The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting
March 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 meetings held on 16 March 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 17 March, 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 27 January interest rate decision.

Financial markets

The average trade-weighted value of the króna in the onshore market was 3.2% higher at the time of the March MPC meeting than at the January meeting. The króna has appreciated by approximately 4.2% against the euro and 8% against the pound in the on-shore market since the last MPC meeting, but has remained broadly unchanged against US dollar. The Central Bank has not intervened in the foreign exchange market since early November. Volume in the foreign exchange market has been low, at 4 m. euros in February and another 4 m. euros during the first two weeks in March. Residents' FX account balances at domestic banks have remained fairly stable since the last MPC meeting.

The króna weakened in the offshore market since the last MPC meeting, trading at 270-290 against the euro. Trading volume remains low.

Risk premia on the Republic of Iceland, as measured by the CDS spread, had subsided since the January meeting and were in line with the levels at the time of Fitch Ratings' downgrade following the president's decision not to sign the Icesave legislation. This may reflect external factors, however, as CDS spreads on Portuguese, Irish, Italian, Greek and Spanish sovereign debt had also declined since their peaks at the beginning of February.

Seven certificate of deposit (CD) auctions had been held since the January meeting, and about 37.1 b.kr. worth of CDs were outstanding at the time of the March meeting.

Overnight interbank market rates remained within the Central Bank's interest rate corridor and were 0.6 percentage points above the current account rate as of the March meeting. Trading volume in the interbank market had been 86 b.kr. since the last MPC meeting, which is just under one-third of last year's trading. Trading is limited primarily to overnight transactions.

The yield in the mid-March Treasury bill auction was 7.75%, compared with 8.0% in the mid-January auction. The yield on T-notes had also declined by 0.4 to 1.45 percentage points from the January meeting. At the same time, yields on indexed HFF bonds were broadly unchanged.

Banknotes and coins in circulation increased towards the end of 2009, particularly in December, but subsided somewhat in the first two months of 2010. Towards the end of the year, M3 declined year-on-year, with a measurable contraction in both November and December after substantial growth in previous years. A portion of this can be attributed to a contraction in the shortest-term time deposits.

Outlook for the global real economy and international trade

According to the latest IMF forecast from January 2010, global growth is expected to be 4% in 2010, 0.75 percentage points higher than predicted in the October 2009 forecast. Economic growth in Iceland's main trading partner countries has therefore been revised up from 0.7% to 1.3%. Furthermore, world trade volumes have been revised upwards by 3.3 percentage points to 5.8% in 2010.

The merchandise trade surplus was 7 b.kr. in January, little changed from the 6.5 b.kr. surplus in December. According to preliminary numbers, the trade surplus rose to 13 b.kr. in February, mainly due to a 16% rise in exports since January. The merchandise trade surplus for 2009 was 93.4 b.kr.: a substantial change from the 38 b.kr. deficit in 2008.

Export values in domestic currency declined by 7% month-on-month in January because of smaller export volumes, most likely due to fewer shipments of aluminium in January than in a typical month. The value of imports in domestic currency declined by just over 7% month-on-month, mainly due to a substantial fall in imports of consumer goods and transport equipments.

The 15% fall in aluminium prices in the latter half of January had reversed and aluminium prices had returned to mid-January levels by the time of the MPC meeting. The value of marine product exports fell by 20% month-on-month in January.

The domestic real economy and inflation

Preliminary quarterly national accounts figures indicate that the Icelandic economy was somewhat stronger in Q4/2009 than was assumed in the Central Bank's January forecast, which appeared in *Monetary Bulletin* 2010/1.

All of the main subgroups of GDP experienced positive (seasonally adjusted) growth in Q4 except public consumption. Private consumption grew for the second consecutive quarter, rising by 1.4%, quarter-on-quarter. Exports grew by 3%, while imports grew by 1.5%, down from 10.3% in Q3. Government final consumption has contracted quarter-on-quarter for the whole of 2009. The Statistic Iceland numbers indicate that GDP grew by 3.3% quarter-on-quarter in Q4; however, this result is critically dependent on the method used for seasonal adjustment, which leads to an upward bias of GDP growth between Q3 and Q4/2009, and therefore to a downward bias of GDP growth between other quarters of that year. Other approaches to seasonal adjustment suggest that GDP was still contracting between quarters in Q4, which is more in line with the January forecast.

GDP fell by 6.5% in 2009. As in 2007 and 2008, the decline in GDP was much less than the decline in gross domestic final expenditure, which was 21% in 2009. This was because of a substantial positive contribution from the trade account. Exports of goods and services increased by 6.2% in 2009, while imports fell by 24%.

The current account deficit was 13. b.kr., or 3.4% of GDP, in Q4/2009. This is a reversal from the previous quarter, when the current account was positive by 1.6% of GDP, but the deficit was smaller than those of the first two quarters of 2009. The current account deficit is due to a 41 b.kr. income account deficit; the merchandise and service accounts were positive at 8 b.kr. and 21 b.kr., respectively.

For the year as a whole, the current account deficit totalled 3.3% of GDP, compared with 18.5% in 2008. The current account balance excluding accrued interest rates related to the undergoing winding up proceedings of the failed deposit-taking institutes, as a share of GDP, was a 3% surplus for the year 2009.

Registered unemployment increased from 8.2% in December to 9.3% in February. The wage index rose by 0.1% month-on-month in January and by 3.1% year-on-year. Real wages fell by the same amount.

A number of economic indicators, such as payment card and groceries turnover, retail sales, and unemployment suggest that private consumption remained relatively stable, although contracting slightly, in January and February from Q4/2009.

The consumer sentiment index and all its sub-indices, apart from the index measuring sentiment towards the current economic situation, increased slightly in February.

After a steady decline since June 2009, end-of-winter sales caused inflation to rise from 6.6% to 7.3% in February, with the CPI rising by 1.15% from the previous month. Annual inflation in February was lower, however, than in December, when it measured 7.5%. Annualised seasonally adjusted three-month inflation measured 7.1%, compared to 6.1% in January. There were no monthly consumer tax effects in February.

End-of-winter sales accounted for almost 0.6 percentage points of the increase in the CPI, private services contributed 0.2 percentage points, and the transport component contributed 0.17 percentage points. The overall housing component accounted for 0.07 percentage points of the increase in the CPI, due to an increase in paid rent and a sizeable increase in the price of repair costs, but owner-imputed rent was unchanged from January.

The Statistics Iceland housing price index for the entire country, published in February, rose by 0.4% from the month before. The housing price index for the greater Reykjavík area, calculated by the Icelandic Property Registry, increased by the same amount, but adjusted to seasonality it decreased by 0.1%. Housing market turnover remains limited.

II The interest rate decision

The Governor informed the MPC of the status of the Second Review and the IMF Stand-By Arrangement, as well as 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 Committee noted that the króna had strengthened in trade-weighted terms in the onshore market since the last MPC meeting, without any Central Bank intervention. Furthermore, this had occurred at the same time as there was continued uncertainty about Iceland´s medium term access to global financial markets and Iceland´s sovereign rating was on a negative outlook. In the MPC's view, this reflected the effectiveness of the capital controls and more favourable current account developments.

The Committee noted that inflation had picked up in February, after declining in December and January. Inflation measured to 7.3% year-on-year in February, or 5.9% excluding the impact of higher consumption taxes. Although inflation is assumed to rise further year-on-year in March due to unfavourable base effects, members agreed that the pick-up in inflation was broadly anticipated and did not fundamentally change the conclusion of the January forecast as published in *Monetary Bulletin* 2010/1. According to that forecast, underlying inflation is expected to reach the target late this year. Some members expressed concerns over the risk of second-round effects on inflation from wage pressures caused by rising profitability in the traded goods sector while one member argued that there was only a modest risk of second-round effects on inflation as long as the unemployment rate remains high.

The MPC discussed the implications of the delay in resolving the dispute over compensation to depositors in foreign branches of Landsbanki, which was delaying the Second Review of the IMF programme and the associated financing, with further effects on private funding of many new investment projects. Although the Committee did not expect it to have a substantial immediate effect on the exchange rate, given the continued effectiveness of the capital controls, the delay had already triggered a sovereign credit rating downgrade to non-investment grade by one rating agency.

Although last year's contraction in output was smaller than forecast in January, mostly because of temporary effects, uncertainty about the economic outlook had mounted because of greater uncertainty about the progress of the economic programme set forth by the Government and the IMF. The MPC noted that if uncertainty were not resolved soon, the result could be curtailed access to international capital markets and reduced likelihood of new foreign direct investment in the short to medium term.

Members discussed effects of and responses to a prolonged absence of both multilateral and bilateral financing or full access to international capital markets on acceptable terms. They agreed that this would call for even tighter fiscal policy than is currently projected, in order to ensure the sustainability of government debt and bolster Iceland's creditworthiness. The Central Bank would in this case also have at some point to enter the foreign exchange market and buy significant amounts of foreign currency in order to ensure that foreign exchange reserves do not become dangerously low after big repayments of sovereign debt in the winter of 2011/12. The result would be a lower value of the króna and higher inflation than otherwise. The short-to-medium term objective of the current economic programme of shielding living standards following the collapse of the banking system would thus be jeopardised.

The delay would also lead to less investment and higher unemployment, as any new investment projects would have to be financed through domestic savings, which would only be generated either through a larger contraction in private or public consumption without putting downward pressure on the exchange rate. Moreover, it would be risky to lift the capital controls under these circumstances.

On the other hand, if the capital controls should remain in effect and effective for an extended period, the Committee agreed that it could have some additional room for manoeuvre in its interest rate decisions in favour of the real domestic economy. However, it was important that the Government either secured the Second Review of the IMF programme or decided to follow an alternative plan of action, since following the current programme without the Second Review being completed and the associated external financing could lead to balance of payments problems. One member expressed the view that the design of such an alternative economic programme, based on the assumption of continued lack of access to international capital markets, IMF funding and the Nordic loans, was timely.

Some members of the Committee discussed the possibility that the committee should, in accordance with Article 24 of the Central Bank Act, issue a warning of a serious threat to the financial system. Their concern was the increased likelihood of a prolonged delay in access to external financing because of the delay of the Second Review of the IMF programme. Such a prolonged delay might bring reserves down to critically low levels after big sovereign debt amortisations in 2011 and 2012, which could in turn undermine creditworthiness and the króna. The Committee decided that issuing such a warning was premature. However, it decided to investigate the matter further and study updated detailed balance of payments projections at its next meeting in May.

As before, members agreed that the current state and outlook for the real economy and limited inflation pressures called for lower interest rates, while elevated CDS spreads and a negative rating outlook associated with uncertainty about Iceland's access to global financial markets supported a relatively cautious move this time, due to potential negative pressure on the króna.

Members discussed the possibility of keeping interest rates unchanged or lowering the policy rate by up to 1.5 percentage points. In light of the discussions 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 7.5% and 8.75%, respectively, the seven-day collateral lending rate to 9.0%, and the overnight lending rate to 10.5%. Although three MPC members would have preferred a slightly different decision, all viewed that the difference was small enough to accept the Governor's proposal.

Of the three members airing different moves, one suggested a rate cut of 1.0 percentage point, emphasising that a larger cut would facilitate the restructuring of domestic balance sheets by shifting income from creditors to debtors and help offset some of the effects of the fiscal policy contraction under way. The other two members suggested a smaller step, with one suggesting unchanged rates and one suggesting a 0.25 percentage points cut. Both recommended caution, expressing concerns about the near-term inflation outlook.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation continues to subside as forecast, there should be scope for continued gradual monetary easing. However, the MPC stressed that, as long as there is significant uncertainty about Iceland's future access to foreign capital markets, it will limit the Committee's room for manoeuvre. Furthermore, the MPC agreed that it should stand 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 meeting.

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 5 May 2010.