



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 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 Central Bank interest rates and other monetary policy instruments; furthermore, the Act states 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 meetings two weeks after each interest rate 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 3-4 November 2009, during which the Committee discussed economic and financial market developments, the interest rate decision of 5 November, 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 24 September, and estimation of the economic conditions in the baseline forecast and alternative scenarios published in the *Monetary Bulletin 2009/4* on 5 November.

Financial markets

The króna has been relatively stable since the last MPC meeting, depreciating by 0.8% in trade weighted terms between September and October monthly averages, after a 0.5% appreciation in September. At the same time, foreign exchange market intervention by the Central Bank of Iceland had remained moderate. Furthermore, residents’ FX account balances at domestic banks have remained fairly stable since the last MPC meeting.

The króna had been trading at close to 200 against the euro in the offshore market following the September meeting, but in the last few days before the November meeting it depreciated to 217, which is close to its level at the time of the September meeting.

At its September meeting, the MPC decided to begin weekly issuance of 28-day certificates of deposit (CDs) to absorb liquidity from the market. Six auctions were held since the September meeting, and about 45.4 b.kr. worth of CDs were outstanding at the time of the November meeting.

After these measures were adopted, interbank market rates rose and aligned with the Central Bank's deposit rate, but the banks' retail deposit rates did not rise correspondingly. Overnight interbank market trading resumed, although volumes were still limited.

Treasury bill yields also moved towards the Central Bank deposit rate in the mid-October Treasury auction. Short-term bond yields have also increased by roughly 0.6 percentage points. Yields on longer-term bonds have however declined since the September meeting by up to 0.2 percentage points. The yield curve has therefore flattened. Long-term real rates have also fallen by about 0.1-0.2 percentage points since the September meeting, depending on maturity.

Risk premia on the Republic of Iceland, as measured by the CDS spread, remained broadly unchanged since the September meeting, ending at roughly 3.5 percentage points, which is its lowest level since mid-September 2008. However, the developments of the CDS spread should be interpreted with caution, as they may be based on limited trading.

Outlook for the global real economy and international trade

International trade has continued to shrink along with the global contraction in consumption and investment and the rundown of inventories. Despite signs of recovery, international forecasts assume that international trade will shrink by roughly 9% this year (compared to 13% in the previous forecast), with the contraction to continue well into 2010. Nevertheless, in Iceland the merchandise trade surplus was 3.1 b.kr. in September, following a 12.5 b.kr. surplus in August. According to preliminary numbers, the October trade surplus was 16.4 b.kr, the largest this year. The merchandise trade surplus in Q3/2009 was 15.9 b.kr. and the combined surplus for the first nine months of the year was 46.4 b.kr., a substantial reversal from the 79.1 b.kr. deficit for the same period last year.

Nominal exports in domestic currency were little changed between August and September, falling by 0.3%, while nominal imports increased significantly in September, mainly due to a substantial increase in imports of fuels and industrial supplies.

Nominal exports in domestic currency of marine products rose in August and September. However, nominal marine exports have contracted by 9% year-on-year, in the first nine months of the year.

Aluminium prices, which had been rising since February, peaked in mid-August at their highest level since November 2008. Prices fell back again in September by around 5%. The effects of this could be clearly seen in the export value of aluminium, which increased by 26% month-on-month in August but contracted by 12% in September. Aluminium prices have inched upward again in October and are, on average, somewhat higher than in September.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey, total hours worked fell by 14% year-on-year in Q3/2009. The fall in hours worked was due to both a three-hour decline in average weekly hours worked and a drop of nearly 9% in the number of people working during the reference week. Labour market participation in Q3/2009 was about 2 percentage points below the Q3 participation rate for the last three years.

Registered unemployment has been falling since April, probably because the Directorate of Labour has stepped up its surveillance of those registered. Registered unemployment measured 7.2% in September, 0.5 percentage points lower than in August. Nevertheless, seasonally adjusted unemployment has risen since last autumn, to 9.4% in September, increasing by 0.4 percentage points month-on-month. Registered unemployment was 7.6% in Q3/2009, and the seasonally adjusted rate was 9.1%.

The results of the Capacent Gallup survey of business sentiment at Iceland's 400 largest companies, conducted over a three-week period from 8-29 September 2009, indicate that labour market conditions will weaken further, although companies, particularly exporters of goods and services, are more upbeat than in a comparable survey conducted in May. Companies intending to shed staff in the next six months still outnumber those wanting to recruit. Just under one-fourth of companies intend to lay off staff in the next six months, while one-fifth expressed an interest in recruiting staff.

The results of an early October survey carried out by the Confederation of Icelandic Employers (SA) are similar to those of the Capacent Gallup survey. One-fourth of private-sector companies surveyed intend to cut staffing levels in the next six months, while 14% intend to recruit. SA estimates that these results correspond to a net increase in private sector unemployment of about 2 thousand persons over the next six months, which would raise unemployment by just over 1 percentage point.

In September, the wage index was up 0.25% from the previous month and had risen by 1.9% year-on-year. In Q3/2009, the index rose by 0.7% from the previous quarter and by 2.3% year-on-year. Real wages were down by 0.5% month-on-month in September, and by 8% compared to the same month in 2008. Real wages have fallen by 12% since they began to decline in March 2008.

According to the Capacent Gallup survey of business sentiment, almost 95% of firms consider the current economic situation to be bleak. However, executives are more optimistic about the economic situation six months ahead than they were in May. Around one-fourth of companies now expect the economic situation to improve, as opposed to 12% of the companies in the May survey; a third believe it will deteriorate, compared to about 55% in May. Over 60% of companies anticipate an improvement twelve months ahead.

About 30% of companies expect domestic demand to decline over the next six months, down from 40% in May, and 24% of companies expect demand to strengthen, as opposed to 19% in May. The survey results indicate that export firms are more optimistic about foreign demand compared to the March survey.

The Capacent Gallup survey of business sentiment suggests that the output slack may be about to stop growing. Increasing number of firms reported labour shortages (14% compared to 10% in the previous survey) and potential difficulties in meeting an

unexpected increase in demand (29%, but 24% previously). These numbers are low, but because they have been on the rise since the beginning of the year, they could imply that capacity utilisation has improved.

The survey results indicate that nominal business investment could contract by more than 44% in 2009 and by about one-fifth in 2010, which is a substantial change from the March survey, when expected investment expenditure was assumed to increase by 62% in 2010.

The Central Bank's evaluation of the status of companies, which is based on information received from credit institutions on the status of domestic businesses' loans and deposits as of end-June 2009, shows that 70% of loans to the business sector are denominated in foreign currency. However, more than half of businesses have no foreign currency debt. These tend to be the smaller companies.

A large portion of loans to businesses will mature in the next four years. Over one-fourth of these loans have maturities that are shorter than one year, and if they are extended, most likely some of the foreign currency loans will be converted to krónur, as access to foreign borrowing is currently very limited and the Central Bank's Rules on Foreign Exchange only allow extension of foreign-currency loans if other terms and conditions remain unchanged.

An estimated one-fourth of businesses are in default. This probably understates the severity of the situation, however, as one-third of business loans are bullet loans, and defaults on bullet loans seldom become apparent before maturity as they typically pay no interest until then.

New Statistics Iceland data on disposable income indicate that households were better prepared to deal with the shock than previously thought. Real disposable income is now considered to have grown marginally in 2008, while the previous estimate suggested a contraction of more than 7%. The main reason for this revision was a re-estimation of financial income.

The year-on-year rate of contraction in payment card turnover in Q3/2009 was 13%, significantly lower than in the previous three quarters. Seasonally adjusted payment card turnover decreased quarter-on-quarter by 1% in Q3/2009, about the same as it did in Q2. Credit card turnover contracted by over 2% in Q3/2009, after having dropped by over 4% in Q2/2009. On the other hand, debit card turnover rose by 2% in both Q3/2009 and Q2/2009, after having declined by 2% in the first quarter.

Nearly 40 thousand individuals had requested pension fund payouts from third-pillar private pension savings as of mid-October 2009. The total amount of approved payouts was around 24 b.kr. before taxes, or about 1½% of GDP.

The index for residential housing prices rose marginally month-on-month in September and October, after declining in the previous few months. In October, prices of apartment houses in Reykjavik, where turnover is greatest, fell but prices of single-unit dwellings and prices in regional Iceland rose. The overall price increase in September and October may, therefore, reflect measurement problems associated with low turnover, rather than a turnaround in the housing market.

The Consumer Sentiment Index rose in September and October, as did all of its sub-indices other than the index covering the current economic situation. The index

measuring expected big-ticket purchases (real estate, motor vehicles, and travel abroad) rose slightly but has remained fairly stable at low levels throughout 2009.

Annual inflation continued to decline in October. The CPI rose by 1.14% in October, bringing the twelve-month inflation rate down to 9.7%, from 10.8% in September. Excluding the effects of recent excise tax hikes, year-on-year inflation was 8.8% in October. Annualised seasonally adjusted three-month inflation was 9.3%, up from 7.9% in September.

Year-on-year inflation was 11.0% in Q3/2009 or 10.1% if the effects of indirect taxes are excluded. This is somewhat higher than predicted in the August *Monetary Bulletin* and is explained primarily by the weaker króna. Of the 1.14% rise in the CPI in October, 0.4% is due to imported goods prices. The transitory rise in the overall housing component of the CPI in October, discussed above, accounted for 0.26% of the increase in the CPI. The remainder, nearly a half of the rise in the headline index, mainly stems from developments in the prices of general services and domestic goods excluding agricultural products.

According to an inflation expectations survey conducted by Capacent Gallup between 25 August and 10 September, households' beliefs about current inflation and their expectation of inflation over the next twelve months are unchanged from the previous survey in June. The median household estimated current inflation at 12% and expects it to be 10% over the next twelve months. Household expectations for inflation two years ahead have decreased however since the last survey in June. Households now expect inflation to be 6% in two years' time, as opposed to roughly 7% in June.

According to the Capacent Gallup survey, firms' expectations of inflation have increased since June, with the median company expecting 4% inflation over the next twelve months and inflation of 4% in two years time. This compares with the May survey where the median firm expected zero inflation over the next twelve months and zero inflation in two years time.

The updated baseline forecast, published in the 5 November issue of the *Monetary Bulletin*, indicates that economic activity will be somewhat stronger in 2009 than was previously forecast and economic recovery will be somewhat faster. Seasonally adjusted quarterly output growth is forecast to turn positive as early as Q1/2010. Modest growth is projected for 2011 and 2012. According to the forecast, the contraction in domestic demand will be just under 20% in 2009, but because of a positive contribution from external trade, mainly as a result of import compression, the contraction in GDP will be much less or about 8½%.

The labour market will take longer to turn around than output will. Unemployment is projected to be lower than forecast in August but to continue rising well into 2010, when it will peak at approximately 10% instead of 11% in the August forecast.

Despite higher income taxes in the current forecast than in the August forecast, the outlook for consumption has improved somewhat since August, with a 16% contraction expected this year (as opposed to 20% in August) and a stronger recovery over the forecast horizon. Apart from a slightly brighter overall economic outlook and lower unemployment, the main reasons for the improvement are the previously mentioned revision of real disposable income data for 2008 and the effects of the private pension payouts on consumption.

The recovery in investment will be slower to materialise than was assumed in August, primarily because of the postponement of aluminium and power sector investment. Other business investment will be limited for some time.

The economic outlook has improved in Iceland's main trading partner countries. As a result, the outlook for Icelandic exports is brighter than it was in August. Exports of goods and services are expected to increase by 1½% per year in 2009 and 2010. The low real exchange rate and the global economic recovery will support robust export growth in 2011-12. Against this is a smaller contraction in imports. Compared to the August forecast, the contraction in imports will be less in 2009 and 2010, in line with stronger domestic demand growth. The surplus on trade in goods and services has been revised downwards for this year and in 2010. It is now estimated at nearly 7% of GDP for 2009, over 10% for 2010, and about 12-13% for 2011-12.

Next year's contraction of disposable income will be larger than previously predicted, mostly because of additional direct tax increases. The above-mentioned revision of the income data for 2008, however, implies that disposable income will decline from a higher level and will therefore fall to roughly the same level as in the August forecast.

The central government budget bill for 2010 emphasises revenue generation through direct rather than indirect taxes, in contrast with the assumptions used to prepare the August forecast. The effects of indirect tax hikes on CPI inflation will therefore be less in 2009 and 2010, but more pronounced in 2011.

The output slack is forecast to be smaller throughout the forecast horizon than was predicted in August. It will peak in Q2/2010, and is expected to close in early 2012.

Unit labour costs will rise somewhat this year even though nominal wage growth will be more modest than in previous years because productivity has fallen and the payroll tax has been raised. Unit labour costs is forecast to rise less markedly in 2010-2012 because rising productivity will offset nominal wage increases after new wage agreements are concluded.

A weaker exchange rate and a stronger economy suggest that the inflation outlook has deteriorated somewhat from the levels forecast in August. Underlying inflation, i.e. inflation excluding the effects of indirect taxes, will nonetheless approach the inflation target in the latter half of 2010, and headline inflation is projected to reach the target less than a year later. The forecast assumes a prolonged period of underlying inflation below target. Underlying inflation will be close to target, however, by the end of the forecast horizon.

II The interest rate decision

The Governor discussed progress made since the September meeting. He gave an account of the Icelandic delegation's meetings with IMF representatives, and his meetings with government representatives and financial institutions at the International Monetary Fund's (IMF) Annual Meeting in Istanbul. Also discussed were the recently completed First Review of the economic programme supported by the IMF Stand-By-Arrangement; the first phase of capital account liberalisation, implemented on 31 October; the status of the ongoing Icesave discussions; the recently passed legislation

on temporary measures to assist indebted households and businesses; the status of the budget for 2010; and the recently extended 2008 wage agreement to end-2010.

The Committee agreed on the importance of this progress for the future monetary stance. Members saw the First Review of the Stand-by Agreement with the IMF as an important element in restoring confidence and supporting the króna. It had also been a prerequisite for the first stage of capital account liberalisation. It was noted that once a stock of new investment has been built up the exchange rate could become more sensitive to current and expected monetary policy decisions.

In the view of most MPC members, the current risk-adjusted rates of return on domestic assets should offer sufficient incentive for investors to hold or buy króna-denominated assets in the current external environment. Hence, given the outlook for improved fundamentals and in view of declining risk premia in global capital markets, the outlook for the króna may be becoming more favourable.

In the MPC's opinion, the passage of the 2010 Budget should also help to boost confidence in the króna and the economy, as this will ensure a sustainable fiscal programme.

The Committee discussed recent steps in the financial sector restructuring process and the Central Bank's newly published *Financial Stability* report. Particular attention was given to the results of the Bank's evaluation of the status of domestic businesses' loans and deposits, which indicates that corporate sector balance sheets may be less exposed to foreign exchange risk than previously thought.

The MPC noted that the króna has remained broadly stable since late summer, although at a lower value than the Committee considered desirable. Central Bank intervention in the foreign exchange market has remained moderate, and intervention by the Bank is considerably smaller than during the summer. The króna has, however, been weaker than previously forecast. The disinflation process had therefore been somewhat slower than anticipated, although inflation had continued to decline. The forecast published in the 5 November *Monetary Bulletin* showed that, due to the somewhat weaker currency and slightly smaller contraction in domestic demand, inflation would decline more slowly than was forecast in August. Inflation is still expected to fall sharply in 2010, and underlying inflation will be close to target during the latter half of the year.

MPC members agreed that there was only a moderate risk that currency depreciation would generate second-round effects on inflation, either through wages or the prices of domestically produced goods. Furthermore, as inflation is now driven primarily by weaker exchange rate, with a small contribution from wages and a negative contribution from house prices, a speedier recovery of the króna than is assumed in the forecast would bring inflation down faster than projected.

Some members, however, expressed concerns over the substantial share of domestic goods and other services in inflation, which indicated that the contraction in demand appeared to have been insufficient to prevent the currency depreciation from passing through to the price of non-tradables. One member pointed out that the experience from past financial crises showed that the risk of sustained inflation was limited because of the large slack that emerges in the labour market. That member emphasised that current inflation mainly reflected relative price adjustments that did not call for monetary policy responses aimed at stabilising inflation.

Some members emphasised that the low real exchange rate was helping the tradable goods sectors by raising the relative price of its output. This was dampening the fall in overall demand for domestic goods and services and improving operating conditions of the tradable goods sectors. Other members, however, also pointed out the possible distortions that might develop if the real exchange rate were to remain too low for a prolonged period, as resources might be shifted to the traded goods sector in greater amounts than are sustainable once the real exchange rate had returned to its long term equilibrium level.

The MPC discussed recent financial market developments. The Committee was of the opinion that measures to drain liquidity from the market by auctioning 28-day CDs had been successful and noted that interbank market trading had resumed, although volumes were still limited. Treasury bill yields had also moved closer to the Central Bank deposit rate. However, some Committee members expressed concerns that the banks' deposit rates had not risen commensurably.

The Committee saw the CD issuance as a tightening of the monetary policy stance after considerable unintended relaxation in the weeks prior to the last meeting. The effective monetary policy stance was in the 9.0-9.5% range at the time of the November meeting.

The Committee agreed that the progress made in important matters since the last meeting allowed for either an unchanged monetary policy or a slight easing. CD bid rates of a minimum of 9.5% and a maximum of 10.0% to 10.25% were discussed, as was the possibility of increasing the volume of CDs offered. The range discussed for the deposit rate was from 9.0% to 9.5%. The Committee also discussed whether to leave its collateralised lending rate unchanged or to lower it to 11.0%, and whether to cut the overnight lending rate from 14.0% to 13.5%. There were some concerns that lowering the collateralised lending rate could be perceived as a relaxation of the monetary policy stance over and above the slight relaxation implicit in the decisions on the deposit rate and the CDs. Concerns over the lack of transparency of the decision were also expressed. However, the need to adjust the interest rate corridor was acknowledged.

It was argued that, in its decisions, the Committee had to weigh together three factors: the inflation outlook, the output gap, and the interim objective of exchange rate stability. The weight on exchange rate stability was currently paramount, but the weights will evolve through time as the situation changes or new information affects the assessment of past and current conditions. Some Committee members argued that new information on corporate sector balance sheets and the newly passed bill on debt restructuring indicated that the weakness of the króna might be somewhat less of a danger to private sector balance sheets than previously thought, and ongoing debt restructuring should reduce this exposure further. This would therefore give the MPC some additional room for manoeuvre in favour of the real domestic economy.

In light of the discussion, the Governor proposed that the deposit rate (current account rate) be lowered by 0.5 percentage points to 9.0%, and that the maximum volume at weekly auctions of 28-day certificates of deposit (CDs) be increased from 25 b.kr. to 30 b.kr., with a minimum bid rate of 9.5% and a maximum of 10.25%, which implies a 0.25 percentage points increase in the maximum interest rate.

The Governor invited other MPC members to vote on the proposal. Four MPC members voted in favour of the Governor's proposal, and one member voted against, calling for rates to be kept unchanged.

All members agreed to lower the collateral lending rate from 12% to 11% and the overnight lending rate from 14.5% to 13%, as this would not change the effective monetary policy stance.

In the Committee's view, these rate changes will align the Central Bank interest rate corridor more closely with the effective monetary policy stance, which, before this decision, featured interest rates ranging from 9.5% to 10.0%. The current decision would entail an unchanged or slightly easier stance, depending on CD volumes and rates in coming weeks.

The Committee agreed that, if the króna remains stable or appreciates and inflation continues to fall as forecast, a further gradual easing of monetary policy should become possible. The MPC reiterated its intention to move cautiously, however, and stressed that it stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability, while ensuring that inflation will be close to target over the medium term.

The following members of the Committee were present:

Már Gudmundsson, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Professor Anne Sibert, external member

Professor Gylfi Zoëga, external member

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

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday 10 December 2009.