CENTRAL BANK OF ICELAND

MINUTES

MONETARY POLICY COMMITTEE

2024

OCTOBER
124th 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 30 September and 1 October 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 2 October.

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 21 August.

Financial markets

Since the August meeting, the króna had appreciated by 1.1% 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 August 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 August interest rate decision. In terms of twelve-month inflation, it was 3.7% and had risen by 0.9 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 were virtually unchanged at that time, and there was no turnover in the market during the period. Yields on long-term nominal Treasury bonds had fallen by as much as 0.4 percentage points since the August meeting, and yields on long-term indexed Treasury bonds had fallen by 0.1 percentage points. Interest rates on inflation-indexed mortgages rose between meetings, whereas fixed rates on non-indexed mortgages declined.

In terms of three-month interbank rates, the short-term interest rate differential versus the euro area had widened by 0.2 percentage points between meetings, to 6.3 percentage points, while the spread versus the US had widened by 0.4 percentage points, to 4.7 percentage points. The long-term interest rate spread narrowed by 0.3 percentage points between meetings, however, to 4.7 percentage points versus Germany and 3.1 percentage points versus the US. The CDS spread on the Treasury's five-year obligations in US dollars was 0.4% and had held virtually unchanged between 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.

Financial institutions' analysts had projected that the MPC would hold interest rates unchanged, on the grounds that part of the recent decline in inflation could be attributed to the abolition of certain public levies and that long-term inflation expectations were still high by most measures. Furthermore, the housing market remained tight, and both investment and payment card turnover were still robust. On the other hand, underlying inflationary pressures, the breakeven inflation rate in the bond market, and tension in the labour market had all subsided.

Annual growth in M3 measured nearly 9% in August. Household deposits still account for a large share of the increase, while growth in corporate deposits fell nearly to zero during the month. Growth in credit system lending had gained pace during the year, measuring 7.1% in July. Lending to households was up by 5.9% year-on-year in July and has been close to 6% ever since August 2023. Lending to companies grew by 9.2% year-on-year in July. The year-on-year growth rate has picked up thus far in 2024, but net new lending to companies has been tapering off this summer.

The Nasdaq OMXI15 index had risen by 3.6% between meetings. Turnover in the Main Market totalled 614 b.kr. in the first eight months of 2024, some 19% more than over the same period in 2023.

Global economy and external trade

According to the forecast from the Organisation for Economic Co-operation and Development (OECD), published in September, global GDP growth is projected at 3.2% in 2024, or 0.1 percentage points above the Organisation's May forecast. The year-2024 output growth outlook for the UK has improved considerably relative to the May forecast, while it is unchanged for the US, the eurozone, and China. Furthermore, the OECD forecasts GDP growth at 3.2% in 2025, which is in line with the May forecast. The Organisation expects inflation in G20 countries to fall to an average of 5.4% in 2024 and 3.3% in 2025. These projections are below the previous forecast by 0.5 and 0.3 percentage points, respectively. However, the downward revisions are due mainly to Argentina, where inflation is expected to fall but remain sky-high, at almost 150% in 2024 and nearly 50% in 2025. The OECD is of the view that core inflation among advanced G20 economies will decline even further in 2025, aligning with inflation targets in most countries towards the end of that year.

In Iceland, the deficit on goods trade measured 209 b.kr. in the first eight months of 2024, according to preliminary figures from Statistics Iceland, and was virtually unchanged year-on-year at constant exchange rates. Goods export values rose by 0.8% between years, but excluding ships and aircraft they declined marginally. This is due to lower aluminium and marine product values, which are offset by higher values of aquaculture products, pharmaceuticals, medical equipment, and other manufactured goods. At the same time, import values rose by about 0.5% year-on-year, owing to an increase in the value of commodities, operational inputs, investment goods, and consumer goods, which was offset by a decrease in the value of transport equipment and fuels.

Global aluminium prices rose by 7% after the MPC's August meeting, to around 2,640 US dollars per tonne by the time of the October meeting, or roughly 15% above the price at the beginning of October 2023. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products fell month-on-month in August and were down by about 0.7% year-on-year in the first eight months of 2024. The global price of Brent crude fell by nearly 5% between MPC meetings, to 74 US dollars per barrel at the time of the October meeting. This is about one-fifth below the price at the beginning of October 2023. Other commodity prices had also fallen since the August meeting.

The real exchange rate in terms of relative consumer prices fell by 1.5% month-on-month in August, when it was 22% above its 25-year average and 4.5% higher than in December 2019. By this measure, the real exchange rate rose by 3.6% year-on-year over the first eight months of 2024, owing mainly to higher inflation in Iceland than in trading partner countries, as the nominal exchange rate of the króna was virtually unchanged between years.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland at the end of August, GDP contracted by 1.9% in H1/2024, as compared with the 1% contraction forecast in August. The larger contraction can be attributed to a considerably less favourable contribution from net trade, with the difference due partly to base effects from the revision of the previous year's data. Growth in domestic demand was unchanged in H1, in line with the forecast.

Private consumption contracted by 0.9% in Q2, and key indicators of developments in Q3 are ambiguous. Payment card turnover grew year-on-year in July and August, although the rise was due largely to increased turnover abroad. New motor vehicle registrations (excluding car rental agencies) continued to shrink in July, but less strongly than before. The contraction in July measured 12% year-on-year, whereas in H1 as a whole it was 43%. Furthermore, households have apparently grown more pessimistic, according to the Gallup Consumer Confidence Index, which has been declining over the course of this year.

According to the fiscal budget proposal for 2025, the Treasury is expected to show a deficit of 41 b.kr., or 0.8% of estimated GDP, which represents an improvement of 16 b.kr. between years. Furthermore, the Treasury primary balance is projected to be positive in 2025 by 36.4 b.kr., or 0.7% of GDP, the same percentage as is forecast for 2024. According to the budget proposal, the fiscal stance in terms of Treasury Part A1 will tighten by just over 2% of potential output in 2024 and about 0.5% in 2025.

According to the results of Gallup's autumn survey, conducted in August and September among Iceland's 400 largest firms, respondents' assessment of the current economic situation was far more negative than in the summer survey. Executives' expectations six months ahead were also markedly more negative, as 31% of executives expected the economic situation to deteriorate in six months' time, a much larger share than in the summer. About 43% expected the economic situation to be unchanged over the next six months. Executives were also somewhat more pessimistic about domestic and foreign demand than in the summer survey, particularly those in transport, transit, and tourism and those in wholesale and retail trade.

The outlook for firms' operating performance also deteriorated relative to the spring survey, with 44% of executives expecting profits to be weaker this year than in 2023, while another one-fifth expected profits to be stronger this year. In all sectors, profit margins for the past six months worsened between surveys: 45% of firms reported a contraction and one-fourth reported an increase. Executives' expectations about profit margins in the coming six months had deteriorated as well, with 39% of respondents expecting them to shrink and 22% expecting them to grow. Prospects for investment during the year deteriorated somewhat between surveys, with one-third of respondents expecting to cut back on investment in 2024. Nevertheless, a plurality of executives, or 45%, expected their investment levels to remain unchanged between years.

The seasonally adjusted results of Gallup's autumn survey show that labour demand continues to subside. The share of firms planning to recruit workers net of those planning to downsize was negative by 1 percentage point. Not only is this a turnaround from the summer survey, when the balance of opinion on the same topic was positive by 9 percentage points, but it is also below the historical average. By the same token, firms' staffing problems have eased: 24% of respondents reported that they were understaffed, which is 5 percentage points less than in the previous survey and in line with the historical average. Furthermore, 46% of firms reported that their firms would have difficulty responding to an unexpected increase in demand. This is a smaller percentage than in the summer survey but is still somewhat above the historical average.

The general wage index rose by 0.1% month-on-month in August and by 6.3% year-on-year. Real wages were 0.3% higher during the month than at the same time in 2023.

Statistics Iceland's nationwide house price index rose 1% month-on-month in September, when adjusted for seasonality, and by 11.7% year-on-year. The nationwide house price index compiled by the Housing and Construction Authority (HMS) rose by 1.4% between months and 10.8% between years in August. The HMS index of capital area house prices increased by 11.1% year-on-year, and the index for regional Iceland rose by 10.2%. The number of purchase agreements registered nationwide rose by just under 66% year-on-year in the first eight months of 2024, while the number of contracts for new construction increased by nearly 76% 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. The average time-to-sale nationwide increased between July and August, however, to 3.4 months, while the number of homes for sale, particularly newly built homes, has risen in the past five months.

The CPI declined by 0.24% month-on-month in September, and twelve-month inflation fell from 6% to 5.4%. Inflation excluding housing declined as well, to 2.8%. The difference between inflation including and excluding housing therefore continued to grow. Underlying inflation measured 4.8%, according to the median of various measures, and fell by 0.4 percentage points between meetings.

Movements in the CPI in September were due mainly to higher clothing and footwear prices after the end of seasonal sales, higher owner-occupied housing costs, lower airfares, and the Government's decision to offer free school meals. Owner-occupied housing costs have risen by 14.8% year-on-year, but the annual increase has lost pace slightly since August. In keeping with the typical seasonal pattern, international airfares and the price of accommodation declined. Food and beverage prices were down 0.2% in September and have fallen for two consecutive months. The twelve-month rise in food prices measures 4.2%, its lowest since January 2022.

According to Gallup's autumn survey, households' and businesses' inflation expectations were unchanged by most measures. Business executives still expect inflation to average 4% over the next five years, and households expect it to measure 5%. Both short- and long-term breakeven inflation rates in the bond market have fallen, however. The ten-year breakeven rate has declined marginally since the MPC's August meeting, to 3.8% as of end-September.

II Decisions on the Bank's monetary policy instruments

At the October meeting, the MPC discussed the monetary stance, in view of developments in the economy and the real interest rate since the August meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its August meeting to hold interest rates unchanged. At that meeting, the MPC had observed that inflation remained high and demand pressures in the economy had subsided very little.

Committee members noted that inflation had eased in the recent past, measuring 5.4% in September. Although certain one-off items weighed heavily, the scope and frequency of price increases had tapered off. The MPC noted that underlying inflation had declined as well, to 4.8% in September. The breakeven inflation rate in the bond market had also fallen.

Members observed that economic activity had continued to ease in tandem with the tighter monetary stance. Furthermore, there were signs that labour market pressures had subsided and that households and businesses had grown more pessimistic.

The MPC discussed whether to hold interest rates unchanged or to lower them. Members agreed that various indicators suggested that growth in economic activity had continued to taper off. Inflation had fallen more than anticipated, the contribution of domestic goods and services to inflation had eased, and price increases were less widespread than before. In addition, inflation expectations had fallen by some measures. Although labour demand was still strong, there were clear signs of a slowdown, as job growth had lost pace and registered unemployment had continued to inch upwards. Furthermore, staff shortages had subsided, firms had scaled down their staff recruitment plans, and the share of companies operating at full capacity had fallen. It emerged that all else being equal, the recent increase in the commercial banks' indexed mortgage rates and structural changes in the credit market that had caused borrowing terms to tighten could lead to a more rapid downturn in lending growth than would otherwise be seen. This could result in a more rapid decline in housing market activity, whereas the rise in the housing component of the CPI still accounted for a large share of headline inflation. It was also pointed out that overall economic activity could lose pace quickly in 2025. Many factors had therefore moved in the right direction in the recent term, and the impact of high real interest rates was clearly visible.

On the other hand, it also emerged in the discussion that about half of the recent drop in inflation was due to one-off items and underlying inflationary pressures were still present. It was pointed out that it was not clear that underlying inflationary pressures had tapered off decisively between meetings. In the discussion, members noted that domestic demand remained strong, the real estate market was still robust, and payment card turnover figures suggested that demand had picked up in Q3, as previous wage increases were still supporting demand. It therefore appeared that underlying demand pressures remained in the economy. Households', position was strong overall, as could be seen in a high saving rate and strong growth in deposits. It was also pointed out that under these circumstances, Government transfers to households could stimulate demand. In this context, concerns were expressed that even if inflation continued to fall in the near term, it could then plateau at a level somewhat above target. It was therefore important to maintain a tight monetary stance further ahead. The MPC discussed the fiscal budget proposal, noting that while the proposal provided for a more or less neutral fiscal stance in 2025, it had yet to be discussed in Parliament.

On the whole, growth in economic activity had eased steadily since 2023. The Committee agreed that the monetary stance had tightened in the recent term, particularly in view of the fact that transmission to long-term real rates had grown more effective. In addition, it was likely that the stance would tighten further in the coming term. In light of this, it would be possible to lower nominal interest rates cautiously, while still maintaining an appropriate monetary stance.

In view of the discussion, the Governor proposed that the Bank's interest rates be lowered by 0.25 percentage points. The Bank's key rate (the seven-day term deposit rate) would be 9%, the current account rate 8.75%, the seven-day collateralised lending rate 9.75%, and the overnight lending rate 10.75%. All members voted in favour of the proposal, although Herdís Steingrímsdóttir would have preferred to hold interest rates unchanged.

The Committee was of the opinion that persistent inflation, inflation expectations above target, and strong domestic demand called for caution. As a result, it would be necessary to maintain an appropriately tight monetary stance in order 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

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 20 November 2024.