*The Monetary Policy Committee of the Central Bank of Iceland*

# Minutes of the Monetary Policy Committee meeting, July 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.

These are the minutes of the MPC meetings held on July 1, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of July 2, and the communication of that decision.

## I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, 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 June 4.

### Financial markets

The restructuring of the banking system is underway and it is expected that the new banks will be recapitalised by mid-July. Recent legislation on the asset management company and the state banking agency will facilitate both bank and corporate-sector restructuring.  However, many problems in the banking system remain unresolved.

Icelandic banks still appear to be hoarding domestic currency and limited trading has been taking place in the interbank market since the MPC meeting in June. This has reduced the MPC's ability to influence short-term market interest rates. On July 1 the Central Bank announced new rules that expanded its authorisation to manage market liquidity. At the same time the Bank tightened the eligibility rules governing collateral at its facilities.

The króna was trading at about 179 against the euro in the onshore market at the end of June. This was 3% lower than at the beginning of the month and is significantly below the rate that the MPC considers acceptable. The Bank intervened in the foreign exchange market in June. On a net basis the reserves of the Bank have, however, improved through Q2 2009.

The spread between the onshore and offshore exchange rates widened after narrowing in previous months. At the end of June, the króna traded at close to 215 against the euro in the offshore market, compared with rates in the range of 190-210 in May. These figures must be viewed with caution, however, as very few trades are taking place in the offshore market. Volume in the onshore foreign exchange market also remained limited in June, amounting to only 6.1 b.kr.

The government has taken some important steps towards bolstering confidence in the króna since the last MPC meeting. A medium-term fiscal plan has been agreed upon, bilateral loan agreements with the other Nordic countries have been approved and the IMF programme is advancing.

The CDS spread on the Republic of Iceland had declined slightly since the beginning of June, but still remained high at 6.5-7.0 percentage points. Trading is very thin, however, and spreads may be influenced by factors other than sovereign risk. The MPC discussed the methodology used to compute the published CDS spreads.

Since the MPC meeting on June 3, interest rates on long-term nominal government bonds have risen by roughly 1 percentage point. Yields on longer government-guarantied indexed HFF bonds, have at the same time risen by 0.25-0.4 percentage points. This combination of a sizable rise in longer-term nominal interest rates and a more moderate increase in longer-term real interest rates could suggest rising long-term inflation expectations. It could also indicate a rise in the inflation risk premium or changes in market liquidity.

**Outlook for the global real economy and international trade**

In its June 2009 *Economic Outlook*, the OECD has revised upwards its forecast for growth in the OECD economies in 2009-10. This is the first upward revision in two years, but the OECD emphasises that substantial uncertainty exists. The OECD is now predicting that economic growth in OECD economies may be nearing its trough and that it appears that a weak recovery will begin soon and may already be underway in most of the large non-OECD economies. After a collapse in world trade, growth in trade may turn positive by the end of 2009. This is important for Iceland, which will rely on an export-led recovery.

The merchandise trade surplus was 7.4 b.kr. in May. This compares with an April surplus of only 2.3 b.kr. The May surplus is the second-largest one this year. This increase is entirely due to a 19% rise in the value of exports, as imports were little changed since April.

By the end of June, aluminium prices had risen 18% from their low in February. This price rise, coupled with an 8% increase in the quantity of aluminium exports, resulted in an 11% month-on-month increase in the value of aluminium exports. Nevertheless, the value of aluminium exports was down by 50% year-on-year. Marine products accounted for almost half of total merchandise trade exports in May, rising 16% month-on-month. This was due primarily to an increase in quantity, although prices were slightly higher as well.

**The domestic real economy and inflation**

Real GDP fell by almost 4% year-on-year in Q1/2009: the largest quarterly contraction since quarterly national accounts were first published in 1997. The decline was, however, somewhat smaller than had been forecast in May. This was due to a smaller-than-expected decline in domestic expenditures and more robust exports.

Private consumption fell by 22% year-on-year in Q1/2009. Gross fixed capital formation fell by 52% year-on-year: by far the largest decline in the short history of the national accounts. Of that decline, business sector investment was down by over 57%, residential investment was down by 50% and government fixed investment was down by 40%.

The current account deficit amounted to 49 b.kr. in Q1/2009, or equal to 15% of GDP. Broken down into sub-accounts, there was a 15 b.kr. surplus on merchandise trade, a 3 b.kr. deficit on services and a 59 b.kr. deficit on income. The current account figure was a marked improvement over Q4/2008 when the deficit was 311 b.kr., or 78% of GDP. Most of the difference was due to an improvement in the income account resulting from an upturn in the dividends and reinvested earnings component. The largest component of the income account was the interest payments component, which had a 61 b.kr. deficit. However, as some of these interest payments were obligations of the old banks which will not be paid, this number overstates the cash flow out of the country.

Unemployment was 8.7% in May, 0.4 percentage points lower than in April. This mainly reflects an increase in the labour force in May, with the number of unemployed remaining broadly constant for the past three months. Seasonally adjusted unemployment was also 8.7%, 0.4 percentage points higher than in April.

The wage index rose by 0.2% month-on-month in May, after a 0.2% decline in April. The year-on-year rise was 4.1%. Real wages fell by 1% month-on-month in April and by 6.8% year-on-year.

At the end of June, wage renegotiations were concluded with the signing of the stability pact. Along with increases in wages in 2009 and 2010, it was decided to raise payroll taxes by 1.66 percentage points. As a result, increases in wage costs are higher than was assumed in the May forecast, but the risk of significant wage inflation before the end of 2010 is probably reduced.

According to a Capacent Gallup survey of business sentiment at Iceland's 400 largest companies conducted during May 19-29, 2009, almost 97% of firms consider the current economic situation to be bleak. The small increase in optimism seen in the March survey seems to have faded somewhat. About 55% of firms now expect the economic situation to deteriorate further in the next six months and only 12% of them expect an improvement. About 40% of firms expect that domestic demand will decline over the next six months. Sentiment toward foreign demand has improved since the last survey, however, with 36% of firms now expecting foreign demand to strengthen over the next six months.

The survey suggests that labour market conditions will weaken further, as 35% of firms wanted to lay off workers and only 10% wanted to hire new workers. This compares with 25% of firms wanting to lay off workers and 10% wanting to hire in the March survey.

The Consumer Sentiment index, as well as all of its sub-indices other than the index covering the current economic situation, fell in June. The index measuring expected big-ticket purchases (real estate, motor vehicles and travel abroad) also rose slightly.

Payment card turnover rose during Q2/2009. This might indicate that domestic demand is picking up after plummeting in Q4/2008. The increase during the second quarter could also indicate that payment card turnover is returning to pre-crisis levels after the payment system disturbances that occurred in Q4/2008.

The CPI rose by 1.4% in June. Year-on-year inflation was 12.2%, compared with 11.6% in May. Excluding the effects of recent excise tax hikes, the year-on-year inflation was 11.5% in June. Annualised seasonally adjusted three-month inflation, which had fallen to nearly zero recently, was 9.5% or 6.3% excluding the tax hikes. Year-on-year inflation was 11.9% in Q2/2009 and 11.4% if the tax hikes are excluded. This is somewhat higher than was assumed in the May *Monetary Bulletin* forecast.

A significant share of the rise in inflation in June was due to the depreciation of the króna, with prices of imported goods rising by 22% year-on-year. Higher world oil prices, an increase in taxes on diesel fuel, and a weaker króna pushed up the prices of petrol and oil by 7.8% month-on-month, contributing to a 0.36% rise in the CPI.

The cost-of owner occupied housing declined by 0.8% month-on-month in June. If the housing component is excluded, month-on-month inflation measured at 1.9%, while year-on-year inflation was 16.7%.

According to the Capacent Gallup survey, firms' expectations of inflation remained unchanged from March, with the median firm expecting zero inflation over the next twelve months.

## II The interest rate decision

The Governor informed the MPC of recent meetings with the social partners, the IMF representative, and some of Iceland's largest exporters. At the meeting with the social partners, their representatives presented the recently signed stability pact. The Governor told the MPC that he had stated his general support for the pact's objective of accelerating the economic recovery process and his appreciation of the broad consensus achieved in a challenging period that was demonstrated by the agreement, which should reduce the risk of significant wage inflation. However, the Governor emphasised in his meeting with the social partners that the policy rate is set by the MPC in accordance with the Central Bank Act. At the meeting with the IMF representative, the representative expressed the Fund's concerns about the weakness of the króna and emphasised the importance of stabilising the exchange rate. Finally, policies and practices related to the capital controls were discussed with some large exporters. The companies confirmed their commitment to the objectives of the capital control legislation. The Bank's data for most of these large exporting firms showed a robust inflow of foreign currency. However, a change in practices for some firms was warranted and is currently being implemented. This build-up of foreign exchange export earnings, primarily in the domestic commercial banks, could provide important support for the króna in the future.

The Governor described the recently presented fiscal plan as likely to reduce the risk premium on Icelandic government debt and bolster confidence in the króna, thus facilitating monetary easing. He noted the potential positive effects of the progress on bank recapitalisation and the bilateral loan agreements with other Nordic countries but stressed that a resolution of the Icesave dispute is necessary to clarify the public debt situation.

However, while sustainable public finances should contribute to facilitating the removal of the capital controls, the MPC agreed that current conditions do not warrant their easing. The recent weakening of the króna suggests that downward pressure on the currency is still substantial. In the Committee's view the capital controls would still be needed to support the króna for some time, however, a plan for the gradual removal of the controls is being worked on.

The MPC discussed the stock of non-resident ISK positions in the financial system. According to the latest estimates, this has declined from roughly 680 b.kr. in early 2009 to roughly 610 b.kr. in June-end. Long-term holdings have increased slightly, while shorter-term positions have fallen from about 330 b.kr. to 260 b.kr. Although these numbers are somewhat uncertain, they suggest a significant reduction in the possible overhang of non-resident ISK positions.

The MPC also discussed the recent developments in financial markets. Among the issues covered were the excess liquidity in the domestic market, the extent of circumvention of the capital controls, the volume in the onshore and offshore foreign exchange markets, the slope of the yield curve and the maturities and issuances of government debt.

Some MPC members expressed concerns over excess liquidity in the króna market and stressed the importance of improving the Bank's liquidity management. This excess liquidity could be contributing to the weakening of the currency, and it would therefore be important to remove this excess liquidity from the market.

All MPC members expressed concerns over the recent depreciation of the currency. Some expressed concerns that possible circumventions of the capital controls are offsetting the surplus on the trade account. This, together with deteriorating terms of trade and large interest payments in June, has therefore contributed to continuing weakening of the króna in June.

Some MPC members believed that the recent weakening of the króna was not caused by previous rate cuts to any significant extent. However, some members argued that one could not entirely dismiss the possibility that the significant lowering of the policy rate and in particular the policy rate in May could have played a part. Hence, further easing of monetary policy was at this stage viewed as inappropriate until the króna had recovered significantly from its current position. An interest rate hike might even become necessary if the króna does not strengthen within some time.

The MPC also discussed the rise in inflation in June. The factors contributing to this increase were recent indirect tax hikes and the weakening of the króna. With developments in the real economy broadly in line with expectations, it was agreed that limited inflationary pressures were present in the economy. In the Committee's view, the disinflation path towards the inflation target will commence once the exchange rate stabilises.

Some members of the Committee expressed the opinion that monetary policy might have to remain tight for some time to maintain the value of the currency. They were concerned that rising inflation posed the risk of undermining confidence in monetary policy and the króna. The policy rate should not be allowed to fall too low during the disinflation process to avoid further damaging investors' confidence in the currency. The MPC discussed the options of leaving the policy rate unchanged and of increasing it slightly. The possibility of increasing just the deposit rate was also discussed. In light of the discussion, the Governor proposed that the policy rate and deposit rates be left unchanged and the proposal was accepted unanimously.

Although the Committee recognises the progress that has been made regarding fiscal consolidation, as well as the contribution from the social partners, it is the MPC's view that the weak exchange rate precludes further interest rate cuts. However, these factors should bolster confidence in the króna over the medium term and thereby contribute to its appreciation. The Committee also stated that if the króna does not appreciate, it might be necessary to raise interest rates at a later date.

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 Anne Sibert, external member
Professor Gylfi Zoëga, external member

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

Adalheidur Ósk Gudlaugsdóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday, August 13, 2009.