



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

## Minutes of the Monetary Policy Committee meeting

June 2010

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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 meeting held on 22 June 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 23 June 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 interest rate decision on 5 May.

#### **Financial markets**

The average trade-weighted value of the króna in the onshore market was 5% higher at the time of the June MPC meeting than at its May meeting. Between meetings, the króna had appreciated by 6% against the euro, 4.1% against the pound sterling and 1.4% against the US dollar.

The Central Bank has not intervened in the foreign exchange market since early November. The volume of trading in the foreign exchange market has picked up recently and amounted to 19.5 m. euros since the May meeting.

Residents’ FX account balances in domestic banks have decreased slightly since the last MPC meeting, which can probably be attributed to the appreciation of the króna against the euro.

In the offshore market, trading volume has been low since the last MPC meeting and the króna continued to trade at 270-290 against the euro, although it has appreciated in the offshore market to 235-255 following the announcement on 31 May that pension funds would buy Housing Finance Fund bonds from the government and the announcement on 9 June of a bilateral swap agreement between the People's Bank of China and the Central Bank of Iceland.

Risk premia for the Republic of Iceland, as measured by the CDS spread, had subsided since the May meeting. The CDS spread for the sovereign was 327 basis points at the June meeting, down from 376 basis points at the May meeting. This has occurred despite a concurrent rise in CDS spreads for many European countries reflecting the European debt crisis.

An invitation was issued by the Central Bank on 16 June to buy back foreign currency bonds due in 2011 and 2012. At the MPC meeting it was announced that the buybacks would total 160 m. and 32 m. euros nominal value of the respective series. Over the past six months the Central Bank had already acquired notes from the same series on the secondary market. Total purchases, including the buybacks in June, amount to 362 m. and 42 m. euros nominal value of the respective series. This will reduce the outstanding stock of foreign currency bonds maturing in 2011 and 2012 by 404 m. euros.

Seven auctions of certificates of deposit (CDs) had been held since the May meeting, and about 101.2 b.kr. worth of CDs were outstanding as of the June meeting.

Overnight interbank market rates remained within the Central Bank's interest rate corridor and were 0.5 percentage points above the current account rate as of the June meeting. Trading volume in the interbank market since the last MPC meeting remains relatively low, at 52 b.kr. and is concentrated in overnight transactions.

The yield in the mid-June Treasury bill auction was 5.95%, compared with 6.74% in the mid-April auction. The yield on Treasury notes had also declined by 0.39-0.52 percentage points from the May meeting. At the same time, yields on indexed HFF bonds had declined by 0.37-0.41 percentage points.

Revised data on money holdings in March 2010 shows that the money supply has contracted since the beginning of the year, with narrow money (M1) contracting by 5% and broad money (M3) by 2%, consistent with the bank's limited lending activity. The year-on-year increase is 3% in both cases.

New preliminary figures on the banking system have now been published. Deposit institutions' total assets amounted to 2,956 b.kr. at year-end 2009, as opposed to 14,895 b.kr. at the end of September 2008. Loans accounted for approximately 70% of total assets at the end of 2009. As of year-end 2009, deposit institutions' loans to residents totalled just under 1,769 b.kr., decreasing from 4,786 b.kr. at the end of September 2008. Changes in residents' deposits have been much less. Since September 2008 residents' deposits have increased by 167 b.kr. to total 1,580 b.kr. at year-end 2009.

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

According to the latest OECD forecast, published in May 2010, growth in OECD countries is expected to reach 2.7% in 2010, which is higher than in the OECD forecast published in November 2009. The forecast for average output growth in Iceland's main trading-partners is also somewhat higher, at 1.5% in 2010. Furthermore, the forecast for world trade has continued to be revised upwards and trade is now expected to grow by 10.6% this year, 4.6 percentage points more than in the previous forecast, and 3.6 percentage points more than IMF assumed in their latest forecast in April 2010. This revision is due mainly to a very strong start to the year.

The merchandise trade surplus in Iceland was roughly 6 b.kr. in April but rose to 16.8 b.kr. in May, according to preliminary figures, due primarily to a substantial increase in exports. The merchandise trade surplus in the first five months of the year was 52 b.kr., 51% larger than in the same period in 2009.

The króna value of exports increased by 25% year-on-year in April, with the value of all main export products rising significantly. According to preliminary data, exports increased even further in May and were 39% higher than a year ago. The króna value of imports increased by 6% year-on-year in April, due to an increase in imports value of capital goods and industrial supplies. According to preliminary figures, króna value of imports grew by almost 16% year-on-year in May, with increases recorded in most components.

The price of aluminium peaked in mid-April and has since fallen somewhat; at the beginning of June aluminium prices were 10% lower than in April and 5% lower than in May. Nominal exports of aluminium fell by 39% in April, due to fewer shipments that month than in a normal month.

## **The domestic real economy and inflation**

Preliminary quarterly national accounts figures for Q1/2010 were broadly in line with the Central Bank's May forecast in *Monetary Bulletin 2010/2*, although the figures suggest that economic activity was slightly weaker than predicted. Q1 data, however, tends to be revised substantially after its first preliminary publication.

The contribution to GDP quarterly growth in Q1/2010 (seasonally adjusted) was positive from both private and public consumption, while the contribution from gross fixed capital formation and net trade was negative. Private consumption grew for the third consecutive quarter, rising by 2.7% quarter-on-quarter. Public consumption grew by 0.2% quarter-on-quarter, after declining for the whole of 2009. Exports, on the other hand fell by 9.4%, resulting in a negative contribution from net trade of 4.9%.

Statistics Iceland numbers indicate that seasonally adjusted GDP grew by 0.6% quarter-on-quarter in Q1, while Central Bank of Iceland seasonally adjusted figures suggest that GDP was still contracting between quarters in Q1, in line with the May forecast. Thus, the interpretation of the Q1 GDP data and the perceived timing of the recovery critically depends on the seasonal adjustment method used.

The current account deficit was 27. b.kr., or 7.2% of GDP, in Q1/2010. This is a reversal from the previous quarter, when the current account was positive by 6% of GDP. In Q1-Q3 2009, the deficit amounted to 6-8% of GDP. Although the current account deficit is

mainly due to a 54 b.kr. income account deficit, the services account was also negative by 3.6 b.kr. The merchandise account, on the other hand, remained positive, as in previous quarters, in the amount of 31 b.kr.

The current account deficit excluding accrued interest arising from the ongoing winding-up proceedings of the failed DMBs, was much smaller or 0.7% of GDP in Q1/2010.

Registered unemployment fell from 9.3% in March to 8.3% in May. Unemployment usually declines in April and May, although other factors also appear to be involved here. The fall in unemployment may also reflect changes in methods of calculating unemployment and changes in entitlement to unemployment benefits.

Indicators suggest that the labour market may soften somewhat further. According to the Capacent Gallup business sentiment survey carried out among Iceland's 400 largest companies, with the exception of the wholesale sector, more firms in all sectors expected to lay off staff in June than in a comparable survey carried out in March, and a proportion similar to that of the March survey are considering hiring staff. The wage index rose by 0.1% month-on-month in April and by 0.2% in May.

A number of indicators, such as payment card and groceries turnover, as well as retail sales, suggest that domestic private consumption weakened somewhat in April and May from Q1/2010, and residents' seasonally adjusted payment card turnover abroad has started to decline month-on-month. Nevertheless, the Consumer Confidence Index increased by further 2.7 points in May to its highest level since the onset of the financial crisis.

According to the Capacent Gallup business sentiment survey in June, executives continue to be pessimistic about the current economic situation. While 87% of firms considered the current economic situation bleak, they were less pessimistic about the outlook six months ahead than they were in March. In June, roughly 30% of companies believed that the economic situation would improve in six months' time, compared to 25% in March, while 28% of companies expected further deterioration of the economic situation, slightly higher than in March. Despite the improved overall outlook among businessmen they were more pessimistic concerning domestic demand. Roughly 30% of companies expected domestic demand to decline over the next six months, compared to 27% in March, and only 17% of respondents assume it will increase. Also according to the survey, corporate inflation expectations have continued to decrease, with the median company expecting 3% inflation over the next twelve months, or 1 percentage point lower than in the March survey.

Annual inflation continued to decline in May, measuring 7.5%, as the CPI rose by 0.41% month-on-month. Underlying inflation, measured by the CPI excluding tax effects, was 6.1% year-on-year. Annualised seasonally adjusted three-month inflation measured 3.6% in May, compared to 7.1% in April.

Base effects played a significant part in the annual measure in May as the May 2009 increase of 1.1% disappeared from twelve-month measurements. Cost of owner-occupied housing rose by 1.2%, the highest month-on-month since October 2009, and reverses the steady downward trend since that month. Prices of various other components increased in May mainly due to seasonal effects.

The appreciation of the króna since January has affected prices of imported goods to some extent. Prices of groceries decreased by 0.6% in May mainly reflecting price decreases for domestic food products.

## **II The interest rate decision**

The Governor informed the MPC of the status of the dispute over compensation to depositors in foreign branches of Landsbanki. The MPC was also informed of the recent steps in the financial sector restructuring process, the Supreme Court ruling on the legality of FX-linked loans, the agreement with the Banque centrale de Luxembourg and the liquidator of Landsbanki Luxembourg SA, concerning the purchase of outstanding Avens BV bonds, the decision to buy back some of the outstanding euro notes due in 2011 and 2012, the request to draw on bilateral credit lines negotiated with the other Nordic countries and Poland, and the signing of a bilateral currency swap agreement between the People's Bank of China and the Central Bank of Iceland.

The Committee discussed the strategy for relaxing capital controls and the need to replace borrowed reserves with non-borrowed reserves. The appreciating króna and lower external risk premia could allow modest regular purchases of foreign currency. The committee was of the view that it was important that the timing and quantity of such purchases would be conducted so as to minimise the effect on the króna. Furthermore, the committee agreed that no decision on such purchases would be taken before the August MPC meeting.

The Committee noted that the króna had strengthened, both in trade-weighted terms and against the euro, in the onshore market since the last MPC meeting, without any Central Bank intervention. Furthermore, Icelandic sovereign risk premia have fallen since the last MPC meeting. In the MPC's view, the króna continued to be supported by the capital controls, current account developments and the risk-adjusted interest rate differential with major currencies.

As the Committee had expected, inflation declined in May. Furthermore, this was broadly in line with the forecast published in the *Monetary Bulletin* 2010/2 on 5 May. Inflation excluding consumption tax effects is expected reach the target early next year. All members agreed that the macroeconomic outlook was broadly unchanged from the last meeting.

The Committee also discussed the possible macroeconomic effects of the Supreme Court ruling on the legality of FX-linked loans. The committee was of the view that in the short term this might boost private consumption, but that offsetting negative effects on aggregate demand are likely over the medium term due to a greater fiscal burden and the negative effects on bank balance sheets. This would reduce their readiness and ability to supply new credit to the private sector and their capacity to continue ongoing debt restructuring. There was therefore a risk that the ruling could slow the economic recovery. The Committee agreed that the ruling could also have financial stability implications and if not resolved promptly, could undermine confidence and further constrain monetary policy.

The Committee discussed the evolution of the real stance on monetary policy as measured by real policy rate and the risk-adjusted interest rate differential with major

currencies. Overall, its stance was deemed to be broadly unchanged or to have tightened somewhat, depending on different measures of the policy stance.

In light of the discussion, Committee members discussed the possibility of keeping the policy rate unchanged or lowering the policy rate by up to 0.75 percentage points. As before, members agreed that a forecast of declining inflation in the context of a weak economy was an argument for a reduction in interest rates. Furthermore, the improving current account, declining CDS spreads, rising risk-adjusted interest rates and the appreciation of the króna provided scope for continued cautious easing of monetary policy.

The MPC noted, however, the need to take into account the planned removal of capital controls. Furthermore, the MPC was of the view that uncertainty arising from the Supreme Court ruling could affect confidence in the króna and public finances. This argued for smaller rate cuts than otherwise would be advisable.

In light of the discussion and the range of views expressed, the Governor proposed a rate cut of 0.5 percentage points. This implied that the deposit rate (current account rate) and the CD rate would be lowered to 6.5% and 7.75%, respectively, the seven-day collateralised lending rate to 8.0%, and the overnight lending rate to 9.5%. All the MPC members accepted the Governor's proposal. Although two MPC members would have preferred a slightly different decision, their view was that the difference was small enough to accept the Governor's proposal.

Of the two members favouring a different action, one suggested a rate cut of a 0.25 percentage points, arguing that the true risk premium on Icelandic assets was underestimated by the CDS spread and that scope for easing without undermining the króna was therefore less than suggested by the CDS spread. The other member argued that the declining inflation rate reflected the final stages of the exchange rate pass-through following the weakening of the króna last year. With falling inflation, steady inflation expectations, and the króna appreciating, an interest rate cut of 0.75 percentage points would therefore be warranted. This member also added that the uncertainty created by the recent Supreme Court ruling could deepen the financial crisis by weakening the banking system, favouring lower rates, but could also magnify the currency crisis, making higher rates advisable. However, this member argued that the effect on the currency crisis would be best dealt with by through capital controls, enabling lower interest rates to respond to the financial crisis.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation develops as forecast, there should be some scope for continued gradual monetary easing. It was noted, however, that the room for manoeuvre is limited by remaining uncertainty concerning Iceland's medium-term access to global financial markets and the prospect of capital account liberalisation. The additional uncertainty caused by the recent Supreme Court ruling on the legality of FX-linked loans could, if not resolved promptly, undermine confidence and further constrain monetary policy. Furthermore, the MPC agreed that it should stand ready to adjust its 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 meeting.

Regína Bjarnadóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday, 18 August 2010.