



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

## Minutes of the Monetary Policy Committee meeting

September 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 21 September 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 22 September 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 18 August.

#### **Financial markets**

The average trade-weighted value of the króna in the onshore market was 0.4% higher at the time of the September MPC meeting than at the August meeting. Between meetings, the króna appreciated marginally against the euro, by 2.9% against the pound sterling and 2.1% against the US dollar.

The volume in the interbank market continues to be low. The Central Bank began modest purchases of foreign currency at the end of August, buying 1.5 million euros once a week. Furthermore, the Central Bank has bought 8 million euros from the market makers, at their initiative, in two separate transactions.

In the offshore market, trading volume has been low since the last MPC meeting, and the króna has traded at 215-240 against the euro.

Risk premia for the Republic of Iceland as measured by the CDS spread have been broadly stable since the August meeting. The CDS spread for the sovereign was 300 basis points at the September meeting, as opposed to 320 basis points at the August meeting. The CDS on Iceland has not followed the developments seen in other high-CDS European countries, where spreads have risen since August.

About 66 b.kr. worth of certificates of deposit (CDs) were outstanding as of the September meeting, compared to 73 b.kr. at the August meeting.

Overnight interbank market rates were 0.5 percentage points above the current account rate as of the September meeting. Trading volume in the interbank market amounted to 24 b.kr. since the last MPC meeting, with the volume concentrated in overnight transactions.

The yield in the mid-September Treasury bill auction was 4.58%, compared with 4.68% in the mid-August auction and 5.49% in the July auction. The yield on long Treasury bonds had declined by 0.31-0.60 percentage points since the August meeting. At the same time, yields on indexed HFF bonds had declined by 0.81-1.07 percentage points.

Preliminary figures on the banking system in July showed that the downward trend in lending had continued since May. Outstanding loans to residents had decreased by 1.3% from May, due primarily to a 0.4% drop in loans to companies. Outstanding loans to companies in the service sector had increased by 1.3%, however. Foreign currency-denominated loans have declined by 2.3%, mainly due to the appreciation of the króna.

Since the announcement of the MPC decision on 18 August, the real effective policy rate (average of CB deposit and CD rates) has increased by 0.3 percentage points in terms of current year-on-year inflation but been broadly stable in terms of most forward-looking measures (CB inflation forecast, inflation expectations of corporations and breakeven inflation in the bond market). The risk-adjusted short-term interest rate differential with main trading partners had decreased by 0.2 percentage points.

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

Iceland's merchandise trade surplus was 4.6 b.kr. in July. According to preliminary numbers, the surplus was lower in August, at 2.4 b.kr. The value of merchandise exports was 42 b.kr. in August, while the value of imports was 39 b.kr.

The July and August surpluses were smaller than in previous months due both to a decline in export values and an increase in import values. Increases in the range of 2-4% month-on-month were recorded in most major import components in August. For the first eight months of this year, import values have been 10% higher than during the same period in 2009.

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

Preliminary quarterly national accounts figures from Statistics Iceland show that the Icelandic economy was somewhat weaker in Q2/2010 than assumed in the Central Bank's latest forecast, which appeared in *Monetary Bulletin* 2010/3 in August.

Compared to Q1/2010, Q2 shows a much larger year-on-year contraction in all subcomponents except exports and imports. The quarter-on-quarter contraction of seasonally adjusted GDP was 3.1%, larger than in the previous two quarters. In the first half of this year, the economy has contracted by 7.3% from the same period in 2009.

Both private consumption and gross fixed capital formation fell sharply in the second quarter of 2010, declining by 3.2% and 4.7%, quarter-on-quarter, respectively. The decline in consumption follows a much smaller drop of 0.9% in the first quarter while the fall in gross fixed investment was the smallest quarterly contraction since the onset of the crisis. Government final consumption grew by 1.0%, quarter-on-quarter, after having fallen for five consecutive quarters. The trade component grew by almost 4%, after having fallen for three consecutive quarters. This was due to a 2.8% increase in exports and a 5.1% decline in imports.

The current account deficit was equal to 2.4% of GDP, or 9 b.kr., in the second quarter of 2010, following a deficit of 4.9% of GDP in the first quarter. This was due to a large income account deficit (54 b.kr.), which more than offset service account and trade account surpluses of 14 b.kr. and 33 b.kr., respectively. The current account balance, excluding accrued interest expense related to the settlement of banks in winding-up proceedings, had a surplus of 3.9% of GDP, or almost 15 b.kr., in the second quarter; this was the second quarter of surplus in a row.

According to revised national accounts figures for 2009, the economy was slightly weaker than the preliminary figures from March had indicated, with GDP contracting by 6.8%. This was due to larger declines in private consumption and gross fixed capital formation than previously reported. Also, the apparent increase in government final consumption is due to the National Broadcasting Service being reclassified as public consumption. However, the contribution of trade was larger, as export numbers were revised upward by 1.2 percentage point due to larger service exports. There was no change in imports.

The 2009 current account deficit is now reported to be 2% of GDP, substantially smaller than the previously published figure of 3.8% indicated. The revision is due to a smaller income account deficit and a larger surplus in the trade and services account. The revised data also indicate that there was a surplus of 3.5% of GDP in the current account balance, excluding accrued interest expense related to the settlement of banks in winding-up proceedings, instead of the 2.1% that was previously reported. According to revised numbers for Q1/2010, the year-on-year contraction in GDP was 0.6 percentage points smaller than in the June numbers, or 6.3%. A major factor was a substantial downward revision in inventory growth.

Registered unemployment was 7.3% in August, down from 7.5% in July. Seasonally adjusted unemployment, on the other hand, inched up from 8.3% in July to 8.5% in August.

The wage index rose by 0.3% month-on-month in July. Nominal wages rose by 6.0% year-on-year. As a result of this wage increase and the 0.66% decrease in the CPI in July, real wages rose by 1.0% month-on-month and 1.1% year-on-year.

Statistics Iceland's nationwide housing price index, published in August, declined by 0.2% from the month before. The greater Reykjavík housing price index, calculated by the Icelandic Property Registry, remained unchanged from the previous month after having dropped by 1.3% in July. Seasonally adjusted, however, it rose by 0.2%. In August, the index had decreased by 3.6% year-on-year in nominal terms and by 7.8% in real terms. Activity in the real estate market has picked up somewhat. Accumulated turnover was around 43% higher in the first part of September than at the same time in 2009, although turnover remains very low in a historical context.

A number of economic indicators, such as payment card turnover, groceries turnover and retail sales, suggest that private consumption was stronger in Q3 than in Q2. The Consumer Sentiment Index has continued to rise, reaching a post-crisis high in August. Sentiment towards the current situation was still very negative, while expectations towards the economic situation six months ahead exceeded 100 points for the second consecutive month, indicating that respondents who were positive about the future economic situation exceeded those who were negative.

Inflation continued to subside in August, after a marked decline since March. The consumer price index (CPI) increased by 0.25% month-on-month and by 4.5% year-on-year, or 3.8% excluding consumption tax effects. Seasonally adjusted, the CPI fell by 0.3% in the last three months, a 1.2% decline on an annual basis.

The August increase in the CPI was due mainly to a 4.6% increase in the price of clothing and footwear, as summer sales had begun to come to an end. Prices of food and beverages increased by 0.55% in August, mainly due to higher prices of fruits and vegetables.

## **II The interest rate decision**

The Governor informed the MPC of the status of the Third Review of the IMF Stand-By Arrangement, the associated funding and outlook for reserves, the status of the dispute over compensation to depositors in foreign branches of Landsbanki, the recent meeting with the Confederation of Icelandic Employers (SA) and the Icelandic Federation of Labour (ASÍ), the meeting with the IMF representative, and the sale of the FIH Erhvervsbank.

The MPC was also informed of the recent Supreme Court judgment on the reference interest rate to be used in loan agreements with non-binding exchange rate linkage clauses. Furthermore, the half-year results for Íslandsbanki and Arion Bank were presented.

The MPC noted that short-term market rates have persistently been close to the bottom of the interest rate corridor. As a consequence, the Committee discussed the desirability of moving market rates closer to the middle of the corridor and possible ways of accomplishing this. The Committee agreed to look further into this issue at the next MPC meeting.

In the MPC's view, weak economic activity and this year's appreciation of the króna should continue to support further reduction in inflation. The Committee noted that the inflation outlook was also more or less unchanged since August, and, given a broadly stable exchange rate, it expected that inflation, excluding tax effects, would reach the

Bank's inflation target by year-end and fall somewhat below the target early in 2011. Inflation expectations have also continued to decline.

The MPC noted that the monetary stance, as measured by real Central Bank rates and the risk adjusted interest rate differential with trading partners, had remained broadly unchanged since the announcement of the 18 August interest rate decision.

The Committee noted that the króna has appreciated by roughly half a percentage point in the onshore market since the August meeting, both in trade-weighted terms and against the euro. As the Committee had expected, regular purchases of foreign currency by the Central Bank, which commenced on 31 August, appeared not to have significantly affected the króna. In the MPC's view, the capital controls, developments in terms of trade and other factors affecting the current account balance, and the monetary policy stance relative to trading partner countries will all continue to support the onshore exchange rate.

National accounts data for Q2/2010 indicate that demand and output are developing broadly in line with the Central Bank's updated forecast from August, although weaker-than-expected investment might suggest that the contraction in 2010 will be closer to that forecast in May. However, recovery is still expected to begin in the second half of the year according to the Bank's forecast.

In the Committee's view, with the probable completion of the Third Review of the Government-IMF economic programme by the end of September, the prerequisites for the resumption of capital account liberalisation will be in place in terms of the level of foreign exchange reserves and macroeconomic stability. However, although uncertainty about the stability of the financial system had significantly been reduced by the Supreme Court judgment in September it will take a few more months before the final judgment on the capital adequacy of the banking system can be made. Overall the conditions for removal of the capital controls are closer to being met than they were in August, although uncertainty over the exact timing and the effect of capital account liberalisation continues to create complications for monetary policy.

Members discussed the possibility of lowering the policy rate by 0.5 to 1.25 percentage points. In light of the discussion and the range of views expressed, the Governor proposed a rate cut of 0.75 percentage points, which would lower the deposit rate (current account rate) and the CD rate to 4.75% and 6.0%, respectively, the seven-day collateral lending rate to 6.25%, and the overnight lending rate to 7.75%.

Although some members preferred a smaller rate cut and one member supported a larger one, all agreed that, in the current climate, the difference was small enough to accept the Governor's proposal.

The argument made by those members who wanted a smaller step was that the monetary policy stance needed to be tighter because the removal of the capital controls was getting closer. The arguments made by the member who wanted to make a larger cut were that the measured real rate of interest provided an underestimate of the tightness of monetary policy because measured inflation reflected primarily exchange rate developments in the past twelve months. Moreover policy was still too tight given the weak economy and the impending fiscal contraction.

The Committee considers that, if the króna remains stable or appreciates and inflation subsides as forecast, the premises for some further monetary easing should be in place. However, the prospects of capital account liberalisation create uncertainty about short-term room for manoeuvre. The MPC 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 meeting.

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday, 3 November 2010.