The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

December 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 9 December 2009, during which the Committee discussed economic and financial market developments, the interest rate decision of 10 December, 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 5 November.

Financial markets

The average trade-weighted value of the króna was 0.6% lower in November then it was in October. Foreign exchange market intervention by the Central Bank of Iceland had remained moderate since the last MPC meeting, with no intervention since early November. Residents' FX account balances at domestic banks also remained fairly stable since the last MPC meeting.

Tighter enforcement of the capital controls in early November probably led to a depreciation of the króna in the offshore market, with the króna trading at above 260 against the euro. In the discussion it was argued that this depreciation should not be seen as a negative development as it reflects the effects of tighter capital controls rather than higher risk premia.

Five certificates of deposit (CD) auctions were held since the November meeting, and about 48.6 b.kr. worth of CDs were outstanding at the time of the December meeting.

Overnight interbank market rates moved into the Central Bank's interest rate corridor and were 0.25 percentage points above the current account rate as of the December meeting. Trading volume in the interbank market was however still limited in comparison with 2008.

The yield in the mid-November Treasury bill auction fell to 8.0%, compared with 8.5% in the mid-October auction. Only one-third of the bids were accepted. After the legislative bill on the Depositors' and Investors' Guarantee Fund became public, the yield curve for indexed bonds shifted downwards and the slope of the short end of the curve became significantly steeper than before. The nominal yield curve also shifted downwards and flattened.

Risk premia on the Republic of Iceland, as measured by the CDS spread, rose somewhat since the November meeting and increased slightly following the publication of negative news from Greece and Dubai. However, developments in the CDS spread should be interpreted with caution, as they may reflect limited trading.

Outlook for the global real economy and international trade

According to the latest OECD forecast, the outlook for trade has improved since the Bank published its last forecast in the November *Monetary Bulletin*. The OECD forecast assumes that world trade has already begun to recover, led by Asian non-OECD countries, whereas the Central Bank's forecast has been based on the assumption that world trade would not begin to grow until 2010.

At 16.4 b.kr., the October merchandise trade surplus was the largest monthly surplus so far this year. According to preliminary numbers, the trade surplus was smaller in November, or 6 b.kr., mainly due to increased imports.

The value of exports in domestic currency was almost 7% higher in October than in September, while the value of imports declined by 25% month-on-month, mainly due to a drop in imports of fuels and industrial supplies.

The value of imports in domestic currency contracted by 28% year-on-year in October. This is a substantial decline, as it comes on the back of a prior 50% year-on-year contraction in October 2008, the month the financial crisis struck. The value of exports in domestic currency fell by 16% year-on-year, as the value of industrial goods exports declined by 23% and the value of marine products exports fell by 4%.

Aluminium prices continued to rise since the last MPC meeting and were 4% higher on average in November than in October. Rising aluminium prices contributed to a 12% month-on-month increase in the value of aluminium exports in October export. The value of marine products exports increased by 3% between October and September, as the average price of all marine products rose by 3.4% month-on-month.

The domestic real economy and inflation

Preliminary quarterly national accounts figures from Statistics Iceland show that the Icelandic economy was somewhat stronger in Q3/2009 than was assumed in the Central Bank's November forecast, which appeared in *Monetary Bulletin* 2009/4.

After little change in Q2, seasonally adjusted GDP fell by 5.7% in Q3/2009 quarter-on-quarter. In Q1, GDP fell by 5.1%. The decline in GDP increased in year-on-year terms as well, rising from 6.2% in Q2 to 7.2% in Q3. GDP has fallen by 6% in real terms in the first three quarters of 2009 and was 1,111 b.kr. in nominal terms.

The contribution to quarterly GDP growth in Q3/2009 was negative from all subgroups except private consumption. The negative contribution from net trade was the largest, however, caused by a substantially larger increase in imports (12.9%) than exports (1.3%). The contribution of private consumption to quarterly GDP growth amounted to 2.8%, after having been negative quarter-on-quarter since Q1/2008. The contraction in private consumption has been subsiding year-on-year throughout 2009, measuring 13% in Q3. Public consumption fell by 1.4% year-on-year in Q3/2009. The quarterly contraction in public consumption measured 4.5% after being close to zero in Q1 and Q2. In Q3, the year-on-year decline in gross fixed capital formation was similar to that in the preceding quarter (48%). The most pronounced change from Q2/2009 was in residential investment, which contracted by 57% in Q3/2009 and by 45% in Q2/2009. Business sector investment is still sharply lower than year ago (56%), but quarter-on-quarter numbers show a small increase in both Q2/2009 (1%) and Q3/2009 (0.5%). Public investment grew by 2.8% between quarters in Q3/2009, after having contracted since Q4/2008.

The current account deficit was 36. b.kr., or 9.3% of GDP, in Q3/2009. This is significantly smaller than the Q2 deficit, which measured 17.5%. The current account deficit is due to a 72 b.kr. deficit on the income account, while the merchandise account and the service account were positive by 16.3 b.kr. and 20.8 b.kr., respectively. The large income deficit is mainly a result of interest payments related to the "old banks". Most of this interest is accrued but has not been paid; therefore, it has not resulted in actual payment outflows. Excluding this item, the income account deficit was 46 b.kr. and the current account deficit 9.5 b.kr., or 2% of GDP.

Revised national accounts figures for the first two quarters of 2009 show that the economy was marginally stronger than preliminary figures from September had indicated. The main reason for the revision is a larger increase in public and private consumption and a larger surplus on services than in the September numbers.

Registered unemployment, which had been falling since April, rose by 0.4 percentage points month-on-month in October, to 7.6%. Seasonally adjusted unemployment had been rising since last fall, but fell slightly between months in October, measuring 9.2%.

In October, as 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 0.8% month-on-month in October, and by 7.1% compared to the same month in 2008. Real wages have fallen by 12½% since they began to decline in March 2008.

The Consumer Sentiment Index and all of its sub-indices fell slightly in November. The largest decline was in sentiment towards the economy. Sentiment towards the economic situation in six months' time and towards the economy and labour market turned downwards for the first time since July 2009.

Annual inflation continued to decline in November. The CPI rose by 0.74% in November, bringing the twelve-month inflation rate down to 8.6%, from 9.7% in October. Excluding the effects of recent excise tax hikes, year-on-year inflation was 7.7% in November. Annualised seasonally adjusted three-month inflation was 8.7%, down from 8.9% in October.

The increase in inflation is explained primarily by the weaker króna. Imported goods prices accounted for 0.84% of the November rise in the CPI. The contribution to inflation from domestic components accounted for 0.1% of the fall in the CPI in November.

The Statistics Iceland housing price index for the entire country, published in November, was unchanged from the month before. Turnover in the market is still limited. In October, only 190 flats and houses were sold in the greater Reykjavik area, compared to 1,000 at the peak in turnover five years ago.

II The interest rate decision

The Governor informed the MPC of developments in financial sector restructuring, the status of the Second Review of the IMF Stand-By Agreement, and the results so far of the first phase of capital account liberalisation, implemented on 31 October.

The MPC noted that the preconditions for further monetary easing, outlined in its 5 November statement, had materialised. The króna has remained broadly stable since the last MPC meeting, with limited intervention by the Central Bank and no intervention at all since early November. Although the króna remained weaker than the MPC deemed desirable, the Committee believed that the prospects for the currency over the medium term had improved. Tighter regulation, enhanced surveillance, and more effective enforcement had made circumvention of the capital controls more difficult. Some MPC members argued that although significant uncertainty remained concerning short-term capital flows, the króna should be supported by a growing trade surplus in the period ahead.

Inflation has also continued to decline, broadly in line with the latest forecast, falling from 9.7% year-on-year in October to 8.6% in November, or 7.7% excluding the impact of higher consumption taxes. The MPC was of the view that the risk of second-round effects on inflation was moderate and that inflation was driven primarily by exchange rate movements; thus the pace of disinflation would depend mostly on near-term exchange rate movements.

The MPC discussed recent financial market developments. The Committee was of the opinion that auctions of 28-day CDs had been successful in draining liquidity from the market and that monetary policy had begun to affect market rates more effectively.

The Committee also discussed changes in the procedure of the auctions for the CDs in light of the experience so far. As the Central Bank now has a reasonable idea about the volume sold, it was argued that it was no longer necessary for the Committee to announce rates other than the maximum bid rate. From now on, it would be sufficient that the Central Bank announce the amount of CDs to be auctioned one business day in advance of each auction on the basis of its liquidity forecast.

The Committee noted, however, that some important issues were still outstanding that are relevant for the process of rebuilding confidence in the króna and the economy. The negotiated settlement of the dispute with the UK and the Netherlands regarding deposit insurance had not yet been ratified by Parliament, and the 2010 National Budget was not yet completed.

On the whole, the Committee agreed that developments since the last meeting allowed for some monetary easing. Maximum CD bid rates of 9.75% to 10.0% were discussed. The range discussed for the deposit rate was from 8.5% to 9.0%, and for the collateralised lending rate 10.0% to 10.5%. For the overnight lending rate, the Committee discussed lowering it by 0.75 to 1.50 percentage points.

In light of the discussion, the Governor proposed a 0.5 percentage point easing of the monetary policy stance. This implied that the deposit rate (current account rate) and the CD rate would be lowered by 0.5 percentage points to 8.5% and 9.75%, respectively. In addition, in order to further align the Central Bank interest rate corridor with the effective monetary policy stance, the Governor proposed that the seven-day collateral lending rate be lowered by 1 percentage point to 10%, and the overnight lending rate lowered by 1.5 percentage points to 11.5%.

The Governor invited other MPC members to vote on the proposal. Three members voted in favour of the Governor's proposal, with one member pointing out that the smaller gap between the CD rate and the seven day collateral lending rate might result in a somewhat less easing that actually suggested by a 0.5 percentage points lowering of the CD and deposit rates.

Two members voted against the proposal and wanted to take a smaller step, relaxing the monetary policy stance by 0.25 percentage points. Favouring greater caution, they preferred to lower the deposit rate and the CD rate by 0.25 percentage points to 8.75% and 10.0%, respectively. They also suggested that the seven-day collateral lending rate would only be lowered by 0.5 percentage points to 10.5%, and the overnight lending rate by 0.75 percentage points to 12.25%. These two members argued that some major issues were still unresolved and this could raise the risk premium on króna-denominated financial assets. A resolution of the Icesave dispute, which is needed to clarify the public debt situation, was not yet in hand, and the 2010 National Budget had not been passed by Parliament. Furthermore, one member was of the view that some risk to the near-term inflation outlook remained. The effect of second-round effects on inflation could therefore not be ignored.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation continues to fall as forecast, there should be scope for continued gradual monetary easing. Furthermore, the MPC reiterated that, as always, it stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is 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 Wednesday 27 January 2010.