



MINUTES

MONETARY POLICY COMMITTEE



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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 March 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 March.

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 7 February 2024.

The Committee was given a presentation by the Ministry of Finance and Economic Affairs on the Government's actions related to the wage agreements and in response to the seismic activity in Grindavík.

Financial markets

Since the February meeting, the króna had depreciated by 0.1% in trade-weighted terms. Between meetings, the Bank bought foreign currency for 62 million euros (9.2 b.kr.). The Bank's transactions during the period accounted for 22.5% of total turnover in the foreign exchange market.

In terms of the Central Bank's real rate, the monetary stance had tightened since the February meeting. In terms of the average of various measures of inflation and one-year inflation expectations, the Bank's real rate was 3.8%, or 0.5 percentage points higher than just after the announcement of the February interest rate decision. In terms of twelve-month inflation, it was 2.5% and had risen by 0.1 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, but turnover in the market totalled 3 b.kr. during the period. Yields on long-term nominal Treasury bonds had fallen by as much as 0.2 percentage points since the February meeting, but yields on long-term indexed Treasury bonds were virtually unchanged over the same period. The average interest rate on inflation-indexed mortgages rose marginally between meetings, whereas non-indexed mortgage rates were broadly unchanged.

In terms of three-month interbank rates, the short-term interest rate differential had narrowed by 0.1 percentage points versus the US, to 4.2 percentage points, whereas it was unchanged at 5.9 percentage points

versus the euro area. The long-term interest rate spread narrowed by 0.3 percentage points between meetings, to 4.2 percentage points versus Germany and 2.4 percentage points versus the US. The CDS spread on the Treasury's five-year obligations in US dollars was 0.5% and had narrowed between MPC meetings. The spread between the Treasury's euro-denominated issues and German government bonds narrowed by 0.2 percentage points at the same time, to 0.9-1.1 percentage points.

Most analysts from financial institutions projected that the MPC would hold the policy rate unchanged, although some also forecast a rate cut of 0.25 percentage points. Analysts noted that inflation and inflation expectations were still above target and that underlying inflationary pressures were strong. Furthermore, wage agreements were still pending for large worker groups and the labour market remained tight. On the other hand, inflation had subsided somewhat, there were indications that the economy was continuing to cool, and the results of recently concluded wage agreements appeared favourable.

Annual growth in M3 measured just over 8% in January. Household deposits accounted for the majority of the increase, although businesses' share in growth had been on the rise in the previous three months. Year-on-year growth in credit system lending measured 6.1% in January and has continued to lose pace. Lending to households also grew by 6.1% between years in January, while lending to businesses grew 5.6%.

The Nasdaq OMXI15 index had fallen by 6.6% between meetings. Turnover in the Main Market totalled 236 b.kr. in the first two months of 2024, some 39% more than over the same period in 2023.

Global economy and external trade

According to the Organisation for Economic Cooperation and Development's (OECD) forecast from early February, global GDP growth is projected to ease from 3.1% in 2023 to 2.9% this year. This is 0.2 percentage points above the OECD's November forecast. The increase is due mainly to a more promising outlook for the US, where year-2024 GDP growth is now projected at 2.1%, or 0.6 percentage points more than in the last forecast. The outlook for the eurozone has worsened, however. As before, global GDP growth is expected to measure 3% in 2025. The OECD forecasts that inflation will rise marginally in the G20 countries, to an average of 6.6%. However, this is due mainly to Argentina, where inflation is projected at 251%, and Turkey, where it is forecast at nearly 50%. Excluding these two countries, the outlook for the G20 has improved since November, with inflation forecast to average 2.6% in 2024. In particular, prospects have improved for the US, Canada, India, and the eurozone, according to the OECD. Inflation in OECD countries is still expected to taper off to around 2.4% in 2025.

According to preliminary figures from Statistics Iceland, the deficit on goods trade measured 30 b.kr. in the first two months of 2024, as compared with a deficit of 23 b.kr. at constant exchange rates over the same period in 2023. Exported goods values increased by 5.6% year-on-year at constant exchange rates. The export value of marine products and aquaculture products increased, whereas there was a decline in the value of manufactured goods, particularly aluminium and ferrosilicon. At the same time, import values grew by 9%, with all key subcategories increasing year-on-year.

Global aluminium prices rose marginally after the MPC's February meeting, to about 2,200 US dollars per tonne by time of the March meeting. This was similar to the March 2023 price. Preliminary figures from Statistics Iceland indicate that foreign currency prices of marine products rose by 0.5% month-on-month in January but had fallen by 2.3% year-on-year. The global price of Brent crude fell by 11% between MPC meetings, to 87 US dollars per barrel by the time of the March meeting. This is about 18% higher than in March 2023. On the other hand, other commodity prices had fallen somewhat since the February meeting.

The real exchange rate in terms of relative consumer prices rose by 2% month-on-month in February. At that time it was 11% above its 25-year average and 2% higher than in December 2019. In the first two months of 2024, it had risen by 7.6% year-on-year, as the nominal exchange rate of the króna was 3.4% higher and inflation in Iceland was 4.2 percentage points above the trading partner average.

Domestic economy and inflation

According to preliminary figures published by Statistics Iceland at the end of February, GDP growth measured 0.6% in Q4/2023, somewhat below the forecast in the February *Monetary Bulletin*. For 2023 as a whole, GDP growth measured 4.1%, as compared with the February forecast of 3.6%. The majority of 2023 output growth was attributable to a 2.9 percentage point contribution from net trade, which in turn was due to growth in tourism and a contraction in imports. Both private and public consumption increased as well, while investment shrank between years. Previous figures were revised, and growth in domestic demand proved stronger in the first three quarters of 2023 than previously estimated. For the year as a whole, domestic demand growth measured 1.2%, as compared with the February forecast of 0.8%. Furthermore, GDP growth figures for 2020-2022 were revised sharply upwards, and year-2022 growth proved to be 8.9%, or 1.7 percentage points higher than the previous estimate. This increase is due to much stronger growth in investment, particularly business investment, and the revision is based on corporate asset register data available at the end of 2023, which show more investment in structures and rental vehicles than previously estimated.

Indicators of developments in private consumption in Q1/2024 are somewhat ambiguous. Payment card turnover grew year-on-year in the first two months of 2024, after contracting in the recent past, although the increase is due mainly to growth in card turnover abroad. According to the Gallup Consumer Confidence Index, households had grown less pessimistic during the quarter and the index had risen since the turn of the year. New motor vehicle registrations contracted again, however, after an uptick in late 2023.

According to the results of Gallup's spring survey, conducted in February and March among Iceland's 400 largest firms, respondents' attitudes towards the current economic situation were somewhat more positive than in the winter survey. Their expectations six months ahead were also more positive, as 31% of executives expected the economic situation to improve in six months' time, a somewhat larger share than in the winter. About 47% expected the economic situation to be unchanged over the next six months. Executives were also somewhat more upbeat about domestic and foreign demand than in the winter survey, especially those in miscellaneous specialised services and in the transport, transit, and tourism sector.

Prospects for firms' operating performance in 2024 deteriorated marginally relative to the autumn survey, with 28% of executives expecting weaker profits than in 2023 and 22% expecting this year's profits to be stronger. Some 29% of firms saw their profit margins increase in the previous six months, while 27% of firms' margins contracted. Just over half of firms assumed that their margins would remain unchanged in the coming six months, and another one-fourth expected them to contract. Expectations concerning investment during the year were unchanged from the autumn survey, and as in that survey, executives in transport, transit, and tourism were most optimistic about increased investment.

The seasonally adjusted results of Gallup's spring survey show that firms have scaled up their recruitment plans since the previous survey. The balance of opinion on staffing plans (i.e., firms planning to recruit as compared with those planning redundancies) was positive by 17 percentage points, whereas it had been positive by 9 percentage points in the winter survey. As a result, it was still 9 percentage points above its historical average. About 37% of executives considered themselves short-staffed, which is marginally higher than in the previous survey. The share of companies operating at close to full capacity rose between surveys as well, to 53%. Both shares were still more than 12 percentage points above their historical averages.

The general wage index rose by 0.5% month-on-month in January and by 7% year-on-year, and real wages were 0.4% higher during the month than at the same time in 2023.

Statistics Iceland's nationwide house price index, published at the end of February, rose by 0.6% month-on-month in February, after adjusting for seasonality, and by 5.4% year-on-year. The capital area house price index, calculated by the Housing and Construction Authority, rose by 0.9% month-on-month in January when adjusted for seasonality, and by 5.4% year-on-year. The number of purchase agreements registered nationwide rose by 24.6% year-on-year in the first two months of 2024, while the number of contracts for new construction increased by 80% over the same period. The average time-to-sale for properties in greater

Reykjavík was 3.5 months in February, slightly longer than the 3.1-month average from February 2023, but the number of homes for sale has fallen somewhat since November 2023.

The CPI rose by 1.33% month-on-month in February, and twelve-month inflation eased to 6.6%. Inflation excluding housing declined as well, to 4.7%. The difference between inflation including and excluding housing has grown recently and is at its largest since year-end 2022. Underlying inflation fell month-on-month as well, to 5.6% according to the average of various measures.

As is customary at this time of year, end-of-sale effects were discernible in February, and the price of clothing, footwear, furniture, and housewares rose. In the case of clothing and footwear prices, end-of-sale effects were stronger in February than in the same month of 2023. Public services prices rose 2.5% between months, owing mainly to a 17% hike in waste collection fees. The overall seasonal increase in public services prices at the beginning of 2024 was considerably larger than the average of the past few years.

Households' and businesses' two-year inflation expectations declined, according to Gallup's spring survey. Corporate executives expect inflation to measure 4% in two years' time, while households expect it to measure 5%. Furthermore, households' and businesses' long-term inflation expectations fell between surveys: corporate executives now expect inflation to average 4% over the next five years, while households expect it to average 5% over the same period. The breakeven inflation rate in the bond market had fallen slightly since the Committee's February meeting, and the five-year breakeven rate five years ahead was just under 3.5% in mid-March.

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 continued to rise since the February meeting. Members discussed whether the monetary stance was appropriate in view of the inflation outlook, as the Committee had decided at its February meeting to hold interest rates unchanged. At that time, inflation had eased somewhat, but long-term inflation expectations were broadly unchanged. Although labour market tightness had eased somewhat, pressures remained.

Committee members discussed the marginal decline in inflation, to 6.6% in February. Underlying inflation had eased as well but, like headline inflation, was well above the target. Inflation expectations were also above target, which could indicate that inflation would remain persistent.

The MPC observed that Statistics Iceland's recently revised national accounts showed that GDP growth had been stronger in recent years than was indicated by earlier figures. All else being equal, the revised figures suggested the presence of a larger positive output gap, although potential output was probably greater as well, as revisions of historical investment data weighed heavily in the updated GDP growth figures. The Committee was therefore concerned that demand pressures in the economy appeared to be stronger than previously estimated, although members agreed that economic activity was continuing to ease, as the monetary stance was tight.

The MPC noted that uncertainty had receded with the signing of private sector wage agreements. However, demand pressures in the economy could lead to more wage drift than would otherwise occur. Furthermore, fiscal measures could increase demand and inflationary pressures.

The Committee discussed the fact that inflation and inflation expectations were still high. Although growth in domestic demand had slowed in the recent term, indicators implied that it remained strong. It emerged that firms had scaled their hiring plans upwards again, the share of firms reporting staffing shortages was still high, and the strain on production factors was significant. The labour market therefore remained tight and unemployment low. Furthermore, housing market activity was still strong, and house prices had risen in

the recent term. It was also pointed out that there was a reasonable probability that 2023 GDP growth had been underestimated in the most recent data, as previous figures had been revised substantially. As a result, it was important to interpret the most recent data with caution. It also emerged in the discussion that even though the recent signing of long-term wage agreements was a positive development, there was some risk that firms would pass a large share of the wage hikes through to prices, as had happened at the beginning of 2023. Moreover, it was not yet clear how fiscal measures would be financed, what impact they would have on demand, and whether the fiscal stance would ease. It was pointed out that a high real rate was still needed to ensure that inflation would not remain persistent for a protracted period of time. The risk that the monetary stance was too loose to bring inflation back to target within an acceptable time frame was still greater than the risk that it was too tight. Unambiguous indications that inflation was clearly on the decline would have to emerge in order to make it possible to lower interest rates, and it was important to begin the monetary easing phase at a credible point in time.

It emerged in the discussion that growth in private consumption and economic activity had lost pace quickly in the recent past, as real interest rates had risen markedly. It was also noted that the revision of GDP growth figures for prior years could indicate that economic activity had slowed much more sharply in the recent term than would otherwise be the case, as the change was from a higher level. Uncertainty had receded between meetings, and recent surveys indicated that inflation expectations had inched downwards. It emerged that it was also important to consider the long-term impact of tight monetary policy.

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 Steingrímisdóttir, 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 considered the situation similar in most respects to that prevailing at the previous meeting but was of the view that uncertainty had diminished because of the signing of benchmark-setting private sector wage agreements. Furthermore, the real rate had continued to rise rapidly, and households' and businesses' situation had tightened. In addition, the effects of previous interest rate hikes had yet to emerge. In view of the current situation and the data available to the Committee, it was appropriate to begin lowering the policy rate incrementally.

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 Steingrímisdóttir, 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 8 May 2024.