The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, August 2009

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set the policy rate and that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its policy rate meetings two weeks after each decision. The votes of the individual MPC members will be made public in the Bank's *Annual Report*.

The following are the minutes of the MPC meetings held on August 11 and 12, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of August 13, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, financial stability, the outlook for the global real economy and Iceland's international trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the previous interest rate decision on July 2 as reflected in the updated forecast published in *Monetary Bulletin* 2009/3 on August 13.

Financial markets

The króna has been relatively stable since the last MPC meeting, depreciating by 0.8% in July, as opposed to 3.1% in June. The exchange rate in the offshore market has also been broadly stable. The króna was trading at close to 220 against the euro in the offshore market in the beginning of August and in the range from 200-230 against the euro for the last three months. Volume in the FX market has been low over the summer months.

FX intervention by the Central Bank of Iceland was limited in July, amounting to 7.5 billion euros, compared to 14.3 billion euros in June. Although the Bank's interventions have been sizeable in recent months, they have only been a small share of the total turnover in the market, and remain well within the criteria set out by the Letter of Intent.

Foreign residents' ISK positions have declined somewhat since the beginning of the year, but have been stable the last two months. There has been some movement from short-term positions to longer-term bonds. Some excess liquidity was removed from the system as maturing CD positions were re-invested in Treasury bills. Total reserves positions of the banking system within the Central Bank did not increase even though the Bank stepped down its issuance of CDs and accepted tied deposits, with reserves shifting towards excess reserves.

The amounts that Icelanders hold in FX accounts have stabilised recently, reducing pressure on the króna.

Volume in the interbank market has remained very limited. Price formation in the market seems to be impaired, with the REIBOR rate currently below the Central Bank's deposit rate, at 8.7%. The bond market has, however, deepened in recent month as can be seen in increased trading volume.

Risk premia on the Republic of Iceland, as measured by the CDS spread, have continued to decline. This could be attributable to recent positive developments in Iceland, such as in bank restructuring, the application for EU membership, and the progress made in fiscal consolidation. However, a general decline in risk aversion in global markets could also explain this development.

Outlook for the global real economy and international trade

Although Q2 GDP figures for many countries turned out to be disappointing, leading indicators and, to some extent, actual data suggest that the global recession may be coming to an end and that the recovery is closer in time than previously forecast. Revisions to the outlook on global trade broadly reflect the global outlook revision.

Iceland's trade balance for Q2/2009 was positive in the amount of 18.7 b.kr., broadly similar to the 17.3 b.kr. surplus in Q1/2009, but a marked improvement over the 1.3 b.kr. deficit from a year earlier. The improvement in the trade balance can be attributed primarily to contracting imports, which shrank by 50% year-on-year and 4% quarter-on-quarter. Lower aluminium prices had a pronounced effect on export revenues, with total exports contracting by 40% year-on-year and 2% quarter-on-quarter. Aluminium prices have recently begun to rise again and were almost 9% higher in Q2/2009 than in Q1/2009. The outlook for aluminium prices over the forecast horizon has also improved. This will have important positive effects on the trade balance in the near future. The value of marine products exports declined by 20% year-on-year in Q2, but rose by 9% quarter-on-quarter. According to preliminary numbers, the July trade surplus was 6.4 b.kr.

The domestic real economy and inflation

The Consumer Sentiment Index and all of its sub-indices fell in July. The largest decline was in sentiment towards the economic situation six months ahead, which dropped to a new low.

According to the Statistics Iceland Labour Force Survey (LFS), total hours worked fell by 14% year-on-year in Q2/2009, due to a drop in both the average number of hours worked (2.8 hours) and the number of people working (8%) during the reference week. Male workers in the greater Reykjavík area have been disproportionally hit by the contraction in total hours. Their share of the decline of total hours was 66% while their share of total hours was 35%. Furthermore, the survey shows that a part of the contraction in demand has been met with increased part-time labour.

According to the LFS, 16,600 persons were unemployed and actively looking for work in Q2/2009. This corresponds to 9.1% of the labour force. Unemployment as measured by the Directorate of Labour (DOL) totalled 8.6% in Q2/2009.

Registered unemployment has been falling since April, most likely because the DOL has stepped up its surveillance of those registered. Registered unemployment measured 8.1% in June, 0.6 percentage points lower than in May. Nevertheless, seasonally adjusted unemployment has risen slightly since April, to 8.6% in June.

In June, the wage index was up 0.2 from the previous month but had risen by 3.0% year-on-year. Real wages were down by 1.2% month-on-month in June and by 8.2% compared to the same month in 2008.

Annual inflation subsided further in July, after rising in June. The CPI rose by 0.17% in July. Excluding the 0.6% drop in March 2009 this is the smallest monthly increase since August 2007, bringing the twelve-month inflation rate down to 11.3% from 12.2% in June. Annualised seasonally adjusted three-month inflation was slightly lower or 10.6%.

The Government's decision in June to raise taxes on petrol and diesel fuel had a 0.23% effect on the CPI in July, as the effects were not fully realised in June. Excluding the effects of the tax hike, twelve-month inflation measured 10.4% in July.

The largest contributors to the July decline in twelve-month inflation are the housing component and summer sales. Owner-imputed rent decreased by 2.6% from June due to lower market prices, while prices of clothing and footwear declined by 7.3%. Twelve-month inflation excluding the housing component measured 16.4% in July.

Some exchange rate pass-through is still evident in the CPI, as prices of imported goods rose by roughly 1% between months in July, and by 22.4% in the last twelve months.

According to an inflation expectations survey conducted by Capacent Gallup between May 28 and June 4, households expect inflation to measure 10% in twelve months time, as opposed to 12% in March. This is the same rate as in the survey conducted in June 2008. Inflation expectations peaked at 14% in October 2008.

Household expectations for inflation two years ahead have increased since the last survey in March. Households now expect inflation to measure 7.2% in two years' time, as opposed to 6% in March.

Inflation sentiment has fallen since the March survey. Households estimated current inflation at 12%, as compared with 15.5% in March. Both numbers are in line with actual inflation levels.

The updated baseline forecast published in the August 13 issue of *Monetary Bulletin* indicates that economic activity will be somewhat stronger in 2009 than was previously forecast. The contraction in national expenditure and exports is projected to be smaller than in previous forecasts, about 9% instead of 11%, as forecast in May. On the other hand, the outlook for 2010 has deteriorated, with a 2% contraction instead of the previously projected 1%. The prospects for 2011 have deteriorated as well, with GDP growth at around 1% instead of 2½%, as forecast in May.

The less favourable outlook for GDP in the coming two years compared to the May forecast is explained, firstly, by a sharper contraction in real disposable income, largely because fiscal consolidation will be achieved to a much larger degree through tax increases and lower fiscal transfer payments than was assumed in May. The contraction in private consumption will therefore be greater over the next two years. Secondly, further delays in previously planned aluminium sector investments are assumed, as a result of difficulties in financing energy-intensive projects. Consequently, recovery in overall investment will be delayed beyond what was assumed in May. More robust investment growth in 2011 will, however, counteract this.

In line with a more robust recovery of global demand and a lower real exchange rate, exports, apart from energy-related and marine exports, are projected to grow faster in the next two years than previously expected. Marine exports are however expected to contract in 2009 and 2010 due to quota cuts, and aluminium exports are expected to drop in 2011 due to delays in development projects.

Compared to the May forecast, the contraction in imports will be less in 2009, in line with weaker domestic demand growth, but larger in 2010, owing to weaker domestic demand and a lower real exchange rate. The trade surplus has been revised downwards for 2009 but upwards for 2010 and 2011.

In line with the GDP outlook, the output gap is forecast to be somewhat less negative in 2009 than in the May forecast, or just below 7% instead of 8½%. Unemployment will be broadly in line with the May forecast. Wage costs will be higher, however, mostly due to a 1.66% hike in payroll taxes July 1.

The updated forecast suggested that the inflation outlook has deteriorated somewhat from May. First, the exchange rate has remained weaker than expected in May and the outlook is for a weaker exchange rate throughout the forecast horizon. Second, wage costs are forecast to rise faster than previously assumed. Third, the output slack for this year will be smaller the previously assumed. Fourth, the Government's fiscal consolidation measures will entail sharp rises in indirect taxes in the coming years, which will have a direct impact on headline inflation. The rise in indirect taxes will add nearly 1 percentage point to the CPI in 2009 and about 2 percentages points in each year of 2010 and 2011.

However, disinflation is forecast to continue, albeit at a slower pace, with very limited inflationary pressures in the next few years. A sizeable negative output gap and high unemployment will counteract higher wage costs and a weaker exchange rate and limit any risk of second-round effects emerging. Underlying inflation is therefore expected to reach the inflation target in the middle of next year. A sizeable undershooting of the target is forecast, with temporary deflation not ruled out in late 2010 and 2011. Underlying inflation is however forecast to be close to target by the end of the forecast horizon in the middle of 2012. Headline inflation will, however, be higher or around 4%.

II The interest rate decision

The Committee discussed recent developments in the FX market and the extent of possible circumvention of the capital controls as, for example, suggested by the recent decline in non-residents' ISK position. Businesses also appear to have been building up reserves in their foreign exchange deposit accounts in domestic banks. The accumulation of deposits has stabilised in the past few weeks, however. Moreover, the recently introduced strategy for phased capital account liberalisation was discussed.

The MPC agreed that, with capital controls in place, improvements in the trade account should support the currency. Although temporary factors – e.g., a deterioration in the terms of trade, seasonal interest payments to non-residents, and lately, a seasonal increase in imports – have at various times had a negative impact on the króna, the absence of a significant intermittent recovery is, in the Committee's view, a matter of concern. The Committee therefore agreed on the need to provide sufficient return on króna assets, which would affect both the incentives for circumvention of the capital controls and exporters' incentive to convert their foreign exchange earnings into ISK-denominated assets.

The Committee discussed the inflation outlook. The MPC agreed that a path of solid disinflation is a key element in restoring confidence in the economy and the currency. The MPC noted that the króna had remained stable since the last monetary policy decision, albeit significantly below the level the Committee has referred to as acceptable. After a period of rapidly declining inflation between January and April, the depreciation of the króna since March seems to have slowed down the disinflation process and even led to a temporary reversal if inflation is measured in terms of annualised, seasonally adjusted three-month rates. However, the MPC expects inflation to resume a strong downward trend later this year, in line with the baseline forecast in the *Monetary Bulletin* discussed above.

The Governor informed the MPC of meetings with the IMF representative and the progress of the IMF programme. The Committee also discussed the delay in the First Review of the IMF Stand-by Agreement. The Committee noted that progress has been made on several fronts. A medium-term fiscal plan has been established, bank restructuring is at an advanced stage, and bilateral loan agreements have been negotiated. Iceland has therefore met almost all of the requirements of the IMF programme. However, the delay in ratifying the bilateral negotiations with the UK and the Netherlands government by Parliament has put the other bilateral loan agreements and the foreign exchange swap agreements with the Nordic central banks at risk. This could undermine confidence and delay the whole recovery process, including the plan to remove the capital controls.

The MPC also discussed the state of the domestic financial institutions. The Committee noted that the banks have made some improvements in their liquidity management recently, although the Committee is still concerned over excess liquidity in the króna market and the FX imbalances of the banks. The banks have lowered their deposit rates in recent months, widening the spread between deposit rates and lending rates and increasing their profitability. However, they still appear to be hoarding cash, with credit creation almost non-existent. Competition remains limited.

MPC members agreed that there was a strong case against lowering interest rates further as long as the króna remained at its currently depreciated levels and discussed raising the deposit rate by up to 1.0 percentage point. While, in the Committee's view, there were no clear signs that past policy rate reductions have been an important cause of capital control circumvention, accumulation of foreign exchange deposits, or the weakness of the króna in general, such an effect could not be ruled out. Moreover, the Committee was of the view that further interest rate cuts might not be consistent with the aim to start the liberalisation of capital controls before November 1 2009, especially given the low interbank rates.

Some Committee members noted that while exchange rate stability was an interim goal of monetary policy during the restructuring phase, a low exchange rate was contributing to a recovery based on a switch of demand from imports to domestic products and services, as well as increasing the competitiveness of the export sector, as manifested in an improved trade balance. As a result, some sectors were doing well due to the lower exchange rate.

One member noted that there were no clear signs of domestic inflationary pressures: the observed rise in the CPI was simply capturing the rise in the relative price of imported goods which was aiding the recovery of the domestic economy and improving the trade balance. However, he noted that any sign of mounting inflationary pressures would have to be met forcefully.

The Committee agreed that it should avoid any actions that could call into question its commitment to exchange rate stability and low inflation, particularly in the run-up to the liberalisation of capital movements. In this way, it was argued that monetary policy could best contribute to the restoration of confidence that is a prerequisite for the eventual abolition of the capital controls. This could imply raising interest rates if conditions call for it.

In light of the discussion, the Governor proposed that the policy rate and deposit rates be left unchanged. The proposal was approved unanimously.

The following members of the Committee were present:
Svein Harald Øygard, Governor and Chairman of the Committee
Arnór Sighvatsson, Deputy Governor
Thórarinn G. Pétursson, Chief Economist
Professor Gylfi Zoëga, external member

In addition, a number of staff members participated in the meetings.

Adalheidur Ósk Gudlaugsdóttir and Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday, September 24, 2009.