Monetary policy and domestic financial markets

II

Monetary policy and market interest rates

Key rate raised still further

Prior to the publication of this *Monetary Bulletin*, the Bank's key interest rate – the rate on seven-day term deposits – was 2.75% (Chart II-1). It was raised by 1.25 percentage points in 2021 and another 0.75 percentage points in February 2022. Short-term market rates have risen accordingly.[1]

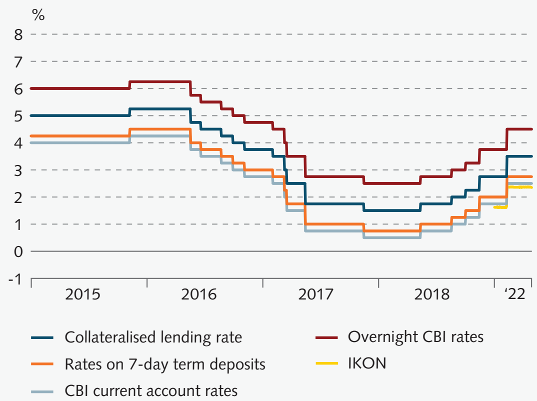
The Bank's key rate is now at the same level as it was before the COVID-19 pandemic reached Iceland in February 2020. The Bank's real rate is lower, however, as inflation is considerably higher and short-term inflation expectations are above the level prevailing during the lead-up to the pandemic. The Bank's real rate, based on the average real rate as calculated from various measures of inflation and one-year inflation expectations, is currently -3.3%, whereas it was 0.4% in February 2020. It is also 0.7 percentage points lower than it was before interest rates were raised in February 2022. The interest rate differential with abroad has widened, however, and short-term real rates in Iceland are now 1.9 percentage points above the trading partner average.

The baseline forecast assumes that the key rate will develop in line with the monetary policy rule in the Bank's quarterly macroeconomic model, which ensures that forecasted inflation is in line with the Bank's inflation target over the medium term.

Chart II-1

Central Bank of Iceland interest rates and short-term market rates

2 January 2018 - 29 April 2022



Source: Central Bank of Iceland.

1 The Central Bank started publishing data on the IKON rate (Icelandic króna overnight rate) at the beginning of April 2022. This new reference rate, derived from market rates on unsecured overnight deposits with the commercial banks, is considered a more accurate benchmark for short-term rates in Icelandic krónur than conventional interbank rates are, as it is based on far more trading activity than interbank rates.

According to the survey taken by the Bank in April, market agents expect the key rate to be raised even further, to 4.5% by the year-end and 4.75% by mid-2023 before starting to ease back again (Chart II-2). This is a larger rate hike than they expected in the last survey. Forward interest rates also suggest larger rate hikes than expected in February. Furthermore, the dispersion of market agents' responses on interest rates, inflation, and the exchange rate has increased since the last survey, indicating greater uncertainty.

Long-term nominal rates are at their highest in three years …

The yield on ten-year nominal Treasury bonds has risen by 1.1 percentage point year-to-date. It was 5.3% just before this *Monetary Bulletin* was published (Chart II-3). Long-term nominal rates are at their highest since March 2019. The yield on five-year nominal bonds has risen somewhat more, or 1.4 percentage points, and the slope of the yield curve has flattened slightly. The yield on ten-year inflation-indexed Treasury bonds has risen by 0.1 percentage point year-to-date, to 0.8% just before this *Monetary Bulletin* went to press.

… owing mainly to a rise in the breakeven inflation rate

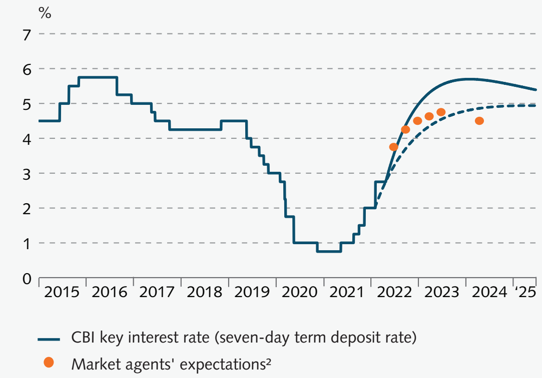
The rise in nominal bond yields since last autumn can be attributed for the most part to rising inflation expectations and increased uncertainty about the inflation outlook. This is reflected in the breakeven inflation rate, which rose sharply until the Bank's February interest rate decision, particularly after the publication of the January CPI measurement, which rose more than investors had expected (Chart II-4). The breakeven rate rose still further after Russia invaded Ukraine on 24 February, an event that has exacerbated inflationary pressures worldwide (see Box 2).

Demand for inflation-indexed bonds has been strong recently, but supply is limited, and most of the bonds are owned by pension funds. In addition, uncertainty about inflation has grown during the year, as can be seen, for instance, in greater dispersion of responses on inflation and interest rates in the Bank's most recent market expectations survey. Therefore, part of the rise in the breakeven rate probably stems from a higher inflation uncertainty premium, in addition to the effects of the limited supply of indexed bonds. Even so, the higher breakeven rate also reflects a rise in inflation expectations (see Chapter V).

Chart II-2

Central Bank of Iceland key interest rate[1]

1 January 2015 - 30 June 2025



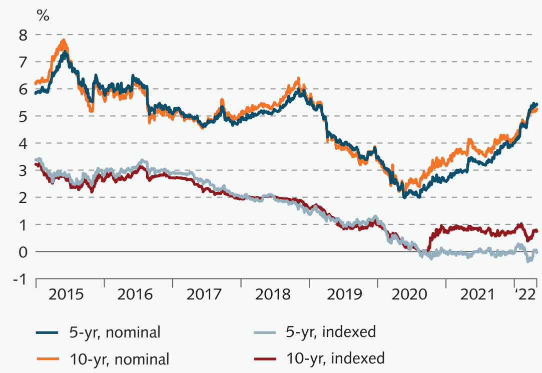
1. The Central Bank's key interest rate and Treasury bond yields are used to estimate the yield curve. The broken line shows forward market interest rates prior to MB 2022/1. 2. Estimated from the median response in the Central Bank's survey of market agents' expectations concerning the collateralised lending rate. The survey was carried out during the period 19-22 April 2022.

Source: Central Bank of Iceland.

Chart II-3

Government-guaranteed bond yields[1]

2 January 2015 - 29 April 2022

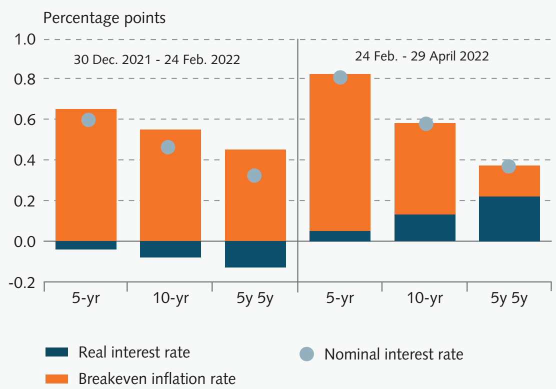


1. Based on the zero-coupon yield curve, estimated with the Nelson-Siegel method, using money market interest rates and Government-guaranteed bonds.

Source: Central Bank of Iceland.

Chart II-4

Breakdown of change in nominal bond interest rates[1]



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.

Source: Central Bank of Iceland.

Exchange rate of the króna

The króna has appreciated year-to-date …

After sliding through much of 2021, the króna began to appreciate vis-à-vis the trading partner average towards the end of the year. It kept strengthening in early 2022, until Russia's invasion of Ukraine, when it fell sharply (Chart II-5). The appreciation during the period before the invasion partly reflected increased optimism about the relaxation of public health measures and a brighter overall economic outlook. The exchange rate was supported still further by increased forward currency sales, after authorisations for derivatives trading involving the króna were expanded significantly in mid-2021. Exporters have used this increased flexibility to sell their future foreign exchange revenues forward, and speculative trading has probably increased as well. However, the invasion of Ukraine caused severe turmoil in financial markets, and for a while investors sought out the secure assets and currencies that are considered a safe haven in times of heightened uncertainty. Strong downward pressure on the króna ensued, and the Central Bank sold large amounts of foreign currency in late February and early March, in line with its intervention policy. The sudden depreciation in the wake of the invasion may also have taken place because some of the investors that had sold currency via forward contracts closed their positions when uncertainty spiked. The króna began to appreciate again in early March, however, but by then it had weakened by 3.3% since the war began. It is now 1% higher than before the invasion and 3.9% stronger compared to a year ago. The trade weighted index is currently close to the level just before the pandemic hit Iceland in late February 2020.

Capital flows due to new investment were relatively limited from mid-2021 until March 2022, whereupon they increased marginally, owing in part to the Treasury's sale of shares in Íslandsbanki but also to increased inflow into Government bonds. The possibility of a further increase in inflows later this year cannot be ruled out, as the domestic stock market will be moved to the secondary emerging market category by FTSE Russell this coming September. The pension funds' net foreign currency purchases totalled 14.6 b.kr. in the first three months of 2022. Their purchases have declined since before the pandemic, as their foreign assets have grown markedly and some of the pension funds are approaching the foreign asset threshold provided for in their investment strategies.

… and is projected to remain broadly unchanged over the forecast horizon

The trade-weighted exchange rate index (TWI) stood at 191 points in Q1/2022, and the króna was therefore

Chart II-5

Exchange rate of the króna[1]

2 January 2015 - 29 April 2022

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

about 1% stronger, on average, than was forecast in the February *Monetary Bulletin*. According to the baseline forecast, it will remain broadly at that level throughout the forecast horizon (Chart II-6). The real exchange rate will therefore be nearly 6% higher by 2024 than it was, on average, in 2021, and a full 8% below its 2017 peak.

Money holdings and lending

Growth in money holdings driven by an increase in corporate deposits

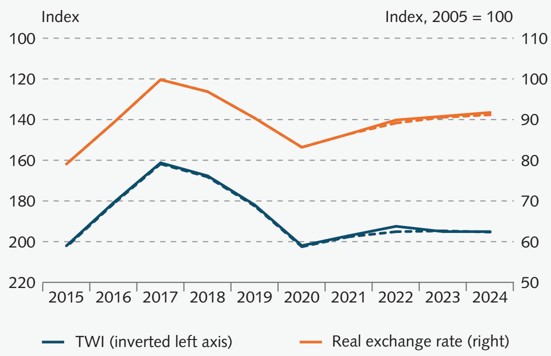
Year-on-year growth in M3 measured 11.8% in Q1/2022, somewhat more than in 2021 (Chart II-7). Growth picked up over the course of last year, in line with an increase in corporate deposits. Corporate deposits have grown in nearly all sectors in tandem with rising turnover, although the lion's share of the increase stems from services companies. Increased activity in tourism may explain this trend in part, although companies in the services sector are a diverse group. Furthermore, deposits owned by non-bank financial institutions have picked up again, after contracting for virtually all of 2021. Growth in household deposits remains strong, at 6.9% year-on-year in Q1/2022, although the pace has eased relative to Q1/2021, when it measured nearly 11%. This coincides with the slowdown in mortgage lending towards the end of last year, the waning impact of the pandemic on individuals' consumption capacity, and a decline in household saving (see Chapter III).

Mortgage lending growth has eased ...

Year-on-year growth in credit system lending has been relatively stable at around 6% over the past year (Chart II-8). As before, lending to households accounts for most of the increase, although the pace of growth has started to ease. Year-on-year growth in credit system lending to households is estimated to have grown just over 10% in Q1/2022 but has subsided since mid-2021, when it peaked at nearly 11½%. It is likely that policy rate hikes are starting to affect mortgage lending growth; furthermore, it appears that refinancing is on the decline and that households are less inclined to use increased collateral capacity to finance other consumption spending. The results of the Central Bank's new lending survey, carried out in April, suggest that demand for mortgages will stand still or ease further during the year (see Box 3 in *Financial Stability* 2022/1). Concurrent with the slowdown in mortgage lending by the commercial banks, prepayment of pension fund loans has declined, as some of the pension funds are now offering better terms than the banks do.

Chart II-6

Exchange rate of the króna 2015-2024[1]

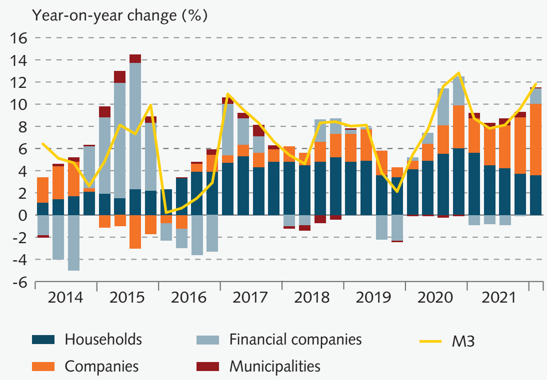


1. The trade-weighted exchange rate index (TWI) is based on a narrow trade basket. Real exchange rate in terms of relative consumer prices. Central Bank baseline forecast 2021-2024. The broken lines show forecast from MB 2022/1.
Source: Central Bank of Iceland.

Chart II-7

Money holdings[1]

Q1/2014 - Q1/2022

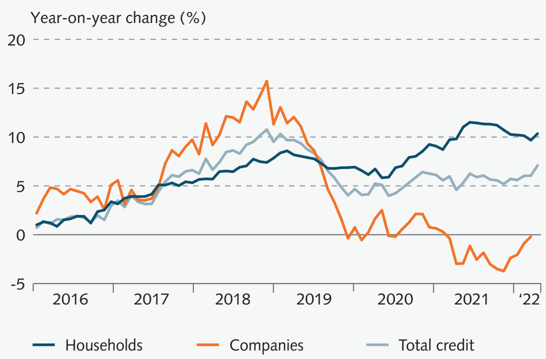


1. M3 is adjusted for deposits of failed financial institutions. Companies include non-financial companies and non-profit institutions serving households.
Source: Central Bank of Iceland.

Chart II-8

Credit system lending[1]

January 2016 - March 2022



1. Credit stock adjusted for reclassification and effect of Government debt relief measures. Excluding loans to deposit institutions, failed financial institutions, and the Government. Companies include non-financial companies and non-profit institutions serving households. March 2022 figures are Central Bank estimates but data on corporate lending is not available that month.

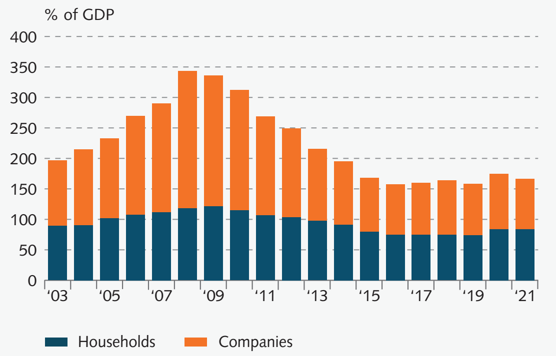
... but corporate lending has stopped contracting
Credit system lending to companies remained broadly flat between years in Q1/2022 but increased slightly when adjusted for the effects of exchange rate changes on foreign-denominated corporate loans. Net new lending to businesses has increased in the recent term, and corporate credit growth may therefore be picking up again after contracting continuously since the beginning of 2021. This probably reflects increased need for investment in tandem with greater economic activity, and the first signs of an upturn in lending to the construction sector can now be seen (see Chapter III). Furthermore, corporate executives are more optimistic than before, though there is increased uncertainty due to the war in Europe and the growing impact of supply-chain problems. Despite this, the commercial banks do not expect large changes in the demand for corporate loans during the year. In addition to this, some firms have sought funding directly from the market or through alternative investment funds.

Households and businesses well positioned
Household debt has increased somewhat since before the pandemic but remains moderate (Chart II-9). Household arrears have also declined and are low in historical context. Furthermore, households' net worth improved throughout the pandemic, and the household saving ratio is still above its historical average (see Chapter III). It is therefore safe to assume that households are quite resilient on the whole, and reasonably well equipped to face the effects of higher interest rates and inflation.

Expectations about further interest rate hikes have apparently prompted more households to take non-indexed fixed-rate loans, even though they bear higher interest than variable-rate loans do. Credit spreads on non-indexed mortgages have also narrowed slightly, as interest rates on new mortgages have risen less than deposit rates and the Central Bank's key rate have (Chart II-10).

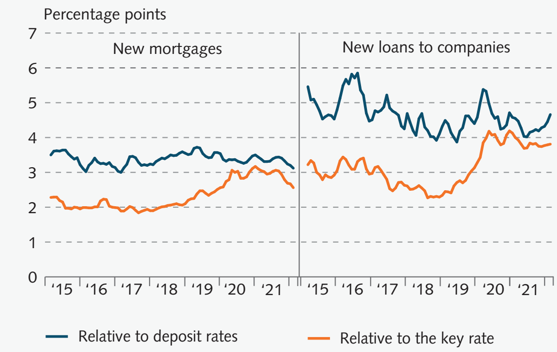
In spite of the economic contraction, corporate debt has declined slightly since before the pandemic, and firms appear better positioned than was anticipated at the onset of the pandemic. Although the firms hit hardest by the pandemic are still vulnerable, many companies less affected by it have been doing well. Some of Iceland's larger firms took advantage of easier access to credit and lower interest rates and refinanced their debt on better terms, although credit spreads on new loans have generally widened in comparison with the deposit rates offered to companies (Chart II-10). In addition, the banks' corporate loan losses have been less than was projected early in the pandemic, and corporate arrears declined in 2021.

Chart II-9
Household and non-financial corporate debt[1]
2003-2021



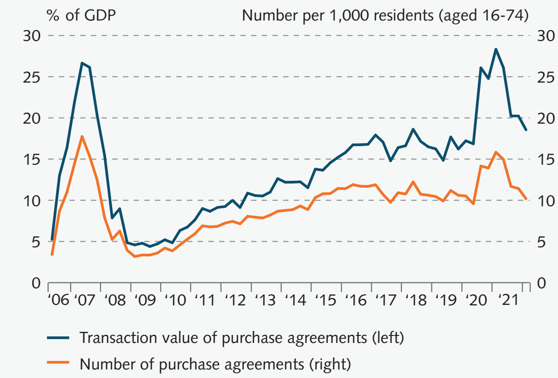
1. Debt owed to financial undertakings and market bonds issued. Excluding financial institutions (which includes holding companies).
Sources: Statistics Iceland, Central Bank of Iceland.

Chart II-10
Credit spreads[1]
March 2015 - March 2022



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.

Chart II-11
Number and transaction value of house purchase agreements nationwide[1]
Q2/2006 – Q1/2022



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, but GDP data by Statistics Iceland. Central Bank baseline forecast for GDP in Q1/2022.
Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

Asset prices

Residential property in short supply, and prices have kept rising …

House prices have surged in the recent past, with real estate market activity starting to pick up in late 2020 and peaking in H1/2021. Lower interest rates, significant accumulated savings, and higher disposable income made it easier for households to buy larger homes and enabled a larger share of first-time buyers to invest in their first home. Since interest rates began rising in mid-2021, market activity has subsided somewhat, and the number of purchase agreements per 1,000 inhabitants is now back to the pre-pandemic level (Chart II-11). In spite of this, house prices have kept rising, with the year-on-year increase in greater Reykjavík measuring 22.2% in March 2022, the second biggest surge since the May 2017 peak (Chart II-12). Presumably, limited supply is a major contributing factor: in April, an all-time record low of roughly 1,000 properties were advertised for sale nationwide, down from nearly 2,200 a year earlier. This severe mismatch between supply and demand can also be seen in an unusually large share of homes that sell above the asking price. The proportion of homes selling at a premium has more than quadrupled since mid-2020 and is at its highest since measurements were introduced (Chart II-13). In addition, the average time-to-sale has been very short, at about 1.2 months in March.

… well in excess of fundamentals ever since mid-2021

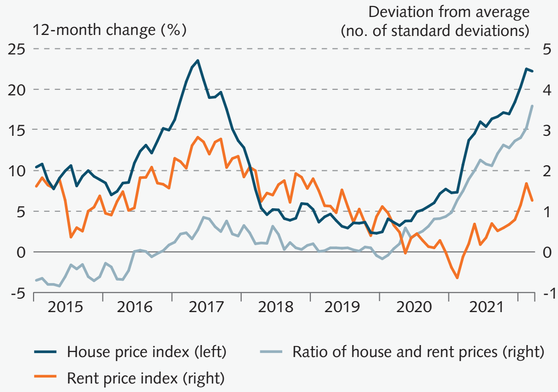
Rent prices have jumped this year and were up 6.3% year-on-year by March (Chart II-12). To a degree, the increase is due to a resurgence in immigration and the number of young people who seek out rental property, as the share of first-time homebuyers has begun to fall again after rising steeply in recent years. Even so, house prices have increased far in excess of rent, with the result that the ratio of house prices to rent has kept rising and is now well above its historical average. A similar trend has been seen in many other advanced economies, where substantial capital has been invested in the housing market because of low interest rates and generous government support measures during the pandemic (Chart II-14). As in many of these countries, there are signs that the rise in house prices since mid-2021 has been larger than can be explained by macroeconomic fundamentals (Chart II-15).[2]

2 Based on a dynamic forecast prepared using the house price equation from the Bank's macroeconomic model. For further discussion, see Chapter II of *Monetary Bulletin* 2021/4.

Chart II-12

House prices and rent[1]

January 2015 - March 2022



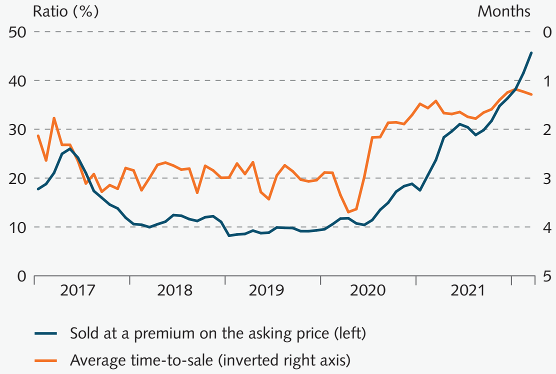
1. House prices and rent in the greater Reykjavík area. Deviation of the house price-to-rent ratio from the 2011-2022 average, measured in number of standard deviations.

Sources: Registers Iceland, Central Bank of Iceland.

Chart II-13

Residential properties sold at a premium on the asking price and average time-to-sale nationwide[1]

January 2017 - March 2022

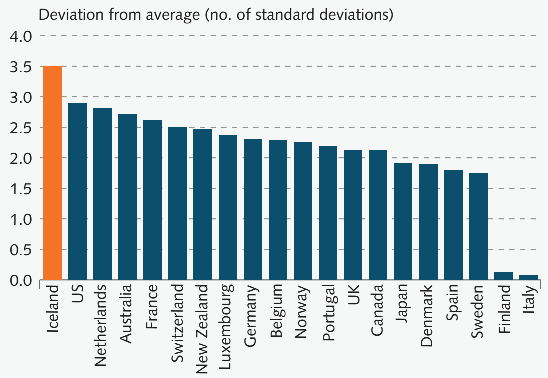


1. Properties sold at a premium on the asking price as a percentage of properties for sale. Three-month moving average. The number of purchase agreements is seasonally adjusted by the Central Bank.

Sources: Housing and Construction Authority, Morgunbladid Real Estate Website (mbl.is), Registers Iceland, Central Bank of Iceland.

Chart II-14

House prices-to-rent ratios in selected OECD-countries[1]



1. Data for Iceland in Q1/2022 and for Q4/2021 in other countries, except Netherlands and New-Zealand in Q3/2021 and Japan in Q2/2021.

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

Tighter financial conditions and increased supply should ease price pressures in the housing market

It seems clear that the number of homes built during the pre-pandemic years did not satisfy the increased demand for housing in the wake of the pandemic. As is discussed in Chapter III, construction activity has been picking up in the recent past, which should ease supply constraints and price pressures in the housing market in the coming term. In addition, the reduction in the maximum LTV ratio on new mortgages, the new rules capping debt service-to-income ratios, and Central Bank interest rate hikes should slow down house price inflation.

According to the baseline forecast, house price inflation is expected to slow down in H2/2022, although the situation is uncertain. For instance, the war in Europe has pushed many commodity prices sharply upwards, and shortages of inputs could result. This could complicate matters for construction companies, cause a setback in plans to boost housing supply, and contribute to further rises in housing costs. There is also some uncertainty about the impact of the upcoming wage negotiations and the economic outlook more generally. A sudden increase in immigration and a surge in demand for short-term rental housing for foreign workers could put more pressure on house prices than is currently envisioned.

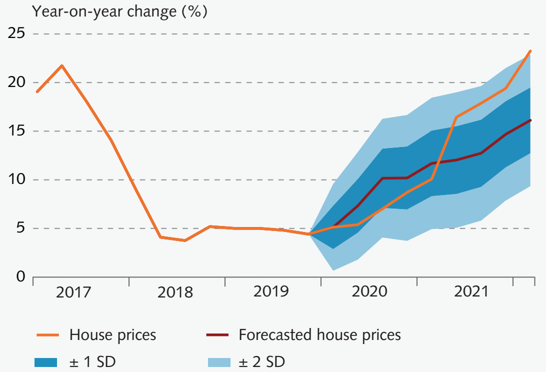
Share price volatility in the wake of the Ukraine invasion

The Nasdaq Iceland OMXI10 index has fallen by nearly 11% year-to-date (Chart II-16). As has been the case in many markets abroad, the equity market was highly volatile in the wake of the invasion, causing the price of shares listed on the Nasdaq exchange to fall when investors shifted to safer assets. The post-invasion decline in share prices reached 12% in early March, and apparently there were widespread demands for additional collateral and forward contracts were closed out, either entirely or in part. Prices have recovered to a large extent, but they are still about almost 7% lower than before the invasion. Stock market turnover totalled 176 b.kr. in Q1/2021, which is consistent with the average turnover over the past year.

Chart II-15

Actual and forecasted house prices[1]

Q1/2017 - Q1/2022



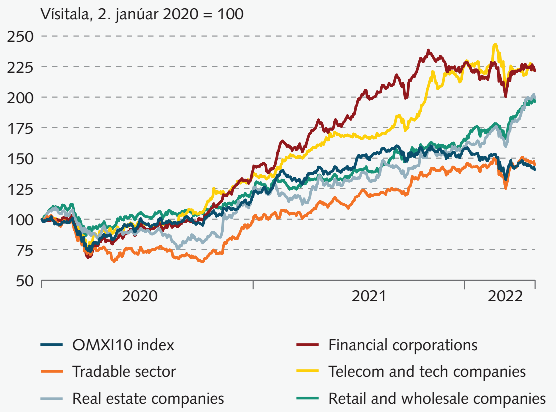
1. Forecasted year-on-year change in house prices from Q1/2020 through Q1/2022, obtained with a dynamic forecast using a house price equation similar to the one from the Bank's macroeconomic model, estimated for the period from Q3/2001 through Q4/2017.

Sources: Registers Iceland, Central Bank of Iceland.

Chart II-16

Share prices by sector[1]

2 January 2020 - 29 April 2022



1. Average change in share price of listed companies in selected sectors, adjusted for dividend payments and share capital reductions.

Sources: Kodiak Pro, Nasdaq Iceland.