale for residential property was growing longer, labour importation had lost pace, and the number of new homes on the market had increased. The impact of Grindavík residents' relocation had largely come to the fore, and demand pressures in the economy had continued to taper off.

Because the Bank's real rate had risen since the previous meeting, the MPC was of the opinion that there was scope to lower the key rate without weakening the policy stance as represented by the real rate. Members agreed, however, that there was a need for caution in unwinding the monetary policy stance, even though the positive output gap had narrowed in the recent term and inflation had eased. Inflation and inflation expectations were still somewhat above target, and inflationary pressures from the labour market were still in evidence, as could be seen in the continued rise in labour costs above a pace consistent with the inflation target. Furthermore, there were indications that the underlying resilience of domestic demand could possibly be underestimated in Statistics Iceland's preliminary figures, and households' sizeable accumulated savings could imply that they had the financial scope to increase consumption spending despite tight monetary policy. Because of this underlying pressure, the Committee is of the opinion that a tight monetary stance is still needed to bring inflation down to the 2.5% target.

The MPC also took account of how monetary policy was transmitted to the financial system and the real economy. Members noted that the impact of a tight policy stance had yet to come fully to the fore, as inflation-indexed mortgage interest rates had risen noticeably during the autumn and maturities on mortgages had grown shorter. A comparable trend could be seen in loans to businesses. Furthermore, the effects of tight monetary policy and its interaction with the borrower-based measures currently in place should become more visible in the housing market now that the impact of the Grindavík volcanic eruptions on the housing market has tapered off for the most part.

The extent to which the new Government's fiscal policy will support monetary policy also had yet to grow clearer. Funding of various newly planned expenditures was still somewhat uncertain, and it was important to bear in mind that the economy was still running at full capacity. New spending plans could lead to stronger demand pressures, even if they were fully financed. Moreover, However, committee members were of the opinion that the proposed changes in the framework for public finances represented a move in the right direction. They were also of the view that elevated global economic uncertainty could have a detrimental effect on global economic activity and push trading partner inflation higher.

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 8.0%, the current account rate 7.75%, the seven-day collateralised lending rate 8.75%, and the overnight lending rate 9.75%. All members voted in favour of the proposal.

Although inflation had eased and inflation expectations had fallen, inflation pressures remained. In the MPC's assessment, this called for a continued tight monetary stance and caution regarding decisions going forward. The situation was compounded by elevated global economic uncertainty. 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 Committee

Thórarinn G. Pétursson, 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

Karen Á. Vignisdóttir, Chief Economist of the Central Bank, was present for the entire meeting. In addition, several Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 19 March 2025.