III Monetary policy and domestic financial markets

The Central Bank's key interest rate has been unchanged since November 2018, and the Bank's real rate has been broadly unchanged since February. Market agents expect the key rate to be lowered this year, and long-term interest rates are now at their lowest since nominal rates were liberalised in the 1980s. After depreciating last autumn, the króna has held broadly stable in 2019 to date. Growth in M3 eased at the beginning of the year, and corporate lending growth has slowed since the autumn, whereas household lending growth is still gathering pace. House price inflation has tapered off. The private sector debt ratio has risen slightly but is low in historical context. Some lenders have tightened their lending requirements, but private sector financial conditions appear broadly unchanged in other respects.

Monetary policy

Central Bank key rate unchanged since November 2018 ...

The Central Bank's Monetary Policy Committee has held the Bank's interest rates unchanged since November 2018. Prior to the publication of this *Monetary Bulletin*, the Bank's key interest rate – the rate on seven-day term deposits – was 4.5% (Chart III-1). Accepted rates in auctions of bills issued by the Treasury and the banks have developed in line with the Bank's key rate, as have rates in the interbank market for krónur, but trading in the interbank market has been sparse year-to-date.

... and the Bank's real rate is broadly unchanged since February

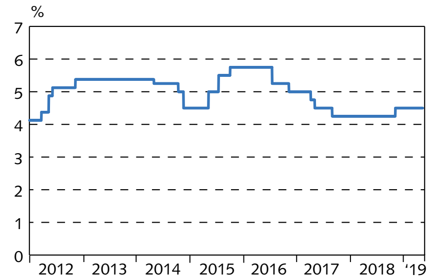
The Bank's real rate in terms of the average of various measures of inflation and one-year inflation expectations is now 1%, broadly where it was just before the February *Monetary Bulletin* but down 0.5 percentage points since mid-May 2018 (Table III-1). The real rate in terms of current twelve-month inflation has developed in a similar manner and is currently 1.2%. Other real rates have generally developed in line with the Bank's key rate (Chart III-2).

Table III-1 The monetary stance (%)

Real interest rate in terms of:[1]	*Current stance (17 May '19)*	*Change from MB 2019/1 (1 Feb. '19)*	*Change from MB 2018/2 (11 May '18)*
Twelve-month inflation	1.2	0.1	-0.7
Business inflation expectations (one-year)	0.5	0.0	-0.7
Household inflation expectations (one-year)	0.5	0.0	-0.7
Market inflation expectations (one-year)[2]	1.5	0.5	-0.1
One-year breakeven inflation rate[3]	1.2	0.2	-0.4
Central Bank inflation forecast[4]	1.5	0.3	-0.1
Average	1.0	0.1	-0.5

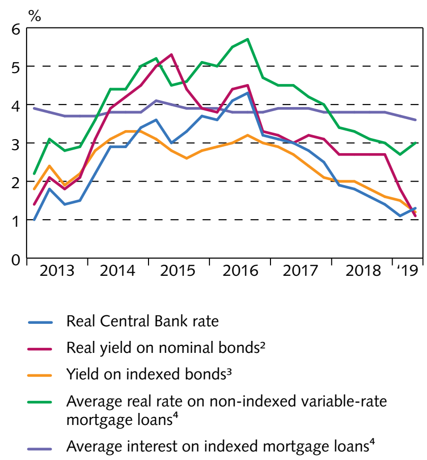
1. The nominal rate on financial institutions' seven-day term deposits with the Central Bank. 2. Based on survey of market participants' expectations. 3. The one-year breakeven inflation rate based on the difference between the nominal and indexed yield curves (five-day moving average). 4. The Central Bank forecast of twelve-month inflation four quarters ahead.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-1
Central Bank of Iceland key interest rate[1]
2 January 2012 - 17 May 2019



1. The Central Bank's key interest rate is defined as follows: the 7-day collateralised lending rate (until 31 March 2009), the rate on deposit institutions' current accounts with the Central Bank (1 April 2009 - 30 September 2009), the average of the current account rate and the rate on 28-day certificates of deposit (1 October 2009 - 20 May 2014), and the rate on 7-day term deposits (from 21 May 2014 onwards).
Source: Central Bank of Iceland.

Chart III-2
Real Central Bank interest rate and real market rates[1]
Q1/2013 - Q2/2019

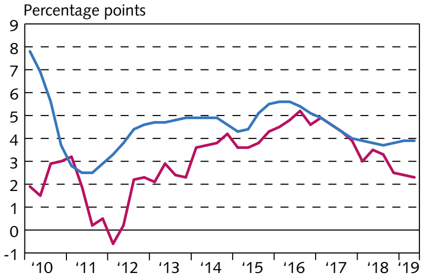


1. Based on data until 17 May 2019. 2. Five-year rate from the estimated nominal yield curve. 3. Five-year rate from the estimated real yield curve. 4. Simple average lowest lending rates from the three largest commercial banks. Fixed-rate period of five years or more on indexed mortgage loans.
Source: Central Bank of Iceland.

Chart III-3

Interest rate differential with main trading partners[1]

Q1/2010 - Q2/2019



Short-term nominal interest rate differential

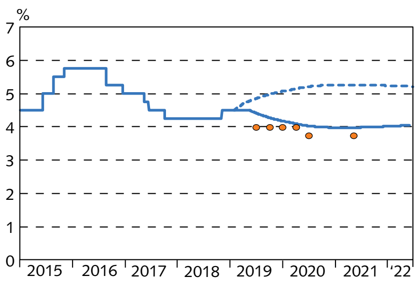
Short-term real interest rate differential

1. The difference between the Central Bank of Iceland's key interest rate and the weighted average key rate in Iceland's main trading partner countries. Real rates are based on current twelve-month inflation. Based on data until 17 May 2019. Central Bank baseline forecast Q2/2019 for international data.
Sources: Thomson Reuters, Central Bank of Iceland.

Chart III-4

Central Bank of Iceland key interest rate and expected developments[1]

1 January 2015 - 30 June 2022



CBI key interest rate (seven-day term deposit rate)

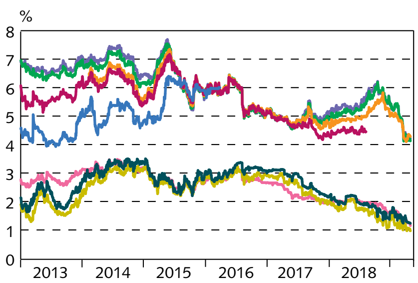
Market agents' expectations[2]

1. The Central Bank's key interest rate and Treasury bond yields were used to estimate the yield curve. Broken lines show forward market interest rates prior to MB 2019/1. 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 6-8 May 2019.
Source: Central Bank of Iceland.

Chart III-5

Nominal and indexed bond yields

2 January 2013 - 17 May 2019



Nominal Treasury bond maturing in:

2016 2019 2020 2025 2031

Indexed Treasury or HFF bond maturing in:

2021 2024 2044

Source: Central Bank of Iceland.

Real interest rate differential with abroad has narrowed

Although the difference between nominal interest rates in Iceland and its main trading partners has changed little year-to-date, the real interest rate differential has narrowed in line with the decline in domestic real rates and the rise in other advanced economies' real rates. It has narrowed by 1.2 percentage points since Q2/2018 and is at its smallest since H2/2013 (Chart III-3).

Market agents expect key rate to be cut

According to the Central Bank's survey of market agents' expectations, carried out in early May, respondents expected the Bank's key rate to be lowered by 0.5 percentage points by the end of June and by a further 0.25 percentage points in H1/2020 (Chart III-4). This is a significant change from the January survey, when respondents expected rates to be hiked this year. Forward rates show similar developments. They suggest that the Bank's key rate will fall over the course of this year, to about 4% by the year-end.

Market interest rates and risk premia

Long-term interest rates have fallen to a historical low

Yields on long- and short-term nominal Treasury bonds began falling late in 2018 and have continued to do so in 2019 to date. Yields on longer bonds have fallen more steeply, to just over 4% on all maturities just before this *Monetary Bulletin* went to press. For the longest bonds, this is a decline of about 2 percentage points from the autumn 2018 peak (Chart III-5). Long-term interest rates are at their lowest since nominal rates were liberalised in the 1980s. Indexed long-term interest rates have fallen as well and are now at a historical low. The yield on the longest indexed Treasury and Housing Financing Fund (HFF) bonds was 1.2% just before this *Monetary Bulletin* and has fallen by 0.5 percentage points since the beginning of the year.

With falling bond market rates, the yield curve has flattened and the breakeven inflation rate – i.e., the spread between indexed and nominal rates – has fallen. This probably reflects increased pessimism about the economic outlook, as well as falling inflation expectations. Market agents therefore expect the Bank's key rate to fall, as is indicated by forward rates (Chart III-4). Inflows of foreign capital into the bond market have increased since the special reserve requirement on foreign currency inflows was lowered to zero in early March (Chart III-6). Inflows are still relatively modest, however, and the situation is different from that in autumn 2015, when inflows of foreign capital and reduced market interest rates coincided with strong economic activity, rising inflation expectations, and clear signalling from the Central Bank of further interest rate hikes to follow.

Risk premium on Treasury foreign obligations broadly unchanged

Measures of the risk premium on Treasury foreign obligations have changed little in 2019, and rating agencies Fitch and Standard & Poor's recently affirmed Iceland's sovereign ratings, with a stable outlook. The CDS spread on the Treasury is now 0.8 percentage points. Interest premia on domestic commercial banks' international bond issues rose in 2018, partly because of increased global economic uncertainty, but have fallen again this year.

Exchange rate of the króna

Net capital outflows increased over the course of 2018

Net capital outflows increased in H2/2018, primarily due to foreign securities purchases by domestic buyers – pension funds in particular – and deleveraging of foreign debt by domestic borrowers. Net capital outflows excluding changes in the Central Bank's international reserves totalled just under 92 b.kr. in Q3/2018 but fell to just under 31 b.kr. in Q4 (Chart III-7).

Króna broadly stable in the recent term

The króna has been relatively stable thus far in 2019, after a steep drop last autumn (Chart III-8). The tumble last autumn began with news about airline WOW Air's financing difficulties, followed by increased pessimism about the economic outlook and growing concerns about the results of the forthcoming wage agreements. The króna hardly moved after WOW Air finally collapsed in late March, however, and it appears that the impact of the company's insolvency had already been priced into the exchange rate. Furthermore, the reduction of the special reserve requirement on foreign capital inflows and the signing of wage agreements are likely to have supported the currency. Foreign exchange market outflows following Parliamentary approval of the release of the remaining offshore króna assets in early March have been smaller than expected to date, and offset to a degree by inflows for new investment. Since the February *Monetary Bulletin*, the Central Bank has intervened in the foreign exchange market three times, selling currency for approximately 4.5 b.kr., or roughly 7% of total market turnover for the period.

Market agents expect the króna to depreciate slightly

According to the Bank's survey of market agents' expectations, carried out in early May, respondents expect the króna to depreciate by roughly 2½% against the euro until May 2020 and remain broadly stable from then on. This is a slightly larger depreciation than they expected in a corresponding survey from January.

Money holdings and lending

Growth in money holdings slightly weaker than in H2/2018 …

Year-on-year growth in M3 measured about 8% in Q1/2019, slightly below the growth rate in H2/2018 (Chart III-9). Growth is due largely to an increase in household deposits, as household saving has grown steadily in the recent term despite a surge in consumption spending (see Chapter IV). In Q1, household deposits grew year-on-year by just under 10%, which is roughly the rate prevailing since Q3/2016.

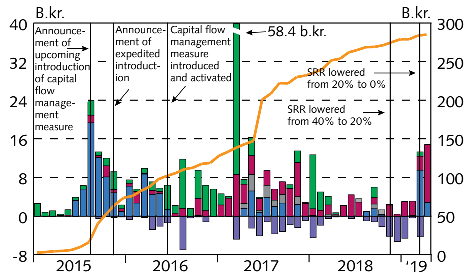
… and credit growth appears to have peaked …

Growth in credit system lending to domestic borrowers began to gain pace in 2017, peaking at just over 10% year-on-year in Q4/2018. The

Chart III-6

Capital flows due to registered new investments[1]

January 2015 - April 2019



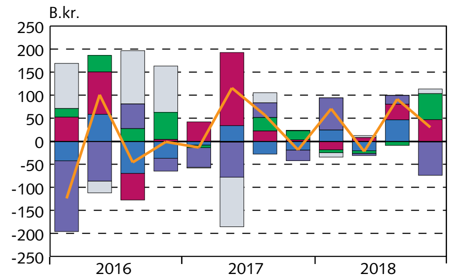
Capital inflows into government bonds (left)
Capital inflows into listed shares (left)
Other capital inflows (left)[2]
Capital inflows into special reserve accounts (left)
Capital outflows (left)
Cumulative net capital flows (right)

1. Investment commencing after 31 October 2009 and based on new inflows of foreign currency that is converted to domestic currency at a financial instititution in Iceland. 2. Other inflows in March 2017 derive almost entirely from non-residents' acquisition of a holding in a domestic commercial bank.
Source: Central Bank of Iceland.

Chart III-7

Capital flows[1]

Q1/2016 – Q4/2018



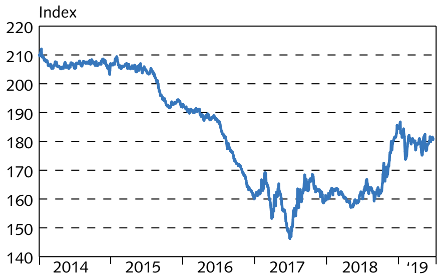
Direct investment
Bonds and derivatives
Equities
Other investment
Foreign exchange reserves
Capital account excluding reserves

1. Capital account balance (net capital outflows) and net capital flows to foreign direct investment, portfolio investment (bonds, derivatives, and equities), and other investment. Positive (negative) numbers represent an increase (decrease) in resident entities' foreign assets or a decrease (increase) in their foreign debt.
Source: Central Bank of Iceland.

Chart III-8

Exchange rate of the króna[1]

2 January 2014 - 17 May 2019



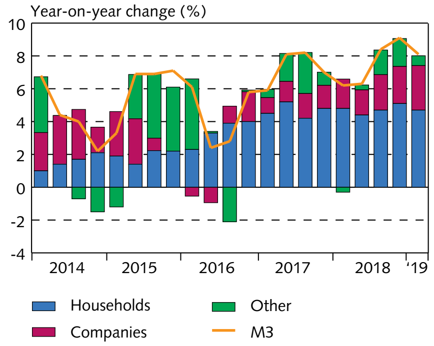
Trade-weighted exchange rate of the króna

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

Chart III-9

Money holdings[1]

Q1/2014 - Q1/2019

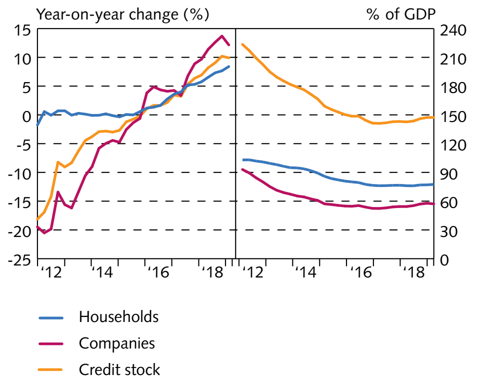


1. M3 is adjusted for deposits of failed financial institutions.
Source: Central Bank of Iceland.

Chart III-10

Credit system lending to resident borrowers[1]

Q1/2012 - Q1/2019

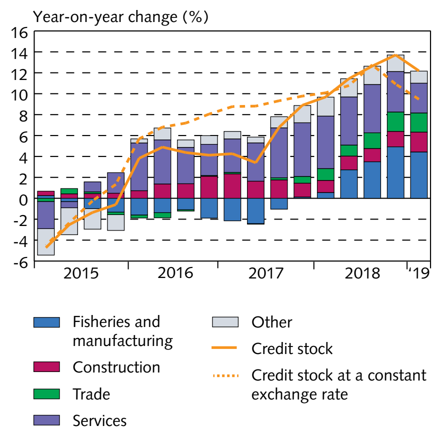


1. Credit stock adjusted for reclassification and effect of Government debt relief measures. Only loans to pension fund members are included with pension funds. Excluding loans to deposit institutions, failed financial institutions and the Treasury. Companies include non-financial companies and non-profit institutions serving households. Q1/2019 figures are Central Bank estimates.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-11

Credit system lending to non-financial companies[1]

Q1/2015 - Q1/2019



1. Excluding loans from failed financial institutions. The foreign-denominated credit stock is calculated using the March 2019 trade-weighted exchange rate index value.
Source: Central Bank of Iceland.

Q1/2019 growth rate was similar, but the credit stock has changed little relative to GDP since 2016 (Chart III-10).

… reflecting reduced growth in corporate lending …

Since 2016, corporate lending growth has outpaced household lending growth; however, corporate lending growth fell to 12% in Q1/2019, after apparently peaking in Q4/2018 at just over 13½% (Chart III-10). The increase in corporate lending reflects in part the impact of the depreciation of the króna on foreign-denominated corporate loans. After adjusting for exchange rate movements, growth in corporate lending measures just under 9½%, which is closer to the household lending growth rate (Chart III-11). Corporate lending growth is spread across a broad range of sectors, although loans to manufacturing and fishing companies, on the one hand, and services companies, on the other, weigh heaviest. Growth in lending to services companies has subsided rather quickly, however, possibly reflecting expectations of reduced activity in tourism.

… while household lending growth continues to gain pace

Lending to households is still rising (Chart III-10). Year-on-year growth in household lending measured nearly 8½% in Q1/2019, and since H2/2018 households have turned increasingly to deposit institutions rather than pension funds for loans. This change could reflect a higher ratio of first-time homebuyers, who are probably likelier to borrow from deposit institutions offering higher loan-to-value (LTV) ratios.

Asset prices and financial conditions

House price inflation has eased …

In March 2019, house prices in greater Reykjavík rose by 4.3% year-on-year, down from nearly 8% in the same month of 2018 and 24% at the May 2017 peak. In the past year, house prices have also risen more slowly than rent, which increased by 5.7% year-on-year in March. The decline in house price inflation reflects weaker economic activity and greater caution among households as regards spending decisions, but the strong increase in housing supply is also a factor. The number of properties for sale has risen steeply in the recent past (see *Financial Stability* 2019/1), and the supply of newly built homes is increasing rapidly.

House prices have risen faster in regional Iceland, which includes communities on the periphery of the capital area, than in greater Reykjavík. High prices per square metre in greater Reykjavík may well have stimulated demand for housing in communities on the outskirts of the capital area. In April 2019, house prices rose by 8.9% year-on-year in regional Iceland, as opposed to 4.6% nationwide (Chart III-12). In Q1/2019, the number of purchase agreements registered nationwide fell by 1.4% between years, including a nearly 17% decline in contracts for new construction. First-time buyers accounted for a fourth of house purchases in 2018, the largest share since before the financial crisis.

… and developments are better in line with economic fundamentals

In Q1, real house prices were 58% above the early 2010 trough (Chart III-13). The surge in demand for housing is due largely to strong population growth and a steep rise in households' disposable income during this period. This coincided with limited growth in the supply of new housing, and a sharp increase in short-term rentals to tourists, which cut into the supply available to potential buyers. Unlike the pre-crisis upswing, however, the recent rise in house prices has not been driven by rapid growth in household debt. Real house prices have fallen marginally from their late-2018 peak, while the rise relative to wages, income, and construction costs has halted. It is still uncertain what impact the recently finalised wage agreements and the contraction in tourism will have on house prices. If the contraction proves short-lived and wage agreements boost real disposable income, demand for housing will probably increase and house prices will be higher than they would otherwise. This is offset in part by an increased supply of new housing. There is also considerable uncertainty about the impact of planned Government measures on the mortgage lending market.

Share prices up in 2019 to date

The OMXI8 index is some 26% higher than it was at the time of the February *Monetary Bulletin* and about 22% higher than in mid-May 2018 (Chart III-14). The rise has been driven mainly by shares in Marel, which weighs heaviest in the index. Marel's stock price has risen 57% year-to-date, partly because of the planned dual listing on the exchange in Amsterdam. Total trading in equity securities on the Nasdaq Iceland exchange amounted to 149 b.kr. in Q1/2019, slightly less than in the same quarter of 2018. Of that total, companies on the OMXI8 accounted for 115 b.kr. and Marel 54 b.kr. Only six of the 19 companies on the Main List recorded an increase in profit between 2017 and 2018.

Private sector debt relatively low in historical context …

Private sector debt totalled 164% of GDP at the end of 2018, nearly 4 percentage points higher than at the end of 2017 (Chart III-15). Corporate debt increased by 11% year-on-year in nominal terms, to 88% of GDP, 3 percentage points higher than at the end of 2017. Corporate debt owed to domestic financial institutions increased most. Debt owed to foreign financial institutions and issued marketable bonds changed very little, apart from changes attributable to the depreciation of the króna in autumn 2018. Household debt increased in nominal terms by nearly 8% year-on-year, and the debt-to-GDP ratio was nearly 76% at the year-end. Although private sector debt relative to GDP has risen slightly in the recent past, it is still low in historical context, and households and businesses appear to have grown much more resilient in recent years (see also Box 2).

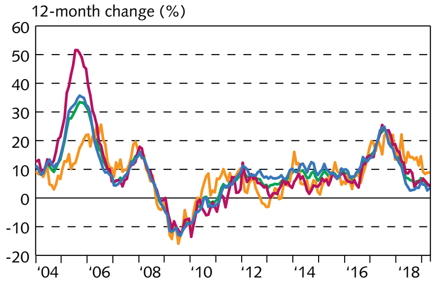
… and non-performing loans are on the decline

The share of household debt in arrears to the three large commercial banks and the HFF measured 2% of total lending at the end of March,

Chart III-12

Market price of residential housing

January 2004 - April 2019



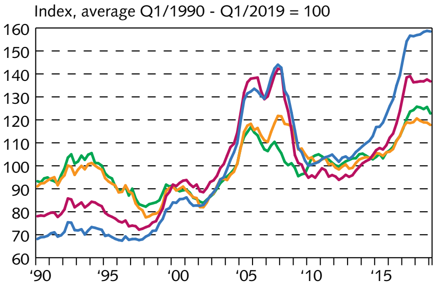
Capital area - Condominium
Capital area - Single-family homes
Regional Iceland - Total
Entire country - Total

Source: Statistics Iceland.

Chart III-13

House prices relative to prices, construction costs, wages, and income[1]

Q1/1990 - Q1/2019



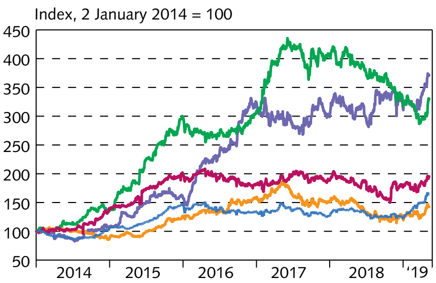
Relative to prices
Relative to construction costs
Relative to wages
Relative to seasonally adjusted disposable income per capita

1. The ratio of house prices to the CPI, the building cost index, the wage index, and disposable income per capita (based on the working-age population).
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-14

Share prices by sector[1]

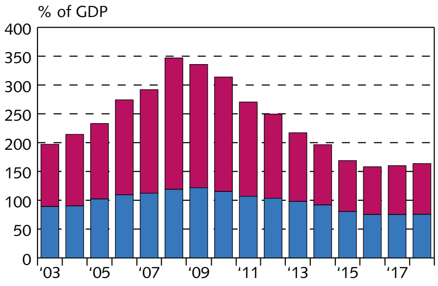
2 January 2014 - 17 May 2019



OMXI8
Tradable sector
Real estate companies
Telecom and tech companies
Petroleum sales and distribution

1. Sectors refer to the average change in share price of listed companies in selected sectors, adjusted for dividend payments and share capital reductions.
Source: Nasdaq Iceland.

Chart III-15
Household and non-financial corporate debt 2003-2018[1]



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

after falling by 0.7 percentage points between years. The number of individuals on the CreditInfo default register fell by 3.4% over the same period. The share of firms in default to credit institutions has also fallen, to 5.9% by March, a reduction of 2 percentage points from the previous year. The number of firms on the default register fell as well, by nearly 7% year-on-year. Despite declining arrears, the number of corporate insolvencies rose between years in 2018, although it fell again year-on-year in Q1/2019. The number of new company registrations fell in 2018 but rose again year-on-year in Q1/2019.

Several pension funds have lowered LTV ratios

The commercial banks' non-indexed deposit and lending rates and the pension funds' non-indexed lending rates have moved broadly in line with the rise in the Central Bank's key rate in November 2018, although non-indexed lending rates have fallen slightly since the February *Monetary Bulletin*. The commercial banks' fixed indexed rates and the pension funds' variable indexed rates have also fallen over the same period. As before, pension fund loans bear somewhat lower interest rates than comparable loans from the commercial banks. Some lenders have tightened their lending requirements, including several pension funds that have lowered their maximum LTV ratios, as loans to fund members are nearing the benchmarks provided for in some of the funds' investment strategies.