



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

## Minutes of the Monetary Policy Committee meeting, June 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 interest 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 June 3, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of June 4, and the communication of that decision.

### **I Economic and monetary developments**

In its discussions, the MPC emphasised the following new information that has emerged since the previous interest rate decision on May 7.

#### **Financial markets**

Payments on external loans and outflows associated with large scale investment projects exerted pressure on the króna in the onshore market in the first three weeks of May, but the currency recovered somewhat during the last week of the month. The foreign exchange market is quite thin and large payments can have a significant affect on the exchange rate.

The exchange rate was significantly below the level the MPC had previously considered to be acceptable. In trade-weighted terms, the króna was roughly 0.5% weaker in the first two days of June than it was at the publication of the last MPC statement on May 7. It was almost 7% weaker than was assumed in the baseline forecast for Q2/2009 for the *May Monetary Bulletin*.

Turnover on the foreign exchange market totalled 5.2 b.kr. in May. The Central Bank intervened in support of the króna in mid-May. The Central Bank did not intervene

during the last week of May when the króna strengthened somewhat. Despite earlier intervention, net reserves strengthened somewhat over Q2/2009.

The spread between the onshore and offshore exchange rates had narrowed between MPC meetings, with the króna trading at 190-210 against the euro on the offshore market. This must be interpreted with caution, however, as few trades were taking place in the offshore market.

Prices in both the bond market and the CDS market suggest that since the last MPC meeting, the market's assessment of the credit worthiness of the Republic of Iceland had improved somewhat. The CDS market, however, is very thin and reported prices do not necessarily reflect actual trades or committed quotes.

Short-term interest rates in Iceland's main trading partner countries declined by up to  $\frac{1}{3}$  of a percentage point since the monetary policy decision in May. The spread between the domestic policy rate and the European Central Bank policy rate had narrowed by 2.25 percentage points to 12 percentage points. The three-month interbank interest rate differential against the euro was roughly 1 percentage points lower at the beginning of June than on May 7, although the spread remained sizable at around 6 percentage points.

Since early May, market interest rates have fallen significantly. Short-term interest rates have come down by roughly 4 percentage points and longer-term real and nominal rates by 0.5 and 1.5 percentage points, respectively.

Although rates had already started to decline prior to the last MPC rate decision, a significant share of the decline occurred after the decision. From the publication of the MPC decision on May 7, short-term nominal rates had fallen by roughly 2.4 percentage points while longer-term rates had declined by 0.6 percentage points. The nominal yield curve had therefore become slightly upward-sloping. Real rates had also declined since May 7: by 1.2 percentage points at the shorter end of the yield curve and by 0.2 percentage points at the longer end. The publication of the higher than expected CPI figures in May (see below) did not have much effect on indexed yields, with rates fluctuating around 4%. The real yield curve is now flat after shifting down in the first weeks of May.

With the ample liquidity in the financial system, the Bank's deposit rate appears to be playing a more important role in determining short-term interest rates. Retail deposit rates had also fallen substantially in line with other interest rates.

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

The external trade surplus was down from 8.4 b.kr. in March to 2.3 b.kr. in April, which is the second-lowest surplus since the balance of trade turned positive last September. Excluding irregular items such as ships and aircraft, the trade balance was 1.9 b.kr in April. The lower April surplus is a result of lower export prices, as the value of imports continued to decline.

In April, the value of imported goods had declined by 0.7% month-on-month and had declined by 50% over the previous year. Only imports of irregular components, such as fuel and industrial supplies, increased in month-on-month terms.

The total value of exported goods amounted to 31.7 b.kr. in April, the lowest since August 2006. This was a result of lower prices for aluminum and fish products, which accounted for 83% of the value of merchandise exports. The month-on-month contraction of exports amounted to 19%, but the year-on-year contraction was 45%. The value of marine product exports declined by 12% month-on-month and 35% year-on-year, while the value of exported aluminium declined by 5% and 23%, respectively, over the same periods, despite volumes remaining robust.

Preliminary figures, based on data from large firms, estimates based on data from 2008 and VAT reports for small and medium-sized firms, indicate a deficit of 2.9 b.kr. for the services account for Q1/2009. This follows deficits of 4.4 b.kr. for Q4/2008. The Q1/2009 deficit is mainly a result of the travel component: transport services had a deficit of almost 4 b.kr., while trade in other services was in balance.

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

The Consumer Confidence Index decreased by 9 points in May to 29.9. Based on a three-month average, the index has fallen by 60% year-on-year. All sub-indices except the index covering the current economic situation fell in May; sentiment concerning the economic situation in six months decreased the most.

In April, the wage index decreased by 0.2% from the previous month but had risen by 4.5% year-on-year. Real wages were down by 0.6% month-on-month in April and by 6.7% compared to the same month in 2008.

Registered unemployment totalled 9.1% in April, up from 8.9% in March. Seasonally adjusted unemployment increased by 1 percentage point month-on-month to 8.5%.

Prices of residential housing had fallen by 12.1% in May from their peak in October 2007 and by 27.2% in real terms. Turnover is at an historical low; roughly 100 contracts are concluded per month as opposed to almost 1100 at the time when prices reached their peak. The share of housing swaps has increased and amounted to roughly 50% of agreements in the housing market contracts in May.

Year-on-year inflation measured 11.6% in May, decreasing by 0.3 percentage points month-on-month despite the significant month-on-month increase of 1.13%. The CPI excluding the housing component increased by 1.44% month-on-month and has increased by 15.5% year-on-year. Underlying inflation, according to core index 3 (i.e. headline CPI excluding volatile items such as agricultural products and petrol, prices of public services, and mortgage payments costs) was 13.1% over the previous twelve months.

Annualised seasonally adjusted three-month inflation was 1.8% in May, as opposed to 1.2% in April.

The increase in the CPI was mainly due to the recent depreciation of the króna and the lingering effects of last year's depreciation. Higher prices of imported goods accounted for 0.8% of the overall increase. The 1.3% price increase for private services, mainly due to an increase in international airfares, explains just under 0.3% of the CPI increase.

The depreciation of the króna since March 12 affected prices of items which respond rapidly to exchange rate changes, such as petrol and diesel fuel and prices of new motor vehicles, both of which increased by 5% in May. Prices of other items that typically respond more gradually to changes in the exchange rate also rose significantly.

Housing prices rose 1.3% in May. The data can be volatile, but house prices have been declining rapidly in recent months and this rise was unexpected. It is mainly due to a 4.2% increase in housing prices outside Reykjavík and a roughly 2% increase in prices of single-unit dwellings in Reykjavík. Outside Reykjavík, prices have declined by 10.3% year-on-year.

GDP declined by 3.9% between Q1/2008 to Q1/2009, according to the preliminary National Account data released on June 8. This is a smaller decline than was expected in the baseline forecast in the May *Monetary Bulletin*. A 22% decline in domestic demand was nearly offset by a 34% decrease in imports and an 11% increase in exports.

## **II The interest rate decision**

The Committee discussed the financial restructuring and the options that are being considered to address the foreign exchange imbalances of the banks. The state of the domestic financial institutions was also discussed.

The Governor informed the MPC about meetings held with staff from the Ministry of Finance, the social partners and the IMF representative. Staff from the Ministry of Finance presented an outline of the fiscal adjustments planned for 2009-2013 and the options being considered to establish balanced budgets within this timeframe. The social partners presented the status of the ongoing processes, including measures to accelerate the recovery process. The IMF representative presented the Fund's view on the importance of currency stability to stabilise the economy and rebuild balance sheets; continued prudence in reserves management; and easing capital controls in a way that is compatible with supporting the króna.

The Committee observed that, since early May, nominal and real market interest rates had fallen significantly. As a consequence, the nominal and real yield curves have flattened and even turned upward sloping. Furthermore, retail deposit rates had fallen markedly. The nominal yield curve implied that the market had already priced in a roughly 1 percentage point cut in the policy rate. This is also consistent with expectations of most financial market analysts.

The main concern of the MPC was the need to support the value of the króna. This would protect vulnerable private sector balance sheets, reduce pressures on the capital controls and promote a decline in inflation. Members were of the view that significant exchange rate effects from the earlier depreciation were still being passed through into the CPI. This would explain a part of the rise in CPI in May.

The MPC argued that the rise in the housing component that had contributed to the increase in May appeared temporary, since it probably reflects phenomena linked to sampling variability and the increased share of housing swaps. The year-on-year inflation rate had continued to ease in May. Given stable exchange rates and the continued stability of nominal wages, the Committee agreed that the disinflation process would probably continue at broadly the same pace as in the May forecast. Projections continue to indicate that inflation will be close to the 2.5% target by early 2010.

In its May 7 statement, the MPC had anticipated further easing of monetary policy, conditional on favourable exchange rate developments and progress in fiscal consolidation. Since then the króna had been weak in the onshore market. Although the currency had been supported by a significant trade surplus, it appeared that, due to a deficit on the services account and a significant deterioration in the price of exports, the Q1/2009 surplus was smaller than expected. In addition, the April merchandise trade surplus had been relatively small as previously discussed.

As in May, the MPC considered it appropriate to shift the overall policy stance towards fiscal tightening and monetary easing to the extent that was possible without threatening exchange rate stability. The first fiscal policy measures had been passed by Alþingi but some members worried about a lack of a firm political commitment to significant expenditure cuts and tax increases. As further fiscal measures are implemented, the MPC decided to assess their impact and their implications for monetary policy decisions. The MPC viewed a decision on 2009 fiscal measures and a firm commitment on 2010-2012 fiscal consolidation as the cornerstone in re-establishing market credibility and thus allowing further monetary easing.

The main arguments presented for keeping rates unchanged or taking a smaller step this time were the importance of exchange rate stability, both in the short term and in the medium term when capital controls are removed, and the fact that key market rates have come down significantly since early May. A further reduction in the policy rate should thus be preceded by improved exchange rate developments and progress in establishing solid economic fundamentals, including a clear commitment to a credible plan of medium term fiscal consolidation, conclusion of bilateral loan agreements and financial restructuring. Some members particularly stressed that a large rate cut given the weak króna could send an inappropriate signal concerning the MPC's commitment to exchange rate stability, thus exerting further pressure on the exchange rate.

Members emphasised that stronger measures be taken to enforce the capital controls. One member argued that one of the main reasons for the weakening of the exchange rate in May had been increased circumvention of the controls.

The Committee also considered the specifics of easing capital controls. The risk of a premature easing is a sharp depreciation of the króna. The finalising of a sustainable fiscal programme and the completion of the bank restructuring will support an economic recovery and lessen the risk of exchange rate overshooting when the capital controls are removed. Thus, a cautious approach to monetary easing, in association with appropriate fiscal policy, should facilitate the removal of the capital controls while

maintaining the value of the króna. Once a medium-term fiscal consolidation plan is under way, bilateral and multilateral loan arrangements to supplement foreign reserves concluded, and financial sector restructuring had advanced, the first steps can be taken towards easing capital controls by lifting restrictions on new investment later this year.

In light of the above discussions, members discussed a potential rate decision in the range of unchanged to lowering the policy rate by 2.0 percentage points and the deposit rate by up to 1.25 percentage points.

The Governor proposed that the policy rate be lowered by 1.0 percentage points to 12.0%. The Governor invited other MPC members to vote on the proposal. Three MPC members voted in favour of the Governor's proposal. The other two members voted for leaving the policy rate unchanged. All members agreed that the deposit rate should be kept unchanged at 9.5%.

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.

Rannveig Sigurðardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday, July 2, 2009.