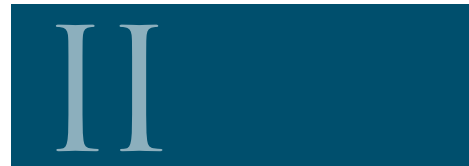


Monetary policy and domestic financial markets



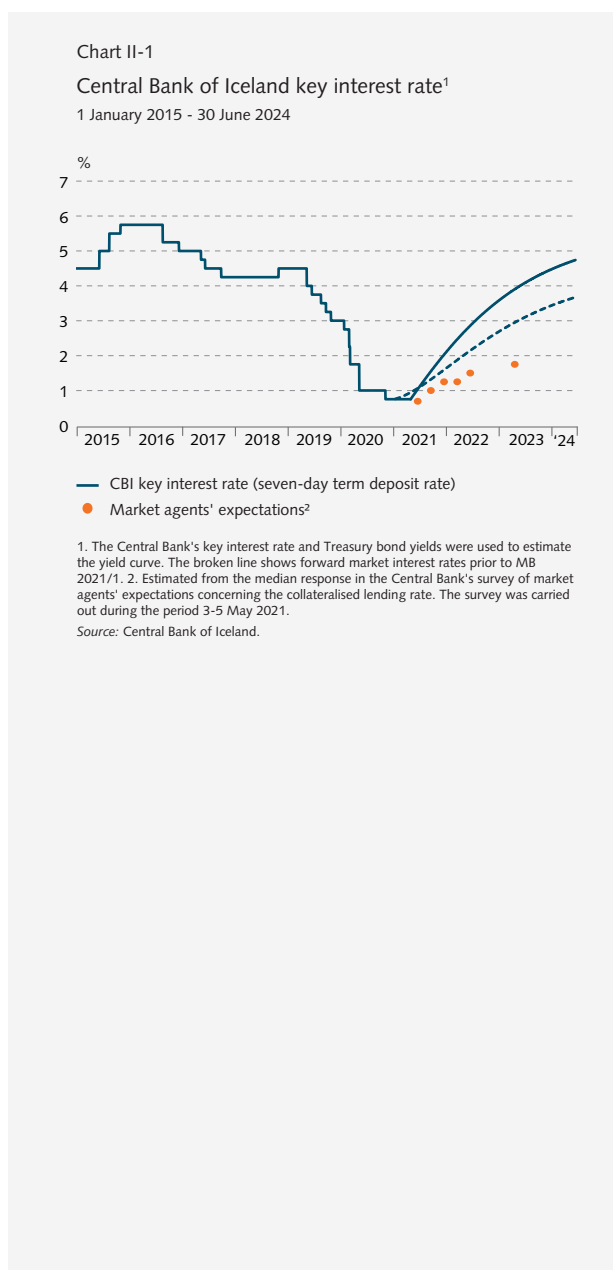
Monetary policy and market interest rates

Key rate unchanged since November ...

Prior to the publication of this *Monetary Bulletin*, the Bank's key interest rate – the rate on seven-day term deposits – was 0.75% (Chart II-1). It has been unchanged since November, when it was lowered by 0.25 percentage points. The baseline forecast assumes that, during the forecast horizon, the key rate will develop in line with the monetary policy rule in the Bank's quarterly macroeconomic model, which ensures that inflation will be broadly at the Bank's inflation target over the medium term.¹

According to the Bank's market expectations survey, taken in early May, respondents expect the Bank's key rate to rise to 1% in Q3/2021 and reach 1.25% by the year-end. They expect it to continue rising in 2022 and reach 1.75% in two years' time. This is a more rapid increase than they expected in the last survey, but forward rates suggest that rates will be 4% after two years.

The Bank's real rate has been negative since March 2020. In terms of the average of various measures of inflation and one-year inflation expectations, it is now -2.8% and has fallen by about 2.2 percentage points since May 2020. The interest rate differential with abroad has narrowed concurrent with the reduction in the key rate, and the short-term real rate in Iceland is now 2.2 percentage points below the trading partner average.



¹ According to the monetary policy rule in the model, the key interest rate is determined in part by developments in the Bank's neutral real rate, which is the real rate that would be required, all else being equal, to keep inflation at target and ensure full factor utilisation. As is discussed in Box 1 in *Monetary Bulletin* 2019/4, this rate is estimated to have fallen gradually to 2% during the post-crisis period. It is estimated to have fallen still further in the recent term, to around 1%.

... but long-term rates have risen

The yield on ten-year nominal Treasury bonds was 4.1% just before this *Monetary Bulletin* went to press. It has risen by 0.9 percentage points in 2021 to date (Chart II-2). The yield on five-year nominal Treasury bonds has risen in a similar manner. The yield on ten-year indexed Treasury bonds was 0.9% just before this *Monetary Bulletin* was published and has risen by 0.1 percentage points year-to-date.

Since mid-August 2020, when the current rise in nominal rates began, the yield on five-year nominal bonds has risen by 1.4 percentage points, and the ten-year yield has risen slightly more. As Chart II-3 shows, the increase initially reflected the rise in real rates, which stemmed in part from greater optimism about the GDP growth outlook and expectations of the Treasury's increased financing need. On the other hand, inflation expectations were broadly unchanged. Since the beginning of the year, however, the rise in nominal rates appears to have been driven largely by a pickup in breakeven inflation, reflecting rising inflation expectations and increased uncertainty about the inflation outlook (for further discussion, see Chapter V).

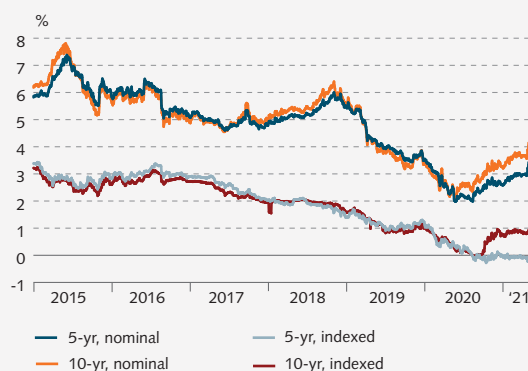
The spread between one-year and ten-year nominal bond rates is currently about 2.6 percentage points and has widened by 0.4 points in 2021 to date. The term premium on Treasury bonds therefore appears to have risen, as it has in many other countries (see Chapter I), reflecting greater hesitancy among investors to tie up their funds for long periods of time.

Revised Treasury issuance calendar

The Treasury's financing need has increased substantially because of the pandemic; however, terms on foreign borrowing have never been better, and the Treasury took advantage of this with a 750 million euro issue early this year. Given that the Treasury's position is better than was assumed when the last fiscal plan was prepared, estimated Treasury bond issuance for the year was reduced from 200 b.kr. to 180 b.kr., concurrent with the publication of Government Debt Management's most recent quarterly issuance calendar at the end of March. Furthermore, the Treasury has shifted more to long-term financing, whereas at the beginning of the pandemic it financed its deficit largely by issuing bills and short-term bonds.

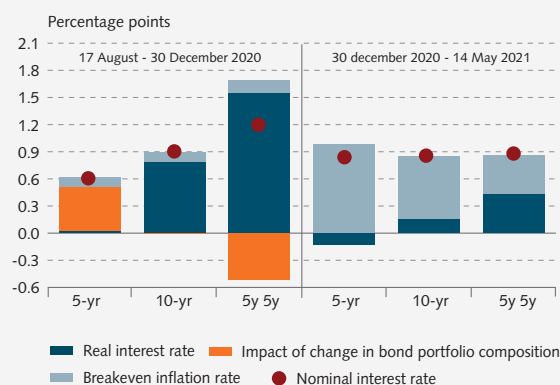
The Central Bank has bought Treasury bonds in the secondary market for a total of 18.9 b.kr. (Chart II-4). In H1/2020, the Bank bought Treasury bonds for around 900 m.kr., but in November it scaled its purchases upwards, buying for another 6.7 b.kr. from then until the

Chart II-2
Government-guaranteed bond yields¹
2 January 2015 - 14 May 2021



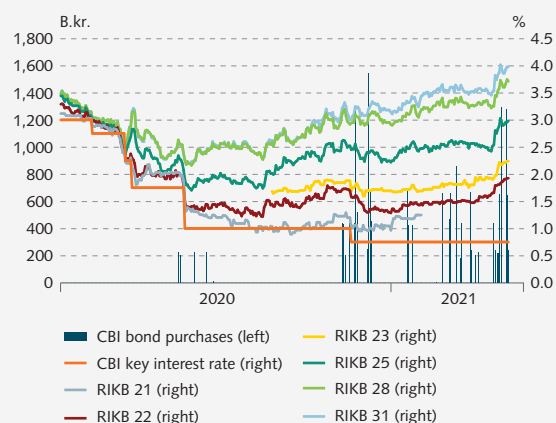
1. Based on the zero-coupon yield curve, estimated with the Nelson-Siegel method, using money market interest rates and Government-guaranteed bonds.
Source: Central Bank of Iceland.

Chart II-3
Breakdown of increase in nominal bond interest rate from August 2020 onwards¹



1. Change in nominal Treasury bond yields (estimated using the Nelson-Siegel method) and the contribution of corresponding changes in indexed bond yields and the breakeven inflation rate, adjusted for the effects of changes in the composition of the underlying bond portfolio on the calculation of the real zero-coupon yield curve.
Source: Central Bank of Iceland.

Chart II-4
Central Bank of Iceland bond purchases and nominal Treasury bond yields
2 January 2020 - 14 May 2021



Source: Central Bank of Iceland.

year-end. Since the last *Monetary Bulletin*, the Bank's bids have been accepted more often, and its purchases in 2021 to date total 11.4 b.kr.

Exchange rate of the króna

The króna has appreciated in the recent term ...

The króna has appreciated by 3% in trade-weighted terms since the February *Monetary Bulletin* and by 9% from its local trough last September (Chart II-5). The average exchange rate is still about 6% lower than when the pandemic reached Iceland, however.

Since last June, non-residents have sold domestic securities and exported the proceeds in larger amounts than before, with net sales totalling about 50 b.kr. in H2/2020. This trend has continued in 2021, and net sales of domestic securities in the first four months of the year have totalled nearly 60 b.kr. Domestic pension funds traded heavily in the foreign exchange market in late 2020, and their currency sales offset a significant amount of their increased currency purchases. Their net purchases have increased thus far in 2021, totalling 20 b.kr. in the first four months of the year.

The króna has therefore appreciated year-to-date in spite of net outflows from non-residents, worsening terms of trade, and unfavourable external trade. This is probably due in part to increased forward currency sales. The Central Bank intervened more actively in the foreign exchange market in H2/2020, and in September it began a programme of regular foreign regular currency sales with the aim of deepening the market and improving price formation. At the end of March, however, the Bank decided to cut back on its regular currency sales, and in early May it discontinued the programme altogether, as the foreign exchange market appeared to be better balanced than it had been the previous autumn.

... but will remain relatively stable during the forecast horizon, according to the baseline forecast

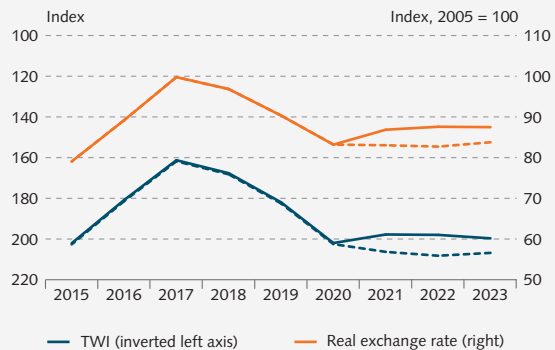
The trade-weighted exchange rate index (TWI) stood at 200 points in Q1/2021, and the króna was therefore about 1½% stronger, on average, than was forecast in the February *Monetary Bulletin*. Since mid-March, the TWI has fluctuated between 193 and 198 points. According to the baseline forecast, it will remain broadly in this range throughout the forecast horizon; therefore, the króna will be nearly 5% stronger in 2022 than was projected in February (Chart II-6). As a result, the real exchange rate will rise by a full 5% over the forecast period, although it will still be more than 12% below its 2017 peak at the end of the forecast horizon.

Chart II-5
Exchange rate of the króna¹
2 January 2015 - 14 May 2021



1. Price of foreign currency in krónur. Narrow trade index.
Source: Central Bank of Iceland.

Chart II-6
Exchange rate of the króna 2015-2023¹



1. The trade-weighted exchange rate index (TWI) is based on a narrow trade basket. Real exchange rate in terms of relative consumer prices. Central Bank baseline forecast 2021-2023. Broken lines show forecast from MB 2021/1.
Source: Central Bank of Iceland.

Money holdings and lending

Growth in money holdings has eased

Growth in money holdings began to ease early in 2021, after rising strongly in H2/2020. The rapid growth in 2020 can be attributed in part to the easing of the monetary stance and the Central Bank's implementation of special pandemic-related measures to boost financial system liquidity. Annual growth in M3 averaged 12.8% in Q4/2020 but slowed to 8.7% in Q1/2021 (Chart II-7).² Household deposits have grown markedly in the recent past, especially after the pandemic reached Iceland, and annual growth in deposits measured 11% in Q1/2021. This is largely attributable to reduced consumption options as a result of public health measures and Government support measures, although sizeable contractual pay rises and increased mortgage lending due to strong housing market activity are factors as well. Furthermore, financial sector deposits other than those owned by credit institutions have declined since last year.

Strong growth in lending to households ...

Credit system lending grew by an average of 5.2% year-on-year in 2020. The pace of growth increased over the course of the year, reaching 6.4% by Q4 (Chart II-8). Credit growth is driven by household lending, as corporate lending virtually stood still. Growth eased in Q1/2021, measuring 5.4%, and while the credit-to-GDP ratio has risen, it is still close to the average of the past decade.

Lending to households increased over the course of 2020. Twelve-month growth in the household credit stock peaked in November and has hovered around 10% since then. It stems almost entirely from increased mortgage lending, as the housing market has been lively in the recent past, fuelled by a significant drop in mortgage interest rates and a modestly leveraged household sector before the pandemic struck. Refinancing has accounted for a large share of the total, although it peaked as a share of total lending in October. Households have turned increasingly to non-indexed loans with variable interest rates. The commercial banks' market share has risen, but their covered bond issuance has not kept pace with the increase in lending; therefore, a larger share of their loan portfolio is financed with deposits than before.

Chart II-7

Money holdings¹

Q1/2014 - Q1/2021

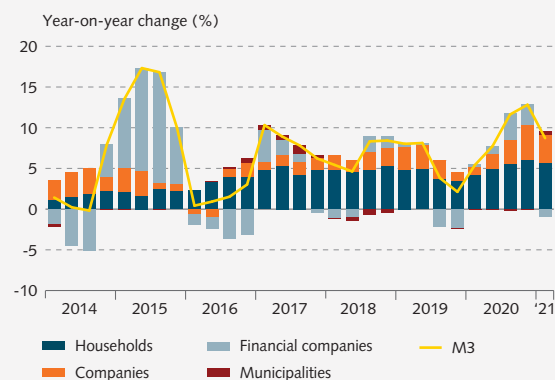
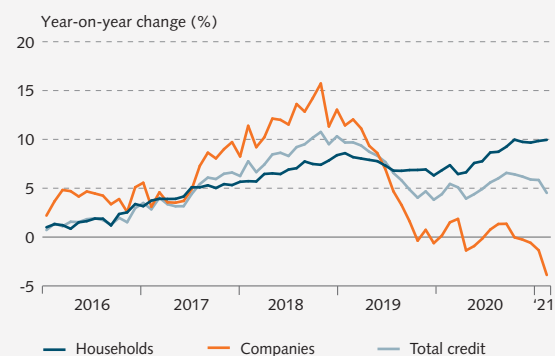


Chart II-8

Credit system lending¹

January 2016 - March 2021



² Several changes have been made to the method used to calculate money holdings, which relate to the reclassification of a number of Government-owned firms and institutions (see the 18 May 2021 press release on the Central Bank website).

... but corporate lending has begun to contract

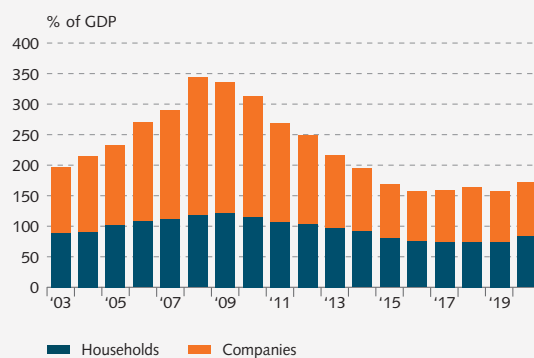
Corporate lending remained broadly flat year-on-year in 2020. The growth rate had slowed in 2019, alongside declining economic activity and higher returns required by banks on corporate loans. In 2021 to date, however, corporate lending has contracted. In Q1, the corporate credit stock was 2.5% smaller than in Q1/2020, and 4.3% smaller after adjusting for the impact of exchange rate movements on foreign-denominated corporate loans. Lending to individual sectors has either stalled or started to decline. Lending to construction companies gained pace early in 2020, but it slowed in the autumn, as new buildings have been selling well and construction companies' need for credit financing has been declining. Support loans and bridge loans, which bear a partial or full Treasury guarantee, have supported growth in lending to the companies affected most severely by the pandemic, however. Since July 2020, loans of this type have been granted in the amount of 12.4 b.kr. In addition, companies have obtained increased market financing, offsetting the contraction in lending, although financing through institutional investment funds has declined.

Debt ratios have risen, but credit spreads have been broadly unchanged recently

Household lending has grown rapidly in the recent term, and GDP contracted in 2020; therefore, the private sector debt-to-GDP ratio rose after having held virtually unchanged for four years (Chart II-9). The increase is relatively modest, however, and the debt-to-GDP ratio is now similar to that in 2015. There are no signs that households' financial conditions have deteriorated, either, and the non-performing household loan ratio is still low, at less than 3%. The corporate non-performing loan ratio rose sharply in 2020, however, and was still nearly 18% at the end of March (see also *Financial Stability 2021/1*). Most arrears are due to frozen loans, particularly loans to services firms and real estate companies. Corporate insolvencies have declined, however. Presumably, special Government measures (such as business closure subsidies) and forbearance measures from financial institutions have helped firms to withstand pandemic-induced revenue losses.

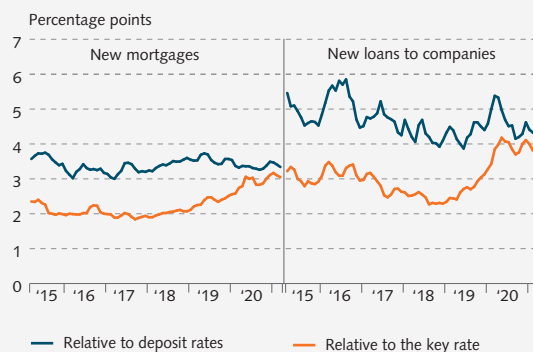
Even though households are more heavily leveraged than before, credit spreads on household loans have changed very little relative to the deposit rates offered to them (Chart II-10). Credit spreads on corporate loans rose sharply in early 2020 but peaked in March of that year and then declined later in 2020. They rose again towards the end of the year but have now begun to ease once more.

Chart II-9
Household and non-financial corporate debt¹
2003-2020



1. Debt owed to financial undertakings and market bonds issued. Excluding financial institutions (which includes holding companies).
Sources: Statistics Iceland, Central Bank of Iceland.

Chart II-10
Credit spreads¹
March 2015 - March 2021



1. The difference between a weighted average of the large commercial banks' non-indexed lending rates and, on the one hand, the Central Bank's key rate, and on the other, a weighted average of their deposit rates. Three-month moving average.
Source: Central Bank of Iceland.

Asset prices

House prices have risen markedly, and market turnover has been strong ...

After the pandemic started in 2020, real estate market activity began to increase steadily, peaking in H2. The ratio of market turnover to GDP was 21% in 2020 as a whole, the highest since 2007 (Chart II-11). Activity in the market has continued to grow in 2021 to date. The number of registered purchase agreements rose by nearly 47% year-on-year in Q1/2021, and the number of flats for sale has fallen. House prices have risen as a result. In 2020, the twelve-month increase in capital area house prices peaked at 7.7% in December. At the beginning of 2021 it tapered off slightly, but then in March the pace quickened again, to 10.7% (Chart II-12).

A large number of new flats have been sold recently, and the number of contracts for newly constructed properties has risen by 87% over the same period. The increased share of new properties in the data used to measure prices may well exaggerate the rise in prices. The number of first-time buyers in the capital area has also increased rapidly, reaching a record high of one-third of homebuyers in Q1/2021. There has been keen interest in Government equity loans, which are intended to give first-time buyers easier access to the housing market and boost demand for new, economical housing.

... but price increases do not appear out of line with fundamentals

The decline in interest rates in 2020 has given asset prices a lift and stimulated demand for owner-occupied housing. The rental market has softened as a result, and the contraction in tourism has both reduced demand for rental housing and boosted supply, as many properties previously used for short-term tourist rentals have been put on the long-term rental market. Rent prices have therefore fallen significantly and were down 0.6% year-on-year in March.

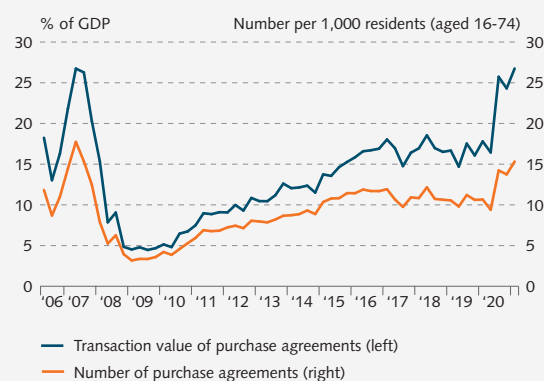
Even though house prices have risen noticeably in the recent term, they have developed broadly in line with macroeconomic fundamentals, and there are no unambiguous signs that imbalances have developed. Chart II-13 gives a comparison of developments in house prices with a forecast from the Bank's macroeconomic model, from Q1/2019 through Q1/2021. House prices have risen less than could have been expected based on the historical relationship between house prices, disposable income, and real mortgage interest rates.³ Imbalances

3 Similar results are obtained using statistical tests that identify asset price bubbles (the GSADF test developed by P. C. B. Phillips, S. Shi, and J. Yu, 2015, "Testing for multiple bubbles: Historical episodes of exuberance and collapse in the S&P 500", *International Economic Review*, 56, 1043-1078).

Chart II-11

Number and transaction value of house purchase agreements nationwide¹

Q2/2006 – Q1/2021



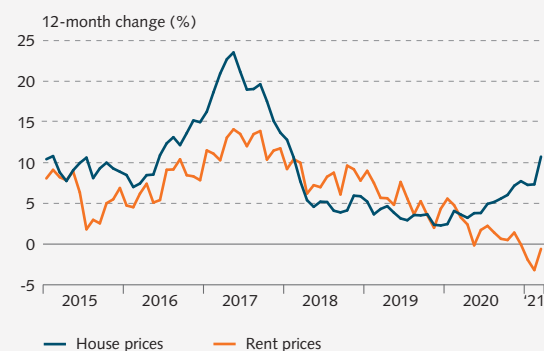
1. Number and transaction value of purchase agreements on date of purchase. Number and transaction value of purchase agreements, seasonally adjusted by the Central Bank. GDP data from Statistics Iceland. Central Bank baseline forecast for GDP in Q1/2021.

Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

Chart II-12

House prices and rent¹

January 2015 - March 2021



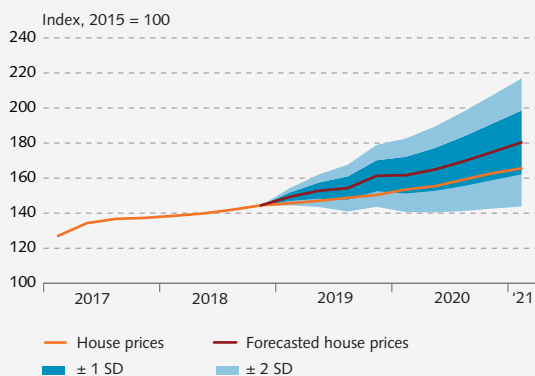
1. House prices and rent prices in the capital area.

Source: Registers Iceland.

Chart II-13

Actual and forecast house prices¹

Q1/2017 - Q1/2021



1. Forecasted house prices according to a dynamic forecast from Q1/2019 - Q1/2021 using the Central Bank of Iceland house price equation in QMM, estimated over the period Q3/2001 - Q4/2017.

Source: Central Bank of Iceland.

could develop, however, if price hikes are increasingly debt-driven in the coming term. It is also important to bear in mind that the fundamentals that have supported house prices recently could reverse, causing house prices to give way again; for example, an increase in interest rates could create challenges for households that have financed home purchases at the low rates currently on offer.

Share prices have risen despite the economic contraction

The OMXI10 index has risen 16% year-to-date. In February it passed the 3,000-point mark for the first time since the financial crisis a dozen years ago. The domestic equity market has been vibrant so far this year, with turnover up 22% year-on-year in Q1 and the trade count up 42%. Low interest rates probably play a major role in share price increases, as prices are now 50% higher than they were before the pandemic reached Iceland. With rising prices, the share of direct pledging in the market has fallen. Between end-February 2020 and end-April 2021, the market value of listed shareholdings owned by individuals rose by 37 b.kr.

