

# Minutes of the Monetary Policy Committee meeting, May 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.

These are the minutes of the MPC meetings held on May 5 and 6, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of May 7, and the communication of that decision.

## **I Economic and monetary developments**

During its discussions, the MPC emphasised the following new information that has emerged since the previous interest rate decision on April 8:

### **Financial markets**

The króna had been broadly stable since the April MPC meeting. The trade-weighted exchange rate index (TWI) was 0.6% higher on May 5 than at the publication of the last MPC statement on April 8.

The spread between the onshore and offshore exchange rates had narrowed again after widening during the first months of the year, with the króna trading at 200 - 210 against the euro on the offshore market, or roughly 23% lower than on the onshore market.

Short-term interest rates in Iceland’s main trading partner countries had declined by 1.0 percentage point since the monetary policy decision in April. The spread between the domestic policy rate and the European Central Bank (ECB) policy rate had declined by 2.5 percentage points to 11.7 percentage points. On average, the three-month interbank interest rate differential against the euro was roughly 2 percentage points lower in the first week of May than in the first week of April, although still 11.5 percentage points.

The CDS spread on the Republic of Iceland had declined somewhat. It remained high, at nearly 8%. However, trading is very thin and the CDS-spread is most probably influenced by characteristics of the market instruments, not only country risk considerations.

Volume in the foreign exchange market totalled 1.2 b.kr. in the first week of May, compared to 1 b.kr. in the first week of April; however, these figures reflect the fact that most of the foreign exchange trading of the commercial banks is concluded in-house ever since the interbank foreign exchange market resumed operation in December.

Forward interest rates on nominal Treasury bonds implied that the last policy rate cut was broadly in line with market expectations, as the path shifted downwards while its shape changed only slightly. The downward slope of the interest rate path reflects market expectations of further policy rate easing. The publication of the CPI figures at the end of April did not have any marked effect on indexed HFF bond yields.

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

The global downturn and lower export prices have had a negative effect on Iceland's export income, which declined by 25% in Q1/2009 from the previous quarter. The trade balance for Q1/2009 was positive by 14.6 b.kr., compared with a surplus of 35 b.kr. in Q4/2008. Including irregular components such as ships and aircraft, the trade balance for Q1/2009 was 13 b.kr. The trade surplus totalled 8.4 b.kr. in March but declined again to 2.3 b.kr. according to preliminary figures for April.

In Q1/2009, the value of imported goods declined by 13% over the previous quarter, with both fuel and industrial supplies import values down by around 20% quarter-on-quarter. Investment goods also posted a modest decline of 4%. Imports of durable consumer goods, which have proven a relatively good leading indicator of changes in private consumption, contracted by 32% quarter-on-quarter, the second quarter in a row.

Aluminium prices peaked in July 2008 but fell sharply thereafter. The downward trend continued during the first two months of 2009, although at a slower pace. In March and April, prices rose again and were near end-2008 levels by the beginning of May.

Reduced demand from Iceland's main business partners has caused prices of the most expensive products to fall markedly in the past few months. Less expensive products have also fallen in price, but not as sharply. Thus marine prices overall were 9.1% lower in Q1/2009 than in Q4/2008.

Marine products and aluminium together constitute 77% of Iceland's total export value. Because of the recent decline in aluminium prices, marine products have again become the largest single export category, accounting for 43% of total export value in Q1/2009, as opposed to 34% for aluminium. The value of exported aluminium declined 38% from Q4/2008 and 17% from Q1/2008, while the value of marine product exports declined by 18% and 12%, respectively, over the same periods.

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

The Consumer Sentiment Index and its sub-indices rose only slightly in April. Sentiment towards the labour market improved slightly. Sentiment towards the current economic

situation remains pessimistic, while expectations about the overall economic situation six months ahead are more upbeat and are similar as in July 2008.

According to the Statistics Iceland Labour Force Survey (LFS), total hours worked fell by over 9% year-on-year in Q1/2009, due to a drop in both the average number of hours worked (-1.9 hours) and the number of people working (-5%) during the reference week. The response to declining demand for labour differs somewhat between core workers (aged 25-54) and the most flexible part of the labour force (aged 16-24).

According to the LFS, 12,700 persons were unemployed and actively looking for work in Q1/2009. This corresponds to 7.1% of the labour force. Unemployment as measured by the Directorate of Labour (DOL) measured 7.5% in Q1/2009.

Registered unemployment totalled 8.9% in March. Seasonally adjusted, registered unemployment was 7.6%, up from 6.7% in February.

In March, the wage index was up 0.1 from the previous month but had risen by 5.5% year-on-year. Real wages were down by 0.7% month-on-month in March and by 8.4% compared to the same month in 2008.

Inflation continued to decline in April. Despite a 0.45% month-on-month increase in the CPI, annual inflation dropped to 11.9%, from 15.2% in March. For the most part, the disinflation is due to base effects, as the 3.4% rise in the CPI in April 2008 disappeared from the twelve-month comparison.

Annualised seasonally adjusted three-month inflation measured 0.8% in April, as opposed to 4.6% in March.

The currency depreciation of the króna since March 12 primarily affected prices of petrol and new motor vehicles in April. Prices of food and beverages declined in April in spite of the weaker exchange rate.

Lower house prices have begun to affect the CPI more strongly. The CPI excluding the housing component rose by 0.8% month-on-month and has increased by 15.6% year-on-year in April. Owner-imputed rent declined by 1.6%, following a roughly 5% fall in March. Owner-imputed rent has fallen roughly 11% year-on-year. Paid rent is still increasing month by month, partially reflecting the fact that a large share of rental contracts are for social housing and are indexed to inflation.

According to a Capacent Gallup survey on inflation expectations, conducted between March 26 and March 31, 2009, households expect inflation to measure 17% over the next twelve months, compared with 14% in a similar survey carried out in October 2008. Inflation expectations have never been so high in this survey. Firms' inflation expectations are much lower, however, at only 0% over the next twelve months, according to another recent Capacent Gallup survey.

Households expect inflation to measure 7% in two years' time. These expectations are unchanged from the October 2008 survey. In comparison, firms expect inflation to measure 4% two years from now.

Households estimate present inflation at 23%, a considerable increase from the March 2009 survey, in which present inflation was estimated at just over 15%. It is also much higher than actual inflation of 15.2% at the time of the survey.

According to the baseline forecast published in the May 7 issue of *Monetary Bulletin*, inflation will be lower in late 2009 and 2010 than was assumed in the baseline forecast in the January issue, but broadly in line with the outlook assumed during the March MPC meeting. Inflation is now projected at 5% year-on-year in Q4/2009 and is expected to approach the 2.5% target early in 2010.

Simple time-series models suggest slower disinflation but are likely to underestimate effects of demand contraction on inflation, inflation expectations, and exchange rate pass-through. The cost-push model forecasts 6% year-on-year inflation in Q4/2009, while a ARIMA model gives a value of 8%.

Due to weaker exports and investment, this year's contraction in domestic demand and output is expected to be sharper than previous projections indicated. The new baseline forecast indicates that the real economy will contract slightly faster and that recovery will be delayed longer than in the updated forecast in March. This is also reflected in the labour market outlook.

The GDP level is forecast to reach a trough in the beginning of 2010, after having fallen 20% from its Q3/2008 peak. Economic activity is expected to pick up in the second half of 2010 and GDP growth to recover to 2½% in 2011.

Primarily because of the postponement of the Helguvík aluminium project from 2009 to 2011, total investment is expected to contract far more in 2009 than was assumed in the January forecast, or by 45%, as opposed to slightly below 30%.

In view of the deteriorating economic outlook, unemployment is expected to peak at around 11% in the first part of 2010 but to decline slower than was assumed in the January forecast.

Real disposable income is forecast to shrink by 15½% in 2009 and remain roughly unchanged in 2010 before rising moderately in 2011. The baseline forecast assumes that fiscal consolidation will give equal weight to spending cuts and tax hikes. Public consumption must therefore contract throughout the forecast horizon, but its share in GDP will nevertheless be above the long-term average for most of the period.

The króna is expected to remain somewhat weaker over the next three years than was forecast in January. This reflects, among other things, the deteriorating outlook for the global economy, which affects the balance of payments outlook. Consequently, the real exchange rate will fall somewhat more in the medium term than was assumed in January.

## **II The interest rate decision**

The Committee reiterated that the current interim objective of monetary policy is to stabilise the króna, while private sector balance sheets are being rebuild.

The Committee agreed that economic developments since the last MPC announcement on April 8 had been consistent with its earlier assessment that the conditions for continued monetary easing are in place. As expected, inflationary pressures had continued to subside. The year-on-year inflation rate dropped from 18.6% in January to 11.9% in April. Annualised three-month seasonally adjusted inflation had fallen even farther over the past few months. The Committee did not expect that the depreciation of the króna since March would delay the disinflation process to any marked degree, although the April CPI number was slightly higher than expected. Current projections indicated that inflation would be lower in late 2009 and 2010 than was assumed in the baseline forecast in the last Bulletin but broadly in line with what was assumed during the March MPC meeting. Inflation was assumed to approach the 2.5% target early in 2010. Due to weaker exports and investment, this year's contraction in domestic demand and output was also expected to be sharper than previous projections indicated. The new baseline forecast indicated that the real economy would contract slightly faster and recovery be delayed compared to the updated forecast in March. This was also reflected in the labour market outlook.

The Committee discussed at length the recent developments in the domestic financial system. The FX-position of the banks was discussed at length. Among issues covered were turnover on the onshore and offshore markets and the importance of FX trading settled within the Banks, the reasons for appreciation of the króna on the offshore market, and the interactions of the policy rate and the exchange rate. The Committee also discussed the CDS market; trading volume and price formation.

The króna had been broadly stable on the onshore market since the last MPC meeting, supported primarily by a significant trade surplus. The Committee agreed that there was no evidence of a negative impact of the policy rate reduction in March and April on the króna. In view of the long-term fundamentals, the króna also appears likely to strengthen from its recent level over the medium to long term. The authorities have addressed problems related to circumvention of the capital controls by closing loopholes in the pertinent legislation.

The Governor discussed the steps the Central Bank is taking to strengthen surveillance and enforcement, in cooperation with the relevant authorities.

The Governor also informed the Committee of the measures the Central Bank is in the process of implementing, which will enable impatient non-resident investors to unwind their ISK positions while preserving the Central Bank's foreign currency reserves. Non-residents' short-term ISK holdings are estimated at 200-300 b.kr. Although capital controls are expected to remain in effect for some time, targeted measures allowing partial conversion should reduce outflow pressures significantly. These measures should facilitate further convergence of the offshore to the onshore rate.

The MPC expected that fiscal policy would be tightened by the summer. This implies significant cuts in public expenditure, as well as tax increases and other revenue-enhancing measures that will be implemented in steps towards 2011, thus re-establishing a balanced primary budget by 2012. This should pave the way for a gradual reduction of general Government debt thereafter. In addition to fiscal tightening, the

restructuring and normalisation of the commercial banks' operations will expose borrowers more directly to the true cost of funds. This implies a tightening of monetary conditions. The expected contractionary fiscal measures suggest that it was appropriate for the policy mix to shift towards fiscal tightening and monetary easing.

Committee members agreed that inflation developments and conditions in the real economy supported a further easing of monetary policy. The Committee also agreed that the scope for monetary easing had increased in light of the improved stability of the króna, enhanced capital controls, and tailored policies allowing the most impatient investors to sell ISK assets in an orderly manner.

The MPC argued that further clarity about balance of payments prospects, an approved medium-term fiscal consolidation plan, bilateral and multilateral loan arrangements to supplement foreign reserves, and progress in financial sector restructuring are the prerequisites for broad-based easing of capital controls. While current domestic and external circumstances do not yet allow for the dismantling of the capital controls without the risk of serious instability, there has been progress on several fronts that should allow the gradual, systematic easing of controls.

The MPC discussed a rate cut in the range of 1.5 to 3.5 percentage points. All members agreed that there were arguments for a relatively large step this time but had varying opinions on its exact size. In light of the discussion, the Governor proposed that the policy rate be lowered by 2.5 percentage points to 13.0%.

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 a 3.0 percentage points cut in the policy rate.

The Committee agreed that cautious yet significant easing of monetary policy would gradually contribute to economic recovery. The MPC expects that further elements of the economic programme will have been put in place by the time the Committee reconvenes in June. Conditional on favourable ISK developments and progress on the fiscal plan, the Committee agreed that another significant adjustment of the policy rate could be made at the June MPC meeting, but anticipates the pace of adjustments to be more gradual thereafter. However, this adjustment could only be made following the publication of a credible fiscal plan.

The Committee argued that, while progress had been made in the area of financial restructuring, action is needed on several fronts in order to re-establish viable commercial banks. This requires cost reductions, downsizing, reducing foreign currency imbalances, and exposing borrowers to the true cost of funds. More generally, the banks need to formulate a business plan that makes them profitable. A more transparent and accountable asset management structure needs to be put in place. The Committee found it important that the lowering of the policy rate be followed by reduced retail deposits rates, ideally exceeding the policy rate reduction.

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  
Anne Sibert, Professor  
Gylfi Zoega, professor

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, June 4, 2009.